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Silicon Valley Bank



State of the Wine Industry 2017

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Introduction

No Lifeguard on Duty. Swim at Your Own Risk.



“There’s blood in the water!”

That ominous phrase strikes fear in swimmers throughout the world. But in business, it means a market opportunity exposed by a changing tide. That blood in the water could be a buyer’s market flooded with predatory bargain hunters scheming to feast on the carcasses of the weak. Or it could be a seller’s market bursting with schooling challengers, each vying for a few highly desirable assets. In either case, the ensuing feeding frenzy leads to either exalt or demise for participants.

We lead this year’s report with a reminder that while market conditions appear strong in places, some market components are weakening and dangerous, and still others are overheating as currents of change gain momentum. Once again, “average” is not a useful term when describing the wine business. You need to look below the surface because what you see on top belies risks that lurk in the depths.

In 1975, the U.S. wine business was still considered a backwater — quiet but soon to make some big waves. It was the year before the historic Judgment of Paris¹ that opened the eyes of the world to premium California wines. News of that seminal event caused ripples through all producing regions, rearranging the worldview of fine wine² and setting the stage for unabated growth in premium U.S. sales for decades to follow. 1975 was also the year the blockbuster³ movie “Jaws” was released.⁴

Starring Roy Scheider, Robert Shaw and Richard Dreyfuss, the film was about the small vacation island of Amity that seemingly had everything: clear skies, gentle surf and warm water. People flocked there every summer, making it the perfect feeding ground for a marauding great white shark.

With a little creative license, we are using the movie “Jaws” as a metaphor to describe the ups, downs and hidden threats in the U.S. wine business. You might ask, why would a serious business report use a popular movie as a metaphor? It’s something we do for fun to make a long business report more readable. By reading, we hope you catch a few ideas and avoid unforeseen business risk. If there is blood in the water, we don’t want it to be yours!

We invite you now to make ready and cast off as we present Silicon Valley Bank’s annual review and discussion of and predictions for the U.S. wine business in 2017. ■



1

Tom Cassidy: What's your name again?

Christine "Chrissie" Watkins: Chrissie.

Tom Cassidy: Where are we going?

Christine "Chrissie" Watkins: Swimming!

Our Predictions in Review

Chrissie opened the movie running toward the moonlit surf, peeling off her clothes while coaxing her inebriated new male friend to follow. Clearly not her first encounter with that section of ocean, she seemed expert in her subject matter and confidently predicted to her acquaintance that the water would be fine.

Sadly, Chrissie's ocean forecast missed vital analytic components and had undesired consequences when the shark, rising up from the depths, struck her with such force that she appeared to be an oceangoing ragdoll stuck inside a big Waring blender. Obviously, the prediction about the water being fine is one she would have liked to rethink.

We have been researching the wine business since 1991 and making predictions for more than a decade. Some years, we properly characterize a market change and coax others into the deep end. In other years, we issue beach warnings and caution market participants about looming risks. On rare occasions, our findings might be off in timing or even wrong,⁵ but we always review the forecasts made the prior year just to make sure that no one ended up being fish bait. In particular, this year a key assumption we got wrong set up a broader discussion of the market. Here is what we said in last year's report.

Wine-Specific Predictions

- ▶ We forecasted a sales growth range of 9 to 13 percent for the premium wine segment in 2016, down from 14 to 18 percent in 2015.
- ▶ Growing local regulations around tourism would continue to damage opportunities for small wineries to sell direct.

- ▶ With the transactions we saw in the queue, we said we would start the year with some large and notable sales of premium vineyards and wineries. Mergers and acquisitions (M&A) would remain active throughout the year.
- ▶ Tens of thousands of additional grape acres would be permanently removed from California's Central Valley.
- ▶ A strong and strengthening U.S. dollar, available foreign supply and willing millennials would encourage imports at all premium price levels.
- ▶ Growing market share of bottled imports should be a heightened concern of U.S. producers.
- ▶ The narrowing supply of arable land suitable for higher-end wine production would drive vineyard prices upward.
- ▶ Oregon and Washington would continue to see high interest for vineyard acquisition for premium and luxury wine production.
- ▶ We expected to see bottle prices rise by 4 to 8 percent above the \$10 price point and both volume and price to drop below the \$8 bottle price. →

Our Predictions in Review

continued

Supply

- ▶ Our guess for total harvest in California in 2016 was 3.6 million tons crushed, which would have been about 8 percent lower than the 3.9 million tons crushed in 2014.
- ▶ We said worldwide supply was beginning to creep up into uncomfortably familiar territory, particularly in the European Union. Area under vine was increasing, while world and EU per capita consumption was decreasing.
- ▶ We said quality was excellent, but some area-specific challenges would be noted from set issues in the spring. Harvest was early everywhere. The crop size was average in the San Joaquin Valley and light elsewhere.
- ▶ We noted that Oregon's harvest was early, huge and another consecutive "Vintage of the Decade."
- ▶ Our early read on Washington's harvest suggested that it would be similar to Oregon's in timing and quality but more of a normal yield.

Demand

- ▶ Per capita consumption of wine (case volume divided by population growth) in the United States would temporarily reverse trend as millennials, who consume more craft spirits and beer, began replacing retiring baby boomers, given the larger consumer focus placed on premium vs. generic sales overall.
- ▶ We said that millennials were beginning to affect the lower price range of premium sales. They were most visible in the \$8 to \$14 red blend category but would trend higher as their incomes allow.
- ▶ We noted that millennials are more open to world wines compared with baby boomers at the same time in their palate evolution.

- ▶ We noted that growth in restaurant wine sales fell dramatically in 2015 across all premium price points. We expected that to stabilize in 2016.
- ▶ We said the Gen X cohort would surpass the baby boomers around 2021 to become the largest fine wine consumer demographic in the United States. We also said that a short five years later, by 2026, millennials would surpass Gen Xers to become the largest fine wine-consuming cohort.
- ▶ The young consumer was giving blends a chance and, from our view, taking a page from the mature cohort, who placed their trust in brand vs. varietal. That has implications for producers that have leaned on varietal labeling to develop a brand identity.
- ▶ We noted that the lowest-price generic segment that appealed to entry-level consumers of the 1960s had permanently lost its appeal. According to wine brokers with whom we've spoken, producing countries are showing no interest in that segment today.
- ▶ We would see decline and stagnation in wine sold by volume, as the premiumization trend persisted and wine by volume continued to lose favor. The \$3 to \$6 segment appears most at risk. →

Producing countries are showing no interest in the generic wine segment.



Shark fishing has a certain risk attached to it, as does forecasting future business conditions. Sometimes all the correct preparation still results in missing the desired target and pulling up an old boot. This past year, we reeled in virtually all of our forecasts, but there was one big one that got away.

What we got wrong ...

Per capita consumption of wine in the United States would temporarily reverse trend as millennials, who consume more craft spirits and beer, began replacing retiring baby boomers, given the larger consumer focus placed on premium vs. generic sales overall.

and here is why ...

Nielsen scan data through November 2016 show that total wine case growth was up 1.96 percent, while estimates from the World Bank show that the 2016 U.S. population will end the year larger by 0.82 percent. With cased volume growth exceeding population growth by about 1 percent, total per capita wine consumption was actually slightly higher year over year in 2016, and we have to call that a missed prediction.⁶

What we got close ...

A strong and strengthening U.S. dollar, available foreign supply and willing millennials would encourage imports at all premium price levels.

and here is why ...

The dollar did indeed strengthen, but domestic sales gained slightly over foreign market share by 0.5 percent. In the import category, France in particular has had a very strong year due to rosé exports.

Our guess for total harvest in California in 2016 was 3.6 million tons crushed.

Close guess, but the final number came in at 3.7 million tons.⁷

What we got right ...

We forecasted a sales growth range of 9 to 13 percent for the premium wine segment in 2016.

and here is why ...

We expect final sales growth figures to come in at about 10 percent for 2016 when the final numbers are calculated. SVB Peer Group Database information shows year-to-date sales growth through September of 9.9 percent. Respondents to the SVB State of the Industry Survey expect year-end sales growth of 11.9 percent.⁸

30k

grape acres will be removed in California's Central Valley by 2018.

What we got right ... *continued*

Growing local regulations around tourism would continue to damage opportunities for small wineries to sell direct.

We would start the year with some large and notable sales of premium vineyards and wineries. M&A would remain active throughout the year.

Tens of thousands of additional grape acres would be permanently removed from California's Central Valley.

We expected to see bottle prices rise by 4 to 8 percent above the \$10 price point and both volume and price to drop below the \$8 bottle price.

Growth in restaurant wine sales fell dramatically in 2015 across all premium price points. We expected that to stabilize in 2016.

and here is why ...

This was particularly true in Santa Barbara, Sonoma and Napa counties, with Santa Barbara County demonstrating the most restrictive and damaging regulatory climate (e.g., except for some grandfathered wineries, tasting at a winery is essentially not allowed in Santa Barbara).

That trend was quite accurate and remains part of the industry fabric in 2017.

This was accurate and still needed for balance in supply. Current estimates suggest that 30,000 acres will be removed by 2018.⁹

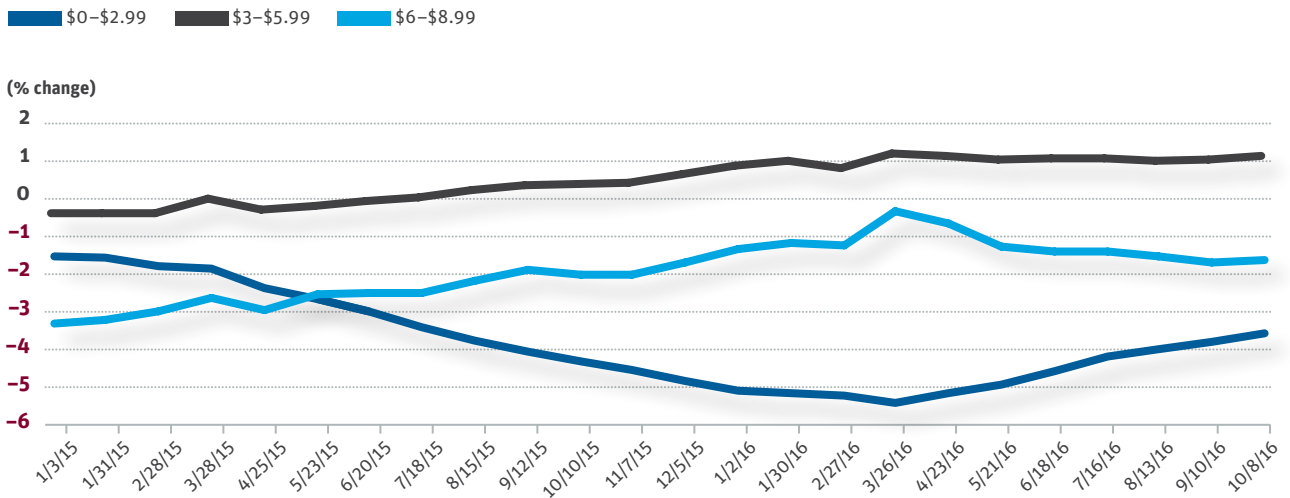
According to Nielsen, below \$8.99 sales did drop in dollars and volume; above \$8.99 sales growth was 8.8 percent through the period ended October 8, 2016.

By all measures, this appears accurate, though "stabilizing" off a precipitous decline is not positive for restaurant wine sales. Total restaurant wine sales and traffic are still trending lower.

Steaming out of the harbor toward 2017 predictions, we first have to tip our hat to the great work done by the large wine companies to market and sell in a difficult price segment. I am reminded that there is more than one way to skin a catfish.

Figure 1
Changes in Cased Sales of Wines Below \$9

Source: Nielsen



While I would love to be right about all the observations and forecasts, I will take being mostly right in this case.

The interesting miss for me was the lower per capita call, which is instructive because it shows how the macro trends I forecasted can be overridden by good marketing.


Given the trends at the time for the volume drops in the below \$9 group, we predicted that 2016 would be the first year since 1994 that we would see declining per capita consumption (see figure 1). The overall per capita growth rate in 2015 was near zero, and there was nothing to suggest that it would change, but an interesting event took place in the middle of 2015: The growth rate in the \$3 to

\$5.99 price segment, which represents 44 percent of total volume, turned decidedly positive in July.

Fishing for clues, we discovered that the reversal in trend was due to the popularity and marketing of the 3-liter box and Tetra Pak format wines from Constellation, Delicato and Gallo. Without the large formats, the category would have remained negative in growth, but that did spur added volume sales.¹⁰

Steaming out of the harbor toward 2017 predictions, we first have to tip our hat to the great work done by the large wine companies to market and sell in a difficult price segment. I am reminded that there is more than one way to skin a catfish. ■

2



Ellen Brody: What am I going to tell the kids?

Brody: Tell them I'm going fishing.

2017 Summary Forecast

For longer than I want to admit, we've researched the wine business, and we have been making our observations and forecasts public for more than a decade now. In 2017, we expect improving business conditions with some notable sinkholes, such as a worsening regulatory environment, interest rates that have been increasing of late and poor markets for generic wine. Otherwise, the forecast is for sunny and mild business conditions — ideal for a deep-sea fishing trip.

Wine Business Predictions and Observations

- ▶ We predict a sales growth range of 10 to 14 percent for the premium wine segment in 2017, up from 9 to 13 percent in 2016. The confluence of better retail conditions in the economy, strong consumer demand and good supply will collide to deliver improving industry performance.
- ▶ For the industry as whole, we believe that dollar sales will rise by 4 to 6 percent while volumes will increase 2 to 3 percent. The growth will be exclusively in premium wine, with volume and price drops below the \$9 bottle price segment.
- ▶ With the new federal administration's agenda for the first 100 days possibly including deportation, we believe that farm labor supply and costs will be a more dominant concern in both headlines and conferences in 2017.
- ▶ Even with M&A facing greater headwinds from interest rates that have trended higher, we expect acquisitions to remain quite active through 2017.

- ▶ A strong and strengthening U.S. dollar, available foreign supply, foreign in-country marketing support and willing millennials will encourage import growth in lower premium price points.
- ▶ Federal, state and local regulations will continue to garner headlines in the trade press in 2017.

Pricing

With the median baby boomer rolling toward retirement while retaining wealth and the cash-strapped millennials growing in purchase influence:

- ▶ Under \$9 bottled wines will continue to struggle. Price drops for glass format wines are to be expected.
- ▶ Wines sold between \$12 and \$25 will grow in demand, and limited price increases will be available.
- ▶ Wines sold between \$35 and \$75 will find price increases difficult without the U.S. economy demonstrating improved performance.
- ▶ High-end luxury wines *with an established brand* will have no problem retaining volume levels and taking small price increases. →

2017 Summary Forecast

continued

Supply

- ▶ Our guess for total harvest in California for 2017 is 3.95 million tons crushed, which is about 7 percent higher than the 3.7 million tons crushed in 2016.
 - ▶ Quality was excellent in 2016, and the harvest size was average but heavier than the 2015 light harvest. Crop size in 2016 was slightly below average in the San Joaquin Valley, but that is a good thing given demand weakness for generics.
 - ▶ Oregon, Washington and the Okanagan Valley in British Columbia take the “Vintage of the Decade” honors, with all three regions reporting concurrent strong quality and yields.
 - ▶ Overall supply is balanced with shortages of high-quality pinot noir and cabernet, but excesses are evident in certain non-core varieties and for grapes destined for lower-priced wine.
 - ▶ The narrowing supply of arable land suitable for higher-end wine production combined with good buyer interest will drive vineyard prices higher in premium regions.
 - ▶ Oregon and Washington vineyards will continue to see high interest from larger wine companies.
 - ▶ California’s Central Valley has some additional acreage to remove.
- ▶ Today millennials are beginning to affect the lower price range of premium sales. Their presence is most visible in the \$8 to \$11.99 red blend category, but they will gradually move away from blends and into varietal wines or imports as their incomes improve.
 - ▶ Growth in restaurant wine sales stabilized somewhat in 2016 but still dropped once again across virtually all premium price points. The exception is premium red and red blends, which demonstrated positive sales growth last year. Restaurant wine sales should show no to limited growth in 2017, which is an improvement over recent declining sales.
 - ▶ The Gen X cohort will surpass the baby boomers around 2021 to become the largest fine wine consumer demographic in the United States. Five years later, by 2026, millennials will surpass Gen Xers to become the largest fine wine-consuming cohort.
 - ▶ The young consumer is giving blends a chance and, from our view, is taking a page from the matures, who placed their trust in brand vs. varietal wine throughout their beverage-consuming years. If premium blends and branding are done well, that approach reduces the confusion for entry-level wine consumers. If new consumers are content with brands over varieties, the observation has massive implications for producers that have leaned on the fighting varietal¹¹ to develop their brand identity.
 - ▶ The lowest-price generic segment that appealed to the entry-level consumers of the 1960s has permanently lost its appeal. According to wine brokers with whom we’ve spoken, producing countries are showing no interest in that segment today.
 - ▶ Gen Xers and millennials will remain the growth demographics for premium wine. While baby boomers will retain their dominance in wine consumption, their overall purchases will continue to decline. ■

Demand

- ▶ Per capita consumption faces crosscurrents with retiring wine-loyal baby boomers being replaced by less affluent millennials, who are ambivalent about their alcoholic beverage of choice. If economic conditions continue to improve in 2017, we will offset those currents, leading to slightly higher per capita consumption for another year.

The Gen X cohort will surpass the baby boomers around 2021 to become the largest fine wine consumer demographic in the United States.

3



Ellen Brody: Martin hates boats. Martin hates water. Martin ... Martin sits in his car when we go on the ferry to the mainland. I guess it's a childhood thing. It's a ... there's a clinical name for it, isn't there?

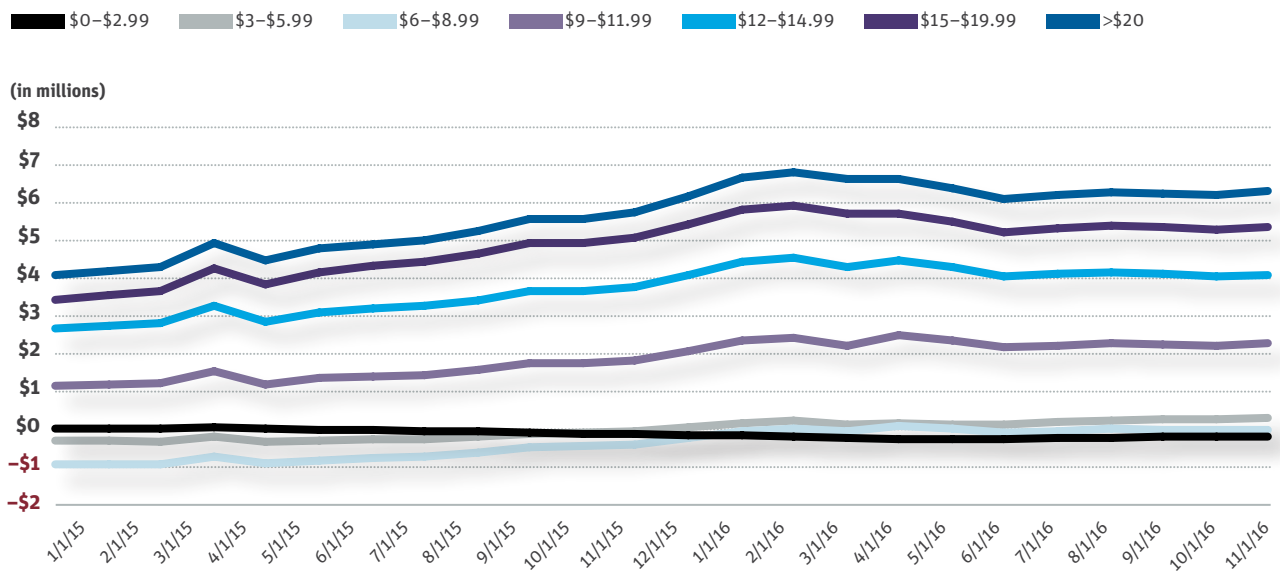
Brody: Drowning.

