WINE INDUSTRY

SEPTEMBER 2015

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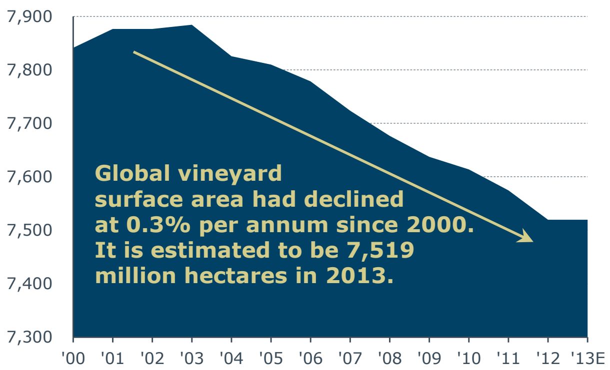
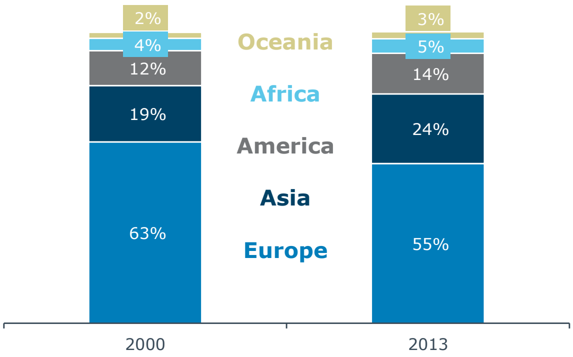
The global wine industry, which is dominated by European countries such as France, Germany, Austria, Italy and Spain, has recently seen a change, both in terms of production and consumption patterns. This is reflected in the shrinkage of vineyard surface area, which declined continuously in the past decade, largely attributed to the reduction of European vineyards. Shrinking margins and implementation of schemes to reduce the supply glut in the market have contributed to this shrinkage. Vineyard area has considerably declined in Spain (by ~17%), France (~13%) and Italy (~17%) since 2000. Overall, Europe's share of vineyard area has declined from ~63% (in 2000) to ~55% in 2013, while the share of Asia has significantly increased over the same period. Asia and Oceania countries which have seen an increase in the acreage include China - ~127% rise, India (+177%) and New Zealand (+179%), while Australia remained more or less stable.

Global Vineyard Surface Area
In '000s hectares



Source: OIV International Organisation of Vine and Wine

Share of Global vineyard area (%)
From 2000 to 2013



Source: OIV International Organisation of Vine and Wine

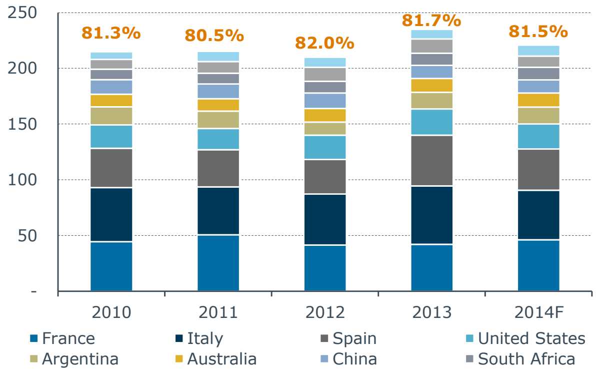
GLOBAL WINE PRODUCTION

Despite the different trends, overall global wine production remains largely concentrated, with the top ten countries producing over 80% of the world's production; France, Italy and Spain together produced over 47% on average during 2010-13. Europe's wine production declined in the five years to 2012, but recovered in 2013 after the end of the Common Market Organisation (CMO) scheme[1] in 2011. Mixed weather conditions in Europe – favourable in countries like Spain, Italy, Portugal, Romania and Greece, unfavourable in Germany, France and Austria – led to an overall increase in Europe production in 2013.

The United States (US), which is the fourth largest wine producing country, is estimated to have produced ~23.5 million hecto litres (mhl), which is 8.1% higher over 2012. US had seen significant growth in wineries and it is estimated that it had ~8,300 wineries at the end of January 2015, which is ~18.0% increase over January 2011.

