
**Sonoma County
Economic Development Board**

presents a report on the

**2004
Wine Industry**



Prepared in Partnership with the
Sonoma County Workforce Investment Board

April 2004

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The Sonoma County Economic Development Board (EDB) is pleased to bring you the 2004 report on the local wine industry. Throughout each year, the Economic Development Board presents several economic reports on specific industries that are important drivers of the Sonoma County economy. This report series is made possible through a partnership with the Sonoma County Workforce Investment Board. In this report you will find important information regarding current trends in the Sonoma County wine industry. The EDB has commissioned this research report from Economy.com.

Highlights from the *2004 Wine Industry Report* include:

- Wine exports were up 15% in 2003 thanks to the weakened dollar.
- Consumption of luxury wines (\$15+) will increase this year.
- The long-term outlook for demand of wine is favorable and is predicted to improve.
- The wine industry has been dealing with weak pricing power due to excess supply but prices are predicted to stabilize.
- Consolidation of distributors and large winemakers has squeezed profits on grape growers, and has made branding of smaller labels more difficult.

Please note the attached list of underwriters whose generous support make this research information possible. Thank you for your continued interest in the Economic Development Board's research. As always, if you have any questions please feel free to contact us at (707) 565-7170.

Sincerely,



Ben Stone
Director

Wine Industry - Sonoma County

Recent Trends. The seeds for improvement in Sonoma County's wine industry have been sown amid the difficult corrections the industry was forced to undertake over the past several years.

Locally, grape growers cut back production in 2003 to make up for the glut in wine grapes in the market. In the Central Valley alone, over 100,000 acres of vineyards have been pulled out of the stock, which has helped ease the oversupply conditions. According to the latest California Grape Crush Report, the Sonoma-Marin district's crush tonnage declined by 13% in 2003, the largest decline among all districts in the state. The short crop for all varieties except cabernet sauvignon has brought winery inventories into better balance. Local growers and winemakers look to enjoy firmer prices in the coming year.

While chardonnay grapes are now largely in balance, the glut in cabernet grapes is expected to last through 2006. This is discouraging for Sonoma County, where cabernet is the second most widely planted variety. Pinot noir planting declined 4% in 2003, but new bearing acres may contribute to still-weak pricing in the next two to three years, since much of the recent plantings have yet to reach productive yields. Pinot noir is the third most important varietal in Sonoma.

Indeed, the wine industry's problems remain largely supply-driven. Mostly thanks to low prices, U.S. wine consumption grew at a strong pace in 2003. Further, exports of wine were up 15% in 2003, the fastest growth since 1995. Much of this was driven by the weak dollar, poor chardonnay yields in Australia and strong demand in the local grape juice concentrate market. However, weak pricing meant that vintners were unable to capitalize on this demand.

Meanwhile, competition from foreign wines remains a persistent problem, although the steady weakening of the dollar over the past year has helped mitigate this threat. Wine import growth slowed from 14% in 2002 to 12% in 2003; import growth slowed to 6% on a year-ago basis by December 2003.

Macro Drivers. Improving conditions in the macroeconomy generate some upside potential for the wine industry. Over the past two years, weak economic growth and a subpar recovery have added to the wine industry's own tribulations. Specifically, weak employment and income growth nationally and low consumer confidence have con-

spired to dampen discretionary spending since 2001.

This turned around in the second half of 2003. Although national payroll growth remains weak, it has accelerated over the past six months. Rising corporate profitability and accelerated GDP growth suggest a return to more robust hiring as the year progresses. In addition, consumer confidence has rebounded nicely since hitting its nadir in March 2003. Dramatic gains in equity markets over the past year have fed optimism on spending for consumers.

Some concerns remain, however. Chief among them is the potential impact of rising interest rates on consumers' high household debt burdens. Still, the Federal Reserve Board appears committed to maintaining low interest rates in the near term. As such, the overall consumer spending outlook for 2004 remains positive. Rising interest rates will affect growers and vintners as well, further squeezing profitability.

More broadly, the recovering U.S. economy will spur a global economic recovery by the end of this year. Targeting export markets could help the U.S. ease its ballooning wine trade deficit, which soared to \$460 million by the end of 2003, although wines in the export market tend to have lower price points and thus offer weaker margins for vintners.

Industry Drivers. This year looks set to be the year of the luxury wine, with expectations for a pickup in demand for wines priced above \$15. This is especially good news for Sonoma County producers who tend to cater largely to this market. Evidence of this trend is a recent increase in luxury goods consumption by consumers, a projected improvement in personal income growth in 2004, elevated equity market indexes and lower tax burdens. This will be a welcome diversion from the "extreme value" phenomenon over the past two years, where wines priced as low as \$2 to \$4 a bottle have flooded the market. Already, lower returns are encouraging retailers to minimize their "value brand" wine offerings.

