Worth Noting

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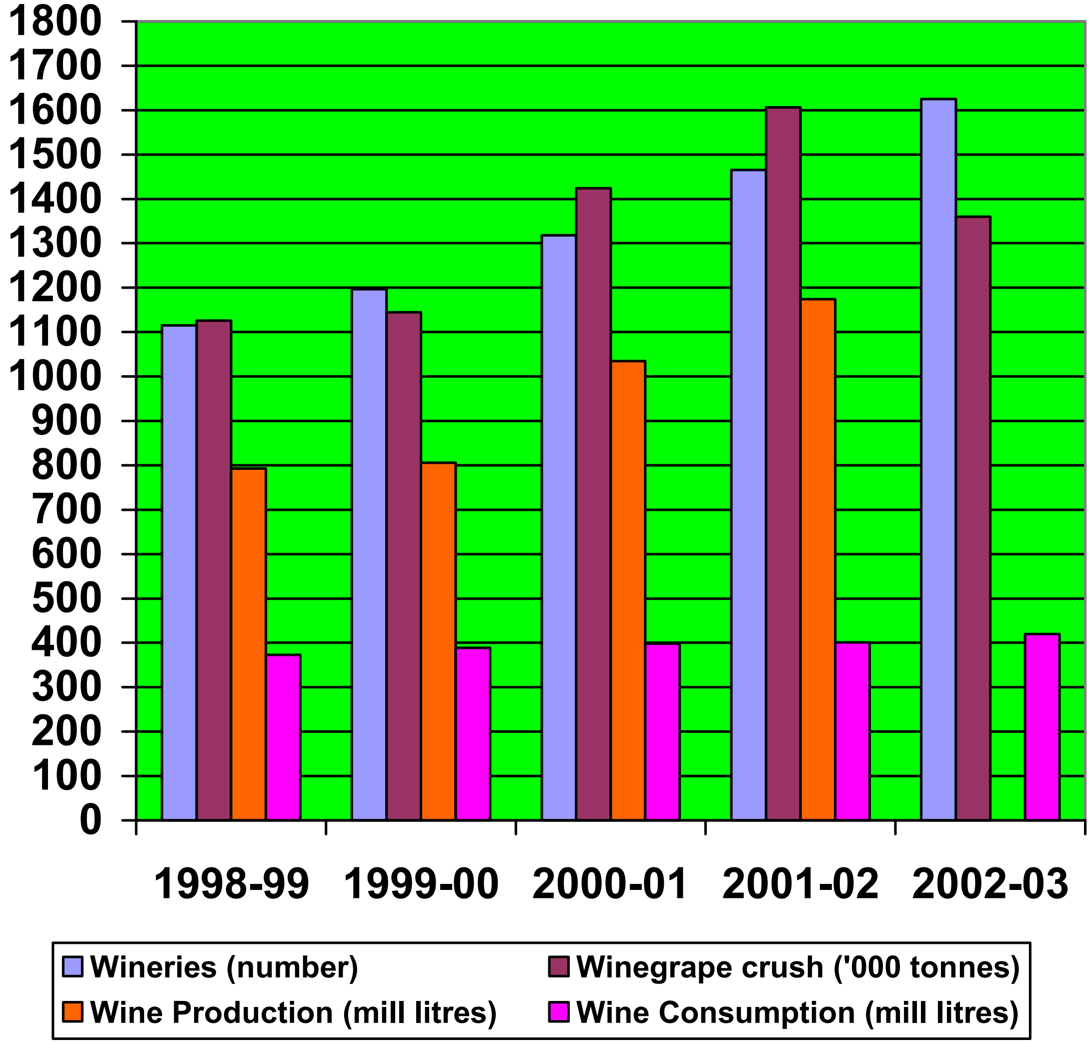
Worth Noting is the fortnightly management journal of research and conferences company L21. It is focused on management strategy issues of relevance to senior executives.

What is going on in the wine industry? Have we reached saturation point or is it still a growth industry? In this edition of *Worth Noting*, we look at some important facts behind the wine industry to find out what is really happening in this sector.

