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INDUSTRY PROFILE

Industry, Science and Technology Canada
Industrie, Sciences et Technologie Canada

Distilling

Canada

I N D U S T R Y

P R O F I L E

D I S T I L L I N G

1988

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FOREWORD

In a rapidly changing global trade environment, the international competitiveness of Canadian industry is the key to survival and growth. This Industry Profile is one of a series of papers which assess, in a summary form, the current competitiveness of Canada's industrial sectors, taking into account technological and other key factors, and changes anticipated under the Canada-U.S. Free Trade Agreement. Industry participants were consulted in the preparation of the papers.

The series is being published as steps are being taken to create the new Department of Industry, Science and Technology from the consolidation of the Department of Regional Industrial Expansion and the Ministry of State for Science and Technology. It is my intention that the series will be updated on a regular basis and continue to be a product of the new department. I sincerely hope that these profiles will be informative to those interested in Canadian industrial development and serve as a basis for discussion of industrial trends, prospects and strategic directions.

Robert R. de Cotret

Minister

Canada

1. Structure and Performance

Structure

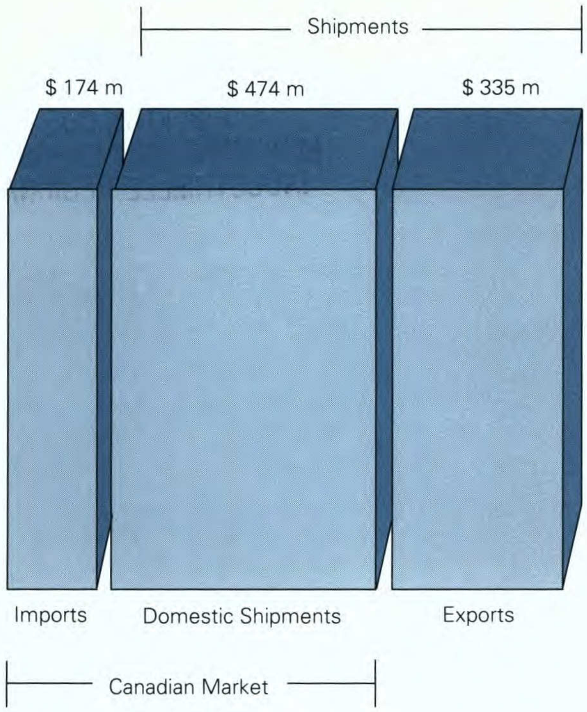
The Canadian distilling industry consists of establishments producing most types of distilled spirits, in particular Canadian whisky, rum, vodka, gin, liqueurs, brandy, spirit coolers and raw ethyl alcohol. Canadian whisky is the most important product as it accounts for more than 70 percent of the value of shipments and over 95 percent of exports. It is followed by rum and vodka, each accounting for approximately 10 percent of shipments. The products are categorized as either "dark goods" such as whisky which requires aging, or "white goods" such as vodka and gin which do not. The market is divided into premium-priced and lower-priced segments. Consumers of these products are very brand-loyal.

The main production inputs to the distilling industry are grain and packaging. In 1986, the industry shipped product worth $809 million from 31 establishments. Total employment stood at roughly 4400 people, of whom approximately 1000 were employed in marketing. Plants are located in all regions of Canada but are concentrated in Ontario and Quebec.

The industry has a strong export orientation. More than 40 percent, or $335 million of the total value of shipments, was exported in 1986. The major component was the $304 million in Canadian whisky exports to the United States, more than 60 percent of which are in bulk. Premium brands, however, are bottled in Canada prior to export. The industry exports much smaller volumes to Japan and the European Community (E.C.), as well as to some one hundred other countries. Imports in the same year were only $174 million and accounted for some 25 percent of the domestic market. Scotch whisky and liqueurs were the main imports, primarily from the E.C.

The distilling industry operates within a highly regulated environment. Both the federal and provincial governments have significant influence on its operations and profitability. The federal government controls aspects of plant layout, product standards, product labelling, and levels of excise duty, federal sales tax and the price of grain inputs. Provincial governments influence the price and availability of distilled spirits through provincial taxes, liquor control boards' price mark-ups, and control over retailing and distribution of distilled spirits. Both levels of government apply restrictions on advertising and promotion.

