SLICING THE SALAMI - Nature cuts into the 2014 vintage.

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This article reviews the Australian bulk wine market in light of the 2014 vintage, and discusses the major influences and uncertainties surrounding the current outlook for bulk wine. The key issues that are addressed include an analysis of the 2014 crush, the current bulk wine market, 2015 crop outlook, demand assessment, and finally, the overall outlook for 2015.

2014 Vintage Summary

Last winter, the 2014 crush was looking to be even bigger than the large 2013 vintage. Three years of steadily increasing wine grape prices buoyed the spirits of growers and winemakers alike, and they responded by increasing grape production. However, as the growing season unfolded, a series of events conspired to each slice a little away from the potential size of the 2014 crop, much like slicing a salami[i]. Some of these events included:

- **Mid-Sept:** Isolated but significant hail in Loxton, South Australia.
- **Sept-Oct:** Widespread reduced berry set, due to unusually cold weather.
- **Mid-Late Oct:** 10 days of intermittent but damaging frosts across much of South Eastern Australia.
- **Nov:** Some early powdery mildew development.
- **Jan-Feb:** A prolonged & damaging heatwave across South Eastern Australia. (In Renmark, for example, from New Year to 13 February, 65% of days were above 35C and 39% of days were above 40C.)
- **Mid-Feb:** The heatwave ended abruptly, with up to 100mm rain recorded in many regions during the 24-72 hours after Valentine's Day (14 February).

Without this series of events, the 2014 vintage would have been a monster: potentially over 1.9 million tonnes! Whether all tonnes would have been picked is less likely, but indications last winter were that the cropping potential was clearly there.

2014 Crush Size?

We just don't know yet. Official crush figures will only be released in October this year, rather than the usual July release date. Some regional crush data is available, but not the overall crush size. 2013 has been estimated by different agencies at between 1.83mT[ii] and 1.748mT,[iii] and 2014 was smaller, but how much smaller?

I hazard a guess: 1.6-1.7mT, which is the same as our forecast immediately before harvest.

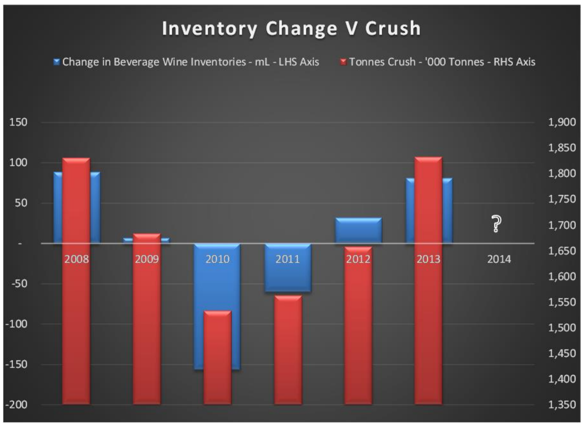
I am sticking to our pre-harvest guess for the following reasons:

- 2 out of the 3 main inland irrigated areas were down on last year and one was up. Murray Darling crushed 414,000 T (down 10%) and SA Riverland crushed 436,000 T (up 10%). These were adequate crops and relatively small tonnages were left unpicked. These unpicked grapes were mostly from contract 'over tonnes', or from uncontracted vineyards.
- The Riverina crushed 268,000 tonnes, down 11% on 2013, mostly due to losses experienced during the widespread October frosts.
- The premium areas generally experienced lower crops compared to last year: Adelaide Hills (-37%) Coonawarra (-32%), Padthaway (-8%), Wrattonbully (-7%) and McLaren Vale (-6%), were all down on 2013. Clare was up (+10%), as was Langhorne Creek (+4%) and the Barossa (+3%). In recent years Barossa crops have been constrained, leading to ongoing upward pricing pressure, and this year's crop was perhaps not as low as initially thought immediately before vintage started.

Furthermore, we did not witness a scramble for grapes and wine (except maybe in the Barossa), nor did we observe extremely low grape prices toward the end of harvest (except perhaps in the Murray Darling).