Premiumization and Restaurant Sales

What's the clinical name for being afraid of the water? Drowning! Sometimes business is simple, and if it were a shark, it would have bitten you!

Figure 2
Wine Sales Growth by Price Segment

Source: Nielsen



Sometimes it's easy to see trends when reality stares you in the face like the steel gray eyes of a shark. Other times business trends aren't what they appear to be, and that shark you saw swimming at you from the shadows was just seaweed. In the case of premiumization, it's the former. It's now a very clear business trend and an obvious driver of consumer demand.¹²

Premium wine dominates sales today and is responsible for nearly all the growth in the trade (see figure 2). Looking back, the only time in recent memory we have seen trading down as a trend was during the Great Recession, but in reflection things weren't what they seemed.

During the financial crisis, wine conference discussions centered around the direction of spending. Consumers who were hit by the financial collapse didn't give up their wine; they just switched to less expensive wines. But in a market-driven paradox, many of the less expensive wines that sold during the recession were actually the more expensive fine wines from producers who had to discount them to move product. It didn't give lower-cost producers a true advantage, so the argument can be made that the consumer has never traded down. →

Premiumization and Restaurant Sales

continued

Even if we acknowledge the single trading-down data point during the recession as being true, there's no way to create a business from it. A model based on the hope of recession is clearly on rocky ground, a fact to which our growers in the Central Valley can attest firsthand.

That said, an interesting change has taken place in the nonpremium segment below \$9. In the past year, the segment has slowed the rate of decline in both dollars and case volume, going against the other trends (see figure 1, page 9). While still negative in sales volumes, the below \$3 price point bottomed in March 2016 and then started trending upward, and the \$6 to \$8.99 price point also ended the year on higher ground.

The growth came from Constellation, Delicato and Gallo, who used their distribution muscle to push \$18-plus 3-liter boxes and Tetra Pak formats. Therefore, the trend is a bit of a mirage because better juice is being sold more efficiently in larger containers. Because the price segment represents such a large component of volume sales (44 percent), it was noteworthy to see the growth, but the trend should not be seen as a reversal in premiumization.

For the majority of the San Joaquin Valley farmers, that last point isn't comforting because it's hard for the average grower there to make money below \$5.99 a bottle, but it's nonetheless encouraging to see a lower-priced sweet spot for value-conscious consumers.

Restaurant Wine Sales

Quint in his colorful way was really singing about the way things were — the good old days when a drink was a buck and a cup of coffee was 10 cents. We can also see his rhyme as a metaphor for restaurant wine sales, which in the good old days were a healthy part of a fine wine producer's revenue expectations but over the past decade have dropped precipitously: Here lies the corpse of restaurant sales, sunk to the bottom like bricks. For decades they were important, but now they've been deep-sixed.¹³

At the individual producer level, restaurant wine sales have been declining for a decade, with the trend accelerating of late (see figure 3). Restaurants themselves have been suffering from declining same-store sales for some time.

Technomic's growth forecast for wine sold in restaurants for 2016¹⁴ was just 2 percent, but given recent downward revisions in 2016 foot traffic and same-store sales expectations, that number should decline somewhat when full-year results are reported.

Separate confidential measures to which we are privy support the Technomic full-year estimate. These reports show that restaurant wine sales are growing less than 1 percent in dollars and are shrinking 2 percent by volume.



Quint: Here lies the body of Mary Lee; died at the age of a hundred and three. For fifteen years she kept her virginity; not a bad record for this vicinity.

Figure 3
Decline in Restaurant Sales Share

Source: SVB Annual Wine Conditions Survey

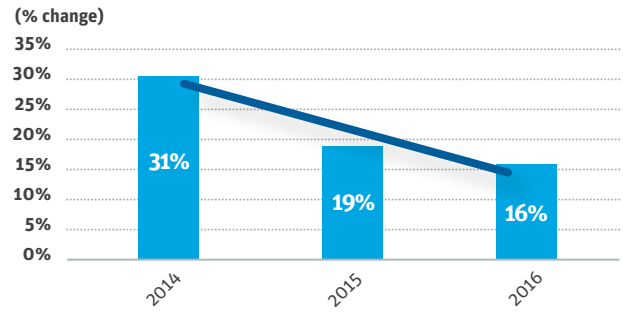
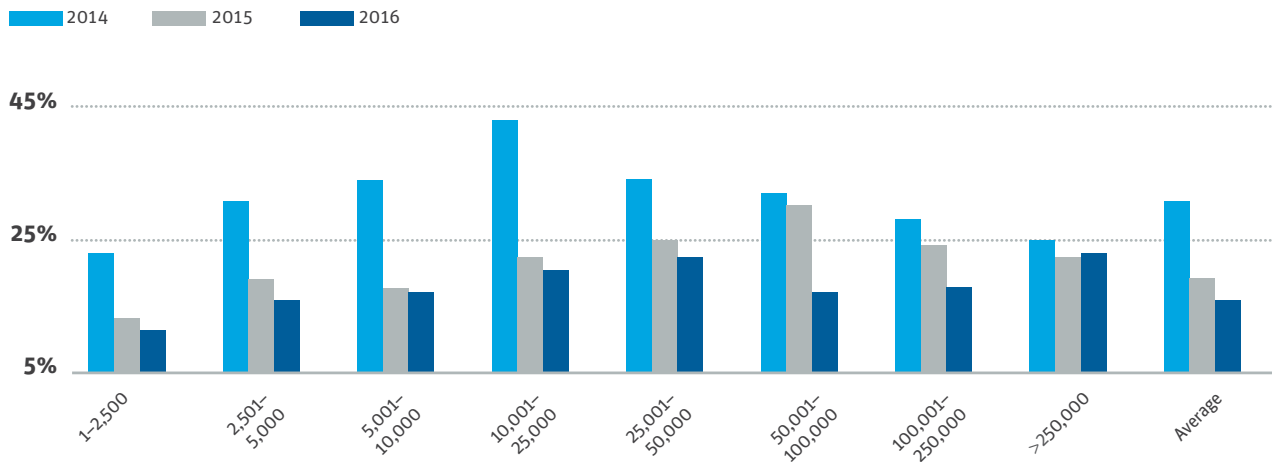


Figure 4
Annual Change in Restaurant Sales by Production Size (in Cases Produced)

Source: SVB Annual Wine Conditions Survey



With all other sales trending lower in volume, the only restaurant category with positive growth is the group of red varietals and blends above \$25. That segment is up about 1 percent.

On a dollar-weighted basis, the news is slightly better, with total U.S. restaurant wine sales flat for the year. The only growth category again is in the segment of red varietals and blends above \$25, with a 12-month growth rate of 1.8 percent. Those same tides of flat volumes but higher dollar sales are also reflected in retail sales as a whole, so the trend of lower volume and higher dollar sales isn't a surprise. The extent to which sales of wine in restaurants have fallen makes one wish for the good old days.

In our survey work, we ask wineries to give us relative weightings of their overall sales channels. With that information, we are able to track relative movement in sales to restaurants from year to year (see figure 4). From those findings, we can see that all wineries have trended lower in restaurant sales over the past three years. Only the wine segment of larger than 250,000 cases showed a year-over-year improvement in restaurant

sales. That segment has better access to distribution and so will rise and fall with general drinking and visitation trends in restaurants, whereas the small wine producer is being shut out of restaurant wine sales entirely.

Why are restaurant sales showing poor performance? Without the ability to attract distribution, the small producer has limited restaurant access. Every day, restaurant lists are becoming increasingly captive to large producers with access to distribution. Big restaurant chains are served by big wholesalers, who in turn get their wine from big wineries. Nevertheless, there are other, more permanent changes taking place that indicate consumer preferences also are at play.

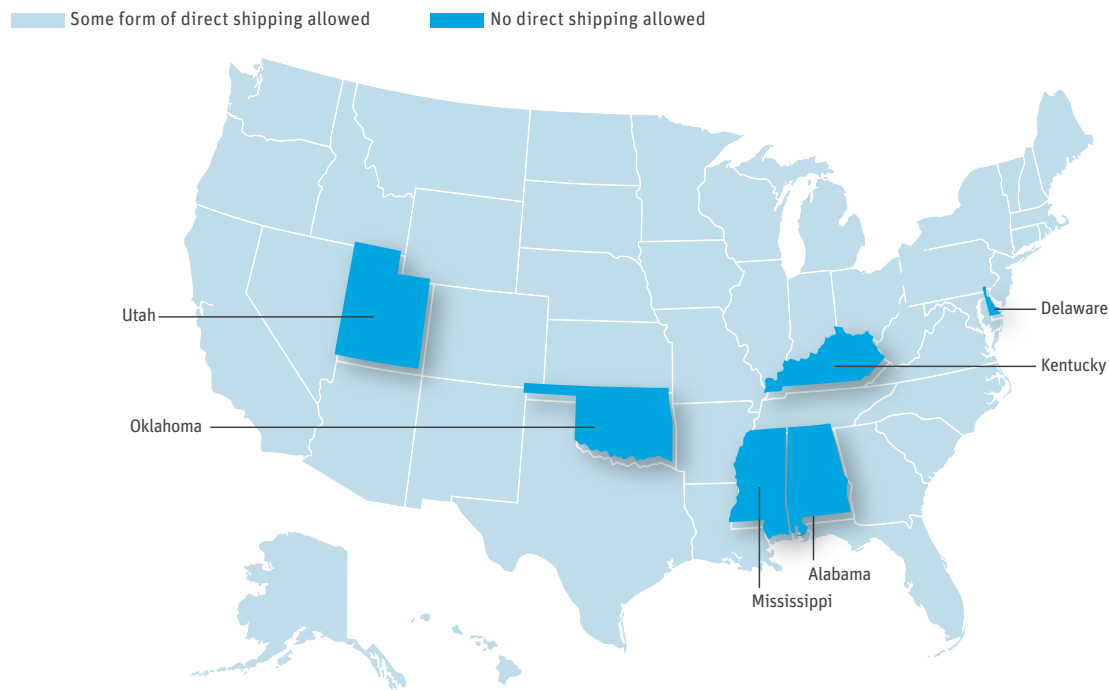
Our frugal millennial consumers don't want to pay restaurant wine markups. They know they can buy a bottle of wine at the store for less, so in the restaurant they are more likely to satisfy their consumption needs by starting with a beer or cocktail and having a glass of wine with dinner.¹⁵ More baby boomers are retiring and living on fixed incomes, and that influences their restaurant beverage choices, as well. →

Premiumization and Restaurant Sales

continued

Figure 5
Small-Winery Sales Channel Evolution

Source: ShipCompliant



With many economists expecting overall inflation to move higher in 2017, Technomic has cut its growth forecast for the restaurant industry as a whole to a real rate of growth of just 0.8 percent.¹⁶ The good news for the fine wine business is that the white tablecloth segment of restaurant sales is expected to see the highest growth. That's where high-income consumers and improving business development spending enhance the prospects for better wine sales. Given structural dynamics, restaurants are not a good source of growth for small wineries in 2017.

Small Winery Sales Channel Evolution

The wine business is mostly composed of family-run wineries, but there was a time when that was put in doubt because direct sales weren't viable nationwide and distributors weren't interested in representing the growing numbers of small family wineries.

In 1996, wineries could ship to only 13 reciprocal states and an additional 17 "personal use" states, many of which restricted consumers to less than a quart of wine annually.¹⁷ Direct-to-consumer sales were estimated by some to total less than \$100 million per year.¹⁸ There

Figure 7
Growth in Direct Sales Share

Source: SVB Annual Wine Conditions Survey

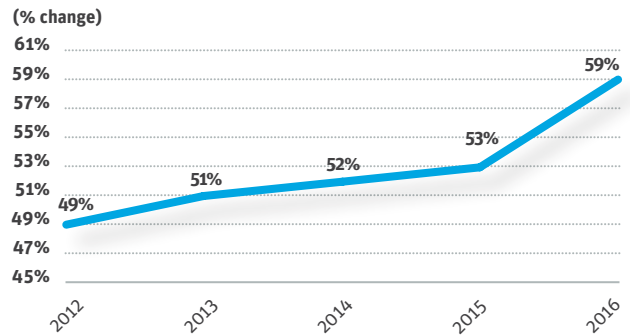
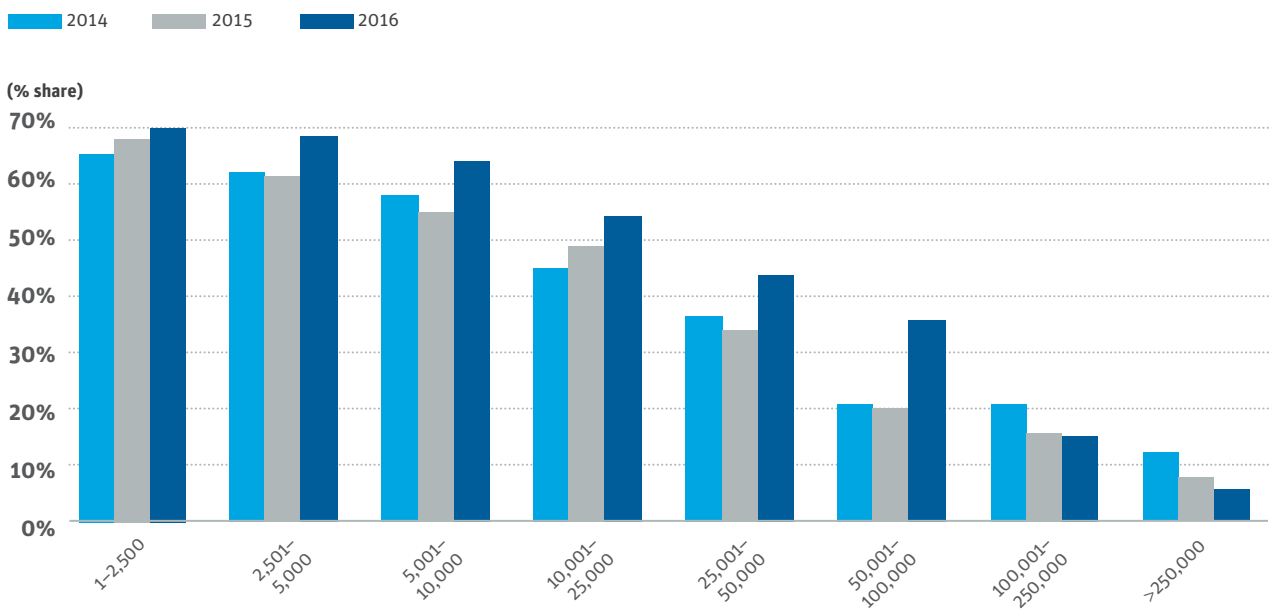


Figure 6
Direct Sales Share vs. Producer Size (in Production Size)

Source: SVB Annual Wine Conditions Survey



were far more closed states, where consumers could not purchase wine directly, compared with states where shipping was legal. Underscoring the absurdity, more states allowed people to carry concealed weapons than to buy wine directly from the producer. At that time, wineries depended on wholesalers, and direct purchases from the tasting room or wine club represented less than 20 percent of total sales.

The industry dodged a bullet with the favorable Granholm decision in 2005.¹⁹ That ruling knocked the legs out from protectionist state laws that favored in-state wine producers. The timing couldn't have been better because wholesalers had moved away from the small winery en

masse in 2001 as the wholesaler client base evolved from small chains and unit retailers into nationwide big box retailers. Without the three-tier system willing to move wine, the small producer was in a bind, but that all changed with Granholm vs. Heald.

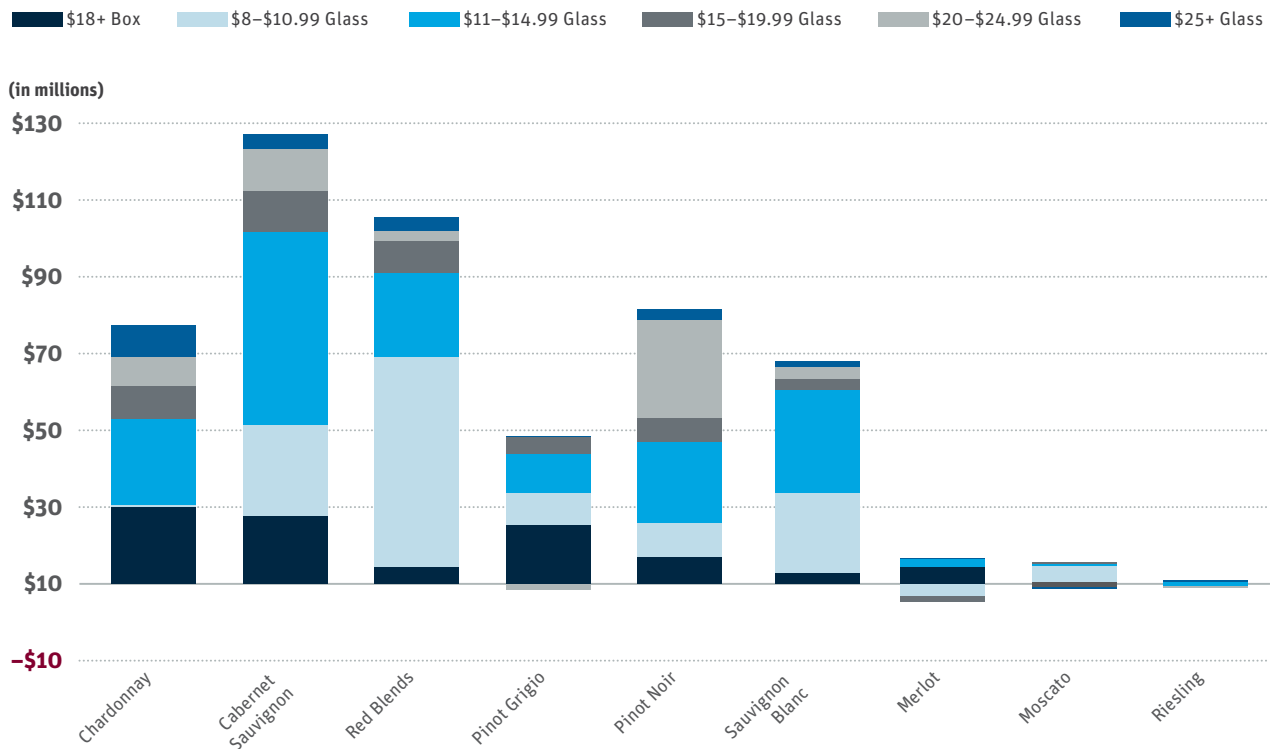
The smaller producers would have been put out of business long ago without the subsequent evolution of direct shipping, and when we say “small” in this context we are talking about wineries with less than 100,000 in case sales (see figure 5). Large wineries don't need direct sales and so, not surprisingly, the percentage of direct sales for the larger companies is dropping and nearly insignificant (see figure 6). →

Premiumization and Restaurant Sales

continued

Figure 8
Varietal Growth in Premium Wine Categories

Source: IRI data 52 weeks through 10/31/16



Direct-to-consumer sales are now a large and critical part of a family winery’s revenue base (see figure 7, page 19). While state laws vary — and some permitted state laws can only be described as arcane if not stealth protectionism — at this point wineries cannot legally ship to Alabama, Delaware, Kentucky, Mississippi, Oklahoma and Utah, with Utah and Kentucky retaining felony anti-shipping laws.

