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Status Quo Under Pressure in US Route-to-Market

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Channels and strategies for reaching the US wine consumer continue to evolve

Route to the US consumer

Major changes are occurring today in how wine reaches the US consumer. Changes in technology, business models and market structure are disrupting the market and creating new sets of winners and losers among wholesalers, retailers and suppliers. Responding quickly to these changes will determine who survives, who thrives, and who fades away.

M&A: Wine distributors closing deals

The number of deals involving wine distributors is growing. Covering new areas, incorporating other products, or achieving economies of scale are major reasons behind these acquisitions. In the last few months, US and German players were particularly active, but deals for wineries and wine distributors were seen across the globe.

Global trade reflects 2017 harvest

The tight 2017 harvest meant higher prices, but also a shift in trade flows: In Q1, exports of bulk wine from Australia, South Africa, and the US increased by 21% to 60%; while Argentina, Chile, and Italy saw declines of 20% to 30%.

Bulk wine prices remain firm

European wine production is expected to show marked improvement over 2017 levels, which should theoretically lead to easing bulk wine prices. However, growing concerns over exceptionally wet weather in France and Spain are keeping an upward pressure on prices

Disruptions to traditional paths to the US consumer

The US has emerged as the largest wine market in the world, and by most measures, the most profitable and most attractive. While most wineries – both foreign and domestic – recognise the profit potential of the market, it is also widely seen as an exceptionally difficult market to penetrate (particularly for small wineries), given the three-tier system, retailer consolidation, etc.

While many of the fundamentals of the US market remain intact, it is also important to recognise that there are major changes occurring in how wine reaches the consumer today. Consolidation, changes in technology, and new business models are disrupting the market and creating new sets of winners and losers across all three tiers of the industry. For wineries that are active in the US market (or looking for ways to penetrate it) it is worth examining a few of the more important changes that are happening among wholesalers, retailers, and wineries.

Wholesalers

The next phase of wholesaler consolidation

When looking at the changes in the route to consumers in the US, one of the most obvious changes has been the recent round of wholesaler consolidation. The merger of Southern Wine & Spirits with Glazer's in 2016, and the subsequent merger of RNDC and Breakthru (formed by the merger of Charmer-Sunbelt with Wirtz) has created two wholesaler networks that cover almost the entire country.

This process of consolidation has had tangible benefits for some large suppliers who can now access the market via a single wholesaler, but small suppliers suggest it is now even more difficult to maintain support for their brands.

Each new round of consolidation creates opportunities for smaller wholesalers because many small suppliers have trouble getting support for their brands from the large wholesaler networks. However, working with smaller wholesalers has other challenges, in that it requires managing a network of various wholesalers to reach different markets. Furthermore, small wholesalers often face more challenges penetrating the large retail chains, which dominate many US markets.

There are, however, some smaller wholesalers who are trying to expand their geographic footprint and expand their scale (see the discussion on Winebow and Wilson Daniels in the M&A section that follows). While these smaller wholesalers still lack the strength and reach of the larger wholesalers, they are positioning themselves as a viable alternative to the larger wholesalers.

LibDib: a three-tier compliant alternative model

The dilemma facing small suppliers of whether to work with a large wholesaler that may not give their brand sufficient attention and support, or to work with a smaller wholesaler that may not have the same market access is not new, but has become exacerbated with the ongoing consolidation.

What is new, however, has been the emergence of a new wholesaler model which is three-tier compliant and allows small suppliers to access the market. Liberation Distribution – LibDib – functions more or less as a virtual wholesaler, connecting brands with retailers and on-premise accounts via an online platform. Currently, LibDib only functions in California and New York, but it has plans to eventually expand across the country. LibDib is open to all suppliers, and creates access to the market for brands that were previously kept out because they could not find a wholesaler. In that sense, this new model has been a boon for small, new brands attempting to penetrate the market.

Retailers

The changes within the wholesaler tier are well-documented and well-known, but there are also critical changes occurring within the retail tier. New retailers are disrupting traditional models, and new technology is changing how consumers access the market.

