Silicon Valley Bank

A Member of SVB Financial Group

Wine Division

What Will 2010 Bring for Fine Wine Sales?

SVB Predicts Sales Growth in its Preliminary Findings for the 2010-2011 Annual State of the Wine Industry Report

Written by Rob McMillan, *Founder, Wine Division*

Forward

Clarence: *Strange, isn't it? Each man's life touches so many other lives. When he isn't around he leaves an awful hole, doesn't he?*

That was the synopsis delivered by the Angel Clarence in the 1946 Frank Capra movie, *"It's a Wonderful Life,"* one of my all-time favorite movies. Clarence was trying to get George Bailey to see how his life mattered and how the human component couldn't be replaced in business. George forgot that lesson for a while but rediscovered it in the story line. In the same way, the fine wine business at some point in the past decade began to believe the product was about an expensive purchase and ego-based conspicuous consumption. The industry now finds a humbled consumer still wanting luxury products, but products made by real people, and not just expensive brands without a soul. Each producer has to figure out new ways to touch every one of its consumers in an authentic manner. That is the good news for an industry connected to family business, the earth, and hand made production.

For those unfamiliar with our wine reports, we like to use a movie as a foil to present otherwise mundane economic information. *"It's a Wonderful Life"* is an appropriate backdrop given the sweeping changes taking place and multiple business touch points altered in what have become the most difficult business conditions of the last 20 years for family wineries. It is also perfectly suited to a pre-holiday edition looking at our initial findings for our upcoming report that will be released in spring 2010. We hope some of our early observations give you food for thought in advance of your year-end planning, and it at least gives us a chance to remind ourselves and our readers what is important and even with some gloomy news, *"It's a Wonderful Life."*

Summary

George Bailey: *[yelling at Uncle Billy] Where's that money, you silly stupid old fool? Where's that money? Do you realize what this means? It means bankruptcy and scandal and prison. That's what it means. One of us is going to jail - well, it's not gonna be me.*

Some might have thought the world was coming to an end last year when the financial industry was coming unhinged. What happened to all the money? It could drive a person to drink! (That's not so bad by the way.)

I don't think there were many quite as desperate as George Bailey, but Q4 last year was the worst quarter for holiday sales in our memory. We were in the spot to deliver not only the bad news about what we were experiencing, but forecasting more bad news in what we were about to experience in 2009. That was certainly no way to add to our already blemished popularity as bankers. It wasn't great news, but in trying to give it to you straight, we said that we expected:

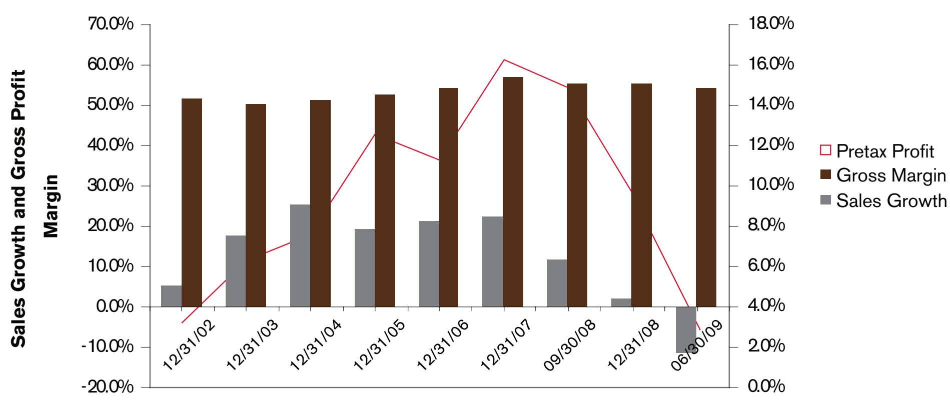
"Flat growth from depressed restaurant sales, higher unemployment (exceeding 10 percent by year end), higher foreclosures, and depressed consumer spending through the year as we seek a bottom. The economy will not return to the market experienced during the past decade. Price points below $35 are selling 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."

While many suggested at the time that our forecasts were overly pessimistic and even hurting the industry, it appears we were pretty accurate on most of the forecast, and the zero growth guess was even slightly *optimistic*. Perhaps pessimism really is the new realism …

We use several databases to determine the range of actual sales growth. Our research shows mid-year sales growth for the fine wine business has been negative through Q2. Depending on the source data, this is anywhere between a 4% decline using the most favorable estimate, to an 11% decline in year over year sales in the most unfavorable estimate.

