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State of the Wine Industry 2016

Written by Rob McMillan, EVP and Founder
Silicon Valley Bank Wine Division



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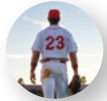
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Introduction



Umpires Meeting



This year we hope marks the easing of one of the longest droughts in California history.¹ The national economy, emerging from a long real-estate related recession, is just beginning to deliver a consistent pulse. The stock market was getting back to record highs, coming off one of the worst worldwide downturns in the history of equities.² The price of oil has been cut by more than 50 percent and oil from Non-OPEC producing countries is flooding the market. OPEC continues to show that it's unable to enforce production quotas and manage price.³

In the wine business, the grape harvest is regarded again as excellent in quality but with lower yields across most regions and varieties following a string of several good vintages. Premium wines are in very strong demand as buyers trade up⁴ into fighting varieties, but grapes destined for lower price segments are starting to lag, leading farmers to consider vineyard removals in the San Joaquin Valley.⁵

Imports are grabbing shelf space; in part the result of an unusually strong U.S. dollar. Distributors are proving fickle and starting to ignore wine made by small domestic producers, thus putting increased importance on tasting rooms and wine club sales channels. The change to direct to consumer sales has increased tourism, which is becoming very controversial in Napa County in particular.⁶

There are 1,541 working wineries in the U.S.⁷ The cost of a movie ticket is \$4.11, and the movie *Bull Durham* is quietly released to theatres, coming in as the fourth most popular film of June ... 1988.

If you work in the US Wine Business, that narrative seems familiar until you get to the end. While the circumstances seem a lot like today, the narrative is from industry conditions in 1988, not 2015.

We lead this year's report with a reminder that the wine business often runs in cycles and endures very long trends. History, as we know, can be quite helpful when used to forecast the future, so this year we've taken a little time to remind ourselves where we've been before making our predictions. And once again we're using a movie theme to frame the discussion and hopefully keep you entertained.

1988 looked a lot like 2015 in the wine business and was the year *Bull Durham* was released.⁸

Many elements of the movie can be overlain with events symbolic of today's wine business, but one of the movie's themes in particular, adapting to change and passing the torch, is a message the wine business should consider in 2016.

We'll use America's pastime and *Bull Durham* to frame our views in this year's report. Hoping you catch a few ideas, we now invite you to lace up your cleats and dig in as we present our annual review, discussion and predictions for the U.S. wine business in 2016. ■



Joe Readon: He walked 18.

Larry: New league record!

Joe Readon: Struck out 18.

Larry: Another new league record! In addition, he hit the sportswriter, the public address announcer, the bull mascot...twice!

Larry: Also new league records! But Joe, this guy's got some serious sh*t.

1

Records and Statistics: Our Predictions in Review

In the movie, Nuke had just pitched his first professional game and was already in the record books for strikeouts, walks and hitting the mascot. His grades were a little erratic, but at least they were keeping score. The same can't be said for most economists who give "cautiously optimistic predictions." I say you either point to the fence and call your shot like the Babe, or go sit on the bench.

We don't weasel out in this report. We take a position and we will be judged on our record just like Nuke. We throw hard and let the chips fall where they may. Sometimes we throw strikes and on rare occasion, we hit the mascot. But we still review the forecasts made the prior year just to make sure we are presenting more strikeouts than walks. Here is what we said in last year's report:

Global and U.S. Economic Factors

We are seeing real strength in the U.S. economy going into 2015:

- ▶ Oil price declines are transferring wealth to oil-consuming countries and will deliver hundreds of millions of dollars in stimulus to U.S. consumers in 2015.
- ▶ The employment picture is improving at an accelerating pace in the United States. We expect the U3 unemployment rate (the primary measure of unemployment) will approach 5 percent during the year.
- ▶ Japan, China and the EU are delivering sub-optimal results, and those currencies are weakening against the dollar.
- ▶ The likelihood the Fed will increase rates in 2015 has grown, and we predict some movement in messaging first in early 2015, and actual rate moves higher by Q3.

- ▶ Interest rate moves will happen at a slow pace given that inflation will be in check from lower-priced imports and fuel savings, leaving deflation still a concern.
- ▶ We predicted U.S. GDP would be better in 2015 compared to the prior year and come in near 3 percent. It appears as though it will end well below 3 percent and about even with 2014 when final Q4 numbers are released.
- ▶ The unknown in the world equation is unrest from countries such as Russia and Iran, should their oil-based economies falter more than they already have.

As long as the industrialized world economies can hold their own and not drag down the U.S. economy as their own recoveries catch up, the middle-income U.S. consumer will see improved prospects and will be toasting to that.

The drop in the price of oil has been due to sagging world demand early in the year, but we believe the impact of the fracking boom has added to the situation, putting oil prices into a strong downward trend.

We expect oil prices to remain low throughout 2015. →

Records and Statistics: Our Predictions in Review

continued

Supply

When harvest is analyzed and reported, we expect we'll announce a third consecutive harvest of heavy yield and great quality across most appellations. That is unprecedented.

While there are varietals and regions where there is excess supply, we believe fine wine producers who feel slightly long will find the gallons in their cellar to be a blessing in disguise by the end of 2015.

Massive bulk imports will continue to dominate the wine categories at the lowest price points, but bulk imports should be held back by the size of the 2014 harvest and supplies currently in cellar.

Demand

Starting in mid-2014, wines priced above \$20 a bottle broke out strongly higher. "Trading up" is a clear trend again. Red wines in particular showed the strongest growth. We expect that to continue throughout 2015.

Growth in 2014 sales of wines priced above \$20 was driven by accelerating volume with little in the way of price increases getting through to the consumer.

Pricing

While the large supply of wines in winery cellars should normally indicate continued depressed pricing, we believe 2015 will be a year of both volume and price increases driven by an improving economy and higher demand in the higher-priced wine categories.

Wines priced below \$9 per bottle performed poorly both on and off-premise in 2014. The poor performance is likely to continue into 2015.

After finishing the year at the top end of our predicted growth in sales of 6–10 percent, we are predicting a breakout year of sales growth in fine wine⁹ and anticipate accelerating sales through the year, ending in the 14–18 percent range in 2015.

Planting

Grape planting opportunity is shifting north: Oregon and Washington are showing strong growth in planting on a percentage basis, and we expect that will continue for the foreseeable future given favorable quality/price dynamics relative to the fine wine growing regions in California.

The growing regions in the North Coast are running into difficulty in permitting and with high land costs. Replanting is continuing in older vineyards and those with red blotch. Suitable sites for expansion are becoming more difficult with each passing year.

The Central Valley reports it will pull about 20,000 acres of grapes that were directed to wines priced under \$7 given a structural oversupply.¹⁰

Financial Performance

Direct-to-consumer sales will continue as the largest growth channel for most wineries.

Most wineries will say 2015 was one of their best seasons by the end of the year.

It seems when we look at last year's report, we see that we hit the ball out of the park on predictions and came in with only one strike against us:

What we got wrong:

We predicted U.S. GDP would be better in 2015 compared to the prior year and come in near 3 percent. It appears as though it will end well below 3 percent and about even with 2014 when final Q4 numbers are released.

What we got close:

We predicted the Fed would change their messaging and guidance in early 2015, which we got right. But we believed they would move rates by Q3, and instead they moved in Q4. Still not a bad guess if you tracked that debate through the year.

We said interest rate moves would be slow and deflation would be a concern. Deflation is not a real concern at this point, but in mid-2015 the Fed did clarify that any rate increases would be “measured,” which was our expectation.

What we got right:

We forecasted a 14–18 percent growth in the fine wine segment, and will come in at the low end of the range.

We predicted the unemployment rate would approach 5 percent, which was spot on.

We predicted strength in the U.S. dollar against the EU, China and Japan.

We expected oil prices to remain low throughout 2015.

We “guessed” we couldn't have a record fourth harvest yield, and with higher consumption trends, we thought the heavy 2014 would end up being a blessing in disguise.

We said bulk foreign imports would drop in 2015. We said trading up was a clear trend again. Red wines in particular showed the strongest growth. We expected that to continue throughout 2015. It's hard to imagine repeating the success of last year's predictions. We focused on the economy as that's where all the variability was for the year ahead, and we came in solid with predictions in interest rates, oil prices, and exchange rates — all things my economics professors told me never to forecast in writing. It's probably not as rare as a triple play, but it was a good year with the crystal ball in 2015.

For 2016, we are going to throw a screwball and leave out most of the economic discussion we would normally present. Instead, we are going to spend all the report talking about the industry shifts underway so we all clearly see the pitch that's being thrown. ■



Skip: You guys. You lollygag the ball around the infield. You lollygag your way down to first. You lollygag in and out of the dugout. You know what that makes you? ... Larry?

Larry: Lollygaggers!

Skip: Lollygaggers!

2

Box Score: 2016 Summary Forecast

Lollygagging is not a winning strategy. A good baseball team can't lollygag. They have to be a step ahead in the field to cut down the speed of the game. One strategy to get that extra step on the runner is called the "the wheel" play. That's a scheme where the infield rotates to cover other positions while the third baseman charges to field a bunt.¹¹

In the wine business today, we have a similar mass rotation underway where elements of the wine business are evolving to different roles and making new investments for the future.

There's a permanent rotation to higher-priced wines, along with a pivot by large wine producers away from the mass-production wine brands of the past. Those big wineries still have overhead to cover so they are making acquisitions in premium wineries and positioning themselves in front of the play.

Existing luxury wineries are growing with brand and winery acquisitions, as are large wineries looking for strategic purchases to gain a toehold in the premium space or control land. Institutional players are in the game buying up vineyard holdings to diversify their investments.

Regarding the team composition in the year ahead, the mature generation has announced its retirement from the game in 2015 after having a great career. Baby boomers, who have dominated the business over the past twenty years, are rotating to cover the mature's vacated bag. By 2021, Gen Xers will slide over to cover the baby boomer's spot as the dominant fine wine consumer in the league.

The millennials, who have been hounding the coach for increased playing time but were just too young before, finally look like they will get a starting role this year. For the first time ever, their consumption habits have passed the mature generation with 16 percent of the consumption-share in fine wine. They are showing the promise that scouts have seen and talked about in the hot stove leagues for the past decade.

We are worrying a little about the popularity of the domestic game with so many choices and competition from foreign franchises. We believe we will see bottled fine wine imports begin to take a larger market share in the business this season, while bulk foreign wine loses market share. The bulk league is a low price show and fans are losing interest.

We believe attendance will be impacted a little this year, and the growth in per capita consumption of wine will reverse the long term growth trend, as the millennials now on the field are showing the willingness consume other alcoholic entertainment at this time in their drinking careers. As they get consistent playing time, we believe they will improve their focus, but sadly, foreign wine will be a permanent part of that focus. →

Box Score: 2016 Summary Forecast

continued

The cost of tickets will be going up this year. We expect to see bottle prices rise by 4–8 percent above the \$10 price point, and we will see both volume and price drop below \$8 bottle price.

Growth in the fine wine game will be slightly off of the 2015 season given demographic shifts, and slowing 2015 restaurant sales extending into 2016. There is a lot of good wine out there and some négociants are angling to take some of the fans interest away from established brands. That will make it a good year to be a consumer seeking new values.

A good ball club anticipates, and we want you to be ready when the play comes your direction. So, here are our observations and predictions for 2016 to help you make the best business decisions:

Wine Specific Predictions

- ▶ We are forecasting a sales growth range of 9–13 percent for the premium wine segment in 2016, down from 14–18 percent in the prior year.
- ▶ Growing local regulations around tourism will continue to damage opportunities for small wineries to sell direct.
- ▶ With the transactions we presently see in the queue, we will certainly start off the year again with some large and notable sales of premium vineyards and wineries. Mergers and acquisitions (M&A) will remain active throughout the year.
- ▶ Tens of thousands of additional grape acres will be permanently removed from the California Central Valley.
- ▶ A strong and strengthening U.S. dollar, available foreign supply, and willing millennials will encourage imports at all premium price levels.
- ▶ Growing bottled market share of imports should be a heightened concern of U.S. producers.

- ▶ The narrowing supply of arable land suitable for higher-end wine production will drive vineyard prices higher.
- ▶ Oregon and Washington will continue to see high interest for vineyard acquisition for premium and luxury wine production.
- ▶ We expect to see bottle prices rise by 4–8 percent above the \$10 price point, and see both volume and price drop below \$8 bottle price.

Supply

- ▶ Worldwide supply is beginning to creep up into uncomfortably familiar territory, particularly in the EU. Area under vine is increasing, while world and EU per capita consumption is decreasing.¹²
- ▶ Our guess for total harvest in California is 3.6 million tons crushed, which is off about 8 percent from 3.9 million tons crushed in 2014. Quality was excellent, but some area-specific challenges will be noted from set issues in the spring. Harvest was early everywhere. It was average crop size in the San Joaquin Valley, and light elsewhere.
- ▶ Oregon's harvest was early, huge and another consecutive vintage of the decade.
- ▶ The early read on Washington's harvest suggests it was similar to Oregon's in timing and quality, but more of a normal yield.
- ▶ Bulk imports will decrease, but that will be due to shrinking consumer demand for low-priced wine rather than U.S. wine recovering market share.
- ▶ Overall supply in California is still slightly long, but close to balanced in premium wine regions. A light 2016 harvest wouldn't be desirable. →

We are forecasting a sales growth range of 9–13 percent for the premium wine segment in 2016, down from 14–18 percent in the prior year.

Box Score: 2016 Summary Forecast

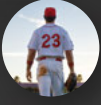
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Demand

- ▶ Per capita consumption of wine in the U.S. will temporarily reverse trend as millennials, who are consuming more craft spirits and beer, begin to replace retiring baby boomers, and as a larger consumer focus is placed on premium versus generic sales overall.
- ▶ Today, millennials are beginning to impact the lower price of premium sales. They are most visible in the \$8–\$14 red blend category but will trend higher as their income allows.
- ▶ Millennials are more open to world wines compared to baby boomers at the same time in their palate evolution.
- ▶ Growth in wine restaurant sales fell dramatically in 2015 across all premium price points. We expect that to stabilize in 2016.
- ▶ The Gen X cohort will surpass the baby boomer cohort around the year 2021 to become the largest fine wine consumer demographic in the U.S. A short five years later, by 2026, the millennial cohort will surpass the Gen X cohort 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 mature cohort who placed their trust in brand versus varietal. That has implications for producers that have leaned on varietal labeling for developing a 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, there are no producing countries showing interest in that segment today.
- ▶ We will see decline and stagnation in wine sold by volume as the premiumization trend continues to strengthen and wine by volume continues to lose favor. The \$3–\$6 segment appears most at risk. ■



Per capita consumption will temporarily reverse trend as millennials, who are consuming more craft spirits and beer, begin to replace retiring baby boomers.



Larry: [Larry jogs out to the mound to break up a players' conference] Excuse me, but what the hell's going on out here?

Crash Davis: Well, Nuke's scared because his eyelids are jammed and his old man's here. We need a live ... is it a live rooster? [Jose nods]

Crash Davis: We need a live rooster to take the curse off Jose's glove, and nobody seems to know what to get Millie or Jimmy for their wedding present. [looks to the players]

Crash Davis: Is that about right? [the players nod] [looking at Larry again]

Crash Davis: We're dealing with a lot of sh*t.

Larry: Okay, well, uh ... candlesticks always make a nice gift, and uh, maybe you could find out where she's registered and maybe a place setting or maybe a silverware pattern. Okay, let's get two! Go get 'em.

3

The League: Worldwide Supply and Consumption Patterns

Sometimes life can get confusing with distractions galore; a cursed glove, what to get for a wedding gift and your father watching you. When life gets confusing, you need a Larry around to sum it up and give perspective. You need someone to keep the big picture in mind, which is just what we will try to do in reviewing the current state in worldwide supply and demand for wine.

World Production

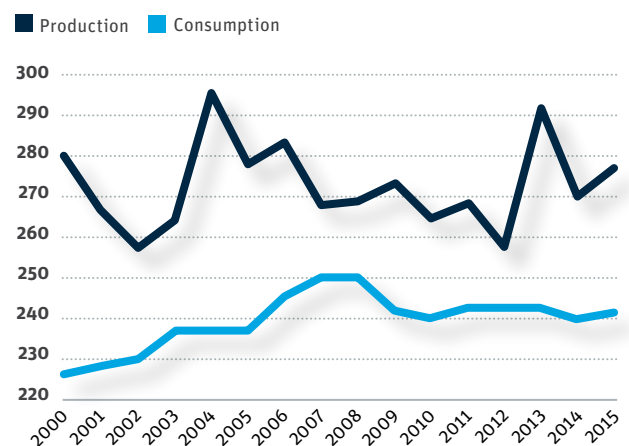
Prior to recent history, the inventory balance in world markets was off significantly. For decades leading up to the mid-2000s, the EU produced materially more wine than was needed. Catering to popular sentiment at the time, those producers who couldn't sell their harvest were paid for their unsold grapes with government entitlements, in what was termed "emergency distillation," a program in which excess grape production was converted into industrial ethanol.

The EU recognized that the obvious non-market support mechanisms were killing prices for their successful farmers and perpetuating a disastrous over-supply. So after several years of negotiations between producing countries, in 2007 the EU put into place a controversial Communal Regulation (CMO), which phased out emergency distillation and ended the program entirely by mid-2012. A new program was then established which paid European growers to uproot 175,000 hectares (about 430,000 acres) of economically unsustainable and lesser-quality vineyards. To give that perspective, what was taken out of production is equivalent to 87 percent of the entire planted wine grape acreage in California.

According to the OIV,¹³ Spain, Italy, France, Portugal and Hungary have been the major benefactors of the CMO. In concert with increased EU exports, that lake of wine that once existed in Europe has now receded to a pond. But when one looks at Figure 1, consumption and production never cross or meet. The gap between the two is surplus and one has to ask, where does that surplus go? →

Figure 1
Worldwide Production vs Consumption (in Mhls)

Source: OIV. Includes all information through May 2015

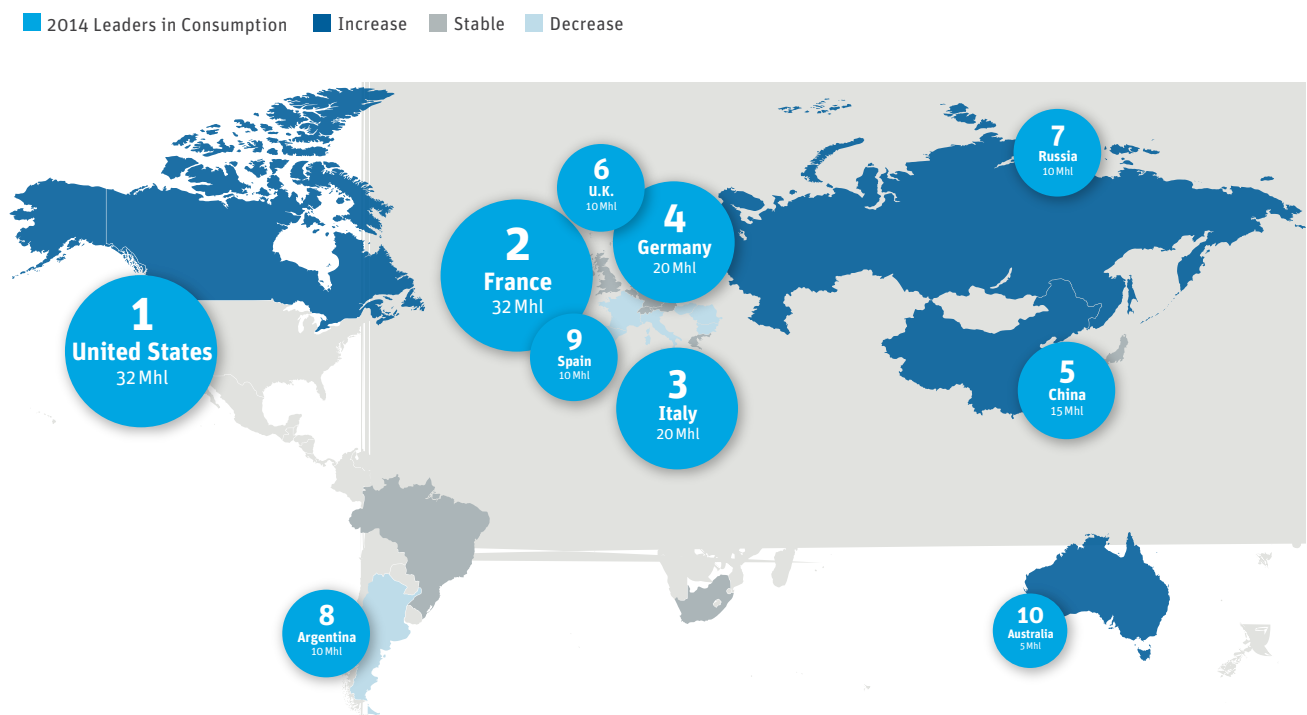


The League: Worldwide Supply and Consumption Patterns

continued

Figure 2
2000–2014 Worldwide Change in Consumption

Source: OIV



The gap in production and consumption is mitigated by demand for wines used for retail-industrial purposes. The major uses are brandy, vinegar and vermouth production.¹⁴ Reviewing Figure 1 prior, it's obvious that the gap in production and consumption is widening again. Is Europe again overplanting? The OIV as of this writing believes the world supply and demand are in a balance,¹⁵ but we believe recent plantings in Spain, France and Italy, and slowing per capita consumption throughout the EU and U.S. might make that world balance tenuous.

