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Outlook for Global and Regional Markets

Rabobank International

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- **Increasing pricing pressure in the premium and above segments of the US wine market**
- **Growing presence of chains and discounters**
- **Price management tools gaining importance for wine marketers to optimise profits**

The price is right… or is it?

Improving price management to drive profits

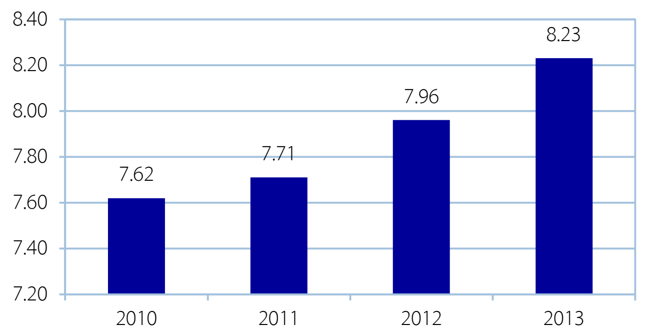
Pricing decisions in the wine category are extremely challenging, but when properly managed can reap important benefits. Pricing decisions have a critical impact on the positioning and profitability of a wine brand, and yet wine marketers often have very little clarity on when and where to make optimal pricing changes to maximise profits. Pricing is becoming a greater challenge in the US market, which is already highly complex due to the three tier system and varying regulations and taxation rates from state to state. In this increasingly challenging environment, wine companies with more sophisticated price management tools will see direct results to their bottom line.

Pricing supports segment growth

In the US market, there has been a great deal of coverage of the fact that, along with improving sales volumes, the average price of wines sold is rising, with the high-end of the wine market gaining share at the expense of lower priced wines (*see Figure 1*). In recent years, there has been strong growth in of wines priced in the USD 9 to USD 15 range, while wines priced below USD 9 have seen broad based decline.

Figure 1: Average price per unit of wine sold in the US off-premise, 2010-2013

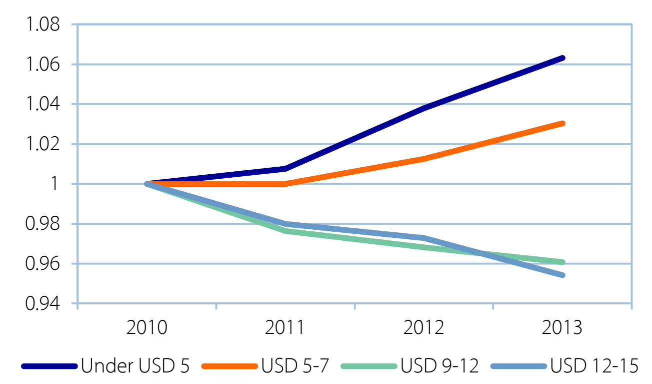
USD



Source: IRI, 2013

Improving wine sales and rising average prices are good news for the market, but what often receives less attention is the role that pricing has played in these trends. Wines priced below USD 9 have seen volume declines largely because prices have increased in response to rising grape costs. The growth of the USD 9 to USD 15 category has been partially supported by innovation—The Nielsen Company estimates that 44% of new items introduced in the past two years were in this price segment—but it is largely supported by the pricing pressure on individual brands, as major brands in higher price segments have faced consistent YOY price declines (*see Figure 2*). For those looking to introduce new brands into the market, this pricing pressure must be taken into account in advance, and sufficient margin must be built into the brand to be able to remain profitable over time as margins become compressed.

Figure 2: Index in change of average price for groups of selected brands by price segment, 2010- 2013



Source: IRI, 2013

Luxury wines in the US, particularly those brands from Napa and Sonoma going direct to consumer (DtC), have generally had more success raising prices because of scarcity of supply and because the relationship between the brands and the consumer functions differently than brands sold through wholesale. Many small wineries are finding that selling DtC can be more profitable than selling through wholesale channels, but focusing on DtC requires additional investment and effort to manage properly.

