Wine Business Solutions

The Wine Paper 23

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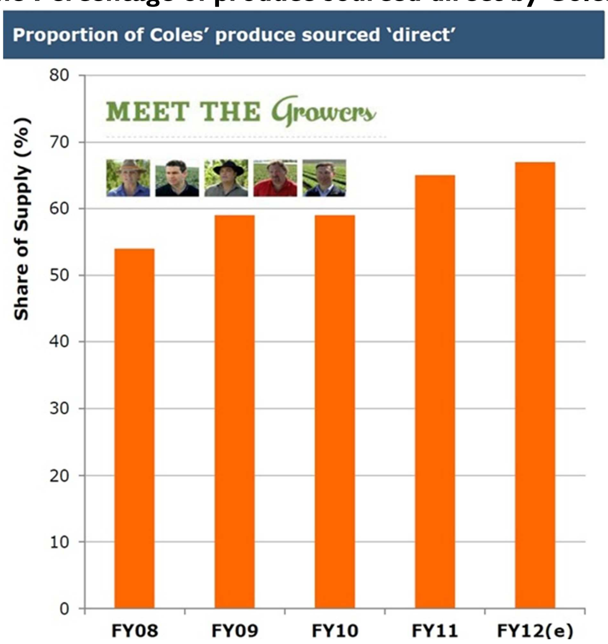
The Tipping Point

Many of you will have read or seen extracts from Malcolm Gladwell's book, 'The Tipping Point'. He talks about how a small upset in equilibrium can lead to sweeping change. Most that I talk to in the industry believe that we are at one of those tipping points right now. The old model is essentially broken. The trickle of people looking to deal direct with both trade and consumer customers is turning to a torrent. The Principals of the larger distribution companies, many of whom I talk to regularly, all seem agreed that if their business models do not change fundamentally in the next 2-3 years, they will not exist.

Some are pushing up margins in the hope that they will still be able to support the same infrastructure and ways of doing business whilst selling less wine. As increasing wholesale margin from 30 to 35% typically results in a 50% decrease in profit for suppliers, this is unsustainable. Others, like Red and White in Australia, have pushed suppliers to sell on consignment and to run A & P themselves to try to improve cashflow as much as profits. This is putting major stress on relationships to the point where suppliers will make the change faster than anyone previously anticipated. For others still, like Waverley TBS in the UK, it's already too late. Since we started researching the British market just 4 years ago, the On-Premise market in the UK has changed hugely. A more sophisticated offer, level of business intelligence and customer interface was required. Waverley simply didn't respond quickly enough.

Supermarkets are pushing ahead with their bid to tie up their sources of supply ahead of anticipated global food shortages. Wine is just another category caught up in the tide. Many of our customers report a much increased effort by the supermarkets in the last 6 months to rest supply away from distributors so as to deal direct. Giesen in Australia is one of the biggest to take the bait but many more are following.

Figure One – The Percentage of produce sourced direct by Coles Supermarkets.



For those that think that they have a secure relationship with a major supermarket, a comparison of Coles and Woolworths prices vs a year ago should prove sobering. Supermarkets' agenda globally is to drive out cost in order to compete from the lowest cost base. They are not going to hurt profits in order to achieve that result. You know who they're going to come to to drive that outcome…

Figure Two – Effect of Coles and Woolworths price war – Source Citigroup Analysis Nov. 2012

In the recently aired Chateau Chunder, the story of Australia wine as told by the BBC, the comment was made that the quality of Australian wine might have gone down in recent years. If prices remain fixed in the eyes of Supermarket buyers and the British public, tax goes up every year as well as basic costs and the currency moves against you then quality is an inevitable casualty. All supplier countries wrestle with this. Eventually, supermarkets will do for wine what they have done to their fish counters.

Herein lies the opportunity. High-end consumers have never been more susceptible to a better offer. If it can work for bread (the Sonoma Bakery) and meat (the Churchill Butchery) why not for the world's most value added food product – wine?

The time is right for the Apple Store of wine - the showcase that informs, educates, entertains and sets the aspiration for wine in a way that a supermarket owned outlet never can. Some might suspect that shoppers will simply do their research at such an outlet and buy at a discounter. This doesn't have to be the case. Apple had 394 stores worldwide, with global sales of US$16 billion in merchandise as at the end of 2011. They are the world's leading retailer in terms of sales per square meter of floor space.

