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# **Adaptation of South African Wine Cooperatives to Challenging Business Environments**

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## **Abstract**

After more than seven decades of regulation and protection, South African wine cooperatives were brutally exposed to the market and international competition in the early 1990s. How did they respond to these new challenging environments? In a number of case studies we show that although the wine cooperatives share a general thrust of technical modernisation and upgrading, they also diverge considerably in their organizational innovation, strategy and business models. In their adaptation, the wine cooperatives were aided by the fact that they possessed features of “new generation cooperatives” and the space granted by legislation, putting them in a position to go beyond the latter. It remains to be seen whether these organizational innovations are sufficient to meet the next big challenge, namely to get off the bulk wine trajectory and “move up the value chain”.

## **Introduction**

For more than seventy years, between 1918 and the mid-1990s, the South African wine industry (SAWI) was tightly regulated (Vink et al. 2004; Ponte and Ewert 2007a). Empowered by law, a giant cooperative, the KWV,<sup>4</sup> came to regulate the

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4 In English, Cooperative Winegrowers Association of South Africa.

industry in detail. Farmers, the large majority of which were organized into local cooperatives, were guaranteed a minimum price per liter from the mid-1920s onwards.

The cooperatives had no direct contact with the market. The latter was controlled by a handful of producing wholesalers to whom the cooperatives sold most of their wine (in bulk). Whatever could not be sold (i.e. the “surplus”), was “removed” from the market by the KWV – most of it distilled into brandy. The KWV also had a monopoly on exports, completing the cooperatives’ isolation from market forces. Although not completely devoid of attempts at innovation, the regime was mainly geared to system maintenance.

However, the whole system started to unravel in the early 1990s, starting with the suspension of “planting quotas” in 1992 and completed with the conversion of the KWV into a company in 1997 (Williams 2007). With regulation something of the past, the cooperatives could free themselves from the stranglehold that the producing wholesalers had frequently exercised. Cooperatives now had new options, selling to the estates, and especially exporters who needed the additional quantity. At the same time, they came face to face with a series of new challenges.

First, there were the signals from the international markets. As managers of cooperatives became exposed to newly accessible markets, they brought back a strong message: what the markets wanted was not brandy or fortified wines, but red and so-called “noble” cultivars. As a result, growers planted “noble” red varieties on a big scale, significantly reducing the traditional “workhorses” of the industry, such as Chenin Blanc and Colombar, in the process.

Soon after, the realization took hold that it was not enough to have the “right” varieties, one also had to improve quality if one wanted move out of the low-price band. This contributed to the accelerated diffusion of better vineyard practices (e.g., canopy management and block grading) throughout the Cape wine lands, going hand in hand with the introduction of so-called differentiated payment systems at the cooperatives, rewarding growers for better quality and allowing members to form strategic blocks or member groups. In addition, the last ten years or so have seen the diffusion of market related vineyard management.<sup>5</sup>

After the initial honeymoon period when South African wines were still a novelty and riding on the Mandela wave of sympathy, new uncompromising demands followed, i.e., clients were becoming increasingly particular – not only as far as food safety standards were concerned (e.g. HACCP,<sup>6</sup> BRC<sup>7</sup>), but also

5 Depending on market prices, the canopy is managed more or less intensively. More labor intensive normally means higher wage costs.

6 Hazard Critical Analysis and Control Points

7 British Retail Consortium.

regarding wine styles, price points and the “full package”. For instance, different customers often wanted the same wine, even the same style, but in their own particular packaging. It is now common that South African suppliers to overseas retailers are expected to support promotions and even buy shelf space. These are standard expectations and provide no market advantage – all in exchange for low margins.

In this context, the aim of our article is to understand how South African wine cooperatives (and ex-cooperatives) have responded and adapted to these challenges, particularly with regard to their governance structures and business models.

### **Cooperatives and their principles**

Particularly in the “Old World”, (marketing) cooperatives have a long history of patronizing the businesses of their members in the wine industry. In this context, a cooperative is a legal entity owned and democratically controlled by its grape producing members, i.e., the growers pool their resources for mutual economic benefit. The cooperative structure may be organized along three principles: user-ownership, user-control and user-benefit (Hendrikse and Bijman 2002). The traditional organizational model of agribusiness cooperatives entails exclusive members’ ownership, democratic control, open membership and a uniform pricing policy (Barton 1989).

