



**Australian Government**

**Australian Wine and Brandy Corporation**



Some Like it Hot 2008

# *Industry and market dynamics*

6 November

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*Manager-Information and Analysis*



# Introductory remarks ...

1. The Australian wine sector currently faces extraordinary uncertainty in both supply and demand.
2. Seasons, water availability and fledgling water markets contribute to supply-side uncertainty.
3. The demand-side is challenging with faltering economies, exchange rate volatility and finally, rising costs for both producers and consumers which combine to squeeze margins from both ends.
4. With such uncertainty, supply and demand forecasts are fraught and this treatment will focus on supply and demand issues instead.

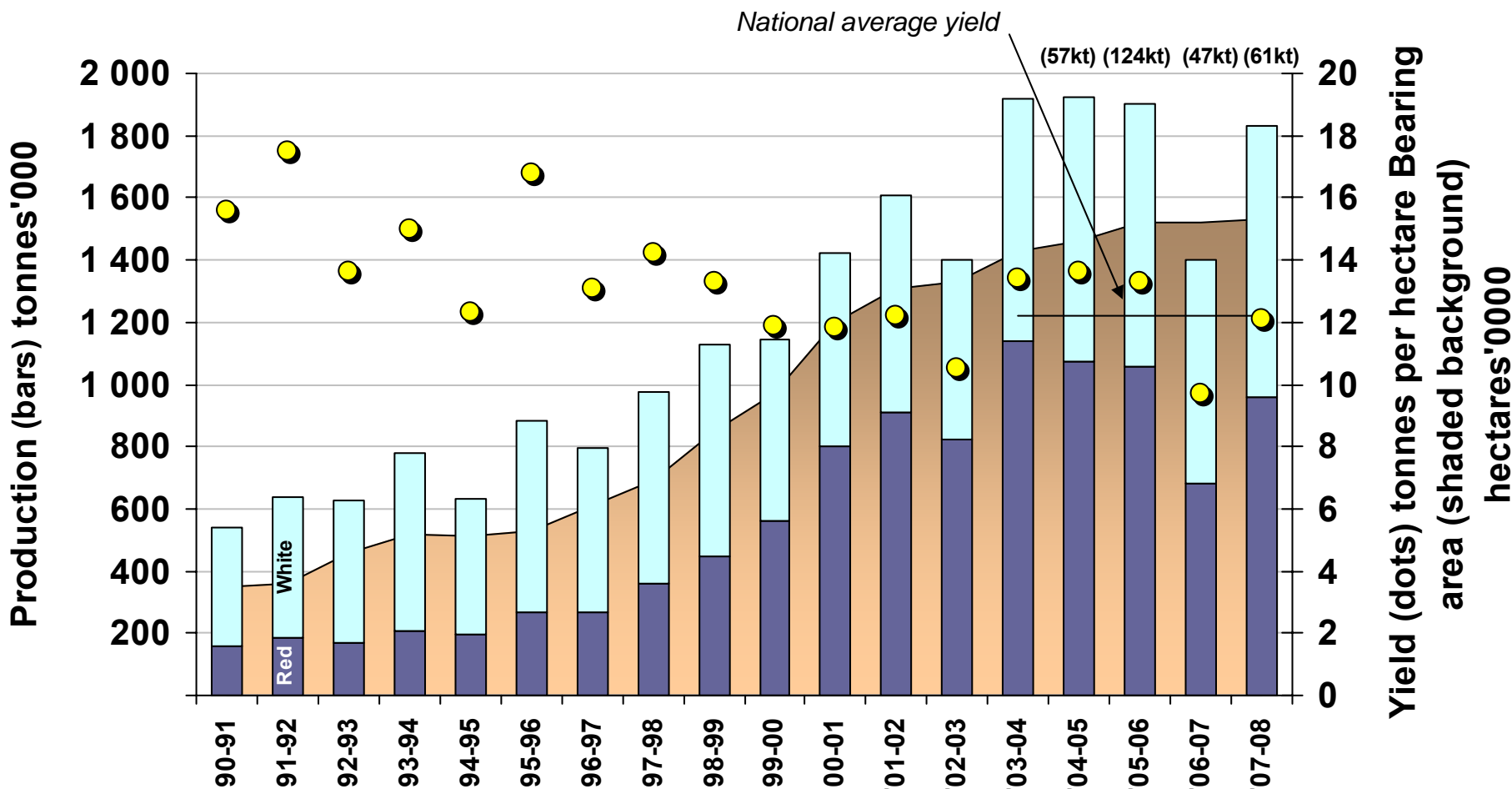
## ... *introductory remarks continued.*

5. The demand challenges examined in this treatment are viewed as largely short-term. They are expected to challenge the value-building efforts of the industry as expounded in *Directions to 2025*, but in no way diminish the merits of the objective.
6. In the face of a volumetrically smaller, but higher value, market opportunity going forward, the belief that the Australian wine sector needs to downsize is becoming more and more compelling.

# *Presentation overview ...*

1. Supply potential
2. Factors affecting supply
3. Demand issues
4. Current sales and implications
5. Future shape of the industry – a hypothetical

Harvests 2004 to 2006 were three above-average seasons in a row, 2007 a 30-year low in yields per hectare, 2008 should have been less than 2007

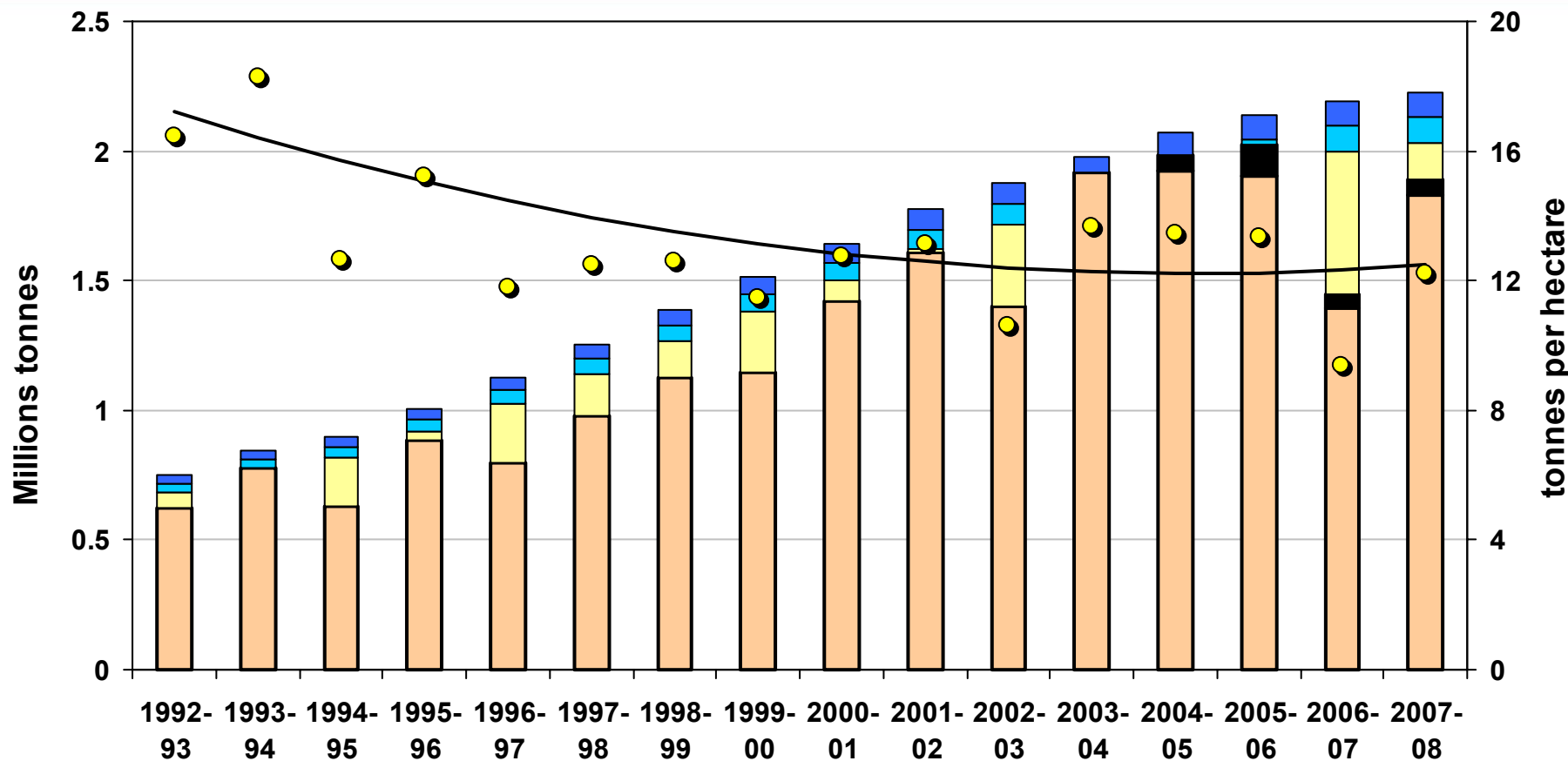


Note: The bars represent the tonnages crushed while yields from 2004-05 onwards include grapes left on the vine and dropped at harvest (tonnages left on the vine are indicated above the bars).

## *Why was 2008 bigger than expected (1.22mt >>1.83mt)? ...*

- Warm-inland and cooler-climate districts contributed in roughly a 60:40 proportion.
- Warm-inland
  - ... water purchases, based on expected higher winegrape prices, raised tonnages beyond expectations.
- Cooler-climate
  - ... no carry-over of 2007 frost damage or 2008 drought effects - rather, a 'bounce-back' year.

