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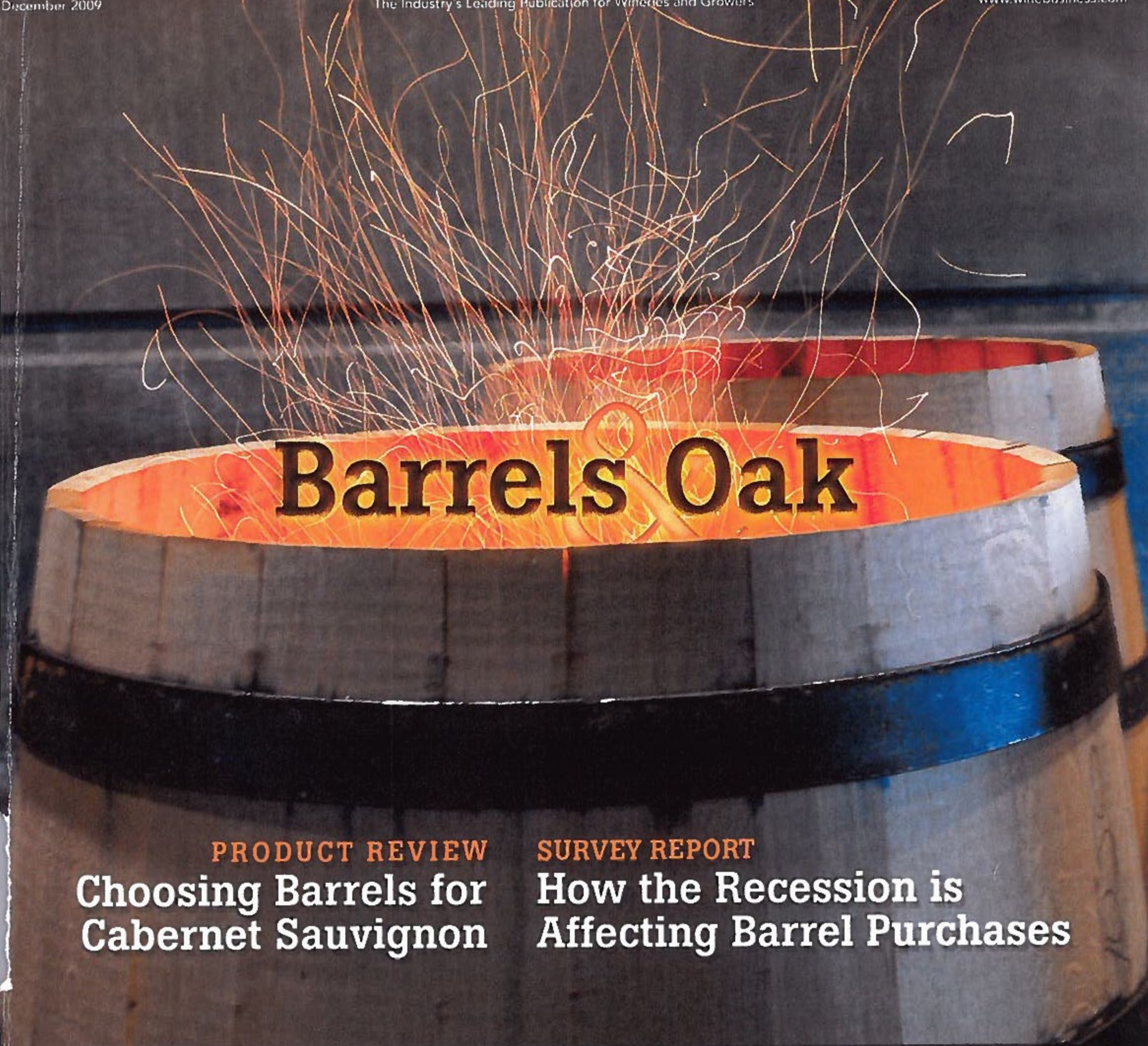

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What Lies Ahead for the High End?

When will the market return to pre-recession levels? Cyclical change or sea change?

Cyril Penn

IT WASN'T LONG AGO that the wine industry was abuzz with talk about consumers "trading up" to pay more for small luxuries and premium products. Much was made of the strategic growth opportunity presented by "premiumisation." There was continual talk about "affordable luxury" as rising living standards spurred consumers to seek better quality products. The more consumers spent on products, the more they seemed to like them. Many companies, including high-end wineries, made decisions based on assumptions that consumers would continue to trade up. Average growth rates for wines priced over $15 grew at 15 percent between 2002 and 2008 while wines under $3 saw negative growth.