Total Wine & More – disrupting traditional retail

Within the retail environment, few developments have been more disruptive to traditional retail models than the rise of Total Wine & More (TW&M). Its well-designed stores, broad product selections, and low-prices have made it a formidable competitor for every other retailer in the markets where it operates. Its reliance on clearance wholesalers (wholesalers that provide minimal services – and thus fulfil the three-tier obligations – but charge minimal service charges) are disruptive to traditional wholesalers. Its heavy reliance on retailer-exclusive brands (but often using well-known national brands as price references) has created dilemmas for other retailers, as well as for some large brand-owners, but has helped make it an extremely successful retailer. It now generates approximately USD 3bn in sales from 182 stores across 22 states, and it continues to grow.

While TW&M's strategies are disruptive for established players, the chain has been a boon for many small to medium-size suppliers that have found success in supplying the retailer with exclusive brands at very reasonable margins. In this sense, TW&M has become an important means for small suppliers to access a market that otherwise can be very difficult to penetrate.

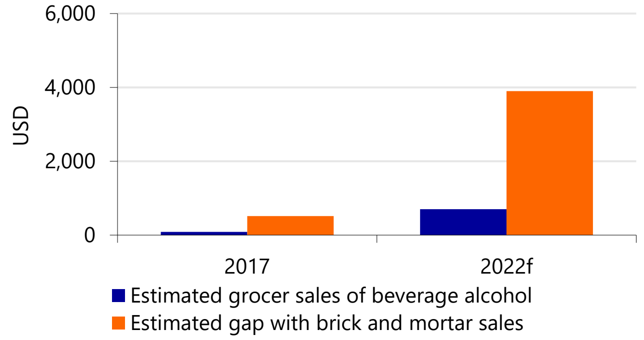
The 'Amazon Effect' and its impact on wine retailing

While many aspects of retail have been shifting to ecommerce, grocery sales had been moving to this channel at a much slower pace. This has changed dramatically over the past year, in the wake of Amazon's acquisition of Whole Foods in June of last year. Grocers are now aggressively trying to make up for lost time, building up their ecommerce capabilities to fend off the threat of the Amazon Effect. But as grocers have been busy building up their ecommerce capabilities, and online sales of groceries are gaining momentum, the alcoholic beverage category has been notably lagging. Beverage alcohol generates 4.7% of grocery store sales in brick and mortar stores (B&M), but only 0.7% of grocery stores' online sales. In other words, grocery stores sell more than six times as much alcohol in B&M than they do online.

There are numerous reasons why grocers' online alcohol sales lag B&M, including onerous individual state regulations, as well as retailer concerns around effective age verification at the time of delivery. In many cases we've reviewed, however, it is clear that grocers have plenty of room for improvement in developing effective online marketing of alcohol brands.

The shift to online grocery sales, coupled with the under-penetration of alcohol, has resulted in retailers missing out on an estimated USD 100m in alcohol sales in 2017. If retailers continue to underperform at the same rate, and online grocery sales continue to grow as projected, retailers will be losing nearly USD 4bn per year in alcohol sales by 2022 (*see Figure 1)*. With consumers finding it more difficult to buy wine online with their groceries than they do in B&M, it remains to be seen if they will make the extra effort to buy wine through other channels, or if they will simply reduce purchases. This should present a legitimate concern for both grocers and wineries.

Figure 1: Estimated online beverage alcohol US grocers and sales gap with brick and mortar, 2017-2022f



Source: Rabobank estimates based on FMI data, 2018

The shift to e-commerce has been a challenge for retailers, but also represents the potential for a major shift in competitive positioning among suppliers. There is a whole new learning curve ahead on how to effectively market to consumers online. The factors that drive success are changing. Future success will depend on whether or not companies embrace these changes and make the appropriate changes to their business models.

One client recently described the current environment as "jump ball"... and it's anybody's game.

Specialty wine retailers dealt a blow

While most of the major grocery chains have been lagging in the move to online sales, there are a myriad of small, specialty retailers around the US that have been quietly building up their online sales capabilities – often well ahead of many of the major grocers. In a recent research note, *The Times They Are E-Changin'*, Rabobank estimated that these retailers were responsible for nearly 60% of all beverage alcohol sold online – primarily wine.

