



Silicon Valley Bank

WINE REPORT

State of the Wine Industry: **2014**

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The 1994 movie *Forrest Gump*, featuring Tom Hanks in one of the most memorable movies of his career, won six Oscars including the trifecta of Best Picture, Best Actor and Best Director awards. The film took a walk through the historic times when Boomers matured from fighting against the establishment, to becoming the establishment. Like Forrest, Boomers were gifted with a fair amount of luck along the way and have driven growth in the wine business for the past 20 years. But now with the first Boomers hitting 65 and retiring at a pace of 11,500ⁱ per day, should we expect imminent change in U.S. consumption?

Forrest's mama said, "*Life is like a box of chocolates. You never know what you're gonna to get.*" While that was true for Forrest, as business people we don't have the luxury of taking that kind of laissez-faire approach to life. We have to make educated predictions and then plan. I think we can do a little better job of reading the chocolate box compared to Forrest, and have success separating out the nuts from the crèmes. We hope you will agree after reading this year's version of the *2014 SVB State of the Wine Industry Report*.

2014 BUSINESS PREDICTIONS

RECRUITING OFFICER:

Have you given any thought to your future, son?

FORREST GUMP:

“Thought?”

2014 BUSINESS PREDICTIONS

There are some years when the future looks pretty much like grass growing: the same thing happens over and over. Predicting a breakout from a pattern when you're in the middle of it is a little more difficult, but that is indeed what we are doing as we survey the wine business in 2014.

We believe we are trending to a transition point as Boomers hit retirement and the economic condition of the Millennials replacing them is burdened with high levels of student debt and weak job prospects. In the current period we expect to see continued growth in overall demand but only limited pricing power for producers. Within the next five to seven years however, the evolution from Boomers to Millennials as dominant purchasers of wine will prove a significant headwind to sustained growth in the wine business. Other noteworthy predictions for 2014 include:

- ▶ Harvest on the West Coast was large for the second year in all three states. In California we are estimating a 3.94 million ton harvest, making it the second largest harvest on record.
- ▶ Sales growth in fine wine will increase **for the first time after three years of consecutive and accurate predictions of growth rate declines**. Sales in the fine wine business will increase six to ten percent over 2013.
- ▶ Gross profit of wineries will be negatively impacted in 2014, the result of higher grape costs from the 2012 vintage year.
- ▶ All data suggest higher per capita trends in the U.S. population, but economic weakness should restrain younger consumers from trading up into higher price point wines for another 5-7 years.
- ▶ Luxury wines and those wines priced between \$10 and \$18 should see the greatest growth in demand in 2014.
- ▶ The euro will lag the U.S. recovery and the currency will weaken as QE eases in the U.S., leaving an opportunity for more bottled imports and additional pricing competition from offshore.
- ▶ Inventory is balanced in all segments as long as we look forward to the 2014 harvest which we expect to be average. A third harvest of record or near record yield will have the industry in the position of being over-supplied again.
- ▶ Grape planting is restrained compared to prior periods when supply was in balance. The Central Valley is at the greatest risk in planting ahead of demand.
- ▶ The highest price point wines report particularly short inventory positions. The high volume and very small estate producers report inventory position slightly above their requirements.
- ▶ There are broad expectations in the wine business that bottle price increases can be taken in 2014. Due to the higher volume of wine available for sale in a slow economy, we don't believe the opportunity is there to take broad increases with the exception of selective increases in the higher priced luxury segment.
- ▶ The Millennial generation is consuming more foreign wine



2014 BUSINESS PREDICTIONS (CON'T)

than other cohorts today. The likely outcome of this trend is not positive for U.S. producers going forward. A Marketing Orderⁱⁱ delivering a positive mass-market message to consumers about domestic wine quality is something the industry should strongly consider.

- ▶ Grape pricing has hit a high mark and contracts could see a level of renegotiations downward in exchange for term. Current supply has already led to a lower spot price reflecting current period heavy stocks.
- ▶ With one of the driest winters on record as of this writing following two drought years and an NOAA long-range forecast of below normal precipitation in California through end of March, water conditions entering this third year of drought may play a much larger role in planting and production decisions in 2014. You should consider preparation for the worst case situation for your vines and winery. Remediation and hedging strategies should be developed at the earliest possible time.
- ▶ Mergers and acquisitions of wineries and vineyards will continue at a record pace.
- ▶ Massive bulk imports will continue to dominate the lowest price point wine categories, but bulk imports should be held back by the size of the 2013 harvest and bulk supply currently in the cellar.
- ▶ Direct-to-consumer sales will continue as the largest growth channel for most wineries.
- ▶ We remain in a period of lower GDP performance that should reset our view of growth opportunity, business returns and prices for years to come. Other economic predictions:
 - Short-term interest rates will continue very low and stable for the next 12 months and probably longer. Longer term rates could increase slightly as the US economy strengthens.
 - Oil prices are an unknown and at this point but with the U.S. now leading the world in production, lower prices at the pump will help with middle class recovery.
 - Uncertainty from Washington's inability to develop a budget has been temporarily lifted as of the end of 2013, but the debt ceiling debate looms for February or March of 2014.
 - The Fed will reduce bond purchases but retain accommodative policy for 2014 as employment levels, particularly the Participation Rate, take on greater emphasis.
 - Consumer credit is not growing substantially and probably won't grow much, based on increased regulation and greater caution on the part of borrowers.
 - After a year of growth in GDP in 2013, we expect GDP in 2014 to moderate on a quarter-to-quarter basis. Given a higher starting point compared to 2013, we expect better year-over-year results by the end of 2014.



2013 PREDICTIONS IN REVIEW

FORREST GUMP:

*My Mama always said you've got to put the past
behind you before you can move on.*



2013 PREDICTIONS IN REVIEW

At its core, we've always authored this report beginning with a fundamental understanding of consumer demand versus current supply. It sounds simplistic enough, but the surrounding business conditions continue to evolve each year right along with the consumer and the economy. Tracking all the components that impact the business and then forecasting out a year is a challenge. Somehow we've Gumped our way through and put out some good information in the past decade — some luck and some common sense. But before moving on to 2014, let's start by putting the past behind us and review the accuracy of our findings in the 2013 report:

1. A perfect growing season produced a rarity — a perfect harvest with very good yields AND great quality. It's no exaggeration to call this 2012 vintage perhaps the best ever for the West Coast as a whole.
2. We have entered a period of domestic economic stagnation that should reset our view of growth, business returns and prices for years to come.
3. SVB's prediction of sales growth in fine wine will drop for the fourth consecutive year to a range of four to eight percent, but it's still growth.
4. The general financial condition of the wine industry is improving at a slow and steady pace and there is a strong belief that 2012 will be seen as a good, but not a great, year financially.
5. Gross and net profit of wineries will be negatively impacted in 2013 due to higher grape costs.
6. With the very strong 2012 vintage year many fine wine consumers will forgo the 2011 wines and wait for the release of the 2012s.
7. The euro will lag the U.S. recovery and the currency will weaken, leaving an opportunity for more bottled imports and additional pricing competition.
8. Inventory is balanced.
9. Grape planting will be restrained compared to prior periods when supply was in balance.
10. Higher price point wines report particularly short inventory positions.
11. 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.
12. Wineries that expressed having the most difficult year were often in smaller production models with average retail pricing in the range of \$20-\$29.
13. 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.
14. 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.
15. Mergers and acquisitions of wineries and vineyards will continue at a record pace.
16. Massive bulk imports will continue to dominate the lowest price point wine categories.
17. Direct-to-consumer sales will continue as the largest growth channel for most wineries.



2013 PREDICTIONS IN REVIEW (CON'T)

18. Fine wine producers were unable to pass on higher costs to consumers or recover higher pricing from prior periods in 2012.
- 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 \$3.2 trillion in foreign exchange reserves.ⁱⁱⁱ
 - 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.
19. The financial recovery has shown signs of stalling out for months now... We do believe... the economy will start the year off slower before beginning a longer trend recovery at the end of the year.

We believe we did pretty well. Starting with the baseline view of the economy (#19) we did see the economy bob in the water in the first half and it has continued to be slow to rebound (#2) but we have as predicted seen improvement in the back half of the year. We should hit the growth rate band for fine wine sales (#3) for the fourth year running at year end, but on the low side of the forecast band. We were the first to predict a four-million ton harvest (#14) at the end of 2012 and that was nearly spot on. 2013 will go down as a good but not great year for wineries as the costs of higher priced grapes and bulk wine couldn't be passed on to the consumer in 2013. (#5)

The bottle pricing that most wineries said they wanted to take didn't materialize, as we predicted (#11). Higher-priced juice was shorter than juice in lower-cost bottles. (#10). While our determination of an industry in balance was a little out of step with industry consensus at the time, that appears to have been a good call as well (#8).

Even though rumors of grape shortages had spread through the business when the last *SVB State of the Wine Industry Report* went to press last year, the planting reaction from growers has been restrained. There hasn't been a planting boom as there was during the 1990s. Among several reasons, information is a little better in this cycle and growers don't want to see a return to the decade of excess grape supply as was the case in the 2000s. Speculative planting seems to have been kept in the barn thus far and that's a good thing for everyone (#9).

Bulk imports dominate the under \$10 wine category now — probably permanently, though overall bulk imports did in fact drop in 2013 due to the availability of domestic supplies (#16). The direct-to-consumer channel was definitely the highest growing sales channel in the wine business (#17). Short-term rates have remained low and longer-term rates have increased. (#18a). M&A has also remained quite healthy through the year with industry buyers such as PlumpJack, Vintage Wine Estates, Kendall Jackson, Duckhorn, and Foley among others, all expanding their operations right along with several new industry entrants.

There are a few places where our predictions were off: While the euro zone has lagged the U.S. recovery, the euro actually gained strength against the dollar. I still don't get that one. After talking to an economist in Spain last fall who shared my belief — and I still believe the euro is priced too high — I'm going to say it was just timing and we'll see that prior prediction of a weakening euro this year ... because I couldn't be wrong, could I? Our biggest miss was the prediction about the 2011s potentially being harder to move in the market if buyers decided to wait for the 2012s. (#6) Turns out many fine wine distributors had to allocate the 2011s because it was the second short crop in a row. They are all eagerly awaiting the 2012s which should flow through the system in an orderly manner.

Forrest might have been a little slow, but hey - just like everyone else knows, mama is always right. So with the past behind us, let's move on and look at the 2014 year in the wine business.

SUPPLY BALANCE

[Forrest Gump referring to Apple Computer]

FORREST GUMP:

Lieutenant Dan got me invested in some kind of fruit company. So then I got a call from him, saying we don't have to worry about money no more. And I said, that's good! One less thing.



SUPPLY BALANCE

Perhaps the biggest story of 2013 was grape supply. That's better than having the economy get top billing as has been the case for the past several years. Coming off very short harvests in 2010 and 2011 in the U.S., the *2012 SVB State of the Wine Industry Report* released early in 2012 reported that we were "trending to a wine shortage." Then we ended up getting Forrest Gump kind of luck with the 2012 harvest when we were handed ideal weather along the entire West Coast for virtually the whole season, leading to the rarest of vintage years: very large yields and great quality. That's good. One less thing.

