

DEEP ROOTS DISTILLERY

Professor Paul Beamish wrote this case solely to provide material for class discussion. The author does not intend to illustrate either effective or ineffective handling of a managerial situation. The author may have disguised certain names and other identifying information to protect confidentiality.

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INTRODUCTION

By September 2015, Deep Roots Distillery (DRD) had been operating for 22 months. While the start-up had taken a little longer than originally estimated, material progress was now in evidence. By November, the company expected to have six of its products (either spirits or liqueurs) available in the Prince Edward Island Liquor Control Commission (PEILCC) outlets.

However, numerous questions remained for Mike Beamish and his small, family-run business. Given capital and resource constraints, how could DRD grow into a competitive business? How should time be allocated between research and development, production, marketing, and administration? Would the start-up's current product/market strategy allow it to achieve its goals? If not, which expansion route should DRD take?

BACKGROUND

DRD was located in Warren Grove, Prince Edward Island (PEI), a village about 15 kilometres outside Charlottetown, the largest city in Canada's smallest province. PEI's population was only 140,000, but the province was a popular tourist destination, with 1.3 million visitors annually. The tourists were mostly from Canada (87.7 per cent), but with material numbers from the United States (7.7 per cent) and other countries (4.6 per cent). Most tourists visited from June to September, and tended to enjoy the area's laid-back lifestyle, beaches, fresh seafood, music, and scenery.

The family-owned Beamish Orchard had been growing tree and field fruit since 1990. With over 500 apple trees, and by 1995, the orchard started to sell its apples by the roadside. As production grew, the family opened the farm to customers looking to pick their own fruit (u-pick). With a consumer trend toward more organically grown food products, the family decided in 2004 to move away from conventional agricultural practices. In 2005 the Beamish Orchard acquired full organic certification from Atlantic Certified Organic. The Department of Agriculture and Fisheries stated:

Fruit production was very diverse on Prince Edward Island. Lowbush blueberries made up the largest acreage of commercial fruit crops at 13,000 acres. Commercial cranberry bogs and strawberry fields were located across the province. Strawberry nursery stock was produced for export to the Southern [United States]. Twenty-thousand apple trees filled Island orchards, and the industry was expanding rapidly. Specialty fruits including raspberry, gooseberry, rose hips, black currants, and highbush blueberry were produced on small acreages. Rising interests in grape and the haskap berry had resulted in new developments of these crops. PEI had an active honey bee industry, which supplied approximately 6,000 colonies towards pollination services to the Island's fruit crops annually. High-quality honey was also produced by the PEI beekeepers.¹

By 2012, the Beamish family fruit business had steadily grown, with sales reaching CA\$17,000.² That year Mike Beamish retired from his full-time teaching job. His plan was to develop value-added products to increase the profitability of the farm. The business had previously introduced non-alcoholic apple cider, apple/fruit preserves, and apple butter.

The idea of operating a distillery had been “fermenting” with Beamish for some time as a “fun retirement project,” and as a succession-planning business venture to ensure a viable future for younger family members. With increasing consumer demand for specialty alcoholic beverages, Beamish felt that a niche opportunity existed to produce and market a selection of “organically certified” vodka spirits and flavoured liqueurs. It would utilize fresh local fruit, contribute to PEI's agri-culinary tourism, and add to the increased economic performance of the PEI organic food sector.

In February 2013, an Artisan Distillery Workshop was offered through the PEI BioFoodTech, a government unit that provided technical services to PEI food and bioprocessing industries. Mike Beamish and his son, Paul, participated in this one-week comprehensive course from the Artisan Craft Distilling Institute of Washington State. It covered the fundamental technical aspects of distilling, equipment, licencing, processing, marketing, and sales. Additional workshops were offered in PEI in January and February of 2014.

DRD was incorporated as a craft distillery in November 2013, using its own and other organically grown PEI fruit from which to generate distilled beverages. It used its own equipment and facilities, plus some newly purchased equipment. DRD already had access to a recently constructed Beamish Orchard building for its manufacturing and tasting area, which had cost the Beamish family \$85,000 to build. The family also put together a budget of \$58,000 for distilling equipment and some lease hold improvements, and was able to access a provincial grant to cover half this amount. Distillation required less space and equipment than the production of hard cider or wine.

DRD complied with the prescribed PEILCC and Canadian Food Inspection Agency regulatory requirements to acquire a manufacturers licence. The business was a member of the PEI Vintners/Distilled Beverages Association and certified as Atlantic Certified Organic. It took about 18 months to obtain all the regulatory approvals for the distillery.

