SVB Silicon Valley Bank
A Member of SVB Financial Group

*Wine Division*

# STATE OF THE WINE INDUSTRY

## Forecast and Strategic Recommendations, 2007 - 2008

Written by Rob McMillan, *Founder, Wine Division*

## RAYMOND: "I'M AN EXCELLENT DRIVER."

In the 1988 film, "Rain Man," Raymond Babbitt, played by Dustin Hoffman, is jolted out of his institutionalized routine when his brother Charlie, played by Tom Cruise, in a flash of spontaneity kidnaps him for a cross-country passage. Charlie, always the hustler, perceives the world as opportunity for the strong. He moves, shakes and shoves everyone out of the way who slows him down. Raymond on the other hand, is an autistic-savant who lives in an emotionally numbing routine. He is a self-proclaimed "excellent driver," but can't drive. He can't dress himself, but can count a four deck shoe in Las Vegas with precision. Raymond likes things the way they are and is sheltered from the world. Charlie on the other hand only wants things his way and ignores conclusions most people would come to.

We all experience pieces of the wine industry as Raymond and Charlie. Some of us have been numbed by routine and time and see the world as a repetition of annual events: harvest, bud break and bottling. We talk to the same people, attend the same annual conferences, and repeat. Grape shortages are followed by over-planting, and then a wine lake. But we still see ourselves as "excellent drivers." Others see rapid development in an increasingly world-impacted industry, dismiss the status quo to see what might be, discard the lessons of the past and take our best shots with limited information. We see only what we want to see and say to ourselves, "I'm an excellent driver."

In this year's State of the Wine Industry, we examine the nuance of change in the industry. More than any other year in our memory, the "average winery" is hard to find. There are winners and losers at all price points, business models, appellations and production sizes, increasing the risk of failure for investors, financiers, producers and growers alike.

Is the industry doing well? Like most excellent drivers, your success and strategy all depend on your point of view. As risk continues to grow, your point of view is less likely to be representative of the "average winery."

## EXECUTIVE SUMMARY

> In our view, 2007 will be an outstanding year for growers and wineries in the premium wine segment with improving prices, sales volumes and margins. We expect growers in the higher volume and lower price-point segments to experience a challenging, but slightly improved year.

Many industry leaders point to an over-abundance of grapes in the wine industry, however, the wine industry is less homogenous than ever before. Vines are still being pulled in the Southern Interior of California on the one hand, and grape shortages are already surfacing in higher-priced segments in Sonoma and Oregon in particular. Distributors are begging for product when a winery can deliver in volume, but smaller lots are shunned without brand pull already established.

### PREMIUM SEGMENTS

Despite significant press emphasizing excess wine supply, *we predict grape shortages emerging across several varietals in the North Coast and Oregon in the premium segments*. This creates better grower pricing in Napa, Sonoma and Oregon. Despite the optimistic forecast, bottle prices will remain flat for the year or see only modest growth, and several hurdles remain to sustained profitability. Looming threats include margin compression between a closed distribution system holding prices flat and higher grape prices, the threat of foreign wines getting a foothold due to market shortages, labor shortages, and high land costs.

### VOLUME SEGMENTS

For growers producing for lower price-point wines, we expect a continuing struggle against the tide of lower-priced imports (bulk and bottled) and lower- or negative-growth rates on box wines and wines priced below $3 retail. The reduced overhang from the huge 2005 harvest in California should improve conditions slightly over 2006 crop pricing, subject to the price of foreign wine. But distributors are looking for volume-based sales of wine. Consequently, we believe opportunities for greater growth in the segment may be possible if, and we emphasize if, the industry promotes quality and stimulates demand for broad-based California wines. As of this writing, it does not appear those promotional efforts can be expected to bear results this year.

## THE U.S. WINE INDUSTRY

> *Raymond: "Wheel! Of! Fortune! Look at the studio filled with glamorous merchandise. Fabulous and exciting bonus prizes. Thousands of dollars in cash. Over $150,000 just waiting to be won as we present our big bonanza of cash on Wheel! Of! Fortune!"*

The U.S. wine industry exceeds $10 billion wholesale. According to Winery Exchange's 52-week information from February 2007, case volume grew at 4.6 percent while overall sales grew at 9.5 percent, suggesting either rising prices or a continuing shift to consumers buying more expensive wines. The industry, predictably cyclical in 7-10 year increments bracketed by under-supply and over-planting following with over-supply, has been at times a Wheel of Fortune. The Charlie Babbitts of the world are out there ready to make a fast buck – and sometimes they do, thus creating

### 2006 CASE SALES BY PRICE POINT

| Category | Case Change (000) | Change % |
|---|---|---|
| $0 - $2.99 | -674.9 | -3% |
| $3.00 - $5.99 | 879.1 | 6% |
| $6.00 - $8.99 | 623.2 | 9% |
| $9.00 - $11.99 | 816.2 | 17% |
| $12.00 - $14.99 | 285.9 | 21% |
| > $15.00 | 264.7 | 27% |

*Source: 2006 ACNielsen Premium Wine Scan*

more vino-prospecting Charlies. But the consumer wave moves quickly; too quickly for a product that is planted five years before getting a mature yield. In the end, even the best Charlies are limited by the volume Bacchus will annually present to the common man, beginning the cycle that defines the U.S. wine industry.

For perspective, let's look at the cycle in which we find ourselves presently, beginning with 2000 as a cyclical low point. The tech bubble had burst and over-planting created over-supply as earlier planted vineyards came into mature production. Restaurant sales slipped with the start of a recession, and the growth rate in the sales of fine wine dropped from more than 25 percent in the mid- to late-1990s, to just 5 percent by 2002, according to SVB statistical information. The goldmine turned into a minefield for many who were ill-prepared and had stocked up to support expected higher growth rates. Consequently, most wineries were left holding heavy inventory positions that needed discounting to move. For many Cabernet producers, the negative impact of the 2000 vintage year panned by the press further exacerbated the problem, as buyers decided to just wait for 2001 vintages.

Fast forward to today — the U.S. wine industry is firing on all cylinders. Why? Because of continuing growth in demand across virtually all price points, with the more expensive wines demonstrating the highest growth rates, and only wine under $3 demonstrating negative growth. This is coincident with limited plantings, which is different from what we experienced in the 1990s.

#### PREMIUM MARKETS

In last year's forecast, we said, "We believe that conditions are right in the industry to climb back to a cyclical high." The January 2007 SVB Wine Business Conditions Survey supported the accuracy of our forecast with more than 75 percent of industry respondents suggesting that 2006 was a "very strong" or a record "best year." When asked the same question about 2007 expectations, respondents were even more bullish.

Is their faith in the future justified? Certainly there are good reasons to be optimistic about 2007, but there are risks that should be accounted for in your present planning. For wineries producing wines between $25 and $65, 20 percent of survey respondents cited availability of grapes as the primary concern for sustaining profitable growth. Why are we running short of grapes? One needs to look no further than the growth in consumer demand for fine wine.

