

Post-vintage bulk wine review

2006: Another king hit or end of the beginning?



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Was the 2006 Australian wine grape harvest just another in a series of seemingly unstoppable surges in wine production, or are there signs that we are somewhere near the bottom of the current wine industry downturn?

Overview

The latest estimate is that the 2006 Australian vintage winegrape crush was 1.846 million tonnes.⁽¹⁾ At this time of relatively abundant vintages, it is certainly encouraging that 2006 was actually a bit less than the last two years: 2005 was 1.925 million tonnes and 2004 was 1.917 million tonnes⁽²⁾ although some of the differences may be accounted for by grapes left unpicked.

For the last three years our annual vintage crush seems to have stabilised at roughly around 1.8-1.9 million tonnes. This means that each year we currently have about 1.3-1.4 billion litres of wine to sell.

The outlook for the next 2-5 years is for more similar-sized vintages: The ABARE⁽³⁾ two-year forecast indicates stable wine production of about 1.4 billion litres by 2008 (reported as 1.936 million tonnes). The AWBC⁽⁴⁾ 5-year forecast also indicates fairly stable wine production, which is expected to be around 1.442 billion litres by 2010.

So is this good news or bad news?

Figure 1 shows for the period 2004-2006 actual sales and production data, and for the period 2007-2008, published forecasts are used.⁽⁴⁾ I have omitted using forecasts beyond 2008, since such longer range forecasts tend to be more subject to influences that are presently unknown, such as a sustained movement in exchange rate or widespread vineyard mothballing or vineyard removal.

A simple analysis is to look at sales volume and production during 2006 compared with just two years ago, 2004, which was the first of the 1.3-1.4 billion litre wine harvests. In 2004 total industry sales were about 1.0 billion litres and, it would be fair to say on such fundamental data, it was a big over supply year. This year, 2006, our sales will total 1.2 billion litres and during the next year (when we actually sell most of the 2006 harvest) sales are forecast to total 1.3 billion litres, surprisingly close to balance.

Further analysis of the data displayed in Figure 1 leads to these tentative conclusions:

