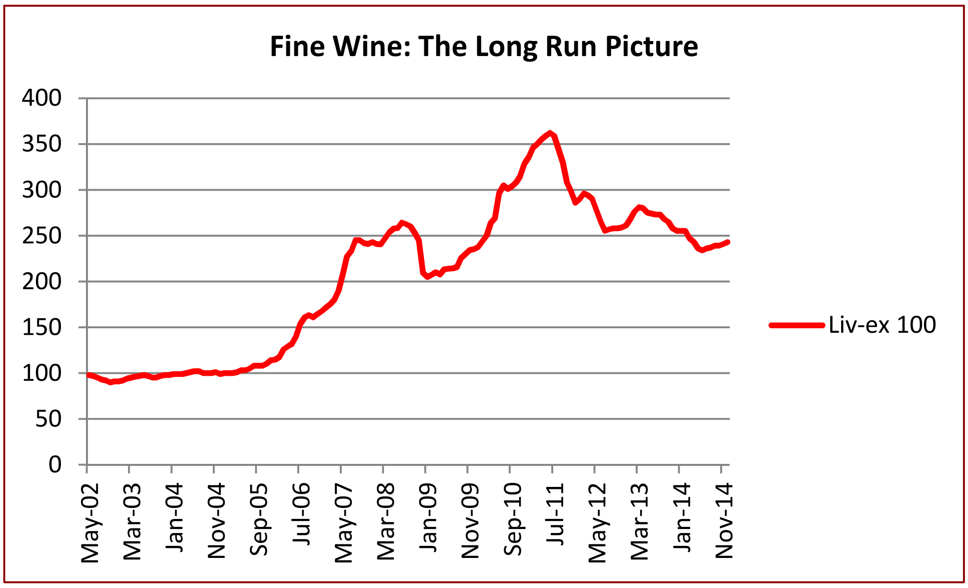
Fine Wine Market Outlook

BI Investment Group, March 2015

Context

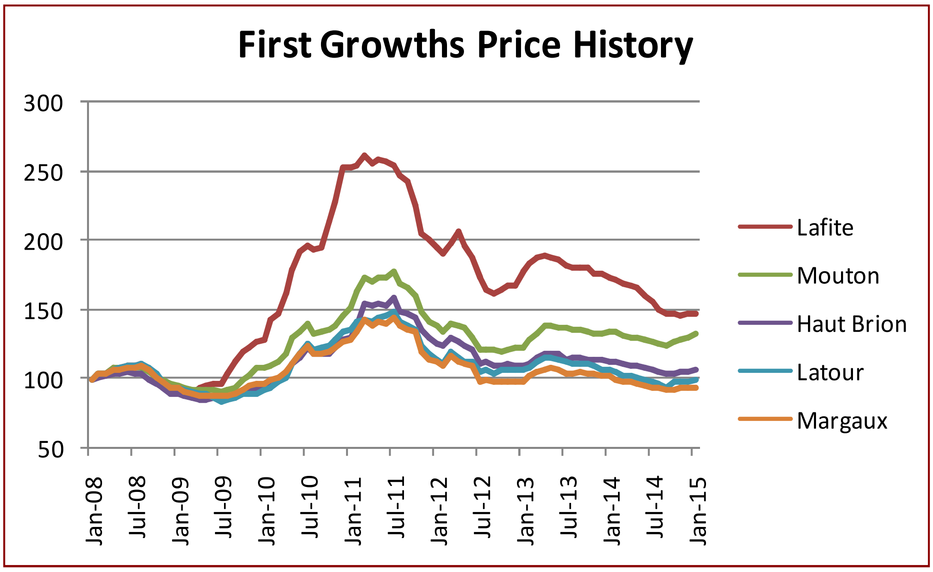
The long-run performance of the fine wine market is an impressive one. With a compound annual growth rate of nearly 10% since 1990 it compares favourably with most conventional and alternative investments. However, as the chart below shows, trend growth over recent years has been accompanied by uncharacteristically high volatility. Following a period of essentially static prices from 2001 to 2005, the market enjoyed several years of heady growth (2005-2008) before falling sharply in the wake of the Financial Crisis. Thereafter, from early 2009 to mid-2011 wine experienced a further period of enthusiasm as Asian buyers and worldwide investors pushed prices to new highs. Again this period of growth was followed by a significant correction from Q3 2011 as large institutional investors exited and excess supply pushed prices lower. By the summer of 2014 we were looking back on almost 40 months of declines taking aggregate prices down by over a quarter. To put this in context, the BI Index is today at the same level as early 2010 and prices for many of Bordeaux's blue chip wines are back to 2005/6 levels. In some ways it is as if the explosion of interest over the last decade never happened.