I believe wine can do the same. We have world's best practice examples, if anyone wants to benefit.

The same philosophy can be applied to how wineries go about presenting their offer directly to consumers. Wineries just simply have to be better at doing this than Supermarket owned retail. Through the feedback we have had from our Direct-to-Consumer workshops, the relationships we have with regional bodies and connections we have with the organisers of the most successful wine consumer and trade events, we now have a wealth of knowledge as to how to build a business this way.

Direct-to-Customer sales are growing at a staggering rate. We've just conducted the first ever Direct-to-Customer benchmarking study to be undertaken in Australia, New Zealand and South Africa - Taking the Direct Route 2012. Forty Three companies provided us with their data (four submitted after close off) giving us a very solid foundation from which to benchmark the success of Direct-to-Customer strategy implementation going forward and to do so against the US where similar benchmarking is carried out.

As you may have seen in the press (or read if you bought the Taking the Direct Route Report) the wineries that participated in our survey now derive 18% of their income from Direct-to-Customer sales and managed to grow that by 20% in the last year. When you consider that some of the wineries involved in the survey have yet to begin their Direct-to-Customer journey and that it is the medium sized Australian and South African companies (that have been put under the most pressure by supermarkets) who are driving growth rather than smaller companies as is the case in the US, it's clear that Direct-to-Customer can grow significantly still. The report focuses on where those growth opportunities are.

Considering all of the above, it now seems that 2013 is going to be a bit of watershed year in terms of how wine businesses think about how they go to market. The big question is how to manage the transition and work the available channels to maximum advantage.

Strategies to reduce exposer to and dependency on supermarkets are critical to all but those with the lowest cost base or who help supermarkets reach lower cost through becoming part of their supply chain. Examples include Warburn Estate a quasi-winery for Woolworths and the wineries that use Vinpac, a contract bottler owned by Woolworths. There are a handful of other exceptions that follow the same principle, if not in an immediately obvious way. Wine listed in the Langtons Auction Index, for example, will get bought, displayed and protected, almost as of right. Woolworths owns Langtons too.

Other than that, wineries with a production of between say 25,000-350,000 cases need to be getting well out of the monster's way. The only exceptions are strong brands that are not category-leading (i.e. not in the firing line for loss-leading discounting) that make the retail chain looks good. Many of our clients are now being made the offer by supermarkets that they will share the margin if they cut their distributor out. Most know deep down that the ultimate intension is to take it all...

On Premise - Who is going to be left to service this market and what does a sustainable On-Premise business model look like? Relying on being able to sell the most popular Off-Premise brands in Restaurants killed Waverley and it has all but driven the listed companies out of the UK and Australian On-Premise markets. The major brands can still buy their way onto lists in Canada and the US but this will eventually break down too as customer sophistication outstrips the listed companies' ability to keep up and the demand for more authentic / eclectic wine increases.

For those 25,000-350,000 case production companies who can't afford to run a salesforce on their own, who need wide ranging distribution and who shouldn't be looking to sell anything under $US15 per bottle, getting it right is going to be very important. On-Premise represents around 50% of the wholesale opportunity in most markets for these companies. Even businesses that are selling mostly direct should look to the On-Premise as a way of keeping your brand in front of your fans and growing your business. Rockford, for example, is widely believed to be mail order only but is in fact, the most listed wine brand in South Australian restaurants, according to our research.

The distributors that are doing best, and this applies to all markets, are the ones that invest in understanding what the fastest growing wine ideas are (meaning countries / regions / wine styles etc), who know who the best producers are and most importantly, understand why the strongest On-Premise brands work. This doesn't always happen as part of standard process. You've only to look through the portfolios of the largest US importers to see that.

The best On-Premise distributors are typically the ones with a passion for wine that inspires their customers leading to trust and long term relationships in a sector of the industry where this still matters. They are run incredibly lean. Typically they work off average margins or less, discount less, spend A & P wisely and throw it back to the Principal if more aggressive price promotion is desired. They will not assist in destroying brands through supporting heavy discounting. This may sound old school but your best bet are companies whose core is and has always been On-Premise sales and whose founding Principals, or their descendants, are still involved in operations.

