

Supply & Demand for Lake County Cabernet & Sauvignon Blanc

EXECUTIVE SUMMARY

Commissioned by the Lake County Winegrape Commission



FULL GLASS RESEARCH

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Introduction

The Lake County Winegrape Commission (LCWC) desires to increase the average sales price of Lake County grapes, as well as the proportion selling above the average market rate for California-appellated wines. In particular, the LCWC believes that there is significant untapped potential in wines selling over \$15 for usage of Lake County grapes. To help set goals and strategies to achieve this, the LCWC engaged Full Glass Research to carry out market research to accomplish the following:

- Estimate the relative size and growth trends for the 3 main vectors of demand for Lake County Cabernet Sauvignon & Sauvignon Blanc grapes: high end Napa wines (as blender); California blends above \$12; bottled Lake County AVA wines.
- Review price and volume trends and project supply for Lake County Cabernet Sauvignon and Sauvignon Blanc grapes, including breakdown by price segment. Compare the anticipated supply to the potential demand for Lake County grapes.
- Measure and analyze perception and usage of Lake County grapes among winemakers and grape buyers who represent all three sources of demand.
- Measure and assess business practices in marketing and supplying Lake county grapes, as perceived by winemakers and grape buyers who represent all three sources of demand.

The decision was made to focus on Cabernet Sauvignon and Sauvignon Blanc because these were the most important grapes in the county in terms of volume of production and total revenue. Where the word Cabernet is used in this report, it refers to Cabernet Sauvignon only, not Cabernet Franc. Sauvignon Blanc statistics and references do not include Sauvignon Musque or Sauvignon Vert.

The following methodology was used in preparing this report:

- 1) A survey of California grape buyers, winemakers, grape/wine brokers and vineyard managers was undertaken in 2014. (See report section #1 for details) In addition, a number of growers, winemakers and grape brokers were interviewed in person or via phone.
- 2) The 2005-2013 acreage and crush statistics from the California Agricultural Statistics Service were organized in a database and used to examine historic grape production and sales data. In addition, a projection model for Lake County (CASS district 2), Napa County (CASS district 4) and Total California Cabernet and Sauvignon Blanc production out to 2018 was developed using the CASS data. (See report sections #2 and #3)
- 3) Nielsen scan and Gomberg-Fredrikson depletions data, as well as winery and wine consumer surveys were used to determine demand trends for various grapes and price segments. (See report section #3)
- 4) As the report was nearing completion, the preliminary 2014 crush data was released by CASS. While it was too late to incorporate the data into the grape production database or projection

model, some of the charts and analysis in sections #2 and #3 were manually updated to reflect the 2014 data. Readers should note that these numbers are preliminary, and there are always revisions in the final report. While the revisions are rarely significant for the summary numbers (Total California Cabernet for example), they can have significant impact on individual numbers such as the price average and distribution for a single variety in a single district.

The report is organized into three sections.

Section #1 – Survey of Lake County Grape Buyers & Users reports the results of the survey mentioned in step 1 above. This will give Lake County growers a clear picture of how they and their grapes are viewed by winery clients in California, the uses for Lake County Cabernet and Sauvignon Blanc and how Lake County compares to other regions. In addition, the pricing and blending usage data from the survey was used in the supply-demand analysis in section #3.

Section #2 – Analysis of Grape Supply for Lake County and Client Regions analyzes the historic crush data to determine pricing and volume trends for Cabernet Sauvignon & Sauvignon Blanc in Lake County, Napa County and all other California. This provides a better understanding of the supply and price trends for Lake County and the supply situation in regions that compete with Lake County and use its grapes for blending.

Section #3 – Analysis of Demand for Lake County Grapes – compares the supply (projected out to 2018) of Sauvignon Blanc and Cabernet grapes to expected demand for three sectors – blending into Napa wines; blending into California or North Coast wines priced \$12-20; and sales of wines labeled as Lake County. This section provides insight into the supply/demand balance for each sector up to 2018, how much demand for each usage will increase, and whether there will be upward or downward price pressure.

GENERAL OBSERVATIONS

CABERNET SAUVIGNON

* As of 2013, expected market size for Lake County Cabernet selling as blender into Napa Cabernet was roughly 500 tons; this could increase to 1000-1200 tons if Lake County is considered a preferred blender. The market for Napa Cabernet is trending towards balance to somewhat oversupplied in the short term, but undersupplied in the long term.