The general absence of these two sorts of extreme market behaviours indicates that crop sizes were probably around average. An average crop means about 1.6-1.7mT, as the following graph illustrates.

It shows vintages above this level being too big (and so inventory increases) and below this level being too small (and so inventory decreases):



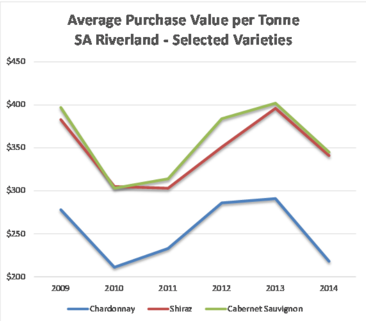
Of course, this is just an educated guess, based on the limited information that is currently on hand. So I could *very easily* be wrong in sticking with our pre-harvest estimate of an average crop size of 1.6-1.7mT.

One of the few comforts supporting such an estimate is from observations in the bulk market place: market players are *currently behaving* as though the crop size is at average levels.

An average crop size, but with lower grape prices

In the inland irrigated regions, three years of gradually increasing grape prices from the lows of 2010 stimulated additional efforts to increase grape production, culminating in 2014.

Check out the following chart of SA Riverland grape prices. Shiraz, Chardonnay and Cabernet comprise a bit over 60% of the total crush for SA Riverland and are the bellwether varieties[iv].



Notice how the grape price evolution is closely correlated to production volumes in the previous chart. A simple case of Economics 101: Grape supply increases and decreases in direct proportion to the grape price. 2014 was an exception to the rule only due to the intervention of nature during the growing season, which reduced the size of the crop.

This increase in production over the last few years was generally not from new vineyards. In fact, across South Australia the total vineyard area increased by a mere 2.3% to 76,156 Ha over the 3 years to 2014[v]. Rather, the increase in production can be attributed to increased inputs by growers, and rehabilitation of previously neglected vineyards, *in anticipation* of grape higher prices in 2014, which generally did not eventuate.

- Why did this happen?

Why then did grape prices generally decline in the inland irrigated areas?

The answer lies in winemaker expectations. After the large 2013 vintage, with its highest grape prices in 4 years (see chart above) winemakers generally experienced much lower bulk wine prices immediately after vintage. So they were under big pressure to restore profitability or reduce losses.

Almost all inland wineries crushed less in 2014 compared with 2013: most wineries had been carrying excess inventory, and were happy with a smaller crush.

Generally, growers were pretty surprised by the lower grape prices posted in December before vintage, after three years of steadily increasing prices and increasing optimism. Winemakers felt that 2014 was going to be tough after the large 2013 vintage, but either did not broadcast likely reduced 2014 grape pricing widely enough, or growers may not have listened too closely to any such news.

In the end, higher grape prices did not eventuate in the inland irrigated regions, but growers had already made the effort to increase production. The eventual crop size was to be reduced by a series of natural events during the course of the growing season, each event slicing a little from the final tonnage crushed.

- What does this mean for 2015?

All things being equal, the lower grape prices actually paid this year will probably contribute to lower grape production next year, but more on this later.

Bulk Market

There were signs of life in the bulk market immediately after vintage this year, unlike last when all we could hear was the silence of our phones <u>not</u> ringing. (This also indicates the 2014 crop was not as large, however there is still carry over stock from 2013 to be worked through, and this may present well priced opportunities for buyers.)

This year we have observed a steady to sometimes even brisk trade for new vintage SEA wines, at generally static or slightly lower prices (except perhaps Chardonnay). Of course, a lower exchange rate has generally improved international competitiveness this year.

We have also observed a steady stream of inquiries from the premium regions which generally experienced smaller crops this year, as buyers seek to top up their inventories. This is especially the case in the Barossa.

Interestingly, we can report little interest in bulk wine from the traditional, large volume domestic winery buyers this year, with most activity generated by fast moving traders, intermediaries or agents of foreign buyers.

