

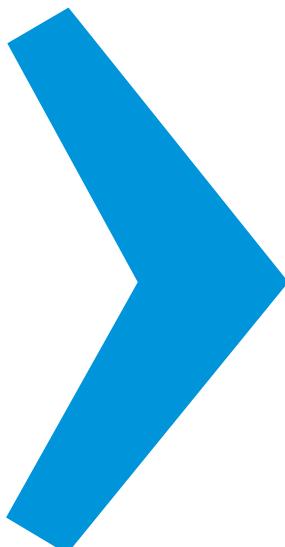
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Silicon Valley Bank



State of the Wine Industry 2018

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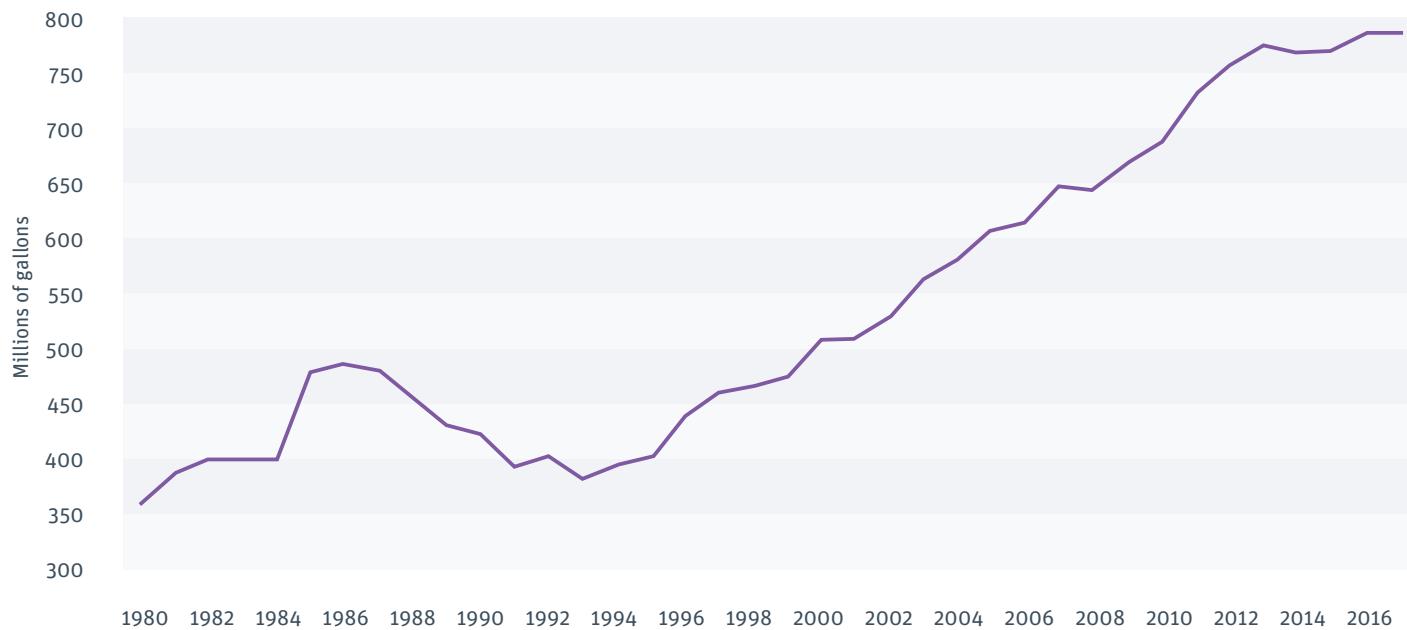


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Introduction

The US wine industry is at the tail end of its largest growth period in history. Since 1994, the industry has experienced long-term trends of increasing volumes and higher prices, with only minor flattening periods during recessions (see figure 1).



Figure 1: US wine consumption*Volume*

Sources: California Wine Institute, Gomberg-Fredrikson, BW166

Today, consumers are leaving the lower price segments in favor of better-quality offerings, but after more than 20 years of straight-line growth trends, total volume growth is leveling out. Premiumization is still the dominant trend, so volume drops in lower-priced generics are part of the explanation for flattening volume; but in a more recent development, even premium wine growth is slowing.

Winery owners, who have seen grape prices escalate markedly over the past five years, are finding that cost increases are difficult to pass on to new consumers, who are signaling that they have a lower indulgence ceiling than have prior generations.

While the economy overall, as of this writing,¹ is demonstrating the best results since the 2007–2009 recession, the economic circumstances that set the stage for the industry's 20-year growth trajectory cannot be repeated. The factors that made you successful to this point will not enable you to sustain that success. This means the winning sales strategies you are leveraging in the operating environment today will slowly prove fallible tomorrow.

*Successful wineries
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Successful wineries 10 years from now will be those that adapted to a different consumer with different values — a customer who uses the internet in increasingly complex and interactive ways, is frugal and has less discretionary income than their predecessors. Successful companies will be those that evolve retail strategies away from the winery location as the sole point of experience and find other, scalable means of delivering the experience — and the wine — to consumers where they live.



2 2017 predictions in review

We have been researching the wine business since 1991 and making predictions for more than a decade. Some years, we properly characterize a market change; in other years, our findings might be off in timing or even wrong,² but we always review the forecasts made the prior year just to keep score. In 2018, a key prediction we will miss in sales growth sets up a broader discussion of market changes.

What we got right

- We were correct when we suggested that labor shortages, which were an understated part of the conversation in 2017, would escalate throughout the year.
- We predicted that M&A activity would remain very high in 2017, and it did, capped by the 600-acre Stagecoach Vineyard purchase by E. & J. Gallo.³
- We said that import growth in lower premium price points would increase. France, Italy and New Zealand all have accelerated their wine sales in the US and are gaining market share from domestic wineries.
- With respect to segments, we correctly predicted the following:
 - Under \$9 bottled wines would continue to struggle. Price drops for glass format wines were to be expected.
 - Wines sold between \$12 and \$25 would grow in demand, and limited price increases would be available. Price increases were quite limited, but demand in the segment did grow.
 - Wines sold between \$35 and \$75 would find price increases difficult without the US economy's demonstrating improved performance.
 - High-end luxury wines *with an established brand* would have no problem retaining volume levels and making small price increases.
- With respect to land, we were correct to predict the following:
 - The narrowing supply of arable land suitable for higher-end wine production combined with good buyer interest would drive vineyard prices higher in premium regions.
 - Vineyards in Oregon and Washington would continue to see high interest from larger wine companies.
 - California's Central Valley would have some additional acreage to remove.
- Per capita consumption (case volume divided by population growth) would face headwinds in 2017, but if economic conditions continued to improve, those impediments would be offset, leading to slightly higher per capita consumption for another year.

- The presence of millennials would be most visible in the \$8 to \$12 red blend category, but they would gradually move away from blends and into varietal wines or imports as their incomes improved. We saw growth in chardonnay and lower-priced imports in 2017.
- Restaurant wine sales would show limited to zero growth in 2017, which is an improvement over recent negative-growth years. Restaurant sales did have limited overall growth, but the industry continues to struggle with closings, declining same-store sales and outdated store concepts.

What we got wrong

We predicted a sales growth range for the premium wine segment of 10 to 14 percent in 2017, up from 9 to 13 percent in 2016, describing the confluence of good supply, strong consumer demand and better retail conditions as factors in delivering improved industry performance. We also said that industry growth would be 2 to 3 percent in volume and 4 to 6 percent in dollars.

From all the sources we can find today, we see growth ranges in wine consumption dropping over our expectations at the start of 2017. That is not to be confused with lower sales. Sales are still increasing, but growth rates are slowing.

Our own database of winery financial statements shows that sales growth through the nine months ended September 2017 is 0.3 percent, vs. 9.8 percent for the same period in 2016. For the industry overall, we are showing 0.6 percent growth in volume and 2.4 percent growth in dollars, using Nielsen data,⁴ so again we were high on both estimates.

While we still have the October-November-December data to potentially improve 2017 results, it looks as though we will miss our sales forecast for the first time when the final year-end numbers are tabulated. We can lick our wounds a little because we were correct in saying that all the growth would be in the above \$9 segment, but that's little comfort.



3 | 2018 wine business predictions and observations

Industry

- We predict a sales growth range of 4 to 8 percent for the premium wine segment, down from the 2017 sales growth estimate of 10 to 14 percent. For the industry as whole, sales will rise by 2 to 4 percent, while volumes will increase up to 1 percent.
- We expect acquisitions to cool somewhat from the torrid pace of the past three years as many of the major buyers digest their recent purchases. We will still see foreign purchases of US wineries and significant transactions for vineyard properties over the next 12 months.
- Increasing imports will continue in the lower premium price points.

Supply

- By all accounts, when 2018 totals are calculated California will have crushed about 3.8 million tons of grapes, slightly more than in 2017. Pacific Northwest harvests will set another record in terms of yield in Oregon and will moderate slightly in Washington.
- Overall supply is balanced, with chardonnay demonstrating particularly strong demand. Cabernet is balanced with flat to down pressure at the high end of the market.
- California vineyard prices in premium regions will flatten compared with the strong growth we've seen for the past five years.
- Oregon and Washington vineyards will continue to see high interest from larger wine companies with increasing pricing.
- The California Central Valley is closer to being in balance after 2017 acreage removals, but some additional removals will be needed in the southern San Joaquin Valley to produce sustainable pricing opportunities.

Demand

- Retiring baby boomers and frugal millennials drive a rotation of consumer preferences. Premiumization will continue, but softening is likely on the luxury end for wineries without strong brands. For established brands, growth opportunities remain positive.
- Millennials are migrating away from red blends and introductory wines and are starting to have a positive impact on lower-priced still wine categories — both domestic and foreign. This trend will continue.
- The Gen X cohort will surpass the baby boomers around 2021 to become the largest fine wine consumer demographic in the US. By 2026, millennials will surpass Gen Xers to become the largest fine wine-consuming cohort.

Price

- Price increases will be difficult to pass through in 2018. Overall pricing should be flat.
- Routinely increasing both volume and price, as has occurred over the past 20 years, will prove difficult for wineries given the low-growth, low-inflation environment.



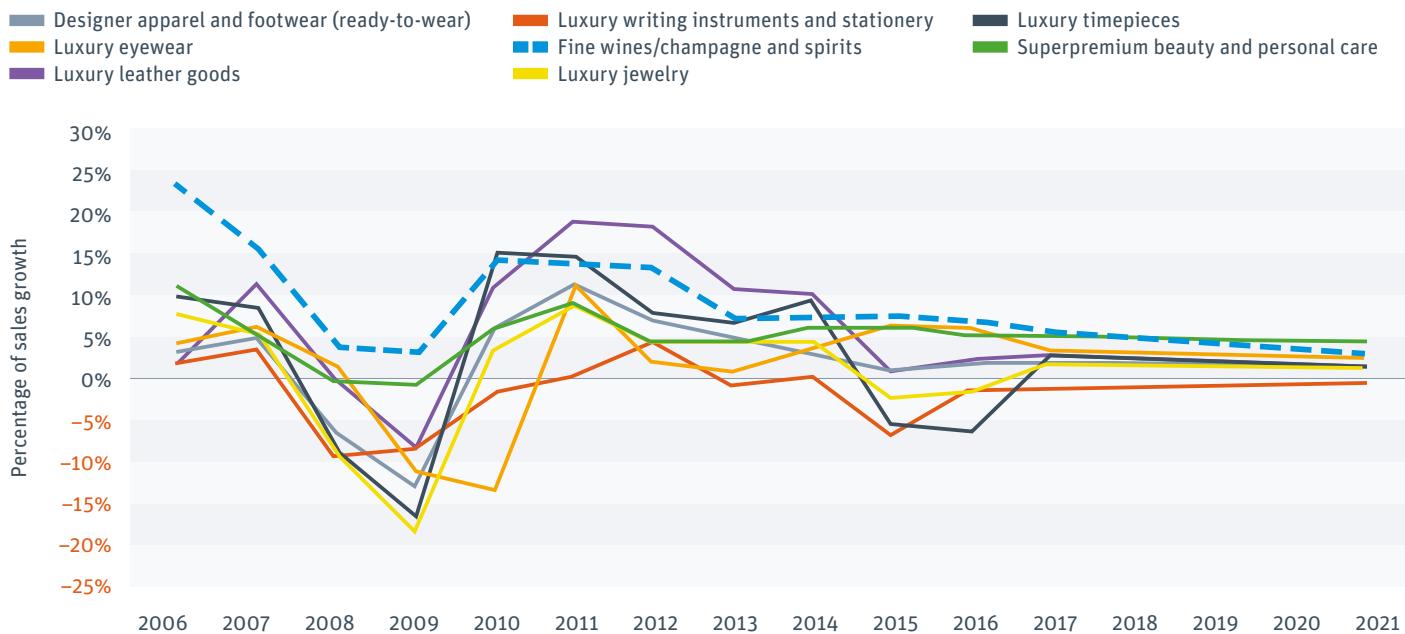
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Evidence of changing consumer preferences

Luxury goods

Premium wine is a luxury product. It sells in different ways than do luxury automobiles, leather and eyeglasses, but there are insights to glean from the behavior of the luxury market – the channels in which it operates, how products are sold and how they are marketed.

