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Rabobank Wine Quarterly

Trends and outlook for the international market

Rabobank International

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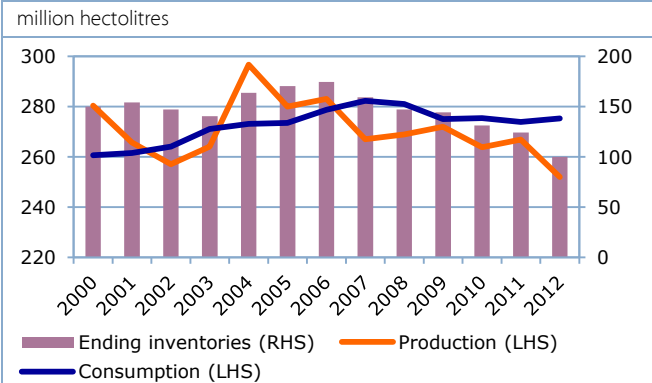
- **The impact of tighter global wine inventories has mainly been felt in Europe and in the lowest price segments to date.**
- **Russian bulk wine buyers have been adjusting sourcing as European bulk prices have risen, but have yet to purchase significant quantities of higher priced New World bulk.**
- **For the time being, price premiums have kept highly price-sensitive bulk wine buyers from bidding more aggressively on New World supplies.**
- **Preliminary expectations are for a larger Southern Hemisphere wine harvest in 2013, with the potential to lower bulk wine prices from those regions.**

Tighter supplies and the impact on bulk wine pricing

In March 2013, the International Organisation of Vine and Wine (OIV) updated its estimates of global wine production and consumption for 2012. While details of production estimates were modified slightly from initial projections, the overall message stayed the same: global production dropped significantly in 2012 (down approximately 6%), led by declining production in Europe, while consumption, including industrial use, was relatively flat.

As discussed in a recent Rabobank Wine Quarterly, global wine consumption has been outpacing production for more than six years, and global inventories are now 75 million hectolitres below the highs reached in 2006, a drop of approximately 40% according to Rabobank estimates (see Figure 1).

Figure 1: Global wine production, consumption and ending inventories, 2000-2012



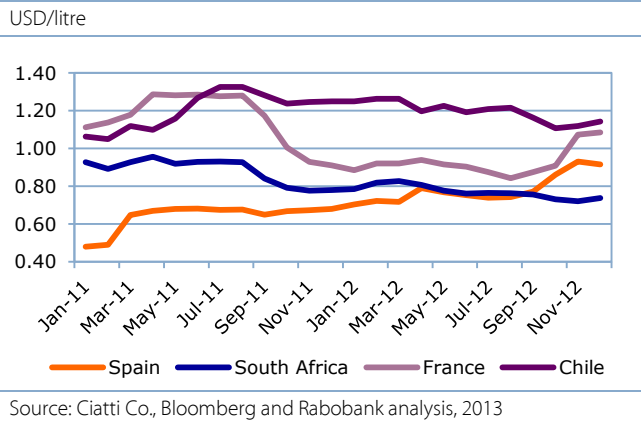
Source: OIV, USDA, Rabobank estimates, 2013

Consumption cannot continue to outpace production indefinitely. With the fall in production and tightening supplies, it is clear that consumption will come under pressure from rising prices. What is less clear is where the decline in consumption will occur and which countries will be most affected. A look at bulk wine prices for key suppliers provides some insights into the impacts to date (see Figure 2).

Although bulk wine shipping has helped to globalise the world wine trade, the impact of tighter supply has been felt very differently across producer regions. To date, most of the impact has been concentrated within Europe, and has been felt most dramatically in the lowest price segments.

The price of bulk wine in France and Spain rose significantly towards the end of 2012 as it became clear that inventories had tightened and the coming harvest would be light. South African bulk wine prices remained stable in the domestic market, but the weakening of the ZAR lowered the cost for foreign buyers seeking alternative sourcing. Somewhat surprisingly, the tightening supply situation has not yet caused Chilean bulk prices to rise. This likely reflects a combination of factors, such as its higher average price, the expectation of a large harvest in April and the fact that its largest buyer (the US) just had its largest harvest on record.

