

# The game is changing... Back to the Future!

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It's Back to the Future<sup>1</sup> for the Australian wine industry and this short piece examines why. The rapid shrinkage of Australia's vineyard area has gone largely unnoticed in recent years: the vineyard area in 2015 has taken us right back to the vineyard area of 2001. Combined with a lower exchange rate, multiple Free Trade Agreements, and China's rapid demand growth, the shrinking vineyard area is a game changer for Australian wine.



## 2016 Vintage Size?

The main question that I have been asked over the last two months has been: "What is the size of this year's Australian wine grape crush?" Some areas were up slightly (e.g. a number of premium SA regions), some areas were down slightly (e.g. Murray Darling) but we will not know for sure for several months yet. It is most likely that 2016 will be an average sized, good quality vintage. But the reality is that the exact size of the 2016 vintage probably does not matter much and here's why:

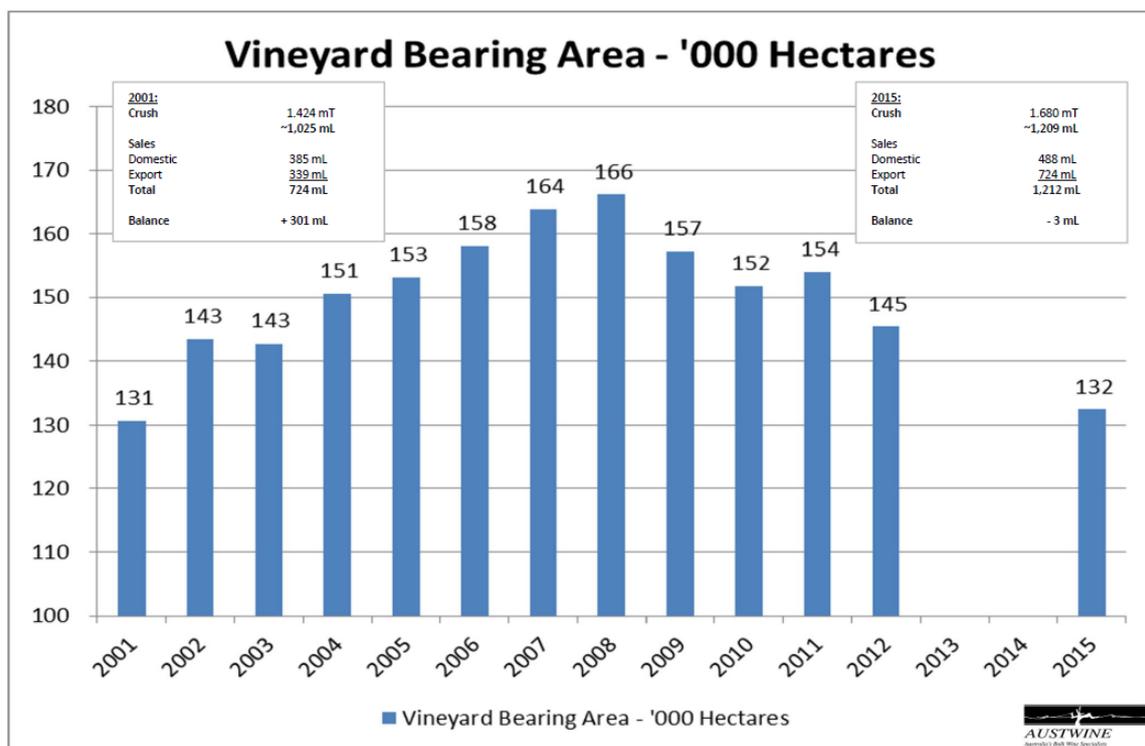
In recent years, Australia has removed a *very significant* quantity of vineyards, which far eclipses any natural variation in crop levels that can ordinarily be expected each year. Even if nature produced a bumper crop in 2016 across the country (unlikely), we will start facing supply challenges very soon. Yes, you have read it correctly: supply challenges from Australia.

If the current fundamentals remain in place, it is only a question of time: a larger vintage this year will delay it, and a smaller one will accelerate it. But there is no doubt that the difficult oversupply conditions experienced by Australian winemakers and grape growers over the past 15 years are coming to an end.

I am certainly not saying that every variety and every region will be short, or is even currently short – we are certainly some way from that scenario. Some regions are still experiencing structural oversupply (for example, many of the newer premium regions that experienced rapid growth in the late 1990's and early 2000's). Other regions are in a much better position following years of painful restructuring to reduce supply (e.g. Riverland & Murray Darling), or consistent long term marketing to grow demand (e.g. Barossa & McLaren Vale). Other regions are also going well for various reasons (e.g. Tasmania).

## Back to the Future!

Consider the chart below, drawn from publically available data, which shows that vineyard area in 2015 (the most recent survey ahead of vintage 2016) is right back at the same levels as 2001. Note the rapid reduction from the next most recent survey done in 2012 - nearly a 10% reduction on vineyard area during that time, equivalent to 13,000 Ha. The reduction from the peak year of 2008 to 2015 is around 20%, or 34,000 Ha, which is a very significant reduction in vineyard area.



## So what is going on?

If vineyard area in 2015 (132,000 Ha) is *almost identical* to the vineyard area way back in 2001 (131,000 Ha), what is happening?



2001 was near the end of the Australian wine export boom and an inevitable bust followed. In 2015 the game is very different, and the difference in annual supply/demand balances is remarkable, which are highlighted below:

Back in 2001 Australian wine sales totalled 724mL, about 1/3 below the 2001 annual production of 1,025mL.

- **2001 apparent annual supply/demand balance?** **301mL surplus**
- **Vineyard area?** **Growing**
- **Overall Outlook?** **Deteriorating**

Fast forward one-and-a-half decades to 2015 and Australian wine sales totalled 1,212mL, about the same as production in 2015.

