



Industry Sector Report

Wine Industry Insider

2014
SONOMA COUNTY

SONOMA COUNTY EDB ECONOMIC DEVELOPMENT BOARD

SONOMA COUNTY WORKFORCE INVESTMENT BOARD

2014 Wine Industry Insider

June 2014

The Sonoma County Economic Development Board (EDB), in partnership with the Sonoma County Workforce Investment Board, is pleased to present the 2014 Wine Industry Insider for Sonoma County. Our research partner, Moody's Analytics, provided the research for this report.

Highlights of the 2014 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 2.9% in 2013. 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. Sonoma County's direct sales reached $1.6 billion in 2013, slightly higher than the value of US wine exports.

- Overall tonnage of wine grapes increased 1.3% from the previous year, while revenue rose 4.3%. Sonoma County's 2012 as well as 2013 vintage were of exceptionally high quantity and quality.

- 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,

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Recent Performance

The environment for Sonoma County winemakers is improving after years of challenging market and economic conditions. Wine drinkers are becoming less cost-conscious, setting up stronger growth for higher-priced wines than for cheaper varieties. Inventories are generally balanced, although some luxury wines are short on inventory.

Sonoma County's 2012 vintage was one of exceptionally high quantity and quality, and it appears that the 2013 vintage has followed suit. Overall tonnage of wine grapes increased 1.3% from the previous year, while revenue rose 4.3%. In aggregate, there were even stronger gains in the county's four major grape varieties—chardonnay, pinot noir, cabernet sauvignon and zinfandel—which account for a combined 81% of wine revenue. Production of chardonnay rose 7.7% in tonnage and 9.8% in revenue and, among major red varieties, pinot noir output rose 3.9% in tonnage and 6.1% in revenue. This was offset by declines in cabernet sauvignon, which fell 6.2% in tonnage, though only 0.2% in revenue, and zinfandel, which fell 4.9% in tonnage and 3.9% in revenue.

Wine consumption by volume in the U.S. increased 2.7% to 370 million cases in 2013, according to Gomberg, Fredrikson & Associates. Retail sales of wine rose an estimated 6.3%, according to Silicon Valley Bank, indicating further reduction in the post-recession policy of discounting to reduce inventories. By value, three-fifths of wine sold in the U.S. originates in California.

Expanding international demand for American wine continues to fuel sales. The value of U.S. wine exports rose 16% in 2013 to $1.6 billion, the fourth consecutive yearly increase, according to the Wine Institute. The volume of shipments was up 7.5%. The European Union and Canada together comprise a market for more than two-thirds of U.S. wine exports and each has become more important, with sales in 2013 up 31% and 12%, respectively, from 2012, compared with 5% growth elsewhere. The value of exports to Asia declined, driven by weaker sales to Japan and Hong Kong; along with mainland China, these economies make up most of the Asian market. California is the source of 90% of U.S. wine exports, although these exports generate only about 6% of the revenue of domestic sales for California producers.

The value of U.S. wine imports rose by 3.6% last year to $5.2 billion, as foreign producers continued to penetrate the American market. Imports from the two largest sources of foreign wine, Italy and France, increased by 9% and 4%, respectively. Latin American imports declined for the first time in a decade, as Argentina's sales fell 6% and Chile's fell 7%.

Macro Drivers

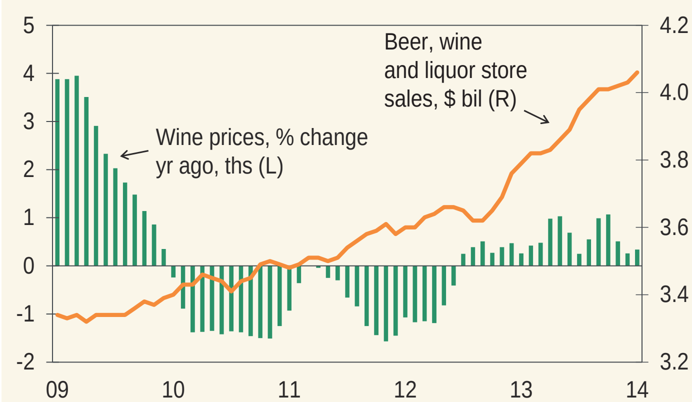
The U.S. economy grew in 2013 by 1.9%, slightly below the forecast at the beginning of the year. A faster recovery was hindered by heightened uncertainty surrounding federal fiscal policymaking, softness in the housing market, regulatory uncertainty harming business confidence, and investor concerns over disappointing performance in emerging markets. Although inventory changes accounted for much of last year's growth, the economy surmounted a weak first quarter to achieve steady growth excluding inventories. Household balance sheets have improved and businesses remain highly profitable.

