

2009-2010 State of the Wine Industry



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Forward

Jerry Maguire: I am out here for you. You don't know what it's like to be ME out here for YOU. It is an up-at-dawn, pride-swallowing siege that I will never fully tell you about, ok?

The 1996 movie *Jerry Maguire* tells the story of a sports agent living the high life of sports celebrity, with all the accoutrements: fancy cars, nice clothes, a beautiful fiancée, Rolex watch, hot car, expensive wine and membership in the local country club. Jerry told clients what they wanted to hear and made them fortunes by being loose

with his word and fast with his pen. Then one day it was all gone (except for the wine, in our Betamax version of the story). It's a hauntingly familiar story if you called Wall Street your home last year. Seven-figured high-flyers living in the Financial Center of the globe were taking risks that proved catastrophic.

The attitudes and preferences of the U.S. taxpayer and wine consumer are in markedly different places today than they were a year ago. If the prevailing mood in early September was disbelief, popular

opinion today places our Wall Street banker cousins somewhere beneath fungi, mold, roundworms and viral parasites. Along with the Dow, fine wine consumption tumbled in Q4, taking our retirement balances with it.

To be fair to our Wall Street relatives, the blame for our economic situation should be shared by some of our current and former elected representatives who are making some progress today, but doing an even better job of deflecting constituent scorn by vilifying others. Paradoxically,

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as of this writing, to bring about a happy ending to our economic fairytale and drive improved prospects for the wine industry, our elected officials find themselves in the awkward position of asking the same people undressed for public spectacle and pilloried in the court of C-SPAN to participate in a public/private partnership to rid the banks of toxic assets and restart lending. Someone should write a movie about it someday. But in the meantime, you will have to satisfy your curiosity by reading through our *State of the Wine Industry Forecast and Recommendations*.

Jerry Maguire: *But if anybody else wants to come with me this moment will be the ground floor of something real and fun and inspiring and true in this godforsaken business and we will do it together! Who's coming with me besides..."Flipper" here?*

Come with us in the following pages, and you will find our predictions for 2009 and 2010, as well as commonsense explanations for the present state of the economy and timing of a rebound, a view of the rapidly changing wine industry and practical advice from our experienced staff to guide you on investment strategy and tactics in the brave new world we face.

Executive Summary

Good News and Bad

Good news

- On a year-over-year basis, we predict slightly improved sales in Q2, flat sales in Q3 as the economy continues to

bump on the bottom, and positive Q4 sales. We believe the year will end essentially flat in terms of overall growth in the fine wine segment, and show modest growth in higher volume segments.

- Wine supply is running in balance to short.
- More electronic tools are available to support direct-to-trade and consumer sales.
- Per capita consumption continues to rise in the U.S.
- Credit is available for smaller wineries, though spreads have widened over Treasuries, the Prime Rate and LIBOR.
- Cult wines sold out their allocations in Q4.

Bad news

- Q4 2008 was the worst Q4 in memory for the fine wine business.
- Restaurant sales are depressed.
- We expect higher unemployment (exceeding 10 percent by year end), higher foreclosures and depressed consumer spending through the year as we seek a bottom. The economy will not return to the market experienced during the past decade.
- Price points below \$35 are selling, but wines between \$50 and \$125 are in a "dead space," with only established labels selling.
- Some wineries will trade hands this year at bargain prices.
- Distribution has all but ended as a viable sales channel for small wineries.

- Large credit extensions to single entities are harder to find, and syndicated credit markets are nearly frozen.
- The secondary market for collectable wines continues to soften.
- Drought conditions persist in California.
- Sin taxes are being widely applied to alcoholic beverages nationwide.
- Distributors continue to drop small brands from their books.

The Wine Industry at Large: Value Comes in Vogue

The next 12 months will be difficult for the fine wine segment, with declining growth rates and flat year-to-year sales overall. This is offset by higher volume segments that are experiencing good business conditions as consumers trade down to value-priced wines, for which positive year-over-year results are expected.

Down-trending economic conditions in the U.S. have exposed business models in the fine wine segment that were already in need of change, largely due to distributor consolidation. This will lead to some transitions in the near term at less-than-hoped-for prices. That said, the negative impact will be winery-specific and will depend on several factors including price points, brand strength, appellation, volume produced and most importantly, sales strategy.

"Supply in both the volume and premium segments is in balance overall, which is a significant positive factor."

Supply in both the volume and premium segments is in balance overall, which is a significant positive factor allowing for less discounting than would otherwise be the case. The opportunity to raise prices, however, is limited at present for producers and growers alike, though growers in volume segments may have a little more upside negotiating room this year depending on the strength of the dollar, corresponding prices of foreign substitutes, inventory levels in large scale producers and consumer spending.

With continuing increases in per capita consumption, planting should take place as non-bearing acreage is below vine replacement levels. That said, a number of factors will lead to continuing shortages in vineyard planting: falling asset prices, the high cost of land, lack of committed contracts, confusion about pricing in a deflationary economy, uncertainty over the strength of the dollar and the consequent impact of imports, credit tightening and general fear. Because we see a lack of development today, growth in the U.S. wine industry will be eclipsed by imports. We acknowledge those plantings have to be in the right places and at prices that the market will support in bottle price.

Feedback from the 2009 SVB Wine Conditions Survey shows winery owners believe 2009 will be a difficult year, with Central Valley suppliers the most optimistic and Napa and Sonoma suppliers the most pessimistic. Oregon producers are more optimistic than their California fine wine counterparts, but they may be overly optimistic in our opinion.

Large-Scale Producers: Ever the Optimists

Dorothy: I just want to be inspired.

The SVB Annual Wine Conditions Survey suggests this segment is appropriately the most optimistic and inspired segment, with many expecting solid growth rates in the coming year and improved contract prices at the grower level. It's an assessment with which we agree. Only a strengthening dollar opening the door for higher volumes of cheaper imported bulk wines, deepening economic problems, tariffs and protectionism, possible higher carried inventories in large producers that right-size later in the year and water restrictions could moderate the opportunity.

Fine Wine: Growth Declines and Sales Stay Flat

Jerry Maguire: Jump in my nightmare, the water's warm!

Despite declining growth rates and nightmarish results in the fourth quarter of 2008, we predict wine sales will be sluggish through the early part of 2009, but finish the year with a better Q4 thus creating flat year-over-year sales in the segment. While zero growth is comparatively good in this economy, a growth rate that has fallen from 23 percent to zero percent in 24 months causes many problems for a business that has long-term contracts with growers and has to commit to production and inventory positions well ahead of the kind of financial collapse we experienced last year. This will inevitably lead to declining gross and net profit margins over the next two years.

The fourth quarter of 2008 saw winery level sales slow precipitously into negative growth territory compared to Q4 in the prior year. Full-year growth rates in 2008 were modest, but positive, however. Distributors and restaurateurs aggressively worked down inventories in the last quarter of 2008, sending a demand shock through the business when they held off reorders. But we believe depletion-level sales still took place, albeit at a slowed pace, based upon information we have developed from various industry sources,

“Despite declining growth rates and nightmarish results in the fourth quarter of 2008, we predict wine sales will be sluggish through the early part of 2009, but finish the year with a better Q4—thus creating flat year-over-year sales in the segment.”

which include proprietary financial information, surveys distributor-level depletion information, retail and winery interviews. During the market collapse in Q4, even expensive wine was still being consumed, but distributors were not ordering and overall winery-level sales in Q4 were dismal with more expensive wines suffering disproportionately more. Sales in Q1 are still negative compared to the prior year, but we believe the U.S. economy will start to bottom out during 2009, and consumption will pick up requiring inventory restocking.

On a year-over-year basis we are forecasting slightly improved sales in Q2, flat sales in Q3 as the economy continues to bump on the bottom, and positive Q4 sales. We

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believe the year will end essentially flat in terms of overall growth in the fine wine segment. Inventories in the cellar were built for higher growth assumptions, so we will expect some bulk eliminations and reduced contracted demand for purchased grapes during this harvest.

A zero percent growth rate would be coveted in most businesses these days, but this “good news” masks the truly tumultuous change underway in many family-owned wineries, which is causing predictable capitalistic Darwinism in the weakest businesses on the one hand, and allowing market share growth among the best run businesses on the other. Furthermore, flat growth when inventory positions were built for higher growth will produce compressed margins.

General risk conditions have increased substantially for owners, investors and bankers alike, and action is required to navigate rough conditions both today, and in a less vibrant landscape that will emerge after the official end of the current recession. The next year will produce transitions in some wineries at distressed prices.

The Economy

Rod Tidwell: Show me the money!

Investment bankers held this as a motto early in 2008, but by the end of the year, many were looking for work, and in their place it was the U.S. taxpayers who were asking the very same questions of some of the same people. We wish we could just improve the situation with the snap of our fingers, but we still have a way to go to find the real bottom of this recession. It is coming, but we believe 2009 will not

produce an end; instead, we anticipate higher unemployment (exceeding 10 percent by year end), higher foreclosure and depressed consumer spending through the year.

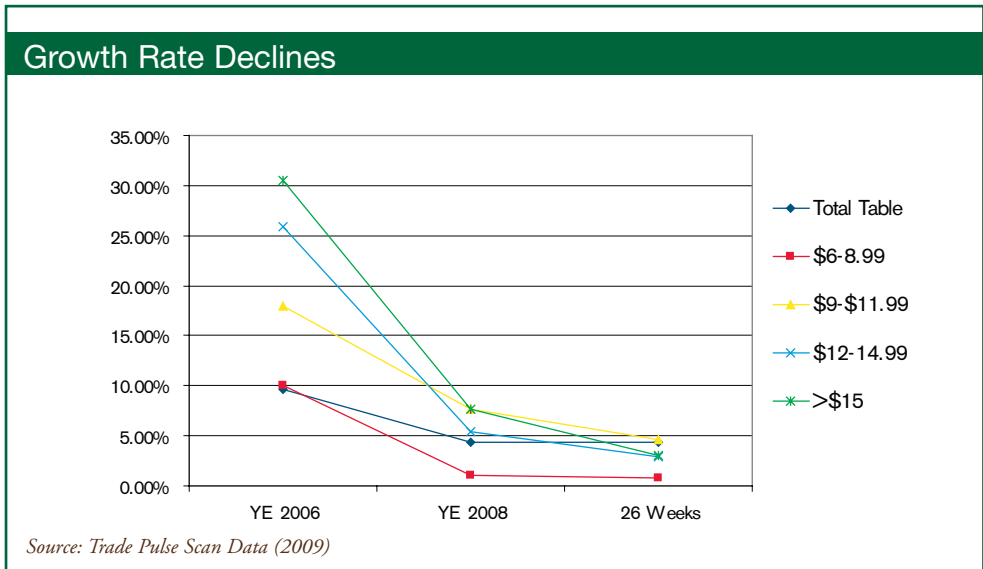
While the stimulus is unlikely to have a significant impact this fiscal year (based on administration estimates of timing and spending), we believe the actions of the Fed are improving credit conditions, and eventually those massive interventions will have a positive impact and the rate of impairment in market conditions will slowly fall, leading to a bottom in the economy in Q1 or Q2 2010 before starting a modest improvement in business conditions. The stock market as a leading indicator is likely to remain highly volatile, but it should see improvement in front of the upturn in business. Once the recession ends, business conditions will not return to what we had previously experienced over the past 20 years, as tail-end scenarios of a recovering economy all include negative impacts related to the trillions being spent to stem the current problems.

