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# ***Staff Paper***

**Emerging Businesses:  
The South African Wine Industry Case**

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# **Emerging Businesses: The South African Wine Industry Case**

by

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## Abstract

Emerging economies such as South Africa, only a few years out of apartheid, have been feeling the strains of socio-political change. While South Africa has experienced political reform, economic reform and access are slow to come. Currently, South Africa is the 7th largest producer of wine in the world. Although this industry is impressive, the apartheid era production practices have caused primarily the European consumers and media to be vocal about this issue. However, this concern has spread to other regions.

The South African government and wine industry must respond to the external and internal market pressures and minimize transaction costs. Both entities want to increase wine exports and expand market share, however, given the socio-economic and political climate in the country neither knows how to manage this difficult process which emanates from deeply rooted distrust of groups within the country. Socio-political constraints facing previously disadvantaged groups (PDG) as emerging business owners need to be understood; and, measures which could be undertaken by government and industry need to be identified. The objectives of this research were to identify: institutional constraints and transaction costs faced by PDGs aspiring toward production and leadership roles in the wine industry; ways the government can collaborate with the KWV to build social capital and promote PDG ownership in the wine industry, thus minimizing social conflict; and, identify industry strategies to increase exports and international market share under the “New South Africa” banner.

This analysis was based on primary and secondary data and information gathered on site. Several potential solutions were suggested for ways to include PDGs in the South African wine market while minimizing the impact on the market shares of existing producers. It is anticipated that the window of opportunity to increase exports and involve PDG is quite small.

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<sup>2</sup>The authors would like to acknowledge the contributions made to the article by Jabulani Nthangani and Jerry Brown.

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# **Emerging Businesses: The South African Wine Industry Case**

## **Abstract**

Emerging economies such as South Africa, only a few years out of apartheid, have been feeling the strains of socio-political change. While South Africa has experienced political reform, economic reform and access are slow to come. Currently, South Africa is the 7th largest producer of wine in the world. Although this industry is impressive, the apartheid era production practices have caused primarily the European consumers and media to be vocal about this issue. However, this concern has spread to other regions.

The South African government and wine industry must respond to the external and internal market pressures and minimize transaction costs. Both entities want to increase wine exports and expand market share, however, given the socio-economic and political climate in the country neither knows how to manage this difficult process which emanates from deeply rooted distrust of groups within the country. Socio-political constraints facing previously disadvantaged groups (PDG) as emerging business owners need to be understood; and, measures which could be undertaken by government and industry need to be identified. The objectives of this research were to identify: institutional constraints and transaction costs faced by PDGs aspiring toward production and leadership roles in the wine industry; ways the government can collaborate with the KWV to build social capital and promote PDG ownership in the wine industry, thus minimizing social conflict; and, identify industry strategies to increase exports and international market share under the “New South Africa” banner.

This analysis was based on primary and secondary data and information gathered on site. Several potential solutions were suggested for ways to include PDGs in the South African wine market while minimizing the impact on the market shares of existing producers. It is anticipated that the window of opportunity to increase exports and involve PDG is quite small.

## **Introduction**

Political and social conflicts increasingly have an impact on international markets and their viability in many parts of the world. Emerging economies such as South Africa, only a few years out of apartheid, have been feeling the strains of socio-political change. While South Africa has experienced sweeping political reform at the national level, provincial and local politics are largely indistinguishable from the apartheid era. Animosity has dramatically increased within South Africa between the haves and have nots, land owners and squatters, and with large corporations

who sell to everyone but only hire from particular groups of people. Building trust within the business and economic sectors of South Africa is a major challenge; furthermore, it is key to reducing transactions' costs of doing business, both domestically and internationally.