Early reports from distributors and wineries for Q4 sales suggest improvement over last year's melt-down. But those same sources suggest holiday sales will not be 'normal' compared to what the industry has come to expect in past years. When the final accounting is tallied, we expect to see full year sales declines in the -2% to -8% range.

High-End Industry Profitability



Source: Silicon Valley Bank Peer Group Metrics

	12/31/02	12/31/03	12/31/04	12/31/05	12/31/06	12/31/07	09/30/08	12/31/08	6/30/2009*
Sales Growth	5.2%	17.6%	25.5%	19.4%	21.2%	22.3%	11.6%	2.0%	-11.2%
Gross Margin	51.5%	50.2%	51.5%	52.8%	54.5%	57.1%	55.5%	55.3%	54.3%
Pretax Profit	3.2%	6.3%	7.6%	12.6%	11.3%	16.3%	14.9%	9.5%	3.0%

** 6/30/2009 is an estimate*

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Preliminary Outlook

Mary: *Bread... that this house may never know hunger.*
[Mary hands a loaf of bread to Mrs. Martini]
Mary: *Salt... that life may always have flavor.*
[Mary hands a box of salt to Mrs. Martini]
George Bailey: *And wine ... that joy and prosperity may reign forever. Enter the Martini Castle. [George hands Mr. Martini a bottle of wine]*

I like the sound of the last part …. "Wine… that joy and prosperity may reign forever." I don't know if I can quite link prosperity with the fine wine business just this second, but we can at least be happy. We would like to report that the Guardian Angel Bacchus has heard the pleas of winery owners and will transpose business conditions back to 1999 again. Well … we'd like to report that.

However, the market isn't going back to the way it was when the rising economic tide of growing consumer wealth floated all boats. Looking ahead to 2010, absent further economic shocks to the consumer such as a large stock market correction, we expect modestly improving prospects for producer level sales of fine wine, and positive growth in sales for the segment as a whole. Demand for wine, even modestly expensive wine, has not completely abated and there are early indications that there is a slow thaw in prices of even more expensive wine. The soft market conditions presently felt are not just a reflection of the economic tumult, but equally due to de-stocking that has taken place throughout 2009 in private cellars, restaurants, and distributor warehouses. The de-stocking phase of this correction is largely complete so producer level sales will improve slightly, even if there is no real change in consumer demand in 2010. That said, conditions in the business will still be muted by the jobless recovery.[1] We will expand our forecast with the release of the Annual State of the Wine Industry Report in the spring of 2010.

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Reacting to Change

George Bailey: *A toast! A toast! A toast to Mama Dollar and to Papa Dollar, and if you want to keep this old Building and Loan in business, you better have a family real quick.*
Cousin Tilly: *I wish they were rabbits.*

Today, many have been stunned by the observed change in business conditions but are waiting to recognize the surrounding landscape before making real decisions. Some are holding out hope for good holiday sales before making any significant directional changes. Others are expecting a V-shaped recovery and a return to improved market conditions in 2010 because it's all they have ever experienced in the business. We are all hoping that Mama Dollar and Papa Dollar are rabbits! But the reality is in the background, several wineries that have already run out of cash are experiencing bargain transitions.[2] We expect this trend to continue through 2010 as the realization sets in with financially weaker wineries that a rapid and full recovery in high-priced wine sales is not in the cards this time. That is not to suggest that is a characterization for the industry as a whole, but for a minority it's their reality and the spring may accelerate the trend.

In our view, the most successful wineries today are those who took corrective action early in the year to manage and protect their liquidity positions. Since this is a first-in-our-lifetime economic event, if you didn't take that action you should ask what is it those owners recognized that gave them the confidence to take early action? It's a simple answer: they didn't confuse the fuzzy economic questions with the facts of a supply/demand imbalance.

This isn't the first time we have been long in inventory and not even the first time we have seen demand changes impacting inventory levels. The middle 80s and early 90s also had periods of economic weakness impact supply. But even more recently the Tech Bubble created an imbalance. The reasons for the supply problem today are of course different and are nearly fully demand driven. But the reason for the situation is not as relevant as is recognizing the problem and taking steps to adjust.

What Will 2010 Bring for Fine Wine Sales?

The good news is that going into this recession we were largely in balance for fine wine. With the exception of the Oregon market, there isn't a significant amount of non-bearing acreage that will come on-line and exacerbate the imbalance, so getting out of this inventory bubble will also be a short-lived issue.

