

Grape Grief,
Finidng the Bottom of the Wine Cycle

by Tony Correia and Richard Brockmeyer

In recent years, a debate over future grape/wine supply/demand has continued within the wine industry. The debate began some years ago, as some industry observers began to question industry projections of future grape supplies, in large part due to inherent inadequacies in the grape acreage statistics. In the early 1990s, California had struggled to replace vineyards devastated by the persistent pest phylloxera, and the grape shortages suffered as the declining vineyards were removed and replanted came at the same time as a surge of demand for our wine. The major wineries, in search of guaranteed supplies of high quality grapes, embarked on massive vineyard development programs, intended to ensure their control of product for decades to come. While planting continued throughout the state, many industry observers were, at the same time, crying of impending doom, as the impending sea of Merlot (and all grapes) threatened to drown us all...

The debate accelerated significantly when Barron's magazine published a full-color cover warning of "The Coming Wine Glut" on August 3, 1998. While the cover story suffered from the usual journalistic inaccuracies, it did address the burgeoning grape supply, and the consequent wine supply, relatively accurately. The Barron's story hit the market in the same week as a drop in the general stock market. Buffeted by both the general malaise in the market, and the negative tenor of the Barron's article, public wine company stocks suffered significant losses. The irony of this particular situation was that the predicted increase in grape supply could, perhaps, be the greatest boon the wine industry would have seen in many years, as the industry would, for the first time in the 1990s market, have a sufficient supply of quality product, at reasonable prices, to move to a thirsty market.

Conversely, a 1998 study of future grape trends, by the highly respected accounting/consulting firm of Motto, Kryla and Fisher (MKF), had flatly stated "There is no grape glut." MKF demonstrated how the major premium varieties, Cabernet Sauvignon, Chardonnay, Merlot, and Sauvignon Blanc, could actually continue to be in short supply in the premium market segments. While MKF's analyses were based on some rather optimistic assumptions regarding future domestic wine consumption and economic conditions (Rosé-filled glasses?). The report did address one issue, in which there appeared to be general consensus, lower-priced Merlot, especially in the southern Central Valley, appeared headed for significant oversupply. The reality of the 2000 crush, however, illustrated that not only was Merlot in serious oversupply at the bottom end of the market, but almost all varieties. As we now work through the 2001 crush, excess, uncontracted tonnage of Chardonnay, and many other premium varieties is being sold at sugar-point prices in the Central Valley. This phenomenon, of course, is a consequence of the huge shift in production of the "premium" varieties in the Central Valley.

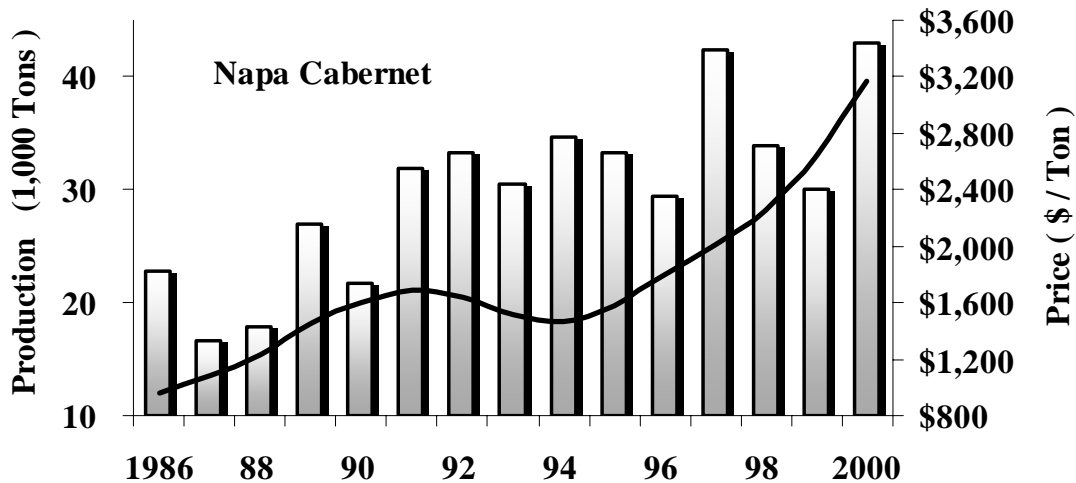
As the industry struggles with this crush, Barron's has responded with a sequel to its 1998 article, "Son of Glut" released August 27, 2001, predicting the "blatant" discounting of wine now infecting the lower-priced jug markets will soon work its way up the ladder of quality and pricing.

