Wine Industry Insights

Key Emerging Issues August 2023

Wine Australia has released its much-anticipated 2023 Australian wine grape vintage report and latest export report for the 12 months to 30 June 2023. KPMG Australia unpacks the supply and demand effects on the Australian wine industry, considers why the lower 2023 yield hasn't helped the current oversupply of red wine domestically and globally, and provides a general outlook for the industry in the short to medium term.

PART 1 – SUPPLY

Australian Wine Production

Background

The Australian wine industry is broadly split into two categories – the commercial sector and the premium sector.

The commercial sector which largely comprises the warm inland irrigated wine regions - Riverland (SA), Murray Darling/Swan Hill (VIC/NSW) and Riverina (NSW) – and accounts for ~68% of the national wine grape crush. The enduring hallmark of the commercial sector over the past few decades, notwithstanding the cyclical peaks and troughs, has been its ability to deliver significant volumes of fruit/wine of consistent quality at certain price points to large retail outlets in key export markets (notably the UK and the US).

The scale of operations and mechanisation has enabled costs of production to be controlled to allow the supply chain to share the margins to deliver sufficient returns. However, given ever increasing input costs, the continued bargaining strength of global retailers and the rise of alternative sources of supply, the sector's global competitiveness is being increasingly challenged.

The premium sector which consists of cool/temperate climate grape growing regions including the Barossa Valley (SA), Yarra Valley (VIC), Hunter Valley (NSW) and Margaret River (WA) accounts for ~32% of the national wine grape crush by volume but significantly more by value. Businesses within these regions cut across the tourism and hospitality sectors with visitor traffic to cellar doors being an important driver of returns along with other traditional sales channels.

[1] per Wine Australia [2] per NAB

For many of the premium or cool climate regions that were not overly dependent on China, supply in recent years has been short and reasonable returns achieved especially with the rise of domestic regional travel during the pandemic period driving a temporary uplift in high margin direct to consumer sales. This has since softened as travel patterns have normalised and cost of living pressures have impacted visitor numbers.

By its nature, including the shift toward premiumisation being driven by consumer demand, the premium cool/temperate regions command higher price per tonne for grapes produced than the commercial warm inland regions as shown in Table 1 below:

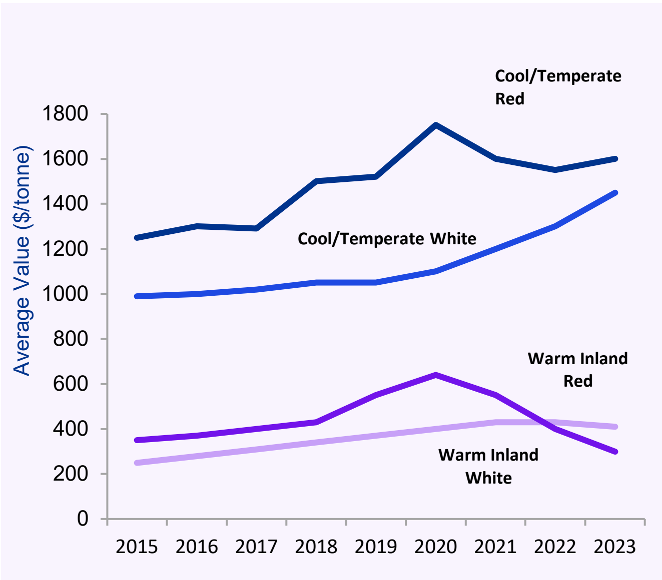


Table 1 – Australian wine grape average price per tonne Source: Wine Australia

The Australian wine industry over the last two years, in particular the commercial sector growing regions, have been severely impacted by the five-year tariffs imposed by China (which halted all bottled wine exports from Australia), the ongoing impact of COVID-19 (supply chain, costs, current economic environment of reduced consumer spending and falling global consumer wine consumption) and changing consumer taste trends away from commercial wines toward premiumisation.

Despite the push to premiumisation, producers of 'heavy reds' varietals such as Shiraz, Cabernet Sauvignon and Merlot, in both commercial and premium sectors have been impacted, particularly those without a strong brand presence or heavily focused on the China market.

The resulting challenge of the decline in total sales for the Australian wine sector is two-fold to:

01 Reduce the current total inventory level back to the **10-year average** of **~1.84 billion litres** by a reduction of over **~0.4 billion litres**

02 Sustain a balance between future **supply and demand.**

Vineyards

The total vineyard area, based on the most recent 2022 data, is said to be 146,244 ha, of which South Australia accounts for ~52%, New South Wales ~24% and Victoria ~15%. While no certainty, anecdotal evidence suggests total planted hectares is anticipated to decline in the coming years.[1]

One of the key factors relevant to an anticipated decline is vineyard removals as producers seek the most economical use of land (e.g. replacing wine grapes with other permanent plantings/horticulture especially on land with secure water supply). We have seen that the French Government has recently supported a vine-pull scheme in Bordeaux which will allow approximately 9,500 hectares of vineyards of the total 108,000 hectares in the region to be pulled as part of its efforts to cut the continued overproduction, as well as committing additional funds in August 2023 to bolster a European Union USD$172 million funding from June 2023 to destroy nearly 302 million litres of surplus bulk wine.