DRD as a craft distiller featured hands-on operation in the making of small-batch spirits and liqueurs. Using craft pot/column distillery technology, it allowed for finer control over flavours and gave broad room for experimentation. In some instances, DRD used its own organically certified fruit and incorporated other local organic ingredients and employed unusual techniques to make small batches of

¹ Prince Edward Island Department of Agriculture and Fisheries, “Agriculture on Prince Edward Island,” revised July 2015, accessed December 31, 2015, www.gov.pe.ca/agriculture/AgonPEI.

² All currency amounts are in Canadian dollars unless specified otherwise.

high-quality liqueurs and spirits. In a few instances, the product was crafted with locally sourced but not certified organic produce.

The production process included the harvesting of fruit, the pressing of fruit to dispel the fruit cider, the fermenting of this cider liquid, and the distilling of the fermented liquid to produce 180-proof ethanol alcohol (90 per cent). DRD's distilled spirits resulted from the collection of the ethanol (alcohol) that had been made by heating the liquid resulting from the initial fermentation of apple cider so that it became a vapour. The vapour was condensed on a cold surface and collected. A portion of the produced ethanol was bottled and sold as a pure vodka-type beverage (45 per cent alcohol), and the remainder was blended with fruit or liquid flavours to generate 25 per cent alcohol liqueurs.

COMPETITION

In the last 20 years the PEI alcohol beverage processing sector had grown considerably. By March 2014, there were three small distilleries, four wineries, and a growing number of craft brewing companies in PEI. The wineries were: Rossignol Estate Winery, Little Sands; Newman Estate Winery, Murray River; Matos Winery, St. Catherine's; Honeydew Apiaries/Winery, Canoe Cove. The distilleries were: Prince Edward Distillery, Hermanville; Myriad View Artisan Distillery, Rollo Bay; and Matos Distillery, St. Catherine's. Per capita sales of spirits and alcohol in PEI were \$226, versus a national average of \$182.

Prince Edward Distillery was founded in 2007, and was best known for a vodka it produced using PEI potatoes. Its vodka was available in the PEILCC and some of PEI's better-known restaurants and pubs. Between 2009 and 2014, the company had received a grant from the provincial government of over \$70,000 for marketing and trade assistance, and a "conditionally repayable grant from the Atlantic Canada Opportunities Agency of \$75,000 to build markets in Germany and Japan." In March 2014, the owners announced that they were personally moving to Nova Scotia to open a second distillery, but planned to continue to operate the PEI distillery.³

The Myriad View Artisan Distillery was founded in 2006. Overlooking the Northumberland Strait (the body of water separating PEI from the provinces of Nova Scotia and New Brunswick), it was advertised as the "Producers of Canada's First Legal Moonshine and PEI and Atlantic Canada's First Vodka, Gin, and Rum." The pride of its distillery was a hand-crafted copper still from Germany.

Matos Winery & Distillery had its start in 2007, when the two owners (both of Portuguese descent), purchased 50 acres of land and began planting Chardonnay and Gamay-Noir vines. Matos was best known for its award winning wines. It also had a distillery, and produced Portuguese-style alcohols such as licorice-flavoured anisette liqueur, a version of grappa, and a light port or sherry. Its products were available in PEI liquor stores and many restaurants on the island.

Exhibit 1 provides a selection of the products (and prices) of some of the locally (and off-PEI) produced spirits and liqueurs.

COMPANY PRODUCTS

By September 2015, DRD had four products for sale in-house and at the PEILCC:

³ Teresa Wright, "Vodka Distillery Owners Leaving P.E.I.," *The Guardian*, March 21, 2014.

- Island Tide — 45 per cent spirit similar to a moonshine or vodka
- Blueberry — 45 per cent single-release spirit from a one-time available supply of wild blueberry wine
- Maple Liqueur — 25 per cent liqueur with maple syrup
- Camerise Liqueur — 26.5 per cent liqueur made from the haskap berry (edible blue honeysuckle)

In addition, the company offered a gift pack containing 50-millilitre (ml) mini bottles of the first three products

DRD expected to have two additional products for release by late November 2015 (both had gone through the required analysis and approval processes):

- Spiced Apple Liqueur — 33 per cent liqueur made from organic apples and flavours
- Absinthe — 72 per cent spirit from a blend of herbs and spices (small batch)

Furthermore, before December 1, 2015, DRD expected to have all products available in individual 50-ml minis so as to take advantage of the tourist trade and the increased demand for small Christmas gift items.