2009-2010 State of the Wine Industry and Recommendations

The U.S. Wine Industry Primer

The U.S. wine industry, a \$30 billion business according to the Wine Institute, has been growing in its allure for corporations and many wealthy investors over the past 30 years. The industry, predictably cyclical in 7- to 10-year increments bracketed by undersupply and overplanting, has seen tremendous growth — particularly in the decade of the 1990s when a record number of new wineries formed and planting levels increased.

For a perspective on how the cycles work, let's look at the most recent bottom-to-bottom cycle, beginning with 2001 as a low point. Early in 2001, the economy softened, the tech bubble burst and over planting from the late 1990s created over supply as vineyards came into mature production. Restaurant sales slipped with the start of the business-led recession, and then



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plummeted after 9/11. The growth rate in the sales of fine wine dropped from more than 25 percent in the mid to late '90s, to just 5 percent by 2002.

Unprepared for the supply shock that hit the system after 9/11, many premium wineries were left holding high-inventory positions that needed to be discounted to move. For many Cabernet producers, the negative impact of the 2000 vintage year widely covered by the press further exacerbated the problem, and buyers decided to wait for the 2001 vintage. The lower growth rates in fine wine and slowing restaurant sales that ensued from the tech recession soon reversed as employment numbers held relatively well and home prices ballooned, causing many people to continue to feel wealthy. Consequently, consumers continued spending right through that recession, and by the end of 2006 the premium business was flying high again with growth rates above 20 percent, while the lowest price points were lagging. "Trading up" was the catch phrase of the day, explaining the consumer preference for higher priced wines. But that recovery was triggered by the Wealth Effect,¹ which was based on false home values. It was money consumers felt they had available to spend. This phenomenon is clearly not the case in the current recession.

Fast-forward to the present, and the term "trading up" has been turned on its head; "trading down" is the new catch phrase to describe the business. Consumer spending hit the skids in 2008 and value came into vogue. Unlike the last recession, in which fine wine held its own on market share with higher volume producers, in the

present recession we see the volume in wine consumption still growing slightly, but the more modest price segments experiencing better resiliency in their rate of growth. Also, unlike the past recession in which consumers quickly resumed purchasing wines at high price points, the destruction of consumer wealth along with what are predicted to be muted business conditions and business spending after the recession is over, will likely keep price pressure on wines over \$35.²

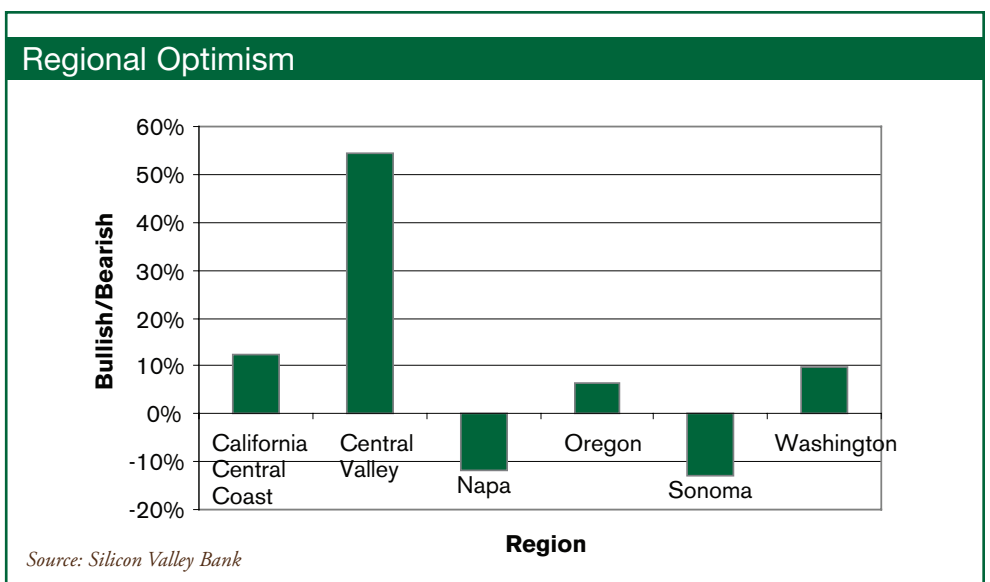
Wine Conditions Survey³: What winery owners say

Results from the 2009 SVB Wine Conditions Survey show winery owners believe this will be a difficult year, with Central Valley suppliers the most optimistic, and Napa and Sonoma the most pessimistic. Oregon producers are more optimistic than their California fine wine counterparts. While there may be some basis for that given generally lower prices in Oregon, we believe there may be more planted acreage than presently needed in the state. We suspect

distributors that helped the market grow when Pinot Noir was in severe shortage in the market may drift back to higher volume suppliers in California if Pinot Noir becomes more readily available there.

Other opinions noted in the Wine Conditions Survey:

- Size of winery: There is increasing optimism for smaller versus larger wineries. One can only surmise the impact is related to the smaller wineries' direct models, which cause their owners to feel they have greater control over their direct sales, versus larger wineries. Small wineries also wield the least amount of influence with distributors.
- Price points: Companies are more pessimistic as their price points increase with \$40-65 and >\$90 the most concerned. Our own experience is that under \$35 works for red wines (less for white), \$35-50 is a gray area and \$50-125 is a dead zone with only the best brands doing well. Ironically,



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wines that can sell for more than \$125 to this point are selling out. There is a question about a bulge in the secondary market for collectable wines, however, with restaurants and consumers moving bottles in their cellars to generate liquidity and the secondary market experiencing reductions in the gavel prices.

- Longevity in business: The more time our respondents have spent in the business, the more pessimistic their response. Wineries in business one to four years were the only group with a positive outlook. The result is slightly counterintuitive, but we think it has to do with smaller wineries dominating the startup results. They are more focused on a more successful direct approach. Of course, the other possibility is that the guys who have been doing this the longest are just plain grumpy and tired.

Adding to the good news, the U.S. broke through the 3.0 gallons per capita mark of consumer consumption in 2008. While a new high for the country, per capita consumption is still five to six times less than the major wine consuming countries of France and Italy, demonstrating there is still ample upside growth.⁴ According to the International Organization of Vine and Wine, the U.S. became the largest consuming country of wine in 2008 in total consumption ahead of both Italy and France. The home court advantage is nice, but that newfound status also makes the U.S. the single biggest target for exporting countries that are suffering their own economic tribulations and will look for opportunities to sell where they can.

High-volume production

Dorothy: Maybe love shouldn't be such hard work.

Talk to farmers and you will discover optimistic people who love what they do. But over the past several years, growers in the high-volume segments suffered through lower demand due to overplanting. That was subsequently magnified when large-scale wine companies extended their traditional sourcing to include foreign bulk wine. The change in sourcing replaced grapes that had been purchased historically from domestic growers. Even guys who loved what they do couldn't do it for free.⁵ Starting in the early 2000s more than 100,000 acres of production were removed in California, mostly in higher production appellations. Then just as supply and demand seemed to be normalizing, the tech recession evaporated, trading up reasserted itself and 2005 produced a record crop size lowering price for the 2004 crop year. The series of events was discouraging for long-suffering producers and made many wonder if they would ever see fair profits and just a little love from buyers again.

Now in a reversal, worldwide oversupply which was present for years has now been demoted from "lake" status to "pond" status, and the concentrate market that essentially puts a floor on that business is extending better pricing than has been seen in years. Consecutive years of moderated yield have reduced wine in domestic tanks, and the recession is driving consumers to value pricing.

As a consequence, the supply of grapes is presently better balanced than it has been since the late 1990s, and contract pricing has improved to the point where many, if not most, growers can make at least a modest profit. In a sign of optimism for the segment, for the second year in a row several knowledgeable industry participants cautiously suggested that planting the right varieties in the right locations under contract would be advisable given current supply.

In a continuing unfavorable trend, according to Gomberg-Fredrikson, full-year imports of foreign bulk wine grew at an astonishing 27 percent (13.2 million 9-liter case equivalents) in 2008, further commoditizing the lowest price segments. A strengthening dollar or a weak harvest could accelerate this trend. Water supply in draught-stricken California may also have a destabilizing effect regionally, reducing supply from some vineyards and enhancing value from another.

Other issues that may emerge (but for which the scale of impact is impossible to predict) include tariffs and protectionism, in addition to higher taxes on alcohol from both state and federal lawmakers that can affect lower priced wines to a greater extent than higher priced wines. We are also aware anecdotally of current higher carried inventories in some large producers. We are unable to fully determine the depth of the situation as of this writing, but if it's sizable and widespread, it also may affect harvest purchasing decisions later this year and contract pricing next year.

Fine wine production

Laurel: *Don't cry at the beginning of a date. Cry at the end, like I do.*

Fourth quarter 2008 was the worst Q4 we can remember for fine wine sales at the winery level. But like Laurel in the movie, we remind people this is the beginning of the date and it's the wrong time to start crying. If you are going to presume that 2009 will be like Q4 2008 multiplied by four quarters, you might convince yourself into jumping off a tall chair with a short rope. That position would be a little too negative, and there is still plenty of time to cry later.

Good news

Let's start with the good news because it exists even in today's market. Unlike the last recession earlier in the decade, neither the segment nor the industry is sitting on large unsold inventories in the cellar, which would otherwise force even greater discounting. For the most part, the fine wine segment has inventories that are in balance with demand.