Argentina is estimated to have produced ~15.0mhl of wine in 2013, which experienced ~27.2% growth year-on-year (yoy) on the backdrop of favourable climatic conditions and increased grape production. However, according to United States Department of Agriculture (USDA), production is expected to decrease due to rising production costs with the devaluation of peso since January 2014. Furthermore, government restrictions on imports have adversely affected the domestic producers, as nearly 90% of winemaking accessories are imported.

Top 10 Wine producers in the World
In million hecto litres; % shows share of global production



Source: OIV International Organisation of Vine and Wine

Source: OIV, USDA, ABS, ABARES, Wine Australia

Note 1: Under the CMO scheme, grape growers received financial incentives for voluntary withdrawal of vine growing. It aims to reduce the over production and it was in force between 2009 and 2011.

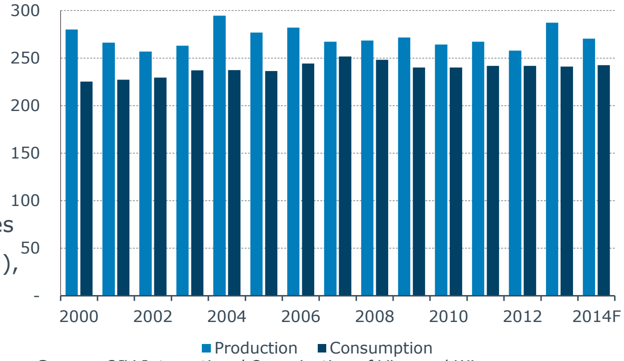
In **China**, increasing vineyard area is driving production growth and is estimated to have produced 13.8mhl in 2012[2], ranking fifth in the global wine production. Other major producers ('over 10mhl') include Australia, South Africa and Chile, which experienced 2.5%, 5.6% and 13.3% growth respectively in 2013.

GLOBAL CONSUMPTION

After global consumption peaked in 2007/08, it has stagnated over the past few years. This is despite certain changes in consumption patterns including increasing consumption in US, especially in sparkling wine, driven by low-price offerings, increased marketing, and a better understanding of wine among the millennia population. In addition, on a per capita consumption basis, the US is estimated to consume ~10.4 litres (lt.) per head, behind Italy (37lt.), France (44lt.) and UK (20lt.), highlighting the room for further growth in US consumption, which will drive global demand.

Global Wine Production and Consumption[3]

