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What the Wine Industry Can Learn From Concha y Toro (and Constellation Brands)

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Summary

- **Building resiliency.** While the Covid-19 crisis has weighed on results of most wineries, Chile's Vina Concha y Toro posted outsized growth in its most recent earnings call. While some external factors have clearly moved in its favor (e.g. exchange rates), we argue that the growth is mainly driven by its recent efforts to adjust its strategy. We see numerous similarities with changes implemented by Constellation Brands ten years ago that also drove improved results. We explore four key takeaways from the change in strategy that we believe provide food-for-thought for others in the industry: **1.** Organizational structures can become obsolete, and should be reviewed and updated to reflect changes in the market; **2.** Measure what you want to manage (but this requires knowing what you want to manage); **3.** Remuneration incentives must be appropriately aligned with (short-term *and* long-term) organizational goals; and **4.** Learn to let go (brands, personnel… and even customers).
- **Export trends.** The pandemic, coupled with geopolitical tensions and rising tariffs, has weighed on exports of most major wine producers. New Zealand was the major exception, and it continued to see solid growth.
- **US import trends.** The value of wine imported into the US in the first half of 2020 declined 6%, but volumes rose 7%. France saw the biggest declines in the period, as a result of the increased tariffs, while volume growth was driven by less traditional categories, such as high-alcohol wines and vermouths.
- **Currency outlook.** Volatility has been affecting the currencies of major wine exporters – and there will be more in the future.

Building a More Resilient Wine Company

The Covid-19 pandemic has created massive challenges for the wine industry, mainly due to the difficulties facing the on-premise. Given the disruption that this channel continues to face, it will likely take several years for bars and restaurants to return to pre-Covid-19 sales levels. The wine industry will be tested in its ability to adapt to a rapidly changing environment.

Concha y Toro Bucks the Trend

While wine and other beverage companies have come under significant pressure in the current context – particularly during the first half of 2020 – one interesting outlier has been Chilean wine company Vina Concha y Toro (VCT). While declining revenues and margins have been a common theme on earnings calls of publicly traded beverage companies during this period, VCT reported revenue growth during Q2 2020 (the peak of quarantine measures in many markets) of 16.5%, and it noted outsized growth of key, premium brands.

Table 1: Change in net revenues (percent) and operating profit margins (percentage point change) for selected beverage companies during peak lockdown period, 2020

	*VCT**	*Constellation-W&S***	*TWE****	*Diageo****
Net sales	16.5%	-6.5%	-19%	-9%
Op margin	5.6	2.37	-10.2	-13.2

Source: company reports, Rabobank 2020

* three months ending June 30, 2020
** three months ending May 31, 2020
*** six months ending June 30, 2020

It might be tempting to dismiss the positive performance as a case of simple good fortune, driven by external forces beyond VCT's control. To be clear, the results were certainly helped by some changes in the operating context that worked in its favor: the shift to off-premise consumption, lower bulk wine prices, favorable exchange rates, etc. However, to chalk this up to simple good luck would be to ignore the 9% growth in wine sales in 2019, and the outsized performance of priority brands and markets.

The point here is not to put VCT on a pedestal, but to point out that the improvement in earnings was not by chance. The company has implemented a major change in strategy in recent years, to better respond to a changing environment – and the strategy appears to be paying dividends. It is also worth noting that Constellation Brands undertook a similar change in strategy ten years ago, which also led to improved performance.

Wine companies looking to make adjustments in the current environment may find food-for-thought from these experiences, which are worth exploring. Below we lay out some of the key components of the revised VCT strategy; compare this to some previous, similar initiatives at Constellation Brands; and extrapolate the key lessons we think are relevant for others in the industry.

Key Components

Similar to Constellation's experience, The VCT strategy revamp included two main areas of focus:

- Cost savings
- Commercial strategy overhaul

It is important to note that the first component – a focus on improving efficiency and reducing costs – was critical, both in terms of improving profitability, and for freeing up funds that could be allocated to strengthening and improving the commercial strategy.

