Wine Restructuring Action Agenda

Supporting Report

This paper presents selected explanatory graphs and tables in support of the statement released to industry on 10 November 2009 by the Winemakers' Federation of Australia, Wine Grape Growers' Australia, the Australian Wine and Brandy Corporation and the Grape and Wine Research and Development Corporation

The objective of the Wine Restructuring Action Agenda (WRAA) is to facilitate and accelerate the restructuring of the Australian wine sector. The ambition is transformational change.

The key drivers behind WRAA are that:

- Australia's wine oversupply exceeds 100 million cases and at the current production rate this will more than double in three years.
- The scale of the problem is such that we cannot expect normal market forces or external factors to solve it.
- Even ambitious sales growth ambitions in new markets would eliminate less than a quarter of the oversupply.
- The combined impact of drought, water shortages and climate change would over time eliminate less than one-tenth of the oversupply
- Too much current activity is not viable in terms of competitiveness, margins and target market demand.
- The problems relate both to demand and supply.

There is little evidence that market signals are acting to realign supply with demand. In fact, a number of factors are distorting market signals and allowing uneconomic supply to continue. These include:

- high fruit prices achieved due to the expected but unrealised low 2008 vintage
- multi-year set-price contracts
- continued demand from processors and traders for bulk and own label wine
- the high sunk-capital cost and lack of alternative sale options for processing infrastructure (leading to marginal cost production pricing)
- unintended application of WET Rebate to non-targeted-recipients
- some wine companies paying out profits in advance to get out of supply contracts, allowing growers to continue to produce on a speculative basis
- some MIS schemes
- unrealistic expectations of export market growth and a significant number of smaller 'lifestyle' producers who can tolerate unprofitable businesses due to off-farm income.

> "It would appear that the Australian wine industry is at a crossroads. Under the current industry structure, some growers and wine producers must and will exit the industry as margins fall below sustainable levels in the face of oversupply and weakening demand for Australian wine in the global marketplace."
>
> *Rabobank Global Focus: Australian Wine*, Winter 2009

The supply dimension

Endemic surpluses of undifferentiated wine devalue the Australian wine category generally and, for individual producers, offer little ongoing prospect of that surplus wine being sold at sufficient profit to maintain the viability of the supply chain. It is imperative that the grape supply capacity corresponding to the uncompetitive surplus be retired from the wine industry.

Australia is producing 20-40 million cases a year more than it is selling – roughly equivalent to total sales to our second largest export market, the UK. This equates to 270,000-500,000 tonnes of grapes (20,000-40,000 hectares of vines). Our surplus already exceeds 100 million cases and at current rates of production and demand this will more than double in two years.

