Sonoma County
Economic Development Board

presents a report on the

Regional Wine Industry

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The Sonoma County Economic Development Board is pleased to bring you the Fall 2004 Regional Wine Industry Report. In the following pages, you will find a regional analysis of current trends in the North Bay wine industry. This report was made possible through the Pacific Gas and Electric Company's Local Economic Development Grants Program.

Highlights from the *Fall 2004 Regional Wine Industry Report* include:

- The regional wine industry is emerging from its three-year slump, and is set to return to stronger growth in the next few years.

- Cutbacks in production have helped the winegrape market come into balance over the past year. Nearly all varietals, with the notable exception of cabernet sauvignon, are currently in line with demand.

- Wine growers are finally seeing better pricing power after three difficult years. For Sonoma County, chardonnay is seeing a particularly light year, which has helped improve pricing. Similarly, the sauvignon blanc harvests in Napa County are estimated to be 40% lighter than last year, which also bodes well for prices.

- According to the North Coast Wine Growers Association, Sonoma County is expecting a 10% increase in total harvest tonnage from last year. This compares to an estimated 2% rise in production in Napa County, a 12% rise in Lake County, and a 7% drop in Mendocino County.

- Consumer spending on wine and brandy for personal consumption is growing at a near-record pace, soaring 10% in mid-2004 on a year-ago basis. In addition, more sophisticated branding and marketing, especially to the 21-25 age group, may be needed to broaden the wine industry's appeal.

- Notably, the weaker dollar continues to fuel wine exports, up nearly 15% in mid-2004. Moreover, if the dollar weakens further, as expected in the coming year against most Asian currencies, regional cost-competiveness will improve in key emerging markets. However, the dollar is expected to strengthen some against the euro and the yen, which will take some steam out of exports to Europe.

This report was prepared by our research partner, Economy.com. 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 - North Bay Region

Recent Trends. The North Bay wine industry is in far better shape than it was at the last writing of this report six months ago. The industry is by and large emerging from its three-year slump, and is set to return to stronger growth in the next few years. A few soft spots continue to hound the industry, which will temper the industry's recovery in the very near term.

Severe cutbacks in production have helped the winegrape market largely come into balance over the past year. Nearly all varietals, with the notable exception of cabernet sauvignon, are currently in line with demand, according to several local sources; cabernet is still in excess supply, and is likely to stay so for about two more years. Pricing for grapes has concurrently improved.

Notably, the 2004 harvest season has come almost a month earlier than usual, thanks to unseasonably warm weather. As a result, harvests are already well under way across the North Coast region for sauvignon blanc, pinot noir and chardonnay, with merlot and cabernet harvests beginning to pick up. An estimated 30% to 40% of the crop had already been harvested in Sonoma County by early September.

Overall, the 2004 crop is projected to be below average, but slightly above last year's nadir for most varietals. Sonoma County is expecting a 10% pickup in total harvest tonnage from last year, according to the North Coast Wine Growers Association (NCWGA). This compares to an estimated 2% rise in production in Napa County, a 12% rise in Lake County, and a 7% drop in Mendocino County.

On the pricing end, chardonnay, Sonoma's most important crop, is seeing a particularly light year, which has helped improve pricing. The sauvignon blanc harvests in Napa are estimated to be 40% lighter than last year, which also bodes well for prices.

Consumer appetites for wine seem insatiable. Consumer spending on wine and brandy for personal consumption is growing at a near-record pace, soaring 10% in mid-2004 on a year-ago basis. Low prices and increasing choices from imports seem to be fueling demand for wine, despite a moderation in overall consumer spending over the past few months. The inventory-to-sales ratio for wine and distillates at wholesalers is also very low currently as per Census Bureau estimations, as inventory growth slowed to a halt earlier this year. This suggests a potential uptick in wine demand and prices in the near term, particularly as the lucrative holiday season starts to come around.

Growth in wine imports has moderated markedly over the past year, despite healthy growth in demand. Data from the Census Bureau indicate that wine import growth slowed from a peak of 20% in late 2002 to around 4% in mid-2004. Meanwhile, exports continued to grow at a steady clip, up nearly 15% in mid-2004. All of this affirms improved bottom lines for domestic winemakers. The weaker dollar has certainly helped export growth. Still, increased price-consciousness among consumers is dampening domestic winemakers' margins.

Macro drivers. The steady expected improvement in macroeconomic conditions is a net positive for the wine industry. Employment growth is now slowly but surely gathering steam, and income growth has been accelerating for the past year. Consumer confidence has moderated in recent months, but remains well above its low point of early 2003.

The outlook calls for slow but steady payroll and income growth in the near term, which will help shore up demand for wine. Improving corporate profits are also a positive sign.

