The Perfect Storm

Backgrounder: The Wine Industry in 2005 and in 2015

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Today's United States wine industry is at a juncture in its history unlike any it has ever experienced. The challenges are 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 forces of globalization. One thing is sure – by year 2015, the wine and alcoholic beverage distribution system will be more efficient, and more unforgiving of failure, than it is today.

Each tier of the entire '"drinks"' industry will be impacted by complex challenges (wine, beer, spirits, RTD, CSD's, energy, premium water and juice). Tomorrow's successful industry participants will be proactive. New business models will emerge in response to market challenges and successful operators will effectively leverage new opportunities.

This backgrounder and associated chart connect five interrelated dynamics that together are having a cataclysmic impact on all industry participants - a perfect storm is gathering steam, and generating monumental change in how all tiers of the industry are positioning for growth and profitability. Industry players will need to develop essential, focused and disciplined strategies to weather this storm and prosper. Ultimately, the consumer will benefit from the innovation created by the forces of competition, from better access to higher quality wines for the price, and from increased retail resources available to incentivize customer purchase behavior.

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1. **Supply and Demand Pressures**. The sheer volume of global wine supply is massive and provisioning a constantly expanding multibillion dollar consumer market. The net results of industry growth are supply-chain pressures forcing producers to continually improve wine quality and production efficiencies; and demand-chain pressures driving producers and retailers to apply innovative practices, achieving more customer-focused and differentiated products.
2. **Producer Consolidation**. The large are getting larger and are mostly publicly-held companies, a status that provides better access to capital sources for funding growth. With one notable exception (Gallo, which is privately held), the largest '"drinks"' producers are dominant merchandisers in all three major alcoholic beverage product markets – spirits, wine and beer. The inherent driver of producer consolidation is to achieve economies of scale in production and distribution, which equates to profit opportunities, market power, lower per unit administrative and delivery costs, and more sales and marketing clout. These billion dollar, mass merchandisers are forcing mid-sized ($60 million to $500 million) and small (<$60 million) producers to become more focused, specialized and better differentiated. The outcome is a widening chasm in how wine is sold - separating the billion dollar, mass '"drinks"' merchandisers from all other segments.
3. **Distributor Consolidation.** The strong are getting stronger. In the U.S., the alcoholic beverage distributor has benefited from a protected environment within which to do business, as a result of the legal and regulatory system created by the repeal of Prohibition. The mandatory "three-tier" system, which still exists in most states, is a complicated weave of restrictive regulations (cash laws, credit restrictions, primary source laws, at-rest laws, franchise laws, product registration, price posting, and prohibitions on direct retail sourcing from out-of-state). These regulations were designed to prevent brand movement between distributors and assure comfortable distributor margins regardless of the economic climate. Over the last ten years, wholesale margins have been squeezed with new overhead costs in technology, retailer-required merchandising and advertising - accelerating consolidation. This trend is not abating. The wholesalers are increasingly focusing on doing what they do best – transporting and delivering product – and requiring the producer to market, sell and merchandise if they want their product to move.

   The modernization of the alcoholic beverage distribution system is being driven more by economic factors than by legal action. This is apparent in the reduction in the number of wine and spirits wholesalers. This tier has shrunk from approximately 2,400 wholesalers in the mid-1980's, to approximately 250 today. This is without the spur of current legal decisions adverse to the distribution tier. The expansion in size of distributor networks is another sign of the storm. Southern Wine and Spirits spans the U.S. from California to Massachusetts. NDC is expanding its base in the South and the South East. Glazier's is growing by aggressively acquiring distributors in the Mid-West. Young's Market Company is a force in the West and Hawaii, and the Charmer group (Charmer, Sunbelt and Premier, among other companies) is powerful in the North East, the South and, the West.

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4. **Retail Consolidation**. When wholesale margins are squeezed, the opportunity exists for large retailers to capture a significant portion of wholesale profits, sharing these with producers and using them to compete for consumer attention. This is happening today. The retail wine industry is segmenting into two broad categories – on one side is wine sold in restaurant chains and broad market off-premise retailers with good price-to-value ratios (including private and controlled labels); on the other side is high-end and scarce wine from high-profile producers positioned as a "luxury good'. These wines are sold to customers on allocated lists, located on wine lists in high-end restaurant accounts, and available at specialty alcoholic beverage retailers and in secondary markets, often at exceptionally expensive prices. The implications of this 'divide' are important. Positioning within one category or the other has a huge impact on the ultimate potential value of a brand.

