

## PART THREE

## PERFECT STORM REVISITED

# Predicting future trends and opportunities

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Over the next 24 months, consumer demand for wine will continue to grow globally and the U.S. consumer will lead the way. Industry advisors Steintal, Valentine, and Hinman predict, "However, the wine industry will see the fallout of weak players as the strong get stronger."

The **Great Recession** has accelerated the professionalization of the wine industry. Figure 1 illustrates how wine industry A-players are adopting new business practices at a faster rate, managing more strategically, and building more financially viable businesses.

In November 2005, co-authors Deborah Steintal and John Hinman published a groundbreaking article: "U.S. Wine Market Liberalization by 2015: Perfect storm forming," in *PWV journal*, defining a ten-year framework for change. We predicted that interlocking dynamics — the forces of globalization, consolidation, and wine market liberalization — would drive change in all tiers of the wine industry (see Figure 1).

By 2015, U.S. wine consumers would benefit from better access to higher quality wines for the price, dramatically accelerating innovation created by the forces of competition.

Four years later, as we move into 2010, we are exploring what has really changed. The purpose of this article is to challenge our assumptions and ask

ourselves: What is ahead for wine business leaders? How do we prepare for future opportunities and challenges? We also want to revisit our predictions in the context of what we are now calling "the New Road." The state of the world economy and its impact on the wine industry can no longer be referred to as a "bump in the road."

### Last 24 months: New reality

By December 2007, when we published our update, *A Perfect Storm Revisited (II)*, in *Wine Business Monthly*, the industry's largest players had continued to grow through acquisition and global sourcing. Globalization was helping to mitigate production over-supply.

More states were open to interstate shipping. Regulators, driven by wholesaler trade associations looking to control market access, were at the same time making it more complex to market and ship wine direct, legally. This was inhibiting wineries and logistics providers from building profitable new direct-shipping business models.

Over the last 24 months, notwithstanding the new legal complexities, winery direct-ship permitting and three-tier delivery models have tapped into consumer markets for premium and super-premium wines that were nonexistent even four years ago. The net effect has been to limit growth in this segment to those marketers and wineries who have heavily invested in the new technology, while also empowering consumers to demand access to premium wines in the most restrictive states.

An unexpected **Great Recession** has had the net effect of accelerating some of our predictions and slowing down other predictions. Although the real ramifications of the **Great Recession** are still unknown, many are expecting a long recovery period, with long-term impacts on consumer purchasing behavior. Some impacts include:

- The recession, interstate logistics hurdles, and a concentration of wines above \$50/bottle have put small

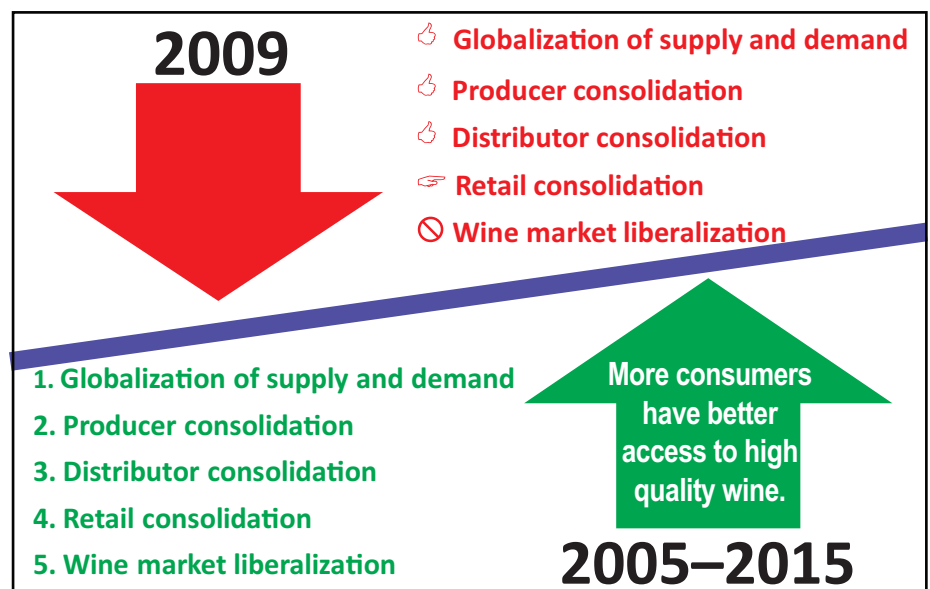


Figure 1: Five interlocking dynamics continue to have a dramatic effect on the wine industry.

wineries in a perfect storm predicament, many reporting sales down as much as 40%.

