



Rabobank

Wine Quarterly Q2 2018

Reflections from ProWein 2018

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Higher prices do not discourage investors

Thoughts from ProWein

Higher prices for wine are now assumed and accepted and innovation is increasing as categories blend. Demand for organic wine is growing, even if it has taken longer than initially anticipated. These, and other items, provided food for thought after our visit to ProWein.

Russia, China, Brazil import more wine

In 2017, these three countries sharply increased their imports of wine from Italy, France, Spain, Australia, and Chile. The wine trade continues to move further away from its traditional markets.

M&A: Two deals to remember

The collapse of the UK's Conviviality is a good reminder of how severe growing pains can be. The rapid reaction of AB InBev and C&C also offers some food for thought. Accolade's acquisition by US P.E. Carlyle for USD 770m reflects the appeal of China's growth potential for Australian wineries as well as investor interest in the wine industry.

Bulk wine prices remain firm

Closing Q1 and entering the harvesting period for the Southern Hemisphere, bulk wine prices remain high after having steadily increased in the last months of last year. Tight availability is likely to prevent any correction in the near future.

What we saw at ProWein: thoughts after the event

Dusseldorf's ProWein was 'the place to be' in terms of wine industry events, bringing together over 6,800 exhibitors – large and small, historic and start-ups – from over 60 countries. This year's event was very busy, even though the unseasonal weather left some visitors grounded. Given the scale of the fair, it would be misleading to say that we saw it all, but we still saw enough to come out with some food (or drink?) for thought. Here are some of the trends that could be observed around the stands:

Higher prices, no discussion

Given the 2017 harvest and the bulk wine prices seen in the last few months, it was unavoidable to see bottled wines trading at higher prices at this moment of the year. Buyers were therefore neither surprised nor pushing those prices back. We understand that some of them were perhaps more cautious with their volumes, but in general terms, deals were closed as usual.

Blurring boundaries

Wine companies are flirting with spirits. Although predominantly a wine trade fair, some (craft) beers and spirits were also represented. Interestingly, we identified a number of wine companies with extensions into the spirits segments, going beyond the historic production of brandy (gin was unsurprisingly a recurrent offer). In some cases, their spirits portfolio was already incorporated in a fully-owned but standalone subsidiary or division that gave the business its own identity. In other cases, established wine producers had created an independent new spirits business in joint venture with third parties, such as Les Bienheureux, producing rum and French whisky and jointly owned by two partners well-rooted in the wine industry. Other wineries remain closer to their core business but offered innovative products more associated to spirits than wine, such as wine-based gin & tonic flavoured cocktails in single-serve bottles. Others looked to narrow the gap with beer. In addition to some blended products, we saw Winebeer, a Chilean wine-based drink with macerated hops. Its flavour is closer to beer, but it has wine alcohol and is gluten free.

Packaging equals glass in Europe

In the US, it is increasingly acceptable to see quality wines in cans, bag-in-box, or other packaging alternatives. But we were in Europe and I dare to say that over 90% of what we saw was packed in glass bottles.

Some suppliers confirmed that it is hard to push other packages for anything that is above the value segment.

That triggers a collateral thought: If glass is going to maintain its share in wine, bulk exports combined with bottling closer to the retail/consumption point (where possible) will keep gaining traction in order to maintain costs and keep sustainability targets on track. With wholesalers aligning with their buyers to launch their own brands, the demand for quality bulk can only be reinforced.

New consumer trends vs. stubborn reality: organic and non-alcohol wines

We saw quite a bit of organic wine in all pavilions. The producers that we spoke to were happy but cautious, indicating that demand is definitely growing but at a slower pace than originally anticipated by trend gurus. We were surprised to hear that consumers are still rather confused about what organic wine is, let alone natural or biodynamic wine, for which no official definition or certification is available. The profusion of terms and perhaps the fact that each market has its own sensitivities – we hear that Irish are very sensitive to 'bee friendly wines', while organic is in high demand in Scandinavia – does not help to standardise and roll-out the products.