*An average Australian winegrape harvest is 1.93 mts. The most likely upside potential is 2.13 mts (yields 10% up on average), or at the extreme, 2.22 mts (yields 15% up). The highest production has been 2.02 mts in 2005-06.*



- Crush
- Production (yields 5% above 5 year ave trend)
- Production (yields 10% above 5 year ave trend)
- Production (yields 15% above 5 year ave trend)
- Production including grapes left
- In-year yield (t/ha)
- Trend for the moving 5 year average yield (t/ha)

Note: Going forward into the medium-term at least, areas removed from production are likely to mean these upside estimates will represent a peak in Australia's production capability

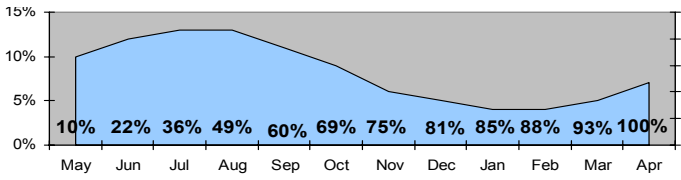
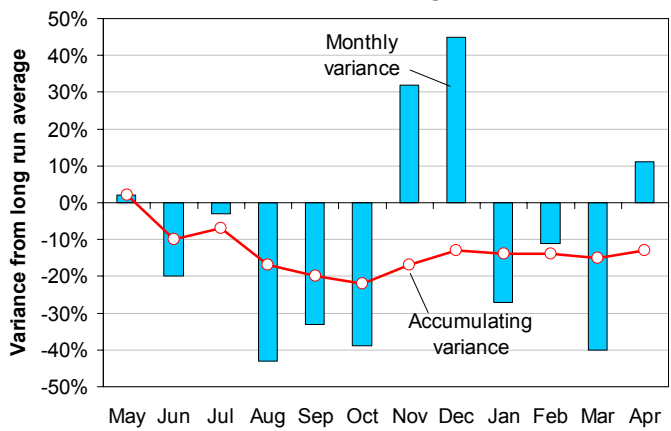
# Factors affecting supply

*To be examined –*

- **Water**
  - ... Cooler-climate rainfall
  - ... Warm-inland catchment rainfall >>> MDB inflows >>> MDB storages >>> Warm-inland irrigator allocations >>> Warm inland use (water accounting)
- **Vine removals**
- **Vine planting**
- **Other**

The 2008 cooler-climate harvest was helped by Nov-Dec rains. This year is starting as poorly as last ...

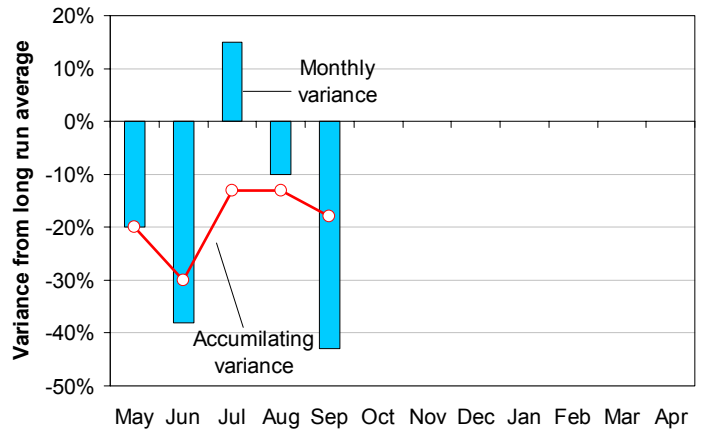
**Rainfall - Cooler climate regions in 2007-08**



**The 'window of opportunity'**

<<< long-run average monthly rainfall indicated in shaded outline  
 <<< an accumulating long-run average share of annual rainfall is indicated by the percentages

**Rainfall - Cooler climate regions in 2008-09**



Note: rainfall data was obtained from Bureau of Meteorology stations representing all winegrowing zones in Australia and were then weighted by the relative production in each zone to generate measures that reflect the impact on the industry as a whole.

*Warm inland water 101 - warm inland production is located in the MDB with 3 key catchment areas and 4 winegrape-critical distribution districts ...*

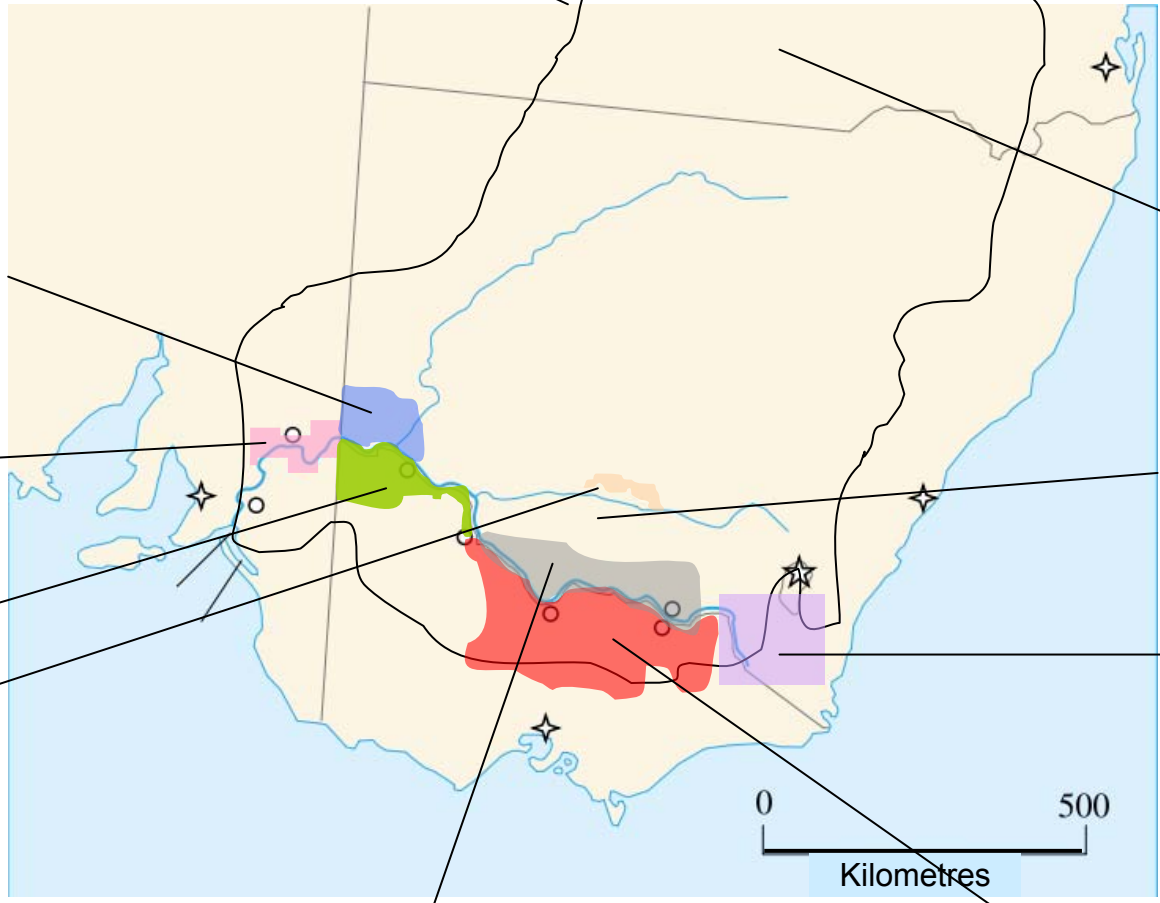
The Murray Darling Basin

Winegrape-critical distribution districts

- NSW Murray (WMI – 61GL entitlement)
- Riverland (CIT, RIT – 202GL combined)
- Vic Murray (LMW+FMIT – 503GL combined )
- MIA (1120GL)

Catchments

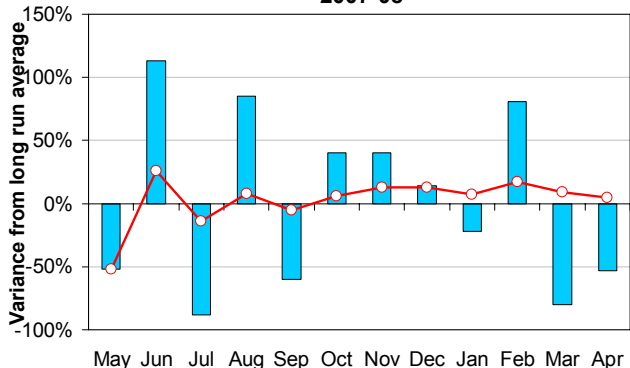
- Upper Darling
- Murray
- Snowy Mountains



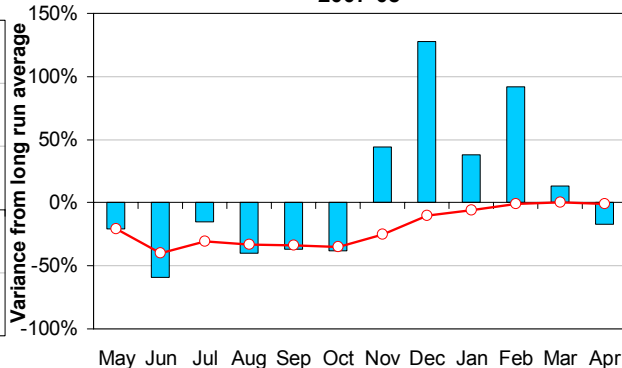
Additional distribution (Murray Irrigation Limited (1192GL), Goulburn Murray Water)

# 2009 will benefit from the 2007-08 rains in the Snowy and Upper Darling while 2008-09 rains so far, do not point to 2010 prospects being as favourable ...

