Wine Renaissance Redux

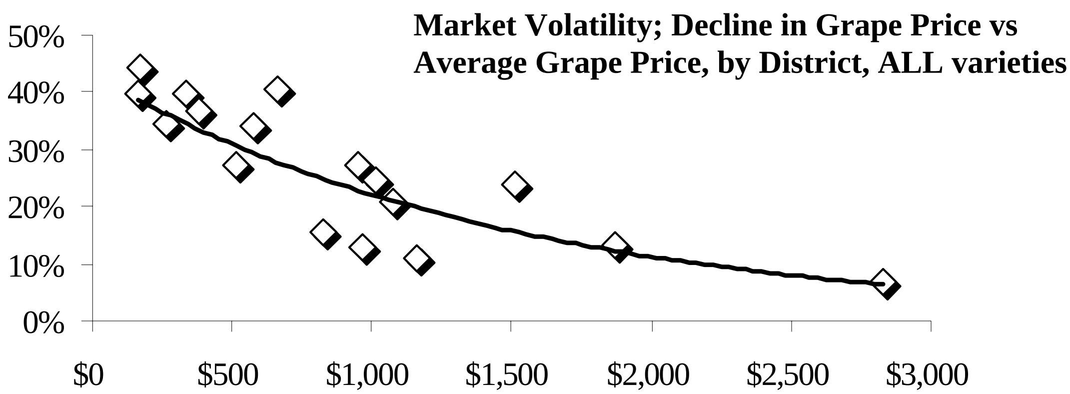
Presentation at The Western Economic Association International Conference
July 6, 2005, San Francisco, California, USA

Tony Correia
President; Correia-Xavier, inc.
Phone: 707.933.9915
Fax: 707.581.1759
Email: tonyc@c-x.com

The California wine industry repeatedly suffers a dramatic cycle of supply and demand. Over the past few years, we have seen another repeat of the bottom of the cycle, 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 dramatically in 2005, and the rising tide is lifting all boats, with Cabernet, Sauvignon Blanc, Pinot Grigio and Syrah all enjoying increased sales.

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.

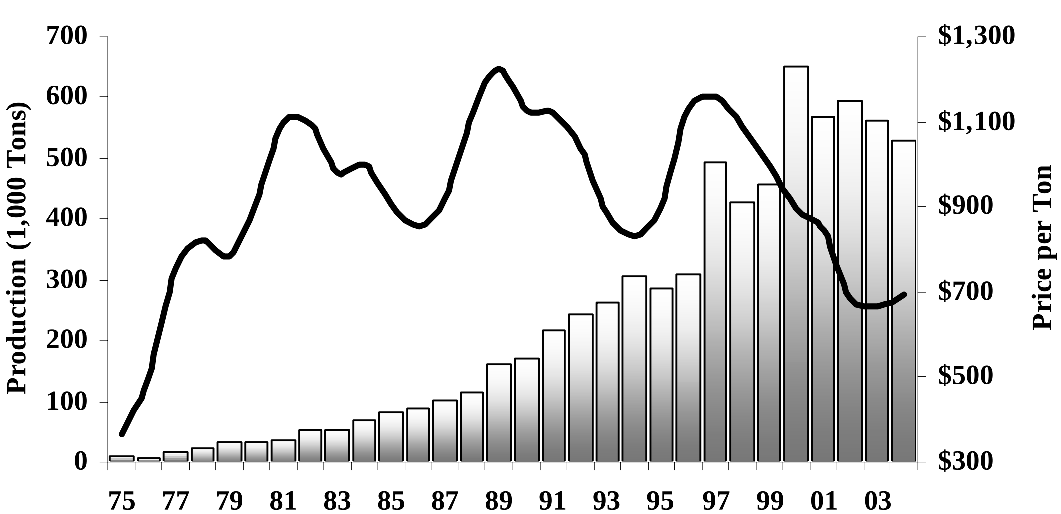
If we look towards the average price of grapes sold, by district, we can see a very strong correlation of price volatility to average price, i.e., the greatest volatility is seen in the lowest priced districts, and the least volatility seen in the highest priced districts. Viewing the data, we can look at the overall decline in grape prices as a proxy for volatility, and contrast this with average grape price to see the degree of correlation. Each grape pricing district is presented as a data point, with the decline in grape price expressed as a percentage, and correlated with the average grape price in that district, at the low point of the cycle. E.g., District 4, Napa County, is seen as the extreme data point, with a decline in price of only 6.8%, and an average grape price at $2,827. Conversely, District 14, Kern County, in the southern San Joaquin Valley, shows the greatest decline, at 44.2%, and an average price at only $169.62.



