PART FOUR
PERFECT STORM REVISITED

Predicting Trends and Opportunities

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Inside the convention center, at the 2011 Wine and Spirits Wholesalers of America (WSWA) convention in Orlando, Florida, William Goldring, chairman of the Sazerac Company and the Crescent Crown Distributing Company, warned the crowd of mostly wholesale distributors that the three tier alcoholic beverage distribution system was in danger from supplier and retailer battles to undermine it. "Should any one of the tiers get greedy…and we don't hang together," Goldring told his audience, "we will hang separately. I caution our supplier friends here today about slicing the pie too unevenly."

Outside the convention center the sun was shining. The balmy April weather gave no hint of the storm within the alcoholic beverage industry itself -- and in the last 24 months that storm has picked up speed, intensity and power.

The authors of this report predicted in 2005 and again in 2007 and 2009, that a perfect storm was generating monumental change in the alcoholic beverage industry

The forces of globalization, consolidation and market liberalization are converging and ringing cataclysmic changes to the industry, producing an alcoholic beverage distribution system that will ultimately be more efficient – and more unforgiving of failure – than it is today. As the leadership at the WSWA convention recognized, only those industry participants that develop winning strategies will weather this storm and prosper.

Figure 1 shows how key industry participants at every tier will need to develop such strategies. In Figure 5 the authors provide readers with actionable insights and winning strategies to consider.

What will change over the next 24 months? In Part Four - Perfect Storm Revisited, the authors offer new predictions (the next 24 months) regarding five interlocking dynamics that are game-changing to the wine industry: 1) globalization of

- **Short global supply will make it harder to serve growing U.S. market demand as the economy slowly expands again**.
- **Producers will be singly focused** on how to grow top and bottom line again.
- **Economics are changing the distributor powerbase,** and new distributor solutions may disintermediate traditional models.
- The **rise of the large billion-dollar retailer** is of increasing importance to consumer choice and changing the relationships among the three tiers.
- **Consumer choice** itself and the Millennial segment specifically have the potential to reshape what the wine business will look like over the next quarter century.

Figure 1: All Three Tiers Need New Strategies to Stay Ahead of a Growing Number of Traditional and Non-traditional Competitors

supply and demand, 2) producer consolidation, 3) distributor consolidation, 4) retailer consolidation and 5) U.S. market liberalization. Figure 2 shows how these dynamics continue to have a profound effect on all tiers of the U.S. wine industry.

In 2011, the storm brews at a near tsunami level, and the authors maintain that by 2015 a very different industry from 2005 will emerge from the forces of change. The U.S. wine market is undergoing its most exciting and dynamic cycle in 30 years. As large wineries and producer groups dominate and control a more limited number of wholesalers, smaller wineries are being locked out, unable to sell profitably to traditional retail outlets through existing national distribution channels, at least until pre-Prohibition era laws are changed to enable a fully liberalized market. Ultimately, consumers will benefit – from better access to higher quality wines for the price, and from increased retail resources available to incentivize customer purchase behavior. Over the next 24 months, we will see the following developments:

1. Capital investments driving new marketing and distribution systems will continue to be slow, impeding innovation and limiting growth for smaller wine businesses.
2. The pendulum will shift due to changing economics and the industry will become even more polarized than it was in 2005. More than a chasm between the large and the small, the U.S wine industry splits in two different distribution systems, driven by very different margins.
3. Figure 3 illustrates how large, billion-dollar producers will continue their alignment with very large distribution companies, while small producers still continue to seek new or alternative marketing and distribution systems. The long term impact of these shifts is dramatic under 250,000-case wineries on especially smaller wineries with portfolios in the above $30 msrp/bottle categories.

SUPPLY AND DEMAND PRESSURES

In 2009, when Part Three of this series was published, the world was in the midst of the Great Recession. In July 2011, economies are slowly rebounding, with the result that wine sales have picked up; only grape supply is short again, driving prices up. Emerging markets in Asia and Eastern Europe are continuing to grow, although they are not expected to match the top Western markets in value and volume