The South African wine industry is a good case study on how the lack of trust and good will can translate into increased transaction costs and decreased market shares. South Africa has exported wine since 1699. Currently, South Africa is the 7th largest producer of wine in the world, 27th in terms of per capita consumption, and has 4,700 wine producers who cultivate more than 100,000 hectares (KWV, 1996). Although impressive, the wine industry and the KWV (The Cooperative Wine Growers Association of South Africa, Ltd.) face increasing tensions in their relationships with the government, laborers, and their domestic and international consumers. The KWV was sued by the government for attempting to privatize without paying retribution for capital accrued during its time as a government granted monopoly cooperative from 1924 - mid 1990's; laborers resent that there were no management opportunities; and previously disadvantaged groups (PDG) while consuming 75% of all wine produced, were not represented in the wine supply chain. Furthermore, an outcry from European consumers occurred when the persistence of the illegal "Dop system" ( paying workers with wine to get them inebriated such that they forget to request payment) was reported in the media (Equinox, 1997).<sup>4</sup>

The government, the wine industry, and the emerging businesses have a strong incentive to work together to resolve these issues for two main reasons: first, the international market is at

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<sup>4</sup>This system has been illegal in South Africa since 1983 (KWV, 1996). It is estimated that 20% of the producers still use the "Dop system" as a method of payment to their workers (Equinox, 1997).

stake, consumers are very concerned about how the wine is produced as well as the quality of taste; second, violence against farmers is on the increase. All parties need a stable South Africa with a good image to increase production, exports and economic growth. The South African government and wine industry must respond not only to external changes, but also to internal pressures and minimize transaction costs which arise from social conflict. Building trust and social capital is the cornerstone to establishing new relationships and creating an enabling environment for emerging businesses in the wine industry.

Building trust and social capital is key but none of the groups know how to manage the difficult socioeconomic problems which are so deeply rooted within the country. Socio-political constraints facing PDGs as emerging business owners must be understood. Measures which could be undertaken by government and industry need to be identified. In this paper we will identify and discuss the following:

- institutional barriers to entry and transaction costs faced by PDG businesses aspiring toward production and leadership roles in the wine industry;
- ways the government can collaborate with the KWV to build social capital and promote PDG ownership in the wine industry, thus minimizing social conflict; and
- industry strategies to increase exports and international market share under the “New South Africa” banner.

## Market Structure

The South African wine industry is controlled by few companies. Figure 1 (The South African Wine Industry: Ownership Structure) illustrates the ownership structure of this industry. South African Breweries (SAB) and Rembrandt KWV Investments control more than 80% of the domestic wine market (Wesgro, 1994). The market structure of the wine industry in South Africa is vertically and horizontally integrated. Most of the wine estates own their established plantation, processing plants, and cellars for wine production.

Until recently, the distribution and marketing of wine, including exports, was primarily handled and controlled by the KWV cooperative. The KWV, which was granted its monopolistic position by the apartheid government (1924), was also until recently, granted the authority to determine the minimum price for South African wine. In 1998, the KWV reorganized from a cooperative to a corporation after settling a lawsuit out of court with the government concerning privatization.

South Africans produce approximately 950 million liters of wine annually and this amount is increasing rapidly (KWV 1996, 1997). In 1996, only 11% of all wine produced was exported, however, exports have grown rapidly since the end of apartheid. This growth may be due to the fact that the exchange rates have made South African wine relatively inexpensive, and due to the “Mandela effect.”<sup>5</sup> The top four importers of South African wine are the U.K., Germany, Netherlands, and Canada, and exports are expected to continue to increase.

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<sup>5</sup>President Mandela has created a pro-South Africa environment worldwide. Companies and individuals purchasing and investment decisions have most likely been positively influenced by his presence as President.



Although the export market looks promising, there are two factors that may have a negative effect on the international marketability of South African Wine. First, the European and American markets responded strongly to a scathing article by South Africa's wine aficionado about the racist and apartheid era like labor practices in the South African Wine Industry. In England, there were rumors and reports that South African Wine was poured into the streets in protest. The article also explained the issues of wine production in South Africa, stating the fact that there are no PDG producers of wine, only PDG planters and pickers of grapes as shown in Table 1. Second, disgruntled workers and the landless may create havoc on the white wine producers farmers due to slow land redistribution. (Presently, more than 500 white farmers have been killed and many more injured (Dunn, 1998)). In addition to production being interrupted, this could negatively impact foreign direct investment and the trade flow of South African goods. In order to diffuse growing tensions and improve its image abroad, the South African wine industry and the government are under pressure to create space for PDG businesses by eliminating barriers to entry into the wine industry.

