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Covid's Long-Term Impact on the Wine Industry

RaboResearch

Food & Agribusiness
far.rabobank.com

[Stephen Rannekleiv](#)

Global Strategist –
Beverages
+1 718 755 9312

[Jane Foley](#)

Head of FX Strategy
+44 20 7809 4776

Summary

- **Covid's lasting impact on wine industry structure:** The global pandemic made 2020 a challenging year for the wine industry. While the on-premise is expected to start to recover later this year, we believe there will be structural changes facing the industry that will create additional advantages for larger wineries and support industry consolidation.
- **Global wine M&A outlook:** 2020 was a relatively quiet year for M&A, as the pandemic put many in a more cautious mood, and even some of those looking to close deals encountered hurdles from travel restrictions and social distancing measures. We believe 2021 will see a much higher level of M&A activity, with some of the usual players doing deals, but we also expect some new faces (both among acquirers and types of targets).
- **Sustainability updates:** Given the rising importance of sustainability, we've created a new section in the Wine Quarterly aimed at sharing sustainability news and initiatives that we believe add value to the industry. The first story we highlight is the progress the IWCA is making in launching a do-it-yourself (DIY) emissions inventory tool aimed at lowering the cost of doing emissions assessments while maintaining rigorous standards. We also highlight the Hallbar awards recently awarded to Concha y Toro, Trivento, and Gruppo Mezzacorona and reflect on the growing importance of effectively communicating sustainability initiatives.
- **Currency outlook:** Among currencies relevant to the wine industry, US dollar weakness remained the driving theme in the FX markets in the final quarter of last year, as has been the case since the spring of 2020.

Covid's Lasting Impact on Wine Industry Structure

As we begin 2021, rising numbers of Covid cases have forced many major wine markets back into lockdown (or some form of heightened social distancing measures), even as governments make slow progress on rolling out vaccines. By summertime, most experts expect that we will have enough people vaccinated that the economy will begin to move back to some semblance of normalcy. While we believe that the worst of the pandemic's impact will be behind us by the second half of this year, it also seems likely that the developments over the past year will have a lasting impact on the structure of the global wine industry and on what it will take to be successful moving forward. After years of increasing fragmentation in the industry, we see a context forming that will favor larger wine companies and create additional complexities for smaller players that

are not sufficiently differentiated in the market. We believe these changes will be driven by at least three major factors:

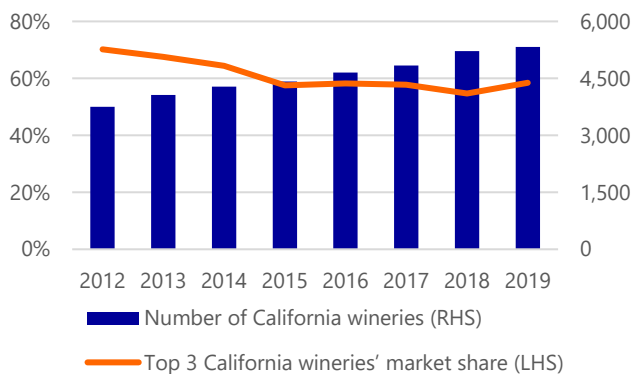
- The restructuring of the on-premise
- Large players investing in e-commerce
- Massive liquidity held by private equity

A Quick Look at Fragmentation

Though perhaps a bit of an extreme case, the US is a clear example of the increased fragmentation of the wine sector in recent years.

From 2012 to 2019, wine consumption in the US grew ~6% (by volume) while the number of wineries in California increased by ~40%. During this time, the three largest California wineries saw marked declines in market share (see Figure 1).

Figure 1: The three largest California wineries saw marked declines in market share



Source: TTB, Gomberg-Fredrikson, Rabobank 2021

Of course, looking at the growth from a purely volumetric perspective overlooks the significant growth in value, driven by premiumization, but the underlying story is that of a growing number of premium wineries battling for a relatively fixed share of the market. While the larger players have maintained share by dominating the off-premise channel, this growing number of small wineries have focused more on the on-premise channel, direct-to-consumer (DTC) sales, or some mix of the two.

Looking forward, the on-premise channel will remain challenged, and as for DTC sales, small wineries will face increasingly tough competition from larger players.

