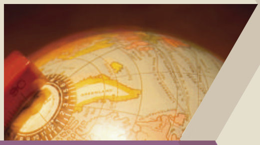






Industry Sector Report

Wine Industry Insider

2015
SONOMA COUNTY

SONOMA COUNTY
EDB
ECONOMIC DEVELOPMENT BOARD

SONOMA COUNTY
WORKFORCE INVESTMENT BOARD

2015 Wine Industry Insider

June 2015

The Sonoma County Economic Development Board (EDB), in partnership with the Sonoma County Workforce Investment Board, is pleased to present the 2015 Wine Industry Insider for Sonoma County. Our research partner, Moody's Analytics, provided the research for this report.

Highlights of the 2015 Wine Industry Insider include:

- Prospects for Sonoma County's wine industry remain bright. After years of challenging market and economic conditions, the environment for Sonoma County winemakers is improving.

- The average price for Sonoma grapes rose 3.4% in 2014. Prices will continue to rise modestly, with larger increases for luxury wines. However, a secular shift in preference toward wine will aid sales in the long run.

- Extended drought in Northern California will cause difficulties for Sonoma County grape producers. Unless rainfall picks up sufficiently to end this third consecutive year of drought, allocations for agricultutal water will be curtailed.

Thank you for your interest in the Economic Development Board's research. For additional information, questions, comments, or suggestions please contact us at (707) 565-7170 or visit www.sonomaedb.org.

Sincerely,

Pamela Chanter
Chair
Economic Development Board

Ben Stone
Executive Director
Economic Development Board

Recent Performance

Sonoma vintners rang in 2015 with much to celebrate, as improv-ing market and economic conditions gave way to a long-awaited flight to quality. With the U.S. recovery shifting into high gear, wine drinkers are finally becoming less cost-conscious, propelling sales of higher-end wines produced by Sonoma vintners. Winemakers are reporting a surplus in inven-tories on the lower end of the price curve as wine drinkers trade up and the long period of post-recession discounting draws to a close.

From the vantage point of 2013's record-breaking yield, the 2014 vintage came in slightly underweight, though the harvest stands as the third largest on record and all signs point to another year of exceptional quality. Overall tonnage of wine grapes fell 5.5% compared with the prior year, while revenue declined by 2.2%, according to the California Department of Food and Agricul-ture. Despite a decline in volume, average grape prices for three of the county's four top varietals—chardonnay, pinot noir and zinfan-del—outpaced 2013's gains. Only cabernet sauvignon increased in production, though prices fell short of the 8% gain notched in 2013. Together, the four grapes account for 83% of wine growers' revenues.

Although U.S. wine consumption grew at a slower pace in 2014, California winemakers outperformed the broader U.S. market, notching a 4% increase in cases shipped versus a 1.3% rise for the country as a whole. Total wine consumption in the U.S. reached 375 million cases in 2014, according to Gomberg, Fredrikson & Associates, with California's share standing at 224 million. Sonoma and Napa wineries led gains in the lucrative direct-to-shipping market, where they account for more than half of direct-to-consumer sales, according to ShipCompliant and Wines & Vines Analytics. However, Sonoma's 14% gain in volume came at the expense of lower bottle prices, which fell for the fourth consecutive year. As a result, total revenue via direct-to-consumer sales rose by just 6.4%.

A strengthening dollar and a stagnating global economy proved powerful headwinds for U.S. winemakers in 2014, though volume and value were buffered by a surge in sales to emerging markets. While sales to the EU, Japan, China and Hong Kong, four of the top five export markets for U.S. vintners, fell by a collective 15% in value and 8% in volume, robust sales in emerging markets helped off-set the decline. Sales to South Korea, Mexico, Nigeria and Vietnam were particularly strong, lifting total cases sold abroad to a record 49.2 million. Export revenues in 2014 reached $1.49 billion, the second highest on record. While exports represent just 4% of total U.S. sales, they remain an important avenue of growth for higher-priced wines, especially those grown in California, the origin of 90% of wine sold abroad.

Foreign producers made further headways into the U.S. market in 2014. The value of U.S. imports rose by 3.5% to $6.6 billion, in line with the previous year's growth. Imports from France and Italy, the two largest sources of foreign wine, increased by 8% and 5%, respectively. Latin American imports declined for the second straight year after rising for more than a decade. Imports from Chile were down 7.6%; wine sales from Argentina fell 6.8%.