Varietal Segment Growth

Value is defined as *price divided by quality*, and it is a dominating component for consumer purchase decisions. When it comes to fine wine, I believe it’s really *price plus experience divided by quality* that defines value, but

there is no question that consumers buy everything with value in mind. For that reason, understanding the evolving industry trends in price segments and varieties is another key to unlocking the real drivers of industry growth.

We can look at growth from two angles: price segment and varietal category. With respect to price segment, reds are dominating premium wine growth at this point. Cabernet, red blends and pinot noir are the top three growth varieties (see figure 8). The \$11 to \$14.99 price point is the strongest consumer price segment today in the U.S., with chardonnay, cabernet, red blends, sauvignon blanc and pinot noir all doing well. ■



Understanding the evolving industry trends in price segments and varietals is another key to unlocking the real drivers of industry growth.

4

Hooper: Ah. Just like I thought ... He came up with the Gulf Stream – from southern waters. *[He pulls a Louisiana license plate from the shark. Brody examines it.]*

Brody: He didn't eat a car, did he?

Hooper: Naw, a tiger shark's like a garbage can, it'll eat anything. Someone probably threw that in a river.

Varietal Demand

Hooper wasn't so sure the shark he was examining was the same variety they were hunting. He understood what various species consumed and their dining preferences. The license plate was a good clue that he wasn't looking at a shark that liked cold water. He probably would have been a good wine business analyst ... if only he were more handsome.

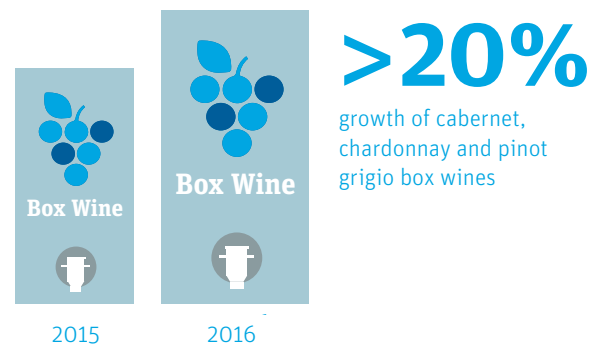
Knowing what consumers are drinking is a key in planning. Reviewing emerging trends gives clues that can be important when examining strategies, for not only the big wineries but the smaller family-run wineries as well. And this year, the trends are continuing their defining move to fewer varietals and more blends.

While cabernet is still the king of varietal growth in the \$11 to \$14.99 price range, red blends come in second and are the current darling of discussion in the business. The reason is obvious from the large producer's perspective.

The category allows the large wine companies that dominate production enormous freedom in the substitution of varietal and place of origin, yet they are still able to maintain overall quality and margin. There may be wide bottle-to-bottle variation, but for the price, quality is there. It's really the jug wine craze of the 1960s on steroids. Emerging consumers are acquiescing to branding from the large wine companies because it makes their purchase easier to understand. It replaces varietal and vintage comparisons with something simple and catchy like Sexy Wine Bomb, The Prisoner, Vicious Red Blend, SLO Down Sexual Chocolate, or Cupcake Red Velvet.²⁰

While the \$11 to \$14.99 segment is the strongest overall in growth, the hottest spot for price and varietal taken together is in red blends in the lower \$8 to \$10.99 space. Technomic data suggest that growth in the lower price tier is driven by frugal-minded millennials.

From a packaging perspective, 3-liter premium box wine and Tetra Pak formats have continued to grow, with cabernet, chardonnay and pinot grigio each posting more than 20 percent growth. Merlot, syrah and moscato have struggled — the result of overplanting the “next hot varietal,” which always results in wines with no consistent characteristic in the bottle. Sadly for me, even zinfandel has dropped below riesling as a growth varietal and is falling out of favor with consumers in general. →



Varietal Demand

continued

Who is driving the growth in these categories? Our own research suggests that the two growth cohorts are the millennials and Gen Xers. While it's just supposition at this point, we expect the retiring baby boomers to have an impact on growing the lower premium price segments compared with the higher price segments they previously occupied. But there is no question: We are seeing a sea change in premium wine. The young consumer is giving blends a chance, and from our view their palate maturation looks like a sequel to the baby boomers' entrance to wine, which started with Bartles & Jaymes²¹ and then moved to white zinfandel and chardonnay before settling on merlot.


The millennial, in the same way, experienced the short moscato boom promoted by recognizable hip-hop stars such as Kanye West and Lil' Kim.²² While premium moscato still exists (see figure 8, page 20), like the post-wine cooler baby boomer, the post-moscato millennial is evolving to favor more-complex albeit lower-priced red blends and box wine. Where they move next is anyone's guess, but I suspect we will see growth in cabernet and foreign wines in the short term. Longer term, we should see some varietal, country or domestic region emerge from the blend fog to forge a new relationship with emerging U.S. consumers.

Supplying Segment Growth

I always cringe when I attend conferences with the topic "The Next Hot Varietal." Whenever growers follow a trend, it is seemingly already over right at the time the plants are producing (Muscat of Alexandria) or the varietal ends up being ruined by overplanting (merlot and syrah). Some suggest that merlot was hurt by the 2004 movie "Sideways," but that was more helpful for pinot noir than it was a drag on merlot sales. That conclusion is supported by past research.²³

From our vantage point, a decade or longer after their planting booms neither merlot nor syrah gained a consistent and identifiable character profile with the consumer, leaving the door open for popular growth in other red wines. While it's not something that is clearly identified in literature, observation tells us that many of the red blends being produced now include significant, if not dominant, quantities of merlot and syrah.

Large wine producers participated in the moscato boom-and-bust and are active in the lower-priced varietals and red blend craze too. But what happens when more of the matures leave the consuming market and the baby boomers move down the premium price ladder and collide with millennials, who also want wines that are more distinctive and consistent and that have a greater sense of place than a red blend? This leads to the next question: *Can the large wine companies produce consistent and remarkable wines in mass quantities to meet the premium consumer demand of tomorrow?* The answer leads us to a discussion about real estate and trends. ■

A close-up photograph of a person's hands holding a bunch of dark blue grapes. The person is wearing a dark, textured sweater. The background is a blurred vineyard with autumn-colored leaves, including a prominent yellow leaf in the upper right. The lighting is soft and natural, highlighting the texture of the grapes and the person's hands.

Can the large wine companies produce consistent and remarkable wines in mass quantities to meet the premium consumer demand of tomorrow?

5



Quint: Hooper, ya idiot. Starboard.
Ain't you watchin' it?

Harvest Yield and Quality

The wine business is still agriculture. Port, starboard, bow, stern — you need to understand the change in direction of vineyards because it will influence pricing and competitiveness for juice and grapes. If you are looking port when you should have been watching starboard, you'll miss an opportunity or, worse, get eaten alive!

Drought should get headlines in California's Central Valley, where the lack of effective water policy is leading to catastrophic damage of irrigated permanent crops and sinking terrain from pumping. But it's really not the same issue in other regions.

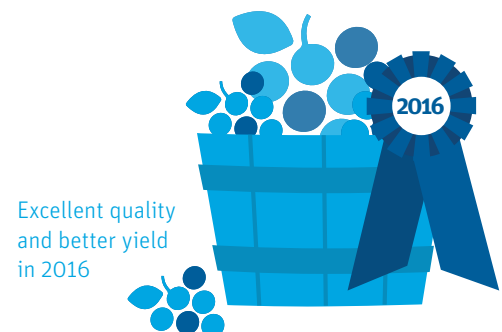
Reporters routinely call me, fishing for information about a disaster on the North Coast or in Oregon or Washington. They hope to see the corpse of the wine industry washing up on the shores of unavoidable cyclical weather patterns. We all know the news saying: "If it bleeds, it leads." They all bite down hard when I say, "Write this: *Drought ruins wine harvest! No grapes to crush. Consumers switch to cannabis.*"²⁴ Then I reel them in, dashing their predatory hopes. I say, "Not really. The water is fine."²⁵

Anyway, with regard to wine grapes, droughts produce good growing conditions generally speaking, as the harvests in 2012, 2013 and 2014 proved by delivering historically heavy yields and great quality in most of the West. The reporters never printed those good-news stories, of course.

Harvest Yield

I don't put 2015 in the heavy-yield category. Quality was great generally, but yield was a little lighter compared with other years. I've heard some explain that salts need to be leached from the soils with rain; others suggest what I've always believed: Vines don't normally produce routinely heavy yields year over year without taking a rest. I'm not a viticulturist, but, no matter the cause, yield was light in 2015 and quality in the vintage year was fantastic overall.

The news from the 2016 harvest was even more boring for reporters because on average the yield was, well, pretty average. That's not entertaining enough to report, and it isn't going to sell newspapers or generate clicks. Yield was a little heavier than last year's short crop, but with good demand for premium grapes the higher haul in 2016 is welcome. →

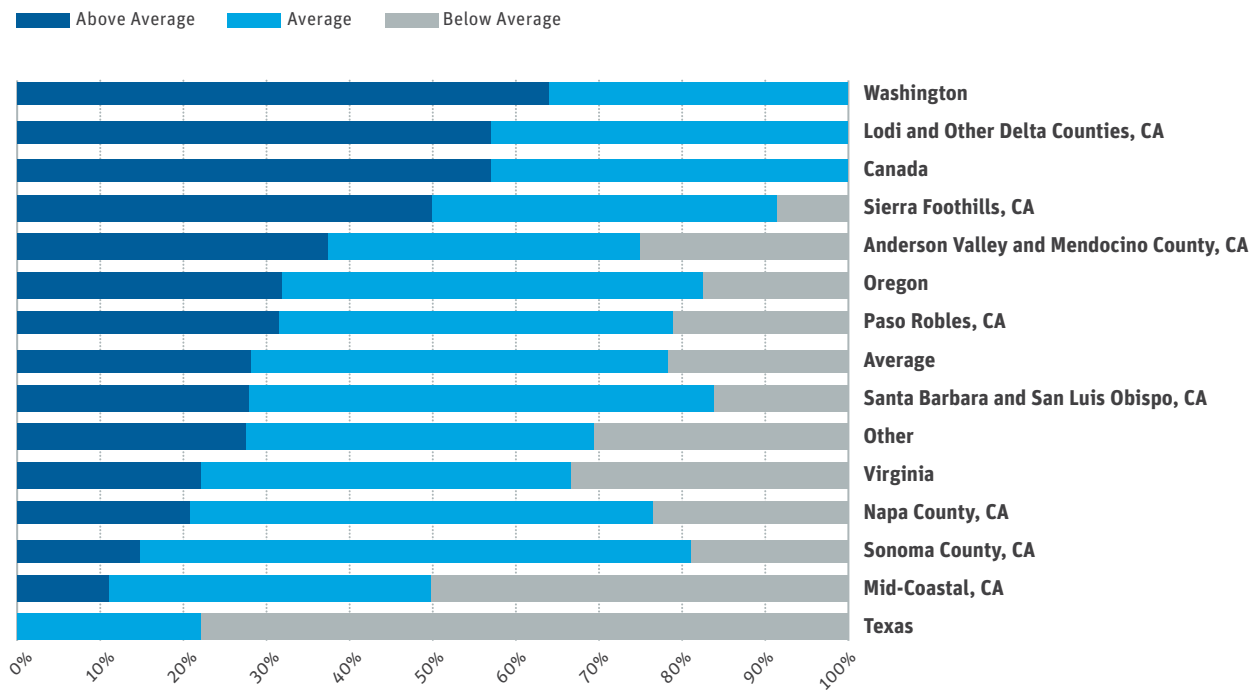


Harvest Yield and Quality

continued

Figure 9
2016 Harvest Yields by Region (% of Respondents Reporting Each Condition)

Source: 2016 SVB Annual Wine Conditions Survey



Fortunately, we did get a little rain on the drought-stricken areas this past winter, setting up more—healthy conditions for the 2016 harvest. But, as always, there was regional variation (see figure 9). In California, the early rains in November and December 2016 were welcome, but much more is needed.

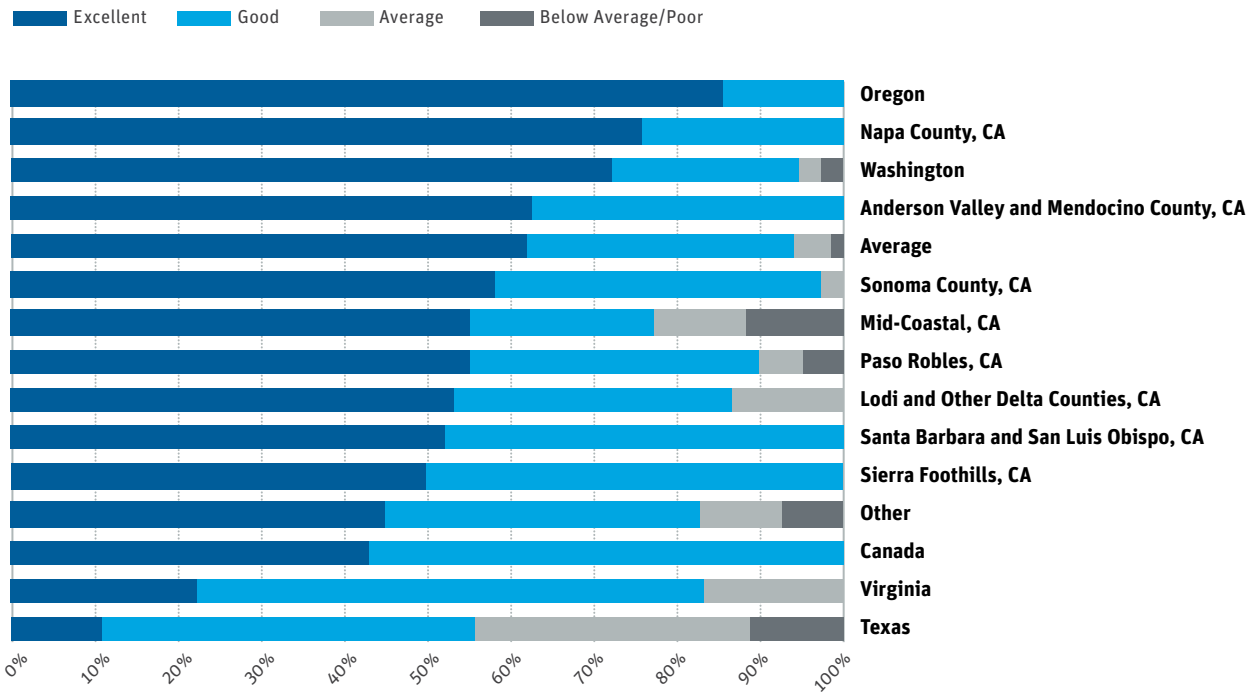
Growers in California’s Delta region, Lodi and Canada²⁶ also reported harvests slightly larger than normal. Oregon, California’s Central Coast, Mendocino and the Sierra Foothills were slightly above average, but Sonoma and Napa were closer to average production. The central and southern interior of California reportedly came in light. That’s a good thing for that region, and from a supply perspective it all worked out just about right — except a lot more Napa cabernet and some Sonoma pinot noir would have been great news, as those varietals are short.



“Vintage of the Decade” honors go to Washington, Oregon and Canada. Oregon has won the honor three years in a row.

Figure 10
2016 Harvest Quality by Region (% of Respondents Reporting Each Condition)

Source: 2016 SVB Annual Wine Conditions Survey



Harvest Quality

Moving off yield, harvest quality in 2016 was again excellent across all West Coast regions. The U.S. wine business is really on a hot streak in producing great vintages (see figure 10).

Oregon and Napa reported the best results comparatively, but I don’t think any region will complain much, with the exception of Texas, which reported mixed results this season because of heavy rains and hail in May and early June.

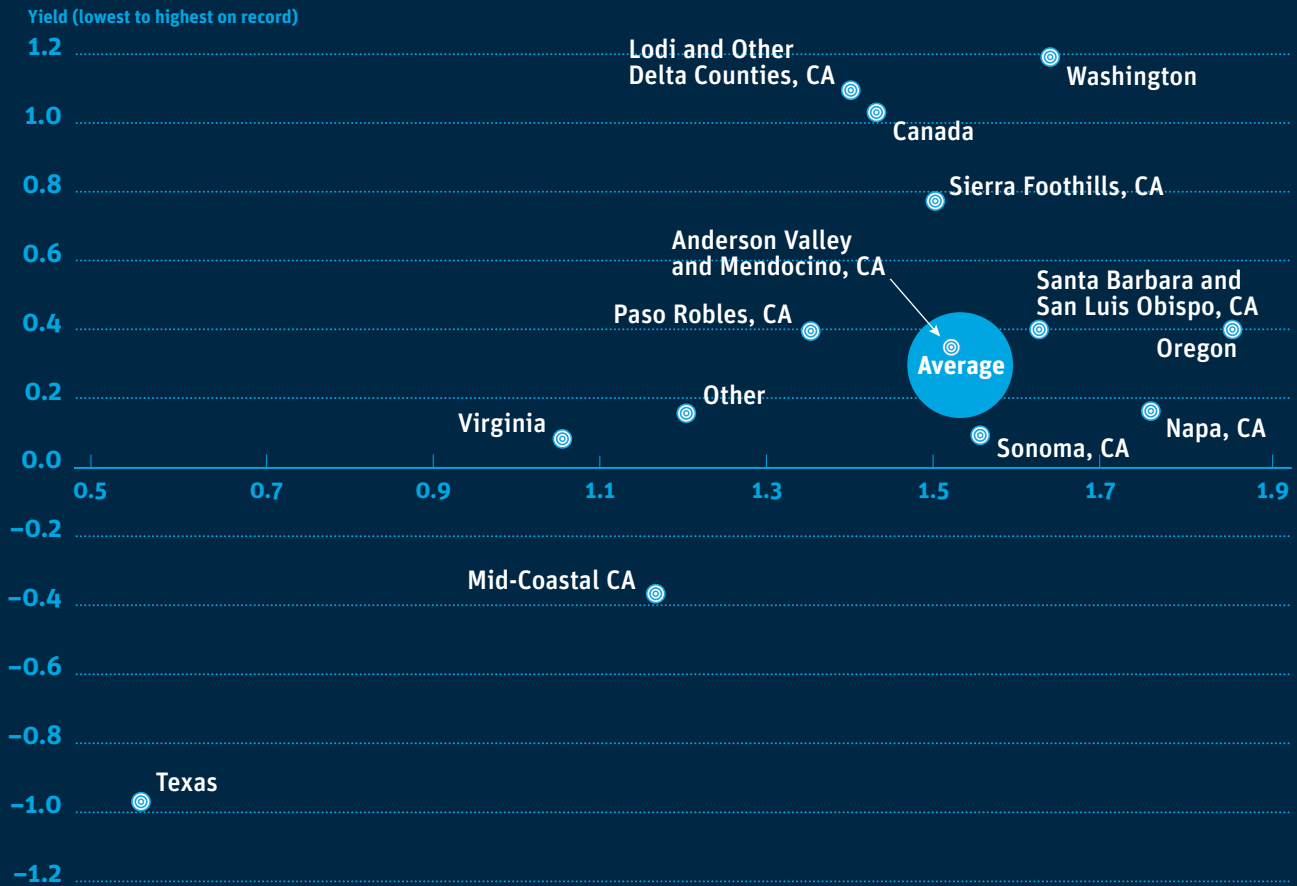
Of course, from a winery perspective the Valhalla of vintage years is when you get heavy yields and excellent quality at the same time. It doesn’t happen often, but it can, as we’ve seen recently with some regions having a “Vintage of the Decade” in consecutive years. This past season, a few locations reported just such an event (see figure 11, page 30). In 2016, “Vintage of the Decade” honors go to Washington, Oregon and Canada, with Canada overrepresented in our survey with Okanagan producers. Not coincidentally, all the regions are in the Pacific Northwest (broadly defined). ■

Harvest Yield and Quality

continued

Figure 11
2016 Harvest Quality by Harvest Yield

Source: 2016 SVB Annual Wine Conditions Survey



2016 was again excellent across all West Coast regions. The U.S. wine business is really on a hot streak in producing great vintages.