Figure 2: Average bulk wine prices for key suppliers, Jan 2011-Dec 2012



With rising prices and tighter inventories in Europe, a key question for the industry is whether the traditional buyers of European bulk wine (e.g. other EU countries, Russia and China) will accept higher prices, move to seek lower quality sources of supply, or simply reduce bulk wine purchases because consumers will not accept higher prices for wine.

Spanish bulk wine exports may be a good bellwether for how the market is responding, as they are an important source of supply for other European countries as well as for many emerging markets. According to OEMV data, Spanish bulk exports fell 20% in 2012 as the average price rose 33.7%. Germany, a major importer of Spanish bulk wine and a notoriously price-sensitive market, appeared to take the price increase in its stride. German buyers increased imports of Spanish bulk wine (+15.8%) and only moderately reduced imports of Spanish bottled wine (-7.9%). China cut its imports of Spanish bulk wine by approximately 12 million litres, but this was more than compensated by their increase in Chilean bulk imports, which increased more than 25 million litres.

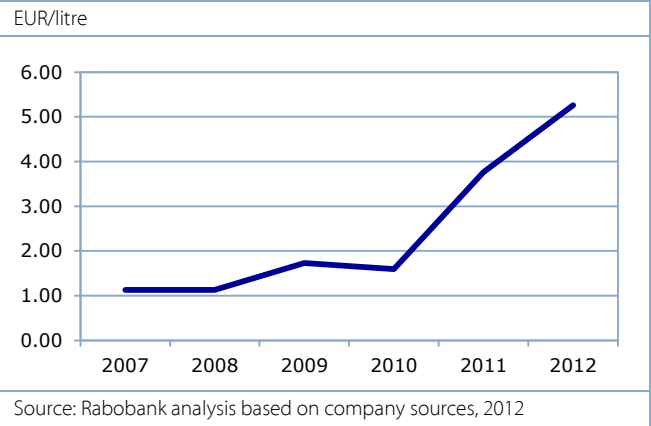
While some buyers have taken the rising prices in their stride, others appear to be reducing consumption, and the ultimate response across the market remains to be seen.

Wine distillation declining

One segment that we believe has seen a notable reduction in demand for bulk wine is the European distillers. Generally, distillers use the lowest priced wines as quality is not critical. Alcohol distilled from wine has various uses, but one notable use is in brandy and cognac. Western Europe currently accounts for over 150 million litres of brandy and cognac consumption. But brandy is a price-sensitive category and its consumption has been steadily declining at a rate of around 4% per year from 2006 to 2012.

In the EU, distillation of grapes had been subsidised as a means of removing excess supply. With the removal of distilling subsidies starting in 2008 and the tightening of the grape market, the cost of alcohol distilled from grapes increased by nearly 400% between 2008 and 2012 (see Figure 3). With rising input costs eroding margins, brandy producers in some European countries are reducing their use of distilled wine and beginning to reformulate their lower priced brands using alcohol from sugar. The products can no longer be marketed as brandy and instead are positioned as liqueurs, but essentially taste the same and consumers have not shown any adverse reactions..

Figure 3: Average price of alcohol distilled from grapes in the EU, 2007-2012



How will Russia respond to higher prices?

A key factor in any attempt to identify the potential impact of tighter supplies on consumption patterns and wine pricing is the reaction of the Russian market. Russia is the fifth-largest wine importer in the world and a notoriously price-sensitive market. Its four largest suppliers are Spain, Italy, France and Ukraine—all of which experienced significant production declines in 2012. Russia was the fourth-largest importer of Spanish wine in 2011, importing over 166 million litres of mostly low-priced Spanish bulk. But with Spanish bulk wine prices for the Russian market rising approximately 38% through 2012, Russian imports declined by 67%, or more than 110 million litres.

