Economic and Financial Analysis of Options to Improve Retail Access for Ontario Wines in the Ontario Marketplace

Wine Council of Ontario

October 15, 2007

Grant Thornton LLP
Chartered Accountants
Management Consultants

October 15, 2007

Ms. Hillary Dawson, President
Wine Council of Ontario
110 Hanover Drive
St. Catharines, ON
L2W 1A4

Dear Ms. Dawson:

In accordance with the terms of the request for proposal issued in March 13, 2007 we have prepared an Economic and Financial Analysis of Options to Improve Retail Access for Ontario Wines in the Ontario Marketplace.

During the preparation of this report we held a number of meetings with committee members of the Board of the Wine Council of Ontario, we wish to take this opportunity to thank those members and the staff members who participated in this project.

It has been a pleasure to work with yourself and the committee members.

If you have any questions regarding this report please contact myself.

Yours truly,

GRANT THORNTON LLP

Grant Thornton LLP

Thane MacKenzie, CA
Partner
Encl.

Suite 1040
Standard Life Centre
120 King Street West
Hamilton, Ontario
L8P 4V2
T 905-525-1930
1 800 858-3092 (Ontario)
F 905-527-4413
E Hamilton@GrantThornton.ca
W www.Grant Thornton.ca
Canadian Member of Grant Thornton International

PAGE

CONTENTS

Executive Summary

As was outlined in the terms of reference by the Wine Council of Ontario the objective for this project was to improve access to the retail marketplace in Ontario for wines manufactured by members of the WCO. The project scope included the preparation of financial models for three options including:

- A Manufacturers' style Co-operative
- Individual Licenses operating Ontario VQA Wine Retail stores
- Individual Licenses operating Wines Retail stores

During the completion of this project we held numerous meetings with members of the Wine Council of Ontario and we wish to thank those individuals for their contributions. It was agreed that the financial modeling would cover a three year time period with a goal of achieving breakeven results over this three year period.

In preparing the financial models it was agreed that the manufacturers' co-operative model would be based upon a ten store model. It was felt that if the model was recommended it may start on a pilot basis with ten stores with potential to expand in the future. A key concern in evaluating this model would be the investment required to be made by the members of the co-operative. During completion of this model, under the assumptions outlined within this report, it was determined that a $1 million investment would be required.

Individual licenses were modeled for VQA only stores and "Wines of the World" stores which would market Ontario wines along with wines from other regions of the world. A total of six forecasts were completed, three for each individual license option. As actual operations will vary depending on decisions made, the financial models allowed for variance in the rent costs incurred and investments in leasehold improvements and reflect the required sales volumes to achieve breakeven operations.

As a result of the findings made during the project the recommendation is that the Wine Council of Ontario promotes the creation of Individual Licenses operating "Wines of the World" Retail stores. The enclosed report outlines the steps taken in reaching this recommendation.

Project Scope

The Wine Council of Ontario's (WCO) objective for this project was to improve access to the retail marketplace in Ontario for wines manufactured by members of the WCO. To that end, the WCO identified the following success factors that must form part of any new or alternative retail system.

1. Increased distribution and sales of Ontario wine.
2. Economic viability for both manufacturer and retailer, with margins equal to or better than the LCBO channel.
3. Freedom for manufacturers to deliver directly to retail store locations.
4. No net decrease in government revenues.

A number of studies/reports have been commissioned by the WCO in the past and the following were provided to us to assist in completing this study:

i) Beverage Alcohol System Review Panel Report, 2005

ii) VQA Store Proposal, D.F.Wilcox, 2003

iii) Privatization: Analysis of Selected Jurisdictions, Syd Girling, 2003

iv) Retail Experts Study, Evans & Associates, 2003

v) Enhancing Access Markets for Ontario Wineries, The Waterfield Group, 2006

vi) WCO submission to the Beverage Alcohol System Review Panel, 2005

vii) Andre Bergeron Proposal to WCO, 2006

As well, discussions were held with individuals from the BC Wine Institute and information was also provided by officials at Andrew Peller Limited and Vincor. We wish to thank these groups and all others who provided insight into this project.

At the request of the WCO, it was determined that the models to be considered would include:

- A Manufacturers' style Co-operative

This model is based on a manufacturers' co-operative jointly operated by all manufacturers selling into the new chain. It would be similar to the Brewers' Retail System currently operating in Ontario (The Beer Store). Such a co-op could sell VQA Ontario wine.

