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Trends and outlook for the international market

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- **Global supply and demand balance improving and stocks to become tighter in the short term**
- **Diminishing pressure for wineries to participate in less profitable markets or price segments**
- **Strategic sourcing gaining importance**
- **Shift in negotiating leverage in favour of wine companies that control supply**

Global supply: A precarious balance

Excess supplies diminishing

The oversupply situation in the global wine market has been so chronic over the past few years that at times it has seemed like a permanent characteristic of the industry. From 2004 through 2010, the wine industry battled with excess supply, driven first by a series of large global harvests starting in 2004, and then by declining consumption during the global recession that started in 2008. For brand owners, the relatively low cost of goods that accompanied the oversupply situation had its advantages, but the excess supply also meant that there was a myriad of wineries willing to undercut competition on pricing, creating a difficult environment for brand-building.

Since the large global harvests between 2004 and 2006, wine grape production has declined dramatically. Consumption, which experienced a sharp decline with the global recession starting in 2008, has begun to recover, and the increase in consumption in the US, China and other emerging markets has more than compensated for the declines in the traditional major European markets. By Rabobank estimates, global inventories of commercial wine are at their lowest point in over a decade, and stronger grape and bulk wine pricing in many markets suggests that the industry is much closer to balance (*see Figure 1*).

Potential for tighter supply conditions

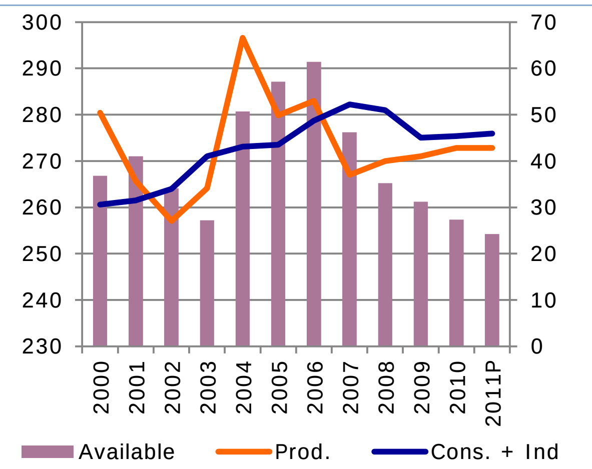
Current estimates suggest that Europe is likely to have a significantly reduced harvest, which will further tighten supplies, though it is still not clear if the overall market will be short or if this will allow the market to eliminate unsustainable sales. In any case, the shift towards a more balanced–and potentially tight–supply position is changing the dynamics of the global wine industry.

The drive to improve profit margins

Without excess volumes to move, there are fewer incentives for wine companies to remain as active in segments that do not offer sufficient returns. For more than a year now, an increasing number of wine companies have been showing more willingness to sacrifice volumes to support margins, particularly in difficult markets such as the UK.

Figure 1: Global wine production, consumption and remaining available stocks, 2000-2011p

million hectolitres



Source: OIV, The Wine Institute, Rabobank, 2012

Treasury Wine Estates, Pernod Ricard, Gallo and others have all recently implemented strategies in the UK to sacrifice volumes in order to recover margins. This decision was driven in part by the fact that wine companies have no longer had any margins left to sacrifice in that market, whether due to rising excise taxes, currency shifts or other factors. However, the tighter supply situation has since eliminated much of the unsustainable competition that had been undercutting pricing, allowing wine companies to focus on more sustainable brand development.

Uneven impact

The tightening of global supply will likely have a direct impact on global markets in the near future, but the effects will not be felt evenly. Markets that currently pay the lowest average prices for bulk wine will be outbid by those that pay higher prices, and their volumes can be expected to decline. Western Europe, Russia and some of the emerging markets (excl. China) are likely to see the most notable declines in bulk imports (and therefore consumption), and we expect western European exports to face volume declines in 2013 (*see Figure 2*).

