



INDUSTRY

WINE INDUSTRY INSIDER 2007



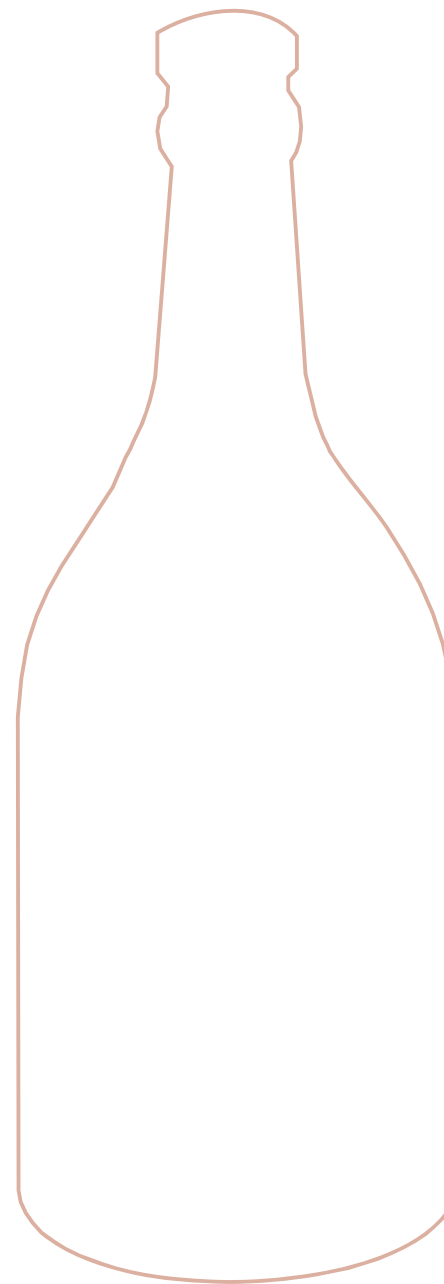


Sonoma County
2007 Wine Industry Insider Report



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WINE INDUSTRY INSIDER 2007

March 2007

The Sonoma County Economic Development Board (EDB), in partnership with the Sonoma County Workforce Investment Board (WIB), is pleased to bring you the 2007 Wine Report. Our research partner, Moody's Economy.com, produced this report for the EDB.

Highlights from the 2007 Wine Report include:

- After a large, record-setting harvest last year, a smaller grape crush in 2006 is a welcome follow-up for growers and vintners, as it is helping them work through last year's inventories. Sonoma County's harvest was 6.5% smaller than in 2005.
- The average price of grapes grown in Sonoma County increased by 6% due primarily to increases in chardonnay and Pinot noir.
- The weakening of the U.S. dollar in 2006 against more major currencies gave some support to the wine industry. In particular, the dollar has weakened relative to most of the domestic wine industry's competitors, except Chile.
- The U.S. dollar is expected to continue to depreciate against most foreign currencies, which will give further support to wine exports going forward.
- Sonoma County's tight labor market is making it difficult for growers to recruit the migrant workers they rely on. Federal immigration policies will have a significant impact on growers, as they will set the trend for the long-run availability of labor in the area.
- 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.

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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Recent Trends. Sonoma County's wine industry is enjoying another good year. After a large, record-setting harvest last year, a smaller grape crush in 2006 is a welcome follow-up for growers and vintners, as it is helping them work through last year's excess inventories. Furthermore, for the second year in a row, quality is expected to be very good, despite more challenging weather conditions.

Total grape tonnage in California was down by 20% from last year's record crush and, on average, prices increased % over last year. In general, prices for red wines were higher in 2006, while white wine prices declined. Sonoma County outperformed the rest of the state, however, as its total harvest was only 6.5% smaller than in 2005. The average price of grapes grown in Sonoma County increased by 6% due primarily to increases in chardonnay and Pinot noir.

Consumer demand for wine has moderated somewhat in recent months but remains strong, as personal consumption of wine and brandy at home grew 8% in the second half of 2006. Similarly, prices that consumers paid for wine grew at a slower pace in the second half of 2006 than the first, but growth was still above average at just under 2%.

Chardonnay remains the most popular white varietal, but demand is increasing for both sauvignon blanc and Pinot grigio. Furthermore, although total volume is still very small, riesling sales climbed nearly 30% in 2006, which was the greatest increase of any white varietal and second to only Pinot noir. Planted acreage for Pinot noir continues to increase, but has not been able to keep pace with the booming demand over recent years. Sonoma County's total tonnage of Pinot noir grapes grew by more than 40% while prices grew by 15%.