The four largest corporations in this industry account for roughly three-quarters of total shipments. The industry is dominated by two multinationals, Joseph E. Seagram & Sons and Hiram Walker-Allied Vintners. The parent firms of both companies have worldwide holdings in the distilling and winery sectors. They own or market many of the popular European brands of Scotch and Irish whisky, cognacs and liqueurs as well as Canadian whisky. Seagram is Canadian-owned, although the Canadian operations of the company account for only five percent of its worldwide sales. Hiram Walker-Allied Vintners is now owned by Allied Lyons PLC of the United Kingdom. A few smaller distilling companies are Canadian-owned.



Imports, Exports and Domestic Shipments 1986

Performance

The performance of the Canadian distilling industry is being influenced by changes in demand and declines in the consumption of spirits generally. This shrinkage of the market has contributed to excess capacity and reduced production. Production has declined more markedly than industry shipments due to the need to draw down excessive inventory levels of aged product. Nonetheless, the industry is mature and financially strong, although recent acquisitions, and the high costs of carrying large whisky inventories have reduced profits.

Demand for distilled spirits has been declining. Per capita consumption peaked in 1979 at 3.33 litres of absolute alcohol. It has since declined by 20 percent to 2.60 litres in 1986, a consumption equivalent to the low levels characteristic of the early 1970s. This decline has occurred partially because there is a perception that distilled spirits are stronger and more intoxicating than either beer or wine.

There has also been a shift in demand within the distilled spirits industry in North America. "Dark goods," such as whiskies, have lost market share to "white goods," such as vodka and light rum, because of the increasing consumer preference for lighter tasting beverages. Liqueurs and spirit coolers have also made market gains. This shift is further exacerbating the position of the Canadian industry, as Canadian whisky has been its mainstay.

Consumption of spirits generally, and of "dark goods" specifically, has also declined in the U.S. market, although at a slower rate than the drop in Canadian consumption. Canadian whisky nevertheless has maintained its U.S. market share, whereas bourbon, its major whisky competitor, has lost ground. The success of the Canadian product is partially due to the perception that it is "lighter" than either Scotch or bourbon. "Canadian" is now the largest selling category of whisky in the United States.

In spite of these trends, the premium-priced whisky market has held steady and some increased demand is being forecast for these goods in the future.

The industry's real output, however, has been declining, as has employment. As a result, some rationalization has been taking place — there were two fewer distilleries in 1986 than in 1982. Current production levels are a little over one-third of the peak 1980 level. Capacity-utilization rates are now less than 50 percent of distilling capacity and around 60 percent of bottling capacity.

The industry has taken the position that increases in the rates of taxation and subsequent price increases have contributed to consumer resistance and reduced consumption. In 1981, the federal excise duty was linked to the consumer price index, and it was adjusted frequently. The indexation ended in 1985, but further tax increases have taken place since then. Provincial taxes and mark-ups are applied on an ad valorem basis to the delivered cost of the product and thus magnify the impact of the increases in federal duties. Taxes, both federal and provincial, now account for some 85 percent of the retail price of spirits in Canada.

Distilled spirits bear a higher rate of tax on an alcohol-content basis than other alcoholic beverages. Wine attracts an average of $3.73 in excise tax per litre of absolute alcohol (LAB) as compared to excise duties of $3.86/LAB for beer and $10.73/LAB for spirits.

Over the past 10 years, capital spending for new equipment and machinery has remained relatively stable. However, investments in affiliates have increased dramatically with a rise in acquisition activity. Some companies have diversified into other sectors, although most of the acquisition activity is within the distilling sector.

2. Strengths and Weaknesses

Structural Factors

Canadian distillers have a solid, worldwide reputation for quality, particularly for Canadian whisky. The domestic distilling industry is large by world standards and includes one of the largest, most modern distilleries in the world. The industry is able to take full advantage of available economies of scale.

The "dark goods" segment of the industry, because of the length of time these goods must be held in inventory, is sensitive to interest costs. Regular whisky must age for at least three years; premium brands, for up to 12 years. As noted previously, this is the major product of the Canadian industry.