Moving into 2018, these retailers are now facing a challenge, as FedEx, UPS, and other carriers have announced that they will no longer accept interstate shipments of wine, responding to pressure from states that have been increasingly seeking to enforce bans on shipments from out-of-state retailers. It is unclear just how much of the USD 975m in (conservatively) estimated sales that this segment generates will be lost, given that intra-state shipments will not be affected, but this has clear potential to weigh on overall wine sales this year and moving forward.

Suppliers

With all of the changes that are happening in the market, it is not surprising that suppliers are also changing the models they use to reach consumers.

Treasury Wine Estates makes a bold move

The recent changes to the route-to-market announced by Treasury Wine Estates – establishing their own distribution system in states where it is permitted, while switching wholesaler networks in other states – is perhaps the most dramatic change seen among the large suppliers. It remains to be seen how successful they will ultimately be in this effort, but the moves reflect the growing sense among many suppliers that they need to change their modus operandi in the face of changing market conditions.

DTC becoming e-DTC?

The combination of wholesaler consolidation (making access to traditional retail markets more difficult) and increasingly favourable laws for direct-to-consumer (DTC) shipments, have driven many small US wineries to focus on this channel. As a result, DTC sales have been growing at a CAGR of 12% (value) since 2011, and this is the main source of revenue for small wineries.

But even in this channel, the market is changing. In many key wine regions, local municipalities are trying to contain the growth of the wine industry to limit challenges with traffic and noise. In this context, it is becoming increasingly difficult to drive sales growth solely by increasing the number of visitors to the tasting room. Wineries must look to become more effective at driving sales from their existing customer base. A recent study by WineDirect suggests that the wineries that were most successful with their ecommerce programmes were also the most successful at DTC. According to their data, 89% of all ecommerce sales were made by the top 20% wineries. Building out ecommerce capabilities is also becoming a priority for the DTC channel.

Conclusions: Jump ball!

For wine companies active in the US wine market, the channels for reaching consumers are undergoing numerous and profound changes, all occurring at a rapid pace. These changes – and how companies respond to them – will likely re-write the list of winners and losers in the market over the coming years. The oft repeated refrain that it is no longer about 'big versus small', but about 'fast versus slow', is extremely relevant.

If we truly are in a 'jump ball' situation, it may be time for wine companies to reassess their strategies for bringing their brands to market in order to be sure they are prepared for tomorrow.

Winery M&A

More on route-to-market: Distributors search for scale

In a search for scale, product, and market diversification, wine wholesalers and distributors continue to close deals across the globe. As wine supply and demand becomes more international and routes to market evolve, these factors will gain further relevance, triggering further consolidation.

In the US, Concha y Toro acquired full control of Excelsior Wine Co., the import and marketing agency joint venture it had formed with Banfi. With this move, Concha y Toro will finally be able to bring its imported South American brands into the same portfolio as Fetzer and its other US brands, giving it greater distribution strength in this key market.

The challenges for smaller brand owners resulting from the consolidation of the top US wholesalers appears to be creating incentives for smaller wholesalers to focus on expanding the markets they cover. Winebow Group has continued to build out its distribution footprint by acquiring Negociants USA, a California-based importer of wines from Australia and New Zealand. Similarly, California-based wine distributor Wilson Daniels acquired Galaxy Wine Company (Oregon) to expand its operations on the West Coast and establish itself as a bi-coastal wholesaler.

In Europe, wine companies have been actively expanding their route-to-market, taking direct distribution into their own hands, while established distributors have been expanding their footprint to adjacent markets.

Henkell has bought a 75% stake in Lithuanian distributor Filipopolis, increasing the number of countries in which it operates subsidiaries to 22, and closing its sole distribution gap in the Baltics. Rotkaeppchen-Mumm bought wine trading company Eggers & Franke, and German wine wholesaler and distributor Hawesco is negotiating the acquisition of Austrian wine distributor Wein & Co.