- Regional Roundup

- ***Barossa:*** After a few short crop years, Barossa is in a world of its own: Supply is still quite short and there is much buoyancy in the market for Shiraz.
- ***Coonawarra:*** A short crop in 2014 will most likely be covered by good levels of existing inventory from prior years.
- ***Adelaide Hills:*** Short this year, but could swing back quickly. This region tends to experience very high production variability from year to year. Sauvignon Blanc supply is currently very tight.
- ***Langhorne Creek:*** A bit expensive to compete head-to-head with the inland irrigated regions, but used effectively to enhance blend quality at an economical price.
- ***McLaren Vale:*** Generally good supply of most varieties, despite a slightly shorter crop this year. Asking prices seemed to have firmed due to the lack of supply from the Barossa.

- Varietal Roundup

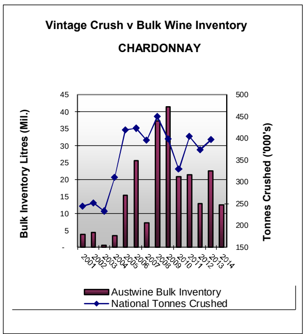
A brief summary of the main varieties. Prices are for SEA wines, unless otherwise indicated, in AUD, per litre, pre bottling, FOB Port, on drawdown.

- ***Dry White:*** $0.55-0.70. Good supply with moderate demand.
- ***Dry Red:*** $0.70-0.80. Weak supply with moderate demand.

- ***Shiraz:*** $0.90-1.10. Good supply still around from 2013 and also 2014. Good demand.
- ***Cabernet Sauvignon:*** $0.90-1.10. Supply more limited in 2014. Moderate demand.
- ***Merlot:*** $0.85-1.00. Moderate supply and weak demand.
- ***Pinot Gris:*** $1.10-$1.50. Supply from anywhere is very tight. In hot demand.
- ***Chardonnay:*** $0.65-0.80. 2014 not that abundant, but buyers donøt believe it, yet. Stock of 2013 is available as a cheaper alternative.
- ***Semillon & Colombard:*** $0.65-0.85. Not as abundant as they usually are this year, due mainly to frost.
- ***Regional Shiraz & Cabernet Sauvignon***: ï Apart from Barossa, any shortfalls in 2014 regional crops are likely to be covered by good 2013 inventory. Very little 2012 available in the market place.

- A word on SEA Chardonnay

An interesting development this year is inland irrigated Chardonnayøs *much reduced* abundance. This is something that has caught a number of buyers by surprise.



Check out the graph opposite, which clearly shows a big reduction (almost ½) in Chardonnay inventory listed with us compared to last year[vi].

Whether this translates to price rises is another matter, but it is probably safe to say that price falls are unlikely this year.

2015 crop outlook

- Winter rainfall: Two very different tales

To date, inland rainfall this winter has generally been very poor or below average. For example, Renmark and Mildura recorded about ½ their average winter rainfall, whilst Griffith was about 20% below its winter average.

Elsewhere, winter rainfall has been recorded at about average to above average.

The contrasting rainfall is set out in the table below.

Winter Rainfall (mm)

Month	Average	2013	2014	Average	2013	2014	Average	2013	2014
	Adelaide			Nuriootpa			Coonawarra		
May	79	55	64	55	55	36	51	42	58
June	76	76	104	56	63	96	76	55	72
Jul	69	120	95	66	73	78	80	139	67
Total	**224**	**251**	**264**	**178**	**190**	**210**	**207**	**236**	**198**

	Renmark			Mildura			Griffith		
May	25	41	20	25	29	23	35	26	30
June	25	33	9	23	34	5	33	39	34
Jul	23	20	6	26	14	13	34	38	18
Total	**73**	**94**	**36**	**74**	**77**	**41**	**102**	**103**	**82**

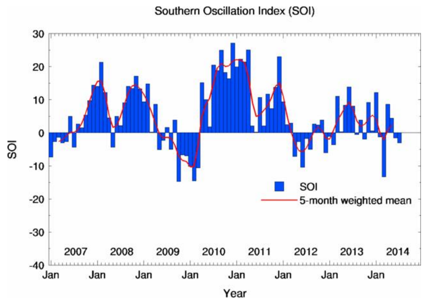
Source: Australian Government, Bureau of Meteorology

All things being equal this could mean more constrained crops in inland areas and more abundant crops in premium areas in 2015.

