Rabobank

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Focus on Europe

RaboResearch
Food & Agribusiness
far.rabobank.com

Stephen Rannekleiv
Global Strategist -– Beverages
+1 (212) 808-6823

Maria Castroviejo
Senior Analyst – Beverages
+31 30 712 3811

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Say goodbye… say hello

The first Rabobank Wine Quarterly was published in January 2010. For more than seven years now, this publication has mainly been a collaborative effort between myself (Stephen Rannekleiv) and my Australian colleague, Marc Soccio. As of May, Marc has left the bank to pursue a career as an advisor to the wine industry and was recently selected to be part of the Australian wine industry's Future Leaders 2017 programme. Best of luck, Marc!

At the same time, I'd like to welcome Maria Castroviejo to the beverage research team. Maria, based in Utrecht, is recently returning to the team after a number of years in another part of the bank, and she will be collaborating on this publication in the future. Welcome back, Maria!

Investing in the European wine market

Investments in the European wine industry

The European wine industry has undergone important changes in recent years. Wineries have used different types of investment strategies to respond. There have been different avenues to success, but those that have lacked a clear strategy are the ones showing the most lacklustre results.

M&A drivers in European wine

The past seven years have seen plenty of M&A activity in the European wine space. We have identified five key drivers of M&A over the period and look at several examples of each.

Global supply

Global inventories of wine remain balanced to slightly tight. Bulk wine prices across most varietals are generally stable or rising. Much will depend on how the 2017 crop fares in Europe, but recent weather disruptions suggest that any major increases in inventories are unlikely in the near future.

US imports

US wine imports continue to rise, with value growth (6%) outpacing volume growth (2%). Prosecco, rosé from Provence, and New Zealand sauvignon blanc continue to be the main winners. In a reversal of recent trends, imports of Chilean bulk wine declined, while Australian bulk imports saw a dramatic rise.

Investments in the European wine industry: What's working? What's not?

Recent years have seen some dynamic changes in the European wine industry. Some wineries have responded by investing in assets and acquisitions, some have been shedding assets to become leaner, while many others have remained on the side lines. Those that invested in growth saw improved revenues and margins. Those focused on becoming leaner saw improved return on capital. And those that lacked a clear investment strategy struggled and underperformed.

Stable production, stable demand… but a dynamic industry

The EU remains a key region for the wine industry, accounting for around 65% of global production, 57% of consumption, and around 70% of global wine exports. In the past few years, total wine production in Europe has been broadly stable. Under the EU's CAP wine-planting restrictions, total area under vines in Europe declined until 2015, and it is unlikely to increase significantly in the future. Worldwide consumption is also broadly stagnant. Moreover, drastic changes in aggregated production and demand are not expected in the near future. But this apparent stability hides a different reality: Demand is shifting to new markets, while in the well-established wine-drinking markets, consumer patterns have evolved, confronting the wine industry with a new reality.

The European wine industry has seen significant activity and capital flows, as reflected by the more than 150 M&A deals since 2010. In addition, producers have benefited from EU support for investments in innovation or efficiency gain, among other investment triggers.

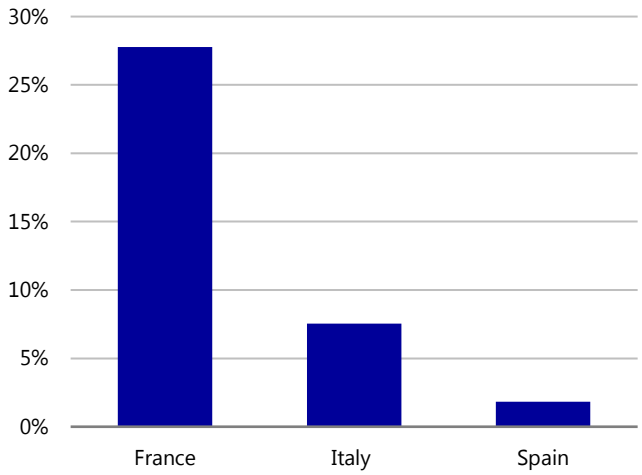
New money flowing into the industry… or just changing hands?

