COMPETITIVENESS OF GEORGIAN AGRICULTURE: INVESTMENT CASE STUDIES

GEORGIAN WINE AND SPIRITS

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ABSTRACT

This case analyses a foreign-owned enterprise with a long history in Georgia, JSC Georgian Wine and Spirits (GWS). Initially established as a state-owned enterprise in the Soviet era, it has since become a domestic private venture, then part of a global luxury goods conglomerate and now part of a mid-sized Paris-based private beverage group. GWS' performance and its attraction for foreign investors and partners have been closely tied to external factors, such as Georgia's investment climate and ability to access export markets, which are beyond the company's control. These external factors have had a very significant effect on the short term profitability of the company and its ability to implement internal productivity improvements. GWS has a significant impact on small and mid-scale growers in the Alazani and Iori Valleys of Kakheti, as it is one of the largest buyers of grape in the country. Having received significant investment in skills and technology as a result of acquisition by Pernod Ricard in 1997-98, the company is also a source of managerial staff and knowhow for many competing ventures. Under French management since 2013, GWS is currently implementing ambitious technological innovations in its vineyard operations, but it may take a number of years from implementation to observing measurable increases in productivity.

ACRONYMS

USAID	United States Agency for International Development
WEF	World Economic Forum
GWS	JSC Georgian Wine and Spirits
CIS	Commonwealth of Independent States
ERP	Enterprise Resource Planning

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I. EXECUTIVE SUMMARY

Georgian Wine and Spirits (GWS) is a French-owned beverage company based in Telavi town, Kakheti region, engaged in viticulture and winemaking. Acquired in 2011 from French beverage giant Pernod Ricard by Marussia Beverages, the enterprise has recently been aggressively investing in management reform, administrative reform, technical innovation in vineyards, expansion of areas under vine, and quality management.

This study examines the existing shortcomings in the business enabling environment and how GWS has been dealing with them. A key shortcoming identified is managerial training and productivity, which the company is addressing by investing in staff training and the implementation of an Enterprise Resource Planning (ERP) system to monitor productivity parameters both physically and financially. Importantly for Georgia, many of the company's technical innovations are imitated by suppliers and competing ventures.

Unlike some other large agribusinesses, GWS has been able to maintain constructive dialog with the local community and government. This seems to be a matter of the age of the business—the company has been operating in different guises since 1970s—and having an "inclusive" business model that integrates considerably with the local economy. GWS employing many locals, retains the services of local contractors, and outsourced grape production to smallholders. In particular, the enterprise purchases 70% of its grape requirement from small and medium-scale producers in the Alazani and Iori valleys of Kakheti, both of which are low-income regions. All told, GWS disburses almost GEL 8 million a year to the local economy in the form of wages, payments for grape and fees paid to local contractors, helping maintain a healthy symbiotic relationship.

The GWS experience carries many lessons to be learned for private investors, the first of which concerns the benefits of acquiring an existing enterprise instead of undertaking a greenfield development. In Georgia, the risks of a greenfield investment include the potential of a falling out with the local community before cooperative relationships can be developed. When considering this risk, and applying an appropriate discount to the Net Present Value of a greenfield investment, in many cases the acquisition of an existing enterprise may represent better value.

Second, continued improvements in Georgia's access to export markets, as experienced by GWS, and the legislative requirements of Georgia's Deep and Comprehensive Free Trade Agreement (DFTA) with the European Union, will provide an impetus for the Georgian food and beverage processing companies to expand their supply chains to keep up with demand. It will also require processors to implement internationally accepted food safety and quality assurance standards. To remain competitive, Georgian companies should:

- Seek opportunities to integrate vertically by investing in their own land and/or developing long-term contractual relationships with commercial farms, farmer organizations and smallholders. Sourcing arrangements will eventually need to include rigorous safety and traceability protocols as part of their contracts.
- Make better use of existing land assets by putting fallow land into production, investing in modern production and post-harvest handling technologies, and providing extension services to farmers and farmer organizations that form parts of their supply chains
- Implement other measures to improve productivity (and competitiveness), including modern IT solutions to monitor operational and financial performance and investing in foreign management when skills deficits are obvious and cannot be addressed by local hiring.

To enable Georgian companies to maintain their competitive edge and take advantage of new export opportunities, the Georgian government is advised to:

- Repeal the ban on foreign investment in agricultural land and put in place a comprehensive set of land market regulations taking into account the needs and interests of both foreign investors and smallholder communities;
- Maintain the current “cheap loans” policy framework, possibly with the help of EU and other donors, to facilitate the implementation of (expensive) food safety and quality standards, and investment in productivity-enhancing cultivation and post-harvest treatment technologies;
- Exercise great care in the implementation of the EU-compliant regulatory framework concerning food safety and quality standards. The main concerns should be i) to provide Georgian businesses with sufficient time, knowhow and resources to make necessary adjustments, and ii) make sure that the new standards uniformly and simultaneously apply to all businesses in the each sector (to incentivize compliance and ensure fairness);
- Carefully evaluate the unintended consequences of interventions in particular value chains (e.g. provision of price support in the grape market) and consider repealing interventions that do more harm than good;
- Co-operate with technically advanced processing enterprises that are willing to integrate smallholder farmers and farmer groups into their supply chains and invest to lift yields and enhance product quality.

