Wine Business Solutions

The Wine Paper

Issue Two – January 2008

Contents

The Price is Right?

Many of you will be looking at the supply & demand situation and wondering whether now is a good time to be putting up prices? Part of the answer lies in something called "price elasticity". That is – if you put your price up by 10%, for example, will sales drop off by more or less than 10% and what will be the impact on profits? A recent analysis piece carried out by Citigroup looked at eight studies into beverage price elasticity.

Figure 11. Academic studies determining price elasticity by category for beer, wine and soft drinks

Own-price elasticities	Beer	Wine	Soft Drinks
Clements and Johnson, The demand for beer, wine and spirits - a system wide analysis, 1983 (Australia)	-0.36	-0.43	n/a
Tsolakis, Riethmuller and Watts, The demand for wine and beer, 1983 (Australia)	-0.23	-0.43	n/a
Selvantahan, Empirical regularities in cross-country alcohol consumption, 2005, (Australia)	-0.20	-0.43	n/a
Average Australia	**-0.26**	**-0.43**	**n/a**
Nelson, Economic and demographic factors in U.S. alcohol demand, 1997 (USA)	-0.16	-0.58	n/a
Selvantahan, The effects of advertising on alcohol consumption, 1995 (UK)	-0.24	-0.55	n/a
Lariviere, Larue and Chalfant. Modelling the demand for Alcoholic Beverages and advertising specifications, 1999 (Canada)	-0.38	-0.75	n/a
Selvantahan, Empirical regularities in cross-country alcohol consumption, 2005, (10 country mean)	-0.19	-0.35	-0.31
Fuss and Waverman, The demand for alcoholic beverages in Canada, 1987 (Canada)	-0.27	-0.76	n/a
Average all regions	**-0.25**	**-0.54**	**-0.31**

Source: Citi Investment Research

As you can see, the average for wine is minus 0.54. In other words, put the price up 10% and (on average) you can expect sales to drop off 5.4% What would this mean for that container of wine that you have sitting in your warehouse waiting to be shipped to that price rise resistant importer?

1000 cases @	$100 per case	Plus 10%	less 5.4%
Revenue	$ 100,000	$110,000	$104,060
COGS @ 50%	$ 50,000	$ 50,000	$ 47,300
Op Ex @ 27%	$ 27,000	$ 27,000	$ 27,000
EBIT	$ 23,000	$ 33,000	$ 29,760
Change		43%	29%

For a "sustainable" (according to Deloitte) wine company operating with a 50% gross margin and having 27% operating expenses, a percentage change in revenue is more than four times as powerful as a percentage change in operating expenses (i.e. business running costs such as Administration and Sales & Marketing) and twice as effective as reducing COGs (cost of production) in terms of increasing profits (EBIT).

Focusing on optimising revenue at the same time as building brand equity (the positive stuff people carry around in their heads about your brand) is **the key to making money in the wine business.** Price rises are one way to do it but you can also achieve the same ends by simply focusing your sales efforts on higher value product in higher value markets (the sales mix)

"But hang on", you say – "What about the drop off in sales". Even though you would typically see sales drop by 5.4% with a 10% price rise, you would still see a 29% increase in EBIT during the period it would normally take the sell that 1000 cases. You would then have to commercialise 5.4% less finished wine to achieve the same result next time - a positive result for cashflow. It may take you slightly longer to get your next order, however and a lot longer if you've crashed through an important price ceiling. Slower sales and better profits are fine. Falling distribution is not. The trick lies in holding listings whilst using the additional profits to invest in the brand and getting all concerned to believe "you're worth it".

Whether you can increase price successfully or not also depends on a number of factors that lead to what analysts call "pricing power". In Australia, for example, the beer market is the most profitable in the world (don't you hate that?) due in part to the now very "cosy" relationship between the two big players. As detailed in Wine Paper One, it wasn't always that way… In New Zealand the two majors still enjoy spending most of their time beating each other up. This then negatively impacts their ability to raise prices (So beer is cheap - yet another reason to start planning your next Rugby / Fishing trip!) In South Africa, even though Coca Cola / SAB have a much greater level of market dominance, their ability to raise prices is constrained by what the core consumer will pay.

