Wine Business Solutions

The Wine Paper 39

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Making it to the Top

Success is a highly personal thing. The question – what does success look like? – however, has to be answered if it is to be attained. Much as it would be nice to carry on doing what we like on our own terms, if a competitor has a better, more profitable business model, then they will use that extra cash to take away our business from us. We must, therefore, either fight or differentiate what we do until competition becomes an irrelevance.

You may perhaps recall that a Harvard Business Review study of 25,000 plus companies over more than 40 years confirmed that the only common factors, where the successful companies were concerned, were that they focused on growing <u>revenue</u> rather than on costs and that they were led by innovation / <u>differentiation</u>.

In the course of putting together our Wine On-Premise Australia 2016 research this year, something stood out to me. There are brands that year after year get stronger. Equally there are brands, regions and whole countries that, after a long period of sustained success, are rapidly losing relevance and market share.

So what sorts the winners from the losers? How are <u>they</u> differentiated? We start every workshop we run with the question – who is your customer? We won't stop asking that question until we see evidence that everyone gets it. Every day we see and hear people in positions of great power and influence talking about wine as if it were one thing and speaking of opportunities for a very small number of businesses as if they are opportunities for all.

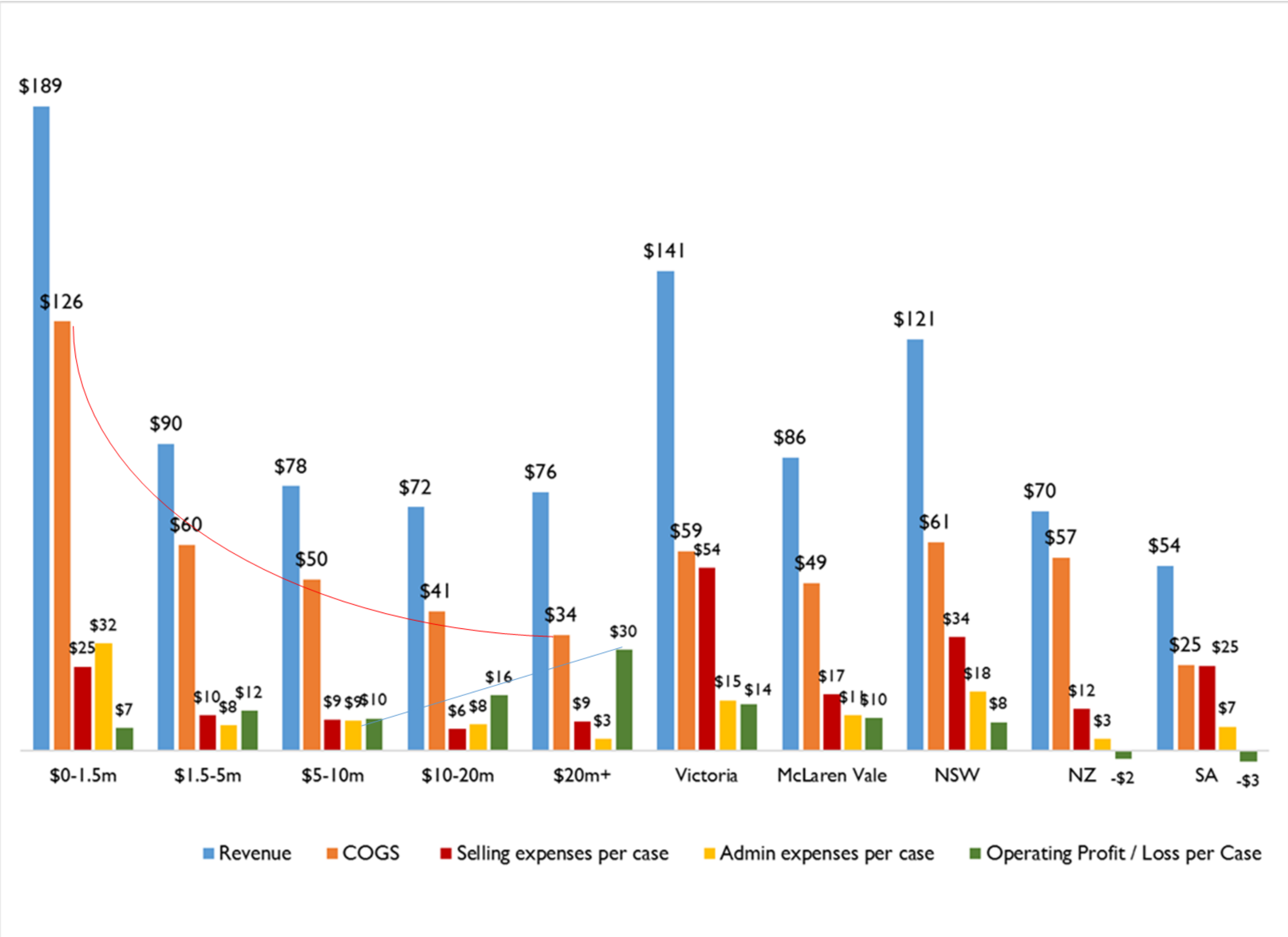
For example, I recently attended the Australian Wine Marketing Conference organised by Uni. SA. It was a huge success and will doubtlessly be a bigger event next time. Wolf Blass gave a keynote speech. It was one of the best that I've ever heard. He summarised neatly all of the woes and great strengths of the Australian wine industry in a way that was both rousing and inarguable. He then closed by imploring every Australian winemaker to get on a plane and fly to Ontario. No, Wolf. We love you but No! Only around six or so Australian companies should be making long term plans to participate in an unregulated supermarket environment in Canada. (Conference attendees note that the LCBO is not selling those 250 stores Wolf was referring to. They now say they were simply seeking real estate management partners).

