

The Australian wine industry: following a prophetic script



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“I see a maturing... around about 2001...followed by a very competitive cost-pressured 10-year period...what I loosely call... 'the horror zone'. Every industry has it, and it usually occurs when you least expect it.”

So predicted PK Ruthven², speaking at the Australian Wine Industry Technical Conference back in 1998. I suspect that most Australian wine industry participants are feeling pretty horrible at the moment as we work our way through the latest market down-leg of Ruthven's forecast 10-year 'horror zone'.

In light of these prophetic words, what is the outlook for the bulk market in Australia?

Bulk wine market overview and 2009 outlook

The market for bulk wine has steadily softened since the beginning of 2008, as more and more market participants assessed the likely size of the 2008 winegrape crop. At 1.83 million tonnes it was larger than widely expected, and a vicious cycle led up to the 2008 vintage: expecting an impossibly short crop and white-hot competition for grapes, many wineries posted very high grape prices very early (up to six months earlier than usual), in order to secure grapes, and to encourage growers to buy water. Armed with sustainable grape prices, growers embarked on a water-buying frenzy, pushing water to over \$1000 per megalitre (ML). The vines received the water they needed and they yielded well. Wineries bought all the grapes, filled their tanks with high cost wine, and put their surpluses on the bulk market at cost plus a small margin. But a lot of wineries found themselves in this similar position, and not much of that surplus wine moved: there was simply too much wine asking too high a price. Naturally, the market softened.

As the size of the 2008 vintage became more apparent, our company, Austwine, experienced a large increase in bulk wine inventory. Our total inventory³ doubled from about 60 million litres (ML) in week 1 of 2008, to peak at over 140ML in week 28. Since then total inventory has been hovering between 120-130ML, which is about the same levels experienced during 2005 and 2006.

In the lead-up to the 2009 vintage, growers have been given much less pricing guidance from wineries and firm grape prices have certainly not been posted to date. In those regions with extreme water scarcity (mainly NSW & Vic Murray Darling & SA Riverland), growers have been left to make their own decisions on water purchases, resulting in much more subdued and sensible water market activity. During this irrigation season, prices peaked at half of last year's record prices. Through caution and restraint

in grape buying, the wine industry has significantly improved its competitiveness by not sponsoring growers to force the price of water to record levels, which happened last year.

The current outlook for 2009 is for another reasonably significant crop, at least similar in size to 2008. There is currently little evidence that might suggest otherwise⁴. If anywhere near the entire crop is harvested, this will be in excess of the Australian wine industry's current annual sales, so it is less likely that the general market for Australian bulk wine will rise. Indeed, it is likely that we may see further falls in bulk wine prices over the next 12 months.

2009 vintage to send confusing market signals

In times of over-supply, the price of all grapes becomes nearly the same, regardless of where they are from. In such circumstances, if presented with a choice, winemakers will more likely buy (generally better quality) cooler climate⁵ grapes and leave warm inland grapes unpicked. This is what happened during 2005 and 2006 when conditions were similar to those expected for 2009. Not that this is great news for cooler climate growers, because 2009 spot grape prices are likely to be below the cost of production in most regions.

Therefore, if grapes are left unpicked in 2009, there is likely to be a disproportionate volume of warmer inland grapes left on the vine and this is likely to hasten the exit of grapegrowers from these regions. Indeed, a recent survey⁶ showed that nearly 60% of growers in SA Riverland were considering leaving the industry due to adverse conditions, including drought, compared with the Adelaide Hills (14%), McLaren Vale (18%) Barossa (19%) and Coonawarra (21%).

Furthermore, the following two government interventions in the marketplace will further serve to potentially diminish supply from the warmer inland grapes as a percentage of our overall production:

1. The Australian Government recently announced⁷ Exit Grant Packages to assist Small Scale Irrigators, which disproportionately favours irrigators from warmer inland regions, including grapegrowers from these areas.

Table 1.

Austwine Bulk Wine Availability The top 4 varieties ⁸					
	Warm		Cool		Total Mil. Ltrs
	Mil. Ltrs	%	Mil. Ltrs	%	
December 2008	28.5	36.7%	49.2	63.3%	77.7

2. The Wine Equalisation Tax Rebate which disproportionately favours cooler climate growers, who are more likely to also be sellers of wine than warmer inland growers, effectively subsidising cooler climate grape production.