Figure 1 – source AWBC

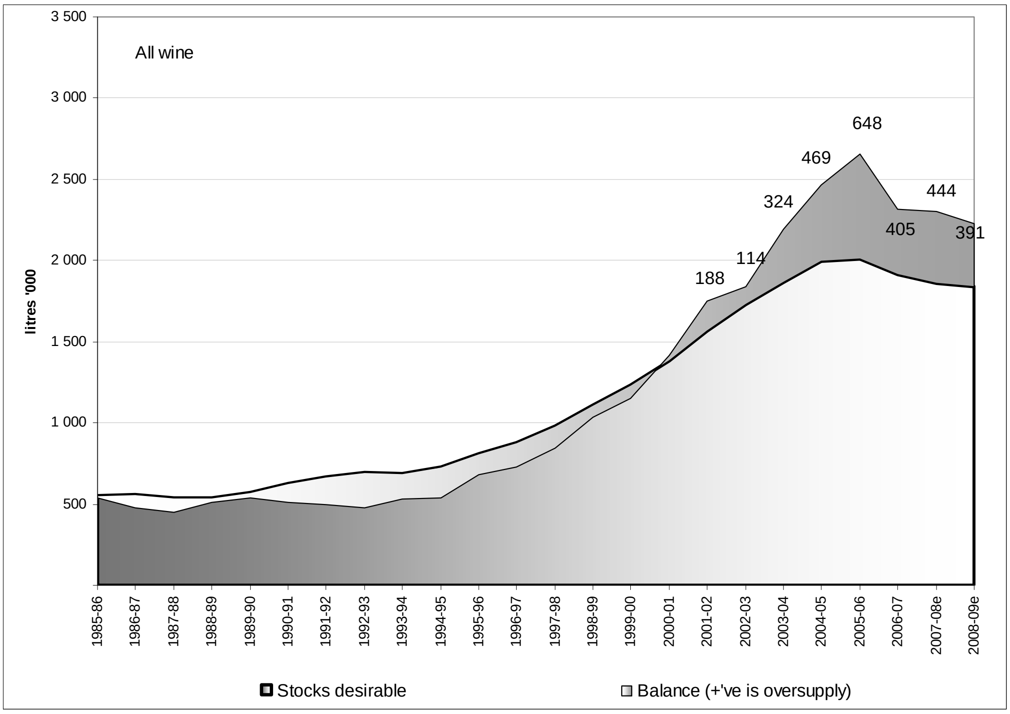


Figure 2 – source Rabobank

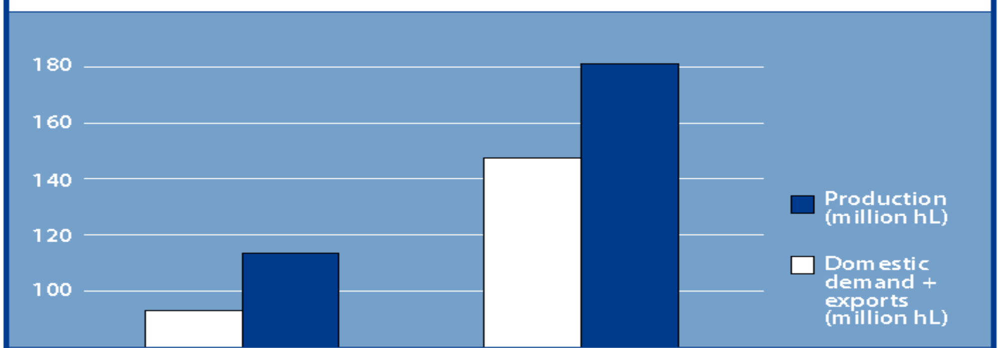


Figure 3: Cumulative overproduction In Australia 1999-2013f
Million hectolitres

Source: AWBC, ABS (Actual) and Rabobank (f=forecast*)

*Forecasts are made based on the assumption that vineyard area and production levels continue in line with recent averages

The demand dimension

Export demand

Australia's wine exports have fallen by 8 million cases and 21% in value since their peak in October 2007. The decline has been greatest for higher value exports, and where there has been growth at lower price points it frequently has been unprofitable and thus unsustainable.

Figure 3 – source AWBC

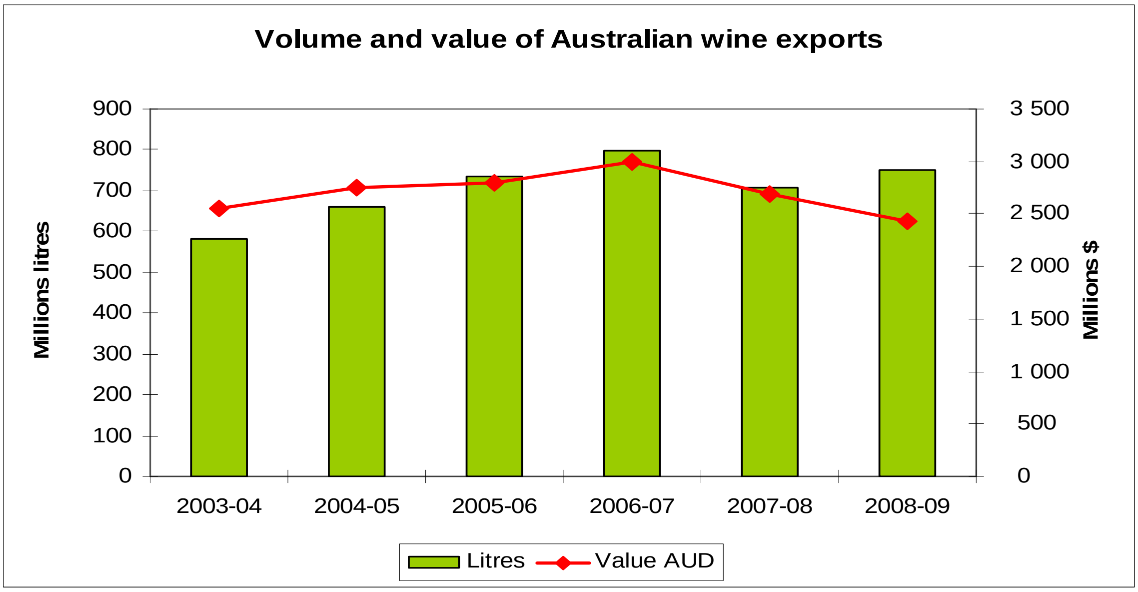
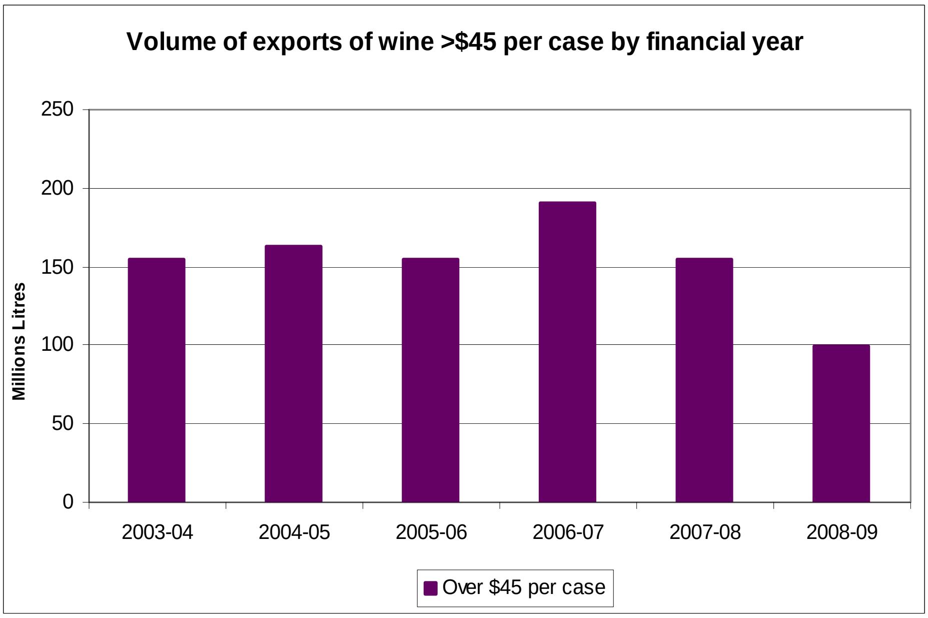