However, due to their unique institutional form as a member-owned firm, cooperatives face several problems (Bijman and Hendrikse 2003). Using a property rights approach, Cook (1995) pointed out five general sets of problems: free riding problems, horizon problems, portfolio problems, control problems, and influence cost problems. Eilers and Hanf (1999) point out that it is not clear who is the principal and who is the agent, i.e., both the cooperatives and the members can be principals and agents. For this reason, neither leadership mechanisms nor selective terms of delivery can be enforced by the cooperatives, i.e., the members can deliver all the commodities that alternative dealers do not accept. Cooperatives that are forced to accept these commodities face the problem of adverse selection. Cook (1994) shows that in comparison to the manager of an investor-owned firm the overall challenges of a cooperative manager are not significantly different, but more difficult. Furthermore, Karantininis and Zago (2001) draw attention to the tendency that instead of selling their commodities to open cooperatives, farmers would rather sell them to investor-owned firms if they had a choice.

In the context of wine, Pennerstorfer and Weiss (2013:144) state that “quality coordination problems could be even more detrimental to the prosperity of cooperatives, in particular in situations where the quality delivered by individual members is difficult to verify and is non-contractable between independent actors”. As Goodhue et al. (2003) clearly show, this is particularly the case for premium wine. In an empirical study of the German wine market, Frick (2004) was able to show that ownership structures (investor-owned firms versus cooperatives) determined the product quality. Problematic principal agent settings were identified as one of the major determinants. These findings were supported by Dilger (2005).

Despite creating value for their member-owners, cooperatives often fail to respond to market changes because they lack a well developed strategic focus (Kyriakopoulos 2000). The lack of connection to market demand limits their viability and requires the rearrangement of their organizational and strategic attributes (van Dijk 1999). The choices cooperatives make regarding organizational and strategic attributes are crucial in dynamic markets and in periods of transition when adaptations are required (Cechin et al. 2013). Hence, many cooperatives have undergone profound organizational and strategic changes (Nilsson et al. 2012). The extent to which cooperatives modify their organizational attributes result in organizational forms that range from traditional, collectively organized, equality-based organizations to restructured models. These restructured, proportional models are designed to facilitate improved adaptation of cooperatives to agricultural industrialization and to market challenges (Hendrikse 2011).

One way of successfully overcoming the problems of traditional cooperatives has been the introduction of New Generation Cooperatives (NGCs) in the U.S.A. (Chaddad and Cook 2004; Harris et al. 1996). In contrast to the traditional model, this restructured cooperative model is composed of individualized equity, non-member funding, closed membership, proportional decision control and the allocation of benefits through price differentiation and personal shares (Cook and Chaddad 2004). Another approach pursued in the German wine sector is the formation of strategic member groups. Hanf and Schweickert (2007) define strategic member groups as clusters of members of a cooperative with a similar strategy or aim at the same market, i.e., the cluster members have homogeneous interests regarding at least one particular business goal.

### **The distinctive features of South African wine cooperatives**

For most of the last 100 years, cooperatives have been the backbone of the SAWI. First established in 1905, their number grew to a maximum of 71 in 1993. After two decades of transformation, they have been reduced to 52, mostly through

mergers. Since 2006, they are called “producer cellars”. Only half of these are cooperatives in the traditional sense, the others having converted to companies.

Deviating from the traditional model, most wine cooperatives in South Africa have always imposed *barriers to entry*. Not only does the applicant have to be a grower, but normally an “entry fee” has to be paid in the form of a capital investment. Although anybody is welcome to apply, most cooperatives have a strong sense of family and they try to keep it that way. Non-member funding is not allowed, unless the cellar has converted to company.

A further defining feature of the cooperative system in South Africa’s wine industry is the *pool* (of grapes/wine) – a separate legal entity that is managed by the cooperative on behalf of the members. It only charges the pool for the production costs.<sup>8</sup> The pool itself is a non-profit company and pays no taxes. Payouts from the pool to members are staggered and so are their income tax obligations. This may be one, if not the most important reason why most of the cooperatives that converted to companies, have retained the pool.

