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WINE INDUSTRY ADVISORS

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U.S. Three Tier System

The United States is somewhat unique in its distribution of beverage alcohol products. Many countries use a mix of two tier and three tier distribution systems whereas the U.S. primarily uses a three tier system. The three tier system is an out-growth of the repeal of prohibition in 1933 with the ratification of the 21st amendment to the U.S. constitution. It is interesting to note that the beverage alcohol industry is the only industry that is the subject of two constitutional amendments.

In 1933 one of the goals with the repeal of prohibition was to assure that suppliers would not have undue control of retailers. At the time the major suppliers were relatively large in a marketplace of mostly independent retailers. As the marketplace has evolved retailers have become the dominant factor for most consumer goods. The term category killer is a fitting descriptor for some major retailers. As retailers have evolved the tenants of the repeal of prohibition may now protect suppliers from over domination by retailers.

Conventional wisdom holds that the U.S. is the most profitable beverage alcohol market in the world. This is due to several factors including the size of the marketplace, the disposable income of the U.S. consumer, the diversity of market in terms of the accounts and channels in which to sell, and a highly efficient distribution system for the majority of products. The three tier system does not materially contribute to the first two factors but it is the major contributor to the later two factors.

As an industry we have seen significant litigation regarding the three tier system and this document will not focus on the relative merits of the commerce clause versus the 21st amendment. However, an interesting consideration is what would happen if the current three tier system, which is legally mandated for selling most wine, ceased to exist in the United States? One cannot assume that the marketplace would stay the same and wineries would just have the option to either use the existing system or sell direct to licensed accounts. Looking at marketplace dynamics in countries such as the U.K. or Australia, the likely evolution over a decade or so would be:

- Major retailers would expect to buy directly from suppliers. Shipments would be made to their regional distribution centers and the retailers would be responsible for deliveries to individual stores. This is generally how the major retailers operate in states such as California but would likely drive the same system in states such as Illinois and Washington.

- As major retailers were able to drive the wine business through their regional distribution centers they would put more pressure on state legislators to allow sales of wine in grocery stores in all open states. Economic pressure would probably necessitate this as the marketplace evolved leading to the major retailers being the major source of wine in almost all states.

- The major retailers would push for their costs to be comparable to the laid in prices of the wholesale tier less any price support typically paid by the suppliers which would happen fairly quickly. Major grocers who have relied upon the distributors for merchandising support would initially use some of the incremental margin to underwrite additional staff in their stores. It is likely that discount chains would pass on the cost savings to consumers which would lower prices in the marketplace. The major grocers would have to meet these prices to be competitive and wine prices would in general fall. After a decline in wine prices the major grocers would not be able to underwrite store support staff for the wine category so they would simplify the product offering to cut costs. This could mean a reduction in the number of SKUs that they offer of between 10% and 25%.

- As overall price points fall the total ring for wine may actually decline. This would make the wine category less interesting to retailers. To address this they would simplify their offering further by reducing more SKUs and the number of items they maintain in their warehouses. They would also expect higher margins for the SKU's that they retain on their shelves thus lowering producer's prices and margins even further.

- The major wholesalers would be significantly impacted by this as they lost the volumes to these major retailers. To adjust their business models, since they would be primarily focused on independent off premise accounts and on premise accounts, they might expand their portfolios to all types of beverage products for the customers they would be serving.

- The wholesaler's customers would be at a competitive disadvantage to the major retailers since they need to rely on a local wholesaler which adds additional costs compared to the major retailers. To address this cost disparity the wholesalers would need to become more efficient by simplifying their business. Like the retailers, they would also cut the number of SKU's that they handle and probably reduce value added services. This would likely mean that the wholesaler may become more of a delivery service and all true selling skills would decline over time. (Some people might say this is already the case but a close examination of the UK model shows that there is actually a significant amount of selling that goes on in the current U.S. model that does not take place in a market like the UK.)

