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Silicon Valley Bank

Wine report

# State of the Wine Industry 2015

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**Come along with us as we explore how economic factors, increased demand, record yields and pricing opportunities are setting the stage for one of the better years the industry has seen in a decade.**

**Don't tell anyone, but I love movies that tug at the heartstrings. I guess I'm just one of those guys who likes tractor pulls and walks on the beach. That's probably why one of my favorite films is *Cast Away*, the symbolic backdrop for this year's State of the Wine Industry report.**

The 2000 film stars Tom Hanks<sup>1</sup> as Chuck Noland, a FedEx executive who asks the love of his life to marry him and then goes down in a plane crash in the South Pacific. He survives the crash, washes up on a deserted island and learns to live off whatever the tide washes in.

He's desperate, but resourceful — he even creates an imaginary friend out of a volleyball, which he names Wilson. After being stranded for more than four years, Chuck finally makes his escape. But when he returns to civilization, he finds that his fiancée — along with the rest of the world — has moved on.

After the market crash we all experienced — which wasn't any walk on the beach — the economy and the wine business are now returning to about where we were before the crash in many ways. But, like Chuck, we're finding that not everything is as we left it.

Things have indeed changed, and there's nothing we can do about that. We need to be resourceful and stay focused on our next move, just like Chuck. The question is: Do you see the new day in a clear light? If you do, how will you navigate to success in this evolved world?

In this report, Silicon Valley Bank gives you a compass. Based on our extensive expertise and deep relationships in the wine industry, we assess where the industry finds itself today, and offer our view on where it's going in 2015.





# 1

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## Predictions:

Looking back,  
moving forward

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# 2014: Our predictions in review

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**When we create this report each year, we begin with a fundamental understanding of consumer demand versus current supply. It sounds simple enough, but the surrounding business conditions continue to evolve each year right along with the consumer and the economy.**

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When Chuck Noland realizes he's stranded, he considers jumping off a cliff. But first, he sets up a test to determine if it will work. It didn't, and when he looked back on his experiment, he said, "It was what, a year ago? So let's just forget it."

It would be great if we had a way to test our beliefs before jumping off the proverbial cliff as Chuck tried to do, especially this year as we make economic calls on oil, interest rates and currencies, which are normally suckers' bets. Tracking all the components that impact the wine business and economy, then forecasting out a year is a huge challenge, but we know it helps our clients plan their course for the year to come.

Before we look forward to 2015, let's put the past behind us and review the predictions we made in our 2014 report.

## Global and U.S. economic factors

- We continue in a period of domestic economic stagnation that should reset our view of growth opportunities, business returns and prices for years to come. Other economic predictions:
  - Short-term and long-term interest rates will continue to be very low and stable for the next 12 months and probably longer.
  - Oil prices are an unknown at this point, but with the United States now leading the world in production, lower prices at the pump are helping with middle-class recovery.
  - Uncertainty from Washington's inability to develop a budget has been temporarily lifted as of the end of 2013, but the debt ceiling debate looms for February or March of 2014 without accounting maneuvering.
  - The Fed will reduce bond purchases but retain an accommodative policy for 2014 at least as employment levels — particularly the participation rate — are viewed with greater focus.



- Consumer credit is not growing substantially and probably won't, based on increased regulation and more caution on the part of borrowers.
- After a year of growth in U.S. GDP in 2013, we expect 2014 to moderate on a quarter-to-quarter basis, but show better year-over-year results at the end of 2014.
- The euro will lag the U.S. recovery, and the currency will weaken as quantitative easing slows in the United States, leaving an opportunity for more bottled imports and additional pricing competition from offshore.

## Supply

- In 2013, we saw a second consecutive harvest of excellent quality and yield across most appellations.
- Harvest on the West Coast was again large through all three states. In California, we are estimating 3.94 million tons, making it the second largest harvest on record.
- Inventory is balanced in all segments as long as the 2014 harvest is average and consumer demand increases as predicted.
- The wines at the highest price points report particularly short inventory positions. The high volume and very small estate producers report inventory positions slightly above their requirements.
- Massive bulk imports will continue to dominate the lowest-price-point wine categories, but bulk imports should be held back by the size of the 2013 harvest and supplies currently in cellar.

## Demand

- SVB's prediction of sales growth in fine wine will increase for the first time after three years of consecutive and accurate predictions of declines in growth rate. We predict sales in the fine wine business will increase 6–10 percent over 2013.
- We believe we are trending to a transition point that will prove choppy for most retailers, as the Boomers hit retirement and the economic state of the Millennials replacing them is clogged with high levels of student debt and weak job prospects. While all data point to increasing desire for consumer fine wine in the U.S. population, the capacity for these younger consumers to move upmarket may be impacted, leading to a greater separation between luxury wines and "aspiring luxury" wines. The price points between \$10 and \$20 should see the greatest consumer demand, in addition to luxury wines and those delivering an enhanced consumer experience.
- The Millennial generation is consuming more foreign wine than other cohorts today. The likely outcome is not positive for U.S. producers going forward. A marketing order delivering a positive mass-market message to consumers about domestic wine quality is something the industry should strongly consider.

## 2014: Our predictions in review

continued

### Pricing

- There are broad expectations in the wine business again that bottle price increases can be taken. We believe increases will again prove difficult, this time more because of the volume of wine available for sale versus a deteriorating economy.
- Grape pricing has hit a high mark, and contracts should see renegotiations downward in exchange for term. Current supply has already adjusted prices lower, reflecting current heavy supply stocks.

### Planting

- Grape planting is restrained compared with prior periods when supply was in balance. The Central Valley is at the greatest risk in planting ahead of demand.
- With one of the driest winters on record, and following three drought years, water conditions entering this fourth year of drought may play a larger role in planting and production decisions. Preparation for the worst-case situation for your vines and winery should be considered, and remediation and hedging strategies should be developed at the earliest possible time.

### Financial performance

- The general financial condition of the wine industry is improving slowly. At the end of 2014, wineries will say that the year was good, but not great, financially.
- Gross profit of wineries will be negatively impacted in 2014 due to higher grape costs from the 2012 vintage year.
- M&A and vineyard acquisitions will continue at a record pace in 2014.
- Direct-to-consumer sales will continue as the largest growth channel for most wineries.
- Fine wine producers were unable to pass higher costs on to consumers or recover higher pricing from prior periods in 2013. We expect that to continue in 2014.

## Some 2014 predictions we got right:

- We did correctly predict the Fed would reduce their bond purchases but retain an accommodative policy and not be bound by their prior statement about unemployment rates. We thought they would look to other measures of employment such as the labor force participation rate, and they did.<sup>2</sup>
- The United States did lead the world recovery, and the Eurozone lagged.
- The harvest last year was the second largest on record, but we were a little light in the tonnage guess.
- The bottle price increases presaged from winery survey results were hard to come by for producers.
- Grape prices were at a high point, and we've seen renegotiations downward.
- Bulk imports in the lowest price segments have been held back by the huge harvest, and the drought has produced changes in production and planting decisions, with the Central Valley in the most vulnerable position.
- We predicted interest rates would continue to remain low for the year.
- We noted better GDP on a year-over-year basis at year end 2014, but we didn't expect to hit 3 percent growth for the year. That was a good call.<sup>3</sup>

## And a few things that didn't turn out as forecast:

- We hinted at lower pump prices, but the drop in oil we've seen exceeded our expectations.
- Our lead comment regarding economic stagnation, while true, overstated the potential of the U.S. economy, which has proven more resilient in the second half of the year.
- While the euro did weaken in the back half of 2014, we haven't yet seen increased offshore competition or bulk imports as we guessed.

# 2015: Our view on what's next

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**There may have been some years after the crash when you or someone you know didn't have a clue what to do next.**

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Like Chuck Noland, you might have thought to yourself: "I gotta keep breathing ... because tomorrow the sun will rise." And the sun did rise.

The currents that might have tossed you around one day also brought positive change the next, maybe because you rode it out on a raft, or perhaps you used this report as a means of fixing your coordinates and developing a plan.

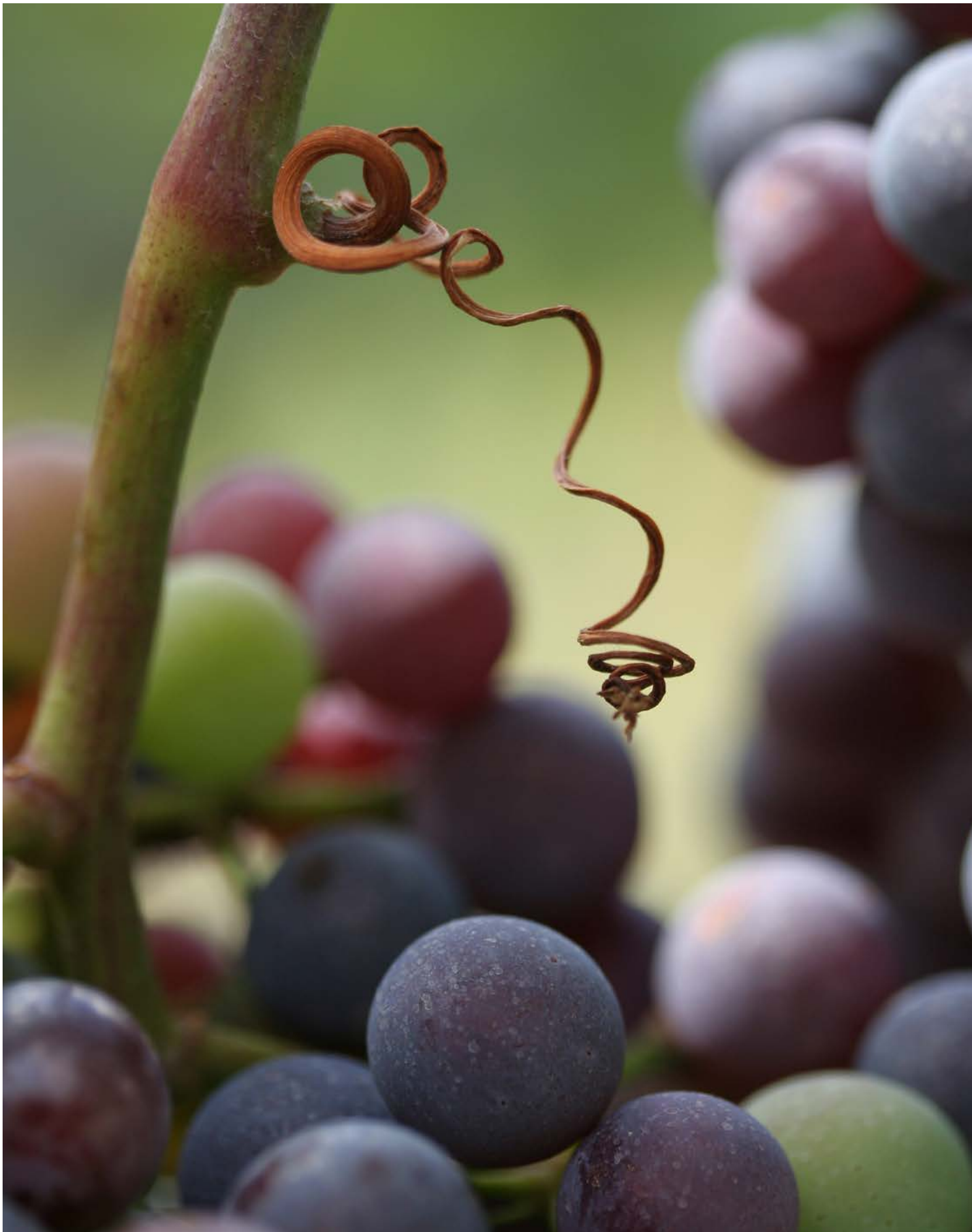
As in previous reports, our predictions for what's on the horizon are informed by our experiences living in the business, our annual Wine Conditions Survey, analysis and interviews.

