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Rabobank Wine Quarterly

Trends and Outlook for the International Market

Rabobank International

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- **The Brazilian wine market has shown strong growth over the past ten years, fuelled largely by imported wines.**
- **Over the past two years, soft economic growth rates and transportation infrastructure limitations have raised concerns about the long-term prospects of the market.**
- **Rabobank believes that 2013 will be another soft year for imported wine but that underlying growth prospects of the Brazilian market over the longer term remain strong.**

Can Brazil regain its rhythm?

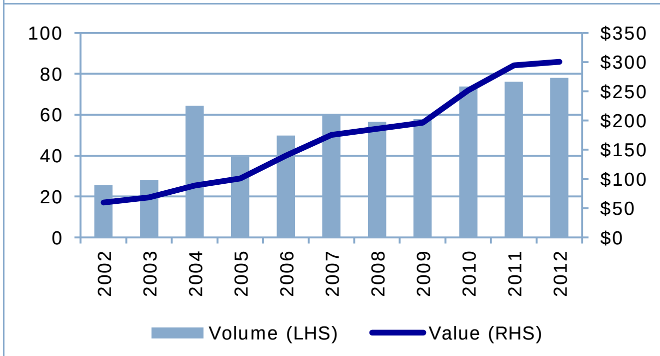
The Brazilian wine market has been drawing increasing attention from international wine marketers in recent years, and with good reason. Wine consumption in South America's largest economy has been growing, and imported wines have been capturing consumer attention. In spite of onerous import duty regimes and other hurdles that many foreign suppliers face, annual wine imports have tripled over the past ten years, with strong participation from both New World suppliers (i.e. Chile and Argentina, which enjoy free trade agreements with Brazil) and Old World suppliers (i.e. Italy and Portugal).

Over the past two years, however, the prospects for continued growth in wine consumption have become more questionable. Import growth rates slowed dramatically in 2011 and 2012, and 2013 appears set to remain lacklustre as well (*see Figure 1*). The main question for wine marketers is whether the anaemic growth rates represent the new norm or are simply part of the short-term volatility that is common with many emerging markets.

Economic outlook—softer growth and a weak currency

The economic challenges facing Brazil are the main hurdle for a return to growth in wine imports. From 2006 to 2010, the Brazilian economy enjoyed annual growth rates of between 4% and 8%, with the exception of 2009 due to the impact of the global recession (*see Figure 2*). Fiscal tightening to control inflation has slowed economic growth in recent years, and the projections for the coming years of growth at just over 2% imply little expectation of a return to strong growth in the near future. For consumers, the reality of lacklustre growth is exacerbated by the fact that inflation continues to erode their purchasing power, in spite of recent government efforts.

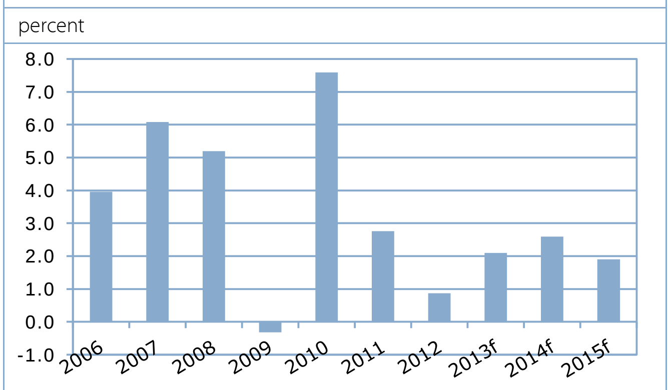
Figure 1: Brazilian wine imports by volume and value, 2002-2012



Source: Brazilian Ministry of Development, Industry and Foreign Trade, 2013

For exporters targeting the Brazilian market, a major challenge has been the exchange rate, as the Brazilian real has depreciated approximately 25% since 2011. This situation is unlikely to improve in the near future, as Rabobank forecasts suggest further easing of the Brazilian real over the next 24 months.

