2007: Is there light at the end of the tunnel, or is that just another locomotive coming our way?

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What's happening in the bulk market leading into the 2007 vintage? Could it be that we've reached a pivotal point in the market that signals the end of the current downward leg of the wine industry cycle?

Outlook for the 2007 bulk wine market: The Big 3

Frost. Drought. Water Restrictions. These are the main factors influencing the outlook for bulk wine leading into 2007 vintage.

Frost

Generally speaking, spring frosts have been severe and repeated during a very cold (and dry) spring this year. An example of the extremely cold conditions was snow in parts of Victoria, down to as low as 500m during the second week of November. The frosts have had a major negative impact on 2007 crop potential throughout cool climate[1] Victoria as well as in the Limestone Coast, including Coonawarra and Padthaway. Reports of multiple major frosts in these regions have been common and such repeated frost events have destroyed or severely restricted both primary and secondary bud development in many vineyards. One report has average crop damage assessed at 59% across cool climate Victorian regions.(2) Spring frosts have been generally less severe, but still significant enough to constrain 2007 crop levels, in many other regions across South East Australia.

Drought

The current Australian drought, which has been widely reported in the media, is influencing all wine producing areas as very dry mid-row soil profiles also conspire to restrict 2007 crop potential. The exception is perhaps the MIA where flood irrigation is more common, allowing complete saturation of vineyard root zones. But nothing nourishes vines like good spring rains, which have not been at all common this year.

Water restrictions

As a result of the widespread drought conditions, water restrictions have been declared in many irrigation districts. For example, in South Australia, irrigators are at 60% allocation (at the time of writing) and additional cuts have not been ruled out for either this year or next. Furthermore, even with good to average rains next winter, restrictions are likely to persist into future seasons. In many cases this has presented grape growers with some very difficult choices, such as sacrificing portions of their vineyard in order to keep other, more valuable areas, alive. This is after a couple of very difficult vintages of very low grape prices and unharvested crops due to insufficient demand. Consequently many growers are now struggling for economic survival.

Will the Big 3 lead to price rises for bulk wine?

I foresee the following likely pricing outcomes in the bulk wine market:

- The volumes of bulk wine (and grapes) that have traded at extremely low and unsustainable prices will be severely restricted, to the extent that the bottom 5-15% of current transactions in the bulk wine market will probably disappear. These opportunistic prices have been an irregular, but not uncommon feature of the bulk wine market during the past couple of years
- If the bottom 5-15% of transactions disappear, then it is reasonable to conclude that average prices will rise
- However this does not necessarily translate to price rises for individual existing bulk wine programs or an end to aggressive retail discounts or cheap cleanskins. There is still plenty of bulk wine stock in the system in order for average prices to stay generally low for some time yet. But looking ahead to 2008, I think there will be increased pressure for price increases, particularly if the 2008 vintage is also restricted by the same factors that are restricting the 2007 vintage
- The exception is generally isolated increases in bulk prices in those regions that have been most severely hit by frosts. Such rises will be tempered by existing (relatively abundant) inventory levels in such regions and generally in the market.

Other likely developments arising from the Big 3

There is currently significant uncertainty about the 2007 vintage and at least some uncertainty about 2008 vintage.

During the past three years there has been a great tendency for buyers to delay bulk wine purchases until the very last moment. Why? Two reasons: Firstly, because they could, secure in the knowledge that their target wine was unlikely to be sold, and if it was sold, there was plenty of other wine to choose from. Secondly, because they wanted to avoid the possibility of sustaining losses in a deflationary wine market and so they worked to minimise stock holdings. In short, to use share market terminology, the bears were in control and the bulls were nowhere to be seen.

In the last month or two, I have detected a shift in sentiment as buyers re-assess their positions in light of the possibility of reduced stock abundance over the next year or so. This means that buyers are beginning to plan further ahead to ensure their positions are better covered – for example securing, say, 6-12 months of stock rather than, say, 3-6 months of stock. And this generates inquiry activity in the bulk market, which in turn signals a strengthening market to sellers.

This is the demand side analysis and I think buyers may be displaying a slight overreaction: Our inventory at the time of writing was 106 million litres and this time last year it was 102 million litres. No significant difference in this fundamental indicator.

However, some sellers will point to the increased activity from buyers who are securing their stock needs for longer periods, together with the possibility of a short 2007 vintage and increase their prices too early and by too much. So they may miss potential sales and then be stuck with unsold wine. Put another way, if a seller feels that the market is now tighter at, say, $1.00 per litre, they may overreact and increase their prices to (the equivalent indicative price of, say) $1.20 per litre. At this increased price, my view is that the market will be long. This is the supply side analysis.

Return on bulk wine is highest when bulk wine is scarce, but right now there are few varieties that are scarce. In fact, for the past 5-6 years bulk wine has generally not been scarce at all and a shorter 2007 vintage is unlikely to change that. A shorter 2008 vintage is more likely to change some of the market fundamentals, but 2008 is quite some time away yet.