Those events almost never seem to line up at the same time and couldn't happen twice in a row, could they? That is indeed what appears to have happened in most appellations with the 2013 harvest. Based on conversations with AVA Associations, wineries, growers and survey information, we believe 2013 will probably come in around 3.94 million tons making it the second largest vintage ever in California. But even with a second near-record harvest, the industry appears balanced with current supply. That is not to say we have sufficient planting. That's a secondary issue which is covered later in this report.

WORLD SUPPLY

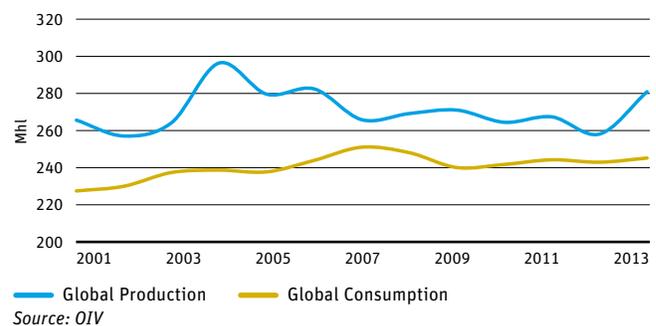
FORREST GUMP: [TO JENNY] *They're sendin' me to Vietnam... It's this whole 'nuther country.*

Wine like everything now is affected by world interest, the speed and openness of communication, politics, political correctness, currency fluctuations and international pressures. There are more whole 'nuther countries out there making and sucking down wine — or fighting against the sucking down of wine — than there ever were before. Some of those suckers are even competing for our U.S. consumers' wallets. While most know that China is a rather large producing country now (number five in the world), even Vietnam with its French colonial roots has gotten into the act with about a six percent CAGR in its wine production.^{iv} That said, China and Vietnam will likely not surpass the European states as dominant producers anytime soon.

The good news is that the current stocks of wine supply in the world come in as close to a balanced position as we've seen in decades as described in Figure 1.

Since 1998 the larger consuming countries of France, Italy, Spain, Portugal and the UK each experienced significant declines in per capita wine consumption,^v so much so that by

Figure 1: Global: Production vs. Consumption (million unit cases)



2006 Europe was producing about 150 million cases more than it could sell. Catering to popular sentiment instead of dumping the wine, European producers were paid for their surplus in what was termed Emergency Distillation: a program where excess grape production was converted into industrial ethanol.

Finally the European Union recognized the obvious non-market support mechanisms were killing prices for their successful farmers and perpetuating a disastrous oversupply. In late 2007, after several years of negotiations the EU adopted a controversial^{vi} Communal Regulation (CMO), phasing out Emergency Distillation entirely by mid-2012 and paying European growers to uproot 175,000 hectares^{vii} (about 430,000 acres) of economically unsustainable and lesser quality vineyards. The countries of Spain, Italy, France, Portugal and Hungary have been the major benefactors of the program. The result has been — in concert with increasing world demand and more EU exports — that the lake of wine that existed before in Europe has now dried up to a pond.

Imported foreign bulk wine is here permanently in the US however as our productivity can't compete with lower labor and land costs in many other large producing countries. First

SUPPLY BALANCE (CON'T)

surfacing on a large scale in the late 90s as an alternative to short supply then disappearing just as fast, imported bulk wine is now de rigueur as a mainstay in large-scale domestic wine production. Through October of 2013, there were over 30 million equivalent cases of foreign bulk wine imported into the U.S. over the prior 12-month timeframe with Australia, Chile, Argentina and South Africa leading the way.^{viii}

Forrest Gump's mom could have said^{ix}, "...then there was the man who drowned crossing a stream with an average depth of six inches..." Viewing current supply in total and on average is only part of the discussion. There could be some pockets of supply where someone might drown or find a sandbar. It's possible to be long in bulk wine as a whole, but be unable to find pinot noir. It's also possible to be balanced as a whole, but be unable to find zinfandel for one of your programs at the right price.

U.S. SUPPLY BALANCE

MRS. GUMP: *What's normal anyways?*

West Coast Harvest

The 2012 harvest presented a record yield in all the West Coast winegrowing states. California hit a record 4.02 million tons at harvest with the states of Oregon and Washington experiencing equally outstanding vintages in both quality and volume. So is that normal now — record harvests and great quality? Wineries desperate for supply coming off two consecutive low production years in California still bought up most of the uncontracted fruit that was left and available in 2012 and were paid well for their excess production.

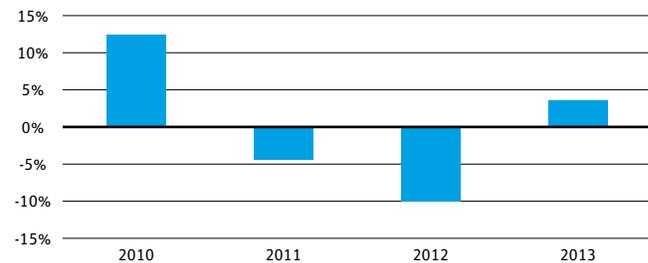
Combined with conversations with AVA Associations, winemakers and growers and applying our own research, we estimate the 2013 harvest will probably come in around 3.94 million tons making it the second largest vintage ever in California.^x It's possible 2013 was another record, but we are scaling back our earlier estimates after reviewing the impact of harvest time dehydration, the rejection of fruit at the crush pad, and the shortage of tank space.

The message from Washington State was equally good as California's, with another record yield guaranteed due to significant planting that has taken place over the past six years, as well as a second year of nearly ideal growing conditions statewide.^{xi}

After perhaps the vintage of the decade in 2012, Oregon experienced a return to fickle weather conditions in 2013 which tested growers when record rainfall was recorded in many areas of the state in late September. Yields will likely end up setting a record based on new plantings and the added hydration of grapes, but quality will be variable between wineries and we'll have to wait on a better quality assessment until later in the 2014.^{xii} In Washington and Oregon, early December's freezing, single-digit temperatures were widely reported, causing damage to new plantings. The extent of the damage to buds, if any, has yet to be determined.

We are able to take a deeper dive into the framework of current supply by using information reported in the SVB Annual Wine Conditions survey.^{xiii} In Figure 2 we have synthesized the survey answers from the past four years by netting out the respondents who said they were long, from those who said they were short. What you can see is even after the large 2012 harvest, wine producers were still feeling short. After the 2013 harvest, however, wineries indicate on the whole they are slightly long on wine, but we have to underscore the word "slightly." While today it's clear we have excess juice available and probably in greater amounts than the chart would otherwise indicate, we believe the current state, while slightly long, will be offset by a more normal harvest this year, right-sized planted and non-bearing acreage, and increased demand so we characterize the overall existing supply of wine generally as being in balance.

Figure 2: Net Inventory Balance

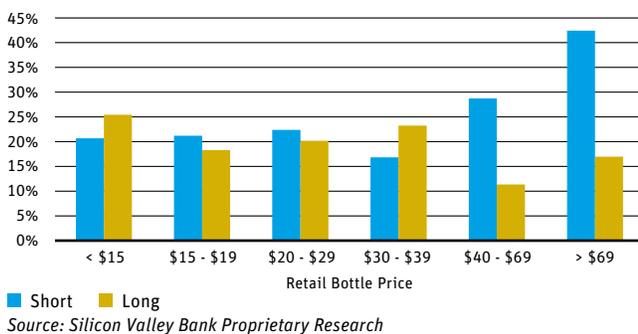


Source: Silicon Valley Bank Proprietary Research

SUPPLY BALANCE (CON'T)

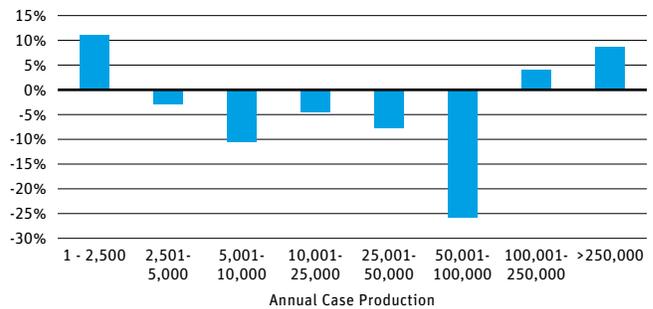
Reviewing inventory positions sorted by bottle prices, in Figure 3, we see those producers selling wine above \$69 per bottle report being short on wine, yet those who sell wine below \$15 a bottle report being slightly long. That's not a particularly bad thing at this point as the hottest moving wines in the market today are in the \$10 to \$15 price range. Any minor excess in that price band can be quickly erased by importing less foreign wine and selling down what we have domestically. And in the luxury wine segments ... is there ever enough great wine?

Figure 3: Net Inventory Balance by Retail Price Point



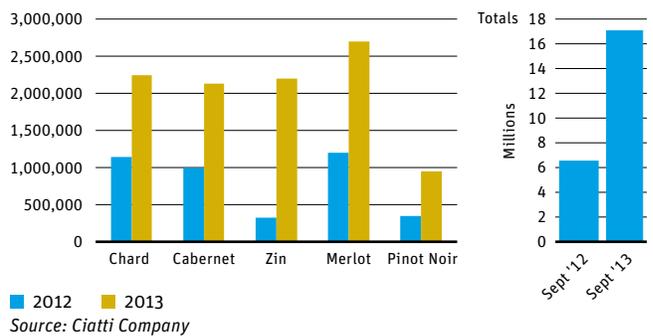
We further segmented the survey responses by production size in Figure 4 where we subtracted those who said they were long from those who said they were short, ignoring those who were reporting being balanced. We discovered the smallest wineries — those most likely to have their own estate production — as well as the larger wineries say they felt they had slightly too much wine. The larger wineries were more than likely planning out well in advance. In some cases, they had contracted already for Southern Hemisphere juice to hedge their supply positions going into 2013, which on average should have been average to below average after the record harvest in 2012. At the same time, they were under domestic grape contracts and ended up surprised by the crop size. The fact the larger wineries are reporting excess positions should lead to the matching conclusion that bulk wine imports for 2014 should drop absent the dollar substantially strengthening against the currencies of the countries exporting wine to the U.S.

Figure 4: Net Inventory Balance by Production Level



Finally in Figure 5 you can see year-over-year measures broken down by varietal. In September 2012 we had about six million gallons in the state of available bulk inventory. One year later with some of the harvest still out, that increased to nearly 17 million gallons which is roughly the equivalent of 7.2 million cases of wine available for sale. It is a lot of bulk wine, but we've had 20 million gallons or more available three other times in the past decade: in 2006, 2007, and even 2010, according to Turrentine Brokerage.

Figure 5: California Bulk Wine Inventory



SUPPLY BALANCE (CON'T)

While we didn't expect a huge 2013 harvest either, I feel safe in guessing that 2014 will be a more restrained crop compared to 2012 and 2013 for many reasons some covered later in the report when we cover planting decisions. Varietals that are slightly long are merlot, zinfandel and chardonnay.

