Market Outlook for 2016: what the wineries say

This is the "new normal"

WGCSA market outlook survey of wineries 2015

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Executive Summary

A survey of major purchasers of South Australian winegrapes was undertaken in May-June 2015 to find out the market outlook for grapes in 2016 from the wineries' perspective. This was the third survey of its kind, following a year after the last one. The main findings of the survey were:

- Despite some small signs of improvement, trading conditions continue to be very tough. These conditions are now accepted as "normal" and are not expected to improve dramatically despite the FTAs and more favourable exchange rates.
- The main reasons for this assessment are: the continuing difficulties in the domestic market, stagnant demand for Australian wine in major markets, continued oversupply and the strong bargaining position of buyers, and difficulties in accessing Asian markets despite the FTAs
- The main responses being made by wineries to deal with the conditions are: being creative – creating as many opportunities as possible, increased investment in sales and marketing strategies, working very hard and making cost-saving measures.
- The practice of "feeding the beast" (ie selling wine very cheaply on the bulk market – made possible by buying fruit at prices well below cost late in the season) is creating a "false demand" and an incentive to increase tonnages – further driving prices down and making it difficult for other wineries to stay in the commercial market
- The expected intake for 2016 is similar to 2015 – but dependent on sales opportunities and possible changes to tax regulations
- Most wineries achieve their grape supply through a combination of short-term contracts and spot market purchases, to ensure their core requirement is met and to give them flexibility to respond to rapid changes in demand
- There is no significant change expected in the varietal mix – although there has been a slight tightening in supply of Chardonnay and strong demand for Pinot Gris.
- Barossa Shiraz is in strong demand but there are cautions that it may be on the cusp of pricing itself out of the market, in which case demand is expected to drop
- The outlook for grapegrowing is not considered to be very bright, with grape prices acknowledged to be still below cost of production and not expected to improve significantly in the near future
- The future for commercial fruit is particularly bleak, where competition is entirely price driven and oversupply drives prices downward and creates an incentive to grow higher tonnages which further exacerbates the situation
- Opportunities exist for growers to be successful if they can find the right buyer for their fruit and grow fruit to match the buyer's specifications at a sustainable price
- There is an appetite for reform of industry organisations to achieve efficiencies and save money, and to provide a unified voice for the wine industry on external issues such as tax and government investment in marketing.

Background

WGCSA has committed to providing grapegrowers with relevant, up-to-date outlook information to assist them in their decision-making regarding future production. As part of this commitment, WGCSA has commissioned a survey each year since 2013 to find out and collate qualitative information about near-term future grape demand in South Australia from the perspective of the purchasers (wineries) – including:

- The wineries' view of the overall economic outlook for the wine industry and how they are responding in terms of marketing strategies
- Varieties increasing and decreasing in demand
- Grape buying intentions for the next vintage
- What wineries are looking for from growers
- Overall outlook on the industry over the next five years

Methodology

The survey involved a 30 – 40 minute interview conducted either by phone or in person. A semi-structured interview format was used. The information provided has been kept strictly confidential. Results are presented in aggregate form only and no individual respondent's answers can be identified.

Responses

Interview data was collected from 14 wineries that between them purchased an estimated 550,000 tonnes of South Australian grapes in 2015. This is estimated to be over 95% of South Australian purchased fruit in 2015.

Note: the findings presented in this report reflect the results of the research and the opinions expressed by the respondents. WGCSA does not endorse or vouch for the accuracy of the views expressed.

Findings

How have trading conditions changed in the past 12 months?

Since the previous round of interviews, the Australian dollar had reduced in value from over 90c to below 80c (US) and had remained there for some months. A Free Trade Agreement had been signed with Japan and another was about to be signed with China, where austerity measures had also eased. These factors were expected to have had a positive impact on the wineries' view of the outlook for Australian wine. However, most of the respondents did not consider that the outlook had significantly improved. There were some qualified indications of small improvements such as:

- Some good signs in China
- AUD impact minor but in the right direction
- Steady increase [but] still tight
- Bulk has picked up a bit in the last six months
- Possibly slightly more confidence among buyers

"More people are ringing"

However, it was still considered "extraordinarily tough to make a buck".