In summary, I think that buyers will not be adequately rewarded for the risks of taking longer bulk wine positions and sellers will not be adequately rewarded for becoming overly or prematurely bullish.

Don't bank on price rises

It is a brave winery proprietor who budgets for general or widespread prices rises during the next 12 months. Let's examine the last time our industry was in a downturn for some clues on what or how price rises might occur:

15 years ago in 1992 the Australian wine grape crush was just 636,000 tonnes – about 1/3 of last year's crush. Furthermore, in 1992 the Australian wine industry exported 1 in 5 litres of production, compared to almost 2 litres exported to every 1 litre sold domestically now; and supermarkets were an important, but

not overwhelming, route to market for wine such as they are now in Australia.

These 2 key developments are critical for us to assess the likelihood of sustained wine price rises being achieved in the short to medium term.

1992: 1 in 5 litres exported
2007: 2 to 1 litres exported

In Australia, local producers have a strong hold on the local market and consumers can choose wine from a wide array of Australian grape growing regions which, usually, are all at a similar point in the wine industry cycle. This means that when you are long on Chardonnay, most other Australian wine producers are too, and you can expect aggressive discounting. But when you emerge from oversupply, so do your competitor wineries, and the aggressive discounting subsides and steady price rises are indeed possible.

In our main export markets, by contrast, competing producer countries tend to be at different points in the industry cycle at any one time. Invariably those producer countries with the best value for money tend to be in oversupply, and consumers seem to be equally happy to drink wine from Australia one day and wine from Chile or Spain the next. Thus consumers tend to bias their choices from those countries that offer the best value for money proposition at any one time. Therefore our major export markets tend to exhibit much higher substitutability than the Australian market and this means higher levels of price competition.

Now that such a much big proportion of our overall sales pie is represented by markets with high substitutability. This means that we will in fact be under constant pricing pressure in future in our export markets due to other producer countries coming into oversupply when we emerge.

1992: Australian supermarkets an important route to market
2007: Australian supermarkets dominate the route to market

The way that wine is sold has really been revolutionised by the major retailers here in Australia. In the past, wine has been about brands, image and price points. The ability of producers to extract a pricing premium when the industry cycle turned from oversupply to undersupply, based on limited international competition and brand equity, has also been significantly eroded by the strong negotiating power of the major retail chains. These chains are intent on sharing pricing premiums that would otherwise flow to producers between their shareholders and customers.

Furthermore, retailers now have great purchasing power and resources. It does not take too much imagination to see that they could move to internationalise their product offering in the Australian wine market (through significant imports) as protection against sustained local producer price rises. Of course, consumers will have a major influence in the outcome of this rather bold, but not wild, prediction.

Whilst the lessons from history are very important, the world is a very different place now compared to 1992 – for example, the internet, mobile phones, the rise of China & India, globalisation and 9/11. So we must adjust our business strategies according to the current marketplace realities because, "if past history was all there was to the game, the richest people would be librarians" (3)

In summary, as an industry, I think our overall pricing power has been irrevocably reduced by our high exposure to international markets with high substitutability and the increased power of the major retailers here at home. Therefore price rises will be much harder to come by this time around than compared to 1992.

What's Hot: What varieties are currently in greatest demand?

The varieties that are in greatest demand in the bulk market are Sauvignon Blanc, Pinot Noir and Pinot Gris.

On a recent road trip to the three main warm inland regions (Griffith, Mildura & SA Riverland), almost all the people I met inquired after these varieties. While such demand is currently strong, it is difficult to assess the underlying demand at the retail and consumer level since the production volume of these varieties is tiny. For example, in 2006, less than 40,000 tonnes each of Sauvignon Blanc and Pinot Noir were crushed, each representing about 2% of the Australian wine grape crop in 2006. Pinot Gris was even smaller, at less than 10,000 tonnes or about 0.5% of the crop. The size of these three hot varieties compared to the overall 2006 wine grape crush can be seen in Fig.1.

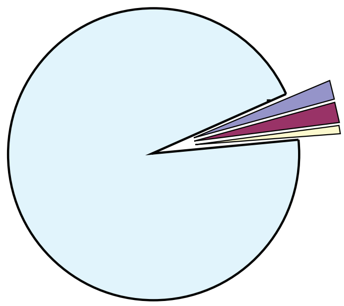

Fig.1.

I suspect that not an insignificant proportion of our current inquiry for the smallest of these varieties, Pinot Gris, is to feed inter-winery demand. This often serves to amplify apparent consumer demand, so we need to be cautious against drawing too many conclusions about the long term demand for it. Pinot Gris is a very small part of the total crush and a relatively small planting burst could easily overwhelm underlying consumer demand.