Financial activity has also been far from dull in recent years: With changing demand and a very fragmented industry, all players have to evaluate their options and choose a strategy in order to achieve long-term success. This is triggering new M&A deals and significant direct investments. But have all the money flows resulted in net increases in investments at the corporate level, or do they just reflect changes of ownership? Has EU/domestic public money triggered increases in fixed assets in these companies, or has it just gone on covering annual expenses and one-off costs? When money has resulted in rising fixed assets, has it been profitable? These are all valid questions in this context.

Net fixed assets increased moderately in Spain… but significantly in France

To further investigate what has happened, we took a closer look at a sample of over 200 wine companies (74 in France, 76 in Italy, and 52 in Spain), with annual sales of over EUR 15m (EUR 10m in Spain). We checked how much their fixed assets had increased (tangible and intangible—thus reflecting both acquisitions and direct investments, but not financial investments that would not have directly contributed to operating profits) and how their operating profits had performed in the 2010-2015 period *(see Figure 1)*.

Figure 1: Average fixed-asset increase for wine companies by country, 2010-2015



Source: Amadeus, Rabobank 2017

In Spain, aggregated net fixed assets for our sample increased by just 2% in the period, which is not much over the replacement rate. The aggregated numbers for our French sample show an increase of 28%, with 8% for the Italian companies. We wanted to know which type of company performed better within the same country: those that made above-average investments, those that remained unchanged, or those who reduced their assets. For our analysis, we divided the companies from each country into five groups, depending on their net fixed-asset increase relative to their respective average *(see Table 1)*.

Table 1: Aggregated net fixed-asset (tangible and intangible) increase by country and by group, 2010-2015

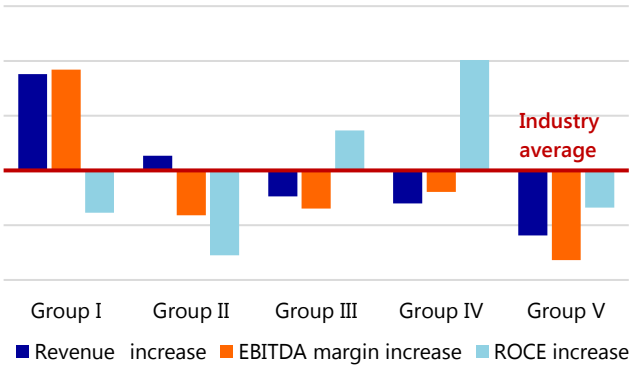
	France	*Italy*	*Spain*
Group I: Dynamic asset-builders	101%	106%	88%
Group II: Moderate growers	40%	39%	23%
Group III: Maintainers	20%	11%	4%
Group IV: Moderate off-loaders	0%	-9%	-6%
Group V: Clear downsizers	-21%	-35%	-26%
Total industry	28%	8%	2%

Source: Amadeus, Rabobank 2017

Sales and EBIT margin improvement as indicators

It was no surprise to see companies that had seen a larger increase in their operational structure achieving above-average sales growth. Unless start-up costs were very high, better operating-margin trends than those of the companies' (domestic) peers should also be expected, in particular at the EBITDA level, as economies of scale or strategic changes prove their worth. In all three countries, sales growth for the dynamic asset-builders outperformed other groups. (Below industry average does not necessarily mean a contraction, but underperformance.) For the same reasons, clear downsizers underperformed compared to their peers in terms of sales growth. EBIT and EBITDA margin growth followed similar trends (Group I outperforming and Group V underperforming), but with less consistency. In terms of return on capital employed (ROCE), Group I clearly underperformed, but this was somewhat expected, given the time it takes for investments to generate returns. Given that these companies are outperforming in terms of both revenue growth and margins, we believe these investments will likely lead to improved ROCE over time *(see Figure 2)*.

