

CONSOLIDATION AND LABEL ACQUISITION IN THE CALIFORNIA WINE INDUSTRY

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Chapter 1

INTRODUCTION

The United States economy has experienced a severe downturn for the past several years. As a result, businesses of all kinds have been forced to seek alternative sales and marketing channels in order to survive. The California wine market has not been immune from the effects of global recession. The wine industry has been experiencing a trend of consolidations and acquisitions over the past decade. Large companies are acquiring smaller labels and brands are merging together in order to benefit their business.

The reaction to the downturn by the California wine industry has been multifaceted. Most California wine firms have resisted the temptation to simply lower prices, although some have offered ancillary incentives, such as free shipping or quantity discounts, in an attempt to bolster sales. Others have introduced new labels at different price points in an attempt to maintain sales volume. Since new labels are created, customers will not associate the lower priced wine with the company name, thus reputation will not be compromised. This strategy is viewed as preferable to outright price-cutting on the theory that price increases on existing labels might be met with resistance once the economy recovers.

Another response some wineries have had is to produce a lesser quantity of wine but at a higher quality. This means the wineries are focusing on making higher priced wines for certain consumer segments that may not be affected by the downturn. Not all wine consumers are going

to buy lower priced wines, especially consumers that are more knowledgeable about wine and prefer to consume quality over quantity.

Finally, some California wine firms have reacted to economic pressures by merging with larger wineries which presumably have more capital and staying power to outlast the recession (Martin and Heien 2004). When a winery consolidates with a larger operation, they may receive the benefits of reduced production cost and expanded distribution. Many large wine firms own more production input such as equipment, bottling lines, or trucking that will significantly reduce the costs of wine production. These wine firms also have an established relationship with distributors. Many distributors prefer to work with wine firms that have a diverse portfolio which means having numerous labels at different price points. With a very limited amount of distributors, this established relationship becomes extremely important in the wine industry.

Problem Statement

Has there been a change in consolidation and label acquisitions in the California wine industry in recent years?

Hypothesis

There has been a substantial amount of consolidation and label acquisitions in the California wine industry in recent years.

Objectives

- 1) To determine whether consolidation and label acquisitions have occurred in the California wine industry in recent years.
- 2) To establish what factors have influenced consolidation and label acquisitions in the wine industry other than the recession.
- 3) To assess the effects consolidation has had on the California wine industry in recent years.

Justification

The California wine industry is the fourth largest wine producer in the world, making up 90% of all United States wine (Wine Institute 2010). There are over 6,705 wineries in the United States, with 2,972 of them in California alone (Wine Institute 2010). Many of these wineries have fallen under the ownership of larger wine producers such as E&J Gallo, Constellation, or The Wine Group. These top 3 companies account for 50% of the total wine market in the United States with a combined volume of 150.3 million cases (M. Shanken Communications 2010). Investigating the recent consolidation and acquisition trends of these larger companies will produce valuable information for all members of the wine industry, but most importantly for the wineries, producers, and consumers of California wine.

Small and medium sized wineries will benefit from the results of this report because if there is indeed an increase in consolidation since the economic downturn, wineries will need to prepare themselves during the next economic crisis. If there is another economic downturn in the next several decades, wineries may want to revamp their marketing schemes in the event that consolidation does increase. They can then better protect themselves against industry giants who

have the upper hand in terms of market power and distributorship. Wineries and producers across the country will also need to understand the effects of consolidation and how it relates to their winery. For example, small wineries (less than 100,000 cases per year) may need to make the decision to sell to a large producer or find a better marketing strategy to stay afloat in the competitive industry. Medium sized wineries (100,000 to one million cases a year) are experiencing the most trouble from consolidation trends because they cannot charge the premium price that boutique wineries can, nor can they get priority from distributors because their volume of wine produced is not nearly as much as the volume of the top producers (Bird *et al.* 2002).

Consumers of wine will benefit substantially from consolidation and acquisitions in the industry. The “core wine drinkers” who drink wine approximately once a week include 19 million Americans. Another 29 million Americans drink wine at least once every three months (Bird, *et al.*, 2002). These roughly 48 million wine consumers will be pleased to know that consolidation will create higher quality wines at all price levels.

