Wine Quarterly Q2 2016

Global Sector Update

Global trade activity picked up in 2015, courtesy of the US and China markets, while we check in with the New Zealand wine industry as it moves further along its impressive growth path.

New Zealand grows up (and up?)

As we look ahead to the 2016 vintage, the NZ wine industry has just posted another strong year of export growth in 2015. There's good scope for further growth, but it is not as widely distributed across the industry as it once was, with smaller wine companies struggling to keep pace.

Global export trade flows

A number of wine countries recorded strong rises in export trade volumes in 2015, but the corresponding movement in average export prices was far less uniform. The boost to import competitiveness in the US market helped to support trade, as did the strong rebound in import demand in the Chinese market.

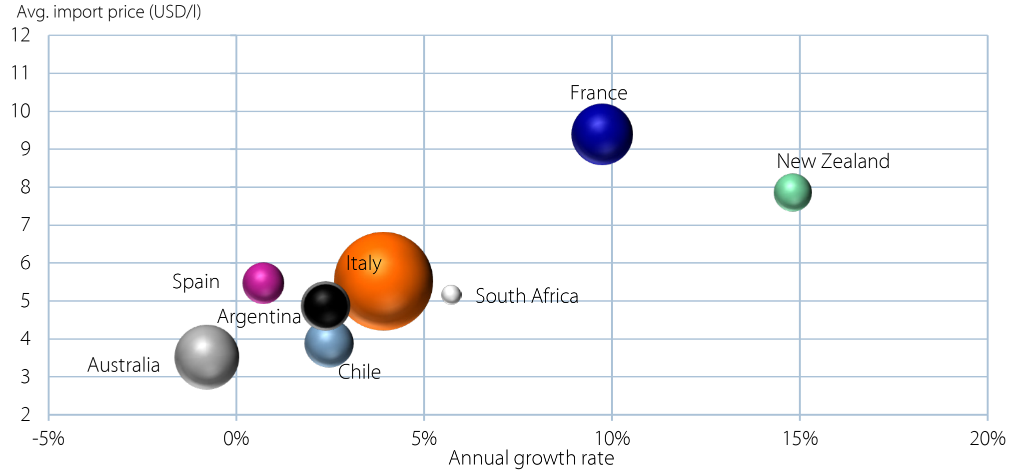
Global wine supply

Early indications of the Southern Hemisphere harvest in 2016 point towards a lighter crop, with Chile, Argentina and South Africa facing significant falls in production. Production in Australia and New Zealand looks more in line with historical average levels.

US wine imports

US wine imports continued to grow in 2015, assisted by the stronger US dollar. Total imports rose 5% by volume and 2% by value. Bottled wines from more premium suppliers (especially Italy, France and New Zealand) continued to grow strongly, while bulk wine import volumes were generally soft, down 4% YOY *(see Figure 1)*.

Figure 1: Still, bottled wine imports into the US market by country of origin, 2015



Source: Gomberg, Fredrikson & Associates; Rabobank, 2016

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Food & Agribusiness Research and Advisory

Published by the Global Beverages Sector Team.

Lead authors

Stephen Rannekleiv

Stephen.Rannekleiv@rabobank.com

Marc Soccio

Marc.Soccio@rabobank.com

For a full list of team members, see back page

far.rabobank.com

New Zealand grows up (and up?)

As we look ahead to the 2016 vintage, the New Zealand wine industry has just put paid to another year of strong export growth in 2015. Early indications predict a rebound in wine production following on the back of the very short 2015 harvest, which will be broadly welcomed by an industry looking to capitalise on growing global demand for its core products.

But as this remarkable growth story continues to play out, questions arise as to how demand for New Zealand wines might be changing in today's marketplace, who is best placed to satisfy it and how the industry is likely to evolve as a consequence. In an industry that has matured considerably over the past ten years (as have its major markets, for that matter), what is becoming increasingly evident is that the rising tide of export growth might not be sufficient to lift all boats in the same way that it has done in the past. Nevertheless, New Zealand wines remain well-positioned to take advantage of well-established consumption trends.