Similar deals for distributors have also been closed in other parts of the globe, including emerging markets: In Romania, Alexandrion bought wine importer and distributor Halewood Romania, and in Brazil online wine and beer retailer W2W has bought Bodegas Selecionadores de Vinhos, an importer and distributor of wines for the corporate market.

Private Equity Thirst

Finally, in our previous quarterly we noted Carlyle's acquisition of Accolade and signalled that the number of deals closed by financial investors was growing. If anything, this trend has accelerated. Given the characteristics of the wine industry (fragmentation, family/private ownership, scope for synergies and efficiencies through consolidation), more will follow.

Carlyle continues its acquisition spree in the wine space, this time taking a controlling stake in Spanish winery Codorniu, a leading Cava producer.

In Norway, investment group Canica acquired Arcus, a major Scandinavian wine and spirits wholesaler and producer of a range of spirits.

In Italy, private equity firms 21 Investimenti and Aberdeen will jointly buy a minority stake in Casa Vinicola Zonin, ahead of a potential IPO in the future.

In New Zealand, Gladstone Vineyard has been acquired by Odyssey Capital Group in partnership with Australian wine producer The Flying Winemaker.

Global trade

Export trends of major producers

France

Exports of French wine during Q1 2018 were virtually stagnant in volume terms, as a 3.8% increase in sparkling wine exports was offset by lower volumes in other bottled wines and bulk. Sparkling wines, other than champagne, saw the best performance, up by 7.2% in volume. The 2 litre-10 litres packaged wine segment also enjoyed a particularly strong quarter, up by 13.7% in volume and 26.3% in value, even if it remains just a marginal part of total trade. In value terms, exports increased by 3.2% YOY, with average prices rising in still wines and bulk, while contracting slightly for sparkling. The US (+11.7% in value) consolidates its position as the largest buyer of French wine, even if sales of Champagne to the country diminished in the period (-14% in value). Sales to Germany increased both in volume and value terms, while exports to the UK contracted in volume – although they were around 3.5% higher in value.

Italy

Exports of Italian wines declined by 9% in volume during Q1 2018, although they increased by 4.6% in value terms. The numbers reflect the lower product availability after 2017's tight harvest and the resulting higher prices, in particular for common table wines, bulk, and 2 litre-10 litre packages. Volume and price trends were more positive for sparkling (+2.8% in volume; +14.6% in value) than for still wines (-1.2%; +1.8%), but export growth for sparkling wines is slowing down. Exports to the US increased further (+5.8% in volume and 3.7% in value), while sales to the UK and Germany suffered double-digit declines in volume. In Germany, this predominantly reflects a sharp decline in bulk and a modest reduction in bottled. Exports to the UK saw lower volumes in all categories, with 2litre-10 litres and still bottled wines suffering the greatest contractions.

Spain

In Q1 2018, exports of Spanish wine declined by 6% in volume but increased by 7.5% in value when compared to the same period of last year. Bulk wine saw an average price increase of 40%, reflecting the impact of a tighter output in 2017 – for other categories average prices increased 8% to 11%. Bulk wine exports to France were stable in volume terms. Exports to Germany, Italy, and Denmark increased but Portugal, Russia, and China imported less Spanish bulk. Meanwhile, bottled wine sales to China were up by almost 10% in volume, partially offsetting lower demand from Germany, the UK and the US.

US

In Q1 2018, US wine exports increased by 9.4% in volume and 6.6% in value terms. The apparent decline in the average price per litre reflects a change in the mix between bottled wines (-13% in volume) and bulk (+60.8%), while average prices actually increased in both segments. The UK's position as largest bulk wine buyer is again reinforced as the country increased its imports. Other European countries, such as Belgium, Denmark, Germany, or France have also increased their bulk purchases from the US, although often reducing their imports of US bottled wine at the same time.

