Hardly a week goes by without an article in the press heralding some new achievement of the Australian wine industry and a re-statement of the industry target of exports of $1 billion by the year 2000. Roughly translated, on current market parameters, year 2000 exports would top 250 million litres, or a 150% increase on the recently announced milestone of 1993 exports of 100 million litres.

What does this mean in terms of winegrape production and vineyard development?

In line with the rest of the world, domestic wine consumption, currently at 310 million litres per annum, has been declining. However if we assume it stabilizes or, at best, grows marginally to 320 million litres during the period to the year 2000, we are looking at a total potential market of 570 million litres in the year 2000, from an annual crush of around 760,000 tonnes.

In their 1992 projections of wine grape production, the Australian Bureau of Agricultural and Resource Economics (ABARE), using data based on what was known to be in the ground at that time, estimated 1994–5 winegrape production would reach 679,000 tonnes. A continuation of the historical industry growth rate of 3% per annum would see production increase 106,000 tonnes (80 million litres) to reach 785,000 tonnes by the year 2000, suggesting that future demand is covered.

However, when it is considered that most of the export growth will occur in existing and new premium varieties, a simplistic view of the above numbers can be quite misleading. If all the new production was in premium varieties, there would still be a 70 million litre (93,000 tonnes) shortfall on projected export demand.

Part of this apparent shortfall will be met by the redevelopment of current non-premium vineyards; however, on current plantings and historical growth trends, we are looking at a shortfall in the range of 50–70,000 tonnes of premium varieties to service our target markets.

At average yields, this production shortfall represents an additional 4–6,000 hectares of new vineyards, which, at a development cost of $35,000 per ha, calls for an industry investment program of $150–200 million.

If production is to be available to meet expected demand in the year 2000, and assuming an average 4 year period until a vine is fully bearing, this development will have to be completed over the next 3 years at a rate of $50–65 million per year.

This is a big task in anyone’s language. However, it accurately quantifies the challenge facing grapegrowers and winemakers and underscores the opportunity for what is arguably
Australia's best value-added industry to consolidate its position in the international market place.

Looking at these supply and demand numbers, any newcomer to the wine industry would be excused for thinking that winegrape growers are facing greatly improved income prospects.

The export market opportunities now being contemplated by the industry are completely without precedent, and having regard to the experiences of the 1990s, I get more than a little concerned when I see the word 'boom' starting to creep into some press reports. The export success of an Australian wine has been founded on quality and price and unless we can maintain both, our hard fought gains will be rapidly dissipated.

We now have the opportunity to develop and consolidate substantial markets and production resources over the medium term, and, in the process, build a stable and sustainable industry generating above average returns for both growers and processors.

Therefore, I suggest that we are now in a completely new set of circumstances, and to ensure that all participants share in the benefits, we will need to re-shape the relationship between growers and processors, so that, together, we can continue to deliver a predictable product at a predictable cost.

In terms of the amount of wine traded internationally, Australia really only has a toe-hold in the market, our total exports amount to approximately 1.9% of the annual volume. However, having now established our presence in the principal markets of the U.K, mainland Europe and North America, there is virtually unlimited opportunity to spread laterally within these markets, constrained only by limitations to supply.

Who is going to take up the challenge to develop 4-6,000 ha of vineyards?

The wine companies

During the past few months there have been announcements by a number of wine companies regarding the initiatives they are taking regarding future fruit supply. Part of these initiatives includes the expansion of existing vineyards and the development of new vineyards.

A part from the four major groups, Orlando, B.R.L. Hardy, Mildara Blass and Penfolds, the capital bases of the remaining listed and private wine companies are relatively small and, at $35,000 per ha, they may not be in a position to contemplate significant areas of vineyard development without major capital raisings.

Penfolds has a policy of maintaining 40% self-sufficiency in overall fruit requirements and up to 70% in premium varieties. Currently it has in excess of 4,500 ha of established vineyards. Programs are in place to ensure that we maintain at least this degree of self-sufficiency in the expanding markets through to the year 2000, and this represents a major ongoing capital commitment to the continued development of the industry.

Institutional investors

Direct investment in vineyards by institutional investors is not particularly widespread, and any exposure institutions have taken to the Australian wine industry has tended to be via the listed wine companies.

However, given the long term nature of a vineyard investment and the high level of capital inputs during the development stage, the capital strength of institutional investors would be a decided advantage in effecting a rapid, cost effective expansion of the industry, provided the resulting returns were competitive and commensurate with the risks involved.

At the end of the day the vineyard investment has to compete against the 'safe' fixed interest securities, the (potentially) shorter term gains and flexibility of the equities market, and, until more recent times, the 'security' of the urban property market. Unfortunately rural based investments, no matter of what ilk, have traditionally been placed in this last category, despite the fact they have little in common with bricks and mortar.

