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# COMPETITIVENESS OF GEORGIAN AGRICULTURE: INVESTMENT CASE STUDIES

CHÂTEAU MUKHRANI

25 July 2014

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# **COMPETITIVENESS OF GEORGIAN AGRICULTURE: INVESTMENT CASE STUDIES**

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# ABSTRACT

This case analyzes a joint venture involving two prominent Georgian entrepreneurs and a Swedish investor centered on the restoration of a unique Georgian château dating back to the second half of the 19<sup>th</sup> century. The business concept is, *first*, to use a mix of modern and traditional methods to create a premium brand (based on the 19th century story) representing Georgian wines on the international market, and, *second*, to develop the winery, castle and other historical assets to provide wine tourism and hospitality services, in line with the European small luxury hotel model.

# ACRONYMS

<b>CSR</b>	Corporate Social Responsibility
<b>GWS</b>	Georgian Wine and Spirits Company
<b>PPP</b>	Public Private Partnership
<b>USAID</b>	United States Agency for International Development
<b>WEF</b>	World Economic Forum

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# I. EXECUTIVE SUMMARY

This case analyzes a joint venture involving two prominent Georgian entrepreneurs and a Swedish investor to restore a unique Georgian château dating back to the second half of the 19<sup>th</sup> century. The business concept is, *first*, to use a mix of modern and traditional methods and leverage the 19<sup>th</sup> century story of the château to create a premium brand of Georgian wines on the international market, and, *second*, to develop the winery, castle and other historical assets to provide wine tourism and hospitality services, in line with the European small luxury hotel model.

The project took advantage of Georgia's liberal business environment to acquire full ownership of the entire estate, including 160 ha of land and historical buildings. At the same time, the investment phase has taken much longer than originally envisaged. To date the company does not have full access to about a third of the land it lawfully privatized in 2009, and the project has had to deal with many of the bottlenecks that seem to characterize doing business in Georgia. These include limited access to long-term finance (particularly after the 2006 Russian trade embargo and the armed conflict in 2008), an inadequately educated workforce, low labor productivity due to an inadequate management culture and resistance to learning, a very small number and low quality of local suppliers, and very small foreign and domestic markets.

The group of Georgian investors, which had initially received Château Mukhrani in a 50-year lease in 2001, changed in the process. Frederik Paulsen, a Swedish businessman, academic, philanthropist and explorer, joined the company in 2006, buying out the shares of other partners and bringing a much needed infusion of cash. Paulsen currently owns 80 percent of Château Mukhrani shares through Marussia Beverages (which also owns Georgian Wine and Spirits Company (GWS)).

The enterprise was ultimately a great success thanks to a unique constellation of factors, including long-term vision, a well-executed branding and marketing strategy, and access to significant equity funding from a foreign partner. The project also benefited from an excellent international management team, which combines knowledge of Georgian and global best practices in wine production, hospitality business, and marketing. The investment carries many benefits for the local community and Georgia's economy as a whole.

- While its self-sufficiency in grape production—integral to the château concept—means that the Château does not buy the output of local farmers, the company brings many benefits to the local community. The main one is employment, which peaks at harvest time, and Château Mukhrani plans to expand the breadth and depth of services it already procures locally once the wine tourism and hospitality business reaches full scale.
- Château Mukhrani's business concept provides a key reference point for the Georgian wine industry as a whole, with modern wine production coupled with the branding and marketing possibilities of Georgia's rich history.
- Finally, the company's prominent shareholders and senior management play a crucial role in organizing the Georgian wine industry, facilitating its dialog with the Georgian government, and promoting Georgian wines on the international scene.

## **II. APPENDICES**

- A. BACKGROUND
- B. METHODOLOGY
- C. FINDINGS
- D. RECOMMENDATIONS
- E. ADDITIONAL INFORMATION

## A. BACKGROUND

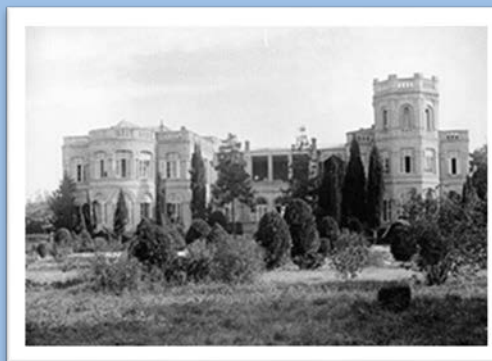
The new chapter in the history of Château Mukhrani started in 2001, when the land and the 19th century castle – until then owned by the Agrarian University – was provided under a 50-year lease to a group of private Georgian investors led by Levan Gachechiladze and Mamuka Khazaradze. The Château had been physically destroyed, but all of the investors quickly came to appreciate marketing potential of the story behind it.