Figure 2: Volume, value and average import prices of bulk wine for leading bulk wine importers, 2011

	Volume (million litres)	Value (EUR million)	EUR/litre
Germany	930.5	472.2	0.51
France	524.4	180.5	0.34
UK	384.8	353.9	0.92
US	234.5	179.6	0.77
Russia	225.9	99.3	0.44
Italy	201.5	91.8	0.46
China	120.2	89.6	0.75
Sweden	96.6	141.3	1.46
Portugal	93.7	34.4	0.37
Canada	92.7	65.8	0.71
World total	3,723	2,421	0.65

Source: Global Trade Atlas, 2012

Price increases vs. cost increases

Given the projections for a short crop in Europe, bulk wine prices are expected to remain strong. This can be expected to add pressure to margins, particularly for many European suppliers who are additionally confronted by weak domestic economies and little scope to raise consumer prices.

In the growing US market, where a tight supply situation has been felt for the past year, suppliers have been somewhat more successful in slowly gaining traction in reducing discounts and taking price increases, and the looming prospect of a large harvest in California will likely ease grape and bulk wine costs in the near term, providing some relief from high input costs of the past year..

Strategic sourcing

A tighter supply situation will often require large wine companies to review their sourcing strategies to secure sufficient supply, as traditional sources become less available. In California, wine companies have been aggressively acquiring additional vineyards and incentivising growers to add vineyards by signing new supply agreements at attractive prices.

For wine companies with international aspirations, the prioritisation of markets is likely to help determine where long-term investments should be made to secure supply. In 2011, The Wine Group acquired the 7.5 million case Loxton Winery, which should provide advantages in supplying bulk for its programmes in its home market in the US, as well as any initiatives it may have in the Eastern Hemisphere. With the tightening of global inventories, there appears to be a shift in power at the moment in favour of those that control their own supply.

With tighter supply conditions and increasing speculation about the potential for the market to move into a period of short supply, it is important to keep in mind the cyclical nature of supply movements. Much of the recent decline in global production is due to poor weather across Europe, and capacity remains in place for significantly more wine to be produced in coming years. Planting activity has resumed in some parts of the world where price increases and other market signals have been strongest, but suppliers in many areas also have the means to lift production in response to higher prices without further capital investment. Wine companies may need to remain wary not to over-compete for supply in a short market that may become surplus to requirements in the longer term. Even without excess new planting, inventories could again return to oversupply with one large harvest, or further deterioration in the global economy.

International supply

- With the exception of Chile and South Africa, Southern Hemisphere production was relatively light in 2012,
- The US is set to see a significant rise in total wine grape production for the 2012 harvest,
- The increase in US production will be more than offset by the significant declines in European production that are expected across nearly all major producing countries.

Total global wine production is set to decline in 2012. Inventories appear set to see further declines.

Northern Hemisphere update

The upcoming Northern Hemisphere harvest appears to be mixed, with the US likely to see a very strong harvest, well above 2011, while Europe is expecting a notable decline in wine production.

US. The California wine grape harvest appears set to show a marked improvement over 2011. According to official estimates, the 2012 crop is expected to be around 3.7 million short tons, an increase of 10% from last year, and quality looks to be excellent. Unofficially, there is speculation from several sources that the harvest may actually come in at 3.8 million short tons or more. The prospect of a large harvest comes as welcome news to wineries that have been struggling with high grape and bulk pricing over the past year. Growers do not appear overly concerned about a potential decline in pricing from the large harvest, as demand remains robust and pricing is strong.

Europe. The harvest among the largest wine producers of Europe looks set to be extremely low. Initial indications out of France estimate that the harvest will be roughly 8.5 million hectolitres (MHL) lower than the 2011 harvest. The 2011 harvest was quite large, but this is still well below recent average harvests. Italy will also see a decline from last year—down roughly 3 MHL—but as last year's harvest was extremely low, this year's production will likely be almost 9 MHL below more average harvests in recent years. Spain's harvest is also projected to experience a significant decline. The combined production of the three largest producers in the world will likely decline by well over 10 MHL compared to 2011. To put this in perspective, 10 MHL is approximately equal to Chile's total wine production.

Southern Hemisphere update

Australia. It remains too early to gauge production for the upcoming 2013 vintage, but seasonal conditions across South East Australia to date have been favourable for good yields and many growers have been buoyed in 2012 by the first significant rise in grape prices since 2008. Some signs of life have also begun to return to asset markets, albeit still at depressed prices.