- 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 have closed their 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 industry phases and economic cycles, many more wine business owners are looking to exit sooner through sale to third parties or to the next generation (February 2008 joint report published by Scion Advisors/ Silicon Valley Bank: “Ownership Transitions in the Wine Industry.”)

Most importantly, the pendulum has shifted and the industry is more competitive and polarized than it was four years ago. Figure 3 illustrates how the large, billion-dollar producers are more aligned with the very large distribution companies and the small producers desperately need new or alternative marketing and distribution systems.

The U.S. wine market is undergoing its most difficult cycle in 30 years. As large wineries are dominating and controlling a more limited number of wholesalers, small wineries are literally being locked out, unable to sell profitably through existing national distribution channels.

Many wholesalers are heavily cash-flow-constrained due to the global economic downturn and/or debt incurred during recent consolidation dynamics. Given economic and competitive pressures, this market phase could last for two to three years.

The long-term impact of these forces is dramatic on under 250,000-case wineries, especially those with

portfolios in categories above \$30 msrp/bottle. Even A-players, unable to move inventories, are down 30% to 40%, and are discounting heavily.

We expect a wave of foreclosures and bankruptcies among wineries most dependent on national channels and unable to cover cash requirements over an extended down-cycle.

Figure 4 revisits six key predictions from our 10-year framework for U.S. wine market liberalization (Wine Market 2015).

Little has moved the business of producing, marketing, and selling wine forward more efficiently than the economy. Wine producers have not yet been able to quantify the impact to their balance sheets of either the health effects of wine or the green movement, but they are continuing to benefit from the impact of wine consumption by millennials.

### Key predictions in next 24 months:

#### “The new road?”

Inspired by the Granholm Supreme Court judgment, the dream of deregulation has not played out in exactly the way the industry has anticipated.

We predict that by 2012 stronger players will emerge with more financially viable and technologically sophisticated wine businesses. They will provide better quality wine even more suited to today’s emerging consumers, and will be positioned to take

**Figure 2: Over the next 24 months, ‘A’ players are building more financially viable businesses**

STRONG WILL GET STRONGER	WEAK WILL DROP OUT
<b>Pruned, profitable product portfolios</b>	>\$50 category takes long term hit
<b>Focused, differentiated brands</b>	>100 ‘hobbyists’ quietly close doors
<ul style="list-style-type: none"> <li>• Wine culture shifts as consumers seek closer social connections with their favorite brands</li> </ul>	
<b>Stronger, leaner teams</b>	Thousands of jobs lost
<b>Cash becomes king</b>	Hundreds of equity lines close down
<b>More diverse sales channels</b>	Thousands of brands drop out of national distribution
<ul style="list-style-type: none"> <li>• Hundreds of new retail private and control labels launch</li> <li>• Hundreds of new consumer channels launch</li> </ul>	
<b>Selective growth thru acquisition</b>	Hundreds of properties sell
<ul style="list-style-type: none"> <li>• Excess grape supply gets absorbed by \$12–\$25/bottle wine categories, driving category quality up</li> </ul>	Hundreds of properties go into foreclosure
<b>Next generation owners step up</b>	Next generation owners drop out

advantage of emerging marketing channels.

Rob McMillan (founder of the Wine Practice at Silicon Valley Bank), foresees rough seas through mid-2010 for producers with cash flow issues or strictly luxury-priced portfolios. “For those willing to do the hard work required to sell-through inventories over the next six months, their business should begin to stabilize by the end of 2010,” predicts McMillan.

