Economic and Financial Analysis of Opening Licensed Wine Retail Stores in Ontario

Report to the Wine Council of Ontario

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Executive Summary

A current objective of the Wine Council of Ontario (WCO) is to improve the retail access in Ontario for wines produced by its members through independent "Wines of the World" retail stores. Critical to the success of this objective would be that the Government of Ontario would also have increased revenues as their legislative approval would be required in order to open new licensed retail stores.

We reviewed wine consumption per capita data from various jurisdictions, to determine whether Ontario could support additional retail access points given its population. This information was used to determine a range for the number of independent retail stores that could be supported. Assuming that increased retail access would move Ontario per capita consumption of wine more in line with other jurisdictions, we believe that the market place could support anywhere between 65 and 385 new retail stores. With increased sales in Ontario, the Province, including the LCBO and tax authorities as a whole would enjoy significant additional revenues from the taxes and markups generated by these additional sales. An additional 65 retail stores could generate over $50 million per year, while 385 new retail stores could generate additional government revenues of over $340 million per year. These estimates represent direct revenues, and are exclusive of any additional economic spinoff effects. In addition, once the independent retail stores became profitable, these businesses would be paying corporate income taxes.

Financial models were prepared to establish the viability for entrepreneurs to open these retail stores. Actual results of operations will vary depending on the decisions made by the owners. The models allowed for variability in the rent costs and the investment in leasehold improvements to reflect the projected costs in a variety of markets and reflect the estimated sales required to achieve overall breakeven operations over a three year period.

As a result of the information gathered during this project, we believe that there is a case to support the Province of Ontario approving the creation of independent "Wines of the World" retail stores which will also allow for the Ontario wineries to increase their access to the Ontario marketplace and generate significant additional government revenues.

Project Scope

The Wine Council of Ontario has studied a variety of potential options available to its members to improve their access to the retail marketplace in Ontario for their manufactured wines. Based on the findings of the Grant Thornton report completed in 2007 and the consensus of the WCO Board of Directors, the WCO concluded that the best option would be to open licensed "Wines of the World" retail stores throughout Ontario. This option is dependent upon the Government of Ontario permitting the licensing of individual retailers to operate these stores. As the proposal would be to offer wines for sale from any region of the world, there would be no conflict with federal trade agreements currently in place. The following are the parameters for a successful alternative retail system;

1. Net increase in revenues to the Province, directly through taxes and indirectly through markups to be paid to the LCBO,
2. No net loss in revenue for the LCBO,
3. Financial viability for Ontario wineries,
4. Financial viability for the retailer, and
5. The pricing structure for similar wines in the new retail system would not be lower than in the LCBO.

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) A Retail Wine Option in Support of Ontario Wineries: Summary of Qualitative and Quantitative Research for the Wine Council of Ontario, The Gandalf Group, 2011

ii) Privatization: Analysis of Selected Jurisdictions, Syd Girling, 2003, updated tables for 2009

iii) Economic and Financial Analysis of Options to Improve Retail Access for Ontario Wines in the Ontario Marketplace, Grant Thornton LLP, 2007

iv) A Report on the VQA Store Proposal, D.F.Wilcox, 2003

As well, we arranged for discussions and reviewed financial information regarding Licensed Retail Stores with individuals from the Grant Thornton practice in British Columbia. Our British Columbia practice has a number of Licensed Retail Store clients and provided helpful industry financial insight.

Key Assumptions

A number of assumptions were used in the preparation of the pro-forma statements. The financial projections forecast three years of operations for a 1,500 square foot store and include a pro-forma statement of earnings, balance sheet, and statement of cash flows 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, the most significant being the financing of the company, the rental cost for the site selected, staffing levels and pay scales used to staff the store, selection of wines, inventory management, marketing and customer service. The pro-forma statements were prepared based on various rental lease costs. Leasehold improvements and other equipment costs tend not to vary from location to location and $100 per square foot was determined to be reasonable in most instances. A cost of $125 per square foot was used for locations with higher rental costs, primarily in the Greater Toronto Area, where installation costs could be more expensive.

Common assumptions

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

Capitalization

The initial owner's contribution ranged from $139,000 to $160,000. We have assumed that this contribution is in the form of share capital and there will be no payments to shareholders until there are sufficient retained earnings to pay a dividend. The balance of the initial working capital and capital costs incurred for leasehold improvements and equipment would be financed with a term loan repayable over a five year period in equal monthly principal payments plus interest at prime plus 3% per annum, or currently 6%.