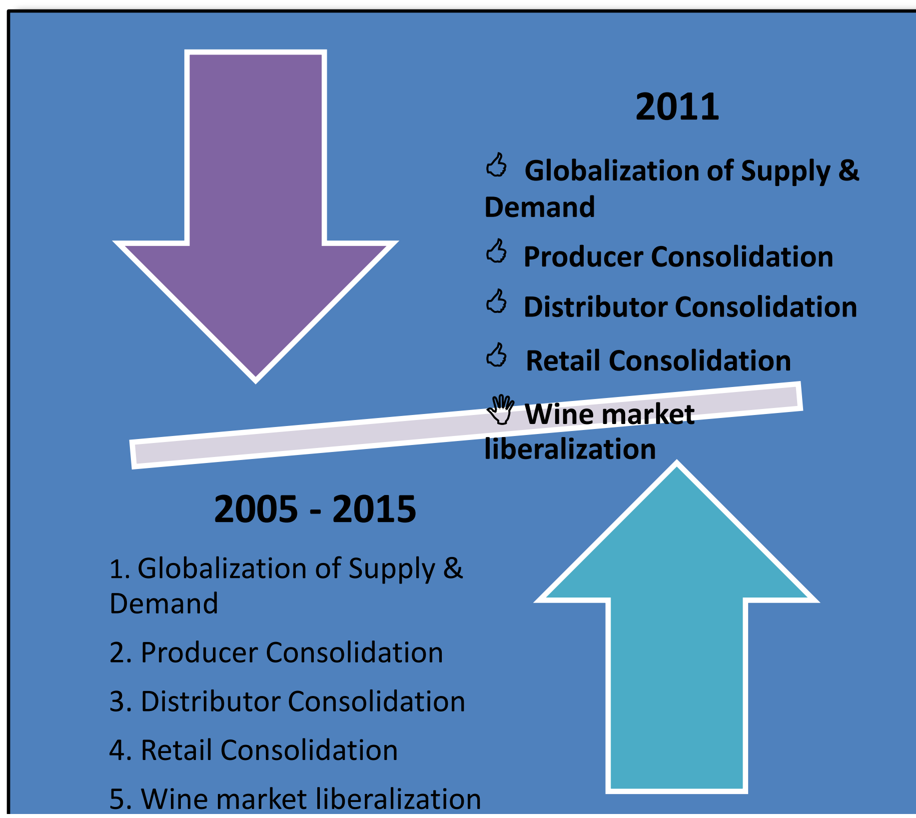

Figure 2: Five Interlocking Dynamics Continue to Have a Dramatic Effect on the Wine Industry

for the foreseeable future. *Consumer choice* itself and the Millennial segment specifically have the potential to reshape what the wine business will look like over the next quarter century. Despite this potential, there is a lot more competition for the American wine consumers' share of pocket.

Short Supply Cycle again Driving Higher Grape Prices. Short global supply will make it harder to serve growing U.S. market demand as the economy slowly expands again. "The world has moved from a very 'long' position to a very 'short' position in no time at all," says Steve Dorfman, Partner at Ciatti Company, a leading wine industry brokerage firm. And the weakness of the US dollar is keeping foreign bulk wines at bay, which allows Americans to "drink" their way through any excess in American Chardonnay and Sauvignon Blanc. Experts are concerned about access to enough supply to cover growth in future market demand, due to inadequate planting in California.

Growing United States Wine Market. America has become the world's largest wine-consuming nation by volume and value. Jon Fredrikson of Gomberg,Fredrikson & Associates, a wine industry consulting firm states: "Overall, Americans spent $30 billion on wine in 2010, with the average American drinking only 2.6 gallons annually. With the average Frenchman drinking 12.3 gallons a year, the U.S. market still presents huge future growth opportunity."