Figure 2: Performance relative to the mean for Groups I-V across countries in terms of revenue, EBITDA, and ROCE, 2010-2015

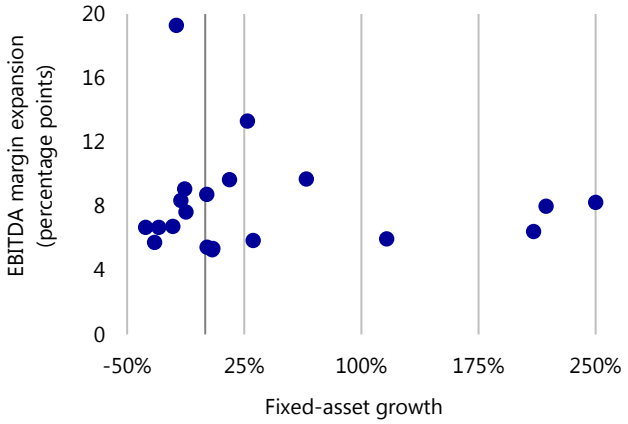


Source: Amadeus, Rabobank 2017

Top performers and the paradox of the downsizers

Group V, the clear downsizers, seems to have underperformed compared to its domestic peers in all measures (Spain being an exception, in part due to a number of weak performers in Group II). But aggregated numbers may hide a different reality. This becomes evident when we look at the top 20 performers who achieved the greatest improvement in terms of EBITDA margins. Of the 20 companies with the best margin improvement, 40% were actually downsizers and fixed-asset off-loaders *(see Figure 3)*.

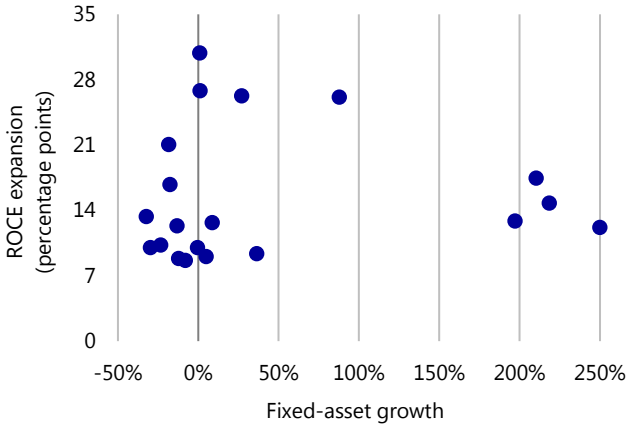
Figure 3: Top 20 EBITDA margin expansion performers and corresponding fixed-asset growth, 2010-2015



Source: Amadeus, Rabobank 2017

Likewise, we see a similar trend among the top 20 ROCE growth companies, of which 40% were downsizers and asset off-loaders *(see Figure 4)*.

Figure 4: Top 20 ROCE expansion performers and corresponding fixed-asset growth, 2010-2015



Source: Amadeus, Rabobank 2017

Group I not only outperforms as an average, but sales growth and margin performance are also strong on an individual basis, with any deterioration being modest if it occurs and margin expansions ample.

As the data illustrates, an intentional shift to a leaner, asset-light model can be an effective strategy for improving profitability. However, the downsizers are a far less homogeneous group, including some over-achievers, but also a significant number of weak players, for which asset contraction is not necessarily a choice, but the consequence of a struggling performance.

Conclusion

The European wine industry is undergoing deep changes behind apparent stability. This is resulting in a number of players expanding their assets through organic growth or acquisitions, while others are becoming leaner. Given stagnant global consumption, changing demand patterns, and the prevailing industry fragmentation in Europe, we expect these opposed strategies to continue.

Performance so far indicates that asset-builders achieved operating improvements, but they need to select and time their expansion plans adequately in order to avoid a severe (short-term) deterioration in profitability (ROCE, ROAA) that could leave the entity vulnerable to other unpredictable headwinds (from weather-related price swings to Brexit and further—unavoidable in this industry). A shift to an asset-light model as a strategic decision remains a clear and profitable option for some players.