II. APPENDICES

A. BACKGROUND

B. METHODOLOGY

C. FINDINGS

D. RECOMMENDATIONS

E. ADDITIONAL INFORMATION

A. BACKGROUND

JSC Georgian Wine and Spirits (GWS) was established in the 1970s as a state-owned enterprise in Telavi, Kakheti Region, when Georgia had substantial quotas to fill for wine and brandy for the rest of the Soviet Union. At that time, the enterprise's major output was bulk table wine, and until the 1980s GWS was the largest and most modern winery in Georgia. Over the course of that decade, however, the enterprise's operations deteriorated as a result of the USSR's public anti-alcohol campaigns.

In 1993, having been dormant for a couple of years after the dissolution of the Soviet Union, GWS was privatized with a substantial wine storage capacity of 25 million liters. The enterprise also owned over 400 Ha of land, some two-thirds of which had been cultivated as vineyards. The supply of the grapes that make up their primary raw material was partly satisfied through internal production, but GWS acquired the majority of its raw materials by buying grapes from outside contractors at vintage.

Through that 1993 investment, entrepreneur Levan Gachechiladze became the first substantial private wine entrepreneur in post-Soviet Georgia. He reactivated the winery, engaged Dutch technicians to improve quality, and began exporting bulk wine to the Netherlands for bottling and re-export to Georgia. At that time there were no modern bottling plants in the country, and this very expensive option still proved somewhat profitable. It also began to reestablish Georgia's damaged reputation for wine of consistent quality. At that time, most wine of quality was made in people's homes and not bottled, and bottled wine had a reputation both for poor quality, frequent counterfeiting, and use of poor quality raw materials—including inputs other than grape. GWS was able to establish to Georgian consumers and foreign buyers that bottled wine of consistent quality could be produced in Georgia, even if bottling took place abroad.

French beverage group Pernod Ricard bought a majority stake of GWS in 1997-1998. They had the specific aim of re-launching Georgian wine to the Russian market, where it had been only sporadically available since 1991. Georgian wine had been favored by Russian consumers since the early 19th century, and with Moldovan and Ukrainian the only other wines consumers could find during the Soviet era, Pernod Ricard believed that the prestige of Georgian brands could be restored. Pernod Ricard also established an office in Moscow and purchased the famous Armenian brandy maker, *Ararat*, as part of a Caucasian regional portfolio of brands to grow in the Russian market. Pernod Ricard were successful in capturing market share for GWS products in Russia, and during their ownership of the company they invested an estimated EUR 25 million to improve product quality and boost output. GWS has a large stable of brands aimed at the lower-to-middle market, including the budget Old Tbilisi wine brand and the middle-market Tamada brand. The firm is no longer producing brandy.

From 1998 onwards, a number of other private wine producers emerged in the Georgian market, mostly under domestic ownership. These included Teliani Valley, Tbilvino, and Marani, as well as foreign-invested firms like Château Mukhrani. In all cases, senior management personnel had worked previously at GWS. Without the presence of GWS in the marketplace, and its role in developing native winemaking and managerial talent, these other enterprises may never have accumulated experienced management teams at relatively low cost to drive their development.

In 2006, political tension between the Russian and Georgian governments spilled over into the trade sector, with Georgian wine excluded from the Russian market based on alleged breaches of food safety requirements. The sudden loss of the Russian market hit GWS very hard, with an 80% reduction in sales from 2005 highs between 2006 and 2011.

In 2011, Pernod Ricard sold GWS, having lost interest in Georgian wine production if the Russian market was closed to them. The buyer was Marussia Beverages, part of a group of companies owned by Swedish pharmaceuticals billionaire Frederic Paulsen. Marussia Beverages was not unfamiliar with Georgia and the regional market, having previously established a successful brand of vodka produced in a Siberian distillery and taken a controlling interest in Château Mukhrani.

Prior to the Russian market reopening, GWS was selling around 1 million bottles per year, almost all of which was exported to other CIS countries. Since the Russian market re-opened in 2012, GWS has rapidly increased sales to 6 million bottles a year, of which 5.7 million bottles are exported (including 2.2 million sold into the Russian Federation). Efforts to capture market share in the EU and China commenced soon after Marussia's acquisition of the business, and while the CIS market is very much the legacy market for GWS's brands, the firm recognizes the need to diversify its markets to reduce market risks, and to capitalize on fast-growing wine markets like China, which analysts suggest will exceed Russia in wine consumption by 2016.

