THE SOUTH AFRICAN WINE CLUSTER

MICRO-ECONOMICS OF COMPETITIVENESS

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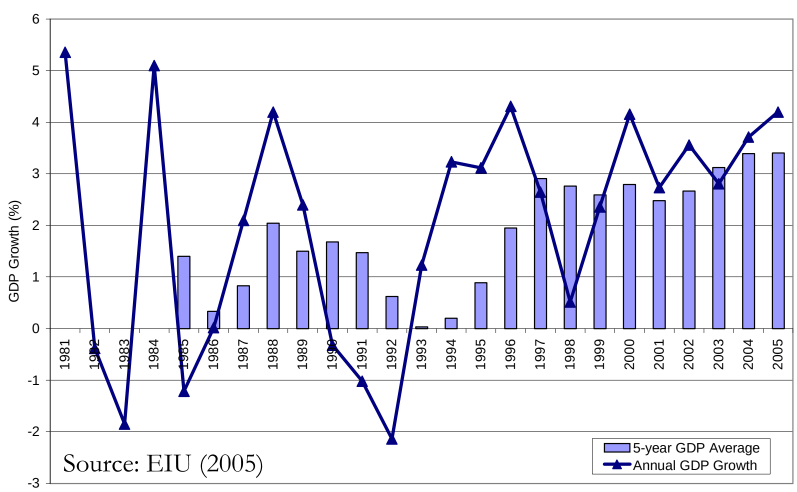
1. Introduction and Country Analysis

1.1 Political and Economic Performance

Situated at the Southern tip of the African continent, a considerable distance away from most of its traditional markets, South Africa has had a traumatic history. Beginning with the arrival of the first Dutch settlers in 1652, the past three centuries have been marked by colonization, war, and racist oppression. Nonetheless, South Africa has experienced a level of industrialization unrivalled in Africa, with a heterogeneous population of 42-45 million people (EIU; WDI 2005), which is about 80% black, 10% Indian and Coloured (mixed-race) and 10% white.

Since the end of apartheid in 1990-94, South Africa has been a success story when it comes to *political* transition. However, the *economic* transition has not been as easy. The legacy of apartheid remains quite profound: a Gini coefficient of 0.58, making it the fifth most unequal country in the world; unemployment of 27%; and nearly 57% of the population living in poverty (WDI 2005). At the same time, however, South Africa remains a middle income country: its GDP per capita stands at US$10,798 (in PPP terms), and real GDP growth has picked up from an average of 3% in 1994-2004 to almost 5% in 2005 (WDI, 2005; EIU). Business confidence is high, and the country's sovereign risk rating, at Baa1, is at the high end of lower investment grade ratings (www.brait.com).

South Africa: GDP Growth



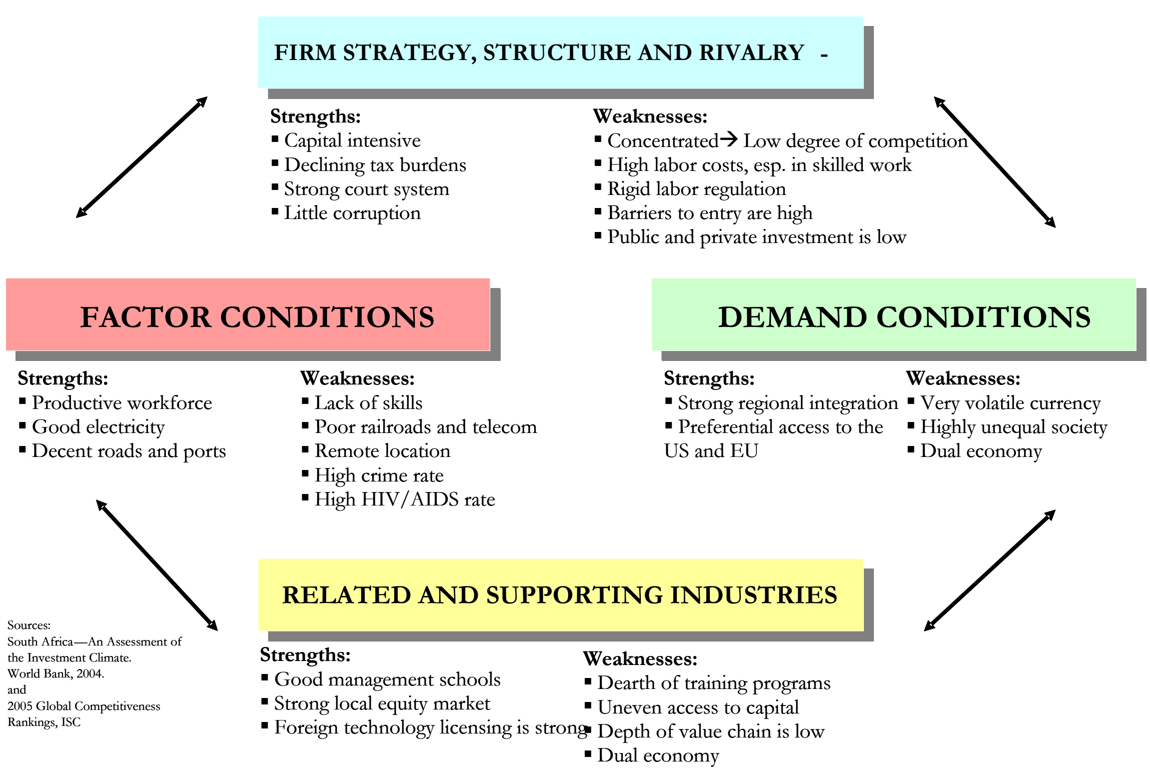
From a macroeconomic perspective, South Africa has had a flexible exchange rate since 1995, and a central bank which focuses (quite competently) on targeting solely inflation since 1998. However, the exchange rate has been very volatile, hurting business confidence. After a steep 33% depreciation at the end of 2001, which created significant inflationary pressures, the rand has appreciated by nearly 50% since 2002. This has resulted in significant difficulties for exporters, the wine sector included (IMF Article IV, 2005; World Bank, Investment Climate Assessment (ICA) 2005). However, The size of the country's current-account deficit, which reached 4.5% of GDP at the end of 2005 (www.brait.com) continues to pose a threat to the stability of the exchange rate.

Over the past decade, South Africa has moved from a resource-based economy, focused on mining, to one based on services and manufacturing. Services now account for 61% of the country's GDP, manufacturing for 19% (and more than half of exports), and mining for only 6% (World Bank, ICA, 2005). This would suggest that the country has moved from a factor-driven economy to an investment-driven one, with innovation taking an increasing importance, particularly in financial services, the fastest growing sector of the economy.