- **2015 apparent annual supply/demand balance?** **3mL shortfall**
- **Vineyard area?** **Shrinking**
- **Overall Outlook?** **Improving**

So in 2015 we have roughly the same vineyard area as we did 15 years ago, but that is where the similarities end. In 2015 a larger production was recorded (mainly due to a greater percentage of fully mature vines in production), however there is an absence of any significant surplus apparent in 2015. This is in stark contrast to the large surplus that was evident in 2001, a surplus that increased further until demand caught up with supply.

Furthermore, bulk wine inventories listed on our book are now *falling*. For example, at the moment, it is pretty hard to get any significant volumes of good quality one year old bulk 2015 SEA Shiraz, Cabernet, Chardonnay, Sauvignon Blanc or Pinot Gris. This time last year there was a good selection of many one year old wines and this time a year earlier, in 2014, there were plenty of one year old wines still available from the bumper 2013 vintage.

Moreover, it is harder to find older vintage, distressed parcels from many regions, which were much more abundant just two short years ago. This is not entirely unexpected as any recovery in the fortunes of Australian wines is likely to start from the bottom end and these economically priced wines are being snapped up.

## How did we find ourselves in this place?



Four key events have contributed to our current situation:

### 1. Reduction in Vineyard Area:

The rapid shrinkage of Australia's vineyard area in the past few years has gone largely unnoticed in the marketplace.

In particular, many market players are doing their reckoning of supply and demand balances based on out-of-date vineyard area data.

For two years (2013 and 2014) our industry was too broke to undertake surveys of vineyard area, so we didn't know exactly how much vineyard area was being removed. Vineyard removals were certainly happening due to the overall terrible industry economics and, from the anecdotal evidence pouring into our office, we knew that removals were likely to be large. Happily, the survey of vineyard area was reinstated in a limited form in 2015 and the results included in the chart above. The reduction in vineyard area of 10% recorded between surveys 2012 and 2015 was rapid and significant.

In contrast, in the mid-2000's, the reduction in vineyard area could not occur fast enough, as the newly planted vineyards produced wines well in excess of winemakers' ability to sell at a profitable rate. Until quite recently, industry bodies encouraged vineyard removal rather than market growth, as a solution to Australia's oversupply woes, on the assumption that demand for our wines in the enormous world wine trade was fixed at some arbitrary level.

Add into the economic mix increased retailer concentration in Australia, rapid domestic market share gains from New Zealand Sauvignon Blanc, industry asset write downs and asset sales and later, a crippling high exchange rate. As a result of all these factors our industry stopped looking outward and instead looked inward to solve its problems. Overall, our innovation fell short and led to a market perception that Australian wine had become boring, uninteresting and passé. Despite the efforts of many winemakers to reinvent themselves, and make new and interesting wines to be marketed in new and interesting ways, the wine world seemed to have moved on from Australia. Those were tough times indeed.

## 2. A\$ Falls:

The A\$ is currently at its lowest against ALL the currencies in its top 5 markets, as follows:

£UK	Down 35% in 2 years
€ Euro	Down 30% in 3 years
\$US	Down 40% in 4 years
¥Yuan	Down 35% in 4 years
\$CAD	Down 10% in 1 year



Clearly, significant improvements in the competitiveness of Australian wine exports occurs as the A\$ falls.

## 3. An improved international trade environment:

In recent times, Australia has signed 3 key FTA's in very quick succession:

Dec 2014	South Korea
Jan 2015	Japan
Jun 2015	China

Also, very recently the following agreements were concluded:

Oct 2015	Trans-Pacific Partnership Agreement
Dec 2015	WTO Elimination of Agricultural subsidies



All these agreements improve the outlook for Australian exports, including wine<sup>ii</sup>.

## 4. The Rise of China:

Exports to China continue to grow at extraordinary rates, currently tracking at over 60% per annum.

Add in Hong Kong and these two markets combined are now the largest destination for Australian wine by value, eclipsing the historical dominance of the USA and UK. As these Asian markets mature it will be natural for these extraordinarily high growth rates to fall. Nevertheless, such current high growth rates are certainly putting a spring in the step of many Australian wine producers.



### Where to from here?

A lot is yet to be said and written about Vintage 2016 in Australia. Early reports from winemakers are that it was a very good quality vintage across many parts of Australia, with most talking up the merits of their fresh wines currently in tank or barrel.

The quantity was probably slightly above average per hectare, on the reduced hectares discussed above. Final outcome? Likely to be about average tonnes overall against a market that has swung back into growth.



The open question is whether there is enough wine around to sustain the current “just-in-time” buying strategies of many buyers.

Some buyers expect this strategy to work well for them over the next 12 months, but this ignores the reduction in bulk wine inventories that we have witnessed during the last 1-2 years. A reduction in inventories means more wine is being sold than produced, indicating demand exceeding supply *at current market prices*.

A reduction in inventory also means there will certainly be less choice this year, especially for wines from South Eastern Australia.

Suddenly Australian wines could become more interesting again.



**About the author:**

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<sup>i</sup> *Back to the Future is a 1985 American science-fiction adventure comedy film directed by Robert Zemeckis and written by Zemeckis and Bob Gale. It stars Michael J. Fox as teenager Marty McFly, who is sent back in time to 1955, where he meets his future parents in high school and accidentally becomes his mother's romantic interest. Christopher Lloyd portrays the eccentric scientist Dr. Emmett "Doc" Brown, Marty's friend who helps him repair the damage to history by advising Marty how to cause his parents to fall in love. Marty and Doc must also find a way to return to 1985.*

<sup>ii</sup> *Top 5 markets for Australian Wine: Courtesy AGWA, 2016*

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