Sonoma County
Economic Development Board

Industry Report Series

2006
Wine Report

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EDB Sonoma County Economic Development Board

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2006 Wine Report

August 2006

The Sonoma County Economic Development Board (EDB), in partnership with the Sonoma County Workforce Investment Board (WIB), is pleased to bring you the 2006 Wine Report. Our research partner, Moody's Economy.com, produced this report for the EDB.

Highlights from the 2006 Wine Report include:

- **The local wine industry is in the midst of a healthy recovery.** A strong grape crush in 2005 and improved prices have contributed to one of the best years the local wine industry has seen in almost a decade. The outlook for the industry also remains broadly positive.

- Total grape tonnage set a new record in 2005 for both Sonoma County and California. **Sonoma County's total grape tonnage was up a whopping 39% in 2005**. At 230,000 tons, the crop barreled past the previous record set in 2000.

- **Consumer spending on wine and brandy rose by over 10% in 2005, the fastest pace of growth since 1990.** Further, consumer spending data through April 2006 affirms that spending continues to grow at a double-digit clip through early 2006, suggesting that this will be another banner year for wine demand nationally.

- **The average grape price rose a modest $3 per ton in 2005, just over 0.1%, relative to the 1.8% average increase seen statewide.** This was largely on the back of a 9.4% surge in prices for Sonoma County pinot noir. Even with the 18% increase in tonnage of pinot noir harvested in Sonoma, demand for the grape appears to have grown even more strongly.

- **The long-term outlook for Sonoma County's wine industry remains favorable.** With wine named in a recent Gallup survey as the most preferred alcoholic beverage by a majority of Americans, the prospects are only getting better.

Thank you for your continued interest in the Economic Development Board's research. As always, if you have questions or suggestions, please feel free to contact us at (707) 565 - 7170.

Sincerely,

Ben Stone
Executive Director

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Wine Industry - Sonoma County

Recent Trends. The North Bay wine industry is in the midst of a healthy recovery. A strong grape crush in 2005 and stable prices have contributed to one of the best years the local winemaking industry has seen in almost a decade. The outlook for the industry also remains broadly positive.

Virtually all indicators of economic activity in the wine industry point to an excellent year. Total grape tonnage set a new record in 2005 for both Sonoma County and California. Sonoma County's total grape tonnage was up a whopping 39% in 2005. At 230,000 tons, the 2005 crop barreled past the previous record set in 2000. The record wine harvest is good news for wineries, but not so good for growers.

With white wine production accounting for 39% of Sonoma County's grape crop, the county benefited from the increase in white wine grape prices in 2005. Prices for most white wine varietals, especially chardonnay, generally rose in 2005, while most red wine varieties saw a drop in prices in 2005. The exception was pinot noir, which saw a robust increase in planted acreage and a modest increase in prices. Concurrently, Sonoma County acreage of chardonnay also increased in 2005, allowing local growers to benefit from the higher prices.

Demand for wine grew at a remarkable clip though 2005 and into early 2006, as the broader economic recovery drove healthy income growth. Spending on wine and brandy rose by over 10% in 2005, the fastest pace of growth since 1990. Further, consumer and corporate spending data though April 2006 affirms that spending continues to grow at a double-digit clip through early 2006, suggesting that this will be another banner year for wine demand nationally.

Notably, unlike two years ago, consumer and corporate demand growth is not being driven solely by the availability of affordable domestic and imported wines. In fact, consumer prices for wine have been steadily rising. Consumer prices for wine rose in 2005 at the fastest pace since 1997, a marked turnaround from the lackluster price growth seen between 2000 and 2004. Prices paid by consumers for wine accelerated further through April 2006. This confirms other recent research suggesting that consumer tastes are shifting to higher-priced wine. Sales of higher-priced wine have risen markedly, even as sales of wines priced at below $7 a bottle fell in 2005.

Strong domestic demand for wine has also led to sturdy imports of wine. Wine imports nationally returned to a double-digit growth pace in 2005. The strength of the dollar in the past year likely also helped boost wine imports, although it correspondingly weighed on exports. Total U.S. wine exports fell over 7% in 2005. This follows two years of 20%+ growth in exports. With the dollar weakening in the first half of 2006, exports are already getting some support.

Macro drivers. U.S. economic growth has peaked and is poised for slower growth in the coming year. Growth in the first quarter came in much stronger than expected, on the back of strong corporate profit growth and steady expansion in industrial activity. Consumer confidence has moderated in recent months, but remains well above its low point of early 2003. Record corporate profits are also bolstering business entertainment spending.