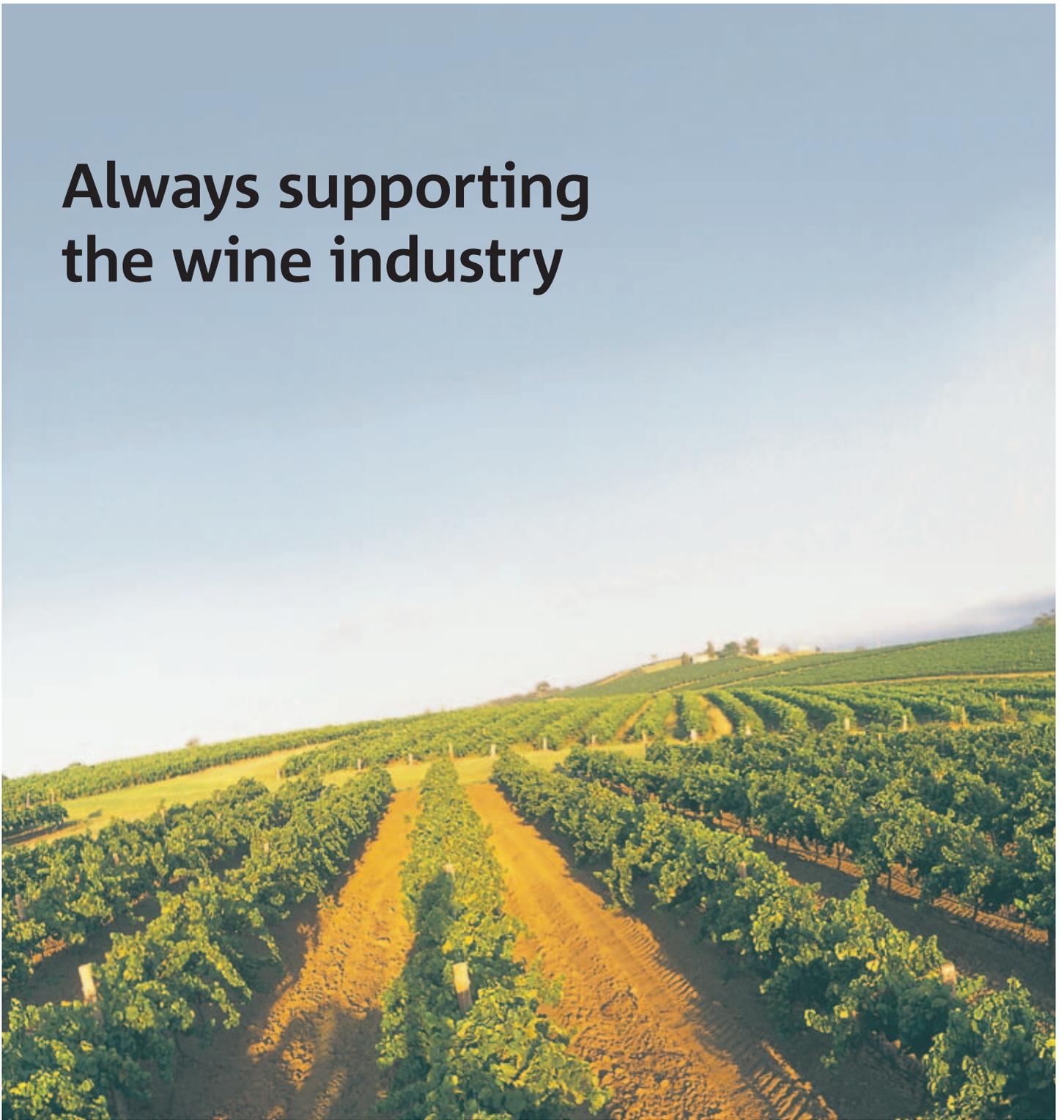
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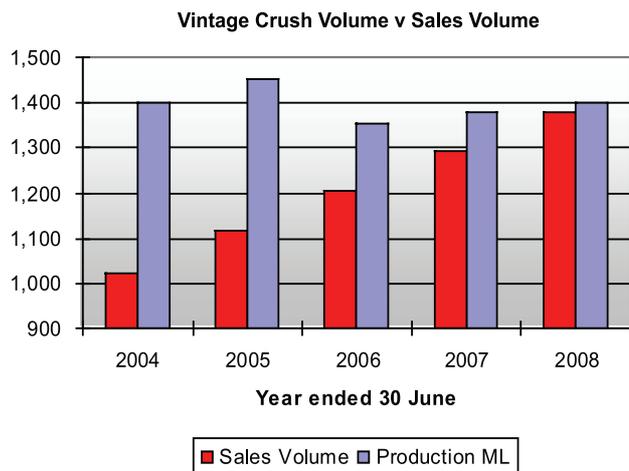


Fig. 1.

- production appears to have peaked, while sales volumes continue to rise fairly steadily
- since our annual surplus is much smaller than just two years ago, our overall supply/demand fundamentals are actually in better shape now than in 2004
- what the chart does not show is that wine prices are lower now than in 2004, which is mainly due to delayed pricing signals in the market place.

The final point about lower prices coincides with the current excessive media noise about how bad things are for the Australian wine industry. For example, on one recent Saturday during April both my home delivered newspapers, which are published for otherwise disinterested city dwellers, detailed the current woes of our industry.

But amongst all the bad news, something must be working for Australian wine: sales volumes continue to grow, albeit at lower price points, but off a larger base than ever before.

By comparison, this does not seem to be the case in much of the Old World, where the EU announced another crisis wine distillation as recently as June this year. Unfortunately for Old World producers, wine distillation has become a regular feature of EU wine policy, which was originally only intended as a temporary measure when first introduced in 1982 – and that was almost a generation ago.

Post-vintage bulk wine inventory round-up of major varieties

For each of the four big varieties of Australian wine production, in descending order of importance, the change in tonnes crushed from 2005 to 2006⁽¹⁾ is compared with the change in Austwine bulk wine inventory⁽⁵⁾ across the same period. A longer-term view (of six-years, as far back as our records go) is also presented graphically for each variety. All prices are ex-works for spot domestic sale of average-grade wine for immediate delivery with short payment terms.

Shiraz

National tonnes crushed of Shiraz fell 2.6% this year to 441,000 tonnes, compared with a rise in Austwine Shiraz bulk wine inventory of 2.8% to 30.6 million litres.

