Wine Business Solutions

The Wine Paper 30

April 2014

The Price of Success

Money matters. Not normally as an ends in itself for us, the passionate people of the wine industry, but certainly as a means through which to achieve what we most desire.

Money matters. Because not having money really sucks. One the hardest things I get to do is to watch the faces of family members as they walk to meet me in the car park past their ecstatic guests relaxing next to sunlight vineyards believing that they are in paradise. If only they knew. Having the bank hold a gun to your head is no fun.

Money matters. It matters in a way that many clients miss. That is - if you are competing directly with a hundred or so other producers in your region and they have better margins and cashflow than you do, then they will most likely reinvest into making it so very much harder for you to attract customers.

Certainly, a lot of our consulting is about making life better by working towards balance and removing complexity. Pushing too hard for volume growth usually ends in tears. Competition determines, however, that taking a 'Zen-like' approach and trying to learn to live with what you've got may not be a safe platform.

So how do you fight and win? You can, of course, concentrate on containing costs and making better utilisation of existing assets. We can and do advise on how best to do that in the wine industry context but then again so can some accountants and generalist consultants.

Many of you will have read about the "Three Rules for Making a Company Truly Great" article that appeared in the April 2013 Harvard Business Review where 40 years of research into tens of thousands of companies determined that 'Three Rules' set the successful apart: -

1. Better before cheaper - in other words, compete on differentiators other than price.
2. Revenue before cost - that is, prioritise increasing revenue over reducing costs.
3. There are no other rules - so change anything you must to follow Rules 1 and 2.

This has been our focus since day one. This is the stuff that accountants and generalist consultants cannot usefully advise upon.

So if growing revenue and differentiators are the keys to success, I thought it worthwhile to take a fresh look at how to do this in the current context.

Probably the single most important thing that I have learned in 30 years in business is the effect of leverage on the revenue line.

To give you an idea of how this works: - Our Wine On-Premise Australia 2014 research is due for release next week. One of the findings is that the average price of a bottle of Australian wine on an Australian wine list has increased 3% in the last year to $57.31. So if a winemaker were able to take that 3% increase to the bottom line (not an easy thing to do, admittedly, when inflation is running at 3%), what impact would that have on profitability?

Theoretically if:

- the supplier winery was able to keep their distributor to a 30% margin (getting tougher all the time)
- the restaurant marks up 2.5 times on LUC (landed unit cost including taxes but before GST/VAT)
- the producer keeps their COGS (costs of production) to half of Revenue and
- the producer keeps Sales & Marketing investment and Administration costs to within Deloitte benchmark ratios,

then that supplier would have increased their bottom line profitability by 24%. This is where the game is won or lost. If that producer then turns that premium into brand reinvestment then it is easy to see how far ahead that business would be compared to its competitors.

Figure 1 – The Average Return to Producers Using Deloitte Benchmarks and 2.5 Times Mark Up

2014			2013		
Plus GST	$ 57.31		Plus GST	$ 55.64	
Mark Up 250%	$ 52.10		Mark Up 250%	$ 50.58	
LUC	$ 20.84		LUC	$ 20.23	
Wholeslae Margin	$ 16.16	30%	Wholeslae Margin	$ 15.69	30%
Price per Bottle	$ 11.32		Price per Bottle	$ 10.93	
Revenue per Case	$135.84		Revenue per Case	$131.20	
COGS	$ 65.60	50%	COGS	$ 65.60	50%
Admin	$ 26.24	20%	Admin	$ 26.24	20%
Sales & Marketing	$ 19.68	15%	Sales & Marketing	$ 19.68	15%
EBITDA	$ 24.32	18%	EBITDA	$ 19.68	15%

Our Building a Better Wine Business workshops series has been by far the most successful to date. 35 people tried to register for our Stellenbosch program. (We always limit places to a maximum of 24).

We addressed this same issue in relation to Chenin Blanc sales in the UK On-Premise. SA Chenin Blanc achieves an average price on a UK wine list of just £19.81. That is lower than what generic Pinot Grigio from the Veneto sells for and hardly the image you would choose for a wine style capable of greatness.

I posed the question – 'What if we were to sell Chenin Blanc at the average price of white wine sold On-Premise in the UK?" being £28.40 which incidentally is roughly what Marlborough Sauvignon Blanc sells for. (Note-Marlborough is now the number one regional supply source to the UK on-trade as it is in Australia.)