Cost savings. In the case of VCT, cost savings were generated by reducing the number of distribution centers in the domestic market from 13 to 8, consolidating production facilities and automating processes (i.e. reducing personnel), and other initiatives. VCT estimates that these changes resulted in annual cost savings of approx. USD 24m.

Commercial strategy overhaul. The revamp of the commercial strategy was an intensive project. VCT was a strong player in the value end of the wine market, but the company recognized that it needed to premiumize in order to stay relevant with its consumer base. This required a shift in focus – not just of its brands, but also of its whole route-to-market strategy. This required a review of the brand portfolio (prioritization of brands, culling of unnecessary brands, etc.) to improve focus, a review of personnel, and adjustment of remuneration policies to better align incentives.

The result of this process was a smaller, more focused portfolio of brands – skewed more to the premium segment of the market – and a rejuvenated sales and marketing force that appears more aligned to drive profitable growth.

Key Takeaways for the Industry

Rather than go through a step-by-step review of VCT's overhaul of its commercial strategy (much of the information is available in its reports to investors), we think it is more valuable to focus on some of the important lessons that can be learned.

Organizational structures require updates. The opportunities to generate cost savings will vary from one organization to another, and VCT's experience cannot be generalized. However, the key lesson is that operating structures are built over time and often remain static, even as the market changes. A strategic review of operations with a fresh set of eyes can often identify changes that are both more efficient and more effective. VCT realized that having 13 distribution centers was important when the retail market was highly fragmented, but the consolidation in the retail space in recent years presented an opportunity to reduce the number of regional warehouses – thus reducing costs and improving operations.

Likewise, when Constellation began its strategic review in 2009, it had just come through a series of major acquisitions, leaving it with a very diverse set of brands. As a result, its wine portfolio was housed under four separate divisions, each with its own management. By consolidating the four divisions into one – with one set of management instead of four – the company was able to generate significant cost savings and create one, coherent wine company.

Updating structures and improving efficiency can improve operations, freeing up resources that can be used to grow the top line.

What you measure is what you manage. A key component of VCT's commercial success was knowing which brands it needed to grow and measuring the growth of those brands. This was the result of a process of looking at its portfolio and categorizing the different brands by the role they played. VCT prioritized the brands that offered the greatest potential to grow profits, and it set institutional goals to drive growth for those brands – these are the brands that are driving growth today. While VCT's total volumes rose 3.3% in Q2, its priority 'Principle' and 'Invest' brands rose 11.5% and 16.4%, respectively.

Again, the VCT experience seems to follow very closely what Constellation has done in the past: prioritizing certain brands and tracking their growth. Though it started this initiative nearly ten years ago, Constellation continues to focus on select, priority brands (though the list of brands may change over time). Constellation's Power Brands' (its high-priority group of brands) depletions grew 5.5% during the three months ending May 31, 2020, compared to a decline of 1.1% for the total wine portfolio.

Measuring the things you want to improve is critical, but the hardest part is setting the right priorities.

Aligning incentives with goals. While setting and measuring the right priorities are important first steps, incentives for personnel must also be appropriately aligned. Prior to the new strategy, VCT personnel were more incentivized to focus on growing volumes (with the assumption that increasing volumes would drive an increase in profits). This is likely one of the important contributing factors to VCT becoming heavily skewed to the lower end of the market.

Under the new strategy, compensation has been changed, and it is now skewed much more to driving sales of priority brands via simple, but specific KPIs. This change in remuneration plays an important role in the growth of priority brands, along with the resulting growth in profitability.

Focusing on profitability is important, but there is an important caveat. When Constellation went through its transformation ten years ago, it also shifted incentives for its executives to favor profit growth over volume growth. While this was generally positive, there were also reports that, at times, when top-line growth of profitable brands began to slow, this could create incentives for executives to look for ways to cut operating costs – measures that arguably were not always good for the long-term health of the brand.

Creating incentives that focus on growing profits is a necessary and powerful tool to align activities that result in improved profitability, but companies must be careful that the incentives do not sacrifice the long-term growth potential in favor of short-term profits.

