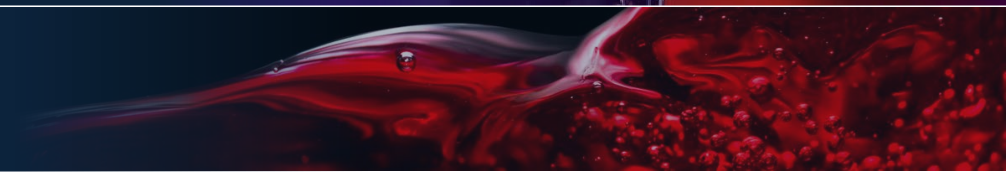
Wine Industry Insights

Key Emerging Issues – July 2022



State of the Market

i. National

The Australian wine industry continues to grapple with the demise of the China export market. While not all producers were directly impacted, gradually the whole Australian industry is coming under pressure due to a myriad of factors including; decreased consumption internationally, increased input costs to vineyards, COVID causing labour shortages, supply chain and logistics disruptions and increased cost of dry-goods. These factors are exacerbated by a red wine oversupply.

Most wineries are reporting tanks are full following a record Vintage 21, which saw prices rise for grapes to over $700 per tonne on average. However, this fell by 10 percent to $630 per tonne on average for Vintage 22 assuming a purchaser was able to be secured.

Vintage 22 is now complete and according to the Wine Australia National Vintage Report released on 5 July 2022, despite some regions experiencing above average rainfall causing grapevine bud loss and disease, a total crop of c.1.73m tonnes was achieved, which is 2 percent below the 10-year average and 13.5 percent below the record Vintage 21. Quality was reported as good to exceptional because of the long, slow summer providing ideal growing and ripening conditions resulting in an unusually late finish to vintage.

Cool climate white varieties including Sauvignon Blanc, Chardonnay and Pinot Gris/Grigio remain in high demand along with Pinot Noir.

Traditional red varietals like Shiraz and Cabernet Sauvignon (which together accounted for c.40 percent of Australia's total grape crush in Vintage 22) are in oversupply emanating from the demise of the China export market and the lack of demand or contracts, especially in the inland irrigated wine regions, causing many grape growers to drop their fruit for Vintage 22. Those overweighted to Shiraz and Cabernet Sauvignon will experience some distress with vineyard valuations in certain regions almost certain to fall. This may have been a trigger for Casella Wines recently offering a substantial portion of its vineyards (c 7,500 ha of land) for sale, although in doing so it is also reducing the agricultural risk of being a producer, a path already trod by the other major wine companies in Australia which compete with Casella.

ii. International

As the sun moves to the Northern Hemisphere, European countries such as France, Spain and Italy are all enjoying favourable growing conditions with minimal frost events noted in France (compared to 2021 where yields were down 27 percent on average) and good rainfall in Spain negating the drought. Californian vineyards (mainly Cabernet Sauvignon) are continuing to feel pressure due to ongoing drought conditions.

There is a slowdown in consumption across the majority of global export markets which is affecting the supply and demand balance of global wine supplies, leading to a softening of bulk wine prices in global markets. This decrease in consumption and demand is exacerbated by higher production costs at vineyards and increasing dry goods (glass and packaging) and logistics costs.

Australia v International Bulk Wine Pricing

At a global level (taking the eight largest producers of bulk wine internationally which accounts for over 75 percent of global wine production), red bulk wine prices have been stable with the average price rising from $0.81/litre to $0.84/litre.

White bulk wine prices over the same period have risen from an average of $0.73/litre to just under $0.94/litre.

When we look closer at the Australian bulk wine market (refer table 1), since approximately mid-2020, Australian red bulk wine prices have halved from nearly $1/litre to under $0.50/litre (as compared to an average cost/litre to produce in the range of $1/litre to $1.10/litre).

This decline reflects the severe oversupply of mainly Shiraz and Cabernet Sauvignon in Australia and producers exposed to these varietals and who are reliant on export markets, are producing wine at a significant loss.

Other countries, such as Chile who are increasing production to meet global demand especially in China, have a lower cost of production than Australia and therefore not as exposed to losses on production from tight bulk wine pricing.

White varietals (refer table 2) have improved markedly since mid-2020 to date with prices increasing over $0.20/litre. As KPMG has previously reported, coming off years of drought with white wine inventory levels being near record lows, Australian producers have had the fortune of benefitting from strong domestic vintages in 2021 and 2022 with New Zealand down c.30 percent in Vintage 21 and frost affecting Vintage 21 in France, Argentina and Chile (where the bulk price has increased due to local shortages in certain varietals).

