Crushed: The Search for an Investment Opportunity in Wine

Not every industry is conducive to long-term growth. In the wine industry, a disruptor from Down Under faces an especially steep climb.

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Key Takeaways

- Viewed through the framework that Harding Loevner uses to examine an industry's competitive environment, winemaking is a horror show. Thousands and thousands of producers must heavily incentivize a highly concentrated set of distributors just to get their products to market.
- Occasionally a company can disrupt and transcend a poor industry. If there was one company in recent years that had a chance to do that in wine, it was Australia's Treasury Wine Estates (TWE).
- TWE's strategy was twofold: leverage the halo effect of its ultra-premium Penfolds Grange brand to create the first global luxury brand of scale in wine, and conquer China.
- Chinese regulators blew up half of TWE's strategy by imposing tariffs of up to 200% and more on Australian wines.
- The company has proved resilient. With disruptive marketing, distribution, and cultivation techniques, it is finding ways around the long-standing distribution bottlenecks and may have even found a clever way back into China.

It is hard to resist wine. Each glass transports us to a different time and place. The more a discerning drinker learns—about the distinctions among vintages, the influence of climate, terroir, and aging—the more opportunities for enjoyment seem to open up. Yet the near-infinite variety and joy of discovery are part of what makes producing wine a difficult business. Durable competitive advantages and the ability to capture a significant market share are keys to sustaining profitability, but they are exceedingly difficult to achieve in an industry where there is always an enticing new offering from an upstart producer beckoning from the shelf.

Source: Treasury Wine Estates

Coldstream Hills Vineyard, owned by Treasury Wine Estates, located in the Yarra Valley just outside of Melbourne, Australia.

This is not to say they *can't* be achieved. On occasion a company in a difficult industry creates such strong advantages versus competitors that it transcends its unforgiving conditions. This phenomenon is admittedly rare but can be quite powerful. Take airlines: for decades, it was a shareholder graveyard haunted by high costs, an undifferentiated product, and exit barriers leading to periodic overcapacity and state support. Then Ryanair wrung savings from airports, crew, and its use of a single efficient plane type, while boosting traffic with fully à la carte fares, to string together years of impressive profits and growth.

The point is one never knows whether among the mass of businesses in a bad industry there might be a gem. But when you look at the wine industry, the conditions for durable growth of profits aren't grape.

Porter, Meet Parker

Historians have traced the practice of winemaking as far back as 7000 BCE in the Yellow River basin in China. The pottery shards recovered at the site are silent on this point, but as Harding Loevner Consumer Staples analyst Rick Schmidt observes, "I think we can assume the industry dynamics have been poor for at least that long."

Schmidt doesn't arrive at his cynical view lightly. When researching a company, analysts at Harding Loevner examine the dynamics of its industry: the extent of internal rivalry, the threat of new entrants, bargaining power of suppliers, the ease with which a company's products might be substituted, and the bargaining power of customers. Together, these "Five Forces" form Harvard Business School Professor Michael Porter's framework for describing an industry's competitive environment.[1]

The wine industry doesn't show well when viewed within this framework. Following are some of the challenges the forces pose to a company looking to grow profitably.

Rivalry

The extent of rivalry in the wine business isn't merely a function of the manifold places and ways in which wine is produced; it's exacerbated by the ways consumers are encouraged to experience the product and think about pairing wine with their mood, music, or meat. At the top of the market, a handful of esteemed vignerons sit above the fray—but these are generally niche players whose products' astronomical prices are driven as much by scarcity value as product quality. For example, Château Lafite Rothschild, one of the world's oldest and most iconic surviving producers, produces only about 35,000 cases (at 12 bottles per case) a year, a drop in the bucket of the 31.4 billion-bottle global wine trade.[2] At the opposite end of the market, mass producers sell tens of millions of bottles each year of the supermarket variety at US$8.99 a bottle on residue-thin margins. For most everyone else in between, it's a constant battle to find buyers for their wine. Definitive numbers are elusive, but there appear to be about 40,000 wineries in the world, say 11,000 in the US alone.