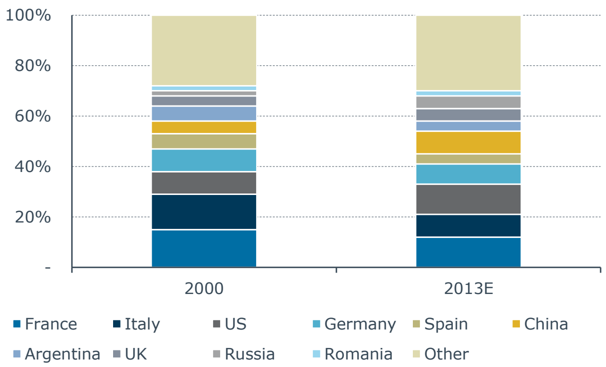
In Million hectolitres



Source: OIV International Organisation of Vine and Wine

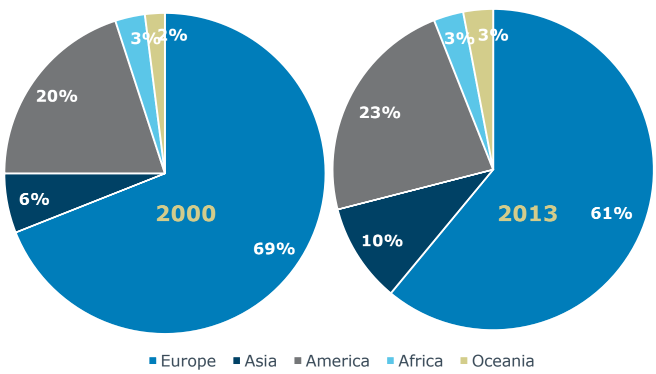
Major Wine Consumption

% Share in 2000 and 2013



Source: OIV International Organisation of Vine and Wine

Regional Share of Wine Consumption



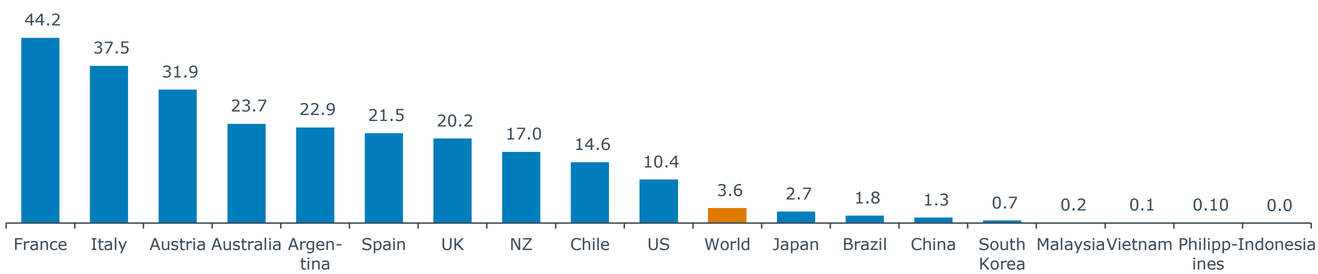
Source: OIV International Organisation of Vine and Wine

Note 2: Statistics from OIV for China provide only provisional numbers for 2013 (11.8mhl) and 2014 (11.8mhl), which show ~14.7% decline in wine production over 2012

Note 3: Global production exceeds consumption for reasons including cellaring, wastage, vinegar manufacturing and distillation

A regional shift in consumer base to Asia, caused by rising disposable incomes and greater influence of westernised lifestyles remain the key long term demand drivers. While Chinese wine consumption has increased over the long term, demand has recently plateaued. Total wine consumption in other Asian markets remains well behind China, though continues to grow – wine consumption per capita in Japan, for example, is over twice that of China. South American countries including Argentina, Chile, Brazil, as well as South Africa, have seen an increase in consumption in 2013 in the range of 1-3% over 2012. This is largely attributed to marketing campaigns and rising middle class population in these countries. Overall global consumption, which has remained stagnant over the past few years, is expected to increase with the demand from new and emerging countries, which have favourable demographics – research shows that in non-traditional wine drinking countries, the post baby boomer "millennials" are drinking more wine than previous generations. Further, with this change in consumption global trade in wine is expected to increase, from traditional markets to new markets/regions.

Per capita consumption by country - 2012
in litres per annum



Source: Wine Institute website

GLOBAL TRADE

Global wine exports were estimated at 98mhl in 2013, representing ~34% of global wine production. The share of domestic consumption has increased from ~21% in 2000. Export volumes have increased at a CAGR of 3.8% since 2000, lower than the export value – which increased at ~4.9% per annum over the same period. The relatively low harvest in 2012 in the Northern Hemisphere led to increases in wine prices due to a perceived scarcity of wine. Although exports from Chile and South Africa increased, this failed to cover the deficit due to reduced availability from Italy and Spain[3].

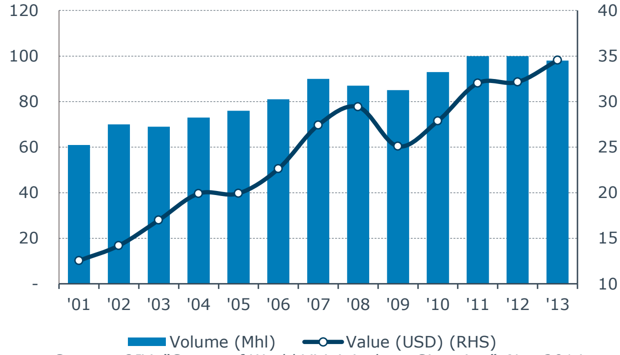
In terms of product segmentation, significant fall in trade was among the bottled wines, which were estimated to be ~2mhl out of the total decline of 2.4mhl. On the other hand, sparkling wines saw an increase along with bulk wine exports. Despite such changes, bottled wines still accounted for almost 71% of total wine sales, while sparkling made 17% of total revenues (although only represented 6.6% of total volume) and wines in bulk and in containers of more than 2 litres accounted for 12% of total value, even though they made up 38% of total volume.

Among the exporting countries, European nations continue to dominate, with France leading the region with an estimated export value of USD 10.4bn. While on volume basis, Italy and Spain are the leading countries, although the two have suffered due to low production in 2012. As such, this has led to a lower inventory in Northern Hemisphere, which helped Chile to overtake Australia as world's 4th largest wine exporter in 2013. However, the export market is still dominated by the top 5 producers accounting for over 70% of total export volumes and value.