Foreign involvement in the enterprise began with Jacques Fleury, who joined the company at the request of Mamuka, his long standing business partner in Borjomi Mineral Water. Jacques acquired a small stake in Château Mukhrani, but was given a leadership position to launch the project in 2002 using his experience of developing properties for the Iranian Shah and the King of Morocco. Frederik Paulsen, a Swedish businessman, academic, philanthropist and explorer, joined the company in 2006, bringing a much needed infusion of cash and a long-term vision for the château. Paulsen currently owns 80 percent of Château Mukhrani shares through Marussia Beverages, which also owns the Georgian Wine and Spirits Company (GWS).

From the very beginning, the aim of the project was to use a mix of modern and traditional technologies to create a strong brand that would represent Georgian wines on the international market. Since the basic concept of a château is about self-sufficiency, Château Mukhrani grows 100 percent of the grapes it uses for wine production. Finally, an important element of the concept is a strong emphasis on wine tourism and hospitality services, based on the European small luxury hotel model.

- **Vineyards.** The vineyards were planted in 2003-4 with the consulting support of an Italian viticulture expert, Professor Liuni. This allowed to start wine production in 2007, under the guidance of Lado Uzunashvili, who joined the company in that year after more than 15 years of working in France and Australia. Total planted area of vineyards is 87ha; an additional 20ha are to be planted in 2014 on the hillsides close to Mukhrani (mostly the Shavkapito variety). All land is in freehold and has been fully privatized prior to the July 2013 moratorium on the acquisition of agricultural land by foreigners.
- **Estate.** In 2013, Château Mukhrani hosted about 10,000 tourists for wine testing, meals and social events. Restoration of the estate is now very close to completion, with the garden, stable and old cellars receiving visitors since 2012. The castle is in the very final stages of interior decoration, with an expected opening in 2015. The building will be able to offer luxury hospitality services, conferences and public functions for several hundred people.

### The Old Story of Château Mukhrani



Prince Ivane Mukhranbatoni was born on Feb 7, 1812 into the family of the famous General Konstantine Mukhranbatoni. Having concluded his military career in 1854, Ivane was appointed Military Governor of West Georgia, where he helped establish schools, newspapers, and the Georgian State University in Tbilisi. The Prince's interest in farming was greatly enhanced on his trip to France in 1875, where he learned about the art of winemaking of the Bordeaux and Champagne regions.

Upon returning to Georgia, he planted a vineyard and built a 1.2 million liter capacity winery on his forefathers' Mukhrani estate. The demand for Mukhrani wines was growing steadily and they were successfully marketed within the Russian empire, as well as in Paris, Vienna and the US.

Ivane Mukhranbatoni died at the age of 85 in 1895. He was buried in the Svetitskhoveli Cathedral in Mtskheta, the traditional burial place of the Royal House of Bagrationi.

- **Winemaking.** Built in 2007, the winery is equipped with modern technology and equipment corresponding with ISO 9001: 2005 Food Safety and ISO 9001: 2008 Quality Management standards. It currently produces more than 12 wine varieties, including the Reserve du Prince Saperavi, Muscat and Chacha. In 2013, production stood at 300,000 bottles, and is expected to reach full capacity of 1 million bottles in 2-3 years. While initial export figures stood at only 10-20,000 bottles per year, thanks the opening of the Russian market, close to 40-50 percent of all Château Mukhrani production has been exported in 2013. The long-term expectation is that exports will reach 60 percent, which is lower than the norm for most Georgian wineries (80 percent). This has to do with the success of Mukhrani in the local market, despite the high price. The main export destinations are Russia (70 percent), Kazakhstan (10 percent), UK (Marks &Spenser) and France (Nicolas).
- **Foreign capital and knowledge transfer.** While it may be common for Georgians to believe that “no foreigner can understand Georgian wine” Château Mukhrani’s management team mainly consists of foreigners or Georgians with considerable experience of living and working abroad: Jacques Fleury (CEO until 2009), Petter Svaetichin (CEO in 2009-2013), Lado Uzunashvili (chief winemaker from 2007-2013), and Patrick Honnef, who replaced Lado as chief winemaker in January 2014. A gradual transition to local management started in 2013 with Mikhael Khundadze’s appointment as CEO. All marketing functions are currently outsourced to a the Marussia Group.
- **Local employment.** Not counting its hospitality business, Château Mukhrani employs about 40 permanent local staff, including 20 in the winery (bottling, fermentation/cellar, lab), six in viticulture, and the remainder in administration and support. Depending on the season, the chateau employs 80-300 workers on a daily basis.
- **Financial performance.** The company does not disclose its financial performance data such as total sales and profit. The costs are largely fixed (the cost of investment) and profits depend on volume. The operational profit was negative in the first few years, but the company showed a profit in 2013, thanks to growing volumes. In any case, the company’s operating profit is likely to be exceeded by capital gains associated with the underlying assets.

## B. METHODOLOGY

This case study is based on a series of interviews with Château Mukhrani stakeholders, who shared confidential information about their businesses and investments, including data on sales and exports performance and ongoing disputes with members of the local community. After initial interviews with company leaders identified challenges, successes, lessons learned and themes that could support broader conclusions about the investment environment, ISET sought to identify other voices to ensure nuances and other points of view were included in the report. When they are included in the report, ISET clearly identified instances where stakeholders’ views of the facts or outcomes differ significantly or are contradictory.

