Silicon Valley Bank

SILICON VALLEY BANK WINE REPORT

STATE OF THE WINE INDUSTRY **2013**

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Contents

Lorraine Baines: It's our first television set. Dad just picked it up today. Do you have a television?

Marty McFly: Well, yeah. You know we have ... two of them.

Milton Baines: Wow! You must be rich.

Stella Baines: Oh, honey, he's teasing you. Nobody has two television sets.

Didn't you ever wanna go back in time — maybe to the Stone Age to see what it was like when there was no TV, your mother tapped her toes to Benny Goodman, and a salad didn't include escarole? Or maybe you'd prefer the other direction and go into the future to see how things turn out and if TV even survives, then come back to the present so you can have some do-overs, like maybe not buying that fourth TV. I'm sure you've thought about it: What would you do over? For me on a personal level, I would have been nicer in fifth grade to that girl with cooties who ended up homecoming queen six years later, and I wouldn't have left my sister's new bike on the train tracks while I caught frogs that one spring.[i] Financially, I would have bought Apple stock when it was $10 a share in 2004, cashed out of my home in 2006 and bought gold, and purchased a Napa vineyard in 1990 when you could get good property for $25,000 an acre.

The *Back to the Future* trilogy is a series of films starring Michael J. Fox that takes us exactly into that corner of our imagination. It's this year's film choice to help us add some humor to otherwise mundane topics like the supply and demand of grapes, foreign exchange and the prevention of microbial spoilage.[ii]

Of course, nobody gets to go into the future, but as business people you are forced to make future bets based on what you expect to happen anyway. Crystal balls with any clarity are hard to come by and really good information and predictions on the direction of the wine business are about as easy to find as plutonium in 1955. It's a tough task, but ride along with us as we give it another try. We'll take you back to the future then gaze forward with our own predictions in the *2013 SVB Annual State of the Wine Industry Report.*

Executive Summary

- The perfect harvest: a perfect growing season produced a rarity, very good yields AND great quality. It's no exaggeration to call this vintage perhaps the best ever for the West Coast as a whole.
- We have entered a period of domestic economic stagnation that should reset our view of growth, business returns and prices for years to come still.
- SVB's prediction of sales growth in fine wine will drop for the fourth consecutive year to a range of 4-8 percent, but it's still growth.
- The general financial condition of the wine industry is improving at a slow and steady pace and there is a strong belief that 2013 will be seen as a good, but not a great year financially.
- Gross and net profit of wineries will be negatively impacted in 2013 due to higher grape costs.
- With the very strong 2012 vintage year many fine wine consumers will forgo the 2011 wines and wait for the release of the 2012s.
- The euro will lag the U.S. recovery and the currency will weaken, leaving an opportunity for more bottled imports and additional pricing competition.
- Inventory is balanced.
- Grape planting will be restrained compared to prior periods when supply was in balance.
- Higher price point wines report particularly short inventory positions.
- There are broad expectations in the wine business that bottle price increases can be taken. We believe increases will prove difficult, particularly early in the year.
- Wineries that expressed having the most difficult year were often in smaller production models with average retail pricing in the range of $20-$29.
- For those wineries that purchase grapes, there is a majority view they will purchase more tonnage in 2013 at about the same price per ton. We believe the purchase volume of wine grapes and pricing will largely be flat versus the end of 2012. Some lower priced bulk will be available early in the year because of the high yield.
- Harvest was quite large estimated at 3.7 million tons by most, though we at SVB suspect it was a record yield approaching 4 million tons.
- M&A and vineyard acquisitions will continue at a record pace in 2013.
- Massive bulk imports will continue to dominate the lowest price point wine categories.
- Direct-to-consumer sales will continue as the largest growth channel for most wineries.
- Fine wine producers were unable to pass on higher costs to consumers or recover higher pricing from prior periods.

The Year and SVB Predictions in Review

Dr. Emmett Brown: If my calculations are correct, when this baby hits 88 miles per hour … you're gonna see some serious stuff.[iii]

When it comes to perceptions about grape supply, 2012 was almost as unpredictable as driving a DeLorean in a mall parking lot at 88 miles per hour. "We're long! We're short. No … check that … we're running through a demand wall and long so now we have grapes nobody wants to buy. OK, we'll sell the excess at half the contracted price. Great Scott Marty!" A perfect vintage and yet some grape prices on the spot market tanked at the end of harvest? How can that be in a market that's short?

Perception of supply never used to change that fast, in part because the wine business is comprised of strong-willed, independent people who stick to their beliefs. They move off their beliefs about as often as someone requests a live band play Jonny Be Goode on an acoustic guitar. But 2012 was an exception when we're talking supply.

At the time we published our annual report in 2012, there wasn't much agreement on the subject of grape inventories after a decade of being long. Both in our early speeches and in the report we took the position that "*wine was closer to being in balance than most believed*" and supply was "*evolving to shortage.*" By the time the report came out in April, articles started to work through the press talking about grape shortages and bottle price increases such as one from *Time Magazine* framed around the quote "Panic! Wine Prices Due To Rise.[iv]"

Whatever the cause, wine people shifted perceptions faster than Marty McFly on his skateboard, and we saw very rapid grape price increases across all regions through the early part of the year. We predicted modest bottle price increases in the report versus anything close to the panicked rises described in some headlines. Those who combed through our complete report would have seen the following calmer view for grape supply in 2012.

"Taken as a whole, we believe 2012 is going to be a year when buyers and sellers of grapes and bulk will be shifting around for equilibrium in price negotiations. Oregon and Washington with their slightly stronger inventories will lag the California market. We believe grape prices will set slightly higher before getting a view on projected yields in California. We expect to see growers trying to hang more fruit and in fact in our tours of growing regions, have seen kicker canes added to vineyards for the first time in quite a while. A large harvest should be expected simply because the demand is there and farmers will farm for more volume if Mother Nature cooperates."

The author of this report also writes the *SVB on Wine* blog and, in the July 15, 2012 piece with the industry seemingly convinced there was a critical shortage, wrote an article titled "Is There Really a Grape Shortage?[v]" It had become clear the wine community was overestimating the current year shortage based on prices being paid for fruit up through the spring and into summer.

We now know that harvest was quite large estimated at 3.7 million tons by most, though we at SVB suspect it was a record yield approaching 4 million tons. The timing of weather in 2012 was about as perfect as trying to catch a lightning bolt with a DeLorean. **It was also the finest modern era vintage ever when viewed in the context of all West Coast growers.**

It was indeed quite a year; positive in so many respects. But before moving forward in our time machine, let's go back and review the 2012 predictions in full, both to validate our methods and give context for our 2013 forecast. Reviewing the highlights from 2012 we predicted:

- Wine inventories evolving into a state of shortage that will last for some time domestically
- Increasing prices for grapes and bulk juice as growers finally get to start to see recovery
- Increasing difficulty for negociants to find wine of consistent quality for their price point
- Fewer private labels on the shelves
- More transitions, sales, and mergers taking place than at any time in memory
- Increasing plantings to feed the looming grape shortage
- Imports taking on larger market share compensating for lacking domestic supply
- Bottle price increases, but not a return to those prior to the recession
- Increasing difficulty for those third party marketers who have sold with a culture of discounting
- Functional evolution of digital options creating a Fifth Column;[vi] a cobbled together group of wine businesses partnering with producers to sell direct and replacing the theoretical role of the wholesaler in a fully functioning supply chain
- 2012 will show sales growth rates of 7-11 percent; a slight drop from the prior year
- Declining wine quality for the price paid. Consumers will have to decide if they are willing to drink lesser quality domestic wines, or pay higher prices, or find foreign substitutes
- Economically we believe:
  - U.S. employment will continue to recover slowly.
  - We are at the bottom of the housing price bubble.
  - Housing prices won't recover until the securitization process is revisited.
  - The wealth divide is really a demographic divide which has implications for marketing wine.
  - The euro zone will continue to sort out the cultural differences that are leading to the near certainty of changes to the Agreement.
  - The euro will enter a weakening trend versus the $US.
  - The U.S. economy will gradually positively evolve with more middle class consumers jumping on the moving train.
  - Short-term interest rates will continue to be very low for the next 12 months and probably longer. Longer-term rates may see some increase especially if China continues its current strategy of diversifying its $3.2T in foreign exchange reserves.
  - Oil prices are an unknown and at a point now well over $100 a barrel could hurt the U.S. recovery if price continues to increase.
  - Uncertainty in geopolitical risk is still noise in the background that could come to the forefront should tensions continue to evolve with Iran, her allies and the rest of the world.

We believe we did pretty well. We should hit the growth rate band for the third year running and were out ahead of the changing grape market. Imports increased dramatically in 2012. Our predictions of changes in grape and bulk inventories led to a linked prediction of higher grape pricing. Economically, we also did pretty well in predicting the housing bottom, a weakening euro zone and continuing low rates. We correctly predicted market share of wines would be surrendered to imports, but more of the growth came from non-EU countries which was our belief. That said, EU countries did have the highest growth in packaged goods imports. While we have seen planting taking place, in fairness we thought we would see more planting at this point, so that will be a discussion later in this report.

Taken as a whole, the amount of accurate conjecture from us might lead a person to wonder if we did in fact use a time machine to get those predictions. We aren't telling either way, but the DeLorean is running, so it's time to move on and discuss the 2013 wine industry.

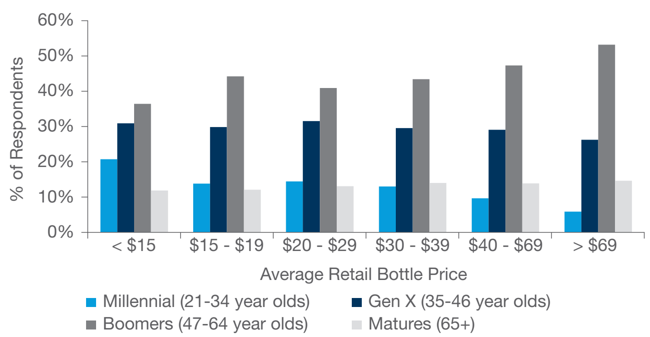
Pricing

George McFly: Last night, Darth Vader came down from Planet Vulcan and told me that if I didn't take Lorraine out, that he'd melt my brain.

Pricing decisions can melt your brain. So, how do you make a good decision? Cost of production plus a margin? What if the market won't bear that cost? What about doing it the other way and getting a survey of the market to determine where there is more pricing opportunity? Should you raise price, cut price, offer higher distributor promotions?

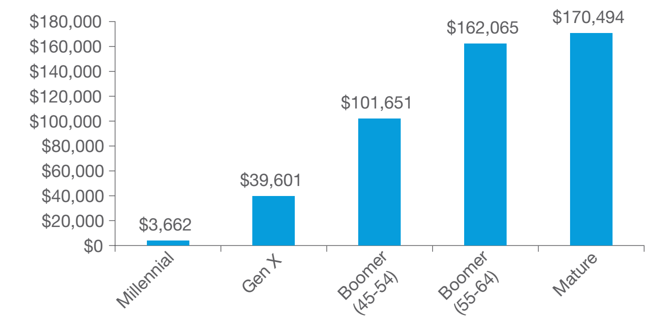
In 2013 we will get a lot of discussion among growers, producers, distributors and consumers alike on the topic of pricing because producer prices are up, their margins are squeezed by higher grape prices and the consumer is pushing back on increases.

Figure 1: 2012 Wine Sales by Age Group



Source: Silicon Valley Bank Proprietary Research

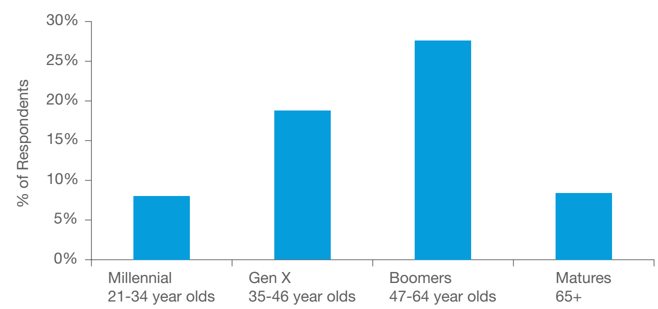
Figure 2: Median Net Worth



Source: Survey of Income and Program Participation, Table E

In 2012 we might have sounded more like Dr. Emmett Brown living in some fantasy world when we said there would be some *modest bottle price increases taken in the fine wine business in 2012 but not anything like a return to past years*. Coming off several years where discounting was as about as likely as a bad Dr. Brown invention, that prediction was met with some skepticism. But based on Nielsen Beverage information, the SVB Peer Group Database[vii] as well as distributor and winery interviews, it does appear that bottle pricing has gone up, but only slightly as predicted.

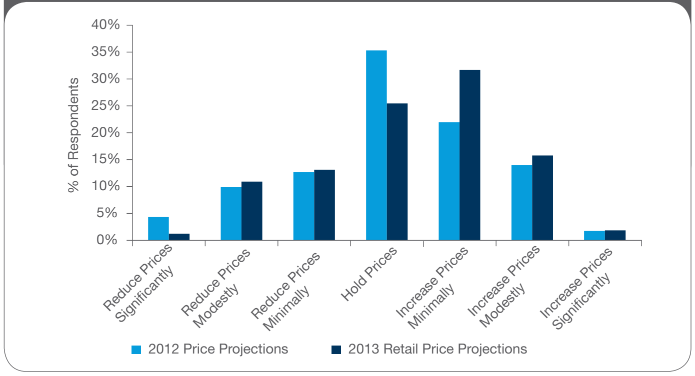
Figure 3: Average Sales per Demographic



Source: Silicon Valley Bank Proprietary Research

Restating what should be obvious to most everyone despite continuing misinformation to the contrary, the Boomers as seen in Figure 1 from the Annual SVB Wine Conditions Survey,[viii] are by far the majority buyers of the higher price point wines, and unsurprisingly older consumers have the greatest amount of wealth as seen in Figure 2. Said the other way, the younger Millennials have both the lowest net worth and buy the cheaper priced wines. Reviewing Figure 3, wineries with CRM[ix] report the Boomer is still the overwhelming buyer of wines of all price points.