The choice to produce spirits versus liqueurs (or both), and mainstream versus more niche products, was motivated by a combination of founder preference, opportunity (in the case of converting blueberry wine into a liqueur), experimentation, and a perceived link to PEI.

FINANCIALS

In order to initiate production, DRD had incurred approximately \$21,200 in capital costs to obtain the required equipment. Its production facility was leased from Beamish Orchard at \$500 per month.

In 2014, its first year of operation, DRD had a financial loss of \$16,822 (see Exhibit 2). This was in line with expectations.

In 2015, DRD expected to have a slightly larger net gain than forecast. Early expectations were that the company would break even for its first full year of sales; however, this estimate proved to be slightly conservative. The financial gain for 2015 was estimated to be \$62,600, but this excluded all salaries and included \$40,000 of year-end inventory (see Exhibit 2). The company balance sheet was also expected to improve in 2015 (see Exhibit 3).

The price of the product sold to the PEILCC was \$8.37 per bottle. The “final retail” price was just below \$20.00 per 350-ml bottle. The remaining \$11.58 went towards bottle deposit, provincial health tax, harmonized sales tax (HST), PEILCC mark-ups, and excise tax.

For bottles sold at DRD’s retail store (or the Charlottetown Farmer’s Market), DRD earned approximately \$12.24 per bottle, before production costs. For each of the four products, the production cost was \$4.73 per 350 ml of spirits or fruit-flavoured liqueur. This \$4.73 included ingredients for the production of the liquor, the bottle, label, cork, and boxes (approximately \$3.50) (see Exhibit 4). Sales forecasts were \$53,000, at retail, for 2015.

No employee salaries had been paid to date. Mike Beamish wanted to first create a stable operation with sustainable income before withdrawing additional funds or paying salaries from the business. In practice,

this meant that any of his children could work evenings and weekends to help out, but would require paid full-time work elsewhere until the business grew in scale.

MARKETING

The company had lots of ideas for promoting and advertising its products (see Exhibit 5), and had earlier developed a marketing budget of \$17,150 for the period from October 2013 to December 2014. Budgets were tight however, so the company was unclear about where its relative emphasis ought to go. Its website (<http://deeprootsdistillery.com/>) provided a history of the company, new product details, drink recipes, information on tours, and a map to its location.

SUCCESS TO DATE

DRD's four products had been well received in the marketplace and had begun to develop a loyal client base. The original expectation was that Island Tide would be the number one product. However, the Maple Liqueur was outselling the other currently available products by a factor of approximately five to one. Its success was in part based on the use of pure maple syrup and the versatility of the liqueur in beverages as well as cooking. The liqueur had been widely promoted to Island chefs and was used in some meals and drinks at various restaurants.

With the release of the Camerise Liqueur in July, uptake had been encouraging but it was too soon to know if there were going to be a significant number of repeat purchases (see Exhibits 6 and 7). Again, the popularity was based (at least in part) on the uniqueness of the flavor, as well as the versatility of use.

All DRD products enjoyed steady repeat sales both from PEI residents and from visitors. The company had received many requests to introduce a mail-order option.

The fall 2015 edition of the Food Island Partnership⁴ publication had opened up networking and promotional opportunities for all Island businesses. PEI, as a whole was becoming recognized as a destination for all food-related services. DRD was included in the "Culinary Trail Guide to PEI Flavours," and this had resulted in significant interest. DRD also tracked several visits resulting from its appearance in Trip Advisor with positive recommendations.

CURRENT CHALLENGE

Mike and Carol Beamish had five children ranging from ages 22 to 31. An overarching objective was for DRD to become a viable business that was sufficient to generate a net business income of \$36,000 during the initial year of operation, and ultimately, to support at least two people with a combined annual salary of at least \$80,000 for the long term. The big question was how to get there.

⁴ Foodland Partnership, accessed December 31, 2015, <http://foodislandpei.ca/>.