Since we are neither experiencing large negative declines in average consumption as far as we are aware, nor are there large stocks of non-bearing acreage to account for, we expect supply to remain in a balanced state for the next year at least.⁶

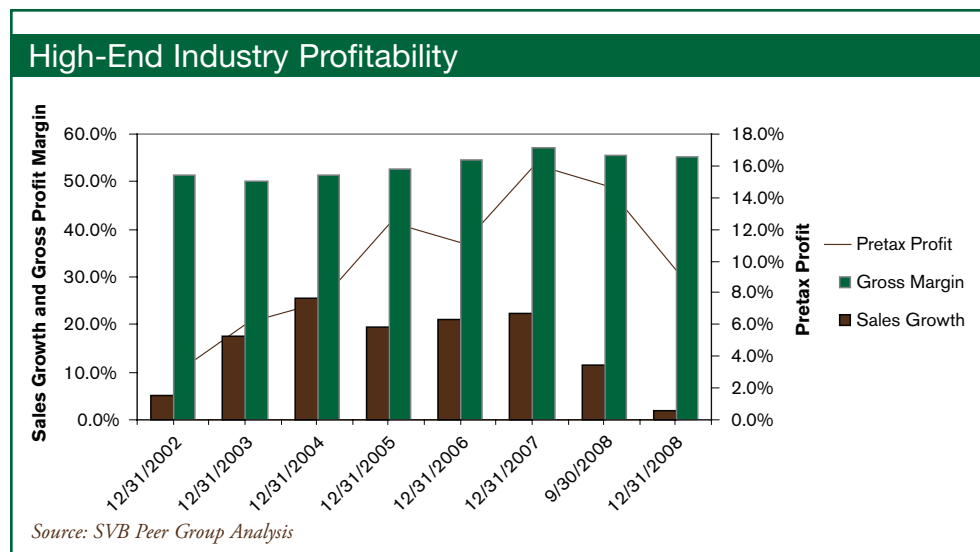
Adding to the good news, domestic consumption of wine continues to increase per capita, and there is every reason to believe that trend will continue. After discouraging sales at the winery level in November, the months following have been good. In talking to distributors, we are told depletions did not stop, though they were softer than in the same period the prior year. People are definitely still drinking. (With all the bad news, it's hard not to drink!) The other good news is the price of potential substitutes from France, Italy and Germany have all dramatically increased since 2001 causing volume reversals in bottled imports from all countries except Spain.⁷

Consumers still aspire to luxury consumption—albeit only “inconspicuous consumption” for the present, given social sensitivities. Per capita consumption is still

climbing. While there is abundant bad news, it's offset with wine businesses that are still doing well, even in this depressed market. Those models that are performing better include established brands, cult and near-cult brands with allocated mailing lists, wineries with established direct-to-consumer models that already have a good handle on customer relationship management, regional wine operations with concentrations of local sales in economically sound geographies and larger-scale production wineries that sell wines under \$35 price points.

Financial performance

Financial performance in the fine wine segment gave many participants a whiplash in 2008. Early reports using proprietary and still unaudited financial information from SVB showed that sales



	12/31/2002	12/31/2003	12/31/2004	12/31/2005	12/31/2006	12/31/2007	09/30/08	12/31/08
Sales Growth	5.2%	17.6%	25.5%	19.4%	21.2%	22.3%	11.6%	2.0%
Gross Margin	51.5%	50.2%	51.5%	52.8%	54.5%	57.1%	55.5%	55.3%
Pretax Profit	3.2%	6.3%	7.6%	12.6%	11.3%	16.3%	14.9%	9.5%

Source: SVB Peer Group Analysis

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growth through Q3 came in at 11.6 percent annualized, then fell to just 2 percent sales growth at the end of the year as many wineries reported a poor October followed by a gut-wrenching November.

Sales growth for the segment in Q4 was negative. Sales in December were slightly better, and the first quarter of 2009 also appears to have produced improved results compared to Q4, but decreased sales overall when compared against Q1 2008. Unaudited gross and net profit estimates of 55.3 percent and 9.5 percent, respectively, should be adjusted downward as wineries complete work with their CPAs.

Bad news

Wait that was the good news?

The fine wine industry, which has demonstrated percentage growth rates in the low twenties and high teens for some time, has reached a tipping point where the weight of the economy and both distributor and retailer consolidation have teamed up to tilt some business models in the direction of failure. But despite a tough economy and severely affected restaurant segments, we still predict flat year-to-year rates of growth. That said, the modest sales forecast masks the truly tumultuous change underway in many family-owned wineries.

Emerging trends resulting from distributor consolidation and evolving consumer preference patterns (both covered in prior State of the Wine Industry reports), have been magnified by falling restaurant sales and the worst recession since the 1930s, causing a reexamination of priorities and opportunities with many family-owned wineries.

Distribution

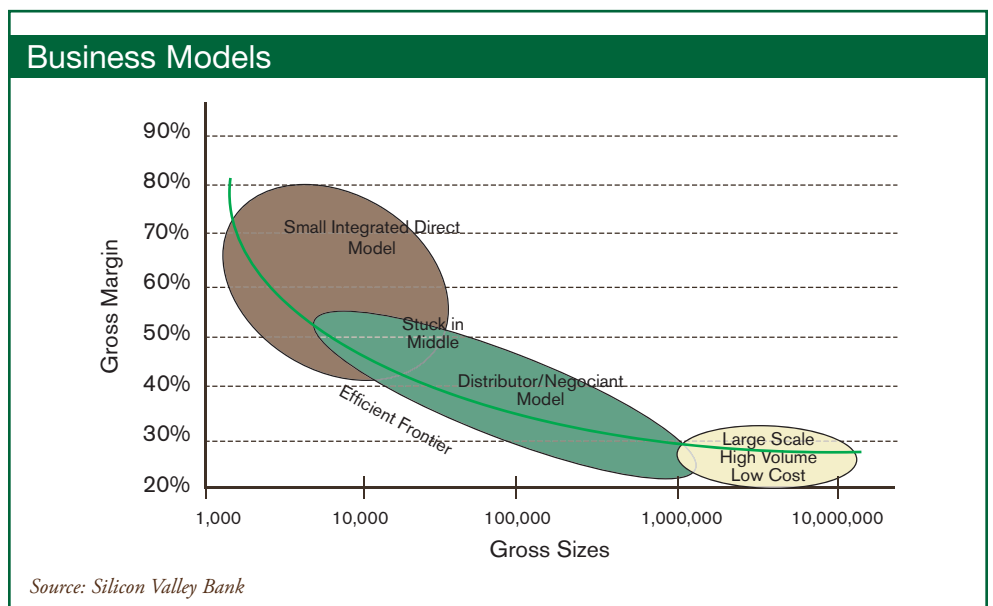
Avery Bishop: *There is no real loyalty, and the first person who taught me that was you.*

In the past year, distributors have dropped hundreds of small brands from their portfolios, citing them as unprofitable. And we see a continuing trend of bigger producers aligning with national distribution. It hasn't always been so.

When SVB began its dedicated wine practice in 1994, it was common to see successful models in nearly all volume segments and price points. Micro-brands seemed to thrive right alongside estate operations, 50,000-case wineries and smaller businesses; all through a nationwide distribution model of regional distributors. Of course, there have always been some who were more successful than others, but the opportunity was there to manage a small winery in a marginally profitable manner and let the distributor

sell the wine and handle compliance and logistics. The landscape has evolved due to consolidation of distribution and retailers, changing buying patterns of younger consumers and the Internet.

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 has been increasing almost daily, precise information is not available and distributors are still consolidating. The most recent available data suggest there are about 6,000 U.S. wineries producing conservatively about 7,000 wine brands.⁸ Those brands have to squeeze through an estimated 550 distributors — half the number of 10 years ago — or find alternative distribution channels to reach the roughly 76 million wine consumers in the U.S. According to estimates from Gomberg-Fredrikson last year, the top 10 wine companies accounted for 82 percent of total domestic shipments.⁹ That leaves the other 5,990 wine



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companies fighting over the remaining 18 percent of available space in wholesale channels. The predictable result is that it's been increasingly difficult for smaller producers to find good representation. Now, the current recession has exacerbated the problem and accelerated the trend beyond the ability of some wineries to adjust and move into a new sales channel fast enough.

After interviewing more than two dozen distributors in confidence, we discovered, not surprisingly, that the economy is taking a toll on their businesses and margins as well. In an effort to stabilize their own returns, most have taken rational actions to become more efficient. Noteworthy to the fine wine producer, they are eliminating less important brands, smaller brands, slower moving brands and those brands that deliver fewer nominal dollars to their business. Furthermore, we have not found any mature distributor willing to take on new brands or labels. These actions hit square in the center of the fine wine business.

While there are numerous startup distributors who believe they can use this trend to their advantage and expand their own markets by taking the leftovers from large distributors, those newer distributors are often undercapitalized, especially in this environment. On the selling side, they have to fight for accounts against the larger distributors that have more influence with the end retailer.

Some of the newer distributors will find success by watching for larger distributors to react to the recession and vacate lower volume territories and fragmented retailers

in favor of more efficient ones. But that is only an emerging opportunity that will need to play itself out. It won't be much help this year for most producers looking to go to smaller distributors in smaller markets.

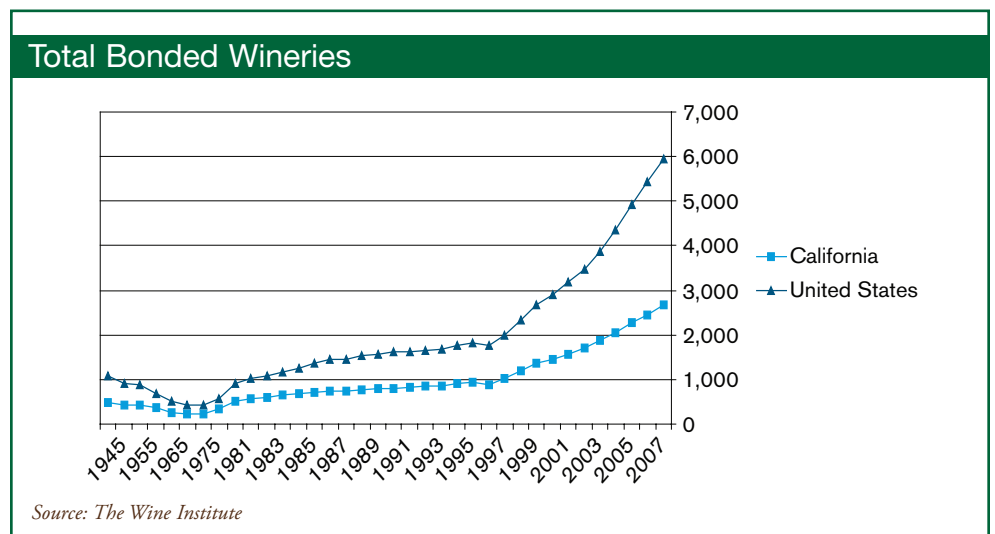
Our business models chart on page 8 depicts the landscape. The trend of distributor constriction and current distributor brand tactics have two consequences. They force a smaller fine wine producer more rapidly to the direct market for higher margins (moving to the left and up in the chart), or imply they need to get bigger to retain their importance to a distributor, (moving down and to the right in the chart). Getting bigger means building inventory and borrowing more, and that is a roll of the dice in a flat-growth market for small wineries. The second option to scaling bigger is acquisition or an outright sale, but these options are still difficult in today's tight credit markets.