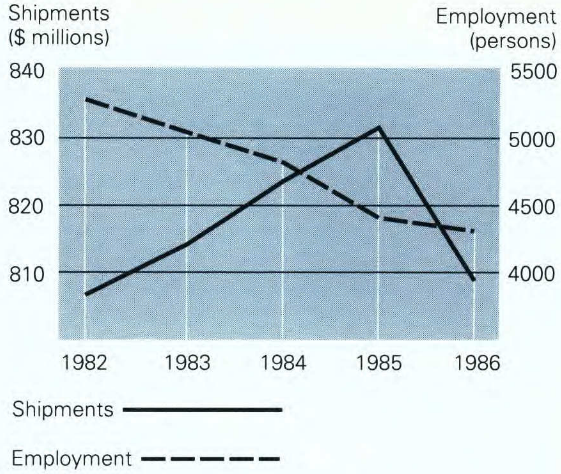
Grain inputs, primarily corn, account for five percent of the cost of production, while packaging materials represent more than 40 percent. The cost of the malt used in distilling is higher for Canadian distillers than for their U.S. counterparts. However, malt costs are an extremely small portion of total production costs.

The industry is limited in its ability to expand its domestic market because restrictions on advertising and promotion applied to distilled products are greater than the restrictions on those beverages against which distilled spirits compete. Brand recognition and consumer loyalty are very important to the distilling industry. Restrictions on advertising and promotion, therefore, make it difficult for the industry to introduce new products to increase market share and compete against other beverages. Furthermore, distribution and product availability are restricted, as distilled spirits for home consumption are sold only through provincial liquor control outlets.

Trade-related Factors

Tariffs are levied on distilled spirit imports worldwide. Canadian tariffs range from C$0.20 per proof gallon for whisky to C$1.00 per proof gallon for rum. Some spirits not produced in Canada, such as tequila, enter duty-free. U.S. tariffs range from US$0.24 per proof gallon for Scotch and Irish whiskies (C$0.29 based on an exchange rate of US$1=C$1.21) to US$3.40 (C$4.11) per proof gallon for some brandies. Excise duties on imports, equivalent to those applied to domestically produced products, also apply in both countries. Complex systems of tariffs are in effect in the E.C. and Japan, but they are not as significant as non-tariff barriers.

Non-tariff barriers have a significant influence on world trade in distilled spirits. An important element is whether a spirit is recognized as a distinctive product in the legislation of the importing country. Such recognition protects the product from being blended with any other, adds to its prestige and enhances marketing efforts. Canada, for example, recognizes Scotch and Irish whiskies, cognac and armagnac as distinctive products. Canadian distillers have been seeking this recognition for Canadian whisky in Europe, particularly within the E.C. Lack of such recognition in Europe has constrained Canadian marketing efforts. Canadian whisky is recognized in the United States, a fact that has contributed to its market acceptance there.



Total Shipments and Employment

In Canada, distillers can import bulk spirits only for blending with domestic spirits. Regulations preclude the domestic bottling of distinctive products such as Scotch whisky, Irish whisky, cognac, armagnac and tequila by the Canadian industry. These products may be imported and bottled without blending only by provincial liquor control authorities or their agents. Premium-brand products, however, continue to be imported in bottles.

In 1988, after a formal complaint by the E.C. on the pricing, distribution and retailing practices of provincial liquor control boards, a General Agreement on Tariffs and Trade (GATT) Panel found these practices were inconsistent with international trading rules. The Panel Report has been adopted by the GATT Council and Canada has agreed to report back to the Council by the end of 1988 on the measures it will take to comply.

Under the Canada-U.S. Free Trade Agreement (FTA), Canada will grant U.S. products national treatment for listing of distilled spirit products, eliminate all differential price mark-ups, except for those which cover a reasonable cost of service, and rescind any measure requiring distilled spirits imported in bulk from the United States for bottling to be blended with domestically produced distilled spirits. Canada will also grant bourbon distinctive product recognition for the purposes of standards and labelling. Tariffs on whisky and rum will be eliminated immediately; all other tariffs will be phased out in equal increments over a period of 10 years. Relevant excise duties will continue to be applied by both countries.

Technological Factors

The distilling industry in all countries uses traditional, mature technology. The Canadian distilling industry is as technologically sophisticated as its major competitors. Technology development is primarily carried out by production equipment suppliers, while the distillers themselves focus on product development.

New product development is increasingly important as the industry tries to stem declining consumption. Canadian distillers have recently introduced new products into the Canadian market, including light beverages such as fruit-flavoured schnapps, cream liqueurs and spirit coolers.

Other Factors

In so far as the industry depends on exports, it is sensitive to exchange-rate fluctuations. The favourable exchange rate between Canada and the United States has likely contributed to the positive performance of Canadian whisky against Scotch and Irish whiskies in the U.S. market.