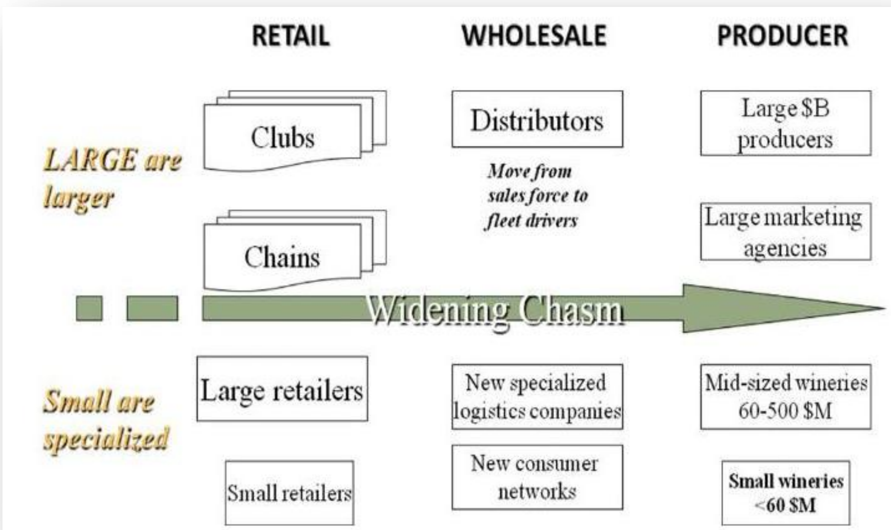

Figure 3: The Tale of Two Cities: Under 250,000- Case Producers Need a New Distribution System to Grow Profitably

1. The short-term future for the U.S. wine industry looks rosy, with 2011 forecasted sales growth for the fine wine segment to be 11 to 15 percent higher year over year, and for winery profits to marginally improve. [1]
2. U.S. *off-premise* wine sales were up 4.1 percent in volume in 2010 and 4.7 percent year-to-date through May 15, 2011. Anticipate *off-premise* sales to increase 21 percent over the last year in the priciest wines – those in the $20-plus categories. [2]
3. While *on-premise* numbers lag behind those of off-premise, growth is also returning to the restaurant market.[3]
4. Total *imports* in 2010 were 107.5 million cases, including 20.2 million cases of bulk wine in equivalent cases; not all shipped into trade channels, notes Jon Fredrikson.
5. A weak U.S. dollar at press time means imports are down, especially from Australia and Chile. But

[1] Silicon Valley Bank's 2011-2012 Annual State of the Wine Industry Report.
[2] According to Chicago-based Symphony IRI Group.
[3] Wine Market Council's 2010 overview of the industry.

while *bulk wine imports* were down 23 percent by volume in 2010, imports are still up over 50 percent from 2008 numbers. There are 25 countries that ship at least 50,000 cases of wine to the U.S.

6. While bulk wine imports are down, *bottled wine imports* continue to climb – by more than 7 percent in 2010.[4] New Zealand, Argentina, Germany and Spain led the pack in terms of percentage increases, and only Australia showed a decrease (2 percent) among the top 10 importing countries. Other countries want a share of the U.S. wine market – witness the 2011 purchase of Fetzer Vineyards by Chile's Concha y Toro.

Increasingly Global, Savvy and Younger Americans Consume Wine. With more and more Americans choosing to drink wine for lifestyle and health reasons, the potential to reach these millions of consumers is irresistible. U.S. wine producers will face more competition from other countries. The producers that survive and thrive in the global marketplace will do so by determining how to appeal to the globally savvy American consumer. "The Millennial generation[5] offers the wine industry the kind of growth potential not seen in more than 30 years," noted the Wine Market Council in its 2009 consumer tracking study.

1. "Many [Millennials] are well-traveled, Internet-savvy and total networkers, encouraging and sharing wine, beer and cocktail favorites as never before."[6]
2. Although beer remains the beverage of choice for this group, accounting for 42 percent of their alcoholic beverages, wine captures 20 percent – up from 13 percent for GenXers when they were a similar age 10 years ago," according to Danny Brager, VP Group Client Director, Beverage Alcohol Team, The Nielsen Company.
3. "If the usual pattern holds true for Millennials [of drinkers shifting from beer to wine and spirits as they get older], wine will account for 26 percent of all alcoholic beverages consumed by all U.S. generations by 2020, up from 24 percent today, while beer will fall from 41 percent to 38 percent," according to Nielsen.

Giant wine producer Constellation Brands, appealing to this critical market segment, has introduced more "whimsical" brand ideas at lower prices to capture this market. The company's Rex Goliath brand, sporting a large rooster on the label and selling for less than $10 a bottle, is one example, one which Jay Wright (Chief Operating Officer) says has "been on fire" with Millennials.

Long-term Impact of Discounting and Flash Sales. The big question of whether pricing has taken a permanent reset with the recession and the shift in consumer demographics is most prevalent among producers. "Will the value-system of the Millennials ever permit them to embrace luxury/icon wines to the same degree as Baby Boomers did," ponders the CEO of a large wine company, "or should the wineries who depend on these price points focus more intensely on China, as the French have done?"