Riding high on global trends

New Zealand's cool climate wine styles and premium positioning remain very much in its favour in most major markets. For some time now, New Zealand wines have become representative of how consumers—from across the UK, mainland Europe and Australia to the US and Canada—all seem to be willing to pay up for more expressive and lighter-bodied wines. And there is little evidence of this trend reversing any time soon. In fact, the growing role women and younger generations play when it comes to purchasing decisions only seems likely to support it further.

At the same time, despite its popularity, the high degree of exposure that the New Zealand wine industry has to one variety from one region still makes its fortunes the subject of great conjecture. This risk is real, with there being no shortage of cautionary examples of shooting stars within the global wine market over the years. But contrary to the view of those aficionados who might look to belittle the 'simplistic' style of Marlborough sauvignon blanc, many, many more are still drawn to its refreshing style.

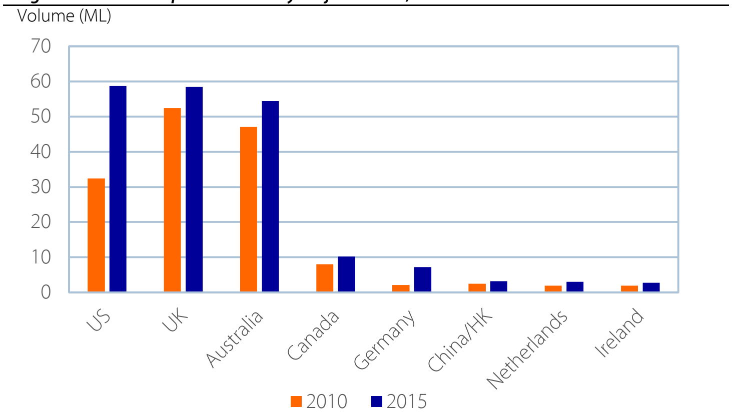
Inevitably, demand will indeed plateau and even wane in markets, as we are currently seeing in the Australian market, where penetration is approaching mature levels and demand is becoming increasingly price-sensitive. Elsewhere, however, there still remains considerable room for profitable demand growth, as this inflexion point still seems some way away. But what is nevertheless concerning for many in the industry is that this apparent upside is becoming increasingly concentrated in the hands of the country's larger wine producers.

Fortune favours the big

New Zealand wine's most buoyant market over the past five years is also one of those that still has considerable upside. On the back of 12% volume growth in the 12 months to December 2015, the US market has just edged out the UK as New Zealand wine's largest export market *(see Figure 2)*. What these figures don't reveal, however, is which companies and brands have been acting as the driving force behind this growth.

It is no secret that distribution holds the key to success in the US market, and New Zealand wine producers are proving to be no exception to that rule. Consolidation within the distribution space has left little room on distributors' lists for the multitude of brands that wish to make their fortune in the US market. Even some of New Zealand's larger independent wine companies are struggling to find effective distribution in order to keep pace with those New Zealand brands owned and handled by the big US-based companies *(see Figure 3)*. Some of these are fully integrated with a production footprint in New Zealand, while others, such as E&J Gallo's Starborough relies on various third-party supplier relationships.

Figure 2: NZ wine export volumes by major market, 2010 vs. 2015



Source: New Zealand Winegrowers, Rabobank, 2016

Figure 3: Sales of select NZ wine brands in the US grocery channel, 2015

		MAT value growth		MAT volume growth	
Brand	**Company**	**YOY**	**3-year CAGR**	**YOY**	**3-year CAGR**
Starborough	E&J Gallo	29.5%	26.4%	29.9%	26.9%
Kim Crawford	Constellation	31.6%	27.8%	30.4%	29.4%
Nobilo	Constellation	16.3%	18.0%	17.3%	19.8%
Matua	TWE	62.8%	49.1%	44.1%	51.1%

Source: IRi (data ending 20 Dec 2015), Rabobank, 2016

As New Zealand wines move further and further into the off-premise channel, scale becomes an increasingly important factor to attract distribution and drive the sort of cost efficiencies needed to invest behind your brands in the market. And as Marlborough sauvignon blanc grape prices look set to tighten again in the 2016 vintage, the structure of a brand owner's supply chain is becoming a more important asset. In this respect, owning vineyards in order to contribute a greater proportion of your own grape supply needs is now delivering significant production cost savings.