Figure 2: Sales growth rate of US luxury goods



Source: Euromonitor International Passport, December 2017

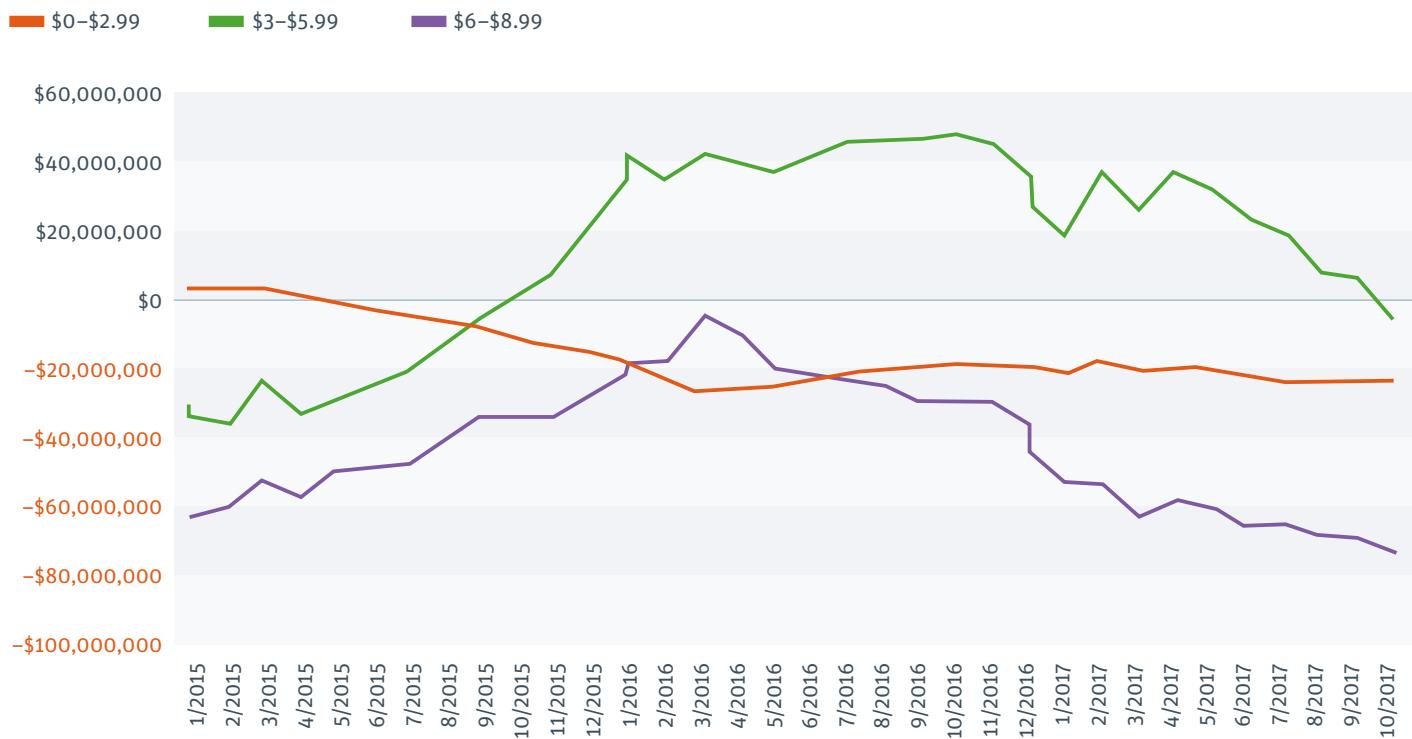
According to the newly released annual Bain Luxury Study,⁵ the large American market (including both North and South America) has been undergoing wrenching changes in consumer preference and retail strategies. The American market was expected to report flat growth for 2017 but instead managed to finish the year in positive territory, growing by 2 percent. This is compared with other developed luxury markets – which show much better growth opportunities – led by China, which boosted sales by 15 percent.

For the US specifically, growth following the market collapse was robust, exceeding 10 percent in all categories except eyewear, with the growth rate in luxury wine and spirits nearing 15 percent. But since 2011 the growth rate in luxury sales has trended down to the current rate of 2 percent. Fine wines, champagne and spirits are a near proxy for the sector's growth change (see figure 2). Why is growth slowing in the US but advancing in other parts of the world?

The face of the US consumer is changing, as are the paths to market. Bain estimates that online selling, which at one point was thought of as an anathema to the luxury experience entirely, is now an accepted channel and is expected to represent up to 25 percent of total sales by 2025. Retailers are now struggling to define their digital experience away from sales by location, and that is proving difficult, particularly for the mono-brand stores.

The consumer too is evolving. While single-brand stores are struggling, off-market stores and airport shopping are thriving. The US consumer, whether young or old, is focused on experience and value, and that is forcing change in retail marketing strategy. No longer can the store experience be the defining characteristic for the luxury buyer; in that fact is a warning for wineries that depend on the tasting room as their only path to direct sales.

Figure 3: Rolling 52-week sales growth of wine below \$9



Sources: Nielsen Beverage Group, SVB Analysis 2

Premiumization: Below \$9 retail wine

Over the past decade, the moniker that has stuck to describe consumers' willingness to pay more for wine has been "premiumization." Besides butchering the English language, it's not really an apt term because, as any winery owner will tell you, while consumers are trading up on average, it's still very difficult to increase prices. So how are consumers trading up if prices aren't rising?

The truth is, while the consumer has been willing over the past decade to spend more on average, the trade-up has more to do with a decline in demand for lower-priced value wines vs. a willingness by all consumers to spend more on a given bottle (see figure 3).

The break point between growth and decline in sales falls at around \$9, and in 2017 the segment below \$9 declined in both dollars and case volume. The only countervailing dynamic of the trend has been a short-lived improvement in \$3 to \$6 wines, but even that minuscule bright spot is not what it seems. It really is reflective of larger-format box wine.

Figure 4: Top-growth box brands

52 weeks

Company	Top-growth box brands	Total category tracked sales	Total category tracked growth	Brand growth rate
Constellation Brands	Vendage, Black Box	\$256,533,915	\$57,351,551	28.8%
Delicato Family Vineyards	Bota Box, Cellar Box	\$201,189,114	\$41,740,002	26.2%
Trinchero Family Estates	Sutter Home	\$19,466,059	\$391,683	2.1%
E. & J. Gallo Winery	Peter Vella, Liberty Creek, Naked Grape	\$153,718,861	-\$835,355	-0.5%
The Wine Group	Franzia	\$473,322,778	-\$12,342,791	-2.5%

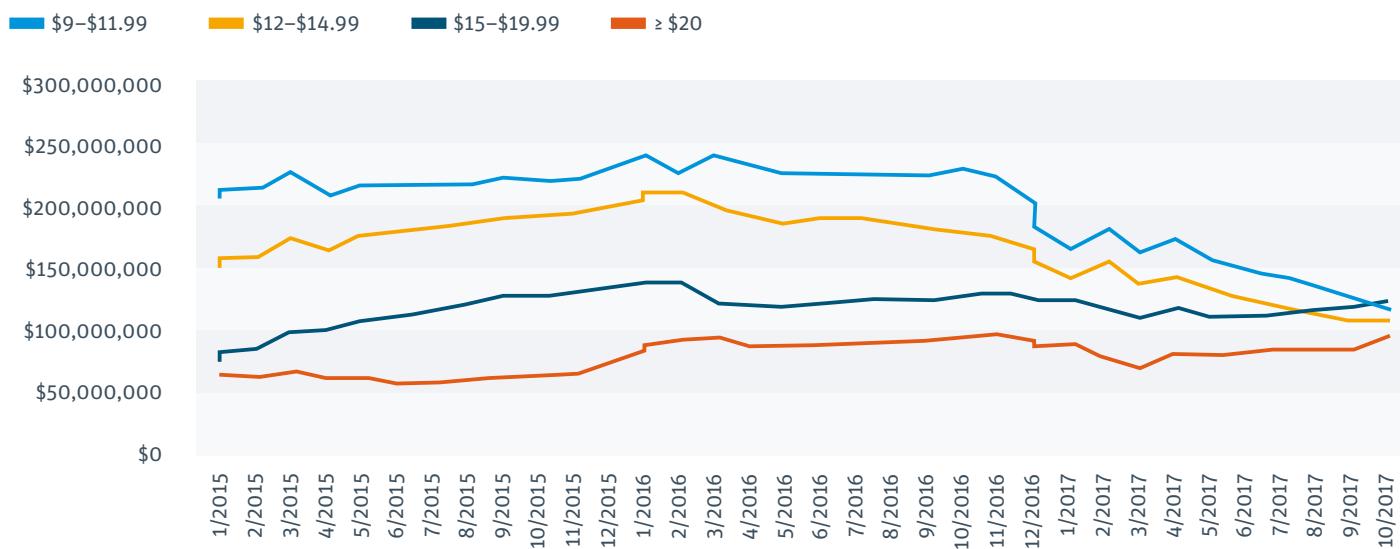
Sources: Nielsen Beverage Group, SVB Analysis 3

The volume and growth came in \$3 to \$6 wines because all the formats are converted to 750-milliliter bottles, and \$14+ box wine is a growth segment. The box wine category has been largely dominated by Constellation Brands and Delicato Family Vineyards, but Trinchero Family Estates, E. & J. Gallo Winery and The Wine Group also participated, each using its distribution muscle to push larger box and Tetra Pak formats (see figure 4). So even the minor positive news in the below \$9 segment is a bit of a mirage because better juice is being sold more efficiently in larger containers. It does demonstrate how consumers remain value conscious.

Because the \$3 to \$6 price segment represents such a large component of volume sales — 45 percent — it was noteworthy to see the growth, but it should not be viewed as a reversal of the premiumization trend.

Premiumization: Above \$9 retail wine

While there is no real definition of the term “premium wine,” we define it as wine above \$10 per bottle. That segment dominates sales and is responsible for all the growth in the trade today (see figure 5).

Figure 5: Rolling 52-week sales growth of wine above \$9

Sources: Nielsen Beverage Group, SVB Analysis 4

Looking back, the only time in recent memory that we have seen trading down as a trend was during the Great Recession of 2007–2012, but in reflection things weren't what they seemed.

During that financial crisis, wine conference discussions centered around the direction of spend, and trading down was discussed as a consumer trend. There was supply chain and demand disruption, but consumers who were hurt by the financial collapse did not give up their wine; they just switched to less expensive options, but it wasn't trading down in terms of consumer preference. In a market-driven paradox, many of those less expensive wines sold during the recession were actually the more expensive fine wines from producers who had to blend down or discount wine to move product. It didn't give lower-cost producers a true advantage, so an argument can be made that the consumer has not traded down in the past 50 years.

Even if we acknowledge the single trading-down data point during the recession as being valid, there is no way to create a business from it. A model based on the hope of recession is clearly misguided. As we often say, "Hope is not a strategy." But the question worth answering is: Can premiumization (trading up) continue unabated forever?

Slowing premium sales trends

Which current market conditions might be signaling a change to premiumization? Impaired restaurant sales might be one, but we see that more as a channel and consumer preference shift. Value-conscience consumers aren't eating out as often or spending as much on alcohol when they do go out, but they are drinking more at home.

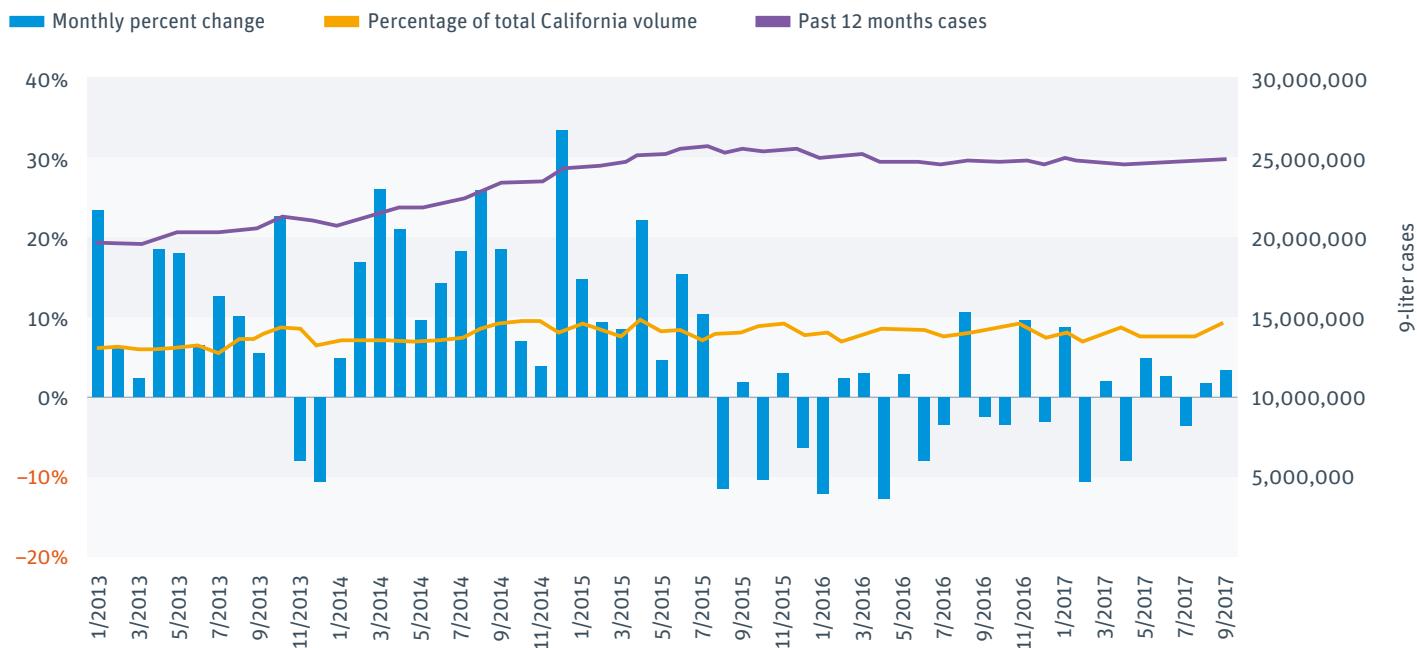
One possible clue that premiumization is beginning to break down somewhat is shown in figure 5: While there remains growth in wines above \$9, since the end of 2015 that growth rate has been declining. That's a newsworthy change in market direction, but is it real?

The first thing we do when we see surprising, contradictory or confusing data is to consider bias and question the context. It is possible to draw bad conclusions from good research.

Nielsen data are biased in favor of wine sold wholesale. The data exclude some nontraditional channel information like Costco, direct-to-consumer (DTC) sales and some private labels like Aldi and Lidl that don't participate in syndicated data collection. It is possible that the decline is not a decline at all but rather a channel shift that Nielsen doesn't pick up in its stats.

Can premiumization (trading up) continue unabated forever?

Costco is the largest US wine retailer, with close to \$2 billion in wine sales annually, and its wine programs are growing. DTC sales would also offset Nielsen trends, as there is nearly \$3 billion in direct sales, and purchases are clearly growing there.⁶ No matter what, we always have a hard time dismissing obvious trends from robust data collectors like Nielsen, so we need to dig a bit deeper.

Figure 6: Warehouse shipment trends

Sources: Gomberg-Fredrikson, BW166

Winery shipments

Gomberg-Fredrikson shipment data from wine warehouses come at sales trends from a different perspective and reflect sales from the winery vs. the retailer (see figure 6).

