The Perfect Storm, Revisited

Authors review *Granholm* court ruling, make predictions and say how wineries can stay ahead during dynamic times that will ultimately benefit the consumer.

Deborah Steinthal and John Hinman

IN LATE 2005, keying off the landmark May 16, 2005 *Granholm* Supreme Court decision[1] and its immediate effect on the industry, we published "U.S. Wine Market Liberalization."[2] We predicted that five interlocking dynamics would have a cataclysmic impact on all tiers of the United States wine industry:

(1) **Globalization of Supply and Demand.** More informed consumers are upping the ante, compelling wine regions to ship more affordable, higher quality wine. Traditional producers such as France and California's Central Valley are particularly pressured to respond to the challenge to maintain market share.

(2) **Producer Consolidation.** Large global players with deep pockets are forcing smaller producers to differentiate to survive and sell more wine directly to consumers and trade. Nascent wine production models, in which the consumer is becoming the producer, have potential to disintermediate the winery.

(3) **Distributor Consolidation.** Profit margins are squeezed as distributors and producers fight for more trade and consumer mind share.

(4) **Retail Consolidation.** Large multi-regional retailers control an increasing percentage of wine sales volume and most of the industry's merchandising currency.

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(5) **Wine Market Liberalization.** Consumers, wanting access to wine brands not available through current three-tier distribution systems, are fueling the forces of deregulation, pitting consumers, producers and retailers against distributors through legal battles at state and national levels.

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In just the past 24 months, the convergence of the five dynamics described above has polarized the wine landscape into virtually two industries—the large multi-billion dollar corporations and the small privately-held wine businesses—each operating quite differently and playing to different margins.

Since late 2005, opportunities for new wine distribution systems and producer models have arisen, challenging players at all tiers to develop new strategies or be forced out of the game. By 2015, we maintain that the end result is a much more efficient $2^{1/2}$ tier system: an open market with fewer legal barriers at the state and national level, where all players are required to compete on the basis of their own merit and where revenue streams—as well as system costs—are much more transparent.

Twenty-four months later, so much has altered in the world of wine. In this article we want to revisit our original assumptions and ask ourselves: What has changed since the May 16, 2005 *Granholm* Supreme Court decision? What could the next 24 months bring?

PAST 24 MONTHS: WHAT HAS CHANGED?

Given the 10-year framework of our initial predictions, it struck us that at Year 2 some dynamics have crested faster than expected, yet others remain barely a swell on the horizon: globalization, health effects and the green movement are generating headlines, yet innovation still eludes the industry. We have seen the big rapidly getting bigger, new wines entering the market at breakneck pace and enormous litigation at the state level.

FASTER THAN EXPECTED

Globalization's impact on calibrating supply and demand on the U.S. market has caused an exponential surge in foreign imports filling expanding U.S. consumer demand for principally Pinot Grigio and Pinot Noir varietals. This is driving global procurement as a strategy for large wine companies who are de-emphasizing region of origin (in favor of brand identification) to support better value grape sourcing.

Trends in consumer health awareness are having huge impacts on our industry. Coinciding with the baby boomer rush to incorporate better nutrition and wellness into their lives, the positive health aspects of wine are helping sales. "The whole idea of 'Drink Wine, Live Longer' is having a profound impact on 50+ (age) consumers who used to drink their fair share of beer," said **Bump Williams, Information Resources Inc.**'s (IRI) executive vice president for alcohol beverages.

The green planet movement is accelerating sustainable farming and business practices: 32 wineries in Napa County alone have converted to solar; many across California are certifying products and vineyards as organic and biodynamic.

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SLOWER THAN EXPECTED

U.S. wine business innovation continues to grow slowly across all areas: supply chain, product development, distribution and placement, packaging, marketing and production technology. "For U.S. vintners to stay ahead of the competition, they must drive new packaging and push the envelope on current distribution, retailing and stocking strategies," said Williams of IRI.

THE STRONG PREVAIL

The industry's largest players continue to grow through acquisition. Wineries in the above $500 million range are increasing market share and consolidating distribution for all beverage sales across broad regional markets rather than in individual states. This strategy is driving up the value of smaller, healthy winery brands. In the last 24 months, more smaller winery owners are exiting the market through selling to third parties.

The "Big Five" distributors now have an estimated 52 percent share of the market, up nearly 14 percent over the past five years, and their market share is expected to increase substantially over the course of the next decade[3]. Distributor consolidation has occurred quickly post-Granholm, many combining beverage categories to drive profitability. The handwriting is on the wall for the small, local distributor: without scale, their future could be dim. However, distributors aggregating too many wines have little to no effect on retail sales and marketing practices and as a result are relying on producers to market and communicate brand messages to retail, a cost that cannot be sustained by the smaller producer.

