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Winemaking business in Russia.

I was recently approached by a correspondent from a business publication, who asked me to answer a number of questions regarding the winemaking business in Russia. Due to the fact that we had a limit on the number of characters, I decided to publish the complete version of my responses.

How much money should one invest in establishing a winery and what is that money used for?

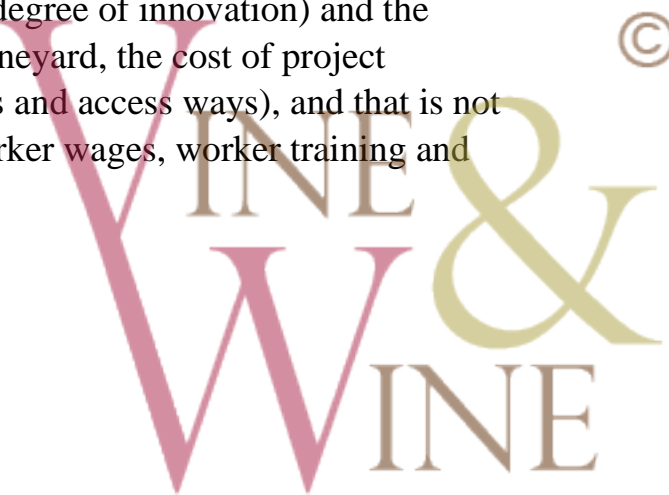
In order to answer that question, we must first figure out the volume of wine production we're talking about. For the purpose of this discussion, we can categorize wine producers into small, medium and large-scale, depending on the cultivated area of the vineyards and the production output.

If we are talking about small businesses by Russian standards, then what we have are wineries with roughly 30 – 60 ha of vineyards and the production output of about 150 – 300 thousand bottles of wine per year.

Medium businesses include those with vineyard areas of 100 – 150 ha and greater, and with the output volume of 1 million bottles a year and more.

In our country we are quite familiar with large-scale producers with vineyard areas of around 3 – 4.5 thousand ha and the production output of 10 – 20 million bottles of wine per year and more.

It's very hard to provide an estimate for starting a winemaking business because it depends on the choice of terroir (land parcel), planting stock (country of origin, producer), planting density for vine seedlings, how well the soil is prepared for planting, the system and materials used for the trellis, agricultural and viticultural equipment, plant protection agents, production strategies for the winery (mass market, medium, premium or super premium segments of the produced wine), technological equipment (country, producer, degree of innovation) and the expenditures associated with maintaining a vineyard, the cost of project construction (including design, utility systems and access ways), and that is not counting the expenditures associated with worker wages, worker training and various payments to third-party contractors.



In 2018, the expenditures associated with laying out a quality vineyard with imported seedlings and trellis materials and a planting density of 5000 vines per ha virtually from scratch amount to roughly 1,300,000 – 1,500,000 rubles per ha. And that does not take into account the cost of agriculturally designated land itself, which can currently range anywhere between 250,000 to 540,000 rubles per ha in the southern regions of Russia and can go as high as 2,500,000 rubles and even 5,000,000 rubles per ha, depending on the location of the lot.

The yearly expenditures associated with vineyard maintenance can start at 600,000 rubles per ha and reach up to 1,500,000 rubles per ha. The expenditures depend directly on the degree of mechanization of the vineyard, the quality of the cultivated grapes, the quality and types of field operations, the planting system, soil structure, the cost of plant protecting agents, materials and payroll fund.

When it comes to constructing a winery, everything depends on the planned output volume, the number of employees and designing solutions. The construction of a quality agrarian winery with a 500,000 bottles a year capacity can cost about 180,000,000 rubles, not including the expenditures associated with manufacturing equipment. The cost of imported equipment for a winery of this output volume will amount to roughly 200,000,000 rubles.

If we are talking about construction of an ultramodern winery complex with a personalized winery design project by a world-renowned architect firm, the total amount of investments can increase tenfold.

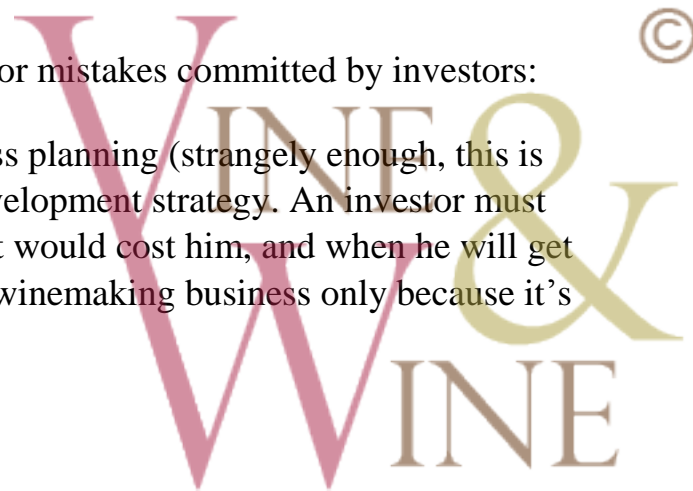
Let us not forget about the costs of the design of the finished wine product (the cost of the bottle, the cork, the capsule, the label, the back label, and the development of the design of the aforementioned materials), as well as marketing and advertising expenses.