Where to next for growth?

Marlborough sauvignon blanc is not only a favourite with consumers, but equally with the wine companies who produce it. In Marlborough, in particular, the typical season promises ample yields of high-quality fruit that is efficiently processed through a relatively uncomplicated process, leaving wineries ready to recoup their working capital in no time flat, as stocks hit the market in the months following harvest. But this also means that diversifying the industry's exposure to one variety in one region will continue to prove challenging, as most other varieties and regions struggle to compete for capital.

As the industry has steadily recovered from the oversupply conditions that wracked it in the wake of the 2008 vintage, attention has returned to securing supply lines to fuel future brand growth. Scope for further expansion of vineyard area is somewhat limited, with little availability in the Wairau Valley 'dress circle' and remaining viable areas of the southern valleys being progressively land-banked and earmarked for development. Asset values have consequently rebounded strongly, making it difficult for smaller and less well-capitalised wine companies to expand their holdings. More supply is coming online as vineyard investment has recovered with wine grape prices, but grape prices will have to rise much further in order for some of the least productive areas of Marlborough to come into production.

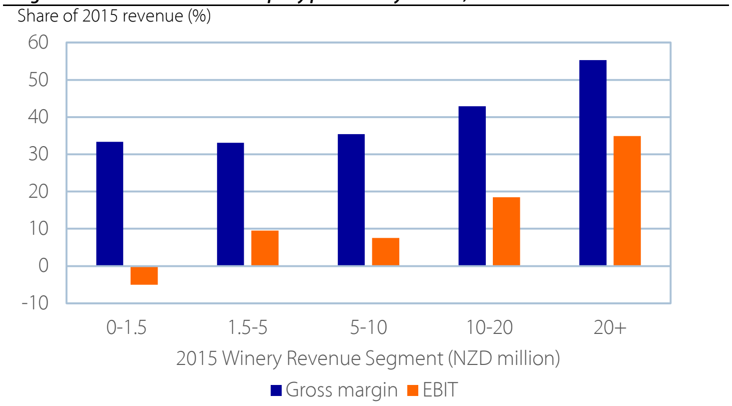
What is becoming increasingly evident is that a combination of more limited market opportunity and limited access to cost-competitive supply is placing pressure on the profitability of small to mid-sized wine companies. The annual financial benchmarking survey conducted by Deloitte shows the markings of this clearly, with the industry's largest companies achieving far greater returns *(see Figure 4)*. A lower New Zealand dollar is certainly assisting smaller producers to recover some lost profitability, but a process of industry consolidation is nevertheless likely to gather pace over the coming years, as mergers and acquisitions seek to more profitably employ the assets of smaller independent firms struggling to compete and grow.

Investment in other varieties and New Zealand regions is nevertheless taking place. Marlborough wine companies are having notable success with pinot noir and pinot gris, and they continue to see the benefits of diversification as a worthwhile investment, even if stand-alone returns don't quite stack up to sauvignon blanc. Other regions, such as Hawke's Bay and Central Otago, have their own diverse offering to bring to market, and they will continue to benefit as Marlborough-based companies seek diversification benefits elsewhere.

Shaping supply and the NZ wine premium

At this point in time, vintage 2016 in New Zealand looks set to deliver production volumes that are about 'just right', i.e. not too big, yet not too small for most companies entering the year with stocks erring on the tight side. Keeping stocks within a manageable range is a perennial challenge for wine producers

Figure 4: New Zealand wine company profitability metrics, 2015



Source: Deloitte, New Zealand Winegrowers, Rabobank, 2016 the world over, and it is certainly one of the greatest challenges that continues to confront the New Zealand wine industry.

The potential for large vintage variations—both in terms of quantity and quality—is considerable, owing to New Zealand's cool climate. This adds a further degree of risk and complexity to business planning and brand-building efforts, where just two successively large vintages can have far-reaching consequences for the industry's profitability. This is accentuated in the case of Marlborough sauvignon blanc, which typically needs to be marketed within 12 to 18 months from harvest, creating enormous pressure to discount when stocks are long.

