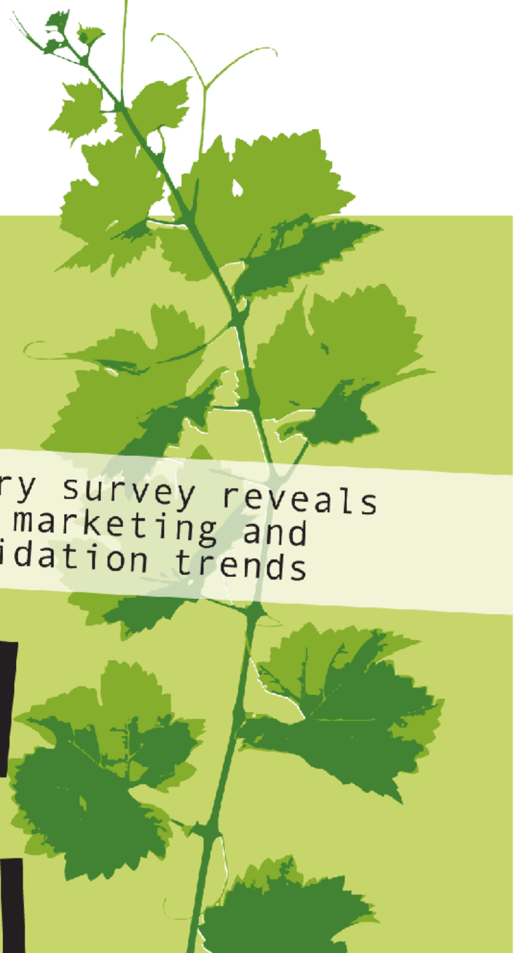
WINE INDUSTRY REMAINS POSITIVE AS 2016 APPROACHES



BY BILL VYENIELO, STEVE FREDRICKS AND BILL RODDA

Industry survey reveals sales, marketing and consolidation trends

Slow-but-steady growth in sales has members of the U.S. wine industry feeling fairly positive, even on the heels of three large-crop years.

Because of California's consecutive big yields, wineries have already financed more barrels and facility expansions, and they anticipate even more. Vineyard planting activity in some regions, especially California's North Coast, where most of the plantable land has already been cultivated, is increasingly being utilized for replanting existing vineyards.

According to the 2015 Winery & Grower Benchmarking Survey distributed by Moss Adams, the Farm Credit Alliance and Turrentine Brokerage, there is cautiousness behind the industry's optimism. This is due to the increased inventory that resulted from the large crops, as well as price-point trends showing that sales below \$7-\$10 per bottle are trending down. (On the upside, sales are trending up at higher price-points.) More than 300 wineries throughout the West Coast participated in the survey.

By and large, California has been able to sell its wines and increase supply, and the United States continues to be the biggest target for importers.

AT A GLANCE

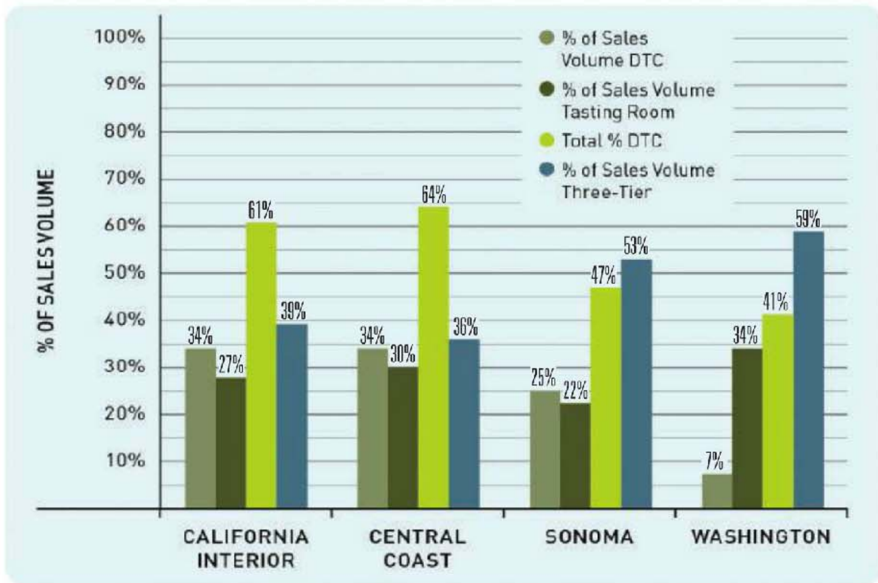
- While members of the U.S. wine industry have a positive outlook for 2016, there is caution behind the optimism.
- This is due to increased inventory from three consecutive large-crop years, plus a decline in wines priced at \$7-\$10 per bottle.
- The idea of the traditional winery is changing, and many new entrants opt for a "virtual winery" model.
- Large wineries continue to grow by adding smaller wineries to their books