Rather than struggle through the current economic and industry challenges, more first-generation, luxury-brand owners will seek exit strategies by selling their businesses and properties rather than weathering the storm.

The biggest industry challenges are still ahead. At greatest risk are wineries without scale in the national market (under 250,000 cases) and continuing to depend on traditional marketing models that rely on distributor sales forces. The primary hurdle facing these small wineries is assessing how to profitably build sustained national sales volumes, with gross margins at least at 50% of sales revenues.

“National sales channels that contribute less than 50% margins are most likely not sustainable, especially since most wine business models are so dependent on capital-hungry assets,” says Hank Salvo (Scion Advisors Partner and former Robert Mondavi Winery CFO).

Some will survive and potentially prosper by tightening their product portfolios, improving branding, and upgrading their teams and business practices. Those most likely to prosper long-term will radically change how they sell to the trade and consumers.

Looking ahead to 2012, five interlocking dynamics continue to be increasingly important for winery CEOs. These dynamics are straining both large and small players, forcing major operational changes along with new modes of marketing and distribution to better engage with consumers.

**Global grape supply pressures will exist: There is no substitute for brand strength.**

A-brands are defined by increasingly efficient supply chain practices; established, healthy distribution channel management; and strong cash flow disciplines. Global procurement management by large wine companies, in tandem with crop reductions caused by Mother Nature, have put grape supplies more in balance with normal market trends. This will help the path to stability for growers who are positioned to weather the drop in demand for the 2009 and, possibly 2010, crops.

Contrary to industry predictions less than six months ago, oversupply is a reality everywhere — a trend that is expected to persist throughout the world. Pricing will likely continue to take hits. Growers that have catered to luxury wineries are facing drastic drops in demand. Over-leveraged growers will be in trouble when their grapes go unsold.

Large wine producers with global sourcing options will profit from the resurgence of the popular premium price point segment and are using new inventory tracking and transportation technology to profitably shift supplies from market to market. Small players will experiment with new sales channels that will maintain image and drive cash flow from higher volume and lower-priced offerings.

Banking pressures and cash-constrained businesses will limit the launch of secondary tiers, while fueling the production of private or con-

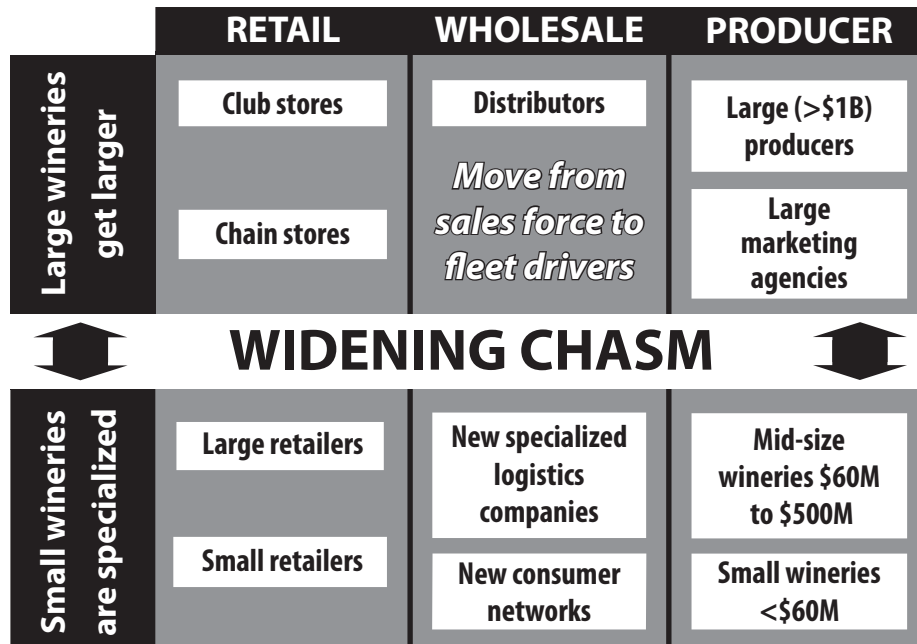


Figure 3: Pendulum shifts – small producers (under 250,000 cases) need a new distribution system.

trol labels, a common trend during periods of excess supply.