Regardless how this debate rages, or whomever holds the current advantage in this ongoing saga, it is clear we have, once again, entered a period of increased grape supply, and consequent wine supply, in the mid and lower tiers of the market. This burgeoning supply has already caused some significant trauma for some grape growers, most especially those in the central valley who have gambled and developed new vineyards without firm, long-term, grape contracts. Excess supply of specific varieties in specific locations, and price segments, has depressed "spot" prices, following the classic laws of supply and demand. Depressed prices are reducing growers' net operating income, impacting profitability, and in extreme cases, limiting the growers' ability to service debt, thus, causing immediate trauma to the grower/landowner.

The reverse is true, however, in the upper market tiers, as demand continues unabated, as supplies of the high quality grapes needed to produce world class Cabernet, Merlot, Chardonnay, and Pinot Noir continue to remain tight. It is unlikely this supply/demand imbalance will change much within the foreseeable future, as little land remains to be developed in the true premium areas. Also, winemakers, in search of great wines, demand lower yields, and consequent higher quality, of fruit, thus, production of this level of product will remain lower.

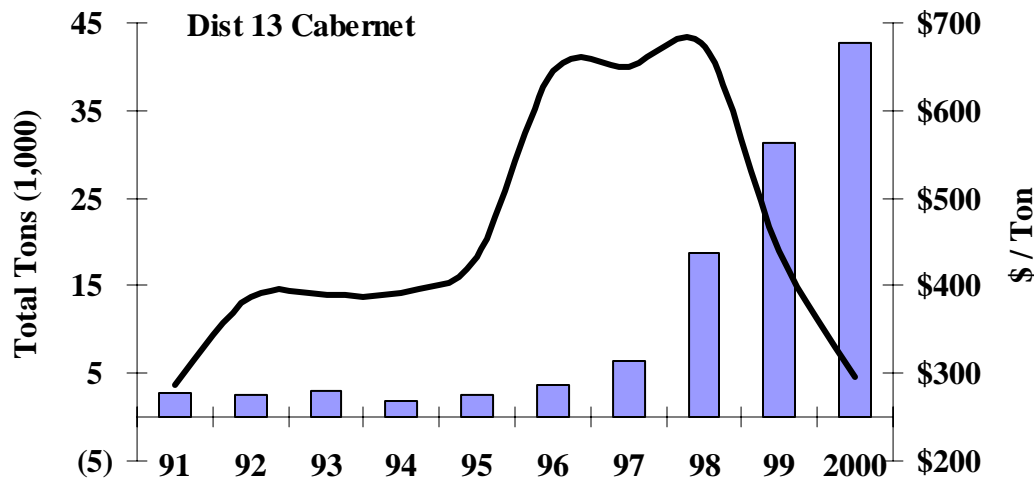
As hearty consumers of the product in question, both authors would be overjoyed to see precipitous drops in ultra-premium Cabernet or Pinot bottle prices. Unfortunately, however, such price changes are unlikely, as demonstrated by the recent pricing seen for 2000 Bordeaux futures. The basic reality is production of the highest quality wines demands a combination of climate, soils, viticultural resources, oenological skills and historical knowledge seldom found in today's world. This assemblage of resources required to create a true world-class ultra-premium wine will serve to limit production at this highest plateau of quality and price. While demand will likely fluctuate as world economies migrate through their various evolutionary cycles, there will always be a market for truly great wine. Recognition of this phenomena has led to the major wineries' flight to quality, as, collectively, they continue to move up the ladder of quality and price.

It is noteworthy that, while total production of Napa Cabernet has increased 158% since 1987, the average Napa Cabernet grape price has increased 193%.



