



Fine Tune Your Brand Strategy Based on the true cost of your operation

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“Live Poor, Die Rich”. Chances are you have heard this one before, or something like it. The adage refers to that prototypical multigenerational wine business whose owners are squeaking by only to bequeath a fortune in assets to the next generation. Unfortunately, those who most identify with this adage have likely overlooked the true costs of their operation, ultimately jeopardizing its longevity.

The true cost of your business is more than its operating costs; it should also factor in your assets and reward you with a return on your investment. If you invested in company stock or bought a bond, you would expect to be paid an appropriate return for the use of your money. Similarly, your business should do more than break even; it should pay you a return on your investment.

We recommend that you determine your desired rate of return before setting brand and product strategy. This becomes a critical step to achieving bottom line profit in your business. Without this understanding, your brand’s pricing and positioning strategy may not support the margins needed for your asset base or level of capital investment. Brand strategies take on a new urgency when they are much more focused on a suitable bottom line.

Case Study. Consider a fictitious North Coast California winery that has reached an inflection point. It currently produces 20,000 cases from various appellations in Sonoma County. Its tasting room operation has been run successfully and grows at about 15% per year. However, wine club membership has plateaued - new sign ups just keep pace with the cancellation rate. Further growth in direct sales will come with a cost: either expand the capacity of the tasting room or invest in a professional consumer-direct manager.

Additionally, national distribution channels have been a challenge. Volume growth has been stagnating. Margin pressures multiply every year as distributors keep pushing for lower prices; it seems as though some are only interested in selling the least expensive wines. The winery has considered adding sales people, but is also contemplating lower prices to achieve scale.

So what is this winery to do? Invest in the tasting room? Add staff to help drive the top line? Should they lower prices?

To answer these questions with more confidence, we recommend the following 3-step approach:

1. Identify an **appropriate return on invested capital (ROIC)** to use as your “hurdle rate”¹ for benchmarking your business performance.
2. Calculate a **full capacity profit scenario**² using basic cost assumptions to determine how your business performs at different thresholds. To calculate this, a simple worksheet is provided below.
3. **Analyze the results.** Are your ROIC and critical performance thresholds achievable?

1. What is your appropriate ROIC?

We find that many family businesses, not paying attention to this concept, often are fundamentally flawed. Return on invested capital (ROIC), expressed as a percentage of the total capital investment in your business, should represent the minimum return you expect your business to generate. It should be equal to or higher than a return you can achieve by selling off the assets and investing the money elsewhere and should be thought of as a performance “hurdle rate”. Your alternative investment options could range from a bank savings account to a professionally managed portfolio of stock investments, depending upon your appetite for risk.

If your business is not generating returns at least equal to your identified ROIC you are essentially losing money. By understanding the true cost of your operation and by positioning your brands to deliver the margins needed to support your asset base – everything changes.

2. Full capacity profitability

Once you identify your ROIC, you can run scenarios to grasp how your business performs at different cost thresholds.

On the next page we demonstrate a simple spreadsheet calculator to learn about our case study winery. [Click here to download the calculations](#) and feel free to adapt the spreadsheet for your own analysis.³

¹ Hurdle rate is a minimum rate of return the business must achieve that is equal to or greater than a return earned by liquidating the business and investing the money elsewhere. This rate can vary, depending upon your appetite for risk.

² Full capacity profitability is a P&L target scenario for which the winery, when running at full capacity, meets its hurdle rate.

³ The spreadsheet defines many of the financial terms used in the analysis for your reference.

ASSUMPTIONS

Production Capacity (cs)	20,000
Total Invested Capital	\$ 15,000,000
ROIC Target	5%
COGS assumption (per cs)	\$ 90
Sales and Marketing	10%
Administration	15%
Tax Rate	38%

TARGETS	P&L	Per Case	% of Revenue
Volume (cs)	20,000		
Net Revenue	\$ 4,012,903	\$ 200.65	
COGS	\$ 1,800,000	\$ 90.00	45%
Gross Profit	\$ 2,212,903	\$ 110.65	55%
Sales and Marketing	\$ 401,290	\$ 20.06	10%
Admin	\$ 601,935	\$ 30.10	15%
EBIT	\$ 1,209,677	\$ 60.48	30%
Taxes	\$ 459,677	\$ 22.98	38%
NOPAT	\$ 750,000	\$ 37.50	19%
Effective Retail	\$ 30		
Effective Winelist	\$ 59		

Derived from analysis of our case study, their critical performance thresholds are:

1. They must sell 20,000 cases at an average effective retail price of \$30 per bottle
2. The winery must generate \$750,000 of after tax profit on net revenues of \$4 million
3. They can budget \$1 million on sales and marketing and administrative costs

Using these thresholds, our case study winery can now more confidently make appropriate decisions regarding staffing and further capital investment. You can check the assumptions and conduct your own sensitivity analysis simply by changing the variables.⁴ A whole host of scenarios can be explored.

⁴ The table and analysis tool is for illustration purposes only. The model defines profit as the net operating profit after tax (NOPAT) and does not account for interest payments if the organization carries debt. There are many ways to calculate an appropriate profitability hurdle rate. Consult with your CFO or a qualified outside advisor to find one that is right for your business.

3. Analyze the results

Take a good hard look at the numbers and ask some important questions: Is the plan realistic? Is it achievable? Is the business model fundamentally flawed?

Problems commonly uncovered utilizing this approach include:

1. **Flawed pricing strategy:** In our case study, to achieve a desired ROIC, the winery in question must achieve an average price of \$30 a bottle at full capacity. However, what if the winery is currently at 50% capacity with an average price of \$18 per bottle? The average value of a bottle sold would need to increase by 67% at the same time volume doubles. This is clearly a major brand positioning issue and may indicate a major flaw in brand strategy.
2. **Too much capital for the scale of business:** Are all the assets of the business truly contributing to the bottom line? Are there assets, say a vineyard outside of the key AVA that can be liquidated so that the money can be reinvested more profitably? If the answer is yes, the total investment against the business could be lowered, effectively lowering the profit threshold the business must generate.
3. **Poor allocation of capital:** Perhaps the capital invested is appropriate, but not allocated properly. The liquidation of a vineyard asset may allow for improvements in your facilities - such as a bigger visitor center for our case study winery – that enable the winery’s ability to generate revenue growth on the same asset base.

Conclusion

Understanding the total cost of your operation is a critical, although often overlooked, element to determining which brand strategy to pursue. Be sure that you understand these costs and build a business that pays you a return on your investment. You then may have a business that allows you to live, as well as die, rich.

For businesses facing difficult transitions, reviewing strategy and market potential are paramount to success. Successful leaders, on the cusp of driving a critical new decision, invite trusted outside advisors to evaluate the strength of their new plan and the strategies supporting it. That’s how Scion can help. At Scion we work alongside wine business leaders with an approach that guides you through your planning process to produce more effective “Go-to Market” strategies that make the most sense for your family business.

