

### INSIDE THIS REPORT

Summary	1
Global Picture	2
Local Picture	3
NZ Supply/Demand Balance	4



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**An analysis of the trends influencing the wine and grape market prepared by Con Williams - Head of Investment Research.**

### SUMMARY

Marlborough Sauvignon Blanc exports have been surprisingly strong in 2020 so far. All major markets have performed well with export volumes up 10% y/y and overall pricing steady. The advent of lockdowns and social distancing has seen a significant market shift in demand to retail/e-commerce sale channels at the expense of foodservice.

Marlborough Sauvignon Blanc is most definitely benefiting from the fact the majority is sold through off-trade channels. Positioned as a premium wine but at an affordable price, consumers have been treating themselves to cope with recent events increasing demand. Well-known brands and larger wineries have been the main beneficiaries with consumers choosing what they know in times of uncertainty.

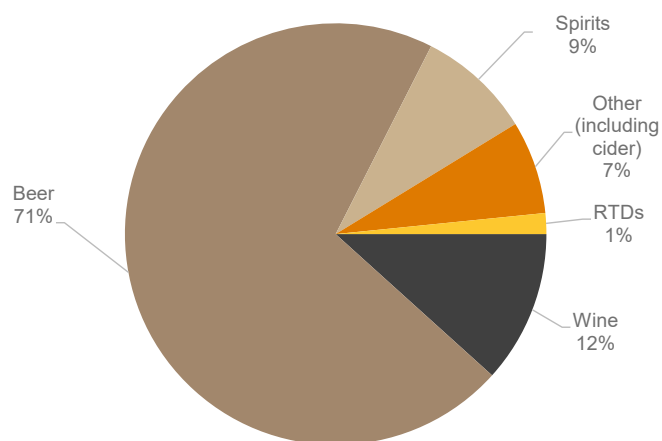
Generally, it is a tougher road for smaller wineries and more boutique offerings/varieties. Competitive pressure from other producers in many markets and the hit to foodservice demand having a larger negative effect.

In the current environment a primary sector does not want to be operating in an oversupplied situation – there is likely to be an outsized fall in earnings. For Marlborough Sauvignon Blanc if the current export run rate is maintained the supply/demand balance will remain positive, even with a larger 2020 vintage. This bodes well for supporting grape prices in the 2021 harvest.

*The big question is how do recent events affect the wine market? And critically, what shifts could be more permanent through the creation of new consumer habits?*

### Global Picture

Figure 1: Global consumption of alcoholic drinks



Source: MyFarm, West Alumni, Euromonitor.

Wine is one of the mostly widely consumed alcoholic drinks globally. It is often consumed at restaurants to celebrate special occasions, at home with friends and family enjoying a festive occasion, or just as a routine feature of everyday life.

In the advent of Covid-19 and enforced lockdowns many of these occasions have been disrupted over recent months and the ability to dine out is non-existent or at least restricted due to enforced lockdowns and social distancing requirements.

The big question is how do recent events affect the wine market? And critically, what shifts could be more permanent through the creation of new consumer habits? Given the length of time for lockdowns and social distancing in many countries some long-term behaviours seem likely to change. The longer these social distancing requirements last more new ways of shopping and living could become ingrained.

One of the clearest impacts so far has been a market share change for the major sales channels. Obviously off-trade which encompasses retailers, liquor stores and direct-to-consumer channels has benefited at the expense of on-trade channels that covers restaurants, bars, cellar door etc. In most major New Zealand wine markets off-trade accounts for around 80-85% of total sales and on-trade 15-20%. Generally a higher proportion of New Zealand red varieties sell through on-trade channels compared with white varieties.

It is difficult to assess whether the Covid related disruption has caused an overall reduction in wine consumption, or if there has simply been a shift in where consumers source their wine.

Market evidence to-date from the US suggests wine consumption has increased as many seek solace. How long this might be sustained is the open question if labour markets remain weak reducing purchasing power and the unprecedented government support in many countries reduces. Such dynamics at least suggest a weakening in the wine category's premiumisation trend of the past decade and some consumption moderation, but these are not givens.