According to SVB Silicon Valley Bank's proprietary Peer Group Analysis metrics and supported by industry scan data, the high end of the wine market is growing by more than 20 percent a year at present. With nonbearing acreage only a small percentage of planted acreage, we expect the surplus created by the large 2005 crop to fall into the rear view mirror, as vintners start to feel grape shortages across most

### FREQUENCY ANALYSIS

Question: 2006 was ______________.

| | Answer | Count | Percent |
|---|---|---|---|
| **1.** | **our best year ever** | **212** | **42.66%** |
| 2. | a very strong year | 167 | 33.0% |
| 3. | an average year overall | 73 | 14.69% |
| 4. | a slight disappointment | 41 | 8.25% |
| 5. | very disappointing overall | 4 | 0.80% |
| | Total | 497 | 100% |

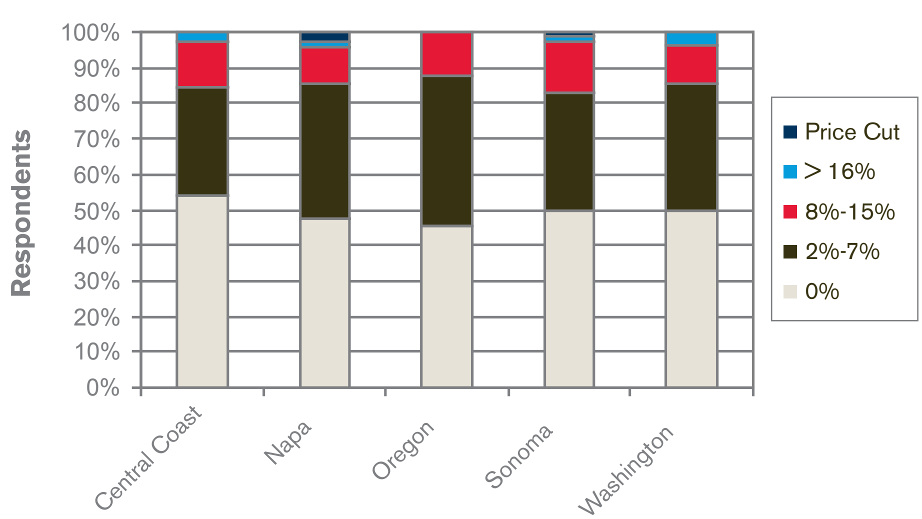
*Source: 2007 SVB Wine Industry Conditions Survey* major varietals in the premium wine growing regions starting with the 2007 harvest.

If demand growth for fine wine continues at the present robust rates, even if new and significant plantings in the North Coast and Oregon are undertaken immediately, we will still see continuing high-end wine grape shortages occurring across most varietals for the next several years.

Given our forecast of shortages, it is reasonable to presume that bottle prices in the high-end should start to rise. But at the winery level, according to the SVB Wine Industry Conditions Survey, 80 percent of wineries in existence for more than five years will hold bottle prices flat, or take a 2 to 7 percent increase in 2007. Given the looming shortages, it is somewhat counter-intuitive for retail prices to show only minimal increases. The probable reason comes from four sources:

- The discussion of shortages is not widespread at this point and producers may not have discovered leverage with buyers at this early stage.
- Domestic pricing at the high end increased dramatically in the last cycle, and wineries may be acting on the adage that trees don't grow to the sky.
- Distributor consolidation is making it more difficult for wineries to get their goods to supermarkets and restaurants. Wineries have limited negotiating leverage, so price or promotion incentives are needed. In any case, price increases are difficult for many smaller wineries dealing with powerful distributors.
- While appellation specific wines do offer some protection from commodity behavior (fewer pure substitutes), the Internet is playing a role in getting more information about price and quality into consumers hands and making foreign wines more available as options.

2007 REGIONAL PRICING STRATEGY



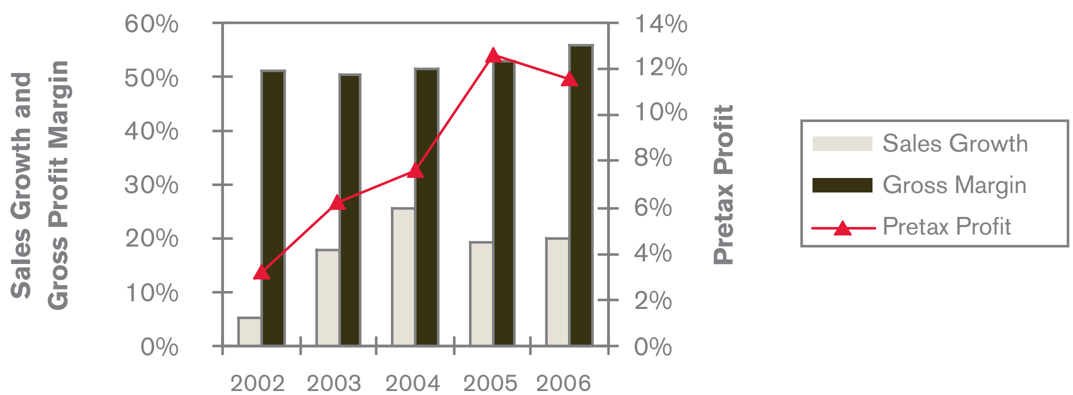

*Source: 2007 SVB Wine Industry Conditions Survey*

## WINERY FINANCIAL PERFORMANCE

How are wineries doing financially? Overall, the numbers are good. However, there are exceptions in a market that is becoming increasingly more difficult to negotiate. Given SVB Silicon Valley Bank's market share of premium wineries, we are able to construct reasonable industry profitability metrics using our own proprietary SVB Peer Group Analysis metrics. This database includes West Coast wineries with an average bottle price of about $33 retail and case production ranging from approximately 5,000 to 250,000 cases.

The trend for sales growth has shown excellent upward momentum from 2002, and while nominally impressive in 2006, is slightly off the 2004 high of 25.5 percent. Gross margins for producers continue to show improvement from 2002 cyclical lows. Since these are accrual financials, grape costs pass through the cost of goods sold two years after harvest. Those stable costs are matched against later sales that are trending upward due to better sales volumes and, in small part, reduced promotional allowances. With increasing grape costs expected this year and next, we would not expect to see increasing gross margins in this segment beyond two or three years. As a consequence, a leveling out of industry profitability is likely at that point unless those prices are passed on to the consumer. Because of better gross margins in the past two fiscal years, industry pretax profitability is at a five-year high of about 12 percent according to SVB Peer Group Analysis information.

### HIGH-END INDUSTRY PROFITABILITY




*Source: SVB Peer Group Analysis*

| | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|
| **Sales Growth** | 5.2% | 17.6% | 25.5% | 19.4% | 20.0% |
| **Gross Margin** | 51.1% | 50.2% | 51.5% | 52.8% | 55.8% |
| **Pretax Profit** | 3.2% | 6.3% | 7.6% | 12.6% | 11.6% |

*Source: 2006 FYE Estimated from Q3 Information*

### SUPPLY AND DEMAND BALANCE

Balancing supply and demand is probably one of the most critical jobs in running a winery. The ability to forecast the demand growth accurately two or more years before a release is no easy task. Wineries may, at any time, go from having too much wine to not enough wine, and that condition will back up into the bulk wine and grower markets.