Recent developments show that Russian buyers have been actively seeking alternative suppliers at lower costs to fill the gap left by Spanish bulk. Russian imports from Moldova and Ukraine grew significantly in 2012, but as these suppliers were also affected by the light recent harvest, they may find it difficult to maintain such volumes. As South Africa's pricing position improved with the weakening of the ZAR, Russia's imports from that country nearly quadrupled. Similarly, Russia became the largest importer of Brazilian wine by volume in 2012 (after importing no Brazilian wine in 2011), though at one-tenth of Brazil's average export price from 2011. While these are noteworthy developments, the increases in imports from these suppliers only compensate for one quarter of the decline in imports from Spain. Even with the recent news that Russia is lifting its ban on wine imports from Georgia, it is unclear whether this will be enough to compensate for the loss of volumes from Spain.

As all its major suppliers have experienced a decline in production in 2012 and are seeing a rise in bulk wine prices, Russian importers will be faced with a decision: seek alternative suppliers (e.g. Chile, Australia and Argentina) at higher prices than they had been paying, or accept a decline in wine import volumes.

Implications for the industry

The degree to which Russia (and other price-sensitive markets) is willing to secure supply from alternative sources at higher prices has critical implications for the industry as a whole. Bulk wine prices in Chile have not yet risen in spite of the tightening global supply situation. The fact that they haven't declined yet either, despite the prospect of a large harvest, may be a reflection of the tighter supply situation. The current expectation is that pricing to growers for the upcoming harvest is set to decline and that bulk prices could follow. These conditions could change if alternative buyers, such as Russia

(or even some European countries), start to bid more aggressively for New World production and place additional upward pressure on bulk wine prices. This could have positive implications for growers in markets that export bulk wine, such as Chile, and even for parts of California, where bulk wine pricing plays a role in setting grape prices at harvest, but could create additional cost pressure for wineries that source through third-party growers. Additional cost pressure would be an unwelcome development as many are already struggling with the impact of inflation and the increasing strength of their currency.

At this time, some of the most price-sensitive buyers appear to be waiting on the side lines, possibly to see how pricing develops after the Southern Hemisphere harvest, which looks set to rise. As the year progresses, it will be important to watch how these price-sensitive markets react and whether consumers will accept higher prices or switch from wine to spirits and/or beer.

International supply

With the final production figures in for 2012, and supply becoming tight in some markets, the attention now turns to the 2013 Southern Hemisphere harvest, which is currently underway. The Northern Hemisphere harvest of 2012 was mixed, with production increasing more than 20% in the US and declining 10% in Europe. The Southern Hemisphere harvest appears set to be quite healthy.

Northern Hemisphere update

US

The results of the USDA 2012 Crush Report confirmed what many expected. The recent California wine grape harvest was the largest in history, reaching 4.38 million tonnes, up 13% compared to 2011. The weakness of the USD and tight supply conditions going into the harvest helped drive prices 25% higher over the previous year. Rising prices and concern about sufficient supply for long-term demand are helping to drive a significant increase in new vineyard plantings in California, with Allied Grape Growers estimating that an additional 30,000 acres was planted in 2012.

Europe

The short European harvest of 2012 has been well-documented (see Rabobank Wine Quarterly Q3 2012). Supplies, particularly for lower priced wines that are in strong demand, remain tight. Unlike in the US, the rise in prices should not drive vineyard expansion in Europe. EU regulations prohibit additional vineyard planting for the coming years.

Southern Hemisphere update

Australia

Warm, dry conditions have prevailed across much of southern Australia this season, and there is an expectation of moderate yields in many key growing regions. Extended periods of elevated temperatures have presented some of the greatest challenges, acting to expedite ripening and placing significant pressure on winery logistics. Prices of wine grapes intended for mass-market wines have remained largely range-bound by the high Australian dollar.

