

The *Doubtless* Letter

Analysis of Business Issues Affecting Strategy & Value

November 2004

To most New Zealand winegrowers and wine aficionados Europe is a world away, but California may as well be on a different planet altogether. New Zealand receives a small but select dose of Europe's finest wines, but very little of the wine produced in California (and even less of the product of the other states of the USA) reaches this country. In part this is because of a (not entirely unjustified) perception that Californian wines are expensive – although this is less the case today thanks to the exchange rate. The simple reality is that California produces a large number of very high quality wines and their absence from New Zealand wine shelves is arguably unique when compared with what is available from all other major producing countries.

Some Lessons from Abroad

California and New Zealand

This is particularly disappointing in the sense that it seems to consign the developments of the Californian wine industry to a degree of irrelevance in New Zealand. The point is that this ought not be the case. Like New Zealand, California's wine industry is extremely varied. This is not only in terms of styles, but also of focus and economics. It has huge producers capable of economies of scale New Zealand can never achieve, but it also has a plethora of tiny producers.

For all that it may have an image of selling primarily to its home markets (shades of New Zealand not so long ago!), California is a significant sized exporter to the UK and its export market share is growing. So much so, in fact, that it arguably shares with (and may come to lead) Australia in terms of defining future stylistic fashions and trends. For the record, Californian producers seem to be in a process of toning down their fruit-dominated reds in a search for more elegance and structure, although still very much Californian in character (and definitely not French!).

Moreover, there is an enormous amount that California can teach New Zealand about wine marketing and the economics of the business. However, California has come increasingly into focus of late for the wrong reasons: the tribulations of its most famous wine company, brand and persona: Robert Mondavi.

On Mondavi and Being Public

Like the rest of the World, many New Zealand wine people may look on the near dismemberment and eventual loss of control of the Robert Mondavi Corporation and question the suitability of the public company model for ownership of wine businesses.

Unfortunately the Mondavi case has highlighted a number of misconceptions about the model, just as it has highlighted some important characteristics that are essential for the public company model to work.

It is worth reflecting on some important elements of the Mondavi story. At the time it was floated as a public corporation, Robert Mondavi was a prestigious quality wine producer with a strong brand and aspirations to grow that were beyond the Mondavi family's financial capabilities at the time.

As a public company Mondavi branched out into production and sale of high volume branded wines in addition to its premium products and a number of high profile offshore investments. However, as a consequence of changed economic conditions and a structure that struggled in both cost and marketing terms to bridge the increasing difference between a high end and mass market focus, profitability suffered.

The company stagnated, and it did not help that Mondavi family members became involved in very public spats with elements of the wine media. Nor did it help that although owning less than half of the company, the Mondavi family retained over 80% of voting rights and a significant degree of Board control. This became a bigger issue when the company contemplated projects, such as the modernization of the original Napa winery, which were perceived as family "pet" projects rather than in the interests of shareholders.

The irony in the decision to sell the high end and luxury wine assets is that these were not necessarily to blame for the profit stagnation experienced by the company. Much has been written of the views of American equity analysts that they wanted predictable quarterly sales and profits that could be provided by the mass market business. Unfortunately these comments are somewhat

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disingenuous as they imply the premium business is fundamentally volatile.

Paradoxically, aside from low returns from some of the company's more recent investments, especially offshore, the profitability woes at Mondavi really set in when the weakening of the US economy hit the mass consumer side of the business. It is there that fluctuating grape prices and supermarket price wars can do spectacular damage to profit margins – the only difference is that the analysts can track such things constantly. At the premium end of the market there are significant variables, such as seasonal labour intensity dictated by growing conditions, but subject to the influence of crop size on inventory levels and on subsequent year sales, profitability for a well developed and branded premium wine business can be no less predictable.

