Silicon Valley Bank

STATE OF THE WINE INDUSTRY 2012-2013

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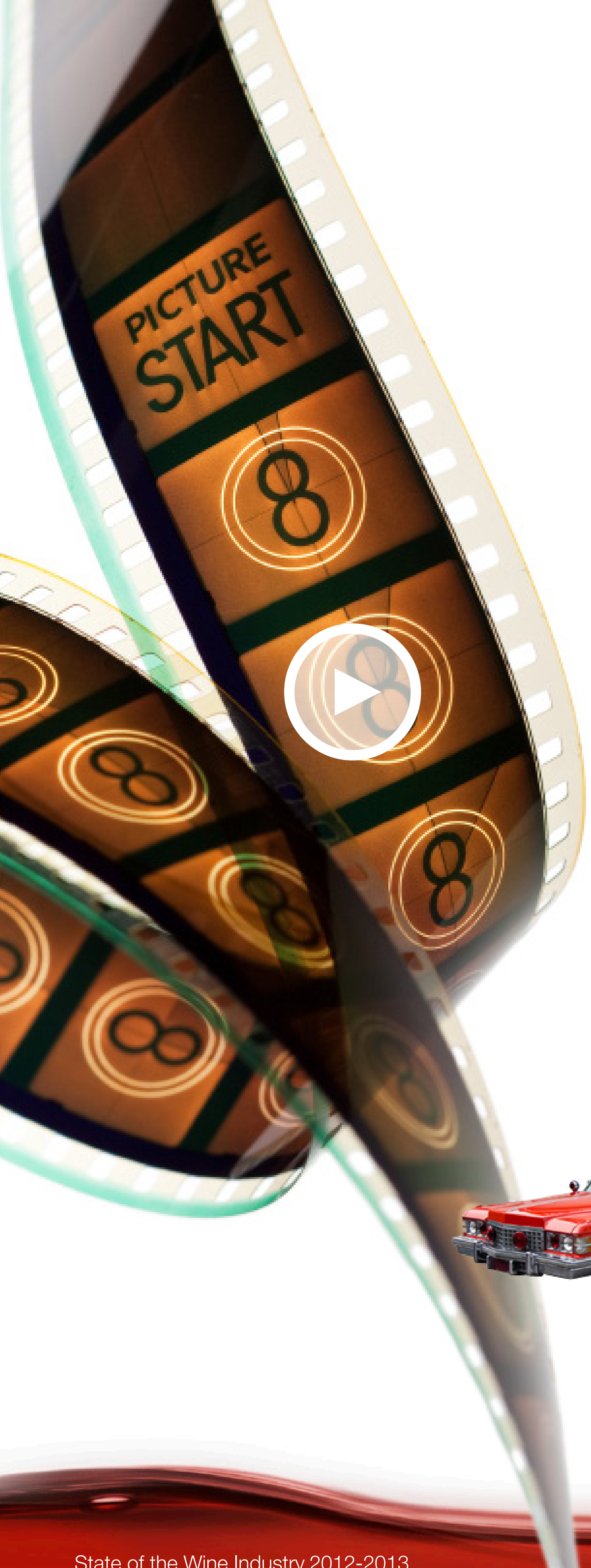


Dr. Peter Venkman:	This city is headed for a disaster of Biblical proportions.
Mayor:	What do you mean, “Biblical”?
Dr. Ray Stantz:	What he means is Old Testament, Mr. Mayor: Real wrath of God type stuff.
Dr. Peter Venkman:	Exactly.
Dr. Ray Stantz:	Fire and brimstone coming down from the skies! Rivers and seas boiling!
Dr. Egon Spengler:	Forty years of darkness! Earthquakes, volcanoes ...
Winston Zeddemore:	The dead rising from the grave!
Dr. Peter Venkman:	Human sacrifice, dogs and cats living together, Republicans and Democrats governing ... mass hysteria![i]

Wait … what? That's like some parallel universe, an altered reality. Republicans and Democrats governing[ii] — now that's preposterous. You probably recognize the dialogue, though. It's from the 1984 critically ridiculed movie and box office success *Ghostbusters*.[iii] That's the backdrop we are using this year to paint our view and predictions for the wine business. Why *Ghostbusters*? The scene above sounds really bad: human sacrifice, the dead rising and dogs and cats living together. Are things that bad? Just what is Silicon Valley Bank predicting this year, Armageddon?

To the contrary, we are using this year's report to "ghostbust" the disillusionment from the financial collapse that still haunts the wine industry. Last year we said the wine industry was at the beginning of another long-term steady growth pattern in fine wine sales. That's a prediction that we believe was, and is still, accurate. We can say for certain the year ahead is going to be much better than the financial collapse of Biblical proportions just experienced, which for many in the wine business did feel like 40 years of darkness. We are solidly in the post-collapse phase now and thankfully not in a post-apocalyptic phase. Breathing still? Absolutely. Maybe out of breath and festooned with a little slime, but for most wine producers things are finally looking up, the ghosts of the Great Recession are in retreat and the slime will start to wash off this year. In this version of the report we are going to exterminate the vestiges of doubt that have crept in and will forecast some emerging changes that might make your head spin.

Part of that change will be in wine consumers. They are about to experience a re-haunting and it's not the Stay Puft Marshmallow Man[iv]. For the past several years consumers have been unsympathetically dancing on the graves of bloated wine inventories, and numbing the painful residue from the trillions lost in consumer wealth. We've all been happy to come to that party as consumers, but that dance is coming to an end. We hope you stocked up on a few cases because reality is knocking at your cellar door. Cats and dogs are returning to their separate proliferate ways; Republicans and Democrats aren't governing; inventories are now starting to run to the short end of the scale; and bottle prices will start to increase in 2012.

So yea! Take heart ye downtrodden wine producers. Recovery is at thy door! (King James English just seems so much more prophetic.) Bring forth now the lute and harp. Dance and make merry o' ye vinedressers. I saith, rejoice now ye prophets of gloom. Un-gird your loins, oh ye girders of loin and come hither whilst we bust-eth the ghosts of confusion in the *2012-2013 SVB Annual State of the Wine Industry Report*. <Queue theme song … >[v]

Executive Summary

The wine business was historically a sleepy cottage industry with few signs of paranormal activity. Oh sure, there were and still remain the occasional cries of "witch" from those misunderstanding the bio-dynamic farmers practicing their peculiar science under a full moon with manure-filled cow horns.[vi]

But historically the business was mostly a place of rest for the free-spirited seeking solace in a rural lifestyle and perhaps a gracious working retirement.

Today, because of a number of colliding events including improved worldwide sourcing, the Granholm Decision, big-box stores served by a consolidated distribution network, the digital revolution, strong growth in premium vineyard land costs, and finally the financial bust, those bucolic days are now permanently gone. The U.S. wine industry has stepped out of the eerie mist and is evolving quickly on multiple fronts creating winners for those jumping at opportunity and losers for those ill-equipped to evolve. Those events and our analysis of the business cause us to predict the following conditions for 2012-2013.

In the wine industry, we predict:

- 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 start to see recovery
- Increasing difficulty for négociants 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
- Continuation of new mergers in the wholesale networks
- 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;[vii] 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 sales growth rates of 7-11 percent, a slight drop from the prior year
- Declining wine quality for the price paid, pushing consumers to decide if they are willing to drink lesser quality domestic wines, or pay higher prices, or find foreign substitutes

In terms of the macro and global economy, we believe:

- U.S. employment will continue to recover slowly
- We are bumping along the bottom of housing prices
- Housing won't recover until the securitization process is revisited and repaired
- The wealth divide is really more of 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 European Union Treaty
- The euro will enter a weakening trend versus the U.S. dollar
- 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.[viii]
- 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 geo-political arena 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

While those are macro and industry views, it's important to realize the obstacles wineries face continue to be winery-specific depending on several factors, including pricing on grape contracts, price points for wine in market, brand strength, appellation, volume produced, individual skill in executing a cogent sales strategy, and managing cost efficiencies in a grape market trending to shortage.

A wide disparity between business models continues to exist, making the "average winery" even more difficult to define today. That is why looking at arithmetic averages can be so deceptive. What might be a defined risk for one winery could be strength for another, but the average might suggest a middle path ill-suited for either. This increases both the opportunity to redefine and differentiate a given winery and brand. However, it also raises the risk for owners, investors and lenders alike who might otherwise act on instinct, old patterns and rules of thumb versus clear metrics and analysis of what has become a distinctly different business than what we have seen for the past 20 years. The business is going through a rapid evolution that will soon place the function of selling wine on par in importance with managing costs, especially grape, bulk and production costs.

Visiting Ghosts of The Past

Dr. Peter Venkman:	I don't have to take this abuse from you. I've got hundreds of people dying to abuse me.
Dr. Egon Spengler:	I feel like the floor of a taxi cab.

Until last year, we weren't the most popular of prognosticators. Prior to the crash we started handing out predictions as we saw them, a housing bubble, certain market correction, etc. Strangely, after the first gloomy prediction my literary agent stopped getting any calls for book signings and speaking opportunities. "Call someone with a more cheery outlook." We were pariahs, lepers, outcasts with the likability of ectoplasm on the floor of a taxi cab. Then last year after we declared we were at the beginning of another long-term period of growth in fine wine, the phone stared to ring. We were once again quotable and in demand for speaking engagements. What's the old saying? Failure is an orphan, but success has many fathers? It's so nice to have a family again!

