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Decision time for winemakers

Standing on the brink of the 2010 vintage harvest many wine grape growers and wineries face some difficult decisions about their future. Looking back over a tough 2009 and ahead to an uncertain 2010, many will be asking themselves: "Is this my last harvest?"

The continued wine glut has seen wineries cut back their 2010 fruit intake and reduce their grape prices by up to 25%. Industry leaders including John Casella (Casella Wines) and Doug Lehmann (Peter Lehmann Wines) have called on the sector to rip out thousands of hectares of vines in an effort to restore balance. The entire sector is under stress. Even the larger players are feeling the pain as they undergo restructuring and – in some instances – collapse. Cockatoo Ridge was placed into administration in January, reportedly due to its inability to fund the 2010 vintage.

Foster's, the biggest vineyard holder in Australia, made its view of the sector clear last year when it put 33 vineyards on the market. So far it has sold 20; many, according to media reports, came with grape contracts. Things are so grim that the buyer of one of the Foster's vineyards, in NSW's eastern Riverina, is considering pulling out the vines in favour of lamb production.

The wine industry is undergoing a major shakeout. Those that survive may well be presented with golden opportunities. The last time winemakers were pulling out their vines was in 1987: arguably the turning point in the downcycle. Within three years the market had recovered and through the 1990s the sector experienced unprecedented growth.

In this article we are going to examine the condition of the Australian wine-making industry, how it came to be this way and what businesses can do to improve their chances of survival – so they will be there to make the most of the opportunities that emerge when the market turns around.

The grape imbalance

Historically, the Australian wine industry has been very cyclical, experiencing an estimated 20 booms and busts over the past 120 years. Over the last 20 years the industry experienced unprecedented growth, particularly in export sales. However, the growth in volume has slowly eroded our pricing and arguably the quality of the wines exported: today Australia is often seen as a producer of "cheap" wine in a world market flooded with cheap wines. The industry has now entered another downturn and some participants will not survive.

The greatest challenge facing the industry is the imbalance between grape production and wine consumption. A Winemakers' Federation of Australia (WFA) report released last November said Australia is producing 20 million to 40 million cases of wine a year **more than is sold** – that is equivalent to the production of 20,000 to 40,000 hectares of vines. The wine surplus – already more than 100 million cases – is expected to double over the next two years. This is what has driven calls for 35,000 hectares of vines to be bulldozed in order to correct the supply/demand imbalance.

The first evidence of oversupply emerged in 2004, driven by a combination of large corporate planting and growth in Managed Investment Scheme (MIS) investment in the sector. The Wine Grape Growers' Association estimates that 10 per cent of Australian vines were planted by MIS companies and 21 per cent by large corporates. Many of the MIS vineyards were established for short-term tax concessional reasons rather than for long-term financial returns.

Consequently, there are a number of vineyards in cool climate premium areas (generally associated with A and B-class fruit) producing C and D-quality fruit and receiving C and D-level pricing for their grapes. It is ultimately not sustainable to extract C and D-level returns from A and B-standard land. The WFA report stated that 17% of vineyard capacity was uneconomic and that 20% of fruit-bearing vines in Australia are "surplus to requirements". This suggests that the reality is many growers are simply not viable.

The industry has commenced a review to identify uneconomic growers but the general belief is that market forces will bring about rationalisation rather than a return to the government-funded vine-pull schemes that occurred in the late 1980s. In other words, it is the individual growers and wineries that need to take a hard look at themselves and make some tough decisions.

On the demand side of the equation, the combination of the Global Financial Crisis (GFC) and a high and fluctuating Australian dollar has decimated export sales. Sales to both the UK and US markets have declined in both volume and dollars per litre and export sales are being redirected back to Australia, adversely impacting on price points and margins in the domestic market.

Increased competition from cheaper production countries such as Chile and Argentina is also impacting on Australia's traditional export markets. It could be argued that the oversupply problem is due to a fall in demand for our wines causing a loss of our share of the global wine market rather than an excess of production. The higher Australian dollar has also seen old world countries such as France and Italy increase their market shares via imports into the Australian domestic market.

As well as increased discounting, the major wine companies have started flooding the Australian domestic market with cheap wine, impacting on sales and margins. At the same time, the major supermarket chains have established their own in-house or Buyers Own Brands ("BOBs") which they are discounting heavily. Increasingly, the supermarket chains are becoming more like wine-making competitors than customers: they are now reportedly some of the largest owners of brands in Australia. Sales of BOBs have doubled in the last three years and now represent approximately 20% of sales and a significant portion of gross margin for the major supermarket chains. For wine companies, BOBs are making it more difficult to obtain shelf space and achieve higher price points, consequently eroding margins.

Key questions for growers

1. Do I produce grapes which are in demand, are of sufficient quality and at an efficient cost?
2. Am I receiving an appropriate price for my grapes?
3. Should I be buying more water or selling water?
4. Should I be increasing or reducing production?
5. Do I have too much debt?
6. Should I be buying more vineyards and consolidating to gain efficiencies or selling my vineyards?
7. What are the values of my vineyards?
8. What are alternative uses for my property and how long would it take to convert it to an alternative use?
9. What is the cost of removing vines, wire, posts and irrigation and rehabilitating the soil?
10. Do my financial forecasts indicate that I am likely to survive the downturn?

