The Changing Structure Of The Global Wine Industry

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Abstract

This paper examines the distinctive economic structures that exist in the wine industry in various regions of the world, and it identifies the critical forces driving changes in the structure of this industry. The paper accomplishes these objectives by applying concepts from industrial organization economics, agency theory, and the field of competitive strategy.

The economic structure of an industry affects the intensity of competition and the average profitability of firms in a particular market.[1] While strategy scholars have debated the extent to which industry structure explains differences in firm profitability, virtually no one disputes the idea that structural forces have a sizeable impact.[2] More recently, researchers have demonstrated that industries exhibit substantial structural differences across various geographic markets around the world. These structural differences are driven by institutional heterogeneity and contrasting patterns of historical development.[3]

Over time, the structure of a global industry can change dramatically. In particular, many industries have experienced consolidation in recent years. Industry consolidation raises several important questions for scholars and practitioners. First, why do these structural shifts take place? Second, do structural differences across geographic markets persist as consolidation begins to occur? Finally, do firms that actively pursue global consolidation strategies create value for their shareholders?

The wine industry offers a unique opportunity to examine these questions. There are substantial differences in the structure of the wine industry around the world. For instance, there are 232,900 wine producers in France and the top 10 brands control only 4% of the market. In contrast, four firms control over 75% of the Australian wine market. Overall, one can see a marked difference in industry structure when comparing the "New World" producers (e.g. Australia, Chile, United States) to the "Old World" firms (European producers). These structural differences are driven by institutional heterogeneity and contrasting patterns of historical development. However, they are also driven by the competitive strategies employed by particular firms. This latter point is extremely important. Differences in industry structure are not purely exogenous; they are also a product of the strategies employed by firms in the industry.

The structural differences have become more substantial recently, as industry consolidation has accelerated in some regions, particularly in New World markets. Why is consolidation taking place rapidly in an industry that has remained highly fragmented for centuries? Two sets of explanations exist. One set consists of rational economic (profit-maximizing) drivers of consolidation. For instance, the market power of the distribution channel is rising dramatically, and there are increasing scale, scope, and learning economies available to producers. A second set of factors may be driving consolidation, though this may not be profit-maximizing behavior. Firms in other segments of the alcoholic beverage industry (i.e., beer and spirits firms) are acquiring wineries and driving consolidation because their own markets are maturing. They see entry into the wine business as a mechanism for re-energizing revenue growth. Of course, the motives and behavior of the managers in these firms may not be consistent with shareholder value maximization (i.e. there may be agency problems). Nevertheless, this behavior is fundamentally altering the economic structure of the global wine industry. Thus, we see that not only do firm

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strategies shape industry structure around the world, but the behavior of particular executives, who may be pursuing their own interests at the expense of shareholders, can also alter industry structure over time.

Overview of the Global Wine Industry

There are over one million wine producers worldwide, and no firm accounts for more than 1% of global retail sales in 2001. However, market concentration differs substantially by country. Four firms account for 75% of the Australian market, while the top 20 firms control 75% of the U.S. wine industry. In contrast, the European market remains highly fragmented (See Table 1 below).

Table 1: Market Concentration in Selected Countries – 1998

Nation	# of Primary Producers	Hectoliters (HL) per Producer (000s)	Mkt. Share of Top 10 Wine Brands
US	4,500	4,200	37.6%
Australia	3,000	2,500	24.3%
South Africa	4,654	1,750	24.7%
Germany	68,500	160	8.0%
Italy	275,000	200	6.0%
France	232,900	220	4.3%

Source: Adapted from Morgan Stanley Dean Witter Research

Though its market is highly fragmented, Europe still dominates the global wine industry. 75% of the world's production and consumption take place in Europe, with three countries alone (France, Italy, and Spain) accounting for one-half of the world's supply of wine. Industry observers often distinguish between these "Old World" producers in Europe, and the "New World" wineries in countries such as Australia, Chile, South Africa, and the US. The "New World" increased its share of the global market in the past two decades, while wine production declined dramatically in Europe.[4]

Global consumption has followed a somewhat similar pattern, with overall growth of 1-2% per year since 1994 (**Exhibit 7**). Demand has increased for premium wines, while consumption of inexpensive, lower quality wine has fallen. Industry analysts expect the demand for premium wines to grow at 8-10% per annum for the foreseeable future. These changing consumption patterns have created a great deal of excess capacity in Europe, while New World wineries continue to increase vineyard acreage in response to strong demand for high quality wines.[5]