Non-alcoholic wines are lagging alcohol-free beer. We saw some offers, in particular in the German pavilion, but were unable to test the product. And taste may be the main drag for the expansion of alcohol-free wine, as the difference in flavour between the alcoholic and the non-alcoholic versions is, so far, much bigger in wine than in beer.

Route to market has further room for consolidation

In the wine industry and in many others, the middle-man in all its shapes and positions – wholesaler, distributor, importer, and exporter – has been getting squeezed out for some time. This is perhaps why we were surprised to see and hear how fragmented the industry still is, often forcing producers to negotiate with several counterparties for each country. Given the number and nature of wholesalers and other intermediaries still around, we believe that domestic consolidation on the route to market will continue in the coming years, at least in a number of European countries.

Cider's identity struggle

Admittedly, cider is an outsider in the wine quarterly. But we felt it was almost a matter of justice to at least mention it once. As niche premium cider producer Ramborn fairly indicated, cider is 'closer to wine in production issues and closer to beer in consumption, but eventually out of both large categories'. Artisanal cider made directly from fresh fruit is vulnerable to volatile harvests, like wine. But it also ticks a few boxes in terms of new consumption trends: traceability (possibilities of using single varieties of apples, single origin), lower alcohol, natural product, history (some orchards are rather old). However, a large proportion of the cider currently available on the market consists of low-priced products made from concentrate. The premium alternatives, with significantly higher costs and prices, are for now just a niche. We see a future for it, but only as a niche product in selected markets for the time being.

Winery M&A

Among all the corporate activity of the first quarter, we would like to highlight two events: The rollercoaster at Conviviality and Carlyle's purchase of Accolade.

Conviviality: Operational risk and distribution control

Conviviality expanded rapidly through transformational acquisitions to become the largest alcoholic drinks wholesaler in the UK, with a market cap of GBP 550m. Within a few weeks this was reduced to nil. Conviviality's fate triggers two major thoughts: First, it is a hard reminder of how operational risk can derail a company if control structures and processes do not match the scale of the deals. Consolidation and subsequent economies of scale remain a very valid strategy, but each player should assess their capabilities before choosing their role in the game.

Second, it is about having distribution and the route to market under control. Conviviality was a major distributor of AB InBev's products. Its collapse would have affected the beer producer, among many others. The speed at which C&C and AB InBev stepped in to minimise the disruptions is a good example of the importance of keeping the route to market under control, even when it is externalised.

Accolade: PE growing bullish on wine

In the antipodes, Accolade Wines was purchased by US private equity group Carlyle for AUD 1bn. The rising exports of Australian wine to China and the remaining

upside potential is reshaping the Australian wine industry. But the deal also highlights the positive stance of PE sponsors and other private investors on the wine industry's medium-term outlook. And this not only in Australia, but across the globe: DeA Capital in Italy; Artemis and Wertheimer Brothers in France, and Scranton Enterprises (Spain) are other recent examples of investment vehicles and funds stepping into the wine industry.

Global trade

Export trends of major producers

France:

Exports of French wine in 2017 increased both in volume (+7%) and value (+10.3), with all segments showing a positive trend. Sparkling wines other than champagne showed the strongest performance (+11.8% in volume, 13% in value), while Champagne exports benefited from strong demand from the US, Singapore, and other markets that could more than offset a weaker performance in the UK (-9.3%). Exports of still wine to the top four countries: US, UK, China, and Germany increased and average prices were higher, except for Germany. Although small in absolute terms, growth in demand from Brazil (+74%), Poland (+45%), and Russia (+30%) must be highlighted.

Italy

In 2017, export growth was strongly supported by sparkling wines, up by 9.2% in volume and 13.6% in value. Still wines and bulk also had a positive trend but were less spectacular, with volumes up approximately 2.3%. By destination, exports to Russia, Brazil, and China showed remarkable increases for both sparkling and still wines. The US, Germany, and UK remain the three largest markets for Italy and exports of sparkling wines increased for all three, but among these countries, only the UK imported more still wines in 2017.