But a number of companies are just struggling. Those that struggle the most appear to be the ones that are remaining stagnant—neither investing for future growth, nor divesting to become leaner. For them, it is time to either pick a more coherent strategy or consider exiting the market. If selling is the best option, timing is even more important, as a deteriorating position will not add to the price.

Winery M&A

Recent M&A deal-drivers in Europe

We have identified over 150 M&A deals in the European wine industry for the 2010-2017 period. The drivers of acquisitions generally fell into one of the following five categories:

Non-European investors buying into prestigious wine-producing areas. Most recurrent are US and Chinese investors (most of the largest players from these countries have already established a base in Europe), their interest triggered by increasing domestic demand in their countries. Recent examples include Domaine Bonneau du Martray, bought by US private investors in Q1 2017; La Guyennoise, bought by a China-based consortium in 2016; the French Les Domaines CGR, bought by Hongkong Funshare Life; and Château Perenne, bought by Jack Ma, the founder of Alibaba. In Spain, Yantai Changyu bought Marques del Atrio and Dicot Partners in 2015.

Local wine producers as domestic consolidators and international transactioners. Given the fragmentation of the industry, there is an ongoing flow of deals. Among the most recent: Maison Ackerman's purchase of Château de Sancerre from Campari and the Cazes family buying Château haut-Batailley in France in 2017. In 2016, Grands Chais de France bought Béejot, and Masi Agricola bought a 60% stake in Canevel Spumanti.

Local producers acquiring abroad. Other deals involve wine operators buying in other countries in order to complete their portfolio within Europe: Piper-Heidsieck buying the Italian Biondi Santi or Rotkäppchen-Mumm buying Ruggeri earlier this year. Globally, we saw Reh Kendermann's purchase of South African Napier Winery or Maisons & Domaines Henriot buying a stake in premium US winery Beaux Frères.

Financial investors seeking opportunities: Bouvet Ladubay in France and Vintae Luxury Wine Specialists in Spain, among others, have been bought by private-equity investors in the last year. Financial investors have also acquired wine-trading companies and merchants.

Consolidation or vertical integration involving wine distributors, wholesalers, or exporters. We have identified over 30 deals involving wine marketers. The French cooperative group InVivo, complementing its wine-producing activity with Cordier Mestrezat in 2015 and Baarsma in the Netherlands in 2017, is a major exponent of this trend. Distributors have also shown interest in wine producers, such as Terra Moretti buying Sella & Mosca in Italy.

On the selling side, small and large companies slimming their assets and focusing their portfolios, privately-owned companies/family owners exiting the industry, and operators giving up a stake to open the door to new business partners are recurring themes.

Global supply

Broadly speaking, global inventories of wine appear fairly well-balanced and stable, with variations by geography, variety, and price segment.

Northern Hemisphere review

In Europe, April frost damage looks likely to trigger higher prices. Temperatures dropping as low as -6°C affected the young vine buds and caused widespread damage in France, Spain, and the north of Italy. This affected numerous prestigious areas and PDOs, such as Bordeaux, Burgundy, Champagne, Alsace, Rioja, Rueda, and Ribera del Duero, among others. Although the final impact will not be known until the harvest later this year (producers are hoping for second buds, but these normally lead to smaller production), it seems certain that yields will be hit. Still, in most cases, existing stocks should ensure adequate availability. For instance, in Champagne, the 'reserve champagne', or stock from previous years, should ensure sufficient output, even in an adverse scenario, as producers have 3.5 to 4 years of existing stock to draw on.

Production in the US has not suffered any major disruption, but heavy rains earlier in the production cycle, followed by unusually high temperatures in recent weeks, are creating some challenges. Production in the North Coast is expected to be average, while the Central Valley may be somewhat light. Overall production volumes for 2017 are somewhat similar to 2016.

Southern Hemisphere review

Chilean and Argentine production look to have risen 9% to 10% in 2017, compared to the poor harvests in the prior year. However, as these still represent relatively soft numbers from a historical perspective, inventories remain under pressure.