Whereas the overall outlook in 2013 was "looking better" and in 2014 was "looking worse", in 2015 the outlook could be summed up as "this is the new normal" – ie the respondents considered that these were going to be the prevailing trading conditions for the foreseeable future and that businesses need to work out how to be successful in this environment – not "hang on" and wait for things to improve. Most considered the industry to be generally only marginally profitable and some felt that this new normal was not sustainable.

"This is the new normal"

Why hasn't the outlook improved?

The effect of the improved exchange rate was seen to have been "bringing buyers back to the table" and making Australia competitive with Argentina, Chile and South Africa, rather than improving prices. In other words, it was easier to shift volume but not to increase value. It was noted that sales demand is still stagnant, and "people are not begging and screaming for Aussie wine". Other reasons given for the lack of improvement in outlook were:

- Buyers expect their share of the improved margin
- The effect [of improved exchange rates] is slow to filter through
- It's still very much a buyers' market (we still have too much supply)
- The domestic market has not improved at all
- Compliance requirements in Asia are inconsistent and challenging – making it hard to capitalise on the Free Trade Agreements

"People are not begging and screaming for Aussie wine"

There were a few bright spots mentioned:

- The 2015 Australian harvest was good for quality and not too big
- Stock overhangs are being cleared and vintage changeover has occurred earlier
- World supply and demand are looking a bit more balanced
- The lower NZ harvest and increased demand for their product in the US have meant less supply for Australia
- The exchange rate improvement has given wineries more confidence to invest in export market development again
- Sales in China are picking up again as the market is maturing

"It helps everyone if there are more Aussies out there… creates a sense of buzz around the category"

Issues in the domestic market

Those wineries dealing principally with the retailers on the domestic market were particularly pessimistic. It was noted that Buyers Own Brands have driven prices down even further and forced wineries to compete on price, with "quality a distant second". The retailers are pushing wineries harder as they face their own challenges: from shareholders for continued growth (difficult for WLG when it already has 45% market share) and from threats to their market share in the form of Aldi wine shops.

Wineries are being "encouraged" to deal directly with retailers instead of via distributors – thus increasing the margin for the retailer – but wineries (especially smaller ones) may need retailers for other parts of their distribution such as on-premise, and the distributors need the supermarket part of a winery's business to generate volume and hence profit. Therefore it is a difficult dilemma for a winery whose business model traditionally relies on a distributor.

What changes have wineries made in response?

In general, the three main responses mentioned by the wineries for responding to the market conditions were:

"You can't sit still"

- Being creative – creating as many opportunities as possible
- Increasing the investment in sales and marketing (despite overall budget tightening)
- Working very hard

This year the survey focussed particularly on finding out about the marketing strategies being applied. A particular theme that emerged was of tailoring products to meet particular markets and customers. This strategy incorporates the need to be creative (in product development) in order to create opportunities (for particular markets or customers) and to work very hard (to win business). As one respondent said: "15 years ago one wine would fit all markets. Now it's much more complex……. Customer specific blends, labels etc."

"One size doesn't fit all"

It also explains the need for more sales people and for those people to be "close to the markets to identify the opportunities". One winery noted that making wine was the easy part – selling it was the hard part.

"Making it is the easy part"

Another theme this year was a continuation of the "premiumisation" first identified in 2013. This included:

- Investing in building brand recognition and positioning
- Offering "exclusives" to compete with Buyers Own Brand products
- Sacrificing volume to maintain price point – rather than being willing to discount a product to increase sales
- Gradual increase in shelf price with occasional deep discounting
- Shift away from Riverland fruit and focus on premium regions

It is also known that, since the last survey, two of the larger respondent wineries have purchased premium Barossa Valley-based wineries to extend their portfolio of wines.

Other strategies mentioned included:

- Developing new channels for sales – eg building cellar door sales and tourism facilities; focusing on e-commerce; developing specific on-premise offerings
- Leveraging assets – eg adding complementary brands to existing portfolio, supported by existing customer base; using cellar door to increase brand awareness;
- Playing to strengths (region recognition, focus on core varieties)
- Investing in local distribution channels (in China) to facilitate entry into that market
- Further increasing efficiencies – including "network optimisation" and "running lean as much as possible".

Feeding the beast

Several respondents referred to the practice of selling very cheap bulk wine, negotiated at short notice late in the season and based on buying grapes on the spot market for a very low price (below cost). This was considered by some to be a speculative opportunity to be taken advantage of if the grapes could be supplied at the right price, with the benefit of maintaining volumes through the winery and hence reducing unit costs of production. Others however considered this to be "feeding the beast" – creating a false demand for grapes and perpetuating the oversupply in the long term.

