



WINE & CRAFT BEVERAGE

INDUSTRY INSIDER

2021



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EXECUTIVE SUMMARY

July 2021

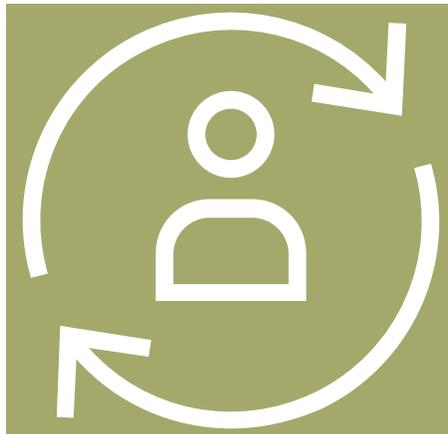
The Sonoma County Economic Development Board (EDB), in partnership with the Workforce Investment Board (WIB), is pleased to present this 2021 Local Industry Insider Report. For additional information, questions, comments, or suggestions, please contact us at (707) 565-7170 or visit www.sonomaedb.org.

Disclaimer to the Reader: *The forthcoming details in this report reflect trends sourced from data gathered during the novel COVID-19 pandemic. Figures, such as employment rates, have been susceptible to great variability and are ever-changing.*

HIGHLIGHTS



Wine: Despite the effects that fires and the pandemic has had on in person interactions for wineries, the industry has shown the ability to be resilient and adaptable. Total wine consumption managed to change course from the 2019 decline and advanced by approximately 1% by volume. This is especially surprising considering the shift that Sonoma County Vintners and Spirit makers had to forcefully make towards selling products off their premises via direct to consumer markets and grocery stores. Price trends show that bottles priced at thirty dollars and under are exhibiting greater consumer demand, especially in the direct to consumer market place. All things considered, Sonoma County producers leveraged the direct to consumer market with a 38% increase in shipments.



Craft Beverage: The Millennial cohort, who are approximately 1/3 of the adult beverage market, are continuing to display a preference for craft beer and spirits. This shifting demographic in the adult beverage market is offering support for craft beer and spirit producers. Though craft beer sales did fall in 2020, the robust growth is expected to continue as restaurants and bars reopen. Though craft spirits are generally priced higher than craft beer, spirit producers will find opportunities to grow from millennial consumers that value drinking better quality beverages. Craft beer and spirit makers will benefit from pent up demand as tourism reopens and visitors look to diversify their Sonoma County dining and drinking experiences.



Outlook: The industry is expected to show robust growth as restaurants and bars reopen. Though craft spirits are generally priced higher than craft beer, spirit producers will find opportunities to grow from millennial consumers that value drinking better quality beverages. Craft beer and spirit makers will benefit from pent up demand as tourism reopens and visitors look to diversify their Sonoma County dining and drinking experiences.





Recent Performance. Sonoma County vintners, brewers and spirit makers navigated through an extremely difficult 2020, marred by a yearlong pandemic, acute oversupply, and another fire season headlined by the Glass Fire in Napa. The COVID-19 pandemic particularly hurt wineries that require the close proximity of employees and customers and sapped a key driver of sales, as in-person wine tastings were closed for the majority of the year. Nonetheless, wineries were able to adjust to the shifting marketplace, and demand for higher-priced wines in grocery stores held up surprisingly well given the pandemic's effect on the labor market.

Overall U.S. consumer spending on adult beverages looked markedly different in 2020 than in prior years but continued to tick higher. With most on-premise sales markets shuttered as COVID-19 restrictions were enacted, Sonoma vintners and spirit makers were forced to accelerate the shift to off-premise markets, whether through the direct-to-consumer channels or increased shipments to grocery stores. Total wine consumption is forecast to have modestly advanced, at about 1% by volume, after the 2019 decline—the first decline in a quarter-century.

