# Wine Industry: Back to Turmoil

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SPECIAL EDITION

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As war rages in Ukraine, Georgian wine industry finds itself in turmoil again.  Since 2006, after the embargo, Georgia has sought to diversify its wine exports. Still, as of 2021, almost three quarter of Georgia's wine market (57% share of Russia, 12% of Ukraine) is under risk as Russia's invasion of Ukraine has shocked world markets.

Majority of large and some medium-sized producers, which mostly depend on compromised markets, face range of complex challenges from payment issues to ethical dilemmas. Today, Georgia's total export is larger and more diversified than during the 2006 shock. However, fierce competition on alternative markets complicates the diversification task for the wine exporters.

In this special edition, we assess the outcomes of the war in Ukraine for the wine industries under two possible scenarios.

The circumstance change rapidly, and TBC Capital will continue to update these assessments accordingly.

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# In Brief

Georgian wine industry, having undergone significant difficulties caused by Russian Embargo, faces yet another crisis stemming from war in Ukraine. This time Georgia has higher diversification level and larger export volume; however, the negative impact is still inevitable.

Had 2022 continued in peace, TBC Capital expected a balanced growth of wine industry compared to 2021 with total export increasing by 11%, Russia and Ukraine growing by 10% and 9%, respectively.

TBC Capital evaluated the impact of the war on wine industry for two, timely and delayed resolution scenarios. Economic and reputation related factors will be the main obstacles of wine export in coming months.

In the timely resolution scenario, total export falls by 33% in 2022 relative to baseline (26% YoY), while in delayed resolution it decreases by 44% compared to the baseline (38% YoY).

In the attempt to mitigate negative impact of war, producers discuss two alternatives, either redistributing the wine to the alternative markets or retaining it as reserves until the preferable conditions on the market are established. However, access to alternative markets is rather limited to due to already fierce competition, increased supply of wine from other countries that also try to substitute Russian market with alternative markets and type of wine Georgia sells on Russian market.

| **Export** | **2020 Actual** | **2021 Actual** | **Expected results 2022** (without war) | **Scenario 1** Timely Resolution of War | **Scenario 2** Delayed Resolution of War |
|---|---|---|---|---|---|
| **Russia** | **119 mln $** -10% YoY | **130 mln $** 9% YoY | **144 mln $** 10% YoY | **89 mln $** -32% YoY -38% relative to Baseline | **65 mln $** -50% YoY -55% relative to Baseline |
| **Ukraine** | **22 mln $** 4% YoY | **23 mln $** 6% YoY | **25 mln $** 9% YoY | **3 mln $** -89% YoY -90% relative to Baseline | **3 mln $** -89% YoY -90% relative to Baseline |
| **Other Countries** | **65 mln $** -1% YoY | **81 mln $** 24% YoY | **92 mln $** 14% YoY | **82 mln $** 2% YoY -10% relative to Baseline | **78 mln $** -3% YoY -15% relative to Baseline |
| **Total** | **206 mln $** -6% YoY | **234 mln $** 14% YoY | **260 mln $** 11% YoY | **174 mln $** -26% YoY -33% relative to Baseline | **145 mln $** -38% YoY -44% relative to Baseline |

# Diversification Level of Georgian Wine Industry In 2021

Wine Export
**$234m**
14% Growth

Russia
**$130m**
Share 56%

Ukraine
**$23m**
Share 10%

Other Countries
**$81m**
Share 34%

In 2021, the export of wine reached $234m, registering 14% increase compared to the previous year. Despite discovering new markets, dependency on Russian market remained significant since the cancelation of embargo in 2013, ranging from 47% to 67% percentage. In 2021 the share of Russia in export equaled 56%, followed by Ukraine with 10% share, China - 7%, Poland - 6%, Belarus - 5%, and Baltic countries - 4%.

Although Georgia experienced serious consequences of Russian domination in exports in the past, companies found it difficult to diversify in favor of more stable markets. However, there were still positive signs on the market as diversification improved significantly compared to the year prior the embargo, export to Russia fell from more than 80% to 56%, while total amount of export significantly increased.