Figure 2 – The Return Selling at the Average Price for SA Chenin vs. White Wine Average Price

Number of cases needed to make R1,000,000		**17,778**	8	**2,122**
EBITDA	15%	R 56.25		R 471.25
Op EX	30%	R 112.50		R 112.50
COGS	55%	R 206.25		R 206.25
Ex cellar price -		R 375.00		R 790.00
Exchange rate	18.18	£20.63	18.18	£43.45
Freight	£1.80	£22.43	£1.80	£45.25
Warehousing	£2.40	£24.83	£2.40	£47.65
Freight out	£3.00	£27.83	£3.00	£50.65
Duty	£24.00	£51.83	£24.00	£74.65
Agent Margin @ 20%	20%	£65.00	20%	£93.00
Wholesaler Margin @ 20%	20%	£80.94	20%	£116.00
Price per bottle		£6.75		£9.67
Restaurant Margin @ 60%		£16.86		£24.17
Value added tax @ 17.5%	0.175	£2.95	0.175	£4.23
List price		**£19.81**		**£28.40**

As you can see, this would cause winery revenue to more than double (R790 per case vs. R375). You might then say that selling the same volume at the higher price may not be achievable. Given that you would only be selling at the average price, this may or may not be true (you might even sell more) but let's just park that idea for now and ask the question – "How many cases would we now have to sell to net R1Million?" given the above ratios and margins.

The answer is that you would only need to sell one eighth the volume. The reason is that this leverage effect is even greater when you have large chunks of cost in the middle of the profit and loss statement that don't change with volume. Freight, warehousing and certain taxes are charged on a per case basis.

Pricing is the most difficult element of the market mix to master. Some people just get it. This is usually because they have clocked up thousands of hours in market. I was lucky enough to have had some of the world's most export driven wine companies sponsor that part of my education. Managing clients through the process of mastering price, if they are new to the discipline, generally takes up a lot of time.

Winemakers typically have to battle with retailers, distributors, their own sales staff and even their own self-belief at times telling them that their wines are worth less than their customers are actually prepared to pay for it. One of the best weapons in this battle is knowing what those prices actually are.

In relation to Direct to Consumer sales, for example, we know from our benchmarking across Australia, New Zealand and South Africa that wineries generally achieve around double the revenue from direct sales as they do from wholesale sales.

That leverage effect we spoke about earlier means that these sales either bring about 8-10 times the profit of wholesale sales or, looking at it another way, you would only have to sell one eighth to one tenth the volume to achieve the same outcome in terms of profit. US research confirms the same result for their wineries- source. ShipComplaint.

When it comes to On-Premise sales, knowing what wine actually sells for can be key. According to our 2014 research, the most common price on an Australian wine list for a bottle of wine was $38. It was also $45. Each had exactly the same number of listings in our survey. As a matter of fact, $48 was almost as common. These Top Seven most popular price points make up over 25% of all listings.

Figure 3 – The Top Seven most listed price points on Australian wine lists 2014

Price	Share
$ 38	4.3%
$ 45	4.3%
$ 42	4.1%
$ 48	3.7%
$ 40	3.6%
$ 55	3.0%
$ 32	2.9%

Let's then just examine what happens if:

Winery A supplies to price at $38, (believing that $38 provides better 'value' being just below the $40 that they suspect the customer thinks they should pay for a 'decent' bottle of wine)

vs.

Winery B that prices at $45 (believing that the $45 actually creates more 'value' as it provides the customer with the assurance that they haven't left anything to chance by not spending enough).

Figure 4 – Profit outcomes from different pricing options

Plus GST	$ 38.00			Plus GST	$ 45.00	
Mark Up 250%	$ 34.55			Mark Up 250%	$ 40.91	
LUC (+29%WET)	$ 13.82			LUC (+29%WET)	$ 16.36	
Wholeslae Margin	$ 10.71	30%		Wholeslae Margin	$ 12.69	30%
Price per Bottle	$ 7.50			Price per Bottle	$ 8.90	
Revenue per Case	$ 90.00			Revenue per Case	$ 106.80	
COGS	$ 45.00	50%		COGS	$ 45.00	42%
Admin	$ 18.00	20%		Admin	$ 18.00	17%
Sales & Marketing	$ 13.50	15%		Sales & Marketing	$ 13.50	13%
EBITDA	$ 13.50	15%		EBITDA	$ 30.30	28%

Winery B would be more than twice as profitable as Winery A if nothing else changed. This different perspective on value is so often where older, more established family companies lose the war.

But it is not only established companies who miss out. It has been interesting traveling around the regions with this year's workshop series listening to the different local lore that has developed around price. I am constantly hearing, for example that the 'right to price' can only be yours after a long period of time in business, that you have to 'earn' it. Try telling that to people in the Barossa.