On the whole we're not worried about the bulk market being heavy at this point despite two back-to-back record years, nor are we too disturbed by any of the varietal reports of slight excess. It's really going to get down to what consumption and harvest looks like in 2014. With our view of both better consumption and an estimated average yield in 2014, we believe we are really pretty well-positioned in the cellars and with bulk availability, with the slight exception of merlot, chardonnay and lower cost bulk juice intended for higher production wineries.

California Spotlight

[Forrest Gump getting on the bus for his first day of school and looking for a seat.]

BOY WITH EMPTY SEAT NEXT TO HIM: **Taken.**

GIRL WITH EMPTY SEAT NEXT TO HER: **Seat's taken.**

YOUNG JENNY CURRAN: **You can sit here if ya want.**

With higher relative pricing for grapes at the beginning of harvest, perhaps it's not surprising the 2013 excess production was received at the winery with about the same warm reception Forrest got from his new classmates. With the record from 2012 still filling cellars, bulk wine readily available, and 2013 contracts being fully met from the outset of harvest, some excess grapes were left hanging longer than needed just to clear tank space, overage contract options were declined, some excess couldn't find a home, and enforcement of quality standards at delivery was the norm. The refrain from wineries was, "Tank's taken." Grapes that would have been gladly accepted in 2012, flaws and all, were rejected outright in 2013. The obvious conclusion is wineries are full up. They have the juice that is needed and as a consequence, spot prices have dropped back from the record high levels experienced during the 2012 harvest. (Figure 6)

Figure 6: 2013 Spot Market Grape Prices

	Early Season	Late Season to Date
Chardonnay		
Sonoma County	\$1,300-\$2,200	\$850-\$2,000
Monterey County	\$1,100-\$1,300	N/A
Northern Interior	\$500-\$600	\$250-\$300
Pinot Noir		
Sonoma County	\$2,000-\$4,600	\$1,400-\$3,200
Monterey County	\$1,600-\$2,000	\$1,000-\$1,400
Northern Interior	\$600-\$800	N/A
Cabernet Sauvignon		
Napa Valley	\$3,200-\$7,500	\$2,500-\$3,000
Paso Robles	\$1,650-\$3,000	\$1,200-\$1,400
Northern Interior	\$750-\$850	N/A

Source: Turrentine Brokerage

Caught a little by surprise at the consistency of the message from wineries during the 2013 harvest, growers quickly changed gears and worked to their traditional fallback positions doing things like offering grapes for half the price of the met contracts. In some rare cases, they offered to give the fruit away in exchange for "future considerations," but often found even then price wasn't the issue. Tank space just wasn't available.^{xiv} In terms of current supply positions, those kinds of indicators point to the industry being long on supply which is quite a change from 12 months prior. Acknowledging the current period excess, we feel the right sized bearing acreage, and a normal crop, combined with better consumption will make this a blip. We would feel very different if the planted acreage was more than it is at present.

DEMAND FORECAST

DOCTOR:

His legs are strong, Mrs. Gump, as strong as I've ever seen. But his back is as crooked as a politician. But we gonna straighten him right up now, aren't we, Forrest?

DEMAND FORECAST

MACRO LEVEL

To understand changes in the demand for wine, we have to look at the psychographic trends of consumers — their willingness to buy in addition to economic trends supporting a consumer's capacity to buy. It's been a pretty crooked path to the still improving market where we find ourselves today. I wish our discussion could be on finance and economics, business earnings and GDP, but the performance of our elected officials in this recovery has played a negative fiscal and psychological role in most of 2013, and that has to be considered in any forecast of 2014.

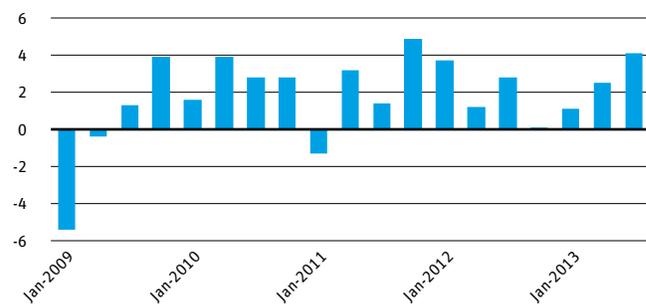
How bad was Congress's performance in 2013? They passed the fewest number of bills in modern history and presided over a lengthy government shutdown that added more instability to financial markets at a time when job growth was at risk, taking money out of consumers' pockets. And with nearly as many investigations started on their own crooked members^{xv} by the House Ethics Committee in 2013 as there were bills passed,^{xvi} it's hard to imagine things could get worse in Washington in 2014. The situation is so bad, Congress's approval rating fell into the single digits as of this writing, placing them lower than bankers — as if that were possible.^{xvii} The good news is while we write this report in mid-December, two major items have occurred in government action that each signal an important positive change in the trajectory for events in 2014.

With the negotiating duo of Republican Paul Ryan and Democrat Patty Murray, Congress came to agreement on a two-year, one trillion dollar government spending plan, thus removing the fear of additional sequestration cuts for the present. Of course, it's a panacea to believe Congress has turned another leaf. It's estimated that we will breach our debt ceiling again in February, so you are living in a Forrest Gump fantasy if you think that won't be used as a bargaining chip. We don't have to be very good prognosticators to guess that there will be more Congressional infighting with the economy held ransom this year, but the temporary cease fire is indeed good news.

The second piece of good news is that the Fed announced the economy was starting to demonstrate the kind of strength needed to begin tapering the bond buying programs that have been a mainstay of Quantitative Easing (Q.E.). In the announcement, Chairman Bernanke referred to coordinated efforts and agreement with incumbent Chairwoman Janet Yellen.^{xviii} Along with several remarks showing this is only a measured step and directional improvement, the markets have inferred that the Fed's accommodative policy will continue even with the likely transition to Yellen. It was an effectively balanced messaging for a beginning to the taper.

What is the Fed seeing at this stage that has encouraged it to ratchet back Q.E.? First and foremost is GDP improvement as can be seen in Figure 7. While the 2013 year was up and down in Washington, the most recent report shows with the revisions, there are three consecutive quarters of good growth in the economy after several years of an aimlessly wandering GDP.

Figure 7: United States GDP Growth Rate

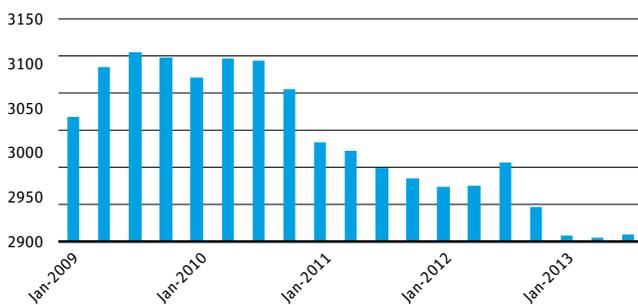


Source: Bloomberg

DEMAND FORECAST (CON'T)

Sequestration ... the fiscal cliff that we were all worried about actually had a positive outcome — strangely because it was better to drive off the cliff than continuing to drive the bus faster. As demonstrated in Figure 8, government spending, a component of GDP, has been dropping rather consistently. This is having the desired consequence of reducing the growth in total U.S. Debt/GDP, one of the major issues discussed when the U.S. debt rating was cut and another factor that made for a poor investment environment in the U.S. Showing the world our government can cut the growth in spending — no matter how they really did it — helps lower the uncertainty that business and consumers have lived under for some time.^{xxix}

Figure 8: United States Government Spending



Source: www.tradingeconomics.com, U.S. Bureau of Economic Analysis

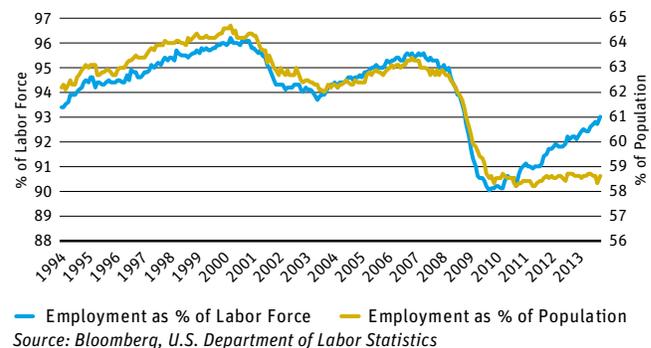
It's not all peaches and cream — or peas and carrots if we want to carry on with the Forrest Gump references.^{xx} There are several issues that we continue to face. There is some worry about another bubble being created in the stock market with all the free money floating around, but the main issue is averages don't always tell the whole story. On average we are recovering, but that doesn't feel good to someone who can't find work, isn't seeing wage growth, or owns a house that is under water. That describes an uncomfortably high percentage of the population.

For the wine business to experience the same kind of growth that we saw through the 1990s and early 2000s, we need to see the middle class participate in the recovery. After all, the upper 10 percent can only drink so much, or store so many bottles in a cellar.

While the decline in the unemployment rate below seven percent was constantly cited as one of the metrics that would lead to a change in policy stance by the Fed, it acknowledged the shortcoming of using that measure in the December 18th release when it chose to reset the unemployment target downward as a target for the further easing of quantitative easing. It is admitting what most economists have pointed to for the nearly the past two years: The problem isn't the unemployment rate; it's getting people in jobs as measured by the Employment Participation Rate.

The unemployment rate at its simplest is defined as the total workforce that is unemployed and looking for a paid job, divided by the total workforce.^{xxi} Among other nuances of the

Figure 9: Household Employment as a % of the Labor Force and Population



— Employment as % of Labor Force — Employment as % of Population
Source: Bloomberg, U.S. Department of Labor Statistics

DEMAND FORECAST (CON'T)

measure when we are in extended recoveries like this, people who are discouraged and who stop looking for work are just removed from the equation. Those people removed from the unemployment rate still don't have jobs even with the metric showing improvement. They still can't buy your wine, so it's less meaningful in this case to use the unemployment rate as a milestone to denote economic health.

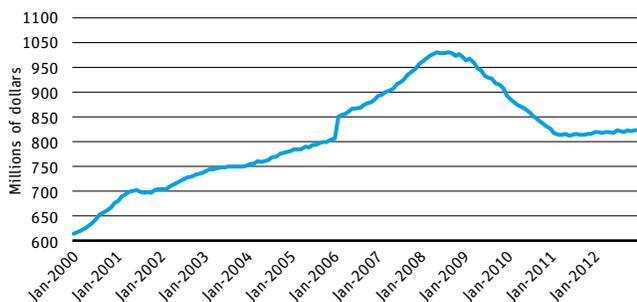
The best visual I found to express the issue is in Figure 9. When we look at the participation rate as a percent of the labor force, we can see nice gains,^{xxii} but when we look at employment as a percent of the population, we are really flat-lining. We are still sitting on nearly historic levels of low work participation, some of which is due to an aging

population but some due to the fact real job growth for the middle class hasn't rebounded as politicians would have us believe.