The sales figures paint a sourer picture, however. According to Gomberg-Fredrikson, total wine consumer expenditures fell around 9% in 2020, owing entirely to the approximately 45% decline in on-premise sales. Sonoma's key market segments are performing well, with sales of bottles under \$30 showing robust growth, especially in the direct-to-consumer channel where Sonoma is the largest shipper by volume. Indeed, Sonoma capitalized on the pandemic to extend its lead in this market, with a 38% increase in shipments.

Macro drivers. The economy is off and running. Growth will be rip-roaring later this year, with real GDP expected to rise 7% year over year by the end of the year and payrolls by more than 6 million jobs. The winding down COVID-19 pandemic will power this growth, with herd immunity expected by July Fourth, massive fiscal support totaling \$2 trillion this year, and the unleashing of pent-up demand by higher-income households that socked away cash while sheltering in place. If everything sticks roughly to script, the economy will fully recover from the pandemic, with a sub-4% unemployment rate, two years from now, in early 2023. It will have taken three years for the economy

to return to full employment. For context, it took nearly a decade for the economy to find its way back after the financial crisis, and approximately five years after the 1990 and 2000 recessions. The risks to this optimism also appear increasingly two-sided: Much could go wrong if the vaccines fall short of quelling the fast-evolving virus. But things could turn out even better than anticipated if other countries can ramp up their vaccination programs.

The rebound in consumer spending paused late last year under the weight of increased infections and restrictions and slow vaccine distribution, but the pause is over, as infection rates are falling and new stimulus has put cash in consumers' hands. Another, smaller, surge in spending is taking place. Later in the year, growth will be healthy as a strengthening economy offsets drags from still-weak employment. Excess saving will gradually shift to below-trend saving over the next few years. Changes in the composition of spending will slowly and incompletely reverse.

The end of business restrictions and easing contagion fears will play a large role in determining the fortunes of Sonoma County vintners and spirit makers. While they adapted well to the changing landscape, a rebound in visitor spending at wineries and restaurants will help ease the pain after months of shuttered nonessential businesses.

TSA traveler volumes are improving and will likely accelerate rapidly as we approach herd immunity in the summer. Data from OpenTable, which charts seated diners at restaurants, show a similar rapid improvement, growing from 60% below 2019 levels at the end of January to just under 20% by the beginning of April. Consumers are growing more comfortable with traveling and dining, and this will improve further as herd immunity approaches.

Industry drivers. The rise of the millennial consumer continues to grow in importance 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, in 2020 wine consumption bucked the 2019

decline to post a modest increase, but consumers were bargain hunting in light of the pandemic-induced recession. As the labor market recovers, it will bear watching if sales of higher-value wines recover in earnest.

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 two severe recessions may 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 fifth consecutive year in 2020, and craft beer sales reversed course to post a decline after robust growth in 2019. Once again, these trends are due to a shift in beer volume from bars and restaurants to packaged sales, and Moody's Analytics expects the craft market to benefit from the lifting of capacity restrictions as we approach the end of the pandemic. 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. Rising ocean surface temperatures have coincided with less predictable climate events that could put county vineyards, wineries, breweries and distilleries in peril. Another year of deadly wildfires close to the county's wineries is another reminder that these risks are growing.

Pricing. A smaller than expected crop yield, improving labor market conditions, and the economy's reopening all pave the way for better pricing power for Sonoma vintners, brewers and spirit makers. About 75% of Sonoma County vintners are reporting weaker than average crop yields. Overall pricing will improve compared with last year,

as consumers will act on pent-up demand to celebrate in groups, whether with in-person winery visits or restaurant outings, which will likely boost alcohol consumption throughout the year. According to the preliminary Grape Crush Report, grape prices fell approximately 15% in Sonoma County last year, not only because of the weaker demand caused by the COVID-19 pandemic but also because of oversupply from years prior.

Craft beer producers face a 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 will further dampen the pricing power of smaller producers. Craft brewers will see some respite from restaurant reopenings, however.

Compared with craft beer, the craft spirits movement is relatively young, and demand is swelling. The market is nonetheless growing more saturated, but growth avenues are more pronounced in Sonoma given its early entry.

