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MKF WINE INDUSTRY BUSINESS UPDATE

Wine In A Down Economy

How is Wine Affected by a Down Economy?

Eric N. Sims - Wine Economist

The news in recent months has been dominated by global economic concerns. The past seven years of economic growth in the U.S. economy has meant "good times" in the wine industry. But uncertainty about the strength of the world economy and its impact on America is coming from a deepening recession in Asia, political turmoil in Russia, a nervous stock market, and domestic political issues surrounding the President.

Is the boom over? What's ahead? The MKF 1998 Grape Trends report said, "It's the Economy" that looms larger than the potential grape oversupply. Here in wine land, the question on the minds of all vintners is, "How will wine be affected by an economic downturn?"

Four years ago, California premium wine volume exceeded generic wine volume for the first time in history. The California wine industry is now driven by the premium wine sector. This bodes well for the long-term financial strength and success of the industry, but this is also a new factor going into the next economic recession. How will the wine industry fare?

Uniqueness of Wine-

"Histories make men wise" said Francis Bacon. Wine's history is longer and more complex than that of any other branded consumer good. (Even Noah had a vineyard.) It follows that an evaluation of the economics of the wine industry will be more complex than that of other manufacturing industries.

A simple analysis of supply and demand is complicated by the long time lag between harvest and retailer. In this industry we are matching a demand determined today against a supply determined some years ago, rather than days ago, as in most

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How Will Vintners Respond to a Down Economy?

Vic Motto - Wine Business Consultant

After the record size vintage of 1997, the word on the tongues of wine industry executives was "glut." Focusing solely on the supply of grapes and completely ignoring growth in consumer demand, the industry was certain that the next crisis was just around the corner.

Only in agriculture can otherwise really bad news, such as a short crop, actually turn out to be good news. With a lighter than normal crop in 1998, vintners' worries turned from an oversupply in the wine industry to a potential downturn in the U.S. economy. The industry now believes that the economy is a more important factor than a potential oversupply. In fact, the more important factor is how the wine industry will respond to the next economic downturn. That will determine more about how the industry fares than the downturn itself.

The Japanese Paradox-

It is rare to have a laboratory to test "what if?" economic questions. However, the current crisis in Japan allows us to speculate on how wine sales may behave during a downturn in the economy. The Japanese economy is in turmoil. U.S. exports of rice, cotton, beef, and other products are depressed. However, wine sales are stronger than ever.

In 1998, California wine exports to Japan more than tripled. During the same period, total exports of other goods from California to Japan fell 15 percent. Coinciding with the increase in exports, the value of

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other industries. Given this timing difference, the first question we need to ask is "demand or supply - what is the binding constraint?" **In the wine industry, supply is the binding constraint** (for the foreseeable future).

For most consumer goods, the available supply is relatively easy to adjust as demand fluctuates. Mattel can produce as many Barbie dolls as the market demands. And, they can constantly monitor the market and make real time adjustments to inventory. Wineries, in contrast, must operate with the level of supply that Mother Nature provides. If the market demands more, the wine industry is unable to provide it. In fact, it usually takes several years for the winery to adjust to the market, and by then, the market has changed.

Another difference between other consumer goods and wine is that the price differential between the low quality and high quality product for most goods is relatively small. For example, the price differential between a national brand dishwasher soap and a generic soap is a couple of bucks. For wine, the price differential can be as much as one hundred dollars between the price of a generic California red and a cult-status California Cabernet.

It is this spectrum of prices that makes it dangerous to treat the wine industry as a single industry. Each price segment is unique and faces its own demand curve. It is even questionable that wines from different price segments compete with each other. During a recession, each major price segment functions differently. Beware of any analysis (or analyst) that does not segregate the market into clear price segments.

Wine is different from other agricultural products and consumer goods. Supply (yield) always fluctuates. The use of price adjustments to modify demand to match a given supply is common in agricultural goods. Typically, prices are adjusted to a level that will sell the available supply. Due to shelf and wine list requirements wineries want a vintage to last exactly one year – no more or less. In other words, where most industries have a continuous supply of product from year to year, the wine industry manages each vintage as a discrete product. This is more true at higher price levels, but there is certainly a sensitivity to having the timing of each vintage in sync with the market.

The unfortunate circumstance today is that the small 1998 crop will be expensive to produce and not alleviate any shortages. Simultaneously, other consumer goods will be relatively more inexpensive and domestic wines will have more upward price pressure.