A final component of economic growth that should be reviewed is consumer credit. While specific purpose credit cards like Diners Club have been around much longer, the first general purpose credit card for the masses was issued in 1966 and called BankAmericard, later becoming Visa International. The older and Greatest Generation lived under the general view that if you couldn't afford it, you had no business buying it. Of course, there were carve-outs for cars and homes, but unsecured consumer credit was not something the generation was comfortable with. Boomers, on the other hand, became addicted to the charge card and later home equity lines of credit. That addiction became the afterburner that ignited the U.S. consumer economy and the Boomers' penchant for spending ahead of wealth and salary.

Over the past several decades, consumer credit has helped restore spending in the economy when income faltered. With the housing bubble and market crash, consumers and institutions alike have become less free-wheeling with credit as anyone who has recently applied for a home loan or tried to refinance will tell you. When Forrest Gump went to Alabama where he played football, he probably got some credit card offers in the mail even though he didn't have a job. That's the way it was in the day. He's not seeing those offers anymore as you can see in Figure 10, partly because of new government regulations and partly because consumers now are behaving more like the Greatest Generation and are less comfortable spending ahead of earnings as a result of the Great Recession. And, of course, home equity lines of credit – that wonderful

Figure 10: Consumer Credit Outstanding: Revolving



Source: Bloomberg

DEMAND FORECAST (CON'T)

product that allowed so many Americans to spend up on charge cards and refinance them into their burgeoning home equity – well ... since there is no home equity it's hard to see that product recovering as it was in the days of free and easy credit. There is no possible way we will see consumer credit return to the same conditions that we've experienced for 30 years and that will be another factor in drawing out the recovery and creating headwinds against wine demand compared to prior recoveries.

There's a lot more to look at, but we can say the economic situation in the U.S. got a lot clearer at the end of 2013, and fear and uncertainty in the U.S. markets has taken a turn for the better with the major indexes looking to end the year in record high territory.

We can say that we've seen: a bottom in housing, improvement in employment numbers, a ray of hope with

the federal deficit and the federal budget process, improving retail sales despite a weaker than anticipated 2013 holiday shopping season, and lower retail gas prices with the increase in U.S. oil and gas fracking giving the consumer more money to spend. In addition with inflation moderated, as of this writing, the stated goal of the Fed for the next couple of years will be to maintain accommodative policy including near zero interest rates which will be good for the stock market, good for the housing market, and good for consumers (to the extent they have floating rate debt to manage). The economy is slowly building up a very small level of positive momentum and inflation while a threat, is presently tame.



DEMAND FORECAST (CON'T)

BASE FINANCIAL FORECAST FOR 2014

We believe the financial recovery is starting into a year where we will see the consolidation of existing improvement since the crash, and markets looking for direction. In 2014 we expect to see the slowing of corporate M&A, an increase in corporate investment, decline in government support both state and Federal, slowing of the gains in housing values, continuation of increased regulation, higher taxes, and increasing GDP growth year-over-year. We don't believe we will return to GDP growth exceeding three percent per year for at least the next several years, unless we start to see higher levels of inflation. The period of time we are entering is one where current financial returns will be modest, which will support heavier risk-taking by entrepreneurs willing to take risks.

We believe we will see growth in consumer wealth and spending, a pick-up in real job creation and hiring with more predictable monetary and fiscal policy, as well as stable interest rates through the entire year. The wild cards are: gas prices, the small possibility of a stock market bubble and political unrest from the dissatisfaction with opportunity stemming from the divergence between the wealthy and middle class. There is also the wildcard of political and other Washington shenanigans, which could change the context of the recovery thus decreasing market stability and trust in the system.

THE AFFLUENT CONSUMER AND LUXURY MARKETS

MAN ON THE BENCH:

Hold on there, Boy! Are you telling me you're the owner of the Bubba Gump Shrimp Corporation?

FORREST:

Yessir... We've got more money than Davy Crockett.

MAN ON THE BENCH: [man walks away laughing in disbelief]

Boy, I've heard some whoppers in my time, but that tops 'em all. [laughs and turns to the woman still on the bench – mockingly]
We was sittin' next to a millionaire!



THE AFFLUENT CONSUMER AND LUXURY MARKETS

Do you recognize the affluent consumer? You should because that's the person who buys your wine. The man on the bench couldn't believe Forrest was affluent because he had a different idea of what that person should look like. Haven't we all fallen prey to that mistake in profiling? Have you ever worked in a position — perhaps a tasting room — where someone dressed the part and acted the part even drove the right car, only to discover he was putting on a show? And what does your consumer look like if they are visiting your tasting room from China or South Korea?

As emerging growth countries continue to influence world trading patterns, and domestically as the Boomers start to retire and evolve their tastes and spending habits one more time, you will need more than eyeballs to spot a potential client because they will start to look very different from what you are accustomed to seeing over the past 20 years. You will need real information and will need to beef up your CRM and technology platform in order to pick out the affluent shopper and focus your direct marketing efforts. The investment will be worthwhile because the top 20 percent of wage earners presently account for 40 percent of consumer spending and that number is even higher when it comes to fine wine.

WORLD LUXURY MARKETS

LIEUTENANT DANIEL TAYLOR: *Have you found Jesus yet, Gump?*
FORREST GUMP: *I didn't know I was supposed to be looking for him, Sir.*

After the Crash, everyone was looking for market leadership, someone to follow. We were all adrift — technical analysts and fundamentalists alike. Worldwide, people were looking to America to spend our way out of the economic problems but America was the region that showed the greatest weakness in luxury spending. No problem because, in 2010 and 2011 demand for luxury goods in China grew by an astonishing 30 and 35 percent respectively. There was the leadership we were looking for and that event led many marketers of luxury goods to believe the BRIC^{xxiii} countries would be the new growth target. Growth in wine, particularly top wines from France became the main beneficiary of the Chinese largesse, largely due to their gifting customs. And so it would seem with luxury spending leadership found again, nobody needed to look anymore. China and the rest of the BRIC countries would save us all.

Fast forward to today. In a reversal of the trend of the last few years, North America has again become to luxury goods spending what Bubba Gump is to shrimpin'. Chinese leader Xi Jinping's policy to restrain displays of power and wealth in the ruling class has led to a cooling of luxury buying in China. French wines have lost some of their earlier luster as the Chinese start to experiment with wines from other countries. The BRIC Countries aren't dead but are experiencing growing pains in consumer demand, governance, their financial systems, education and economic policies. Without addressing those areas, it is difficult to see the degree of investment and success earlier assumed. North America is now estimated to grow four percent in luxury spending through year-end 2013, surpassing the estimated 2.5 percent growth rate for China.^{xxiv}

Overall, worldwide luxury goods spending will grow by about two percent in 2014. The challenging recovery in Europe and China's economic slowing are components in the lower growth rates. World growth in luxury cars, wine and spirits, and hotels are expected to outpace personal luxury goods spending however, and those categories are predicted to increase six percent worldwide in 2014.



THE AFFLUENT CONSUMER AND LUXURY MARKETS (CON'T)

EVOLUTION OF LUXURY MARKETS IN THE U.S.

FORREST GUMP: *When I was in China on the All-American Ping Pong team, I just loved playing Ping-Pong with my Flexolite ping pong paddle.*

Madison Avenue has worked their magic on us for years, making us want what we didn't know we wanted in the name of marketing, which can be mistaken for educating consumers. Forrest made a "little white lie" in this case because he never actually played with the Flexolite paddle. Marketers call that taking creative license. Forrest's momma said it was OK this one time because they gave Forrest a lot of money. Mrs. Gump had what we call situational ethics, but no matter. She was just thinking of all the Ping-Pong® players who would feel like they could best anyone because Forrest played with the paddle. It's just marketing.

Marketing to luxury consumers has been interesting to see evolve over the past 50 years. The meaning of luxury has always included something that was rare and desirable, or something that made you feel special. In the early 50s and heading into the 60s, luxury meant high-margin, low-volume products or services priced so only the wealthiest could afford them. That part of the market still exists and has evolved.

Then one day someone on Madison Avenue got the idea of "mass luxury": goods that were not really custom and not really mass produced but were well-made in larger quantities nonetheless and could be sold to more people. Everyone could feel wealthy if they just bought *[fill in the blank]*, Americans at that point spent their waking hours trying to keep up with the Joneses. It was the era when Mad Men went crazy brand building and later when you wore your manufacturer's label on the outside so everyone knew you were wearing something expensive. That market still exists but the logos have now become huge or very small, and the stores exclusive or discount shops - which begs the question: can luxury goods be discounted?

Moving into the 1990s and easing into the 2000s as the Boomers hit their top spending years and luxury was lacking a growth cohort for the future, someone on Madison Avenue tried to go a little more down market again. Mass-affluent, aspiring affluent and mass-elitism are some of the names attached to that group. They were slightly below the affluent level, with a home and large mortgage, minimal stock market exposure, younger and perhaps blue-collar, and typically two-income families. They were thriftier than their more affluent counterparts. Knock-offs, on-line shopping, pricing comparison, and purchasing through outlet stores became part of their repertoire. The 2000s weren't kind to many people but least of all this segment of the emerging consumer class.

First came the tech bubble then the Great Recession. Gen X'ers and the emerging Millennials are this Aspiring Affluent class and it still remains to be seen how that age group reacts to this financial event. Will it change their future spending habits? As of this writing today with the stock market reflat and trading at record levels, the wealth gap has only widened and marketers are struggling to come to grips with defining the luxury consumer both domestically and in the context of the world.

Today we find ourselves at a crossroads, one in which the younger consumer is being trained to believe luxury purchases should come with a discount, and wine is as good or even better coming from foreign sources. With Boomers hitting retirement age, we have a real question about the ability to increase wine sales when older generations who are willing to pay for a good bottle simply can't consume the volumes they used to, and younger generations can't afford a good bottle but could consume more.

THE AFFLUENT CONSUMER AND LUXURY MARKETS (CON'T)

AFFLUENT DEMOGRAPHICS

FAT MAN AT BENCH: *It was a bullet, wasn't it?*

FORREST GUMP: *A bullet?*

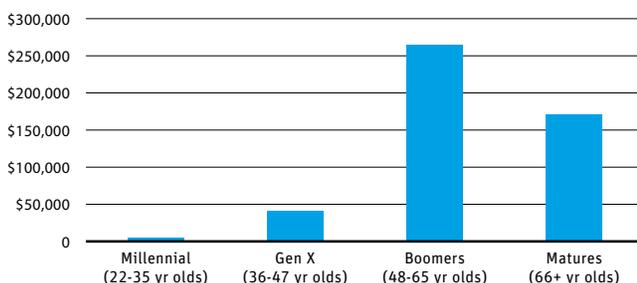
FAT MAN AT BENCH: *That jumped up and bit you.*

FORREST GUMP: *Oh, yes sir. Bit me right in the buttocks. They said it was a million dollar wound, but the army must keep that money 'cause I still haven't seen a nickel of that million dollars.*

The affluent consumer is the target of fine wine producers. Everyone takes aim at them, but sometimes their aim is off in promotion, packaging, or even recognition of the consumer, so they hit the wrong target and never see a nickel of sales. If you want to target your marketing dollars effectively, you want to know what these consumers look like: how old they are, how much they make, their likes and dislikes, and maybe even how much they are worth.