Wine-making in the New World differs from the Old World in many ways. Small family-owned vineyards produce most of the wine in Europe, while many larger publicly traded firms compete in New World markets. European governments often provide subsidies to these small vineyards. Moreover, many European families continue to make their own wine for household consumption, while Americans and Australians purchase nearly all of the wine that they drink. The New World producers invest much more heavily in technology and automation. These investments and innovations enable them to enhance the consistency and the quality of their wines and to reduce operating costs considerably. For instance, New World producers rely increasingly on machines to harvest the grapes in their vineyards, while most European wineries continue to hand-pick their entire supply of grapes. The New World also has more extensive and well-developed markets for grapes, making it easier for wineries to find multiple avenues for sourcing their most critical inputs.[6] The level of outsourcing differed markedly by region. California wineries outsource 70-85% of their grapes, while French winemakers grow nearly all of their own fruit.[7]

In Europe, strict regulations control many aspects of winemaking including planting, irrigation, classification, and labeling. The French government imposes the most severe restrictions. Often, it takes legal action to protect the nomenclature created centuries ago. For instance, wineries only can designate sparkling wine as "Champagne" if they produce it using three grape varieties grown in the region with the same name. Fewer controls constrain production in nations such as the US, Chile, and South Africa. The Australian industry has

particularly loose controls. The producers can label wines based upon the sourcing of grapes from broad geographical regions.[8] They also can identify the wine by the year it was bottled, rather than when the grapes were harvested. This enables them to combine grapes from different vintages to make a particular wine.[9]
The European wineries also engage in very little consumer branding. Instead, the wines are known primarily by their appellation (region) – Bordeaux, Burgundy, Chianti, etc. The New World producers tend to classify wines according to the variety of grapes used to make the wine (Chardonnay, Zinfandel, etc.) Inexperienced consumers find it much easier to associate the flavor of the wine with a particular variety of grape rather than a geographic region. New World wineries invest heavily in activities designed to educate consumers about wine. They hope to raise per capita consumption by enhancing the level of product knowledge among New World consumers, and by removing some of the "mystique" associated with winemaking. They also spend more money on advertising and promotion in order to build brand equity. After developing a well-known name, many firms extend the brand to an entire line of products, each serving a different market segment.

Structural Differences: Old World vs. New World

Clearly, the New World is much more highly concentrated than the Old World. However, the structural differences go far beyond market concentration. Each of the principal competitive forces differs as well when comparing across geographic markets. In general, the New World appears to have a slightly more attractive industry structure than the Old World.

Buyer Power

Buyer power appears to be higher in the Old World. Consumers are more sophisticated and somewhat more price sensitive in the Old World than in the New World. More sales occur through supermarkets and other off-premise locations in Europe, which would also suggest more buyer power there. In addition, the supermarkets offer private label wines in Europe, while they generally do not in the United States (the exception is Wal-Mart, which recently introduced a private label wine through an alliance with E&J Gallo). The branding in the New World also creates more product differentiation, which reduces buyer power.

Barriers to Entry

Historically, the barriers to entry have been low in the wine industry. However, the big investments in technology and automation in the New World and the increased spending on advertising has begun to raise barriers to entry in those markets. Large physical and working capital investments are now required to start an independent, high-end winery in New World regions such as Napa Valley. American firms such as Gallo and Mondavi have made very large capital investments in new, high-tech wineries. The Old World continues to eschew automation and technology as well as advertising. Therefore, the barriers to entry appear to be lower in those parts of the world.

Substitution

Other beverages are clearly a substitute for wine. However, the most significant difference across geographic regions may be the in-home production of wine. In the Old World, many families still produce their own wine – a clear substitute to purchasing wine at the store. In the New World, people do not generally produce their own wine. Thus, substitution appears to be more of a competitive issue in the Old World.

Supplier Power

The liquid market for grapes in the New World provides wineries with many alternative sources of supply. In the Old World, such markets do not exist, largely due to regulatory regimes in countries such as France. Landowners appear to be able to exert power in particular locations where high-quality land is scarce. This appears to be a problem particularly in France, where most producers are small, and good new acreage is extremely scarce. Land has been more plentiful in many parts of the New World, so the landowners have not been able to appropriate as much of the rents. Landowners have exerted a great deal of power in Napa Valley more recently, as good land has become scarce. In addition, wealthy individuals have bid up prices in that region as they satisfy their desire to enhance their status by becoming a winery owner.

Rivalry

Rivalry among wineries appears to be higher in the Old World for several reasons. First, a great deal of excess capacity exists in Europe. Second, there is a lack of consumer branding, and therefore less product differentiation in the Old World. Finally, the higher price sensitivity of consumers creates more rivalry relative to the New World.

Explaining the Structural Differences

Three main factors explain the structural differences between the New World and the Old World markets. First, there are major institutional differences between these geographic markets. The most obvious institutional difference concerns the regulatory regimes in various nations. France, for instance, employs very strict regulations that constrain producer behavior. On the other hand, Australia has a very loose regulatory structure. For instance, the Australian government allows winemakers to source grapes from disparate geographic regions within the country, while France has very clear and rigid rules regarding its appellations and associated nomenclature.