We've arrived at the following touchpoints that we hope will help you set your course in 2015.

## Global and U.S. economic factors

- We are seeing real strength in the U.S. economy going into 2015, which will push wine demand up:
  - Oil price declines are transferring wealth to oil-consuming countries and will deliver hundreds of millions of dollars in stimulus to U.S. consumers in 2015.
  - The employment picture is improving at an accelerating pace in the United States. We expect the U3 unemployment rate (the primary measure of unemployment) will approach 5 percent during the year.
  - Japan, China and the EU are delivering sub-optimal results, and those currencies are weakening against the dollar.
  - The likelihood the Fed will increase rates in 2015 has grown, and we predict some movement in messaging first in early 2015, and actual rate moves higher by Q3.
  - Interest rate moves will happen at a slow pace, given inflation will be in check from lower-priced imports and fuel savings, leaving deflation still a concern.





## 2015: Our view on what's next

continued

### We are predicting a breakout year of growth in the fine wine category in the 14–18 percent range in 2015.

- We believe U.S. GDP growth will improve over 2014 and come in near 3 percent for the full year.
- The unknown in the world equation is unrest from countries such as Russia and Iran, should their oil-based economies falter more than they already have.
- As long as the industrialized world economies can hold their own and not drag down the U.S. economy as their own recovery catches up, the middle-income U.S. consumer will see improved prospects, and we will be toasting to that.
- The drop in the price of oil has been due to sagging world demand early in the year, but we believe the impact of the fracking boom has added to the situation, putting oil prices into a strong downward trend. We expect oil prices to remain low throughout 2015.
- Massive bulk imports will continue to dominate the wine categories at the lowest price points, but bulk imports should be held back by the size of the 2014 harvest and supplies currently in cellar.

### Demand

- Starting in mid-2014, wines priced above \$20 a bottle broke out strongly higher. “Trading up” is a clear trend again. Red wines in particular showed the strongest growth. We expect that to continue throughout 2015.
- Growth in sales of wines priced above \$20 was driven by accelerating volume with little in the way of price increases getting through to the consumer.
- Wines priced below \$9 per bottle performed poorly both on and off premise in 2014. The poor performance is likely to continue into 2015.<sup>4</sup>
- After finishing the year at the top end of our predicted growth in sales of 6–10 percent, we are predicting a breakout year of growth in the fine wine category in the 14–18 percent range in 2015.

### Supply

- When harvest is analyzed and reported, we expect we'll announce a third consecutive harvest of heavy yield and great quality across most appellations. That is unprecedented.
- While there are varietals and regions where there is excess supply, we believe fine wine producers who feel slightly long will find the gallons in their cellar to be a blessing in disguise by the end of 2015.



## Pricing

- While the large supply of wines in the cellars should normally indicate continued depressed pricing, we believe 2015 will be a year of both volume and price increases in the fine wine segment, driven by an improving economy and higher demand.

## Planting

- Grape planting opportunity is shifting north:
  - Oregon and Washington are showing strong growth in planting on a percentage basis, and we expect that will continue for the foreseeable future given favorable quality/price dynamics relative to the fine wine growing regions in California.
  - The growing regions in the North Coast are running into difficulty in permitting and high land costs. Replanting is continuing in older vineyards and those with red blotch. Suitable sites for expansion are becoming more difficult with each passing year.

- The Central Valley reports it will pull about 20,000 acres of grapes that were directed to wines priced under \$7, which are structurally oversupplied.<sup>5</sup>

## Financial performance

- Direct-to-consumer sales will continue as the largest growth channel for most wineries.
- Most wineries will say 2015 was one of their best seasons by the end of the year.

# 2

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# Demand forecast:

Up and to the right

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**The hardest job a winery owner has is balancing wine supply with demand two years before it's sold.**

Of course, there are supply issues to be dealt with in any given year. But when there is good supply, as is the case today, determining how much wine to bottle is pretty difficult without first deriving a sales growth forecast.

To do that, you have to understand the direction the trade winds will take consumer demand next year. The good news we are happy to deliver: We believe consumer demand for higher-priced wine will be up and to the right in 2015.

As Chuck Noland said, attempting to get back to civilization on a makeshift raft: “This could work! This could work ...”

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# Our base financial forecast for 2015

**We are particularly positive on the year ahead. We expect the fine wine business will see accelerating growth, while at the same time, the cellars are full with several consecutive years of very good vintages.**

## Oil prices

The global economy was slowing going into the end of 2014, but beneath that was the crash in oil prices that will transfer trillions of dollars in wealth from oil-producing countries to oil consumers. As of this writing, Europe, Japan and China are each working on methods of supporting their economies with their own version of quantitative easing, right at the same time the United States is ending its bond-buying programs and starting to show signs of stabilized GDP.

## The economy

The world economies are still quite fragile, and deflation is a risk that can pull down the improvement the United States has made thus far. That said, the countries we should be most concerned with are Japan, those in the European Union, China and India. Each of those countries, along with the United States, benefits from the collapse in oil prices. It's a little optimistic, but we believe lower oil prices will prove to be the catalyst that ignites more robust business conditions.

## Interest rates

Interest rates play a role in 2015. We believe the Fed will have a hard time raising rates in the first half of the year. Once recovery is more certain, if the world political landscape is calm and if our forecast of low oil prices proves out, we do expect rate increases in the back half of 2015.

## Consumer confidence

While a raise in interest rates will slow consumer spending, we believe GDP growth will end the year around a 3 percent growth rate, and the United States will start to lead the rest of the world along in economic improvement with our consumers purchasing imported goods.

# Shifts in oil production favor the U.S. consumer

## The big story of the U.S. economy going into 2015 is the precipitous decline in oil prices.

The economy has been making measured progress, but heading into 2015, the revelation of fracking<sup>6</sup> as a force has added between 0.5 percent to 1.0 percent to the U.S. GDP, or about a third of total GDP according to estimates from Bridgewater Associates, Goldman Sachs and others.

The United States, which was importing two-thirds of its oil at a point, is now producing two-thirds of its need. The emergence of fracking has led to a radical change: U.S. oil production, which was roughly half of Saudi production in July 2011, has now increased to just 10 percent below Saudi production (Figure 1). As of this writing, the price of oil has dropped to below \$50 a barrel. At its peak, on July 3, 2008, it was \$145.40 a barrel.

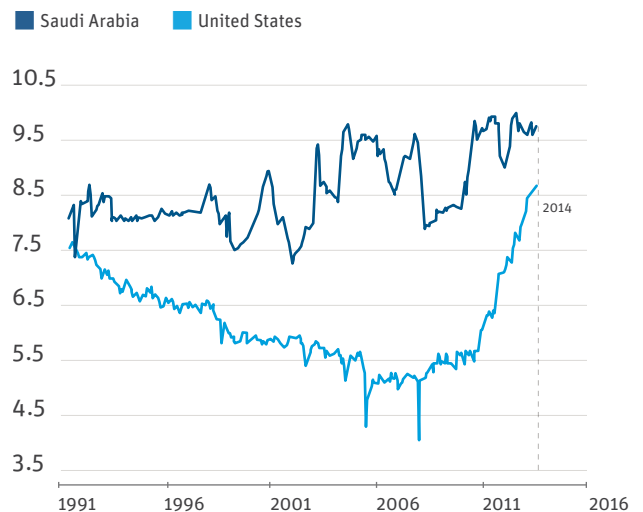
Why does this matter to the wine business? High gas prices are a tax on domestic consumption of goods and services. Lower gas prices, which are down \$1.00 off their high point as of this writing, favorably impact shipping and production of industrial goods and add about \$230 billion dollars annually to U.S. disposable income at that price (Figure 2, see page 21).

Lower gas costs are particularly good for the middle-wage earners who have thus far lagged the recovery. That group, who are more likely to live hand to mouth, will spend every dollar they get.

Figure 1

### Daily oil production

Millions of barrels per day



Source: Bloomberg, Silicon Valley Bank

## Shifts in oil production favor the U.S. consumer

continued

That in turn helps the United States, whose economy is built on consumer spending. The \$60 fall we are already seeing in price puts about \$1,000 per year in an average family's pocket if the price is maintained.<sup>7</sup>

While earlier price drops were more closely linked to a slowdown in world economic output — and some economists still believe the drop is only about the world slowdown — prices should be headed lower no matter the cause, with some analysts predicting oil will fall below \$40 a barrel. A \$40 fall in the price of oil, which is what we've seen from June to November of 2014, represents a shift of roughly \$1.3 trillion; close to 2 percent of world gross output. That transfer goes from producer countries to consumer countries.

The losers in the United States will be the oil drilling companies who have expensive land leases, which at the current price are hitting their breakeven on pumping costs. Regional banks, companies supplying equipment and oil services, and probably real estate in Texas may well see some contractions as well, but unlikely the kind of impact seen after the 1986 oil price collapse.

