Industry Sector Report

Wine Industry Insider

2016
SONOMA
COUNTY

Sonoma County EDB Economic Development Board

Sonoma County Workforce Investment Board

Moody's Analytics Wine Industry Insider

The Sonoma County Economic Development Board (EDB), in partnership with the Sonoma County Workforce Investment Board, is pleased to present the 2016 Wine Industry Insider for Sonoma County. Our research partner, Moody's Analytics, provided the research for this report.

Highlights of the 2016 Wine Industry Insider include:

- Sonoma County vintners closed out 2015 on a high note and are holding their ground in the increasingly competitive marketplace for fine and premium wines. With the U.S. economy hitting full stride, **wine drinkers are trading up to higher priced bottles**, boosting sales of higher-end wines produced in Sonoma County.

- Though the average price of California grapes plummeted by 10% in 2015, **prices for grapes grown in Sonoma posted a healthy 5.3% gain**. Retail wine and grape prices do not always move hand in hand, but with **grape quality among the highest in the state**, rising demand will help Sonoma winemakers recover pricing power ceded in the aftermath of the Great Recession.

- While **millennials consume more wine than past generations**, they have reached drinking age in an era of cheap imports and ever increasing options for alcoholic beverages. Absent initiatives to market American wines to this key demographic, **Sonoma vintners risk ceding market share to craft beverages in the long run**.

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,

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Chair
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Recent Performance

Sonoma County vintners closed out 2015 on a high note and are holding their ground in the increasingly competitive marketplace for fine and premium wines. With the U.S. economy hitting full stride, wine drinkers are trading up to higher priced bottles, boosting sales of higher-end wines produced in Sonoma County. Despite the strong dollar, exports are providing support, and Sonoma wines are making headway in the lucrative direct shipping market as well. Sales of bottles on the lower end of the price curve, however, are slipping amid fierce competition from craft beer and spirits, which are quickly increasing their share of the adult beverage market.

The 2015 vintage was the lightest in nearly a decade, but after three consecutive record-breaking harvests, the lower haul should ease concerns of excess supply. Overall tonnage of Sonoma County wine grapes fell 29% to 181,000, according to the California Department of Agriculture, slightly below the average for the previous 10 years. Despite the crop's smaller size, Sonoma vintners celebrated another year of outstanding grape quality. Prices for the county's top varietals—chardonnay, pinot noir, cabernet sauvignon and zinfandel— rose 5.5% over the prior year, outpacing the previous year's gains. However, the lighter crop weighed on growers' revenues, as price gains were not sufficient to offset declining volume.

Wine consumption grew modestly in 2015 as wine drinkers reached for higher-priced bottles. Total U.S. wine consumption rose 2% to 383 million cases, according to Gomberg, Fredrikson & Associates, about even with last year's gain. However, the moderate increase belies a surge in sales of fine and premium wines. According to retail and supermarket scan data collected by Nielsen, sales of bottles priced $9 and above rose at a double digit pace, while sales of bottles priced below the $9 mark were flat or outright declined. Sonoma and Napa wineries are dominating the lucrative direct shipping market, where they account for just more than half of direct-to-consumer sales. However, prices for wines purchased directly from Sonoma's wineries fell for the second year in a row, resulting in a slight drop in revenue from direct sales.

Despite headwinds from a stronger dollar and subdued global growth, U.S. winemakers continued to grab shelf space in foreign markets. Total wine exports reached a new high in 2015, driven by rising sales to the European Union, Hong Kong, and Japan. Overall exports rose 7.6% to $1.6 billion, breaking 2013's $1.5 billion mark. Though sales to China fell for the second straight year, rising consumption in Mexico, Brazil, Nigeria and the Philippines more than made up for the shortfall. Exports account for just 4% of U.S. wine sales, but are an important avenue of growth for higher-priced wines, especially those produced in California, the origin of 90% of wine sold abroad.