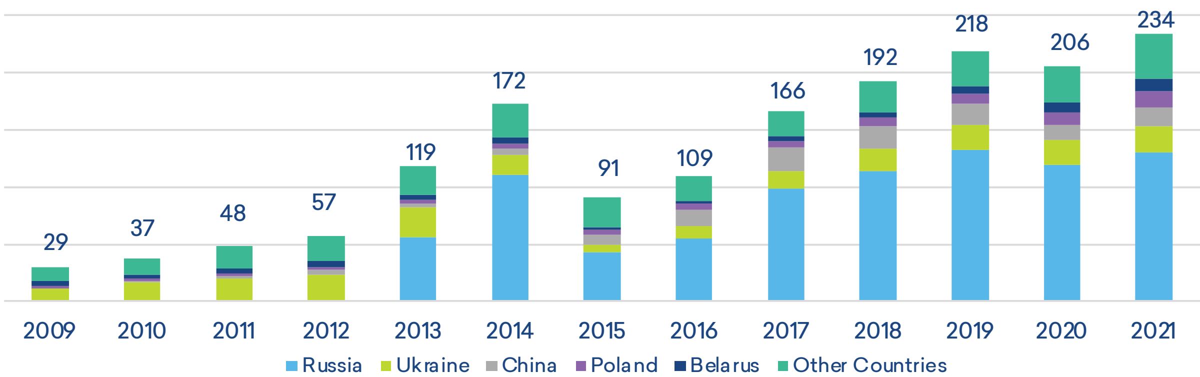
The significant difference between this crisis and previous one is its scale. Ukraine played an important role in helping wine industry cope with the Russian embargo taking 39-47% share in export in the absence of Russian market. Recent crisis lacks this opportunity.

The situation is worsened by the fact that export is the main driver for sector revenue. The share of export in wine sector turnover totaled 79% in 2020.

Furthermore, Russia is contributing the most to the export, but consumes the cheapest wine. Average export price of Georgian wine to Russia was $2.65 in 2021, which is lower compared to the price offered on new target markets.

FIGURE 01

## Diversification of Georgian Wine Export (000' USD)




Source: Geostat

# Expected results in business-as-usual circumstances

| Wine Export | Russia | Ukraine | Other Countries |
|---|---|---|---|
| **$260m** | **$144m** | **$25m** | **$92m** |
| 11% Growth YOY | Share 55%<br>10% Growth YOY | Share 10%<br>9% Growth YOY | Share 35%<br>14% Growth YOY |

TBC Capital expected a balanced growth of wine industry, had 2022 continued in peace. Export was estimated to increase by 11% compared to 2021, with export in Russia and Ukraine growing by 10% and 9%, respectively.

The world is no longer in a 'business as usual' situation and TBC Capital changes estimates accordingly.

We evaluate the impact of the war on wine industry for two scenarios that were recently developed by TBC Capital to assess the impact of war on economy. See following links for our latest publication on the macro impact:

Weekly Update From Chief Economist, March 7

Weekly Update From Chief Economist, February 28

## The Two Scenarios

FIGURE 02

| **Scenario 1**<br>Timely Resolution of War | **Scenario 2**<br>Timely Resolution of War |
|---|---|
| Invasion is relatively short-lived. Part of Ukraine is challenged, however, an uneasy peace returns | The war continues for more than a quarter. |
| Sanctions are imposed on Russia, however, Russia continues to export energy to Europe using carve-out regarding energy payments and there is only temporary cut-off from SWIFT system for most of the banks. Though, Nord Stream 2 is blocked. | The West imposes full-scale sanctions, including cutoff from SWIFT system and export bans on energy sector, carve-out clause regarding energy payments is abolished. |
| There is some lifting of the other sanctions, but the process is only gradual. | Russia's own financial messaging system, cryptocurrencies or underlying technologies do not serve as an effective alternative of SWIFT for the international payments, though, domestic payments system continues to operate. |
| Unlike 2014-2015 shock, oil & gas and other commodity prices surge, being important for both economies. | Energy prices still surge before normalizing to around $120 by the end of the year |
| In 2022 Ukrainian economy shrinks by around 10-15%, and Russian one by around 4%. | In this scenario, in 2022 Ukrainian economy shrinks by around 20% and Russian one by 7-10%. |

# Factor Analysis

The war compromises economies of the countries, especially of those with close ties to Russia and Ukraine. Negative economic impacts include reduced GDP growth, currency depreciation, both affecting the demand; difficulties with receiving payments from Russia due to sanctions makes trade less reliable and challenging. In addition, the war puts Georgian wine producers in front of ethical dilemma. On one hand, continuing export to Russian market might damage their reputation, on the other hand, Russia represents a major market for many Georgian wine exporters and leaving this market might bring dramatic results. We estimated the possible impact economic and reputation-related factors may have on markets important to Georgian wine producers.