Until 2013, much of the day-to-day management of the enterprise was under Georgian management. A general observation was that while winemaking was quite well managed, management of vineyards was of a lower standard than seen in Europe, USA or Australasia. In 2013 a French winemaker and vigneron, Philippe Lespy, was hired as Production Manager and given responsibility for winemaking, vineyard operations (including renovation) and new vineyard development. Mr Lespy, a native of Champagne district, had worked for many years in southern France's Bordeaux region, which has a not dissimilar climate to the Alazani Valley, and ran wineries in Morocco for Rothschilds. Both of Marussia Beverages' winemaking operations in Georgia are run by Europeans with developing country management experience (in China for Château Mukhrani's technical manager, and in Morocco for GWS's technical manager).

GWS is a 100% foreign-invested company and holds freehold title to all its winery and vineyard assets. Its vineyards were acquired with the winery before the moratorium on foreign purchase of farmland was introduced in 2013. Of GWS' 250 Ha of vineyard land, 140 Ha has yet to be planted to vine.

B. METHODOLOGY

This case study is based on a series of interviews with the foreign managers of the enterprise (Director Jacques Fleury and Production Manager Philippe Lespy) who shared confidential information about their business and investments, including data on predicted sales. This supplements the extensive on-the-ground experience gained by one of the authors, who has been consulting for GWS since 2010 in a technical capacity. After initial interviews with company leaders we identified challenges, successes, lessons learned and themes that could support broader conclusions about the investment environment.

C. FINDINGS

THE BUSINESS ENABLING ENVIRONMENT

Since 2003, Georgia has been steadily climbing many international rankings that are supposed to reflect the quality of local business environment. The most dramatic of these was ranking 8th of 189 countries in the IFC/World Bank's Doing Business survey, but Georgia has also done well in World Economic Forum's Global Competitiveness Index and Transparency International's Corruption Perceptions Index. Despite these very important advances, all surveys point out to a number of major bottlenecks for further investment and economic growth.

For example, according to the Georgian Executive Opinion Survey conducted by The World Economic Forum (WEF) in 2012/13, the three most problematic factors for doing business in Georgia are **access to finance** (19% of responses), **inadequately educated workforce** (14.2%), and **poor work ethic in national labor force** (12.2%). Of almost 100 competitiveness indicators analyzed by the WEF, Georgia ranks lowest on *local supplier quantity* (136 out 148!) and *quality* (129). The country is lagging far behind on other key indicators as well: *financing through local equity market* (126), *property rights* (120), *foreign market size* (114), and *domestic market size* (102).

GWS has been financed by a mixture of equity and debt sourced at low cost in the EU, but recent Georgian government programs to finance the purchase of vineyards have substantially reduced the cost of local finance for this activity. Management have assessed their full-time labor to possess an adequate work ethic, but inadequate education of both local management and labor is considered to be a major shortcoming that the company is actively addressing. The re-opening of the Russian market for Georgian wine has alleviated concerns about the size of the export market, and the firm has been allocating resources towards capturing market share in the world's fastest growing wine market, China. The size of the domestic market is of only moderate concern as the company exports almost all of its products. Local suppliers are lacking in many key areas, compelling the company to import many inputs, and post-sales service from local input vendors varies from very good to entirely absent.

ACCESS TO FINANCE

As part of a substantial European business group, including pharmaceutical and healthcare companies, GWS are able to arrange debt financing in Euro through EU banks at low interest rates. That being said, mortgaging their vineyards to foreign investment banks, or pledging shares against a loan, or participating in some kind of convertible share arrangement with an investment bank, cannot currently be accomplished due to the ban on foreign-invested entities acquiring shares in farmland-owning companies. While not an immediate concern, it does reduce the flexibility of financing and investment for the firm; if they were not as solidly backed by such a substantial and liquid investor it may be a serious concern.

The new program of the Georgian government providing interest rate subsidies for vineyard purchase has reduced this substantial annual expense significantly, while having such liabilities in GEL reduces some element of exchange rate risk.

LABOR QUALITY

The production manager has described the local labor force as not being particularly industrious, and lacking in many key skills required as standard for an international standard vineyard worker, for example pruning or training vines.[1] Vineyard staff have little knowledge of preventive maintenance for farm machinery and are slowly improving their skills in machinery operations. Management has been investing considerable time and effort in training vineyard staff to higher levels and competence and productivity over the past year, and the quality of pruning has visibly improved over this period.

MARKET SUPPORT SYSTEMS AND SERVICE PROVIDERS

GWS, like many other wineries in Georgia, is a member of the Georgian Wine Association, which aims to promote Georgian wine to the world. Director of GWS Jacques Fleury is a board member of the GWA. The Georgian State Department of Wine and Vine SAMTREST, the Ministry of Agriculture, and the Ministry of Economy provide some support periodically associated with trade fairs and export enhancement.