On the import side, Germany, the UK and the USA are the clear leaders. On a value basis, the USA is the largest importer. Favourable macro factors in China have driven domestic consumption, leading to increased imports; with imports nearly quadrupling in value terms and more than doubling on volume basis. Among global imports, the top five markets accounted for over 50% of total imports in value terms. At a regional level, ~26% of the volume and 48% of value of wine consumed in Asia Pacific is imported. It is estimated that imported wine demand in Asia should increase by 27.7% between 2013-17[4].

World wine exports – Volume and Value

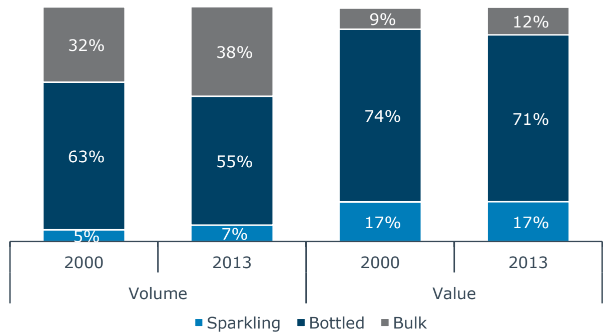
Volume in Million hecto litres, Value is in USD bn



Source: OIV, "Status of World Vitiviniculture Situation", Nov 2014

World wine exports – by product

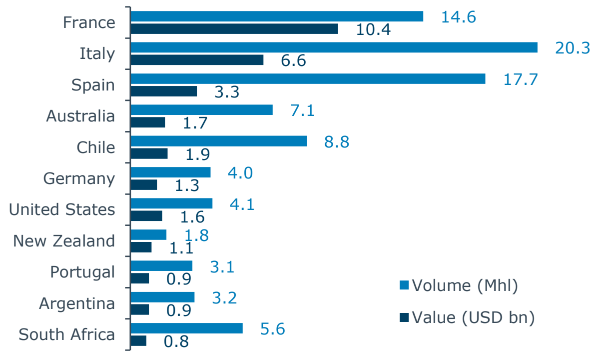
% share of total export volume and value



Source: OIV, "Status of World Vitiviniculture Situation", Nov 2014

Top wine exporters – Volume and Value (2013)

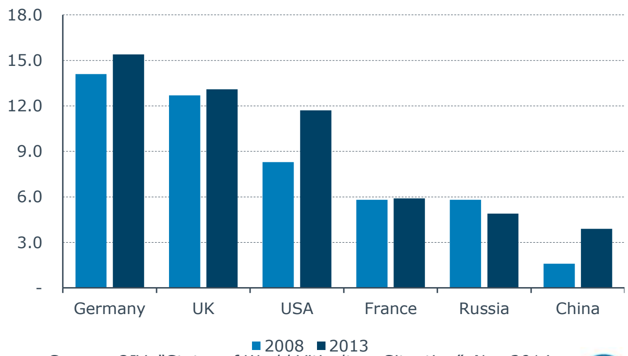
Volume is in Mhl and value is in USD bn



Source: OIV, "Status of World Vitiviniculture Situation", Nov 2014

Major Importers by volume

in Million hecto litres



Source: OIV, "Status of World Viticulture Situation", Nov 2014

Note 3: OIV, The Wine Market: Evolution and trends May 2014

Note 4: Vinexpo sector study, "The Wine and Spirits Market in Asia-Pacific and Worldwide with Prospects Until 2017", May 2014

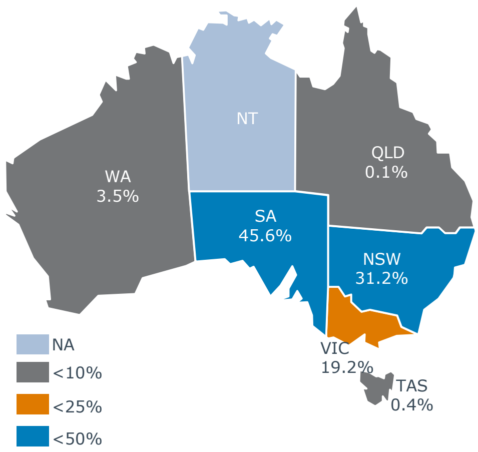
Australia is the sixth largest wine producer in the world, producing over 12mhl in 2013. On a regional basis, South Australia and New South Wales dominate the industry – together producing over two thirds of the wine produced. Over the past decade, the industry faced significant challenges including a supply glut of wine and wine grapes. In 2009, according to a joint statement issued by Australian wine and grape producer industry bodies, an estimated 20% of Australian grape bearing vines were in surplus and at least 17% of vineyard capacity was uneconomic. Further, it said Australia was producing nearly 20 to 40 million cases of wine per year more than demand levels. This led to a series of measures which resulted in vineyard area decreasing since 2009 from 157,000 hectares to an estimated 133,000 hectares in 2013.

