



INDUSTRY INSIDER
WINE & CRAFT BEVERAGE

INDUSTRY REPORT

2017



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EXECUTIVE SUMMARY

April 2017

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

HIGHLIGHTS



Total wine sales rose 4% in 2016, edging out last year's increase. Wines priced \$15 and above experienced double-digit gains, while sales of bottles priced \$9 and below are sliding. This shift to higher-quality wines benefits Sonoma's small and medium-size wineries, which rely more on direct-to-consumer purchases. Sales of Sonoma wines via direct shipping rose 29% last year, topping all other U.S. wine growing regions. Rising grape costs represent a slight challenge to profits, but Sonoma vintners can make up for this with higher prices.



The growing importance of millennials presents challenges and opportunities in the market for adult beverages. Millennials drink more wine than other generations did their age, but tend to select wines based on label design and price range and avoid higher priced wines. However, millennials are among the most avid consumers of craft beer. Total craft beer sales in the U.S. rose 10% in 2016 and now account for more than one-fifth of beer sales. In Sonoma County the number of craft breweries increased by a third in just three years.



The strong dollar poses two-fold challenges for Sonoma winemakers and craft beverage producers. The strong dollar will grant consumers greater flexibility to substitute foreign wine, beer, and spirits for beverages produced in the U.S. Furthermore, the strong dollar will make U.S. wines and craft beverages more expensive for consumers overseas. Although the value of total California exports increased 1%, the volume fell by nearly 10% as consumers in the EU, Canada, and Japan, purchased fewer cases.

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.



Recent Performance. Sonoma County vintners and craft beverage makers tipped their glasses to another marquee year in 2016 and are staking out gains in the increasingly competitive marketplace for adult beverages. Vintners are seizing on consumers' thirst for more sophisticated wines, which has elevated sales of high-end bottles produced in Sonoma County. Meanwhile, local craft breweries are growing in sales and prestige as more beer enthusiasts make their way to county taprooms. Sonoma brewers are pushing ahead with plans for expansion both nationally and within the county. Craft spirits represent a small share of county beverage production, but local distillers are growing quickly and gaining recognition at the national level.

The larger 2016 wine grape harvest will bring welcome relief to county vintners following the light 2015 crop. However, rising grape costs will turn up the pressure for producers on the low end of the price curve. Overall tonnage of Sonoma County grapes came in at 226,000, according to the California Department of Agriculture, about even with the historical average. Despite the larger yield, surging demand for North Coast grapes is pushing up prices. Prices for Sonoma County's top varietals—chardonnay, pinot noir, cabernet sauvignon and zinfandel—rose 5.8%, slightly ahead of last year's gain and the largest increase in a decade.

Wine enthusiasts and casual sippers alike are trading up to higher-priced bottles even as they purchase more wine. Total U.S. wine sales rose 4% in 2016 to 399 million cases, according to Gomberg, Fredrikson & Associates, edging out last year's increase. Wines priced \$15 and above are chalking up double-digit gains, while sales of bottles priced \$9 and below are sliding. The shift to quality has paid large dividends for Sonoma's small and medium-size wineries, which rely more on direct-to-consumer purchases. Sales of Sonoma wines via direct shipping rose a heady 29% last year, topping all other U.S. wine-growing regions.

California vintners are making inroads in foreign markets, but the strong dollar is starting to take a toll. Total California wine exports rose 1% to a record \$1.6 billion. Despite the increase in value, the volume of shipments fell nearly 10% as consumers in the European Union, Canada, and Japan—the three largest export markets for California wines—purchased fewer cases. Meanwhile,

imports rose at a faster clip as consumers flexed newfound purchasing power to explore European wines.

Sonoma's craft breweries are booming as more beer drinkers opt for craft ales over mass-market offerings. Total craft beer sales rose a solid 10% in 2016 and, at \$24 billion, now account for more than one-fifth of overall U.S. beer sales. Not only does the county boast several of the largest craft brewers nationwide, but smaller players are expanding as well: The number of craft breweries in the county has increased by one-third in the past three years alone. Abundant warehouse space, an increasingly diverse dining scene, and rising tourist interest in craft beers have fostered growth, but proximity to artisanal food producers provides another advantage by supplying ingredients vital to crafting distinct tastes.

County craft spirits producers are coming into their own as local whisky, vodka and gin makers gain national acclaim. Although most production is destined for local taprooms, the number of distilleries has more than doubled in the last three years and is among the highest among California metro areas. Gains in direct-to-consumer shipments will enable county distilleries to increase their share of the \$2.4 billion market for craft spirits.

Macro drivers. The U.S. economy is performing strongly and is poised to accelerate this year as better wage gains support consumer spending and as businesses increase outlays for equipment and other productivity-enhancing investments. Trade will remain a significant drag as monetary easing in Europe and Japan extends the dollar's run, but increased residential investment and greater domestic energy production will soften the blow. As equipment spending firms and the housing market recovery hits full stride, growth will pull north of last year's subdued pace.