The world changed in a short period of time, however, as the worst recession since the Great Depression kicked in.

The confusion seen in financial markets in late 2008 and into 2009 changed the tenor of the conversation. Overall wine consumption continued to increase as it typically does during recessions but consumers started trading down. Spending on non-necessities slowed. High-end wine sales hit a wall.

As 2009 drew to a close, consumer spending fell and high-priced wines were backing up in warehouses. People spoke of the headwinds of consumer change. Even the rich were more cautious about their spending. The sudden drop in demand was difficult to quantify and came while bulk wine imports surged and as U.S. wine exports fell. Wineries were holding the line on costs, sitting tight and watching their fall sales numbers. All were wondering: Would high-end wine sales ever return to their pre-recession levels?

CURRENT SITUATION: TRADING DOWN

Through the end of June, sales of wines retailing at more than $20 a bottle were off about 10 percent year-to-year, according to Rob McMillan, founder of the wine practice at Silicon Valley Bank. "I expect Q-4 is actually going to be better than last year in the fine wine business, so we may wind up with single-digit declines—not too bad. When you look at that relative to the massive destruction in the economy, that's pretty good."

"As an industry, it's pretty painful," McMillan said. "I don't know if many people (in the industry) have experienced this kind of pain because of the run-up and opportunity people have seen in recent years. A strong amount of consumer wealth was created, and there was low unemployment for a period of time."

An October 2009 Wine Opinions report on wine purchase and preference trends among high-frequency consumers and the trade showed that more than half of high-end consumers polled had decreased purchases of wines over $30 and were more likely to have increased their purchases of wine in the $10 to $20 range.

TABLE 1

Changes in California Wine Purchase Amount by Price Point

Percentage by price category and change in purchase amount

	much more	somewhat more	about same	somewhat less	much less
Under $10	16%	21%	49%	6%	9%
$10 to $20	10%	27%	51%	10%	2%
$20 to $30	3%	13%	46%	22%	15%
Over $30	2%	6%	38%	22%	32%

SOURCE: Wine Opinions

The report also showed that some of the trade-down among upscale consumers benefited mid-priced wines (see TABLE 1).

The Nielsen Company data also confirmed the trade-down (see TABLE 2).

Wine as a category held up well, though, when compared to other consumer goods products, at least in food stores. During 2009, wine was the No. 4 category in terms of unit growth among products tracked by The Nielsen Company while 63 percent of all other categories Nielsen tracked were in decline (see TABLE 3).

TABLE 2

Table Wine – Price Tiers

Price point growth being led by <$6, and around the $10 level. Weakness at >$20.

		Value % Change			Volume % Chg
		Last 52 weeks	Last 26 weeks	Last 13 weeks	Last 13 weeks
100%	Ttl Table Wine	+4.4	+3.3	+3.8	+2.3
8.2	$0-$3	+5.2	+4.9	+5.5	-1.9
25.1	$3-$6	+11	+9.6	+9.3	+6.2
25.4	$6-$9	+0.5	-1.5	-1.2	-1.3
18.3	$9-$12	+5.6	+5.6	+6.5	+7.1
11.1	$12-15	+1.9	+0.5	+1.4	+1.2
6.5	$15-$20	+0.9	-0.7	+0.3	+2.0
4.8	>$20	-5.8	-7.5	-6.9	-7.8

SOURCE: The Nielsen Company (thru 8-22-09)

TABLE 3

If consumers are only buying what they need, then wine must be meeting some of those needs.

(In channels where multiple goods are sold)

Top 15 Categories: % Unit Growth	
Canning & Freezing Supp	17.7
Seasonal GM	8.1
Fresh Meat	6.7
Wine	**5.5**
Dry Mix Prepared Foods	4.8
Frozen Novelties	4.5
Pasta	4.1
Baking Mixes	4.1
Vitamins	3.9
Cheese	3.6
Yogurt	3.0
Baking Supplies	2.8
Condiments, Gravies & Sauces	2.7
Ref Juices & Drinks	2.5
Spices, Seasonings & Extracts	2.0

SOURCE: The Nielsen Company (thru 8-8-09)

BOTTOMING OUT?

There were signs of economic recovery in 2009. Consumer confidence rates stabilized as the stock market started to recover. Unemployment levels, a lagging indicator, remained high, however.