The strong domestic demand for South African wine and the potential for increased exports has created an enormous opportunity for expansion, and a need for increased productivity in the industry. The opportunity exists for emerging businesses, particularly members of the PDG, to fill the new demand for South African wine without decreasing demand for existing wines. This can be accomplished in many ways but most easily through marketing and advertising as a specialty product. A socially responsibly produced wine product from South Africa would be welcomed in the market. The question is, how can the historically disadvantaged population gain access to the wine industry and become active participants and owners within it?

## **Constraints to Entry in the South African Wine Industry**

The introduction of emerging businesses into this market structure is risky due to a number of factors: the present oligopolistic ownership structure, the high capital investment involved in the wine industry, the average period of five to seven years before any profitable returns,<sup>6</sup> and the real possibility that a segment of the existing power structure will resist these efforts. Although risky, there are certain large black investment groups that have the capacity and interest to enter the wine industry. The characteristics of a PDG emerging business being proposed here are as follows:

- has access to financial capital,
- good business management experience,
- well-educated personnel (lawyers and MBA's), and
- is well connected politically.

What is lacking in these emerging businesses is experience in the wine industry as well as access to land, vineyards, cellars and the market.

The model presented in Figure 2 illustrates the existing and potential bottlenecks for emerging businesses within the South African Wine industry. The model illustrates the important factors and necessities of pre-production, production, and marketing. Inter-linkage relationships exist among all three stages and impact the viability and fundability of the potential projects. Constraints and barriers in each of the three stages have to be relaxed simultaneously to have

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<sup>6</sup>The authors estimate that the average emerging business would need approximately R8 - R10 million in order to purchase an existing vineyard with a cellar.

successful new entrants into the industry. A detailed discussion of these constraints and barriers will be given in the following three sections.

### **Pre-Production**

The pre-production constraints represent a complicated array of issues. The long history of cheap labor policies and employment segregation has resulted in concentrating the management skills in the minority group's hands, thus creating a dual labor market. This duality is evident throughout the vertically integrated production system but only the pre-production process will be discussed in this section. From fertilizer, root stock production and onto planting, the labor force is largely made up of unskilled workers from the PDG. The producers and the owners are all from the advantaged minority group which embodies all of the highly specialized skills. The non-PDG's do not have a history of sharing their technical or managerial know-how or creating opportunities for training and upgrading their workers' skills. In fact, the manager for Groot Constantia, a government-owned winery (large vineyard, cellar, and wine tasting facility) stated that the majority of his workers are illiterate, and because of this, he does not see the need to send them for training. He, however, contended that as more literate workers join the company, he would definitely create the opportunity for them to participate in short-term courses. No answer was given on why they do not hire literate workers in the first place. The short term courses that the manager was willing to send the workers to usually last for one or two days maximum.

Western Cape farm workers, unlike other South African agricultural workers, have no recent history of land access or ownership. Du Toit (1993) explains that in that region, farm work has, for more than 100 years, been done by a "landless rural proletariat." This is in direct contrast

to the rest of South African agriculture, where share cropping and labor tenancy have existed alongside commercial farming until fairly recently (Karaan and Tregurtha, 1996).

More than ten non-governmental organizations have been established to assist wine producers in South Africa. In interviews with these groups, the authors asked the various directors if they have plans to assist emerging businesses to become successful in the wine industry. From their responses, it was evident that no thought had been given to assisting emerging businesses to become stakeholders in the wine industry. Cooperatives are another group that assists producers, however, by definition these organizations represent their constituents only. Therefore to gain access to technical, financial, or any other type of assistance, you must be a member. They exist for the mere fact that they sell inputs or provide services at a lower price than one could find elsewhere. A great example of how producer cooperatives can reduce costs is in the provision of root stock. Presently, there is a two to three-year wait for root stock in South Africa because of a shortage of domestic root stock and there are restrictions on importing root stock. Since the KWV is at the apex of the wine industry and controls root stock, non-KWV members are more likely to wait longer for root stock than members.

The Western Cape Province's Agricultural Dept., the main wine producing region, has only one government viticulture extension agent assigned to work with vineyard owners. The majority of the wine producers utilize the extension services provided by the KWV or their individual cooperative. These services are critical for technology transfer addressing pre-production issues and market information.