Table 1: Red Wine Price Comparison - August 2020 against May 2022

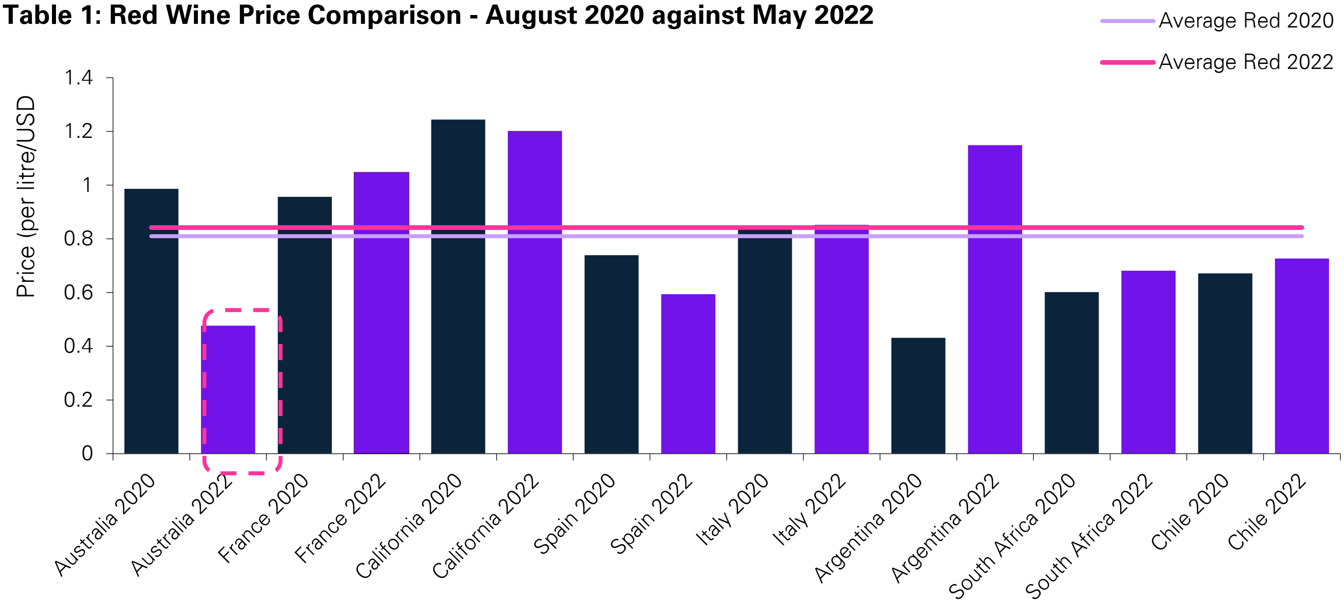
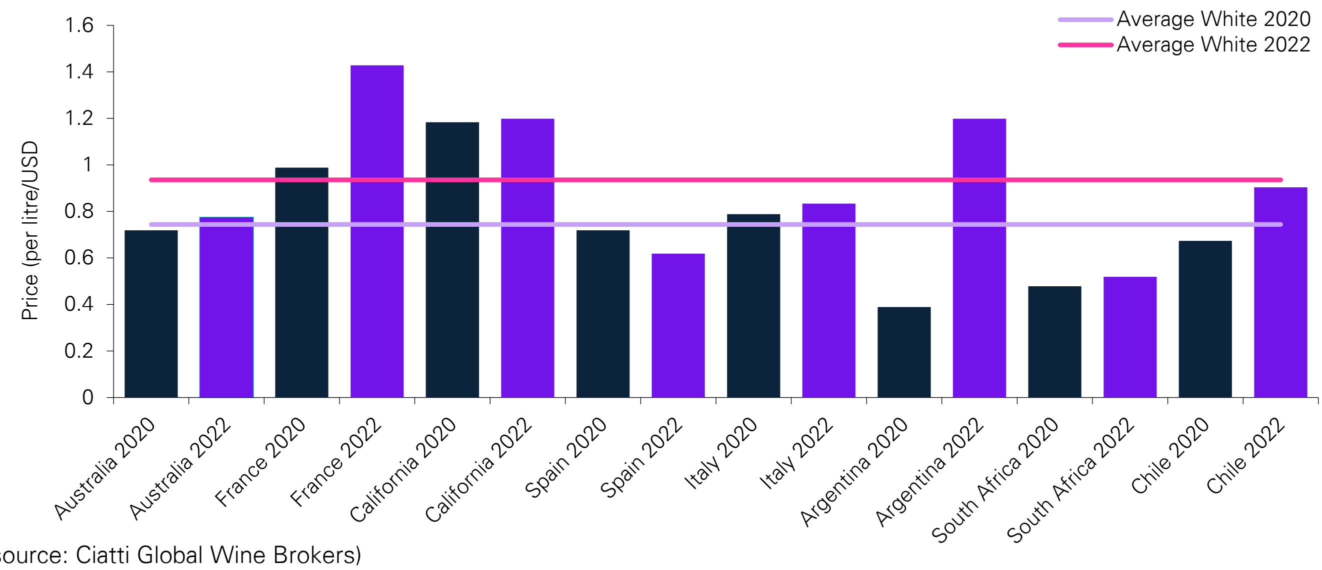