New Zealand

Current signs are for a much improved New Zealand wine harvest in 2013, with moderate yields and warm, dry weather across the country helping to promote fruit quality. Grape pricing has generally continued to improve and wine companies are again looking to shore up supply.

Chile

Some delay in the 2013 harvest makes it difficult to give accurate crop estimates, although there is a general sense that Chile will see a good season. Estimates put this year's crop at 2012's level with some most optimistic forecasts showing a rise of 10%, while the presence of powdery mildew in some regions may move the needle to the low end of the forecast. Grapes are trading substantially below last year's prices, in some cases up to 40% lower.

Argentina

Argentina's grape harvest is currently underway, and the current estimate is that yields should be normal. This year's production will be approximately 20% above the 2011 harvest, which was extremely light.

International trade

Export trends of major producers

Italy

Italian export volumes in 2012 fell 8.8% on lower supply, while values grew roughly 6% as pricing advanced and a depreciating euro paid dividends in export markets outside the euro zone. The volume and value of quality sparkling wine exports, led by DOP prosecco, grew very strongly, while the value of bulk wines also experienced strong growth.

France

Continued interest in French wines from emerging markets helped propel 2012 exports 3.4% by volume and 4.7% by value. As noted in our last report, champagne volumes have experienced modest volume declines (-1%) but value continues to grow (+4.7%). Growth in still wines was led by higher valued wines with certified appellation, which rose 5.9% by volume and 12.1% by value, from a large base. Wines with varietal designation, but without a certified appellation, saw impressive growth (+26.8%) from a much smaller base than wines with certified appellations. The growth in sales of varietal wines represents a major achievement for French wines as it offers a path to improved profitability for French producers, as varietal wines command a 50% premium over other non-appellated wines.

Spain

With tightening global inventories, Spain has seen a decline in export volumes but marked improvements in value. Spanish export volumes declined 8%, led by a 20% decline in bulk wine exports. Average pricing improved dramatically (+21.6%), leading to an 11.9% increase in total export revenues. Average bulk wine prices rose EUR 0.12/litre, dramatically impacting sales to some of its more price-sensitive major export markets.

Australia

Australia's export volumes recorded only modest growth of 2.9% in 2012, while the value of trade declined 1.7%. Trading conditions in the EU deteriorated on a stronger currency and flagging demand, while trade to the US has begun to show signs of stabilising. The

rate of growth to China/Hong Kong has begun to tail off somewhat, while pricing to this market has continued to improve.

New Zealand

New Zealand export volumes grew 4.7% in 2012 and average pricing recovered somewhat in a difficult global trading environment. Shorter supplies have provided New Zealand wine producers with the opportunity to ration stock to higher value markets and restore some value to the supply chain in the face of a strong currency.

Argentina

Argentine wine export volumes grew 17% in 2012, while value grew only 10%. As wineries continue to grapple with the impact of inflation, bottled wine exports declined 2%, while bulk wine exports grew 58%. The US remains the major destination of Argentina's bottled varietal wine exports, comprising nearly 40% of exports in this category.

Chile

Chilean wine export volumes grew 12.8% in 2012, but as growth was led by sales of bulk wine, export values grew only 5.9%. The US is the largest importer of Chilean bulk wine, and bulk exports to the US grew 57% in 2012. China continues to gain importance as an export market, with exports growing 81% in 2012. Unlike the US, China is showing solid growth in bottled wine imports and registered the most important growth in wines priced above USD 40/ bottle. Export volumes to the UK saw a slight decline (-5.5%), but average prices improved 2.7% as Chilean wineries are becoming more willing to sacrifice volumes in order to achieve more reasonable margins in the UK. Finally, it is worth noting that Spain entered the Chilean bulk wine market aggressively towards the end of 2012, importing 44 million litres of Chilean bulk in 2012—up from less than 100,000 litres in 2011. However, the quality of the imported bulk wine was likely somewhat suspect as it was sold at less than half the current average export price of Chilean bulk wine.