Emerging businesses in this industry would face higher prices due to their lack of experience and not being a part of the cooperative system. Currently there are 260 vineyards, all of which have been in operation for a number of years. Through experience, these vineyards have developed a high degree of efficiency which emerging businesses could not easily match in the short run. In addition to start-up costs, emerging businesses would face tremendous transaction costs in terms of organization and access to information. These pre-production barriers must be addressed before PDG emerging businesses enter into this industry.

### **Production**

The constraints for emerging businesses in the production sector mirror those of the pre-production sector; they are just more intensified. Membership in producer organizations is important at the wine production level as well. An example of these organizations is a cooperative wine cellar. Those producers who do not have enough capital to construct and manage their own cellar, can join a cooperative and have their grapes turned into wine at a minimal cost. Presently, there are 71 cooperatively operated wine cellars. It remains an open question whether these types of organizations would allow emerging businesses to join.

As in the pre-production stage, access to land is critical for wine production. Most vineyards operate their own cellars where they produce and bottle wine. In order to be successful, emerging businesses must have access to land with cellars as well as wine production technology.

South African wine production is characterized by state of the art technology. However, as in the pre-production stage, human capital associated with this technology is totally embodied

within the minority population. Typically, managers of vineyards and cellars are required to have 3 - 4 years training in viticulture and oenology. Only two schools in the country, University of Stellenbosch and Elsenburg College of Agriculture offer such training. Currently, there are no nonwhite trained viticulturalists, from either school, and only three winemakers from the previously disadvantaged community.<sup>7</sup>

Regulatory measures in the 1995 White Paper on Agriculture, were designed to provide a new initiative that could give farm workers, especially the disadvantaged farmers, an opportunity to own land. These have not been carried out as stipulated. The White paper, providing a new vision of agriculture in South Africa, states that “a highly efficient and economically viable market-directed farm sector, characterized by a wide range of farm sizes, will be regarded as the economic and social pivot of rural South Africa, which will influence the rest of the economy and society (WPA, 1995).” It is not pellucid on how these regulatory measures will assist PDG emerging businesses given our assumptions about these types of firms. However, in order to accomplish this task, the government is faced with the challenges of how to meet the needs of the farmers from the PDG who are in general, uneducated, landless, and economically and financially incapacitated, to actively take advantage of the program. However, the slow land reform has caused tensions to rise and is partly to blame for the attacks on the white farmers. Land redistribution is key to the survival of agriculture in South Africa.

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<sup>7</sup>Presently, there are five PDG students studying viticulture and oenology at the University of Stellenbosch.

## **Marketing**

Most of South Africa's wine is consumed domestically. They are ranked 27<sup>th</sup> in the world with a per capita consumption of 9 liters. This strong domestic demand for South African wine coupled with the potential for increased exports, creates an enormous opportunity for expansion in the industry. As a response to this demand, entrepreneurs have started to emerge in South Africa. Among these are businesses made up of members from the PDG who are seeking opportunity under the new political dispensation. However, the wine sector like other sectors of the South African economy have been subjected for decades to a range of regulatory measures that prevented many producers from fully utilizing market opportunities (WPA, 1995). In many cases, the value-added supply chain in agriculture in South Africa has been characterized by concentration and regulatory measures that limit entrance by new or smaller entrepreneurs (WPA, 1995). However, since the 1980s, marketing has gradually been deregulated and reshaped within the framework of norms, consistent with those of a market-directed economy. The more recent deregulation resulting from political reform focuses on minimizing inequalities and creating opportunity for the new disadvantaged emerging businesses.

It must, however, be emphasized that apart from political problems resulting from decades of discrimination, the new emerging businesses in the wine industry will be faced with an array of problems in marketing. These problems include but are not limited to the following: low risk financing, lack of infrastructure, lack of management skills, lack of cohesive organization, technical constraints, lack of information, and no existing international market channels that can be expanded to include wine.

## **Building Social Capital and Trust: Diminishing Barriers**

This paper briefly detailed the enormous amount of barriers PDG emerging businesses would have to overcome to enter and be successful in the wine industry. Some of the barriers were exogenous to the system (market perception and demand, foreign investment, media, and socioeconomic environment in S.A. and abroad), which new policies would have little effect on. The barriers that are endogenous (capacity building, technology transfer, historic baggage, and the policy environment) to the system can be affected by policy adjustments. Regardless of the political, economic, or social situations, emerging businesses must assess their weaknesses and strengths and the opportunities and threats that present themselves in this market.