Table 2: White Wine Price Comparison - August 2020 against May 2022



(source: Ciatti Global Wine Brokers)

Australian Wine Industry – Exports declining

The rapid demise of the China market continues to weigh heavily on the export results. In the 12 months 1 April 2021 to 30 April 2022, being post China tariff introduction in November 2020, total exports declined from $2.77 billion to $2.05 billion (or by 26 percent). Australia's two biggest markets United Kingdom (UK) and United States (US) declined in volume and value for varying reasons after periods of intermittent growth.

Notwithstanding the fanfare accompanying the announcement of a UK free trade agreement (FTA) and elimination of tariffs, the reality on the ground is that it remains a tough market to preserve reasonable margins in light of the bargaining power of the major supermarket buyers there through which most Australian wine is sold. There have been some gains in the on-premise environment at premium price points for some exporters but off a small base. The US remains a tough nut to crack with some gains at premium price points.

Overall, the export volume alone is down 628 million litres which is more than Australia's annual domestic consumption which is now up c.20 percent from pre-COVID levels to c.500 million litres (or 40 percent of Australia's average wine production). When coupled with the equivalent domestic consumption produced but unsold from Vintage 21 (refer our industry update in August 2021), means there should be at least 2 times the annual domestic consumption currently sitting in tanks without a consumer. It's impractical to store commercial red wine for the medium to longer term and hope the industry turns around and establishing new tank storage for most is unaffordable in the current market.

Maintaining relevance to China

Market leaders including Treasury Wine Estates (Rawson's Retreat and Penfolds brands) and Casella (Yellow Tail) have looked outside local shores to ensure they remain relevant to the China market with solutions to continue supply major brands into the country:

- Casella will source grapes from Chile to supply Yellow Tail to China (import tariff free due to Chile's FTA vs 160.2 percent tariff on Australian production) by going to market as Yellow Tail World Series.
- Treasury Wines brand Rawson's Retreat will be made in South Africa (at an import tariff of 14 percent vs 169.3 percent on Australian production).
- Flagship Penfolds is set to launch a portfolio of wine grown and produced in China, relying on the integrity of the Penfolds brand to gain local support.

Consumers move to premiumisation in liquor retail

An outcome of COVID is that domestic consumption increased including price/bottle spend, creating a pause (for how long is unknown) in the discount cycle of the major liquor retailers. Further, consumer taste and preferences continue to mature and develop with many wine drinkers looking for more than just a well-known label or brand and a sub-$12 bottle of wine. Whether it be the story behind the winemaker, the vineyard, the boutique winery, the region, or; confirmation the grapes are organic, biodynamic, from a single vineyard, cool climate, alternate varietals; rare finds are driving the modern consumers tastes and buying habits. And they are happy to pay a premium for it.

In response, Australia's largest liquor retailer Endeavour Group (Dan Murphy's) has recently opened its first premium wine store, with sommeliers on staff and wine being marketed as stored at a constant 17 degrees celsius.

The notion of higher spend/bottle and lack of discounting is also driving M&A activity in the sector (and enabling a family succession exit where desired) as larger wine businesses continue to seek to build their brand portfolio and major retailers like Endeavour Group drive a vertical integration strategy and grow premium wine production capability (eg recent acquisition of Josef Chromy in Tasmania for instance) to deliver on a private label growth strategy. This strategy may start to put the squeeze on shelf space for those medium to small wine businesses within the major domestic retailers. Only time will tell.

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