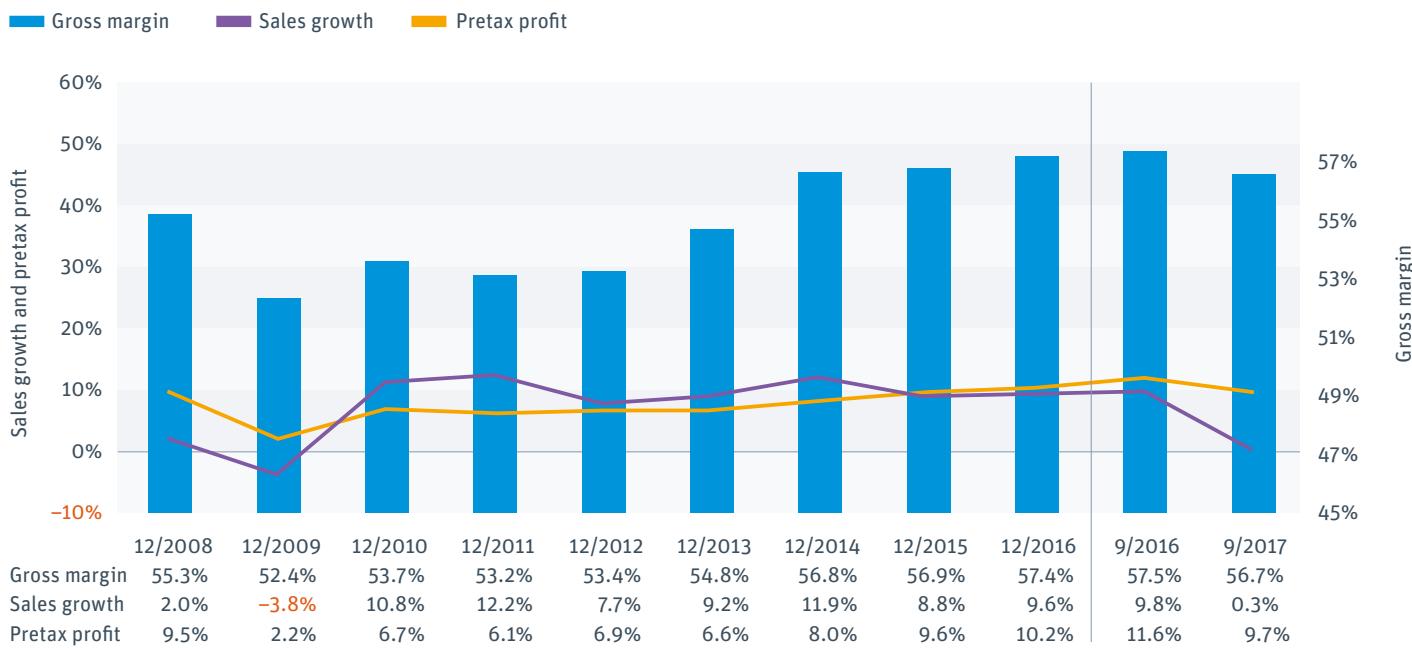
Through September 2017, wine shipments from warehouses slowed beginning in August 2015, roughly equivalent to what Nielsen shows in its time line in figure 5. The Gomberg-Fredrikson data in figure 6 do include DTC and Costco shipments, whereas the Nielsen data do not.

Winery financial performance

Silicon Valley Bank collects financial statements from clients and non-clients as part of our daily routine. We then provide our clients with gratis consulting and benchmarking, and with that information we can track larger-scale industry moves, as well.

Our database reflects the wine industry overall and includes hundreds of wineries, overwhelmingly from the US West Coast. Average case production in the database is 27,886, with a range of 1,000 to 730,000 cases. The average retail bottle price is about \$28.

Figure 7: Premium wineries' financial benchmarks



Source: SVB Peer Group Analysis Database

Figure 7 is a product of that database, starting in 2008 when the financial crisis was in full swing. Note that in 2009, sales growth for the industry was -3.8 percent and that it rebounded thereafter. The trended growth rate has slowed over the past decade, while wineries simultaneously evolved their strategies to direct models, which should imply higher average sales prices and gross margins. Gross margin has trended higher as expected, and while pretax profit remains between 8 and 12 percent, the latest period of sales growth in the figure is another point of concern.

Through the nine months ended September 2017, average sales growth has been a paltry 0.3 percent. That's less than a 1 percent growth rate. The only close comparison is the recession-impacted period in 2009. Although the nine-month information is missing the heavy October-November-December period and undoubtedly year-end sales will improve, in 2016 the sales growth rate for the comparable nine-month period was 9.8 percent, so it's unlikely we will see sales growth improve

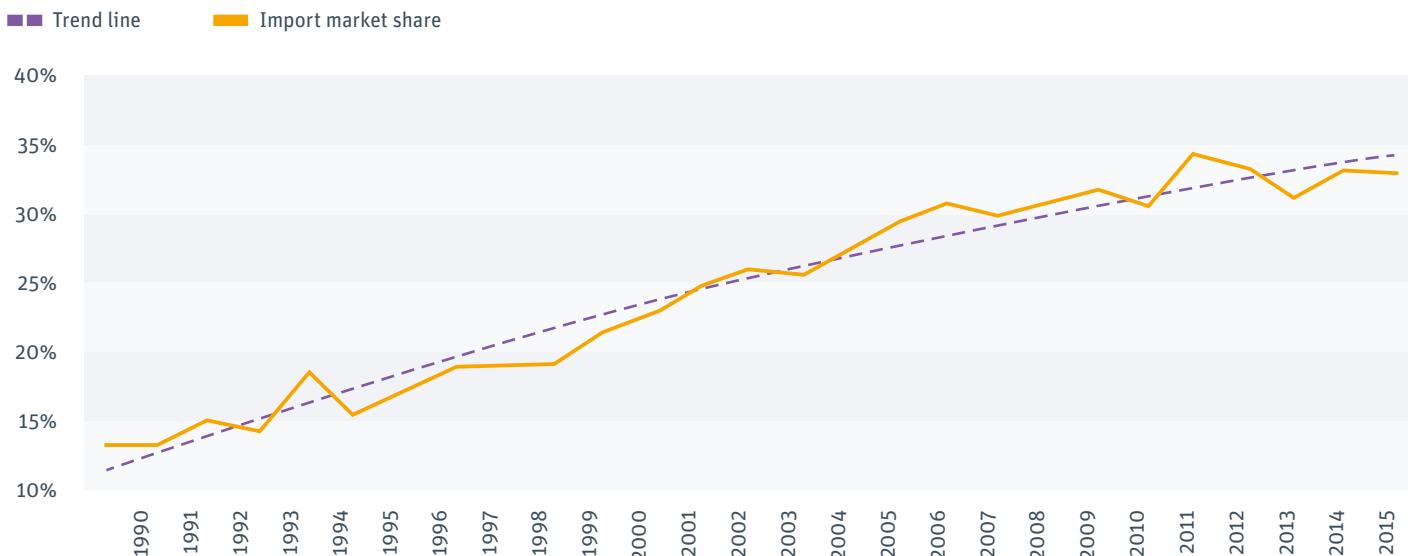
before year-end to the 8 to 12 percent we've become used to over the past seven years.

The growth rate for wine overall and even for premium wine started to slow in late 2015 by most available measures, which implies that there are underlying changes in demand

Any of the information in isolation is not concerning, but we are noting declines in volume growth starting in 2014 from Wine Institute information (figure 1), shipment declines from warehouses starting in August 2015, restaurant sales declines for an extended period now and sales growth declines from interim winery financial statements in 2017.

While overall volume in dollars and cases is still growing, the growth rate for wine overall and even for premium wine started to slow in late 2015 by most available measures, which implies that there are underlying changes in demand. Understanding those trends is key to developing future strategies.

Figure 8: Imports' share of the US market



Sources: Gomberg-Fredrikson, Nielsen, SVB analysis

Imports

Most US fine wine producers have been oblivious of the growth trends of imports over the past 20 years. Bulk imports have a more volatile trend but are currently on the rise, and bottled wine imports continue to grow to record levels (see figure 8). It's hard to blame domestic producers for ignoring the international interloper. When you have the best worldwide market to sell wine and you can sell all you make, increase your prices and still grow your volume, why worry?

There has always been enough US consumer demand to feed imports and domestic production alike, but the future holds different conditions for domestic wineries compared with the past two decades. Routinely increasing both volume and price going forward will prove difficult for wineries given a low-growth, low-inflation environment.

As domestic wineries see growth opportunities tapering, they will start taking notice of the good-value imported wines that are hitting domestic shores and eroding their market share. When that day comes, the fight will inevitably become a competition over the young customer for value. Younger consumers come to the table with sharper pencils, always looking for the best deal, and are more open to a world view. Pushing back that tide a year from now will prove difficult.

Today, the larger producers are ahead of the curve (see figure 9). Given the high prices being paid for arable vineyard property in established appellations that drive bottle prices, they are hedging their bets by buying foreign brands or finding ways to partner with foreign producers, handing them the precious keys to the distribution network they seek.

Figure 9: Bottled imports' price growth

Year ended 10/7/2017	Year-over-year dollar growth	Year-over-year case growth
French	15.2%	13.4%
New Zealand	10.7%	9.7%
Italian	2.4%	1.4%
Australian	-2.0%	-2.1%
Spanish	-3.4%	-2.9%
Argentine	-5.0%	-5.7%
Chilean	-5.9%	-3.9%

Sources: Nielsen Beverage Group, SVB Analysis 8

Figure 10: Sales to restaurants by producer size



Source: 2016 SVB Direct-to-Consumer Survey

Imports are a threat, and if domestic wine starts losing value in the consumer's mind, the big wine companies have foreign supply to bring into the equation, which will add further pressure on the smaller fine wine producers.

Reacting to the same set of market circumstances and clamoring for access to US consumers, foreign wine companies are also looking for the best way to pursue the US market. Dozens of European buyers today are waiting in the wings to purchase domestic wine companies or to establish their own domestic sales companies in the US and gain a foothold in the world's largest consumer wine market. They believe that owning assets in America will improve their access.

Bottled wine imports continue to hit record levels, driven by French rosé and sparkling wine, Italian pinot grigio and New Zealand sauvignon blanc. Australian buyers are importing a large amount of bulk wine but are seeing declines in bottle sales, as they are focused on lower-price-point wines that are out of favor.

Restaurant wine sales

On a dollar basis, restaurant wine sales improved in 2017 over 2016, with total US restaurant wine sales up about 2 percent in dollars but down slightly in volume (see figure 10). Over the

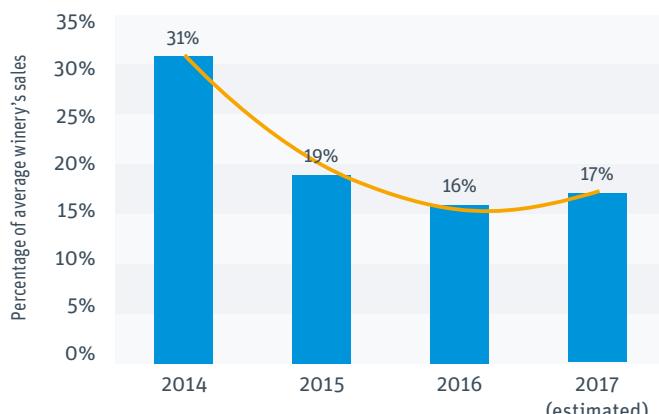
Wineries are depending less on sales to restaurants each year

longer term, growth rates continue to slow. Those same trends of flat volumes and higher dollars in restaurant sales are also reflected in retail alcoholic beverage sales overall, so the trend of lower volume and better dollar sales is no surprise.

In our survey work with wineries, we ask them to tell us the percentage of their sales that flow through each of the major routes, such as club, wholesale, DTC and restaurant. With that information, we can track relative movement in sales to restaurants from year to year (figure 10).

What is obvious is that wineries are depending less on sales to restaurants each year, and the larger wineries are more successful than the smaller ones in selling to restaurants.

Figure 11: Small-winery sales to restaurants



Source: 2016 SVB Direct-to-Consumer Survey

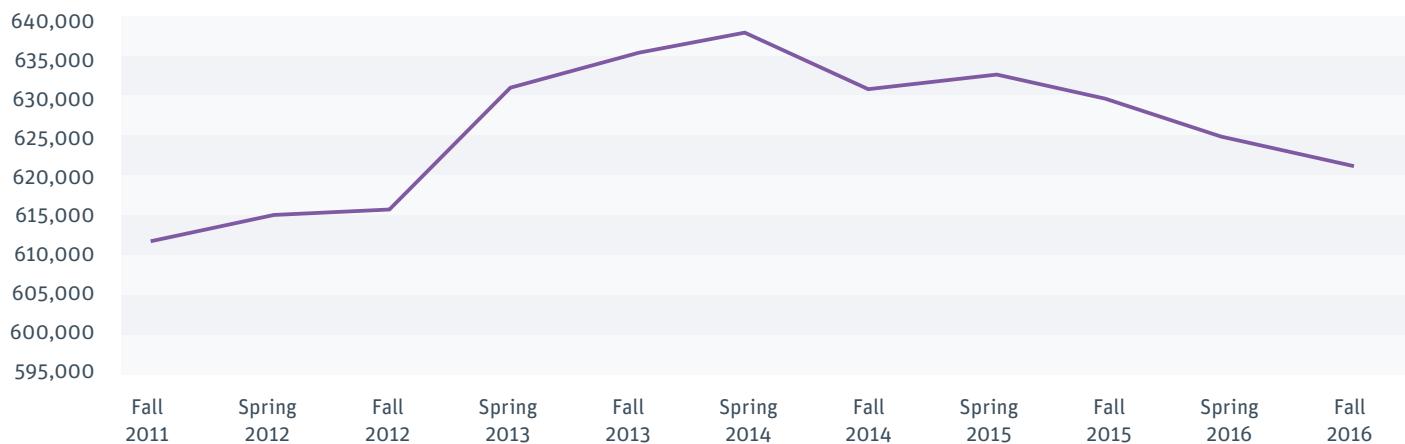
For the smaller winery, sales of wine to restaurants has been declining in importance for nearly a decade, though the decline has bottomed out of late (see figure 11). At the same time, restaurants themselves have been suffering from mixed same-store sales and declining bar tabs — both of which are a major concern of restaurateurs, as alcohol sales have traditionally been a significant source of profit. Because of the pressures on restaurants, which extend beyond this short list, the raw numbers of US restaurants have been declining (see figure 12).

Explaining this sales trend within the on-premise trade is complex. The factors shaping restaurant sales of wine today are a mix of events, starting with traditional three-tier⁷ movement away from smaller wineries. It is magnified by a consumer movement away from many of the full-service chain restaurants, the growth in fast casual dining that doesn't feature wine, increasing at-home wine consumption and declines in overall same-store visits. All of that is against the countervailing backdrop of an improving consumer economy in 2017, leading to higher average checks. It appears, however, that a better economy alone is not sufficient to fully offset the headwinds.

Big restaurant chains are served by big wholesalers, who in turn get their wine from big wineries. Every day, restaurant lists are increasingly being held captive by large producers with access to distribution, but permanent changes with consumer behavior are taking place that play into the results, as well.