BRAND PROLIFERATION BEGETS COMMODITIZATION

Despite expectations that consolidation would reduce industry fragmentation, competition is accelerating as new brands, both domestic and foreign, enter the U.S. market[4,5]. Such proliferation may be driving U.S. consumers to see wine as a commodity; if a consumer's wine of choice is not available, they will buy another. This dynamic is driving everyone to invest in differentiating their brands at the retail level, potentially powering huge growth in private and proprietary labeled wine as retailers seek to grow profits.

REGULATORY DOMINO EFFECT

Today's regulatory environment has heated up since the *Granholm vs. Heald* event which catalyzed uniformity of laws across state boundaries. Subsequently, wineries in 34 states are now legally shipping direct, up from 26 states in May 2005, although barriers to direct shipment caused by burdensome permit procedures, restrictions on winery size, eligibility criteria and other similar complications introduced by the wholesale tier are currently inhibiting the ability of this channel to prosper to the extent that it would in a completely deregulated environment. Litigation in this area on behalf of all direct shippers is inevitable.

The onslaught of legal actions has triggered enormous uncertainty at the regulatory level—an uncertainty that is expected to persist through the next decade because regulatory agencies are experiencing serious budgetary and personnel shortages that have resulted in the continuing retirement of senior experienced regulators.

At the District Court level in Seattle, **Costco** won an overwhelming victory, effectively dismantling key regulatory inefficiencies such as prohibitions on central warehousing, anti-trust aspects of price posting, mandatory margins, credit laws and quantity discount restrictions. The finding that winery self-distribution is legal (a two-tier system) was probably the most significant part of the decision.

If the Ninth Circuit affirms the Costco decision currently under consideration (with a decision from the Circuit Court expected before the end of the year), the pace of litigation will increase in the United States, leading to even more lawsuits and greater uncertainty for all industry participants. This is already happening with retailer suits in California and Texas past the pleading stage, the expectation of a lawsuit in Illinois over the leveling down of the state (which has been open to retailers for 15 years) to out-of-state retailers and the appeal of the recent District Court decision in New York that shut New York down to out-of-state retailers in reliance on the dissents in the *Granholm* case.

NEXT 24 MONTHS: KEY INDUSTRY PREDICTIONS

Looking ahead to 2009, the five critical dynamics will continue to create waves in the wine industry, pounding hulls to test their strength and causing some to bail. For the nimble, there are great rewards to be reaped as the United States becomes the world's largest consumer of wine by 2010.

"Our latest research is showing that shoppers are leaving spirits and migrating towards Wine and Craft Beer faster than any other Beverage-Alcohol segment," said Williams of IRI. "Year-to-date price to consumers in the U.S. has been slightly above consumer price index (CPI), and to me that means 'price is not a deterrent' for wine growth. The only things that can 'hurt' the future of wine are a downturn in quality, distribution/availability, shortage of retail execution (display presence, out-of-stocks and feature activity) and a sense of complacency from the wineries across the country."

OPPORTUNITY BREEDS INNOVATION

Consumer interest in exploring wine will continue to fuel growth in new wine categories and alternative retail solutions. Of particular influence are new categories being defined by companies like **Crushpad**, where wine consumers are becoming producers; large consumer social networks organized by bloggers, such as **Vinography** and **Wine Library TV**; specialty retail groups like **Women & Wine** and wine lifestyle broadcasts like **Wine TV**; and home tasting groups, such as **The Traveling Vineyard** and **Wine Shop at Home**.

Big box wine merchandisers will expand both regionally and globally, developing new retail options for selling and stocking wines. Giant retailers such as Costco and **BevMo** will see category ownership driven by brand relationship models with large wineries. If franchise tax laws change, innovation within small- to mid-sized wineries will accelerate by expanding one-to-one sales strategies and driving important trade and consumer relationships. Sophisticated logistics companies such as **Inertia Beverage Group** and **New Vine Logistics** are poised to service this area as states continue to deregulate shipping rules.

DEREGULATION TRIUMPHS

Consumers are leading the national thirst for deregulation and greater access to wine products. Franchise laws interfering with product movement will open up as the industry is able to effectuate change amid distributor control of the legislative process. In this climate, assertive risk-takers like Costco and BevMo will thrive, but this situation cannot persist without further meltdown. Antitrust lawsuits against a top distributor may materialize as rural areas begin to only support one distributor.

Newly integrated distribution models will emerge where one entity legally owns and operates a winery, import business, wholesale business and retail business—selling wine to large national networks of consumers. Early examples include web-based wine clubs like **My Wines Direct** and **Vinesse**, and multi-regional wine bars, such as **Vino Venue**.

INDUSTRY POLARIZATION

The widening chasm between large mass merchandisers and small- to mid-sized producers is undeniable. Large and small players will need to mind the gap, that is, decide where to play and become stronger at positioning their brands if they want to remain profitable.

Some wine businesses over the $500 million revenue mark will persist with acquisitions, striving for increased market share. Other large wineries (namely **Constellation**, **Diageo** and **Kendall-Jackson**) will derive economic profit and bottom line growth when they integrate holdings to realize synergies in sales, marketing and supply chain management practices. Large companies like **E&J Gallo**, **Foster's Wine Estates** and **Bronco Wine Company** will seek top line growth by elevating product mix and expanding their over-$15 brand portfolios.