We like reviewing our prior year's predictions to validate our methods, fess up when we have a miss and give context for our current forecast. Reviewing the bullets from last year we said:

Positives:

- Growth in luxury goods will outpace the rest of the economy
- The trading up trend will accelerate in higher priced wine
- Marginally improved pricing power at the producer level
- Boomers and Gen X, not Millennials, will support most of the fine wine recovery
- Improving restaurant sales, specifically in full-serve restaurants
- Producer level inventory closer to balanced than most seem to think
- Sales growth in the fine wine segment of 11-15 percent with marginally improving profits

Negatives:

- Continuing distribution issues/changes
- Shifting threats to the legal landscape for direct shipping
- Flat or declining pricing on grape contracts except in best properties
- Decline in the number of affluent spenders between the ages of 35-54
- Low adoption rates in the use of digital marketing tools
- High fixed costs to produce wines with lowered and reset price points
- Slowly improving economy, but several issues that hold back the recovery:
  - Euro zone challenges
  - State, municipal and large pension funding/budget problems
  - Geopolitical risk in oil producing countries
  - Surging commodity prices act like a tax on consumption
  - Federal spending: to spend or not to spend?
  - Inflation in emerging markets and the EU
  - Increasing domestic interest rates
  - Quick swings in the FX markets
  - Balancing a weak dollar against inflation, recovery and rate hikes

We believe we did pretty well. We hit the growth rate band for the third year running and were out ahead of the changing grape market. But we never did see the state and municipal problems emerge as we expected, and didn't see interest rate increases as expected. Our predictions of changes in grape and bulk inventories should have led to a linked prediction of higher grape pricing. We instead predicted flat or declining prices in grapes except in the best properties where we expected increases. We were wrong by failing to anticipate the severity and speed of real price changes in the latter half of the year due in some part to the short harvest. Our base case assumed a more normal year. All in all though, our crystal ball was pretty clear.

We hope you will find the following information helpful in sorting through some of your top level thoughts, and that the exercise will assist in your decision-making and drive greater success for your business in 2012 and beyond.

Supply Busters

Dr. Egon Spengler: Its getting crowded in there, and all my recent data point to something big on the horizon.

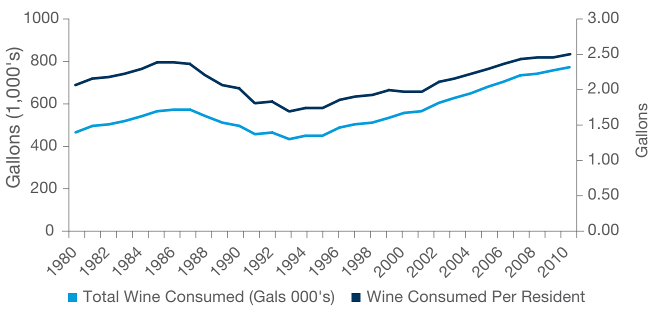
Winston Zeddemore: What do you mean big?

Dr. Egon Spengler: Well … Let's say this Twinkie represents the normal psychokinetic energy in the New York Area. According to this morning's sample, it would be a Twinkie 35 feet long weighing approximately 600 lbs.

Winston Zeddemore: That's a big Twinkie.

The data are pointing to something big on the horizon, or maybe we should say smaller in this case, but it's still big news. Inventory, which only a few short years ago was significantly long, is now moving quickly toward a shortage. How can that be? There is an important distinction to be made between structural problems in supply or demand and temporary problems.

Figure 1: Wine Consumption 1980-2010



Source: Wine Institute

What we are just finishing was a temporary demand shock. It wasn't a structural issue. The only thing that changed was price, not volume. There was adequate acreage planted for the demand at the time of the crash. Even though we had sufficient plantings, distributors and restaurants worked down their own inventories instead of re-buying wine. The temporary demand shock impacted supply by creating a backup at the producer level; much like the proverbial "pig in a python." It's not really like there was more wine at the producer level. The wine started selling slower than needed to clear the cellar in a normal 12-month release cycle. That temporary event has largely cleared as of this writing.

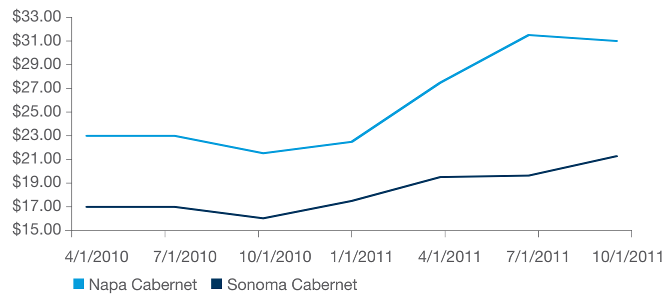
Different from a temporary issue, when SVB began in the wine business in the early 90s, we were just moving out of a time of a structural change that led to declining demand both in gallons consumed and per capita consumption as you can see in Figure 1. The decade prior had two moderate, or one long, recession depending on whom you believe. Those were the days when people actually thought wine did not contribute to a healthy lifestyle. I know, hard to believe, but that belief led to a structural shift in consumption patterns. Since then, scientists have decided wine consumption is as good for you as broccoli[ix] and we've had nearly 20 consecutive years of growth in consumption.

By the mid-90s wine sales expanded so fast, wine supply became very short causing routine stock-outs in the high-end wineries and forcing larger brands to augment domestic demand with imported bulk wine from exotic places like Chile and Australia. That seeming good news was the opposite of what was experienced in the late 1980s but was a structural issue that needed fixing. That fix came quickly as farmers rushed to plant sticks in the ground and by the end of the decade we saw the last of supply shortages.

As we moved into the 2000s, we had the trifecta of doom when the Tech Bubble and 9/11 slowed up demand, right at the same time non-bearing acres planted earlier started to come into production and generate significant tonnage. In that case, we had a structural supply shock and a temporary demand shock concurrently. Even after removing more than 100,000 acres of vines out of California's Central Valley, we never did get back to being in a place of balanced supply.

When there is too much wine on the market, discounting goes up and grape contracts drop in price. When there is a shortage of wine, bottle pricing and grape prices rise, but that never happens at the same time so there are the transition years when supply is moving between established positions and we see a mixture of impacts depending on price point, appellation, and varietal. That's where we find ourselves today: transitioning to a market shortage. Is that a problem? Being short a little bit is preferable to being long at all, as there are better returns for both producers and growers when we're a little short.

Figure 2: Cabernet Bulk Values



Source: Turrentine Wine Brokerage

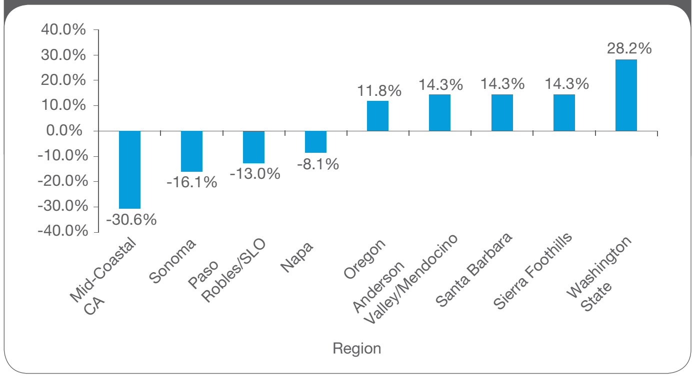
Being significantly short, however, isn't good for anyone as it raises costs of supply to ghoulish levels, pushes up price at the shelf for the consumer, and can then limit consumption. There is the discussion of foreign substitutes, but we will reserve that for the section on foreign exchange rates following.

Last year when we looked at supply, 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 2, you can see Cabernet bulk prices did respond to lower supply with higher prices early in the year in the North Coast. The same was true for the other varietals as well.

Looking purely at a total long/short for the fine wine industry doesn't give all the information we would like either, as fine wine is appellation-based. For example, if a winery needed Russian River Pinot Noir, it doesn't really matter that the Willamette Valley in Oregon has an excess.

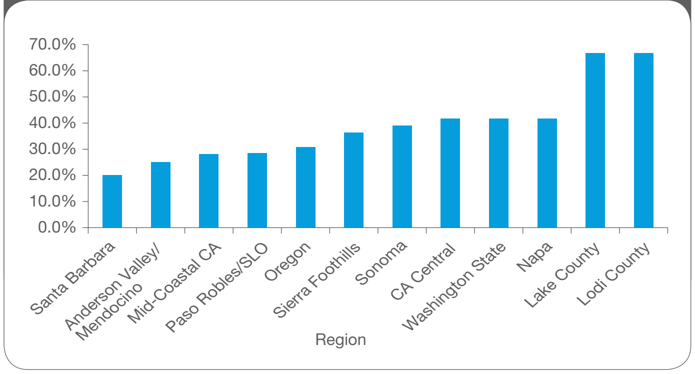
To better understand the appellation positions, we netted out the responses of those wineries that reported excess positions against those reporting short positions, ignoring those who said they were in balance. Figure 3 reports nearly all the larger appellations except those in the Pacific Northwest (PNW) believe they are short on grapes already. It should be noted the Santa Barbara sample was light and more prone to sampling error.

Figure 3: Net Grape Supply by Region



Source: Silicon Valley Bank Proprietary Research

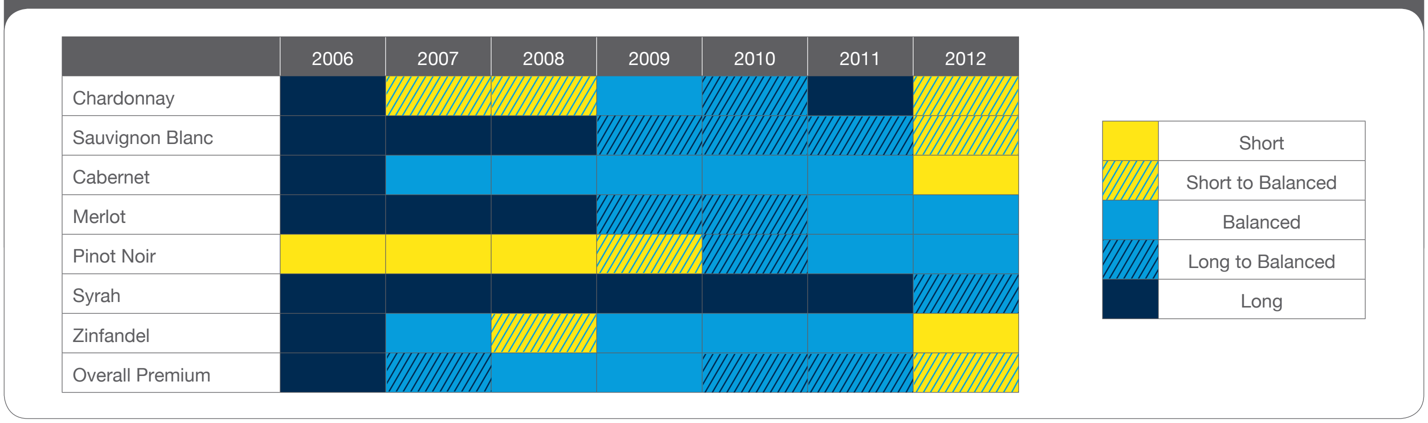
Figure 4: Net Grape Purchase Expectations by Region



Source: Silicon Valley Bank Proprietary Research

Taking that one step further, we asked in the conditions survey what wineries expected to purchase in the way of grapes for 2012 and then sorted the responses on a net basis by appellation. You can see from Figure 4 the view is unanimous from vintners that they are planning to take on more grapes at harvest in 2012. That in and of itself is a notable finding because even if this harvest is large, it implies demand is likely to be there for most, if not all, grapes this year.

