

2010-2011 State of the Wine Industry



Written by Rob McMillan, *Founder, Wine Division*

Forward

The 1975 movie *Monty Python and the Holy Grail* has become a cult classic, rated #4 all-time on the IMDb top-rated comedies list. The story puts King Arthur, King of the Britons, defeater of the Saxons, Sovereign of all England on a quest to seek The Grail. It's a fitting story to use as our backdrop this year for a couple of reasons. First, ever since the pillaging and sacking beginning with the last quarter of 2008, we've all been on a quest to understand and recognize the post-crash shape of the new kingdom stretching before us — that which is true and just, and that which is but wizardry. Second, we could really use a laugh these days.

We have to confess that we hesitate each year when we throw the movie theme onto the canvas of the report because the information contained herein is serious. It's the culmination of a huge amount of diligent, scholarly work from many people that begins in November of each year to spot, drill down and explain emerging trends in the wine business. But we know that few winery owners can be cast as gravely serious souls, nor dost thou talit above the masses.¹ Thus, we have come to believe — nay, we've been besought — to make merry of the dismal science.

What is the grail you seek this year: a new bank (please call us); information on social media, demographics and market segmentation; a better idea of pricing moves, restaurant and luxury consumer trends; or an understanding of when the siege will end and your own Dark Knight will be vanquished? We pray thee come hither with us and the good Knights of the Round Table wilt we traverse the countryside of Camelot, pressing forth on the wine business and present you our *2010-2011 State of the Wine Industry*.

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Executive Summary

King of Swamp Castle: Please!
This is supposed to be a happy occasion. Let's not bicker and argue over who killed who.

Last year we knew our observations and forecast would not be pleasantly received in the village. There was a fair amount of bickering in the realm over just who killed whom, or oddly from some readers, if anyone had been injured at all. Ours is a business that taketh not kindly to naysayers. We nonetheless girded our loins, dressed in our best armor expecting an incoming barrage of spoiled produce and forecast:

"Flat growth from depressed restaurant sales, higher unemployment levels (exceeding 10 percent by yearend), higher foreclosures, and depressed consumer spending through the year as we seek a bottom. The economy will not return to the market experienced during the past decade. Price points below \$35 are selling but wines between \$50 and \$125 are in a 'dead space,' with only established labels selling. Some wineries will trade hands this year at bargain prices. Distribution has all but ended as a viable sales channel for small wineries."

Many said at the time we were far too pessimistic to predict no growth, yet in hindsight we were pretty accurate on not only that, but most of our prognostication. Where we were not

accurate, we have conveniently left that out of this record to maintain our dignity. Specifically to the growth forecast, we show final 2009 sales ended in a range of 3 percent positive growth to a 4 percent decline, depending on the source cited.

For 2010 we shalt not make thee truly merry as in days of yore, but do bring some cheer so we doth not expect spoiled produce to soil our armor:

"We are forecasting improving conditions in the fine wine business. The trading-down trend will end this year. It's a completed trend that will gradually reverse on itself. Growth in \$20+ price points will develop momentum and end the year in a range 8%-12% higher year over year. Revenue growth in higher priced wine will outpace the growth rate in lower tier wine segments though the best opportunity is still favoring large scale production of modestly priced wine given the National economy and consolidation in the chains and distributors. The forecast is supported by improving prospects for luxury buying from the affluent, slight improvements in corporate spending and emerging improvement in restaurant sales – notably in the white table cloth segment which has been the most impacted in the correction. In addition while there will continue a prominent level of discounting into Q3, we expect improving distributor purchases for the year as depleted wine is reordered. We further believe we will see continued positive results and measured momentum

in the adoption of direct-to-consumer sales tactics. Large farming operations should also fare well with improved water shipments, though the continued increase in imported bulk wine as a replacement for traditional domestic sourced fruit from the Central Valley is a concern.

There are many obstacles still to overcome. We expect persistent financial and economic hurdles nationally which are too numerous to give anything but the shortest of attention to in this report. We do not believe the improving consumer climate will catapult fine wine sales to the high point of the past decade anytime soon. We expect continued downward price pressure in all but those wineries selling on allocation, large scale producers, or established brands in wide distribution. Wineries selling sizeable production above \$50 will again find 2010-2011 a difficult time. Producer profitability in family wineries will be negatively impacted again this year as the higher price paid for grapes from purchases made before the crash are sold in a post-crash market that is still discounting.

There is still slightly too much wine at the producer level and distributors have some SKUs that have received no sales attention for some time. Those wines will be moved at deep discounts through the first two thirds of the year to clear the decks. The impact of higher inventories at the producer level means growers supplying fine wine producers will get less for their grapes on expiring contracts, except in the pinnacle of the quality range" ²

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Value versus Frugality



In the late 1990s, if you had good wine, you could take an aggressive pricing stance with distributors and consumers buying direct. You could hold to your price and if buyers didn't like the price, they didn't need to buy because there was a line at the door. One winery owner at the time said, "I only sell wine to people I like. If I don't like you, I'm not selling you any wine." In a reversal of fortune, today the negotiating power is tilted firmly to the consumer. If they don't like you, they are not buying your wine. That said, reading analysis and press about the U.S. consumer, you might come to the conclusion consumers just don't want to buy anything at all, and if they do buy it better be cheap. We hear sound bites used to put handles on much longer discussions such as "the new normal, the new frugality, and permanent consumer change." But

the U.S. consumer is not homogenous. Unemployed consumers on assistance will make different purchase decisions from blue-collar consumers who have a secure job, retired consumers with a rebuilt stock portfolio, or affluent consumers.

What does your wine customer want? Do they want cheap wine; is it all about price? Looking at retail sales trends, the increase in couponing and growth rates in less expensive bottles of wine, it's easy to draw a high-level conclusion that consumers have become more frugal. There is no question about some consumers dropping out altogether from buying non-necessities. Likewise, it's apparent some wine consumers have established a mental ceiling for their wine purchases, although that describes only part of consumer purchase decision. Who are your consumers now? Are they all iPhone-carrying Millennials? Are they arthritic Boomers or mid-career Gen-Xers? Maybe they want to be part of your club, or maybe they hate your idea of a club? Maybe they are green and want something that is authentic and environmentally-friendly? If your customer's attitudes are changing, what will you do to stay relevant with them? How will you get the answers? What strategic decisions will you make this year to position your winery for future success?

Pricing Decisions

Last year with the economic hardships surrounding us, the foul mood of the U.S. taxpayer, and resultant inventory bulge ensuing from slack retail sales, there were many who thought the luxury goods business was dead. The cold fog of doom settled across the countryside as grim

reapers dressed up as real estate bottom feeders circled the carcass of the fine wine business. Gone were the vestiges of conspicuous consumption and any public celebrations. There were none who made merry. The world was fearful and the expensive wine business was dead. No, it wasn't. Yes, it was.... IT WASN'T!

The Dead Collector: Bring out yer dead.³

[a man puts a body on the cart]

Large Man with Dead Body: Here's one.

The Dead Body That Claims It Isn't: I'm not dead.

The Dead Collector: 'Ere, he says he's not dead!

Large Man with Dead Body: Yes he is.

The Dead Body That Claims It Isn't: I'm not.

The Dead Collector: He isn't.

Large Man with Dead Body: Well, he will be soon... he's very ill.

It really wasn't dead and, to the dismay of the bottom feeders looking for winery foreclosures, has been anything but grave of health. But it was and still is painful. Just how bad was discounting last year? From media reports and the flurry of spam e-mails promoting the next bargain crashing servers, you would expect everyone producing fine wine dropped price at least 20 percent and the most expensive wines were probably discounted the most. We can offer many examples of wineries that had very public discounting programs. However, the notion that the wine business behaved like a group of lemmings jumping off a cliff, executing a

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face plant into the rocky shore en masse, appears to be unfounded. Would it surprise you to know that more than 70 percent of wineries did not lower the price of their most expensive wine in the market?

“...more than 70 percent of wineries did not lower the price of their most expensive wine...”

In SVB’s Annual Wine Conditions Survey,⁴ we asked respondents to tell us what the retail price of their most expensive SKU was both before and after the crash.⁵ The qualifier was that there needed to be at least 1,000 cases produced. The short answer is that the average of all respondents’ highest-priced SKUs was \$56 before the crash and dropped only 4 percent after the crash. That’s hardly an alarming drop. But like the industry as a whole today, the arithmetic average almost never describes what is really taking place.

In Figure 1, the horizontal axis is price, and the three bars are wineries that decreased their price, made no change or increased price. The different colors in the stacked bar chart show what they opted to do with their volume of production. So for example, in Figure 1 the top left (green block) says that 12.78 percent of those surveyed decreased both their price and the volume produced. The surprise is really in the middle column — 63 percent made no change to price at all. An additional surprise is in production choices where nearly 65 percent of all respondents said they either left production unchanged, or even increased their volume.

This information is interesting because it focuses on a key component of all wineries production — their flagship wines. It partially reveals a phenomenon we see time and time again: The market for any given producer’s top brand is still doing well. In fact, as we talk to brokers and wineries, we find (not surprising to us) that there is a shortage of juice to go into those wines in many instances. Discounting is not a figment of your imagination. The pain point for wineries is most often in their higher-volume mid-priced SKUs — wines that are more available to the consumer.