Citigroup have developed an industry scorecard for pricing power and compared to say Australian Beer, which they rate 27/40, global wine doesn't look so hot…

Figure 10. Export wine segment pricing power scorecard

	Score today	Score 2-yr forward	Comments
Industry structure	4	4	The top 10 global wine players share just 16% of industry volumes
Competitive environment	2	2	Despite some industry consolidation, the wine market remains fragmented with low barriers to entry
Distribution channels	4	4	Varied but increasing retailer share of wine sales in the retail channel will limit pricing potential
Brand equity	3	3	The number of new wine brands is increasingly rapidly
Total score	**13/40**	**13/40**	**Wine has limited pricing power in export markets**

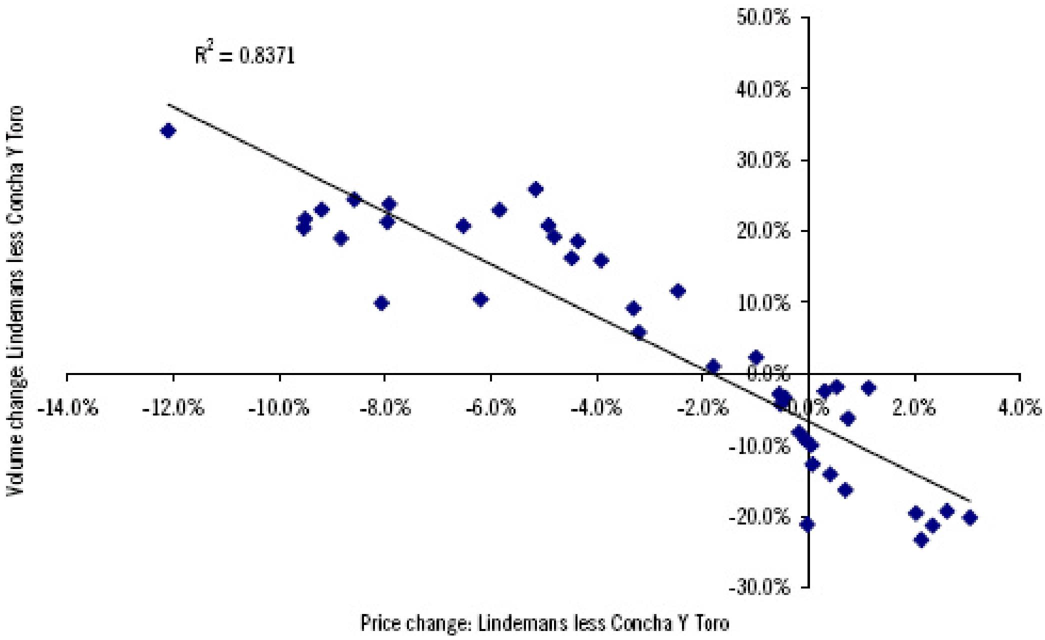
Source: Citi Investment Research

But remember that pricing dynamics change dramatically as you move from one consumer segment to the next. Generally, the lower the level of involvement, the more resistant consumers are to price increases and vice versa.

In the under $10.00 "Enjoyment Orientated" branded wine consumer category there are high levels of "cross elasticity". That is, a price rise for one brand leads not just to a drop in sales but an increase in sales of certain other brands. This is due mainly to the intensity and regularity with which major retailers promote these brands.

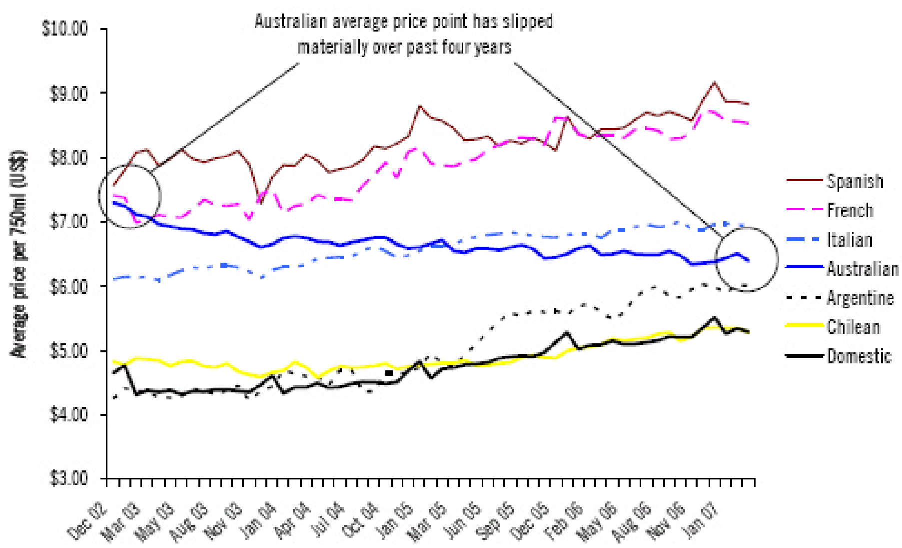
As you can see in the following example ex Citi Investment Research, there is a highly correlated relationship between sales of Concha Y Toro and Lindemans in the US.