There are other institutional differences as well. For instance, the European governments often subsidize small farmers who grow grapes. Subsidies tend to be lower or nonexistent in most New World nations. In addition, capital markets and corporate ownership patterns differ across the geographic regions. Europe tends to have many more privately held firms, while most of the largest winemakers in the United States and Australia have become publicly traded corporations. Finally, the prevalence of competitive markets for various commodities differs across nations. For the wine industry, one sees this with the supply of grapes. Liquid markets exist for grapes in places such as the United States, but they are not as prevalent in Europe..

Historical patterns of development represent a second major factor explaining the structural differences between the New World and the Old World. In the Old World, winemaking has been organized around the family farm for centuries. The land has remained in family ownership and control for generations. Consumer attitudes and behavior are also different, because wine plays a very different role in European culture as compared to American or Australian culture. Wine remains part of everyday life in Europe, and consumers drink it along with the daily meal. Wine appeals to a much smaller segment of society in the United States, where a small percentage of people consume most of the wine. These tend to be wealthier and more highly educated individuals. Finally, the motives of the farmers in Europe often are not purely economic; many of these farmers are not interested, for example, in considering the return on their investment including the opportunity cost of the land that they are utilizing to produce the wine. If they considered the opportunity cost, and were interested in maximizing the return on capital employed, then a number of them would seek alternative uses for the land. However, many of these families have made wine for generations, and they have no interest in optimizing economic returns.

Finally, the competitive strategies of firms have re-shaped the industry structure in regions such as the United States and Australia. Publicly traded firms are much more prevalent in these markets. These firms, often in pursuit of new revenue and/or cost savings, have altered the industry structure in particular geographic regions. They have done so through their acquisition strategies, consumer branding and advertising strategies, capital investment plans, and technology initiatives. These strategic choices have re-shaped the competitive landscape in New World markets.

Industry Consolidation

Industry consolidation began to occur in the past decade, particularly among the New World producers. This consolidation took place through three different types of acquisitions. First, some premium wineries purchased or merged with direct rivals. For instance, Southcorp and Rosemount recently merged to become the leading Australian wine producer.[10] Second, jug wine producers began to acquire premium wineries in order to keep pace with changing consumer tastes. For example, Constellation Brands, a leading jug wine supplier, recently purchased small premium wineries such as Franciscan Estates and Turner Road.[11] Finally, other alcoholic beverage firms have begun to diversify into the premium wine business. Foster's Group of Australia, a large Australian brewer, purchased Beringer's Wine Estates of California for $1.47 billion in 2000.[12] Similarly, leading global distilled spirits firms such as Diageo and Allied Domecq have acquired several premium wineries. Table 2 lists some of the largest mergers and acquisitions in recent years.

Table 2: Selected Merger and Acquisition Activity

Year	Acquirer	Target
1999	Brown Forman	Sonoma-Cutrer
2000	Foster's Group	Beringer's
2000	Mondavi	Arrowood
2001	Southcorp	Rosemount
2001	Constellation	Turner Road
2001	Allied Domecq	Buena Vista
2001	Constellation	Ravenswood
2001	Diageo	Seagram's
2001	Allied Domecq	Montana
2002	Allied Domecq	Mumm Nuvee Napa
2002	Allied Domecq	Bodegas y Bebidas
2002	The Wine Group	Glen Ellen Winery
2003	Constellation	BRL Hardy

While consolidation has taken place, the global wine market remains highly fragmented, particularly when compared to other alcoholic beverage industries. The beer industry, for instance, is highly concentrated. Five firms controlled over 50% of the global market in 2000, and this level of concentration rose again recently with the acquisition of the number two American competitor, Miller Brewing, by South African Breweries. In wine, the top five firms account for less than 5% of global retail sales. However, in certain countries, high levels of industry concentration now exist. For instance, the Australian market has become highly concentrated with four firms controlling 75% of that market. See Figure 1 below for a comparison of market concentration in the three principal alcoholic beverage industries.