In late 2009, a survey showed that most business economists thought the recession had already ended with the caveat that the recovery would be more moderate than those seen following other economic downturns. "The good news is that this deep and long recession appears to be over," The National Association of Business Economists proclaimed, "and with improving credit markets, the U.S. economy can return to solid growth next year without worry about rising inflation."

THE FUTURE

Though the consensus view seems to be that the economy will recover slowly, the wine industry appears split on how quickly high-end wine sales will return to pre-recession levels.

Is it a cycle or is it a sea change?" **John Gillespie** of Wine Opinions, **Wine Colleagues** and the **Wine Market Council** asked rhetorically while speaking during the Wine Industry Financial Symposium in fall 2009. "The industry is absolutely split on this issue of what it's going to look like two to three years from now."

WHERE HIGH-END WINE SALES ARE GOING: THREE VIEWS

Some argue that all recessions are cyclical so that luxury wine sales will rebound rather quickly; others say the market at the high-end won't come back to previous levels at all—or at least not for a very long time; still others say the market has recalibrated and is permanently changed.

SCENARIO 1: THE DOWNTURN IS CYCLICAL

The world will look very different in a matter of months and consumer demand for fine wine is growing. The industry has weathered downward economic cycles before. If you've been through it before you have the perspective to take the current slowdown in stride. What goes down goes back up. "We've seen it before."

- Consumer Behavior hasn't changed.
- Business spending is cyclical and will come back.
- Wine is an affordable luxury.

It's well known that the economy goes up and down in a series of up and down cycles. The wine industry has historically followed these cycles. Many are familiar, for example, with the Turrentine Wine Wheel of Fortune, illustrating how the "manic" grape market follows economic cycles. Wine is a long-term business and industry veterans take a long-term view.

Though frugality is suddenly fashionable, some believe that with the stock market topping 10,000 and talk of recovery, it's already getting harder for some people to keep suppressing their urges to shop.

"When we ask consumers if they're going to spend more after the recovery, it's a mixed bag," noted **Danny Brager** of The Nielsen Company.

"I don't think consumer behavior has structurally changed," financial analyst **Kaumil Gajrawala**, an executive director of **UBS Securities**, argued, though he expects a tough road ahead for fall sales (see TABLE 4).

TABLE 4

Likely in the Bottom of the "U"

There is only one thing that has been true about every recession/depression...

1940s	1947 – sterling ceases to be a reserve currency
1950s	Late 1950s – creation of eurodollar market 1957 – Treaty of Rome
1960s	Late 1960s – start of the great inflation
1970s	1971 – gold convertibility ends 1974 – bonds are no longer boring – the crisis of yield calculation 1979 – UK ends capital controls 1979 – Volcker shock
1980s	1986 – UK big bang
1990s	1990 – Second Gulf War 1995 – Second Barings collapse 1998 – Russian default, LTCM collapse
2000s	2000 – NASDAQ bubble burst

...they all end.

SOURCE: UBS Global Economics

Another argument supporting the cyclical argument for high-end wine sales is that wine is an *affordable* luxury, so that while consumers may forgo other luxuries, they will be more willing to "splurge" on a fine bottle of wine.

"Vintners are in a good position," **Greg Furman**, president of the **Luxury Marketing Council**, said. "The area that is going to come back quicker and sooner is all things related to entertainment for the home and business, meaning clients, even at the high end." Furman points out that some 2.7 million people in the U.S. have liquid portfolios of $1 million and said those consumers are migrating to the home both for business, family, friends and entertainment.

Business spending crashed along with the stock market but is likely to recover as it has in past recessions, and the road to high-end wine sales goes through restaurants that benefit from business-related spending. Restaurant wine sales represent roughly 25 percent of U.S. wine sales volume but just a bit more than half of the dollars, according to the 2009 *Adams Wine Handbook*. Restaurants, and in turn high-end wine sales, get a boost when business spending rises.

McMillan of Silicon Valley Bank sounds cautiously optimistic about 2010, in part because he thinks fine wine is actually more of a need than a want in some people's minds. "Fine wine in a recession is up there with cigarette smoking in terms of needs versus wants," he said. "A lot of people think it's a need—it's up there with other addictions. Demand is still pretty good, relatively speaking."