Australia and South Africa saw production increase slightly in 2017, while New Zealand saw a somewhat smaller crop than last year, but still in line with historic production levels. While production in the Southern Hemisphere was slightly larger in 2017 than in the prior year, solid demand from export markets and tighter global inventories are helping to keep upward pricing pressure on available supplies.

Global trade

Export trends of major producers

France

In Q1 2017, exports of French wine increased by 5.9% in volume and by 14.7% in value, showing an average price increase of over 8%. Champagne exports were up by 7.3% in volume and 12.1% in value. Other sparkling wines also saw a positive trend (+11.9% in volume and +14.8% in value). But the most relevant price increases took place in bulk wine and in still bottled wine. Among the latter, Bordeaux showed a very strong performance, up by 10.7% in volume and 26.4% in value. Among the largest importers of French bottled wine, the US and China saw solid advances in volume and value terms. It is remarkable that exports to the UK increased by 2.9% in volume and by 13.8% in value terms, reflecting a 10.6% average price per litre increase in euros (*see Table 2*).

Italy

In the first quarter, exports of Italian still bottled wine increased by 2% in volume and by 5.4% in value, compared to Q1 2016. Sparkling wine experienced a 10.8% increase in volume and 15.1% in value. Export of still wine to the US, Germany, and Switzerland suffered some contraction in volume terms, but saw higher prices per bottle. Canada and China saw a positive performance, both in value and volume terms, while in the UK, volume increased, although at a lower average price per litre (-3.5%). In the sparkling segment, export to the UK, the US, and Germany saw further gains in volume and value terms, even if the average price per litre contracted for German exports.

Spain

In Q1 2017, Spanish wine exports increased by 8.9% in value and by 0.1% in volume, compared to Q1 2016. Bulk wine (including 2-10-litre packages, now a stand-alone new segment under official EU nomenclature) saw a contraction in volume terms, but an increase in value of almost 11%, evidencing a significant increase in price per litre. Aggregated exports of still bottled wines increased by 8.4% in volume, with a marginal decline in average prices that hid the good performance of PDO still wines (16.2% of total exports in volume, but 47% in value), up by 8.4% in value and 4.1% in volume. Sparkling wines saw a double-digit decline in average prices, with volume up by 23.7% and value by 9.4%. In still bottled wine, the US remained a very strong market for Spain, with volume up by 4.3% and value by 6.5%, consolidating its position as the number-one destination in value terms. Exports to Germany (#2) and the UK (#3) increased in volume, but saw prices contract.

US

US wine exports saw a decline of 15% decline by volume and 8% by value. The decline in both bottled (-15%) and bulk (-15%) shipments was led by a major fall in sales to the EU.

Australia

Total Australian wine exports fell 1.6% by volume in the first three months of 2017, but value rose 13.1%. The volume decline was driven by a decline in bulk wine shipments, though these were largely compensated by improving trends in bottled shipments, which helped drive value growth. Shipments to the UK were the biggest drag on overall volumes, but these were largely compensated by improving trends in bottled shipments to China and bulk shipments to the US.

Table 2: Change in wine exports for selected countries, YTD 2017

Country	*Volume change (%)*	*Value change (%)**	*Period of measure*
France	5.9	14.7	Jan-Mar
Spain	0.1	8.9	Jan-Mar
Italy (bottled)	2.0	5.4	Jan-Mar
US	-15	8	Jan-Mar
Australia	-1.6	13.1	Jan-Mar
Argentina	-2.2	-14.8	Jan-Mar
Chile	4.9	8.2	Jan-Apr
South Africa	11.2	N/A	Dec-May

* Note: value changes in local currencies
Source: Wine Australia; Gomberg, Fredrikson & Associates; Observatorio Vitivinícola Argentino; SAWIS; Oficina de Estudios y Politica Agraria de Chile; New Zealand Winegrowers 2017

Argentina

Argentine wine exports fell 14.8% by volume and 2.2% by value. Bulk exports volumes (-39%) fell at a much faster rate than bottled volumes (-6.5%).

