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Crafting Winning Strategies in a Mature Market:

The US Wine Industry in 2001

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This case was written by Jason Hunter, Brian Marks, and Wayne Mortensen under the supervision of Professors W. Chan Kim and Renée Mauborgne. It is intended to be used as a basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. This case is to be used with the video "Creating a Blue Ocean in the U.S. Wine Industry" by Professors W. Chan Kim and Renée Mauborgne.

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Crafting Winning Strategies in a Mature Market

In this case study we explore the strategic landscape of the US wine industry – its history, its competitive forces, and its key players – as we survey the American wine market in 2001. While reading this case, ask:

1. How attractive is this industry?

2. Following the logic of competitive strategy, should a company enter this industry and if yes, what should its strategy be?

3. Following the logic of competitive strategy, what strategy should an established player follow?

Also, think about and be prepared to answer:

What are the factors the industry competes on and invests in? How long has the industry competed on these factors?

A Brief History of Wine

Archaeologists believe that wine was first consistently produced in the late Stone Age – some 7,000 years ago – in what is modern day Iran. Over centuries of development, winemaking techniques evolved, storage vessels were made and wine production spread across Persia to the Middle East and into Egypt. Wine's scarcity and high price immediately made it a marker of social distinction, according to Maria Rosa Guasch-Jané, professor of Egyptology at the University of Barcelona.[i] Detailed accounts of the winemaking process have been found painted on the walls of pharaohs' tombs dating as far back as 2700 BC. And it was the pharaohs who were the first to distinguish between wines based on grape varietals and varying qualities among vintages. In so doing, they set in motion the process of defining the parameters of wine connoisseurship. At the same time, wine became deeply bound up with religious ritual in ancient Egypt and its consumption was seen as a means of reaching a higher plane, of becoming closer to God.

As wine drinking expanded from North Africa to Greece around 1600 BC, so did its association with spirituality and ritual. The ancient Greeks worshipped Dionysus, the God of wine and revelry, and as the popular cult spread across Greek settlements to modern day Italy, France, and Spain, so did winemaking. As winemaking techniques improved and different regions were recognized for producing different qualities of wine, the Greeks began labeling wine vessels by the region the wine was produced in, a practice that continues today. And wine to the Greeks, like the Egyptians before them, remained the choice tipple of the "pious and civilized" elite, while beer remained the choice of the "godless and debauched."[ii]

The Romans learned winemaking from the Greeks around 800 BC, and as the Roman Empire rapidly expanded in the 2nd century BC so did winemaking. At the same time the Romans were the first to introduce glassware for wine drinking as well as *grand cru* vineyards (a regional wine classification for vineyards that were known for excellent vines). During this era it is estimated that in the city of Rome alone, over 47 million gallons of wine were drunk

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each year, enough for every man, woman and child to have a pint (half a liter) of wine each day.[iii] By the 1st century BC, the Roman Empire encompassed all of Europe from the Middle East to Scotland and within these bounds existed every known wine producer in the known world. As Roman conquerors demanded better local wine for their cortèges, viticulture techniques improved across all of Europe.

In the Middle Ages (476 AD - late 1600s AD) wine was democratized and became the drink of every strata of society. With water quality a central concern, wine, with alcohol levels high enough to kill any bacteria, was drunk throughout the day.[iv] This helped power a winemaking renaissance during the Middle Ages in the country that would become France. Beginning in the rural episcopal towns and monasteries and later spreading into secular urban areas, wine became the staple companion to every meal of the day, and the age-old practice of pairing wines with foods took hold.[v]

The wine industry continued to expand across Europe over the next four hundred years. Wineries popped up from the Canary Islands to Russia. Yet wine remained an everyday drink into the 18th century, with the average French working-class household consuming three bottles a day. However, it was in France during the 1700s that wine was taken to a higher level. As the Age of Enlightenment took hold, the ruling class developed more sophisticated wine-producing techniques to match their increasingly refined tastes. As a result, two wine markets shaped 18th century France: a luxury premium market and a low-priced market for the common people. While the low-end market remained largely unchanged, the premium market rapidly evolved.

At the heart of the Enlightenment's embrace of scientific rationalism, French winemakers developed new techniques to boost their wine's complexity, flavor profile, and varietal character. As winemaking became more refined, edicts were passed determining what was premium wine and what was table wine, how the label must be presented, how the wine must be aged, with appellations, dominations, and grape varietals codified into law. As the wine trade consolidated up-market, winemakers increasingly focused on the special qualities and heritage of the land where the vines were grown. The nobility of the land – and by association that of the winemaker – became the central focus of wine. If the vineyard did not have a noble lineage they invented one. Soon wineries began adding the word *château* to wine labels, even if, as often was the case, there was no château on the property.