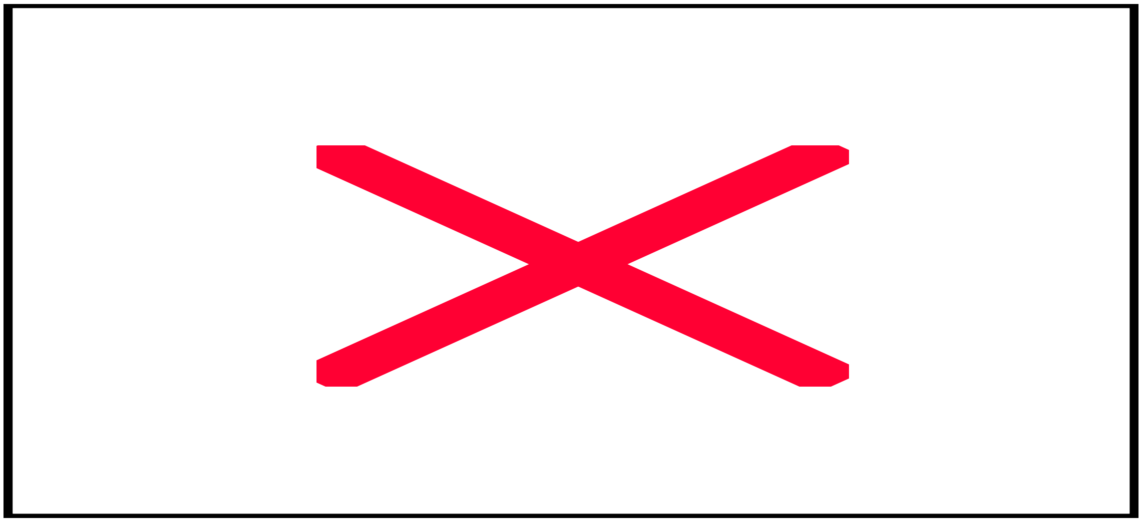
Rationale for Consolidation

What explains the surge in merger and acquisition activity in an industry that has remained highly fragmented for centuries? There are two sets of arguments that bear discussion and evaluation. First, there are rational economic arguments for why consolidation should be taking place in the global wine industry. Second, there may be a series of non-profit maximizing behaviors on the part of the executives managing many of the large alcoholic beverage companies. In short, the consolidation activity may be a result of a substantial agency problem.[13] In the pages that follow, each of these arguments is discussed, and evidence is presented to support both sets of rationale.

Economic Rationale

Four key factors may explain the consolidation trend in the global wine industry. First, scale economies may be achieved by merging vineyards and wineries. Second, scope economies may be realized if wineries are combined with other alcoholic beverage producers (i.e. beer and distilled spirits firms). Third, learning economies may be achieved if global firms have multiple facilities in various regions of the world. Finally, global firms may be able to geographically diversify risk more effectively than focused firms operating in a single area.

Figure 1: World Market Share of Top Five Firms: Beer, Spirits, and Wine – 2000



Market Power with the Distribution Channel

Most producers sell their wine to wholesalers who distribute the products to retail outlets. The typical wholesaler employs a sales force to sell many brands of wine and other alcoholic beverages to both "on-premise" and "off-premise" retail accounts. "Off-premise" retailers include supermarkets, wholesale price clubs, mass merchandisers, and liquor stores "On-premise" locations include restaurants, hotels, and pubs, and accounted for 55% of US dollar sales in 2000.[14]

Major changes have taken place recently in the wholesale and retail wine businesses. For instance, the number of alcoholic beverage wholesalers in the US has decreased by 75% since the early 1960s.[15] Five distributors now control a substantial share of the national market. See Table 3 for data on the industry concentration of the alcoholic beverage wholesalers in the United States.

Table 3: 1999 Market Share – US Wine and Spirits Wholesalers

Distributor	**Market Share**
Southern Wines & Spirits	11.7%
Charmer/Sunbelt	6.6%
National Distributing Co.	5.7%
Young's Market	4.5%
Glazer's Wholesale	4.5%
Total Top 5	**33.0%**
Total Top 10	**45.0%**

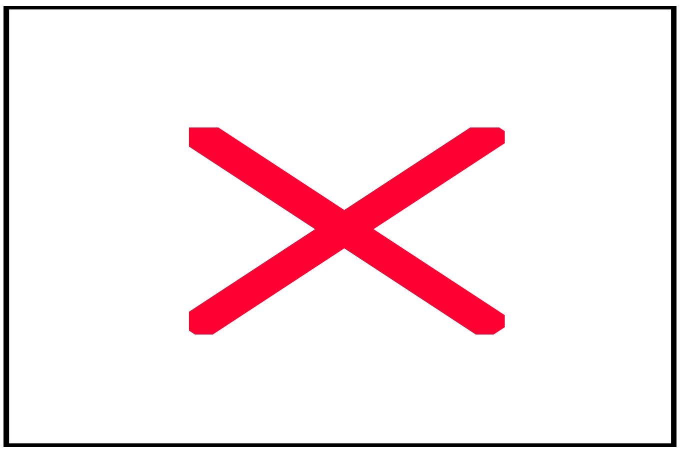
Source: Robert Mondavi

Considerable consolidation has taken place at the retail level too. Moreover, Americans increasingly purchase wine from supermarkets, wholesale clubs, and mass merchandisers. In fact, Costco recently became the largest wine retailer in the United States.[16] Changes have occurred in the off-premise channel too. Many large hotel and restaurant chains now purchase wine centrally rather than at the local establishment level. Matt Kramer, a