The implication for marketing is intriguing. It suggests to us that, at least for flagship wines, in an era when consumers look for value, winery owners don’t view lowering price as the solution to increased value. At a minimum, it suggests that they rely less on price and more on something else to create value for the consumer in those wines. That “something else” is different between winery models, but should be of great

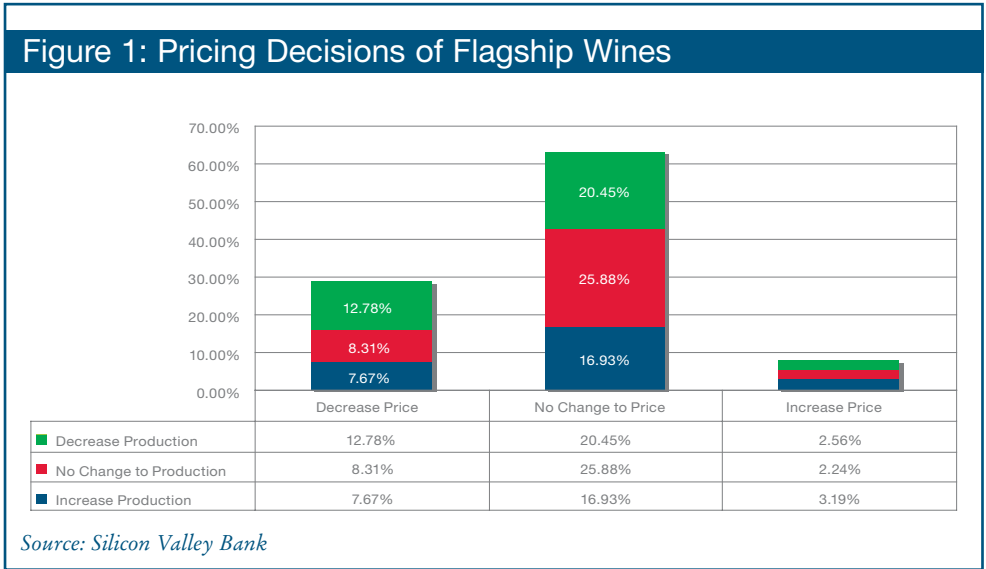
interest to owners because at the core of that solution is a partial answer to the question: What tactics should I employ to sell my slower moving wine?

Is the change permanent?

Sir Bedevere: *What makes you think she’s a witch?* ⁶
Peasant 3: *Well, she turned me into a newt!*
Sir Bedevere: *A newt?*
Peasant 3: *[meekly after a long pause] ... I got better.*

One of the most debated topics in the wine business last year continuing into this has been the question of the permanence of consumers trading down to lower price points. One day the fine wine business was admired for its princely charm and the next day <poof> it was a newt. Well ... it is getting better.

“Price compression made an already littered field of brands even more confusing...”



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We know there has been historic discounting taking place and we will see even more taking place at least through mid-year, if not through Q3. In many instances, price points have been reset to lower tiers and producers are now working through the mechanics of adjusting their costs to recover their margins. A winery that pre-crash might have sold a \$35 wine with modest profitability woke up one day to find new neighbors from the high-rent district above \$50, dropping their price and shoving their way into the neighborhood. As has happened in many consumer products over the past two years, price compression made an already littered field of brands even more confusing by pressing more brands into still narrower pricing tiers. That makes the non-price decisions in brand building that much more critical.

"Prices have reset to lower tiers and it will take some time to fully recover to the place industry participants have enjoyed seeing build over the past 15 years."

It was very difficult for winery owners to make pricing decisions last year. Like everyone, they were short on information about consumption so they had to use instinct, a good guess and consult a sorcerer. But despite the gloom cast from the still-burning economic train wreck, conditions for fine wine sales weren't quite as bad as they seemed, and hopefully you didn't overreact.

It's important to remember this is the de-stocking phase of a normal

inventory cycle and is always the worst part for producers. Think of it this way: Distributors, when confronted by a change in demand or supply, stop ordering while they work down their stocks.⁷ Once they reach their optimal inventory level, they start ordering again to match depletions. The same is true for restaurants and even consumers with cellars. Wine didn't stop selling in 2009; distributors just slowed their ordering and the producer experienced more depressed sales than what was actually being consumed. But since there is no non-bearing acreage hangover (except in Oregon), the de-stocking phase will end in 2010. That, in and of itself, even with no change in consumer demand will make for higher producer level sales this year.

Now to the question: Is this a permanent change? I remind everyone the term "permanent" represents a rather long time horizon. So the answer is no, but with a limitation. Prices have reset to lower tiers and it will take some time to fully recover to the point which has been built during the previous 15 years. Actual recovery will take time to sort through as unemployment is lagging the positive GDP recovery, businesses have reduced spending on client entertainment, restaurants are serving more value-conscience consumers, and plenty of uncertainty remains around financial markets, government spending, sovereign defaults and credit availability. This is not a V-shaped recovery and, as we said in last year's *State of the Industry* report, *"The economy will not return to the market experienced during the past decade anytime soon."*

Distribution

King Arthur: Can we come up and have a look? ⁸

French Soldier: Of course not. You're English types.

King Arthur: What are you then?

French Soldier: I'm French. Why do you think I have this outaaaageous accent, you silly king?

Sir Galahad: What are you doing in England?

French Soldier: Mind your own business.

The Backdrop

The large wholesale partners in the business locked themselves inside their castles last year and pretended they didn't know the small wine producer.

Winery Owner: Good morning Sir
Big Distributor: I was wondering how you were doing selling my wine this year?

Big Distributor: Mind your own business you silly red-headed step child!

One day you had a partner and the next day you had an uncomfortable alliance. Where did the love go?

When SVB began its dedicated wine practice in the early 1990s, it was common to see successful business models in nearly all volume segments and price points. Small brands making a few thousand cases of super premium wine seemed to thrive right alongside estate operations making 10,000 cases, negociants making 50,000 cases of popular premium wine, and larger

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scale wineries making 100,000 cases and more. Each had a very similar selling strategy: They moved wine through a nationwide distribution system and sold a little in their tasting room. A very small winery might not make a lot of money, but it could at least break even and find several distributors willing to work with them.

The foundation for selling has been morphing for 20 years — slowly until recently when we now witness the almost complete consolidation of both the distribution system and the large retailer accounts for both chains and restaurants. Now the relationship between distribution and the family winery can kindly be described as in transition.

SVB has been underscoring the trend illustrated in Figure 2 for at least the past seven years, and encouraging both clients and prospects to consider their place with this chart as a backdrop for a discussing their business model. But when the business is working, it's hard to change.

The Crash

In 2009 the Great Recession brought the discussion into focus and kicked out the supports of moth-eaten strategies. Restaurants whittled back their inventories of expensive wines, opting instead for lower priced offerings. White tablecloth restaurants that served \$100+ wines were caught up short when conspicuous consumption became politically incorrect. Distributors enforced their own financial realities and dropped hundreds of small brands from their portfolios, then slowed or halted orders while they worked

down inventory levels. Causing even more confusion, large wine companies like Constellation realigned their supply chain, focusing their products into fewer distributors and leaving their former distributors scrambling for replacement wine brands. Trying to key in on a perceived opportunity, new regionally focused distributors started up to capitalize on the vacuum left from the big players that had abandoned smaller markets. But since the market crash, we've noticed some of those companies pushing out payment terms and, in some cases, those debts have gone bad when their doors closed.

The Response

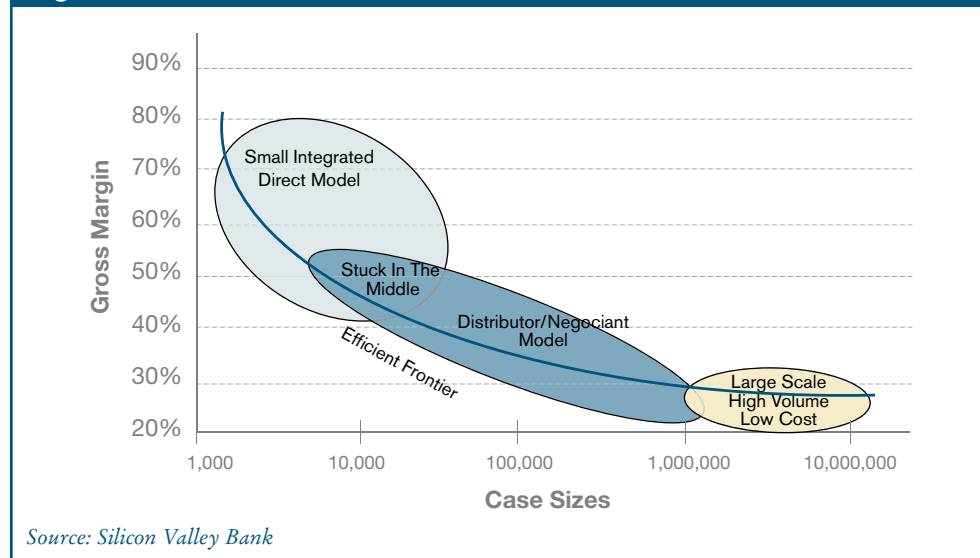
What is abundantly clear today is the available sales channels for a winery are firmly dictated by the size of the operation and gross margin of the wine sold. The wineries with a proverbial foot in the boat and one on the dock wishing they could sell all direct but still managing cobbled together national distribution

and sales relationships. Those businesses are feeling financial pressure to make a strategic but difficult change away from that which might have been successful in the past. For most small brands, the best opportunities lie in developing direct marketing strategies, both to the trade and consumers. That starts by understanding who your customer is and employing low-cost consumer research and survey tools, then aligning your strategy and product with the right grape suppliers and sales channels consistent with the scale of your business.

"The new normal for your winery should not be fully defined by the fate of a damaged consumer, but by your own sales strategy."

We acknowledge that it's very difficult in this economy to change your model, right size production, align resources and develop new digital skill sets that evolve

Figure 2: Business Models



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a business away from what may have been your model for the past decade or more. We encourage you to remember that doing so can be coordinated with a strategy to shrink less profitable SKU's, creating a level of cash that could support the change. Some wineries will no doubt continue without reviewing their sales strategies in the new markets we face and will be disadvantaged. Their strategy will be to hope everything returns to "normal." As we consistently say, "Hope is not a strategy." The new normal for your winery should not be fully defined by the fate of a damaged consumer, but by your own sales strategy.

Restaurants

[taunting from the castle wall]

French Soldier: *I don't want to talk to you no more, you empty headed animal food trough wiper. I pass gas in your general direction. Your mother was a hamster and your father smelt of elderberries.*

Sir Galahad: *Is there someone else up there we can talk to?*

French Soldier: *No, now go away or I shall taunt you a second time.*

Yes, for you Python devotees, we had to clean that quote up just a little.