When setting up a winery, it is very important to take into account the exchange rate of euro to ruble, as virtually everything needed to set up a winemaking business is purchased abroad.

What are some of the mistakes that investors and winemakers commit when they launch their business?

The following can be categorized as the major mistakes committed by investors:

The first thing is the lack of advance business planning (strangely enough, this is very commonplace) and a clear business development strategy. An investor must know what he is signing up for, how much it would cost him, and when he will get a return on his investments. Many invest in winemaking business only because it's



prestigious. Some winemaking projects have even gotten the nickname “image” projects. Still, sooner or later, the question of payback comes up.

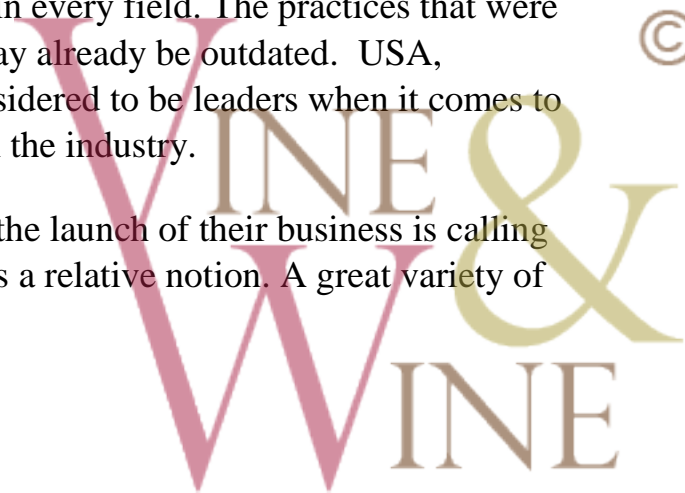
Not all investors have a clear understanding of what is involved in the production of a bottle of wine, how to evaluate its quality and, most importantly, where and how to sell it. It’s important to understand that winemaking is, first and foremost, a for-profit business and that such investments are long-term in nature.

The second thing is the lack of a production concept for a winery. For instance, an investor starts investing in a winemaking business, wishing to produce, let’s say, super premium quality wines. As the business grows and the winery is constructed, the investor begins to crave more and starts to significantly expand vineyard areas and, consequently, to increase production volumes. With this scenario, the initial concept becomes dissolved, the quality of the wine inevitably decreases, and the brand is no longer viewed by consumers as super premium. As a result, this approach can negatively impact the sale of the wine. Wine is a very particular product that requires special approach to its marketing. The marketing concept must a priori be developed on the basis of the chosen industry.

The third thing is involving laymen in the project development. In any business, including viticulture and winemaking, one should never rely on people that don’t have extensive relevant theoretical knowledge and practical experience working in that specific field. Having the desire, the financial capabilities, loyal friends, family and authorized representatives alone is not enough for successful establishment and development of this business. Failure to seek the help of an expert and trusting solely in one’s own abilities will inevitably lead to numerous mistakes and financial losses. As for being sure that the experts you invited truly are experts in their field is another matter entirely ...

The fourth thing is the unwillingness to invest in employee training. Winemaking industry can be roughly divided into the following areas: viticulture, winemaking, wine appraisal (wine quality appraisal), and wine marketing. Taking into account the industry’s rapid growth on the world map, the implementation of state-of-the-art technology, the problem of global warming, the highly competitive nature of the wine market, it is imperative to invest in industry-specific basic additional training and development of key specialists in every field. The practices that were used around the world, say, 10 years ago, may already be outdated. USA, Germany, France, Austria, and Italy are considered to be leaders when it comes to investments in science and expert training in the industry.

