Abstract

Today the vast majority of South African wine is still produced by wine cooperatives or former cooperatives. Emerging from decades of regulation and international isolation in the early 1990s, investment flowed into the industry, new vineyards were established, cooperatives modernised themselves, process and product upgrading took place, wine quality improved, and export volumes increased dramatically, most of it sold in the bulk market.

While this has inevitably stimulated innovation, the financial rewards for ‘basic’ quality are limited. Conventional value chain theory suggests that adding further value and improving quality is the way forward.

However, given the classical constraints of traditional cooperatives, is the ‘premium’ quality trajectory a realistic option? The paper tries to provide answers by analysing the particular features of South African wine cooperatives, and dissecting the response of three cellars to their new environment.

The paper concludes by suggesting that by showing adaptability and flexibility, it is less the structural features of the cooperative that is keeping South African cellars back from improving quality, than the costs and capital involved in ‘moving up the value chain’.

Keywords

Cooperatives, South Africa, Quality

Introduction

Today approximately three-quarters of South African wine are still produced by wine cellars which adhere to cooperative principles. These principles include the identity of users and owners, the democratic principle of voting and the non-existing of barriers of entry. Additionally, the legally manifested business aim to nurture their members can be seen as a further characteristic. Traditionally, the aim to establish countervailing power has been regarded as the most important duty of a co-operative. Other business aims like correcting market failure, guaranteeing markets and enhancing margins can be seen as levers to operationalize the main business aim.

By using a property right approach Cook (1995) pointed out five general sets of problems: Free Riding Problems, Horizon Problems, Portfolio Problems, Control Problems and Influence Cost Problems. Using a principal-agent approach and the concepts of opportunistic behavior, conflicts of interest, asymmetric information and stochastic conditions Eilers/Hanf (1999) show that it is not clear who is the principal and who is the agent, i.e. both the co-operatives 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 which alternative dealers do not accept. Cooperatives being forced to accept these commodities face the problem of adverse selection.

In this context the aim of our paper is to analyze whether these problems exist at South African wine cooperatives and if they exist we try to work out some solutions applying a case study approach.

In the following chapter we will introduce cooperatives and their principals. In this context we will also address the main problems that occur within cooperatives regarding their efforts enhancing product and process quality. In order to apply the theoretical finding in a specific setting we will introduce afterwards the South African wine industry and the role of wine cooperatives within it. Following we will introduce some case studies in order to generate some solutions for improving the wine quality for South African wine cooperatives.

Cooperatives and their principles

Worldwide in the wine industry (marketing) cooperatives have a long history of patronizing the businesses of their members. These members are farmers which produce grapes as the “raw material input” for wine which is produced by the cooperative. Hence, wine (marketing) cooperatives processes and also sell the wine as an end product.

A cooperative is an autonomous association of persons who voluntarily cooperate for their mutual social, economic, and cultural benefit (ICA 2014). Hence, in the context of the wine business a cooperative is a legal entity owned and democratically controlled by its grape producing members i.e. the grape growers pool their resources for mutual economic benefit.

The principles of cooperatives are the identity of users and owners, the democratic principle of voting, and the lack of barriers to entry. In addition, cooperatives are legally obligated to nurture their members (Cook 1997, Laurikinari and Brazda, 1990). The goal of establishing countervailing power has traditionally been regarded as the most important duty of a cooperative (van Dijk, 1997). Other business goals such as correcting market failure, guaranteeing markets, and enhancing margins can be viewed as tools to meet those business goals. Sykuta and Cook (2001), in the context of increasing vertical coordinated agri-food systems, showed that contracting is the most practical coordination mechanism at the producer level. Producer co-ops, because of their very own property rights structure, have advantages compared to investor-owned firms.

However, due to their unique institutional form as a member-owned firm, co-operatives face several problems that are of a more general nature and are particularly related to verticalization (Bijman and Hendrikse 2003). Fulton and Giannakas (2001) showed that the cross-subsidization and member heterogeneity in large centralized, multipurpose co-ops may lead to substantial financial pressures for the cooperative because members do not see a strong connection between the success of the co-op and their own business. However, cooperatives can be characterized as being Janus faced, i.e. they are member-owned firms as well as associations of individuals (Anshoff and Henningen, 1986). In addition to economic matters, social mechanisms such as trust and loyalty to the cooperative firm are of high importance. However, the more heterogeneous the members, the more these social mechanisms lose their function (Bijman, 2005).

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. Furthermore, Karanitinis and Zago (2001) showed that instead of selling their commodities to open co-ops, farmers would rather sell them to investor-owned firms if they had the choice. Fulton (1995) concludes that if markets disappear as a result of increased vertical coordination, cooperatives may also begin to disappear. Hendrikse and Bijman (2002) share this assessment in the event that the investment of the processor or retailer becomes more important for the total chain value than the investments by the farmers.