Foreign wine producers made further inroads into the U.S. market in 2015. Total imports rose 3% to $6 billion, propelled by sales of French and Italian wines. Despite the sharp depreciation of Latin American currencies vis-à-vis the U.S. dollar, imports from Latin America fared less well. Sales of Argentine and Chilean wines fell for the second straight year after nearly a decade of uninterrupted growth.

Macro Drivers

The U.S. economy is steadfastly advancing in the face of headwinds from falling energy investment and sluggish global expansion. While energy and trade will drag on growth in the near term, consumers are stepping up to the plate and will do more to lift the economy over the next year. The housing market recovery is making steady progress, and greater construction activity is spurring better growth in mid-wage jobs. The Moody's Analytics forecast calls for the economy to advance by 2.3% this year, sustained by rising consumer spending and a more robust recovery in residential construction.

The modest outlook for output growth stands in contrast to the white-hot labor market. The economy is adding jobs at a breakneck pace, pulling the unemployment rate below 5% even amid strong labor force growth. On average, employers have added more than 200,000 jobs in each of the last six months, and at the current rate of job gains remaining slack in the labor market will be absorbed by summer. The tightening labor market is already beginning to pull up wages: Average hourly earnings growth has trended upward since the fall, even as the average workweek has lengthened.

Better wage growth and improving consumer fundamentals bode well for Sonoma's winemakers. Real consumer spending growth in 2015 rose the fastest in a decade, and the forecast calls for an encore performance this year as wage growth firms and rising house prices lift household wealth. Though retail sales growth has slowed, outlays in discretionary categories such as restaurants, drinking establishments, sporting goods and apparel stores are still rising on a year-ago basis. Firming wage growth and improving access to credit will clear space in household budgets for larger discretionary purchases, including fine and premium wines.

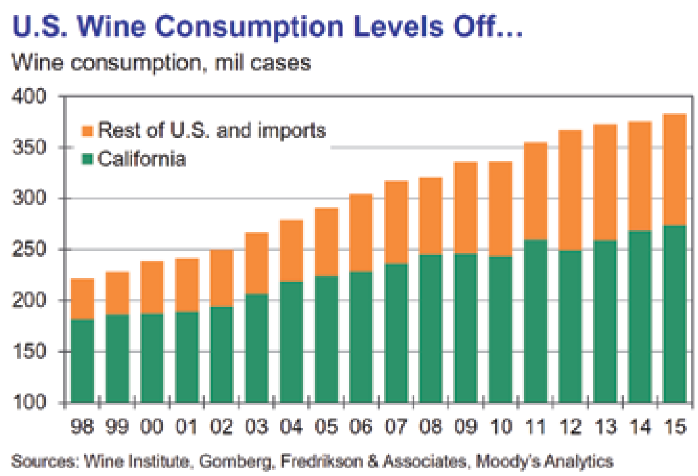

Chart: *Total wine consumption rose modestly in the past two years as wine drinkers across the demographic spectrum reached for value over volume. While the U.S. has surpassed France as the world's top wine-consuming country, per capita consumption still falls far shy of that of Europe, suggesting that there is still ample room for growth. However, total consumption will rise only moderately as income- and debt-constrained millennials grow in share of the adult population. Baby boomers will begin to taper consumption, leaving the less numerous Generation X as the primary driver of fine wine sales.*

Industry Drivers

Sonoma vintners are poised to benefit as consumers across the demographic spectrum satisfy their thirst for more sophisticated wines. However, the strong dollar and growing importance of millennial drinkers will make for an increasingly competitive marketplace.

The relative strength of the U.S. economy will support a strong dollar for some time to come, posing a twofold challenge for Sonoma vintners. All else equal, a stronger dollar will make wines produced in the county more expensive for foreign consumers, dealing a potential setback to exports. Though exports of California wines have proved remarkably resilient to the rise in the value of the dollar, a stronger domestic currency will make further gains all the more difficult.