Threat of New Entrants

There's an old joke about how to make a small fortune in wine: "start with a large one." That's true in practice because making wine requires a hefty capital outlay. Land must be purchased and prepared, vines planted and nourished for three years before they can produce the first usable fruit. Once the grapes are picked and processed, the wine is aged in expensive barrels (see "Supplier Power" below) for anywhere from 6 to 30 months, and (advance-sale auctions for rarefied wines aside) the first revenue is typically not generated until year five. This would seem to pose barriers to entry to the advantage of large players with deep pockets. And yet existing winemakers must continually compete against a procession of film directors, retired athletes, tech entrepreneurs, and others who have access to capital and for whom profits often are not a priority—and some of whom develop (or hire) sufficient expertise to earn a high enough score from a top critic like Robert Parker, James Suckling, or *The Wine Enthusiast* to be competitive.[3]

Supplier Power

Supplier power cuts into winemakers' margins in several ways. Grapes for Bordeaux wines are grown only in Bordeaux, Champagne in Champagne, etc. Supply of a varietal from a given terroir can only be sourced from that one place, whose quality and quantity are dependent on the vagaries of weather. Even a good harvest is finite, and you have to wait until the next season to harvest more. So, to the extent you're a winemaker but not a grower or relying on your neighbor's crop to supplement your own, you may need to pay up. In addition, compared to the number of vineyards, providers of other key supplies are far fewer, providing them with a certain amount of leverage. Supplier power has recently come to the fore with pandemic-induced bottle and barrel shortages. The latter has winemakers even more over a barrel after the French government's recent cap on raw oak exports, increasing the bargaining power over foreign vintners enjoyed by oak suppliers and French coopers, whose casks are especially prized by winemakers for their soft tannins.[4]

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Substitution

When an industry's customers can readily substitute for its products another *type* of product, the industry's pricing power is low. An example would be millennials' and Gen Z's apparent preference for fancy cocktails made from spirits and for hard seltzer (technically classified by regulators as a type of beer although no hard seltzer drinker would ever think of it as such) instead of earlier generations' inclination, say, to grab a Bud. Wine actually doesn't fare badly on this force. While it is true that in major markets like the US and Europe the fancy cocktail trend has propelled spirits to faster growth than wine, standard non-seltzery beer has been losing ground even more quickly. Wine at least benefits from being one of the few major consumer categories where consumption increases with consumers' age. Wine still comprises around 20% of the overall alcoholic beverage market by value, with sales growth in the US having generally held steady at around 3% annually over the last decade. However…

Buyer Power

… *within* the wine category the competitive dynamics are abysmal, owing to the concentration of power in the hands of the wholesaler—in effect, the buyer—who decides which bottles make it onto retailers' shelves. The issue is most acute in the US, the world's largest wine market, where distribution is governed by the antiquated "three-tiered" system, established following the repeal of Prohibition to prevent organized crime from vertically integrating alcohol production and sales. To this day, states require retail stores and restaurants to buy wine from distributors. These distributors are the only parties with direct access to wineries, and aside from loopholes like wine clubs or cellar-door promotions requiring sign-ups or subscriptions, neither the distributors nor the wineries can sell directly to the public. The system has contributed to an oligopoly for the distributors. Over the past 20 years, consolidation has allowed the two largest distributors, the privately held Southern Glazer's Wine and Spirits and Republic National Distributing Company, to control over 50% of the US wine market, and the top 10 distributors to account for nearly 75%. Given that the world's largest winery, the family-owned E & J Gallo, manages only 3% market share, the only way most winemakers can reach their sales goals is to incentivize distributors with high commissions. "Producers are basically pasting a hundred dollar bill on every case to get it to market," Schmidt says. It is also a reason why companies like Constellation Brands, Pernod, and Diageo have reduced their exposure to wine relative to beer and spirits, or sold their wine interests altogether.

An Exception to the Rule?

Harding Loevner's analysts estimate that, even in industries with favorable competitive structures, only about 7% of the companies are businesses of sufficient quality and growth to qualify (at the right price) for our investment. In an industry such as wine, it's fair to say the proportion is lower.

