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# Rabobank Wine Quarterly

## Trends and Outlook for the International Market

### Rabobank International

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- **Economic and regulatory headwinds remain in the UK market, but will begin to ease and provide more support to consumption in 2014 and beyond.**
- **Consumer behaviours are changing, and wine suppliers need to change with them to lay a foundation for future growth.**

### UK market and the winter of our discontent

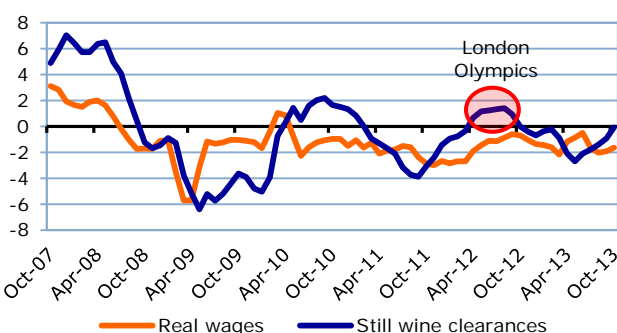
The prolonged economic downturn in the United Kingdom (UK) has provided the world's winemakers with few reasons for optimism in recent years. After a long period of buoyancy, UK wine consumption took a severe hit when the storm clouds rolled in back in 2008 and has struggled to regain traction ever since. But while the absence of growth in many categories has led many global suppliers to reconsider their commitment to the market, for a lucky few, the economic climate has created some valuable opportunities to better engage with increasingly value conscious consumers.

#### Challenging economic and regulatory climate

One relationship that became glaringly obvious during the economic downturn was the strong connection between real wage growth and still wine consumption in the UK market. As real wage growth plummeted in late 2008, growth in still wine clearances followed suit and has remained mostly negative ever since (see Figure 1). The London 2012 Olympics did help bring some life back to the market, but volumes duly normalised after the event.

Figure 1: UK real wages and still wine clearances, Oct 2007-Oct 2013

monthly change, 3-mma (YOY percent)

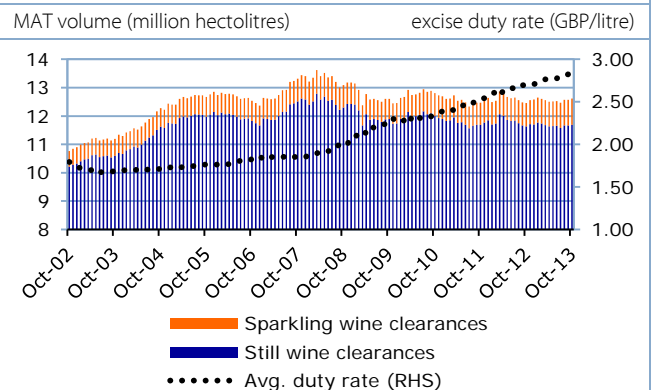


Source: UK ONS, Rabobank, 2013

In comparison, as a more discretionary product, sparkling wine consumption took a greater initial hit than still wine consumption, but has subsequently rebounded much more strongly as lower value offerings such as Cava and Prosecco have come to the fore.

To make matters worse, product costs have not provided any form of support to consumption during the downturn. Usually, prices would be expected to soften as household budgets come under pressure, but policy makers have taken little pity on the industry by acting to accelerate excise duty rate increases (see Figure 2). Prices in the market have duly risen, with little capacity for suppliers to continue to bear the cost despite the high degree of bargaining power of their customers in the concentrated grocery retail market.

Figure 2: UK wine clearances and excise duty rates, Oct 2002-Oct 2013



Source: UK ONS, Rabobank, 2013

The UK and Ireland now have the highest wine excise duty rates in the European Union (EU), even eclipsing those in Scandinavia, and the expectation is that while the Alcohol Duty Escalator may end with the May 2014 budget, excise duty rates will continue to rise with inflation for the foreseeable future. Long gone are the days of '3 for £10' deals, with average retail prices in the off-trade now at GBP 5.19 per bottle and over half of the grocery trade by value being conducted at average prices above GBP 5 per bottle (Wilson Drinks Report, 2014).