The financial model prepared was based upon a ten store operating platform. Although an actual Co-operative model may encompass any number of stores it was agreed to limit the model to this size

- Individual Licenses operating Ontario VQA Wine Retail stores

This model is based on the assumption that the Government of Ontario would issue a series of licenses to individual retailers. In this case, third party licensees (i.e. not manufacturers) would each set up their own stores based on a pre-determined business model, but using their own capital. These licenses would attract an annual license fee, probably payable to the Government of Ontario or one of its agencies such as the AGCO. This model would be similar to the VQA store system now operating in British Columbia.

- Individual Licenses operating Wines Retail stores

This model is based on the assumption that the Government of Ontario would issue a series of licenses to individual retailers. These licenses would allow for the operation of "Wines of the World" retail stores. As these licenses would allow for the sale of wine from any region in the world it would be trade compliant. In this case, third party licensees (i.e. not manufacturers) would each set up their own stores based on a pre-determined business model, but using their own capital. These licenses would attract an annual license fee, probably payable to the Government of Ontario or one of its agencies such as the AGCO.

Key Assumptions

For the financial models prepared a number of assumptions were used in the completion of the models. The financial projections forecast three years of operations and include a pro-forma statement of earnings, balance sheet, statements of cash flow and a listing of key assumptions used.

The actual operating results of a wine store will vary widely depending on some key decisions made by the operator. To allow for the variances models were prepared under a number of alternatives that impact key decisions regarding investments in leasehold improvements, rent incurred for the location selected and staffing costs that may vary based upon staffing levels.

Common Assumptions

The pro-forma financial models were prepared on an assumption of breakeven operations over a three year period.

Capitalization

Capital costs incurred for leasehold improvements and equipment were financed 65% with a term loan repayable over a five year period in equal monthly principal payments plus interest at 7.5% per annum. The balance of the capital costs and initial working capital are provided as owners equity with no interest paid on the equity investment.

It was assumed that a sufficient operating line of credit would be obtained to finance initial operating losses with interest at 6.5% per annum.

Staffing levels

Staffing levels allow for varying levels of floor coverage. It was assumed that store managers would provide 24 hours of floor coverage per week and hourly staff would provide the remaining coverage. For example, in a store with a staff coverage average of 2 there would be a total of 146 person hours required per week with 24 of them provided by the store manager and the balance of 122 provided by hourly staff. The staff coverage level would be an average and allow for staffing to match peak customer hours.

Hours of operation

It was assumed that stores would operate for 73 hours per week, 10 to 9 Monday to Friday, 10 to 8 on Saturday and 10 to 6 on Sunday.

Cost of sales

The gross profit margin to the retailer is comprised of the following components, for presentation purposes the statements of earnings shows revenues inclusive of taxes and net revenues after taxes. The result is a gross profit margin of approximately 40% on net revenues.

Gross margin to retailer	32%
Cost of sales is comprised of:	
Cost of wine to retailer	46.5%
Government taxes	
Provincial retail sales tax	12%
Federal GST	6%
AGCO levy	2%
Environmental/bottle levy	1.5%
Total	21.5%

For the "Wines of the World" option the cost of wine was increased 2% to cover additional costs.

A percentage was used for environmental/bottle levy although it is a fixed amount per bottle to simplify calculations.

Sensitivity analysis within the model

Both the amount paid for rent on a square footage basis and amounts spent on leaseholds were varied to allow for differing levels of fixtures depending on the market place being served.

Rents were varied from a low of $40 per square foot to a high of $144 per square foot. For purposes of the modeling completed rents included common area costs and property taxes. Utilities are allowed for separately.

Leasehold improvements also varied from a low of $100 per square foot to a high of $175 per square foot.

Comments on three models

The Manufacturers' Co-operative and Individual VQA options assume that wineries would provide 30 day terms to assist in financing inventories. For the Wine retail stores selling "Wines of the World" it was assumed that inventory would be paid for at time of delivery therefore no amounts are provided for accounts payable.

For the Manufacturers' Co-operative option a ten store model was projected. Within the ten stores the make-up of the stores consists of two flagship style stores of 2,000 square feet with leasehold costs of $200 per foot and eight other stores averaging 1,250 square feet with leaseholds averaging $130 per foot. As part of the purpose of this model would be to enhance the image of Ontario VQA wines higher average staff coverage was allowed to provide additional interaction time with the consumers. Staffing costs allowed for an overall manager and individual store managers.

The Individual VQA option projects the operations for a 1,250 square foot store. Three options are presented to show the impact of varying rent costs and leasehold investments. It was discussed that this model may attract licensees with a personal passion for the wine industry. To reflect this assumption it was assumed that most of the wages would be paid to the owner and family members with limited external staff. The projections for these stores allows for a fixed amount of remuneration varying with the amount of initial investment required.