It was assumed that a sufficient operating line of credit would be obtained to finance initial operating losses with interest at prime plus 2% per annum, or currently 5%.

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 150 person hours required per week with 24 of them provided by the store manager and the balance of 126 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 75 hours per week, 9:30 to 10 Monday to Saturday and 11 to 5 on Sunday, which are similar to existing hours of operation for LCBO stores.

Cost of sales

The gross profit margin to the retailer is comprised of the cost of wine to the retailer and government taxes including the Ontario wine tax, environmental tax, bottle tax, HST and excise tax on non-VQA and imported wines. Although existing government taxes are comprised of those that are both fixed and variable, for the purposes of modeling, a 17% variable rate was used to account for all government taxes.

Sensitivity analysis within the model

The estimated amount paid for rent on a square footage basis varied from a low of $30 per square foot to a high of $100 per square foot depending on the location of the market being served. The square footage costs included common area costs and property taxes. Utilities are additional costs which have been estimated separately.

Advertising costs were also varied depending on the location and the year. It was assumed that significant advertising would be required in the initial year of operation in order to promote consumer awareness in the marketplace. Advertising costs were reduced in the subsequent years as the concept of an alternative to the LCBO gained acceptance.

Summary of Projected Operating Results

Appendices 1 to 3 provide the detail for each of the rental markets.

The Wine Retail Stores require initial capital investments varying from $150,000 to $188,000 per store with bank financing ranging from $170,000 to $200,000, and the investors' share ranging from $139,000 to $160,000 (see Appendices 1 to 3). In order to achieve breakeven operation over the three year period, revenue net of government taxes of $3.3 million for low rent locations, $3.6 million for medium rent locations and $4.8 million for high rent locations would be required. This represents store averages of $930,000 in year one rising to $1.3 million in year three for the lower rent option versus $1.4 million in year one increasing to $1.8 million in year three for the higher rent option.

The gross profit margin approximates 23% of revenues. It is reasonable to assume that most other costs would remain static if revenues increased, with the possible exception of wages as staffing may have to be adjusted as sales increase. Therefore, each additional $100,000 of revenue could add as much as $23,000 to operating profits.

Other considerations

In addition to the reports listed earlier, other information was also considered. The 2010 Annual Report for the LCBO was reviewed to assist in determining current wine buying patterns. Consideration was given to the fact that wine buying consumers are influenced by policies and promotions set by the LCBO. The wine revenues reported in the LCBO annual report totals $1.6 billion. Of this, Ontario wine represents 23.6% of revenue by dollar value and 29% of revenue by volume. VQA table wines continue their strong growth with a 19 percent growth in fiscal 2010.

The Grant Thornton practice in British Columbia also provided information regarding inventory levels, leasehold costs and other operating costs. Licensed Retail Stores in British Columbia are often profitable in their first year of operations. As the B.C. market is more mature, an assumption of breakeven operations over a three year period was thought to be realistic for new retail stores in Ontario. Advertising costs are considerably lower in B.C than those used in our modeling as Ontario stores will have to develop consumer awareness.

The Gandalf Report commissioned by the WCO indicates that Ontarians support the premise for a new retail option for wine other than the LCBO preferably at wine only retail stores, and not corner and convenience stores. More locations, better hours and more variety of wines were the most common benefits of private stores mentioned by the group surveyed. Also, most Ontarians trust private, wine only stores to manage the sale of wines more responsibly than convenience and grocery stores.

Conclusion

The creation of independent "Wines of the World" licensed stores is a viable proposal which will meet the objectives for this project as set out by the WCO. Independent licensed retail stores selling a full selection of wine will offer the best opportunity for success in increasing the distribution of Ontario wine, increasing the viability of Ontario wineries, creating a successful environment for the entrepreneurs who apply for these licenses and generating significant additional government revenues.

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

1. Net increase in revenues to the Province, including an increase in revenues to the LCBO,

2. No net loss in revenue for the LCBO,

3. Financial viability for Ontario wineries,

4. Financial viability for the retailer, and

5. A pricing structure that would not undercut the current pricing structure for similar wines carried at the LCBO.

The creation of independent licensed retail stores offering a full selection of wine will allow WCO to meet these goals, provided that the demand for wine consumption in Ontario mirrors the other Provinces and that the consumer does not currently have sufficient retail options available to him/her.

1. The sales generated via this new channel will increase the taxes collected on behalf of the Provincial and Federal governments. With an increase in consumption, Ontario manufacturers will have to increase production to meet demand and imports will also increase. With this increase, the two levels of government will collect additional taxes (HST, excise, wine basic, volume and environmental).

