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WINE & CRAFT BEVERAGE

INDUSTRY REPORT | 2018

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SONOMA COUNTY BOARD OF SUPERVISORS

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EXECUTIVE SUMMARY

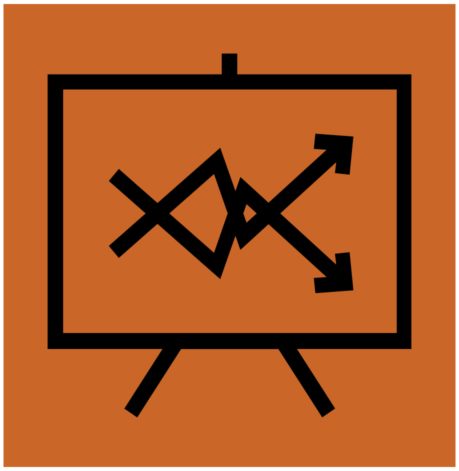
May 2018

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

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

HIGHLIGHTS

The consumer habits of millennials will present challenges and opportunities for the wine and craft beverage industry. In the medium- to long-term, millennials' tastes will shift towards premium products, but burdensome student debt and the experience of the Great Recession continues to soften their demand in the short-term. Craft beer, cider, and spirit makers currently gain the most from the consumption patterns of millennials, who represent a sizeable and ever-expanding customer base. Those vintners and brewers who manage robust digital marketing teams stand to gain the most from millennials, whose purchasing behavior emphasizes branding and experience over specific varietals.



The industry has recently seen countervailing forces of increasing costs and revenue. Labor costs stemming from an insufficient workforce, constraining land availability for both planting and storage/processing, and competition with the budding cannabis industry for workers and capital are all driving up input costs. Sonoma County wine prices have increased for two years in a row, but vintners have largely hit a price ceiling for retail market fine wines. Premium wines will continue to have room to push prices upwards, as will craft spirit makers. But profit margins for the industry broadly will decline unless input costs—especially labor—are brought back down.

For vintners and brewers alike, consumer preferences are dramatically changing the landscape of market share. For wine, sales have risen for the 25th consecutive year, but growth in sales last year was driven overwhelmingly by fine and premium wines. While Sonoma County is the first to benefit from a surge in sales and interest for premium wines, it is prudent to note that premium goods are the first victims of future economic downturn. Craft beverages continue to see increased consumer spending as customers shrink away from mass-market, established brands. Beer sales continue to lose ground to spirits and wine, the latter of which is receiving the lion's share of conversions.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ICE CREAM AND PIE BAR
HEALDSBURG | CALIFORNIA
OPEN LATE EVERY DAY
12PM TO 9PM

Recent Performance. Sonoma County vintners, brewers and spirits makers braved October wildfires to defend their clout in the fiercely competitive marketplace for fine wine and craft beverages. County wineries, breweries, vineyards and distilleries were largely unscathed by the fall blazes and emerged from the ashes to meet rising demand for premium wines and craft beverages. While mass-market labels have struggled to increase sales, Sonoma vintners and craft beverage makers are thriving. Consumers' growing taste for more sophisticated wines and adult beverages has played to county producers' strong suit, lifting sales and burnishing the county's repute among wine, beer and spirits enthusiasts alike.

Sonoma County winemakers completed the bulk of the grape harvest before the wildfires began, and damage from smoke taint was minimal. However, vintners grappled with a late-summer heat wave that reduced the size of the critical chardonnay crop and pushed up prices; the overall yield of Sonoma County grapes came in at 206,000 tons, well below the prior year's total and the five-year average. Although yields for the county's other top varietals increased, larger hauls were insufficient to replenish already-tight inventories. While rising prices bolstered grower returns, wineries in need of additional supply were hard-pressed to avoid hefty premiums.