The Wine Retail option projects the operations for a 1,500 square foot store. Three options are presented to show the impact of varying rent costs and leasehold investments. Wage costs allow for the hiring of store managers and retail staff at similar rates that would be paid in the Manufacturers' Co-operative option.

Assuming the government allows for the creation of a new retail option for wine in Ontario, the actual operating results of the stores created will vary depending on a number of variables. Each licensee will need to determine their operating structure, financing and the related costs. The most significant costs will include the initial investment to fixture the store, the rent cost for the space occupied and the staffing decisions made in terms of staff levels and pay scale.

Summary of Projected Operating Results

Appendices 1 to 7 provide the detail for each of the individual models.

The Manufacturers' Co-operative option requires an initial capital investment of approximately $2.5 million with $1.5 million in bank financing and $1 million in member financing. In order to achieve breakeven operation over the three year period revenue net of government taxes of $25.5 million would be required. This represents store averages of $750,000 in year one rising to $950,000 in year three.

The Individual VQA option requires initial capital investments varying from $160,000 to $260,000 per store with bank financing ranging from $100,000 to $160,000, and the investors share ranging from $60,000 to $100,000. In order to achieve breakeven operation over the three year period revenue net of government taxes of $1.9 million to $3.4 million would be required. This represents store averages of $550,000 in year one rising to $710,000 in year three for the lower rent option, versus $940,000 in year one rising to $1,300,000 in year three for the higher rent option.

For each of the above options the gross profit margin approximates 40% of net revenues. It is reasonable to assume that most other costs would remain static if revenues increased with the possible exception of wages, which may require adjustment if sales increase. Therefore, each additional $100,000 of net revenue could add $40,000 to operating profits.

The "Wines of the World" option requires initial capital investments varying from $210,000 to $330,000 per store with bank financing ranging from $110,000 to $190,000, and the investors share ranging from $100,000 to $140,000. In order to achieve breakeven operation over the three year period revenue net of government taxes of $2.5 million to $4.1 million would be required. This represents store averages of $740,000 in year one rising to $950,000 in year three for the lower rent option versus $1,180,000 in year one rising to $1,570,000 in year three for the higher rent option.

For each of the final options the gross profit margin approximates 38% of net revenues. It is reasonable to assume that most other costs would remain static if revenues increased, with the possible exception of wages which may require adjustment if sales increase. Therefore each additional $100,000 of net revenue could add $38,000 to operating profits.

Other considerations

During the completion of this project other information outside of the reports listed earlier was also considered. The 2006 Annual Report for the LCBO was reviewed to assist in determining wine buying patterns of the general public. Consideration was given to the fact that the wine buying public is influenced by policies and promotions set by the LCBO. The wine revenues reported in the LCBO annual report totals $1.2 billion. Of this, Ontario wine represents 21.6% of revenue by dollar value and 28.5% of revenue by volume.

The BC Wine Institute also provided information regarding revenues generated in the BC VQA wine stores. The VQA wines stores have existed in BC for over 7 years. Sales volumes vary greatly by store depending on a number of factors including location, retail expertise of the operator and competition in the area. Average store revenue has grown over the past four years from approximately $550,000 to $790,000 per store. The top 50% of stores are averaging approximately $1 million in annual sales.

Consideration was given to studying a LRS model store similar to the current BC model that would allow for the sale of wine, beer and spirits. After much discussion with the committee of the WCO it was decided to only model Wine Retail stores. The mandate was to improve access to the retail marketplace in Ontario for wines manufactured by members of the WCO and the creation of an LRS model would impact many other parties in the alcohol beverage industry and would likely overshadow the WCO efforts to promote Ontario wines.

Conclusion

During the completion of this study each of the three alternative models were reviewed to select the model with the greatest chance to succeed in improving access to the retail marketplace in Ontario for wines manufactured by members of the WCO.

The Manufacturers' Co-operative model has certain restrictions including:

- A significant capital investment to start a ten store operation; $1 million.
- Future expansion could require additional capital investments.
- Governance model for a co-operative could place a strain on the existing limited resources of the WCO.

The Individual VQA model also has certain restrictions to consider including:

- Trade compliance issues that may arise with Ontario Wine only retail licenses.
- Acceptance by consumer of an Ontario only wine store, a review of LCBO sales experience and the challenges faced by retailers in BC with their VQA only stores indicates that challenges may exist in this model.
- Given the challenges reconciling existing consumer buying patterns with a VQA only model this option may have a challenge in attracting the strongest retail entrepreneurs.