Pricing pressure and the evolving retail environment

Why is pricing for so many mainstream wine brands under so much pressure? In the US market, this is partially a reflection of the evolving retail environment. Research from The Nielsen Company suggests that the growth in the number of chain account locations selling wine (+4%) has far outpaced the growth in the number of independent stores (+2%) in recent years. Perhaps more importantly, it is the chain accounts that are generating most of the growth in the US wine market—the market has been growing at a 5.5% CAGR including chains, but only 0.2% excluding chain accounts. Food retailers have been emphasising the wine aisle as it is one of the few categories demonstrating sustained growth.

Price management can have exponential volume impact

Chain accounts, such as grocery stores, are playing an increasingly important role in the wine market and cannot be ignored by brands that hope to achieve scale. Chain accounts will often (though not always) have better retail execution than many smaller independent accounts, and can quickly deliver important volume growth opportunities. However, it should be noted that traditional chains are coming under increasing pressure from the rising presence of new discount-focused chains, creating downward pricing pressure in the market. An appropriate pricing decision can have an exponential impact on volumes with large chains, not only because of consumer response, but also because it means the difference between gaining shelf space or not. Volume growth inevitably comes with margin pressure, but profits can be improved due to increased sales velocity if the brand is priced appropriately.

Most brand owners understand this, but the challenge often stems from the complexity of measuring how changes to the FOB price will impact the final retail shelf price for each state (or market) after different taxes, freight costs, and wholesaler and retailer mark-ups are added in. The brand owner must also look at how the resulting price will position the brand relative to competitors in the market. This process must be managed on a regular basis for each brand, size format, varietal, etc. To help manage these complexities, some companies are working to develop in-house price management systems, while others are purchasing external software and services. The latter often have a high price tag but can offer proven solutions that are justifiable for brands with scale.

Depending on how a brand is currently positioned, profitability can also be increased by raising prices. However, raising prices on wine brands being sold through chain accounts can be very difficult and can result in dramatic volume declines. Managed correctly, it can have a positive impact on consumer perception and the long-term profitability of a brand, but there are far fewer wine brands being sold in chain accounts that have had success with price increases than with discounting.

The need for visibility on price elasticity

Price elasticity—the change in sales volume resulting from a change in price—will vary dramatically from brand to brand. Furthermore, the same brand will see variations in elasticity depending on varietal, time of year, competitor pricing moves, etc. One recent study suggests that wine categories (i.e. varietal and price segment) have an average elasticity of as much as -1.28%,[1] (a 1% price increase results in a 1.28% decline in volumes) but there is significant variation around that average. Strong brands in growth mode can have limited positive elasticity, while several wine marketers we have spoken with suggest a typical established wine brand will often have elasticity of closer to -3.

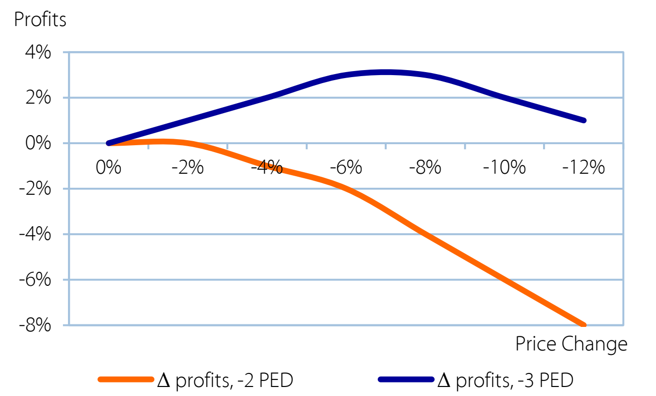
These complexities are compounded by the fact that to be truly effective, pricing decisions must be managed on a market-by-market basis. Tax structures, wholesaler margin expectations and retailer margin expectations vary by market. The same FOB price will result in very different shelf prices from one market to the next, and competitor pricing moves will also be different in different markets, which adds to the complexity of the analysis.

In comparing the impact of various levels of discounting for a brand[2] at a price elasticity of -2 versus -3, the difference in impact of price changes under the two scenarios are dramatic and point to the need for an accurate understanding of a brand's elasticity in order to make pricing decisions (*see Figure 3*). It is also clear that some level of discounting can potentially improve profitability by generating a disproportionate lift in volumes, but eventually the trend will always turn negative.