Spain

In 2017, wine exports increased by just 2% in volume terms, driven by rising sales of bottled wine (+4%), while exports of bulk and sparkling wines were virtually stagnant. Exports in value terms, up by 7.7% in the year, show a much rosier picture, as bulk wine prices escalated, particularly in 2H. In 2017, China was the fourth-largest buyer of Spanish bottled wine and fifth for bulk wine.

US

In 2017, US wine exports contracted by 9.4% in volume but a positive trend in average prices resulted in a 6.7% reduction in value terms. Trade with the UK was the most remarkable change in the industry: US exports of bottled wine to the UK contracted by 64%, or over 31m litres in the year. This was only partially compensated by a 34.5% increase (around 23m litres) in exports of bulk wine to the same country.

Table 1: Change in wine exports for selected countries, 2017

Country	Volume change (%)	Value change (%)	Period of measure
France	7.0	10.3	Jan-Dec
Spain	1.8	7.7	Jan-Dec
Italy	3.4	6.2	Jan-Dec
US	-9.4	-6.7	Jan-Dec
Argentina	-13.7	-2.3	Jan-Dec
Chile	4.5	9.4	Jan-Dec
South Africa	3.2	-2.1	Jan-Dec
Australia	9.4	16.7	Jan-Dec

*Value changes in local currencies, Argentina and Chile in USD
Source: Wine by Numbers, OIV 2018

Argentina

In 2017, exports declined by 13.7% in volume and 2.3% in value terms. The numbers reflect a sharp contraction (-40.6% in volume) in bulk exports due to scarcity in the market. It is worth noting that the UK was the largest market for Argentine wines in 2017, following an 11.4% increase in exported volumes for bottled wine and a modest 1.6% contraction in bulk. Exports to the US contracted by 12.9% for bottled wine and 47.5% for bulk.

Chile

Chilean exports increased by 4.5% in volume and 9.4% in value, with price increases particularly high for bulk wines. Argentina has been a major purchaser of bulk wine due to its own meagre production, while China has clearly emerged as the largest market for Chilean bottled wine, with an increase of more than 30% in the year.

South Africa

In 2017, wine exports increased by 3% in volume, with both bulk and bottled wine edging up. However, export value in local currency declined by 2%. Among the largest buyers of South African wine, lower sales to the UK were offset by higher exports to Germany, the Netherlands, and the US. While sales of bottled wine to the US increased by only 1.6% in volume, exports of bulk wine grew ten-fold compared to the previous year.

Australia

Australian exports in 2017 reflected the sharp increase in sales to China, which is now the largest buyer of Australian wine in value terms, outpacing the US. Exports of bulk wine contracted, with the exception of sales to China, while exports of bottled wine to Europe – UK, Germany, The Netherlands, and Sweden – saw a positive trend that more than offset weaker sales to North America

US import trends

US wine imports rose 8% in volume and 7% in value in 2017, compared to the prior year (see Table 2). Two segments stand out as key growth drivers: Bulk wine, with import volumes up by 24%, and sparkling wines, up 11% on a sustained positive trend. Vermouth is also becoming an increasingly popular segment, with volumes up by 8%, but imports increasing by 18% in value terms.

Italy continues to be the largest supplier of imported wine in the US, generating almost twice as much volume as the next closest competitor. Imports from Italy rose 4% by volume and value in the period, led by growth of sparkling wine (12%) – accounting on its own for 60% of the additional volume. The remaining increase corresponded to vermouth and bulk wines, followed by mixes and still wines over 14%.

Imports from France rose 14% by volume and 15% by value. The growth is being led by bottled table wines, reflecting the ongoing demand growth for French rosé, as well as by sparkling wines. Bulk wine imports are marginal but were up by 50% in the year.

Import volumes from Spain rose by 14%. While absolute volumes remain dominated by bottled table wines (+7%) followed by sparkling (+6%), the fastest growth corresponded to bulk wine (+152% in volume).

