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Local Economic Report Series

Wine Industry

2003



Presented By
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in partnership with
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The Sonoma County Economic Development Board, in partnership with the Sonoma County Workforce Investment Board, is pleased to present another issue in the *Local Economic Report Series*. This report focuses on the wine industry.

Over the past few months, the wine sector has been beset with increasing worries about industry performance. While the shaky economy makes luxury goods less popular, lowered prices may attract more wine drinkers and diversify the customer base. *Wine Industry 2003* explains this complicated climate in the national as well as local context. Highlights from the report include:

- ◆ Expanded markets and current market conditions have created an over supply of grapes, and the weakened economic conditions are preventing the industry from matching the excellent performance of the last decade.
- ◆ A gradually weakening dollar over the past year, most notably against the euro and the pound, may help the industry to penetrate European markets.
- ◆ Mid-range brands have gained popularity.
- ◆ The weakened dollar will likely increase the cost competitiveness of Sonoma County appellations overseas, and raise the cost of competing import brands in the U.S.
- ◆ The aging baby-boom generation may increase their demand for wine as the economy improves, especially in regard to collectible luxury wines.

Economy.com produces the Local Economic Report Series for the EDB with the cooperation of the Sonoma County Workforce Investment Board (WIB). Thank you for your continuing interest in the local economy.

Yours sincerely,

Ben Stone
EDB Director

Wine Industry - Sonoma County

Recent Trends. It has been a trying year for Sonoma County's wine industry, especially at the high-end of the market. The weak economy has stifled new demand for perceived luxuries, including expensive wine, as consumers conservatively opt for less expensive alternatives.

Competition with other wine-producing countries also is mounting in both local and international markets. Wine imports from all the major competitors increased throughout the year, with notably high gains by Australian wines.

Apart from the problem of weak demand, wine inventories are affected by an oversupply of crushed grapes. Strong demand led to a rapid expansion of vineyard acreage during the 1990s, especially for popular varieties such as Cabernet Sauvignon. In light of expanded harvests and current market conditions, however, the supply of grapes is exceeding demand, which depresses prices. Across the board, 2002 prices for Sonoma County's leading varieties fell short of their 2001 levels, by as much as 9.7% for Chardonnay. These trends have wine inventories backed up, as vintners struggle to find a market for their wines.

Some consolidation in the nationwide wine industry has become evident over the past two years, and there are inklings of this trend in Sonoma County as well. Allied Domecq recently purchased Buena Vista Winery along with 718 acres of vineyards from Racker USA. The trend has slowed, however, because oversupply and slow wine sales have eroded profitability, and the general economic malaise makes it difficult to accurately value wineries and vineyards. Few companies will put themselves on the block voluntarily at a time when they're least likely to fetch a good price.

Macro Drivers. Broadly weak economic conditions keep the industry from matching its performance of the past decade. The greatest downside factor for the industry is weak demand due to the slow recovery of jobs, income, and consumer confidence following the 2001 recession. Moreover, there is every indication that consumers will continue to be cautious in their spending going forward. Household debt is currently high, resulting in mounting financial stress. The number of bankruptcy filings is also at a record high, and mortgage foreclosure rates and direct auto loan repossession rates are nearly at record highs. Fragile consumer

confidence also has been due to the substantial economic and political uncertainties leading up to the Iraqi war, although one can expect a rebound in confidence, albeit muted by the underlying weak labor market, once the war is over.

A gradually weakening dollar over the past year, most notably against the euro and the pound, has helped the industry to penetrate European markets. Europe is still the largest international market for Sonoma County wines. The downside is that it has made intermediate capital goods imports from Europe more expensive. Furthermore, economic conditions in the industry's major international markets are not any better than they are domestically, which curtails near-term export growth.

Industry Drivers. The wine industry is beginning to consolidate as it matures and the major firms jockey for clout in an increasingly competitive environment. In the wholesale distributor market, the entrance of the goliath Diageo, a liquor/wine branded products company that has developed exclusive distributor agreements for its products in many states, in late 2001 significantly upped the ante for smaller distributors. This, coupled with the generally hard times, has forced a number of smaller players out of business altogether. For those that have survived, consolidation will increase their bargaining power in purchasing from vintners. Consequently, vintners are also consolidating, albeit at a slower pace because those that can are opting to weather the trough in expectation of better days down the road. Ultimately, wineries will resume consolidating once market conditions even out, in order to exploit economies of scale and as a defense mechanism to bargain with wholesalers. At the cutting edge of this trend was the September marriage of the Gallo and Martini winemaking families to become one of the world's largest winemaking operations.

