

May 2009

Wine choices

Climate change and oversupply may force restructure in Australia's wine industry

There comes a day in the life of a successful winemaker or grower when he stands assessing his favourite row of vines and realises the vines' best days are over. Maybe the gnarled old trunk has been irreversibly damaged by the drought. Maybe the grape variety has been superseded by something more popular. But in that moment, the winemaker must make a personally difficult but commercial decision: it is time to rip up those vines and replace them with something new. For many in the Australian wine industry, that day is approaching.

The industry is facing the combined impact of the global financial crisis, high exchange rates, falling demand, falling margins, rising costs and an oversupply of grapes. At the same time there is the impact of climate change: drought, heatwaves, bushfires, smoke taint and, ironically, frosts. The Australian wine industry is here for the long term, but for some individual winemakers – already struggling under a mountain of debt – the most recent challenges will be enough to make them take some difficult decisions. In some instances they may be looking for the exit.

In this article we examine some of the changes and challenges that have impacted the industry over the past year and some of the issues it needs to focus on going forward. It has been a difficult 12 months, but there remains reason for optimism.



A hot and dry 2009 harvest

The Australian Wine & Brandy Corporation harvest update shows the 2009 wine grape harvest – estimated at 1.63 million tonnes – is down 11 per cent from 2008 and well below the 2005 record harvest of 1.93 million tonnes. While it remains well above the drought- and frost-affected 2007 harvest, which totalled just 1.34 million tonnes, the 2009 vintage has been troubled by smoke taint from bushfires, lack of irrigated water and a devastating heat wave in late January and early February 2009.

The fall in the harvest is not enough to soak up the existing oversupply as the industry's stock-to-sales

ratio remains too high. The current grape surplus is estimated at between 250,000 to 300,000 tonnes per annum based on the average Australian harvest of 1.8 million tonnes and demand at 1.55 million tonnes. In 2008 winemakers' inventories rose 5 per cent to 1.9 billion litres compared to Australia's production of 1.2 billion litres¹.

Grape prices this year are expected to be down approximately 30 per cent in the Murray Valley compared to last year, with prices likely to continue to fall over the next five years². The oversupply also places pressure on the bulk wine market, with some wines, particularly chardonnay, selling for as little

¹ Australian Bureau of Statistics

as 60 cents per litre when the average cost of production is around \$1.20 per litre. Wineries relying heavily on low-grade bulk wine sales will continue to struggle.

The challenge for many wine producers is to find new markets for higher price point products at a time when global markets are trading downwards.

Cheap wine and no export growth

During the 12-month period ending April 2009, the value of Australian wine exports declined 14.2 per cent to \$2.41 billion, while the total volume of exports fell 0.7 per cent to 726 million litres. The average price declined 13.6 per cent to \$3.32 per litre.³ In particular, it's evident that Australia's two major wine export markets, United Kingdom and United States that together contribute 66.4 per cent of the volume – and 60 per cent of the value – of Australian wine exports, have been hit hard by the global financial crisis.

In the UK, sales are down two per cent compared to the same period last year, as consumers cut back on wine by purchasing cheaper wines or buying less. This coupled with recent increases to the Excise Duty in the UK and the powerful supermarket chains pressuring wineries to absorb the tax has had a detrimental impact on Australian winemakers. The decline in the UK and US markets require Australian exporters to look at other opportunities such as Asia if they are to continue to grow their export sales.

The good news is that sales to Australia's three major Asian export markets were the best performers in value growth in 2008, with the value of shipments to China increasing by 54.6 per cent (up \$30 million), to Hong Kong by 25.8 per cent (up \$9 million) and Japan by 3.6 per cent (up \$2 million) in the 12-months ending April 2009. China is becoming more important for the Australian wine industry, climbing from the eighth largest market by volume to fifth, and from fifth largest by value to fourth. China is expected to be in the Top 10



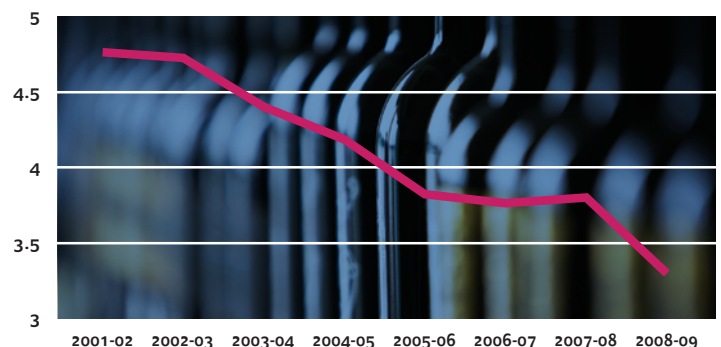
Popping the cork on the Chinese market

Australian winemakers wishing to take advantage of the growth in the Chinese market should:

- Develop an understanding of the routes to the market and select an appropriate distributor
- Be able to provide low price point products which can achieve a profitable margin
- Ensure payment is received by negotiating significant upfront payments before shipping

Wine Consuming Countries by 2010⁴: Hong Kong and Japan also remain significant export destinations for Australian wine.

Export price per litre (AUD)



The fall in the value of wine exports per litre is not only impacting margins and therefore profitability of winemakers, but also flows through as a negative impact on grape prices.

Source: ABARE

Time to change?

In the current economic climate, demand has increased for lower price-point wines, placing downward pressure on grape prices, while the drought and reduced water allocations have increased the cost of production for grape growers in warm irrigated areas. If Australian winemakers are unable to compete with low-cost producers from Argentina and Chile, they need to restructure their supply side to improve the profitability of both grape growers and winemakers. For some growers that may mean exiting the industry or removing vineyards,

² Australian Bureau of Agricultural & Resource Economics (ABARE)

³ The Australian Wine & Brandy Corporation, Wine Export Approval Report, April 2009

⁴ The Australian Wine & Brandy Corporation

especially those with grape varieties which are no longer in demand.

