Postcard from Napa

Wine improves with age, but don't forget the young

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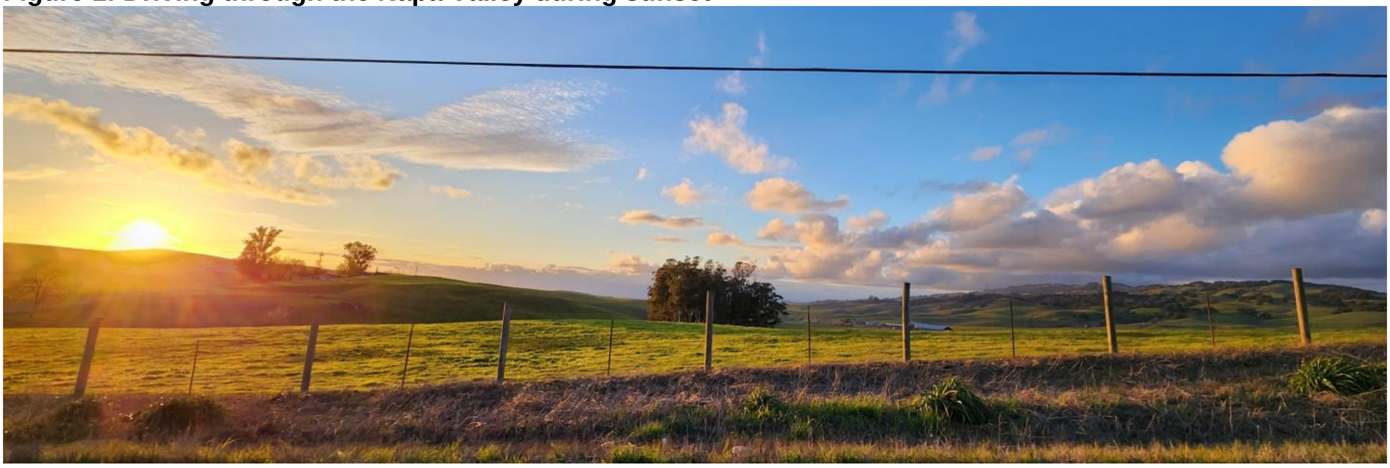
As part of the Treasury Wine Estates (TWE) investor tour, we spent some time in Napa, which is a 90-minute drive over the famous Golden Gate Bridge from San Francisco (if you take the scenic route!). The Napa is a renowned wine region in the US. During Cabernet season it sees wine aficionados, big spenders from nearby Silicon Valley, and LA celebrities flock there for a drop of the latest vintage.

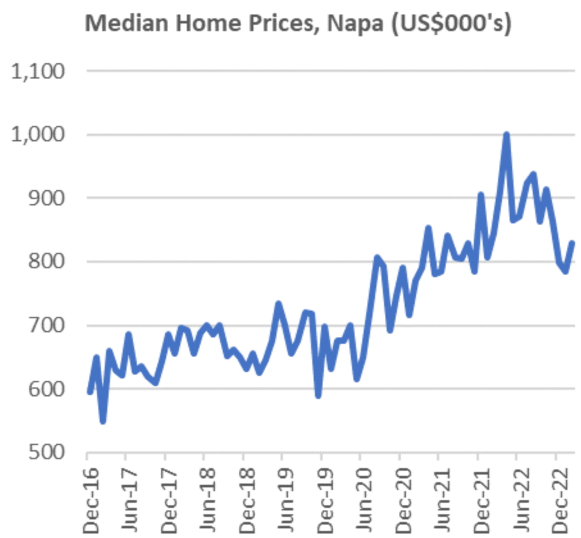
Figure 1: Driving through the Napa Valley during sunset

