Bulk wine review

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Introduction

In this article, I would like to briefly examine three topics of current relevance to Australian wine producers:

- older-vintage Cabernet Sauvignon
- where are you in the queue of bulk wine sellers?
- a paradigm shift in business supply models.

Older-vintage Cabernet Sauvignon, where is it going to go?

Older-vintage Cabernet Sauvignon bulk wine, most particularly from dryland cooler regions, which is currently sitting unsold in tanks, is probably of greatest concern to many Australian wine producers.

Generally speaking, there exists a big volume of such inventory with a very high cost base. For instance, for 2002 dryland Cabernet Sauvignon we have 78 parcels totalling 3.5 million litres listed for sale on our books. The average batch size is 61,500 litres, or just under 100 tonnes worth of grapes, with an average asking price of $2.57 per litre. In a few months this wine will be three years old.

When these wines were planned to be made during the winter and spring of 2001, the Australian wine industry was a very different place. Then, bulk wine prices for such material were over $3 per litre. With the exception of the very best 10-15% of parcels, which still fetch prices as high as $4.50, today the equivalent price is $0.50 – $1.50 per litre. The reason that these wines are still in tank is that their asking prices are simply way above the prevailing market price.

The story does not really improve for 2003 dryland Cabernet Sauvignon where we have 108 parcels totalling 5.4 million litres listed for sale. The average parcel size is slightly smaller (probably in line with the smaller vintage) at 50,400 litres, at an average ask price of $2.58. For 2004 vintage dryland Cabernet Sauvignon we have 126 parcels totalling 13.3 million litres with an average parcel size of 107,000 litres at an average asking price of $2.55.

In summary, for all vintages Cabernet Sauvignon: 23.2 million litres or approximately 31 million bottles. This equates to 1.5 bottles of Cabernet Sauvignon for every living Australian. This is a lot.[1]

In a few months the 2005 crop will be in tank, so what then will happen to all these surplus volumes? Clearly, from the average asking prices of around $2.50, compared with the generally prevailing market prices of $0.50-$1.50, there are some significant pricing adjustments yet to occur in order for these wines to find a use in the marketplace. Otherwise, these wines will continue to age gracefully whilst burning holes in their owners' balance sheets.

Economics 101: where are you in the queue of bulk wine sellers?

We are now entering our third vintage after the huge 2002 crop. The 2002 grape crush, at 1.606 million tonnes was 12.8% larger than the 2001 crush, which in turn was up 24.3% on 2000.

The 2002 crop was probably the key pivot point in the supply/demand balance. It was the first year in a decade that significant tonnages of grapes were left hanging unpicked on the vine. But the growth in production continued what seemed a relentless rise, with the 2004 vintage reported to be 1.860 million tonnes, up 33% on the drought-constrained 2003 year.[2]

So are you at the top of the queue of sellers or are you languishing somewhere else, but not exactly sure where, in the market place? This is a particularly relevant issue to those many owners of older-vintage dryland Cabernet Sauvignon described above.

The triangle in Figure 1 represents the population of potential buyers in the market at any given asking price. At the very top there are no buyers, hence it is illustrated as vacant. Don't be caught here if you plan to sell any wine. In the "above market" area, few buyers exist and in the "market price range", the market is in equilibrium for any given point in time.

As the asking price is lowered further, more and more buyers emerge until there is much buyer interest generated. This is best illustrated when the sellers become buyers themselves, who can sometimes behave much like hungry carnivores during a feeding frenzy.

Fig. 1.

Most sellers, and this is not inappropriate, price their wines at just above the prevailing market price at any given time. This provides flexibility to trade price, payment terms, drawdown schedule or such other parameter as the buyer may reasonably demand. But trouble can soon develop for sellers if the gap between the asking price and the market price is, or over time becomes, too great. This leaves the seller stranded high and dry as the pool of potential buyers who are willing to negotiate rapidly dries up.

Usually such over-priced wines are ruled out of tastings completely as busy buyers can only be bothered with more appropriately-priced wines. If this occurs over an extended period during a falling market, the gap becomes larger and larger until a crisis of some sort finally forces the seller into sales action, usually in the bottom part of the triangle. Many opportunistic buyers lurk here, so it is an area best avoided!

Over time, this process can best be seen illustrated in Figure 2. The wine business is clearly cyclical, and in a falling market such as the current one, you must not be caught consistently above the prevailing market price. Following a falling market price results in much unsold wine and a lot of shareholder value destroyed.

In a falling market, you need to clearly understand and heed the market signals in order to identify the real market price, rather than hoping for, or worse still expecting, buyers to pay a reasonable market price that covers your costs and provides you with a modest return.

In a falling market, you cannot price your wine this way and simply wait your turn, since the buyers will have long gone elsewhere.

If you do in fact have to sell below your cost of production, then managing your costs, stock levels, and key business constituents such as shareholders and banks is critical in order to see your business successfully through this current downturn.

Give your business the best chance by hovering near the front of the price queue: price your bulk wine correctly.