Unlike the traditional model, most South African wine cooperatives are *not* governed by a simple one man, one vote system. Instead, a dual system of voting is the rule. Most cooperatives’ statute makes provision for the *weighted vote*. Essentially the more tons a member delivers, the more votes he commands – mostly capped at 20% of the votes. Whereas routine matters are decided by a showing of hands, the weighted vote is evoked in the case of controversial issues, the election of the board, or changing of the statute. This arrangement has the result, amongst others, that the bigger farmers strongly influence decision-making, including issues of investment.

Since the late 1990s, approximately half of the former cooperatives have converted to companies. However, this had little to do with business reasons. Instead, the reasons were political, touching on the issues of accumulated assets, voting powers and the legal identity of members. Fearing that a new “hostile” black government may force them to share their assets with workers, the first handful of cooperatives converted towards the end of the 1990s, taking their assets with them (Ewert 2003). Mirroring these changes, the Cooperative Cellars Committee (KWK), an umbrella organization, decided to rename them “producer cellars” in 2006.

The second, bigger spate of conversions has occurred over the last eight years. These were in direct response to new legislation, the 2005 Cooperative Act. The latter tried to give South African cooperatives a more “social” character by doing away with some features that had become firmly institutionalized at the wine

8 As a consequence, the turnover of most cooperatives is so low (i.e., less than R 5 mill. p.a.) that they are not obliged to engage in “black empowerment”.

cooperatives, e.g., the proportional vote. In the event, nothing came of this law as a new 2013 Act restored the status quo. However, many cooperatives had become so uneasy with the social thrust of the legislation that they converted anyway – although many are keen to point out that “we still function like a cooperative”. What that means we explain below.

However, whether a cooperative, a new style company or a hybrid of the two, when looking at the defining features of South African producer cellars – individualised shareholding, closed membership, and proportional vote – it is clear that they were already new generation cooperatives before deregulation. What is new is their market orientation and organizational innovation. In response to market trends and pressures, they have developed new organizational features and forged their own particular business model. This has helped them to survive and stay competitive – although, as we shall see, they may now find themselves at a new strategic crossroads.

### **Case studies**

This study was done in March-May 2014. Using a random purposeful sampling method, we selected 11 producer cellars, at least one per wine district, making this a representative sample. In each case we used a questionnaire mailed in advance, supplemented by a lengthy interview with the general manager/CEO, in some cases assisted by accounting staff. After analyzing the case material, we can distinguish three types of producer cellar: the traditional cooperative, the hybrid cellar (cooperative *and* company), and the pool based company. For the purposes of this article, we discuss one cellar from each of these categories (keeping the names confidential). Our approach during the interview was a comprehensive one, touching on the post-regulation history, membership, voting system, division of labor, management structure, cultivar composition, approach to quality and the like. The focus, however, is on the cellar’s strategy and business model.

#### *Cellar A: Traditional cooperative<sup>9</sup>*

Of all the cellars in our sample this is perhaps the one with the least organizational and strategic change. We describe it as a traditional cooperative, because almost all of its production (96.5%) is sold in bulk to one local producing wholesaler and a small percentage to one European retailer. The cellar has no idea for what brands

9 The general manager has been in this post for the last 10 years. He holds a B.Sc. degree in Agriculture from the University of Stellenbosch. The interview was conducted on 10 April 2014.



or labels its wine is destined. This was very much the pattern during the KWV era. Only 3.5% is sold in bottle through self-marketing, less than half of it in overseas markets. What is new is the shift from a white to a red wine cellar over the last twenty years.

In the region where the cellar is situated the yields are comparatively low and input costs high. The cellar tries to control its costs by maintaining a small staff and only two specialized personnel (i.e., wine maker and accountant).

The cellar only has 16 members. This has promoted consensus decision-making. Unlike most other cooperatives, each member has only one vote, regardless of the number of shares, i.e., there is no weighted vote. Together they farm 725 hectares of vineyard. The average yield is 9.98 tons per hectare. Red cultivars represent 70.4% of all plantings. The most prominent cultivars are Cabernet Sauvignon, Shiraz and Merlot. To make the shift to a red wine cellar possible, the cellar has invested R16.3 million, most of it into the expansion and modernization of the cellar, especially storage capacity.