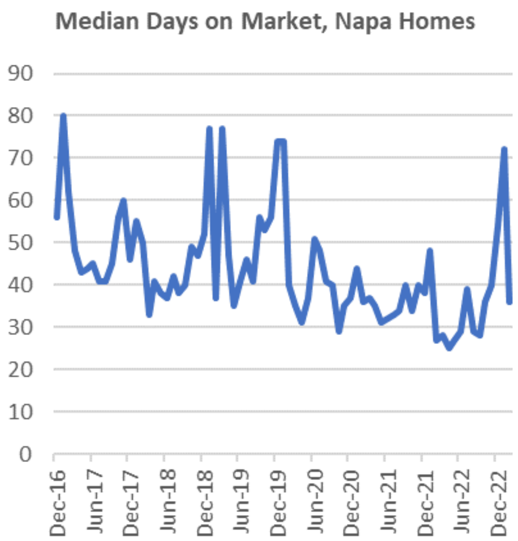


Source: Antares Equities; March 2023

Our meetings with wineries, vineyards, distributors, industry consultants and advisers revealed that the region is certainly cooling on the back of the tech layoffs over the past 12 months. Hotel room rates are moderating but still high vs pre COVID on the back of strong demand from travel. However, according to data from Redfin, home prices in Napa are down 6% compared to the same time last year and the average time on the market has extended from 38 days to 54 days. No doubt, Napa's property market has been a beneficiary of the previously low interest rate environment which has been unwinding. Coinciding with this are some emerging challenges (and opportunities) which wine companies will need to navigate in order to be successful in coming years.

Figure 2: Napa Home Data





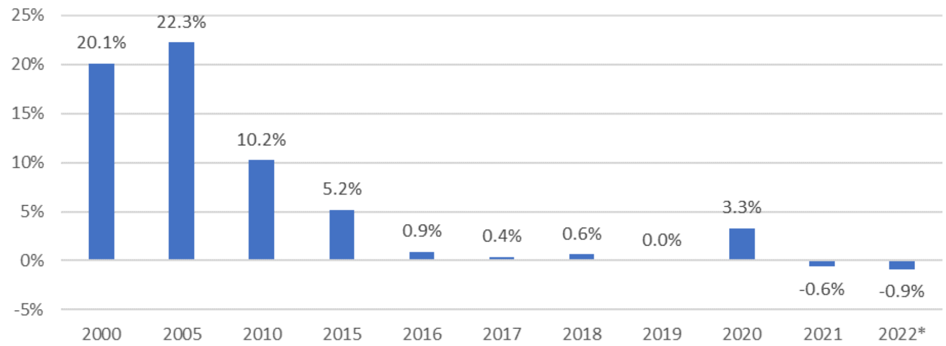
Source: Redfin, March 2023

Emerging challenges to be navigated in the US wine market
Our research on the ground (or on the vines so to speak) revealed there are a number of challenges emerging in the US wine market:

- Total US wine consumption volumes are now in modest decline.
- Wine is losing "share of throat" to spirits and ready to drink (RTDs)
- The industry is not doing enough to recruit younger consumers into wine
- There is an ongoing bifurcation in wine between high volume, low priced wine (<US$15/bottle) which is shrinking, and lower volume premium/luxury wine (>US$15/bottle) which is growing.

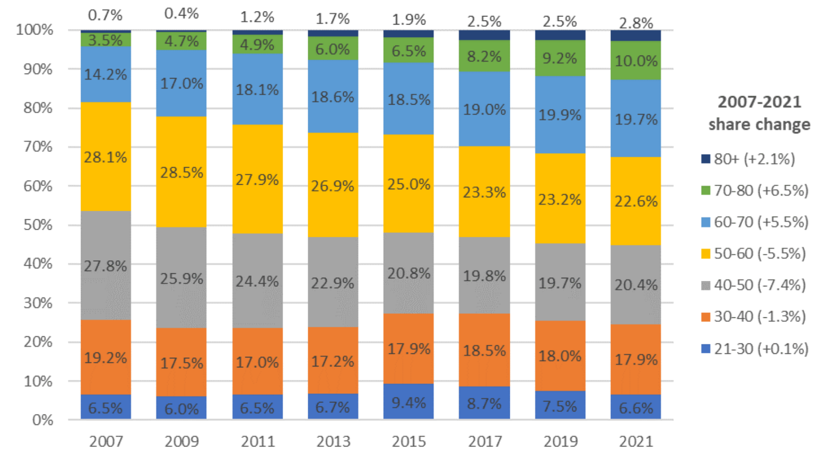
The following charts illustrate some of these dynamics.