Since the end of apartheid, South Africa has been characterized by a fairly open trade regime, though with some protection and/or complex tariff schemes, such as in automobiles. Nonetheless, Most Favored Nation (MFN) import tariffs have dropped from an average of 20% in the early 1990s to an average of 11% today (IMF Article IV, 2005). In the wine sector, tariffs remain at 25%, however. South Africa enjoys a strong position in world trade: wide access to the US market through the African Growth and Opportunity Act, a trade agreement with the EU which is expected to result in a full free-trade area by 2012, and a share of outward foreign direct investment stock in Africa rising from 5% in 2000 to 9% in 2003 (IMF Article IV, 2005). South Africa continues to be the largest economy in Africa; Johannesburg alone accounts for 9% of sub-Saharan Africa's entire GDP (www.joburg.org.za). The country especially dominates its immediate neighbors, several of which (Botswana, Namibia, Lesotho, and Swaziland) form, along with South Africa, the Southern African Customs Union.

Since specific legislation passed in 2004, the South Africa government has mandated a policy of Black Economic Empowerment (BEE), an affirmative action program for both government and business, to reduce the high inequality wrought by apartheid. BEE is intended to be broad-based, and involve not only "previously disadvantaged communities" (Africans, Indians, and Coloureds) but also women, youth, the disabled, and people living in rural areas. A key part of BEE is measuring firms' progress via a balanced scorecard, which measures variables such as black ownership, black management, black human resource development, procurement from black firms, and corporate social investment (Alexander, Black Economic Empowerment, 2005).

1.2 National Diamond Analysis



Because apartheid deliberately separated a first world (largely white) economy from the traditional (largely black) economy, development and industrialization have been very uneven. The resulting dual economy has had a direct impact on South Africa's competitiveness, as highlighted in the country's national diamond above.

Labor productivity, as measured by value-added per worker, is high at US$14,000, compared to peer countries such as like Malaysia (US$11,000), Brazil (US$7000), or China (US$5000; World Bank, ICA, 2005). However, productivity is high because the formal labor force has been shrinking since 1994, to only 9.6 million (www.statssa.gov.za) and because there is a highly-skilled professional workforce which masks the low productivity among unskilled workers. For example, the value-added for garment workers in South Africa (most of whom are unskilled), is at US$7000, not much different from its comparator countries (World Bank, ICA, 2005).

Furthermore, labor costs in South Africa are high, partly as a result of redistributive post-apartheid policies and an inflexible labor market. Labor costs account for 45% of value added in South Africa, versus 25% in China, and 40% in Brazil (World Bank, ICA, 2005). High mandated minimum wages, and a difficulty of hiring and firing index nearly three times as high as East Asia, makes labor rigidity one of the key constraints for South African firms (IMF Article IV, 2005; World Bank, ICA, 2005).

Although crime appears to have come down since 2000, it skyrocketed in the 1990s, with 60% of firms reporting a break-in, 40% experiencing employee theft, and 20% reporting vandalism. Police services, while not generally corrupt, are largely under-funded and spread out too thinly. As a result, 70% of firms reported that incidents of crime remain unsolved. This has translated into rising costs for private security and lost property, equivalent to a comparatively high average 1.1% of sales for firms (World Bank, ICA, 2005).

South Africa's dual economy is further highlighted by other indicators of South Africa's competitiveness. A high degree of foreign technology licensing, efficient corporate boards, a sophisticated financial market, and local equity market access are South Africa's highest rankings in the 2005 Global Competitiveness Rankings (GCS) report. Finance also appears to be readily available: 72% of firms say they do not need access to more capital (World Bank, ICA, 2005). However, because the South African economy is characterized by a lack of competition and a concentrated number of firms in most industries (another legacy of apartheid), there are high barriers to entry to local fledgling (especially black-owned) firms and foreign investors (World Bank, ICA, 2005).

The current South African government has a host of issues to deal with, from maintaining peaceful relations among the various ethnic groups, to redressing the economic legacy of apartheid, to confronting the HIV/AIDS challenge currently infecting 23% of the adult population (WDI, 2005). As such, the government's ability to address *all* of the challenges to South Africa's competitiveness is limited. While improved roads, falling corporate taxes, and a gradual release on capital controls have all been cited as *improvements* in the competitive environment, general bureaucracy (especially in labor), lack of deregulation of the state telecom monopoly, congestion of the ports and railroads, poor schooling, and an ineffective police force have all been cited as the most salient competitiveness *challenges* (World Bank, ICA, 2005; 2005 GCS Rankings). The lack of a clear move towards a less volatile, more competitive, and innovative business environment underpins South Africa's low investment levels: gross capital formation as a proportion of GDP is only 15%, versus over 30% for most of the Asian tigers, and 20% in Brazil and Poland (World Bank, ICA, 2005).

2. Cluster Background

2.2 History of Wine in South Africa

The first of the "new world" wine regions, South Africa's first vineyards were planted in 1655 by the original Dutch settlers in Cape Town. Because of the Cape's status as an entrepôt economy, South Africa's wine production grew throughout the 18th and 19th centuries primarily as an export-based industry (www.wine.co.za).

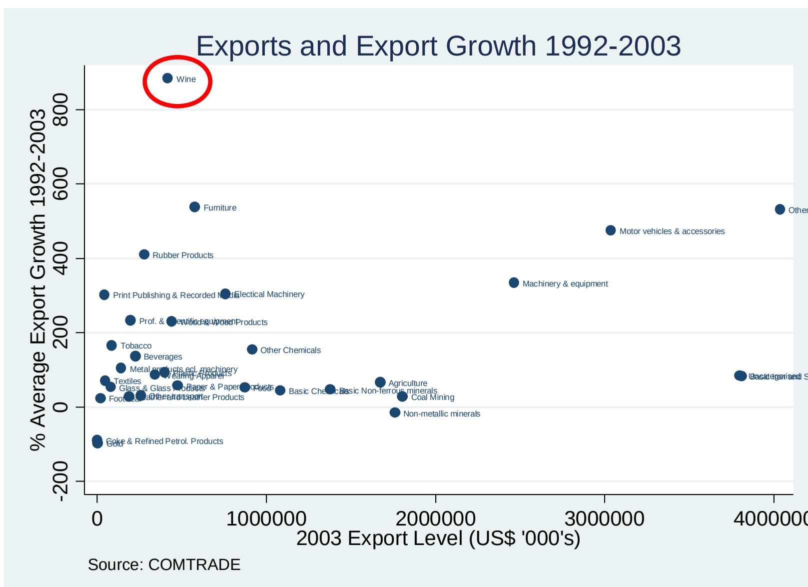
As a result of volatility within the worldwide wine industry at the turn of the 20th century due to surplus production and a phylloxera outbreak, South Africa's wine farmers formed the KWV[1] cooperative in 1918. With strong government backing, KWV acted as the regulatory body and agent for the entire South African wine industry until deregulation in 1992-97. During the apartheid years (1948-94), KWV imposed regulated prices, plantings, and quotas (SAWB "Ministerial Commission," 2006). Combining this fact with South Africa's increasing pariah status, the country's export wine industry stagnated. However, developments in tourism, nascent IFC formation (especially at the universities), and new cultivars (such as pinotage) did occur during these years (www.wine.co.za).