Australia-based Treasury Wine Estates (TWE) stumbled onto the public stage in 2011 when it was spun out from Foster's Group, the brewing conglomerate, in a US$1.3 billion write-down by the parent. At one point in 2013, the winemaker mismanaged its inventory so badly that steamrollers were called in to smash millions of unsold bottles. But in 2014, a new management team arrived with a bold plan: it jettisoned low-margin labels in its portfolio to focus on boosting global sales of its crown jewel, the 170-year-old Australian brand Penfolds.

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While Penfolds had experienced its own share of struggles, by the latter part of the twentieth century the label was producing the best wines in Australia.[5] Moreover, head winemaker Max Schubert had created the architecture for something truly novel in his industry: a *scalable* global brand, what he termed a "dynasty of wine." Batch Identification Numbers, or "Bins," were introduced to identify branches of the dynasty by the intensity of resources and focus (aging times, production volumes, etc.) that had gone into each. In this way, echoing a strategy successfully employed by luxury fashion brands, the company could sell Penfolds Grange (Bin 95) for US$500-700 a bottle (if you can find it) while leveraging its halo effect to charge $40 for Bin 311 Chardonnay that might otherwise go for $30. While Lafite (about US$950 per bottle) continued to levitate in its rarified niche, Penfolds managed a neat trick—creating a prestige wine label with production more than 40 times greater than Lafite's.

Today, as the fourth-largest winery globally with over 70 brands including notable Napa vintners Beringer and Stags' Leap, TWE enjoys a leading position in its selected markets—it is the number one producer in Australia with a 20% market share, double the next-largest producer. TWE was also, until recently, the import leader in China, the world's fastest-growing wine market. Wine sales globally have benefitted from the long-term trend of consumers trading up ("premiumization") across all alcoholic beverage categories. In China, wine has become a prestige good and wine drinking a signifier of status. And as wine is a relatively new luxury item in the country, consumers are more willing to choose what to buy based on what those with more experience value. Penfolds, or as it is known locally, *Ben Fu* ("chasing prosperity"), spent liberally on marketing and social media to establish itself as a brand that would not embarrass purchasers in front of their wine-snob friends and is now one of the few wines that many millions of Chinese are able to ask for by name.

TWE also built its own Chinese sales and marketing team so it could sell its product directly into retail outlets and keep more of the profit that even in a less oligopolist distribution structure like China's would otherwise be siphoned off by the company's distribution partners.

According to Schmidt, the combination of these strategies allowed TWE "for about a year or so" to generate the highest returns on capital of any company in the wine industry. By 2019 its returns comfortably exceeded its cost of capital and were trending toward comparing favorably to the Consumer Staples sector as a whole.