Table 1: Change in wine exports for selected countries, Q1 2018

Country	Volume change (%)	Value change (%)	Period of measure
France	-0.1	3.2	Jan-Mar
Spain	-6.0	7.5	Jan-Mar
Italy	-9.0	4.6	Jan-Mar
US	9.4	6.6	Jan-Mar
Argentina	-8.3	1.2	Jan-Mar
Chile	-10.3	4.4	Jan-Mar
South Africa	-3.9	10.2	Jan-Mar
Australia	21.0	18.7	Jan-Mar

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

Argentina

In Q1 2018, exports declined by 8% in volume but increased by 1.2% in value YOY. A higher average price per litre is a result of both higher prices for each category and a change in the mix, as bottled wine exports declined much less than bulk wine sales. However, it seems that bulk wine exports have been increasing in more recent months. Lower volumes bought by the US and Canada were only partially compensated by higher exports to Brazil, Mexico, Germany and China. Germany and France also bought more bulk wine from Argentina.

Chile

Chilean exports declined by 10.3% in volume and increased by 4.4% in value. Exports of bulk wine were down by almost 22% in volume, with the average price per litre 24% higher than a year earlier. Bottled wine also had a strong start to the year, with volumes up by 1.1% and value up by 6.1%. Exports to China – now the largest buyer of Chilean wine – increased significantly, reflecting the positive impact of the country's trade agreement.

South Africa

Exports declined by 4% in volume but increased by 10% in value. Bulk wine exports were 9% lower than a year ago and this was only partially compensated by a rise in 2 litre-10 litre packaged wine (+21%). Average prices increased for all segments, in particular for bulk wine (+30.6% in local currency). Volumes of bulk wine sold to the major European buyers were up significantly: UK (+28%), Germany (+46.7%), Denmark (+81%), France (+6.7%), while sales to North America and other markets declined. Exports of bottled wine were stable as a 40% increase in volumes sold to the UK could offset lower sales to other countries.

Australia

Exports increased by 21% in volume and 18.7% in value. Volumes of bulk wine exports increased by over 51% when compared to Q1 2017, while bottled wine volumes were stagnant and exports of 2 litre-10 litre packages contracted by approximately 15%. With this change in the mix, the average price per litre declined, despite higher export prices at each segment. Exports to China increased by more than 80% in volume terms and sales to the UK also increased double-digit, while the US bought more bulk but less bottled wine than a year earlier. Looking ahead, delays at Chinese ports amid strained ties between China and Australia may distort exports in the short term.

US import trends

US wine imports rose 14% in value but declined by 1% in volume during the first two months of 2018 and when compared to the same period of 2017 *(see Table 2)*. The lower volumes reflect a contraction in bulk wine imports, as bottled wine imports were up by 4% in volume and 14% in value during the period. Sparkling wines saw further growth both in volume (+12%) and value (+8%), although the growth rate is slowing down. Vermouth remains a relatively small segment but maintains a very strong momentum, up by 22% in volume and 224% in value. Imports from Italy, France, and New Zealand saw double-digit growth in value terms, more than offsetting lower purchases from Germany, Argentina, Australia, and Chile

Imports from Italy rose 7% in volume and 20% in value, with double-digit growth in value terms in all categories. In volume terms, bottled table wines increased by just 1% and bulk wine declined by 7%. Volumes of imported vermouth, sparkling and still wines over 14% ABV increased by 26% to 28% in volume. All categories experienced increases in average import prices.

Imports from France rose 18% by volume and 22% by value. The growth is being led by bottled table wines (+32% in value and 22% in volume), while sparkling wine imports declined by 7% in volume and 9% in value. Bulk wine imports are marginal but were up by 48% in the period.

Import volumes from Spain declined by 1% in volume terms, reflecting a similar contraction in bottled table wines. Fortified wines also declined by 5% in volume, while volumes were up for sparkling wine (2%) and for vermouth (47%). As for France and Italy, average prices increased.

Imports from Australia declined by 32% in volume and 13% in value. Bottled wine imports were virtually stable. However, imports of bulk wine virtually halved, reversing the trend seen in 2017.

Imports from New Zealand rose by 55% in volume and 65% in value, with both bottled wine (+36%) and bulk wine (+106%) volumes up, and average prices in USD somewhat lower than a year earlier.

Chile saw volume sales to the US increase by 5%, with declines in shipments of bottled (-23%) being offset by rising bulk volumes (22%).

