

The *Doubtless* Letter

Analysis of Business Issues as if Strategic Value Counts

August 2004

In recent times the weight of increasing production upon the wine industry (at the same time as the New Zealand dollar has strengthened materially against export market currencies) has caused commentators to predict a period of business failures and industry consolidation. What is not so well understood is the mechanics that would drive such industry change, if indeed it occurs, including why, when or how.

A key facet of industry dynamics is its ownership structure, and we discuss some recent analysis of overseas ownership below, before considering the drivers for change.

Wine Industry Ownership and Change

Overseas Ownership

According to recent media reportage the producers of approximately 85% of this country's wine output are owned by overseas interests. This may be a slight exaggeration. Even if over 20% is produced by small producers (data from New Zealand Winegrowers shows small or category 1 wineries alone produced approximately 22% of output in the 2003 vintage), it is likely that overseas owned companies crush as much as 70% in a normal year and sell closer to 80% once bulk purchases are added. The percentage by value will of course be materially lower.

It is worth noting that of the four large or category 3 wineries (over 2 million litres sales) two are overseas-owned, including the industry giant, Montana. Of the 34 medium-sized wineries (category 2 or sellers of between 200,000 and 2 million litres), 7 are overseas-owned and another two have significant overseas minority shareholders with the balance all locally-owned. Only a very small, but often high-profile, portion of the 426 small producers are overseas owned. In other words, take Montana out of the equation and the industry is still "dominated" by local interests.

Doubtless Strategic has analysed the most recently available financial information from 11 overseas owned producers (most of which are from the financial year ending in 2003). For the record, two of these are large producers, five medium and four small. Collectively this group had sales of \$587 million, paid tax of \$22.5 million, reported profits of \$44.6 million, and paid dividends to their offshore shareholders of just \$2.5 million (which was, in fact, paid by one solitary company).

To add to the picture, this group of companies has total assets of over \$1 billion, and invested more than an

additional \$95 million into new assets ("more than" because this figure could not be calculated for one company which is known to have invested heavily since 2002).

Moreover, excluding the solitary dividend mentioned above, the owners of this group invested an additional \$289 million into the country which went to capital spending on new assets, financing increased working capital (despite the small 2003 vintage), and refinancing an aggregate debt to local bank balance sheets of \$71 million.

All in all, the industry's recent experience of overseas investment has been extremely positive in financial terms, not at all one of "pillaging" local resources, and that is before taking into consideration technical and marketing input that are really also investments in terms of value adding.

Size, ownership and structure

Nevertheless, according to New Zealand Winegrowers' data, the large wineries' share of national production has trended down in recent years. For the first time in the history of the modern New Zealand wine industry the large wineries' share of production fell below 50% during the small 2003 vintage. While this continued a trend, it was probably due in part to the fact that the highest production growth areas that vintage were those where the large wineries are relatively unrepresented.

What this really reflects is the dynamic of natural change. As much as the large and small ends of the market consolidate, new entrants continue to arrive or develop. Small companies continue to grow into larger ones.

This may be illustrated by looking at the then Wine Institute as it was comprised 12 years ago, in 1992. One of the 3 large wineries in 1992 is no longer in

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separate existence. One of the then 11 medium wineries is no longer in separate existence. Most importantly, 44 of the then 152 small wineries are no longer in separate existence (and a number of others have restructured or changed owners).

However, of the 34 medium size members today, just 6 were in the same category in 1992, 19 were small producers and 9 (or 26%) did not even exist.

However, it is also true that a number of significant factors can contribute to higher rates of industry change or consolidation: (1) rapid growth (with its consequent financial pressures); (2) changing requirements of lenders; (3) increased competition; and (4) excess supply pressures.

With the increased volumes coming on stream over the next few years it should be abundantly clear that some of these factors are recurring, and possibly all four, as they are really all related. Higher crop levels mean increased stock levels, which must be funded. Increased stocks tend to be followed by increased competitive pressures and often lower prices. The result can be higher debt levels and reduced ability to meet bank covenants.