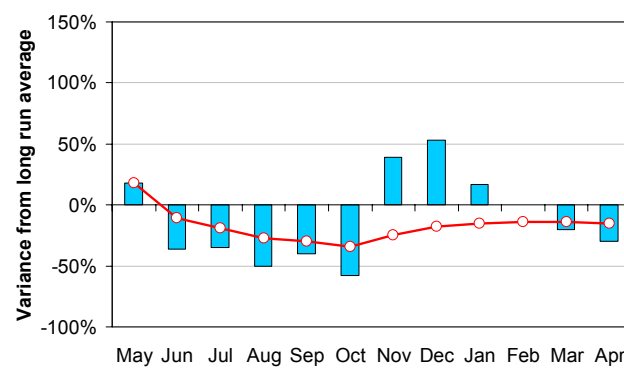
**Rainfall - Darling major catchment regions in 2007-08**



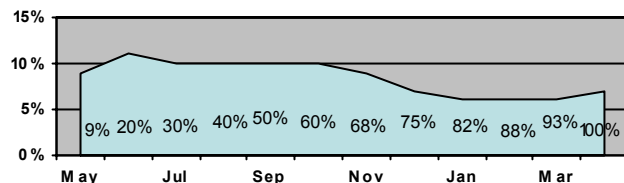
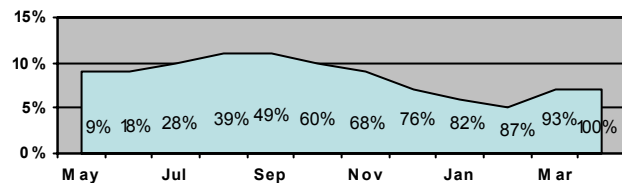
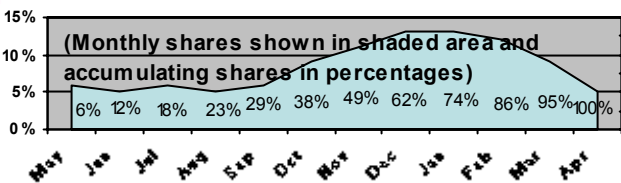
**Rainfall - Snowy major catchment regions in 2007-08**



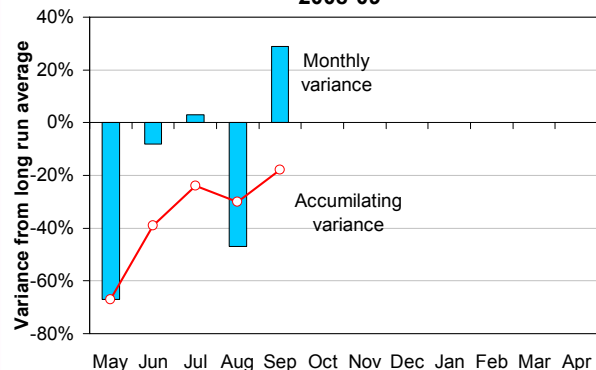
**Rainfall - Murray major catchment regions in 2007-08**



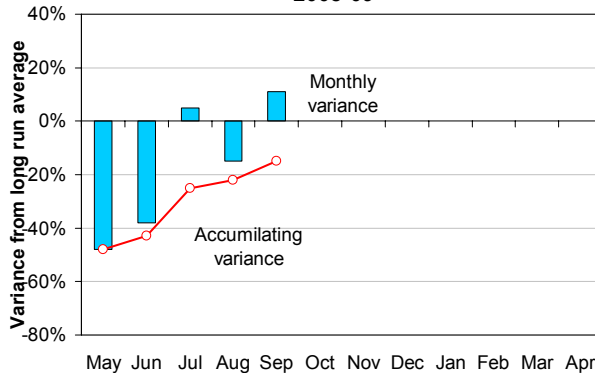
**(Monthly shares shown in shaded area and accumulating shares in percentages)**



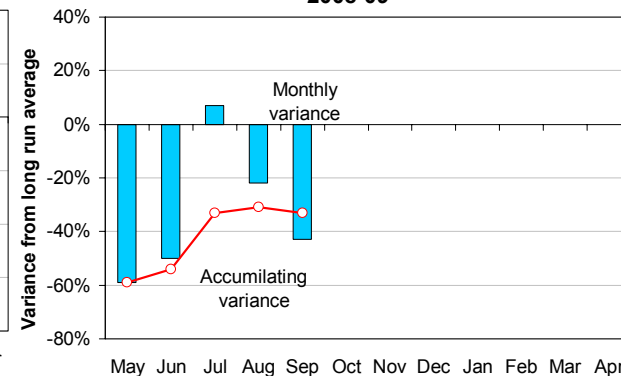
**Rainfall - Darling major catchment regions in 2008-09**



**Rainfall - Snowy major catchment areas in 2008-09**



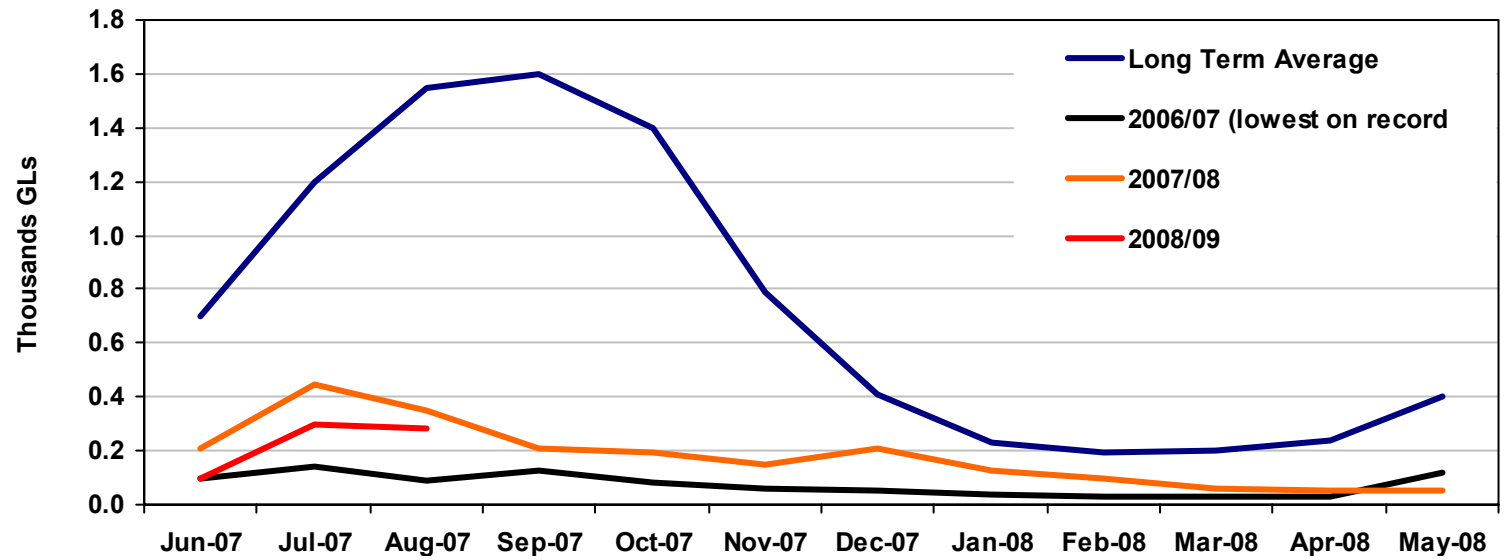
**Rainfall - Murray major catchment areas in 2008-09**



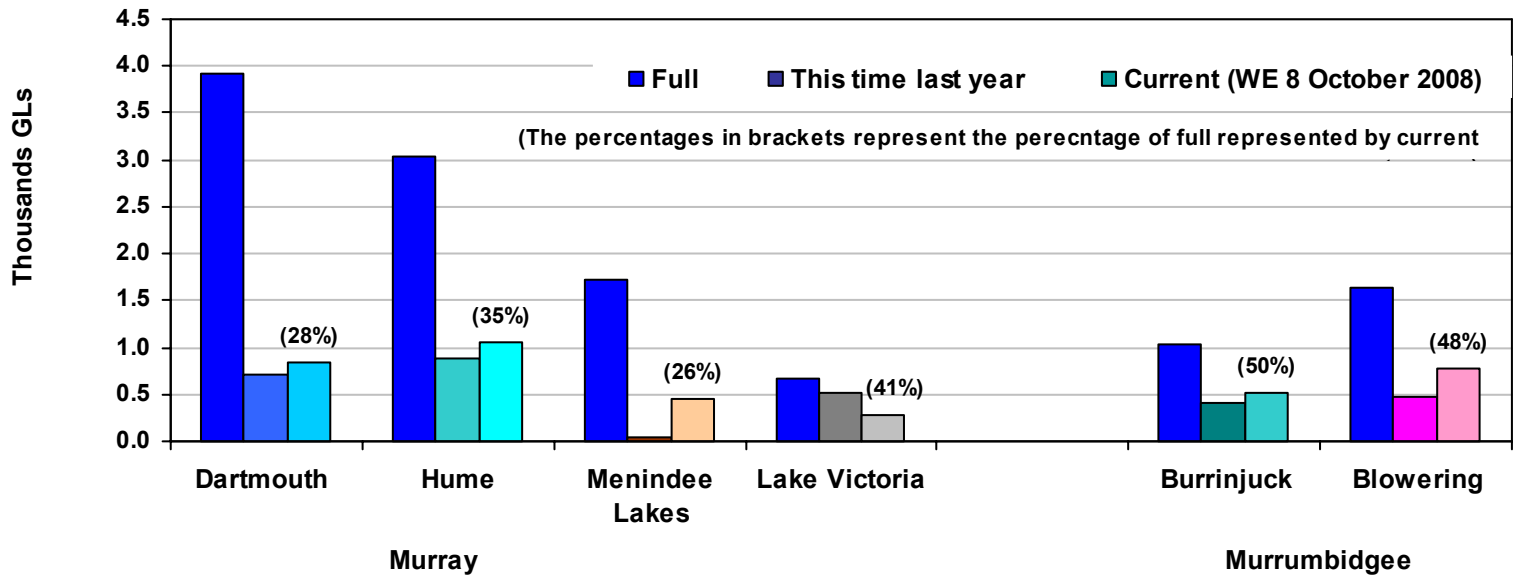
Note: Rainfall data was derived from representative Bureau of Meteorology stations in each catchment area.

