Wine Renaissance Redux

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Behold!!! I say unto you, the California Wine Biz has been born again!!!
Again….

We have all seen the stories of the recent troubles in our wine industry, with growers battling a grape glut, and vintners awash in a sea of wine. However, the tide has clearly turned within the past six months, and we now find ourselves in a brave new world, with supply slipping back into balance with demand in many market sectors. Wine sales have improved dramatically, with Pinot Noir leading the charge. The impact of the popular film "Sideways" has driven Pinot sales up 70% in recent months, and Cabernet, Sauvignon Blanc, Pinot Grigio and Syrah are all up approximately 20%.

Vintners are actively searching for grapes for the first time in many years, with a consequent rebound of grape prices. This phenomenon is merely another recurrence of the wine business cycle, an endless mobius loop, driving grape, wine and vineyard prices up and down, in response to the immutable laws of supply and demand. The cycle tends to play itself out every ten years or so, sometimes longer, sometimes shorter, but always the same. The dynamics of the cycle appear to enjoy an inverse relationship to quality, as the cycle hits first, hardest, and longest in the lower quality regions, and later, softer, and shorter, in the highest quality regions. So the premiere California wine region, Napa Valley, remains relatively insulated, although not immune, from the worst excesses, while the lower quality production areas, such as the Central Valley, suffer first, and to the greatest degree, and for the longest duration.

Vineyard values tend to follow grape prices, as we may see, graphically, by viewing average vineyard values, vs average grape prices, in the various north bay wine regions, over the past decade. Beginning with the world famous Napa Valley, we see a fairly dramatic trend. Vineyard values, from low to high, are shown as bars, while overall average district grape prices are shown by the single line.

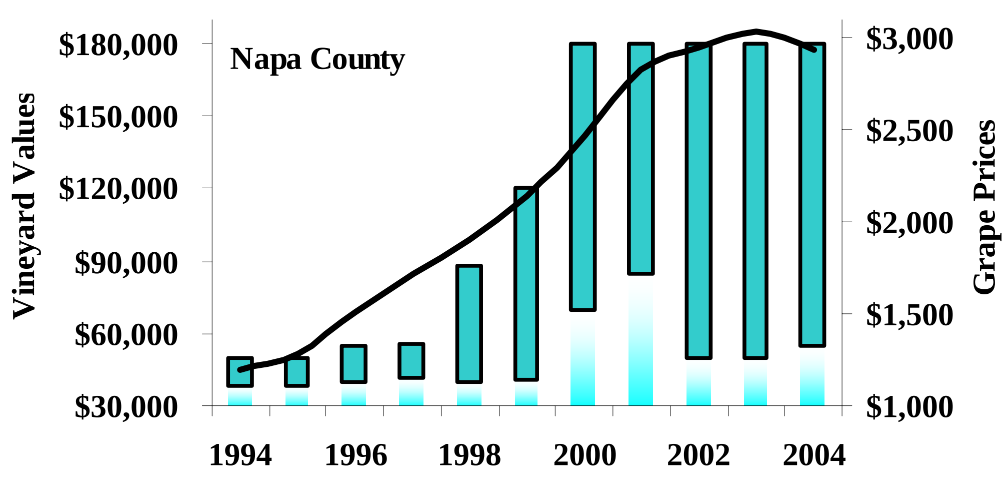

Figure 1. Napa County Vineyard Values, vs Average Grape Prices

Clearly, vineyard values are tied to grape prices, but, while grape prices grew at an average annual rate of 13% from 1997 to 2000, vineyard values rose at almost 50%, over the same time period. This rise in vineyard values was driven, to some degree, by the influx of newly-minted dot.com gazillionaires, but then supported by grape prices as the dot.com influence eroded. However, this phenomenon is reflected throughout the agricultural real estate sector, as ag land values across the US have grown far in excess of income.