In the current climate, institutional fund managers have had difficulty obtaining allocations of funds for rural/property type investments, however if they want a slice of one of Australia's most exciting and dynamic value-adding industries, then I suggest they may have to sharpen their pencils.

Private investors

Historically, private winegrape growers have accounted for 80% of industry supplies, and collectively, they represent the greatest capacity to rapidly expand production.

The higher costs and lower yields of the 1993 vintage will have affected the ability of some growers to contemplate expansion, however, with interest rates and inflation at low levels, and likely to stay that way for some time, there probably hasn't been a better opportunity to undertake expansion or re-development for some years.

What are the essential ingredients of a profitable vineyard investment?

Economic unit size

In addition to the basic requirement of land with the desired viticultural attributes of soil type, aspect, water, drainage and climatic conditions for a particular variety or varieties, the vineyard needs to be of sufficient size to ensure that it generates economies of scale, particularly in the areas of:

- labour and management
- machinery
- infrastructure

In cases where there is an employed vineyard manager, the investment will have to be of sufficient size to both attract, and afford, a high quality manager. The old truism holds: 'You only get what you pay for'. Quality management needs to be complemented by an efficient workforce, balanced between permanent and casual employees, and, given the nature of the tasks involved and the indivisibility of labour units, a manager and two permanents is likely to be the minimum combination.

This suggests that, ideally, the minimum economic unit vineyard investment should be around 80 (+) ha.

Compared with many vineyards in the established winegrape growing areas of South Australia and the Sunraysia, this suggested minimum economic unit may seem a gross overstatement; however, if we are to achieve the efficiencies that will keep our industry world competitive, I am convinced that this is the way we must go.

The argument is reinforced when you examine the utilization of machinery and the justification of major capital items, such as tractors, spray units and mechanical pruners and harvesters. To minimize the costs of production growers need to embrace the labour-saving benefits of mechanization, but for many existing growers the opportunity is denied, due to their small size. Competitive forces will continue to pressure these growers to amalgamate, further utilize contractors, form machinery co-operatives or, ultimately, leave the industry.

The major infrastructure expenditure is generally in the area of water supply and drainage, and the cost of a bore, pump site or channel does not vary much whether it is servicing...
In the primary industry strategy document New Horizons, released earlier this year by the National Farmers Federation, primary producers were urged to look beyond the farm gate for their returns and to view themselves as part of a value-adding production chain, rather than as a producer of a basic commodity.

This philosophy applies equally to grapegrowers as it does to wool and wheat producers, and, as I suggested earlier, calls for an even closer working relationship between growers and wineries.

The ability of the wineries to deliver a consistent retail product relies, to a large extent, upon them having a predictable cost of production. The establishment of overseas marketing and distribution channels is a very expensive exercise, and to have the confidence to tackle new markets and the vagaries of foreign exchange wineries need a stable platform on which to build their markets.

Similarly, in these uncertain times, growers have a parallel requirement for greater predictability and security of income.

In the aftermath of the banking and corporate fiascoes of the past few years, the bankers' 'theme' of the 1990s is 'Risk Management', and this just as applicable to vineyard investments as it is to foreign exchange dealings.

Supply contracts between growers and wineries have been a feature of the industry for a number of years. However, I have detected a healthy degree of scepticism in some quarters where people consider current grape contracts to be not much more than a 'statement of intent'; the more unscrupulous growers 'dutch auction' contracted fruit in times of shortage.

With the solid industry outlook we are now facing, it is timely to review the grower/winery system of contracted fruit supply with the aim of forging a closer, cooperative working relationship between growers and wineries.

Some suggested changes are:

• longer terms, i.e. 8–10 years instead of 3–5 years
• agreed or indexed prices for up to 5 years, rather than annual re-negotiation
• pre-determined grade incentive payments for improved fruit quality
• agreed viticultural practices to ensure fruit quality
• agreed re-development schedule

While the amount a winery can afford to pay for fruit is ultimately determined by the selling price of the bottled product, in setting grape prices the winery also has to be conscious of the need for growers to earn a competitive return on their vineyard investment, commensurate with the risks involved and having regard to the returns offered by alternative investments.

By working between these points of reference, growers and wineries should be able to achieve an equitable sharing of the benefits flowing from new market opportunities and at the same time achieve the mutually desirable predictability of incomes and costs.

A s I mentioned at the beginning of this paper, the success of Australian wines is a factor of both price and quality.

By removing the annual uncertainty regarding grape prices, through improved contract pricing, I am confident we can go a long way towards eliminating the 'tonnage mentality' which exists amongst some growers, who push their crops to maximize yields, invariably at the expense of fruit quality.

Through a combination of pre-determined incentive payments for higher grade fruit and agreed viticultural practices, I am confident growers can be encouraged to concentrate on achieving optimum sustainable yields and fruit quality.