Chapter 2

LITERATURE REVIEW

Prior to the recent recession in the United States, the wine industry was experiencing several mergers and acquisitions among industry giants. Some of the notable acquisitions in 2007 include Duckhorn and Stags Leap (Smith 2011). Duckhorn sold a controlling share to GI Partners, which is a private equity firm in California (Heimoff 2007). Stags Leap was bought by Chateau St. Michelle in 2007 but was sold again to Treasury Wine Estates (formerly Foster's Wine Estates) in 2009 (*Wine Business Monthly* 2009). Aside from these well known winery brand acquisitions, approximately twelve more major transactions took place in 2006 and 2007 that involved wineries and brands worth over \$40 million dollars each. When the economic crisis began in 2008, many of the wine industry giants virtually ceased their merger and acquisition frenzy because like the rest of the economy, they were not in the condition to buy more brands. The few sales that did take place were due to distressed wine companies in a financial decline (Smith 2011).

The Economic Downturn and its Effect on Consolidation

When the economic crisis began in 2008, many of the wine industry giants slowed down their merger and acquisition frenzy because like the rest of the economy, they were not in the condition to buy more brands. Most of the sales that did take place during this time were due to distressed wine companies in a financial decline (Smith 2011). As wine brands lost profitability and began to decline as a business, larger wine firms saw this as an opportunity to purchase brands for a “bargain” price and use their capital and skill to turn things around (Motto 2011). This type of acquisition is a form of horizontal integration.

There are two types of integration: vertical and horizontal, both of which are achieved by acquisition and/or merger. Vertical integration is one that creates innovation within a company by making a new product line under the same company. An acquisition, on the other hand, is one company buying out another (Chatterjee, Lubatkin, and Schoenecker 1992). In response to the recent economic downturn, the wine firms trended towards horizontal mergers in order to combat disintegration of smaller wineries that could not gain access to distribution (Cholette 2006). Through this horizontal relationship, larger wineries can gain profits once the smaller wineries that they merge with gain name recognition. This name recognition is garnered by bargaining power of the larger wineries that already have recognizable (and thus economically profitable) labels.

Horizontal integration has been a trend with major wine companies in the United States such as Gallo, Constellation, and Kendall Jackson. In a 2001 study of horizontal integration, researchers attempted to determine what firm effects influenced horizontal mergers. The results of this study stated that performance benefits of horizontal mergers can be affected by several factors such as characteristics of the product-market that the firm competes in, the influence of the firm, the state of the industry, the population size of the time, who the firm is and the power

they hold in the industry, how much of a market share the product has, and the similarities of the two companies or products merging (Cotterill, *et al.*, 2001). What these variables signify is that not every horizontal merger has the same success. A horizontal merger between Gallo and another wine label may be quite different than a merger of two small wine labels. Gallo is larger and thus has more of a market share, clientele, and capital to invest, while two smaller wine labels may not have the resources to successfully merge.

Other Reasons for Consolidation

Bird, *et al.* (2002) attributed one reason for consolidation to the low level of core wine drinkers in the United States. Even though the United States is the fourth largest producer of wine in the world, it is not a wine oriented country such as other top producers like France, Italy, and Spain whose culture is linked tremendously to the consumption of wine. Only ten percent of the adult population drinks eighty-six percent of wine produced in the United States (Bird *et al.* 2002). While the industry is trying to create more advertisements for wine, most producers know that a dramatic increase in wine drinkers is not likely, so they strategize to increase profits by increasing the quality of all wines in their portfolio, thus increasing the price point of the wines.

A second reason for consolidation according to Bird *et al.* (2002) is the alcohol distribution system in the United States, which was implemented after the Prohibition era. The alcohol distribution system, also known as the three tier system, consists of producers, distributors, and retailers. Wineries may follow the three tier system by selling to wholesalers who then sell to retailers, and finally the consumer purchases the product from the retailer. Wineries can certainly choose to sell their wine directly to the retailer however this is often very

difficult and time consuming, especially for small sized wineries. Besides the difficulty and time factors, selling direct to wholesalers has become an issue because distributors are consolidating as well, making it difficult for any winery that is not a part of a large producer to find distributor representation.

Cook (2007) believes consolidation is due to several reasons, one of which is the low rate of organic growth in the industry. Organic growth refers to the natural growth cycle of any business by using its own resources and assets, as opposed to inorganic growth which would involve growth via mergers and acquisitions. Since there has been a low level of organic growth, wine companies have been acquiring other wine labels in order to fill gaps in their portfolios and keep their shareholder value. Large producers would like to fill their portfolios because the broader a portfolio is, the more wine they will have to sell to distributors. Balancing the portfolio will also result in added return (Masset and Weisskopf 2010). Not only does a broader portfolio allow for more products to be sold to distributors, but it also allows for greater access to stable or adequate juice and wine supplies (Pick and Pompelli 1999).