Table 2: US imports by country of origin, Jan-Feb 2018

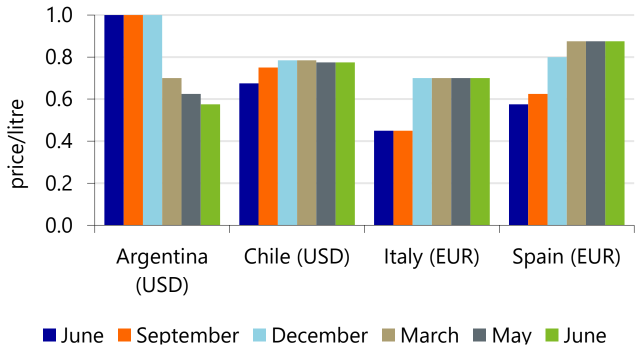
	Value (USD million)	Change (%)	Volume (thousand cases)	Change (%)
Italy	310.2	20	5,809.7	7
France	273.4	22	2,765.9	18
Spain	57.9	8	1294.5	-1
Australia	65.5	-13	3,261.7	-32
New Zealand	79.7	55	1,586.8	65
Chile	48.2	-8	2,966	5
Argentina	44.0	-23	1,041.6	-40
Portugal	13.8	2	283.2	6
World total	970.7	14	22,675.6	-1

Source: The Gomberg-Fredrikson Report 2018

Bulk wine pricing

'High, but stable' is the best way to define generic bulk wine prices in the first half of 2018 (*see Figures 2 and 3*). Argentina seems to be a clear exception, but this is only because in our charts, its wine prices are quoted in US dollars and therefore their price contraction in 2018 reflects the ongoing weakness of the peso and subsequent devaluations.

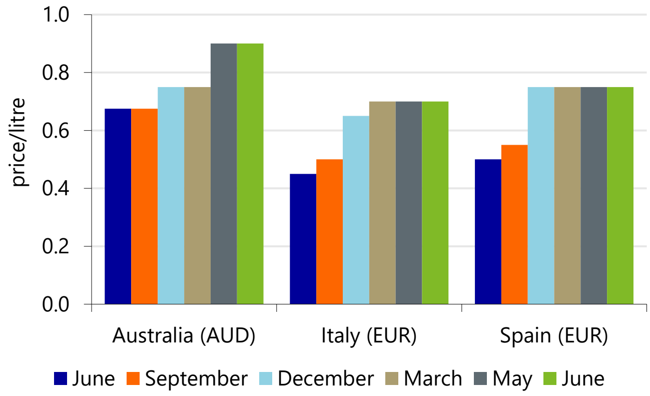
Figure 2: Prices for generic red bulk wine by country of origin and currency, June 2017-June 2018



Source: Ciatti Company 2018

The harvest in the Southern Hemisphere is now finished and the aggregated volume is broadly similar to that of a year earlier, as a larger than expected harvest in Argentina is more than offset by the short production of South Africa. Strong demand from China and other Asian markets, in particular for Australian and Chilean wines, is supporting prices.

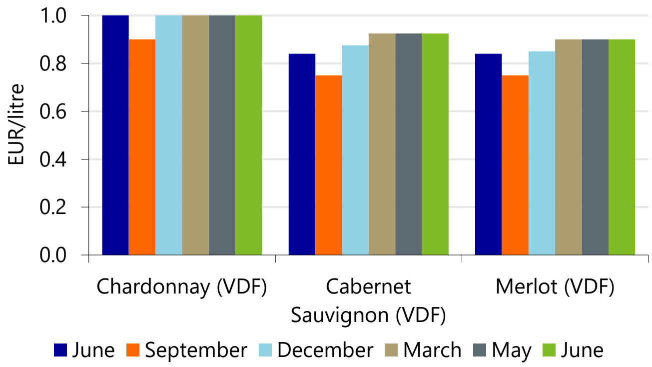
Figure 3: Prices for generic white bulk wine by country of origin and currency, June 2017- June 2018



Source: Ciatti Company 2018

In Europe, prices remain stable awaiting the 2018 harvest, which is expected to be larger than that of 2017. With that said, the weather in some regions of France was unusually wet in May and June, increasing the risk of diseases. Although there is still no evidence that this is going to affect 2018 crop volumes, the uncertainty seems enough to support stable prices for the time being (*see Figure 4*). Spain is in a similar situation, as the country has also suffered from an unseasonable cold and wet spring, with many growers also suffering the same disease risk as their French counterparts. Spain, however, still has a high likelihood of a larger harvest than in 2017. In Italy, weather conditions have been very favourable so far. A price softening is likely if there aren't any negative surprises in the coming months.