## C. FINDINGS

### THE BUSINESS ENABLING ENVIRONMENT

Since 2003, Georgia has been steadily climbing international rankings that are supposed to reflect the quality of local business environment. The most dramatic of these was ranking 8<sup>th</sup> 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, surveys of businesses point to a number of 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 percent of responses), **inadequately educated workforce** (14.2 percent), and **poor work ethic in national labor force** (12.2 percent). Of almost 100 competitiveness indicators analyzed by the WEF, Georgia ranks lowest on *local supplier quantity* (136 out of 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).

Château Mukhrani shareholders and management had to deal with every single one of these issues. Moreover, the project was initiated in 2001, in the legal murkiness characterizing the late Shevarnadze era, and to date the company cannot gain access to about a third of the land it lawfully acquired through the original lease agreement and subsequent privatization in 2009. Despite all these difficulties, however, the enterprise is a great success. The constellation of supporting factors includes a long-term vision linked to underlying historical assets, access to equity funding from a foreign partner, and an excellent management team that combines knowledge of Georgian and global best practices in wine production with marketing savvy.

### ACCESS TO FINANCE

The Georgian capital market is still at an infancy stage and the Georgian banking sector, while very well regulated, is unable to support large projects or projects that require long-term structural funding. In contrast with standard agricultural projects, which only require short-term financing to cover operational costs, financing has been a major challenge for Mukhrani because of the need to attract sufficient *long-term* investment in non-production assets – to renovate the castle and the garden. While basic renovation works and planting started early on, capital funding from cashflow became a major bottleneck in 2006, following the imposition of the Russian embargo, which was a major blow to the Georgian banking sector and the wine industry. Consequently, attempts by one of the Georgian partners to liquidate some of his assets or arrange for a bank loan did not produce any results. Other Georgian partners, who collectively owned 60 percent of the shares, did not have the means to make a long-term investment in the business. In the absence of cash, necessary actions, such as improvement of irrigation, were delayed, leading to losses.

Frederik Paulsen, who now owns 80 percent of the shares, introduced the substantial infusion of cash that enabled the whole project to commence in earnest in early 2007. According to Fleury, Frederik's decision required a little bit of "craziness" and passion that are rarely found in purely return-oriented investors, but which seem to be quite common to foreign investors in the Georgian wine industry. Other examples, like Burkhard Schuchmann<sup>1</sup>, can be found in the industry, and all of them are adventurers who fell in love with Georgia.

Frederik Paulsen was approached by Levan Gachechiladze through his connection to Pernod Ricard . Initially, he bought 5 percent of Levan's shares in 2006 (\$150,000 of a total value of \$3,000,000) but very quickly became the main financier of the whole project. Since the harvest of 2007 (200-300,000 tons) had to be processed, it was very urgent to invest in processing capacity. The company took a convertible loan of \$5m from Frederik, which enabled the opening of the winery in September 2007, in just nine months. In parallel, Mr. Paulsen started negotiations to buy the shares of other Georgian partners (who collectively owned 55 percent, including the remaining 25 percent of the company owned by Gachechiladze).

A further breakthrough happened in the wake of the 2008 military conflict with Russia, when Jacques Fleury left his position as CEO of Borjomi and became CEO of Mukhrani. In 2009, the owners were able to fully acquire the castle and land in exchange for assisting the Georgian government with IDP resettlement, and an additional payment of \$500,000. Fleury recalls that Frederik's own view, based

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<sup>1</sup> Owner of Schuchmann Wines (<http://www.schuchmann-wines.com/en/georgian-wine-tour/hotel-and-restaurant.html>)

on his knowledge of the UK real estate sector, was that a 50-year lease is as good as having full property rights. However, the Georgian partners insisted on fully acquiring the property having observed a number of instances in which long-term lease agreements concluded in the Shevarnadze era have been cancelled by the Saakashvili government.

## LABOR QUALITY

Rather paradoxically, Georgia's long, ancestral tradition of vine growing is one of the greatest obstacles to increased labor productivity, according to Château Mukhrani's chief winemaker Patrick Honnef. Local workers often refuse to learn new tricks, too often deploying the "my-grandfather-used-grow-grapes" argument and making no effort to learn, or simply ignore new instructions. Patrick Honnef provides plenty of examples. He had little luck in convincing his team leaders to select higher quality wood supports when unloading them from the truck. By the time he found out that his request was ignored, a lot of work had to be redone. Similarly, workers initially ignored his instructions to dig wood supports at least 60cm into the ground. He had to repeat his instructions, this time explaining the rationale – wood supports have to be able to resist strong winds! Workers likewise resented the introduction of more labor intensive mechanical weeding (claiming that herbicides could do the same job). Again, an explanation was in order: Château Mukhrani is trying to develop an exclusive brand, which means that excessive use of toxic materials should be avoided when possible.