#### Emerging opportunities to re-engage with consumers

Fortunately, signs suggest that the economic environment is ever so gradually improving in the UK. Economic growth has resumed, unemployment is estimated to have eased again in the three months to October 2013, consumer sentiment is recovering, and

the latest inflation data shows consumer price pressures also beginning to return to more manageable levels. Furthermore, the regional economy in London, which contributes 20% of UK GDP and is especially important for the on-premise trade, is generally outperforming other parts of the country.

While it is difficult to ascertain exactly which consumer groups have been behind declining wine sales, it is understood that middle-aged women and the Baby Boomer generation have traditionally formed the core consumer demographics for wine in the UK. Interestingly, there are signs that these consumers are becoming more and more responsive to more diverse offers and even more premium offers when they are given a convincing reason to shift. A recent example is leading independent retailer Majestic Wine's success in showing that UK consumers will still reward a more engaging and up-market in-store experience. Over the recent Christmas trading period, Majestic reported that sales of GBP 20+ bottles showed especially strong growth.

It is also apparent that general drinking behaviours are changing in the UK. More and more consumption has shifted away from the on-premise and into the home, making brand building an even more difficult proposition. Furthermore, when consumers do go out, more and more consumption is occurring alongside food, with old pub formats continuing to flounder in favour of more contemporary offers. Incumbent market leaders, such as Australia in the off-premise and France in the on-premise, will need to adapt to such trends as consumers look for more food-friendly offerings.

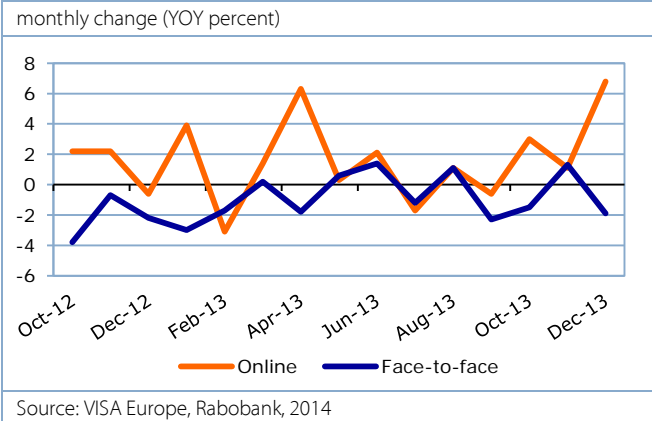
But just as in many other markets around the world, the wine category needs to do more to engage with younger generations who think and behave very differently than older consumers. It is estimated that drinkers aged 25 to 34 are the biggest spenders on alcohol in the UK, and encouragingly the amount they spend on alcohol out of the home tends to be similar to the amount spent on in-home consumption. In this respect, this group is even more receptive to new messages and product innovations, and online media and distribution channels are emerging to provide wine suppliers with a new and exciting platform.

### Online retail presents an opportunity to up-sell

The UK is fast turning to e-commerce as many of the world's most progressive retailers seek to engage with consumers online where they are spending more and more of their time. The growing importance of this emerging channel was recently highlighted by two major grocery retailers with reference to the Christmas trading period. Tesco reported that 3 million grocery delivery orders were placed online during the six-weeks covering Christmas and the New Year (+11% YOY), with one-third of these orders being placed via a mobile device. In stark contrast, direct competitor Morrisons posted much less flattering numbers, crediting part of its poor performance to an apparent lack of a compelling online platform. More generally, VISA Europe has reported the value of online spending in the UK grew 6.8% YOY in December 2013 as compared to a 1.9% decline in spending in brick-and-mortar stores (see Figure 3).

It is estimated that in 2010, only 1% of e-commerce sales were placed via a mobile device, but according to IAB, smart phone penetration is poised to top 75% in 2014, the proportion of e-commerce sales conducted using mobile devices is expected to push past 30% this year (IMRG, 2013).

