TAYLOR COLLISON

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29 January 2016

Australian Vintage Limited (AVG)

Hold

Initiating Coverage

$0.385

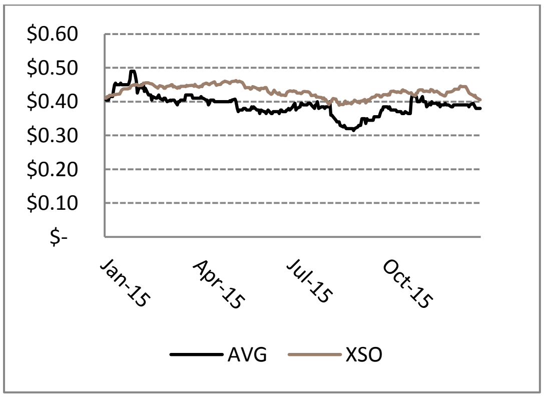
Summary (AUD)

Market capitalisation ($m)	**$89.4**
Share price	**$0.385**
52 week high	$0.50
52 week low	$0.30
Ave Monthly Vol (year rolling)	3.743m

Key Financials (AUD)

Period	FY15 Act.	FY16 Est.	FY17 Est.
Revenue ($m)	**232.8**	**244.0**	**256.0**
EBITDA Adj.($m)	23.3	23.9	26.4
EBIT Adj.($m)	16.7	17.2	19.6
NPAT Adj.($m)	**7.1**	**8.4**	**10.2**
PE Ratio Adj. (x)	**12.5**	**10.7**	**8.8**
EPS Adj. (c)	3.1	3.6	4.4
DPS (c)	0.0	0.0	0.0
Div Yield	**0.0%**	**0.0%**	**0.0%**
Franking	100.0%	100.0%	100.0%
Payout ratio	0.0%	0.0%	0.0%
EV ($M)	193.7	189.7	173.7
EV/EBITDA Adj. (x)	8.3	7.9	6.6
EV/EBIT Adj. (x)	11.6	11.0	8.9
EBIT Margin Adj.	7.5%	7.3%	7.9%
ROE Adj.	2.5%	2.9%	3.4%

Share Price Graph (AUD)



Our View

In recent years AVG has battled with high debt, market oversupply of wine, margin squeeze from supermarkets and free cash flow conversion. Despite this, we are starting to see some light at the end of the tunnel by way of incremental cash generation from the expiry of above market and onerous grape supply contracts and proposed changes to Wine Equalisation Tax ("WET") Rebate reform. The sheer size of untried markets is also of interest, however market penetration is not guaranteed.

Trading on 11.0x our FY16e adj. EV/EBIT, a significant discount to peers, the current valuation alone may prove attractive to value oriented investors, but we note the that debt remains significant and profitable stock turns continue below one per year. As such, we remain cautious and initiate with a Hold recommendation.

Key Points / Investment Highlights

Under the microscope – We continue to look for improvements in a number of areas before we have increased comfort in AVG going forward. These include: (1) high debt levels with non-disclosure of specific bank covenants; (2) recent stock turns of less than one per year; (3) margin squeeze from UK Supermarkets from lost market share to discounters; (4) weakened Australian Dollar already reflected in numbers; and (5) poor recent free cash flow conversion.

Grape supply savings – In comparison to 2015 average grape prices, ~$6m p.a. of savings will be made from termination of the Del Rios vineyards lease. Also, from 2016-2018 onwards expiries of above market and onerous grape supply contracts should provide ~$2.3m p.a. cum. to $6.9m p.a. (post 2018). Combined with a reducing sales mix of the 2014 frost affected Vintage we believe these savings could double the Company's Adj. NPAT in comparison to FY15 over a three year timeframe.

WET rebate reforms a real possibility – Removal of the WET Rebate on bulk and unbranded wines could be the industry catalyst for raising of bulk wine prices (forecast $1.5-$2m pre-tax benefit to AVG). It could also shift large retailers' energies from private labels back to branded products. Other likely outcomes from such reforms include removal of unsustainable bulk producers from the Australian market, tightening the supply and demand gap for Australian wines, as well as, longer term a possible improvement in the image of Australian wines.

US distribution could become a reality – AVG is close to signing an exclusive distribution agreement into the US, the largest consumers of wine in the world. Over the next 10-15 years it is feasible a maturing of the US wine palate could lead to consumption doubling bringing the US in line with other developed nations. This would be advantageous to wine exporters into the US as domestic supply struggles to meet demand. We stress this is a long term thematic opportunity, hence our reluctance to recommend AVG as an Outperform at this stage.

Australian Vintage Ltd - Summary of Forecasts

Price $ 0.385

PROFIT & LOSS SUMMARY (A$m)

Period	FY14A	FY15A	FY16E	FY17E
Operating Revenue	214.8	230.9	242.3	254.3
Other Revenue	2.5	1.9	1.6	1.6
Total Revenue	**217.3**	**232.8**	**244.0**	**256.0**
EBITDA Adj.	26.8	23.3	23.9	26.4
Dep'n	(6.5)	(6.0)	(6.0)	(6.0)
Amort'n	(0.6)	(0.6)	(0.7)	(0.7)
EBIT Adj.	**19.7**	**16.7**	**17.2**	**19.6**
Net Interest	(8.7)	(6.4)	(5.3)	(5.1)
Pre-Tax Profit Adj.	11.0	10.4	12.0	14.5
Tax Expense	(3.3)	(3.2)	(3.6)	(4.4)
Minorities	0.0	0.0	0.0	0.0
NPAT Adj.	**7.7**	**7.1**	**8.4**	**10.2**
Abnormals (net of tax)	2.9	2.2	(9.4)	0.3
Reported Profit	**10.5**	**9.4**	**(1.0)**	**10.4**
Margins on Sales Revenue				
EBITDA Adj.	13.3%	10.4%	10.2%	10.7%
EBIT Adj.	9.8%	7.5%	7.3%	7.9%
NPAT Adj.	3.8%	3.2%	3.6%	4.1%
Change on pcp				
Total Revenue	3.5%	7.2%	4.8%	4.9%
EBITDA Adj.	-0.6%	-12.8%	2.5%	10.3%
EBIT Adj.	-0.8%	-15.2%	3.2%	13.7%
NPAT Adj.	86.4%	-7.0%	17.5%	21.4%

PER SHARE DATA

Period	FY14A	FY15A	FY16E	FY17E
EPS Adj. (c)	**3.7**	**3.1**	**3.6**	**4.4**
Growth (pcp)	*18.9%*	*-16.8%*	*17.5%*	*21.4%*
Ordinary Dividend (c)	2.2	0.0	0.0	0.0
Special Dividend (c)	0.0	0.0	0.0	0.0
Franking	100%	100%	100%	100%
Gross CF per Share (c)	(1.8)	0.9	3.4	8.7
NTA per share (c)	117	107	107	112

KEY RATIOS

Period	FY14A	FY15A	FY16E	FY17E
Net Debt / EBITDA Adj. (x)	4.2	4.5	4.2	3.2
Net Debt : Equity (%)	38.8%	35.7%	34.4%	28.0%
EBIT Interest cover (x)	2.2	2.6	3.2	3.8
Free CF / NPAT Adj. (5 yr avg)	8.9%	35.0%	99.3%	50.1%
Current ratio (x)	4.2	4.3	4.2	4.0
ROE Adj. (%)	2.9%	2.5%	2.9%	3.4%
ROIC Adj. (%)	2.7%	2.3%	-0.3%	2.7%
Dividend Payout Ratio (%)	59.6%	0.0%	0.0%	0.0%

VALUATION MULTIPLES

Period	FY14A	FY15A	FY16E	FY17E
PER Adj. (x)	**10.4**	**12.5**	**10.7**	**8.8**
Dividend Yield (%)	**5.7%**	**0.0%**	**0.0%**	**0.0%**
Free CF Yield	-8.8%	14.7%	4.4%	17.9%
EV/EBITDA (x)	7.5	8.3	7.9	6.6
EV/EBIT (x)	10.2	11.6	11.0	8.9

BALANCE SHEET SUMMARY

Period	FY14A	FY15A	FY16E	FY17E
Cash	4.2	2.3	2.3	2.3
Receivables	41.7	39.2	41.1	43.2
Inventory	168.1	165.5	166.9	166.7
Assets Held for Sale	0.0	0.0	0.0	0.0
Other	3.9	5.0	5.0	5.0
Total Current Assets	217.9	211.9	215.3	217.2
Receivables	0.0	0.4	0.0	0.0
Inventory	23.7	33.5	34.1	35.8
Biologoical Assets	33.2	32.8	32.8	32.8
Property Plant & Equipment	90.1	83.2	81.2	79.2
Water Licences	7.6	7.6	7.6	7.6
Intangibles	45.4	43.8	43.1	42.3
Other	52.6	50.8	47.2	42.8
Total Non-Current Assets	252.6	252.2	246.0	240.6
TOTAL ASSETS	**470.5**	**464.1**	**461.3**	**457.7**
Payables	41.0	40.3	42.3	44.4
Borrowings	3.6	1.5	1.5	1.5
Financial Liabilities	1.1	1.5	1.5	1.5
Provisions	5.6	6.0	5.9	6.2
Liabilities Assoc. Assets Held for Sale	0.0	0.0	0.0	0.0
Other	0.5	0.5	0.5	0.5
Total Current Liab	51.8	49.8	51.7	54.2
Borrowings	112.3	105.0	101.1	85.0
Provisions	3.5	2.1	2.4	2.5
Other	14.6	14.7	14.7	14.7
Total Non-Current Liab	130.4	121.9	118.2	102.3
TOTAL LIABILITIES	**182.3**	**171.7**	**169.9**	**156.4**
TOTAL EQUITY	**288.2**	**292.4**	**291.4**	**301.3**

