WINE&SPIRITS DAILY

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How Small Distillers are Changing the Dynamic of the Industry

Dear Client:

As you know, the US alcoholic beverage industry is complex and highly regulated. This presents a challenge to many of the growing craft distillers who started their businesses with stars in their eyes. Often times they're not equipped to handle their own back-office logistics, compliance, or distribution networks. That's where companies like Park Street come in. Founded in 2003, Park Street offers small and medium-sized alcoholic beverage companies importing, distribution, consulting services as well as trade financing. They have worked with dozens of brands, including the likes of Atlantico Rum, Whyte & Mackay's portfolio, Aviation Gin, Chicken Cock Whiskey and several more wines and spirits.

Park Street chief Harry Kohlmann is a 17-year veteran of the alcoholic beverage sector and has advised some of the leading global beverage companies including Bacardi, E&J Gallo and Coca Cola. Needless to say, he has his finger on the pulse of the industry. WSD recently sat down with Harry to discuss the role of small distillers and how they're changing the dynamics of the industry.

Wine & Spirits Daily: What's your view on the role of small and medium-sized brands when it comes to innovation in the spirits industry?

Harry Kohlmann: My view is that over the last 10-15 years, the players in the innovation game have changed. The top players in the industry used to invest heavily in new brand development, and I think over time, they realized that it's not a high return on investment business for them. As a result, they shifted a lot of their innovation capacity from new brand development towards new product development.

Basically, the mandate shifted from "How do we build new brands?" to "How do we effectively extend existing brands?" The main driver of this shift was that large players would create new brands and push them through their distribution network, but then wouldn't be able to give them enough time to survive in their overall system. While the new brands might have been great ideas and would have had the potential to survive in an entrepreneurial setup, in a large company setup, they just die and are written off.

Where new brand development has been most successful is with entrepreneurs in entrepreneurial environments. [They] have been successful building new brands by bringing all types of innovation: everything from packaging and usage to provenance, formulation, production methodology and more. These entrepreneurs are attracted to this industry by the breakout success stories--for instance, Grey Goose, Eppa, and St. Germain. Every year, there are a couple of new brand exits that are basically the benchmarks.

WSD: Do you think the majority of them are entering this industry with a goal of selling like Grey Goose, Eppa and St. Germain?

Harry: My sense is that not everybody enters with the objective "Okay, I've got to sell and that's my plan." I think new entrants want to create compelling brands built on great products, but they also appreciate an exit channel in case they want it. Essentially, if someone, most likely a larger strategic player, offers them an attractive price for the brand they built, they don't have to take it, but it's great to have the option.

WSD: A lot of small and medium-sized suppliers have told us that distribution is their biggest challenge. How do you view the relationship between small suppliers and distributors right now?

Harry: Distribution is a big challenge and there is nobody really to blame because each one of the players that is involved in this discussion is just acting in its own interest. A pivotal point in history was the time when Diageo started its Next Generation Growth program (NGG) in 2001. With this program, Diageo decided to take bigger control of their distribution system and demanded more from their distributors. With Diageo demanding more, distributors had to make accommodations, and as a result, they had to make adjustments throughout their system to recoup what they had just given up to Diageo and then subsequently to other large suppliers, who launched their own versions of NGG.

With distributors accommodating the larger suppliers and giving them essentially their fair share of attention, the small suppliers were faced with this challenge of "Am I really going to get in and if I get in, what can I do to get attention? Do I have to pay more? Or what type of other incentives can I provide? "

I think the mindset that might have been there many, many years ago for small brands when they thought they just needed to get distribution and then they were all set, that the distributor would build the brand by getting it widespread distribution in all target accounts without any major involvement by the brand owner -- that mindset is out the door because now, if somebody is lucky enough to get distribution, they would be requested or required by the distributor to put their own resources on the ground to basically help with account openings, to service the accounts, to educate store owners, gatekeepers and distributor sales people and more. Without an in-market infrastructure that provides attention to smaller brands, it is going to be a big challenge to make the brand prosper.

It is a complicated problem for smaller brands. I think you will see a market reaction by a larger number of smaller distributors entering the market that will service smaller brands in more tightly defined areas . But even these smaller distributors will require the brand owner to deploy in-market resources in order to make the business work for both sides. The challenge for small distributors will be to keep brands once they show traction. Larger distributors have economies of scale and scope and are in a much better position to drive rapid growth acceleration.

WSD: So basically, the smaller distributors will be like incubators.

Harry: In a way, yes and to a certain degree. Small distributors would have to be smart to scale up with the success of their brands to become a big distributor themselves. This is going to be very difficult, but I'm sure we will see some of the small distributors succeed. From the supplier side, I think you will see the emergence of sales networks. In the current environment, local level broker networks represent brands to support the distributors for small brand owners. Once a brand becomes successful, brand owners want to scale up and brokers might lose the brand.