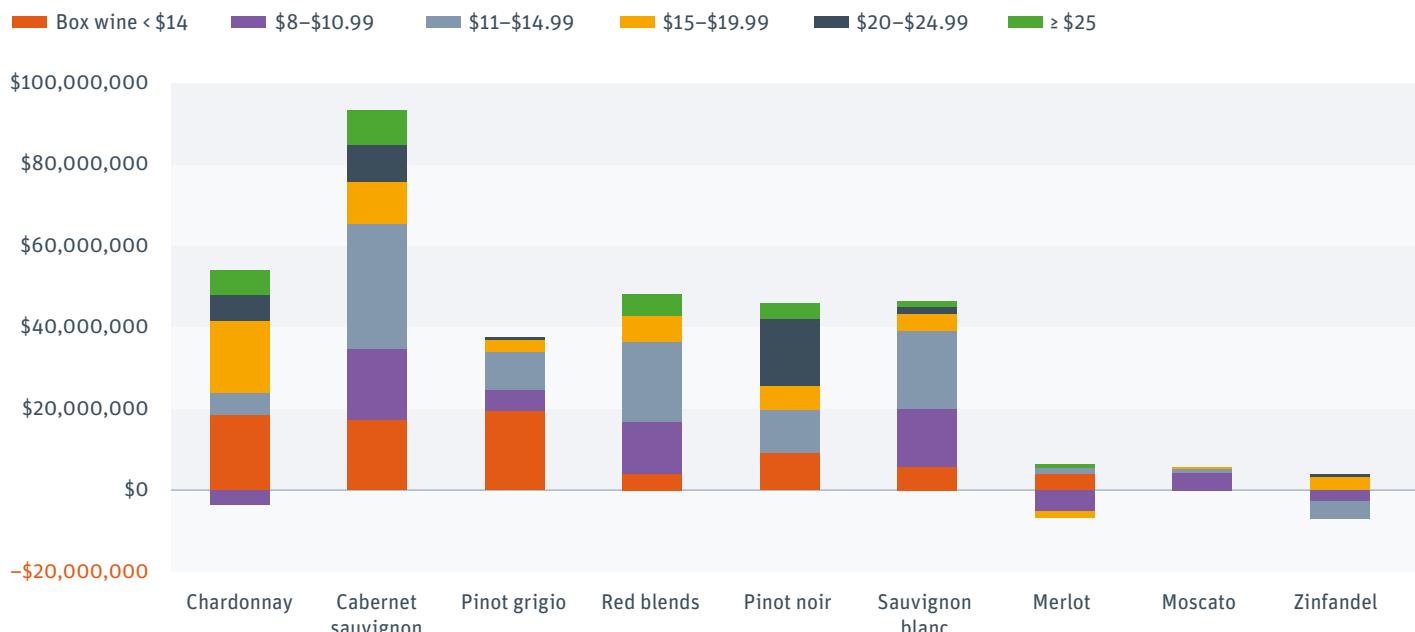
Our frugal younger consumers don't want to pay restaurant wine markups, and retiring boomers are slowing both their spending and their alcohol consumption volume. Young consumers know they can buy a bottle of wine at a store for less, so in the restaurant they are more likely to start with a craft beer or a cocktail and have a glass of wine with dinner.⁸ A more recent observation is that as millennials are entering their thirties and finding a career foothold, they are opting out of restaurants in favor of at-home meals.⁹

Figure 12: Number of restaurants in the US



Sources: NPD Group, Statista.com

Figure 13: Growth in varietals



Source: IRI

There is good news for the fine wine business: While full-service chains are struggling with dated restaurant concepts, the small, independent, local white-tablecloth restaurants continue to see modest growth, and those are the venues where smaller producers are more likely to compete for space on the wine lists.

The value equation

“Value” is defined as quality divided by price, and value is the dominant component for consumer purchasing decisions. When it comes to fine wine, it’s really quality *plus* experience divided by price that defines value, where “experience” is a placeholder for a shopping experience or the way owning or consuming the product makes you feel about yourself. But there is no question that customers buy everything with value in mind, and for that reason understanding the evolving industry trends in price segments and varietals is important.

$$\text{value} = \frac{\text{quality} + \text{experience}}{\text{price}}$$

Knowing what consumers are drinking is a key in planning and planting — and another key to unlocking real drivers of industry growth. Reviewing emerging trends reveals clues that can be critical when examining strategies, not only for the big wineries but also for the smaller family-run ones.

Varietal segment growth

With respect to price segments, reds are still dominating premium wine growth. Cabernet, red blends and pinot noir are three of the top four growth varietals (see figure 13). The \$11 to \$15 price point is the strongest US consumer growth segment today, with premium box wine close behind as its own category. This year the growth trends are showing a couple of surprises.

Figure 14: Top-growing brands sold in the US

	Cabernet	Average price	Chardonnay	Average price	Red blends	Average price
All brands	Josh Cellars	\$12.57	Butter	\$14.75	Apothic Wines	\$9.42
	Robert Mondavi Winery	\$12.42	Josh Cellars	\$11.37	Roscato	\$10.88
	Black Box Wines	\$18.86	Black Box Wines	\$18.86	19 Crimes	\$9.68
	Caymus Vineyards	\$76.98	Ménage à Trois Wines	\$9.16	Stella Rosa Wines	\$11.84
	Sauvignon blanc		Pinot noir		Pinot grigio	
	Kim Crawford Wines	\$13.96	Meomi Wines	\$19.11	Bota Box	\$18.31
	Whitehaven	\$15.59	Black Box Wines	\$19.13	Black Box Wines	\$19.06
	Prophecy Wines	\$10.43	Prophecy Wines	\$10.14	Prophecy Wines	\$10.58
	Oyster Bay Wines	\$11.41	Line 39	\$9.14	Liberty Creek Vineyards	\$7.08
	Cabernet		Chardonnay		Red blends	
Brands > \$20	Caymus Vineyards	\$76.98	Rombauer Vineyards	\$34.19	Cooper & Thief Cellarmasters	\$24.96
	Jordan Vineyard & Winery	\$52.79	Sonoma-Cutrer Vineyards	\$21.87	Conundrum Wines	\$21.85
	Justin Vineyards and Winery	\$23.33	Frank Family Vineyards	\$30.26	The Prisoner Wine Company	\$41.05
	Intrinsic Wine Co.	\$20.25	Mer Soleil Vineyards	\$27.54	Pessimist	\$20.15
	Sauvignon blanc		Pinot noir		Pinot grigio	
	Duckhorn Vineyards	\$26.35	Decoy Wines	\$20.19	Santa Margherita	\$20.63
	Cloudy Bay	\$28.51	J Vineyards & Winery	\$20.55	Livio Felluga	\$24.17
	Cakebread Cellars	\$31.86	Flowers Vineyards & Winery	\$46.15	Jermann	\$24.51
	Frog's Leap Winery	\$22.33	Belle Glos	\$50.12	Cantina Terlano-Kellerei	\$24.06

Source: Nielsen Beverage Group

While cabernet is still the king of varietal growth overall, and strongest in the \$11 to \$15 price range, chardonnay comes in second this year, replacing the red blend category, which dropped to third place. Sauvignon blanc, pinot noir and pinot grigio rounded out the top growth varietals (see figure 14).

Red blends, though cooling off slightly, are a dream from the large producer's perspective. The category allows the large wine companies, which dominate production, enormous freedom in the substitution of varietal and place of origin, yet they are still able to maintain overall quality and margin. There may be wide bottle-to-bottle variation in a given SKU,¹⁰ but for the price the quality is generally there for the current entrants. This is no longer just a sub-\$20 product, however; note the success of the top four red blend brands above \$20 in figure 14.

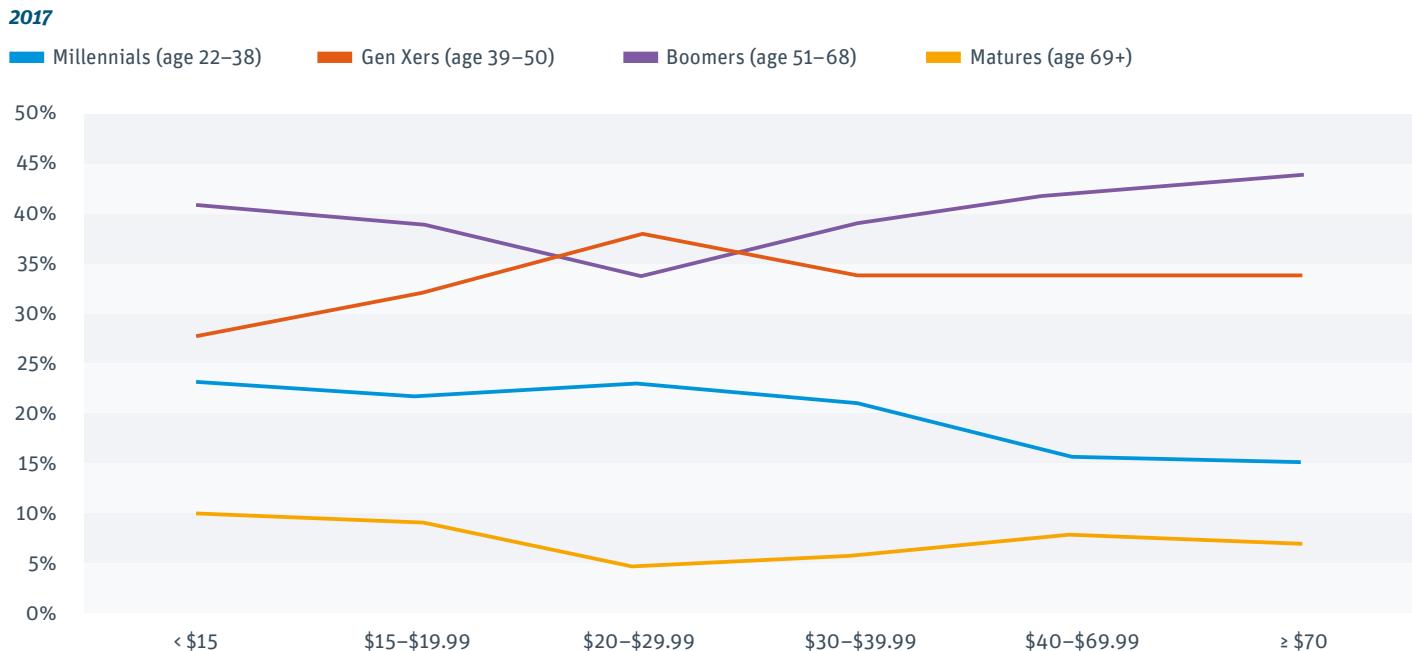
From the consumer perspective, red blends are really the jug wine craze of the 1960s on steroids. Like the mature generation who cut their teeth on generics, emerging consumers are acquiescing to the branding of the large wine companies because wine is a complex consumer good and branding makes their purchase easier. It replaces varietal and vintage comparisons with something simple and catchy like Sexy Wine Bomb, The Prisoner, Vicious Red Blend, SLO Down Sexual Chocolate, or Cupcake Red Velvet.¹¹ If consistency is maintained in these red

The inexpensive red blend category might today be seeing the beginning of the end of the fad

blends targeting the emerging wine consumer, brand loyalty will be there until the customer seeks more-distinctive wine. At that point, the red blend will fade just like Lancers, Mateus¹² and Blue Nun¹³ did for the boomer and mature generations before them. The inexpensive red blend category might today be seeing the beginning of the end of the fad.

Packaging is playing a role in consumer demand, as well. The 3-liter premium box wine and Tetra Pak formats continue to grow, with cabernet, chardonnay and pinot grigio each individually responsible for more than 20 percent of varietal growth. Canned wine continues to garner press because it's growing by 66 percent off a small base, but it's a tiny sector, representing less than 1 percent of total wine sales, and is unlikely to truly gain anything but a footnote in sales results.

Figure 15: Generation share of wine consumption by bottle price



Source: Estimated from 2016 SVB Annual Wine Conditions Survey data

Consumer preference

Who is driving the growth in these categories? Our own research suggests that the two growth cohorts are millennials and Gen Xers. The retiring baby boomers, however, are starting to have an impact on growing lower premium price segments and are edging back from the higher-price segments they previously dominated (see figure 15). You can see the evolution of their preference curve, which is starting to form a V shape, demonstrating that boomers are still a power in luxury wines but are affecting lower-priced wine too.

There is no question that we are seeing a changing of the guard in premium wine. Young consumers are giving blends a chance, and from our view their palate maturation looks like a sequel to the baby boomers' entrance to wine, which started with Bartles & Jaymes¹⁴ and then moved to white zinfandel and chardonnay before settling on merlot. It is interesting to note that the No. 2 growth varietal under cabernet this year is chardonnay, which is a natural place for palate-expanding millennials to move after sweet red blends.

Where does the consumer push the growth curve next?

What happens when more of the matures leave the consuming market and the baby boomers move down the premium price ladder and collide with millennials, who also want wines that are more distinctive and consistent and that have a greater sense of place than a red blend? Where does the consumer push the growth curve next? My bet is Oregon pinot noir, \$15 to \$25 limited-production domestics and premium foreign wines.

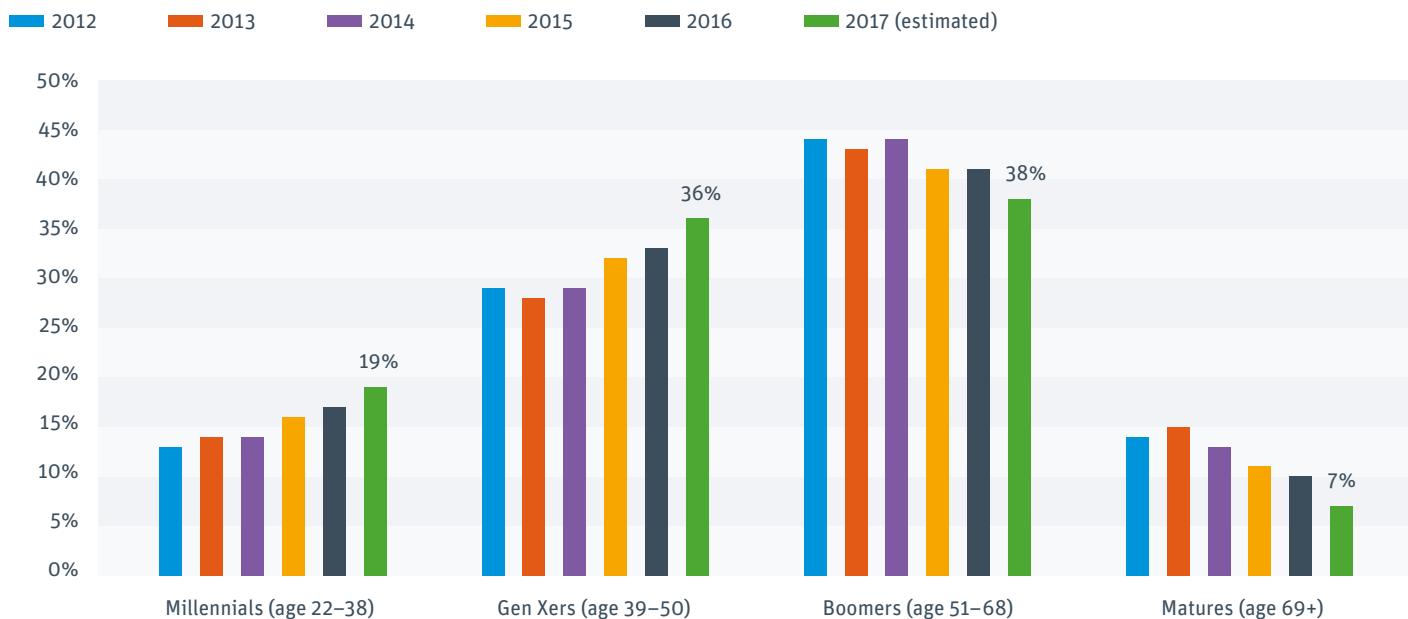


5

Generational changes and wine demand

Today, we see the impact of four generations in the US wine trade, with Generation Z on the doorstep. The consumer behavior and demand from each is evolving the industry in obvious ways. At the same time, the consolidation of the three-tier system has forced distributors to favor relationships with larger wine producers, leaving smaller wineries to fend for themselves. The growth cohorts are millennials and Gen Xers, but it's still baby boomers and Gen Xers, not millennials, who dominate premium wine sales (see figure 16).