Another reason for consolidation in the wine industry is consolidation in the retail industry (Cook 2007). The retail industry is no stranger to industry giants with big players such as Costco, Wal-Mart, Safeway, and Kroger. These retailers use their bargaining power to dictate price and promotions to the manufacturers, in this case, the wineries (Heffernan, *et al.*, 2001). Retailers also demand a lot more of the product from the wineries. The combined effects of low cost and high volume make it hard for small suppliers to compete. This may be an incentive for wine producers to make label acquisitions because the more wineries they own, the more cases they can supply to retailers. Another factor in the retail industry influencing consolidation is the desire for own-label products (Cook 2007). Many grocers are contracting out large wine

companies such as Adler Fels and Bronco Wine Company to create exclusive blends that will solely be sold at their store. An example of this is the infamous “Two Buck Chuck”, a Charles Shaw wine owned and produced by Bronco Wine Company as a private label for Trader Joe’s. Small wineries do not have the resources or capital to produce private labels in mass quantities.

Wine producers are also finding that the more labels they acquire, the easier it is to expand distribution and sales because they have the name recognition to sell those labels in more places. Another similar reason for consolidation is the reduced costs for wine producers in all aspects of winemaking from equipment to packaging (Cook 2007).

Implications of Consolidation

Wineries and producers across the country need to understand that the competitive landscape in the wine industry is changing (Taplin 2006). Consolidation is producing industry giants that have the power to purchase smaller companies for their portfolios. Those that will be most affected by consolidation are small and medium sized wineries. Small wineries (less than 100,000 cases per year) may need to make the decision to sell to a large producer or find a better marketing strategy to stay afloat in the competitive industry. Medium-sized wineries (100,000 to one million cases a year) are experiencing the most trouble from consolidation trends because they cannot charge the premium price that boutique wineries can, nor can they get priority from distributors because their volume of wine produced is not nearly as much as the volume of the top producers (Bird, *et al.*, 2002).

Consolidation Now and in the Future

Beginning in late 2010, mergers and acquisitions in the wine industry began to heat up again. In October 2010, Four Vines Winery of Paso Robles, California, was purchased by The Purple Wine Company (Wine Business Monthly 2010). However, this time around purchasers are not just industry giants, but medium sized companies in the wine industry as well as firms outside of the industry such as private equity firms or wealthy individuals (Smith 2011). An example of this is in December 2010 when Winery and Roll International Corporation, better known for its ownership of Fiji water and POM Wonderful, purchased Justin Winery of Paso Robles, California (Daniel 2010). Companies outside the wine industry such as private firms and wealthy individuals have interest in acquiring wine brands because they view it as an investment as the stock market begins to pick up again (Smith 2011).

Chapter 3

METHODOLOGY

Procedures for Data Collection

In order to determine whether there has been an increase in consolidation and label acquisitions in the wine industry since the economic downturn began in 2007, data will need to be gathered about the top California wine companies and the brands they own. The easiest way to begin this data collection will be to start off with a list of top California wine firms. This list will be obtained using Adam's Wine Handbook, which is an informative handbook published annually that has detailed information on wineries, regions, grapes, history, etc. If all top wine companies are not listed in the Adam's Wine Handbook, the remaining wineries will be found using online research. Sources with promising potential include *Wine Business Monthly* and the 2010 edition of *IMPACT: the U.S. Wine Market Databank Review and Forecast*. Once the list of top California wine companies is finished, internet research will be conducted to determine the brands under each company. If the brands are not found online via the wine company's website or other respectable source, a personal telephone call or visit will be carried out. Since a similar project was done by Doug Cook and published by *Wine Business Monthly* in 2007, any other methods of data collection will be done by contacting

Cook himself, if possible, and inquiring about his methods used. All other objectives of the project will be addressed by similar data methods of online research and personal research.

Procedures for Data Analysis

Once the brands owned by top California wine companies have been found, the data can be analyzed. Since the previous consolidation report by Doug Cook was done in 2007, the data gathered for this project will simply be compared to the data in the 2007 consolidation project. Since there is not enough available information to the public on wine brand and industry reports, it would be impractical to compare this information mathematically or statistically. Instead there will be an excel chart prepared to compare the information.