Patrick's general lesson learned from the first few months of working in Georgia is that people can learn but they have to understand why they are doing what they are doing. It should be the vineyard director's responsibility to test team leaders' understanding of new instructions and their ability to deliver these instructions to simple workers. The response one often gets from Georgian staff, "*vitsi, ki batono*,"<sup>2</sup> is not a guarantee of proper understanding. According to Patrick, relentless repetition is not only recommended, but the required "mother of learning."

Westerners are a valuable source of new skills and professionalism that many Georgians lack after 70 years under Soviet rule and the anarchic period that followed. In Kakheti workers demonstrate a better understanding of winemaking, but in Kartli training is needed for all seasonal workers. In many cases, workers simply have to be shown how to do things, and a lot of learning happens through personal example. For instance, Honnef is the first person to come to work, and he does not shun getting his hand dirty in the field.

Fleury, Svaetichin and Honnef all agree that the attitude of Georgian managers is too often about centralizing information to fortify their position, rather than to effectively reach an objective. The perception is that the manager's authority comes from possession of unique knowledge, so knowledge is safeguarded. This is the opposite of effective western style management, which relies on delegation of authority and dispersion of knowledge to empower better decisions. Where a foreign executive is willing and able to nurture a successor, this kind of proactive mentorship is not yet common in Georgia.

Honnef's immediate objective is to improve the basic management skills of his team, including the vineyard manager and team leaders ("brigadiers"). There is an established Georgian tradition that "brigadiers" don't get their hands dirty as a matter of principle. This has to change, and in Honnef's view the "responsible" person has to be not at the end of the row, but in middle of it, leading by example.

Georgian labor is no longer as cheap as it was several years ago, and among other management innovations Patrick is trying to promote mandatory daily objectives and daily reporting against those objectives. His overall objective is to improve productivity in line or even ahead of salary increases.

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<sup>2</sup> "Yes sir. I know."

## MARKET SUPPORT SYSTEMS AND SERVICE PROVIDERS

Château Mukhrani relies on a multitude of input and service providers. Due to the company's emphasis on quality, reliability and post-sale servicing, though, most of their suppliers are either foreign companies or local companies under foreign management. Examples are a local Irish contractor engaged for well drilling and an Australian agronomist assisting with soil testing. Architectural design and civil engineering services, on the other hand, have been provided by Georgian businesses. This results in a higher cost structure, and it diminishes Mukhrani's direct engagement with the local economy.

The winery itself relies on a supply network that spans the globe. The plant uses German machines for bottling and filling, an Italian machine for corking, and a French one for capping and labeling. The corks come from Portugal, the bottles from France, the caps from Ukraine, and cardboard packaging from Turkey. Unfortunately, the only local inputs are history, grapes—which are themselves grafted onto American rootstock—and labels.

One of the key questions is why Mukhrani continues to rely on so many foreign inputs, and by extension so few contributions from the local economy. The response to that question is instructive, with the main drivers being the economies of scale that affect per-unit cost, the quality of inputs, and the after-sale service Mukhrani can rely on. Even when they are available, local suppliers have not yet been able to meet Mukhrani's needs on any of these fronts.

- The bottling plant in Ksani now has a new furnace, which could potentially produce wine bottles of sufficiently high quality. But the plant has not yet reached sufficient scale to be able to compete with French producers, even accounting for the cost of importation.
- Local equipment providers are happy to sell, but they do not keep stocks of spare parts, and they seem to entirely neglect after-sale service. Companies that are best able to meet the minimum service standards are those that have been trained by established European suppliers.<sup>3</sup>

## SMALL MARKET SIZE

Georgia's eight-thousand year history of winemaking, unique production traditions and exceptional soil and climate conditions provide an excellent starting point for an international marketing success. But Georgia is a small country, not suitable for mass production, and Georgian wine is a niche product that requires special care in the management of quality and international branding/marketing. Complicating the revenue potential for commercial producers, the domestic market for bottled wine is extremely small, with the lion's share of domestic demand met by home production. For Georgia's commercial producers, wine is mainly marketed to restaurants and hotels.

Until the reopening of the Russian market in 2013, which dramatically increased the export market for Georgia's wine and mineral water products—Château Mukhrani's exports stood at only 20-30,000 bottles per year. In 2013, their exports shot up, reaching 40-50 percent of total production.<sup>4</sup> The long-term expectation, however, is that Mukhrani's exports will not exceed 60 percent of production, which is reflective of their success as a domestic brand.<sup>5</sup>

## OVERCOMING MARKET LIMITATIONS

The story of Château Mukhrani is one of professionalism meeting business adventurism and excitement for a beautiful but risky project. While the main shareholders and investors played their

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<sup>3</sup> According to Honnef, Bayer has best Georgian technical team for spraying products. Other reasonable options are BASF and Syngenta.

<sup>4</sup> The main export destinations are Russia (70 percent), Kazakhstan (10 percent), UK (Marks & Spencer) and France (Nicolas). Château Mukhrani is not present in Ukraine due to the absence of proper distribution channels.

<sup>5</sup> Most Georgian wineries export about 80 percent of production.

role in getting the project off the ground, it was up to the international management team to make sure that in the end the project is crowned with success.