Major wine export markets are Russia, Ukraine, China, Poland, Belarus, and Kazakhstan. It is not surprising that the economic repercussions of war disrupt Ukrainian and Russian markets the most.

Belarus also experiences significant economic spillover affecting demand on wine in this market. We do not expect significant economic impact on the rest of the markets.

As it comes for reputation, we estimate that European markets may be more demanding towards Georgian wine industry if it continues to export to Russia.

Economic and reputation related factors limit companies' access to Russian market. This is true for not only Georgian, but other wine exporters. Georgia possesses 19% share in Russia's wine imports, Italy - 24%, Spain - 15%, and France - 15%. Georgia will face increased competition on alternative export markets as world supply of wine will seek to substitute Russian market.

FIGURE 03

## The Impact of Economic and Reputation related Factors on the Georgia's Major Export Markets

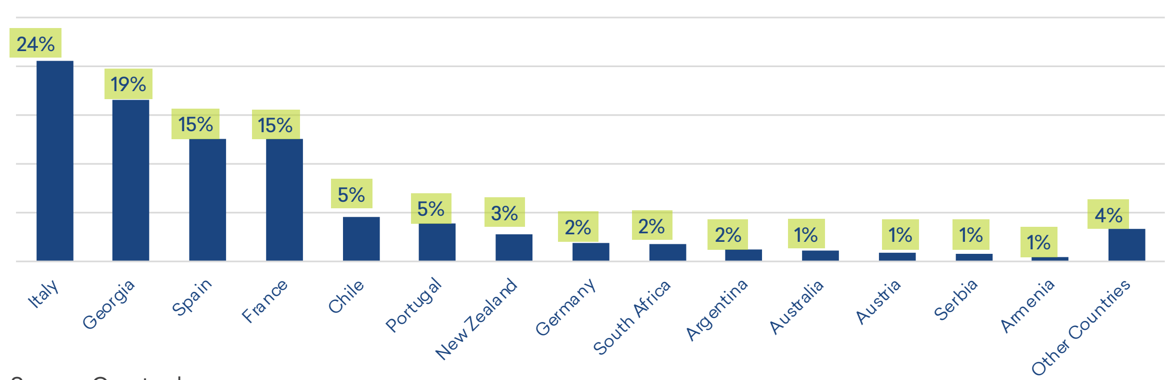
| Market | Economic | Reputation |
|---|---|---|
| Russia | ✓ (Significant) | ✓ (Insignificant) |
| Ukraine | ✓ (Significant) | ✓ (Significant) |
| China | ✓ (Insignificant) | ✓ (Insignificant) |
| Poland | ✓ (Insignificant) | ✓ (Moderate) |
| Belarus | ✓ (Significant) | ✓ (Insignificant) |
| Kasakhstan | ✓ (Moderate) | ✓ (Insignificant) |
| Other Countries | ✓ (Insignificant) | ✓ (Moderate) |

- ✓ Insignificant
- ✓ Moderate
- ✓ Significant

Source: Geostat

FIGURE 04

## The Shares of Countries in Russian Wine Import, 2020 (USD)




Source: Comtrade

# The impact on wine industry: Timely resolution scenario in 2022

| Wine Export | Russia | Ukraine | Other Countries |
|---|---|---|---|
| **$174 m** | **$89m** | **$3m** | **$82m** |
| -33% Change compared to Baseline | -38% Change compared to Baseline | -90% Change compared to Baseline | -10% Change compared to Baseline |

In the timely resolution scenario, total export falls by 33% in 2022 relative to baseline (26% YoY) mainly due to the economic sanctions imposed on Russia. Assuming payment related issues are solved shortly, the estimated export to Russia drops by 38% compared to baseline (32% YoY).