For most small brands, the best opportunities are in direct-to-consumer marketing strategies. Finding the right

strategy may become absolutely critical to a winery's success, if not its outright survival during the next several years. But being stuck in the middle — too small to get distributor attention and at the same time, too big to position wines at higher price points — is proving increasingly unworkable as a viable business strategy.

Even at this stage, somewhat early in this economic tumult, we have noticed some wineries quietly change hands at prices that would have been considered bargain prices less than a year ago. We believe the trend will likely continue to accelerate.

The most likely candidates for transitions like this are newer brands that never established a viable sales channel, brands and properties that were under development before the market crash, modest-to small-scale producers selling through distribution, wineries largely focused in the restaurant trade, low price-low volume wineries and wineries carrying too much leverage. We are describing wineries on the edge of the risk curve, and many in the segment will see real sales



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setbacks and losses in 2009 without rapid adaptation.

Like any business segment, this economy will expose the weaker players in the wine business and capitalistic Darwinism will play its role in right-sizing the playing field and strengthening and streamlining the survivors. Since most of the U.S. wine industry started subsequent to 1980, and this kind of recession is historic, it is worth noting that we are experiencing entirely new operating conditions today, and management teams can't go to a past playbook for answers. New rules have to be written, and that will challenge many management teams that were used to a fairly slow rate of change.¹⁰

The delicate balance of supply and demand

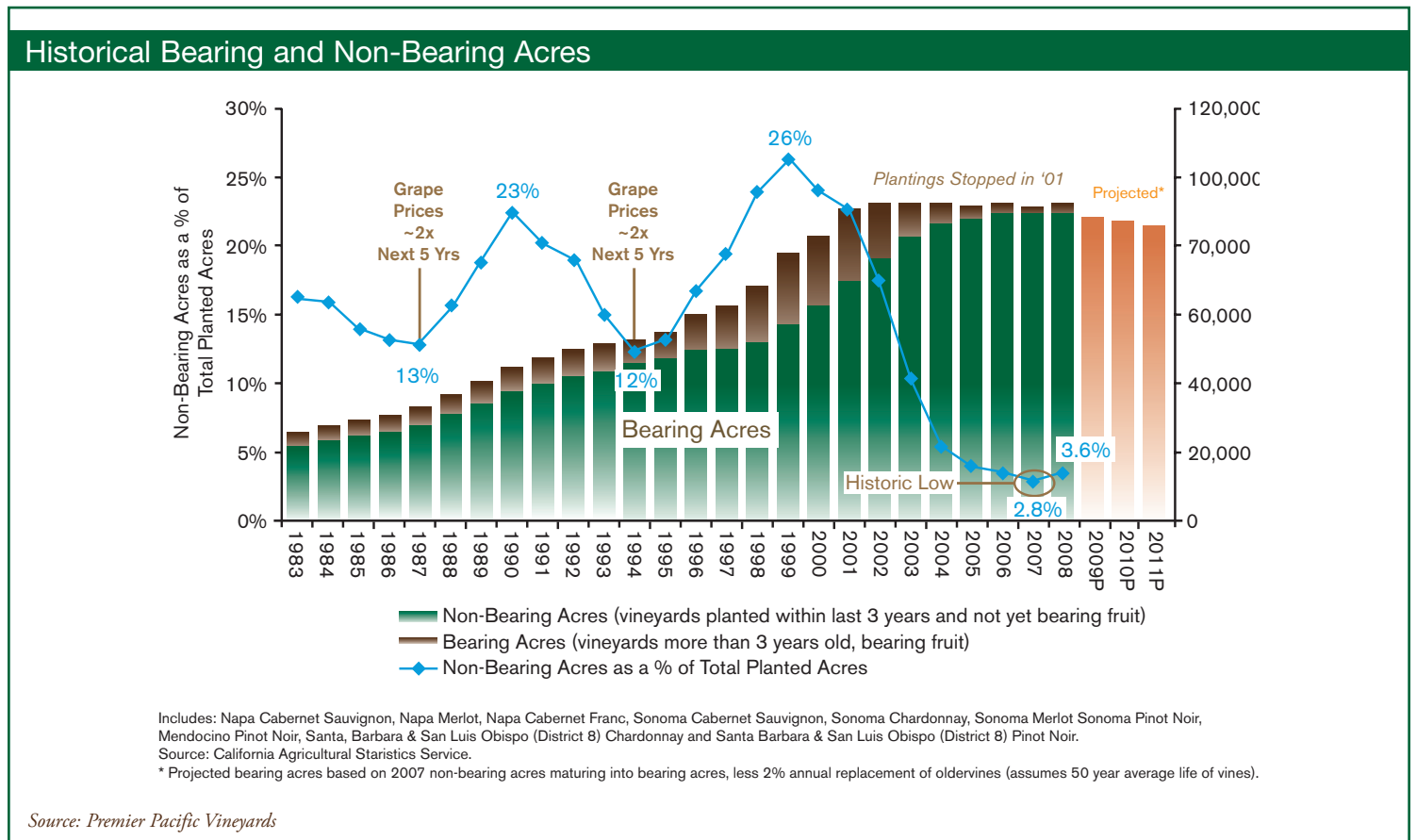
Land

Jerry Maguire: This is going to change everything.
Dorothy: Promise?

Supply starts with land in production. We have grown accustomed to long agricultural swings in overplanting leading to oversupply until demand catches up. But what we are experiencing might change everything we have become used to in the land cycles. Up to this point, high vineyard costs in the established appellations have been supported by consumers trading up to high-priced wines, allowing for cheaper

foreign wine to take growing market share underneath. In the past decade, unplanted acreage would never get to 3 percent non-bearing before plantings would take over, thus spurring the next cycle. But this time, planting has not picked up despite non-bearing acreage below both growth rates and replacement rates, and it's been like that for several years now. Why the difference?

We believe cheaper imports, a more experimental consumer and the Internet making quality comparisons easier and imports more available are together changing the game. Add in a recession that moves the consumer from trading up to trading down and better supply-and-demand



information for the industry as a whole, and we may be at a point where we will not see the same kind of cycles that had become normal in the fine wine industry in decades past. We are not ready to call a long-term end to the pattern of trading up because consumers still aspire to better goods. It's more likely a little lull in the trend. But consumers don't have to buy domestic products when trading up comes back, and growers will correctly choose not to plant if there aren't buyers for their grapes going into the right-priced wines. In either case, it's not likely investors will plant large swaths of vineyards as long as good value imports are available and the dollar stays strong.

Regarding overall land values, this recession will lower appraised values of properties in the business on the whole, but the best properties will retain value and even see increases given their scarce nature. With a setback in the purchase of higher priced wines, discounting will emerge in some bottle price/quality ranges, which will eventually lead to concessions from those growers producing that fruit, and finally lower land prices in vineyards that are producing lower returns on their investments.

Grape and Bulk Supplies

Jerry Maguire: *How's your head?*
Rod Tidwell: *Bubblicious.*

Managing the volume of inventories at the winery level is probably one of the most critical jobs in running a winery. Depending on year-to-year yields and predictions of growth, this activity is

full of SKU bubbles each year, leading to potential discounting and problems with shelf pricing on the next vintage. It's obvious that cost in the supply and demand equation will take on a larger role this year, even in a balanced and "bubblicious" supply situation.

In the 2008 SVB Wine Conditions Survey, we asked wineries on the West Coast what they thought about the inventory supplies in the cellar. At that time, 90 percent felt they had either adequate or short supplies in the cellar. Our conclusion back then was that in general for fine wine, supply and demand were about in balance on the whole. Though sales growth slowed during the 2008 year, non-bearing acreage has not grown and is now below the 3 percent level often cited as a minimum replacement level for vines. Further, the 2008 harvest was light in general. Finally, in reviewing our clients' inventory positions, wineries are not sitting on large excesses of wine, and that allows for a little more patience from producers to find where monthly sales levels will fall in these uncertain times.

As of this writing, there is a question raised about some of the larger producers relating to the number of days worth of inventory they are carrying. Our sources suggest those positions may be high, but we have no present confirmation of that situation.

To get a better perspective on supply, we need to look past the inventories at the winery level, since it's their job never to have too much wine, even in an oversupplied market. Examining the relationship between vineyard production/

yield and the dollar sales of varietal wines gives us another indication of what is in the production queue.

We use 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 the supply of \$15 and above wines. It's not a precise examination of the balance, but it's another indicator that gives us a better feel.

In a perfect world, we would like to see a chart that has a ratio of harvest yield to sales growth of zero percent, indicating there were just enough grapes supplied in the current year for demand. We always prefer to have relative supply in balance, or even slightly short, (as indicated by yellow boxes on the right of the chart) because that offers the best opportunity for the best returns for growers and producers alike.

Taken together, we believe high-end supply and demand is in balance for the 2009 crop year and could run short in high-end Cabernet depending on sales affected by recession.

Merlot and Cabernet had short harvests in 2008. Cabernet sales were good in dollar terms, and while Merlot sales were modest, we believe some of the volume of Merlot went to support higher Cabernet growth. Merlot is still slightly long in the high end of the market, but it is now closer to a balanced state than might have been predicted prior to harvest. Without the recession, we would suggest Cabernet supply for the fine wine segment was short now, especially considering a weak yield in the San Luis Obispo region, where the

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harvest was down the equivalent of more than 1.4 million cases. Pinot Noir is still short on average, but it is more balanced than it has been in the past several years, and sales growth of the varietal has slowed from the high rates of growth triggered by the movie *Sideways* over the past several years to a still healthy 11.3 percent.

Marketing and selling fine wine: Tone it down

Dicky Fox: *If this [points to heart] is empty, this [points to head] doesn't matter.*

Understanding what the consumer is feeling in this recession is key to selling wine. Consumer behavior in luxury markets has drastically changed in the past six months. The most important changes for the marketing of fine wine are:

- Conspicuous consumption has changed to inconspicuous consumption.
- Consumers have lost faith with

institutions and seek non-institutional and authentic products.

- Price matters and “aspirational brands” that sold to the aspiring wealthy have been hardest hit.

Bling has given way to understatement today. Public criticism over the unsympathetic actions of Wall Street and Detroit auto executives has led most socially conscious consumers — who might still have the desire and means for luxury purchases — to go underground. Luxury apparel brands were quick to pick up on the trend, marketing less ostentatious offerings, trending back to soft neutrals, more traditional looks and raised necklines. One high-end watchmaker this year came out with a new offering that included a patina finish, making it look like an antique. The takeaway for fine wine sales is that marketing using a *Lifestyles of the Rich and Famous* approach may actually come off as

vulgar today. Consumers still aspire to luxury and always will, but today for the highest priced wines, you may even have to assuage a consumer’s feelings of guilt for having the means to afford a very expensive wine. Add a component of social consciousness of your own, perhaps donating a percentage of each sale to a cause, for example. A wine estate owner today can’t be identified as a rich winery owner. Better brand positioning would be as a family farming operation.