CASH FLOW SUMMARY

Period	FY14A	FY15A	FY16E	FY17E
EBIT (excl Abs/Extr)	**19.7**	**16.7**	**17.2**	**19.6**
Add: Depreciation	6.5	6.0	6.0	6.0
Add: Amortisation	0.6	0.6	0.7	0.7
Change in Payables	8.0	(0.7)	2.0	2.1
Change in Provisions	(5.0)	(1.0)	0.1	0.4
Change in Other Liabilities	1.4	0.4	0.0	0.0
Other non cash/unusual items	3.3	(6.1)	(9.4)	0.0
Less: Tax paid	(3.3)	(3.2)	(3.6)	(4.4)
Net Interest	(8.7)	(6.4)	(5.3)	(5.1)
Change in Receivables	(6.1)	2.1	(1.5)	(2.1)
Change in Inventory	(19.6)	(7.1)	(1.9)	(1.5)
Change in Other Assets	(0.4)	0.7	3.6	4.4
Gross Cashflows	(3.7)	2.1	8.0	20.2
Net Capex	(2.9)	11.2	(4.0)	(4.0)
(Acquisitions) / Divestments	0.0	0.0	0.0	0.0
Other investments	(0.5)	(0.2)	0.0	(0.2)
Free Cashflows	(7.0)	13.1	4.0	16.0
Dividends Paid	(3.5)	(5.1)	0.0	0.0
Debt Issued / (Repaid)	(25.7)	(9.9)	(4.0)	(16.0)
Equity issued / (Buyback)	39.4	0.0	0.0	0.0
Net Cash Flow	**3.2**	**(1.9)**	**0.0**	**0.0**

Longer Term Business Attractions

We believe the following factors will be key drivers of FFI's business and share price going forward:

1. Termination of Del Rios lease

Effective from 31 December 2015, AVG terminated the lease of the Del Rios vineyard in Kenley, Victoria on the grounds of a natural disaster. During the 2015 Vintage AVG's cost of grapes from the Del Rios vineyard was ~$6m p.a. higher than 2015 average grape price purchased in the same region. After termination payments and write-off of vineyard running costs the net cash benefit to AVG will be ~$35m over the remaining 8 year lease term. The cashflow benefit should be felt immediately, however the P&L impact will take 18-24 months to crystallise after sales of the 2017 Vintage become meaningful.

2. Completion of above market grape supply contracts

From 2016-2018 Vintage, AVG has a number of onerous and above market grape supply contracts due to expire. Based on 2015 weighted average grape prices, we expect the cash benefit after the 2018 vintage to be $6.9m p.a.

3. Possible margin increases post 2014 vintage sales

The 2014 Vintage was badly impacted by frost which reduced yields across a number of vineyards. This adversely affected 2015 results by $6.2m in comparison to expected yields. We understand that some residual 2014 Vintage sales should eventuate 1H16, and post sell through, margin improvement should be seen from 2H16.

4. Significant untouched markets:

a. USA

Until now AVG does not export wine into the US. The US wine market is the largest wine consumer in the world consuming ~30mhl of wine p.a. In comparison, Australia consumes ~5mhl of wine p.a. The consumption of wine per capita in the US is approximately 10ltr vs. 23ltr in Australia – the wine drinking market is somewhat immature and still growing. It is feasible in the next 10-20 years consumption in the US could double. The US import 30% of consumption p.a. A doubling of consumption could lead to a wine supply shortage in the US, which domestic production would struggle to fill. We are attracted to the enormity of the US market and the significant market growth over the next 10-20 years.

b. China

In August 2014 AVG signed an exclusive distribution agreement for McGuigan Wines into China with COFCO Wine & Spirits Co Ltd. According to the Australian Grape and Wine Authority the China Wine Market is ~US$22 billion p.a., of which Australia supply $242m p.a. We note the current Chinese wine market appears to be an egg-timer shape, in that there are buyers at both the lower and higher ends of the market, however very little in the middle. The lower end of the market is controlled by local state owned producers who are difficult to compete with on price and thrive on national patriotism. The higher end of the market is dominated by the imported iconic premium brands. We believe McGuigan Wines to be situated within the mid-range market which until now has been viewed as "no-man's land" in China. Providing AVG can actively manage the COFCO relationship, we see the growth of middle class China as a possible catalyst in the medium term for sales penetration into China.

c. Japan / South Korea and Mainland Europe

Over the past 12 months Australia has entered into free trade agreements with China, Japan and South Korea removing import tariffs immediately or over the coming years. Also, until now distribution into Europe has been problematic with very few distribution channels eventuating into meaningful sales. We are attracted to the size of these markets and opportunity to gain market share, though note significant penetration is likely to be long winded (+5 years) if successful.

5. Building brands over bulk supplies

Historically, 80% of wine supplied by AVG was bulk and 20% branded wines. We estimate this is now closer to 50/50, slightly favouring branded wine. We are attracted to the transformation AVG has undertaken, building brand recognition and shifting its reliance on low margin bulk wines. We believe this is a far more sustainable business model than the former.

WET rebate reforms – will help, but will take time

Overview

Since May 2015 when the Assistant Treasurer announced that the Treasury had been asked to prepare a discussion paper examining the WET Rebate reforms, the Australian Wine Industry has been unable to reach a consensus on desired reforms necessary. Part of the industry would like WET rebate removed on bulk and unbranded wines as *"these are not conducive to building sustainable businesses and therefore do not play a long term role in encouraging regional development"*. The WFA would like the legislative definition of rebatable wines to include: "*grape wine, grape wine products, fruit or vegetable wine, cider or perry, mead or sake, that is packaged in a single container with a capacity not exceeding 5 litres at the time of the dealing, and which is labelled with a brand on the primary packaging that is wholly owned by, or licensed exclusively to, the producer of the wine."* This will enable the following sustainable businesses to continue: (1) winemaking and grape growing businesses that produce their own branded and packaged wine; (2) winemakers and grape growers who lease their production assets or contract out the making of their wine and produce their own branded and packaged wine; and (3) businesses that purchase grapes or lease vineyards and produce their own branded and packaged wine.

Others would like a move to a volumetric tax, abolishing WET and WET rebate, thus lowering the retail price of better quality wines. Whilst industry consensus is missing it is difficult to see a move to a volumetric tax. The Wine Federation of Australia ("WFA") "proposes as part of its reforms that the WET rebate should be limited to producers who *"sell wine in a form that is packaged ready for retail sale and where the finished product is identifiably theirs"* (phased out at 25% p.a. commencing at 75%). We expect WET reforms to fall within the WFA recommendations, most likely mid to late this year in time for the next Federal Election.

What does this mean for the Australia Wine Industry which has become heavily dependent on WET rebates?

Wine is a global commodity and thus the price of bulk wines is set by the export market price. Under current schemes producers/virtual wine makers and so forth are obtaining multiple rebates, which is at times lowering the pre-VAT price of bulk wines below export price, as well as underwriting unsustainable businesses. By removing the rebate on bulk wines and private labels it will create the following affect: (1) promote only sustainable business models and brands, as well as inspire innovation – this should improve the Australian wine brand leading to higher demand and increase profitability; and (2) reinstate domestic bulk wine prices inline with both global prices and/or cost of production – ensuring branded wines are more cost competitive against Coles and Woolworth's private labels, which currently can be blended from these bulk wines supplied at below global prices.

What does this mean for AVG?

We estimate that AVG bulk sales are ~13% ($30m) of total sales, declining steadily over the past 10 years. We estimate ~$19m p.a. are domestic bulk sales at EBIT margins of -5%. These margins were compromised based on a series of factors discussed above in "longer term business attractions" points 1-3. That being said, given the commodity nature of bulk wines it is difficult to see EBIT margins exceeding 2-3% if we assume branded sales are 10-12% EBIT margins in a normal year. If the WET rebate is abolished on bulk wines we expect the benefit to AVG through a rebasing of domestic bulk wine prices to be $1.5-2m p.a. (pre-tax), based on FY15 results. We would not expect such benefits to appear until ~2020 onwards. Given Coles and Woolworths control 80% of the retail distribution we are a little less confident rebasing bulk wine prices will affect private label branded sales margins to the extent these retailers shift their focus back to branded partnering.