Tesco (UK), I discovered through making an analysis for a client recently, deals with no more than about 50 companies, where its main instore and online offer is concerned, all of them being the world's largest. Unless you are producing more than a million cases, in other words, there is simply no way that you would want to do business with a customer like that. Unless key players understand all of the key moving parts of the international wine business, major strategic mistakes will continue to be made.

The 'Cost vs Differentiation' question made famous by Michael Porter, has as much relevance for the wine industry as any other. Our recently completed financial benchmarking exercise shone the light on this. From the 2015 Deloitte NZ report we used the benchmarks for $0-1.5 Million, $1.5-5 Million, $5-10 Million, $10-20 Million and $20Million plus wine companies. We had a good number of McLaren Vale wineries participate, ranging in turnover from $2.5 to $15Million. All are competing using roughly the same business model, one that is very different to Marlborough's and everyone's else's.

We also had a number of smaller Victorian wineries running a similar business model that is very different to both the New Zealand wineries' and McLaren Vale's. We had a medium sized NSW wine business, a very small New Zealand business and a 'normal' sized South African business participate. Regrettably, all we can say from a scientific standpoint is that these wineries are 'indicative', not 'representative' of what's going on. If we were ever to run this financial benchmarking exercise again, we'd need a lot more broad-based support. We were, however, still able to draw some very useful insights in relation to this question.

Figure One – Cost Structure – 2014/5 WBS Survey Participant Data and Deloitte 2015 Data



Note – All Figures Converted to Australian Dollars

You can see that NZ (read Marlborough) wine businesses operate a classic manufacturing model where the 'cost curve' works perfectly. The small wineries have simply copied the large companies with the effect that their operating margins are about 2/3 what they should be. Under this scenario, the larger the production, the better the profitability. Tie that to a very strong brand like Oyster Bay and you can see how profoundly advantaged they are. It's exactly the same model that LVMH (Cloudy Bay, Moet etc.) use. By using scale and profitability together they become a formidable competitor. By then combining that "great swinging bag of money" advantage with uniqueness (it's almost impossible to copy either Champagne or Marlborough Sauvignon Blanc) they use cost and differentiation together to become unbeatable.

Or do they? New Zealand has lost more than 30% of their On-Premise listings in the last 2 years according to our Wine On-Premise Australia research. Moet Hennessy did the same just in the last 12 months. Why? They stopped innovating. They are still talking to an Aspirational customer when the market has moved on.

The Australian market and most mature wine markets around the world have undergone a significant gear change whereby the 'Wine Appreciator' is no longer a fringe dweller but the most important part of the market both numerically and commercially. According to the Wine Market Council (US), those high frequency consumers who regularly spend more than $US20 per bottle are now the largest segment (36%).

Restaurants and their customers no longer seek the safety of the big Champagne brands. They are more than happy to try a 'grower champagne' or lesser known brand based upon the wait staff's quality impression. They are also keen to avoid brands with high price visibility in retail but that is a side issue. Similarly, where New Zealand is concerned, that singularity of flavour profile, that ease of understanding, that simplicity is now the country's worst enemy. Restaurants want to challenge their customers and they are up for it. France, Italy and Spain are benefiting enormously. East Coast restaurants in Australia now have more than 40% imported wine listed. France and Italy now have more listings than wines from NZ.