On the demand side, producers who have faced stiff international competition are now looking to take the fight to the other side. Especially appealing is the growing consumer class in booming Asian markets like China, Korea and India. As these markets mature from export-driven to domestic consumer-driven economies, they are also

witnessing the growth of a new class of brand-conscious consumers whose demand for foreign goods and lifestyles is improving. Notably, while wine consumption remains low in Asia, it has grown rapidly, creating a potential market for branded wines such as those from Sonoma County. For example, wine imports in China rose 30% in 2003. China maintains very high tariffs on foreign produce—over 37%, which compromises exporters' profits. But, these tariffs are set to fall to 14% later this year. While Chile, France and Australia dominate the Chinese market currently, U.S. exports are inching up. That said, once again, lower price points for most export wines make them unattractive to local wineries.

The wine industry also continues to make steady progress chipping away outdated Prohibition-era laws that hamper direct shipping of wine to a number of states. Currently, 26 states have laws permitting direct shipping of wine. New York and Washington present the frontiers of this challenge; a court ruling permitting direct shipment of wines to New York from other states was recently overturned, and legal battles are set to continue. In Washington, wholesaler Costco is suing the state for the right to purchase directly from out of state producers. A favorable outcome would make it easier for Sonoma County's smaller wineries to sell online, broaden their domestic market and bypass expensive distributor networks.

Pricing. The tide is slowly turning in the pricing of wine. A more balanced supply and improving demand are finally giving vintners some semblance of pricing power this year. Anecdotal evidence from local and state sources suggests that bulk buyers are now paying higher prices for bulk wine than a year ago, especially for chardonnay and merlot. Growers are also facing rising demand; large buyers such as E.J. Gallo, The Wine Group and Golden State Vintners put their contracts out for 2004 vintage grapes in November, well before the usual time, which again suggests increased confidence.

On average, wine grape prices fell 5.4% for Sonoma County growers in 2003, nearly twice the 2.5% decline seen statewide. Prices for chardonnay, Sonoma's most popular variety, declined 9% last year despite a 14,000-ton drop in output. Cabernet sauvignon output in Sonoma County, the second most widely planted crop in the

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county, rose 4,200 tons in 2003, which contributed to lower prices into the early months of this year. Prices for other top varieties grown in the county—merlot, pinot noir and zinfandel—all declined in 2003.

Operating Expenses. Operating costs for wine production focus on the labor costs that encompass two-thirds of the cost of producing wine grapes. Labor force growth in Sonoma County was virtually flat in 2003, the weakest since 1995. Still, there are no real signs of a labor shortage. Further, the cutback in production and slower ripening helped alleviate labor demand in the past year, according to the Sonoma County Grape Growers Association.

By and large, growers and vintners have welcomed President Bush's call to legalize undocumented workers in the U.S. and set up a system to allow migrant workers to work legally in the U.S. for three-year periods. This will increase the labor supply for the wine industry, although chances of this proposal's passage are slim.

While the weak dollar prices American wine competitively overseas, it adds to the cost of imported production equipment. For example, German filters, French oak barrels and Italian crush equipment have all been more expensive for winemakers over the past year.

Sonoma County's wine industry must deal with a potential water shortage due to flow cutbacks in the Russian River that could lead to higher costs and increased calls for conservation. New vineyards in ag-zoned areas have had more difficulty obtaining zoning approval due to residents' concerns of water use as the area's water table has fallen in recent years.

Profitability. Profitability is expected to improve moderately for both wine grape growers and vintners this year. Firming grape prices and improving demand buttressed by the global macroeconomic recovery will improve profits. Profitability among large corporate winemakers was weak last year; Mondavi recorded a slim 4% revenue growth rate for the first half of 2003, and wine revenues were the only component dampening profit growth in wine and spirits giant Brown-Forman's third quarter earnings report.

One factor dampening profitability is the amount of consolidation among wineries, distributors, and retailers. Greater consolidation among large wine distributors has

enhanced their pricing power and profitability, which squeezes profits for grape growers and small vintners. Further, consolidation has also diluted these new behemoth distributors' abilities to provide effective marketing for individual wines in their large roster of products. Thus, wineries are being forced to bear a greater marketing burden. Consolidation among large winemakers is also allowing them to increase market share and support profitability.

The dollar is expected to remain weak relative to major currencies over the coming year. This will 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 thus should receive a continued boost from increases in both domestic and foreign sale volumes.