1. In just a few years the '*flash wine market*' grew to about $100 million in annual sales, fueling new wine sales models including WinesTilSoldOut, Invino, Lot18, Cinderella Wines, Groupon, Gilt Group, and Ideeli. Tim Bucher, founder and CEO of Tastingroom.com, an

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[4] Impact Databank.

[5] Millennial cohort: 50 million between the ages of 21 and 30 in the U.S., and another 25 million turning 21 in the next few years.

[6] Scion Advisors' Trend Watch 2011 report.

innovative online marketplace that enables consumers to "sample before buying" wine, asks: "What is the long-term impact [of flash sites]? Are we educating consumers that the Internet is the discount channel for wine? Or are consumers learning they can buy wine online – opening up this channel to innovative marketers looking to capture consumer share of wallet?"
2. "The *high end market* was extremely volatile in 2010," notes Christian Miller, the Research Director of Wine Opinions, a leading wine research group. "Substantial numbers of high frequency and high end consumers are still reducing their purchases of over $30 wines (msrp), especially classics such as Napa Valley Cabernet and Bordeaux. Yet there were strong positive trends for wines from Oregon, Washington and South America, as well as for Zinfandel, Sauvignon Blanc and Pinot Noir."

Wine *IS* Mainstream in America. Wine Opinions' in-depth analysis of wine consumption at home and on premise shows strong signs of wine incorporation into everyday life in the U.S. "Fully a third of all wine that high frequency wine drinkers consume is on Monday through Thursday," says John Gillespie, the Founder and CEO of Wine Opinions, "Not only are we seeing more wine being enjoyed on a casual, everyday basis, but significant amounts of wine are being consumed without food at all, or while preparing a meal, or with snacks. And the proportion of red wine consumed without food is astounding."

PRODUCER CONSOLIDATION

On the back of more cautious strategies formulated during the economic downturn to meet more conservative shareholder demands and as the U.S. economy emerges from the Great Recession, all *producers will be singly focused* on how to grow top and bottom line again. They face decreased consumer demand for higher priced wines, increased competition from bottled imports and the loss of branded shelf space to large retailers' private label products.

While the large producer is ostensibly king and the small producer fights to survive, both segments have their own challenges and opportunities as consolidation within all three wine industry tiers intensifies. Large producers with greater market share will compete with well-positioned small and midsized wineries that learned how to capitalize on brand building to capture the consumer's share of mind or have formed brand groupings to capitalize on multi-brand distribution efficiencies.

Large Producer Challenges. After sluggish activity during the Great Recession, the pace of acquisitions is increasing in 2011, and the market is far more active now than it has been in recent years. Privately owned wine companies like Foley Family Wines Boisset Family Vineyards are buying up standalone wine brands, and even the Chinese are entering the action with the recent purchase of Rutherford based Sloan Winery. Answering stockholder expectations for return on assets, large publicly traded wine companies are offloading subsidiaries and brands that drag on investor returns:

1. Constellation Brands was the world's largest wine maker until December, 2010 when it sold its Australian and U.K. operations to an Australian private equity firm for $290 million, shedding its value brands (wines that sell for $3 or less).
2. In 2011, Brown-Forman Corporation sold Fetzer Vineyards and a portfolio of other brands to Chilean lead producer, Concha y Toro.
3. Also in 2011, the expected demerger of Treasury Wine Estates from Foster's Group became a

reality, with speculation that the standalone Treasury may, in turn, sell some of its wine brands in an effort to increase shareholder value.

Large Producer Opportunities: Reducing Cost of Sales through Outsourced Services. With traditional wine distributors no longer being paid for in-store support for many of the products they deliver, likely hundreds of millions of dollars will stay in the hands of the producers, or at the retail tier, even after taking merchandising fees into account. One of the biggest developments in the last year has been the rise of alternative distribution services, potentially driving improved margins for producers and retailers though logistical service providers such as Warren Buffet's McLane Company[7] and Core-Mark, as well as third party merchandisers such as Advantage Sales & Marketing and Daymon Worldwide Inc.