Because of the importance of quality in the verticalization of the agri-food business, the findings of Eilers and Hanf (1999) address a major weakness of co-ops. Using a principal-agent approach and the concepts of opportunistic behavior, conflicts of interest, asymmetric information, and stochastic conditions, they showed 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) showed that in comparison to a manager of an investor owned firm the overall challenges of a cooperative manager are not significantly different but more difficult.

Traditionally, an open membership policy has led to co-ops having rather heterogeneous members. In general, members can vary according to their geographic dispersion, variance in age and education, farm
Per capita consumption has dropped from 9.7 litres in 1997 to 6.9 in 2012 (SAWIS).

However, ‘new world’ competitors like Chile and Australia have done even better (Vink et al 2012).

Including so-called ‘planting quotas’, laying down the type of cultivars a grower was allowed to plant, as well as management on behalf of the members. For its services the pool pays the coop production costs.

Which prompted Jancis Robinson (1999: 648) to describe the ‘old’ South African wine industry as ‘…a vast distillery of labour rights to farm workers. This ‘triple transition’ (Ewert and du Toit 2005) set in motion a process of maintenance of an acquired position. The extras (e.g. promotional support) that need to be delivered to the KWV could export ‘north of the equator’. Because the cooperatives could not compete with their products in international markets, this never became an issue. What was more detrimental in the long run, was the fact that it cut off management and members alike from exposure to the market. In a sense, members’ thinking stopped at the cellar ramp.

For most growers though the regulation regime represented a ‘comfort zone’ which provided for a secure, if not luxurious livelihood. The farmers, in turn, showed their gratitude by supporting the ruling National Party, which bestowed an increasing number of powers onto the KWV (Vink et al 2004) whilst withholding the most elementary rights from workers, in line with an authoritarian political system and serving as a reminder that the industry had been founded on slave labour (Ewert and du Toit 2005).

The KWV also had a monopoly on exports. While it left the domestic market to the wholesalers, only the KWV could export ‘north of the equator’. Because the cooperatives could not compete with their products in international markets, this never became an issue. What was more detrimental in the long run, was the fact that it cut off management and members alike from exposure to the market. In a sense, members’ thinking stopped at the cellar ramp.

For most growers though the regulation regime represented a ‘comfort zone’ which provided for a secure, if not luxurious livelihood. The farmers, in turn, showed their gratitude by supporting the ruling National Party, which bestowed an increasing number of powers onto the KWV (Vink et al 2004) whilst withholding the most elementary rights from workers, in line with an authoritarian political system and serving as a reminder that the industry had been founded on slave labour (Ewert and du Toit 2005).

This whole system started to unravel in the early 1990s. Giving in to the spread of neo-liberal economics and deregulation of the agricultural sector (similar to Chile under Pinochet), increasing resistance by the estate wineries to bureaucratic KWV control and the fear of a hostile new state keen on confiscating cooperatives’ assets that had been build up with the support of successive white governments, planting quotas were suspended in 1992. The minimum price could not be sustained and was abolished in 1995, which made the ‘surplus pool’ redundant even before the conversion of the KWV into a company in 1997 (Williams 2007). By then the KWV had lost all its regulatory powers.

With regulation something of the past, the cooperatives could free themselves from the stranglehold that the producing wholesalers had frequently exercised. Coops now had new options, selling to the estates, especially exporters who needed the additional quantity. Others could find their own market.

Deregulation coincided with two other profound developments that finally unid a system almost 5000 growers had come to know and rely upon, i.e. the opening of international markets and the extension of labour rights to farm workers. This ‘triple transition’ (Ewert and du Toit 2005) set in motion a process of change and transformation which continues to this day.

\footnote{Per litre of wine.} 
\footnote{Which prompted Jancis Robinson (1999: 648) to describe the ‘old’ South African wine industry as ‘...a vast distillery draining a partly subsidised annual wine lake’} 
\footnote{Including so-called ‘planting quotas’, laying down the type of cultivars a grower was allowed to plant, as well as the quantity.} 
\footnote{They often tried to force coops to sell all their wine to them or they wouldn’t buy any.}

\section*{Backdrop: twenty years of transformation}

\subsection*{The regulation era: quantity instead of quality}

Regulation of the South African wine industry (SAWIS) lasted for just more than seventy years, from 1918 to the early 1990s. Empowered by law a giant cooperative, KWV (translated: Cooperative Winegrowers Association of South Africa), came to regulate the industry in detail. The lynchpin of the system was the minimum price. Farmers, organized into cooperatives, were guaranteed the minimum price per litre from the mid-1920s onwards. Most of the wine was sold to a handful of producing wholesalers who also controlled the domestic retail market. Whatever could not be sold (i.e. the ‘surplus’), was ‘removed’ from the market by the KWV – most of it distilled into brandy. The leftovers were supplied to workers as a form of remuneration (Williams 2010).

The KWV also had a monopoly on exports. While it left the domestic market to the wholesalers, only the KWV could export ‘north of the equator’. Because the cooperatives could not compete with their products in international markets, this never became an issue. What was more detrimental in the long run, was the fact that it cut off management and members alike from exposure to the market. In a sense, members’ thinking stopped at the cellar ramp.