* If California continues to sell out its supply of mid-priced Cabernet (\$12-20), and Lake County achieved only its fair share of California blends based on its proportion of the total 2013 \$1200-2000 Cabernet supply, that usage could absorb 81% of Lake County's available Cabernet. Note that this also implies that there should be little or no Lake County Cabernet sold below \$1200. While not the most profitable route to market, this is a considerable safety net for Lake County Cabernet. At current segment growth rates (9%), the \$1200-2000/ton Cabernet market will be running short somewhere between 2015 and 2017. However, 9% is historically very high rate to maintain; a more reasonable 5% projection shows the market slightly short but trending long, depending on whether 2013 winery stocks are mostly depleted by now.

* Based on retail data, approximately 129,000 cases of Cabernet are sold as bottled Lake County wine, equivalent to 15% of the Lake County crush. Other data suggest the number could be somewhat higher. Lake County Cabernet sales are growing very fast, up 32% in scan data for 2014, but dependent on a relatively small number of brands/SKUs. Consumer surveys show low awareness and trial for Lake County wines, slightly higher for Sauvignon Blanc than Cabernet. However, even a conservative

projection of current sales trends shows up to 17-27% of Lake County Cabernet could potentially be sold under Lake County brands.

* The overall picture of strong consumer demand, relatively little growth in Lake County supply and improving quality indicates that sales of Lake County Cabernet under \$1500 will continue to dwindle and the main issue is how much can be shifted above \$2000 or \$2500.

* Interpolating from all the data, a very rough estimate of recent Lake County Cabernet demand by sector would break down as follows: 4-6% into Napa blending, 8-12% into Sonoma or other high end blending, 62-73% blended into \$12-20 California or North Coast wines and 15-20% sold under Lake County labels. However, the surge in pricing in the CASS 2014 preliminary crush report suggests a different breakdown: 10% into Napa blending, 22% into other high end uses, 15-20% under Lake County labels and just 48-53% going into California or North Coast blends.

* In the case of Cabernet, there is growing tension between price trends for the grapes, and what survey respondents say they are willing to pay for various uses in blending. Based on the 2014 preliminary data, nearly all of Lake County Cabernet is now out of the survey-based price range for wine retailing at \$12/bottle, and most of it is higher-priced than what the majority says they will pay for a \$15/bottle target price. For Lake County Cabernet pricing to hold up, either the wineries will have to accept lower margins, or most of the grapes will go into \$15-30 wines. This implies that makers of California and North Coast wines are going to be looking hard at Lake County Cabernet vs. the competition in the next few years. Lake County Cabernet must offer superior quality, and growers should enhance their relationships and responsiveness, in order to maintain a developing Lake County premium.

SAUVIGNON BLANC

* There is 250-300 tons of potential sales from blending into Napa Sauvignon Blanc, based on the 2013 vintage; double that if it is regarded as a preferred blender. The current Napa trend for Sauvignon Blanc is towards shortage, both near term and longer. Thus potentially 6-12% of Lake County Sauvignon Blanc sales could use this route to market in by 2018.

* The market for \$1200-2000/ton Sauvignon Blanc grapes (into California or North Coast blends) would absorb only about 20-25% of Lake County Sauvignon Blanc at its "fair share". However, if Sauvignon Blanc becomes the preferred blender or base for this segment, up to ¾ of Lake County's Sauvignon Blanc can take this route to market.

* An estimated 100,000 cases of Sauvignon Blanc is sold under Lake County labels. Retail sales are strong, up 19% in 2014. Yet as with Cabernet, they are dependent on relatively few brands and wines. Consumer surveys show low awareness and trial for Lake County, but somewhat higher association with Sauvignon Blanc than Cabernet. Conservative to optimistic projections indicate that from 18-30% of Lake County Sauvignon Blanc could potentially take this route to market by 2018.

* For Lake County Sauvignon Blanc grapes, getting past the \$1300/ton barrier seems to be the major issue.

* Interpolating from all the data, a very rough estimate of recent Lake County Sauvignon Blanc demand by sector would break down as follows: 2-3% into Napa blending, 4-5% into Sonoma or other high end blending, 48-60% blended into \$12-20 California or North Coast wines, 14-31% blended into low-priced California wines and 15-20% sold under Lake County labels. For Sauvignon Blanc, the shift in pricing in the CASS 2014 preliminary crush report is much less dramatic than for Cabernet, but suggests that significant volume shifted from \$10-and-under California blends to the \$12-20 segment.

* In the case of Sauvignon Blanc, the expected pricing from the survey and the market pricing are much more in accord. In addition, Sauvignon Blanc's quality role relative to its market price appears to be higher in the survey.