Shiraz is arguably Australia's flagship red variety, and this seems to be a key reason that winemakers tend to feel more comfortable holding Shiraz inventory than our next most prolific

red, Cabernet Sauvignon. Yet it seems to be a little known fact that our Shiraz inventory outstrips Cabernet Sauvignon inventory by over 40% (30.6 million versus 21.6 million litres). Perhaps this explains why we are finding a shortage of Shiraz parcels at prices that are acceptable to buyers, despite the abundance of this variety in our inventory.

Looking at the last three years of Figure 2 (Shiraz) indicates a steady rise in Shiraz inventories each year, despite production peaking last year. Shiraz is the only one of the big four varieties that recorded a rise in bulk inventory this year while recording a fall in tonnes crushed. But the changes in both production and inventory are relatively modest during the past three years when compared with the major fluctuations that are illustrated in the chart for the three years prior. This indicates that we are basically bumbling along at the bottom of the industry cycle with this variety and I think this trend will continue for the next year or two, in the absence of a crop failure. ABARE⁽³⁾ forecasts Shiraz production to remain fairly static over the next two years at 435,000 and 448,000 tonnes respectively and inventories are likely to be abundant enough to absorb the likely sales growth during that time. Current prices for current vintage commercial quality inland irrigated Shiraz ranges from \$0.70-\$1.20 per litre.

Chardonnay

National tonnes crushed rose 0.9% this year to 423,000 tonnes, compared with a rise in Austwine bulk wine inventory of a whopping 66.6% to 25.6 million litres.

Figure 3, (Chardonnay) displays little ambiguity: while Chardonnay production growth was almost completely restrained in 2006, bulk wine inventory ballooned again this year on top of a large increase last year. Chardonnay is now the second most prolific variety in our inventory, just 15% below Shiraz. So how did this occur? Quite simply, in the last four vintages production has almost doubled (from 234,000 tonnes in 2003) and the marketing opportunities have clearly lagged behind the large and rapid increase in production.

ABARE forecasts Chardonnay production will increase by about 8% per annum for each of the next two years, to 457,000 tonnes and then to 494,000 tonnes. By that time, Chardonnay will be Australia's most abundant winegrape.

Chardonnay has been breaking records for some time on its way to becoming number one, for example, last year Chardonnay bulk inventory exceeded Merlot for the first time in several years, and this year there is more Chardonnay inventory than Cabernet Sauvignon also. Current vintage commercial quality inland irrigated Chardonnay ranges from \$0.65-\$1.10 per litre.

Cabernet Sauvignon

National tonnes crushed fell 7.3% this year to 278,000 tonnes, roughly in line with a fall in Austwine bulk wine inventory of 6.4% to 21.6 million litres.

Compared with both Shiraz and Chardonnay Figure 4 (Cabernet Sauvignon) indicates improving fundamentals for this variety, since both production and bulk wine inventory are down.

Nevertheless Cabernet Sauvignon is a favourite of few winemakers, even though bulk wine inventory, while still abundant, is down by about one-third of its 2004 peak of 33.6 million litres.

Interestingly, ABARE forecast Cabernet Sauvignon production in 2006 to be 305,000 tonnes – 9% higher than the latest

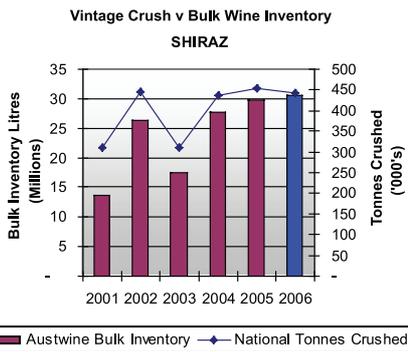


Fig. 2.

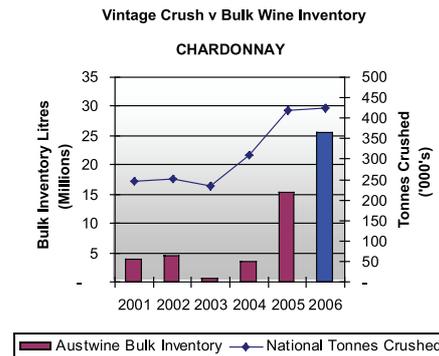


Fig. 3.

inventory of 12.9% to 11.3 million litres.

Merlot, (Figure 5) like Cabernet Sauvignon, recorded an improvement in its supply fundamentals, but it recorded a better performance albeit off a much smaller production base. Merlot is the smallest of the big four, less than half of the next largest variety, Cabernet Sauvignon.