The main mistake that winemakers make at the launch of their business is calling themselves professionals. Professionalism is a relative notion. A great variety of



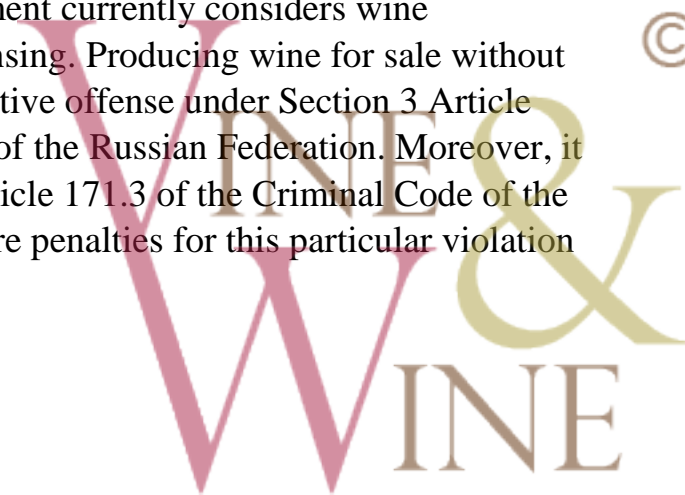
wines are being produced in the world today and in that total only a handful can be categorized as “great ones”, and not that many can fit the “high quality” category. The presence of a great number of mediocre and even low-quality wines on the market speaks to the fact that not all winemakers are capable of producing high-quality wines. For the sake of fairness, aside from terroir, we must note the crucial role that a winegrower plays in producing high-quality grapes that a winemaker would use to make wine. Those two specialists need to have a strong cooperation and understanding between them.

What is the legal side of the issue like: many winemakers complain that obtaining a license is very difficult and unprofitable. Can you comment on that?

A license must absolutely be obtained. The procedure for obtaining a license is specified in the Federal Law No. 171-FZ “On the state regulation of the production and trading volume of ethyl alcohol and alcoholic drinks and the restriction of consumption (drinking) of alcoholic products” of 11.22.1955. Production, storage and delivery of manufactured alcoholic and alcohol-containing food products by enterprises as well as production, storage and delivery and retail sale of wine products manufactured by agricultural producers are all subject to licensing.

The legislator specified an exhaustive list of documents for legal entities, peasant (farm) enterprises and individual entrepreneurs recognized by agricultural goods producers that must be presented to a licensing authority in order to receive a license. The amount of state tax for granting a license to legal entities is 800,000 rubles; for peasant (farm) enterprises and individual entrepreneurs recognized by agricultural goods producers it amounts to 65,000 rubles. The amount of state tax for granting a license for the production, storage and delivery of produced wine with protected designation of origin, wine with protected geographical indication, including sparkling wine, is also 65,000 rubles. The decision by the licensing authority to grant or to refuse a license is taken within 30 days from the receipt of the application and all the required documents.

In my opinion, it’s not entirely correct to talk about the unprofitability of getting a license. One must understand that any business that deals with alcohol falls under strict standardized regulations. The government currently considers wine production to be subject to compulsory licensing. Producing wine for sale without obtaining a license constitutes an administrative offense under Section 3 Article 14.17 of the Administrative Offences Code of the Russian Federation. Moreover, it is also a criminally punishable act under Article 171.3 of the Criminal Code of the Russian Federation. The law stipulates severe penalties for this particular violation with up to three years imprisonment.



In licensing wine production, the legislator aims to shut down its illegal production which can represent a health hazard. The main difficulty in obtaining a license lies in providing all the required documents and complying with the established manufacturing requirements. I've never heard of commercial establishments with expert lawyers and production workers on the payroll being unable to obtain a license. It's true that small producers have a harder time obtaining a license because they are subject to the same norms (with a few exceptions) as large-scale producers who have different financial capabilities. With that in mind, it makes sense to continue the legislative work on establishing differentiated requirements for obtaining a license for wine producers based on the output volume. Nevertheless, under the current conditions a license is required because it will protect the producer from the risk of losing their business as well as from criminal or administrative responsibility.

How do you rate the state of Russia's wine industry today?

Russia's winemaking is currently in its infancy. The Russian system, analogous to the French Appellation, is being developed before our very eyes. We now have PGI (Protected Geographical Indication) wines, which means that no less than 85% of the grapes for their production must be grown within the boundaries of that specific geographical area, and even PDO (Protected Designation of Origin) wines, which means that 100% of the grapes used for their production must be grown within the boundaries of the corresponding geographical area. Now the informed customer that buys a bottle with proper descriptions understands that wine was produced with grapes cultivated in that specific area.