The coefficient of correlation observed in this analysis is seen at an R^2 of 0.75. However, district averages can be easily distorted by varietal mix, so we may track one single variety by the same method in search of more meaningful data. If we look towards the dominant California variety, Chardonnay, we see even more dramatic price swings, but also a higher degree of correlation between market volatility and price.

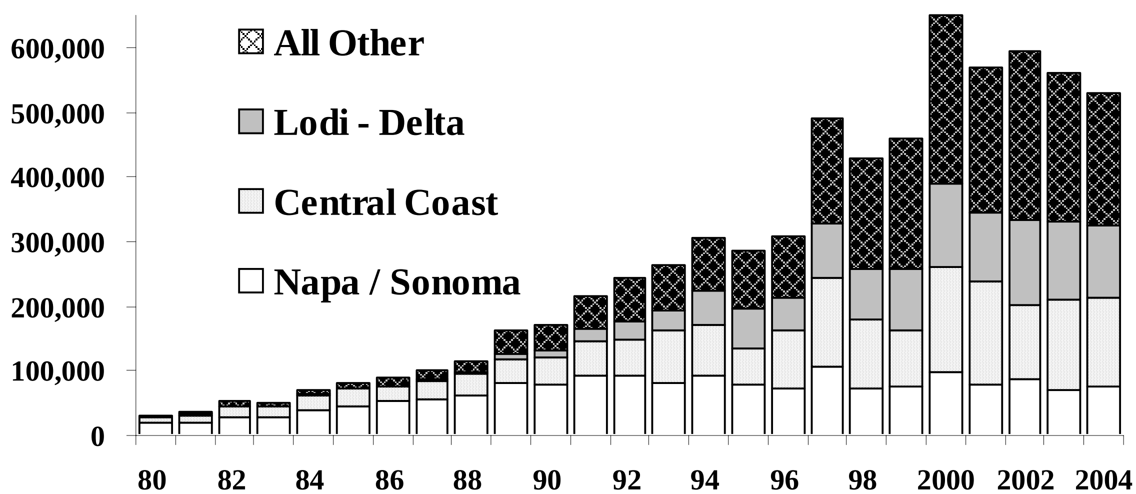
This market phenomenon has proven to be a recurring cycle of boom and bust, as supply and demand dance a delicate waltz of imbalance, with demand overwhelming supply in the boom years, and supply drowning demand in the bust years. This most recent episode of the cycle was accompanied by another phenomenon, 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.

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.

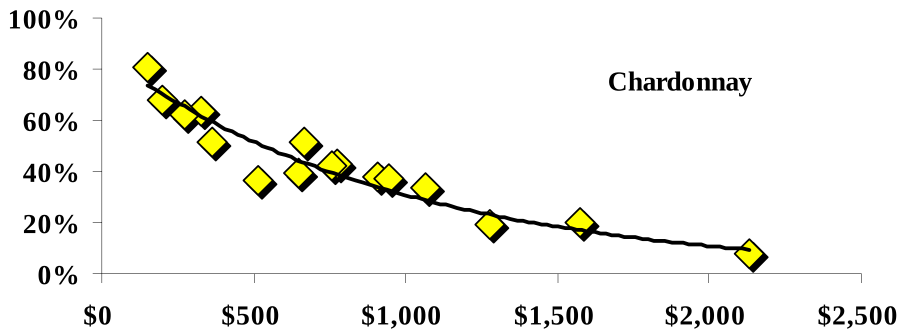
California Chardonnay, Total Production (Tons)



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.

So, returning to our volatility analyses, and targeting only the Chardonnay variety, we see an even more dramatic expression of the dynamics of the wine cycle. Revisiting our analysis of market volatility, but focusing on the Chardonnay variety, only, we see a similar, but much more volatile, view of the market.