Long-term Outlook. The long-term outlook for Sonoma County's wine industry remains solid. Favorable name recognition and rising wine consumption globally are the positive fundamentals driving the industry's outlook. That said, the coming decade will not see the soaring demand, rising prices or solid profitability of the decade just behind us.

Demographic trends suggest healthy longer-term prospects. The Wine Market Council reports that per capita consumption of wine has been rising steadily since the early 1990s, and finally crossed the 2.5 gallon rate in 2002, originally set in 1982. Core wine drinkers—those who consume wine at least weekly—account for 12% of the total population but 80% of consumption, and this share of core drinkers has risen from 2000 to 2003 after holding steady through the 1990s.

Per capita consumption in the U.S. is still well below rates in Europe, suggesting potential for growth. As the baby boom generation moves into its fifties and sixties, its disposable income will rise. 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.

Longer term, the wine industry will benefit from the new 'millennial generation' of wine drinkers that will hopefully pick up the mantle as baby boomers age. The oldest of this new large cohort, almost as big as the baby-boom cohort, are now in their early 20s, and 40% of this cohort are considered

core wine drinkers. The challenge for the wine industry will be to deepen its attraction of marginal drinkers, who have cut their consumption of wine over the past three years.

The strategic threat from New Age wineries with fruitier flavors in Australia, Chile and South Africa is very real. Increased consolidation in the industry across borders reduces global winemakers' exposure to this, but local growers and small vintners will continue to be pressured by the cheaper and consumer-friendly (i.e. no-wine-knowledge-required) wines from the New Age wineries.

Upside Risks. A more rapid macroeconomic recovery would certainly boost wine demand beyond our expectations. The wine industry is also making forays into several new markets, by re-branding and labeling wines to attract more women and minorities. Success in these new strategies would also boost wine consumption.

Foreign markets also present some upside potential as untapped consumer markets in Asia, Eastern Europe and the Middle East blossom.

Downside Risks. A number of long-term risks abound in the industry. The most devastating would be from pestilence, specifically from the glassy-winged sharpshooter and its accompanying Pierce's Disease, or from the vine mealy bug (VMB). In Sonoma, the VMB 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. Still, this is a threat that bears watching.

Longer term, a potential ban on genetically modified crops in Sonoma, much like the recent ban in neighboring Mendocino, could deter new research into methods to combat pestilence, which will be detrimental to the local wine industry.

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.

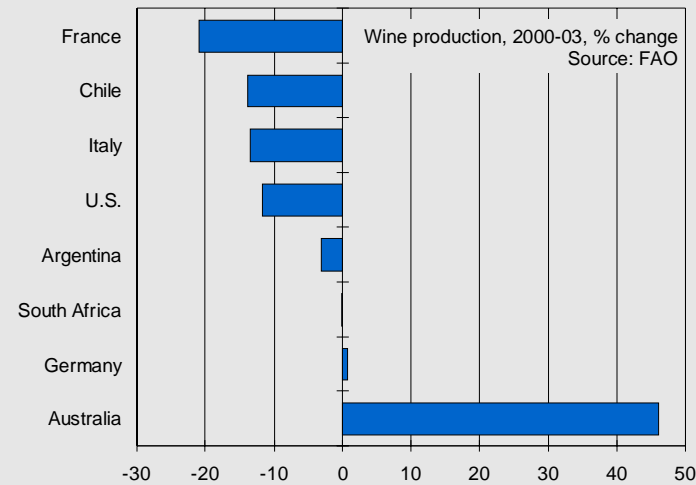
Continued consolidation among beverage distributors in the future could make it difficult for new labels to gain wide distribution. Furthermore, competition from other appellations in California and other regions nationally and internationally may make it increasingly difficult for Sonoma County labels to maintain their recognition.

Rakesh Shankar

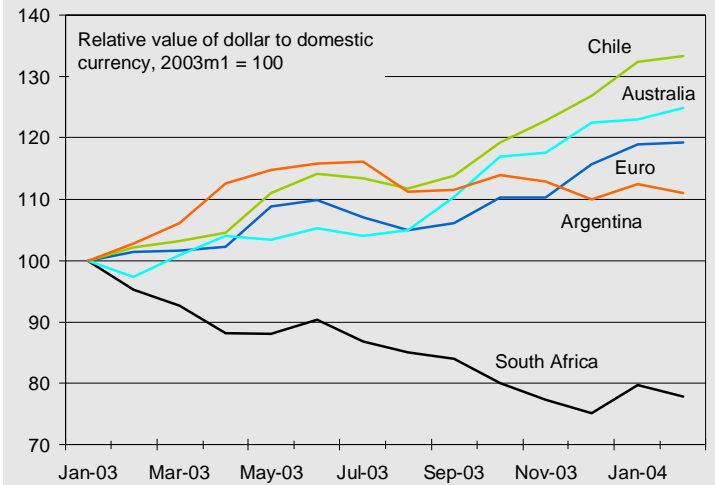
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Global: A Bad Stretch for Most Winemakers...Except One