Wine enthusiasts and casual drinkers' zest for higher-end wines has not abated, and rising sales of higher-priced bottles testify to the bifurcation in consumption patterns. Total U.S. wine sales rose for the 25th consecutive year in 2017, according to Gomberg, Fredrikson & Associates, reaching 403 million cases. Although growth has slowed, the increase in sales was driven entirely by premium and luxury wines: Sales of bottles priced $10 and below contracted for the second consecutive year. The lucrative direct shipping channel, which is the primary avenue of sales for most small and medium-size Sonoma wineries, continues to grow rapidly and now accounts for a tenth of off-premise sales. Shipments by Sonoma wineries rose at a double-digit rate, outpacing all other California wine-growing regions.

After almost a decade of steady growth, California wine exports dipped in 2017, dropping close to 6% in both volume and value. Although the dollar's run ended last year and the greenback depreciated slightly against the currencies of major wine-exporting countries, it is still up substantially from its average over the past decade. The combination of exchange-rate pressures and bumper grape harvests in Europe and South America eroded demand for California wines. These same forces worked to raise imports of foreign wines. Total wine imports in 2017 rose 7% to $7.6 billion, led by France, Italy, Spain and South Africa. Despite larger grape harvests in Argentina and Chile, the two countries gave up ground.

Sonoma brewers continue to hone their craft, with offerings by large producers Lagunitas, Bear Republic, and Russian River Brewing Co. consistently topping the list of the most coveted beers nationwide. Sales of craft ales grew at a slower rate last year but still bucked the decline in overall beer sales and now claim nearly a quarter of the domestic market. Not only does Sonoma County lay claim to one of the densest clusters of craft breweries in the nation, with numerous smaller breweries and brewpubs rounding out its lineup of large producers, but the number of independent breweries in Sonoma has grown even as slowing craft beer sales spur buyouts by traditional brands.

Consumers' thirst for craft ales has stoked a similar fervor for craft and small-batch spirits, delivering a boost to county distilleries. Although most production is consumed within the county, several local whisky, vodka and gin makers have gained national acclaim as visitors to wine country frequent county restaurants, taprooms and production centers.

Macro drivers. The U.S. economy is operating at full capacity, and the combination of tax cuts and deficit-financed fiscal spending will press on the throttle and test supply-side constraints. With monthly net job gains running north of 200,000 and an unemployment rate heading below 4%, the labor market has blown past full employment. Wage growth will accelerate, and larger paychecks will support discretionary spending on wines and craft beverages as well as long-distance travel to destinations such as California's wine country.

The counterpoint to faster economic growth will be higher interest rates. The Federal Reserve is on track to raise the fed funds rate by a cumulative 150 basis points over the next year, and higher interest rates will slow household and business investment spending and dampen house price gains. After growing by better than 3% this year, the economy will rapidly cool and expand at rates consistent with its long-term potential.

The rising global economic tide will take pressure off the dollar and also stimulate demand for fine and premium wines as well as craft ales and spirits. However, more restrictive trade and immigration policies pose considerable downside risk. The Trump administration has stopped short of a full overhaul of U.S. immigration policies, but stronger enforcement of existing laws and the end of the Deferred Action for Childhood Arrivals program have coincided with a deceleration in net international migration to the country. Trump administration pledges to restrict legal immigration and take a harder line on undocumented immigrants could choke off the supply of farm labor and cause simmering labor markets in the West to quickly overheat.

Meanwhile, the escalation of trade tensions with China and NAFTA partners Mexico and Canada could raise the cost of farm machinery and brewing and distillery equipment critical to Sonoma vintners and craft beverage producers. Neither China nor Mexico is a large market for Sonoma wines, but sales to the two countries have grown especially quickly in recent years and wine-specific tariffs could put a dent in demand.