1. *Logistics companies*, such as McLane, have improved economies of scale largely through centralized warehousing and vast transportation fleets, possibly resulting in lower costs for producers. Large producers that work directly with retailers on private and control label brands (PL/CL) and don't need in-store product management for products that traditional distributors provide, are in a better position to take advantage of non-traditional distribution channels.
2. Similarly, alcoholic beverage *merchandisers* are arising to help producers manage product at the retail store level. Unlike traditional distributors, these unlicensed third-party merchandising companies do not negotiate sales, are paid a flat fee for their services and are more affordable. Large producers that deal directly with stores' category managers and don't need a distributor to facilitate sales at the retail level are able to benefit from these services.

Large Producer Opportunities: Capitalizing on Technology and Social Media. Wine market leaders are using data to tailor products and customize direct marketing campaigns with customer information. Winning business models are those that allow each brand to maintain its separate and strong connection with customers. Developments in technology are helping to facilitate this strategy. While the rise of social media has provided unique opportunities for small producers, large producers also are capitalizing on this unprecedented direct route to consumers. Constellation, Diageo, Kendall Jackson and Treasury Wine Estates have all put together special teams of Millennial marketers to work on digital media advertising strategies. One Constellation campaign includes a Facebook page for Arbor Mist, which reputedly has become the largest wine community on the social network site. Another campaign includes a YouTube video contest for Constellation's Black Box line of wines.

Small Producer Challenges. More and more, smaller wineries complain they have no voice within the distribution channel. Small and mid-sized wineries will be hard pressed to survive in today's competitive environment, as they are unable to compete against large producers through the current three-tier system or build alternative sales channels. Even with DTC (direct to consumer) or DTT (direct to trade) opportunities, smaller producers still face the huge

[7] McLane is a U.S.-wide grocery and food service supply chain business that has entered the alcoholic beverage distribution business by buying existing distributors in Tennessee, South Carolina and elsewhere and applying for state wholesale licenses across the country.

logistics challenges of getting their products to market on time, affordably and with minimal product damage.

1. *Direct to trade strategies* may not solve the small winery distribution dilemma. Many smaller players believe an elimination of the distribution tier would help their businesses, but there may be no easy alternative, according to a 2011 survey by Steven Rannekleiv of Rabobank. Retailers told Rabobank they would not add shelf space any time soon to make way for small producers' products sold outside the usual distribution channel.
2. The *legal and regulatory hurdles* facing any concerted DTT effort are significant. Truman Reynolds, vice president of third party order fulfillment company, Pack n' Ship Direct states: "Regulatory challenges still dominate as we tip toe through the legalities of clearing product through to trade customers and consumers in many markets." Pack n' Ship Direct (www.packnshipdirect.com), Wineshipping.com and Winetasting Network are the three dominant third party logistics providers servicing the California wine industry.
3. With Washington and Oregon currently the *only legal direct to trade states* from out of state, huge hurdles must be overcome before direct to trade becomes a viable channel for smaller wineries -- including how to reach and sell to trade customers.
4. *Margins* will continue to suffer in a market where consumers expect deep discounts, and short supply is driving increased cost of goods. "I am surprised we have not seen more small producer consolidation into business models where front end [market muscle] and back end [economies of scale] are leveraged more" says Rachel Dumas Rey, CEO of Compli Beverages, a leading beverage compliance services company. "For example, administrative, purchasing and licensing economies."
5. *Overwhelming challenges* may tempt many producers to sell out. Top properties with stellar reputations, valuable brands and winning management teams will always be attractive to buyers. However, this doesn't make for a practical exit strategy for a majority of small and mid-sized properties. While private equity remains interested, the asset-intensive nature of the wine industry is not a top investment choice when times are tough, except for the rare occasion where family succession dynamics push top brands to sell, as in the recent sale of Seghesio Family Vineyards to the Crimson Wine Group[8]. Typically, time to returns is upward of five years before investors see any returns, and profit margins often don't stack up favorably against those of other beverage products.

Small Producer Opportunities: The Wine Consumer Is Shifting to the Digital World. U.S. wineries are expecting the Direct To Consumer (DTC) channel to be their fastest growing sales channel for 2011, with online sales continuing to be a beacon of hope for small producers. The savvy small producer is already engaged with consumers and learning the best ways to use social media – think conversations, not sales pitches – and making this a key part of its marketing strategy. Figure 4 shows how social media, with its promise of direct conversations and meaningful exchanges between customers and producers, fits perfectly with these trends. Observe

[8] http://www.pressdemocrat.com/article/20110601/BUSINESS/110609985?Title=Napa-wine-group-acquires-historic-Seghesio-winery. [Press Democrat, June 1, 2011]

the scale of the wine industry's "digital social connection" today:

1. U.S. consumer *direct wine sales* – consisting of online, wine club, tasting room and event sales -- grew 12 percent in 2010 to a record $3.4 billion.[9]
2. *Online wine sales* alone grew 38 percent, and projections for 2011 are even higher.
3. Many expect *online sales to speed up and double* by 2012 to a $500 to $600 million channel (depending on the rate of growth of flash sales as the economy improves).[10]
4. Big upside with *focused resources*: online sales are constrained by inadequate strategy, resource commitment and tools/platforms. Out of 6,500 U.S. wineries, only 25 to 30 have a full-time dedicated ecommerce staff person, says Paul Mabray, founder and CEO of Vintank, the leading wine industry digital marketing think tank. Most ecommerce staff is still carrying multiple hats (wine club, tasting room, ecommerce).
5. *Flash sales* grew to become a $100 mm digital retail channel. Since many of these transactions are accomplished through the three-tier system, producers do not always benefit from a direct sale margin.
6. Thirteen to14 million *conversations* were about wine online in 2010 – predicted to easily grow to 20 million by 2012. "This provides wineries with intelligence and visibility to mass consumers and means to sell product," says Paul Mabray.
7. Consumers have become enamored with artisan, handcrafted products in a world of mass production.[11] Today's wine consumers are engaging with producers directly in the tasting room and through social media channels, or indirectly through shopping for wine online or at a brick and mortar store.

However, as noted, both small *and* large wine companies are now engaging with consumers. Social media is no longer just the turf of founder-run smaller artisan businesses. This is both an opportunity and a competitive challenge for small producers. Says Paul Mabray: "Social CRM (customer relationship management) is a critical tool which winery marketing and PR departments need to

60 percent of core wine drinkers and 40 percent of marginal drinkers use the Internet to get information about wine.

Wine Opinions' 2011 Consumer Trends Report shows that wine consumers increasingly tune in to their favorite passion through social media.	38 percent of core wine drinkers use social media to discuss wine.
	45 percent who use Twitter "follow wine people" on Twitter.
	46 percent Tweet family or friends about wine.
	41 percent are Smart Phone users. Among these Smart Phone users,
	39 percent use wine/food/restaurant applications.

Figure 4: Wine Consumers Are Heavily Engaged through Social Media

[9] VinterActive LLC 2011 report.
[10] Online wine sales have only doubled in the last 10 years to $200 million in 2010.
[11] Scion Advisors Trend Watch 2011 report.

effectively leverage and convert social media into online sales." Over the next two years, we will see maturing industry skills and platforms enabling social connections to convert to commerce.

Small Producer Opportunities: Retailers Are Positioning Uniquely with Consumers. On and off premise retail physical and Internet outlets (see Retail Consolidation, below) are blurring the lines between winery tasting rooms and sampling at home and in stores.

1. Sample sizes or tastes of different wines (www.TastingRoom.com), beers, spirits and sakes are being offered online and in wine bars, stores, restaurants and hotel lounges. Small producers who participate are building customers faster and more affordably by getting more people to sample their products, telling their unique story through more outlets and offering educational experiences that build meaningful memories and more loyal brand ambassadors.
2. Wineries are seeing a surge in local and regional restaurant chains catering to consumers' heightened drive for taste adventures. Top restaurants have become much more creative with their beverage programs, inviting distilleries and wineries around the world to give customers more choices than ever before.
3. Finally, specialized retail grocers with a niche offering, such as ethnic foods or local artisanal products, are faring well even in the aftermath of the economic downturn. Small producers, who might otherwise get lost in the mass of products at mainstream supermarkets, now have more opportunities to hand sell through specialized retail outlets where customers are more likely to expect to pay for quality.[12]

There is no question the big will get bigger, but smaller, highly specialized producers can survive and even thrive through quality product, untraditional trade channels and niche marketing, thanks to the adventurous nature of the new consumer and their quenchless thirst

[12] Scion Advisors' Trend Watch 2011 report.

WINNING STRATEGIES AND ACTIONABLE INSIGHTS

To weather the storm and prosper over the next 24 months, all three tiers need new strategies to stay ahead of a growing number of traditional and non-traditional competitors and win consumer share of mind. Figure 5 (below) illustrates how *small and large producers* can address winning strategies to leverage trends and overcome hurdles.