For most growers though the regulation regime represented a ‘comfort zone’ which provided for a secure, if not luxurious livelihood. The farmers, in turn, showed their gratitude by supporting the ruling National Party, which bestowed an increasing number of powers onto the KWV (Vink et al 2004) whilst withholding the most elementary rights from workers, in line with an authoritarian political system and serving as a reminder that the industry had been founded on slave labour (Ewert and du Toit 2005).

This whole system started to unravel in the early 1990s. Giving in to the spread of neo-liberal economics and deregulation of the agricultural sector (similar to Chile under Pinochet), increasing resistance by the estate wineries to bureaucratic KWV control and the fear of a hostile new state keen on confiscating cooperatives’ assets that had been build up with the support of successive white governments, planting quotas were suspended in 1992. The minimum price could not be sustained and was abolished in 1995, which made the ‘surplus pool’ redundant even before the conversion of the KWV into a company in 1997 (Williams 2007). By then the KWV had lost all its regulatory powers.

With regulation something of the past, the cooperatives could free themselves from the stranglehold that the producing wholesalers had frequently exercised. Coops now had new options, selling to the estates, especially exporters who needed the additional quantity. Others could find their own market.

Deregulation coincided with two other profound developments that finally unid a system almost 5000 growers had come to know and rely upon, i.e. the opening of international markets and the extension of labour rights to farm workers. This ‘triple transition’ (Ewert and du Toit 2005) set in motion a process of change and transformation which continues to this day.

\footnote{Per litre of wine.} 
\footnote{Which prompted Jancis Robinson (1999: 648) to describe the ‘old’ South African wine industry as ‘...a vast distillery draining a partly subsidised annual wine lake’} 
\footnote{Including so-called ‘planting quotas’, laying down the type of cultivars a grower was allowed to plant, as well as the quantity.} 
\footnote{They often tried to force coops to sell all their wine to them or they wouldn’t buy any.}
### Table 1: Structural change in the SA wine industry 1993-2012

<table>
<thead>
<tr>
<th></th>
<th>1993</th>
<th>2002</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total ha planted</td>
<td>82833</td>
<td>94412</td>
<td>100568</td>
</tr>
<tr>
<td>White cultivars %</td>
<td>82</td>
<td>59</td>
<td>56</td>
</tr>
<tr>
<td>Red cultivars %</td>
<td>18</td>
<td>41</td>
<td>44</td>
</tr>
<tr>
<td>Total production (million litre)</td>
<td>857 389</td>
<td>746 485</td>
<td>1 012 771</td>
</tr>
<tr>
<td>Wine (% of total production)</td>
<td>46</td>
<td>71</td>
<td>82</td>
</tr>
<tr>
<td>Rebate (% of total production)</td>
<td>13</td>
<td>1</td>
<td>3</td>
</tr>
<tr>
<td>Distilling (% of total production)</td>
<td>35</td>
<td>15</td>
<td>11</td>
</tr>
<tr>
<td>Grape juice (% of total production)</td>
<td>7</td>
<td>13</td>
<td>4</td>
</tr>
<tr>
<td>Producers (n)</td>
<td>4734</td>
<td>4390</td>
<td>3527</td>
</tr>
<tr>
<td>Cooperatives/Producer cellars (n)</td>
<td>71</td>
<td>67</td>
<td>52</td>
</tr>
<tr>
<td>Private cellars &amp; estates (n)</td>
<td>173</td>
<td>310</td>
<td>505</td>
</tr>
<tr>
<td>Producing wholesalers (n)</td>
<td>6</td>
<td>11</td>
<td>25</td>
</tr>
<tr>
<td>Total no. cellars (n)</td>
<td>257</td>
<td>409</td>
<td>582</td>
</tr>
<tr>
<td>Exporters (n)</td>
<td>7</td>
<td>21</td>
<td>44</td>
</tr>
<tr>
<td>Domestic sales (% of total production)</td>
<td>94</td>
<td>67</td>
<td>57</td>
</tr>
<tr>
<td>Exports (% of total production)</td>
<td>6</td>
<td>33</td>
<td>47</td>
</tr>
</tbody>
</table>

Source: Personal communication, Francois Viljoen (Vinpro), 5 May 2014.

In the last years of the KWV era, the latter’s extension officers had started to experiment with the planting of non-standard cultivars, introduced ‘cultivar guidelines’, new trellising and irrigation systems, but these were small islands of innovation in a sea of crude mass production. At the time (1993) there were 71 cooperatives, with their members totaling more than 90% of the 4734 growers. Of the 82 833 ha planted, only 18% were red grapes. 48% of the output consisted of rebate and distilling wine, surpassing drinking wine by 2%. The rest was grape juice. 94% of production was for the domestic market, with only 6% exported. Most of the latter was not table wine, but fortified.

