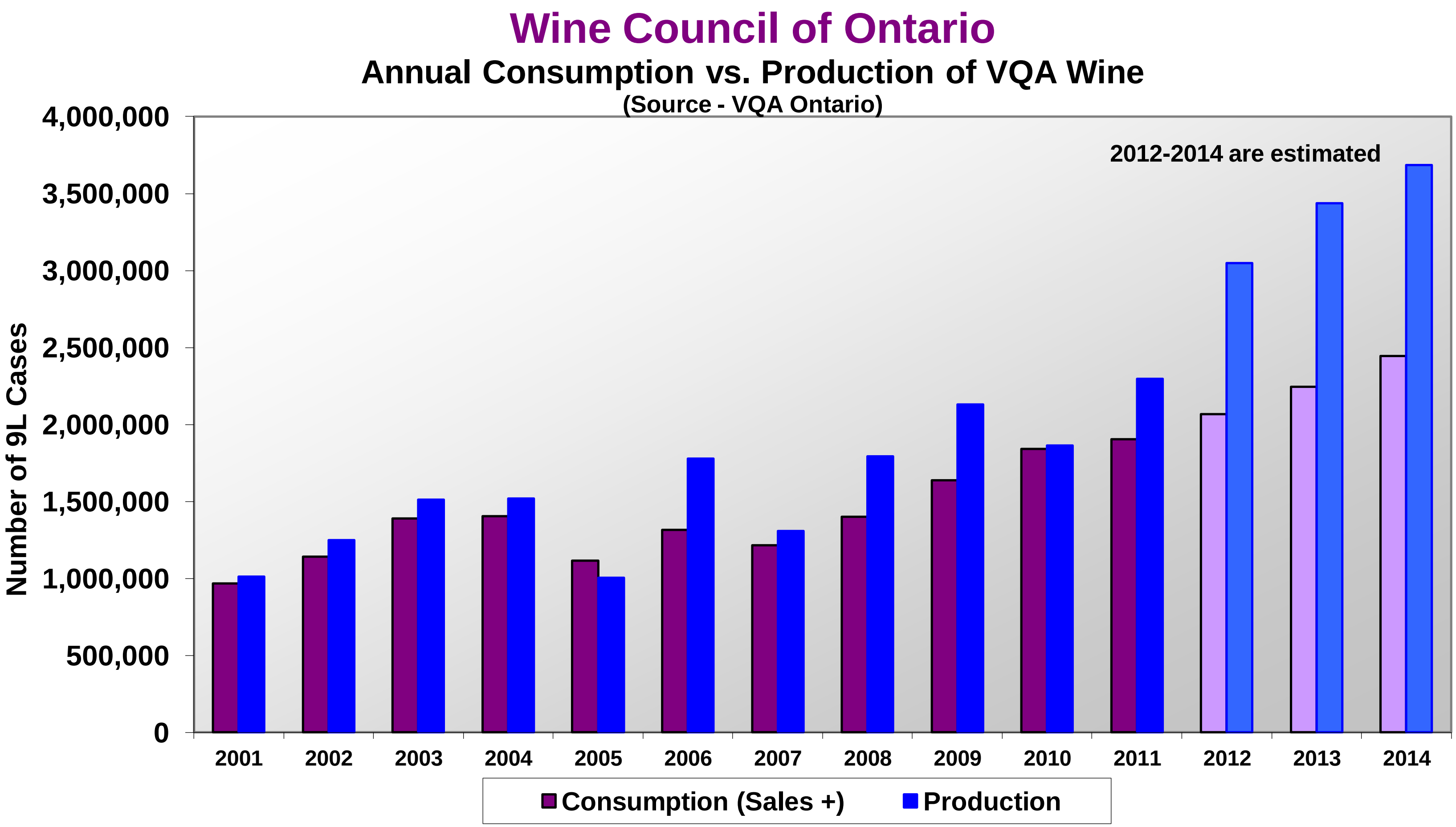
Building on Success – Next steps for growing VQA performance for Ontario

Presentation to Ministry of Finance
February 27, 2012
COMMERCIAL CONFIDENTIAL

Situation Analysis

- Important for all partners supporting our industry to have a sense of the scope of the issues and opportunities surrounding VQA wines
- Critical to step back and look at this starting point and then we can collectively look at options to addressing the issues across all channels
- In some cases regulatory reforms may add great results, in others, a more serious overhaul remains a necessity from our perspective
- Lets start with the problem we are trying to tackle – In our view, we have a 250,000 case challenge