Although there is speculation occasionally that similar initiatives should be replicated in Australia, this is considered extremely unlikely as many recall how such schemes have been operated in the past (notably the Barossa in the 1980's).

Vintage 2023

The 2023 Australian wine grape crush is reportedly estimated to be 1.32 million tonnes, 26% lower (or 325 million litres of wine equivalent) than the 10-year average of 1.78 million tonnes and 24% below Vintage 2022. Over the last ten years, Australia's warm inland irrigated wine regions have produced an average of 74% of Australia's annual grape crush, most of which was for the commercial wine segment.[1]

Vintage 2023 was impacted by above-average rainfall (wettest year since 2011), as well as below-average temperatures (coolest year since 2012). Certain regions struggled to recover from heavy rainfalls at the commencement of vintage resulting in disease pressure, particularly downy mildew, at a time when the cost of inputs to help manage disease had increased substantially for grape growers who, in many cases, were already stressed financially. Furthermore, cooler weather frustrated certain regions causing delayed ripening with some fruit failing to ripen to desired baumé levels.

While a lower yield was thought necessary to address the current (red) oversupply, it hasn't entirely helped. This is because red wine is reportedly 54% (down from 55% in 2022) of the crush yet white wine (supply balanced) was also hit hard, down 22% from 2022 to 46% share of total Vintage 2023 crush.

This is consistent with global producers, in particular the US, where there are large holdings of Cabernet Sauvignon that are still in tank heading into the Northern Hemisphere vintage.

Inventory pressures leading into Vintage 2023 resulted in some yield caps being imposed on grape growers by wineries, uncontracted grapes not being sold and/or vineyards being temporarily taken out of production (with large volumes of fruit reportedly dropped to the ground across the warm inland wine regions), which further reduced the size of the crush.

It is unknown what share of the overall reduction (compared with an average vintage) can be attributed to these inventory pressures as opposed to the seasonal conditions. However, as white wine grapes (which are in higher demand) were reduced by a similar percentage to red wine grapes, and that the decrease in the crush of winery grown grapes was higher in percentage terms than the crush of purchased grapes, it is highly indicative that seasonal effects were the main contributor to the lower crush.[1]

This means winemakers will restrict intake of red wine grapes (especially the 'heavy reds') again in 2024. As such, grape growers, especially in the inland regions, must react now to the real prospect they may not have a customer/income in 2024 or, if they do, it is unlikely they will recover the cost of production, which will be much higher than the likely grape price (especially for the 'heavy reds') to be offered by wineries. Grape growers should now be managing costs, considering mothballing vineyards and seeking appropriate advice.

[1] per Wine Australia [2] per NAB

The current balance of white wine is primarily due to the lower yield from Vintage 2023, stemming from weather events. If normal production levels were achieved in Vintage 2023, we expect that white wine would also be experiencing an oversupply. The white wine balance over the last few years was predominantly due to the lower-than-average Vintage 2021 in New Zealand (primarily a white wine/Sauvignon Blanc growing country), which assisted with balancing the Australian whites during the golden vintage of 2021 – particularly Sauvignon Blanc.

Given the current market dynamics and changing climate, those grape growers who have balance sheets (or access to debt funding/equity investment) that can support such an investment might consider a regrafting programme for vineyards planted with 'heavy reds' to lighter style red or white wine grape varietals.

We are aware some wineries are financially incentivising their grower base to pivot a portion of production from red wine grapes to white wine grapes. Whilst this will help rebalance the mix between red and white wine grape supply, without export growth (or the China market reopening) and assuming a normal season, both red and white grapes would be in oversupply.

Inventory Levels

From 2010 to 2017 there was almost no change in inventory levels at the end of each year, indicating almost perfect balance between supply and demand. Between 2018 and 2020 there was a net decrease in inventory levels each year, as sales exceeded production by an increasing margin each year, off the back of strong demand from China. This however was not sustainable without an increase in production or a major decrease in domestic sales, as stocks were being further drawn down.[1]

In 2021 and 2022 (and expected in 2023 despite the lower production), there was a significant increase in inventory levels, as production exceeded sales in both years as the China export market for bottled wine evaporated due to tariffs.