When sanctions were lifted in 1993, most cooperatives and their members did not immediately embark on a program of investment and modernization. Not sure of the political outcome, most preferred to wait until after the first democratic election in 1994. New plantings, expansion, technical upgrading and forays into foreign markets only took off in earnest in 1995/96. This became the watershed for new SAWI.

Responding to broad market trends: the rush to plant red and noble cultivars

Although most managers of cooperative cellars were steeped in a productionist paradigm and had little or no marketing experience, they were fast learners. Returning from wine expos and meetings with (mostly European) retailers, they brought back a clear message: what the market wanted were red and so-called ‘noble’ cultivars.

With something akin to a frenzy, growers at the Cape uprooted old vineyards and planted new ones, thereby reducing the ‘workhorses’ of the industry, viz. Chenin Blanc and Colombard, whilst breaking new ground with plantings of Chardonnay, Sauvignon Blanc, Cabernet Sauvignon, Shiraz, Merlot and Pinotage. By 2002 the number of hectares had increased to 94 412 (from 82 833 in 1993), 41% of which was under red grapes. Drinking wine’s share of total production had increased to 71% and exports to 33%.

However, the newly founded Wines of South Africa (WOSA), tasked with the generic marketing of SA wine overseas, transmitted a message from its offices in Europe that local producers were under-pricing themselves and that efforts should be made to move out of the low price (LP) and into the medium (MP) and higher price (HP) bands. This new emphasis on not just the ‘right’ cultivars, but better quality, contributed to the accelerated diffusion of focused canopy management and ‘block grading’ throughout the Cape wine lands.

This went hand in hand with the introduction of differentiated payment systems, distinguishing between different classes of quality. The latter in turn made possible the formation of ‘strategic membership groups’, coalescing around the different categories. Together this represented a third significant quality shift, after the introduction of cultivar guidelines in the late 1980s/early 1990s and the planting of red and noble cultivars.

Keeping the customer satisfied: increased product differentiation

However, in the wake of the increased contact with all kinds of customers and the movement into new markets, South African producers were faced with a new development, viz. that customers were becoming increasingly demanding and particular – not only as far as food safety standards are concerned, but also regarding wine styles, price points and the total ‘package’. For instance, different customers often wanted the same wine, even the same style, but in their own particular packaging.

This challenge was coming their way at a time when economic conditions started to deteriorate. By the mid-2000s red wine prices plummeted as a result of a global glut. Growers’ financial position was further aggravated by the onset of the world recession in 2008, customers ‘trading down’, and stagnating grape prices, whilst input prices kept on rising. The industry only started to recover in 2011.

This had a visible effect on the profitability of the producer cellar sector. Although net revenues per hectare in 2012 (R36 000.73) were considerably higher than in 2008 (R24 105.51), profits per ton (R45.37)
were still below the 2008 figure (R54.93). Although the average price per litre in 2012 (R4.90) was higher than in 2008 (R3.90), it was lower than in 2011 (R5.00). In 2012 few cellars were able to break through the R6 per litre barrier for red varieties and R6 per was also the maximum obtained for white varieties (PricewaterhouseCoopers 2013).

The difficult revenue and profitability situation of the cellars is reflected in the negative 'acid test'16 ratio of 0.38:1 for 2012. Return on investment17 in 2012 (11%) was worse than 2008 (17%). On top of this the Own vs Loan Capital ratio was 27% : 73% (2012).

Increasingly differentiated customer demands plus unfavourable market conditions resulted in a new orientation in the vineyard: not better quality as the open-ended, ultimate goal, but ‘market related vineyard management’, i.e. a particular vineyard (‘block’) is managed for a particular customer and/or market. Depending on market conditions, this could mean that in one year a specific block on grower X’s farm may be managed as a class ‘A’ vineyard, while in another year it may be farmed as a class ‘B’ – simply because it makes economic sense, given depressed prices on the one hand and rising input costs on the other.

However, one could argue that for all the focused vineyard management, it doesn’t change the fact that most of the wine is sold as bulk in the ‘popular premium’ price band. That is why of late much has been made of a ‘new’ trellising system that holds the promise of a killing two birds with one stone, i.e. not only higher yields, but also better quality, possibly replacing the VSP18 ‘hedge’ system which currently dominates the Cape vineyards. One reason is its suitability for machine harvesting, currently standing at 58% of all vineyards19.

Trials with the Smart-Dyson however, have produced increased yields by an average 40% and improved quality20. The first results have shown that ‘profitability is considerably higher than with standard hedge systems’ (Bosman 2011). For those concerned with the diffusion of technical know-how and the profitability of the average grower, the new system is like a godsend. Combined with high yielding clones and more mechanization, it could put producers in a position to absorb ever increasing costs and stay competitive.

In the meantime exports of South African wine are on the increase again. By 2012 they had recovered to 47% of total production – a 17% increase on the previous year21. In 2013 they increased by a further 27% (SAWIS), strongly driven by shortages in the ‘old’ wine producing countries. Although reduced to 5222, ‘producer cellars’ still supply most of it – be it as traditional co-operatives, companies or a combination of the two.