Those traders that have stretched margins in recent years to fund discounts are typically in the most trouble now. In the worst position of all are those that thought the retail chains were going to be the easiest route to achieve sales targets instead of doing the grinding work of establishing wide ranging On-Premise distribution and brand building.

The primary purpose of our On-Premise research is to provide guidance as to who those best distributors are.

Independent Retailers – What role will they play? Sadly, it seems that the view narrowing effect of working in day to day in retail is the biggest inhibiter to developing the sort of vision necessary to evolve. Traditional retail has never been adequate competition for the supermarkets and they seem less likely than ever to suddenly switch on. Retail chains in Australia, for example, are imploding as they look to replace brands with private labels to an even greater extent than the supermarkets only to find that people really do like brands. As earlier discussed, there is still great opportunity for retailers who master value adding to the wine shopping experience.

Online Retailers – Australian On-line wine retailers are the world's most effective by a very long way in terms of selling volume. So far, their success has been mainly driven by acting as clearing houses rather than as brand builders. There is still a glaring opportunity for a low cost portal for wine that;

- enables wineries to place their offers, service enquiry and manage fulfilment.
- acts as a central repository for brand information
- is the hub of social media and other conversation about brands
- is the place that wine lovers go to learn about events and other brand experience activity

In the US, this concept is known as a "marketplace" and Amazon have just launched their version. Wine.com has countered and at this stage has an advantage in that they manage fulfilment and compliance for the customer. They also ship to 20 States and opposed to just 12 for Amazon. As a wise brewery marketing manager once said to me, however, never underestimate the importance of size. Amazon currently has around 100 million unique visitors per month.

Export – The whole reason for researching the UK On-Premise market in the first place is that it provides the ultimate test of each country's brand strategy. It is still the largest market on earth for imported wine and there's not a large local industry skewing brand choices. It is a level playing field, in other words. The UK market may be mature but it remains the litmus.

Figure Three – Comparison of Selling Wine in the UK verses Australia

Ex cellar price - $A		$115.13
Exchange rate	1.535	£75.00
Freight	£1.80	£77.40
Warehousing	£2.40	£79.80
Freight out	£3.00	£82.80
Duty	£21.72	£104.52
Agent Margin	20.0%	£130.60
Wholesaler Margin	20.0%	£163.20
Price per bottle		£13.60
Restaurant Margin	60.0%	£34.00
Value Added Tax	17.5%	£5.95
List price		£39.95

Ex cellar price - $A			$140.00
Freight Out		$ 3.00	$143.00
WET Tax		29.0%	$184.47
Landed Unit Cost			$ 15.37
Wholesaler Margin		32%	$ 22.50
Restaurant Margin		60%	$ 55.75
GST		10%	$ 61.33
£ Equivalent		1.535	£39.95