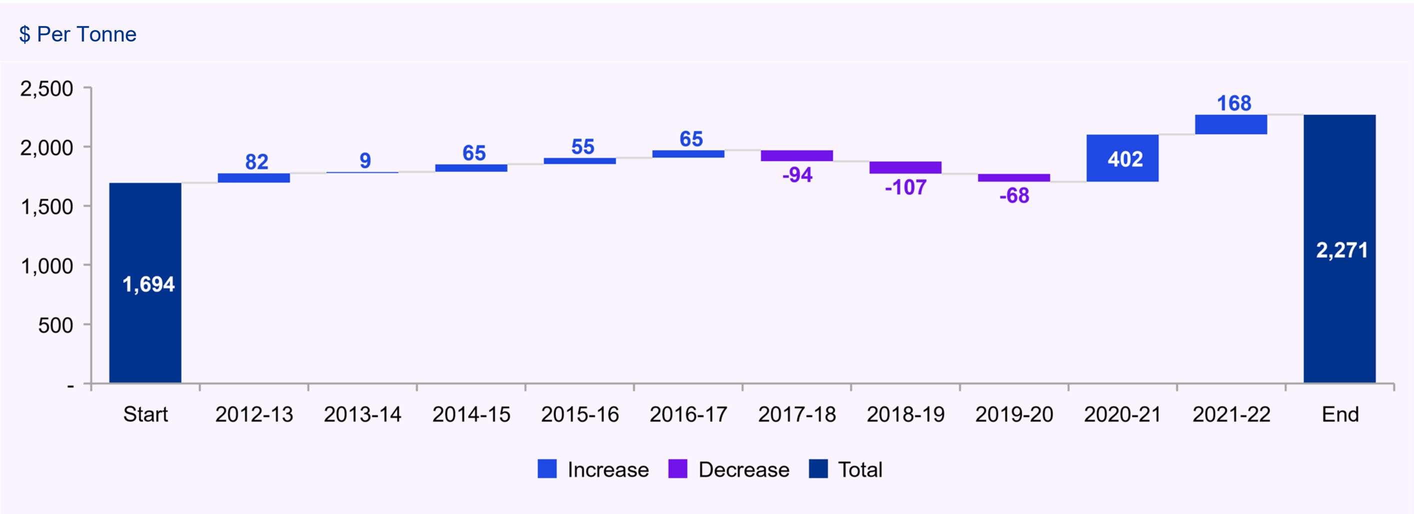
This left wine inventory at 2.2 billion litres as of 30 June 2022 (see Table 2 – 30 June 2023 inventory holdings will be reported later this year), significantly higher than it has been at any time in the past 15 years.[1]

Average annual wine production over the past 15 years has been 1.24 billion litres. Domestic sales volume has remained largely static at approximately 500 million litres. This leaves an average amount available for export of 744 million litres, which exactly matches average exports over the past 15 years, but is ~17% higher than exports for the 12 months to 30 June 2023.[1]

Consequently, the three warm inland wine regions in particular are suffering from write-downs of red bulk wine from cool/temperate regions at lower than warm/inland region prices, which is displacing inland produced fruit.[1] We note this occurred during the last period of oversupply.

As storage was tight (due to the current oversupply of red wine) in the lead up to and following Vintage 2023, many wineries with contract wine in tank may be having some difficult conversations related to the removal of contracted wine in tank that has little prospect of sale.[1] Those wineries with bulk wine stored in third party tanks may therefore be forced to come up with an alternative storage solution (and incur the cost of same subject to them meeting the cost of storage) otherwise having to walk away from bulk wine inventory.

Given the structural oversupply of red wine, the only solution in the medium to longer term is to grow less fruit, especially traditional 'heavy reds' like Shiraz and Cabernet Sauvignon which together account for ~40% of Australia's total wine grape crush in Vintage 2023. We know, however, historically the supply base has been sticky and is slow to react despite strong adverse market signals.[1] This also assumes no change to the China export market position which we explore in Part 2 of this series.



[1] Table 2 – Australian wine inventory Source: Wine Australia

[1] per Wine Australia [2] per NAB

PART 2 – DEMAND

Australian Wine Consumption

China Market

Before the imposition of the tariffs on Australian wine, the China export market for Australian wine peaked at ~$1.28 billion in value equating to ~140 million litres of (almost entirely red) wine for the 12 months to 31 December 2019. Presently, wine exports to mainland China for the 12 months to 30 June 2023 only equates to ~1 million litres or ~$8.1 million in value.

Whilst China trade relations have shown recent signs of improvement with reports indicating tariffs on certain other commodities are starting to be relaxed (including most recently tariffs on Australian barley) and a Wine Australia delegation attending the International Conference on Grape and Wine Industries in Ningxia, China, in June 2023 by invitation from China's Ministry of Agriculture and Rural Affairs, there has been no such announcement or formal indication of a relaxation of tariffs on bottled wine.

Though these events represent significant steps on the journey to resuming unfettered bilateral trade, Australian wine producers must tread cautiously and not commit the same mistake as a sector by becoming over reliant on one export market for prosperity. Many producers off the back of the recent events will have commenced planning a strategy to re-enter the China market with Australian wine if China removes its tariffs, however, the market will not return to the levels seen in 2016-2019. Furthermore, considering the extent producers have been able to pivot to, or develop new export markets, they should not be working to re-enter the China market at the cost of supplying other markets, particularly in Asia.

In sounding this warning, it is worth noting that the consumption of wine in China has been in decline for the past 10 years and the wine market there is in decline (see Table 3).