The current market structure is extremely horizontal and vertically integrated with few businesses controlling the industry. The introduction of emerging businesses into this market structure is risky, particularly if the existing power structure does not want them in the business. Figure 3 was developed as a model plan to address the constraining issues identified in the text. For emerging businesses to gain market access, it is essential that the existing wine producers, the government (all levels), educational institutions, and financial institutions work together to address the issues in figure 3. There are policies that must be revised, but more important is the fact that the general business opportunity atmosphere must be improved through government induced incentives and cooperation with the KWV and training via the educational institutions.



## **Recommendations:**

Given the review, there are several general recommendations followed by a list of detailed recommendations for the government, KWV, and educational institutions. The recommendations are as follows:

- ▶ The government as an active participant in providing necessary intervention to create an enabling environment in the wine industry for new entrants must be more active in removing constraints like access to land, finance and technological transfer that impede ownership and productive participation.
  - ▶ National and provincial government should speed up the process to make governmental land available to emerging businesses.
  - ▶ Government intervention is needed to assist emerging businesses in getting access to private arable land and financing at an affordable cost.
  - ▶ Government should foster an enabling environment by creating incentives for KWV to work with the PDGs.
  - ▶ Allow the importation of root stock for a limited time period so that PDGs have immediate access to planting stock.
  - ▶ Regulatory measures that are discriminatory and unnecessary and that prevent equitable access to the market for new and smaller participants, should be discontinued.
  
- ▶ The authors agree that the government was correct in allowing the KWV to privatize. However, the assets that were amassed by the KWV due to the government granted monopoly, should be remunerated to the government.

- ▶ The government should use those funds to provide a “soft landing” for the emerging businesses in the wine industry.
- ▶ Insist that the KWV restructure to minimize its monopoly power.
  
- ▶ The KWV should assist the industry by encouraging emerging businesses by:
  - ▶ mentoring them until they are able to manage the business.
  - ▶ assisting with technology transfer, and access to information, thus reducing their transaction costs.
  - ▶ providing extension agents to these businesses as they do for their members.
  - ▶ promoting joint ventures and organizational activities to build collegiality and social capital between old members and new entrants in the industry.
  - ▶ encouraging their members to not bid up the price on adjacent properties.
  
- ▶ The Institutes, Universities, and Extension Services Centers should all become participants in building the capacity of the economy through training and technological development and transfer, particularly to the previously disadvantaged population. The government could invest in such a program within the wine region. The educational and research institutions should conduct:
  - ▶ short term courses to assist emerging businesses in the areas of oenology, viticulture, management, and marketing.
  - ▶ research on what special needs emerging businesses might have.
  - ▶ seminars to keep the emerging businesses abreast on what is occurring in the industry worldwide.

The authors feel that these collective actions will expand the market for South African wine worldwide without reducing the demand for current producers products. It is also thought that the unique wine products from the new emerging businesses could create a new/niche market and improve South Africa's global competitive position. Lastly, the positive relationships developed via this approach could help stabilize the country by reducing racial tension.

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**Table 1: South African Wine Industry Structure based on Race**

<b>Owners</b>	<b>Workers</b>	<b>White</b>	<b>PDG<sup>1</sup></b>	<b>Wine Production Phases</b>
<b>Owners of Vineyards</b>		<b>4,700</b> (100%)	<b>0</b> (0%)	<b>Pre-Production</b>
	Vineyards	<b>5,000</b> (10%)	<b>45,000</b> (90%)	
<b>Cellars</b>		<b>260</b> (100%)	<b>0</b> (0%)	<b>Production</b>
<b>Wholesalers</b>		<b>7</b> (100%)	<b>0</b> (0%)	<b>Marketing</b>
	Wholesale Industry	<b>4,000</b> (40%)	<b>6,000</b> (60%)	
<b>International Wholesalers</b>		<b>13</b> (100%)	<b>0</b> (0%)	
<b>Licensed Retailers</b>		<b>?</b>	<b>?</b>	
<b>Non-Licensed Retailers</b>		<b>8,500</b> (17%)	<b>41,500</b> (83%)	
<b>Consumers</b>		<b>3,074,500</b> (25%)	<b>9,223,500</b> (75%)	

Source: Provincial Statistics, Western Cape, 1995.