   The development of on-premise, as well as off-premise, multi-outlet and multi-state retailers has driven much of the producer and wholesaler consolidation of the last two decades. This retail model exists to service a highly identifiable, targeted, mass customer base and relies on controlled margins requiring participating vendors to play a volume game. Wine is an attractive product for these retailers because it both exerts a pull on customers and provides more profit per unit of cost than general merchandise or food. These types of retailers will continue to expand globally and are likely to become even more focused on targeted customer segments. Some examples include: Chevy's and other Mexican restaurant chains, specialized pasta chains, or groups of white-table cloth restaurants sharing a common management and administrative structure. Competition in this arena continues to intensify, following today's mantra of "driving costs out of the system."
5. **U.S. Market Liberalization**: However it comes to pass, whether by opening or restricting the flow of goods, slowly and one-by-one, in the wake of the Granholm decision the states will have to repeal illegal laws that discriminate in favor of local interests to the detriment of competitors in other states. It is our view that by 2015 wholesalers, retailers and wineries increasingly will be operating in an environment where they will have to compete on the merits of their products, their prices in relation to the entire market and customer service. The May 18, 2005 Supreme Court Granholm decision is the most important development in the industry in the last four decades. This decision is the culmination of a decade long legal battle over the right of wine producers to ship out of their state markets directly to consumers in states that permitted their wine producers to ship to consumers within their state.[1] The Granholm decision supports the more general conclusion that no state law can benefit a private in-state interest as against an out-of-state interest in the same line of commerce absent a compelling state interest (or when the state itself is the actor, such as in the control states).

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[1] The Supreme Court in Granholm v. Heald, 544 U.S. ___ May 18, 2005 found that the 21st Amendment did not authorize discrimination between in-state products and products from out-of state. Justice Kennedy held for the Court: "*The Amendment did not give States the authority to pass nonuniform laws in order to discriminate against out-of-state goods, a privilege they had not enjoyed at any earlier time.*" In our view, this is the key holding in the opinion and represents the beginning of a clear line of authority.

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This decision will create a domino effect in the long-term, accelerating the purging of State-level discriminatory laws preventing direct shipping of wine; first as they pertain to wineries, and then as they pertain to other industry members. The immediate state-level direct shipping disputes will be legislative and political in nature and will include attacks against in-state wineries' right to ship as a defensive mechanism on the part of wholesalers concerned about losing business. These attacks will ostensibly further the goal of equality on the anti-alcohol theory that everyone should be prohibited from shipping in order to protect minors and the entrenched state interests. This has already happened in New Jersey, been threatened in Michigan and Indiana, and has been ordered as a remedy by a Federal District Court in Virginia in a follow-up case there.

21st Amendment jurisprudence has evolved from the late-30s cases that allowed a state to regulate alcohol any way it wanted, without regard to the rest of the Constitution, through a series of cases moderating that position: a state cannot affect another state's commerce[2,3]; a state cannot violate anti-trust laws[4]; a state cannot impose discriminatory taxes[5]; a state cannot violate 1st Amendment[6,7]. This continues to evolve right up to today's Granholm decision: a state cannot discriminate against out-of-state interests.

These five essential dynamics are catalysts for change, consequently producing new global opportunities and challenges.

Supply and Demand Pressures - Opportunities and Challenges

Opportunities

New customer segments are evolving both in the United States and globally. 70 million consumers from the millennial generation will be the single most significant factor affecting United States market demand in 2015. This generation appears to be wine-savvy at a much earlier age than their parents were and early studies predict they are likely to appreciate quality products and brands. This phenomenon is equivalent to the post-WWII boomer explosion and is double the number of the millennials older "echo-boomer" brethren. Early adopters in this generation also appear to be large consumers of high-end spirits products, energy drinks and premium water.