For most of the wine business, Texas is an important consuming state. Twenty percent of the Texas economy was based on the energy sector in the middle 1980s, when oil crashed and took the state down with it. But at this point, Texas has diversified substantially to the point where energy is only 11 percent of the state's economy.<sup>8</sup> Still, we should expect our friends in the Republic of Texas to feel the pinch in 2015.

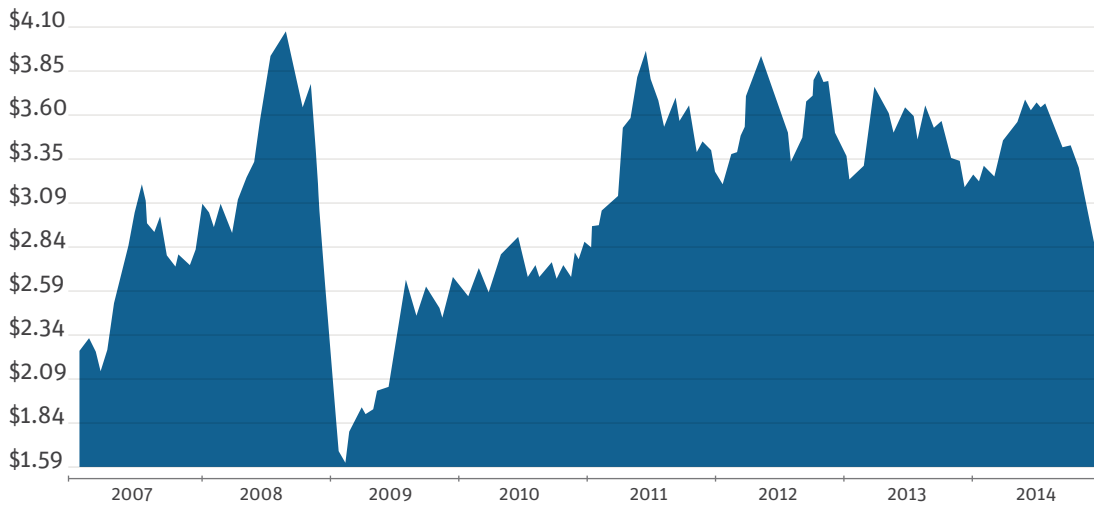
What it means is lower-priced oil isn't a cyclical change or another bubble. The bubble was popped when oil hit \$145 a barrel just before the Great Recession. We don't know exactly where the bottom is, and some predict a boomerang, with prices ratcheting back up.

From our position, this is not a short-term price adjustment, but rather a secular change that will help heavy users of oil, including countries in the European Union (EU), Japan, China, the United States and India, each of whom are important contributors to a healthy world economy. This is a good thing for the U.S. economy and the average wine consumer.

Lower gas costs are particularly good for the middle-wage earners who have thus far lagged the recovery.



Figure 2  
**Average retail U.S. gas price**  
Regular gas price (\$USD/gallon)



Source: GasBuddy.com





# A stronger U.S. dollar means cheaper imports

**If you were on a deserted island nation like Chuck, what would you use for currency? Of course, the answer is nothing, because currency has no value if there is no one to trade with.**

Here in the real world, shifts in the value of currency — particularly in the U.S. dollar — have far-reaching implications, well beyond our own little island.

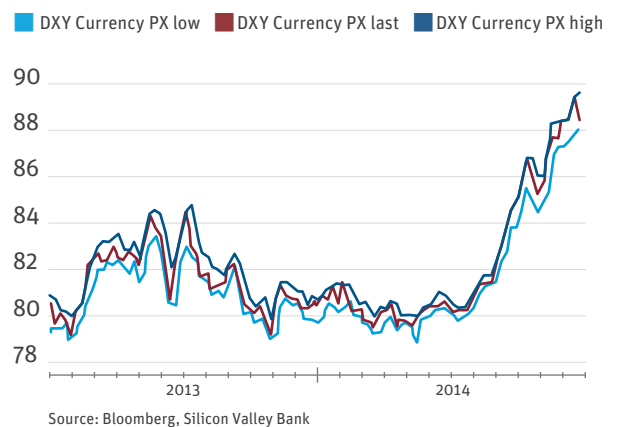
In the early 1980s, we saw a very strong dollar and very high interest rates. The dollar was so strong that imports of foreign wine began to crush our emerging U.S. wine business, which was still struggling with wine quality.<sup>9</sup> It wasn't uncommon back then to find a very nice bottle of Bordeaux for \$10 against an interesting domestic wine like a white cabernet, or a mustang single varietal. A strong dollar makes imports cheaper, increasing the opportunity for foreign competition.

The U.S. dollar has seen remarkable strength of late (Figure 3). Since the middle of 2014, its value has climbed almost 10 percent compared with a basket of world currencies. Why the dramatic change?

Currencies are relative, and the improvement in the U.S. dollar is partly due to a slowdown in the world's major economies. At the same time, the U.S. economy has shown signs of real strength. Japan has gone back into a recession. China's GDP has been decelerating for some time as it struggles with a switch from a producing economy

Figure 3

## U.S. dollar index



to a consuming economy. And in June 2014, the European Central Bank unveiled a range of anti-deflation measures meant to weaken the currency and improve exports. The drop in oil prices plays a role in the strength of the dollar, and in times of world turmoil, the U.S. dollar serves as the world's reserve currency.

We expect the U.S. dollar to continue to gain strength through 2015, as the U.S. economy improves ahead of world industrial economies, and interest rates begin to rise.



# Interest rates are likely to rise

**Predicting movements in currencies, oil prices or interest rates is probably a foolish endeavor, but call me a fool.<sup>10</sup> Each of those price changes impacts our winery and vineyard clients.**

In particular, an increase in interest rates will raise wineries' costs of financing, which impacts their decision making and timing on capital-expenditure budgets. For those wineries without locked-in rate protection, that will also reduce profitability on floating rate debt.<sup>11</sup>

From a U.S. domestic perspective, our Central Bank ended its bond-buying program in late 2014 as planned. In theory, that should have driven rates higher. Because the U.S. dollar is still the world's reserve currency, and Russia decided to destabilize the Ukraine, a flood of world purchases actually lowered bond rates for a period after the program ended (Figure 4). That's why it's so foolish to actually predict price movements.<sup>12</sup>

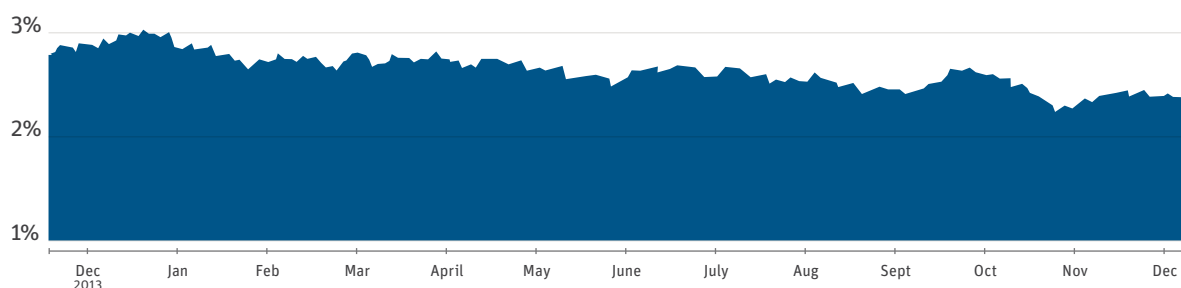
While the 2013 announcement of the end of the Fed bond-buying program caused a chill in the U.S. stock market, the planned end combined with the still-improving U.S. economic indicators had no real impact at the end of 2014.

Now, with strong year-end economic data in 2014, any discussion of rate increases being held out into 2016 has become quieter. The growing consensus is interest rates will start to increase in the middle of 2015.<sup>13</sup> After all, the Fed has consistently messaged that rate increases will be data dependent.

With year-end 2014 growth in employment, right along with growth in hours worked and wages, the data are pretty conclusive. We are predicting a change in Fed forward guidance in Q1 and actual rate increases in Q3 2015.

Figure 4

## 10-year treasury rates decrease in 2014



Source: Bloomberg, Silicon Valley Bank



# U.S. consumers show confidence in the economy

**After the U.S. economy crashed and consumers washed up on the beach of broken dreams with no shelter or home, they found they were locked in a battle just to survive.**

Like Chuck during his low points, consumers began to express doubt and fear. Concerns about our financial system led to the realization of the growing divide between the haves and have-nots, with many wondering if we were ever going to make it back without changing the economic rules and status quo.

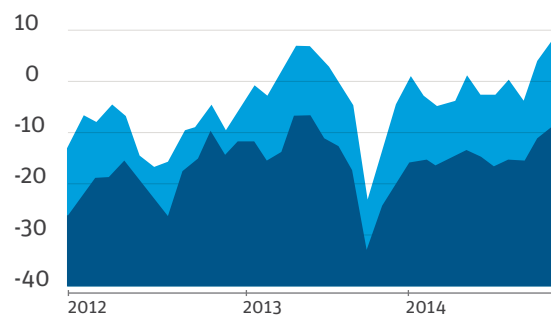
For the United States to truly regain its footing, we need to see the middle class re-establish its traditional purchasing strength and start to paddle out into the economic sea. The good news for those consumers: Your ship is coming in!

While we don't talk much about consumer confidence in this report because it's a lagging indicator of economic activity, it is worth noting that Gallup's measurement of economic confidence has taken a decidedly upward movement in the back half of the year (Figure 5).<sup>14</sup> That is coincident with many other metrics, including what we see in fine wine purchasing activity. What is more important in my mind is the accelerating confidence shown in the middle-income consumers making more than \$90,000 a year. That is a growth opportunity for the wine business.

Figure 5

## U.S. economic confidence index scores by income

■ Middle and lower income (less than \$90,000 annually)  
■ Upper income (\$90,000+ annually)



Source: Bloomberg, Silicon Valley Bank

For the United States to truly regain its footing, we need to see the middle class re-establish its traditional purchasing strength.

# U.S. employment outlook rises with the tide

**While there are various measures of economic vitality, nothing is as important as employment.**

The U3<sup>15</sup> Civilian Unemployment Rate is the most cited measure of unemployment, and as of this writing, the rate has dropped to 5.6 percent.<sup>16</sup> More than 300,000 new jobs were created in November, making 2014 a lock to finish as the strongest year of jobs growth since 1999. The unemployment rate continues to decline in a steady fashion. At the current pace, it should hit 5.5 percent in the second quarter of 2015.