How this affects the industry depends very much on the companies. Some companies have the financial flexibility to “weather the storm,” whether because of low levels of indebtedness, high margins (and price flexibility), or thanks to parents with deep pockets. Some companies have the market presence to move their increased output without much difficulty. Others will most certainly not have done the hard work building brands and developing robust, quality sales channels during the easier times of recent years.

A shakeout?

Is a shakeout inevitable? Probably, but not straight away. It may take a couple of years, and it may be that it is barely noticeable, but it will happen. Nor is it necessarily a negative thing: there are many who would agree that consolidation or a shakeout will make the industry stronger in the longer-term.

It is certainly clear that there are plenty of reasons for banks to be concerned, and to want to tighten up on credit requirements. The banks are already well aware

that the higher NZ dollar has eroded margins. They are also becoming aware of the rising stock levels. Within just 12 months (after a moderate to large 2005 vintage) New Zealand wineries could be facing stock levels climbing above 3:1 (i.e. 3 times one years sales). As the same banks lend to an Australian wine industry with stock levels of closer to 2:1. The difference seems even more concerning when one takes account of the fact that the Australian industry is red wine focussed, since red wines typically need longer aging before release, whereas the NZ industry is predominantly white wine for drinking young. The banks have faced a rash of high profile failures in Australia over the last couple of years, so any potential nervousness must be respected. The fact is that bank debt has fuelled a significant proportion of the industry expansion of recent years, including vineyard developments and new wineries.

Does this mean a rash of winery failures in New Zealand? Maybe, but that is by no means certain. It is far more likely that banks will want to spot potential problems early and encourage actions to avoid more drastic consequences.

Companies may be encouraged to reduce debts through selling assets or refinancing with new equity – it is quite possible that a number of wine businesses may raise capital by floating over the next few years. The industry may also get an uplift of private equity investment – professional investors taking small or large stakes to either fund growth or reduce debt.

The other alternatives include ones owners often prefer to avoid when facing pressure: merging with other businesses, or the more obvious selling up altogether.

People understand what selling involves - it is an option that many businesses exercise every year for one reason or another, but the days of trying to exit at “top of the market” prices are now gone. Even in an area such as Marlborough, values may be dependent on the strength of the branding and infrastructure as much as the values of underlying real estate. Amongst other things, buyers will value the strength of purchasing contracts and the flexibility to make changes. The importance of quality cannot be underestimated.

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It seems surprising that more businesses do not consider the option of merging, rather than selling. Mergers with other businesses usually mean no longer having sole control and accepting some compromises. Of course many companies that have grown from small family-focused businesses may actually consider this less onerous than the demands of being responsible for all management, from the vineyard right through to international marketing. Indeed, the merging of vineyard resources and brands may offer the potential to improve, strengthen and add value to both businesses if the respective owners are compatible and understand the reasons for what they are doing.

The Bottom Line

Things have changed in the wine industry as production has increased and the requirements for success have become more sophisticated. Not the basics: quality in the vineyard, quality operational management, quality sales and marketing channels. These remain the ingredients to the best profit margins and the greatest value over time. Ownership is not necessarily an

ingredient for any of these basics, although there are obviously times when it can help.

However, wine producers face greater pressures than at any time in the last 18 years (since the fallout from over-supply and price wars that led to the Government-financed vine-pull of 1986).

Unfortunately, in our experience many firms lose objectivity when it comes to assessing their own financial or market strength, or for that matter their true value. Nor, in our experience, do they think laterally about strategic options.

The answer is to be able to think about what someone is trying to achieve with their business. Is it "just" lifestyle (which may be a perfectly sensible option for many owners), or is there a serious intention to grow a business and create wealth? Is there a plan for succession, and is it regularly reviewed - does it stack up under the new environment?

Understanding the options is the key to taking control.

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