Viability

The industry is facing a crisis in terms of financial viability. The headline price in the market this year in the irrigation regions is chardonnay at $150 or less per tonne. With the average costs of production in the order of $230 - $300 per tonne, that makes it clearly uneconomic. The lucky ones who locked in prices at more economic levels several years ago will be sweating out the sunset stages of their contracts and hoping things turn around before it is time to sign again.

To make things worse, irrigation regions expect to see crop production down by 20% to 30% on last year because of the impact of recent heatwaves and reduced watering. Some wineries are limiting grower tonnages per acre under their contracts. On top of this, a significant volume of grapes are likely to be left on the vine this vintage due to cancelled or unrenewed grape contracts.

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The industry has to restructure which in the short term means cutting supply by reducing production. In the long term the industry needs to expand demand by opening up new markets (such as China) as well as winning back its image as a high quality, good value wine producer. However, this will take time and significant investment and its success will be subject to external global economic forces. The industry will recover but how long it will take is uncertain.

Consolidation of industry players, both wineries and vineyards, looks inevitable. The highly talked about proposed merger between Australian Vintage and Constellation appears to be based on strong strategic reasoning. Other mergers are likely to occur due to pending economic failure and opportunistic pricing of wine assets.

Key questions for winemakers

1. Am I producing a product that is in demand?
2. Do I have the appropriate distribution channels in place to sell my product?
3. Should I be expanding or reducing my portfolio of brands?
4. Which brands are making/losing money?
5. How can my winery be more efficient and how can I save costs?
6. Should I be cancelling grape contracts and buying grapes on the spot market or buying bulk wine?
7. Should I sell my winery assets and outsource the winemaking to an external grape processing facility?
8. What are the values of my brands and the value of my winery?
9. How can I maximize my margins – can I move my brands to higher price points and limit discounting?
10. Should I be opening a cellar door and establishing direct mail orders?

With the wine sector in a state of flux, industry knowledge is essential to bring together players with complementary needs. The importance of this was highlighted earlier this month with the sale of the Poplars Winery in Coonawarra. Ferrier Hodgson partner John Hart, with the assistance of Colliers International, sold Poplars to a purchaser seeking production facilities. The 12,000-tonne production facility will become a key part of a well-known farming family's wine-producing infrastructure. For the remainder of this vintage, Ferrier Hodgson as receivers will continue operating the winery as a contract processor.

What can you do?

Growers, wine makers and their financiers are facing a series of key issues that need to be addressed. Sit down and make a list of responses to the following issues. Then consider whether you need to call on the assistance of an experienced, independent third party to help you evaluate your position.

- **Fruit prices.** Growers need to review their fruit contracts in regard to price and terms. As wine makers struggle with falling demand, they will try to reduce the cost of fruit. Most will give preference to their own fruit and may try to renegotiate prices with growers, who may find themselves with little alternative but to accept. The Cockatoo Ridge collapse is a good example of a winery that had done its numbers and realised it could not fund the 2010 vintage. The issues of oversupply and excess planting do not suggest that prices are likely to improve in the near term.
- **Outlook for 2011.** By June or July many growers will need to start committing to the 2011 vintage. That means committing to expenses such as pruning, fertiliser, water and maintenance. Growers will need to do their vintage costing and look closely at profitability. Now is the time to make a decision on whether to commit to the next vintage. There is no point incurring the expense of maintaining grapes through the growing period only to abandon them prior to harvest because the prices are not economic. This is a difficult decision and one that needs to be made quickly.
- **Finances.** Many growers have been under stress for a number of years. They may have exhausted their cash reserves and have limited access to additional debt or equity. It will be critical for vineyards to prepare robust financial forecasts to provide a clear picture of the times ahead. Given the state of the industry, financiers will be reviewing credit risks based on the future viability of many small to medium wineries.
- **Water.** Growers may be able to sell water rights in certain regions – various Government buy-back schemes are providing growers with a potential means of generating cash.

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- **Domestic market focus.** With the Australian dollar high, wineries may need to return their focus to the Australian domestic market. Strategies such as investing in a cellar door or direct marketing should be considered. Some wineries are considering new varieties (such as tempranillo, pinot gris and viognier) in order to boost demand.
- **Exit strategy.** If the decision is made to exit the industry, there are a number of issues to consider:
  - There are a large number of vineyards on the market at present, as large and small operators exit the industry.
  - The transaction rate is low and it may take time to complete a sale.
  - In some regions, properties are simply not selling.
  - Examine whether it is worthwhile maintaining the crop whilst preparing to sell the property.
  - In some regions agents say the vines have no value and are suggesting they are removed to enhance value.

Conclusion

With the 2010 vintage in progress, the next few months will be critical for many participants in the Australian wine industry. Key decisions need to be made quickly and they need to be based on accurate, well-informed industry knowledge. Ferrier Hodgson's specialist wine team includes partners who focus on the financial and strategic issues and wine-sector consultants with excellent knowledge of operational issues. Ferrier Hodgson has experience helping growers, wineries and financiers address these issues in a measured and tactical manner. Let us help you:

- Prepare forecast models for profit & loss and cash flow
- Review product costing
- Assess strategies to improve profitability and cash flow
- Determine financing requirements
- Prepare and execute workout, restructure or exit strategies
- Assist growers, wineries and financiers in assessing viability and the options available

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