We believe any repair of the Australian Wine brand within the global market will take a while despite the obvious benefits of only sustainable businesses contributing to output. We do not believe the proposed WET Rebate reforms will be the silver bullet for AVG's business, and instead expect growth in AVG's branded wines from penetration into relatively untouched markets of Europe and the US to be far greater.

Company Overview

AVG is an Australian based wine company which produces, packages, markets and distributes branded and bulk wines for the domestic and international market. To a lesser extent, AVG also provides private label wines, contract wine processing and vineyard management. AVG first listed on the Australian Securities Exchange in 1992, under the name of McGuigan Wines Limited (incorporated in 1991 as Roserim Limited), subsequently changing its name to Australian Vintage Limited in 2008.

AVG is one of Australia's largest wine producers, crushing 110,000 tonnes and selling 80 million litres of wine per annum. Current production facilities are capable of producing 1.5m casks and 6m cases of bottled wine. AVG has 2,700 planted hectares across 11 vineyards and have two wineries operating year-round:

- **Buronga Hill:** Located in the Sunraysia district of southern NSW, Buronga Hill has a processing capacity of up to 150,000 tonnes. Buronga Hill is the home of AVG's no and low alcohol production facility Austflavor, which also produces concentrate for key export markets.
- **Hunter Valley:** Focusing on production of small batches, crushing 700 tonnes annually. This winery specifically deals with manufacturing premium wines.

AVG provides bottled and bulk wines to wholesale and retail networks across Australia, South East Asia, North America, UK and Europe. AVG's flexible bottling and packaging facility is located in Merbein in Victoria, close to its Buronga Hill winery. The Merbein facility caters for bottled and bag-in-box lines in a variety of sizes and specifications.

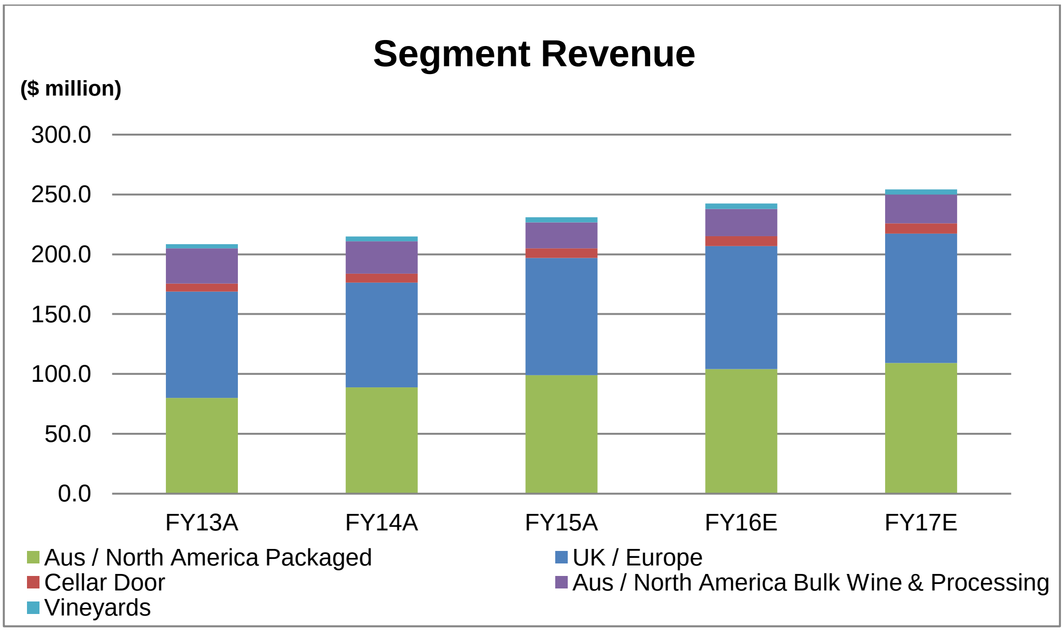
Some of the key transactions that have shaped the core business include:

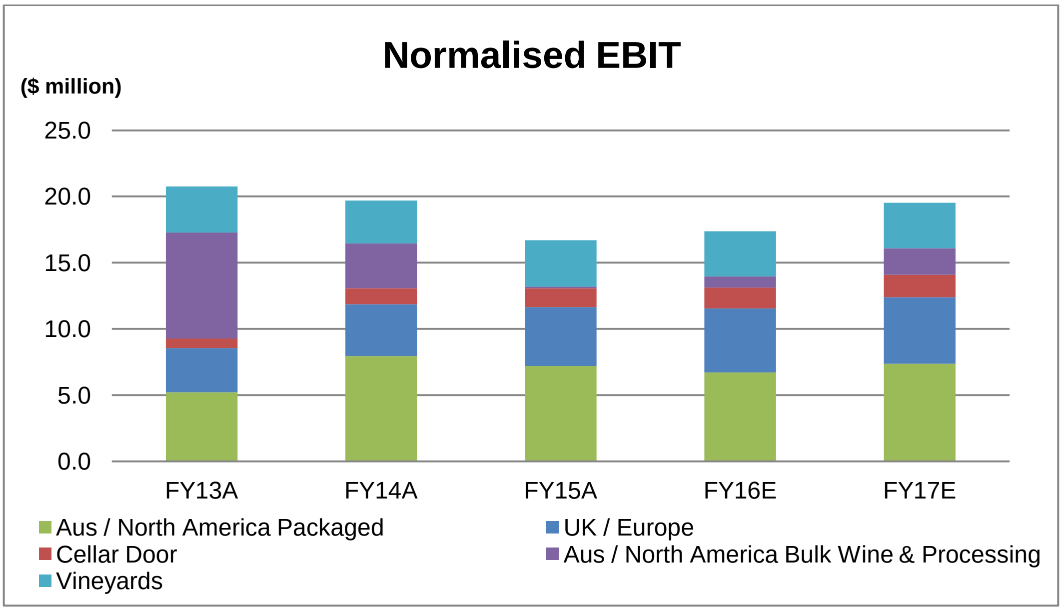
- 1991 - Roserim Limited incorporated
- 1992 - Change of name from Roserim Limited to McGuigan Wines Limited and listing on ASX.
- 1997 - Tempus Two brand is launched
- 2002 - Merge with Simeon Wines to creating McGuigan Simeon Limited
- 2003 - Acquire Miranda Wines
- 2007 - Acquire Nepenthe Wines
- 2008 – Change of name from McGuigan Simeon to Australian Vintage Limited.

Business Segments

AVG provides various services within its five reporting segments:

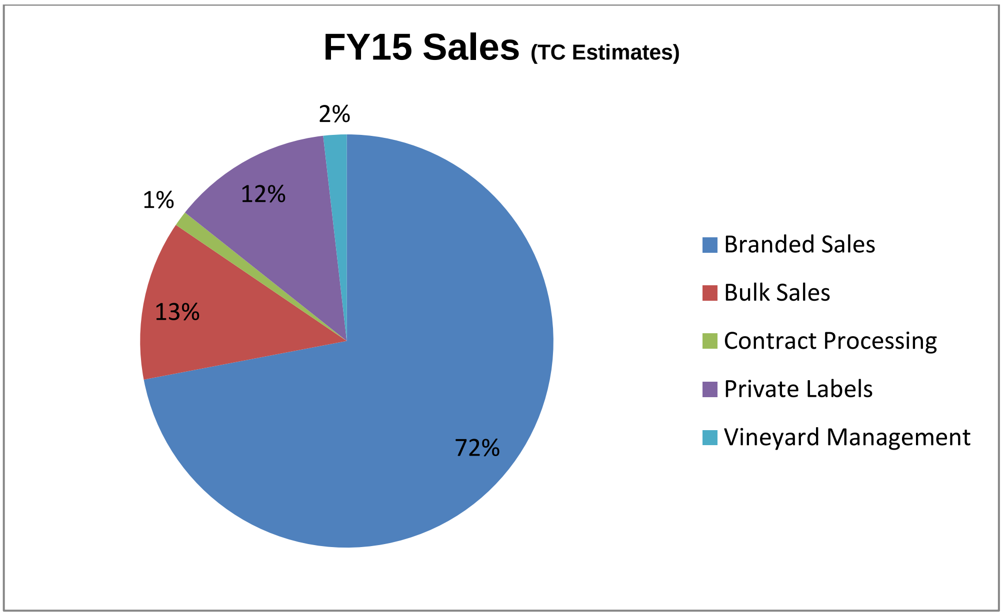
- **Australia / North America Packaged -** Supplies packaged wine within Australia, New Zealand, Asia and North America through retail and wholesale channels.
- **UK / Europe -** Supplies packaged and bulk wine in the United Kingdom and Europe through retail and distributer channels.
- **Australasia / North America bulk wine and processing -** Supplies bulk wine, concentrate and winery processing services throughout Australia, New Zealand, Asia and North America.
- **Cellar Door -** Supplies wine direct to the consumer through regional outlets.
- **Vineyards –** Provides vineyard management and maintenance services within Australia and includes biological assets income.