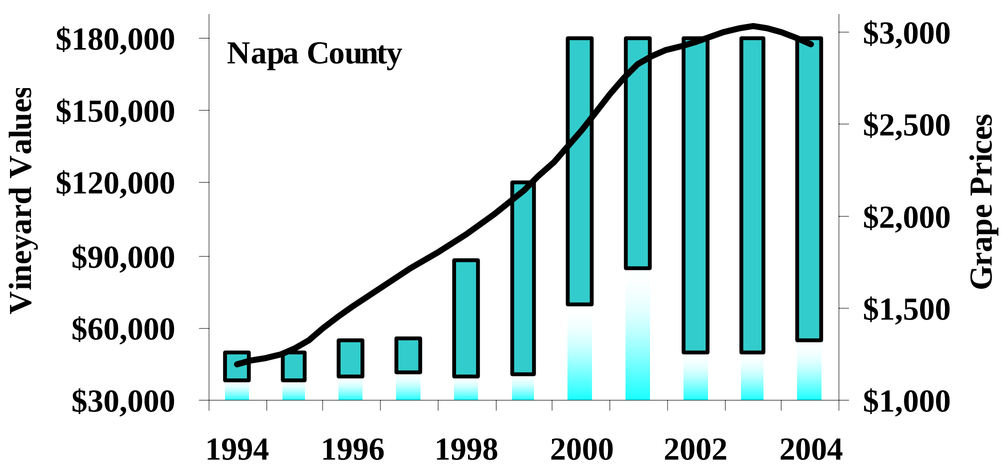
Market Volatility, Chardonnay, Average District Price vs. Price Decline (%)



Here, again, the two ends of the spectrum are Districts 4 and 14, with District 4 seeing only an 8.1% decline in price, at a district average price of $2,129, while District 14 suffered an 80.8% decline, with an average price at $153.50. The R^2 factor is now seen at 0.93 in this analysis.

Vineyard Values and Grape Prices

As we know, vineyard values tend to follow grape prices, and follow similar patterns of volatility. We may demonstrate this phenomenon, graphically, by viewing average vineyard values, vs average grape prices, in districts at the top and bottom of the quality/price spectrum. 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.

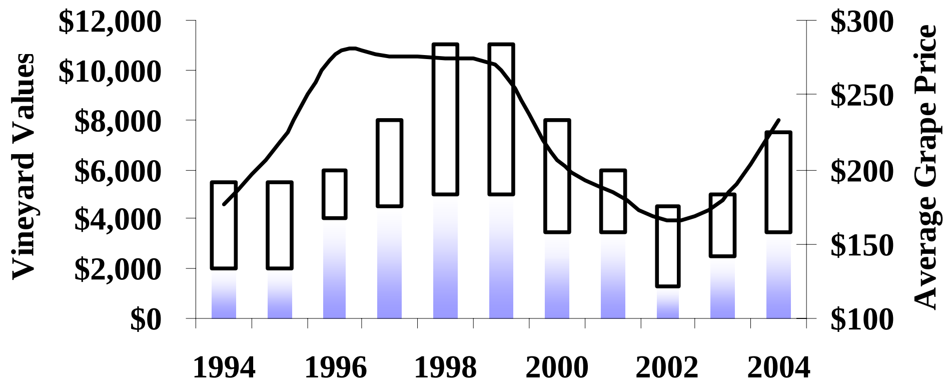


Napa County Vineyard Values, vs Average Grape Prices

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 also 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, in District 13, 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.

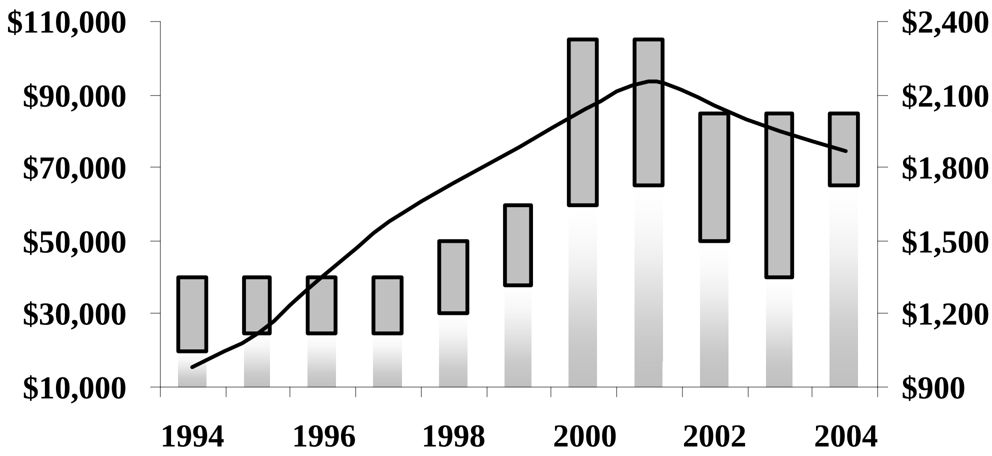
Fresno County Vineyard Values, vs Average Grape Prices



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.