OTHER

* Wines labeled as Lake County are showing strong sales growth as measure by both depletions and scan data. However, the proportion of Lake County Cabernet and Sauvignon Blanc sold under Lake County brands or appellations is quite small, and only account for 15-20% of the Lake County Cabernet and Sauvignon grape supply. Only a few brands have widespread or national distribution, and several of them are store or private brands. An increase in the number of Lake County wines selling at \$15/bottle or above would help maintain the upward price momentum for the grapes by providing incremental demand and reducing the supply of Lake County grapes sold on the market.

* Lake County has some competitive advantages vs. other regions, but not by a large margin. For ease of communications and visiting, grape quality and style, and reliability, very few survey respondents rated Lake County worse than average and from 19-31% rated Lake County superior. But the majority believed Lake County growers to be average or variable (both better and worse than average). One quarter of respondents believed Lake County was worse than average for logistics and transport. Nearly ¾ called Lake County Sauvignon Blanc better than that from competitor regions and over half said the same for Cabernet. Very few would call either variety worse than average.

* The 2014 preliminary crush data showed dramatic upward shifts in the price distribution of Lake County Cabernet and a significant shift away from the low end for Lake County Sauvignon Blanc. It appears to show Lake County Cabernet following and exceeding the price shift potential seen in our original report based on 2013 data. It is recommended that the LCWC do a careful reading of the 2014 final crush report and discuss with growers the circumstances of the price shift in 2014 to analyze the causes and compare them with the trends and factors covered in this report.

SECTION HIGHLIGHTS

#1 – Survey of Lake County Grape Buyers & Users

- Sample is small (64) but important in terms of buying power, estimated to represent roughly 55% of the market (total crush) for Lake County grapes. In addition it includes several grape brokers and consulting winemakers with wide experience of Lake County grapes and wine. The sample also includes a wide diversity of respondents by size, location, and number of brands.
- Answers to most questions did not vary significantly with the size of the winery. A few differences are worth noting. Small wineries were somewhat more positive on Lake County quality, and had a high opinion of a broader range of Lake County varieties, especially Syrah, Petite Sirah and Tempranillo. Small and medium wineries were somewhat more likely to focus on using Lake County blenders to meet production goals, whereas cost reduction was a higher priority for large wineries.
- Respondents were optimistic on sales of Lake Count Cabernet and Sauvignon Blanc, more so in mid-price ranges (\$10-15 Sauvignon Blanc, \$10-20 Cabernet) than higher price. Very few expect declines.
- Lake County is perceived to have developed a distinct style of Sauvignon Blanc by nearly 3/4; but less than half say so for Cabernet. Lake County Sauvignon Blanc has the highest quality reputation, followed by Cabernet and Petite Sirah. Most other varieties from Lake County are perceived as average slightly above average, or mixed/variable, by the majority of respondents.
- When asked what other California regions were most similar to Lake County, the most frequently cited was Mendocino. Significant numbers of respondents also stated Sonoma or parts of Napa, in particular for Sauvignon Blanc.
- Majorities, often substantial, agree that Lake county has improved quality, viticulture, consistency. Very few think these have decreased. However, less than ¼ would say that Lake County has outpaced competitor regions in quality.
- Only Cabernet and Petite Sirah from Lake County were seen as useful or important in blending with over \$20 wines by more than 1/3 of respondents. Sauvignon Blanc was seen as playing an important role in \$12 or \$16 wines by nearly half. Perceived impact or importance of Lake County Chardonnay or Merlot was generally low.
- 30% of qualified respondents (i.e. Napa experience) believe that ¾ to most of Napa wineries blend in wine from other regions if the wine is under \$30. 47% believe that half or more of Napa wineries do so. This declines to 13% if the wine is above \$30. There is a range of opinion on what proportions are blended, but about half believe it is 12-15% of the resulting wine.
- There was a wide range of estimates for the maximum price that would be paid for Sauvignon Blanc blending into Napa wine, but most fell \$900-1500.
- There was even wider range of estimates for Cabernet being blended into Napa wines, with distinct clumps around \$1300, \$2100 and \$3000. Apparently it is highly dependent on the client and price of the final wine.
- Cost reduction is by far the most important goal when blending Lake County grapes into Napa wine, with meeting production goals in second place.
- There are a variety of reasons cited for blending Lake Count Cabernet into North Coast or California Cab, with ¾ citing cost reduction but half also citing production goals and half citing improving the blend's quality. Responses were similar for Sauvignon Blanc, but with over 2/3 citing quality improvement and just 2/3 citing cost reduction.
- Prices paid for blending into North Coast were less variable than for Napa usage, and fell into distinct segments based on the price of the final wine, with clear majorities stating prices of

\$800-1200 for \$12 wine, \$1100-1500 for \$15 wine, and three distinct clumps around \$1400, \$1900 and \$2400 for a \$25 wine.