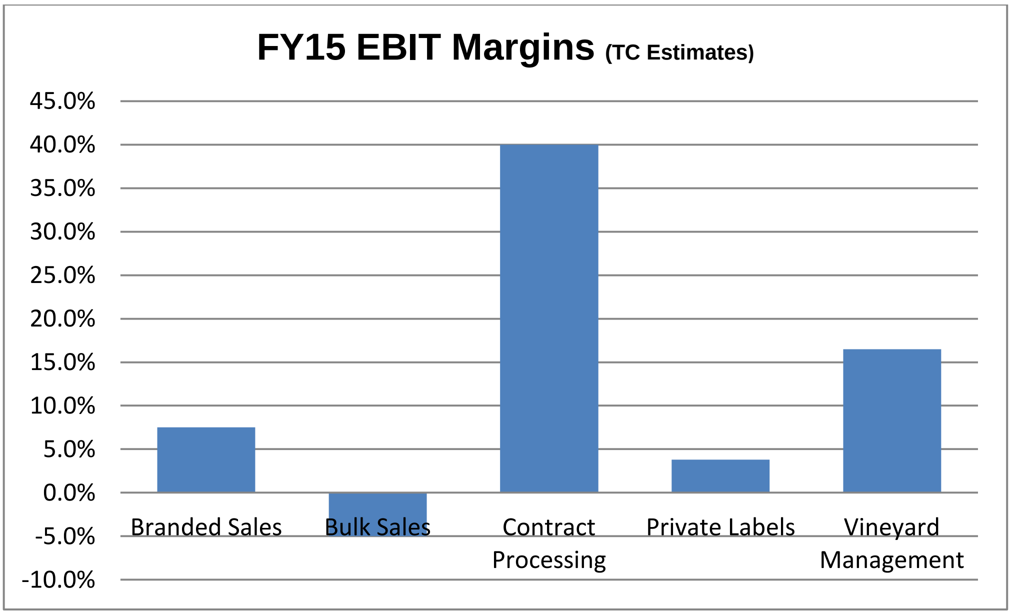




We note segment reporting is a mixture of geographical and functions performed. Below we have attempted to split the business into supplies provided, which is beneficial when considering market position and future strategy.

- Branded Sales
- Bulk Wines
- Private Labels
- Contract Processing
- Vineyard Management





BRANDED WINE

AVG branded sales contributed 72% of the Groups revenue during 2015, growing steadily the past few years. Branded sales include the supply of bottled and cask varietals both domestically and internationally under the brands of McGuigan Wines, Tempus Two, Nepenthe Wines, Miranda Wines, Passion Pop; as well as newer brands such as The Shy Pig, YOU and Orchard Grove.

- **McGuigan Wines**
  - Established in 1992
  - Best known for <$10 bottle Black Label wines
  - Won Winemaker of the Year at the International Wine & Spirits Competition three times (2009, 2011 and 2012)
  - Wineries and cellar door in Hunter Valley and Barossa Valley
  - Black Label Red continues to be the highest branded bottled red by volume in Australia
  - Trying to build brand recognition into higher value varietals (process remains slow)
  - 15% brand growth in domestic market from pcp underpinned by meaningful Black Label growth across Wesfarmers and Woolworths Group as well as independents
  - Internationally the brand has grown 18% from pcp, strong gains in Canada and UK/Europe.
  - Remains the 2nd largest Australian brand and 4th largest global brand supplied into the UK
- **Tempus Two**
  - Established in 1998 by Lisa McGuigan
  - Best known for traditional European varietals and blends, hand-crafted with an Australian twist
  - Brand is about fashion and harmony and uses old and new world wine technique to generate substance and style
  - Aligned with fashionable brands such as Aje, Mercedes Benz Fashion Week and the Portsea Polo Season
  - Marketed at slightly higher end as fashion, luxurious and affordable
  - Based in the Hunter Valley
  - Brand sales grew 14% during FY15
  - Vineyards in the Hunter Valley, Coonawarra, Griffith, Barossa Valley, McLaren Vale, Limestone Coast and Adelaide Hills
- **Nepenthe Wines**
  - Established in 1994
  - Best known for elegant range of wines built on varietal character and subtle regional nuances
  - Produces predominately white varietals
  - Holds approximately 130 hectares of vineyards across Lenswood, Charleston, Balhannah and Hahndorf
  - Brand grew 47% during FY15
  - Based in the Adelaide Hills
- **Miranda Wines**
  - Established in 1938
  - Best known for “better for you” lifestyle category of wines

  - Industry leader in no and low alcohol wines across the globe
  - Range includes Somerton (easy drinking wines), Summer Light (full flavour at reduced alcohol levels) and Summer Fresh (4 varietals at <0.5% alcohol).

- **Passion Pop Flavoured Sparkling**
  - Established in 1979
  - Best known for low price Flavoured Sparkling Wine
  - Market leader in the Australian Flavoured Sparkling Wine category for over 30 years
  - Three different flavours: original (passionfruit-flavoured); mixed berry and pink (strawberry-flavoured)
- **The Shy Pig (new)**
  - Wine based drink (contains minimum 75% wine)
  - Best known for low cost drink sold in UK Supermarket
  - Shipped as bulk wines to the UK where they are bottled
  - Three flavours include Juicy Red, Blush (Rose) and Crispy White
- **YOU (new)**
  - Targeted towards capturing GenY consumers based on a series of questions to align them with an “identity of wine”
  - Four types include grigio, shiraz, cab sav and chardonnay
  - Available exclusively at Dan Murphy’s and BWS
- **Orchard Grove (new)**
  - Fruit infused wines
  - Three flavours include Passionfruit & Pineapple (White), Strawberries & Cream (Rose) and Cherry & Coconut (Red)

BULK WINES

Bulk wine is supplied to the customer to finish and blend to its specifications, style and quality. AVG manages the supply of wine and the customer manages its own branding, packaging and logistics. AVG supplies bulk wines to small, medium and large customers both domestically and internationally, supplying domestic retailers Coles and Woolworths and international retailers Tesco and Sainsbury to fill retail private lines.

It is estimated that domestically and within the UK the large retailers of Coles, Woolworths, Tesco, Sainsbury, Morrisons etc distribute and sell 80% and 40% respectively of all wine sold. Bulk wines make a significant portion of shelf space and it is estimated between Coles and Woolworths alone they have 200 registered private label brands. Although it cannot be definitively calculated it is argued that retailer private labels consume up to 60% of the wine shelf space.

We estimate bulk contributes ~13% of AVG’s sales at an estimated EBIT margin of -5%.

PRIVATE LABEL

Private Label' or 'Buyer's Own Brand' is a bottle label or brand owned by and produced exclusively for the client. The wine and label design is chosen specifically by the client who will promote and sell the product as their own exclusive brand.

We estimate bulk contributes ~12% of AVG's sales at an estimated EBIT margin of 3.8%.

CONTRACT PROCESSING

AVG has the capabilities for contract processing, converting grapes into finished wines from niche production up to more commercial volumes. All processing is provided at fixed price terms to customers and is BRC certified. Contract processing services extend to advice regarding wine style, de-juicing, legislative requirements, stabilisation and blending, as well as complete laboratory services.

We estimate bulk contributes ~1% of AVG's sales at an estimated EBIT margin of 40%.

VINEYARD MANAGEMENT

AVG's vineyard management division operates under Nepenthe Viticulture, based in the Adelaide Hills, and services customers across South Eastern Australia. Vineyard management services includes but is not limited to yield estimation, plant tissue sampling, grape maturity sampling, irrigation, pest and disease monitoring, herbicide, fungicide and fertiliser applications; soil management; pruning and canopy management; machine harvesting and vineyard re-development

We estimate bulk contributes ~2% of AVG's sales at an estimated EBIT margin of 16.5%.

WINE MARKETS

<u>Domestic Market</u>

Australia consumes ~5.4mhl of wine p.a. (~85% domestically produced wines and ~15% imported wines), in comparison to producing ~12mhl of wine p.a. Australia's consumption is approximately 1.6% of global wine consumption. The Australian wine industry is highly fragmented with ~2500 difference wines producers and over 30,000 difference SKUs. The largest 38 producers account for 88% of total production.

At a retail level the market is dominated by Coles and Woolworth who control approximately 80% of the retail market distribution. The large retailers have numerous sourcing options which allow them to leverage producers with rebates and discounts as a result of: (1) industry fragmentation; (2) its ability to sell imported wines from places such as New Zealand, France, Italy and Spain at attractive margins and (3) excess supply of Australian wines with a stock to sales ratio of ~1.5 times.

