HD **Private equity looms over Australia's wine industry**

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It is sometimes said that at least investors in vineyards can drink their losses. Indeed, it's been a rocky few years for the Australian wine industry. External pressures have been challenging and much of the industry is in a deep malaise. This is most true for smaller producers, and even more especially true for those at the bottom of the industry's value chain – the growers of non-premium wine grapes.

The pressure was ramped up in May's with a bid from private equity firmKohlberg Kravis Roberts for Treasury Wines Estate (TWE) - the owner of the renowned Penfolds - at $4.70 per share. Joined this week by fellow New York-based hedge fund Rhône Capital, the offer was upped to $5.20. In the absence of something better, or the bidders getting cold feet, the offer looks likely to succeed.

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Foster's foray

Times were not always so tough for small producers. Throughout the 1990s, both wine production and export prices grew steadily , marking a renaissance for an industry long seen, at home and abroad, as trailing the traditional wine growing regions of Europe in terms of quality and efficiency.

Steeped in the history of the South Australian wine industry, Penfolds led the growing recognition of quality Australian wine with Grange (once Grange Hermitage), generally considered one of the world's great reds – with a price tag to match.

In hindsight its acquisition by Foster's in 2005 was a disaster , more so for Foster's than the Oatley family, who cashed out their stake acquired when they rolled their Rosemount business into Southcorp Wines previously.

Foster's takeover was driven by the view that the beer industry was mature and lacking in growth, and thus Foster's management wanted something more exciting. They certainly found this through the acquisition of wine producers.

Beer and wine – what could possibly go wrong?

As it turned out, just about everything went wrong! Beer and spirits are essentially industrial products, while wine is deeply rooted in agriculture. External factors beyond the control of the company did not help – including a soaring Australian dollar, drought, powerful retail buyers and a production glut producing intense competition from other "new world" producers for sales.

Foster's spun off the various wine businesses that it had assiduously acquired into TWE in 2011. Independent of Foster's, TWE did well for a time, before falling foul of the buying power of Australia's retail duopoly of Coles/Wesfarmers and Woolworths in late 2013 and 2014. This was especially true in the vital lead-up to Christmas 2013, when sales slumped and profit projections were downgraded .

What next for Australia's wine industry?

What the Treasury Wines buyout means for the remainder of the Australian wine industry is an important question. KKR and Rhône clearly see an opportunity to cut costs and build profits before selling the business off in a few years. Likely casualties in such a scenario will be the less profitable labels that produce low margin, low priced wine. This process was already underway at TWE, but will likely accelerate under the new ownership.

For many grape growing communities, this process may spell disaster. Already struggling with prices that barely cover the cost of picking, a smaller industry more focused on premium wine will likely see a mass exodus of producers within SA's Riverland, Victoria's Murray Valley and the NSW Riverina.

The upside for the bidders will be building the penetration of their major labels, especially Grange and the remainder of its ' icon and luxury brands ' into Asia, and especially China.

China's love affair with (premium) wine

China's love affair with imported premium wine is symptomatic of wider trends. An escalation of both import volumes and average prices per bottle to China have been driven by gift giving and extravagant hospitality. KKR and Rhône see this trend as likely to continue, in spite of the mooted austerity drive of top Communist party officials.

Chinese consumers of wine are generally within its upper economic echelons, and for them consumption of imported wine is as much about status symbolism as the product itself. Thus, for Australian wine producers hoping to replicate Penfolds' success, the challenge will be to get the right balance between price, volumes and market image.

This won't be easy. Penfolds has both an established brand story and access to Chinese consumers through its distribution network. For smaller producers, replicating both of these will be a challenge. Groups like Australia's First Families of Wine are attempting to do just this in a collaborative manner. As private companies, their success is hard to gauge, but their premium products and strong brands should hold them in good stead.

Longer term, the prospect of a hundred million middle-class Chinese drinking imported wine (albeit of the more humble, non-premium variety) regularly is an enticing prospect for Australian exporters. What the last two decades have shown, however, is they will have strong competition. Barriers to increasing supply of such wine from producers in Chile, New Zealand and South Africa are limited. Even if exports in wine volumes in these lower priced products increase, margins will be scant.

In this regard, the future for wine grape growers throughout inland Australia does not look good. Combined with perennial problems of water scarcity and salinity, images from Steinbeck's Grapes of Wrath come to mind. Managing the social and economic consequences of this for inland wine grape growing regions will be an important challenge.

John Rice is a member of the Australian Labor Party and the National Tertiary Education Union.

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