The air in The Castle of the Lord of Restaurant was fouled last year by the stench of rotting employment data, the lack of merriment and barren tables. Grog peddlers almost had to scale the parapets to seek an audience with Lord Restaurant to present a new wine for the castle wine list. Once inside in the presence of the master of the castle, the peddler was often

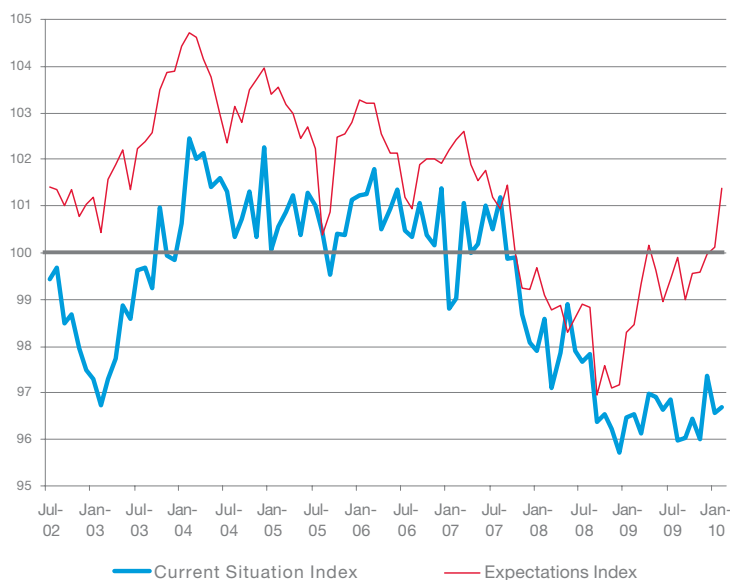
disheartened to learn the Lord, too, was a little short on sustenance and was unable to assist in the sale of one more \$35+ wine or participate in another by-the-glass-program. Despite these challenges, winery owners were valiant indeed, not running away as Brave Sir Robin⁹ but pressing on.

Most wineries selling fine wine move between 20-30 percent of their product through restaurants. So the changes that have taken place in restaurants in 2009 have been of particular interest to the fine wine business. That said, the changes we've seen started in early 2007 when the restaurant industry began a contraction phase according to the National Restaurant Association (NRA). That downward trend was later magnified by cuts in corporate T&E budgets and a recession-based shift to more at home

entertaining. When negative press from the big bonuses for CEOs and Wall Street bankers collided with news of bailed-out insurance giant AIG's lavish spending on corporate retreats, conspicuous consumption of all types was snuffed out. According to Nielsen, the most impacted part of the restaurant trade has been the independent white tablecloth restaurants —, precisely the target accounts in which fine wine is sold. Examining the NRA Current Situation Index¹⁰ (Figure 3), we note that as of this writing the index is still reflecting contraction for the 30th consecutive month.

The good news is the restaurant trade is bottoming and slowly crawling out of its bunker. While no exceptionally strong indicators are yet present showing a definitive restaurant recovery, several analysts have recently upgraded some

Figure 3: Current Situation & Expectations Indices



Source: Source: NRA; Values Greater than 100 = Expansion; Values Less than 100 = Contraction

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key restaurant stocks including Brinker, Darden and Ruby Tuesdays, citing increased sales and foot traffic. Restaurant industry employment also has shown improvement in the early part of 2010 — the first growth since May 2009.¹¹ The NRA Expectations Index¹² in February was at its strongest level in 29 months and, with the second consecutive month over the 100 level, signifies expansion in the forward-looking indicators. There is also growing consensus that corporate spending on T&E and spending from affluent consumers is improving. According to Malcolm Knapp, President of the New York-based consulting firm bearing his name, families earning \$70,000 or more are beginning to spend again as they are less affected by job loss and are likely to come out of the recession sooner. Knapp cites this as a target demographic for the restaurant segment, making up about 28.5 percent of U.S. households but accounting for about 50 percent of food eaten away from home.

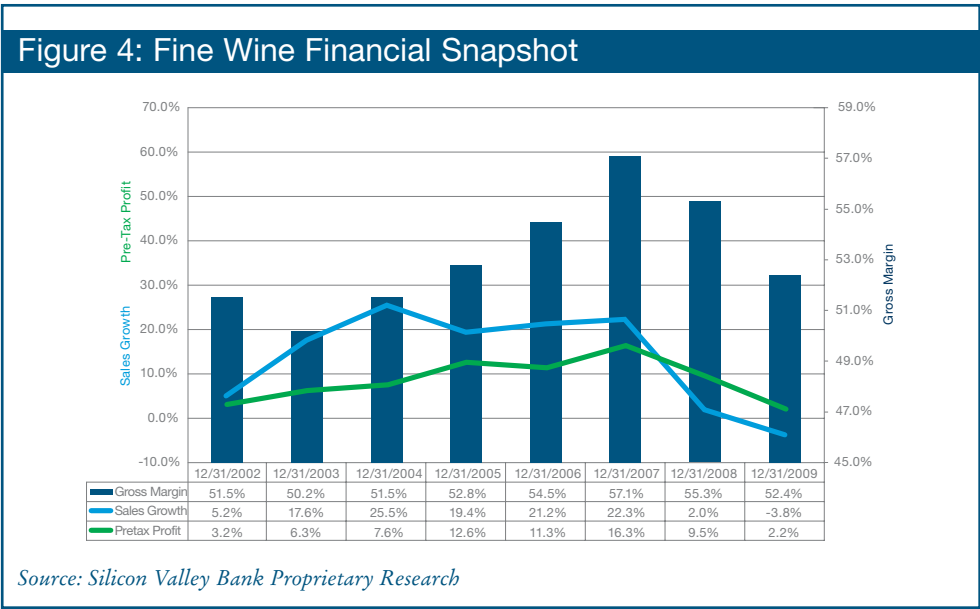
Financial Performance of Wineries

[King Arthur cut's off the Black Knight's arm]
King Arthur: Now stand aside, worthy adversary.¹³
Black Knight: 'Tis but a scratch.
King Arthur: A scratch? Your arm's off.
Black Knight: No it isn't.
King Arthur: What's that, then? *[Points at severed arm on the ground]*
Black Knight: ... I've had worse. Come on ya pansy.
[King Arthur cuts off the Black Knight's last leg.]
Black Knight: All right, we'll call it a draw.
[King Arthur rides off]
Black Knight: *[Black Knight just a stump calls after King Arthur]* Oh, oh, I see! Running away, eh? You yellow bastards! Come back here and take what's coming to you! ... I'll bite your legs off!

Many of our fellow travelers had more than a paper cut when reviewing financial results in 2009. A few lost a limb here and there yet soldiered on through the red ink. All things considered, the campaign was successful. Nary a one was alone in battle and many fared well compared to their comrades in other businesses across the U.S., some of whom were winnowed out by a combination of negative consumer events and credit woes. All in the land were encouraged by the bravery displayed by the knights who conquered 2009 and, at the end of the year, they drank their fill.

“...as it relates to wineries, ‘average’ is not descriptive of the health of the industry.”

Reports using proprietary but still unaudited financial information from SVB's PGA¹⁴ showed full-year sales growth through Q4 was a negative 3.8 percent for the year, roughly in line with our 2009 projection of flat producer level sales in fine wine. For comparison, Nielsen Scan Data showed total wine sales for the >\$20 category ended 2009 with a drop of 3.7 percent, while the total wine category grew 2.8 percent when lower-priced wine sales were included. Gomberg-Fredrickson noted fine wine shipments from all warehouses were significantly stronger in Q4. In the case of the one warehouse that reported their full year results, sales were off 16 percent through the first half of the year, but grew 30 percent in Q4 ending the year flat which was our forecast for 2009.



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Negative sales growth in the fine wine segment has not been witnessed for decades nor the degree of the recent bloodletting, but there is an encouraging part to the soft result for the year: We appear to be moving up again.

Consistent with reports from the warehouses noted previously, SVB PGA data for nine months ended September 30, 2009 showed sales were tracking to 10-percent declines before finishing the year with a moderately successful quarter leading to low single-digit declines.

Confirming the positive Q4 data in the Conditions Survey, we asked wineries to compare the last good Q4 (2007) with 2009 holiday sales. Sixty-four percent reported their holiday sales were the same or better than Q4 2007 (Figure 5). Verbal interviews with wineries, brokers and restaurateurs also indicate improved conditions in Q1.

Examining gross margin and pretax profit in Figure 4, the fine wine segment has cycled back to the lowest levels of profitability since 2002 — the bottom of the tech recession. Many owners still might expect the recovery in fine wine to be V-shaped and match the last recession, but there is a difference this time compared to the recession experienced in the early 2000s. That was a shallow and fast recession. We were led out of it by increasing home values bolstered by a massive amount of liquidity looking for an investment.¹⁵ This time we don't believe there will be a fast recovery with the national economy

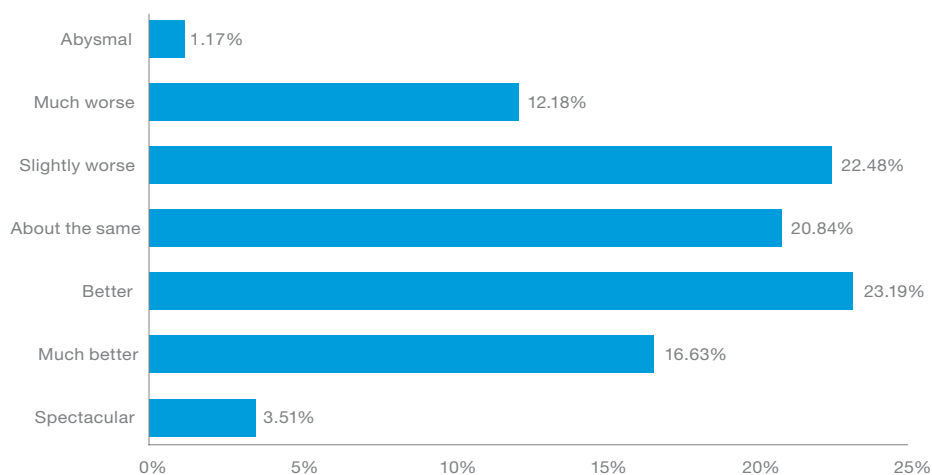
for reasons too numerous to give any meaningful treatment. The slower recovery will continue to produce a drag on the financial performance of family-owned wineries at least through this year as higher cost inventory moves through the income statement. That will likely continue through 2011 and longer as grape contracts will not have been fully renegotiated to improve sagging margins from lower-priced wine sales.

