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Industry Update

An “Allied Press” Newsletter Publication

January 2010

Reflections on 2009:

Looking back at our January newsletter from last year, we highlighted a quote within our narrative that said, "We have approached that sought-after position called balance, where things can turn on a dime in either direction." Coming out of the 2008 crop, the general trend was positive, with a stable supply outlook and growing demand for wine. In fact, we were very bullish on the 2009 crop before 2009 actually happened. Unfortunately, the continually weakening economy coupled with plentiful global wine supply created a situation where the wine market did not necessarily turn in California's favor in 2009.

Balance is a precarious position to be in, because you almost never stay there. Last year was no exception for most areas of the state. What was seen as balance suddenly turned into a situation of "under-demand". Notice we didn't call it "over-supply". Strictly speaking, the two phrases are one-in-the-same when describing the chasm between supply & demand lines, but we like to refer to our current situation as a demand issue, not a supply issue.

> **"Balance is a precarious position to be in, because you almost never stay there."**

In the early 2000's, when bearing acreage was increasing by 40,000 acres per year, we could say the market softness was due to an over-supply. But now that new supply has slowed to the point of simply replacing pullouts, it is hard to argue that growers are over-supplying the market. Although the end-of-the-year numbers are not tallied yet, heading into November, California was on track to see its first annual decline in wine shipments since the 1990's. Further compounding the problem is that the segments of the market that were growing the strongest are now suffering the most.

To speak further on being in an under-demand situation, let's examine the obvious. For almost two decades the California wine industry has experienced steady growth in shipments. Some years were up by as much as 6% and some were only up by 1%, but there was always growth, and as a result, always optimism. In addition, the mid and upper end of the market was where much of the growth was occurring with growth rates commonly entering double digits most of the last ten years. After a while, most people in the business became accustomed to the growth and planned on it. In other words, forecasts for growth in sales, shipments and profitability become automatic. Then, without a whole lot of warning, the bottom fell out of the economy, and consumers changed their purchasing behavior.

There are actually a few that benefit from changing behavior (in this case those at the lower end of the market), but by and large the wine industry is facing some challenging times, as are most non-essential consumer goods industries. It's hard to expect anything else when the percentage of those unemployed in the U.S. increased by almost 40% from about 7% to nearly 10% in one year's time. Consumers can't spend money they aren't making, and the people that are still making money are scared to death that they won't be, so they're not spending it either. Maybe the old saying "all good things come to an end" is true. It's too bad it had to come to an end right when the industry seemingly achieved supply/demand balance.

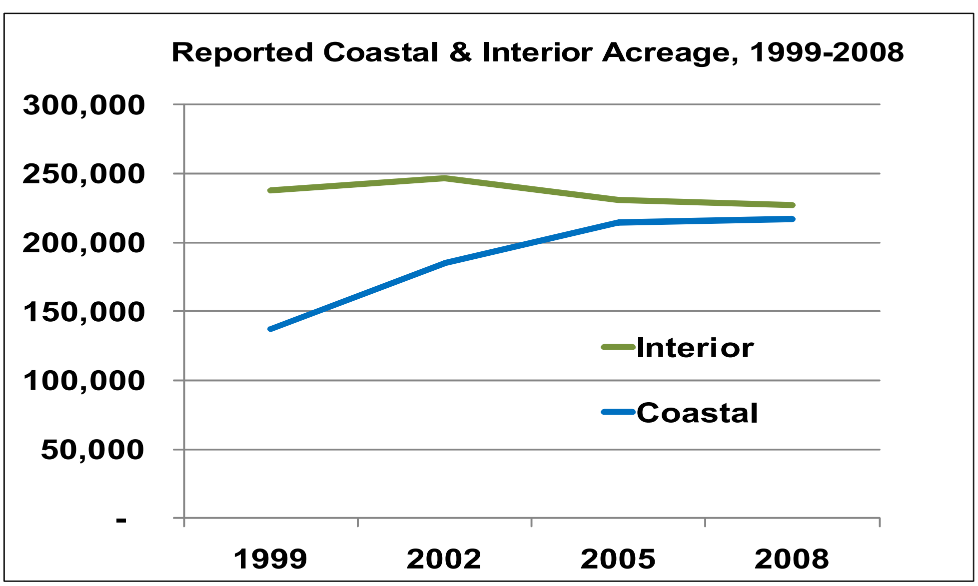
It's not all bad though:

Please forgive us if the beginning of this Industry Update sounds a bit pessimistic. We just want to review reality and re-establish the overall position of the industry. Not all areas of the state, nor all segments of the wine business, are suffering to the same degree due to changing consumer behavior. The issue at hand is equally one of recent trends within the business as much as changing consumer behavior.