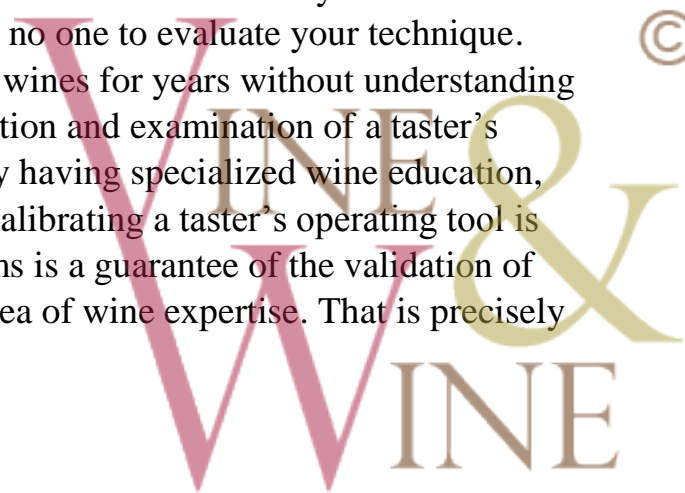
Still, many consumers are worried less about the geographical origin of the grapes than about the quality of the wine they purchase. The 2018 Russian Wines Competition, which I organized and judged, revealed serious issues in the quality of the wines produced in Russia. And, most importantly, those issues were the result of mistakes made in vineyards and wineries, in other words, they were manufacturing problems and were not related to violations of the conditions of storage for the wine at its points of sale. The question of correspondence between price and quality of certain wines likewise raised some flags.

Russia is currently developing positive traditions of conducting various wine competitions, some of them independent, and establishing a professional expert community. I am convinced that the more competitive the competition and expert community get, the greater the investment will be toward raising the quality of Russian wines. Producers of low-quality wines will simply no longer find it profitable to remain on the market.



There's an emerging positive trend in Russia of obtaining quality specialized wine education in the area of wine expertise abroad. There are more and more knowledgeable wine specialists in our country, and that's gratifying. This year, Russia added 5 new Wine Academicians to the mix (Alexandra Alexandrova, Anna Baranova, Daria Vereshchagina, Snezhana Revchuk, Nikolay Chashchinov), and two more Russian citizens (Alexandra Alexandrova and Leonid Fadeev) were admitted to an academic program at the Institute of Masters of Wine in Great Britain. The number of Russian citizens with diplomas from the world's oldest wine school – WSET (Wine and Spirit Education Trust, Great Britain) has also increased. However, professional education for many Russian “wine experts” constitutes only short-term sommelier courses, if that. Such education can be considered as a good professional start for working in the restaurant industry and food services industry, but it is no longer enough for further development. Live and learn, as they say.

Unfortunately, we're seeing a tendency to interchange the notions of sommelier and wine expert. A sommelier is, first and foremost, a specialist, who has undergone the sommelier training and has the appropriate qualifications, is employed in the food service industry, and whose primary responsibilities include compiling a wine menu, recommending a specific wine to a client, one that would be paired well with a specific dish, proper serving and presentation of the chosen wine, as well as testing the wine for defects which would require the wine to be replaced (for instance, cork taint – 2,4,6 – trichloroanisole or oxidation). A wine expert is a specialist with a specialized education in the area of wine expertise, who passed the qualifying exams and received the appropriate qualifications (for instance, Master of Wine, Wine Academician, WSET diploma holder), works in the wine-selling and/or winemaking industry, and whose primary responsibilities include determining the quality of the wine, its commercial appeal and potential. Presentation and selection of wines to pair with particular dishes is not part of wine expert's responsibilities. Both professions are very important to the wine industry, but they are not one and the same. In any case, without proper wine education and confirmed qualifications you won't be able to succeed in either of these professions. Lack of qualifications can lead to an illusion of having knowledge and deviation from the right course. A perfect example in this context is sports activities. You can perform some physical exercises or others for years and perform them incorrectly, because there was no one to evaluate your technique. With regard to wine expertise, you can taste wines for years without understanding the subject and the proper systematic calibration and examination of a taster's operating tool (nose and mouth). That is why having specialized wine education, doing systematic continuing education and calibrating a taster's operating tool is the norm for today. Passing qualifying exams is a guarantee of the validation of theoretical and practical knowledge in the area of wine expertise. That is precisely

