Wine Business Solutions

The Wine Paper 50

July 2018

The Meaning of Life?

50 Papers. 15 years in business. Time for a 'stock take'. Whether it is Pablo Picasso or William Shakespeare who owns the phrase "The meaning of life is to find your gift. The purpose of life is to give it away" who can say but give it away we certainly have. ('Gifted', I very much doubt in my case. Focused, absolutely.)

Thankfully, our workshops have never been fuller, and the phone keeps ringing with wine businesses, regional bodies and even wine producing countries looking for strategic advice. So, I guess you can only conclude that the risk taken in putting it all out there via these newsletters and our blog etc. has paid off.

Where did all this start? It was in a coffee break during a program on Strategic Management that I was attending at Columbia University, New York, when my great friend, mentor and boss for nearly a decade, Bernd Halbach said to me; "Peter – we need to know where all the wine in world comes from and where it goes to." Even at that time, Freixenet sold wine in over 100 countries. Still today, it is one of just a handful of truly global wine brands. So, it was <u>the</u> question to be asking.

I couldn't have been more excited. It was like asking an astronomy graduate to find the meaning of life and the universe. Never mind that that question is about as easy to answer as the one put to me. We didn't even have a business intelligence function. I had to pretty much make it all up. Luckily, Freixenet had an open cheque book and most of what was known at that time could be purchased for a reasonable price.

At first, I didn't really understand what the purpose of 'business intelligence' was. As I worked with the global management team, produced insights for them and got their feedback, it became clear. My job was to act as a kind of cheerleader. We first managed to establish that Freixenet was the biggest selling méthode champenoise wine in the world. That was motivating. We then confirmed that Freixenet was the biggest selling sparkling wine in the world. That really got everyone fired up.

Freixenet's exports went from 3 Million cases to 9 Million in just 5 years. The business grew even faster than the New World wine sector did in the 90s. Entertaining our top 500 hundred customers at the Barcelona Olympics set the stage. Getting the brand's global brand positioning right was a major factor and a lot of fun. Getting it all right in the German market was huge and is where most of the credit must fall. I am certain, however, that the continuous positive reinforcement provided by these insights was critical.

All I was doing was borrowing from Wine Australia's strategy of the time. When Wine Australia fell silent in the early 2000s, Australian wine fell off a cliff. I've had this conversation with current CEO Andreas Clark. Andreas would have formed his own conclusion, but you've seen the change both in message and in sales.

The basis of all of our consulting advice from day one has been that there is a minimum of five different wine businesses that have nothing to do with one another in terms of how they must produce their wine, what kind of scale those businesses need in order to be competitive, how they must seek to go to market, the commercial context within which they operate, their natural end customer and how that customer wants to be communicated with. These are not consumer segments as such but business operating models.

Almost all of our consulting assignments are the result of a wine business or region getting some part or all of this wrong. If you can fully understand each one of these business types individually and the way in which they each contribute to / detract from your regions' and country's brand image, only then can you contemplate a successful collaborative / competitive strategy, the likes of which led to so much success for Australia in the 90s and, it has to be said, the abandonment of which led to failure in the 00s.

Only a very small group of brands like [yellow tail], Freixenet and Penfolds are big enough and strong enough to swim on their own, although they can fail just as easily. All others rely upon the actions of other producers and the quality of thinking amongst their regional and national peak bodies for their survival.

One of the biggest impediments to gaining this understanding is the major research companies. Whilst the best of them provide invaluable insights, most seem to want to represent the part of the 'Milky Way' that they can measure as 'The Universe'. This is both incredibly dangerous and, I think, morally reprehensible.

For example, South Africa and Australia, in particular, were completely thrown off course in the UK by one particular research company representing the grocery sector as 'the market'. The result is that today, Australia is the market leader in a channel that is almost impossible to make money out of unless you are the lowest cost provider. Meanwhile France's exports to the UK are worth 4 times what Australia's are. The French weren't silly enough to fall for that one. They know where the money is, and they play there.

It happened in the US as well, when Constellation launched their 'Project Gnome' barely a decade ago claiming that the most engaged wine drinker was a woman who hadn't spent more than $15 on a bottle of wine in the last six months. Because that was who answered when the non-industry research firm phoned?

