

Rabobank Wine Quarterly

Trends and outlook for the international market

Rabobank International

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Trends

Varied seasonal conditions have resulted in mixed harvest outcomes across Europe but on the whole will deliver a 2011 EU crop largely similar to the prior year. Crop outcomes across the major producing countries of France (+11%), Italy (-14%) and Spain (-2%) have varied widely and are divergent enough to significantly affect relative pricing for each country in the year ahead.

The broader 2011 Northern Hemisphere harvest has been restrained when taken alongside the lower US crop (-9%), and generally supportive to grape prices at a time when the low euro and US dollar are acting to support demand.

European Sector Update

In 2012 the European Commission (EC) is scheduled to review the five-year EUR 5.3 billion EU wine market reform plan that was enacted in 2008 to reduce systemic overproduction and improve the market orientation of the EU wine sector. The plan is well advanced and entering an important phase in its evolution, with the third and final year of the vineyard 'grubbing-up' scheme having been completed in 2011 and various structured distillation and grape must subsidies due to terminate on 31 July 2012.

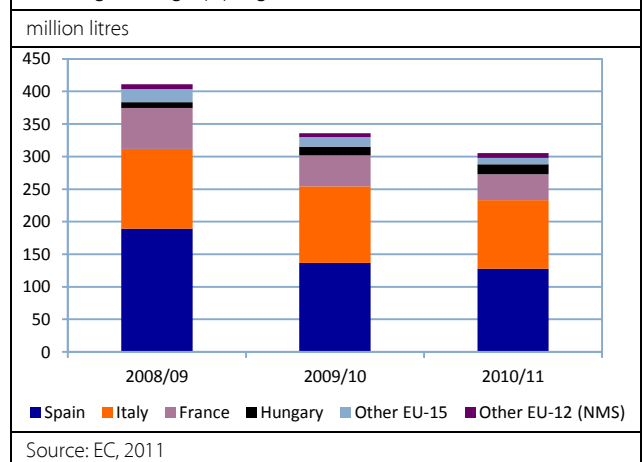
Overview of recent EU vineyard reforms

At a cost of around EUR 1 billion, the vineyard grubbing-up scheme is one of the largest measures implemented under the plan. An estimated 162,000 hectares, or around 4.3% of the EU-27 vineyard area, was removed from production in the three years to 2011. The EC estimates that on a yield-adjusted basis this equates to the theoretical equivalent of 1,052 million litres of wine production, or roughly 6% of the five-year average level of EU production (EC, 2011).

Figure 1 shows the incremental reduction in EU wine production forecast by the EC as a result of its grubbing-up programme. The impact declined gradually over the three-year period, in line with the structure of compensation payments that encouraged early adoption. Approximately 90% of removals took place across Spain (43%), Italy (33%) and France (14%), while Hungary (4%) removed most production from the block of new member states to the east.

The scale of the reform is certainly impressive, however it appears that the supply reduction has only just kept pace with declining consumption of EU wine across the EU. For some time there has been a trend in the traditional wine producing countries of Europe for consumers to drink less wine but better quality wine, while New World competitors have made significant inroads into EU markets.

Figure 1: Forecast incremental supply reduction associated with the EC grubbing-up programme



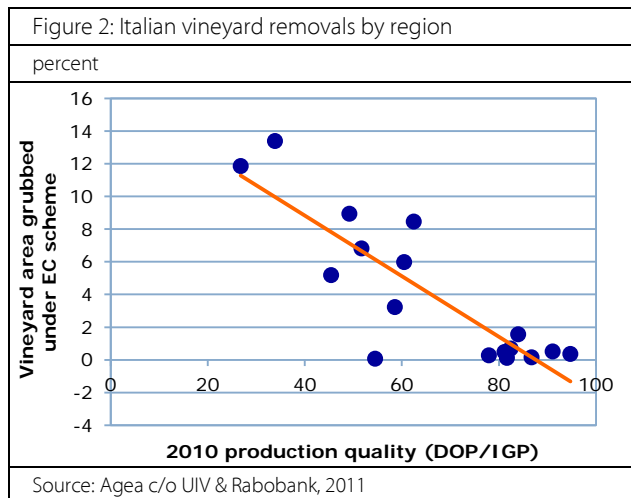
Calculations based on other EC wine market data indicate that the reduction in production capacity is only around 7% greater than the 985 million litre decline in personal consumption of EU wine in the EU market over the five years to 2009-10. Concerns for the future are that structural and economic forces are likely to continue to erode EU wine consumption over the medium term, and that the elimination of EC distillation subsidies will soon remove another outlet for future production.