The "Wines of the World" Individual Retail model has advantages over the other two models:

- Trade compliance issues should not arise as licensees would not be restricted in what wines they can sell.
- The ability to offer a broader selection to consumers should enhance success of individual licensees. After conducting their own market research they may chose to differentiate their operations by focusing on certain regions or styles of wine.
- As the existing consumer buying patterns suggest a desire to have selection the ability of licensees to offer this selection should ensure a strong list of candidates for the licenses to be granted.

We feel that the creation of Individual Licenses allowing for the operation of retail stores selling a full selection of wine will offer the best opportunity for success in increasing the distribution of Ontario Wine and creating a successful environment for the entrepreneurs who apply for these licenses. The most significant factors that contributed to this recommendation includes existing consumer buying patterns that request a wide variety and selection of wines and the fact that this system would be trade compliant.

The Wine Council of Ontario's (WCO) objective for this project included the following success factors that must form part of any new or alternative retail system.

1. Increased distribution and sales of Ontario wine.
2. Economic viability for both manufacturer and retailer, with margins equal to or better than the LCBO channel.
3. Freedom for manufacturers to deliver directly to retail store locations.
4. No net decrease in government revenues.

The creation of Individual Licenses allowing for the operation of retail stores selling a full selection of wine will allow WCO to meet these goals.

1. New channels of distribution will allow for increased distribution and sale of Ontario wine. A free market environment will provide opportunities for Ontario wineries to increase their access to the consumer.

2. The retail gross profit margin calculated within the forecasts is 38% based on revenues net of government taxes. The cost of sales to the licensee will allow for an improved margin to Ontario wineries and will also allow the LCBO to operate as the importer of record for foreign wines and receive a return on the warehouse and distribution costs it may incur.

3. A number of policy decisions will need to be considered in creating this new system. Included within these policies should be the opportunity for wineries to deliver direct to the licensees to avoid warehousing and distribution fees going to other parties.

4. The sales generated via this new channel will result in all the existing government taxes being collected. Annual license fees may be assessed to ensure any oversight and compliance costs incurred by the government are recovered from the retailers.

Impact on Ontario Wine Industry

The increase in access to the retail marketplace would have a favorable impact on the Ontario Wine Industry. Based upon a study previously commissioned by the Wine Council the Ontario marketplace has one of the lower number of retail outlets per capita. Per the Privatization: Analysis of Selected Jurisdictions, 2003 report the following comparisons can be drawn:

Jurisdiction	Population	Retail Outlets	Population Per store	Consumption Per Capita
Ontario	11,400,000	1,103	10,335	10.9 litres
Quebec	7,200,000	9,914	726	16.3 litres
Alberta	3,000,000	1,580	1,899	12.9 litres
BC	3,900,000	817	4,773	13.9 litres
Canada				12.2 litres

Given the above data it is reasonable to assume that increased retail access may move consumption per capita in line with other jurisdictions and towards the national average.

To assess the impact on the Ontario VQA Wines sales a number of factors must be considered. Based upon a review of the 2006 Annual Report of the LCBO Ontario VQA wines sales were estimated at approximately 5% of total wine sales. The LCBO reported wine sales of 106 million litres (the equivalent of almost 12 million 9 litre cases of wine). The Ontario VQA share would be approximately 600,000 cases. Assuming increased consumption of 2 litres per capita an additional 23 million litres of wine would be consumed (the equivalent of almost 2.6 million 9 litre cases of wine).

If through a combination of increased retail access and continued promotion of Ontario VQA Wine overall market share could be increased from 5% to 10%, the combined impact could move volumes from 600,000 cases to 1,460,000 cases.

Growth in the Ontario Wine Industry is dependent upon increased access and increased market share. If the recommended channel was designed to assist in the Ontario VQA Wine industry in growing market share the impact would be significant. As illustrated above a 2 litre per capita increase in consumption and a doubling of Ontario VQA market share from 5% to 10% could allow for almost 1 million more cases of Ontario VQA Wine to be sold.

The following table outlines the potential volume of Ontario VQA Wine that may be sold through the recommended channel, this volume is defined as a 9 litre case of wine.

Percentage of VQA sales	5%	10%	20%	30%
Number of stores				
25	10,416	20,833	41,666	62,500
50	20,833	41,666	83,333	125,000
100	41,666	83,333	166,667	250,000
200	83,333	166,667	333,333	500,000

Key assumptions:

Average sales volume per store inclusive of taxes $1,300,000

Average retail price of bottle of VQA wine $13.00