[2] Brown-Forman Distillers Corp. v. New York State Liquor Authority, 476 U.S. 573 (1986 and United States Brewers Association v. Healy, 692 F.2d 275 (1982)
[3] Hostetter v. Idlewild Bon Voyage Liquor Corp., 377 U.S. 324 (1964)]
[4] California Retail Liquor Dealers Association v. Midcal Aluminum, Inc., 445 U.S. 97 (1980)
[5] Bacchus Imports, Ltd. v. Dias, 468 U.S. 263 (1984)
[6] 44 Liquormart, Inc. v. Rhode Island, 517 U.S. 484 (1996)
[7] Cooper v. McBeath, 11 F.3d 547 (5th Cir. 1994)

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As developing countries are industrializing and expendable income becomes a reality, untapped, new regional wine markets are emerging in China, India and Eastern Europe. Although United States wine producers face global competition in these markets, well positioned luxury goods and mass marketed wines that leverage local cultural differences and values will encounter growth opportunities as these new wine consumers expand exponentially in volume. One country's mass produced wine and beer is often another country's luxury product and many multi-national producers are currently capitalizing on that phenomenon.

Improvements in bulk transportation technology are now supporting growth in international bulk wine shipments. Bulk wine increasingly is shipped between Eastern Europe and South Africa, California and the UK, South America and California and between Australia and China. This is a trend that will persist and will play an important role by year 2015, enabling significant growth in negociant trade, as well as private labeling and smoothing out price differentials between regional markets. Most importantly, large global wine companies will be able to optimize their cost of goods in every market they choose to enter.

Challenges

Global wine supply is perhaps too abundant? Wine is produced in almost every developed country in the world. Even India, China and several Eastern European countries are becoming wine producers. Countries with excess wine supply - such as Chile, Argentina, Australia, New Zealand, South Africa, Georgia and Moldavia and the traditional European producers (France, Italy, Spain, Germany), are hitting the world market. In order to compete more successfully, many are replanting to take advantage of new production technology and soon will present more competition for California winemakers.

Driven by forces of good and bad, consistent growth in demand may still be tentative. Population growth, increasing world-wide income by the middle and upper classes in developed and developing countries, higher-quality wine at reasonable prices and improved marketing and advertising are fueling growth in consumption. However, gross demand is slowed by unfriendly legal climates (Russia and much of Eastern Europe), counterfeiting and other illegal trade practices, decreased consumption by historically high consuming nations (Italy and France particularly), the anti-alcohol movement, and religious and cultural practices in many parts of the world.

Global consumer perception of United States' wine quality is varied, inconsistent and complicated by politics and currency fluctuations. Aside from Gallo, very few other U.S.-based wine companies have shown the staying power and commitment to profitably develop global wine products and markets. Untapped global markets may be price constrained and become the domain of globalized mass merchandisers such as Diageo, Fortune Brands and Constellation, since these large-scale, multi-national business models are more impervious to currency fluctuations and have the budgets to establish and maintain market share. Smaller players export when the value of the dollar is weak and retire from global markets when the currency pendulum shifts.

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Producer Consolidation - Opportunities and Challenges

Opportunities

Large wineries have the opportunity to become more profitable through vertical integration of their distribution systems and aggressively segmenting their products and services to take advantage of market opportunity. From a distribution perspective, "drinks" are all liquid (also heavy, usually fragile and must be protected from temperature variations) and need to be properly stored, delivered on time and managed in accounts. More and more beer distributors today are multiple line houses handling many products, and many of them are also moving into wine distribution because it's simply another box on the truck. This is a trend that is inevitable and impacts every "drinks" market because it makes economic sense to consolidate as many products as possible on the same truck for delivery to the same accounts. For this reason, the major consolidated marketing companies are increasingly focused on producing premium products in almost every beverage segment. For example, Constellation has Corona, and Diageo has Guinness. These same companies are also active in the RTD categories.

The best examples of well-managed, large entities are Gallo with over 70 million cases shipped in 2004, the industry leader in wine depletions, and Anheuser Busch (AB), the industry leader with more than a 50% market share in beer. Gallo and AB are category leaders, function as "category managers" for many major off-premise chains and are expanding their product offerings to capitalize on the "premium is better" marketing climate.