To get at the real picture at a high-level, we went to the Census Bureau and as reflected in Figure 11, see the Boomers and Matures are the ones who have all the country's net worth. The Gen X and Gen Y cohorts aren't that far apart, but we believe net worth isn't as highly correlated to wine purchases as is income. That makes intuitive sense because it's a little difficult to spend the equity that's in your home on a bottle of fine wine.

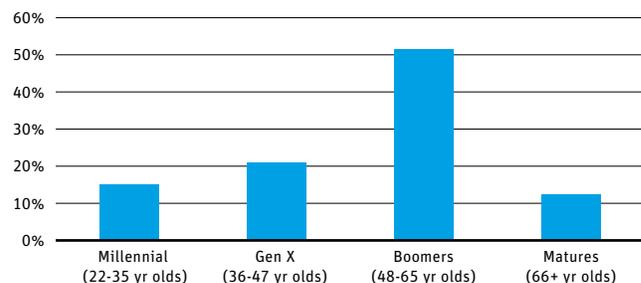
Figure 11: Net Worth of Cohorts



Source: U.S. Census Bureau, Current Population Survey, 2011 Annual Social and Economic Supplement

Going back to Census Bureau measures on incomes in Figure 12, the cohort rankings appear similar, but magnitudes look a little different. The oldest cohort has more net worth, but has less earning capacity than the other age groups. That makes sense as the oldest generation is retired, so should fall in income rankings. Boomers still have the largest income rankings – over half, so that tells you Boomers are still the main cohort to attack in selling fine wine. But what about Gen X and the Gen Y Millennials?

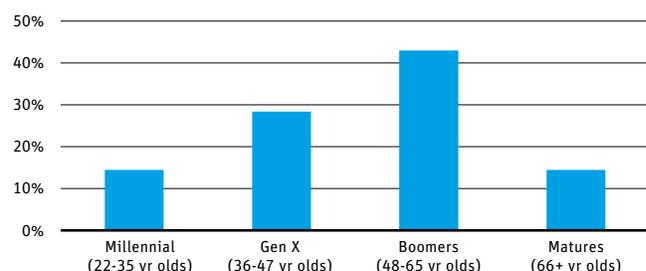
Figure 12: Income by Cohort



Source: U.S. Census Bureau, Current Population Survey, 2011 Annual Social and Economic Supplement

We asked wineries in the SVB survey – only those wineries who tracked the information – what were their sales splits in fine wine purchases sorted by cohort. The answers are summarized in Figure 13 in which you can see predictably the Boomers are still dominating sales of wine getting close to 50 percent of total sales. This information is consistent with information from VinePro^{xxv} taken from online sales receipts and shows the under 30-year-old crowd is currently responsible for only six percent of current online wine sales which is a surprising stat for the internet generation consumer in using that channel.

Figure 13: Fine Wine Buyers



Source: Silicon Valley Bank Proprietary Research

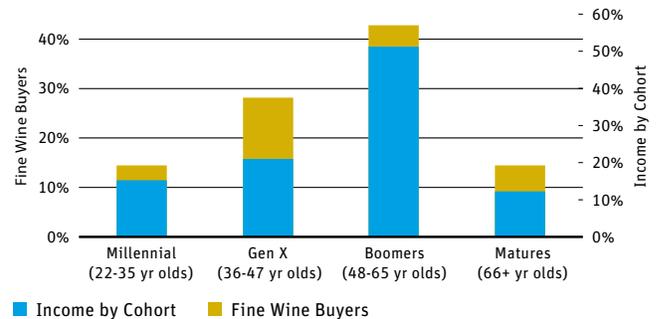
THE AFFLUENT CONSUMER AND LUXURY MARKETS (CON'T)

Looking at Figure 14, we took the analysis one step further and layered the chart of the income surveys from the U.S. Census Bureau over the chart of consumption patterns reported from wineries noted prior. This chart demonstrates that income is highly correlated with fine wine purchases.

What do we do with this information? From my perspective it shows that for current period marketing purposes the Matures and Millennials aren't your cohort. It demonstrates that Boomers are overwhelmingly the cohort to pursue today to **maintain** sales. Perhaps the most interesting conclusion from the chart to me is the neglected Gen X ... that 35 – 55 year old consumer; they have the purchasing capacity and are spending a larger amount on wine than the other cohorts. That will only improve as they progress in their careers. That is the **growth** cohort for the intermediate term; the next seven or so years.

What about the Millennial we hear about? It would be even better if they weren't weaning their palates on imports. That point is a concern as they are both buying more foreign wines than other cohorts, and are being weaned on discounts post recession. But as Millennials age if they develop the capacity (income) to buy wine, and if their appreciation for wine is strong as reported in the press, they will be the long-term **growth** opportunity we can anticipate in the business out past 2020.

Figure 14: Income Correlates with Fine Wine Purchases



Source: U.S. Census Bureau, Current Population Survey, 2011 Annual Social and Economic Supplement, Silicon Valley Bank Proprietary Research

THE AFFLUENT CONSUMER AND LUXURY MARKETS (CONT)

LUXURY MARKETS

One particular trend in luxury that seems to span all the generations at this point is the increasing value each generation places on an experience with the good itself. It's beyond my ability to research to say with conviction why that's true, but I would suggest as the Boomers and Matures continue to age, the value of "things" fall in proportion to living in the present and evolve to enjoying the moment. Millennials, on the other hand, seem to have higher expectations of all product purchases and are far more vocal in calling out bad experiences in public online venues.

Of course, scarcity and quality will continue to play a major role in the marketing of all luxury products but in the next decade of retail wine sales, those attributes – quality and managed scarcity, must be focused in a customized approach to providing the optimal customer experience no matter what customer age demographic you're targeting.

In your winery, the customer experience should translate at all levels of the product and sales process from harvest to sale, tasting room and even return policies. Creating that vision and communicating that experience to the prospective buyers is the job of marketers as well as everyone in your winery from field worker through to the owner.

SETTING THE CONTEXT FOR PREDICTED DEMAND CHANGE

JENNY CURRAN:

Do you ever dream, Forrest, about who you're gonna be?

FORREST GUMP:

Who I'm gonna be?

JENNY CURRAN:

Yeah.

FORREST GUMP:

Aren't-aren't I going to be me?

SETTING THE CONTEXT FOR PREDICTED DEMAND CHANGE

Forrest was just reacting to the obvious. Of course he was going to be Forrest when he got older, but as he would discover, life events help make us who we become and influence our behaviors and choices. It's like Newton's first law of motion: An object either is at rest or moves at a constant velocity, unless acted upon by an external force. History and consumer behavior can be viewed in much the same way. *Given the same circumstances*, a consumer 30 years ago will probably make the same choices as one today. If you can review history and determine what altered the trajectory of consumer choices before, it can help in predicting future behavior.

Looking back, the past two decades have provided for spectacular growth in the wine business — 19 consecutive years of growth at this point — but the growth rate has been flattening out for several years now as can be seen in Figure 20. Why is that, and can we duplicate the kind of growth we'd become accustomed to when Boomers took to wine in the 1990's, a period just like today that also followed an asset based recession.

THE BLACK AND WHITE YEARS

JOHN F. KENNEDY: *Congratulations, how do you feel?*

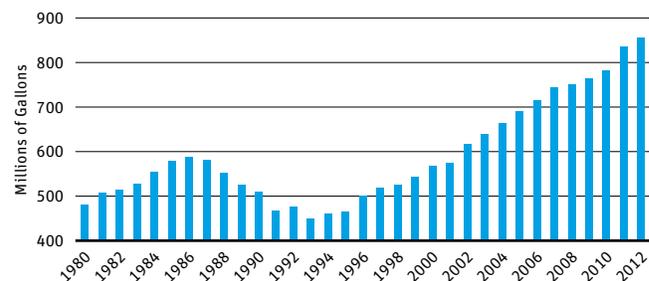
FORREST GUMP: *I gotta pee.*

JOHN F. KENNEDY: [TURNING TO CAMERA] *I believe he said he had to go pee. Heh heh.*

They called it Camelot, the era when John F. Kennedy was president of the United States. It was the time characterized by inventions like solid state televisions replacing tube television sets.^{xxvi} The original televisions were all color which is one fact that is concealed from younger generations. Here's the real story: Life was lived in black and white up until the middle 1960's. There was just no color yet in nature. It was all a big cover up by the M7 countries. If you doubt, try and find TV shows in color from those years. All the shows in color from the era were digitally altered much later to match "living color," which was invented in 1966 by General Electric and fed into the water supply.^{xxvii}

The time was also characterized by the three-martini lunch: that glorious tradition fostered by the older generation who having survived a Great Depression and World War II, thought they deserved a little snoot-full^{xxviii} every so often, or maybe even a little more often than that. The generation's drinking patterns as popularized in the show "Mad Men" were really more weighted to cocktails and beer versus wine but they did their part in growing the U.S. wine business too, helping increase per capita consumption through the 1950s and 1960s, establishing new wineries and brands in Napa, Sonoma, Santa Barbara, Oregon and Washington and beginning the marketing of wine as varietals.

Figure 15: Total U.S. Wine Consumption



Source: Wine Institute

This is important to consider because the pattern is repeating itself: By 1985 the WWII vet who was 20 at the start of the war was hitting retirement age, and the median Boomer who was just 25 and less interested in wine wasn't ready to pick up the corkscrew and continue the growth pattern in fine wine consumption. That began the last secular decline in wine consumption starting in the middle 80s as you can see in Figure 15. It's an important to note because just like that period when the Greatest Gen was hitting retirement, the median Boomers will hit retirement age in seven years. Will the Millennials be able to replace them or will we have another flattening in demand like that period? Because of that, it's worth looking a little closer at what happened when consumption dropped last time.

SETTING THE CONTEXT FOR PREDICTED DEMAND CHANGE (CON'T)

THE COLORED YEARS

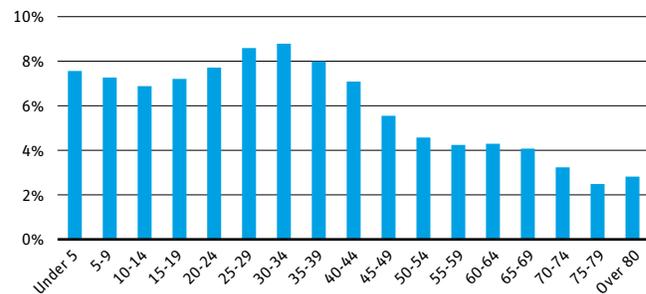
FORREST GUMP: *Me and Jenny goes together like peas and carrots.*

While the Greatest Generation was losing liver function by the mid-80s, the Boomers could have been pulling a little more of their own weight but they were watching their brand new color television sets with cable, were influenced by neo-prohibitionists^{xxix} and had a major case of Peter Pan Syndrome to boot. They never wanted to grow old so rejected the “bad for you” booze-consuming tradition of their parents and replaced it with the “good for you” cult of Jazzercise, which most will identify as an exercise activity that required the participant to wear big hair covered by a headband, leg warmers and thong leotards. The mood in the country in the middle 80’s was against alcohol, fueled by groups like MADD^{xxx} that were appropriately working to lower the deaths from drunk driving, but also included a strange brew of right-wing anti-liquor evangelists, segments of the liquor trade working to maintain the status quo post-Prohibition, and blue state legislators pandering to their dry-leaning constituents.