The Bureau of Labor Statistics reports that job openings have now surpassed the growth from 10 years ago (Figure 6), and employers in many industries are reporting difficulty again finding employees for the hospitality industry, as well as technical and skilled labor openings. As of this writing, restaurant and hotel openings have the

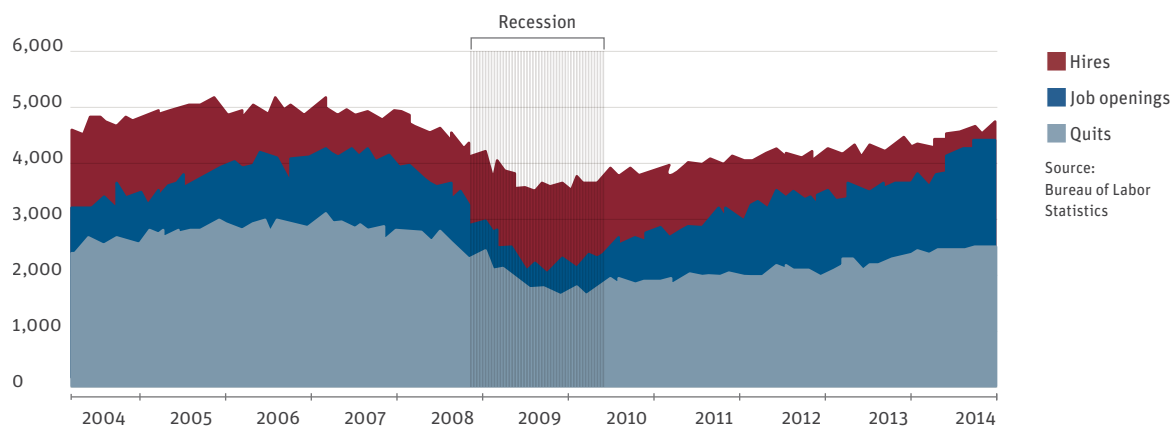
longest-open job postings, arguably because they are lower paid jobs. At some point, those salary offers have to come up, which again is a good sign for the middle class.

It's perhaps a bit counterintuitive, but another encouraging sign is that more people are quitting their jobs — a sign that employees are more secure in their jobs and confident they can find better-paying opportunities elsewhere. If these trends continue, it's only natural to expect an uptick in hiring and some wage inflation, a sign the economy is heating up. With the strength of the November jobs numbers and given the growth in job openings, we expect to see wage inflation start to emerge as a trend beginning in Q2 2015.

Figure 6

## Employment strength

Total private job openings, hires and quits (seasonally adjusted, in thousands)





# The Millennials haven't taken over just yet

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**When Chuck went down in the South Pacific, he was an overweight, middle-aged, clean-shaven executive. Four years later, he was a bearded, skinny man who looked like he was from the Middle Ages. Imagine his shock when he returned to the world he once knew to find that his appearance wasn't the only thing to change dramatically. His fiancée had remarried, she had a daughter and something he had never thought possible had come to pass — there was now a pro football team in Nashville!**

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Coming into 2015, producers in the wine industry might feel that same sense of shock and disbelief. With all the hype over the past decade about the Millennial generation overtaking the Boomers, if Chuck were in the wine business and returned to his life today, he might expect to find the tee totaling Boomers in rocking chairs with the Millennials at the head of the table. But despite the hype, that hasn't come even close to happening. Millennials have yet to make a dent in the fine wine business. So why the difference between the media reports and reality?

In order to take a dominant role in the economy, the younger generation needs jobs that pay well and an appetite for the juice of the vine. The latest data from the U.S. Department of Labor shows the workforce is split in equal thirds between

Boomers, Generation X and Millennials (Figure 7). While equally split, there are important differences. Boomers are starting to hit retirement age and pulling back from the workforce, while Millennials are just getting started in their careers or may still be in school.<sup>17</sup> Those who are in jobs have the highest unemployment rates and an unnatural burden of debt from student loans.

Another critical difference between potential wine consumers is income and wealth. To be a meaningful consumer of fine wine, you need to be in the top 25 percent of wage earners in the United States, or substitute wine for food in your budget as I've been known to do on occasion. As we've documented in past reports, the vast majority of the nation's wealth lies with Boomers.

In order to take a dominant role in the economy, the younger generation needs jobs that pay well and an appetite for the juice of the vine.

Figure 7  
**The workforce in 2015**  
 Projected size of U.S. labor force (in millions) by age

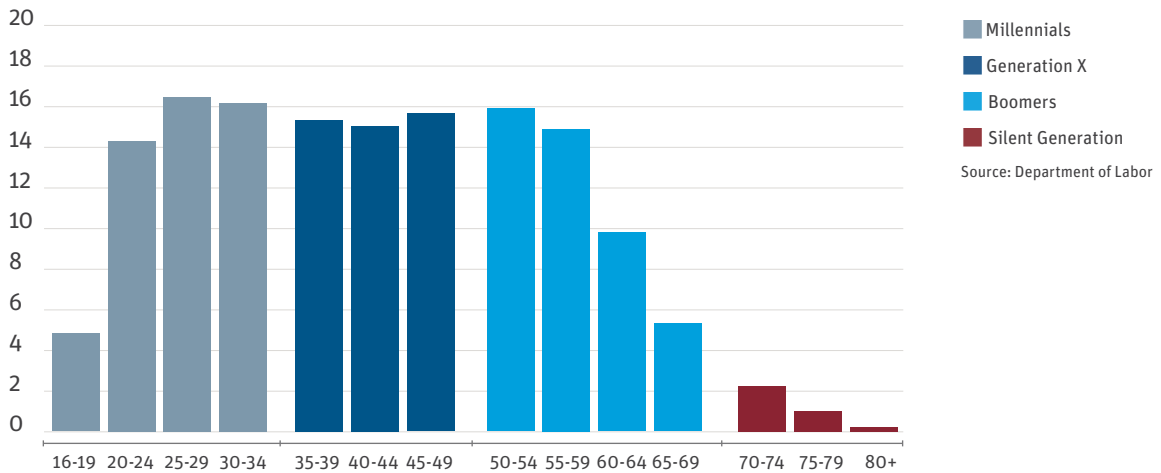
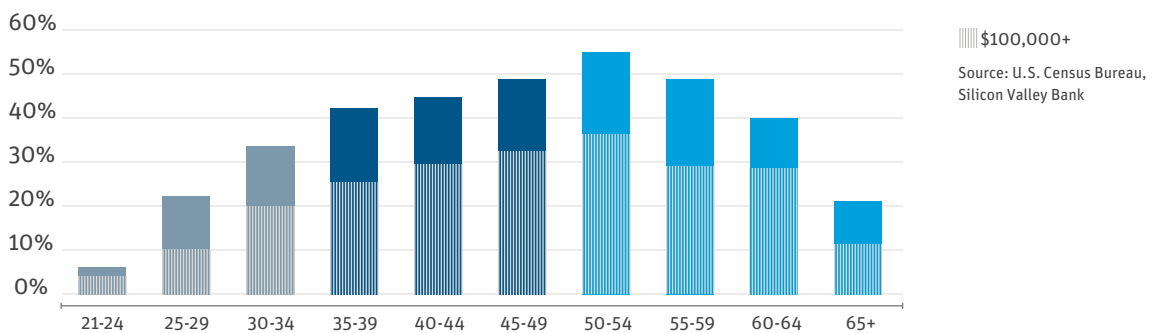


Figure 8  
**Potential fine wine consumers by age**  
 Percentage of families in group (\$75,000–\$100,000+ annual income)





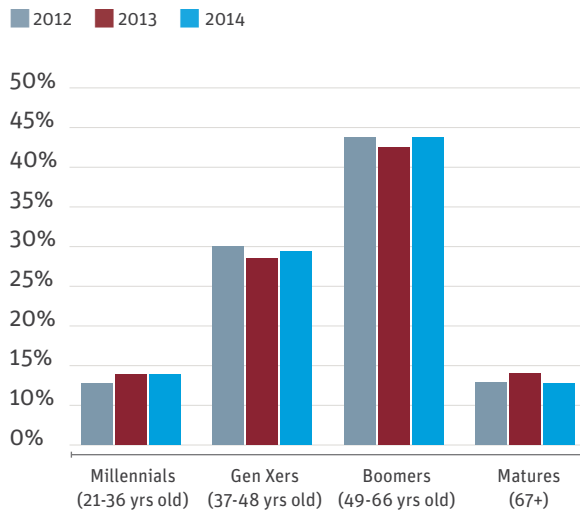
## The Millennials haven't taken over just yet

continued

There is an obvious and stark difference in incomes among the three cohorts. Figure 8 (see page 29) depicts the percentage of families within each age band who make more than \$75,000. As we've consistently pointed out, the greatest spending years are between 35 to 55 years of age. The data shown here indicate the majority of people capable of buying wine fall within that age group.

Figure 9

### Year-over-year sales trends in fine wine



Source: Silicon Valley Bank 2014 Wine Conditions Survey

In our annual Wine Conditions Survey,<sup>18</sup> we asked wineries who have customer relationship management<sup>19</sup> systems in place and could track sales by age group, to tell us what the cohort market shares were from each, shown in Figure 9. Not surprisingly, the Boomers lead sales in the fine wine category, and the forgotten Gen X has the second largest market share. The results of this survey question have not materially changed in the three years we've been asking it.