Vintage Variations in Quality and Quantity-

The 1989 vintage was larger than normal. The quality of the vintage was questioned by the wine press. Then, most of the wine from the 1989 vintage came to market during the last slowdown in the economy, when consumer confidence was at the lowest point since 1975. Wine sales still grew, but at a slower pace. The question is, was the slowdown in sales caused by "sub-standard" wines that were panned in the press, or was demand reduced because the economy was weak?

The 1994 thru 1996 vintages had small harvests in California, and demand for wine far exceeded the supply. Wineries increased prices to moderate demand. Then with a record crop in 1997, oversupply became an immediate concern.

During President Bush's final year, the economy recovered, and wine sales took off. However, the increase in wine sales was attributed more to the positive health news announced for wine than to the economic recovery.

Wine Demand in a Downturn-

Each economic slowdown comes about for different reasons and impacts the economy in different ways. In the 1970's, inflation choked the economy. In the early 1980's, the economic slowdown was triggered by high interest rates coupled with a banking crisis. If there is a recession in the late nineties it will be more of a deflationary recession than due to inflation.

Deflationary recessions were common before 1930. Typically, despite falling prices and lower interest rates, the economy would stall. Often, uncertainty about the future makes consumers postpone purchases leading to lower economic growth. The Conference Board has reported a decrease in consumer confidence throughout the second half of 1998.

The question is, how will nervous consumers impact wine demand? Wine is a simple luxury. Even an expensive bottle of wine does not take a significant share of a consumer's budget. Eating out may get trimmed from the budget, but staying home and cooking a nice dinner with a bottle of wine may fit into the consumer's budget.

However, there are some changes and pressures in a downturn. On-premise sales are usually adversely affected by a downturn, and off-premise distribution becomes relatively more important. Travel and entertainment budgets are often reduced in a downturn, which adversely affects the hotel and restaurant business. When the stock market drops, many people feel less wealthy and therefore become a little more price conscious.

Elasticity-

Economists use price elasticity to determine how sensitive a product is to changes in price (both its price and prices of substitutes) and disposable income. Economists consider wine to be inelastic or somewhat insensitive to price changes. This assertion has been supported by what wineries have experienced during the past few years. Wine prices have increased dramatically, yet demand for wine is still very strong.

Income elasticity measures how

demand changes when consumer income changes. Wine is **income inelastic** (i.e. wine demand does not vary significantly with changes in consumer income). Both of these facts indicate that wine demand will be fairly constant during a broad spectrum of economic conditions. By comparison, restaurant meals are very **income elastic**. In a recession, when incomes decline, restaurant business tends to also decline, and consumers drink wine at home.

Wine Consumption in a Downturn-

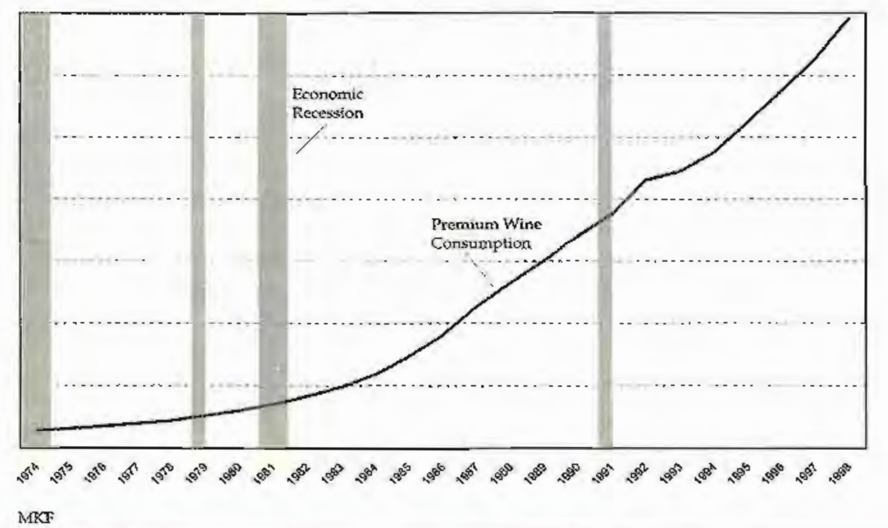
Is wine similar to beer? The Online Investor on September 1, 1998 touted Anheuser-Busch as a "safe-haven" if there is a recession. They note that "beer consumption increases when times turn bad." Based on prior studies beer sales have been recession-proof.

It is possible that with the base of wine drinkers expanding during the nineties, wine may be a "safe-haven" too. The core group of wine drinkers is dedicated to wine consumption. And, the base of wine consumers has been expanded to unprecedented levels.

