

## **A changing market: the role of a fine wine exchange**

*Exchanges have been in existence for hundreds of years, yet the concept of an exchange for fine wine is relatively new. In this article, Liv-ex Director **James Miles** examines the origin and role of exchanges, and why the fine wine exchange has played a central role in the growth of the global market.*

The human habit of exchange has been central to economic progress since the beginning of time. Formalised exchanges have existed for anything from stocks and fuels to metals and foods for hundreds of years but it was not until the formation of the Liv-ex Exchange in March 2000 that one was available to fine wine merchants.

Liv-ex (London International Vintners Exchange) is no different from any other exchange. It provides an independent meeting place where its members - bound by a common profession - can come together to find out what is happening in their market and identify opportunities for profit.

The earliest evidence of wine production dates back over 8,000 years and it is likely that people have exchanged wine for profit for just as long. Chateau Haut Brion – classified as a First Growth in 1855 – was first referenced in Samuel Pepys's diary in 1663 and is still one of the most traded wines on Liv-ex today. For a long time the market was dominated by French and British merchants, but today it is a global market with producers, merchants, investors and collectors spanning every populated continent of the world.

So why, when the fine wine market has operated for so long without an exchange, does it need one now? What value does it add? How could it help shape the market's future? This paper attempts to answer these questions by exploring the definition and role of an exchange, as well as the benefits it offers to its members and the growing worldwide marketplace now and in the years ahead.

### **The role of an exchange**

The term exchange is often misunderstood. When using the term stock exchange, metal exchange or fine wine exchange, it is easy to be drawn to the product i.e. stocks, metals or fine wine. In fact, an exchange is less about an exchange of goods and services – this is the role of its members – and much closer to its dictionary definition: "to give and receive information, ideas".

An exchange is actually an information exchange. It is a meeting place, where the members of an industry come together to find out what is happening in their market and identify opportunities for profit. It is true that many exchanges now operate marketplaces on behalf of their members (banks, brokers, metals traders or fine wine merchants), but as we will discover, this is a relatively new phenomenon.

The London Stock Exchange (LSE) is amongst the oldest exchanges still operating today and neatly illustrates the essence of an exchange. Its origins can be traced back to a coffee house called Jonathan's in the City of London in 1698. Here, like-minded stock dealers – by most accounts a pretty unruly bunch – would meet to gossip about the state of the market and transact business. Jonathan's was one amongst many similar coffee houses that spawned not just financial markets, but also many newspapers and political movements in 17th and 18th century Europe.

Since these early days, exchanges that evolved as modes of communication have become more efficient and taken a more active role in their members' trade, but this took many centuries. It was 100 years before stockbrokers formalised the coffee house structure into a membership club funded by subscription in 1801. And it was not until 1997 – another 200 years – that the LSE started to earn transaction fees by operating an electronic marketplace for banks and stock brokers. Only in 2001 (in partnership with the London Clearing House) were LSE trades settled by central counterparty and anonymised.

Maintaining trust is fundamental to the efficacy of any exchange. This makes them particularly well suited to a club structure with a membership committee to oversee procedures. The threat of being "blackballed" from the club remains a powerful means of keeping members

honest and uniting often fierce competitors behind a common cause. In the case of the LSE this ethos was formalised on its coat of arms in 1923 with the motto "Dictum Meum Pactum" (My Word is My Bond).

It is perhaps for this reason that exchanges have been most successful as trade bodies and commonly operate almost exclusively in wholesale markets; producers or consumers are rarely found amongst their members. Exchanges do not compete against their members. No shares, metals or fine wine will be found on their balance sheets. They are collaborative bodies and conduits for change.

Exchanges, in collaboration with their members, have long played a crucial role as both spokesmen for – and innovators of – improvements in price discovery, defining and standardising units of exchange, settlement, transportation, warehousing, electronic trading and messaging, derivatives and financing. All of which have underpinned the success of global commerce over the last 300 years.

### **The case for a fine wine exchange**

So why did an exchange not exist for fine wine until the year 2000? The fine wine market was a prime candidate; it was fragmented in terms of players and products, there were no standard trading rules and information sharing was poor. It is true that the courtiers in the Place de Bordeaux had performed similar functions between the Chateaux and Negoce for centuries, but it had never been attempted on a merchant-to-merchant basis and on a global scale.

This might have been down to ancient traditions - the market worked, so why fix it? Or powerful vested interests, but most likely it was down to cost. The fine wine market is tiny compared to those of the financial world and the cost of setting up an exchange was high relative to the potential benefits. As for so many other industry sectors the internet was the real game changer. It provided a ready means to dramatically reduce the cost of bringing the global market together and the ease with which participants could connect made the necessary investment financially viable.

