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## 2007: The Australian Wine Industry's "Annus Horribilis"

By all measures the 2007 vintage will be remembered by the Australian wine industry as the worst it has ever experienced. No wine regions were spared from the severe seasonal events as Mother Nature dealt out black frosts, drought and bushfires. For grape growers and wine makers it has been heart-breaking.



### 2007 Vintage

The national grape crop is expected to be down 40 to 50 per cent this year – from 1.9 million tonnes last year to somewhere between 1 million and 1.2 million tonnes. Some regions, like the Coonawarra, have lost more than 80% of their crop. It is rumoured that as many as 90% of grape growers are struggling to remain viable.

But beyond the impact of frosts and drought, this \$6 billion-a-year industry has battled for five years with a massive wine glut. The latest estimate is that Australian wineries are collectively carrying surplus stocks totalling 460 million litres, or approximately 40% of annual sales. This oversupply has resulted in heartbreak of its own: sparking crippling contract terminations and severe price reductions.



Photo: Di Davidson

Could it be that the 2007 vintage is Mother Nature's effort to return balance to the supply-and-demand equation?

The truth is we won't know until the drought ends and we develop a clearer picture of what long-term impact the drought and frosts have had on vines and future vintages. And while Mother Nature's intervention may have reduced by one to two years the time it will take us to re-achieve the supply-demand equilibrium, it will take a lot more than that to ensure the future of some industry participants.

Through Ferrier Hodgson's involvement with key Australian wineries like Normans Wines, the Gartner Group and the Barrington Wine Group, we have identified that the future viability of the industry depends on the operators' ability to take an analytical and strategic approach to the business.

### A Return to Equilibrium

The next two to four years will prove critical for the sector – a failure to return to equilibrium within that time frame will leave many businesses unviable. The key thing equilibrium will achieve is a reduction in the downward pressure on pricing that has seen grape prices fall between 50% and 75% over the past five years. Australian bulk wine prices have fallen from

as high as \$5-\$7 per litre in 2001 to as little as \$0.30 in 2006.

The expectation of a very small 2007 vintage has increased demand for both grapes and bulk wine. Recently, some bulk wine prices have doubled – albeit off a very low base. And although growers have seen the re-emergence of grape contracts by some of the major wineries, it is unlikely grape prices will recover to the levels achieved in the late 1990s.

Fortunately, it is unlikely there will be any significant vine plantings in the near future: the conclusion of the tax incentives incorporated in the Managed Investment Scheme virtually guarantees this. As a result – assuming the drought breaks and yields return to normal – the supply side of the equilibrium equation looks set for the next few years at least.

## Increasing Reward

That leaves us to address the demand side of the equation, and it is here that the industry needs to place its focus. On the assumption that yields return to normal in the next couple of years, the key to the future of the Australian wine industry is a demand issue – in particular, increasing export sales whilst maintaining and improving margins. In the face of growing competition from other New World wine-producing nations and tougher competition with alternative beverages, we need to grow both domestic and international demand for Aussie wine. Domestic consumption of Australian wine totalled 431 million litres in 2005/06 and is showing negligible growth (0.2%) at a time when imports – like Kiwi Sauvignon Blanc – are growing at 22%. On average, every Australian consumes 22 litres of wine per annum, making us the 17th largest wine consumer in the world. Hurdles to growing this market include the \$AUD, competition from New World suppliers, concerns about the impact of alcohol consumption on health and more aggressive marketing by

alternatives within the beverages market – RTDs, beer, spirits.

Greater opportunities lie in growing the export business. More than 60 per cent of Australian wine sales are exports: in 2005-06, Australia exported 735 million litres of wine valued at \$2.8 billion. Over the last 20 years, those export sales have been growing at a compound rate of 24% per annum, with the majority going to the UK and USA. These two markets alone are expected to account for an additional 129 million litres of Australian wine over the next four years.

But the easy pickings are gone. Other New World wine producers such as New Zealand, South Africa, Spain and Chile are also targeting these markets, placing Australia's export growth under pressure. And while export volumes continued to grow significantly, last year the value of those exports plummeted, mainly because of the increase in bulk wine sales compared to bottled wine sales and the increase in demand for wines at lower price points.

**Australian Wine Exports – Volume Versus Value**

	2002/03	2005/06
Volume increase	92 million litres	77 million litres
Total value increase	A\$416 million	A\$53 million
Value increase per million litres	A\$4.52/mlitres	A\$0.68/mlitres

*Source: Australian Wine & Brandy Association data*

## Key Markets

The UK remains a pivotal market for Australian wine. While there has traditionally been a focus on the basic and popular premium (£3-£6 bottle) sectors where there are tight and unsustainably low margins, the Australian wine industry should be moving its focus to the mid-price premium (£7-£10 bottle) sector where reasonable margins are achievable but where demand

for Australian wines, particularly from cooler climate regions, has been low. Australia currently has a good foothold in this sector and should be looking to grow this into the high-value specialty sector (£10+ bottle).