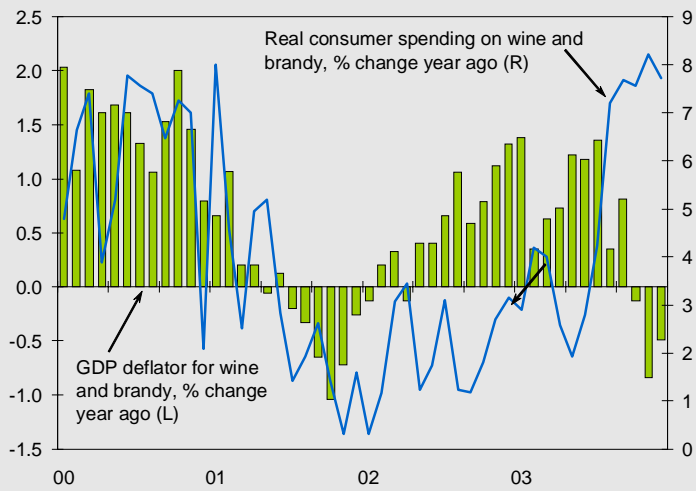
Global: Pricing Power Has Improved Against Most Competitors



Sonoma County winemakers are not alone in their travails. Across the world, winemakers are coming off a bad 3-year stretch of low pricing fed by a global supply glut, which in turn has forced most winemakers internationally to prune production. Indeed, the overall EU vintage for 2003 was the lowest the region has seen in a decade. A searing drought contributed to the production cutback in 2003. The notable exception to this trend is Australia, which has fed the global oversupply with its production. However, even Australian winemakers suffered a cutback in production in 2003, also due to a drought.

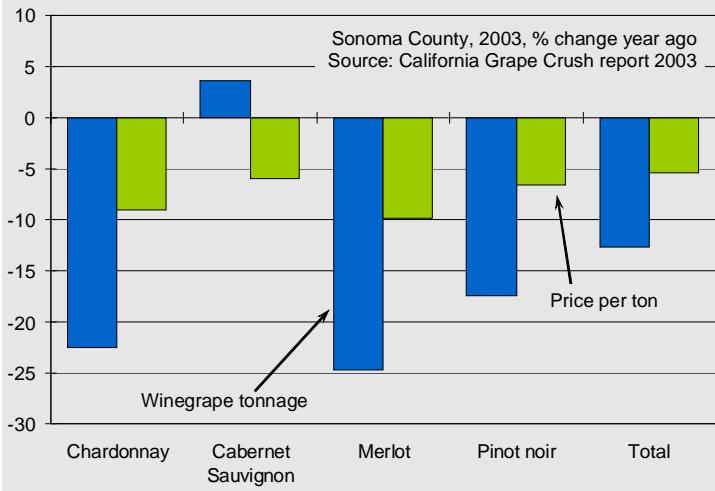
The sinking dollar is indeed a winemaker's best friend. The U.S. dollar has been losing value against most of its winemaking competitors over the past year, thus boosting U.S. winemakers' competitiveness against Australian, European and Chilean rivals. South Africa is the notable exception where the rand has dropped sharply against the dollar. America is the fourth largest producer of wine in the world, after France, Italy and Spain. The strongest competition is from Australia, Argentina, and, surprisingly, China, which is now the seventh largest wine producer in the world.

National: Strong Demand Driven by Lower Prices



Real consumer spending of wine in late 2003 grew at a pace rivaling the roaring late-1990s. Unlike the 1990s, however, this growth was driven not by a strong macroeconomy and concurrent income growth. Much of this new consumption has come from cheap imports and the flood of cheap domestic wines. Total sales for domestic producers rose a weak 1.5% in 2003, while over 70% of growth in wine sales in 2003 was covered by imports. The real test for producers will be in maintaining high consumption rates even as pricing firms up in the coming year.

Regional: A Year to Forget



The year 2003 was certainly one to cut losses and run for Sonoma winemakers, a necessary but painful transition period. With the exception of cabernet, all major varieties saw double-digit drops in production. Despite this, grape growers in Sonoma received even lower prices in 2003. While this pain now sets the tone for future gain this year, the continued increase in production for cabernet, Sonoma's second most widely planted varietal, means a persistent supply glut and weaker pricing potential in this subsector of the Sonoma wine industry.



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