1 April 2011

DECISION TIME FOR WINE GROWERS
2011 VINTAGE OUTLOOK

OVERVIEW

- Australia and New Zealand's wine industries continue to face a range of challenges, leaving a number of growers considering their future.
- The Wine Grape Growers' Australia's December Vineyard Survey estimated the 2011 vintage will be 1.4 million tonnes, down by about 200,000 tonnes from the previous year.
- This downturn is a result of a number of risk factors, such as the outbreak of disease in Victoria, New South Wales, South Australia and Queensland, continued vine removal and extreme weather conditions.
- Despite the fall in production the industry is still battling a large grape glut that continues to result in depressed prices and falling margins.
- These factors need to be understood and managed in order to protect and enhance investment decisions.

INDUSTRY OVERVIEW

With the 2011 harvest underway, many growers are considering their options for the year ahead.

In 2011, the Australian wine industry faces a range of ongoing challenges, including:

- **Oversupply of grapes** leading to a wine glut, depressing prices and reducing returns to growers;
- **High Australian dollar** negatively impacting export conditions and supporting importing;
- **Competition** from overseas producers providing the market with a source of cheap, good quality wines;
- **Extreme and unpredictable weather** conditions impacting growing and size of harvest and significantly increasing capital costs, for example, to repair damage caused by the recent flooding in some states; and
- **Supermarket chains** entering the retail and wholesale alcohol market, further increasing competitive pressure on suppliers.

In many growing regions the costs of production this year will again exceed the grape price growers can expect. This may lead to growers taking extreme measures including leaving grapes on the vine or removing vines, notwithstanding the sunk costs.

According to the Australian Wine and Brandy Corporation ("AWBC"), the average purchase price per tonne of grapes across all regions in Australia has fallen 43 per cent over the last three vintages (see table below). The downward pressure on prices is forecast to continue in 2011.

Average price per tonne across Australia		
Vintage	**Average price per tonne $**	**% movement from previous year**
2008	817	27
2009	527	(36)
2010	464	(13.5)

Source: ABS Australian Wine and Grape Industry update 7 December 2010

Despite growing domestic and export demand for wine, the 2011 production is forecast to fall by a further 200,000 tonnes or 12.5 per cent according to Wine Grape Growers' Australia ("WGGA").

The WGGA believes that up to 20 per cent (or 30,000 ha) of vines need to be removed in order to restore structural balance to the industry.

In this newsletter we analyse the key factors impacting the industry in both Australia and New Zealand, the specific risk factors for stakeholders to be aware of and outline how Taylor Woodings can assist industry participants make financial and operational decisions to protect and enhance their investment.

2010 VINTAGE

Due to a range of factors, the 2010 vintage was 7.5 per cent lower than 2009, producing 1.6 million tonnes of grapes and 1.1 billion litres of wine.

The main factors leading to the reduced vintage were extremely hot weather conditions in late November 2009 and a general reduction in grapes harvested with growers, leaving approximately 9 per cent of fruit on the vine. In addition, throughout 2009 approximately 6,000 ha, or 4.3 per cent, of fruit bearing vines were removed.

The reduced production has been considered as a positive for the industry as it continues to battle the large grape glut.

Despite the increase in wine consumption during 2010 (Australian exports up 4.8 per cent and domestic consumption up 8.7 per cent), wine prices continued to fall.

Some regions have been more affected than others, for example, prices for grapes from the Riverina are expected to be around $150-$200 per tonne on average in 2011, considerably lower than the $300-$400 per tonne achieved in recent years and well below the $1,200 per tonne received in the late 1990's.

2011 VINTAGE

As noted above, the WGGA's December Vineyard Survey estimated the 2011 vintage will be 1.4 million tonnes, down by about 200,000 tonnes from the previous year. We consider contributing factors include:

1. Outbreak of **disease** in Victoria, New South Wales, South Australia and Queensland;
2. Continued **vine removal**; and
3. **Extreme weather** damage, including heat, cold, rain and hail.