Learn to let go (brands, personnel, and customers). Looking at the recent experience of VCT, perhaps some of the most interesting changes in the company have come not from what it has added, but from what it has let go (and, once again, lots of parallels with the previous experience at Constellation).

<u>Brands.</u> After the initial review of the brand portfolio, a decision was made to discontinue 82 brands – more than 25% of the 300+ brands in VCT's original portfolio. Culling brands can be hard decisions to make, as every brand is important to one customer or another, often generating some level of incremental sales. That said, a highly fragmented portfolio can make it difficult for the sales force to focus on brand-building and to explain to customers the 'unique role' that each of those brands plays in the market.

For wine companies carrying brands that no longer fit their needs, the VCT strategy of culling brands is one option, but they may also consider selling brands that no longer fit their strategic priorities – assuming the brands still have value in the market (e.g. Constellation's pending sale of ~30 brands to E&J Gallo).

It is important for wine companies to innovate and test new brands in the market to meet emerging consumer needs. However, this can result in portfolios cluttered with brands that serve little purpose, undermining the ability to focus on building brands. Whether a wine company decides to discontinue or divest unnecessary brands, it is important to continually review portfolios for brands that no longer serve a critical purpose.

<u>Personnel.</u> Several years ago, Rabobank invited Gary Veynerchuk, the famed wine industry entrepreneur, to speak at an annual North American client event. Among the points he raised, he noted that companies looking to effect change need to be willing to let go of employees who cannot, or will not, get on board with the new strategy – even if they are top performers. Of course, all efforts should be made to maintain current staff to the degree possible… but there will always be those who resist change, and this can derail the process. Companies need to be willing to let them go, even if they have been star performers. For VCT, implementing the new strategy has required personnel changes (fairly dramatic ones in specific regions). New roles were created, and employees with new skill sets were brought in, but some employees with time in the company also needed to be let go because they lacked the skills (or willingness) to change. This can be the most painful part of implementing a change in strategy, but it is often a necessary part of survival.

<u>Customers.</u> Perhaps the most counter-intuitive lesson from looking at the VCT experience is the need to be willing to let go of customers. The success that VCT is currently enjoying in (at least) one of its major export markets is due to the fact that, several years ago, it came to the conclusion that it was spreading itself too thin, spending too much time selling to too many retailers who generated too few sales. VCT decided to change tactics and build deeper

relationships with a smaller number of larger retailers – and the strategy appears to be paying dividends.

Once again, we see some correlations to Constellation's experience ten years prior, as it reassessed its relationship with its wholesalers in the US. Prior to its strategic review, Constellation's wine portfolio was under four different wine divisions, each one with a different wholesaler in any given state. Given the fragmented nature of the portfolios, they were not particularly important to any one of their multiple distributors. When Constellation combined the portfolio, it was much larger and much more valuable to wholesalers. The company awarded the distribution contract based on a competitive bidding process. This instantly made it the largest wine supplier to the largest, most important US wholesalers, giving it much more leverage in the market.

The experiences of both VCT and Constellation serve as an important reminder that, when it comes to relationships with customers, investing to create deeper relationships can be more fruitful than having more, shallow relationships, though it is important to remain mindful of concentration risk.

Conclusion

At a time when most wine companies are struggling, both VCT and Constellation Brands have been able to deliver growth in the operating profits of their wine portfolios. In both cases, this appears to be the result of changes in tactics – changes that have required difficult decisions about the brand portfolio, remuneration, personnel, and customers. The precise moves that these companies made are not necessarily a blueprint for all wine companies to follow, but they should, at the very least, provide some useful food-for-thought about the path forward.

Export Trends of Major Producers

The Covid-19 pandemic has brought mixed fortunes for wine exporters across the globe throughout 2020. For some, when combined with trade and geopolitical tensions, sales momentum established in recent years to key markets such as the US and China has stalled or even reversed. At the same time – somewhat against the odds – some countries have experienced positive demand, driving both increased export sales value and volumes year-on-year in the eight months to August 2020.