Some concerns remain, however. Chief among them is the potential impact of rising interest rates on consumers' high household debt burdens, as well as the impact of persistent high oil and gas prices on consumer spending. High debt burdens are expected to constrain consumer spending primarily among lower-income households, muting the impact of such a slowdown on the wine industry. Rising interest rates and fuel prices will affect growers and vintners as well, further squeezing profitability.

Industry drivers. Within the North Bay region, Sonoma has the largest grower industry, with 58,200 total planted acres in 2003, followed by 48,300 acres in Napa and 16,000 in Mendocino. Sonoma County is more vested in white wine varietals, with almost 60,000 tons of grapes crushed, or 37% of total crush tonnage in 2003 to Napa's 35,000. In Napa, 72% of vineyards grow red wine grapes, the highest by far of the four counties. As a result, the lingering glut in cabernet sauvignon grapes is likely to have a stronger effect on Napa than in Sonoma, where chardonnay, pinot noir and zinfandel are the more important varietals.

One marked problem with the broader domestic wine industry, and particularly in Sonoma, is branding constraints. Wine drinkers in general maintain very little brand loyalty, making wine purchasing decisions based on price, region and brand, in that order. Thus, winemakers in Napa are able to charge on average 15% higher for their wines than Sonoma, largely due to better name recognition.

There is some evidence that more sophisticated branding and marketing, especially to the younger 21 to 25 year age cohort—or millennials—who are the hope of the wine industry to pick up the mantle after the baby boomers. Wines like Australia's Yellow Tail and Don Sebastiani & Son's Smoking Loon have posted phenomenal growth over the past few years, largely on the back of more hip marketing. More wineries will need to replicate this approach to broaden wine's appeal.

Export markets remain underdeveloped, due both to low price points of current exports and continued difficulty in raising quality perceptions among foreign drinkers. The flow of cheap California wines abroad for the last two years has worked to further weaken perception. A recent survey among wine drinkers in the U.K., California, Canada, Germany and Japan noted increased awareness of California wines, but a decrease in perceived quality.

Recent trade agreements that eliminate tariffs on wines imported to the U.S. will only have a marginal impact. For instance, the recently signed U.S.-Australia free trade agreement (FTA) eliminates the 3% tariff on Australian wine imports, small enough to avoid much of a price effect. Similarly, the U.S.-Chile FTA plans to first harmonize wine tariffs to low rates, then eliminate them completely in 12 years. But, with Chilean wine import tariffs as low as 2%, the U.S. is not likely to see a surge in imports as a result of the FTA.

Pricing. With most markets slipping closer to supply equilibrium, wine growers are finally seeing better pricing power after three difficult years. Since the 2004 harvest is just under way, we do not have more recent pricing data past 2003, but indicators and anecdotal evidence point to higher prices for growers this year. The NCWGA has released its recommended prices for the 2004 harvest, which are above 2003 prices, although still below the peaks seen in the late 1990s. A pickup in forward contracts for grapes also suggests a better pricing environment in the near term. On average, wine grape prices fell 5.4% for Sonoma County growers in 2003, nearly twice the 2.5% decline seen statewide.

The four North Coast counties cater to different wine markets, with the highest priced grapes grown in Napa County, followed by Sonoma, Mendocino and Lake, in that order, as determined by data from the NCWGA. As a result, Napa and Sonoma tend to cater to the higher-end wine market, Mendocino to the middle, and Lake to the lower-end market. Napa prices are the highest across most varietals, with the notable exception of zinfandel, where Sonoma enjoys the highest prices in the region. The cabernet market is most strongly differentiated by region, with average price per ton in Napa almost $1,600 higher than average Sonoma prices.

Operating expenses. Labor costs comprise two-thirds of the cost of producing wine grapes. The Sonoma County labor force contracted in 2003 and continues to shrink through 2004. The earlier harvest season this fall has produced a bit of a scramble for laborers. Still, there are no real signs of a labor shortage. Further, increased mechanization of harvesting techniques has helped ease demand for labor in the region's vineyards.

The larger wineries are lobbying for a change in the U.S. government requirement that 95% of the wine in a bottle should come from the same vintage year. Winemakers in Australia, New Zealand and the EU are only required to have 85% of the grapes from the same vintage year, which gives them more flexibility and reduces costs. In Chile and South Africa, it is as low as 75%. Such a change would benefit large winemakers that dominate the export market, although smaller wineries are opposed to the potential erosion in wine quality that will result from the rule change.