How do winery owners view their own financial health? That's a question that we posed in the Conditions Survey and those results are displayed in Figure 6. The good news is that about 70 percent describe themselves in the range from "good" financially, to "rock solid." But nearly 30 percent describe themselves as falling in the range from "slightly weak" to "dead."¹⁶ Not too much should be read into the 7 percent who report their financial condition as "very weak" or "on

life support" as it's a small number and slightly better than national statistics for small business.

In the *2009-10 State of the Wine Industry Report* we forecast the coming financial landscape would support higher levels of what we coined bargain transitions, a nice way of saying distressed sales. In fact, we have seen that happen from our perch on the tower wall, but what is clear is: 1) there are a lot more buyers than sellers for established wine brands and 2) sellers have a remarkable penchant for holding out for a fair price. The consequence is there are fewer transactions closing than what casual observers might otherwise suppose. We still expect a level of distressed transactions consistent with the survey results of very weak wineries in Figure 6.

Figure 5: Holiday Sales in 2009 vs 2007



Source: Silicon Valley Bank

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Trading Sideways

King of Swamp Castle: You only killed the bride's father, that's all.¹⁷

Sir Lancelot: Well, I didn't mean to.

King of Swamp Castle: Didn't mean to? You put your sword right through his head.

Sir Lancelot: Oh dear... is he all right?

Perceptions are at times reality. Some days you can ignore certain things, but that sword sticking out of your head — well, that's a hard one to miss. There is a general tendency we all have when discovering something we don't want to believe. We see first, then ignore what we see, surrender to the reality of what we saw and, finally, incorporate the conclusion into our beliefs. We seem to believe a trend will continue until it doesn't. That's what happened to a lot of people who were in the stock market in early September of 2008. The stock market had gone up and down, but over time always up ... until it didn't.

The term “trading down” has been that sword in the head of the fine wine business. It's not something anyone wanted to notice, but it was hard to miss and now, an accepted belief. SVB began noticing and publicly commenting on the trend in 2008 — early enough that one industry pundit, when asked to comment on our point of view, was quoted saying, “there is no evidence the consumer is trading down today.” In fact, conceptually it was a new trend, so maybe there was little evidence, but it was a real trend nonetheless as history has shown.

Two years later we've grown tired of people talking about trading down because, frankly, we believe there is no evidence the consumer is trading down today. What? There is no evidence the consumer is trading down today. It's a dated trend. The consumer has already traded down (past tense). There is no indication the consumer will trade down more unless the economy stops its recovery or fear rolls back into the markets. Today we think the consumer is trading sideways and bumping along the bottom of a recovery. But as the year progresses, we have every reason to believe the consumer will start trading up again.

While we are sure that sounds great to the principals in many family-owned wineries, let's clarify what that means and doesn't mean. We will reinforce and repeat that we are not even close to suggesting a V-shaped rebound in the fine wine segment is on the way. We expect the recovery to be muted and a long process. We aren't implying discounting has entirely ended, that the unemployment rate will drop below 9 percent this year (it might get to 9 percent) or that there is a wholesale move afoot to return to the conspicuous consuming ways of the 1990s and mid-

2000s. We are simply emphasizing that the consumer, in a bottomed and improving economy, on average will be more willing to spend slightly more for a bottle of wine compared to last year. It's trading up, but it's the new normal version of trading up and just a baby step on a long path to better days.

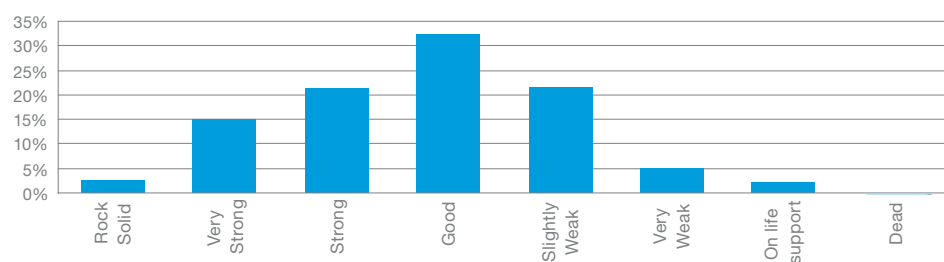
The Shape of the Opportunity

Sir Bedevere: ...and that, my liege, is how we know the Earth to be banana shaped.

King Arthur: This new learning amazes me, Sir Bedevere. Explain again how sheep's bladders may be employed to prevent earthquakes.

For years starting in the early 1990s we saw consumers in the U.S. grow their net worth, spend forward on credit, and develop a sense of substance from the inflated values in their homes. That feeling of financial safety along with the French Paradox and continuing studies on the health benefits of moderate consumption, spurred increased consumption of wine at higher and higher prices. The lowest ends of the wine pricing universe saw declines in sales, while the highest saw growth

Figure 6: Financial Health of Your Winery



Source: Silicon Valley Bank

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that was limited only by production and planting. In some cases, luxury brands were created with more of a production mindset, but still found acceptance in the market for consumers basking in the warmth of the largest creation of wealth the country had ever experienced.

Last year the shape of that opportunity curve radically shifted as consumers traded down and the affluent consumer began to question the safety of their wealth. The sound bites we hear now from the media are statements such as average U.S. underemployment is now about 17 percent.¹⁸ The average consumer has become a frugal spender. Average consumers are flocking to discounting and couponing as never before. But “average” is not helpful when forecasting the future shape of an opportunity curve for luxury wine sales. The shape of that curve, which used to look like a sideways and backwards ‘S,’ now looks like a banana. (Not very scientific we know, but it’s what it looks like. Read on ...)

While the economy clearly matters, the industry is nonetheless recession-resistant. Why? Because the product is considered closer to “need” versus “want” status by all wine drinkers and in the case of fine wine, is sold to people of greater means who are less impacted by recessions.

Affluent Consumers

Chateau Anthrax has a harder row to hoe than you do. After all, your winery’s name is infinitely better. But all wineries have to refocus on hospitality and the customer’s experience, which may not be exactly like that of the maidens of the Castle Anthrax.

Keep in mind, you aren’t just selling wine. You are selling an experience: what the wine does for your consumer. Affluents more than any class of consumers can have any “thing” they want. It’s an experience they desire, and have it they will!

Zoot: *Welcome, brave sir Knight. Welcome to the Castle Anthrax.*

Sir Galahad: *The Castle Anthrax?*

Zoot: *Yes... it's not a very good name, is it? Oh, but we are nice, and we'll attend to your every need.*

Affluents represent a much smaller percentage of the consumer by number, but have far greater impact on retail spending. Even when the unemployment rate climbed above 10 percent in 2009, affluents did not fully retreat from spending on luxury goods. According to survey information, the “Absolute Affluent”¹⁹ continued spending on luxury goods at pre-crash levels throughout 2009, but other affluent segments went into hiding. This affluent spending pattern was reflected in the performance of luxury retailers in 2009. Absolute luxury retailers such as Hermès²⁰ and Burberry Group (OTC:BRBY) saw quarterly gains in top-line sales even in the worst part of 2009, but mass-market luxury retailers such as Nordstrom (NYSE:JWN), Saks (NYSE:SKS) and Tiffany’s (NYSE:TIF) delivered much more disappointing results.²¹

Results began to change in the holiday sales period. Hermès continued their good results in Q4 and expanded by 20 percent in the Americas, 12 percent in Asia, and 9 percent in Europe, reporting

full-year sales up 8.5 percent and profits up 4.1 percent. Mass-market luxury retailer performance has now joined in the improvement as the retail environment in luxury consumption starts to move into other affluent segments. Tiffany’s, for example, reported Q4 (as of January 31, 2010) sales up 17 percent across a broad range of their price ranges and product offerings. LVMH Moët Hennessy Louis Vuitton (MC.FR) posted an 11 percent surge in first-quarter revenue, beating expectations. The company noted distributors began replenishing stocks of wine, watches and high-end jewelry, the weakest performers in recent quarters for the company and the industry. Saks posted March same-store sales up 12.7 percent and Nordstrom was up 16.8 percent. That can only mean that those with wealth who had gone into hiding are now more encouraged with their financial security and are now loosening the purse strings. Analysts are now gradually raising their forecasts on the luxury markets. According to a study released in March 2010 by the trade group Fondazione Altgamma, global luxury goods industry sales will grow 5 percent in 2010.

With fine wine sales, we have noted the same trends reflected in luxury retailing. The absolute cult brands that sell on an allocated basis — those with long waiting lists of customers just to be offered a bottle — sold out their wine with no price adjustments in 2009. But just below that level, 2009 was a difficult time, particularly for wineries selling wine above \$50 if they were doing so in any significant volume.

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The graphic depiction of this phenomenon in wine sales can be seen in Figure 7. (Hey ... it is banana-shaped, just like the shape of the world!) We asked wineries to tell us how much they felt they would grow in 2010 and then sorted the answer by the winery's average retail price point. To get at a level of conviction, we netted out the difference between those who believed they would have 5 percent growth or more from those that believed they would shrink 5 percent or more, and ignored the responses that forecast limited or zero growth. What we are left with is an interesting opportunity curve of the industry that shows wineries producing wines at the lowest and highest average case price showing the strongest conviction about their opportunities in 2010. There is a secondary trend noted in the \$20-\$40 price range, again consistent with our observation in the market. The trends from the luxury retailers tell us that the demand for higher-priced wines should be improved this year.

Market Segmentation

King Arthur: Go and tell your master that we have been charged by God with a sacred quest. If he will give us food and shelter for the night, he can join us in our quest for the Holy Grail.

French Soldier: Well, I'll ask him, but I don't think he will be very keen. Uh, he's already got one, you see.

King Arthur: What?

Sir Galahad: He said they've already got one!

King Arthur: Are you sure he's got one?

French Soldier: Oh yes, it's very nice!