Many successful New World wine exporters like Chile, Australia and New Zealand have promoted national brand recognition abroad by enforcing mandatory membership of their wine associations or industry-owned corporations, and imposing a small export promotion levy on each bottle sold. These levies provide the financial resources for national branding campaigns that yield significant returns in generating sales and national brand loyalty. That is yet to be adopted in Georgia, and so organized industry-wide Georgian export promotion activities abroad are dwarfed by that of more established New World exporters or Old World exporters like France, Spain and Italy.

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[1] Vine training is the manipulation and management of vines to grow along specific paths or structures like canes, fences, spurs or, as in ancient techniques, through mature trees. In modern viticulture, vine training and pruning are central to managing the foliage canopy, air circulation, vine spacing and other aspects of vineyard management for optimum quality and yield.

GWS uses a number of local service providers. One of the lead consultants in this study has been engaged in precision viticulture services for GWS, especially soil testing, tissue testing and developing vine fertilization programs, as well as irrigation design. He received his training in Australia, USA and Spain. Local chemical suppliers have been of variable service quality, with Sungenta and Noblex (Bayer) assessed as being superior to their competitors. Local machinery vendors carry little in the way of modern vineyard machinery and the company must import directly from France or Italy and do its own servicing.

INFRASTRUCTURE

When questioned about infrastructure, GWS leaders identified the long time between picking a contractor's grapes and receipt at the winery as a key limitation in the production process. This period can often stretch to a day, and while there is little mass loss associated with it, a great deal of the positive quality of the grape is lost as a result of this delay. Some reasons for this delay are the shortage of labor in the Georgian countryside, unwillingness of labor to work at night or in early morning, and a shortage of trucks for cartage. More importantly, the poor condition of many village roads causes the trip from vineyard to winery to be much slower, and for more damage to the vehicle to be done, causing an increase in cartage rates.

Gas and water supply to the winery are satisfactory, and the irrigation systems supplying the vineyards are being upgraded over time.

PROPERTY RIGHTS

The enterprise has not encountered any problems with securing access and use of its properties. Relations with neighboring communities are regarded as being sound, and full-time security staff for the vineyards is staffed from the adjacent villages. Given the strong, two-decade long economic connection between GWS and neighboring villagers (almost all of whom own small vineyard plots and supplement their household incomes with grape sales at vintage), community attitudes to the enterprise range from neutral to approving in general, which may in part explain the lack of conflict over property rights. As the enterprise did not privatize vineyard or territory being used informally by other smallholders, the tensions associated with other large, new enterprises engaged in greenfield developments have not been encountered.

Prior to the land ban being enacted, the company had purchased small plots of land in Ojaleshi for semi-sweet red wine production and in Racha for production of the famous Kvanchkara semi-sweet red wine. The ban on foreign-invested enterprises acquiring agricultural land has had the effect of preventing geographical expansion of the firm's estates, which creates a sense of urgency for the development of its existing fallow estates and intensification of its current vineyards in order to reduce reliance on outsourced production.

An additional effect has been the inability of the company to sell any shares to new foreign investors. As a landowning enterprise, GWS cannot take on new foreign shareholders without running afoul of the foreign land ownership ban. While the company has no immediate plans to exit the market, the flexibility to be able to sell shares to outsiders as needed, either to access finance, improve cash flow or to create new strategic marketing alliances, has been removed from the table by the government's initiative. The overall effect is a higher cost of capital and capital, which has an inevitable drag effect on the business.

This dampening effect will ultimately present a drag to the competitiveness of the entire sector. Mr. Fleury believes that some consolidation of the Georgian wine industry is inevitable, as it is a common trend in most wine markets. Through natural mergers and acquisitions, the current dozen or so mid-sized wineries could realistically be condensed into two or three larger wine business groups, with stables of brands and substantial vineyard assets. This would enable economies of scale and enhanced export competitiveness. But an essential ingredient of this natural process is foreign capital, which is often provided by European or American investment banks in the form of debt, equity or hybrid instruments. The current ban of foreign ownership of agricultural land (or foreign mortgages on agricultural land) impedes entrepreneurs from expanding their businesses through mergers and acquisitions.

THE EFFECTS OF THE INVESTMENT IN GEORGIA

LOCAL EMPLOYMENT AND WORKFORCE DEVELOPMENT

One major benefit of many foreign investments is knowledge transfer, a key aspect of which can be employee training and workforce development. This often includes technical and operational training as well as knowledge upgrades in management, health and safety. GWS employs 117 full-time employees, most from the Telavi district. Another 200 workers are engaged on a seasonal basis in the vineyards in May and June, and the bottling line employs seasonal labor as needed.

There has been an obvious change at GWS since day-to-day operations came under the control of a foreign manager. Relationship-oriented management has moved towards task-oriented management, with senior management spending a great deal of time in the vineyards, frequently perusing the winery production lines, and coaching employees at various levels how to do their jobs more efficiently and to a higher technical standard.