Wine Spectator columnist, commented on the impact of these changes: "Today, the problem isn't making fine wine. There's plenty of talent available. The problem now is selling fine wine…distribution, you see, is the real problem...we're seeing wine diversity slowly being strangled."[17]

Distribution and retailing has changed in other countries as well. Large firms, particularly the leading brewers, dominate alcoholic beverage distribution in Europe. For instance, Scottish and Newcastle, the world's eighth largest brewer, distributes more wine than any other wholesaler in the UK, and runs a close second to Heineken in France. At the retail level, the European supermarket industry has become more concentrated in the 1990s.[18] Supermarkets and discount chains represented a major distribution channel in Europe, often accounting for 70% or more of off-premise sales. Many large chains also offer their own highly popular private label wines.[19] See Figures 2 and 3 below for information on the increasing concentration of the food retailing business in both the United States and United Kingdom.

Figure 2: US Market Share of Top Five Food Retailers, 1995-2001



Source: Adapted from Bear Stearns Research

Figure 3: European Market Share of Top Five Food Retailers, 1990-2000

Source: Adapted from Fideuram Wargny Research

In sum, this data suggests that consolidation may be taking place in order for wineries to achieve sufficient scale to combat the market power of the retailers and distributors. This market power presumably enhances the wineries ability to both gain valuable shelf space and to achieve favorable contracting terms. This may explain why wineries have merged, as well as why beer and spirits firms have acquired wineries.

Branding and Advertising

With respect to marketing, the jug wine producers engage in a great deal of television and radio advertising to promote their brands. In contrast, the premium wineries traditionally have not spent much on consumer advertising; they tend to focus on channel promotion. Most large premium wine companies spend only 2-3% of sales on advertising, while such expenditures account for 10-20% of sales for the typical brewer or spirits producer.[20] However, several premium wine firms have begun to advertise aggressively on radio and TV over the past five years. The focus on building brands has become much more intense.

This increased emphasis on branding and advertising creates the potential for scale and scope economies. First, with regard to advertising, larger firms may have more negotiating and bargaining power with advertising agencies, broadcast networks, and print media. Second, larger firms can leverage a brand image first established by creating a prestigious high-end wine by then extending the brand to offer a full range of wines at various price points. For example, Beringer's Wine Estates has effectively leveraged the brand they built in the ultra and super premium segments of the market to then create a lower priced product that has become very popular. Similarly, Mondavi has leveraged its brand name, first established by offering quality products under the Robert Mondavi Winery brand, to then offer lower priced wines under the Robert Mondavi Coastal and Woodbridge by Mondavi brands.

Scale and Scope Economies in Production

Few production economies exist in the wine industry. However, a few are worth mentioning. First, there are scale economies in bottling and packaging. Small wineries pay as much as $2.00 per bottle for packaging, corks, glass, etc. Larger firms pay as little as $0.30 per bottle for this material. In addition, firms with multiple brands and product lines can re-use the oak barrels in which the wine is aged. Oak barrels are a substantial capital cost for wineries. French oak barrels, employed to age high-end wines, typically cost $550-$600 each. A French oak barrel houses 225 liters of wine, or the equivalent of 300 bottles. Thus, the capital investment in French oak barrels runs approximately $2 per bottle. This is substantial particularly because the oak barrels cannot be re-used to make high-end wine. However, large wineries, with multiple brands and product lines, can re-use these barrels when aging lower-priced, lower-quality wines. This enables the larger firms to amortize their capital investment in barrels more effectively than small, focused firms that produce only the highest quality wines.

Sales Force Economies

In the United States, the typical large distributor handles more than 2,000 products.[21] These wholesalers sell wine and spirits to both on-premise and off-premise retail locations. To insure that the distributors will carry a firm's products and ultimately that retailers will provide adequate shelf space, the larger wineries typically employ a direct sales force. The individuals call on both the independent distributors and the larger retail accounts.[22] Direct sales forces are also employed in a similar fashion in other nations.

Some alcoholic beverage producers have tried to leverage a single sales force to sell a broad array of products, including wine and spirits. The goal is to capture substantial scale and scope economies. The results, however, have been mixed. For example, Robert Mondavi has employed a single sales force to sell all of its products in recent years. However, several large distributors have expressed displeasure recently with Mondavi's sales organization. They have argued that a single sales force cannot market and support the company's entire product line effectively. For instance, they note that salespeople need to spend a great deal of time educating the channel about Mondavi's ultra premium and luxury wines. In contrast, the sales force must focus much more on promotions, competitive pricing, demand forecasting, and shelf space management for popularly priced products.