I think moving forward, you will see the emergence of companies that will maintain a larger platform to provide sales and distributor support on a regional or national level. This support includes selling into a distributor, programming a distributor and even selling into retail. BlackHeath Beverage Group is one of the companies that has done this successfully on a national level, and I'm sure there will be others that will be emerging overtime.

Stay tuned for Part II of our conversation with Harry Kohlmann.

WINE&SPIRITS DAILY

March 27, 2014

Part II: A Talk with Park Street's Harry Kohlmann

Dear Client:

Yesterday, we published the first part of an interview with veteran consultant and Park Street ceo Harry Kohlmann, in which we discussed how small distilleries are changing the dynamic of the industry (see WSD 03-26-2014). Today, we're continue our conversation exactly where we left off.

Wine & Spirits Daily: What do you think is the most important factor in a brand success?

Harry Kohlmann: Overall, I would say that a new brand's success is driven by its ability to differentiate itself in the market and that the differentiation [needs to be] relevant for a target consumer group which is large enough to make it a viable business. The consumer brand DNA has to speak to a targeted consumer group in a way that it breaks through the clutter.

WSD: Vodka is a particularly overcrowded category right now. Do you have any advice on how to differentiate within that realm?

Harry: If you analyze the vodka market over the past thirty years, you'll see an interesting evolution of how the vodka market developed: Absolut was first to break out as an innovation brand, and then Grey Goose and Belvedere topped it; this was followed by the rise of lower price point brands that were still premium, like Svedka; then you have Tito's suddenly at the craft brand level coming in and maybe Ciroc on the celebrity-endorsed, African American side and you wonder what's next? That is certainly a lot of activity, and those are only highlights of brands that made it. The pressure to innovate in vodka is enormous.

We have a host of clients that have different ideas about what is next, but it's definitely not going to be just another Swedish vodka at $15 or $20 that is undifferentiated. It has to be something differentiated and I don't think it's about provenance only. I think it's more about a story. Through social media and through mobile internet, today's consumer is much more open to hear background stories on brands and is willing to connect on a deeper level than what had typically been conveyed by packaging and print advertising.

Therefore, if somebody has a provenance story for their vodka, it should be connected to the brand DNA through certain elements that are really tied to the product itself. For example, if a product is emphasizing a country of origin, is there a particular ingredient that is only available in that country and what is the story that makes it relevant for the consumer? Does this particular ingredient out of this country resonate with the consumer or is there a particular benefit that is affiliated with that ingredient?

WSD: Speaking of what's next, I regularly report on suppliers who think that rum is going to be the next category to premiumize. Do you think it seems like a realistic possibility that premium rum is going to take off?

Harry: I can definitely tell you that a lot of people believe in that and that a lot of people are putting significant resources behind it. If you look at Zacapa or Atlantico or Diplomatico, these are brands that have had some early success. I don't think there's anything that speaks against ultra-premium rum to be as successful as ultra-premium vodka. It just hasn't happened yet and there is no indication yet who will be the runaway winner in the segment.

WSD: Do you think premiumization in the spirits category in general is going to continue?

Harry: Yes, I think premiumization will continue to be one of the growth drivers in the industry. There is a certain trend with regards to the [spirits] market that is a reflection of what might be happening in society. On the one side, we have the ultra- and super-premium segments that were hit hard in the recession and that came back strong and are going to get stronger and stronger.

On the other side of the spectrum, we have the entry or regular premium segment, which was one of the beneficiaries of the recession, taking advantage of down-trading activity. When you look at examples such as New Amsterdam or Svedka --that's obviously on the vodka side but you have it across categories -- you see the rise of more sophisticated brand propositions in the entry level premium segments. Brands in that segment actually borrow a lot of attributes from the ultra- and super-premium categories and make them affordable on that level. Brands that do this successfully are gaining notable traction in the market. During the recession, a lot of consumers were educated that it's okay to buy these type of products and they liked them.

Moving forward, consumers might share their brand loyalty and behave differently in on-and off-premise settings. In an on-premise setting, a consumer might order the super-premium product that provides a good badge value and shows his or her personality and gives a lot of additional benefits--enabling the consumer to essentially co-brand with the product, while when at home, that same consumer may consume a premium product that has a lower price point.

WSD: On-premise suffered in 2013. Do you see the suppliers changing their strategies or staying the course?

Harry: I think everybody is trying to see what the real trends are, but my sense is that there is a certain segment of suppliers that are actually increasing their activities in the on-premise from a brand building perspective.

The challenge for large suppliers is determining where they receive the best return on investment when they look to increase volume. The volume expectations across the industry are much higher than what the industry will provide in terms of growth, so the question is where can you secure the growth better or where can you control it better?

I think the off-premise is easier to control or at least that's the perception... so a lot of effort went into driving off-premise sales, which has led to an overall decrease in on-premise supplier spending. Another driving force for off-premise activities have been the liberalization of off-premise tastings in many states over the last ten years. Having said this, I still believe that it's difficult to imagine an ultra-premium brand becoming a blockbuster success without on-premise activities.

WSD: Thank you for your time, Harry.