Imports from Australia increased by 24% in volume, driven by an 89% increase in shipments of bulk wine that more than offset a 6% decline in bottled wine imports. Bulk wine import volumes are quickly approaching those of bottled wines, and the change in the mix has a clear impact on the average price per liter.

Imports from New Zealand rose by 5% in volume and 6% in value, mainly reflecting a faster growth of bottled wine imports (+7%) than bulk wine (+2%).

Chile saw volume sales to the US decline by 9%, with declines in shipments of both bottled (-5%) and bulk (-11%).

Table 2: US imports by country of origin, Jan-Dec 2017

	Value (USD million)	Change (%)	Volume (thousand cases)	Change (%)
Italy	1,931.9	4	39,214.80	4
France	1,829.4	15	17,995.30	14
Spain	378.9	5	10,212.10	14
Australia	407.2	3	20,694.80	24
New Zealand	442.7	6	7,703.80	5
Chile	281.6	-2	15,659.90	-9
Argentina	307.5	-6	7,911.50	-15
Portugal	96	9	2,055.50	8
World total	6,131.6	7	144,866.00	8

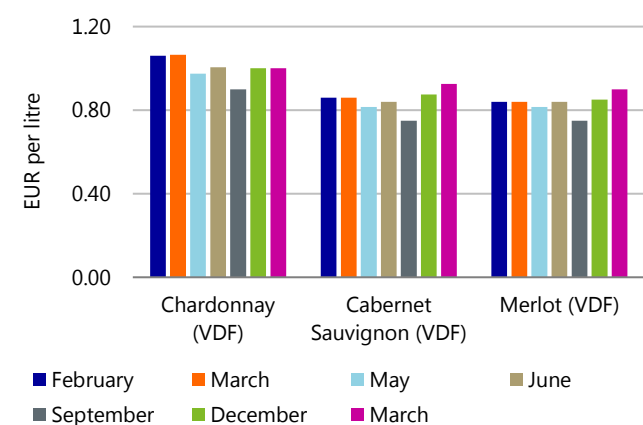
Source: The Gomberg-Fredrikson Report 2018

Bulk wine pricing

Generic bulk wine prices in the first months of 2018 remain at the high level reached at the end of last year, or have edged up further, as they continue to reflect the impact of the short harvests in Europe. Even in France, where bulk wine exports consist mainly of varietals as opposed to generic wine and initially shrug-off any price increases, scarcity triggered higher prices towards the end of the year that are continuing to hold steady (see *Figure 1*).

Having said so, lack of availability is probably a bigger problem than prices for many products.

Figure 1: Prices for French bulk wine by varietal, June 2017-March 2018

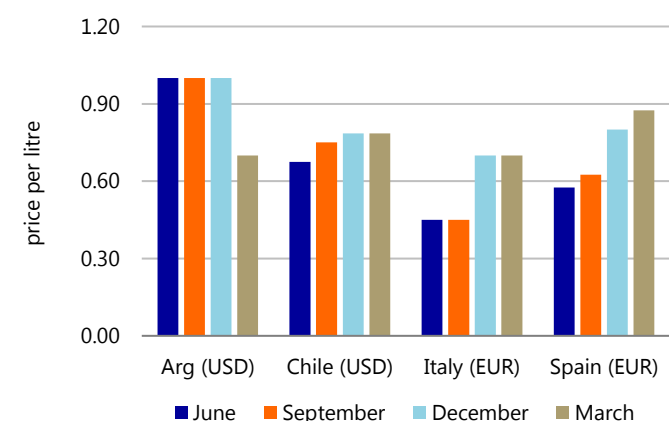


Source: Ciatti Company 2018

Given this situation, all eyes are now turned towards the harvest in the southern hemisphere. Although larger volumes are expected in various markets (South Africa being the key exception), this is not enough to move the market back to balance and continued tight supply from Europe is encouraging early purchases. So far, bulk prices remain high when compared to a year earlier (see *Figure 2 and 3*).