It may sound odd but by far the varieties in greatest demand are those that are the largest: Shiraz, Chardonnay, Cabernet Sauvignon and Merlot, which between them accounted for two thirds of the 2006 crop. But, simply put, current supply exceeds current demand for these varieties (frost, drought & water restrictions aside), so we tend not to think about them in terms of greatest demand. This is particularly so when we consider that much of this oversupply is from the large plantings that occurred in the late 1990's which were concentrated in cooler climates, where 40% of supply is trying to squeeze into 20% of the market opportunity and much economic pain is being felt. ▶

Conclusion

To summarise, I have taken a few words from Richard Bernstein (4) when asked about his views on when a stock market might reach bottom. His rather blunt reply was: “Frankly, when investors stop asking the question.” If he doesn’t know how to pick the bottom of a market, I certainly can’t figure it out. The light at the end of the tunnel may well be just another locomotive, so it would be wise to plan for both eventualities.

But what I do know is this:

- Frost, drought & water restrictions will restrict the size of the 2007 vintage, and possibly even the 2008 vintage to some extent
- Transactions at bargain prices for bulk wine and grapes will be diminished, leading to a rise in the average price of bulk wine and grapes
- Apart from some isolated regional exceptions, general price rises for bulk wine are much less certain
- Our wine market environment is very different now compared to the last wine market downturn, due to the dominance of wine exports and local supermarket retailers, both of which will exert continued downward pricing pressure
- Sauvignon Blanc, Pinot Noir and Pinot Gris are currently hot, but they represent just a tiny proportion of the overall wine grape crush.

References

(1) 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.

(2) The Australian & New Zealand Grapegrower & Winemaker magazine, November 2006, p.11

(3) Warren Buffett, investor & the worlds 2nd richest man.

(4) Richard Bernstein, Chief U.S. Strategist & Chief Quantitative Strategist, Merrill Lynch.

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USA: imports without Yellow Tail

Mary-Colleen Tinney

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New data shows just how much of an impact W. J. Deutsch’s Australian brand Yellow Tail has on the overall ACNielsen-tracked food stores segment. While Australian imports, excluding Yellow Tail, have grown 49% between October 2003 and May 2006, Yellow Tail on its own has grown by 90% in the same time frame.

Although the Australian market is healthy with or without Yellow Tail’s influence, it would not be the force it is today without the brand. Yellow Tail, which encompasses several different varietals, and now includes a higher-priced Reserve line, accounts for 39% of the total Australian market in the food store segment. Australian wines account for about 9% of all imported wine volume versus a total imported wine sales volume of 20% (in the ACNielsen channel).

Total Australian imports claim a volume market share of 9%, but if Yellow Tail were to be excluded, this figure would drop to 5%. Italian wines, which have a 6% market share and a healthy 8% growth rate, would be the imported wine leader if Yellow Tail were removed from the equation.

Yellow Tail’s success has been well documented. In November 2005, W. J. Deutsch announced that they had sold one million cases of Yellow Tail in a single month, the first varietal wine brand in industry history to accomplish the feat. This was a phenomenal achievement for a brand that hadn’t even been introduced until 2001, making its introduction into the US market the most successful wine brand launch in history.

“It’s also successful in many other countries, too,” noted Jon Fredrikson of Gomberg, Fredrikson & Associates. “It had a wonderful run because it happened to hit the right nerves with consumers. It’s a combination of the packaging, the name, the distinctive font they used on the package, and the value that it offers consumers. It has grown very rapidly in the UK and Canada; it’s very unusual that a brand hits it off well in more than one country and in multiple different channels at the same time. There’s a lot in the inherent nature of that name and packaging that really attracts consumers around the world.”

The brand’s popularity crosses several consumer retail segments. At a recent Channel Blurring Summit hosted by ACNielsen in Napa, California, Danny Brager, vice president client service, beverage alcohol, told attendees that Yellow Tail is the only brand to appear in the top 12 wine brands sold in each of the following channels: grocery, natural grocery, convenience, drug and liquor stores. Grocery and liquor stores combined account for about 75 percent of the dollar sales in off-premise wine channels.

Does Yellow Tail’s success hurt higher-priced Australian wines?

The success of Yellow Tail has been a bit of a double-edged sword for Australian wines overall. While consumers around the world have been exposed to a quality wine at a good value, there is a concern that American consumers might not accept Australian wine at higher price points.

“I would argue that Yellow Tail has been a wonderful courier or messenger to talk to Americans about wines from Australia, but only at $6 to $8 a bottle,” said Peter Click, CEO of Click Wine Group, importers of an array of premium and boutique Australian wine brands (including Jackaroo, 2 up and Dalwhinnie, as well as brands such as Fat Bastard from France and Bootleg from Italy). “What Yellow Tail has done [in the marketplace] is very positive, but the danger is that Americans perceive Australian wine as homogenised, and it absolutely is not. We have to be careful and diligent, those of us who specialise in high-quality wines with a sense of place, that we are voicing that in the marketplace.”

Fredrikson feels that Yellow Tail’s impact may be felt more in price category than country of origin. “Yellow Tail has an effect