The strong dollar will also come to bear through heightened import competition. A stronger domestic currency will lower the cost of foreign wines across price segments, including higher-priced French and Italian wines that compete more closely with Sonoma varietals. The increased availability of lower-cost imports will prove particularly challenging since foreign wines make up more than one-third of domestic wine sales.

Though the changing of the demographic guard is not yet at hand, millennials are already making their mark on the domestic wine market. According to Silicon Valley Bank, millennials have surpassed the mature, or pre-baby boomer, generation in wine consumption across all price points, and now make up the third largest demographic group for sales of fine and premium wines after baby boomers and GenXers. However, millennials may prove a tougher sell for Sonoma vintners than previous generations. Millennials consume more wine than other generations did at their age, but they have shown a greater enthusiasm for foreign wines and blends. Numerous surveys indicate that millennials rely on label design, rather than grape origin, in informing consumption decisions. This could pose an especially difficult challenge for Sonoma wineries, many of which have staked marketing efforts on the emphasis of grape varietal and appellation.

Furthermore, although the boomer generation is starting to retire, most millennials have yet to enter their prime earning years. Saddled with large student loan burdens and earning less, in general, than older cohorts with more work experience, millennials lack the wherewithal to both drink better and drink more. As a result, total wine sales will grow slowly as boomers begin to sip less and are overtaken in consumption by the less numerous Generation X. Meanwhile, Sonoma vintners face increasing competition from craft beer and spirits, which count millennials among their most zealous consumers.

California's drought showed signs of easing in early 2016, but climate conditions will remain a concern. Moderate dry conditions are an overall positive, as Sonoma's diverse geography provides just enough shelter to sustain smaller, more delicate grapes. However, persistent droughts have strained wine growers' resources, especially when it comes to younger vines, and continued dry weather could foil plans to increase acreage in both coastal and inland appellations.

Pricing

Rising demand for fine and premium wines and a lighter 2015 harvest will sustain price gains in the near term. Though the consumer price index for wine was little changed in 2015, prices for fine and premium wines are rising steadily at the expense of mass market offerings. Though the average price of California grapes plummeted by 10% in 2015, prices for grapes grown in Sonoma posted a healthy 5.3% gain. Retail wine and grape prices do not always move hand in hand, but with grape quality among the highest in the state, rising demand will help Sonoma winemakers recover pricing power ceded in the aftermath of the Great Recession.

Nevertheless, the combination of rising production in France and Italy and a stronger dollar could temper price gains. Though rising imports of foreign wines will strike first at the bulk wine market, the increasing availability of fine and luxury imports from Europe could exert downward pressure on prices for Sonoma wine.

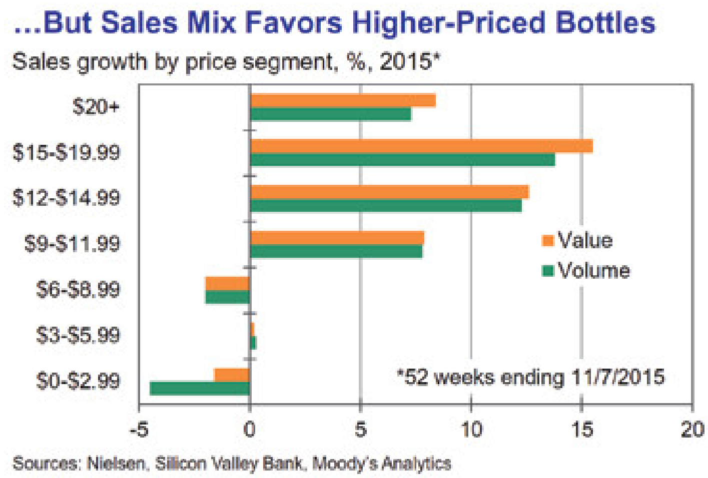

Chart: *Although total consumption growth has slowed, the U.S. wine market has bifurcated, with sales of bottles priced $9 and higher breaking into the low double digits. Improving consumer fundamentals, firming confidence, and better wage growth will sustain demand for higher-end wines. As a result, growth in fine and premium wines should outperform the broader wine market over the next few years. Sonoma vintners are well-positioned to benefit as rising disposable income enables consumers to satisfy their thirst for more complex and sophisticated wines.*