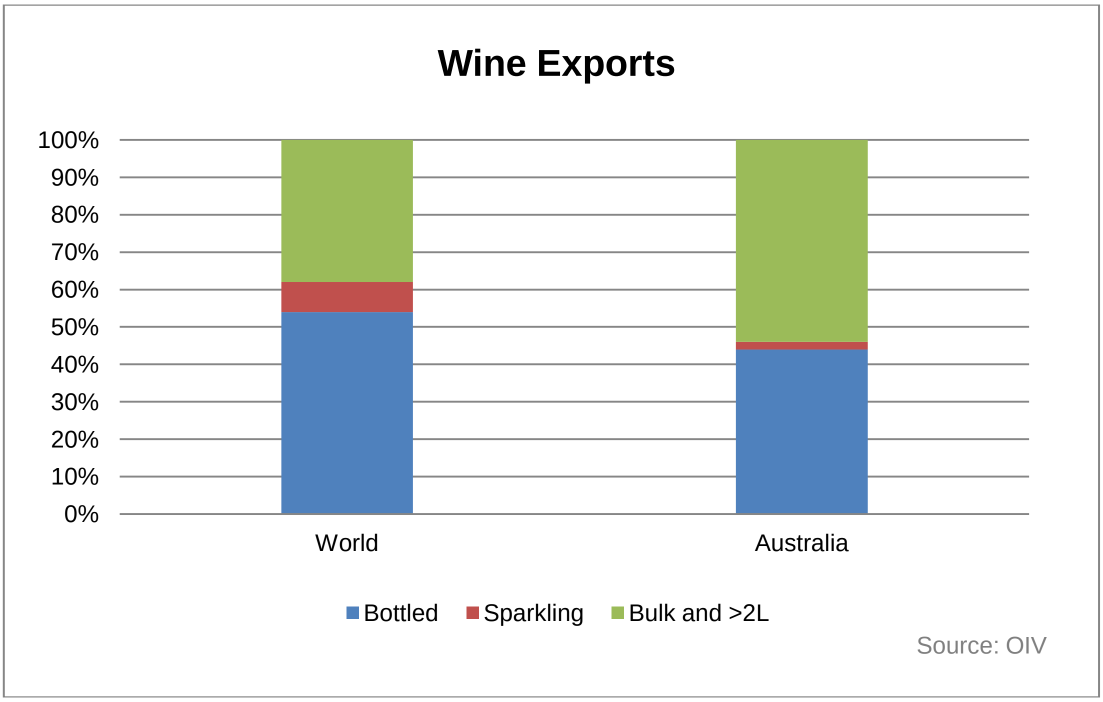
The domestic market is the largest market for the Australian Wine Industry, accounting for approximately 40% of sales. According to ABS the CAGR of domestic wine sales volumes from 2009-2014 was 1.02%. Domestic produced wine sale volumes increased at CAGR of 0.32% during this same time, whilst imported wine sale volumes increased at CAGR of 5.63%, predominately driven by white wines supplied from New Zealand.

Within the Australian market the Company provides its entire suite of branded products, along with bulk, private label solutions and new product innovations. As well as supplying the larger retailers directly, AVG use distributors such as Estate Wine, Chace Agencies and The Wine Company to service a range of clubs, bars and restaurants with its flagship brands of McGuigan Wines, Tempus Two and Nepenthe Wines. We understand 70-80% of AVG sales within Australia are provided through the large retailers, which appears consistent with the general market.

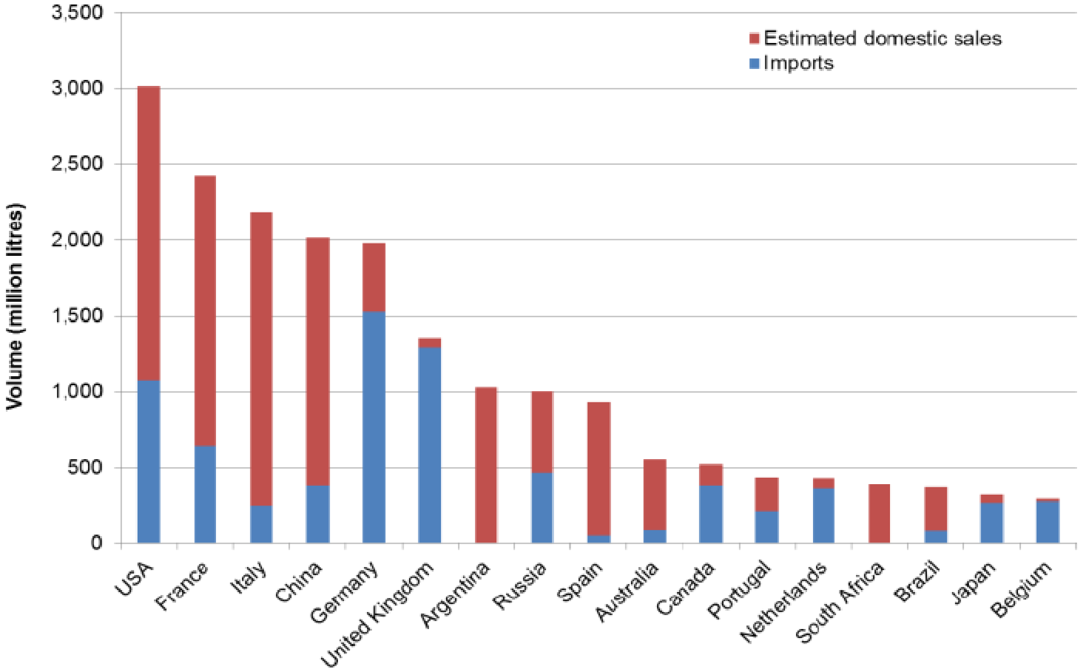
AVG has stated its relationship with Coles and Woolworths has never been better. Despite this, it is targeting on-premise sales (restaurants/pubs/clubs) as areas where market share can be captured. Ongoing awards such as Winemaker of the Year (McGuigan's) at the International Wine & Spirits Competition provide the credibility to drive sales. On-premise sales are a great way to reach additional customers which in turn builds brand recognition. AVG has identified in order to hold and build on existing market share it must remain relevant to the consumer through innovation. In recent times AVG has provided a range of new lines (discussed above) which are tailored to consumer demands, and have largely been well received. We see continual innovation being both a backstop on current market share and a catalyst for further growth.

Export Markets

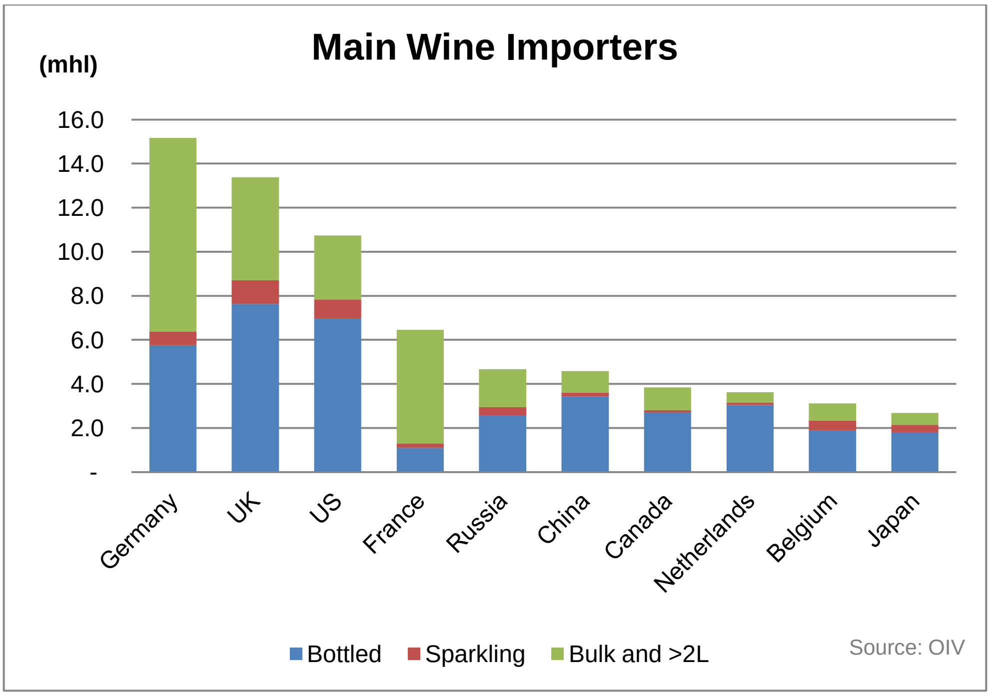
The global wine export market is worth €26b p.a. (A$41.2b) (104mhl of wine traded p.a.) of which Australia supplies 4.8% in value and 6.7% of volume. The graph below shows the disparity Australia experiences in comparison to the world average in the percentage of types wines exported, due to non-branded commodity based producers flooding the export market with cheap bulk wines. Australian volume driven producers are constrained on price in the export market from lower cost bulk wine producing nations of Chile, Argentina and South Africa.



The graph below shows the wine consumption p.a. split between domestic sales and imports. This shows that whilst France, Italy and China were amongst the highest consumers of wine it did not translate into large importers of wines. The largest importing countries of wine in the world are Germany, the UK and USA.