> "Recent growth characteristics of the grape supply/wine industry are counter to what the current consumer market is serving up."

To expand on the idea, the overall industry has been in a growth phase for years with specific segments being the shining stars. The planting/pulling trends of growers was a perfect guide to see the expanding and contracting wine business statewide. The State of California reports that between 1999 and 2008, bearing acreage in the coastal areas increased by 58%! During that same time period, interior bearing acreage decreased by 4%. We point this out to emphasize the direction the industry was heading in with regards to price points (i.e. the lower end of the market was stable to slightly contracting, while the higher end of the market was expanding significantly). Recent growth characteristics of the grape supply/wine industry are counter to what the current consumer market is serving up. This puts a particularly tight pinch on all those folks at the higher end of the market who made logical projections that their sales and shipments would continue to increase at the rates they had been growing, while ironically & simultaneously providing some optimism for folks who provide grapes and wines at the lower end of the market.

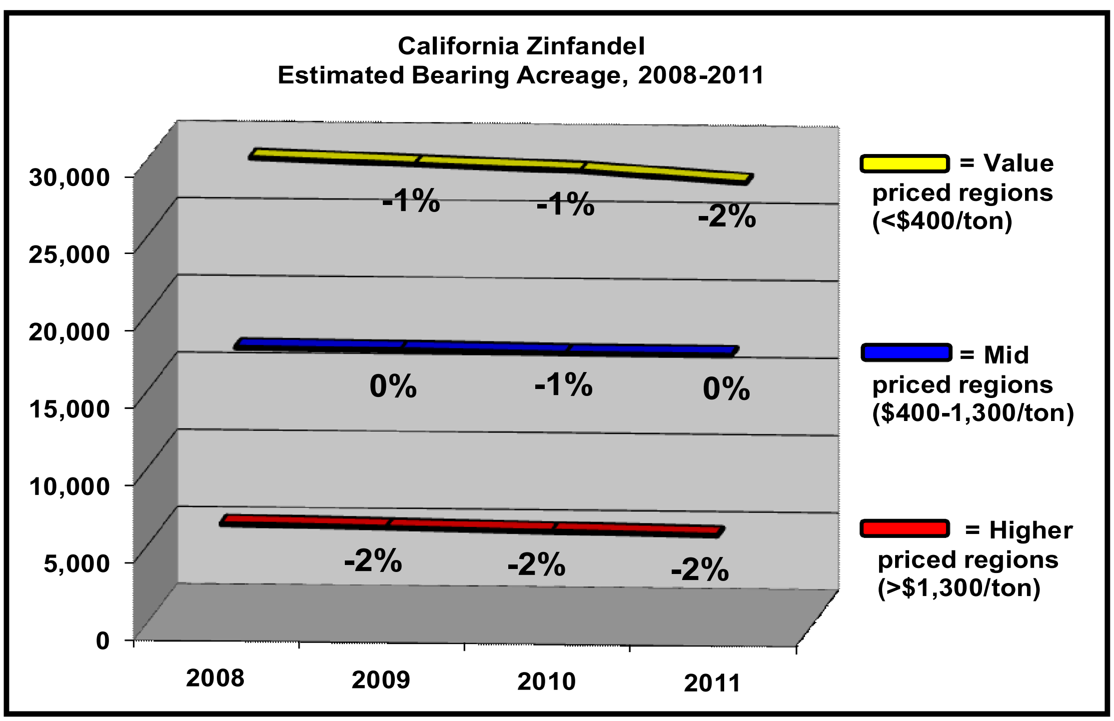
It's not all roses for the folks at the lower end of the market. The squeeze will be (and is) on from plentiful low-priced imports as well as higher end California grapes and wines with no home, willing to sell at relatively low price points. Even though consumers seem more interested in less expensive wines these days, competition to fill that demand will be present from multiple angles. We do anticipate a relatively stable market for lower end grapes & wines throughout 2010, but have concerns about the health of the market at the higher end. The real question is whether or not we have seen bottom with the economy. Most analysts say even if we have hit bottom, they don't expect consumer behavior to change anytime soon.