If proportionally more warmer inland grapes are left on the vine, is this evidence that we are on strategy to value build our wine sales, so necessary to produce a vibrant and healthy industry? At first blush the answer to this question is in the affirmative, but Table 1 paints a very different story. Surplus wine, represented by bulk wine inventories listed with our company, is now dominated by wine from the cool climate regions.

In 2008, grapes from these areas represented about 41% of Australian wine production⁹, but it can be seen that wines from these regions represent a disproportionately large 63% of inventory volume.

Furthermore, of the 695ML of Australian wine exported in the

Table 2.

Austwine Bulk Wine Availability The top 4 varieties			
	Warm Mil. Ltrs	Cool Mil. Ltrs	Total Mil. Ltrs
September 2008	45.8	41.5	87.3
December 2008	28.5	49.2	77.7
Change (%)	- 37.7%	+18.6%	-11.0%

12 months to November 2008, 575ML (83%) was below \$45 per case¹⁰. This means that just 17% of our export volumes are above \$45 per case and, using some very, very crude assumptions about the costs of grapegrowing, winemaking and bottling, wines above \$45 per case FOB tend to come from cooler climate regions.

Ouchy Mama!

Moreover, in the 12 months to November 2008, Australian wine exports fell by 99ML or 12%. Wine below \$45 per case fell by 20ML (3%) to 575ML. Whilst this is a contraction in sales, it is a reasonably respectable effort in light of drought and (until very recently) high exchange rate pressures. But wines above \$45 per case fell by 79ML representing a huge 40% drop, to 120ML. Ouchy Mama!

Consider also the trend during just the last three months (Table 2), which shows cooler climate bulk wine inventories ballooning during the time of the year when inventories generally decline in time for the next harvest.

Based on the size of our bulk wine inventories, cooler climate supply (for both red and white wine) is very abundant. These wines have a relatively high cost base and there are currently few bulk wine market opportunities for such wines at or above their cost. For a large volume of these wines to change hands in bulk, sellers will need to come close to, match or beat current warmer inland prices, which serves to further depress warmer inland prices.

So by a combination of market forces, government intervention and historical accident, wine production is likely to be curtailed in the warmer areas during 2009, despite the empirical evidence of export sales telling us that this is not where the reduction should

Our purpose is to provide buyers the best choice and sellers the best opportunities when dealing with Australian Bulk Wine.



L-R: Leanne LeCornu, David Hill, Mark Wyatt, Megan Molenaar, Anthony Turbill, Sue Murphy, Séamus O’Fathartaigh, Jim Moularadellis, Cade Lawson, Jessica Mügge, Ben Preston, Gary Manthorpe and Ben Munt.



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Table 3.

Austwine Bulk Wine Availability The top 4 varieties ¹¹					
	Mil. Ltrs				
	Chardonnay	Shiraz	Cab. Sauv.	Merlot	Total
Total, December 2008	29.2	22.4	14.9	11.2	77.7
By Vintage					
2008	24.2	16.7	9.0	6.8	56.7
2007	4.1	1.7	1.6	1.7	9.1
2006 & older	0.9	4.0	4.3	2.7	11.9

occur. Put another way, the market evidence shows us that we have some way to go on our journey to value build our wine sales and we could potentially over-shoot by taking warmer inland vineyards out of production prematurely.

Unusual dynamic

The above analysis suggests that the market for warmer inland wine is closer to balance than the market for cooler climate wine. But there are further confusing market signals as we observe an interesting and unusual dynamic: although the volume of warm inland bulk wine that is listed with us is shrinking, the price is falling also. Luckily this can be fairly easily explained by the lower prices for grapes and bulk wine expected from 2009, together with the overhang of cooler climate wines.

We are also seeing the market punctuated by sellers coming to market with very urgent requirements to sell significant volumes of wine within a very short timeframe, not unusual for this time of year as tanks are cleared in readiness for the next harvest. Calendar year 2008 also saw a resumption of wine companies who had been placed in some form of external administration approaching us to assist with moving their bulk wine inventories, after a drought-induced suspension of such inquiries during the prior 18 months.

