Covid-19 and fine wines: the ‘perfect blend’ for a severe headache?

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Covid-19 has only been officially declared a pandemic since March 11, but its effects on the economy are already dramatic. For some industries, such as the travel & leisure industry, the current crisis is likely to become the most severe since the Great Depression. In this article, we investigate the impact of Covid-19 on the fine wine market (the upper segment of the wine market). The market for fine wine is dominated by France, with Bordeaux and Burgundy accounting for close to 50% and 20% respectively of the trading activity in 2019 (Liv-ex.com, 2019). Other major players include Italy, Spain, Germany, the U.S. (for production and consumption) and China (mostly for consumption). Buyers typically include fine-dining venues – whose revenues are currently down to zero; as well as consumers, collectors and investors – whose purchasing power suffers from the economic and financial turmoil. Given the context, it appears obvious that the fine wine market will experience negative effects due to the pandemic.

But two questions remain open: how severe will these effects be? And how long will the market take to recovers?

There are two ways to answer these questions. One is based on an economic analysis of the fundamental determinants of fine wine prices. The other is based on a comparative analysis of the economic crises that have impacted the fine wine market in the past. A synthesis of these analyses is proposed before looking at a prospective conclusion on the long-term effects of this crisis.

Looking at the economic determinants of the fine wine market

Following a negative income and wealth effect on economic agents in the aftermath of the Global Financial Crisis (GFC) of 2007, the fine wine market had witnessed a strong negative impact on the demand-side. The Covid-19 crisis could be much deeper for two reasons. The negative income and wealth effect will be much more pronounced than during the GFC and additionally could affect fine wine supply.

Uncertainty on the supply-side is not coming from production itself. It should remain stable as wine is deemed a priority agricultural sector in all producing countries. Despite occasional labor problems, the harvest in the southern hemisphere and the springtime work on the vines in the north do not suggest a drop in production. The uncertainty stems much more from two interlinked issues: inventory management and the state of traditional distribution channels. Indeed, restaurants selling fine wines are in a delicate situation. In most countries the prospects of reopening are close to nil in the short run. Some restaurateurs have extensive cellars representing a very important marketable asset. To get through this crisis, the sale of part

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of their inventory in the coming months is a definite possibility. Worse, in the event of bankruptcy, stocks would automatically be sold by creditors. Other fine wine owners (private individuals, as well as investors) could also go down that road to compensate for important income losses. A significant, but difficult to quantify, increase in the supply of fine wines could therefore emerge in the course of 2020 and induce downward pressure on prices.

At the same time, demand for fine wines should also fall due to the strong decrease in hotel and restaurant business (according to STR average occupancy rates have been between 20% and 25% in many European countries for March 2020). The low level of footfall in airport shops (around 95% of flights have been cancelled in Europe according to IATA) will also affect sales of fine wines in 2020. These Covid-19 specific effects come on top of the traditional negative demand effect following most “common” drops in global economic growth.

Economic studies on the wine industry are clear and convergent on the outcome of this issue: the income elasticity of wine demand is larger than 1, all segments combined (Fogarty, 2010). However, these elasticities are higher in the U.S. and especially in China (Cardebat and Figuet, 2019), the main markets for fine wines. In the case of China, Bargain (2020) reveals income elasticities close to 5, all the higher as the appellations are prestigious. Fine wine, like all luxury goods, thus shows a very high-income elasticity by nature.

In the World Economic Outlook published in April 2020, the IMF is forecasting a 3% drop in world GDP for 2020 (-6.1% in developed countries and -1.0% in emerging countries). Assuming an average income elasticity value of around 3.5 and a 3.0% contraction in world GDP, the anticipated drop in demand for fine wines for 2020 could top 10.5%. What would be the impact in terms of prices on the fine wine market? If we refer to the price elasticities revealed by the studies cited above, we can retain a range of -0.2 to -0.5 for fine wine, -0.35 on average. Combined with a 10% drop in world demand, this would lead – *ceteris paribus* – to a reduction in the price of fine wines of 30% on average. This large downward effect in relation to the contraction of world GDP does, however, not consider the possible impact of an increase in supply, or a specific decrease in demand due to the closure of shops and food venues. Two effects that could further accentuate this fall in prices.