The labor market is on the march, with total job gains averaging upwards of 185,000 in the last six months. At the current rate of job additions, the economy will reach full employment by summer. The belated rise in wages is finally beginning to materialize as the tight labor market heightens competition for workers.

Better income gains and improving consumer fundamentals will create space in household budgets for discretionary purchases, including wine, beer and spirits. With house prices surpassing prerecession peaks in more markets, firming household balance

sheets will support additional spending. Real consumer spending turned in another strong performance last year and will continue to lead the rest of the economy as greater competition for workers translates into larger paychecks. Though personal consumption expenditures on alcoholic beverages took a step back in the first few months of the year, spending will resume its upward climb as disposable incomes rise.

More restrictive immigration policies proposed by the Trump administration introduce considerable risk into the outlook, given already-tight labor markets in the South and West. Executive or congressional action to limit immigration would deal a setback to agriculture- and tourism-reliant economies as well as downstream industries such as wine-making and small-batch beverage production, which rely on farm commodities as inputs.

Industry drivers. The dollar's run will continue, posing a twofold challenge for Sonoma winemakers and craft beverage producers. All else equal, the strong dollar will grant consumers greater flexibility to substitute foreign wine, beer and spirits for beverages produced in the U.S. Second, the strong dollar will make U.S. wines and craft beverages more expensive for consumers overseas, while raising the cost of tourist visits to U.S. wine-growing regions, including Sonoma County.

The rise of the millennial consumer will present several hurdles for Sonoma winemakers. Though the changing of the demographic guard is not yet at hand, millennials have already surpassed the mature—or pre-baby boomer—generation, to become the third largest wine-drinking cohort, behind baby boomers and GenXers. Though millennials drink more wine than other generations did at their age, they enter their prime earning years with the experience of the financial crisis and still-large student loan burdens. Millennials' thrift will pose a challenge for county winemakers, which have staked marketing efforts on varietal and appellation. Consumer surveys indicate that millennials are more likely to select wines based on label design and price range. Though millennials are trading up to higher-priced bottles, they are starting from a lower base and will be less reliable sources of revenue for fine and luxury wines produced by the county's small and medium-size wineries.

The economic constraints facing millennials will play into the hands of craft beer makers, which offer taste and sophistication

at a more affordable price point. Millennials are among the most avid consumers of craft beer, and this trend will persist as brewers hone distribution channels and grab space in bars, supermarkets and liquor stores. Though craft spirits command higher prices, independent distilleries have piqued the interest of millennial consumers. Deft marketing campaigns have redefined spirits as a luxury good that could in time challenge wine's cachet.

Sonoma vintners will also contend with the increasing prestige of Washington and Oregon wineries. Vintners in the Pacific Northwest are producing more top-quality wines and command a small but growing share of the lucrative direct-to-consumer sales channel. As more wine enthusiasts make their way to tasting rooms in the Pacific Northwest, competition for fine and premium wines will intensify. Sonoma craft breweries and spirit producers will also face steep competition from beer meccas Seattle and Portland, but soaring sales of craft ales and spirits will create space for new entrants.

Pricing. The pricing environment for Sonoma vintners remains positive, but rising grape costs will apply restraint, especially for bottles on the lower end of the price curve. Rising imports of foreign wines—particularly of higher-priced French and Italian wines that compete more closely with Sonoma varietals—will also temper pricing power. Still, with grape quality among the highest in the U.S., Sonoma vintners can expect to make up much of the increase in grape costs in the form of higher prices. Wineries positioned in the fine and luxury end of the market will eke out larger price gains as demand for higher-end wines swells.

Craft beer producers will face a more competitive pricing environment. Robust sales growth has opened the market to new entrants, but the proliferation of new breweries will increase choice and shift the balance of pricing power back to the consumer. The consolidation of larger craft breweries under the umbrella of mass-market brands will further curb price gains, given beer giants' scale and distribution advantages. Despite these hurdles, demand outstrips supply and modest price gains are to be expected. In contrast, the barnstorming growth of craft spirit sales will safeguard pricing power over the next few years.

Operating expenses. The combination of rising grape prices and higher labor costs will push up operating costs for Sonoma vintners. Large producers' charge into the North Coast

during the three record harvests of 2012 to 2014 has increased demand for Sonoma fruit, sending prices paid to county grape growers up 12% in the past two years, compared with a 1% decline in grape prices statewide. The price increase will push up costs, since grape prices exceed those in most other California wine-growing regions. California's minimum wage increase will further push up labor costs; average weekly pay for grape growers has shot up nearly 15% in the past two years, according to the Quarterly Census of Employment and Wages, and mandatory overtime pay will further increase wage expenses.