US

Declining bulk wine exports to the UK and Italy led the 5% decline in US export volumes in 2012. Overall supplies in the US market were tight, and prices of available bulk wine were bid higher as wineries sought to secure supply for their domestic brands. In spite of the volume decline, export revenues grew 4%, led by the continued success of US wineries in the Canadian market at attractive prices.

South Africa

South Africa's export volumes grew 17% in 2012, but the trend of bulk wine exports (+43.9%) taking share from bottled wine (-9.7%) accelerated, particularly in the second half of the year. Traditional importers of Spanish bulk wine sought alternative suppliers as Spanish bulk inventories tightened and prices began to rise. The UK (+43%) and particularly Russia (+344%) saw dramatic increases in imports of South African bulk wine. Although bulk wine exports continue to take share from bottled wine, growth in bottled wine exports to attractive markets such as Canada and the US are cause for optimism.

Figure 4: Change in exports for key exporters, 2012

Country	Volume change (%)	Value change (%)	Period of measure
France	3.4	8.5	Jan-Dec
Spain	-8	11.9	Jan-Dec
Italy	-8.8	6.0	Jan-Dec
US	-5	4	Jan-Dec
Australia	2.9	-17	Jan-Dec
Argentina	16.4	10	Jan-Dec
Chile	12.8	5.9	Jan-Dec
New Zealand	4.7	7.2	Jan-Dec
South Africa	16.7	na	Jan-Dec

Note: Value changes in local currencies

Source: Australian Wine and Brandy Corp, 'The Gomberg-Fredrikson Report', Instituto Nacional de Vitivinicultura (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

US import trends

Total US wine imports rose 15% in 2012 as the growth in bulk imports more than compensated for minor declines in bottled wine imports (see Figure 5).

The decline in bottled wine imports (-2%) was led by an 8% drop in imports from Australia, in addition to modest declines from Italy (-1%). Imports of French bottled wine saw a marked improvement in both volume (+7%) and value (+14%), but still have not returned to their peak levels reached in 2007. Although Argentine bottled wine import volumes declined (-5%), revenues improved as sales of higher priced Malbec continue to enjoy strong success in the US market.

Concern about tightening domestic supplies contributed to strong growth in bulk wine imports (+71%), led by Chile (+94%), Argentina (+68%) and Australia (+68%). Anecdotal evidence suggests that a growing portion of the bulk imports, particularly from Chile and Argentina, are due to brand owners bottling in-market, though this is difficult to quantify.

Figure 5: US imports by country of origin, Jan 2012-Dec 2012

	Value (USD million)	Change (%)	Volume (million cases)	Change (%)
Italy	1,505	-1	32.8	1
France	1,347	10	12.6	14
Spain	326	7	9.8	12
Australia	531	-4	22.7	11
New Zealand	247	25	4.5	25
Chile	341	17	18.1	39
Argentina	402	18	19.2	33
World total	5,135	5	133.8	15

Source: 'The Gomberg-Fredrikson Report', 2013

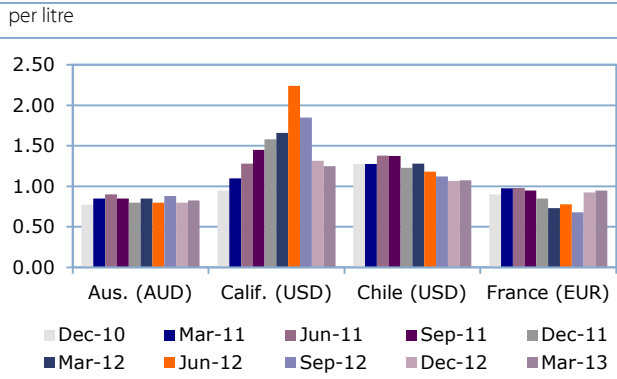
Bulk wine pricing

International bulk wine prices have had a bumpy ride over the past year. California bulk prices continue to moderate but are still well above previous levels. Prices in Italy and Spain also remain strong, though Spain is reporting some minor pricing moderation to try to

regain some of the volumes lost to the rapid price increases. Chilean bulk prices have seen steady moderation, and the prospect of a large 2013 harvest is expected to continue moderating prices (see Figures 6-8).