Figure 12. Cross-elastic relationship between Lindemans (Australia) and Concha Y Toro (Chile) in US market



Many small to medium wine producers are letting what the 4-5 big Australian/US companies do in this sector (and the bullying tactics of big retailers) drive their pricing decisions. This makes little sense when considering the way the rest of market is heading. What's worse is that US retailers generally don't want to even hear those hard luck stories of oversupply. They'd much rather listen to the good news about growth and the way in which your brand fits in.

Figure 13. Average Australian wine price points in US has fallen consistently in the US market



Source: AC Nielsen, Citigroup Investment Research

This all makes even less sense when considering the pricing dynamics of your two main target market segments – the "Aspirational" wine drinker and the "Appreciator" segments described in Wine Paper One. Let's take the case of Oyster Bay - the biggest selling brand in Australia by value and "dominator" of the Aspirational wine drinker category in an ever increasing number of markets.

When they entered the Australian market, for example, they had the choice of taking their lead from the incumbents (Montana / Stoneleigh and Giesen) and pricing at $12.99. This pricing was led by Montana who figured that as they were the biggest and had the lowest cost base, they would add more value for consumers through providing lower prices. But what happens if the consumer doesn't see lower prices as better value? Research shows that younger wine consumers particularly will spend more money to compensate for uncertainty and that in the absence of other information, wines that are priced closer to the limit of what people are willing to spend are viewed as more valuable. In the case of the Aspirational wine consumer – that limit is $A / NZ / US 15.00 / 80-90 Rand / £7.99 / $20C etc…

Taking Oyster Bay's sales in Australia to be around 400,000 cases, an average case priced realised of roughly $100, expected COGs of 50% and expense ratios ex their 2007 annual report, we can measure the impact of this decision.

Increased Revenue	**$12.99**	**$14.99**
Retail Sales- $000s	**81,112**	**93,600**
WET & GST and Retail Margin @ 80%	36,050	41,600
Wholesale Sales @ 30% Margin	45,062	52,000
GROSS REVENUE	**34,663**	**40,000**
TOTAL COGS @ 50%	**20,000**	**20,000**
TOTAL GROSS PROFIT	**14,663**	**20,000**
LESS EXPENSES		
Operating Expenses @ 26%	10,400	10,400
EBIT - 24% @ $14,99	**4,263**	**9,600**
Interest and Other Expense	1,085	1,085
NET PROFIT BEFORE TAX	**3,178**	**8,515**
PROVISION FOR TAXATION @ 30%	953	2,555
NET PROFIT AFTER TAX - 14.9% @ $14.99	**2,225**	**5,961**
Change		-63%
Dollar Change		$ 3,735,824