By working closely with merchants and traders, Liv-ex established a fine wine exchange firmly rooted in the "coffee house" tradition. The vision was to provide a global network of vintners with a simple means to collaborate via access to an online electronic trading and information marketplace. In so doing the founders hoped that they might make trading fine wine more transparent, efficient and safe for the benefit of merchants and merchants' customers.

### **The Liv-ex Exchange**

The Liv-ex Exchange was launched in March 2000 and today has 440 members in 35 countries spread across six continents. They use Liv-ex's internet trading platform to check prices, spot opportunities and match and settle trades. Members enjoy the considerable convenience and economy of transactions by pooling the world's fine wine traders in one place, allowing them to better serve both their customers and the producers they represent.

Liv-ex guards its independence jealously. Its membership committee vets new members, sets rules and polices disputes. It has created a standard industry contract – the Standard In-Bond Contract – to codify the condition, tax status, and payment and delivery terms of transactions on its exchange. As in other markets this contract has simplified the terms of trade, avoiding the expense and uncertainty of negotiating each bargain anew. Trading is fully automated and secure and the prices at which wines are actually traded are transparent. Its indices and data services inform trading decisions and provide benchmarks to price changes. All trades are anonymous and Liv-ex operates as central counter party between buyers and sellers on its platform.

Liv-ex actively promotes price transparency; a critical success factor for any market exchange. Transparency is widely acknowledged to stimulate a powerful virtuous circle of increased confidence, participation and volumes. Some fear it compresses margin but experience in other markets suggests that any loss in this respect is more than compensated for by increased turnover. Transparency reduces uncertainty, keeps market participants better informed and attracts new entrants, increasing the size of the market from which everyone benefits.

## **A changing market place**

So what benefits has the fine wine market seen? There is no doubt the effect of price transparency, trading efficiency and security have been beneficial for the fine wine trade. Standard contracts, for example, have added rigour and certainty to the process of buying and selling wine and improved the process of price discovery. Transactions completed under contracts can be directly compared with each other, providing more accurate insights into what is actually going on, making it easier to identify opportunities to collect and profit.

This has certainly played a part in confirming what merchants and collectors have understood for centuries. Fine wine is an important store of value and its unique characteristics make it appealing, not just for pleasure, but also as an investment. In the last decade prices and volumes have (even after recent falls) increased many times. Today the fine wine market is estimated to be worth about \$4bn, a number that seems certain to grow in the years ahead, helped by the newly rich in emerging markets developing a passion for the product and coming to understand its appeal as an alternative investment.

As we look forward the role and values of the Liv-ex exchange will remain firmly rooted in coffee house tradition as pioneered by the London Stock Exchange and others. It will continue to seek to remove barriers to trade, such as opacity, inefficiency and risk by designing and applying new standards and innovations in collaboration with its members. This is a well proven formula in other industries.

Examples of new innovations include LWIN – a universal product identifier – which will facilitate a system of messaging over the internet allowing the trade to share information with each other electronically. Liv-ex has also introduced a unique identity number (UID) that allows merchants (and their customers) to track wine through the supply chain at the individual case level, something that has always been difficult in the wine trade. These and similar initiatives have the potential to drive down costs and speed up cycle time, which will be helpful as margins come under pressure in these challenging times.

## **Conclusion**

So why is a fine wine exchange needed now? What value does it add? How will it shape the market's future?

An exchange is an important addition to the long established fine wine market. It brings together a fragmented, changing and increasingly globally dispersed marketplace. Its standards define the terms of trade and unite competitors behind a common cause. It is made possible by the internet that has created a gap in the market for a trade-to-trade fine wine exchange in the coffee house tradition.

For an ancient market with supposedly old-fashioned mores, fine wine traders have proved increasingly receptive to the transparency, convenience and economy that an electronic exchange brings. There is a growing recognition that it enables them to better serve both their customers and the producers they represent.

Rapid changes in technology will continue to bring efficiencies and revenue opportunities to the fine wine industry. Until recently such innovations could only be afforded by much larger industries, like food stuffs, energy, metals and financial services. Liv-ex expects, in collaboration with its members and other market participants, to be an important conduit for change. It believes it will succeed if its members succeed. As principally a data and technology business, the exchange will continue to introduce new innovations and standards that remove barriers to trading and make the industry more transparent, efficient and safe for the benefit of everyone with an interest in fine wine.