The real reasons for the decision Mondavi initially took to sell its high end assets are more likely to have been based on the level of profitability and the amount of capital employed in the Napa business and investments. Making “super premium” and luxury quality (and high-priced) wine involves significant investments of capital. It can require a mix of expensive land, expensive vineyard set-up (eg. high density planting), expensive winery plant for production of (generally) smaller volume lots and investment in higher levels of inventory. Typically it can take many years of toil to build such a business to a financially sustainable level so as to get a payback on that investment.

The Reason for Going Public

There is another paradox here, and it is the fact that the public company structure exists primarily to fund the capital requirements of businesses that are beyond the capacity of a small number of owners or investors to manage. Stock exchanges exist to allow public company investors liquidity – the ability to sell if they wish without having to withdraw funds from the company – and this liquidity improves the price that investors will be willing to pay so that the cost of the capital to a company is reduced.

What this means is that the public company format may be appropriate for all manner of wine industry businesses, including grape growing, top-end “boutique” producers, and also companies focused on selling larger volumes to the export or mass consumer

markets. It does not mean that the public company is the only, or even necessarily the best solution – just that it may work the best in appropriate circumstances for people who understand why they are using it and what the future requirements will be.

It is also important to understand that investors often have very different requirements for the companies they invest in. Some investors want dividends as a priority, whereas other investors may prefer capital gains and are much less concerned with dividend levels. Professional fund managers are sometimes categorised as belonging to one or other of two different investment philosophies: growth oriented investors who want to see a future growth profile of sales and profits as the means of adding value over time; and value investors who buy into companies because they believe that regardless of the growth outlook there is a latent value not perceived by other investors.

In the case of the wine business one can never ignore the fact that whatever part of the business one is invested in (as the owners of all of New Zealand's hundreds of grape growers and winemakers are), it is based on an agricultural product that is highly susceptible to seasonal variations and influences even if the end product is shipped and sold in flash packaging to a consumer that may be blissfully unaware of what the producers had to go through (not unlike like the consumers of milk, cheese and apples etc.).

Closer to Home

Of course not all of the larger wine producers in Australia and New Zealand have this issue of skewed focus between mass market and luxury market products. Of the larger New Zealand producers it would be fair to say that with the exceptions of perhaps Montana's “Tom” and Esk Valley's “The Terraces” (both of which are relatively recent innovations, and neither of which is pivotal to its company's marketing strategies) none have an icon driven policy and all seem to have a goal of ensuring that their product does not move too far out of the consumers' reach.

There are a number of New Zealand wine businesses that are growing rapidly. Some have offshore owners or shareholders to ensure access to capital (and support with bank financing). Others have managed their resources intelligently and should be able to grow much further before they too, inevitably, will need to ask the

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questions about future growth goals and strategies. Some may be reaching the limit of what can be achieved with existing resources, and for them the questions come sooner. The foremost issue, as owners of a business, will be to question their objectives, and to consider the options available to achieve those objectives.

Public company status is one such option, and may work really well for some businesses, but although it can be a highly efficient way of creating wealth it also comes with strings attached – most notably with regard to control and to how the business operates. This is what happens when one is answerable to investors other than oneself or one's immediate family, for example.

Which brings us back to the Mondavi lessons. Robert Mondavi Corporation is a useful case study of how governance issues can cause problems when there is a family with a significant or controlling stake and competing ideals and aspirations. Clearly the public

company route is not for everyone and the Mondavi experience is a salutary reminder that there need to be clear objectives and strategies when going public. The eventual fate of Mondavi, and how Constellation Brands came to acquire control through the smart use of a textbook takeover strategy, are another story altogether.

Doubtless Strategic Limited has a wealth of experience in analysing and in advising on decisions regarding the most appropriate capital and financing strategies for businesses in the wine and other industries. We particularly pride ourselves on the ability to deliver this advice from a truly independent standpoint, and a corresponding willingness to look at a wide rather than narrow range of alternative solutions. In our experience most business owners do not fully understand the completely different process, timing and pricing requirements of such alternative options as floating, private equity, debt, mergers, etc., or of the associated value implications.

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