With the lifting of international sanctions in 1991, and deregulation, exports began to increase considerably, local surplus production dropped, and quality began to improve. The dominance of KWV over the entire industry began to dissipate as it was transformed from a government-backed cooperative into a private company in 2002, though today it still accounts for around 50% of the value-added in the wine industry. Nonetheless, deregulation has allowed South African wine to flourish in the highly competitive worldwide wine industry, and today South Africa is the world's 9th largest producer of wine (www.wine.co.za).

[1] Ko-öperatiewe Wijnbouwers Vereniging van Zuid Afrika

2.3 South African Wine in a Global Context

The increase in South African wine output from 427 million liters in 1992 to 713 million liters in 2003 has been driven by export growth of over 800% during that period (authors' calculations using comtrade data). The increase in wine exports has been underpinned by the general increase of South African in exports in following the lifting of apartheid- related sanctions in 1991. South Africa's total exports rose from 21% of GDP in 1992 to 33% of GDP in 2002 (World Development Indicators, 2005). However, as the figure below shows, even among South African exports, wine has done particularly well.



South African exports have benefited from new consumer interest in developed markets for premium-mixed grape varietals (The Economist, 1999) produced primarily by 'new world producers, which are also generally able to provide more consistent wines. As a result, the market share in value terms of wine from 'New world' countries grew from 4% in 1990 to 18% in 2001. Traditional producers (such as France, Italy, Germany and Spain) have struggled to adjust to shifts in market demand, and outside of the EU, their market share decreased from 88% to 64% (Labys, 2004). The share of the market leader, France, where production remains focused on small, private, family-owned wineries, has declined to 40% of world exports in value terms, down by 10% since 1990. In the UK for example, these wines now account for over half the market, while France's share has fallen from over 35% of the UK market in the late 1980s to 18% in 2006. 'New world' producers now account for 60% of the UK market, with South Africa coming fifth with a 10% market share (Reed, 2006).

Source: SAWIS, 2004

Country	**Liters**	**Rank**
Luxembourg	59.10	1
France	56.00	2
Argentina	36.10	6
Australia	20.60	17
Chile	15.70	26
South Africa	*9.00*	*33*
USA	8.80	34

Unlike in South Africa, wine clusters are driven by domestic demand in the United States and Argentina. Although the US has a very low per capita consumption, at nine liters (similar to South Africa's) the scale of the US makes it the third largest wine market in the world. In Argentina, per capita consumption stands at 36 liters, among the top 10 in the world, and only 4% of that is from imported wines. An additional advantage other new world wines have is government support. In Australia, for example, research and development expenditures are matched by the Government, through the Grape and Wine Research and Development Corporation (HBS, Case 9-703-492). In the US, the state of California has worked closely with the wine industry to ensure policies that would benefit production (HBS case 9-799-124).

2.4 South Africa's Wine Production

While agriculture is a relatively small portion of South Africa's GDP, at 4%, it contributes to about 30% of formal employment in the country and provides work for casual laborers (World Bank, ICA, 2005). The wine cluster represents 40% of agriculture's valued-added. In Cape Town and the Western Cape province, wine has a major economic impact, accounting for 8.2% of the provincial domestic product or R11.4 billion in 2003 (SAWIS). In addition, the cluster employs 126,000 people.

This figure includes about 50,000 farm workers, 27,400 retailers, 4,400 producers and 3,300 cellar staff. An additional 140,000 are employed in related and supporting industries, mostly tourism (Bekker, 1999; www.tips.co.za).

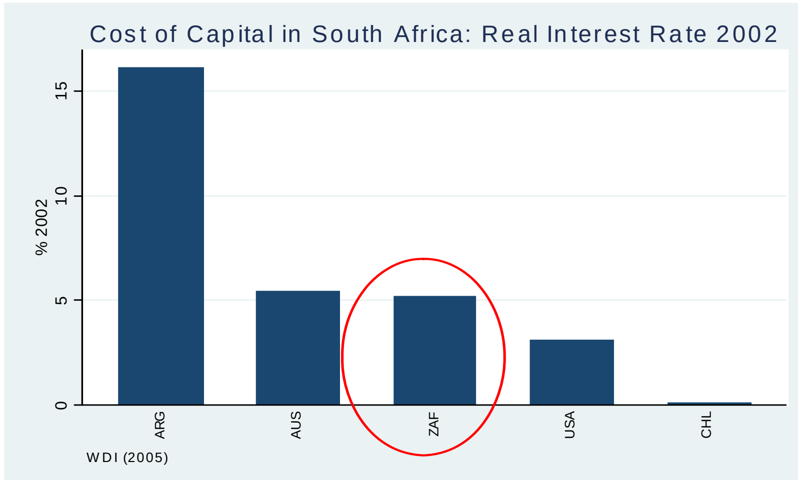
Vineyards are concentrated in the Western Cape, with major production regions in Paarl, Stellenbosch and Worcester. Wine is also grown on the banks of the Orange River in the Northern Cape. From a *terroir* perspective, the Western Cape is particularly well-suited for grape growing, and the Cape winelands are within easy driving distance to Cape Town, which has a major seaport and an international airport. Since 1994, the hectares under cultivation for wine production have grown 2% per annum, to about 100,000 hectares today (SAWIS, 2006) while wine sales have increased at 6% per annum, from R1.6 billion in 1994 to R2.9 billion in 2004. About 55% of grapes are planted for white varietals, 30% for red wines and 15% for rose wines. Like many other 'new world' producers, South Africa uses "blending techniques" to engineer the taste of wine. South Africa is best known for Pinotage, developed in the 1960s (www.wine.co.za).

3. Cluster Analysis

3.1 Factor Conditions

Capital

When compared to other 'New World' growers, the cost of capital in South Africa is moderate, at around 5% in real terms, as highlighted by the graph below. A local bank, Nedbank, provides customized financial products to the wine industry, and evidence suggests that foreign investment in vineyards and production have been increasing (www.wine.co.za). A major threat remains the volatile exchange rate, however. In addition, funding for wine-related education and research and development institutions is about half of international best practice (SAWB, Vision 2020).



Labor

Traditionally, through the "dop" system, vineyards enjoyed the benefits of nearly free labor, paying their workers only in room, board and the wine they produced. Labor is now regulated, but in spite of a minimum wage introduced in 2002 and the removal of the "dop" system, producers still have access to cheap labor. The level of unionization is generally low, and farm relations remain marked by paternalism. The minimum wage of R4.54 per hour for farm workers (South African Department of Labour) is the lowest in the country and squatters from the Eastern Cape, Mozambique and Angola provide even cheaper labor. At the production level, while the wine cluster is amply supplied with winemakers, there is a shortage of skilled managers and cellar assistants (Bekker, 1999). Overall, however, labor productivity is low, at 1 worker per four hectares, compared to eight in Australia (www.wine.co.za).

Land

South Africa ranks 15th in the percentage of world surface under vines (SAWIS). However, only 0.5% of land in the wine sector was owned by non-whites in 2003 (www.tips.org.za), at a time when the government has made land redistribution a greater priority. The government's redistribution program aims to have 30% of agricultural land in black hands by 2014, compared to 14% in 1994. Countrywide, about 4% has been redistributed since, and 60% of the 80,000 claims had been settled by 2004 (Department of Land Affairs). Tenure reform, legislated in the 1997 Extension of the Security of Tenure Act has already been able to secure the rights of farm workers, labor tenants and people living on state and communal land.

