
## WGCSA market outlook survey of wineries 2013

*Prepared on behalf of WGCSA by*

***Sandy Hathaway, Felix Business Consulting***

*November 2013*

# Executive Summary

A survey of major purchasers of South Australian winegrapes was undertaken in October 2013 to find out market outlook information from the wineries' perspective. The main findings of the survey were:

- Overall demand for grapes is expected to remain stable over the next five years, which indicates a likely excess of supply if there is a large vintage in South Australia.
- Premium red varieties, particularly Barossa Valley and McLaren Vale Shiraz, are increasing in demand, while all white varieties, in particular premium Chardonnay and Semillon, are in decline. There is seen to be no way of growing these varieties profitably in McLaren Vale or the Barossa.
- Red blends are seen as a potential growth market and an opportunity for regions such as Langhorne Creek and Wrattonbully to deliver the right quality at a sustainable price point.
- These trends reflect a strategy of "premium-ising" being adopted to some extent by most wineries – moving towards more premium products which are seen to offer higher margins. These are small trends not major changes and commercial products are not expected to decline substantially overall.
- The main opportunities for future growth are seen to come from export markets but are dependent primarily on an improvement in the exchange rate. The main export market focus is on the US and China, followed by Europe and the UK (a declining market).
- Wineries are not making major changes to contracting practices but there appears to be a slight shift towards more annual agreements and shorter-term contracts. Some wineries are looking for new growers of premium fruit in premium regions and some are looking to buy premium vineyards (on a small scale) to shore up supply of A and B grade fruit.
- Wineries are looking for quality and reliability in supply of fruit from growers, as well as good communication, flexibility and business skills. Overall they want to be treated as a customer.
- The prospects for the near future are seen to be tough for both wineries and grapegrowers, while uncertainty prevails and the dollar remains uncompetitive. However there are seen to be opportunities for growers who are able to help their winery achieve a competitive advantage in the marketplace.

# Background

A recent survey of SA grape growers by the Wine Grape Council of South Australia (WGCSA) identified access to market information as a priority for most respondents. Lack of market information may be one barrier to supply adjustment in the industry. WGCSA has identified as a priority the need to provide grapegrowers with specific, practical information that will help them to make adjustments in response to the current industry conditions.

## Objectives

The aim of the research project was to find out and collate qualitative information about near-term future grape demand in South Australia from the perspective of the purchasers (wineries) – including:

- Varieties increasing and decreasing in demand
- Regional variations in the above
- Quality/grade variations in the above
- Insights into buying strategies
- What wineries are looking for from growers
- Overall outlook on the industry over the next five years

## Survey methodology

A list of major grape buyers estimated to be the top 20 purchasers of South Australian fruit was identified using the Wine Industry Directory and anecdotal industry knowledge. These wineries were contacted by email to explain the purpose of the research and request that they participate; they were then followed up with a phone call.

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 17 wineries. The total tonnes reportedly purchased by the respondents in 2013 was approximately 560,000 tonnes – over 95% of the total South Australian purchased fruit (587,000t[1]). No winery refused to participate; three were omitted due to their relatively small size compared with the others, difficulty in making contact and/or lack of time.

In addition, two major brokers of bulk wine were interviewed with a particular emphasis on how they saw the current export market opportunities for Australian wine.

[1] PIRSA levy collection data 2013

# Findings

## What is the overall outlook for demand for grapes over the next five years?

14 of the 17 respondents reported that they intended to purchase a similar or slightly higher amount of fruit in five years' time. Two indicated an increase in expected purchases of up to 10,000 tonnes and none indicated a planned decrease. (One was unable to estimate.)

However it was noted by one winery that "we are only one season away from a monster vintage" and others noted that the wine industry is still oversupplied, with sales of around 1.5MT compared with production of around 1.8MT nationally.

*"We are only one season away from a monster vintage"*

## Which varieties/regions are in demand?

The varieties in demand were overwhelmingly premium reds – in particular Shiraz from the Barossa Valley and McLaren Vale, Cabernet Sauvignon from Coonawarra and Shiraz from Clare. Other varieties mentioned were:

- Pinot Gris (but tentatively as this variety was in over-supply two years ago)
- Commercial grade Merlot (but not necessarily long-term)
- Adelaide Hills whites and sparkling
- B/C grade material from Clare (red and white)
- Sparkling base from the Riverland
- Riverland fruit rather than other warm climate fruit because of lower freight costs and better quality)

In general although some wineries considered the market to be more competitive for the premium reds, most were not having difficulties sourcing the fruit they need. The opinion was expressed that recent higher prices were a result of two recent low vintages in the Barossa Valley in particular and these would ease if crops returned to normal.