This means that when the tariffs on bottled wine are removed or eased, re-establishing markets in China may not be as straightforward as Australian wine producers envisage, especially as Australia will be competing with rival producers, such as France and Chile who, in Australia's absence, have established a strong market share (as the top two exporters of wine into China with a combined value of ~USD$1 billion).

Consumer preferences towards wine may have also changed in China that is consistent with trends seen in other markets. Anecdotally, we are hearing consumers in China are moving away from wine towards spirits (especially whiskey). As such, the China market should not be assumed as being the same as when Australia held the majority market share (ie pre-2020), which means it may take some time for Australian producers to regain meaningful share of the China wine market.

Australian Wine Exports

The total value and volume of Australian wine exports declined substantially in the 12-month period to 30 June 2023, with value falling 10% to ~$1.87 billion and volume declining 1% to ~621 million litres[1] (or a decline of ~$1.04 billion (or 36%) in value and ~123 million litres (or 17%) in volume since 31 December 2019).

The 31 December 2019 wine export numbers included Hong Kong in the China numbers, whereas the latest 30 June 2023 wine export numbers report Hong Kong separately as the special administrative region (like Singapore) has become a trading hub for Australian wine where export levels can vary depending on the exporters business practices[1].

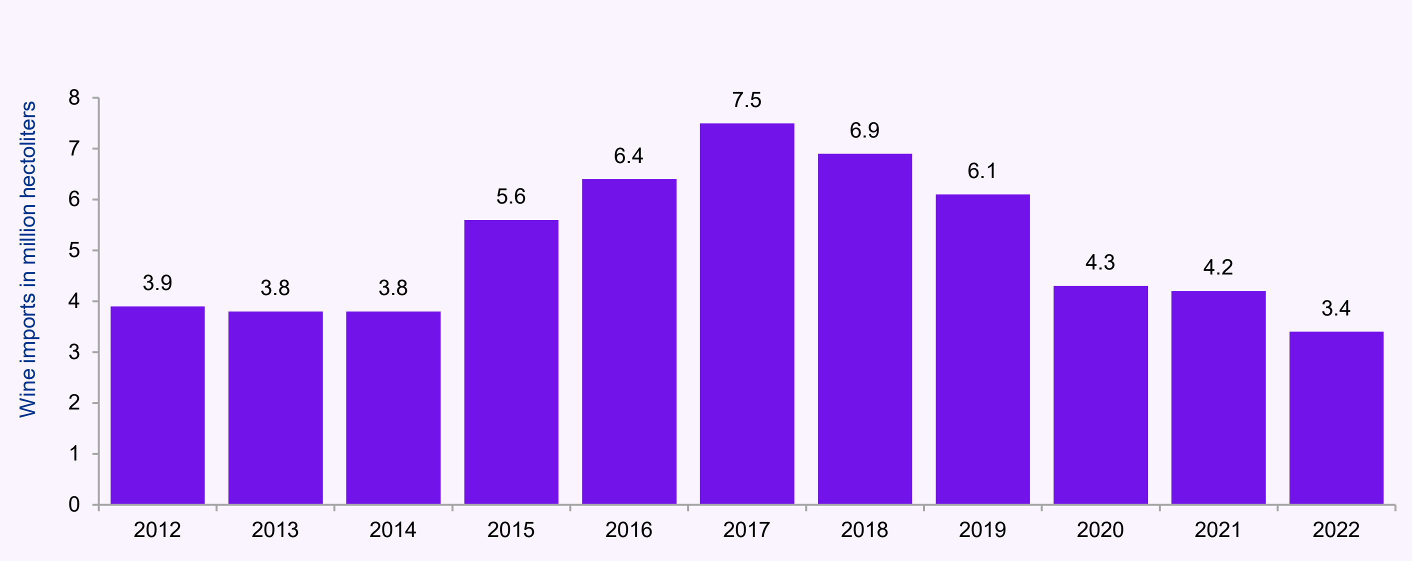


Table 3 – Volume of wine imports to China from 2012 to 2022 Source: Statista (https://www.statista.com/statistics/791338/china-wine-imports-volume/)

[1] per Wine Australia [2] per NAB

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For the 12 months to 30 June 2023, wine exports to Hong Kong were ~$220 million and ~8 million litres, meaning that the loss in exports since 31 December 2019 effectively represents almost entirely the lost mainland China export market in terms of value with marginal net volume growth (~9 million litres) across all other export markets.

The main driver of the decline in value for the 12 months to 30 June 2023 was exports to the US, which is experiencing structural decline in the lower priced commercial wine price segments where Australian wine is predominantly sold in that market.[1] Furthermore, the UK market for Australian wine has been in decline for similar reasons and the commencement of the additional alcohol duty on wine from 1 August 2023 (off setting any benefits from the post-Brexit free trade agreement commencing from 31 May 2023) means the export performance to the UK is unlikely to recover in the short term.

The challenge for the Australian wine industry is that against this backdrop, the UK and US are Australia's two largest wine export markets (see Table 4) by value (~$0.7 billion or 39% of total wine exports) and volume (~355 million litres or ~57% of total wine exports). Structural decline in these two markets will be challenging to replace in other export markets and will only contribute to a worsening structural oversupply of wine in Australia, unless the mainland China market was to reopen in some form.