Figure 4: Prices for French bulk wine by varietal, June 2017-June 2018

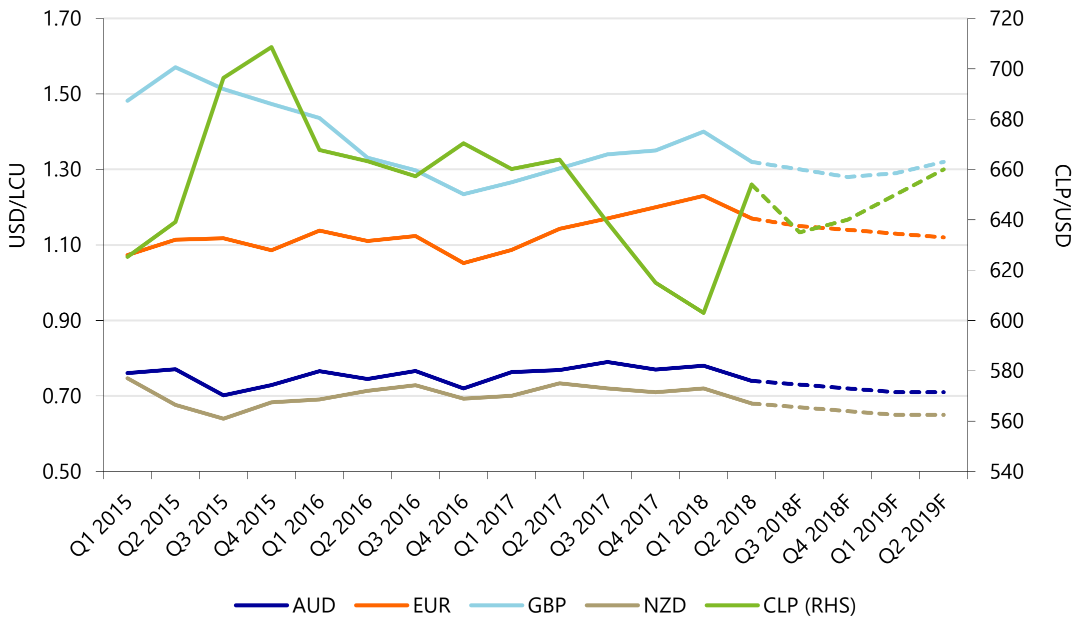


Source: Ciatti Company 2018

Currency outlook

USD strength was the overwhelming theme of the last quarter. Fears that an escalation of trade wars would slow world growth, combined with an increase in the cost of USD-funding has sparked a huge outflows from emerging markets back into the perceived safety of the USD. The ARS was one of the worst-performing currencies in the world over the last quarter, as a domestic crisis compounded the pressure on the currency. The CLP also experienced significant losses, and the fall in the NZD versus the USD was not far behind. While many central banks in emerging markets have had to resort to interest rate hikes to protect their currencies from downward pressure and thus stave off some of the inflationary threat, neither the RBA nor the RBNZ are in any rush to alter monetary policy. Both the AUD and NZD remain overvalued versus the USD on many models of fair value, and both Australia and New Zealand still have moderate inflation rates. Interest rate differentials were also responsible for pushing EUR/USD sharply lower, with the ECB warning that rates could be on hold until at least summer 2019. The Bank of England backtracking from its more hawkish guidance weighed on the GBP in April. Political uncertainty connected with Brexit has also been a negative factor for the British pound *(see Figure 5)*.

Figure 5: Wine currency movements and forecasts, Q1 2015-Q1 2019f



Source: Bloomberg, Rabobank 2018

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