Varietal breakdown:

Generally speaking, changing consumer behavior affects sales at specific price points more than it does specific varieties (i.e. the type of wine people are buying). Although, it could be argued that Pinot Noir will suffer more than other varieties because of its association with the high-end of the business. Further, Pinot Grigio may not suffer as much due to its affiliation with the lower end of the market. But for most other major varieties, sales come at multiple price points along the spectrum.

Understanding the supply of the major varieties, which are sold at all price points, is important regardless of the economy. First off is Chardonnay. Although our acreage projections do not show a significant amount of new Chardonnay coming into production, we can never be sure of the impact of global supply. The foreign supply definitely caught us off guard in 2009 and has the potential to do the same in the future. Our estimates only show a 1% increase in bearing California Chardonnay acreage by 2011, so California is not the issue. Other countries, specifically Australia, need to be watched closely, since they do have such an immediate impact on our market.



Pinot Grigio bearing acreage increases significantly over the next two years, with an anticipated 24,000 acres or more in production by 2011 (up about 25% from current). The question remains whether the market has capacity for this new production. Fortunately it will almost exclusively come in at the lower end of the market where wine shipments remain strong, but growers should anticipate softening spot market prices as more and more buyers are able to fill their needs with the additional supply.

Sauvignon Blanc (SB), unfortunately, may be the victim of Pinot Grigio's (PG) success. Although SB has not traditionally been viewed as a lower priced wine, stylistically it is similar to PG. As consumers trade down, PG may become the wine of choice for some SB drinkers. Additionally, fewer winemakers are using SB to extend their PG blends these days, as PG is becoming more readily available in the market. Our projections for SB bearing acreage between now and 2011 is flat, but demand is soft at all price points.

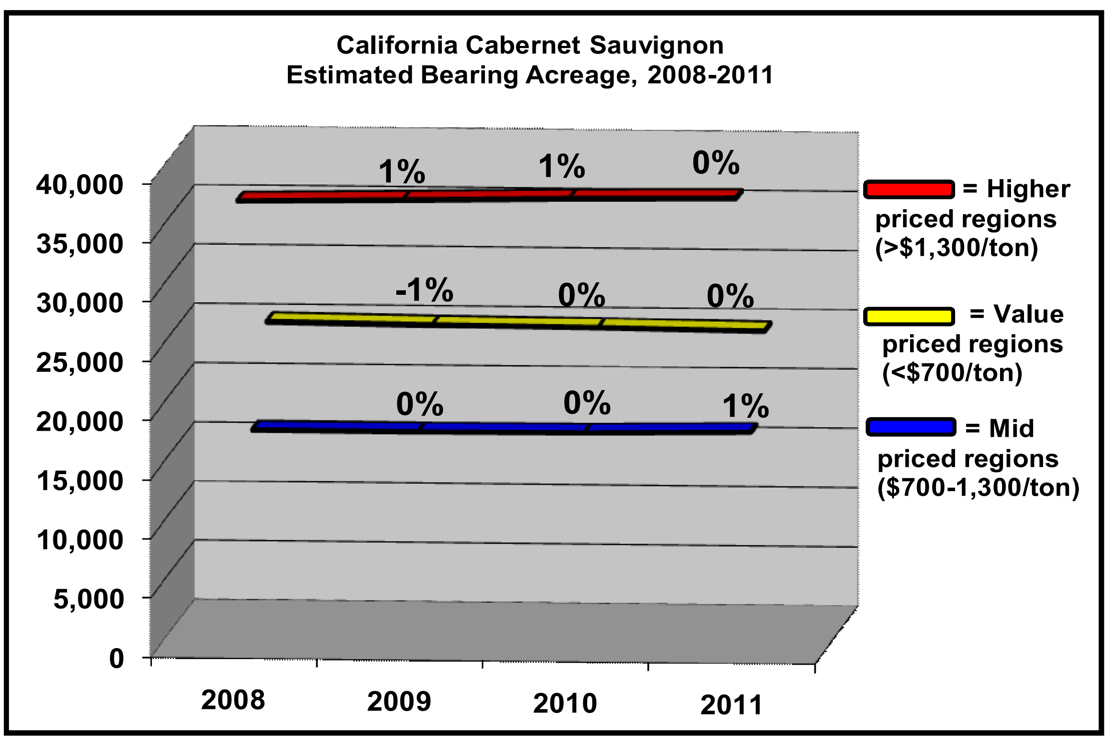
Zinfandel bearing acreage will likely decrease over the next two years based on vineyard attrition, low replacement rates and market conditions. We are projecting a 2.5% decrease in total bearing acreage by 2011, with most of that coming at the lower end of the market (mainly for White Zin production). The market for Red Zin is relatively weak except at the highest price points for “old” vineyards in premium regions. There is a surplus of “California” Red Zin. Most of this comes out of Lodi due to the efforts of growers to switch from white production to red in light of much lower White Zin prices the last two years. We don’t see any relief in sight with regards to that trend.