Figure 5: Bulk Wine Positions



Sources: Ciatti Brokerage, Turrentine Wine Brokerage, Silicon Valley Bank Proprietary Research

Varietal Inventory

We have monitored the level of bulk and grape supply by varietal and referenced our view of varietal supply in Figure 5 since 2006. This year, with the slightly small harvest, we have moved past being balanced into a position that's trending to shortage overall. High-end Cabernet and Zinfandel are clearly short and the only varietals we view as being close to balanced are the usual suspects in Merlot and Syrah. That said, with demand for Cab and Bordeaux-styled blends growing and Cab short, we can expect Merlot to be used to fill in for scarce Cabernet and should see some of the Syrah lost in blends as well.

Supply Summary and Forecast

Gozer: Are you a God?
[Ray looks at Peter, who nods]

Dr. Ray Stantz: No.

Gozer: Then ... DIE!
[Lightning flies from her fingers, driving the Ghostbusters to the edge of the roof and almost off]

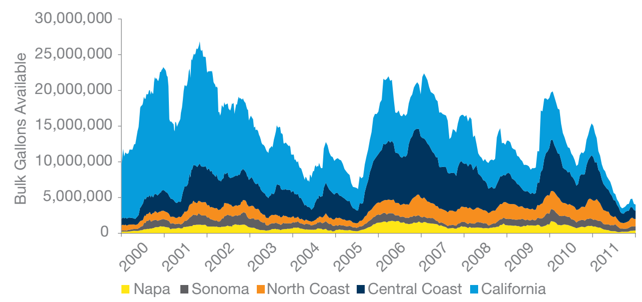
Winston Zeddemore: Ray ... when someone asks you if you're a god, you say "YES"!

A large harvest should be expected simply because the demand is there and farmers will farm for more volume if Mother Nature, Gozer, or to be politically correct, the god of your choosing cooperates. Since we aren't gods ourselves we can't predict what will happen with growing conditions this year. But if we had to make an educated guess — even though there is no non-bearing acreage that is going to beef up the overall harvest in 2012 — it wouldn't come as a surprise to us if we had a record yield overall because we expect to see growers hanging more fruit. The news is apparently out already as in our tours of North Coast appellations we've spotted something that hasn't been seen for many years: kicker canes left in pruning for extra bud set.

We believe grape prices will set slightly higher this year before we get a clearer view on projected yields in California. A particularly mild spring means an early bud set is likely and that will increase the risk of frost damage. This year is going to be one when buyers and sellers of grapes and bulk will be evolving their beliefs about the market and what's fair in price negotiations. Oregon and Washington, with their slightly stronger inventories, will lag the California market with price increases. The extra supply that looks like a liability to some in the PNW will evolve into an asset as demand for wine and grapes continues to grow.

At last, the cycle of excess started at the Tech Bubble a decade ago has worked itself through and the wine grape growers in virtually in all regions from Northern Washington State to the San Joaquin Valley should see contract negotiations that justify their investments.

Figure 6: Bulk Wine Inventory in California 2000-2011



Source: Turrentine Wine Brokerage

What comes in 2013 is the real question. I like Figure 6 from Turrentine Wine Brokerage that shows bulk wine inventory in California over the last decade. What it graphically depicts is bulk juice now at a decade low, and if we went back a little more, it's probably in line with what we last experienced in about 1997. The difference is that 1997 was a time when we had substantial non-bearing acreage coming into production in California. This time, with very little non-bearing acreage, where will the supply come from to quench our domestic consumer's palate?

The Central Valley is not long on acreage and has been burned before trying to time grape planting cycles. As a result, many acres have since found happier haunts in other permanent crops like almonds, pistachios and pomegranates. In addition, the water wars that California is again fighting in this drought year will give pause to an

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independent grower trying to plant a new vineyard. We believe we are fast trending to a position not yet experienced in the business: one where supply will be structurally short for an extended period in both the high volume production wineries and the fine wine business, demand will continue to grow at a little slower pace, and the dollar will strengthen relative to the wine producing regions in the euro zone making those imports cheaper.

Where will the needed supply come from in 2013 and the near future? Domestically the states of Oregon and Washington should see the most benefit because there is a higher level of non-bearing acreage and land costs are more reasonable. Largely the demand will be met from foreign bulk and bottled wines. Simply put, even though worldwide supply is about as balanced as any time in memory, imported juice is available to buy and that will decrease the market share for domestic producers in U.S. wine sales.

The longer-term solution is additional planting in all appellations, with the exception of Napa which is essentially planted out as a county. Land costs are going to play a large role in planting decisions given the 20-year cycle we've just come through, which included higher and higher costs for plantable dirt. The hurdle for minimum revenue per acre and ROE is more difficult today than a decade ago. And while a low interest rate environment is extremely helpful in developing productive and profitable vineyards, imported substitutes provide a base price for what a vineyard operation needs to get in revenue per acre. If a vineyard can't compete with the costs of imported substitutes, it's hard to make a business case for development.

Make no mistake. This is a structural problem that has been a very long time in coming. While we forecast some relief this year with expected heavier yields, that's not a sustainable solution. This will take a minimum of five years to see any domestic solution to a shortage and it has to come from domestic planting.

Euro Busters

Dr. Ray Stantz:	I think we'd better split up.
Dr. Egon Spengler:	Good idea.
Dr. Peter Venkman:	Yeah ... we can do more damage that way.

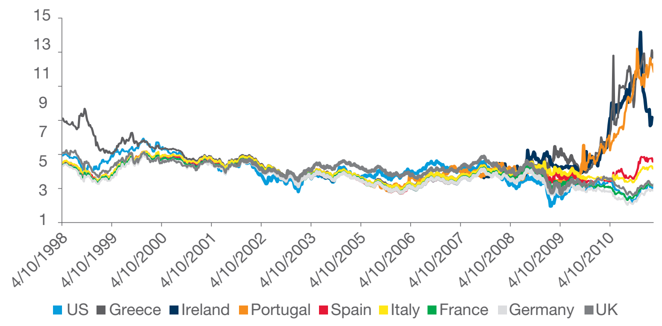
A splitting up of the sibling countries and complete collapse of the euro isn't likely in our thinking. If the euro did break up and the sibling countries left to their own devices, a lot of self-inflicted damage would result to the strongest of the EU countries. For the U.S. wine industry, an EU split would mean a flood of cheap imports from the more stressed wine-producing countries, specifically Spain, Portugal, and Italy. While France isn't in that group, it is to be expected it would also see its exports to the U.S. increase in that scenario.

A year ago in April of 2011 the discussion wasn't about the strength of the U.S. dollar, but rather about the euro's strength trading near $1.50. Economists watching the U.S. were more concerned about the potential of a double dip here versus Europe. Rating agencies began openly discussing the U.S. deficit, our ability to tax, and questioning the federal government's ability to govern and solve our financial problems. The U.S. AAA credit rating was in jeopardy and eventually would be lowered.

Conversely in Europe, the Financial Stability Fund[x] (EFSF) had been put in place the year before to make sure there was enough dry powder to put a net under the banking system and support troubled countries. With some initial optimism for success, £440BN was earmarked. But as the year went on questions were raised about the true depth of the sovereign debt contagion. Regulators and rating agencies began to look more acutely at the interconnectedness of the Continent's financial system, the counterparty risk associated with potential country-level bond defaults on the European banks, as well as the transparency and accounting standards employed by European banks to account for troubled sovereign debt purchases.

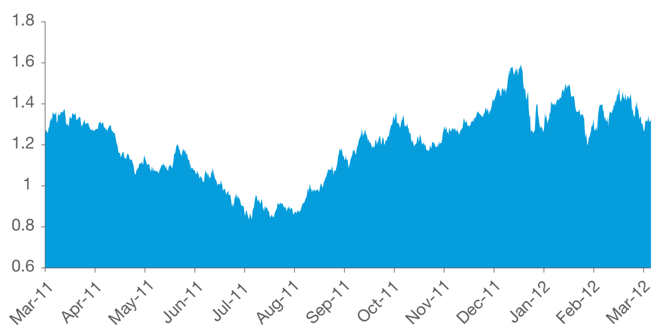
Now it wasn't just Portugal, Ireland, and Greece being discussed. The banks in Italy, Spain and France started to receive scrutiny and their own borrowing costs went up, separating further from Germany as shown in Figure 7.

Figure 7: Interest Rates on 10-year Government Bonds



In December of 2011, the ECB lent just under a half-billion euros to banks and the long-term refinancing operations (LTRO) to stave off liquidity pressures in the financial industry. By early 2012, the offer was repeated with nearly 800 banks collectively borrowing a reported £ 529.5 billion, but not before the rating agencies downgraded many of the EU countries' debt ratings, including the LTRO itself. The result of those events — the role reversal of a healing U.S. economy compared to continuing drama from Europe — has led to a weaker euro as seen in Figure 8. What's next for the euro?

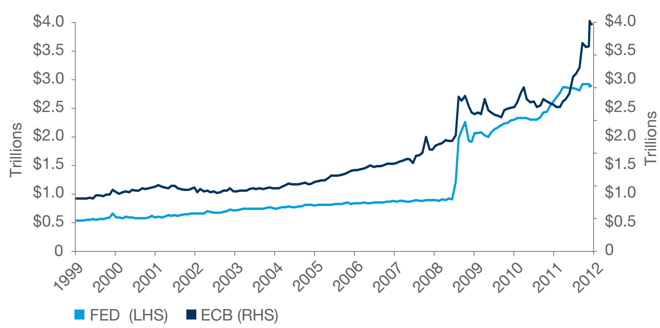
Figure 8: Euro vs. US Dollar



It's important to note the economic driver of the euro bus is Germany. In a strange twist, even though they are helping fund and guarantee billions in debt relief for the southern euro states (none too popular with their citizenry we should add) a collapse in the euro would create a very strong German currency, thus severely damage the competitiveness of Germany's own exports. So while a euro collapse is possible, it's really in most country's own interests to hang together.