And it goes on today, like when a certain company's 'Adventurous Connoisseurs' are supposed to buy brands like Oyster Bay and Devils Corner. Perfect accompaniments for these wine aficionados' Petrus collection, no doubt. Again, this is the result of ramming all wine consumers into a supermarket setting. As Stuart Barclay, Head of Marketing for Wine Australia said to me, you need to see all the research.

We also produce original insights, so we need to be very careful. We do the only [research into what is on wine lists](#) in all States of Australia, in the UK and in the US independent On-Premise sector. (Restaurant chains are well covered by another business in the US). Most of you would know that we also do benchmarking of Direct to Consumer across Australia, New Zealand and South Africa comparing directly with US data. We'll be starting that again soon so please do keep an eye out for that email

That puts us at risk of letting SME companies' view of the world, which is dominated by these two channels, taint our assessment. We can't do that. We have to adopt the position of Stuart and his equivalents in other countries and continuously ask that same question that Bernd asked me all those years ago.

To do that, you've got to understand the key moving parts and how they are evolving. Whether we like it or not, all our fortunes are tied to global supply and demand. As you would know, this part of it is looking about as rosy for Australasian producers as it has for the last 40 years. A series of climate related disasters dramatically reduced the 2017 crop in most other producer countries. This will help but remember that the best businesses flourish in the worst of times and improved market conditions won't fix bad strategy. This is particularly true for smaller businesses. What it does do, and this is especially important for South Africa now, is give you cash / breathing space that can be used for appropriate business reconfiguration.

The grocery space has never been harder but Citigroup's monitoring of Australian supermarkets (one of the tougher environments on earth where price is concerned) shows that the majors are pulling back on the number and depth of promotions they are running. Again, this all helps. At the same time, the proportion of wine sold at more than $16 a bottle has increased from 15% to 33%. This, however, has only brought increased competition from big companies into a space that used to be the sole domain of small producers.

The same thing is happening in the US. For example, Silicon Valley Bank's customers report markedly decreased sales in the On-Premise. I don't dispute that there is more in-home consumption of wine taking place as a result of delivery apps, income pressure felt by parts of the population and changed lifestyles. But why would expenditure on eating out decline significantly in an economy that is otherwise booming? Other sources show sales dollars steadily rising in the On-Premise.

You see, the US market both On and Off-Premise is the perfect place for major brands. Our research strongly supports that. They are winning, will only get stronger and may not bank with Silicon Valley Bank.

Rob McMillan is the best in the business but as Rob says, all numbers are somehow or other wrong. And I'm motivated to defend our research. So maybe the truth lies is in the middle somewhere…

The largest businesses in turn will let their view of the world cloud their judgement and even attempt to distort others' in order to sell their strategy to analysts. TWE, for example, would rather pretend that the Wine Appreciator sector didn't exist than admit that they aren't any good at servicing that market any more.

TWE have been very sly, however, in that, rather than let the fact that they no longer have the manufacturing pipeline in place to produce the highly site-specific wines that that customer is looking for and getting stuck at the bottom of the market, they have found a new Aspirational customer in China with money who cares little for provenance and buys on brand. Likewise, with 19 Crimes. They have successfully targeted an 'Aspirational' male customer who is more interested in the brand story than the wine's.

The trouble then starts when these large companies look to drive country strategy. They are in the box seat to do it. They make up the majority of exports. They therefore contribute the majority of funding. They are the only ones who can afford to buy certain types of research (note, we price ours to be distributed as widely as possible and SVB do better still in providing theirs for free) and those major research houses act sycophantically in supporting those large companies' world view.