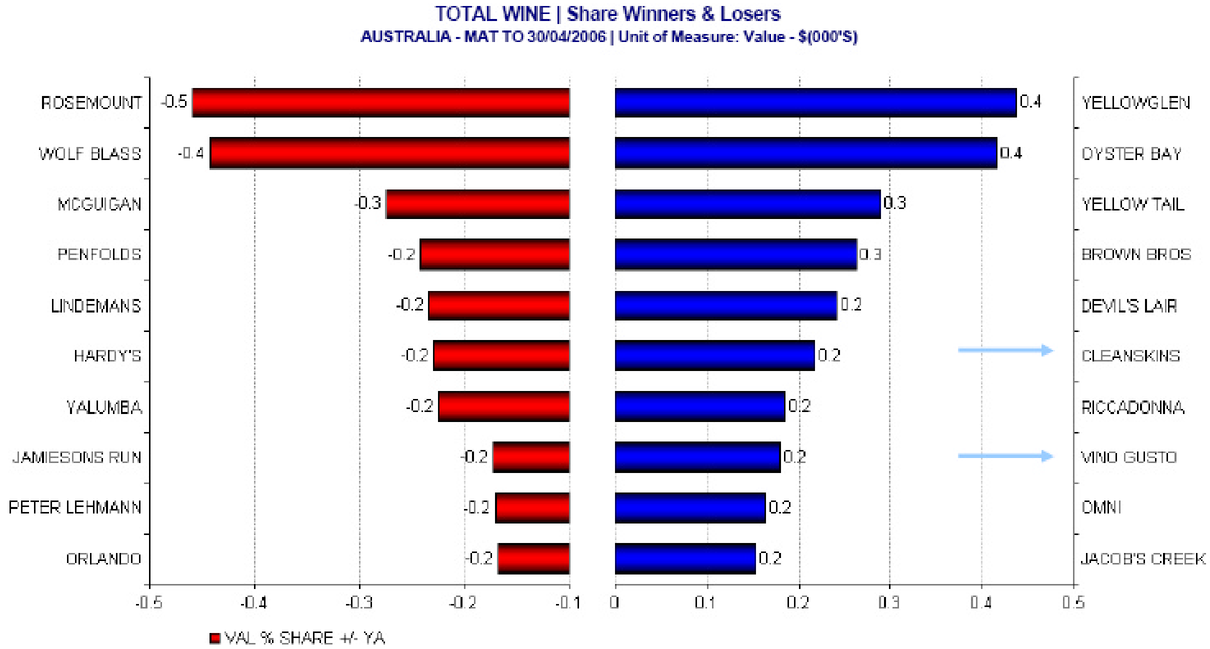
As you can see, the difference in profits is **<u>$3.7 Million or 63%</u>** ! Imagine how far and how fast Montana were being punted out of the park if most of that was being turned back into Sales and Marketing…

That's why WBS maintains that pricing up to what your chosen consumer segment will pay is **<u>the most important decision</u>** that any wine business owner makes. It's far too important to leave to sales managers, distributors or retailers. All will have their valuable contribution to make to the pricing discussion. All should be roundly ignored in favour of developing your own acute sense of just what that price is in your chosen markets…

What Women Want

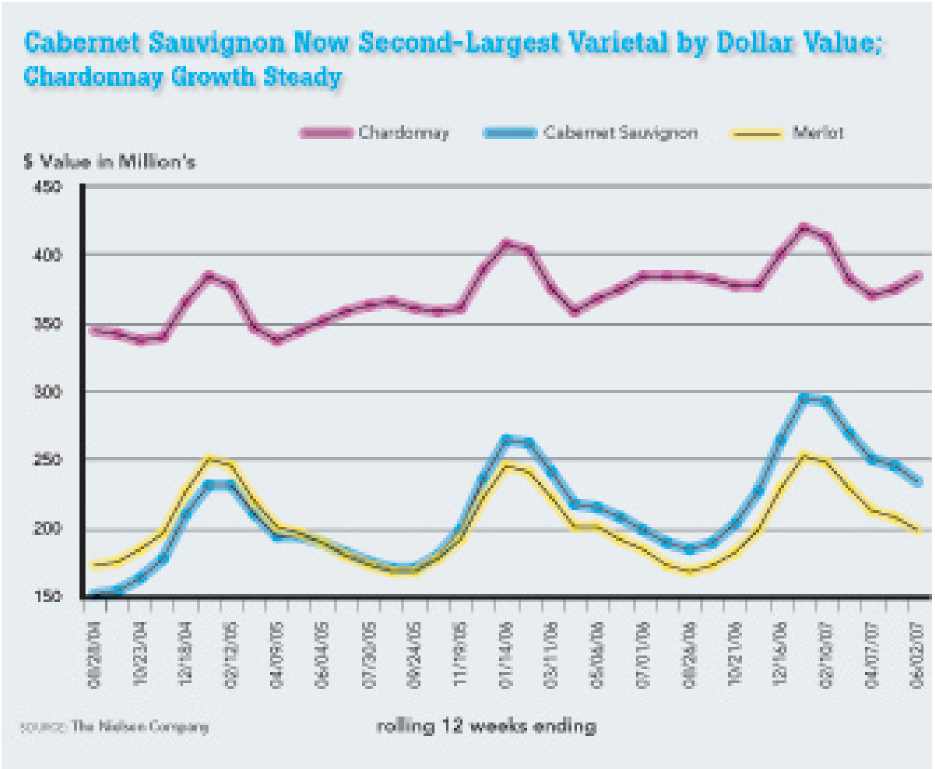
To quote Bill Deutsch (US importer of [yellow tail]) - **"Women Rule!"** I guess we all knew that but did you know that 65% of US wine drinkers are women? More importantly, they buy 70% of all wine according to the Wine Market Council.