The question still remains if the political will exists in the stronger countries to support the weaker ones longer term, particularly if it seems like the bucket has no bottom. Our guess is the political will doesn't exist to support unending bailouts of the numerous weaker states, and something will change the euro zone status quo. It's not an end of the euro, but change to its founding tenets. We believe the can will run out of road to be kicked down, before economic growth comes to the rescue as many are hoping. The reality is that economic activity in the European region continues to disappoint. Unemployment is at its highest level in 14 years and the economy is assured of entering back into recession after first quarter's GDP figures are released. Government austerity in the southern states of the euro zone that thrive on public-sector jobs will continue to drive the job creation down in the intermediate term. Given the size of the balance sheet, the ECB's ability to fund deficits indefinitely and gain member support has to be questioned. Today with $US 4 trillion lent from the European Central Bank, its balance sheet is already roughly $US 1 trillion larger than the Federal Reserve's balance sheet which sits at $2.928 trillion as seen in Figure 9.

Figure 9: Comparing the Fed and ECB's Balance Sheets



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The optics of the situation in Europe, while not dire, certainly can't be viewed as on a road to recovery just yet. There is uncertainty and financial markets hate that. Furthermore, these bailouts are requiring investors to accept a strategy of "implement austerity and hope for growth." As we all should know by now, hope is not a strategy.

As a consequence, we expect longer term weakness in the euro versus the U.S. dollar. That will lead to cheaper imports: better priced foreign bulk in the hands of the big wine producers and lower priced imported wine on store shelves. As continuing demand growth in wine is starting to exceed our ability to fill from domestic sources, market share in total wine sales will be handed over to imports in 2012. The guess here is that growth will come from the EU countries.

Econon Busters

Dr. Ray Stantz:	You know, it just occurred to me that we really haven't had a successful test of this equipment.
Dr. Egon Spengler:	I blame myself.
Dr. Peter Venkman:	So do I.
Dr. Ray Stantz:	Well, no sense in worrying about it now.
Dr. Peter Venkman:	Why worry? Each one of us is carrying an unlicensed nuclear accelerator on his back.

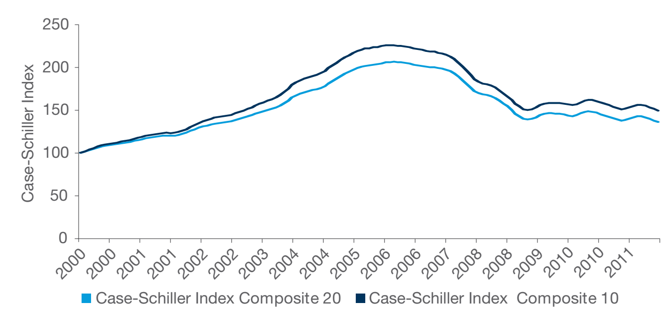
The Great Recession is a type of financial calamity that had never been experienced before in this country. Fed Chairman Bernanke wrote his thesis and several essays on this kind of event and what actions could be taken to prevent a second Great Depression … at least theoretically. Since this kind of crisis had never been experienced, there was never a successful attempt to test the equipment and solutions he pondered. When he was given a wide expansion of his powers in his first term, the U.S. Congress and the American people were essentially put in a place of pledging our reluctant faith. No sense in worrying about the untested solutions. We were along for the ride.

Thus far, it appears the American people's forced faith was justified. At the end of 2011 investors were running scared due to the almost daily news about calamity in Europe. In October when MF Global blew up as a result of bad sovereign debt bets, all were wondering if there was another shoe to drop in the financial markets. The terms "risk-on" and "risk-off" became synonymous with daily movements in the market seemingly linking the U.S. recovery to fallout from Europe versus any positive momentum here.

Early in 2012, however, that correlation became less evident as jobs numbers started to improve and the unemployment rate dropped a bit. Nonfarm payrolls grew an average of 200K for the early part of the year, mirroring an improvement in a number of sectors, including manufacturing, service providers, professional and business services, construction, education, leisure, healthcare and hospitality. The variety of industries that added jobs raised hope that the recovery might be real and was reflected by an increase in the University of Michigan confidence index and an early run-up in the stock market.

That said, there is every indication that we are still years away from a true recovery and full participation from the middle class that could turbocharge wine sales. While there is optimism about a bottoming in house prices as seen in Figure 10, the large number of homes without any equity, and a broken securitization process mean housing will continue to be a drag on recovery and a vaporous wish. But at least now there is a heartbeat to the consumer's wraithlike recovery.

Figure 10: Nominal House Prices



The summation of the current economic view is data are improving, but not close to the activity that would be deemed healthy. For the wine business it means a difficult slog as costs of production will increase, but the ability to raise bottle price will be challenging, compressing producer margins in the near term and slowing the overall rate of growth in fine wine sales. With respect to the fates of Europe and the U.S., we appear to be the least ugly date for the ball.

Demand Busters

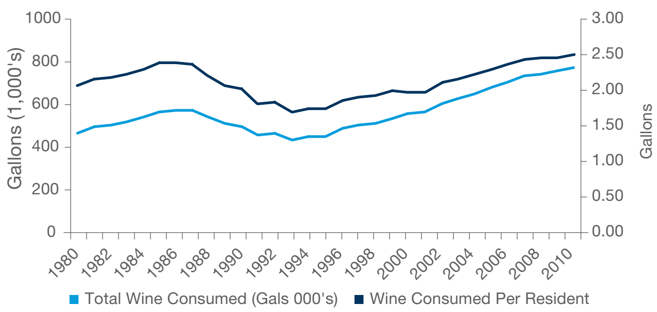
(Warning: The Film Clip linked in the above caption heading was Rated PG by the Motion Picture Association of America, and is not suitable for people who possess no sense of humor.[xi])

Dr. Ray Stantz:	Everything was fine with our system until the power grid was shut off by d***less here.
Walter Peck:	They caused an explosion!
Mr. Mayor:	Is this true?
Dr. Peter Venkman:	Yes it's true ... (pauses)
Dr. Peter Venkman:	This man has no d**k.
Walter Peck:	Jeez! [Charges at Dr. Venkman to choke him]
Mr. Mayor:	Break it up! Hey, break this up! Break it up!
Walter Peck:	All right, all right, all right! ... (pause)
Dr. Peter Venkman:	Well, that's what I heard!

Lawmakers and regulators seem to have their own agenda and from a distant perspective, appear to bend to the whims of the best-funded lobbyists. The messages surrounding the consumption of alcohol can seem passionately contradictory. It's good for you, and it can kill you. It's a sin for some, and a sacrament for others. We need to control the sale, and allow consumer choice. Opposing sides can manipulate information to suit their own ends, and debates about alcohol seem very much like those happening on the floor of the U.S. Congress with nobody changing entrenched views and seemingly no middle ground to be had.

Mixed messages were pretty much the norm in 1986 in the U.S. when total wine consumption peaked at 587 million gallons. Liquor companies were building brands with nationwide advertising on TV and consumption still dropped as a combination of M.A.D.D., neo-prohibitionists and health advocates teamed to deliver a convincing anti-alcohol message. Gone were the three-martini lunches. In its place we started eating tofu and drinking wheatgrass, watched celebrities endorsing Jazzercise videos and exercise equipment; went through a boom in gym openings; and after work, we all came home and kicked the dog before having a nice glass of nothing, thank you very much.

Figure 11: Wine Consumption



Source: Wine Institute

Then In 1991, the CBS program 60 *Minutes* did their own visionbusting and aired a segment called "The French Paradox" citing the findings of Serge Renaud, a scientist from Bordeaux University. His report linked wine consumption to the lower risk of coronary heart disease. Lost in the discussion, but perhaps an even bigger impact, the median of the Baby Boomers hit their mid-30s right at the same moment. Consumption started to bottom beginning in about 1994. We had the mid-point of a huge population bulge combining with a good economy and the best reason to drink a glass of wine: It's good for you![xii] I think everyone was really just waiting for a reason to return for an adult beverage, and when it became healthy, well that was good enough for us.

As seen in Figure 11, consumption has been on an uninterrupted string of consecutive growth years since that report.[xiii] Combined with the Boomers discovering wine and the country discovering mass luxury goods, the wine business and the high end of the business found itself in the Valhalla of business metrics: growing volume and higher price paid per unit of production.

Today we at SVB are starting to wonder if there aren't emerging factors that could reduce the growth rate we've seen over the past 15 years: 1) the decimation of the middle-class and their slow recovery as noted and 2) the demographic trends vis-à-vis the Boomers which supported the growth in consumption through the middle 90s, are starting to ebb in their consumption patterns.

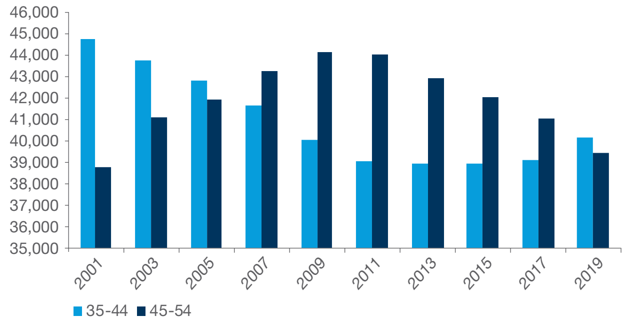
Demographic Busters

Dr. Peter Venkman:	He slimed me.
Dr. Ray Stantz:	That's great. Actual physical contact. Can you move?
Dr. Egon Spengler:	[over walkie-talkie] Ray, Ray, come in please.
Dr. Peter Venkman:	I feel so funky.

