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## The Perfect Storm, Revisited

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In November 2005, co-authors Deborah Steintal and John Hinman published “U.S. Wine Market Liberalization”<sup>1</sup> in which we predicted that the forces of globalization and wine market liberalization would accelerate dramatic change in all tiers of the wine industry. We postulated that five interlocking dynamics are having a cataclysmic impact on the United States wine industry; a perfect storm gathering and generating monumental change:

1. Globalization of Supply & Demand Pressures
2. Producer Consolidation
3. Distributor Consolidation
4. Retail Consolidation
5. Wine market liberalization

In this article we revisit those assumptions and ask ourselves: What has changed since the May 2005 Granholm Supreme Court decision? What will the next 18 months bring?

### Past 18 months: What has changed?

#### Faster than expected

1. Globalization’s impact on calibrating supply and demand on the U.S. market – exponential surge in U.S. imports filling market niches (Pinot Grigio, Pinot Noir).
2. Global procurement as a strategy for large wine companies; de-emphasizing region of origin to support better value grape sourcing.
3. Positive health aspects of wine helping wine sales. “The whole idea of ‘Drink Wine, Live Longer’ is having a profound impact on 50+ Consumers who used to drink their Fair Share of Beer,” says Bump Williams, Information Resources Inc.’s (IRI), executive vice president for alcohol beverages.

#### Slower than expected

U.S. wine business innovation: supply chain; product development; distribution and placement; packaging; marketing; production technology. “For U.S. vintners to stay ahead of the competition, they must drive new packaging and push the envelope on current distribution, retailing and stocking strategies,” says Williams of IRI.

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<sup>1</sup> [“U.S. Wine Market Liberalization” by 2015<sup>1</sup> \(Practical Winery & Vineyard, page 2\)](#)

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### **Consolidation accelerates, making it tough on everyone**

The industry's largest players continue to grow through acquisition. Wineries in the above \$500 million range are increasing market share and consolidating distribution for all beverage sales. The "Big Five" distributors now have an estimated 52% share of the market, up nearly 14% over the past five years<sup>2</sup>.

Distributor consolidation has occurred quickly post Granholm, many combining beverage categories to drive profitability. The handwriting is on the wall for the small, local, distributor; without scale, their future could be dim. However, distributors aggregating too many wines have little to no effective retail sales and marketing practices.

### **Brand proliferation begets commoditization**

Despite expectations that consolidation would reduce industry fragmentation, competition is accelerating as new brands, both domestic and foreign, enter the US market<sup>3,4</sup>. Such proliferation may be driving U.S. consumers to see wine as a commodity; if a consumer's wine of choice is not available, they will buy another. This dynamic is driving everyone to invest in differentiating their brands at the retail level, potentially powering huge growth in private and proprietary labeled wine as retailers seek to grow profits.

### **Regulatory domino effect**

Today's regulatory environment has heated up since the May 16, 2005 (Supreme Court) Granholm vs. Heald event which catalyzed uniformity of laws across state boundaries. Subsequently, wineries in 34 states are now legally shipping direct, up from 26 states in May 2005. The onslaught of legal actions has triggered enormous uncertainty at the regulatory level.

At the District Court level in Seattle, Costco won an overwhelming victory effectively dismantling key regulatory inefficiencies such as prohibitions on central warehousing, anti-trust aspects of price posting, mandatory margins, credit laws and quantity discount restrictions. The finding that winery self-distribution is legal (a two-tier system) was probably the most significant part of the decision.

If the Ninth Circuit affirms the Costco decision currently under consideration, the pace of litigation will increase in the United States, leading to even more law suits and greater uncertainty for all industry participants.

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<sup>2</sup> Top Five Distributors in 2006: Southern Wines & Spirits, Charmer, Republic/NDC, Glazer's, Youngs.  
Source: Impact Magazine

<sup>3</sup> Number of new brands: 2002 = 42, 2004 = 115, 2006 = 234

<sup>4</sup> Over 65,000 wine skus (shop keeping units) were sold on the U.S. market in 2006

## **The next 18 months: Key Industry Predictions**

The United States is on track to become the world's largest consumer of wine by 2010. "Our latest research is showing that shoppers are leaving Spirits and migrating towards Wine and Craft Beer faster than any other Beverage-Alcohol segment", says Bump Williams of IRI. "Year to date price to consumers in the US has been slightly above consumer price index (CPI), and to me that means "price is not a deterrent" for wine growth. The only things that can 'hurt' the future of wine are a downturn in quality, distribution/availability, shortage of retail execution (display presence, out-of-stock's and feature activity) and a sense of complacency from the wineries across the country."

### **Innovation**

Consumer interest in exploring wine will continue to fuel growth in new wine categories and alternative retail solutions. Of particular influence are new categories being defined by companies like [Crushpad](#); large consumer networks organized by bloggers such as [Vinography](#) and [Wine Library TV](#); specialty retail groups like [Women & Wine](#) and wine lifestyle broadcasts like [Wine TV](#); and home tasting groups such as [The Traveling Vineyard](#) and [Wine Shop at Home](#).

Big box wine merchandisers will expand both regionally and globally, developing new retail options for selling and stocking wines. Giant retailers such as Costco and BevMo will see category ownership driven by brand relationship models with large wineries. If franchise tax laws change, innovation within small- to mid-size wineries will accelerate by expanding one-to-one sales strategies and driving important trade and consumer relationships. Sophisticated logistics companies such as [Inertia Beverage Group](#) and [New Vine Logistics](#) are poised to service this area as states continue to deregulate shipping rules.