Figure 16: Cohort share of wine purchased



Source: SVB 2016 Direct-to-Consumer Survey

The evolution of both consumer preference and price sensitivity to buy wine across the generations is changing the way wine is sold — so it is imperative that you evaluate your successful consumer strategies for emerging signs of weakness. New strategies must be found, and finding the right one requires evaluating each cohort's demand and ability to afford the wine you're producing, then scaling that strategy effectively.

Matures

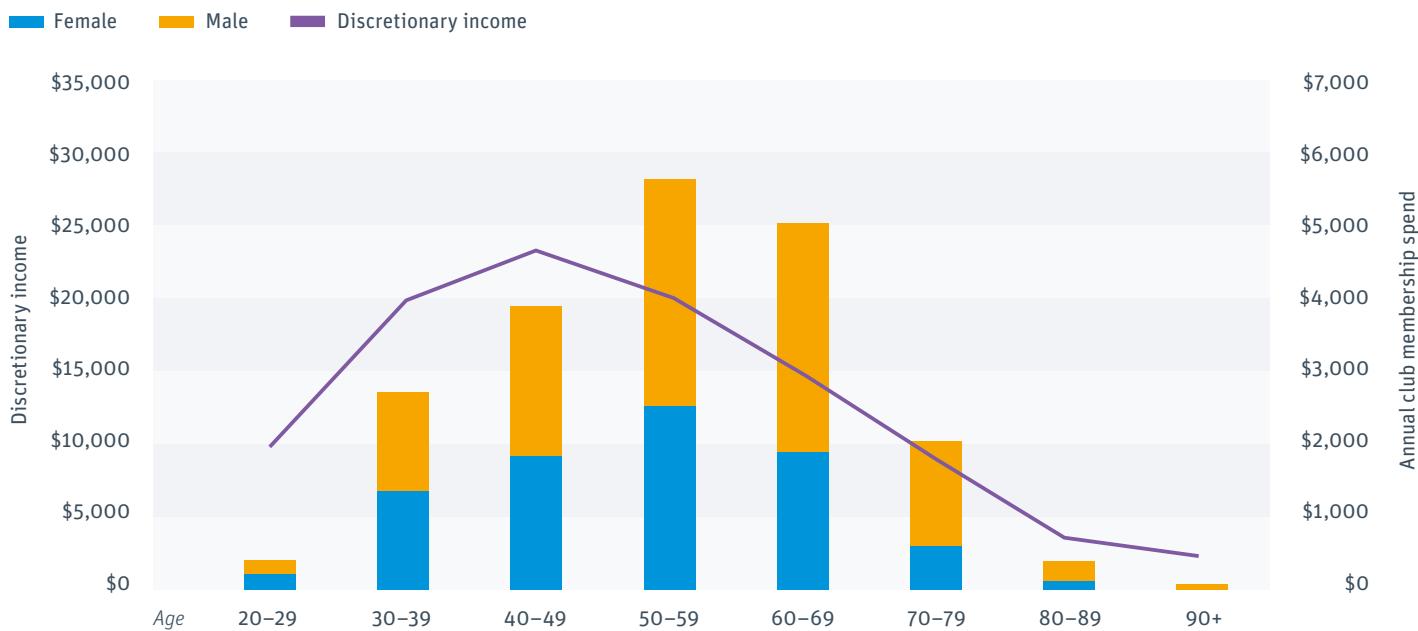
Matures grew up during the Great Depression.¹⁵ Their ensuing behaviors, such as thriftiness, saving and the conservative use of debt, resulted from their inability to find employment or even the bare necessities early in their lives. Add rationing during WWII to the younger component of the cohort and, decades later, many still save everything and throw away nothing — ever.¹⁶

Known more as a spirits-and-beer generation, the matures' wine consumption fit their economic status, and the value of alcoholic beverages was viewed in part based on alcohol content or the proof per dollar spent. As a component of purchase, it was very

practical to consider how much alcohol you really were getting for your money. Wine had a lower alcohol content, so when the matures purchased wine, they gravitated to low-priced value wines in large formats.

Evaluate your successful consumer strategies for emerging signs of weakness

Figure 17: DTC spend by age and gender vs. discretionary income



Source: Customer Vineyards

Baby boomers

Baby boomers represent the largest native population boom in US history. Reaching drinking age, they first demonstrated their thirst for wine, driving the wine coolers trend¹⁷ in the mid- and late 1980s. Neo-prohibitionism¹⁸ led to short-term declines in wine consumption through the early 1990s, but beginning in 1994, with the median boomers reaching 35 and established in their careers, wine sales started demonstrating strong volume growth.

To this day, boomers are still the leading consumers of fine wine, but they are now retiring or nearing retirement (see figure 17). They are consuming less wine as they age, are changing their spending patterns in dollars spent and volume consumed and are evolving from the high price points as they come to grips with living on a fixed income. Today, boomers who built their cellars over time are more inclined to consume the wine they've stored vs. aging new purchases, which has a negative impact on the luxury wine market.

When wine club staff ask why a member is leaving the club, increasingly the answer is "I'm retiring." That answer should make wineries with overwhelming shares of boomers in their clubs reevaluate their current marketing strategies.

When wine club staff ask why a member is leaving the club, increasingly the answer is "I'm retiring"

Figure 18: Median net worth and income of US families



Sources: US Census Bureau, Statistica.com

Gen X

One of the messages I consistently offer when speaking is “No matter the cohort, the age where consumers spend the most in retail falls between 35 and 55.” Gen X is that cohort today, but they are in second place in terms of consumption of fine wine. They have the willingness and capacity to buy, but they lack numbers compared with boomers (see figure 18).

Largely ignored by the retail press, Gen Xers entered the workforce at a good time economically, and with fewer college graduates competing for careers compared with the generations bracketing them, Gen Xers have had a comparatively easy time building wealth.

Today, Gen X is at the top of income and spending (figure 18). Their presence has been below the radar, but their consumption continues to increase. They are perfectly positioned to surpass baby boomers as the dominant cohort in fine wine consumption around 2021. With both capacity and willingness, Gen Xers should be a major focus of winery owners and tasting-room managers today.

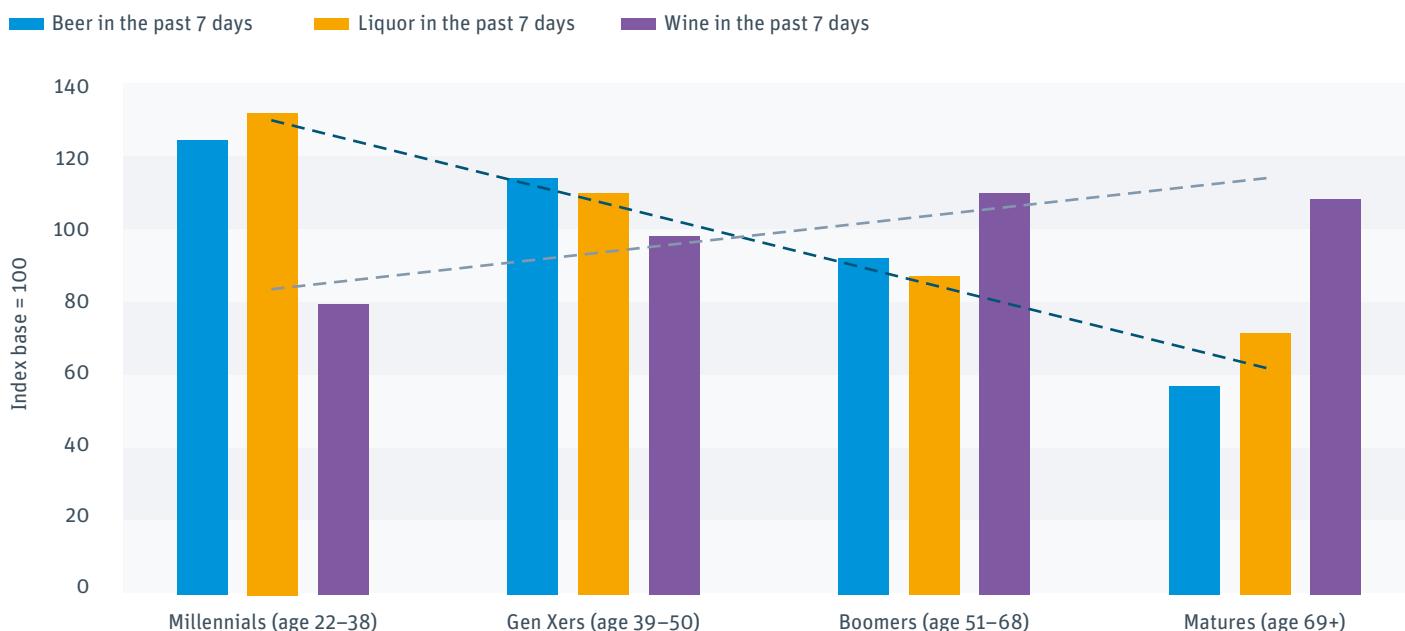
Millennials

Representing 19 percent of current fine wine consumption¹⁹ is the millennial generation, whose outsized impact has been falsely prognosticated by the wine press²⁰ for at least a decade.

The unfortunate reality is that while millennials have by all accounts a better appreciation of wine compared with the other cohorts at a similar age in development, their appreciation has not reflected itself in fine wine consumption yet because, to buy anything, a person needs to have both the desire *and* the financial capacity to purchase, and millennials lag prior generations in terms of buying power.

No matter the cohort, the age where consumers spend the most in retail falls between 35 and 55

Figure 19: Alcohol consumption preferences by generation



Source: Scarborough Research, 2015

One study suggests that a typical college graduate of 2008 has earned \$58,600 less over the following decade in unrecoverable wages compared with a college graduate of 2007. College graduates skew high on wine consumption, so that's a significant fact, and there is more negative news for the younger generation.

More millennials today live with parents than with roommates. Almost two-thirds of them receive some type of financial support from their parents for day-to-day living. They carry 300 percent more student debt than their parents did, and those age 25 to 34 are half as likely to own a home compared with young people in 1975. With respect to alcohol consumption, the news is mixed.

Still seeking a premium product and a positive experience, millennials are inclined to substitute craft beer and spirits for wine, especially on-premise, and are ambivalent as to the place of origin.²¹ The youngest consumer cohort has demonstrated a propensity for frugal hedonism,²² meaning they are quite price conscious but don't sacrifice quality when selecting their adult beverages. They are looking for the best deal, and price is paramount in their purchasing decisions, which today skew

to lower-priced offerings. But over time, millennials will undoubtedly increase their wine consumption, as have the generations that preceded them (see figure 19).

In an interesting collision of consumer preferences, as millennials age and become more substantial in the workforce, they will gradually spend more on wine. At the same time, retiring boomers will move down the price ladder and into more-modest bottle prices as they also pull back in their volume purchased. The result is that both generations will consider price more important than the average consumer does today. In the next 10 years, there will be a price range for premium wine sales where the cohorts meet; that sweet spot will grow and become important to all wine companies.²³

Our forecast is that the millennial cohort will surpass the Gen Xers around 2026 to become the largest fine wine-consuming generation.



6 Direct-to-consumer sales

A casual observer of the business would think that direct sales have always been an important part of a winery's strategy, but that is not the case. Small winery owners must wear a lot of hats, and while gross margins are doubled by selling direct, owners have always been most comfortable growing grapes, making wine and letting the distributor sell it. But if that's true, why bother selling wine directly to the consumer?

The simple answer is that selling wine directly to the consumer has been an afterthought in some eras and a survival requirement in others. You'd think the industry would be more strategic than reactive, but it has been cautious with the evolution of a DTC strategy. Today perhaps more than at any other time, the business needs to be out ahead on strategy because for most wineries the solution will spell the difference between success and failure in the coming decade.

Direct sales v1.0

When Prohibition ended in the 1930s, Beringer Vineyards started wine tours and tastings as a promotional effort to bring back customers. In the decades that followed, wineries opened tasting rooms so that consumers could sample and purchase their wares. It was the winery equivalent to the roadside fruit stand.

Much like Procter & Gamble, which sent samples of its products to every mailbox in the country, wineries saw a need to deliver samples to their consumers to support retail sales in the three-tier system. Outside of providing a little tax-free cash for the family, that DTC effort was not about driving direct profitability.

Tastings were generally free, and success was measured by how many people you could get to your tasting room. Legh Knowles, chair of Beaulieu Vineyard in the Napa Valley, said in the 1980s, "I have the greatest respect for our customers, but I will admit the daily touring and tasting doesn't sell a lot of wine."²⁴

Direct sales v2.0

In the late 1980s, with the economy coming off two recessions, total wine sales were declining due to both neo-prohibitionism and the aging of the mature generation. Wineries reacted to declining three-tier sales by focusing their efforts on what they could control, which was the tasting room and, more specifically, developing the wine club concept. It was DTC v2.0, and promotion wasn't the reason this time. This iteration was needed for survival.

Winery owners began to recognize the benefit of collecting physical addresses of the people visiting their wineries. Many started focused US mail campaigns and shipping programs so that customers could receive wine directly from the winery once or twice per year. Direct shipping across state lines going into the early 1990s was quietly growing, despite laws prohibiting it.

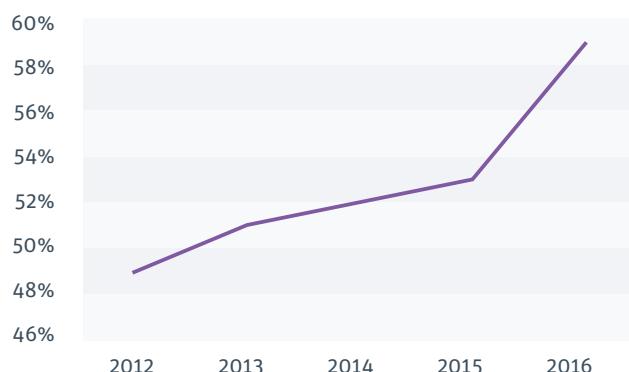
In 1996, wineries could legally ship to only 13 reciprocal states and an additional 17 "personal use" states, many of which allowed consumers to buy less than a quart of wine annually.²⁵ Underscoring the absurdity of the laws, more states allowed people to carry concealed weapons than to purchase wine directly from the producer. Direct-to-consumer sales were estimated by some to total less than \$100 million per year,²⁶

"I have the greatest respect for our customers, but I will admit the daily touring and tasting doesn't sell a lot of wine."

and that may be a generous estimate. There were far more closed states, where consumers could not purchase wine directly, compared with states in which shipping was legal.

Direct sales v3.0

By 1994, the median baby boomer hit age 35, which is the magical time historically when consumers begin their serious consumption careers. After almost a decade of declines, US wine sales took off and distributors started knocking on doors of even the smallest wineries to meet consumer demand. During the nineties, it was common to see winery growth rates exceeding 20 percent and wineries completely sold out of wine before the next release.²⁷

Figure 20: Increasing importance of DTC revenue*DTC revenue as a percentage of total revenue*

Source: 2016 SVB Annual Wine Conditions Survey

With demand refreshed and with less pressure to make the direct model work, wineries stopped their erstwhile questionable shipping practices over state lines and sold everything they could back into the three-tier system. With the selling function again outsourced to wholesalers, owners stayed home and focused on growing grapes and making wine.