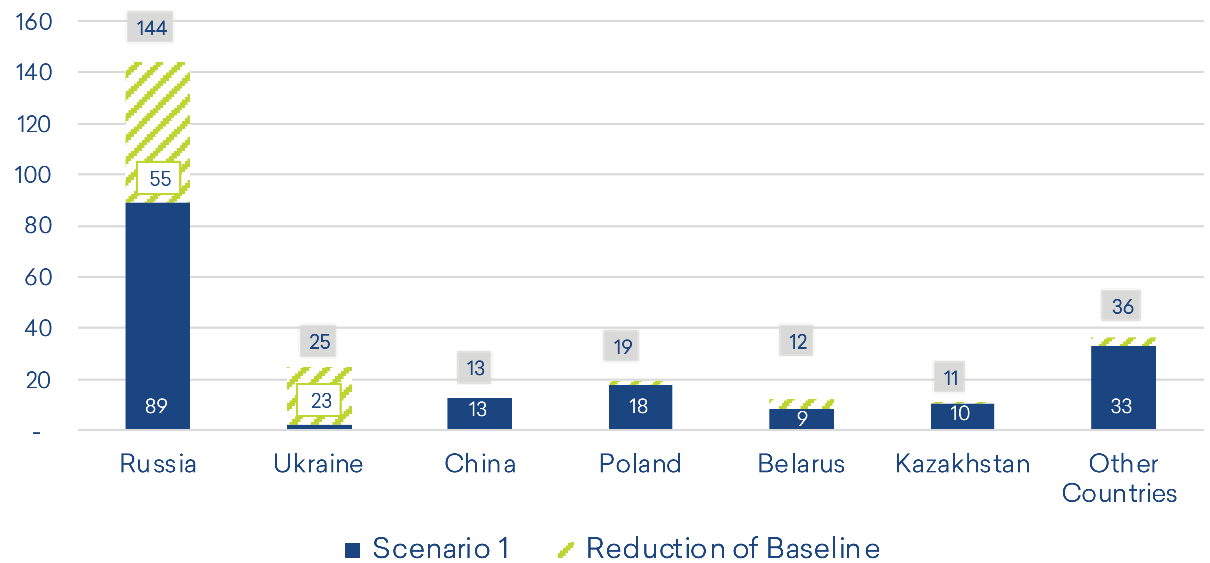
Due to the ongoing war, we do not expect wine to be exported to Ukraine from March till the end of the year. This will cause drop in annual export to Ukraine by 90% compared to the baseline (89% YoY).

The export to other countries will be mostly affected by reputation risks, causing less damage in comparison to economic ones.

We estimate the value of Georgian export wine left unsold to constitute $87m in this scenario.

FIGURE 05

**Change in Baseline by Source Markets, Timely Scenario (USD, M)**



# The impact on wine industry: Delayed resolution scenario in 2022

| Wine Export | Russia | Ukraine | Other Countries |
|---|---|---|---|
| **$145 m** | **$65m** | **$3m** | **$78m** |
| -44% Change compared to Baseline | -55% Change compared to Baseline | -90% Change compared to Baseline | -14% Change compared to Baseline |

In case of delayed resolution, total export decreases by 44% compared to the baseline (38% YoY). In this scenario, Russian companies will not be able to solve payment problems till the end of the year, dropping the export significantly by 55% compared to baseline (50% YoY).

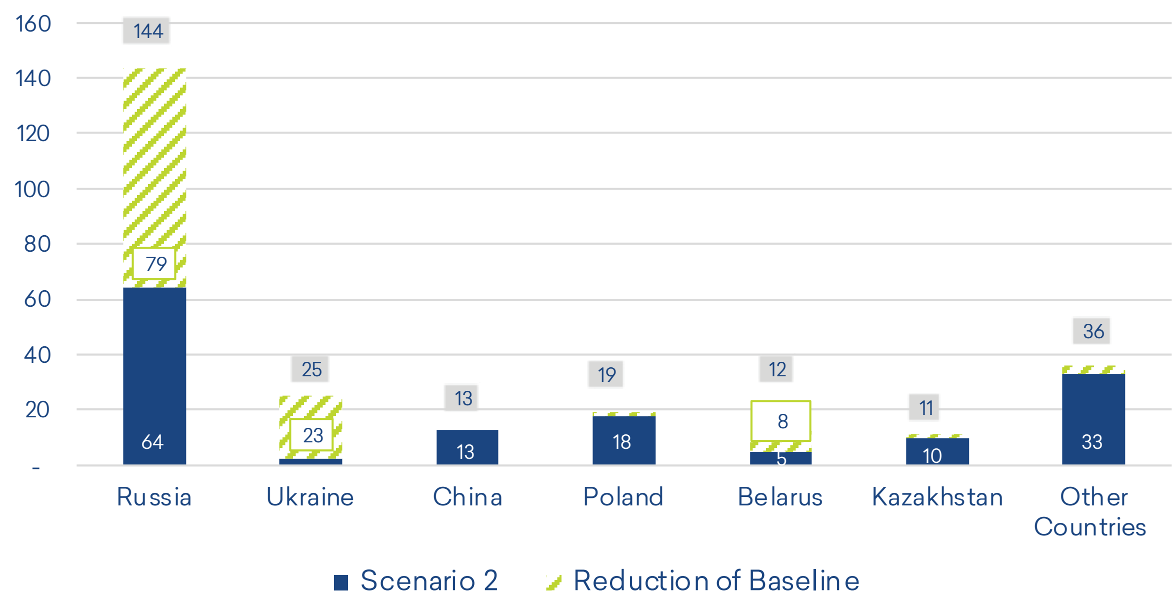
The estimated export in Ukraine remains the same as in the first scenario. The export in other countries declines by 14% compared to baseline (3% YoY).

