

SOUTH AFRICA

THE HONEYMOON IS OVER

Although only five players account for 75% of total wine sales, the number of small estates has doubled over the past five years. Many were banking on further euphoric growth; others transformed from fruit-growing to winemaking only because of the collapse of the bulk market. That should have been a warning, thinks Michael Fridjhon.

The Mandela miracle of the Cape wine industry – the extended honeymoon period that followed the first democratic elections in 1994 – is now indisputably over. At the end of 2006, the Wines of South Africa (WOSA) office finally admitted that the year-on-year export growth, which had been the trend for a little over a decade, had turned suddenly into a net volume loss. In certain key export markets the decline is nothing short of catastrophic. The UK, long the Cape wine industry's biggest trading partner, had shed 18%, year-on-year. The Netherlands, another big, though low-priced, customer of South African wine, was down an extraordinary 31%. All that kept the total literage loss below 10% was an increase in bulk sales and significant volume growth in Germany and France. Since this sales decline comes at the same time as what is euphemistically called stagnation on the home front, in fact slightly shrinking per capita consumption, the industry has nowhere to hide. Unsurprisingly, bulk stocks have increased by more than 25%, a situation made more uncomfortable by the fact that there is now no useful surplus-removal mechanism to bail out those who grow grapes but cannot sell their produce.

In many respects, this is a new era for the Cape wine industry. Until the KWV transformed itself into a trading company, it functioned as a parastatal national co-operative with statutory powers to manage the industry – and therefore its over-production – by acting as a buyer of last resort. However, in the boom that followed Mandela's release, the KWV negotiated with the African National Congress (ANC) government to abandon these statutory functions and to take over assets it had used to perform them. The then Minister of Agriculture Derek Hanekom had no objection to ending the quasi-socialist role played in the South African economy by the agricultural control boards. He clearly understood that the future would

have to be subsidy-free. However, no one appears to have anticipated the speed with which the export boom would suddenly come to an abrupt halt.

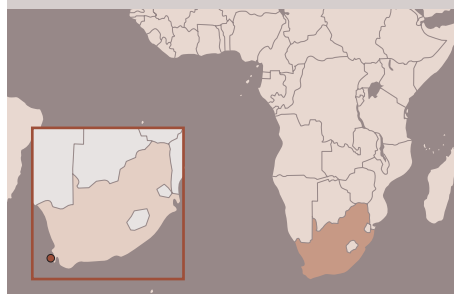
The problem has also been exacerbated by the surprising resilience of the South African currency. The rand had been losing value since the mid-1980s, and even the rise to power of Nelson Mandela and the evidence that the ANC government was better at managing the economy than the old National Party, did little at first to stem the slide. By early 2002, £1 cost R19. Twenty-five years earlier it had cost around R1.60.

The ever-weakening currency provided a perfect safety net for grape growers and wine producers in the post KWV era – their subsidy came in the form of a currency losing value at a rate of at least 10% per year. Certain in the knowledge that the rand would weaken, they happily granted customers extended credit terms, relying on the exchange rate to pay a bonus when the funds arrived.

From the absolute trough of early 2002, the rand has clawed itself back to a position of relative stability and to a fair reflection of its value and buying power in international terms. At the moment, slightly less than R14 buys £1, less than R10 buys €1 and just

over R7 buys \$1. Except for a brief blip when emerging markets took a pounding in May to September of last year, the rand has been strong or strengthening for most of the past five years. While it has not recovered its pre-May 2006 value, it is finely poised, yielding adequate income to the country's resource producers without hammering inflation on the back of high rand-based petrol prices. In short, currency is unlikely to provide the redemption so fervently prayed for by the 4,000-plus grape farmers. The 2007 vintage is likely to be the largest harvest on record, and grape prices are presently hovering well below the cost of managing vineyards.