Operating Expenses

Sonoma vintners could see further increases in grape costs should this year's harvest come up short. Prices paid by Sonoma winemakers surged by 9% over the past two years as grapes destined for bottles on the higher end of the price curve were quickly snapped up by wine producers. A second small harvest could push grape costs even higher. Additionally, while Sonoma's moderate climate has protected vines from the worst of California's drought, continued dry conditions could result in long-term damage to vines and significantly raise costs for grape growers and vintners alike.

In the meantime, farm laborers will account for the lion's share of winemakers' costs. Though total agricultural employment in Sonoma County is trending downward, wages have shot up by 20% over the past two years, suggesting that low employment figures could stem from a shortage of labor. However, while another small harvest would put upward pressure on grape prices, it would also reduce the need for labor, thereby curbing overall cost pressures.

Profitability

Early financial results point to steady growth in both sales and profits for Sonoma wineries over the past year. Sonoma vintners are well-positioned to benefit as consumers flex newfound purchasing power to slake a thirst for more sophisticated wines. After rising by 14% in the past year, retail sales of fine and premium wines, priced at $10 and above, are set to expand by 9% to 13% in 2016, according to Silicon Valley Bank. Growth in top-line revenues should prove more than sufficient to offset higher grape and labor costs, setting Sonoma vintners up for another strong year of profit growth.

Rising tourist visits to Sonoma County will be a boon for vintners' bottom line, as wineries earn nearly four times the profit from direct-to-consumer sales as from sales to wholesale distributors. According to the Conference Board, the share of Americans planning a vacation in the next six months is near its highest point in five years, and Sonoma wineries will benefit as more tourists make their way to the county's tasting rooms.

Long-Term Outlook

The long-term outlook for Sonoma winemakers remains bright. Improving consumer fundamentals, firming confidence, and strong growth in disposable incomes will sustain demand for fine and premium wines over the next few years. However, total wine consumption will grow more slowly as the boomer generation begins to taper consumption and income-constrained millennials step into the driver's seat. There are signs this is already beginning to happen: Wine consumption on a per-capita basis was unchanged in 2014, according to the Wine Institute, ending 20 consecutive years of growth, and early data from 2015 show only marginal gains. Though the U.S. has surpassed France as the world's largest wine market, consumption on a per capita basis remains far behind that of Europe, suggesting that there is ample room for growth. However, further inroads will be difficult because of the tremendous popularity of craft beer. Sales of craft beer reached 10% of the $216 billion adult beverage market in 2015, just over half of wine's 18% share. Aggressive marketing by craft beer, spirits and alcoholic soda producers has helped boost consumption among millennials. Sonoma winemakers' reliance on more traditional promotional channels, such as wine tourism and direct-to-consumer sales, could hinder efforts to connect with a new generation of wine drinkers.