Marketing

Marketing has been an area where South Africa's wine industry has lagged behind. In the domestic market, the industry spends only R40million per annum while R160million is spent yearly on advertising for beer (Rands, 2006). More marketing efforts are required to promote a lifestyle which includes wine, and engages a black middle class that has grown by close to 700,000 consumers between 2001 and 2004 (www.brait.co.za). Internationally, South Africa has not yet created a niche for its premium wines, and the country lags behind other 'New World' producers, which have dedicated significant resources to creative international marketing campaigns resulting in large export gains. In the US for example, South Africa spent about $500,000 on wine promotion in 2004, whereas Argentina will spend $5 million from 2004 to 2008 (www.wineland.co.za).

3.2 Demand Conditions

South African wine serves three distinct markets: (i) the high-end domestic market, (ii) the low-end domestic market, and (iii) the export market. Historically, wine has been consumed among the white and Coloured (mixed-race) communities, centered around the Western Cape and Gauteng province (Johannesburg).

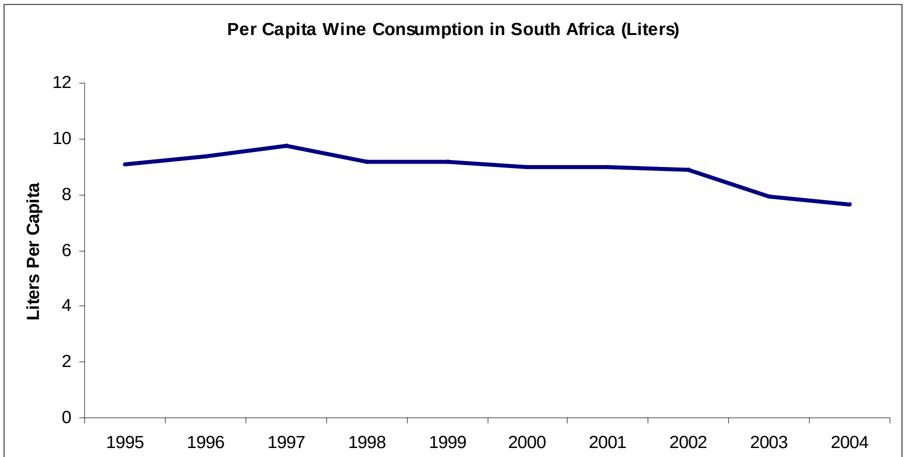
The domestic market

The low-end domestic market caters essentially to the relatively poor coloured market, where the historical prevalence of the "dop" system (see previous reference) has led to high levels of consumption, but unfortunately alcoholism as well. One liter of wine for such a market costs generally between R5-10 (own observation), and is generally produced by amalgamating different harvests of grape. KWV remains a major player, and wine is generally distributed through low-cost retail outlets. The amount of imported wine is very limited (SAWIS).

The high-end domestic market is relatively small and consists of discerning high-income white (but also increasingly black) consumers located mainly in the main cities, such as Cape Town and Johannesburg, whose consumers are sophisticated, generally have a good knowledge of wine, and are receptive towards innovation. The quantities of wine sold are relatively small, and distributed generally through specialist retail outlets. The wine consumed tends to come from smaller estates around Stellenbosch, with bottles selling at R50-150 (own observation).

Overall, however, South Africa's per capita wine consumption, at nine liters per person per annum, is relatively low, especially compared to other major wine producers (see previous table). Among the majority African population of the country, beer remains the alcohol of choice, accounting for 68% of the total domestic alcohol market, while wine represents only 12% (SAWIS, 2003). This has been changing, however, as the new upwardly mobile segment of the black population has increasingly taken to consuming wine, as a symbol of newly acquired wealth and status. In 2005, for example, a wine festival was organized in Soweto, Johannesburg's main black township (www.wineland.co.za).

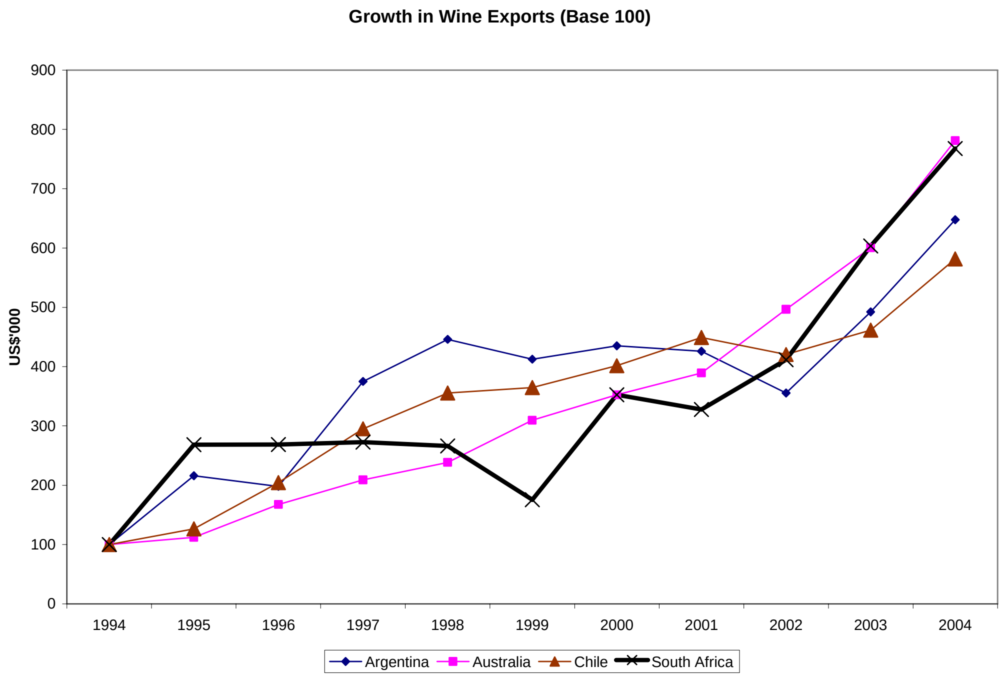
That being said, the domestic market remains a challenge for South African producers. The limited uptake among black consumers has not been sufficient to counteract the falling demand among whites, which have tended to emigrate over the past ten years. The local market has been growing by only 1.2% per annum since 1994, and the country is ranked 33rd in worldwide consumption per capita, compared to being 9th worldwide in terms of production (SAWIS, 2004).



Source: SAWIS Database, 2006

The Export Market

Fortunately for South African wine producers, the export market has largely compensated since 1994 for the stagnant domestic market. Wine has been South Africa's fastest growing export between 1992 and 2003, increasing from 20 million liters to 124 million liters (SA Wine and Brandy Company Vision 2020), representing a compounded annual growth rate of nearly 18% in volume terms. In value terms, exports have grown eightfold since 1994 to US$534m in 2004, when wine represented about 1% of South Africa's total exports of goods. The export market now absorbs more than a third (38%) of the country's production, and South Africa has become one of the larger New World producers, outperforming in terms of growth most other New World producers since 1994, and producing 3.1% of the world's wine.