Avoiding the temptation to over-discount

Trading off some margin for improved volumes can have a positive impact on the bottom line, particularly in the short term, but discounting must be managed with extreme caution. Discounts are generally offered on a short-term basis through price pulsing, but pervasive discounting can erode a brand's image, particularly if prices drop below certain key price thresholds—even temporarily. As common wisdom in the wine industry suggests, pricing tends to go in one direction—once it starts declining, it can be very difficult to recover. The US wine market is littered with once-profitable brands that were seduced by the short-term benefits of discounting and degraded their brand equity.

Figure 3: Impact on gross profits from various levels of discounts for wine with FOB of USD 102.60 and elasticity of demand of -3



Source: Rabobank analysis, 2014

Summary

Given the increasing role of chains in the US wine market, successful management of prices is becoming a critical skill for those seeking to penetrate this channel. Developing these skills is made more complex by the variety of SKUs and the varying costs, regulations and mark-up structures from one state to another. However, investments to improve these capabilities can deliver long-term dividends to wine marketers, particularly if they are attempting to sell through chain accounts.

[1] Cuellar, Steven and Ryan Huffman. (2008). "Estimating the demand for wine using instrumental variable techniques". American Association of Wine Economists. Working Paper 24.

[2] This assumes the brand is currently selling 100,000 cases at an FOB of USD 102.60, COGS of USD 55.00 per case, and a retail shelf price of USD 19.

International supply

With the exception of France, wine grape production in 2014 appears set to decline across nearly every major production region, compared to the large 2013 crop. The International Organization of Vine and Wine (OIV) has yet to release its official estimate, but we believe that total global production could decline between 2% and 4%.

Northern Hemisphere update

US

The US wine grape crop looks set to come in well below last year's record-sized harvest, but will still be a very healthy sized crop of good quality. Estimates from various sources suggest that the 2014 crop will be between 5% and 10% below last year, which would still be larger than most crops prior to 2012. Given the series of large crops in recent years, most wineries are carrying relatively high inventory levels and storage capacity is becoming tight, but the threat of ongoing drought is mitigating the perception of oversupply.

Europe

European production looks set to register a significant decline in 2014. Production in Spain will be well below last year's enormous crop, but will still be large compared to many recent vintages prior to 2013. Italian production looks set to decline by 15%, led by declines in Sicily, and will return Italy to a position of tighter inventories. French production is set to rebound, with quality and quantity improving in many regions compared to the challenging 2013 vintage, though Languedoc will be down which is tightening supply of bulk wine from this important region.

Southern Hemisphere update

Australia

The Winemakers' Federation of Australia has confirmed the 2014 harvest was 7% lower than the prior year at an estimated 1.70 million tonnes. This was still substantial enough to replenish stocks and cause average wine grape prices to fall back across most regions in 2014, with some exceptions for premium region/varietal combinations.

New Zealand

The New Zealand Winegrowers Association estimates the harvest at a new record level of 445 thousand tonnes, up 29% on the prior (record) year. Weighted average wine grape prices held mostly steady across the industry.

Chile

Figures from Chile's Ministry of Agriculture suggest that Chile's wine production fell 22.8% in 2014 compared to the prior year. The decline was seen mainly in white wines and was the result of the exceptionally hard frost that hit the country in the early stages of the growing season. In spite of the decline in production, Chile appears to enjoy strong enough inventories to meet much of its current demand.

Argentina

Although production declined in 8% in 2014 compared to the large 2013 crop, it was still a reasonably healthy sized crop, and supply is broadly available.

International trade

Export trends of major producers

Italy

Italian wine export volumes inched ahead in the first half of the year, rising by 0.9% in volume and 1.5% in value as compared to the prior year. Sparkling wine volumes continue to grow at strong double-digit rates, as traditional markets such as Germany and Russia are quickly falling away in favour of more dynamic markets elsewhere. Still bottled IGT classified wines outperformed their DOC/DOCG counterparts, while still bulk wine export volumes fell by 2.4% despite a sharp 15.9% drop in average prices over the period (*see Figure 4*).

France

Total French wine exports fell 3.5% by volume and 7% in value in the first half of 2014, according to FEVS. Champagne exports managed to register respectable growth, but this was not enough to offset the 28% decline in revenues for Bordeaux. Challenges in the Champagne market were mainly the result of challenges in the Chinese market, which Rabobank believes could begin to recover by the second half of 2015.