*Inflows into the Murray continue to be low and storages, while critically low, are generally up on last year. MIA storages are better than the other districts.*

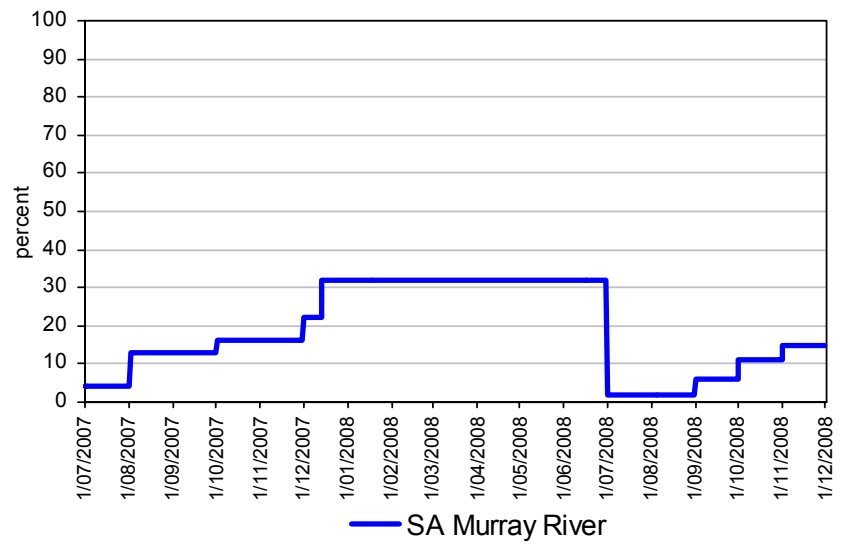
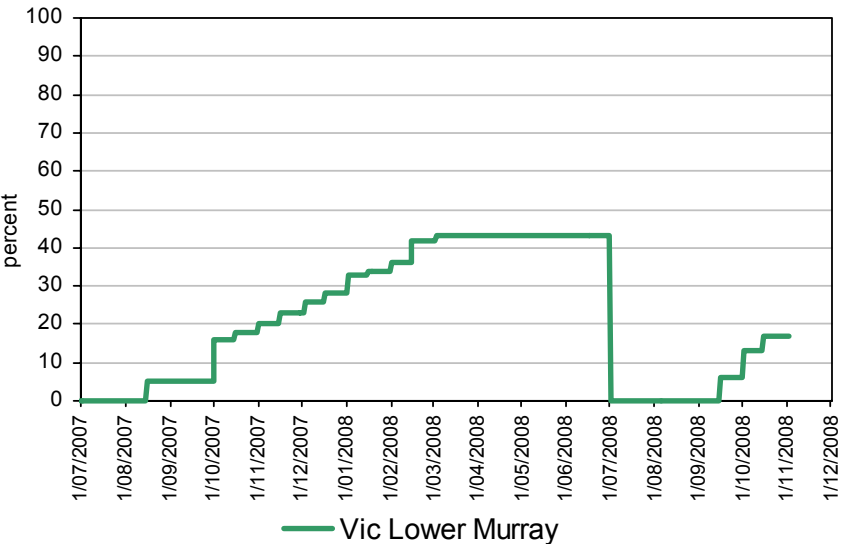
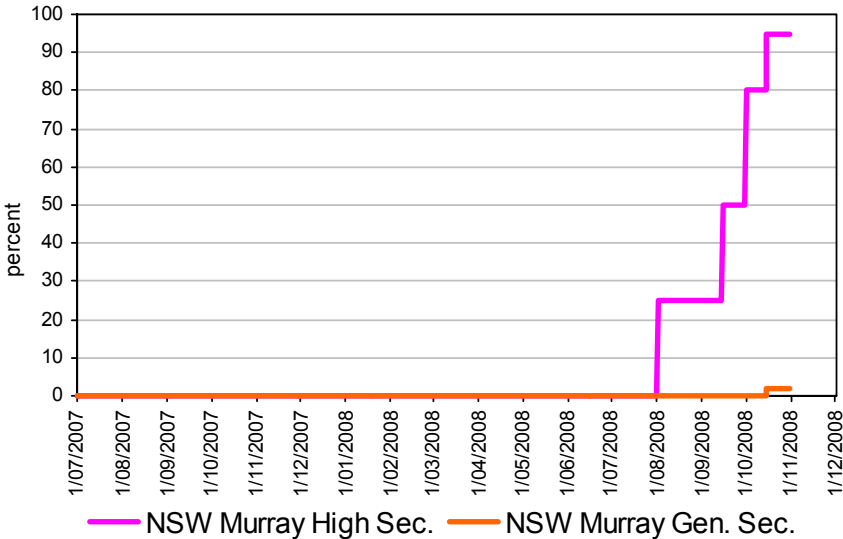
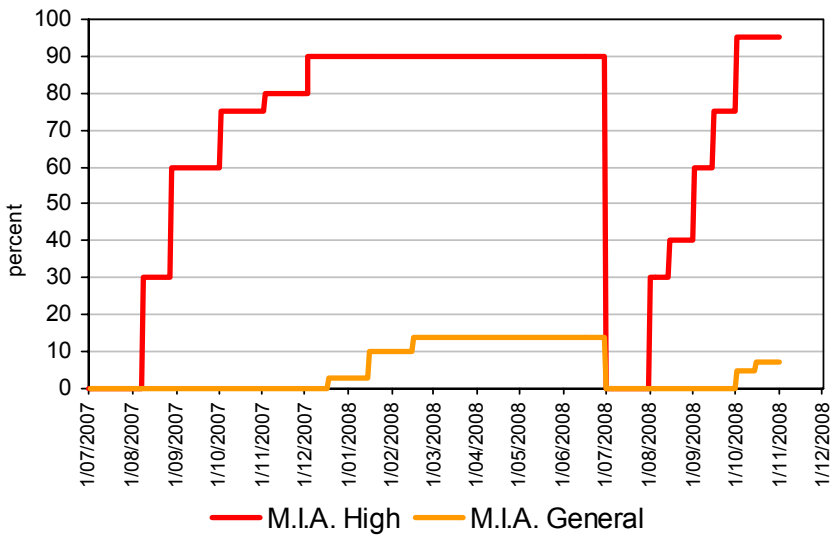
**Run-off**  
into the Murray River (excluding  
Medindee and Snowy)



**Water storage**



# NSW wine growing districts have 'full' water entitlements for 2009, while Victoria and SA lag ...

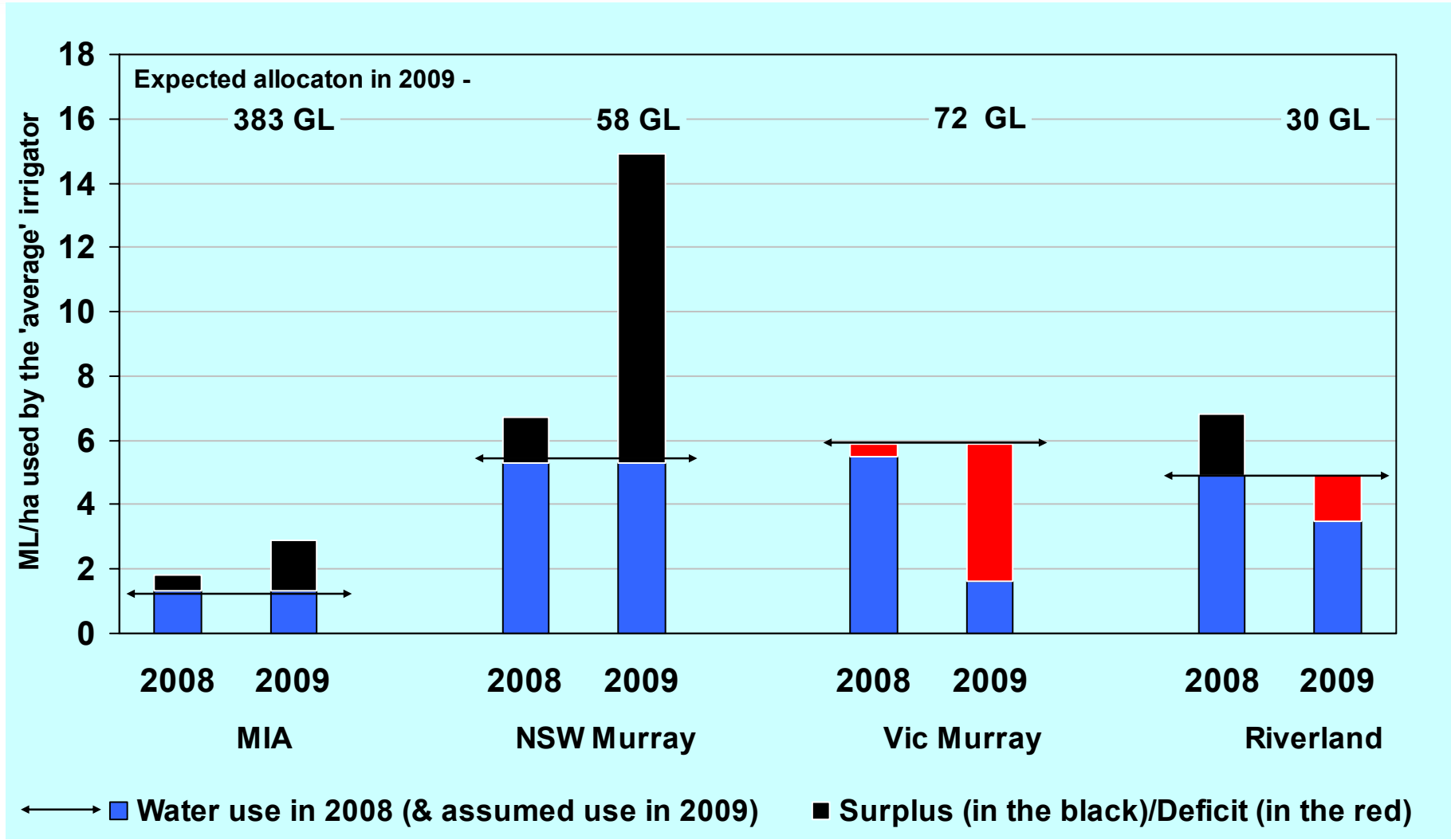


*Water accounting across the major water distributors in the warm inland districts suggests the physical availability of water will not stand in the way of a 2009 crop size similar to 2008. Water stocks are dwindling though.*