Source: FAOSTAT

The UK, Netherlands, Germany Sweden, and USA markets account for 75% of South Africa's wine exports. One of the salient features of South African wine sold overseas is that it is often marketed under brands that do not exist in South Africa. KWV handles about 70% of the country's exports (US Department of Agriculture), and operates a number of joint-ventures overseas, such as Golden Kaan in Europe (www.wine.co.za). Several independent South African vineyards have also recently entered the foreign market under the Matuba name (www.wine.co.za). However, South African wine is mostly sold in bulk quantities (focusing on cultivars rather than vineyards) to wholesalers and retailers in major Western markets, where it is branded under catchy African-sounding names, such as the Canadian-owned Kumala, which sells in the UK. South African wines are targeted towards the lower to middle-range of the market, with wines at less US$10 (£5). In the UK for example, the average selling price for South African wine was £3.68 in 2004, compared to £4.40 for Australian wine (www.wineland.co.za).

While the increasing importance of exports has proven a boon to the South African wine cluster, it has also made the South African cluster more dependent on world demand and vulnerable to the volatility of the country's currency. About 38% of the production was exported in 2004, up from 12% in 1994. In recent years, such an exposure has created some difficulties in the sector. The collapse of the rand at the end of 2001 resulted in considerably higher local currency revenues for local producers, but the situation was just as suddenly reversed, when the currency not only recovered lost ground, but appreciated by 50% against the US dollar from 2002 to 2004. This has squeezed local producers, who now receive considerably less revenue in local currency terms. As a result, while the *volume* of South Africa's wine exports from 2002 to 2004 grew by 24% from 210m kgs to 261m kgs, and the US$ *value* of South Africa's wine exports grew by 87% from $286m to $534m, the revenue in local currency terms actually decreased from R3.4 billion to R3.2 billion (own calculations based on SAWIS).

3.3 Firm Context & Rivalry

South Africa's wine cluster is characterized by a dichotomy between large, historical, producers, such as KWV, which dominates the industry, and a myriad of smaller producers. Since 1997, KWV has restructured itself into several entities: KWV Co-operative, which comprises its member farms; KWV South Africa, a private company that focuses on domestic sales, and KWV, a private company that focuses on exports. KWV Investments, a joint operation with South Africa's Rembrandt Group, also owns 60% of Distillers Corporation (Distell) and Stellenbosch Farmers Winery (www.kwv.co.za).

Production

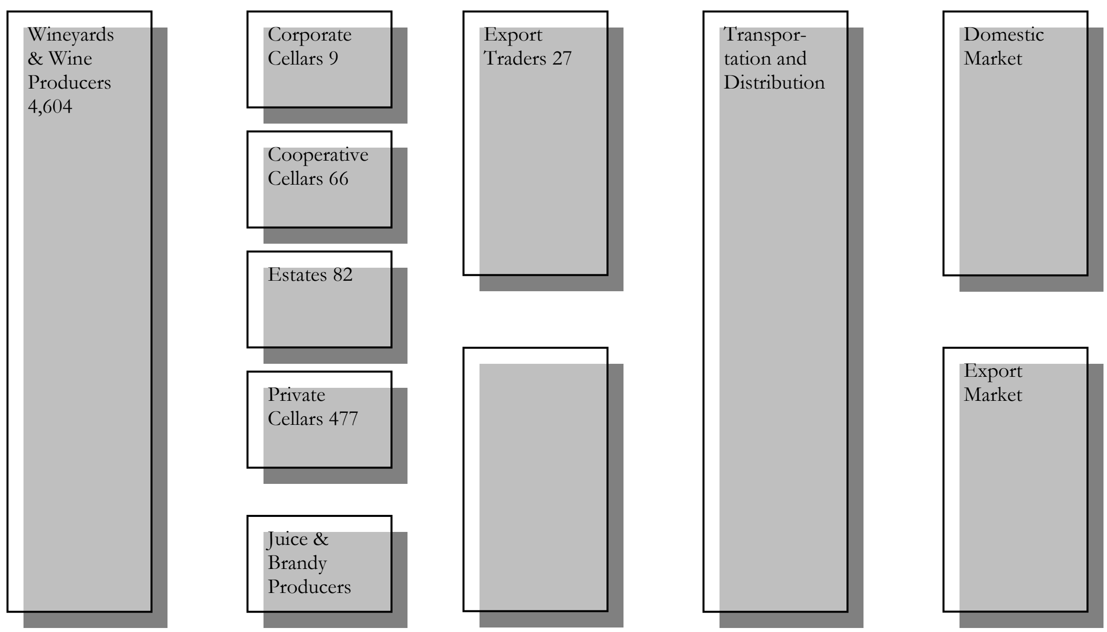
The deregulation of the cluster since 1992 has spurred the entry of new producers, and the associated expansion of vineyards into new areas of the Western and Northern Cape. There are now about 4,406 producers in the market, more than half of which have been in business for less than eight years (SAWIS, 2004). At the same time, more than half of the farms have been inherited, with the same family owning the farm for an average of 80 years (Bekker, 1999). Small wine growers, which produce less than 500 tonnes represent 81% of all wine growers and produce approximately 31% of total output (SAWIS, 2004).

Producers can be divided into two categories. The most important ones are the 66 cooperatives, which process grapes from their member farms into wine. About half are affiliated to KWV. Cooperatives account for about 80% of production (www.wine.co.za). In addition, there are 82 estate vineyards, mostly small and upscale producers that grow wine for sale under their own labels. These estates are however, at times owned by large corporations: this is the case for example of Anglo-American Corporation's Vergelegen estate. The industry is similarly fragmented among cellars, which tend to bottle most wines: of the 561 vineyards and cellars in South Africa (477 of which are private), only 38 crush more than 10,000 tons of grapes per year, and KWV has a market share exceeding 50% (SAWIS, 2004). Some of the cellars also make wine from their own farms. The industry has also seen the entry of foreign purchasers, mostly from Europe, although these have been individuals rather than corporations.

Distribution

Traditionally, wine was either distributed through wholesalers, or individually by the wine estates. Some wholesalers also grow their own grapes. However, wholesalers are becoming an increasingly important part of the value chain, accounting for 64% of wine sold in 2003, compared to 46% in 1998. There are about 103 bulk wine buyers, comprised of 76 wholesalers and 27 exporters (SAWIS, 2004). KWV continues to play a paramount role here, representing 90% of all wine sales in South Africa (US Department of Agriculture) although retailers such as Pick 'n Pay and Woolworths, two more up-market chains, have increasingly bought their wines directly, reselling it occasionally under their own brand names.