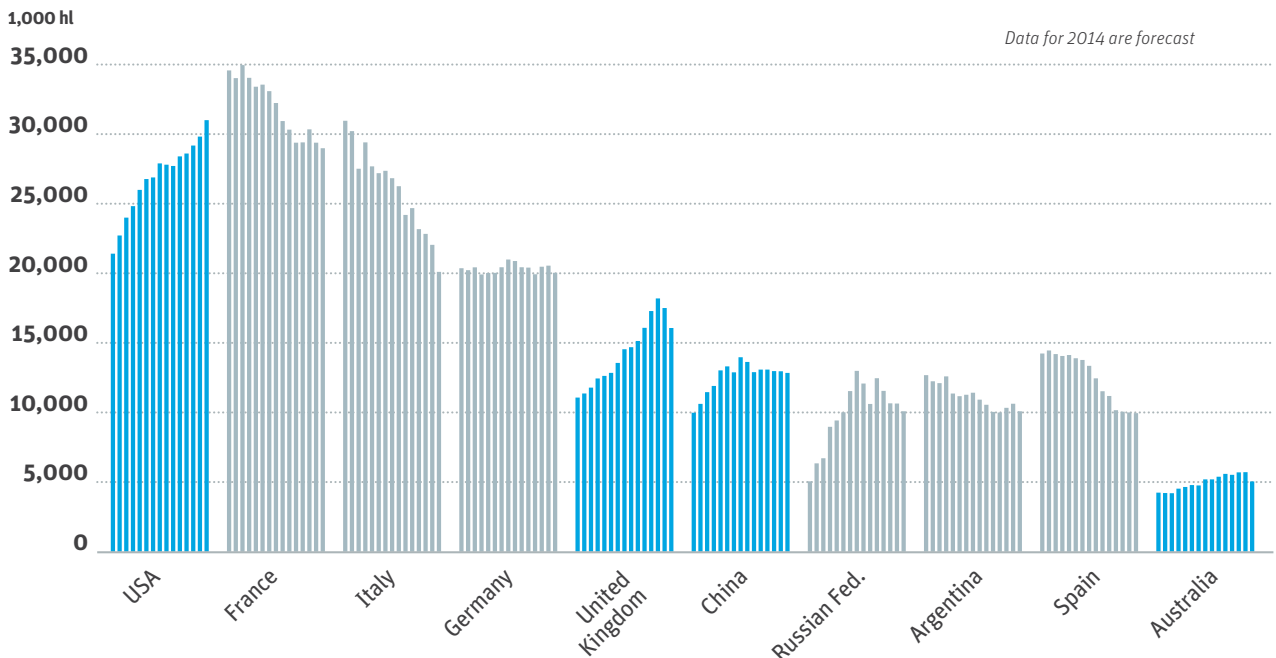
World Consumption

World consumption of wine has stalled at around 240 million hectoliters, but there is a clear shift in consumption away from France, Italy and Spain, and toward the United States, the United Kingdom, China, Russia and Australia. Today, about 39 percent of wine is consumed outside Europe, compared with 31 percent in 2000,¹⁶ and the United States is the world's top-consuming country. →

Figure 3
Trends: New Customers 2000–2014

Source: OIV

■ New consumers have entered the scene, due to increasing incomes and changes in drinking preferences

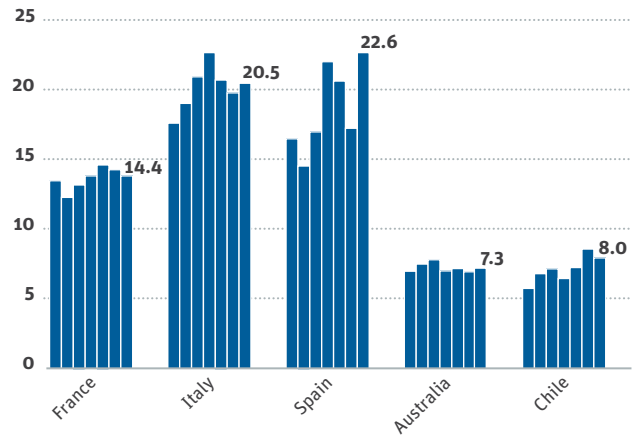


World consumption has been going through a rotation for about a decade. Since 1998, the higher-consuming countries of France, Italy, Spain and Portugal each experienced significant declines in per capita wine consumption (Figure 3), so much so that by 2006, Europe was producing about 150 million cases more than it could sell.

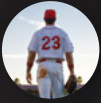
Italy has led the world in export volumes for some time, but last year (2014), exports from Spain bypassed Italy (Figure 4). France leads Italy and Spain in the value of their exports, with each reporting the value of exports at €7.8, €5.0 and €2.5 billion respectively, which is roughly

Figure 4
Trends: Exports in Volume 2008–2014 (in Mhls)

Source: OIV



unchanged from the prior year. Countries making moves in world exports include Chile, which has moved into the fourth position worldwide over Australia, and South Africa, which has leapfrogged several countries to move into the sixth spot. The largest importing countries are Germany, the U.K. and the U.S. with 15, 13 and 11 percent of the total world import volume. ■



Annie Savoy: The world is made for people who aren't cursed with self-awareness.

This is one of Annie's unique views. Someone who is unaware walks around in his or her own world. But the world today doesn't stand for the unaware. They get run over

like a collision at home plate.¹⁷ If you want to succeed, you need to be smart, lucky, work hard and learn the lessons on how to be a pro from the vets around you.

History of the Game

4

1800s–Today

History has a thousand lessons, yet many even in the business don't know the history of wine in America, so this year we are taking a different path with the report and spending time talking about how we got to 2016 as a commercial industry. While interesting in and of itself, the changes and trends in this business are long-lived and our predictions are much more impactful when one considers them in the context of historic industry events.

History of the Game

continued

1800s–1960s

Early History

The first 100 years of the wine business in the U.S. saw its birth, near death and revival.

The story essentially begins after the gold rush as European immigrants started the early wineries in California. After a promising start, from the 1890s through the 1920s, the industry was slowly undone by events and attitudes of the day. Prohibition all but killed off the industry. After the repeal of Prohibition in 1933, however, the wine business started its comeback.

1849



The story begins after the Gold Rush with European immigrants starting early wineries.

1898



By 1898, California's 40-year-old industry reaches peak production of 30 million gallons.

1919



A constitutional amendment passes, setting up the future enactment of Prohibition in 1920.

The 1800s–1930s

The Birth and Death of an Industry

Most Americans would probably guess the U.S. wine business started with Jefferson or perhaps in California, but neither would be correct.¹⁸

The U.S. wine industry really only got its start in the West in the late 1800s after the gold rush. Though focusing here on California, the paths taken by Washington and California were similar early on.

At the end of 1848, California was estimated to have fewer than 14,000 inhabitants, exclusive of Native Americans. Four years later, the official state census recorded a population of 224,000.¹⁹ At the end of the gold rush, the state was swollen with European immigrants who were looking for real work and a beverage to drink besides Red Eye. Taking a page from their home countries, they decided wineries might be a good thing to start.

Successful commercial winegrowing first started in Southern California, but by the mid-1870s was increasingly successful in the northern part of the state. By 1898, forty years after the commercial founding of the industry, California reached peak production at 30M gallons. California developed a burgeoning reputation for making great wine and even began winning gold medals in European competitions. But to think today's version of the U.S. wine business had its founding in the 1800s would still be a generous reading of history, as the nineteenth century wasn't at all kind to the founding entrepreneurs. To name some of the obstacles:

There were wild yield variations early as farming evolved, the Panic of 1893 led to a steep economic depression and bread lines across the country and world, and phylloxera hit vintners in the late 1800s. World War I redirected attention →

1933



Prohibition ends, but the resources and expertise needed to produce wine have been lost. The Great Depression kills off most of what remained.

1940



Rapid growth has California home to nearly 500 wineries.

and resources, and several states enacted dry laws due to the temperance movement. Prohibition in 1920 was nearly the final blow in the once hopeful business. But threads still hung on through both implementation and the duration of the Volstead Act.²⁰

Many growers found ways to stay in business through home winemaking sales, producing concentrates, and selling raisins.²¹ A thriving North Coast trade existed selling wine to Italian restaurants in San Francisco where it was served in coffee cups, but production trended down, and by 1930 reached a low point of 3 million reported gallons.²² The final nail in the coffin of the early U.S. wine business was the beginning of the Great Depression that same year. By the early 1930s, the commercial wine business in California was essentially gone. The experience of the founding entrepreneurs reminds me of the joke: His luck was so bad, if he bought a graveyard, nobody would die! <bada-bing>

The 1930s–1960s Awkward Re-Start

The wine industry restarted after the repeal of Prohibition in 1933, but a survey of business conditions revealed a dismal landscape with few business resources remaining. Much of the technological expertise that existed in the wine industry prior to 1920 was lost during Prohibition and almost no viticulture or enology research had been done anywhere in the U.S. from 1920 to 1933. Many vineyards had been replanted to other crops or let go to waste. Barely a handful of wineries had survived and there were no experienced wine-makers or vineyard nurseries left to help restart the tattered trade. But with the promise of a better future, investors smitten with the romance of the trade rebuilt and wineries started popping up in numerous states throughout the U.S. and the West.

The volume producers found California grape growers were producing about a quarter of a million tons of excess grapes each year until 1971, giving volume producers significant pricing power over growers.

The majority of new winery growth took place in California, but by 1938, there were 42 wineries located throughout Washington and a handful of fruit-based wineries in Oregon. By 1940, California was home to slightly less than 500 small wineries. But despite that impressive early growth in new wineries, growth quickly stalled and reversed course. Thirty vintages later in 1970, the number of California wineries had dropped to fewer than 250,²³ with just a few larger high-volume wineries dominating the business. With a few exceptions, the premium side of the business never quite got traction. For perspective, until 1967, desert wines, port, sherry and muscatel were the largest selling California SKUs.²⁴


Why the reversal in new business starts after such a promising rebirth? The volume producers found California grape growers were producing about a quarter of a million tons of excess grapes each year until 1971, giving volume producers significant pricing power over growers. From the consumer perspective, the large producers were able to deliver what the consumer wanted: simple wines, at times sweet or fortified.

Large brands also had advertising muscle and they focused on their own brand instead of the varietal making the wine, which in the thinking of the day would only dilute the value of the producer's trademark. The large producers also benefited from economies of scale and could deliver in-demand wine at an inexpensive price. Under those business externals, the big wineries thrived and the bootstrapped small family wineries who had been built up following Prohibition were nearly out priced, out maneuvered, and marketed out of existence. →

History of the Game


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1960



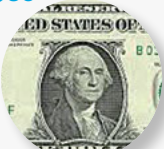
Grape growers produce a quarter of a million tons of excess each year; at the same time consumers favor jug wine. Conditions are perfect for large wine companies.

1970



Unable to get consumer traction with lower volume premium wines, the number of wineries in California drops to about 250.

1980



The exceptionally strong U.S. dollar made premium imports great values, at the same time the premium business is trying to develop an identity.

The 1960s–1980s The Era of High Volume Production

The 1960s was the high point in mass production of jug wine in America, and the start of the commercial wine business in Oregon and Washington. The top five varietals planted in California in 1972, in order, were carignane, French colombard, zinfandel, grenache and barbara,²⁵ which interestingly is close to what is planted today in the San Joaquin Valley as we note elsewhere in this report.

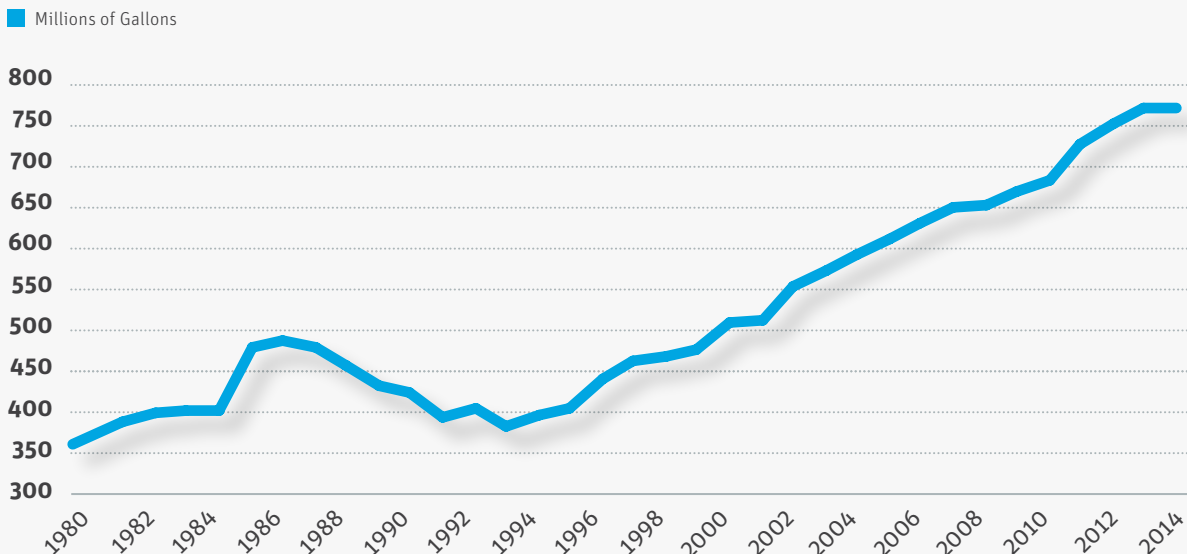
The wines produced at the time were often retailed in large screw-top containers and targeted to the growing middle class²⁶ which was dominated by World War II veterans. The 1960s–1980s saw the mature generation cut its teeth on mass-blends. The matures also modeled consumption behavior around the dinner table which the baby boomers adopted.

The volume and market share of foreign imports were significant in the late '70s and early '80s, helped about by a very strong domestic currency, the result of short-term interest rates that were at historic highs. Foreign wine found it easy to gain shelf space in 1980.

The U.S. wine industry's version of fine wine wasn't yet a fair match against a centuries-old business in Europe. The North Coast counties of Napa, Sonoma and Mendocino in California were still just figuring out what and where to plant grape varieties, while Washington and Oregon were still very early in development. Experimentation in the cellar and vineyards was normal during the period, leading to product quality that was still hit-and-miss. For instance, the Wente chardonnay →

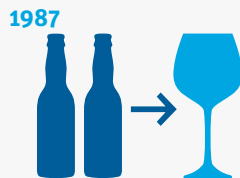
Figure 5
U.S. Wine Consumption by Volume

Source: California Wine Institute





1985
Neo-prohibitionism leads to a consistent decline in domestic per capita consumption, forcing industry changes including TV advertising and a focus on wine clubs.



1987
Gallo's iconic Bartles & Jaymes TV commercials and Sutter Home's white zinfandel push beer-drinking boomers into entry level wine.

1988
The U.S. wine industry's version of fine wine wasn't yet a fair match against a centuries-old business in Europe.

clone that was in heavy use in California was planted early in Oregon. When the clone failed in Oregon, it contributed to a belief that chardonnay couldn't be produced in the state. Of course, the real issue was that the warm-weather clone wasn't suited to Oregon. Similar experiments took place throughout California.

Up to the early part of the 1980s, with some notable exceptions in California, the wines from Europe were still viewed by U.S. consumers as preferable. The term 'imported wine' actually connoted an exotic and sophisticated product that carried an emotional attachment for many veterans who served in the European theatre during World War II. Successful everyday imports like Lancers, Blue Nun and Mateus²⁷ were popular premium bottled brands in the 1960s, peaking in sales during the mid-'80s.

Neo-prohibitionism²⁸ in the mid-'80s led the U.S. consumer to believe the consumption of alcohol in any form was unhealthy, driving consumption declines. To underscore the remaining divide in the country over the repeal of Prohibition, even in 1970 there were still local prohibition laws remaining in 32 states.

Total wine sales by volume (Figure 5) started to drop in an extended trend for the first time since the end of Prohibition. Large wine companies trying to combat this negative consumption trend turned to Madison Avenue to help promote their entry-level brands around themes of sophistication, celebrity endorsements, family celebrations, and whimsy.²⁹ Those positioning efforts helped the high-volume wine companies push back imports to a periodic low point of about a 13 percent market share by the early 1990s. The effort kept wine somewhat separate from spirits and beer in the minds of consumers.

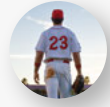
Partly the result of soft business conditions for most of the 1980s, the dollar lost some of its strength, making it more difficult for foreign imports to compete. The term "fighting varietal"³⁰ was coined in California's North Coast as a marketing tool to target the premium imports from Europe that were confusing to American consumers. The fighting varietal was also an attempt to segment and separate premium wineries from mass-production wineries. The latter continued to market their own brand and eschewed varietal characterizations in favor of made-up names such as Hearty Burgundy.

Noting the demographic shifts going against them, Gallo Wine Company came out with the Bartles & Jaymes³¹ wine cooler, a sparkling wine with fruit juice and lower alcohol. That proved an excellent on-ramp for the baby boomers who were losing interest in beer. But credit the North Coast wine business in Napa, Sonoma, and Mendocino, which was rapidly evolving to produce substantially better premium wine.

The high volume segment of the U.S. wine market was still dominant, but the mature generation was aging. Foreign imports possessed a smaller market share during the baby boomers' formative years as consumers, which resulted in baby boomers' developing a preference for affordable domestic premium wine. →

History of the Game

continued



1990–Today

Annie Savoy: *Baseball may be a religion full of magic, cosmic truth and the fundamental ontological riddles of our time, but it's also a job.*

I love that quote. It reminds me of how others view the wine business, versus what it's like to work under the hood. Don't get me wrong, it's a nice place to work — as most would attest — but just like professional baseball, it is still a job.

That the wine business was a job was more of a question mark in the early '90s when there were lots of people starting wineries and telling me this was going to be a working retirement. And truth be told, there were about five years in the mid-'90s when wine did sell itself and made running a winery easy. All you needed were grapes, a winemaker and scissors to clip coupons.

Demonstrating how far the selling side has evolved, one of my clients told me back then, “I only sell my wine to people I like. If I don't like you, you don't get my wine!” True story. But it really was a unique time when the premium business came into its own and it set the tone for where we find ourselves today.



The 1990s

Rotation to Premium Wine

Worldwide grape supply wasn't really a huge factor when analyzing the U.S. consumer market by the time the '90s rolled around. The overwhelming majority of wine consumed domestically was sold in volume packaging and there was no such thing as bulk imported foreign wine. The premium part of the wine business was just getting a firm foothold as a successful segment. To put price in context, a \$14 Napa cabernet at that time would give significant pause at the checkout line.

Despite the 1976 success of the Judgment of Paris,³² the growth in U.S. wineries producing fine wine was still slow through the early '90s. Washington and Oregon were still early in their industry's development, each less than 5 percent of the size of the California business.

In 1991, *60 Minutes* aired a segment called The French Paradox³³ which contributed to changing the consumer's prior opinion of domestic fine wine. While that single event is generally acknowledged as the change agent that turned wine consumption in the U.S. back into positive growth territory, it was really only part of the explanation. The French paradox gave consumers a better reason to drink, but it didn't give them the capacity to pay for wine that was more expensive.

In 1994, the big event that really made wine sales accelerate was the median baby boomer hit the magic age of 35. The ages between 35 and 55 have long been considered by retailers to be a consumer's most active spending years. Those years are bracketed with life events that spur consumption such as college graduation, career advancement, access to credit, home purchase, marriage and the birth of children. →

1994



Growers recognize there is a shortage of wine grapes and start an aggressive planting program.

1995



Boomers demand for well-made, value priced domestic varietals leads to retail shortages, forcing wholesalers to court small producers.

1994

In 1994, the big event that really made wine sales accelerate was the median baby boomer hit the magic age of 35. The ages between 35 and 55 have long been considered by retailers to be a consumer's most active spending years.

Those 1990s families had another U.S. economic first: the U.S. nuclear family developed from the traditional stay-at-home mom within a one-income family structure, to the two-income household. Consumers could afford more stuff and they bought bigger houses, then learned to refinance and pull out home equity and live life a little larger. Much bigger household income, higher levels of education, luxury branding from mass-marketers, improved global sourcing and the raw processing power of data were each important factors driving the change toward mass-luxury products during the decade.

Marketers helped too. Luxury retailers fueled desire with alluring lifestyle messages and delivered mass-luxury prices that were within the reach of U.S. households, who had by then accumulated \$1 trillion of disposable income.

Conditions were ripe for a retail explosion, and the U.S. stock market responded to the business conditions throughout the 1990s growing nearly 350 percent. That provided even more disposable income for luxury goods and wine purchases. The wine industry drafted in the wake of the trend, elevating wine from something occasionally used for celebrations in the prior decade to the status of an affordable luxury good consumed with everyday meals.

While Prohibition had long since ended, the three-tier system remained in place, limiting how small independent wine producers could sell. The states had complete control of all activities within their borders and most sided with their state's individual interests whether based in grape and wine production, neo-prohibition on moral grounds, or favoring regional distributors. Wineries in the early part of the decade had been ignored by distributors and faced with the limitations of the three-tier system, spent more time developing direct sales and wine clubs through their tasting rooms.