6



Quint: [The Orca, their boat, is clearly sinking, with water all over the deck; Quint hands Brody a small hand pump] Pump it out, Chief!

Bulk Wine and Imports

The wine business is cyclical. Some years, we have a light yield and are underplanted to a variety. Other years, we are overplanted, following a string of heavy years with bulk imports flooding our domestic decks. Any action we take may seem like trying to siphon the *Orca* with a hand pump, and doom starts to loom over us. But not today. The vintage yields in 2016 have lined up with consumer demand, and with exceptions on the edges of expensive cabernet and generic juice, we're not getting close to the gunwale.

The bulk wine markets had been a little oversupplied with heavy vintages prior to 2015, so last year even juice from 2013 and 2014 was available. The overall picture was largely described as being in balance; with the past average-sized harvest added, the situation for bulk wine is still described as in balance, with some bulk categories in shorter supply because of strong consumer demand.

Using our survey information that shows higher yields than 2015 and applying math²⁷ and a little estimating using a dart, *our guess for total harvest tonnage in 2016 in California is 3.95 million tons crushed, which is 7 percent higher than the 3.7 million tons crushed in 2015.*

As we've noted, demand for premium wine has been healthy, especially for cabernet, red blends, chardonnay, sauvignon blanc, pinot grigio and pinot noir. Merlot, syrah, riesling and zinfandel²⁸ haven't seen the same degree of consumer demand, and the varietals have struggled. All of those red varietals consumers think

they don't like have been blended into brands consumers do like. At some point, with the new generation of wine consumer, I think we will see a breakout of some other defining red varietal or maybe an imported wine. But for today, blends trend higher as non-core varietal wines trend lower.

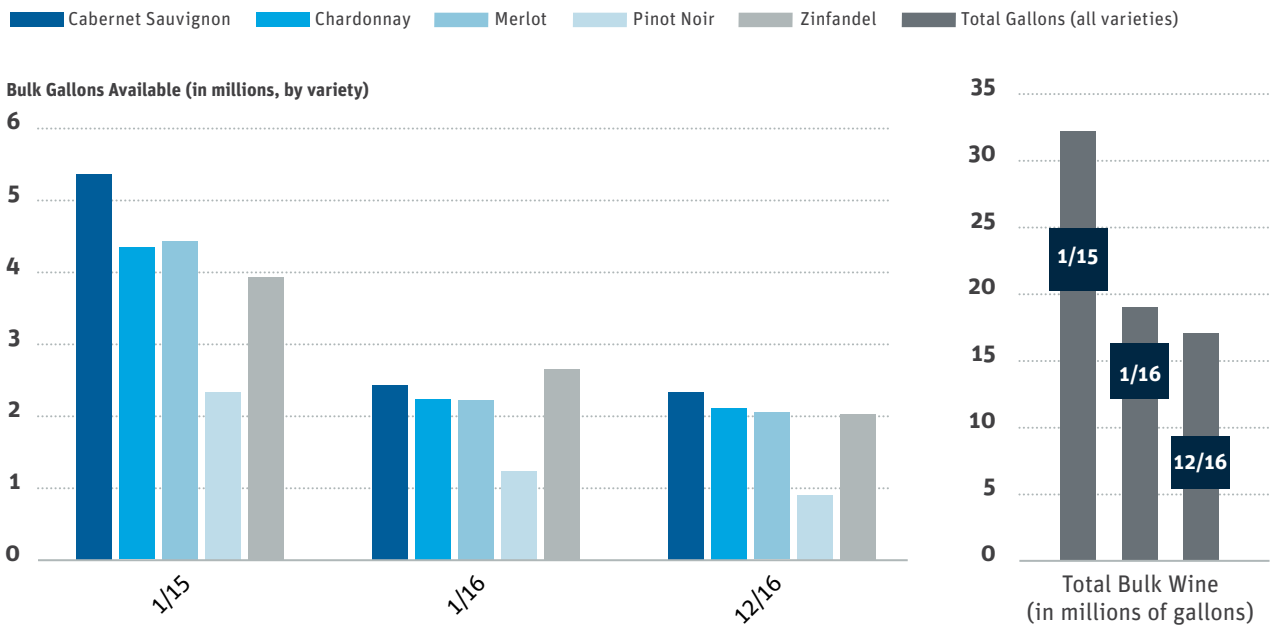
The overall impact of higher varietal demand combined with the average harvest size has led to a rapid drop in bulk cabernet, chardonnay and pinot noir. Prices have increased accordingly over the past year (see figure 12, page 34). Merlot is dropping in volume available not because it's become popular again but because it's filling out the short demand for cabernet sauvignon. Good merlot can be found at a significantly lower price than similar-quality cabernet. →

Bulk Wine and Imports

continued

Figure 12
California Bulk Wine Inventory

Source: The Ciatti Company



Imported Wine

There can't be a discussion of supply without addressing the impacts and threats from foreign wine.

The import winners in the past year have been easy to spot. While Italy and Australia have the top import spots by volume in 2016, New Zealand, with the continuing growth of its sauvignon blanc, and France, with demand for low-price rosé, are gaining popularity, as their wines appeal both to consumers' palates and pocketbooks. Argentina, with its political problems; Australia, with its marketing problems and stronger currency; and Chile, which isn't well positioned for a premium consumer, are the losers (see figure 13).

Foreign bottled wine makes up 35 percent of the U.S. market, but that share is slowing after a long growth march. I believe that bottled imported wine will start to take market share from domestic producers again. That conclusion is drawn from the following observations:

- ▶ Millennials drink beer and spirits as well as wine and are slowly gaining consumer share over wine-drinking baby boomers.
- ▶ Good-value bottled foreign wine is widely available for purchase in multiple chain retail outlets and grocery stores.
- ▶ Digital access and evolving direct-shipping laws make foreign wine as available as domestic wine for the first time in history.

Foreign bottled wine makes up 35 percent of the U.S. market, but that share is slowing after a long growth march.

- ▶ Declining per capita consumption in the European Union, the evolution to more “new world” wine styles in export brands and in-country export marketing support – all contribute to the momentum to expand exports to the U.S.
- ▶ The growing millennial demographic has an evolved view of world wines vs. the baby boomer and Gen X cohorts, who favored U.S. producers in the same period in their development. We shouldn’t expect millennials to assume the baby boomers’ preference for domestics.
- ▶ Given a choice, large U.S. producers have shown a willingness to switch to foreign-bulk sources when there are cost advantages. They can easily do the same with bottled imports and have distribution access.

Imported bulk wine has already damaged and permanently replaced a share of the wine sourced in California’s Central Valley. While we believe that it’s inevitable that import share in U.S. bottled wine will grow, it’s not yet clear if bottled imports will absolutely hurt the growth of domestic wineries.

With per capita consumption still growing, it is possible to surrender low-price market share to foreign wine and still see growth in domestic wineries. That’s what we’ve witnessed since the late 1990s, with good domestic growth and a shrinking domestic share of U.S. wine sales. Imports represent about 35 percent of U.S. wine sales today.

While we could still see growth in the total number of wineries in the United States, higher volume of wine produced and more wine sold by value, we believe that growth in per capita consumption will indeed slow for a time, and imports will become a greater threat to domestic wineries’ financial returns. The question must be asked of fine wine producers at some point: How much market share are you willing to cede before imported wine becomes a threat to your growth and health? The parallel question is of equal importance: How will U.S. wine producers defend their market share? ■

Figure 13
Imported Wine

Source: Nielsen

52 Weeks Ended 11/5/16

Total Premium Varietal Table Wine	\$ Volume	Volume % Change vs. a Year Ago	Case Volume	Case Volume % Change
Domestic	10,092,730,550	5.4	121,966,923	2.7
Imported	3,726,592,876	3.2	41,317,891	0.2
Italian	1,232,164,747	6.2	11,186,488	4.6
Australian	720,386,902	-3.7	12,367,133	-3.4
Argentine	407,296,950	-4.4	4,763,651	-7.2
New Zealand	387,066,144	15.4	2,841,704	13.5
French	348,624,773	16.1	2,311,059	13.5
Chilean	280,447,184	-4.6	4,019,081	-4.6
Spanish	167,092,200	2.6	2,103,334	-0.4

7



Quint: Y'all know me ... know how I earn a livin'. I'll catch this bird for you, but it ain't gonna be easy. I value my neck a lot more than three thousand bucks, Chief. I'll find him for three, but I'll catch him and kill him for 10, but you've gotta make up your minds.

If you want to stay alive, then ante up. If you want to play it cheap, [you'll] be on welfare the whole winter. \$10,000 for me by myself. For that, you get the head, the tail, the whole damn thing.

Land and M&A

Quint had negotiating power. The businesses in Amity made all of their money in the summer, so it was a seller's market for white shark hunting. The town folk didn't want to make waves. They wanted to keep the news of the attacks quiet, but it was already leaking out when a reward was offered for the shark's capture. The city wanted to buy cheap, but Quint knew his value and he set his price higher than anyone expected.

In the wine business, there is blood in the water. The fishing is for premium wine assets, but there are more buyers who want land, brands and production space, particularly on California's North Coast. The line snaps too often because there are fewer and fewer arable acres, and owners are in no hurry to sell. The combination is making for some eye-catching property transactions today, and it's also driving up asset prices in regions other than Napa and Sonoma.

Mergers and Acquisitions

In 2008, Silicon Valley Bank and Scion Advisors issued a report titled "Ownership Transitions in the Wine Industry" in which we forecasted that more than half the wine industry would change hands in the succeeding decade.²⁹ At the time, there wasn't much movement in winery sales, and of course there were other things taking place in the financial world that certainly should have slowed down transition activity.

In the report, we defined transitions broadly to include sale or transfer to the next generation, but no matter; many transactions fly under the radar in this family-run industry. So while it is impossible to truly research all the transitions in the wine business and determine if we

were right, directionally the findings and predictions appear accurate. 2016 was another banner year for M&A in the wine business, with numerous transactions that closed (see figure 14, page 39).

Interesting wine can be produced in mass quantities so long as the consumer is looking only for something round, ordinary and consistent in style. As discussed elsewhere in this report, that is the current intersection of segment growth and consumer demand, where the \$8 to \$10.99 red blends are prominently found. That explains the growth of the \$8 to \$10.99 red blends segment. A wine with merlot, syrah and zinfandel will be interesting but not distinctive, and variability is a given.

The pace of M&A has seemingly increased, and schools of new buyers have formed. Large wine companies know that the breakpoint is arriving when consumers won't be satisfied with blended wines, so they are already planning for the next wave of consumer trends by buying foreign brands, acquiring domestic wineries and brands, or buying arable property that can support a future premium brand. →

Land and M&A

continued

Companies like Constellation, Gallo, Diageo and Jackson Family Wines might have dominated transitions in past years, along with a host of individual buyers. Today the large wine companies continue their buying but are more focused in their strategy. They are joined by medium-sized players such as Huneus Vintners, Crimson Wine Group, Foley Estates, Vintage Wine Estates and Chateau Ste. Michelle, each of which is looking for strategic acquisitions in the premium segment along with better production efficiencies.

Several private equity companies were fishing in the background in 2016. Some closed deals and some did not, but of note were the Far Niente and Duckhorn deals. With low interest rates favoring risk taking and with debt available, there is every reason to believe that we will see several more private equity companies put their toe in the water in 2017 and perhaps one or two close on a transaction.

There were a few more acquisitions by smaller wine companies in 2016. In the past, it was rare for a boutique or luxury winery to buy another, but we are now seeing more transactions in which existing smaller wineries are looking for vineyard and winery assets to secure supply, permitting and capacity, but as it is for all other buyers, vineyards are in primary demand (see figure 15).

There has to be an end to a cycle; but while we got lucky in 2008 and predicted this boom in M&A, it's a little more difficult to pin down when the cycle will end. Typically, that comes with changes in debt availability or cost; fluctuations in other, competing business conditions; or an evolution of the overall business environment. But we have again asked wineries about their desire to sell in the next five years, and still 30 percent say that they are considering their options or will look at a transaction in the next five years (see figure 16). I read in that response that *there is a good chance 2017 will continue with the torrid M&A pace we've witnessed over the past five years.* →

Figure 15
Target Assets for Acquiring Wineries

Source: 2016 SVB Annual Wine Conditions Survey

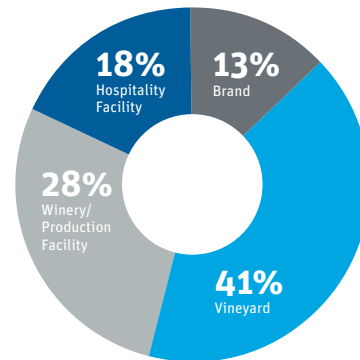


Figure 16
Likelihood of Winery Sale within Five Years

Source: 2016 SVB Annual Wine Conditions Survey

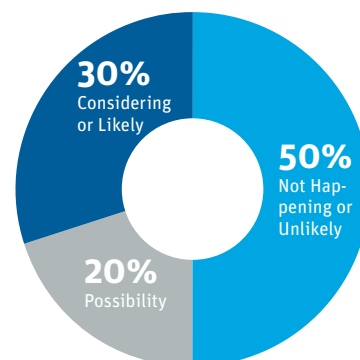


Figure 14

Mergers and Acquisitions

Source: Various public sources; SVB

Seller/Target	Acquirer	Asset/Type
Ardente Estate Winery	Sill Family	Brand and real estate
Benzinger Family Winery	The Wine Group	Wineries and brand
Cerise, Demuth and Knez Vineyards	Kosta Browne	Vineyards
Charles Smith Wines	Constellation Brands	Brands
Copain Wines	Jackson Family Wines	Brand
Dancing Hares Vineyard	Tuck and Boo Beckstoffer	Winery, brand and vineyards
Diageo sale of Chalone Estate Vineyard	Foley Family Wines	Winery, brand and vineyards
Diageo US	Treasury Wine Estates	Wineries and brands
Duckhorn Wine Company	TSG Consumer Partners	Wineries, brands and vineyards
Evolve Winery	West Coast Wine Partners	Brand
Far Niente Wine Estates	GI Partners	Winery, brand and vineyards
Field Stone Winery	Jackson Family Wines	Winery, brand and vineyards
Gamache Vineyard	Sagemoor Vineyards	Winery and vineyards
Goldrock Ridge Vineyard	Paul Hobbs	Vineyard
Greenwood Ridge Winery	Wilson Artisan Wineries	Brand and tasting room
Hartwell Estate Vineyards	Realm Cellars	Winery and vineyards
Hop Kiln Winery	Roll Global/Landmark Vineyards	Winery and vineyards
Huneus Vintners, The Prisoner Wine Company	Constellation Brands	Brands
Kosta Browne	J.W. Childs Associates	Winery and brand
Milliken Creek Vineyard	Private investment group	Vineyard
Oak Knoll Ranch Vineyard	Hancock Agricultural Investment Group	Vineyard
Olsen Estates	Smasne Cellars	Winery and tasting room
Orin Swift Cellars	E. & J. Gallo Winery	Brand and tasting room
Patz & Hall Wine Company	Ste. Michelle Wine Estates	Brand only
Penner-Ash Wine Cellars	Jackson Family Wines	Winery and vineyards
Rita's Crown Vineyard	Sea Smoke Cellars	Vineyard
River Road Vineyard	Delicato Family Vineyards	Vineyard
Robert Hall Winery	O'Neill Vintners & Distillers	Winery and vineyards
Robert Rue Vineyard and Winery	Venge Vineyards	Winery and vineyards
Saitone Vineyard	Williams Selyem Winery	Vineyard
Seven Hills Winery	Crimson Wine Group	Winery and brand
Striker Sonoma Winery	Foley Family Wines	Winery and tasting room
St. Clement Vineyards	Huneus Vintners	Winery
VML Winery	Huneus Vintners	Winery
Willakenzie Estate	Jackson Family Wines	Winery, brand and vineyards