And that brings us to the next point: At a time when consumers have lost faith in “the Establishment” — both the corporate and Washington status quo — authenticity has become one of the most important aspects in a consumer sales strategy. Mass-produced goods are not authentic. According to some researchers of consumer trends, hand-made products are of far more value in gift-giving today than a year ago. This is a trend that favors the family wine producer since

Napa and Sonoma Dist 3 & 4	2007 Yield (tons)	2008 Yield (tons)	2008 Growth in Yield	2008 Growth in Sales (Dollars)	Ratio of Harvest Yield to Sales Growth	Relative Supply			
						2006	2007	2008	2009
Chardonnay	82,665	76,272	-7.73%	5.20%	-1.49	Short	Short to balanced	Balanced	Long
Sauvignon Blanc	20,742	22,094	6.52%	7.70%	0.85	Long	Long	Long	Long
Cab Sauvignon	99,956	75,398	-24.57%	9.10%	-2.70	Short	Short to balanced	Balanced	Long
Merlot	44,110	28,183	-36.11%	2.80%	-12.90	Short	Short	Short	Short to balanced
Pinot Noir	38,237	37,227	-2.64%	11.30%	-0.23	Short	Short	Short	Short to balanced
Syrah	11,329	7,228	-36.20%	-1.90%	19.05	Long	Long	Long	Long
Zinfandel	18,703	15,220	-18.62%	5.20%	-3.58	Short	Short to balanced	Balanced	Long
Overall Premium						Short	Short to balanced	Balanced	Long

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

these products are about as authentic as they come. The takeaway from this trend is that wineries need to play up the hand-crafted production of their product and emphasize the detail and care they take in producing wines for their consumers. That may take the form of a packaging change, so someone in a grocery store can tell your bottle was touched by human hands. For a self-made person or winery owner who bet it all to make wine their life and succeeded, talking about humble beginnings and hard work may be a point of connection with your consumers today. But in all cases, finding ways to touch the consumer of your product through electronic and or direct contact will be more important than ever for fine wine sales.

Price: Focus on perceived quality first

Rod Tidwell: Anyone else would have left you by now but I'm sticking with you. And if I have to ride your ass like Zorro you're gonna show me the money.

In the late 1990s, if you had good wine, you could almost take an aggressive position with distributors and direct clients at the same time. I remember one client at the time who said, "I only sell wine to people I like. If I don't like you, I'm not selling you any wine." Honestly, I appreciate that perspective in relationships since nobody ever wants to deal with an ass either in business or in personal life. But string together some soft years in sales and for a single transaction at the right price I don't know.

The amount of wealth destruction we have seen in this economy, and the fear emerging from such a bad Q4, can make anyone start to panic and drive straight to the conclusion to drop the price. That may be a solution, but we would suggest reading a little further for our perspective on that. A few of our clients have tried the other approach — raising prices in this market — and we can report their efforts were met uniformly with anger. While a consumer may not really care that much about the retail price between a wine that is \$17.99 versus \$18.99, distributors and restaurants are offended when a winery suggests raising prices today, in the same way that a winery owner will be irritated if a winemaking consultant raised his or her consulting fees today. Increasing bottle prices is viewed by restaurants and restaurateurs as unsympathetic at best, and at worst, it's the Wall Street and AIG bonus syndrome repeated. That said, direct-to-consumer channels may bear small price increases within pricing bands in a minority of cases.

Luxury marketers break the wealthy into categories because of behavioral and scale difference in purchase decisions. One descriptor of a class is the "aspirational wealthy," composed of consumers who have a modest net worth, but relevant discretionary income. While we haven't yet seen statistics on this broad and loosely defined class of consumers, it is reasonable to presume this would be a class heavily affected by falling home prices, and also consisting of the kind of consumer who would in better times be willing to scrimp on a necessity to afford a luxury, such as a moderately expensive fine wine purchase. Paired with distributor consolidation that

favors higher volume lower price point wineries, we suspect wineries producing above \$50 as a retail price point without cult status or a solid direct model may come under extended price pressure, and such producers will have more difficulty with price as a consumer objection.

We hear over and over that consumers are looking for good value. We encourage you not to consider "value" as a synonym for "price." Value is defined as "perceived quality¹¹" divided by price. There are value purchases at all levels of goods. For instance, you can get a good value when you purchase a Mercedes, even if it is a \$75,000 purchase. We advise you to think about all the things that you can do to enhance perceived quality before dropping price. And when you do get to the price part of the equation, make sure that you are first surrendering margin to a distributor or retailer to enhance sales volume instead of dropping price on the shelf.

Here is an important example to emphasize the point: We are aware of a producer that, at the suggestion of its distributor, dropped price about 20 percent on the shelf to get its brand more in line with another that was considered a direct substitute. After two months, the producer's reported increase in volume was: zero. Dropping price did not increase volume. Two actions might have improved its situation: It could have differentiated the product from the winery that produced a near substitute, or, if it decided to give in on price, the decrease should have been divided between the retailer's and distributor's pockets without affecting shelf price by much. Bottom line: When

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you work with the value equation, focus on the perceived quality aspect of the equation first. Hit your consumers with what matters to them. If you focus on the price part of the equation, your choices are limited to dropping price, and when that is exhausted as a strategy, raising price later becomes difficult.

Direct-to-Consumer: Wineries need to get better at Internet dating

Laurel: *Dorothy, this guy would go home with a gardening tool if it showed interest.*

Buying a bottle of fine wine is a little like trying to date. For a person who has never tried your wine, it's like a blind date. The consumer is in the position to spend meaningful sums of money on something he or she has never tried. But the buyer isn't desperate for your bottle. There are many fish in the sea. While showing interest in the consumer is a large part of the battle in the sale of a fine wine, just like a finding good date, getting a recommendation from a friend you trust will rank high on the list of selection criteria. Traditional tasting rooms can support a piece of the sales puzzle, since that means it's not a "blind date" anymore, but for most wineries, electronic and more regional methods of selling wine outside the distributor channel are becoming required skills for success. Bottom line: Wineries are going to have to get better at Internet dating.

Jerry Maguire: *Help me... help you. Help me, help you.*

We would love to be proven wrong, but with the sole exception of [insert your

winery name here], we can't point to a single wine production company that integrates anything close to a practical suite of electronic applications and social media tools available to execute a successful direct-to-consumer digital sales strategy. With so many wineries losing distribution, one would think management teams would flock to these solutions, but it's been slow in coming.

The explanation for slow adoption is varied, but part of the reason is that online sales are still a much smaller percentage of most wineries' total sales, which remain dominated by clubs, tasting rooms, direct-to-trade and traditional distribution. Since it's a small part, there is less emphasis placed on digital distribution. In an environment like the present, the problems with existing strategies get the attention of owners, instead of the opportunities in other solutions. The situation reminds me of a Japanese story I heard as a child:

Amaya: Why don't you fix the holes in your roof?

Masumi: It's not raining.

Amaya: Are you going to wait and fix the holes when it rains then?

Masumi: Of course not. I'd have to go outside and get wet.

How many Masumis are out there looking at the holes in the ceiling when there are clouds overhead? According to Inertia Beverage, less than 1 percent of all U.S. wineries have a dedicated online sales and marketing team. For many in the throes of decision making, younger available consumers, distributor consolidation and the failing economy will now force

marketing changes and new approaches to selling wine that use electronic tools as support. The real question for a large percentage of these companies is, "Where do you even start?" Increasingly, vendor and technical solutions are emerging to help wineries do a better job of selling online:

- E-commerce platforms like Cultivate, Inertia Beverage and Vin65 continue to improve the ground floor of a digital marketing plan.
- Consulting firms like Vintank are available to walk wine companies through the development of customized, practical and cutting-edge digital strategies that maximize opportunities in wine marketing, business development and software architecture.
- Compliance solutions from ShipCompliant, eCompli and Rethinkcompliance offer solutions to help streamline the challenges of compliance.
- Fulfillment houses like Wine Tasting Network, New Vine Logistics and Copper Peak Logistics are investing in technologies to improve all aspects of delivery.
- WISE Academy (www.wineindustrysaleseducation.com/) has been formed by a pair of industry veterans to raise the caliber of direct sales employees.
- Well over 25 social media companies for wine have launched, and more than a dozen wine-specific iPhone applications are now live.

We are happy to make introductions to people who might assist you in thinking through your digital sales and marketing plans if you give us a call.

Alternative sales channels

Sign in Locker Room: A positive anything is better than a negative nothing.

Some clients in November 2008 told us they pretty much hit a “negative nothing” in sales that month. There are other ways that can include little in the way of up front investment and can make a “positive something.” For instance, 2009 could be the year alternative sales channels enabled by the Web make a meaningful impact. The two most noticeable will be the e-Marketing agents like *The Wall Street Journal*, and the growth and development in social networks and blogs.

Winery direct and e-Marketing agents

A new direction for moving wine online is the e-Marketing agent. Many of the largest online businesses, including Amazon.com, Expedia and eBay, serve as marketing agents for other products. The marketing agent is an entity that delivers customers and/or purchase orders for a fee but holds no ownership in the product. Last year, attracted by the high customer value potential of wine as a category, we saw the launch of such initiatives from *The Wall Street Journal* and 1-800-Flowers, as well as some tests with other major online entities. We also heard the announcement that both Amazon.com and Sears were entering the wine industry, as well as a slightly different direct model in a partnership between Costco and Inertia Beverage. Though new retailers are challenged at learning how to manage the intricacies of the wine industry, the entities have tremendous amounts of cash to invest and audiences that will drive sales or customers to specific brands.

Social networks

Jerry Maguire: Have you ever gotten the feeling that you aren't completely embarrassed yet, but you glimpse tomorrow's embarrassment?

If you can't explain what Facebook or MySpace do, or if a blog sounds like something Drano would help remove, then social media may not mean much to you—but it should. I may be glimpsing tomorrow's embarrassment by admitting this, but before writing this report, I actually signed up on Facebook and MySpace and within a day, had all these people who wanted to be my “friend.” I even knew most of them! Why would I sign up? Because I started to understand that I am a dinosaur and late adopter of social media. I wanted to see what it was all about and can report to you neophytes, it's pretty interesting conceptually. If you're like me, I'll bet you didn't know the Web site Facebook is growing by 500,000 new subscribers daily according to a recent Oprah interview with Facebook's founder. Which age group presently is responsible for the largest growth? People over 30. That might surprise those who believe these social media sites are simply digital entertainment for 13-year-olds.