Gallo has segmented its products more than any other company in the wine industry, and is capitalizing on the current popularity of low-priced brands from other countries, such as Yellow-Tail from Australia, with its launch of Red Bicycle from France. Gallo owns its distributors wherever possible, for example, Mid-Cal in California, and is an assertive partner in other United States markets. AB owns distributors wherever it is permitted to own them, rewards loyal managers with franchises, and has adopted a distribution agreement that compensates distributors that focus on AB products to the exclusion of competitive products with additional margin on sales.

A "two-and-a-half" tier system could eliminate close to $1 billion a year in distribution inefficiencies by year 2015[8]. Large producers and large retailers increasingly work directly with each other on pricing, market positioning, advertising and merchandising. They do not rely on distributors for these functions. Rather, they inform the distributor what the terms are and then pay for the services they actually receive (transportation, storage, billing, timely delivery of product and local market information). If distributors provide extra services, such as merchandising support, they are paid for those services. This leaves more money in the hands of the retailer and producer to apply to developing consumer awareness and loyalty, and fewer profits in the hands of wholesalers.

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The Diageo distribution agreement institutionalized these practices over two years ago and is now being emulated by other very large producers through special promotional programming to encourage product movement at the retail level.

At the same time, large retailers are increasingly embarking on selling their own private, proprietary and controlled label brands, which afford them larger margins. Trader Joe's Charles Shaw brand is a perfect example of this trend. This new dynamic provides distributors no effectual role other than to deliver product. Beer industry analysts coin the phrase "two and half" tiers to describe this trend and ascribe a billion dollar a year number to the expected annual efficiencies extracted from the distribution tier. These cost savings would most likely be split between producers and retailers as additional margins. We believe that similar cost savings exist within the wine industry because individual unit values in wine are much higher than in the beer industry. Therefore, higher cost savings per unit are more likely to occur when the real value of services provided is substituted for a distributor margin. In response to market dynamics, the modern distributor is certain to provide more cost-effective local services such as merchandising and product servicing in an attempt to recoup lost profits.[9]

Smaller and mid-sized wineries that survive consolidation will grow in value and observable brand equity by becoming specialists. Concentrating on what they do best, these producers are investing in transforming their businesses through more professional and disciplined product portfolio and customer-based management practices. Many wine consumers are looking for unique experiences or luxury goods that do not fit the mass merchandisers' business models; they get that unique experience from feeling that they are part of a winery "family," and that only comes from personal relationships built up over time and maintained.

By 2015 most successful small wineries will be 100% customer focused – with consumers and retailers being the customers. To the extent that traditional distributors are relied upon, it will be for the purpose of servicing high-profile or important accounts in regions or areas where there is a large base of existing customers. High-profile account relationships provide a venue for obtaining and tasting wine; therefore driving winery direct sales and building small winery brands in the marketplace.

Large wine producers who are collecting smaller, more specialized brands are a trend that will mark the next ten years. The market is rewarding significant mergers of specialized mid-sized wineries such as RH Phillips and Hogue under the management of Vincor from Canada, the Franciscan portfolio of brands under the management of Constellation, and significant internal growth through the development of multiple stand-alone brands such as the brands produced by Gallo both in Sonoma and Modesto. The business models that will win are those that allow each specialized brand to maintain its separate, but strong and consistent, relationship with its consumers. Kendall-Jackson's Artisan Estates are a good illustration of this strategy.

[9] Ibid.

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Challenges

Except for the few top (A) brands, most smaller and mid-sized wineries are being locked out of the current three-tier distribution system. The cost of marketing and sales has escalated for most wineries, costing upwards of 25- 30% of sales; consequently, many brands are not realizing their plans. Many expect that relief is on the horizon from the three-tier system itself - from the Granholm Supreme Court decision expected to liberalize State shipping laws and potentially opening new consumer direct channels. This is false hope for many because it will take a long period for changes to be fully processed through each state legislature and it will still be necessary to penetrate local markets to create demand-pull. Timing is important because the winners will be the first to market - with the right product, story, and communications structure and customer service. The window of opportunity is now, because successful brand building takes years, requiring a serious commitment of time and focused resources. In order to survive and grow, small and mid-size wineries must already be building the infrastructure capable of capitalizing on these opportunities. Brand building over the long term will become more and more difficult as large producers segment their brands to fill available niches and well positioned small wineries use their agility to capture the consumer's share of mind.