Current market supply continues to grow

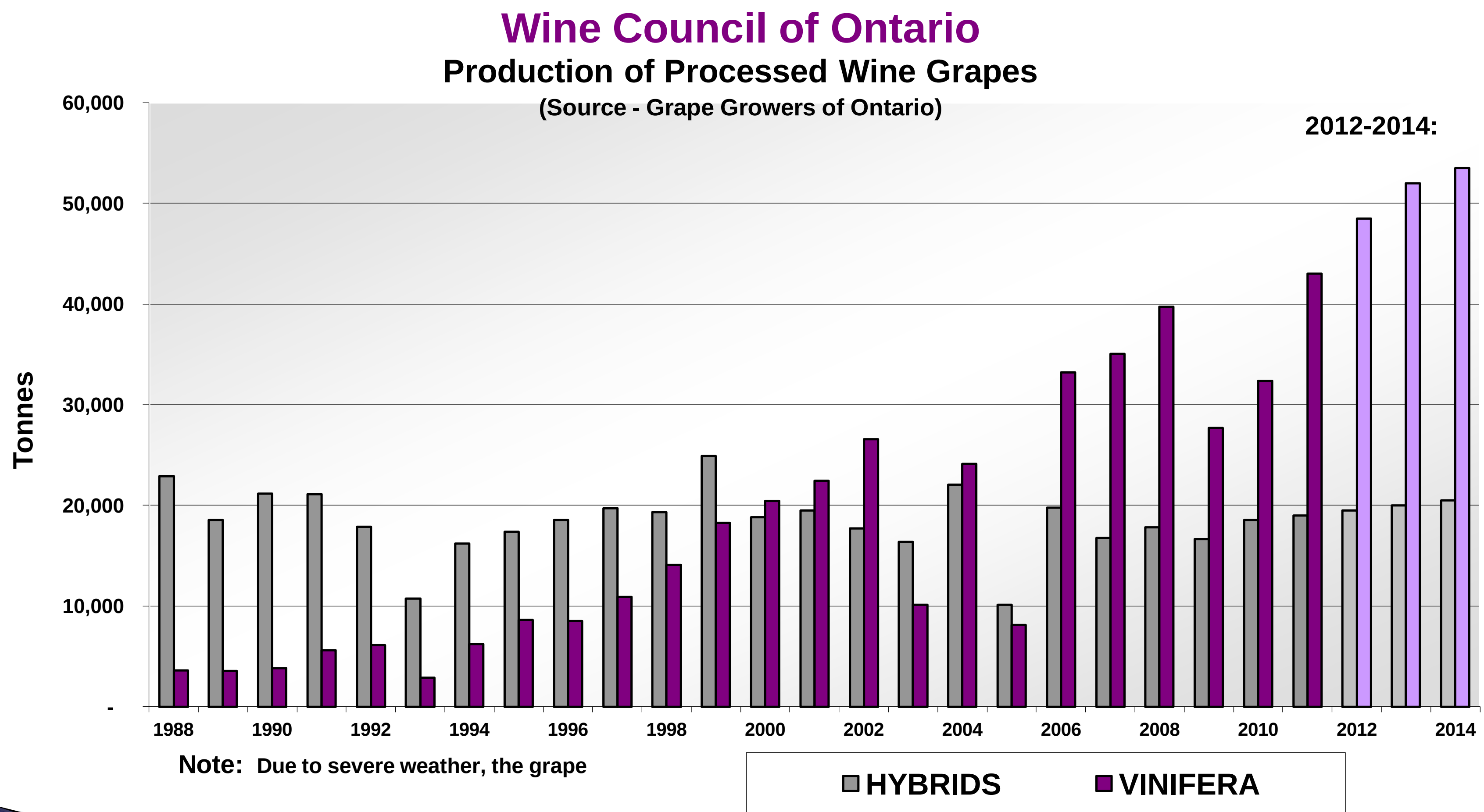


250,000 cases year until 2014

- Of the cases excess to sales and promotion, the wine can be sorted into two distinct categories:

1. Inventory – Deliberate action has been taken on the part of VQA wineries to build inventory. However the pressures are stable now versus years past – Short crop risks are lower now than in 2005:
   - VQA producers have built inventory to backstop crop failure
   - Viticulture practices (wind machines as examples) have been implemented and investments continue further reducing risk
2. Commercially viable wines – Wines that have the ability to be sold in the marketplace (meet price quality parameters).
   - This can be quantified to 250,000 cases of VQA each year for the next 3 years that we should build a market to support
   - Assumed that vast majority of wine would be premium priced (over $15)
   - Amount of wine in need of markets will continue to grow due to consistent growth of crop for VQA

Grapes in the ground are the foundation of the challenge



Policies for years have supported this rate of growth for the industry

- Greenbelt
- Wine Content Act to 40% (until 2015)
- Federal and Provincial tender fruit replacement/grape replant programs
- OMAFRA/FedDev Ontario initiatives
  - Manufacturing supports to encourage growth in capacity
  - OVIP dollars designed to encourage growth of quality in viticulture to support VQA
- VQA Support Program
- Tobacco transition dollars
  - Wine Grapes are now becoming key transitional crop in tobacco belt
  - Regions like Norfolk County have now built growth and development of wine grapes and wineries as core economic driver (like Prince Edward County had done – the model)
  - Strategy to become a DVA which necessitates planting
- Proactive and successful partnership with LCBO to grow VQA performance
  - Increase in shelf space to accommodate capacity

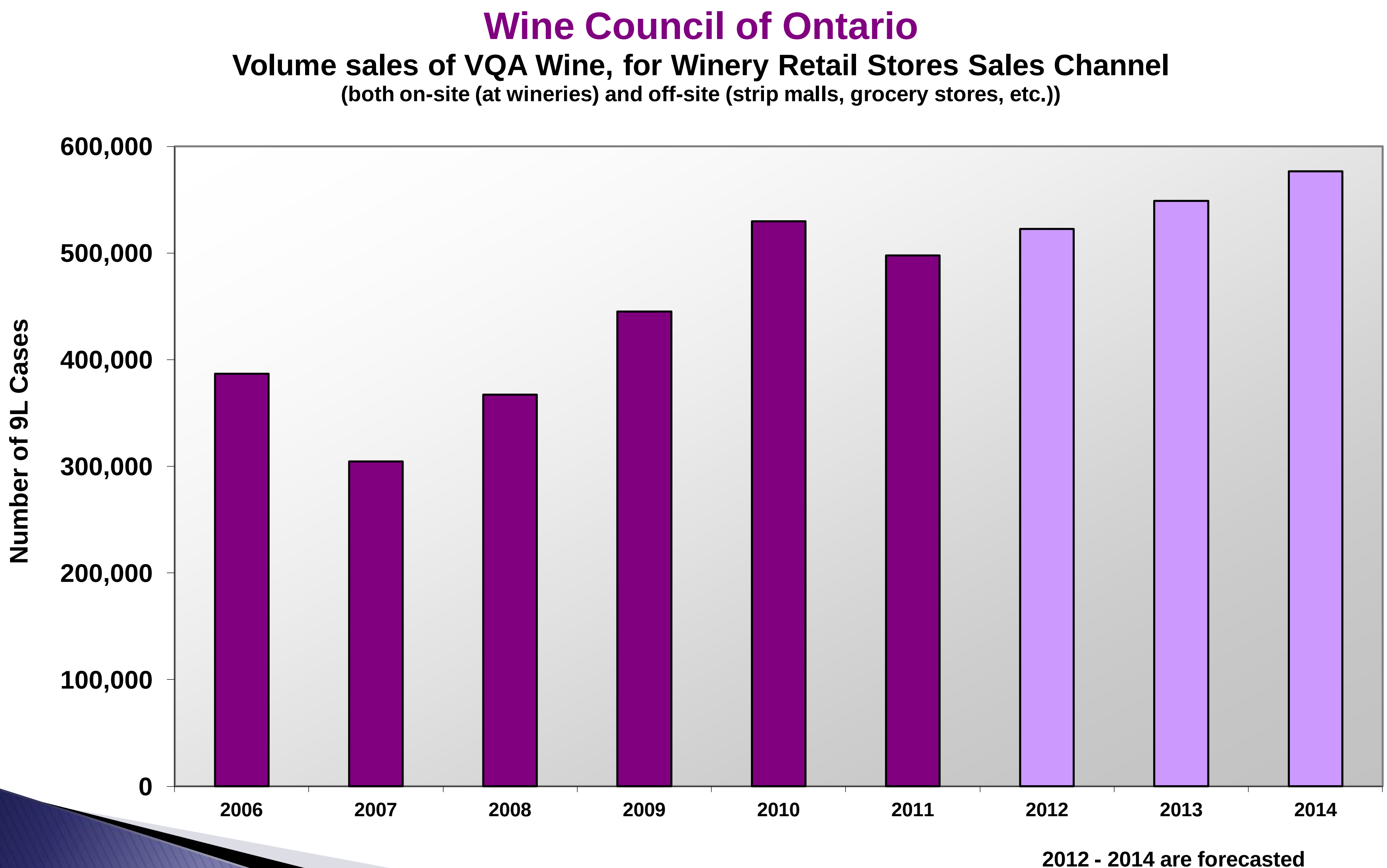
And driven good results for the province....