Warm inland varietal reds such as Shiraz, Cabernet Sauvignon and Merlot currently have moderate supply, roughly matched to moderate demand, but transactions are very price-sensitive. Warm inland varietal whites are in abundant supply and are experiencing weak demand. This is driven by the large volumes of Chardonnay currently on the bulk market, which also drives down the prices of its traditional blenders Semillon and Colombard, as well as Dry White. Chardonnay is the most abundant variety in our bulk inventory by a significant margin (Table 3).

It can also be seen from Table 3 that due to the short 2007 vintage, there is relatively little older vintage inventory for sale.

After comparing the above inventory with our historical inventory levels over the

past seven years, the following observations become apparent:

- there is evidence that the over-supply of Shiraz, Cabernet Sauvignon and Merlot *may* have peaked, but there is no evidence that Chardonnay over-supply has peaked
- there is also evidence that over-supply *may* have peaked in warm inland areas (except perhaps Chardonnay), but there is no evidence that over-supply has peaked in cooler climates (particularly in light of 40% drop in export volumes above \$45 per case).

General market outlook very uncertain

The general market conditions remain very uncertain and includes the following features:

- worldwide economic slowdown.
- the value of Australian wine exports falling significantly to major markets UK and USA during the last 12 months (17.3% and 25.4% respectively).¹²
- two of the big three Australian wine companies actively reviewing their asset portfolios
- one of the big three wine companies announcing a 75,000 tonne grape intake cut over next three years
- the absence of a large new export brand growing to 10 million cases within five years, which occurred from 2001
- the large position that New Zealand Sauvignon Blanc now has in the Australian domestic market, and the likelihood of another large New Zealand crop in 2009
- EU moderately reducing production via a vine pull scheme
- California coming out of over-supply
- shortage of white wine in France.

Two key forces that could easily change the current outlook

In addition to the general market conditions listed above, the Australian wine industry remains hostage to two key forces, both outside of its control: water availability and the sudden fall in the Australian dollar. Both have the potential to rapidly and substantially change the current outlook.

Water availability

Water availability seems to no longer be the major constraint on supply that it was thought to be immediately following the 2007 vintage. The larger than expected 2008 winegrape crop, grown despite some of the toughest water restrictions ever, showed us that. But I think it is premature to project the current set of circumstances of sufficient water availability as the new, permanent, paradigm. Water reserves remain critically low in South Eastern Australia and there is absolutely no guarantee that there will be sufficient rain next winter. Extreme rainfall variability is a permanent feature of Australian agriculture¹³ and we could easily experience another low vintage sometime soon, due to drought.

The sudden fall in the Australian dollar

The A\$ rose from lows during 2001 of just under US\$0.50 to peak at almost US\$0.98 on 15 July 2008. But in less than four months, it surrendered most of the gains of the previous *seven* years. The currency fell to a low of under US\$0.61¹⁴ on 27 October 2008 and the fall has been so dramatic, with financial markets so volatile in the interim, that international buyers remain extremely nervous. But with the current exchange rate at under US\$0.70, a fall of over 30% from recent highs, together with the recent falls against the Euro and UK Pound, should it prove to be sustained, will clearly improve the international competitiveness of Australian wine. Things could be much worse if the A\$ went back to above US\$0.90 and I don't think the opportunities presented by a low A\$ have been fully factored into the thinking of market players.

Conclusion

How can all of the above be drawn together to any meaningful conclusions? Quite simply, it is extremely difficult, however, the following key factors will significantly influence the outlook in the Australian bulk wine market:

- 2009 is likely to be another reasonably significant crop, at least similar in size to 2008
- the market for bulk wine has steadily softened since the beginning of 2008 and this is expected to continue
- if grapes are left unharvested in 2009, there is likely to be a disproportionate volume of warmer inland grapes left unpicked
- bulk wine inventories are now dominated by cooler climate wines

- although warm inland bulk volumes are shrinking, their price is falling also
- evidence exists that the over-supply *may* have peaked for warm inland wine, except perhaps Chardonnay
- no evidence exists that over-supply has peaked for cooler climate wine, particularly in light of 40% drop in export volumes above \$45 per case
- the general market outlook remains very uncertain and current assumptions about water availability and Australian dollar could change very rapidly.