Operating expenses. Improving prices for wine grapes combined with accelerating wage growth will have mixed effects on operating expenses. Wages for agriculture workers flat-lined in 2020 after around 5% growth in 2019. Wage pressures will increase as the economy accelerates and supply chains ramp back up to full capacity. While prices will improve compared with last year, grape prices will settle at a lower than normal historical price.

Craft beverage makers will likewise see an increase in operating expenses, but the future of tariffs remains uncertain. The Biden administration chose to reinstate the steel and aluminum tariffs that the Trump administration had lifted on his last day in office. Aluminum prices play a significant role in bottling prices for craft beverage producers. The tariffs would raise input costs for Sonoma craft beverage producers, and the uptick in demand as the global economy recovers in earnest through the summer will likewise pressure costs of materials.

Profitability. Sonoma wineries had a mixed year, with those agile enough to switch to off-premise sales channels enjoying even stronger sales numbers in 2020 than in the prior year while those that rely heavily on in-person winery visitation struggled. The return to normal will help wineries across the board, but those that are able to capitalize on the accelerated shift to e-commerce will fare

the best. According to financial statements collected by Silicon Valley Bank, through June 30, sales growth was down 7%, but enough cost-cutting measures were implemented in order to turn a pretax profit of nearly 7%, roughly on par with previous years.

Wineries that rely heavily on tasting room visits will see a boost as pent-up demand for travel is unleashed once herd immunity is reached, expected to occur this summer.

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. With the economy set to hit its stride in the coming months, the outlook is much brighter, and for the most part, Sonoma County's wine and craft beverage industry showed its mettle last year to persevere through the difficult environment. However, some of the pain from the COVID-19 pandemic will linger, and it will take some time for small breweries and family-owned wineries to recover from the 2020 recession.

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 face similar 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. Fiscal stimulus and a historically high saving rate raise the upside risk for a boom in consumer spending later this year. A sharp drop in discretionary spending during the pandemic has resulted in billions in excess savings. The forecast calls for some release of pent-up demand, but there is an upside risk that consumers will spend more of their savings than expected. This would disproportionately benefit Sonoma wineries and breweries that depend heavily on visitor traffic. Furthermore, recreation and travel spending could surprise on the upside, as would-be travelers have postponed vacation plans for more than a year.

Downside risks. The baseline forecast assumes that herd immunity will be reached this summer. However, there is still the risk that public mistrust of the vaccine could slow its adoption and usefulness, delaying herd immunity and causing economic growth to fall short of expectations. A potential setback for the U.S. vaccination campaign is the FDA's decision to temporarily halt the use of the Johnson & Johnson COVID-19 vaccine. Supply is only one concern, since the FDA decision could weigh on people's confidence in COVID-19 vaccines. A Gallup poll showed that of those who said they would not be vaccinated, one-quarter of respondents said they want to wait until it is safe.

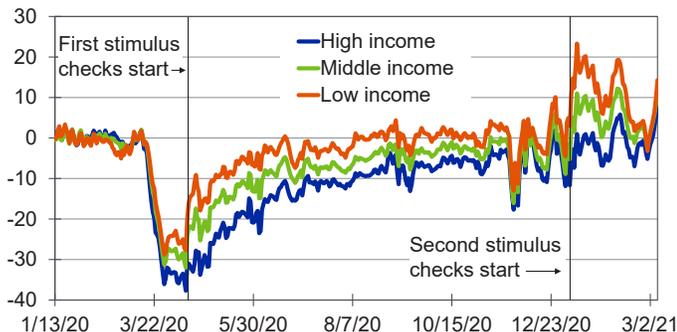
A more devastating risk would be if new variants of the virus become either partially or fully resistant to current vaccines. Under such a scenario, the odds of widespread lockdowns would increase, stressing the global recovery.

Climate change remains a particularly important downside risk for Sonoma County's wine industry. Another severe drought or wildfire could deal a more serious blow to vines and production facilities. The California wildfire season is getting progressively longer, and insurers are growing hesitant to shield against wildfire risk given the enormous losses suffered in recent years.