### FREQUENCY ANALYSIS

Question: I feel I have ______ wine inventory for the 2007 calendar year.

| | Answer | Count | Percent |
|---|---|---|---|
| 1. | insufficient | 144 | 28.86% |
| **2.** | **about the right amount** | **302** | **60.52%** |
| 3. | too much | 49 | 9.82% |
| 4. | way too much | 4 | .80% |
| | Total | 499 | 100% |

*Source: 2007 SVB Wine Industry Conditions Survey*

In the SVB Wine Industry Conditions Survey, we asked wineries on the West Coast what they thought about their inventory supplies in the cellar. For reference purposes, the average survey respondent sells in the $26-$40 price range with only 10 percent selling below $15. Eighty-nine percent of the respondents feel they have either adequate or short supplies in the cellar, and only a small number of wineries feel they are long on wine. By appellation, 50 percent of the Oregon wineries that participated in the survey feel they are short on wine, while 20-28 percent of the other appellations feel they are short.

| Napa and Sonoma Dist. 3 & 4 | 2005 Volume (tons) | 2006 Volume (tons) | 2006 Growth in Volume (tons) | 2006 Growth in Sales (cases) | Nonbearing (% of total) | Relative Supply | |
|---|---|---|---|---|---|---|---|
| | | | | | | 2006 | 2007 |
| Chardonnay | 107,176 | 88,465 | -17.46% | 42.10% | 3.94% | | |
| Sauvignon Blanc | 24,815 | 24,863 | 0.19% | 19.46% | 9.16% | | |
| Cabernet Sauvignon | 114,577 | 94,029 | -17.93% | 25.29% | 4.59% | | |
| Merlot | 63,252 | 52,564 | -16.90% | 15.16% | 2.48% | | |
| Pinot Noir | 37,030 | 49,061 | 32.49% | 27.90% | 3.30% | | |
| Syrah | 12,124 | 9,915 | -18.22% | 60.34% | 3.95% | | |
| Zinfandel | 23,104 | 21,124 | -8.57% | 23.40% | 2.53% | | |

Shortage Excess Shortage Looming

*Sources: Winery Exchange, California Ag Statistics, Turrentine Wine Brokerage, SVB Analytics*

To get a better perspective on supply, we need to look past the inventories at the winery level, since it's the winery's job never to have too much wine, even in an oversupplied market. Examining the relationship between vineyard production and the sales of varietal wines gives us a fair indication of what is in the production queue.

For this analysis we've used Winery Exchange Scan Data as a proxy for sales above $15, and Napa and Sonoma (District 4 and 3) growth rates in harvested volume as a proxy for supply. We have also noted nonbearing acreage, and given a broad indicator of the availability of varietal wines in the bulk market in the high-end for 2006 and 2007, with red denoting shortage, green excess and yellow reaching a point of caution with shortages looming, based on trends.

### TRENDING TO SHORTAGE

In a perfect world, we would like to see a chart that was all yellow to the right indicating limited excess wine in the channel, and flat trends with harvest growth matching sales growth. Instead what we generally see is harvest tonnage dropping predictably off the large 2005 harvest, and continuing strong sales volume across all varietals. The 2006 green oversupplied varietals in Chardonnay, Zinfandel, and to a lesser extent Cabernet, are at a cautionary point of running short in 2007. Chardonnay growth at 42 percent seems high and probably is, but when we check with high-end growers and wineries that market Chardonnay, we find verbal support for emerging shortages.

Sales growth in Pinot Noir dropped off its frenetic pace of last year, as all the varietal excess dried up, truncating domestic sales growth and fueling imported Pinot Noir growth. Oregon remains short on Pinot Noir but has 1,403 nonbearing acres (16 percent of total) to support future growth. Merlot is still in a state of significant oversupply, but has demonstrated some resiliency, with sales improving over the single digit growth rates in the prior year. High growth in the sale of high-end Chardonnay in 2006 has reduced the stock of grapes and wine available, leaving a shortage, especially from the Russian River, Oregon and potentially the Carneros appellation. Despite widespread reports of some limited Napa Cabernet acreage that went unpicked in 2006, strong Cabernet sales growth is cutting through the existing back-log rapidly and will be close, or in balance in 2007, presuming a normal harvest and continuing strong demand.

Last year, the Central Coast of California found itself awash in wine, particularly Cabernet Sauvignon. Not surprisingly, according to locals, there have been substantial blocks of Cabernet that have been grafted to Pinot Noir, which may not be included in California Ag Statistics data.

The moderated harvest in 2006 was good news, with all varietals dropping meaningful amounts while sales growth remained strong. The 2005 Central Coast production of Pinot Noir has easily worked its way out of the system at this point, and the expectation is that Chardonnay should right-size itself this year given emerging shortages in Sonoma, and very strong varietal demand. But Syrah and Bordeaux varietals are still long, particularly Merlot.

## SUPPLY AND PRICING FORECAST

*Raymond: "That's my pen. That's definitely my book."*

*Charlie: "Well taking your book is not a serious injury!"*

*Raymond: "Serious injury book is a red book, that book is blue."*

*Charlie: "Well forgive me; I've lost my secret decoder ring!"*

What's it all mean? Where are the pain and injury points? Here is the way we've decoded the market, starting with a look at our 2006 SVB Forecast and Recommendations Report. Regarding supply we said, "Given strong sales growth, in many instances, the large harvest of 2005 will probably mask a shortage that will start to show itself in 2007 and be fully evident in 2008. Nonbearing acreage in the North Coast will not keep pace with current demand growth and will lead to a rush of plantings in areas where land is available for high-end production."

We reiterate that forecast and emphasize there is an emerging shortage and a lack of vineyard development for grapes directed to the $15 and above price points. We add the caveat that land prices are high relative to bottle prices in Napa and Sonoma, and getting more expensive for the production of fine wine. That may lead to less planting than we originally believed, and more extended periods of shortage than we have seen in past cycles. That will open the door for planting in other less established appellations, and allow imports to grab high-end market share. While adequate distribution is a significant problem today, an emerging shortage of wine will force distributors to look to smaller producers, reducing – not eliminating – the impact of this issue on producers for a period.

| Monterey and Central Coast (Dist 7 & 8) | 2005 Volume (tons) | 2006 Volume (tons) | 2006 Growth in Volume | Total Nonbearing Acres | % of Total Acres |
|---|---|---|---|---|---|
| Chardonnay | 220,816 | 134,572 | -39.06% | 1,012 | 3.67% |
| Sauvignon Blanc | 17,389 | 14,346 | -17.50% | 193 | 7.60% |
| Cabernet Sauvignon | 111,114 | 80,822 | -27.26% | 71 | 0.49% |
| Merlot | 81,731 | 61,188 | -25.13% | 710 | 6.14% |
| Pinot Noir | 42,671 | 36,491 | -14.48% | 543 | 6.28% |
| Syrah | 34,757 | 26,540 | -23.64% | 404 | 7.25% |
| Zinfandel | 17,945 | 14,027 | -21.84% | 368 | 11.68% |

*Source: California Ag Statistics*

For Napa and Sonoma, we expect to see general grape and bulk price increases for Pinot, and particularly Chardonnay through the year; flat to slight increases for Cabernet, and flat prices for Merlot. Nonbearing acreage will not have a meaningful impact on supply. By 2008, with no change in trends, we expect a supply shortage of all major varietals, with the exception of Merlot. We are hearing more growers talk about ripping out Merlot and grafting to Cabernet, given the contracted price differences between the varietals.