Table 2: Change in wine exports for selected countries

Country	*Volume change YOY (%)*	*Value change* YOY (%)*	*Period of measure*
France	-11.0	-21.0	Jan–Jun 2020
Spain	-10.0	-5.6	Jan–Jul 2020
Italy	-2.6	-4.1	Jan–Jun 2020
US	-6.2	-14.3	Jan–Jun 2020
Argentina	48.2	-2.7	Jan–Jul 2020
Chile	-1.6	-8.1	Sep 2019–Aug 2020
South Africa	-9.3	n.a.	Sep 2019–Aug 2020
Australia	-8.9	-0.8	Jul 2019–Jun 2020
New Zealand	10.7	9.7	Jan–Aug 2020

* value changes in local currencies, Argentina and Chile in USD.

Source: Istat; I numeri del vino; OEMV; French Directorate-General of Customs and Indirect Taxes; Wine Australia; SAWIS; ODEPA; Stats NZ; Observatorio Vitivinícola Argentino; Gomberg, Fredrikson & Associates; Rabobank 2020

US

In 1H 2020, US wine exports declined by 6% in volume and 14% in value. Bottled wine exports drove this decline, down by 22% in volume and 19% in value. The numbers reflect a significant contraction in sales by volume to Europe (-42%), China (-66%), Japan (-25%), and Hong Kong (-32%). By value, these four groups accounted for almost 75% of the reduction in total sales value of USD 103m, with Hong Kong accounting for almost USD 45m of the reduced sales value and China almost USD 9m. Overall bulk wine sales rose modestly by 6% and 5%, respectively, for volume and value – but nowhere near enough to offset bottled export reductions.

Argentina

Argentine wine exports in the first seven months of 2020 slowed from the first four months, but still saw a massive 48.2% increase in volume, with value declining by 2.7% when compared to the same period of 2019. Bulk wine exports have accounted for the majority of the growth, up by 137% (73m liters) and 44% (USD 15m). But this growth has come with a reduction in average value per liter of over a third.

Chile

In the 12 months to August 2020, Chilean wine exports decreased by 1.6% YOY in volume terms and by 8.1% in value (USD). Bulk wine suffered the largest decline in price per liter, down by 14.4%. Although volume was only down by 1.3%, there was a marked reduction in total bulk export value, down by 15.5% (USD 55m).

Following the trend of earlier in the year, packaged exports to China continued to decline, down by around 36% YOY, respectively, for both value and volume, as Chinese wine imports continued to decline under the impact of Covid-19. Packaged wine sales to the UK, Brazil, and Japan helped to offset these losses – collectively up by 23% for volume and 15% for value. Bulk exports declined by 4.6% for value and 17% for volume, with sales to China also suffering materially, down by 60% for volume and 68% for value YOY. Increased exports to the US, UK, Canada, and others did not do enough to offset this.

Australia

In the 12 months to June 2020, the value of Australian exports dropped by less than 1% YOY, to AUD 2.84bn, with volumes declining by almost 9%. Underlying this volume change was a decline in the lower value segments, with a continued focus on lifting more sales in the premium packaged wine segment. Average prices per liter for Australian wine rose to AUD 3.89, which is the highest average price in over 15 years for Australian wine exports. This is despite a contraction in wine sales to China over the period 1H 2020, as Covid-19 hampered Chinese wine import demand.

At around 39% of total sales value, but only around 17% of volume, the ratios of Australia's wine exports to China were similar to 2019. However, absolute volume dropped by around 17%, while value rose slightly, by 1%, for the 12 months to June 2020. In 1H 2020, Covid-19 pushed the total value of exports to China down by 16% YOY and 23% YOY, respectively, for value and volume for the six-month period.

Exports to the US and UK rose in 1H 2020, meeting increased demand borne by a switch to retail channels and home-based consumption in both markets with the disruption created to foodservice by Covid-19. Bulk wine exports declined by 9% in value and 14% in volume for the period.