Spain

Spanish wine exports are showing signs of recovery through the first seven months of 2014, with total volumes up 24% by volume, led by a 40% increase in exports of bulk wine. The rise in bulk wine sales has been supported by a 35% decline in average prices. Significant increases have been seen in exports to many of Spain's traditional markets in the EU (e.g. France, Germany and Portugal) but also notably to Russia (+291%). The increase in exports to the latter reflect how dramatically the Russians pulled out of Spain last year, but may also be a reflection of importers securing supply ahead of any potential trade disruptions.

Australia

Australian wine exports recorded modest growth in the first half of the year, with volumes rising by 1.8% and values rising by 2.0% as compared to the prior corresponding period. Bulk shipments to Canada rose sharply over the period, while bottled exports to mainland China stabilised in volume but fell back in value.

New Zealand

New Zealand wine exports rose strongly in the first six months of the year. Average export prices slipped, with volume growth of 16.1% outpacing value growth of 13.9% as the share of bulk shipments in the mix is again rising. All major markets are recording solid growth led by the US, while the fifth-ranked German market has been the strongest of all growing by 41% over the period in question.

Argentina

During the first six months of 2014, Argentine exports fell 4.9% by volume, while value grew 0.3%. Growth in exports of varietal wine (+16.2%) and sparkling wine (+23.5%) were offset by a decline in wines without varietal specification (-53.9%). Exports of varietal wines are shifting from bottled formats to bulk- presumably brand owners are bottling in country of sale- which is helping to drive a continued shift towards higher average prices for bottled exports. The weakening of the ARG seen since the beginning of the year is expected to provide continued support for Argentine bulk exports, and may allow exporters to recover some of the margin lost due to inflation in recent years.

Chile

Chilean bottled wine exports appear to be finding success in higher value segments, mainly due to the successful diversification of markets. Total exports were down 11.2% by volume and 1.8% by value, mainly due to the 24% decline in bulk wine export volumes. Bottled wine exports rose 3.5% by volume; declines in bottled exports to the US and UK were more than compensated by strong growth in higher paying markets such as Japan, China, Brazil, the Netherlands, Canada and Korea. Kudos to the Chilean exporters!

US

US wine exports grew 2% by volume and 4% by value through the first seven months of 2014. Bottled table wine volumes declined 1%, while bulk rose 5%. Declining exports of bottled wines to the UK and Japan were only partially compensated by growth in exports to Canada and (believe it or not) Nigeria. The decline in bottled exports to the UK seems to represent a shift to bulk formats to the market, which grew 2%.

South Africa

South African exports for the last 12 months were down 19.1%, with nearly all of the decline being registered by bulk exports (-27.5%). The decline likely reflects tighter inventories in South Africa, following strong export success seen in 2013, but also the increased availability of bulk wine at reasonable prices in other markets, most notably Spain.

Figure 4: Change in exports for key exporters, 2014

Country	Volume change (%)	Value change (%)	Period of measure
France	-3.5	-7	Jan-June
Spain	24.3	0.6	Jan-July
Italy	0.9	1.5	Jan-June
US	2	4	Jan- July
Australia	1.8	2.0	Jan-June
Argentina	-4.9	0.3	Jan-June
Chile	-11.2	-1.8	Jan-June
New Zealand	16.1	13.9	Jan-June
South Africa	-19.1	n.a.	TTM Aug

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, 2014

US import trends

Total US import volumes declined 1%, led mainly by declines in bottled imports (*see Figure 5*).

Bottled Italian still wine import volumes were flat, though value rose 6%. The 2% increase in volumes was led by a continued improvement in imports of sparkling wines (+18%).

Imports of French wines were somewhat lacklustre (-1%), as bottled still wine imports were flat and improvements in sparkling wine trends failed to keep pace with declines in bulk imports.

The Australian category continues to struggle disproportionately in the US market, with ongoing declines in bottled (-8%), bulk (-22%) and sparkling wines (-9%).

Rising US imports of Chilean bulk wine (10%) outpaced declines in bottled imports (-4%), resulting in a5% increase in total import volumes.