Chile

Chilean wine exports rose 4.9% by volume in the first four months of 2017 and 8.2% by value. Bottled wine export volumes (5.9%) grew faster than bulk wine exports (2.1%). Perhaps most notable, though: Growth in bulk exports to Argentina compensated for declines in exports to nearly every other major market.

South Africa

South African wine exports rose 11.2% in the six months to May 2017. While both packaged and bulk wines registered improvements, bulk exports (+15.6%) easily outpaced growth in bottled wine shipments (+4.7).

US import trends

US wine imports rose 2% in volume and 6% in value in the first three months of 2017, compared to the same period in the prior year *(see Table 3)*.

Imports from Italy rose 3% by volume and continue to be led by outpaced growth of prosecco (9%).

Imports from France rose 12% by volume and 14% by value. Much of this growth is being driven by champagne and rosé from Provence.

Australia saw a marked decline in bottled wine shipments to the US (-15%), but this was more than compensated by a dramatic increase in bulk wine imports (+150%).

In a reversal of trends from recent years, Chile saw bulk wine shipments to the US decline (-11%), while bottled exports grew (+7%).

Table 3: US imports by country of origin, Jan-Mar 2017

	Value (USD million)	*Change (%)*	*Volume (thousand cases)*	*Change (%)*
Italy	422.6	2	8,923.1	3
France	373.9	14	4,032.9	12
Spain	87.8	-1	2,279.3	6
Australia	105.1	0	6,553.0	41
New Zealand	99.6	6	2,068.6	12
Chile	78.1	13	4,541.6	-6
Argentina	328.6	-4	9,271.1	-23
Portugal	23.6	21	509	26
World total	1,382.6	6	36,324.1	2

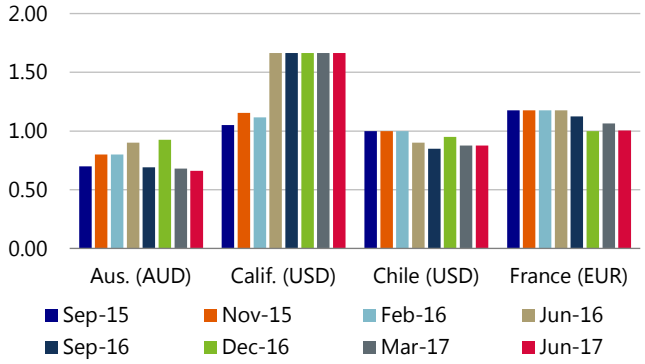
Source: The Gomberg-Fredrikson Report 2017

Bulk wine pricing

For most of the regions and varietals we track, bulk wine prices are generally showing upward pricing pressure, reflecting the balanced/slightly tight overall global supply situation. As always, select geographies or varietals will present exceptions to the rule.

For bulk chardonnay, prices in the US remain quite firm, but in other key regions, pricing has been stable or slightly down. The gap in pricing between Australia and the US may create some additional opportunities for Australian bulk Chardonnay in the US market moving forward (*see Figure 5*).

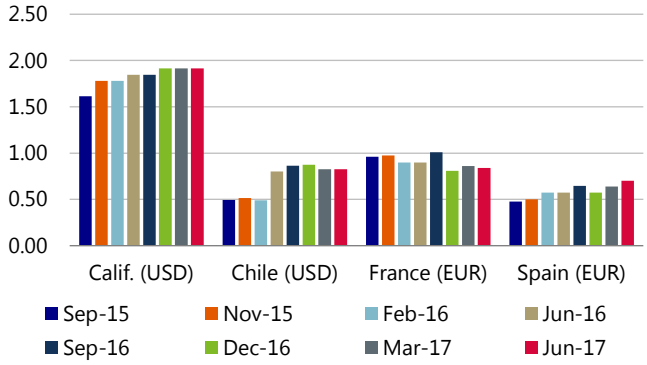
Figure 5: Prices for chardonnay bulk wine by country of origin, Sep 2015-Jun 2017



Source: Ciatti Company 2017

Prices for bulk cabernet sauvignon remain elevated in the US and have shown some recent strengthening in Spain. Pricing for bulk Chilean cab remain high by historic standards, but have come off their peaks slightly (*see Figure 6*).