Figure 2: Brazilian real GDP growth rates, 2006-2014f



Source: Bloomberg, Rabobank forecasts, 2013

Brazilian infrastructure- improvements with time

The lack of adequate infrastructure for ports and transportation in Brazil has created challenges for many importers and exporters, but the impact of these challenges can be particularly acute with wine. The inadequate facilities to accommodate the flow of trade in a timely manner, which has been aggravated by a series of ongoing strikes among port workers, can leave containers of high-value wine detained in ports in less than ideal conditions.

Land transportation costs were already high due to strong demand and limited availability, but rising diesel prices and new legislation that limits the amount of hours that truck drivers can work are expected to continue to drive transportation costs higher.

Looking forward, diesel prices will likely remain stable but the new legislation limiting working hours for drivers creates some structural challenges in the medium term. According to a recent Rabobank report[1], some sources estimate that transportation companies will be forced to hire nearly 50,000 new truck drivers to maintain transport capacity under the new system at a time when unemployment is at an all-time low. This will likely keep upward pressure on transportation costs for some time.

Over time, port and transportation infrastructure is expected to see continued improvements. In December of 2012, the Brazilian government announced a new five-year plan to invest more than USD 26 billion to upgrade ports and improve efficiency. While this plan will not provide immediate relief to foreign suppliers in the Brazilian market, it does point to an improved environment in the longer term.

Improvements in the market, but concerns remains

The market environment in Brazil is still evolving rapidly. Perhaps the most positive news for foreign suppliers came at the end of 2012 with the announcement that the threat of safeguard measures on imported wine had been lifted. The push for safeguard measures was supported by the domestic wine industry, and as part of the agreement not to introduce these measures, retailers have agreed to provide improved access to retail shelf space for domestic wines—which have been rapidly losing share to imports. Although this agreement is a moral victory for domestic suppliers, most sources point out that the agreement will be hard to enforce, and it is unclear whether greater shelf space will necessarily result in domestic wineries recovering share.

If the measures being implemented to support the domestic wine sector are not successful, there is some concern that threats of safeguard measures could resurface. However, Rabobank views this as an unlikely scenario for both technical and strategic reasons.

There is doubt within the industry whether there are technical grounds for safeguard measures under WTO rules. It seems unlikely that the Brazilian government would pursue this course of action as it would incur costs, risk backlash from trading partners and ultimately, may not be successful.

Safeguard measures may also be avoided for strategic reasons, as the threat of these measures created adverse consequences for the domestic suppliers that proposed them. The threat of protectionist measures irritated many of the main clients of the domestic industry—the same retailers and restaurants that have profited from the growth of imported wines.

While the safeguard measure pitted foreign suppliers against the domestic industry, other market changes affected all brand owners regardless of origin. Large retailers such as Pao de Azucar, Carrefour and Wal-Mart, have been engaging in a process of refining their management of the wine category and seeking to reduce brands that do not generate sufficient rotation. The elimination of slower-rotating brands has been a challenge for some, but creates a great opportunity for stronger brands to consolidate their position and gain market share. Brands that struggle to attain the level of rotation required by retailers are increasingly looking at alternate routes to market, such as focusing on the on-premise channel or via e-commerce.

Reports suggest that direct-to-consumer channels have seen strong growth in recent years. Security issues are making entertaining at home a more attractive option for many wealthy consumers, and direct-to-consumer sales are becoming an increasingly important channel for sourcing wine for parties and for daily consumption.

In addition to changes in the retail segment, adjustments to tax laws are impacting the development of distribution channels. The Brazilian government recently harmonised its tax code to eliminate tax differentials between states, which often distorted decisions on how wine was imported and distributed within the country. The new tax code has helped to create greater transparency in the import and distribution process, which has attracted greater investment from both foreign and domestic players and generally made the distribution process more modern and efficient. On a less positive note, it now looks as though São Paulo will be further raising ICMS-ST taxes on wine starting in September, which will create additional headwinds for wine sales as the cost of the taxes are passed on to consumers, though the degree to which this will affect final prices to consumers is still unclear.