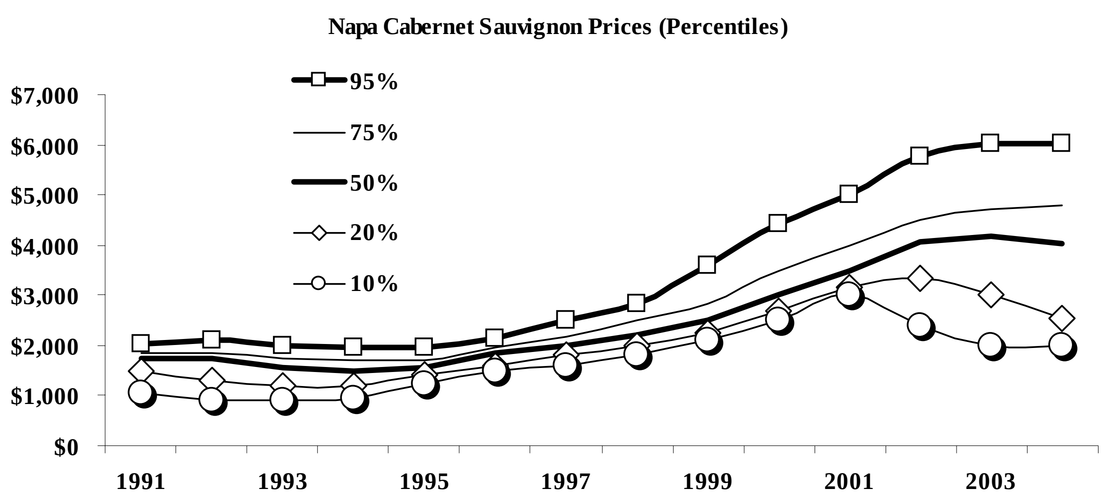
Returning to our exploration of the Chardonnay variety in this exercise, we may now look towards District 3, Sonoma and Marin Counties. Chardonnay is the dominant variety in Sonoma County, and we see a similar trend here, as grape prices, and vineyard values, rose dramatically in the late 1990s, before 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.

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.

Similarly, we may see the same pattern even within a specific variety, within a specific District. If we look towards our upper benchmark, Napa Valley, and measure the history of the dominant Napa variety, Cabernet Sauvignon, we see a similar pattern emerging.



Viewing the Napa Cab prices in terms of grape price percentiles, we see a familiar pattern, the lower percentiles, 10th and 20th, begin their price declines much earlier, and suffer greater declines, as a ratio of price. E.g., the 10th percentile begins to decline in 2002, while the 20th percentile begins its decline in 2003. Conversely, although the AVERAGE price (50th percentile) has declined, the 75th and 95th percentiles have remained stable through 2004.

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 Ciatti, 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.

The VWT model allows a vineyard owner to sell their asset to the REIT in an all cash transaction, and then lease the property back at a lease rate fixed in the original transaction. Lease rates are planned to be tied to midterm treasury notes, with the first acquisitions generating lease rates in the range of 9%. Thus, a seller pockets the full proceeds of the sale in cash, and then continues to operate the vineyard under the lease, with full operational control over the property and grape production, with the lease payment a fully expensable annual operating expense.

Typically, vineyards are carried at cost on corporate balance sheets, but even at this lower basis, vineyards tend to underperform most other winery assets, as returns to the grower are more typical of farming operations, with single digit Returns on Assets. Also, land, a non-depreciable asset, is typically a major component of vineyard value. Thus, relieving the entity of such underperforming assets tends to enhance the entity's perceived level of performance.

Also, REITs can offer some interesting tax advantages for closely held entities, presenting some attractive estate planning options.

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 Reports;
http://www.nass.usda.gov/ca/bul/acreage/indexgab.htm

2184 words