1. **Win 'share of mind' by developing strategic marketing and sales programs.**
   - Target the growing casual, everyday wine drinker and people who consume wine without food, or while preparing a meal, or with snacks.
   - Develop unique digital media advertising strategies: Experiment every week with affordable Facebook and YouTube tactics. Track results.
   - Understand how new integrated, cross channel go-to-market strategies will drive consumer awareness and sales. (See Scion Advisors' blog: What are you doing to win consumer share of mind?)
   - Populate the Internet with information and stories about your wine brand – more than half of all U.S. wine drinkers are on Facebook, and 25 percent also use MySpace, YouTube and Twitter.

2. **Differentiate or die!**
   - Carve out a niche to separate your brand from your competition. Allow your brand to maintain a separate and strong connection with customers.
   - Find niche retailers, such as wine bars, where consumers can sample your wines and will want to hear your story.
   - Initiate direct conversations and meaningful exchanges between customers and your company through social media and other tools – think conversations, not sales pitches.

for undiscovered, high-quality wines.

DISTRIBUTOR CONSOLIDATION

Despite distributor clout, the industry's middle tier is hardly celebrating victory.

Economics are changing the distributor powerbase, and new distributor solutions may disintermediate traditional models. In late 2010, Wine & Spirits Daily speculated that Buffett's McLane entry into the alcoholic beverage distribution business meant more mergers and acquisitions, as distributors seek improved efficiencies in a changing marketplace. Since that article was written, more distributor consolidation[13] has indeed taken place.

As the legal battles over maintaining the three-tier system demonstrate, distributors worry about maintaining their protectionist system -- and the greater pricing power and profitability this system brings. Their continuing efforts to strengthen legislation already favorable to their tier – most visibly by pushing for passage of the CARE Act[14] but also by battles at the state level – point to their discomfort with the economic and social forces that question the value of the current system. Big forces of change are in movement at this tier:

1. Distributors are expressing concern over the *rise of the big retailer*.[15]
2. A *growing market share* of *private and control label products (PL/CL)*[16] is driving much *lower distributor margin*s, with distributors acting essentially as no more than delivery services for PL/CL. Some experts estimate PL/CL has grown from 22 percent[17] to comprise 30 percent of the market today; other large producers speculate

[13] In Texas, the large South Texas Anheuser Bush distributor and L&F Distributors (a 20-million case wholesaler) entered an agreement to purchase Avante Beverage, a statewide wine distributor based in Dallas. In Arizona, Young's Market Company and Republic National Distributing Company recently combined forces to create a single alcoholic beverage distribution company in that state.

[14] The Community Alcohol Regulatory Effectiveness Act, HR 1161, currently stalled in the House of Representatives.

[15] 2010 Rabobank survey.

[16] Including Charles Shaw and Oak Leaf Vineyards as control labels.

[17] Estimated by the owner of Total Wine when speaking to the 2009 WSWA conference.

WINNING STRATEGIES AND ACTIONABLE INSIGHTS (CONTINUED)

3. **Grow online sales by converting social conversation to social commerce (sales).**
   - Develop an integrated sales and marketing strategy and detailed plan.
   - Dedicate experienced staff full-time to the ecommerce channel.
   - Invest in the platform: Use data and CRM tools to tailor products and customize direct marketing campaigns with customer information.
   - Connect website information to the biggest digital categories of travel and journaling.
   - Connect website information and technology to work with mobile applications. (Fifty percent of Internet conversations are now through mobile.)

4. **Tailor new products through nontraditional retail channels.**
   - Sell sample sizes or tastes of different wines online (www.TastingRoom.com), in wine bars, at stores, at restaurants and in hotel lounges.
   - Develop local and regional restaurant chain relationships with venues that are catering to consumers' heightened drive for taste adventures.
   - Focus on specialized retail grocers with a niche offering, such as ethnic foods or local artisanal products, where customers are more likely to expect to pay for quality.

PL/CL represents up to 40 percent of total wine sold on the U.S. market.

3. The authors noted back in 2005 that by 2015 large retailers would increasingly work directly with large producers on pricing, marketing and merchandising, with distributors no longer getting paid for these services – *moving potentially $1 to $22 billion in income to the producer or retailer side of the ledger.*

Distributor Challenges/Opportunities: Economics are transforming the powerbase in the middle tier. With new logistics providers ready to step in and offer delivery services at lower (often fixed) cost and with greater efficiency, and with third-party merchandisers dedicated to providing producers with in-store display and related services. Where does this leave the middle tier?