We have examined a host of relationships between wine demand and various other economic activity variables as they relate to wine. Our conclusion is that wine sales growth actually bears very little relationship to growth in the GDP, or to changes in the general economy. In fact, experience of the publicity from the *French Paradox* broadcast on *60 Minutes*, and other experiences strongly indicate that wine sales are affected more by marketing efforts than by changes in the economy.

An example of our research is shown in the chart above. **Chart I** shows the relationship between consumer spending and wine business cycles. The gray shaded area represents business cycle contractions as defined by the National Bureau of Economic Research. This chart clearly shows that wine sales have grown

Chart I
Premium Wine Consumption



throughout several economic downturns.

Imports-

With uncertainty in the international economy, the U.S. dollar will only grow stronger. In particular, South American currencies seem to have the potential for prolonged weakness. The price advantage they currently enjoy will continue. The importation of foreign wine will continue. In the commodity segment of this business, wine will be sourced from the cheapest nation.

Chart II presents the relationship between the French franc and the U.S. dollar. As the dollar strengthens against the franc, French wine imports to the U.S. increase. It is obvious that the French exporters track the foreign exchange market to exploit opportunities in the U.S. market. U.S. wineries looking to make up for the short 1998 crop may look overseas for bulk wine to cover any shortage in popular-priced wines. Furthermore, given the strong dollar, the imported bulk wine market will look more attractive from a cost standpoint.

Exports-

In 1995 the United Kingdom surpassed Canada as the number one export market for U.S. wines. Canada is now the second most important export market for U.S. wines. Unfortunately, the Canadian currency has reached a low against the U.S. dollar that has not been seen since the 1800's. This makes U.S. products more expensive in Canada, which tends to dampen demand. Japan is the third most important destination for U.S wines. The economic crisis in Japan has been well publicized in the popular media and is discussed in the accompanying article.

Although export markets are showing very strong growth, the absolute volume of wine exports is still relatively small. These export markets are very important to the long-term growth of the U.S. wine industry, but they do not hold the answers right now for the industry overall. The domestic market is still the most important market for our wines. The biggest opportunity and challenge for the wine industry is still how to expand the domestic market, and convert occasional ("marginal") wine drinkers to core wine consumers.

Stock Market-

Today there are publicly traded wineries, so we now have "winery

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the yen plunged and the price of imports, including wine, rose substantially. In just the first six months of 1998 Japan imported $61.6 million dollars worth of wine. In 1997 and 1996 Japan imported $36.1 million and $28.7 million dollars of wine for the entire year.

In spite of a weak economy, wine sales are booming in Japan. Last year, Japanese wine consumption increased 25%. The wine boom dates back to 1997 when a news program similar to *60 Minutes* publicized reports on the health benefits of drinking wine. Practically every importer ran out of red wine.

What does this mean? Our conclusion is that wine can be successfully marketed even during economic turmoil. Why? It's simple. Because wine is the most under-marketed consumer good anywhere! Although wine is one of the oldest branded consumer products (maybe the oldest), it still has the largest untapped market potential of any consumer product. This fact is underscored by the excellent and now familiar research done by the Wine Market Council.

Wine and Marketing-

Historically, wine has been sold more like an agricultural commodity, that is, driven more by supply than by any other factor. In other words, the primary goal of most wineries has traditionally been to sell 100% of their production within the normal cycle for each vintage. Other business factors like prices, profitability, distribution, position in the marketplace and image have been less important. The most important factor has always been volume.

The success of individual brands has produced more strategic thinking. Now the other business factors mentioned above have risen in importance. However, the industry overall is still unduly volume-driven. This has changed in the luxury segment of the wine market, but still needs to change in the other price tiers as well.

It would seem that after spending many years and many millions of dollars to establish a strong, profitable wine market, the industry would want to protect its profit margins. The next downturn in the economy will be very telling. Will the industry revert to sacrificing profits for volume, as they did in the last recession? Or will vintners invest in marketing to maintain the profitable business they have created?

Wine in the Previous Recession-

In the last recession, the circumstances were quite different for the wine industry. Instead of shortages, we had a surplus. The large 1989 vintage was just being released as the recession started, and to mixed reviews in quality. Then the 1991 vintage came in at a record size. Most industry decisions were being driven by this massive wine supply.

In the last recession, wineries emphasized volume. Not selling 100% of a vintage meant that the next vintage (usually larger) would be worth even less. Wineries did little or no marketing. When the recession hit, any marketing budget was the first cost to be cut.

The wine wouldn't move by itself, so distributors demanded price cuts. They claimed that people wouldn't pay those "high" prices for wine. (Now they pay much more.) Price cuts alone still didn't move all the wine, so "special purchase allowances" and "depletion allowances" became the "marketing" currency of the industry. We paid distributors to buy the wine, then we paid them to sell it. This created a downward spiral in prices and profitability for wineries. It was a very dark period for a fledgling industry.