Domestic acquisitions aside, many winemakers with the wherewithal are extending their production ventures internationally to include foreign brands, mostly Australian, that are growing in popularity on the U.S. market. The Gallo and Mondavi winery groups are among the wineries that are making such forays into international territory. Lower production costs are a major factor fueling this trend;

the cost of acquiring land and building a vineyard from scratch in Australia is about half of what the cost would be in Sonoma County.

Another factor driving interest in foreign appellations is their relative success in catering to changing consumer tastes. Traditionally, winemakers have made their names with a unique trademark taste that has been oaky and complex for most of the top brands; however, the successes of the consumer-oriented fruitier flavors of Australian wines highlight a viable line of wine products that will help shape the industry going forward.

A positive factor is that outdated Prohibition-era laws that have hampered direct shipping of online sales of wine are beginning to crack. Currently, direct shipping of wine is a cumbersome and involved process in over half of the states, but a recent wave of court rulings has set off a reversal of this trend. Notable among them is the recent ruling in New York State that its State Liquor Authority can no longer prevent out-of-state wineries from shipping directly to New York residents. The state is the biggest U.S. wine market after California. It is expected that these rulings will be appealed all the way to the Supreme Court. A favorable outcome would make it easier, particularly for Sonoma County's smaller wineries, to sell online and broaden their domestic market. This way they will also be able to bypass wholesale distributors and reap higher margins on at least a fraction of their product. In the meantime, a little progress has been achieved as President Bush signed legislation in November that allows wine purchased while visiting a winery to be shipped directly to another state.

Pricing. Demand pressures are the most significant pricing determinant in these days of abundant supply. While restaurant sales are up again after a steep fall post-9/11, the market for luxury wines, above \$20, has shriveled. This trend poses considerable difficulty for Sonoma's high-end wineries, many of whom are struggling. Summed up, demand conditions aren't nearly as good as they were in the roaring 1990s, and stiffer competition among local wineries and from imported brands have kept prices depressed.

On the supply side, the global glut of grapes hurts growers and wineries alike. For wineries, the excess supply of wine is driving down retail prices. Prices for two of Sonoma's leading varieties, Chardonnay and Pinot Noir, were down in 2002 over 2001, for the first time in many years. The upside is that

Wine Industry - Sonoma County

vintners can now afford to be very discriminating in the quality of crush that they will use. Ultimately, this should ensure the survival of only the best wine growers, which should be good for wine quality and prices going forward. Already, weather and aggressive crop thinning for quality brought in 2002 harvest tonnage for Sonoma County about 15% below projections.

Operating Expenses. Generally, costs involved in producing wine have not increased substantially, although there is potential for increases going forward. Employment in wineries is shifting toward temporary help over permanent workers, as vintners slow production in response to high inventories, thereby cutting labor costs. Additionally, two bills that would have expanded farmers' liability for labor violations committed by farm labor contractors were vetoed in September, eliminating a potential source of higher labor costs. This does not eliminate land-owner liability for FLC violations under California Code. However, unit labor costs are growing and this will affect total costs over the long term.

With the dollar as weak as it currently is, the cost of importing winemaking equipment, mostly from Europe, is increasing. One can expect that the cost of German filters, French oak barrels and Italian crush equipment among other inputs, will rise well into the forecast horizon commensurate with a moderate but sustained slide in the dollar.

Profitability. Oversupply and increased international competition will undercut the profit potential of the wine industry in the near term. Expected wine quality improvements suggest that demand at the high end of the wine spectrum may lose its pricing flexibility and high margin since even connoisseurs are going to be able to find high quality wine at lower prices. The upside is that fewer people are going to leave the wine market for lack of good value during these hard times, and then once the economic climate brightens it will be easier to gradually mark up prices for those consumers who have acquired or maintained a taste for good wine. Thus, Chardonnay and Cabernet Sauvignon will be subject to depressed prices and improving quality for the next couple of years. Sales of Pinot Noir were brisk in 2002 with 14% growth over 2001. Sonoma County is home to about half of all California Pinot Noir acreage and will benefit if this growth is sustained.

The dollar is expected to remain weak relative to major currencies. This would

not only improve the cost competitiveness of Sonoma County appellations overseas, but would also raise the cost of competing import brands in the U.S. Wineries would thus get a boost from increases in both domestic and foreign sale volumes.

Long-Term Outlook. The long-term outlook remains good, but the coming decade will not see the soaring demand, rising prices or solid profitability of the decade just behind us. One factor limiting the long-term prospects is that domestic per capita consumption has leveled off, and it is falling in mature overseas markets. According to data from the Wine Institute, global wine consumption peaked during the first half of the 1990s, with U.S. consumption on a gradual upswing until a slight decrease in 2002. Thus, long-term demand drivers for the industry have eased. In other words, the supply/demand balance has tipped toward excess supply at a time when demand growth will be moderate at best. However, the key is price point, where generic wines are experiencing decreased volume sales, but growth continues in wines priced above \$7/bottle.

