

The *Doubtless* Letter

Analysis of Business Issues as if Strategic Value Counts

July 2004

In our February issue we considered the issue of how New Zealand might meet the impending growth in production through changes to its export marketing strategy. In particular, we suggested that New Zealand has to adjust away from its focus on producing high dollar value premium wine. The reasons: there simply isn't the growth available in that sector of the market in the niches that New Zealand specialises in and, moreover, we are leaving a potentially significant opening in the market for lower priced competition (with its own ambitions to move up the price scale).

Contrary to the reactions of many in the industry, the innovation of one producer selling bag in box Marlborough sauvignon blanc to the UK may be exactly what needs to be done! However, there needs to be differentiation between the up market, high dollar value branding, and lower tier protective branding.

However, the New Zealand wine industry faces other structural issues which will need to be dealt with over the next few years.

The Wine Industry Challenge (2)

When people think of wine businesses, they sometimes think of large, medium and small. Some think in terms of vineyard size, while others think in terms of sales or of volumes. While all perfectly reasonable alternative forms of classification, they really lack significant value when considering industry structure from an economic perspective.

Another way of viewing the industry is to say that there are really two distinct industries: that based on the regions of Marlborough, Hawke's Bay and Central Otago; and everywhere else. Those three regions are the ones with both a focus and infrastructure often missing elsewhere, with a proliferation of wineries from small to (relatively) large, with developing scale, and with international market recognition. At the risk of sounding peremptory, those are the only regions that (a) the wider world is really interested in; (b) that also offer the potential for sufficient planted areas so as to be able to achieve a degree of regional scale for world markets (Central Otago is nevertheless marginal); and (c) that as a consequence are at all likely to attract genuine global investment interest.

There are other areas that have parts of this mix, but not all: Martinborough, with its focus on pinot noir especially but with opportunities for real scale limited and with no large indigenous companies; Waiheke similarly in that land values reflect proximity to a major city rather than scale or global interest; Gisborne with a focus on Chardonnay and

white grapes and with relatively large areas planted but lacking the critical global recognition; Waipara, which is also probably too finite in suitable land terms and is internationally more often confused as an overflow from Marlborough; and Nelson for which similar sentiments might be expressed.

It is still possible that one of these, or even another area altogether, may yet in time build a global reputation that focuses and transforms the industry in that area. However, to achieve such recognition they may need to ensure that there are both stylistic and varietal differences from the three regions. The chances of achieving a global reputation for Sauvignon Blanc in their own right, for example, seem very distant.

The consequence of the distinction, however, is that if there were two identical and undistinguishable businesses for sale, one based in either Marlborough, Hawke's Bay or Central Otago would attract a higher price than one situated anywhere else (and indeed, given both the level of international interest and associated underlying land values if vineyards are involved, the Marlborough business would very likely attract a premium to either Hawke's Bay or Central Otago).

What this distinction does not do is ensure that a business in any of those three areas is necessarily more profitable than anywhere else, that it is any more free from commercial misjudgements than anywhere else, or that it cannot be an excellent investment.

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It simply reflects the age old economic law of supply and demand.

So even a star in an “also ran” district may have the same market value as an “also ran” in a star district, analogous to the “worst house in the best street”.

This simply means that if investing in assets outside of the three districts, it is important to understand the economic issues and realities. There is no reason why a wine producing business in a smaller area cannot be highly profitable and valuable if it has all of the right ingredients. One of those ingredients may even be the exclusivity associated with relative smallness, but the consequent reliance on bottle pricing as a driver to offset lack of scale in cost terms, especially when faced with high land values, means that such businesses are limited in terms of ability to expand significantly, without sacrificing margin, in order to achieve the exposure necessary.

From a selling perspective, the distinction has obvious practical consequences. Outside of the three key districts, with the exception of a relatively small number of high profile businesses, it would be quite logical to use a real estate agent to handle the sale of a wine business (including brands, plant and stocks).

However, within the three districts (or for other businesses with size or profile) the sale of a business would be expected to be handled by a specialist to get the best results, with a more targeted sale process to ensure the right buyers and the use of techniques to ensure competition. For example, a real estate agent would probably not be the right person to conduct the sale of a part interest in a business or a more complex transaction with appropriate warranties and financial structuring issues.

The bottom line for all businesses remains to stay focussed on the basics for adding value.

Management Strategies

There are a number of structural changes or adjustments that wine producers should think about if they are serious about future growth and profitability. Not all suggestions are appropriate

for all businesses, just as each producer has its own reputation and branding as a producer.

1. Get smaller. Is your production level really the most profitable way of capitalising on your market position? Cutting yields or even removing low margin labels might result in improved profitability if able to be done without materially sacrificing cost efficiencies (and would lower yields result in higher quality and allow you to better defend or even improve pricing). Indeed, some producers ought to be asking whether they are spending marketing dollars trying to break into inherently lower margin markets in order to justify production driven decisions.

2. More specialisation. Is there really value in having a long list of labels based on trying to produce just about every type of wine? A long list may be helpful in an operation with a heavy reliance on cellar door or on-premise restaurant sales, but is usually far more problematic for overseas distributors who know what their markets do and do not want. From an external investor’s perspective, lack of specialisation equates to lack of focus, as if you really don’t know what you do well or not. Harkening back to the first point above, it also equates not only to carrying labels which are less profitable, but potentially also tying up capital in assets (such as the vineyard) which may not be producing adequate returns when other varieties, or even selling the land, might make more sense.

3. Treat your vineyards differently. If it is clear that some areas or vineyard produce better quality grapes than others (including younger vines), go for smaller yields and hands on treatment to maximise quality and price point. For vineyards that do not have the same potential, the options include higher yields and lower cost management as a corollary to conscious decisions to optimise profitability at lower price points. This makes far more economic sense than growing everything the same way and deciding afterwards whether it is a \$15/bottle wine or a \$25/bottle wine. Sometimes conditions will determine that what was intended to be a higher value product must be downgraded, but there are still too many producers who do not differentiate according to potential

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from the time when the platform for the following year's season is determined.

4. Get the debt and equity mix right. Many family-owned businesses rely on bank debt to supplement the limited capital resources that might be available. This might work out when lifestyle is still a significant factor for the owners, but may mean significantly different risks if trying to grow the business and develop export markets.

The reality is many wine companies are clearly "asset rich" but "cash poor". They are valuable businesses in terms of the market value of their land, but earn very poor rates of cash return on investment. Managing for value means getting the mix right. Companies with well balanced production and cost structures that match well developed brands and distribution plus sensible financing strategies should be able to survive the impending challenges.

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