Another factor in the last recession was that the banking industry was in crisis. The largest commercial wine industry bank was calling in loans from all but their best customers. Capital was just not available. At the same time, we were losing vineyards to phylloxera, so the need for capital was very high.

On top of these other factors, the wine industry was not on the best financial footing going into the last recession. At that time, over half of the wineries were operating at a loss. Price cuts created even larger losses. Today, virtually all of the surviving wineries are profitable.

The Wine Industry Today-

Things are much better today. Wine sales are booming, prices and profits are at an all time high, and the U.S. consumer loves California premium wine. The higher the price, the more consumers want it. Wine shortages have served to push up prices and demand for wine to record levels. In fact, wine shortages have done for the wine industry what all of the discounts, allowances, and price cuts combined could not do. They made the industry viable. Now, consumers gladly pay reasonable prices for wine, whereas when wine was heavily discounted, it was seen as "cheap" and less desirable.

One would think that this is a vintners dream come true, and that this position would be protected at all costs. Certainly, the lesson has been learned. But no, quite to the contrary. After the huge 1997 crop, vintners started telling the world that there was too much wine, a "glut" in fact.

Wine writers, picking up on this theme, started writing about all of the wine bargains that were just around the corner. They announced passionately that prices would now return to those of the good old days when wine was "affordable" (and when over half the wineries were losing money).

Retailers celebrated and distributors joined in. They started demanding price reductions before the 1997 vintage was even bottled.

We had this strange situation where wines from the 1995 and 1996 short vintages were on allocation, or more often, not available, while at the same time retailers and distributors were calling for price cuts. (On unavailable wine?!) Distributors were claiming that the shortages were a myth. ("We can get all the supply we want, and at good prices.") Of course, the real myth was the "glut".

The point is that the wine industry was poised to kill its margins again with price cuts, and return to the good old days when only distributors and the trade made money on wine.

The Solution-

At this point, the solution is clear. Success has been defined, and it's there for the taking. Now that vintners and growers are earning a normal profit, they should keep it. The key to profitability is to *manage* for profitability, not for volume. If spending is needed to hold up profits, the dollars should be spent on marketing to maintain the market, rather than on price cuts or sales programs designed to maintain the volume. Volume gains are easy to get. They're just not profitable.

However, the industry does need to maintain growth, not just maintain market share, but that growth should be profitable growth. That means maintaining adequate margins.

Other beverages maintain good margins. Beer, soft drink, and bottled water producers certainly maintain good margins. They are all very capable of overproducing for their markets much more easily than the wine industry can. But they don't. They can drive prices down more easily than vintners, until no one is making money. But they don't.

Instead, other beverage industries keep prices at a profitable level and invest some of the profits in marketing to grow their markets and their profit margins. We can learn from this. This is a business model that works. It works extremely well for most other beverages, and it can work even better for wine. In fact, given the capital structure for wine vs. other beverages, it must work better for wine.

Public Companies-

The large public wineries need to grow earnings to keep Wall Street happy. Stock prices are based on future earnings potential, so earnings must keep growing, ideally even during a downturn.

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Public wineries can grow by acquisition, but that has limitations and problems. It's very difficult to find acquisitions at a price that does not dilute earnings. The winery stocks are trading substantially lower than their historic highs, so their stock, or "acquisition currency" is devalued right now, which makes acquisitions more costly. Lastly, most of the potential acquisitions are smaller brands that don't add much volume, but do compete internally with the other brands for resources and attention.

Another growth approach is to import foreign wine to cover domestic shortages, and to create new brands based on this plentiful and cheap resource. This is more challenging than would appear at first sight. Importers have been trying to build a larger market for these wines in the U.S. for years. The biggest swing factor is the exchange rate. As long as the dollar is strong, this option looks attractive. However exchange rates fluctuate, and at popular prices, it doesn't take long for profit margins to disappear.

The alternative to these other measures is for publicly-held wineries to grow the market for their existing brands. This would be the best long-term solution for individual companies as well as for the wine industry overall. In order to grow their brands, these large wineries must grow the market. There is a limit to growth obtained by taking market share from competitors. Ultimately, if the market doesn't grow, the companies can't grow. The public wineries are in the best position to lead the industry going forward. They have the impetus to grow, and the means to make it happen.

The wine industry has been operating on an agricultural business model for too long. Wine is a branded consumer product, and must be marketed as such. That should be easy, because the business models for this exist: all we have to do is follow them. Besides, there is no product on the market quite like wine. Its' easy to get people interested in a natural, healthy, pleasurable, interesting product.