Australian imports are already a force to reckon with, and such international competition will only grow fiercer with time. Although some of the bigger winemakers have already begun to reduce their exposure by buying into the competition, this trend bodes ill for the highly leveraged and/or smaller wineries of Sonoma County.

There is a positive demographic trend that may boost the industry, however. As the baby boom generation moves into its fifties and sixties, its disposable income will rise. Thus, there is a good likelihood that their demand for wine will rise as the economy improves, and their penchant for collecting luxury wines may increase as well.

However, as the baby boom generation ages and passes, Sonoma's high-end wineries will have to step up their efforts to reach the next generation of beverage consumers. The success of the consumer-shaped taste approach adopted by some Australian wineries is evidence of a broad cross-industry trend of growing consumer power. The determinant of survival in the wine industry in the long run may very well be the ability to be flexible and adapt alongside changing consumer tastes.

Upside Risks. If the U.S. economic recovery is quicker and more rapid than expected, consumers could rapidly return to some semblance of their wine consumption

habits of the past decade before any permanent shift in buying habits is made. Expected improvements in quality, as a result of oversupply, will boost such a rebound.

Despite the vagaries of exchange rate fluctuations, changing tastes toward fine wines overseas offer further potential for Sonoma County wine. With entry into the WTO pulling trade barriers down in China, and Eastern Europe turning westward for imports, many markets remain untapped.

Downside Risks. A number of factors pose some long-term risks to the industry. The most devastating would be the arrival in Sonoma County of the glassy-winged sharpshooter along with its accompanying Pierce's disease. This issue has slipped out of the limelight, but there is significant behind-the-scenes preventive activity as a result of the threat it poses. Over the last five years, 775 acres of vines on the North Coast have been replanted as a result of Pierce's Disease infestation.

The vine mealybug has also made its way from the Central Valley to the North Coast. The mealybug problem is expected to come to a head once the weather warms this year, when the pests emerge from underground, after feeding on roots during the winter. In Sonoma, the pest so far has been mostly limited to newly planted vineyards that are not yet ready for harvesting, thus they pose less of an immediate threat, and even less so in light of the market oversupply. Still, this major pest must be controlled with insecticides, adding costs for growers.

Rising labor costs pose additional risk to profitability as both skilled and unskilled labor are difficult to find in this county where housing costs are extremely high.

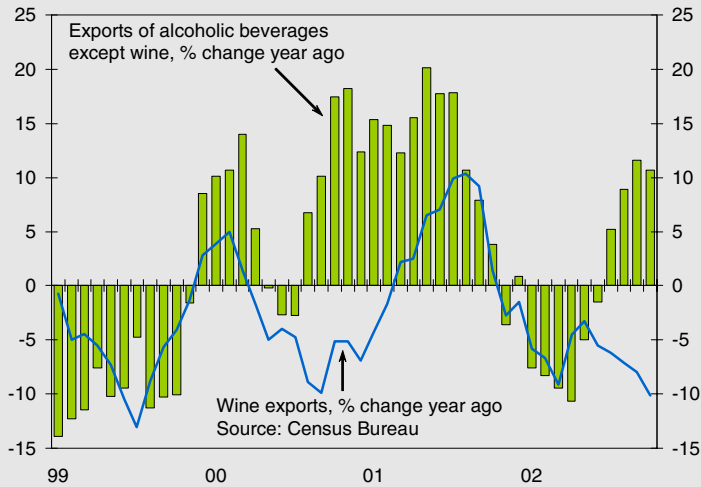
Also, continued consolidation among beverage distributors in the future could make it difficult for new labels to gain wide distribution, although the opening of Internet marketing channels would bolster the industry's marketing power. Furthermore, competition from other appellations in California and other viticulture regions around the country and internationally may make it increasingly difficult for Sonoma County labels to maintain their recognition. Finally, there is a risk that Sonoma County wines may not remain price competitive with imports of increasing quality, particularly as labor and other costs continue to mount.