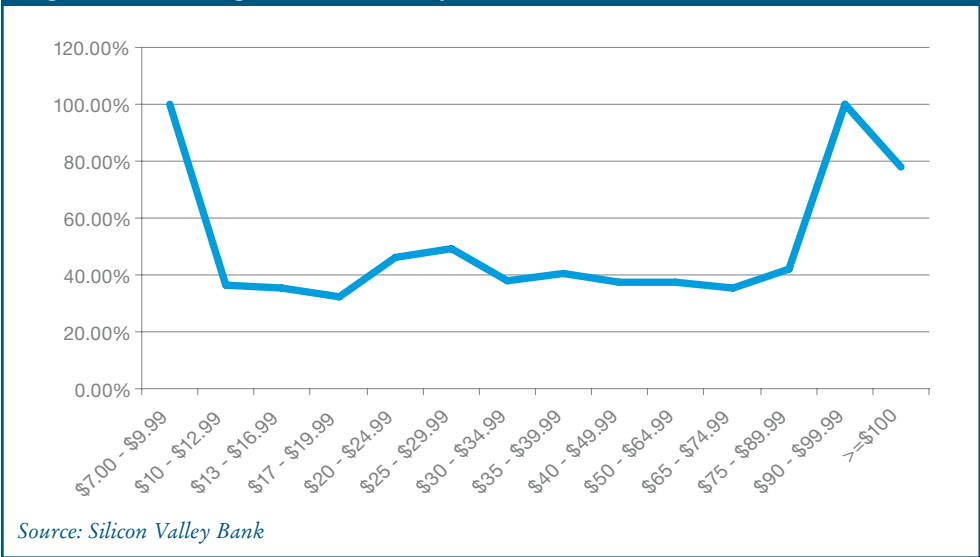
Surveying

How do you know what your customers want? What if they already got one of the items you want to sell them? And what if you lower the price of your luxury wine? Will they pry some hard-earned quid

from their money belts or is it possible lowering the price could drop your wine into a price band frequented by a consumer class who knows not your label or its regal heritage? Maybe they want an edgier-looking bottle. Maybe they like wines that are all fruit with a little residual sugar and aren't fond of a balanced hand-made wine. Then again, it's also possible that by not discounting, you will miss an opportunity to sell to your existing buyers who have made decisions about how much they will spend on any one bottle of wine, or discovered a better value wine that dropped its price to get into your traditional pricing range.

If the sales velocity of your wines slowed last year, you need to make some decisions about changes to the quality, price, how you market and sell the wine, and the appeal of your products to buyers. But those choices shouldn't be made without some study of the individuals who buy your wine already, or an understanding of the characteristics of people to whom you want to sell.

Figure 7: Strongest Growth By Retail Price Point



“...wineries that won't take on water will be those who devote time and resources to developing customer level preference information.”

There is a saying carpenters often cite: “Measure twice. Cut once.” Even weekend carpenters hate to make a mistake measuring and be forced to make another trip to the lumberyard. But when it comes to pricing decisions and marketing, family owners too often skip the measuring step. They estimate once, make a decision, and then adjust with thousands of dollars in lost opportunity in play. Instinct in a “new normal” may be deceptive.

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In this market where the rising tide doesn't float all boats anymore, the wineries that won't take on water will be those who devote time and resources to developing customer-level preference information (CRM) and embed curiosity into their culture. Questions such as: Why did members leave the club? How old are my customers? Do younger buyers purchase different SKU's? How do my customers prefer to communicate? Do they like to come to consumer events, or do they really prefer to entertain at home with my wines? How often do they buy? Are older buyers purchasing more than younger buyers? Are those who buy my wine using social media? What is the most a given age group paid for a bottle of wine in the last six months? The list of questions is endless and each drives at actions that can be taken to improve sales and marketing.

There are many ways to collect data, including asking the sales force to collect information from their drive-arounds, asking tasting room staff to do verbal interviews, using highly-evolved CRM tools, and taking advantage of inexpensive or free online survey tools that wineries can employ to get at some of these answers.²²

Demographics

With your market research department now formed, how do you group customers? Are they male or female? Young or old? Have they enough pence to make a purchase? We are aware of one tasting room that profiles each wine buyer and checks off a box on the internal sales document to group buyers by demographics. From that data, it knows in large terms who is buying what and

how much they spend. That information helps make better marketing decisions. Of course, sometimes the guess is wrong, but most of the time it's close enough.

King Arthur: *Old woman.*²³

Dennis: *Man.*

King Arthur: *Man, sorry. What knight lives in that castle over there?*

Dennis: *I'm 37.*

King Arthur: *What?*

Dennis: *I'm 37. I'm not old.*

King Arthur: *Well I can't just call you "man".*

Dennis: *Well you could say "Dennis".*

King Arthur: *I didn't know you were called Dennis.*

Dennis: *Well you didn't bother to find out did you?*

King Arthur: *I did say sorry about the "old woman", but from behind you looked...*

Each generation — or cohort as it is called by demographers — has its own palate of generalized experiences that support its own values and tastes. Here's a test: Do Millennials, Gen-X, Boomers, or the Greatest Generation most value club memberships?²⁴ The answer according to social anthropologists is the Greatest Generation. You may have noticed how many Elks, Moose, Masons and Grange Hall organizations are in disrepair. That's because the Greatest Generation has less spending power today and are getting along in years and Boomers didn't follow their lead to replace them in social clubs. Those in the Greatest Generation have a different idea of socializing compared to

Millennials.²⁵ That information might make you adjust your club strategy, depending on the consumer demographics in your club.

Millennials have been consistently noted as the next greatest opportunity for growing the wine business and indeed, the Millennials by all accounts are more tuned into wine, find more pleasure in it and show a stronger interest in the product compared to their largely Boomer cohort parents. Studies show this generation is less divided by cultural and geographic boundaries than ever before. They're closer socially and more homogenous even between different countries and cultures because of the advent of e-mail, text messaging and online social networking — channels which ought to in theory make life easier for wine marketers. They are more interested in a work-life balance than their parents were, and more group-oriented.²⁶ But the question you should ask is: Are Millennials buying fine wine? Largely the answer appears to be no. That said, if they are of drinking age (most are not), they have a fair amount of discretionary income.

"...are Millennials buying fine wine?"

Purchasing Power Post-Crash

According to the Nielsen Company, last year the Boomers spent the most on wine at \$125 per capita, followed by Greatest Generation who spent \$124 per capita, Gen-X \$78 per capita, and the Millennials who brought up the rear spending \$61 annually (half the spending of their older and wiser cohorts). The

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data are not broken into price points per bottle, but if one can assume the Millennials drink about the same volume as the Boomers,²⁷ it can be intuited that Boomers are spending about twice as much per bottle as the Millennials. The Wine Market Council further noted in their 2009 report on wine trends that Boomers still have almost twice the impact in the purchase of wine for the core drinker category,²⁸ compared to either the Millennials or the Gen-Xers.

Actual spending by the Boomers is in contrast to a comment we made at the bottom of the market crash in April of 2009 that said, *"For that segment of Baby Boomers who have seen their net worth drastically reduced and who have been the prime target of wine marketing for nearly 20 years, a \$50 bottle of wine is now permanently out of the question for a normal purchase."* Certainly the statement is true for those Boomers nearing retirement who had to alter their previously spendthrift, credit-enhanced and saving-averse ways out of need. And it's also true that wine over the \$50 price point has slowed in the market. But the comment was overstated as the spread of wealth and income across age groups suggest the Boomer cohort is reacting to the diminution of their wealth in a little different manner than we supposed.²⁹ Paraphrasing Mark Twain's quote in his letter to the *NY Sun*, as it relates to the fine wine business, reports of the Boomers' demise have been greatly exaggerated.

"...reports of the Boomers' demise have been greatly exaggerated."

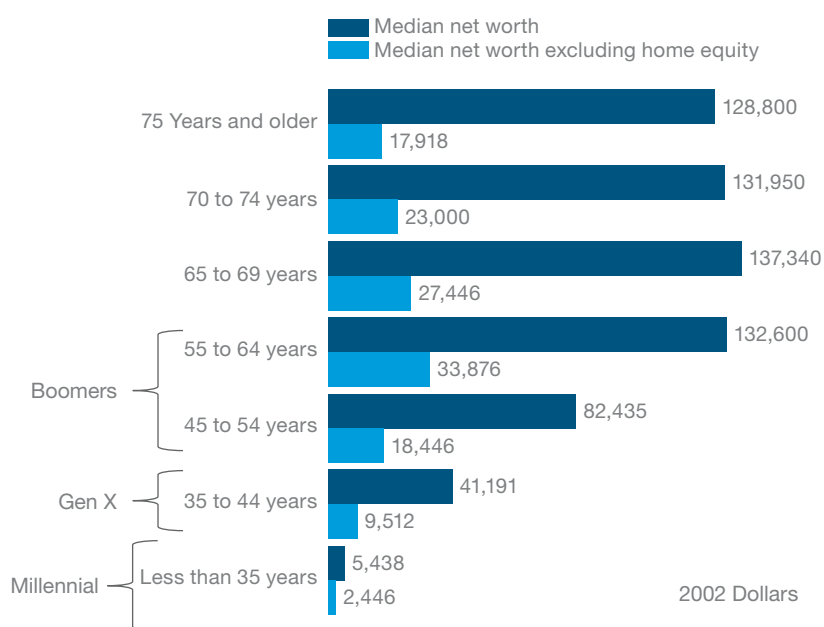
Cohorts with Capacity

Demographics and profiling can help us understand one's *willingness* to buy, but economics comes into play when it comes to understanding one's *capacity* to purchase a luxury good. To get a sense of which cohorts and age groups have the capacity to purchase luxury goods, we looked to information provided by the U.S. Census Bureau on both wealth and income levels. The last information we found on wealth broken out by age was from the 2002 survey year released in April of 2008 (Figure 8). It wasn't precisely broken out by cohort range, and the wealth numbers using 2002 survey information are slightly dated. That said, the market correction probably reversed wealth from 2009 back to 2002 levels, so the information is close enough for making the point. The data reveal that the Greatest Generation still has the most wealth of

the generations, followed closely by the Boomers, dropping significantly with the Gen-Xers and again with Millennials having amassed about 2 percent of the Boomer wealth early in their careers.

As previously noted, the National Restaurant Association tracks households making more than \$70,000 as they are the ones most likely to dine out and less impacted by recession. We reviewed Americans sorted by age in the top 20 percent of all wage earners. That group roughly starts at \$100,000 per household and intuitively would be the wage earners most likely to significantly impact fine wine sales. In Figure 9, we note again that the Boomers lead the pack in the highest paid, followed by the Gen-Xers, the still-working Greatest Generation, and last again are the Millennials.