Impact of FX on Export

A key variable impacting the growth or decline of Australian wine exports is the exchange rate. With a lower and favourable Australian dollar, Australia's wine exports are more internationally competitive from a price perspective and thus are likely to experience growth. A clear example of the correlation between export growth and the exchange rate was seen in 2011 to 2013 when the AUD/USD pair reached parity and remained above AUD$0.90 for much of 2014. This exchange rate led to total exports declining ~8% in value and ~5% in volume (2011-2014). Export to the US in particular was severely impacted, with export value declining ~18% from 2011 to 2015.

The Australian dollar is forecast by NAB to reach AUD$0.74 by December 2024, a ~12% rise from the time of writing (AUD$0.65 to AUD$0.74).[2] Historical evidence suggests such an upward movement would result in a further decline in Australian wine exports in the short-term, with cheaper commercial wines likely being the category hit harder than premium wines, as premium wines have fewer substitutes and consumers are less price sensitive, hence the lesser impact.[1]

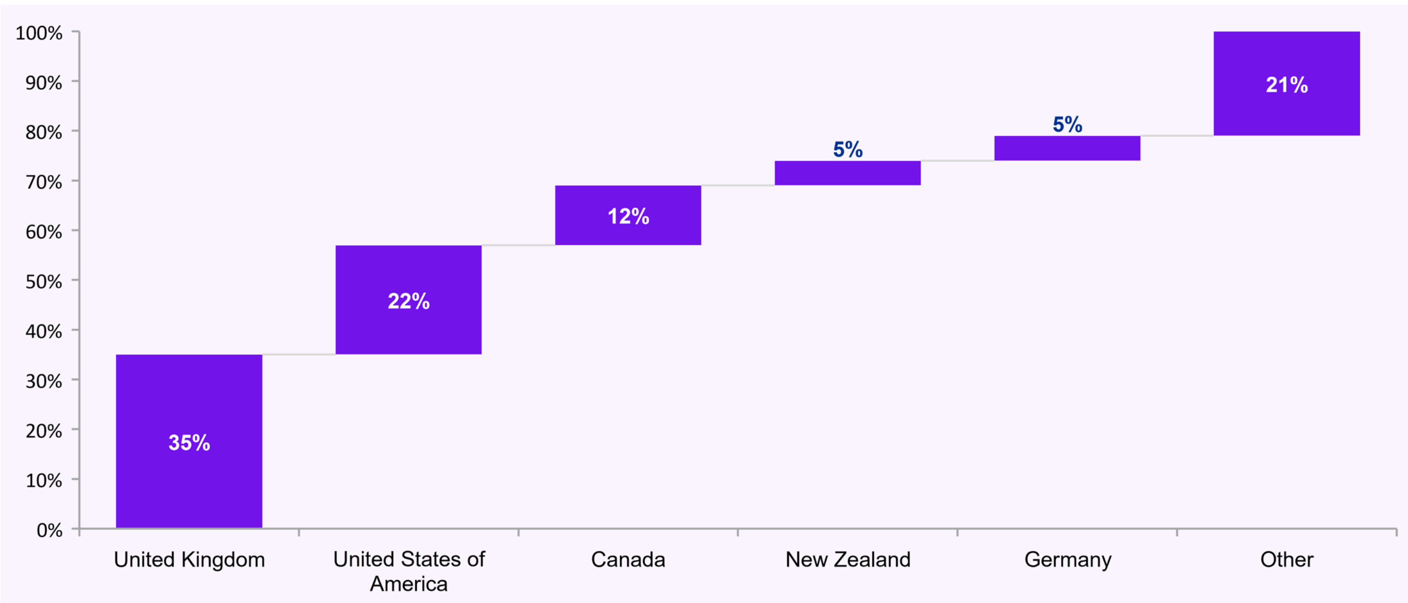

Table 4 – Volume of Australian wine exports for the 12 months ending 30 June 2023 Source: Wine Australia

[1] per Wine Australia [2] per NAB

Australian Domestic Market

The Australian domestic market is by far our largest market, accounting for approximately 500 million litres of Australian wine per year. According to a Wine Intelligence – Australia Wine Landscapes 2022 Management Summary published on 2 August 2023, the key findings relevant to the Australian domestic wine market are[1]:

Key Findings

01

The regular wine drinking population has shrunk slightly, but a higher proportion of them now consume wine more frequently.

02

There are more involved wine drinkers (42% of the population), driven by Millennials, who are enthusiastic to learn and often willing to spend more.

03

Knowledge levels have dropped since 2019 of the top regions and countries of origin.

04

Consumption of the top varietals (including the 'heavy reds') have declined whereas niche varietals have increased, from a low base.

These findings reinforce the importance of premiumisation and innovation to achieve higher margins but provide no comfort to the Australian wine industry that the domestic market can solve the oversupply, meaning the impacts of the oversupply on bulk wine values, grape pricing and vineyards is likely to be felt for some time to come, which we will explore in Part 3 of this series.