“Social media” refers to Web-enabled communities of people who share common interests. One of the largest difficulties of online wine retailing is sampling. You can't do it. But beyond firsthand experience, the next most noted driver for wine sales is peer-to-peer recommendations — a friend who gives you a tip about a wine. Currently such diverse sites as eRobertParker, Wine2.0, Crushpad, Vinfolio, WineBid, Wine Woot, Wine

Spectator, Vinography, Snooth and many other forums are filling with people sharing their discoveries of new wines and their love of the grape. Influencing those channels can stimulate demand in a manner previously reserved only for the wine rating services. Social media are becoming more relevant for creating awareness each day, and delivering tactics that authentically influence these groups.

Digital sales and marketing recommendations:

- Make sure in this economy that you aren't just focused on tactics and responding to the problems of slower distribution or tasting room sales. Don't miss the opportunity to make progress in developing or furthering a digital sales and marketing strategy.
- Consider directing a portion of production to an e-Marketing agent.
- When developing a digital plan, start at the foundation: Figure out which systems to use, how you'll manage and leverage your data and information and how you intend to grow using the technology to support the actions. (Electrons don't sell wine.)
- Create a customer service plan that crosses all four direct consumer channels (tasting room, club, phone and e-commerce).
- If you have been using an in-house Web platform, consider upgrading to use an e-commerce company that specializes in wine and can help direct your progress in the channel.
- Consider shipping costs as a marketing opportunity. Avoid channel conflict

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with your retailers by posting higher prices and give free shipping.

- In cost containment environment, analyze shipping rates with your shipping team or fulfillment partner to make sure you are getting what you and your customers want in service and cost.
- Keep your customer relationship management database clean by scheduling twice a year phone conversations with your customers. It's also an opportunity to reinforce your personal relationship with them and encourage higher purchases.

The Economy

Avery Bishop: *There is a sensitivity thing that some people have. I don't have it. I don't cry at movies, I don't gush over babies, I don't buy Christmas presents five months early, and I DON'T tell the guy who just ruined both our lives, "Oh, poor baby." But I do love you.*

Over the past six months, like Avery in the above quote, we've all had to adjust to new surroundings. Talking to clients about the economy, we've been direct and tried to be sensitive; not dwelling on bad news because some people believe with conviction that talking about bad news will elongate the recovery. Still, no matter what we do or how short a discussion we make of this, people always want to go back to the credit crisis and the economy and dig deeper. So we will give the topic a small treatment this year, and avoid easy topics like how we got here. It feels good to debate and assign proper puritanical blame, but it won't affect decisions you make about running your

wine business—though we have to admit it is excellent theatre.¹²

While the final accounting on market destruction, asset devaluation and government spending is still out and the markets are still retracting and de-leveraging, this March 11, 2009 comment from CEO Stephen Schwarzman of the highly regarded Blackstone Private Equity Group stands out: "Between 40 and 45 percent of the world's wealth has been destroyed in little less than a year and a half." Needless to say, that is not a good thing, especially considering we aren't done.

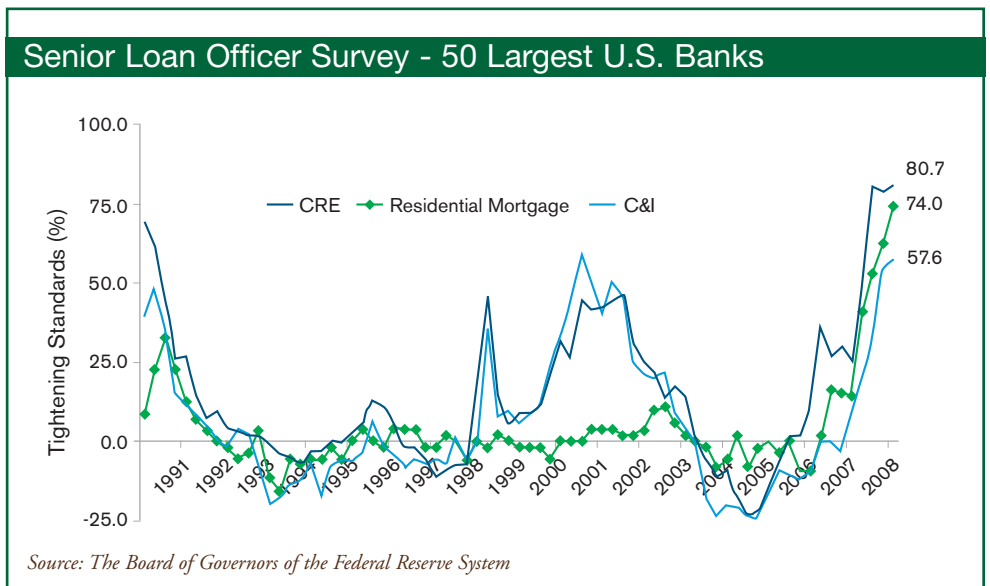
To effectively plan for the future, you still have to have an idea of how long the recession will last and how bad it will get. Will we be through the trough and back to normal by year end, or will this be a longer term issue? We can say with some level of certainty that the housing problem will be corrected in the next 18 months, with or without

the help of the government programs, so we will skip that discussion.¹³ What is more important than deflating home prices getting back into line with median family income is median family income itself. We can't get the economy going without the consumer spending, and the consumer can't spend without consumer credit. Focusing on just the credit market, we have a perspective to share in the hope it will cut through the haze of battle and give you an idea of the state of the credit markets that affect your business and the consumer, as well as an understanding of where the real problem is and what has to be done to get the markets functioning.

Credit Markets

Lending conditions in the wine business

We noted this quote from the CFO a major U.S. bank in early March 2009: "We are returning to our core business as an enabler of commerce and eschewing risky ventures. The days of exotic instruments and low-cost credit are gone."



I honestly don't know if that is news or not, but it is a repeat of what the wine industry has experienced in past down markets relative to lender commitment, and it reminds us of this quote: Jerry Maguire: "I'm still sort of moved by your "my word is stronger than oak" thing.

In a positive cycle, well intentioned people who run lending institutions will go after markets and believe in their commitment to the business. When lending markets are in a negative cycle though, the same people will always internalize what they don't fully understand as risk and retreat to the core business they do understand.

As noted in the graph, according to a recent survey of the 50 largest banks conducted by the Federal Reserve, credit conditions are tightening across all lines of banking. The same holds true of the insurance industry and Farm Credit System, which are experiencing their own issues and funding problems. For most wine industry borrowers, this means greater scrutiny of business plans and forecast assumptions, more questions asked regarding collateral valuations, and perhaps slightly more restrictive covenants and terms than you experienced in the past.

Most lenders will tell you with their corporate face on, "It's business as usual," or something along those lines. But that is counter to the Federal Reserve Chart of the Top 50 Banks showing conditions are not "as usual." In talking casually to most of the lenders in the business, we believe as of this writing the hardest place to find credit is a new transaction larger than \$30 million to a company with a short track record. Today, \$50 million transactions

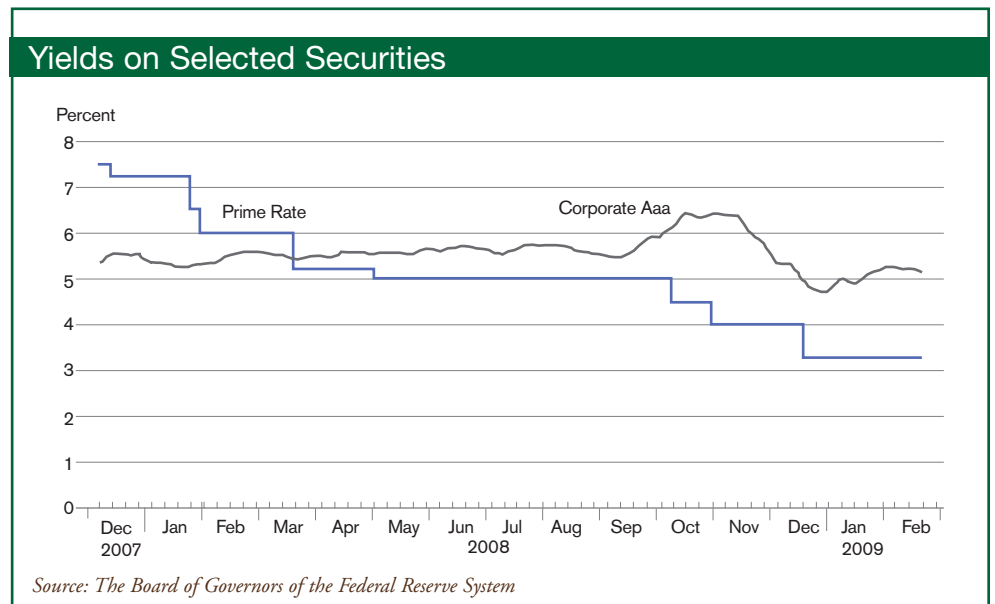
that a lender would have happily taken alone a year ago will probably require a couple of banks to work together in a club-type facility. Larger syndications over \$100 million are the most affected, as it's difficult to get a team of lenders on the same page and to evaluate risk in a consistent manner.

The good news is that credit is available for most family wineries looking for credit below \$15 million. In fact, while there are fewer lenders in the wine space today than there were in 2008, those that remain are anxious to support well-run winery operations, and banks still compete for that business, though at slightly higher spreads. Credit tightening means companies at the edge of the risk curve will suffer the most. Specifically, wine businesses with unproven or bruised business models, those with high leverage, the inability to absorb a setback and those with inexperienced management teams will have a more difficult time finding financing support from banks today.

Loan pricing in the wine industry

Jerry Maguire: So this is the world, and there are almost six billion people on it. When I was a kid, there were three. It's hard to keep up.

Loan pricing has changed radically in the past year, and it is hard to keep up with the market changes. The chart of yields on selected securities demonstrates what has happened to the relationship between NY Prime and AAA Corporate Securities since December 2007. It shows for the best rated corporate borrowers in America, while NY Prime has dropped, the actual borrowing rate for the top-rated companies in America hasn't changed that much. Higher rate spreads are reflecting uncertain and more risky business conditions, as well as a lack of overall bank industry profitability, which has been declining since the mid-1990s, as noted in the chart of Credit Availability in U.S. Markets. That said, we are still talking about very low nominal rates when considered in the context of the last 40 years.



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Credit availability in U.S. markets

Jerry Maguire: *I'm not trying to make history here.*

History has definitely been made this time. Our financial system broke down last year and credit markets did and still are seized up in spots as of this writing in early April 2009. Fixing this historic credit crisis is one of the keys to getting the U.S. economy working again.