- Southern Oscillation Index: Neutral

The SOI [vii] is a model that predicts the amount of rainfall that is likley in South Eastern Australia.

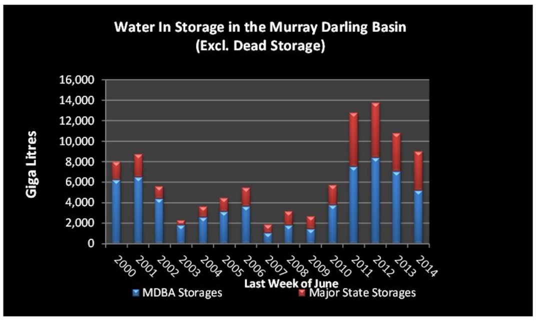
Sustained *negative* values of the SOI of below ï 8 often indicate El Niño episodes, which usually means less rain. Sustainted *positive* values of the SOI above +8 are typical of a La Niña episode, which usually means more rain.



It can be seen from the chart that most recent values are neither strongly positive nor strongly negative, so this model does not predict either excessively dry or wet conditions. This relatively neutral outlook supports the differing, but not extreme, winter rainfall experiences that various regions have reported.

- Water in Storages: Still very good

Volume in storages has declined from record levels in 2011 and 2012, and the price of water has been steadily increasing over the past couple of years, but supply is still relatively abundant.



We are a very long way from any acute water shortages such as those which characterised the 2007 vintage.

A quick review of the chart above shows water storages well in excess of the levels recorded in 2008, which was a large vintage with adequate water availability for wine grapes. Back in 2008, water costs were 10x the current price of water of around $80-$100/mL, when grape producers were able to out-bid the very large volume users of cotton, rice and pasture.

- Water Allocations: Excellent

Final water allocations for the year ending 30 June 2014 were almost all at 100% and are detailed in the table below.

Given the relative abundance of water currently in storages, the same outcome appears likely for the year ending 30 June 2015.

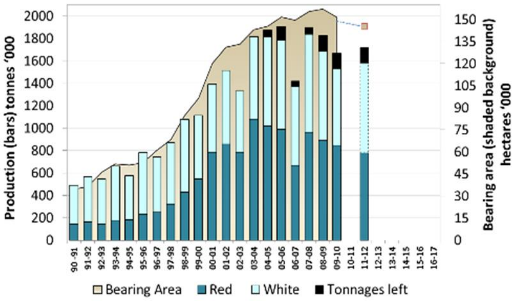
Furthermore, interim allocations are already quite high and these are also detailed below.

State Water Allocations	Last Year Final As at 30 Jun 2014	This Year Interim As at 13 August 2014
New South Wales (High Security)		
Murray Valley	100%	97%
Murrumbidgee Valley	95%	95%
Lower Darling	100%	100%
Victoria (High Reliability)		
Murray Valley	100%	90%
Goulburn Valley	100%	100%
South Australia (High Security)		
Murray Valley	100%	100%

Source: Murray Darling Basin Authority

- Vineyard area? We just don't know.

The most recent information on vineyard area is reproduced below, courtesy of Wine Grape Growers Australia and a broad downward trend is evident.



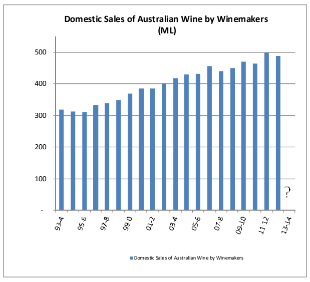
However, for the reasons discussed earlier, an increase in vineyard area was likely in both 2013 (due to *actual* higher grape prices) and 2014 (due to *expected* higher grape prices).

