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Over the next 24 months, consumer demand for wine will continue to grow globally and the United States consumer will be leading the way. However, the wine industry will see the fall out of weak players as the **strong get stronger**, predict industry advisors, Steinthal, Valentine and Hinman.

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

Stronger Will Get Stronger	Weak Will Drop Out
<b>Pruned, profitable product portfolios</b>	>\$50 category takes long term hit >100 'hobbyists' quietly close doors
<b>Focused, differentiated brands</b> – Wine culture shifts as consumers seek closer social connections with their favorite brands.	
<b>Stronger, leaner teams</b>	1,000 jobs lost 100s of equity lines close down 1000's of brands drop out of national distribution
<b>Cash becomes king</b>	
<b>More diverse sales channels</b> – 100's of new retail private and control labels launch – 100's of new consumer channels launch	
<b>Selective growth thru acquisition</b> – Excess grape supply gets absorbed by \$12-25/bottle wine categories, driving category quality up.	100's of properties sell and/or go into foreclosure
<b>Next generation owners step up</b>	Next generation owners drop out

**Figure 1 – Over the next 24 months: A-Players are Building More Financially-Viable Businesses**

In November 2005, co-authors Deborah Steinthal and John Hinman published a groundbreaking whitepaper: [A Perfect Storm: “U.S. Wine Market Liberalization”](#), defining a ten-year framework for change. We predicted that interlocking dynamics - the forces of globalization, consolidation and wine market liberalization, would drive change in all tiers of the Wine Industry (see Figure 2). By 2015, U.S. wine consumers would benefit from better access to higher quality wines for the price, dramatically accelerating innovation created by the forces of competition.

<sup>1</sup> The Great Recession: Global economic meltdown started in Fall 2007 which saw the unraveling of financial institutions, collapse of the housing market and mortgage financing industry, a growing health care crisis and continued instability in war-torn countries.

Four years later, as we move into the fall of 2009, we ask ourselves: what has really changed? The purpose of this article - [Perfect Storm Revisited, Part III](#), is to challenge our assumptions and ask ourselves: What is ahead for wine business leaders; How to prepare for future opportunities and challenges. In this article we also want to revisit our predictions in the context of what we are now calling “The New Road”. The state of the world economy and its impact on the wine industry can no longer be referred to as a “bump in the road.”

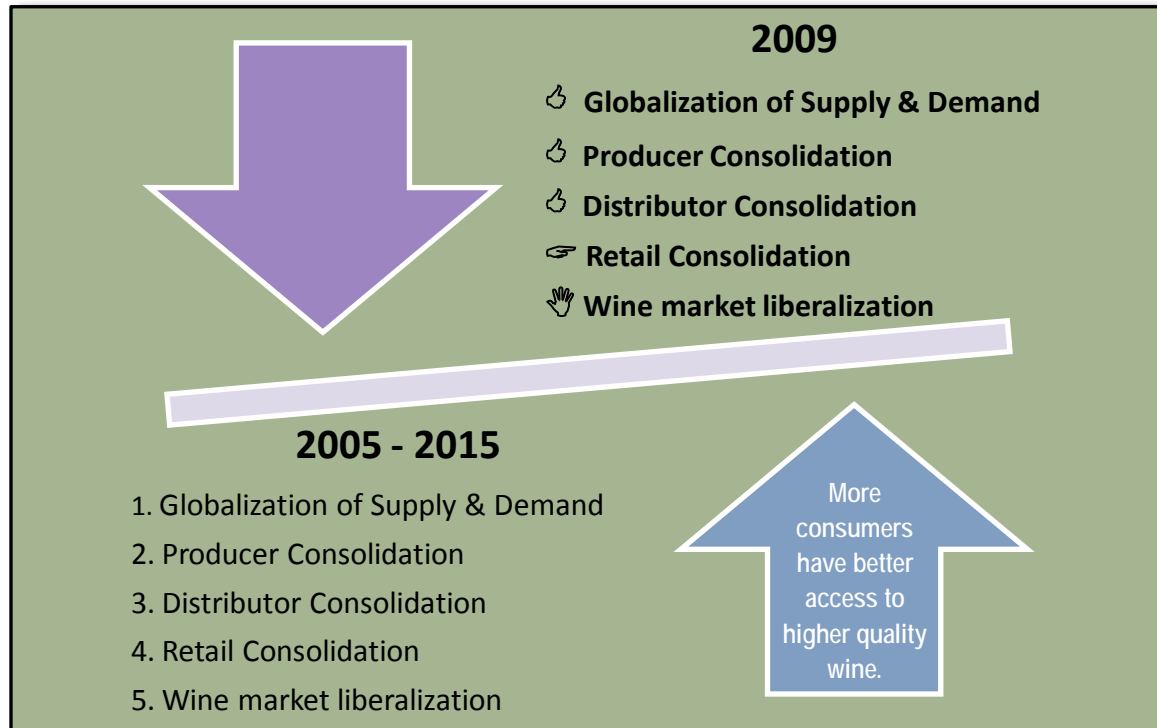


Figure 2 - Five Interlocking Dynamics Continue to Have a Dramatic Effect on the Wine Industry