Figure 8: Median Net Worth By Age – Who Has Wealth?



Source: US Census Bureau – April 2008

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Finally we reviewed the unemployment rate sorted by age post-crash and found the severity of the unemployment rate today is inversely related to age. Said plainly, the youngest have the highest unemployment and the oldest non-retirees the lowest unemployment rate. By cohort, the latest data show 16 percent unemployment for the Millennials, the Gen-Xers about 9 percent, and the Boomers hovering in the low 7 percent range.

The clear reviews of the data indicate that the Millennials may someday be the center of a family winery's customer demographic, but post-crash and probably for the next decade, they are unlikely to matter as much as the Boomers and Gen-Xers when purchasing luxury wines. Their palates and wallets will grow, so the wineries that have lower priced SKU's will find this a fertile marketing opportunity that will bear longer-term results.

"Millennials may someday be the center of a family winery's customer demographic, but post-crash and probably for the next decade, they are unlikely to matter as much as the Boomers and Gen-Xers when purchasing luxury wines."

Electronic Support

Electronic support seems to have its own lifecycle of introduction, adoption, misuse, correct use, and finally acceptance of some defined use by the masses. Throughout these stages, so that no traveler in the land need consult the Book of Armaments, support business will form beneath thy

feet to both enlighten and give application to the newest and greatest weapon.

King Arthur: *How does it... um... how does it work?* ³⁰

Sir Lancelot: *I know not, my liege.*

King Arthur: *Consult the Book of Armaments.*

Brother Maynard: *Armaments, chapter two, verses nine through twenty-one.*

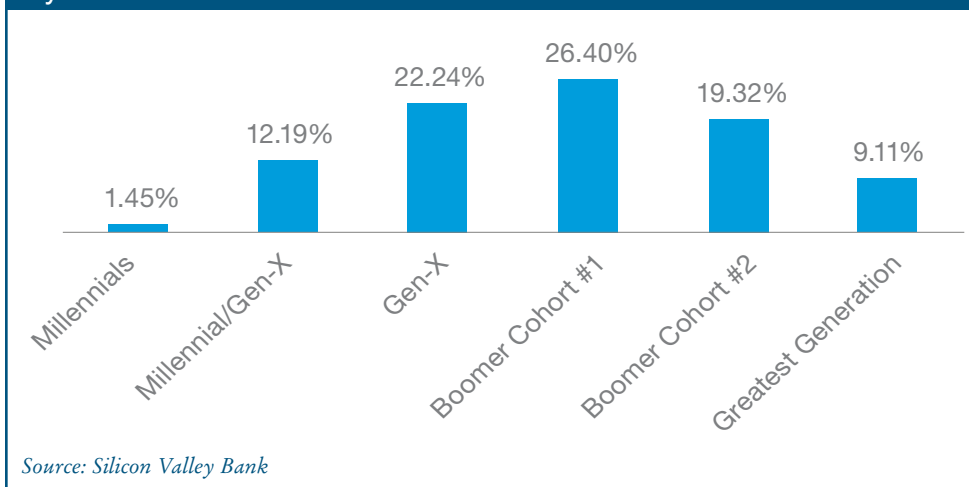
Cleric: *[reading] And Saint Attila raised the hand grenade up on high, saying, "O Lord, bless this thy hand grenade, that with it thou mayst blow thine enemies to tiny bits, in thy mercy." And the Lord did grin. And the people did feast upon the lambs and sloths, and carp and anchovies, and orangutans and breakfast cereals, and fruit-bats and large chu...*

Think back not too long ago and most of us still remember when the e-mail era began and some early adopters used it as

a cost effective way to send mass e-mails to lure people into purchase decisions with discount offers.³¹ That was cool, until the term "e-mail blast" later became synonymous with spam³² and lost its usefulness. Then the Web became real and wineries all got "Web pages." That was pretty cool too, because it meant computers were connected with each other. But nothing happened with sales until the advent of electronic shopping carts, faster modems, fulfillment and the addition of POS tools. About that time we started driving eyeballs to our sites and became obsessed with clicks, thinking a sale was all about the number of at bats, versus the quality of the plate appearance. More recently we have seen the dynamic growth and evolution of "social media."

Many early adopters of social media have their business profile pages up and running. It's easy enough to get a Facebook page, but is it helping you sell? Just what is your digital media strategy? And what about you Twits? (I think I'll leave

Figure 9: Composition of the top 20% of US Wage Earners By Cohort



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that discussion for the present ... mostly because I don't get Twitter yet.) But rounding back to market segmentation, are you targeting mature affluents or are you targeting the Millennials with your social media efforts? You might be getting friends and followers, but what is social media creating for your brand image? Is that positive or negative? Who uses social media anyway?

Of course, the answer to the last question is evolving as each year the users of social media grow and the masses discover the power of that connectivity. But it may surprise you to know that in one survey of affluents recently, 70 percent of people over 40 and nearly 80 percent of total affluents say they have a profile page on a social media platform, but its use is to gather information about a purchase decision rather than actually buying something. In reality, the evolving use of social media may be to connect with your customers and hear what they think, more than specifically selling.³³

"...70 percent of people over 40 and nearly 80 percent of total affluents say they have a profile page on a social media platform."

For 2010, if you haven't already started some level of customer segmentation and research, start in a meaningful way and embed the process into your culture. If you haven't yet adopted CRM, consider implementing that as a connecting tool for email, phone, social media, Web sales, the wine club, tasting room fulfillment

and compliance. CRM at its core is simply collecting information about your customers so you can properly market to them, giving them what they want. It limits the guess work that takes place in transactional selling where you have to taste through or discover a prospect's preferences each time. It allows you to scale electronic relationship building by creating individualized experiences for groups of people. CRM is the glue that links all the other electronic tools together, collecting data, then allowing you to segment your Millennials from your Greatest Generation customers. A marketing genius in the Silicon Valley once told me the most important sale is the second one. Understanding how to link this data and support relationship building and the second sale will be a key to the health of your online and offline business in the future.

Credit Availability

A big topic in the world in the past couple years has been the system. Is it working? Are businesses able to get working capital or are they being repressed by the system? And before we go further, may we just say ... it's not our fault! (We're just sayin'...)

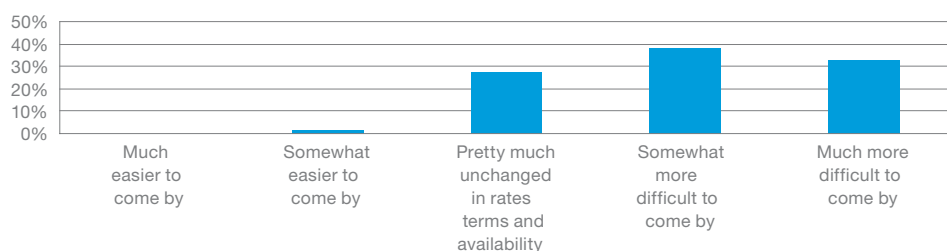
Dennis: *Come and see the violence inherent in the system. Help! Help! I'm being repressed!*

King Arthur: *Bloody peasant!*

Dennis: *Oh, what a giveaway! Did you hear that? Did you hear that, eh? That's what I'm on about! Did you see him repressing me? You saw him, didn't you?*

But back on point, when we asked wineries to compare commercial credit availability, terms and price pre- and post-crash, the answers were far more negative than we expected (Figure 10). Perhaps our experience is unlike other banks. SVB's wine division has certainly seen a significant up-tick in new borrower requests this past year, and we grew substantially as a result. From experience, we knew intuitively credit had been tightened at most institutions, but the surprise was the magnitude and unanimity of belief with 71 percent saying credit has become more restrictive than it was pre-crash.

Figure 10: Ease of Finding Commercial Credit



Source: Silicon Valley Bank

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A bank jumping into the wine business after the last recession would experience favorable conditions up through Q3 of 2007. Most deals it booked performed well in the growing economy, but regulators get very direct when a portfolio of loans has more than about 12.5 percent of the loan balances characterized as having a “material weakness.” With 7 percent of the industry describing themselves as “very weak” today and almost 30 percent slightly weak or worse, it’s not hard to imagine a lender taking on more than average risk in the past several years and now being required to make changes to their lending practices. Those changes would apply to healthy and weak borrowers alike. It’s unfortunate from a borrower perspective because 71 percent describe themselves as good financially or even better. Those owners would clearly be confused or frustrated over changes in their lending relationship when they are doing well. The variable in this case is the specific financial institution’s understanding of the wine business and/or its own regulatory health.

Producer Level Supplies

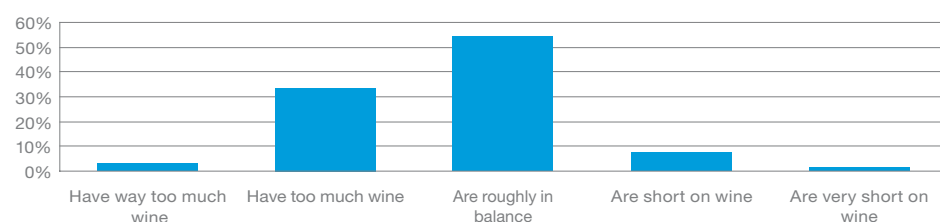
French Soldier: *You don't frighten us, English pig dogs. Go and boil your bottoms, you sons of a silly person. I blow my nose at you, so-called "Arthur King," you and all your silly English K-nig-hts.*

I don't know what this quote has to do with anything... pigs hording wine ...no ... dog wine not moving ... no. It didn't matter in the final analysis. I cracked up watching that part so had to put it somewhere.

When the wine industry experiences an inventory imbalance, whether from a supply shock (excess supply) or a demand shock (reduce willingness to spend), the reaction by producers is the same. They blend down reserve wines into lower-priced offerings and sell off bulk. Higher quality bulk is then purchased by other wineries oftentimes for less than the cost to produce, and put into less expensive SKUs. The end result is the value-conscience consumer can find better value at lower prices, but the trend is not sustainable.