Retail sales have faltered in the past few months, with year-ago growth slowing to a mere 1.5% in February, but this appears largely the result of inclement weather: Stronger data should be on the horizon. High stock prices and rising house prices are creating positive wealth effects. Declines in the saving rate will be sustained, aiding consumer spending overall and a return to quality among wine drinkers. The savings rate has fallen below 4.5% and is expected to remain there this year. Although above the average savings rate of the decade before the recession, this is markedly below the 6% peak of recent years.

With fundamentals remaining solid, real GDP is expected to rise around 3% in 2014 and accelerate to 4% in 2015 as the economy transitions into expansion. In the near to medium term, surging domestic energy production will cut into imports and help give manufacturers in the U.S. a cost advantage.

Discounting Days Are Over

3-month moving average



Sources: BEA, BLS, Moody's Analytics

Chart: *Strengthening demand and balanced inventories are putting an end to discounting and driving up retail sales of wines. More confident consumers purchased 3% more wine by volume in 2013 than in the previous year. Prices will rise modestly, with larger increases for luxury wines. A secular shift in preference toward wine will aid sales in the long run, but younger drinkers have developed a post-recession attachment to discounting and may avoid high-priced wines.*

Industry Drivers

Supported by a liquid and now well-capitalized financial system, this will become a primary driver of growth. Risks associated with federal fiscal policy are fading but are being replaced by the Federal Reserve's tapering of its quantitative easing program. The Fed must increase longterm interest rates gracefully, in concert with continued recovery, to provide stability to the financial sector, as monetary policy rates will take years to normalize.

Developments in the labor market have been mixed. The U.S. unemployment rate has fallen rapidly, to 6.7% in February from 7.9% at the beginning of 2013. Most of this improvement has come as the result of lower labor force participation, however, which recently hit a post-recession low. Net job gains dropped to an average of 130,000 from December through February, half the average in the previous three months, although employment data may have been affected by a combination of unsuitable seasonal adjustments and harsh winter weather. In the wake of faster net job growth, the decline in labor force participation is expected to reverse. The unemployment rate will decline, albeit at a milder pace, falling below 6% in 2015.

The greatest risks to recovery are external. Disappointing growth across emerging markets in general has been joined by pronounced political turmoil in a few. Although the direct impact on the U.S. is minimal, there is a potential for financial panic that could scare skittish investors and spread to other markets. Aggressive actions by the European Central Bank have averted the threat of renewed crisis in the euro zone for now, as confidence in the stability of its financial and monetary systems has returned. Nonetheless, the ECB's tight monetary stance is supporting an overvalued euro, low inflation—even deflation in some member states—and sluggish recovery. This raises the risk that unexpectedly poor growth in 2014 could precipitate another crisis in more debtburdened countries.

Industry Drivers

Many of the barriers to wine sales across the U.S. are being challenged, raising upside risks. Pennsylvania legislators are in negotiations to expand wine sales beyond state-owned liquor stores and allow a limited amount of direct shipping. Washington state and Maryland also recently joined the majority of states in allowing direct shipping. Sonoma County specializes in four of the top five grape varieties purchased via direct sales and accounts for around one-fifth of the total amount sold via direct sales both by volume and by revenue. The county has benefited greatly from the rise of direct sales. In 2013, these reached $1.6 billion, slightly larger than the value of U.S. wine exports.

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 agricultural water will be curtailed. Water deficits will reach a point where they significantly limit the volume of harvests and possibly their quality. Indications are that planting has been scaled back in response to the situation.

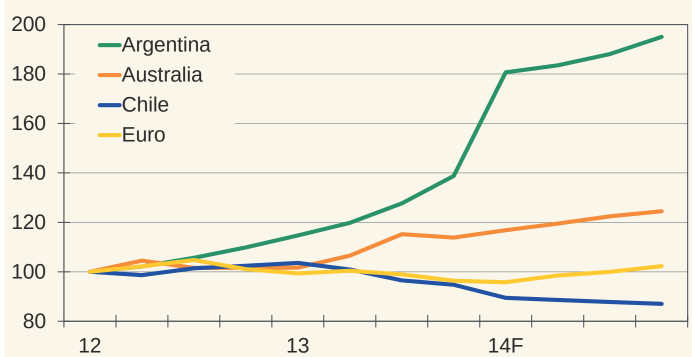
A state labeling law that went into effect at the start of this year will assist in Sonoma County's branding efforts over the long run. All wines produced in the county are now required to carry the phrase "Sonoma County" on the label in addition to the specific American Viticultural Area, in an attempt to emulate the success of Napa Valley in creating broader name recognition to enhance demand. This may come at the expense of wineries in AVAs that already possess well-known reputations.