Employee training at this stage is strictly on-the-job, although GWS has hinted that more formal and preparatory training may be introduced. For instance, as an ISO certified producer, GWS will inevitably need to provide all permanent labor with some instruction on record keeping and quality assurance procedures.

GWS has secured HACCP and ISO9001 certifications, both of which are challenging, internationally recognized quality assurance schemes. In order to maintain these standards, management personnel must remain acquainted with innovations in quality assurance operations and administration, and food safety risk management, and be trained to a high level of proficiency. A benefit of these certifications is that importers from non-traditional markets for Georgian wine, like the EU, Japan and China, are confident to import GWS products, knowing that formal systems are in place to guarantee consistency and safety. Sales growth in these markets is encouraging. This provides a useful alternative market should the volatile Russian market be closed to Georgian product again.

Mr. Lespy assesses middle management at GWS as being quite well educated, but they lack some skills and training that would be considered standard by international winery managers. GWS has introduced a number of staff development innovations, including enrolling the group CEO in an MBA program in France, sending middle management to ISO9001 certification workshops, sending staff to Italy for training in vineyards, sending assistant managers to Germany for training in a modern winery, creating a technical library for staff, and bringing in IT trainers to train staff in IT and administrative skills. Mr. Lespy admits it is too early to notice a difference in productivity as a result, but he is confident that these investments will result in improvements.

As the company invests in training its staff and introducing sweeping managerial reforms to increase productivity, it also resolved to implement a proper ERP system. Recognizing that they must have accurate measures of processes to properly manage them, the company has invested considerably in a European ERP system, Exact, and training management personnel in its use. The system provides for all standard ERP functions, including proper profit center cost control, partial budgeting, resource allocation, inventory management. Few wineries in Georgia operate with anything more sophisticated than a spreadsheet. The advanced reporting capacities of an ERP system will allow GWS to identify constraints to productivity enhancements, measure productivity parameters in a standardized way, and measure productivity trends in response to investments and process improvements.

As GWS change in management orientation and investments in modern managements systems are less than a year old, the benefits of these changes are only beginning to become apparent. Leaders have already noticed improvements in subjective parameters like the quality of pruning and the effectiveness of weed control in the vineyards. With continuous improvement programs backed by staff training, and performance monitoring enabled by an ERP system, the next two harvests should reveal objective data on the return on investment from these improvements.

GWS has also had a positive incubator effect for new wine producers. Most of the senior managers of rival companies are former employees of GWS, from its days under Pernod Ricard. Some, like former Chief Winemaker Lado Uzunashvili, went on to establish their own wineries. The grandson of the last Czar's personal winemaker, Lado studied oenology in Moscow. In the face of the economic collapse in Georgia post-1991, he emigrated to Australia and worked as a winemaker with experienced Australian winemaking mentors for more than ten years. He returned to Georgia in 2003 to consult for Pernod Ricard, and in 2004 was the winemaker for GWS under Pernod Ricard's ownership. In January 2007 he took up the post of Chief Winemaker with Château Mukhrani as it was being established, and then he returned to GWS as Chief Winemaker when it was purchased by Marussia Beverages. In late 2013 Lado resigned from Marussia Beverages and established his own boutique winery in the Alazani's premier appellation, Mukuzani, called "Mukado Wines".

As an emerging winemaker in his own right, Mr. Uzunashvili cites his experience with GWS under both Pernod Ricard and Marussia Beverages ownership as a key factor in his success. His experience demonstrates the role that GWS has played as an incubator of native winemaking talent, exposing Georgian managers to foreign distribution networks, and seeding a range of enterprises with qualified and experienced managers or entrepreneurs.

EFFECTS UPON LOCAL SERVICE PROVIDERS AND SUPPLIERS

GWS uses a network of local suppliers and service providers in the day-to-day management of its business. It spent more than GEL1 million in Telavi last year for outside tradesmen, including electricians, drillers, and construction companies for new facilities. It also purchases new vines and chemicals from Georgian vendors, particularly Noblex and Syngenta. The company also uses the services of some local consultants. The agribusiness company YFN Georgia provides soil and plant tissue testing and precision viticulture consultancy services, including detailed fertilizer recipes and application schedules. In the past, Multitest also provided some soil testing services. New vineyards GWS plans to developed on 250 ha will likely investment of more than GEL 8 million, most of which will be paid to local suppliers, contractors and laborers.

Many smallholder farmers rely on the sale of grapes for a substantial proportion of their annual cash income.[2] GWS purchases 70% of its grape from outside growers, which in 2013 represented payments of GEL 5 million to small and medium sized farmers in the Alazani and Iori Valleys for 5,600 tons of grape. Depending on yield, quality and variety, GWS's annual purchases from smallholders range from GEL2,500-GEL16,000 per hectare. In addition to sourcing from traditional appellations like Napareuli, Mukuzani, Kindzmarauli and Tsinandali, GWS purchases grape from further south around Sagarejo and Manavi, in the Iori Valley region. GWS expects its grape purchases for the 2014 vintage to exceed 6,000 tons, depending on availability and price, making GWS one of the largest buyers of grape in the country.