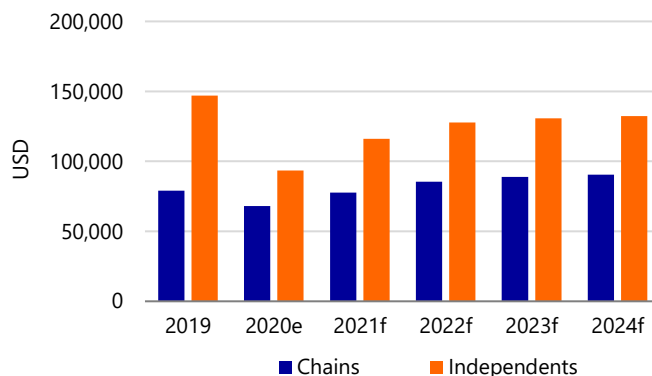
On-Premise to Re-Emerge With a Different Look

Given wine's natural pairing with food, restaurants and bars have always been an important channel for wine sales across most markets. They are a particularly important channel for small wineries, as the on-premise tends to be much more fragmented than the off-premise (making access more viable) and the average bottle value skews a bit higher (i.e. consumers tend to splurge on wine while eating out).

Of course, the on-premise has been severely battered as a result of social distancing measures put in place during Covid. The relative weight of the on-premise channel varies from market to market, but small, independent restaurants are a critical sales channel for small wineries in most major markets. The recovery of the on-premise channel will play a critical role in the recovery prospects of small wineries.

Looking forward, the on-premise channel should begin to return by the second half of 2021, but the return to pre-pandemic levels is expected to be a prolonged process that will result in a sector that looks very different in five years' time than it did before Covid. In the US, sales at full-service restaurants will take years to recover to pre-2020 levels, and the recovery will be dominated by restaurant chains that enjoy solid financial backing, while independent restaurants will still not have fully recovered by 2024, according to projections by Rabobank analyst Amit Sharma (see Figure 2).

Figure 2: Projected sales of full-service restaurants (independent vs. chained), 2019-2024f



Source: Euromonitor, Rabobank 2021

A look at this recovery process has multiple implications for the wine industry:

- The off-premise will maintain some of the market share gains it made during the pandemic, even after social distancing measures are lifted (favoring large, national brands).
- The rising share of chain restaurants will likely favor stronger brands with scale, rather than smaller, boutique brands.
- Many restaurants will not survive the prolonged loss of business due to Covid, but permanent closures will be more skewed to independent restaurants, resulting in more restricted access to the market for smaller brands.
- The independent on-premise accounts that reopen will have existing stocks of wine they will need to sell and will likely have more restricted wine lists moving forward, as they focus on creating efficiencies.

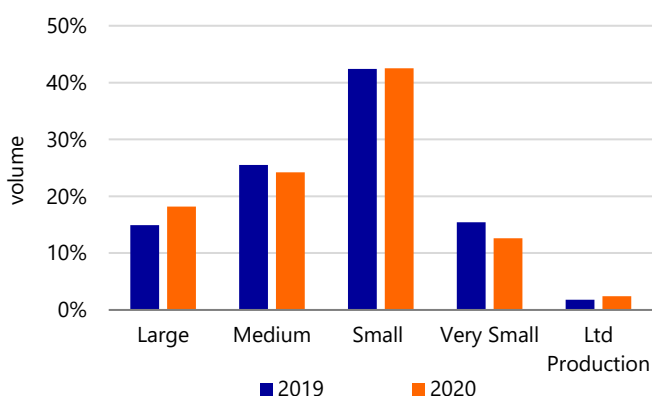
While restaurant chains are far less prominent in Europe than in the US, there is speculation that the recent challenges faced by the on-trade during the pandemic could create opportunities for consolidation of the space in the coming years, with chains potentially gaining share. This trend already started prior to 2020, but Covid is expected to accelerate this phenomenon.

In short, the challenging times facing small, independent restaurants are likely to flow back and create challenges for small wineries that have not created a clear point of differentiation in the market. From a structural perspective, we believe that the prolonged recovery of the independent on-premise channel will create challenges for the small wineries that depended on them for access to the market. Larger wineries will have an advantage in the increased share of off-premise sales and will likely also gain share in the on-premise, due to the rising influence of chains.