Meanwhile, the wine consumer market continues to grow, supporting demand for wine. According to the latest survey by the Wine Market Council, more than 17% of U.S. adults are now classified as core wine consumers, outnumbering marginal consumers for the first time ever. Core consumers are those who drink at least one glass of wine per week, and account for nearly 90% of total wine consumption. This trend is a result of many marginal consumers drinking wine more regularly, while wine is also gaining popularity with younger drinkers.

Macro Drivers. U.S. economic growth will be sluggish during the first half of the year due to the ongoing housing correction and cuts in vehicle production, but these economic drags will fade as the year progresses. Sturdy business investment and hiring and a modestly improving trade balance will support growth throughout the year. Real GDP is expected to grow below potential in 2007.

Consumer confidence has hit its highest point since 2002. Consumers have seen an energy windfall over the past six months from the dramatic drop in gas prices. However, prices have likely hit a nadir, as rising oil prices and tighter refining capacity will work to raise gas prices as the summer driving season approaches.

Furthermore, the impact of the current housing downturn on consumer spending is expected to intensify over the coming months. Due to the housing wealth effect, lower house prices and reduced homeowner equity will cause less wealthy households to become more cautious in their spending. Moody's Economy.com estimates that each dollar of housing wealth translates to about nine cents of spending, which is much stronger than the stock wealth effect. As consumer spending eases in 2007, discretionary spending on items like wine could see a marked effect.

The negative impacts on spending growth from weakening housing markets will be compounded by the fragile nature of household budgets. The aggregate saving rate is currently negative and our research indicates it is most negative for households that have tapped the equity in their homes. Beyond that, household financial obligations are at a record high. Driven by large debt service burdens, the financial obligations ratio is hitting a new record with each quarterly data release. As consumers devote a larger share of their incomes to financial obligations, less is available for spending, especially with no saving cushion to fall back on.

The U.S. dollar is expected to continue to depreciate against most foreign currencies, which will give further support to wine exports going forward. Wine exports rebounded in 2006, rising more than 15% over last year, while imports continued to grow at a steady 10% year-to-year pace. Although a weaker dollar will weigh on wine imports, strong consumer demand will support continued growth of imports.

Finally, although real disposable income growth has lagged real GDP growth in recent years, consumers have not been afraid to spend more money on more expensive wines and consume wine more regularly. According to the Wine Market Council, the percentage of core consumers who order wine in casual chain restaurants has increased from 44% in 2003 to 58% in 2005.

Industry Drivers. The total size of California's grape crush has returned to average levels after last year's record-setting harvest, which is fortunate for growers in Sonoma County. The smaller harvest was a result of the cool, wet spring, which fostered Botrytis infections, as well as the early October rains, which caused many of the thinner skinned grapes to rot on the vine. Nevertheless, 2006 grapes are reported to be of high quality. This will give a significant boost to the industry, as vintners draw down on their inventories and two consecutive years of high quality help them expand their sales volume.

An important industry development has been the Supreme Court ruling that has begun opening up the national 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, as a whole, the development is positive news for vintners looking to expand domestic share, while avoiding expensive distributor networks.

Pricing. Pricing power continues to improve for growers, while it is relatively more limited for wineries. Last year's bumper crop depressed pricing power with a glut of grapes, although quality was high. This year quality remains high, while the smaller crop is allowing growers to work through their oversupply. As a result, pricing

power is recovering, both on the growers' and on the vintners' ends. Prices received by wineries increased steadily by more than 6% on a year-to-year basis throughout 2006. This is the sharpest increase in PPI for wineries in ten years.

Meanwhile, growers have seen prices for grapes increase very sharply in recent months. As a whole, prices received for grapes grown in Sonoma County also increased 6% over last year, and remain the second highest in the state, trailing only Napa County. Chardonnay remains Sonoma County's most popular varietal by volume, and its price increased by nearly 9% over last year. Meanwhile, prices for Pinot noir grapes grew by a substantial 15%, while tonnage of the wildly popular varietal now equals that of cabernet sauvignon. Other leading varietals, such as cabernet sauvignon and merlot, saw further price declines, although prices are expected to firm in 2007.