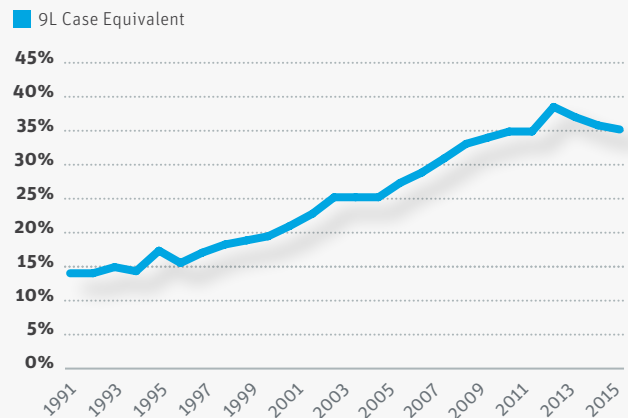
By 1994 grape growers realized demand was starting to soar and there was going to be insufficient domestic productive capacity. Planting started in every corner of the West, particularly in California.

Because of the lag between planting and production, there wasn't enough product for domestic wine producers. Consequently, starting in 1996, Europe, which had too much wine, found perfect conditions in the U.S. for success, and imports began to show marked share gains making up for domestic shortages (Figure 6).

Along with a few other producers, The Mondavi Wine Company (Viña Caliterra S.A. joint venture) tried something new: importing bulk wine from Chile to load into domestic labels. For a short number of years, that helped the domestic juice shortage until the gap in domestic production and consumption could narrow and then foreign bulk wine vanished. →

Figure 6
Volume Import Share of U.S. Market

Source: Gomberg Fredrickson, California Wine Institute, SVB Estimates



History of the Game

continued

1990s

The U.S. was the only European solution for overproduction, and with U.S. sales going through the roof, nobody in America seemed to notice the surrender of market share.

1996



Export countries with excess see the opportunity to sell into the U.S. shortage and start to take domestic market share.

The 1990s, continued Rotation to Premium Wine

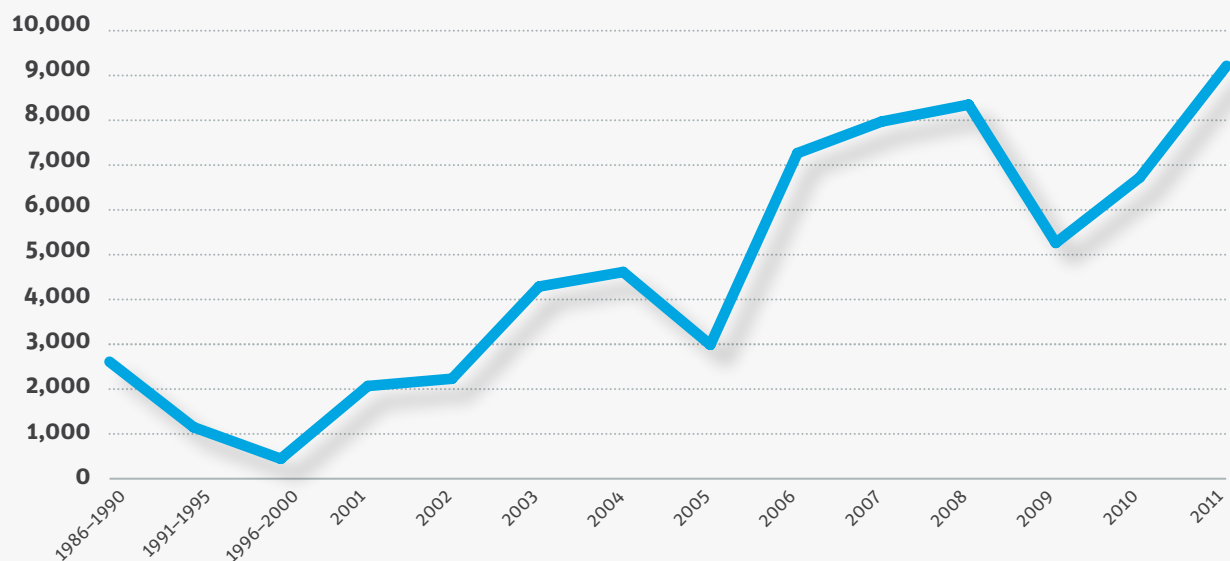
Of course, everyone in the wine business enjoyed watching the upturn in U.S. consumption, but in the background, Europe was sitting on a growing lake of wine while per capita consumption was declining in their countries. That fueled their need for exports, and with substantial government marketing support Europe started to recover their market share lost in the 1980s. The U.S. was the only European solution for overproduction, and with U.S. sales going through the roof, nobody in America seemed to notice the surrender of market share.³⁴

California dominated the industry, accounting for more than 90 percent of the wine produced in and exported by the United States. The Northwest wineries in Washington, Oregon and Idaho, totaling approximately 200 small wineries, were making large improvements in wine quality as well as farming practices, and with the California shortages, the Pacific Northwest was beginning to get the attention of hungry distributors, the national press and serious wine lovers. →

Figure 7
Shortfall in U.S. Production vs U.S. Consumption

Source: OIV

■ Billions of Dollars



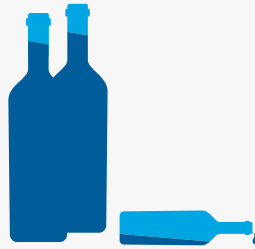
1999



1500

The U.S. has 1,500 wineries with at least one in each state.

2000



Large producers catch up with earlier shortage and smaller producers are again ignored by wholesalers.

2001

9/11

The Tech Recession and 9/11 put a stop to the overheated '90s. Small wineries are forced to a DTC focus.

2002



Foreign bulk wine begins to take market share from domestic growers. 100,000 acres of vines are removed from the Central Valley.

By the mid-'90s, wholesalers had a problem they've never experienced since. They had far more sales demand than wine available for sale. To make more money they only needed more cases, so distributors went down-market and courted small wineries again, pledging their eternal troth. The winery owners most of the time believed the sweet talk.

When the new plantings in the mid-'90s started to come on line at the end of the decade, wholesalers fell out of love and filed for divorce from small wineries, leaving them to wonder what happened to eternal troth.

The final straw was the tech bust that slowed consumption. Ever since then, the small producer has had to focus on direct to consumer sales to survive and beg wholesalers even to get a date.

By 1999, the U.S. wine industry was composed of approximately 1,500 wineries. While virtually every state had at least one winery, the business was still highly concentrated with the top 10 wineries accounting for 70 percent of the market by volume.³⁵

The 2000s Consolidation and Alignment

The decade of the 2000s began with a supply bulge of domestic juice from the 2000 vintage in California, a vintage that wasn't well regarded in the press. It would have made sense if the market share of imports slowed, but heavy domestic supply didn't reverse the growth in imports this time. Europe was still paying hundreds of millions in support to export their surplus. In addition, the low price of the Australian dollar allowed the Yellow Tail phenomenon to get a foothold.³⁶

Wine as a product had gained a firm grasp in American culture. But with the domestic producers showing nice growth rates, we didn't notice clouds on the horizon. We were losing total market share to imports again (Figure 7) even as consumption was racing higher.

The U.S. was back to producing enough wine grapes for domestic consumption (Figure 8 on next page), but the demand for wine traditionally produced in the Central Valley had changed. Central Valley growers responded to the events by removing over 100,000 acres of vines from production right after the tech bubble burst.

Though it was unspoken at the time, big wine companies weren't exclusively looking for domestic supply solutions with their traditional grower partners. Instead, they wanted to find ways to reignite domestic demand by lowering price, and there was no way to do that without lowering the cost of inputs. →

History of the Game

continued

2003



Social media dominates discussion in wine conferences, but concrete success stories are hard to find.

The 2000s, continued Consolidation and Alignment

Their solution was to revisit the imported bulk wine experiment that first showed up in the business during the '90s shortages. Supporting the change and seeing an opportunity of trading in world inventories, international grape brokers started cooperating to move bulk wine around the globe.

It appeared from our desk that there was a sea change underway and we viewed the situation as an imminent threat for our wine grape growers producing for the mass-scale wine companies. We issued our view in the 2006 State of the Industry Report. While our call raised the hackles of some growers, it proved to be accurate.³⁷ Today, imported

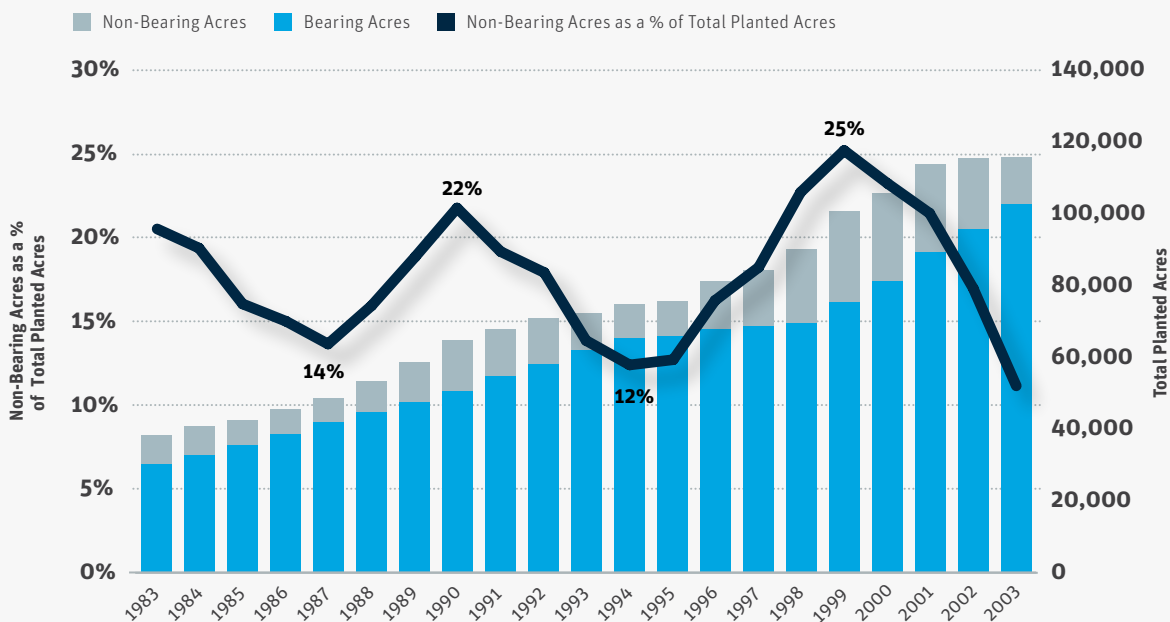
bulk wine has found a permanent place in the underlying high-production wine business, and our Central Valley growers are struggling.

What was then a warning and a prediction has become fact and a nightmare. The internet has changed the way the world communicates. World trade has indeed become easier, and consistent with our call, a substitute for lower-priced domestic wine has gained a permanent foothold in domestic production.

By the early 2000s, baby boomers had become the dominant buyer of wine. Acreage in the best growing regions started to take off in price moving in tandem with higher bottle prices. →

Figure 8
Boom & Bust Cycles in Fine Wine Plantings*

Source: US Department of Agriculture, Ian Malone



2008



Consumers trade down, giving false hope to volume growers. Fine wine producers struggle to find growth.

2009



Trading up takes over as the economy recovers and boomers recover their stock valuation and home equity.

2015

What was then a warning and a prediction has become fact and a nightmare. World trade has indeed become easier and consistent with our call; a substitute for lower-priced domestic wine has gained a permanent foothold.

Social media was the talk of the conferences, but best practices that actually sold wine with social media were hard to find. And that background brings us to the present.

As industry professionals, we have had to overcome a lot, but there are always new challenges and we try and bring those issues to light in this report.

This year we have started a new segment of the Wine Conditions survey to ascertain owners' views of the degree to which industry events impact their success.

Overall, net industry sentiment at the end of 2015 was positive at 12.1 (Figure 9), which indicates the industry is only slightly confident about the market conditions today. A net

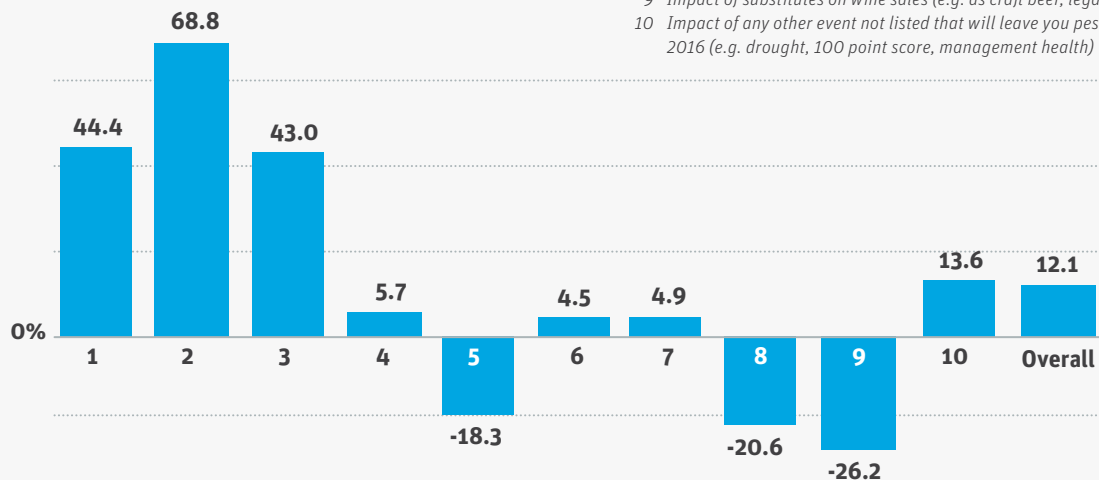
negative reading would imply the industry is not confident. The most worrisome areas are labor, foreign competition and substitutes for wine from other products such as craft beer and spirits.

The areas contributing most to owners' positive feelings regarding market conditions are the economy, good consumer demand and regulatory changes allowing improved access to markets. By production size, the smallest wineries are the most positive, perhaps reflecting the premiumization underway in the business. By price point, the lowest-priced wineries are showing the least confidence, but are still net positive about business conditions. The luxury wines above a \$69 average price show as very confident, perhaps reflective of their brand strength, which allows them to sell wines with such a high price. ■

Figure 9
Wine Industry Net Sentiment

Source: SVB Annual Wine Conditions Survey

Net sentiment scale ranges from -100 (entirely pessimistic) to +100 (entirely optimistic), with midpoint zero (entirely apathetic)



Net sentiment of each statement and its expected wine industry impact in 2016:

- 1 Impact of the performance of the economy on your winery
- 2 Impact of U.S. consumer demand for your wine
- 3 Impact of changes in direct, wholesale or export channels in which you sell your wine
- 4 Availability of grape/juice supply for your winery
- 5 Impact of a sufficient and skilled labor market for grape growing
- 6 Impact of evolving alcohol laws and ordinances on your ability to conduct business
- 7 Changes in the availability, rates, or terms of capital and/or debt for your winery
- 8 Impact of foreign competition on wine sales
- 9 Impact of substitutes on wine sales (e.g. as craft beer, legalized marijuana and spirits)
- 10 Impact of any other event not listed that will leave you pessimistic or optimistic about 2016 (e.g. drought, 100 point score, management health)



Larry: Sears sucks, Crash. Boy, I worked there once. Sold Lady Kenmores.
Nasty, whoa, nasty.

5

Park Concessions: Consumption, Demographics and Demand

Remember Sears? When I grew up that brand meant quality, but as time passed, they couldn't retain their image with new consumers. They needed to change, but brand change wasn't easy. Some big wine companies have ended up in a similar place. They have been producing a lot of generic wine that has fallen out of favor, but they still have to feed their fixed overhead so they can't produce in small lots. So what can they do? They are too big to make luxury wine aren't they?

What they do have is a war chest of money and a lot of smart business people. But producing interesting wines for tomorrow's premium consumer will be a challenge for the large wine companies.

Changes to Consumption

The mature generation grew up during the Great Depression.³⁸ The matures ensuing behaviors such as thriftiness and monetary conservatism resulted from a lack of employment or ability to procure the bare necessities in life during their youth. Decades later, many still save everything and throw away nothing ... ever.³⁹ The same can't be said for their children, the baby boomers.

After World War II, the mature generation had babies — lots of babies. With the rest of the industrialized society in ruins, the world came to the U.S. for manufacturing and materials. Our country experienced many golden years of prosperity and strong economic growth. The baby boomers were raised in a time of plenty, and due to their relative size, Madison Avenue marketed to their every

need. Without the same fear of financial failure as their parents, the baby boomers started to spend on goods and services at a historic clip, which drove GDP to new heights. They saved less, and as they entered the workforce in the 1970s, they began to spend ahead of their financial means by ramping up consumer credit.⁴⁰

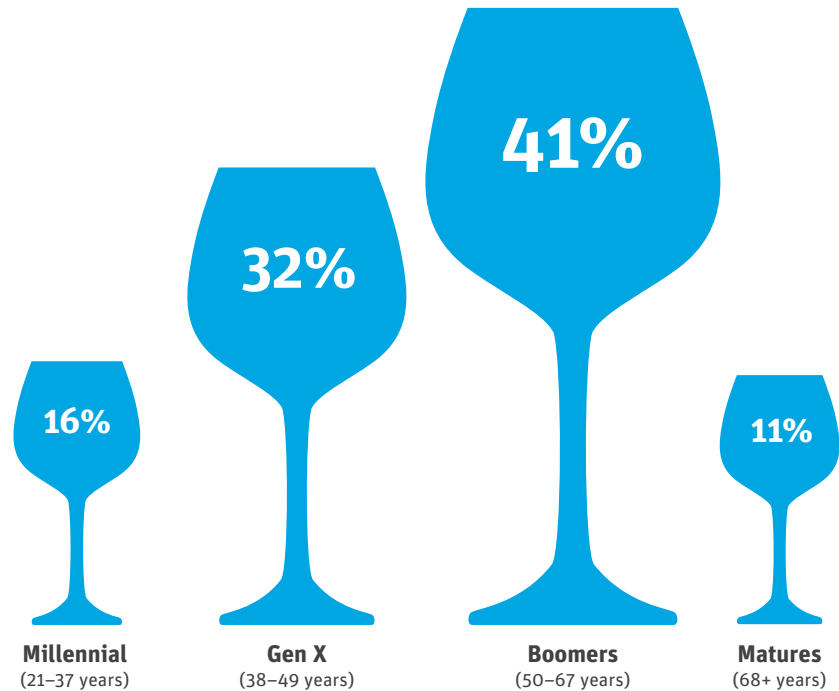
What is the life event that defines the up-and-coming millennial generation? Most will say it's their exposure to the digital world — the first generation to be raised with computers. I don't think that is what will define the generation any more than a color TV defined the baby boomers. Experiences define generations and their subsequent behaviors and preferences.

Some research now suggests that the millennials will be defined by their experience living through the Great Recession.⁴¹ Other issues will influence them as well, such as a decade-long zero interest rate environment, no belief in Social Security for their retirement, delayed entry into the job market, loads of student debt and the slowdown in worldwide GDP. →

Park Concessions: Consumption, Demographics and Demand

continued

Figure 11.1
2015 Sales by Demographic
 Source: SVB Annual Wine Conditions Survey



I see very few behavioral differences in millennials from Gen Xers when it comes to computer usage, so I discount that as a unifying trait for the millennials. Millennials, unlike their parents, won't likely begin their consuming lives by abusing consumer credit.⁴² They have seen what that does.

The millennials will behave more like the matures, who lived through the Great Depression, only they will have better information and a desire for mass luxury. They are going to be more value conscious, greener than the baby boomers and they will likely save more.

History to some degree is repeating itself with the millennials, and that will impact spending in the wine business too, when compared to the baby boomers' wine spending patterns of the last 20 years.