From cooperative to company – the response to ‘impractical’ and ‘political’ legislation

Unlike wine cooperatives in some other parts of the world (e.g. Languedoc-Roussillon in the south of France), the raison d’etre for cooperative cellars in South Africa was devoid of any socialist motive. For quasi-feudal white land owners ruling over cheap, black, subordinate labour, nothing was more foreign than socialism. From the beginning the ethos was less egalitarian. Instead their motives were more practical, viz. to pool resources and to improve wine quality.

20 The ‘acid test’ is calculated as the ratio between debtors and cash held vs the debt owed by the cellar’s creditors.

21 Return on investment is calculated earnings before interest and tax as a percentage of capital and reserves. It provides a picture of the cash flow situation.

22 VSP: Vertical Shoot Positioning

23 Personal communication, Francois Viljoen, Vinpro, 5 May 2014.

24 The Smart-Dyson trellis is here to stay. It is mainly recommended where average to more vigorous growing conditions are expected. Profitability is considerably higher with standard hedge systems. This is ascribed to increased yields while wine quality is mostly also better, mainly due to more balanced vigour...Although pruning costs are slightly higher with SD, summer canopy practices such as suckering and tipping are less and no leaf plucking is required. The total running cost is approximately 10% more’ (Bosman 2011).

25 In 2013 exports increased by a further 27% on 2012.

26 This is mainly due to mergers. Very few if any have gone bankrupt and stopped functioning as production sites. They few that went out of business were snapped up by private investors, e.g. Overheuwel cellar near Worcester.

With the support and encouragement of the Cape colonial government the first producer cooperatives were formed between 1906 and 1909. The next, and most rapid expansion was between 1939 and 1949 when 27 new cooperative cellars were established, especially in the high production areas of the Breede River valley (i.e. Worcester, Robertson and Bonnievale). It reached its apex in 1993, where there were 71 (Botha 1966).

Most wine cooperatives in South Africa are ‘closed coops’23, i.e. they only accept and process the grapes of their members. Entry is not without barriers. 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, even if the payment is sometimes staggered over a number of years24. Although ‘anybody’ is welcome to apply, most cooperatives have a strong sense of ‘family’ and they try to keep it that way. This is clearly borne out by those cellars that have converted to companies, but where the new shareholders are de facto limited to the ex-members of the cooperative.

Members have a ‘delivery right’, but also a ‘delivery obligation’. The lynchpin of the cooperative system is the ‘pool’ (of grapes/wine) - a separate legal entity25 that is managed by the cooperative. It only charges the pool for the production costs26. The pool itself is a non-profit company and pays no taxes. Pay-outs 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 co-operatives that converted to companies, have retained the ‘pool’.

Having a pool means that a producer can deliver any grapes within his ‘delivery right’ (i.e. fixed tonnage). The choice of cultivar and quality is his and being a cooperative, the cellar has to accept them, although there are also an absolute minimum standard as far as quality is concerned27. At the same time the member does not necessarily know what price he will get, or when he will get paid.

In its financial decisions, the coop management has to tread a careful path between pay-outs and investments. Pay-outs have to be ‘reasonable’ in order to provide funds for replanting and upgrading in the cellar. On the other hand management has to be careful not to over-invest in cellar equipment in a way that it does not make itself felt in the growers’ return.

In a fully-fledged company the relationship between management and grower is different. Such a cellar would have contracts with suppliers, setting out exactly what price they will get and when they will be paid. This arrangement has the consequence that management can not only be more selective as far as grapes are concerned, but is also that under constant pressure to pay its staff and suppliers. This promotes efficiency. Efficiency aside, companies can also have shareholders that are non-growers, thereby sourcing outside capital. Growers receive payments almost immediately, but also have to pay taxes earlier.

Coops are governed by their ‘statute’ or constitution. Within the framework of the law there was considerable flexibility regarding shareholding and voting rights. Every cooperative could devise its own system of voting rights (usually linked to the number of tons delivered), as long as no member commanded more than 20% of the votes. Most of the time decisions would be taken by a show of hands, in which case every member had one vote. However, in the case of controversial issues, the election of the board, or changing of the statute, the ‘weighted vote’ can be evoked. In such cases, voting takes the form of a secret ballot. Thus in the South African case it was never a simple, uniform matter of one member, one vote. This had the result, amongst others, that smaller farmers with fewer votes could not obstruct important (investment) decisions.

24 In terms of the Cooperative Act, 1981.

25 Exiting a coop is not easy. When doing so a member has to pay his portion of the debt in proportion to his share.

26 A Section 21 company, i.e. non-profit company.

27 As a consequence most cooperatives’ turnover is so low (i.e. less than R 5 mill. p.a.), that they are not obliged to pay corporation tax on their turnover.

28 Management can reject grapes that are not even fit for the lowest quality class, i.e. distilling wine. For instance, rotten or partially rotten grapes. However, at most co-operatives even in such instances there would be right of appeal to the board.
Most cooperatives were managed by board of directors elected by the members. These would normally be the bigger farmers, having considerable clout because of their size. As a result, once a decision had been passed by the board, there would normally be little resistance by the rank and file.