Likewise, there is a belief that because your region doesn't have a reputation for a varietal then you can't price beyond existing parameters. Do those people ever question whether holding those wines to those price points might be the reason for not having the right image in the first place? Angelo Gaja certainly didn't let that slow him down when he went about singlehandedly redefining what Piemontese wines should be worth.

Our advice to clients is to understand where your wines sit in the global context (because competition is global) and to price accordingly.

Maximising your revenue is as much about managing your pricing mix as it is about pricing up to where your customer expects to pay. Each channel has its own pricing dynamics and it is critical that the person managing the front end of your business understands this. It is equally important, as one of my favourite distributor friends reminded me recently, that sales people who are without a background in finance never be allowed to set price.

Managing your mix is about always working towards selling higher value products in higher value channels in higher value markets to higher value customers

Where that value sits changes with the style and size of your operation. We have many medium to large sized clients who find that dealing with the chains is actually their most profitable channel, despite all of the much talked about risks and drawbacks. The largest companies, however, typically exercise terrible judgment about the On-Premise through not understanding its financial dynamics properly. By contrast, small companies who have not built a really strong brand in the On-Premise very rarely achieve a good outcome from dealing with the chains. This can also change by market. In the US, for example, the largest retailers work to push prices up over time. This is obviously one hell of lot smarter that what UK and Australian supermarkets do, showing no respect for / understanding of winery pricing dynamics.

Just to show you how different markets are within Australia, for example, here is the average listed price per bottle by State and Territory from our 2014 research. (Note that imports increase average prices).You can very easily see that if Tasmanian or South Australian producers set prices based on their local market that it would be disastrous. Fortunately, South Australia is the most active State where exports are concerned and the most successful interstate. Small Tasmanian producers don't always have the same opportunities to take a read of the market first hand. Hopefully our research helps.

Figure 5 – Average price per bottle and per glass – Source, Wine On-Premise Australia 2014

State / Territory	Glass Ave	Bottle Ave
ACT	$ 10.42	$ 66.26
NSW	$ 10.05	$ 69.29
NT	$ 10.05	$ 54.69
QLD	$ 10.30	$ 64.89
SA	$ 9.31	$ 52.90
TAS	$ 9.41	$ 53.58
VIC	$ 9.38	$ 58.38
WA	$ 9.87	$ 59.70
Grand Total	$ 9.83	$ 62.44

Having strong currency is definitely worse than it being weak. That leverage effect mean that it is infinitely better to have stronger top line revenue than blowouts in cost. That doesn't stop our South African customers from complaining and I do sympathise. It's tough when your glass, packaging or any industry is monopolised. Just ask Australians trying to sell to supermarkets. What this revenue leverage effect means, however, is that you now have so much more to spend on upgrading product image. Indeed, price repositioning is rarely possible without working the whole marketing mix.

The standard of wine **packaging,** in Australia particularly, has improved out of sight in the last five years so nothing much is being left to chance there. We've had a lot of fun working with clients on that front. As with all our partnerships, we neither take nor receive commissions from anyone. We simply promote the best and Tardis Design of Wellington consistently deliver.

The **promotion** piece is definitely getting harder as supermarkets suck the life out of what used to be known as the Advertising and Promotion budget. These days the main focus of our workshops and consulting is how to employee / engage the very best people in using new technology to grow your communications capability. This is another very important example of leverage.

As to **product,** that is another big part of the focus of our workshop series. We have talked about the evolution of winning wine styles many times in these Papers. The most successful wine styles are an important element of our 2014 On-Premise research (as of course are the most successful distributors and suppliers).

There has arguably been more innovation in product in the last year than there has been in the last 20 years. Do make sure that you get to Rootstock next year or similar 'Real Wine' festivals in your area. There are people making great wine in new ways and there is much to learn.

The biggest change of all is, I believe upon us. As some of you know, I have been saying for 20 years or more that wine is at risk from a 'better' product that can be served at the dinner table from a 750ml bottle. The flavoured wine revolution has started, as revolutions often do, in France. Time to take control of this important opportunity and do it with class or risk being 'disrupted' Walkman vs iPod style.

Better, I feel, to take a lead from the Champenoise on packaging, the Americans on making wine exciting and our innovative young winemakers on creating an even better version of that which we all love.

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

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.

Wine Business Solutions

Phone +612 9744 8332

info@winebusinesssolutions.com.au

http://winebusinesssolutions.com.au