We would expect generally flat pricing for grapes in the Central Coast of California, with the exception of Chardonnay, and perhaps some additional price increases on already expensive Pinot Noir. While there is still sufficient bulk Chardonnay in the market today, we believe we will start to see increased pricing pressure due to shortages emerging in the North Coast. Given the wide distances between Santa Barbara, San Luis Obispo, Paso Robles, Santa Rita Hills and Monterey, some plantings in the region will command higher prices reflective of grape quality that can be directed appropriately to higher price points.

Oregon is well-positioned for longer-term growth because of the growing popularity of its primary varietal, Pinot Noir. There are 3,000 total nonbearing acres of grapes (19.2 percent of total acreage) to support additional growth, consistently improving wine quality and reputation, and distributors who are clamoring for domestic Pinot.[1]

## FACTORS OUTSIDE OF SUPPLY

*Charlie: "I'm gonna let ya in on a little secret, Ray. K-Mart sucks."*

Outside the positive aspects, there are many issues to solve including the evolving role big-box retailers

## STRATEGIC RECOMMENDATION

For premium wineries, the word has not yet spread that the market is tilting to a grape shortage. However, in the next 12 to 24 months it will become apparent and will influence the price of grapes and bulk wine. Now is a good time to think about extending grape contracts with growers, before shortages become too apparent and prices increase. It's also important to start to plan and focus wine allocations and distributors to the right regions to ensure the markets in which you want to build your brand have the right supply allocated.

Narrowing distribution has the added benefit of reducing the numbers of contacts you manage and trips you take, thus lowering selling costs. Nevertheless, costs will increase in a grape shortage environment. It's anyone's guess as to whether those costs can be covered through increased bottle prices, given the challenge of getting access to markets through standard distribution channels. If wineries can't raise prices and winery owners are not willing to make smaller margins, managing the other components of the operation for greater efficiency will take on greater importance in coming years.

For growers, it's a good time to make sure your grapes are being used by the best brands. This will build your ability to attract higher-than-average pricing in subsequent vintages over the long haul. For growers and investors, as we've noted, there is a looming grape shortage. Plantings to support growing demand are needed in the right varietals in the North Coast, and more cautiously in other areas where value-priced land can support $15 and above price point wines. It will be important to secure contracts prior to planting, particularly in lesser-established regions.

[1] U.S. Department of Agriculture, February 2007

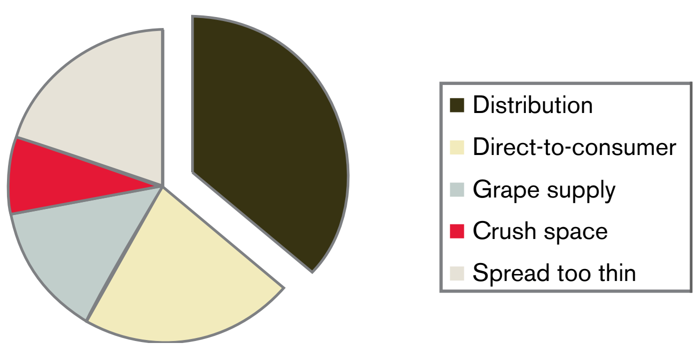
will play in the future, both in creating store brands that may compete against domestic brands (K-Mart and Gallo), and in becoming destinations for direct sales from producers. There is no way to avoid it — the industry is evolving, creating opportunity for the brave and risk for those who won't change.

Our observation through the late 1990s was that the critical success factor for the industry was wine quality. Belief in this viewpoint led to outsized growth in winemaker salaries. If you made good wine, it would sell. It was the era of the small boutique winery. Today, wine quality is the price of admission, and we see successes throughout multiple price-points, different wine quality, wider appellations and varied case production models. The critical factor for winery success now is a combination of a viable sales plan, experienced sales managers and a good handle on costs. Not surprisingly, we now see the growth in winemaker salaries begin to moderate, and salaries for experienced sales people escalate. There is also a growing need for finance-oriented employees.

There are numerous other issues winery owners talk to us about, all of which can keep a small producer up at night. These include inadequate distributor representation and continuing consolidation, brand proliferation, high land costs, competition from premium foreign wines, the competition for high-end customers in direct-to-consumer channels, a potential recession and the growing issue of being stuck in the middle from a production standpoint. Let's take a look at some of these issues more closely.

Our 2007 SVB Wine Industry Conditions Survey asked wine industry respondents to name the greatest obstacle to sustained profitability. Of 500 respondents, 36 percent said "distribution," 22 percent said "direct-to-consumer problems" and 19 percent said being "spread too thin."

GREATEST OBSTACLE TO SUSTAINED PROFITABILITY




### DISTRIBUTION

There are varying statistics regarding the number of brands in the U.S. and the number of distributors selling those brands. In part this is because the number of brands increases almost daily, and distributors are continuously consolidating. The most recent numbers we found suggest there are 4,929 U.S. wineries producing, conservatively, about 7,000 brands. Those brands have to squeeze though an estimated 600 distributors — half the number of 10 years ago — or find alternative distribution channels.

According to estimates from consulting firm Gomberg, Fredrickson & Associates, the top 10 wine companies account for 82 percent of total domestic shipments. That means the other 4,919 wine companies have to compete for the remaining 18 percent available in wholesale channels. The practical impact of this constriction takes two forms: Distributors seek producers with higher volume production that is more efficient for them to sell, or wineries with big scores or established brands pull product through at a higher margin, without the distributor dedicating time to the sale. That means a large and growing number of wineries are not getting the representation they seek in what should be a very good market for fine wine.

Given the wholesale challenges, the game for the small winery today is direct-to-consumer. One of the best alternatives for a winery is Internet-based marketing and sales. But most of us find ourselves in a position today where we're wholly inexperienced in Internet-based marketing tactics. The need to learn is complicated by the fact that the state-of-the-art keeps changing. You have to adapt while you learn.

### DIRECT-TO-CONSUMER

For those wineries that don't produce in volume, don't get high scores or are not established brands with pull-through demand, the only other choice is to go direct to the consumer through one of three ways: Standard tasting room tactics, direct-mail and wine clubs, or the Internet. High-end wineries are the main beneficiaries in this emerging channel as consumer trends are favoring affordable luxuries such as fine wine. Fixed shipping costs per bottle are lower as a percentage for more pricey wine, consumers are trading up in price, and marketing costs for direct e-mail campaigns make Internet-based marketing for small wineries potentially affordable. Another supporting trend for Web-enabled sales are Millennials (born 1978 – 1998), who are responsible for a growing percentage of consumption, and are statistically more comfortable with and more likely to purchase through the Internet, according to the Wine Market Council's report.

But there are issues in direct-to-consumer selling:

*Nascent E-Commerce*

Building a Web site is not e-commerce as many believe. Over the past several years, when we ask a client or prospect about their site, we often receive answers such as, "I have a friend who updates my site for free," or, "We don't have a shopping cart but people can fax us."