Distributor Consolidation - Opportunities and Challenges

Opportunities

In most of the world, the middle tier of the "drinks" industry exists as a service provider, or as an adjunct of large producers. The distribution tier has always performed a valuable function in assuring proper product storage, delivery and merchandising where, when and as required by producers and customers. An essential component of these relationships is the mid-tier investment in vehicles, warehouse and transportation technology; offset by a concomitant return on the investment. This is understood by beer, RTD, CSD, juice and energy drink segments of the US market. Participants in these segments, seeking improved efficiencies in their distribution systems are consolidating products for storage, shipment and delivery on a common base of trucks, warehouses and personnel. As the wine industry follows in these footsteps and our laws continue to change, the large U.S. distribution houses should evolve from sales management to fleet management. This leaves more money in the hands of the retailer and producer to build brands with consumers and less profit in the hands of wholesalers. In doing so, the industry becomes a 2 ½ tier system and the projected elimination of close to one billion dollars a year in inefficiencies becomes more likely.[10]

[10] Prudential (Kanter) January 11, 2005 Report – Future Shocks

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Investment in more efficient delivery technology is supported by large suppliers and retailers. Examples of functional, vertical integration are commonplace in the non-alcoholic beverage "drinks" segment, primarily achieved through shared investment, brand equity and regional distribution networks. Driven by technology and economics as much as by legal challenges, the development of large producer networks and large retailer networks inevitably will spur the development of large, coordinated delivery networks.

Challenges

United States distributors are being forced to invest in new technology and systems necessary to serve today's customers, especially the large multi-state retail chains. Without the scale necessary to efficiently compete, many old-line distributors are selling to larger competitors – rather than invest in the requisite technology and systems. Regardless of these economic developments, as long as the current wholesale tier is able to profit from the protectionist legal system they created, change will be slower and more incremental than it would be in a non-regulated product market.

With a lot more wine being sold through fewer distributors only the mass merchandisers and a few top (A) brands are getting properly serviced in exchange for a large share of their profits. New, specialized distributors and brokers are emerging to support smaller brands. As laws continue to change, new specialized shipping companies will emerge to fill the gap and facilitate direct shipping from producer to their retail customers as well as their consumers, in return for a market-based service fee rather than a margin.

Retail Consolidation - Opportunities and Challenges

Opportunities

The large consolidated producer and the large consolidated wholesaler are becoming category managers for certain large retailers. The large national retailers share a common growth strategy. Examples of these include: grocery store chains (Safeway, Albertson's), the super premium grocers (Andronico's, Whole Foods), the specialty food and beverage chains (Trader Joe's, Cost Plus World Market), the super retailers and warehouse stores (Costco, Wal-Mart, Target, K-Mart,), the chain restaurants (Olive Garden, Red Lobster, Chevy's) and the convenience store operators (7-11). These retailers are centrally managed. They are committed to vigorous competition (which means low-margins) and good pricing to consumers, efficient and cost-effective customer service, and limited SKU's which are easier to manage and have a high turn ratio usually better than 10-12X per year. They are also expanding into every geographic market that they can reach.

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As they expand into these markets, the natural inclination is to implement centralized, regional product fulfillment at the lowest cost for every product they carry, including beverage products. This model emulates a “two-and-a-half” tier system because the retailer hires the distributor to provide a delivery service for a fee rather than to be paid a margin for product. Retailers are already favoring selected (large) wine producers who demonstrate the ability to analyze profit opportunities and assist the retailer in making difficult decisions among an ample supply of competing products for scarce shelf and wine list space. These (large) mass merchandisers also have the scale to provide advertising support, another critical component to category management.