Funding

The sort of money we are talking about is not exactly lying about in growers' bank accounts and, apart from a proportion of the development requirement which will be undertaken by the major corporates, wineries with access to funds, the majority of the development capital will be sourced from the banking sector, through public raisings or from institutions.

Banks

In the light of the 'new prudence' which has swept through the banking sector of late, the maximum funding a grower could expect for a new development would be 50% of the development costs through to maturity, against a full equity funding of the balance.

On current cash flow estimates for the minimum economic unit outlined above, payback would be expected within 7–10 years. Banks would naturally take great comfort from a winery grape contract for the life of the loan, as it underwrites, to a large extent, the income stream from the vineyard and the bank's potential exposure is reduced to the abilities of the manager and the climatic reliability of the area of the vineyard.

We have seen a lot in the press in recent times regarding excessive risk margins charged by the banks to primary producers.

It is one thing to complain about the charges and another to demonstrate to the banks that financial risks are being actively managed. Using a type of contract along the lines of contract the grower can achieve up to a 1% reduction in the risk margin on their borrowings.

Public

Some of the smaller public floats of wine companies in recent times—e.g. McGuigan and Lehmann—are predominately winemakers and marketers with a relatively small investment in vineyards, relying mainly on contracted growers. These floats have been heavily supported by private investors and have little or no institutional shareholders with the financial muscle to finance significant vineyard developments.

Investment syndicates in the form of Limited Partnerships or Unitised Public Companies were popular during the 1980s, but unfortunately for the wine industry, some less than successful tax-driven ventures have left a sour taste in investors' mouths and could make them a little cautious second time around. The regulatory requirements for this type of public capital raising have now become prohibitively expensive—up to $250,000 for the simplest prospectus—and there is a tendency for such funds to be sourced through a limited offering to a closed investment group, such as the clients of a broker, accountant or solicitor.

The decision by the current Federal Government to tax Limited Partnerships as companies was indeed by short sight-
ed and has effectively killed off a number of development projects in Australia, in which the establishment risks were, to a significant extent, underwritten by the ability of the Limited Partners to utilize the taxation losses in the early years. This structure was particularly suited to vineyard investments, with their high front end costs and long lead time to full maturity.

Institutions
As mentioned earlier, there is very little direct institutional investment in vineyards and the principal exposure of institutions to the industry is via the larger listed wine companies, Mildara Blass, BRL Hardy and Penfolds via SA Brewing.

With an increasing emphasis on industry-based super funds, a very large amount of long term investment capital is being accumulated by Australian fund managers. While some of this capital will find its way offshore, there is a valid case for investment in domestic projects which will directly and indirectly benefit the members for whom the funds are being invested.

Given the limited capacity of the private sector to fund major vineyard development projects, I firmly believe there is a golden opportunity to marry up the proven management and viticultural skills of the private sector with the capital strength of the institutional sector, by way of joint ventures, managed investments or specialized ‘wholesale’ institutional investment vehicles, such as the Pooled Development Fund concept recently promoted by a Sydney investment bank, AustAsean Ltd.

There is an interesting parallel in the needs of the wine industry and the development of the cotton industry in Australia. Cotton required large amounts of capital to develop the land and water resources, and compared with other irrigated crops, it has a relatively high level of annual inputs. Like most agricultural industries, it has its share of weather problems. However it has developed a sophisticated processing and marketing structure which allows growers to manage their risks, with the support of superior technical and financial services.

From where I stand, I can see no reason why the Australian wine grape industry cannot emulate this success, and, in fact, do it that much better, because we control our product right through to the finished product.

Returns
For the industry as a whole to be successful, all elements must be profitable and in dividing the ‘profit cake’, due regard must be given to the relative risks and capital commitments of each of the participants.

In evaluating the risk profile of a winegrape grower one looks at the comparable returns from other long term investment alternatives. These generally comprise:

• fixed interest securities
• listed shares
• urban property.

With 10 year Government Bonds yielding around 7.5% and the better quality urban property investments changing hands on yields of 10%, the target yield for an efficient winegrape vineyard investment producing premium varieties, on this scale, should, in my opinion, be a minimum of 15% per annum.

Depending on the location of the vineyard, mix of varieties, and ultimate fruit quality, some investments may be capable of much higher returns, however, as mentioned earlier, when negotiating long term fruit supply contracts, wineries need to ensure that efficient growers achieve a return on their investment commensurate with the risks they carry, because if they go out of business, then so do we.

Conclusion
Successful investment is all about backing winners.

Australia has now firmly established itself as a serious participant in the premium end of the world wine market, and, given the competitive position of our production resources and the depth of our viticultural and winemaking expertise, the industry is worthy of significant support from the finance and investment sectors, at the level where, many will argue, all great wines are made— in the vineyard.