In North America, wine arrived in 1521 with the first Spanish conquistador Hernán Cortés. After famously depleting his wine stock celebrating the conquest of the Aztecs, Cortés ordered vine cuttings from Spain and in one of his first decrees ordered all new Spanish settlers had to plant "1,000 vines of the best quality available."[vi] Winemaking flourished. In fact it was so successful that in 1595 the King of Spain forbade new plantings or vineyard replacements in Mexico for fear that the colony would become a self-sufficient wine producer.[vii] As in Europe, viticulture was preserved and perfected in North America by the church, in particular the Franciscan missions across Mexico. The first vineyard in what would become America was planted in Mission San Diego, California, by Father Junipero Serra in 1769. The grape variety he planted became known as the Mission grape and dominated California wine production until the 20th century.[viii] By the mid-1800s, with a wave of European immigration and a massive injection of new money from the Gold Rush, the California wine industry was born. For the next 150 years the US wine industry continued to

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march methodically yet unremarkably forward, following in the footsteps of the European wine industry until the early 21st century.

All of this set the stage for the industry's strategic landscape in 2001.

The Industry Landscape in 2001

In the late 1990s, in anticipation of soaring demand during the dotcom boom, California wine growers began planting new vines with abandon. The production of Chardonnay and Cabernet Sauvignon grapes doubled, and Merlot tripled within the decade, making America the fourth largest wine producer in the world. In the four years prior to 2001, the US wine industry witnessed tremendous growth with the number of wineries growing more than 24% to over 3,000 domestic producers overall.[ix] But while America was the fourth largest producer, it remained stuck at 34th place in world per capita wine consumption.

Consumers faced a choice of hundreds of different grape varietals (Syrah, Shiraz, Cabernet, Zinfandel, Chardonnay, Riesling, Pinot Grigio etc), colors (red, white, pink), packaging sizes (187 ml, 750 ml, 1.5 l etc), styles of wine, countries of origin (US, France, Australia, Italy, Chile etc) and regions (California, Bordeaux, Barossa etc). The myriad choices made becoming better informed a daunting proposition: more than 80% of wine drinkers felt that their knowledge of wine was average or below average, according to a nationwide survey.[x] "Many people still don't understand the place name difference. That Burgundy, if it's red is going to be pinot noir, unless it's from Beaujolais. Côte-Rôtie is Syrah," says Rebecca Chapa of Tannin Management, a San Francisco-based wine consulting firm. "It's really difficult for them [people] with so many options and with so many SKUs on the shelf now."[xi]

Overall the industry was divided into two strategic groups: budget and premium segments. The intense competition in the budget segment fueled industry consolidation. "The consumer wants quality or price – one or the other," according to Denise Johnson of Napa Valley Winery Exchange. "They've got to get one of them. If you're not competing in one of them then, well, you're probably not going to make it."[xii] The top eight companies in the US produced more than 75% of the wine volume, while the estimated 2,500 other wineries produced the remaining 25%. In dollar terms, however, the wines produced by the top eight companies were low priced, selling below $7 per bottle. These low-priced wines accounted for 77% of the volume of wine sold, yet brought in just 48% of sales. At the other end of the spectrum, the remaining 23% of wine sold above $7 were considered premium wines and accounted for 52% of sales. The dominance of a few key players in the low-price volume market gave them an ability to leverage distributors to gain shelf space and put millions of dollars into marketing budgets. Small boutique wineries survived, but they were forced to remain small or risk being clobbered by the majors.

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Estimated 1999 California Table Wines by Price Class

	Retail Price per Bottle	Price Segment	Percent of Total Volume	Percent of Total Revenue
Premium	Over $14	Ultra-Premium	7%	25%
	$7 to $14	Super-Premium	16%	27%
Budget	$3 to $7	Popular Premium	33%	31%
	Below $3	Jug Wine & Others	44%	17%
			100%	100%

Source: M. Silverman, A. Gilinsky, M. Guy, S. Baack, "Robert Mondavi Corporation", in A.Thompson & A.J. Strickland (Eds.), Strategic Management: Concepts and Cases, New York: McGraw-Hill Irwin. 2002.

In the late 1990s, as the wine sector consolidated at the lower end of the market, there had been a simultaneous consolidation of retailers and distributors across the United States. The number of distributors had fallen from nearly 5,000 in the 1950s to approximately 250 by 2000.[xiii] On average there were only two major distributors per state. According to the American Vintners Association, this left only 50 to 100 of the largest wineries – out of more than 2,500 producers – with access to widespread national distribution.[xiv] Reinforcing this claim, research by the American Wine Institute showed that only 17% of its members had distribution in all 50 states.[xv]

At the same time there was also enormous retail consolidation, with the top ten supermarkets controlling 55% of the US market in 2000.[xvi] The giant warehouse chain Costco was the number one wine retailer in America by volume, with Target, Sam's Club, and Wal-Mart close behind. As a result, tens of thousands of local, national, and international wine brands were vying for space on the store shelves of a handful of powerful supermarkets who demanded popular wines at very low prices.