Ex cellar price - $A		$140.00
Exchange rate	1.867	£75.00
Freight	£1.80	£77.40
Warehousing	£2.40	£79.80
Freight out	£3.00	£82.80
Duty	£21.72	£104.52
Agent Margin	20.0%	£130.60
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Value Added Tax	17.5%	£5.95
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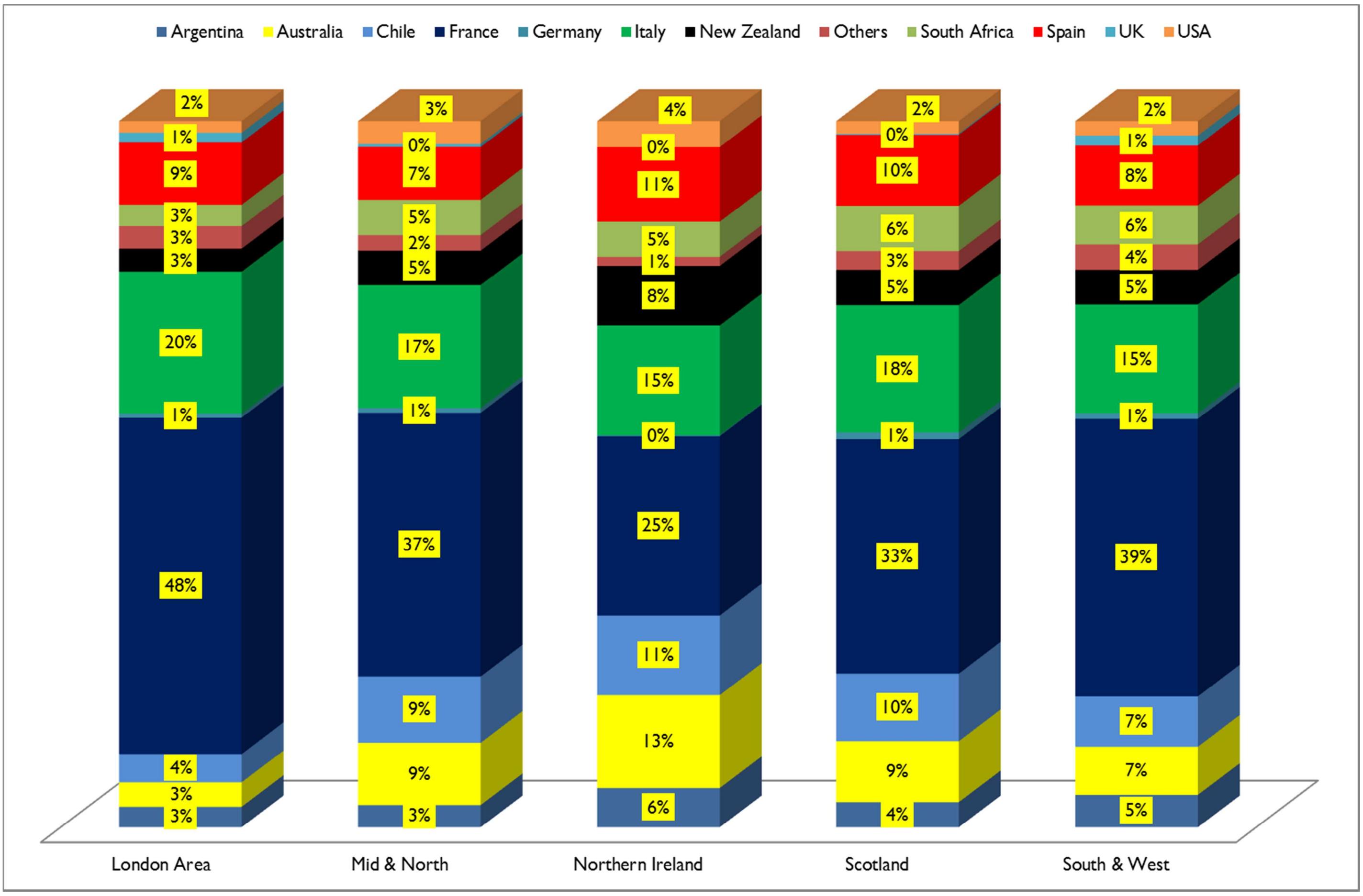
The average price of a bottle of wine on a UK wine list is roughly £40 which currently netts the supplier around $A115 per case FOB. Those 25,000-350,000 case production companies can easily live with that. The problem is that exchange rates need to improve by around 20% to yield the same revenue as selling through distributors to restaurants in Australia. Then there is the 'Wine Equalisation Tax' rebate which only applies to Australian domestic sales creating a massive disincentive to export until it is fully taken up. This has changed the focus of New Zealand wineries who can also claim it. Add to that the rush to establish distribution in China and you can easily see why the UK is receiving less focus.

Most Australian producers are probably hoping that the Australian category is marking time whilst they get on about building a direct platform and nailing down opportunity in Asia. Sadly this is not the case. According to our just released [Wine On-Premise UK 2012] research, in the last year, Australia has dropped from 3rd to 5th place behind France, Italy, Spain and Chile, in terms of total listings.

The number of listings of Australian wines bearing a regional appellation has dropped by 21% in the last year. The amount of wine labelled 'South Eastern Australia' has increased from 40.6% to 46.2% during the last year. This compares to less than 3% on Australian wine lists. These are not, however, brands that Australian drinkers would generally recognise. If you think about it, Brand Australia and Australian independent retail chains are employing the same tactics and are on the same collision course.

Figure 4 – The Share of Listings Held by the Major Supplier Countries by Market



The sad thing is, this shouldn't be happening as strong currency generally means that there is more value in concentrating on your premium offer given that your competitors will be working off a lower cost base. The larger American producers, for example, buoyed by weak currency, are flooding the UK market with lower end pouring options. As is the case with Australia, this is bringing the average price / perception of the category down and top end wines are being delisted. Unlike Australia, however, they lack the great quality, variety and value at mid-level price points to fight back with.