At times statements seem to stick when they keep getting repeated. That's how urban legends are born … like the guy in Arizona who attached JATO rockets to his car to see how fast he could go. Fact or fiction? Remember Saccharin? Canadian rats got tumors eating it, so it was dangerous and pulled from the market. Many people wouldn't think of using Saccharin today but are happy they have Sweet and Low as a substitute.[xiv]

Millennials are driving wine sales. That's another one that seems to stick. It must be true since we hear it so much. Is it true? Boomers are slowing in their consumption patterns. Is that true? Yes and no. What is true? Boomers are still the largest consumers of wine and fine wine. Affluent boomers are by far the most important cohort today for fine wine producers. But Boomers are also aging and with that comes an inevitable decline in consumption.

Figure 12: Population Trends in Affluent Consumers



Source: Unity Marketing

Standing in the way of a stronger wine recovery today are trends that are lowering the absolute number of the highest spending affluents: those between the ages of 35 to 54. Affluents represent a much smaller percentage of the consumer by number, but have far greater impact on retail spending. Pam Danziger of Unity Marketing points out the top 20 percent of U.S. households represents 50 percent of the nation's income, 40 percent of all consumer spending and 80 percent of premium wine sales. So a decline in the absolute number of affluent consumers is a headwind on price recovery for the fine wine producer, in addition to the economic issues faced by the U.S. and the world.

Reviewing Figure 12 you notice the 45 to 54-year-old affluent population begins to crest starting in 2011 as the Boomers start to fall out of the range. The smaller cohort Gen X can't replace the demographic in pure numbers but they are in a place where their window of affluence is upon us. What about the echo-Boomers or Millennials? Aren't they going to make up for the eventual loss of Boomer-based consumption given their larger population? Here are some recent unattributed statements from wine people that we've heard drive at that open question:

"34 percent of Millennials are drinking more today, versus only 7 percent of Baby Boomers."

"Millennials are now the fastest-growing segment of wine drinkers."

"Millennials accounted for 46 percent of the growth in the wine business last year."

"The Millennial is responsible for nearly half of the frequency of wine purchases over $20."

For many, reading those types of statements has helped you conclude there is nothing to fear from fewer Boomers. Millennials are here to take up the slack … if only we can market appropriately to them. That generation is the most digitally literate,[xv] so you've probably also concluded that is the best way to get at that group. The problem is, you're wrong; wrong on the current impact of Millennials on your fine wine business and wrong about the reasons to invest in social media. You are solving for the wrong problem. You've been slimed.

The reality is the consuming Millennial generation is not even close to the most important age demographic for the fine wine business today. That notion is a myth created from the misapplication of data and the repetition of misconstrued sound bites like those mentioned earlier. It's not challenged by wine producers in some part because most producers go by instinct when they talk about demographics and their own wine sales. The growth curve for Millennials in their appreciation of wine will be very much like those in generations before, with the exception of starting with more information, more selection and doing it all in a digital age. Believing Millennials are developing their palates starting with expensive and complex wines is nothing short of a fairy tale, but that's the message that is being heard by many winery owners with whom we've spoken.[xvi]

Fine wine is an affordable purchase, but it's still a luxury purchase. While I can make a personal argument that wine is a necessity in life, luxury purchases intuitively are going to be made by consumers only after taking care of the necessities in life.[xvii] A consumer without income or cash (net worth) — and perhaps living with his or her parents — is not likely to be a target customer of a fine wine retailer.

The most recent information from the U.S. Census Bureau as analyzed by the Pew Research Center in Figure 13 show the Millennials have not only the lowest net worth among all cohorts at $3,662 per person, they also have the largest negative change in their net worth relative to similar age groups over the last 25 years. I've heard some in the wine business argue this group is moving back home and has lower living expenses and higher disposable income to buy wine. However, that argument ignores the fact this demographic today has the largest unemployment rate and at the same time is starting out more burdened by college loans, is experiencing delayed entry into the labor market, and later marital commitments which negatively impact two-income family wealth creation. Millennials simply can't afford to buy luxury wine today.

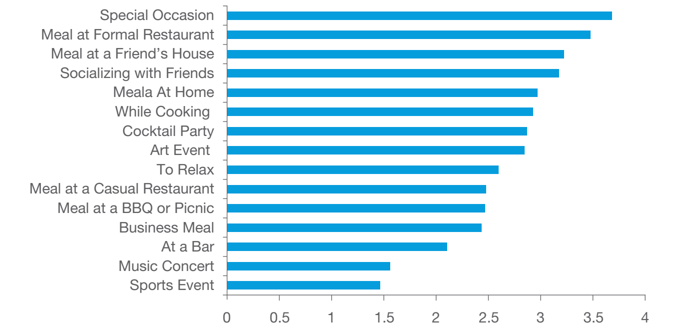
Figure 13: Median Net Worth by Age of Householder, 1984 and 2009

Median Net Worth by Age of Householder, 1984 and 2009			
in 2010 dollars			
	1984	2009	Change
All	$65,293	$71,635	10%
Millenials	$11,521	$3,662	-68%
Gen-X	$71,118	$39,601	-44%
Early Boomers	$113,511	$101,651	-10%
Late Boomers	$147,236	$162,065	10%
Matures	$120,457	$170,494	42%

Source: U.S. Census Bureau

Further to the point, according to a recent study from Sonoma State University (Figure 14), the most common reasons cited for wine consumption among Millennials are a special occasions and meals at a formal restaurant. Recognize that the question concerns wine as a product, not fine wine specifically. If the question were focused on fine wine, the answer would be far more skewed to special occasions. Nielsen reported early in 2011 that Millennials account for 17.4 percent of total wine sales. Unsaid in the report but a reality is when looking at fine wine sales, Millennials represent even a smaller percentage of total wine consumers.

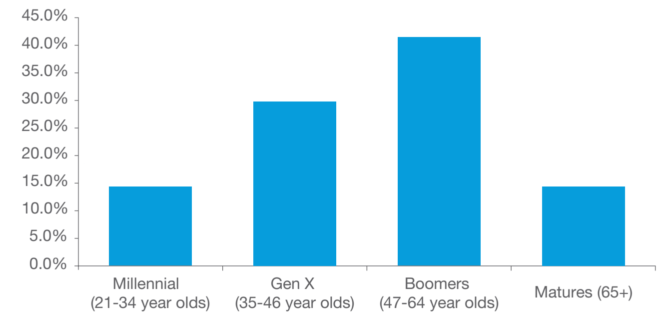
Figure 14: Frequency of Millennial Wine Consumption by Occasion



Source: Sonoma State University, School of Business and Economics, Wine in the Shower -- Study Explores New Occasions When Milennials Drink Wine, Figure 1

To get another view of demographic consumption, in the 2012 SVB Wine Conditions Survey, we asked producers themselves who used CRM, how their sales were spread among the standard cohorts. Looking at Figure 15 Only 14.3 percent of purchases were by Millennials. Still overwhelmingly, it's the Boomers who show up as the dominant purchaser of wine as a category. Not surprisingly, it's the Gen Xers, those between the ages of 35-46, who show up taking the second spot at nearly 30 percent of total purchases.

Figure 15: Wine Sales Demographic



Source: Silicon Valley Bank Proprietary Research

What is actionable with this information? It seems in our zeal to prematurely promote the ascension of the Millennials as the replacement for the Boomers, we neglected to talk about what to do in the transition years before those Millennials come into their own. It's not to undercut all the positive notions of Millennials being more wine savvy than their parents at similar times in their lives, but to put a dose of reality into the discussion about the timing of their arrival as meaningful wine consumers.

The Gen X cohort is just now coming into their own with roughly 10x the average net worth of the Millennial. They are more likely to be in a place in their careers, in their finances and in their family situations where some level of affordable luxuries are within their reach. The implication for the producer is a closer look is required for Gen X today as they are more likely a source of growth for your brand over the next eight years while we await the arrival of the Millennials.

What occurs to me as I write this section is the Occupy Movement has it all wrong. There is rightful indignation over the misbehavior and obsessive greed in parts of corporate America, the inequity and failure of governments to care for the less fortunate, and the general loss of opportunity by so many. But this perceived disparity isn't really about the difference between the haves and the have-nots. It's not about Wall Street versus Main Street either. It's not about the One Percent compared to the 99 Percent. With the great wealth divide between the under-35-year-old crowd and the over-35 crowd expanding as noted, it's really about the old people versus the young people. When it comes right down to it, the movement should be "Occupy the Elderly" or "Occupy Your Parents House." That's the real establishment. That's where "the man" lives. Someone please tweet that idea.

Social Media Busters

Dr. Egon Spengler:	It's here!
Dr. Ray Stantz:	A torso apparition. And it's real!
Dr. Peter Venkman:	So what do we do now?
Dr. Ray Stantz:	We gotta make contact. One of us should actually try to speak to it.
Dr. Egon Spengler:	Good idea. (The three walk out from behind the book shelves huddled together)
Dr. Peter Venkman:	Hello. I'm Peter. Where are you from ... originally? [Ghost placed her finger to her lips. Shhhhhhh.]
Dr. Peter Venkman:	OK. The usual stuff isn't working.

Social Media is almost a ghost unto itself. You can see it, sorta. You can go to conferences about it and learn from mediums channeling vaporous digital descriptions of what they see. You think you might understand it. But it still doesn't make complete sense to you. It's just a sense you have that you are missing something. And yet, it's real, or so I'm told. So now what do we do?

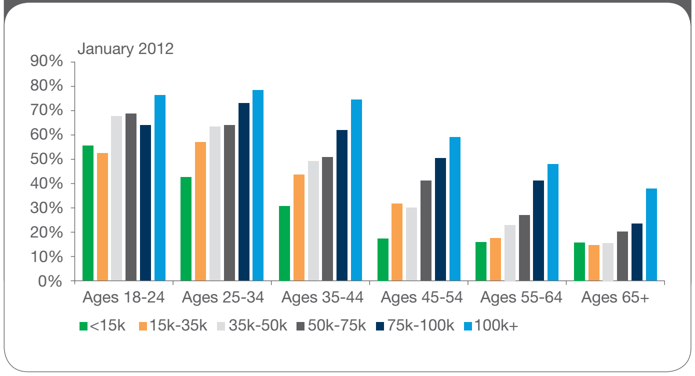
You are a with-it kind of person. You have your Facebook. You have a Klout score. You have a smart phone and check in with Foursquare. You're tweeting even, but like Bill Murray's character the usual stuff isn't working. Then again, who cares? Now that we've busted the Millennial Myth as being premature, you just discovered you've been wasting your time reaching out to Millennials in the first place. They might be reading your social media outreach, but they are without means. So now you don't have to invest anymore into social media, right? Nope. You are solving again for the wrong problem.