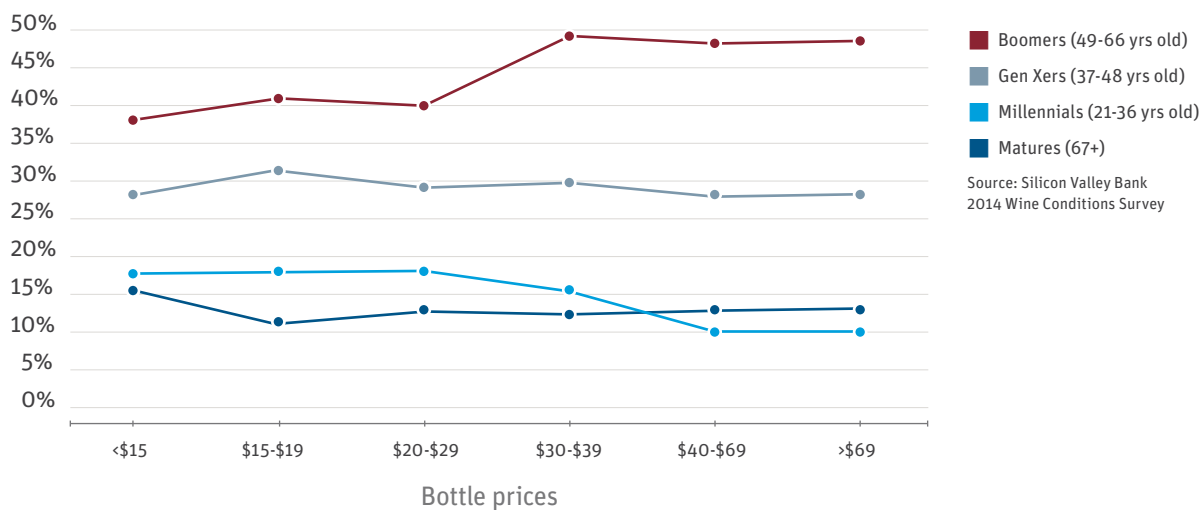
When we sort out the responses from the survey by average price point (Figure 10), we have another way to understand real buying behavior, segmenting wine drinkers by price segment. Boomers are dominant across the board on price, taking the market share in every price range. Gen X shows up second in market share in all prices. Millennials appear to have a larger market share than Matures however, with the exception of the highest-priced wines, and they are starting to overtake Matures in the lower-priced categories.

We can't stress more emphatically that one day, Millennials will be at the center of fine wine sales. But the reality is — no matter what a generation is called, the most active buyers of fine wine and luxury goods will continue to be in the 35- to 55-year age group. The younger generation is just now entering an age where they can participate in a more meaningful way. Today, the largest consuming cohort is the Boomers, and the cohort with the greatest immediate growth opportunity is Gen X. That's where wealth is centered, and that's where income supports purchasing at higher prices.

Today, the largest consuming cohort is the Boomers, and the cohort with the greatest immediate growth opportunity is Gen X.

Figure 10

**Boomers top the charts in bottle sales across all price points**



# 3

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## Supply:

New challenges  
impact planting  
and pricing

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**L**ast year, we began our report with this: “Perhaps the biggest story of 2013 was grape supply – which is better than having the economy get top billing.”

What a difference a year makes, because this year the economy got top billing, in a good way. This year’s grape supply is, well, one more year of ho-hum great quality and big yields for the third year running, which has pressured grape and bulk prices lower.

So, put yourself in the position of a grape grower. You had three great years in a row. If you were in sales, three record years would get you big bonuses. But what does that get you as a farmer? Lower prices for your grapes and a collapsing spot market. It just doesn’t seem right, but the lot of grape growers is being subject to the whims of Mother Nature. At times, it seems they have no control over their destiny.

They might feel like Chuck Noland, who looked back on his experience and said, “I had power over nothing. ... I knew, somehow, that I had to stay alive. Somehow, I had to keep breathing.”

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**34** Supply and consumption shift worldwide

**37** Record yields continue on the U.S. West Coast

# Supply and consumption shift worldwide

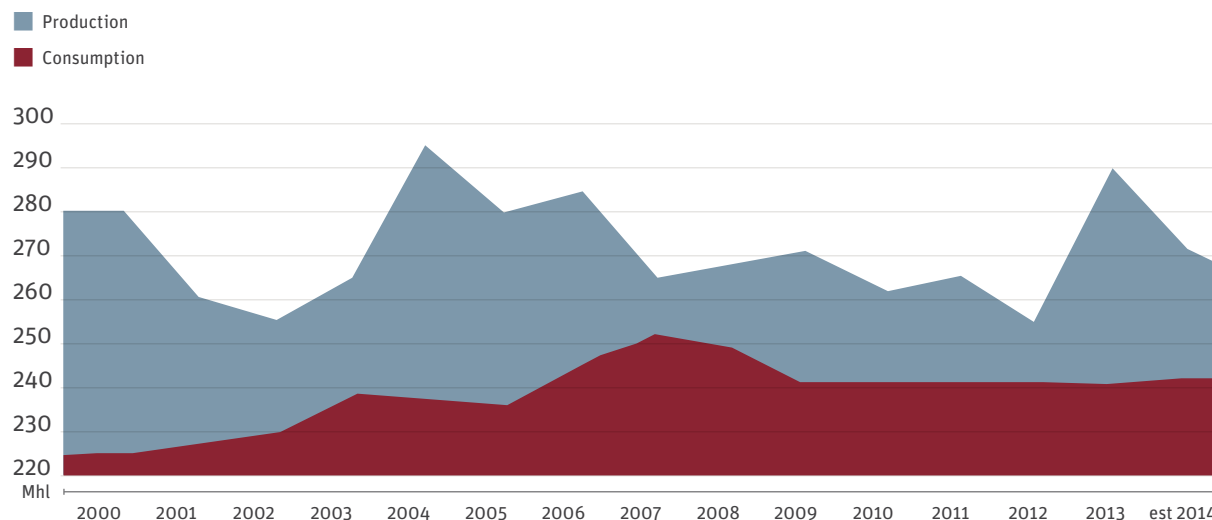
**In recent years, the traditional producing countries seem to have suffered greater variability in weather events impacting both volume and quality.**

World consumption of wine has stalled out at about 240 million hectoliters (Figure 11), but there is a clear shift in consumption away from France, Italy and Spain, and toward the United States, the United Kingdom, China and Argentina (Figure 12). Today, about 39 percent of wine is consumed outside European countries, compared with 31 percent in 2000,<sup>20</sup> and the United States is now the world's top-consuming country.

World production has been going through a shift for about a decade. Since 1998, the higher-consuming countries of France, Italy, Spain, Portugal and the United Kingdom each experienced significant declines in per capita wine consumption, so much so that by 2006, Europe was producing about 150 million cases more than it could sell. Catering to popular sentiment, instead of dumping the wine, producers were paid for their surplus in what was termed *emergency distillation* —

Figure 11

## Worldwide production vs. consumption



Source: L'Organisation Internationale de la Vigne et du Vin

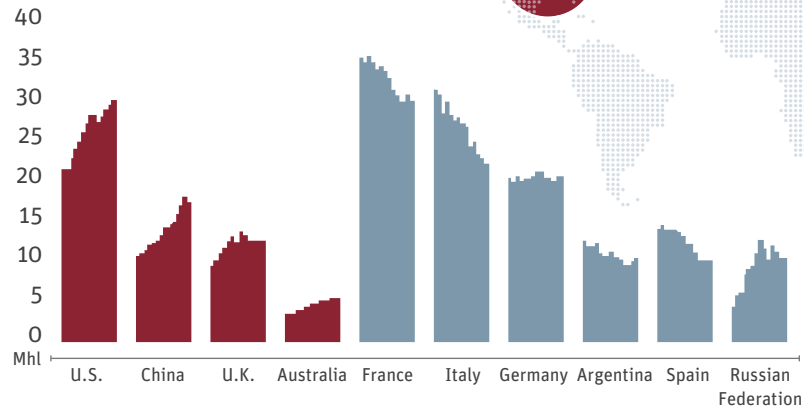


Figure 12

**Global consumption trends**

2000-2013

■ Increased consumption in millions of hectoliters



Source: L'Organisation Internationale de la Vigne et du Vin



## Supply and consumption shift worldwide

continued

a program where excess grape production was converted into industrial ethanol. Finally, the EU recognized the obvious non-market support mechanisms were killing prices for their successful farmers and perpetuating a disastrous oversupply.

After several years of negotiations, the EU put into place a controversial Communal Regulation (CMO) in late 2007, phasing out the emergency distillation program entirely by mid-2012 and paying European growers to uproot 175,000 hectares (about 430,000 acres) of economically unsustainable and lesser-quality vineyards.

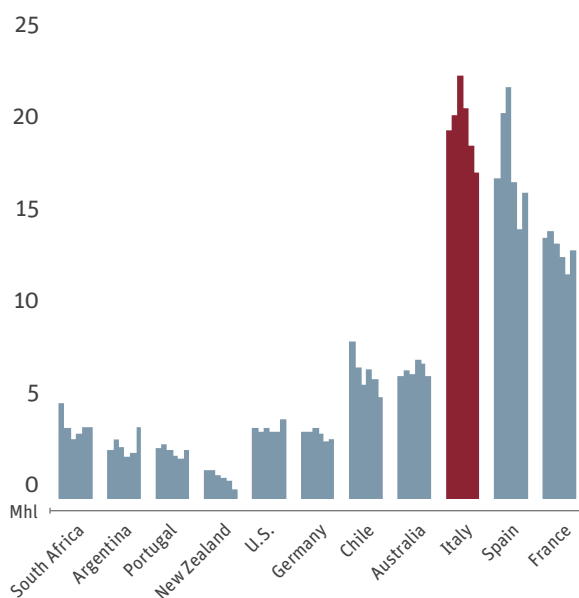
Spain, Italy, France, Portugal and Hungary have been the major benefactors of the CMO, and — in concert with increasing world demand and more EU exports — the result has been that the lake of wine that once existed in Europe has now dried up to a pond. Still, with those initiatives, in 2014 the Organisation Internationale de la Vigne et du Vin (OIV) announced France had again reclaimed its top spot over Italy among world producers, with 46.2 million hectoliters produced in total.<sup>21</sup>

Italy has led the world in export volumes for some time now (Figure 13); however, France leads Italy and Spain in the value of their exports, with each reporting the value of exports at €7.8, €5.0 and €2.5 billion euro respectively. Countries making moves in world exports include Chile, which has moved into the fourth position worldwide over Australia; and South Africa, which has leapfrogged several countries to move into the sixth spot.

Figure 13

### Trends in export volumes

Six-year span (2008-2013)



Source: L'Organisation Internationale de la Vigne et du Vin

# Record yields continue on the U.S. West Coast

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**In 2014, we ended with a three-peat in California thanks to another great harvest and yield. Oregon had perhaps its best harvest of all time, with both strong yield and excellent quality, and Washington reportedly experienced nearly ideal growing conditions and normal yields.**

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This continues a pattern that began with the 2012 harvest, which presented a record yield in all the West Coast wine-growing states. California hit a record 4.02 million tons at harvest, with Oregon and Washington experiencing equally outstanding vintages in both quality and volume.

Wineries desperate for supply coming off two consecutive low production years in California still bought up pretty much all of the uncontracted fruit that was left and available in 2012, and were paid well for their excess production.