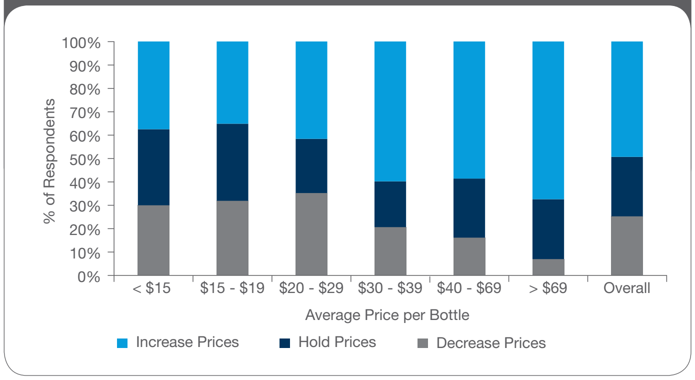
Figure 4: 2012 vs. 2013 Retail Price Projections



Source: Silicon Valley Bank Proprietary Research

We continue to be questioned when more aggressive pricing increases will be accepted in the market. The SVB Annual Wine Conditions Survey this year reveals owners believe the market may now be ready to swallow some additional increases in 2013 as you can see in Figure 4. Fifteen percent of respondents believe the market might even accept modest pricing increases, which is an upturn in response rates over the results from 2012. But is that a true perception?

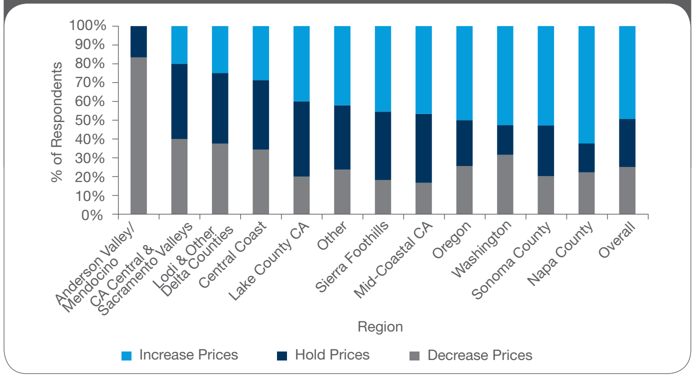
Figure 5: Net Retail Price Expectations for 2013



Source: Silicon Valley Bank Proprietary Research

Reviewing Figure 5 titled Net Retail Price Expectations for 2013, you can see a little more information. The higher priced producers have more confidence in their ability to increase prices versus the lower price point producers. The producers making $20-$29 wines are predicting the greatest difficulty. Other survey results point to poor distributor representation and higher stocks of wine as larger issues for the $20-$29 price range and a possible cause for the slightly different view of the market opportunity. But another possibility is the wines in that range were in price points in which the high-end consumer traded down post-Crash. During the last several years we saw pricing compression and blending down of reserve wines by many fine wine producers. Negociants produced a better quality of wine from the temporary market excess as well. The consumer had prior become enamored with the value in that segment. But with wines more in balance now, those producing wines in that reduced price range have had to lower quality, making price increases difficult.

Figure 6: Net Retail Price Expectations for 2013 by Region



Source: Silicon Valley Bank Proprietary Research

By region as you can see in Figure 6, wineries in the major producing areas of Oregon, Washington, Sonoma and Napa have the highest confidence in being able to attract higher pricing, which is consistent with the higher pricing opportunity available when an AVA or region spends time branding and building the perception of quality and differentiation.

There is a lesson in that for California appellation wines. Growers and producers of those wines have to come to terms with foreign imports taking market share. And they must acknowledge the fact that younger consumers are changing their views about the superior quality of traditional California gateway wines and drinking more foreign wines than generations of the past, demonstrating very different preferences. They are increasingly more ambivalent about region, not caring much about the origin of the product. They care about the color, price and the varietal.

Pricing Strategies

We believe the survey respondents may be a little optimistic this year and that 2013 will be a more difficult year in which to expect pricing increases for two primary reasons: 1) despite growing consumer optimism as of this writing, we believe the U.S. economy is closer to stall speed entering Q1 2013 as will be discussed later in this report; 2) with the very strong 2012 vintage year, we expect many fine-wine consumers will forgo the 2011 wines and just wait for the release of the 2012s. The implication for the producer of vintage-dated wines is that it's probably the right time to take some of the chips off the table, and move through the 2011s with some alacrity so the 2011 vintage won't end up on the shelf competing against other producers' 2012s. Those wineries who take price increases early in 2013 might be surprised by sales slowdowns when other wineries push through their 2011s. While it's possible that economic conditions might be better than we anticipate and that could then improve demand, the risk in holding back on the 2011's is a bet we wouldn't take in 2013. To the extent there are opportunities to price up a little, it will be in reserve and higher priced wines.

The longer-term implication of developing a young consumer with loyalty to foreign products isn't positive for the U.S. wine business. Larger domestic producers seem ambivalent about place of origin based on the level of bulk imports, but even they have risk in seeing their own products usurped by foreign brands. That will have a long-term toxic impact on price.

Financial Performance of Wineries

Dr. Emmett Brown: Oh, my God. They found me. I don't know how, but they found me. Run for it, Marty!

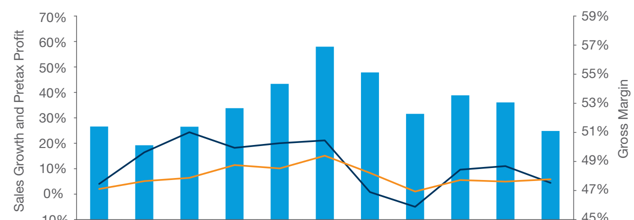
Marty McFly: Who? Who?

Dr. Emmett Brown: Who do you think? The Libyans!

Marty McFly: Holy s**t![x]

The wine business is a family run industry and financial statements and returns aren't just lying around on the interwebs. As bankers, we have the information and have for years condensed that data into statistics which we give to our clients for free. As a result, people from Libya[xi] to the Languedoc contact us about getting help in financial modeling. I always disappoint them when I say the information is reserved for clients only, but pointing them to Figure 7 does help somewhat.

Figure 7: Wine Industry Financial Performance



	12/31 2002	12/31 2003	12/31 2004	12/31 2005	12/31 2006	12/31 2007	12/31 2008	12/31 2009	12/31 2010	12/31 2011	9/30 2012
Gross Margin	51.5%	50.2%	51.5%	52.8%	54.5%	57.1%	55.3%	52.4%	53.70%	53.20%	51.20%
Sales Growth	5.2%	17.6%	25.5%	19.4%	21.2%	22.3%	2.0%	-3.8%	10.80%	12.20%	5.60%
Pretax Profit	3.2%	6.3%	7.6%	12.6%	11.3%	16.3%	9.5%	2.2%	6.70%	6.10%	7.00%

Source: Silicon Valley Bank Proprietary Research

Each year in this report we take a look at the financial condition of wineries, review historical trends and forecast a sales growth band for the fine wine segment which we define as wines sold over $20 retail. Last year in 2012 we predicted sales growth of 8–11 percent and expect to end in the lower end of the range. This year, our forecast range will drop.

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The good news is there was sales growth in the segment. As we look at the financial position of wineries this past year starting with Figure 7 developed from SVB's Peer Group data base,[xii] revenue growth through nine months ending September 30 was about six percent. Our data are not seasonalized so it's likely we will see an increase in that number when the heavy October through December data are included. Symphony IRI data for 12 months in off-premise accounts during the period ending November 15 shows positive revenue growth of 7 percent for all pricing SKUs, but even higher growth rates in the $20+ category. Nielsen Scan Data for 52 weeks in the $20 and above price points from off-premise sales ending October 13 show fine wine sales growing 7.2 percent. Each of those data bases suggest we were at the low end of our forecast range for 2012. Will we hit our year end prediction of 8-11 percent? It's going to be close but I'm going to say we will with a good Q4.

The bad news in 2012 was all the various information we reviewed on sales pointed to the same thing: slower sales growth rates through the year. Furthermore, higher-cost inventory passed through income statements from a short vintage and that lowered gross profit for the industry. Pretax profit through September was flat despite the modest sales growth. Financially, wineries in 2012 look about the same as they did in 2011 except for sales growth. Taken as a whole, the financial performance of wineries in 2012 was … well … just OK[xiii] much like what we are seeing in the U.S. and world economies. There was positive sales growth, but the rate of growth was lower, the trend is down, and there was no improvement in profitability. **Fine wine producers were unable to pass on higher costs to consumers or recover higher pricing established in prior periods.**

Financial Summary and Forecast

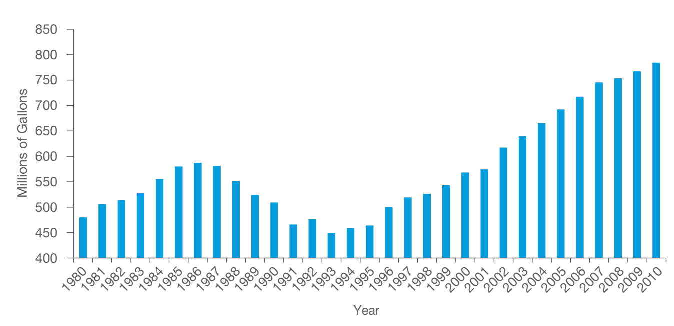
What is clear in reviewing information from multiple sources is revenue growth in the fine wine business will end the year lower than the prior year. That is driven home visually in the SVB PGA information in Figure 7. As will be discussed in a later section on the economy, the negative trend is mirroring the slowdown in the U.S. economy over the past year. Among other indicators, those events have us predicting sales growth in fine wine sales in 2013 will drop for the fourth consecutive year in a range between 4-8 percent. While that is growth, it's a prediction of very tepid growth. Given higher grape costs from the 2012 vintage, we expect gross and net profit for wineries to be negatively impacted as well in 2013.

Economic Insights

The U.S. Wine Business

Decades ago, total wine consumption in the U.S. peaked at 587 million gallons and then started to drop beginning in 1987 when a combination of M.A.D.D.,[xiv] neo-prohibitionists and health advocates teamed to deliver an anti-alcohol message that stuck with a changing consumer. In 1991, the CBS program 60 *Minutes* aired a segment called "The French Paradox" citing the findings of Serge Renaud, a scientist from Bordeaux University in France who linked wine consumption to lower risk of coronary heart disease. Consumption started to bottom then beginning in about 1994 wine consumption started to grow again. It has been on an uninterrupted string of consecutive growth years ever since[xv] (Figure 8) as the Boomers discovered wine and wealth at the same time, leading to the Valhalla of business; growing volume and higher price paid per unit of production.

Figure 8: Total U.S. Wine Consumption



Source: Wine Institute

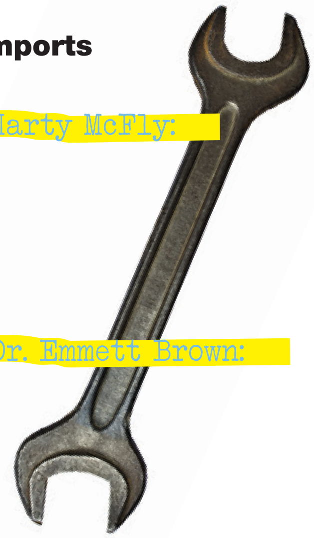
Post-Great Recession, the major factor in the growth of wine sales came largely from the affluent encouraged by accommodative fiscal policy and low interest rates. Said plainly, the stock market reflated off its lows, recovering wealth for the affluent in their stock investments. With that the Wealth Effect[xvi] took over, which is growing back sales. But for the middle class who have little stock investment and more of their wealth tied to their homes, their recovery is not close to being what it was pre-Crash and they won't participate until the economy shows signs of real life and the securitization process is rebuilt.[xvii]

Where is the U.S. wine business headed? Expecting to see the kind of growth — concurrent with pricing increases as seen in the

1990s — is unlikely in the future for many reasons, including slowing worldwide economic growth discussed later in the report, the maturation and retirement of the Boomer, high land prices for U.S. fine wine, and our own domestic debt issues. **We have entered a period of domestic economic stagnation that should reset our view of business returns and prices for years to come,** at least until either the middle-class regain their purchasing power, or we see inflation begin to dominate financial discussions. Neither is imminent.

The Big Drinks Business

Imports



Marty McFly: Wait a minute, Doc. Ah ... Are you telling me that you built a time machine ... out of a DeLorean?

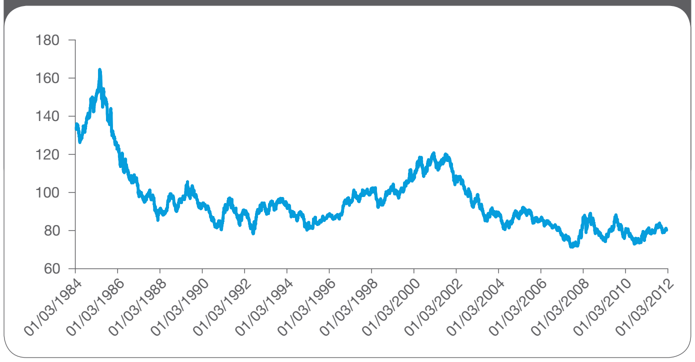
Dr. Emmett Brown: The way I see it, if you're gonna build a time machine into a car, why not do it with some style?

It used to be a measure of style if you consumed or possessed some import from Europe, including cars. French wine and German or British cars showed your sophistication and wealth. While the DeLorean really looked cool, it was a brick to drive. I'd feel more comfortable in a BMW versus the DeLorean if I were building a time machine. Since this film was shot in the 1980s the price would have been more affordable for the import as well.