We've come a long way to draw a simple conclusion, but it is the same as the Harvard Business Review's. Growing revenue is all about understanding where the 'centre of gravity' in any given market is, where it's heading and how fast. Australia failed in the US market in the early 2000s and are still paying for that now, chiefly because some thought the market was dumber and slower, by a long way, than it actually was.

Treasury, is trying to jump over all and make Penfolds a 'luxury' brand. This is the right strategy in a developing market like China. It's a pretty good strategy in retail too, being the end of the lifecycle. Treasury have 20% of all listings over $30 dollars in Dan Murphys, according to our research. It's not the right longer term game at all for the UK, the US, Australia or any other mature market. If you don't make 'wine for people who like wine' (those most influential consumers and trade), sustainability is highly questionable.

Winners start by understanding who they are. Our research shows that for the first time in a long time, exports are now more profitable than domestic sales for Australian producers. Further, medium sized participants in our survey (those in the 25-150,000 case range) have had their profits halved in the last 12 months, on average, as a result of the what the local supermarket duopoly is doing to them. They, unlike some of the largest family run businesses who may not see out the next few years, can respond and recover.

Another interesting insight from our financial benchmarking is that direct sales, although highly profitable, are expensive to attain for most businesses. In the US the Top 20% of operators account for 89% of DtC sales so, as with all areas of wine business, unless you are in the top group, direct sales may not necessarily mean that you are better off. It is interesting to note that in the US, for example, wineries operate on higher margins than their Australian counterparts and yet yield about the same level of profit.

Figure Two – Profitability. Sources – 2014/5 Survey Participant Data, Deloitte 2015 Data, Silicon Valley Bank

	$0-1.5m	$1.5-5m	$5-10m	$10-20m	$20m+	$0.7M	$0.2-2.5M	$3.5M	$2.5-15M	$10M	ALL
	New Zealand Wine Businesses Ex Deloitte					NZ	Victoria	SA	McLaren Vale	NSW	US
Net case sales revenue	**84.5%**	**77.5%**	**80.4%**	**68.8%**	**85.3%**	**86.7%**	**80.0%**	**65.7%**	**89.2%**	**91.0%**	
Bulk Wine	0.6%	10.8%	6.8%	8.2%	9.8%	0.0%	0.0%	0.9%	1.4%	0.9%	
Grape sales	9.0%	5.0%	1.2%	0.2%	0.9%	0.0%	0.2%	0.0%	1.3%	0.0%	
WET Rebate	3.2%	2.3%	0.9%	2.1%	0.4%	13.3%	19.0%	0.0%	5.4%	5.1%	
Other revenue	2.6%	4.4%	10.7%	20.7%	3.6%	0.0%	0.8%	33.3%	2.7%	3.0%	
Total revenue	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**
Cost of goods sold	66.60%	67%	65%	57%	45%	81%	42%	47%	57%	51%	43.9%
Gross margin	**33.4%**	**33.1%**	**35.4%**	**42.9%**	**55.3%**	**19.2%**	**58.4%**	**53.5%**	**42.9%**	**49.3%**	**56.1%**
Selling Expeneses						9.1%	31.4%	16.4%	15.3%		
Marketing Investment						8.6%	6.7%	29.9%	4.1%		
Selling and Marketing Total Expense	**13.1%**	**11.6%**	**11.8%**	**9.0%**	**11.5%**	**17.7%**	**38.1%**	**46.2%**	**19.4%**	**27.8%**	
Admin	16.7%	8.5%	11.3%	10.9%	4.6%	5.0%	10.6%	13.2%	12.3%	14.5%	
EBITDA	**3.6%**	**13.0%**	**12.3%**	**23.0%**	**39.2%**	**-3.4%**	**9.7%**	**-6.0%**	**11.1%**	**7.0%**	
Less: Interest expense	3.5%	2.6%	3.0%	4.9%	5.0%	4.6%	3.8%	0	1.8%	-0.6%	
Pre Tax Profit before D & A and Extraordinary Items	**0.1%**	**10.4%**	**9.3%**	**18.1%**	**34.2%**	**-8.0%**	**5.9%**	**-6.0%**	**9.3%**	**7.6%**	**7.8%**
Less WET Rebate	**-3.2%**	**8.1%**	**8.4%**	**16.0%**	**33.8%**	**-21.3%**	**-13.1%**		**3.9%**	**2.5%**	

With the removal of the WET (Wine Equalisation Tax) rebate on the table, the $A being at the 'right' level and the local market getting ever more challenging, medium sized Australian companies now simply have to start thinking more about exports.