The EC reforms have, however, not only been about cutting production levels. There has been a strong emphasis on transitioning production to higher quality regions and products, and in better positioning EU wine producers to compete in foreign markets. To date EUR 708 million has been invested in marketing and promotion in addition to an investment of EUR 608 million to upgrade wine production assets to improve productivity and quality outcomes.

The EU vineyard reforms in practice - The example of Italy

A look into how the Italian wine industry has evolved over recent years provides some insight into how the reform plan has impacted the volume and market orientation of production.

The Italian wine industry is estimated to have recorded its smallest harvest in 50 years in 2011. While unseasonal hot and dry conditions impacted yields across much of the country, it is evident that recent vineyard rationalisation efforts have had a material impact, especially in the south.



An estimated 31,000 hectares has been removed in Italy under the three-year EC programme. The greatest change is indeed taking place, as intended, in those regions with relatively low quality (non-IGP or Indication Géographique Protégée) production that has suffered from steadily declining domestic and export demand (see Figure 2). In addition to vineyard removals, a total of EUR 30 million was spent financing crop thinning or 'green harvesting' across many regions in 2011, indicating that large areas of what has not yet been removed is still uneconomical.

Paradoxically, ever larger quantities of low-cost Spanish bulk wine have been imported by Italian producers to supplement supply in 2011. At present, bulk supply from Spain appears to be more economical and/or its quality is better matched to the market that Italian suppliers face than the supply that is being removed. For value-oriented wine companies in Spain, this demand has injected additional competition into markets for bulk wine and is placing upward pressure on wine sourcing costs (see Figures 6 & 7).

Experience from around the wine world shows that finding the right supply mix is an inherently difficult and dynamic process, and Italy is no different. A more defined subset of wine varieties and/or styles is increasingly in demand in global popular premium wine markets, not to mention the growing emphasis on price. Italy's great diversity of varieties and its smaller average scale of production can often be a defining advantage at the premium end of the market. However, judging by current trends, further consolidation appears necessary towards the low-value, high-volume end of the market.

Taking stock of EU reforms to date

The EU wine sector reform plan has certainly not lacked ambition, but whether it has achieved as much as was originally intended seems less certain. Reforms of this scale and breadth are notoriously inefficient in their implementation and monitoring.

That said, progress is evident, with EU stock levels having stabilised and some transition having occurred towards a higher average quality of production. External trade appears to be benefitting from investments into marketing and promotion, although the weak euro has undoubtedly provided a much welcome boost to competitiveness. It is hard to disaggregate the two factors, but wine exports from the EU-27 region are estimated to have increased 26% in volume and 25% in value in 2010 (EC, 2011), and trade in the first three quarters of 2011 appears to have continued at a solid pace (see Figure 3).

In terms of the success in reducing supply, it is difficult to disentangle seasonal from structural impacts on the 2011 harvest results. Nevertheless, there is reason to question whether the projected supply reduction is being realised in its entirety, particularly given the stable crop in Spain and the above-average crop in France this past year, in spite of the removal of a combined total of nearly 120,000 hectares of vineyards.

It is generally believed that EC grants to restructure existing vineyard areas have resulted in a more productive EU vineyard than has existed in the past, despite stipulations to the contrary. Another distortion may be that unlawful planting activity is occurring alongside reductions, something that the EC has previously recognised during past reform programmes, and there is little reason to believe that this is not still a significant problem.

In short, the impact of the EC reform plan has been mixed. The wine world can expect some reduction in supply and heightened competition in global markets as a result, but not the degree of adjustment that was originally intended. Whether Brussels is willing to bankroll another round of reforms on this scale seems more and more unlikely, so there is little doubt that many European wine producers will scramble to future-proof their businesses and markets with the almost EUR 2.5 billion in funds that remain under the current plan.

International Supply

Northern Hemisphere Harvest Review

US: The official estimate of the 2011 California wine grape crop was 3.3 million tons, down roughly 9% from 2010, but in line with the five year average (USDA, 2011). Production declines were much more pronounced in the Northern and Central Coast regions, but quality was reportedly good.

EU: 2011 wine production was down roughly 2% compared to the 2010 crop, but with significant variation between regions. Production increases in France (11%), Germany (30%) and Hungary (38%) were offset by declining production in Italy (-14%), Spain (-2%) and Portugal (-17%) (OIV & various national industry bodies, 2011).