The flow of imports waxes and wanes based on the domestic supply of grapes and wine, as well as the value of the dollar. The clearest example of imports hurting the domestic wine business was in the early 80s just before *Back to the Future* was filmed, when U.S. fine wine was just getting its footing and most of the world currencies were considerably weaker. As a consequence, we saw an explosion in very nice European bottled wines imported to our shores. It was very difficult to compete in those days as often the imported wines were better qualitatively, and on par or cheaper than what we made in our fledgling domestic fine wine business.

On the higher volume side of the business back then, we saw domestic growth in large consumer brands such as Reunite from Italy which peaked at almost 12M cs., Blue Nun from Germany which peaked at 1.25M cs, and Mateus from Portugal which at the time represented 40 percent of Portugal's total wine exports. Each of those brands peaked in the middle 80s in the U.S. market in part because of the abject strength of the dollar.

Figure 9: USD Index



Source: Bloomberg, Silicon Valley Bank

The reason the dollar was so strong was Fed intervention. Paul Volker's Fed raised the prime interest rate past twenty percent in an effort to kill inflation. In fact, so strong was our currency that world powers came together for the first time and agreed to a unified effort to reset the world currency markets in what became known as the Plaza Accords.[xviii] The consequence of the agreement deflated the dollar as seen in Figure 9 on the left side of the chart, altered our own balance of trade and current accounts, and effectively transferred wealth to other countries. The Plaza Accords stalled out the growth in wine imports into the U.S. and reversed the course of those mass consumer labels.

Today world interest rates are at an all-time low and many countries are waging a battle to weaken their currencies further to give their exports a boost. Despite the legislative incompetence of Washington and the resulting loss of our AAA debt rating, the U.S dollar is still the world's reserve currency attracting money flows and strength. We are the most beautiful sweater in an ugly sweater party. The EU is range-bound as we write this report, and we can't today describe the euro as weak just yet relative to the dollar, but the day is approaching and will likely happen once Washington restores some certainty to markets by legislating us off the fiscal cliff and making tax policy clearer.

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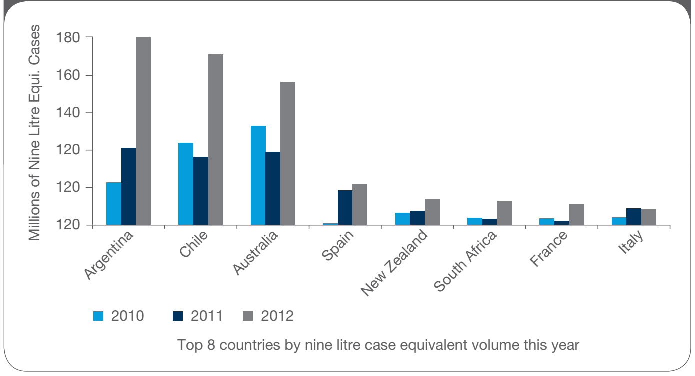
In some ways really nothing has changed for the wine business from the early 1980s, except our winemaking is a whole lot more evolved. Today the wine exporting countries of Chile, Argentina and even South Africa share a common fate having a currency that is weakening or is already weaker than the U.S. dollar much like European currencies were in the early 80's. That is driving their market share of the U.S. business higher.

Jon Fredrikson, the dean of wine business analytics, credits recent short supplies as the major factor for 2012 bulk increases, explaining the situation as follows:

> **"Bulk wine imports to the U.S. more than doubled this (last) year, soaring from 13.7 million cases, to 31.5 million cases, and totaling over 40 million cases in the past 12 months.[xix]"**

Fredrikson noted the countries of Chile, Argentina and Australia are responsible for 75 percent of all bulk imports in 2012 as you can see in Figure 10. But in our estimation, it's not just the current supply change that is fostering such dramatic growth in bulk imports. This is a structural change caused by higher domestic demand, better access to foreign bulk today for a host of reasons, and favorable exchange rates for those mentioned wine exporting countries. If we are right, don't expect to see bulk imports drop this year despite the large 2012 harvest. If the dollar strengthens, expect bulk wine imports to only increase. In fact, **we believe imports of foreign bulk wine will continue unabated as long as domestic producers have the ability to buy cheaper generic bulk wines that are perfect generic substitutes for Central Valley grapes.**

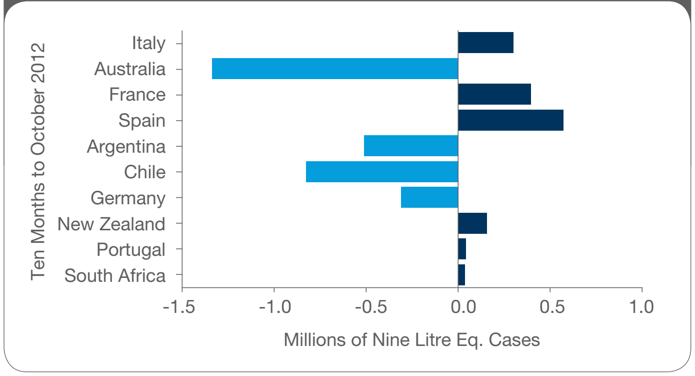
Figure 10: Bulk Wine Imports Pour Into the U.S. as California Wine Supplies Dwindle



Source: U.S. Department of Commerce, Gomberg, Fredrikson & Associates

What about bottled imports? In our 2012 report we did predict more imports in 2012 from the euro zone. While we didn't see the bottled volume we expected, the countries of Spain, France and Italy did post the largest gains in imported packaged wines in 2012[xx] as seen in Figure 11. Still, we really aren't at the point where we are seeing a flood in European bottled wines, which would make domestic sales substantially more difficult as it did in the 1980s. That is due to the real and perceived intervention of the ECB,[xxi] and statements from Mario Draghi[xxii] — most notably his proclamation from July 26, 2012 when he told an investment conference in London that "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough." That statement has since led to a higher trading range for the euro.

Figure 11: Change in Packaged Wine Imports from Spain, France and Italy Posted Solid Gains



Source: U.S. Department of Commerce, Gomberg, Fredrikson & Associates

The EU Factor

We believe Draghi's comments on the prior page were directed at preserving the Eurozone Agreement and not aimed at strengthening the currency. Long term, every indication is the euro should weaken against the U.S. dollar. While our economy bumps along at a weak rate of growth, the EU must: deal with massive problems in basic agreements, repair huge cultural differences, deal with debt and banking crises, and repair a recession. As the entirety of the EU slips back into recession, the ECB will want to weaken the currency to enhance exports. The combination of their weak economic markets and a need to enhance exports suggests to us that the currency will weaken in 2013, perhaps for an extended term.

Global Drinks Business

Marty McFly: Calvin? Wh … Why do you keep calling me Calvin?

Lorraine Baines: Well, that is your name, isn't it? Calvin Klein? It's written all over your underwear.

The OIV announced this past fall that global wine production slumped to the worst production in 37 years after weather damage across the globe in producing countries. It sounds really bad to hang that moniker on the situation the worst in 37 years. Reading it makes one think we might run out of wine! The reality is we will run out of wine when Michael J. Fox changes his name to Calvin Klein. Ain't gonna happen.

World output was estimated at 6.56 billion gallons, down 6 percent from the prior year. In their annual release the OIV said "market feedback suggests bulk wine availability is falling and prices are climbing." Regionally, France's wine production slid 19 percent, Argentina's by 24 percent, and Spain's by 5.7 percent. But those statistics don't take into account the forthcoming harvest in the Southern Hemisphere, which is on the way and looks good at this early date.

Like several economic indicators, the performance of the world wine companies, Diageo (NYSE: DEO), LVMH (Paris: MC) and Pernod Ricard (Paris: RI) all reported positive but slowing growth in 2012 particularly from Asia. That decline in growth offset the decline in world wine inventories to some extent. For three months to the end of September, sales growth at LVMH was 6 percent compared with 15 percent in the same period in 2011; at Diageo it was 5 percent versus 9 percent in 2011, and at Pernod Ricard it was 6 percent versus 11 percent.

It should be noted that the growth was off a weak base. Part of the drop in year over year growth was due to simply being unable to sustain large post-recession growth rates indefinitely. But projecting world growth rates in 2013 is a little trickier because underneath all of it, the world economies are slowing, including all of Asia's conspicuous consumption of luxury goods. So with declining economic output, how crucial is lower world production?

U.S. Economic Forecast

Dr. Emmett Brown: I'm gonna read your thoughts. Let's see … You've come here from a great distance.

Marty McFly: Yes exactly!

Dr. Emmett Brown: No! Don't tell me! Ughh. You want me to buy a subscription to the Saturday Evening Post.

Marty McFly: No!

Dr. Emmett Brown: Not a word! Not a word now … quiet. … Donation! Ughh … You want me to make a donation to the Coast Guard Youth Auxiliary!

Marty McFly: Doc … I'm from the future. I came here in a time machine that you invented. Now I need your help to get back to the year 1985.

Dr. Emmett Brown: ‹sighs› My god … Do you know what this means? … It means this damn machine doesn't work at all!

It used to be that finance and economics were more about earnings, GDP, interest rates, taxation and Fed actions. No longer. We spend more time talking about politics now, and market activity is based on technical analysis and risk on - risk off trades. The sad state in Washington is about the same as a Dr. Brown mind reading machine. The Washington governance machine doesn't work at all.[xxiii] The situation is so bad in Washington these days, Congress is thought of less highly than bankers — as if that were possible.[xxiv] Congress and the President don't need to be mind readers to know the electorate is expecting them to act for the good of the Country instead of trying to score political points.

As we write this report in mid-December, the decision on the fiscal cliff has not been made. But putting on Dr. Brown's machine, I can see that we will all need shin guards to keep the kicked cans moving down the road from hitting us in the shins. I am sensing it won't be finalized in December, but there will be the framework for an agreement completed. Let's hope the machine works on this one because the markets are focused on it just like they were on the euro in the summer and the U.S. presidential election in the fall.

The message from the Fed and others is if we go off the cliff, we will be in a recession. Why? Because the economy is very weak to start and if you cut government's contribution to GDP because of sequestration cuts, of course we will be in another recession. GDP has been propped up by government spending.

Because of media-driven, ADD-fueled, flavor-of-the-month, homogenous news production, there exists a lack of focus on the fundamentals of the world and the U.S. economy. Markets and news outlets seemingly get tunnel vision and focus on the next shiny thing to come along. Nevertheless, business people still are forced to understand their own economic surroundings and make forecasts of growth despite the unknown. Wineries need to get a feel for the business climate in a given year because understanding the economy allows you to forecast consumer demand, and that leads to decisions on your bulk wine decisions in the spring.

There are important trends that will impact U.S. wine producers' success that aren't getting attention in the media, and leading the parade is a discussion on the nominal rate and negative trend of GDP growth today.

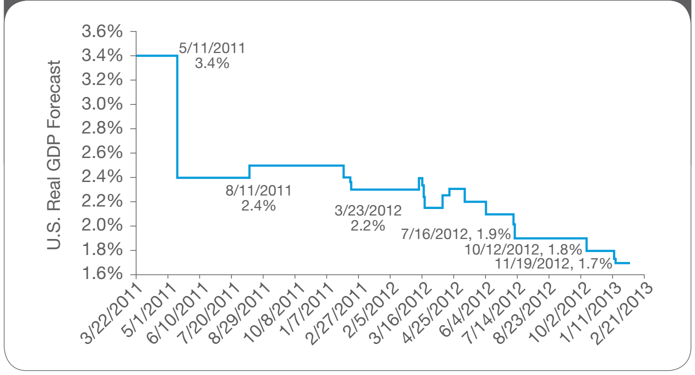
Figure 12: Quarter to Quarter Growth in Real GDP

Source: U.S. Department of Commerce, Bureau of Economic Analysis

The pace of GDP growth in the first half of 2012 totaled just 1.8 percent, the same as for all of 2011. In fact, looking back to 2010 — the first full year since the recession ended — with its growth of 2.4 percent, the three-year span will be the three slowest consecutive years of economic growth outside of a recession or depression dating back to 1930. While Q3 GDP improved as you can see in Figure 12, the improvement came largely from defense transfers that were one-time events and aren't sustainable. The remaining text from the BEA[xxv] on the quarter noted consumer spending on goods and services slowed, business investment in equipment and software declined, and the upward revision announced in November was due to higher inventories in manufacturing and wholesale trade.

Silicon Valley Bank

Figure 13: Bloomberg Median Q1 2013 U.S. Real GDP Forecast



Source: Bloomberg, Silicon Valley Bank

As seen in Figure 13, the expectation for growth in Q1 2013 according to the Bloomberg's median GDP forecast of economists continued to drop in 2012 as economists watched the ticker instead of the U.S. elections. The consensus forecast for economic growth for Q4 and the Q1 of 2013 is 1.7 percent. That's like getting a half ton off your vineyard.

Once GDP gets momentum in any direction, it feeds on itself through the strength of consumer and business confidence. Said another way, when your good old wine-making neighbor decides it's time to hire more people and you notice, that influences your decisions causing an up-tick in hires that are multiplied as those salary dollars are spent in different ways throughout the economy. **The problem for now is GDP has continued to drop to very bland levels over the past year with both current and projected consensus real GDP now solidly below 2 percent. That doesn't bode well for growth forecasts in the wine business.**

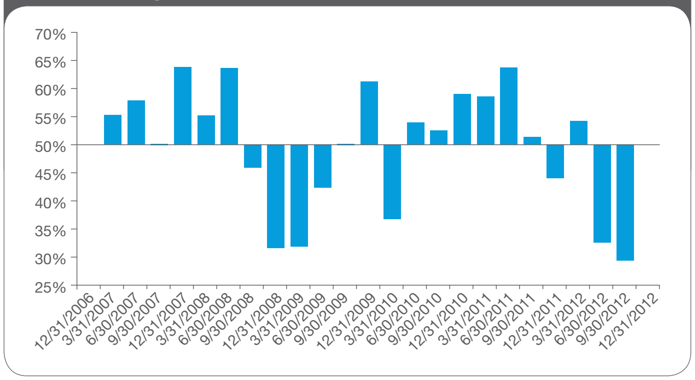
Corporate America

Dr. Emmett Brown:

Don't worry. As long as you hit that wire with the connecting hook at precisely 88 miles per hour, the instant the lightning strikes the tower … everything will be fine.