The reasons behind the shift were straightforward, i.e., the demand for red wine in international markets. Like all producer cellars this cooperative does not only engage in differentiated quality production, in the sense of a differentiated payment system,<sup>10</sup> but also vinifies the grapes of each member separately, hence the big investment into additional tanks. Nevertheless, under current market conditions the cellar is satisfied that only 10-15% of all wines fall into its top class. For most members increasing labor and other costs to improve quality would not be worthwhile. In times when wine drinkers are trading down, the wholesalers select only the best. Wine that in other times would have passed as class A, would now only achieve a lower price.<sup>11</sup>

Although the cellar was only one of a handful to attain more than R6 per liter<sup>12</sup> for its red wine in the domestic market last year, its overall financial situation looks less positive: in 2013 its acid test (i.e., cash flow) ratio was 0.11:1 (compared to the sector average of 0.38:1 in 2012) and the own to loan capital ratio 23% to 77% – also weaker than the sector average of 27% to 73%.

On the whole, the cellar presents a picture of technical innovation, but playing it safe strategically. Its business model (if it can be called that) has essentially remained unchanged from the regulation days. Although management seems to entertain the idea of not renewing its long-term contract with the wholesaler, this is

10 For instance, the cellar pays R6350 per ton for class A Cabernet Sauvignon (2014), R4080 for class B and R2800 for class C.

11 For instance, some ten years ago the same wholesaler accepted 70% of the wine as top class, while last year it was only 15%. Thus, the same intrinsic quality does not always fetch the same price.

12 At the time of writing the Rand was exchanging at approximately R14.5 against Euro 1.

everything but easy. To embark on a self-marketing, value-adding trajectory would not only require considerable investment – something the cellar can ill afford given its financial situation – but experience over the last ten years or so have also shown that the market does not necessarily reward better quality.

*Cellar B: Hybrid: cooperative and company*<sup>13</sup>

This cellar is situated in the Breede River valley, historically a high-production distilling wine region. It is a pioneer in the sense that it embarked on a process of restructuring and change before the lifting of sanctions in 1993 and the democratic elections in 1994. In 1992, it took two important decisions: first, it launched an organizational innovation in the form of Pool B. This was done to promote the production and sourcing of market related cultivars, and to accommodate members who wanted to deliver more grapes than their shares allowed. The important feature was that one did not have to own shares in the cooperative in order to deliver grapes to Pool B. This also made it possible to source grapes from non-members and accelerate the transition. Second, it drew up a 15-year cultivar plan to manage the transformation of members' vineyards in a coordinated fashion.

In 1994, a further innovation followed in the form of a subsidiary company to act as an international trading vehicle for the cooperative's wines. The company also sources grapes and wine from third parties. The members of the cooperative are the shareholders.

In all this, the current manager, trained in both wine making and business administration, was the main change agent and innovator, overcoming the resistance "of older members who did not want to grow the business and invest". The main impetus behind the changes was the realization that we "did not have the cultivars that the market wanted".

The cooperative is governed by a board of directors, which is elected by the members using the weighted vote. Each director is responsible for a specialized function, e.g., new plantings and trends. In addition, there is a non-executive director appointed for his financial expertise.

In 1991, when the current manager was appointed, the cellar was a rebate producer, distilling wine and grape juice. Today 76% of production is drinking wine. Twenty-eight member farms grow a total of 1800 hectares of vineyards, producing an average yield of 17 tons per hectare. White grapes constitute 71% of all plantings, with Colombar, Chenin Blanc and Chardonnay providing the backbone.

13 The general manager has held this post since 1991. He holds Diplomas in Agriculture and Cellar Technology from Elsenburg Agricultural College and a Business Diploma from the University of Stellenbosch. The interview took place on the 11 April 2014.

Like Cellar A above, this cellar makes use of a pool and differentiated payment system.<sup>14</sup> However, unlike Cellar A, the differentiation is less refined. Members' grapes are not vinified separately. Instead the same class grapes of a particular variety go into the same tank. Even so, the cellar invested R75 million over the last two decades, mainly in pressing and storage equipment.