The board appointed the manager who, in the mass production era, more often than not was a wine maker, with little or no management training. This or any other specialist training was not deemed necessary.

Role differentiation first started to occur in the wake of the general modernization push in both vineyard and cellar from the mid-1990s onwards. At most ‘producer cellars’ the roles of winemaker and manager have become separated. In many cases viticulturists have been appointed to act as the link between the winemaker and the growers. Most have their own accounting staff, while laboratory services are bought. Frequently the board has been professionalised with directors being tasked with different functions (e.g. cultivar trends). Where they can afford it, cellars have appointed marketing managers, bought the services of an agent or gone into a joint venture with the latter.

The conversion to companies however, had little to do with business reasons. Although managers quickly discovered that ‘coops do not have a good name [in the wine business]’, that was not enough reason to change their legal status. The reasons were decidedly political, touching on the issues of accumulated assets, voting powers and the legal identity of members. The first conversions took place in the second half of the 1990s and were closely linked to the KWV’s legal battle over the retention of its assets.

In 1995 the KWV appointed a new chairman and managing director to oversee KWV’s reinvention of itself as ‘free enterprise and market oriented’ organisation (Williams 2007). Part of the strategic considerations was to take with them the assets the KWV had accumulated over decades – with the assistance of the (white) state, as the new (ANC) minister of agriculture argued. It was only after bitter recriminations that the two parties reached a compromise and settled out of court (Vink et al. 2004; Ponte and Ewert 2007). The KWV agreed to transfer several hundred million into a development fund for the historically disadvantaged over a certain number of years.

Fearing similar action from what some perceived to be a ‘hostile’ black government, the first handful of cooperatives converted towards the end of the 1990s, taking their assets with them (Ewert 2003). Mirroring these changes, and responding to the publication of the 2005 Cooperative Act, the Cooperative Cellars Committee (KWK), the umbrella organisation of the cooperatives, decided to rename them ‘producer cellars’ in 2006.

The second spate of conversions over the last eight years or so were in direct response to the 2005 Act. In it the government tried to give cooperatives in South Africa a more ‘social’ character, thereby bringing them into line with the international (or classical) principles governing cooperatives and promoting them as vehicles of development.

The 2005 Act tried to do away with some features that had become firmly institutionalized at the wine cooperatives, e.g. the weighted vote. At a whole number of cooperatives there was a concern for instance, that if a member farm had become subject of a black economic empowerment (BEE) project, involving a large number of individuals or families, they could easily outvote the established members.

Another objection was that the new act did not recognize a ‘juristic entity’ (e.g. company, closed corporation or trust) as a member. Many farmers found this to be extremely problematic as most farms had been registered in the name of such entities and not individuals.

After a raft of submissions and several consultative workshops, the government backtracked on most of the contested clauses in the Cooperative Amendment Act of 2013 and restored the status quo ante, including the weighted vote, barriers of entry etc. 28.
the cellar’s classification system between 10–15% of all wines fall into the top class, satisfying the manager that the cellar ‘has reached its quality objectives’.  

All grapes of members are accepted (as stipulated by coop legislation). This has no dramatic detrimental consequences as only 1% of production (2013) ends up as distilling wine. Members have the right to sell grapes to third parties, as long as the cellar is notified and the fixed production costs are paid. Selling grapes without notification incurs an extra fine.

At the cellar tasting the wines of each member are kept separate, e.g. class A Cabernet of members X, Y and Z to confirm the classification (or not). At a separate meeting the wines are presented to the cellar’s clients to see whether the two parties can agree or not.

The cellar’s most important client is a producing wholesaler with whom it has had an ‘evergreen’ contract for the last ten years. Some six months before the tasting takes place, the same client sets out the different quality classes it wants per cultivar, after which the respective prices are negotiated. The wholesaler prescribes the style of wine and gives advice on the desired vineyard practices. An advance payment of 30% is made, the rest is paid on the 1st of July in the following year, after the tasting.

This is by no means a pro forma affair, but subject to the vagaries of the market, is illustrated by the fact that some ten years ago the wholesaler accepted 70% of the wine as top class (and paid the appropriate price), while last year it was only 15% - although intrinsically it may have been the same quality. With customers trading down, the market for ‘top quality’ had simply shrunk and buyers can be more selective.

Even though the cellar tries to manage its costs very carefully, its ‘acid test’ ratio was 0.11:1 in 2013 (compared to the sector average of 0.38:1 in 2012). Its Own vs Loan Capital ratio was 23% : 77%, also slightly weaker than the sector average of 27% : 73%.

Nevertheless, it was one of the few producer cellars that attained more than R6 per liter for its red wine in the domestic market (i.e. R6.81). This may help to explain the significant replantings (65 ha) over the last five years. That amounts to 8.9% of the total number of vineyards. At a minimum of R130 000 establishment costs per hectare, this represents a considerable investment on the part of the members.