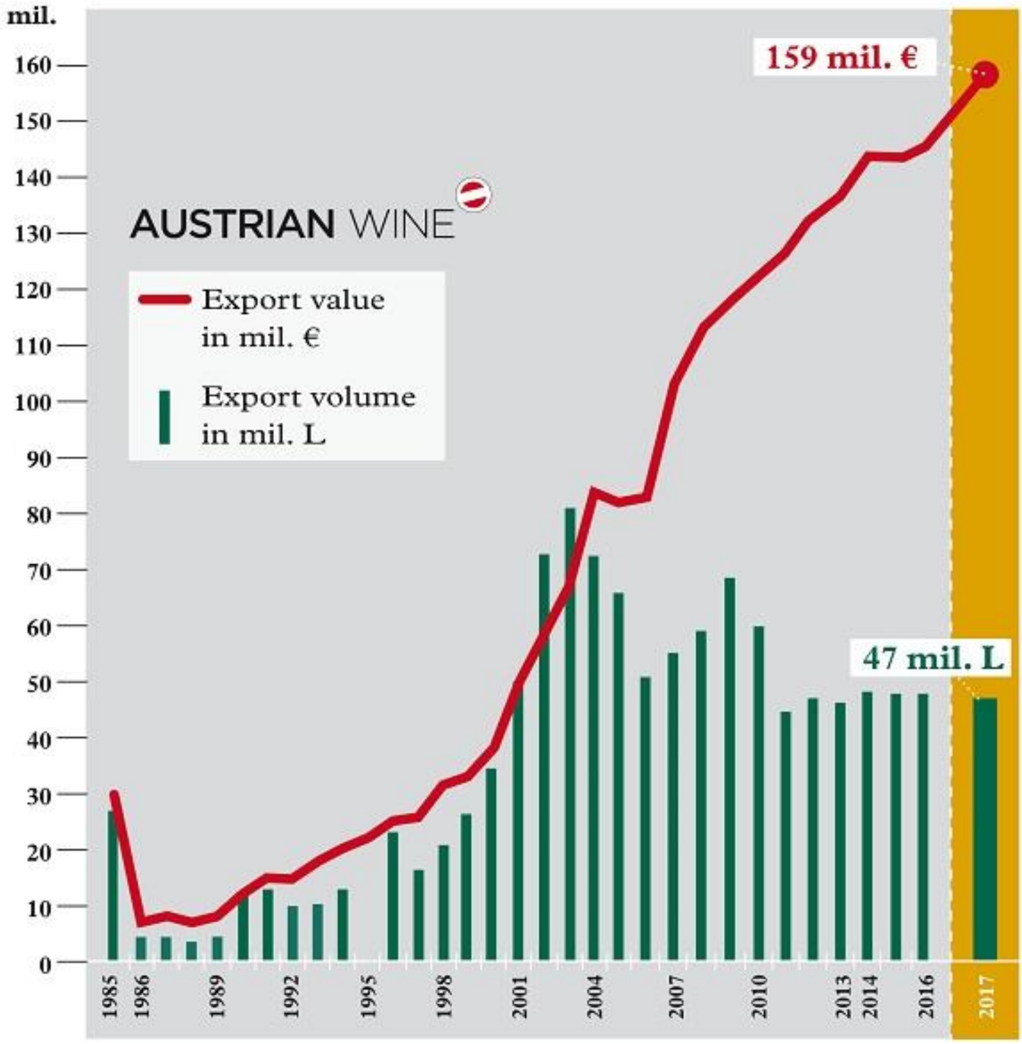
So, Stuart and his like have a lot of work to do to get to the truth and understand just how critically important the Wine Appreciator and Collector business segments are to profitability and brand image. Australia has suffered bitter failure in the US and UK as a result of not making highest quality site specific wines the promotional focus. New Zealand will head over the same cliff if it continues to let their Aspirational customer drive strategy. In the end, great wine is just one thing. People, place, provenance, proprietorship of the earth and quest for perfection. The rest of the market exists but it's not compulsory to address it and if you are going to build a credible brand that is sustainable, selling quality always wins out.

Ferrari don't make hatchbacks. All parts of the puzzle continue to evolve but, in the general case, it's the leading edge that is where the money and the margins are. That is why we devote a disproportionate amount of energy into tracking were the 'centre of gravity' is for each market and each channel within it.

TWE have nailed an opportunity in China by 'fast following' France and using a single brand - Penfolds. But how sustainable is that particularly as Chinese consumption decreases in the face of sky rocketing imports?