The fact is, just building a Web site will not result in sales. Internet sales require the same marketing effort as traditional wholesale marketing, if not more. Getting buyers to your site and then managing their information is a necessary part of a Web-based wine marketing plan. Some Web-based wine system companies such as Inertia Beverage, Masters Wine, Nexternal and Cultivate Systems, are actively looking for new ways to drive sales to the Web sites of wineries

But vendors providing e-commerce support are a relatively new phenomenon to the market. They too are still learning, and are continuously evolving their products, delivery and support systems as a result. That means frustrated wineries. Our discussions with industry vendors suggest that the tools are evolving and improving, but at this early stage, not all vendors are capable of doing all things for all models. We expect to see more segmentation, differentiation and effectiveness over time.

*Alternative Marketing Approaches*

With the age of direct-to-consumer marketing becoming ever more dependent on electronic means, many wineries are adapting their marketing tactics to match the manner in which newer, tech-savvy consumers receive information. For instance, there are presently more than 900 wine blogs in the U.S. with readership ranging from 20 to 20,000 people apiece. The impact of these bloggers is growing because they are viewed as offering objective, community-driven commentaries on wine at a time when the community of established traditional wine writers can't possibly cover all the fine wine being made. Podcasts are another emerging channel of communication about wine that are gaining popularity with both established and alternative communication forums. Podcasts allow consumers to download spoken content such as wine-maker interviews, tasting discussions and wine education.

*State and Federal Laws*

Compliance with state and federal requirements for licensing, labeling, pricing and reporting can only be described as a pain – or maybe something more colorful. New laws are being passed each day, and each state expects producers to abide by its changing laws. For a winery or distributor shipping to multiple states, compliance can be an administrative nightmare.

*Cost of Sales*

Because the direct-to-consumer market requires a one-to-one brand-building process, producers new to the direct sales model may underestimate sales costs. While selling through a distributor allows you to work with retailers who sell multiple cases of your wine, selling direct means making multiple smaller sales, which increases the per-bottle sales cost. Moreover, effective direct sales may require the use of metrics and mail list management techniques that ensure you are dedicating the right resources to the most profitable customers.

While there seems to be an endless and growing supply of consumers willing to buy fine wine online, the Internet makes direct marketing more of a challenge by making price and quality comparisons easier than ever. And for the high-end producer, that means international competition is gaining more acceptance and traction. According to the Wine Market Council's report on Consumer Trends, 45 percent of Millennials' consumption is now from imported wine. Millennials are more likely than most to try new things, but the downside of this open-mindedness is they're less likely to be brand loyal. Add to this the proliferation of brands, and getting your brand differentiated and noticed in the market becomes more difficult, and potentially more costly, than ever.

### SPREAD TOO THIN

The third most frequently cited business hurdle from the 2007 SVB Wine Industry Conditions Survey was "being spread too thin." Wineries that are too small to attract distribution, but too large to sell all their wine using the direct-to-consumer path suffer from being stuck in the middle. Far from the bucolic lifestyle that many a would-be winemakers imagined a decade ago after buying 20 acres and putting their name on a label, the wine business has become a real business with plenty at risk. It has its own demands, from being in the market, to oversight of the vineyards, to managing human resources issues that come with a migrant work supply, to finance and business forecasts, managing consultants, distributors, mailing lists, wine clubs, and the list goes on and on.

## STRATEGIC RECOMMENDATIONS

With continuing brand proliferation, and easier access to information and international brands, more than ever before, fine wine is a recommendation-driven industry. Blogs, podcasts, and the growing list of wine-focused social networks provide the ideal forum for viral wine marketing. Think of every participant in an online community as a mini Robert Parker espousing an opinion on wine that will undoubtedly resonate with someone else, or at least be noted. Emerging companies offering online reviews, user-driven wine communities, hyperlinks to online wine sales, or software that helps wineries better understand their consumers, are an attractive solution for the small direct-to-market winery trying to gain expertise.

To take advantage of this new and critical marketing approach, winery owners must find an e-commerce partner, and embrace rapid change and evolving marketing tactics. In addition, they must be prepared to spend money to provide the same sort of support they might give their other marketing initiatives. Direct-to-consumer is about customer service. As a result, when these potential new customers travel from a wine blog to your winery Web site, they need to experience the same type of brand feel, message, service and support they would experience in your own tasting room. That will build the positive consumer experience needed for successful brand building of high-end wines. And finally, as part of the direct-to-consumer solution, wineries need to develop appropriate direct sales metrics, determine how to manage information, and staff for or outsource compliance activities.

In some cases, the work load, or parts of the workload, can be outsourced. But in many cases, the cost of finding contract solutions or not being able to afford a full time person means the entire responsibility is on the small winery owner's shoulders. In the high point of the last cycle when fine wine was a demand-pull market, there was a more accessible distribution system and a less complex compliance environment. A winery owner could take on all of these roles because sales were easier. Today, it's becoming increasingly difficult to pull that off. Many who thought they were going to take on owning a small estate winery as a retirement activity have been surprised at the extensive demands.

### LAND COSTS AND LAND USE

The old rule of thumb in Napa was that if an acre of land cost $25,000, you needed to sell a wine with a $25.00 retail price point to make an effective return. Those rules are obviously out the window when an acre of land in Sonoma can exceed $75,000, and in Napa, $150,000 and more. There are $75 and $150 Sonoma and Napa wines, but they aren't the norm. In fact, if an investor uses Napa county averages and tonnages to back into debt service, they often find the production will support less than 50 percent of the purchase price, with the rest needing to come from equity.

While land prices rise, everything is getting harder to do. Land-use ordinances are making vineyards more difficult to plant and develop. Permits for any purpose are more difficult to obtain. Nevertheless, demand for small family wineries has never been higher from the irrationally exuberant. That is causing many wine estates to go for far more than a buyer should reasonably expect, and their owners to defer payback on the investment to their heirs. Last year, we asked an investor facing that exact situation when he expected to see a return. The response was, "Well, I like to think in multigenerational terms."

The topic of land use would require a complete report of its own, and is outside the scope of this report.

## STRATEGIC RECOMMENDATIONS

*Doctor: "Ray, do you want to stay and live with Charlie?"*

*Raymond: "Yeah."*

*Doctor: "Or do you want to go back to Walbrook?"*

*Raymond: "Yeah."*

*Doctor: "Which is it? Go back to Walbrook or stay with Charlie Babbitt?"*

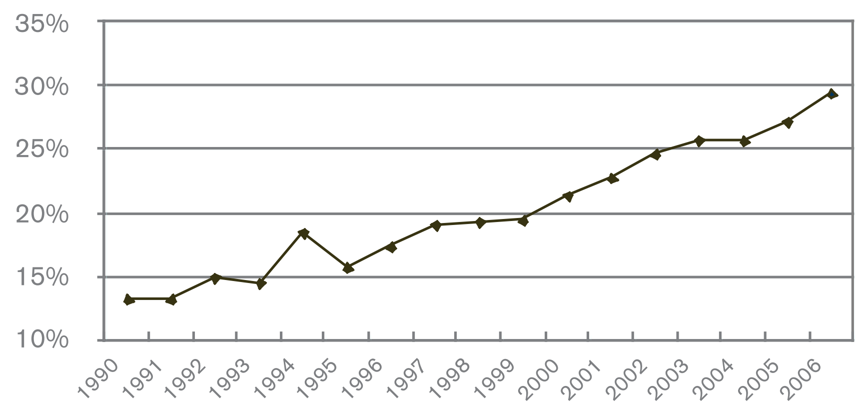
For winery owners who believe they are spread too thin, your heads are probably spinning about now. Do you want to grow and attract distributors? Yes. Do you want to shrink, and sell a smaller amount of wine at higher prices? Yes.