Germany is the largest importer of wine by total volume. However, 58% of Germany's imports relate to bulk wine. Comparing only bottle wine imports, Germany ranks third behind the US and UK. On the surface it appears the German consumers are highly price sensitive and aggressively targeting this market could be devaluing to AVG brands.



AVG has distributors across UK & Ireland, Europe, Asia, New Zealand and the Americas offering branded suite right down to bulk wines. We understand the vast majority of AVG's export sales are made to the UK, and to a lesser extent Canada, Scandinavia, the Benelux, Eastern Europe and New Zealand. AVG does not supply both the US or German markets, two of the three largest importers of wine p.a. Each market has its own complexities, nuances and consumer demands and thus a targeted sales approach would appear to prevail over a general approach.

AVG has performed well at expanding its UK distribution over the past 5-6 years with major retailers. Historically, AVG were heavily weighted toward 2-3 supermarkets. The Company now has lines with all major retailers in the UK and continues to grow. AVG are making promising in-roads into the UK hoteliers market. Both provide strong platforms for growth. Whilst we have no guidance on sales breakdown, we estimate ~70% of overseas sales are generated from the UK. We note McGuigan's is the largest Australian brand in Ireland and is looking to reclaim the largest global brand in Ireland in the next 12 months.

AVG has virtually no sales across mainland Europe, though see Scandinavia, the Benelux, Eastern Europe as growth areas, as well as the US. Obtaining meaningful distribution and complementary sales staff are essential for growing these large regions; and are not overnight events. We see this as medium to long-term growth for the business, and therefore would not expect a meaning contribution for 5-10 years.

Canada returned strong sales increases from a low base in FY15 and AVG sees potential to double its current market share in this profitable region. Additionally, whilst starting slowly, management are hopeful the China COFCO agreement will start delivering, however we are a little less optimistic given non performance to date.

Key Risks

Supply risk

After the termination of the Del Rios vineyard lease it is expected that AVG will source approximately 20% of its grapes from owned vineyards, 25% leased and 55% growers. We note that typically 90% of AVG's grapes are supplied from the Riverland and Sunraysia regions. Our channel checks in these areas suggest that the 2016 Vintage looks slightly lower at this stage than 2015 due to lower than average winter and spring rainfalls, as well as the hot dry start to the summer. We note water restrictions are not in place and are unlikely to impede the 2016 Vintage. However, water reserves are depleting and if conditions persist it is possible restrictions could be in place for the 2017 Vintage. We are not concerned in the current production/consumption environment that AVG will be required to purchase grapes for the 2016 Vintage at above market prices or significant increases to 2015 prices to meet production requirements.

Dependence on Supermarket Retailers

We estimate 70-80% of AVG wine sales in Australia and UK are made to large retailers. In Australia, Coles and Woolworths control 80% of the wine retail distribution market, and in the UK, large retailers such as Tesco, Morrisons, Waitrose etc control 40% of the wine retail distribution market. This provides significant leverage on the retailers side which can be used for rebate or discount requests.

Trade credit risk

AVG manages its trade credit risk by undertaking credit worthiness reviews on all customers and look to obtain debtor insurance for all significant customers. Ongoing credit evaluation is performed on the financial condition of accounts receivable and, where appropriate, credit guarantee insurance cover is purchased. As a result of such strong trade credit procedures AVG has had ~0.06% of sales not collected over the past two years. Therefore whilst a trade credit risk exists, it is virtually negligible.

Yield risks

Each vintage AVG is exposed to a number of factors that can impact yields. Underyields, which adversely impact the Group's profitability can be a result of a number of factors, not limited to: crop disease, distress from drought and frost. Whilst factors such as disease control and distress from drought are somewhat mitigated by AVG's vintage management procedures, other factors such as frost damage, as experienced in the 2014 Vintage cannot be prevented, and will remain an outgoing risk to AVG. Whilst it is too early to call (more will be known late February), channel checks throughout the Riverland, Sunraysia and Barossa regions suggest yields for the 2016 vintage could be a little below the 2015 vintage (approximately 5-10%).

Forex risk

AVG somewhat mitigates its risk to forex for highly probable sales made and estimated expenses incurred in foreign currencies by using forward contracts. AVG's procedure is to cover 50-75% of the transaction value if it is highly probable the transaction will eventuate in the next 12 months. Furthermore, AVG's will cover 25-50% of the transaction value if it is highly probable the transaction will eventuate in the next 13-24 months.

Quality assurance

Operating in the highly regulated beverage manufacturing environment AVG is exposed to risks of product recalls exposing it to potential customer claims and loss of reputation. We note AVG is exposed to a number of different quality accreditations which involves regular independent audits. We are not aware of any claims in AVG's recent history.

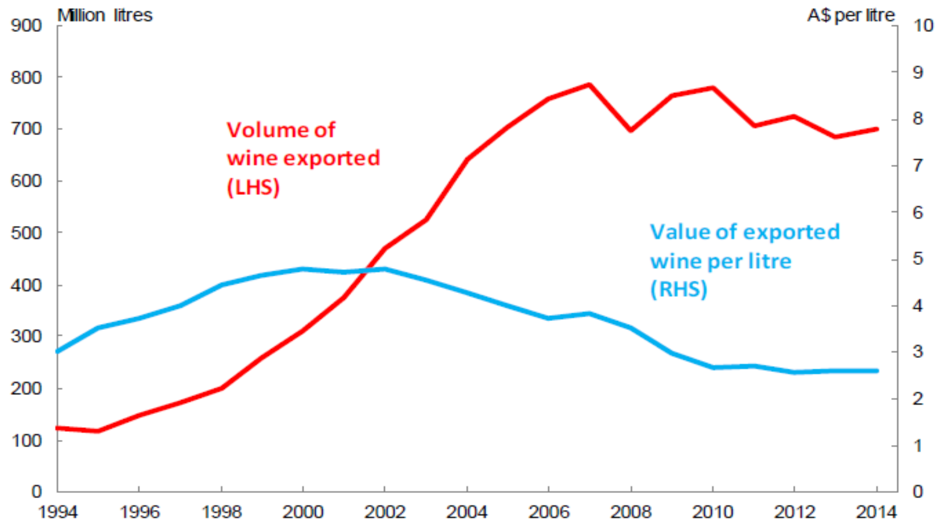
Interest rate risk

The majority of AVG's current facility comprises commercial bills with a variable interest rate. The Company effectively manages its exposure with a series of interest rate swaps of approximately 60-70% of the total borrowings.

Australian wine brand damaged by oversupply likely to be a slow recovery

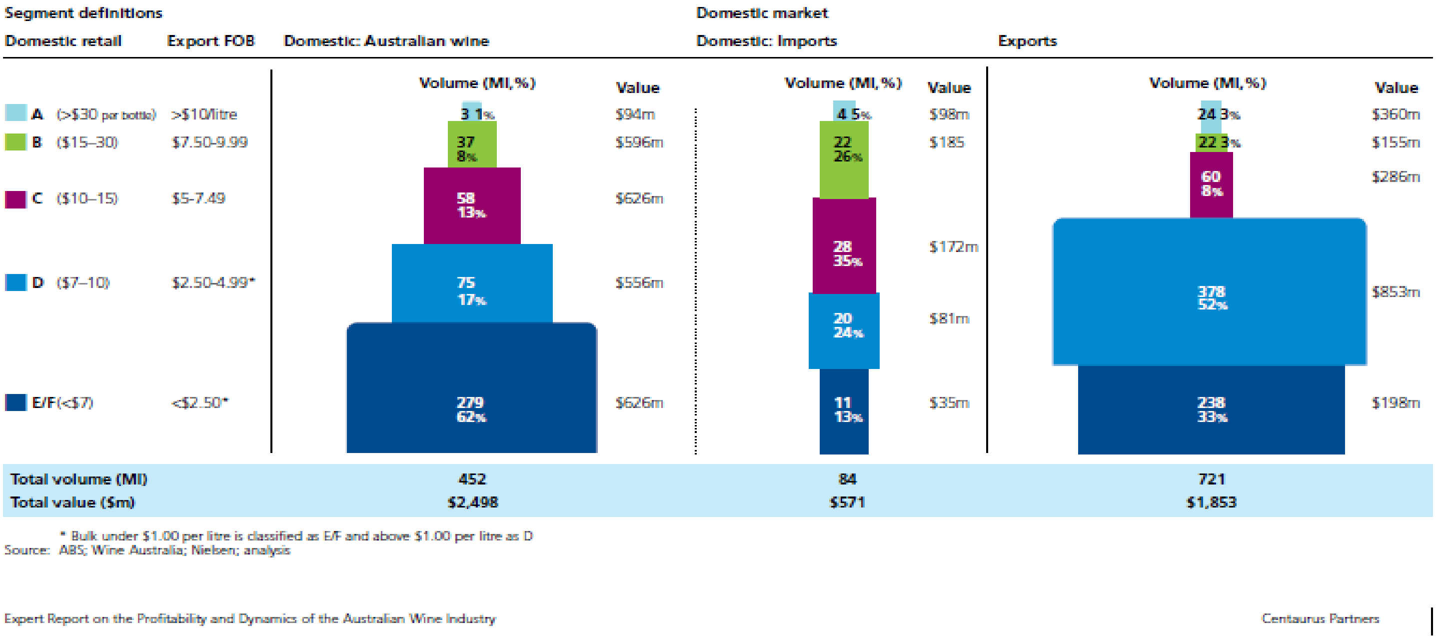
Over the past 20 years the volume of Australian wine exported has increased from just over 100ml to approximately 700ml whilst the value of exported wine (A$/ltr) peaked at approximately $5/ltr around 2002 and has dropped off to lowest levels in the 20 year period to well below $3/ltr. We note the below graph is based on export values adjusted to A$/ltr and does not include changes in business decisions such as sending branded wines in bulk at reduced FOB export prices and bottling overseas, and therefore is somewhat compromised and exaggerated.