Some of the steps that are being taken include: renegotiating grower contracts, dropping less important contracts, examining farming costs for savings and upward adjustments in yield to enhance per acre revenue, selling down excess bulk wine, developing programs for the slowest moving SKUs, and blending down reserve wines to boost value in lower priced wines. Of course that's only half the battle. Sales and marketing have to take a forward position as well, but conserving cash by adjusting inventory is an important first step for success.

***George Bailey:** [Praying] Clarence! Clarence! Help me, Clarence! Get me back! Get me back, I don't care what happens to me! Get me back to my wife and kids! Help me Clarence, please! Please! I wanna live again. I wanna live again. Please, God, let me live again. [It begins to snow again]*

We all want to get back to where we were before and the question we often get is, "When will the market return to normal?" The real answer is not very soon, but if you are asking this question at all, you are probably not seriously planning changes to your business strategy — and you should be. Doing little or nothing is the right strategy when there is a strong chance of a fast and full recovery. That's what we experienced in the last tech-led recession when business conditions were impacted and restaurant sales slowed, but consumers spent right through the bottom because of the wealth impact on ballooning home values. As we noted in our Annual State of the Industry Report this past spring, our belief is that, *"The economy will not return to the market experienced during the past decade."* We reiterate that belief.

"When will the market return to normal?" The real answer is not very soon.

Taking the question one step further: Are the business conditions experienced in the past fifteen years what we should normally expect? Is that really normal? What winery owners and luxury marketers have come to believe was normal was really an aberration when viewed from an historic context. The run up in U.S. consumer wealth due to growth in the market cap of the stock market between 1990 and 2000 was unprecedented and is mirrored in double-digit growth in fine wine prices, luxury goods, and the number of brands.[3] That was followed with a run up in house prices. Both collapsed at the same time last fall. With that trend partially reversing now, it would seem reasonable to expect damaged consumer net worth will negate some of the growth. That is in fact what is observed in mass marketed luxury brands. Add in predictions from restaurateurs that 2010 will be another difficult year, and defining a new normal is more prudent than waiting for the old normal.

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Affluent Adaptations

***George Bailey:** I wish I had a million dollars ... Hot dog!*

For only the fifth time since 1982, the collective net worth of The Forbes 400 has declined, falling $300 billion from $1.57 trillion to $1.27 trillion. We know it's hard to feel sorry for them but even they miss a million today. I just wish I could still eat all the sodium in a hot dog … but that's a different story. Anyway, according to government information, there are 18% fewer millionaires than there were pre-crash. It's a good thing we don't depend on the wealthiest to keep wine sales afloat. But as the post crash dust is settling, two important demographic shifts are just now emerging:

1. Not all affluent consumers are created equally nor are they all pulling back on luxury purchases at the same rate. According to survey information, the 'absolute affluent' consumer which represents about 40% of the affluent

spender, is still spending on luxury goods at pre-crash levels. However, the 'aspiring affluent' consumers, the main targets of luxury good and fine wine marketers over the past decade, have pulled back in their spending patterns coincident with their reversals in real estate wealth, retirement savings, and investment losses.[4]

2. Baby boomers, who have grown alongside the fine wine business over the past 20 years have been severely impacted by the economic trauma. Late Boomers, those between the ages of 45 to 54 saw their net worth fall by more than 45 percent between 2004 and 2009. Placing that in perspective, if the median late baby boomer household applied all of the wealth it had accumulated during a lifetime to pay down a mortgage, it would still owe approximately 45 percent of the price of a typical house and have no other assets whatsoever.[5] The older early Boomers are in only a slightly better position, but have no time to repair their retirement savings and will either work longer or depend more on government retirement programs in their golden years. For many Boomers, a $50 bottle of wine is now permanently outside of their budgets and the fine wine industry will need to give more attention in marketing to the under 40 consumer.

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Retail Revelations

George Bailey: *I'm shakin' the dust of this crummy little town off my feet and I'm gonna see the world. Italy, Greece, the Parthenon, the Colosseum. Then, I'm comin' back here to go to college and see what they know. And then I'm gonna build things. I'm gonna build airfields, I'm gonna build skyscrapers a hundred stories high, I'm gonna build bridges a mile long ...*

Reviewing the performance of luxury retailers provides some interesting evidence of these changes. Absolute affluents are still traveling to far away places like George had intended, and still are looking for customized experiences. They are still willing to spend for goods in rare supply. Absolute luxury retailers such as Hermès (HESAF.PK) and Burberry Group (LSE: BRBY) have seen recent quarterly gains in top line sales, and even at the lowest point in the economy they fared much better than their broader luxury competitors. Just beneath these companies, mass luxury retailers such as Neiman Marcus (NYSE:NMG.B) and Saks (NYSE:SKS) have had much more disappointing results getting consumer spends back up in their stores.