1	Benchmark Data	www.co.za
Inhabitants:		47.4 million
GDP:	US\$ 570.2 billion (€ 426.7 billion)	
Currency:	South African Rand ZAR (ZAR 100 = € 10.40)	
Per capita wine consumption:		8.6 litres
Total wine consumption:		3.45 million hectolitres
Legal drinking age:		18
Vineyard area:		132,000 hectares
Total production:		8.9 million hectolitres
Exports:		2.72 million hectolitres



To make matters worse, the producer and wholesaler side of the industry is characterised by some five players who account for more than 75% of the national wine sales, and about 600 whose combined efforts dispose of the rest. Since this last figure has more than doubled in the past five years, it is clear that the dearth of experience and capital that tend to go hand in hand with the majority of such start-ups will undermine the industry's ability to buy its way out of trouble.

The prospects are therefore anything but comforting: a significant percentage of South Africa's producers have only transformed from fruit-growing to wine-making because of the decline in the market for bulk grapes. Many have borrowed against the value of their land to build the cellars that have now re-defined their existence. They have little or no extra money with which to establish brands or to buy their way into the local or export market. All they have done is throw good money after bad, investing heavily in deferring the insolvency scenario, which inevitably overwhelms operations that can never recover their running costs from the income the market is willing to grant them.

Mostly, the industry still comprises grape farmers, a breed whose objectives - maximum yield for maximum income - is inimical to the objectives of the fine wine market. The majority grew up in the KWV-dominated era when a floor price was guaranteed - and was set at a level which ensured the certain survival of the greatest number. In the boom years of the Mandela administration, sustained demand for their fruit saw prices rise in real terms by 20% to 30% annually. A shortage of premium red grapes and only adequate supplies of internationally acceptable whites created an extraordinary seller's market. Conditional selling - premium noble cultivar reds were only traded on condition that the buyer agreed to take the almost unsaleable whites - created the illusion that there was a market for

QUOTE UNQUOTE

» Golden Kaan is the category opener for the South African segment in Germany. «

Thys Loubser is the newly appointed CEO of KWV

The KWV sells about 2 million cases of wine and brandy each year, with 75 % of that volume on the export market. Their turnover till 30 June 2006 was ZAR1,186m (€123.5m), permitting the company to employ 550 people in South Africa and another 50 in Germany.



the fruit and an insatiable demand for grapes, irrespective of provenance and condition.

Plantings and the Vineyards

In the past 12 years, the Cape has seen a massive replanting programme. In the early 1990s, white varieties comprised over 60% of the national vineyard. This percentage has substantially been reversed - particularly at the premium end. A 700% increase in Shiraz in as many years is the most striking indication of the pendulum's swing. For those who undertook the capital investment - it costs around R100,000 to replant a hectare in constant 2001 prices - borrowing was pretty much essential. At current average grape prices, assuming average yields, growers are losing R5,000 per hectare before debt service on these investments or on any other of the property's borrowings.

Growers are compelled to continue their plantings, mainly because South Africa suffers from a world-class collection of vineyard viruses. Even material supplied by the nurseries as 'virus-free' often show - within five years of the vineyard

2 Liquor consumption in South Africa

Year	Litres				% Change
	Natural wine ¹⁾	Fortified wine ²⁾	Sparkling wine ²⁾	Total litres	
1994	320,378,032	36,509,698	8,568,835	365,456,565	7.6
1995	342,100,466	36,236,207	7,940,366	386,277,039	5.7
2000	355,203,198	28,430,650	5,605,035	389,238,883	-0.4
2005	301,092,670	35,500,000	8,431,000	345,023,670	-1.7

¹⁾ Includes wine used in grape-based liquor and alcoholic fruit beverages.

²⁾ Figures based on various industry sources.

3 Total quantity of wine exported

Year	Natural wine	Fortified wine	Sparkling wine	Total litres
1994	48,446,024	1,284,187	961,597	50,691,808
1995	71,207,264	793,035	806,708	72,807,007
2000	139,800,022	471,513	68,237	140,956,772
2005	279,117,217	406,982	1,537,164	281,061,363
2006	269,130,800	486,549	2,018,211	271,635,560

Table 3 shows that while exports of natural wine and even sparkling wine have risen dramatically, exports of fortified wines have lost significant ground despite general off-shore growth.

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being established – tell-tale russet-coloured leaves early in the ripening season. In an era when almost all fruit came from partly or wholly virus-infected vineyards, this was accepted as something of a ‘given’ among grape buyers. However, the massive vineyard renewals of the past decade, coupled with the depressed prices for almost all red grapes, has empowered buyers at the expense of sellers. There is virtually no market for compromised fruit, a situation that fuels the new planting mania even in the current tough trading environment.