The increase in Napa Cabernet comes primarily from displacement of other varieties, as vignerons have focused on those varieties best suited to their specific locales. E.g., while Cabernet accounted for less than 20% of total Napa production prior to 1990, it now averages over 30% of Napa, since 1996. Certainly, one could grow very good Chardonnay on the upper, volcanic, masculine slopes of Stag's Leap, but is that the best use of such land, when it is one of those very few spots in the world capable of producing a world-class Cabernet, as Warren Winiarski demonstrated to the wine world in 1976. Vintners and growers have slowly begun to match varieties, soils, climates, etc, much as the French and Italians have done. Of course, the French and Italians have a small headstart, of a few millennia, on California.

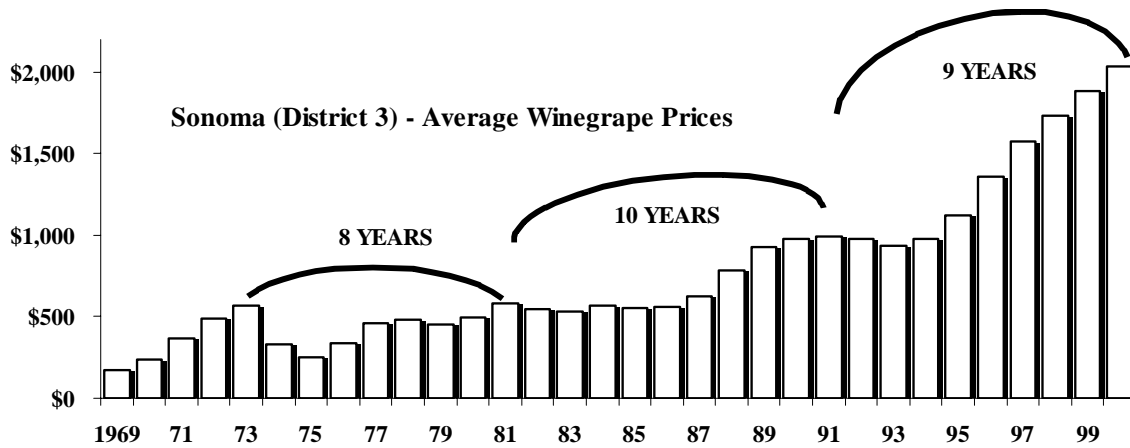
The trauma will, most likely, work its way up the ladder of quality and price, moving beyond the generic varieties in those areas, e.g., the Central Valley, noted for lesser quality grapes. E.g., Cabernet in District 13 experienced an increase of over 50,000% in production, from 1987 to 2000, bringing it almost exactly equal to Napa, in terms of total tons crushed, in 2000. However, while Napa prices continued to climb in 2000, District 13 saw a 56% drop in price in only two years, from 1998 to 2000. Major wineries, strapped for Cabernet sources in the mid 1990s, seduced Central Valley growers into planting and grafting thousands of vineyard acres to premium varieties, but, once new sources of higher quality grapes came into production, those same wineries quickly abandoned the Central Valley grapes. One is reminded of old stories of traveling salesmen, and gullible farmers with beautiful young daughters...



Conversely, however, many growers with desirable varieties in the premium locations, and firm contracts, can continue to prosper, as long as the contracting winery continues to honor its commitment to purchase grapes, at the contracted prices. History, however, teaches us that not all wineries will weather the storm, and some may be forced to reset prices, or to refuse some grapes at the scale.

The interesting aspect of this current quandary is that this scenario has been played out many times in the California wine industry, with times of perceived strong demand for wine prompting rapid expansion of productive capacity, with the growth of production typically accelerating, and eventually outstripping demand, leading to lowered wine and grape prices, and eventual reduction in production driven by failures of both vineyards and wineries. Bill Turrentine, a major bulk wine and grape broker, frequently presents his model of the “manic-depressive” cycle at industry events, a circle of continuing supply/demand changes. Turrentine’s model reflects a generic cycle averaging eight years for a full trip around the wheel of fortune. As the cycle continues, supply and demand eventually find balance, with successful vineyardists and wineries weathering the storm. The road through these cycles, however, is littered with those who have not.

A look back at historic prices for various regions clearly shows these cycles. The last 30 years has included three full cycles of nine years, plus or minus two years. “Cycles” are defined as a complete turn around the wheel, measured by the number of years between the high price for each phase. The average Sonoma grape price chart (below) provides a good example.



The chart below shows similar patterns for several diverse price/quality growing regions (Districts): Sonoma (3) and Napa (4) Counties, the South Central Coast (8), the Lodi District (11) and Kern County (14).