Figure 3: Online versus store-based retail sales in the UK, Oct 2012-Dec 2013



On face value, e-commerce platforms are a powerful information and communication tool, which in turn provides a valuable opportunity to encourage consumers to trade-up with a greater understanding of products in the marketplace. Early indications indeed suggest that consumers purchasing wine online are generating a higher level of average spend, but this may simply be an inter-temporal effect if consumers are tending towards purchasing in bulk to minimise delivery costs. Whatever the case, the science is still budding, and wine supplier strategies to harness the power of the internet have a long way to come.

### Summary

The economic environment will remain the dominating influence in the UK wine market for the foreseeable future. However, there are signs that the winter of our discontent is passing. Improving economic fundamentals should begin to provide more support to wine consumption, despite many of the old pressures remaining as suppliers deal with rising excise tax rates and a concentrated grocery retail sector.

Emerging from the economic downturn is a far more digitally connected but fairly battered and bruised consumer, looking for new inspiration and exploring more contemporary and cosmopolitan consumption occasions. Suppliers that can make sense of this environment will find that all may not be lost in the UK market and that better times lie ahead.

### International supply

While final official data is not yet available for all countries, it is clear that harvests in the Northern Hemisphere rebounded somewhat in 2013. This fact, coupled with the strong Southern Hemisphere harvest earlier in the year, has allayed concerns over the potential tightening of global wine supplies.

### Northern Hemisphere update

#### US

All reports out of California suggest a very large US harvest for 2013. Estimates vary, but it is clear that this harvest will be similar in size to the record-breaking 2012 harvest and could possibly be larger. With two large harvests in a row, inventories are plentiful and tanks are full. Prices for domestic bulk wine are falling, and bulk wine imports are declining.

#### Europe

Wine inventories in Europe have rebounded as both Italy and Spain revised 2012 production figures upwards and experienced a

rebound in production in 2013. France bucked the trend, with estimates of the 2013 harvest downgraded to 42.3 million hectolitres after a difficult season, only 2% above the historically low 2012 crop. Production in the Bordeaux region suffered from cool weather, hail and other challenges, with many cooperatives estimating declines as high as 35%.

Spain experienced the most dramatic increase in production, with the 2013 crop jumping almost 40% to a near-record 49.5 million hectolitres, making it likely that Spain will overtake France and possibly Italy as the world's largest wine producer in 2013. Restructuring of vineyards in La Mancha to raise yields are starting to bear fruit (literally); however, the second half of the harvest in La Mancha suffered from rains which reduced quality. There is a growing expectation that two tiers of pricing will emerge in the region reflecting the differences in quality.

### *Southern Hemisphere update*

#### **Australia**

The 2014 Australian wine harvest is well underway, and very early expectations are for a slightly smaller crop. The harvest has again been tested by a severe heat wave, and although the prior year's experience with extremely hot weather proved less impactful than initially anticipated, this year's conditions are more severe and widespread, which could prove more difficult to negate. Notwithstanding this issue, yields in the major inland river regions were tracking around last year's levels prior to the heat wave, while yields in more temperate climate regions across southeast Australia were estimated to be a fraction lighter than last year.

#### **New Zealand**

The 2014 New Zealand wine harvest has yet to get underway, but favourable growing season conditions and early indications suggest that last year's record vintage could potentially be rivalled in 2014.

#### **Chile**

Chile will see its 2014 crop hampered after a severe frost hit the country's prime agricultural zones in September 2013. The impact of the frost was uneven across the valleys and varieties, with early season varieties such as Chardonnay and Pinot Noir the hardest hit. Estimations of the damage on the forthcoming crop are still varied across surveyed clients, but the general sense is that the 2014 harvest could be reduced by as much as 15%, with the production of Chardonnay contracting between 20% and 40%. Industry sources agree that wineries will not feel wine shortages thanks to the stocks built up following the two bumper crops in 2012 and 2013.

#### **Argentina**

In contrast to previous years, the National Viticulture Institute (INV) has not released detailed estimates for Argentina's forthcoming crop but rather only a general evaluation of the state of the national vineyard estate. The INV has reported incidences of poor fruit set in some zones, but no impact from any major adverse climatic events as yet, which points to a more normal 2014 harvest.