It's time to back up and start planning to make sure your model is relevant and current with where the industry is headed. It may be time to pick a new direction and focus. You may need to grow, shrink, outsource, hire more staff, get new vendors or perhaps find a cooperative marketing arrangement with another winery.

High land prices are not likely to abate. The option for small high-end wineries is to be subject to variable and increasing grape costs, decide to not grow under an estate model, dive in and purchase more land and absorb smaller returns than desired if you are appellation constrained, or find grape sources outside your appellation that can support your brand quality. Opening your mind to opportunities outside the country, such as exporting, joint ventures with a small foreign producer, buying foreign wine to sell under a domestic label, or buying a winery in a foreign country to gain lower cost supply may also be viable solutions.

However, bottom line, as it relates to vineyard estate prices, is that established appellations are, at times, too expensive to see the kind of return a rational new investor would expect. There are other regions, both in the Western U.S. and outside the country, where the price, cost and quality relationships are better than those of established appellations. With greater availability of information through the Internet, and with successful marketing campaigns, other regions and countries can cut into established regions' markets and the fine wine market.

IMPORT MARKET SHARE OF US




*Source: Gomberg-Fredrikson*

## VOLUME SEGMENTS

> *Doctor: "Ray, do you know how much a candy bar costs?"*
>
> *Raymond: "'Bout a hundred dollars."*
>
> *Doctor: "Do you know how much one of those new compact cars costs?"*
>
> *Raymond: "'Bout a hundred dollars."*

In any high-volume product, costs matter and efficiency is the name of the game. Since the costs of grapes and wine are the largest components of finished wine, large-scale wine producers naturally look hard at managing those costs. Growers in the high-volume segments have gone through profitable times, but today, given the low prices large wine marketing companies are willing to pay for grapes, returns have fallen to marginal or uneconomic levels. This is partly due to cheaper bulk and bottled imports, a record 2005 harvest and reduced demand for the lowest priced wines.

Picking up the cycle, in the late 1990s many Central Valley farmers saw strong demand, with prices averaging more than $500 per ton in California's District 11. But after 2000, the harvests from planting that had been going on since the early 1990s collided with a recession to create an oversupply that growers have been trying to cut through ever since. Prices then started to fall, dropping to $366 per ton in 2003.[2] However, 2004 was a short crop and prices moved up slightly, giving hope to growers. But the good news was short-lived, as the 2005 harvest came in at epic yields that overflowed tanks. Good news and bad news came in 2006 with yields down from the monstrous 2005 yields, but with so much remaining in tanks, that the per-ton prices dropped in California Districts 12 and 13 to an average of $200-$300 a ton.[3] For many, that set overall grower returns to their worst point during the current cycle. According to one organization, 2006 prices in the San Joaquin Valley dropped on the spot market a minimum of 10-20 percent, with Merlot demonstrating a precipitous fall exceeding 50 percent.

### BOTTLED IMPORTS

The over-supply position from the large 2005 harvest is exacerbated by cheaper foreign wine which, in today's market, is a direct substitute

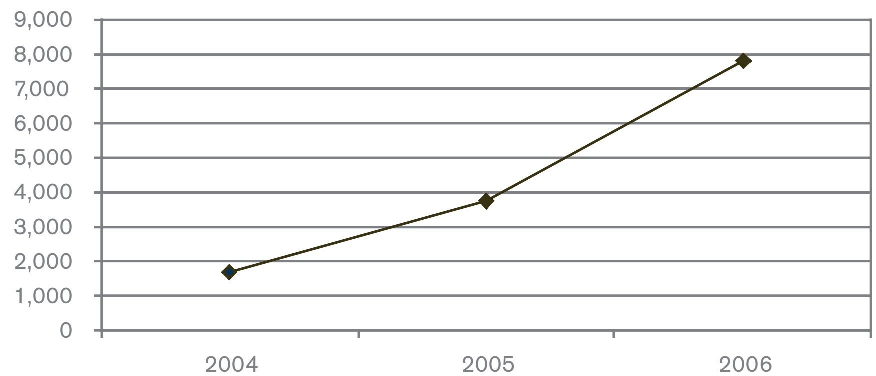
[2] San Joaquin County Agriculture Commissioner

[3] California Grape Crush Report , 2006

for non-appellation wines. Today, foreign wine sales make up a record 29.4 percent of the U.S. wine market, up from 27 percent in 2005. Foreign competition is not expected to subside. Simply said, the costs of many foreign bulk wines are less than what it costs to produce domestically. Global wine brands with multiple sourcing options, such as Gallo, Constellation and The Wine Group, have been particularly successful in dominating the market for lower-priced wines. To get a feel for the foreign wine penetration in price segments, Gomberg, Fredrikson reported that imports comprised 43 percent of the $5 to $7 price range, and 53 percent of wine sold between $6 and $7, price points historically filled by Central Valley and broader appellation California fruit.

### U.S. BULK WINE IMPORTS

(Australia, France and Argentina – 9 liter Case Equivalent)




*Source: Department of Commerce, Gomberg, Fredrikson & Associates (000's omitted)*

We picked up an interesting comment last year from Steve Spadarotto, senior vice president of operations for Diageo's Chateau & Estates division. He framed up the structural hurdle facing the California grape-growing industry succinctly. Spadarotto said his company's research has shown that a consumer's first consideration in picking a wine is price, followed by color, followed by appellation. But place-of-origin jumps to the top of the list for wines retailing for more than $10 a bottle. With roughly 50 percent of U.S. wine purchases below $10 and the majority of those wines made either from grapes produced in California's Central Valley or from off-shore, the issue of foreign imports at this price point comes into focus.

### BULK IMPORTS

According to a University of California, Davis study completed late in 2006, 60 percent of the largest wineries in California intend to source grapes internationally during the next three years. The growth is expected not only in imported bottled wine, but also in bulk wine being used by many wineries to fill large formats, for nonvintage brands, and for blending into domestic brands under a legal loophole.

### INTERNATIONAL BULK WINE PRICES

| | United States | Europe | Chile | Argentina | Australia |
|---|---|---|---|---|---|
| Chardonnay | $3.00 – $4.00 | $2.25 – $3.00 | $4.25 – $5.00 | $2.75 – $3.50 | $2.85 – $3.25 |
| Cabernet Sauvignon | $3.00 – $4.00 | $2.00 – $3.00 | $1.15 – $1.75 | $1.70 – $2.00 | $2.85 – $3.25 |
| Merlot | $3.00 – $4.00 | $2.00 – $3.00 | $2.00 – $2.50 | $1.70 – $2.00 | $2.85 – $3.25 |
| Syrah | $3.00 – $4.00 | $2.00 – $2.50 | $2.00 – $2.50 | $1.70 – $2.00 | $2.85 – $3.25 |
| Dry Red | $2.00 – $2.50 | $1.35 – $1.50 | $1.55 – $2.00 | $1.10 – $1.25 | $2.50 – $3.00 |
| Dry White | $1.90 – $2.25 | $1.35 – $1.50 | N/A | $0.75 – $1.00 | $2.25 – $3.25 |

*Source: Joseph W. Ciatti Co., LLC, March 2007*

To get an idea of the magnitude of the issue, consider the following: In 2006 bulk wine imports from Argentina, Australia and France alone reached almost the equivalent of 8,000,000 9-liter cases, a 100 percent growth rate over the prior year. That represents about 8 percent of the total production of wine grapes from Districts 12, 13 and 14 in 2006 in bulk wine alone.