*Colin Seitz
April 2021*

Consumer Spending Bounces Back

Consumer spending by income group, % change from Jan 2020

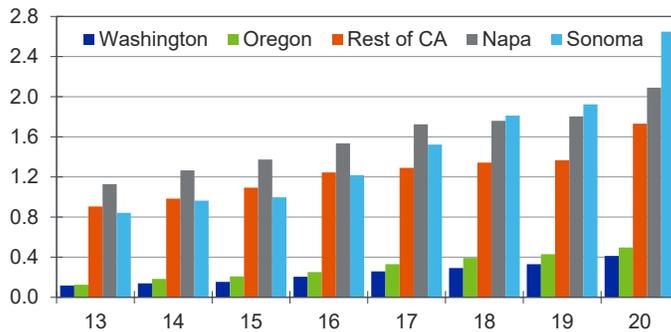


Sources: Affinity, Opportunity Insights, Moody's Analytics

Even though households are putting an increasing share of their stimulus checks toward savings and deleveraging, the latest round of \$1,400 payments will still pack a punch in terms of consumer spending. Across the board, consumer spending is revving back up as the COVID-19 pandemic subsides, and Sonoma County vintners, breweries and distilleries will benefit from a further release of pent-up savings, particularly in the high- and middle-income groups.

Sonoma Extends Lead in Direct Shipments

Cases, 9 liters, mil

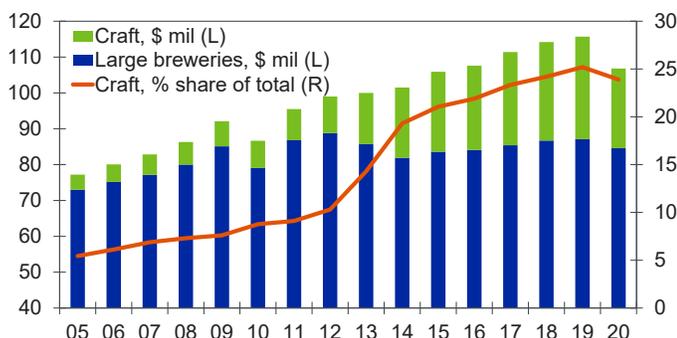


Sources: Wines & Vines Analytics, ShipCompliant, Moody's Analytics

Direct shipments are a crucial avenue of sales for Sonoma County's smaller and midsize wineries and provided a key source of stability and even growth amid the large-scale closures of nonessential businesses that affected California for much of 2020. Sonoma has outmuscled fierce competition from within the state and the Pacific Northwest to extend its lead in shipment volumes. Sales volume still trails that of Napa because of a lower average price point, but the direct-to-consumer channel will remain a source of strength for Sonoma.

Craft Ales Nab More Market Share

Retail sales, beer, U.S.

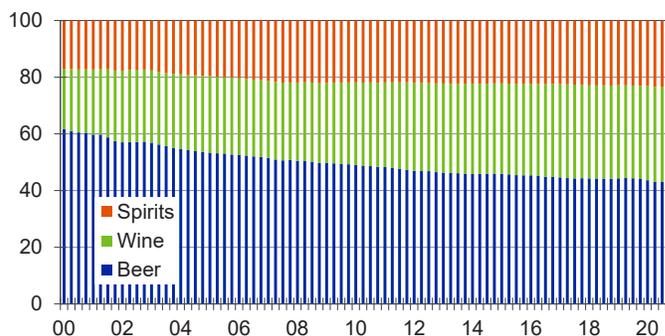


Sources: Brewers Assn., Moody's Analytics

For the first time in more than a decade, the craft beverage share of the overall U.S. beer market retreated in 2020. Craft beverage sales typically rely more heavily on on-premise sales, and the closure of restaurants and taprooms weighed more heavily on craft sales than large brewery sales. Local brewers' nationally renowned ales will safeguard sales amid an increasingly concentrated market. Though the market is growing saturated, consumers have a demonstrated preference for craft beer, and we expect this trend to resume in 2021 as the economy reopens.

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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707 - 565 - 7170

141 STONY CIRCLE, STE. 130, SANTA ROSA, CA 95401