New Zealand (+22%) and Argentina (+8%) registered the largest volume gains during the period, though Argentina's growth came almost exclusively from bulk wine imports.

Portugal, though still a small player in the US market, continues to make good progress. Total imports from Portugal grew 16% in the period, driven exclusively by growth in bottled wines.

Figure 5: US imports by country of origin, Jan-Jul 2014

	Value (USD million)	Change (%)	Volume (million cases)	Change (%)
Italy	1,006.7	8	19.7	2
France	795	6	7.3	-1
Spain	206	3	4.6	-8
Australia	269	-10	10.6	-12
New Zealand	184.7	21	3.2	22
Chile	182	-8	11.4	5
Argentina	217.8	2	7.7	8
World total	2,950.2	5	54.1	-1

Source: 'The Gomberg-Fredrikson Report', 2014

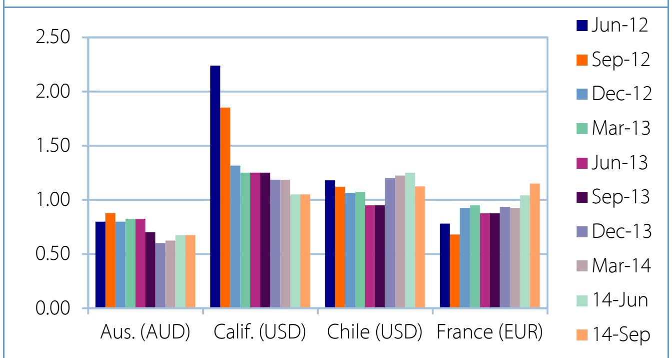
Bulk wine pricing

In general terms, bulk wine prices appear to be stable, though with some exceptions. Bulk wine in France continues to see upward pressure due to the light harvest last year and lower yields this year in Languedoc. Likewise, the decline in Italian production appears to be weighing on yields.

Bulk Chardonnay prices appear to be mainly stable, with France as the notable exception (*see Figure 6*).

Figure 6: Chardonnay bulk wine pricing for various countries, Jun 2012-Sep 2014

Index of price per litre

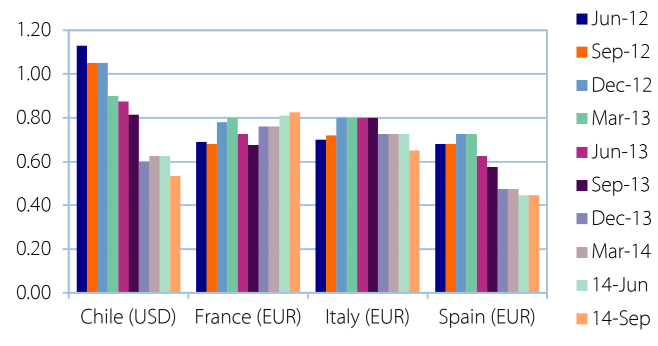


Source: Ciatti, Co., 2014

Cabernet Sauvignon prices have been easing slightly, largely due to broad availability in both Chile and the US, though, again, France is the notable exception (*see Figure 7*).

Figure 7: Cabernet Sauvignon price by country of origin, Jun 2012-Sep 2014

per litre

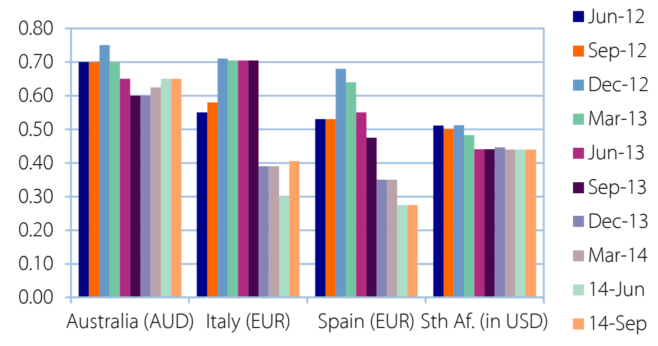


Source: Ciatti Co., 2014

Generic whites are generally stable in most countries, with rising prices in Italy as the notable exception(*see Figure 8*).

Figure 8: Prices for bulk generic white wine by country of origin, Jun 2012-Sep 2014

per litre



Source: Ciatti Co., 2014

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