The imports were used in several cases to supplant domestic grapes used by larger producers for non-appellation and nonvintage wines. Diageo this year will supplement French Pinot Noir wine in its previously all-Central-Coast-based BV Coastal brand to meet demand. Some domestic wineries have created brands based on imported wines such as Gallo's Black Swan, Red Bicyclette, Bella Sera and DaVinci labels to name a few. Other producers such as Woodbridge are importing Pinot Noir from France and Riesling from Germany to supplement their Classics series. But even moderate sized brands, like Don Sebastiani & Sons, have decided to import foreign wines for their own domestically bottled brands. Our own experience shows us that small operators are reviewing opportunities for selling foreign wine under domestic brands as well. As one industry insider said, "A boatload of foreign wine is just a phone call away."

March 2007 information from Ciatti Wine Brokerage noted that worldwide bulk supplies are still large, though reduced, particularly from Australia.

## FORECAST AND STRATEGIC RECOMMENDATION

Early in 2006 we forecast the following for the segment growing wine grapes for volume producers:

> "California appellation wines don't appear to have a significant brand advantage over the volume imports from many countries, and certainly their value proposition is in question, given (higher) costs. In addition, pistachios and almonds presently show better business fundamentals… Over the long term, without the benefit of some combination of favorable currency changes, outsized domestic consumption growth… or development of a brand image supporting the domestic consumption of Interior California wines, the high-volume end of the California wine industry is at risk of entering a period in which market metrics will be sustainably negative."

We believe that forecast was largely accurate, as 2006 revealed difficult pricing conditions for the segment, a 100 percent increase in foreign bulk wine imports, hangover problems from the large 2005 vintage, and additional acreage pulled out of production and replaced with tree crops. The combination of lower yields in 2006 versus 2005, and flat to lower pricing paid to growers, made 2006 a forgettable year for many.

For 2007, we reiterate our prior forecast, but note four important changes that will improve conditions over last year:

- In general, expect smaller bulk positions from Australia, Italy and Chile for many varietals.
- There is an emerging grape shortage in the North Coast that will increase demand for specific varietals, particularly in the northern Interior regions.
- The 2006 vintage wasn't as big as the 2005 vintage, though there is still more of it in the tanks that needs to move.
- Consumer demand continues to grow.

Reiterating the broad economics, according to growers with whom we've spoken, it takes about $1,500 an acre to produce grapes in the Interior. With yields at 7 tons per 1 acre, current prices do not produce the return a rational investor would expect. Consequently, finding ways to intensify mechanization, reduce costs, improve quality and remove outdated and low vigor vineyards should continue. Ideally, growers in the California Interior and elsewhere should work through quality and branding efforts to direct their grapes to wines carrying price-points above $7 retail.

Due to a combination of production efficiencies, cheaper labor, excess production, and less-expensive land, on average the wines are about one-third less expensive than wine produced from the Interior of California, as seen in the figure on page 14.

For California as a whole, the structural issue is a little more difficult to solve since large U.S.-based wine companies with the greatest marketing impact are often the ones bringing in the largest volume of imports. In fact the big wine companies appear agnostic about grape origins, and have demonstrated a predisposition to turn increasingly to lower-cost producers from any region for their domestically produced brands. For them, the major issues are margin and consumer price satisfaction.

## RESPONSES TO ISSUES

> *Charlie: "I'm sorry ma'am, I lied to you. I'm very sorry about that. That man right there is my brother and if he doesn't get to watch 'People's Court' in about 30 seconds, he's gonna throw a fit right here on your porch. Now you can help me or you can stand there and watch it happen."*

Grower associations are discussing many initiatives geared to improving their lot, from supporting legislation closing the 1942 loophole allowing the blending of up to 25 percent foreign wine, to funding viticulture research, to supporting export initiatives. Of particular importance, we believe, is a branding initiative. Growers in the Interior aren't just standing there and watching the gradual surrender of their market to lower priced foreign competition. Initiatives have started that aim to establish a promotional program directed at raising awareness of the quality of California wine grapes. We would encourage participation of the large wineries in the furtherance of this initiative, as it's not in their best long-term interest to remain ambivalent about their source of grapes, or watch their own historic supply removed from production permanently.

The best outcome would be a partnership of large wine companies and grape-growers that produce for the segment. That being said, at present we see no indication that large wine companies are willing to support such a branding effort. Consequently any promotional activity that takes place will likely have to come from growers and trade associations banding together to successfully raise the significant war chest needed to position these grapes as a better value than cheaper foreign wines.

## FINAL POINTS

> *Woman in the Casino: "What are you doing here?"*
>
> *Raymond: "We're counting cards."*

We can estimate supply and draw out trends all we want, but without "counting" the impact consumption has on the equation, no forecast is complete.

### CONSUMPTION

Though we still have a ways to go at 2.5 gallons per capita compared to France's 14 gallons per capita, we continue to increase our consumption of wine. It is now predicted that by 2010, Americans will consume 3.8 billion bottles of wine annually, making the U.S. the largest nominal wine consuming country in the world, ahead of both Italy and France. Where will those grapes come from to satisfy consumer demand? Since there are not sufficient cost-effective plantings, they will come from off-shore. The U.S. is the single biggest opportunity for exporting countries like Italy, Australia, France and others.

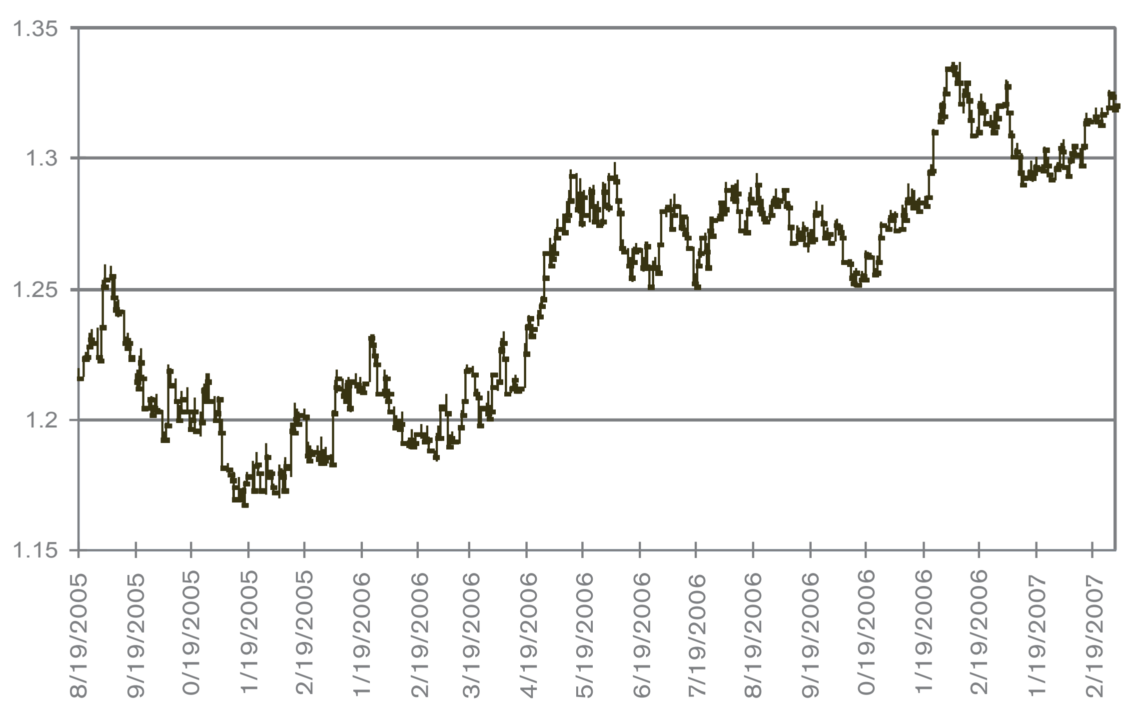
Wine consumption continues to climb, and climb aggressively for fine wine. The trend appears sustainable over the near term, subject to adequate grape supply according to the Wine Market Council. To the extent there are shortages in 2007, it will once again be filled with imports, as was the case in 2006 when imported Pinot Noir rose 68 percent in response to shortages in domestic Pinot Noir production.