Land and M&A

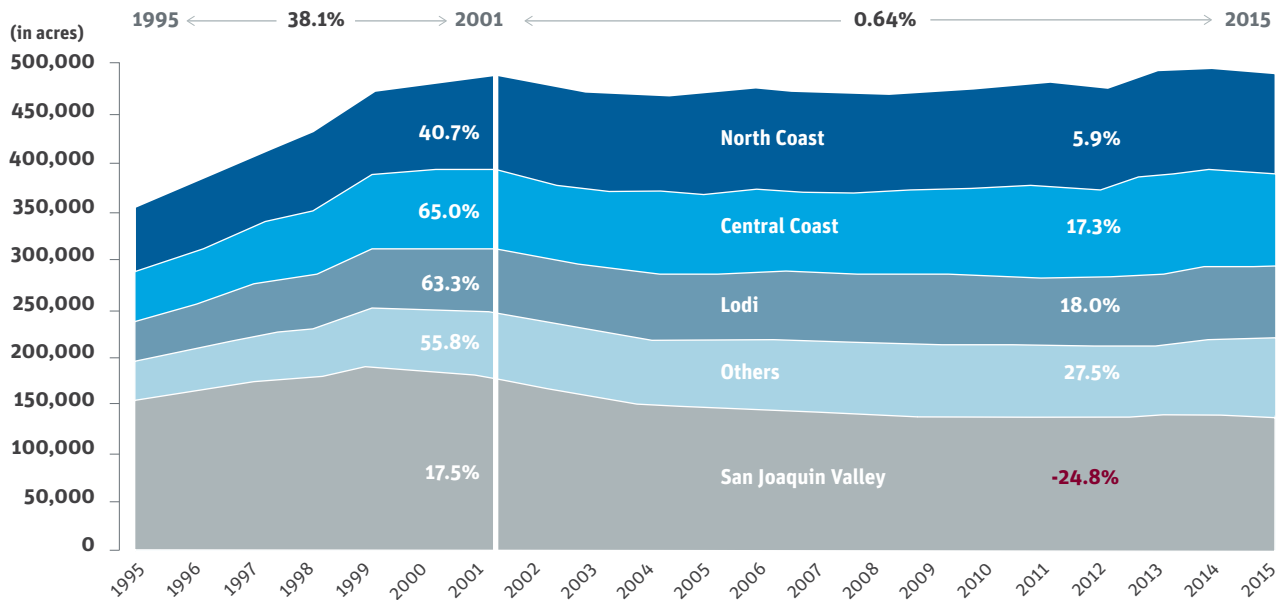
continued

↑ **66%**
Oregon acreage

↑ **18%**
Washington acreage

Figure 17
Total Growth of California Regions

Source: California Agricultural Statistics Service Grape Acre age report; The Correia Company



Planted Acreage Changes

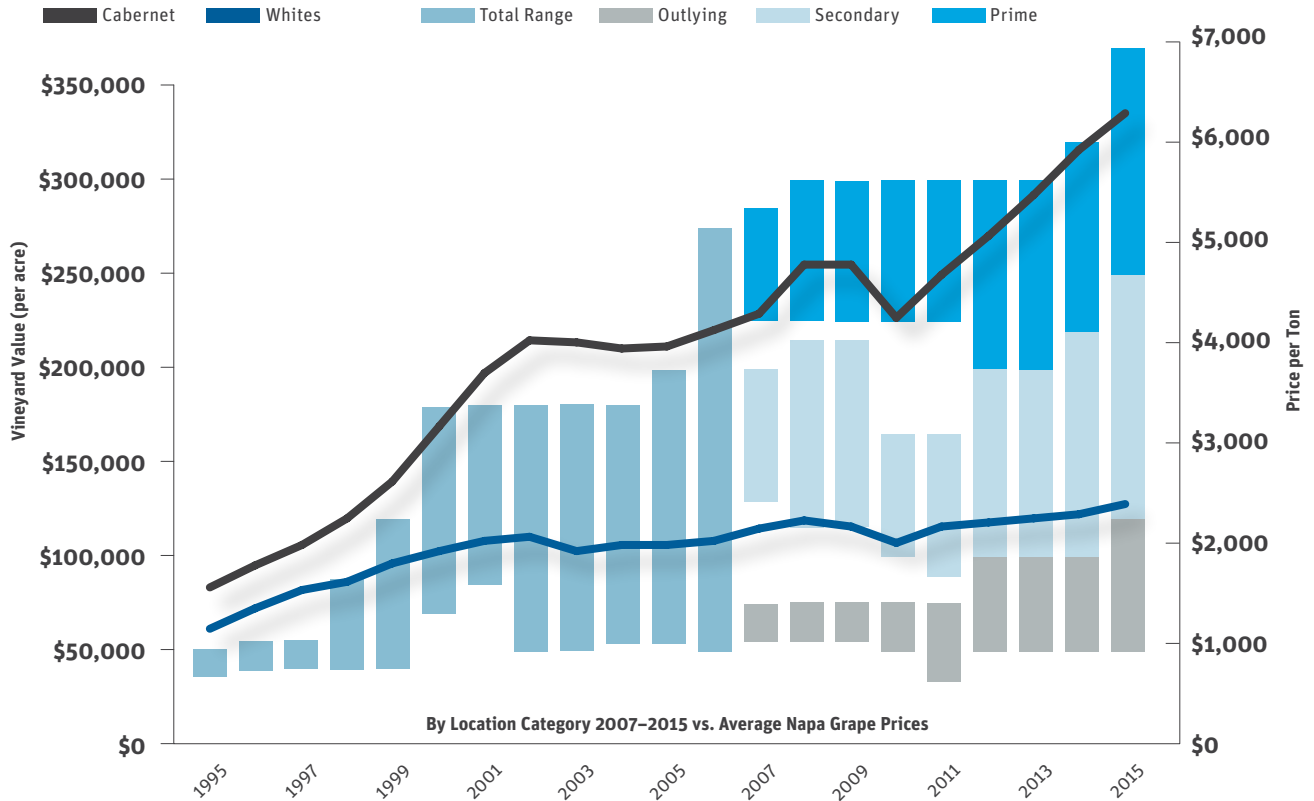
The old pattern of domestic consumers drinking American gateway wines³⁰ early in their lives and then gradually trading up to more complex and expensive domestic wines has ended. This change in the new domestic consumer's drinking pattern is a threat to U.S. wine companies because those consumers are now using foreign wine as their gateway instead of domestic wine — but there's no stopping that ship now. It has left the dock.

The scale of changing consumer demand is hard to see if we look at averages or general trends, but the shift is etched into planted acreage reports and works almost like a viticultural thermometer.

While total vineyard growth since 2001 has been up slightly less than 1 percent, a look beneath the surface shows a monumental change that's been under way for 15 years (see figure 17). The San Joaquin Valley, which has traditionally produced generic wine, has removed 45,000 acres from production; other regions that grow grapes destined for more premium production have grown by about 48,000 acres. Moreover, in the smaller growing regions in Oregon and Washington, where essentially all production is premium, acreage is estimated to have grown by 66 percent and 18 percent, respectively, just since 2008, underscoring the rotation into premium and out of generic wine.

Figure 18
Napa County Vineyard Values vs. Grape Price

Source: Wine Industry Investment Consulting; Annual “Trends” Report of the California chapter of the American Society of Farm Managers and Rural Appraisers; annual California grape crush reports; The Correia Company



The Luxury Component of Grape Acreage

Given the reputation of Napa and Sonoma as premium wine-growing regions, it is logical to presume that California’s North Coast should have the highest growth rates in planted acreage, but that’s not the case. The highest growth rates are in regions where plantable land is available and where prices are more reasonable compared with those on the North Coast.³¹

While the growth rate on the North Coast is smaller than in other regions, price per acre is a different issue. As noted earlier, cabernet is leading the growth among all

premium varietals today, and Napa cabernet acreage has a value structure unto itself. That price and value equation has become even more distorted in the past year (see figure 18).

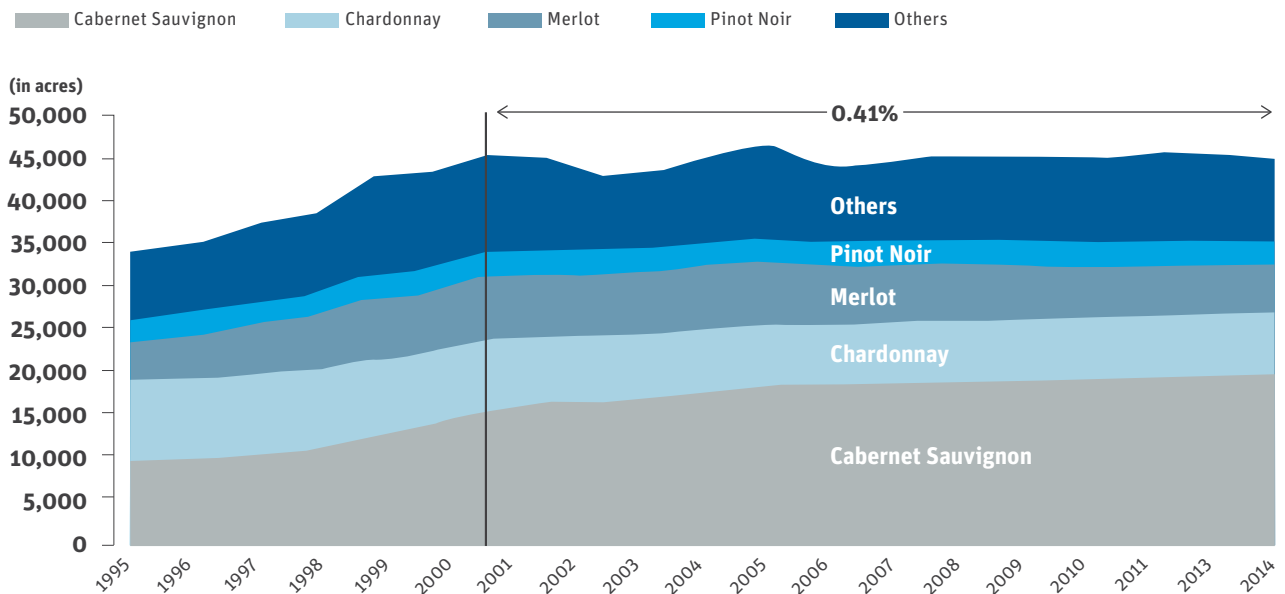
With Napa at one end of the growing spectrum, you can see how the average price per ton of cabernet (black line) has increased dramatically over the years since the median baby boomer hit age 35 in 1994. In the past several years, the price for grapes has risen steadily, with good-quality Napa cabernet now fetching north of \$8,000 per ton. →

Land and M&A

continued

Figure 19
Napa Total Varietal Acreage

Source: California Agricultural Statistics Service Grape Acreage Report; The Correia Company



Grape prices will drive land values, so with the exception of a small decline in secondary regions of Napa during the recession, there has not been a noticeable downturn in the price of Napa grape acreage in the past 30 years. The reason comes down to consumer demand but also to the lack of plantable land in Napa.

Total planted acreage in Napa (see figure 19) has grown slightly less than 0.5 percent per year. More land would be planted if it were available, but it's not, with the exception of small sections in the hills, the southern Carneros region and the edges of the county.

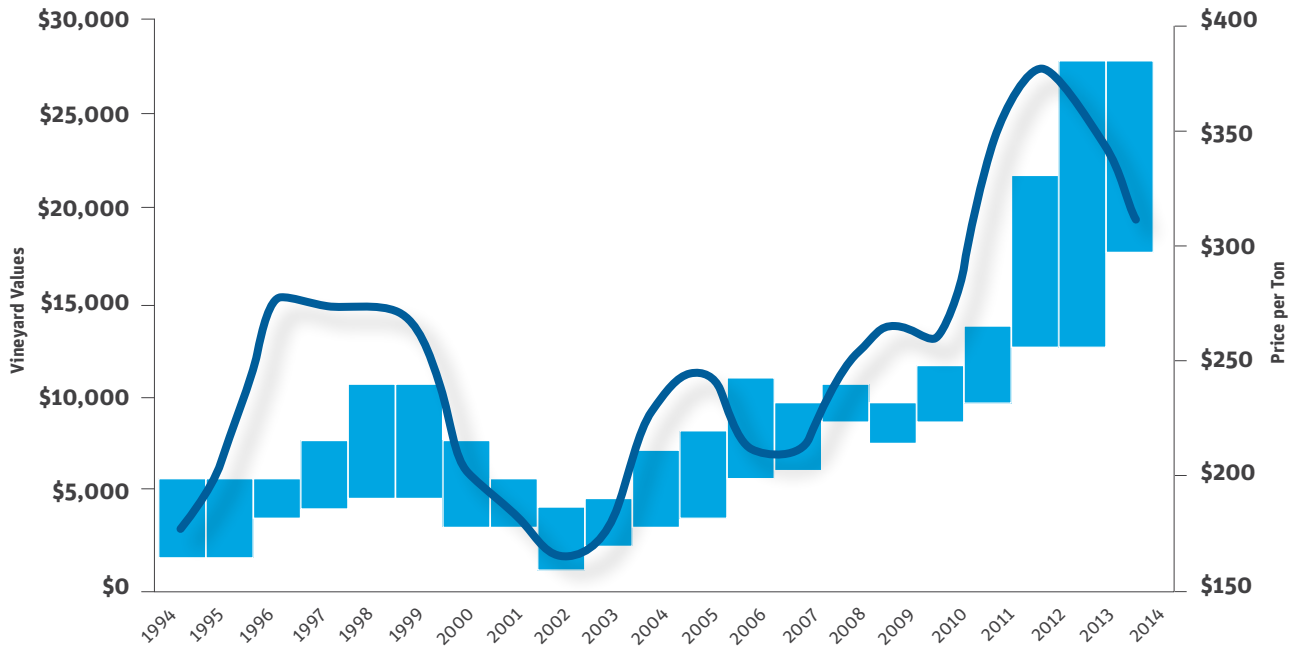
The Napa cabernet bottle price has been on a constant upswing because of growing worldwide and domestic demand for Napa cabernet. But there is a permanent cap on grape production, which is limited by acres planted. So in an increasing bottle price environment, the only variable that can move is the price per acre.

In theory, the price of land and grapes will stop climbing when the demand for Napa cabernet stabilizes at some future price. Even then, land and grape prices may not fully stabilize because the best properties behave

Compared with Napa’s price of \$8,000 per ton, Fresno’s \$300 per ton seems like a mistake, but you have to look at it as revenue per acre.

Figure 20
Napa vs. Fresno-Madera in Revenue per Acre

Source: District 13 (Fresno-Madera) statistics from the California Agricultural Statistics Service and The Correia Company



like superior goods. As a result, Napa land will likely always be more expensive than land in other wine-growing regions.³² To paraphrase Mark Twain, they aren't making land anymore.

The Commodity Side of Grape Acreage

Not all regions are like Napa, so we should review the other end of the grape spectrum and look at District 13 (Fresno-Madera) to see the opposite view.

Compared with Napa’s price of \$8,000 per ton, Fresno’s \$300 per ton seems like a mistake, but you have to look at it as revenue per acre. In the case of Napa, presuming an average yield of 4 tons per acre, revenue per acre comes out to \$32,000. With Fresno, we presume 12 tons per acre, which comes out to per-acre revenue of \$3,600. Growers will affirm that that insufficient return is unsustainable. Valuation is appropriately different, with District 13 averaging around \$20,000 per acre vs. Napa at \$270,000 per acre (see figure 20). →

Land and M&A

continued

In Fresno's case, instead of growers replanting popular varieties, much of the production has gone into unfamiliar generics at the behest of large wine-producing companies (see figure 21). Finding a home for those out-of-favor grapes with a reasonable return has become difficult and at times impossible. Stories abound of growers getting offers of \$100 per ton on the spot market, especially for zinfandel, white zinfandel, merlot and syrah.

Because the grapes in California's inland region have not been effectively differentiated from foreign juice, better-priced foreign bulk has replaced vine acres in the Central Valley. That productive capacity is now forever lost to other world producers.

The impact on land values given this rotation away from generics is probably not as bad as might otherwise be expected because land is used for other crops such as almonds, pomegranates and pistachios that historically carry better returns. That said, in the past year the nut crops in Fresno have also had a pricing setback to go along with extended drought conditions. That too will influence land values.

It should be noted that my colleagues and friends in Fresno who planted uncontracted and out-of-favor varieties are in a dire position today. Everyone in the industry hopes the growers there can find a better path for their future, but it's not an easy solution. It's going to require a rebranding to premium varieties that are not commodities or subject to threats from lower-priced foreign bulk juice. While a little luck is helpful, too, I believe that with proper effort the interior can be recast as a premium wine-producing region in its own right.

Land Summary

Average vineyard land prices are moving strongly higher because the large wine companies aren't the only ones that see the need to buy land that can produce premium wine. Wine companies in the next tier down from the majors have been active, as well, in California, Oregon and Washington, where more-favorable price/quality measures exist compared with California's North Coast.

The Napa Valley, known for cabernet, is effectively planted out. No more acreage exists of any size. The smaller wine companies with growth plans in Napa are desperately seeking land and/or vineyards to acquire, but absent adequate cabernet acreage many are looking toward Sonoma County to start pinot noir programs. The added buying pressure combined with the favorable growth in pinot is driving vineyard prices higher in Sonoma, Lake and Mendocino counties as well.

The result of high demand for coastal land, combined with the strong M&A market and low long-term rates, has been that land prices in all wine-producing regions have been moving strongly higher. Although we have correctly predicted bubbles in the past, we don't believe that this is one. The growth in price per acre and price per ton in premium areas could flatten, but given that the underlying demand for premium wine continues to grow, we can't see any reasonable event that turns the current price environment into a bubble in the near term. ■

“They aren't making land anymore.”

0.41%

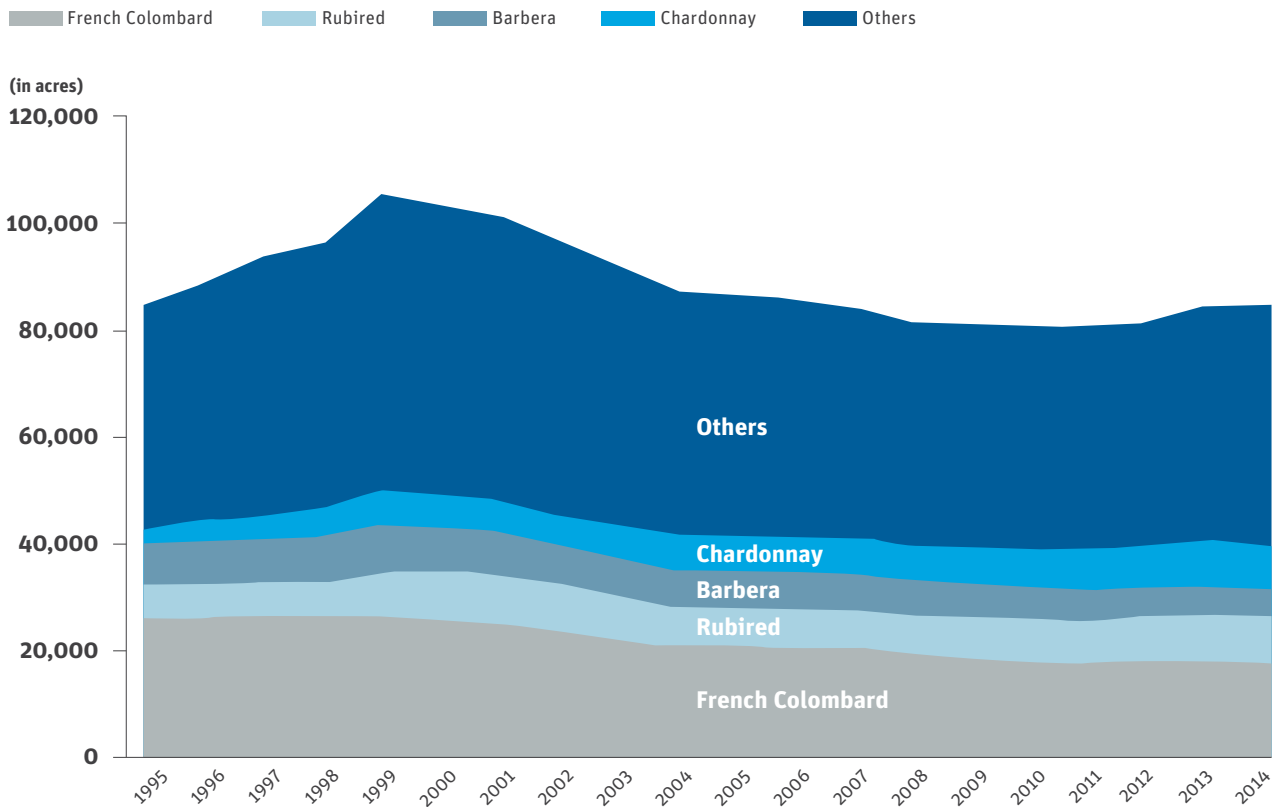
growth over 15 years
in Napa



Average vineyard land prices are moving strongly higher because the large wine companies aren't the only ones that see the need to buy land that can produce premium wine.