Chart 6: Wine exports: volume and value per litre



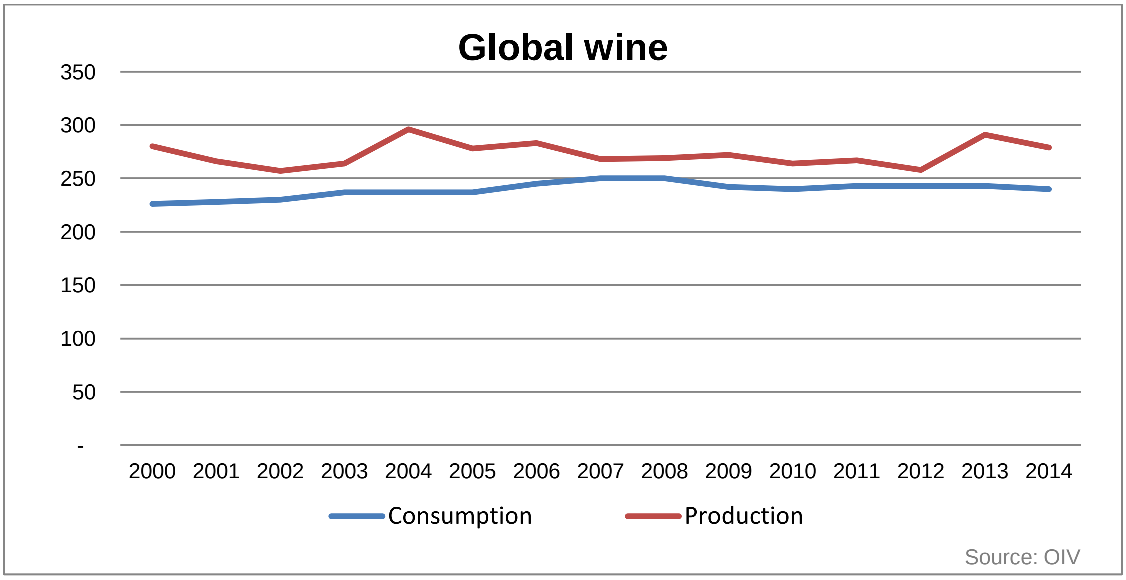
Source: Wine Australia (December 2014) *Wine Export Approval Report*. Accessed through Winetitles (2015) *Australian and New Zealand Wine Industry.*

Nevertheless, part of the reason for the value per litre reduction is due to the increased supply of inferior wines which has damaged the Australian wine brand (2012 data below). Whilst acknowledging a WET Rebate reform will improve the quality of Australian wines supplied to exports markets we expect a brand turnaround to be years away from playing out. Currently this macro brand damage somewhat impedes AVG's ability to build a premium wine brand and increase profitability.



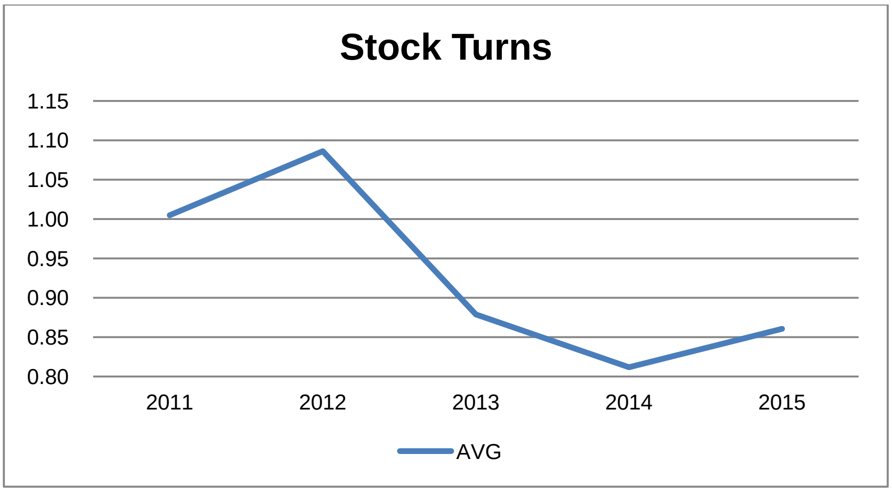
Oversupply leading to price pressures

The graph below demonstrates worldwide consumption consistently trailing production. This oversupply, mixed with price pressures from lower cost producing New World countries such as Chile, Argentina and South Africa has impeded wine price growth over this time, and could continue into the future. Whilst we acknowledge the world area under vines has been slowly reducing in recent times, improved growing techniques have ensured global production remained relatively constant.



Stock obsolescence or write down

AVG's business is working capital intensive, in particular, inventory with ~$200m on hand in FY15. While inventory turns may also be a feature of accounting policy choices and business strategy, the past few years have witnessed deterioration in AVG's stock turns, which has increased work capital requirements in excess of sales growth. We believe some of this is attributable to sales mix being more heavily weighted to branded sales, instead of bulk sales. While these trends aren't particularly alarming, they highlight room for operational improvement and elevated risks around inventory stagnation. As experienced in FY09, a moving commodity price mixed with large stock reserves can at times lead to stock write-downs. We note increased stock flexibility is now available with 25,000 tons no longer being supplied from the terminated Del Rios Vineyard lease.



Analysis of FY15 Financials

	FY14A	FY15A
Total Revenue (m)	217.3	232.8
Revenue Growth	3.5%	7.2%
* EBIT (m)	19.7	16.7
* NPAT (m)	7.7	7.1
* EPS (c)	3.7	3.1
* EPS growth	18.9%	(16.8%)
Ordinary Dividend (c)	2.2	0.0
Payout Ratio	59.6%	0.0%
* ROE	2.9%	2.5%

* FY14 figures adjusted for gains on provision for onerous contracts. FY15 figures adjusted for gains on provision for onerous contracts and sale of Yaldara winery as well as legal fees for vineyard disputes and non-recoverable incentives to customers.

FY15 Adj. NPAT decreased 7.8% to $7.1m, with revenue increasing 7.2% to $232.8m. This resulted in Adj. ROE decreasing 0.4% to 2.5% on pcp. The profit decrease was primarily driven by the reduction in 25,000 tonnes of processing contribution from expiry on long term processing contract. This was partially offset by increases in branded sales across Australia, UK, New Zealand and North America. Lower exchange rates did not flow through to margin increases as a result of higher 2014 Vintage costs and margin pressures from UK Supermarkets.

Net cash contributed from operating activities increased by $5.7m on pcp to $2.1m as a result of increased branded sales. Whilst this was an improvement on last year, the conversion of normalised cash profits into net cash from operating activities continues to be of concern.

The sale of the Yaldara winery for $15.5m provided AVG with surplus cash to deploy toward net debt repayment of $7.5m, leaving net debt at $104.3m (~$15m facility headroom). This resulted in net debt to equity reducing 3.1% from pcp to 35.7% leading to EBIT interest recover increasing from 2.2x to 2.6x. It is expected that AVG will continue to make modest debt repayments as it looks to deleverage the business further.

Management declared nil dividends for FY15, stating it has allocated funds toward improving operating efficiency and increasing branded sales margins.

Financial Forecasts

	FY14A	FY15A	FY16E	FY17E
Total Revenue (m)	217.3	232.8	244.0	256.0
Revenue Growth	3.5%	7.2%	4.8%	4.9%
* EBIT (m)	19.7	16.7	17.2	19.6
* NPAT (m)	7.7	7.1	8.4	10.2
* EPS (c)	3.7	3.1	3.6	4.4
* EPS growth	18.9%	(16.8%)	17.5%	21.4%
Ordinary Dividend (c)	2.2	0.0	0.0	0.0
Payout Ratio	59.6%	0.0%	0.0%	0.0%
* ROE	2.9%	2.5%	2.9%	3.4%

* FY14, FY16 and FY17 figures adjusted for gains on provision for onerous contracts. FY15 figures adjusted for gains on provision for onerous contracts and sale of Yaldara winery as well as legal fees for vineyard disputes and non-recoverable incentives to customers.