- KPMG analysis and observations have validated as strong performance for VQA wines for Ontario
  - **1300 incremental jobs** in the past 4 years
  - **Value add of $191 million** in fiscal year ended March 31, 2011
  - KPMG observed that VQA wines were growing economic impact where other industries were status quo
- **$12.29 of valued added impact per litre of VQA wine sold**
  - Over and above taxation
  - Up from $11.50 in 2007
- If it is agreed that there is value to getting this wine to market and realizing the benefits of this wine to the economy, the next question is how and where

How can each channel work to keep up with needs for market?

- Important to understand the role that each channel available to us currently can work to ensuring a market for these 250,000 per year (and growing) cases
  - Incremental beyond predicted growth
  - Know that there is untapped consumption in the province
- Each element can absorb some in the way they are configured now and each has challenges
- For each channel it will be instructive to understand its capacity and some of the regulatory, legislative or other policy issues that challenge their performance
- Will review each in turn – Winery Retail Store, Direct Delivery, Exports/Interprovincial (Out of Province) and LCBO

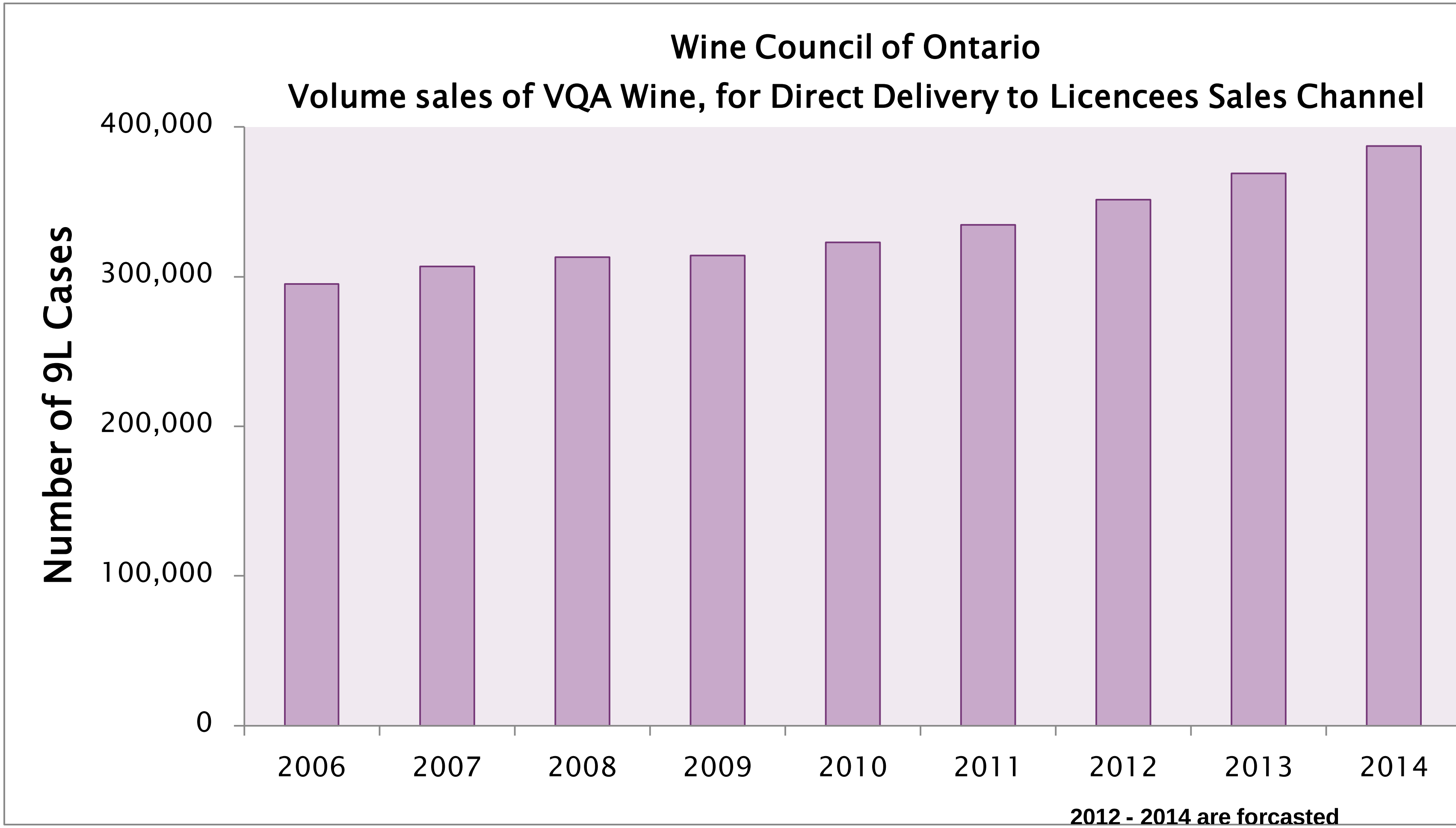
Winery Retail Stores



Winery Retail Stores

- Most impacted by tourism trends, and most difficult to adequately forecast (no separation of on and offsite sales)
- At 5% growth per year over the next three years, channel could absorb an incremental 78,480 cases
- Key barriers that could be addressed
  - Reconciling licenses and policies
  - Holiday closings (AGCO Policy)
  - Hours of operation (AGCO Policy)
  - Flexibility on Promotional Pricing
  - Allow bundling of wine in wine tourism packages
  - Flexibility for gift packaging
- Other opportunities
  - Distilling License to permit product extensions
- Net impact estimated to be 1% additional growth or 16,625 cases (over same 3 years)