Industry drivers. Consumers' maturing taste buds will continue to tilt purchasing decisions toward artisanal goods, and Sonoma vintners, craft brewers and spirit makers stand to benefit as seasoned and casual drinkers slake a thirst for more sophisticated wines and craft beverages. Though the market for craft beer appears increasingly saturated, unique entries will be rewarded, and as consumers continue to venture beyond retail wine and spirit offerings in search of distinct flavors and experiences, the importance of marketing for smaller brands will increase. The changing of the demographic guard is not yet at hand, but the rise of the millennial consumer presents hurdles for Sonoma winemakers. Although millennials will migrate to higher-priced bottles as they enter their prime earning years, large student loan burdens and the experience of the financial crisis will encourage thrift, making millennials less reliable sources of revenue for fine and luxury wines produced by the county's small and medium-size wineries.

These constraints will play out more favorably for craft beer makers. Millennials are among the most avid consumers of craft beer, and numerous consumer surveys highlight the diverse offerings and relatively affordable price point as the primary drivers of demand.

Craft spirits command higher prices than craft beer and retail spirit labels, but they are generally less expensive than luxury wines and will capture a greater share of overall spending on spirits as discerning millennial consumers grow more secure in their economic status and prize drinking better over drinking more.

More volatile climate conditions will be an ever-present challenge for Sonoma vintners and craft beverage makers. Though the severe California drought has faded, rising ocean surface temperatures have coincided with less predictable climate events that could put county vineyards, wineries, breweries and distilleries in peril. The growing prestige of winemakers in the Pacific Northwest poses another long-term challenge for Sonoma vintners. The North Bay dwarfs Oregon and Washington wineries in wine sales and tourist visits, but vintners in the Pacific Northwest face few land constraints and could one day rival Sonoma wineries in quality if not quantity.

Pricing. After two successive years of price increases, Sonoma vintners will find it difficult to raise bottle prices without pricing county wines out of the retail market. Although consumers are trading up to higher-priced bottles, the rise of low-cost imports and high-quality wines from other U.S. growing regions will curb pricing power in the retail distribution channel. Smaller wineries that rely primarily on direct shipping are better poised to eke out price gains. Luxury wine consumers' relatively inelastic preferences and fervor for more sophisticated wines will grant small and medium-size producers greater pricing flexibility.

Craft beer producers face an even more challenging pricing environment. While beer enthusiasts have migrated en masse to craft ales, the swell of new breweries has dented pricing power for all but the most coveted brews. Traditional brewers' purchases of independent breweries will bring economies of scale to the craft market and dampen the pricing power of smaller producers. Compared with craft beer, the craft spirits movement is relatively young, and demand is swelling. The more recent emergence of small-batch and artisanal spirits makers will enable new and existing producers to fetch higher prices.

Operating expenses. Sonoma vintners will face a double whammy of rising land and labor costs, which will combine to push up grape prices over the next few years. While mechanization has reduced the need for labor, the scarcity of farm workers has pushed up wages, and the limited supply of vineyard acreage will make it difficult for producers to plant more in response to rising demand. The rapid rise of the recreational marijuana industry in the North Bay has quickly absorbed vacant industrial and warehousing space. As a result, the cost of new bottling and storage facilities will rise. Craft brewers and spirit makers also face rising labor and warehousing costs, but the surplus of hops and other grain will stem the rise in operating expenses. With the U.S. and major global grain producers struggling to offload excess production, input costs for breweries and distilleries will rise only slowly.

Profitability. Flat bottle prices and rising grape costs will compress margins for Sonoma vintners over the next few years. Consumers' thirst for more sophisticated wines has boosted profits, but further gains will be hard to come by given slowing sales growth in fine and premium wines and rising land, labor and grape costs. Early financial results suggest that winery profit margins were almost unchanged last year and rising costs will limit gains. While lower hops and grain prices will curtail input costs for craft beer makers, a saturated market and the rising clout of large producers will curb revenue and profit growth. More robust demand for craft spirits will buoy profits, although producers selling beyond the county will face pressure from retail stores to increase volume and adopt lower prices.

