

## Positive 2012 outcomes: cause for optimism?

Two positives in 2012:

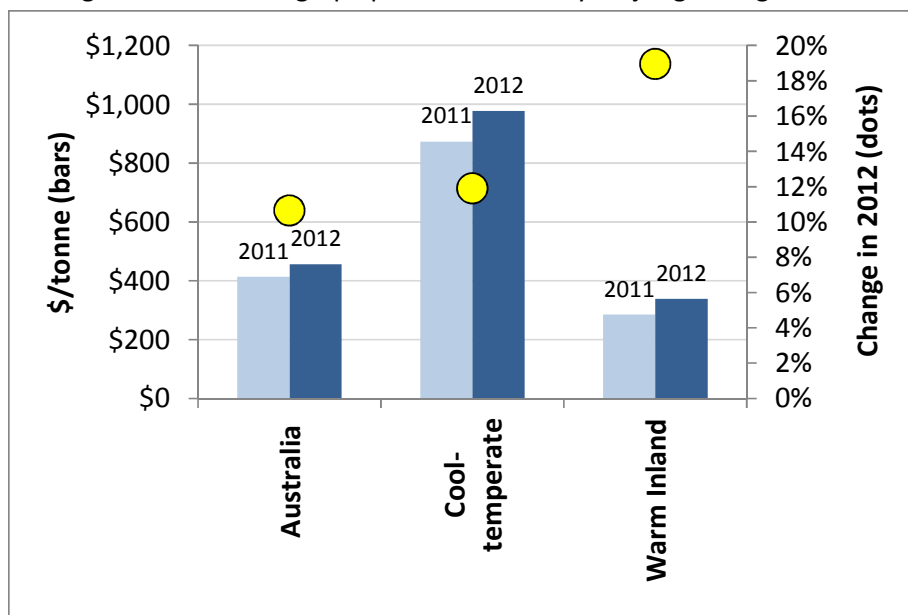
- a 4% rise in the fob \$/litre price for Australian wine exports, and
- an 11% improvement in the national average winegrape price – mainly driven by price improvements in red winegrapes and warm inland fruit<sup>1</sup>

have been heartening news and growers desperate for good news may have been encouraged to see them as heralding (or at least whispering) the start of a revival in fortunes.

The following analysis digs deeper and questions the cause for optimism about a turnaround (yet, at least).

The 2012 winegrape price dispersion results showed that warm inland prices experienced larger percentage price increases (up 19% overall - reds 22% up and whites 16% up) compared to cooler-temperate price increases (up 12% - reds up 17%, whites up 2%). Figure 1 shows these results for all varieties in aggregate.

Figure 1: 2012 winegrape price outcomes by major growing districts



Source: ABS, price utilisation reports, price dispersion reports, WGGGA analysis

Before concluding that the industry is at the start of a recovery however, seasonal explanations must be considered. There are two possible seasonal explanations for these price rises:

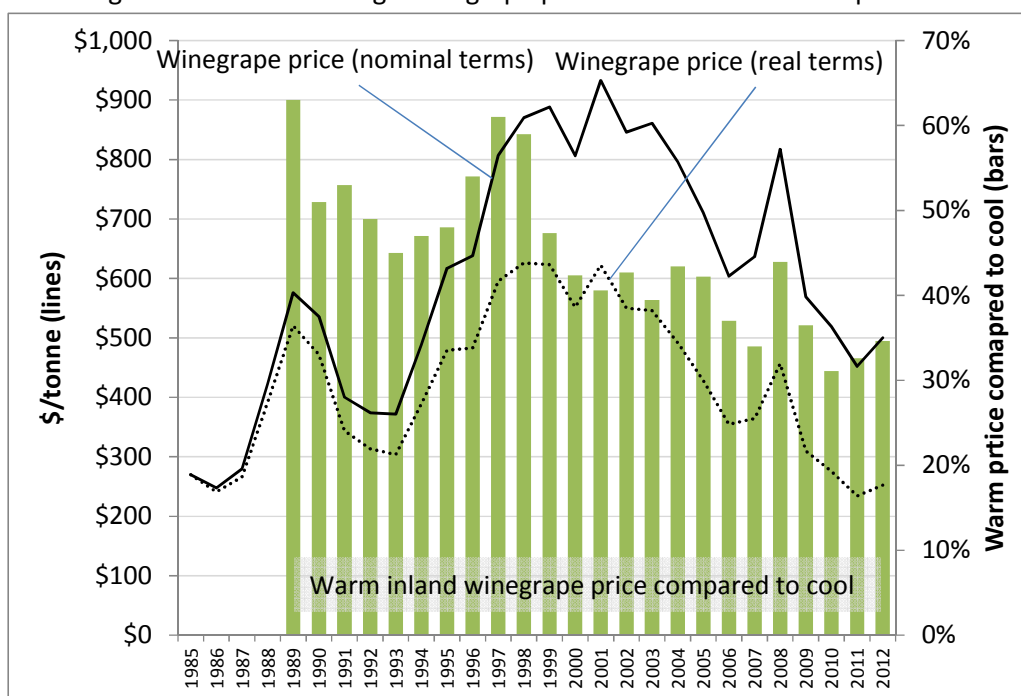
1. The very difficult 2011 season, which saw widespread examples of high yields (tonnes per hectare) all but destroyed by disease - meaning that quality downgrades would have affected prices.
2. The more substantial rises in red prices suggest an influence of short-term supply deficits, as the reds have had poorer seasons than whites over the last two vintages and are therefore in relatively short supply – particularly good quality red winegrapes.

<sup>1</sup> Winegrape Price Dispersion Report, Wine Australian Corporation 2012

However, these seasonal influences do not explain why warm inland prices increased by more in relative terms than cooler-temperate prices since after all, that past two seasons have been crueller on cooler-temperate districts and they should be in shorter supply. The simple answer is that warm inland prices were so low in recent years, the \$54/tonne price improvement in the warm inland average price was greater relative to the low absolute price than the \$104/tonne improvement over the higher cooler-temperate prices.

Figure 2 illustrates warm inland versus cooler-temperate price relativities and how the former are due for a substantial 'relative' increase. In Figure 2, the ratio of warm to cool prices (the bars in Figure 2) is plotted. A pattern emerges from the comparison illustrated. In times of high demand (eg when prices were growing around 1993/1994 through to around 2000/2001) warm prices were closer to cool. This is because the strength of demand exhausted the availability of preferred cooler-temperate fruit and drove up the price of warm fruit needed to fill the gap. On the other hand, in times of low demand (when prices were falling), between 1989 to 1993 and generally after 2001, the depressed prices of cooler-temperate fruit and its greater availability compared to demand meant that it was taken in preference to warm, because of its favourable cost/quality ratio. As a result, the less sought-after warm fruit experienced a greater price collapse than cool.

Figure 2: National average winegrape prices and warm-cool comparisons



Source: 2012 Winegrape Purchases: Price Dispersion Report, Wine Australia Corporation

This provides at least part of the answer to why warm prices may have increased more than cool in 2012. They simply improved from a much lower.

Figure 2 also shows that the overall national average winegrape price is still very low. In real terms (that is, after taking into account the lower spending power of a dollar after inflation has eaten into it), the prices in 2011 and 2012 are at the level they were 25 years ago – back when there was a vine

pull because they were so low. From a national point-of-view, the prima facie case for a return to profitability from such a low base does not look promising just yet.

The following analysis assesses profitability of grapegrowing between 2010 and 2012 to determine whether the improvement in prices restored profitability in 2012 *on average*. In dealing with averages, it is important to keep in mind that above-average operators will have been more profitable and that below-average operators will be much less profitable than indicated.