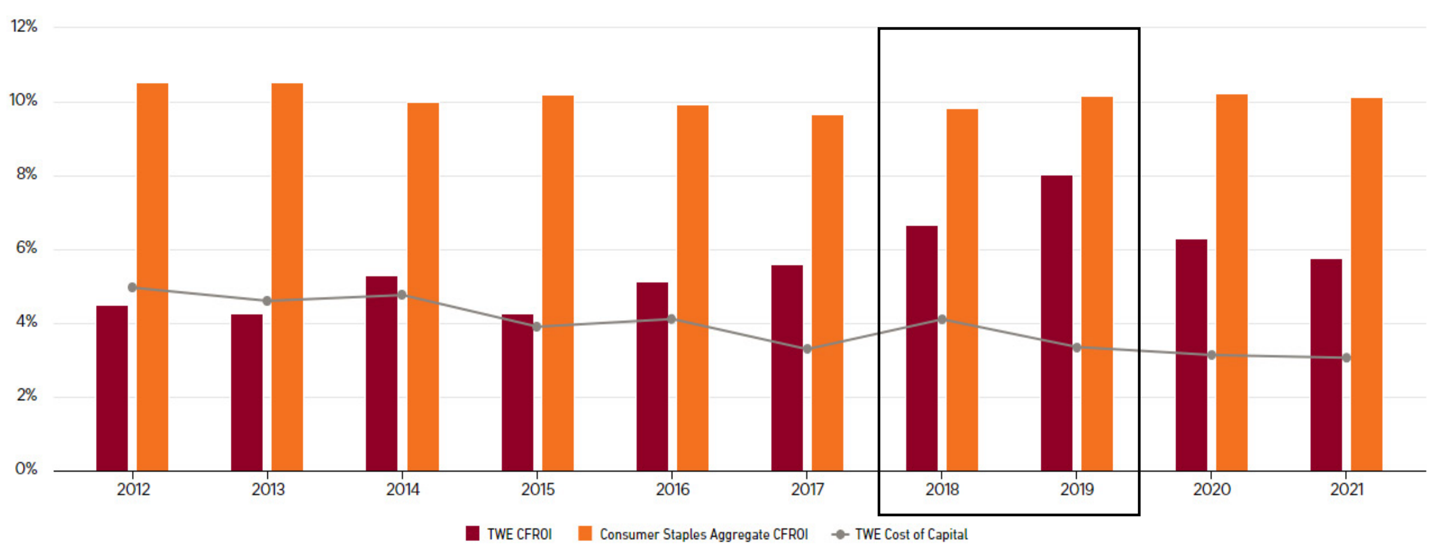
But those returns were soon crushed. In early 2020, China's Ministry of Commerce accused Australian winemakers of dumping product on the Chinese market to grab share from domestic producers.[6] The accusations occurred against a backdrop of rising political tensions between the Chinese and Australian governments over territorial claims in the South China Sea, bans of Chinese-made cellular equipment over concerns about surveillance risk, and a long list of anti-dumping investigations by *Australia* against *China*. In March 2021, after Australia led calls for an investigation into the causes of the original COVID-19 outbreak in Wuhan, China imposed hefty import duties on Australian wines. TWE, faced with 176% duties on its already pricey Penfolds bottles, halted all sales of Australian wine in its biggest and most-lucrative market. The company diverted its excess inventory and efforts elsewhere, including in previously underserved Asian markets such as Vietnam and Thailand.

World Wide Wine

The loss of the Chinese market is a significant blow to TWE. China contributed over a quarter of sales and more than a third of profits in the last fiscal year.[7] However, Schmidt approves how the company has pivoted to pursue new paths to growth. Viewed from a glass-half-full perspective, the loss of its China business is forcing TWE to diversify geographically and go all-in on the ultimate extension of Max Schubert's original vision—transforming itself from one of thousands of premium wine companies into a global luxury brand.

Some of these efforts were in the works before the tariff announcements. For example, in 2020 TWE partnered with the rapper Snoop Dogg on Cali Red, a new California wine under its entry-level premium (US$15-20 a bottle) 19 Crimes label, named for the list of crimes that earned an eighteenth-century English convict banishment to Australia. Bottles feature augmented-reality "Living Wine Labels" allowing anyone with a smartphone to get the photo of Snoop or one of the colonial convicts that's pasted on the front to start talking. According to TWE, 19 Crimes has become its second-largest-selling brand globally after Penfolds and is on track to sell a whopping five million cases a year.

Almost Attractive: Treasury Wine Estates (TWE) vs. Consumer Staples Aggregate



Source: HOLT, Harding Loevner.

Cash-flow return on investment, or CFROI, is a measure of a company's economic value created as a function of the total investment in the business. The chart above shows the CFROI for TWE and for the Consumer Staples sector as a whole superimposed on TWE's cost of capital, also known as the company-specific discount rate.

The company has also accumulated premium vineyards in California, part of its effort to extend its reach among high-end consumers by expanding its Bin system to new growing regions. In a move that strikes at the very heart of the industry's cherished notion of provenance, the company has planted cuttings from some of its old-growth Australian vines and launched various California Penfolds, each of which garnered 90+ scores from critics *The Wine Enthusiast*, James Suckling, *and* Robert Parker. Having also acquired vineyards in France, TWE is preparing to introduce "Penfolds France" produced from similar Australian cuttings.