This economic mechanism does not account for the microstructure of the fine wine market either. The characteristics and behavior of the participants on this market play an important role for price dynamics. A key point will be the ability to avoid panic sales in a bear market. This capacity is linked to the economic health of the players and their attitude towards risk. The IMF anticipates a significant recovery in activity for 2021, making the Covid-19 crisis a severe but temporary shock, while nevertheless specifying the strong uncertainty weighing on this forecast. Consequently, the least risk-averse players and those in good financial health could keep their wines and wait for the recovery before selling. In this case, the price effect would diminish, and the adjustment variable would become market liquidity. In a scenario in which the market becomes illiquid, the drop in prices could be contained to a lower level than indicated above.

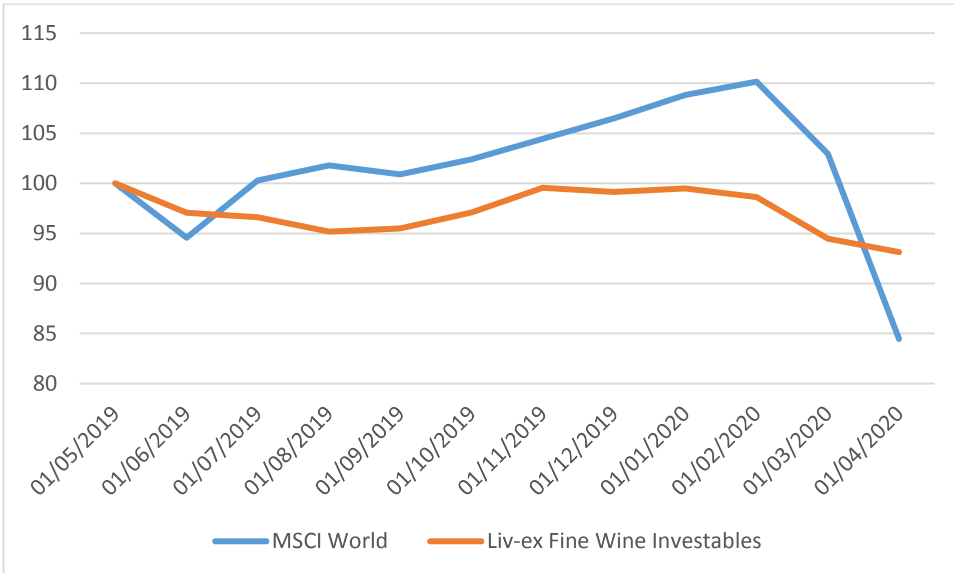
The best strategy to limit severe price declines could therefore be to dry out the market, freeze it to some extent, and bet on a solid recovery in 2021. This purely and simply involves the cancellation of the *en-primeur* campaign that should have been held at the beginning of April and is now possibly taking place in the summer. In view of the crisis context, organizing the 2020 *en-primeur* sale risks dragging the whole market into a very sharp decline and crisis if buyers stay out of it. The shock would be considerable and could call into question the very principle of *en-primeur* sales.

Looking for a point of comparison

Another possibility of understanding the effect the Covid-19 pandemic may have on the fine wine market is to analyze past crises and how they impacted the wine market. From a medical standpoint, the only, but rather imperfect benchmark, is the Spanish flu pandemic of 1918. Over this period, inflation-adjusted wine prices dropped by more than 25% (Dimson et al., 2015), but rebounded by close to 30% in 1921. However, apart from the sanitary situation that bears some resemblance to the current Covid-19 outbreak, the context could hardly be more different. 1918 marks the end of the Great War, the wine market was much less globalized than today, the political situation extremely unstable, and the economic conditions marked by rising inflation.