Southern Hemisphere Harvest Preview

Australia: Improved seasonal conditions and ample sub-soil moisture and irrigation water supplies across South East Australia is generally conducive to increased marketable production in 2012. What remains to be seen is the degree to which current year yields have been impacted by the extreme disease pressure experienced by many vineyards in 2011. The grape market remains constrained by the high dollar, but supported in places by lower industry stock levels.

New Zealand: An unusually cool spring has impacted flowering and fruit set in the Marlborough region and the cool conditions have extended into summer. Average vineyard yields are likely to be down on last year, while the 2012 harvest is currently running late and may encounter complications with long term forecasts of above average rainfall. Other major production regions such as Hawke's Bay and Gisborne have also experienced an unseasonably cool and dry spring.

South Africa: Current industry estimates are for the 2012 grape crop to be roughly 4% larger than in 2011, but the growth will be mainly for distilling, for concentrate and for brandy. Wine production is currently projected to fall 1% (SAWIS, 2011).

Argentina: Industry forecasts point to a lighter 2012 Argentine harvest compared to 2011. Preliminary estimates suggest as much as a 10% production decrease, with declines to be most pronounced in San Juan. The millerandage caused by the dry and hot Zonda wind reportedly affects table grapes more than wine grapes, nevertheless there is some expectation of lower Malbec yields (INV, 2012).

Chile: Early evidence points to a potentially larger 2012 Chilean wine grape harvest. The higher prices received by many growers in 2011 are likely to provide some incentive to boost yields, aided by generally favourable seasonal conditions.

International Trade

Global wine exports continue along a general growth trend. South Africa and Australia continue to be the major exceptions, as the strength of their domestic currencies has dampened demand in key markets. Chile also suffered volume declines but benefitted from improvements in product mix and pricing as bottled shipments took share away from bulk shipments. The weakness of the euro continues to provide impetus to exports from France, Italy and Spain, whose exports are growing faster than their New World competitors, but the growth rate appears to be slowing for some (see Figure 3).

Major import markets continue to show mixed signs. In the UK, wine sales were down 3% in the 12 months through November, and the rate of decline accelerated in Q4 due to the increase in excise duty and VAT. The US, on the other hand, is showing signs of steady growth in import volumes and average pricing. For many exporters, however, most growth continues to come from secondary markets such as Canada, and from emerging markets such as China and Russia.

Figure 3: Changes in exports for key exporters, 2011

Country	Volume change (%)	Value change (%)	Period of measure
France	3.8	14.6	Jan- Oct
Spain	26.8	19.3	Jan- Oct
Italy	12.9	13.5	Jan- Sept
US	6	23	Jan- Oct
South Africa	-7.3	n.a.	Dec- Nov
Argentina	2.7	10.8	Jan- Sept
Chile	-10.4	9	Jan- Nov
Australia	-10.9	-9.5	Jan- Oct
New Zealand	9.5	4.5	Jan- Oct

Sources: Australian Wine and Brandy Corp., 'The Gomberg-Fredrikson Report', Instituto Nacional de Vitivinicultura (Arg), Observatorio Español del Mercado del Vino, South Africa Wine Industry Information System, Istat c/o Unione Italiana Vini, French Federation of Wine and Spirits Exporters, Wines of Chile, The New Zealand Winegrowers
Note: Value changes in local currencies

- French wine exports were up 3.8% by volume and nearly 15% by value in the ten months to October 2011. Growth in exports continues to be led by Champagne, Bordeaux and Côtes du Rhône, while other regions (Alsace, Loire, etc.) are experiencing varying levels of decline.
- Italian exports are having another strong year; up 12.9% in volume and 13.5% in value in the nine months through September 2011 versus the same period last year. The strongest growth rates were associated with sparkling wines (+25% by volume) driven by strong demand for Prosecco, and bulk wine (+21%) driven by particularly

strong demand from Eastern Europe. Nevertheless, bottled still wine exports also grew strongly (+7%) and continue to represent the lion's share of shipments.