In contrast, the recent evolution of falling bulk wine prices in 2013, followed by falling grape prices in 2014, means that some vineyards will probably come out of production ahead of 2015. A proportion of these will be taken out of production for the last time. But what proportion remains very unclear, because collection of this data ceased in 2013.

Demand Assessment

- Domestic Sales of Australian Wine

These sales are the ñbread and butterò for the overwhelming majority of Australian wineries.



As the chart illustrates, domestic sales have been relatively static over the last few years, after 20 years of steady growth.

Unfortunately, this data series[viii] which samples all wineries, ceased publication last year.

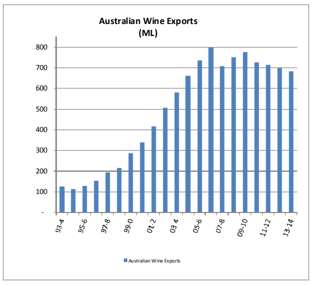
An alternative series[ix], which samples wineries with annual sales greater than 250,000L, shows a similar trend.

Unfortunately, this latter series has also ceased publication recently.

Despite the incomplete data the recent trends are still useful and, if they continue, indicate no major demand stimulus.

- Export Volumes

In contrast, Australian wine export volumes have been falling steadily for much of the last decade, as the following graph shows.



The easy explanation is that the slow ñpython squeezeò of a persistently high currency has crimped wine export volumes little-by-little each year. Certainly a high exchange rate has not assisted, but I have a nagging feeling that there is more to it than that. Some examples:

- Continued instability in the market place caused by ownership uncertainty and strategic direction of our two largest wine companies. Naturally any company that is subject to ownership speculation and change is more likely to be inwardly focused, rather than focusing on making better or more interesting wines, or marketing wines more creatively. Itôs hard to stay ahead of the curve in such circumstances.

- Australia still lumbers under a Common Customs Tariff for wines exported to our *largest* market, the EU. At around ú0.10/litre for bulk wine, (depending on alcohol level, and higher rates apply for packaged wine) this translates to ***over $A100/t at the farm gate.***

  Whilst recently announced Australian Free Trade Agreements with our key Asian trading partners are very, very welcome, the EU buys vastly more Australian wine. In contrast, Chile has negotiated a Free Trade Agreement with the EU.

  Imagine the stimulus to the Australian wine industry without the CCT imposté .

- The lack of a broad representation of Australian wineries of all shapes and sizes at major international fairs and expositions to showcase and promote Australian wine.

  For example, at last yearôs London Wine Trade Fair, I personally counted more exhibitors from tiny, cash strapped Greece, than exhibitors from Australia! We make great wines in Australia, and more of us need to be wearing out shoe leather and earning frequent flyer points to showcase our world class product.

  Sales donôt happen if you are too afraid to venture beyond your front gate. Sales happen in the market!

- The continued existence of the WET rebate scheme which, amongst other things, effectively provides a $300m incentive for Australian wineries to sell domestically, rather than seek new export markets.

  Imagine what a $300m scheme to promote exports could achieveé .

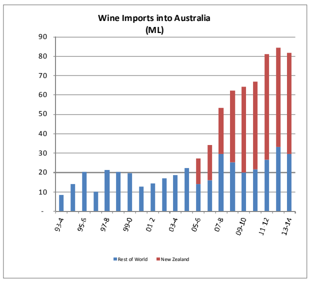
- The rest of the world is catching up rapidly and is now overtaking us. Whilst Australian export volumes are slipping, export volumes from South Africa and Chile are growing at 34% and 23% respectively. Furthermore, we have very recently slipped to now become the 2nd largest New World Wine Exporter behind the new leader, Chile.

- The rapid rise of the 2 European discounters in the UK will probably lead to a rationalisation of SKUôs in the 5 major incumbent UK retailers. It is an open question whether the incumbent UK retailers have a successful response to this big threat to their profitability, but it may mean that they will rationalise their offerings to lower costs. This probably will result in these retailers wanting to deal with even fewer suppliers and fewer SKUôs.