The wholesalers also argue that the brands sell through different channels, making it difficult for a single sales person to support an entire product line. For instance, approximately 80% of the Woodbridge sales (low-priced premium wine) occurs through supermarkets and mass merchandisers, while most high-end wines are sold in restaurants and specialty liquor stores.[23]

Several competitors have chosen to forgo these potential sales force economies of scale and scope, because they have met with resistance from retailers and distributors. For example, Constellation Brands has chosen to employ four separate sales forces for its different product lines. One sales force focuses on the beer and spirits business, while another markets the company's jug and popular premium wines. A third sales force focuses on the imports distributed through Pacific Wine Partners, and another dedicated team markets the company's super and ultra premium wines.[24]

Grape Procurement

Grapes represent 50-70% of the cost of goods sold for a typical producer. Wineries can choose to acquire land and grow their own grapes, or they can procure fruit in the market. Typically, wineries choose to grow a high percentage of grapes for their best wines in order to insure the quality of the final product. In addition, producers often try to establish long-term contracts with growers to insure grape quality. Some evidence suggests that large wineries can realize better contractual arrangements (i.e. better pricing) than smaller producers. However, specific numbers are not available.

Learning Economies

An argument can be made that global firms benefit from having vineyards and wineries in multiple geographic locations, because they can learn about new developments in many parts of the world and then transfer those best practices, innovations, etc. to other regions much faster than smaller firms. For instance, perhaps Constellation can now leverage the knowledge they acquire through their ownership of BRL Hardy's vineyards in Australia, and apply that knowledge quickly and effectively in their vineyards in the United States. Presumably, this type of knowledge transfer is difficult to execute through contractual arrangements among firms; therefore, firms need to actually acquire other vineyards in order to tap into these sources of information about innovative practices and technological advances.

Geographic Diversification of Risk

The final argument for industry consolidation concerns the geographic diversification of risk. Clearly, climate, weather, and crop disease issues create substantial risks for vineyard owners. Therefore, some wineries have sought to purchase vineyards in multiple geographic regions throughout the world so as to diversify away some of this risk. Of course, the counterargument is that shareholders can presumably diversify away this risk more effectively than wine producers. This assumes, naturally, that capital markets are reasonably efficient.

Summary

In sum, there are a number of reasons why consolidation is taking place in the global wine industry. There are some economies of scale and scope as well as other economic factors that could make consolidation an economically efficient outcome. However, consolidation is not taking place in all geographic regions of the world at the same pace. For example, while food retailer consolidation is taking place in Europe as well as in the United States, we do not see the same level of wine industry consolidation in Europe. What can we conclude from this? To answer this question, we have to think carefully about the factors that might constrain a trend toward consolidation in certain regions.

Two issues become apparent when considering this question. First, the size of the scale and scope economies appear to be modest in this industry. As noted above, production economies are limited, sales force economies are questionable, and the geographic diversification of risk may be more effectively achieved by shareholders rather than wine producers. Second, institutional contexts in various nations are quite rigid, i.e. the French regulatory regime is not changing very quickly, nor is it likely to do so. In short, two sets of factors affect global industry structure: economic factors and institutional/contextual factors. While economic factors may be a catalyst for consolidation, contextual factors may be quite rigid, and therefore, may be constraining the trend toward consolidation in some regions of the world.

Competitive Strategies of Firms

Of course, consolidation may not be taking place solely because of changes in underlying economic forces or conditions. Industry structure also changes as a result of the competitive strategies chosen by the firms who operate in an industry or who choose to enter an industry.

Several large firms in the alcoholic beverage market have embarked on aggressive merger and acquisition strategies, to either expand their position in wine, or in the case of some of the beer and spirits firms, to enter the wine business. The question, of course, is whether these firms are truly enhancing value for their shareholders, or whether they may, in fact, be pursuing strategies that destroy value. This raises the question of whether agency problems may be affecting their strategies, and thereby re-shaping industry structure.

Consolidation is taking place because of mergers within the wine industry as well as because beer and distilled spirits firms are entering the wine business. Southcorp, for example, merged with Rosemount – another Australia-based wine producer. Foster's Group of Australia, a leading beer producer, has moved aggressively into the wine business. It's biggest move was the acquisition of Beringer's Wine Estates, a California-based company. Allied Domecq, the world's second largest distilled spirits producer, also has enhanced its presence in the wine business through a series of acquisitions.