Next, let’s take a look at the major red varietals. The Merlot market is stable in the interior but weak in the coast. Over the last four years we’ve seen Merlot vineyards being removed and grafted to other varieties, which is slowly balancing supply. It’s hard to predict what growers will pull or graft in the future, but we do know virtually no Merlot has been planted the last three years. Our projections indicate a slight drop in bearing Merlot acreage statewide by 2011, based on no new plantings and modest vineyard attrition. However, if the market stays weak, that slight drop in acreage could turn out to be more significant. The upside is that Merlot could benefit from a potential shortage of Cabernet Sauvignon.

Speaking of Cabernet, we see potential for the Cab market to be one of the most exciting markets over the next couple of years. Cabernet bulk wine inventories seem to be modest (especially at the “California” level), and consumer demand is fairly vibrant at most price points. In addition, supply is not anticipated to increase dramatically anytime soon. As the below graph indicates, we are not projecting any real growth in bearing Cabernet acreage before 2012. Lower-end Cabernet seems to be in particular demand as the trading down behavior of consumers is evident within this variety.

Syrah, like Merlot, is simply unexciting. There’s no real forward progress on it in

Varietal breakdown, continued on page 7:



President's message:

Everyone wants me to have a crystal ball to tell them what to expect from the wine and grape markets. I can get numbers crunched for California supply all day long, but I can't always predict global supply or consumer demand. We've known the economy is sagging and consumers are watching how they spend their disposable dollars. Consumers trading down on what they are buying is evident in all products, but we definitely experienced the effects first hand on winegrapes sales in 2009, specifically in the coastal regions. Yes, there were some wineries buying and honoring their term contracts and paying a fair price, but overall, sales for 2009 coastal grapes were off significantly. Many of these grapes may end up being utilized in lower priced, yet quality programs, giving the consumer great 2009 wines.

> "Unfortunately, we are faced with a global market that seems to be oversupplied somewhere every year."

The shifting of consumer dollars did allow stability in demand for grapes grown in the San Joaquin Valley. Demand matched supply for most red grapes as well as Zinfandel for white production. Whites (other than florals) were a bit weaker due to the importation of millions of gallons of Australian Chardonnay. It is being reported that roughly 25 million cases of wine was imported as bulk wine. That is about 60 million gallons that displaced over 350,000 tons of mainly California grapes. Much of the wine was believed to be Chardonnay from Australia. When combined with the large 2009 Chardonnay crop, we saw prices drop below $200 per ton on the spot market in the interior regions. Unfortunately, we are faced with a global market that seems to be oversupplied somewhere every year. Wineries are scouring this global supply of wine, buying it cheap and utilizing it in their various wine programs.

Another aspect to further understand is that after the past few years of strong export growth, we are looking at a decrease in exports for 2009. As we look into 2010, a topic that needs to be better understood by both vintners and growers is the complex use of "drawbacks" by the larger importers and exporters of wine. Drawbacks allow winemakers to receive export "credits" based on the amount of wine they import, which could be creating an incentive to import. As an industry we need to investigate this in more detail to determine the actual effects of these drawbacks.