The ability to manage supply for any premium product cannot be overstated, and the premium positioning of New Zealand wines in global markets is essential to the sustainability of its business model. While this risk is slightly lower today than in the not-too-distant past, when significant new vineyard plantings were still entering production and maturing, it presents a very real threat to the premium perception of New Zealand wines, which remains the envy of wine producers the world over.

Global supply

The balance of global stock levels entering 2016 looks considerably different at opposing ends of the market. The lower end of the market—generic and basic wines—continues to contend with surplus supply, while stocks of super-premium wines remain a bit tighter across many regions.

Looking ahead to vintage 2016, the major Southern Hemisphere producers look set to deliver a lighter crop in aggregate at this stage of proceedings.

Southern Hemisphere update

New Zealand

The 2016 harvest is well underway, and early expectations are for a larger harvest than the very short 2015 crop—but not as large as the record 2014 crop. A quality crop of this magnitude would help to fuel growing export markets, while not placing undue pressure on pricing and profitability.

Australia

Preliminary indications suggest Australian wine grape production is likely to test last year's level, which landed right on the five-year average. The growing season has been conducive to good yields and ripening across much of the country, with more testing conditions in some isolated pockets. Grape markets have been most active for more premium red wine varieties.

Chile

Early estimates suggest that the Chilean wine grape crop of 2016 will likely see a decline of approximately 10%, compared to the 2015 crop, but will still be fairly large by historical levels. It has been a complicated year for growers, who have battled mildew and botrytis on the one hand, along with soft demand from wineries that are already holding full inventories on the other. Erratic weather factors resulted in early harvests in some regions and late harvests in others.

The decline in production is a step in the right direction, but will be unlikely to bring inventories back down to more normalised levels in the near term. Inventories reached record levels at the end of 2015, after several years of production growth outpacing consumption growth. In February, Concha y Toro told growers that it would not be buying generic-quality red grapes this year, sending tremors throughout the industry. This reflects the current dynamic of robust inventories and soft demand for generic, low-quality wines, even as demand for higher-quality grapes and wines remains relatively strong.

Argentina

Argentine wine grape production looks set to come in quite low in 2016. Initial estimates suggest it will be down 15% or more from the light crop of 2015 and may be the smallest wine grape crop seen in several decades. This will likely move the Argentine market very quickly, from having excess inventories of generic grapes to a situation of tighter supply.

South Africa

The South African harvest came in quite low in 2016 as a result of extreme dry weather. Official estimates are still not available, but sources suggest significant declines compared to the 2015 harvest, which was lower than the 2014 harvest.

Northern Hemisphere review

US

California crushed 3.7 million short tons of wine grapes in 2015, 4.8% less than in 2014 and well below initial estimates. The total crop figures mask the fact that production in many of the more premium regions (such as Napa, Sonoma and the Central Coast) declined by approximately 30% or more, while production in the southern San Joaquin Valley—aimed at the lower-price segment of the market, where demand has been declining—increased by 10%.

Europe

Wine production in France registered a slight increase in 2015, in spite of significant production challenges in Champagne and Burgundy, mainly due to the larger harvest in Languedoc. Production in Bordeaux remained similar in size to the 2014 harvest, and while many are claiming an exceptional vintage, others are quietly referring to some variability in quality.

Italian production was particularly strong in 2015, on the back of warm, dry weather. Italian wine production rose across nearly all regions, but the large increases in production in Veneto, Tuscany, Puglia and Sicily were particularly impactful. Estimates from Unione Italiana Vini suggest total production was up 12% compared to 2014.

Hot, dry conditions in Castilla-La Mancha (CLM) dramatically affected production for growers without irrigation. The most recent estimates from Spain's Ministry of Agriculture, Food and Environment suggest total Spanish wine production in 2015 was 8% lower than in 2014 and far below production levels of the bumper crop of 2013.

Global trade

Export trends of major producers

France

French wine exports volumes fell 3.6% in 2015, mainly driven by declines in lower-value wines without geographic identification *(see Figure 5).* In spite of the volume decline, export value grew 6.7%, supported by solid growth of champagne exports and the strength of the US dollar. It is also worth noting that, while exports of bordeaux saw a mild decline overall in 2015 (-3.1%), exports to China rose by more than 30%.