Market outlook—challenging but attractive

The Brazilian wine market is likely to remain challenging in the short term. Weak economic growth coupled with inflation and possible tax increases will create challenges and uncertainty for nearly all players, with the weak Brazilian real and import infrastructure challenges creating additional hurdles for foreign suppliers.

While the near- term picture may not be very encouraging, we believe that the underlying growth story remains positive in both the medium and longer term, though not at the double-digit rates of the previous ten years and not without some ongoing volatility. The economy is expected to gradually improve and the investments going into the import/export infrastructure should help reduce those limitations over time. Savvy wine marketers with well-positioned brands that invest for long-term growth in Brazil should be able to reap strong rewards. As Randy Millian, outgoing President for Diageo's Latin America & Caribbean division, recently noted 'Despite some headwinds in Brazil and volatility in Venezuela, these are long-term, high-growth markets with very favourable population demographics'[2].

International supply

Yields in the Southern Hemisphere look quite healthy across the board. Although most of the global production is centred in the Northern Hemisphere, the Southern Hemisphere plays an important role in global trade and the increases in production are already having important repercussions in the market.

[1] *The Road to Ruin: Brazil's Agribusiness Logistics in 2013* reviews in detail the challenges that Brazil faces due to the lack of adequate infrastructure and touches on the challenges of the new legislation.

[2] Diageo 2013 Investor Brunch Time Call

Southern Hemisphere update

Australia

The estimated size of the 2013 Australian wine harvest, at 1.83 million tonnes, has surprised many, increasing by 10% on the prior year (WFA, 2013). The extended heat wave at the beginning of the year seemingly had little effect on the crop in hot inland regions that contributed roughly 60% of what will be the largest crop in five seasons. Wine grape prices also strengthened, with average prices across cool/temperate climate regions rising by 13.1% on the prior year, while prices across hot inland regions increased more modestly by 3.5%.

New Zealand

The New Zealand wine harvest posted a new record of 345 thousand tonnes in 2013, an increase of 28.5% on the very short 2012 crop and 5% higher than the prior record set in 2011. Low carryover stock levels have meant that exports of 2013 Sauvignon Blanc have already commenced with gusto.

Chile

Preliminary indications point to a good 2013 harvest in Chile, showing very good quality and also good yields that might result in total production matching last year's bumper crop. This situation, combined with high ending stocks in 2012 (up 28% from 2011), have resulted in strong pressure on wine grape prices, which in some cases have contracted as much as 50%.

Argentina

Argentina experienced a normal sized crop in 2013 of approximately 2.85 million tonnes, 28% larger than the short crop of 2012, but similar to the average crop size of the past five years. Overall quality appears to be very good by most reports.

South Africa

South Africa's 2013 harvest was the largest in history, reaching nearly 1.5 million tons. This is 5.4% higher than the 2012 crop, which was also quite considerable.

Northern Hemisphere update

US

US production is in its early stages but appears to be advancing well. Early forecasts point to healthy yields in 2013, but not as large as last year's bumper crop.

High grape prices have led to an increase in vineyard planting and renewals. Allied Grape Growers estimates that in 2012 nurseries sold vines to plant approximately 30,000 acres (12,000 hectares) for the spring of 2013, though how much was for new vineyards versus vineyard replanting is not clear. By several reports, there is still pent-up demand to plant additional vineyards in California that is being held back by two factors: nurseries running short of plant stocks and rising land prices. Agricultural land is currently being bid to record high levels as farmers seek to expand highly profitable almond production.

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.

International trade

Export trends of major producers

Italy

Italian wine export volumes declined by 1.9%, while the value of trade increased strongly by 9.8% in the first quarter of 2013 versus the same period last year. Sparkling wines were one of the few categories to post increases in export volumes, while average export values increased across most categories. Of particular note was the rise in bulk wine export prices which jumped by over 30% aided by downbeat preliminary forecasts of the 2013 harvest (*see Figure 3*).