Not only is the financial picture a mixed one, the cellar’s overall position is double-edged: on the one hand the long term relationships with its main clients provides a certain kind of security, but it also points to a relationship of dependence. Although the manager seemed to entertain the idea of not renewing the ‘evergreen’ contract that has just run out, the reality is that to embark on a self-marketing, value-adding trajectory ‘overnight’ is difficult. Not only would this require considerable investment and further weaken the cellar’s financial situation, but experiences over the last ten years or so have shown that the market can play havoc with ‘top quality’ and when this happens it is not worth the extra costs. When markets are down, it merely aggravates the systemic problem of ‘adverse selection’.

Cellar B: Hybrid: cooperative and company

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 1994 election. In 1992 it took two important decisions: firstly, it created a ‘Pool B’ in order to promote the production and supply 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 order to deliver grapes to pool B. This also made it possible to source grapes from non-members and accelerate the transition.

Although he repeatedly added: ‘...under current conditions’.

This means that the wholesaler guarantees the purchase of a certain volume of wine for a ten year period, but that the prices are negotiated every year.

In the same period they uprooted 83.1 ha.

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 11th April 2014.

Secondly, it drew up a 15 year ‘cultivar plan’ in order to manage the transformation of members’ vineyards in a coordinated fashion.

In 1994 the cellar established a trading company to act as an international marketing vehicle for the co-op’s wines. In addition it sources grapes and wine from third parties. The members of the cooperative are the shareholders. Neither its name, nor that of the cellar contains the word ‘cooperative’.

In the early 1990s it already sold wine to British supermarkets, but the real breakthrough came when it landed a big red wine contract with a Swedish client in 1999.

In all this the current manager, who was trained in both wine making and business practice, 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 change was the discovery early on that we ‘did not have the cultivars that the market wanted’.

In 1991 when he was appointed, the cellar was a rebate, distilling wine and grape juice producer. Together its members only produced 20 tons of red grapes. Today its product mix consists of 61% drinking wine, 35% grape juice and 4% distilling wine.

In addition to the manager, the cellar has two full-time and one part-time wine maker, an in-house viticulturist, full-time marketer, and accounting and laboratory personnel (the latter only during harvest). The manager’s remuneration is not performance linked.

Over the last 20 years the cellar’s membership increased slightly to 63, but the number of farming operations has stayed the same (28:35). In that sense the cellar has stayed within the ‘family’. Together they farm 1800 ha of vineyards, producing an average yield of 17 tons per ha. 77% of vineyards are machine harvested. Members are allowed to sell 0.5% of their grapes to third parties, but the payment has to be made via the cellar.

Members have one vote per 10 tons delivered, up to a maximum of 1000 tons (i.e. 100 votes). No member is allowed to own more than 20% of the shares.

Directors are elected by the members. At the board level there is a division of labour. Every director is responsible for a specialised function, viz. finance, planning, quality of produce, new plantings and trends, marketing and human resources. In addition there is a non-executive director appointed for his financial expertise.

Seventy one percent of all plantings are white grapes, with Colombar (29%), Chenin Blanc (17%) and Chardonnay (12%) providing the backbone. Cabernet Sauvignon, Ruby Cabernet and Pinotage are the most prominent red cultivars.

Although only 10% of the blocks are graded, ‘every block is earmarked for a specific market’. All grapes are subject to an inspection that involves chemical analysis, physical appearance and temperature parameters.

This quality assessment system goes hand in hand with a differentiated payment system. For Chenin Blanc and Colombar there are four classes, with the lowest two classes destined for juice production. Over the last five years that amounts to 8.9% of the total number of vineyards. At a minimum of R130 000 establishment costs per hectare, this represents a considerable investment on the part of the members.

With customers trading down, the market for ‘top quality’ had simply shrunk and buyers can be more selective.

In the same period they uprooted 83.1 ha.

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 11th April 2014.

©www.vdqs.net/2014 Lyon – France

11

©www.vdqs.net/2014 Lyon – France

12
The general manager has been in this position since 2006. He is a qualified Chartered Accountant. He was one of the first South African cellars to sign up to the 'labour code' of the London based ETI (Ethical Trading Initiative), and the precise investment in research, vineyard and wine making practices and cellar and packaging technology.

It was one of the first South African cellars to sign up to the 'labour code' of the London based ETI (Ethical Trading Initiative), and it moved away from juice and distilling wine production and established wine cultivars instead. In 2006 the cellar converted to a company, because of 'the impractical provisions in the 2005 Cooperative Act' (e.g. doing away with the weighted vote). The grape producers own the shares in a holding company which controls several affiliates, incl. the two cellars, and the distribution company. However, the producers still deliver to the time honoured 'pool'. The latter remains the business model.

During the whole process of change, the cellar has kept in the hands of the founder members. No new growers have joined. Instead the cellar has lost 20 members over the last twenty years, with owners of small, uneconomical farms selling off to bigger ones.