Structural oversupply reduced profitability, forcing many small players to shut their operations. Despite this, it is estimated that the total wine produced and available stock is nearly double the total demand. Further, the reluctance of some small producers to stop production (as they consider wine production as a way of life) adds to the industry's woes.

The supply glut in the domestic market not only led to increased price discounts, but continues to limit the revenue growth potential of the industry. Despite this, domestic wine production is expected to recover from this situation over the next five years, as industry players reduce production and close underperforming wineries. This is expected to strike a balance between consumption and production. In addition, a number of players are moving up the value chain to produce better quality wines and move away from the traditional low-cost high-volume operating model. On top of this, the Australian dollar is anticipated to depreciate in the near term, which would be considered good news by the industry. Not only will it make Australia more competitive in export markets, the increasing cost of wine imports, should help improve domestic demand.

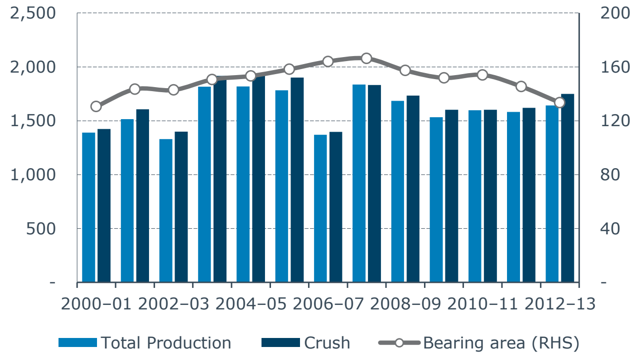
Export demand is key to the Australian wine industry, with over two thirds of wine production exported to markets including US, UK, China, Canada, Hong Kong, New Zealand, Netherlands, Singapore, Japan, Malaysia, Germany, Sweden, Thailand and Ireland.

Wine production by State
(In 2012-13)



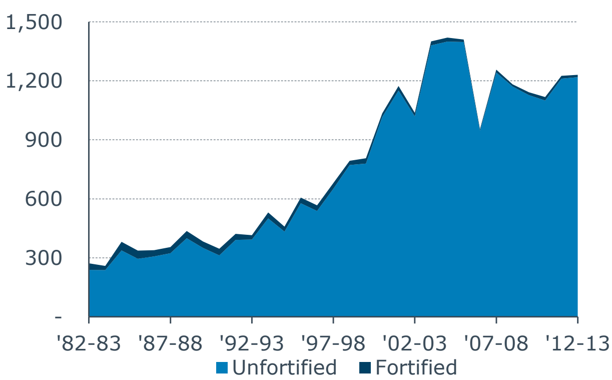
Source: Australian Bureau of Statistics

Australian Wine Grape Production
Production is in kt and Area is in '000 ha



Source: Australian Bureau of Statistics

Australian Wine Production by type
In '000 litres



Source: Australian Bureau of Statistics

Source: OIV, USDA, ABS, ABARES, Wine Australia

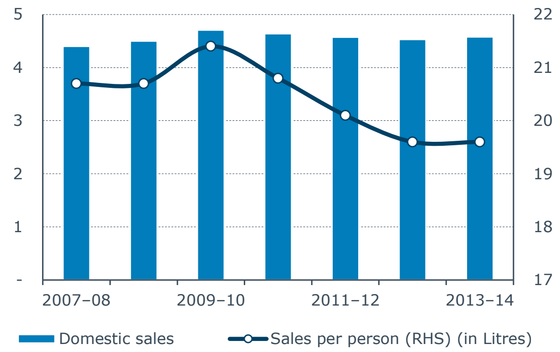
Total sales of wine (table, sparkling, carbonated and fortified) fell slightly in 2012/13 to 4.5mhl. Sales of Australian bottled wine were up 7.5% in 2012/13, domestic sales of wine in soft packs and in bulk fell by 3% and 23% respectively; whereas, sales of sparkling wine rose 1% (to 0.4mhl)

Though the iconic wine cask has just turned 50, bottled wine continues to grow in dominance in Australia, as glass bottles are viewed as the more 'premium' packaging. While Australians are consuming less wine in general, they are prepared to pay more for a higher-quality wine.