## Which varieties are in decline?

There was consistent reporting that whites are in decline. In the warm regions this was seen to be a result of "too much in the ground", although the fruit had a market, while in the cool climate regions, it was seen that there was very little demand for premium whites. New Zealand Sauvignon Blanc was seen to have taken over the market for whites in the popular premium and premium markets ($7 - $15 per bottle) – making it difficult to sell any Australian whites in this market[2].

In particular there was a consistent message that the respondents did not see a future for Chardonnay or Semillon in the Barossa Valley or McLaren Vale, as the consumers would not pay a premium for a GI-identified white wine which would enable it to be sold at a price point that could deliver a sustainable price to growers.

*"People don't think Barossa when buying a white – especially Semillon or Sauvignon Blanc"*

There was some reported decline in demand for fruit from Clare – especially Riesling – because of transport issues and costs and because "we can't afford to pay sustainable prices" (in a region with low yields and high growing costs).

In contrast to the above, one respondent maintained that "varieties in demand change constantly – within the bounds of the right variety for the region."

[2] Approximately one in every 10 bottles of wine sold in Australia's off-trade is a NZ Sauvignon Blanc.

## What are the regional dynamics around varietal demand?

- Fruit blends – manipulating the mix to achieve an optimum price/quality balance
- Whites more substitutable than reds
- Choice of GI region for a GI-identified product is a strategic decision
- Distance of region from processing facility is an important consideration
- Innovation opportunities from new regions

Discussions with the buyers suggested that the regional and price dynamic is complex. There is a limit on how much the winery can afford to spend on a particular product and playing with the mix is a way to keep a ceiling on the cost. A premium, GI-identified product can have up to 15% fruit in it from elsewhere; hence a Barossa or McLaren Vale product may be blended with fruit from (for example) Langhorne Creek or Riverland. If the price for the premium fruit goes too high – the amount of fruit from the alternative region may increase (within the 15% limit). Similarly, a commercial product made with a small percentage of premium fruit to provide a quality lift may use less of that premium fruit if the price goes up – or if a cool season means that the warm climate fruit is better quality.

***"We can get the mid-range material from anywhere"***

It was noted that mid-range material can come from "anywhere" – ie is highly substitutable. In particular, Langhorne Creek was seen as a good blending option for both the mid-priced commercial products containing predominantly Riverland fruit and the premium products – but that this was very price sensitive; if the price went above $1000 then the buyer would switch back to more of the Riverland or Barossa / McLaren Vale fruit. It was noted that Langhorne Creek has an opportunity to sell more fruit at $600 - $900 per tonne – offering an alternative to the premium regions at a better price rather than trying to be a direct competitor at the same price point.

It was suggested that whites in particular are more substitutable than reds – further reducing the demand for premium whites. It was noted that advances in winemaking mean that generally the standard of Australian commercial wine is very high – so commercial fruit can be used with less reliance on premium fruit.

***"The gap between commercial and premium wine has closed and the culture has changed"***

Some wineries choose to have a particular GI-identified varietal product in their portfolio and the choice of which GI region to buy from is a strategic decision based on a number of factors. For example, the GI-identified Riesling could be a Clare, Barossa Valley, Eden Valley or Adelaide Hills product. The main factors taken into account are likely to be price and distance from the winery's processing facility. Some choices may be long-term but others may be negotiated with a customer from year to year or on a one-off basis and switched between regions depending on price and availability.

The Riverland was seen by South Australian based wineries as having an advantage over other warm climate regions because of the cheaper freight, lack of interstate quarantine requirements and perceived better quality. It should also be noted that the same is likely to be true for interstate-based wineries. In general, regions closest to the processing facility have a competitive advantage over regions further away. However, it was noted that if supply tightened, this could lead to the buyer diversifying more into the other warm climate regions to spread their agricultural risk.

***"The winery you are closest to is the one [where] you are most competitive"***

There were seen to be possible "innovation opportunities" from new regions such as Langhorne Creek and Limestone Coast – ie to create a new product such as a mid-priced red blend from these regions to appeal to a different market segment. It was seen that "new products can't come from existing regions".

## What strategies are the wineries pursuing?

- Premium-ising
- Single vineyard and other "one-off" products
- Buyer's Own Brands
- Innovation in premium and popular premium products
- Dropping whites
- Reducing commercial export products
- Consolidating processing
- Producing high-end bulk wines for other wineries

Buyers indicated a definite trend towards "premium-ising" – ie shifting their portfolios towards more premium products where the margins were better and "cutting out the bottom end". Products under $10 were generally considered unprofitable (with premium fruit). This translates to withdrawing from purchasing C grade fruit and below in premium regions – "[we] can't make money on it" – in particular white varieties.