Assumptions

Given that this project is loosely based off of the previous report published in *Wine Business Monthly* in 2007 by Doug Cook, it has two major assumptions. This project first assumes that all wineries that had consolidated by 2007 were listed in the report. Since *Wine Business Monthly* is a respectable magazine in the wine industry, and the particular issue the report was published in focused on reviews of the wine industry, it is safe to assume that the majority of consolidations that took place were included in the report. The second major assumption this project makes is that the top California wine companies are representative of the entire California wine industry. As mentioned previously, even though there are over

2,000 wineries in California, the top 3 wine companies account for 50% of the total wine market in the United States (M. Shanken Communications 2010). With this in mind, the project assumes that the top thirty companies account for an even higher amount of wine production and thus are a good representation of the wine industry. A smaller assumption made in this project is that internet technology used to conduct the data is constant. Internet technology is a major source for the data gathered in this project, and it is safe to assume that given the advancement of technology in today's society, the information needed to carry out this project will be available online.

Limitations

The results of this study will be meaningful for the wine industry as a whole; however it will be most meaningful for the California wine industry. Consolidation is a trend that is being experienced globally in the wine industry. Anyone involved in the wine industry will benefit from the information this report will render about increases in consolidation, effects of consolidation, and implications of consolidation. While the report is tailored for the California wine industry, the information can certainly be used as a base for further studies in consolidation in the industry. The information rendered from this study could also be used as a base to predict whether an economic downturn in another state or country that produces wine will result in a change in consolidation.

Chapter 4

DEVELOPMENT OF THE STUDY

After the research and data was collected, there was enough evidence to prove the hypothesis true. All of the data was put into an excel spreadsheet and organized similarly to the *Wine Business Monthly* spreadsheet to see if any new brands were added since their 2007 report of consolidation in the wine industry (see Appendix Table 1. at end). The top wine companies owned a substantial amount of brands in 2007, and many have acquired more since the previous report. However, a few wine companies owned very few brands, such as Bogle Vineyards which solely owns the Bogle label, but is produced in mass quantity and does not need to merge or consolidate with another company in order to stay afloat in this economy. Examples of wine companies who have made substantial acquisitions since the previous report include E&J Gallo, who acquired twenty-four new brands since the 2007 report, Bronco Wine Company with an astonishing forty-four new brands, and Diageo, who added approximately 17 brands to their portfolio. On the other hand, The Wine Group has only added 2 new brands, Almaden and Inglenook, acquired in 2008 (*Wine Business Monthly* 2009). While many of the acquisitions that took place in recent years were not documented in a form available to the public, the few that were publicized seemed to mostly take place in 2008.

Aside from brand acquisitions, another interesting trend that took place with large wine companies was the changing of names. Foster's Wine Estates recently changed their name to Treasury Wine Estates for all of the wine products in order to achieve a better image, since Foster's is mostly known for their beer products. This will allow the wine products to be more respected and not seen as poor quality in the eye of the customer.

Chapter 5

SUMMARY, CONCLUSIONS, AND RECOMMENDATIONS

Summary

Collectively the top thirty companies added many new brands to their portfolio in recent years, but individually, some companies acquired more brands than others. As researched in the literature review, the reasons for this consolidation and label acquisition (or lack thereof) can be attributed to several factors. These factors include the economic downturn, the alcohol distribution system in the United States, the desire to fill a company's wine portfolio for ease of gaining distributors and wine supplies, the consolidation in the retail industry, and the reduced costs of production associated with large companies. Whatever the reason may be for a wine company to consolidate or add a new brand to their portfolio, the effects of this consolidation on the wine industry as a whole are the same. Wineries will be experiencing more competition as large companies continue to buy out smaller brands in their quest to build a thorough portfolio. The effects of increased competition will mostly be felt by small and medium sized wineries as they struggle to compete with industry giants. Mergers and acquisitions will continue to be a trend in the wine industry as the economy picks itself back up, however this time around there

will be more purchases from medium sized companies in the wine industry, companies in unrelated industries, and affluent individuals.

Conclusion

In conclusion, there was a substantial change in consolidation over the past few years. While unable to come to this conclusion statistically, methods of comparing and contrasting the previous *Wine Business Monthly* report to the new consolidation chart revealed a considerable amount of growth of label acquisitions.

Recommendations

Anyone who would want to expand on this project could branch out of the top 30 wine companies and begin finding information on brand ownership of all wineries in California. If this project was to be continued at a later year, a student could add on to the consolidation chart and compare their new information on brand ownership to this 2011 list. As the economy pulls out of its slump in the next few years, students continuing this project could also investigate which companies or individuals purchased wineries, aside from the industry giants.

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NOTE: All sources used for creating the consolidation list came directly from the individual winery websites or a direct phone call to the winery