[1] per Wine Australia [2] per NAB

PART 3

Challenged wine sector due to supply/demand imbalance

Wine Grape Prices and Stock to Sales Ratio (SSR)

Wine grape prices are highly dependent on the supply and demand of wine grapes. As wine grape producers only have one downstream market – wine producers – wine stock is used as a proxy for supply and wine sales as a proxy for demand. Stock to Sales Ratio (SSR) represents the level of wine stock compared to wine sales.

Grape price and SSR have an inverse relationship (see Table 5) as a high SSR indicates there is more supply than demand for wine grapes in the market. This will place downward pressure on wine grape prices and vice versa. However, price is not solely dependent on SSR due to various factors unrelated to the supply and demand of wine grapes – for instance, time lags, price contracts and inflation.

From 2015 to 2017, the SSR experienced a steady decline while grape prices saw the largest growth at a CAGR of 7%. This was largely driven by an increase in Australian wine exports, supported by favourable exchange rates and free trade agreements with China, Japan and South Korea.[1]

The SSR saw the largest decline in 2018, decreasing ~10% from 1.54 to 1.39. Consequently, 2018 experienced significant growth in grape prices, increasing ~8% from $566 to $611 per tonne.[1] The decline in the SSR was largely due to the significant increase in Australian wine exports, with export volume increasing ~10% from 777 million litres in 2017 to 861 million litres in 2018. This was predominantly driven by exports to China, where Australian wine saw 50% growth and peaked at 176 million litres.[1]

In 2019 and 2020, the SSR continued to see a steady decline, while price per tonne increased from $663 to $694. Exports to China began to slow down, however this was offset partly by the Wine Equalisation Tax (WET) rebate reforms, which reduced the rebate cap and discouraged bulk wine production.[1] The SSR saw the largest increase in 2021, increasing ~29% from 1.39 to 1.80. This consequently led to the lowest growth seen in average grape prices since 2015 at ~1% from $694 to $701.[1]

The further increase in the SSR in 2022 is attributable to the oversupply of wine and this trend is expected to continue when Wine Australia releases the FY23 Production, Sales & Inventory Report later this year.

According to Wine Australia, the red wine grape price increased by ~3% in 2023, with an overall average wine grape price increase of ~2% as a result of increases in the average value of red and white grapes from cool/temperate regions, together with the increased share of grapes from these regions in the overall mix, countering the reduction in average value of grapes from the warm inland regions.[1]

Tables 6 and 7 below provide a snapshot of the prices for the main red wine and white wine grape varietals showing average red grape prices falling since 2020 whereas white grape prices have slightly increased – a possible reason why some grape growers are being lured into regrafting vineyards to white wine varietals:

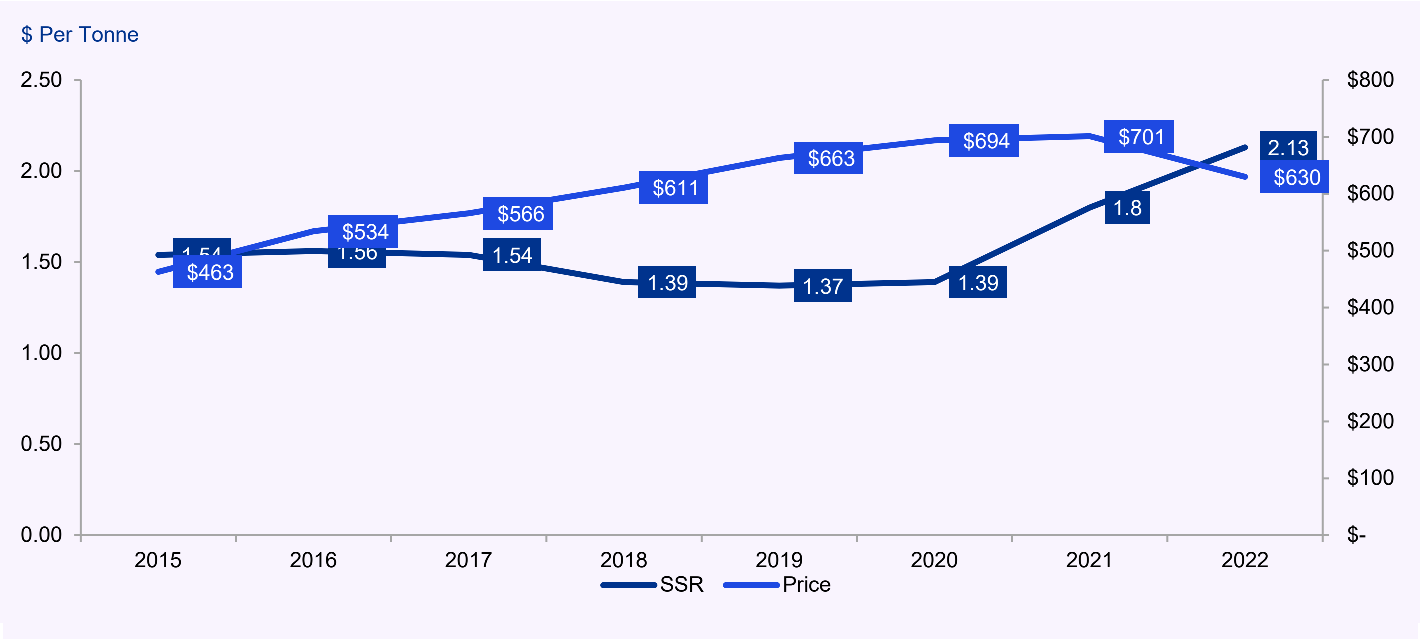

Table 5 – Australian wine grape price per tonne and Stock to Sales Ratio Source: Wine Australia

[1] per Wine Australia [2] per NAB

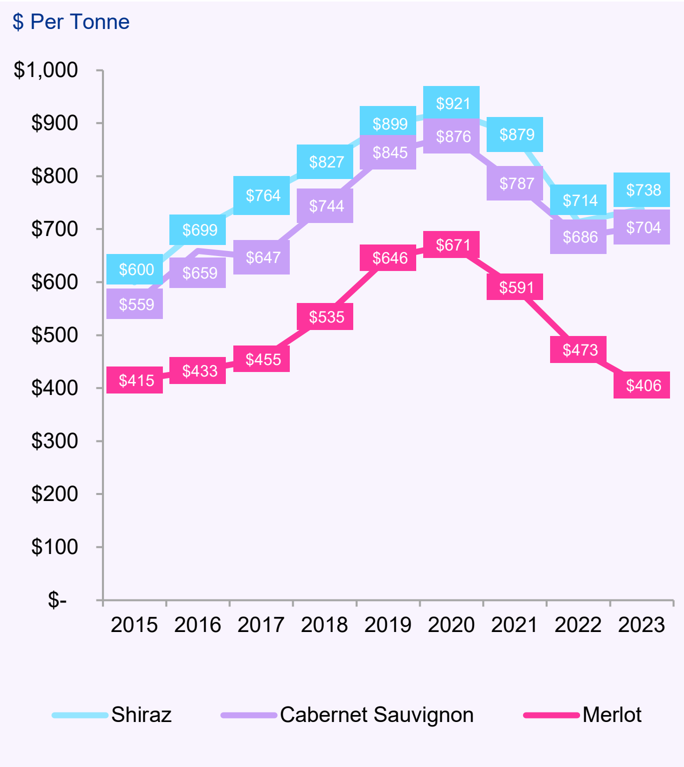

Table 6 – Australian main red wine grape varietals price per tonne
Source: Wine Australia

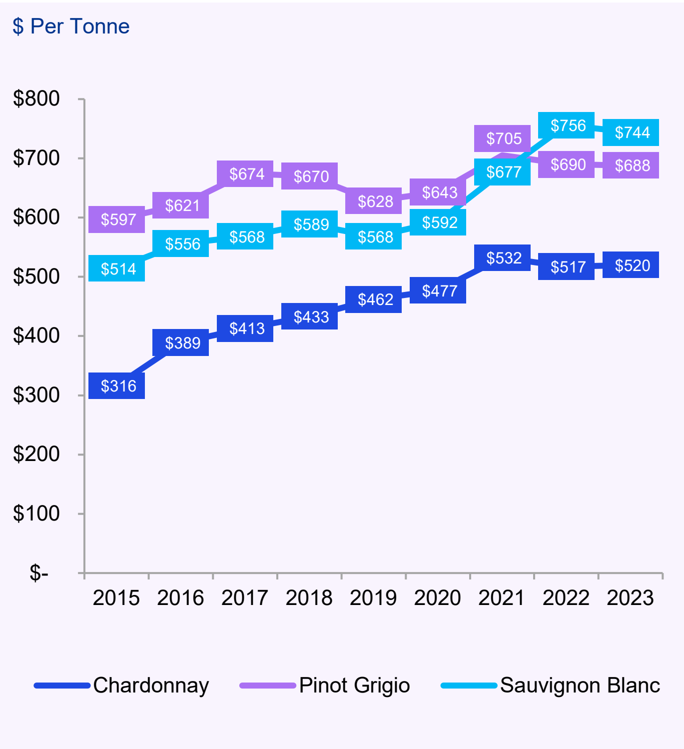

Table 7 – Australian main white wine grape varietals price per tonne
Source: Wine Australia

Bulk wine market

Recent reports have highlighted that the national wine inventory level has increased for the second consecutive year, particularly for commercial red wine. The SSR of red wine has increased from 2021 by ~35% to 2.77 times compared with the 10-year average of 1.64 times. This represents a severe and unsustainable structural oversupply of red wine in Australia, suggesting that bulk wine markets will remain at low pricing levels for the foreseeable future (see Table 8). White wine has remained stable at 1.52 times, only slightly above the 10-year average of 1.33 times.[1]