2013 was another large harvest — slightly off the 2012 production record in California, but still fantastic quality. Oregon and Washington experienced more difficult growing conditions in 2013.

Now, with the outstanding 2014 harvest in California, one has to wonder if the 4 million ton harvest is now the norm. Or, will volume of domestically produced fruit retreat?

Each of the regions on the West Coast reported excellent quality in 2014, with the Pacific Northwest leading the way, followed by Napa and Sonoma County. Lodi, the Sierra Nevada and the Central Valley also reported good quality but with greater variability. The Central Valley and Central Coast reported experiencing the greatest variability due to drought and wind in some locations, which reduced berry size and yield (Figure 14, see page 38).

## California's high yields create excess supply

Most estimates for the 2014 harvest are somewhere around 4 million tons as of this writing, which would make it the third largest harvest on record. Our guess is slightly lower than that, based on discussions and information from our annual Wine Conditions Survey (Figure 15, see page 38). But we fall into line with the general consensus that the year will prove to be right up there with the largest three or four crop sizes ever, and the heavy volume is changing the shape of the supply balance in the business.

# 2014: High yields, high quality

Figure 14  
**Percentage of wineries reporting excellent harvest quality**

**87%**

Oregon

**73%**

Washington

**72%**

Napa County, CA

**64%**

Sonoma County, CA

**58%**

Lake County, CA

**50%**

Anderson Valley & Mendocino County, CA

**50%**

Central Coast, CA

**50%**

Mid-Coast, CA

**46%**

Central Valley, CA

**44%**

Sierra Foothills, CA

**25%**

Lodi & Other Delta Counties, CA

Source: Silicon Valley Bank 2014 Wine Conditions Survey

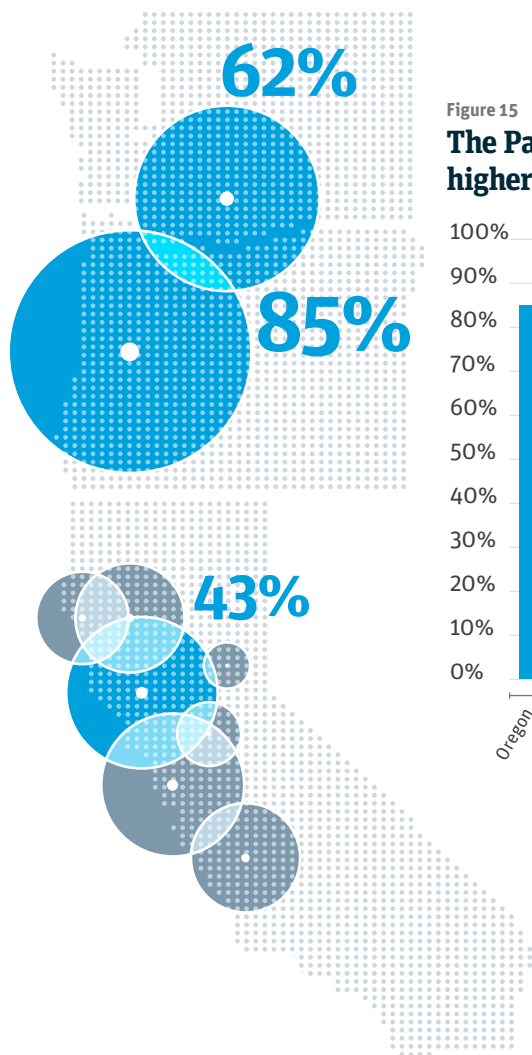
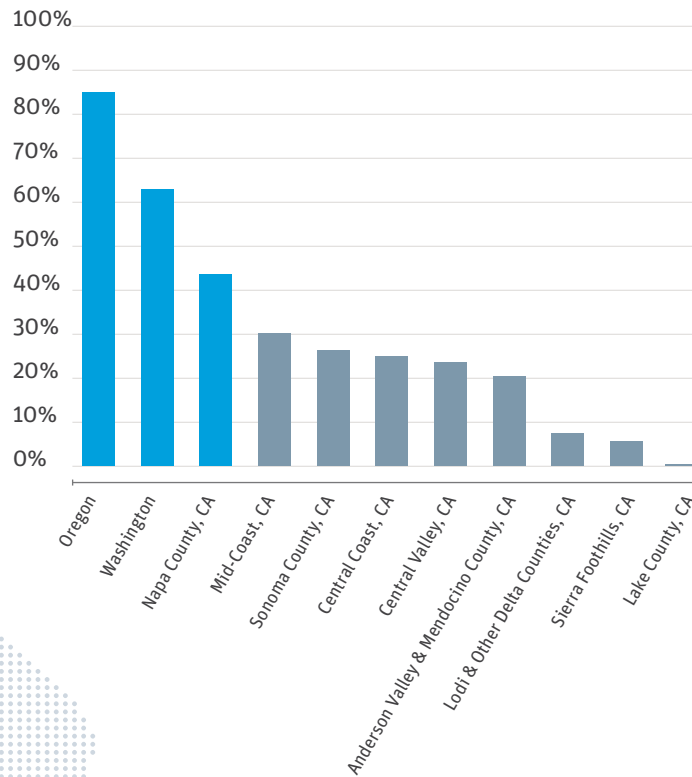
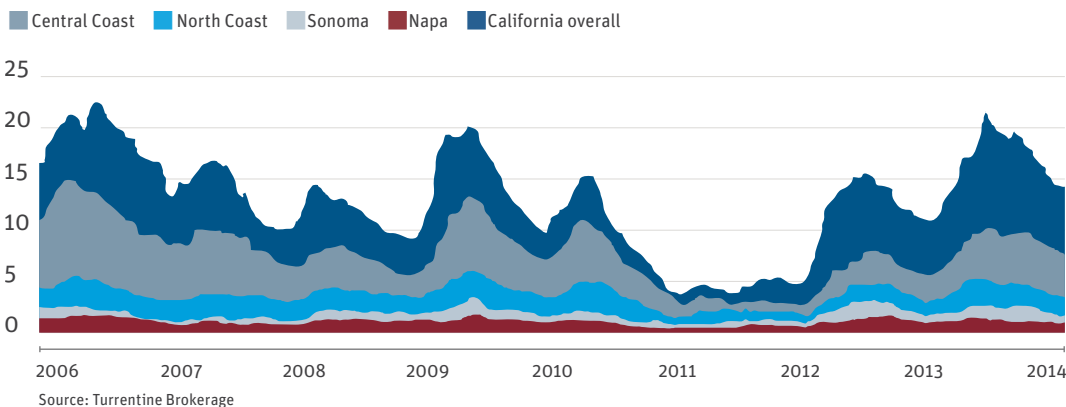


Figure 15  
**The Pacific Northwest led the pack in reporting higher-than-average yields**



Source: Silicon Valley Bank 2014 Wine Conditions Survey

Figure 16  
**Bulk wine available by region**  
 Millions of gallons



## Record yields continue on the U.S. West Coast

continued

### In California, one has to wonder if the 4 million ton harvest is now the norm. Or will volume of domestically produced fruit retreat?

2010 and 2011 were poor harvests, as you can see by the big dip in the right side of Figure 16. But at the time, given where we were in a challenging recovery, it wasn't a total disaster to have a couple thin crops.

By 2012, wineries had pushed through the bulge in inventory from decelerated sales and started needing supply again. The record 2012 harvest was met by producers and growers alike with the same joy Chuck experienced after he lost and then found his best friend, Wilson the volleyball.

2013 was a different experience for growers. With the record yield from 2012 still filling cellars, bulk wine readily available and 2013 contracts being fully met from the outset of harvest, some excess grapes were left hanging longer than needed just to clear tank space, overage options were declined by wineries, some excess couldn't find a home, and enforcement of quality standards at delivery was the norm. Grapes that would have been gladly accepted in 2012, flaws and all, were rejected outright in 2013. Spot prices also showed declines as would be expected.

This is what we predicted in last year's report for grape supply balance in 2014:

"On the whole, we're not worried about the bulk market being heavy at this point despite two back-to-back record years, nor are we too disturbed by any of the varietal reports of slight excess. It's really going to get down to what consumption and harvest looks like in 2014. With our view of both better consumption and guessing an average yield in 2014, we believe we are really pretty

well-positioned in the cellars and with bulk availability, with the slight exception of merlot, chardonnay and lower-cost bulk juice intended for higher-production wineries."

The prediction was probably just about right — if only Mother Nature would have cooperated and given us an average yield. While our take on lower-cost juice seemed spot on, given the third consecutive record yield, there is now a fair amount of juice out there looking for a home, but activity on bulk purchasing is low because producers have what they need.

Today, you can pretty much describe the shape of supply as *long*, as you move further down the ladder of expected price per ton. It's very long under \$8 and slightly long in the wine destined for middle-tier bottles priced between \$9 and \$18. However, the highest-priced bottles, and particularly red wine and North Coast cabernet, are short (Figure 17, see page 41).

### Shifting cargo in low-priced wines

Once Chuck was able to escape the barrier reef in his raft, he discovered how his low-priced conveyance wasn't well-engineered for the wind and weather the high seas threw at him, and his little craft started to lose pieces in the midst of the storm. In a similar way, the grape growers producing for the lower-priced segments have experienced outside forces on their operations and have lost some pieces of their traditional business models.





## Record yields continue on the U.S. West Coast

continued

The Central Valley has long been and still is the gateway for U.S. consumers to cut their teeth. In this writer's view, it's critical to the long-term health of the U.S. wine business. As early as 2004, we've noted the threat imported bulk wine could have on our Central Valley winegrowers, particularly those producing wine for the lowest-priced wine segment. It was clear to us back then that the Internet would make access to unlimited amounts of bulk wine a real possibility for the largest-production wineries. If there isn't any difference for those producers except price, our Central Valley growers are more significantly disadvantaged. We believed that needed to be addressed in some way back then, and we still believe that now.<sup>22</sup>

In a November 2014 presentation at the San Joaquin Valley Winegrowers Association, the presenters noted several issues that needed to be dealt with. The part of the market producing grapes destined for wines priced less than \$7 had become overplanted. Foreign bulk imports that typically go into those bottles were taking an equivalent of 30,000,000 cases annually in market share, which is somewhere near the equivalent of 60,000 acres of grape production lost — ceded to foreign competition.