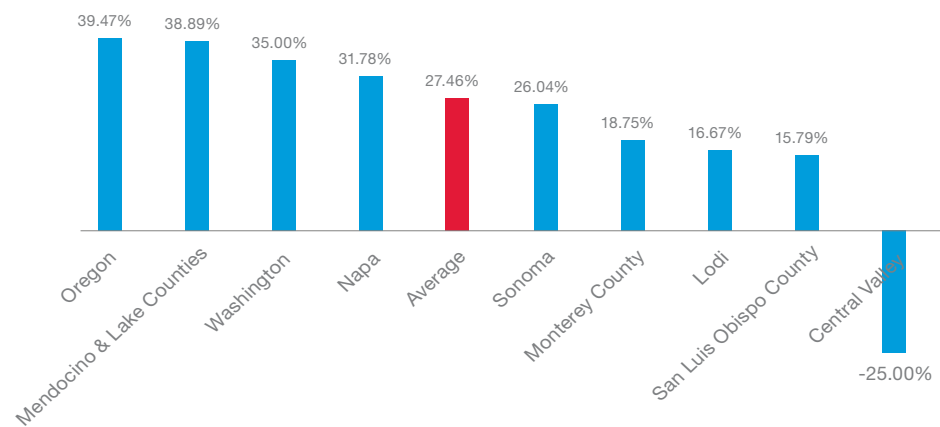
The production of fine wine is an expensive, lot-by-lot and barrel-by-barrel undertaking. Wineries won't produce uneconomically for much more than one to two years as they balance their supplies. Once inventories are corrected in the cellar, the wine consumer who discovered great values in a disjointed market is forced with the choice of paying the same for lesser quality wine in the bottle, or has to be willing to price up slightly to find the quality they want.

Figure 11: Balance of Supply of Wine In Cellar



Source: Silicon Valley Bank

Figure 12: Percent of Respondents Reporting Net Inventory Imbalance



Source: Silicon Valley Bank

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So with the value-seeking consumer feasting on values in 2009, (lower priced and higher quality), the next most obvious question is when wineries will stop blending down their good juice into less expensive wines. Knowing that answer gives a good indication of where we are in the inventory-balancing cycle a little more than a year into the correction, as well as an indication with respect to the likelihood of continued discounting.

From the SVB Wine Conditions survey in January 2010, it was a bit of a surprise to us that 35 percent said they still had too much wine on hand in the cellar. We have seen clients and prospects aggressively discounting, blending down, and selling bulk, taking their first loss and positioning for the future. But the 35 percent who still say they are long portends a continuing period of discounting for the consumer, as well as a level of additional bulk wine sales as we move deeper into 2010. That said, wineries walk a tightrope on their cellars predicting what will sell in two years. We

believe at least a part of the excess supply in bulk is being held by wineries that are now hedging their bets on the future and want to get a better feel for the market before cutting loose of upside opportunity in good bulk wine.

A second question regarding supply regards the appellation as some are closer to being in balance than others. We netted out the responses of those wineries that reported excess positions, against those reporting short positions with inventories, ignoring those who said they were in balance. Figure 12 shows that Oregon has the largest imbalance and the appellations that produce wines in higher-scale and in lower price points are the closest to being in balance. The region reporting the only net shortage is the Central Valley of California, though it should be noted that it is the most at risk for continuing foreign bulk imports that today are being used to fill 25 million cases of domestic brands. The clear message is that we will continue

to see some level of discounting in 2010 and good value wines will be available to the consumer, much to the consternation of fine wine producers who will take the financial hits for another year.

We have monitored the level of bulk and grape supply by varietal in a chart since 2006 to understand the impact on evolving and changing tonnage from the vineyard. As we have said in the past, the best thing about the current recession is we are largely not in a position of over-supply and, with the exception of Oregon Pinot Noir and Pinot Gris, not going to see non-bearing acreage make the current imbalance worse. This year there are no varietals we view as long. Even with the recession, we are closer to being in balance. But that is an average and there will be some vineyards this next season that may still find it hard to get a contract, while others in higher demand will have their choice of suitors.

Figure 13: Bulk Wine Positions

Varietal	2009 Sales Growth Rate >\$20	2006	2007	2008	2009	2010
Chardonnay	2.50%	Long	Long to Balanced	Long to Balanced	Balanced	Long to Balanced
Sauvignon Blanc	7.40%	Long	Long	Long	Long to Balanced	Long to Balanced
Cabernet	4.80%	Long	Long to Balanced	Long to Balanced	Balanced	Long to Balanced
Merlot	-1.70%	Long	Long	Long	Long to Balanced	Long to Balanced
Pinot Noir	7.20%	Short	Short	Short	Long to Balanced	Long to Balanced
Syrah	-7.60%	Long	Long	Long	Long to Balanced	Long to Balanced
Zinfandel	3.20%	Long	Long to Balanced	Long to Balanced	Balanced	Long to Balanced
Overall Premium		Long	Long to Balanced	Long to Balanced	Balanced	Long to Balanced

Short	
Short to balanced	
Balanced	
Long to Balanced	
Long	

Sources: Nielsen Scan Data, Ciatti Company, Turrentine Wine Brokerage, SVB Research

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Forecast

Sir Bedevere: *There are ways of telling whether she is a witch.*

Peasant 1: *Are there? Oh well, tell us.*

Sir Bedevere: *Tell me. What do you do with witches?*

Peasant 1: *Burn them.*

Sir Bedevere: *And what do you burn, apart from witches?*

Peasant 2: *Wood.*

Sir Bedevere: *Good. Now, why do witches burn?*

Peasant 3: *...because they're made of... wood?*

Sir Bedevere: *Good. So how do you tell whether she is made of wood?*

Sir Bedevere: *Does wood sink in water?*

Peasant 1: *No, no, it floats!... It floats! Throw her into the pond!*

Sir Bedevere: *No, no. What else floats in water?*

King Arthur: *A Duck.*

Sir Bedevere: *...Exactly. So, logically...*

Peasant 1: *If she weighed the same as a duck... she's made of wood.*

Sir Bedevere: *And therefore...*

Peasant 2: *...A witch!*

This is just about how we come up with our forecasts. It's all logical and makes complete sense. A little wizardry and a glass of vino and this is what thou can't expect? We sayeth, "If music be the food of love, play on. Give us excess of it, that

surfeiting the appetite may sicken, and so die."³⁴ What?

Looking forward, the U.S. is expected to be the number one wine-consuming country in the world by 2011–2012, with a projected volume of around 310 million cases by 2013 due to growth in per capita consumption by Americans.³⁵ The outlook for small family-owned wine business in 2010-2011 is probably best described as mixed, with success defined more by the business model, capitalization and professionalism of management. There will be more winners, losers and some start-ups taking advantage of opportunities created by change.

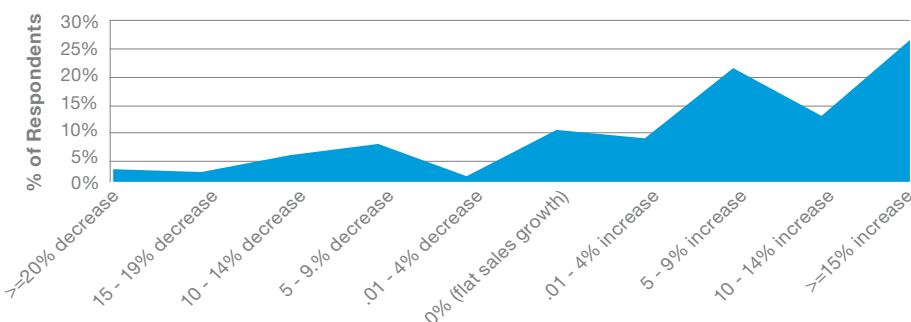
In 2010, we expect sales of fine wine to grow in the range of 8-12 percent. Our forecast is supported by improving luxury consumer trends, bottoming of the de-stocking phase of the business cycle, recovering stock market wealth for Boomers, forward-looking improvement in restaurant sales, better spending from corporate T&E and the national economy remaining somewhat more stable than the year behind us.

We believe the financial performance will be negatively impacted by continued discounting as inventories balance out this year with demand, higher taxing from states scraping to balance their own budgets, distribution and channel shifting issues, and echoes of the market crash that will be addressed in national and global politics then played out in world debt and equity markets. Our forecast would be changed if there were a second dip in the stock market. It's not something we are anticipating, but the possibility still exists.

Overall profitability in the family-run wine business will continue to be soft with lower gross and net profit for the next two years as higher cost inventory is flushed through the income statement. Growers will continue to find difficult conditions renegotiating for prices paid in prior agreements, except for the most prized fruit.

Following our forecast of modest growth in the fine wine segment, we believe Figure 14 is probably close to reasonable, relative to what we expect for market

Figure 14: Expected Sales Growth



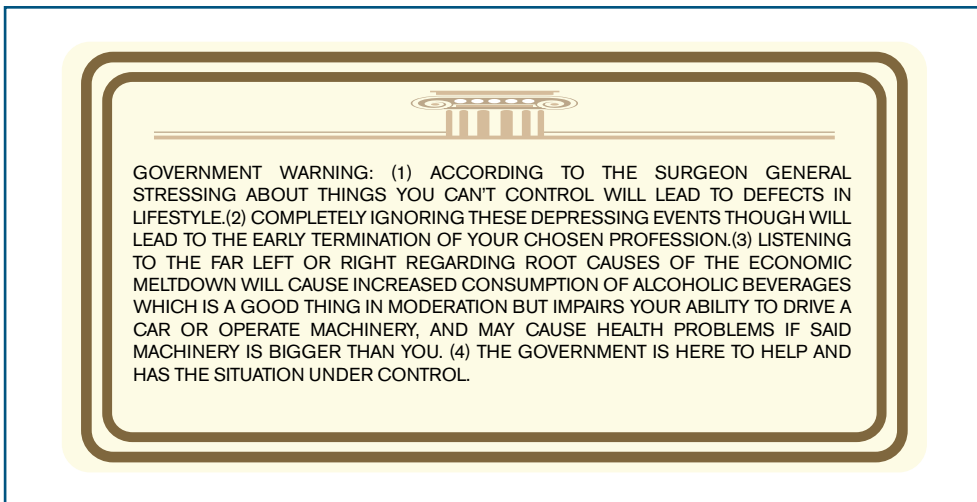
Source: Silicon Valley Bank

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growth. Added up, 80 percent of those surveyed are expecting sales growth in 2010. The 40 percent that expect growth above 10 percent may be a little optimistic in our view, but we haven't drilled down on the detail of those respondents and it's possible they are small, maybe newer and coming off a small base ... then again, they could just be optimists!