## LAST 24 MONTHS: NEW REALITY

In December 2007 – when we published our update, [A Perfect Storm Revisited \(II\)](#), the industry’s largest players continued to grow through acquisition and global sourcing. Globalization was helping to mitigate production over-supply. More states were open to inter-state shipping. Regulators, driven by wholesaler trade associations looking to control market access, were at the same time making it more complex to market and ship wine direct and legally. This was inhibiting wineries and logistics providers from easily building profitable new direct shipping business models.

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

An unexpected **Great Recession** has had the net effect of accelerating some of our predictions and slowing others down. Although the real ramifications of the **Great Recession** are still unknown, many are expecting a long recovery with long-term impacts on consumer purchasing behavior<sup>2</sup>. Some impacts include:

- The recession, inter-state logistics hurdles and a concentration of wines above \$50/bottle have put small wineries in a perfect storm predicament, many reporting sales down as much as 40%.<sup>3</sup>
- Big players have been reconfiguring and trimming their portfolios to grow profits organically instead of getting larger through acquisition.
- SKU<sup>4</sup> rationalization is hitting even the smallest players.
- Thousands of white table cloth restaurateurs close doors, heavily impacting the luxury sector.
- Luxury consumerism is considered 'Un-American' as consumers globally struggle to keep their jobs and feed their families.
- Distributor consolidation has escalated as that segment struggled to survive in this economy, essentially shutting smaller players<sup>5</sup> out of national wholesale channels.
- Worn down by industry phase and economic cycle, many more wine business owners are looking to exit sooner through sale to 3<sup>rd</sup> parties or to the next generation, February 2008 joint report published by Scion Advisors/Silicon Valley Bank: [Ownership Transitions in the Wine Industry](#)<sup>6</sup>.

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

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<sup>2</sup> HBR Video interview with Professor John Quelch: [How to market during a downturn](#).

<sup>3</sup> "Luxury Wine Business Reels from Downturn" - Wall Street Journal, 7/8/09

<sup>4</sup> SKU = Shop Keeping Unit

<sup>5</sup> Most wineries, less than 250,000 cases in volume, are struggling to remain relevant to large distributors.

<sup>6</sup> [New Report: Ownership Transitions in the Wine Industry](#). Rob McMillan, Silicon Valley Bank Wine Division and [Deborah Steintal](#), Scion Advisors