That said, the outlook has taken a decidedly darker hue during recent months. The economy is clearly hitting capacity, with the jobless rate steadily declining and industrial capacity utilization peaking. Consumer spending is holding up, but growth is slower than before. More importantly, the national housing market is showing a sharper slowdown than anticipated, with the pace of new home construction, and home sales both clearly slowing. Job growth has also slowed through May 2006. Finally, inflationary pressures are picking up. Accelerating inflation raises the possibility of further interest rate hikes.

The main concerns currently are the potential impact of rising interest rates on consumers' high household debt burdens, as well as the impact of persistently 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. All of this will have a stronger effect on lower and middle class homes, while the wealthier consumers are better insulated against credit and energy pressures.

Industry drivers. Apart from the sheer quantity of wine grape harvest this year, 2005 also promises to be a good year for quality. A perfect storm of factors, from the long, cool growing season to the delay in winter rains, all have helped craft a high-quality crop for the year.

The big crop in 2005 took most industry participants by surprise, coming as it did after two years of subpar harvests. Although this year's bumper crop will have a dampening effect on prices for growers, it could also help alleviate what is expected to be a much smaller harvest in the coming year, according to early predictions by viticulturists. Further, the larger crop has translated into a significant boost in income for local growers, helping ameliorate lower revenues of the past two years.

An important industry development in the past year has been the Supreme Court ruling that has begun opening up the national wine market to direct shipping from California. In May 2005, the Supreme Court ruled that states could not ban direct shipments of wine through the mail for wineries outside of their border if they allowed the same for wineries within their border. The ruling opened up over eight large states to national competition for direct shipping, including New York, Pennsylvania, Florida and Texas. The number of states allowing legal shipping of wine by mail rose from 25 to 33, representing 78% of total consumers in the U.S., versus 50% previously.

Despite the vast increase in the potential market, the ruling has not been a universal positive for the industry. This is because several states have enacted new bureaucracy and taxes that make it difficult for the smallest wineries to compete and take advantage of the new provisions. Still, by and large, the development is positive news for vintners looking to expand domestic share.

Trade with Europe, a destination of over half of U.S. wine exports, is bound to be helped by a new trade agreement signed by the U.S. and the European Community (EC). The agreement settles several long-running issues between the two communities in the wine trade arena, most importantly the recognition of each other's winemaking practices. Previously, EC recognition of American wines required temporary approvals every time wine was shipped, which made it expensive and cumbersome for American wineries to ship to Europe. The EC had already accepted the winemaking practices of countries like South Africa and Australia under separate trade agreements, which had put American winemakers at a distinct disadvantage in the European market.

The opening up of the European market also coincides with a change in domestic vintage regulation that could improve winemakers' production efficiency, and increase total wine consumption. The U.S. Alcohol and Tobacco Tax and Trade Bureau recently approved regulations that would trim the minimum content of wine designation for a given year from 95% to 85%. This is more consistent with practices in

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New Zealand and the EU, and closer to the 75% allowed in South Africa and Chile. This should improve the flavor of the wines by allowing blending with smoother aged wine, and weigh on some of the appeal of the new world wines.

Pricing. Pricing is starting to improve for Sonoma County winegrowers in 2005, although at a pace well below the state average. The average price rose a modest $2 per ton in 2005, just over 0.1%, relative to the 1.8% average increase seen statewide. This was largely on the back of a 9.4% surge in prices for Sonoma County pinot noir. Even with the 18% increase in tonnage of pinot noir harvested in Sonoma, demand for the grape appears even stronger. Sonoma County's more dominant white wine varieties like chardonnay and sauvignon blanc both saw very modest but still positive increases in price from last year.

Most red varietals continue to be weighed down by excess supply. Cabernet sauvignon and merlot prices both fell about 3% in 2005 on robust increases in tonnage. Sonoma County zinfandel also saw a drop in prices last year.

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 California Grape Crush report. As a result, Napa and Sonoma tend to cater to the higher-end wine market, Mendocino and Lake to the middle-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.

Operating expenses. Labor costs comprise two-thirds of the cost of producing wine grapes. After tepid labor force growth in 2004 and the first half of 2005, the Sonoma County labor force started to shrink again through the second half of 2005 and 2006 thus far. Still, there are few signs of a labor shortage. Further, increased mechanization of harvesting techniques has helped ease demand for labor in the region's vineyards.