#### **South Africa**

According to national industry body SAWIS, early indications of South Africa's 2014 harvest are for a 4.5% smaller crop than the record harvest of 1.49 million tonnes in 2013.

## **International trade**

### *Export trends of major producers*

#### **France**

French wine exports fell by 3.3% in volume and 0.5% in value over first ten months of 2013 as lower stocks from the small 2012 harvest, and now the 2013 harvest, impact trade and provide support to prices (see Figure 4). Shipments of still wines within the EU are slightly higher than a year earlier, while shipments to extra-EU countries have fallen despite the United States (US) market recording significant gains. Of particular note are shipments of DOP wines to Asian markets, which continue to record strong declines.

#### **Italy**

Italian wine exports fell by 2.7% in volume but grew 8.5% in value over the first ten months of 2013. Bulk wine volumes recorded the largest declines while sparkling wine volumes continued to grow strongly to new heights, with average export pricing across most categories strengthening over the period.

#### **Spain**

Spanish wine export volumes declined 15.7% in the first nine months of 2013, led by a 19.3% decline (-146 million litres) in bulk wine exports. The dramatic decline in bulk wine exports was driven by a 45% increase in average prices versus the same period in 2012, with the biggest declines seen in France (-38 million litres) and Russia (-32 million litres.). Bottled wines with DOP saw a more modest increase in average prices (+6.8%) and fared better in terms of volume trends (+7.0%).

#### **Australia**

Australian wine export fell by 5.9% in volume and 5% in value during the ten months to October 2013. Bottled wine exports to the China/Hong Kong markets slipped by 1% over the period, but the value of trade remained resilient, lifting by 5% as the benefits of a lower Australian dollar begin to be felt.

#### **New Zealand**

New Zealand wine exports are firmly back in growth given the higher supply available from the record 2013 vintage, and the share of bulk wine in the product mix is again rising. Export volumes grew 10.3% in the first ten months of 2013, while their value grew less strongly by 2.9% over the period. Exports to northern European markets have experienced strong growth in 2013, while the US continues to be the best performing of New Zealand's major markets.

#### **Argentina**

Argentine wine export volumes experienced a material decline in the first 10 months of 2013—particularly in bulk—which largely reflects tight wine stocks in 1H 2013 due to the light 2012 harvest. Total exports declined 18.5% by volume and 6.2% by value over the period; with a 37% contraction in bulk wines and a 3% decline in bottled wines. Following the good 2013 crop, bulk wine exports have regained strength in 2H 2013.

#### **Chile**

The large Chilean harvests of 2012 and 2013 have replenished inventories and driven significant export volume growth. Total export volumes increased 24% in the first 11 months of 2013, predominantly driven by an increase of more than 70% in bulk

exports. A weaker domestic currency during 2H 2013 has helped restore the industry's competitiveness and provided some welcome relief from the anticipated adverse impact that frost will have on production volumes in 2014, notwithstanding the likely cushioning effect of significant carryover inventories.

## US

US wine exports continue to register solid growth. Export value growth (+12%) has outpaced volume growth (+6%) in the first ten months of 2013, in part because bottled wine exports (+7%) have grown faster than bulk exports (+5%) but also because of strong pricing improvements for both bulk and bottled wines. Strong volume growth in higher-paying markets such as Canada (+12%) and Sweden (+29%), in addition to improvements in average pricing in high volume markets such as the UK and Germany, are driving improvements in average bottled wine prices.

## South Africa

South Africa's exports continue to be supported by the soft rand, with total exports climbing 25.6% in the year to November 2013. Bulk wine exports have contributed the greatest share of growth, rising 37.5% over the period as compared to 7.5% for packaged wines. However, the rate of growth in bulk wine exports is beginning to slow.

Figure 4: Change in exports for key exporters, YTD 2013

Country	Volume change (%)	Value change (%)	Period of measure
France	-3.3	-0.5	Jan-Oct
Spain	-15.7	7.3	Jan-Sep
Italy	-2.7	8.5	Jan-Oct
US	6	12	Jan-Oct
Australia	-5.9	-5.0	Jan-Oct
Argentina	-18.5	-6.2	Jan-Sep
Chile	23.9	7.3	Jan-Nov
New Zealand	10.3	2.9	Jan-Oct
South Africa	25.6	n.a.	Dec-Nov

Note: Value changes in local currencies, except CHI & ARG in USD.