Figure 21
Fresno Total Varietal Acreage

Source: California Agricultural Statistics Service Grape Acreage Report; The Correia Company



8



[... about to go fishing for the shark]

Brody: On the water?

Hooper: Well, if we're looking for a shark, we're not gonna find him on the land.

Shifting Cohorts and Improving Economics

Understanding the evolving consumer is one key to developing strategies to maneuver your business into safe waters. You aren't going to find satisfying sales if you are fishing in the wrong place.

When it comes to the discussion of who is biting on the line, the story about millennials being the largest consuming cohort of wine is nothing but a wild fish tale and flat-out inaccurate.³³ Casting into that pond today will not yield the result that premium wine owners are hoping for. That said, all generations over 21 years of age have some component of consumer demand that, depending on your own model, could be an important consideration.

Each year, we survey wineries to better understand the key issues they face, and we receive between 550 and 800 responses. The wineries that track their direct sales are able to give us data on the thousands of consumers who buy their wine. From that, we are able to derive several views and estimates of overall cohort demand.

Today we see the impact of four different generations in the U.S. wine trade, and all are evolving the business in obvious ways with their consumption patterns.

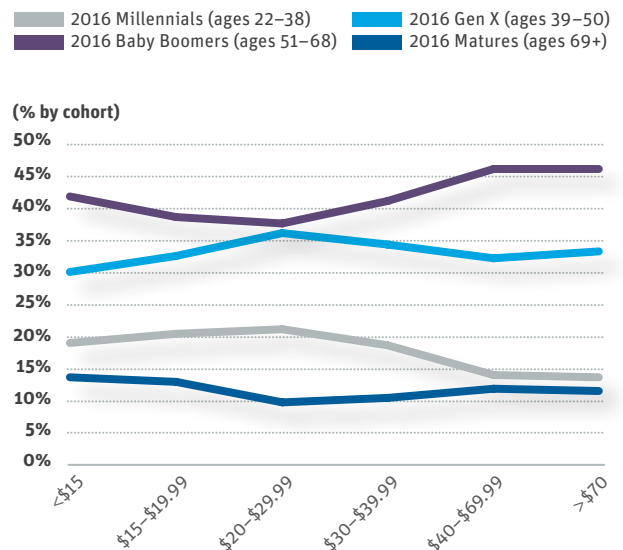
Baby boomers are still the dominant consumer of fine wine, but this year for the first time the millennials moved fully off the bottom in all price points, bypassing the mature generation, which now occupies the bottom position in wine consumption (see figure 22).

Matures

Matures grew up during the Great Depression.³⁴ Their ensuing behaviors, such as thriftiness, saving and the conservative use of debt, resulted from their inability to find employment or even the bare necessities early in their lives. Add rationing during WWII, and decades later many still save everything and throw away nothing — ever. Their wine consumption historically has been in low-price value wines. Consistent with their cohort shift to the bottom, inexpensive wines are also falling permanently out of favor with consumers. →

Figure 22
Proportion of Direct-to-Consumer Sales to Age Cohorts by Price Point

Source: 2016 SVB Annual Wine Conditions Survey

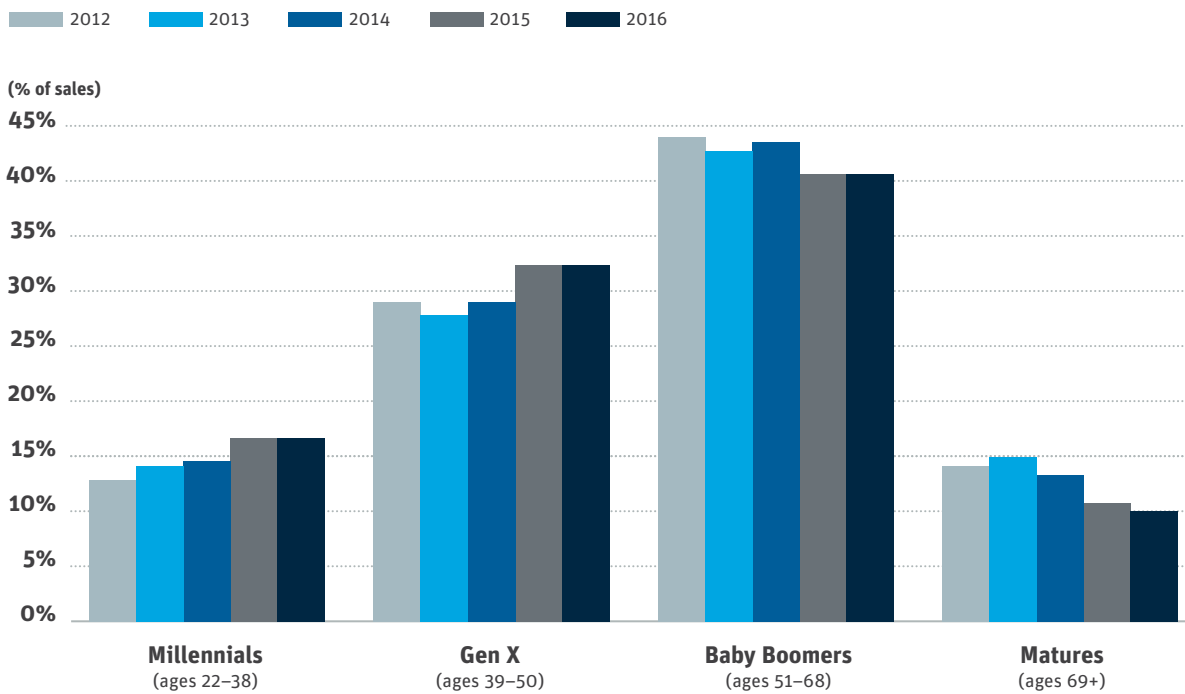


Shifting Cohorts and Improving Economics

continued

Figure 23
Change in Cohort Share of Wine Sales

Source: SVB Annual Wine Conditions Survey



Baby Boomers

The baby boomers, who are responsible for the past 20 years of growth in the American fine wine sector and still maintain the largest demographic footprint on the business with a 41 percent share, are beginning a slow decline in their consuming patterns (see figure 23). That trend will continue as the group ages and should accelerate within the next six years as the median baby boomer reaches retirement age in 2022. The cohort will have increasingly less discretionary income.

Gen X

The always-overlooked Gen Xers are currently in second place, and their consumption of fine wine continues to increase. While the cohort is smaller, they are perfectly positioned to pass the baby boomers as the dominant demographic of fine wine consumption. As noted last year, if current trends are maintained and all other external factors remain constant, *we expect Gen X to surpass the baby boomer cohort around 2021 to become the largest wine-consuming demographic in the United States.*

Baby boomers are still the dominant cohort.

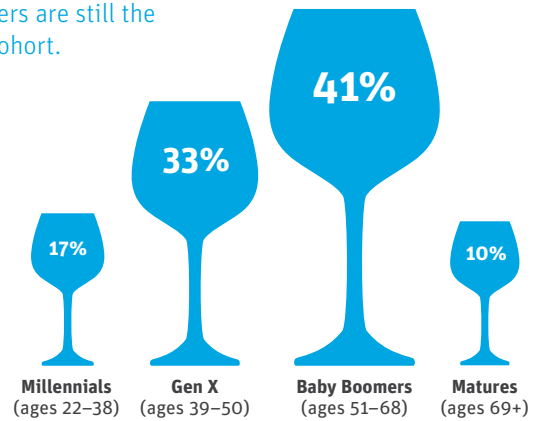
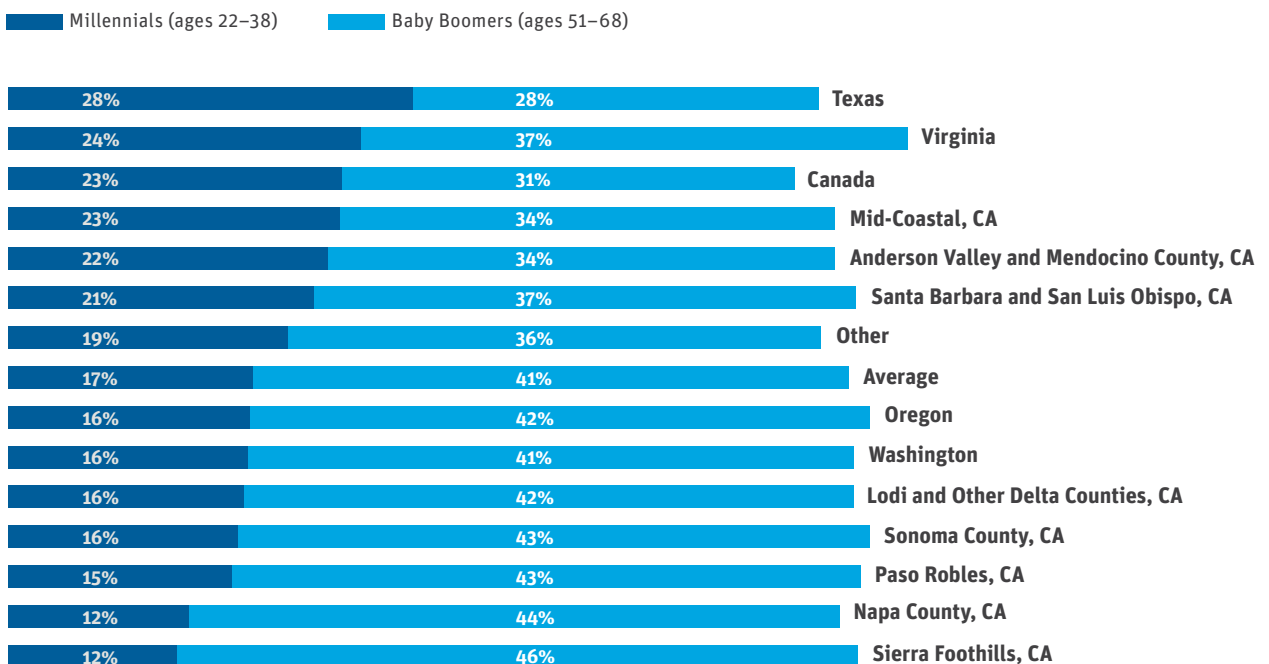


Figure 24
Cohort Share of Sales by Region

Source: 2016 SVB Annual Wine Conditions Survey



Millennials

Representing just 17 percent of the current consumption market share of premium wine is the millennial generation, whose outsized impact has been falsely prognosticated in the trade press for at least a decade.

The reality is the generation does not have the same financial environment to push spending compared with the baby boomer and Gen X cohorts at the same life stage. Significant headwinds include underrepresentation in the U.S. workforce, significant amounts of student debt, declining productivity and the setback in wealth accumulation during the Great Recession. But in an interesting parallel, the millennials are living at home

with their parents longer than any prior generation except the matures, who lived with their parents due to the Great Depression and only started moving out in the early 1940s as the economy improved.

While the millennials' overall impact on fine wine buying more closely resembles that of the matures in volume and price point today, millennials are a growth cohort and the future of the wine business. Today, as one would expect with lower financial capacity, they have greater impact in regions such as Texas and Virginia, with lower average bottle prices, but they have lower representation in more expensive regions such as Napa and Sonoma (see figure 24). →

Shifting Cohorts and Improving Economics

continued

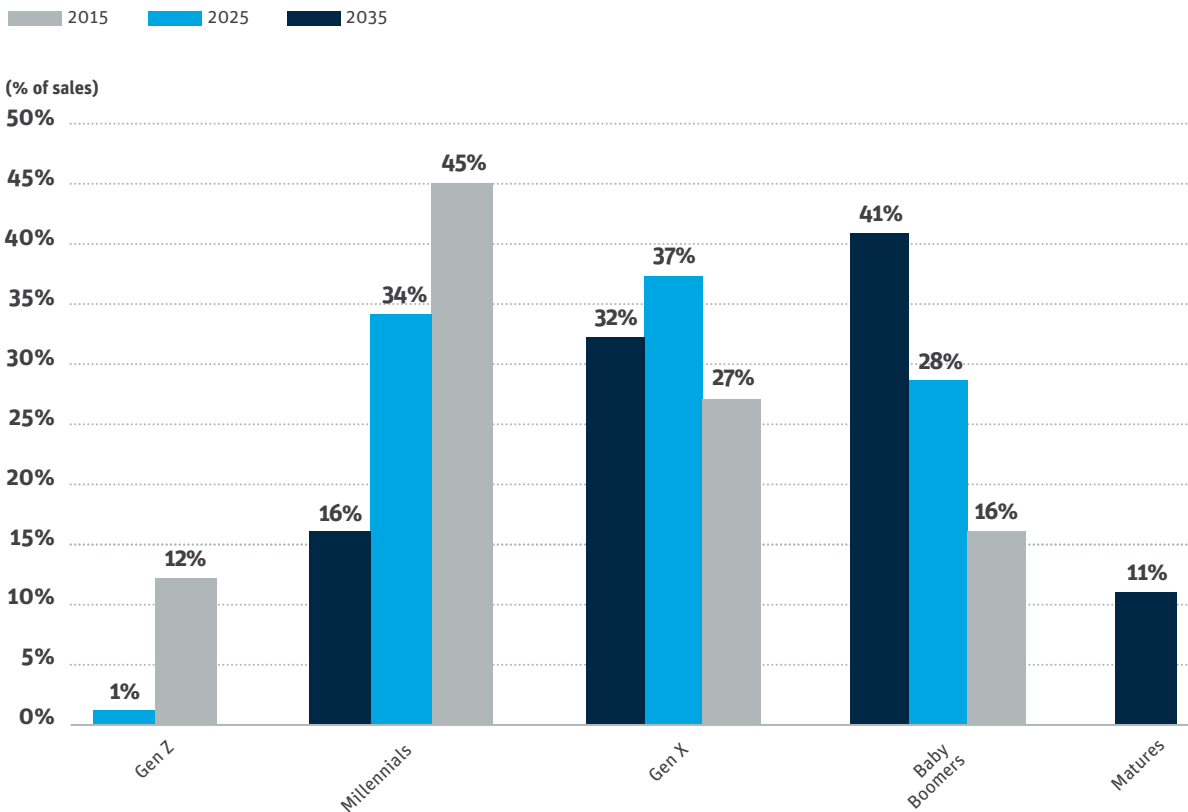
Building on the premium evolution of the American wine culture, since the 1960s each successive generation enters its consuming years knowing more than the previous generation. Matures began with jug wine. Baby boomers followed with premium domestic wine, as did Gen Xers. Millennials are no different, but they have the added advantage in their formative years of the digital age, which allows them wider selection, better pricing information and greater ease of purchase. Perfect digital price information in the hands of a thrifty consumer is a nightmare for marketers.

While still after a premium product and experience, evidence from many sources suggests that *millennials are inclined to substitute craft beer and spirits for wine, especially on premise, and are ambivalent as to the place of origin.*³⁵ The youngest consumer cohort has demonstrated a propensity for frugal hedonism,³⁶ meaning they are quite price conscious but don't sacrifice quality when selecting their adult beverages.

The hope for the group as they gain traction in life and careers is that they evolve to become less penny-wise and loosen up the grip on their wallets, becoming traditional mass-luxury consumers. *Our forecast is that the millennial cohort will surpass the Gen Xers around 2026 to become the largest wine-consuming demographic* (see figure 25).

Figure 25
Forecast Changes in U.S. Cohort Purchase Share

Source: SVB Annual Wine Conditions Survey





Brody: You're gonna need a bigger boat.

The Economic Engine

What? You thought we'd leave that quote out of the report? It has to be one of the most iconic lines of all time. Interestingly, according to screenwriter Carl Gottlieb, "You're gonna need a bigger boat" was not scripted but was ad-libbed by Roy Scheider. As they say, sometimes it's better to be lucky than good.

When it comes to the U.S. economy, we've been both since the recovery started. Writing this in early December 2016, it looks like the economic engine that is driving U.S. consumer sales is indeed sufficient to drive a bigger boat, so while most economists are predicting an improving economy in 2017, we aren't going to be getting the same-sized boat we once had.

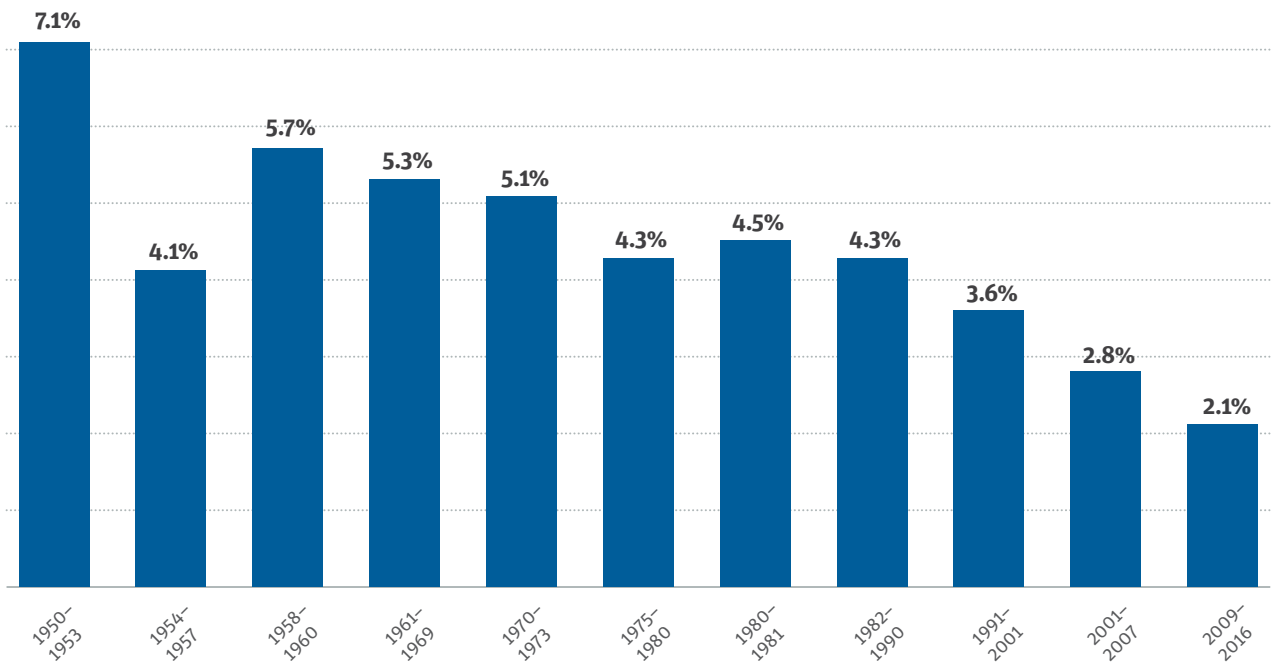
In past reports, we dedicated up to half the space for economic issues simply because they were the most important aspect of changing consumer demand. The U.S. economy is still every bit as important overall, but today thankfully we don't need to spend so much time discussing economics because the U.S. economy is looking pretty good!³⁷ Still, a couple of overarching aspects of economics are important to note: the potential growth of U.S. gross domestic product and cohort opportunity.