Figure 3: US total wine volumes consumed (% change) – now in decline



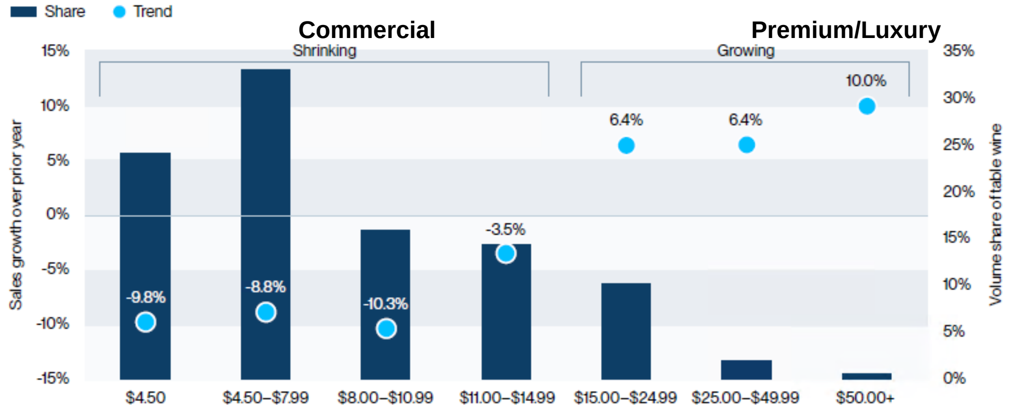
Source: Shanken Impact Databank Review & Forecast, 2022 (* denotes estimate).

Figure 5: US share of wine sales by age category – >60 yo's gaining, <60's losing value share.



Source: Customer Vineyard, Sovos ShipCompliant, 2022

Figure 6: US market share and growth of wine at different price points – bifurcation between commercial & premium/luxury



Source: SipSource, 2022

Premiumisation is important in a declining market
With the commercial end of the market declining and becoming increasingly commoditised, there is less margin available to invest in brand and innovation to stimulate additional demand. As such this end of the market is in material decline. However, as Figure 5 highlights, the premium and luxury categories are still experiencing mid to high single digit trend growth.

We believe TWE's sharpened focus on premium and luxury wines in this context is the right one. The company strategically divested its US commercial wine portfolio and acquired Frank Family Vineyards in 2021 (such that now luxury/premium is now 92% of the Americas net sales revenue). These moves position TWE in the growing segment of the market and provides greater portfolio resilience from economic cycles given the end consumer tends to be wealthier.

The need to recruit younger consumers
Whilst there will be some consumers that enter the wine category at high price points, the majority of new consumers tend to enter the category at lower "premium" price points ($15) and graduate to higher price points over time. Therefore, in order to benefit from premiumisation over the long term, there is a need to introduce younger consumers to the category to underwrite future growth.

The majority of wine industry contacts we met with agreed that the fragmentation in the US wine industry means there is a lack of coordination in bringing new consumers into the wine category. This is supported by the data in Figure 5 that <60-year old's have consistently had a declining share of sales since 2007.That is not to say industry participants are not making any effort. On our travels we noted experiential based wine bars, wine clubs and tasting rooms set up closer to the city with a view to capture the San Francisco crowd (the price of an uber from San Francisco to Napa is >US$100 and the trip takes 90 minutes). There is also some packaging innovation occurring with canned wine. Beyond this, we think ongoing brand innovation has a large part to play in encouraging new consumers into the category