With China announcing two investigations of Australian wine exports to China in August – separate anti-dumping and countervailing duties investigations – a shroud of uncertainty now hangs over exports to Australia's highest-value market across the balance of 2020 and possibly into 2021.

We expect to see a deceleration in exports across the next quarter, reflecting the impact of Covid-19, uncertainty related to China, coupled with subdued Chinese wine import demand and a low 2020 vintage applying pressure to Australian inventory levels.

Italy

For the first half of the year, Italian wine exports declined by 4.1% YOY in value, to EUR 2.9bn, and by 2.6% in volume, to 10m hectoliters. The numbers benefited from an improvement in the trend in June (-4% YOY, although this was in part due to a lower comparable base, as June 2019 was a weak month), following the dramatic decline experienced in May, at -24% YOY. By products, bottled wines were down by 3.5% in value and 2.9% in volume; bulk wine was up by 1.5% in value, but volumes were down by 5.9%. Sales of sparkling wines, which have been a key motor in Italian wine exports in recent times, have slowed, due to their greater exposure to out-of-home consumption: volumes were up by 3.2% YOY, but exports in value terms declined by 7.6%. Only in June, sparkling wine exports declined by 12% in value and 7% in volume, when compared to the same month last year.

In markets, exports to the UK, Switzerland, Japan, and the US were down. Sales to the Netherlands, Belgium, and Canada increased, while sales to Germany were virtually unchanged.

France

In 1H 2020, French wine exports declined by 11% in volume and by 21% in value terms. Export values were therefore not only affected by lower volumes, but also by an adverse change in the mix. As an example, champagne exports were down by 30% and Bordeaux wines by 32%. In July, the trend saw some improvement, with exports down by 9% in value terms when compared to the same month of the previous year. Exports to the US – down by 30% in 1H and in value terms – remained weak in July, at -19% YOY. Sales to other major countries were also sharply down: UK -23% for 1H and -7.5% in July; China -43% and -11.5%, respectively; and Germany -11% and -15% – all in value terms.

Spain

During the first seven months of 2020, Spanish wine exports declined by 5.6% in value, to EUR 1.44bn, and by 10% in volume terms, to 1.1bn liters. Despite the negative numbers, there has been some recovery in June and July, with year-on-year growth in value terms for both months, even if volumes were virtually flat year-on-year (+0.2% in June and -1.8% in July). The lower volumes in July reflect a contraction in bulk wine exports that was only partially compensated by an increase in bottled and bag-in-box sales. For the accumulated seven months, exports of bottled wine to the UK, the Netherlands, and Canada increased in value, but sales to other major markets such as Germany, the US, and China were down. The new legislation in Russia has had a very adverse impact on imports of Spanish bulk wine.

New Zealand

Despite the Covid-19 environment globally, demand for New Zealand wine has continued to rise. Exports of New Zealand wine by volume and value are running 10.7% and 9.7%, respectively, ahead of the same time in 2019 for the eight months to August 2020. Packaged exports have dropped slightly, by 2% for volume, but are up by around 2% by value. Increased home consumption, driving retail demand in key northern hemisphere markets, is supporting an increase in bulk wine exports, particularly to the UK and Europe, with packaged exports to the US also rising. MAT to August 2020, sauvignon blanc exports were 261m liters (up 13% YOY and 88% of total exports). Exports of the 2020 sauvignon blanc vintage are also running ahead of the same time in 2019, with shipments of this year's vintage commencing in May 2020.

South Africa

South African wine export volumes declined by 9.3% in the 12 months to August 2020. Bulk wine exports were down 8%, and bottled wine exports were down 11%.

Exports to the UK, the largest buyer of South African wine, declined 2% by volume for bulk wine and 7% for bottled wine sales. Exports to Germany, the second-largest destination, also declined. Wine exports to China were down by 41%, or 3.3m liters for the 12-month period. South Africa, like most other exporters to China, is also feeling the impact of Covid-19 on China's foodservice sector.

US Import Trends

Over the six months to June 2020, US wine imports decreased by 6% in value, but rose 7% by volume – with the impact of Covid-19 biting into foodservice sales across the back end of Q1 and all of Q2.