The Global Financial Crisis constitutes a more relevant benchmark. It followed a period of economic growth and political stability in most wine producing, and consuming countries and inflation was fairly limited. The wine market was increasingly globalizing with the emergence of new customers from the Far East and the rapidly financializing with the emergence of wine investors and funds. Until summer 2008, wine prices were rising and even after the collapse of Lehman Brothers, they remained rather resilient. According to Masset & Weisskopf (2018), they declined by a mere 25%. However, these limited losses occurred in a market marked by a quasi-absence of transactions. The trading activity resumed in late spring 2009 after the release of the new 2008 vintage in Bordeaux, which can be considered as relatively successful thanks to better-than-expected quality and attractive prices. The wine market not only rapidly rebounded but entered a strong upward trend. This can be explained by the pressure on demand due to the arrival of new customers from the Far East and the development of wine investments. The interest of speculators for this new asset was initially spurred by the diversification potential it offers and then further reinforced by the buzz surrounding the release of the outstanding 2009 and 2010 vintages. Since then, the fine wine market has further evolved. The Bordeaux wine-bubble popped and led to a 4-year correction (see the graph 1). In parallel, other regions have seen their reputation and wine prices increasing rapidly. Burgundy, in particular, is now challenging the leading position of Bordeaux. The Rhône Valley, Piedmont and Tuscany follow the path of Burgundy, but are still rather far behind it in terms of prices.

Graph 1: Evolution of the MSCI World and Liv-ex Fine Wine Investables Index (both in euros) 01/01/2008 (base 100) to 03/31/2020.



Graph 2: Evolution of the MSCI World and Liv-ex Fine Wine Investables Index (both in euros) 04/01/2019 (base 100) to 03/31/2020.

What to expect then?

The current resilience of fine wine prices (see graph 2) could be misleading. The price has dropped very little compared to that of stocks or commodities such as petrol, which have been much debated in the press. However, the correction that could take place on the wine market could just be delayed. In the same way, it would also be exaggerated to predict a general collapse of the market. Indeed, the price and income elasticities of demand proposed and the experiences from past crises all suggest a common factor. The reaction of the fine wine market will not be uniform and needs to be contextualized by market segment. It will, for example, vary for different wines, appellations, vintages, or the degree of rarity of the fine wines considered. Apart from the elements discussed above, other differences between the current situation and the GFC may reinforce this phenomenon. Last year, President Trump imposed tariffs on European products, including French wines (of less than 14.0% alcohol), but not Italian wines. Moreover, given the sanitary nature of the current crisis, many communication & marketing actions and tasting events have been postponed or cancelled. The creativity, innovation and dealing with political risk by wine regions and specific producers may lead to an even more fine-grained continuum of reaction on this fragmented and segmented market for fine wine.

In Bordeaux, the good, but not exceptional, 2019 vintage will have to be released on the primary market at significantly lower prices than the previous three vintages to attract some interest. Stated differently, a discount of at least 30% (as estimated above) compared to last year prices is *necessary* for these wines to attract buyers. Prices on the secondary market will follow the same direction even though the amplitude of the decline should, at least initially, be less pronounced. Obviously, if the Covid-19 crisis should worsen, prices may drop substantially more as many players would discount their prices to incentivize opportunistic purchases.

Trees do not grow to the sky. It has become increasingly common to hear people arguing that Burgundy was close to overheating before the Covid-19 outbreak. For this region, the current crisis may mark the beginning of a long-awaited correction. Over the last decade, prices have quickly increased due to a severe imbalance between demand and supply. This imbalance is due to both the low quantities produced and the organization of the distribution channel in Burgundy. Most wineries sell an important part of their production through an allocation system,[1] which reduces the number of bottles of the best cuvees that ever reach the secondary market. This means that market prices are based on a limited proportion of the overall production and implies that even a small change in demand may rapidly lead to important price adjustments. For most wines, this should translate into a price decline comparable to what Bordeaux will experience. But, for the top five to ten most sought-after producers the decline is likely to be less pronounced as opportunistic buyers will try to replace those people that cannot afford these wines anymore.