MARKETING CHALLENGES

Getting to the consumer is more challenging than ever, with myriad complex options. As reported in the benchmarking survey, wineries have to work harder to market their wines in order to grow sales. Domestic wines priced under \$7 per bottle are competing with imports, beer and spirits, dealing with unfavorable exchange rates, and fighting for space with fewer distributors. For perspective, we now have more than 8,000 wineries in the U.S. and less than 700 distributors – an 11 to 1 ratio; in 1995 there were 1,800 wineries and 3,000 distributors – a 2 to 3 ratio.

Wineries in today's modern world have to be more professional in their marketing and sales plans when it comes to packaging, pairing and delivering their wines. The silver lining is that there are more opportunities to succeed as things change.

PERCENTAGE OF CASES SOLD BY CHANNEL - Integrated Wineries <10,000 Cases



In the 2015 Winery & Grower Benchmarking Survey, wineries making under 10,000 cases per year reported that DTC channels accounted for more than 40% of their sales. Source: Moss Adams

DIRECT-TO-CONSUMER SALES

If you're a small winery looking to break into domestic distribution channels, you'll find it tough doing it the traditional way, unless you've produced a very highly rated wine or created a unique demand for your product. As a result, small wineries have been reinventing themselves with direct-to-consumer (DTC) sales options and utilizing technology to reach out and touch the consumer. This includes events, wine clubs and mobile outreach, which accounts for a significant and growing volume of sales. In the 2015 Winery & Grower Benchmarking Survey, smaller wineries reported making between 40% to more than 60% of their sales volume through DTC sales channels.

NEGOCIANT LABELS

Continuing with the notion of wineries reinventing themselves to get distribution, the idea of a traditional winery is changing. In the past, people built wineries, planted grapes and designed their labels. In 2014, the number of virtual or negociant wineries in the U.S. grew by 23% to more than 1,200. Because you aren't investing in expensive fixed assets such as buildings, equipment, and vineyards, it's easier to get a label up and running very quickly. It's too early to see whether these negociant wineries will survive long term.

CHERRY-PICKED BRANDS

The bigger wineries that have clout and can power through the market don't face as many difficulties as smaller ones, but they're still part of the shifting business landscape, as they continue to grow by adding smaller wineries to their books. These larger producers can cherry-pick high-end brands that have cachet, and can offer enticing deals to the principals of these small, upscale family-owned wineries.

Many of the principals at these smaller wineries are getting older and face having to borrow money to adapt, continued hard work, and uncertainty when it comes to finding a successor for their businesses. Those small wineries that have built a solid reputation and consistently delivered quality wine are a high-value target, which make them tempting acquisitions for larger producers.

DROUGHT ISSUES

At the forefront of everyone's mind this year is the drought. For the short term, through 2015, there's a general sense of confidence in the grape supply despite the lack of water in California. Grapes are hardy plants, and it's possible to dry-farm them due to their ability to grow deep roots.

There has also been an increase in research on the science side of viticulture. Farmers know better than anyone the value of water, and they're adopting tools to measure water use and are more aware of how they can attain maximum quality and yield with minimum amounts of water. Early spring rains in the North Coast also have helped. Reservoirs throughout that area are fuller compared with a year ago when they were at record lows.

To help alleviate the stress of the drought, many grapegrowers are drawing from their wells and financing the digging of new wells, some in excess of $200,000. It's truly the difference between being in business and out of business: no water, no crop, no operation.

We've seen tremendous activity and demand related to ground water. Because of this increased withdrawal of ground water, the elevation of the land throughout some parts of California is actually dropping. As a result, expect to see regulations put forth in the next one to two years with greater scrutiny of water rights.