Length of Market Cycle (Years)

<i>Area</i>	<i>District</i>	<i>1970s</i>	<i>1980s</i>	<i>1990s</i>
<i>Sonoma</i>	<i>3</i>	<i>8</i>	<i>10</i>	<i>9</i>
<i>Napa</i>	<i>4</i>	<i>9</i>	<i>9</i>	<i>9</i>
<i>South Central Coast</i>	<i>8</i>	<i>10</i>	<i>7</i>	<i>11</i>
<i>Lodi</i>	<i>11</i>	<i>8</i>	<i>7</i>	<i>8</i>
<i>Kern</i>	<i>14</i>	<i>9</i>	<i>11</i>	<i>6</i>

Clearly, Napa (District 4) demonstrates the most consistent pattern, with repeated terms of nine years in each of the last three cycles. The lower quality/price regions tend to enter the down legs of the cycle earlier, as the Central Valley has in the current episode, and spend longer periods at the bottom of the cycle.

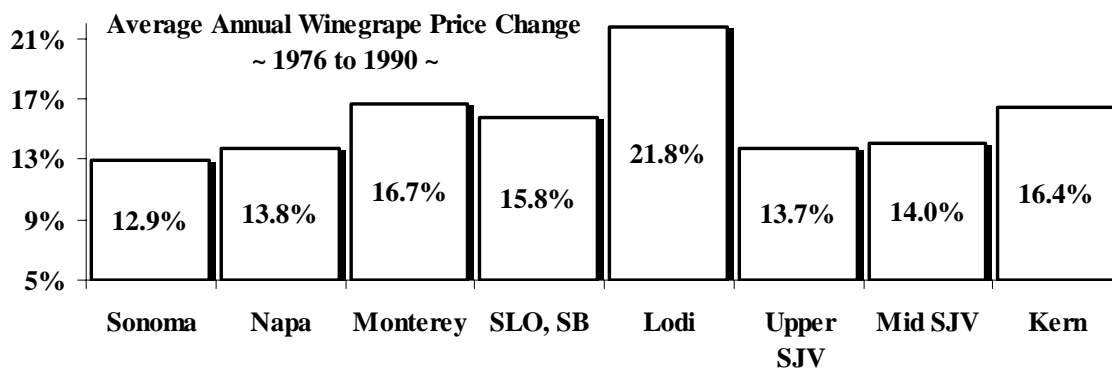
One major industry participant we interviewed, a “luxury” segment winemaker, referred to the “decommoditization” of the market, with grape buyers viewing grape purchases with an increasingly critical eye, looking to the geography and climate of the specific property, and the reputation of the specific vineyard. This reflects the most recent industry trend, focusing on the “place” of wine, the “terroir” of grape production, and a consequent differentiation between grape growing areas, and even between specific vineyards within a defined area. The reverse, of course, is seen in the ubiquitous Chardonnay, rapidly becoming a generic commodity in all but the best locations.

The differentiation of prices between regions for the same varietal is a type of decommoditization that has been evident since the move to varietal wines began in the 1960’s. In the late 1960’s the predecessor of the state of California’s “Grape Crush Report” had 3 reporting regions.

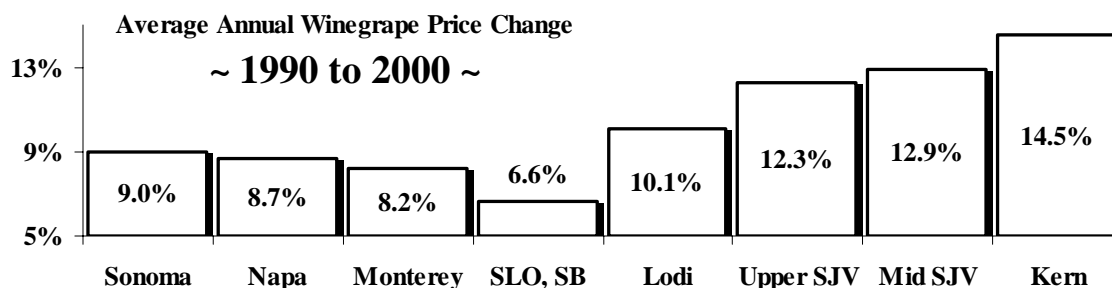
As wineries continued to differentiate regions by distinctive pricing, the state's reporting was expanded to 14 regions in 1976. There are currently 17 reporting regions. The wide range of prices for a specific varietal within a region testifies to the point made by the winemaker – the industry is becoming “vineyard-specific”.