Cohort Shift

The prior model of buyers starting their understanding of wine by drinking American gateway wines⁴³ then gradually trading up and evolving to more complex and expensive domestic wines has ended. →

Figure 10
Demographic Demand by Price Point

Source: SVB Annual Wine Conditions Survey

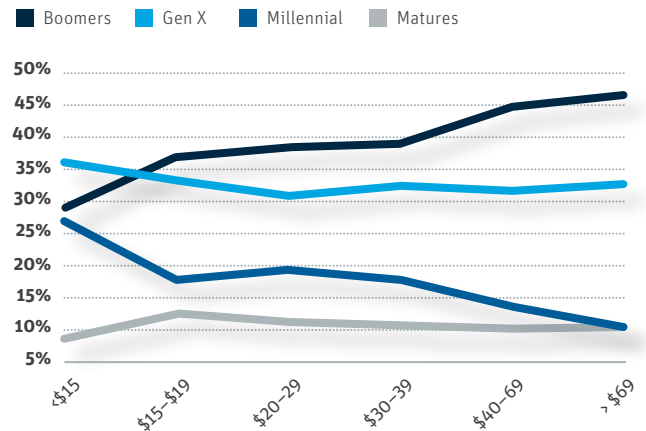
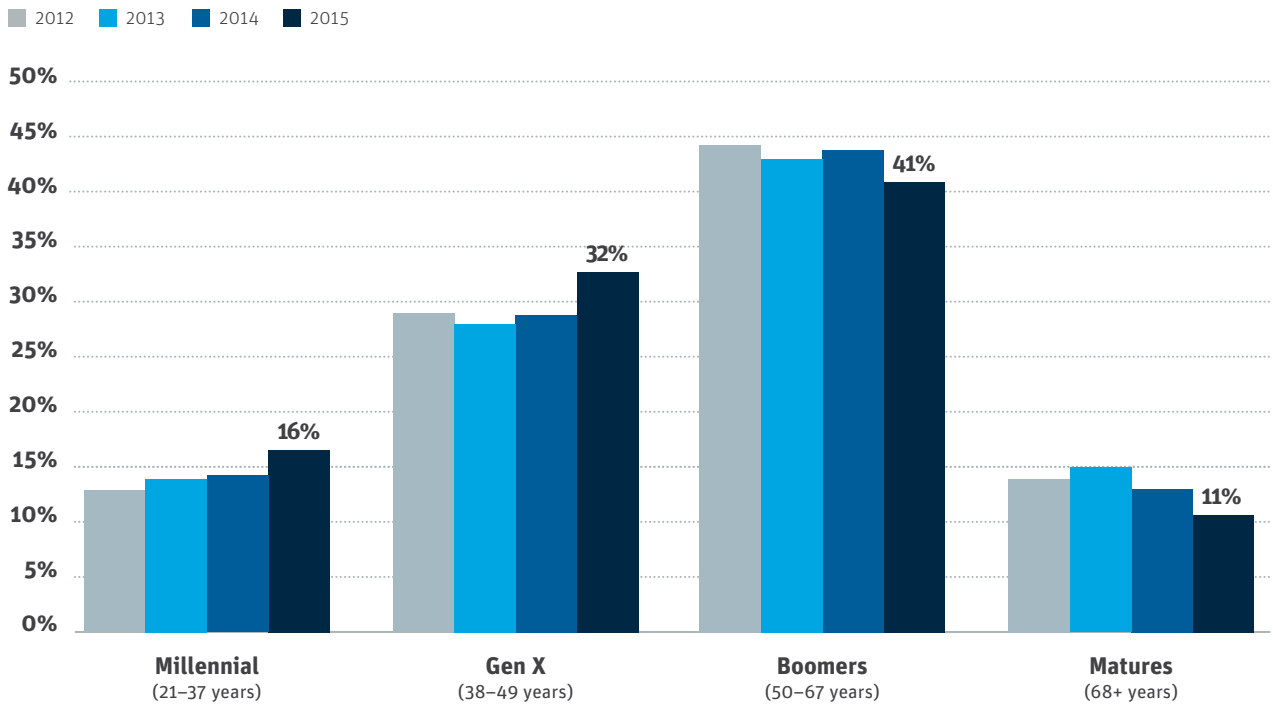


Figure 11.2
YOY Changes in Cohort Purchase Share

Source: SVB Annual Wine Conditions Survey



Today we see the impact of four different generations in the U.S. wine trade. Each is evolving the business in obvious ways with their consumption patterns of fine wine.

The mature generation, who blazed the wine-drinking trail by drinking branded jug wines, is for the first time at the bottom of consumption market share across all price points (Figure 10).⁴⁴ Consistent with that evolution, inexpensive jug wines are permanently out of favor with consumers.

The baby boomers, who are responsible for the last 20 years of growth in the American fine wine business and still maintain the largest demographic footprint on the business at 41 percent,⁴⁵ are now beginning a slow decline in their consumption market share (Figure 11.2). That trend will continue as the group ages and should accelerate within the next six years as the median baby boomer reaches retirement age.

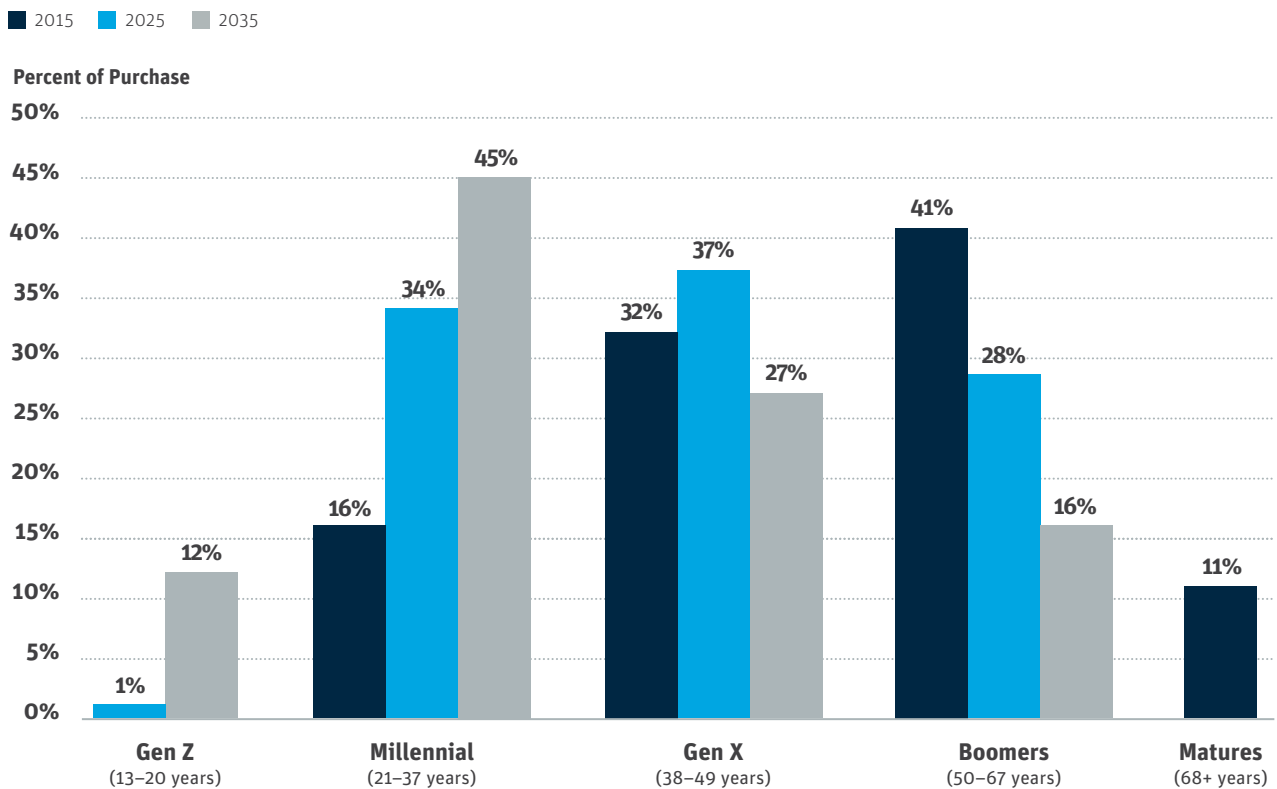
The always-overlooked Gen X is the cohort presently in second place in consumption market-share of fine wine, and their share continues to increase. While the cohort →

Park Concessions: Consumption, Demographics and Demand

continued

Figure 12
Forecast Changes in U.S. Cohort Purchase Share

Source: SVB Annual Wine Conditions Survey



is smaller, they are perfectly positioned to pass the baby boomers as the dominant cohort. If current trends are maintained with all other external factors remaining constant, we expect the Gen X cohort will surpass the baby boomer cohort around the year 2021 to become the largest wine consuming demographic in the U.S.

Representing just 16 percent of current consumption market share of premium wine is the millennial generation, whose out-sized impact has been falsely prognosticated in the wine press for at least a decade.

As we have noted for several years in this report, at some point the millennial cohort will be the top consuming segment. Many predictions have been aggressive with respect to the timing of their ascendance as wine drinkers, as well as their economic impact.

This generation does not have the same financial environment to push spending compared to the baby boomer and Gen X cohorts at the same life stage. Significant headwinds include the lack of employment representation in the U.S. workforce, the significant amount of student debt and the setback in wealth accumulation during the Great Recession. →

Park Concessions: Consumption, Demographics and Demand

continued

Forecast for largest wine consuming demographic in 2026

2021 **2026**
 Year of Gen X Year of the Millennials

That said, for the first time in history, SVB analysis shows the millennials have moved off the bottom as fine wine consumers and have passed the mature cohort across all price points (Figure 11.2 prior). They are the future fine wine consumers, and we're now just starting to see their impact in the business.

Premiumization

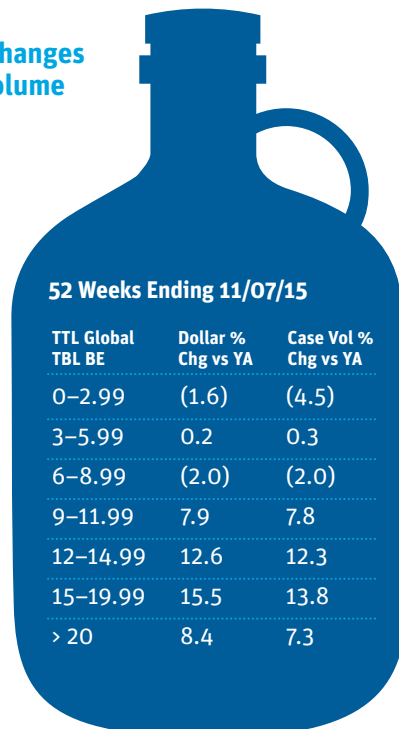
Building on the evolution of the American wine culture, since the 1960s each successive generation enters their consuming years knowing more than the prior generation. Matures began with jug wine. Baby boomers followed with premium domestic wine as did Gen Xers. Millennials are no different, but they have an added advantage in their formative years of a digital age that allows them wider selection, better information and greater ease of purchase. That's a good thing.

That said, perfect digital price information in the hands of a frugal consumer is a nightmare for marketers. Evidence from many sources suggest millennials are inclined to substitute craft beer and spirits for wine, especially on-premise, and are ambivalent as to its place of origin.⁴⁶ The latter issue should be a concern to domestic wine companies and consideration should be given to brand promotion of our premium products to reenergize the view of domestics with the younger generation. It has worked for Detroit where Cadillac is now cool, so why not?

Both a positive and a negative trend is that the youngest consumer cohort has demonstrated a propensity for frugal luxury,⁴⁷ meaning they are quite price conscious, but don't sacrifice quality when selecting their adult beverages. The hope is that as the group gains traction in life and their careers, they evolve to become less frugal and loosen up the grip on their wallets and purses, becoming traditional mass-luxury consumers. Our forecast is the millennial cohort will surpass the Gen X cohort around the year 2026 to become the largest fine wine consuming demographic. (Figure 12)

Figure 13
Price Segment Changes in Dollars and Volume

Source: Nielsen



Premium Segment

It's become abundantly clear that premium wine is dominating the day and is responsible for all of the growth taking place in the trade. Shoppers are trading up to more expensive and complex wines (Figure 13), and when looking back, the only time in recent memory we have seen trading down into lower-priced wine was during the Great Recession. That wasn't a business trend but rather an exception. Obviously a business model based on the hope of recession is clearly on rocky ground. →

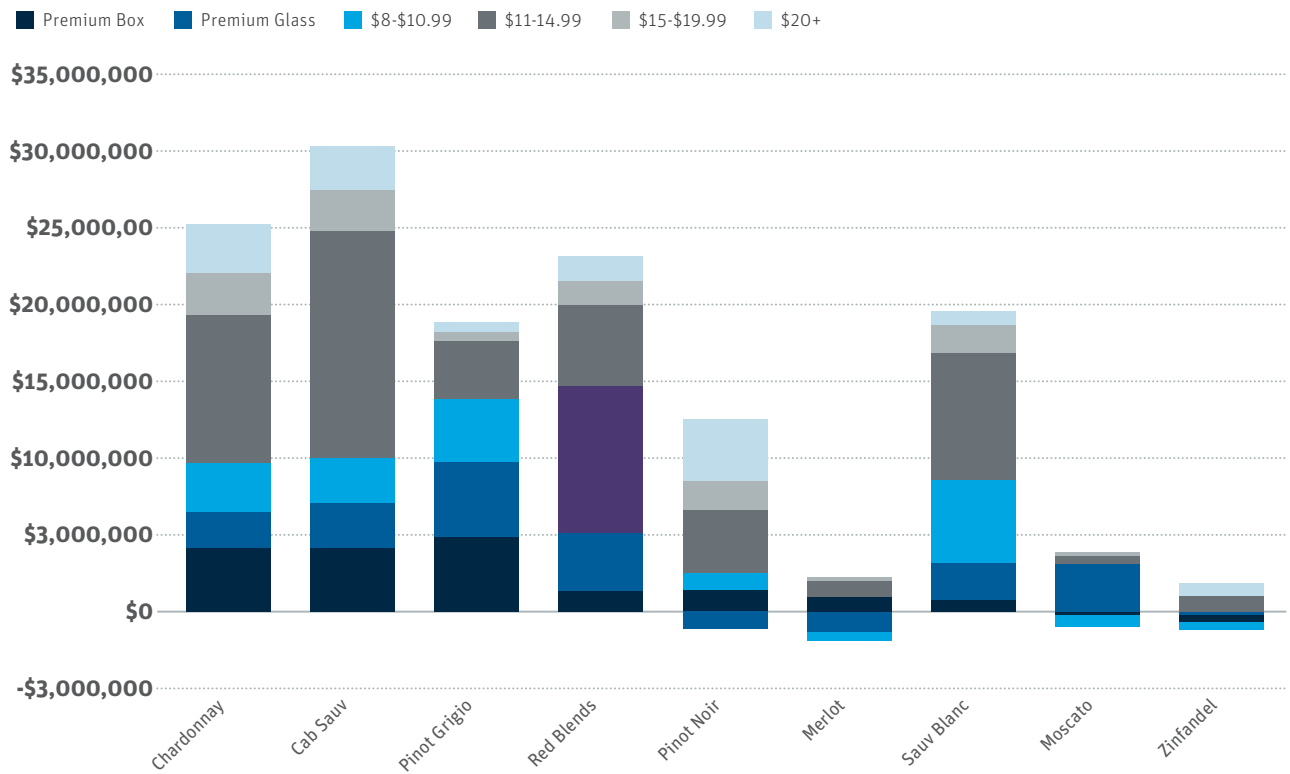
Park Concessions: Consumption, Demographics and Demand

continued

Figure 14
Premium Varietal Growth By Price Segment

Source: IRI

Total U.S.—Multi-outlet+ convenience, 12 weeks ending Oct 4 2025



Segmenting by varietal gives another view of what's taking place in consumption. Chardonnay is still the dominant varietal sold. Of the major varieties, all the growth is taking place in higher-priced segments (Figure 14). Notably in the \$11–\$15 price points, we see dominant segment growth in chardonnay, cabernet sauvignon and sauvignon blanc.

The growth in the red blend category is taking place more in the \$8–\$11 price categories (purple bar in Figure 14), which is consistent with information from Technomic and others, suggesting growth is taking

place largely with millennials. Today, it's a price category overwhelmingly dominated by larger wine companies. Red blends are the current darling of discussion in the business and it's obvious why from the producer side of the story. Merlot and syrah have struggled as varieties; the result of overplanting the “next hot varietal.”

Whenever growers follow a trend, the trend is seemingly over right at the time the plants are producing (e.g. Muscat Alexander), or the varietal is ruined by overplanting (e.g. merlot, syrah). Some suggest merlot was →

Park Concessions: Consumption, Demographics and Demand

continued

The growth in the red blend category is taking place more in the \$8–\$11 price categories, suggesting growth is taking place largely with millennials. Today, it’s a price category overwhelmingly dominated by larger wine companies.



\$8–11
Red Blend Category

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 in past research.⁴⁸

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

The young consumer is giving blends a chance, and from our view is taking a page from the mature cohort, who placed their trust in a brand rather than a varietal. That finding is summarized in the 2015 Gallo Consumer Wine Trends survey that found millennials are also four times more likely to select a wine based on its label where they look for personality and originality. Baby boomers, by contrast, often look to the label for information such as region of origin and product details.⁴⁹ →

Park Concessions: Consumption, Demographics and Demand

continued

Small Winery Sales

The wine industry really dodged a bullet in the Granholm Decision in 2005.⁵⁰ That decision knocked the legs out from protectionist state laws that favored in-state wine producers, and the timing couldn't have been better for small wineries because they were being left by distributors.

In 1996 wineries could ship to only 13 reciprocal states and an additional 17 "personal use" states, many of whom allowed consumers to buy less than a quart of wine a year direct.⁵¹ At the time, direct-to-consumer sales were estimated by some to be less than \$100 million per year.⁵² There were far more closed states where consumers couldn't buy wine directly from a winery compared to states where shipping was legal.

As noted elsewhere in the report, the wholesalers moved away from the small winery around 2001. The small wineries were in a bind without the three-tier system willing to move their wine, and the direct options were limited. That all changed with the Granholm Decision, concurrent with the continuing evolution of the internet.

Today the smaller producers absolutely could not live without direct sales, and when we say small in this context, we are talking about wineries with less than 100,000 in case sales.

Direct-to-consumer sales are now a healthy part of a winery's revenue base. While state laws vary and some permitted state laws can only be described as arcane, if not stealth protectionism, the only remaining prohibited states are Alabama, Delaware, Kentucky, Mississippi, Oklahoma, Pennsylvania and Utah. But in the wine business, it seems there is always a new challenge.

Evolving Local Regulations

Small wineries take up space in oftentimes bucolic settings. Some would argue that the wine industry might even add to the beauty and culture of an area.⁵³ But not everyone likes wineries, and local regulation aimed at slowing tourism and winery growth has started to gain traction in several regions. What seems common at this stage is an alignment of anti-change agendas using media and the political process to paint a negative view of the industry and its practices.

We asked winery owners what they thought locals felt about the growth of wine tourism in their region. The good news is 80 percent felt tourism was appreciated and wanted. Not surprisingly, Napa County wineries were the least positive about the question, but Sonoma, Mendocino and Santa Barbara weren't far behind. (Figure 15)

According to articles and comments from readers in newspapers that cover the wine business, the debate is about a threat that is changing the character of [fill in your town or AVA here]. Those accusations are backstopped with references to the negative impacts from traffic, noise, tourism and heavier water use. →

Percent of winery owners who feel tourism is appreciated

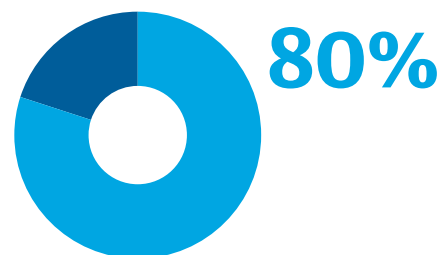
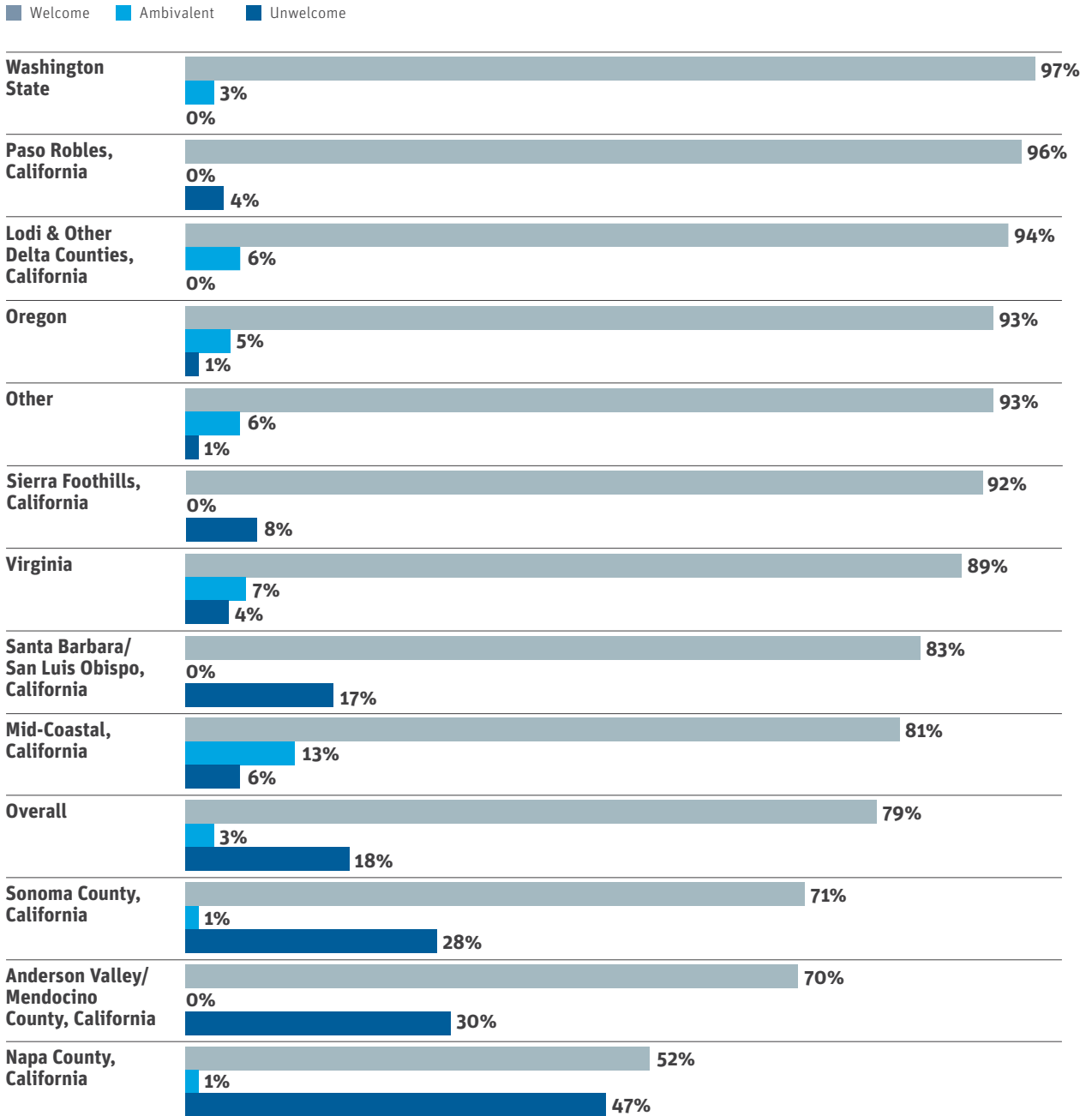


Figure 15
Wine Tourism

Source: SVB Annual Wine Conditions Survey



There are, however, few studies that look at these perceived problems and what actually causes them. In the case of Napa for instance, the public narrative was that heavy traffic was from tourism. A traffic study, funded and run by the county, determined the source of the traffic was actually locals;⁵⁴ on most days, tourism represented just 15–17 percent of the traffic.