Monitoring the growth in vineyard plantings in South Africa is an exercise in tracking the fortunes of the wine industry itself. In 1993 – the year before the first democratic elections – wine grape vineyards covered 83,717 hectares. In 1998 this had risen to 89,935 – less than might have been expected, but a fair reflection on what was available at the nurserymen. By 2005 – the last year for which official statistics are available – this had increased to 101,607 hectares.

Unsurprisingly, upgrades in terms of variety ‘nobility’, as well as the phyto-sanitary condition of the vines, are a central part of this exercise. From 1997 to 2005, Chenin Blanc, still the most widely planted variety, declined from 30.1% of the national vineyard to 18.8%; Colombard from 12.4% to 11.3%; Crouchen Blanc from 3.7% to 1.1%; and Muscat d’Alexandrie from 6.0% to 2.6%. In that same period, Cabernet Sauvignon increased from 5.7% to 13.4%; Shiraz from 1.6% to 9.6%; Merlot from 2.5% to 6.8%; and Cabernet Franc from 0.3% to 1.0%.

The Major Export Markets

The United Kingdom: Notwithstanding the dramatic drop in exports to Britain, the UK remains South Africa’s most important export market. In 2006 it accounted to just over 82 million litres (compared with over 97 million in

QUOTE UNQUOTE

»» Our new campaign is a winner, but is not going to change the world tomorrow. ««

Su Birch, Wines of South Africa

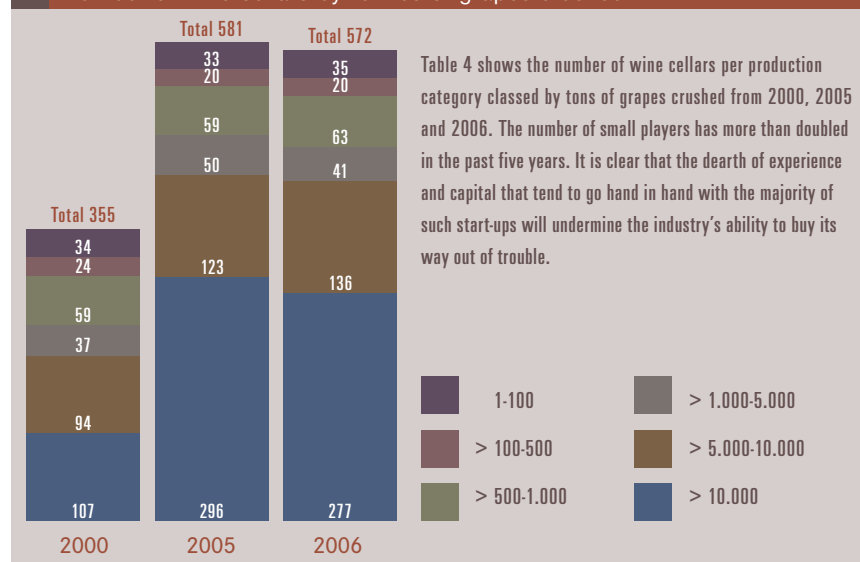
Su Birch the new managing director of Wine of South Africa, the country’s wine marketing board. Resolute and calm, she points out that figures for the most recent three-month period suggest a significant turnaround, which would make the dip no more than a blip.



2005) – 30% of the total South African offshore trade. There is obviously considerable concern at the loss of literage. Some explanations include the ‘no discount’ policy applied by Constellation following its acquisition of Western Wines, owners of Kumala, the number one South African brand to the British market. Margin rather than literage may work for Constellation, but it obviously knocks the statistics. Jan Scannell, CEO of Distell, offers another view. He believes that the attrition taking place at the commodity end of the spectrum is costing – and will continue to cost – South African market share. ‘As long as there is a global wine glut, this market will be ruled by price alone,’ he said. ‘It is unlikely that the Cape will ever be able to perform competitively in such an environment, and it’s not certain that it is even desirable to try.’