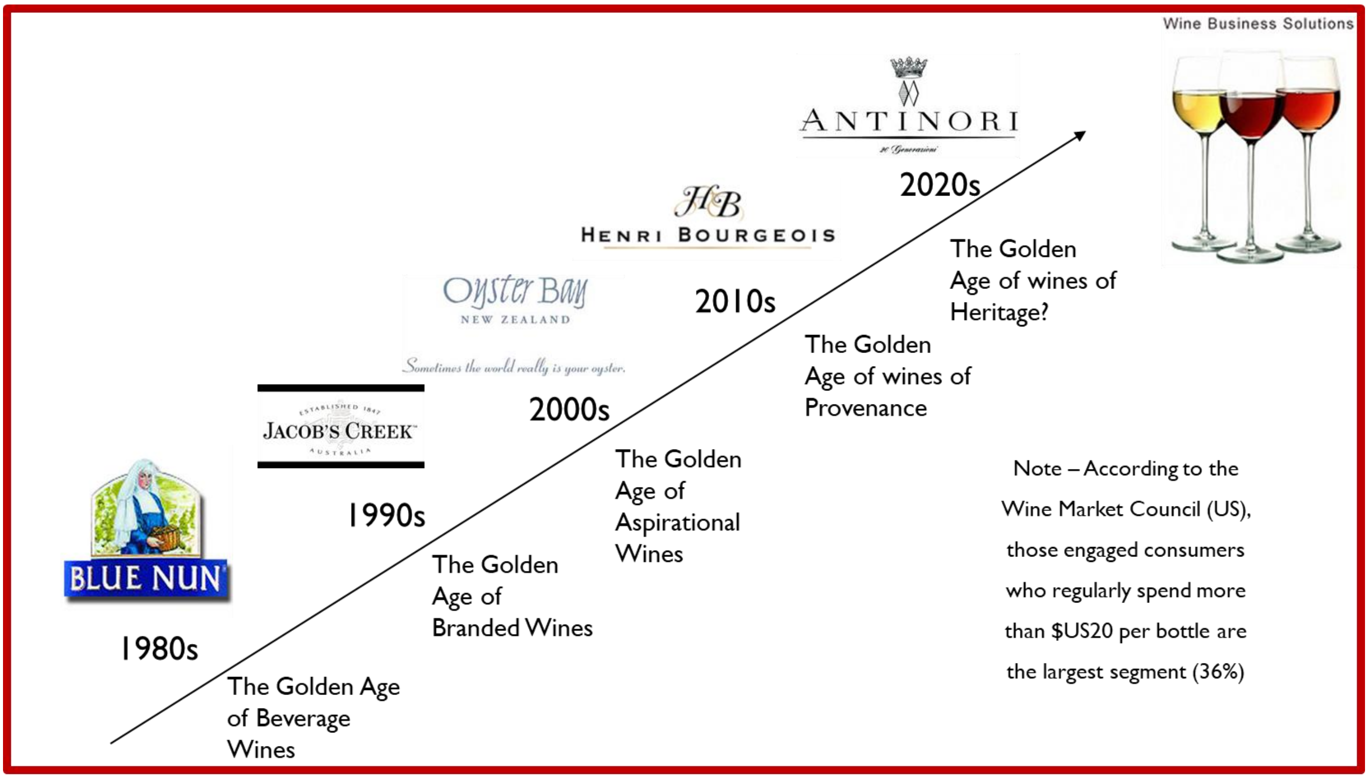
By stark contrast, the decision of the Austrian Wine Marketing Board to only launch into new countries targeting the Wine Appreciator and up is typical Willi Klinger genius. Many critics still don't get it suggesting that they should be trying to grow volume. But if you want to see cash start pouring into your wine business, try holding production and keep raising prices. So long as you reinvest in quality, this is a killer strategy.