WINE VALUE CHAIN



Source: Bekker, 1999

Profitability

As highlighted by the entry of new producers over the past decade, the wine industry appears to be profitable. According to SAWIS, the average income for wine growers increased 54% in real terms from 1993 to 2003, while production costs only increased by 34% over the same period (SAWIS, 2004). The internal rate of return (IRR) in the wine industry was estimated at 30% in 1998, higher than for other agricultural ventures (Ewert, 1998). However, industry bodies contend that the average return on investment has dropped in 6.9% in 2004 (www.wynboer.co.za). It is also important to differentiate between large and small-scale producers.

According to a study commissioned by Deloitte & Touche, 36% of small-scale producers (less than R25m in annual revenues) made a loss in 2004, compared to 25% of large-scale producers (revenues between R25m and R90m; www.wine.co.za). Small wineries find it difficult to manage their costs, particularly since labor absorbs between 44% and 51% of these (www.wine.co.za). Furthermore, smaller wineries, and especially estates, are constrained by that fact that they cannot mix their wines with other wines (particularly in drought years) due to the appellation of origin restrictions. As a result, smaller wineries made an average profit in 2004 of R12.5 per case, compared to R20.5 in Australia. Larger wineries made higher profits, at R32.5 per case, but this figure remains significantly lower than in Australia, where the figure for large producers was at R87 per case (www.wine.co.za).

There seems therefore to be some scope for efficiency gains, especially compared to Australia. It would seem that the boom in exports, and the depreciation of the rand until 2002, has allowed many farms to make profits without due attention to their cost structure. In particular, many estates seem to have taken on debt, facilitated by links with local banks, such as and Nedbank (see previous reference), which provide long-term finance (www.wine.co.za). As a result, the debt to equity ratio is now at about 1:4, representing an important burden on many smaller wineries (www.wine.co.za). This is highlighted by the fact that most wineries show a positive Earnings Before Interest and Tax (EBIT), but many only have a small Earnings Before Tax (EBT) as they are over-leveraged (www.wine.co.za). The appreciation of the rand since 2003 is now forcing many farms to engage in cost-cutting to maintain their profit margins.

The average producer price per ton of wine has increased from R1.43 in 1995 to R3.78 in 2003 (SAWIS), and growth in turnover for producers from 1999 to 2003 has exceeded that of cellars, wholesalers and retailers. However, producers receive only 24% of the total turnover of R10.7 billion in the wine cluster (excluding tourism) and an even lower share, at 6%, of the export market of R3.1bn (see graph below; www.tips.org.za).

South African Wine Industry: Turnover (R million)

	Turnover		Exports		Domestic Sales	
	2003	% annual Growth 99-03	2003	% annual Growth 99-03	2003	% annual Growth 99-03
Producers	2,597	22	192	9	2,406	23
Manufacturers, etc	8,078	3	2,692	61	5,116	5
Total	10,675	13	3,153	25	7,522	9
Tourism	4,198	7	914	-1	3,285	9
Grand Total	**14,874**	**11**	**4,067**	**4,067**	**10,806**	**9**

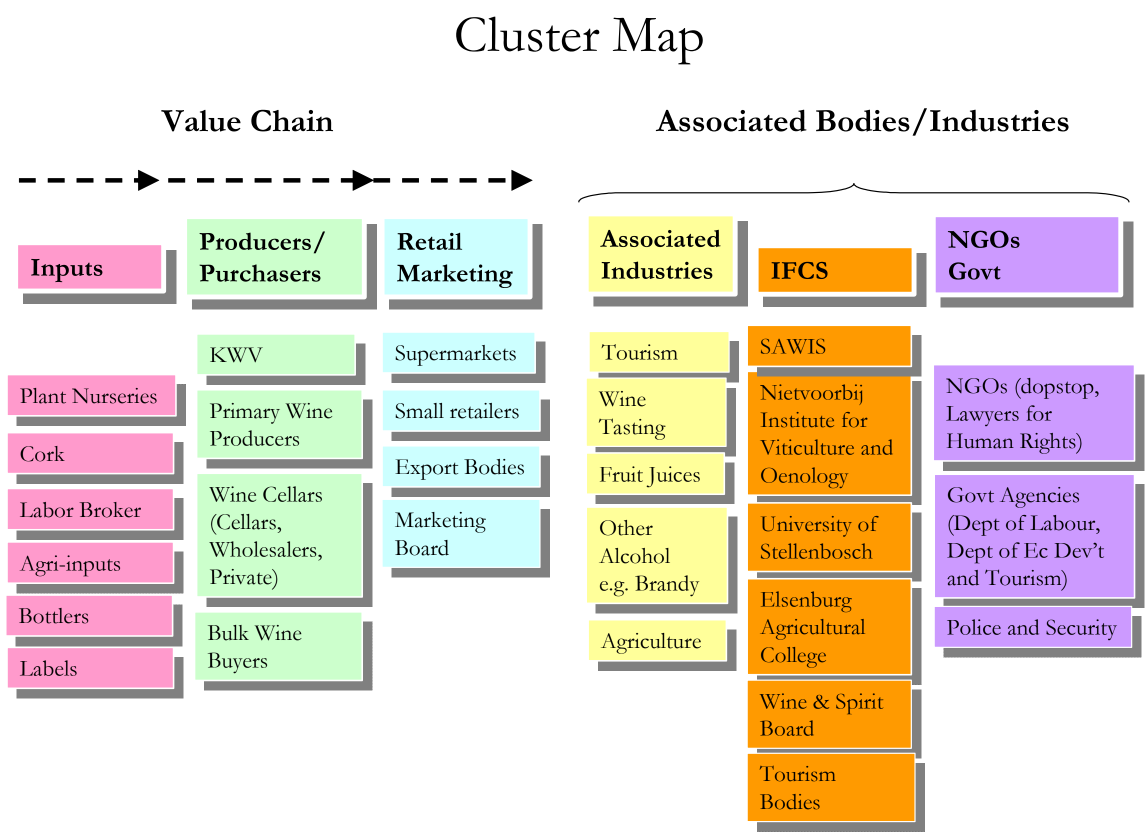
Source: www.tips.org.za

Finally, it is important to note that the wine industry remains an extremely segregated industry (SAWB, Wine Industry Strategy Plan). Vineyards and other entities in the cluster have been traditionally been owned, managed and staffed by whites, with Coloureds, and increasingly blacks, providing only menial labor. Only a handful of estates are owned by non-whites, mostly by successful black entrepreneurs, such as Tokyo Sexwale, the owner of Mvelaphanda, a mining conglomerate. There are also a few estates which focus on fair trade and are jointly owned by former Coloured farmworkers, but overall the cluster remains largely white. It is also telling, for example, that the Nietvoorbij Institute has trained very few non-white professionals in recent years.