DGB’s Tim Hutchinson does not dispute this analysis. ‘Everyone talks about the poor performance of the South Africa industry, but the discussion is always around the £3.99 commodity end of the market – which is not where our future lies,’ he says. He believes that a commitment to

4 Number of wine cellars by tonnes of grapes crushed



5 Planting of wine varieties by colour

Year	Colour	Vines	Hectares
1986	Red	997,601	289.08
1986	White	9,800,945	2,994.94
1996	Red	3,765,814	1,223.61
1996	White	6,308,062	2,040.88
2006	Red	1,536,436	506.52
2006	White	6,702,355	2,268.69

Table 5 shows that, although the size of red wine vineyards has grown in proportion, white wine varieties continue to lead in the planting charts, as growers convert to more noble varieties.

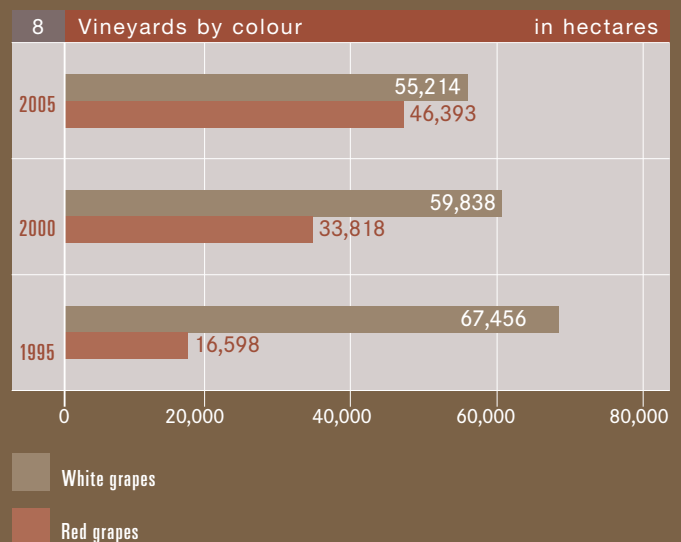
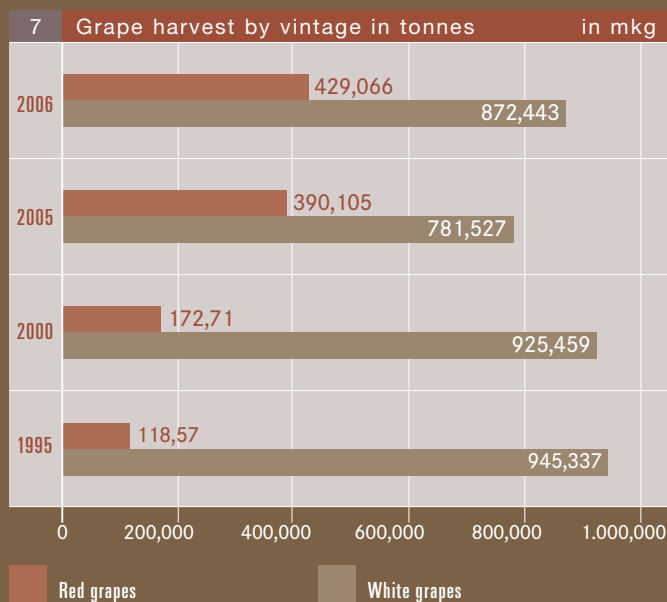
6a	Exports by country in litres in 1997		
	Country	Litres	% of Total
1	United Kingdom	45,684,203	41.515
2	Netherlands	12,651,601	11.497
3	Germany	9,233,414	8.391
4	Belgium	6,979,146	6.342
5	Canada	6,105,315	5.548
6	Japan	4,237,745	3.851
7	Switzerland	4,104,879	3.730
3	Germany	3,946,011	3.586
9	France	3,839,402	3.489
10	Denmark	3,198,831	2.907

6c	Exports by country in litres in 2005		
	Country	Litres	% of Total
1	United Kingdom	97,746,863	34.778
2	Netherlands	47,197,815	16.793
3	Germany	35,952,286	12.792
4	Germany	20,103,981	7.153
5	Canada	12,749,601	4.536
6	USA	10,178,043	3.621
7	Denmark	9,727,217	3.461
8	Belgium	8,290,373	2.950
9	New Zealand	5,629,585	2.003
10	France	5,430,348	1.932