Despite, or perhaps because of, this challenging retrenchment, the fine wine market is today in more robust health than it has been for many years. It is worth reflecting that during the last 3 plus years whilst investment activity went in to reverse, the regular business of selling wine for export, collection and consumption has continued in good health. Indeed, the depth and scope of the fine wine business has never been more benign. Whilst much remains amiss in the macro environment, we are seeing, for the first time in several years, a positive outlook emerging as stock overhangs have been worked out of the market and real, export-driven demand is picking up again. Looking to the future there are strong grounds for thinking that the sell-off has run its course and may indeed have over-shot and that as confidence builds, capital returns and crucially a more representative period of stability and growth will again assert itself.

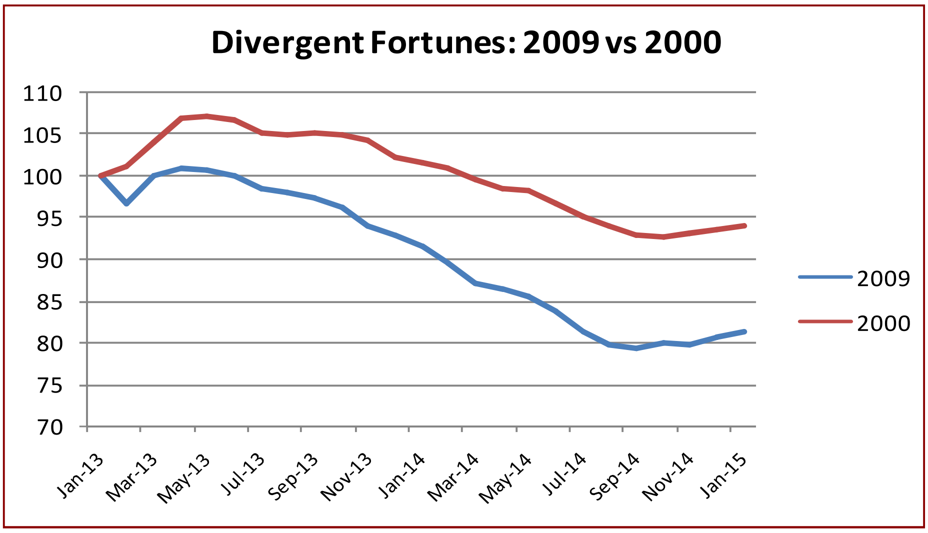


Winners and losers

Whilst there is a very clear trend to prices across the brands, vintages, critical assessments etc. individual experiences have and do vary significantly. As the chart below illustrates, Lafite has enjoyed the wildest of rides over the last decade as it came to be the 'must have' fine wine of the emerging China market only to be unceremoniously dropped as knowledge grew, prices slipped and government crack-down bit.



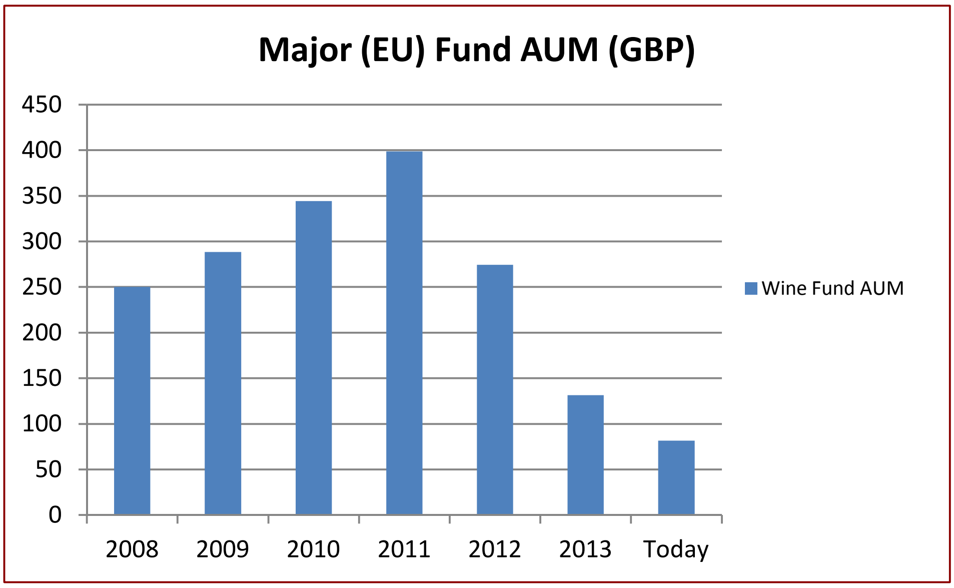
Vintages also provide a snap shot of divergent fortunes as, for example, the much-hyped, and equally over-priced, 2009 vintage has significantly under-performed the 2000 vintage where speculation was rife and consumer support more in evidence. Even within brands there can be large differences; again looking at Lafite to illustrate, for the period of 2008-2015 the price of the 1986 vintage increased a modest 3% whereas the 2005 slumped by over 30%. Indeed, in the post-spring 2011 period where positives are almost non-existent wines such as Mouton 2000, Angelus 2012 and Montrose 2010, for reasons of idiosyncratic demand or re-rating, have provided strong positive returns. All of which is to say, fine wine provides ample scope for alpha, especially so given the market's disaggregated OTC structure and data opacity.