Corporate America tries to dial in its performance with a high level of precision. Like Marty, it wants to hit the electrified wire on the mark or it ends up crashing into analysts' expectations. That's exactly what happened in the third quarter of 2012: Corporate America missed the mark (Figure 14).

Figure 14: Percent of the S&P 500 That Beat Quarterly Revenue Expectations



Source: Bianco Research

The S&P 500 companies each forecast what their earnings and revenues will look like in the next quarter. They normally hit their targets because when they announce their forecasts during their quarterly earnings releases, they already have one month in the bag and an idea of upcoming orders. They really have to forecast out just two months and most know what the backlog looks like. It's always the case that public companies manage shareholder expectations. They won't stretch on a goal. They would rather under-sell and over-deliver. So it was with a lot of interest that the Q3 misses for the S&P came in at 70 percent. That means 70 percent of the S&P couldn't figure out where their revenues would be for just the next two months in Q3.

Something happened in July-Aug-Sept that was surprise to Corporate America. Whatever it was, it attracted no discussion, but does show up in the Conference Board Measure of CEO confidence which fell in the second quarter and declined again in the third quarter. The index is at 42 which is down from 47 in Q2. A reading of more than 50 points reflects more positive than negative responses from CEOs. Current information suggests Corporate America is becoming more pessimistic with just 9 percent responding the economy is better than it was in Q1 and as a result, nearly a third of CEOs report scaling back on capital expenditures, with only 10 percent saying they planned on spending more in 2013.

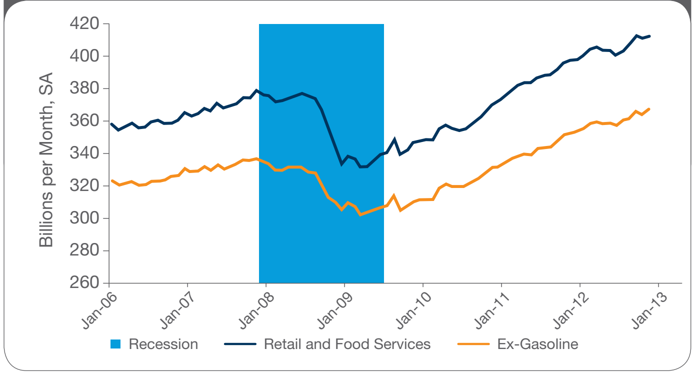
The Consumer

George McFly: Lou, give me a milk ... [dramatic pause]

George McFly: Chocolate.

George McFly was acting the part of many U.S. consumers over the past several years. After getting a handle on the U.S. housing crisis, they gathered themselves up, had a good stiff drink — chocolate in his case — and with determination and confidence adjusted their attitudes and planned for a changed future. In fact, the consumer has been more confident this past year based on higher consumer sentiment readings. That's a good thing, especially going into the big holiday shopping season. The Nielsen Consumer Confidence Index increased in November and is now at its highest level since February of 2008 — almost a five-year high. The Conference Board reported the improvement explaining that since August 2012, consumers have grown increasingly more upbeat about the current and expected state of the job market. That's very good news as we know the consumer is responsible for roughly 70 percent of GDP and 100 percent of wine drinking.

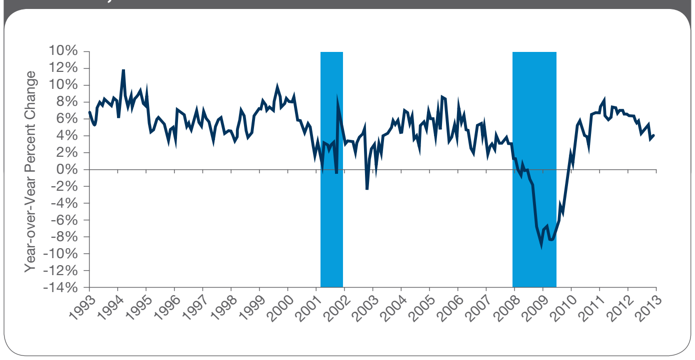
Figure 15: U.S. Retail Sales



Source: www.calculatedriskblog.com

In past reports we've discussed the issue of the aging boomer and that they hold the majority of wealth and purchasing power. Consumers must both have the desire to buy and have the capacity to spend. But since the start of the Great Recession their capacity has been impaired. Retail sales are an indicator of both willingness and capacity. When retail sales move up, the consumer is in the mood to shop and generally is expecting good things. Retail sales continue to see growth as we see in Figure 15. Gasoline is akin to a hidden tax on consumer spending, so when that's taken out of the equation, spending on the non-gas items remains. Both trends flattened this summer but consistent with Consumer Confidence, retail sales over 12 months ending in September 2012 were up 5.4 percent for the period. Reviewing Figure 16 however, you can see while retail sales are up, just like GDP they are higher but at a decelerating rate.

Figure 16: Year over Year Change In Retail Sales and Food Service, ex-Gasoline

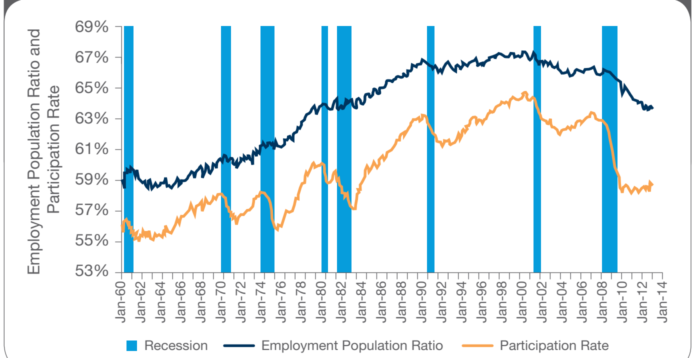


Source: www.calculatedriskblog.com

What it does show is the consumer seems blind to the Kabuki Theater in Washington and the finger pointing from Bohener and Obama that has Wall Street and the news outlets transfixed. Give the consumer this much: they might not be agricultural majors, but they don't need a degree to smell the bulls**t[xxvi] coming out of the Beltway. Given the chance, they will spend if they have the capacity to do so and capacity (jobs) is the key.[xxvii]

The unemployment rate is continuing to drop and that makes us feel better, but the number of employed persons really isn't changing much because of the way the measure is calculated. In order to see growth in the economy, we need to have more employed people and fewer people on unemployment. Figure 17 is instructive to the point. The employment participation rate is now about the same place it was in 1982. There are more people than 1982, however, and while the employment-to-population ratio seems to have found a bottom, it shows the economy is adding barely enough jobs to keep up with population growth. According to Bloomberg, the biggest single factor driving the unemployment rate lower in recent years has been the 10,000 Boomers who are retiring daily and retirement of Boomers who represent more than 40 percent of wine purchases, isn't going to help improve growth in the fine wine segment.

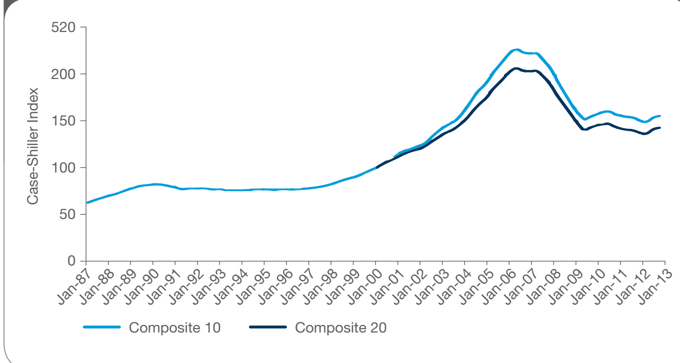
Figure 17: Employment Population Ratio and Participation Rate



Source: www.calculatedriskblog.com

As of this writing, about 23 percent of all homes in the U.S. have equity that is less than the mortgage amount. That's not only a drag on the healing economy, it's a drag for that percentage of the population who are in a bad spot and unlikely to spend much on luxuries. For there to be any sustained upward pricing opportunity accepted by the consumer, we are going to need to see the middle class more forcefully join the recovery.

Figure 18: Case Shiller Composite Indices SA (Nominal)



Source: www.calculatedriskblog.com

The good news when looking at Figure 18 is we have formed a bottom on price. That stops the bleeding and for homeowners close to being in the black, is an encouragement that they might see some light at the end of the tunnel. It's not the same as getting a pay increase, but psychologically consumers will feel like they are better able to negotiate their financial future and firming home prices can only help. At this point, however, Personal Consumption Expenditures, essentially a measure of goods and services targeted toward individuals and consumed by individuals, are growing at a miniscule 1.4 percent.

The Affluent Consumer

Marty McFly:

[whilst with his girlfriend] What happens to us in the future? Do we become assholes or something?

Back in the 1955 when *Back to the Future* was set, people in the U.S. aspired to be millionaires and billionaires … though I'm not even sure there were many billionaires back then while now it's a rounding error in weekly government spending. In any case, the affluent class were admired either as a type of American royalty if they inherited their wealth through some industrialist, or they were respected as hard-working self-made people who were an example of the American Dream at work. Today, millionaires and billionaires are fair game for derisive comments and abuse. Rather than people to be emulated and admired, politicians have cast them as a bunch of greedy assholes who got their wealth unfairly and don't pay taxes. That was

Marty's greatest fear. While the butt of jokes and scorn, the reality is the affluent pay the majority of taxes in the U.S. The top 10 percent of wage earners making a little more than $100,000 a year pay 70 percent of total federal income taxes.

Affluent shoppers have a major impact on retail spending as well with the top 20 percent of wage earners accounting for 40 percent of consumer spending[xxviii] and representing a unique opportunity in the retailer's eyes. The luxury consumer is the primary fine wine buyer and — just like the average Joe —ran hot and cold in 2012, picking back up in their confidence according to Q3 surveys but reining spending in during Q2. Overall and affluent expectations for the holidays continue to be modestly optimistic for retailers as of this writing and we are keeping our fingers crossed for good results.

Base Financial Forecast for 2013

We believe the financial recovery has shown signs of stalling out for months now and while we are not forecasting a recession for 2013, it is possible to see negative growth for a period. We do believe based on the ECRI Index of leading indicators, the mood of the consumer and spending, and the housing bottom, the economy will start the year off slower before beginning a longer trend recovery at the end of the year.

There are a number of changes taking place with affluent consumers and their purchasing patterns worldwide. Fine wine sales in restaurants have been slowing for all of 2012 and that trend accelerated toward the end of the year according to depletion and distributor information. According to Bloomberg, Burberry (LSE: BRBY), Mulberry (LSE: MUL), Harry-Winston (NYSE: HWD), and Tiffany (NYSE: TYF), each reported a slowdown in Q3 sales largely due to uncertainty in European sales, the fiscal cliff debate in the U.S., the softening of consumer demand in China, and lower demand from status-seeking consumers in emerging countries.

Bain's *Annual Report on the Luxury Market*[xxix] noted that in 2010 and 2011 demand for luxury goods in China grew by an astounding 30 percent and 35 percent respectively, but will slow to a still quite respectable 18 percent in 2012 as the country's overall economy drops to a 7 percent growth rate. Fueling the slowdown in purchases has been new Chinese leader Xi Jinping's policy to restrain displays of power and wealth in the ruling class.

Bain release on the Report noted the nature of luxury spending is shifting substantially in several key ways:

- Chinese consumers have further transformed the luxury market, with growth in domestic sales and continued voracious spending as tourists. Greater China has bypassed Japan as the sector's second market, behind the United States. Chinese consumers now make half of the luxury purchases in all of Asia, and nearly one-third of those in Europe. Globally, one in four purchases of personal luxury goods comes from Chinese consumers.
- Ecommerce is continuing to grow at 25 percent growth a year, while sales at off-price (i.e., discount) outlets will see 30 percent growth in 2013. Together, these emerging channels amount to the equivalent of luxury sales in Japan.
- A generational shift is under way as young consumers seek significantly different experiences from luxury consumption, seeking uniqueness over heritage, 24/7 access over exclusivity, and entertainment over mere shopping.
- Accessories have become the core category in personal luxury goods. For the first time, leather goods and shoes have become the largest piece of the market, now at 27 percent of total luxury sales. The category is seeing increasing levels of male spending, and increasing interest in higher quality, higher price items.
- Tourists now account for 40 percent of global luxury spending. As tourism and luxury spending become more tightly intertwined, the experiential dimension of luxury consumption becomes as critical for brands to deliver as their products

Several of these findings are closely linked with fine wine sales and marketing strategy, in particular the final point. As we have said on numerous occasions, fine wineries are as much about creating an experience as they are about creating wine. Wine tourism is an area of economic growth and all wine growing regions and AVA's should be supporting wine tourism as they look for new areas of local tax revenue.

Dr. Emmett Brown: Then tell me, future boy, who's President of the United States in 1985?

Marty McFly: Ronald Reagan.

Dr. Emmett Brown: Ronald Reagan? The actor? [chuckles in disbelief]

Dr. Emmett Brown: Then who's vice president? Jerry Lewis?

Dr. Emmett Brown: I suppose Jane Wyman is the First Lady!

The Role of the Internet on Consumer Demand for Wine

One of the differences between today and the Age of Enlightenment is the Internet. On the positive side, we now have a more effective way to sell direct, and the consumer has a way to get their wine to their door. Many companies have or are working on updating algorithms that that better direct the buying decision of consumers … if you like this wine, you'll love this one. It's not a brand new concept but the engines behind the initiative are growing more and more sophisticated. Put in the hand of a retailer, they will more effectively offer individualized choices that present the best margin for a retailer.

Online retailing also gives the consumer information on pricing, quality, value, and the location where you can purchase the product. Consumers can now have what they want, when they want it, AND a computer can now tell them what they will want next time they purchase.