Alas, however, the premium wine grape market began to suffer after the turn of the millenium, as did Silicon Valley, as the dot.com boom turned to dot.compost. The grape is a fickle fruit, and, while Napa continues to enjoy strong demand for its grapes, the same was not true in other regions. In the great central valley of California, where **most** of the state's wine grapes are grown, grape prices crashed, rather dramatically, amid the global grape glut, and the wines they make. A quick look at Fresno County reveals vineyard values rose rapidly, following the rise in grape prices, in 1995 through 1998, but also dropped rapidly as the grape glut drove prices down precipitously in 2000 through 2002. A slight rebound in grape prices in the 2003 crush (+8%) was followed by a stronger rebound in 2004, at 30%. Vineyard values responded rapidly, with a 30% increase in 2003, and another 47% in 2004.

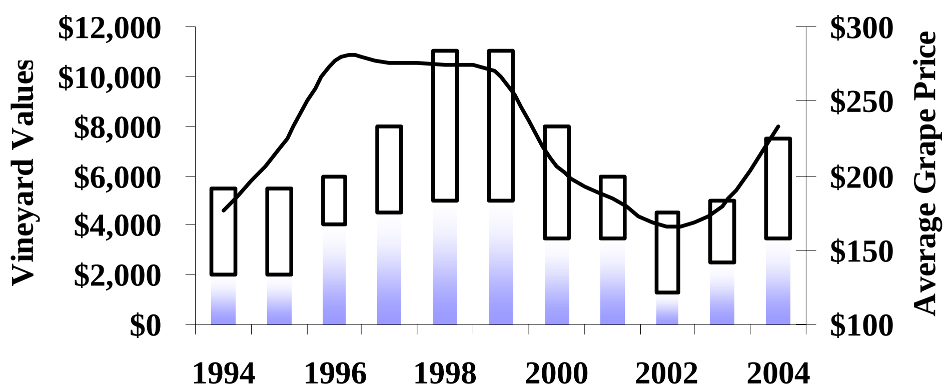

Figure 2. Fresno County Vineyard Values, vs Average Grape Prices

Absent the influence of dot.com dollars, and a world class real estate market fueled by the romance of the Napa Valley, vineyard values in the great central valley are clearly tied much more closely to grape prices, and consequent revenues generated from grape sales. So here, the risks and rewards of vineyard ownership are highly subject to the slings and arrows of the outrageous grape market.

This market phenomenon has proven to be a recurring cycle of boom and bust, as supply and demand dance a delicate waltz of imbalance, with demand overwhelming supply in the boom years, and supply drowning demand in the bust years. This most recent episode of the cycle was accompanied by another phenomenon, a shift away from the traditional generic jug varieties, and towards the premium varieties such as Chardonnay, Cabernet, and Merlot. The history of California Chardonnay serves to illustrate both trends, with the shift to the premiums obvious in the total level of production, which grew steadily through 2000, and the iterations of the recurring market cycle demonstrated by the overall average price of Chardonnay grapes, per ton.