Growth in the Wine Industry

Everything about the wine industry seems to be getting better and better. A new winery literally pops up every 2 days; the number of tones of grapes we crush is on the up; wine production is on the up; and the number of bottles of wine we consume is on the up. How far has it gone, and how far can it go?

Growth in Australian Wine Industry – Sector Breakdown



* Winegrape crush for 2002-2003 is not yet released

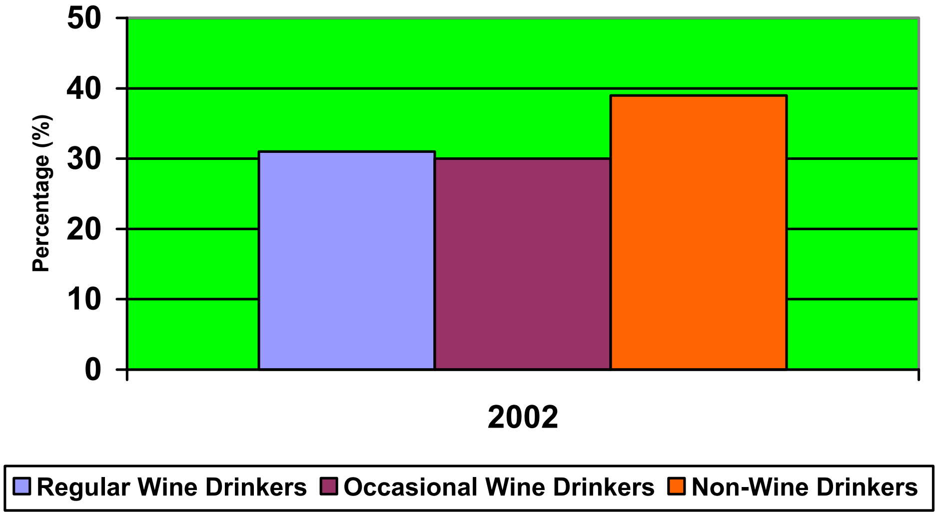
Source: ABS Vineyard Survey; Australian Wine & Grape Industry; AWBC Wine Industry

What is immediately noteworthy is that local wine consumption has not increased at anywhere the same rate as the production rate. This is despite the fact that while Australia might still have a tag as a beer drinking nation, since 1970 wine consumption has grown from 8.9 litres per head to 22.7 litres per head in 2003.

When we look at glasses per day for those who drink the vast majority of wine (18-64 years old), that's about 270 glasses of wine per year per person.

Moreover, marketing studies done by AWBC Wine Industry suggest that Australian drinkers can be roughly divided into three groups.

Broad Classification of Consumers



Source: AWBC Industry Research

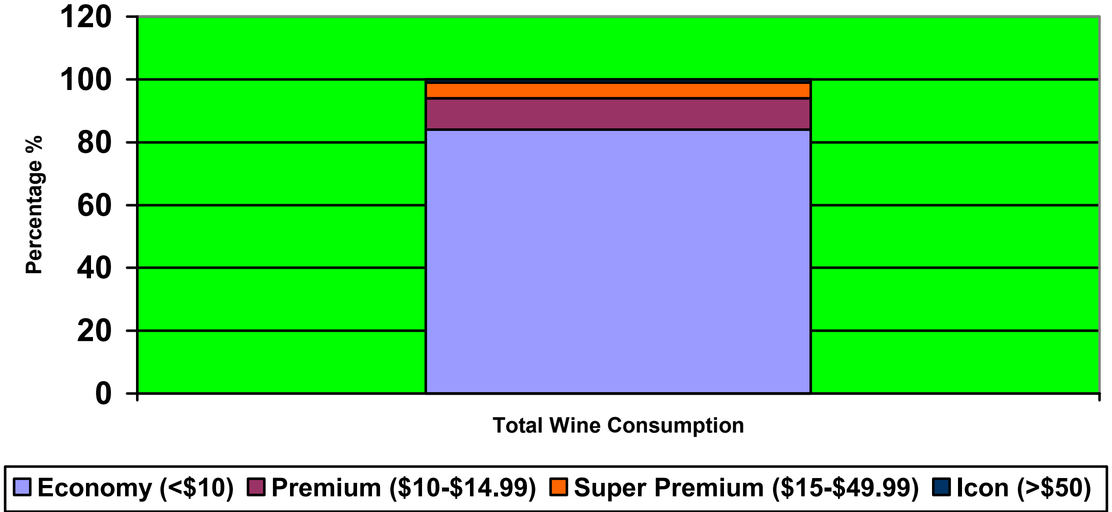
Further research suggests that ‘regular wine drinkers’ are unlikely to significantly increase their wine consumption whilst marketing executives have found it difficult to convert ‘non-wine drinkers’ into even part-time wine buffs. Hence, much of the marketing focus has been on the ‘occasional wine-drinkers’ which the industry sees as the strongest growth group out of the three.