Social media isn't really about selling today or about reaching the young tech savvy buyers. It's about adapting to a revolutionary change in the way we all communicate. In reality, the evolving use of social media may be to connect with your customers and hear what they think, versus actually telling them what you want or think. Understanding and collecting their preferences and selling is more the function of CRM today and that function should definitely be integrated into your digital business plan if it isn't already.

But we agree: There's is a lot of confusion about electronic and digital support. Most remember when social media consisted of a flyer from the Elks Lodge and CRM was an abbreviation for cream on your shopping list. But the world evolves and access to markets has become increasingly complex. Competition comes from every side now; legal turbulence remains; digital tools continue to evolve, but are not yet sufficiently integrated; and traditional distribution is increasingly ambivalent about the small producer. The digital world and the Internet are now critical for success.

Go online and take a look at any chart on circulation rates of traditional print media. Without even looking I'm sure you will know that they all point down. Mainstream media is being radically changed and smartphones, social media and the Web are largely replacing traditional radio, TV, newspaper and magazines as a means of reaching customers. That's forcing a move to understand this change by all generations, and for business to discover how to use new tools and platforms to not only continue to remain relevant and build brand image, but to more cost effectively drill down to groups of consumers and engage them — regardless of age — through these new media and technologies.

Figure 16: Smartphone Penetration by Age and Income



Source: Nielsen

What's at stake? Figure 16 displays the adoption of technology specifically in the smartphone segment. Looking at the chart you can tell more than half of smartphone users are in the target wine producers demographic above age 35. But when income is added to the mix, the result is more dramatic as older subscribers with higher incomes are more likely to have a smartphone. Those 55-64 making over 100K a year are almost as likely to have a smartphone as those in the 35-44 age bracket making $35-75K per year.[xviii] That is the wine producer's prime demographic audience. Are you as a wine producer reaching that audience?

The digital world seems to have its own lifecycle of introduction, adoption, misuse and overhype, correct use, and finally acceptance of some defined use by the masses. Jump in too fast and you waste time and money. Don't jump in at all and you risk being left in the dust with a learning curve too steep to overcome. Our recommendation specifically with respect to social media is to get in the game and experiment. Don't over-commit scarce resources, but do develop a thoughtful approach to what you want to do, how much time you can afford to spend, what good measurements for success are, and develop a feedback loop to evaluate your successes and failures on some schedule.

CRM Busters

Dr. Peter Venkman: Alice, I'm going to ask you a couple of standard questions, okay? Have you or any of your family been diagnosed schizophrenic, mentally incompetent?

Librarian Alice: My uncle thought he was Saint Jerome.

Dr. Peter Venkman: I'd call that a big yes. Uh, are you habitually using drugs, stimulants, alcohol?

Librarian Alice: No.

Dr. Peter Venkman: No … no. Just asking. Are you, Alice, menstruating right now?

Library Administrator: What has that got to do with it?

Dr. Peter Venkman: Back off, man. I'm a scientist.

It's important to take a scientific approach in evaluating your customer's needs. If you don't know their tastes, how are you going to sell them what they want? In this market, the wineries that will do best will be those that devote time and resources to developing customer-level preference information and embed curiosity into their culture. I wouldn't suggest asking the questions Dr. Venkman was asking, but some questions you might want answers to relative to your customers might include:

- Why did members leave the club? How old are my customers?
- Do younger buyers purchase different SKU's?
- How do my customers prefer to communicate?
- Do they like to come to consumer events, or do they really prefer entertain at home with my wines?
- How often do they buy? Are older buyers purchasing more than younger buyers?

- Are those who buy my wine using social media? What is the most a given age group paid for a bottle of wine in the last six months?

The list of useful questions is endless and each drives at actions that can be taken to improve sales and marketing.

There are many ways to collect data, including asking the sales force to collect information from their drive-arounds, asking tasting room staff to do verbal interviews, using highly-evolved CRM tools, and taking advantage of inexpensive or free online survey tools that wineries can employ. It's somewhat ironic that as we push deeper into a digital existence, it only emphasizes the need to return to the fundamentals of knowing your customer. Fortunately, tools are finally emerging that help us understand and properly scale client experiences so we can deliver seemingly individualized experiences in groups of communications.

Today with the convergence of technologies, every serious wine producer has to begin to understand and employ digital tools that we've mentioned and consider integrating those with other platforms to improve the direct-to-consumer business.

The Vision of the Fifth Column

Dr. Egon Spengler: Vinz, you said before you were waiting for a sign. What sign are you waiting for?

Louis: Gozer the Traveler. He will come in one of the pre-chosen forms. During the rectification of the Vuldrini, the traveler came as a large and moving Torg! Then, during the third reconciliation of the last of the McKetrick supplicants, they chose a new form for him: that of a giant Slor! Many Shuvs and Zuuls knew what it was to be roasted in the depths of the Slor that day, I can tell you!

The sides were drawn. It was humanity versus the Ghostbusters. Gozer had a plan. He had a fort in Dana Barret's apartment. He had minions in ghosts assisting but to win, he decided to take over Louis' and Dana's bodies and fight from within the people's ranks.

In the same way, the term Fifth Column was coined during the Spanish Civil War when Madrid was under siege from General Vidal. Vidal announced over the radio that in addition to the four columns of attackers closing on the city, there would emerge a Fifth Column — an ad-hoc group of loyalists emerging from within the city who would rise up against the incumbent order.

The pioneers in internet wine sales and DtC[xix] such as the original Wine.com, New Vine Logistics and My Wines Direct have come and gone now. They were trying to solve for different pieces of the same puzzle: getting wine from the producer to the consumer. The early pioneers tried to take on the whole problem when many of the functions needed for successful direct shipping required focused expertise in disparate functions such as legal, compliance, software design, sales, logistics and transportation, and e-commerce. Their DNA and learnings are still resident in the settlers who now work the growing wave of e-business supporting the wine business. As a consequence, today the rudimentary business segments of a compliant and effective e-commerce sales platform are now in place and available. There is a Fifth Column of wine sales now — an ad-hoc assembly of focused and better capitalized businesses, some emerging from within the existing 3-Tier network itself. Taken together, a winery can now cobble their own distribution system together supported by these new businesses and platforms, avoiding the wholesaler altogether. The Fifth Column includes disparate, focused companies such as:

- ShipCompliant who can handle the legal part of shipping and track the unending changes in state to state shipping laws
- TastingRoom.com who can provide small package samples to those wanting to try and buy
- Third-party marketing agents and Flash sites such as Wine Woot, Wineaccess.com, Winestillsoldout.com, Cinderellawine.com, and Lot18
- Sophisticated e-commerce solutions like Vin65.com and VineSpring to power their e-commerce coupled with third party logistic companies like WineDirect and Pack n' Ship

- Dedicated e-tailers like the reborn Wine.com, Winetasting.com, Vinfolio.com, Plonk, and the internet stores of many brick and mortar retailers like Winelibrary.com, K&L Wine Merchants, and Sherry-Lehmann
- European e-commerce veterans such as NakedWines, Tescos, and VirginWines, some moving to the U.S. market
- VinTank who can offer thought leadership, digital understanding, plus software tools like social CRM and social media listening
- Social Media tools like Social-Candy.com that enhances a producer's opportunity to create custom experiences on Facebook
- Outsourced call centers like ChatterBox and Wine Leverage
- Over 452 wine iPhone apps to help customers connect to wineries and key consumer sites like Cellartracker.com that empowers consumers to discover and validate their wine selections.

The evolution and momentum of the Fifth Column of wine sales leads us to believe the genie is finally out of the bottle and there is no putting it back for state-to-state and direct wine e-commerce. The amounts being sold through this channel are hardly trivial now, estimated at the high end to represent 12.5 percent[xx] of the market. With a little bit of effort now, a producer has the opportunity to add to their traditional in-house, online retail presence by partnering with these businesses and appropriately scale and customizing their own retail direct sales channel.

Legislative Busters

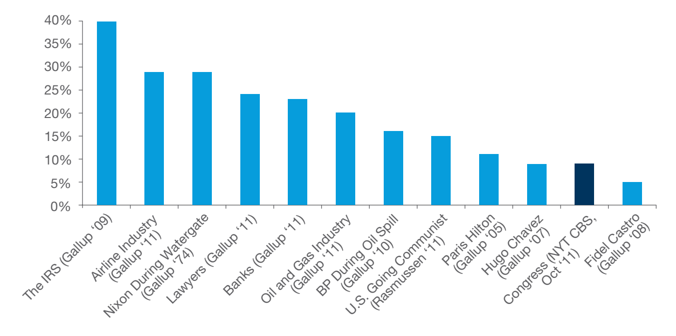
Dr. Ray Stantz: Gozer the Gozerian … good evening. As a duly designated representative of the City, County and State of New York, I order you to cease any and all supernatural activity and return forthwith to your place of origin or to the nearest convenient parallel dimension.

Dr. Peter Venkman: That ought'a do it. Thanks very much, Ray.

There was a day when our politicians in Washington enacted legislation that included negotiated settlements. There was a level of public civility that was expected to provide a platform to get the work done and write common-sense laws that supported the middle view of America. Somehow, today we end up with a legislative and executive branch that caters to special interests and the extremes of the electorate. Our officials in Washington spend more time trying to make the other side look bad than fixing problems.

Campaign speeches today remind me a little of Ray talking to the Gozarian. They step forward; take a spoken position that panders to someone in the background who supported their campaign; and then leave smiling knowing the goal wasn't really to do anything. The goal was to appear that you wanted to do something. The result of this situation is Congress has a 9 percent job approval rating as shown in Figure 17. The silver lining in this news is bankers look pretty good comparatively with a 23 percent approval rating. Needless to say, few people are happy with Washington (or bankers) and the antics that take place.

Figure 17: The Popularity of Congress Today



In the wine business the debate has been over access. Producers and consumers alike got a gift when the U.S. Supreme Court ruled on GRANHOLM v. HEALD[xxi] in 1995, putting a sizeable crack in discriminatory laws that served to protect the wholesaler. At the same time, the Internet developed out as an alternative sales vehicle. The traditional wine clubs and tasting room activities could now begin to be supported with e-commerce. With the advent of more and more businesses supporting direct-to-consumer sales, everyone lived happily ever after. Well, not quite. That's not what happened at all.