Uncomfortable would be the best way to describe the mood in 2014 in the Central Valley. While contracted fruit delivered good prices, uncontracted grapes in the Big Valley attracted prices as low as \$100 per ton, impacting about 10–15 percent of the valley's total production according to estimates.

Figure 17

### Supply and demand 2013 vs. 2014

#### Cabernet Sauvignon

	Est. tons crushed	Bulk inventories	Bulk demand
Napa Valley	↘	↘	<b>Strong</b>
Sonoma County	↘	↘	<b>Strong</b>
North Coast	↘	→	<b>Strong</b>
Central Coast	↗	↗	<b>Moderate</b>
Northern Interior	↗	↗	<b>Weak to moderate</b>
Southern Interior	↗	↗	<b>Weak to moderate</b>

#### Chardonnay

	Est. tons crushed	Bulk inventories	Bulk demand
Napa Valley	→	↗	<b>Moderate</b>
Sonoma County	↘	→	<b>Moderate</b>
North Coast	↘	↗	<b>Weak</b>
Central Coast	↗	↗	<b>Weak</b>
Northern Interior	↘	↘	<b>Weak</b>
Southern Interior	↘	↘	<b>Weak</b>

Source: Turrentine Brokerage

# 4

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## Bottle pricing:

Highs move higher  
and lows trend down

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**A**fter a thorough search for Chuck, covering the area where his plane was believed to have gone down, everyone was left with the only reasonable conclusion: Chuck had been lost at sea. Turns out, they didn't have all the information. In reality, Chuck's plane had veered hundreds of miles off course.

When you add up all the data points with the wine business as we know and as discussed above, many people will say to themselves: heavy inventory loads equal lower bottle prices. That is a reasonable thought process, because in a static environment holding demand constant, an increase in volume should decrease price. But, that simplistic view ignores a few factors.

When we asked participants in SVB's annual Wine Conditions Survey about their expectations regarding bottle price in 2015, we drew some interesting conclusions (Figure 18). The expectation of price decreases in 2015 is minimal, but more prevalent in the lower-priced segments. That seems to fly in the face of economic theory, since we have three years of great yields. But the black trend line in the chart gives one clue why the wineries might be right in this question this year.<sup>23</sup> The shape of the inventory curve is tilted up, with wineries selling the lowest-priced wines less likely to expect they can drive price increases. That's consistent with the information presented above, which shows the

lower-priced segments are long and the highest-priced wines are short, particularly in red wine. It's also consistent with what we know about cohort purchasing behavior, with the youngest consumers preferring lower-priced wines, but lacking the financial resources to move the needle.

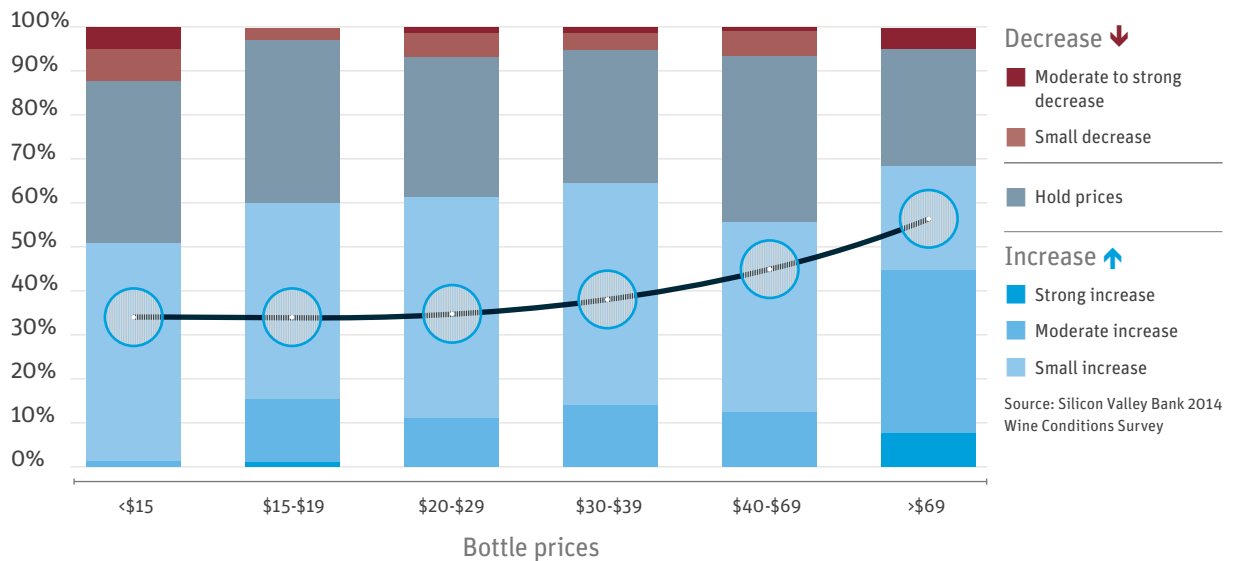
2015 will allow some increases in bottle prices above the \$20 price point and perhaps slightly below that in red wine because of an improving economy and wines that are closer to being in balance. The lower end of the market — below \$8 retail — is already trending down. Something will have to happen to make that trend reverse course, and we can't see anything at this point that would reverse the trend. In fact, a strengthening dollar could increase bulk imports, so the lowest end of the market from a price perspective will probably see price discounting and perhaps volume declines as well in 2015.

At the lowest end of the market, we expect to see pricing declines given there is abundant supply and trading up, which isn't a good recipe for success in this segment. In the \$10–\$20 part of the market, there is a lot of wine available to be sold. *Négociants* and branded wines will soak up some of that, such that we expect to see volume increases and some discounting. Wines priced from \$15–\$18 will have better luck maintaining their price. Despite the higher volumes, we believe we may see modest price increases in bottle prices greater than \$20.

The shape of the inventory curve is tilted up, with wineries selling the lowest-priced wines less likely to expect they can drive price increases.

Figure 18

### Pricing expectations among wineries





# 5

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# Financial performance:

2015 looks like  
a breakout year

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## **You have to watch your business, identify issues and potential problems, then take early action. That means planning and using financial statements and other business metrics to quantify your performance.**

An understanding of what happened in the past and an informed view of what's coming next is critical. As Chuck Noland said, "We live and die by time, and we must not commit the sin of turning our back on time."

Each year in this report, we take a look at the financial condition of wineries, review historical trends and forecast a sales growth band for the fine wine segment, which we define as wines sold over \$20 retail. In 2014, we predicted sales growth of 6–10 percent and expect to end in the upper end of that range, if not a percentage point or two above it. Consistent with our information, Symphony IRI Group data from marketing consultants Wines & Vines for 12 months in off-premise accounts show positive revenue growth of 6 percent for the period ending in November 2014, with 13 percent growth in direct-to-consumer sales.

The economy had a rough Q1 in 2014 due to weather, but sales of higher-end wines made a strong comeback in the back half of the year. Sales of lower-priced wines, however, dropped off in volume and were discounted.

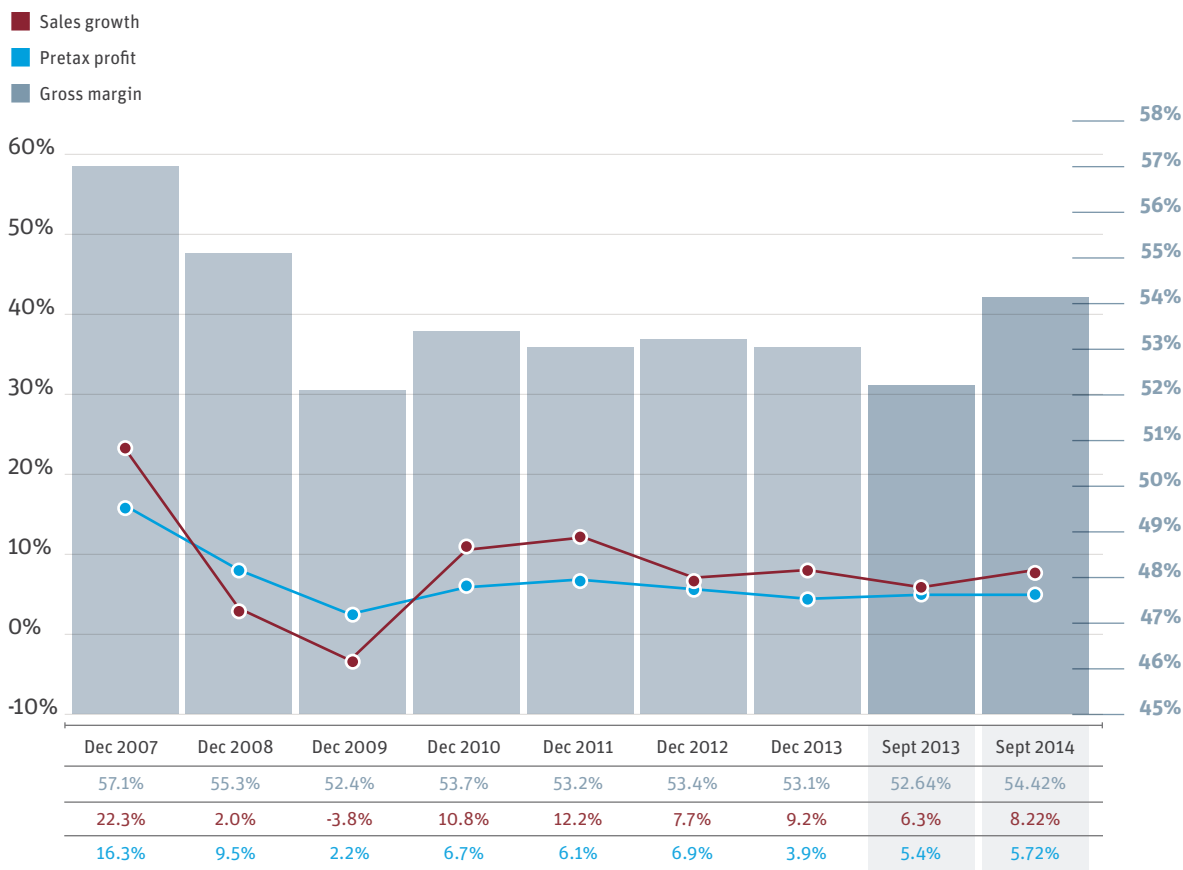
Overall wine consumption increased for the 20th straight year. Overtaken blue laws, better employment, relaxed restrictions on direct shipments and customers trading up to more premium-priced wines all led to the industry's improved year-over-year success in 2014.