New Zealand. The dramatically low 2012 harvest and the resulting increases in pricing have stimulated grape markets in Marlborough.

Growers are receiving more buyer interest and signals to raise production in 2013.

Chile. According to the most recent official estimates, Chile saw a bumper crop in 2012, with production up 20% from the 2011 harvest. Growth in varietal wines with appellation (accounting for nearly 80% of the country's total) outpaced the rest of the market, up 23% over 2011. The classic four, (Cabernet Sauvignon, Merlot, Sauvignon Blanc and Chardonnay) all grew by over 20%. The output of Pinot Noir increased by 56%, reaching 2.4 MHL. Wines made from crushed table grapes contracted more than 30%, though these mostly supply the domestic market, and had experienced strong growth in 2011 as a result of the smaller wine grape harvest.

Argentina. Argentina's 2012 crop fell 22% compared to the previous year due to weather adversities such as hail storms and late frosts. Red varietals contracted 15% though Malbec fell only 6%. White varietals—less than 20% of Argentina's wine grape output—fell 24% with the Pedro Giménez and Torrontés varieties recording the largest drops of 29% and 24%, respectively. The generic varietals such as Criollas and Cereza faced the largest crop contraction, close to 30%.

International Trade

Looking back, in Q3 2011, the main story was the success that Old World exporters were enjoying. Spain in particular had registered nearly 30% volume growth in exports, led by strong demand for its bulk wine, supported by the weakness of the euro. In 1H 2012, Spain no longer had large volumes available for sale, and it is the New World suppliers that are once again experiencing strong growth in exports. Unfortunately, most are seeing bottled wine exports stagnate while bulk exports are gaining share.

Export trends of major producers

Italy. Export volumes fell 10.7% while values grew 7.2% for Italian exporters in 1H 2012 on significantly higher average pricing. Bulk volumes fell sharply while bottled wines and higher quality wines more generally continued to experience growth. Higher value markets such as Canada, Japan and Scandinavia were some of only a handful of markets that showed volume gains as stocks have gradually tightened (*see Figure 3*).

France. French wine exports continue to show strong growth, and value growth (+13%) is outpacing volume growth (+4%). Bordeaux continues to lead the growth, up 15% by volume and nearly 30% by value. Other regions, such as Languedoc, are also registering strong growth compared to 2011–up 10% by volume and nearly 20% by value. Champagne saw a modest volume decline but continues to improve pricing.

Spain. Exports grew 3.4% by volume, and 13.5% by value. Value is outpacing volume as bottled wine exports are gaining share from bulk wine. Average bulk wine pricing is much higher than last year (+29%) which has led to a modest decline in bulk sales. Bottled wines, on the other hand, saw some price reductions, allowing for increased volumes and an improvement in average export price.

Australia. Export volumes increased 3.6% in 1H 2012 while export values fell 2.9% as bulk shipments continued to take share. The decision of another major supplier such as TWE to ship in bulk and bottle in-market in the UK will only further skew and invalidate official export data in this regard**.**

New Zealand. Export volumes grew 11.1% while export values grew slightly less strongly at 9.1% in 1H 2012. Monthly shipments remain strong and export shipments of Sauvignon Blanc from vintage 2012 have begun in earnest.

Argentina. Argentine wine exports grew 31% by volume but only 12% by value. Bulk wine continues to take share of exports from bottled wines as inflation continues to force Argentine wineries to seek ways to reduce costs or to pull out of less profitable market segments.

Chile. Chilean wine exports surged 17% in 1H 2012, though value growth lagged volume growth as bulk wine gains outpaced bottled wine. Bottled wine pricing was roughly flat, but bulk wine pricing posted strong gains (+21%) versus 2011 due to strong demand from the US.

US. The tight supply market in the US has led to a decline in US exports as wine companies reduce sales to less profitable markets. The decline in bulk exports (-13%) was much more pronounced than the decline in bottled exports (-2%). The decline in exports was led by lower sales to the EU.

South Africa. As with many other New World suppliers, bottled wine exports continued to lose share to bulk wine. Total export volumes grew 3.8% over 2011, led by improved sales to Germany, the US and Canada.