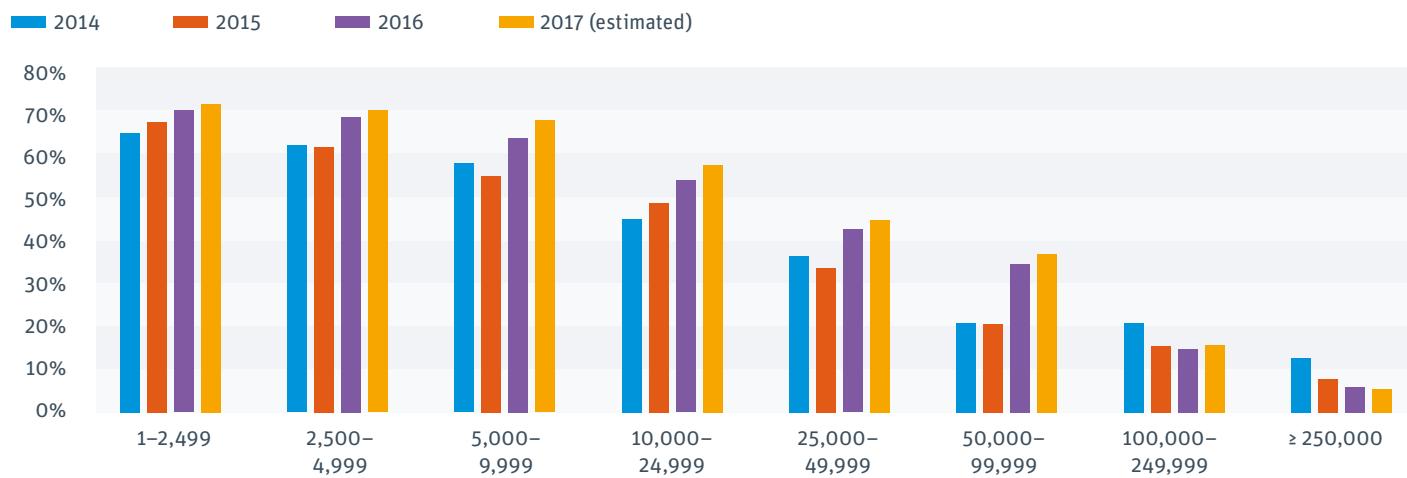
Wine sold itself, and tasting rooms and wine clubs were only passively managed. Unlike today, when direct revenue is 60 percent of the average winery's sales, through the 1990s direct sales represented about 20 to 25 percent of total sales for the small family winery (see figure 20).

Direct sales v3.5

Like flipping a switch, coincident with the short 2001 tech recession²⁸ and large 2000 vintage, supply caught up with demand, and wholesalers, now with a choice, moved away from selling the product of small wineries.

The wholesaler's client base had evolved from small chains and unit retailers toward nationwide big box retailers, and at that point larger wineries could fill consumer demand. The prior decade's playbook was dusted off and, once again, DTC sales were critical to the survival of smaller wineries. Tasting-room and wine club activity was again promoted by owners, but shipping laws were being enforced, which limited growth.

The industry caught a break with the favorable Granholm decision in 2005.²⁹ That ruling knocked the legs out from under the protectionist state laws that favored in-state wine producers. Smaller producers would have been put out of business long ago without the subsequent evolution of direct shipping, including logistics companies and those specializing in keeping up with constantly changing state laws (see figure 21).

Figure 21: Direct sales as a percentage of total winery sales*By production size*

Source: 2016 SVB Annual Wine Conditions Survey

Figure 22: Premium winery sales growth



Source: SVB Peer Group Analysis

While state laws vary — and some permitted state laws can only be described as arcane if not stealth protectionism — today the only states to which wineries cannot legally ship are Alabama, Delaware, Kentucky, Mississippi, Oklahoma and Utah, with Utah and Kentucky retaining felony anti-shipping laws.³⁰

Because larger wine companies can attract wholesalers, dependence on direct-to-consumer sales are less important to them, but DTC sales for smaller wineries are now the most critical component of their sales strategy (see figure 22).

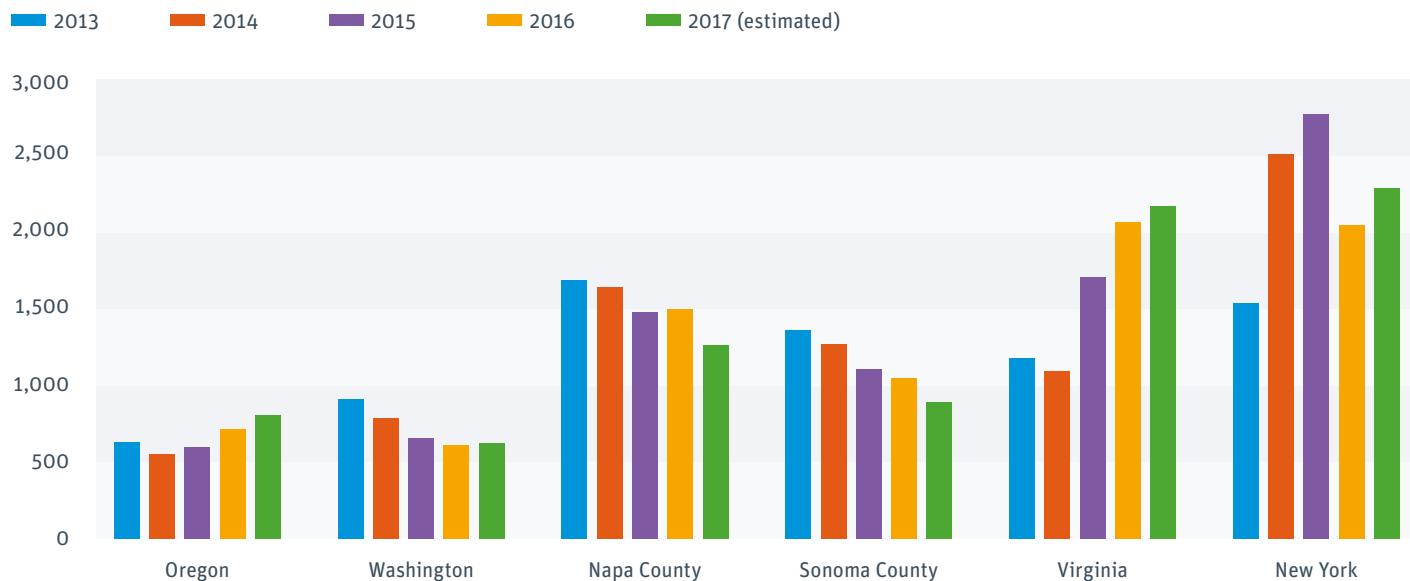
The small winery segment has fully grasped the reality that selling fine wine includes the customer experience. All wineries are improving their performance in direct sales and are zeroing in on the use of key performance indicators (KPI)³¹ to help execute on their success.

The number of tasting rooms has increased, and the owner focus on tasting-room activities and DTC sales has intensified. Direct revenues continue to climb, but there is a limit to how far the current strategy will take us.

Can we continue to insist that the consumer come to the tasting room for an experience? How is that working in malls throughout the US? In view of clear changes in consumer demand, now is the time to start thinking about direct sales v4.0.

Can we continue to insist that the consumer come to the tasting room for an experience?

Figure 23: Changes in monthly visitor counts



Sources: 2013–2016 SVB Annual Wine Conditions Surveys

Direct sales v3.75: Winery visitation

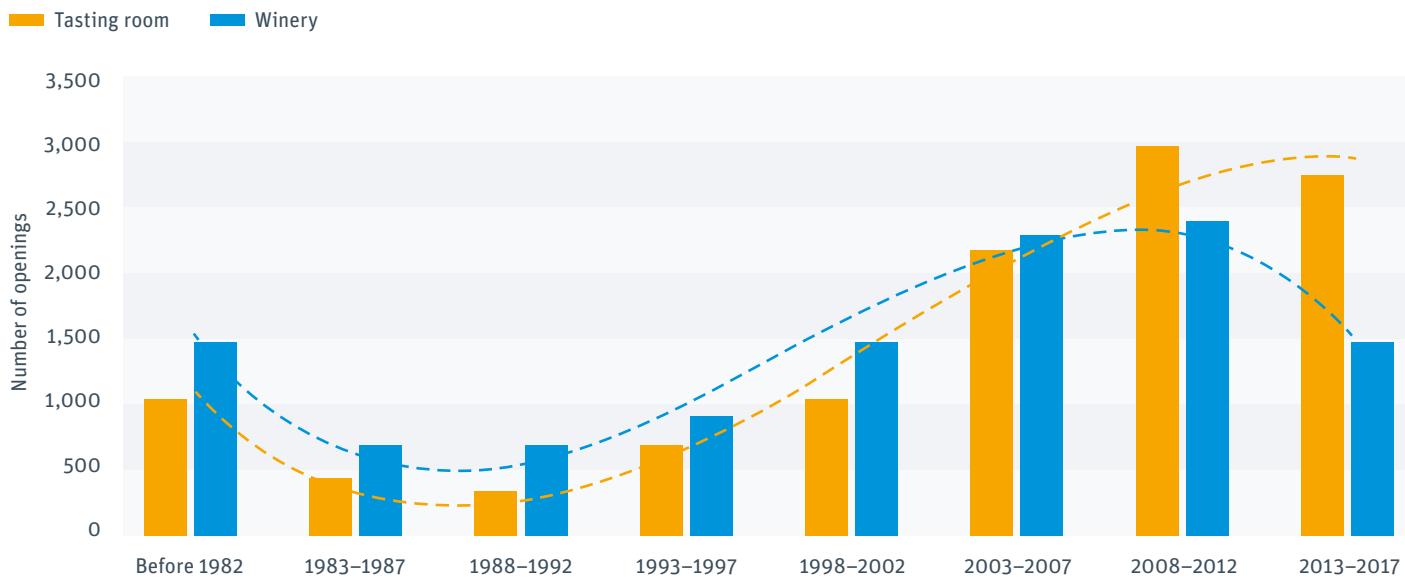
We have been watching an interesting phenomenon for a few years now: Tourism is up in the major wine-growing regions. Hotel stays are increasing, and average room rates are up, as well. But, with the exception of Oregon, Virginia and New York, average winery visitation is down (see figure 23). How do you explain the paradox of more tourism in a wine region but lower visitation to the wine-tasting rooms?

In 2015, we were uncertain about the cause of the trend because the negative direction made no sense in light of higher tasting-room income, better wine club metrics and the increasing focus that wineries were putting on DTC sales. We suspected that the negative trend might simply be better reporting from wineries that were focusing more on their KPI, but we weren't certain and could not take a position.

In 2017, we started hearing more wineries quietly lamenting declining visitation. After additional research and reflection, we are convinced that there is more going on than we first suspected. Tasting-room revenue is up, but what is driving that higher revenue is improved average purchases. Wineries are doing a better job of selling to the guests they host, but the number of visitors is nevertheless declining, and we believe there are several reasons why.

How do you explain the paradox of more tourism in a wine region but lower visitation to the wine-tasting rooms?

Figure 24: Historic openings of wineries and tasting rooms



Sources: SVB 2017 Direct-to-Consumer Survey and SVB analysis

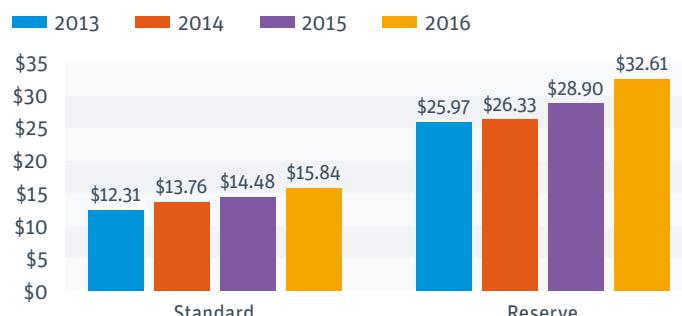
The first issue is the number of tasting rooms being opened (see figure 24). Prior to 2000, growers didn't always include a tasting room when they established a winery; but as new winery formations have slowed over the past five years and direct sales have become critical, tasting-room openings have accelerated, with more existing wineries opting to employ duplicate type O2 licenses. This has started a discussion in several communities regarding the rapid growth of downtown tasting rooms.³²

Average tasting-room fees have been increasing at a steady pace for years — and for decades on California's North Coast (see figure 25). Each year, wineries ask themselves if they can increase their fees. They see tasting-room revenue up, review comps from neighboring wineries and then decide to raise their rates. At some point, that tasting fee becomes a deterrent, and in some cases we have reached that point.

The aging of the consumer is also playing a role. Older customers with declining discretionary income have been to wine country. They used to come, taste for free at as many places as they could visit and then leave town with wine in the trunk. Today, they plan where they are going to go, have a bucket list of places to see, stay at a nice hotel and also factor in food, shopping and other regional entertainment. Because the visit is planned and they aren't going to so many tasting rooms, they are more likely to buy at the wineries they plan to visit. The bottom line, though, is that they aren't visiting as many wineries.

At some point, that tasting fee becomes a deterrent, and in some cases we have reached that point

Figure 25: Annual changes in tasting fees



Source: SVB 2017 Direct-to-Consumer Survey

Figure 26: Winery visitor sales and fees

	Oregon	Washington	Napa County	Sonoma County
Average tasting-room purchase	\$77	\$69	\$304	\$140
Standard tasting fees	\$13	\$9	\$38	\$21
Reserve tasting fees	\$25	\$18	\$66	\$39
Net wine club growth rate	10.8%	14.0%	12.7%	13.9%
Annual visitation growth (2013–2016)	3.0%	-7.9%	-2.8%	-6.0%

Source: SVB 2017 Direct-to-Consumer Survey

For the young frugal-hedonist consumer, high tasting fees are a clear deterrent and are part of the reason why Oregon is still growing average visitation while Napa and Sonoma are not

Younger consumers are shrewd in their planning of a wine country visit. A group of four is unlikely to pay a reserve tasting fee in Napa or Sonoma because that might amount to what they budgeted for their dinner together (see figure 26). They will share tastings, if allowed, and will find as many ways as possible to reduce their total spend while retaining the experience level. Still in a discovery mode, they will scout out tasting-fee structures and reimbursement policies beforehand or will negotiate at the counter. Like older consumers, they aren't bound to visiting as many wineries as possible and will look for other entertainment, as well.

For the young frugal-hedonist consumer, high tasting fees are a clear deterrent and are part of the reason why Oregon is still growing average visitation while Napa and Sonoma are not.



7

Retail evolution

Pinpointing the exact cause or source of large-scale change is never easy, and the earlier you predict it, the more difficult it is to support the prediction. In the case of the wine business, this year's changes can be tied to several causes, some of which are reflected in retail and luxury sales overall.

Much of the disruption we see in retail is due to shifting consumer shopping behaviors – from how they shop via different digital and physical platforms to differences in the way they value goods and experiences. This disruption has left manufacturers and retailers struggling to adapt; but to keep up, they must first understand where dollars are being spent and how to tap in to changing shopping habits to drive growth.