## **BRANDING AND MARKETING**

Given the high fixed cost of restoring historical assets on the one hand and production volumes limited by the size of their vineyards on the other, Château Mukhrani can only be financially viable as a *premium* brand in both wine production and hospitality. This basic understanding and the business strategy it implied have been a major factor in the project's success to date. Invented and adopted in 2009, the name "Château Mukhrani" served this ambitious marketing agenda.<sup>6</sup>

The early involvement of Westerners was instrumental in the early stages of creating and promoting the brand, since most major Georgian hotels were run by foreigners who were more comfortable with Western business partners. At the same time, local retail networks were happy to do business with a reliable Western-managed company.

As part of a larger Paris-based group producing and distributing premium wines and spirits (Marussia Beverages, in full ownership of Frederik Paulsen), Château Mukhrani has the advantage of having its main marketing functions centrally performed by the group. However, it does employ a brand manager and operates a wine studio in Tbilisi, on Meidan Square in the heart of Old Tbilisi District.

## **INTERNATIONAL MANAGEMENT TEAM**

From the very beginning, Château Mukhrani has been led by a very strong management team, which until 2013 consisted mainly of foreigners or Georgians with considerable experience of living and working abroad. The following key individuals have been involved in the creation of Château Mukhrani:<sup>7</sup>

- **Jacques Fleury** is a minority shareholder and the first CEO. Jacques brought to the company the invaluable experience of restoring another historical Georgian brand, Borjomi Mineral Water, and developing properties for the Shah of Iran and the King of Morocco. Jacques came to Georgia in 1998 to restore Borjomi and has since become an integral part of the Georgian business community.
- **Petter Svaetichin**, the second CEO, is a seasoned hospitality industry professional. Petter took primary responsibility for restoring the castle, implementing the company's marketing strategy and developing the hospitality business. He is currently sharing his time between Marussia Group headquarters in Paris and Château Mukhrani, where he remains in charge of the hospitality direction.
- **Lado Uzunashvili** served as the company's chief winemaker until 2013. A Georgian/Australian national, Lado came to the company with more than 15 years of experience in the Australian wine industry. His initial station in Georgia was GWS, at that time owned by Pernod Ricard. He joined Château Mukhrani in 2007, replacing the Italian viticulture experts who consulted the company during the initial vine growing stages. Lado completed the construction of the factory and oversaw the production of wines subject to a very tight schedule.<sup>8</sup>
- **Patrick Honnef** replaced Lado Uzunashvili in January 2014 as the company's chief winemaker. Patrick was born in the Rhine region of Germany. Having studied economics at the Free University in Berlin and Mainz, he worked a few years for an advertising agency, but

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<sup>6</sup> Early iterations of the name, which appeared on the first labels, included *Mukhrani Valley* and *Mukhrani Estate*.

<sup>7</sup> Château Mukhrani also engaged quite a number of foreign consultants to assist with the planting of grapes, architectural designs for the castle and planning of the garden. For instance, the chief gardener of Versailles advised the company on the restoration of the garden while his junior colleague was responsible for the ultimate design.

<sup>8</sup> Having left Château Mukhrani in late 2013, Lado is currently building his own new winery in Mukuzani (Mukado Wines).

then decided to quit and follow his passion. He studied wine business and viticulture in Heilbronn and after one year moved to the Bordeaux region in France. During his ten years in France, Patrick worked in close cooperation with the famous French wine consultant Stéphane Derenoncourt. Since 2009, Patrick has been visiting Georgia on invitation from Château Mukhrani shareholders, and he was acquainted with the project before moving to Georgia and assuming the chief winemaker position in January 2014.

## **THE EFFECTS OF 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.

Château Mukhrani has created many local jobs, including both full-time and seasonal staff. About 40 workers are employed full-time, not including the hospitality segment, and up to 300 day workers are hired for seasonal tasks, receiving on the job training. The presence of highly qualified Western and Western-trained professionals in all key positions has been a major factor in imparting and continually updating the skills of local workers. A major contributing factor to this was the opportunity afforded by the project to bring to Georgia top notch winemakers, Lado Uzunashvili and Patrick Honeff, and the continued engagement of Petter Svaetichin in building the hospitality and wine tourism segments.

As far as workforce development is concerned, the company's immediate priority is to prepare a qualified cadre of local team leaders, with an initial focus on basic management skills. The transition to more organic methods—a medium term strategic objective for Château Mukhrani—will require focused and continual training in organic production technology and techniques.

### **GOVERNMENT REVENUE, EXPORTS OF GOODS AND TOURISM SERVICES**

Given the very high cost of their initial investment, Château Mukhrani has yet to make a profit and contribute corporate income tax for the government. The company pays property taxes on its 160ha of land and income tax on salaries.

The company is exporting a significant portion of its wine production, earning foreign currency and contributing to Georgia's trade balance. As a four-season tourist destination and a small luxury hotel, Château Mukhrani is also well positioned to start exporting tourism services and add to Georgia's attractiveness for high value tourists from Western Europe, North America and Russia.