So there exist quite a number of competing and conflicting factors to consider when analysing the current Australian bulk wine market. But what is certainly very clear is that we are well entrenched in PK Ruthven's very competitive cost-pressured 10-year horror zone, which commenced around 2001.

Jim Moularadellis is Chief Enthusiasm Officer (CEO) of Austwine, Australia's Bulk Wine Specialists. He was named 2007 Entrepreneur of the Year, Services, for South Australia by Ernst & Young and in 2008 Austwine was announced the winner of the Business SA Agribusiness Award. For the past two years Austwine has been in the top 25 Fast Movers for South Australia, an index of South Australia's Fastest Growing companies. Established in 1993, Jim joined Austwine in 1998 and 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.

EU remains Australia's top trading partner

The EU has maintained its status as Australia's most important trade partner according to a DFAT report 'Composition of Trade Australia 2007-08' released on 25 November. In 2007-08, the EU accounted for 17.1% (\$A82.9bn) of Australia's total trade, followed by China (\$A63bn), Japan (\$A60bn) and the United States (\$A50bn). Two-way trade between the EU and Australia rose 7.8% from 2006-07, comprising \$A63.7bn of merchandise goods trade and \$A19.2bn of services trade. In 2007-08, the EU was the largest source of merchandise and services imports into Australia, accounting for 21.3% (\$A53.6bn) of Australia's total imports. The EU was also the third-largest destination for Australian merchandise exports and largest market for Australian services exports, comprising 12.6% (\$A29.2bn) of Australia's total export trade.

References

- ¹ The next 30 years – are we ready? P.K. Ruthven. Proceedings. Tenth Australian Wine Industry Technical Conference. 1998.
- ² Phil Ruthven is the founder and Chairman of IBISWorld Pty Ltd, a leading Australian business information, forecasting and strategic services company.
- ³ Austwine Bulk Wine Database, 12 December 2008, all volumes for all vintages, regions and varieties, with and without asking price.
- ⁴ *For the seed shall be prosperous; the vine shall give her fruit, and the ground shall give her increase, and the heavens shall give their dew...Zechariah 8:12*
- ⁵ "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.
- ⁶ Riverland Winegrape Growers Association, 19 August 2008, ABC News.
- ⁷ The Australian Government will offer up to \$150,000 as a special exit payment, along with other transitional assistance, to eligible irrigators on 15 hectares or less. Prime Minister of Australia, Joint Media Release with the minister for Climate Change and Water, Penny Wong, New Exit Grant Package to Assist Small-Scale Irrigators, 20 September 2008.
- ⁸ Austwine Bulk Wine Database, 12 December 2008, all volumes for all vintages, regions and varieties, with and without asking price.
- ⁹ Australian Wine and Grape Industry, Cat No. 1329.0, Australian Bureau of Statistics, 28 November 2008.
- ¹⁰ FOB Australian Port. Wine Export Approval Report, November 2008, Australian Wine & Brandy Corporation.
- ¹¹ The top 4 varieties are Chardonnay, Shiraz, Cabernet Sauvignon and Merlot. Austwine Bulk Wine Database, 12 December 2008, all volumes for all vintages, regions and varieties, with and without asking price.
- ¹² Wine Export Approval Report, November 2008, Australian Wine & Brandy Corporation.
- ¹³ Rainfall variability regularly appears in Australian folklore and tradition. For example, set out below is an extract from My Country, by Dorothea Mackellar (1885-1968), first published 100 years ago, in 1908:
*love a sunburnt country,
A land of sweeping plains,
Of ragged mountain ranges,
Of drought and flooding rains.*
- ¹⁴ www.x-rates.com

Tasmania launches cellar door guide

Wine Industry Tasmania (WIT) has launched its 2008/2009 Guide to Tasmania's Wine Routes which it hopes will spearhead increased cellar door visits and sales. The publication features the State's four major wine routes – Tamar Valley, East Coast, North West and South – in one, easy-to-read publication that is small enough (A5) to fit into handbags and pockets.

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