3. Evolving Environment

Taxation levels and their impact on consumption will continue to be a concern to the industry. It considers domestic taxation levels to be the major contributing factor in the decline of consumption. The United States is considering modifications to its excise taxes which could result in retail price increases as high as 47 percent. Such price shocks could result in an accelerated decline in consumption, which in turn could reduce Canadian exports to that market.

Public attitudes toward intoxication, especially of drinking and driving, and health-related concerns over the consumption of alcohol, will continue to affect the industry and curtail demand for these products in the North American market.

In the face of declining consumption, the major firms will continue to consolidate or rationalize domestic operations to improve capacity-utilization rates and to seek increased market presence through acquisitions. The concentration and internationalization of the industry will thus increase.

Exports will remain crucial to maintain production levels. The United States will continue to be of prime importance for Canadian whisky because of the established brand loyalties of consumers there in both premium- and regular-priced brands. A key to expanding offshore markets, particularly in the E.C., will be to obtain distinctive product recognition for Canadian whisky. Such recognition would provide opportunities particularly for premium brands.

Provincial policies relating to the pricing, listing and distribution of spirits have not been major factors affecting competitiveness because of the international nature of the Canadian distilling industry. Therefore, any changes to those policies as a result of either the FTA or GATT are expected to have little impact.

The position of Canadian exports in the U.S. market will improve in relation to other countries because of the tariff reductions arising from the FTA. The overall impact, however, is not likely to be significant.

4. Competitiveness Assessment

The Canadian industry includes some of the largest distilling companies in the world, which have both the market expertise and the strength to pursue opportunities as they arise.

The industry is internationally competitive and will remain so in its export market for whisky. It should also be able to withstand the threat of import competition from "white goods" and the increasingly popular spirit cooler segment of the market.

For further information concerning the subject matter contained in this profile, contact:

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Ottawa, Ontario
K1A 0H5

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PRINCIPAL STATISTICS

SIC(s) COVERED: 1121 (1980)

	1973	1982	1983	1984	1985	1986
Establishments	31	33	32	32	30	31
Employment	6 209	5 282	5 027	4 790	4 454	4 358
Shipments ($ millions)	433	807	814	823	832	809
('000 hl of absolute alcohol)	1 522	1 610	1 595	1 607	1 519	N/A
Production ('000 hl of absolute alcohol)	1 618	1 464	1 167	1 152	N/A	N/A
Gross domestic product (constant 1981 $ millions)	377.7	290.2	300.2	279.5	278.1	265.8
Investment ($ millions)	30.0	36.0	28.1	28.1	28.8	35.9
Profits after tax ($ millions)	78.7	227.2	177.0	51.7	75.7	N/A
(% of income)	16.9	24.8	19.7	5.9	7.8	N/A

TRADE STATISTICS

	1973	1982	1983	1984	1985	1986
Exports ($ millions)	232	345	354	388	363	335
Domestic shipments ($ millions)	201	462	460	435	469	474
Imports ($ millions)	59	157	132	165	153	174
Canadian market ($ millions)	260	619	592	600	622	648
Exports as % of shipments	53.6	42.8	43.5	47.2	43.6	41.4
Imports as % of domestic market	22.8	25.3	22.3	27.5	24.6	26.9

Source of imports (% of total value)		U.S.	E.C.	Asia	Others
	1982	9	72	—	19
	1983	8	73	—	19
	1984	9	69	—	22
	1985	7	73	—	20
	1986	8	70	—	22

Destination of exports (% of total value)		U.S.	E.C.	Asia	Others
	1982	96	1.0	1.0	2.0
	1983	96	1.5	1.0	1.5
	1984	97	1.0	1.0	1.0
	1985	96	1.5	1.0	1.5
	1986	96	1.1	1.1	1.5

(continued)

REGIONAL DISTRIBUTION — Average over the last 3 years

	Atlantic	Quebec	Ontario	Prairies	B.C.
Establishments – % of total	6	24	45	16	9
Employment – % of total	N/A	27	57	N/A	N/A
Shipments – % of total	N/A	22	59	N/A	N/A

MAJOR FIRMS

Name	Ownership	Location of Major Plants
Joseph E. Seagram & Sons	Canadian	Quebec, Ontario
Hiram Walker - Allied Vintners	British	Ontario, British Columbia
Corby Distillers	British	Ontario

Note : Statistics Canada data have been used in the preparation of this profile.

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