At over 7mhl, exports in 2012/13 were 3% down on the previous year remaining flat during 2013/14. Looking forward, under the Korea Australia Free Trade Agreement signed in December 2014, additional export volumes can be expected as wine tariffs immediately dropped from 15% to zero.

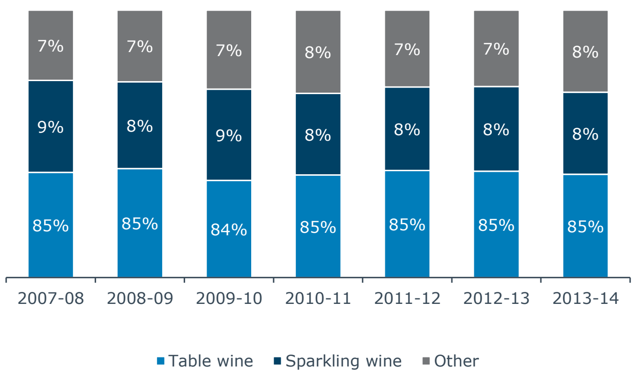
Australia imported an estimated 0.9mhl of wine in 2013/14, an increase of 3% over the previous year. New Zealand (NZ), France and Italy are the major exporters to Australia in 2013/14 by import value. Imports from New Zealand are largely low cost white varieties such as sauvignon blanc. Over the past decade, average value of New Zealand wine imports had decreased from A$ 10 to A$ 6 per litre. Further, on the backdrop of high Australian dollar and fierce competition between champagne houses and the supermarket giants has seen low champagne prices driving the sales reflected in 12.1% increase in imports from France in 2013/14 over previous year.

Australia Domestic wine sales
In Million hecto litres



Source: Australian Bureau of Statistics

Australia Domestic wine sales by category

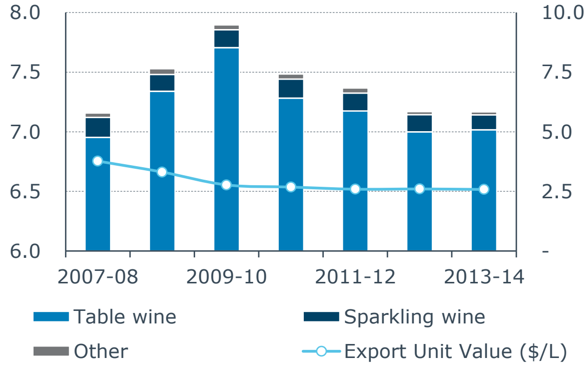


Source: Australian Bureau of Statistics

The Australian wine industry body, Wine Australia is actively developing strategies to market/ brand Australian wine, highlighting 'A+ Australian Wine' as the brand underpinning this strategy. This new branding exercise is aimed at increasing awareness, improving engagement and positioning Australian wine across all price levels. These programs are expected to cater to consumers in Canada, China, Ireland, Japan, UK, Europe and US. Further, it will largely concentrate on emerging nations by creating more demand in the young generations. In addition, it would help build the brand across the demand regions and thus may lead to better returns.

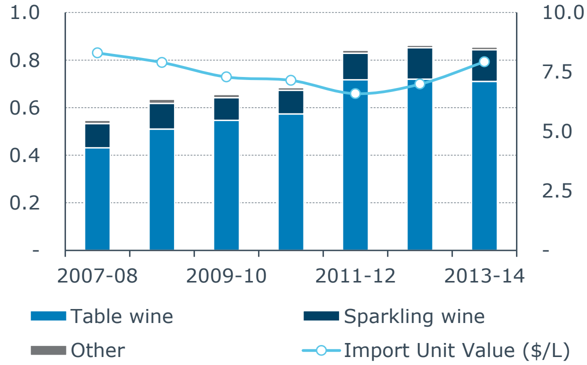
Another initiative of the Australian wine sector is the formation of the Australian First Families of Wine, a group of twelve family-owned Australian wine producers. Utilising their distinctive brands and collective volume, the First Families have worked together to promote their distinctive Australian brands to major markets, including Canada, the UK and China.