The summary provided in Table 1 shows returns per hectare for the major growing areas<sup>2</sup>. The analysis shows that warm and cooler-temperate districts have not achieved cost of production in any of the last three years. On the other hand, classic cool climate has been ahead of cost in all three years although not by much in the last two. The table reflects the improvement in returns for warm inland regions in 2012 as a result of price and yield improvements; however, returns are still in negative territory. The table also shows that, across the last three years, profitability (or rather – net loss) has been roughly equal on average in warm and cooler-temperate regions. In fact it is sobering to reflect on the fact that growers of around 95% of Australia’s winegrape production have run at an average loss of 25% over each of the past three years.

Table 1: Winegrape profitability by major growing districts

		2010	2011	2012	Average
<b>t/hectare*</b>					
Warm Inland	WI	15.4	16.7	19.4	17.2
Cool-Temperate	CT	6.7	6.2	5.8	6.2
Classic Cool Climate	CCC	7.3	7.0	6.6	7.0
<b>\$/tonne</b>					
Warm Inland	WI	\$298	\$285	\$339	\$307
Cool-Temperate	CT	\$916	\$813	\$978	\$902
Classic Cool Climate	CCC	\$1,472	\$1,369	\$1,450	\$1,430
<b>\$/hectare</b>					
Warm Inland	WI	\$4,590	\$4,760	\$6,577	\$5,276
Cool-Temperate	CT	\$6,137	\$5,041	\$5,694	\$5,631
Classic Cool Climate	CCC	\$10,746	\$9,583	\$9,543	\$9,956
<b>Cost of production</b>					
Warm Inland	WI	\$7,000	\$7,000	\$7,000	\$7,000
Cool-Temperate	CT	\$7,500	\$7,500	\$7,500	\$7,500
Classic Cool Climate	CCC	\$9,000	\$9,000	\$9,000	\$9,000
<b>Returns compared to break-even return per hectare</b>					
Warm Inland	WI	-34%	-32%	-6%	-25%
Cool-Temperate	CT	-18%	-33%	-24%	-25%
Classic Cool Climate	CCC	19%	6%	6%	11%

WI = Warm Inland, CT = Cool-temperate, CCC = Classic Cool Climate \* estimated in 2012

The 2012 harvest was 1.66m tonnes<sup>3</sup> - despite the widely reported lower yields per hectare and some losses from rain and flooding in the east of the country. Given that the national vineyard has only been reduced by around 5% since bearing areas peaked in 2008, and that the ABARES production predictions are for bearing areas will grow by nearly 2% and tonnages by over 6% by

<sup>2</sup> Warm inland refers to the SA Riverland, the Murray Darling/Swan Hill and the NSW Riverina. Classic Cool Climate includes Yarra Valley, Tasmania, Adelaide Hills, Mornington Peninsula and Macedon Ranges. Yield figures come from Australian Bureau of Statistics production data in 2010 and 2011 and are estimated for 2012 from the 2012 WFA Vintage Report. Prices come from price dispersion reports. Costs of production data have been provided by grower contacts. Although there is inevitably variation in what is included in costs, it is generally understood that these costs include operating costs plus fixed costs, including interest and wages, but do not include the capital to establish the vineyard or extra costs such as water purchases.

<sup>3</sup> WFA Vintage Survey 2012

2014<sup>4</sup>, it can be estimated that an average year will produce a national crush of 1.72mt to 1.75 mt and in a high-yielding year, up to 1.9mt. These circumstances point to the fact that not only is there a reduced chance in the short term of any structural reduction in supply that would put upward pressure on prices but also that there is a likelihood that a large vintage would re-inflate the diminishing oversupply and downward pricing pressures.

In summary, there is reason to believe that winegrape price improvements in 2012 are more about seasonal factors and comparisons with low bases than changes in the underlying supply/demand fundamentals that would signal a fundamental turn-around leave alone a return to profitability. While 'green shoots' exist (in the classic cool climate areas perhaps?) a larger part of the industry awaits a more substantial and enduring indication of positives.

A revival will inevitably come but 'when' may be important to survival for anyone with depleted assets. Due consideration should be given to when is the best time to bank on an industry revival.

Wine Grape Growers Australia, September 2012

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<sup>4</sup> ABARES, *Australian wine grape production projections to 2012-14*, Research Report 12.3, May 2012