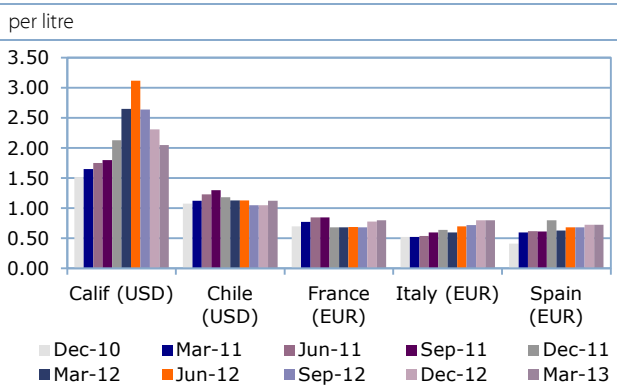
Tightening global inventories may lead to increased interest in Chilean production, but the cost of Chilean bulk wine will place limitations on interest from the most price-sensitive buyers.

Figure 6: Prices for bulk Chardonnay by region, Dec 2010-Mar 2013



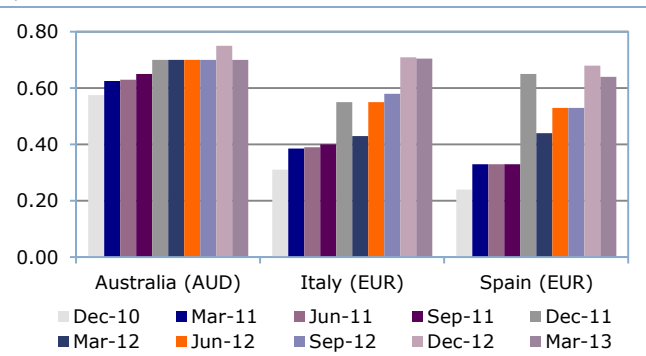
Source: Ciatti Co., 2013

Figure 7: Prices for bulk cabernet Sauvignon by region, Dec 2010-Mar 2013



Source: Ciatti Co., 2013

Figure 8: Prices for generic bulk white wine by region, December 2010-March 2013

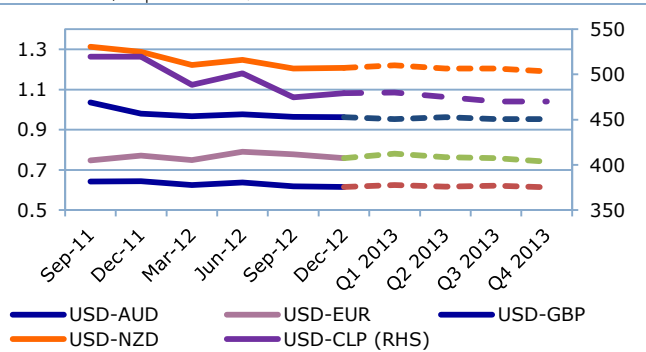


Source: Ciatti Co., 2013

Key currency forecasts

The value of the euro continues to face short-term pressure from crises in various ailing corners of the EU. However the currency is forecast to recover somewhat against key crosses over a 12-month view as recovery gradually takes shape. Across the Atlantic, the looming prospect of further public sector spending cuts in the US, and their negative impact on growth in 2013, is expected to support the case for current quantitative easing measures and see the value of the US dollar weaken against the major wine currencies over the outlook period (see Figure 9).

Figure 9: Historical and projected exchange rate of USD vs. key currencies, Sept. 2011- Q4 2013f



Source: Rabobank, 2013

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