The ABARE forecast is for Merlot production to remain static for the next two years at 129,000 tonnes each year. In light of growing overall sales of Australian wine, this indicates further improvement for Merlot.

Interestingly, despite the relative abundance of bulk Merlot inventory, we are having trouble finding good quality parcels at present. The major challenge with this variety is that buyers seem to want it to have generosity of flavour, somewhat akin to Shiraz, and generosity of tannin structure, somewhat akin to Cabernet Sauvignon. Sadly, most Merlots possess neither. So we often ask for Merlot samples to have up to 15% of another variety in them as a blend enhancement, only to be often disappointed to find the suggested improvement has already been made.

I had hoped better quality Merlots would become available as the recent plantings move closer to full maturity and vines become balanced. Unfortunately, this has generally not occurred, so perhaps much of this variety may be planted in the wrong places.

Current vintage commercial quality inland irrigated Merlot ranges from \$0.70-\$1.10 per litre.

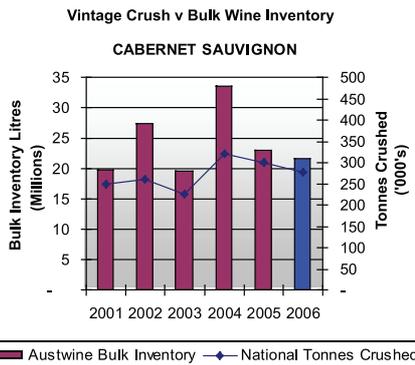


Fig. 4.

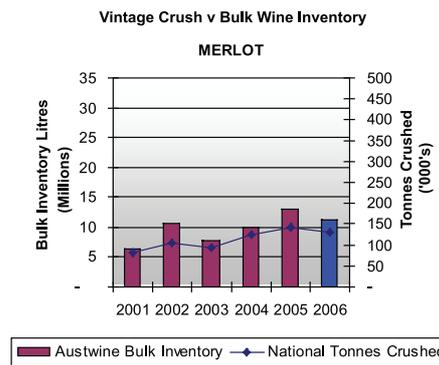


Fig. 5.

estimate of 278,000 tonnes. I suspect a lot of the difference between the forecast and the latest estimate may be represented by grapes left unpicked on the vine. ABARE also forecasts further falls in Cabernet Sauvignon production across the next two years of 4% and 5% respectively and we are selling a lot of Cabernet Sauvignon into programs that have been developed to soak up surplus inventory. Therefore,

the fundamentals of this variety appear set to continue improving. Current vintage commercial quality inland irrigated Cabernet Sauvignon ranges from \$0.70-\$1.10 per litre.

Merlot

National tonnes crushed fell 8.1% this year to 131,000 tonnes, which is about two-thirds of the fall in Austwine bulk wine

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Comparison of the major varieties

Figure 6 plots bulk wine inventory as a percentage of current vintage tonnes crushed for each of the Big Four varieties and it provides a neat summary of the relative supply position of each.

Both Merlot and Cabernet Sauvignon have had the largest bulk wine inventory as a percentage of tonnes crushed each year, and accordingly, these are the most oversupplied varieties, as the chart indicates. Both these varieties are on a trajectory of improving fundamentals, as bulk wine inventory continues to trend downward as a percentage of current vintage crush.

Compare and contrast the performance of Shiraz, which appears to be on a trajectory of deteriorating fundamentals, although this could change with a crop failure. Chardonnay's trajectory is the most dramatic, as it shoots from under supply to over supply in just over two years.

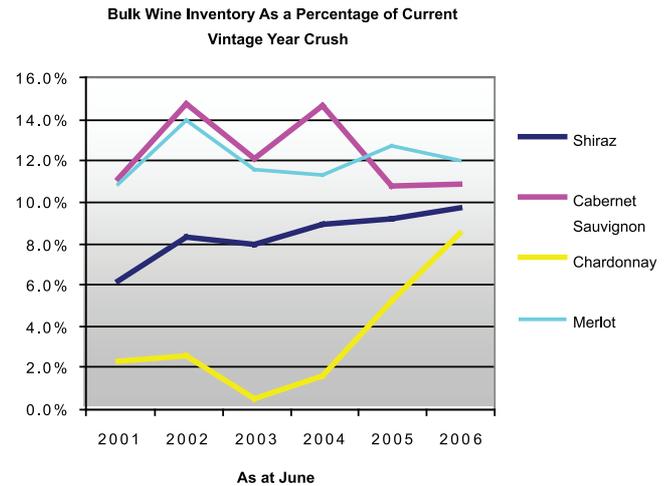


Fig. 6.