### **PRODUCT AND PROCESS INNOVATION**

Château Mukhrani has been instrumental in bringing a number of modern techniques, technologies and innovations to Georgian winemaking and management.

#### ***Vineyards***

The company took advantage of Georgia's soil and climate conditions to produce wines without the addition of beet sugar, a common practice in cool climate appellations of France.<sup>9</sup> The variability of soil and microclimates in Georgia is also a key selling point, since it allows vintners to match small varieties of grapes to specific plots of land, obviating the need to mix varieties to achieve desired qualities (e.g. alcohol levels).

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<sup>9</sup> According to Jacques Fleury, France invented the "vintage" concept as a marketing ploy, effectively transforming the weakness of French wines into a strength. A good "vintage" in the French terminology essentially represents a year in which winemakers did not have to add beet sugar.

Despite reasonably high annual precipitation levels, Château Mukhrani installed modern drip irrigation systems throughout its vineyards. This was deemed necessary because the timing of rain is not always optimal. At the same time, great care is taken to avoid lateral development of vine roots as a result of excessive irrigation (the deeper the roots, the better the quality of grapes). For the new vineyards to be planted on the extra 20ha of land, the company is considering either Israeli (Netafim) or Lebanese drip irrigation technologies.

The initial planting was done in 2003-2004 under the guidance of an Italian winemaker. Scions of Georgian varieties have been *locally* grafted onto phylloxera-resistant American rootstock that was produced in Italy (a global best practice). However, due to poor quality control in the local implementation process, a considerable number of the vines had to be replanted using an industrial grafting method.

About 70 percent of the grapes at Château Mukhrani are Georgian varieties, including Saperavi, Takveri, Shavkapito in red and Rkatsiteli, Guruli Mtsvane, and Chinuri in white. The remaining 30 percent are established Western wines like Chardonnay, Sauvignon Blanc and Muscat in white and Syrah, Cabernet Sauvignon, and Petit Verdot in red. The selection of grape varieties takes into account the need to extend the harvesting period over several weeks and thus reduce the peak load in harvesting and processing operations. Château Mukhrani starts harvesting its white grapes in the second week of September and ends at the end of October with Saperavi and Cabernet Sauvignon.

According to Fleury, thanks to Georgia's superior climatic conditions, the harvest per hectare is very good compared with France. Furthermore, the climate allows Georgian winemakers to bring grapes to optimal maturation and produce wines with 11-13.5 degrees of alcohol. Obtaining a similar result in France would often require adding sugar during the fermentation process. As Jacques put it, the French have transformed their weakness into a strength by convincing the world that having low yields is better for quality.

Becoming more organic is a key medium term strategic objective for Château Mukhrani (France used to rely on a lot of chemical products in the past, but has since embraced much more organic methods). During the next 3-5 years, Patrick Honnef plans to gradually move to more organic production technology, experimenting with smaller dosages of chemicals and fewer products. The company's new meteorological station will be of great help in this regard.

### **Wine Production**

A key aspect of Château Mukhrani's wine production is self-sufficiency in grapes. This comes with several advantages. First, the enterprise does not depend on the vagaries of the market in terms of quality or prices. Because intra-seasonal price fluctuations can encourage smallholder farmers to harvest early to catch good prices, grapes acquired on the open market can vary in terms of quality. The second advantage is the proximity of production facilities to the vineyards. Grapes are brought directly from the fields in small carts in just 10-12 minutes, effectively eliminating the rapid deterioration grapes naturally go through after harvest.

Château Mukhrani's production technology is a mix of Western and traditional Georgian winemaking, which has to do with the method of fermentation. Traditionally, Georgians allow grapes to ferment with the skins and stems, whereas the European way of separating the skins and the stems produces, according to many Georgian winemakers, "orphan wines" or "wines without a mother." Even in Georgia itself, the degree of separation increases as one travels west from Kakheti. Château Mukhrani's own approach is somewhere in the middle, lending a uniquely Georgian quality to the wine while remaining more "accessible" to international palates accustomed to modern methods.

Château Mukhrani has excellent storage capacity, due in large part to its investment in renovating the historical cellar. Located in close proximity to the production facilities, the cellar can store 1 million liters (3,000 barrels) at a nearly constant temperature in the 12-15C range. This capacity is still very far from being fully utilized.

The company's management is quite happy with the general quality of the wines they are now producing. Of course there is room for marginal improvements in workers' qualifications and productivity, but Château Mukhrani is still at the frontier of Georgian winemaking in terms of both its consistent quality and its equipment and technology. In the longer, term, however, Château Mukhrani will have to make some key strategic decisions. Introducing cheaper, mass produced brands would improve operational profitability, but this would risk diluting the premium image they have so far hewed to. An alternative would be to invest in excellence and stick to premium brands.

If Château Mukhrani sticks to the premium path, it will need to innovate to differentiate itself from the Georgian competition. In Patrick's view, other Georgian wineries such as Schuchmann, Khareba, Marani and Tbilvino are also very well equipped, employing expert foreign winemakers.

