



Craft Beverages: Wine, Spirits and Beer

INDUSTRY REPORT

2020



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EXECUTIVE SUMMARY

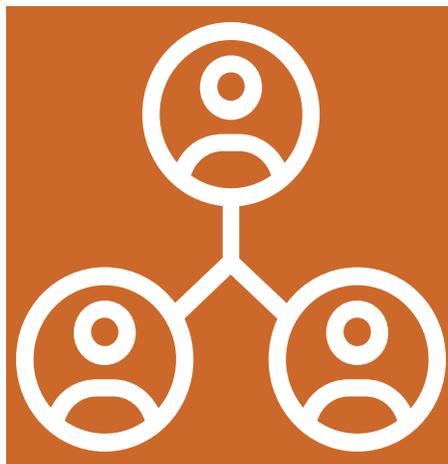
July 2020

The Sonoma County Economic Development Board (EDB), in partnership with the Sonoma County Workforce Investment Board (WIB), is pleased to present the 2020 Craft Beverage Industry Insiders report. Our research partner, Moody's Analytics, provided the research for this report. For additional information, questions, comments, or suggestions please contact us at (707) 565-7170 or visit www.sonomaedb.org.

HIGHLIGHTS



The outlook for Sonoma County's Craft beverage industry remains uncertain in light of COVID-19. One of the more concerning variables is how consumer behavior will play out once income and wealth losses become solidified. Nationally, millions of workers have lost their jobs or have found their hours cut. Initially job losses were concentrated in occupations with income brackets less likely to engage in Sonoma County's craft beverage market. However, as employment losses creep higher in industries such as financial services and healthcare, demand is expected to shrink. Furthermore, the mass loss of wealth from investment downturns will likely change consumers behavior towards saving. Shelter in place orders and travel restrictions will also deal damages to in person visits and sales. The declined foot traffic will deal a greater blow to small and mid-sized producers that rely on in-person visits for sales. Lower pricing for wine grapes and wage growth have resulted in higher operating expenses, but the sharp plunge in global demand for metals will leave input costs lower and offer respite for those needing to replace farm, wine and brewery equipment.



2019 marked the first decline in wine consumption volume in recent history. Over the past decades, Sonoma County has poised itself on the world market as a low-cost producer of quality wines. However, retaliatory tariffs evened the competition field for French and Italian wines and exports fell by 6.5% in 2019 alone. Consumers may be drinking less wine, but they are demonstrating a willingness to pay a premium for better wine. Wine sales below the \$9 price point are plummeting in both volume and value. All the while, sales of bottles priced between \$12 and \$20 have spiked. As millennials continue to acquire increasing importance in the marketplace; vintners, craft brewers and spirit makers are taking notice. The millennial cohort makes up approximately one third of the entire market, but are demonstrating a preference for craft beer and spirits. Vintners have enjoyed consistent annual price increases thanks to the baby boomer cohort, but as they move into retirement their numbers for per capita consumption declines. Moreover, as millennials and generation X take control as the largest wine consuming cohort, the preference for fine and premium wines, at high price points, will slow down.



Craft beer makers have taken advantage of the boomer to millennial demographic switch and saw a 4.1% sales increase in 2019. Lower hops and grain prices will decrease input costs for craft beer makers and offer some respite to their profit margins. However, craft breweries are in a more challenging pricing environment as new breweries saturate the market. Additionally, as larger brewers continue to absorb smaller independent breweries, economies of scale will hinder pricing power to smaller producers through oversupply. On the contrary the craft spirits movement is still young and has room for growth, but as consumers limit discretionary spending producers will also find a more challenging pricing environment. Craft spirits do cost more than craft beer, but they tend to be less than expensive than luxury wines capturing the interest of thrift driven millennial consumers that prize drinking better over drinking more.



Recent Performance. A turbulent external environment, a tightening labor market, and changing consumer preferences made for choppy seas for Sonoma County vintners, brewers and spirit makers over the past year. Still, county producers forged ahead and 2019 marked another year of steady progress, persevering despite a protracted decline in exports and shifting consumer preferences.