Figure 3: Change in exports for key exporters, 2012

Country	Volume change (%)	Value change (%)	Period of measure
France	4	13	Jan- July
Spain	3.4	13.5	Jan- June
Italy	-10.7	7.2	Jan- June
US	-8	-1	Jan- June
Australia	3.6	-2.9	Jan- June
Argentina	31	12	Jan- June
Chile	17	10	Jan- June
New Zealand	11.1	9.1	Jan- June
South Africa	3.8	n.a.	Jan- June

Sources: Australian Wine and Brandy Corp, 'The Gomberg-Fredrikson Report', Instituto Nacional de Vitivincultura (Arg.), Observatorio Español del Mercado de Vino, South African Wine Industry Informatino System, Unione Italiana Vini, Federation deExportateurs de Vin e Spiritueux, Wines of Chile, New Zealand Wine Growers, 2012
Note: Value changes in local currencies

US import trends

The US import market continues to grow, but the shift towards importing in bulk was fairly dramatic in 1H 2012. The Gomberg-Fredrikson Report indicates that bottled wine imports declined by 6% while bulk imports grew an impressive 164%. This represents a reversal from 1H 2011, when bottled wine imports grew and bulk wines declined (*see Figure 4*).

Much of the growth in bulk imports, particularly from Australia, Chile and Argentina, was fuelled by the short supply situation in California, as wineries eagerly sought to secure supply. With the current expectation of a larger 2012 crop, some of the demand for bulk wine may begin to wane in the near term.

Figure 4: US imports by country of origin, Jan 2012-June 2012

	Value (USD million)	Change (%)	Volume (million cases)	Change (%)
Italy	726.6	-1	15.8	-2
France	560	4	5.9	12
Spain	155.6	5	4.8	10
Australia	256	-3	11	17
New Zealand	113.3	28	2.2	38
Chile	168	34	9.5	109
Argentina	189.8	16	87	56
World Total	2,376.2	4	64.8	23

Source: 'The Gomberg-Fredrikson Report', 2012

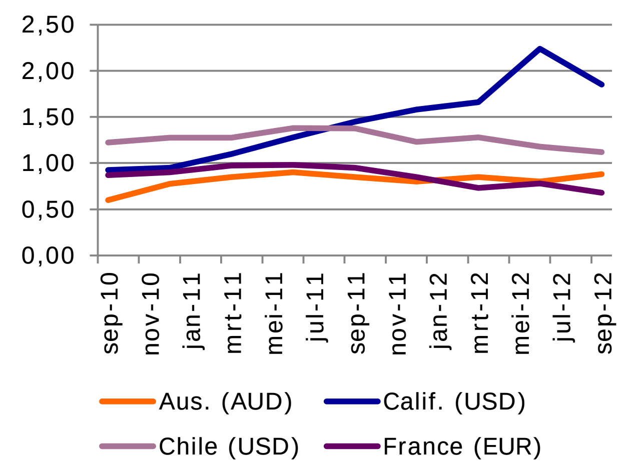
Bulk wine pricing

The reality of a larger harvest in the US appears to be having an impact on bulk wine prices. With tight supplies driving sharp price increases across most California varietals for much of 1H 2012, the prospect of a larger harvest is helping to ease some of the pressure. California Chardonnay prices have eased considerably, though prices in Australia have been lifted by some incremental demand from the US (*see Figure 5*).

Cabernet Sauvignon prices have been fairly stable across most regions. In the US, prices have fluctuated a bit in recent months, but demand remains relatively strong. As with Chardonnay, prices may see some easing with the prospect of a larger harvest. In most other markets, prices for this varietal have remained fairly stable (*see Figure 6*).