6b	Exports by country in litres in 2000		
	Country	Litres	% of Total
1	United Kingdom	58,273,333	41.3
2	Netherlands	25,125,103	17.8
3	Germany	10,850,077	7.7
4	Switzerland	7,851,223	5.6
5	Belgium	6,706,865	4.758
6	Sweden	4,865,883	3.452
7	Denmark	4,768,607	3.383
8	France	4,750,750	3.370
9	Canada	4,381,329	3.108
10	USA	2,356,073	1.671

6d	Exports by country in litres in 2006		
	Country	Litres	% of Total
1	United Kingdom	82,192,304	30.258
2	Germany	41,613,215	15.320
3	Netherlands	37,061,982	13.644
4	Sweden	23,221,869	8.549
5	Canada	12,140,258	4.469
6	Denmark	12,020,811	4.425
7	USA	10,834,251	3.989
8	Belgium	9,257,381	3.408
9	France	8,550,526	3.148
10	Republic of Ireland	5,305,969	1.953

Tables 6a-6d show the Top 10 in South African exports as they have evolved from 1997 through 2000 and 2005 to 2006 by country. Although the United Kingdom remains by far the largest market, volume fell in 2006. The Netherlands, which had shown impressive growth, has also lost momentum. Germany, on the other hand, continues to grow and has quadrupled sales over the past ten years. South African producers hope that emerging markets in the United States, Canada and Scandinavia will soon absorb the current overproduction.



Tables 7 and 8 show the rapid growth of red wine varietals, both in vineyards and harvest.

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brand building and the right commercial partnerships will see volume gains (albeit sometimes only modest) but, more importantly, significant value enhancement. In the past year, DGB has increased its listings in the above-£5 category and sold over 100,000 cases in the on-trade. It has become Waitrose's eighth largest wine supplier, delivering more Cape wine to the upmarket chain than any other distributor. Charles Back - regarded as the most entrepreneurial of the Cape's producers - has had an almost identical experience. In a decision that initially cost him a measurable drop in volumes five years ago, Back shifted the focus of his business from multiples to specialist retailers and the on-trade. The strategy appears to have worked for him: while the Cape was losing literage in the UK in 2006, Back saw a 20% growth in his Fairview and Goats du Roam brands.

Germany: South Africa's number two export slot has changed in the past year, with Germany supplanting the Netherlands as the Cape's second most-important market. Between 2005 and 2006, exports to Germany increased from 36 million to 41.6 million litres. A significant amount of this growth comes from the KWV's joint venture brand with Racke: Golden Kaan appears to be doing for South African wine in Germany what Kumala achieved in the UK. KWV's newly appointed CEO Thys Loubser is upbeat and predicts growth and consolidation with this front-running brand. 'Good market penetration has been achieved globally,' he says. 'Golden Kaan is the category opener for the South African segment in Germany, with now more than one million bottles sold.'

Holland: The dramatic drop in exports to the Netherlands - from 47 million litres in 2005 to 37 million in 2006 - has caused more than its fair share of anguish in the Cape. No one doubts that the bulk of what has been lost is at the most discounted end of the trade. It is probable that Scannell's analysis of the volume losses in the UK applies equally well to the Netherlands, a market that has always been under price

QUOTE UNQUOTE

»» Our future does not lie in the commodity end of the market. ««

Tim Hutchinson is the managing director of DGB

DGB is a privately owned business, with 40% of the equity controlled by management. It does not disclose its volumes, but industry sources estimate the company wine business to be in the vicinity of 2.7 million nine litre cases. DGB does advise that 70% of their wine



volumes are sold in the international market. Their major wine brands include Boschendal, Bellingham, Douglas Green, Saints Legacy, Tall Horse, Beach House, Oude Kaap for Sweden & Benelux, Culemborg, which is sold principally in Benelux and Germany as well as Millstream (Carlsberg -Tetley).

In South Africa DGB do the Warehousing and Distribution for the Pernod Ricard group, the world's second largest Wine and Spirit Company, and the local bottling of a range of their Spirit brands.