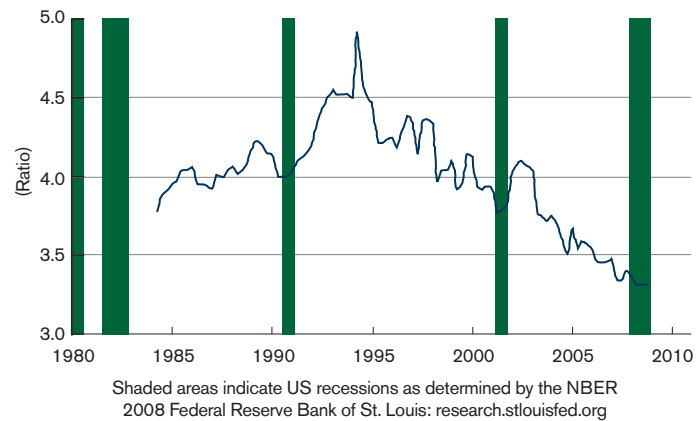
Today, while we are starting to experience a little more optimism in general, despite the massive and unprecedented coordinated efforts between the government, Federal Reserve and the U.S. Treasury, there is still inadequate debt capital being delivered to borrowers. This single topic is generating the largest amount of misinformation, starting with calling the problem a “credit freeze,” as if all it takes is a little patience and a warm afternoon for a “credit thaw.” You have probably heard the following sound bite: “The problem is the banks aren’t lending.” Is that true? Look at the chart from the Federal Reserve, showing that in fact commercial banks in the U.S. have more debt lent than before the recession started.¹⁴ How can that be possible given the number of times credible people have said otherwise?

Most people are surprised to learn that banks as they know them—those on Main Street USA corners—have declined in market share over the years, to the point where traditional banks have less than a 25 percent market share. The larger part of the market is commercial paper¹⁵ and the asset-backed securities¹⁶ (ABS) market. While the commercial paper market has been somewhat resuscitated, the ABS

market is virtually without a pulse. How broken is the ABS market? New issuance in Q4 2008 dropped to \$2.7 billion, down 87 percent from the third quarter. In fact, the fourth quarter marked the first time in history that four of the major ABS sectors (home equity, credit card, student loan and equipment leases) had no issuance whatsoever.¹⁷

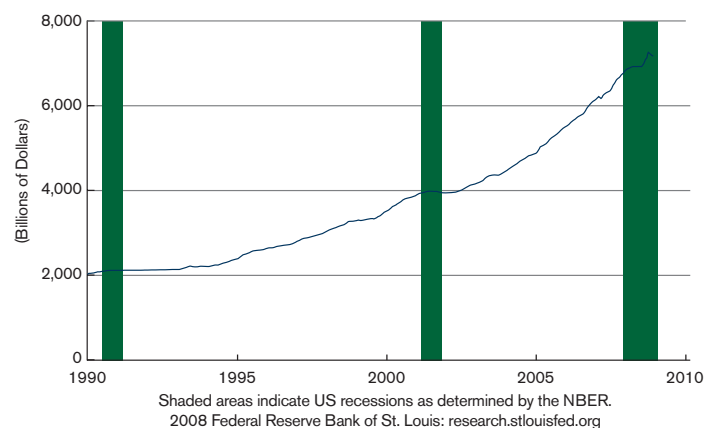
The reasons the market collapsed has to do with a loss of faith in the system by investors; specifically a lack of faith in rating agencies, given their performance in the sub-prime pools, and lack of faith in collateralized default swaps¹⁸ which is an important ingredient to issue new asset-backed securities. With investors unwilling to jump into the market for these securities, consumer credit dries up.

Net Interest Margin for all U.S. Banks (USNIM)



Source: Federal Financial Institutions Examination Council

Total Loans and Leases at Commercial Banks (LOANS)



Source: Board of Governors of the Federal Reserve System

Without either a functioning securitization market or a commercial banking system that can sufficiently expand to make up for the loss of the ABS market, business will continue to de-lever and GDP will continue to fall until it meets up with the debt that is already available. The government developed the Term Asset-Backed Securities Loan Facility (TALF) program to fill the gap from the ABS meltdown and committed a trillion dollars to get the securitization market back on its feet. As of this date, the central bank unsuccessfully offered the first \$200 billion of AAA-rated paper for issuance to the public under the program. It received only \$4.7 billion of subscriptions for the issuance: \$1.9 billion in auto securities and \$2.8 billion in credit card securities and no interest in the pools of Student Loans and Small Business Loans.¹⁹ The second issuance in early April received even less interest.

How bad will it get, and how long until we reach the bottom?

This is a difficult thing to predict because many decisions that are required to find a bottom haven't yet been made. In addition to the surprises that we seem to keep encountering, we also have to trust our government to make good calls on additional programs, bailouts, regulation, taxation, fiscal and monetary policy. Thus far, the track record has been best described as a political dance between "no mea culpa" and hurling the proverbial kitchen sink (a gold-plated one, we might add) at the problem.

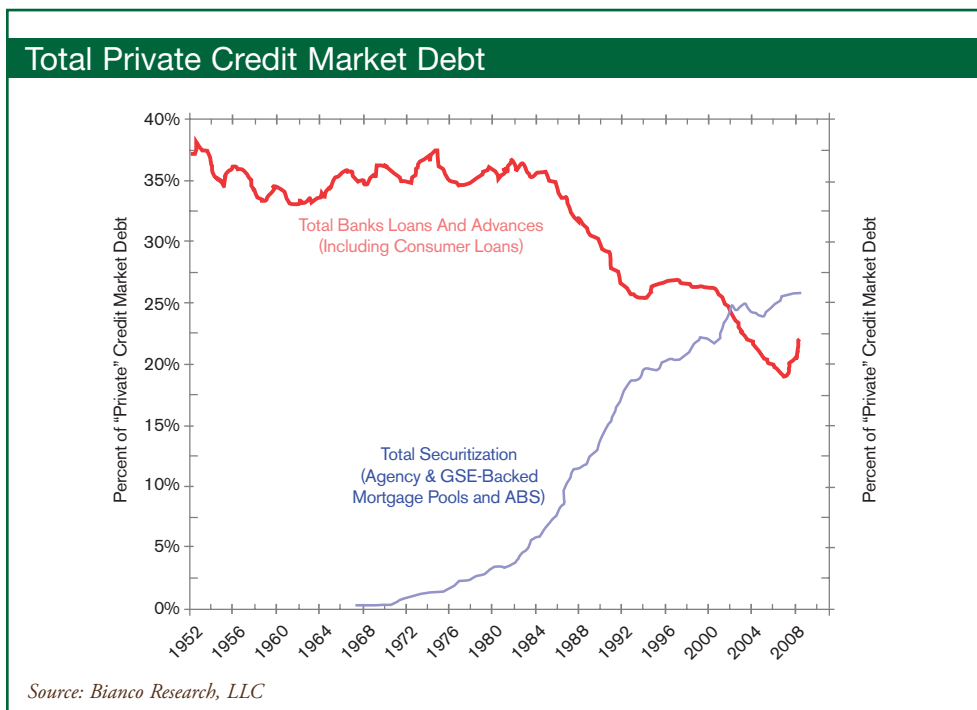
The unknown includes debate about the question of "too big to fail" and the value of just selling some of the large institutions in pieces. Further, there is still a possibility we will see secondary banking bubbles in commercial real estate and consumer loans that will compound

the credit crisis further. Of even greater concern is a failure in the TALF and toxic asset purchase proposals that are intended to be a public-private partnership. If investors do not go along with the offering of assets, there could be a tremendous setback in progress made thus far toward rebuilding confidence in the economy, which could push the timeline back for months or even a year.

For the economy to function at all, a sufficient level of debt has to be available for consumers and businesses. The Treasury and Washington have reacted in historic ways to break the credit freeze, prop up the commercial and investment banking industries and kick-start the ABS and commercial paper markets. They also have flooded the financial market with liquidity to take money supply out of the equation. Federal Reserve Chairman Ben Bernanke has made it clear he is willing to "drop money from helicopters" if needed.²⁰ The supply of money is not the problem. Getting the money into the markets — as well as restoring investor and consumer confidence — is the problem.

Despite the cheerleading of government officials and optimistic, but caveat-laden, forecasts from Chairman Bernanke suggesting the beginning of a recovery this year, our prediction is 2009 will not include a real recovery, but we will see a bottoming process that will evolve throughout the year. Our guess is based on:

- Our estimate that the housing balloon will finally fall back to earth near the end of this year or early next.
- The TALF program will take time to deliver the intended results. We expect



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the end of the year as a reasonable, if not early, time to see the start of real recovery in the ABS markets.

- Price Waterhouse Coopers, LLP in a March 24 report suggests retail sales will be little changed this year before beginning a rebound in 2010, which is an important component in a consumer-driven economy.
- According to the administration estimates, only 15 percent of the economic stimulus funds will be spent in fiscal 2009; so once again, we are looking at next year for the stimulus to have meaningful impact.
- A Bloomberg survey of economists conducted in early March 2009 predicted U.S. unemployment will reach nearly 10 percent this year. We suspect that may be slightly optimistic given subsequent unemployment figures from the Bureau of Labor Statistics, which show a still unabated rate in job losses after the survey was taken.

This year we anticipate a slowing of the rate in broad asset destruction that has been present since early 2007 and a real bottom in Q1 or Q2 of 2010. Markets in general will still remain volatile in the face of continuing bad unemployment data, higher levels of foreclosures, and poor corporate earnings news both domestically and internationally.²¹

But if the world can be slightly more predictable in the second half of 2009, that will reduce fear, encourage consumers to spend some of the money that is sitting on the sidelines in savings and hopefully support modest growth in fine wine sales by the time we reach Q4 2009.

So when will things get back to normal?

Jerry Maguire: [mutters] *I don't believe this. How'd I get myself into this?*

I don't think the magnitude of this degree of change has sunk in for most people yet. It's like a bad dream, surreal at times. Once we find the bottom, it is only the beginning of crawling out from under the economic storm cellar. The question we are most often asked is, "When will things get back to normal?" Often, this is posed by those who have come to expect 10 percent annual returns in both the stock and residential real estate markets. In that sense, things will not get back to any resemblance of normal any time soon. When the economic winter turns to spring sometime in 2010, the freeze of taxpayer mistrust thaws, and the balm of more and new regulatory scrutiny is built back into the financial services industry, the business environment will emerge indelibly changed, and the echoes of the high cost now being paid by the U.S. government for stimulus, new social reforms and bailouts will come due.

When we see a non-recession business landscape again, we will not be in a robust economy producing the inflation-adjusted returns that we have come to think of as normal over the past 15-20 years. Tail-end scenarios for this economic cycle include a return to stagflation as a middle case, muted economic growth for 7- to 10-years as a best case, or a repeat of Japan's Lost Decade as a worst case. Gone for the foreseeable future will be a return to the 1990s genre of conspicuous consumption that spawned the emergence of new wine labels every day and Wall Street closing

dinners celebrated with the intoxicating refrain of "Waiter? Just bring me your best wine and keep it coming."