Three-quarters of the cellar's wines fall into two top quality classes. Bulk wines account for 97% of the cellar's sales, the rest is bottled. A wholesaler purchases 25% of production under a long-term contract, the rest is sold to individual clients on an ad hoc basis. This includes direct sales to overseas customers (40%). The most important export markets are Continental Europe, North America and Scandinavia.

Management describes the cellar's business model as a being a "top supplier of branded bulk wine" – "branded" in the sense that the cellar knows the brands and labels for which its wines are destined. Management emphasizes that this strategy has to be distinguished from the non-traceable bulk or spot market, where clients are less reliable and the margins lower. Management was keen to point out that the main reason why the cellar is not pursuing a value-added, own-brand strategy are the high costs involved.<sup>15</sup>

As it is, the current business model seems to serve the cellar well. In 2013, it realized R4.25 and R5.35 per liter of white wine in respectively the domestic and overseas markets. Although that is still some way off the industry benchmark of R6 per liter, its financial situation is the healthiest of all three cellars discussed in this article. In 2013, the cellar's own to loan capital ratio was 56% to 44%, and its acid test ratio 1.71 : 1.

Against this background it came as little surprise that the manager described the cellar's vision as "keeping and growing its top ranking [as a branded bulk supplier]...". According to him the members support this direction "because there is a well discussed financial plan in place".

#### *Cellar C: Company based on the pool principle<sup>16</sup>*

This is one of only two cellars in our study that created its own brand and sells it through self-marketing.<sup>17</sup> Standing out amongst the rest, almost all of its wine (97%) is sold in packaged form, most of it as "bag in a box".

14 For instance, in 2014 the cellar paid R2521 per ton for class A Chenin grapes and R2144 per ton for class B.

15 According to management, to move 8.4 mill liters of bulk wine costs R 2.8 million. If the same volume were bottled, it would require an investment of R 91.1 million. Bulk transport of this volume requires 350 containers, but 900 when bottled.

16 The general manager has been in this position since 2006. He is a qualified Chartered Accountant. The interview was held on 15 April 2014.

Whilst the cellar is a company (since 2006), it has retained the pool principle. Consisting of two production sites that specialize in red and white wine production respectively, it is located in a hot, irrigated region where yields of 40 tons per hectare were not uncommon in the regulation era. With a pressing capacity of 110,000 tons and 160 farming units, it is one of the largest cellars in South Africa. Over the last 15-20 years, the cellar has gone through a profound transformation, essentially shifting from juice and distilling to drinking wine production. To make that possible, it not only invested heavily in processing, wine making, and fining facilities, but also introduced advanced packaging lines – a key component of the new business model.

In order to have more control over the supply chain, the cellar established its own distribution company in the domestic market. This delivers directly to supermarket chains, liquor groups and independent liquor traders in both the urban and the rural markets.

The process of transformation was set in motion by the appointment of a new general manager in 1996. He launched the cellar onto the “box wine” trajectory by introducing the first in-house packaging line in 2001. At first, there was skepticism and resistance against the new course, but he managed to convince the members and get their buy-in. Since the late 1990s, the members have committed to R254 million of investment.

During the whole process of change, the cellar has been kept in the hands of the founder members. Voting rights are not equal, but linked to the number of tons delivered, up to a maximum of 20% of the votes. The members own the shares in a holding company, which controls several affiliates, including the distribution company. At the operational level, the cellar employs a host of specialist personnel: six wine makers, three in-house viticulturists, plus one on a consultancy basis. It also has its own laboratory. A significant number look after distribution and exports.

A total of 5,000 hectares of vineyard are cultivated. The average yield per hectare is 20 tons. White grapes account for 69% of all vineyards, with the traditional varieties Colombar and Chenin Blanc providing over 50% of production.

Like the two cellars above, it has a differentiated payment system in place, with up to seven quality classes for certain cultivars. For instance, payments for Colombar vary from R1460 to R900 per ton. Approximately 80% of the company’s wine falls into its top quality class. From management’s point of view, the cellar is reaching its quality goal “according to current planning”, although the

17 The other cellar sells 40% of its wine in bottled form.

objective is to improve on this by “continued investment in research, vineyard and wine making practices and cellar and packaging technology”.