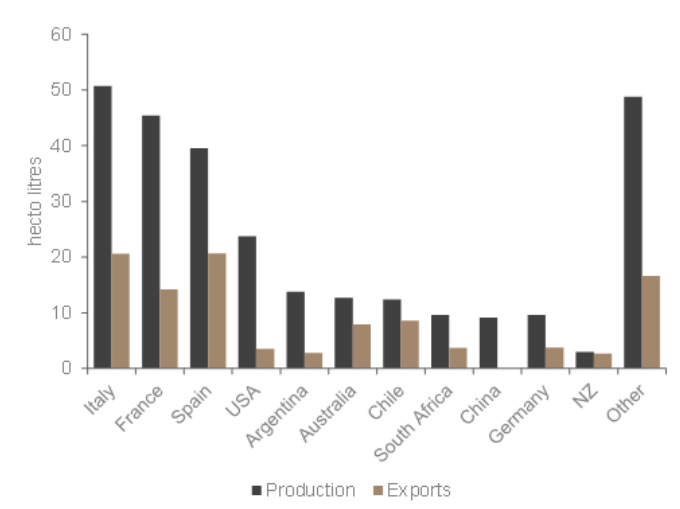
The impacts further back down the supply chain are more obvious with extended payment terms and some bad credit. Depending on a winery's operating model and business relationships recent events have created opportunities for those that could shift more product through reliable off-trade channels, but hardship for others who cannot.

For now, it appears those who couldn't pivot to off-trade have either stockpiled product or managed to sell product via another channel (i.e. e-commerce or wholesale to another winery). The major market risk would appear those wineries with displaced product that will need to sell product at a discount to fund cashflow and meet other financial commitments moving forward.

Perversely, the overall New Zealand wine story appears robust if judged by Marlborough Sauvignon Blanc exports. However, there is certainly a wide range of circumstances. Smaller wineries that rely on cellar door sales of boutique products and serving international tourists a food experience are doing it tough. On the other hand, larger wineries that account for around 70% of total export volume have more options. These larger wineries often sell through a variety of channels under their own brand, buyer own brand and in bulk formats. This means they can easily shift volumes through any channel they see fit and are not tied to just higher value brand centric product. This agility will need to be maintained and given New Zealand wine is a smaller global player it allows a nimbler approach.

On a global basis New Zealand accounts for just 1% of total production and 2.5% of total trade by volume. Because New Zealand produces higher-value wine it accounts for nearly 3.5% of the total value of global trade. This places it 7th on the global league table by traded value and 11th by traded volumes. The top five exporters of Italy, Spain, France, Chile and Australia account for around 70% of the total volume and value of traded wine.

Figure 2: New Zealand's place in the global wine market



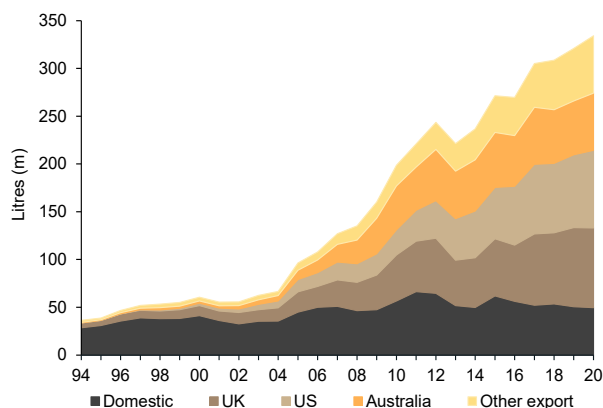
Source: MyFarm, OIV.

## Local Picture

New Zealand's four main markets retained their dominance in the 2019/20 selling season. The domestic market appears to have remained surprisingly resilient despite Covid-19 disruptions with overall volumes only back a small amount. Domestic tourism, stocking up during lockdown and the overall domestic economy bouncing back quickly after lockdown disruption all appearing to support overall demand so far.

Perhaps surprisingly export markets have seen an increase in sales, with all major markets performing strongly in 2020 so far. The reason appears to be that the majority of Marlborough Sauvignon Blanc is sold through off-trade channels (aka global retailers) where it is positioned as a premium product but still at an affordable price. As many of the meals that are eaten away from home are usually by wealthier consumers with higher purchasing power, this spending appears to have been transferred to the retail aisles in many markets.

Figure 3: New Zealand wine destinations



Source: MyFarm, New Zealand Winegrowers, Statistics New Zealand.

It is difficult to say how much stockpiling may have taken place, but the overall market pull through remains solid indicating orders continuing to be placed. Export volumes for 2020 tell the story the best with total volumes 10% higher than the previous year. Over the same period all markets have seen increased export volumes at steady prices.