That said, the Sonoma County wine industry will be closely watching the unfolding immigration debate, and especially the progress of President Bush's plan for a guest worker program for migrant workers.

Mendocino grape growers and wineries recently voted overwhelmingly to institute a new tax to create a commission that would market local wines and grapes. Sonoma County growers will also be voting by July 10 on whether to institute a grower-only commission to help promote local wines and grapes nationally and globally. The approval of such a measure, which is quite likely, will add a cost to local growers, but could well bring far bigger benefits.

Profitability. Wine grape growers and vintners are facing a broad improvement in profitability. For vintners, increased consolidation, coupled with strong consumer demand for wine, especially premium-priced wine, has helped bolster corporate bottom lines. Fewer regulations are also helping vintners bolster bottom lines. Smaller wineries in particular have cashed in on the consumer trend of shifting to premium priced wine.

The general improvement in profitability in the wine industry is best exemplified by the increase in merger and acquisition activity in the industry. The past year has been a busy one for M&A activity in the wine industry, not unlike the broader corporate sector. One of the more notable moves was Pernod Ricard's acquisition of Allied Domecq, followed quickly by the sale of the majority of Allied Domecq's U.S. wine brands—including several Bay Area brands such as Clos du Bois and Buena Vista—to Fortune Brands. Constellation Brand is also digesting its purchase of Mondavi Corp. This reflects the improved fortunes of some of the largest players in the wine world, and a departure from the more strenuous cost-cutting and reorganization following the price wars in 2002-2003.

The dollar is expected to weaken further in the coming year against most global currencies. This in turn will improve the cost-competitiveness of Sonoma County appellations in key emerging markets in Asia, such as China, India and Korea, as well as in Europe.

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. With wine named in a recent Gallup survey as the most preferred alcoholic beverage by a majority of Americans, the prospects are only getting better.

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, rising to a new record of 2.77 gallons in 2004. 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 2004 after holding steady through the 1990s. Finally, the share of the core consumers 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 boomer 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-boomer 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 of lower-cost wine with fruitier flavors from wineries 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 World wineries.

Upside risks. The wine industry is 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. A further departure into higher priced wines by an adoring consumer base is also a possibility.

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 serious downside risk is from pestilence, specifically from the glassy-winged sharpshooter and its accompanying Pierce's Disease, or from the vine mealybug. There have been no significant pestilence problems reported thus far this season, but this is a threat that bears watching.

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
July 2006

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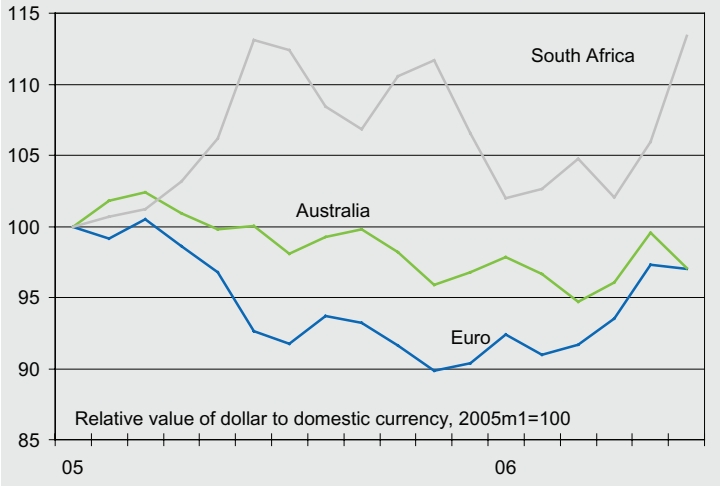
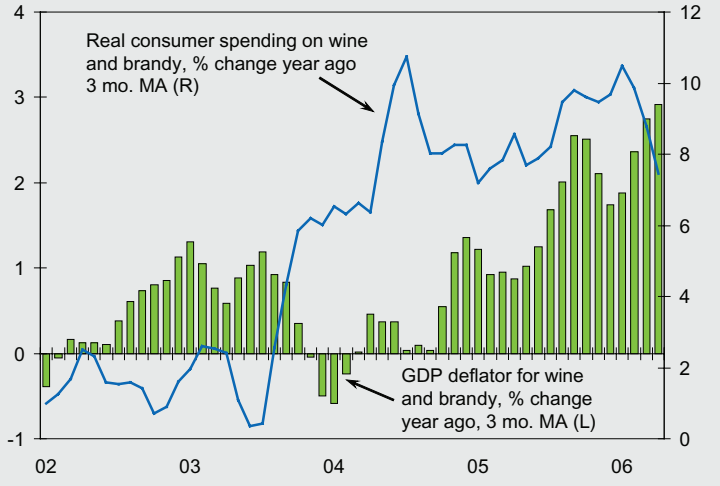
Global Pricing Power Was Weak Last Year, but Will Improve