Finally, if you find that your company is having difficulty reacting quickly enough to market forces, consider the following example. Say that you sell most of your wine as branded wine and each year you make a bit extra, either to choose the best parcels for your brand or in case your branded sales are better than expected. The rest you sell off in bulk. Your bulk wine cost is $2/litre, all other costs are $1/litre and your gross profit margin is $3/litre to yield a sale price for your branded wine of $6/litre or $54/dozen. Say also, that the market price of the bulk is $1, or half of what it nominally cost you.

So how does your business handle your $1 nominal loss on the sale of the proportion of bulk wine?

Figure 3 shows that bulk wine is a minority of possible end uses, and hence a small part of sales revenue and your overall business mix. In this example, it could be quite feasible to apportion the expected loss on the bulk wine to the cost base of the packaged goods. Reason: it will enhance your ability to react quickly to a falling market.

One of the key reasons that many bulk wine sellers have been unable to meet the market price has been a steadfast policy of "we won't sell wine at a loss". So their wine does not sell at all. Then the policy becomes "we won't sell wine for such a big loss". So

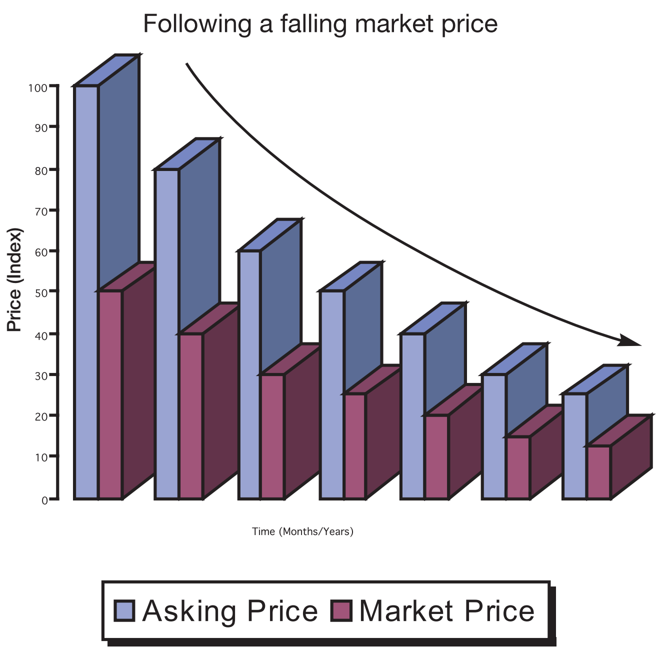

Fig. 2.

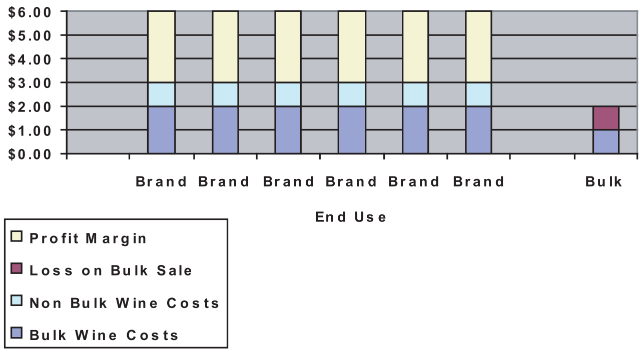

Fig. 3. Bulk vs brand: wine cost apportionment

their bulk wine still does not sell; they are simply following the market price down even if bulk wine is a relatively small part of their business.

There are many methods of apportioning bulk wine costs for internal decision making (as opposed to statutory and taxation reporting) and these are beyond the scope of this article. But whichever one you choose, make sure it does not prevent you from accessing the prevailing market price within the timeframes required by your business.

A paradigm shift in business supply models

On a recent trip to several wine-producing areas, evidence of a paradigm shift in business models emerged more strongly than I had identified before.

It went something like this: "our winery isn't interested in forward-planning bulk wine supply (for reds) – even on a floating price basis – since we can get all we want on the spot bulk market. And besides, we can probably pick up bargains at less than it would cost us to make them".

A variation to the theme was: "We are sellers now, but we are positioning ourselves to be major buyers sometime very soon, we see the surpluses and we want to take advantage of them as an integral part of our business model."

The theme of these models appears so seductive that a lot of people now seem to be following them much more aggressively than I have previously observed. But it is now three years after the big 2002 vintage, and a full seven years after the peak red planting year of 1998, when approximately 16,000 hectares were planted, of which 13,500ha were to red varieties[3].

Furthermore, the Australian bulk market is mainly a market of surpluses and shortfalls and the above is a paradigm shift towards a producer-negotiant model by a significant number of producers all hoping to move toward being a negotiant.

Unfortunately, the more people who follow this model the more difficult it will become to actually achieve.

So we appear to be steaming headlong toward a new way of managing our wine businesses, but at a very advanced stage of the over-supply cycle. In the wine industry, which has some long lead times, the iceberg of under-supply may strike us unawares. Don't be caught mid-voyage without adequate life boats aboard!

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References

[1]Austwine Bulk Wine Availability Database. December 2004.
[2]Australian Wine and Brandy Corporation. Annual Report 2003-04.
[3]Wine Industry News, Volume 8 Issue 3. Sept 2004.