Distribution districts		MIA[1]		NSW Murray[2]		Victorian Murray[3]		Riverland[4]		Sum	
Harvest year		2008	2009	2008	2009	2008	2009	2008	2009	2008	2009
Entitlement	GL	1 220	1 120	61	61	503	503	202	202	1 986	1 886
High Security entitlement	GL	290	300	61	61	497	497	202	202	1050	1060
General security entitlement	GL	930	820							936	826
High Security allocation	%	90%	95%	25%	95%	43%	17%	32%	15%		
General security allocation	%	14%	12%								
Total available allocation	GL	391	383	15	58	214	84	64	30	685	556
Carry-in	GL	44	78	4	3	0	12	12	37	60	129
Temporary purchases	GL	-146	- 146	-10	- 10	105	211	54	27	3	83
Water availability[5]	GL	289	316	29	51	319	307	131	94	767	768
Water use	GL	210	210	23	23	307	307	94	94	634	634
Carry-out	GL	78	105	6	29	12		37		133	134
Carry-over allowed[6]	%	30%	30%	100%	100%	30%	30%	100%			
	GL	366	336	6		151	151	37			

[1] MIL [2] WMI) [3] LMW plus FMIT [4] CIT plus RIT [5] NSW includes 19GL returned from suspension the year before. [6] Refers to percent of entitlement in the case of MIA and Victoria Murray but percent of carry-out for the other districts. Numbers in blue bold font represent assumptions. Note that these figures represent the water accounts of irrigators in general, not just winegrape irrigators.

*The 'average' NSW irrigator will have water to sell in 2009 or to carryover into 2010, while Victorians and South Australians will need to buy ...*



Note that the low ML/ha applied by the average MIA irrigator reflects an averaging across General Security users (27% of the water entitlements at 12ML/ha) and General Security users (83% of the water entitlements at 6 ML/ha). Water use by the other districts represent high security water only. Use in 2009 is based on the assumption that 2009 use will be the same as in 2008. Expected allocation number are included to give a guide to the collective quantum of water involved for each 'average' irrigator category).

# *Observations from water accounting of the major distributors ...*

## **1. If water use in 2009 is the same as in 2008, then –**

- 90% of the water will be available through current allocations.
- Carried-in water would represent 23% of water use (compared to 10% last year).
- If allowed, carry-over water could be carried-over into next year or it could be used to reduce purchases this year.
- Carry over into 2010 could be similar to that being carried into 2009 if the purchasing route is taken.
- Alternatively, net temporary purchases of water across all districts could be well up on the year before (from a net 3GL to a net 83GL).

## **2. There are significant difference between districts.**

- SA and Vic could deplete carry-over in 2009 leaving no carry-over into 2010. NSW will still be left with carry-over for 2010.
- Trading would logically flow from NSW traded to the other states. This transfer process will rely on an effective water market and reasonable terms-of-trade.

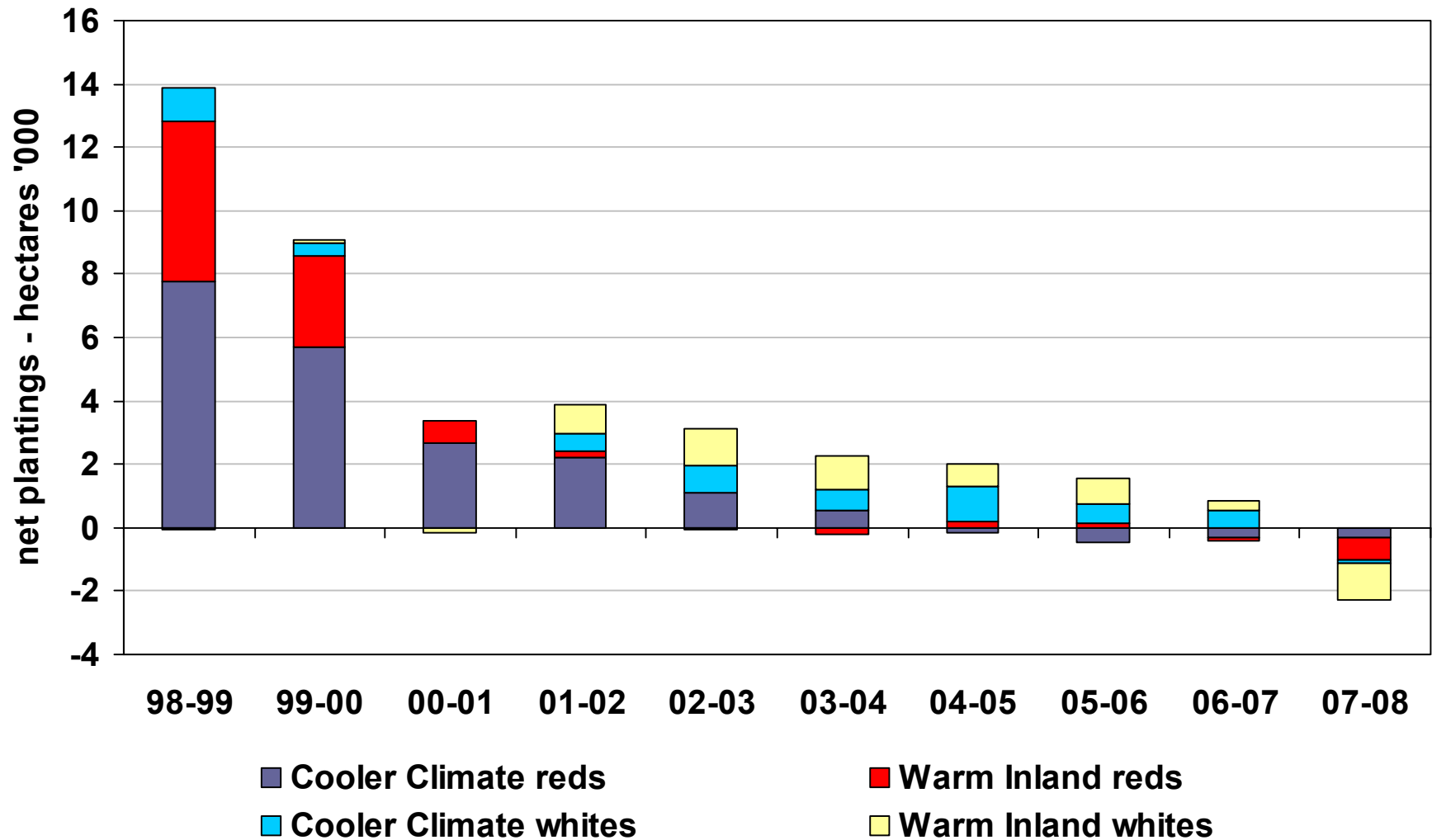
## **3. Water markets**

- The 2008 harvest demonstrated that Australia's water markets work.
- The water market will work more smoothly this year than last.

## **4. Vines are viewed favourably for water purchases.**

## **5. Lower winegrape prices in 2009 may constrain water purchasing.**

*Net removal of vines started to bite in Spring 2007 with warm-inland removals dominating – particularly whites ...*



Source: Vineyard Survey

AWBC © November 2008

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*Behind the negative net plantings statistic, planting for replacement and to meet emerging demand is still occurring ...*

<b>New plantings</b>	hectares	Warm: Cool split
Shiraz	447	
Sauvignon Blanc	396	
Chardonnay	198	
Pinot Gris	192	
Other white grape varieties	151	
Pinot Noir	143	
Other red grape varieties	121	
All	2 190	
Share of major planted varieties	75%	
<b>Removals</b>		
	hectares	
Sultana	713	
Chardonnay	654	
Shiraz	557	
Cabernet Sauvignon	470	
Other red grape varieties	301	
Other white grape varieties	250	
Muscat Gordo Blanco	234	
Merlot	192	
Semillon	137	
Riesling	118	
Colombard	107	
Ruby Cabernet	102	
All	4 479	
Share of major removed varieties	86%	

Source: Vineyard Survey Note: only plantings or removals greater than 100 hectares each are shown

*There are competing upward and downward pressures on the potential size of the 2009 winegrape harvest ...*

Upward pressure on tonnages ...	Downward pressure on tonnages ...
From bud and bunch research, the harvest potential is reported as 'high' (but, there's a long way to go yet).	Grapes left on the vine or left hanging at harvest should encourage vine removal.
Use of irrigation water in warm-inland districts is becoming more efficient.	Production is being actively discouraged through contractual arrangements.
Production perversity – while low winegrape prices should discourage production, higher yields (and therefore production) can maintain earnings per hectare.	Pre-2009 harvest warnings of lower winegrape prices, particularly for Chardonnay.
Anecdotal evidence of Californian Chardonnay shortfalls in '08.	Exit packages will help to remove some vines.

*In sum, 2009 has the potential to be the same as last year...*

## **1. 2009**

On balance, there is reason to believe the 2009 harvest can be just as fruitful as 2008 – once again defying drought.

The risk to this assessment is downside.

## **2. 2010 and beyond**

Production potential is lower for 2010 than for 2009 because –

... further constriction of water availability for warm-inland production,

... poor returns in the current challenging trading environment,

... vine removals,

... continued high stock levels.

There are stark differences between the different warm-inland districts.