The odd coincidence is that the Web provided a new and cost effect channel in which to sell wine, but at the same time provides the information for a consumer to better drill down on pricing decisions and buy someone else's wine. So while the Internet has been a boon to direct sales, it's also been the pathogen that puts more of a spotlight on price, making both producers and retailers alike more price focused.

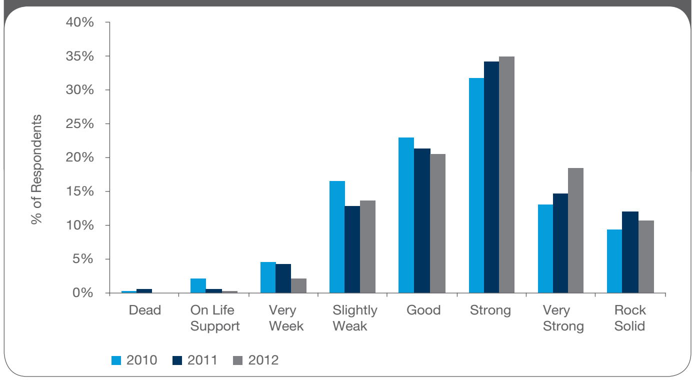
We believe the consumer in 2013 will have a mixed appetite. While we believe the U.S. economy will slow, we believe consumer demand for wine will continue to grow. On the other hand, in 2013, the consumer isn't going to let their purse strings go. Wines in the $20-$30 price range and over $50 in restaurants will continue to be more difficult sells particularly early in the year.

The wine business is private, but has this penumbra of wealth surrounding it. The masses seem to think the wine community lives a luxurious lifestyle replete with limos, gracious dining, and adult beverages on the veranda at sunset. That's about as misleading a conclusion as Dr. Brown's deduction of Jane Wyman as the First Lady.[xxx]

We've had numerous people ask us to include additional information about industry ratios and averages. We have a robust data set we reserve for clients that can be grouped in a true peer-based framework to give our clients very good performance metrics. This year we are releasing a decade of activity ratios that are very broad measures, but helpful in getting instinct for how the wine business has negotiated the ebbs and flows of the economy and harvest yields in the last ten years. We have included that information set at the end of the report in an appendix. The summary of the information contained in the appendix is the wine business has become more liquid over the period since the Great Recession hit, and with production and sales in balance, is positioned relatively well for any minor surprise in the economy during 2013.

Beyond reviewing our own benchmarking measures, each year we survey[xxxi] West Coast wineries about a number of things including their own financial health. Since we are a bank and have accurate financial results, we can also test the survey data against instinct. We believe the data and information reveal an accurate view of the financial condition of the wine industry.

Figure 19: Financial Conditions Year over Year Comparison

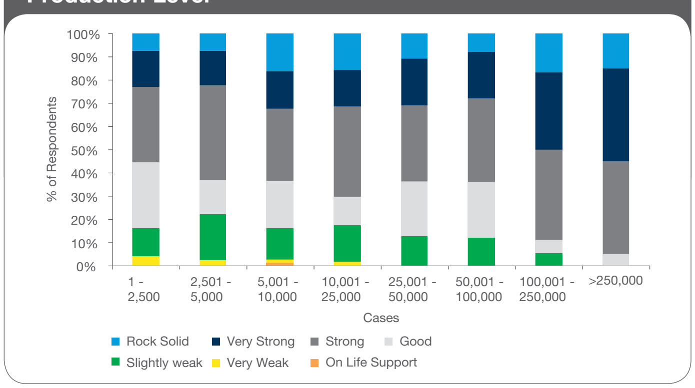


Source: Silicon Valley Bank Proprietary Research

Overall, the wine business is continuing to mend from the disastrous impact of the Great Recession as seen in Figure 19, with the largest year over year changes noted by fewer respondents reporting themselves as very weak and more wineries reporting their condition as very strong.

Reviewing Figure 20, we can clearly see all the weaker wineries are in the lower case production segments: the lower the case production, the worse the reported financial condition.

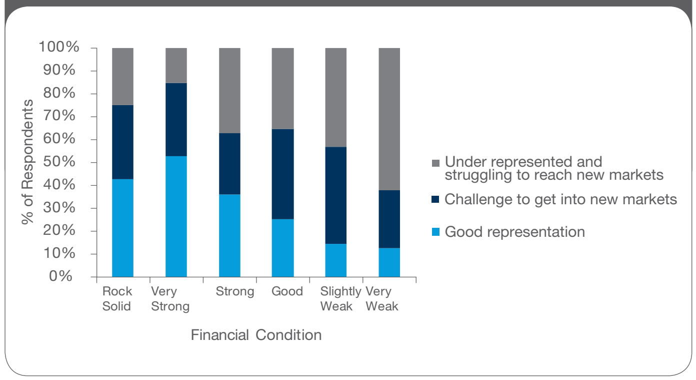
Figure 20: Financial Condition of Wineries by Production Level



Source: Silicon Valley Bank Proprietary Research

Segmented in Figure 21 by winery responses about their feelings on distribution, the healthier wineries are perhaps unsurprisingly the ones who have access to normal 3-Tier Distribution. We believe those two charts together speak to the ongoing difficulty smaller wineries have in sourcing appropriately priced grapes, the pressures on managers who have to wear multiple hats, and less access to institutional distribution.

Figure 21: Financial Condition of Wineries Based on Representation in a 3-Tier System



Source: Silicon Valley Bank Proprietary Research

While we continue to see strides made in direct to consumer sales, that avenue is still not as cost-effective a solution as going through distributors. It's the difference between selling by the bottle or by the case. The application of overhead has to apply to the small sales volumes, and efficiency has to be a part of a manager's thinking process in the ongoing development of a wine brand. Smaller wineries can be commercially successful, but unlike the 1990s, growing grapes and making good wine isn't sufficient for success anymore. Budgeting, developing strategic insight, leveraging information gathering, employing effective sales strategies, finding a unique voice and followers for your message, measuring efficiency of outreach programs, grower relations and a litany of other skills are needed to succeed in a DtC model and overcome the obstacle the lack of distributor representation can cause.

Sales Growth Estimate

There is a clear separation between CEO Confidence and Consumer Confidence. Consumers' confidence is at its highest point in almost five years and they are expecting more jobs on the way. On the other hand, only 9 percent of CEOs think the economy is better than six months ago, and their confidence is lower through 2012 as are job openings and business investment. While the affluent consumer has been spending throughout the recession and recovery, they were hot and cold in 2012.

From this perspective, it seems consumers missed the memo. With top line revenues falling in Corporate America and the prediction of only 1.7 percent consensus GDP growth in Q1 2013, even if the fiscal cliff is resolved, we are quickly moving to a point of stagnation in GDP and new employment. Despite the good mood of consumers, Corporate America won't hire when top line revenues are dropping. We could see unemployment go back up slightly mid-2013 as a consequence, and that is going to make us all a little less confident.

Our forecast for the U.S. economy is for very weak GDP growth throughout the year, with any acceleration taking place toward the end of 2013. The euro should weaken against the dollar over the next 24 months, but earlier movements in 2013 will be hard to predict and depend more on Washington and the ECB actions. The trendline of early stagnating GDP followed by minor improvement later in 2013 impacts our forecast in sales growth for the fine wine business.

While we are quite optimistic about the prospects for the future in the U.S. wine business, the uncertainty of the global economy, domestic markets slowing, lack of world leadership in emerging countries, and euro zone problems are concerning. So while we are forecasting growth in fine wine sales in 2013, we are lowering our growth estimate from the previous year for the fourth year in a row and predicting fine wine growth rates of 4-8 percent in 2013. The industry is making progress, but there are many obstacles ahead and finding new ways of solving problems will separate good and marginal producers.

Forward to the Past

Marty McFly: Doc, about the future ...

Dr. Emmett Brown: No! Marty! We've already agreed that having information about the future can be extremely dangerous. Even if your intentions are good, it can backfire drastically! [Marty nods reluctantly]

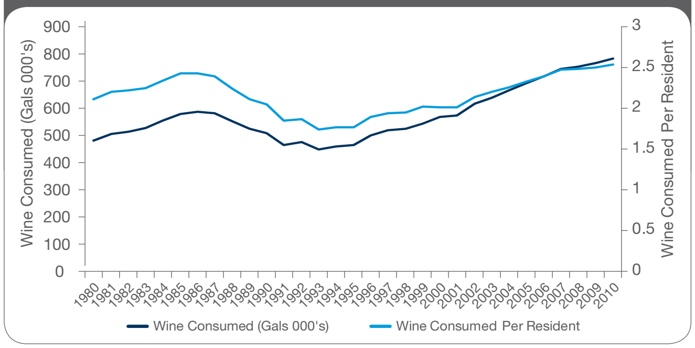
Dr. Emmett Brown: Whatever you've got to tell me, I'll find out through the natural course of time.

I couldn't be as good as Doc Brown in this scene. I'm way too curious about how things work. If I had a chance to know with certainty what was going to happen, I'd take that information and act on it. Can you imagine an envelope in your possession telling you something important about the future and doing nothing with it for 30 years? I guess we'll never know what we would really do in that situation since we can't go forward. The best we can do is look at the past cycles which might produce some information that's useful and can be applied to today.

Take for example the question of how much you are going to crush. How do you make that guess? By looking at what you've produced and making some educated guess about supply and demand for the product itself. It's by far the most difficult thing in the business; balancing current cellar supply and its cost, with expected demand and price for your product. That's particularly difficult when you might not even release a wine you're currently producing for two years. Reviewing prior industry events could give some insight that can be used.

When SVB began in the wine business just a few years after the release of Back to the Future, we were just moving out of a period of declining demand as you can see in Figure 22. Let's call that period "The Dark Ages." It was an era of declining consumption which started in the mid-1980s and was punctuated by the cult of Jazzercise; an exercise activity that required the participant to wear big hair covered with a headband, leg warmers and thong leotards. The period was also marked by the end of the two martini lunch and filled with misinformation. Many theorists believe it was either the CIA or the National Dairy Council spreading the propaganda — no one will ever know for sure — but everyone was led to believe the food pyramid was a conspiracy, and in a balanced diet wine was unhealthy to consume even in moderation. The vestiges of "The Dark Ages" are still able to be seen by warning labels on the back of wine bottles to this day.

Figure 22: Annual Wine Consumption



Source: Wine Institute

As a consequence of those dark days, there was little incentive for new vineyard plantings except by wild speculators. Soft bottle pricing was widespread since we were also coming out of a decade in the 1980s which had two moderate or one long recession depending upon whom you consulted. In many ways, those days are similar to what we experience today with modest demand growth and very limited new plantings.

Beginning in the early 1990s, due to a little mistake made in rootstock development by an unnamed University[xxxii] which allowed phylloxera to reemerge, tens of thousands of acres of dying vines required replanting. Concurrently, demand took off at the same time vineyards were in transition and not bearing fruit, so by 1994 we entered a new era we'll call "The Age of Enlightenment." The French Paradox was partially the cause, but I believe after nearly a decade back then of neo-prohibitionist denial, people would take just about any excuse to have a drink. "It's good for you" only fanned the flames of demand. More important though, it also coincided with the median Boomer reaching age thirty-five; an age which statistics show is the start of a consumers strongest consuming years.

During "The Age of Enlightenment," we were floating along in one of the most prosperous decades in U.S. history and wine supply almost overnight became very short, causing stock-outs in the high-end wineries and forcing larger brands for the first time to augment domestic demand with imported bulk wine from exotic places like Chile and Australia. With a lack of supply, farmers seeking better returns started to rush to plant sticks in the ground.

As we moved into the 2000s it seemed as though the business changed overnight. Gone were the shortages in vineyard land and grape supply. The industry was rocked by the trifecta of all the newly planted, non-bearing acres starting to generate yield, a very heavy 2000 harvest, and a recession resulting from both the Tech Bubble and 9-11. With improved communication from the Internet, large production wineries began sourcing bulk foreign juice as a first option in their sourcing strategy. If the landed costs were cheaper than domestically produced juice, the domestic brand would be filled with foreign wine. That made the farthest southern districts of California un-economic and more than 100,000 acres of vines were removed from California's Central Valley while the U.S. surrendered the least expensive wines to foreign suppliers. We never did get back to seeing balanced supply again until 2012. Wine producers profitability did recover … well, at least until the Great Recession which we all should have seen coming … if only time travel were possible.

This Time it's Different

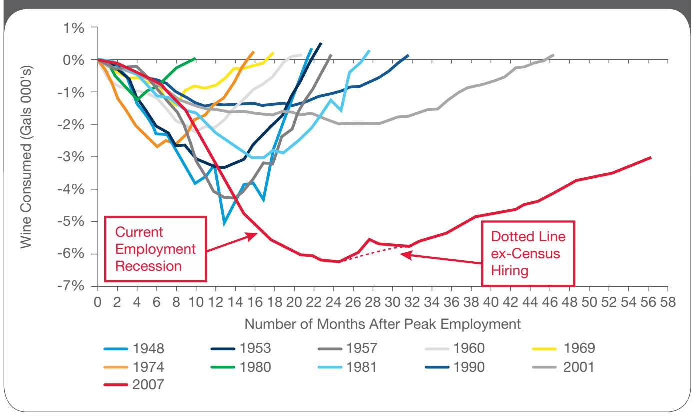
Dr. Emmett Brown: Look! There's a rhythmic ceremonial ritual coming up.

Marty McFly: Of course! The Enchantment Under the Sea dance! They're supposed to go to this. That's where they kiss for the first time.

Dr. Emmett Brown: All right, kid. You stick to your father like glue and make sure he takes her to that dance.

In the movie, Marty's future mom Lorraine takes a liking to her son (Can you say awkward?). If Lorraine's infatuation with Marty had stopped her from meeting Marty's future father George, Marty literally would have just faded into the future. Fortunately, our hero rallies from a disastrous and very different outcome, popping up to save the day at the Under the Sea Dance with a great rendition of Johnny Be Goode.[xxiii] A different outcome would have spoiled more than just the dance.