Long-term outlook. Terroir, gumption and dogged ingenuity have long been the calling cards of Sonoma County vintners and craft beverage makers, and these characteristics will aid county producers as they navigate greater economic volatility and the rise of a new generation of beverage enthusiasts with unique tastes and purchasing patterns. While the ascent of local craft beer and spirit makers has helped diversify the county's economy, reliance on discretionary spending will make for a more volatile pattern of expansion among wine and craft beverage makers over the next few years. As greater fiscal stimulus at the national level redlines the U.S economy, consumer expenditures on fine wines and craft beverages will continue to rise. However, should the economy falter on its path of long-run expansion, premium beverage sales will be among the first victims of falling incomes.

The millennial wave poses additional challenges. Debt- and income-constrained millennials enter the market for premium wines with greater caution and will prize brands that make the leap to digital distribution platforms. Small and medium-size wineries that rely on tasting room visits will need to embrace new forms of digital marketing and communication to bolster sales.

Labor and land constraints pose an additional challenge. With farm labor and industrial space in short supply, raising production capacity within the county itself will prove costly. However, Sonoma's allure as a haven for organic and artisanal goods creates leverage and has factored into several producers' plans to grow locally as they scale up in lower-cost counties and metropolitan areas.

Upside risks. Sonoma's diverse constellation of wine, beer and spirits makers has put the county on the map for a broader range of beverage enthusiasts, and even greater tourist inflows could increase cross-pollination between wine and beer drinkers. Better marketing efforts—including more user-friendly platforms to engage with Sonoma wineries—could sway more millennial consumers toward wine. The millennial cohort has shown a preference toward brand recognition over varietals, and more targeted efforts to brand local varietals could tip the scales favorably for Sonoma. Longer term, more flexible zoning laws could increase land availability for industrial space, causing input costs to rise more slowly, providing some respite for Sonoma vintners from rising grape and labor costs.

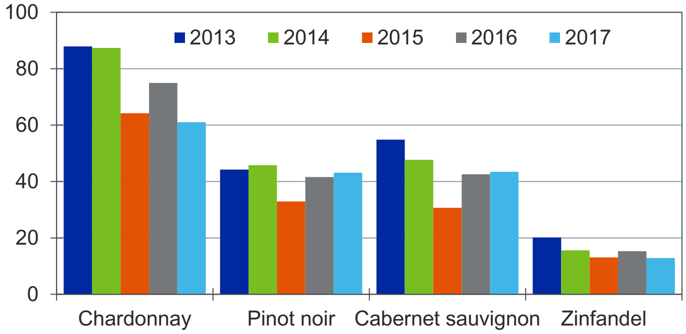
Downside risks. A global trade war poses a significant downside risk given the importance of global markets to the industry's growth. A growing middle class globally is showing a thirst for wine, but protectionist policies could price out Sonoma wines for some European or Asian consumers. China has already imposed tariffs on U.S. wine imports, and an extension of tariffs to beer and spirits would deal a heavy blow.

Even less immigration poses downside risk. Reduced immigration flows would severely hamstring the county's wine and craft beverage makers given the already-tight labor market. More severe weather patterns brought about by climate change are another important risk. Uncertainty about agriculture conditions could depress investment, and a return of drought conditions would hamper the quality and quantity of harvests.

Colin Seitz
Jesse Rogers
May 2018

Heat Wave Hits Chardonnay, Zinfandel

Sonoma County wine grape production, ths tons

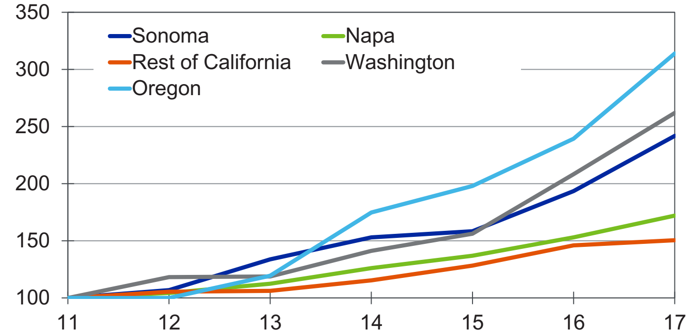


Sources: USDA, Moody's Analytics

Despite favorable growing conditions last spring, a blistering late-summer heat wave reduced the tonnage of the critical chardonnay and zinfandel crops, sending prices for the two varietals soaring. With limited acreage available for the planting of new vines, Sonoma vintners will be more susceptible to adverse climate conditions that could hurt their ability to satisfy growing demand for fine and premium wines. Although the county's diverse microclimates provide vineyards with ample shade, volatile weather patterns could hurt producers at the lower end of the price curve.