Figure 4 – source AWBC



Domestic demand

Historically Australian wine has dominated the Australian market with market shares in the mid 90%. Since 2006 table wine imports have been growing at annual rates of more than 40%, thereby eroding the volume share of Australian wine to 89% in 2007/2008.

This loss of market share to imports has resulted in declining sales for Australian wine despite trend total Australian market annual volume growth of 2.4%.

Figure 5 – source AWBC

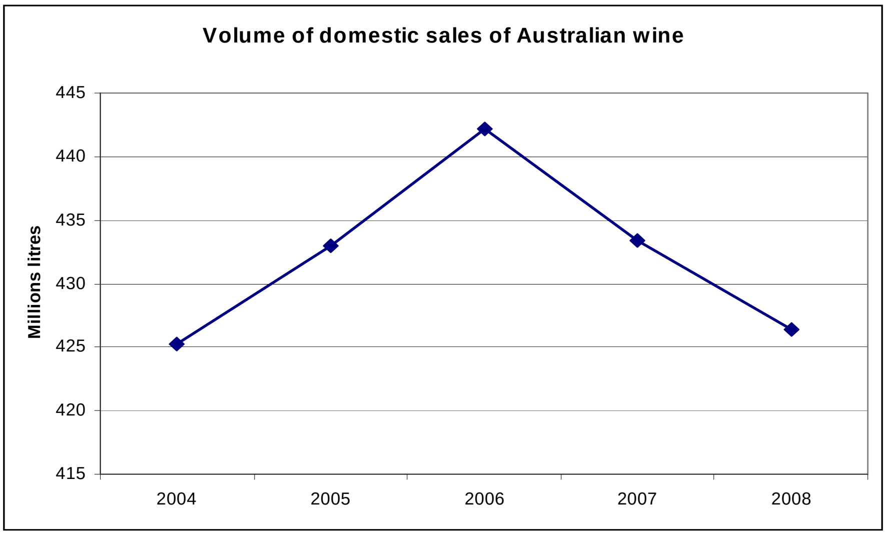
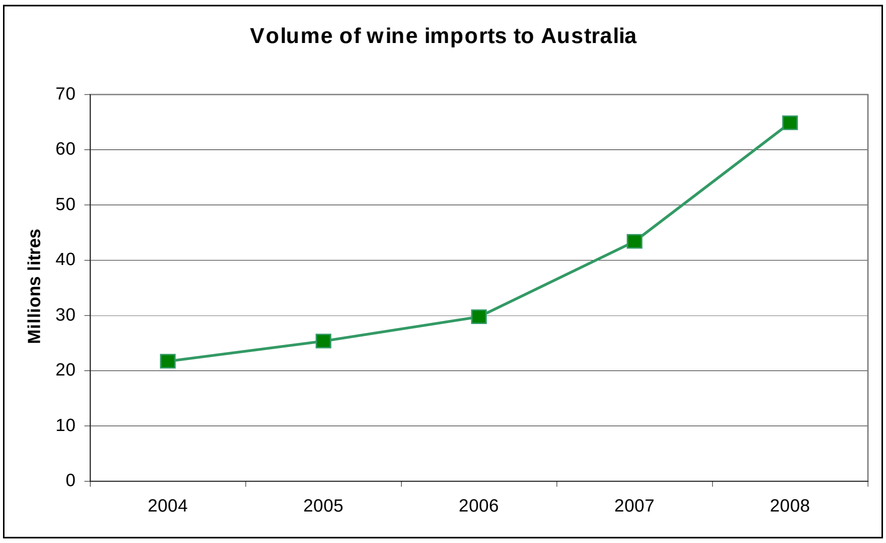