2. A new channel of distribution will allow for increased distribution and sale of Ontario wine. A free market environment, while meeting the requirement to be trade compliant, will provide an opportunity for Ontario wineries to increase their access to the consumer.

3. The ability of the retailer to offer a broader selection of wines to the consumer would meet with consumers expressed wishes and increase the financial success of the licensee.

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 of Ontario, and updated to 2009, Ontario continues to have one of the lowest number of retail outlets per capita. Below is the consumption per capita from the Privatization: Analysis of Selected Jurisdictions, 2009 updated tables:

Jurisdiction	Population	Retail Outlets	Population Per store	Consumption Per Capita
Ontario	13,100,000	1,262	10,380	13.7 litres
Alberta	3,700,000	1,690	2,189	15.9 litres
BC	4,500,000	1,303	3,454	19.7 litres
Canada	33,700,000			15.9 litres
Canada (excluding Ontario)	20,600,000			17.3 litres

Comparing the 2009 data to the data contained in the original 2003 report, the increase in the number of retail outlets in Ontario has kept pace with the population growth so that the population per store in Ontario remains virtually unchanged and well above the other Provinces. Also, while the consumption per capita in Ontario has increased since the 2003 study, it has not increased at the same rate as the Canadian average and continues to lag behind. Therefore, it would be reasonable to assume that increased retail access could result in increased consumption per capita, more in line with other jurisdictions and approaching the national average.

Based on the 2010 LCBO Annual Report, the volume of wine sales per retail store is 117,800 litres (comprised of 156,600 litres per LCBO location and 46,000 litres per Winery Retail location). Assuming that the LCBO does not wish to see a decline from its current average of 156,600 litres sales volume per location and Ontario consumption increased to the national average, an additional 65 retail outlets could be supported. If Ontario consumption increased to 17.3 litres per capita, being the average Canadian consumption not including Ontario, then an additional 185 stores could be supported. Finally, if Ontario consumption reached the level of B.C. consumption, 385 more retail stores would be possible without infringing on the LCBO's current sales volume per location.

Impact on Government Revenues

The following tables outline the potential impact on Government Revenues at varying levels of VQA sales.

5% Market Share for VQA Wine:

Incremental Revenues (000's)

Number of Stores	Province of Ontario: Direct	Province of Ontario: LCBO	Province of Ontario: Total	Gov of Canada	Total
65	$ 10,900	$ 38,500	$ 49,400	$ 8,700	$ 58,100
185	$ 31,100	$ 109,600	$ 140,700	$ 24,800	$ 165,500
385	$ 64,600	$ 228,200	$ 292,800	$ 51,600	$ 344,400

10% Market Share for VQA Wine:

Incremental Revenues (000's)

Number of Stores	Province of Ontario: Direct	Province of Ontario: LCBO	Province of Ontario: Total	Gov of Canada	Total
65	$ 11,100	$ 36,700	$ 47,800	$ 8,500	$ 56,300
185	$ 31,700	$ 104,500	$ 36,200	$ 24,300	$ 160,500
385	$ 66,000	$ 217,500	$ 283,500	$ 50,500	$ 334,000

20% Market Share for VQA Wine:

Incremental Revenues (000's)

	Province of Ontario				
Number of Stores	**Direct**	**LCBO**	**Total**	**Gov of Canada**	**Total**
65	$ 11,600	$ 33,100	$ 44,700	$ 8,100	$ 52,800
185	$ 33,000	$ 94,300	$ 127,300	$ 23,200	$ 150,500
385	$ 68,700	$ 196,100	$ 264,800	$ 48,300	$ 313,100

Key assumptions:

Sales through the new channel will result from increased consumer consumption resulting from better consumer access,

Calculations are based on total sales volume per store from Year 3 Sales from Appendices 1 through 3,

Mix of stores is 40% low rent model (Appendix 1), 40% medium rent model (Appendix 2) and 20% high rent model (Appendix 3),

The average retail price of VQA wine is $14.39 and Non-VQA/Import wine is $14.08 to allow for a 35% markup to the licensee,

A 6% licensee markup would be payable to the LCBO on both VQA and Non-VQA/Import wine,

A 6.1% wine tax would be paid to the Ministry of Revenue for VQA sales similar to the current tax paid on sales through winery retail stores.

Given the assumptions listed above, the impact on annual government revenues would range from $52.8 million to $344.4 million. These additional revenues should make the creation of "Wines of the World" retail stores appealing to both the Province of Ontario and the LCBO.