### **Wineries report a solid 2014**

Getting financial information about the wine business is a little more difficult than getting top-line sales numbers. The wine business is a family-run industry, and financial statements and returns aren't just washing up on the beach. As bankers, we have the information, and for years we've condensed that data into statistics that we give to our clients for free. As a result, people from Spokane to San Diego contact us about getting help in financial modeling. I always disappoint them when I say the information is reserved for clients only, but I can offer the data in Figure 19, shown here.



Figure 19

**Financial performance of premium wineries**

Source: Silicon Valley Bank Peer Group Database

As we look at the financial position of wineries this past year, starting with data developed from SVB's Peer Group Database,<sup>24</sup> revenue growth through the nine months ending September 30, 2014, was about 8 percent, the center of our predicted range. Our data are not seasonalized, and we expect to see the impact of a strong October-November-December (OND) 2014 selling season<sup>25</sup> ramp up end-of-year sales after a weak OND period at the end of 2013. For 2015, we are forecasting a breakout sales year in fine wine, with a year-over-year increase of 14–18 percent.

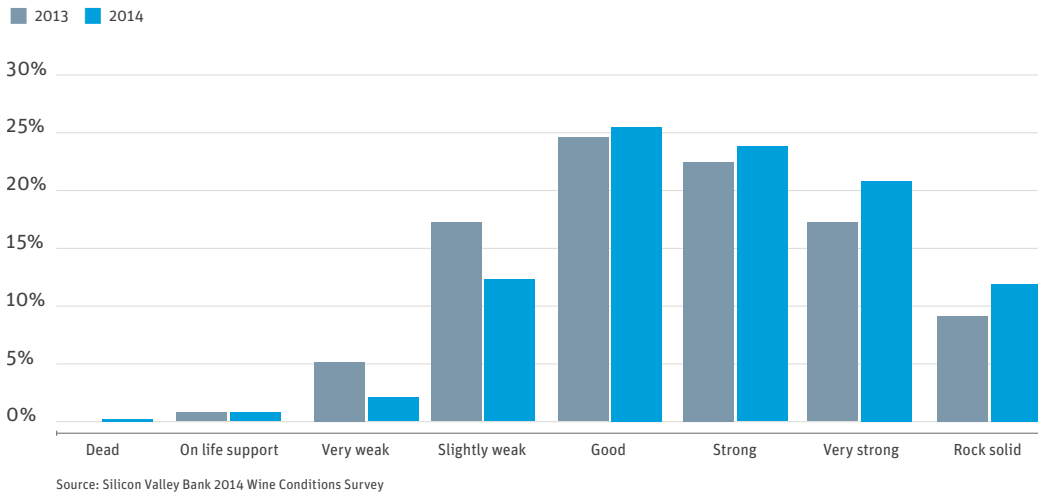
Overtaken blue laws, better employment, relaxed restrictions on direct shipments and customers trading up to more premium-priced wines all led to the industry's improved year-over-year success in 2014.

## Financial performance: 2015 looks like a breakout year

continued

Figure 20

### Financial health: year-over-year comparison



Keeping the good news coming, while we haven't seen bottle price increases in 2014, we have seen an improvement in the cost of goods sold on average, due to the front edge of the larger vintages entering the sales stream.

Harvest costs in the larger vintages are spread over more tons, lowering cost of sales and yielding improved gross margin. Direct-to-consumer sales, which are a smaller part of overall sales but carry higher margins, also contributed to improved margins. Higher general and administrative costs due to a heavier investment needed for direct sales washed out the gains from improved cost of goods sold, leading to flat profitability.

Taken as a whole, the financial performance of wineries in 2014 was pretty good and ended on an uptick.<sup>26</sup> Looking at reported financial health from our survey shows that wineries are making progress, with each breakpoint showing year-over-year improvement (Figure 20).<sup>27</sup>

While there is a high chance we could miss the degree and timing of the U.S. currency improvement, drop in oil prices, Fed actions, impact of a decelerating world on the U.S. economy, or the negative impact of higher interest rates on the economy, we are committed to our belief and path and think the directional improvement we are seeing is real and sustainable.

Like Chuck Noland in the final scene in *Cast Away*, we can't be certain what the future holds, but given what we've been through, we're optimistic. As he stands at a crossroads, he's asked: "Where're you headed?" Chuck's answer: "Well, I was just about to figure that out."

**Taken as a whole,  
the financial  
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wineries in 2014  
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and ended on  
an uptick.**

# Endnotes

1. Q: What do the author Rob McMillan and Tom Hanks have in common? A: Both were born in 1956 in Mt. Diablo Hospital in Concord. Both attended California State University, Sacramento. Both are extraordinarily wealthy. ... Well, maybe not the last one.
2. The labor force as a percent of the civilian noninstitutional population.
3. U.S. Bureau of Economic Analysis data at [tradingeconomics.com](http://tradingeconomics.com).
4. There is no agreed-upon reference point for the term “fine wine” in the industry. We use \$20 a bottle as a definition, because we have access to several databases that have a breakpoint at \$20 or more.
5. [www.winesandvines.com/template.cfm?section=news&content=142644](http://www.winesandvines.com/template.cfm?section=news&content=142644).
6. Shale fracking: [en.wikipedia.org/wiki/Hydraulic\\_fracturing](http://en.wikipedia.org/wiki/Hydraulic_fracturing).
7. [www.washingtonpost.com/opinions/robert-samuelson-key-facts-about-the-great-oil-crash-of-2014/2014/12/03/a1e2fd94-7b0f-11e4-b821-503cc7efed9e\\_story.html](http://www.washingtonpost.com/opinions/robert-samuelson-key-facts-about-the-great-oil-crash-of-2014/2014/12/03/a1e2fd94-7b0f-11e4-b821-503cc7efed9e_story.html).
8. The Southwest Economy First Quarter 2011, Federal Reserve Bank of Dallas, p 34.
9. Here’s a little economic trivia for you. The Plaza Accord was an agreement signed to weaken the U.S. currency and was the first public successful coordinated act made by Central Bankers to stabilize world currency markets: [en.wikipedia.org/wiki/Plaza\\_Accord](http://en.wikipedia.org/wiki/Plaza_Accord).
10. OK go ahead and say it: Rob? You’re a fool. Now go back to doing something useful.
11. I know this stuff because I actually am a banker in the wine business handling client needs, and I work for a living. This writing stuff is what I do in my copious free time.
12. Rob, you’re still a fool.
13. Bloomberg survey of economists, October 2014.
14. [www.gallup.com/poll/179810/economic-confidence-index-month-high.aspx](http://www.gallup.com/poll/179810/economic-confidence-index-month-high.aspx).
15. Unemployment Rate U3: [data.bls.gov/timeseries/LNS14000000](http://data.bls.gov/timeseries/LNS14000000).
16. Bureau of Labor Statistics: [www.bls.gov](http://www.bls.gov).
17. For more on these consumers, see my blog post: [bit.svb.com/1yOuIK9](http://bit.svb.com/1yOuIK9).

18. Silicon Valley Bank conducts a Wine Conditions Survey each year in conjunction with AVA's throughout the West Coast. In 2014, we sent the survey out to about 4,000 wineries, and nearly 500 responded. If you would like to be included in the survey in the future and receive gratis results and analysis, please contact Penny Northrop and request that you be added to our survey list: [pnorthrop@svb.com](mailto:pnorthrop@svb.com).
19. Customer relationship management is a must-have for wineries selling direct: [en.wikipedia.org/wiki/Customer\\_relationship\\_management](http://en.wikipedia.org/wiki/Customer_relationship_management).
20. L'Organisation Internationale de la Vigne et du Vin (OIV) statistical releases.
21. Ciatti Global Market Update, November 2014: [www.ciatti.com/sites/default/files/november\\_2014\\_ciatti\\_world\\_report.pdf](http://www.ciatti.com/sites/default/files/november_2014_ciatti_world_report.pdf).
22. If you would like to read a little more about my "foot in mouth" experience of this prediction, see my blog post "Is California Wine at a Pricing Inflection Point," at SVB on Wine: <http://svbwine.blogspot.com/2012/07/is-california-wine-at-pricing.html>.
23. On questions of expectations, we avoid the common survey mistake of asking something respondents have limited control over. While price increases fall into that category, we don't always accept the general belief as was the case last year. We test the theory to see how it holds up. We know wineries want to pass on higher costs to consumers, and this year in certain price points, we believe they can.
24. The SVB Peer Group Database is a proprietary database of both client and non-client financial statements going back to the early 1990s. With it, SVB is able to benchmark a client's financial information against a highly relevant peer group and review industry-level trends.
25. In the wine business, the months of October, November and December represent about 40 percent of annual sales.
26. "Pretty good" is defined in generally accepted accounting 15 principles as financial performance that is one step better than "good."
27. Reported financial health, while improving in all categories, did have one notable reported negative change year over year, and that was in the "dead" category. We have to call the reporting into question, since reporting when one is dead is only permissible in Chicago elections.



# About Silicon Valley Bank

For more than 30 years, Silicon Valley Bank (SVB) has helped innovators, enterprises and investors move bold ideas forward, fast. SVB provides a range of targeted financial services to businesses of all stages and sizes, with specialized expertise in the technology, life sciences, energy and resource innovation, venture capital, private equity, and premium wine industries. Through offices across the United States and around the world, SVB offers commercial, international and private banking services that address the unique challenges and opportunities innovators face. (Nasdaq: SIVB)

**Learn more at [www.svb.com](http://www.svb.com).**

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## Silicon Valley Bank's Wine Division

Founded in 1994, SVB's Wine Division offers financial services and strategic advice to premium vineyards and wineries in the United States. With one of the largest banking teams in the country dedicated to the wine industry, SVB's Wine Division has offices in Napa and Sonoma counties and serves clients in the fine wine producing regions of California, Oregon and Washington.

**Learn more at [www.svb.com/winedivision](http://www.svb.com/winedivision).**

## Contact us

For more information about this report or Silicon Valley Bank's Wine Division, please call or email:

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Executive Vice President and Founder

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[rmcmillan@svb.com](mailto:rmcmillan@svb.com)

## Silicon Valley Bank's proprietary Peer Group metrics

SVB's Peer Group Analysis program tracks and compares a variety of financial measures among premium wineries. With financial information collected from more than 100 premium wineries over several years, SVB gives clients exclusive benchmarking information and insights into trends shaping the industry.





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