Spain

Prices for Spanish bulk wine during Q1 2013 were 51% higher than during the same period last year. As a result, bulk export volumes declined 28.5% due to reduced demand, but even with the reduced volumes, bulk export values increased 8.6% due to the higher prices. Higher value wines with Denominación de Origen Protegida (DOP) saw volumes grow 6.1% and value grow 6.7% in Q1, with the largest value increases coming from the UK, the US, Germany and China. In the latter case, wine producers from Rioja appear to be benefitting from the growing austerity measures in China, having positioned their product as a high quality, lower priced alternative to French wines.

Australia

Australian wine exports declined by 5.8% in volume and 1.7% in value in the first four months of 2013 compared to the prior year. Shipments to markets across the UK/Europe have continued to contract, while markets in North America and New Zealand recorded gains. Trade into markets across Asia was somewhat mixed, but remains particularly profitable, with average export unit values to China/Hong Kong breaking through AUD 8.00 per litre during the period, while prices to the smaller ASEAN market were not far behind at AUD 7.78 per litre.

New Zealand

New Zealand wine export volumes declined by 8% in the first four months of the year as exporters waited for larger volumes from the 2013 vintage to come on-stream. The value of trade fell more gently by 1.1% as significantly less wine was shipped in bulk format over the period. North American and Asian markets remained the bright spots, while declining shipments to Australia and the UK/Europe are now likely to stabilise as stock levels have been amply replenished.

Argentina

Between January and May, Argentine wine export volumes fell nearly 24%, mainly due to the 52% contraction in bulk shipments following last year's light crop. In terms of revenues, the decrease in volumes was to a great extent offset by rising average export prices (bulk +10% and bottled +5%). Over the last six months, the Argentine peso has depreciated against the US dollar by nearly 11%, thus providing some relief to the exporters. Nevertheless, the sector margins remain under strong pressure on the back of rising domestic costs.

Chile

Total wine exports to May increased more than 30% in volume compared to the same period in 2012. The increase resulted from an 83% growth in bulk sales whereas bottled exports remained essentially flat. The main destination for Chilean bulk wine was the US, with more than 55 million litres (up 23% from 2012) and accounting for almost 29% of exported bulk wine. Spain ranked second among Chile's largest bulk importers, with almost 54 million litres, a sharp increase from 0.2 million litres in 2012, which can be seen as an opportunistic move to compensate for the light Spanish crop in 2012. The main markets for bottled wine remain the US, UK and Japan, though China and South Korea continue to report strong growth both in volume and value terms.

US

US export volumes declined 3% in Q1 2013. The positive impact of a 14% increase in bottled wine exports was more than compensated by the 20% decline in bulk exports. Canada remains the largest market for US bottled wines by value, and continues to register healthy growth (+28% value growth). The UK also registered healthy case volume growth (+28%), though at much lower prices. Other markets where US bottled wine exports registered strong growth include China, South Korea, Mexico, Panama and Malaysia.

South Africa

South Africa's export volumes grew 35% in the six months from December 2012 to May 2013. After several periods of decline, bottled exports have started to register gains (+4.8%) but bulk exports (+60.3%) continue to lead the growth story. Bottled exports to the US, Canada, Denmark and China all experienced growth, while major markets such as the UK, Sweden and the Netherlands, as well as many of the African markets, remained soft. Growth in bulk exports were particularly dramatic in Russia (+31.7 million litres) and Europe (exports to France, Italy and Spain collectively increased by more than 38 million litres). The growth in bulk exports was skewed heavily to white wines, with some reports indicating that part of the demand was for a cheaper source of wine to use in distilling for brandies.