***"Stick with doing what we do… better"***

Some also reported reducing commercial export products because of competition from local European products and new country cheap wines. It was noted that competition in the commercial sector is much fiercer with competition coming not only from other winemakers but other beverages. On the other hand, some wineries use cheap bulk export wine as a way to maintain volume and reduce processing costs.

Some wineries were looking to create new products – eg new red blends, new regions – to absorb current commitments for fruit and/or to increase market share. Red blends were seen as presenting the greatest potential and the price range of >$12 or even >$20.

Buyer's Own Brands were identified as an important market segment for some wineries – where wine is labelled with the retailer's brand name rather than that of the winery.

At the premium end, there was seen to be an opportunity for single vineyard products and other "made to order" exclusive customer products (eg for airlines or wine clubs). All these were in premium GI-identified reds (especially Shiraz).

Consolidation of processing to increase throughput was seen as important by some wineries. SA has a concentration of winery assets, which is likely to be an advantage for SA grapegrowers who are closer to these processing facilities. However, the opposite is true if the purchaser is interstate and similarly intending to consolidate.

The ability to respond to opportunities was seen as important in the current market – for example with exclusive offerings or buyer's own brands, where a potential customer might put out a tender or request samples for a product to be supplied immediately – not after the next vintage.

***"They do the rounds with a shopping list. They want the best wine for the lowest price."***

Buying bulk wine was seen as a way to respond to opportunity because the decision could be made later and quantities could be varied depending on sales, which might be hard to predict with a new product. Buying bulk wine could also be cheaper for a winery than buying fruit and processing it themselves, reflecting the importance of throughput in reducing unit price and creating an opportunity for some wineries to produce bulk wine and sell it to others.

It was noted that most of these strategies were "trends, not radical changes" and subject to alteration if the market moved in a different direction. The importance of being flexible was emphasised.

***"It could change tomorrow"***

## What is the wineries' perspective on the markets?

- Export reliance between 0% and 95%
- Growth seen as coming from export markets
- Main markets: USA, China, Europe, UK

The 17 wineries varied in their reliance on exports from 0% to 95%. Generally the larger wineries rely more on exports. Growth was seen as having to come from the export market because the domestic market is not growing. However, the domestic market was seen as very important to many wineries as a stable base that is easier to service.

The main export markets identified were (in order): US, China, Europe, UK.

The US market was seen as having the best potential and being currently "undercooked". As well as being the largest market in the world, it was considered that the US still likes Australian wine but the exchange rate and depressed economy mean that they are not buying. It was seen that a drop in the AUD would lead to a significant increase in demand.

***"The US is a huge market and our share is small."***

Success in the Chinese market seems to depend on having a reliable distribution network in place. Many wineries were still finding their way in this respect – referring to "going slowly" and "softly softly" and "investing in the relationship first". On the other hand, wineries with good distribution networks were more positive about sales in this market. Most wineries were focusing on the premium end (mainly reds) in China – where margins were considerably higher than in other markets. On the other hand, some wineries identified "huge opportunities but not very profitable" for bulk premium wine at up to $2 per litre (which equates to approximately $750 per tonne).

On a cautionary note, it was pointed out that there are lots of competitors in the Chinese market and China is starting to produce more and better quality wine itself. The citizens have also been asked by the government to reduce spending and slow the economy down.

Europe was mainly seen as a market for commercial products – hence many wineries reported a reduced emphasis here as this is the market where it is hardest to compete with lower cost producers. Chile, for example, has a free trade agreement with Europe which means an advantage of approximately 17c/litre – or $123 per tonne of grapes – which is a significant proportion of the price for a commercial product.

***"Australia is competing with one hand tied behind its back."***

The UK was referred to as a "traditional" export market. The majority of exporting wineries considered it to be declining or dead and high risk because of low margins and low brand loyalty – but some opportunities still exist there for established brands.

Although there was agreement that growth has to come from exports – these markets were seen as volatile and exchange rates as the big hurdle. There are also a large number of international competitors, some of whom have an advantage over Australia in terms of distance and tariffs, while the world-wide over-supply of wine is another major obstacle to success. The world production of wine in 2013 was 3 million tonnes higher than in 2012 – when there was a brief window of opportunity for Australia after a low crop in France and Spain.