Australia Wine exports by type
In Million hecto litres



Source: Australian Bureau of Statistics

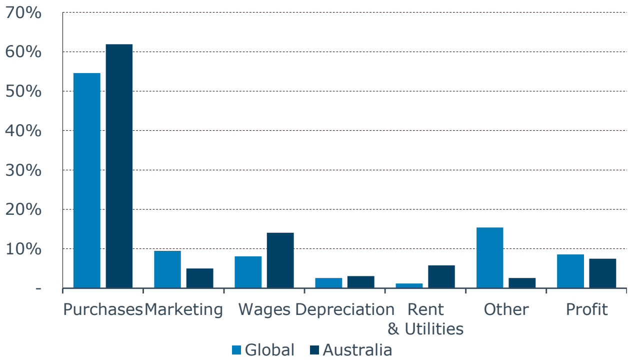
Australia Wine Imports by type
In Million hecto litres



Source: Australian Bureau of Statistics

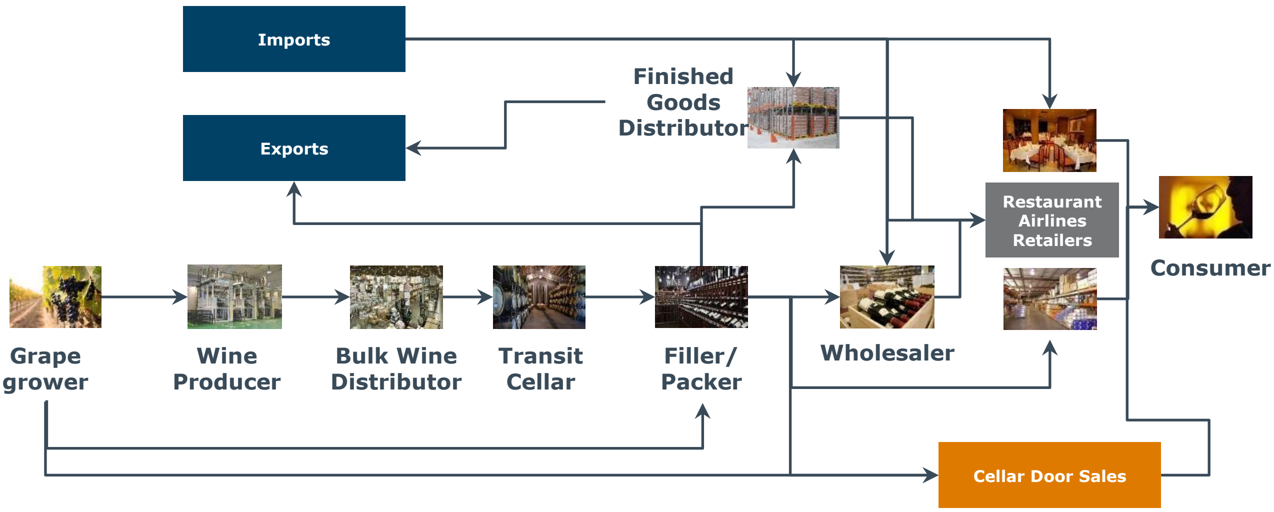
Benchmarking the cost of wine production in Australia against the overall global industry average further highlights the reality that the domestic industry is relatively less profitable. Purchases, which primarily include wine grapes, are higher in Australia – this is in addition to high labour costs. It is interesting to note that marketing expenses of Australian wine producers are lower than the global industry average, a factor which highlights the opportunity to further increase the marketing and promotional activities, especially in export markets. Over the past five years, Australia's global expenses have grown, with increased activities of individual wineries in markets such as Britain and the US, seeking to rebuild the Australian brand

Wine production cost benchmarking
Expense as % of total revenue



Source: IBIS World report

Wine Industry Supply Chain



Source: FLA Freight Logistics

Australia's variability in climate and uncertainty of irrigation has continued to affect the viability of wine grape production. Furthermore, a lack of clarity and effective market signals which prevent close alignment of supply and demand, has led to the current supply glut. On a positive front, the diversity of regions at processing level, although affecting overall efficiency levels, will encourage differentiation and specialisation. In addition, recognising that international trade forms a crucial part of the wine supply chain, the strong Australian dollar over the past few years and the rise in low-cost competitors has weakened export returns. On the other hand, rising volumes of imports continue to pose challenges in the domestic market.