GOVERNMENT REVENUE, EXPORTS OF GOODS AND IMPORT REPLACEMENT

Senior management did not wish to disclose exact figures, but land tax remittances on 350 ha of land are substantial, as are the 1% property tax paid on their winery facilities. Annual salaries are around GEL1.8 million net per year, so GWS employees generate Income Tax remittances of GEL 225,000 annually. All profits are reinvested, so there is no dividends tax liability. Corporate Income Tax is not currently paid as the company has tax losses carried forward from 2006-2012. Excise paid on

[2] Unemployment in Kakheti is around 60%, according to CRRC's Caucasus Barometer survey (2013).

domestic sales would make a modest contribution to the state treasury. Last year's turnover was over GEL35 million.

Exports are on track to exceed last year's figures of six million bottles, which is substantial and one of the largest wine export figures from Georgia since 2006. There is no appreciable effect on import substitutions, as Georgia is not a significant importer of foreign wine.

PRODUCT AND PROCESS INNOVATION

The climate in the Alazani Valley is somewhat forgiving of poor viticulture skills, as the region has a long growing season and plenty of bright sunny days to facilitate ripening and maturation of grapes. And it's a good thing. Local growers practice a low-input, low-output model of viticulture. In most cases vineyards were gifted to them by the state or by parents, so they carry no mortgage. No soil or petiole testing of vines is done to refine fertilizer application programs. Most apply no fertilizer, but those who do usually only apply ammonium nitrate and neglect to address the magnesium, phosphate and other nutrient deficiencies common in the district. Some growers neglect to prune vines at all, others tend to prune poorly. Weeding is absent or sporadic and ineffective. Vintage takes place over four weeks from Sept 10 onwards. Very few local growers practice irrigation, and few use fungicide or insecticide appropriately. Yields are commonly 3-8 tons per hectare, with profit margins to an extent depending on whether price setting by the state is occurring or not. Vine density per hectare is much lower than seen in Europe. Hail is a perennial problem in this valley, which can cause complete losses for 1-2 years and even longer in severe cases.

Since GWS appointed a new production director, there has been substantial management reform and innovation in its vineyards. Its inability to expand estates in the face of the ban on foreign investment in vineyard has driven management to focus on improved productivity on existing vineyards and to plant fallow land to vine. Robust demand from the export market has resulted in the firm buying more contract grape of variable quality, while state intervention in grape prices makes this an expensive exercise. To protect against supply and price risk and enhance quality parameters, the firm now has a clear goal of making the most of its own vineyard assets.

Having worked in hot climates in southern France and Morocco, Mr. Lespy is acutely aware of the benefits to both yield and quality that modern irrigation can provide. He is also aware of how small lapses in maintenance and vineyard management practices can add up. With changes in its approach, GWS has refocused on a lot of these basic but critical practices, including:

- Basic repairs and restructuring of existing drip networks as a matter of urgency, and they will implement a complete overhaul of the system over the next three years.
- Upgraded both mechanical and chemical means to control weeds
- Replaced hundreds of crooked or broken posts
- Purchased new machinery
- Introduced targeted fertilizer programs and integrated pest management. Pesticides are now applied only as needed instead of according to a Soviet-era prescription.

GWS is also making plans to make significant changes to its practices and vineyards to bring them more in line with leading international practices. This includes the introduction of foliar fertilization, a practice rarely employed in Georgia due to cost but common in USA and Australia. It also includes plans for a dramatic and costly reform to increase vine density in existing vineyards.[3] Increasing planting density by 33% will reduce yield per vine, but the quality of production and per-hectare yield will improve. New vineyards will likewise be planted at the higher density. Target yields are between 8-15 ton per hectare depending on variety and quality parameters desired.

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[3] GWS will likely uproot every second row and replant two rows in the newly emptied space.

Mr. Lespy has noted a small number of his grape suppliers also upgrading their infrastructure and improving their techniques in imitation of what is done at GWS, even if their rate of progress is slow. He is hopeful that they will continue with this process and better yields and quality will result throughout the district. GWS has no formal extension program for its contract suppliers, as it has been orienting most of its efforts towards reform of its own estates and has not had the management resources (or indeed the skilled trainers) to provide technical support to its suppliers.

GWS could in fact act as a major center of technology extension to its own suppliers and other smallholders seeking to upgrade their skills in viticulture. Mr. Lespy was frank in expressing that he has only just begun the long process of modernizing the vineyard infrastructure and transforming how the vineyards are managed. He modestly suggests that his vineyards are not yet of a high enough technical and managerial standard to act as a showcase for less sophisticated producers. Still, pruning, irrigation and weed control are still superior in GWS vineyards compared to prevailing practices. It’s likely that several of GWS’s vineyards will be performing at close to international norms of productivity within 2-3 years, with substantial quality enhancements. At that stage extension activities are likely to be of benefit to GWS in building more stable and robust relationships with its contract growers and improving its standing in the community.