Successful wineries under $60 million in revenue will apply stronger business practices, improve team effectiveness and apply new options for national sales. Brands built on authentic family and distinctive regional values will claim meaningful market niches. In this highly competitive market space, small wineries will build stronger direct sales channels by investing in innovative product and packaging, customer service, technology, database management and more professional talent.

Those small- and medium-sized wineries that cannot efficiently penetrate the three-tier system or grow alternative channels will be overwhelmed by regulatory and competitive environments. Rather than struggle through the challenges of growth and change, more first generation, luxury brand owners will seek exit strategies by selling their business to capitalize on market opportunity.

KEY INDUSTRY PREDICTIONS

- Global wine consumption will grow from $107 billion at 5 percent per year (Wine Institute, Dec. 2006).
- U.S. will become the world's number one consumer of wine by 2010 (Wine Institute, Dec. 2006).
- Small wineries' wine sales, shipping direct, will grow from $2 billion to over $5 billion (MKF Mar. 2007).
- U.S. wine trade policy and regulations will encourage innovation and participation (Hinman & Steinthal).
- Integrated distribution models will efficiently serve large and small players (Hinman & Steinthal).
- New technology will drive efficiencies in product and distribution (Hinman & Steinthal).
- U.S. wine industry will be appreciably deregulated by 2015 (Hinman & Steinthal).

GLOBALIZATION DOMINATES

We shall continue to see massive investment internationally, as many countries replant using new technology to generate high quality, price competitive grapes. Less developed countries, such as India, China and several in Eastern Europe, are emerging as both new, regional wine producers and significant consumers. Lower land and viticulture costs, combined with government support of local farming, mean global competitors are only going to get stronger. Global trade policies will be at the forefront of national government involvement as imported brands and wines provide intense competition for U.S. producers, especially in the below $20 wine segments.

On the flip side, it has been reported that the California grape supply is slowing (vineyard replanting at an all time low corresponding with increased non-bearing acreage in the North Coast). This could drive a shortage of premium U.S. wine in the above-$25 wine categories as demand quickens. How this trend impacts U.S. wine producers is too soon to predict. **Rob McMillan**, founder of the Wine Practice at **Silicon Valley Bank**, forecasts a surge

STRATEGIES TO DEPLOY

Wine industry leadership can affect positive momentum in these changing times through supporting fundamental initiatives across several areas.

(1) Win at the margins. Small- and mid-sized wineries should drive to specialize and focus on building profitable and strategic market niches from a customer perspective.

(2) Focus technology and innovation investments where those count and develop competitive advantage. This includes customer relationship management processes, market and customer information, product and production, packaging, distribution and supply chain. Outsource what is less important.

(3) Investigate and partner with viable, alternative distribution solutions. These business models are beginning to cater to wine categories within a changing national retail landscape.

(4) Build stronger business fundamentals to speed up returns. Invest in stronger people, communications and systems; develop improved strategy and execution practices.

of higher priced imported wines over the next five years to satisfy both a domestic shortage of fine wine and the changing consumer appetite for value-priced wine above $15.

According to IRI's Williams, "Retailers across the U.S. grocery industry have begun to really support the wine category through aggressive merchandising, and this in turn has led to a near double digit increase of wine sales in grocery stores. And for those who think 'cheap' wine is the winner, think again: it is the premium and luxury-priced wines that are the real winners in this category. Can you really put a price tag on image?"

FUNDAMENTALLY GOOD NEWS

Continued growth in U.S. wine consumption and more stable global supply will boost revenues and profits for well-positioned industry participants. A reduction or elimination of state-level regulatory bottlenecks will move the needle in the next 18 months enough so natural global market forces can exert more force. Consumers are driving and energizing this revolution with their involvement in the blogosphere and their reaction to legislative gridlock.

In the end, the consumer will prevail. By 2015 the U.S. wine market will be a more efficient and open market. More wine will be sold through more outlets than ever before, giving consumers more choices than ever before. **wbm**

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Footnotes

[1] The Supreme Court in *Granholm v. Heald*, 544 125 S. Ct. 1885, May 16, 2005, found that the 21st Amendment did not authorize discrimination between in-state products and products from out-of state. Justice Kennedy held for the Court, "The Amendment did not give States the authority to pass nonuniform laws in order to discriminate against out-of-state goods, a privilege they had not enjoyed at any earlier time." This is the key holding in the opinion and represents the beginning of a clear line of authority (Authors).

[2] "U.S. Wine Market Liberalization" by 2015 (*Practical Winery & Vineyard*, page 2).

[3] Top Five Distributors in 2006: Southern Wines & Spirits, Charmer, Republic/NDC, Glazer's, Youngs. Source: *Impact Magazine.*

[4] Number of new brands: 2002 = 42, 2004 = 115, 2006 = 234.

[5] Over 65,000 wine SKUs (shop keeping units) were sold on the U.S. market in 2006.