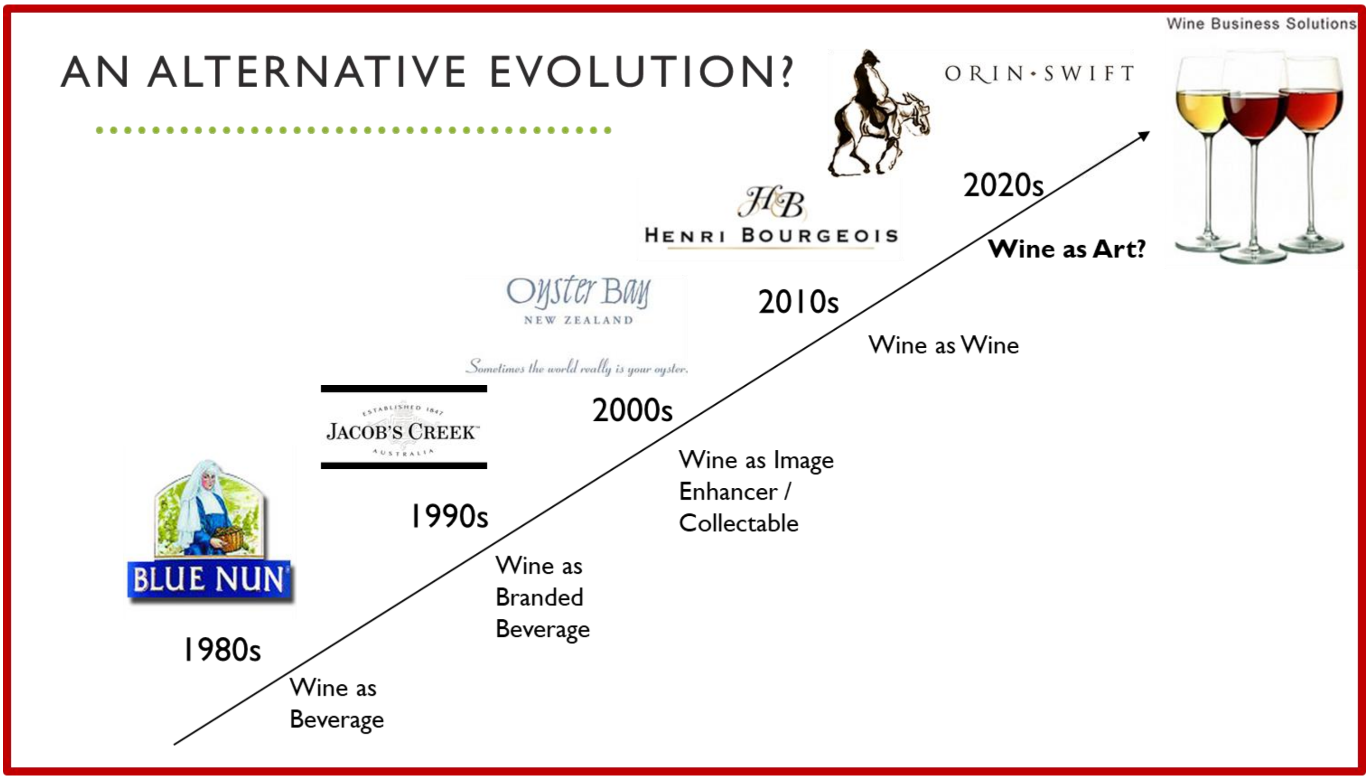
TWE may appear to have done the same thing in jacking up the prices of Penfolds wines. But what happens when their consumer grows up and starts questioning the authenticity of what they are drinking? Australia's experience in the US should have told them – "Nothing good…"



Source: Statistics Austria, preliminary export figures I-XII 2017 (as at March 2018).
The data capture method used by Statistics Austria also includes re-exports of non-Austrian wine. 1995 no data available.

So how and where must the majority of producers compete, those of you who produce less than 50,000 cases per year? With 30 years plus perspective, it's not hard to plot where wine is going using where it's been. Unlike the 'Stairway to Heaven', however, there are more than two paths you can go by. The most probable, based on all that we know, are as below.





There is a theory in relation to war that says that in order to progress, you need creative destruction. This has certainly happened in South Australia and will one day, I am certain, provide a great case study in wine business turnaround if the big companies don't stuff it up for smaller producers and those of them that should, focus on export. Now that the WET rebate export disincentive is going, hopefully this will happen.