COMMUNITY RELATIONS AND THE ROLE OF GOVERNMENT

Management assess community relations as being sound. The winery is a substantial employer in Telavi, with 117 local employees, and each vineyard is staffed by villagers and secured at night by local security guards. Security systems are being upgraded to include electronic systems, but as a rule security does not present a problem. Relations between villagers and the company have been stable for the past decade regardless of who owned the winery. As a major buyer of grape (GEL5 million a year), the company is the main source of a substantial proportion of annual revenue for many families in a district where property sizes tend to be quite small (0.5-2 Ha) and where many vineyard-owning families are assessed as vulnerable.

The lead consultant’s own experience in the Alazani Valley since 2010 has revealed that GWS is seen by most residents of Telavi and the Alazani Valley as a respected and worthwhile enterprise, providing many jobs to the local community and buying substantial amounts of commodity every year.

Mr. Fleury also assesses the relationship between the company and government at all levels as being sound, with some national government intervention in grape pricing being compensated for by credits for wineries to buy grapes. He believes that the current government has a better understanding of the wine industry than the previous government did, and that current policies are less destructive. The previous government price-setting in the grape market was not compensated by any concessions to the winemakers.

Last year’s intervention by the state in the grape market had an unintended consequence. By enforcing price controls on grapes produced by smallholders, but not applying these controls to grapes produced by companies, a two-tiered grape market developed, with smallholders enjoying a higher price per ton than corporate vineyards. This was counter-intuitive, given that corporate vineyards generally supplied grapes of better quality, with better documentation of chemical treatment, more prompt delivery and more consistency. The author is familiar with one owner of a large vineyard in the Iori Valley, a former GWS supplier, so disgruntled with this state of affairs that he raised money abroad to establish his own winery, perceiving that state intervention in prices will always work against him while he remains only a large-scale grower instead of a vertically integrated operator. The party in question saw price controls as a populist Kakheti-specific welfare measure rather than as a serious industry development initiative. GWS lost this grower as a supplier as a result.

OVERALL CONCLUSIONS AND LESSONS LEARNED

Georgian Wine and Spirits is a very different company to its sister enterprise Château Mukhrani, both of which are subsidiaries of Marussia Beverages. Its products are targeted at the low to middle end of the CIS market, it relies upon small and medium-scale growers for 70% of its supply chain, and it is a large scale manufacturer rather than a boutique wine tourism destination.

The current owner of GWS purchased the enterprise at a very heavily discounted valuation from a multinational conglomerate, at a time when regaining access to the Russian market seemed like a remote possibility. With patience and investment in staff, productivity and efficiency of administration is measurably improving, and the fortuitous re-opening of the Russian market has dramatically increased sales volume and price per hectalitre.

It is often assumed by local wineries that only Georgian-owned and -operated wineries, with vineyards managed by Georgians, can capture the essence of Georgian wine. Marussia Beverages has demonstrated that foreign-owned firms with only a few years of wine industry experience, are capable of acquiring and restructuring operations into competitive and profitable enterprises. For GWS, the right formula seems to be a combination of foreign managerial personnel with emerging markets expertise, strong technical capacity, and competent local management with understanding of local and CIS markets.

Wine quality is utterly a hostage to the conditions in the vineyard, and vineyard management expertise is widely lacking in Georgia. If wineries wish to capture higher prices, they must make investments in modern vineyard infrastructure and spend considerable amounts each year on modern crop protection and fertilizer. By doing so they will likely reduce the cost of production per ton of grape well below what they pay their contract suppliers and maintain very tight control over quality and safety.

GWS is one of the few agricultural enterprises in Georgia to allocate funding for formal training activities for management. Its recent drive for improved training quality and quantity, as a means of enhancing productivity and food safety, appears promising but more data must be accumulated over the next two years to determine its effect objectively.

As an established business with longstanding supply chain linkages to smallholders, national and regional governments have a benign attitude toward the business, acknowledging its substantial tax revenues and positive impact on the economy of Kakheti. The stability of Pernod Ricard's relations with neighboring communities, through employment, contracting and grape purchase, meant that the transfer in ownership was comparatively trouble-free, as compared to many other enterprises bought through privatization or secondary market. This may provide a window into how foreign-invested ventures, now newly pioneered and encountering some hostility from local communities, will be viewed in five or ten years when they have fully developed and have much deeper ties economically with neighboring communities than they do now.