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 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. Sonoma County's labor force continues to contract, as it has since late-2005, while the unemployment rate remains below the national average. Sonoma County's tight labor market is making it difficult for growers to recruit the migrant workers they rely on, according to anecdotal evidence. Meanwhile, federal immigration policies will have a significant impact on growers, as they will set the trend for the long-run availability of labor in the area. However, for now, wage pressure remains contained, as average hourly earnings for California's beverage manufacturing industry are increasing at a slow and steady rate. Furthermore, increased mechanization of harvesting techniques has helped ease demand for labor in the region's vineyards.

Profitability. Wine grape growers and vintners are facing a broad improvements 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. Finally, the rise of direct shipping is an important trend, particularly for smaller producers, since bypassing distributors and selling wine directly to consumers greatly increases profitability.

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. However, the dollar is expected to appreciate moderately against the euro and the Canadian dollar, which will take some of the steam out of exports to Europe and Canada.

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. Wine is steadily gaining popularity among Americans, and currently rivals beer as their most preferred alcoholic drink. This trend is supported by the growing evidence that moderate wine consumption can yield many health benefits.

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. The number of core wine drinkers - those who consume at least one glass of wine each week - has grown sharply since 2000 and now accounts for 17% of the total adult population and nearly 90% of wine consumption. Finally, the share of the core consumers in the population rises with age cohort, an encouraging sign in an aging country. At the same time, wine consumption is becoming increasingly popular with the millennial generation, which is nearly as large as their parent generation, the Baby Boomers. These two cohorts together already form a very large demand base of core wine drinkers and offer significant potential for growth.

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.

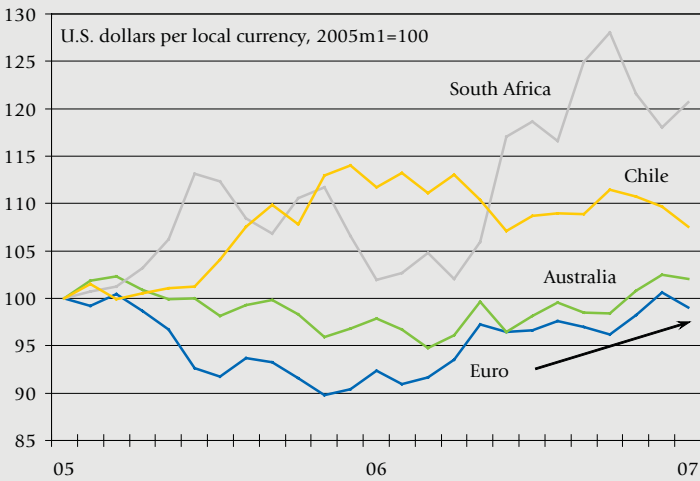
Downside Risks. The most serious downside risk is from pestilence, specifically from the glassy-winged sharpshooter and its accompanying Pierce's disease, or from the vine mealybug. There have been no significant pestilence problems reported thus far this season, but this is a threat that bears watching.

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.

Over the very long run, gradual global climate shifts could pose a serious threat to Sonoma County's wine industry. Temperature and precipitation patterns are already ideal and even subtle shifts could disrupt this delicate balance, with a potentially severe negative impact on the quantity and quality of wine produced in California.