My belief is that tourists come to wine country because it is beautiful. Once they come to wine country, the winery itself benefits with direct sales. If wine country gets crowded and loses its charm – whether from locals or from tourists – we will be killing the goose that lays the golden egg, so the focus for all of these local issues should be on studies to get at the root of the problem. ■



Crash Davis: You don't want a ballplayer; you want a stable pony.

Skip: Nah.

Crash Davis: Well, my Triple-A contract gets bought out so I can hold some flavor-of-the-month's cup in the bus leagues, is that it? Well, hell with this game! [Pause]

Crash Davis: I quit, all right? I freaking quit!

[Crash exits the office and stands in the clubhouse for a minute before turning and sticking his head back through the door]

Crash Davis: Who we play tomorrow?

Skip: Winston-Salem. Batting practice at 11:30.⁵⁵

6

The Farm System: Imports and Mass-Scale Premium Wine

Even though the wine business is a job and we like what we do, sometimes we find ourselves in places we never expected. Just ask anyone who is in national sales for stories about how they ended up in Winston-Salem or Durham. A little like Crash, some days we think things are going just fine, then something happens and it's a new ballgame. Some brand or import takes our shelf space and we're next selling wine in Greenville, Mississippi, and wishing we were lucky enough to be back in Durham.

Imports

There can't be a discussion of supply without having at least a short discussion of the impacts and threats from foreign wine. While the market share of foreign bottled wine is at present taking a break from a long growth march, bottled imported wine will start to take market share from domestic producers again. That conclusion comes from the following observations:

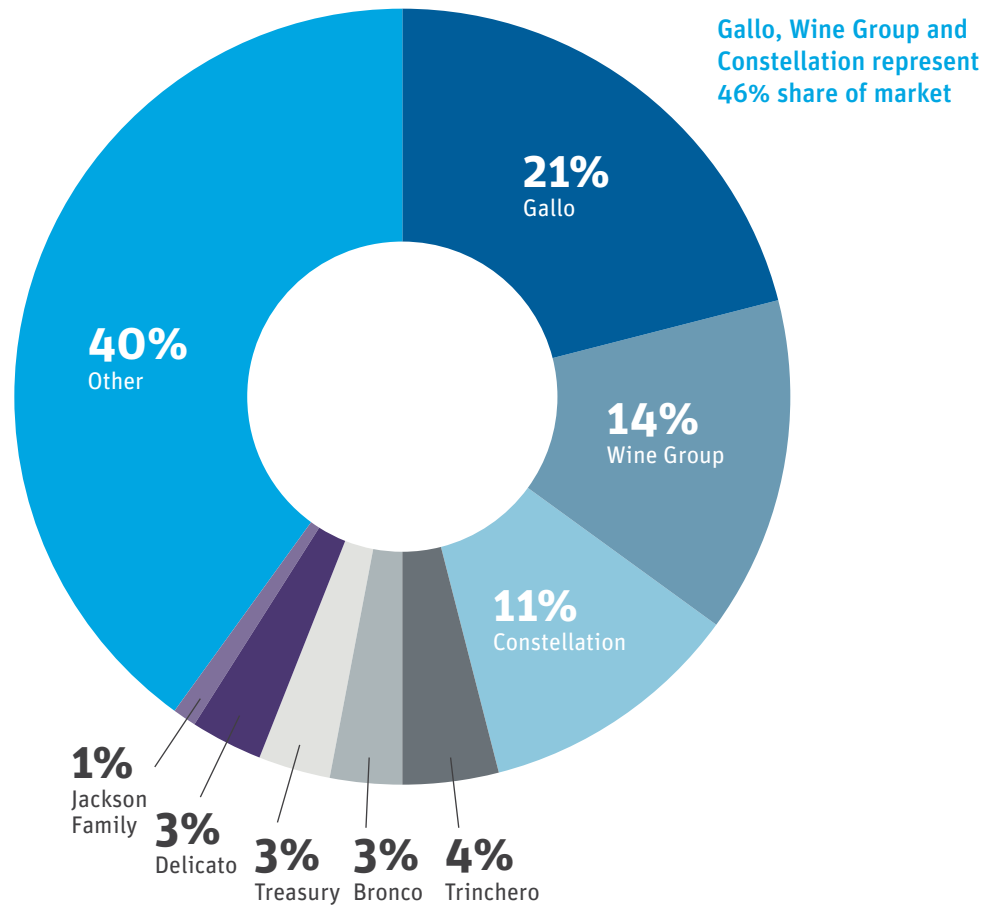
- ▶ Per capita consumption in the U.S. will slow as alcohol-switching millennials grab consumer share.⁵⁶
 - ▶ Good value bottled foreign wine is widely available for purchase in multiple retail outlets.
 - ▶ Digital access and positively evolving direct shipping laws make foreign wine as available as domestic wine for the first time in history.
 - ▶ Declining EU per capita consumption, changes to more “new world” wine styles in export brands, and in-country export marketing support provide the momentum to expand exports to the U.S.
- ▶ The growing millennial cohort has an evolved view of world wines versus the baby boomer and Gen X cohorts, who favored U.S. producers during the same period in their development. We shouldn't expect millennials to repeat the baby boomers preference for domestics.
 - ▶ Given a choice in sourcing, large producers have shown a willingness to switch to foreign sources when there are cost advantages. They can easily do the same with imports.
 - ▶ Foreign companies such as Constellation⁵⁷ and Treasury already have domestic distribution, foreign supply and the marketing heft to deliver good value foreign fine wine to the U.S. consumer. →

The Farm System: Imports and Mass-Scale Premium Wine

continued

Figure 16
Est.U.S. Market Share From Domestic Producers

Source: Gomberg Fredrickson, Wine Institute



Cost Efficiency and Distribution

During the entirety of its history, the commercial wine business in the U.S. has been dominated by larger wine companies which continues to be true today with the top three companies representing almost half of total wine sales (Figure 16). The same is true on the wholesale side in which the top four represent almost 60 percent of total wine sales.

Up through the 1970s, the biggest wine companies were able to produce mass quantities of the simple and inexpensive wine consumers wanted. Mass scale gave those wineries a significant cost advantage when producing formula-based wine products.

Today when consumers want wines with greater distinction, and smaller wineries produce the most interesting handcrafted wines, shouldn't that lead to more fragmentation versus more consolidation? One would think, →

The Farm System: Imports and Mass-Sale Premium Wine

continued

The smaller wine companies don't produce sufficient product volume to fill those stores, hotels and restaurants so big wineries still dominate.

but the opposite is taking place, and large wine businesses are continuing to catch an ever-increasing share of higher-priced wine sales. The reason it's happening is found in the interaction between the retailer and wholesaler.

The stranglehold wholesale distribution has on the movement of wine into national accounts makes the larger wineries critical partners. Those wholesalers prefer to deliver consistent brands across all of the retailer's nationwide sites. The smaller wine companies don't produce sufficient product volume to fill those stores, hotels and restaurants so big wineries still dominate.

Large Production vs. Premium Wine

Today, half of wine is still sold below \$9, but that part of the business is in decline as consumers are trading up and matures are trading out. The \$3-\$6 price segment is the swing category today with the largest share of total domestic sales. (Figure 17 next page)

Our prediction is that consumers will push premiumization even further. The trend will be most noticeable between \$10 and \$20 for the next several years. The \$3-\$6 segment with all the volume is at the greatest risk of decline.

Our prediction is that consumers will push premiumization even further.

↑ **\$10-20+**
↓ **\$3-6**

A recent Sonoma State University study⁵⁸ found that millennial wine consumers prefer fruity or semi-sweet wines to dry and tannic wines, and price is the number one factor in deciding what to buy. Consistent with those findings, when we evaluate the largest growth patterns in premium wines by price segment (Figure 13 prior) we can see growth in the \$8-\$15 range and particularly in chardonnay, cabernet and red blends. That has the fingerprints of evolving millennials.

What is happening today is reminiscent of the baby boomers entrance to wine with Bartles & Jaymes wine coolers. Gallo was looking for a way to engage the young baby boomers, and found lightening in a bottle with Bartles & Jaymes. In less than a decade the phenomenon ended as baby boomers migrated to wine that was more complex.

In the same way, the millennial experienced the short moscato boom promoted by recognizable hip-hop stars such as Kanye West and Lil' Kim.⁵⁹ While premium moscato still exists (Figure 14 prior), like the post wine-cooler baby boomer, the post-moscato millennial is evolving to something more complex already and moscato is on the way out. →

The Farm System: Imports and Mass-Sale Premium Wine

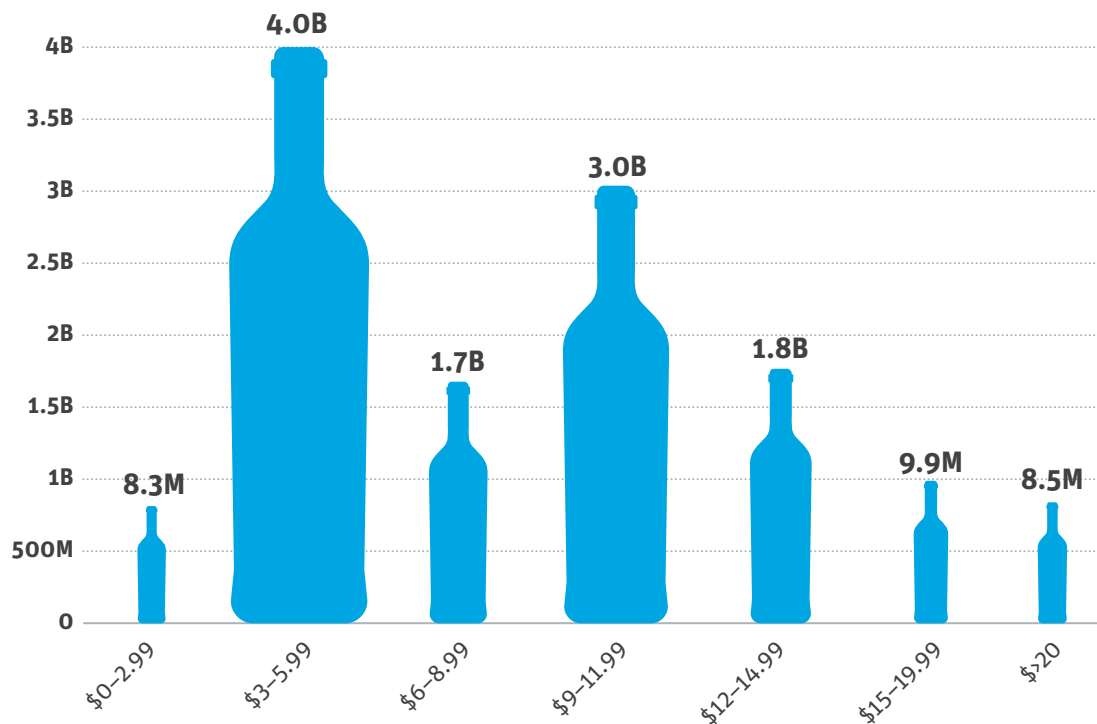
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The large production wine companies participated in the moscato boom and they are active in the lower price varietals and red blend craze too. But what happens when more of the baby boomers and matures leave the consuming market and millennials want wines that are

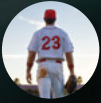
more distinctive and have a sense of place? That leads to the following question: Can the large wine companies produce consistent and remarkable wines in mass quantities to meet the premium consumer demand of tomorrow? The answer leads us to the discussion about real estate and trends. ■

Figure 17
U.S. Off-Premise Wine Sales (52 weeks ending 12/05/15)

Source: Nielsen



Our prediction is that consumers will push premiumization even further. The trend will be most noticeable between \$10 and \$20 for the next several years. The \$3–\$6 segment with all the volume is at the greatest risk of decline.



Crash Davis: This son of a bitch is throwing a two-hit shutout. He's shaking me off. You believe that? Charlie, here comes the deuce. And when you speak of me, speak well.⁶⁰

7

The Farm System: Imports, Land, M&A and Harvest

There are times when we make things happen, and every now and then, stuff just happens. In business, I often say you gotta work hard, be smart and be lucky to find success ... or you can be a trust fund baby I suppose, but that's a different thing. Most of the time you need a team of people on your side, or someone like Crash to tip you off that a curveball is coming.

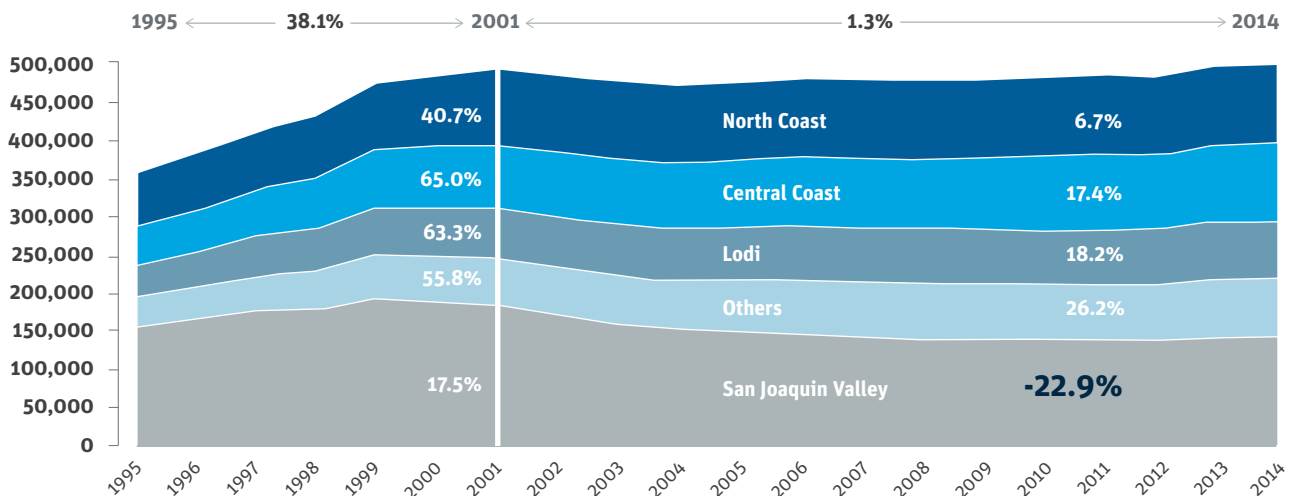
Real estate is often sold that way in the wine business: on a tip. On occasion there is an M&A advisor or realtor involved, but in many cases, it's a tip from a contact that gives you a shot. And given the shortage of good premium wine land now, if you get a tip, that's one you better put out of the park.

The Land Rush

Large- and medium-sized wine companies unanimously see the evolving preferences of consumers, who are moving away from generics to premium wine. They recognize that higher-priced, more complex wines are the trend for the future and they are literally betting the farm by making huge investments in existing brands, wineries and vineyards in coastal regions throughout the West. →

Figure 18
Total Growth Rates of CA Regions

Source: California Ag Statistical Services, Correia Company

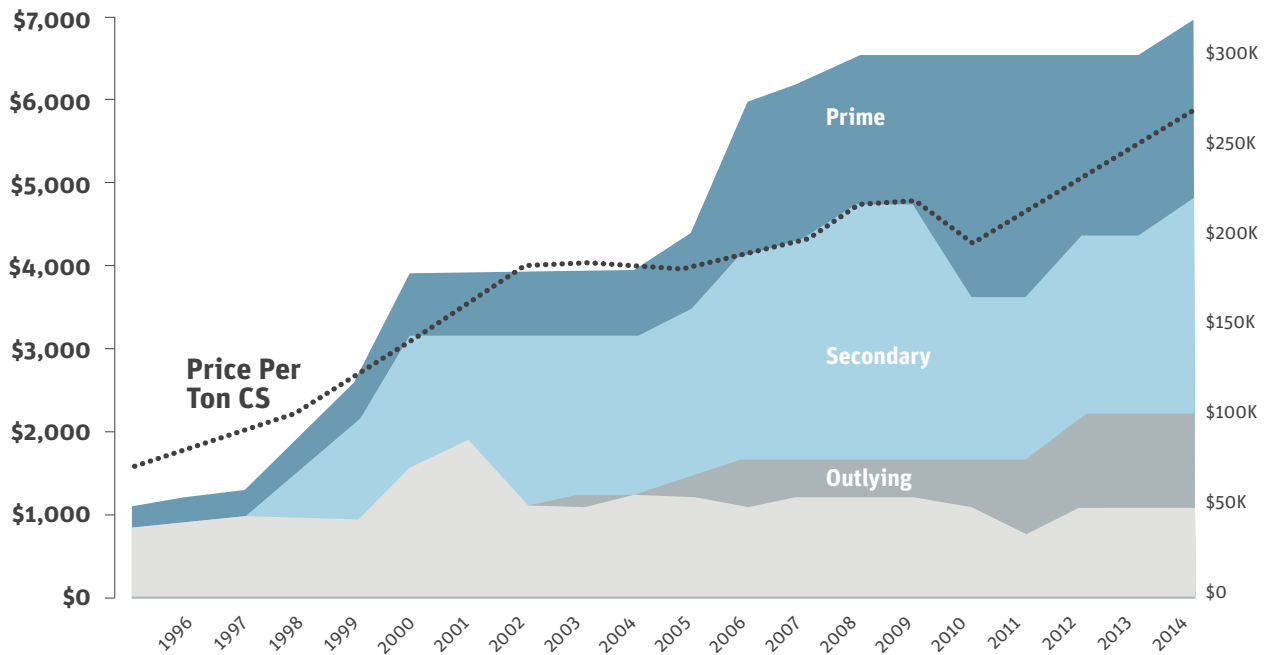


The Farm System: Imports, Land, M&A and Harvest

continued

Figure 19
Napa County Vineyard

Source: CALASFMRA Trends (California Ag Statistical Service), Correia Company



Those shifts can be seen when reviewing planted grape acreage in California (Figure 18 prior page). While growth since 2001 has been only 1.3 percent overall, a deeper look shows how regions that traditionally produce generic wine have fallen, while the premium regions have grown.

Given the reputation of Napa and Sonoma as premium wine growing regions, it's logical to believe the North Coast should have the highest growth rates, but that's not the case.

The largest growth has taken place in regions where there is plantable land available, and prices are more reasonable compared with prices on the North Coast.⁶¹ The growth rate in the North Coast is smaller than other regions, but the growth in price per acre is a different issue.

Using Napa as one end of the spectrum, you can see in Figure 19 how the average price per ton of cabernet (dotted black line) has increased dramatically over the years since the median baby boomer hit age 35 in 1994. With the exception of a small decline in secondary →

Once the 2015 harvest dynamic came into focus, many producers who were listing 2014 bulk for sale pulled it back from the market to supply their own needs.