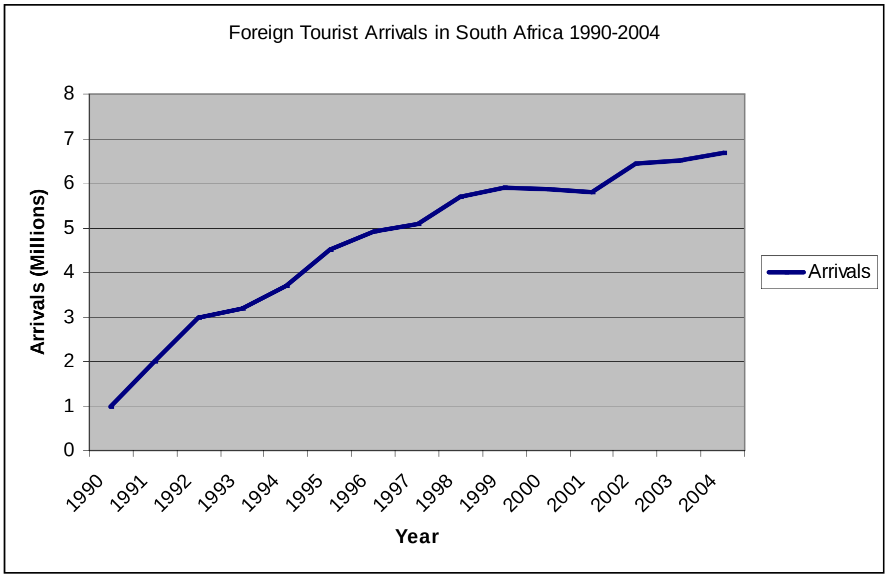
3.4 Related and Supporting Industries

Tourism

The South African wine cluster shares a mutually beneficial relationship with the tourism sector in South Africa. Tourism has boomed since the 1990s and currently contributes around R100 billion each year to the South African economy, or 7% of GDP. The effects of tourism are particularly important in the Western Cape, which attracts about 25% of all visitors to South Africa and up to 30% during the summer months (SA Tourism Research Database).



The Cape Winelands offer numerous regional wine routes, such as the Stellenbosch Wine Route, started in 1972, excellent mountain activities, charming provincial towns, and most of the areas are within a few hours' drive of Cape Town. As a result, tourism is the major supporting industry of the South Africa wine industry, contributing about R4.2 billion in 2003 alone, or about 25% of the total income created by the South African wine industry (Dube). Tourism remains largely domestic, with 75% of revenues coming from South African tourists (almost half of whom were from Cape Town). Of the remaining 25% of foreign tourists, a third were from the UK. Nearly 60,000 people are directly employed in wine tourism-related activities (such as hotels, restaurants, and tour operators), and this area of the cluster is considered one of the best areas for driving improvement in overall BEE within the industry (Dube, 2005).



Source: Global Competitiveness Project

Other Supporting Industries

South Africa's wine cluster is characterized by a diversity of IFCs, a beneficial relationship with tourism, and a still-undefined government role. The wine cluster is also supported by several industries, such as labelers, bottlers and cork producers, of which there are ten in South Africa. The two other major industries are brandy and grape juice. Brandy has had just as long a history in South Africa as regular wine, but since production as a percentage of total wine-based products has fallen from 28% in 1994 to 15% in 2004 (SAWIS), dropping from 224 million liters in to 146 million liters. Production of non-alcoholic wine-based products (almost entirely grape juice) has been flat, with 84 million liters produced in 1994, and 88 million liters produced in 2004, or about 10% of total wine-based products in both years (SAWIS). The total combined value of brandy and non-alcoholic wine production has fallen in real terms from R391 million in 1994 to R203 million in 2003 (SAWIS, deflated by authors using GDP Deflator from WDI). Accordingly, per capita brandy consumption in South Africa has declined from 0.52 liters in 1995 to 0.41 in 2004, eroded by increasing imports of other spirits such as whiskey, tequila, and "alcopops" (alcoholic fruit beverages; SAWB, Vision 2020).

Brandy, however, still remains the South African domestic market's spirit of choice, at 47% of the spirits market, and SAWB's "Vision 2020" clearly seeks to re-energize the production of brandy, primarily through stronger marketing campaigns (SAWB, Vision 2020). Vision 2020 also recognizes the need to innovate on grape juice production, which is increasingly being processed into higher value-added forms for use as a base in making other fruit juices. While Ceres, a South African juice producer, has successfully expanded production both domestically and internationally, grape juice production generally remains a small component of the wine cluster (SAWB, Vision 2020).

Institutions for Collaboration

There are thirty-seven IFCs that support the wine cluster, engaging in a variety of activities. The efforts seem to be disjointed, however. The most significant are described below:

- *South African Wine and Brandy Company (SAWB):* SAWB was created in 2002 to implement the industry's Vision2020 strategy, which highlights how the cluster should target foreign markets. SAWB seems to be a potential leader in coordinating industry strategy. However, the strategy can be criticized for not having quantified targets for wine, and for not detailing enough specific actions to be taken to achieve the strategy's objectives.

- *Wines of South Africa (WOSA)*: With offices in Canada, Denmark, Germany, Netherlands, Sweden, the Untied Kingdom, and the United States, but not in Asia and other emerging markets, WOSA is primarily engaged in export promotion

- *South Africa Wine Industry Information and Systems (SAWIS)*: SAWIS, a data collection agency, has been praised for its clear mission and effective management. However, it is mostly concerned with domestic, rather than international data collection.
- *Wine and Spirit Board:* The Wine and Spirit Board is responsible for providing certification of South African wines. It might be able to take a more active role in promoting higher value production.
- *Nietvoorbij Institute for Viticulture and Oenology*, *University of Stellenbosch*, and *Elsenburg Agricultural College*: these three main educational institutions conduct research in viticulture, oenology, biotechnology, and agriculture.

At a national level, the government has at least acknowledged the importance of innovation, forming the National Advisory Council on Innovation, and creating two bodies to fund research to improve innovative capacity. However, in the wine cluster, expenditures for education and research and development remain at half of the level proposed in the Vision 2020.

The Role of Government

Given competing policy priorities in post-Apartheid South Africa, it is not surprising that the government is still in the process of defining its role in the wine industry. Since full deregulation was completed in 1997, the government has struggled to find an appropriate level of re-engagement. In 2003, the Ministry of Agriculture approved the Wine Industry Strategic Plan to promote competitiveness and resource management. The government currently is partnering with industry stakeholders, especially IFCs, to strategize on the development of the industry, particularly on issues of BEE, social safety nets, land reform, taxes, and trade policy. (SAWB, "Ministerial Commission on Agricultural Deregulation")

4. Strategic Issues

4.1 Factor Conditions

Labor

Results of a survey of South African wine producers (SAWB, 2005) suggest that while there is a plentiful supply of unskilled workers, the industry's competitiveness is constrained by a shortage of some skilled workers. The industry needs to work with universities to encourage potential students to study viniculture, and possibly lobby the government for subsidies or tax incentives to train employees. If there is insufficient domestic demand for these courses at home, the industry could even market these courses to international students, and encourage them to remain in South Africa after graduating. The industry should also encourage exchange programs with universities in other wine-producing countries, such as UC Davis in California, which has a specialized viticulture department. A more short-term strategy is to encourage the immigration of skilled workers, possibly under the government's new Quota Permit program, introduced in April 2006, building on the high quality of life in the Cape Region. The industry could use WOSA's representations to publicize such a program.