For the Australian wine supply chain, three major issues are: (1) fragmentation of vineyard farmers, which has led to a supply glut in the domestic market – an estimated 70% of grape growers are small scale or contract growers; and (2) concentration in the retail channels implies low bargaining power for winemakers. In a market that is burdened with oversupply, discount pricing in order to liquidate stocks, led to falling returns and exit of some of the players. (3) Supermarkets, Woolworths and Coles, are making inroads in the wine supply chain by purchasing wine cheaply from growers and processors and marketing them as proprietary brands at premium. It is estimated 8% of wine sold in Australia is from supermarket private labels, owned by Woolworths and Coles.[5]

Source: OIV, USDA, ABS, ABARES, Wine Australia

Note 5: Choice.com.au, "Coles and Woolworths' control of the liquor market", Sep 2014

WET Rebate

The Wine Equalisation Tax scheme rebate remains a continuous issue in not only the wine industry, but also in the alcoholic beverage sector.

The WET applies a 29% tax to the last wholesale transaction, while the WET rebate provides producers with a rebate of 29% on the tax on domestic sales, up to a limit of $500,000.

Many in the Australian wine industry have highlighted the fact that New Zealand wine producers also receive the rebate, under the Closer Economic Relations FTA.

Australian producers have argued that as their NZ counterparts don't pay the original tax, the rebate represents a subsidy, providing them with an unfair advantage.

In many ways, the WET rebate could be said to assist a number of otherwise unsustainable small Australian wine producers. As such, the rebate contributes to encourage the oversupply of wine in the marketplace.

Labour Costs

The Australian wine sector is far from alone in arguing that labour costs impact on the industry's competitiveness – however, the industry does have one unique facet which is particularly hard hit.

The cellar door remains a vital component on the marketing and selling of wines, especially for smaller wineries.

As with the hospitality sector, the wine industry argues that the maintenance of penalty rates on weekends and public holidays – the times when consumers are most likely to visit wineries – severely impacts their competitiveness.

As such, the industry continues to call for the reduction and abolition of the rates, to allow cellar doors to remain open, ensuring both profitability and continued levels of employment.

China FTA

The Australian wine industry has highlighted the clear benefits in the China FTA. In particular, many domestic producers argue that while Chinese consumers prefer Australian wine over the Chilean product, the price advantage until now of around 20% enjoyed by their South American competitors, under the Chile-China FTA, has severely impacted competitiveness.

Tariffs on Australian wines are to be reduced to zero in four years - tariffs on Australian wines exported to China are currently 14% on bottled wines and 20% on bulk wines. Just as with beef producers, the Australian wine sector will see this as allowing them to become more competitive with the Chilean and New Zealand wine sectors. New Zealand wines have had no tariffs since 2012, while Chilean wine tariffs will be reduced to zero in 2015.

The challenge for Australian wine exporters to China differs by product. For those exporting the less expensive varieties, the consumer price reductions as a result of the tariff cuts will allow them to tackle competitors not just from Chile, but from exporters such as Spain and Italy, as they seek to gain more market share from the younger, less affluent, price conscious but socially aspirational Chinese consumer.

Japan FTA

The Japan Australia Economic Partnership Agreement will benefit Australian wine exporters from two rounds of tariff cuts in the first half of 2015. It eliminates Japan's 15% tariff on bottled Australian wine over seven years and immediately removes the tariff on bulk wine. Bottled wine exports to Japan account for 70% of volumes.

Korea FTA

The Korea Australia Free Trade Agreement will remove the 15% tariff on Australian sparkling, red and white wines to South Korea and it is on par with the duty free access already available to wine imported from US, the EU and Chile.

Source: FAO Growcorm, April 2014; USDA GAIN report Feb 2015

References:

1. OIV, International Organisation of Wine and Viticulture
2. USDA Gain report
3. Australia Bureau of Statistics
4. IBIS Research
5. ABARES
6. Wine Australia