QUALITY IS QUEEN

It's natural for a consumer to be introduced to wine at a lower price-point, then gradually move up in quality and price. If the younger generation in particular follows this trend, it will trade up for better-quality bottles and we'll continue to see the shrinking of demand at the lower end. Meanwhile, the over-$10 segment is growing.

As a result, generic reds and whites of a lower price-point and produced at large volumes are experiencing decreased demand as consumers' palates become more sophisticated globally. Central Valley producers are shifting their grape sourcing north in search of better grape quality in order to be more competitive.

Technology and improved winemaking techniques also contribute to better wine, a trend we're seeing duplicated around the globe, from Chile and Argentina to Australia and France.

BULK WINE INVENTORY

Compared with two years ago, bulk wine inventory

has increased as a result of new bearing acres and good-size crops in 2012, 2013 and 2014. While volume is up some, we're seeing that demand has generally decreased, because buyers are looking for smaller volumes and higher quality bulk wines. Picky buyers are the first sign of good supply.

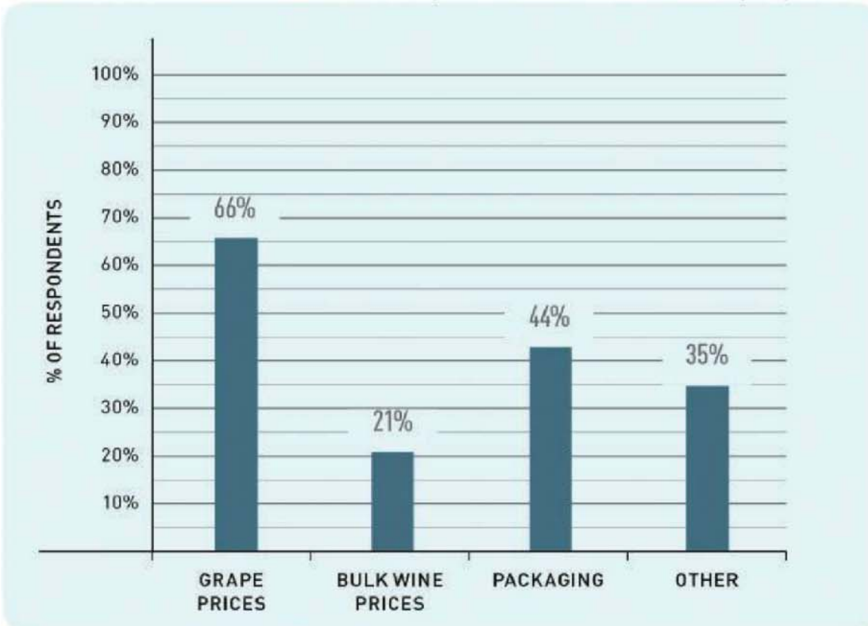
Currently, the majority of grapes are contracted. If these contracts didn't exist, the market would be more challenging.

GRAPE PRICES

The price of grapes long-term will be contingent upon everyone's ability to sell increased quantities of wine at good prices. If this happens, grape prices will maintain and possibly increase. This is particularly true in some regions of California, such as Napa and Sonoma counties, where there's little additional new acreage available to

PRIMARY REASONS FOR THE CHANGE IN COST OF GOODS IN 2014

Note: Respondents were able to select multiple options.



Sixty-six percent of 2015 survey respondents cited grape prices as the primary reason for cost of goods increases in the previous year. Source: Moss Adams

expand vineyard production. This has spurred increased investments in Oregon and Washington state, where there's more undeveloped, plantable acreage at lower cost, compared to California.

PLANTING

A lot of the quality-appropriate acres in Napa and Sonoma have been planted, while there are a lot of new acres in the Central Coast region. There's been some movement away from grapes in southern California due to lack of demand and low prices. Farmers are opting for tree crops such as almonds, which typically have better returns but require much more water. This is a gamble they're willing to take because the price for almonds is so strong (the price in 2014 for almonds reached $4 per meat-ton).

We saw newer planting in Oregon and especially Washington state. As a side note: Washington is emerging as a competitor for Cabernet in the $10 per bottle price category. The state's supply has increased, but so has California's.

While there are definite challenges facing the wine industry – from weather to a changing marketplace – the industry seems poised to have another interesting year.

If you'd like more detailed information, please visit www.mossadams.com/2015winesurvey to access the 2015 Winery & Grower Benchmarking Report.

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