Research

South Africa should also increase research and development spending in the industry up to international levels. This is important since the industry is knowledge-intensive and export-focused, competing with countries which are also constantly innovating. Research and development into new viniculture techniques will also help South Africa in moving to higher value wines in its export markets.

Capital

The availability of start-up capital does not seem to be a constraint to competitiveness in this industry, and the industry benefits from dedicated financing products through Nedbank. However, the industry needs to ensure that financial products continue to be tailored to the characteristics of the wine industry, for example, the very long gestation between start-up investment and subsequent returns and the need for continuous research and development.

Land

The industry needs to co-operate with the government regarding land reform. The industry should acknowledge the inequalities, while arguing the importance of the wine sector to South Africa's export base. The industry should encourage the entry of black entrepreneurs, either as producers, or as stakeholders in existing farms and companies.

4.2 Demand Conditions

The Export Market

Exports will continue to be pivotal for growth, and the industry needs to explore opportunities in international markets. The industry should, for example, seek to consolidate its position in the lucrative UK market, which has a high aggregate wine consumption, and already absorbs 37% of South Africa's exports. Given that developed markets are largely mature, the industry should also focus on emerging markets in Asia, such as China. Asian countries absorbed 35% - or US$35 billion - of the world's wine by value in 2004, and consumption is forecast to increase by 46% between 2000 and 2010 in volume terms, compared to 10% for the world as a whole (Vinexpo, 2004). The locus of Asian wine demand will be China, where wine consumption rose 20% in the 4 years to 2004 and is expected to rise by another 48% by 2007. WOSA has no presence in this market and the growth potential for the South African wine industry could be substantial.

The Domestic Market

Currently, South Africa ranks only 33rd in per capita consumption. The industry should encourage consumption among the new black middle-class, perhaps by having some new black producers as the faces of a marketing campaign. The industry could also partner with existing campaigns such as *"Proudly South African"* in tandem with a marketing strategy. In order to reach a broader proportion of the population, the industry should also expand distribution to non-traditional geographic or socio-economic areas.

4.3 Firm Context & Rivalry

Deregulation has encouraged the entry of small producers into the wine cluster, and to a smaller extent, cellars, but large players still control much of the industry.

Production and Distribution

In terms of production, the cluster should encourage expansion into higher-value added products, including premium red wines, moving from a low-cost producer to a differentiator. The industry produces world-class, high-end wines from vineyards whose tradition is on par with those of European countries. The industry should leverage this advantage to move toward higher-value wines that serve more sophisticated global customers In addition, a continued focus towards exportable products will rely on the ability of the industry to consolidate the distribution of exports. At present, the industry lacks a strong international player that is vertically integrated from production to distribution. KWV, for example, which dominates the export market, has tended to either engage in joint-ventures or to sell to foreign wholesales, but has yet to gain full ownership of the export value chain.

Black Economic Empowerment

Because of its traditional segregation, the wine industry faces new challenges from this government mandate. Since 2003, SAWB have been working towards completion of a "Wine-BEE Charter" and designing a balanced scorecard for the industry. The Charter includes a broad range of goals to enhance access across the entire industry; de-racialize land, management and ownership This unified, industry-wide approach towards BEE is a break from the uncoordinated hoc efforts undertaken to date (SAWB, "A Roadmap Towards a Wine-BEE Charter").

4.4 Related and Supporting Industries

IFCs and Government

Vision2020 seems to mark a clear move towards increased collaboration. With SAWB concentrating on the development of markets, research and technology, human resources, business intelligence, and socio-economic empowerment, the organization has the potential to focus on barriers and opportunities for development of the wine cluster. First, SAWB will need to effectively partner with industry stakeholders and with the government. Second, collaborative strategies need to focus on strengthening training, in order to meet the demand for skilled labor. This includes increased support for research and development, providing incentives for training, and organizing workshops on production and information dissemination available to a broader range of growers and producers. The wine industry depends on the government for support in many activities in the value chain, statutory such as levies to help fund IFCs such as WOSA and SAWIS, access to irrigation, and access to capital through state-sponsored research funding and Land Bank funds.

Tourism

Tourism provides substantial market opportunities for South Africa, particularly for higher value products. There are many spillovers from investing resources in developing a skilled workforce, infrastructure, and information systems, securing a safe business environment, and lobbying government for increased support. Tourism has only been recently harnessed to strengthen the cluster. At the first South African Wine Tourism Forum held in April 2006, a wine tourism steering committee was formed which will focus on (i) "branding the Cape Winelands as a uniquely attractive global destination, (ii) using wine tourism to promote transformation within the wine industry, and (iii) coordinating research and [data collection] with [other areas of the wine industry and tourism industry in South Africa]" (deVilliers, 2006). The Forum highlighted the importance of the domestic market, and the need to engage black South Africans, through events such as the new Soweto Wine Festival (de Villiers, 2006; Dube, 2005). The benefits to the wine cluster from tourism will likely continue to grow, particularly as a result of increased government commitment to promoting the entire tourism industry, including the "Global Competitive Project" launched in 2003.

5. Summary of Policy Recommendations

Overall Recommendations

We recommend a two-pronged strategy to bolster demand for South African wine. First, the industry needs to consolidate its exports to the UK market and pursue opportunities Asian markets, particularly China. Second, the industry should invest in expanding domestic demand, through marketing and distribution efforts that reach a broader range of South Africans. On the supply side, the industry should invest in increasing the number of skilled personnel either through training or immigration.

Recommendations for the Government

The government has a particularly important role in strengthening factor conditions. First, it should provide some subsidy or tax incentives to wine producers who train their staff. To expand the wine industry's world market share and move towards higher-value wines, the government could co-invest with firms to bring research and development up to international levels. Second, it should create greater certainty about its plans for land reform, and work with the industry to strategize on how the latter can contribute to twin aims of greater competitiveness and equality in South Africa.

Recommendations for Firms

Greater consolidation of exporting firms will encourage greater efficiency and competitiveness in the export market. Improving profitability requires a combination of (i) higher prices by producing higher quality products targeted at more sophisticated drinkers, and (ii) lowering unit costs by creating economies of scale by expanding production, increasing efficiency through vertical integration, and improving labor productivity throughout the industry.

Recommendations for IFCs

IFCs can play an important role in bolstering the demand for South African wine, especially through WOSA. This agency needs to aggressively market South African wine in key markets to ensure future export growth. WOSA should also facilitate links between South African producers, distributors, and retailers in key export markets. The universities also have a role in continuing to produce the research and skilled workers the industry requires. Furthermore, WOSA and SAWB in particular need to set quantified targets to achieve Vision 2020 objectives.

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Required Disclosures

Mutsa Chironga traveled to South Africa during the project period, but for unrelated reasons.

Maria Demeke attended the University of Cape Town during the 2001 academic year.

Christopher Maloney has traveled extensively in South Africa and has covered macroeconomic issues in the region while at the US Department of the Treasury.

Markus Scheuermaier worked in South Africa from 2001 to 2003 as a Deal Executive for Brait Private Equity.

None of us had access to private information about the cluster.