Figure 7: Canned wine at Shake Shack, Eco Terreno (Sonoma based) urban tasting room in SF

Source: Antares Equities, Eco Terreno; March 2023

Targeting younger consumers with appealing brands
TWE has had good success in the past in introducing new consumers through brand innovation. The best example of this was with the 19 Crimes portfolio and the flagship Snoop Dogg Cali Red (the most successful wine launch of all time) and Martha's Chard (the most successful wine launch of 2022). TWE revealed at the investor day that Snoop's Cali Red alone had brought >400k new consumers to the wine category. While the 19 Crimes portfolio in the US appears to have stagnated (our visits to supermarkets revealed its price point had been pushed down below $15), the company shared its plans to relaunch the brand to include new labels, limited editions, enhanced augmented reality experiences, a partnership with the Ultimate Fighting Championship (UFC) and a rebellious new tag line "*obedience gets you nowhere*".

TWE has not been alone in brand innovation with younger consumers. There are a number of competitor brands that continue to grow double digits year on year and are introducing new consumers to the category at the >$15 price point. Some of these brands include Josh Cellars, Decoy (Duckhorn), Bread & Butter, Chloe and Seaglass. Other producers such as Accolade wines have followed suit in driving celebrity endorsements in recent times with the company signing NBA star James Harden in January for the J-Harden x J-Shed Wines portfolio aimed at the younger consumer. We believe some of these could be attractive M&A targets for TWE. However, this competitive activity points to an ongoing need for TWE to also aggressively innovate and take risk on portfolio extension.

Connecting with the consumer on the premiumisation journey
As the new consumer becomes more engaged in the category, grows wealthier and more sophisticated, their wine journey generally sees them consider higher priced wines classified as premium ($15-20), super premium ($20-30), ultra-premium ($30-50), luxury ($50-100), super luxury ($100-200) and icons ($200+). Below we highlight key offerings in the premium and luxury space in TWE's Americas portfolio along this journey.

Figure 8: TWE premium & luxury portfolio examples

Source: TWE Investor Day Presentation, March 2023

To take the consumer along this journey TWE needs to have the right portfolio of brands which cover these price points. To this end, TWE have a noticeable gap in the $20-30 super premium segment where its distributors are likely selling competing product. TWE may be able to close this gap through brand extension, or more likely, acquisition. The other issue that needs to be addressed is a lack of brand coherence – consumers looking at the labels above are unlikely to know that they are all TWE wines. Whilst this has appeal to consumers looking for something unique, the task of getting a 19 Crimes Cali Red drinker to try a Stags' Leap or Penfolds cabernet is not an easy one and points to the need for brand awareness to be built across each label in the portfolio. TWE has strong distribution partnerships in the US. In the large states of Califronia and Texas, the company has partnered with Republic National Distributing Company (RNDC) who have a heavy wine focus relative to other distributors. This partnership assists TWE in ensuring its brands are visible in on-premise and off premise locations. However, we also see an opportunity for TWE to be more directly connected to the consumer to drive awareness.

Experiences and brand content are key
This is especially important given the brand fragmentation of the wine category. When we visited supermarkets in the US we were overwhelmed by the sheer choice of brands and the associated difficulty in labels trying to stand out. Before the consumer gets to the supermarket they need to have a connection to the brand. There is an ongoing need to invest in experience (restaurants, tasting rooms, direct to consumer, wine clubs) across the entire portfolio to ensure the consumer is connected to the TWE portfolio along their wine journey. To this end, TWE acknowledges the importance of experiences and direct to consumer capabilities, with an emphasis on talkability and lifestyle in brand content. While we observe some promising activity in parts of the TWE Americas portfolio (Penfolds, 19 Crimes relaunch) we see the need for more activity across the broader suite of brands.

The opportunity is there - further brand innovation and M&A necessary
Premium/luxury wine is arguably a Veblen good – goods which rely on scarcity to drive demand. Hence luxury wine labels eventually get capped in their ability to grow supply without impacting brand perception.