**Consolidation will likely continue in all three tiers: Margins shrink on all sides; 85% of retail space will be occupied by 10 wine companies.**

a. PRODUCERS will learn to navigate a polarized wine market landscape: comprising the large, multi-billion dollar corporations on the one hand and the small to large privately held wine businesses on the other (see Figure III) — each operating quite differently and playing to different margins.

Major players Diageo and Constellation will continue to pull back from acquisitions, seek synergies from merging their multiple operating units in 2009, and focus on gaining greater control of their distributors and market efficiencies.

The top 20 wine brands will use their market presence and line extensions (and new brands) to reinforce their value to national distributor portfolios.

Chris Indelicato (CEO, Delicato Family Vineyards) says, “Wine is a hard sell because of the required knowledge base: larger wineries that

can afford to field sophisticated marketing and sales teams will continue to gain market share.”

The cost of promoting small producers is simply too steep for large distributors to afford. This is also the reason for the resurgence of spirits as a driver of distributor profit margins. Spirits are an easier sell and demand is driven by substantial producer investments in advertising and marketing.

Seeking national distribution muscle through an acquisition strategy, portfolio builders such as Bill Foley (see [www.foleywinegroup.com](http://www.foleywinegroup.com)) or Jean-Charles Boisset (see [www.deloachvineyards.com](http://www.deloachvineyards.com)) and focused private equity players such as The Vincraft Group will buy more wine brands.

According to Pete Scott (Vincraft CEO), “The acquisition of Kosta Browne Winery is just the beginning of a wine portfolio comprising small-scale ultra-premium or luxury-tier California wineries.”

Competition for consumer “share of mind” will intensify in the U.S. market:

- 1) Wineries in every state will create new tourism opportunities and reach more consumers with educational experiences;



2) Companies like Crushpad in San Francisco (soon to be in Manhattan along with City Winery), are building on a “consumer as producer” trend, offering hands-on wine-making experiences;

3) Global competition from Australia, Chile, and Argentina will only be tempered by a weakening dollar.

Many more wineries will experiment with evolving direct-to-trade and consumer channels and will continue to develop brands that are relevant to a new generation of consumers. New Web 2.0 tools will enable wine brands to connect to new consumer networks, build awareness, and engage consumers — and learn to staff, drive strategy, and ultimately monetize “social networking.”

Rachel Dumas-Rey (CEO of Compli, a leading beverage compliance services company) says: “Over the next 24 months, wineries that intend to survive and prosper will invest in the most efficient and pro-

ductive direct shipping logistics solutions. Regulatory compliance is a moving target and so key to both top- and bottom-line growth.”

**b. DISTRIBUTORS** have consolidated from five to four major distributor houses, leaving most mid-size wineries in a worst-case situation. Over the next 24 months, the three-tier distribution system will become even less available to small players. Small wine businesses will continue to seek out alternative paths to market.

State regulators will invest in technology to enforce existing regulations rather than making access for consumers easier. Renewed competition from spirits and craft beer will cut into the wine category’s “share of mind” with large distributors. Pre-packaged cocktails will infringe on wine sales, with TV ads driving consumer pull at retail and eroding market share for wine.

Anti-trust will become a new legal battle front. Consolidation could encounter a backlash on both sides —

wholesale and retail. Demand will increase for integrated logistics models. Consolidation among these models will blur the lines between logistics providers and agency or e-retail models: mywinesdirect.com; wine.com; Adams Wine Group; Inertia Beverage Group; Winetasting Network; Copperpeak, and Provino, among many others.

**c. RETAILER** business models will also undergo dramatic change. Over the next 24 months lawsuits currently pending in the federal court system will force regulators to revisit discriminatory regulations that impact retailer markets. Retail powerhouses will expand very profitable private and control label offerings, and will add to the competition for the consumer “share of mind.”