The USA continues to be the market offering the greatest growth potential: it is a 2.6 billion litre market. The US imports 762 million litres of wine per annum, of which Australia supplies 28%. The fastest growing sector in the US is bottled wine in the US\$6.99 to US\$8.99 sector, although margins are tight and only low-cost producers will survive. A promising opportunity for Australia lies in the premium wine offer at higher price points (US\$20+ bottle), a sector enjoying strong growth.

There is also the opportunity for Australia to take a greater proportion of 'on premise' restaurant sales. Currently, only 16 per cent of Australian imports are sold on premise, but based on current US consumption we believe there is the opportunity to grow this to 27 per cent.

Some Australian brands have benefited from excellent reviews by respected wine reviewers like Robert Parker (Wine Advocate magazine). Parker wrote glowing reviews of such wines as Torbreck, Ringlands, Greenock Creek and Two Hands, which resulted in instant UK and US demand, distributors clamouring for distribution rights, prime retail shelf space and product sell-outs – sometimes before the vintage had commenced.

Our experience indicates that route-to-market is also a key driver for success in these overseas markets and Yellowtail leads the way in this, selling more than 11 million cases of wine per annum with 8.5 million to the US alone.

Other export opportunities for Australian wine lie with Canada, Germany, Denmark, Netherlands and Russia. While the market for wine in China and Vietnam remains unsophisticated, the expanding middle class – which is increasingly experimenting with Western

## Did you know...

- It has emerged that the haze of bushfire smoke that swept across Victoria in December resulted in smoke taint to the grapes in many vineyards. Winemakers in the King and Alpine valleys have discarded as much as 20,000 tonnes of smoke-affected fruit, concerned it could affect their reputation.
- Milawa-based Brown Brothers paid for regular helicopter flyovers during the spring in an effort to remove damaging sub-zero air from around their precious grapes. They managed to avoid the frosts only to end up losing the lot – about 2000 tonnes – to smoke taint.
- Ferrier Hodgson works closely with industry specialists to ensure the right advice to our clients.
  - Murray Najar has 33 years experience in agribusiness and specialises in grapes. His background incorporates extensive knowledge of agriculture, sales, marketing and business.
  - Di Davidson is one of Australia's most experienced viticulturists, having worked in the Australian wine industry since 1975. She is experienced in project management, vineyard management, development, renovation, developing business plans, strategies and business reviews.

### Characteristics of successful vineyards

- Good regional location ('GI' – geographic indicator)
- Access to water
- Qualified viticulture management
- Reinvest monies into vineyard
- Vine consistency
- Varieties that meet the market
- Contract or secure outlet

### Characteristics of successful wineries

- Relatively low debt levels
- Sales and customer focus (supported by strong brands and distribution)
- Demand driven (rather than volume driven)
- Contract processing and processing for own use in balance

### Where wineries fail

- No established brand
- Lack of distribution – no clear route to market
- Cash flow problems (cash tied up in vineyards and stock)
- Onerous grower contracts
- No business plan or unrealistic forecasts
- Poor Management Information Systems ('MIS') and budgeting (especially cash flow forecasting)
- Significant investment in non-performing vineyards (wrong varieties, wrong areas)
- Production push rather than consumer pull mentality
- Unsustainable stock levels
- Highly geared

lifestyles and tastes – may develop an interest in wine consumption. This is supported by recent significant vineyard plantings in China, and has the potential to develop into a major export opportunity for Australia.

## Securing the Future

The 2007 vintage has been a difficult one for the Australian wine industry. The painful cards dealt out by Mother Nature – particularly the drought – are likely to speed the wine industry's return to a supply-demand equilibrium. Assuming the drought breaks and yields return to normal, the return to an equilibrium is likely to stabilise further value declines and prop up many businesses that would otherwise find themselves unviable within two to four years.

But the real key to the future of the Australian wine industry is not a supply issue – it is a demand issue. For longer-term viability, the industry as a whole needs to take a more strategic approach, focusing on export growth and higher-margin niche opportunities.

There are certain to be more challenges as the easy pickings disappear in the increasingly competitive global wine market. But the Australian wine industry will survive and prosper if it takes a more analytical and strategic approach, intelligently identifying and developing targeted opportunities.



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