The industry is still awaiting resolution on a Supreme Court case that will decide if winemakers have the right to ship wine directly to consumers across state lines. Currently, 24 states still have limits on cross-border wine shipments making it difficult and expensive for winemakers to operate on a national scale.

Profitability. Profitability has improved for both winegrape growers and vintners this year from last year's dismal performance, thanks to strong demand and improved pricing. Profitability among large corporate winemakers was healthy last year, but has weakened in the face of competition from lower priced wineries.

Several changes are under way at the large corporate winemakers, largely due to weaker margins. The most dramatic is the breakup and sell-off of legendary Mondavi winery. Bitter internal disputes have led to the company's breakup into two separate companies that cater to the lower tier and upper tier wine markets; Mondavi recently laid off 360 employees at its Oakville headquarters. Meanwhile, Beringer Estates is also undergoing a restructuring in the wake of weak revenue growth, and Fetzer, a part of the spirits behemoth Brown-Forman, is launching new labels and an extensive marketing campaign to shore up flagging sales. All these firms reflect the turmoil in the winemaking industry following the price wars of 2002-2003.

The dollar is expected to weaken further in the coming year against most Asian currencies. This in turn will improve the cost-competitiveness of Sonoma County appellations in key emerging markets in Asia like China, India and Korea. However, the dollar is expected to strengthen some against the euro and the yen, which will take some steam out of exports to Europe. Further, low price points for exports make it a weak growth driver, especially for more expensive Sonoma winegrowers and vintners.

Long-term outlook. The long-term outlook for Sonoma County's wine industry remains favorable. Improving 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, pricing power or solid profitability of the decade past.

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, last year crossing the 2.58 gallon rate set in 1982, and rising to a new record of 2.68 gallons in 2003. 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 consumers has risen from 2000 to 2003 after holding steady through the 1990s. Finally, the share of the core consumer in the population rises with age cohort, an encouraging sign in an aging country.

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. Large wineries have reduced their exposure to this competition by acquiring properties in several of these areas, but local growers and small vintners will continue to be pressured by the cheaper and consumer-friendly wines from the New Age wineries.

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

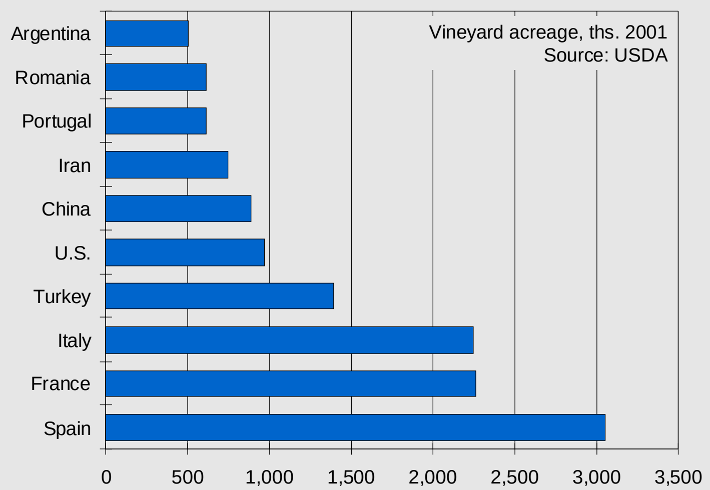
Foreign markets also present some upside potential as untapped consumer markets in China, Russia, Southeast Asia, and the Middle East blossom.

Downside risks. The most devastating downside risk is from pestilence, specifically from the glassy-winged sharpshooter and its accompanying Pierce's Disease, or from the vine mealy bug (VMB). There have been no significant pestilence problems reported thus far this season, but this is a threat that bears watching.

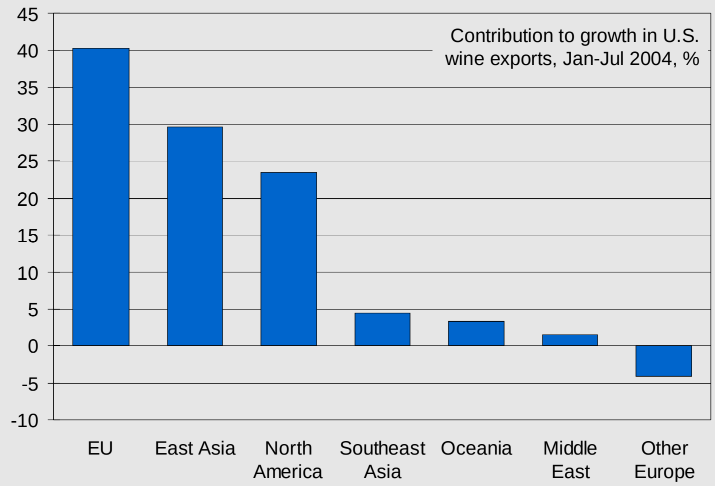
Continued consolidation among beverage distributors in the future could make it difficult for new labels to gain wide distribution. Furthermore, competition from other appellations in California and other regions nationally and internationally may make it increasingly difficult for Sonoma County labels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