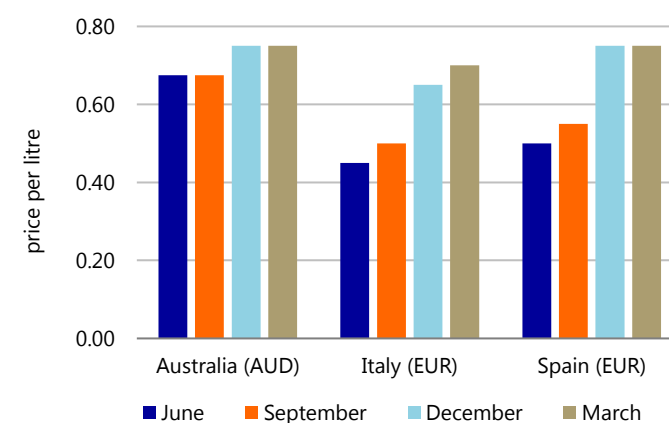
It is worth noting that the Argentine prices above are quoted in US dollars and thus the lower prices in March of this year reflect the weakness of the peso. Nevertheless, this may have an impact on competitor's prices.

Figure 2: Prices for generic red bulk wine by country of origin and currency, June 2017-March 2018



Source: Ciatti Company 2018

Figure 3: Prices for generic white bulk wine by country of origin and currency, June 2017-March 2018

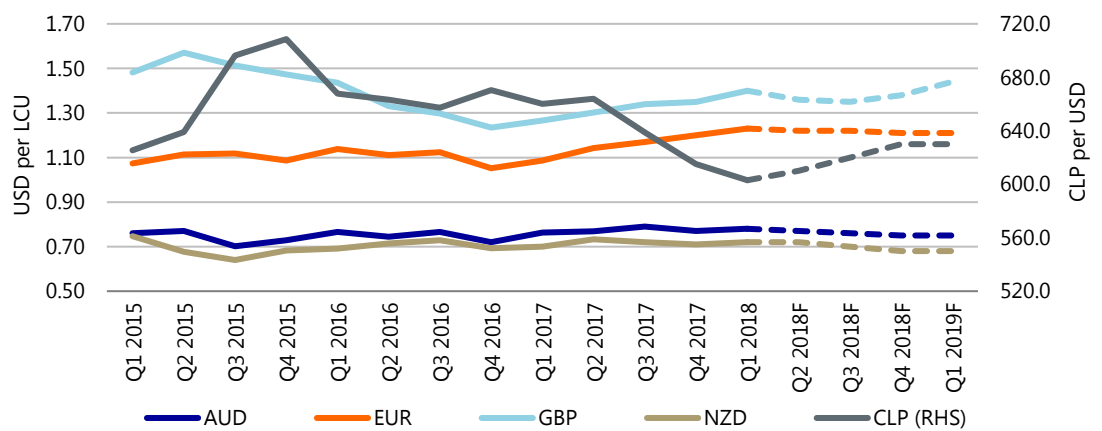


Source: Ciatti Company 2018

Currency outlook

Broadly speaking, 2018 started with a continuation of last year's weak USD tone. Currencies such as the AUD and the EUR were supported by optimism regarding the pace at which their respective central banks could withdraw monetary policy accommodation. These expectations soon petered out. The market now sees no policy move from the RBA in addition to the RBNZ this year, and both the AUD and NZD have softened from their January levels. While the ECB is widely expected to bring its quantitative easing programme to a close this year, we see no rate hike before September 2019 at the earliest. February proved to be a good month for the USD. Although fears of trade wars have caused a few wobbles for the dollar, EUR/USD continues to hold a choppy range, which we expect to persist in the coming weeks. GBP has found support both from a hawkish BoE and from the news that the EU and UK have agreed a Brexit transition deal. The ARS has remained under pressure, despite FX intervention by the central bank. There has been little net change in USD/CLP since the start of the year (see Figure 4).

Figure 4: Wine currency movements and forecasts, Q1 2015-Q1 2019f



Source: Bloomberg, Rabobank 2018

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