If we convert one third of the ‘occasional wine drinkers’ into ‘regular wine drinkers’ – an ambitious target – we would see a boost in wine consumption by an additional 23 million litres.

This sounds impressive but that is only a 5-6% increase in wine consumption. In this best case scenario, we might therefore consume about 445 million litres per year while production levels would still be at about 1200 million litres per year and rising.

It is not surprising, therefore, that Australian wine companies tend to place less emphasis on trying to dramatically increase how many litres of wine we drink and more emphasis on getting us to move from economy to premium and super premium brands. Thus, the message from marketers is not to drink more wine – it’s to drink more expensive wines.

Australian Wine Consumption by Price as Percentage of Total Consumption - 2002



Source: AWBC Industry Research

The Economy and Premium range is dominated by a few huge brands such as Penfolds, Southcorp, Orlando etc – brands that enjoy considerable sway with retailers and distributors. Yet, as we can see, with only 5% of wines consumed in the Super Premium Range, the battle for local market share in the Super Premium range (the market a large number of new entrants always aim for) is intense. New wineries without the volumes of larger players would not find it financially worthwhile to produce wines in the Economy range while their lack of influence on retailers means they will find it hard to get their product sold at significant quantities in this price range.

The inference is clear. The domestic market is not where the action is for the industry. Sure, existing producers are keen to maintain and maybe improve their penetration by a few percentage points but the domestic market is not what is driving the industry now or in the future.

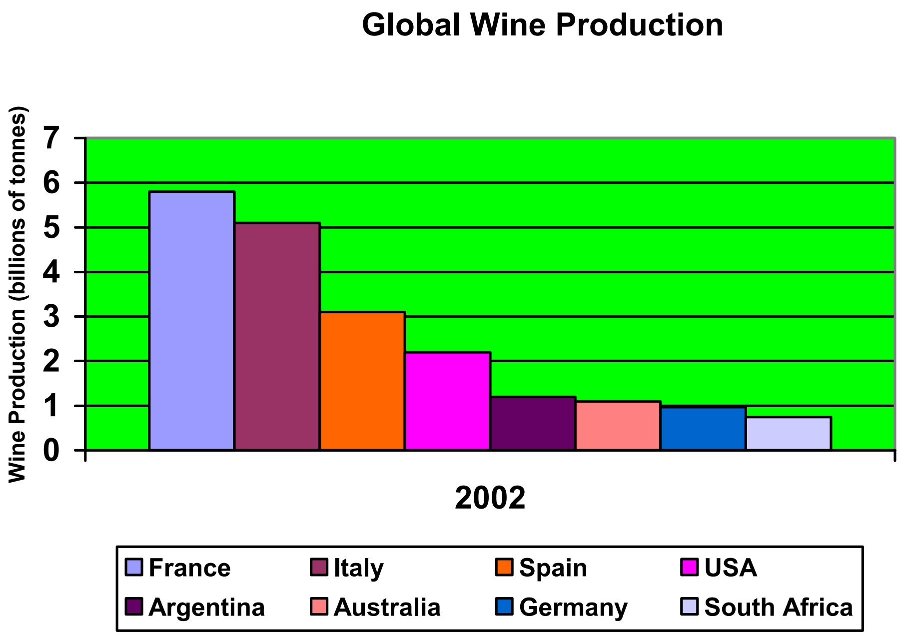
The export market is where the action is. But this is where the big wineries and big names in wine for the last few hundred years become competitors: the Grand Crus from France, the Super Tuscans from Italy, the hard-ball playing wineries from the Napa Valley in California, and so on.