FY16

We estimate revenue to increase by 4.8% to $244m, driven by increased market share captured in the UK and Canada, as well as gross margin increases from sale through of frost damaged 2014 Vintage. We expect this to flow to Adj. NPAT and forecast a $1.3m increase to $8.4m. Despite this increase, we expect Adj. ROE to remain modest at 2.9%.

We have not forecasted any dividends to be declared for the FY16 or FY17 financial years as we expect management will continue to repay debt over this time, and note the $4.9 termination payment due in respect of the Del Rios lease termination.

We estimate capex of $4m p.a. for FY16 and FY17 for general business upgrades, and note at some stage AVG will look to replace some of the volumes lost through the sale of the Yaldara winery. We expect such an acquisition would be for ~$8m, however, do not expect this to occur in the coming 18 months.

We forecast net debt to finish the year at approximately $100.3m, a decrease of $4m from pcp. We note carry forward tax losses total $34.7m as at FY15. Therefore we estimate nil tax will be paid during FY16 and FY17, which we have adjusted back in our cash flow forecast.

FY17

We estimate revenue to increase by 4.9% to $256m, driven by continual growth in on-premise market share across Australia and UK, as well as some market penetration into China from COFCO distribution agreement, and increased sales drive into selected mainland Europe. We note our modest growth forecast does not include sales into the US as distribution has not yet been finalised, and subsequent to this sales need to be secured. Further to this we expect AVG's gross margin to increase from savings from expiry of above market grape contracts and termination of Del Rios lease. We expect this to flow to Adj. NPAT and forecast a $1.8m increase to $10.2m, leading to an Adj. ROE of 3.4%, an increase of 0.5% from pcp.

We expect free cash flow generated will be $16m, a normalised increase of ~$12.3m from FY15, driven by savings from onerous and above market grape contracts. We are forecasting that management will use this free cash flow for debt repayment, further deleveraging the business, and thus expect net debt to finish the year at approximately $84.2m.

Valuation / Price Target

The table below compares listed Australian and International producers and distributors of wine products.

	Mkt Cap (AU$m)	EV/EBIT (x) FY16E	EV/EBIT (x) FY17E	ROE FY16E	ROE FY17E	Net Debt: Equity FY16E	Net Debt: Equity FY17E	EBIT Margins FY16E	EBIT Margins FY17E
Treasury Wine Estates Limited	6,754	21.6	16.2	6.5%	8.1%	6.8%	6.7%	13.3%	15.1%
Brown-Forman Corporation (USD) - Class B	27,037	19.0	17.6	40.8%	42.0%	78.7%	54.0%	25.9%	26.3%
Vina Concha Y Toro S.A (USD)	23,501	14.2	11.7	10.5%	13.0%	56.3%	50.8%	11.4%	12.3%
Constellation Brands (USD) - Class A	41,180	19.7	17.6	17.1%	17.3%	114.2%	104.9%	28.4%	29.3%
Compania Cervecerias Unidas SA (USD)	10,747	24.7	22.5	11.6%	12.7%	1.7%	4.7%	14.3%	15.1%
Australian Vintage Ltd	89	11.0	8.9	2.9%	3.4%	34.4%	28.0%	7.3%	7.9%
Average		18.4	15.8	14.9%	16.1%	48.7%	41.5%	16.8%	17.7%

Our preferred valuation methodology is based on EV/EBIT. AVG is a much smaller and lower quality business to the peer set and thus a discount is justified, however, has battled admirably in structurally challenging markets and its resilience needs to be considered.

Trading at 11.0x our FY16e adj. EV/EBIT, we believe the current valuation provides a value investment opportunity in an industry that feels like it has bottomed if comfort can be reached on our below concerns:

- Debt is a concern but AVG has been able to reduce net debt through various initiatives from $161m to less than $104.3m from FY11 to FY15. A number of these initiatives cannot be repeated but the evolution of the business model to a more branded business rather than bulk supplier should provide increased profitability and subsequently ongoing debt reduction. Current facilities are in place with a banker of 20+ years and are due for renewal in October 2017. Whilst we would prefer disclosure of debt covenant benchmarks, we are aware none of these have been previously breached.
- Slowing stock turns which present both a write down risk as well as an opportunity for increased profitability
- Margin squeeze from UK Supermarkets from lost market share to discounters
- Weakened Australian Dollar already factored into current valuation
- Poor recent free cash flow conversion
- Whether margin and growth expansion can be found in the US/Europe with current brand recognition. Often such process can be a slow burn.

We believe the next catalyst for meaningful stock growth is 18-24 months away driven by margin expansion from lapsed/termination of above market and onerous grape supply contracts, as well as a reduced sales mix inclusive of 2014 frost affected Vintage. All things being equal these catalysts could more than double the Company's Adj. NPAT in comparison to FY15.

Whilst AVG could be attractive to opportunistic investors looking for a short-term re-rating, on balance we view debt as significant and with profitable stock turns below one per year we remain cautious. We initiate coverage with a Hold recommendation.

Board of Directors/Management

Non Executive Chairman

Richard Davis

Mr Davis was appointed as a Director of the company in 2009, subsequently to Chairman in 2015. Mr Davis was a former partner of a national accounting firm. Mr Davis is currently the Chairman of Monash IVF Group Limited, and also holds a directorship with InvoCare Limited, where he acted as CEO for over 20 years growing and managing the business.

Executive Director

Neil McGuigan

Mr McGuigan was appointed as a Director and CEO of the company in 2010. Prior to this appointment Mr McGuigan held the position of General Manager of Production and Wine Supply within the Group. Mr McGuigan has over 27 years' experience in the wine industry, working at Briar Ridge before running Rothbury Estate for the Foster's Group.

Non Executive Directors

Naseema Sparks

Ms Sparks was appointed as a Director of the company in 2015. Ms Sparks has a Master of Business Administration from Melbourne Business School and is also a Fellow of the Australian Institute of Company Directors. Ms Sparks is currently a Director of PMP Limited, Grays eCommerce Group Limited, Melbourne IT Limited and AIG Limited. Ms Sparks specialises in businesses with strong B2C profiles, and disruptive technology playing in traditional industry sectors. Ms Sparks brings a range of complementary skills to the Board including corporate strategy, online commerce, retail, financial services, media - traditional and social, branding and marketing

John Davies

Mr Davies was appointed as a Director of the company in 2015. Mr Davies has over 36 years experience in Finance and Accounting working with Ernst & Young before retirement from the firm in 2011. Prior to retirement, Mr Davies served on the Ernst & Young's Asia Pacific Board of Partners for a six year period. Throughout his career Mr Davies has provided professional services to many of Australia's leading wine companies. Mr Davies is a Fellow of the Institute of Chartered Accountants.

Perry Gunner

Mr Gunner was appointed as a Director of the company in 2002. Mr Gunner has over 30 years experience in Wine Industry. Mr Gunner was the former Chairman and Chief Executive Officer of Orlando Wyndham Group Pty Ltd. Mr Gunner was the current Chairman of Freedom Nutritional Products Ltd and Deputy Chairman of A2 Corporation Ltd (N.Z.).

As at 30 June 2015 the Board and key management personnel held 1,235,124 shares in the Company (0.9%).

Major Shareholders

As at 31 December 2015, AVG's 20 largest shareholders were:

Shareholders	Shares Held	% of issued shares
Orbis Investment Management Limited	45,059,587	19.4%
Maple-Brown Abbott Limited	15,443,000	6.7%
Renaissance Smaller Companies Pty Ltd	13,839,095	6.0%
Perennial Investment Partners Limited	11,601,292	5.0%
Secvest Capital Pty Ltd., Asset Management Arm	8,080,000	3.5%
Norges Bank Investment Management	6,935,962	3.0%
Bendigo and Adelaide Bank Limited, Asset Management Arm	4,787,837	2.1%
Seligson & Co Fund Management Company Plc	4,000,000	1.7%
Dimensional Fund Advisors LP	3,979,004	1.7%
Brandes Investment Partners, L.P.	2,482,293	1.1%
Zhiwei Lin	2,258,687	1.0%
Garrett Smythe Limited	1,801,394	0.8%
Henleaze Investments Pty Ltd	1,500,000	0.6%
127 Victoria Pty Ltd	1,500,000	0.6%
Brian Ditchfield	1,330,020	0.6%
Wauchope & Kilgour Pty Ltd	1,200,000	0.5%
Dr. Kohlhase Vermögensverwaltungsgesellschaft mbH	1,098,631	0.5%
Sunrise Vineyards Pty Ltd	1,010,000	0.4%
Trevor Burke	996,423	0.4%
Zhao Hongyu	852,733	0.4%
TOTAL		**55.9%**

As at 31 December 2015 there were 232,218,382 shares on issue. The top 20 shareholders own 55.9% of AVG's total issued shares.

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