Happy days will come again

Rod Tidwell: *Jerry? You are hanging on by a very thin thread..... AND I DIG THAT ABOUT YOU!*

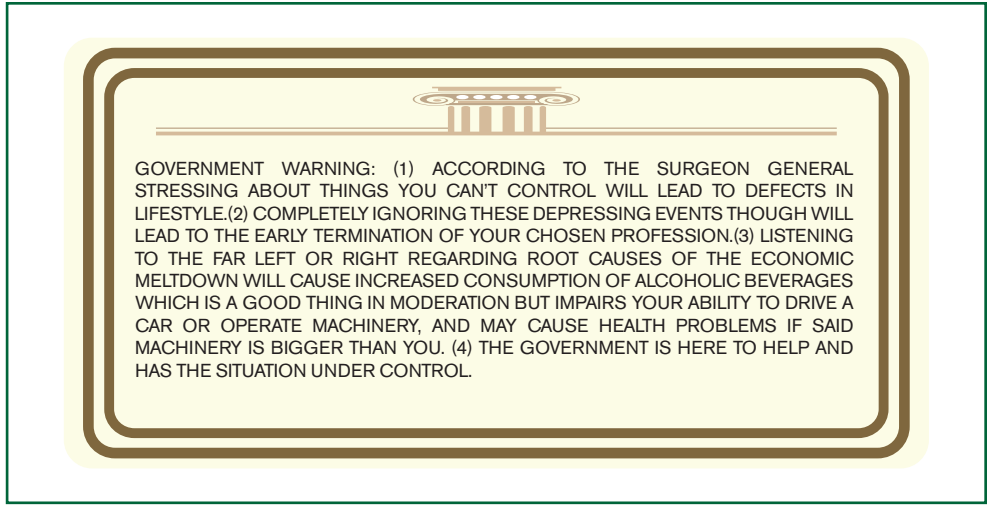
Outside of the higher-volume producers, times are tenuous in the wine industry as producers deal with the unknown of an economy that is working thorough historic shocks. Flying a little blind this year, the industry is forced to make more instinctive reads than usual. But we would remind you of the mood taken by the populace in the 1930s, when faced with a decade that started with a market crash, exacerbated with the Dust Bowl and ended with World War II.

Take a look at the popular music of those days. Sure there were songs like, "Buddy can you spare a Dime" that reflected discouragement, but even more common were songs that talked about what people aspired to be; songs like "Accentuate the Positive," "I've got the World on a String" and "Happy Days Are Here Again."²²

People aspire to a better life. They did in desperate times during the Great Depression, and they do in less desperate times today. What evolves is the definition of "better." Given consistent growth in per capita consumption, there should be little doubt that wine is growing in popularity with the American consumer. In a capitalistic economy that might have a black eye today, we should remind ourselves that at a point, the consumer will look favorably on fine wine as part of a better life.

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Today some of the industry is holding on by a thin thread while we find ourselves in a new world of needs versus wants. Many consumers have voted with their wallets that they don't need to spend so much on wine, but maybe they want to drink wine all the same. Our hope is that by the end of this year, the U.S. consumer will be able to say with confidence, "Happy Days Are Here Again," and with that confidence will come the aspiration to a live a better life that will include just a little more spending on wine.



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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, 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, SVB Global and SVB Private Client Services. 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 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, 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.

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- ¹ The Wealth Effect is a much debated economic principle that suggests people spend more money when they feel wealthy. The dynamic is separated into real wealth (a raise for instance), or perceived wealth when stock or real estate investments appreciate. It can be argued that a consumer may be inclined to spend forward even with no cash by using consumer credit, and refinance that forward credit extension by paying off credit cards by taking stock gains subsequent to the purchase decision.
- ² \$35 is not an absolute number. Price pressure depends on color, quality, appellation, etc. It's just a bookmark for a discussion about relative pricing.
- ³ Separate from this report, the Annual Wine Conditions Survey has information that may be of benefit to you. This year we asked a couple open-ended questions to understand what winery owners were planning to counter the soft business conditions. There are some very interesting responses. We have synthesized the nearly 500 peer responses and placed the responses into categories. That information is available for your review if you were a participant in the survey, or if you are an SVB client.
- ⁴ Quiz: Slightly dated data but a fun fact: Q: According to the Wine Institute, which country had the highest consumption per capita in 2005? A: That's right; it's the Vatican City State at slightly over 62 liters per capita. Putting that in perspective, that's 83 bottles of wine a year or about 400 glasses per person every year.
- ⁵ Estimates at the time showed that many growers were not making enough money to cover their costs and certainly not enough to cover debt payments on leveraged property.
- ⁶ There are regional and varietal differences in non-bearing acreage. Oregon for one has seen large increases in sales of Pinot Noir (PN) in this last economic run up as the effect of the movie Sideways sucked down PN industrywide. Since Oregon happened to produce world-class Pinot Noir, distributors banged down their cellar doors to get supply. At the same time, the state has moved into an aggressive planting program of both Pinot Gris and Pinot Noir. Today, with supply for Pinot Noir more in-line industry-wide, there is a question in our minds about the intentions of distributors. They are today cutting smaller producers from their books. It's early, and PN still has good growth opportunities, but it's also possible for Oregon to end up with more supply than it needs, at the same time distributors eliminate the smaller brands they added when supply was critically short. We will have a better picture on that by the middle of the year.
- ⁷ Gomberg-Fredrikson noted that U.S. Department of Commerce figures show imports of French, Italian and German wine have increased 86 percent, 55 percent and 61 percent respectively since 2001. An emerging problem that could prove a problem for the US fine wine segment are Bordeaux futures which are about half the price of last year. That is a startling drop in price that may impact pricing decisions in the US.
- ⁸ There are rational reasons for major differences between estimates of labels, including how someone defines the difference between a label and a brand, inactive labels still with active TTB licensing, and reporting limits of scan data. For purposes of discussion, we can agree there are more labels than wineries, and in 2007, the Wine Institute reports about 6,000 wineries in the U.S.
- ⁹ Gomberg-Fredrikson report dated 3-9-2009 covering the year ended 12-31-2008.
- ¹⁰ For SVB clients and Wine Conditions Survey participants, we direct you to review the output from the Survey that includes the thoughts your peers have and the directions they are taking in response to the market conditions.
- ¹¹ Perceived quality includes actual quality. We have heard it said that the most important purchase is the second one. Obviously you will never hold perceived quality without supporting that in the bottle.
- ¹² We are happy to have a glass of wine at your convenience and tell you why the economic problem is a confluence of events with plenty of blame to go around for all parties, starting with greed for most institutions involved in mortgage origination and finance, the economic policies driven by the Clinton administration and supported by former Fed Chief Greenspan through the 90's, expanded when the Bush Administration fought against Derivative Trading regulations proposed by Democrats, and compounded again by the House Financial Services Committee who ignored calls by the Bush Administration to strengthen regulatory oversight for Fannie and Freddie. (Conversation starter: Who said in 2003 regarding Freddie and Fannie, "*I do not want the same focus on safety and soundness that we have at the OCC and OTS. I want to roll the dice a little bit more in this situation towards subsidized housing*".)
- ¹³ The short treatment of the housing bubble is that median family income has to again relate to home value. That is because home lenders are asking again, "How much do you make and can you afford the loan?" In normal times, a person making an income of \$100,000 could expect to afford a \$280,000 home, according to historic averages. At the top of the bubble, because of no underwriting, that same person could qualify to buy a \$480,000 house. The distance the market has been out of touch is narrowing and should be finding bottom by the end of 2009 or early 2010, if job losses can also be stemmed by then.
- ¹⁴ Several dates are proposed for the beginning of the recession with the earliest noted as December of 2007. It doesn't alter the argument, however, as commercial banks are lending more than they did before the recession.
- ¹⁵ Banks used to take deposits and make loans to big business. The commercial paper market is a way business skipped the banks and went straight to investors, essentially cutting out the middle man. The government has tried to get this market going by purchasing AAA-rated commercial paper.

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- ¹⁶The ABS market (asset-backed securities) is a system in which assets such as student loans, car loans, home loans, heavy machine equipment, commercial real estate, credit cards and other financial assets are packaged by an investment bank and sold as certificates to investors. This is the system that fed the sub-prime virus to the world.
- ¹⁷Securities Industry and Financial Markets Association, Research Report, March 9, 2009.
- ¹⁸The CDS is an insurance contract for credit extensions. CDS issuance has largely functioned in an unregulated market. The way it works: A business holding a bond in another company like GM may want to insure itself against the risk of default on the bond. A third party (such as AIG) willing to take that risk will insure the risk of default in exchange for receiving payments, just like you might on car insurance. By early 2008, the CDS market was estimated at about \$50 trillion, five times larger than the entire public debt of the United States. That indicates huge speculative risk taken in a largely unregulated market that was functioning without a clearing house like the NYSE. For more understanding of the market, an interesting article written February 17, 2008 can be found at www.safehaven.com/article-9497.htm.
- ¹⁹The application of the TALF for ABS is an attempt at a partnership between the government private fund managers. The government will lend the fund manager \$9 and put up \$1 of equity to purchase \$10 of a new security. The failure of the initial issuance is a major concern. In a Reuters article dated March 20, 2009, issuance failure was attributed to “teething” since according to one economist, “the Central Bank is trying to step in and recreate a market from scratch.” Other economists suggest the failure is due to fear by firms who see the government willing to change deals they make retroactively if the outcome produces results that are politically sensitive. As a consequence, investors can’t assess risk and return properly.
- ²⁰The Bernanke Doctrine essentially suggests that monetary policies of the Fed can still support a faltering economy such as the one we are experiencing, even if there is no room to lower rates. The way that is done is by flooding the system with cash supplied through Treasury issuance, or by simply printing money. As of this writing, the Fed’s balance sheet has swollen by over \$2 trillion and is quickly moving to \$3 trillion. Many economists predict this printing of money will lead to inflation. Both Chairman Bernanke and his predecessor reject Galbraith’s notions that such practices will lead to certain inflation later in the business cycle. We will have to see who is right in a few years.
- ²¹Perhaps a warning is apropos at this point: Former Federal Reserve Chairman Greenspan in testimony before Congress at the end of October 2007 made this famous quote, “*If we are right 60 percent of the time in forecasting, we’re doing exceptionally well. That means we are wrong 40 percent of the time.*” I will add to that, we are no Alan Greenspan here. But you will have to decide if that’s the good news or the bad news.
- ²²Happy Days are Here Again was co-opted by the then Democratic hopeful Franklin Delano Roosevelt for his successful first run at the U.S. Presidency. The song has since been the unofficial theme song of the Democratic Party in the U.S.

SVB *Find a way*

SVB Financial Group

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