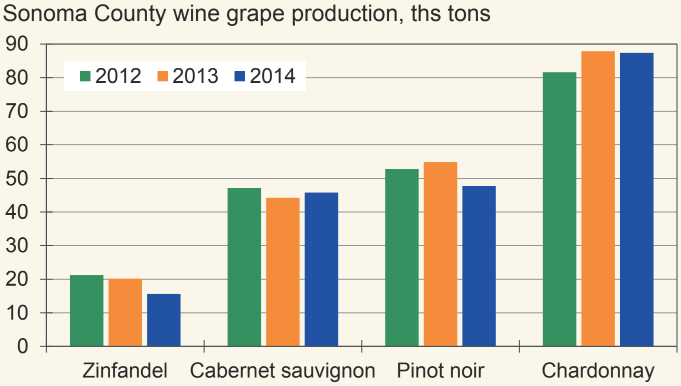
Macro Drivers

With the Great Recession rapidly fading in the rearview mirror, the U.S. economy is poised to expand faster than at any time in the past decade. Growth has accelerated markedly in the past two years, resulting in a rapid decline in joblessness and bringing the U.S. closer to full employment. On average, more than 290,000 jobs have been added to the economy in each of the last six months, pulling the national unemployment rate down to 5.5% even as more workers return to the labor force.While household balance sheets are healthier and businesses are becoming more profitable, wages remain stagnant for the majority of Americans, depressing household formation and keeping the housing recovery in limbo. All ingredients are in place for stronger growth in 2015, however. Moody's Analytics forecasts real GDP growth of around 3.5% this year. As economic growth accelerates, wages will follow suit and the U.S. economy will achieve full employment The dramatic and sustained fall in oil prices has come as a surprise to both oil producers and U.S. consumers. While some drillers have been forced to scale back production, lower input costs for manufacturers and transportation have had a net positive effect on the economy. A rise in the federal funds rate, now expected to take place in the fall, will help keep the recovery on track and prevent the economy from overheating, but the threat of higher rates tilts risk to the downside.

The worsening global outlook is weighing on market expecta-tions for domestic interest and exchange rates. In contrast to the U.S., growth has been lackluster in Europe and emerging markets. With higher U.S. growth and the prospect of rising interest rates, the dollar is appreciating against nearly every major global currency. Amid higher relative costs and reduced external demand, domestic exporters are struggling, and are increasingly pressured by foreign imports.

Another Bountiful Harvest For Sonoma Growers

Sonoma County wine grape production, ths tons



Sources: State of California, Moody's Analytics

Chart: *Sonoma's 2014 vintage was the third largest on record, though overall tonnage fell shy of 2013's record-breaking yield. Drier conditions will improve grape quality, leading to higher prices for local growers and vintners. Of Sonoma's top four varietals, only cabernet sauvignon had an increase in production, though price gains for chardonnay, pinot noir and zinfandel grapes beat those of the prior year. Another historic harvest will help balance inventories, but increased foreign competition may leave vintners with more juice in the cellar for lower-priced bottles.*

Industry Drivers

Underlying trends in the global economy will support a stronger dollar for some time to come, raising several challenges for Sonoma’s vintners. First, a stronger domestic currency will make U.S. wines more expensive for foreign consumers, weighing on exports. Though exports represent a small share of total California wine sales, U.S. wine exports have increased by nearly 50% in the five years since the global recession, according to the Wine Institute. Emerging markets, led by China, have turned into an increasingly important avenue of growth for U.S. wine producers, but China’s slowing economy will weigh on external demand. Heightened import competition will present an even greater challenge, because imports make up nearly a quarter of total domestic wine sales. A stronger domestic currency will lower the cost of foreign vintages across all price points, providing a major incentive to U.S. consumers. The timing of the dollar’s rise is also significant: The recent boost to purchasing power presents the first opportunity in decades to consume more affordable fine and luxury foreign wines. The changing demographic profile of the U.S. wine consumer will emerge as a key driver for Sonoma growers. Though the boomer generation is beginning to retire, millennials have yet to enter their peak earn-ing years. This will present a challenge for winemakers, driving a gap in demand for fine and luxury wines and shifting sales to lower-priced bottles. Furthermore, there are several aspects unique to millennials that will weigh on consumption. High student loan burdens, weaker job prospects, and slower wage growth will limit disposable income growth, and in turn spending on luxury goods such as wine. Although millennials consume more wine than older generations at their age, they have also shown greater enthusiasm for foreign wines.

Weather conditions are a perennial challenge, and in this sense 2015 will be no different. Persistent droughts throughout California are straining wine growers’ resources, especially when it comes to younger vines. But in Sonoma, drier weather has an unexpected upside. The county’s diverse geography provides just enough shelter to sustain smaller, more delicate grapes. The wines produced from this year’s crush will boast a higher quality and sophistication, tilting the composition of sales toward higher value per unit of volume. The evolution of weather conditions deserves close monitoring and extreme conditions pose significant risk, but moderate dry conditions are overall a positive.

