The Doubtless Letter

Analysis of Business Issues as if Strategic Value Counts February 2004

Recent reports on the expected production growth from New Zealand's vineyards over the next few years have rightly focused on the challenge to increase exports dramatically. As domestic demand remains essentially flat, it is simple mathematics to figure that with increased harvests as new plantings come into production, the volume that must be sold to export markets will need to more than treble (and possibly to increase as much as tenfold) within what is a very short period in marketing terms. Quo vadis? Next month we look at structural solutions.

The Wine Export Marketing Challenge (1)

No worries: Overseas markets are clamouring for our product; we can't meet current demand; and, after all, New Zealand only produces a mere 0.1% of World production.

Unfortunately, none of these statements gives reason for confidence. Overseas demand may be strong now, but that is no guarantee against a change in consumer fashions. The global industry produces oceans of formerly fashionable wines.

So even if many producers cannot meet current demand, it does not mean that everyone is in the same position. New Zealand may only produce 0.1% of global production, but its share in the key importing markets that dominate the buy side of the wine trade is considerably higher – and it is that which we must multiply. Market share among imports into the UK, the key market at present, is several per cent and is simply not going to treble under current pricing. The growth available in other markets, including the notoriously tricky US market, is far from obvious.

What is needed is a strategy to grow volumes, and given that the target markets are most unlikely to grow at a sufficient rate, this means that a significant growth in market share is required.

The answer does lie in the development of stronger branding, but the nature of the brands really demands a divided strategy. Especially with its key product, Sauvignon Blanc (62% of export volumes), and to a lesser extent with some of its new growth varieties such as Pinot Noir (5%), New Zealand has to change its mindset and accept that it can't maintain the current strategy of presuming to sell purely at the premium end of the market.

A two-pronged strategy means consciously setting out to create higher quality and value brands in the premium and above market segments, but accepting that <u>the higher those brands move up the quality chain the smaller the market they will cater to</u>. The second prong is delivery of distinctly separate value-based branding that, while meeting basic quality standards does not confuse consumers by pretending to be out of reach.

In fact, New Zealand sauvignon blanc has been sold according to a commercially high stakes strategy for many years. Export price expectations have crept upward, supported at times by the weakness of the New Zealand dollar against many trading partners – a situation that has now reversed sharply.

Many New Zealanders tend to ridicule the attempts of other countries to imitate the Marlborough style of sauvignon blanc. Yet Chilean and South African sauvignon blancs, for example, are winning market share from New Zealand sauvignon blancs in some of the key markets at least in part because of New Zealand complacency. It may be that Chile and South Africa can't match the quality of the Marlborough standard bearers, but that is not to say they can't match Marlborough's also-rans, or that they do not provide better value for money by selling at cheaper prices than those Marlborough producers need to justify local land prices.

Such a strategy means accepting some realities. For example, in France premium wines are rarely made from the fruit of young vines. In New Zealand more than 50% of the country's productive vines are less than 10 years old – young by global standards for premium quality.

Indeed the percentage of producing pinot noir vines older than 10 years is just 20%, and yet a significant proportion of the other 80% goes into wines that its producers are labelling and selling as a premium product with ritzy premium prices.

Another reality is that New Zealand has for some time lived in the relative comfort zone of selling predominantly to niche markets. We still drink most of the chardonnay and cabernet/merlot style wine that we produce and scarcely even try to sell into these hotly competitive categories internationally. In global marketing terms, sauvignon blanc is also really just a niche market.

Most of the increased production will come from the largest producers, all of which (with the exception of Villa Maria) are overseas owned and linked to overseas distribution networks.

This should not be relied on to soak up our potential wine lake, but it is significant nonetheless. These producers have brands intended to meet different price points in the market – not mono-focused on a premium priced image, but they will ultimately be competing for the same consumers as everyone else. The key is that the distribution channels they operate through give them a higher degree of control, and more options when things don't go entirely to plan.

However, it is hard to escape the conclusion that most of New Zealand's second tier or smaller producers lack the resources, including capital, to handle a rapid expansion of production within the next 3 to 5 years – provided of course that they have access to grapes.

The soundness of the industry's capital structures will be shown by the willingness of the banking system to fund growth as credit committees read forecasts of grape gluts, especially if bumpy currency or market conditions occur over the next few years, or worse if a Cyclone Bola/1988 style vintage (let alone simply a 1995-style rainy vintage in Marlborough) occurs during that time.

Mergers to consolidate resources begin to look not only inevitable, but commercially imperative (in the major growing districts with greater export reliance). Yet mergers should only be considered for their commercial sense - not as a knee-jerk reaction to circumstances. It is essential they be between complementing partners, underpinned by sound strategy, then negotiated and executed correctly.

The days of the "comfortable" niche are over.

Post Script:

Wine industry readers may wish to note the Government announcement of a review of allowances for the treatment of replanting expenditure. See www.taxpolicy.ird.govt.nz

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