Figure 23: Percent Job Losses in Post WWII Recessions



Source: www.calculatedriskblog.com

While the circumstance in which we find ourselves most closely resembles the Age of Enlightenment between 1994 and 2004, present day Martys out there can't use those days as a template for action in 2013. While the business continues to rebound from the last recession, the economic recovery isn't the same as you can see clearly in Figure 23. That makes rules of thumb, repetitive strategies from the past and rote responses to business questions dangerous especially when it comes to planting. We can't underscore that enough. Differences between the periods are many and include:

- The Internet
  - Impact on bottle pricing from sites like WineSearcher.com
  - Access to wine through e-commerce including foreign wines
  - A smaller world with better information about foreign supply
  - Faster pace in the business
  - The emergence of the 5th Column[xxiv]
- The Customers
  - Boomers who drove growth in U.S. wine sales are retiring at 10,000 per day
  - Millennials aren't yet impacting fine wine sales
  - All the wealth is with the aging population
- The Economy
  - Trillions lost in consumer wealth from the housing crash
  - Lingering unemployment and slow growth in higher paying jobs
  - Worldwide economic slowdown
  - Large wine producing countries have weakening currencies favoring exports
- The Surrounding Environment
  - High prices for U.S. Ag land
  - Alternative crops that carry better returns
  - U.S. Government's inability to govern, leading to S&P reduction in the debt rating
  - Debt/GDP more than 100 percent with low growth rates

- Granholm decision opening up direct sales into states
- Consolidation of distribution
- More land use restrictions and growing restrictions on water
- According to the OIV, we are at a 37-year low in world wine supply

One of the best things about 2012 versus 20 years ago is the ability to communicate and access information. The world around us is moving quickly but we can make evolved business decisions with a greater degree of certainty given improvement in the speed of communication and raw computational power. For the wine business, that understanding starts with a better grasp of where we are with grape supply, who the competitors are for supply, and how much is going to be required by wineries.

Planting Decisions

Lou: You gonna order something, kid?

Marty McFly: Ah, yeah. Give me- Give me a Tab.

Lou: Tab? I can't give you a tab unless you order something.

Marty McFly: Right. Give me a Pepsi Free.

Marty, sitting down in a diner to figure out what to do next has a conversation with Lou the soda jerk[xxxv] and it seemed they were speaking different languages. The problem was the language had evolved, and a Tab was soda instead of a bill. For clear communication, Lou needed to update his language skills. Fortunately for us today, we have the Urban Dictionary to help us negociate the next gen's idioms.

Figure 24: Manic-Depressive Wine Wheel

Source: Turrentine Brokerage

Many years ago wine industry legend Bill Turrentine[xxxvi] expressed the pattern of cyclicality in the wine business with his Manic-Depressive Wine Wheel (MDWW). It's an excellent model explaining how each of the different constituents behaves given changes in grape supply. In a time like the present when we are structurally short in vine acres, based on this model and all other things being equal we should see the genesis of a planting explosion. But we aren't seeing that at all. Planting is muted in both the Central Valley and the North Coast. So it's time to recognize that, define the causes of the changing pattern, decide whether the models[xxxvii] and rules of thumb we employ are useful, and then execute on the business tactics.

The MDWW is a very good tool that explains how consumers, plantings, growers, and winery behaviors change based on the domestic supply and demand of grapes. The model explains how those constituents behave in a closed system, but the system isn't closed anymore. We still consume virtually all the wine we produce in our own country, but we are importing more supply now from offshore. We don't need to wait five years for non-bearing to hit a fully mature yield. We can just call Chile. Nine months through September, there were 40 million cased equivalents imported in bulk to the U.S. That's 96,000,000 gallons just in bulk imports, which is the equivalent of the production off 53,000 planted and producing acres at 12t per acre from the Central Valley. Where would we be on the MDWW if those 96 million gallons weren't imported in 2012? Answer: We'd be in Quad 2 — acute shortage.

Consumers don't need domestic supply to satisfy their demand anymore. Unlike prior cycles pre-Internet, they have perfect information on price and location of foreign wine as a substitute for domestic wine, and can have it shipped to their door or just stop at Trader Joe's and pick up the value wines from offshore. By the way, in 2011 the value wines in Trader Joe's were domestic and even appellation-based. Those domestic wines are all gone as the MDWW in Quad 1 says should happen in an emerging shortage. But the difference is international bargain wines have replaced domestic discounted wines.

High Production Wineries & Vineyards

Biff Tannen: Since you're new here, I-I'm gonna cut you a break, today. So, why don't you make like a tree and get outta here?

Among several considerations, planting decisions in the San Joaquin Valley are made based on a number of factors including adequate supply of water, access to financing, diversification of crops for a given farming operation, and the outlook and expected returns for wine grapes, versus alternative crops. (alternative crops … like trees … See, Biff was talking to Marty and… never mind. I know it's a weak tie in to the film, but it's the only thing I could come up with. Just work with me here …).

During the 90s an explosion in planting came about to keep pace with the Boomer's demand and improving personal financial outlook. A good percentage of that planting was speculative, causing a moderate vineyard bubble that burst in the early 2000s. While grape prices are finally up to the place growers can find a fair economic return today, the decision to plant new acreage isn't as clear cut as one might think given the strategic shortage in vineyard land we are now experiencing.

Land values have been rising in the San Joaquin Valley and alternative permanent crops such as almonds, pistachios, pomegranates, citrus, and even walnuts are proving more attractive economic options when compared against wine grapes. The cost per acre for planting almonds is less than half the cost of vineyard plantings and the returns have been better and more consistent according to farmers with whom we've spoken. Planting with a "if you plant it they will come" mindset seems to be a thing of the past.

Large producers have purchased some land in the past year and they will dedicate that acreage to grapes and direct the production to their own labels. Those plantings make strategic and economic sense when crushed for an own label. Other plantings have gone in from pre-plant contracts extended by Gallo, the Wine Group, and Franzia to name a few. That said, I am told the values of the contracts being offered are at the low end of the economic range when viewed in the context of the just ended 2000s when a positive return was hard to come by. Farmers have long memories and this time in the cycle, speculative planting isn't going to take place in advance of higher demand for domestic wine grapes.

Marketing Order

The U.S. consumer has more access to world wines than ever. Often those imported wines have both a currency advantage and government support for the product. Our farmers have more expensive land in most cases, so the playing field is tilting away from our producers as imports continue to find their way onto U.S. dinner tables.

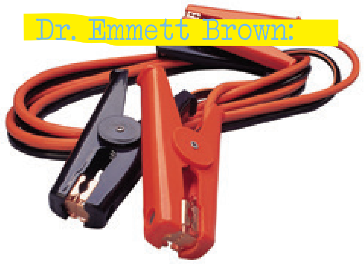
The only way to get a continuing premium for the grapes and support bottle price needed is by educating and promoting the positive qualitative differences in U.S. wine, the improved carbon footprint from growing locally/regionally produced products, and the authenticity of our family-owned wine industry, where even Gallo is still a family business.

While many AVA Associations do an excellent job representing individual regions, no association has the means to mass market to the domestic consumer and grow the pie. A marketing order has worked for the almond industry. The pistachio trade had flourished with an order. Advertising worked for the dancing raisins.

Why not U.S. wine grapes?

We can influence buying patterns of our consumer and the emerging Millennial, but leadership of that effort is going to have to come from within the grape growing community, most likely from the Central Valley and ideally include the growers and vintners from the entire West Coast. It's a big task but one worth exploring again.

Fine Wine Planting

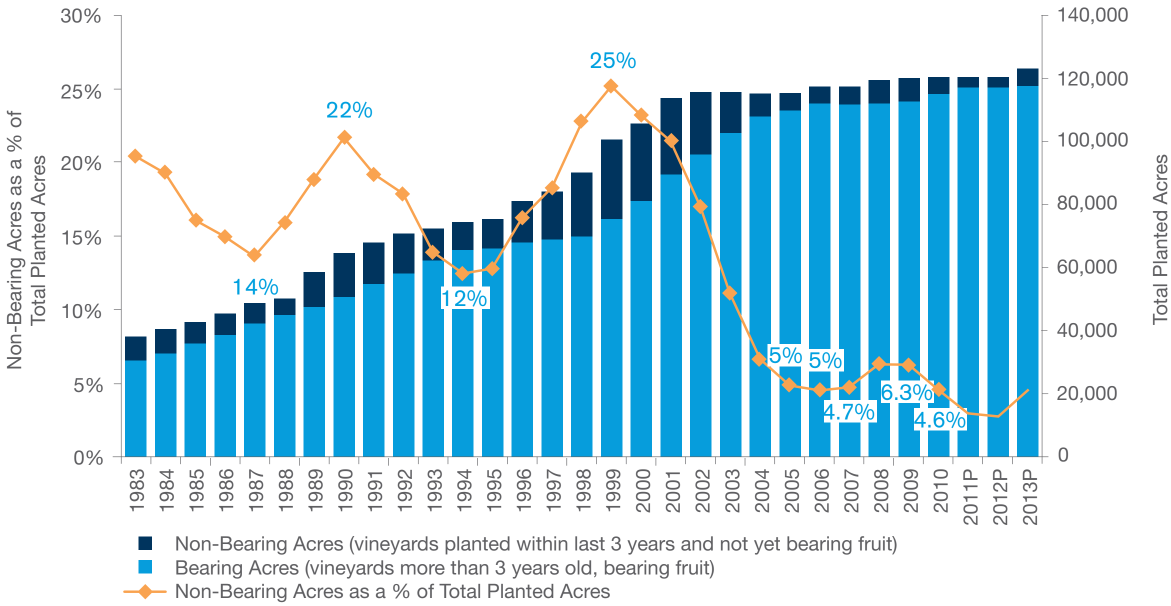


Dr. Emmett Brown: One point twenty-one jigawatts! ... One point twenty-one jigawatts! ... How could I have been so careless?

Planting today on a speculative basis is careless. A jigawatt here and a jigawatt there will soon add up to real voltage, to butcher a colloquialism. There's jiga-scillions of dollars at stake this cycle given the dramatically higher price of good vineyard property. And if you expect to plant on that basis and to find growth about the time you get a fully mature yield in five years, you could be in for a shock. (Get it? shock? … ahem … anyway …)

Figure 25 is one of my favorite charts on planting cycles. In it you can clearly see the last few cycles in the Fine Wine Regions of California including The Dark Age and the Age of Enlightenment.[xxxviii] Over the recent past, the variation in the amount of non-bearing acreage in the fine wine regions of California is showing both reduced volatility, and lower net new plantings. That is a definite change in the pattern from days of yore. The old rule of thumb was you have eight to 10 years of oversupply, a period of balance, and then eight to 10 years of undersupply. We are now moving into a structurally short market, based simply on the growth in wine demand versus growth in plantings.

Figure 25: Premium Planted Acreage on West Coast



Source: Ag Stats Service, Ian Malone & Global Wine Partners

The grape acreage report will have the most definitive survey of planting and that will come out early in 2013. We don't have firm data to support our conclusions other than discussions around the industry and observations. Weak as that may be, it appears there aren't much in the way of new plantings moving into the North Coast of California. Replanting is taking hold in those vineyards which were replanted due to phylloxera in the 90s, but purely new vineyards are less visible and seem to be isolated to the Central Coast, Washington, Sonoma and Carneros. What has also become clear and will be a limiting factor on planting is the traditional rootstock nurseries are out or nearly out of material and according to reports, taking orders for 2014 and beyond at this point.

Forecast of Future Supply

We don't believe we are going to see the aggressive planting we've had in the past because of the advances made in computational power, a slowing economic recovery, the availability of better information, and the significantly higher prices of vineyard land versus the last time we hit this spot in a cycle. This time supply shortages favor growth in imports and that reduces the need for domestic supply.

We believe we are trending to a position not yet experienced in the business; one where domestic supply will be balanced to short for an extended period, demand will continue to grow, and the dollar will strengthen relative to the wine producing regions in countries such as South Africa, Chile, Argentina, and the euro zone. Where will the needed supply come from in 2013 and the future? It will come from foreign bulk and bottled supply, and imports will increase their market share in the U.S.

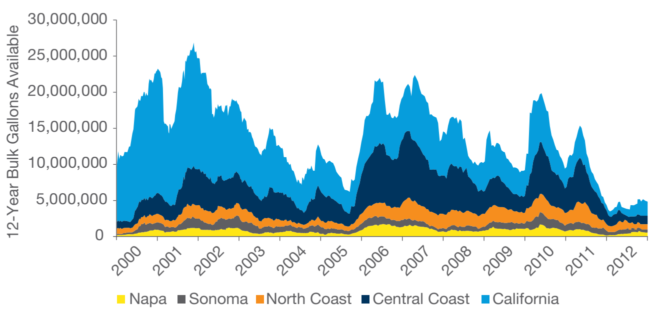
Inventory Balance

George McFly: Hey, you! Get your damn hands off her!

Early in 2012 if you read press reports, one would have thought we were out of grapes entirely. In fact, unsubstantiated rumors from someone whom I can't name, described a fight much like this one between George and Biff. It happened in a vineyard just outside the small community of Bombay Beach, California. I feel bad about that dispute because fisticuffs were not warranted. After all, is being short on inventory really a problem?

Being a little bit short is preferable to being long at all, as there are better returns for both producers and growers when we're a little short and true shortages of domestic wines can be temporarily supplanted by imports. Being significantly short isn't good for anyone as it raises costs of supply to unpalatable levels, pushes up price at the shelf for the consumer, and can then limit long-term adoption rates and consumption of domestic wines because as we discussed in the section on Imports, they can easily support a shortage of domestic grapes under the right financial conditions. What is clear at this point is the 2012 harvest was large and that should improve the record shortages of bulk reported in Figure 26 courtesy of Turrentine Brokerage. We don't see large bulk price increases on the way for the early part of the year, as we expect to see some of that juice hitting the market as producers rationalize their supplies.