# The NOT Suzie slide ...



# Demand issues

*Difficult trading conditions challenge the industry in the short-term with numerous impacts operating at a range of levels ...*

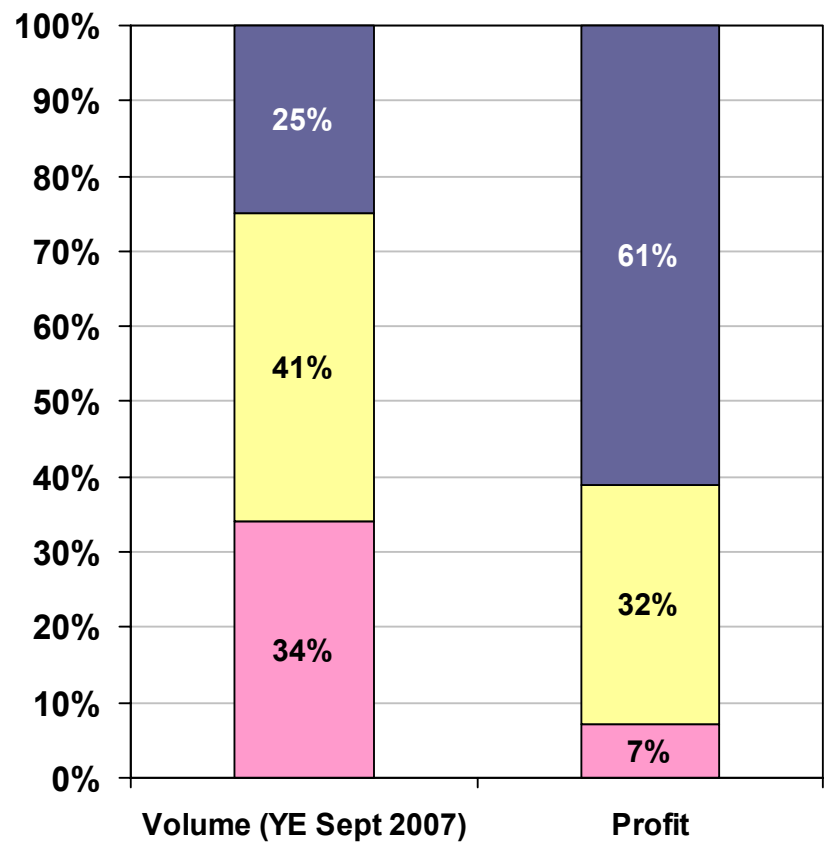
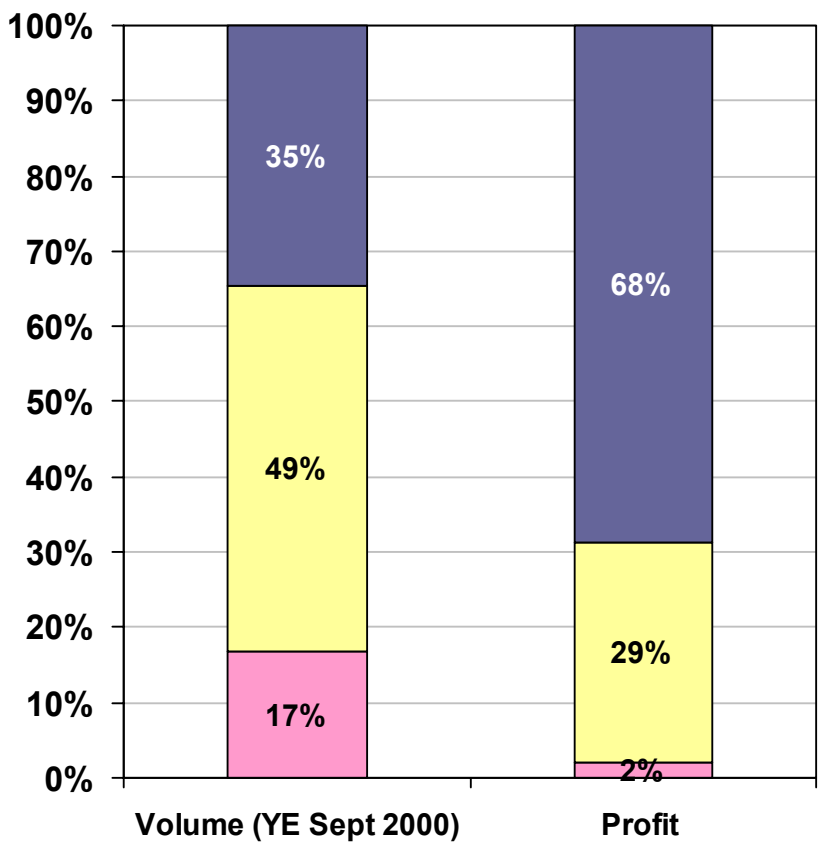
<b>Impact agent</b>	<b>Consumer spending</b>	<b>Spending location</b>	<b>Producer's profitability</b>	<b>Australian competitiveness</b>	<b>Winemaker control</b>
The credit crisis	Less spending	Head for lower price points	Less	—	None
Rising cost of living	Less spending	Head for lower price points	Less	—	None
Alcohol taxes	Less spending	Excises provide incentives to trade up	—	—	None
Foreign exchange - AUD weaker	—	—	Greater	More competitive	None
Foreign exchange - AUD stronger	—	—	Less	Less competitive	None
Rising input costs	—	—	Less	Less competitive	None (fundamentals) Some (operational)
Declining producer market power (incl. S&D balances)	—	—	Less	Less competitive	Yes

Note: none of the above economic impacts are mutually exclusive – only the dominant effects are tabled for the purposes of discussion.

## *Observations about the current trading conditions ...*

1. Current trading conditions are not assisting the value-building ambitions of the industry (*Directions to 2025*). Rather, many of the influences are driving the consumer to lower price points.
2. However, Australia is less able to access these lower price points.
3. Relentless pursuit of quality and cost-savings represent some of the few options for Australian winemakers to cope with these short-term conditions.
4. A recent weakening in the AUD is the only bright spot among generally depressing trading conditions – but still, it is volatile.
5. Most of the unfavourable economic trading conditions are beyond winemaker control.
6. Supply and demand balance is one factor the industry as a whole can influence.

*Despite the short-term challenges to value-building , it's worth re-asserting this central tenet of Directions to 2025 –*



- \$5.00/L and over
- \$2.50/L to \$4.99/L
- \$2.49/L and under

- \$5.00/L and over
- \$2.50/L to \$4.99/L
- \$2.49/L and under

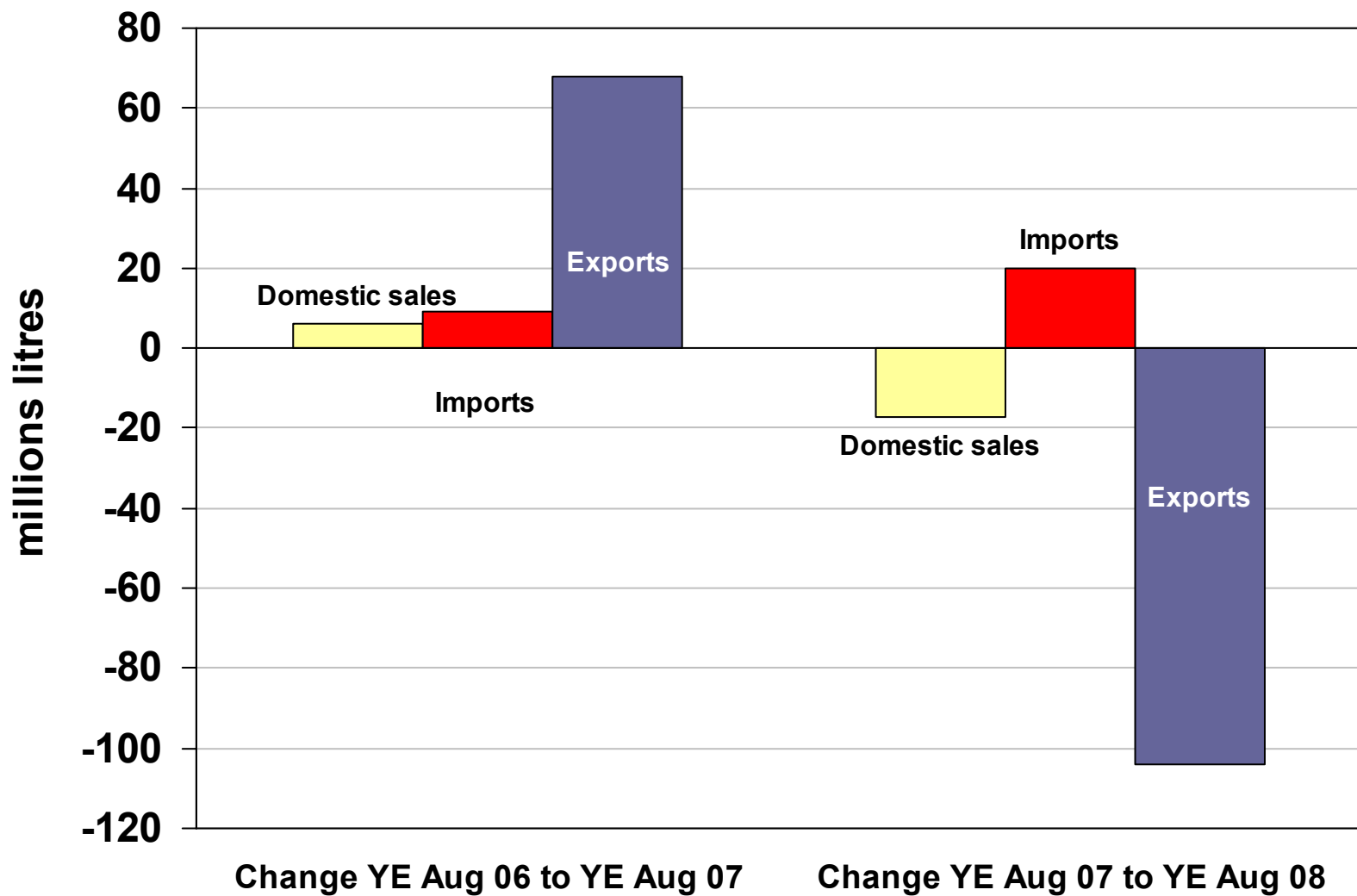
Note: YE Sept 2000 is compared to YE Sept 2007 to contrast a time of supply and demand balance (2000) with the peak of oversupply (2007). Margins in this analysis are assumed to be 50% for \$5/Litre and above shipments, 40% for \$2.50 to \$4.99/Litre shipments and 20% for under \$2.50/Litre shipments. The latter margin is optimistic for under-\$2.50/Litre shipments in 2007.