The question arises: Are there other reasons why firms are pursuing these merger and acquisition strategies, besides the rational, profit-maximizing pursuit of scale, scope, and learning economies? A closer look at the strategies of the beer and distilled spirits producers offers some insight regarding this question. First, it is readily apparent that the beer and distilled spirits firms are facing maturation of their core businesses in many markets. Most of the competitors admit this openly. Therefore, they are searching for growth. The premium wine business offers an opportunity for higher growth rates.

Tables 4 and 5 show the recent pattern in the consumption of beer and spirits in various regions of the world. Global beer consumption has been completely flat for approximately a decade. Spirits consumption has grown by less than 1% per year over the past ten years. The lack of growth in the beer and distilled spirits markets has caused firms such as Diageo and Allied Domecq (the world's largest spirits producers) and Foster's (a leading beer firm) to pursue growth elsewhere. Of course, the pursuit of sales growth may or may not be good for shareholders. This raises the question of whether agency problems may be causing executives in these firms to seek greater revenue and greater organizational size rather than optimizing free cash flow for shareholders.

Faced with maturation in their core businesses, some of the major beer and spirits producers have targeted the premium wine business. Premium wine offers the potential for higher sales growth rates. Figure 4, shown below, provides some evidence of the growth in the premium wine business in recent years. These data represent California wine shipments, but most analysts agree that premium wine growth rates are similar in other areas of the New World as well. For example, Australian wineries have enjoyed rapid growth in the export of their products to other New World nations. In the United States alone, imports of Australian wine have grown by 30% per year since 1995.

Table4: Beer Consumption per Capita (Liters)

	1990	1998
Czech Republic	179.5	161.2
Germany	143.1	127.2
United Kingdom	113.2	100.8
Australia	114.0	91.9
Netherlands	89.9	84.2
United States	89.9	82.5
Total World	21.3	21.5

Source: Adapted from Banc of America Securities Research

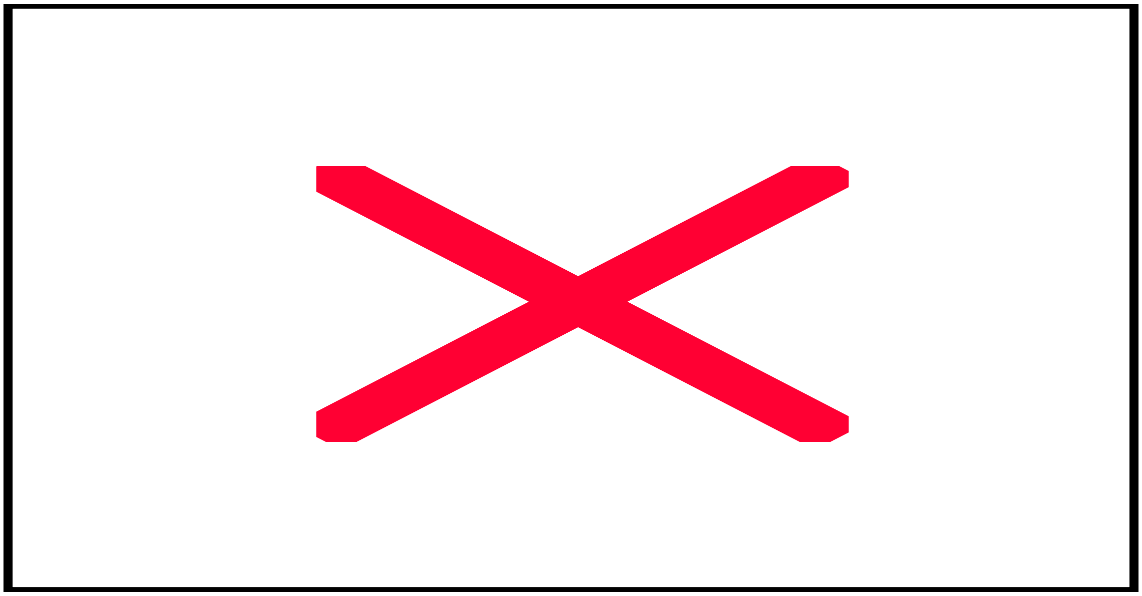
Table 5: Consumption of Distilled Spirits (millions of cases)

	1990	1995	1999
European Union	209	197	193
Rest of Europe	302	271	251
North America	166	149	156
Latin America	286	220	214
Asia	981	1,206	1,282
Africa	19	17	18
Oceania	8	7	8
Total	1,971	2,067	2,122