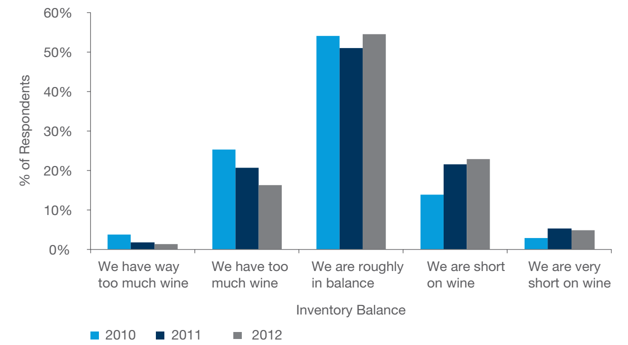
Figure 26: Bulk Wine Inventory in California 2000 - 2012



Source: Turrentine Brokerage

In 2012 when we looked at supply in the Silicon Valley Bank Wine Conditions Survey[xxxix] we said contrary to survey responses and reported beliefs, we thought wine inventories were closer to being in balance than most believed. When looking at Figure 27, you can see over the past three years when we asked that question, the perceived movement of inventory from the cellar has been stable with the exception of slightly long and slightly short responses. But movement is clearly visible in the slightly long and slightly short positions with the weight tipping to shortage.

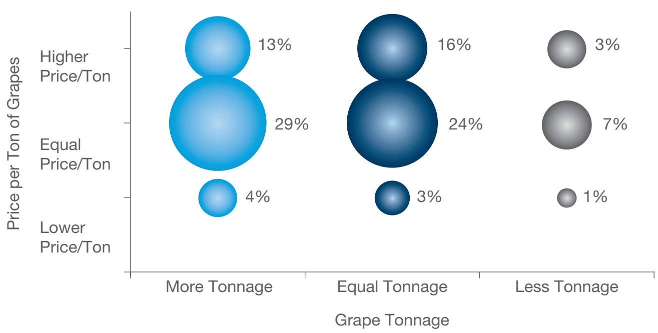
Figure 27: Inventory Position Year over Year



Source: Silicon Valley Bank Proprietary Research

Taking that one step further, we asked what wineries expected to purchase in the way of grapes in 2013 and how much they expected to pay. Taking a view of the bubble chart in Figure 28, the results show wineries beliefs fall almost unanimously to the left and upper side of the chart, meaning the belief from wineries is they will be buying the same or more, and paying the same or more with the most recurring response being purchasing more at the same price.

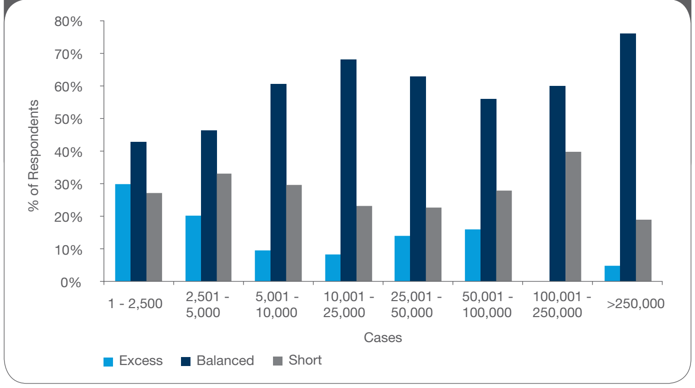
Figure 28: Grape Purchase vs. Price Expectations



Source: Silicon Valley Bank Proprietary Research

Our last view of the purchase expectations of wineries looked at production level in Figure 29. What that chart shows is by case volume, wineries in small production and those in the 100,000 - 250,000 case segments seem to be those who believe they will be the shortest on grape supply. At first glance, that may seem contradictory. What we believe is happening is growers are doing the natural thing when they start to get better pricing. They reduce the number of contracts they have on a vineyard to improve the efficiency of their own operations. Those who lose contracts are the smaller wineries. The largest wineries have access to foreign supply as we've stated elsewhere in the report, so they are more in balance. The moderate sized winery between 100,000 – 250,000 cases is more likely to not have access to foreign supply, instead building an appellation based brand. It's much more difficult for them to get the right amount of supply if they are short.

Figure 29: Inventory Position by Production Level



Source: Silicon Valley Bank Proprietary Research

2013 will be an interesting year for the U.S. economy, and the U.S. winery. The opportunity is there for good success with focused effort. Early success and growth will prove more difficult in general, but should improve through the year.

Will the Future Ever Get Here?

The Direct to Consumer Opportunity and Social

Will the Future Ever Get Here?

The Direct to Consumer Opportunity and Social

George McFly: Well, I haven't finished those up yet, but you know, I ... I figured since they weren't due till ...

Biff Tannen: Hello? Hello? Anybody home? Huh? Think, McFly. Think! I gotta have time to get them retyped. Do you realize what would happen if I hand in my reports in your handwriting? I'll get fired. You wouldn't want that to happen, would ya? Would ya?

George McFly: Of course not, Biff. Now, I wouldn't want that to happen. Now, look. I'll, uh, finish those reports on up tonight, and I'll run 'em over first thing tomorrow, all right

Biff Tannen: Not too early. I sleep in Saturday. Oh, McFly, your shoe's untied. [jabs his finger up to George's face]

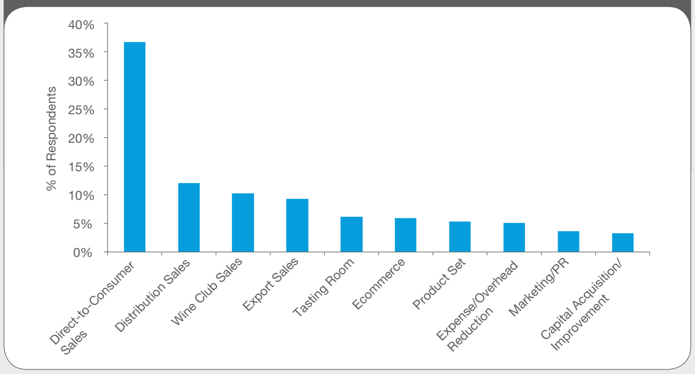
Biff Tannen: Don't be so gullible, McFly.

For many of us, the Direct to Consumer (DtC) business is becoming vaguer instead of more defined. Back when the movie was released in 1985, the direct channel meant tasting room alone, and then club sales were added. Today, DtC encompasses a variety of disciplines that include CRM, POS, SM, LMNOP, AM and FM, and other such acronyms. It can be overwhelming to piece it all together and not feel a little frazzled or — like Biff — need help from someone smarter to help explain the topic.[xl] But it's critical that you do understand. Why? *Hello? Hello? Anybody home? Huh? Think, McFly. Think!*

For many wineries, DtC is now their only sales channel. For everyone else, particularly on the smaller end of production given the lack of distributor attention, it will become your density … errrr … I mean your destiny.[xli]

Wineries recognize the importance of direct sales. According to the SVB Wine Conditions Survey in Figure 30, DtC and its related channels are three of the top five areas of opportunity in the year ahead. Why? Because the economic *potential* is there, and if implemented correctly, DtC will help wineries fight off the industry trend toward slower growth rates and weaker margins.

Figure 30: Top Ten Opportunities Identified



Source: Silicon Valley Bank Proprietary Research

As mentioned earlier in the report, we believe the current state of DtC in our industry is less cost-effective than the traditional distribution model for most wineries, but that is the fact of the current situation versus the upside in the opportunity. The status of current DtC is negatively impacted by current period perceptions and by the complexity in linking disparate platforms together.

The DtC operations some wineries have cobbled together are as complicated as the flux capacitor in the DeLorean. Yet, according to my contacts in that side of the business, many are able to sell direct profitably, successfully negotiate the complexity, and their platforms are scalable. For those still in the State of Confusion — where I was born and live to this day — it is only a matter of time before we sort out the unknown.

Everyone in the path to gain wisdom, has to acquire knowledge first before there can be understanding. Knowledge is the collection of learned facts. Understanding is knowing the likelihood of outcomes in employing those facts. Wisdom is the correct application of the knowledge and understanding. With DtC it has to start with gaining knowledge. Too often we come to a conclusion before acquiring needed knowledge and especially with DtC; I can almost guarantee you are not making clear decisions because the field moves so fast. The knowledge you've acquired is probably outdated and you still make decisions. Are they wise decisions?

The question is: Are you going to wade in and dedicate time to developing a process of collecting knowledge and spread that out in your staff, or are you just going to wait until someone has it figured out and copy them. Start or reengage the DtC journey this year by defining a process to acquire knowledge so you can make wise decisions.

The reality today is there is more knowledge available than most seem to realize. Other industries have long recognized higher profits by dealing directly with the customer and cutting out the middle, but the wine industry has been held back by regulation, and both the lack of time and investment in small companies. Think of the evolution of the hospitality industry starting in the 1980s with development of some of the first customer loyalty programs — all aimed at building more direct ties with customers and shifting the economic balance away from total reliance on travel agencies. Today, most hospitality businesses have strong direct programs with their customers and partnerships with internet travel companies.

The wine industry is headed towards the DtC model for several reasons: 1) direct sales makes sense economically given our three-tier system, 2) many wineries are shut out from significant participation in wholesale because of the proliferation of labels and consolidation of distributors, 3) affluent customers are increasingly buying online and seek personalized connection with their luxury products like wine, and 4) companies with strong direct relationships with their customers (whether onsite or virtual) are more successful in a crowded marketplace — and few markets are more crowded than wine.

Customers who feel connected with a product are better advocates for that product online and offline. If you are known for good wine (a given), a unique experience, and personalized interactions, then your label has a chance vs. 150,000+ other options. This is true whether the customer is buying through a direct or indirect channel. Increasingly, consumers are consulting their smart phones for help from other consumers or independent experts in deciding what wine to buy—whether they are in a restaurant, at Costco or standing in your tasting room. This shift in power away from business and towards the consumer is impacting all industries. The wine industry, however, is even more vulnerable than others given the dizzying array of wine choices and channels the consumer now faces at every turn, and the captive wine lists in many of the chain hotels who work with singular distributors.

The Value Model

It's important to recognize the wine you sell is inert. It is an amalgamation of chemicals. Of course, what you are selling is the flavor profile of the chemicals, but, more importantly, the quality of the product which includes all the Ps in marketing.[xlii] We've put this up before as a value equation to consider and it's particularly important for the DtC model to consider this: All people want value. Value doesn't mean 'cheap.' Value can be found in all price categories from luxuries to commodities. For fine wine we came up with this equation for the value model:

$$\text{Value} = \frac{\text{Perceived Quality} + \text{Experience}}{\text{Price}}$$

Thinking this through, if Perceived Quality were "4" and Price were "2", Value with just those variables would be "2" (4 divided by 2). If we lower price to "1" Value goes up to "4" (4 divided by 1). Makes sense. Anytime you lower price, you enhance value. But there are other variables here. You can enhance Perceived Quality through marketing and promotion and you can enhance the consumer experience. That Experience variable should be where luxury wine retailers spend their time because that's the soul of the DtC model.

If I am guilty of passing judgment on the DtC model in its current state without additional comment on where it is likely headed (because I lack a time machine and this report is already too long) I will now remedy the situation. Here are my predictions and recommendations for the DtC future with a little help from MJ Dale[xliii] among others:

- DtC is already the highest growth channel for the business. We see exponential growth ahead in the next five years.
- If you think the distributors have all the power, consider they too are looking at how to impact the consumer. With the evolution of mobile, social media and CRM evolution, even distributors have to bend their knees to review how they are directly impacting the consumer. Increasingly, power shifts to the consumer in all product decisions.
- Wineries must plan their sales, marketing, product, pricing and service strategies across all channels (direct and indirect) from the point of view of the customer. The same customer shops all channels. Are you consistent in implementing your strategy?
- The Experience variable in the Value Model:
  - Avoiding the focus on Price, differentiate from competitors with individualized and personalized interactions with customers, unique wine experiences, superior service and delivery.
  - Create an experience at your physical or digital location that is core to your brand but original.
- Treat customer information like an important financial asset. Some of this is a legal issue with evolving privacy and credit card protection laws.
  - If you think the brand is the most important asset, think again. It's the customer list: what you know, how you manage and use it, the spending behavior of customers, likes and dislikes, personal information about their interests, etc. If you want to be effective in DtC, it has to start with protecting and utilizing your customer information and CRM database.
- Enhanced segmentation of current customers will allow wineries to become more sophisticated in upselling as well as driving visits from new high value customers.[xliv]
- Mobility and social and location-based services:
  - Mobility is dominating the venture capital landscape. According to one Bay Area VC, 50 percent of Facebook traffic will be mobile very soon and that is why it is spending so heavily on development resources on the platform. Standing idly by makes it vulnerable to next generation social networks.
    - Think about location-based marketing and social listening as a powerful way to get to know your customers better, as well as a way to drive visits to your winery or website. Here's a video of one platform to let you see how this space is evolving: **http://www.youtube.com/watch?feature=player_embedded&v=RyPcvflZM-c**
- Several consultants already have great wine-focused platforms for DtC and social programs, but I believe there is some added movement in the consultant space in the next year that will be newsworthy in 2013.

Turnover Ratios Appendix

Figure 31: Turnover Ratios

	Dec-02	Dec-03	Dec-04	Dec-05	Dec-06	Dec-07	Dec-08	Dec-09	Dec-10	Dec-11	Sep-12
Account Receivable Days	48	50	48	47	40	43	44	42	42	39	58
Account Payable Days	118	117	100	94	99	95	85	102	79	66	85
Inventory Days	961	967	756	752	783	717	761	899	775	695	981
External Funding Required (Days)	891	900	704	705	724	664	721	839	738	668	955
Production to Sales	1.33	1.11	1.06	1.15	1.12	1.09	1.08	1.17	1.10	1.00	0.57
Current Ratio	2.14	2.36	2.21	2.30	2.74	2.69	2.36	2.55	2.66	2.83	1.95

Source: Silicon Valley Bank Proprietary Research

In Figure 31, each of the ratios represents a 12-month period with the exception of the far right column which is a nine month period and subject to a large degree of seasonality as the period misses the large Q4 sales period and includes the addition of a new harvest. Also consider that this information is from a litany of wine business models, some of which sell a higher percentage direct and smaller A/R's, others that sell on open account, and varying degrees of estate vineyards and purchased fruit bought on credit.