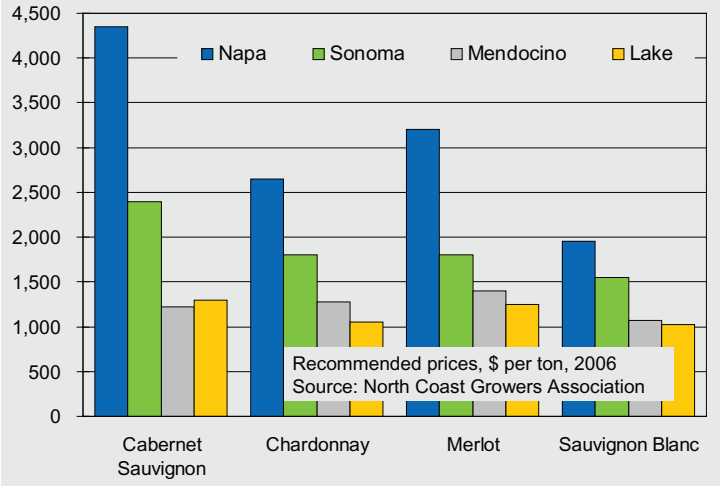
The strengthening of the dollar over the past year was broadly detrimental to the U.S. wine industry. Wine exports fell in 2005 for the first time in over 20 years. Over the same period, the dollar strengthened against the currencies of the U.S.' major wine export destinations. Conversely, weaker currencies in countries that the U.S. import wines from, including Australia and Chile, made imports far more competitive last year. That said, Moody's Economy.com expected the recent weakening in the dollar to persist through the remainder of 2006, which should serve to boost wine exports in the coming years.

A Good Time to Be in the Wine Business



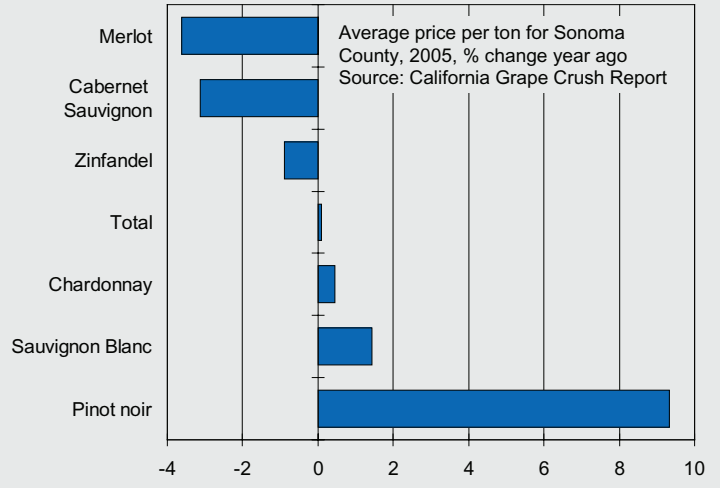
The domestic wine industry is in the midst of a boom period, thanks to steady growth in consumer demand for wine. Robust demand growth has come despite an acceleration in prices for wine, which has been a double benefit to winemaker revenues. There has been some moderation in demand growth in recent months, however, as price growth has hit a five-year high. With a slowdown expected in the broader economy and in housing markets in particular, as interest rates rise and fuel prices are elevated, discretionary spending is expected to moderate. This could limit further demand growth in the next two years.

Clear Price Differentials Across the Region



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, especially for its muscat blanc. 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 varietals.

A 'Sideways' Effect for Pinot Noir



Reds are still in the red in Sonoma County, and in California in general. The market is still dealing with an excess supply situation for most red wine varietals. The record-breaking grape crush from last year hardly helped, putting downward pressure on prices for most red varieties. Harvested cabernet sauvignon and zinfandel tonnage rose nearly 50% in Sonoma County in 2005. The sole exception to the red wine blues has been pinot noir, which has benefited from strong pricing growth despite an 18% increase in harvested tonnage. The success of the movie "Sideways" is widely cited for the increasing American demand for pinot noir.

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