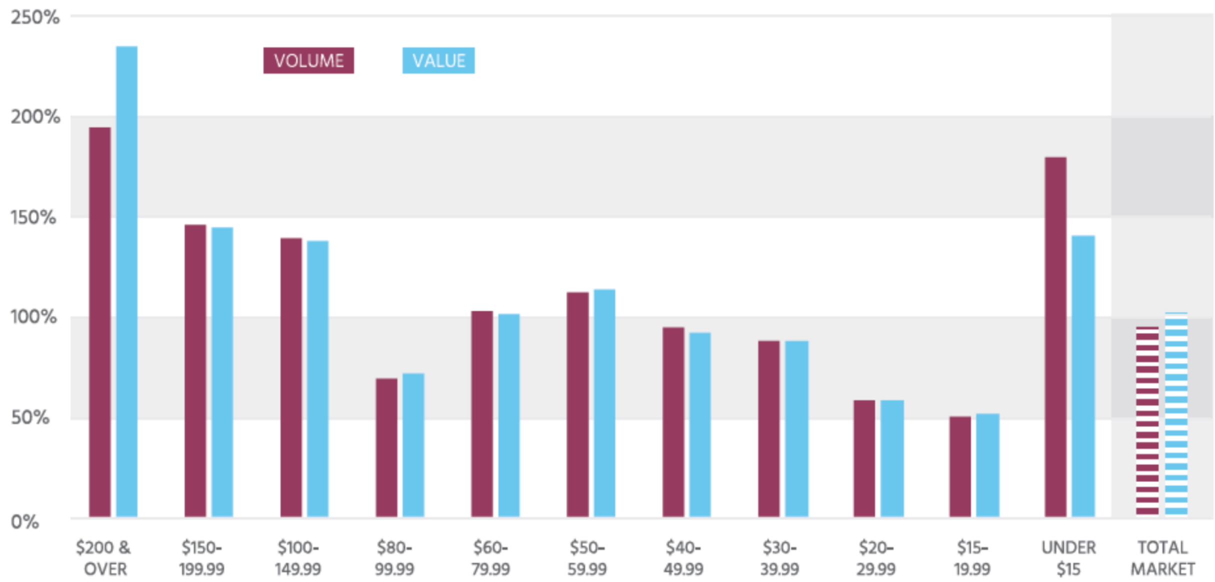
Going back to Austria, they suffered total destruction in the glycerine glycol scandal of the early 80s and had to completely reinvent themselves. They did so by doing the most powerful thing you can do in marketing - linking their quality message to existing perception, in their case to classicism and high culture.

New Zealand had to do the same thing in the 80s dumping Müller-Thurgau and the water hose and starting again from scratch with its wine business. 30 years on, it's to be hoped that New Zealand doesn't have to fall over to know that it's time again for reinvention.

Australia hit rock bottom 15 years ago and that has brought about a new generation of winemakers who are doing some of the most exciting things with wine on the planet as are young South African winemakers.

In the US, Napa, has perhaps the biggest risk. I had believed that it was Americans who best commercialised ideas like 'Natural Wine' even though it is European philosophy. Talking to many wine business long timers, however, most are barely aware of it as a concept and the threat it poses. Meanwhile Napa continues to sell wines at prices and charge tasting fees that the emergent generation are going to seriously question.

Change in the Volume and Value of DtC Shipments – 2011 vs 2017 – Source, Silicon Valley Bank



One thing that we all have to thank US producers for is the discovery that there is a market way beyond most of our expectations in terms of what people will pay when sold to personally. This has certainly helped the viability of a lot of our Australian and South African clients.

Despite, as I said earlier, the apparent lack of awareness of the way in which the world is changing by certain sectors in the US, no one has capitalised on generational change and disruptions better than Dave Phinney.

Horrific war references are not, I believe, coincidental. Having sold The Prisoner Wine Company which was later resold to Constellation for $US285Million and then having sold the balance of Orin Swift to Gallo for what is rumoured to be similar money, that is some sort of capitalisation upon one man's intellect.

So, what is going on there? Essentially, cooks talk about ingredients being king, whilst three-star Michelin chefs talk about capturing an emotion and putting it on a plate.