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

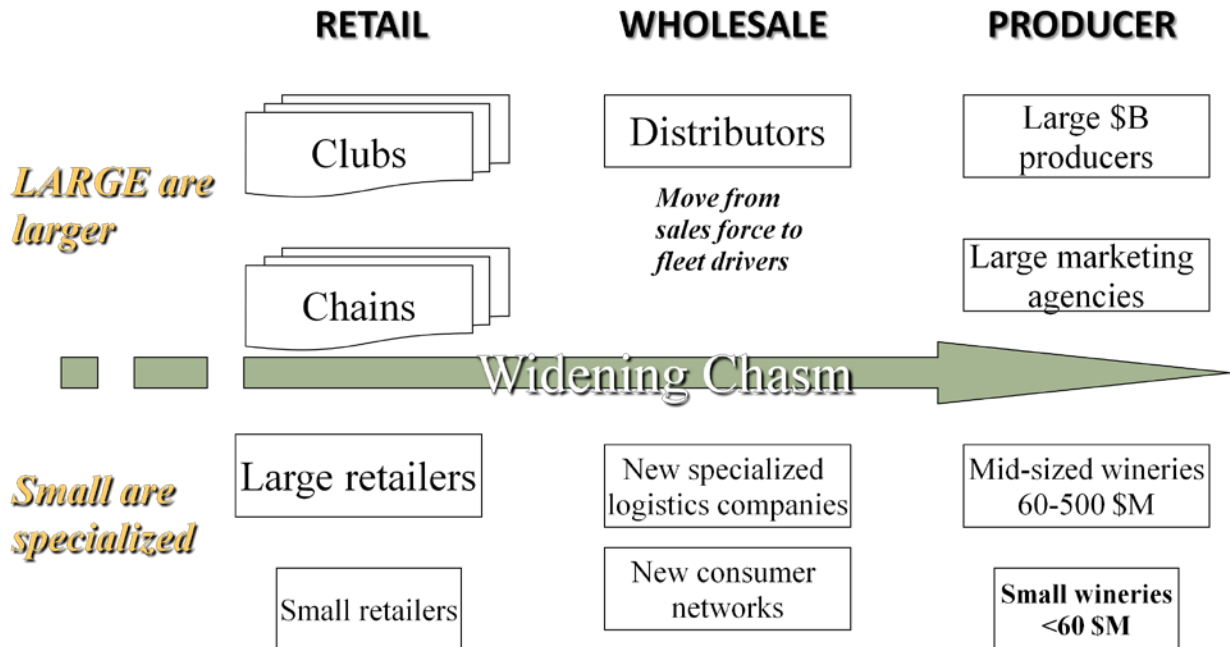


Figure 3 - The Pendulum Shifts: Under 250,000-Case Producers Need a New Distribution System

Furthermore, many wholesalers are heavily cash flow constrained due to the global economic cycle and/or debt incurred during recent consolidation dynamics. Given economic and competitive pressures, this market phase could last for 2-3 years.

The long term impact of these forces is dramatic on under 250,000-case wineries, especially those with portfolios in the above \$30msrp/bottle categories. Even A-players, unable to move inventories, are down 30-40%, and are discounting heavily. We are expecting a wave of foreclosures and bankruptcies among wineries most dependent on national channels and unable to cover cash requirements over an extended down cycle.

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



Figure 4 - 2009 Reality Check: Past 24 Months, Revisiting Six Predictions



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

- 2009 Reality Check: Many initiatives are in play, and we assert that the recession will become the mother of innovation as a critical mass of smaller players struggle to succeed.



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

- 2009 Reality Check: Larger players, more able to invest in technology, are moving into integrated inventory management platforms with key distributors and customers.
- Smaller players are struggling to keep inventories on distributor floors as non-performing SKU's are dropped.
- Filling the void, new distribution business models are investing in technology enabling smaller producers to find new paths to market and ship direct to trade and consumer.
- Integrating with communications, ecommerce and fulfillment systems, experienced compliance solutions such as E-Compli are positioned to support legal shipping direct to trade and consumers.
- Now in development throughout the industry is the "integrated" business model, where one business entity combines winery, import and retail operations (legal in California), and utilizes both direct shipping and three-tier delivery to fulfill national market orders obtained from different marketing sources.

Figure 4 - 2009 Reality Check: Past 24 Months, Revisiting Six Predictions

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

### **NEXT 24 MONTHS - KEY PREDICTIONS: "THE NEW ROAD?"**

Inspired by the Granholm judgment, the dream of deregulation has not played out in exactly the way the industry has anticipated. We predict that by 2012 stronger players will emerge with more financially-viable and technologically sophisticated wine businesses. They will provide better quality wine, even more suited to today's emerging consumers and will be positioned to take advantage of emerging marketing channels. Rob McMillan, founder of the Wine Practice at Silicon Valley Bank, foresees rough seas through mid-2010 for producers with cash flow issues or strictly luxury-priced portfolios.

“For those willing to do the hard work required to sell through inventories over the next six months, their business should begin to stabilize by the end of 2010.” Rather than struggle through the current economic and industry challenges, more first generation, luxury brand owners will seek exit strategies by selling their businesses and properties rather than weather the storm.

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

“National sales channels that contribute less than 50% margins are most likely not sustainable, especially since most wine business models are so dependent on capital-hungry assets” says Hank Salvo, Scion Advisors Partner and former Robert Mondavi Winery CFO. Some will survive and potentially prosper by tightening their product portfolio, improving branding and upgrading their teams and business practices. Those most likely to prosper long term will radically change how they sell to the trade and consumers.

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

- I. **Global grape supply pressures will exist: *There is no substitute for brand strength.*** A-brands are defined by increasingly efficient supply chain practices; established, healthy distribution channel management; and strong cash flow disciplines. Global procurement management by large wine companies, in tandem with crop reductions caused by Mother Nature, have put grape supplies more in balance with normal market trends. This will help the path to stability for growers who are positioned to weather the drop in demand for the 2009 and, possibly 2010, crops.

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

Large wine producers with global sourcing options will profit from the resurgence of the popular premium price point segment and are using new inventory tracking and transportation technology to profitably shift supplies from market to market. Smaller players will experiment with new sales channels that will maintain image and drive cash flow from higher volume and lower priced offerings. Banking pressures and cash-constrained businesses will limit the launch of secondary tiers, while fueling the production of private or control labels, a common trend during periods of excess supply.