Investment in wine

Investment in wine has been a *de facto* part of the market for centuries but it was not really until the mid-2000s that organised investment funds began to emerge. As the chart below indicates, the major players controlled significant assets in their pomp and they undoubtedly helped fuel the booming markets of 2005-2008 and again in 2010-2011. Assessing how influential they were in the rising market is difficult but it is safe to say that their effect in the falling markets of 2008 and again in 2011 was fundamental. The rapid redemption of several tens of millions was a new experience for the normally tranquil waters of fine wine trading; add to this the failure of several smaller, but collectively important, investment companies in 2011/12 and there was real pressure placed on the market 'infrastructure'. Yes, the sales had a large impact on prices and dented confidence, but there is a case to be made that the market was far more robust and liquid than many might have expected. BI alone managed the divestment of over GBP 30m between 2011-2014 for a single investor and did so without pushing spreads unduly or any particular price volatility.

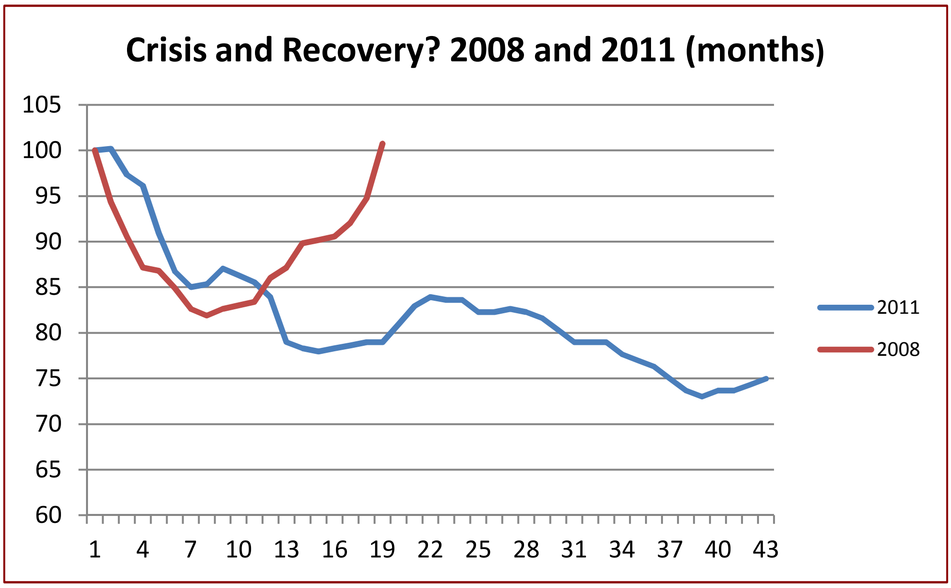
Stock shortages – this is the first time in 5 years that we, as the largest trading merchant, do not know with any great confidence if (let alone where) major pools of stock are still in existence.