Figure 6 – source AWBC



Issues with vineyard viability

Australia has significant problems in terms of vineyard viability. In particular, too many regions produce uneconomic fruit because of high-grade cost structures.

<u>Study 1</u>

Industry analyst Gaetjens Langley developed a benchmarking system grading fruit from A to E, which it used to assess vineyard viability in all regions. Fruit was defined as uneconomic if it was too costly for the quality achieved. Using this definition, around 307,000 tonnes or just over 17% of Australia's vineyard capacity is uneconomic and has few long term prospects.

Analysis shows that:

- there are many pockets of local oversupply, including in high-profile regions
- regions producing significant quantities of high-grade (A & B) fruit do so economically but a number are less successful with their middle-grade fruit
- too many regions produce middle-grade fruit with high-grade cost structures
- while not currently in oversupply, the outlook for low-grade (E) fruit is problematic, with anticipated diminution of long-term terms of trade

<table>
<tr><th>Wine Grape Grade</th><th>Indicative Yield (T/Ha)</th><th>Vineyard Cost / Ha</th><th>Direct Cost / Tonne</th><th>Wholesale Price FOB / Litre Packaged</th><th>Indicative Domestic Retail Price</th><th>Tonnes</th></tr>
<tr><td>A (Specialty)</td><td>5</td><td>$9,500</td><td>$1,900</td><td>>$10</td><td>>$25</td><td rowspan="2">180,850</td></tr>
<tr><td>B (Super Premium)</td><td>7</td><td>$8,000</td><td>$1,143</td><td>$7.50 - $9.99</td><td>$15-$25</td></tr>
<tr><td>C (Premium)</td><td>12</td><td>$6,750</td><td>$563</td><td>$5.00 - $7.50</td><td>$8-$15</td><td>409,552</td></tr>
<tr><td>D (Popular Premium)</td><td>16</td><td>$6,250</td><td>$391</td><td>$2.50 - $4.99</td><td>$5-$8</td><td>553,211</td></tr>
<tr><td>E (Basic)</td><td>25</td><td>$5,750</td><td>$230</td><td><$2.50</td><td><$5</td><td>652,116</td></tr>
<tr><td>Not classified, balancing item to 2008 crush total</td><td></td><td></td><td></td><td></td><td></td><td>35,794</td></tr>
<tr><td></td><td></td><td></td><td></td><td></td><td></td><td>1,831,523</td></tr>
</table>

Uneconomic grapes: cost factors only

Quality Classification	Total Tonnage	Uneconomic Tonnage	% Uneconomic
A & B	180,850	n/a	n/a
C	409,552	147,241	36.0
D	553,211	134,517	24.3
E	652,116	25,592	3.9
Totals	1,795,729	307,350	17.1

1. Uneconomic defined by uncompetitive cost of production only, no allowance for lack of demand.
2. All A & B assumed economic irrespective of production costs.

<u>Study 2</u>

The *Winegrape Purchases: Price Dispersion Report 2009* prepared by the AWBC collected data on more than 36,000 separate transactions. Tonnages purchased at the aggregate level were estimated to represent nearly 80% of total purchases for the year.

The average purchase price for the just over one million tonnes surveyed was $527 per tonne compared with $717 per tonne in 2008.

Problems with competitiveness

Oversupply is unpicking our price structure and turning a premium, branded export industry into a low-value / low-margin trade, yet our costs are too high for us to be viable in that market. Australia cannot match the cost structures of some competitors (including a subsidised Europe) at very low price points and a range of factors suggest our long-term terms of trade will continue to weaken, putting the commodity market further out of reach.