Australia's two largest players, Fosters and Constellation Wines have already commenced the restructuring process following announcements of significant losses due to both stock write downs and brand value impairments.

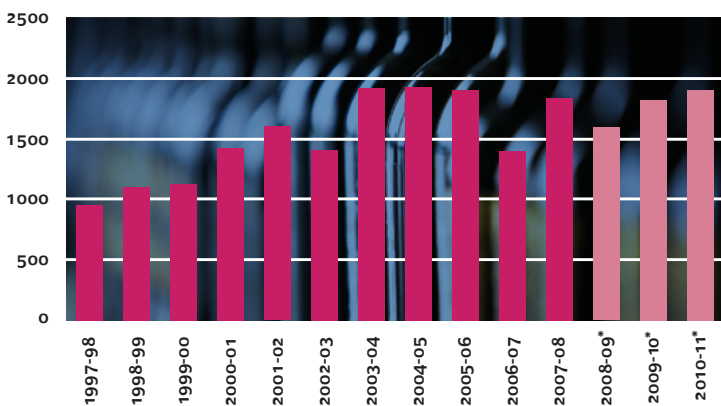
- In February 2009, Fosters announced its intention to rationalise its brand portfolio, sell 36 non-core vineyards and close three wineries.
- In 2008, Constellation Wines attempted to offload three wineries and 15 vineyards to slash costs and bring better returns.

The key challenge for wineries and growers wishing to restructure is that with a number of wineries and vineyards on the market, water issues, low grape prices and oversupply, values are expected to remain soft in the short to medium term.

2005, prices fell in the face of the wine glut and the average price was \$11.48 a bottle. Three years later it was \$11.90 a bottle⁵ Other issues facing the Australian wine industry include:

- The introduction of lightweight packaging in order to reduce the carbon footprint.
- The Government's anti-alcohol message tackling the responsible drinking issue with the "Drinkwise" promotion and the potential for legislation demanding health warnings be placed on labels.
- Uncertainty as to whether there is going to be any reduction in the Wine Equalisation Tax (WET) or any increases in tax on wine to bring it into line with other alcoholic drinks such as beer. Abolition of WET could be a disaster for a number of small wineries whose profitability is reliant upon this rebate.
- A push for more water-efficient vineyards, with record low flows in the Murray River. Warm irrigation growers, who account for approximately 60 per cent of Australia's production, remain under threat as falling grape prices and reduced irrigation allocations have a negative impact on earnings.

Australian wine grape production



The graph reflects the impact of significant vineyard planting which occurred in the late 90's which have come onstream in the early 2000s. Both the 2007 and 2009 vintages have been impacted by droughts, fire and smoke taint. However, the long-term forecast is for grape production to return to the record production levels achieved in the mid 2000s which will add further pressure on the oversupply unless there is either a removal of vineyards or recovery in the growth of export sales.

Source: ABARE

*Projected figures

Domestic trends

The dominance of Coles and Woolworths in the domestic retail market continues, reducing the market presence of independent retailers and placing downward pressure on sales prices for wines. The average price of a bottle of wine has remained static in the past four years. In November

Looking ahead

The world has developed a palate for the sophisticated and affordable wines we produce in Australia and our wineries will continue to have an influential position amongst New World producers. But with reduced exports and oversupply continuing to place downward pressure on grape and bottled wine prices, there will be winners and losers. The characteristics that set apart the wineries that will survive are easy to identify. They will be the ones with:

- Strong balance sheets
- Solid brands
- Access to water
- Access to quality fruit at prices that match their brand requirements
- A product range that meets consumer demand
- Strong distribution
- Strong information systems

⁵ ABARE

Avoiding spillage

A focus on cash flow and debt reduction is essential for winemakers that wish to move forward. Other focuses should include:

- Aligning grape intake with bottled wine sales.
- Matching wines to price points in demand (ie: currently around £5 in the UK and between \$10 and \$20 in Australia, depending on the quality).
- Developing a strategy to reduce inventory without discounting and destroying brand value (eg: maximising cellar door sales and developing cleanskin sales).
- Looking for additional income sources (eg: contract processing).
- Reducing costs by improving efficiencies (eg: consider outsourcing wine processing, using agents rather than having an in-house distribution network, etc).
- Preparing robust forecasts (preferably three-way forecasts – profit and loss, cash flow and balance sheet – on a three-year rolling basis).
- Monitoring performance, particularly cash flow, and acting early to avoid potential unfunded cash shortfalls.
- Having a good relationship with your banker. Financiers of wine businesses that have strong management and systems are working with them, not against them. It is vital that you keep your banker well informed and there are no surprises.

Did you know?

Ferrier Hodgson has extensive experience with wine producers in distress:

- Reviewing their financial situation
- Identifying their problems
- Coming up with solutions to get them back on track

Contact us for advice from our experienced partners and industry experts.

Those wine producers struggling to handle high debt levels and difficult local conditions – such as drought, bushfires or smoke taint – will find their viability threatened. Grape growers holding varieties that are no longer in demand, who have no long-term grape contracts, high debt levels or limited access to water need to put serious consideration into their future in the industry. Wineries and growers unable to restructure due to high debt levels and falling revenues are at high risk of failure as recently seen with the collapse of Great Southern. There are currently a number of Government-funded exit packages for wine producers that could play a key part in an exit strategy.



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