In fine wine, we see much the same behavior with absolute cult brands that have long waiting lists still selling out all their wine with no price adjustment. Just below that, however, it's common to see wineries that just two years ago sold out 100% of their production ahead of the next release, discounting significantly to move their product.

Though still early, these initial findings suggest that we have seen an accelerated demographic shift to a younger luxury buyer than what was present before the market collapse. The trading down we are witnessing is the echo of the destruction of consumer wealth in the aspiring wealth class, and mirrored in other luxury retailers product sales. Since there is no expectation of that wealth being quickly rebuilt, we do not expect to see the buoyant conditions for selling fine wine recently experienced quickly returning.

Is the Change Permanent?

Harry Bailey: *A toast to my big brother George: The richest man in town. (…Crowd starts singing Auld Lang Syne)*

No I am not crying. It's just a cold. But I do love that part of the movie. A happy ending where the hardworking underdog wins and everything works out fine always gets me. So, with all the dour information, is there a happy ending to this story? Is the change in what consumers are willing to pay a permanent shift?

The first thing I remind everyone who asks this question is the term 'permanent' represents a rather long time horizon. But in any case, the answer is no. This isn't a permanent change. Consumers always aspire to better products. Wine as a product category has demonstrated consistently increasing per capita consumption for decades now and nothing suggests that is likely to stop.

What Will 2010 Bring for Fine Wine Sales?

Further, we are seeing improvement in both luxury sales and fine wine even now, which leads us to predict positive growth in the business in 2010. However, true recovery will take time to sort through due to lasting negative impacts in housing, consumer wealth, consumer credit, business spending, and restaurant sales.

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We will go a step further and suggest that despite the gloom of the economic train wreck, conditions aren't quite as bad as they seem today. It's important to remember this is the correction phase of a normal inventory cycle and the correction phase is always the worst part for producers. Think of it this way: distributors in this phase stop ordering while they work down their stocks. Once at their optimal level, they start ordering again to match depletions. The producer experiences more depressed sales than what is actually sold at this point in the correction. This is repeated across grape contracts and bulk wine as well, and given there is no non-bearing hangover (except in Oregon), the correction phase should be short lasting.

We do believe that we are in the midst of a price reset in fine wine that will lower the wannabe cult wine prices and collapse brands into narrower pricing bands below $50. This belief is supported by several facts: unemployment is lagging a GDP recovery, businesses have capped spending on client entertainment, restaurants are serving more frugal consumers, and plenty of uncertainty remains around financial markets, government spending, and credit availability. It's not a permanent change, but it won't be the same either.

We look forward to completing our research, continuing to observe trends and offering up more complete observations and recommendations in the Annual State of the Wine Industry 2010-2011 report due for release this spring. In the meantime, please feel free to contact us with any questions.

1 Many economists have now predicted the economy is already out of recession or will soon be out, based on improving GDP figures. In fact the Advance Estimate of Q3 GDP was up to 3.5% but that was attributed to government payments and motor vehicle purchases under the Consumer Assistance to Recycle and Save Act of 2009 ("Cash for Clunkers"). The efficacy of using GDP as a measure of health and recovery of the U.S. economy is under discussion at the highest levels of government these days. Considering our economy is based on consumer spending, its hard to rationalize a healthy and recovered economy when the government forecasts the unemployment rate will average 10.3% in 2010.

2 A bargain transition is a term we have coined for the distressed winery sale. Unlike many businesses, foreclosure and bankruptcy are seldom seen in the business as there are typically people willing to take over a shattered dream and reconstitute it to their own. These transitions are few in nature and almost always happen quietly.

3 From the beginning of record keeping on the S&P in the last century, the index climbed up to $340. In the 10 years from 1990 to 2000, the market ran up from $340 to $1,499. More consumer wealth was created in that decade than in the prior history of the market.

4 Unity Marketing, Pam Danziger, 2009

5 Center for Economic and Policy Research The Wealth of the Baby Boom Cohorts After the Collapse of the Housing Bubble, David Rosnick and Dean Baker, February 2009

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 make 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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