Overall U.S. consumer spending on adult beverages ticked higher in 2019, but wine consumption volume fell for the first time in a quarter-century. Consumers have demonstrated a willingness to drink better, if not more, adult beverages. Sonoma's vintners and craft beverage makers were supported by domestic consumers' willingness and desire to trade up to higher-priced wines. According to Wines and Vines Analytics, total wine consumption bucked a 24-year trend to register its first annual decline in 2019. Sonoma's key market segment, however, is thriving. While sales of wines in the below-\$9 segment are flagging in both volume and value, sales of bottles priced \$12 to \$20 grew at near double-digit rates. Furthermore, the lucrative direct-shipping channel, which is the primary avenue of sales for most small and medium-size Sonoma wineries, continues to grow rapidly and now accounts for about a tenth of off-premise sales. Sonoma County accounted for 29.1% of all direct-to-consumer wine shipments in 2019, making this region the largest shipper of wine by volume for the second year in a row.

Offsetting some of the positive recent trends for Sonoma beverage makers, county producers remained in the cross fire of protectionist and retaliatory tariffs. A strong dollar and growing competition from lower-cost competitors stymied what had been a strong source of growth for California wines. Over the last decade, California wine exports swelled by 60% and reached an all-time high in 2016. Retaliatory tariffs and increased import competition from French and Italian wines saw exports fall 6.5% in 2019, following a decline of 4.5% in 2018.

Macro drivers. The outlook remains highly uncertain and constantly changing with every new estimate of the impact of COVID-19, and government actions further restrict the population's movement and economic activity. Millions of workers have lost their jobs, at least temporarily, and many more are finding their hours cut; 22 million workers have filed for unemployment insur-

ance claims. Initially, job losses were concentrated among low-income workers who would not be customers of Sonoma's beverage industry, but white-collar employment is also falling as demand shrivels across the board. White-collar employment in such industries as financial services and healthcare will decline by about 5% this year, and a full rebound is not expected until 2022.

A second major blow to household finances comes from the decline in household wealth due to the plunge in the stock market. The stock market lost nearly 20% of its value since its February peak. As households come to grips with their lost wealth, they are likely to cut back on their spending. Baby boomers will be particularly hard-hit. They own more than half of household equity and mutual fund assets, and more than 20% of their wealth was invested in these assets at the end of last year. As they come to grips with the lost wealth, they will change their behavior, cutting spending to conserve cash, as currently businesses are.

Spending will be very erratic for the next six to 12 months. This will be evident both in the pace of spending and its composition. From an aggregate perspective, spending will be severely restrained as long as stay-at-home orders and other restrictions on economic activity remain in place. When restrictions are lifted, people will be eager to get out and do things again. However, after that initial rush, the reality of the lost income, lost wealth and increased uncertainty will result in a return to a normal that includes less spending and activity than prior to the crisis. When restrictions are lifted, there will be a partial reversal, although, after the initial rush of pent-up demand, demand for discretionary goods and services will remain low in response to the drop in income and wealth.

Shelter-in-place orders and travel restrictions will deal a body blow to small and midsize wineries and breweries that rely heavily on in-person visits for sales. Tasting room visits have ceased as the state closed all nonessential businesses as the COVID-19 outbreak worsened, sealing off a crucial source of sales for local wineries. Taprooms are bearing the brunt as well. Laxed restrictions on to-go orders and online selling platforms will provide some respite, but on net the impacts of reduced discretionary spending, closed nonessential retail and restaurants, and low-capacity hotels will weigh more heavily on sales.

Industry drivers. The rise of the millennial consumer continues to grow in impor-

tance to Sonoma vintners, craft brewers and spirit makers. Sonoma vintners have enjoyed several years of rapid growth accompanied by modest price increases across varietals, but the aging baby boomer cohort will put a speed limit on the sales of premium and fine wines. This cohort makes up about a third of total wine consumption, is moving into retirement, and declining in both their numbers and per capita consumption. Nationally, wine consumption recorded its first decrease in a quarter-century in 2019. Millennials, who by their sheer size make up nearly a third of the market, are increasingly turning to craft beer and spirits, and vintners will need to persuade a new generation of wine enthusiasts to take up the mantle from the aging boomer cohort. Although millennials will migrate to higher-priced bottles as they enter their prime earning years, large student loan burdens and the experience of the financial crisis will encourage thrift, making millennials less reliable sources of revenue for fine and luxury wines produced by the county's small and midsize wineries.