Sustainability continues to be a "buzz word" for 2010. To the grower, sustainability means that he is a good steward of the vineyard, the environment and the workforce. But while doing so he must be economically sustainable, or there is no farming operation. The Wine Institute and the California Association of Winegrape Growers (CAWG), which developed the California Sustainable Winegrowing Alliance (CSWA) and self-assessment program, has now released a Certified California Sustainable Winegrowing program (CCSW). The wineries are telling us that the buyers/ consumers are calling for the California wine industry to provide this. In a recent telephone interview for a nationally syndicated television show, the CCSW program was all the producers wanted to talk about. So how do we ensure that this sustainable certification program can work for all stakeholders?

There is grower sensitivity to concerns expressed in some sections of the third-party evaluations. There are also costs associated with the implementation, certification and ongoing operations. We will continue to promote the reasonable application of sustainable farming, all aspects for viticulture production, labor relations and protection of the environment we work and live in. I also will continue to assure growers that they have the same right to pursue economic sustainability. The best relationship is a true partnership between the grower and vintner. As the action taken by the CAWG Board of Directors indicated, they endorsed/supported the certification program as being a voluntary and not a mandatory program required by the wineries.

It is the grower's responsibility to farm the best he can, at the lowest cost possible while growing the highest quality demanded by the winery buying his grapes. The winery should be willing to pay the price per ton that meets their sales program and is a fair return to the grower. If there is a value added component of that sale of wine due to being certified sustainable, then the growers should share in that value added incentive.

Varietal breakdown, continued from page 5:

the marketplace as a varietal, and at the lower end its use is mainly for blending. There is also value in Syrah as a blender at the mid and higher ends of the market, but commonly the price reflects the fact that wineries are not prioritizing it as one of their main varietal bottlings. Bearing Syrah acreage over the next couple of years is expected to fall off by as much as 3-4% as the market takes further victims and no particular planting incentives have existed.

Lastly, we need to discuss Pinot Noir. Initial data from our annual nursery survey is indicating that growers slowed their Pinot Noir planting significantly in 2009 & 2010. With this variety being “top heavy” at the high-end of the market, that is no real surprise. However, in the immediate term, we anticipate continued significant increases in bearing acreage based on the previous years of aggressive planting. Our projections indicate an increase of 14% in bearing acres by 2011, with only modest percentage increases at the high-end of the market (keep in mind that is where most of the acres are) but fairly substantial percent increases at the mid and lower end of the market. Less expensive Pinot Noir has been in demand the last couple of years, but the question is whether it is sustainable to grow it for a <$10 bottle (i.e. Is it a fad variety at the lower price points?).

In conclusion, we reflect on the 2009 crop, one that was likely the second largest California winegrape crop in history (only behind the huge crop of 2005). Based on our total bearing acreage and yield estimates, we think the 2009 winegrape crop will tally close to 3.5 million tons. The challenge now is to move that supply in the wake of wavering demand, aggressive import pricing & supply and a stable California supply. Everyone in the industry needs to do their part, but it won’t hurt if the vines don’t throw a large crop in 2010.

Winegrape Inspection Program:

As winegrape growers, we have faced many challenges over the years. Water shortages, increased regulation, oversupply, etc. Basically, growing grapes takes guts. But one thing we can count on is the impartial nature of the Winegrape Inspection Program. Both growers and vintners should agree that this third party unbiased inspection provides a valuable service, which both sides can trust.

The Winegrape Inspection Program has been in existence since the 1930's. Since 2005, the program has operated under a marketing agreement with the California Department of Agriculture. Currently, the program is directed by the California Winegrape Inspection Advisory Board. This board consists of eight (8) vintner members and eight (8) grower members with the chairman duties alternating between a vintner member and grower member each year. Inspection fees are paid 50% by the vintners and 50% by the growers.

A recently notable accomplishment of the inspection board is the implementation of an inspection standard for the "Yuba City" sampling device that pulls the sample from trucks delivering grapes to wineries which use the inspection service. Growers can be confident that scales, refractometers and now the sampling devices, are certified before each season starts.

By law, anytime the average percentage of soluble solids, MOG (material other than grapes) or rot has an effect on, or is the basis for, the purchase price, the load must have received third party inspection. Inspection can be performed by either the County Ag Commissioner or the Winegrape Inspection Service. But be aware, the inspection program does not test or reject for stress, amber or red berry as well as many other objective "quality measures" we have seen outlined recently in grape purchase agreements. Learn more about the Winegrape Inspection Program at: www.cwiab.org

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"Allied Press" publications are written for the growers and customers of Allied Grape Growers.

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