E-Commerce Becoming Big Business

In the past, larger wineries generally enjoyed stronger distribution muscle in traditional channels, while smaller wineries were forced to be more creative in exploring alternative routes-to-market. When ShipCompliant and Wine & Vines published their DTC shipping report in 2010, small and medium-sized wineries (producing less than 500,000 cases) were generating nearly 99% of shipments, while large wineries (500,000+ annual cases) were responsible for just over 1%. In the following years, large wineries began placing more emphasis on this channel, and by 2019, they were generating ~15% of DTC shipments. Perhaps even more notably, in 2020, when tasting rooms were shut down and DTC shipments relied more heavily on e-commerce to drive sales, large wineries were the biggest share gainers, rising to 18.2% of shipments. Small wineries (5,000 to 49,999 cases) maintained stable share. The biggest share declines in DTC shipments were among medium (50,000 to 499,999) and very small wineries (1,000 to 4,999 cases per year) that appeared to have had the most difficulty growing DTC shipments without physical tasting room visits (see *Figure 3*).

Figure 3: Change in market share of DTC shipments by winery size, 2019 vs. 2020



Source: Sovos ShipCompliant and Wines Vines Analytics 2021

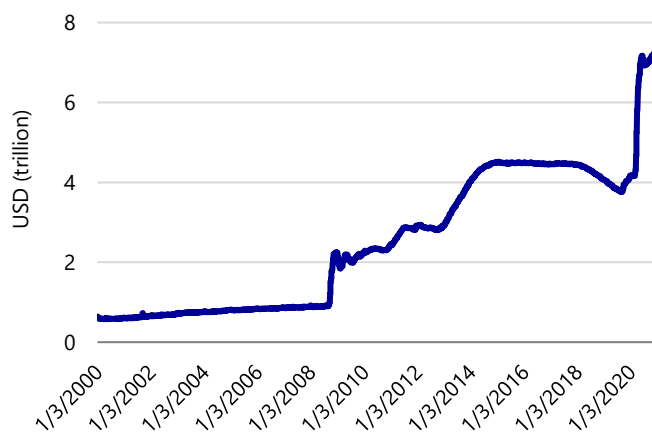
Small, innovative companies have played a critical role in driving e-commerce wine sales over the past decade (Naked Wines, Winc, Vivino, Vinebox, etc.) and will likely continue to play a role in developing this space. More recently, however, large companies have been using their financial muscle to build their e-commerce capabilities. Dr Oetker's EUR 1bn acquisition of e-commerce platform Flaschenpost is a prime example of this. Other, smaller examples abound, such as Constellation's acquisition of Empathy Wines. And of course, only a portion of the investments that large wineries are making has been in acquisitions of companies – much of the investments being made have been in recruiting personnel with e-commerce backgrounds.

In short, while large wineries were initially slow to build out their e-commerce capabilities, many (though not all) are investing to improve in this area. Looking forward, small wineries will likely find innovative ways to connect with the market, but they will be competing with large wineries that are building increasingly sophisticated e-commerce teams.

Private Equity Cash Will Drive Consolidation

In the wake of the Covid pandemic, major industries (travel, entertainment, hospitality, etc.) became paralyzed overnight, bringing economies to a grinding halt. Governments became desperate to take any measure within their grasp to stimulate the economy. Fiscal stimulus plans were introduced in many markets, but monetary stimulus plans were often particularly aggressive. In the US, for example, the Federal Reserve expanded its balance sheet by USD 3.5 trillion over the course of six months in 2020. For reference, this was roughly the same amount it expanded its balance sheet over the six years following the global financial crisis (see *Figure 4*). And it was not just the US – a look at moves by central banks in other developed markets (UK, EU, Japan) show similar trends.

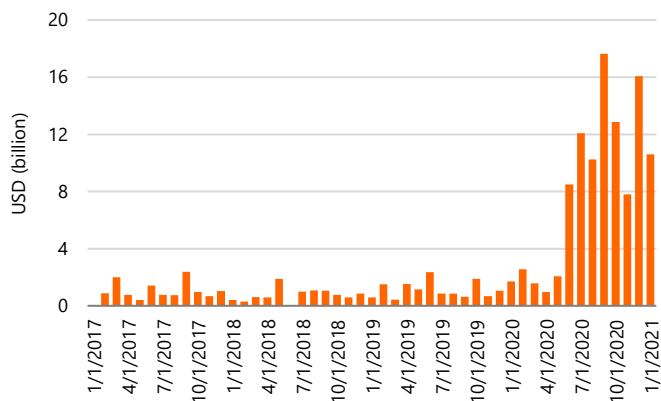
Figure 4: Federal Reserve balance sheet, 1997-2020