The Granholm decision and other such laws aimed at improving access for consumers have been fought tooth-and-nail by the wholesale side of the business. The end result is while the Internet has been a viable sales tool for more than a decade now, up until recently the totals for direct sales have been nothing but an interesting rounding error estimated to be less than one percent[xxii] of total wine sales. We believe the momentum is about to change as the Fifth Column becomes more defined and functional.

It's this Fifth Column that the Wine and Spirits Wholesalers of America (WSWA) most fear because once there is money to be made by companies within the 3-Tier, individual companies can splinter and support the emergence of this alternative sales channel, thus breaking the existing protectionist system from within. Last year WSWA Board Member Bill Goldring emphasized this fear at their annual convention in Orlando saying, "The three-tier system has served me[xxiii] and all of you very well for the better part of a century now. It has been a true godsend." He reminded the audience that, "(t)he wholesalers' work has benefitted suppliers, retailers and consumers." However, he added this caution: "Should any one of the tiers get greedy and think for a second they can live without each other and we don't hang together, we will hang separately."

The battle isn't close to over. The current distribution system in place is well-funded with lobbyists in place fighting any move that could weaken the wholesaler's legislated monopoly and doing what they can to turn back Granholm. The most notable recent attempt was a bill written by the National Beer Wholesalers Association in consultation with the Wine & Spirit Wholesalers of America who employed Congress to enact HR5034,[xxiv] and its sibling bill HR1161.[xxv] I love the bill's acronym "The CARE Act" (Community Alcohol Regulatory Effectiveness Act of 2011).[xxvi] In a paper[xxvii] released in July of 2011, the Specialty Wine Retailers Association framed out the money spent on State and Federal Government officials to keep the system in place through three election cycles between 2005 and 2010:

- American alcohol wholesalers have spent $82 million on contributions to federal and state political campaigns and federal lobbying efforts
- American alcohol wholesalers have spent more than $15.4 million dollars on contributions to federal election campaigns
- Wholesalers have spent nearly double the rest of the alcohol industry on federal campaign contributions
- The primary wholesaler trade associations, the National Beer Wholesalers Association and the Wine & Spirits Wholesalers Association, alone have spent more than $8.8 million on federal lobbying
- Nationwide, wholesalers have contributed more than $58 million to state political campaigns
- Wholesalers have spent roughly twice what all other sectors of the American alcohol beverage trade have spent on state political campaigns.

I had this thought: Wouldn't it make more sense if wholesale interests recognized there is a growth opportunity and money to be made helping build out the developing e-commerce sales channels and try to own a part of the process? Instead of spending all this money, time and effort on protectionism, what would happen if they cooperated with the market forces?

No, I don't expect this powerful group to change anytime soon, but there is a real threat to the wholesalers themselves in continuing to torpedo a developing marketplace that supports consumer access. Swimming against the quickening current will only mean more and more revenue will find a way around the traditional 3-Tier models. I'd say at some point the wholesale lobby will discover they can either hang with the consumer's demand for direct access, or hang alone.

Flash Site Busters

Dr. Ray Stantz: Listen ... do you smell something?

I hear something that smells like its decaying: Flash sites.

Silicon Valley Bank had the world's first wine Flash site (SVBWines.com) in 2004 and soon thereafter Flash retailers were copying us and trying to get traction.[xxviii] After the 2008 crash, with wineries dropping prices to spur sales, many more discounts sites made their debuts. There are market forces at work today which will further evolve this space in the next several years. Several venture capital firms have placed bets on many of these e-commerce companies in the past couple years, providing needed expansion capital to this perennially cash-starved segment. But the Flash sites face their own issues of swimming against the market.

Most of the Flash sites have a culture of discounting. Their businesses were built on the ability to source inexpensive product in an over-supplied market. The problem is buying cheap wine is going to become increasing difficult in a market that is moving to shortage as we have noted. If those companies have a culture of selling on price alone, they will be disadvantaged. In our opinion, sites that focus on replicating the wholesaler's theoretical job in selling and marketing wine will be the survivors in what is sure to be a shakeout in the segment. Those companies who take a consumer sales focus versus a sourcing focus will control the most important asset: direct contact with the buyer from which continuing sales can be made. Tapping global supply might provide some more time for culture changes within these businesses, particularly if the dollar strengthens but there is another risk as wine supply worldwide is more balanced than it's been in perhaps 30 years.

Pricing Busters

Dr. Egon Spengler:	There's something very important I forgot to tell you.
Dr. Peter Venkman:	What?
Dr. Egon Spengler:	Don't cross the streams.
Dr. Peter Venkman:	Why?
Dr. Egon Spengler:	It would be bad.
Dr. Peter Venkman:	I'm fuzzy on the whole good/bad thing. What do you mean, "bad"?
Dr. Egon Spengler:	Try to imagine all life as you know it stopping instantaneously and every molecule in your body exploding at the speed of light.
Dr. Ray Stantz:	Total protonic reversal.
Dr. Peter Venkman:	Right. That's bad. Okay. All right; important safety tip. Thanks, Egon.

Many of us have been trained to believe it would be bad to drop your price on a SKU. To clear any fuzziness on the consequence, the theory is you will train consumers to pay less for better wine and then pay hell raising price back later to get the return you need. Reading the press and survey results, we see this view repeated over and over. But is it true? Our belief is that if your wine is truly a luxury good, that kind of thinking is fraudulent on its face.

Consumers of fine wine in an information age are far more aware of what they like and don't like. While there are wide substitutions available, especially in lower-priced wine, high-priced wine as a luxury when the business is in balance or in short supply has fewer pure substitutes and carries more of an up-and-down demand curve. That means recovering price is quite realistic under the right circumstances. Those circumstances are a healthy affluent consumer and wine supply that is not long.

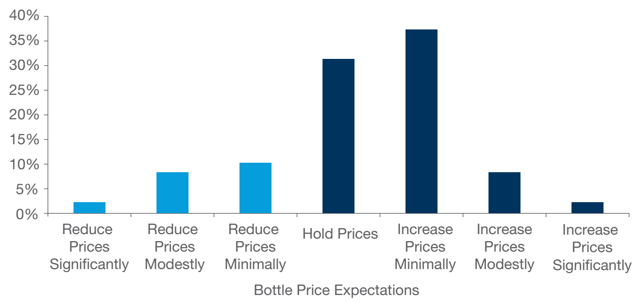
In practical terms, it's important to remember that when a shock hits the economy, there is a predictable reaction from distributors and producers. Distributors, when confronted by a change in demand or supply, stop ordering while they work down their stocks. Once they reach their optimal inventory level, they start ordering again to match depletions. The same is true for restaurants and even consumers with cellars.

In reaction to a shock, producers blend down reserve wines into lower-priced offerings, and sell off bulk supplies. The higher-quality bulk is then purchased by other wineries — often for less than the cost to produce — and put into less expensive SKUs. The end result is the value-conscience consumer can find better value at lower prices in distressed economic times. But that trend is not sustainable.

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

Figure 18 is from the SVB Wine Conditions Survey and shows the net expectations of wineries regarding their ability to change bottle price. While not always in alignment with our views, consistent with the winery owner's views this year, we also believe that with supply imbalances corrected and the economy continuing to make positive progress, we should see modest upward movement in the price/quality scale.

Figure 18: Bottle Price Expectations



Source: Silicon Valley Bank Proprietary Research

Financial Performance of Wineries … busters? (OK I'm out of ideas here)

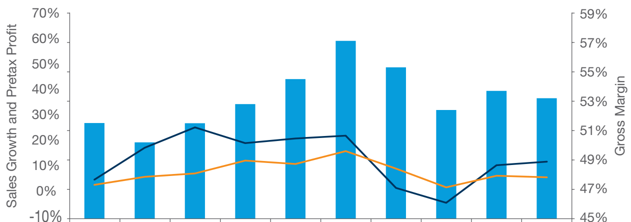
Dana Barrett: [Putting away groceries but strange sounds coming from the refrigerator. Opening the refrigerator Dana sees Zuul] AAAAAAAARRRggghhhh-hhhhhh!

There is a neighborly tendency in the wine business. You want to know about a winemaking trick? No problem. A vineyard practice? Just have to ask. Just ask a neighbor how business is going. Answer: Greeaaat! Like the scene hyperlinked, things might seem fine but when you look under the hood, it might not be as it seems financially.

At Silicon Valley Bank, we have been storing the CPA provided statements of clients and prospects in a database for the past 15 years. With them, we can provide Benchmarking data to our clients so they can see how they are doing against a peer sample. We also are immune from the normal neighborly response. We know when things are good and not so good.

This year we have good news and bad news as we look at the financial position of wineries this past year as revealed in Figure 19. The bad news was last year had higher-cost trailing inventory pass through the balance sheet, which lowered profits. The good news is financially wineries ended up 2011 looking about the same as 2010 … Wait, is that good news? It is considering where wineries came from after the crash.

Figure 19: Wine Industry Financial Performance



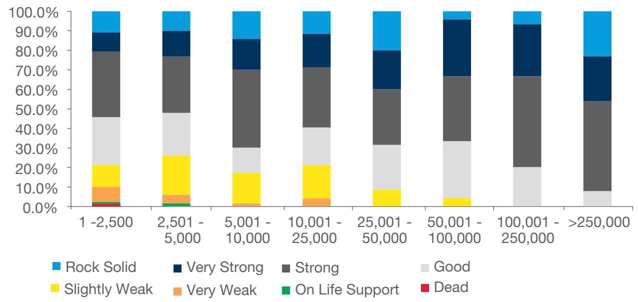
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Gross Margin	51.51	5.02	51.5	52.8	54.5	57.1	55.3	52.4	53.7	53.2
Sales Growth	5.2	17.6	25.5	19.4	21.2	22.3	2.0	-3.8	10.8	12.2
Pretax Profit	3.2	6.3	7.6	12.6	11.3	16.3	9.5	2.2	6.7	6.1

Source: Silicon Valley Bank Proprietary Research

Reports using unaudited financial information from SVB's Benchmarking database showed full-year sales growth through Q4 of 12.2 percent for the year — roughly in line with our 2011 forecast of 11-15 percent growth for fine wine last year. What is nice to see in this data is a firm bottom reflected in performance information and it's a great sign of emerging health for the industry.