SCENARIO 2: THE HIGH-END WINE MARKET ISN'T COMING BACK AS IT WAS FOR A LONG TIME

The market at the high end won't come back to previous levels at all—at least not for a very long time, possibly a decade. Wealth, which for most people means stocks and real estate, isn't coming back the way it was near term—and to the extent that it does, the financial meltdown permanently scarred consumers emotionally. The economy has been in a deep recession, the worst since the so-called Great Depression. High-end wine sales will grow to previous highs but will take a few years for this to occur because so much wealth was eliminated. Some have predicted that the real estate market will continue to lose value in 2010. The wine market was driven by stock market wealth and the housing bubble, both of which will recover, albeit very slowly.

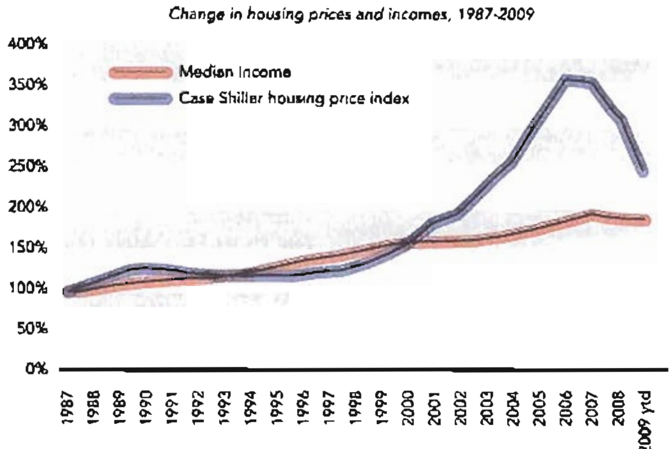
- Households have lost wealth that may not come back for many years.
- Frugality may be cyclical but previous spending levels were unsustainable.
- Demographic trends: Boomers are aging out of the market.

Steven Rannekleiv, executive director for food and agri-business advisory with **Rabobank**, the world's largest agricultural lender, is in the camp that thinks consumer buying habits have changed for the long term. He said U.S. households lost roughly 20 percent of their wealth from the third quarter in 2007 to the fourth quarter in 2008 and that consumers are trying to replace some of that lost wealth by increasing their savings. This increase in savings is often cited as one of the causes of a dip in consumer spending.

Savings rates fell through the 1990s into this decade, reached negative

CHART 1

It will take time for housing, equities (and super-premium wines) to recover lost ground



SOURCE: Rabobank

numbers, and then were near zero from 2005 though 2007. A current increase to around 4 percent is big, but is still relatively low, which is why Rannekleiv thinks the savings rate increase is a long-term trend. Some of the current frugality seen by consumers may be cyclical, he conceded; but, he said, "Many of the pre-recession spending trends we were seeing were unsustainable.

"Even if consumers want to increase their spending they're going to face some real constraints," Rannekleiv noted, pointing to new consumer credit constraints.

"Consumers may improve their level of confidence, but I think food and beverage companies should be prepared for at least several more years of more frugality from consumers."

Many believe consumers will remain frugal until housing prices rebound to pre-recession levels but the housing rebound could take 10 years assuming the lesser growth rates that proceeded the last decade, Rannekleiv said. "That may be an extreme scenario but I wouldn't be surprised if it doesn't take at least five years for consumers to get over some of this current level of frugality.

"We may see growth return, but a more rational level of growth," he said. "Even an improvement in the economy may bring back consumer confidence, but I don't think that consumer confidence—even a positive level, a strong level of consumer confidence—even that may not bring back some of those spending patterns we saw prior to this recession. I think consumer buying habits have changed."

"Once this recession resolves itself, the luxury market is not going to come back the way it was," Pam Danziger, president of Unity Marketing, a boutique market research firm specializing in consumer insights for luxury marketers, said. "People had this perception of wealth. The collapse of the housing market has killed our wealth."

DEMOGRAPHICS

Danziger said today's "affluents" are comfortable but don't have much money left over to splurge on luxury brands now that their homes and 401Ks have declined in value.

The average annual income for a U.S. household today is about $65,000. Households making $130,000 have twice the so-called average income, so are considered "affluent," part of the top 20 percent of the country in terms of wealth, according to Denziger. "You really need to have four to five times the average before you have the kind of discretionary income needed to spend on luxury," she said.

Some 2.5 million U.S. households are defined as "ultra affluent" but it was the "affluent" consumers that fueled the luxury boom. "They're affluent but not rich, and they're cutting way back on spending," Danziger said. They are not eating out as much—they're choosing lower priced restaurants when they dine and are selecting lower priced items on the menu."