Pricing

Despite more abundant harvests, rising demand for higher-end wines will sustain price gains. The average price for Sonoma County grapes rose by 3.4% in 2014, compared with a 2.8% increase statewide. The difference for Sonoma’s top four varietals is even more pronounced: Average prices rose by 4.8%, compared with a decline of 2.7% in the rest of the state. With grape quality among the highest in the state, Sonoma’s growers are well-positioned to benefit from rising demand for fine and luxury wines. After extreme weather left much of France and Italy’s 2013 vintage in ruins, production in Europe’s top two wine producers is on the rebound. Rising production coupled with a stronger dollar will put downward pressure on prices, although the impact will be felt most strongly in the bulk wine segment, providing less of a sting to Sonoma growers.

Operating Expenses

As the post-recession period of discounting draws to a close, Sonoma County wineries will face higher grape costs. Prices paid by processors in Sonoma County have risen by nearly 7% in the past two years, driven by rising grape quality and greater demand. Although Sonoma’s moderate climate has sheltered grapevines from the worst of the drought, continued dry conditions could strain water supplies, further pushing up grape costs.Rising labor costs will be the main cost driver for Sonoma winemakers in the near term. Although median wages for agricultural workers are slightly lower than in neighbor-ing Napa, total private sector wages are rising at nearly twice the U.S. rate as Sonoma races toward full employment. One outcome of persistent drought conditions, however, would be lower labor costs. A shortage of acreage to cultivate would result in a relative surplus of farm labor, putting downward pressure on agricultural wages.

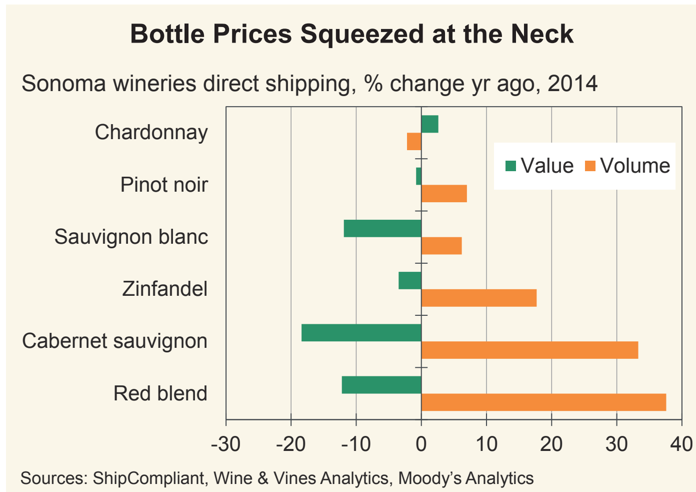


Chart: *Sonoma wineries have performed exceedingly well in the lucrative direct shipping market, though recent years’ gains have come at the expense of declining bottle prices. Sonoma wineries eked out a small gain in market share in 2014, reaching 24.4% of direct-to-consumer sales, while Napa’s share declined to 32%. While success-ners have relied on double-digit gains in volume to make up for need to target price growth to drive future increases in revenue.*

Profitability

Sonoma wineries are well positioned to benefit as sales of fine and luxury wines pick up in the coming year. Profitability has risen consistently in recent years, though wineries have depended on rising sales volumes to make up for a decline in bottle prices, limiting top-line revenue growth. However, Sonoma's specialization in more sophisticated wines will pay off in the coming year. After rising by 8% in the past year, retail sales of premium and fine wines, priced at $14 and above, will expand by 14% to 18% in 2015, according to Silicon Valley Bank. Growth in top-line revenues will more than offset higher operating expenses, setting Sonoma's vintners up for the most profitable year since the recession.

As the U.S. recovery shifts into high gear, rising Bay Area tourism will deliver a significant boost to sales, as more potential consumers make their way to Sonoma wine tasting rooms. Tourist visits are a principal avenue of revenue growth, as wineries earn nearly four times the profit from direct-to-consumer sales as from sales to distributors.

Growth in wine exports will be restrained by exchange rate movements, although slower global growth will prove a larger obstacle to sales as consumption slows in key export markets. Japan's recession and anemic growth in the European Union will be particularly challenging, as they constitute two of the U.S.'s top three export markets. At the same time, the strengthening dollar will boost imports across all segments.