Unsurprisingly, we're seeing a big upsurge in clients looking to open more export markets. That has to start with a very clear understanding of who you are, why you matter and why the world's best distributors would want to add you to their portfolio. That begins with getting your story straight. Vasse Felix is, in our estimation, the best positioned Australian brand, on and-off premise currently. They have put a huge amount of work into their story. The essence is that they are the oldest wine business in Margaret River. They have even had road signs around them changed to better reflect their heritage. They spend most of their A & P budget on getting key people to their place to tell this story.

Usually, whatever part of a wine company's business is dominant drives their offer. Businesses with significant direct sales will typically have a bigger offer than any distributor will want to look at. Companies that are successful in their domestic marketing often have an offer that has grown organically that is a very poor fit with the opportunity in any other market. Think of Montana having at least 5 launches into the Australian market before discovering, almost by accident, that Sauvignon Blanc seemed to be popular.

People who have their own sales force will often develop second brands and different product SKUs that are more a response to their salesforce's need to cover a base than either what that business and others in that region should be doing or what fits best into global distribution.

In this way, European appellation controlled wine regions are significantly advantaged as you know exactly what you are getting, style wise, and the number of styles any region can produce is limited. They then need to innovate more than anybody and this can be very difficult for them but they do start in front.

Vasse Felix made a tough but very smart decision, in my view, to make the two pillars of their offer, Cabernet and Chardonnay. From the numbers below you can see two things. Firstly, clear evidence of that gear change we talked about. For years, WA has used SSB and Cab Merlot as their 'Aspirational play'. There are also fantastic wines made in these styles but in the general case, Australia has found many more interesting things to drink. Secondly, knowing who you are, focusing on what you do best and backing yourself, pays. Vasse Felix are winning, for now, because they are playing to where the market is going, not where it's been. As virtually the only brand to be flying on and off-premise, they now walk a tightrope.

Figure Three – Total Margaret River Wine Listings – Source, Wine On-Premise Australia 2016

Style	2016	2015	CHG
SSB/SBS	16%	25%	-33%
Cab Merlot	10%	13%	-20%
Chardonnay	18%	12%	47%
Cab Sauv	13%	10%	32%
Shiraz	4%	7%	-46%
Sauv Blanc	4%	4%	-6%
Cab Blend	4%	3%	33%
Chenin Blanc	2%	3%	-18%
Merlot & Blends	3%	2%	53%
Riesling	3%	2%	86%
Verdelho	1%	2%	-32%
Semillon	2%	1%	81%

Export is one of those things that you need to do properly or not at all. Otherwise you will most likely not make money out of the exercise. We are so often amazed when we see the books and sales summaries of companies who say they 'do export', where the total volume is considerable but where, when you look through the individual relationships, there is nothing more than a series of trading opportunities taken.

To be successful with export requires a rock solid strategy based upon that one thing that you can do, that one question that you answer, that no one else can.

You've then got to work out, based on the size of your business and the nature of your brand, what channels you can fit into and can win in. Most underestimate the point at which scale stops being the major source of competitive advantage. We've seen a number of Australian companies enter what Americans call the 'hell zone' of between 200-600,000 cases production chasing growth at the $12-18 level. Most haven't survived. Oyster Bay, for example, is now a 2 Million case wine brand. With that scale, it all works.

It's not until you move into $20+ per bottle territory that differentiation trumps scale. It's there that all SME businesses need to be aiming. And it's clear what the best channel choices are. On-Premise, Independent Retail and Direct. Medium sized companies will need to have a globally competitive strategy for each of these channels going forward. Otherwise, it's very clear that the world will come after you.

WHAT SORT OF SCALE?

Beverage Wine Consumer	Branded Wine Consumer	Aspirational Consumer	Adventurous Appreciator	Collector
	12 Million Cases	2 Million Cases	400,000 cases	20,000 cases

It then becomes a question of which partners? What our research shows time and again is that even though it may be frustrating dealing with larger distributors, they invariably achieve the best results.

We note with some amusement, for example that although a very high profile Victorian producer has set a bunch of their consulting clients up with 'Hip' new age distributors of which there have been many emerge in the last two years, that he himself has his distribution done by the strongest distributor in the land. Now I am not implying that anything wrong has been done here. They may have had no other choice. You can, however, see the potential conflict.