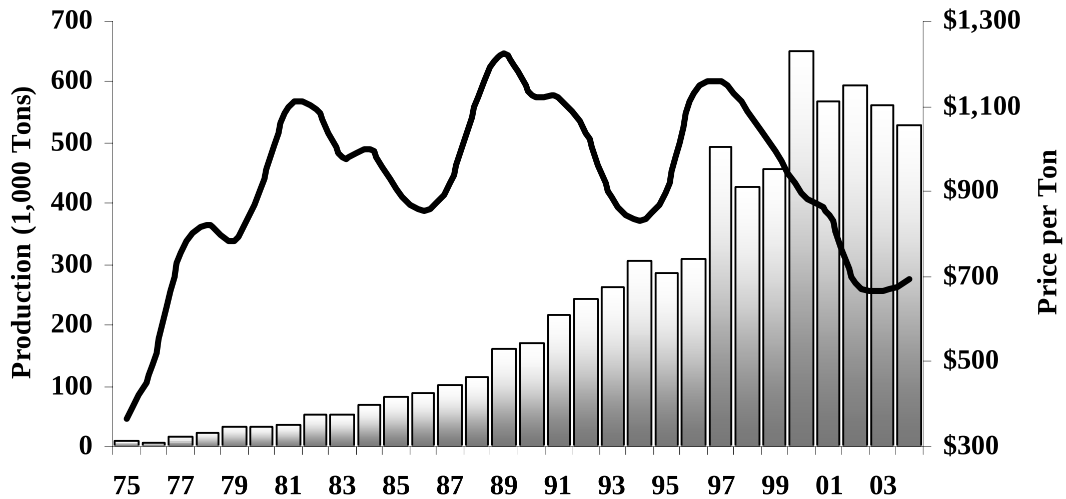

Figure 3. Chardonnay, Production vs. Price, Total California

The trend of increasing production is obvious, as total tons rose from only 17,000 tons in 1977 to over 650,000 tons in 2000. The wine business cycle is also clearly illustrated by the grape price trend, which follows a rollercoaster of eight to ten year cycles. The most recent iteration of the boom and bust is seen as the most extensive decline in prices in several decades, as prices fell from a high of $1,161 in 1997 to a low of $665 in 2003, before rebounding to $693 in 2004. The severity of this decline is a function of another market trend, one I call “A Shift to the Center”. As demand for Chardonnay, and all premium varietals, heated up in the late 1980s and 1990s, the market moved out of the traditional premium coastal valleys, and into the hotter central valley.

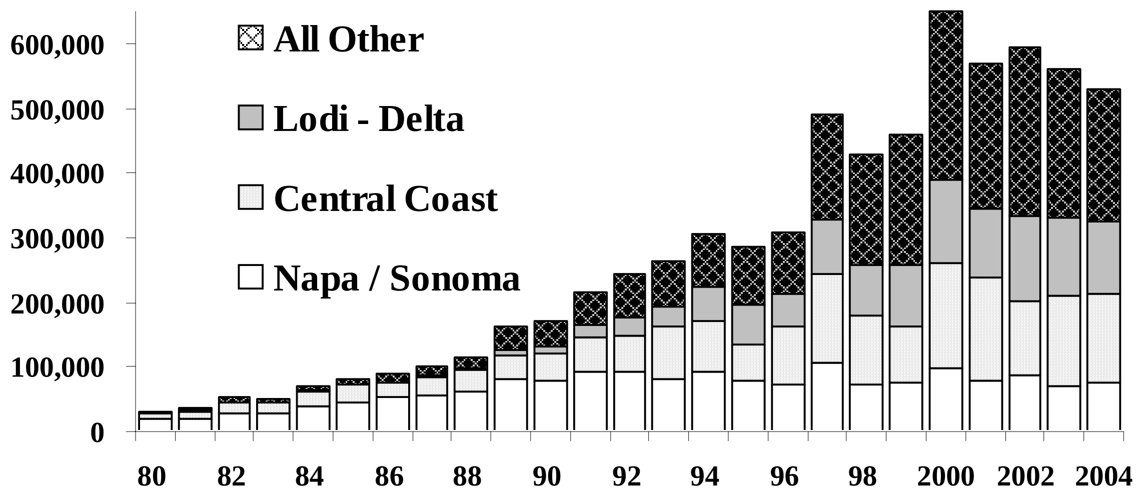

Figure 4. California Chardonnay, Total Production (Tons)

While Chardonnay production was increasing at a breakneck pace, the traditional premium regions of Napa and Sonoma counties actually declined in total production, as both of these regions moved more towards the red varieties. So, as more of the total production came from the lower-priced, hotter, interior, valleys, the overall average price per ton declined even more rapidly.

Chardonnay is the dominant variety in Sonoma County, and we see a similar trend here, as grape prices, and vineyard values, rose dramatically in the late 1990s, before beginning to soften after the turn of the century, slipping downward in 2001 to 2003, and then stabilizing in 2004. Again, here in Sonoma, vineyard values followed grape prices, however, neither grape prices nor vineyard values slid at the dramatic rates seen in the Central Valley. Conversely, however, Sonoma has not enjoyed the stability seen in Napa Valley.