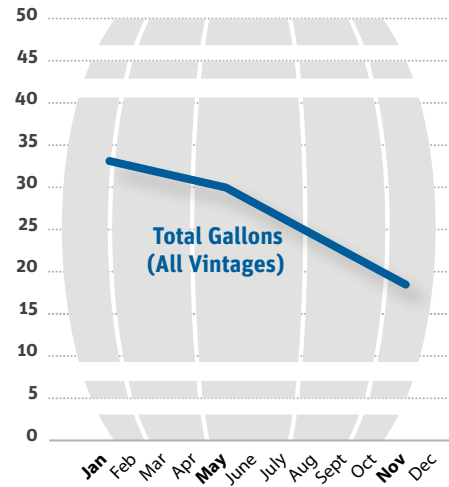
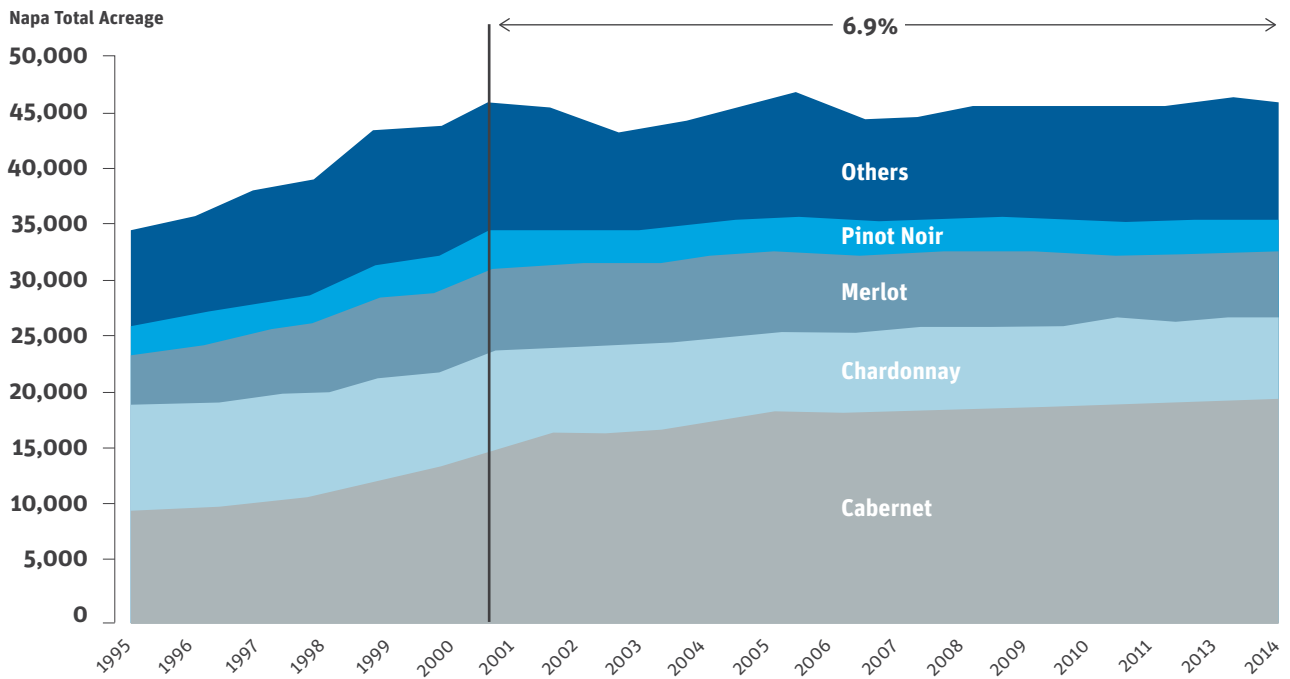


Figure 20
Napa Total Acreage

Source: California Ag Statistical Services, Correia Company



regions of Napa, there haven't been significant downturns in the price of Napa acreage, even during the Great Recession. The reason comes down to consumer demand and the fact Napa has differentiated their brand.

As a general rule, grape prices couldn't evolve higher without improving consumer demand. If a property produces higher-priced grapes, it can command a higher value per acre.

In the case of Napa acreage, total growth since 2001 has been about 7 percent (Figure 20). That's not 7 percent a year. That's an average annual growth in planted acreage of one-half of one percent. More land would be planted if it were available, but it's not except in small sections in the hills and in Napa Carneros.

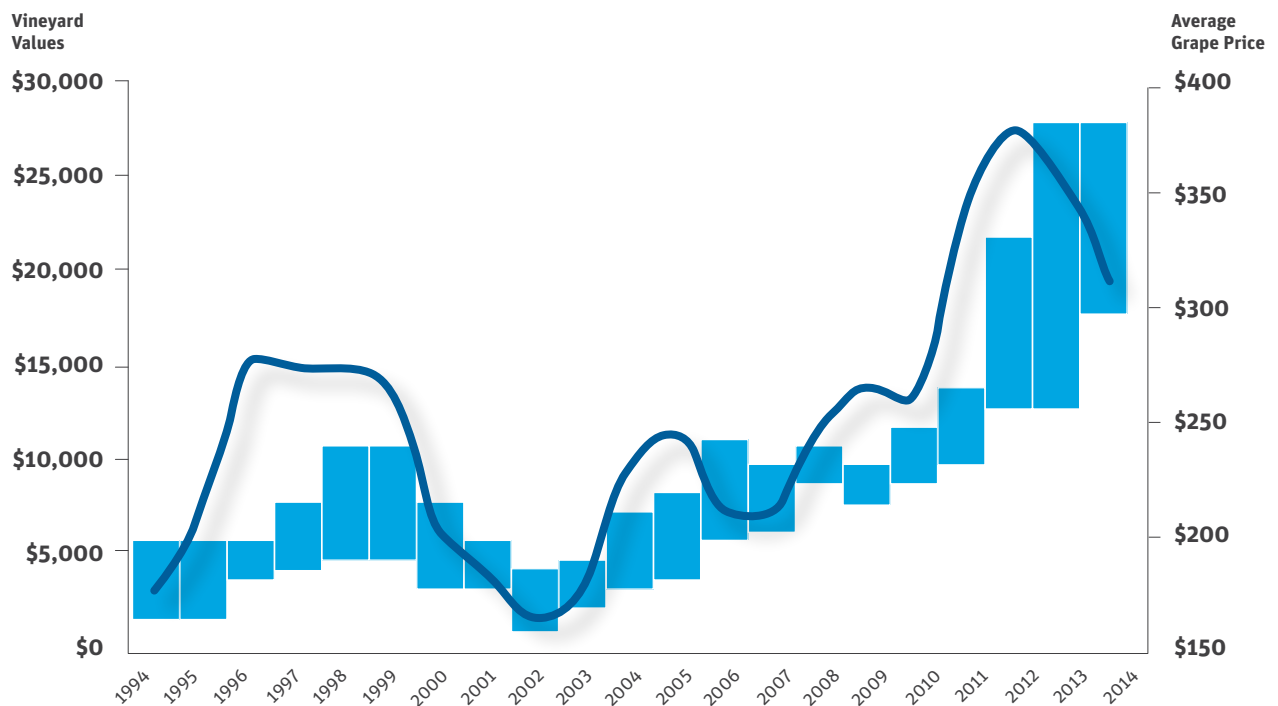
Napa cabernet bottle price has been on a constant growth ramp in part because it has to satisfy growing worldwide and domestic demand. There is a permanent cap on grape production because production is limited by acres planted. So the only variable left to change in a →

The Farm System: Imports, Land, M&A and Harvest

continued

Figure 21
District 13 Fresno—Madera

Source: California Ag Statistical Services, Correia Company



transaction is price per acre. In theory, the price will stop climbing when the demand for Napa cabernet stabilizes at a future price. Even then, it may not stabilize because the best properties behave like superior goods.⁶²

Not all regions are like Napa though, so we have to review the other end of the premium spectrum and look at Fresno-Madera.

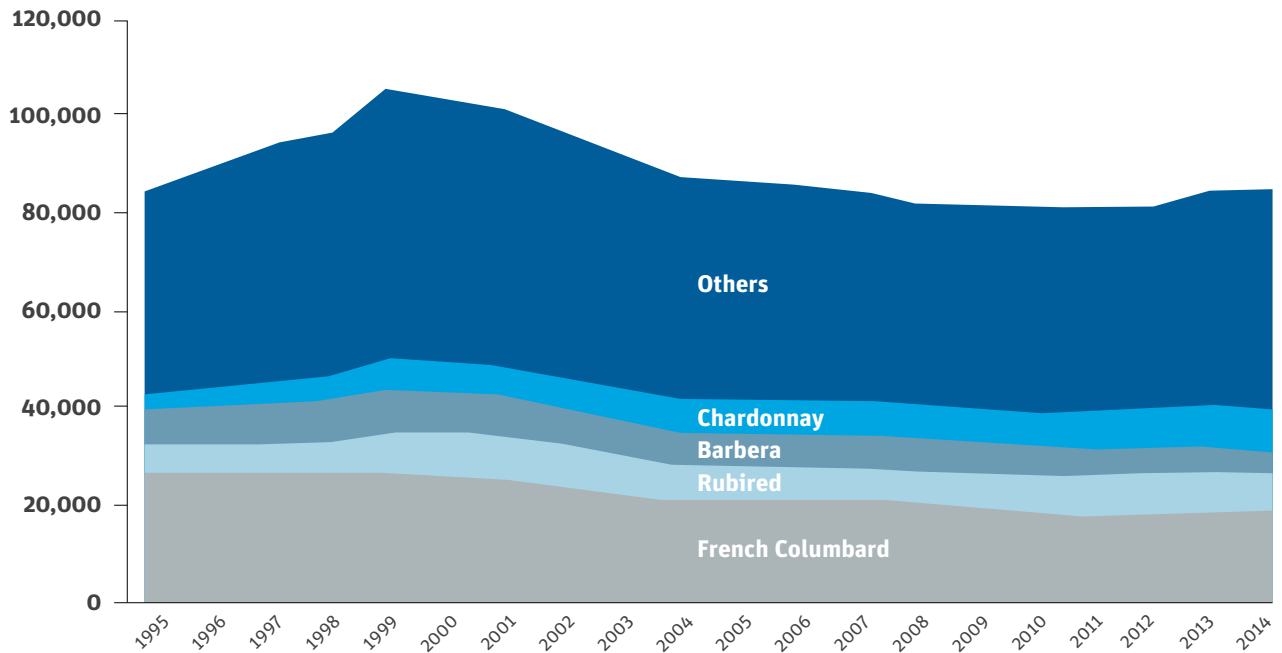
Compared to Napa's \$6,000 a ton price, Fresno's \$300 a ton (Figure 21) seems like a decimal placement error, but you have to look at total revenue per acre to see if the return makes sense.

In the case of Napa, presuming four tons per acre average yield, revenue per acre comes out to \$24,000. With Fresno, we presume 12 tons per acre, which comes out to a per acre revenue of \$3,600. Growers will affirm that's an insufficient return to be sustainable. Valuation is appropriately different with District 13 averaging around \$20,000 an acre, versus Napa at \$270,000 an acre. →

Large- and medium-sized wine companies unanimously see the evolving preferences of consumers, who are moving away from generics to premium wine.

Figure 22
Fresno Varietal Acreage

Source: CALASFMRA Trends (California Ag Statistical Service), Correia Company



In Fresno's case, instead of planting popular varieties, much of the production has gone into unfamiliar generics at the behest of large wine producing companies (Figure 22). Finding a home for those grapes with a reasonable return has become difficult if not impossible today.

Because the grapes haven't been effectively differentiated from foreign juice, foreign bulk imports have played against the region as well and replaced traditional Central Valley acres. The impact on land values given this rotation away from generics is probably not as bad

as might otherwise be expected because land can be used for other crops such as almonds and pistachios, which are carrying better returns today.

Before moving on, it should be noted that my colleagues and friends in Fresno are in a dire position and reporting on it has not been enjoyable for me. I have spoken to the leaders in the community on several occasions recently and offered ideas that might change the game, but change is what is needed for the region to thrive again. While a little luck is needed too, I believe that Fresno can be recast as a premium wine-producing region in its own right. →

The Farm System: Imports, Land, M&A and Harvest

continued

M&A

Interesting wine can be produced in mass quantities, as long as the consumer is only looking for something round, ordinary and consistent in style. That is the current intersection of segment growth and consumer demand, where the \$8–\$14 red blends are prominently found. A wine with merlot, syrah and zinfandel will be interesting but not distinctive.

Large wine companies know that breakpoint will arrive when blending wines won't move the needle, and they are already planning for the next wave of consumer trends by buying foreign brands, buying domestic wineries and brands, or buying arable property that can support a future premium brand.⁶³

In the past few years, we have seen large players like The Wine Group, Gallo, Treasury Wine estates, Jackson Family Wines, Constellation and others purchasing large swaths of land and wine businesses in coastal regions (Figure 23).

Always quick to anticipate consumer trends, Gallo started getting a foothold in Napa in 2002 with the purchase of the Louis Martini Winery, which came with 600 acres of vines and a historic permit in St Helena, California, and followed with the William Hill winery acquisition from Beam Wine Estates several years later. More recently, they have been aggressive in acquiring wineries and land in coastal regions such as J Wine Company, Talbot

Winery, and most recently the historic Asti Winery⁶⁴ in Sonoma and The Ranch in Napa. The latter acquisition will triple Gallo's Napa production capacity to about three million cases.

Constellation has been moving to grow their premium space for years, putting a huge stake in the ground with the Robert Mondavi Winery acquisition and following with a similar size purchase when they acquired Vincor, which included the Kim Crawford and Inneskillin labels among others. Constellation now manages 19 wineries in the U.S., using grapes grown in the California counties of Napa, Sonoma and Monterey. In addition, they manage eight wineries in Canada, four wineries in New Zealand and five wineries in Italy.

Without question, the deal environment in the wine business has been white hot this past year. While many even in the business predicted that 2015 deal formation would slow given several consecutive good years already, the opposite has been true. Consistent with the rest of Wall Street, M&A in the wine business ran at a record pace for yet another year in 2015 and multiples have held, if not increased through the year.⁶⁵ With the transactions we presently see in the queue, we will again start the year with some large and notable sales of premium vineyards and wineries. →

Red blend pricing: intersection of segment growth and consumer demand

\$8–14

Without question, the deal environment in the wine business has been white hot this past year.

Figure 23
Representative Vineyard and Winery Transactions

Source: Various Public Sources, SVB

Wine Company	Asset	Type	Purchase Price
Constellation	Meomi	Brand	\$315M
Constellation	Robert Mondavi	Winery & Vineyards	\$1,030M
Gallo	J Wine Company	Winery & Vineyards	\$90M
Gallo	Talbot Winery	Winery & Vineyards	
Gallo	Asti Winery & Souverain	Winery & Vineyards	
Gallo	Cypress Ranch & Palisades Vineyard	Vineyards	
Gallo	The Ranch	Wine Production	
Gallo	Covey Run Winery	Winery & Vineyards	
Gallo	Columbia Winery	Winery & Vineyards	
Kendall Jackson	Yverdon Vineyard & Winery	Winery & Vineyards	
Kendall Jackson	Gran Moraine	Vineyards	
Kendall Jackson	Zena Crown	Vineyards	
Kendall Jackson	Siduri Winery	Winery	
Pernod Ricard	Kenwood Vineyards	Winery & Vineyards	\$100M
Treasury Estates	Diageo Wine Estates	Numerous	\$600M
Wine Group	Benziger Family Winery	Winery & Vineyards	\$70M

The Farm System: Imports, Land, M&A and Harvest

continued

Land Summary

Average land prices are moving strongly higher because the large wine companies aren't the only ones who see the need to buy land that can produce premium wine. Wine companies in the next tier down from the majors have been active in both Oregon and Washington where more favorable price/quality measures exist compared to the North Coast of California. 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 there, but many are looking toward Sonoma County to start pinot noir programs.

Several years ago there were stories abounding about Chinese investors who were buying up California wine properties, but that was largely a tire-kicking experience with few transactions closing due to the difficulties in expatriating money. Today the phones for acquisitions are silent from the Far East, but are ringing off the hook from wealthy individuals, family offices and private equity firms who are sizing up the business, and in this case, the deals are closing.

The result of the 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. While we have correctly predicted bubbles in the past, we don't believe this is a bubble. Given that the underlying demand for premium wine will continue to grow, we can't see any reasonable event that can change the current real estate trend from continuing for the next 20 years, unless bottled foreign premium wine takes materially greater market share.

Supply of Wine

Over the past several drought years, I've taken numerous calls from reporters who want to know how the lack of water is impacting the wine business. While it has clearly been an issue, especially for the Central Valley farmers, I have to disappoint the writers who were hoping to write something sensational: 'Drought ruins harvest! No grapes to crush. Consumers discover milk.'

The fact is when it comes to wine grapes, droughts will more than likely make for good growing conditions and produce exceptional quality as well — as the harvests in 2012, 2013 and 2014 proved by delivering historic heavy yields and stunning quality in most of the West. →

Our guess for total harvest in California is 3.6 million tons crushed, which is off about 8 percent from 3.9 million tons crushed in 2014.

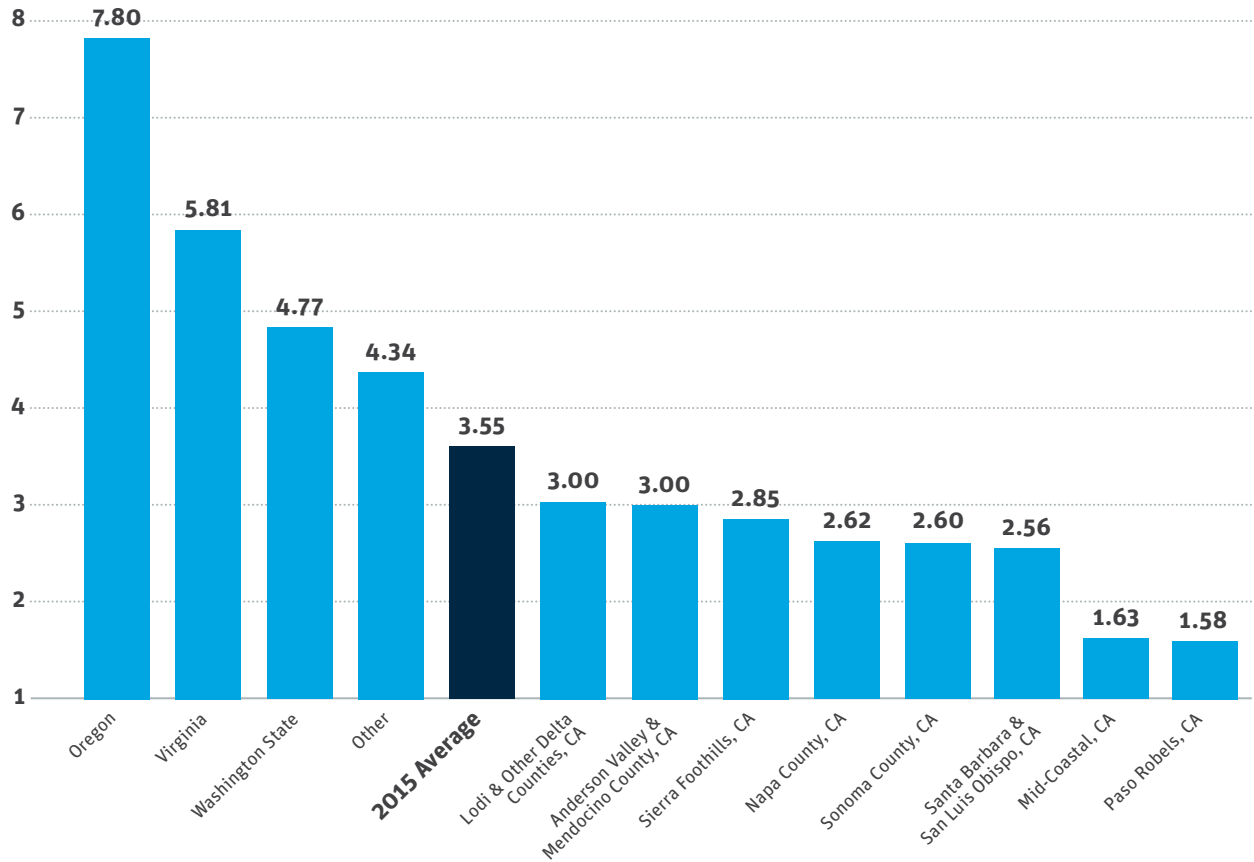
The Farm System: Imports, Land, M&A and Harvest

continued

Figure 24
Relative Magnitude of 2015 Harvest Yield

Source: SVB Annual Wine Conditions Survey

1 = Historical Low 5 = Historical Average 8 = Historical High



So, what do you hope for when coming off three record harvests in California? Rain of course, and not a fourth harvest of record yields. Something average would be appreciated in 2016.