The Amazon effect

Most commentators, no matter their political affiliations, would agree that the US economy has recovered from the recession. Yes, there are differences in this economy vs. the one that preceded 2007, but we can all say that at this moment the US economy is “good,” and good means we are seeing enhanced sales opportunities as we move into 2018. But underneath the positive news, there are evolutionary changes taking place in both the consumer and the way retail is transacted.

In 2017, countless brick-and-mortar retail establishments closed, including JCPenny (138 stores), Kmart and Sears holdings (300+ stores), Macy’s (68 stores), HHGregg (220 stores), MC Sports (68 stores), Payless ShoeSource (800 stores) and many others.³³ But the poster child for this disruption is bookstore chain Borders, which was the early sacrifice to the Amazon effect, also known as digital Darwinism.³⁴

Amazon is by far the largest e-commerce player, with 44 percent of estimated online sales. Some of the above-mentioned stores are working hard to catch up – getting their online retail presence competitive – and finding success, whereas others have filed for bankruptcy.

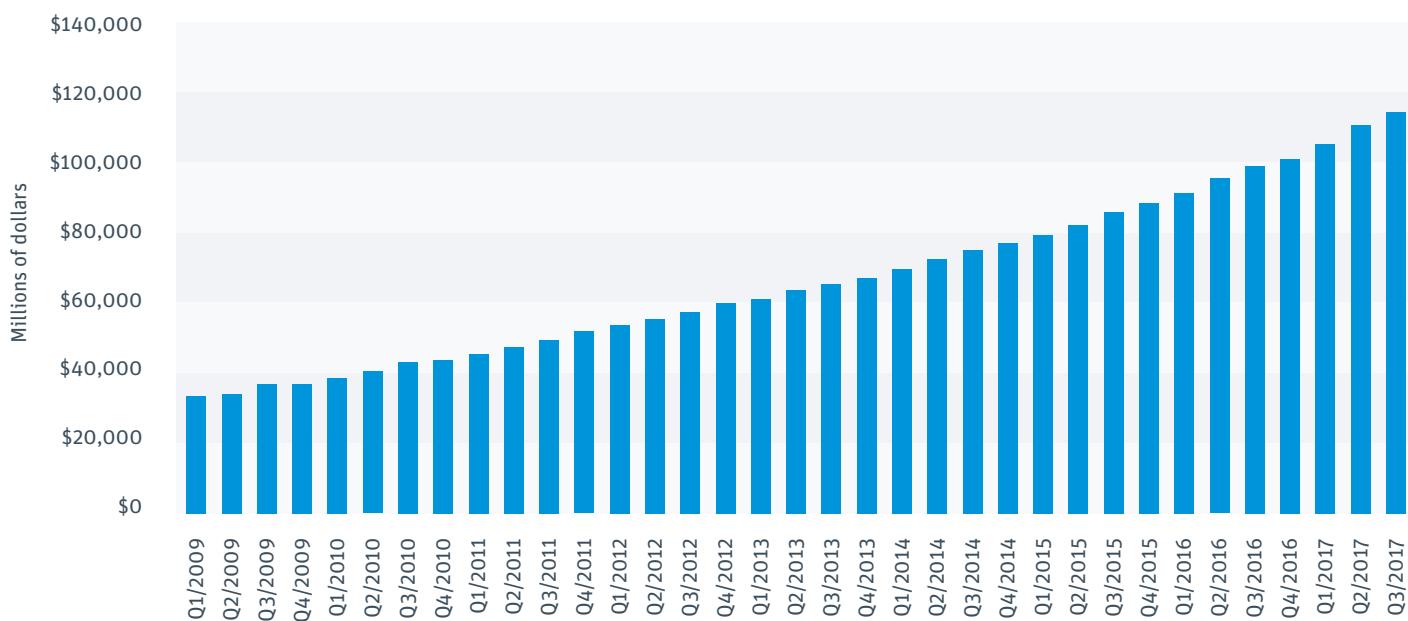
How does that relate to wine? Many of the stores above were late to recognize both the threat and the opportunity of e-commerce. Borders in particular is a case study for the wine industry of what *not* to do.

- Borders saw e-commerce as an extension of what it did, rather than a replacement of what it offered. It outsourced its sales to Amazon, believing that internet sales were a nice-to-have, instead of a critical component of success.
- Borders didn’t foresee the evolution and acceptance of alternative digital delivery platforms for its products.
- It focused its strategy on the experience in its physical locations, ignoring the online experience.
- Like many companies that disappear, Borders took on too much debt to execute on its physical store expansion.
- And finally, to compete Borders decided to expand from books into music, which is something it didn’t know about, and it totally missed the oncoming competition in the iPod revolution.³⁵

In the end, Borders was inhaled by consumer and digital disruption by both Amazon and Apple, two tech behemoths of our day. There is a lesson in that for the wine business.

*Borders in particular
is a case study for
the wine industry of
what not to do*

Figure 27: Growth in e-commerce sales



Source: US Census Bureau

Direct sales v4.0

In the mid-1990s, the internet took hold. Wineries put up websites with their contact information and directions to their locations. Amazon started selling books online in 1995, and PayPal came around to help with payments in 1998. Wineries added shopping carts in 2002 and experimented with online sales, but online DTC has never been successful for winemakers.

Today, e-commerce represents about 10 percent of total US retail sales (see figure 27),³⁶ with Amazon accounting for nearly half of that. While wineries have gravitated to DTC sales, it is old-school sales without current e-commerce tools. With only 3 percent of today's winery sales true online purchases, how can we say that wineries are really focused on DTC sales?

Here are a few facts:

- Wineries still focus on their clubs as their customer universe, instead of on all wine consumers.
- Few wineries have an online presence that engages the customer. Sites lack sophisticated, responsive, fully integrated designs and experiences that allow new and returning customers frictionless e-commerce.

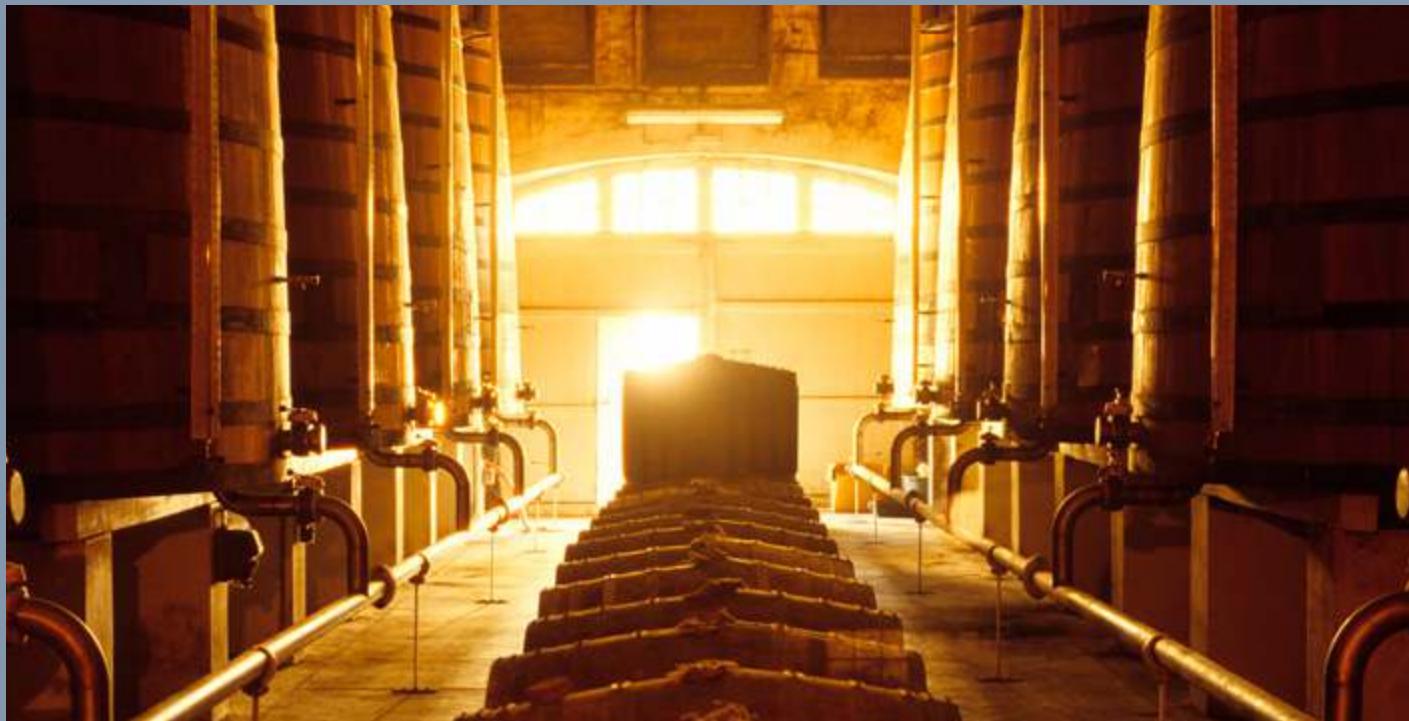
- Winery websites are almost static, and, with the exception of basic Google tracking, they don't harvest visitor information or put it to use for responsive experiences, retargeting and modern FOMO (fear of missing out) tools.
- Online product marketing is rudimentary, lacking a push to consumers who might index high on Google search results. There is virtually no focus on turning Instagram followers into micro-evangelists or deploying targeted Facebook ads.
- The opportunity is wide open for a company using online tools to replace the distributor's sales and marketing role.³⁷
- Digital products that integrate with customer relationship management and the wine club — and that can deliver scalable marketing messages for different buying personas over mixed platforms — simply do not exist.
- There is virtually no investment currently for online acquisition and retention of potential wine customers and no management of the larger universe of prospects.³⁸
- The use of big data to enhance outreach to consumers and improve sales opportunities is not employed at all.³⁹

Supplying segment growth

I always cringe when I attend conferences with the topic “the next hot varietal.” Whenever growers follow a trend, it is seemingly already over right about the time the plants are producing (Muscat of Alexandria) or the varietal ends up being ruined by overplanting (merlot and syrah). Some suggest that merlot was hurt by the 2004 movie “Sideways,” but that was more helpful to pinot noir than it was a drag on merlot. That conclusion is supported by past research.⁴⁰

From our vantage point, a decade or longer after their planting booms neither merlot nor syrah gained a consistent and identifiable character profile with the consumer, leaving the door open for popular growth in other red wines. Although it's not clearly identified in the literature, observation tells us that many of the hot red blends being produced now include significant, if not dominant, quantities of merlot and syrah — the same out-of-favor grapes that consumers shunned. Branding and marketing prove remarkable in shaping a consumer's palate.

Branding and marketing prove remarkable in shaping a consumer's palate



8

Harvest, bulk wine and land

The wine business is cyclical. Some years, we have a light yield and are underplanted to a variety, spiking bulk and grape prices higher. Other years, we are overplanted following a string of heavy years, lowering prices. Any action we take in the short term seems to have little impact because cycles are so long-lived and Mother Nature in the end has veto power.

Harvest expectations

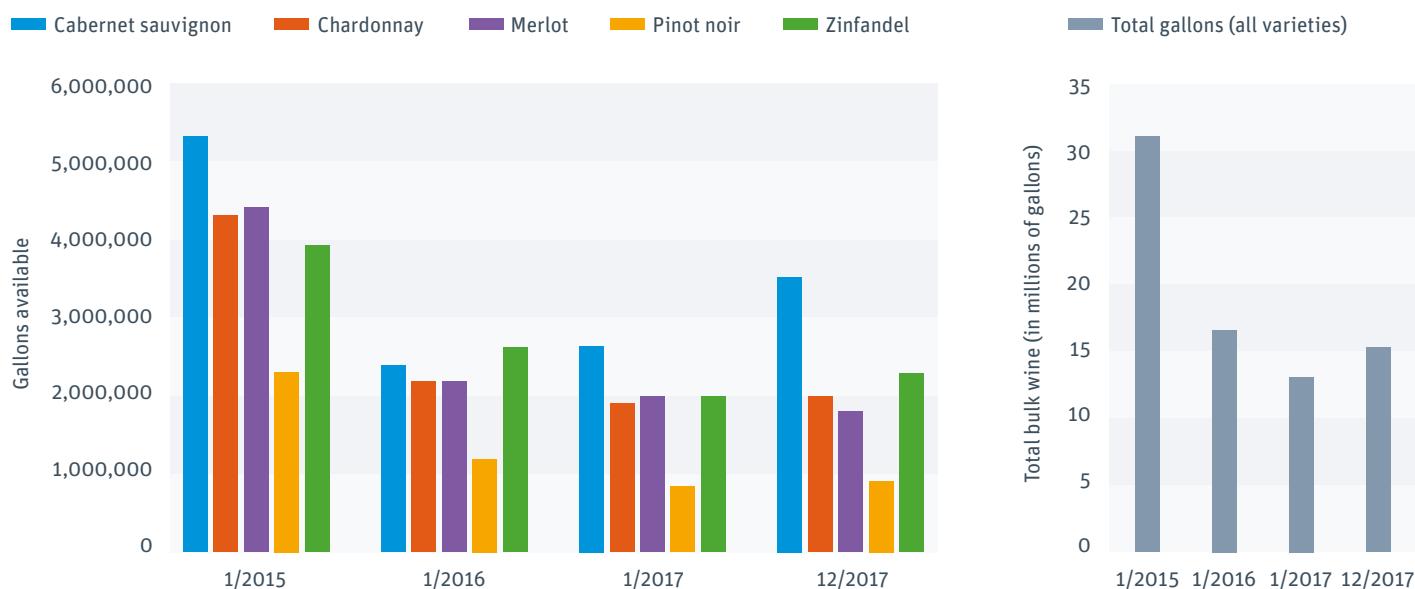
Although California and Washington seldom have the kind of harvest variation that France does, we do have our share of vintage variation — and 2017 was a unique year. The winter was one of the wettest ever, but it helped end the record drought that preceded it, strengthening the vines and leaving added moisture in the soil for the hot summer to come. Budbreak, bloom and the beginning of harvest occurred later than in the past few years but were more in line with historical norms. There were heat spikes on Father's Day and Labor Day, followed by the fires on the North Coast that received worldwide media attention.⁴¹

All things considered, the wild growing season in California will end up coming in slightly low on yield and of good quality overall. While the discussion of “smoke taint” has been widespread, it is unlikely to show up in branded luxury wines. Most of the harvest was already in when the fires broke out, and the grapes that were exposed to smoke were tested before harvest and then separated from other fermenting lots. If smoke taint develops in the next several months, wineries will have many options for that juice other than bottling it and weakening their own brands.

Oregon’s 2017 harvest was a little cooler at the end than in the past two years and was more reflective of what is expected in sugars and ripeness. A very wet winter led to flowering at a more traditional time, but the record size of the clusters before harvest was out of character, which along with additional planting will amount to the largest harvest on record when the totals are tallied. Like California, Oregon had wildfire smoke to deal with through parts of the season, as well as a Labor Day heat spike. Cooler weather and some rain allowed maturity to catch up with ripeness, and most think that Oregon’s harvest quality will again be very good.