"It's easy to sell wine if you sell it cheap enough"

What will the strategy be for buying fruit in 2016?

In terms of volume, most respondents indicated a similar requirement for 2016. However, there was also reference to late decisions being made based on sales and an assessment of opportunities, as well as the possibility of major changes "depending on what happens with tax". Some respondents indicated that they were still quitting inventory but expected to be back in balance after vintage 2016.

Three respondents warned that they were contemplating a big reduction in volume from the Riverland based on their inability to compete in the commercial market.

Most respondents were looking to have a combination of short-term contracts to meet their core requirements and spot market purchases for the rest.

"There's always fruit available"

In terms of the spot market purchases, it was noted that these were essential to provide the flexibility to respond to the rapid fluctuations in product demand, and that customers (often) don't order more than three months out.

In terms of the contracted fruit, there was an emphasis on "buying grapes for purpose" and looking for an ongoing relationship with growers who could reliably supply the right fruit for a particular product. It was noted that customers want specific products so if the fruit does not match specifications it is not easy to find a home for it.

"The wine drives the grape"

Winemaking by numbers

It was evident from the responses that delivering a profitable product has become a significant challenge, and requires achieving a balance in a number of areas:

"You're caught between a rock and a hard place"

- Paying sustainable prices to growers but still being competitive
- Reducing volumes to match demand but maintaining volumes to keep costs of production down
- Making the product mix match consumer expectations but achieving a particular shelf price

One respondent referred to "playing the 15% game" of mixing up to 15% of fruit from a different GI region, different variety and/or different vintage into a product that could still legally be described as a "straight" varietal/GI/vintage product. Another was in the middle of trying to "make the maths work" on a product that needed to compete at a very specific price point on the shelf but also needed to achieve a particular mix of varieties and a GI designation. It was evident that the margins have become very tight and there is no room for error. One winery noted:

"You have to work backwards from the shelf price"

> *We can get the maths to work, but we have to match the grapes to the wine before they come in so that they fit the equation. It requires lots of forecasting and planning.*

What varieties/brands are increasing or decreasing in demand?

There were a few themes around varietal demand that were fairly consistent but none with a complete consensus.

- Most respondents indicated little change in the mix in terms of demand going forward;
- Shiraz and to a lesser extent other reds were considered to be a bit long in supply – with the exception of Barossa Shiraz. While Barossa Shiraz was considered a "hot spot", it was noted that the price of this was becoming very high and that demand would drop if it became too expensive for the market;
- Most respondents referred to an improvement in Chardonnay (either a tightening of supply and/or a genuine increase in demand for commercial fruit);
- Pinot Gris/Grigio was mentioned by several respondents as showing "genuine demand" and to be a profitable variety at a commercial price point; however caution was expressed in overselling the variety and seeing it "go the way of Gordo";

"Barossa Shiraz is a hotspot"
"Chardonnay is not getting worse"

- Sauvignon Blanc was considered by some to be in demand but possibly only in the short-term due to the low NZ harvest;
- A few respondents indicated growth in demand for organic fruit but in very low volumes;
- Alternative varieties were considered important for creating "light and shade" in the industry but not having sufficient volumes to make any significant difference to overall supply and demand, and requiring more effort to sell.

There were no consistent messages in terms of changes to regional demand.

What is the outlook for grapegrowing in the future?

Most respondents did not consider the outlook for grapegrowing to be very bright. Comments made included:

- Most growers are not making money even on the core products
- Prices are not going to improve
- Prospects in the Riverland are "bleak"
- The gap between responsible prices and market prices is too large
- Water restrictions this year could be the final straw
- Growers who understand their businesses are more likely to get out

"I can't understand why they are still doing it"

As indicated above, the prevailing view was that this is how things will continue to be and that there is no point in "hanging on until it comes right". It was also noted that this is no different from other areas of retail and manufacturing where the environment is globally competitive and low margins are the norm.

"The glory days of $1200 a tonne for Chardonnay are gone"

Some respondents noted that there were emerging issues that could become a major problem for the industry and for individual growers – for example that the majority of vineyards are reaching 20+ years old, which is likely to lead to a major decline in vine productivity in the next 5-10 years; also irrigation infrastructure will need to be replaced in that timeframe but growers will not have the money for redevelopment.