<sup>1</sup>PDG means previously disadvantaged group

**Figure 1: The South African Wine Industry: Ownership Structure**

Source: KWV, 1996.

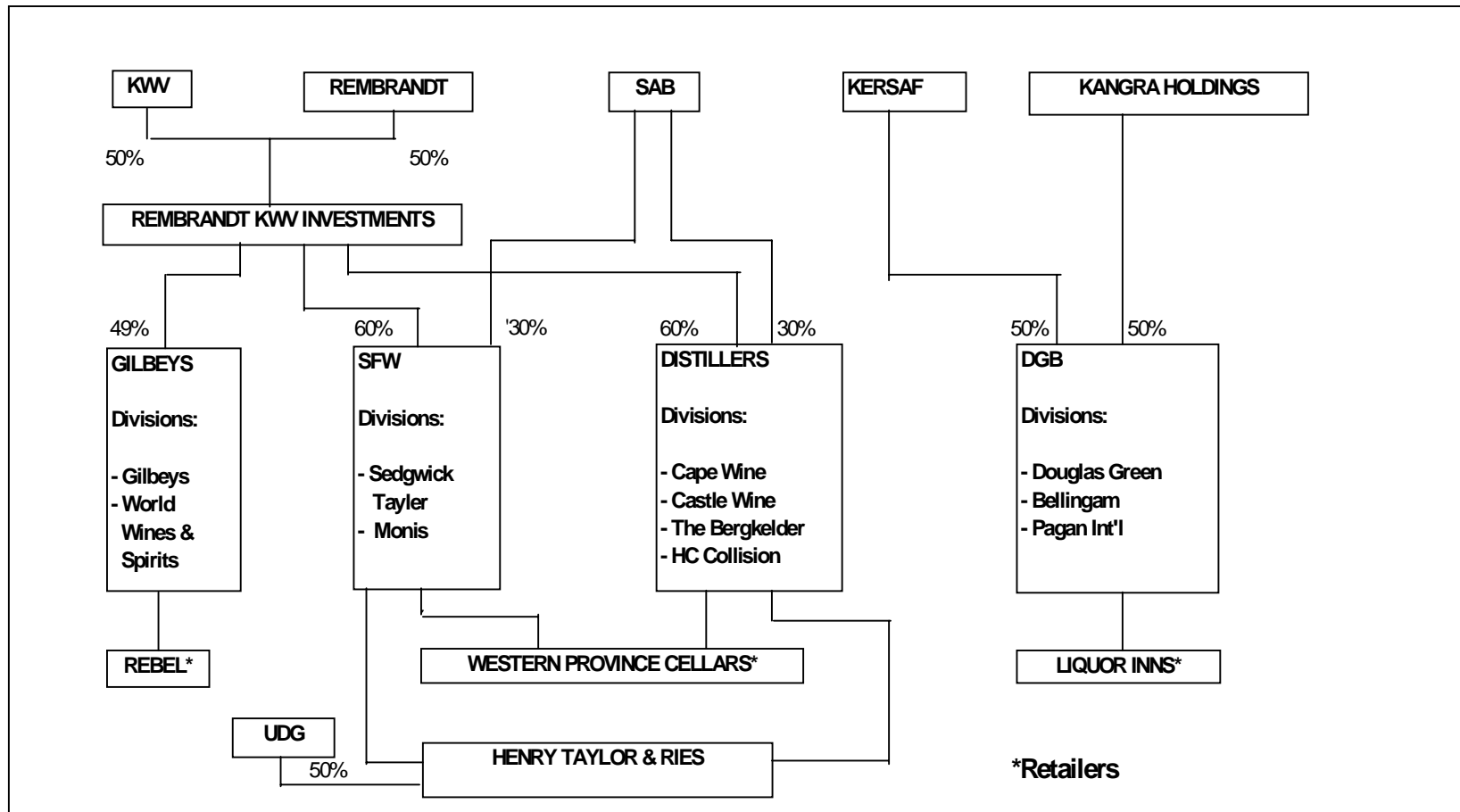