Going a little further, each year we survey[xxix] the West Coast wineries about a number of things including their own financial health. Again, since we are a bank and have accurate financial results, we can test the survey data against instinct and in this case, we believe the data reveal a largely accurate view of the financial condition of the wine industry. Reviewing Figure 20, we note that all the weaker wineries are in the lower case production tiers: the lower the case production, the worse the reported financial condition.

Figure 20: Financial Condition of Wineries



Source: Silicon Valley Bank Proprietary Research

We believe that finding speaks to the difficulty smaller wineries have in sourcing appropriately priced grapes, lesser skilled managers wearing multiple hats, less access to distribution and generally poorer capitalization levels. Smaller wineries can be commercially successful, but growing grapes and making wine is not sufficient for success anymore. Budgeting, developing strategic insight, leveraging information gathering, sales strategies, cost accounting, grower relations and a litany of other skills are needed to succeed if you aren't selling more than 25,000 cases of wine. That said, what we have observed is small wineries have been amazingly resilient in this downturn. Time and again, they find ways to cut costs to survive and hold on.

If one looks at the prior Benchmarking chart over the cycle that starts back after the tech bubble, some might want to predict that we'll have the same type of recovery off the bottom of the recession and believe in much higher growth rates, but there is a difference in this recovery compared to the recession experienced in the early 2000s. That was an isolated, shallow and fast recession. We were led out of it by increasing home values bolstered by a massive amount of liquidity looking for an investment. We also didn't see the same level of price resetting on bottle price.

The slower recovery this time around will continue to produce a drag on the financial performance of family-owned wineries and make price recovery a multi-year task. While we are quite optimistic about the prospects for the future, the uncertainty of the global economy and echoes of the crash will still haunt so while we are forecasting growth in fine wine sales in 2012, we are lowering our growth estimate from last year slightly, and predicting fine wine growth rates of 7 percent to 11 percent. The industry is making progress, but there are many obstacles ahead.

Final Comments

Dana Barrett:	You know, you don't act like a banker[xxx].
Dr. Peter Venkman:	They're usually pretty stiff.
Dana Barrett:	You're more like a game show host.

We revel in the fact we aren't typical stiff bankers as you can probably tell from this report. That said, we are far from game show hosts. We bring an unparalleled level of expertise and flexibility to our clients that improve their chances of success. Think of us as consultants who have a complete suite of custom wine industry financial products from checking and debt, to cash management and barrel hedging. We also help our clients build their brands as part of our day-to-day efforts.

Now proving that I really am a banker, let me ask you a question: If you are a winery on the West Coast of the U.S., what's stopping you from getting this kind of insight and service level on a routine basis? Drop me a line and let's chat: RMcMillan@svb.com.

GOVERNMENT WARNING: (1) ACCORDING TO THE SURGEON GENERAL STRESSING ABOUT THINGS YOU CAN'T CONTROL WILL LEAD TO DEFECTS IN LIFESTYLE.(2) COMPLETELY IGNORING THESE DEPRESSING EVENTS THOUGH WILL LEAD TO THE EARLY TERMINATION OF YOUR CHOSEN PROFESSION.(3) LISTENING TO THE FAR LEFT OR RIGHT REGARDING ROOT CAUSES OF THE ECONOMIC MELTDOWN WILL CAUSE INCREASED CONSUMPTION OF ALCOHOLIC BEVERAGES WHICH IS A GOOD THING IN MODERATION BUT IMPAIRS YOUR ABILITY TO DRIVE A CAR OR OPERATE MACHINERY, AND MAY CAUSE HEALTH PROBLEMS IF SAID MACHINERY IS BIGGER THAN YOU. (4) THE GOVERNMENT IS HERE TO HELP AND HAS THE SITUATION UNDER CONTROL.

Silicon Valley Bank's Proprietary Benchmarking Metrics

Silicon Valley Bank's Benchmarking program is a 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 anonymous and aggregated data available to its clients. The data, based on financial information from over 100 premium wineries over several years, also allows Silicon Valley Bank's Premium Wine Group to monitor industry trends.

About SVB Financial Group

For nearly three decades, SVB Financial Group and its subsidiaries, including Silicon Valley Bank, have been dedicated to helping entrepreneurs succeed. SVB Financial Group is a financial holding company that serves companies in the technology, life science, cleantech, venture capital, private equity and premium wine industries. Offering diversified financial services through Silicon Valley Bank, SVB Analytics, SVB Capital, and SVB Private Bank, SVB Financial Group provides clients with commercial, investment, international and private banking services. The company also offers funds management, broker-dealer transactions and asset management, as well as the added value of its knowledge and networks worldwide. Headquartered in Santa Clara, Calif., SVB Financial Group (Nasdaq: SIVB) operates through 27 offices in the U.S. and international operations in China, India, Israel and the United Kingdom. More information on the company can be found at www.svb.com.

About Silicon Valley Bank's Wine Division

Silicon Valley Bank is the premier commercial bank for emerging, growth and mature companies in the technology, life science, venture capital, 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, in addition to traditional banking services. Silicon Valley Bank is a member of global financial services firm SVB Financial Group (Nasdaq: SIVB), with SVB Analytics, SVB Capital and SVB Private Bank. More information on the company can be found at www.svb.com.

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[i] http://www.youtube.com/watch?v=O3ZOKDmorj0 All rights are owned by Columbia Pictures.

[ii] The quote from the scene was accurate but of course the Republicans and Democrats agreeing to govern, that part was made up. That would never happen.

[iii] The original title was Ghost Busters and later changed to a single word (trailer). Though the film was a critical failure (the 1984 NY Times review was especially nasty), the movie went on to gross over $280,000,000 on a $32,000,000 budget just in the first year. It was a huge success for Huey Lewis, and fostered several new catch phrases used by Americans today. Not widely known, Ghostbusters III is currently in production as we speak staring the lovely Anna Farris. The lesson of course is, never listen to a critic. Drink what you like.

[iv] http://www.youtube.com/watch?v=d-sALU_hveA

[v] Trivia: The theme song from Ghostbusters was written by Ray Parker, Jr. Parker and earned him a 1984 Grammy Award for Best Pop Instrumental Performance. He was later accused of plagiarizing the melody from "I Want a New Drug" written by Huey Lewis and the News which had reached #6 in the Billboard Hot 100 six months earlier. Lewis sued Parker and Columbia Pictures, and the three settled out of court in 1985. Parker's success continued;

[vi] No kidding: Manure-filled cow horns. Seems like an opportunity for the Discovery Channel's Dirtiest Jobs series. But f you haven't looked into bio-dynamic farming, you should. There is something to it, and even if you reject the whole notion, you have to admit it's interesting. Here is a good read if you want to check it out: LINK

[vii] 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.

[viii] As of this writing according to U.S. Treasury data, China remains a strong buyer of U.S. securities increasing their purchases 7 percent to $1.73 trillion as of June 30, 2011; an increase of $115 billion from 12 months earlier, but the percentage of dollar holdings in China's foreign-exchange reserves fell to a decade low of 54 percent versus 65 percent in 2010.

[ix] We mean broccoli is good when consumed in moderation.

[x] http://en.wikipedia.org/wiki/european_Financial_Stability_Facility

[xi] The Motion Picture Association didn't really rate the clip, but www.ESRB.org did rate a similar clip "T" for teen, meaning the content is suitable for teenagers but no younger. Titles in this category may contain violence, suggestive themes, crude humor, minimal blood, and infrequent use of strong language … thus making it appropriate for teenagers to watch and model their lives around?

[xii] The official US nutrition policy on wine states in the Dietary Guidelines for Americans 2010:, "The consumption of alcohol can have beneficial or harmful effects depending on the amount consumed, age and other characteristics of the person consuming the alcohol, and the specifics of the situation."

[xiii] Too much credit is given to the French Paradox for total growth in wine consumption. Silicon Valley Bank entrance to the U.S. Wine Business is 100 percent 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 U.S. adults passed three gallons per capita in 2011 for the first time. Stats from the chart we present are for the total U.S. Population including those under 21.

[xiv] Sweet and Low is saccharin and was removed from the list of substances that cause cancer over a decade ago.

[xv] Digital literacy does not mean counting with your fingers.

[xvi] Here is a 10-minute podcast of college-aged Millennials, one of whom was raised in wine country, representing their views of wine consumption for their demographic at this still early stage in the development of their palates: http://bit.ly/z9stcN. Note: This podcast is rated PG.

[xvii] See Maslow's Hierarchy of Needs: http://psychology.wikia.com/wiki/Maslow percent27s_hierarchy_of_needs

[xviii] Nielsen, January 2012

[xix] DtC: Direct to Consumer

[xx] ShipCompliant data

[xxi] Granholm decision: http://www.law.cornell.edu/supct/html/03-1116.ZS.html

[xxii] Nielsen estimates current Direct to Consumer shipments at 1 percent of volume and 6 percent of dollars. ShipCompliant estimates total volume at 9 percent and dollars at 12.5 percent.

[xxiii] Bill Goldring is also Chairman of the Sazerac Company and Crescent Crown Distributing Company

[xxiv] http://www.opencongress.org/bill/111-h5034/money See the money trail from the non-partisan group OpenCongress.org

[xxv] If you would like to weigh-in on HR1161, here is the Facebook web page: http://www.facebook.com/stophr1161?ref=nf

[xxvi] The CARE act sounds so sensitive. Looking at http://thecareact.org/ the web site supporting the bill, you are greeted with a picture of a little girl going off to school and waiving bye to her mom along with the caption "To keep your kids and communities safe." I'm not the sharpest tack in the shed box, so maybe you can help me understand how this act is related to a little girl going to school or keeping her safe?

[xxvii] http://www.specialtywineretailers.org/TowardLiquorDomination.pdf

[xxviii] I'm not absolutely certain the SVBWines.com website was the world's first but we think it was with a URL creation of July 2004. Don't tell me if I'm wrong. Let me live in ignorant bliss.

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

[xxx] A little poetic license here as we inserted the word banker instead of scientist.

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