Italy

Italian bottled still wine export volumes were relatively flat in 2015 (-0.2%), but, more importantly, saw a 4.3% rise in value. Exports to the US—Italy's largest export market—rose 4.7% by volume and 12.5% by value. Also of note: exports to China rose 7.4% by volume and 21.4% by value. While bottled wine exports showed respectable growth in value, the main story from Italy continues to be sparkling wine (prosecco) exports, which rose 15.3% in 2015, led by exceptional growth in the UK (45.7%) and the US (24.5%).

Spain

Spanish wine exports delivered strong growth in 2015, with volumes rising 7.5% and value growing 4.4%. Export volumes were led by bulk wine shipments, which were up 9.6% for the year, compared to 6.7% growth for bottled wines. In terms of value, the growth was driven by exports of higher-value bottled wines with protected origin. These wines grew only 2.4% in terms of volume, but the value growth (6.8%) was responsible for nearly 70% of the total growth in export values.

Russia was a major growth market for bulk wines (up 32.5%), while China was an important growth market for bottled wines (37%). The US was an important market for value growth (10.9%), driven by the strong US dollar. Also of note: Mexican demand for wines with protected origin rose 4.1% by volume, in spite of an increase in average prices of 14.8%.

Australia

Australian wine export volumes increased by 6.4% in volume, to 744ML, and by 13.8% in value, to AUD 2.072bn FOB over the course of 2015. Bottled wine exports rose by 9% in volume, while bulk wine exports only grew by 4% in volume, signalling that this structural shift in how Australian wine exports are packaged has begun to mature, further aided by the Chinese market's preference for source-country bottling. The Chinese market was the standout performer in 2015. Bottled shipments grew by 55% in volume and 63% in value during the year, catapulting China/Hong Kong into the position of Australian wine's most valuable export market.

New Zealand

New Zealand wine exports increased by 8.5% in volume, to 142.1ML, and 13.6% in value, to NZD 1.536bn FOB in 2015. Aside from sauvignon blanc, exports of New Zealand's second- and third-most popular wine varieties performed strongly, with pinot noir volumes growing by 11% and pinot gris volumes growing by 14% over the course of the year.

Argentina

Argentine wine exports fell 4.9% by volume and 2.2% by value in 2015. The decline was led mainly by the reduction in exports of non-varietal/generic wine, both in bulk and in bottled format. In what was a difficult year in many ways for many in the Argentine wine sector, the exceptional growth seen in the UK market (up 35%) was a worthy highlight.

Chile

In 2015, Chilean exports of bottled and bulk wine combined grew 10.7% by volume, but were flat (0%) in terms of value growth. Bulk wines drove volume growth, up 17% for the year, versus 6% growth for bottled wine exports. But in terms of value, bulk wine exports were a drag, as they saw a 1% decline in value in spite of the volume growth. China and Japan were the biggest growth drivers for Chilean wine exports, growing 55% and 21%, respectively (in volumes). The growth in exports to these markets demonstrates the value of Chile's free trade agreements.

US

US wine exports rose 4% by volume and 8% by value in 2015, according to the Gomberg-Fredrikson Report. Bottled wine led the growth trend, in terms of both volume (5%) and value (10%). Given the strength of the US dollar, the fact that brand owners were able to grow volumes and deliver outsized value growth was a significant accomplishment, and it suggests that US brands are gaining traction in foreign markets. Europe was the biggest growth market for US exports. Gains in that market were enough to overcome considerable declines in Nigeria and much of Asia.

South Africa

Exports of South African wine were relatively flat in 2015, down 0.6% compared to 2014. Exports of red wine slightly outpaced sales of whites, and bulk wine exports showed a mild advantage over packaged wine exports (1.5% growth vs. a decline of 3.4%, respectively). The somewhat lacklustre growth rates of exports masks the fact that the domestic market, which consumes nearly 50% of South African wines, is experiencing somewhat of a boom, growing by more than 8% in 2015.