The culmination of these influences detailed above, plus many more that are beyond the scope of discussion here, have contributed to the pattern of declining export performance in recent years. It seems highly likely that these influences will continue, and so we are likely to witness a further decline in export volumes.

- Import Volumes

In contrast to wine exports, wine imports have been going gangbusters during the last decade, driven by Marlborough Sauvignon Blanc. The good news for Australian wine producers is that wine imports appear to have stabilised over the last couple of years.



One of the consequences of generally low grape prices and poor economics over the past decade has been under-investment in vineyards, denying local producers the ability to properly capitalise on any emerging trends.

As a result, the large Australian retailers are importing more everyday commercial wines to educate their consumers to enjoy foreign wines, alongside local everyday wines so that *they* can still capitalise on emerging trends. For example:

- Prosecco sales in the largest Australian wine retailer have enjoyed average growth rates of 89% over the last 2 years, but imports from Italy have outsold the local product by a ratio of over 2:1 during that period.

Import volumes have now grown to over 15% of all domestic Australian wines volumes. At such a large market share, they are well entrenched in the market place and in consumersô minds. New opportunities and new ideas will need to be exploited to have a chance at earning back some of that lost market share.

Brand Pricing Power: Not dead, just on life support…..

Inevitably, increased imports means increased substitutability, and this leads to reduced pricing power for Australian producers and their brands.

The price competition for grapes is much more muted these days, because brand owners cannot easily extract price rises from their buyers. A couple of different examples:

- The price[x] of Riverland Pinot Gris grapes has increased less than 10% from when it was in relative abundance in 2012 ($407/t), to extreme scarcity in 2014 ($446/t).
- The price[xi] of Riverland Shiraz and Cabernet Sauvignon has moved in a tight price band of $300-$400/t. Similarly Chardonnay has moved in a similarly tight band of between $200-$300/t (see earlier graph above on selected SA Riverland grape prices).

The rise of the big-box format retailers in Australia will reinforce this trend of limited price rises for grapes and bulk wine.

Compare this to the export boom when brands had much greater pricing power and this was reflected in what wineries could pay for grapes and bulk wine in times of shortages.

The consolidation of the Australian retail liquor industry during the last decade has been rapid, and the structure of the retail market has changed forever.

This shift in market dynamics and critically, the likely *permanent* erosion of much pricing power, is most likely under appreciated by many wineries in the market. I get the impression that many wineries still secretly believe that their loss of pricing power is due to grape oversupply and so believe their situation is *temporary.*

I am not at all close to the Australian retail market. However, my overall sense is that many wineries are fighting a losing battle and might be over-estimating the potential of their brands. Ultimately, their pricing power through our highly concentrated retail market channels, which have had such an overwhelming impact on the industry, will remain limited. Wineries may need to continue to radically adjust their business models in order to survive and prosper in the long term.

2015 grape and bulk wine outlook

After reviewing the major drivers of demand, if current trends continue, there does not appear likely to be any major stimulus to demand, heading into the 2015 vintage. Domestic sales volumes are pretty static, imports have finally stabilised and exports are sagging.

So, in the absence of a major seasonal or climatic catastrophe severely limiting the 2015 crop potential, the weight of evidence suggests continued challenging trading conditions into 2015. These ongoing difficult conditions will most likely reduce the potential size of the 2015 crop, as more growers decide to exit grape growing.

The nature and extent of such challenging trading conditions will depend on what bulk wine remains in tanks come Christmas time, as well as the complex social and emotional factors in the market place that drive the confidence levels of participants going into the 2015 vintage.

I donôt believe this is a recipe for the long term decline of Australian wine: opportunities *abound* in the market place every single day.

Australia has been successfully exporting wine for most of its period of European settlement. On a long term view, it is easy to see why: Our wines are excellent because our climate is fitting, our resources accessible, our production assets world class, our intellectual property second to none, and our legal and political systems are amongst the very few that can boast continuity, and stability, for over 200 years.