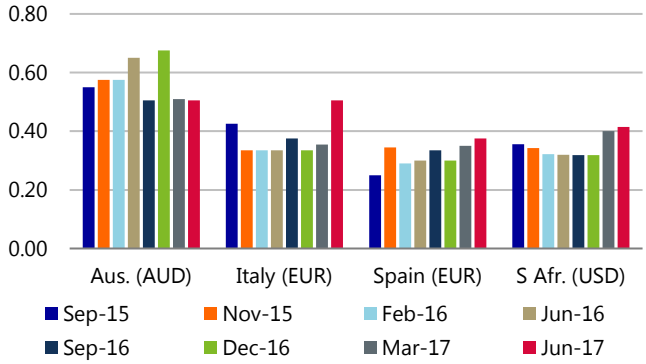
Figure 6: Prices for cabernet sauvignon bulk wine by country of origin, Sep 2015-Jun 2017



Source: Ciatti Company 2017

The recent disruptions to production in the Southern Hemisphere and in Europe appear to be having the most direct impact on generic white wines. Inventories have become notably tighter, driving up pricing across most major production regions (*see Figure 7*).

Figure 7: Prices for generic white bulk wine, Sep 2015-Jun 2017



Source: Ciatti Company 2017

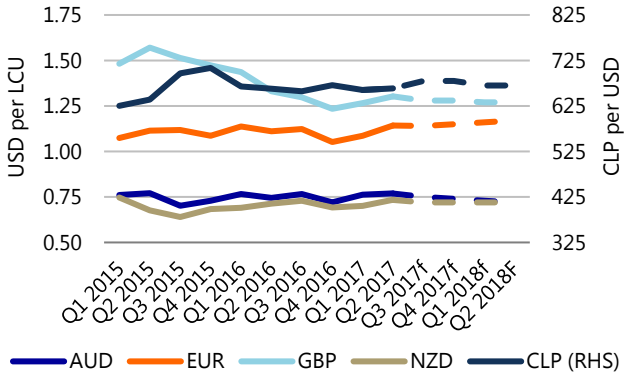
Currency outlook

Volatility has been the name of the game in the GBP markets in recent times, triggered by a mix of political uncertainty and central bank comments. The failure of Prime Minister May to retain her majority in the 8 June election weighed heavily on the pound—though arguably, talk that that a 'softer' Brexit could be on the cards prevented an even steeper decline. Meanwhile, the surge in UK CPI inflation to 2.9% (almost exclusively a result of last year's plunge of the British pound) has pushed down real earnings and weakened the outlook for consumption.

Due to the already-high inflation rate, the Bank of England (BoE) has an interest in preventing further sharp falls in the pound, and further hawkish remarks may thus be heard in the coming months. Faced with uncertainty—related to a weak government, in addition to the Brexit negotiations—the pound was falling towards EUR/GBP 0.90 by the end of the year. We would expect the pound to fall harder and faster in order for the BoE to pull the trigger on a rate rise in the coming months.

Elsewhere, the euro is expected to maintain a relatively strong performance against the US dollar, while other wine-exporting countries' currencies (Australian dollar, Chilean peso) are likely to see a softer trend in the next 18 months *(see Figure 8)*.

Figure 8: Wine currency movements and forecasts, Q1 2015-Q2 2018f



Source: Bloomberg, Rabobank 2017

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far.rabobank.com

Stephen Rannekleiv	Global Strategist -– Beverages	stephen.rannekleiv@rabobank.com +1 (212) 808-6823
Maria Castroviejo	Senior Analyst – Beverages	maria.castroviejo@rabobank.com +31 30 712 3811