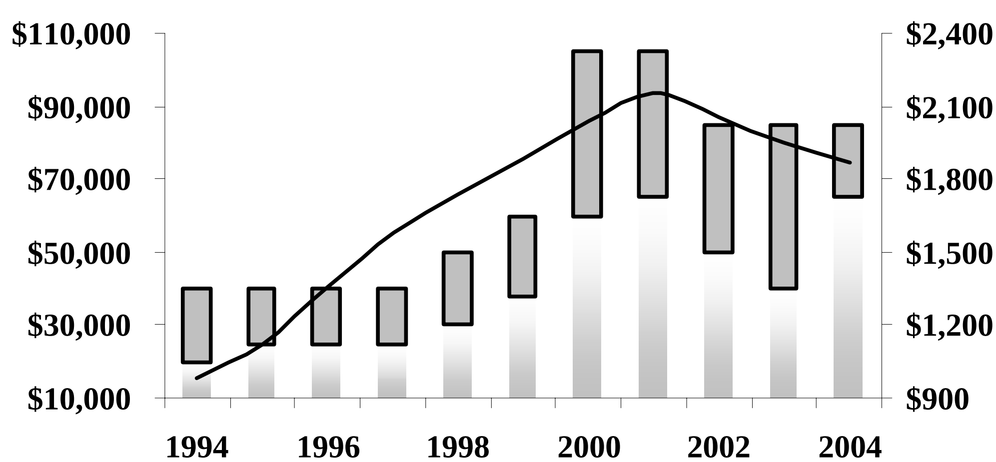

Fig. 5. Sonoma County, Vineyard Values vs. Average Grape Prices

Similar iterations of the wine cycle are played out in the various wine regions of California, and appear to follow similar trends in other wine regions of the world. The highest tiers of quality, e.g., the first growths of Burgundy and Bordeaux, tend to be insulated from the slings and arrows of the cycle, while the lower tiers, of higher volumes, but lower quality, remain the most sensitive to the risks of the volatile markets.

As in so many industries these days, we also continue to see consolidation of the wine industry, with the largest companies swallowing the smaller fish in the race to be the biggest, and the best, in the world. Wine, despite its unique history and characteristics, appears to be morphing into just another drink, as the major wine companies are absorbed into the global spirits mega-companies. Only time will tell who will emerge as the dominant players, but, clearly, they will be humongous. As this is written, Foster’s is pursuing a hostile bid at almost $2 Billion for Southcorp, and Pernod and Fortune, and Constellation, et al, are chasing Allied Domecq. So far, we have seen Diageo swallow Chalone, and most recently, Constellation acquire Mondavi, in a transaction which may prove to be a benchmark deal in this industry.

Perhaps another landmark event may be the emergence of wine related REITs, with two such entities already active in this market. Vintage Wine Trust announced completion of the formation of their REIT, led by Joseph Ciatii, with buying power of up to $425 million worth of vineyards. VWT announced their first acquisitions of three vineyard properties, in Napa, Sonoma, Monterey, and Madera counties, at a total price of $73 Million, in March, 2005. Vintage plans to continue acquiring vineyards, to be leased back to the sellers. The announcement was greeted by positive remarks from many market participants and observers, as a new vehicle providing a new source of capital to the industry. And the ubiquitous Vic Motto, of industry consultant Motto, Kryla & Fisher, has also announced their investment entity, Global Wine Partners, is putting together a similar REIT of up to $200+ million, focusing on premium north coast properties.

And before the REITs, the giant CALPERS fund had contributed $100 million to an investment vehicle managed by Premier Pacific Vineyards, LLC, headed by William Hill and Richard Wollack. PPV’s concept is to buy land in premium production areas, and develop ultra-premium vineyards, but, contrary to conventional wisdom, without any contracts for the purchase of grapes. The operative theory being that by the time these vineyards come into production, the market will be on another upswing, and demand for those grapes, and those vineyards, will once again be strong, and PPV would then be poised to sell (or lease?) their vineyard portfolio. So far, CALPERS would appear to be happy with their deal, having recently contributed another $100 million into the project.

So, as is so often the case, timing is everything, and those who perceive the broader perspectives of the cycles, can reap the rewards of savvy market timing. As a wise old man said, “buy low, and sell high.” Or, as Will Rogers advised; “Buy a stock. When it doubles in price, sell it. If it doesn’t double, don’t buy it.”

Sources:
Vineyard Values; Annual Land Values Survey, California Chapter of the American Society of Farm Managers and Rural Appraisers
www.calasfmra/com

Grape Prices: Annual Grape Crush Report;
http://www.nass.usda.gov/ca/bul/acreage/indexgab.htm

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