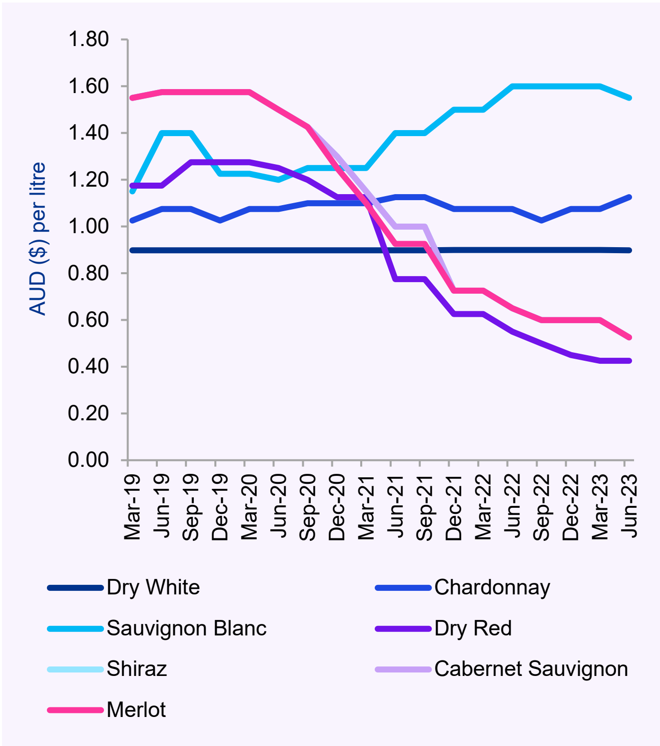

Table 8 – Bulk wine pricing for main red wine and white wine varietals per litre
Source: Ciatti Global Wine & Grape Brokers

Our view is that it is unlikely that bulk wine pricing will see any immediate improvement and the current oversupply will continue to adversely impact grape pricing of the ‘heavy reds’ in the short to medium term (ie Vintage 2024). In forming this view, we note that on 25 May 2023, Treasury Wine Estates (Australia’s largest wine company) flagged challenging market conditions and warned that inflation was squeezing demand for its commercial grade wine, especially in Australia, the UK and US (source: TWE ASX Announcement).

[1] per Wine Australia [2] per NAB

Bulk Wine & Vineyard Markets

Naturally, the downward pressure on the bulk wine price directly impacts inventory valuations meaning the book value of (red wine) inventory on wine companies' balance sheets may not reflect market value. Unfortunately, those wine businesses looking to liquidate excess inventory (particularly non-vintage, red wine) to generate cash flow in the short to medium term are being frustrated because the market for red wine is depressed (both in terms of the buyer pool and pricing) due to the oversupply (domestic and global).

Based on recent advertising and transactions, more and more vineyards are being offered for sale in the warm inland wine regions. However, these markets are under pressure with a diminishing buyer pool and fall in valuations to values which effectively represent the cost to develop the vineyards (before the cost of the land or the cost of water), which means there is no premium for warm inland wine region vineyards without water and water may be the driver for purchasers to consider a different use of the land.

We believe that declining bulk wine and grape prices could see vineyard values fall further (in the absence of any change to the China market situation) impacting LVR lending ratios for financiers (where serviceability is already strained by lack of cash flow generation through sale of bulk (red) wine inventory). Vineyards without grape volume and pricing contracts already locked in will be more vulnerable. Vulnerable grape growers, if balance sheets allow, may consider exiting the oversupplied market by converting their land to horticulture, or permanent plantings such as citrus and nuts (especially if almond prices recover).

What next for grape growers and wine businesses?

It is critical grape growers start engaging with their winery contacts now and seek advice as early as possible. It is also crucial to understand the winery's position regarding grape contracts and supply coming into Vintage 2024, and what varieties must be managed differently this year, including mothballing of vineyards.

The choices wine businesses make and the actions taken in the next few months in particular may determine their long-term success. However, every wine business will have different needs right now and uncertain times can often generate a level of inactivity or indecisive action.

Too often wine businesses are focussed on sales revenue rather than margin or profit, let alone the health of their balance sheet, which should be assessed based on two focus areas:

01

Liquidity –
How quickly can assets be converted to cash.

02

Asset management –
How well are assets being managed and converted into something of worth (or managed to avoid a decline in worth – relevant for family owned wine businesses which account for ~60% of the industry).

If sales are in decline but the balance sheet is reasonably healthy, then an operating runway should be determined, and a plan put in place to increase cash reserves and/or cut expenses such as overheads.

If poor balance sheet health prevails at the same time as declining sales, then there is a risk that a wine business may not be able to generate sufficient cash/working capital to support current operations. In such a scenario, decisions really need to be made to ensure business viability / survival.

KPMG has a strong understanding of the dynamics and key drivers of the wine industry and why wine industry participants sometimes find themselves in difficult situations. This sector experience enables quick and concise decision making alongside uncertainty, so that wine businesses can adapt and change to survive and thrive.

[1] per Wine Australia [2] per NAB


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