- 50-57% saw Lake County as about average on business aspects such as communication, reliability, ease of working with and ability to hit a style or quality. Of the remainder, far more saw Lake County better-than-average on quality, reliability and communications than worse. The weakest aspect Lake County's business relationship with wineries was transport and logistics, with 24% seeing Lake County as worse than average vs. 16% better, with the rest average or mixed.
- Among Lake County AVAs, Red Hills and Guenoc Valley have the highest awareness, while grapes from Clear Lake and Red Hills have the highest proportion of respondents with experience crushing them. Benmore Valley has very limited exposure and awareness. Based on open-end comments, Red Hills has the most distinctive identity. Kelsey Bench had very positive comments, but from only a few respondents.

#2 – Analysis of Grape Supply for Lake County and Client Regions

- From 2005-2010, Lake County Cabernet prices varied inversely with the size of crush; i.e. more grapes=lower price. From 2010-2013, grape prices increase steadily, surging in 2014. The 2011-2013 prices in competitor districts have more or less followed suit, but Lake County had the highest average increase. The proportion of owners crushing grapes in Lake County has declined.
- The gap between Napa and Lake County average Cabernet prices has increased since 2005, while between Lake County and "all other" California Cabernet has shrunk (probably due to very low end Central Valley disappearing).
- The distribution of Lake County Cabernet sales by price has clearly shifted upwards since 2005. The average and central point of distribution have increased since 2011, the proportion sold under \$1000 has shrunk, and the market \$1800+ has enlarged and extended upwards in price. Anecdotal evidence says that the decline of post-recession spot sales and the departure/sale of some growers who dumped Cabernet is part of the reason.
- During 2007-2013 the proportion sold at the high end (\$2000+) did not equal the 2005-2006 period. In the 2014 preliminary data, the proportion far exceeded 2005-2006 period. The question is whether this was a short term bidding up of prices, or the sign of a major shift.
- Taking 5% more share of the \$2000-2500 and the \$2500-3000/ton Cabernet segments would shift an additional 12% of the Lake County Cabernet grapes (1,425 tons) above the \$2000/ton price line.
- But based on the survey, majorities will not pay \$2000+ per ton for Cabernet unless it achieves a retail price over \$20. This means that increasing sales of Lake County Cabernet grapes over \$2000/ton will largely have to come from blending into Napa and perhaps Sonoma wines or building Lake County brands. Shifting 1,425 tons over bracket would require obtaining a dominant (79%) share of outside-the-county grapes used for blending into Napa Cabernet. Selling this amount through Lake County brands implies selling an additional 96,000 cases of \$20+ Lake County Cabernet. Therefore it seems likely that blending into Sonoma or high-priced North Coast Cabernets will be a key outlet as well.
- The 2012 Napa Cabernet vintage was a huge jump in supply over the average of the three previous years, and way over 2011. How the market digests the 2012 will affect demand for Napa blenders in the 2014-2015 vintages.
- There is evidence of under-reporting of new Cabernet acreage in Napa and other parts of California (not so in Lake County). While current projections to 2018 show only 1-2% growth in

Napa, it may well end up more like 5%. California growth in Cabernet acreage may be under-reported by 2-4%, resulting in annual growth in supply of 4-7% rather than 2-5%.

- As with Cabernet, Sauvignon Blanc prices fluctuated inversely with supply through 2010, then increased steadily.
- Lake County Sauvignon Blanc had the largest % increase in average price 2011-2013 (16%), but most competitive regions also registered strong increases. Yet Sonoma (highest-priced of competitors) had by far the lowest increase, suggesting a Sauvignon Blanc price ceiling.
- After 6 years of relatively stable price distribution for Lake County Sauvignon Blanc, the upper side of the price distribution curve expanded substantially from 2011 to 2013. And the very low end (<\$800) almost vanished. However, around \$1200-1300 seems to be the price ceiling, with very few sales above.
- Unlike Cabernet, Lake County has expanded its price premium for Sauvignon Blanc vs. the rest of California, and the gap with Napa Sauvignon Blanc has slightly shrunk.
- Lake County is a very important player in the \$1000-1500 Sauvignon Blanc market with 30% share of market; yet very small above or below. In particular \$1300 seems to be a major price barrier.
- Napa occupies almost half the Sauvignon Blanc market \$1500-2000 and almost all of it above \$2000. Furthermore, projected tonnage vs. demand measures suggests Sauvignon Blanc is in balance, and the market is fairly small. Taking a 5% share of Napa Sauvignon Blanc (as blender) would only shift 8% of Lake County into the above \$1500 price bracket. Moving those tons of Sauvignon Blanc as Lake County wine would imply selling an additional 54,000 cases of \$15 wine.
- Projected growth in Sauvignon Blanc supply all over California is modest, 1-2% by 2018. The supply growth has been outstripped by demand growth for Sauvignon Blanc as measured by Nielsen, and this is likely to continue for another year or two at least.