Figure 5: Change in exports for key exporters, 2015

Country	Volume change (%)	Value change (%)*	Period of measure
France	-3.6	6.7	Jan-Dec
Spain	7.5	4.4	Jan-Dec
Italy	-0.2	4.3	Jan-Dec
US	4	8	Jan-Dec
Australia	6.4	13.8	Jan-Dec
Argentina	-4.9	-2.2	Jan-Dec
Chile	10.7	0	Jan-Dec
New Zealand	8.5	13.6	Jan-Dec
South Africa	-0.6	N/A	Jan-Dec

* Note: value changes in local currencies

Source: Wine Australia; Gomberg, Fredrikson & Associates;, Observatorio Vitivinícola Argentino; OeMv; SAWIS; Unione Italiana Vini; Fédération des Exportateurs de Vins & Spiritueux de France; Vinos de Chile; New Zealand Winegrowers, 2016

US import trends

US wine imports continued to grow in 2015, driven by premiumisation trends. Total imports rose 5% by volume and 2% by value *(see Figure 6)*. Bottled wines from more premium suppliers (especially Italy, France and New Zealand) continued to grow, while bulk wine imports were generally soft, down 4% YOY. As it became clear that the harvest in California was lighter than initially expected and as suppliers worked through existing inventories on-hand, bulk wine imports regained some momentum in the last three months of the year.

Beyond still wines, sparklers continue to be an important growth story, rising 14% by volume and 13% by value in the period. Prosecco and champagne continue to be the main drivers of sparkling wine import growth (up 17% and 13%, respectively), but growing interest in sparkling wines is also driving improving trends for Spain (9%), Germany (32%) and South Africa (50%)—though the latter two from a much smaller base.

Vermouth imports were exceptionally strong in 2015, rising 23% by volume and 14% by value. Italy and France continue to dominate the category, though imports from alternative regions are also showing strong growth. In spite of the fact that volume growth has outpaced value growth to date, we do believe that this is a segment that could be ripe for the introduction of more premium brands, given its relationship with the cocktail category, which has seen strong premiumisation trends.

Figure 6: US imports by country of origin, Jan-Dec 2015

Country	Value (USD million)	Change (%)	Volume (million cases)	Change (%)
Italy	1,744.9	0	36,447.9	7
France	1,542.9	5	14,505.8	13
Spain	343.4	-2	8,165.3	4
Australia	429.9	-4	18,837.9	0
New Zealand	359.7	10	6,438.4	14
Chile	284.3	-4	14,749.9	-11
Argentina	343.2	-2	11,988.7	3
Portugal	90.5	3	1,850.5	12
World total	5,532.2	2	130,853.6	5

Source: Gomberg, Fredrikson & Associates, 2016

Bulk wine pricing

A look at bulk wine pricing trends reflects the recent supply-and-demand dynamics across different markets. The recent light crop in California has led to price increases of 10% to 15% across numerous varietals, while the large crops in Chile and Languedoc (France) have led to easing prices for key varietals in those markets *(see Figures 7 and 8)*.

The recent light crop in Castilla-La Mancha (Spain), coupled with the fact that rising exports have drawn down inventories, has led to a firming of prices in that market across both varietals and generics *(see Figures 8 and 9)*.

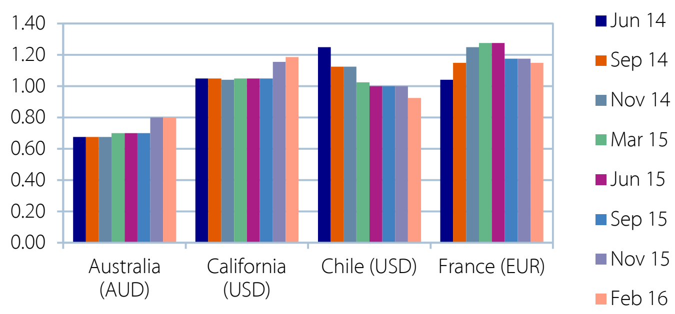
The prospects of a light crop in South Africa have led to some firming of prices for generic whites in that market when measured in local currency, but the ongoing weakness of the rand has made it increasingly attractive in US dollars (*see Figure 9*).