## What is happening with contracts?

- Most wineries not looking at making major changes
- Desire to work with existing growers to achieve strategic objectives
- Prefer to buy fruit rather than bulk wine
- Generally have a mix of contracts and expiry dates
- Some looking for new grower in premium regions
- Slight shift towards shorter term contracts and annual agreements
- Own vineyards seen as important to secure supply of premium fruit

Most wineries were not looking at making major changes in contracting, but planned to work with their existing or core group of growers to increase their fruit requirements or change the mix. Some had reduced their number of growers in recent years but none indicated plans for further reduction.

*"We never stop looking for growers at the top end."*

Generally wineries had a mix of growers and their own vineyards and felt that quality and cost could best be controlled on their own vineyards. Some wineries were looking at purchasing more premium vineyards or had recently done so in order to secure their supply of high quality fruit. Two wineries were interested in signing up more growers with premium fruit in premium regions.

Contracts varied from annual agreements to 3 – 5 year or rolling contracts. Some wineries deliberately maintained a mix of shorter and longer-term contracts – eg shorter term in the commercial regions and longer in the premium regions – or a mix of expiry dates so that all contracts did not expire at the same time.

*"We don't get three year contracts from customers."*

There appeared to be a slight move overall towards more annual agreements and spot market purchases to provide greater flexibility – but this was not a majority trend. In contrast, a small number of wineries noted that they would prefer to sign longer contracts but found that growers were resisting as they were expecting prices to go up (premium regions).

Most wineries noted that they preferred contracts with growers to bulk wine – only buying bulk wine to supplement annual shortages and to give flexibility eg with new products where demand cannot be reliably predicted.

It was noted by one buyer that the cost of buying bulk wine from the Riverland was less than buying and processing the fruit themselves – hence they would be shifting in this direction and reducing contracts with growers in that region.

## What are wineries looking for in their relationships with growers?

- Treat the winery as a customer
- Consistency of meeting specifications
- Open communication and trust
- Business relationship skills
- Professional approach

***"Better growers give us better fruit."***

The number one characteristic that wineries were looking for from growers was reliability in delivering fruit to specifications. This included consistency over a number of years, meeting quantity as well as quality specifications, delivering fruit on the day nominated and providing the required documentation. It was noted that if fruit failed to meet specifications, it could end up unable to be placed in the product for which it was intended and going into a lower priced product – leaving less money available to pay for the fruit. The bigger issue for the winery could be not having a market for the lower-priced product and missing the sales opportunity for the intended product – hence the crucial importance of fruit meeting specifications.

Some wineries also referred to production techniques: using modern techniques, being open to modern methods and ideas, using sustainable practices and being able to change practices where required. For some wineries, particular vineyard management practices such as the fertiliser and irrigation regimes or supporting environmental best practice were seen as crucial to enable the winery to maintain its credentials or marketing message.

***"Old fashioned attitude of mutual expectation and obligation doesn't work."***

Another important consideration for the wineries was good communication – in particular a willingness to work together with the winery to produce the right product, understanding the winery's ethos and maintaining a long-term relationship – "being part of the family". Trust was also seen as important and there was an acknowledgement that relations had not always been good but that "narrow-minded thinking that wineries are just ripping them off" and the "old-fashioned attitude of mutual expectation and obligation" no longer had a place in the industry.

Good business skills and a professional approach were also seen as important, including understanding the whole value chain and the difficulties in it, and growers knowing what price they needed to be sustainable.

Overall – the buyers wanted to be "treated as a customer". It was noted that "the best growers are meeting winemaker requirements and not being adversarial". This in turn provides the winery with a competitive advantage in a highly competitive market.

***"The threat to growers is from other growers – not winemakers."***

It was suggested that growers need to recognise that their competitor is their fellow grower, not the winemaker, and try to work out how to be better than their neighbour. "Any grower can be better than the pack."

## What is the wineries' overall assessment of the prospects for the future?

- Uncertainty prevails
- Still likely to be tough for a few years for growers and winemakers
- An improvement in the exchange rate would make the biggest difference
- Oversupply is still a problem
- There are opportunities to succeed

*"When wineries' prices go up then growers' prices will go up."*

Generally the wineries considered that things were still tough and would be for a few years yet. It was noted that "no-one is getting an easy ride" and wineries are in no different a situation from growers in terms of making money. Several "not insignificant" wineries have gone broke recently.

While prices have improved in the Barossa Valley and McLaren Vale recently, this was seen as a short-term result of low crops. Wineries paid high prices (especially in these regions) in 2013 after two years of low crops and a shortage of wine on the world market following low crops in Spain and France; however there was expected to be a correction in 2014 as a result of the higher prices paid and large volumes in tanks. A large crop would exacerbate this effect. It was noted that a "normal" crop could be 200 – 400kt in excess of requirements.