Brick and mortar stores such as Safeway and Beverages & More (BevMo) will be selling more wine direct than they have in the last two years. Retailers who jumped in over the past few years with direct ship-

**Figure 4: 2009 Reality Check**  
Revisiting predictions from 2007

**PREDICTION: Global wine consumption will grow from \$107 billion at 5% per year (Wine Institute, December 2006).**

2009 REALITY CHECK:

- 2008 U.S. Wine consumption grew for the 15th consecutive year. Through April 2009, total wine shipments in California increased about 5 percent by volume. Millennial consumption grew by 23% in 2008.
- Wine Market Council 2008 report, and Jon Fredrickson in September 8, 2009, *Press Democrat* article: Makers of high-end wines caught in ‘dead zone.’

**PREDICTION: U.S. will become the world’s number one consumer of wine by 2010 (Wine Institute, Dec. 2006).**

2009 REALITY CHECK:

- For the first time, the US surpassed Italy in total wine consumption in 2008 — with 27.3 million hectoliters vs. 26 for Italy. (International Organization of Vine and Wine — VinExpo, April 2009)

**PREDICTION: Small wineries’ wine sales, shipping direct, will grow from \$2 billion to over \$5 billion (MKF Mar. 2007).**

2009 REALITY CHECK:

- 2009 sales should be up overall with new DTC launches from major players such as QVC, *New York Times*, *USA Today*, and the *Wall Street Journal*.

**PREDICTION: U.S. wine industry will be appreciably deregulated by 2015.**

2009 REALITY CHECK:

- We now know that the pendulum has shifted, and wine direct sales have become a bureaucratic regulatory licensing bonanza for many states. By September 2009, it has become more complex to ship wine across state lines.
- Although winery direct sales data is not available, more consumers are buying wine directly from online marketers, telemarketing merchants and cataloguers than ever before. Notable: TV’s QVC channel is marketing wine, WSJ.com is selling >\$90 million in wine; *New York Times*, *USA Today* (and many more) are making their consumer database available to sophisticated wine merchants with the ability to direct ship in all channels.

**PREDICTION: U.S. wine trade policy and regulations will encourage innovation and participation.**

2009 REALITY CHECK:

- Many initiatives are in play, and we assert that the recession will become the mother of innovation as a critical mass of smaller players struggles to succeed.

**PREDICTION: Integrated distribution models will serve large and small players, aided by new technology — driving efficiencies in production and distribution.**

2009 REALITY CHECK:

- Larger players, more able to invest in technology, are moving into integrated inventory management platforms with key distributors and customers.
- Smaller players are struggling to keep inventories on distributor floors as non-performing SKU’s are dropped.
- Filling the void, new distribution business models are investing in technology enabling smaller producers to find new paths to market and ship direct to trade and consumer.
- Integrating with communications, ecommerce and fulfillment systems, experienced compliance solutions such as E-Compli are positioned to support legal shipping direct to trade and consumers.
- Now in development throughout the industry is the “integrated” business model, where one business entity combines winery, import and retail operations (legal in California), and utilizes both direct shipping and three-tier delivery to fulfill national market orders obtained from different marketing sources.

ping across state lines will take cautionary steps in anticipation of a more open (but still complex) state direct shipment permit system.

As regulatory bodies continue to clarify and interpret state law, we will continue to see more integrated new business models enter the wine industry over the next 24 months. More compliant e-retailer models, trusted merchants, and third-party marketing agent businesses will emerge — on the back of a new generation of wine clubs and hundreds of new consumer networks such as *Snooth*, *Wall Street Journal*, *Sunset Wine Club*, *New York Times*, and *winestilsoldout.com*.

**Slow economic recovery will slow wine market liberalization: Producers and retailers will scramble to understand and position for a new generation of wine consumers.**

The **Great Recession** has catalyzed a consumption shift: a largely Baby Boomer-driven wine economy will soon be supplanted by Millennials. Baby Boomers, driving growth in wine consumption for the past 30 years, will enter retirement in droves. As they adjust to fixed incomes, they will consume their cellar reserves and “downsize” their purchases, both by volume and price point.