Currency outlook

The recent weakness in the US dollar has caught many off-guard. The momentum shift has been largely due to some improvement in commodity prices, following their precipitous fall at the start of the year, and the US Federal Reserve distancing itself from the aggressive interest rate-tightening path that it had previously outlined. The good news for most wine exporters is that this rally in the US dollar is expected to dissipate over the coming months, moving most currencies lower. One currency that is expected to appreciate against the US dollar over the coming year is the British pound, which should come as welcome news for many wine exporters *(see Figure 10)*.

Figure 7: Prices for chardonnay bulk wine by country of origin, Jun 2014- Feb 2016

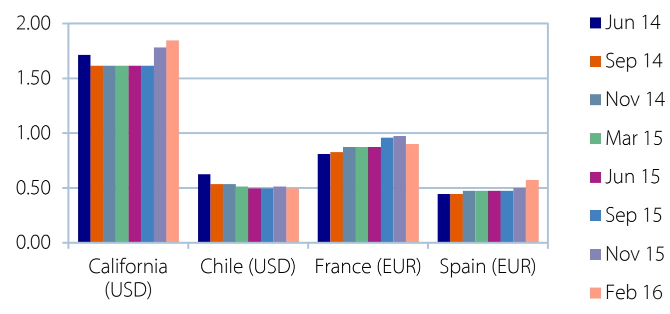
Price per litre



Source: Ciatti Company, 2016

Figure 8: Prices for cabernet sauvignon bulk wine by country of origin, Jun 2014-Feb 2016

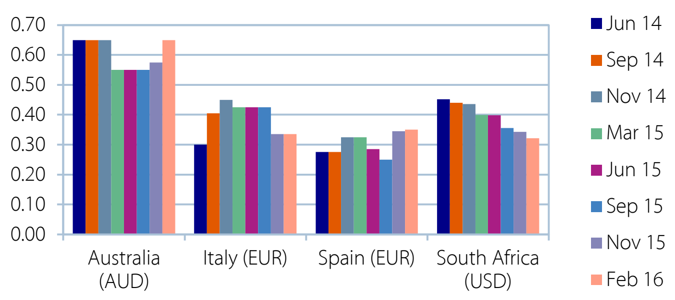
Price per litre



Source: Ciatti Company, 2016

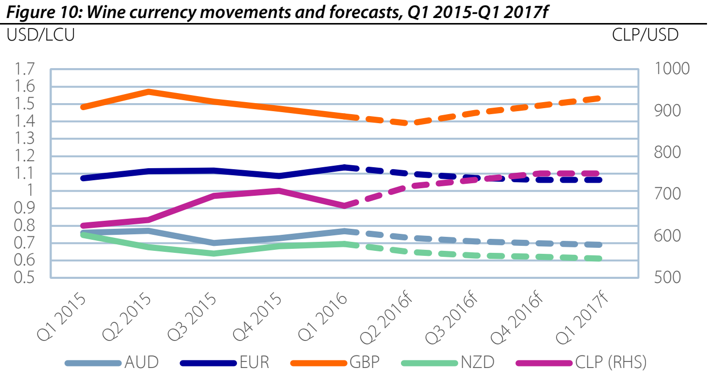
Figure 9: Prices for bulk generic white wine by country of origin, Jun 2014-Feb 2016

Price per litre



Source: Ciatti Company, 2016

Figure 10: Wine currency movements and forecasts, Q1 2015-Q1 2017f



Source: Bloomberg, Rabobank Financial Markets Research, 2016

Rabobank

Rabobank Food & Agribusiness Research and Advisory Beverages Global Sector Team Analysts

Global Strategist – Ross Colbert
ross.colbert@rabobank.com

Australia – Marc Soccio
marc.soccio@rabobank.com

Brazil – Andres Padilla
andres.padilla@rabobank.com

China – Sandy Chen
sandy.chen@rabobank.com

China – Katharine Song
katharine.song@rabobank.com

Europe – Francois Sonneville
francois.sonneville@rabobank.com

US – Xinnan Li
xinnan.li@rabobank.com

US – Stephen Rannekleiv
stephen.rannekleiv@rabobank.com

Singapore – Sudip Sinha
sudip.sinha@rabobank.com

far.rabobank.com