Source: Australian Wine and Brandy Corporation, 'The Gomberg-Fredrikson Report', Instituto Nacional de Vitivinicultura (Arg.), Observatorio Español del Mercado de Vino, South African Wine Industry Information & Systems, Unione Italiana Vini, Fédération des Exportateurs de Vins & Spiritueux de France, Wines of Chile, New Zealand Winegrowers, 2012

## US import trends

The improved supply situation in California has driven a 25% decline in bulk wine imports into the US in the first ten months of 2013. There is nevertheless good news for some exporters to the US as bottled wine imports experienced solid growth in volume (+7%) and more importantly in value (+9%). However, this growth was not enough to prevent an overall decline in US wine import volumes of 3% for the period (see Figure 5).

France showed the largest improvement in bottled import volumes, adding more than 840,000 cases compared to the same period in 2012, though some of this growth came at the expense of average pricing. Italy, on the other hand, managed to generate volume growth of 3% in spite of a nearly 6% increase in average pricing. Also of note, though from a much smaller base, Chile, Argentina and New Zealand all generated double-digit increases in shipments of bottled wine volumes to the US market.

Figure 5: US imports by country of origin, Jan 2013-Oct 2013

	Value (USD million)	Change (%)	Volume (million cases)	Change (%)
Italy	1,359.3	11	28.0	4
France	1,168.1	7	10.9	5
Spain	289.7	8	7.1	-13
Australia	420.6	-5	16.7	-11
New Zealand	233.7	17	4.0	8
Chile	272.1	2	14.0	-2
Argentina	311.4	-3	11.1	-28
World total	4,439.6	6	106.1	-3

Source: 'The Gomberg-Fredrikson Report', 2013

## Bulk wine pricing

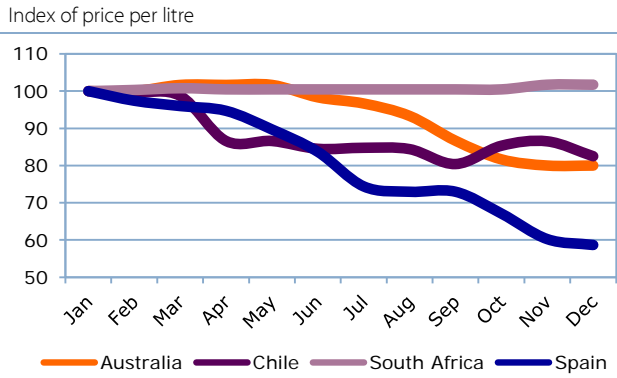
When looking at the bulk wine trends in the past, we have typically focused on the changes occurring by varietals. However, looking back over the past year, the story seems to be more about the change in pricing (or the lack of change) that has occurred within various countries. For example, average bulk wine prices for four major bulk wine supplying countries have seen varying degrees of change over the course of the year relative to their starting prices in January 2013 (see Figure 6).

Later in 2013, it became clear that global wine inventories were not as tight as initially believed, due to upward revisions in 2012 harvest data as well as the healthy crops in both the Southern and Northern Hemispheres in 2013. As a result, bulk wine pricing for nearly all major suppliers has been declining, with South Africa being the lone exception. Broad availabilities and the weak rand made South Africa very competitive throughout most of 2013, particularly in white wines, with little need or pressure to reduce pricing.

Spain, on the other hand, significantly lifted its pricing on bulk wine in 2012, which dramatically affected demand and left international buyers scrambling to find less expensive alternatives (such as South Africa). As a result of this pull back in demand, it appears that Spanish wine inventories in 2013 rose above 2012 levels despite the relatively light 2012 harvest. This was particularly problematic given the eventual size of 2013 crop.

Accordingly, there has been a process of continual reduction in Spanish bulk wine prices, which have declined 40% over the past year—far more than the declines experienced by countries such as Chile and Australia—and likely have further to fall. Buyers are reportedly showing little sympathy for Spanish suppliers, given the magnitude of last year's price increases, and will return to the Spanish market only when pricing becomes extremely compelling.