### **Hospitality Services**

In many ways Château Mukhrani has been a pioneer of wine tourism in Georgia, approaching it as a serious business with a great revenue generation potential. The wine tourism concept has since taken off in Georgia, flourishing in Kakheti at Château Mere, Kvareli Lake, Royal Batoni, and, potentially, the Radisson in Tsinandali.

Petter Svaetichin admits to having never thought that people would have so much interest in visiting Château Mukhrani even during the renovation process. According to him, this is still not fully understood in the company because of its specialization in alcoholic beverages. The Château is not yet ready, but Svaetichin expects about 10,000 visitors in 2014, taking advantage of the four packages being currently available: wine tasting, lunch offer, dinner offer, and wedding/celebration parties in the cellar or the garden. In a year or two, once the castle is completed and fully functional, the number of tourists may reach 50,000 per year, making the hospitality component of Château Mukhrani the largest potential source of net revenue for the company.

The castle itself could function as a four-season hotel, luxuriously classy and representing a premium product. Positive examples that Mukhrani are drawing from include some of the leading small hotels of the world—English country houses—but with a Georgian soul.<sup>10</sup>

## **COMMUNITY RELATIONS AND THE ROLE OF GOVERNMENT**

Château Mukhrani is an important local employer, but strangely enough the local village community is quite ambivalent about the company. The root causes of this attitude go back to the original lease agreement, which was vetted by the Shevardnadze government. The territory consists of 32 different plots, some of which are occupied by privately owned buildings and people. The company currently cultivates 87ha, but another 65ha nominally owned by Château Mukhrani are in fact occupied by local households. Right at the entrance to the property one can see a large football field, which the company maintains as part of the 2009 privatization deal.

The management realizes that the only way out of this situation is to buy out problematic properties. A number of buildings that are closest to the castle have been prioritized and price negotiations are underway. The asking prices, however, are very high even by Tbilisi standards. According to Svaetichin, "the villagers observe the amount of investment going on here, [and] the longer we wait the more we will pay."

Community relations are very important for Château Mukhrani. As Petter put it, "it is difficult to be successful nationally and internationally without being accepted as a reference in your own community and your own country". But it is not always clear what is the right strategy for engaging the community.

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<sup>10</sup> A negative example, to Petter's critical mind, is the Alexander Chavchavadze museum on the Tsinandali Estate, with its questionable antiquities, "Soviet ladies" in the role of tour guides, and large portions of the building not accessible for the visitors.

In Petter's view, "one has to choose the areas in which one can help. We have not provided extension services and trainings, and we have not been very good at using international donor money for these types of interventions." Despite that, professionalism and knowledge of winemaking has proven quite useful in connecting to the locals. This was considerably easier for Lado Uzunashvili, until recently the company's chief winemaker, who was automatically perceived as a Georgian. But it already works for Patrick Honnef, who is making his very first steps in the Georgian language.

The most tangible benefit provided by Château Mukhrani to the community is employment. During the harvest season, up to 300 people are employed on daily contracts, which augments the several dozen of full-time employees. The company also procures goods (khachapuri, churchkhela, traditional bread) and services from the community. The tourism programs offered by Château Mukhrani include horseback riding, churchkhela and bread baking, all of which involve local villagers.

Given that history is an important part of the company's brand, Château Mukhrani employs a professional Georgian historian. In addition to looking after Ivane Mukhranbatoni's exhibition currently on display at the castle's cellar, Mr. Gelashvili is also serving a liaison function to the local government and community. Under his purview, a very important new initiative concerns cooperation with British Petroleum (BP) and the National Georgian Museum on the restoration of Roman villas and baths in Dzalisa, some 3km away from Château Mukhrani. The company is willing to contribute USD 50 - 60,000 to facilitate the site's full restoration. Once completed, Dzalisa will be a great addition to the tourism programs offered by Château Mukhrani.

### **Government Relations**

Château Mukhrani is in contact with the local government – both local village community heads (gamgebeli) and head of the Mtskheta municipality. Most recently, it initiated community actions focused on cleaning the environment and improving waste management. The first action, "Clean Mukhrani Day" is planned for Friday, 16 May. The company also sponsors local school activities and organizes harvest parties for the disable people.

As far as disagreements on land and community relation are concerned, the local government has not been of much assistance but neither had it incited protests, set bureaucratic hurdles or demanded bribes.

The government assisted with the development of the enterprise by, first, allowing the full privatization of the property. The previous administration's meddling with the grape market has had very negative implications for the wine industry as a whole, but had not really affected the company given that it was not purchasing grapes from other growers. Château Mukhrani has not faced any issues with taxation since until last year the company has been accumulating losses.