The greater differentiation between regions can be seen in two pricing phenomenon, both favoring the economic stability of the higher price/quality regions. The higher price/quality regions experience lesser impacts from price decreases, both in terms of frequency and magnitude. E.g., over the years from 1976 to 2000, Napa (4) and the Southern Central Coast, (8) experienced only 5 years of price declines, while the Central Valley districts of 11 (Lodi), 13 and 14 experienced 9, 9, and 10 years, respectively, of price declines.

In terms of magnitude, prior to 1990 there was a definite price differentiation between regions, but the annual variability was not significantly different between regions – as measured by the annual percentage price change, with the sole exception of Lodi (11). E.g, annual price variations averaged 13% to 17%, except for Lodi, at 22%.



However, over the past 10 years, the higher price/quality regions have been blessed with more stable pricing patterns.



As many of us know, painfully, from alternative investment markets, price volatility may be perceived, (and, perhaps, correctly) as an indication of the level of risk associated with any specific investment. The aberration seen earlier in District 11 may be an indication of

a relevant factor, i.e., price volatility may, in fact, be a function of magnitude of production increases. District 11 has experienced rather dramatic increases, with over 465 thousand new tons added from 1980 to 2000, a 384% increase, and over 160 thousand new tons from 1997 to 2000! Even more dramatic is the phenomenal increase in Chardonnay production in Districts 11 and 12, with an increase of almost 195 thousand tons since 1987, an increase of almost 11,000%. Is it any wonder, then, that this region has experienced grape price reductions of 30% to 50% in recent years?

So where are we today, and where do we go, from here? Clearly, the glut has struck the Central Valley hard, already, with significant price drops starting in 1998 in Districts 12 and 13, and in 1999 in 11 and 14. While peak prices were seen in 1997 in 12 and 13, average prices were still climbing in 2000 for Districts 3, 4 and 8.

<i>Area</i>	<i>District</i>	<i>Peak Price</i>		<i>2000 Price</i>	<i>Decline from Peak</i>	
		<i>Year</i>	<i>Price</i>		<i>Drop (\$)</i>	<i>Drop (%)</i>
<i>Sonoma/Marin</i>	3	2000	\$2,034	\$2,034	\$0.00	0.00%
<i>Napa</i>	4	2000	\$2,468	\$2,468	\$0.00	0.00%
<i>North Central Coast</i>	7	1999	\$1,348	\$1,251	(\$97.38)	-7.22%
<i>South Central Coast</i>	8	2000	\$1,349	\$1,349	\$0.00	0.00%
<i>Lodi</i>	11	1998	\$607	\$496	(\$111.41)	-18.35%
<i>North SJ Valley</i>	12	1997	\$408	\$268	(\$140.49)	-34.43%
<i>Central SJ Valley</i>	13	1997	\$275	\$207	(\$68.59)	-24.92%
<i>South SJ Valley</i>	14	1998	\$304	\$210	(\$94.06)	-30.97%

This year (2001) and the next 3 to 4 years will be rocky for the industry, as a whole. For individual growers, it will range from the “Great Depression” to “steady as she goes”. [We’ll ignore the allocated cult vineyard/wine situations.] Where a grower falls in that broad spectrum will be dependent on the interplay of the following items: (1) regional location, (2) varieties grown, (3) demand for those varieties, as evidenced by contracts, (4) strength and integrity of the winery holding the contract, (5) productive characteristics (quality and quantity), (6) production cost efficiencies, (6) debt obligations, and (7) pure blind luck...

As we move through this latest “new economy”, the true ultra-premium production areas will, very likely, continue to reap the benefits of constrained supply. However, the vast majority of producers will experience broadening price differentials, even further, as the lower tiers of the market continue to suffer the slings and arrows of outrageous oversupply. How far up the quality/price ladder will the trauma of overwhelming supply climb? History would suggest only the highest plateau will escape, relatively unscathed, as we tread wine in this latest sea of excess.