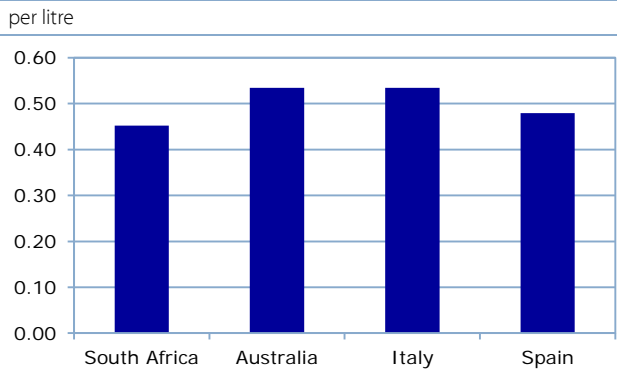
Figure 6: Index of average bulk wine pricing for various countries, Jan-Dec 2013



Source: Ciatti Company, 2013

In spite of the price decrease seen in many countries, South Africa appears to clearly remain the most competitive supplier of generic white wine (see Figure 7).

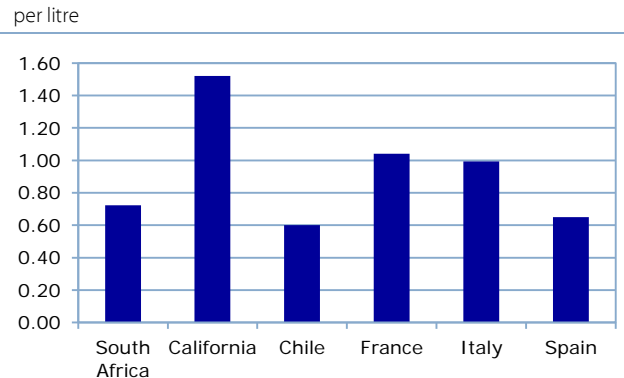
Figure 7: Average prices for bulk dry white wine by country of origin, Dec 2013



Source: Ciatti Company, 2013

The market dynamics in key red wine varietals are quite contrasted, with Chile and Spain holding a price advantage over South Africa in Cabernet Sauvignon for example, given the large inventory holdings and associated price declines experienced in these two countries over the past year (see Figure 8).

Figure 8: Average prices for bulk Cabernet Sauvignon by country of origin, Dec 2013



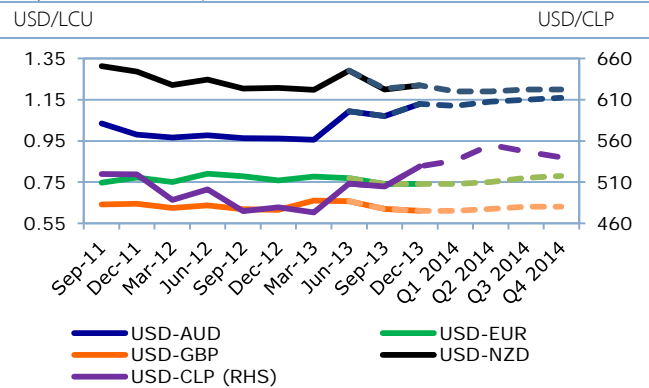
Source: Ciatti Company, 2013

### Key currency forecasts

The much anticipated announcement by the US Federal Reserve that it would begin to wind-back monetary stimulus to the US economy arrived in mid-December 2013, automatically putting the US dollar on the front foot.

The direction of central bank policy will naturally dominate the direction of global currency markets in 2014, with New Zealand expected to be the first major developed economy to raise interest rates in 2014, which will provide relatively more support for the New Zealand dollar against the greenback than most other currencies. By contrast, the Australian dollar and Chilean peso are forecast to weigh against the greenback in 2014 as global commodity prices soften and stimulus is gradually removed from the US economy (see Figure 9).

Figure 9: Historical and projected exchange rate of USD vs. key currencies, Sep 2011-Q4 2014f



Source: Rabobank, 2013

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