## **D. RECOMMENDATIONS**

### **RECOMMENDATIONS FOR GOVERNMENT**

- **Attracting long-term, strategic investment.** Launched in the most difficult time for the Georgian wine industry, the project could only be implemented thanks a strategic Swedish investor who eventually acquired a majority stake in the enterprise. Despite all the excitement with Georgia's progress in international rankings, in practice the country's business environment remains extremely problematic as far as long-term projects are concerned. The main issue is scarcity of long-term capital, which only to some extent can be addressed by the International Financial Institutions and the Georgian government (e.g. through the Partnership Fund). Availability of long-term funding is also a major factor in addressing other bottlenecks such as low quality of the local labor force and inadequate local supplier quantity and quality. By providing equity financing, Georgia's Co-Investment Fund could, of course, facilitate strategic investment in agriculture, energy and other strategic sectors of the Georgian



economy. However, a more comprehensive policy package should include dedicated project management by the Georgian National Investment (or another relevant body) to ensure inter-agency coordination, arrange high-level meetings and cut through the red tape..

- **Maintaining a liberal business environment.** The Château Mukhrani project was implemented thanks to a relatively *liberal regulatory environment* that allowed foreign investors to acquire agricultural land and secure property rights to unique historical assets. This was a necessary (though not sufficient) condition for Frederik Paulsen and other investors to commit their capital, given their modest expectations of short-term profitability, the Russian embargo, and the Russian-Georgian military conflict of 2008. (Incidentally, Château Mukhrani is located less than 10km from the South Ossetian border.) Recent legislative initiatives by the GoG concerning access to freehold land, visa regimes and restrictions on foreign labor rescind important elements of that liberal business environment, and they weaken incentives for foreign investors to commit to low-risk-low-return projects that are very important for Georgia in the long run.
- **Securing investor property rights.** The project was implemented despite the legal complexities concerning an initial 50-year lease agreement and the subsequent privatization of Château Mukhrani assets. The cost of buying out (and demolishing) properties sitting on the land acquired by the company is not trivial, and it will delay investment in more productive assets, including production and renovation works. The company has the capacity to cope with these challenges, but it clearly needs a greater role for the government and the Georgian National Investment Agency (GNIA) to advise foreign investors and mediate between them and relevant local entities. The future policy on land privatization should provide clearer rules concerning compensation and land swaps for investors and affected communities.
- **Promoting access to export markets.** Finally, and perhaps most importantly, the government should develop very close cooperation with foreign investors and Georgian businesses, working with them to open new export markets. This point is particularly true of the Georgian wine industry, but it is valid for other sectors of the economy as well. As argued by Jacques Fleury in his essay “The Georgian Wine Industry: Recent Past and the Way Forward,”<sup>11</sup> it can be assumed

*“...that there is little awareness of Georgian wines outside the ex-USSR region and the ex-USSR immigrant communities in the West. ...Therefore, there is no way to diversify Georgian wine exports without a massive effort to create awareness of the fabulous story of Georgian wine. Georgia’s strategy should incorporate the main lessons learned from the successful experience of such New World countries as New Zealand, Australia and Chile during the last thirty years:*

- *Establish close cooperation between the state and the private sector.*
- *Create a Marketing Board to promote better awareness and image of the Georgian wines abroad. In other countries, this effort was managed either fully by the private sector, or in close cooperation between state institutions and the private sector, but still driven by the dynamism of the private sector.*
- *Launch targeted marketing campaigns designed and monitored by the Marketing Board, staffed by Georgian professionals and having limited support of experienced marketing experts from the New World wine countries or from countries having launched new wines in the last twenty years.”*

Fleury is critical of the go-it-alone attitude of the previous Georgian administration. The state cannot replace the private sector, especially in the field of marketing. At the same time, none of Georgian companies have sufficient size or profitability to engage alone in international communication campaigns. Thus, if Georgia wants to be on the world wine map, its fragile wine

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<sup>11</sup> <http://www.iset.ge/blog/?p=1841>

industry is in need of effective coordination, which could be provided by a strong Marketing Board and supported by the Georgian government and leading companies which excel in international branding and marketing.

## RECOMMENDATIONS FOR INVESTORS

- **Facilitating public-private partnerships (PPP) seeking to promote rural development.**

Château Mukhrani has made a conscientious effort to hire and train local workers, engage local service providers for its tourism programs, and otherwise engage local communities in harvest parties, cleaning actions, and similar Corporate Social Responsibility (CSR) activities. Yet, despite making a significant contribution to local job creation and incomes, Château Mukhrani's overall impact on rural development in its immediate environment remains limited. A lot more can be achieved if foreign investors' resources and expertise are leveraged by international donors and the Georgian government through Public-Private Partnership (PPP) mechanisms.

There is considerable scope for Château Mukhrani to experiment with innovative CSR strategies seeking to promote rural development and productivity in hospitality and wine tourism, grape growing and wine production. A PPP targeting any one of these areas could employ the company's *core technical expertise* in the delivery extension services and otherwise supporting individual farmers or groups of farmers interested in learning modern techniques and exploring new ways of going about their business. A particularly attractive possibility is related to assisting with farmer cooperation – a key priority for the Georgian government and the EU. As part of a PPP, Château Mukhrani's limited CSR resources could be leveraged by interested international donors, such as USAID (through the Global Development Alliance (GDA) mechanism), European Commission's ENPARD program, Swiss Development Cooperation (SDC), or the Swedish Agency for International Development (Sida).

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