And they're having a dramatic impact on wine style preferences. Just take a look again at Australia's biggest winners and losers domestically…



Source AC Neilsen

In the UK (where women drink 70% of the white wine and 50% of the red according to the Drink Handbook 2006 edition), Rose sales were up 32%, Sauvignon Blanc up 12% and Pinot Grigio up a whopping 70% year on year Oct 06, according to Neilsen. Sparking Wine sales were up 6% in value year endSept 07. But before you go ripping out all your Chardonnay, Cabernet and Merlot, it's worth considering which market and which segment we're talking about. After all, these varietals are driving volume and value growth in the US.



We were all amused at the Outlook Conference *(which WBS attended if anyone wants further information)* by Dan Jago *(Tesco's head buyer)* sticking it to the Australian wine industry -

"I would also urge you to make your wines lighter and more refreshing. Wines with 13% or 14% alcohol just aren't exciting any more and customers are now looking to the Old World for more refreshing wines"

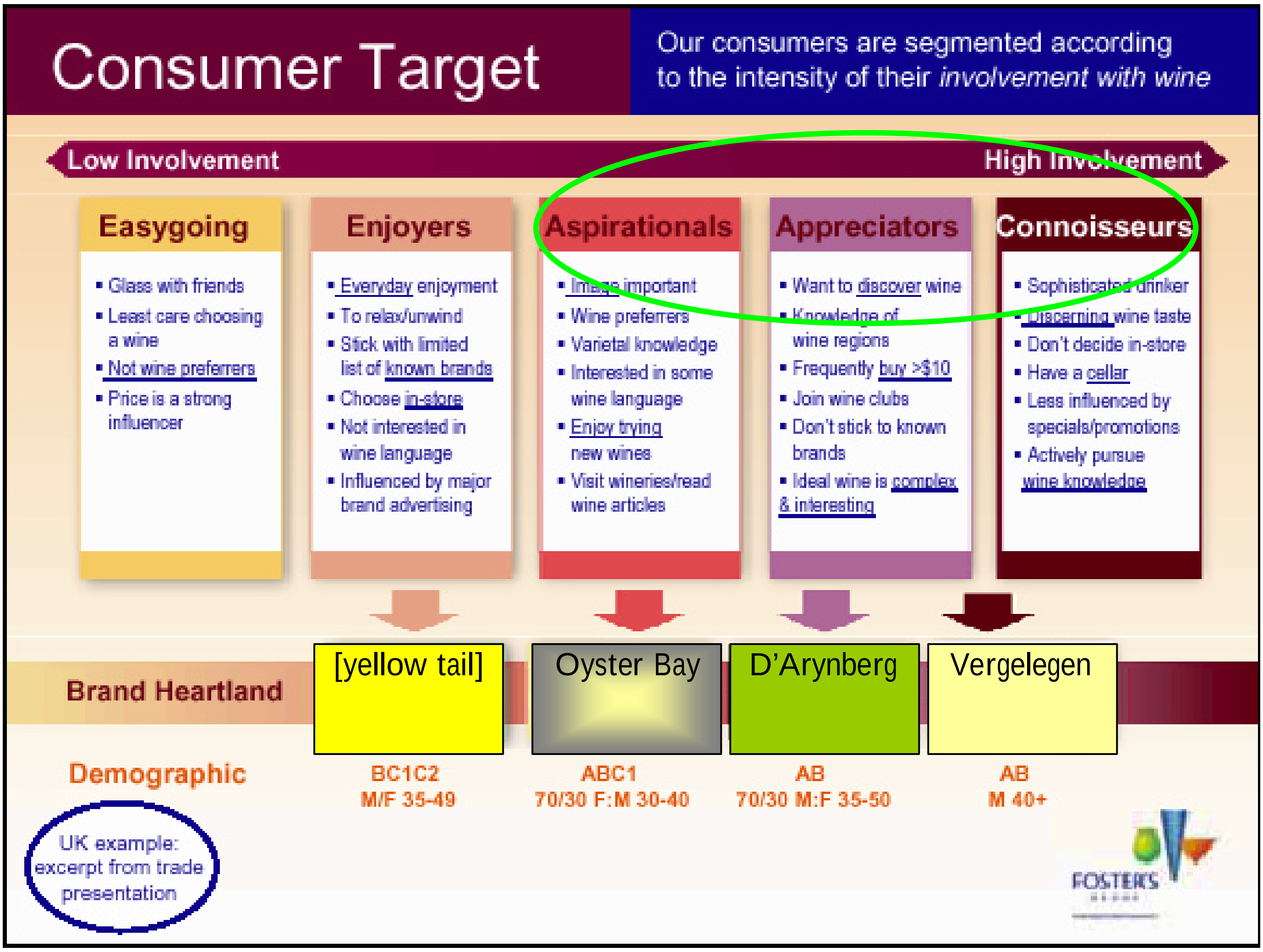
and Bruce Tyrell retorting in the Sun Herald –