1. Disease

As a result of the unseasonal humid and wet weather conditions, many wine regions along Australia's East Coast have been victim to an outbreak of downy mildew and powdery mildew. Due to the large number of regions impacted by the diseases the supply of fungal spray to relieve wine makers has been significantly limited, therefore exacerbating the problem.

This outbreak will impact the level and quality of grapes harvested in the diseased regions, with the impact varying between minor quality issues to the complete loss of the fruit.

Input costs for growers are likely to increase due to the disease, including increased chemical and labour costs (for spraying the fruit) and harvest costs as many vines will need to be handpicked to ensure diseased fruits do not contaminate good quality fruits.

With many wineries imposing strict quality requirements on fruit supplied by their growers, tolerance limits are as low as 3 per cent. Meaning even slightly disease-affected fruit could significantly reduce the growers' ability to sell their produce.

2. Continued Vine Removal

Given the current poor economic matrix in the industry, many growers have decided not to harvest vines or have resorted to alternative farming operations, such as broadacre farming.

This is in line with calls by the WGGA for growers to reduce the area 'under vines' in order to restore structural balance to the industry. It is estimated that only 4.3 per cent of vines have been removed to date, which is well short of the WGGA's 20 per cent target.

3. Weather

Unusual and extreme weather conditions have severely affected the 2011 vintage. While the West Coast Australian regions have received minimal rain and suffered from excessive heat, the East Coast has endured excessive rain and cooler growing conditions. Although grape vines are generally hardy and can survive extreme weather, these conditions impact fruit quality.

The weather has also affected many roads and production infrastructure in Victoria, New South Wales and Queensland, further increasing production cost and potential production delays that may impact fruit quality.

Despite these challenges, an ideal spring and the cooler summer have created great fruit quality in areas such as Tasmania, McLaren Vale and the Hunter Valley, and the dry weather in Western Australia has produced good fruit quality in the Margaret River.

The weather will always play a key role in viticulture with the 2011 vintage looking to be more positive for quality producers (e.g. growers with good management practices who had on-hand chemicals and were able to minimise the impact of the mildew).

NEW ZEALAND

Similar to Australia, the New Zealand wine industry is facing challenges.

The New Zealand 2011 vintage is expected to show a further significant increase in grape volume, particularly with Sauvignon Blanc crops, the major variety for New Zealand export wine. This forecast oversupply has led to a considerable drop in grape prices.

The prices for specialist grape varieties, such as Pinot Noir from Otago and Wairarapa, have remained strong in comparison to other varieties, for example, Chardonnay from Hawkes Bay, where growers have been removing vines.

The impact of wine discounting by major supermarket chains, which comprise the bulk of the retail sales in the industry, is further challenging the smaller vineyards and placing pressure on them to considerably drop their prices. However, larger players who are serving premium markets in the United States and Europe are better insulated from these local market conditions.

Even though the effects of overproduction are already being felt in the New Zealand wine industry, there seem to be an increase in vineyards appearing on the market.

SPECIFIC RISK FACTORS

In order to make the right investment decisions and prevent future debt problems, it is vital for stakeholders to understand the risk factors facing the industry including:

- inadequate insurance to cover capital costs of flood damage;
- grape supply contract terms including damaged fruit tolerance levels and penalties for not meeting supply targets;
- ability to fund increased input costs and likely harvest delays within existing finance facilities;
- likely harvest size and ability to harvest fruit given weather conditions;
- impact of reduced crop size on cashflow and brand in the market place;
- impact of continuing high Australian dollar on export income, also supporting greater competition from importers; and
- increased fixed unit costs as a result of reduced winery throughput.

HOW TAYLOR WOODINGS CAN HELP

Taylor Woodings has specific experience within the wine industry and has worked on a number of wineries in Australia and New Zealand. We understand the operational and financial characteristics of the industry together with the day-to-day knowledge of running the business on the farm and at the cellar door.

We are acutely aware of the current issues facing the industry and are well placed to assist you and your clients with the financial and operating decisions that many growers now face.

More Information

If you would like further information, please contact our Agriculture, Forestry and Fishing team leader, Andrew Schwarz, or one of our team members.

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