- Spanish exports continue to see strong growth; up 26.6% by volume and 19.8% by value in the nine months through September 2011. The weakness of the domestic consumer market, coupled with the weakness of the euro is providing the incentive, as well as the means, to grow exports.
- US exports increased 6% by volume and 23% by value in the ten months through October 2011. Bulk wine exports are slowing, likely due to strong internal demand, but the weak US dollar continues to support growth in exports of bottled wines to markets such as the UK, the EU and Asia.
- Australian export volumes in the 10 months through October 2011 fell 10.9% on the prior year to 655.3 million litres. Reduced supply and the high Australian dollar have pressured export volumes, with exporters upwardly revising their pricing structures to combat margin pressure. Average bottled wine export prices increased 4.8% to AUD 4.30 per litre, while bulk wine prices increased 6.3% to AUD 1.01 per litre.
- South Africa saw total export volumes decline 7.3% for the 12 months through November 2011. Increases in bulk wine exports (up 13%) have not been able to compensate for declines in bottled shipments. Exports to the UK, South Africa's largest wine trade partner, were down 25% while other markets (e.g. Germany, China) have seen significant growth. The weakening of the rand in more recent months appears to be providing some aid to export performance.
- Argentine wine export values increased 3% by volume and 11% by value in the first nine months of 2011. Bulk wine exports (up 59%) are taking share from bottled wine exports (down 8%), but in both cases average pricing (in US dollar terms) is improving. Argentine exporters have been taking price increases to deal with the country's internal inflation, which has also been one of the drivers of bulk wine growth at the expense of bottled wine shipments.
- Chilean export volumes posted a 10% decline in the 11 months through November 2011, but pricing saw notable improvement as export revenues climbed 9%. The growth in revenues was due to higher pricing of both bottled and bulk wines, and the increase in share of bottled relative to bulk exports. Bottled exports grew 4% by volume and 11% by value, and bulk exports declined 34% by volume, but only 6% by value. China was by far the largest growth market for Chilean bottled wine.
- New Zealand export volumes in the ten months through October 2011 grew 9.5% on the prior year, to 131 million litres. Bulk shipments grew to almost half of all shipments in the month of September but are expected to moderate somewhat as surplus inventories begin to clear through the busy pre-Christmas export period. Despite pressures from a higher currency, the average bottled wine export price over the ten months through October has held up at roughly NZD 8.70.

US Imports

Imports into the US grew at a healthy pace in the first ten months of 2011. Bulk wine imports have experienced strong growth in recent months, but both bottled and bulk imports are above 2010 levels. Import growth appears to be accelerating and value growth has outpaced volume growth (see Figure 4).

Figure 4: US imports by country of origin, Jan- Oct 2011

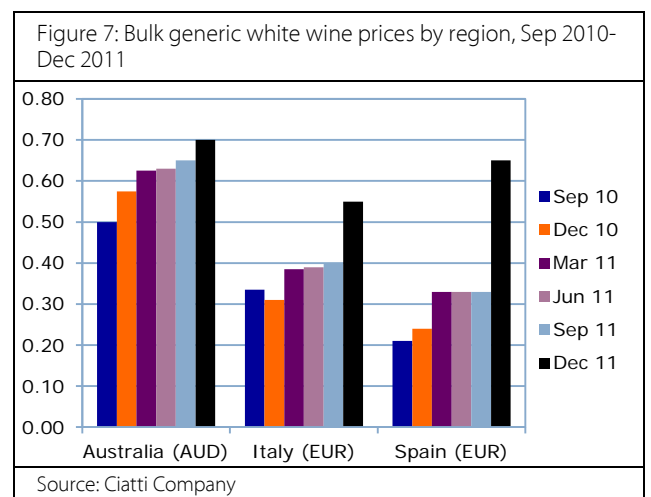
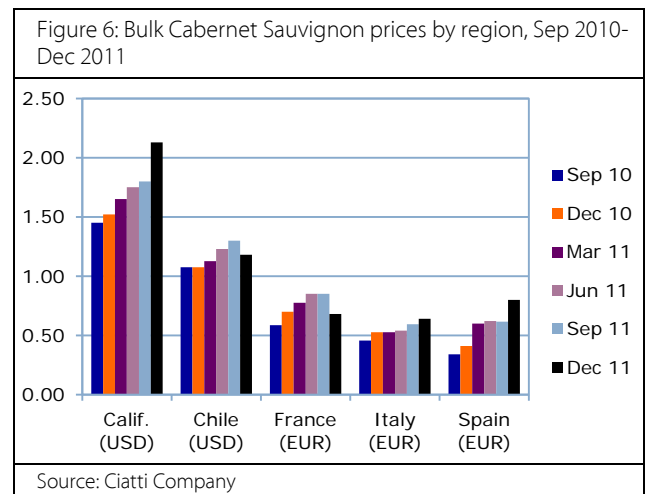
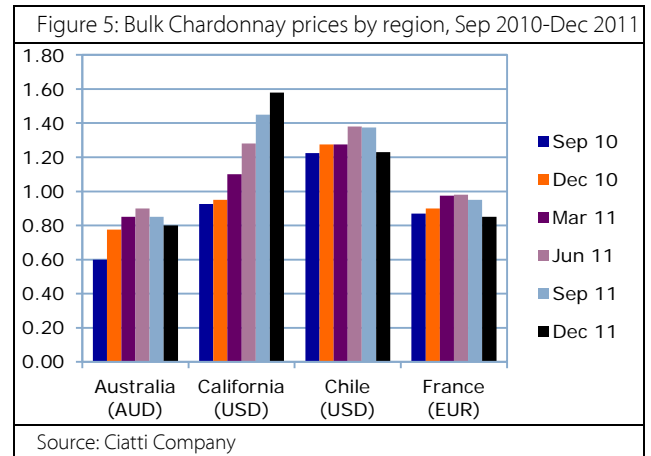
	Value (USD million)	Change (%)	Volume (million cases)	Change (%)
Italy	1,239.9	21	26.7	15
France	1,000.4	28	9.1	12
Spain	251.8	16	7.4	40
Australia	460.5	-8	16.3	-14
New Zealand	161.4	2	2.9	4
Chile	232.6	5	9.7	-10
Argentina	267.6	20	10.1	26
World total	3,893.9	15	92.9	6