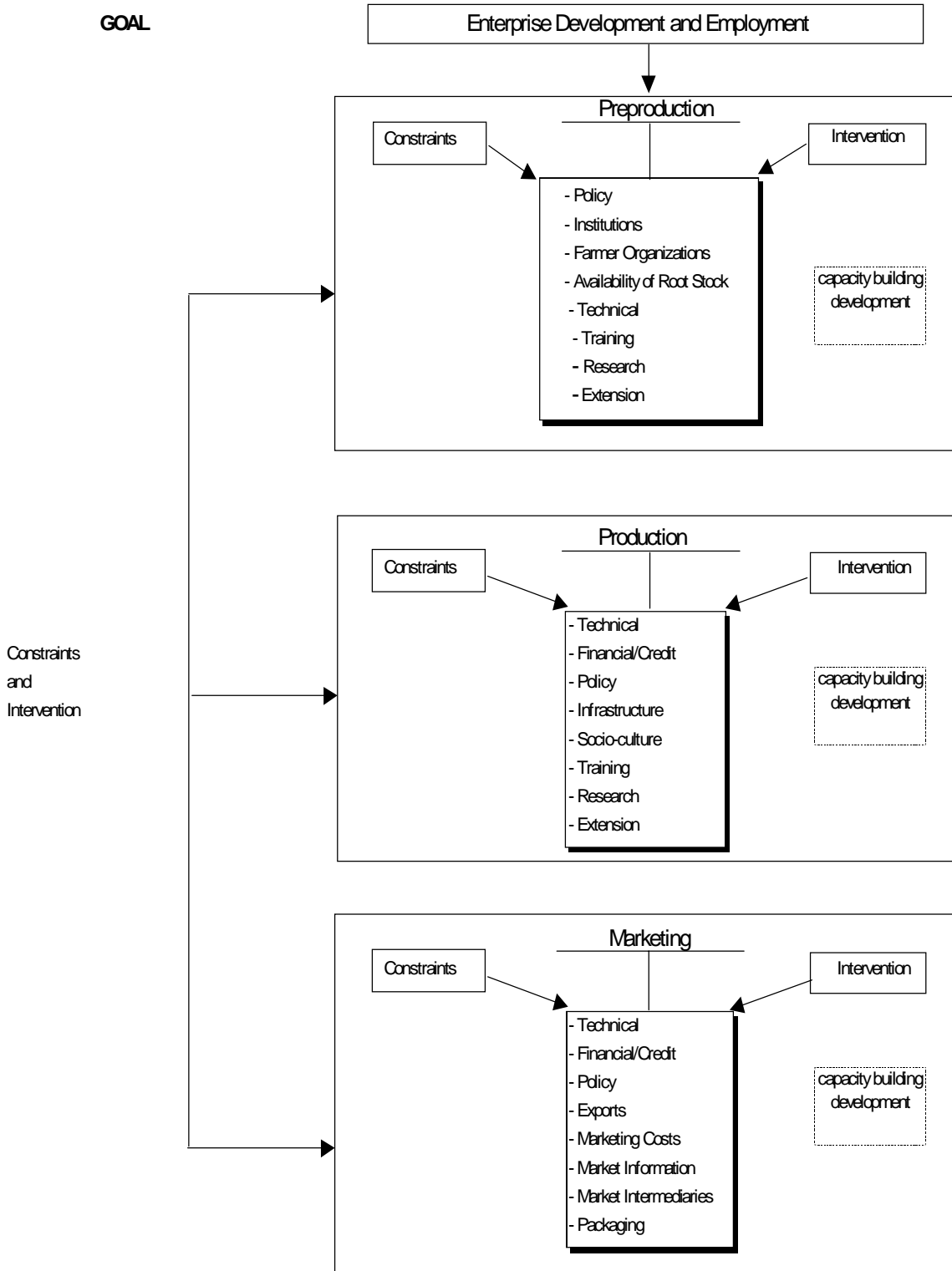


FIGURE 2. A MODEL PLAN FOR ENTERPRISE DEVELOPMENT AND EMPLOYMENT FOR EMERGING BUSINESSES IN THE WINE INDUSTRY



**Figure 3: SOUTH AFRICA WINE INDUSTRY - MODEL PLAN**