"He's a wanker. He should go back to selling dog food. For years, Australians have been supplying the British with technically correct wines that have good colour and are full of flavour, compared with the Europeans, who have been supplying them with technically poor wines with no colour and taste like cat's piss."

and subsequently recanting…

Is this not just a case, as so often happens, of two men getting consumer segments mixed up and using one argument to cover all wine? Clearly the women that dominate the Aspirational segment are expressing themselves and those brands that have positioned themselves against the opportunity are killing it – witness the rise and rise of Marlborough Sauvignon Blanc. Likewise, those Barossa and McLaren Vale producers and the likes of Eban Sadie in South Africa who know how to work Robert Parker are making a fortune producing big, full bodied, alcoholic blockbusters.

Our view at WBS is that the second most important thing after survival (i.e. making enough money to continue) is developing **a clear line of sight from the experience of your brand back through to the dirt from whence it came**. That is to say, you need to see inside the head of the person who is drinking your wine and have the power to adjust the offering at all points in the distribution chain back to and including the vineyard. Once you choose a price point and quality level, you're choosing your market and winning then becomes all about ensuring that every single thing you do in the supply chain delivers accurately to what that consumer wants. As a small to medium producer, you've really got three choices as to who your market is…



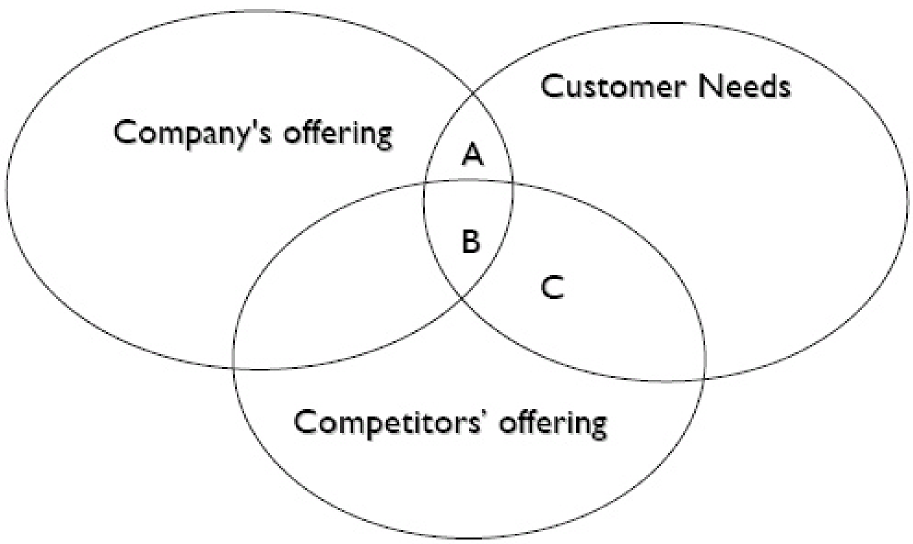
Or what the WFA call them – Generation Next, Regional Heroes or Landmark Australia.