The shifting demographic landscape provides opportunities for the county's craft beer and spirit makers. Overall beer sales fell for the fourth consecutive year, while craft beer sales jumped 4.1% in 2019. Though the national market is growing increasingly saturated, Sonoma's early entry and repute will provide an avenue for modest growth. Craft spirits command higher prices than craft beer and retail spirit labels, but they are generally less expensive than luxury wines and will capture a greater share of overall spending on spirits as discerning millennial consumers grow more secure in their economic status and prize drinking better over drinking more.

More volatile climate conditions will be an ever-present challenge for Sonoma vintners and craft beverage makers. Though the severe California drought has faded, rising ocean surface temperatures have coincided with less predictable climate events that could put county vineyards, wineries, breweries and distilleries in peril.

Pricing. Acute oversupply, slowing volume growth, and a significant economic dislocation will severely hamper pricing power. Though the 2019 harvest came with normal yields in California, 2018's record harvest and sluggish demand mean this will be insufficient to correct the supply problem. The average price in the crop report for Sonoma County wine grapes was \$2,784, down 0.3% from

2018 and the first correction in the county average since the 2009-2010 slump in fine-wine sales after the Great Recession. Bottle price increases will be rare in 2020. Lower demand for luxury wines as discretionary incomes fall, coupled with competition from quality wines in Oregon and Washington, will limit smaller wineries' ability to raise prices.

Craft beer producers face an even more challenging pricing environment. While beer enthusiasts have migrated en masse to craft ales, the swell of new breweries has dented pricing power for all but the most coveted brews. Traditional brewers' purchases of independent breweries will bring economies of scale to the craft market and dampen the pricing power of smaller producers.

Compared with craft beer, the craft spirits movement is relatively young, and demand is swelling. Nonetheless, spirit makers will likewise face a difficult pricing environment in the near term as spending weakens and consumers seek to limit discretionary spending.

Operating expenses. Lower prices for wine grapes and moderating wage growth for agricultural workers will stem the rise in operating expenses. Wages for agricultural workers surged nearly 20% in 2018 before moderating to approximately 5% in 2019. Further moderation is in the cards as the economy suffers through a near-term recession and the labor market tightness dissipates amid wide-scale business closures and layoffs.

Tariffs remain in place, but a sharp downturn in global demand for steel and aluminum will leave input costs much lower over the next year. While firms will pull back on investment, those that need to replace farm wine and brewery equipment will see some respite from lower materials costs.

Profitability. The economic dislocation will suppress demand for fine wines and craft beverages, offsetting any respite from lower input costs and operating expenses. Negative wealth effects from lower equity prices and widespread unemployment will hamstring sales of higher-end wines. Though alcohol purchases are less vulnerable than other luxury goods during economic downturns, wineries and breweries will still be dealt a blow. Evidence from the Great Recession shows that winery pretax profits fell from 16% to 9% to 2% from 2007 to 2009, and sales volume swung from 22% growth in 2007 to 2% in 2008 to a decline of 4% in 2009, according to financial statements collected by Silicon Valley Bank.

Wineries that rely heavily on tasting room visits will likewise be pinched as shelter-in-place orders and travel restrictions are lifted slowly and consumers remain cautious as the COVID-19 pandemic lingers through the summer months.

While lower hops and grain prices will curtail input costs for craft beer makers, a saturated market and the rising clout of large producers will curb revenue and profit growth.

Long-term outlook. The long-term outlook for Sonoma vintners, craft brewers and spirit makers is one of cautious optimism. The near-term pain will sting as discretionary spending cratered, and e-commerce and online sales will only partially offset the losses. Vintners, craft brewers and spirit makers that are able to withstand the temporary demand shock will emerge to a slowing sales environment. In a survey released by the Brewers Association, 2% of breweries announced they will close permanently following the lifting of the shelter-in-place order, and more than 10% estimate they will be forced to close if the shutdown persists longer than a month.