Recovery was seen as primarily conditional on an improvement in the exchange rate – particularly a drop to below 90c against the USD. Although there was seen to be "no easy fix", other factors considered important were:

*"A 15c drop in the AUD would change things overnight."*

- to restore Australia's relevance in the [world] market
- to increase promotion and stimulate demand
- to over-deliver on quality at all price points
- to reduce the amount of wine available

Wineries did not agree on whether reducing supply would have a positive effect. While some noted that "scarcity breeds demand" and leads to increased prices when there is no longer a cheap alternative to be had, others believed that a tightening in supply and increase in price would lead to a drop in demand and losing market share to other countries. Commodity products were seen as particularly susceptible to this.

The future was seen to be very uncertain. Wineries were not able to predict what the "next big thing" would be – or what they would be selling in five years. The only specific suggestion made was that low alcohol wines might become a new trend[3]. Another winery noted that predicting a new trend is "fraught with danger" because it leads to "everyone jumping on the bandwagon". Being responsive to opportunities as they come up was seen by this winery as the better strategy.

*"Things are much worse in France and Spain."*

On the positive side, it was suggested that things are a lot better than they were a few years ago on the world stage, as Europe have been pulling out vines for a number of years. Also, Australia was seen as fortunate because its balance of wine is towards the top end. The total crop in Australia is very small on a world scale, meaning a relatively small increase in market share in an export market can be a substantial percentage of Australian production.

It was also suggested that only a few factors need to turn around for conditions to improve. Meanwhile, "tremendous opportunities" exist for growers who are top of their game – even in a contracting market. However it was noted that success was not a "god-given right" for a grower but needed to be earned.

[3] In a recent presentation to the WGGA AGM, Shane Tremble from Woolworth's Ltd identified low alcohol wines as being a future opportunity that is showing rapid growth in demand.

## What can growers do to improve their prospects?

A number of different suggestions were made – most of which related to planting decisions. A summary of the main points made is given below. Points made by different respondents have been combined where they were similar. These are broad general indications and not individual professional advice.

### *Plantings*

*"Anyone could make money in the 1990s."*

- The right variety in the right region is key. Think about the variety in the context of the terroir, natural advantages, consumer demand, the price you can fetch for that variety in that region. Play to your (and the region's) strengths and stick to core varieties. Consumers drink within a narrow band. "Anyone could make money in the 1990s – now you have to be flexible and attuned to the market".
- C grade fruit cannot be grown profitably in McLaren Vale and the Barossa Valley. The future is in A & B grade varieties grown really well. An A grade vineyard can be cheaper to run than a C & D grade vineyard provided it is balanced.
- Stop growing Semillon and Chardonnay for $200/t in McLaren Vale and Barossa when you can get a much better price for Shiraz. Whites (and Merlot) are not viable in these regions. Don't be concerned about having "all your eggs in one basket": in Europe, all regions are built on the basis of one region one variety.

*"Leveraging one product off another doesn't work."*

- Look at your whole varietal mix – all parts of the package should be in demand. Leveraging one product off another doesn't work and is counter-productive. Winemakers can't bury unwanted fruit on the bulk market as much anymore. Selling unwanted varieties for very low prices compounds oversupply. Assess all your varieties individually for profitability and pull them out or restructure them if they are not performing. Rather than seeing bare land as unproductive – recognise that growing grapes you can't sell for a profit is unproductive.
- High quality won't work if you are not in a premium region because you can't get the price to justify the low yields.
- Replace old plantings with newer, better clones – gives you a competitive advantage.

### *Business practices*

- Don't work harder – work smarter. Get advice. Adopt new ideas eg in soil health, holistic management. Keep focusing on quality and innovating. (Europe is not.)
- Environmental sustainability is important. Wineries will put pressure on growers to be clean and green as more consumers start to expect it. In China in particular, food security is an important consideration.
- Don't increase tonnages to counter lower prices – this causes quality to drop and increases over-supply causing a vicious circle.
- Sell to more than one buyer. This distributes the risk and gives you a possible ready-made replacement when some fruit comes out of contract.
- Expand your vineyard (buy don't plant). Operating on a larger scale leads to efficiencies and lower costs. Alternatively – treat as a property investment where you lease the vineyard back to the winery.

*"What is the opportunity cost of a $1 million vineyard?"*

- Take into account cost of capital, water, your own time, costs of machinery, depreciation etc when working out profitability.