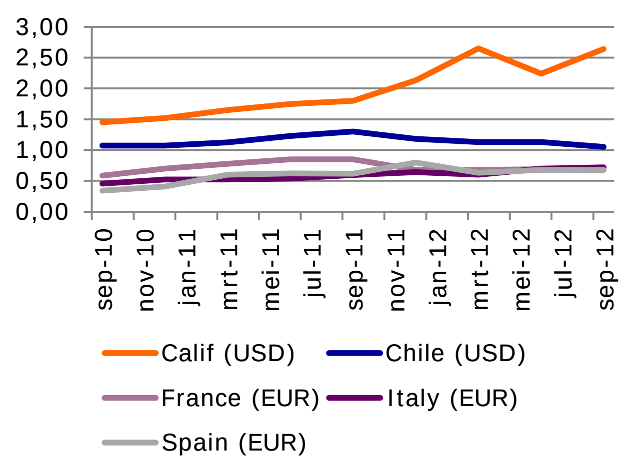
Prices for bulk generic white wine have remained strong throughout 2012 across most regions. Spain in particular has seen price increases of approximately 60% from the same period in 2011 (*see Figure 7*).

Figure 5: Prices for bulk Chardonnay by region, September 2010-September 2012



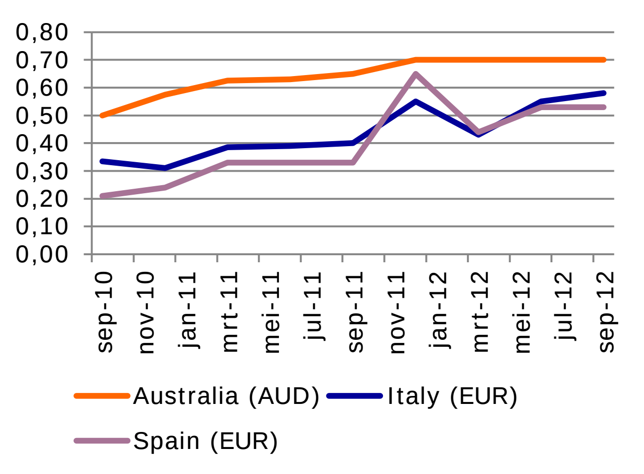
Source: Ciatti Co., 2012

Figure 6: Prices for bulk Cabernet Sauvignon by region, September 2010-September 2012



Source: Ciatti Co., 2012

Figure 7: Prices for generic bulk white wine by region, September 2010-September 2012



Source: Ciatti Co., 2012

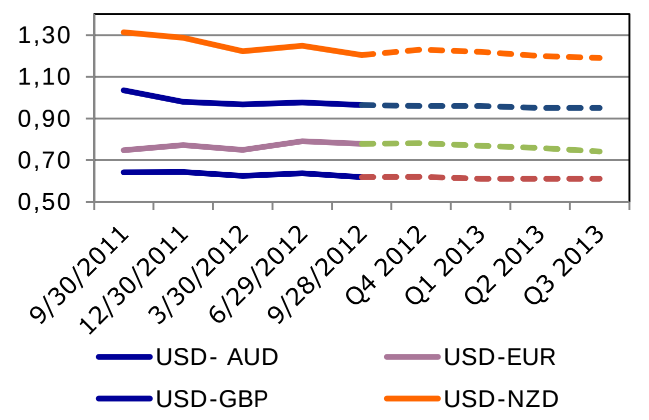
Current bulk wine pricing trends appear to reflect the expectation of a larger harvest in the US, as well as the economic uncertainty in Europe. Looking forward, the significant declines forecast for European production will likely help to keep bulk prices strong across most regions, and may lead to incremental price increases across some regions.

Key Currency Forecasts

The announcement by the European Central Bank of its bond buying scheme, combined with comments from ECB President Draghi that he would do what it takes to provide an effective backstop for Economic and Monetary Union (EMU) has injected a more confident tone to the outlook for EMU and the euro. Across the Atlantic, the announcement of additional, open-ended quantitative easing measures in the US economy has weighed on the US dollar. The additional supply of US dollars combined with a reduction in safe haven demand for the greenback pushed it into the position of poorest performing G-10 currency in Q3 2012.

Accommodative Fed policy means that the dollar is likely to remain on the back foot into 2013, although the risk that tensions could again rise in the euro zone suggests that the US dollar will benefit from further bouts of safe haven demand.

Figure 8: Historical and projected exchange rate of USD vs. key currencies, Sept. 2011- Sept 2013f



Source: Bloomberg, 2012

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