# Current sales

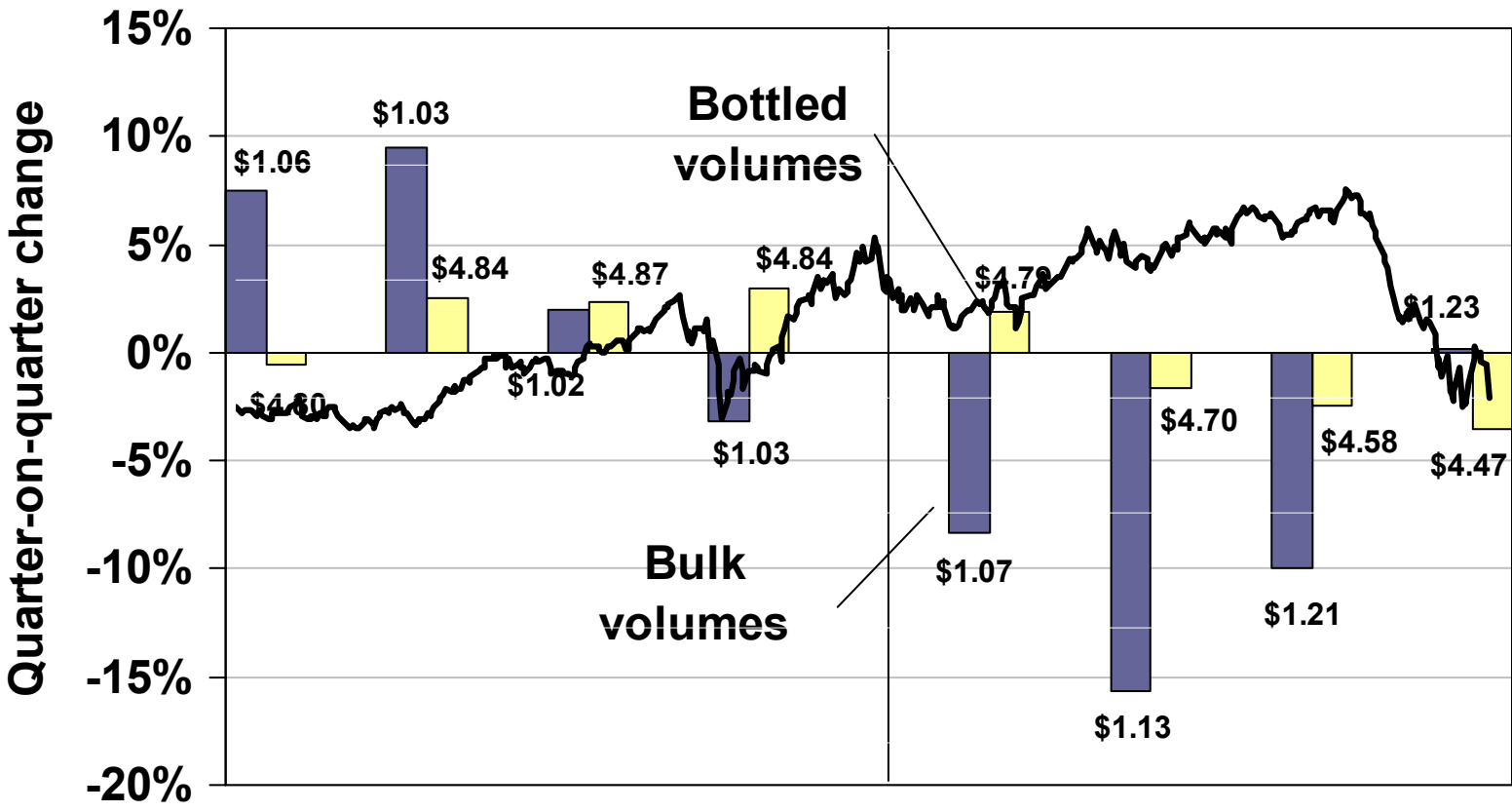
Sales trends in 2007-08 largely reflect heading back to 'balance' after the low 2007 harvest with some downward impetus from a strong AUD.

While the AUD has since moderated, other challenges have emerged.

*Exports fall as expected (or more than) as the industry headed back to balance following a low 2007 harvest - unprofitable bulk wine exports were shed from the mix. Imports almost replace declining domestic sales ...*



*The less desirable, and more price-sensitive, bulk wine exports dropped away first over the last 18 months but bottled shipments followed ...*



Dec Qtr 2006    Mar Qtr 2007    Jun Qtr 2007    Sep Qtr 2007    Dec Qtr 2007    Mar Qtr 2008    Jun Qtr 2008    Sep Qtr 2008

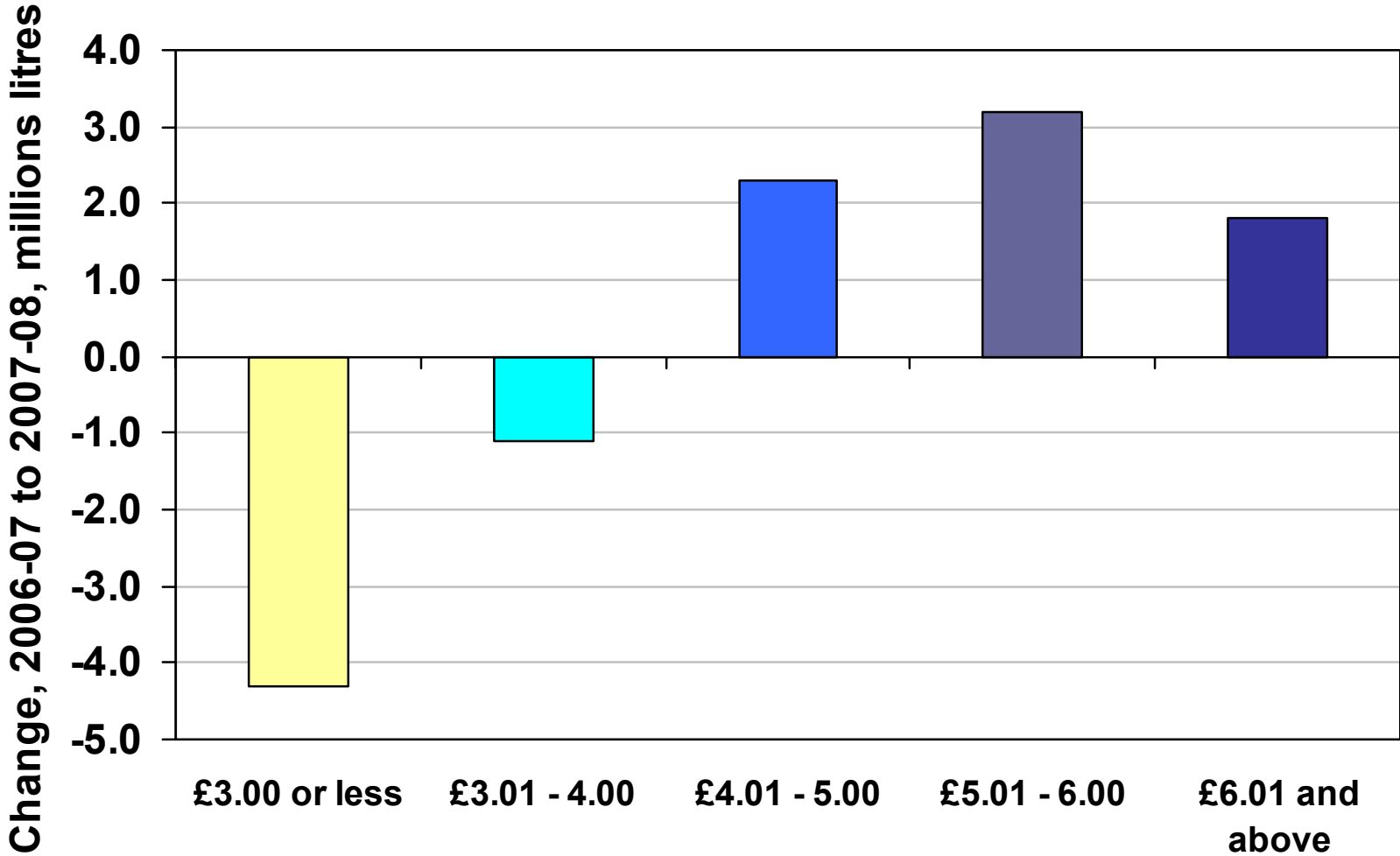
- Qtr on Qtr change in MAT bulk volumes
- Qtr on Qtr change in MAT bottled volumes

*Current trading conditions are squeezing Australia out of lower price points and make life more difficult at higher price points ...*

Year	2007				2008			
	<£3		<£4		<£3		<£4	
Target price point	Sustain-able margins	Margin sacrifice required	Sustain-able for wine-makers	Margin sacrifice not required	Sustain-able margins	Margin sacrifice required	Sustain-able margins	Margin sacrifice required
Comment								
<b>Margins</b>								
Retail margin	40%	17%	40%		40%	17%	40%	31%
Winemaker margin	40%	16%	40%		40%	16%	40%	31%
<b>Critical conditions</b>								
Excise (£/litre)	1.78	1.78	1.78		1.94	1.94	1.94	1.94
ER (GBP/AUD)	0.41	0.41	0.41		0.45	0.45	0.45	0.45
Wgrape price (\$/t)	300	300	400		400	400	500	500
<b>Retail shelf price</b>	<b>£3.81</b>	<b>£3.00</b>	<b>£3.92</b>		<b>£4.25</b>	<b>£3.34</b>	<b>£4.38</b>	<b>£4.00</b>