Many conspiracy theorists believe the misinformation from the neo-prohibitionists was part of a hidden agenda from a tea-totaling Jimmy Carter later rejected by the Reagan and Ford administrations, or a CIA plot later reversed by the FBI and re-reversed by the NSA, or perhaps the National Dairy Council trying to milk the neo-prohibitionist fad for its own designs. It’s unlikely anyone will ever know for sure, but we do know the wine market found its bottom in 1994, as can be seen in Figure 15, which not coincidentally was the point in time when the median Boomer hit 35 years of age; the beginning of their biggest spending years. The smartest of readers recognize that 1994 was the beginning of a 19-year consecutive growth ramp in wine consumption and the same year Silicon Valley Bank started a full-time dedicated wine practice. Coincidence? Were we smart or lucky?^{xxxi}

By the time 1990 came around the largest segment of the Boomer cohort had crested their 30s. By the middle 90s the neo-prohibitionist shading of the wine message started to soften, aided by the broadcast of *The French Paradox*^{xxxii} first aired in 1991. Much less noted in the present day account of the wine industry growth story however, was the sheer size of the Boomer cohort relative to the population at the time as can be seen by Figure 16 above showing total U.S. population broken out in five-year bands. Growth in consumption had something to do with the higher relative numbers of consumers entering their highest spending years.

Figure 16: Population Distribution by Age-1990



Source: U.S. Census Bureau

Another critical component of wine business growth was wealth creation in the decade of the 1990s and the strength of the economy which set a record for consecutive years of growth without a single quarter of GDP decline. The decade delivered nearly a doubling of household net worth and as seen in Figure 17, the NASDAQ as a proxy for wealth creation grew by nearly 10x from January 1990 to January 2000 alone. It was the most prosperous decade in U.S. history and that had an impact on wine sales without question.

Figure 17: NASDAQ



Source: Bloomberg

Given the size of the Boomer cohort, their newfound wealth and their new health craze of wine drinking, wine producers discovered the real secret to selling wine was simply making it. It was the Field of Dreams approach to wine sales: If you vinify it, they will come and buy it... something like that.

SETTING THE CONTEXT FOR PREDICTED DEMAND CHANGE (CON'T)

In a complete reversal of what we see today, by the mid-1990s distributors started falling over themselves to stretch down market and locate sufficient wine supply. They even formed fine wine divisions, promising to be better partners 'til death do we part, unless there is a better supply for wine available later.

By 1994 the Boomer median age hit 35, an age which statistics show is the start of a consumer's strongest consuming years. Now armed with a positive health message that replaced the negative health message, a move away from entry level wine and beer, and now with money to spend, Boomers discovered they fit with wine ... just like peas and carrots.^{xxxiii}

THE BIG SPRINT

FORREST GUMP: *Now you wouldn't believe me if I told you, but I could run like the wind blows. From that day on, if I was going somewhere, I was running!*

Forrest could have been describing the period from 1995 to early in the 2000s with that line from the movie, because everyone in the wine business was caught short of supply and was running to catch up. Supply almost overnight dried up, 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. Seeing the obvious shortage and increased grape pricing, farmers seeking better returns versus alternative crops rushed to get sticks in the ground. Land prices predictably skyrocketed. An acre of Napa land that in the mid-90s cost \$25k, by the early 2000s cost \$150k or more.

The wine business experienced for the first time "truncated growth." While the fine wine segment was seeing growth rates easily in the 20 percent per year range, sales growth could have been much higher had we the supply to sell. Bottle price also sprinted higher as one might predict. Using Napa as a benchmark again, a bottle that sold for \$25 in 1995, by the early 2000s easily fetched \$50 to \$75. New brands were being established daily, and the term "cult wine" that once was reserved for a few American wines, was extended to a host of new entrants who were "new cult wine producers." While a misnomer on its face, each seemed able to allocate their wine production just like the established cult wine producers.

TRANSITIONING

FORREST GUMP: *I had run for 3 years, 2 months, 14 days, and 16 hours.*

[HE STOPS AND TURNS AROUND.]

YOUNG MAN RUNNING: *Quiet, quiet! He's gonna say something!*

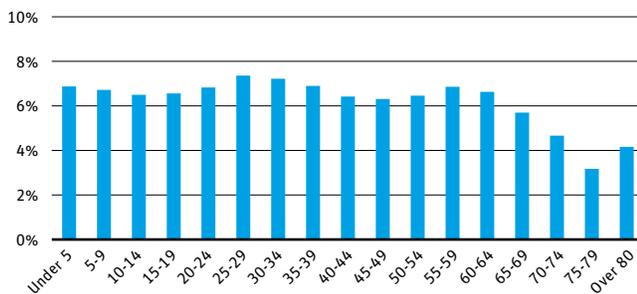
FORREST GUMP: [PAUSE] *I'm pretty tired... I think I'll go home now.*

The 90s gave us dream business conditions, but the big growth years back then lasted three years, two months, 14 days, and 16 hours.^{xxxiv} Looking backward, when the millennium changed-over, something switched off seemingly overnight. The consumer just seemed tired. Gone were the shortages in vineyards and grape supply. The distributors who before were begging for wine from small producers started to push those same small producers away. The industry was rocked by a negative trifecta: 1) a recession resulting from both the tech bubble and the 9-11 terrorist attacks, 2) all the newly planted non-bearing acres starting to generate yield at the wrong time, and 3) a 2000 harvest that was large and average quality at best.

SETTING THE CONTEXT FOR PREDICTED DEMAND CHANGE (CON'T)

The 2000s were a totally unsatisfying decade for many people in many businesses and walks of life. And now that we're reaching a point currently when the economy is starting to bottom and move back into positive territory, **we have to ask ourselves where we are headed next? Can we return to the growth that we experienced in the 1990s?**

Figure 18: Population Distribution by Age-2020



Source: U.S. Census Bureau

The current wine situation is a lot like 1994 all over again, but with a decided twist. What is similar is that the Boomers are now hitting retirement age, just like the Greatest Generation in the previous growth period and the next big generation – the Millennials, just like before, aren't quite ready to take over the growth of the wine business. How do we know?

As you can see in Figure 18, the population bubble that was clearly visible in the Figure 16 when the Boomers hit stride in the '90s, that bubble doesn't exist this time to help spur sales. For all the discussion of the size of the Millennial cohort, its not the same relative size as the Boomers when they hit their big spending years. Further, while we were coming off a similarly long recession during the 1980s, that recession didn't have the destructive power and reset of wealth that the Great Recession had.

While we are slowly growing our way out of the Crash, the recovery of employment is lagging where we were in the 1990s by a magnitude. The next gen – the Boomers back in the previous period – weren't saddled with the kind of debt that the Millennials are carrying into this recovery in the form of student loans.

We believe we are in a long-term growth phase in the wine business, but are now moving away from Boomers dominating the discussion which will lead to a more modest growth opportunity. We will need a significant improvement in employment to see strong sales growth in the industry going out for the next decade in order to offset the loss of spending power of the older generations.

Another change from the 1990s is improved world communication resulting from the Internet. Large production wineries can source bulk foreign juice directly as a first option in their sourcing strategy. If the landed costs are cheaper than domestically produced juice, the domestic brand can be filled with foreign wine. That has already made the most southern districts of California largely un-economic for wine production and the U.S. has surrendered the least expensive wine segments to foreign suppliers. Unless we want to see foreign wine continuing to increase their market share, the next domestic iteration in the US commercial wine industry will have to include a greater willingness by large wine companies to source from less established domestic areas that have lower costs of land, greater availability of water, and more accommodative regulations.

PLANTING DECISIONS

[FORREST GETS ON THE BUS TO GO TO BASIC TRAINING,
GETTING HIS FIRST TASTE OF THE ARMY.]

FORREST GUMP:

Hello. I'm Forrest, Forrest Gump.

RECRUITING OFFICER:

***Nobody gives a hunky shit who you are, pus ball.
You're not even a low-life, scum-sucking maggot.
Get your ass on the bus. You're in the army now!***

PLANTING DECISIONS

HIGH VOLUME PRODUCTION

Last year in this report we discussed the differences between the supply conditions and planting decisions that have been made in the past compared to the situation in which we presently find ourselves. If I were Forrest I wouldn't get on busses anymore because he obviously wasn't expecting that kind of a welcome. He didn't get the full story from the Recruiting Station. In the same way Forrest didn't get the memo about his first day in the Army, during the planting explosion of the 90s, we were lacking credible information. A good percentage of that planting was speculative, causing a moderate vineyard bubble that burst in the early 2000s making us all feel like unwanted low-life.

While grape prices are now finally up to the place growers can find a fair economic return today and vineyard production is balanced, we aren't that far off from being over-supplied again. We still consume virtually all the wine we produce in our own country, but we are importing more bulk supply now from offshore than we used to. We don't need to wait five years for non-bearing to hit a fully mature yield. We can just call Chile.

What consumers are demanding has also changed. They don't need domestic supply to satisfy their demand anymore. Unlike prior pre-Internet cycles, consumers have nearly 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 those value wines from offshore.

To the last point, in 10 months through October there were 27.1 million cased equivalents of bulk wine imported to the U.S. and 79.0 million cases of finished wine, making 282.9 million cases of imported wine destined for U.S. consumers. That represents about 30 percent of existing consumer demand. The market share of imported wines at the bottom of the most recent growth cycle was just below 12 percent of total share, so in the last two decades we've lost about 20 percent of the US consumer market to foreign wine sales. That competitive change in consumer demand impacts the planting equation too.

Land values have been rising in the San Joaquin Valley and alternative permanent crops such as almonds, pistachios, pomegranates, citrus, and 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. That said, grapes as an alternative crop have value

in a diversified operation when water and freeze issues^{xxxv} for farmers with citrus are added into the equation.

The discussion of water is growing louder as rain steers a wide path away from the north coast of California. At the time of this writing in middle December 2013, we are entering into a third year of drought. River flows, ground water, and water storage are each reaching historic lows. Reviewing information from a variety of sources, storage is currently at about 35 percent of normal for the date. Snowpack is the real concern as current estimates place water content for the end of the season at the lowest point since the drought of the middle 1970's.