Rakesh Shankar
October 2004

Global: Some Unusual Leaders Among Winegrape Growers



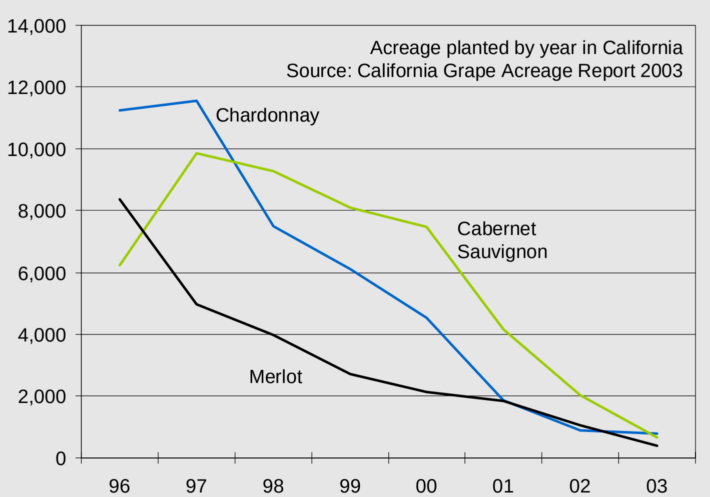
National: The EU Is Still the most Lucrative Target Market



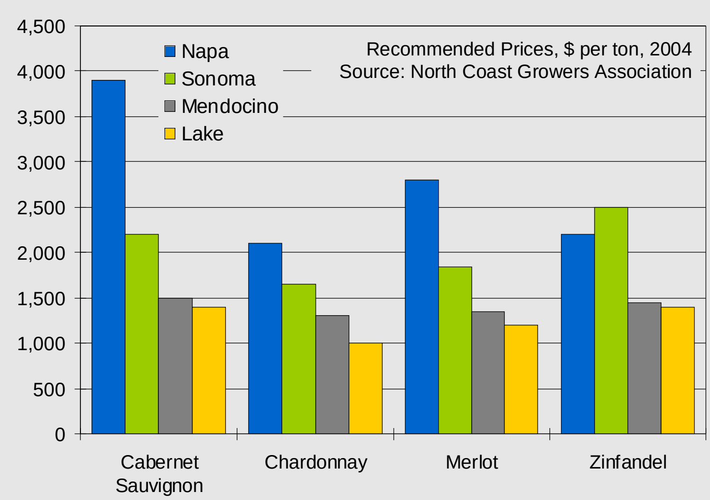
There is a marked difference between countries that produce wine and those that grow winegrapes, which is a little counterintuitive. Notably, Spain has the largest area under winegrape cultivation by far, and yet is only the third largest producer and fifth largest consumer of wine in the world. Countries like Spain and Turkey have the potential to grow as wine producing and exporting nations. In addition, we have countries like China, Iran and Romania among the top 10 winegrape growing nations, but they hardly have a reputation as wine producers or consumers.

Wine exports from the U.S. for the first six months of the year were up 15%. The EU accounted for a large portion of this growth, with over 40% of the increase in exports going to the continent. Exports to Mexico and Canada are also remarkably strong. In fact, over the past two years, nearly 60% of growth in U.S. wine exports has come from exports to the EU. 90% of U.S. wine production comes from California, which dominates U.S. exports as well. The EU thus remains the largest and most promising market for Sonoma wines.

State: Cutting Back on Supply



Regional: Clear Price Differential Across the Region



The winegrape growers industry has had to go through years of cutting back on supply in order to reach the semblance of balance the market is in today. New acreage planted has been declining for all major varietals in California since 1997, with the biggest cutbacks coming in 2001 and 2002. Planted acreage for winegrapes is likely to stabilize over the next two years, although it is not expected to pick up significantly. On a positive note, the recent approval by the federal government of three new appellations in Central California could help boost planted acreage in these regions.

Prices serve as a good indicator of quality in the wine industry and help point to the target market of the wine. Sonoma wines tend to be in the mid-price range, which is typically a weak export category. Sonoma is most invested in white wines and dominates in their production, and also commands higher prices for most of its white wine varietals. Chardonnay is the notable exception, where neighboring Napa still enjoys higher prices and perceived quality. On the red wine front, Sonoma enjoys the highest price in the region for its zinfandel and sangiovese varietals.

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