As the bargaining power of distributors and major retailers rose exponentially against the plethora of wine makers, a juggernaut emerged. While the overwhelming majority of wine producers focused on low volume / high priced wines to gain the maximum return on their investment, the distribution system increasingly focused on high volume / low priced products to maximize their economies of scale. "The distribution model is driven by volume and scale because it is a capital-intensive labor-intensive system," according to Vic Motto, CEO of the Global Wine Partners, a wine investment house. "As such, the people who own that system want to take advantage of economies of scale."[xvii]

By way of illustration, a case of wine weighs 15 kilograms (33 pounds) regardless if it contains a $200 bottle wine or a $2 bottle of wine. Therefore, if a winery wants to gain nationwide distribution it needs to produce high volume / low priced wine as distributors generate the bulk of their profits from top-selling volume brands that replenish quickly.[xviii] In the retail and distribution systems, wine is also competing against spirits and liquor for shelf space. Yet wine turnover is notoriously slow (2.4 times/year), compared to the churn generated by liquor (50 times/year) and beer (70 times/year). This is particularly true of premium wines.[xix] With only 350 wineries producing more than 10,000 cases a year (Gallo sold 65 million cases in 2001) the remaining wineries were finding it increasingly difficult to get their product to market.[xx]

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With a growing global grape glut, more and more wineries entering the market, and a simultaneous squeeze in distribution and retail channels it was nearly impossible for a new company to establish a dominant position. Large wineries sought to increase demand by large above-the-line marketing campaigns but with little effect on overall demand.

Despite these challenges, the prestige, glamour, abundance of low-priced grapes, and low barriers to entry invited more and more wineries into the US market. Wine was being made in every state of the US, including Alaska. Although already in the market for several decades, foreign winemakers were eager to penetrate the US market further to make up for decreasing domestic demand. By 2001 imports accounted for 20% of all wine sales in the US.

Start-Up Costs

For budget producers who needed to grow, harvest, press, ferment, bottle, and package extremely large volumes of wine, the capital requirements for entry were substantial. Annual per acre cost was dependent on economies of scale, which equated to lower per unit production, administrative and delivery costs. For a new entrant, an undeveloped plot of land for wine grape production was typically priced at $15,000 to $40,000 per acre over a four year period (the time it takes vines to mature), not including the value of the land.[xxi] Looking back to 2001, in the best areas of Northern California land was valued between $65,000 and $150,000 per acre. Real estate prices were much lower in other winemaking regions of the country, and even less in other countries such as Chile and Australia.[xxii]

Even for large producers these costs were substantial. In 2000, Robert Mondavi, the sixth-largest wine producer in the US, spent over $78 million in capital expenditures[xxiii] – a substantial investment for a low-margin commodity good. "There are tremendous economies of scale for a brand that sells millions of cases of wine vs. a smaller brand of the same quality from the same region," according to Mike Jaeger, president of Canandaigua table wine group.[xxiv]

Taking a look at the nearly 2,500 premium wine producers in the US reveals that nearly 80% of them were "cottage businesses" producing less than 10,000 cases a year.[xxv] One study estimated the first year operating and capital costs of establishing a small 15,000 gallon/year winery – the size of an overwhelming majority of wineries in the US – was between $125,000 and $500,000 depending on the sophistication of equipment, land price, etc.[xxvi] Fixed costs in this category were largely centered on the cost of oak barrels ($300-$700 per barrel) and the time that the fixed capital and cash flow were tied up in the aging process (24-30 months).

Yet with labor costs representing half of per-acre costs, inexpensive leasing options for specialized machinery widely available, and relatively limited real estate investment, small premium providers with minimal acreage faced relatively low barriers of capital investment. In terms of labor costs, the average salary of a winemaker at a small-to-medium sized (10k-50k gallons/year) winery was just $64,000. Compare this to the salary of a winemaker at a medium-to-large sized winery (100k-500k gallons/year), which topped out at an average of $111,000 at the turn of the century.[xxvii] With little to no opportunity for wide distribution, the capital requirements for a small winery dropped further as the large budget players spent over 40% of their expenditures on marketing and distribution costs.