Australia therefore had to find a niche and have done so quite well so far.

Export Markets

(a) Global Wine Production

Global wine production is just under 30 billion litres per year. The breakdown of production by country is below.



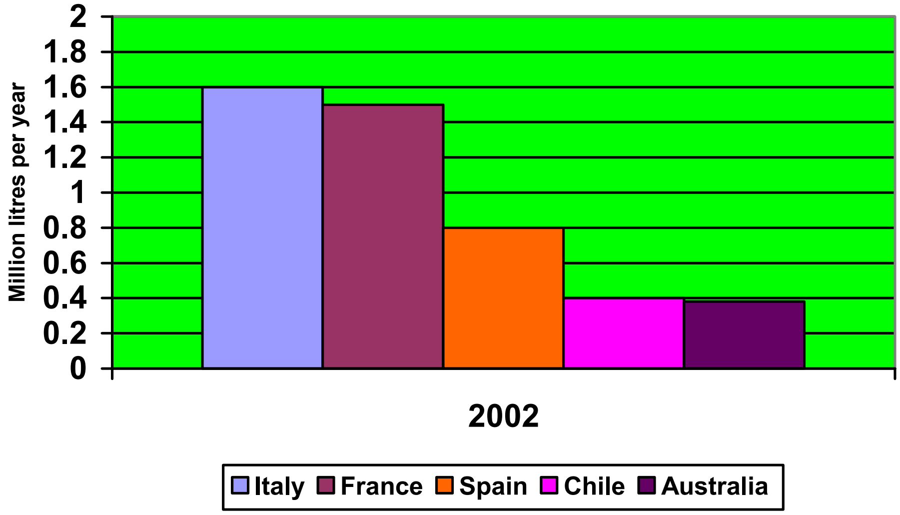
Source: AWBC Industry Research

Australia ranks sixth on the list and accounts for a little less than 4% of global production. A middle range player compared to the big three – France, Italy and Spain – who account for about half of all global wine production.

(b) Global Wine Export Market

The United Nations Food and Agriculture Organisation (FAO) estimate that the world wine trade in 2002 was about 6.5 billion litres. In terms of global export share, Australia punches a bit above its weight. We are ranked 5th in the world in terms of export volumes.