The largest and the one we'll concentrate on in this paper is the Aspirational wine consumer. They are 70% female and mainly "30 somethings" with education and money. If this is where you want to put your focus and you want to build a business big enough to be profitable with an average retail price of $US15.00 then this doesn't' give you too much too have to think about target market wise…

Why then are so few people targeting this market effectively? Why don't the big companies have this nailed down already? Why was it seemingly so easy for the likes of Fairview, Don Sebastiani and Oyster Bay to walk in and take the best part of key markets?

The Wine Makers Federation is calling the segment "Generation Next" with the slightly mistaken view (WBS believes) that what this audience is looking for is constant innovation. They want plenty of innovation, alright – but only because what was being offered was so far apart from what the audience actually wanted in the first place. Compare and contrast for example a 1980s style bottle of Penfolds red with a good Moscato D'Asti. You've got the whole world of difference there and entire producer countries doing little to accommodate it.

Borrowing from a recent Harvard Business Review article, it's well worth considering the world in the way presented below. When you think of all the things this group might like to drink, it's clear that there is still a lot of white space in terms of what we offer them collectively. Maybe we still need more women working in all areas of the supply chain – viticulture, wine making, marketing, sales and most importantly general management. Maybe we also need to ask our wives (and daughters) what they think more often… Definitely, as a starting point if you want to pursue this market, you may want to look at sourcing differently and selling in bulk what's not going to fit your requirement this vintage.



A = Our Points of difference

B = Points of Parity

C = Their Points of Difference

Source – HBR Nov 07

So what do women want? Those End Values we discussed in Wine Paper One are all important. Wine Intelligence research confirms that the two most important "moments" for women are the **"Self"** moment, tying in neatly with that "World at Peace" end value.

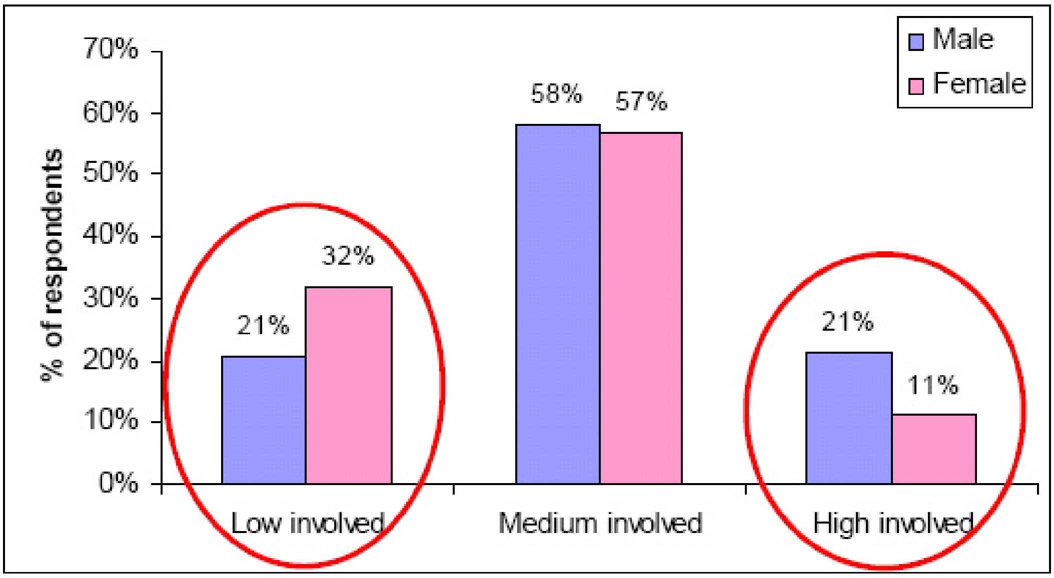
and the **"Sharing"** moment driven by the "True Friendship" end value…

Brands that credibly connect with those moments are going to perform strongly.