Source: Federal Reserve 2020

As a result of the loose monetary policies, private equity funds (PE) have become flush with cash and are becoming more aggressive in pursuing deals. PE funds are increasingly creating special purpose acquisition companies (SPACs) – companies formed with an open mandate (and often without a defined target) to make acquisitions and take companies public without going through an IPO process. These are not necessarily new, but the number of SPACs being formed skyrocketed during 2020 (see *Figure 5*), and with the recent acquisition of Vintage Wine Estates, their presence is already starting to be felt in the wine industry.

Figure 5: SPAC funding by date announced, 2016-2021



Source: Bloomberg Finance L.P. 2021

The increase in liquidity among PE firms (including the rising number of SPACs) could potentially fuel consolidation in two ways. Most obviously, we believe it could create an increase in PE funds looking to acquire and roll up wineries to attempt to create efficiencies.

On the other hand, we believe PE funds (and SPACs in particular) could drive consolidation in the wine industry in a more indirect way. With the number of independent restaurants struggling in the wake of the pandemic, PE funds may be well-positioned to acquire restaurants and small local chains and roll them up into larger, better-funded chains (even in Europe, where chains have traditionally been far less prominent). As noted earlier, the shift from independents to chains will create more challenges for very small wineries.

Summary

The pandemic has created a series of conditions in the market (loss of on-trade sales, increased investment in e-commerce from larger corporate players, and PE funds loaded with cash) that will be much more favorable for larger wineries in the coming years and will likely foster an increased pace of industry consolidation.

That said, there is still strong demand for premium wines, and smaller players will continue to find attractive opportunities in the market if they offer a clear value proposition (it is worth noting that some small wineries performed extremely well last year). For those wineries that have become heavily reliant on the on-premise, though, the outlook will likely remain challenging in the coming years.

Global Wine M&A Outlook

Looking back on 2020, it was a relatively quiet year for M&A in the wine industry. The pandemic created a cloud of uncertainty that kept many on the sidelines. In other cases, deals that had been in the works were delayed, as travel restrictions made closing deals operationally difficult.

2021 to See Much More M&A Activity

However, as we suggested at a recent client event, we believe that 2021 is likely to see a much more active level of M&A deal flow, with some of the deals that were eyed in 2020 finally getting finished in 2021 but also plenty of new deals as well. Some of these will be driven by the types of buyers and sellers we normally see, but we also expect to see deals being driven by less traditional parties, both in terms of acquirers and targets.

Buyers Will Include Usual Suspects and New Faces

Among large wineries, there are some that actually saw an improvement in performance during the pandemic and are starting 2021 in a particularly strong position. This will likely be an ideal time for them to assess new opportunities. Some will be the usual wine companies that have historically been active in acquisitions, but we believe there will be deals by others that have traditionally been less active.

As noted above, we also expect to see PE play a more active role in the space – possibly looking at deals they would not have considered in the past.

Finally, we expect to see an increased level of cross-border M&A, as wine companies seek to tap into growth markets and to respond to a changing competitive environment in the context of the rising threat of trade wars.

China-US Tensions Could Affect Investment Preferences

On the latter point, a [recent Rabobank publication](#) suggests that the rising battle for hegemony between the US and China is likely to have critical implications for trade, as both will use market access as both a carrot and a stick to push trading partners to align on broader policy issues. Viewed in that sense, the recent move by China to hit Australian wines with aggressive tariff increases (after Australia echoed US demands for an inquiry into the origins of the coronavirus) may suggest that China's response was not a one-off retaliation, but perhaps the first shot across the bow in what may become a more protracted conflict with significant implications for trade.

In recent years, China and the US have been the main growth engines of the global wine market, and many exporters have been actively trying to grow in both. It would be worthwhile for wineries to think about contingency plans in the case of sudden disruption of access to either market, given the current context.