Pricing

Bountiful harvests will help affordability, partly offsetting the effects of improving grape quality and the reduction in post-recession discounting. The average price for Sonoma grapes rose 2.9% in 2013 from the previous year. Prices for Sonoma's four major varietals rose 2.6% compared with a 1.2% decline in these same varietals statewide. According to Silicon Valley Bank, an average 2014 harvest will keep inventories balanced in all segments, as the rate of growth in fine wine sales increases.

Imports to Gain Further Pricing Power

Local currency per U.S. Dollar, 2012 Q1 = 100



Sources: Federal Reserve, Moody's Analytics

Chart: *Sonoma County wines will face increased price competition from the main sources of U.S. wine imports in 2014. The euro is expected to belatedly weaken in relation to the U.S. dollar, making higher priced European wines more affordable to U.S. consumers. Weather has damaged French and Italian harvests but has been bountiful for Spain. Favorable exchange rates and U.S.-focused export industries will help Argentine and Australian wines to capture additional market share. Chilean wineries, by contrast, will suffer from an increasingly strong currency.*

Violent weather played havoc with grape crops across France in 2013, causing French wine stocks to fall to their lowest level in 12 years. Italy also suffered from bad weather, albeit to a lesser extent, while an excellent crop lifted Spain for the first time to the top spot among global wine producers. Overall, however, competition from European labels will be less intense in the domestic market, supporting higher prices for Sonoma wines.

Operating expenses

Despite larger harvests, wineries will face higher grape costs. Prices paid by processors are rapidly recovering from the effects of the recession, with rising demand and improving quality prompting a 9% price increase over the last two years. Unless the drought ends quickly and enables a larger than expected harvest, price increases will continue in the near term.

California's drought may limit increases in labor costs, however. Sonoma County's unemployment rate has fallen below 6%, and job growth will remain robust in the near term, expanding the range of alternative employment opportunities for field workers. However, if the drought has severe effects on agriculture in the Bay Area and Central Valley, a surplus of available labor will likely result in the Sonoma area, constraining wage growth.

Profitability

After declining last year, profitability should improve modestly. Revenue growth will accelerate from the combination of increased volumes and higher prices, especially for luxury wines. Sonoma County will benefit particularly from the expansion in direct wine sales, resulting both from the strength of Sonoma wines in direct shipping and to rising Bay Area tourism, which leads to more sales at the wineries themselves. Consumers' "flight to value" has ended, and retail discounting will continue to diminish.

Growth in wine exports will be hampered by exchange rate movements. Both the Canadian dollar and Japanese yen have weakened considerably relative to the U.S. dollar within the last year, while the euro is expected to do so gradually this year and next. Some relief will be provided by renewed depreciation in the Chinese yuan, allowing further penetration into a fast-growing market. However, half of exports to China are sent to Hong Kong rather than the mainland, and the Hong Kong dollar remains firmly pegged to the U.S. dollar. The U.S. dollar has already strengthened against the currencies of Australia, Chile and Argentina, giving wines from these countries an advantage that will last for the near term, while the expected strengthening of the dollar versus the euro will boost imports from France, Italy and Spain.

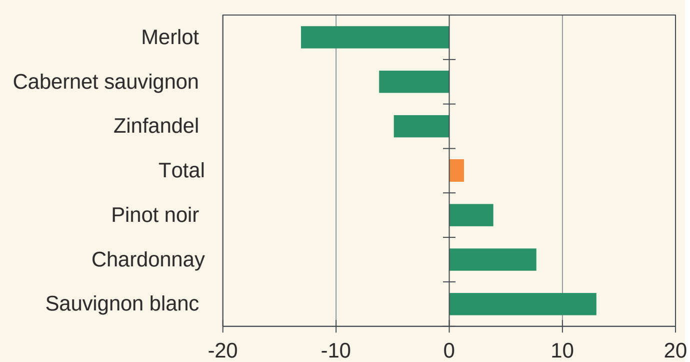
Long-term Outlook

Prospects for Sonoma County's wine industry remain bright. Overcoming cyclical effects, U.S. wine consumption has increased for 19 consecutive years as secular trends have managed to overcome the transitory damage of recessions. A gradual, long-term shift in tastes occurring across generations has led to increased wine drinking on average. Per capita wine consumption in 2007 surpassed the 2.43-gallon rate set in 1986 and reached 2.73 in 2012. Nonetheless, the pace of change has been slow, and Americans still trail far behind Western Europeans in per capita wine consumption, with a rate around half that of the U.K. and one-fourth that of Italy or France. This suggests ample room for further convergence.