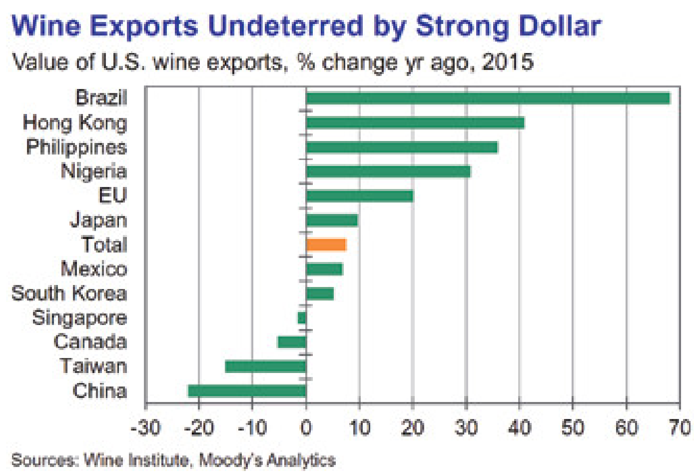

Chart: *U.S. wine exports, the majority of which originate in California, reached a new high water mark in 2015. Despite headwinds from a stronger dollar and sluggish global growth, exports rose by nearly 8%. Wine sales to the European Union, Japan, and Hong Kong notched sizable gains in both volume and value. Though wine sales to China fell for the second straight year, other emerging markets have more than picked up the slack. Exports are a small share of total sales for California winemakers but are an increasingly important avenue of growth for fine and premium wines.*

Upside Risks

Stronger than expected growth in disposable incomes would lift demand for all wines, but in particular for higher-end bottles produced by Sonoma vintners. Despite lower gasoline prices and better wage growth, the personal savings rate stands at twice its prerecession average, leaving plenty of room for households to increase discretionary spending as incomes rise. Though exports make up a small share of total sales for Sonoma vintners, a more robust recovery in Europe and Japan would lift global demand and aid pricing power.

Last year, Massachusetts became the 40th state to allow direct-to-consumer sales. This creates upside risk for Sonoma wineries, as direct sales are a fast-growing source of revenue. Additionally, although the near-term prospects for immigration reform are dim, the passage of a bill to raise legal immigration would assure Sonoma growers a more stable supply of labor.

Downside Risks

Further appreciation of the U.S. dollar presents the greatest risk to Sonoma vintners. A stronger dollar would transfer purchasing power from European wine drinkers to consumers in the U.S., making it easier to substitute once-expensive European imports for wines grown in Napa or Sonoma. Aggressive marketing by craft beers and spirits also presents a formidable risk. The increasing popularity of craft beer combined with greater marketing efforts aimed at millennials could further increase craft brewers' market share at the expense of wine. Finally, while millennials consume more wine than past generations, they have reached drinking age in an era of cheap imports and ever increasing options for alcoholic beverages. Absent initiatives to market American wines to this key demographic, Sonoma vintners risk ceding market share to craft beverages in the long run.

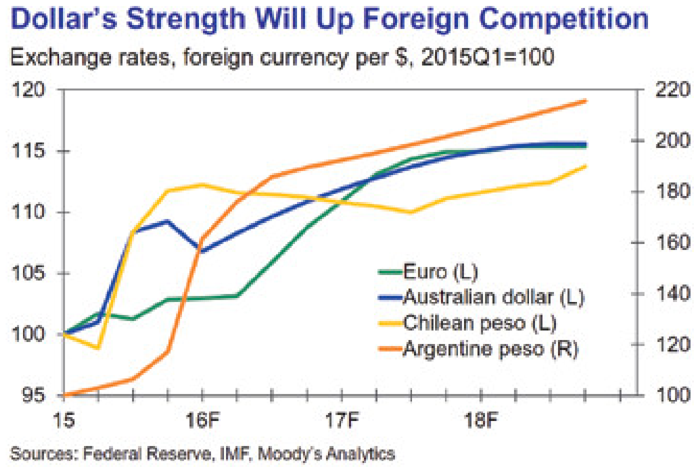

Chart: *The stronger dollar will intensify competition from major wine-producing countries in 2016. Moody's Analytics forecasts a 5% rise in the nominal trade-weighted dollar in 2016, but the dollar's rise against the currencies of major wine producers will be even greater. Imports from France and Italy will be the greatest challenge. Though Argentina is a smaller share of total imports, the sharp devaluation of its peso will significantly improve affordability for U.S. consumers and could help its wines gain market share. Favorable exchange rates will sharply lower the cost of wines from Australia and Chile.*

Jesse Rogers
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