Direct Shipments Buoy Sonoma Vintners

Direct-to-consumer wine shipments, volume, 2011=100

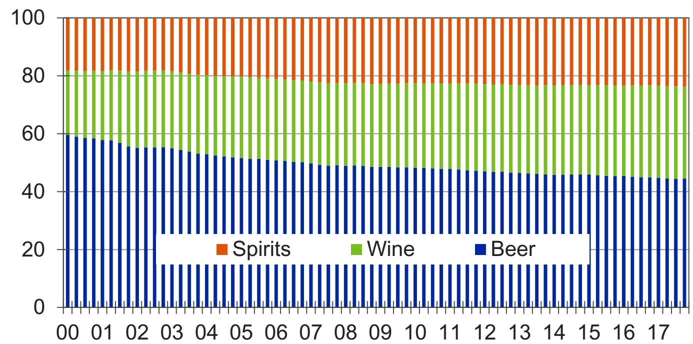


Sources: ShipCompliant, Sovos, Wines&Vines, Moody's Analytics

Sonoma vintners have outpaced all other California wine-growing regions in direct-to-consumer sales and are not far behind emerging wine-growing regions in Washington and Oregon, which have experienced rapid growth in recent years but make up only a small fraction of total direct sales. Direct-to-consumer shipments will continue to be an important avenue of sales for Sonoma's small and medium-size wineries. However, the rise of millennial drinkers will pose a challenge for smaller wineries given income constraints and millennials' preference for value over appellation and varietal.

Beer Makes Way for Wine and Spirits

Real personal spending on alcoholic beverages, %

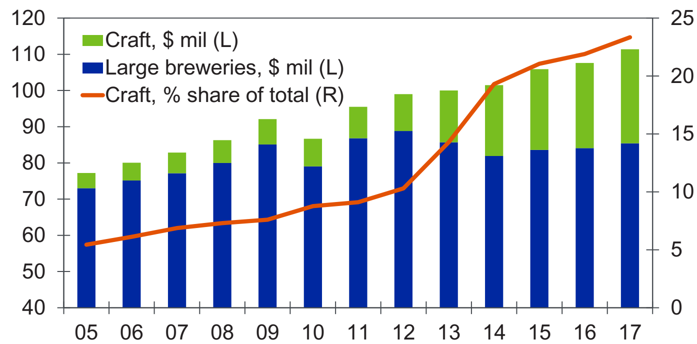


Sources: BEA, Moody's Analytics

Total beer sales continue to lose ground to wine and spirits as consumers take a pass on mass-market ales. Although beer still makes up nearly half of total off-premises sales of alcoholic beverages, its market share has steadily eroded as wine and spirit makers adapt to maturing consumer palates. While sales of mass-market beer brands have flagged, growing enthusiasm for craft beer and spirits bodes well for county producers. Most county spirits are destined for local taprooms, but distilleries will grow in sales and prestige as more visitors to wine country sample craft offerings.

Craft Ales Buck Traditional Brands' Decline

Retail sales, beer, U.S.



Sources: Brewers Assn., Moody's Analytics

The market for craft beer has grown increasingly saturated, but Sonoma County brewers boast numerous structural advantages that will set their offerings apart. Ready access to organic and artisanal agricultural products creates opportunities to craft unique tastes, and Sonoma's thriving dining scene will provide brewers with sufficient demand to accommodate local production. Despite slower growth in U.S. craft beer sales, craft ales now make up nearly one-quarter of the domestic beer market, and rising national demand will bolster the county's larger breweries.

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