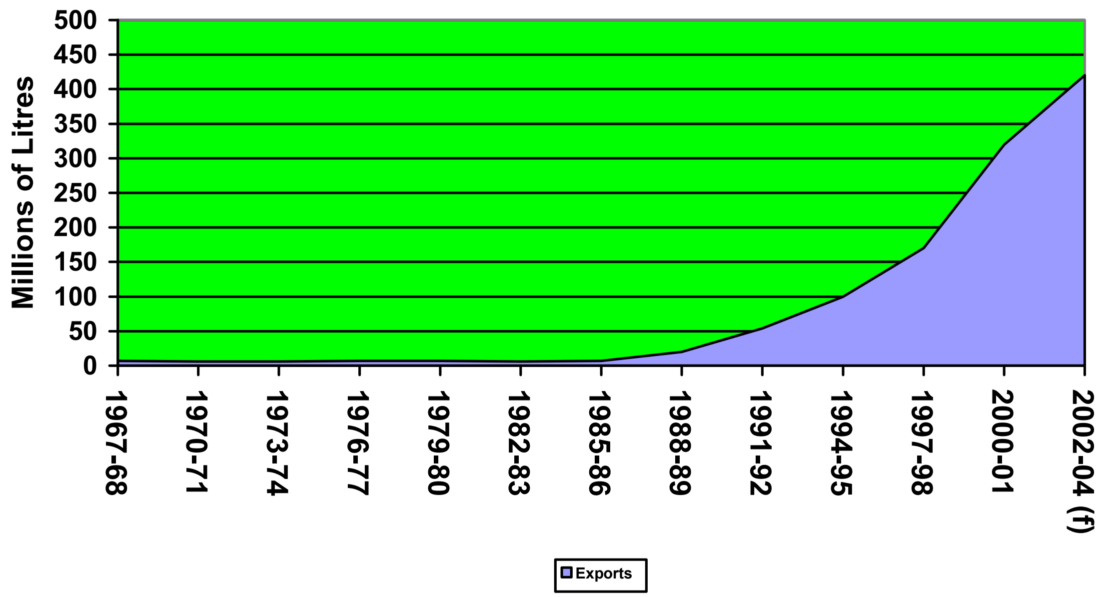
Leaders in Global Wine Exports - 2002



Source: AWBC Industry Research

However, the news gets even better for our wine industry outlook in terms of exports.

Growth in Australian Wine Exports



Source: ABS; AWBC Export Study

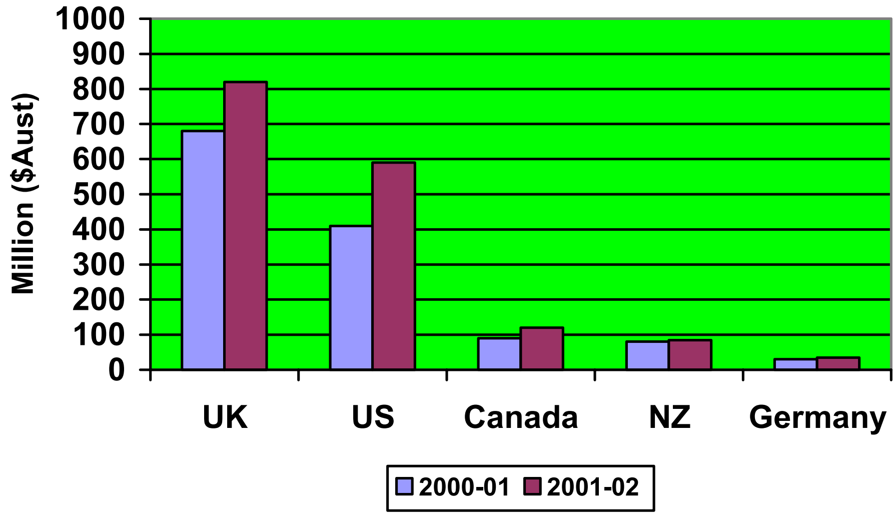
Since 1994-95, export records by volume have been consistently broken each year. The world really is going for Australian wine in a big way. Where once we were fated only to take on the Major New World group (U.S., Chile, Argentina, South Africa etc.), we now appear more than ready to take on the big three of France, Italy and Spain in the premium wine sector.

Moreover, when we look at Australian wine exports in dollar terms, the figure has grown from about $13 million in 1973 to about $2 billion dollars in 2002.

All seems rosy indeed. But there are a few challenges we have to meet to maintain these outstanding export growth rates.

First, our top five export markets tend to remain unchanged. This is not a major problem per se but saturation point for Australian wines in these markets may be reached if we do not balance out our export market base. This is particularly the case in the UK and US who we overwhelmingly rely on for growth in exports.