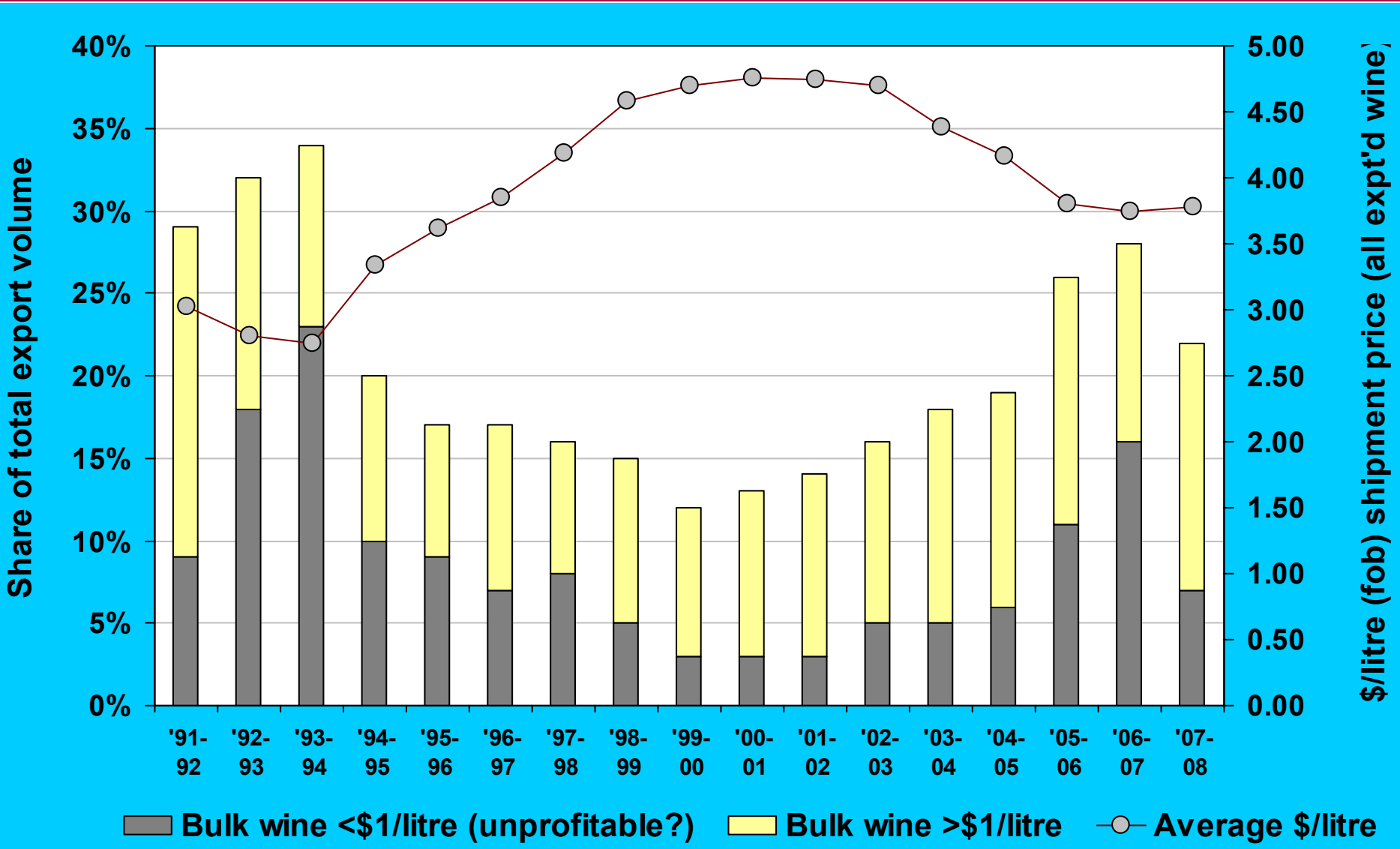
Note: The illustrated example is for major sized producers accessing the two lowest UK price points. This example illustrates the extreme case but exemplifies similar pressures experienced by all sized producers in all price points.

*Not surprisingly, Australia is vacating lower price points in the UK ...*



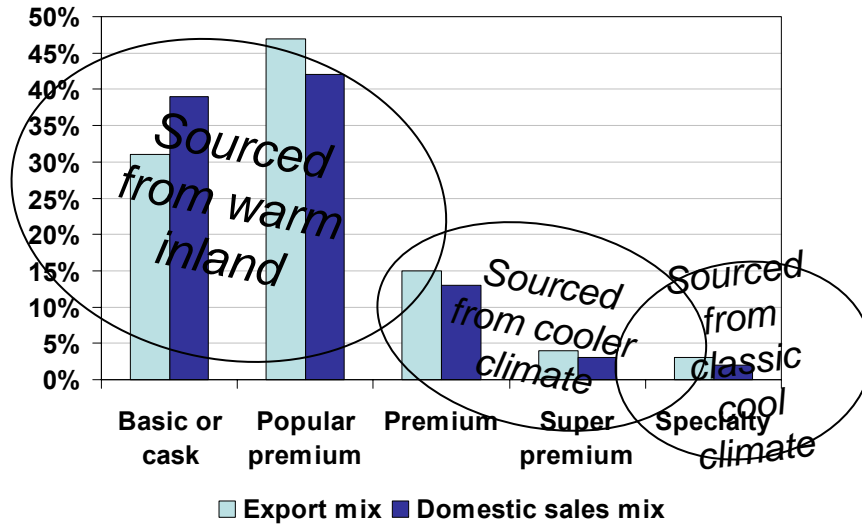
Source: AWBC 2008 Market Insight Report, Opportunities for Australian Winemakers in the United Kingdom.

*Unprofitable bulk wine exports continue and a higher-than-expected 2008 harvest will logically put pressure back into this activity.*

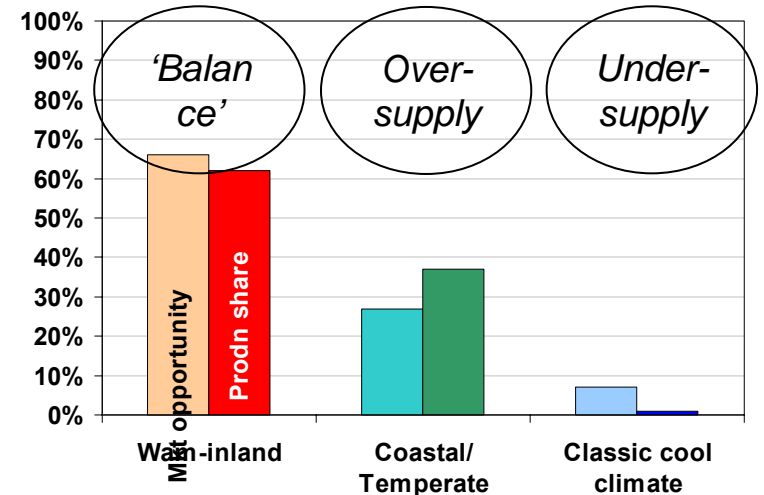
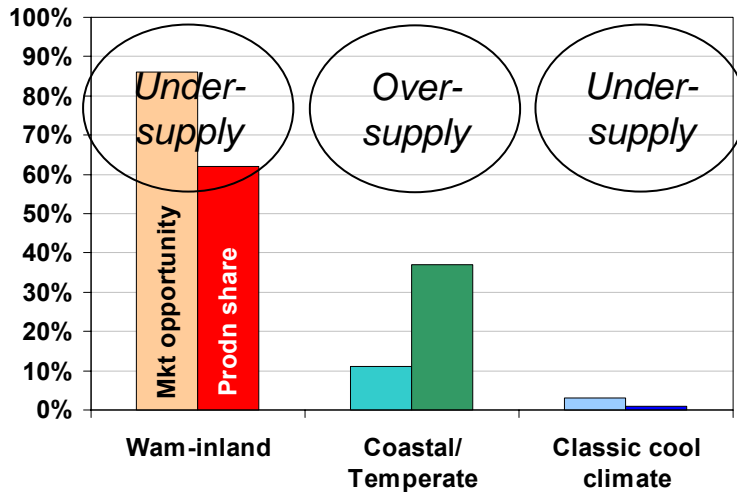
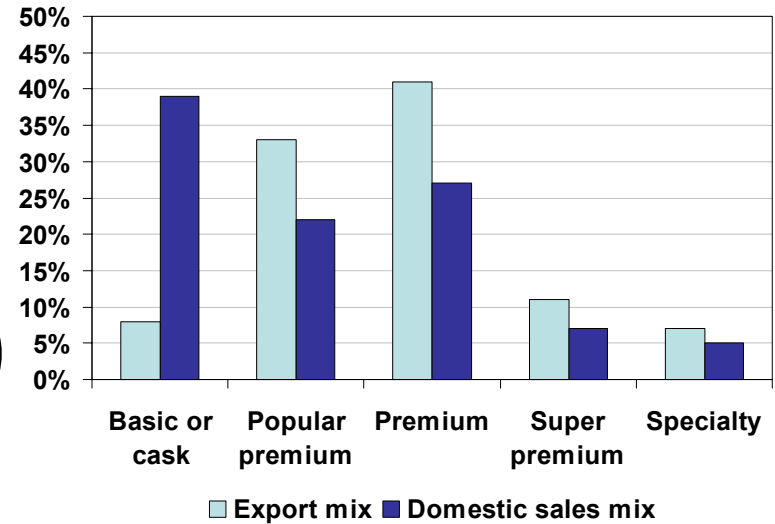


# 80:20~60:40 revisited – can the industry reach 60:40~60:40? ...

## Current status – 80:20 ~ 60:40



## Let's suppose ...



## *Some concluding comments ...*

- The Australian wine sector is in transition from a period of supply growth to value-building.
- There are a number of challenges facing the sector in this transition which are beyond its control.
  - *Extraordinary seasons are making forward planning difficult.*
  - *Competition in overseas markets is intensifying, Australia is a leader but not the only nation excelling.*
  - *A relatively strong Australian dollar is punishing wine exports.*
  - *The credit squeeze is downward-influencing the wine spend.*
  - *Increasing costs are squeezing margins at both the input and consumption ends of the business.*
- With consumers trading down, the only option to maintain margins in the short-term is to reduce costs.
- Australian wine remains a highly successful product based on its quality and uniqueness. The best counter-measure to current economic adversity is to relentlessly improve quality and to effectively tell the Australian wine story.