Long-Term Outlook

The long-term outlook for Sonoma vintners remains bright, though the road forward is not without curves. Wine consumption in the U.S. has risen for 20 consecutive years, a trend that has weathered the transitory damage of recessions. Furthermore, per capita wine consumption has continued to increase after surpassing its 1986 high-water mark in 2007. However, consumption on a per-capita basis remains far behind that of Europe—about half as high as in the U.K. and just a quarter as high as in France and Italy. While the large gap presents ample room for growth, further inroads will be steep, in no small part because of the rising popularity of craft beer. Sales of craft beer reached 7% of the $174 billion adult beverage market in 2014, close to half of wine's 18% share. Given falling wine consumption in Europe and anemic economic growth in both Europe and Japan, exports will become an increasingly difficult avenue for sales. At the same time, a stronger dollar will make imports from Europe, Australia and South America more competitive across all price points. Though the changing of the demographic guard is not yet at hand, millennials' reduced purchasing power and unique consumption patterns will prove a challenge for traditional avenues of sales such as direct-to-consumer shipping. Sonoma vintners' willingness to blend tradition and shrewd marketing will certainly help among this key demographic: Sonoma County wines will be named the official wine of the 2016 Super Bowl, a move that will challenge beer marketers on their own turf.

Wine Exports Pressed by a Stronger Dollar

Sources: Wine Institute, Moody's Analytics

Chart: *A shift toward greater wine consumption in emerging markets sustained exports in 2014. Though exports to the EU, Japan, China and Hong Kong--four of the US top trading partners—plunged in value and volume, rising demand from South Korea, Mexico, Vietnam and Nigeria drove foreign sales to $1.49 billion in 2014, the second highest year on record. A stronger dollar and slower global growth will reduce the competitiveness of U.S. wines in traditional export markets, increasing the weight of emerging markets as a key driver of demand.*

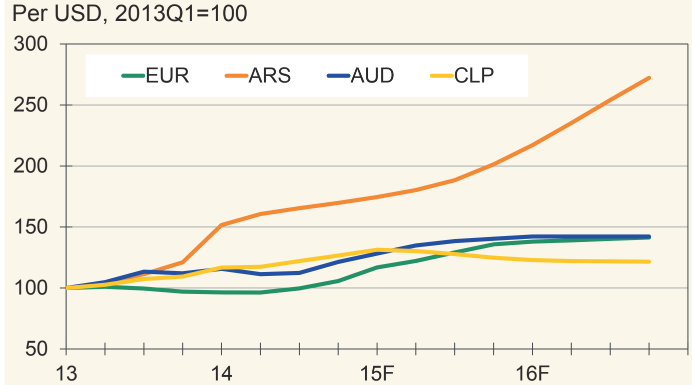
Upside Risks

A faster recovery in the U.S. leading to greater than expected income gains would boost demand for all wines, but in particular higher-end bottles produced by Sonoma vintners. Though emerging markets trail Europe and Japan as a destination for U.S. wine exports, a rising preference for wine would bolster world demand more generally and support higher prices and revenue for Sonoma vintners. As of January, Massachusetts became the 40th state to allow shipping from wineries to consumers in state, representing an upside risk for Sonoma County wine growers. Direct sales are a major source of revenue for Sonoma County wine growers, as Sonoma accounted for a quarter of total direct sales by volume and revenue in 2014.

Downside Risks

A stronger U.S. dollar presents the greatest risk to Sonoma wine growers, transferring purchasing power from European drinkers to consumers in the U.S. If the prolonged crisis in Europe leads to an even greater weakening of the U.S. dollar, wine drinkers will find it easier to substitute once-expensive European imports for wines grown in Napa or Sonoma. The increasing popularity of craft beer could have a tangible impact on wine sales, pressuring bottles in the low to middle range of the price curve. Finally, while millennials consume more wine than past generations of their age, they are more disposed to foreign wine. An absence of initiatives to market American wines to this key demographic would bring long-term harm to Sonoma wines.

Dollar Strength Gives Competitors a Leg Up



Sources: Federal Reserve, IMF, Moody's Analytics

Chart: *Sonoma County vintners will face increased competition from major wine-producing countries in 2015. Moody's Analytics forecasts a 7% increase in the nominal trade-weighted dollar in the next two years, but the dollar's rise against the currencies of major wine producers will be even steeper. European production will present depreciation of the Argentine peso will be especially sharp, Argentina makes up a small share of total imports. In contrast, favorable exchange rates will help Australia and Chile capture additional market share.*

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With acknowledgement and appreciation to key local businesses that support economic development in Sonoma County

DIRECTOR

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