Veblen good: A good where demand increases as the price increases. They enjoy an upward sloping demand curve, which is contrary to normal demand curves that sees demand increase as the price falls. Veblen goods are typically sought after by affluent consumers and are perceived as high quality, well made and status symbols.

For TWE to continue to grow, ongoing portfolio extension through organic innovation, and inorganic portfolio expansion are necessary features. Following the success of the innovative 19 Crimes launches in recent years, we hope to see further innovation and brand launches that extend the portfolio. We also believe TWE is likely to be active in M&A over the next few years to further flesh out its premium and luxury portfolio. Our analysis of its balance sheet position suggests that there is adequate capacity to undertake smaller acquisitions. If necessary, there is also the possibility of using scrip to undertake larger portfolio acquisitions. Good brands and assets come at a price, however our meetings with wine M&A advisors suggested that the down turn in the market may present opportunities.

Wine is an age-old story, but there are new stories to be told
Wine as a beverage is said to be at least 8000 years old, however it continues to evolve over time. There are generational differences between millennial/generation Z consumers and baby boomers in values around work, pleasure, experiences and world views which inform their consumption preferences. Consumer research suggests that these younger consumers are curious, adventurous, health conscious and are interested in experience, connection and relationships with others and the world around them. They are also very interested in provenance – we have seen this in other consumer categories such as cosmetics, skin care and food. Wine has a lot of credibility in this regard relative to other alcoholic beverages - organic wine is one of the fastest growing categories in the wine segment. Attributes around relative health benefits, what is in the bottle, how it was grown and the unique narrative behind each bottle and vintage are all parts of the story that can be articulated better.

Sustainability is a branding opportunity for TWE
Sustainability is an important, yet under-appreciated part of the provenance story for TWE. Touring TWE's vineyards and wineries, we were surprised at how progressed the company is in sustainability initiatives around water, biodiversity and the environment through the use of modern agricultural technology. Examples of these initiatives at vineyards and wineries we visited included:

- Electrification of vehicle fleets and tractors
- Autonomous farming equipment (improved efficiency, safety)
- Solar installation
- Water telemetry (automated remote sensors to measure water usage)
- Use of software and equipment design to improve water and energy efficiency
- Use of biochar and compost for carbon sequestration and improved water retention
- Restoration of biodiversity to shore up long term resilience against invasive species.

Figure 9: Modern hybrid electric and autonomous farming equipment at TWE's Gamble Vineyards

Source: Antares Equities; March 2023

We came away with a greater appreciation of the progress TWE has made on sustainability and believe this will become an increasingly important element of the brand story in the future. Aside from the brand benefits with younger consumers, managing sustainability of natural capital for wine companies is becoming increasingly important against a backdrop of climate change as it relates to land resilience, water security and vineyard location – we see this as equally important to long term growth as investment in brands.

Conclusion – there is still growth to be had in the US
TWE is a portfolio holding across a number of Antares funds (we held it prior to the trip and continue to post).

In recent times the Penfolds portfolio and speculation around Chinese tariffs being lifted have led market participants to believe that TWE is currently a play on the China reopening (we share this view). We have observed share price volatility as news flow around these topics evolves.

However, TWE Americas is a strategically and financially important part of the business (accounting for 37% of group EBITS in 1H23). We believe it is being under-appreciated by the market due to concerns around industry headwinds. We, like many, are cautious on the US consumer more generally, but note that luxury remains one of the bright spots in the US economy. The execution of the Americas premiumisation strategy provides the business with both resilience and growth. As a result, we see the company's targets to grow earnings whilst improving margins towards the 25% target and beyond as achievable. Key to this is execution on:

- having the right portfolio and brand message which will appeal to younger consumers;
- getting closer to the consumer through experiences and brand content;
- engaging in brand evolution, innovation and acquisition; and
- articulating provenance and sustainability credentials more clearly.

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