

CONTRACT WINEMAKING PITFALLS

An article written by Mark Hamilton for Australian Vignerons Magazine

The current wine industry export led growth cycle has seen the emergence of a substantial contract winemaking sector as part of the services infrastructure which has sprung up to support the expanding Australian wine industry.

Contract winemakers service not just small growers and wine companies where the economies of scale associated with small production do not justify building or equipping separate wineries, but increasingly, large wine companies, whose production facilities have been stretched due to tremendously increasing volumes – either just because facilities are fully utilised or increasingly because of timing issues during vintage.

At Vintage 2002, there were newspaper reports of BRL Hardy being unable to accept all their contracted Riverland fruit early during vintage because their wineries were full.

It is a potentially costly hobby for large wine companies to be faced with the possibility of having to pay for fruit, where they don't get the wine, because of production timing issues.

This is not an easy problem to fix for the best laid intake plans may be defeated by variations in expected fruit ripening patterns – for example, all fruit ripening early or together. Wineries' intake models are no doubt based upon average expectations in terms of ripening patterns.

The industry is also struggling to keep up with the significant capital and logistics required to expand winery facilities at the same rate as sales.

There is also a geographical aspect to this in that it may be more efficient for a wine company to have grapes crushed to must or made into wine by a contract winemaker in or near a particular wine region rather than transport grapes great distances.

Although wine companies have become expert at protecting the quality of grapes being transported from vineyard to winery, there may be a quality imperative which dictates that it is preferable to crush the grapes to must or process the grapes to wine nearer the vineyard.

Anecdotal evidence has it that some large wine companies are considering "contracting out" the making of some lines of medium or lower price point export wine – either directly to contract winemakers or by virtue of entering into bulk wine supply contracts with growers (who in turn contract out the winemaking aspect).

Entering into these contracts is one way of creating something analogous to a type of “off balance sheet” financing arrangement by taking on the contingent liability associated with performance of the contract – thereby giving the grower and the contract winemaker a contractual basis for financing their business.

To contract out or not is a cost/benefit assessment to be made by the individual winery – as against the alternative of the winery borrowing money (or raising more share capital) and having the logistical problems associated with winery expansion to contend with.

Generally speaking, it is more expensive for public company wineries to service the expectations of shareholders in terms of dividends and capital growth than to meet interest costs associated with borrowings.

Factor in the depreciating nature of winery assets, and the tremendous demand upon wineries for funding rapidly increasing stockholdings, and the contracting out of part of the winery’s winemaking process may make a lot of business sense.

One problem with contracting out winemaking is a potential lack of or loss of control – with the attendant potential effect on wine quality.

Many within large Australian wine companies are reluctant to engage in large scale, long term contracting out of the winemaking function for this reason. The demands on capital of wine companies, and the demand of shareholders for adequate levels of return, may however dictate that contracting out receives serious consideration in the future.

By far the major pitfall with contract winemaking is a lack of control over the winemaking process. Assuming (of course) that the wine company selects a reputable, professional, well organised and capitalised contract winemaker, then by far the most important thing to do is to set up and maintain a constant dialogue in relation to the winemaking process.

The best practices approach is to regard the contract winemaker and winery as part of the organisation, to set written product specifications, written winemaking techniques and to actively supervise and be involved in the winemaking process - in the same way that the wine company would if it were making the wine itself, utilising its own facilities.

This involves setting up written reporting procedures and maintaining (for example) weekly visits and meetings with the contract winemaker.

Some contract winemakers provide services far away from the clients’ vineyards. The clients rarely make the journey to the winery for tastings and have little idea how their wines are treated.

With or without a written winemaking contract, a classic mistake is to simply arrange for the grapes to be delivered to the winery - and to leave the contract winemaker to it.

Professional contract winemakers who wish to build a long term relationship with wine companies will in fact want to involve the wine company in the winemaking process so that they can identify their desired wine style and deliver the required results.

It is also the same in contract winemaking, like in life, that "the squeaky door gets the oil".

Whilst it is true to a large extent that "wine is made in the vineyard" – particularly with ripe, premium fruit – it is also unquestionably true that there is much "winemaker's magic" (of the legal kind) which winemakers can waive over wine during the winemaking process to improve the result.

The client needs to be there to ensure that the wine is treated in a "best practices" fashion to optimise quality.

With cashflow, quality in the Australian wine industry is King, as quality begets cashflow. It is much easier to sell good wine.

Given the plethora of small wineries producing up to 250 tonnes, contract winemaking is here to stay.

Although opinions will differ, a wine company must produce 500 plus tonnes before even a modest winery investment would begin to make sense, on purely financial grounds. Even then, there would be limited scope for having much sophisticated equipment.

A new generation of written contracts for contract winemaking have emerged in recent years – the advantages of negotiating a written contract are (as always) that it enforces upon the parties the discipline of considering "up front" the process and issues which may arise during the intended business relationship.

From the contract winemaker's perspective it also helps with forward planning (and therefore financing) if a reasonable percentage of the winery's intake is secured by forward contract.

When dealing with a contract winemaker do not expect any "history" or old stone buildings – you will be lucky if there are some immature trees planted along the dirt road in. Expect concrete and a farm of stainless steel tanks on an excavated, flat site – without anything else in sight except that which is strictly required to crush grapes and to produce and store wine. Expect the winemaking plant to be outside – with a small heater in a laboratory to keep the winemaker from catching pneumonia.

If you use a contract winemaker then you'd better take your overseas distributors, and journalists, to your vineyard. Contract winemaking businesses are essentially a financing operation which depend upon total efficiency and volume through-put, for their existence.

Hand in hand with contract winemaking, there is an increasing trend (and new business developing) of contract storage farms. Watch for this to expand rapidly, both for reasons associated with wineries seeking to preserve working capital for stock build-up, but also (interestingly) because many wineries wish to preserve the historical look and feel of their wineries and vineyards – and feel (correctly) that it would be counter-productive to their branding strategy and image to gradually convert the whole of their properties to tank farms. This is becoming a significant issue for many wineries.

When entering into a written contract with a contract winemaker, get some legal advice to ensure that your interests are protected – and try to ascertain the financial standing of the contract winemaker and those associated with it.

Make sure that your wine is made and kept separate from other customers.

If you do not have a winemaker on staff, and you are making a reasonable quantity of wine, consider employing an independent consultant winemaker to assist you in your dealings with the contract winemaker.

Ensure that it is clear that title in the wine remains with you at all times, to avoid potential arguments with liquidators or receivers.

Also ensure that your interests are insured and also that the contract winemaker has indemnity insurance in place to meet your claim if your wine is spoilt due to contract winemakers' neglect or default.

As always, get some advice. It is usually cheaper in the long run if there is a problem. As with insurance, if there is not enough money in what you are doing to pay for insurance or reasonable levels of legal advice, then you probably should not be doing it at all.