Speaking of which, 67 percent expect 2010 will be a good year and only 26 percent are suggesting they will be just treading water. Given the tight credit, constricted marketplace, and excess supply that are described in the other charts, one might reasonably expect a few less optimistic souls, but hey — this is the wine business. My hope is this is simply saying wineries are hoping for the best, but planning with a realistic bent for a slow recovery for the U.S. wine consumer.

King Arthur: *On second thought, let's not go to Camelot. It is a silly place.*



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Silicon Valley Bank's Proprietary Peer Group Metrics

Silicon Valley Bank's Peer Group Analysis program is a benchmarking tool the company developed to track and compare a variety of financial measures among premium wineries. Due to the company's niche focus and significant market share of premium wineries, it is able to develop meaningful benchmarking information and it makes the data available to its clients. The data, based on financial information from over 100 premium wineries over several years, also allows Silicon Valley Bank's Premium Wine Group to monitor industry trends.

About SVB Financial Group

For 25 years, SVB Financial Group and its subsidiaries, including Silicon Valley Bank, have been dedicated to helping entrepreneurs succeed. SVB Financial Group is a financial holding company that serves companies in the technology, life science, venture capital/private equity and premium wine industries. Offering diversified financial services through Silicon Valley Bank, SVB Analytics, SVB Capital, SVB Global and SVB Private Client Services, SVB Financial Group provides clients with commercial, investment, international and private banking services. The company also offers funds management, broker-dealer transactions and asset management, as well as the added value of its knowledge and networks worldwide. Headquartered in Santa Clara, Calif., SVB Financial Group (Nasdaq: SIVB) operates through 26 offices in the U.S. and international operations in China, India, Israel and the United Kingdom. More information on the company can be found at www.svb.com.

About Silicon Valley Bank's Wine Division

Silicon Valley Bank is the premier commercial bank for emerging, growth and mature companies in the technology, life science, private equity and premium wine industries. Its Wine Division specializes in commercial banking for premium wineries and vineyards and the industries that support them. SVB has the largest team of commercial bankers dedicated to the wine industry of any bank nationwide. Founded in 1994, Silicon Valley Bank's Wine Division has offices in Napa and Sonoma counties and serves clients in Napa, Sonoma, the Central Coast of California, Oregon and Washington. By virtue of its dedication to the wine industry, Silicon Valley Bank is able to support its clients consistently through economic and growth cycles, and offer counsel on many aspects of their business, beyond traditional banking services. Silicon Valley Bank is a member of global financial services firm SVB Financial Group (Nasdaq: SIVB), with SVB Analytics, SVB Capital, SVB Global and SVB Private Client Services. More information on the company can be found at www.svb.com.

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Cover photo courtesy of Natalie McMillan Photography.

- ¹ tallt - to stand above others in an arrogant manner; a renaissance-era English word in disuse.
- ² Our forecast is conditioned on the lack of a second dip which we view as possible but not plausible. There is no question that markets still are full of unknowns, stretching from government and central banks actions and lack of action, sovereign default risk and dysfunctional credit markets. Any subsequent shock to the consumer will delay a rebound in all consumer markets.
- ³ <http://www.youtube.com/watch?v=grbSQ6O6kbs>
- ⁴ The SVB Annual Wine Conditions Survey is sent out early each year as part of the preparation for this report. This year, the survey was completed on January 15 and had 465 West Coast respondents and a 21 percent response rate. The complete set of responses, charts and summary analysis is sent exclusively to the participants. All wineries are welcome to participate. To participate in the 2011 survey, please email the author.
- ⁵ It's been pointed out the way the question was asked using the suggested retail price ("SRP") could cause ambiguous results when looked at from the position of the winery and discounting. The SRP could remain the same at the checkout stand even while the winery offered up promotions and allowances to incent the movement of the wine. The point of the question however was from the perspective of the consumer and from that perspective, the consumer would see the same price with or without discounting.
- ⁶ http://www.youtube.com/watch?v=zrzMhU_4m-g&playnext_from=QL
- ⁷ Distributors need to know they can get the wine. In a short market they horde as a measure of safety. In a long market they don't worry about it and go to as close to just in time ordering as they can get. But it doesn't matter if the situation was a demand shock caused by recession or a supply shock caused by over-planting. The reaction is very much the same in the distributor's world.
- ⁸ <http://www.youtube.com/watch?v=9V7zbWNznbs>
- ⁹ <http://www.youtube.com/watch?v=BZwuTo7zKM8>
- ¹⁰ The Current Situation Index measures current trends in four industry indicators (same-store sales, traffic, labor and capital expenditures). Any reading below 100 signifies contraction in the current situation indicators.
- ¹¹ Hudson Riehle, SVP, Research and Information Services, National Restaurant Association.
- ¹² The Expectations Index measures restaurant operators six-month outlook for four industry indicators (same-store sales, employees, capital expenditures and business conditions).
- ¹³ <http://www.youtube.com/watch?v=2eMkth8FWno&feature=related>
- ¹⁴ SVB Peer Group Analysis is a proprietary financial data base that includes both SVB client and prospect information. Aggregated into custom peer sample sets to maintain privacy, it allows SVB Relationship Managers the opportunity to present annual comparative financial performance data clients to the Bank's clients, giving them a unique tool and a leg up on non-SVB clients. With consolidated information dating back to 1991, we are also able to use the homogenous information as a tool to express top-level industry financial trends.
- ¹⁵ We don't want to get too far afield discussing the economy this year, but as we see things, the subprime crisis has very likely created a secondary bubble in sovereign debt. According to Bianco Research, LLC there is just as much worldwide debt as there was pre-crash. It's just morphed to sovereign balance sheets, creating additional risks. Greece is the most visible starting point, but several other countries are dealing with their own debt issues and could likely slow the pace of recovery in Europe. The U.S. has an advantage as the world's reserve currency, but the U.S. is not immune. The U.S. Congressional Budget Office issued a report in March showing that the national deficit, which took 234 years to reach \$10 trillion, will likely double during the current administration's tenure. Further, within this decade, the budget will place the U.S. government at a point where the total debt reaches 90 percent of our own GDP. It's a discussion best had over a glass of wine to numb our perception of reality.
- ¹⁶ After getting the results back, we were not surprised to find there was a zero percent response to the choice of wineries describing their financial condition as "dead." It seemed like a thorough approach to the question when we asked it, but looking at the results it's a little like taking role call in class and asking everyone who isn't there to raise his hand.
- ¹⁷ <http://www.youtube.com/watch?v=GJoM7V54T-c>
- ¹⁸ The Unemployment Rate includes the unemployed, in addition to those who haven't found jobs that have fallen off the formal Unemployment Rate, plus those who are under-employed either working less than full-time.
- ¹⁹ There is no uniform market segmentation for affluent households. We are defining the affluent consumer as one making income above \$100k annually, and the absolute affluent consumer as one with an annual income in excess of \$250,000; the top 2 percent of households according to U.S. Census Bureau Publication H-10 for 2009. Survey information for the absolute affluent from Pam Danzinger, Danzinger Marketing.
- ²⁰ Hermès is a private company. Their financial results can be reviewed at http://finance.hermes.com/en/2009/result_annuel.php.
- ²¹ Dow Jones and other public sources

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²² Some examples of on-line survey tools include <http://www.kwiksurveys.com/>, <http://www.surveymonkey.com/>, <http://www.freeonlinesurveys.com/>, <http://www.freesurveytools.com/> and a host of others.

²³ <http://www.youtube.com/watch?v=dOOTKA0aGI0>

²⁴ Greatest Generation/WWII Cohort (ages 65 to 89), Boomers Cohort #1/Edge Boomers (ages 54 to 64), Boomers Cohort #2 (ages 46-53), Gen-X/Baby Bust (ages 30 to 45), Gen-Y/Millennial (ages 10 to 29)

²⁵ This is the first time we've ever had 4 generations in the work place. Understanding the cohorts is of value if you want to resonate with their value system and sell in a meaningful way. A couple good books: Y-Size Your Business (http://www.jasondorsey.com/books_YSize.html) and "Dot Boom: Marketing to Baby Boomers Through Meaningful Online Engagement" (<http://dotboombook.wordpress.com/about/>).

²⁶ MEININGER'S WBI, May 2009. Lulie Halstead, CEO, Wine Intelligence

²⁷ When I was a Millennial; before I became a Boomer, I used to sample from the gallon jug of wine stored under the sink that my Greatest Generation father stored next to the garbage disposal. Determined to not undermine consumption statistics, I dutifully replaced what I consumed with tap water. So if the writer is any indication of actual consumption trends, it is possible Millennials consume a higher volume of wine relative to Boomers.

²⁸ The Wine Market Council defines a core drinker as one who drinks wine at least once a week. Just once a week ...based on that metric, I'm not sure I want to know how my wine consumption patterns are defined.

²⁹ According to a 2007 study by the American Association of Retired People, more leading-edge Boomers view retirement not as the completion of a career, but an opportunity to change lifestyles. 70 percent expect to continue working into their retirement years and the recession has likely increased that percentage.

³⁰ <http://www.youtube.com/watch?v=xOrgLj9IOwk>

³¹ I remember when the e-mail era began at SVB and, believe it or not, still have my first e-mail address from 1990. It's Rmcmilla@svbank.com if you need a good wine bank. I didn't get to finish my name completely on the address as you might notice (it's missing the final 'n'). That's because we were concerned about the processing and storage of bits and bites in 1991. (I am starting to sound like my dad. You guys have it easy. I remember mimeographs ...)

³² According to the Internet Society and other sources, the term spam is derived from the 1970 Spam sketch of the BBC television comedy series "*Monty Python's Flying Circus*." Didn't think I'd work that into a footnote did you?

³³ Pam Danzinger Marketing. The survey cited placed the average age of respondents at 45.9 years and average household income was \$239,300. Nearly 20 percent of the affluents polled were classified as 'ultra-affluents,' those at the top 2 percent of U.S. households with incomes of \$250,000 or more.

³⁴ William Shakespeare, *Twelfth Night*. We are running out of old English words so dropped in a little Shakespeare.

³⁵ *La Journée Vinicole*, Edition 2010, February 24 2010

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