Besides marketing their own wines, DGB also own a range of locally produced spirit brands and is the South African marketing and distribution agent for Fortune Brands, Jagermeister, Veuve Clicquot, Whyte & Mackay, San Pellegrino and Balvenie Whisky.

With its Cape Exclusive Wines division the company also sells and distributes a range of premium estates: Rustenberg, Buitenverwachting, Capaia, Delheim, Kanonkop, Niel Ellis, Oak Valley, Overgaa, Saxenberg, Hamilton Russell and Vergelegen.

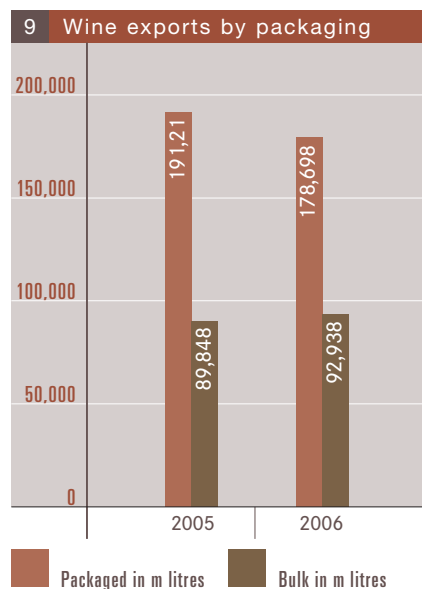


Table 9 shows that while bulk wine exports continue to rise, bottled wines fell by 7% in volume in 2006.

10 Bulk wine prices

Year	Wine	Volume in '000 litres	Average price	Value in '000 ZAR
2000	White	279,186	145.67	406,704
2000	Red	47,534	603.56	286,893
2005	White	286,294	297.57	851,935
2005	Red	113,498	440.49	499,951
2006	White	269,772	310.51	837,681
2006	Red	108,6471	406.02	441,133

Table 10 shows that the average price of red wine in bulk has fallen sharply over the past decade, the consequence - supply and demand - of the rapid growth in vineyard area.

pressure from the brokers and their retail clients, who drive much of this trade. Hermann Böhmer, CEO of The Company of Wine People, which does a lot of its business in Holland, claims that its volumes actually increased in 2006. 'We have achieved very significant volume growth – particularly for Welmoed off an already high base – but there has been listings growth for new SKUs too,' says Böhmer. 'We ascribe this to brands which are correctly positioned, but very importantly to a great partnership we have with our Dutch partners. They clearly see that the promotional tool kit consists of more than deep discounts.'

Sweden: Sweden continues to be South Africa's fourth-biggest market, growing by 15% in 2006 from 20 to 23 million litres. More importantly, it is in the higher value segments that much of this increment is being recorded. DGB's Hutchinson points out that the new Bellingham Shiraz listing – on an international not a South Africa tender – has added 600,000 litres at the price point equivalent of £6.99. As one of the top exporters to the Swedish liquor monopoly, South Africa is well positioned to consolidate both volume and value in this market.

Canada: Canada remains the fifth-biggest market for Cape wine – though literage actually declined in 2006 from 12.7 million to 12.1 million litres. Historically the US's northern neighbour used to be a very important destination for Cape wine and brandy. While much of this volume was lost during the sanctions era, it has slowly been coming back. A strong

QUOTE UNQUOTE

»» As long as there is a global wine glut, this market will be ruled by price alone. ««

Jan Scanell, CEO of Distell

With 4,140 employees and a turnover of ZAR6,7 billion (€698m) in 2006 financial year, Distell is the largest player on the South African wine market. Listed among the top 100 companies at Johannesburg Securities Exchange, it is the market leader in all South African wine price segments, except low price commodity products. 43% of all Distell's premium wines are exported, allowing the company to derive 18% of its turnover outside of South Africa. Distell is also market leader in brandy, which is the largest spirits category in South Africa. Interestingly, it is also the largest cider producer in Africa and 2nd largest worldwide. The latter title also pertains to its cream liqueur Amarula. Analysts award it for flexibility, as in its immediate responsiveness to a three million bottle listing in Germany, and reliability, stating that is the the preferred South African supplier to major international buyers.



expatriate South African population in Canada no doubt contributes to this growth. In addition, until Constellation took control of Western Wines, Kumala was owned by Canadian-based Vincor, and this too must have played a role. Scannell believes that there is still substantial potential in Canada. Accordingly, the company's North American office is working now at building brands - rather than volumes - in both the US and the Canadian markets.