EXHIBIT 1: SELECTIVE COMPETITIVE PRODUCTS, 2014

Company/Brand	Products	Volume/ml	% Alcohol	Price \$
Arlington Orchards (PEI)	Hard Cider	750	7.5	14.95
Rossignol Winery (PEI)	Wild Rose Liqueur	375	15	42.00
Honeydew Apiaries (PEI)	Mead	375	12	8.50
Myriad View Artisan Distillery (PEI)	Strait Rum	750	40	35.00
	Strait Shine	750	50	27.95
	Strait Vodka	750	40	27.95
Prince Edward Distillery (PEI)	Potato Vodka	750	40	55.25
	Gin	750	40	49.85
Matos Winery & Distillery (PEI)	Anisette	750	31.8	34.95
	Bacago	500	40	29.95
Sheridan's (Ireland)	Irish Coffee Liqueur	750	15.5	31.95
O'Darby (Ireland)	Irish Cream Liqueur	375	17	14.00
Sangster's (Jamaica)	Rum Cream Liqueur	750	15	29.45
Amarula (South Africa)	Marula Fruit Liqueur	750	17	26.90
Cadbury (United States)	Cream Liqueur	750	17	29.90
Bailey's (Ireland)	Irish Cream Liqueur	375	17	16.95
Kahlua (United States)	Coffee Liqueur	375	20	16.95
	Cinnamon Spice Liqueur	375	20	16.73
Tia Maria (Italy)	Cream Liqueur	375	20	14.00
Kamora (United States)	Coffee Liqueur	375	20	14.00
Grand Marnier (France)	Liqueur	375	40	23.95
Cointreau (France)	Liqueur	375	40	21.25
Irish Mist (Ireland)	Liqueur	375	35	18.90
Gurtler Schloss Kirsch (Austria)	Cherry Liqueur	375	40	19.00
Sour Puss (United States)	Watermelon Liqueur	750	15	23.50
Dom B & B (France)	Liqueur	375	40	19.95
Jagermeister (Germany)	Herb Liqueur	375	35	15.65
Smirnoff (Canada)	Vodka	375	40	14.50
Polar Ice (Canada)	Vodka	375	40	14.50
Iron Works (Lunenburg, Nova Scotia)	Vodka	375	40	25.00
	Blueberry Liqueur	375	26	25.00
	Cranberry Liqueur	375	26	25.00

Source: PEI LCC retail stores/company websites.

EXHIBIT 2: DEEP ROOTS DISTILLERY**Unaudited Statement of Income and Deficit for the Year Ended December 31**

	2014	Estimate 2015
	\$	\$
Revenue	14,480	53,000
Cost of goods sold		
Purchases	24,819	10,500
Inventory – end of year	16,341	40,000
Subtotal	8,478	(29,500)
Gross profit 2014 – 41.5%	6,002	82,500
Expenses		
Advertising	2,996	1,000
Bank charges and interest	205	200
Credit card commissions	151	150
Depreciation	3,783	4,000
Dues and fees	1,044	1,000
Office	251	500
Product development	3,582	2,000
Professional fees	1,780	500
Rent	6,000	6,000
Repairs and maintenance	927	1,000
Small tools and supplies	1,457	2,000
Training	250	50
Travel	398	1,500
Subtotal	22,824	19,900
Net gain (loss) for the year	(16,822)	62,600
Gain (deficit) – beginning of year	(3,640)	(20,462)
Gain (deficit) – end of year	(20,462)	42,138

*Excludes salaries

Source: Company records.

EXHIBIT 3: DEEP ROOTS DISTILLERY**Unaudited Balance Sheet as at December 31**

	2014 \$	Estimate 2015 \$
Assets		
Current		
Cash	3,221	10,000
Investment tax credits receivable	581	-
Government funding receivable	-	-
Harmonized Sales Tax receivable	7,045	12,000
Inventory	16,341	38,000
Subtotal	27,188	60,000
Property and equipment	17,432	18,500
Investment tax credits recoverable	872	-
Federal excise tax deposit	5,000	5,000
Total assets	50,492	83,500
Liabilities		
Current		
Accounts payable and accrued liabilities	5,417	5,800
Advances from (repayment to) Shareholder	65,437	35,462
Subtotal	70,854	41,262
Deficit less capital stock		
Deficit/surplus	(20,462)	42,138
Capital stock	100	100
Subtotal	(20,362)	42,238
Total liabilities	50,492	83,500

Source: Company records.