A growing number of luxury wine producers are tapping into other large, more specialized, retailers. Specialty alcoholic beverage retailers service a more specialized domestic retail wine market. Examples include multi-outlet retail chains such as Beverages & more in California, ABC Liquors in Florida and smaller but high-volume specialty retailers such as Zachy’s in New York, Sam’s in Chicago, Wally’s in LA, and K&L Wines and the Wine Club in California. These retailers are heavily invested in inventory at higher price points and multiple SKU’s, and are increasingly managing a multi-market customer base with state of the art customer relationship management systems. The hallmark of these retailers is customer handholding, education and service, particularly in the above $15 wine categories. Wine.com may be most technologically sophisticated of these retailers, servicing 35 states through a legally-compliant combination of owned licenses and marketing partnerships with other retailers. These retailers use the three-tier system where possible but do not wholly depend on it for product relationships. Rather, they build relationships with high-end producers and importers and sophisticated customers. Subsets of these retailers are also investing in “collector” luxury wines purchased on the secondary market and sold through to high-end users. This would include the auction houses (WineBid.com, Christies, Acker Merrill and Condit, Butterfield’s and Bonham’s, etc.) and a host of smaller internet based retailers. These channels are becoming increasingly important for the luxury wine segment because it provides both a source of mature investment quality wines and an outlet for selling those same wines.

Challenges

Wine – two markets: the widening chasm between the large mass merchandisers and the mid-small producers is most obvious at the retail level. Mid-sized producers are either merging/being acquired and getting larger, or specializing and getting smaller. More than ever before, mid and small-sized producers are carefully developing key retail relationships based on the value they are able to provide to these relationships, in terms of merchandising support and profit dollars. Small producers are becoming even more specialized and sell to specialized wine shops and restaurants. Specialization requires improved communications; better differentiated brands through packaging, quality distinctions, more focused product portfolios; and a commitment to working more closely with a fewer number of important retail relationships.

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The reality is all wine producers are seeking to become stronger at positioning their brands and are learning from each other in the process. Jug and the emerging "box" wine segments are now using varietal identifiers and upscale packaging. Through specialization and niche marketing, many winery (and retail)-operated, proprietary wine clubs are growing in the US and elsewhere in the world.

The larger retailers are not only looking to manage fewer SKUs (Stock Keeping Units or brands), they are also launching their own, more profitable private labels in all price tiers. Retailers are attempting to build value by creating brands they own to help build their reputation and generate stronger return on brand equity. Private, proprietary and controlled label brands are different strategies for achieving higher retail profits where the margin is essentially spilt, after transportation and delivery expenses, between the producer and the retailer. Typically focused on wines in the low to mid-range price tiers, this fast growing, global market is now moving into the luxury tier. Costco already carries a $60/bottle Kirkland brand. In the last two years multi-state wine distribution projects have been initiated out of California through the Western states, out of Illinois to service the Mid-West and out of Florida to service the South. These projects involve private and controlled labels or mid-to-low price national brands that are centrally priced and managed. Many wineries are actively specializing in supplying wine under these special labels and it is an important outlet for excess production. Others, selling their own brands, compete with retail private labels directly for floor space.

U.S. Market Liberalization

Opportunities

Wholesalers will most likely NOT be successful in maintaining status quo. The depth of their anxiety is demonstrated by WSWA joining forces with the conservative religious right (Ralph Reed and his Christian Coalition filed an Amicus brief in support of the wholesalers) and the traditional anti-alcohol forces. At least four dynamics are preventing wholesalers from holding back the storm: (1) wholesaler consolidation has created fewer wholesalers - diluting their historic power, becoming weaker over the next decade as they join consolidated systems; (2) winery trade associations are more effective than in previous eras; (3) the Granholm decision truly exposes the vulnerability of traditional special interest legislation and (4) special interest legislation is an enormous political risk that benefits one tier at the expense of putting another tier out of business. Wineries can generate votes, the real currency of politics.