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Demand

From 1997 to 2001 global wine production outstripped consumption by 15-20%.[xxviii] Only 10% of Americans drank wine regularly in 2001 and constituted almost 90% of wine purchases.[1][xxix] Of the remaining 90% who were not regular wine consumers, roughly 44% did not drink and the remaining 46% preferred beer or spirits.[xxx] The average wine drinker at the time was somewhat older (51% of wine drinkers were aged 40-59); they lived in the suburbs or urban areas (80%); were Caucasian/white (85%), and were relatively wealthy (median household income of $78,100).[xxxi] Moreover, the industry was not interested in moving outside of its target customer group: “So 35% of the population drinks alcoholic beverages but they don’t drink wine,” according to wine marketing expert James T. Lapsley. “They’ve tried it, they don’t like it. They’re beer or they’re spirits drinkers. We don’t interview them much because they’ve said they don’t like wine so we’re not going to find out about wine. Can those people be moved over? Who knows. But probably not.”[xxxii]

Overall, the global wine industry was worth roughly $130-$180 billion in 2001 with an average growth rate of 1-2% per year since 1994.[xxxiii] Yet it was also highly fragmented with no one company controlling more than 1% of global retail sales in the same year. Yet the number of companies competing in this market was growing rapidly. From 1975 to 2003 the number of US wineries, for example, increased from 600 to over 2,500, or more than 400%.[xxxiv] Worldwide there were over 1 million producers – 230,000 in France alone – accounting for 20% of all foreign wine purchased in the US in 2001.[xxxv] With little growth in demand and an oversupply of grapes, downward pressure on price and margins set in. As an indication, one of the most popular wines in 2000 launched was Bronco Wine Company’s Charles Shaw, “Two-Buck Chuck,” selling for $1.99.

By 2001 the global supply of wine was overwhelming domestic demand and the alarm bells began to ring in the US wine industry. Realizing it needed to raise demand, the industry’s major players turned to the Wine Market Council – an industry association made up of growers, distributors, and other affiliated wine businesses created to help increase wine consumption in the US. The council responded with a multi-million dollar ad campaign: "Wine. Since 6000 B.C."

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[1] The industry considered a person a “core consumer” if they drank at least one glass of wine per week.

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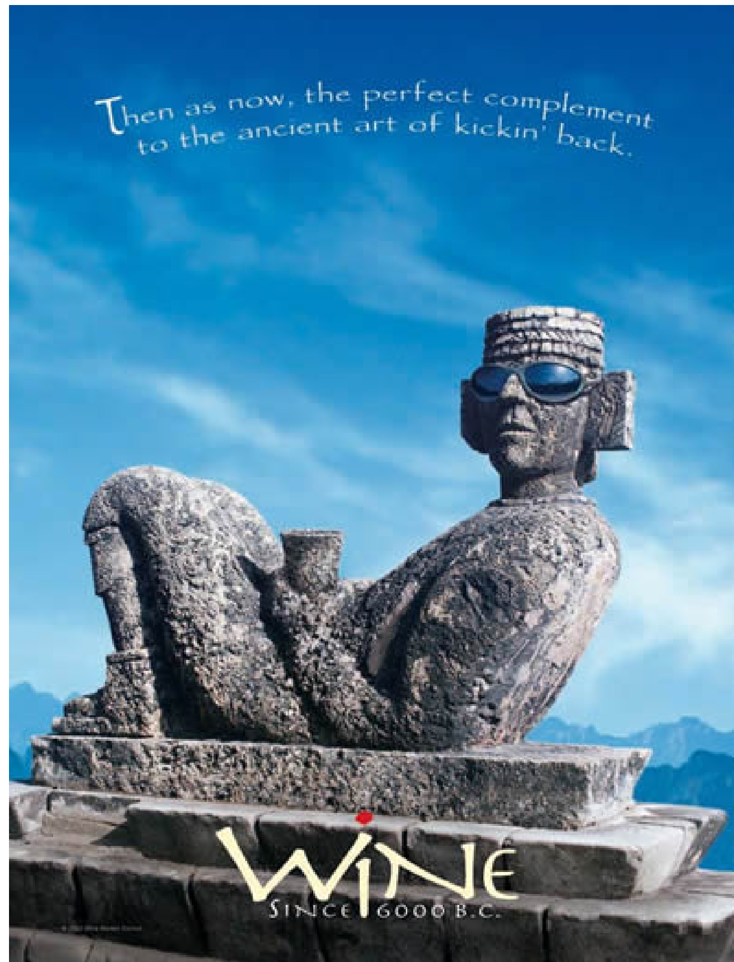

Text in the ad: “Then as now, the perfect complement to the ancient art of kickin’ back. Wine. Since 6,000 B.C."

Now review the questions introduced at the beginning of this case:

1. How attractive is this industry?
2. Following the logic of competitive strategy, should a company enter this industry and if yes, what should their strategy be?
3. Following the logic of competitive strategy, what strategy should an established player follow?

Also, think about and be prepared to answer:

What are the factors the industry competes on and invests in? How long has the industry competed on these factors?

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