What is particularly interesting is the unusual spike in exports that occurred during March at the height of global lockdowns and social distancing rules. Exports were 17% y/y higher lead by the US and Australia. Things have buttoned off in the past quarter, but overall growth of 3-6% y/y has still occurred, and it appears larger wineries are pushing volumes around specific markets depending on product sales.

Figure 4: New Zealand Sauvignon Blanc exports in 2020 (% change on 2019 volumes)

	US	Australia	UK	Other	Total
Jan	11%	22%	30%	8%	19%
Feb	-6%	40%	1%	19%	6%
Mar	31%	20%	11%	1%	17%
Apr	-8%	12%	20%	-12%	3%
May	14%	9%	-8%	4%	4%
June	-13%	-8%	26%	14%	6%
<b>Total</b>	<b>6%</b>	<b>15%</b>	<b>13%</b>	<b>5%</b>	<b>10%</b>

Source: MyFarm, New Zealand Winegrowers, Statistics New Zealand.

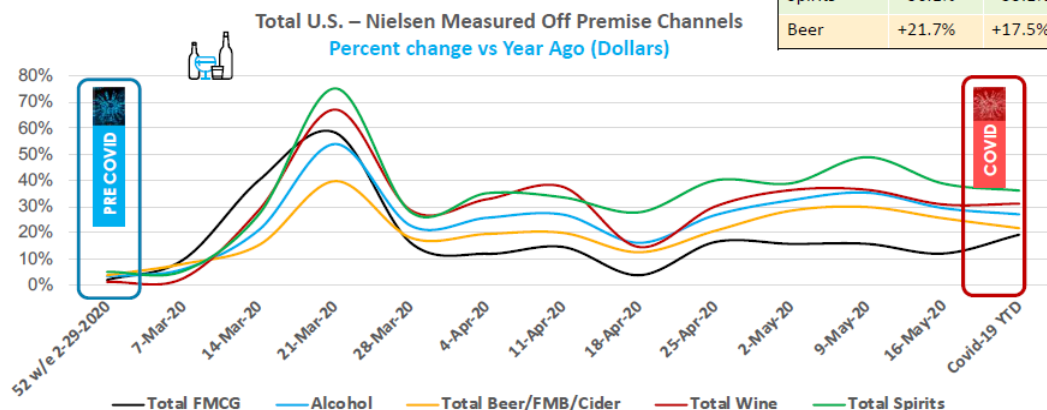
The export statistics are also backed up by actual retail sales in major markets. For example, in the US total off-trade wine sales have increased by 27% y/y in volume and 31% y/y in value (see figure 5). Interestingly Nielsen believe this has more than offset the loss of sales through on-trade channels implying an actual increase in demand. Therefore, the spike in exports sales during March aligns well with retail offtake through this period. It is a similar picture in many other major markets, but with slight differences depending on different countries sales channels and consumer preference/habits.

Figure 5: US off-trade alcohol sales since Covid-19 (value in USD)

### SPIRITS LEADS OFF PREMISE RETAIL GROWTH, WINE CLOSELY BEHIND, AND BEER TRAILING

Week to week changes (since w/e Apr 4) have been more stable

COVID YTD	Value	Volume
Wine	+31.1%	+27.6%
Spirits	+36.1%	+33.1%
Beer	+21.7%	+17.5%



It could appear that stockpiling has occurred. However, the sustained nature of higher year-on-year off-trade sales and evidence of consumers treating themselves to cope with recent events implies decent levels of end consumption.

For New Zealand one area of concern could be bulk exports have lead growth in 2019/20. This raises the fear more wine is being shifted through lower value 'private' brands eroding New Zealand's reputation for premium packaged wine. This does not appear to be the case so far though with packaged wine values holding steady and retail sales suggesting larger and more well-known brands have fared better than others. So while it's tougher for the little guy, it's positive for the overall supply/demand balance of New Zealand's Sauvignon Blanc.

The other challenging area appears to be lagging demand for other varieties. Red wine export volumes are back 23% y/y in 2019/20. A part of this will be due to a smaller 2019 vintage impacting on the volumes available for exports. However, anecdotes suggest it is tougher going with more competitive pressure from other producers in many markets and the hit to foodservice demand having a larger effect. With a bounce back in the size of the 2020 crop, wineries will be hoping they can move their more boutique range of products. Otherwise inventory could build and place businesses under cashflow pressure as the 2021 crop is grown and harvested.