Danziger added that demographic trends will drive a decline in luxury spending because boomers are aging out of the market with only half as many Gen Xers replacing them, many of whom are now becoming the prime market for luxury brands. "It's going to take a while for the millennial generation to become affluent," she added. "It takes middle age before you reach affluence. Given that underlying demographic, I feel comfortable saying it's not going to come back because it isn't."

SCENARIO 3: THE MARKET RECALIBRATES: SELF-FULFILLING PROPHECY?

You can get good wine cheaper: The wine market has essentially been recalibrated—it has been permanently transformed because consumers that traded down realize that they can get really good wines for less. Retirement nest eggs were decimated, making consumers reluctant to spend more than necessary. There will be consumers willing to spend more, but not as many as in the past. While consumers may not be permanently scarred financially or emotionally, they now realize that they can get good wine cheaper. Some ask, "If you can get wine that is as good at a lower price, why would you go back?"

Some also contend that many consumers who weren't previously aware they could get a darn good bottle of

IMPLICATIONS FOR WINERIES?

The ramifications of what many are calling the "Great Recession" are still unknown. However, fallout is expected for a wine industry that has become far more competitive than it was just a few years ago. A white paper issued in late 2009 by industry consulting firm Scion Advisors, for instance, predicts, "Over the next 24 months, consumer demand for wine will continue to grow globally and the United States consumer will be leading the way. However, the wine industry will see the fallout of weak players as the strong get stronger."

The paper notes that:

- The recession, inter-state logistics hurdles and a concentration of wines above $50 per bottle have put small wineries in a perfect storm predicament, many reporting sales down as much as 40 percent.
- Big players have been reconfiguring and trimming their portfolios to grow profits organically instead of getting larger through acquisition.
- SKU rationalization is hitting even the smallest players.
- Thousands of white tablecloth restaurateurs close doors, heavily impacting the luxury sector.
- Luxury consumerism is considered 'Un-American' as consumers globally struggle to keep their jobs and feed their families.
- Distributor consolidation has escalated as that segment struggled to survive in this economy, essentially shutting smaller players out of national wholesale channels.
- Worn down by this industry phase and economic cycle, many more wine business owners are looking to exit sooner through sales to third parties or to the next generation

wine for $20 or even less will wind up "trading down" permanently. As wineries cut price-points and negociants scoop up high quality bulk wine at distressed prices, higher quality wine is made available to consumers at lower prices.

"In some respects, you reinforce the consumers' belief that you can find good wine at less expensive price-points," McMillan observed.

"I do think there is a consumer and market for high-end wines, but that it's just not as big as it was," the chief executive with one Top 30 wine company said. "It will all recalibrate down a little."

"That's the secret," said Danziger, "how good the mass market has become. There are special times at home where we will indulge and trade up to a really special bottle—but for day-to-day drinking—I've got the Black Box."

CYCLICAL AND STRUCTURAL?

E&J Gallo senior director of marketing **Stephanie Gallo** also sees a combination of both cyclical and structural change but veers toward the camp that thinks what is occurring now is more cyclical than structural. "I do believe it's cyclical and it's proven to be so," she said.

"I think it's a blend," said Jon Fredrikson, an economist and industry analyst who has tracked wine markets for four decades, "the worst since the mid-1980s when it was really bleak. It seems like every time we have a severe recession, consumers vow they're not going to spend and will save in the future. Then lives go on and people start buying again. It may take longer this time. I don't think we'll get back to the point where we have the conspicuous consumption that fed the high end. I think everybody has to rethink their positioning."

REDEFINING VALUE

"A lot of people I talk to still hold hope that what's happened in the marketplace is just a normal part of a business cycle and that it will come back," Danzinger said. "I think it is better to opt for the more conservative course—you have to really offer a key value proposition to the consumer. I think too much of luxury marketing in the past during these boom times has focused on image. The way companies market to ultra-affluent consumers is going to have to change toward defining value and really making it clear and measurable."

"I would suggest that 2010 will be muted overall," McMillan of Silicon Valley Bank said. "If we're looking for a recovery, it is certainly going to be a better year than 2009 has been. But if we mean by recovery, going back to what it was in 1999 or 2005—I don't think we're going to see that, and there are very few economists who believe we will be through the bumps in the road. There's little reason to believe that spending on luxury goods will rebound in a heartbeat. We're talking about a jobless recovery."

So when will the high-end wine market return to pre-recession levels?

"I wish we both knew," said Furman. "We'd make a lot of money." wbm