Voting rights are not equal, but linked to the number of tons delivered. A member gets 500 shares per ton. The more shares, the more votes, with a maximum % vote per producer (as was the case in our 'hybrid' cellar above).

At the board level there is no division of labour in the form of portfolios or the like. Also, there are no non-executive directors.

However, at the operational level there is a host of specialist personnel: three wine makers each at the red and white wine cellars. Three in-house viticulturists, plus one from Vinpro on a contract basis.

Because the cellar is situated hundreds of kilometers from the hub of the wine industry in Stellenbosch, the cellar has its own laboratory and staff. Logistically it is too difficult and costly to outsource these services.

For the domestic market it has staff employed at the sales company, plus personnel at 14 branches countrywide. The export market is managed by a specialist marketer and logistics staff (in Cape Town, near the harbour and airport).

On the 160 farms a total of 5 000 hectares of vineyard are cultivated. Over the last five years, 541 hectares were uprooted and 606 planted (12%). The average yield per hectare is 20 tons. 93% of vineyards are harvested mechanically.

69% of all vineyards are under white grapes, with Colombard and Chenin Blanc providing 29% and 24% respectively.

35% of all blocks are graded, supplemented (for all grapes) by visual inspection in the vineyard and sugar levels and temperature at delivery. All grapes are accepted, but downgraded and the price reduced accordingly if they are 'poor' quality.

Like most cellars it has a differentiated payment system in place, with up to 7 different quality classes for certain cultivars (e.g. Pinotage). Payments for Colombard vary from R1460 to R900 per ton (three classes). The highest price is for class A Pinotage grapes at R4500 per ton.

80% of the company's wine qualifies for its top quality class. From the manager's point of view, the cellar is reaching its quality goal 'according to current planning'. However, the objective is to improve on this by 'continued investment in research, vineyard and wine making practices and cellar and packaging technology'.

The cellar tries to motivate its members through vineyard block competitions and prices, vineyard to wine quality monitoring and by rewarding producers for achievements at wine competitions.

In 2013 90% of production was drinking wine, 6% distilling and 3% rebate wine. 1% was grape juice.
Of all three cellars discussed in the paper, this is the only one that sells most of its wine through self-marketing. 85% is sold in the domestic market, 15% overseas. In the local market 99% is sold under its own label, in international markets 20%.

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

Interestingly, in 2013 the most important international market was France - most of it in bulk, supplementing a poor harvest. The next two biggest markets were the UK and Germany.

In 2013 the cellar realised R3.80 per litre (net) for its white wine, R6 for red in the domestic market. In the UK the cellar’s bottled wine sells for £5 on the shelf. Its 5 litre box for £16.37. However, after excise tax, the retailer’s share etc., the cellar’s margin is rather thin 108.

Given that white wine is its main business, this is far from the industry ideal of R6 per liter. However, through its strategy of supplying (mostly boxed) wine for specific markets, the cellar has established itself as ‘the No.1 volume brand’ in South Africa. In the UK market its brand is amongst the top 20 selling labels (measured by volume).

However, a heavy investment program makes itself felt in the financial indicators. In 2013 the Own vs Loan Capital ratio was 30% : 70%, the ‘acid test’ ratio 1,0 : 1,2.

The manager admitted that over the last 10 years or so there had been tension from time to time between members’ desire for higher payouts on the one hand and the need for debt servicing and capital investment on the other, but this had been managed by ‘ongoing structured capitalisation and investment’, going hand in hand with the ‘repeated explanation of the business model and the importance of sustainable progress’.4

Looking into the future the manager underlined ‘higher profitability of the current infrastructure’ as an objective, but at the same time the ‘expansion may be necessary to guarantee organic growth of the business’. He was fairly optimistic that these goals could be reached ‘judged by results in more recent times and if conditions remain more or less the same’.

Conclusion

In the space of twenty years South African cooperatives and ex-cooperatives have moved from producers of mainly rebate and distilling wine for the domestic market to suppliers of demand driven wines in the ‘popular premium’ segment for both local and international clients.

Through the planting of market related cultivars, the focused management of vineyards, upgrading in the cellar, organisational innovation and the mastering of logistics, South Africa’s ‘producer cellars’ have been able to supply wines to a variety of customers in the specifications and at the prices that they want.

As our case studies show they have done this by taking different routes – from the low-risk option of producing for a local wholesaler in terms of a long term contract, supplying ‘branded bulk’ to brand owners, to own branding and marketing.

In their endeavour management encountered relatively little resistance from their members, be it in the form of a limited ‘horizon’ or otherwise. In the new era management was able to decide quite early on the trajectory it wanted to take. Although not everybody was convinced and there was opposition in some cases, the sceptics were not able to put the cellars off course. On the whole there were few ‘control’ or ‘influence’ problems.

---

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

38 Of this the retailer’s margin is £1.07, VAT is 61 pence, Excise tax is £2.10, and the agent’s margin between 5-10%.
Literature