While the rain didn't come in 2015 in any region, the yield was dramatically lower throughout California with the exception of the Central Valley where estimates

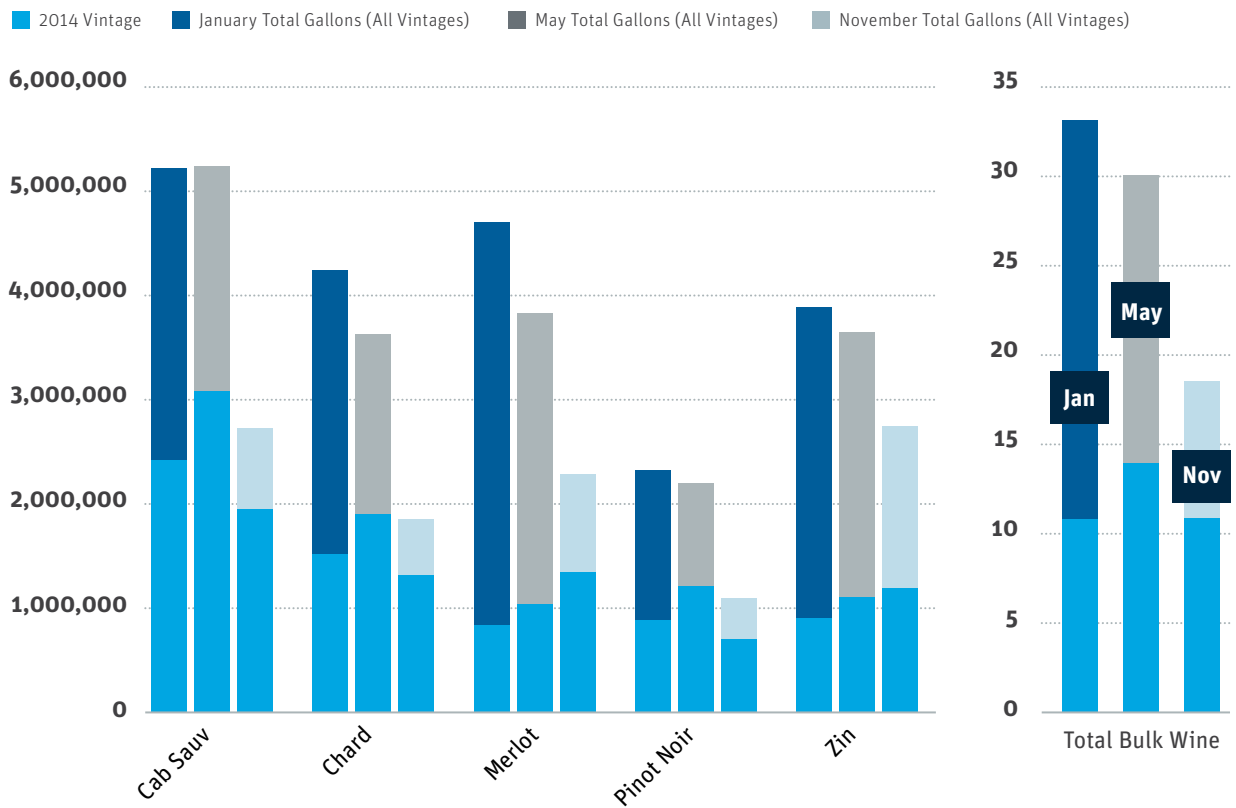
are that the harvest was about even with the prior year. Our guess for total harvest in California is 3.6 million tons crushed, which is off about 8 percent from 3.9 million tons crushed in 2014. Oregon, Washington and Virginia are the outliers with very good yields (Figure 24). →

The Farm System: Imports, Land, M&A and Harvest

continued

Figure 25
California Bulk Wine Inventory 2015

Source: Ciatti Company



The bulk wine markets have been oversupplied with long vintages of the harvests prior to 2015. As of this writing, juice is still available from 2013 and 2014. Once the 2015 harvest dynamic came into focus, many producers who were listing 2014 bulk for sale pulled it back from the market to supply their own needs (Figure 25). The combination of good consumer demand and a light harvest has made the situation much closer to being in balance, according to the brokers with whom we've spoken.

The quality has been described throughout the business as excellent. Of course, every year owners get in front of a camera and say, "This will be one of the best vintages ever!" Nonetheless, that is the report that has come from all regions without exception.

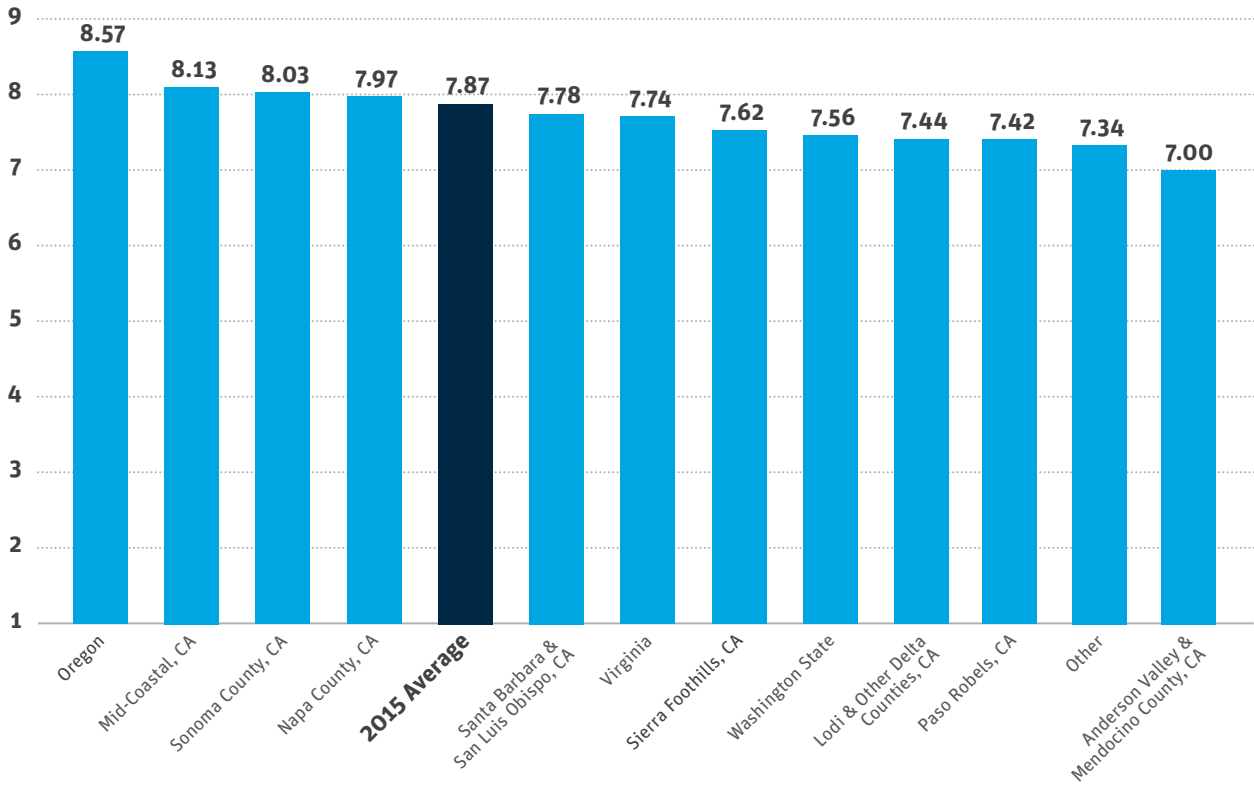
Asked to rank the harvest quality in the SVB Annual Wine Conditions Survey, all wineries rated the harvest quality as exceptional (Figure 26). Perhaps it's global warming in play, but Oregon, for the second year in a row, ended up with the vintage of the decade, reporting highs in yield and quality. ■

Despite lower yields overall, all major wine regions reported “above average” or “excellent” harvest quality in 2015.

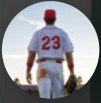
Figure 26
Relative Magnitude of 2015 Harvest Quality

Source: SVB Wine Conditions Survey

1 = Historical Low 5 = Historical Average 8 = Historical High



Oregon ended up with the vintage of the decade for the second year in a row.



Crash Davis: You be cocky and arrogant, even when you're getting beat. That's the secret. You gotta play this game with fear and arrogance.

Ebby Calvin LaLoosh: Right. Fear and ignorance.

Crash Davis: [exasperated] No. You hayseed. It's arrogance not 'ignorance.'

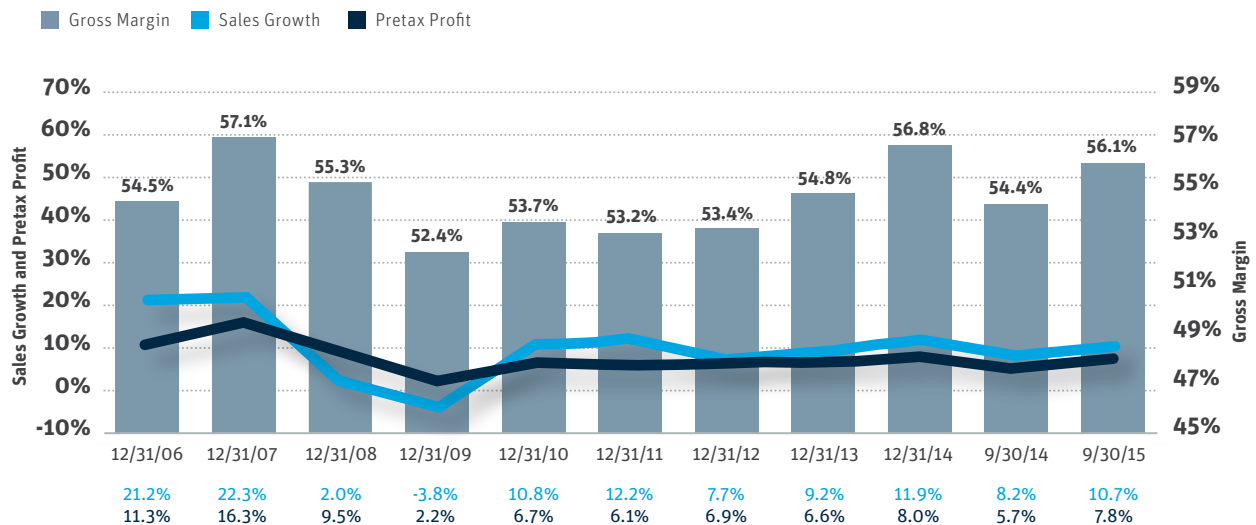
8

Collective Bargaining Agreement: Industry Financial Performance

Getting financial information about the wine business is even more difficult than finding financial information about professional baseball clubs. The wine business and baseball are private companies so financial statements and tax returns aren't lying around in the clubhouse or tasting rooms. Ask a winery owner how the business is going and you are likely to get something garbled like the preceding dialogue between Nuke and Crash Davis.

Figure 27
Financial Performance of Premium Wineries

Source: SVB Peer Group Data Base



As we look at the financial position of wineries this past year (Figure 27), revenue growth through nine months ending September 30, 2015 was about 11 percent. That

is lower than our predicted sales growth range of 14–18 percent made early in the year, but an improvement over the same period in the prior year. →

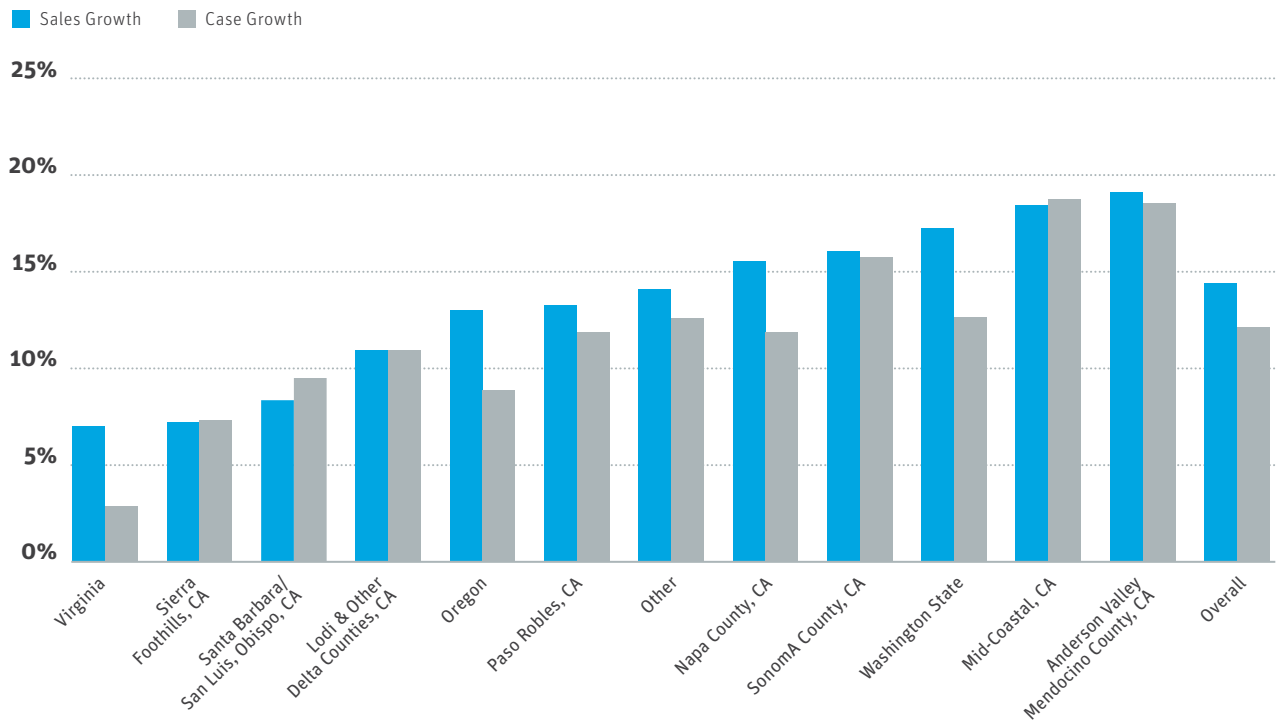
Collective Bargaining Agreement: Industry Financial Performance

continued

Figure 28
2016 Predicted Sales and Case Growth by Region

Source: SVB Annual Wine Conditions Survey

*Case growth refers to year over year increase/decrease in cases sold.
Does not include wineries less than five years old.*



The data for nine months aren't seasonalized and we will see the impact of a strong October-November-December period,⁶⁶ which will boost year-end sales growth figures. From experience, we expect 2015 to end around 15 percent top line growth, which is the lower range of our forecast.

Improved sales are due to increased demand for premium wine overall, the release of the higher volume 2012 vintage, and minor price increases.

The largest percentage price increases were in Virginia, Oregon, Napa, Washington and Paso Robles (Figure 28). Wineries in the regions of Mendocino and Sonoma showed the best growth in volume shipments. Even though they were minor, 2015 was the first year since the recession that price increases were passed on to the consumer, which is a statement about the improving economic situation in the U.S., and was consistent with our forecast early in 2015.

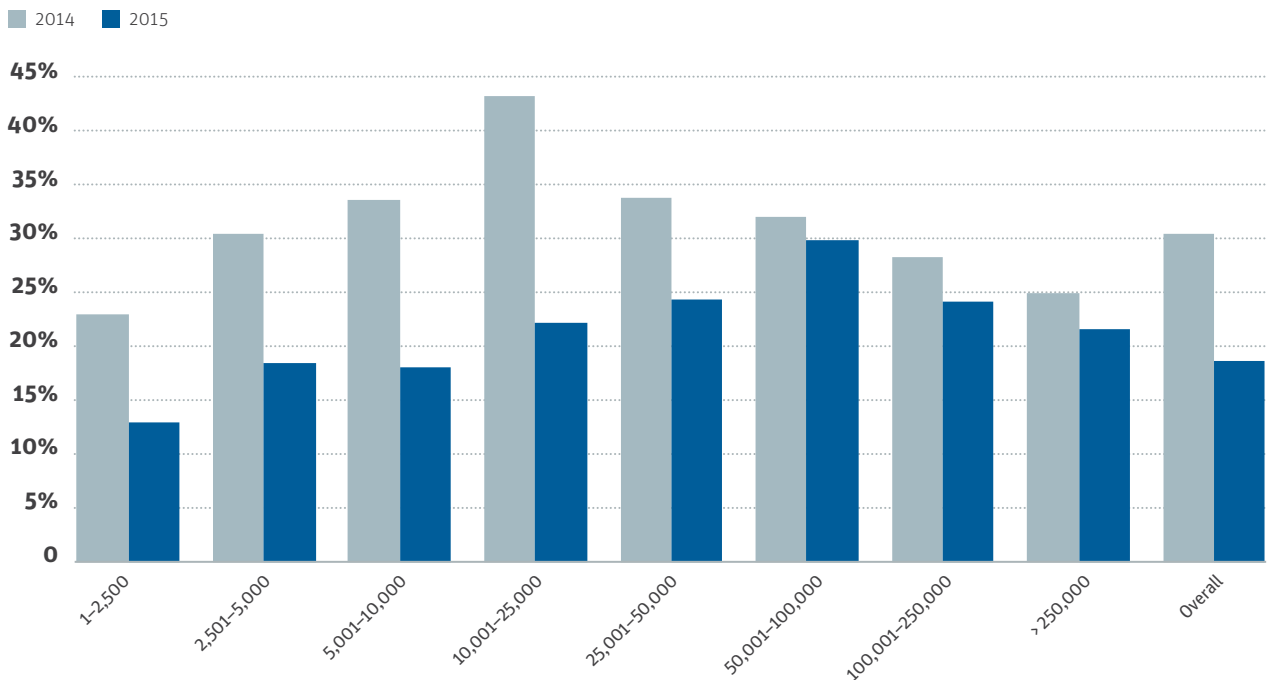
A change that was somewhat of a surprise in 2015 was the declining growth rate of wine sales in restaurants. →

A change that was somewhat of a surprise in 2015 was the declining growth rate of wine sales in restaurants.

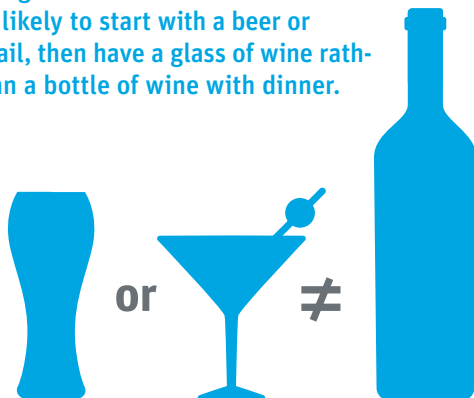
Figure 29
Winery Sales to Restaurants by Production Size

Source: SVB Annual Wine Conditions Survey

Percentage of total wine revenue from restaurant sales considering all distribution channels.



Our frugal millennial consumers are more likely to start with a beer or cocktail, then have a glass of wine rather than a bottle of wine with dinner.



On-premises information suggests the declining growth rate has been consistent through the entire year. Reviewing Figure 29, it's clear that the drop in restaurant sales took place in all price points.

We believe the reasons for this change are explained by more at-home consumption and a behavior change of our frugal millennial consumers who are more likely to satisfy their restaurant consumption needs by starting with a beer or cocktail, then having a glass of wine rather than a bottle of wine with dinner.⁶⁷ →

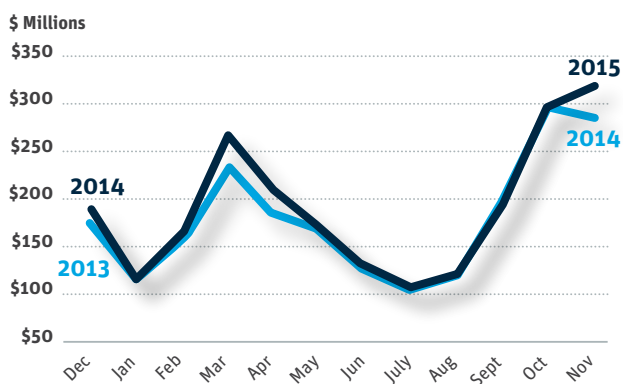
Collective Bargaining Agreement: Industry Financial Performance

continued

Direct-to-consumer trends continue to show impressive growth rates. ShipCompliant is reporting 12-month shipments totaling nearly \$2 billion through October, trending toward a year-end record (Figure 30). Shipments this year were positively impacted by the opening of Massachusetts as a direct state, and by the continuing evolution and learning by wineries discovering new ways to engage their consumers as a luxury retailer.

Overall, wineries reported that 2015 was one of their better years in history and that sentiment is across the board in all premium categories and regions.

Figure 30
Direct-to-Consumer Shipments
Source: Wines & Vines Analytics, ShipCompliant



Signaling Price Changes

When you add three years of record harvests with a fourth that was somewhat light, many pundits would still say that heavy inventory loads should equate to lower premium bottle pricing.

That is a reasonable conclusion because in a static environment and holding demand constant, an increase in volume should yield a decrease in price. But, that simplistic view ignores several factors, the first of which is the increasing demand for premium wine, and an improving domestic economy.

Each year we ask participants in SVB's Annual Wine Conditions Survey about their plans to change prices in the year ahead (Figure 31). This year, 62 percent said they expected to increase price, but what does that really mean? We know wineries want to pass on higher costs to consumers but that's not always possible. Last year was the first year we predicted pricing increases could be taken since the Great Recession and we were proven correct.