Many expect that we will return to "the good old days" and see 4 percent GDP, but that's just not going to happen. Getting to a sustained 3 percent GDP would be fantastic but will require direct investment, fiscal stimulus, the pullback of free money from the Fed and an improvement in productivity. We can use what's been called the Golden Age of Capitalism³⁸ as a model to explain the points. (Stick with me. I won't be too boring here.) →

Figure 26
Real Growth in Gross Domestic Product

Source: U.S. Bureau of Economic Analysis

(% change)



Shifting Cohorts and Improving Economics

continued

As World War II was winding down, economists started to weigh in on how the U.S. economy would fare. They were nearly unanimous in their view that without war manufacturing, the economy would return to the recession that existed prior. Obviously, that prediction was entirely wrong.

Because the United States was pretty much the sole modern industrial power still standing at the end of the war, the world had to come to our shores for goods and services. Massive capital investments were made to retool manufacturing into peacetime uses. That investment drove employment and productivity. In addition, the men and women who served were beneficiaries of the GI Bill³⁹ and received billions in financial assistance to get educations and low-cost mortgages. That fiscal injection should not be overlooked because it too drove the growth in housing and jobs during the period.

Fast-forward to the present era, and the picture is much different. As the world was healing from the war, manufacturing started leaking out to other countries that had lower wages, and by the mid-1970s more than half the U.S. GDP had become based on personal consumption expenditures (the consumer). The echo from the massive peacetime investment ended and was reflected in lower real GDP (see figure 26, page 51).

Today capital investment that leads to job growth and better productivity has been negative for the first time since the end of WWII. That has led to the lowest era of productivity since OPEC put a worldwide chill on investment and inflation raged (see figure 27).

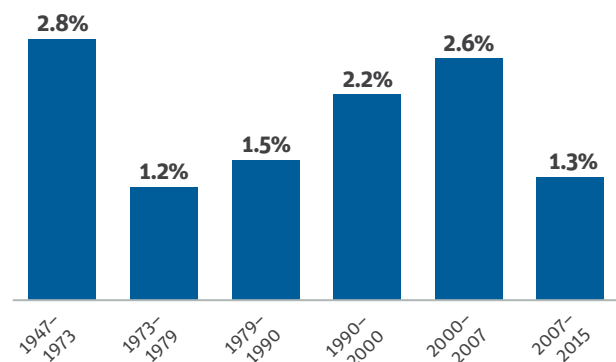
To the point you've waited for about cohort opportunity, the millennials don't have the same opportunity as the generations that preceded them. The GDP potential of the U.S. economy isn't the same. Other world economies are moving up the investment, population and GDP ladder.

If the stock market is indeed a leading indicator, the economy looks like it's readying to make a positive move in 2017. That will be reflected in growing wine sales once again. But with wealth-heavy baby boomers retiring and financially disadvantaged millennials replacing them one for one, it's intuitively obvious that the long-term potential for consumer growth won't be as robust as in previous decades. ■

Figure 27
Average Annual Change in U.S. Productivity

Source: U.S. Bureau of Labor Statistics

(% change)



The millennials don't have the same opportunity as the generations that preceded them.



9



Mayor Vaughn: I don't think either of you are familiar with our problems.

Hooper: I think that I am familiar with the fact that you are going to ignore this particular problem until it swims up and BITES YOU ON THE ASS!

Winery Financial Performance

In the past year, I've seen firsthand the impact of regulations gone haywire. They are frustrating family winery owners across the country, increasing the cost of doing business and reaching the point where some of the regulations will put family-run wineries out of business. The problem can't be ignored, and it's not going away by itself.

Don't get me wrong — I'm grateful for politicians, if for no other reason than that they always show up worse than bankers in the “least trusted” surveys, but let's be nice. We need their help in balancing out good regulations and political ones, and in some cases we need a reversal of administrative overreach, especially regarding immigration.

The topic of regulatory reform and the financial impact on business has been a continuing discussion since the 2016 presidential election. Many in the business community are hoping for tax relief in addition to regulatory reform. Regulations at the state, federal and local levels are hurting the performance of family-run wineries in many ways. Whatever happens, it's not going to resolve itself without every winery owner and stakeholder contributing to change.

Local Regulations

Small wineries take up space in bucolic settings. Some would argue that the wine industry might even add to the beauty and culture of an area.⁴⁰ But running a winery today requires direct sales, which brings a trail of visitors to the countryside — and not everyone appreciates that.

Local regulation aimed at slowing tourism and winery growth has continued to evolve in several regions, most notably Santa Barbara,⁴¹ Sonoma and Napa counties. What seems common at this stage is an alignment of diverse agendas from NIMBYs,⁴² anti-change concerns, anti-alcohol advocates and those with parallel environmental agendas. They align using media and the political process to paint a negative view of the industry and its practices.

We asked winery owners what they thought local residents felt about the growth of wine tourism in their region. The good news is that 80 percent felt that tourism was appreciated and supported locally. Not surprisingly, California's Central Coast wineries were the least positive about the question, but Sonoma and Napa wineries weren't far behind in their responses (see figure 28, page 56).

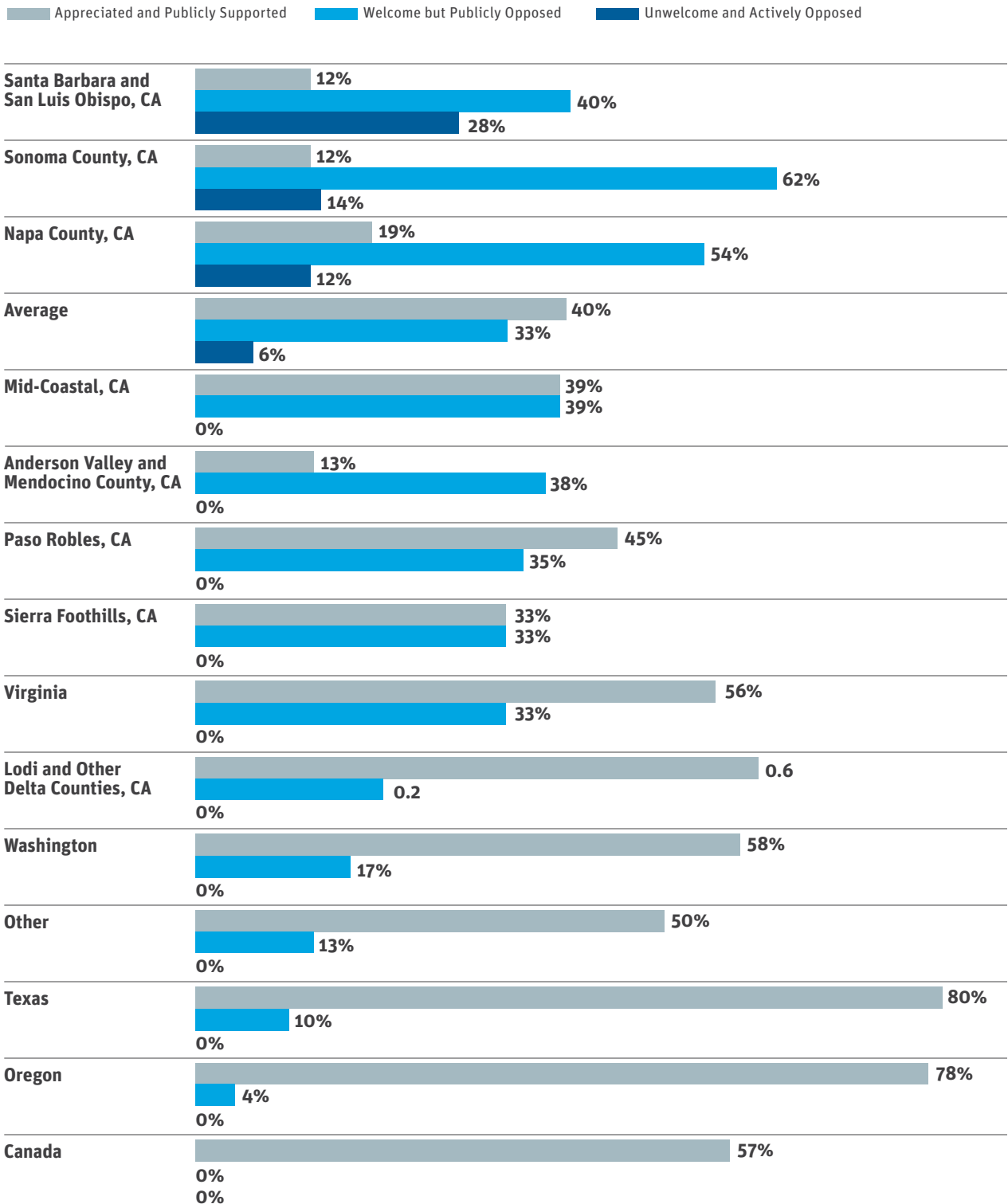
According to articles and comments from readers in the trade press, the debate is about a threat that is changing the character of *[fill in your growing region here]*. Those accusations are backstopped with references to the negative impacts from traffic, noise, tourism and heavy water use. The specter of drunk driving on county roads is often inserted into the discussion, as well. →

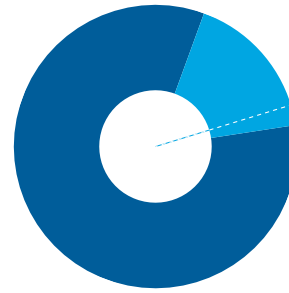
Winery Financial Performance

continued

Figure 28
Are Wineries and Tourism Welcomed by Locals?

Source: 2016 SVB Annual Wine Conditions Survey





15%–17%

Percentage of tourism traffic in Napa on most days

Local Regulation *continued*

While the debate has received immense attention in the regions noted, beyond checking off the CEQA⁴³ box (California Environmental Quality Act), only recently has consistent effort been expended to produce studies that give a supported view of the impact of the wine business on a community. Are wineries responsible for unbearable traffic, noise and drunk driving? It's clear that wineries are responsible for job growth and positive economic impact, and they are among the largest sources of philanthropy, but what of the other claims? How are we promoting the good the wine industry does in a community to offset the vocal minority opposition?

In the case of Napa, the public narrative was that heavy traffic came from tourism, but a traffic study funded and run by the county determined that the source of the congestion was actually locals,⁴⁴ and on most days

tourism represented just 15 to 17 percent of the traffic. Napa, like the rest of the Bay Area, has grown and so has traffic. In the case of Santa Barbara, the narrative was punctuated by pictures of accidents. Secondhand testimony was that wineries were responsible for an increase in drunk driving. Yet when the facts were researched, all the cases of alcohol-influenced driving accidents turned out to be late at night when tasting rooms were closed. Outside of doing that kind of research and study, the local narrative comes from unsupported testimony, but allegations left unchallenged will lead to inaccurate conclusions.

My belief is that tourists come to wine country because it is beautiful, so we all have something to lose from unplanned growth. If wine country gets too crowded and loses its charm, we will be killing the goose that lays the golden egg. The focus in the debate should be on common ground: the protection of a wine region. The emphasis for all the local anti-winery battles should drift toward inserting facts into the debate so that we can protect the beauty, culture and environment from which we all make our living. →



Hooper: *[singing]* Show me the way to go home / I'm tired and I want to go to bed ...

Hooper, Quint, Brody: *[all singing together]* I had a little drink about an hour ago and it got right to my head / Wherever I may roam / by land or sea or foam ...

Winery Financial Performance

continued

State and Federal Regulations

In our annual survey, we ask wineries questions modeled after the methodology used in the Conference Board Consumer Confidence Index.⁴⁵ From that we can get a read on how the general industry views the current state of affairs and what their concerns are (see figure 29).

Looking at the results of the past two years, we can say that the industry is more confident in the economy and the state of consumer demand. But overall, respondents reported that confidence is lower because of critical labor issues and, to a lesser degree, foreign competition and substitutions.

With respect to the latter, it's a reflection of the growing concern about legalized cannabis. It remains to be seen if that will cool demand for fine wine. I'm on the side that believes that fine wine and cannabis will co-exist.

A more pressing concern is labor. In every growing area, the labor force is inadequate, which is leading to

increased costs and more incentive to mechanize. From an American Viticultural Area perspective, Mendocino shows this as the largest concern. In our survey, one respondent said:

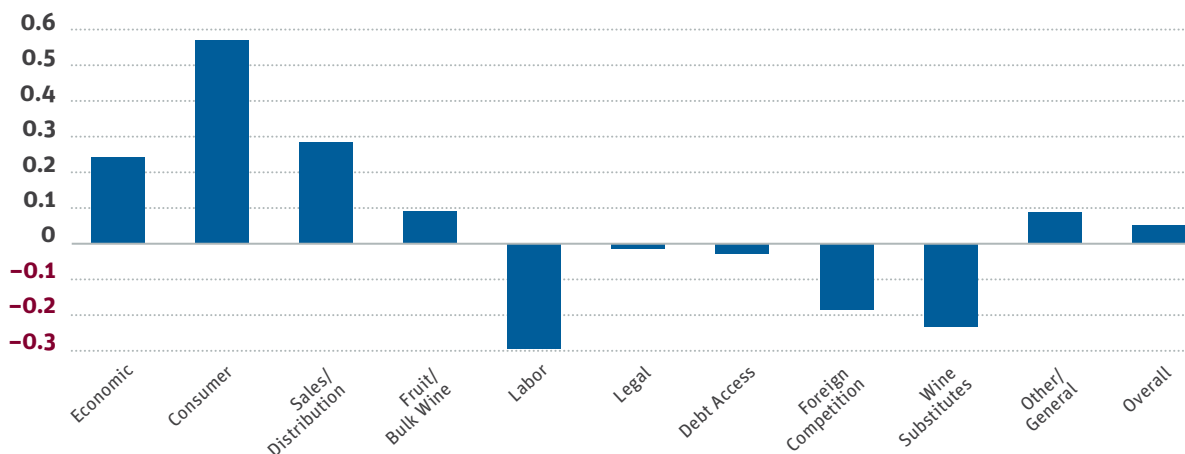
“Much of this shortage, especially during harvest, is caused by the competition from marijuana growers who hire laborers to sit on a white bucket and “trim buds” for \$25–\$30 an hour vs. working in the hot sun in the vineyard, where the average wage is around \$20 an hour.”

Another survey respondent from Paso Robles succinctly pointed out the following problems:

- ▶ Increasing difficulty in finding sufficiently trained and motivated labor for hand harvest
- ▶ Rapidly increasing labor costs as a result of the ACA,⁴⁶ Proposition AB 1513⁴⁷ and soon AB 1066⁴⁸
- ▶ Increasing age of the labor force
- ▶ Political uncertainty concerning immigration and the future supply of qualified labor

Figure 29
Wine Industry Sentiment Index

Source: 2016 SVB Annual Wine Conditions Survey



The last bullet point references the concern that labor issues will be made worse with the possible deportation promises of the president-elect. But the Obama administration also contributed to the issue by tightening the rules under the Fair Labor Standards Act.⁴⁹ I saw this firsthand at a winery client in 2016, when I came for an appointment and found they were getting a surprise audit from the U.S. Department of Labor. Although they had worked through a labor contractor for harvest help and had no vineyard employees, administrative changes to the law now passes liability for recordkeeping to the winery.

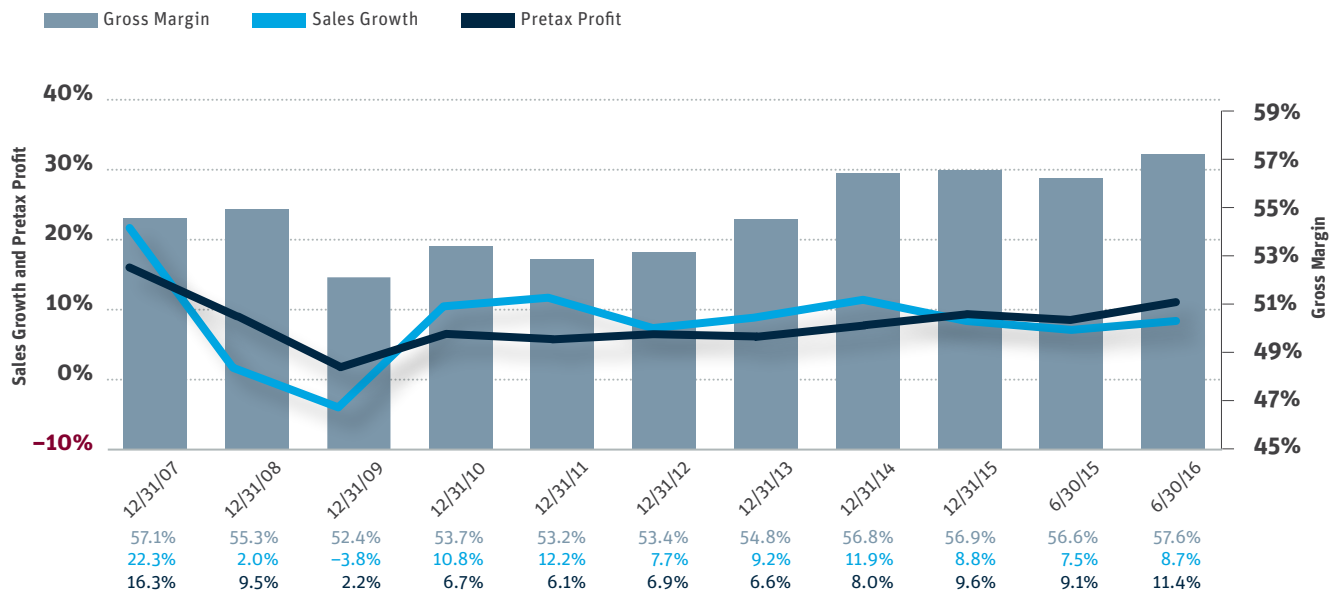
The topic of labor issues is far too long and complex to address in this report,⁵⁰ but there is no question that this issue is a real threat that needs to be addressed – and not just the issue of cost but more importantly the availability of labor or substitutes for labor with more mechanical options employed.

Family Winery Benchmarks

Getting financial information about the wine business is even more difficult than finding someone to go into a shark cage with pork spareribs. The wine business is a collection of private companies, and financial statements and tax returns aren't lying around in the wheelhouse or tasting room. Ask a winery owner how the business is going, and you are likely to get something garbled like Quint when he's had a few too many.