When we look at the UK through the lens of our Wine On-Premise UK research, it's plain to see that, like most markets, there are only a handful of distributors that are selling most of the wine.

An evolving market will, however, put some distributors in a better position than others. Those that have a great, contemporary, international portfolio and those that specialise in sustainable and innovative wine producers are naturally finding it easier going at the moment than those that have been slow to adapt.

In choosing one of these styles of distributor over one of the more classic ones, the rules of gravity still apply. The biggest ones in their respective spaces find it easier to grow their business than the more niche. Likewise, no matter what upstart new distributors tell you about how fast they are growing their business, if they don't have quality brands, they won't be able to sustain that momentum, if indeed they ever had it.

That is why we put so much effort into understanding what the best brands in the world are and why. By standing shoulder to shoulder with them, you've got so much the better chance. By working with distributors who have portfolio construction as their core skill, you'll do better still.

If thinking about ditching your distributor, think twice. We see people firing distributors all the time. Nine times out of ten, it is not the distributor that is the problem. Usually it's that the market has turned against their brand – because grapes have been grown in the wrong places, because it's about the wrong wine styles, because their winemaker is not progressive enough, because the packaging hasn't been constantly upgraded, because pricing hasn't been managed properly and nor have relationships. Because everyone has gotten tired and, as a result, the brand simply has no equity left. At the end of the day, the distributor is just the guy in the middle exchanging boxes of wine for cash. Yes, some have taken a hit recently through being too slow to react to changes in the market. This never usually lasts long. They're in the best place to see change. They work on low margins and can go broke very quickly. They all must sell to survive.

What is it that really sets the most successful brands apart? What is the X factor? What do they have in common beyond those two fundamentals mentioned in the opening? What stands out to me when I see great brands winning? Confidence.

Confidence that you've made the best wine possible in your respective space. Confidence that your offer is right for the market going forward. Confidence that you can own a unique idea. Confidence that there is real consumer driven excitement about your wine. Confidence that you will make money for your partners. Confidence to walk into that prospective quality distributor and make them feel that you are a must have.

Put that in a presentation and you've half a chance. We're doing a lot of that sort of work right now. That, however, is only the beginning.

One of our clients has a unique brand targeting golf clubs – The 19th. Before talking to a distributor, the Principal phoned over 100 golf clubs, asked them about their most popular wines, asked them about pricing, asked them about representative service, asked them about margins, asked them what else they needed.

He then presented to three of the best on-trade distributors in the UK and had interest from all of them. One of them commented that it was the first time they had seen anyone taking the time to properly understand the front end of their market in this way.

Many distributors say to me that the majority of Principals simply complain to them about not selling more wine without the first clue about the environment they're selling into. Whilst this can be difficult to do long distance, it worth investing in to understand. We help a lot of clients with this.

Lastly, once you've clinched that deal, hopefully with an all-encompassing contract which we can also advise on, it's about support. If you can't provide the appropriate level of support to a market, it's better not to do it at all. That's why for some businesses, it may be better to work with a handful of less expectant smaller markets than a big one that you simply can't spend enough time in.

Can you really have it all? Can you make great wine at scale, sell it at good prices all over the world and be admired by everyone? Well yes, I think you can. Look at Henri Bourgeios out of Sancerre, St Clair out of Marlborough, Domain Wachau out of Austria or Antinori out of Tuscany. They've focused on growing revenue, they've worked hard on differentiation, they've built global on-premise distribution, they sell hundreds of thousands of cases each and they might just be sustainable. Antinori (est. 1385) clearly is.

Our 'Becoming more Profitable' workshop has completely sold out in Stellenbosch. We still have places in our WA workshop. Just follow the link to register or you can download the brochure here. We have yet to set dates and determine content for the rest of our Australian and New Zealand workshop series this year. If there is a theme that you would like to see as part of the program, please do get in touch.

We now have mystery shopper, cellar door audit and sales training as part of our offer. This has been immensely popular and successful for clients to date. If you would like to know more, please contact me.

Both our Wine On-Premise Australia and Wine On-Premise UK reports are out now. Just follow the links if you missed those.

We've completed our financial benchmarking exercise covering Australia, New Zealand and South Africa. If you would like a copy of the report at no charge, please just email me. We will not be posting this on our site.

We're currently looking for a Brand Ambassador for a client who is a Leading Champagne House. We have had a huge response as you would expect but if there is someone in your wider network that you think would be perfect for the role, please encourage them to apply.

As always, if there is anything else we can assist you with, we'd love to help.

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.

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