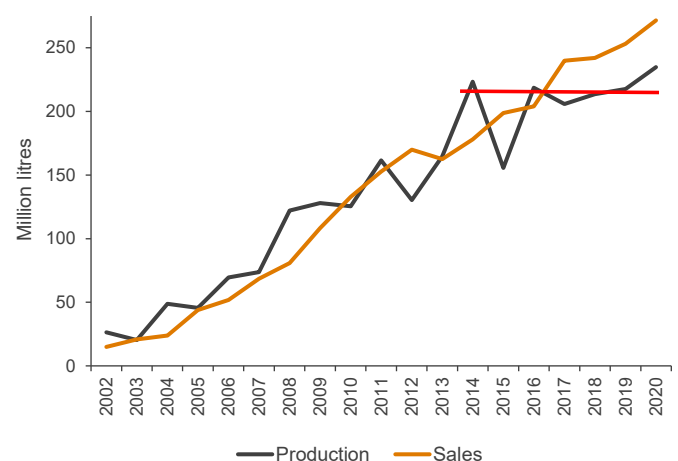
### New Zealand Supply/Demand Balance

A range of different dynamics can affect how the overall supply/demand balance translates into grape prices at the farm-gate. For Marlborough Sauvignon Blanc the overall supply/demand balance is important, but other factors

including retail pricing trends, NZD, alcohol/excise taxes and supply chain/processing costs all have an influence too.

From a Sauvignon Blanc grape growers' perspective there has been a meaningful lift in pricing over the past ten years. The average price was \$1,220/t in the 2010-2012 period, but over the past several years has lifted into the \$1,700-\$1,850/t range. While export prices have been steady the domestic supply/demand picture for Sauvignon Blanc has tightened with the strong export performance to the UK and North America and supply growth plateauing in the low 200,000 tonne range in recent years. Combined with some efficiency gains in other parts of the supply chain this has helped spur the lift in grape prices.

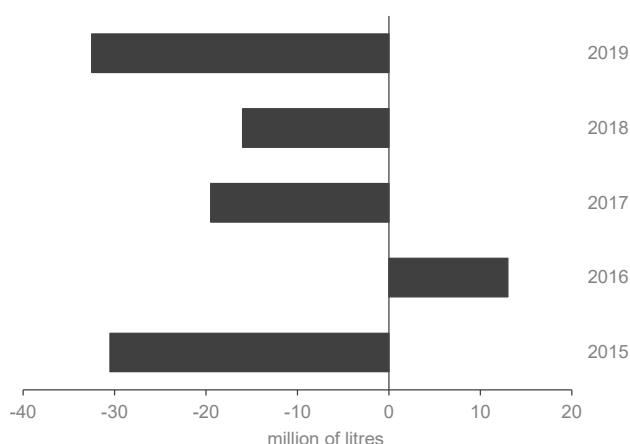
Figure 6: New Zealand's Sauvignon Blanc supply/demand balance





What 2021 will bring has some interesting possibilities given the recent strength in export sales. The 2020 crop was the largest ever at 326,000 tonnes of grapes and around 10% higher than the four-year average. However, a larger harvest was required to support the rate of export sales and rebuild inventory after three years of consecutive deficits. Given the recent strength in export sales and early start to selling the 2020 vintage it's likely another deficit could be created. This bodes well for the 2021 grape prices.

Figure 7: Vintage surplus/deficit (production minus sales in next year).



Source: NZ Winegrowers.

However, there are a number of other anchor points to consider in the near-term, including:

1. Sticky retail price points in the major distribution channels that will not be easily moved. This due to both the current economic environment and fierce competitive pressure for the hearts and minds of consumers from other branded wines and alcohol styles (i.e. spirits).
2. Alcohol/excise tax increases reducing margins.
3. The fall in the NZD has been positive, but it has largely centred on the NZD/USD so far. Additionally, it seems to be give and take with the marketplace on currency gains/losses.
4. There are still production limitations for many growers. There is always a balance to be had with quality, but this would indicate some 'flex' on the supply side yet, before Marlborough is fully planted.

Profit margins have improved for wineries in recent years, but are labour costs going to squeeze these in 2020/21 limiting the scope for higher grape prices?

All in all, there are some good reasons to be positive on Sauvignon Blanc's price prospects, but some notes of caution on how far things can extend in the near-term.



Photo: Grant Payton (MyFarm) with viticulturalist Logie Mackenzie (BVM) at Awatere Valley vineyard, Marlborough.