II. **Consolidation will likely continue in all 3 tiers: *Margins shrink on all sides; 85% of retail space will be occupied by 10 wine companies.***

- a. **Producers** will learn to navigate a polarized wine market landscape: comprising the large - multi-billion dollar corporations on the one hand and the small to large privately held wine businesses on the other (see Figure 3) — each operating quite differently and playing to different margins. Major players Diageo and Constellation will continue to pull back from acquisitions, seek synergies from merging their multiple operating units in 2009 and focus on gaining greater control of their distributors and market efficiencies. The top 20 wine brands will use their market presence and line extensions (as well as new brands) to reinforce their value to national distributor portfolios. Says Chris Indelicato, CEO DFV, "Wine is a hard sell because of the required knowledge base: larger wineries that can afford to field sophisticated marketing and sales teams will continue to gain market share."

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

Seeking national distribution muscle through an acquisition strategy, portfolio builders such as Bill Foley (see [www.foleywinegroup.com](http://www.foleywinegroup.com)) or Jean-Charles Boisset (see [www.deloachvineyards.com](http://www.deloachvineyards.com)) and focused private equity players such as The Vincraft Group – will buy more wine brands. According to Pete Scott, Vincraft CEO, "the acquisition of Kosta Browne Winery is just the beginning of a wine portfolio comprising small-scale ultra premium- or luxury-tier California wineries."

Competition for consumer share of mind will intensify on the U.S. market: (1) Wineries in every state will create new tourism opportunities and reach more consumers with educational experiences; (2) Companies like Crushpad in San Francisco and (soon to be in) Manhattan along with City Winery, are building on a 'consumer as producer' trend, offering hands-on winemaking experiences; (3) Global competition from Australia, Chile and Argentina will only be tempered by a weakening dollar.

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

Says Rachel Dumas-Rey, leading beverage compliance services company CEO – Compli: "Over the next 24 months, wineries that intend to survive and prosper will invest in the most efficient and productive direct shipping logistics solutions. Regulatory compliance is a moving target and so key to both top and bottom line growth."

- b. **Distributors** have consolidated from 5 to 4 major distributor houses, leaving most mid-sized wineries in a worst-case situation. Over the next 24 months, the three-tier distribution system will become even less available to smaller players. Smaller wine businesses will continue to seek out alternative paths to market. State regulators will invest in technology to enforce existing regulations rather than making access for consumers easier. (Re)newed competition from spirits and craft beer will cut into the wine category's 'share of mind' with the large distributors. Pre-packaged cocktails will infringe on wine sales, with TV ads driving consumer pull at retail and eroding market share for wine.

Anti-trust<sup>7</sup> will become a new legal battle front. Consolidation could encounter a backlash on both sides: wholesale and retail. Demand will increase for integrated logistics models. Consolidation among these models will blur the lines between logistics providers and agency or e-retail models: [mywinesdirect.com](http://mywinesdirect.com); [wine.com](http://wine.com); Adams Wine Group; Inertia Beverage Group; Winetasting Network; Copperpeak, Provino – among many others.

- c. **Retail** business models will also undergo dramatic change. Over the next 24 months law suits, currently pending in the federal court system, will force regulators to revisit discriminatory regulations that impact retailer markets. Retail powerhouses will expand very profitable private and control label offerings, and will add to the competition for the ‘consumer share of mind’<sup>8</sup>. Brick and mortar stores such as Safeway and BevMo will be selling more wine direct than they have in the last two years. Retailers who jumped in over the past few years with direct shipping across state lines will take cautionary steps in anticipation of a more open (but still complex) state direct shipment permit system.

As regulatory bodies continue to clarify and interpret state law, we will continue to see more integrated new business models enter the wine industry over the next 24 months. More compliant e-retailer models, trusted merchants and 3rd party marketing agent businesses will emerge – on the back of a new generation of wine clubs and hundreds of new consumer networks such as [Snooth](#), [Wall Street Journal](#), [Sunset Wine Club](#), [New York Times](#), and [winestilsoldout.com](http://winestilsoldout.com).