Figure 3: Change in exports for key exporters, 2013

Country	Volume change (%)	Value change (%)	Period of measure
Spain	-18.2	6.3	Jan – Mar
Italy	-1.9	9.8	Jan – Mar
US	-3	11	Jan – Mar
Australia	-5.8	-1.7	Jan – Apr
Argentina	-23	-1.4	Jan – Mar
Chile	31.0	8.9	Jan – May
New Zealand	-8	-1.1	Jan- April
South Africa	35	Na	Dec - May

Note: Value changes in local currencies

Source: Australian Wine and Brandy Corp, 'The Gomberg-Fredrikson Report', Instituto Nacional de Vitivincultura (Arg.), Observatorio Español del Mercado de Vino, South African Wine Industry Information System, Unione Italiana Vini, Federation des Exportateurs de Vins et Spiritueux, Wines of Chile, New Zealand Wine Growers, 2012

US import trends

In what may be interpreted as a marked departure from recent trends, US imports of bulk wine declined (-17%) during Q1 2013, while bottled wine imports grew (8%) (*see Figure 4*). Growth in bottled wine imports from Italy and France accounted for more than half of the approximately 1.3 million case increase in bottled wine imports.

Australian bottled wine, which has struggled in the US market recently, has enjoyed some improvements, with bottled wine exports growing 5%, even as average pricing mildly improved (1.2%).

Bottled wine import volumes from Argentina rose 7%, with average pricing up 5%. Bulk wine imports, however, declined 50%, dragging total volumes to the US market down by 31%.

New Zealand continues to enjoy strong success in the US market, with volumes growing 21% in Q1, but perhaps the biggest and most surprising growth stories in US bottled wine imports continue to be Spain (+17%), Portugal (+38%) and South Africa (10%).

Figure 4: US imports by country of origin, Jan 2013-Mar 2013

	Value (USD million)	Change (%)	Volume (million cases)	Change (%)
Italy	381.9	13	8.1	8
France	273.7	11	2.7	16
Spain	81.8	13	1.8	-8
Australia	140.9	0	6.3	-2
New Zealand	59.9	13	1	-10
Chile	92.9	4	5.5	3
Argentina	90.5	-2	3.4	-31
World total	12,284	9	32.3	-1

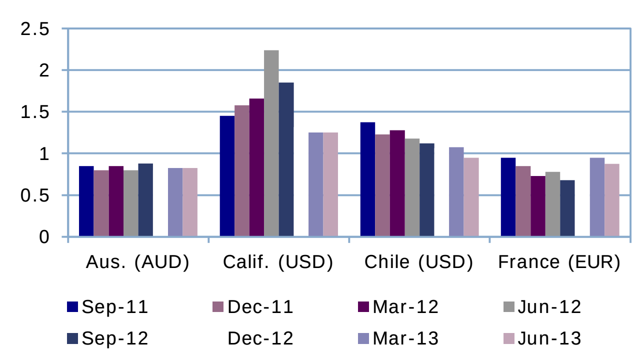
Source: 'The Gomberg-Fredrikson Report', 2013

Bulk wine pricing

With few exceptions, bulk wine pricing is beginning to ease across most regions and varietals (*see Figures 5-7*). In spite of the declines of the past several months, pricing in Europe remains high by recent historical comparisons. For countries such as Chile, the recent decline appears to be an acceleration of a trend in declining prices that began as early as mid-2011.