In 2013, 90% of production was drinking wine; 85% of the cellar’s wine is sold in the domestic market, 15% overseas. In the local market, 99% is sold under the cellar’s own label, in international markets 20%.<sup>18</sup> In 2013, the most important international market was France, followed by the U.K. and Germany.

Despite its apparent success, the margins that the cellar earns for its products are not particularly large in either the domestic or international markets. In 2013, the cellar realized R3.80 and R6 per liter for its white and red wine respectively in the domestic market – both below average. In the U.K. the cellar’s bottled wine sells for £5 on the shelf. Its 5-liter box trades for £16.<sup>19</sup> However, after excise tax, the retailer’s share, and other charges, the cellar is left with a rather thin margin.<sup>20</sup>

The thin margins combined with a heavy investment program make themselves felt in the cellar’s financial situation. In 2013, the own to loan capital ratio was 30% to 70%, the acid test ratio 1.0 : 1.2. Whilst this is better than cellar A’s figures, it is worse than cellar B’s. If anything, it does illustrate that value adding does not necessarily translate into better financial results.

Nevertheless, the cellar has succeeded in implementing its business model to become “the No.1 volume brand” in South Africa. In the U.K. market, it ranks among the top 20. Management conceded that over the last 10 years or so there had been intermittent tensions between members’ desire for higher payouts on the one hand and the need for debt servicing and capital investment on the other. This had been managed by “ongoing structured capitalization and investment”, going hand in hand with “repeated explanation of the business model and the importance of sustainable progress”.

Looking into the future the manager emphasized “higher profitability of the current infrastructure” as a key objective. He was optimistic that this goal could be reached “judged by results in more recent times and if conditions remain more or less the same”.

18 To give some idea of the magnitude of the business: in 2008, the cellar’s total production was 75 million liters; of these 45 million liters were sold under its own label in the domestic market and 15 million liters in the export market. A further 15 million liters were exported in bulk. Of these, 3 million liters were packaged in the U.K., including bottled wine.

19 The prices fetched by competitors like Chile and Australia are slightly higher, with a 5-liter Australian box selling at approximately £18.

20 The retailer’s margin is £1.07, VAT is 61 pence, excise tax is £2.10, and the agent’s margin between 5-10%.

## **Conclusion**

Even before deregulation, South African wine cooperatives had many features of new generation cooperatives. However, their innovative potential could not come to fruition as long as the regulation regime was in place.

Since deregulation and the opening of international markets, the response of the wine cooperatives to the new environment has been diverse. Although all of them have become suppliers of demand-driven wines for local and international clients, our case studies show they have done this by taking different routes – from the low-risk option of supplying non-traceable bulk wines to local wholesalers, to “branded bulk”, and own branding and marketing.

While in some cases modernization and upgrading has been largely confined to the technical side, with the business strategy remaining unchanged, other cooperatives have used the space provided by coop legislation to come up with all kinds of organizational innovations, like a Pool B or the establishment of distribution companies – all changes that go beyond NGCs. In a number of cases, the original cooperative converted to a company, but without exception this was not done for business reasons.

In effecting these changes, the vision of a new manager, a far-sighted board and the proportional vote often played a key role in overcoming resistance where it did emerge. However, in none of our case studies were there significant horizon, control or influence problems. Free riding was largely eliminated by the introduction of differentiated payment systems.

This does not mean that all is well. Judging by our case studies, at least two thirds of producer cellars pursue a bulk wine trajectory. In fact, in our representative sample of 11 cellars only two engage in value adding to any significant degree. In this broad bulk-wine strategy, some are better positioned than others, dealing in “branded bulk” rather than spot markets or locked into dependence on one or two local clients.

However, even for those better placed, it would not be easy to take the next step. As one of our case studies shows, engaging in own branding and marketing does not necessarily deliver better financial outcome. In contemplating such a move “up the value chain”, it is not the structure of the South African producer cellars that would present the biggest challenge. They possess the necessary structures and flexibility to minimize the problem of adverse selection.

More important are the costs involved. As cellar C clearly illustrates the route to market requires big investments, not only in the vineyard and the cellar, but also in the intangibles involved in creating marketing channels, promotion, etc. As it is, most cellars are not in a comfortable financial state. Going up one level is a risk very few are prepared to take at this stage – and if at all, then only gradually.

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