#3 – Analysis of Demand for Lake County Grapes

- There are three main sources of demand for Lake County Cabernet and Sauvignon Blanc grapes: (1) blending into high end wines over \$20, primarily Napa; (2) blending into CA or North Coast \$14-20 wines; (3) making and selling Lake County labeled wines.
- Napa Demand - if you assume Napa blending rates and prevalence found by our survey, and that Lake County obtains a 25% share of that market, the resulting demand accounts for 4% of Lake County Cabernet available for sale (i.e. not used by Lake County wineries).
- If you assume a 4% growth rate in sales of Napa Cab, and that the 2011 is the “current” vintage that represents market demand, then the Napa Cabernet market is long on supply, especially given the 71k+ tons of 2012 Napa Cab. However, if you assume Napa could have sold a lot more 2011, then supply/demand for Napa Cabernet is probably roughly in balance. The growth in demand for Napa blenders depends in part on how fast the consumer market absorbs the 2012 vintage. Excess supply will put price pressure on Napa grapes and wine producers. But the gap vs. Lake County is very large, and margin pressure on Napa wineries could increase demand for Lake County as blender.
- For Sauvignon Blanc, assuming Lake County obtains 25% of the market for blender in Napa, Napa demand will require 4-8% of the Lake County Sauvignon Blanc crop through 2018. Note that for the immediate future, Napa has a large 2013 crop to sell through, although consumer demand should clear it out within two years.

- Assuming a 6% growth rate in sales of Napa Sauvignon Blanc, there appears to be a looming shortage, indicating 4-6% growth in Lake County Sauvignon Blanc sold for Napa blending is achievable.
- North Coast/California demand - with some variations, the old rule of approximately \$100/ton grape price for every \$ of retail bottle price still holds as a price ceiling. This implies that Lake County grape prices to this segment depend in large part on whether people are trading up or down. Currently they are trading up.
- The usage of Lake County grapes in North Coast and California blends is extremely variable, from forming the base of the blend to being the high-priced "top note".
- Lake County's share of the \$1200-2000/ton Cabernet market is 13% through 2013. Based on this "fair share", over 80% of Lake County Cabernet could take this route to market. This implies that little or no Lake County Cabernet should be selling below \$1200. The projected increases in California Cabernet in this segment vs. Lake County roughly keep pace with each other to 2018. However, there is evidence of under-reported plantings in overall California Cab.
- At the current growth rate for consumer sales of California Cabernet \$13-20 (9%), the demand is already out-stripping supply, requiring substantial blending with other varieties, and it will get worse. If you assume a more modest 5%, the market will be slightly undersupplied to slightly oversupplied, depending on how fast it absorbs the substantial 2012-2013 vintages. The tendency will be moving towards undersupply from 2016-2018.
- Sauvignon Blanc supply is more variable year-to-year than Cabernet.
- Lake County represents about 8% of the Sauvignon Blanc supply from \$1200-2000/ton in California. Currently that price segment absorbs roughly ¼ of Lake County Sauvignon Blanc supply. However, surveys show Lake County is a preferred source of Sauvignon Blanc. If Lake County growers can convince 1/3 of users of \$1200-2000 Sauvignon Blanc to blend at 50%, that would absorb up to ¾ of Lake County Sauvignon Blanc, at prices \$1200+.
- Wines labeled as Lake County are showing strong sales growth as measure by both depletions and scan data. However, the proportion of Lake County Cabernet and Sauvignon Blanc sold under Lake County brands or appellations is quite small, and only account for 15-20% of the Lake County Cabernet and Sauvignon grape supply. Only a few brands have widespread or national distribution, and several of them are store or private brands. An increase in the number of Lake County wines selling at \$15/bottle or above would help maintain the upward price momentum for the grapes by providing incremental demand and reducing the supply of Lake County grapes sold on the market.
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