Figure 5: Prices for bulk Chardonnay by region, Jun 2011-Jun 2013

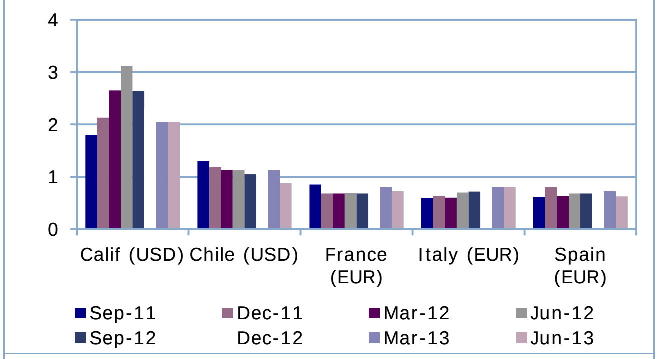
per litre



Source: Ciatti, Co., 2013

Figure 6: Prices for bulk Cabernet Sauvignon by region, Jun 2011-Jun 2013

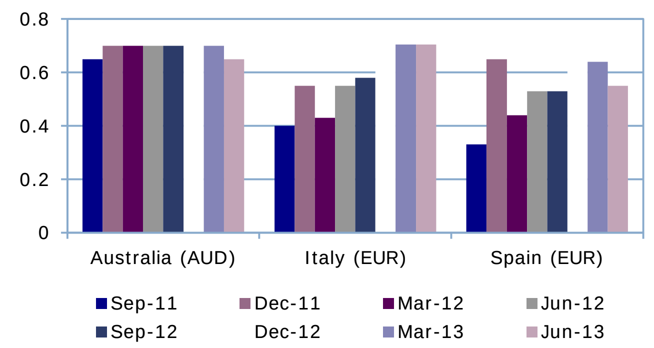
per litre



Source: Ciatti Co., 2013

Figure 7: Prices for generic bulk white wine by region, Jun 2011-Jun 2013

per litre

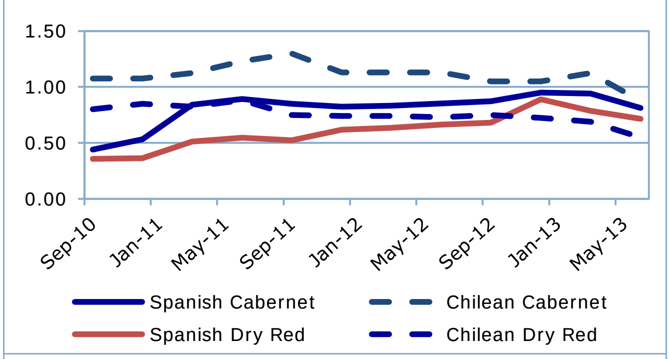


Source: Ciatti Co., 2013

While the light harvest in Europe in 2012 provided some support for Spanish bulk wine pricing, price increases appear to have reduced demand more than expected. Pricing is beginning to soften, but remains high by historical standards. In the Southern Hemisphere, the large recent crops coming in on top of healthy existing inventories are providing downward pressure for pricing as well. Chilean bulk prices had maintained a price premium over Spanish bulk, but declining prices in Chile and rising prices in Spain have eased that gap (*see Figure 8*). Spanish wineries starting to source more wine from Chile at the end of 2012 and in Q1 2013 is a telling sign of the shift in pricing competitiveness, though it is unclear whether this trend will continue or if Spanish bulk prices will be forced into further declines.

Figure 8: Price per litre of Spanish and Chilean bulk wine varietals, Sep 2010-Jun 2013

USD per litre



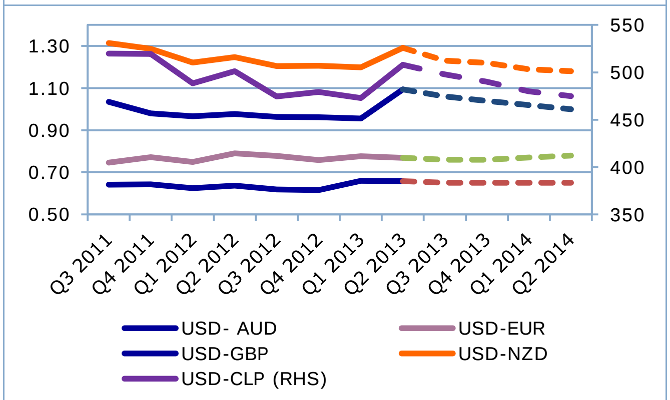
Source: Ciatti Co., 2013

Key currency forecasts

More good news from the US labour market in June 2013 has provided renewed support for the greenback, reversing gains made by the euro through June. The strong gains made against the Australian dollar, Chilean peso and to a lesser extent the New Zealand dollar in recent times have provided welcome relief to weary wine exporters in those countries. However, it is still full steam ahead for quantitative easing and the expectation is for this to again begin to weigh on the US dollar in the foreseeable future (*see Figure 9*).

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

USD



Source: Rabobank, 2013

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