New Faces Among Targets

In terms of acquisition targets, we would expect some of the smaller wineries that are struggling with market access to decide that 2021 may be a good time to sell, but we also believe we are likely to see other types of deals as well. Given the rising interest in e-commerce, acquisitions focused on bringing in technology and know-how will also likely become increasingly important. Further, given the growth of alternative categories in some markets (e.g. hard seltzers and RTD cocktails in the US), we would not be surprised to see some wine companies push more aggressively outside of their traditional core categories.

Sustainability Updates

This is a new section of the report, where we want to highlight relevant sustainability initiatives in the industry. If you have suggestions for future topics that may be of interest to the readership, please feel free to send them along.

IWCA to Create DIY Emissions Inventory Tool

The group of wineries that has banded together to form the International Wineries for Climate Action (IWCA) is developing a new tool to help wineries that are interested in joining but lack the resources to pay a third-party consultant to calculate their emissions (having a baseline GHG emissions inventory is a prerequisite for joining the group). The emissions inventory tool will allow wineries to do their own assessment internally, following the ISO 14064 process for GHG reporting, and then pay a professional for a data quality review. The intention is to lower the barrier to entry for the group while concurrently maintaining rigorous reporting standards and to bring more like-minded wineries together to share insights and take action against climate change. IWCA expects to begin rolling this tool out to US west coast-based wineries later this spring and to adapt the tool to incorporate other global wine regions soon after.

Concha y Toro Sustainability Report Receives Top Honors

In October, Chilean winery Viña Concha y Toro was awarded the Hallbar Award for their sustainability report, which was ranked among the top three overall in the world across all categories (not just wine). Argentine winery Trivento Bodegas y Viñedos and Italian wine company Gruppo Mezzacorona also received top honors among global wineries.

It is important to note that the Hallbar awards are not an attempt to rate the sustainability efforts and impact of the wineries but are based more on the reports themselves.

This is not to diminish the importance of the sustainability work that these wine companies have undertaken. Rather, this is to signal the growing importance of effectively communicating around these initiatives. Sustainability is gaining increasing importance among consumers, retailers, investors, and other stakeholders, and the industry needs to be increasingly intentional about communicating the work that is being done.

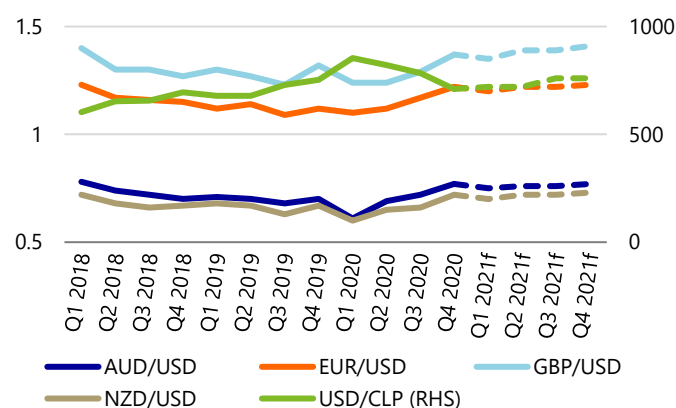
Currency Outlook

US dollar weakness remained the driving theme in the FX markets in the final quarter of last year, as was the case since the spring of 2020. Despite worsening news regarding Covid-19 restrictions, risk appetite was heightened on the back of plentiful monetary and fiscal policy stimulus and vaccine-related optimism.

In the G-10 space, the relatively higher yielding Australian dollar and New Zealand dollar found strong support (see Figure 6). These currencies were also lifted by Australia's and New Zealand's trading links to China and optimism about the recovery of the world's second largest economy. That said, tensions between China and Australia have been associated with various restrictions on Australian exports, mainly in agricultural sectors.

The euro's rally vs. the greenback continued into year-end, buoyed by more attractive real interest rates in the euro zone. US dollar weakness lifted the GBP/USD exchange rate. Though against a basket of G-10 currencies, the British pound failed to find much support from the pre-Christmas EU/UK trade deal.

Figure 6: Wine currency movements and forecasts, Q1 2018-Q4 2021f



Source: Bloomberg, Rabobank 2021

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| Stephen Rannekleiv | Global Strategist – Beverages | Stephen.Rannekleiv@rabobank.com, +1 718 755 9312 |
| Jane Foley | Head of FX Strategy | Jane.Foley@rabobank.com, +44 20 7809 4776 |

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