As millennials overtake Gen Xers and baby boomers as the largest wine-consuming cohort, sales of fine and premium wines will slow from the brisk pace of the past four years. The large presence of craft breweries and spirit makers will help Sonoma's economy weather these changes. While enthusiasm for craft beers and spirits is frequently ascribed to millennials, the thirst for craft offerings cuts across generations and will help the beverage industry diversify.

Still, winemaking remains the beating heart of Sonoma's economy, and vintners will need to do better with millennials to ensure a healthy base of demand in the long run. Income constraints will slow millennials' entry to their prime spending years, but they will wield significant purchasing power as their careers progress. Wineries that emphasize brand origin and environmental stewardship as well as promote new dining experiences will find success.

The landscape for craft beers will grow increasingly bifurcated. While smaller craft breweries will be able to draw on county residents and tourists seeking an increasingly diverse dining experience, midsize and large breweries with national and global ambitions will face price pressures. Recent downsizing by Lagunitas is just one example, with slowing sales and lower profit margins forcing layoffs at local facilities. Makers of craft spirits will eventually face simi-

lar pressures as the craft spirits movement matures. Foreign markets will grow in importance for craft beer and spirit makers. Replicating the success of winemakers in cultivating a taste for more sophisticated offerings in China, emerging Asia and Latin America will be critical to their long-run success.

Upside risks. Upside scenarios are not inconceivable. If the virus were to fade quickly with warmer weather, and jobs return, consumers would benefit from lower energy prices and interest rates and be able to spend with unexpected gusto.

The legalization of cannabis poses risks to both the upside and downside. By pairing CBD-infused beverages and food ingredients with more traditional beverages, vintners, craft breweries and spirit makers could cultivate a new fan base in county tasting rooms and build a bridge to millennial consumers. On the other hand, enthusiasm for stronger cannabis products that are generally consumed in place of alcohol could prevent potential fine-wine and craft beer consumers from developing a taste for local wines, craft ales and spirits.

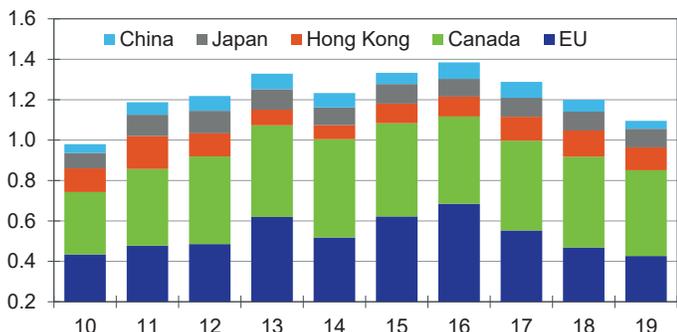
Downside risks. The balance of risks to the outlook is weighted firmly to the downside. A continued deterioration in economic conditions as a result of the COVID-19 pandemic would exacerbate the damage already inflicted on local brewers and vintners. Timely travel and visitor data, including Transportation Security Administration checkpoint throughput, show a near standstill in domestic travel. Limited support from tourists will hamstring local wineries and breweries. Though the worst of the economic fallout from the virus is expected through this summer, without a vaccine or medical treatment for the virus, travel, tourism and trade will remain impaired and the global economy will continue to struggle. Moody's Analytics expects a vaccine by summer 2021.

The continuation of global trade disputes constitutes another key downside risk to Sonoma County producers, given already-depressed domestic demand. Trade tensions have impaired vintners and craft beverage makers through multiple channels, and prior trade disputes suggest that market share, once ceded, is difficult to recover. Should the trade dispute with China grow more contentious, Sonoma vintners would miss out on a generation of aspirational consumers in China and Southeast Asia.