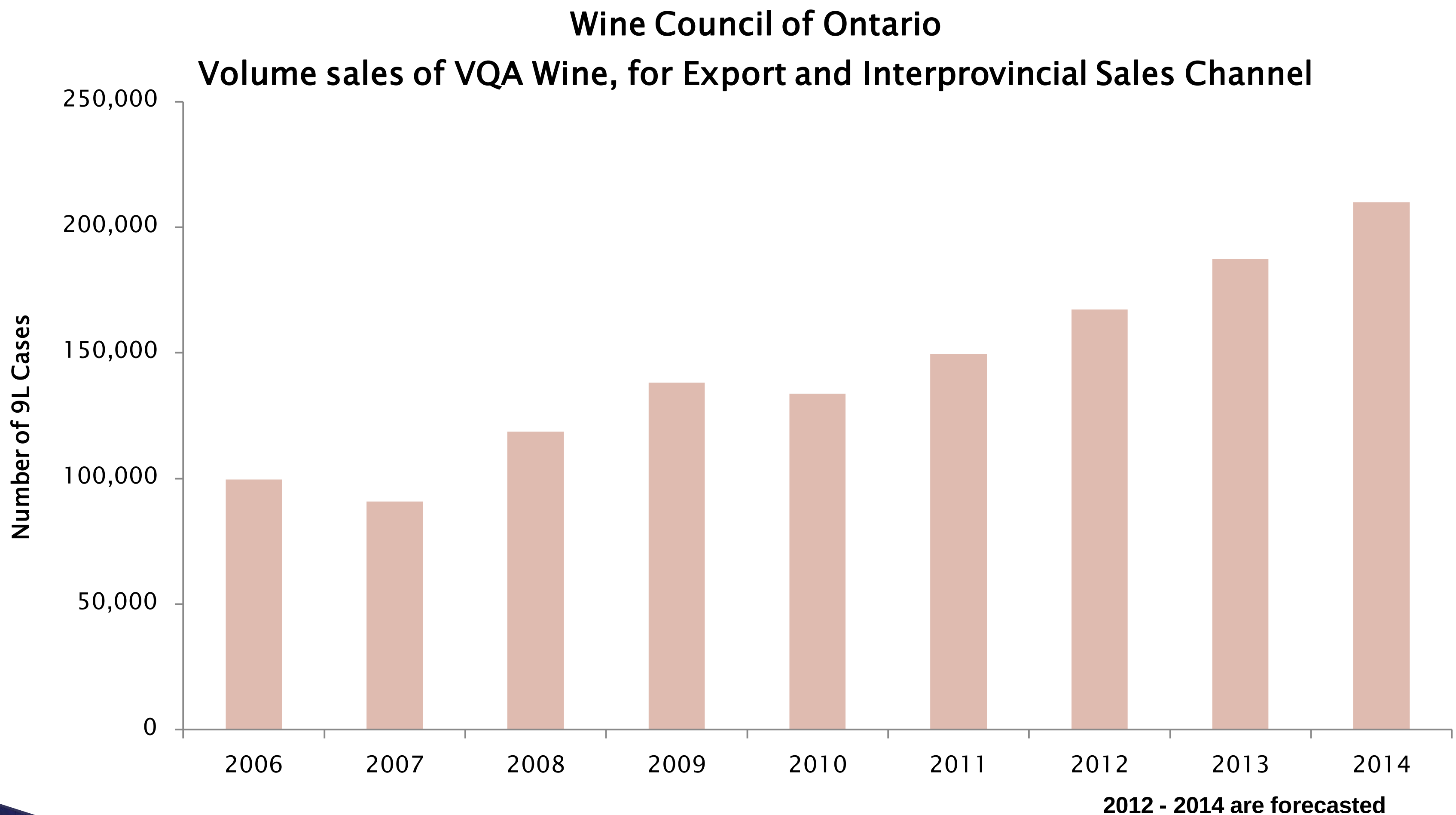
Direct Delivery



Direct Delivery

- Consistently growing since inception, even in the face of recession which challenges this line of the business
- At 5% growth per year over the next three years, channel could absorb an incremental 52,652 cases
- Key barriers that could be addressed
  - Delivery Fees – Ability to Charge
  - Remove fees on delivery to Duty Free
  - Allow wineries to store and ship wine together
  - LCBO launching new licensee channel and deliberately excludes VQA from opportunity
- Net impact estimated to be 3% additional growth or 34,265 cases (over 3 years)