TWE's "Living Wine Label"

And it has hinted at the possibility of launching production in China. Cultivation abroad, be it in China, California, or France, would allow the company to avoid the Chinese duties on wine made from grapes picked in Australia. Indeed, in a sign of faith in its long-term future in China—and perhaps a bit of stubbornness—TWE's global head of the Penfolds brand is still based in Shanghai.

Becoming a global luxury brand is bound to be costly in the short-term. In addition to building out its distribution channels outside of China, TWE will need to convince new customers—in emerging and mature markets alike—of the distinctiveness of Penfolds's approach to winemaking and that its wines produced outside Australia should command the same premium as those from the original vineyards. This is where the company's latest wrinkle in its distribution strategy could be important. Amid the pandemic, selling wine directly to the consumer has been gaining traction. With regulations in the US varying by state, creating a national wine e-commerce site is onerous work[8] that exceeds the capability of most producers; still, 46 states now allow winery-to-consumer sales. In a bid to capitalize on this trend, and potentially upend its industry's competitive dynamics, TWE has revamped its existing piecemeal digital wine clubs and cellar doors into a full-fledged, more seamless direct-to-consumer portal. "When they're ordering online, I think many wine drinkers will be inclined to go straight for what they know," Schmidt says. "In that environment, maybe there is a singular place for a trusted premium brand with great marketing."

The operative word is *maybe*. For now, the forecast of future growth for TWE is hazy and the company—like many others investigated by Harding Loevner—will require more time on the vine to ripen.

Contributors

Analyst Richard Schmidt, CFA contributed research and viewpoints to this piece.

Endnotes

[1]Of Porter's 15 books, his *Competitive Strategy: Techniques for Analyzing Industries and Competitors* is perhaps the best single source explaining the principles we find so helpful in our own analysis.

[2]Known as "the King's wine" after Cardinal Richelieu introduced it to the court of Louis XIII, Lafite also counted Thomas Jefferson and Robert Walpole as early fans.

[3]Hall of Fame NBA center Yao Ming's Yao Family Wines has earned several scores above 90 points (out of 100) from Parker, including a 96 for its 2013 Napa Valley Cabernet Sauvignon; Boz Scaggs, Fergie, and Brad Pitt are among those who have garnered 90+ marks from *The Wine Enthusiast*.

[4]"Shrinking Supply Sends Price of French Oak Barrels Soaring," *The Drinks Business* (August 16, 2021).

[5]Penfolds was founded in 1844 by British-born physician James Rawson Penfolds and his wife, Mary, originally to make sherry and port for his anemic patients. In the 1950s, the winery transitioned to premium red wine production under the direction of Max Schubert. Early vintages were deemed so awful by Sydney wine critics that the liquor control authorities ordered him to cease and desist. Schubert spent several years improving his recipe in secret before the winery was officially allowed to recommence production in 1960.

[6]China has several different wine-growing regions. One of the largest is in Shandong province near the Pacific coast at the same latitude as Bordeaux. While monsoons during growing season can make mold control challenging, the area is conducive enough to grape cultivation that Lafite has purchased vineyards in the area and produced several wines to rave reviews. (As with all Lafite vintages, production has been kept small: roughly 2,500 cases in 2019.) Further inland, Ningxia, in the foothills of the Helan Mountains on the eastern edge of the Gobi Desert, offers more arid conditions. The high elevation contributes to the intensity of the wines and their rich color (the grapes need to be thick-skinned) but forces vintners to bury their vines each winter to protect them from the cold and snow.

[7]A small portion of the ground lost in China has been regained via rising Australian exports to Hong Kong—June 2021 wine shipments there were up 111% year over year, with many of those bottles, it's believed, eventually finding their way into the mainland through the grey market. Whether Hong Kong becomes an important back door to China remains to be seen, but there is recent precedent: Australia's rock lobster exports to Hong Kong rose 2,000% from October 2020 to April 2021, following the halting of mainland Chinese sales in 2020.

[8]Wineries seeking to ship directly to consumers must jump through many hoops, which vary from state to state, including limiting the shipment volume, collecting and paying additional taxes and fees, and obtaining and confirming requisite permits and licenses. Even then, sales of wines from countries outside the US (including Australia) may be more restricted than domestically produced bottles.

Disclosures

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