In contrast, operating costs for Sonoma craft beer and spirits makers will rise modestly as global oversupply of hops and other grain holds down input costs. Flat or falling grain prices in much of the U.S. will offset the increase in costs from higher wages.

Profitability. Early financial results for wineries indicate that margins are proving resilient to higher grape and labor costs. As consumers reach for higher-priced bottles, Sonoma wineries have been able to chalk up larger price gains. According to Silicon Valley Bank, pre-tax profit margins crested 10% for the first time since the Great Recession as wineries sold more fine and premium bottles. Robust demand for higher-end wines will safeguard margins even as grape and labor costs rise. Rising tourist visits to Sonoma wineries will boost bottom lines for small and medium-size wineries, since margins are substantially higher for direct-to-consumer sales than for sales to wholesale distributors.

Despite rising competition and limited pricing power in the craft beer and spirits markets, excess grain supply will hold down input costs, setting up county breweries and distilleries for another solid year of profit growth.

Long-term outlook. The strengthening economy and consumers' increasing preference for higher-end adult beverages underpin the positive outlook for Sonoma vintners, craft brewers and distillers. Firming wage growth will enable wine enthusiasts and casual drinkers alike to slake a thirst for more sophisticated wines. Though per capita wine consumption in the U.S. lags well behind consumption in continental Europe, U.S. consumers are developing a taste for wine. Per capita wine consumption edged higher in 2016, extending a more than 20-year trend. Despite these tailwinds, total wine consumption will rise more slowly as millennials grad-

ually overtake baby boomers as the largest sales demographic for wine.

The ascent of Sonoma's craft breweries and distilleries will enable the county to weather the challenges posed to vintners by the millennial consumer. World-class breweries are drawing a new generation of beverage enthusiasts to Sonoma County. The release of Russian River Brewing Co.'s coveted Pliny the Younger drew nearly 10,000 tourists in 2016, adding an estimated \$4.9 million to the economy. While wineries remain the main draw for high-income tourism, craft breweries and spirits makers will gain prominence as restaurants and brewpubs in the county and broader Bay Area feature county ales and spirits.

Upside risks. Better than expected growth in disposable incomes would lift demand for more sophisticated wines, including those produced in Sonoma County. Though wage gains have improved only recently, the rise in the personal savings rate will clear space in household budgets for discretionary purchases. Better marketing efforts aimed at millennial drinkers could raise sales of Sonoma varietals to this critical demographic. Greater spending at county and Bay Area restaurants would further raise the profile of craft ales and spirits, while a more robust recovery in Europe and Japan would increase sales of county-made wines, beer and spirits. Finally, faster than expected growth in direct shipments would boost sales for the county's small and medium-size wineries and distilleries, which rely more on direct-to-consumer shipments.

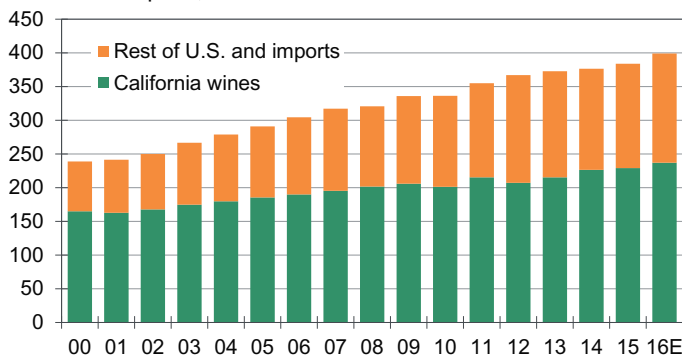
Downside risks. Any policy measures to limit immigration would strike at the heart of the county's wine and craft beverage makers. Immigration from Mexico and Central America has already slowed, and both grape growers and grain producers rely on immigrants for the bulk of their workforce. Immigrants also play a crucial role in Sonoma's hospitality industry, a critical entry point for consumers of county wine, beer and spirits.

The return of persistent dry conditions poses another significant risk. Although greater snowpack in the Sierra Nevada has eased drought concerns, a return of severe dry weather could curb the quality and quantity of harvests. Ever stronger competition from Washington and Oregon wine and craft beverage producers is another prominent risk, given that beverage makers in the Pacific Northwest already enjoy lower labor and input costs.