A brief overview of selected minor varieties

Sauvignon Blanc: There is good demand across most price points, but quite limited supply. Low or difficult crops during 2006 in the Adelaide Hills and Western Australia accentuated the current under supply and prices above \$3 per litre are relatively common from these regions. Asking prices of around \$4 per litre do exist but, at present, are difficult to achieve.

Semillon: There is both reasonable supply and reasonable demand for Semillon, primarily driven by the increasing demand for its popular blend partner, Sauvignon Blanc. Prices have softened due to the surplus of its other popular blend partner, Chardonnay, however, past vintage stocks seem to have been mostly soaked up.

Pinot Noir: Intense demand continues to be driven primarily from the USA, although demand declines rapidly above the \$2-\$2.50 per litre range.

Pinot Grigio: Supply of this variety is very limited and the spot market almost non-existent. Some sellers are trying to sell red with it, which dampens demand quite significantly.

Cabernet Franc, Ruby Cabernet, Petit Verdot and Sangiovese: These all have very weak demand and are very hard to sell, with most ending up in generic non-varietal Dry Red blends.

Malbec: There is patchy demand with a very thin market, matched to limited supply.

The shrinking pricing premium of bulk wine from cooler climates⁽⁶⁾

The massive vineyard plantings of the 1990s, which peaked in 1998 at over 16,000ha⁽⁷⁾, were concentrated in cooler climate regions. The production surge from these plantings is now upon us and the retail prices that these vineyards were destined for have become a lot harder to achieve, leading to increased bulk wine inventories from such plantings.

Consequently, during the last 18 months, we have witnessed a sporadic but steady decline in the average pricing premium of bulk wine from cooler climates compared with bulk wine from warm inland regions (Figure 7). Such shrinkage of the pricing premium of wines from cooler climates varies quite widely from region to region, but we expect the overall trend to continue for at least the next year.

This has meant that the quality of our bulk wine inventory has become better and better as an increasing percentage of bulk

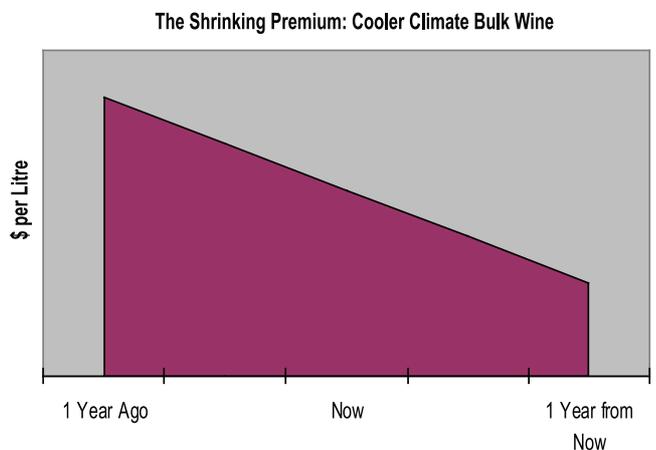


Fig. 7.

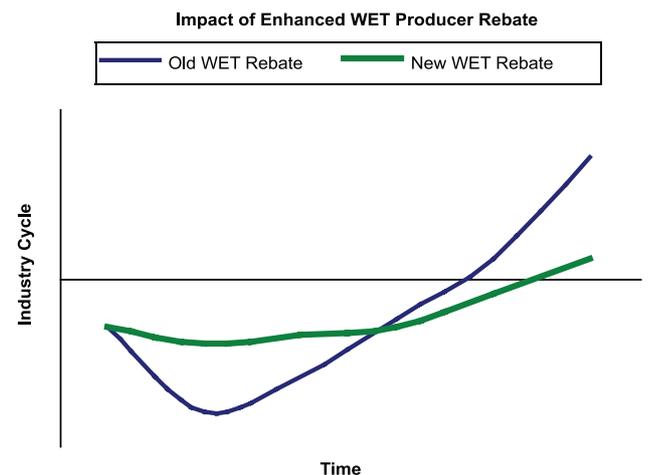


Fig. 8.

South East Australian blends are able to include an increasing proportion of cooler climate wine.