### **Deregulation**

Consumers are leading the national thirst for deregulation and greater access to wine products. Franchise laws interfering with product movement will open up as the industry is able to effectuate change amid distributor control of the legislative process. In this climate, assertive risk-takers like Costco and BevMo, will thrive, but this situation cannot persist without further melt-down.

Newly-integrated distribution models will emerge where one entity legally owns and operates a winery, import business, wholesale business and retail business - selling wine to large national networks of consumers. Early examples include web-based wine clubs like [MyWinesDirect](#) and [Vinesse](#) and multi-regional winebars such as [VinoVenue](#).

### **Industry Polarization**

The widening chasm between large mass merchandisers and small- to mid-size producers is undeniable. Large and small players will need to mind the gap; that is, decide where to play, and become stronger at positioning their brands if they want to remain profitable.

Some wine businesses over the \$500 million revenue mark will persist with acquisitions, striving for increased market share. Other large wineries (namely Constellation, Diageo and Kendall-Jackson) will derive economic profit and bottom line growth when they integrate holdings to realize synergies in sales, marketing and supply chain management practices. Large companies like Gallo, Fosters and Bronco will seek top line growth by elevating product mix and expanding their over-\$15 brand portfolios.

Successful wineries under \$60 million in revenue will apply stronger business practices, improve team effectiveness and apply new options for national sales. Brands built on authentic family and regional values will claim meaningful market niches. In this highly competitive market space, small wineries will build stronger direct sales channels by investing in innovative product and packaging, customer service, technology, database management and professionalized talent.

Those small- and medium-sized wineries that cannot efficiently penetrate the three-tier system or grow alternative channels will be overwhelmed by regulatory and competitive environments. Rather than struggle through the challenges of growth and change, more first generation, luxury brand owners will seek exit strategies by selling their business, to capitalize on market opportunity.

### **Globalization**

We shall continue to see massive investment internationally, as many countries replant using new technology to generate high quality, price competitive grapes. Less developed countries such as India, China, and several in Eastern Europe are emerging as new wine producers and significant consumers. Lower land and viticulture costs, combined with government support of local farming, means global competitors are only going to get stronger. Global trade policies will be at the forefront of national government involvement as imported brands and wines provide intense competition for U.S. producers, especially in the below \$20 wine segments.

On the flip side, it has been reported that the California grape supply is slowing (vineyard replanting at an all time low corresponding with increased non bearing acreage in the North Coast). This could drive a shortage of premium U.S. wine in the above-\$25 wine categories as demand quickens. How this trend impacts U.S. wine producers is too soon to predict. Rob McMillan, founder of the Wine Practice at Silicon Valley Bank, forecasts a surge of higher priced imported wines over the next 5 years to satisfy both a domestic shortage of fine wine, and the changing consumer appetite for value-priced wine above \$15.

According to IRI's Bump Williams, "Retailers across the US Grocery Industry have begun to really support the wine category through aggressive merchandising and this in turn has led to a near double digit increase of wine sales in grocery stores. And for those who think 'cheap' wine is the winner, think again; it is the premium and luxury priced wines that are the real winners in this category. Can you really put a price tag on Image? "

### **Key industry predictions**

1. Global wine consumption will grow from \$107 billion at 5% per year (Wine Institute, Dec. 2006)
2. U.S. will become the world's number one consumer of wine by 2010 (Wine Institute, Dec.2006)
3. Small wineries sales, shipping direct, will grow from \$2 billion to over \$5 billion (MKF Mar. 2007)
4. U.S. wine trade policy and regulations will encourage innovation and participation
5. Integrated distribution models will efficiently serve large and small players
6. New technology will drive efficiencies in product and distribution
7. U.S. Wine industry will be appreciably deregulated by 2015 (John Hinman & Deborah Steintal)

## Conclusions

### Fundamentally good news

Continued growth in U.S. wine consumption and more stable global supply will boost revenues and profits for well-positioned industry participants. A reduction or elimination of state-level regulatory bottlenecks will move the needle in the next 18 months enough so natural global market forces can exert more force. Consumers are driving and energizing this revolution with their involvement in the blogosphere and their reaction to legislative gridlock.

In the end, the consumer will prevail. By 2015 the U.S. wine market will be a more efficient and open market. More wine will be sold through more outlets than ever before, giving consumers more choices than ever before.

### Strategies to deploy

Wine industry leadership can affect positive momentum in these changing times through supporting fundamental initiatives across several areas.

1. **Win at the margins.** Small & mid-sized wineries should drive to specialize and focus on building profitable and strategic market niches from a customer perspective.
2. **Focus technology and innovation** investments where it counts and develops competitive advantage. This includes customer relationship management processes, market and customer information, product and production, packaging, distribution and supply chain. Outsource what is less important.
3. **Investigate and partner** with viable, alternative distribution solutions. These business models are beginning to cater to wine categories within a changing national retail landscape.
4. **Build stronger business fundamentals** to speed up returns. Invest in stronger people, communications and systems; develop improved strategy and execution practices.

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The founding partner of **Scion Advisors**, *Deborah Steinthal*, has been an executive across a variety of industries globally and helped companies transform from startup through high growth; restructure due to poor performance; and integrate new acquisitions. **Scion Advisors** works along side wine business leaders who are navigating important transitions, to identify and align family and business goals, and develop reality-based strategic planning and execution practices.

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**John Hinman**'s experience spans the modern history of the wine industry and includes regulatory defense before state and federal government agencies, distribution litigation throughout the U.S., arbitration and mediation of relations between grapegrowers and wineries, and deep involvement in the direct shipping battles from the very beginning. **Hinman & Carmichael LLP** provides expert corporate, administrative, and regulatory legal services exclusively to the alcoholic beverage and hospitality industries and assists other law firms and in-house counsel as special counsel on alcoholic beverage issues.

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