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Differentiation strategies and winery financial performance: An empirical investigation

Sandra K. Newton, Armand Gilinsky Jr, Douglas Jordan

Business Department, School of Business and Economics, Sonoma State University, Rohnert Park, CA, USA

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Abstract

This investigation into small-to-medium sized wine businesses empirically tests linkages among differentiation strategies and financial performance over time. Using a two-by-two model, we examine the impact of differentiation strategies on profitability and growth. Financial and operational data from a proprietary database of 71 United States wineries, encompassing five continuous years (2006–2010), provide longitudinal robustness. Management decisions regarding resources and capabilities are used to cluster the sample firms into a two-by-two differentiation strategy model. Those wineries sourcing over 50% estate grapes and distributing over 50% direct-to-consumer have higher gross margins compared to other clusters. Direct-to-consumer distribution decisions impact growth. Results of this research indicate that distribution channel choice-direct-to-consumer-positively impacts gross profit margin and winery growth rates. Supply chain choice-sourcing estate grapes also positively impacts gross profit margin. This study uses reported financial data that have not been made available to researchers.

Keywords: Small and medium-sized enterprises (SME); Competitive strategy; Differentiation; Financial performance; Wine industry

1. Introduction

Competition is everywhere! Managers are constantly making decisions among strategic alternatives to produce a competitive advantage in an attempt to earn above-average returns. Yet firms operating in mature, traditional industries, such as the wine industry, are unlikely to achieve a unique advantage, based on resource capabilities and product quality alone (Edelman et al., 2005; Gimeno-Gascon et al., 1997). Mature and fragmented industries such as agriculture, retail, and services are primarily comprised of small and medium-sized enterprises (SME). These industries possess specific characteristics, such as low entry barriers (Porter, 1980), low degrees of private or asymmetric information (Barney, 1991), and low levels of resources with limited strategic substitutability (Wernerfelt, 1984; Barney, 1991). Economies of scale may be challenging to achieve, preventing SMEs from lowering costs of production by spreading fixed costs for capital improvements (Hunger and Wheelen, 2011). SMEs in these industries achieve superior performance not only because they have accumulated more valued resources, but also because they make better use of those resources under their control (Barney, 1991).

‘Better use’ of resources support differentiation within an industry and encompasses: (1) products or service innovation (Banker et al., 2014; Brush and Chaganti, 1999; Brush et al., 2001; Chandler and Hanks, 1994); (2) superior product quality/customer service, e.g. quality control, satisfaction of customer needs, highest product quality, and unmatched service (Edelman et al., 2005; Porter, 1985); and (3) geographical and buyer segmentation (Carter et al., 1994; Miller, 1988). SMEs operating in mature, highly competitive environments may be unable to successfully differentiate due to low barriers to entry, or may have insufficiently rare or easy-to-imitate resources, limiting the range of viable strategic alternatives (Hammervoll et al., 2014; Sandberg and Hofer, 1987).

E-mail addresses: newtonsa@sonoma.edu (S.K. Newton), Armand.Gilinsky@sonoma.edu (A. Gilinsky Jr), jordand@sonoma.edu (D. Jordan).

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1.1. United States wine industry

The United States wine industry is one example of a mature, highly fragmented yet intensely competitive industry, encompassing 7762 U.S. bonded and virtual wineries in early 2014 (Wines and Vines staff, 2014). This total included bonded wineries (those with production facilities and/or vineyards — 6565 wineries) and virtual wineries (i.e. those with neither production facilities nor vineyards — 1197) Wine sales in the United States, inclusive of imports from producers outside the U.S., climbed to 375 million cases in 2014. This represented a growth of 1% from 2013, reaching an estimated retail value of $37.6 billion. Of the total cases sold in the U.S. in 2014, California's 225 million cases sold captured a 60% share of the total United States market (The Wine Institute, 2015). The United States wine industry has been described as 'purely competitive', that is, as there is no single domestic lowest-cost provider, rivals are forced to compete via focused or mass differentiation strategies (Swaminathan and Delacroix, 1991; Porter, 1998), and often try to distinguish themselves through quality or innovation (Duquesnois et al., 2010; Stenholm, 2011). Wine industry strategy has traditionally been production-driven and focused on volume growth dictated by the availability of grapes. However, production-driven strategies in the wine industry do not guarantee long-term financial performance (Brown and Butler, 1995; Steinthal, 2004). Wineries that create differentiation advantages are postulated to become more resilient and profitable (Steinthal, 2004; Steinthal and Hinman, 2007).