- The independent off premise business would evolve to two extremes. Either convenience selling which would be limited SKU's in stores with staff who have no real knowledge of the category, or a limited number of high end retailers that would cater to the very knowledgeable consumer. These accounts would not generally be able to compete with the major retailers for national brands so they would truly be specialist retailers. The mainstream liquor store or large format liquor specialist would primarily fade away due to an inability to compete with the major retailers on national brands.

- The on premise business would find feature prices for national wine brands in the major retailers an impediment to their sales. They would likely move to products primarily sold in the on premise. However, because consumers will be used to lower prices in the major retailers they will expect lower prices in restaurants as well. Restaurants will need lower prices for existing brands not sold in the major retailers, or they will source new brands at lower prices.

- There would continue to be a very high end on premise business likely serviced by small specialist wholesalers. Due to logistic constraints of small wholesalers they would primarily service a limited number of accounts in major metropolitan areas. Likewise this type of wholesaler would only be able to handle a small number of the 6,000 U.S. wineries as well as a small portion of the currently available imported wines.

The outcome of this evolution over time would be a wine industry primarily reliant on a limited number of major retailers. Consumers might have lower prices on key national brands at the expense of significantly less choice in the market. A few wine companies at the very high end, maybe 2% to 3% of producers at most, would not see much change given strong demand for relatively limited wines. The rest of the industry would be impacted by lower price points, lower margins and fewer points of distribution.

A long term future without the legally mandated three tier system would not be very attractive but likewise the current system has its problems as well. Some other points to think about:

- Wholesaling in most industries is consolidating to achieve greater economies of scale. The wine and spirits industry is no different and this is a portion of the ongoing consolidation. Likewise with the consolidation of the major spirits companies this is another driver of the consolidation of the major wine and spirits wholesalers.

- Most major wholesalers in the US are wine and spirits wholesalers except where spirits are handled by state monopolies. There are synergies in selling both wine and spirits from the standpoints of channels served and logistics in warehousing and delivery. Since spirits generally have fewer SKUs and larger brands they will tend to be the bigger generators of both profit and return on assets for a wholesaler. Suppliers need to understand where they fit in the portfolio of a wholesaler and learn how to make themselves relevant.

- In most markets there are either two or three major wholesalers but there are usually a dozen, if not more, small wholesalers as well. Wineries need to consider how to use these smaller wholesalers more effectively if they cannot get adequate attention for the major wholesalers. Using a large wholesaler versus a small wholesaler is the age old conundrum. Would you rather be a large fish in a small pond or a small fish in a large pond?

- The small wholesalers need to think about how they can become both more effective and efficient in the markets they serve. Some wholesalers have moved to the point where they share warehousing and delivery capabilities. This is an interesting way, much like alternating premises, to garner some economies of scale while maintaining the benefits of a small wholesaler.

- The question of the commerce clause versus the 21st amendment has called into question the legality of in state wineries being able to ship direct to a licensed account when an out of state winery has to go through a licensed wholesaler. Barring any legal issues the ability to ship direct to retailers is a viable avenue for many small wineries in the local markets where they want to focus their sales efforts. The development of a wine industry throughout the U.S. is also beneficial to the entire wine industry since it helps develop interest in wine from a local perspective. It would be unfortunate if the preservation of this local shipping option helps drive the elimination of the legally mandated three tier system. Likewise it would be unfortunate if the maintenance of the three tier system in its current form prevents local wineries from shipping locally. This is one area that requires a solution to benefit the industry for the long term. The industry organizations and their members need to find a palatable and legally defensible position that will benefit the majority of companies in the industry.

Currently we have a legally mandated three tier system throughout most of the U.S. which is likely better than the alternative over the long term. Wine companies can either use this system to their advantage or find it an impediment to their business. Wine companies that are clear on their market position, know their unique points of difference versus their competitors and have a clear view of the markets and channels where they want to market their wines can make the existing system work for them.