Source: Adapted from Salomon Smith Barney Research

The alcoholic beverage producers moving into the wine business have been quite explicit about the fact that they see premium wine as their next growth engine, given flat sales in their core businesses. Foster's Group provides the best example of this strategy. They have declared a vision of becoming "a global wine company with a leading presence in every premium wine market worldwide." In their 2001 Annual Report, the company actually has a headline that reads "Beer = Returns," while a second headline reads "Wine = Growth." In short, the company is quite clear that they are deriving cash flow from the mature, but highly profitable, beer business; then, they are using that cash flow to subsidize a growth strategy in the wine business. This raises an important question: does this cross-subsidization strategy enhance shareholder value? If capital markets are reasonably efficient, then shareholders can invest the cash flow from the beer business more effectively than the managers at Foster's; cross-subsidization within the firm's internal resource allocation process is not optimal in this case. Thus, the only way that this corporate strategy adds value for shareholders is if the beer and wine businesses are somehow more valuable together than apart, i.e. if there are sizeable economies of scope. However, the synergies appear somewhat limited. There are no production economies that are readily apparent. Moreover, the same sales force is unlikely to be able to support both product lines. The economies appear to be mainly in the distribution area. Even then, those economies seem to be limited to negotiating power, because there are serious questions about whether firms can consolidate the physical distribution of beer, wine, and spirits without compromising product quality.idate the physical distribution of beer, wine, and spirits without compromising product quality. If, in fact, the synergies are somewhat limited, then one has to question whether it is in shareholders' interests to cross-subsidize from the beer to the wine business.

Figure 4: California Table Wine Shipments by Market Segment



Source: Gomberg-Fredrikson, Robert Mondavi Corporation

The same argument applies for the distilled spirits firms. They appear to be cross-subsidizing as well, using cash flow from their mature, but profitable, spirits business to drive growth in new areas such as premium wine. However, it's not readily apparent that the synergies between the two businesses are substantial. This then becomes a simple story of whether we believe that the capital markets are efficient, or whether we think the executives in these firms are more capable than investors of deploying the cash flow generated by the mature spirits business. Why would executives be employing this cross-subsidization strategy if it does not add value for shareholders? This brings us back to the agency cost argument. Perhaps, this is a classic example of executives whose interests are not well-aligned with those of the shareholders. The executives in these mature businesses may be trying to preserve their power, continue the growth in the size and scope of their organizations, etc. Thus, they may be re-shaping the industry structure through competitive strategies that are a manifestation of an agency problem within these firms.

It is interesting to note that some firms have steered clear of this merger and acquisition wave. In particular, Robert Mondavi and E&J Gallo, two of the largest independent wineries in the United States, have not diversified away from wine into beer and spirits. Moreover, neither has been a big player in terms of acquisitions within the wine industry. After an initial spat of acquisitions of smaller vineyards, Mondavi has been quite clear about their intention to re-focus on organic growth. In their 2001 Annual Report, Chairman Michael Mondavi and CEO Greg Evans described their plans for the future:

We want to stress that as we drive this next phase of our growth, we expect to do so primarily through organic growth, rather than acquisitions. Wine properties have grown increasingly expensive in recent years, and as a result, we are not relying on acquisitions to stimulate our growth. Nor should we. The brands in our portfolio are all high-quality wines with strong market positions and excellent management.[25]

These firms seem to be questioning the validity of the acquisition strategies pursued by many of their rivals. Perhaps this may be explained by the ownership structure of both firms. Gallo remains a privately held firm completely controlled and managed by the founding family. Mondavi is a publicly traded corporation, but the family retains control and Michael Mondavi continues to serve as Chairman of the Board while his brother, Tim, is still the chief winemaker. The fact that both of these firms are family owned, controlled, and led is quite interesting when comparing them to firms such as Allied Domecq or Southcorp. Those firms are led by professional managers who are agents for a widely dispersed set of shareholders. This distinction suggests that the agency cost line of argument may warrant further investigation.

Summary

This paper has documented and evaluated the recent trend toward consolidation in the global wine industry. The main conclusions are as follows. First, the structure of the wine industry is not consistent around the world. This industry provides a vivid example of an industry whose structure varies based on differences in institutional context and historical patterns of development around the globe. Second, the structure is changing, but not at the same pace in different regions of the world. This seems to be the case because of rigidity in the institutional context in the Old World. Thus, we see that contextual rigidities can serve as a constraint on the changing scope of geographic competition even when powerful economic forces are pushing for global consolidation. Third, consolidation is taking place for economic efficiency reasons, and perhaps, for some reasons that are not consistent with shareholder value maximization. The economic efficiency rationale centers on scale and scope economies that have developed in the wine business. The other rationale may be that firms with mature, but profitable, businesses with plenty of free cash flow may be using those businesses to cross-subsidize investments in pursuit of growth in the premium wine industry. This may or may not be in shareholders' best interests. Finally, and perhaps most importantly, this industry analysis provides a vivid illustration of how firms' competitive strategies can re-shape an industry structure, and in a global context, can do so with differing impact across geographic regions. These firms' strategies can alter the economic structure of an industry even when the strategies themselves may not be in the best interests of shareholders.

End Notes

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