However, we do need more courage to translate more of our wonderful assets into market opportunities, to satisfy consumers both at home and abroad, and bring prosperity back to the Australian wine industry. This is indeed happening in many parts of the industry, mostly by long term players with long term agendas, supported by long term thinking. These players are exploiting niches in the market place, and staking their claim to sustainable business models.

Widespread prosperity is well within our reach if we can summon more collective courage to seize more such opportunities. I believe it is only a matter of time...

Some Conclusions

Here are a bakerôs dozen key conclusions from the above discussion:

1. The 2014 vintage growing season was characterised by a series of climatic events that each took a slice off the potential size of the crop.
2. The size of the 2014 crush is likely to be average, at 1.6-1.7m tonnes.
3. 2014 grape prices were generally lower in the inland irrigated regions, as winemakers tried to restore profitability after the large, higher priced 2013 crop.
4. The bulk market has been steady to brisk for new vintage SEA wines, driven mostly by export buyers, whereas most domestic inquiries are from those premium regions that experienced lower crops in 2014.
5. Most premium regions have enough stock from 2013 vintage to cover shortfalls from 2014. Barossa Shiraz and Adelaide Hills Sauvignon Blanc are notable exceptions.
6. Prices for most South Eastern Australian wines are static or slightly lower, after experiencing falls last year (except perhaps Chardonnay.)
7. Winter rainfall has been varied: Satisfactory in the premium regions, but very dry in the inland regions.
8. Irrigation water has been steadily increasing in price, but is still relatively abundant.
9. Vineyard area probably increased in 2013 and 2014 and will probably fall in 2015.
10. Domestic sales volumes are pretty static, imports have finally stabilised and exports are sagging.
11. A new paradigm has been reached, as few wine brands have the pricing power they used to command.
12. After last yearôs fall in bulk wine prices and this yearôs fall in grape prices, further falls in one or the other, or both, could occur in 2015. Anticipation of such developments will serve to probably reduce the crush size in 2015 and so act as a stabilising influence for prices.
13. The Australian wine industry is currently facing challenging trading conditions, and has been for some time, but tomorrowôs innovations and success stories are in incubation.

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Jim Moularadellis is Chief Enthusiasm Officer (CEO) of Austwine, Australia's Bulk Wine Specialists. Jim was named 2007 Entrepreneur of the Year, Services, for South Australia by Ernst & Young and in 2008 Austwine was announced the winner of the Business SA Agribusiness Award. In 2007 and 2008, Austwine has been in the top 25 Fast Movers for South Australia, an index of South Australia's Fastest Growing companies. Austwine celebrated 21 years in business in 2014.

Jim joined Austwine in 1998, five years after the company was founded in 1993. He is a Certified Practicing Accountant, holds an Honours Degree in Law from the University of Adelaide and is married with four children. He can be contacted on +61 (0)8 8363 5188 or at jim.moularadellis@austwine.net.au

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[i] *Salami slicing is the process of gradually reducing the size of something by a series of small incremental steps.*
[ii] *Winemakers Federation of Australia*
[iii] *Australian Bureau of Statistics, 1329.0 Australian Wine and Grape Industry 2012-13*
[iv] *SA Winegrape Crush Survey 2014, Phylloxera and Grape Industry Board of SA.*
[v] *Ibid.*
[vi] *2014 National Crush data is not yet available.*
[vii] *The Southern Oscillation Index is calculated using the pressure differences between Tahiti and Darwin and gives an indication of the development and intensity of El Niño or La Niña events in the Pacific Ocean.*
[viii] *Australian Bureau of Statistics, 1329.0 Australian Wine and Grape Industry 2012-13.*
[ix] *Australian Bureau of Statistics, 8504.0 Shipments of Wine and Brandy by Australian Winemakers and Importers, June 2014.*
[x] *Weighted Average Weighbridge Price: Annual SA Winegrape Crush Surveys, Phylloxera and Grape Industry Board of SA.*
[xi] *Ibid*