Sales outside of Ontario



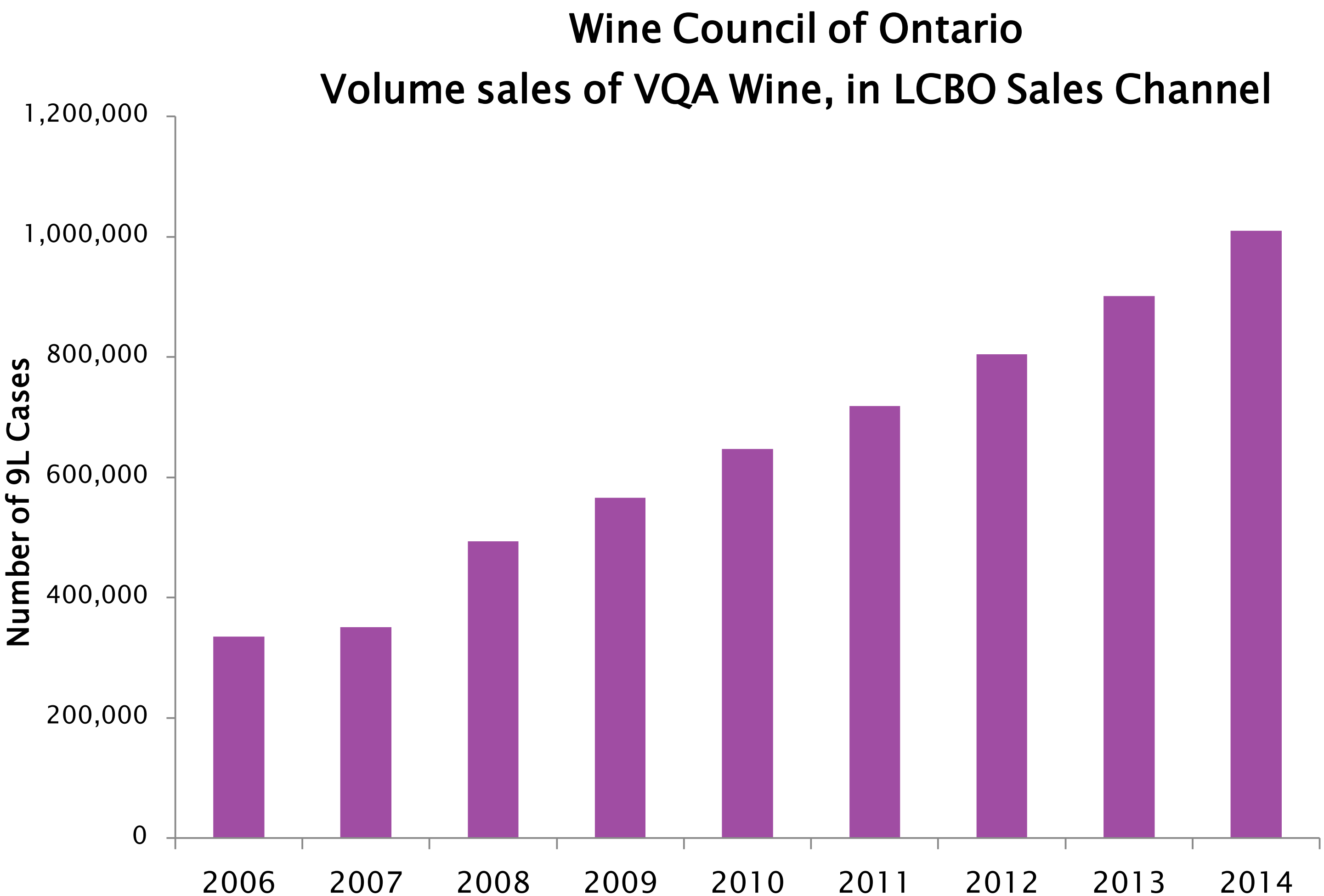
Sales outside of Ontario

- Export outside of Canada continues to grow steadily, especially for high value products like icewine
  - National export strategy less focused on direct sales and more focused on reputation building and bringing trade in market
- Interprovincial sales have potential and can build on deliberate industry efforts to expand VQA portfolio in other provincial markets
  - Manitoba, Newfoundland and Labrador, Quebec
  - Other markets offer small opportunities but industry focused on best margins, ability of buyers to partner etc
- At 12% growth per year over the next three years, channel could absorb an incremental 60,815cases
- Key barriers that could be addressed
  - Start up costs in key markets like Quebec – it is critical that we be able to launch in a significant way into this market
  - Direct to consumer sales
- Net impact estimated to be 2% additional growth or 11,150 cases (over 3 years)

Policy changes so far can address small part of problem

- 750,000 cases (next 3 years) that should have a market
- Policy suggestions would address some of that problem in a best case scenario
  - Winery Retail Channel – 16, 625 cases
  - Direct Delivery – 34,625 cases
  - Sales outside Ontario – 11,150 cases
  - **TOTAL 62,400 cases**
  - **Balance 750,000-62,400 = 687,600 cases**
- So our challenge – is there a market for the balance at our only other channel at the LCBO
  - Sounds possible?

LCBO (Wines and Vintages)



2012 - 2014 are forecasted

LCBO

- VQA wines continue to perform well in this channel and this is our most important channel in terms of volume, and also our most challenging in terms of margin
- Growth in higher price bands remains strong and will found the strategy for continuing to grow VQA in this category going forward
  - Shari Mogk-Edwards – "you are a premium priced business in our portfolio"
- At 12% growth per year over the next three years, channel could absorb an incremental 290,958 cases
- Need to move this new volume plus the balance in this channel (assuming other channels get the support they need)
  - Is it realistic to expect that we can find a home for this volume?
  - With remaining need to find market for 200,000+ more cases per year, how can LCBO accommodate 500,000+ cases year by the end of 3 years?