Generally we have not been able to obtain much of a pricing premium for such warm/cooler climate blends in the market place, although sometimes we do reasonably well with them for our suppliers. In any event, since such wines usually taste better, they usually find a place near the head of the selling queue, leading to reasonable sales success in a difficult market.

That we have been able to deliver better quality wines is obviously a good thing and reflects our country's current good competitiveness in the international marketplace. Of course, few people in the supply chain can sustain the current prices, with most losing money. Nevertheless Australian wine is still in good demand and growing, albeit at a slower rate than the 1990s, and from a significantly larger base.

Impact of enhanced WET Producer Rebate Scheme on bulk wine

From 1 July 2006 the Commonwealth Government enhanced the Wine Equalisation Tax (WET) producer rebate scheme to increase the maximum rebateable amount from \$290,000 to \$500,000 each financial year.

So for every wine producer, the first \$1.7m in domestic sales each financial year will be free of the usual 29% WET, up from the first \$1m in sales previously. This measure will reduce the depth and severity of the current downturn and keep many otherwise unviable wineries operating and in production. This is designed to preserve the diversity of the Australian wine industry during this current downturn, and the measure is biased in favour of small producers who do not have access to many of the economies of scale enjoyed by their larger competitors.

But this measure may also reduce the vineyard area that would have been taken out of production by otherwise unviable operations during this current down cycle. This carries with it the risk of delaying the eventual cyclical recovery.

Graphically, the impact of this measure is crudely pictured in Figure 8.

Since the first \$1.7m in sales will be free of WET, it is small winemakers who will benefit most from this initiative. Most such small winemakers are located in cooler climates, and most have at least some vineyards of their own. This is exactly where the current over supply is most acute, so we can expect more bulk wine inventory from cooler climates for some time yet. This will lead to continued shrinkage of the pricing premium that these wines have recorded in recent times.

Summary

To summarise, I have borrowed a few words from Winston Churchill, who was Prime Minister of Great Britain during the Second World War. After his country had

only just survived one of its darkest periods of the war, he noted: "This is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning."⁽⁶⁾

I think these words describe most aptly the circumstances currently faced by the Australian wine industry: winegrape production has finally peaked, and sales volume is growing steadily, but we still have a long hard campaign to achieve sustainable price levels in light of the surpluses, albeit reducing each year, that are still ahead of us.

Other observations that are discussed in detail above include:

- the four major varieties are basically bumbling along the bottom of the current cycle with no major change in inventory positions, except for Chardonnay
- continued tightness with selected minor varieties such as Sauvignon Blanc, Pinot Noir and Pinot Grigio. Semillon is approximately in balance, and there is generally weak demand for minor red varieties
- the average pricing premium for cooler climate bulk wine is shrinking
- the increase WET producer rebate scheme will reduce the pain of the current downturn in the short term, but may ultimately increase supply of bulk wine from cooler climates and delay any recovery

References:

⁽¹⁾ The latest estimate of the 2006 wine grape crush was published in June 2006 by the Winemakers Federation of Australia: 2006 WFA Vintage Report. Comparisons with 2005 are drawn from the same report, published a year earlier.

⁽²⁾ Australian Wine and Brandy Corporation Annual Report, 2004 – 2005.

⁽³⁾ Australian Bureau of Agriculture and Resource Economics (ABARE), Australian Wine Grape Production Projections to 2007-08, June 2006

⁽⁴⁾ Australian Wine and Brandy Corporation Supply and Demand Assessment 2005, November 2005.

⁽⁵⁾ Austwine Bulk Wine Availability Database, June 2006.

⁽⁶⁾ I have used the same classification and nomenclature employed by AWBC: "warm inland" is defined as the growing districts along Australia's major rivers (SA Riverland, River Murray Valley in NSW & Vic and NSW Riverina) and "cooler climate(s)" is defined as all other regions.

⁽⁷⁾ Wine Industry News, March 2004

⁽⁸⁾ Speech given at the Lord Mayor's Luncheon, Mansion House, London, 10 November 1942.

About the author:

Jim Moularadellis is the principal of Austwine, which was established in 1993 and is now Australia's largest specialist bulk wine brokerage firm. He leads a team of 7 bulk wine brokers, is a Certified Practising Accountant and holds an Honours Degree in Law from the University of Adelaide. He can be contacted on +61 (0)8 8363 5188. ■

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