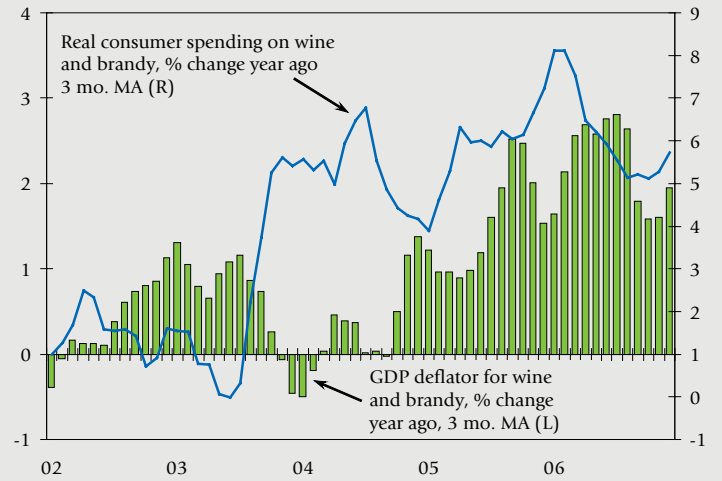
*Sean Maher
March 2007*

Weakening Dollar Boosts Global Pricing Power



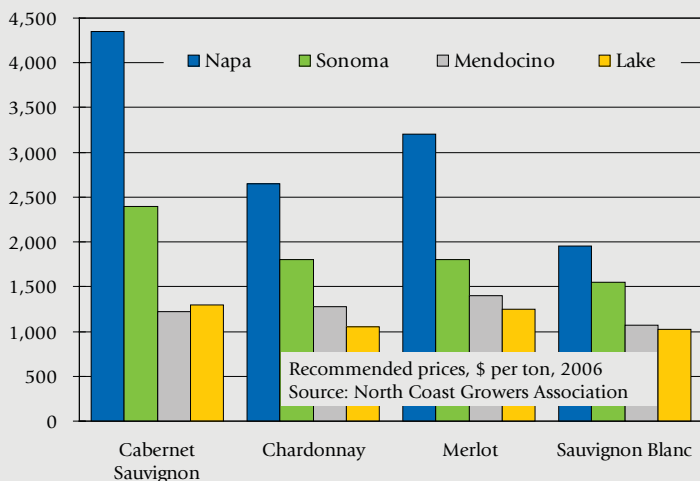
The weakening of the U.S. dollar in 2006 against most major currencies gave some support to the wine industry. In particular, the dollar has weakened relative to most of the domestic wine industry's foreign competitors, except Chile. This allowed U.S. wine exports to rebound sharply in 2006, after falling in the previous year. The dollar is expected to continue depreciating against most currencies. Given this, as well as the high quality of the 2005 and 2006 vintages, Sonoma County's wine industry will be well-positioned against its foreign competitors both at home and in the international market.

The Wine Industry Is Still Booming, for Now



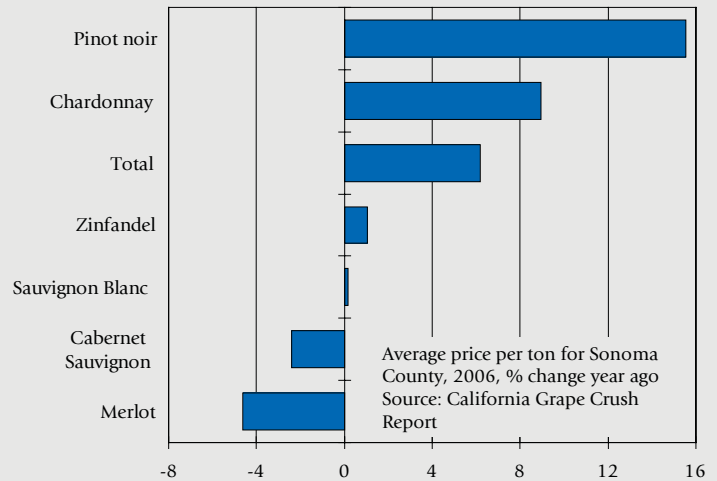
The domestic wine industry is still enjoying a boom period, thanks to steady growth in consumer demand for wine. Robust demand growth has come despite acceleration in prices for wine, which has been a double benefit to winemakers. There has been some moderation in demand growth in recent months, however, as price growth comes down from a five-year high. With the housing market driving a broader economic slowdown, consumer spending is expected to moderate in the coming months. This will weigh on 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.

Pricing Improves Significantly for Growers in 2006



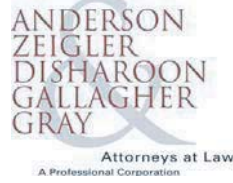
As a whole, grape prices increased by more than 6% in 2006, compared with 0.1% in the previous year. This rebound, which is a result of a smaller, more manageable harvest, was concentrated predominantly among chardonnay and Pinot noir grapes. Prices for chardonnay, Sonoma County's most popular and important varietal, rebounded sharply. Meanwhile, Pinot noir was virtually the only varietal to see increased production. In fact, Pinot noir grapes became Sonoma County's second largest varietal by tonnage. However, its success has come at the expense of other reds. Prices and total output of cabernet sauvignon and merlot declined further in 2006.



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WITH ACKNOWLEDGMENT AND APPRECIATION TO THE LOCAL KEY BUSINESSES SUPPORTING ECONOMIC RESEARCH AND DEVELOPMENT:



- Sonoma County Permit & Resources Management
- Community Development Commission
- Sonoma County Health Services
- Sonoma County Transportation & Public Works