*Colin Seitz
April 2020*

Trade Tensions Erode Export Market

California wine exports, \$ bil, top 5 markets

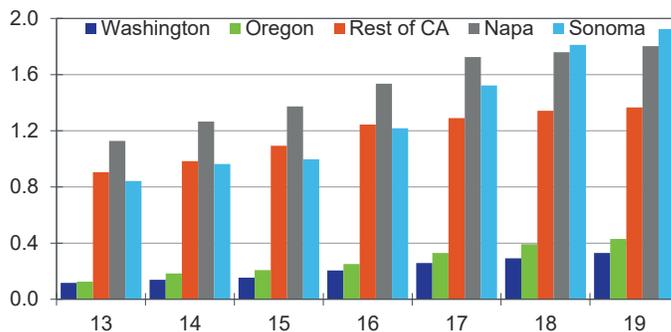


Sources: The Wine Institute, Census Bureau, Moody's Analytics

The value of California wine shipments shrank for the third consecutive year as trade tensions remained elevated and the global economy operated below potential. Craft beverage makers were stung as well. Higher aluminum tariffs increased packaging costs for craft brewers. Although craft spirit makers do not export much of what they produce, European retaliatory tariffs on whiskey cloud the outlook for foreign sales and investment just as local producers had begun to scale up and explore new distribution channels.

Sonoma Retains Lead in Direct Shipments

Cases, 9 liters, mil

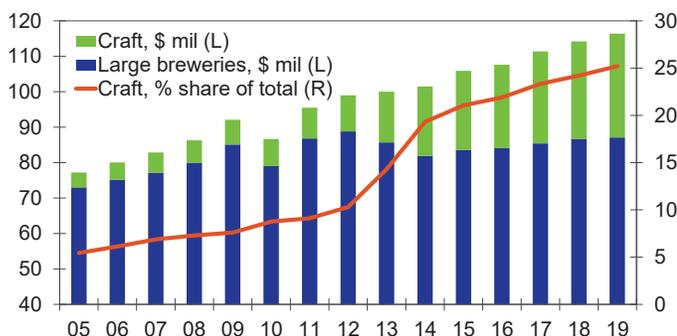


Sources: Wines & Vines Analytics, ShipCompliant, Moody's Analytics

Direct shipments are a crucial avenue of sales for Sonoma County's smaller and midsize wineries; nearly two-thirds of sales for the smaller wineries come from direct shipments. Sonoma has outmuscled fierce competition from within the state and the Pacific Northwest to maintain the lead in shipment volumes. While Sonoma has been dealing with the decline in tasting room sales in recent years, the collapse of the tourism market given the COVID-19 pandemic is an additional near-term concern. Winery visits are often the first point of encounter for potential consumers.

Craft Ales Nab More Market Share

Retail sales, beer, U.S.

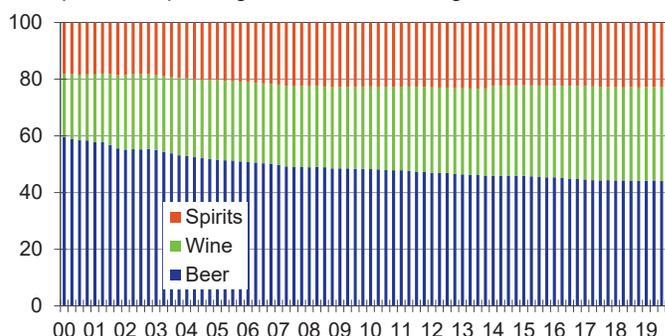


Sources: Brewers Assn., Moody's Analytics

Though the craft beverage market is undoubtedly growing more saturated, consumers' thirst for craft beers is yet to be satiated. Craft beverage sales outran the overall beer market once again in 2019, and craft beer now accounts for more than a quarter of the overall beer market. Local brewers' nationally renowned ales will safeguard sales amid an increasingly concentrated market. However, industry consolidation and the purchase of smaller brands by traditional producers will limit pricing power and hiring.

Beer Makes Way for Wine and Spirits

Real personal spending on alcoholic beverages, %



Sources: BEA, Moody's Analytics

Total beer sales continue to lose ground to wine and spirits as consumers take a pass on mass-market ales. Although beer still makes up nearly half of total off-premise sales of alcoholic beverages, its market share has steadily eroded as wine and spirit makers have capitalized on consumers' willingness to drink better, if not more. While sales of mass-market beer brands have flagged, growing enthusiasm for craft beer and spirits bodes well for county producers.



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