As we look at the financial position of wineries this past year, revenue growth through the nine months ended September 30, 2016, was about 10 percent, which is right in line with our 2016 predicted growth range of 9 to 13 percent (see figure 30). The data for nine months →

Figure 30
Winery Financial Benchmarks
 Source: SVB Peer Group Analysis Benchmarking Database

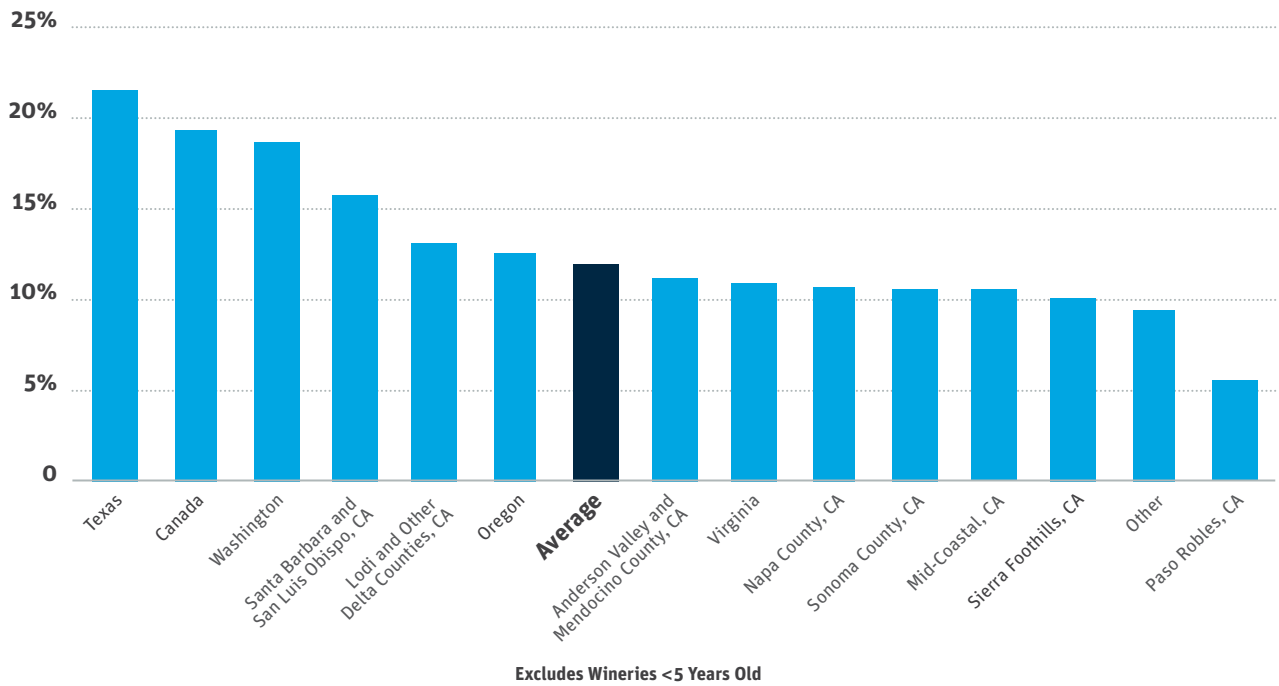


Winery Financial Performance

continued

Figure 31
2016 Owner-Reported Sales Growth

Source: 2016 SVB Annual Wine Conditions Survey



aren't seasonalized, and we should still see the impact of a strong October-November-December period.⁵¹ Survey respondents estimate that average sales growth for the year will end at 11.9 percent, which is a very good report card given the headwinds. Improved sales are due to increased demand for premium wine overall, a growing proportion of direct-to-consumer sales, the release of the well-regarded 2013 vintage and very minor price increases (see figure 31).

Each year, I like to see where producers suggest there is pricing power or a lack thereof. There are several ways to do that, but this year I like the chart of case price increases to bottle price increases. If a segment shows that cases increased 10 percent while sales increased 20 percent, that would be a sign of healthy demand in that segment (see figure 32).

Figure 33
Direct-to-Consumer Sales

Source: Wine Vines Analytics/ShipCompliant

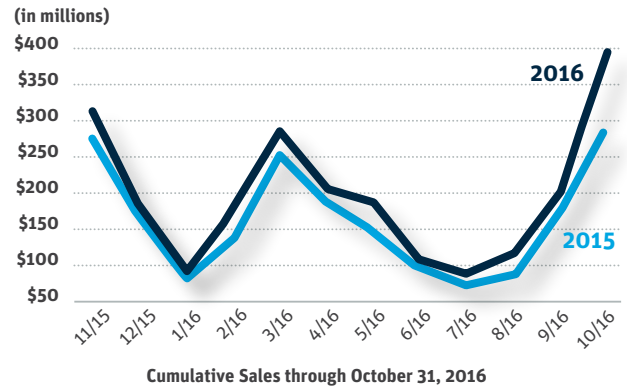
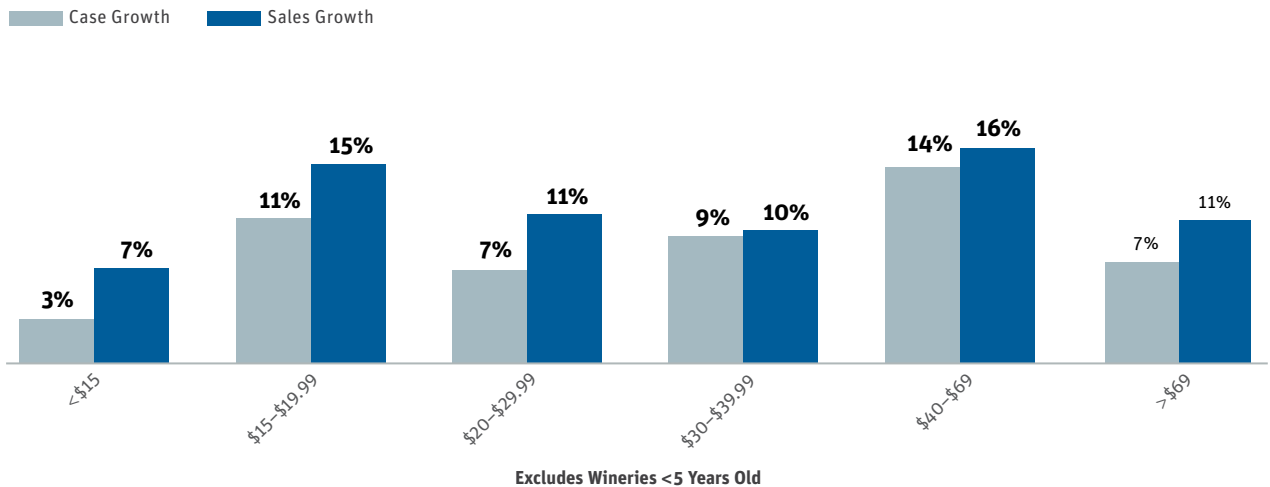


Figure 32
2016 Reported Sales and Case Growth by Price Segment

Source: 2016 SVB Annual Wine Conditions Survey



In 2016, we note stronger price increases below \$30 and more-moderate price increases above. That coincides with the other data in this report that show value growth (dollars) stronger than volume (cases). It also supports my hunch that there is currently limited opportunity to see price increases for luxury wine. Price increases in 2015 were minor, but it was the first year since the recession that price increases were passed on to the consumer; that is a statement about the improving economic situation in the United States and was consistent with our forecast in early 2015.

Direct-to-consumer sales trends continue to show impressive growth rates. ShipCompliant is reporting 12-month shipments totaling nearly \$2.3 billion through October 2016, representing a 20 percent growth rate, with Napa County responsible for the largest component of shipments. The largest varietal component remains cabernet sauvignon, followed in a virtual tie for pinot noir and red blends. The fiscal year will again end with record volume and sales (see figure 33). ■

10



Brody: What day is this?

Hooper: It's Wednesday ... eh, it's Tuesday, I think.

Brody: Think the tide's with us?

Hooper: Keep kicking.

Brody: I used to hate the water ...

Hooper: I can't imagine why.

Final Thoughts

This was the last line in the movie. Chief Brody was noted as being deathly afraid of the water, and by the end he was holding on to a barrel and swimming back to the beach with Hooper.

I'm reminded of the quote: "We can easily forgive a child who is afraid of the dark; the real tragedy of life is when men are afraid of the light." Each of us can become stuck in a rut and believe what we believe, shutting ourselves off from possibilities. It's why I love writing this report each year. I deconstruct the wine business and discover what I missed that was beneath the surface while I was scanning the horizon and doing my full-time day job: being a normal banker.

I hope that the message is an encouragement to you, the winery owner, to stop, look around and get a fresh perspective on the year ahead. Market conditions

don't stay the same, so don't be lulled by the easy response "because that's the way we've always done it." Don't stick with routine without asking why.

Yes, this is a very traditional business, and some things should and will always remain as they are. But the fact that this business resists change only means that there is that much more opportunity to find new and creative solutions. Business is a team sport, so get your team together early this year and dissect the business, strategize, discuss solutions and keep kicking! Your goal is within reach.

Endnotes



- ¹ The Judgment of Paris was a landmark blind wine competition held in 1976 which proved that American wines could compete on equal footing with European wines. <https://www.meininger.de/en/wine-business-international/judgement-of-history>.
- ² There is no widely accepted definition of fine wine. We use the term “fine wine” for wine that sells for more than \$20 per bottle simply because there are several data sources that can be used to look at that segment. In the same way, “premium wine” has no definition. In this report, premium wine is sold in price points generally above \$6 but below \$20.
- ³ Little known fact: The term “blockbuster” was first attributed to the movie “Jaws” and remains a means to describe hit films today. It says that in this link, so it has to be true: <http://jaws.wikia.com/wiki/Jaws>.
- ⁴ “Jaws”: <http://www.imdb.com/title/tt0073195/>.
- ⁵ When I say I’m wrong, I can’t help but think of this scene with Henry Winkler and Ron Howard from “Happy Days”: https://www.youtube.com/watch?v=WkqgDoo_eZE. And, yes, that makes me old because I remember the original airing.
- ⁶ Note that we didn’t actually compute per capita GDP. We used the ratio of case growth to population growth to come up with an estimate. Gallop lists several other stats that could affect the calculation of per capita consumption, such as the percentage of adults who drink, the volume consumed and the mixture of wine to other alcoholic beverages for an average consumer, among others, but this is close enough for the point. <http://www.gallup.com/poll/1582/alcohol-drinking.aspx>.
- ⁷ “Guess the Tonnage” is an annual ritual we all play in California because nobody knows at this time of year, but we all love to apply voodoo and twisted science to see if we can find the perfect algorithm. Dinners are waged and bragging rights won. I was only close this year, but I’ll have to take my lovely parting gifts this time.
- ⁸ SVB State of the Industry: Throughout this report we reference the SOTI or SVB Annual Wine Conditions Survey. We survey the wine business annually to get a better understanding of the state of industry affairs. Respondents get about 75 pages of charts and analysis for 12 minutes’ invested time. If you would like to be added to the two surveys SVB does each year, please email Penny Northrop: pnorthrop@svb.com.
- ⁹ Allied Grape Growers, CAWG 2016: <http://www.alliedgrapegrowers.org/present/CAWG2016.pptx>.
- ¹⁰ Note that the box wines are premium wines above \$18. Box wines below \$18 are not doing well. The reason they show up in the \$3 to \$6 category is the in-store price is divided by four to adjust the 3-liter format to compare with the other 750-milliliter bottles.
- ¹¹ Fighting varietals: <http://www.nytimes.com/1990/04/18/garden/wine-talk-715490.html>.
- ¹² The origination of the term “premiumization” has been attributed to Rob McMillan by the award-winning author Jeff Siegel, aka The Wine Curmudgeon. If Jeff said it, it must be true. <https://www.winecurmudgeon.com>.
- ¹³ Yes, it’s a crappy rhyme, but Quint’s is pretty bad, too.
- ¹⁴ Technomic Anticipates Modest Growth of Alcohol Sales in Bars, Restaurants: https://www.technomic.com/Pressroom/Releases/dynRelease_Detail.php?rUID=434.
- ¹⁵ 2016: A Happy New Year On-Premise?: <https://blogs.technomic.com/2016-a-happy-new-year-on-premise>.
- ¹⁶ Technomic Trims Restaurant Industry Growth Expectations Moving into 2017: <http://www.prnewswire.com/news-releases/technomic-trims-restaurant-industry-growth-expectations-moving-into-2017-300369455.html>.
- ¹⁷ Wine Sparks War Between the States: <https://static1.square-space.com/static/533dbefce4b0b65c53504cf3/t/5368c22be4b0dbc1364ef3b3/1399374379281/wine+sparks+war+between+the+states.pdf>.
- ¹⁸ Estimates of total direct sales in the mid-1990s vary widely in the literature.
- ¹⁹ Granholm vs. Heald: https://en.wikipedia.org/wiki/Granholm_v._Heald.
- ²⁰ Red blend craze: <https://www.fb101.com/2016/12/prowein-2017-specialist-article-no-2>.
- ²¹ Bartles & Jaymes was a marketing masterpiece in the 1980s. If you are interested in marketing, that brand is worth reviewing. Here’s a clip from one of the commercials: <https://www.youtube.com/watch?v=hYdWHK6AA6E>.
- ²² Moscato drives US wine sales to new heights: <http://bit.ly/1XL1Hll>.

Endnotes

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- ²³ The “Sideways” Effect: <http://www.winesandvines.com/template.cfm?section=features&content=61265>.
- ²⁴ I am told that cannabis takes a lot more water than grapes but, no, I am not going to talk about the legalization of marijuana in the West. Don't we have bigger fish to fry?
- ²⁵ See what I did there? Ironically, using drought juxtaposed against “the water's fine” when the water is short while at the same time referencing the movie? I might get a Pulitzer for that one.
- ²⁶ Wineries in Canada have organically started to increase their response rates on the survey. We are to the point today where we can produce some meaningful information. That said, Canada is a big country and the results from a winery in British Columbia can vary dramatically from results in Ontario.
- ²⁷ Instead of saying we applied math to come up with our forecast, I really wanted to say I used an algorithm. Doesn't that sound so much more awesome and intense? Wall Street bankers use algorithms all the time, but I'm a little more old school. I just have math and experience to guide me.
- ²⁸ I can't believe that red zinfandel is falling out of demand as a varietal because it's always been one of my favorites, but this is a bit of a repeat, I think. To this day in the United States, merlot and syrah are still not desirable varietal wines because they were planted in too many different places and consumers never knew what they were getting. With zinfandel, it's the Ravenswood and Rosenblum effect. Big wine companies bought premium brands and tried to make a million-plus cases, but there weren't enough grapes for that and now consumers don't know what good California zinfandel is. <steps off his pulpit>
- ²⁹ SVB Report on wine transitions in 2008: <https://www.svb.com/pdfs/wine/WineTransitionReportJan2008.pdf>.
- ³⁰ “Gateway wines” is a term used in the trade for entry-level wine that has historically been produced in California's Central Valley. They were simple, well-made wines, often with a little residual sugar remaining that appealed to wine consumers at the start of their discovery curve. That's another phrase that should be added to the Urban Dictionary.
- ³¹ Information about Washington and Oregon land and values isn't presented in this report because of a lack of available data. Without question, growth rates in both states exceed what is happening in California precisely because there is plantable land in Oregon and Washington that fits consumer demand at better values compared with California.
- ³² Superior good: https://en.wikipedia.org/wiki/Superior_good.
- ³³ SVB on Wine: <http://svbwine.blogspot.com/2016/03/the-2016-wine-market-councils-findings.html>.
- ³⁴ Great Depression: <http://www.history.com/topics/great-depression>.
- ³⁵ Technomic Finds Millennials' Adult Beverage Choices Evolving as They Mature: <https://blogs.technomic.com/technomic-finds-millennials-adult-beverage-choices-evolving-as-they-mature>.
- ³⁶ “Frugal hedonism” is a term I'm coining to describe a consumer trend I've noticed but haven't seen documented. Younger consumers understand artisanship and quality. Instead of consuming as much as they can by volume on credit as did my generation, they prefer to live in smaller homes, reduce their living expenses, stay away from consumer credit, drive less expensive cars that have appealing style and save their discretionary income for simple luxuries they truly enjoy.
- ³⁷ This past year, I was the keynote and final speaker at the three-day Romeo Bragato conference in New Zealand. I addressed some important economic underpinnings, and just before I went on the organizers told me that normally the final slot was for their inspirational speaker — “so go be inspiring!” My opening line was, “You guys asked a U.S. banker speaking on the dismal science — economics — to be your inspirational speaker?!” It did get a good laugh, which is what's most important. <http://www.bragato.org.nz>.
- ³⁸ The Golden Age of Capitalism refers to the post-WWII economy. Here is a short article if you want better color: http://www.glovesoff.org/features/gjamerica_1.html.
- ³⁹ GI Bill: <http://www.history.com/topics/world-war-ii/gi-bill>.
- ⁴⁰ The findings of a Sonoma State University survey on the locals' views of tourism was revealing and covered in a blog post here: <http://bit.ly/1NSAVmo>. California Polytechnic State University conducted a similar survey several years ago with similar results.
- ⁴¹ I've been speaking to planning commissions about the wine business for the past couple of years. It is important that local officials be given the facts about the business to consider in their deliberations vs. long lines of people taking the podium to complain and then offer unsupported opinions about the business. While that's not a contest anyone wants to win, I'd say Santa Barbara has the worst situation. A small group of residents there is pushing for regulation that is even more restrictive, when the county already prohibits tours or tastings at the winery itself.

Endnotes

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⁴²NIMBY (“not in my backyard”): Individuals who protest any change that may have an impact on their living space, using any variety of true or invented rationale. For instance, someone who moved to the wine country because of its beauty might show up and complain about a winery starting up near their home.

⁴³The California Environmental Quality Act (CEQA) is a law that was put in place to ensure that stakeholders have a say in any development that could affect the environment. It is often used as a stalling tactic because the cost is borne by the party wishing to develop a property; it can cost well over \$100,000 and take several years to complete. http://resources.ca.gov/ceqa/docs/2016_CEQA_Statutes_and_Guidelines.pdf.

⁴⁴Napa traffic is locals: http://napavalleyregister.com/news/local/study-reveals-who-s-clogging-napa-highways/article_267462a6-3de7-58fa-80f4-4055273d2621.html.

⁴⁵Conference Board Consumer Confidence Index: <https://www.conference-board.org/data/consumerconfidence.cfm>.

⁴⁶Affordable Care Act (Obamacare): <https://www.irs.gov/affordable-care-act/affordable-care-act-tax-provisions>.

⁴⁷Piece-rate legislation: http://www.dir.ca.gov/pieceratebackpayelection/AB_1513_FACT_SHEET.htm.

⁴⁸Assembly Bill No. 1066: https://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=201520160AB1066.

⁴⁹Fair Labor Standards Act: <https://www.dol.gov/whd/flsa>.

⁵⁰Immigrant farmworkers are at times politicized and are said to take U.S. jobs. On the face, that seems unlikely to me. The hard labor the farmworkers have been willing to assume isn't something most Americans want. To that end, I found this interesting study from the milk industry in North Carolina: <http://www.renewoureconomy.org/sites/all/themes/pnae/nc-agr-report-05-2013.pdf>.

⁵¹In the wine business, the months of October, November and December represent about 40 percent of annual sales.

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