This situation was highlighted by Rabobank in 2007 and again this year.

The fact that there are many competitors seemingly able to supply the world market at lower prices than Australia suggests a clear cost problem for the Australian industry. This is particularly the case when Australia has to increase exports of bulk wines that must compete head-on in export markets with wine from countries with structurally lower costs.

Rabobank Global Focus for Australian Wine *Winter 2007*

Despite the best efforts of a coordinated national marketing campaign to lift both the image and the average price of Australian wine, it continues to lose ground in the premium segment against more competitive, cost-efficient wine-producing nations which are successfully sniping at the hard fought market share captured by Australia during the last decade.

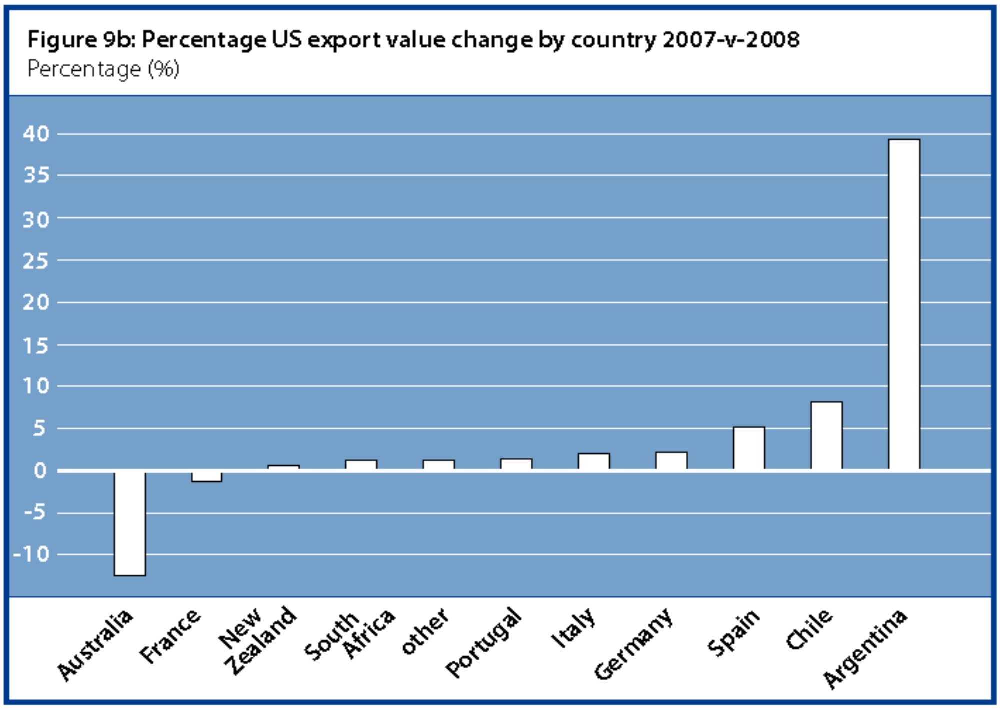
Through improvements in quality and the maintenance of a lower cost base, Chile and Argentina have made significant inroads into Australia's traditional markets.

Even Australia's largest producers are suffering due to a lack of cost competitiveness internationally.

Through improvements in quality and the maintenance of a lower cost base, Chile and Argentina have made significant inroads into Australia's traditional markets

Rabobank Global Focus for Australian Wine *Winter 2009*

Figure 7 – source Rabobank



Source: Gomberg Fredrikson and Rabobank

Problems with exchange rates

In export markets Australian producers face fixed retail price points with little or no opportunity to increase prices in response to impacts on costs and exchange rates. Consequently, changes in costs and exchange rates impact on the price that producers can obtain on an FOB basis.

The table below shows the impact of exchange rates on FOB case sale prices over five years for two price points in Australia's two biggest export markets.

Market & retail price point	**FOB Case sale price, A $**	
	2004	2009
UK £6.99	48.76	24.16
UK £10.00	84.02	41.62
USA $10	56.71	37.50
USA $20	121.48	80.32

Conclusion

Oversupply is having a debilitating impact on Australian wine businesses and restructuring the supply base is both essential and inevitable.

Our objectives in releasing a statement to industry and formulating an action agenda are to advance the adjustment process, to bring about more sustainable operating conditions as soon as possible, and to dispel any notion that the industry can trade its way out of its current problem or rely on the government to step in.

November 2009