Australian Wine Exports, Top Export Markets

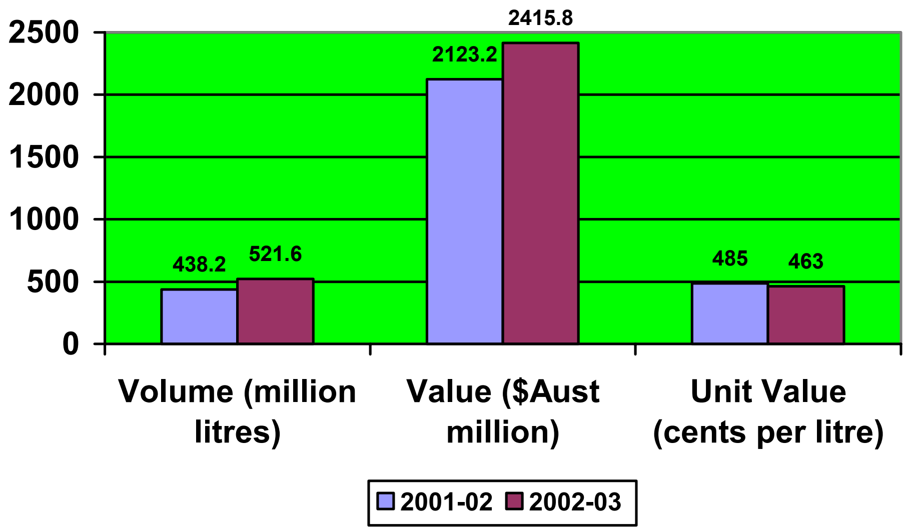


Source: AWBC Export Database

Second, these markets have generally accepted Australia as a top value wine producer – but for the real 'special occasion' stuff, they still tend to go for the French and Italian wines. (Note that while a lot of fuss was created by the release of the 1998 Grange Hermitage in the U.S. and U.K., the wine barely rated a mention in Continental Europe.)

This means that outside of the U.S. market which buys 77% of our premium priced wines, we are struggling to increase the dollar-per-litre price of our exported wine. Hence, in 2002-03, while exports in terms of litres was up 19%, we actually experienced a 4.4% decline in the dollar-per-litre return during the same period.

Comparative Export Annual Totals



Source: AWBC Research

Producing good value wines has been a successful strategy but it can also create a situation where Australian wines become too synonymous with a 'good value wine', not a 'special occasion' one. This is where out marketers have to go to work and take on Europe's big three. It is a strategic marketing issue because most experts agree that Australia's premium wines can hold their own vis-à-vis top Bordeaux clarets and Tuscan super-reds in terms of quality.

Other factors

(a) Managing Supply

Gross grapecrush supply is increasing by about 3% each year while wine sales in volume have increased by about 7% annually. Hence, medium term supply shortages are emerging as a prospect.

(b) Anticipating global consumer trends

Good wines begin from good grapes from vines that have been entrenched in the vineyard for a period of time and are well cared for. This means that we have to make long term predictions about which grape varieties will rise and fall in global demand years from now. This is especially the case for premium wines which generally rely on the older grapevines to produce the best wine making grapes – sometimes vines that are ten, twenty, thirty or more years old. Simply ripping them up and planting a new variety when demand arises is not the way to make quality wines.

Currently, Australian wines are most famous worldwide for shirazes. Subsequently, there has been an increase in shiraz grape production over the past decade.

However, experts generally take different positions on the demand for Australian wines over the next 1-2 decades:

i. Demand for shirazes will continue to rise.
ii. Cabernet Sauvignons will become the iconic Australian wines in the future.
iii. Our Chardonnays will make a triumphant emergence on the world stage.

The point is that failure to correctly anticipate global market expectations and demands at the vine planting level has the potential to impose severe limitations on our export growth prospects. Moreover, compensating for incorrect predictions by mass planting will decrease the quality of the wine and harm the 'value for money' reputation we have worked hard to achieve.

(c) Old World Competitors will become more strategic

Australia has been successful in Major New World Export Markets by targeting all major price levels (beneath the super premium and icon levels) and over-delivering in terms of quality. It is general agreed that the $10 Australian wine is usually of better quality than the $10 French or Italian wine.

The French have had enough of us and who knows how long the U.S. fascination with our shirazes will last. Old World wine producers are beginning to catch onto this and combined with investment in modern wine producing methods and equipment (in order to guarantee consistency in quality) they are now fighting back to recapture the Major New World export markets at all price levels with above average quality wines. In other words, they are beginning to mirror the Australian strategy.

The difference is that rather than begin from a bottom-up marketing campaign (build a reputation for good value → move into prestige markets), Old World Wines have the luxury of employing a top-down marketing campaign (begin with a reputation for old world tradition and prestige → move into lower price levels whilst leveraging off the prestige label).

Australia slipped beneath the radar of many of our Old World competitors who assumed that a country younger than many of their vineyards could possibly compete. That is no longer the case and now the Australian wine industry is the most analysed of all New World producers. This is a great compliment but it also means things will get harder from now on.