Imports of packaged table wine decreased by 11% in volume and by 23% in value. Put another way, volume dropped by 4m case equivalents and value by USD 494m. The majority of this would have been destined for foodservice channels. France, Germany, and Spain took the biggest hits in packaged wine, collectively accounting for the majority of the downside. France was down by 55% for value and 37% YOY for volume, having taken a double hit from a tariff disadvantage alongside Covid-19 disruptions. New Zealand and Portugal were the only two key suppliers who experienced an increase in demand for packaged wine exports for both value and volume.

However, the decline in packaged exports was partially offset by an increase in bulk wine imports. Bulk imports rose by around 0.7m cases (+4%). Much of this import volume will have been redirected into retail channels in order to meet rising consumer demand due to lockdowns. France and New Zealand were the main benefactors of a rise in demand for bulk wine – New Zealand up by 20% for value and 8% for volume. The net effect of this lift for France, however, only partially offset declines in packed wine imports – clawing back 12% and 4%, respectively, of the lost volume and value from packaged exports.

Much of the growth in import volumes was driven by less traditional categories, such as still wines over 14% alcohol, and vermouth.

Table 3: US wine imports by country of origin, Jan–Jun 2020

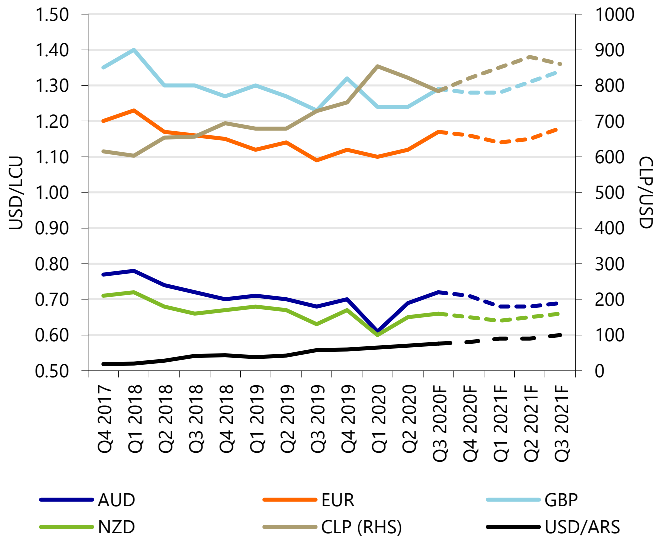
	Value (USD m)	*Change YOY (%)*	*Volume (thousand cases)*	*Change YOY (%)*
Italy	1,054	4	22,011	7
Australia	144	-12	6,819	-8
France	777	-26	9,204	-13
Spain	175	-11	4,495	-9
Chile	112	-5	7,965	12
New Zealand	265	10	4,867	8
Argentina	137	-1	3,304	-19
Portugal	54	6	1,336	13
World Total	3,038	-6	81,243	7.4

Source: Gomberg, Fredrikson & Associates; Rabobank 2020

Currency Outlook

USD weakness was again a theme through most of the third quarter, though this couldn't prevent the ARS from losing more ground amid capital flight and a draining of FX reserves. Against most crosses, the greenback softened amid a revival in risk appetite, in part fueled by the huge liquidity provision on offer by the Federal Reserve. That said, a deterioration in risk appetite late in September did allow the USD to pull back some ground. Volatility in the GBP rose again in September, on the back of a spike in UK political uncertainty, as the British government threatened to break international law with respect to the Brexit Withdrawal Agreement that it had signed less than a year before. This fueled fears that the EU would fail to agree a comprehensive trade deal with the UK. The AUD gained ground, as iron ore prices were buoyed by a revival in Chinese industrial activity – though talk of more monetary easing from the RBA did creep in late in the quarter. The NZD lagged its neighbor's gains, on the threat of negative interest rates from the RBNZ.

Figure 1: Wine currency movements and forecasts, Q4 2017–Q3 2021f



Source: Bloomberg, Rabobank 2020

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