At this point, according to NOAA, rainfall for the remainder of the 2013-14 rainy season is expected to be below average. According to other experts,^{xxxvi} just average rainfall through March of 2014 will result in water deliveries of 20 to 30 percent of normal to the Central Valley Project and with current storage levels, the "initial allocation for Ag Service contractors will almost certainly be 0 percent." Subsequent allocations will depend on export curtailments for fish. The situation does not look good for our farmers in the Central Valley in particular, but everyone will be hurt if the snowpack doesn't get some above-average dumps in the next several months. Drought will likely impact harvest in 2014 without some changes to the Jet Stream soon.

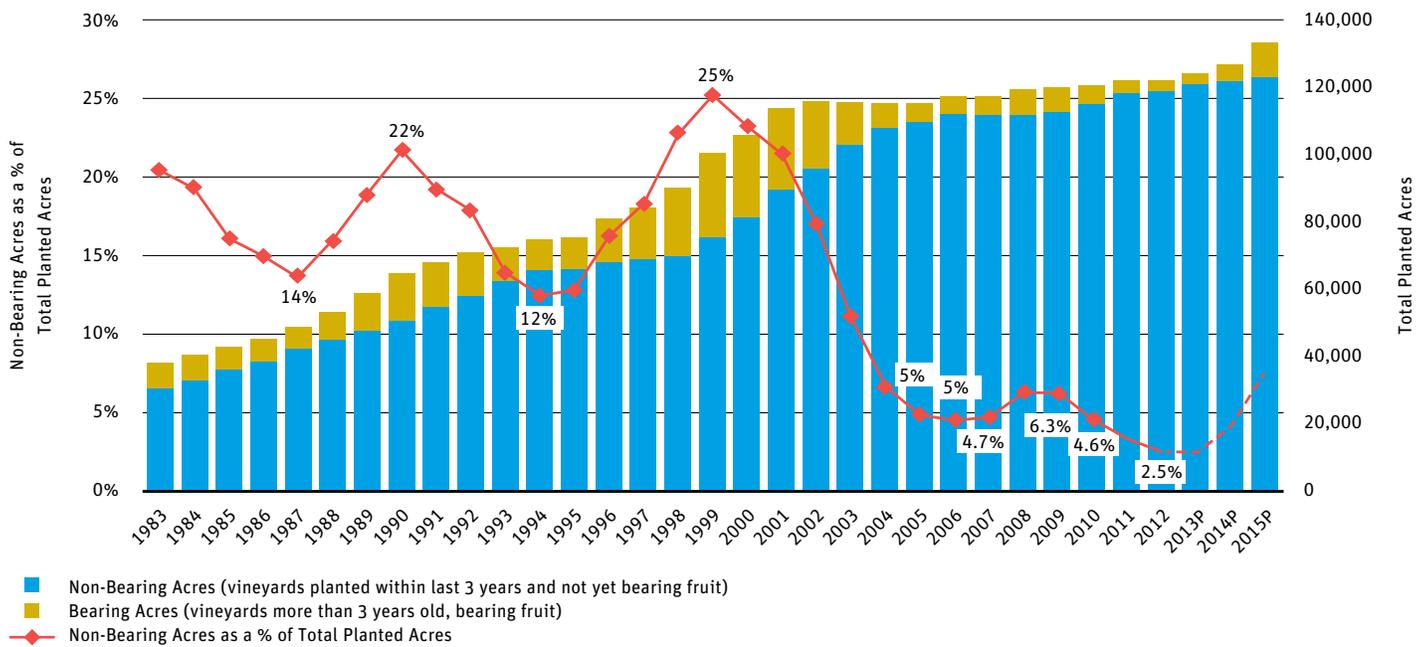


PLANTING DECISIONS (CON'T)

FINE WINE PLANTING DECISIONS

Figure 19 is one of my favorite charts on planting cycles for fine wine. In it you can clearly see the last few cycles in the fine wine regions of California in the red line. 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 prior years and again, we believe planting restraint is due to the higher impact of imports and better information – like the SVB State of the Industry Report for example.

Figure 19: Premium Planted Acreage on West Coast



PLANTING DECISIONS (CON'T)

The premium appellations have varying issues impacting their planting discussions. In Paso Robles, ground water is a major issue and will heavily impact near-term planting decisions.^{xxxvii} In Napa, it's the lack of plantable acreage. In Sonoma and Santa Barbara Counties, politics, water use and regulations are weighing heavily. In the states of Oregon and Washington, recent public sales of large vineyard sites should encourage additional winery specific development, if not some speculative planting needed to replace grapes that were intended for other state domain producers.

Reports from Ciatti Brokers show the following current planting estimates:

- ▶ **Paso Robles:** Approximately 4,000 -5,000 acres being developed with about 85 percent of development winery controlled and dominated by cabernet sauvignon.
- ▶ **Monterey:** Approximately 3,000-5,000 acres being developed predominately to chardonnay and pinot noir. Wineries and larger growers are looking for planting opportunities.
- ▶ **North Coast:** Approximately 2,000-3,000 acres being developed but predominantly redevelopment versus new acreage.
- ▶ **Lake and Mendocino Counties:** New development controlled by larger wineries and grower operations are going into these comparatively less expensive regions.
- ▶ **Lodi:** Approximately 4,000-6,000 acres being developed to major varieties. Activity from larger wineries and growers dominate.
- ▶ **Southern San Joaquin Valley:** Approximately 6,000-10,000 acres being developed. Major varieties and generics and activity from large wineries are dominating the projects.

SUMMARY AND FORECAST OF FUTURE PRODUCTION AND SUPPLY

FORREST GUMP: *I'm sorry I had to fight in the middle of your Black Panther party.*

There is no need for a fight, especially in the middle of the current party when we all seem to be celebrating improving economic conditions. However, if there isn't some meaningful level of precipitation before March, there will certainly be some water wars heating up.

To the extent planting is needed in the industry today to address the smallish volume growth and to cover replants, there is a need to replant North Coast vineyards and increase the supply of fine wine production by planting more grapes in Sonoma, Mendocino and Lake Counties, as well as the states of Washington and to a lesser extent Oregon. Water is quickly moving up on the list of risks spanning all growing regions in drought-inclined California. Red blotch diseased plant material in new vineyards in California might contribute to a few less-than-average years of production as those vines are discovered and replanted again. We are at a tenuous position however.

A boom in replanting could later produce higher volumes of grapes from existing acreage out five to eight years. The higher production regions will need to be slightly more cautious in their planting decisions.^{xxxviii} Recent additional plantings can probably be accommodated but an increase in the pace of planting could tip the scale to overplanting, which would not at all be a welcome event for farmers who survived through some pretty lean years in the 2000s.

We believe we are in a position not yet experienced in the business: one where domestic supply should be balanced for an extended period presuming planting remains restrained, demand continues to grow slowly, and the dollar doesn't 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 2014 and the future? On the margin, it will come from foreign bulk and bottled supply, and imports will more than likely continue to increase their market share in the U.S. A more aggressive planting program will only be required if the dollar begins to weaken, or the employment picture and economy rapidly strengthens, neither of which seem imminent.

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FINANCIAL PERFORMANCE OF WINERIES

FORREST GUMP:

And 'cause I was a gazillionaire, and I liked doin' it so much, I cut that grass for free.



FINANCIAL PERFORMANCE OF WINERIES

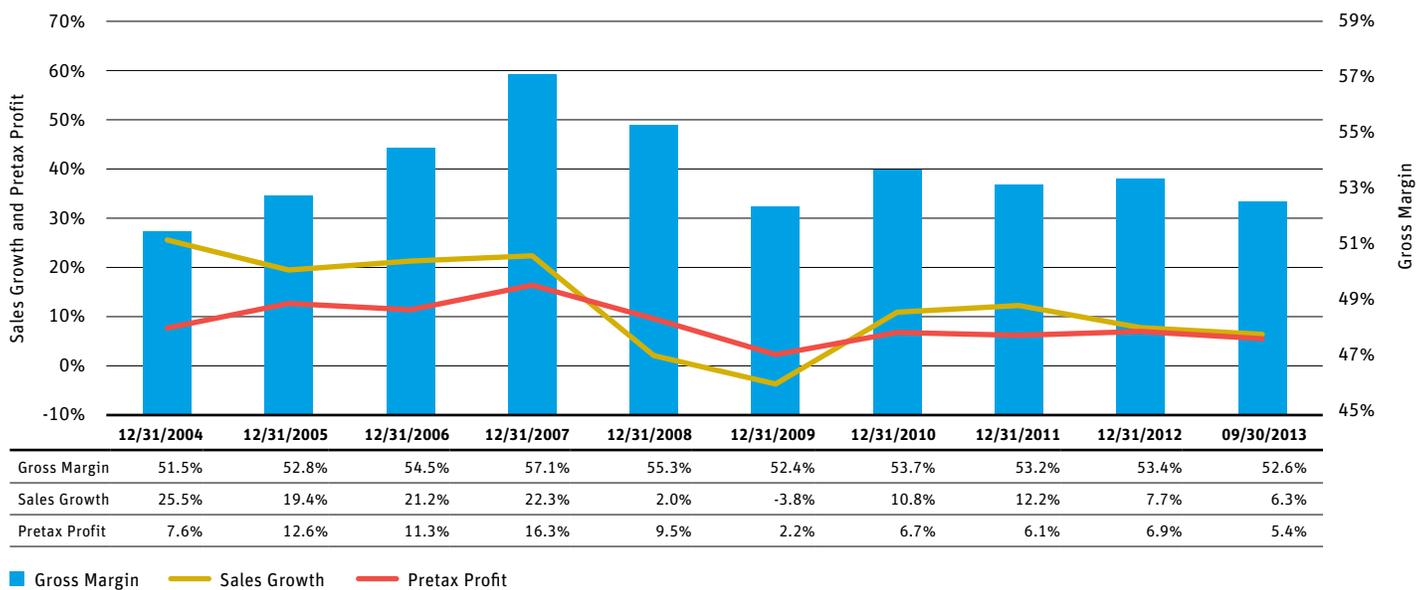
Everyone only needs so much money and the next incremental dollar just doesn't mean as much. Contrary to the consumer view of the wine business, it's not one generally filled with caviar dreams and lavish living. In the past several years wineries have had to make difficult decisions on spending and you've probably already fired your gardener and like Forrest in the above quote, are riding that lawnmower yourself at this point. And while the economy is improving, financially wineries are really just holding their own.

As the economy continued to stabilize in 2013, overall wine consumption increased for the nineteenth straight year. Overturned blue laws, relaxed restrictions on direct shipments, and customers trading up to more premium-priced wines all led to the industry's success last year. According to The Beverage Information Group's recently released 2013

Wine Handbook, the wine industry grew 1.9 percent last year to reach 318.0 million nine-liter cases, although almost all of the growth was due to volume growth which moved up 1.8 percent for the year.

The wine business, is a family-run industry and financial statements and returns aren't just lying around on the interwebs. Fortunately, as bankers focusing exclusively on the wine business, we have the information and have for years condensed that data into statistics which we give to our clients for free to benchmark their performance against peers. As a result, people from Spokane to San Diego 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 20 does help somewhat.