The philosophical debate over who is right or wrong may rage but at the end of the day, these are the questions that all wine businesses must ask themselves. Do you want to be a cook or a chef?

Do you want to be part of the 2/3s plus of the wine market that is a commodity, takes price, wrestles with costs and be just another player in global agribusiness – business that has an average net return of 3-4%? (Well, of course, that is a bit like asking in relation to nuclear weapons, do you want your face to fall off…)

Going up a level – should you do business with major retailers? Some markets are more benign than others but don't be misled. Internationally, big resellers need big suppliers. Your brand may still work well selling off the shelf in South Africa but that is only going to get tougher. The opportunity has already past in many export markets. The consolidation of the 3 tier system in the US has already shut most small suppliers out.

Must we have a 2nd brand or tier to target that Aspirational customer? Should we sell a cheaper version of our best self? Austria says "no". Here, you have to be really careful. Regrettably, most of our assignments over the last 15 years have involved fixing businesses who have somehow or other gotten this wrong.

The key is working out exactly where you need to make the entry point for your brand and how that is changing in terms of price point, competition, channels and markets. There is a huge thought process that needs to be undertaken constantly to stay on top in this space. Did Mercedes need to make hatchbacks? What will be the medium-term brand impact of that decision? We'll soon see.

Is there over-reliance on the wine engaged consumer now? Where is the market now compared to the conversation suppliers are having with it? We have seen with products like Grower Champagne in Australia, the trade getting ahead of the market. Conversely, I see massive opportunities the other way, particularly for European producers. The market has become more sophisticated. Producers and suppliers more so, have in some instances failed to keep up.

There is an over reliance on brands in the Spanish market, for example, when their international clientele particularly, are open to much more adventure than all but the very top restaurants are offering. Good stemware and good wine selections by the glass are rare in all but the very best French restaurants. Even some of those don't meet international standard. People blame generational change for the loss of interest in wine in France. The product has never been better but the selling of it, particularly in the On-Premise, leaves a lot to be desired.

So often I get asked about what the hot new wine styles are or reminded about wine styles such as Viognier and Petit Verdot that were thought to be the next big thing but didn't quite make it. To me this is asking the wrong question completely. Unless you are a huge business that can scale up and scale down quickly. It is the fact the large companies will flood the market in response to these fads often cutting prices quickly that in part makes this the wrong question. Reference Moscato in the US and Australia.

The right question is - where is my customer's palate / level of wine sophistication and how must I respond? Our research shows, for example, that Italian wines in the Australian On-Premise increased share of listings by over 30% last year off a large base. This signals a fundamental and irreversible shift in the Australian palate away from notionally 'sweet' flavour profiles like Marlborough Sauvignon Blanc and traditional South Australian red winemaking to more savoury, complex and notionally 'drier' wine styles.

This won't be happening in isolation. Our research shows the On-Premise in the UK and US is on the same track. What we can say with some certainty, for example, is that if Sancerre producers get their pricing right in Australia, Marlborough is in grave danger. Sancerre is replacing Marlborough in the UK and US in the same way the Italian red wine is replacing certain Australian red wine styles. What is at the heart of this? If you look at why natural wines have been such a hit with young leading-edge consumers, it's because they also have a kind of drying effect and so can be seen to be different to / better than what went before.

How do you then respond to this, just one example of how one market sector is changing? Sometimes it's as simple as being the best expression of your authentic self which, most of the time involves doing less of what you did to chase a market in another era. Think of the way in which the Languedoc is now about Picpoul and old vines Carignan etc. where once it chased the market with 'varietals' following the New World. How do you become classic and collectable, as timeless as Antinori? Quality, focus, self-understanding, self-belief, constant subtle reinvention and reinvestment. Strategy must never sleep.

Thanks to all of you who have come along with us for the ride over the last 15 years. Your ideas, interaction and support as customers is key to us finding our own way to be constantly challenging and reinventing. We hope to continue to be useful to you for many years to come. Please just be it touch if we can 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.

Wine Business Solutions

Phone +612 9744 8332

info@winebusinesssolutions.com.au

http://winebusinesssolutions.com.au