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A victory by Costco will reverberate through other states and lead to direct shipment from producers to retailers. The Costco case is the 800-pound gorilla behind the door of the direct shipping lawsuit, and Wal-Mart is right behind Costco. Costco filed suit in federal district court in Seattle in September of 2003 seeking to invalidate the following Washington state laws: (1) distributor price posting; (2) minimum wholesale markups; (3) credit law (Washington is a cash state); (4) prohibition on QD's and CQD's; (5) prohibition on direct delivery from out of state wineries to Costco warehouse.[11]

Given that Costco is fighting so shipments can be sent directly from out-of-state producers to its Washington warehouse[12], the interests of both wineries and Costco should be aligned. The wholesaler's legislative response to a Costco victory is certain to be an attempted repeal of in-state privileges held by local wineries. The Washington wine industry is also certain to resist encroachments upon the privileges for which it has battled so long. We predict that Costco will prevail in the courts and the Washington wine industry will prevail in legislature.

If Costco establishes that it legally possesses the privilege of receiving direct shipments from out-of-state producers, then ANY retailer in ANY state where in-state wineries have a right to ship directly to retail accounts in their own states should possess the same right. California has the same restrictions as Washington State and the same privileges for its domestic wineries. If challenged the California restrictions on out of state shipments to California retailers will also fall. This is certain to be a contentious and heavily litigated issue that will be battled first in the large coastal consumer market states, such as California, Florida, Texas and New York. State by state, legal action will move to smaller markets as consumer and business pressures rise over unjustifiable price disparities that become transparent because of better consumer and retailer access to market information.

Challenges (or Opportunity?)

The most significant court cases will come from the retail tier. Change will be slow since regulators are disinclined to enforce laws that they believe may be discriminatory and subject to challenge. However, it is highly likely that the retail tier will build there case and win it – dramatically accelerating liberalization of the national wine market. If an in-state retailer can ship through commercial delivery services to a customer, we believe that there is no valid basis for denying that right to an out-of-state retailer. A vast majority of states permit their own retailers to ship direct within the state, clearly discriminating against retailers out-of-state.

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[11] The Costco action survived 2004 cross-motions for summary judgment and was stayed pending the US Supreme Court decision in Granholm. The case is now going back for trial in March of 2006. Of note is the fact that in 2003 the Washington Supreme Court itself expressed hostility to the state regulatory scheme when it invalidated the Washington franchise laws on the basis that they were discriminatory because Washington wineries were excluded. Mt. Hood Beverage Co. v Constellation Brands, Inc., (Supreme Court of the State of Washington, No. 72882-8, Feb. 20, 2003).

[12]Equal treatment with in-state wineries that can ship direct to retail accounts, or with consumers in Washington who are also defined as "people" for legal purposes and who can receive goods directly from out-of-state.

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Judging from the momentum of the last several years and driven by retail legal action, major legal hurdles will be overcome by 2015. While the economic and technological factors are the most predictable drivers of change, definite ***wild cards*** exist with the potential impact of the anti-alcohol movement (which is currently focused on “youth” advertising and reduction in the availability of product through retail outlet control), positive or negative developments in health research and the consequences of religiously based legislation prohibiting alcohol consumption in many parts of the U.S. and the world.

The Perfect Storm is already brewing with a two-and-a-half tier system operating with controlled label or private brands that are delivered through the distributors at essentially transportation and administration costs. As technological and regulatory breakthroughs occur, this two-and-a-half tier system will expand to broadly-sold national brands over the next ten years.

On the global scene, major super-retailers have been expanding world-wide for several years. These include Target, Costco and Wal-Mart. It is likely that the major super-retailers from Europe, Tesco for example, may expand into the US or may either acquire (or be acquired by) their US counterparts. Because of globalization, we believe that the world of 2015 will comprise a dozen super-retailers operating throughout the developed world, who will be working primarily with their world-wide producer counterparts and less so with the smaller, national, producers. In 2015, the average retail wine buyer program most likely will consist of a limited number of well segmented SKU’s purchased from the top 20 wine producers.

So, the big will get bigger. However, highly specialized retailers and producers will continue to grow through niche marketing, because of the adventurous nature of the high-end wine consumer – constantly seeking new experiences and education; many consumers will persist in their quest for undiscovered, still higher quality wines. New wineries will continue to emerge; but the strong who survive will go about marketing and selling their wines in a more focused, segmented and disciplined manner over the next decade than they have over the last. And the consumer will get **more**: **more** brands to chose from, **more** innovative products and packaging, **more** specialized experiences with smaller wineries, and **more** quality for the price.

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