As the overall situation on the market worsens more wine is left unsold. The financial value of this excess is $116m.

The question is how will the companies manage reduced demand on critical market and manage unsold stock? Will they attempt to redistribute the stock on alternative markets or reserve it for better future? What effect will it have on farmers? The following chapter aims to answer these questions based on interviews with large wine companies.

**FIGURE 06**

**Change in Baseline by Source Markets, Delayed Scenario (USD, M)**



# Redistribution VS Reservation

We conducted the interviews with the representatives of large wine producers to determine the extent of negative effect of the war on the Georgian wine industry. The main topics of interest were the future of the companies on the Russian market, the ways to deal with unsold stock and the prospects of this year's harvest.

Leaving Russian markets is a difficult undertaking for wine producers, the interviews reveal. Critical share of Russia in wine exports is the main reason behind the efforts of Georgian wine producers to search for solutions to the payment problems caused by the international sanctions on Russia. While some producers are ready to accept payment in Chinese currency, others may still use rubles if production material supplier sells in the same currency. More alternatives can be considered in the future.

Both scenarios demonstrated a large amount of wine remaining unsold, that has to be allocated in the most profitable way possible. Producers discuss two alternatives, either redistributing the wine to the alternative markets or retaining it as reserves until the preferable conditions on the market are established.

Respondents seem pessimistic regarding redistribution option, because of the short time frame for implementing such a radical switch.

In normal times, it would require many years of advertisement and other efforts. This option seems even more questionable considering harsh competition from other countries leaving the Russian wine market due to their governments' sanctions.

Most of the wine left in reserves are those preferred by the two markets Russian and Ukraine. Red semi sweet wine constituted 78% and 59% of total wine export in 2021 in Russia and Ukraine, respectively. The target market for these type of wine include Poland and CIS countries.

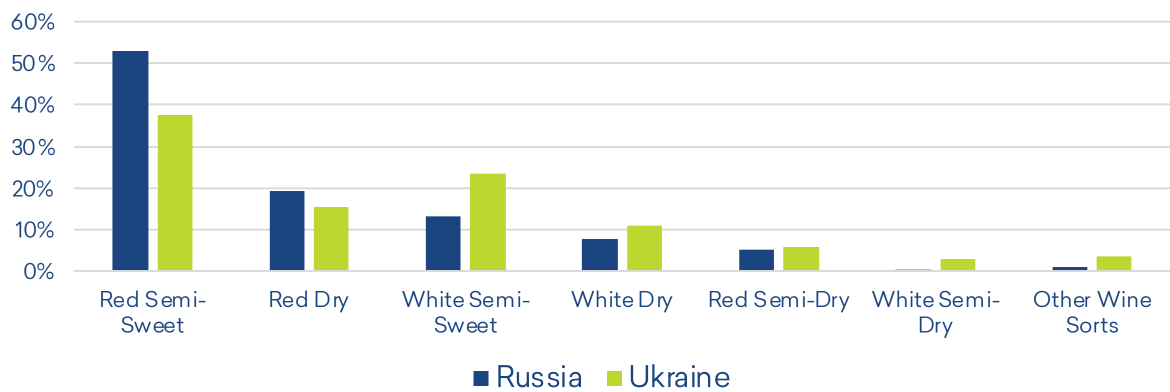
The respondents expressed a variety of perspectives regarding the upcoming harvest. Part of them question requirement for additional supply, while others may see opportunity to purchase grapes at a lower price owing to decreased demand.

The farmers producing grapes are more vulnerable to the existing situation than winemakers. Winemakers can reduce production costs by purchasing less grapes, reducing the negative impact of lower sales. Farmers, on the other hand, rely entirely on wine producers to purchase their grapes and government subsidies, as they lack other significant trade opportunities.

Overall, respondents often found it difficult to speak about the future because of the vagueness of the situation. Most of them prefer to take some time before significant decisions are made, wait for the picture to become cleared and then evaluate the prospects of wine business development in Georgia.

FIGURE 07

**Georgian wine exports to Ukraine and Russia by type of wine (%)**




Source: GWA

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