Millennials, who will become a larger consuming population than Boomers, will pick up some of the slack. Some are already adventurously seeking out imported wines and new wines.

Nutrition, wellness, and green planet movements (biodynamic, organic, sustainability practices) have yet to prove to be growth drivers for the wine category. Consumers will continue to seek quality regardless of origin, and more than ever before, they will demand value.

ENGAGEMENTdb, a July 2009 report published by Wetpaint and Altimeter (available online at [www.engagementdb.com/downloads/ENGAGEMENTdb\\_Report\\_2009.pdf](http://www.engagementdb.com/downloads/ENGAGEMENTdb_Report_2009.pdf)) indicates that the most valuable brands in the world are experiencing a direct correlation between top financial performance

and deep social media engagement. Social media already allows wine customers to share their preferences in real time, as aging media pundits become marginalized and irrelevant to today’s consumers.

Over the next 24 months, wine culture will shift as consumers seek closer social connections with their favorite brands and continue to rapidly adopt social network technology to share their authentic stories.

One great example is the Benziger Winery (Sonoma, CA) 2009 harvest video, which has attracted wine tweeters and drives people to their Facebook fan page. Imagine — a Gary Vaynerchuk for each winery!

Social media could make direct-to-trade programs even more viable if wine fulfillment and distribution challenges can be worked out cost-effectively. Liberalization will open up slowly as permits get easier to acquire and as states understand the tax value of eliminating caps on consumer shipments.

Wine has become mainstream and is now an American tradition. While many wine industry leaders would say that today they have a “tiger by the tail” and chaos prevails, we still hold by our analogy:

“A perfect storm gathering has generated monumental change, and by year 2015, the wine and alcoholic beverage distribution system will be more efficient, and more unforgiving of failure, than it is today.

The challenges are now multifaceted and more complex than ever before: regional, national, and global in scope. They include legal, political, and cultural developments. The speed of change is accelerated by economic drivers, technological innovation, and the forces of globalization.”

**How to prepare for opportunity: Strategies strong players are adopting**

Rather than just “battening down the hatches,” well-positioned wine business leaders are supporting their crew with tools, training, and other lifeline supports to ride out the storm.

Strong and strategically focused leadership is vital in steering wineries through these challenging times. Here are some important practices and strategies to consider:

**Everyone on deck.** Everyone at small and mid-size wineries should be actively selling, on the road and in person, in constant communication with the trade, brokers, distributors, consumers, and the media, through traditional means and the rapidly expanding online network communities that includes social media and bloggers.

**Increase productivity by developing your team.** With more talent available during this recession phase, consider hiring stronger, more productive people; investing in better communications and systems; and developing improved execution practices.

**Drive cash flow and profits.** Large or small, every business team should conduct an annual objective review of their product portfolio strategy, aligned with market opportunity. Each wine must be rationalized with an understanding of cost of goods, margin and overall performance to ensure it is delivering a sustainable return — or phased out if it is not.

**Grow your competitive advantages.** In a highly competitive market, most wineries need to assess and improve customer/consumer relationship management systems and disciplines; expand use of market and customer information; and support constant improvement processes around production, packaging, distribution and supply chain.

**Investigate new ways to convert your customers to brand advocates.** Every brand needs to figure out how to engage consumers differently and to experiment with emerging social media tools more effectively. Rather than an ad hoc approach, implementation should be founded on a more compelling and authentic brand strategy, clear goals, and relevant con-

**WINE BUSINESS**

sumer value propositions delivered consistently. ■

**About the authors**

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John Hinman's ([jhinman@beverage-law.com](mailto:jhinman@beverage-law.com)) experience spans the modern history of the wine industry and includes regulatory defense before state and federal government agencies, distribution litigation throughout the U.S., arbitration and mediation of relations between grape growers and wineries, and deep involvement in the direct shipping battles from the very beginning. He is founder of Hinman & Carmichael LLP.

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*-Rob McMillan, SVB Wine Div., Silicon Valley Bank*

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