- III. **Slow economic recovery will slow wine market liberalization: *Producers and retailers will scramble to understand and position for a new generation of wine consumers.*** The ***Great Recession*** has catalyzed a consumption shift: a largely Baby boomer-driven wine economy will soon be supplanted by Millennials. Baby boomers, driving growth in wine consumption for the past 30 years, will enter retirement in droves. As they adjust to fixed incomes, they will consume their cellar reserves and “downsize” their purchases, both by volume and price point. Millennials, who will become a larger consuming population than boomers, will

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<sup>7</sup> Whole Foods sold off 31 Wild Oats stores, keeping only 42 and selling the Wild Oats name in an antitrust ruling. The National Beer Wholesalers Association (NBWA) is embarking upon a Congressional project to legislatively overrule Granholm (and the line of pro wine industry Commerce Clause SCOTUS cases since 1984). Such a reversal would be coupled with new federal legislation providing an exemption from the anti-trust laws for anti-competitive activity authorized by a state under the 21<sup>st</sup> Amendment.

<sup>8</sup> A 5th circuit ruling on retailer direct sales is due this year: Total Wine won in MD. 300 private label SKU’s at Trader Joe’s leaves less space for traditional brands. At least five states (NY, TN, NJ, CO and KY) are actively seeking to reverse decades old laws that prohibit the sale of wine in grocery stores. This is a consumer and tax revenue driven battle that is not going away.

pick up some of the slack. Some are already adventurously seeking out imported wines and new varietals.

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

ENGAGEMENTdb<sup>9</sup>, a July 2009 report, indicates that the most valuable brands in the world are experiencing a direct correlation between top financial performance and deep social media engagement. Social media already allows wine customers to share their preferences in real time as aging media pundits become marginalized and irrelevant to today's consumers. Over the next 24 months, wine culture will shift as consumers seek closer social connections with their favorite brands and continue to rapidly adopt social network technology to share their authentic stories.

A great example is the Benziger harvest video: their video outreach has attracted wine tweeters and drives people to their Facebook fan page. Imagine – a Gary Vaynerchuk for each winery!

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

Wine has become main stream and is now an American tradition. While many wine industry leaders would say that today they have a 'tiger by the tail' and chaos prevails, we still hold by our analogy: "a perfect storm gathering has generated monumental change, and by year 2015, the wine and alcoholic beverage distribution system will be more efficient, and more unforgiving of failure, than it is today.

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

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<sup>9</sup> July 2009 report, ENGAGEMENTdb, ([www.ENGAGEMENTdb.com/report](http://www.ENGAGEMENTdb.com/report))

## HOW TO PREPARE FOR OPPORTUNITY: STRATEGIES STRONG PLAYERS ARE ADOPTING

Rather than just “battening down the hatches”, well-positioned wine business leaders are supporting their crew with tools, training and other lifeline supports to ride out the storm. Strong and strategically-focused leadership is vital in steering wineries through these challenging times. Here are some important practices and strategies to consider:

1. **Everyone on deck.** Everyone at small- and mid-sized wineries should be actively selling, on the road and in person, in constant communication with the trade, brokers, distributors, consumers and the media, through traditional means as well as the rapidly expanding online network communities that includes social media and bloggers.
  2. **Increase productivity by developing your team.** With more talent available during this recession phase, consider hiring stronger, more productive people, investing in better communications and systems; and develop improved execution practices.
  3. **Drive cash flow and profits.** Large or small, every business team should conduct an annual objective review of their product portfolio strategy, aligned with market opportunity. Each wine must be rationalized with an understanding of cost of goods, margin and overall performance to ensure it is delivering a sustainable return, or phased out if it is not.
  4. **Grow your competitive advantages.** In a highly competitive market, most wineries need to assess and improve customer/consumer relationship management systems and disciplines; expand use of market and customer information; support constant improvement processes around production, packaging, distribution and supply chain.
  5. **Investigate new ways to convert your customers to brand advocates.** Every brand needs to figure out how to engage consumers differently and to experiment with emerging social media tools more effectively. Rather than an ad hoc approach, implementation should be founded on a more compelling and authentic brand strategy, clear goals and relevant consumer value propositions delivered consistently.
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## About the authors

Deborah Steintal ([deborah@scionadvisors.com](mailto:deborah@scionadvisors.com)) is the founding partner of Scion Advisors, a Napa-based wine business advisory firm which enables clients to build more financially-viable businesses. She has been an executive across a variety of industries globally and helped companies transform from start-up through high growth, restructure due to poor performance and integrate new acquisitions.

Erica Valentine ([erica@scionadvisors.com](mailto:erica@scionadvisors.com)) is a senior associate of Scion Advisors. With over 15 years as a marketing executive at Constellation Wines and Seagram Chateau & Estates, and 10 years consulting with privately owned wineries, venture capital and web-based businesses, Valentine advises companies on how to differentiate and compete successfully in a complex marketplace, creating and implementing marketing and sales programs that work.

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

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