Cash is King

One of the first business axioms we all learned when we opened up a Lemonade stand then had to run to Mom for change because we couldn't break a $20, was "cash is king." Current assets such as inventory and accounts receivable have to be financed in some manner with cash, accounts payable, a revolving line of credit, or with new capital (or money from your mom if you are still selling lemonade). The cost of financing varies with new being the most expensive. The cost of capital for equity is always the highest, especially if you get it from your mom and she holds you hostage to chores. A line of credit carries interest charges but is cheaper than new capital and always preferred to missing out on a trade discount for early payment of A/P's. The better a winery manages down A/R and inventory turnover, and can legitimately extend payables without missing the trade discounts, the less they have to borrow or raise new equity to fund current operations … and the quicker you can go out to play.

Accounts receivable days are a measure of the fine wine industry's ability to collect sales on terms. Ignoring the nine-month period for September 2012, wineries in the PGA database have demonstrated a consistent ability to collect under 45 days on average. Year-end collections have shown steady improvement since 2008 to the present where FYE 2011 collections are at the decade low point.

Accounts payable is a measure of how fast you pay your own bills to creditors. In this case it includes payables to growers. Payables worked down from the 2001 recession up to 2008 when they hit a low point. It's obvious reviewing the data that the wine business as a whole pushed out their payables substantially in 2009 but has since worked them back down to period lows and that speaks to the improving health of the business.

Inventory turnover measured in days[xlv] is a little more volatile. Coming off the prior recession in the early 2000's, the fine wine business held nearly three years of inventory on their balance sheet. Working down that spike took several years but reversed course in 2008 when the Great Recession took over commerce. Given the low yield from the 2011 harvest, inventory measures reached a low point of 695 days — right at the same time the word was out that the business was in balance.

One way to review the external funding needed for any given winery is to take a look at the net days of financing required. That's done by adding inventory and A/Rs which require the use of cash, and subtracting that from A/Ps which is a source for cash. Looking at the financing need from that perspective demonstrated that external financing needs were highest in 2003, worked down and then spiked again in 2007, finally receding back to a low point in the 2011 fiscal year end.

Another way to look at that cushion, or the coverage of current liabilities[xlvi] by current assets,[xlvii] is looking at a current ratio.[xlvii] Normally a business should have a ratio well in excess of 1.00 to 1.00.

Production to Sales measures the amount of wine a business produces versus how much they sell. It's the hardest thing to manage as it's a guess what the consumer will want to buy years from now, then a crap shoot to see if Bacchus even gives you the grapes you need in any given year.

Since there is between a two and three-year lead time in the production of fine wine, getting a large harvest that combines with a recession the next year is the worst of all worlds. From Ratios Figure 30 you can observe that the 2002 year was the worst year of the decade at least by this measure, in part because the consumer traded down to cheaper wines in that period which was a surprise to most vintners.

What is important to notice in the most current data is fiscal year 2011 which had decent sales growth but due to a low vintage, a 1.00:1 ratio. That one year is what brought the business back into balance after a decade of long positions in inventory.

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 Silicon Valley Bank

Silicon Valley Bank is the premier bank for technology, life science, cleantech, venture capital, private equity and premium wine businesses. SVB provides industry knowledge and connections, financing, treasury management, corporate investment and international banking services to its clients worldwide through 27 U.S. offices and six international operations. (Nasdaq: SIVB) www.svb.com.

Silicon Valley Bank is the California bank subsidiary and the commercial banking operation of SVB Financial Group. Banking services are provided by Silicon Valley Bank, a member of the FDIC and the Federal Reserve System. SVB Financial Group is also a member of the Federal Reserve System.

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, SVB's Wine Division has offices in Napa and Sonoma counties and serves clients in the fine wine producing regions 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 guidance 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). More information on the company can be found at www.svb.com.

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[i] Did you know when a locomotive hits the handlebars of a bike laying on the track; the force can make it fly up to eye level of the surprised engineer? There is your physics lesson for today.

[ii] Note: In a late edit of this year's report, we've decided we won't cover the exciting topic of the prevention of microbial spoilage. I know that is a disappointment.

[iii] Dr. Brown actually used the "s" word in the movie, but we've cleaned it up to retain our G Rating.

[iv] http://business.time.com/2012/04/20/panic-wine-prices-due-to-rise/

[v] http://svbwine.blogspot.com/2012/07/is-there-really-grape-shortage.html

[vi] The Fifth Column is an apt term we are coining for a new purpose. The original term originated in the Spanish Civil War when General Mola attacked Madrid with four columns and said a Fifth Column would arise from within the City Walls. Today the term can be applied to a group of people who undermine something structural from within. Our use of the term is meant to describe the digital support universe that is emerging which is fostering systemic and organized direct and on-line consumer sales.

[vii] The SVB Peer Group Database ("PGA") is a proprietary database of both client and non-client financial statements going back to the early 1990's. With it, SVB is able to benchmark a client's financial information against a highly relevant peer group, and review industry level trends.

[viii] The SVB Annual Wine Conditions Survey is run for two weeks prior to the writing of this report. This year the survey ran from November 1st to the 16th and consistent with prior years, there were about 500 wineries participating. Those wineries who do participate receive the scrubbed detail output of the survey, along with some light analytics and the full suite of charts discussing topics from CRM to bottle pricing. If you would like to participate in the future survey, please contact the author: rmcmillan@svb.com

[ix] CRM stands for Customer Relationship Management and involves using databases to organize, automate, and synchronize business processes—principally sales activities, but also those for marketing, customer service, and technical support.

[x] We're a family report so no matter how popular the movie was, we just can't print the word shit.

[xi] That was a stretch. I've never had anyone from Libya call me, but just work with the theme here.

[xii] The SVB Peer Group Database ("PGA") is a proprietary database of both client and non-client financial statements going back to the early 1990's. With it, SVB is able to benchmark a client's financial information against a highly relevant peer group, and review industry level trends.

[xiii] "Just OK" is defined in generally accepted accounting principles as financial performance that is one step better than "meah."

[xiv] M.A.D.D. stands for Mothers Against Drunk Driving and is a private charitable institution whose laudable mission is to stop drunk driving, support the victims of this violent crime and prevent underage drinking.

[xv] Too much credit is given to the French Paradox for growth in total wine consumption. Silicon Valley Bank's entrance to the US Wine Business is 100% positively correlated with the growth in domestic consumption. After the French Paradox broadcast, it was another three years before consumption turned around. I rest my case. As an aside, total wine consumption by US Adults passed three gallons per capita in 2011 for the first time. Stats from the chart we present are for the total us population including those under 21.

[xvi] http://en.wikipedia.org/wiki/Wealth_effect

[xvii] Securitization was the mechanism that provided consumer real estate debt, including the sub-prime debt that infected the financial system. Little has been mentioned about repairing that system, but as of today nearly 100% of mortgages made are being purchased by the government either through GSEs like Fannie Mae and Freddie Mac, or by the Fed in their QE programs at the pace of $40BN a month. Allowing the government to continue to buy mortgages is not good for the housing industry, the Governments debt load, or the consumer when the securitization can be repaired and handled by the private markets.

[xviii] The Plaza Accords were the first joint efforts by Central Bankers to intervene and reshape the currency markets. http://www.investopedia.com/articles/forex/09/plaza-accord.asp#axzz27sfW6sAB

[xix] Gomberg Fredrikson Report, Sept 2012

[xx] Gomberg Fredrikson Report, Oct 2012

[xxi] ECB European Central Bank. The European equivalent of the U.S. Federal Reserve.

[xxii] Mario Draghi is an Italian banker and economist who succeeded Jean-Claude Trichet as President of the European Central Bank on 1 November 2011. He was previously the governor of the Banca d'Italia.

[xxiii] Can anyone explain to me how we as a country with the majority who live in the center, elected people to run the country who are at the extremes and can't find common ground? What does that say about Americans?

[xxiv] I know everyone hates bankers, but I am really a musician that is a banker to support my rock habit. Today I'm playing in the SVB House Band: The Exploding Warrants. We play some nice covers, but our CD sales aren't that great right now so I'm just moonlighting as a banker. If it's any consolation, I barely like myself.

[xxv] http://blog.bea.gov/2012/11/29/gdp-third-quarter-2012/

[xxvi] Bulls**t – The word was censored for our audience, but for those without an Ag Degree, it's a placeholder for the word bullsnit which is a foul term for the odor emanating from the digestive process in cattle once expelled from the animal. According to Hiram Webster's Dictionary, it can also be used to describe deception emanating from politicians and on occasion bankers.

[xxvii] ……capacity – jobs – is the key. I know it sounds strange but that are good ghrammar.

[xxviii] Pamela N. Danziger, Putting the Luxe Back in Luxury. Paramount Market Publishing, Inc. ISBN-10: 0-9819869-4-3

[xxix] Bain & Company, 2012 Global Luxury Goods Report http://www.businessinsider.com/bain-global-luxury-goods-report-2012-10#-1

[xxx] Movie notes: Jane Wyman was the first wife of Ronald Reagan. They married in 1940 and divorced in June 28, 1948. With the movie set in the 1950's no way could she have been First Lady….. then again … A DeLorean as a time machine?

[xxxi] This year the Annual Wine Conditions survey was run in November 2012, with nearly 500 unique responses.

[xxxii] The University of California at Davis. (Full Disclosure Note: The author took his undergraduate studies across the Yolo Causeway at a rival college; an institution that would never make such a mistake when it comes to the development of rootstock.)

[xxxiii] I loved this scene …. for all us aspiring musicians it's the dream to have someone say over the speaker …. Our guitar player is sick tonight. Is there a guitar player in the house who can cover for him? http://www.youtube.com/watch?feature=player_embedded&v=S1i5coU-0_Q

[xxxiv] The Fifth Column is an apt term we are coining for a new purpose. The original term originated in the Spanish Civil War when General Mola attacked Madrid with four columns and said a Fifth Column would arise from within the City Walls. Today the term can be applied to a group of people who undermine something structural from within. Our use of the term is meant to describe the digital support universe that is emerging which is fostering systemic and organized direct and on-line consumer sales.

[xxxv] Norman Adelberg played the part of the soda jerk in this scene. He passed away in January of 2012 after a career that began in 1957 and continued until his retirement in 2006. He is credited with work in 2,500 movies, TV series and commercials, mostly bit parts and yet was largely unknown as a celebrity. For those born post Baby-Boom, a soda jerk isn't the same as the rude person getting you drinks in your favorite fast food drive-thru. Much like a bartender who has beer on tap, the soda jerk also stood behind a counter or bar, and "jerked" the handle of the soda on tap to get a soda. So …. with self-service soda now where you get your own refills, does that make you a jerk?

[xxxvi] Bill hates to be called a legend. He thinks it sounds old. He prefers to be called El Guapo, so please call him that next time you see him. I am told by Bill the first 10 people who call him El Guapo in 2013 will receive a discount off their broker fee for bulk wine purchases …. or maybe he said 'receive a broken nose?' Broker ….broken …. I'm not sure now. It was loud at the Justin Bieber concert where he told me that.

[xxxvii] I don't want to imply the Manic Depressive Wine Wheel is no longer useful to describe wine industry cycles. It clearly is quite useful in most ways. But there are economic differences that make it less dependable as a predictive tool versus prior cycles as its missing the impact of foreign supply and export sales in the model.

[xxxviii] For those skipping around the report, we are calling the Age of Enlightenment that period from 1994 to 2000 when the industry was coming out of a long recession and new planting was limited much like today.

[xxxix] The SVB Annual Wine Conditions Survey is run for two weeks prior to the writing of this report. This year the survey ran from November 1st to the 16th and consistent with prior years, there were about 500 wineries participating. Those wineries who do participate receive the scrubbed detail output of the survey, along with some light analytics and the full suite of charts discussing topics from CRM to bottle pricing. If you would like to participate in the future survey, please contact the author: rmcmillan@svb.com

[xl] Several strong people and platforms are available for those wanting to get help from someone smarter. See the last two footnotes for contact information.

[xli] George McFly: Lorraine. My density has brought me to you.
Lorraine Baines: What?
George McFly: Oh. What I meant to say was…
Lorraine Baines: Wait a minute. Don't I know you from somewhere?
George McFly: Yes. Yes. I'm George. George McFly. I'm your density. I mean, your destiny..
There is only one quote allowed per section, but I couldn't resist adding this memorable scene.

[xlii] For those that forgot the Marketing Mix or the 4 P's of Marketing … I always forget them and never can name all 7 Dwarfs either… (… O.K. … we'll wait while you try naming them… tic-tock-tic-toc… Ok you're back. Not that easy is it?) Anyway, marketing decisions generally fall into the following four categories:

- Product
- Price
- Place (distribution)
- Promotion

If you want to dive a little deeper into the model to refresh your memory, here's a good primer: http://www.netmba.com/marketing/mix/

[xliii] In my opinion, Mary Jo Dale is the preeminent consultant in direct sales in the wine industry. She can be reached at MDale@KLHConsulting.com … (that should get me a free lunch)

[xliv] Some resources: KLH Consulting is a great help for DtC Information Strategy, customer insights and Business Intelligence. Vintner's Alliance is great in Customer Analytics, SEM and Customer Re-Targeting. Vintank is a great help for Mobile Social, Social Listening, DtC and Social Strategy.

[xlv] There are two accepted methods of measuring Inventory Days. One formula uses sales but the one we employ uses Total Inventory / Cost of Goods Sold.

[xlvi] Current Liabilities are the accounting values of those debts or obligations that are expected to come due and be paid within 12 months.

[xlvii] Current Assets are those balances that are expected to be collected and converted to cash, or be utilized within 12 months.

[xlviii] Current Ratio is defined as Current Assets divided by Current Liabilities.

Silicon Valley Bank

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