In particular, younger workers of the millennial generation are much more disposed to wine than previous generations were at the same age. This bodes well for future consumption if this generation maintains its tastes. At the same time, however, this generation is also more disposed toward foreign wines and, in the market for higher-priced wines, may not have the earnings power, even when combined with members of Generation X, to compensate for the dwindling number of baby boomers who are at their peak lifetime income. Foreign markets are an obvious avenue of growth for American wines but also a tricky one. Nearly two-fifths of American exports are to the European Union, but per capita wine consumption has been decreasing in a number of major EU countries and an expected weakening of the euro will grant an advantage to native wines.

Grape Yields Reach Another High

Sonoma County wine grape tonnage, % change yr ago, 2011



Sources: USDA, Moody's Analytics

Chart: *For the second consecutive year, District 3, which comprises Sonoma and Marin counties, had a record grape harvest. After years of much smaller harvests, inventories are considered to be balanced. The two most important varietals, chardonnay and pinot noir, enjoyed sizable increases, although the next three largest varietals all declined. California overall experienced a 6% increase in wine grape tonnage, but the statewide average price for wine grapes fell 2%, compared with a 3% rise in District 3.*

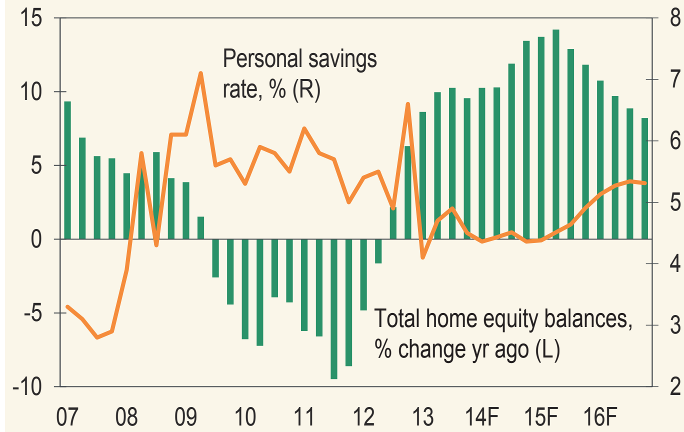
Upside Risks

Faster recovery in Europe or an end to Europeans' declining preference for wine among alcoholic beverages would bolster world demand for wine generally, and thus increase revenue for Sonoma County wines both through increased shipments to the EU and indirectly from higher global prices. A depreciation of the Chinese yuan relative to the U.S. dollar would make Sonoma wines more affordable in a key, rapidly expanding export market. Chinese growth is expected to slow in coming years, but careful policy could sustain higher rates of domestic growth, fueling steady increases in wine imports. A faster recovery in the highly cyclical consumption of luxury goods would accelerate recovery in higher-priced Sonoma wines.

Downside Risks

Millennials consume more wine than past generations of their age, but among prestige labels, they are more disposed to buying foreign wines. They also have been part of a "flight to value" since the recession. Should they retain these biases against more expensive domestic wines, it would bring long-term harm to Sonoma wines. States are becoming more amenable to direct wine shipments, but beer wholesalers' attempts to disrupt this may resurface. Past attempts have been thwarted, such as H.R. 1161, which would have exempted states from the interstate commerce clause to allow them to prohibit out-of-state wine shipments while still allowing in-state shipments. This was neither the first attempt at such legislation nor may it be the last. This would harm wineries in Napa and Sonoma counties, which together accounted for more than half of U.S. direct wine sales by volume and more than two-thirds by value.

Consumers Begin to Loosen Wallets



Sources: BEA, Equifax, Moody's Analytics

Chart: *The personal savings rate has fallen below 4.5% and will remain there for the next year, but it will not return to prerecession levels. With job gains deepening and positive wealth effects from stock and house prices, consumers will increase their purchases of higher-priced wines. Faster earnings growth will enable broader increases in wine consumption and wine prices.*

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

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