*Jesse Rogers
April 2017*

U.S. Wine Consumption Climbs Higher

Wine consumption, mil cases

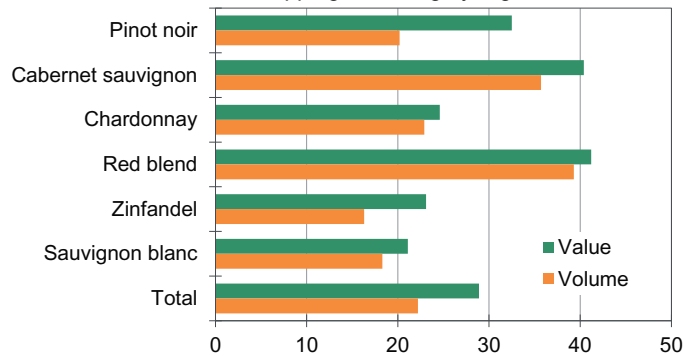


Sources: Wine Institute, Gomberg, Fredrikson & Associates, Moody's Analytics

Total wine consumption is rising briskly even as consumers reach for higher-priced bottles. Sales of fine and premium wines, including those produced in Sonoma County, are on the upswing. Better income gains will sustain demand for more sophisticated wines, and sales of higher-priced bottles should outperform the broader wine market over the next few years. However, the growing prestige of Oregon and Washington wineries will be formidable competition for Sonoma vintners, and the strong dollar will increase consumers' purchasing power vis-à-vis foreign wines.

Direct Sales Bolster Sonoma Wineries

Sonoma wineries direct shipping, % change yr ago, 2016

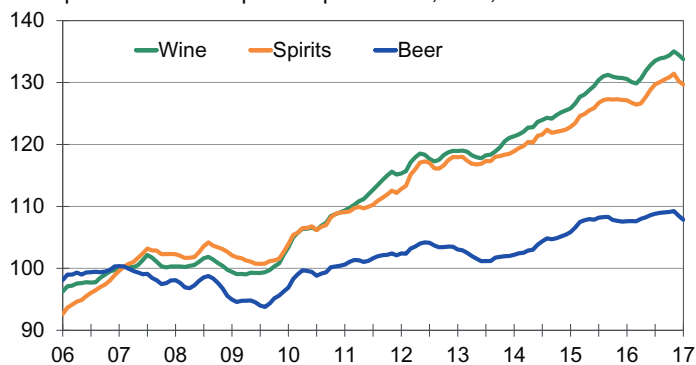


Sources: ShipCompliant, Wine & Vines Analytics, Moody's Analytics

Direct sales are an increasingly important outlet for Sonoma's small and medium-size wineries. Sonoma vintners, which account for almost a quarter of sales in the direct shipping channel, outpaced all other U.S. wine-growing regions in both sales and volume growth last year. More states are permitting direct shipments, creating opportunities for county vintners to grow sales beyond visits to local tasting rooms. However, cost-conscious millennial drinkers will prove a tougher sell for smaller wineries, as they are less inclined to select wines based on grape varietal and appellation.

Beer Sales Struggle to Keep Up...

Real personal consumption expenditures, U.S., Jan 2007=100*



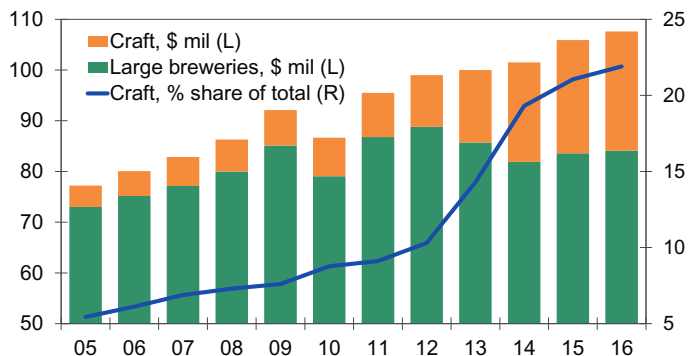
Sources: BEA, Moody's Analytics

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Though beer still dominates the adult beverage market, total sales have stagnated in recent years as consumers shun mass-market offerings for craft ales. Consumer spending on beer has struggled to keep pace with spending on wine and spirits, but increasing enthusiasm for craft ales will revive spending as small and medium-size producers hone distribution channels and grab space at bars, restaurants, supermarkets and retail stores. Breakneck growth in craft spirits bodes well for county producers and along with demand for beer will create opportunity to diversify the economy.

...But Craft Breweries Claim a Larger Stake

Retail sales, beer, U.S.



Sources: Brewers Association, Moody's Analytics

The slowdown in total beer sales belies barnstorming growth in the craft beer segment. Craft beer sales have grown at an annual rate of 17% in the past decade, while sales of traditional beers have declined. Beer lovers' enthusiasm bodes well for the county, which is home to several of the country's largest craft brewers and is emerging as an important destination for beer tourism. Sonoma's ascent as an important destination for craft beer and spirits will play to its advantage in the long run as millennial drinkers overtake baby boomers as the largest demographic for adult beverage sales.



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707 - 565 - 7170

141 STONY CIRCLE, STE. 110, SANTA ROSA, CA 95401