Figure 32 on page 64 depicts price increases sorted by production size. In something of a surprise, the results show the larger wineries have a firmer conviction about their ability to pass on higher prices in 2016. We believe that might be because the smallest producers who make →

62%

of survey participants say they expect to increase prices in 2016

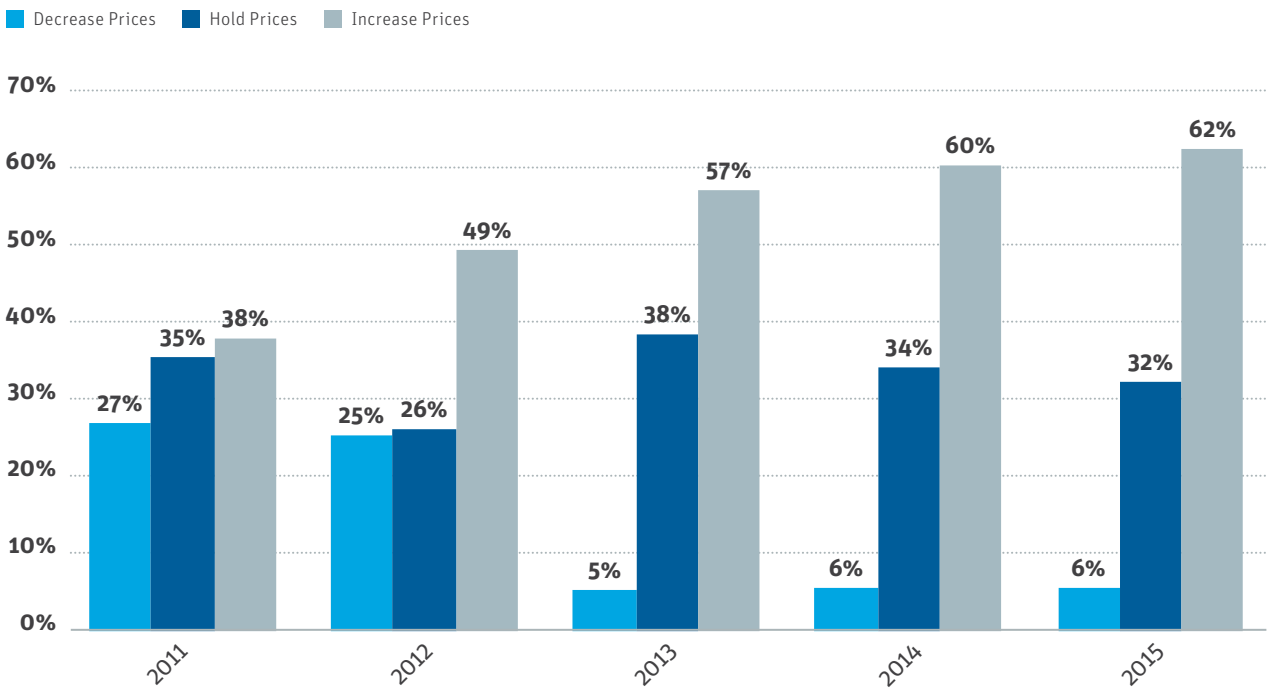
Collective Bargaining Agreement: Industry Financial Performance

continued

Last year was the first year we predicted pricing increases could be taken since the Great Recession and we were proven correct.

Figure 31
Price Projections: Five-Year Comparison

Source: SVB Annual Wine Conditions Survey



the most expensive wines have a more difficult time selling because they have to go direct. Conversely, the larger producers have distribution, making their path to market cleaner.

Once again, we are in agreement with the respondents, however, and believe the premium side of the business will be able to take small pricing increases of around 4–8 percent on average in price points above \$10, with the largest increases coming from wineries who have distribution.

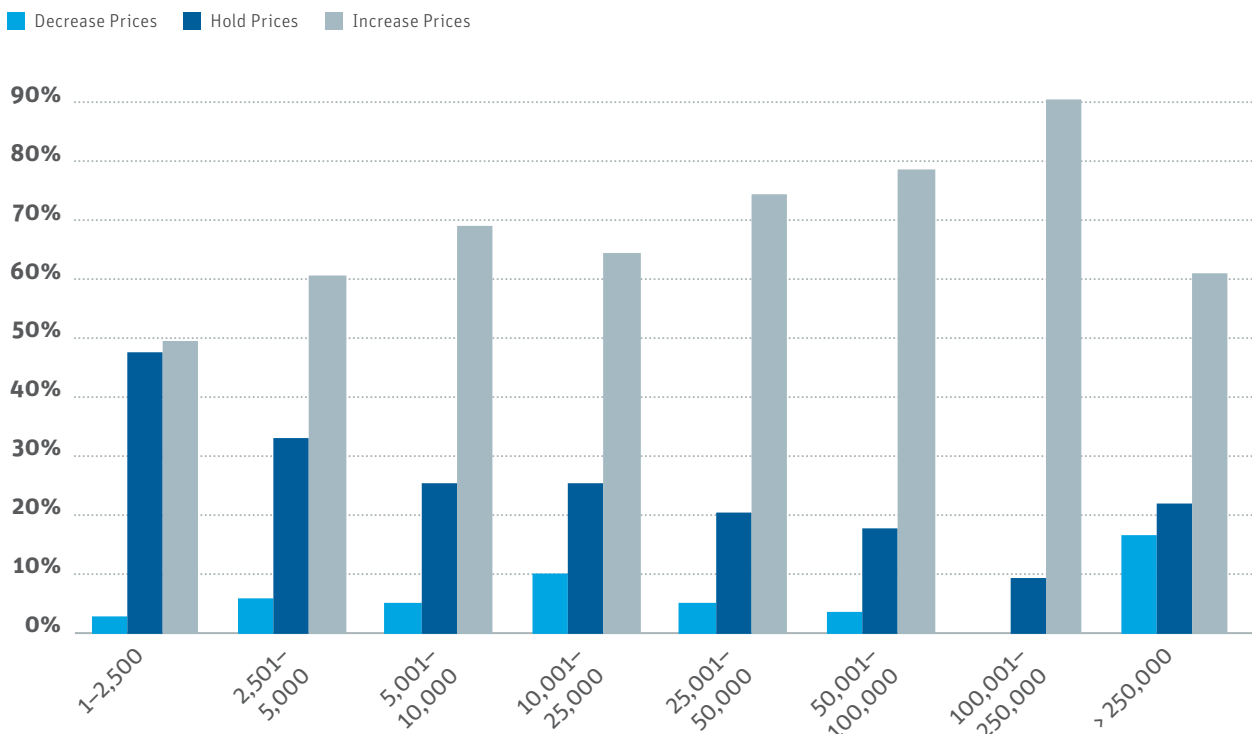
The lower end of the market – below \$8 retail – is trending down dramatically and will be issuing discounts to move wine in 2016. Something will have to happen to make that trend reverse course, and we can't see anything at this point that would do that. In fact, a strengthening dollar and lighter 2015 harvest could increase the strength of bulk imports, which would allow those mega producers to make wines even more cheaply and allow for needed discounting to move volume. →

Collective Bargaining Agreement: Industry Financial Performance

continued

Figure 32
Sales and Case Growth by Price Point

Source: SVB Annual Wine Conditions Survey

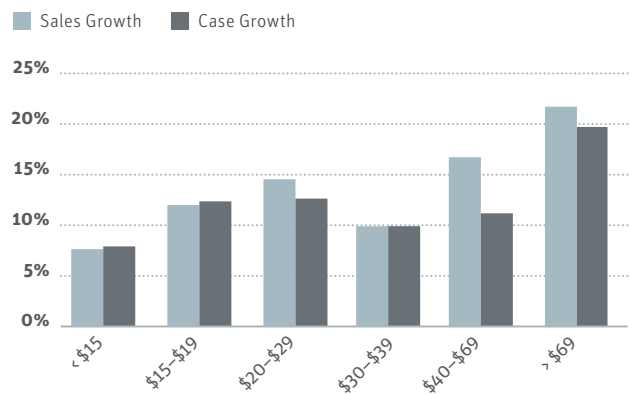



As can be seen in Figure 33 sorted by price, all wineries expect both case and price increases in 2016, but the wineries with the most expensive pricing expect the greatest relative gains and the wineries with the lowest average price points expect the smallest increases. ■

Figure 33
Retail Price Changes by Production Size

Source: SVB Annual Wine Conditions Survey

Case growth refers to YOY increase/decrease in cases sold. Does not include wineries less than five years old.



A close-up photograph of a cork and a metal corkscrew resting on a dark wooden surface. The cork is light brown with some darker spots and is positioned vertically. The metal corkscrew is coiled and lies horizontally in the foreground, partially overlapping the base of the cork. The background is blurred, showing more of the wooden surface and some indistinct shapes.

All wineries expect both case and price increases in 2016, but the wineries with the most expensive pricing expect the greatest relative gains.



Crash Davis: It's time to work on your interviews.

Ebby Calvin LaLoosh: My interviews? What do I gotta do?

Crash Davis: You're gonna have to learn your clichés. You're gonna have to study them, you're gonna have to know them. They're your friends. Write this down:

"We gotta play it one day at a time."

Ebby Calvin LaLoosh: Got to play ... that's pretty boring.

Crash Davis: 'Course it's boring, that's the point. Write it down.

9



Bottom of the Ninth: Final Thoughts

We started this report noting the theme was adapting to change and passing the torch. As the dominant cohort changes, the passing won't be smooth and we are forecasting the evolution will result in a decline in overall consumption for a time. And while premiumization is good news for smaller wine companies, that isn't going to protect them from mass producers who want that premium market too. But perhaps the largest emerging threat for the small premium winery outside of local anti-winery/tourism sentiment is competition from bottled imports.

While this is a competitive business, like baseball there are a set of unwritten rules. The relative youth of the business has created an industry that needed to be collaborative to succeed and that DNA remains. When there is a need, farmers, winemakers, industry organizations, winery owners — and maybe even an enlightened banker or two — come together to find solutions. So we are quite confident the industry will find creative ways to overcome and succeed and remain thrilled to call this business our home field.

Finally, we leave readers with the best advice from Ebby Calvin “Nuke” LaLoosh who, with all of his new interview skills said, *“This is a very simple game. You throw the ball. You catch the ball. You hit the ball. Sometimes you win, sometimes you lose, sometimes — it rains. Think about that for a while.”*

Play ball!

Endnotes

- ¹ The 1988-1999 drought was historic and acute throughout the U.S. http://en.wikipedia.org/wiki/1988%E2%80%931999_North_American_drought
- ² October 19, 1987 was Black Monday which is still the record for the biggest one day percentage loss in history of the U.S. stock market in a single day. [https://en.wikipedia.org/wiki/Black_Monday_\(1987\)](https://en.wikipedia.org/wiki/Black_Monday_(1987))
- ³ The History of Oil Prices: <http://politics.lilithazine.com/History-of-Oil-Prices.html>
- ⁴ The terms trading up, trading down and premiumization are used in the wine trade to explain the general direction of forward consumer pricing preference. The words do not appear in Webster's dictionary in this context thus limiting their use in Scrabble. While the origins of said terms as they relate to wine are undocumented, at least one source has given original attribution to the author of this report. At a minimum, can inclusion in the Urban Dictionary be far behind? <http://winecurmudgeon.com/?s=rob+mcmillan&x=0&y=0>
- ⁵ See Allied Grape Growers Past & Present: <http://www.allied-grapegrowers.org/pdf/AGGhistory.pdf>
- ⁶ Napa County's Wine Definition Ordinance was finalized in 1990 after a great deal of work from interested parties on all sides of the debate. <http://bit.ly/1Rv6ySL>
- ⁷ California Wine Institute shows 1,541 wineries existed in the U.S. in 1988. As of 2014, they list 10,417 wineries for a compound growth rate of a whopping 26 percent annually. <http://www.wineinstitute.org/resources/statistics/article124>
- ⁸ *Bull Durham*: <http://www.imdb.com/title/tt0094812/>
- ⁹ There is no agreed-upon reference point for the term "fine wine" in the industry. We use \$20 a bottle as a definition, because we have access to several databases that have a breakpoint at \$20 or more.
- ¹⁰ <http://www.winesandvines.com/template.cfm?section=news&content=142644>
- ¹¹ Yes, I know the wheel is more complex than that. Just go with me on it. It's an analogy.
- ¹² L'Organisation Internationale de la Vigne et du Vin, April 15 2015 press release. http://www.oiv.int/oiv/files/EN_Communique_de_Presse_15_avril_2015.pdf
- ¹³ Ibid
- ¹⁴ Ibid
- ¹⁵ Ciatti World Report, December 2014: http://www.ciatti.com/sites/default/files/november_2014_ciatti_world_report.pdf
- ¹⁶ L'Organisation Internationale de la Vigne et du Vin (OIV) statistical releases.
- ¹⁷ Yes, I know that the play at the plate has been altered to avoid collisions. You baseball purists need to get a life! Just pretend, OK? And besides, the section is on history so there were collisions at home plate in the olden days.
- ¹⁸ The first successful commercial winery in America was in Vevey, Indiana in about 1806. For more on the topic see my blog: <http://svbwine.blogspot.com/2013/07/where-was-first-successful-winery-in-us.html>
- ¹⁹ Bancroft, History of California , 5: 643; John Walton Caughey, California (New York, 1940), p. 305.
- ²⁰ The Volstead Act was the enabling legislation underpinning the 18th Amendment to the U.S. Constitution. https://en.wikipedia.org/wiki/Volstead_Act
- ²¹ California Winery Oral History Project, Bancroft Library, University of California Berkeley. http://digitalassets.lib.berkeley.edu/roho/ucb/text/adams_leon_ca_wine.pdf
- ²² Of course, not all production was captured as a large amount of wine was made illegally, but there were legal uses that were reported and that was the bottom of reported production.
- ²³ California Wine Institute
- ²⁴ Wine Institute, Dept. Of Commerce, Jon Fredrikson. <https://www.wineinstitute.org/files/Jon%20Fredrikson%20Presentation%20WI%2075th.pdf>
- ²⁵ California Grape Acreage Report, California Agriculture Statistical Service, 1972.
- ²⁶ In my family, we had a gallon of wine with a screw cap always available. It was kept in ideal storage conditions beneath the sink next to the garbage disposal. The value of the screw cap to a young man is that sampling could take place and all removals could be replaced with tap water without knowledge of household regulatory bodies.
- ²⁷ Lancers and Mateus, from Portugal and Blue Nun from Germany were wildly successful brands which got their start post WWII, each peaking at well over 1 million cases imported in the mid-1980s.
- ²⁸ Neo-Prohibitionism <http://fxn.ws/10IZuBO>

Endnotes

continued

- ²⁹ Examples of the 1960s commercials: <http://bit.ly/1XNqntf>
- ³⁰ Frank Schoonmaker (Encyclopedia of Wine, 1964) was an original proponent of the varietal labeling of wines in America. The term fighting varietal has no verifiable author, though several wineries have been suggested, including Glen Ellen and Mondavi. <http://for.tn/1lHkXi6>
- ³¹ Bartles & Jaymes was viewed in advertising circles as an iconic event. <http://bit.ly/1lISOxD>
- ³² Judgment of Paris [https://en.wikipedia.org/wiki/Judgment_of_Paris_\(wine\)](https://en.wikipedia.org/wiki/Judgment_of_Paris_(wine)) see also Bottle Shock; <http://www.imdb.com/title/tt0914797/> a stylized version of the Judgment of Paris from the perspectives of Chateau Montelena and Steven Spurrier.
- ³³ The French Paradox, *60 Minutes*, 1991: <http://bit.ly/1R3Euq2>
- ³⁴ Small wine companies at the time were seeing sales growth as high as 35 percent and their production sold out in six to nine months.
- ³⁵ 1999 Adams Wine Handbook
- ³⁶ The Yellow Tail Story: <http://bit.ly/1NA3fDK>
- ³⁷ The prediction published in the 2006 State of the Industry Report intended to point out a threat and rock the boat a bit; it rocked it more than I had intended. The piece was sensationalized by my now-departed friend Rich Cartiere, publisher of Wine Market Report. His coverage was picked up in newspapers elsewhere. While I can't find his report today, I was able to locate a NYT article on Yellow Tail that cites Rich and the SVB report toward the end of the article. If nothing else, the article here is instructive of the perceptions at the time. The end of the story is I've since been invited back to speak several times by my Central Valley colleagues, and help find new solutions to make the region more successful. <http://nyti.ms/1NaP88B>
- ³⁸ Great Depression: <http://www.history.com/topics/great-depression>
- ³⁹ I moved my 89-year-old mom from her home of 60+ years in July. She bought her house as part of the GI Bill with my dad. They had one mortgage and paid it off in 30 years. They never moved. You can't begin to understand how much stuff she had 'saved,' and how hard that was to move because she couldn't throw away anything. Every piece had to be reviewed and a call made to someone to see if it could be used by someone else ... such as a Mr. Coffee coffee maker from 1973, and fabric scraps that someone could use, held from 25 years of making clothes for the kids. When we got to the end and had to make a few dump runs, she was almost sick thinking about adding to the landfills. It was made even worse knowing we had to pay to throw it away.
- ⁴⁰ The first real revolving consumer charge card was the BankAmericard started in the late 1950s. https://en.wikipedia.org/wiki/Credit_card
- ⁴¹ Many articles are available about the millennials and the Great Recession. Here's one: <http://www.cheatsheet.com/politics/this-is-what-the-recession-did-to-millennials.html?a=viewall>
- ⁴² The Tax Reform Act of 1986 eliminated the deductibility of "personal interest," which effectively was credit card interest. Before that, baby boomer consumers could run up credit card balances and that interest was deductible. That practice is believed by many to have encouraged the overuse and abuse of revolving credit card debt.
- ⁴³ Gateway wines are 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 word that should be added to the Urban Dictionary.
- ⁴⁴ Silicon Valley Bank Annual Wine Conditions Survey, Dec. 2015. The survey is not weighted by volume. Results are averaged with all wineries carrying an equal weight. That allows us to create charts that can be used for benchmarking. The results are skewed to fine wine production since by number, most wineries take the high-quality low-volume path.
- ⁴⁵ Ibid. The question asked in the survey of over 500 wineries was to share information about the demographic makeup of their direct sales. While we asked about direct sales only, we did so because it's not possible for wineries to track cohort information once passed along into the three-tier system. We believe the responses should still be representative of their customers in all channels.
- ⁴⁶ Technomic: <https://blogs.technomic.com/technomic-finds-millennials-adult-beverage-choices-evolving-as-they-mature/>
- ⁴⁷ "Frugal luxury" 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 rent expense, stay away from consumer credit, drive less expensive cars that have appealing style and save their discretionary income for simple luxuries they truly enjoy.
- ⁴⁸ Sideways Impact on Merlot and Pinot Noir sales. <http://www.winesandvines.com/template.cfm?section=features&content=61265>

Endnotes

continued

- ⁴⁹ Gallo Consumer Wine Trends Survey: <http://www.multivu.com/players/English/7693851-e-j-gallo-wine-trends-survey-2015/>
- ⁵⁰ Granholm v Heald: https://en.wikipedia.org/wiki/Granholm_v._Heald
- ⁵¹ Wine Sparks War Between the States, Peter Sinton, Chronicle Senior Writer April 6, 1996, p2.
- ⁵² Estimates of direct sales in the mid-1990s vary widely in the literature.
- ⁵³ The findings of a Sonoma State survey on the locals' views of tourism was revealing and covered in a blog post here: <http://bit.ly/1NSAVmo>
- ⁵⁴ Napa Traffic is from Locals: http://napavalleyregister.com/news/local/study-reveals-who-s-clogging-napa-highways/article_267462a6-3de7-58fa-80f4-4055273d2621.html
- ⁵⁵ The quote from Crash was edited slightly to keep a PG rating.
- ⁵⁶ Wine Intelligence: <http://bit.ly/10OC8Ik>
- ⁵⁷ Constellation Acquires Vincor, Kim Crawford, and other labels: <http://bit.ly/21GdxQ>
- ⁵⁸ The Sonoma State University study has not yet been through peer review and the findings are still preliminary. The complete study hasn't been published. The findings are skewed to millennial wine consumers, but the findings are useful, painting a good view of their current consumption patterns. A story on the survey can be found here: <http://bit.ly/1NDkGDs>
- ⁵⁹ Moscato article: <http://bit.ly/1XL1Hll>
- ⁶⁰ Slight edit of the quote to remove the 's' word.
- ⁶¹ Information isn't presented about Washington and Oregon land and values in this report because of a lack of data available. 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 to California.
- ⁶² Superior good: https://en.wikipedia.org/wiki/Superior_good
- ⁶³ Roger Nabedian, SVP and GM of Gallo's Premium Wine Division said, "As we have an eye toward more luxury wine, we have been pretty aggressive about buying high-quality vineyard land in what I think are the most premium appellations across the coastal areas of California." Similar quotes in the press can easily be found from other of the large producers.
- ⁶⁴ The Asti Winery acquisition by Gallo had an interesting, almost artistic quality to it as in the 1960s, Italian Swiss Colony which occupied those digs, was bigger than Gallo.
- ⁶⁵ I get a lot of calls about wine company multiples. While there is a range, the business is not homogenous so citing a multiple as a data point isn't helpful. I cover the topic in a little more detail in my blog: <http://bit.ly/10ITzfa>
- ⁶⁶ In the wine business, the months of October, November and December represent about 40 percent of annual sales.
- ⁶⁷ Wine Market Council, 2015 and Technomic <https://blogs.technomic.com/2016-a-happy-new-year-on-premise/>

Figure Notes:

[†]Includes: Napa Cabernet Sauvignon, Napa Merlot, Napa Cabernet Franc, Napa Pinot Noir, Napa Chardonnay, Sonoma Pinot Noir, Sonoma Chardonnay, Sonoma Cabernet Sauvignon, Sonoma Merlot, Mendocino Cabernet Sauvignon, Mendocino Merlot, Mendocino Pinot Noir, Mendocino Chardonnay, Central Coast (District 8 SB+SLO) Chardonnay, Central Coast (District 8) Pinot Noir, Oregon Pinot Noir, Oregon Chardonnay (Oregon Vineyard report not published in 2012; figures estimated).

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The Napa Valley Wine Library Association/St. Helen Public Library WPBT2
The Anti-Saloon League Museum

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For more information about this report or Silicon Valley Bank's Wine Division, please call or email:



Rob McMillan
Executive Vice President and Founder
Silicon Valley Bank Wine Division

707.967.1367
rmcmillan@svb.com
3003 Tasman Drive
Santa Clara, CA 95054

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