Washington’s growing season began with a cool, wet spring that pushed budbreak back by about two weeks. A hot summer accelerated the season and put ripening back on track before ideal harvest conditions arrived, with prototypical warm days and cool nights. Like other regions in the west, Washington had to contend with smoke from Canadian and Pacific Northwest wildfires, but there is little expectation that that will become a production issue. Harvest tonnage is expected to be less than that of the past four heavy-yield years.

Figure 28: Annual changes in available bulk wine



Source: The Ciatti Company

Bulk wine

California's bulk wine market had been a little oversupplied with heavy vintages prior to 2015, so even 2013 and 2014 juice was available, and prices were a little depressed, with the exception of Napa cabernet.

After the light 2016 harvest, the bulk market was described as "in balance" throughout 2017 (see figure 28). With another average harvest of around 3.8 million tons for California in fall 2017, price offered and volume demanded should largely be in equilibrium heading into 2018, with the possible exceptions of chardonnay and cabernet. Chardonnay has seen impressive demand growth and declining stocks, which might drive demand and price higher. Cabernet, while still growing in demand, has probably reached a pause in price creep, with slowing consumer growth rates overall and increasing availability of juice. With cabernet there seems to be a disconnect between what sellers think they should get and what wineries believe they can sell that juice for on the open market.

Land

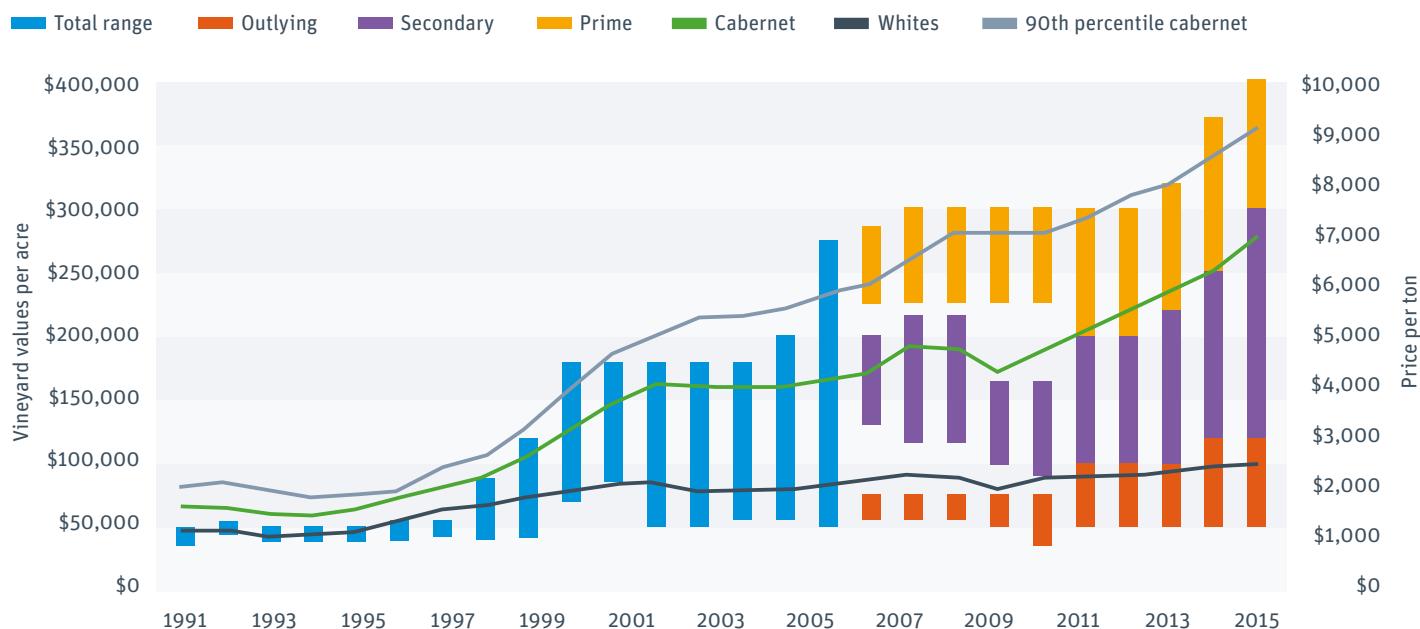
The old pattern of domestic consumers drinking American gateway wines⁴² early in their lives and then gradually trading up to more-complex and expensive domestic wines has ended.

This change in the new domestic consumers' drinking pattern is a threat to US wine companies because those consumers are now using foreign wine as their gateway instead of domestic. One only need look at the growth rates in French rosé, Italian pinot grigio and New Zealand sauvignon blanc to see how the new consumers are being weaned today.

While total vineyard growth since 2001 has been up slightly less than 1 percent in California, a monumental change has nevertheless been under way for 16 years. The San Joaquin Valley, which has traditionally produced generic wine, has removed more than 60,000 acres from production; other regions that grow grapes destined for more premium production have grown by nearly the same amount.

The old pattern of domestic consumers drinking American gateway wines early in their lives and then gradually trading up to more-complex and expensive domestic wines has ended

Figure 29: Napa County vineyard value ranges



Sources: The Correia Company, annual CALASFMR Trends report, annual California grape crush reports, wine industry investment consulting proprietary information

In the smaller growing regions in Oregon and Washington, where essentially all production is premium, planted acreage is estimated to have grown by 70 percent and 20 percent, respectively, since just 2008, underscoring the rotation into premium and out of generic wine.

Given the premiumization trend and the reputation of Napa and Sonoma as premium wine-growing regions, it is logical to presume that the North Coast should have the highest growth rates in planted acreage, but that is not the case. The highest growth rates in California are in regions where plantable land is available and where prices are more reasonable compared with those on the North Coast.⁴³

Although the growth rate in planted acres on the North Coast is smaller than in other regions, price per acre is a different issue. As noted earlier, cabernet is leading growth among all premium varietals today, and Napa cabernet acreage has a value structure unto itself. That price and value equation has become even more distorted in the past year (see figure 29).

Using Napa at one end of the growth spectrum, you can see in figure 29 how the average price per ton of cabernet (green line) has increased dramatically over the years since the median baby boomer hit age 35 in 1994. Over the past several years, the price of grapes has continued to rise, with ninetieth-percentile Napa cabernet now fetching north of \$10,000 or more per ton and the best land in Napa reaching \$400,000 per planted acre.

Despite the heavy unrelenting upward trends in North Coast vineyard values since 1994, the date when wine demand accelerated, we believe we are at a place in the cycle where both grape prices and land values will pause their climb. This is due to multiple factors, including headwinds in sales for wineries selling luxury wine, the aging boomer cohort that drove growth for the past 20 years, an inability to pass grape price increases on to consumers and the delay in the millennials' full entrance to consumerism.

9

Notes

A note about the wine report

SVB's annual State of the Wine Industry report is heavily researched, based on extensive interviews, discussions with key industry leaders and analysts, street-level intelligence, and analysis of regional, national and global economic trends. We also use information collected from SVB's twice-a-year surveys of client and non-client wineries.

In October 2017, several wine-producing regions in Northern California faced devastating fires that disrupted lives, communities and commerce, resulting in the tragic loss of life, homes and businesses. Many of the victims are family, friends and wine industry colleagues. We made the prudent decision to cancel the annual fall survey that was scheduled to go out as the tragedy unfolded. As a result, this 2018 report, released in February, is not based on any fall survey data. Instead, we expanded other research to help guide us in drawing conclusions for the year ahead. SVB and the Wine Division's Northern California offices are involved in helping the affected communities recover and rebuild.

1. This report was written from mid-November to mid-December 2017.
2. I'm never wrong. It's the alternative facts that mess up my always-accurate predictions.
3. Stagecoach Vineyard Sells for \$180 Million:
<https://www.winesandvines.com/news/article/183272/Stagecoach-Vineyard-Sells-for-180-Million>. Note that the sales price in the headline is not the full price paid for the Stagecoach Vineyard property and improvements.
4. Nielsen proprietary beverage scan data, September 2017.
5. Luxury Goods Worldwide Market Study, Fall-Winter 2017:
<http://www.bain.com/publications/articles/luxury-goods-worldwide-market-study-fall-winter-2017.aspx>.
6. DtC Shipments Surge 26% in November:
<https://www.winesandvines.com/template.cfm?section=widc&widcDomain=dtc>.
7. Three-tier system (alcohol distribution):
[https://en.wikipedia.org/wiki/Three-tier_system_\(alcohol_distribution\)](https://en.wikipedia.org/wiki/Three-tier_system_(alcohol_distribution)).
8. 2016: A Happy New Year On-Premise?:
<https://blogs.technomic.com/2016-a-happy-new-year-on-premise>.
9. Millennials lose taste for dining out, get blamed for puzzling restaurant trend:
<https://www.cnbc.com/2017/11/14/millennials-lose-taste-for-dining-out.html>.
10. What Is a Stock Keeping Unit (SKU)?:
<https://www.thebalance.com/what-is-a-sku-in-retail-terms-2890158>.
11. ProWein: The Red Blend Rises, Again!:
<https://www.fb101.com/2016/12/prowein-2017-specialst-article-no-2>.
12. Lancers and Mateus – Representing a Nation of Wine:
<https://cavatino.net/lancers-and-mateus-representing-a-nation-of-wine>.
13. Blue Nun: https://en.wikipedia.org/wiki/Blue_Nun.
14. Bartles & Jaymes was a marketing masterpiece in the 1980s. If you are interested in marketing, that brand is worth reviewing. Here's a clip from one of its iconic commercials:
<https://www.youtube.com/watch?v=hYdWHK6AA6E>.
15. The Great Depression: <http://www.history.com/topics/great-depression>.
16. My 91-year-old mom moved in with me a few years ago, and she brought boxes filled with 8-track tapes, sewing patterns, buttons, books and blankets from the 1950s. She has spent the past three years asking me if I can use [fill-in-the-blank thing]. The mature generation doesn't throw things away like the boomer generation.
17. Looking Back at 5 Wine Trends from the 1980s:
<http://blog.iwfs.org/2015/05/looking-back-at-5-wine-trends-from-the-1980s>.
18. Neo-prohibitionism: <https://en.wikipedia.org/wiki/Neo-prohibitionism>.
19. Millennial consumption share for 2017 was estimated using the 2016 SVB Annual Wine Conditions Survey data.
20. Study: Millennials drink nearly half of all wine in the US:
<https://www.usatoday.com/story/money/nation-now/2016/02/15/millennials-drink-nearly-half-all-wine-us/80420746>.
21. Technomic Finds Millennials' Adult Beverage Choices Evolving as They Mature:
<https://blogs.technomic.com/technomic-finds-millennials-adult-beverage-choices-evolving-as-they-mature>.
22. "Frugal hedonism" is a term I coined to describe a young consumer trend. Younger consumers understand artisanship and quality. Instead of consuming as much as they can by volume on credit, as did the boomer generation, younger consumers prefer to live in smaller homes, reduce their rent expense, stay away from consumer credit, drive less expensive cars that have appealing style or just use ride-sharing, and save their discretionary income for simple luxuries they truly enjoy.
23. I had a whole section on where the future sweet spot in pricing will be – and I even paid a Russian mathematician in Bitcoin to apply an algorithm to prove the case – but I had too many words in the report already, so I'll have to talk about that at my speaking engagements.
24. Napa Valley Register archives, part IV, April 1985, p. 19.
25. Wine Sparks War Between the States:
<https://static1.squarespace.com/static/533dbefce4b0b65c53504cf3/t/5368c22be4b0dbc1364ef3b3/1399374379281/wine+sparks+war+between+the+states.pdf>.
26. Estimates of total direct sales in the mid-1990s vary widely in the literature.
27. Silicon Valley Bank clients routinely had stock-outs in the mid-1990s, with some selling all of their vintage in mere months, which sounds nice, but it puts the brand out of customers' view for the remainder of the year. Planting started unabated in an effort to catch up with shortages, and Mondavi started a Chilean joint venture to help fill the wine shortage (Viña Seña and Arboleda).
28. The NBER's Recession Dating Procedure:
http://www.nber.org/cycles/jan08bcdc_memo.html.
29. Granholm v Heald: https://en.wikipedia.org/wiki/Granholm_v._Heald.
30. Use a wine. Go to jail.
31. The Basics of Key Performance Indicators (KPI):
<https://www.thebalance.com/key-performance-indicators-2275156>. Note that Silicon Valley Bank runs a DTC survey in which nearly 10 percent of the industry participates annually. Only participants receive the data, which includes dozens of KPI. To be included in the survey, please contact the writer at rmcmillan@svb.com.
32. Is Opening a Downtown Tasting Room Smart?:
<http://svbwine.blogspot.com/2017/09/is-opening-downtown-tasting-room-smart.html>.
33. Sears, J.C. Penney, Kmart, Macy's: These retailers are closing stores in 2017:
<https://www.usatoday.com/story/money/2017/03/22/retailers-closing-stores-sears-kmart-jcpenney-macys-mcsports-gandermountain/99492180>.
34. Amazon effect: <http://whatis.techtarget.com/definition/Amazon-effect>; and Digital Transformation and the Race Against Digital Darwinism:
<https://www.prophet.com/thinking/2014/09/digital-transformation-and-the-race-against-digital-darwinism>.
35. The iPod Revolution Transformed Our Lives and Economy:
<https://www.cultofmac.com/125400/the-ipod-revolution-transformed-our-lives-and-economy>.

36. Quarterly Retail E-Commerce Sales; 3rd Quarter 2017:
https://www.census.gov/retail/mrts/www/data/pdf/ec_current.pdf.
37. Online distribution is still in its infancy, but one interesting company I'm watching is LibDib: <https://libdib.com>.
38. Why Evian now spends 80 percent of its marketing budget on digital media:
<https://digiday.com/marketing/evian-now-spends-80-percent-marketing-budget-digital-media>; and Blue Apron is spending more than \$400 for every new customer — and that's creating a major problem for the company:
<http://www.businessinsider.com/blue-apron-spends-big-for-new-customers-low-return-2017-8>.
39. Customer Vineyards — a wine industry data consortium that includes participation by Rob McMillan, Sonoma State University and Vinventions/Nomacorc — is working to deliver a big-data product to the industry in late 2018. Already through its proof-of-concept phase and after analyzing more than 40,000 individual consumer files and linking them to other data from the big-data warehouses, Customer Vineyards' early returns are promising.
40. The "Sideways" Effect:
<http://www.winesandvines.com/template.cfm?section=features&content=61265>.
41. California's wine country wildfires near containment even as structure loss grows:
<https://www.cnbc.com/2017/10/23/number-of-structures-lost-in-wine-country-blazes-jumps-to-8400.html>.
42. "Gateway wines" is a term used in the trade for entry-level wines that have historically been produced in California's Central Valley. They were simple, well-made wines, often with a little residual sugar remaining that appealed to wine consumers at the start of their discovery curve. That's another phrase that should be added to the Urban Dictionary.
43. Information about Oregon and Washington land and values is not included in this report because of a lack of available trended data. We can say with observation, however, that the trend of sales prices is increasing. 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 and is more affordable compared with California.

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