A watershed event for the United States wine industry was the 2005 *Granholm v. Heald* decision that served to liberalize direct-to-consumer (DTC) sales of wine across state lines, e.g. from producer to consumer but absent a trade intermediary (wholesaler, distributor, retailer).[1] DTC sales of wines via websites, tasting rooms, and wine clubs are strategies different from the traditional routes to market via distributors and wholesalers. DTC is expected to produce higher gross margins: wineries normally sell products to distributors and wholesalers at 50% of the final retail price, yet are able to sell products DTC at the full retail price, less any discounts provided to and taken by their wine club members. The value of DTC shipments grew 15% to $1.8 billion in 2014, while volume of DTC shipments in 9-l cases rose to 3.9 million (Gordon, 2015). A strategy that incorporates DTC sales presents both advantages and disadvantages: full mark-up, and positive and ongoing customer relationships, but complicated marketing, tracking, and shipping logistics (Gurau and Duquesnois, 2008).

Strategies that create competitive advantages for wine businesses are understudied (Delmas and Grant, 2008; Fearne, 2009). Just prior to the prolonged recession that negatively impacted all sectors in 2009 and 2010, the effect of the Napa Valley wine industry alone on the U.S. economy was $42.4 billion (Stonebridge Research, 2008). Therefore, with that much money at stake, it is surprising that there have been relatively few recent studies linking the drivers of competitive advantage to performance in the wine industry (Hammervoll et al., 2014; Taplin, 2006; Jordan et al., 2007).

One explanation for the scarcity of such prior studies is the fact that proprietary data, from SMEs and other family-owned businesses that comprise the preponderance of the wine industry, have heretofore been largely unavailable to researchers to determine to what extent differentiation strategy theory and competitive advantage, measured by financial performance, are linked. Prior studies have implied but not demonstrated that such a relationship exists, despite the absence of longitudinal indicators of financial performance (Bernabeu et al., 2008; Melnyk et al., 2003; Orth et al., 2007; Taplin, 2006).

1.2. Research questions

Although many recognize M.E. Porter's (1980) theory of generic competitive strategy as the dominant paradigm in strategy research and practice, some suggest that cost leadership and differentiation (1) act as nothing more than high-level discriminators of competitive strategy designs (Campbell-Hunt, 2000), (2) contribute only tangentially to what has become the challenge of achieving a temporary competitive advantage (D'Aveni et al., 2010), (3) do not predict significant differences in performance in SMEs (Rubach et al., 2002), nor (4) describe completely how SME strategy formulation and implementation occur (Ebben and Johnson, 2005). According to Walters et al. (2005), the competitive advantage of a firm pursuing a differentiation strategy is often a result of management decisions regarding the development of new products and services, product design, product features, brand image, superior service, technology, and distribution. A more recent study confirms that producers with a differentiation are able to maintain a superior performance over those who pursue a cost leadership strategy (Banker et al., 2014).

These observations lead to two research questions:

1. How do individual SMEs in a focal industry — wine — differentiate amongst rivals? (This is particularly salient for the wine industry, given that the product in the bottle is essentially a commodity, albeit a 'luxury' commodity).
2. What, if any, are the impacts of various differentiation strategies on financial performance?

This paper is organized into five sections. Section 2 expands on the literature and sets the stage for the hypotheses tested in this study. Section 3 describes the research design and statistical methodology. Section 4 presents the analysis of data. We conclude with a discussion, inclusive of limitations of this investigation, future research directions, and implications

[1] In the 2005 Supreme Court's *Granholm v. Heald* decision, the Court held that the 21st Amendment "did not give states the authority to pass non-uniform laws in order to discriminate against out-of-state goods." For a typical U.S. winery, this meant that individual state regulations now dictated the fees and taxes, as well as how much, how often, or if any of its products could be shipped directly to a consumer of that state, thus bypassing the three-tier system. In the aftermath of the *Granholm v. Heald* ruling, opportunities in the direct-to-consumer (DTC) channel began to expand (due to the ruling from), as the number of states that accepted DTC shipments continued to increase to 40 states in 2012, an increase of nine states over 2011.