Kwaku Sefa-Dedeh

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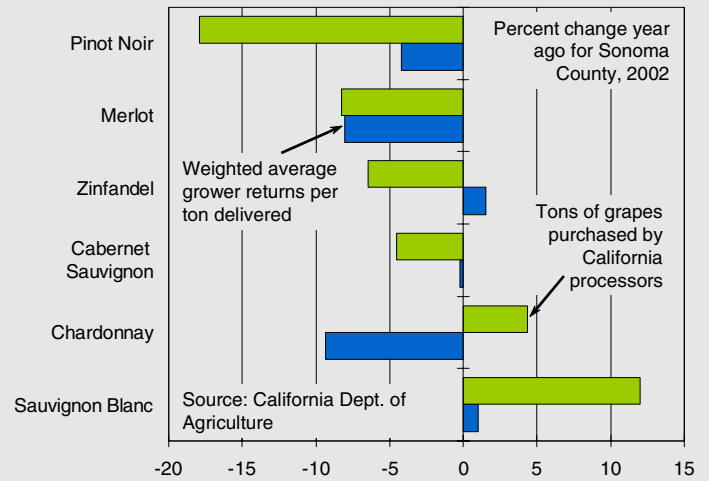
Wine Industry - Sonoma County

Wine Exports Haven't Fared Well



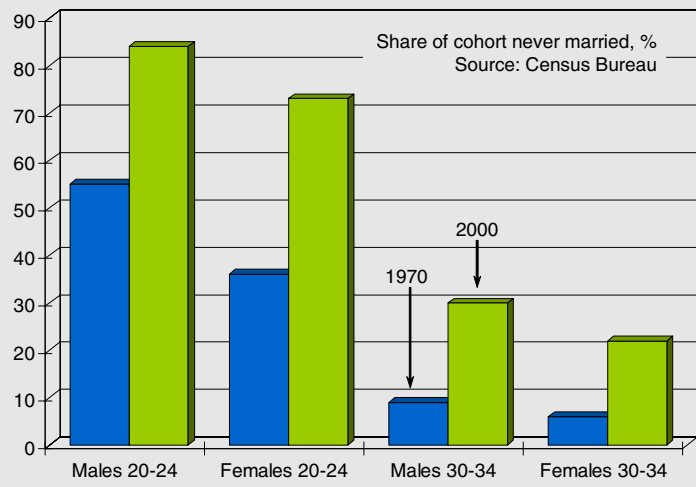
Despite the weakening dollar, which effectively makes U.S. exports cheaper in markets like Europe, wine exports haven't seen any growth for over a year. The euro has appreciated by 21% against the dollar over this period. This trend has facilitated a rebound in exports of other U.S. alcoholic beverages, yet a similar rebound in wine exports has been hindered by stiff competition from other wine-producing countries. Australia and Chile are among the fastest growing competitors for the global wine market.

Producers Are Pulling Back to Counter the Glut



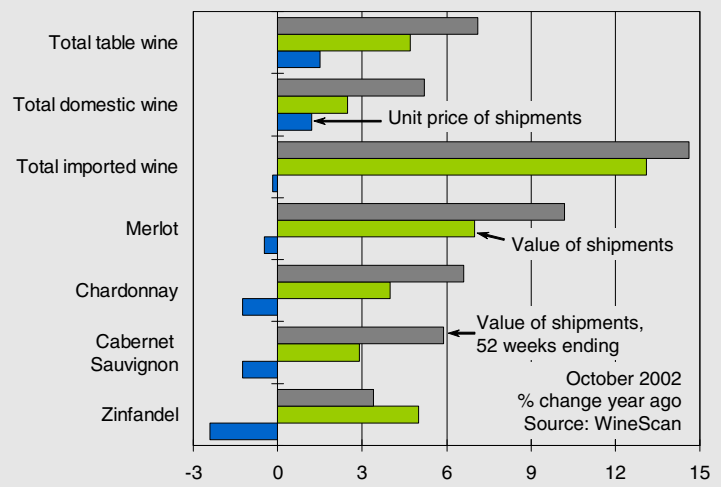
Prices and tonnage for most of Sonoma County's top varieties dropped in 2002, as markets and suppliers adjusted to deal with oversupply. Despite the posted growth in tonnage for Chardonnay, Sonoma's most popular variety, production has fallen considerably from its high 2000 level. Anecdotal evidence from reports indicates that growers are significantly thinning their vineyards for quality. Thus, one can expect that the grape market will be back at equilibrium within the next few harvests.

Singles Have the Time and Money to Appreciate Good Wine



There is a greater share of unmarried professionals in the labor force than ever before, which bodes well for the wine industry. At the height of their productivity, this group commands a hefty share of disposable income without many of the responsibilities and constraints of married life. As such, they have a high rate of luxury consumption, including wine. Additionally, this consumer cohort has been found to be very health conscious. Thus, recent studies touting the value of alcohol consumption may boost their spending on alcoholic beverages, including wine.

Imported Wines Are Driving Down Profits



Although mid-range wines have supported the industry as a whole, it's been a trying year for Sonoma County's wine products. There is a growing disparity between year-ago growth in the moving annualized total and the monthly value of wine shipments, which suggests that growth slowed throughout the last half of 2002. This declining trend can be explained with the prevailing economic weakness and conservative consumer spending. It is also exacerbated by the rapid rise in the volume of imported wines.