Some wineries expressed the view that the outlook was positive for "good growers with quality and efficiency". A consistent message was the need to find the right customer and grow the right product for them. This echoes the strategy being adopted by the wineries: tailoring products to specific customer needs.

"Need to be creative and responsive to customer demands"

Other suggestions for how to be sustainable in the current conditions were:

- Grow other crops
- Sell water instead of grapes
- Don't increase yields – this compounds oversupply, reduces quality and hence price and is not sustainable in the long term
- Work on a business model based on having a balance of varieties
- Produce a style that works for the region
- Move towards biodynamic viticulture: minimal water and chemical use
- Scale is important for success

What external issues are affecting business prospects?

Three major themes emerged in the interviews relating to external issues affecting the business: tax, marketing expenditure and industry issues.

Tax

The WET rebate was still considered a significant distortion to the market. It was noted that this is not just a domestic issue, because the markets are transparent, so if a product is sold for a particular price in Australia, an export customer expects that price to be matched for the same product. There were different views, however, regarding whether the rebate should be removed altogether or just restricted to small producers.

"No business should be built around the WET rebate"

The possibility ("spectre") of a change from ad valorem to volumetric tax for wine had been raised in the media in the weeks before the interviews, with a few of the major wineries publicly stating different positions on this. The survey respondents generally were not in favour of a move to a volumetric tax, which was argued would have a devastating impact on (particularly the commercial part of) the industry. Even respondents whose individual business might be expected to benefit from the change generally stated that they were not in favour of it, for the sake of the whole industry.

"The industry is not in good enough health to handle the change."

More than one respondent expressed dismay or disillusionment at the "level of self-interest" in the industry. It was apparent that the public disagreement over the issue among industry players has been divisive and negative in its impact on individuals. The comment was also made that the "public stoush over tax" did not send a great signal to the market and would have a negative impact on consumer perception of the sector.

Marketing expenditure

There was general agreement that industry needs to spend more money on marketing to develop sustainable (export) markets for Australian wine. However, there was a difference of opinion as to whether that money would be best spent by Wine Australia on generic "brand Australia" marketing or by individual wineries on their own brand development. It was argued on the one hand that generic marketing is not successful (as witnessed by the dairy industry) and that Wine Australia staff do not have sufficient expertise or incentive to "get out and sell our wine"; and on the other hand that "taxpayers shouldn't have to pay for winemaker travel" and that Wine Australia is well positioned to facilitate entry into markets.

"We can't re-establish while sitting in Australia."

Industry internal issues

In the context of the industry divisions in the public arena over tax and also a proposal from WFA to call a national summit of industry organisations to address profitability and examine industry structural issues, it is perhaps not surprising that respondents raised concerns and criticisms about "our own back yard" in this year's survey – when these had never been raised before.

Comments made all related to duplication in industry structures at state and national level and the need for industry reform. Some comments were quite heated – including "industry disorganisation is a farce" and "the current leadership is conflicted – everyone is worrying about their own piece of the pie".

"New Zealand does it well."

One respondent noted:

> *New Zealand does it well. They work together as an industry, have common messaging. We do too much criticising of each other and blame each other for our problems.*

Conclusion

This year, the messages from the winery research for growers are:

- Trading conditions are tough and are not likely to improve dramatically: this is "the new normal". It is no different from most other areas of retail and manufacturing.
- Wineries can be successful but need to be creative, work hard, invest heavily in marketing and tailor their products to suit different customers in order to remain viable. "One size doesn't fit all. "
- For growers, this means that "the wine drives the grape" not the other way around. Fruit must be delivered to meet the winery's requirements. Flexibility is important to match rapid changes in consumer demand.
- Grapegrowing is still generally unprofitable for most, but opportunities exist for growers to find the right buyer for their fruit. Wineries and grapegrowers are not in competition. When wineries make money, growers make money.
- The future for commercial fruit is particularly bleak, where competition is entirely price driven and oversupply drives prices downward and creates an incentive to grow higher tonnages which further exacerbates the situation.
- The continued supply of unsustainably cheap grapes to make very cheap wine for the spot market is "feeding the beast" – creating a false impression of demand and an incentive to grow increased tonnages – both of which perpetuate an oversupply of commercial fruit
- There is an appetite for reform of industry organisations to achieve efficiencies and save money, and to provide a unified voice for the wine industry on external issues such as tax and government investment in marketing