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WINE INDUSTRY ADVISORS

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The Wine Industry and the New Economy

Many people talk about the economic downturn and its origin with the collapse of Lehman Brothers in September 2008. This was obviously the point when a recession became a full blown financial crisis. Even before the fall of 2008 there were signs that the financial system was changing. To understand the implications for the wine industry one needs to consider the crisis as well as the other major trends leading up to it.

An oversimplification of the financial crisis is that lax credit rules allowed the creation of a real estate bubble primarily in the United States. Realistically the bubble was greater than just the U.S. real estate market and extended through many markets due to easy, low cost debt. This bubble had been funded by money from around the globe with risks offset by using credit derivatives. There was not a clear understanding of the true risks represented by all of the various credit derivatives and when the recession hit a tipping point, basically the house of cards started to fall.

Prior to the severe impact of the recession there were other signs that the global economy was changing with, for example, significant movements in both the foreign exchange markets and the commodities markets.

For the past year the main mode of business has been survival. For the wine industry it has been a time of watching importers, wholesalers, retailers and even consumers destock. There have been channel shifts from on premise to off premise. There has either been a trading down on the part of consumers, or at least a slowdown in trading up. The good news is that, generally speaking, there has not been a drop off in overall consumption.

Going forward the economy will be different than what we became accustomed to between 2002 and 2007. No one can accurately predict how the economy will be different, and its implications will vary across the myriad of wine companies in the world. Some economic considerations might be:

- For a period of time up until the fall of 2008 the U.S. dollar had generally been weakening against many of their trading partners. This was a boon to U.S. exporters. With the financial crisis the dollar strengthened significantly due to a flight to safety. How will currencies move going forward and what implications will this have on importers and exporters around the globe?
- During 2008 many commodities experienced significant increases in their value on the world market and then fell back significantly in the fall of 2008. Some of the increases were driven by demand but some of the increases were also driven by speculation. As the economies of the world recover what will happen with commodity prices? If, for instance, oil goes back to prices seen in June of 2008 what will be the effect on wine companies for utility and freight costs?
- In many developed markets a key driver of the economies has been the financial industry. This industry has fundamentally changed. How will these changes impact the wine industry from the availability of credit to the consumption patterns of wine?

- The U.S. was facing a long-term federal deficit as the Baby Boomers aged and payouts under social security and Medicare would increase. New programs such as health care will only increase the deficit without other actions being taken. The federal government will require more funds and if taxes are raised to achieve this what will be the impact on disposable income and wine consumption?
- Environmental issues are major potential points of impact for the wine business. How will carbon trading affect the costs of producing wine and getting it to market? Are water shortages in California and South Australia the new normal or is this a cyclical weather pattern?
- Some economists warn of the danger of deflation. Other economists are worried about inflation due to all of the liquidity that has been pumped into the markets. The wine industry, like all industries, faces a conundrum in trying to plan for either scenario.
- There has been a significant deterioration in the wealth of the US consumer. For the Baby Boomers a double whammy can be considered to be the loss of value in their homes, which had been a cash machine during the boom, as well as the loss of value in their retirement accounts. If the Baby Boomers focus more on retirement saving, rather than returning to their habits prior to the recession, how will this affect their wine consumption in terms of price points and channels where purchased?

This is only a short list of possible economic considerations. A few scenarios that certain producers may need to think about are:

- Australia's economy seems to be recovering sooner than other developed economies and it faces smaller deficit issues than the U.S. or the UK, which are two of its major export markets for wine. In addition a major component of the Australian economy is the mining industry which will benefit significantly from renewed growth in China. These factors could lead to a further strengthening of the Australian dollar. If this happens, wine producers may come under further margin pressure on their exports.
- Champagne producers have always looked at the U.S. market as one of their major export markets. With the economic crisis, Champagne sales have been significantly impacted to the point where overall production in Champagne is being reduced significantly in 2009. If U.S. consumers reduce overall consumption of Champagne due to their reduced personal wealth Champagne producers will need to find other markets for their wines to get back to maximum production potential.
- In the U.S. the on premise business has seen a significant decline at the high end. Many restaurants have reduced purchases from their wholesalers that have led to "out-of-stocks" for certain wines while they sell through inventory of slow-moving wines. As the economy improves these restaurateurs may reduce the number of items on their wine lists. Those wines that were out of stock may see an increase in sales since these are the wines that were in higher demand and will be on the new wine lists. The last wines to sell may see a reduction in demand, or at least points of distribution, as these are the likely losers on the shortened wine lists.
- Consumers might shift toward greater home consumption and look for quality and convenience. The wine producers that can provide the right price value relationship where the consumers find it convenient to shop will likely find opportunities as the markets stabilize.

As noted above these are just a few of the scenarios the industry needs to consider. The new economy will create opportunities for some wine producers while creating problems for others. Smart producers will find their niches both in the wines they produce and the markets and channels in which they sell.