In Italy, prospects appear to be more positive. The vintages currently for sale are 2015 and 2016 and both are regarded as excellent or even exceptional. Antonion Galloni (Vinous) describes 2016 in Barolo as "a vintage full of truly spectacular, breathtaking wines" and Monica Larner (Wine Advocate) call the 2015 vintage as "picture-perfect" for Brunello di Montalcino. It is of course easier to sell great vintages. Moreover, prices of Italian wines remain reasonable compared to their French counterparts and there still is some latent demand as illustrated by the year-long waiting lists of new buyers at many wineries in the Piedmont. Thus, prices will probably retract only moderately, but there will be opportunities to get access to many of the best wines.

The implications of the above analysis for the three main segments of the fine wine market can be summarized as follows:

- Bargains on 'nice' wines: attractive discounts on fine, but not speculative wines. Discounts will be especially important on wines that are produced in large quantities. These wines were already attractively priced and will become genuine bargains.
- Access to 'rare' wines: there will be opportunities to get allocations at renowned wineries. If more people can buy these wines on the primary market, their prices on the secondary market will most probably slightly retract.
- Wait for more reasonable prices on 'investable' wines: the liquidity on the market will first deteriorate, and if the situation worsens, there will be heavy discounts on those prestigious wines that are available in large quantities like Bordeaux First Growths.

Supply & demand, demand & supply - takeaways

The discussion illustrates a few salient facts about the wine market. First, the production of fine wine appears to remain rather fixed in the short to medium run as producers have adapted to the situation and continue their work in the vineyards. However, existing fine wines may be dumped on the market which may lead to an oversupply of fine wines on the secondary market. Second, there is downward pressure on a demand-side, which has evolved compared to 15 years ago. Changes in demand can be exogenous (arrival of new

[1] Every year, so-called 'allocataires' get a sample of wines at prices that are (well) below their market value but they are not expected (and in some cases authorized) to sell on their allocation to someone else.

customers) or endogenous (shifts in the demand/preferences from existing customers). Over the last decades, the demand for fine wines has become truly global. Stated differently, there is less reserve in demand than in the mid-2000s, except perhaps in India (but it will take years before wine consumption becomes significant there). The demand from existing customers is more unstable and highly sensitive to market signals. On the one hand, the release of a critically acclaimed vintage tends to provide support for higher prices on the primary and on the secondary market. On the other hand, during good economic conditions, prices stagnate without a special vintage or occasion to make people purchase wines. Fourth, the wine market is complex, and reputation as well as prices in different regions may follow distinct patterns depending on customers' preferences. Fifth, one of the motivations for holding fine wines is their supposed 'safe-haven' nature. The sharp decline of Bordeaux wines experienced during the Eurozone crisis provides empirical proof that this is *not* the case, at least not for the most liquid[2] and financialized wines. This observation, coupled with the fact that liquidity quickly dried up on the wine market during the GFC, may influence the trading decision of wine investors if the Covid-19 crisis worsens.

Long-run effects: headache or not?

At the time being, we know there will be a global recession but not its shape: V (severe recession followed by a rapid rebound), W (double-dip recession – potentially caused by a second outbreak of coronavirus), U (long recession – alimented by a number of bankruptcies), or L (Japan-like absence of recovery). Clearly the longer and the more severe the recession, the larger its impact on the wine market will be.

Apart from the economic situation, the current crisis may lead to changes in consumption patterns. Governments and people are realizing the importance of producing and consuming locally. In the case of wine, this suggests that there may not only be losers but also winners: producers who benefit from an important local/regional demand, who focus on organic and terroir-driven wines, and who have (or who will be able to develop) a solid direct-selling channel may well in a few years perceive this crisis as having been beneficial for their business.

Local tropism could also become a key success factor due to strategic trade policy reasons. A regionalization of trade in a protectionist context and strong exchange rate instability linked to monetary manipulations are possible evolutions in a post-Covid-19 world. A tripartite trade war between the U.S., China and the European Union would further reduce the possibilities of trade in fine wines. Above all, it would reduce purchases of European wines by Asian and American customers and result in substantially lower prices.

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[2] Bordeaux 'Premier Crus' are produced in quantities ranging from 120'000 up to close to 300'000 bottles a year. In Burgundy, most wineries do not produce more than 5'000 bottles of their most celebrated 'Grand Cru' cuvees per year.

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