Figure 20: Wine Industry Financial Performance



FINANCIAL PERFORMANCE OF WINERIES (CON'T)

The good news is there was sales growth in the fine wine business in 2013. As we look at the financial position of wineries this past year starting with Figure 20 developed from SVB's Peer Group database,^{xxxix} revenue growth through nine months ending September 30 was about six percent. Our data are not seasonalized, but even so we expect to see the impact of a weak OND 2013 selling season^{xl} create flattish end of year sales. Consistent with our information, Symphony IRI data from *Wines & Vines*^{xli} for 12 months in off-premise accounts for the period ending November, shows positive revenue growth of seven percent with eight percent growth in direct-to-consumer sales after a meager one percent growth rate in November compared to the same period one year earlier.

Figure 21 from ShipCompliant supports what we should all expect to see: consistently increasing direct sales cresting \$1.5 billion for the first time in history. This is a trend that should continue for the foreseeable future as larger wine companies start to jump on the band wagon and increase their efforts in direct sales.



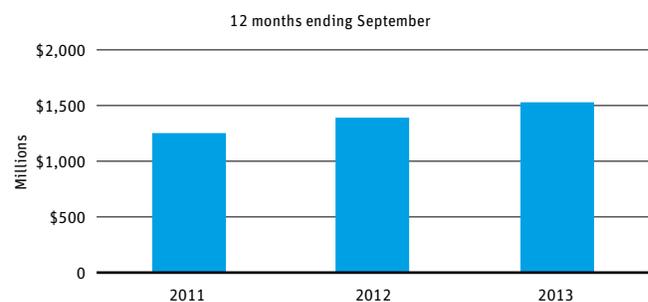
On the bad news side of the ledger, the higher-cost inventory from the short 2011 vintage couldn't be passed on to the consumer in price once again and that lowered gross profit and pretax profit for the industry slightly.

Taken as a whole, the financial performance of wineries in 2013 was ... well ... just OK^{xlii} 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. But we'll end with the good news: We are forecasting the first increase in sales growth in the past 4 years and expect 2014 fine wine sales to fall in a range of 6% - 10% growth.

Life is like a box of chocolates, but now you too can separate the nuts from the cremes.

FORREST GUMP: *That's all I have to say about that.*

Figure 21: Direct to Consumer Shipments Value



Source: *Wines & Vines/ShipCompliant Model*

APPENDIX

- ⁱ U.S. Census Bureau, Population by Age and Sex: 2000 and 2010, Table 2 <http://www.census.gov/prod/cen2010/briefs/c2010br-03.pdf>
- ⁱⁱ SVB on Wine blog covering the idea of a Federal Marketing in more detail. July 29, 2012: <http://svbwine.blogspot.com/2012/07/is-california-wine-at-pricing.html>
- ⁱⁱⁱ A Federal Marketing Order is the entity formed to market crops. Some of you will recognize The California Almond Board (“Just a can a week”), California Raisin Commission (Dancing Grapes... Heard it through the Grapevine.) California Dairy Commission (“Milk from Contented Cows”).
- ^{iv} The largest wine producer in Vietnam is Dalat Winery. They also sell and distribute wine. <http://www.dalatwine.vn/>
- ^v L’Organisation Internationale de la Vigne et du Vin (OIV) statistical releases.
- ^{vi} Controversy, riots and protests in France’s wine business are nothing new. See “Agricultural Workers and the French Wine-Growers’ Revolt of 1907” <http://publishing.cdlib.org/ucpressebooks/view?docId=ft900009sf&chunk.id=d0e8625&toc.id=d0e8625&brand=ucpress>
- ^{vii} See the EU policy summary here. http://europa.eu/legislation_summaries/agriculture/agricultural_products_markets/ag0001_en.htm
- ^{viii} Gomberg Fredrickson, October 2013. p. 3.
- ^{ix} The quote has been attributed to mainly to W.I.E. Gates, but also to Mark Twain among others. I’m not really sure who W.I.E. Gates is so I’ll just attribute the quote to Mrs. Gump since she said a lot of smart things. But if anyone knows who W.I.E. Gates is please let me know.
- ^x Guess the harvest size has always been a fun parlor game for those of us in the wine business. Nobody knows for sure what total CA yields will be because there is only observation, survey, prior trended information, and word of mouth from which each of us makes our guesses. In 2012 we were lucky enough to hit the total yield nearly on the button. Wish us luck this year, but either way – it’s a consensus that this will be the first or second largest crop on record and as we all know, the consensus is always right.
- ^{xi} <http://www.greatnorthwestwine.com/2013/10/31/2013-washington-wine-record-harvest/>
- ^{xii} <http://www.capitalpress.com/article/20131126/ARTICLE/131129926/1318>
- ^{xiii} Silicon Valley Bank runs a Wine Conditions Survey each year in conjunction with AVA’s throughout the West Coast. In 2013 we sent the survey out to 5,000 wineries and had 644 wineries respond to the survey. If you would like to be considered for the survey in the future and receive gratis results and analysis, please contact Penny Northrop and request that you be added to our survey list: pnorthrop@svb.com
- ^{xiv} One of the more creative solutions we’ve seen a few times over the years is wineries taking excess uncontracted fruit under something close to the old style crop sharing arrangements. Grapes are effectively donated to the winery with the grower paid 50% of the profit of the arrangement, but only once the wine is sold.
- ^{xv} I’m wondering if we would have more investigations from ethics committees, or fewer – if the oversight committees weren’t made from elected officials. On the one hand it’s the fox guarding the chicken coop phenomenon so fewer should be in order, but on the other – it seems these committees are turning into the equivalent of political lynch mobs.
- ^{xvi} <http://ethics.house.gov/press-releases>
- ^{xvii} I know everyone hates bankers, but I am really a musician and 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 though, I barely like myself when I’m at work.
- ^{xviii} Yellen hasn’t yet been confirmed as of this writing but there are strong consensus expectations of her confirmation. http://www.washingtonpost.com/business/economy/power-transition-at-federal-reserve-could-influence-dynamics-of-taper-debate/2013/12/16/2087e2f8-6280-11e3-91b3-f2bb96304e34_story.html
- ^{xix} Note: The cut is in the growth rate in spending. We are still running a deficit and a very large one over the past 7 years.
- ^{xx} Remember in the movie Tom Hanks said he and Jenny got along just like “peas and carrots.” I don’t know about you but I hate peas and carrots mixed up. That’s a horrible combination, especially when they are boiled until they have the texture of mashed potatoes and are tasteless. My mom used to make ... oh never mind.
- ^{xxi} A more thorough definition of the unemployment rate calculation can be found here: <http://www.econmodel.com/classic/terms/ur.htm>
- ^{xxii} The one data point at 62% is nice coming back from 59% at the low point, but remember the unemployment rate as of this writing is about 7% when in this measure, as an inverse you would think it would be 93%. So even while 62% is good, it’s really leaving out the difference – 31% of the population who aren’t participating in the employment picture. In technical terms, that sucks.
- ^{xxiii} BRIC is an acronym that refers to the emerging economies of Brazil,

APPENDIX (CON'T)

Russia, India, and China. The original premise of the idea was world economic power was shifting to these developing nations. Since the Great Recession, thoughts on consumer growth transition to those countries and away from the G7 have been hotly debated largely because the influence and stability of governments have not been fully considered. <http://en.wikipedia.org/wiki/BRIC>

^{xxiv} Bain's Annual Report on the Luxury Market, October 28th, 2013. Note the lower growth rates are currency impacted and would be closer to 6% without those adjustments.

^{xxv} <http://www.northbaybusinessjournal.com/84935/vine-notes-data-dispel-wine-direct-sales-myths/>

^{xxvi} Solid state meant the elimination of tubes to run televisions and radios ... not counting the picture tube. It allowed the size of televisions to shrink in half and reduce electrical consumption and heat dramatically. It was a fantastic achievement and advancement for everyone, unless you were a radio and television repairman like my dad, who like so many before and since had to change careers over technological obsolescence. As an aside – he was able to get Federal Job Retraining and worked another 25 years as a biomedical service engineer, fixing hospital and operating room equipment. So while we've recovered in the stock market, why haven't there been any significant programs offered for job training and development for the long term unemployed? Just asking ...

^{xxvii} No ... that really is true. In a sad footnote though, the technology wasn't ever patented by GE and is now in the public domain and used widely, with the exceptions of some remote locations in the Himalaya's and small pacific islands where there is a prohibition against the the use of color.

^{xxviii} Gerald R Ford was quoted saying, "The three-martini lunch is the epitome of American efficiency. Where else can you get an earful, a bellyful and a snootful at the same time?"

^{xxix} Neo-prohibitionism: <https://en.wikipedia.org/wiki/Neo-prohibitionism>

^{xxx} <http://www.madd.org/about-us/>

^{xxxi} Don't answer that question.

^{xxxii} 60 Minutes: The French Paradox <http://www.youtube.com/watch?v=njm1LkXP2sg>

^{xxxiii} Peas and carrots suck together. See above notes for more detail.

^{xxxiv} The period of truncated growth in the 90's was more like 4 years but its close enough.

^{xxxv} In the early part of December in 2013, there was a freeze lasting for several days which severely impacted citrus growers in the San Joaquin Valley. While reports are not yet available on any damage to vines, the temperatures weren't low enough to cause bud damage, but they

were extended in the number of freeze hours to possibly impact new plantings.

^{xxxvi} Delta Mendota Water Authority, December Project Operations Update, Letter dated December 11th, 2013.

^{xxxvii} <http://articles.latimes.com/2013/sep/02/business/la-fi-paso-drought-20130902>

^{xxxviii} <http://www.slideshare.net/fullscreen/audreyadanger/nat-dibuduo-allied-grape-growers/1>

^{xxxix} 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.

^{xl} In the wine business, the months of October, November, and December represent about 40% of annual sales.

^{xli} <http://www.winesandvines.com/template.cfm?section=widc>

^{xlii} "just O.K." is defined in generally accepted accounting principles as financial performance that is one percentage point better than Forrest Gumps I.Q.

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SILICON VALLEY BANK'S PROPRIETARY PEER GROUP METRICS

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

ABOUT SILICON VALLEY BANK

Silicon Valley Bank is the premier commercial bank for companies in the technology, life science, cleantech, venture capital, private equity and premium wine industries. SVB provides a comprehensive suite of financing solutions, treasury management, corporate investment and international banking services to its clients worldwide. Through its focus on specialized markets and extensive knowledge of the people and business issues driving them, Silicon Valley Bank provides a level of service and partnership that measurably impacts its clients' success. Founded in 1983 and headquartered in Santa Clara, Calif., the company serves clients around the world through 27 U.S. offices and international operations in China, India, Israel and the United Kingdom. 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.**

ABOUT SILICON VALLEY BANK'S WINE DIVISION

Silicon Valley Bank's 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 focused 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), with SVB Analytics, SVB Capital and SVB Private Bank. More information on the company can be found at www.svb.com/winedivision.

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