The wine industry has matured sufficiently, and has the financial wherewithal to operate more like other successful producers of well-marketed, branded consumer goods, managed for profitability. Wineries have to become more active in brand management, regardless of the state of the economy. If vintners will approach their business as marketers instead of as producers, the next downturn will be the next economic opportunity.

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stock analysts." Some of them have been fairly pessimistic in their opinion of the future prospects for wine stocks in the face of an economic downturn.

The larger wineries were not publicly held during the last recession, so we have no history to guide us. So, it's understandable that investors and the financial community are all asking: "What will happen to winery stocks when the economy slows down?"

One of the factors that will help the public wineries is that they are managing their businesses for growth. A related factor is that wine is a growth industry in the U.S., and the industry has grown at healthy rates even during the recession years. In the last recession, the wine industry grew at rates that outstripped the economy overall, and that made the wine industry stand out compared to many other industries that had major problems.

Having publicly owned wineries has had positive effects that will help in the next downturn. To begin with, the wine industry is now more aware of the stock market, and how public companies are managed. This has made the industry more profit oriented, and has stimulated the trend to more professional and financial management in the wineries. This has also made the financial community more aware of the wine industry, and has led to more publicity for the wine business, which is helping to bring more visibility for wine overall.

The small premium wineries have shortages, which means explaining to distributors that they can only have a limited number of cases of Cabernet, and at a higher price. With the broadened base of wine consumers in the last decade it appears that smaller well-priced wineries will weather any economic storm, if they stick to their business plan.

The small 1998 harvest will impact net income in 1999 and 2000 depending on release dates of red and white wine. In summary, when the television pundits on *Wall Street Week* turn bearish on winery stocks it will mean very little to a small winery in the Dundee Hills or Santa Barbara (unless the proprietor has winery stock in his portfolio).

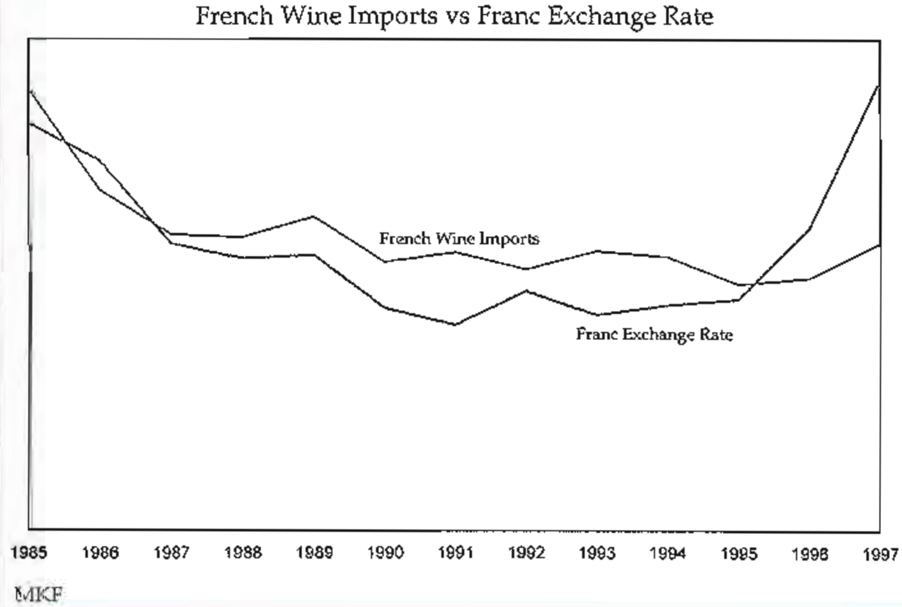
Tourism-

When the economy slows down, the trips to Tuscany may get canceled, but people still take vacations. Tourism in the U.S. wine regions has been on the rise. In a slower economy the Napa, Sonoma and Santa Barbara wine regions may become even more of a prime tourist destination. In particular, the Bay Area and Los Angeles are hot wine markets with many individuals interested in wine. The "tasting room" will become increasingly important as an outlet for wine, and as a medium for influencing and educating consumers. In most cases a bottle sold in the tasting room has twice the impact on the bottom line as a bottle sold to a distributor and then sold to a retailer or restaurant.

Conclusion-

It is clear that many variables will affect the outcome of an economic downturn on individual wineries. Grape supply, price segment, vintage quality and quantity always play a part in winery success. But a changing economic environment results in other variables which require consideration such as changes in consumption trends, imports, and tourism. The economic fate of the wine industry will be determined by how the vintners respond to all of these factors.

Chart II
French Wine Imports vs Franc Exchange Rate



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