Where it gets really scary is when you look at the UK market by region as in Figure 4. Generally, long term trends get set in London and roll through the rest of the nation over a period of ten years or so. Given that Australia has only 3% share of listings on London wine lists, this should raise a huge red flag. Australian producers need to be getting their best and most interesting offerings in front of London Sommeliers right now in order to avoid premium category collapse and immense harm to long term brand health as happened in the US ten years ago and for which Australian producers are still paying now.

New Zealand is the most successful supplier country having grown share during each of the four years we have been measuring the UK On-Premise market. Cloudy Bay is the most listed wine brand in the UK for the 3rd year in a row. Sauvignon Blanc has, for the first time overtaken Chardonnay as the most listed wine style and Marlborough has, again for the first time, overtaken the Loire as its number one source.

The New Zealand category does have its vulnerabilities. Listings of other white wine styles are dropping as Sauvignon Blanc increases. New Zealand is also 3rd last amongst major supplier countries when it comes to listings over £60 per bottle. Building the brand that can provide a genuine threat to France depends upon more producers having the courage to pursue the limits of quality and pricing accordingly.

South Africa has been helped by ever weakening currency. Chenin Blanc has quietly become the 4th most listed wine style and now holds over 6% of white wine listings. South Africa retains over 80% share of the Chenin category but lost ground to the Loire in the last year. The Terroir discussion may have barely begun but Stellenbosch is finally attracting a brand premium particularly for red wines despite there being no specific claim about wine styles that the region does any better than other parts of South Africa.

In Summary – Most businesses, particularly medium sized ones and those with exposure to distribution, will need to undertake significant evolution now in order to survive the next 2-3 years. Periods of rapid change do, however, provide the greatest opportunity.

How can we help? - Our mission from the outset has always been to facilitate the strategic discussion, to inform highest quality decision making and to help you arrive at the best possible solutions so as to fully capitalise on the opportunity that change brings.

In the past, we've always tried to anticipate what the industry wants in terms of insight and support. Now, possibly a little overdue you might say, we're asking you to tell us. What, if it could be understood, would help your business perform better? What would you like to understand more about?

2012 has been by far and away our best year ever. Our nine Direct-to-Customer workshops attracted over ninety wine business owners and senior managers. Eight were held in the major wine regions of Australia, New Zealand and South Africa. The ninth was as part of a strategic review for one of Australia's most important family wine companies. The feedback was the best we have ever had. The client testimonials in relation to results from implementation have been phenomenal.

A key finding from the benchmarking study that followed the workshop program was that although wineries in Australia, New Zealand and South Africa compared well when benchmarked against their US counterparts (about whom there is already a lot of similar research available), the area where participating wine businesses were missing the most opportunity was in using the company web site as a business growth engine. US wine companies typically generated four times the revenue through their web sites than those in our survey did. Very few companies were effectively using Search Engine Marketing and other low cost, easy to implement strategies to drive more direct online business.

One thought as to the program for next year's workshop round was to focus on what are the leading edge strategies in terms of web site design, traffic building, contact capture, offer creation and presentation etc. Whilst there are a lot of people talking about this right now, few are approaching the opportunity from the view point of integrating it with wider business strategy and CRM. If you think this is a good idea (or if you don't and/or have a better idea) please just let us know.

Another area where our business has been growing strongly is asset sale, succession planning and helping wine business owners transition their business to the next generation.

One of the best things you can do for a business is to have it sale ready, whether or not you intend to sell it. US research shows that although most Private Equity firms contemplate a quick exit from businesses they buy, many are continuing to hold them as they discovered that when run as sale ready, these became good investments. What they found was that the disciplines that were enacted were, in many cases, the same as those needed to return the businesses to an acceptable level of profitability. They also discovered that this could be maintained and managed sustainably.

The thought was to develop a workshop program around:

- How to value a wine business.
- How to create saleable wine assets (including brands not associated with vineyards)
- How to get your wine business sale ready.
- How to put together and present an attractive offer to the market.
- How to optimise value upon sale or handover.

Again, if you like this idea or if there are any other themes that you would like to see addresses, please just let us know.

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

(From a Wine Business Solutions article published in Wine Business Magazine)

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 wherever possible. Everybody knows they should do this. Few do. The difference in the 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.