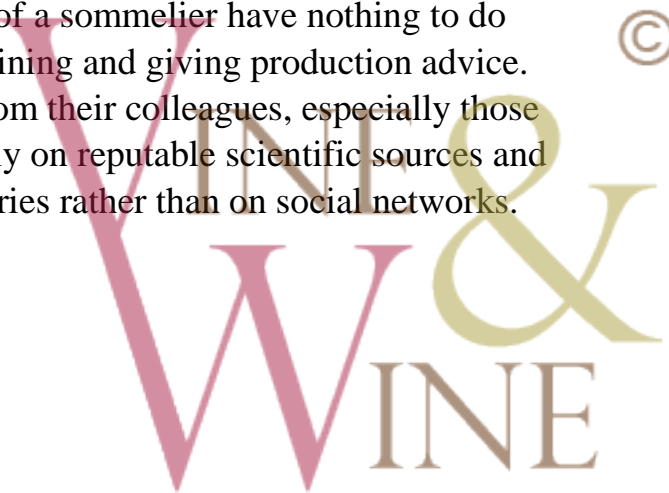


why any professional education system always requires students to pass exams prior to awarding them professions and qualifications.

If we are talking about the wine industry's main players, we must mention viticulturists, winemakers, wine experts, distributors, importers/exporters, sommeliers, and, of course, wine consumers. All players can be loosely divided into groups. The first group is wine producers (viticulturists, winemakers). The second group includes those who check the quality of the wine, determine its commercial appeal and potential (wine experts). The third group is composed directly of those who sell the wine (distributors, importers/exporters, sommeliers). Wine experts can also take part in the sale of the wine. The fourth group is wine consumers. The greatest importance should be placed on consumers, for they are the ones who spend their hard-earned money to purchase wines, which is what "drives" the industry. If no one buys the wine, the industry will cease to exist. With that in mind, consumer has the right to be provided a quality product. Then come wine producers, who are conscious of the market's demand and ensure the supply. Next come the representatives of the second and third groups, who evaluate and sell the wines, in other words, appear as the intermediaries of sorts between consumers and producers. In my opinion, balance should be observed in that chain the same way as it is in wine itself. What I see in Russia today is an overbalance of sorts in "significance" in the direction of the third group. We must work on equalizing that situation.

A very important positive trend in Russia is the emergence of new professional viticulturist and winemaker associations. It is of paramount importance for professional viticulturist and winemaker associations to be led by people with practical experience working as viticulturists and/or winemakers. Theorists or people without production experience will never be able to understand the problems within the industry, let alone find correct solutions. The same applies to state management of the industry. Management of the wine industry at state level should, ideally, be done by people with decades of real experience working in vineyards and wineries.

Training of our viticulturists and winemakers by representatives of the sommelier profession should be exercised with great caution. Such instances do occur. The responsibilities and the scope of competency of a sommelier have nothing to do with viticulture and winemaking, let alone training and giving production advice. Viticulturists and winemakers should learn from their colleagues, especially those from abroad, to self-teach, drawing exclusively on reputable scientific sources and spending more time on vineyards and in wineries rather than on social networks.



Soviet wine school should not be viewed only in a negative and judgmental light. Yes, many provisions became outdated. Nevertheless, there is a colossal database that has been perfected over the decades and that will, with certain adjustments and upgrades, have a positive effect on the industry's development. It is shortsighted to disregard such a resource.

The issue of establishing producer and/or seller responsibility for the production and sale of low-quality wines should also be addressed. In order to do that, we must develop a procedure for determining the cause of defects in the wine (for instance, growing low-quality grapes, mistakes on the part of the winemaker, violation of wine transportation and storage regulations in retail, etc.) and punish violators by imposing a fine. These days, unscrupulous winemakers attempt to shift the blame for wine defects onto wine sellers.

What are the prospects for winemaking business in Russia? Should one start it and invest in it?

In 2017, wine production in Russia decreased by 17.5% (data according to the Kommersant newspaper). The main reasons for decreased production of Russian wine: a cold and rainy summer of 2017 in some of Russia's regions, an abundance of relatively cheap quality imported wines in retail, a decrease in the "patriotic" wave of interest in Russian wine, and a switch of a portion of consumer demand to the cheaper fruit wine category.¹

Over the coming years, the production of Russian wine will depend both on real government support for the industry and on producers themselves. In my opinion, nothing good will come of the government's attempt to ban or restrict the import of wines; on the contrary, it will serve to weaken healthy competition. Russian producers must, first and foremost, learn to produce quality, consistent wines, to understand the level of quality of the product they manufactured, and to accept objective professional evaluation of their product in a constructive way. If that doesn't happen, the quality will stay on the same level and the consumer will give preference to imported wines.

That being said, winemaking in Russia, as a trend, has remained relevant for years, new businesses are emerging, and large-scale enterprises are expanding their existing vineyard territories. So while you are busy deciding, all the free land suitable for planting vineyards may be already gone.

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¹ <https://www.kommersant.ru/doc/3523343>