Crisis and Recovery

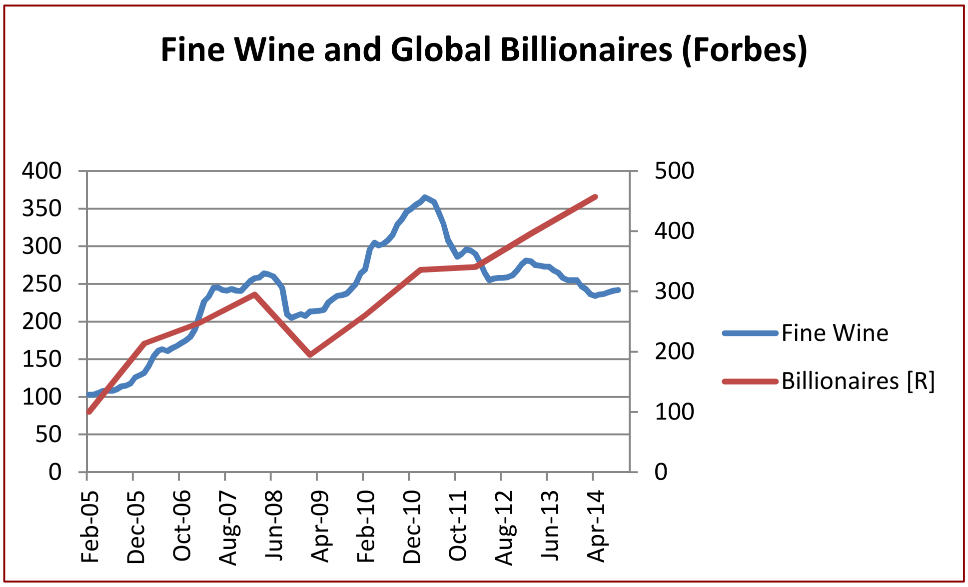
The dramatic way in which the market recovered and then pushed-on in the aftermath of the Financial Crisis was with hindsight clearly exceptional. Voracious buying from China, and those seeking to follow the trend, meant full recovery was achieved in 12 months. It is reasonable to believe that the China demand benefited directly from the large programme of quantitative easing (QE) that PBOC engaged in from 2008. Contrast this with the 2011 'recovery' where, despite multiple and enormous rounds of QE in the US, Japan, UK and the much trailed prospect of the EU, there has as yet been no discernible impact on prices. Being an inflation hawk is a lonely business these days but if the unprecedented money printing of recent years does eventually ignite inflation (or more likely asset bubbles) it is likely that physical/commodity assets will be amongst the chief beneficiaries.

It is also worth observing that the long, drawn-out, 'death by a thousand cuts' of the last 40 months has chased away a great many investors. We've seen waves of selling as redemption periods have arrived or patience has snapped. Formal investments in wine are often made on a fixed duration basis leaving investors little chance to pre-empt the decline. The nature of the clear-out has been both frustrating and painful for participants but it has also been essential in returning the market to a more sustainable footing.

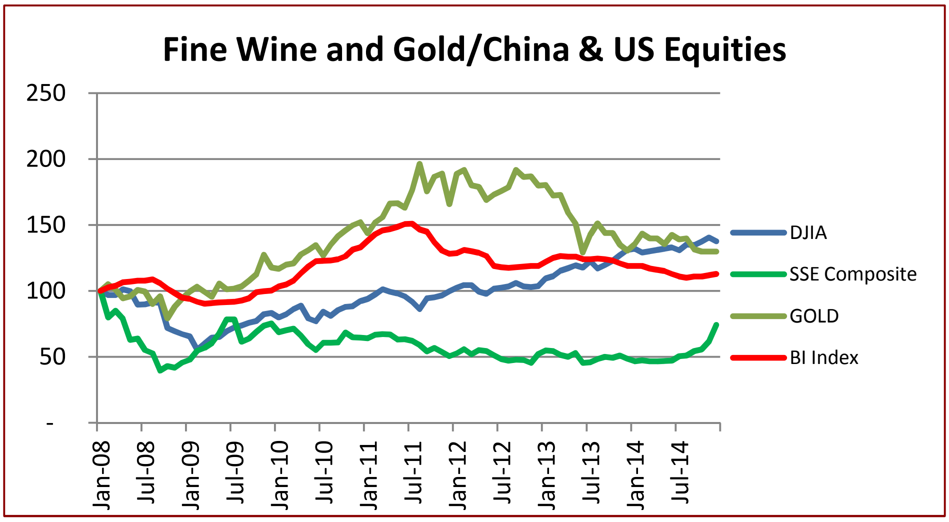


Correlations and Leading indicators

Whilst there have certainly been periods of positive correlation between wine and major asset classes the long-run picture is one of a low/negative relationship. This dynamic makes wine a potentially useful component of a broader portfolio. If correlations are weak leading indicators are even more so. Here are some interesting and perhaps indicative relationships that could credibly provide a direction of travel for wine prices:



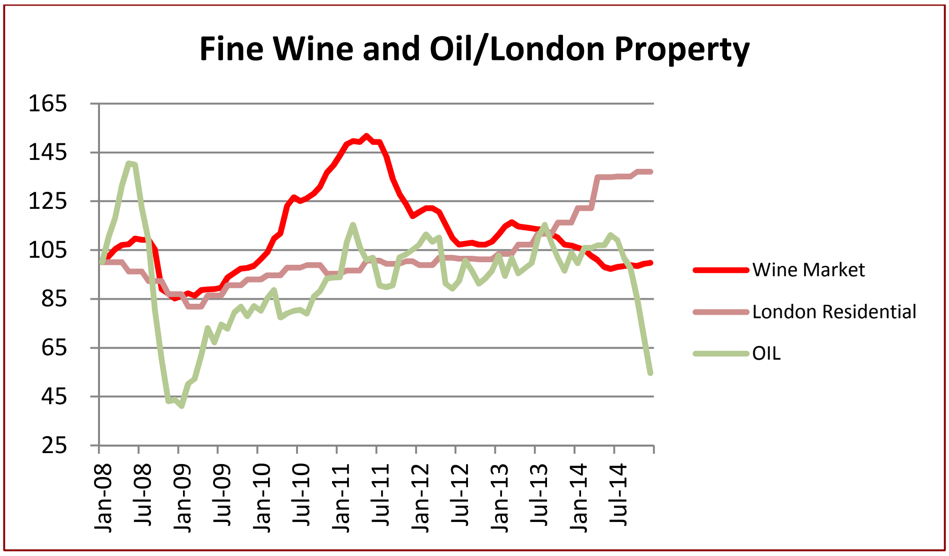
- **High Net Worth Individuals** – One of the most striking features of the post-FC years has been the strength of HNWI wealth. Given that this is a natural demographic for the consumption and ownership of fine wine one might reasonably assume that the relationship would remain positive in the long-run.



- **China** – As mentioned above, China has had a dramatic impact on the fine wine market in recent years (in much the same way that the US did in the early 80’s and Japan in the late 80’s). That said, China remains a limited and highly fractured market. Taxes are high, logistics erratic and currently political influence is pervasive. Being a wine drinker in the Middle Kingdom is not a straightforward activity. With time these limitations will almost certainly soften and we will begin to see the real potential of its consumers. Something similar could be said for India but currently its footprint is negligible.

- **Gold** – Gold provides one of the strongest positive correlations of recent years but one has to observe that the years preceding the FC the opposite was the case. We are far from convinced that the relationship will hold in the long-run as the motivating demand/supply factors are very different.

- **Equities** – No discernible relationship to be found. It is noteworthy that the S&P’s index of listed companies that produce luxury goods is up over 375% since early 2009.



- **Oil** – Oil, and with it EM industrial output, is often cited as a kindred asset but recent activity past has blown this apart and there's no reason to see a re-coupling any time soon.

- **Property** – London residential seems a good example of what can happen to asset prices in a ZIRP environment and contrasts markedly with the experience of fine wine. Given the long-run outlook for interest rates it seems more likely that the direction of wine prices will change rather than that of the investable property market.

One further trend worth monitoring is that of currencies for the simple reason that all the main fine wine indices are sterling denominated while key buyers tend to operate in dollar pegged currencies. As the USD has strengthened the buying power of China, Hong Kong etc. has increased. On the other hand a weak euro will work in the opposite direction.

How best to position an investment today?

In compiling an acquisition strategy we would be led predominantly by what our own trade data is telling us and by achieving an understanding of the changing picture of what our customers want to drink and what they are willing to pay for it. At various stages over the last decade different strategies have proved optimal – ‘100 point Icons’, ‘Second wines of 1st Growths’, ‘off-prime vintages’ and, above all, Lafite. Today, and for the foreseeable future, we anticipate a reversion to the classic model of a consumer-led focus on coveted and valued wines that are ready (or nearly ready) for the table, and young wines with a strong story that appeals to both future consumers and investors alike.

We would expect some new trends to emerge over coming years but we would be most surprised to see the kind of dramatic oscillations that came with the arrival of Asia in general and China in particular. Trading would be a feature of any investment but it would be to capture longer-term patterns rather than ad hoc opportunities. Currently a portfolio would likely reflect the following broad themes:

- **Brands** – Focused on the selection of leading Bordeaux with a strong concentration on the iconic First Growths, supplemented by some top vintage 'Super Seconds'. Bordeaux represents such a dominant component because there is no other region that comes close to having the combination of internationally recognised producers and developed secondary market. The First Growths stand apart, by virtue of their status, history and international reach, from every other fine wine.

- **Vintages** – Target predominantly mature/semi-mature vintages which are supported by a mix of consumers, collectors and investors. Largely eschewing more speculated younger vintages, even where seemingly large discounts exist. This reflects the confidence we derive from seeing consistent ‘end-user’ demand and increasingly squeezed supply.

- **Critics’ Assessments** – Focus the selection on wines that gain not only ringing endorsements from Robert Parker but also from other leading critics (Neal Martin, James Suckling etc). These ‘rating agencies’ are likely to remain key