D. RECOMMENDATIONS

RECOMMENDATIONS FOR GOVERNMENT

- **Repeal the ban on foreign investment in agricultural land.** While GWS is able to expand its landholdings through nominee arrangements, it would be preferable for the company to be able to buy new vineyards in its own name as a matter of security of tenure. Abolition of the restrictions on foreign ownership of land might encourage other international players, such as Toro or Constellation Brands, to enter the market, which would lift the price of vineyards, grape and labor in rural areas of Kakheti through greater competition. To avoid confrontations between investors and the local communities, the government should develop a comprehensive set of regulations making sure that smallholders are duly informed of land repurposing and privatization plans, and that they are offered compensation or alternative grazing lands.

- **Carefully evaluate the unintended consequences of intervention in the grape market and consider repealing interventions.** Intervention in the minimum price of grapes presents a number of risks, not least of which is the permanent expectation that such “temporary” measures often create. It is encouraging that the government is abolishing price-fixing on red wine grapes in 2014, considering that market demand for such wines is strong enough to lift winery-gate grape prices to a level where growers are making a reasonable level of income.

  Offsetting the inflationary effect of price support measures with interest rate subsidies may have limited the adverse effects of price controls in the short run, but in the face of a market downturn (such as the Russian market closing again) there is a real risk that political pressure would result in the preservation of a floor price well above what the market is willing to buy. This would have a catastrophic effect on government finances if state firms were required to purchase the resulting excess. It would also put grape from contract growers beyond the means of commercial wineries operating in more challenging conditions. Floor prices remove the prompt and objective price signals required for efficient operation of the marketplace.

- **Co-operate with technically advanced viticultural enterprises to lift smallholder yields and enhance quality.** Enterprises with technically advanced vineyard management like GWS are a rarity in Georgia, and the Ministry of Agriculture should recognize and use such enterprises as a resource for extension. Bearing in mind that enterprises are stretched for resources in the vineyard, some financial support or concession for providing extension services should be considered by government. In the short term, co-operation with international donors may accelerate the development of such programs, to the ultimate benefit of wineries and contract suppliers alike.

RECOMMENDATIONS FOR INVESTORS

- **Carefully consider the premium payed to acquire a going concern over a greenfield investment**. When comparing it to a greenfield investment in Georgian, it is hard to overstate the value of an existing agribusiness enterprise that has satisfactory relations and economic ties to the community and undisputed title over land resources. Such opportunities are rare, and they may well demand a substantial premium over greenfield investment. However, an established business can relieve a huge amount of management time and anxiety that would otherwise be spent battling with angry neighbors or re-litigating access to one’s own land. Obviously investors should carefully analyze their options based on the best available information, but they should do so with a complete understanding of the risks inherent in the Georgian context.

- **Recognize the value of investment in community and robust linkages to the local economy.** If pioneering a greenfield enterprise, it may be worth looking at aspects of GWS’ business model to see how a stable large-scale agro-business can operate smoothly while surrounded by thousands of small scale landowners. A mixture of local employment, local contracting, sourcing of commodity from small and medium-scale producers, and training of local staff to a high standard in time will yield dividends in terms of sound relations with neighboring communities and government. Of course to reach this level of commercial and social interaction with a village community can take many years, and so a clearly defined plan of engagement with local villagers and their elected representatives is required before ground is broken on a new enterprise, to avoid misunderstandings or conflicts that can put the business in jeopardy.

- **Consider investing in internationally accepted food safety and quality assurance standards.** Investment in HACCP and ISO9001 accreditation has a long payback time, but allows access to non-traditional markets such as the EU and China, which provides a useful hedge in case the Russian market closes again.

- **Plan for formal performance monitoring, both physical and financial, and use modern IT technology to facilitate it.** Investment in ERP systems involves a substantial capital outlay and significant staff training resources, but these investments enable the modern management practices enterprises must adopt to compete. These will enable ready traceability of every carton and can prove a valuable tool in measuring and controlling productivity, quality and food safety. A significant competitive advantage in terms of controlling cost of production and satisfying customers' expectations of quality and safety can be gained over less sophisticated competitors by implementing such systems.
- **Use foreign management when skills deficits are obvious and cannot be addressed by local hiring.** While placing an experienced expatriate manager in a Georgian enterprise presents an enormous cost compared to local staffing, there is little doubt that the investment is worth it when expertise is simply not available in the local labor market. These hires should be done strategically and ideally with an eye toward building capacity in the next generation of Georgian managers. If the foreign manager has capabilities in training, team building, administration and technical competence, then passing on their skills to subordinates will yield substantial long-term returns on investment.
- **When acquiring winery assets, allocate finances and managerial expertise to vineyard development and operations.** Proper plant protection, pruning and fertilization can substantially increase yields and quality within one season, and irrigation systems can pay for themselves in two seasons. Companies need management teams in place who can successfully implement international standard viticulture programs, and allocate the finances necessary to execute such capital development and cover recurrent expenses. Given intermittent government involvement in the grape market, and the highly variable quality of grape available from contractors, it is important that wineries have a solid production base of their own to reduce price and supply risk, and to enable them to reliably meet quality targets for their middle-market and fine wine brands.

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