Source: 'The Gomberg-Fredrikson Report', 2011

- Bottled imports grew 6% by volume and 15% by value.
- Bulk imports grew 13% by volume and 39% by value.
- Growth in bulk wine import volumes from Argentina, Italy and Spain offset the decline in bulk imports from Australia and Chile.
- Australian imports into the US continue to suffer from the strong Australian dollar, with total volumes (-14%) declining well ahead of total values (-8%). Average pricing for bulk wine showed strong improvement, in spite of the decline in volumes, while average prices for bottled Australian wine showed modest declines.
- Argentine exporters took significant price increases in the US market in the first ten months of 2011, driving a notable 1% decline in bottled wine import volumes that coincided with a 6% rise in value. Bulk exports to the US, on the other hand, grew 82% by volume and 111% by value.
- Sparkling wine sales are enjoying strong overall growth (up 30% by volume, and up 33% by value) across a wide range of suppliers (Italy, Australia, France, Spain, Germany and Argentina).

Bulk Wine Pricing

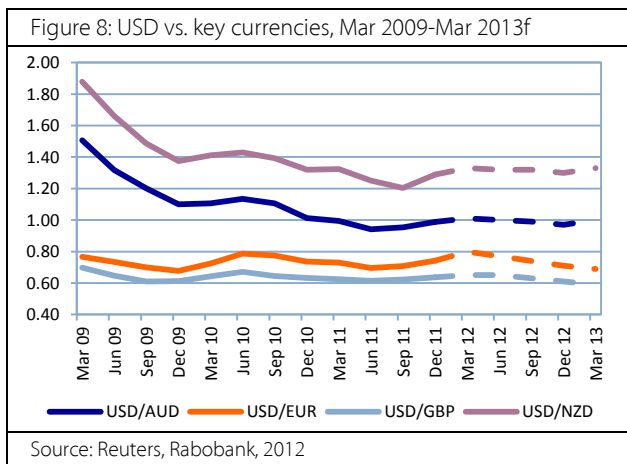
Data from Ciatti shows that bulk wine prices generally remain somewhat elevated, though some signs of moderation are showing in specific regions and varieties (see Figures 5, 6 and 7). Bulk prices across Chile have moderated due to the larger than expected 2011 crop and the easing of the Chilean peso in the fourth quarter. Chardonnay prices appear to have eased across nearly all geographies, with the exception of the US (see Figure 5). US supplies of Chardonnay and many other major varieties continue to register notable price increases due to the short 2011 crop, coupled with the ongoing weakness of the US dollar that aids the competitiveness of local supply.



Key Currency Forecasts

Sentiment surrounding the Eurozone crisis is expected to be the dominating influence in global currency markets for some time to come.

In light of the current uncertainty surrounding a resolution of the Eurozone debt crisis, Rabobank expects the euro to weaken against the US dollar towards USD/EUR 0.80 on a 3 month view. Then, assuming tension in the Eurozone eases later in the year, a subsequent recovery in the euro to USD/EUR 0.71 is forecast in a year's time (Figure 8). Movements in the GBP are expected to take a similar yet less pronounced path to the euro in the year ahead.



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