In a special report to the Wine Market Council, President John Gillespie noted domestic wine consumption grew for the twelfth consecutive year. A large part of the growth is coming from core wine drinkers in Millennials who are showing a strong preference for wine. Gillespie's conclusion was that the consumer market for wine in the U.S. is better positioned for rapid and continuing growth than it has been since the early 1970s when the leading edge of Baby Boomers moved demand. The market growth we are experiencing certainly lends credibility to that argument.

Of course the wild card in consumption is the U.S. economy. We don't claim to have a crystal ball on that, but we do have an opinion. Our experience has been that in a recession, fine wine consumption drops at restaurants at the same time restaurants try and shrink their own cellars and slow their purchasing patterns. At that point, sales of fine wine are directed to off-premise accounts and discounting and promotions ensue. But in the last two industry downturns, recession combined with over-planting. Such is not the case today in the higher price point segments. If we see a recession, we are not likely to experience the same depth of excess that we have felt in the two prior downturns.

The exchange rate has several potential effects on the wine business. In the 1980s, a strong dollar made French and Italian wine imports quite inexpensive and made conditions in the fine wine segment difficult. Today, the weak dollar imports cost more. French oak is used extensively in the fine wine segment, and over the course of the past year, that price has increased as the Euro has crossed

EURO CHART




*Foreign Exchange*

## FORECAST AND RATIONALE

We believe the dollar has further to fall, despite being on a weakening trend since late 2005 versus the Euro, and feel it will still test the late 2004 Euro highs near $1.37.

The U.S. economy has lost some momentum, despite a strong employment picture and continued positive though slower growth, the housing market continues to weaken, led by the subprime mortgage sector and this will result in banks being more cautious about overall mortgage lending. In addition, oil prices have stopped falling and appear set to remain around $60 per barrel in the near-term, which will act as a brake on economic activity. Finally, consumer optimism has fallen and will translate into slower consumer spending; ultimately, this will impact business investment and employment negatively. We look for the economy to grow at around 2 percent for all of 2007 and for the Federal Reserve to remain on hold at 5.25 percent for the next few months, before they begin to cut rates later this year. We see Fed Funds at 4.75 percent by year end.

On the other hand, Europe's economic activity continues to accelerate and the central bank (ECB) is concerned about the inflation picture. The ECB is likely to raise rates more than once this year – the benchmark rates are at 3.50 percent currently. We expect them at 4 percent by year end.

The combination of narrowing interest differentials, diverging economic momentum, the twin budget and trade deficits in the U.S., and an increasing shift of central bank reserves away from the dollar and towards the Euro and other currencies will exert pressure on the dollar.

We see the dollar gradually drifting lower versus the Euro, perhaps to $1.35 by the middle of 2007 and towards $1.40 or slightly higher by the end of the year. It should stabilize next year as the U.S. trade deficit improves, and as a lower dollar increases.

## STRATEGIC RECOMMENDATION

For clients who have Euro payables (e.g. barrels and equipment), our recommendation is to lock in rates on any dip in the Euro under $1.30, with a view to being as fully hedged as possible through April and May. Obviously all forecasts are uncertain by definition, but we believe the balance of risks favor a stronger Euro by year-end and that any dollar rallies between now and then will prove shallow and temporary.

the $1.30 mark. That is bad for wineries that were unhedged in their Euro obligations. The weak dollar is a benefit for the growers in the Central Valley who are living on the margin of profitability, as bulk wine that is being purchased by domestic brands becomes more expensive with a weak dollar. Consequently, tracking the changes in the dollar versus the Euro is useful in planning.

**SVB SILICON VALLEY BANK'S PROPRIETARY PEER GROUP METRICS.** SVB 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 SVB Silicon Valley Bank's Premium Wine Group to monitor industry trends.

**ABOUT SVB FINANCIAL GROUP.** For more than 20 years, SVB Financial Group, the parent company of SVB Silicon Valley Bank, has been dedicated to helping entrepreneurs succeed. SVB Financial Group is a financial holding company that serves emerging growth and mature companies in the technology, life science, private equity and premium wine industries. Offering diversified financial services through SVB Silicon Valley Bank, SVB Alliant, SVB Analytics, SVB Capital, SVB Global and SVB Private Client Services, SVB Financial Group provides clients with commercial, investment, international and private banking services. The company also offers funds management, broker-dealer transactions, asset management and a full range of services for private equity companies, as well as the added value of its knowledge and networks worldwide. Headquartered in Santa Clara, Calif., SVB Financial Group operates through 27 offices in the U.S. and three internationally. More information on the company can be found at www.svb.com.

**ABOUT SVB SILICON VALLEY BANK'S WINE DIVISION.** SVB Silicon Valley Bank's Wine Division has the largest team of commercial bankers dedicated to the wine industry of any bank nationwide. It specializes in commercial banking for premium wineries and vineyards and the industries that support them. The SVB Wine Division opened in 1994 and has offices in Napa and Sonoma counties serving more than 350 clients. The Division continues to grow its client base in Napa, Sonoma, the Central Coast of California, Oregon and Washington. Wine Division employees are 100 percent dedicated to the wine industry, enabling the company to consistently support its clients through economic and growth cycles. By virtue of its dedication to the wine industry, SVB Silicon Valley Bank helps make its clients more successful with counsel on many aspects of their business, beyond traditional banking services. More information can be found at www.svb.com.

**CONTACT US.** For more information about this report or SVB Silicon Valley Bank's Wine Division, please contact us:

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STATEMENT OF THE OBVIOUS

We would be remiss if we did not mention that the above comments amount to our educated guesses and are for informational purposes only. Our recommendations too, are just our opinions. But no forecast is 100 percent correct and no data are perfect. Furthermore, our predictions are based on generalizations about the average winery. Of course, we know there is no such thing as an average winery. Each winery has a different financial situation, a different model and different competitive pressures; each needs to evaluate its strategy with that in mind. Nevertheless, we hope this dialogue helps you plan and evaluate in the coming year.