The Best of the Rest - and an Outside Chance

The US, Denmark, Belgium and France each import between 8 and 12 million litres per year of South African wine. France has shown the greatest growth - from 5.4 million to 8.5 million litres in 2006. This dramatic increase - off a reasonable base and in one of the most patriotic of wine-drinking markets - suggests that South Africa should be focusing its marketing efforts in the heart of the Old World. So it may come as something of a surprise to discover that WOSA, and several of the bigger producers, are investing time and effort in the Far East. DGB has already entered into a joint venture with Chateau Indage that will see Boschendal, Bellingham and Douglas Green represented on the Indian market. Distell has an office in Singapore, while WOSA is working to grow trade between South Africa and India. At this stage, the actual sales don't make it onto the radar screen but, with strong social, political and emotional connections between South Africa and the Indian subcontinent, and trade barriers falling away, this could become one of the bigger markets for Cape wine by the end of this decade.

How does South Africa go forward?

It has often been said that South Africans are a nation of incurable optimists. In the presence of the 2006 decline in exports, WOSA CEO Su Birch is resolute and calm. For a start, she points out, figures for the most recent three-month period suggest that there is a significant turnaround - which would make the dip no more than a blip. She also cites the ongoing success of relative newcomer First Cape and the work being done by Constellation on Kumala in the UK.

However she sees the Cape's biodiversity positioning statement - a campaign launched in 2006 - as the basis for a long-term and unreproducible USP. 'Variety is in our Nature' is catching the increasingly eco-sensitive mood of the world and gaining massive and valuable editorial space. 'It's a winner,' she says, 'but it's not going to change our wine world tomorrow.' With 50,000 hectares conserved on farms in under two years, it is clear that the industry is doing more than merely paying lip-service to a marketing exercise. 'I am convinced,' she says, 'that as a long-term positioning this clearly differentiates our wine industry, underpins authenticity, and builds the quality image we need to trade up. It also helps grow our wine tourism industry, taking it into the whole world of eco-tourism and protecting the values for future generations.' ■



THE SOUTH AFRICAN WINE INDUSTRY - A BRIEF HISTORY

Vineyards were an integral part of the agricultural programme of the Dutch settlers who, in 1652, established their first permanent colony on the site where Cape Town is today. Within seven years of their arrival, they had crushed their first crop. By the end of the 17th century, their competence was strengthened by the arrival of French settlers fleeing religious persecution following the Revocation of the Edict of Nantes. A few were even producing creditable wine.

A hundred years later, just as James Cook was sailing into Botany Bay, the Cape's most famous wine - Vin de Constance - was fetching more on the Dutch East India Company's auctions than the ex-cellar price of either Château Lafite or Château d'Yquem.

In the 19th century, following the Napoleonic Wars, the Cape became a British colony and its wine farmers profited initially from Imperial Preference. However, in the end the English penchant for Claret, as much as the shaky quality of wine exported under a preferential tariff regime, scuppered the arrangement. This financial disaster was followed by oidium and phylloxera, and by the end of the 19th century the Cape wine trade was in ruins.

Replantings on grafted rootstock followed - as did the inevitable glut. In the end, to save themselves the inevitable spate of bankruptcies, the wine farmers banded together to create a national wine co-operative, the KWV, to 'regulate' the industry. A succession of acts of Parliament - designed to strengthen the KWV's statutory powers and to maintain the voting support of the wine lobby - followed. This finally led to the merger in 1979 between the KWV (as the representative of the grape farmers) and Stellenbosch Farmers Winery and Distillers (as key wholesalers with powerful retail interests.)

This was the high point of the grape farmers' power. Insensitive over-pricing opened the way for beer to overtake wine as the beverage of choice among all South Africans. By the time the ANC came to power in the closely-watched 1994 elections, the privileged position of white grape growers was clearly coming to an end. ■