Our premium channel = Vintages

- What does 500,000 cases look like in terms of our business
  - Average Vintages release declining (focus on sell through targets for channel) – one time releases, no opportunity to build business consistently
  - Clear message to industry to expect less volume for orders not more
  - At average of 125 cases per order, unlikely that Vintages could release all of this volume of wine
    - Would mean 4000 releases – currently VQA has 200 per year
  - Opportunity to distribute is limited
    - 5 stores (1500-2000 skus each), 62 Boutiques (800-1500 skus), 147 corners (50-800 skus)
    - No planogram, no measure of linear feet of product, no accountability of Product Consultants to buyers/sales – almost impossible to plan and execute a significant growth strategy in this channel

LCBO Wines

- Channel more able to accommodate volume, but not premium pricing
  - Only 4.8% of sales in this channel are priced over $15
- On average, distribution is around 200 stores per sku (very few have distribution throughout the system)
- Sales performance takes time
  - Wines to Watch program (expectation that over 1000 cases in 3rd year)
  - Best performing skus sell 5,000-7,00 cases in red and 6,000-10,000 cases in whites
- Shelves are full
  - Challenging to keep listings
  - Constant craving for "new" from the buyers – churn and burn approach does not favour brand building and has helped generate some of this new pressure – need for new brands as well as supporting existing performers
- Merchandising costs continue to escalate
  - Fridge space charges, Superstars now has cost
  - VQA support program, which is critical for success, continues to diminish as cap lowers each year

Why does it matter?

Revenue distribution for 250,000 cases of VQA wine

		LCBO
Average retail price / 750 ml. bottle		$ 11.17
Number of bottles		3,000,000
Number of litres		2,250,000
Number of cases		250,000
Gross Revenue (paid by consumer)		$ 33,510,000
Government Taxes:		
Enviro tax	$0.0893	267,900
Bottle tax	$0.2175	652,500
HST - provincial	8.0%	2,372,389
LCBO Wine Tax	$1.2150	3,645,000
LCBO Mark up	65.5%	9,929,668
Retail Store Wine Tax	6.1%	-
		16,867,458
HST - federal	5.0%	1,482,743
Total taxes / markups		18,350,201
Incremental Government Revenue:		
Ontario (direct)		$ 3,292,789
LCBO		13,574,668
		16,867,458
VQA support program funds to Wineries:		**4,547,940**
Net to province		$ 12,319,518
Federal		$ 1,482,743
Incremental Ontario Grapes		3200
Economic Impact at $12.29 per litre		$27,652,500

LCBO

- Are there realistic changes that should be considered to increase the ability of this channel to deliver this wine to market?
  - Where can Vintages realistically go given size restrictions, lack of accountability, desire to buy less to ensure they hit sell through targets (no ability to take any additional time)? Means no ability to build brand through exposure to the consumer at our premium price points.
  - What about the higher volume wines? If price goes above $15 the opportunities diminish significantly.
  - Margin relief is diminishing – if this channel is going to remain the significant customer, we need to ensure that it can be more broadly impactful and can accommodate this kind of volume
  - Simply opening more LCBO stores will not address our issues – same problems, just more stores to deal with, especially where LCBO own figures suggest that each store has 75% cannibalization rate
  - Any tweaks to programs will be good, but will be marginal.

Choices for government

- High value to province to get this wine that should have a market sold and delivering the value back to the economy
- We know that the government shares our goals to see this industry maximize its value to the province
- Clearly there are steps that can be taken to improve the business climate for VQA wineries and we welcome any efforts by government to do so
  - Most of the changes we have been talking about have been issues outstanding for 10+ years
- What is also critical to appreciate is that if we can't find a way to move this reasonable amount of premium priced volume through the systems that exist now, the need for something else is more important

Private Retail

- We still feel strongly that our approach to private retail merits consideration and wanted to take the opportunity to directly address the concerns expressed to us by the government
  - Uniform pricing – exclusive product model, mirrors new LCBO licensee approach?
  - Trade issues – differentiated markup exists in our competitors markets (EU, California)
  - Consumption – how does government reconcile with its growth of LCBO channel
  - Markup structure – there is no consistent pricing of wine at shelf in Ontario, why should this model be held to same standard

Next steps

- **LCBO**
  - Program review (tweaking not overhaul)
  - Strategic discussions to align with marketing plan
- **Government – Min of Finance**
  - Engagement re Drummond Report
  - How to efficiently deal with regulatory and policy issues? Best path forward.
  - Dialogue on specific and problematic LCBO policy issues (warehousing, delivery charges etc) where there is a clear competitive interest in them not being cooperative. How can government ensure constructive discussions and real opportunities for change?
- **Wine Council**
  - Continue to engage stakeholders at political and bureaucratic level on the nature of the problem and potential solutions