Women are interested in wine but generally not passionate about it, according to Wine Intelligence… They're less confident about their decisions leading to risk reduction via:

- Less experimentation
- Choice being more dominated by hard brands
- More reliance on packaging and labelling cues

which is great news for those of you trying to build a brand and bad news for anyone not taking packaging extremely seriously.



So what's the future? That's what we're here to help you with, of course. In our view, there's a lot to learn by expanding the search outside the wine industry. One area that to us seems underdone, is using visual imagery to enhance desire. If consumers believe that food products taste better when the package includes a picture of the food* why do we not see more brands using a visual image of where our consumer wants to be and what they want to be doing? It's also proven that women like and recall food advertising more than men**. Why then are we not seeing more visual theming of brand concepts at all points of customer contact? If this is where we want to play and win, everything from the way we do tastings, to the way we merchandise cellar doors through to the look and feel of our web site should consider **"What Women Want"** - wouldn't you say?

**SourceUnderwood, R.L. & Klein, N.M. (2002. "Packaging as communication: effects of product pictures on consumer responses to the package and brand". Journal of Marketing: theory and Practice, 10, 58-68*

***Source: Ewing, M., Napoli, j., & Plessis, E.D. (1999) "Factors affecting in-market recall of food product advertising". Journal of Advertising Research, 39, 29-38).*

The "Top Ten Tips" for Building Better Wine Businesses.

(from Wine Business Solutions article published in Wine Business Magazine, March 2007)

One - Start by understanding your customer value proposition. Only part of this stems from your company's unique heritage and / or personality. To be successful, this needs to be strongly linked to what your customers ultimately want from the experience of your brands. There is some excellent research on this that is publicly available. Getting it right is therefore not out of the reach of small companies.

Two - Once you understand what customers value most, you can then remove what they don't want (thereby reducing costs and freeing up cash), focus your communication on what they do want (often at no additional cost), differentiate your company on the basis of fulfilling customer needs more accurately than any competitor (again often at no extra cost) and raise prices (because your offering is more highly valued)

Three - Always be asking the question – "If I could start with a blank canvas today – what would our wine business look like?" It's all too easy to let existing assets, existing product lines and existing ways of doing things blind us to what it is that our consumers value most. Often it's simplicity. Complexity usually adds to costs and often only serves to confuse customers. Retaining unnecessary or irrelevant product lines, assets or business processes is the worst contributor.

Four - Make everyone in the company accountable for securing customer preference. This is not just the job of marketing but of everyone in the company, the owner most particularly. Make this the focus of the way every employee innovates their job processes on a daily basis.

Five - Invest in relationships. This is particularly so with major distribution partners. Make sure sufficient time and money is invested before demanding results. Be prepared to invest up front in bringing them to your home base and entertaining them in order to build enduring friendships.

Six - Make all employees champions for profit. Develop a culture of honesty around net revenue. Make sure everyone knows the actual price achieved net of all discounts, rebates, bonus stock and anything else that might otherwise cloud the true profit picture. Keep them focused on reducing costs but let them know that a percentage increase in wine company revenue is, on average, twice as effective as the same percentage decrease in the cost of goods sold and 3-4 times as effective as the same percentage saving in operating expenses.

Seven - Optimise your pricing mix. Focus first on selling more, higher margin product in high value markets to high value customers. Beware of people in love with "big volume". Big numbers make for big stories but often mean a lot of running around for no additional profit.

Eight - Build better business intelligence gathering systems – most companies are good at monitoring their own press. Very few have effective systems in place to monitor competitors, track changes in consumer preferences and turn customer feedback into customer value added.

Nine - Build 5-10 year Strategic Plans, forecast rolling 12 month budgets, link them to the most relevant KPIs and tie remuneration to these where ever possible. Everybody knows they should do this. Few do. The difference in performance of companies that do is enormous.

Ten - Watch your cashflow – building a cashflow forecast is a relatively easy exercise with the right software and some quality assistance. Some people survive years of losses but you can only run out of cash once. In a cash hungry business like wine – Cashflow is not just King but Oxygen.