EXHIBIT 4: COSTS FROM RETAIL TO PRODUCER (350 ml)

	PEILCC	On-Site (DRD Store)
	Maple Liqueur 25% Alcohol	Maple Liqueur 25% Alcohol
Retail price to customer	\$19.95	\$19.95
Deposit	0.10	0.10
HST	2.44	2.44
Basic price	17.41	17.41
Health tax (25%)	3.48	3.48
Price after PEILCC markup	13.93	13.93
Markup from PEILCC (36.45% or 5%)	3.72	0.67
Amount paid by PEILCC	10.21	13.26
Excise duty – 350 ml bottle, 25% alcohol	1.02	1.02
Sale amount to producer	\$9.19	\$12.24
Cost of sales:		
Sugar	0.18	0.18
Fruit/maple syrup/flavourings	0.70	0.70
Other	0.02	0.02
Bottles, caps and labels	2.00	2.00
Shrink tops	0.15	0.15
Boxes	0.12	0.12
Propane	0.01	0.01
Labour	0.55	0.55
Overhead (rent, electricity)	1.00	1.00
Cost of sales:	4.73	4.73
Gross profit	4.46	7.51

Notes: Liqueurs were produced in 400-litre batches. Each batch would provide 1,100 350-ml bottles of output. The actual production time would be spread across four months. Each batch required 30 hours of labour: 10 hours to blend, two hours to mix, and 18 hours to bottle. This worked out to less than two minutes per bottle. Excise duties are based on the alcohol content. The rate is \$11.70 per litre of 100% alcohol.

Source: Company records.

EXHIBIT 5: MARKETING IDEAS

1. Taste testing at events, liquor stores, on-site at the distillery, etc. Product sampling cost \$1,100.
2. Promotion to local chefs in higher-end restaurants. (Liqueurs can be offered as stand-alone drinks, or served over ice cream).
3. Old Home Week cooking demonstration using the products. Old Home Week was the annual local exhibition held in mid-August that drew tourists as well as former PEI residents visiting home.
4. Write-up in local magazines.
5. Advertising in local papers. A Yellow Pages listing was \$50; a product brochure was \$600; newspaper ads were \$1,500.
6. Social media. YouTube video production was \$1,000.
7. Website (original development costs were \$3,000).
8. Meetings and conventions in PEI. A host tourism event was \$200; Cost to sponsor part of Certified Organic Co-op dinner was \$500; PEI Vintners Association networking events cost \$500.
9. Food Island Partnership — A new PEI initiative to market PEI as the “Food Island” and its products nationally and internationally and explore new opportunities for trade.
10. Word of mouth.
11. Charlottetown Farmer’s Market. This market is located about five minutes from the Charlottetown Port and waterfront shops. It operated on Saturdays year-round and on Wednesdays between May and mid-October. It received 1,000 visitors per week in the summer and the shoulder seasons, 500 through the winter. Signage was \$200. Display counter was \$500.
12. G! Magazine. This monthly free publication contained information on what was happening on the Island. About 25,000 hard copies were distributed throughout the Island to tourist attractions and centres and it was available and accessible on line.
13. Signage, road frontage. Distillery gate/road signage was \$1,300; distillery building signage was \$200.
14. Apparel; Glassware, coasters, gift bags. All product bags were stamped with the DRD information and logo.
15. In-store display counter was \$500.
16. Customer testimonials.
17. Tourism PEI Visitor’s Guide: Cost was \$512. There were close to 200,000 copies of the Visitors Guide printed each year, with another 1.9 million people accessing information online.
18. PEI Department of Highways/Tourism PEI road directional signage (\$500 onetime; \$200 annually).
19. Trip Advisor reviews and comments were positive. Clients referenced the site when visiting.
20. DRD hosted an open house advertised on social media in the early part of the summer with coverage by local CBC.
21. The close-knit community of the Island provided a unique opportunity to obtain media attention for events, launches, and information.

Source: Company records.

EXHIBIT 6: ORDERS TO PEILCC FROM JUNE TO AUGUST 2015 (CASES OF 12)

Product	June	July	August	Total
Maple	10	30	10	50
Island Tide	5	10	5	20
Blueberry	10	-	5	15
Camerise	-	-	32	32
Total	25	40	52	117

Source: Company records.

EXHIBIT 7: ON-SITE SALES (BOTTLES) AT FARMER'S MARKET & SHOP LOCATION IN 2015

	Tide	Blueberry	Maple	Camerise	Gift Pack
January	3	3	37		5
February	7	4	19		3
March	9	10	26		4
April	2	2	24		6
May	9	8	33		10
June	17	28	19		12
July	21	44	84		32
August	30	49	116	75	43
Subtotal	98	148	358	75	115

Source: Company records.