1. Inevitably, *margin squeeze* is one result. Some distributor margins are starting to resemble those of spirits distribution margins (18 to 20 percent), and the PL/CL dynamic may be pushing these margins much lower. The modern wholesaler is measuring productivity by margin contribution and less by case volume these days. The proliferation of PL/CL may in fact re-incentivize wholesalers to pursue more branded products with higher margins such as brands in the under 250,000 case range.
2. Some speculate that *beer distributors* – traditionally used to lower margins – may step into this changing landscape, where unrealistically high fixed distributor margins (25 to 35 percent) are no longer par for the course.
3. With traditional large distributors at an uncertain juncture, we foresee a *new generation of smaller regional and specialty wholesalers* emerging to serve small to medium-sized producers. These wholesalers, niche product specialists, are often veterans of large distributor organizations with specialized product knowledge marketing to on-premise and specialty retail chains and independents. Their principal constraint is building a strong enough balance sheet to afford inventory and pay their suppliers. The recent TTB approval of bailment

WINNING STRATEGIES AND ACTIONABLE INSIGHTS (CONTINUED)

5. **Service retailers better: they want to sell a lot of wine too.**
   - Teach retailers about your business: Share your goals, strategies and tactics and do a better job of aligning your recommendations against those goals.
   - Show objectivity: Put the category first and have a professional sales process that is centered around the customer and not so much on your portfolio.
   - Deliver insights/answer the question "So what?" If you have data, explain why it's useful.
   - Share post-program analysis – help retailers learn what went well and what didn't.
   - Make sellers a fan of your product.
   - Keep products streamlined so you don't have to retrain sales staff constantly. They must feel comfortable with your product so they pull it out of the bag . . . less is sometimes more."
   - Once you find your segment and establish your message, back that up with education on how you distinguish yourselves.

6. **Assess alternative distribution services, third party merchandisers and regional wholesalers.**
   - Be ready to experiment with alternative distribution strategies that are better aligned with the target markets or provide more control over margins and pricing.
   - Find ways to collaborate with distributors or brokers more aligned with your goals.
   - Become more meaningful to your distribution relationships

warehouses[18] (essentially consignment facilities where suppliers continue to own their own inventory until orders arrive, at which time inventory is transferred to the wholesaler) may strengthen this channel further in the near to mid-term future.

Regardless, distributors are still a powerful group responsible for selling more than 300 million cases of wine last year, and federal and state laws still protect their power base.

RETAILER CONSOLIDATION

The growing pace of retail consolidation in the U.S. may be the most significant dynamic over the next 24 months. Danny Brager, VP Group Client Director, Beverage Alcohol Team, The Nielsen Company, says large retailers are growing larger in part spurred by PL/CL products. The *rise of the large billion-dollar retailer* is of increasing importance to consumer choice and is changing the relationships among the three tiers.

One embodiment of the giant retailer trend is Total Wine & More, the largest privately owned, multiple-state alcoholic beverage retailer in the U.S. Co-owner David Trone has predicted that revenues chain-wide for 2011 will be more than $1 billion. And private label is an important part of Total Wine's business, although the company has declined directly to give numbers.

Retail Opportunity: National Retail Chains Are Seeing Significant Growth Through Millennials. Successful large-scale retailers are capitalizing on current trends and opportunities by catering to customer choices, experiences and value and convenience customers have come to expect, including by tailoring products and marketing efforts toward Millennials. "We are targeting Millennials because they like convenience and to try new products," Jesus Delgado-Jenkins, 7-Eleven's senior VP-merchandising and logistics said in a statement. A November 2009 Symphony/IRI Group report, "Winning with Millennial Women Shoppers" assesses Millennial psychographics:

1. Millennials are eight times more likely to relocate than Baby Boomers in the next few years, mostly to emerging cities in the Southeast, Southwest and Rockies.
2. Demographic shifts, especially among Millennials moving from North to South, favor the large chains. These mobile consumers expect a certain level of service and variety of products – even the same commercial environment – they experienced in one state to be available in another.
3. Millennials tend to shop less and spend more when they do shop, prefer big box stores and are believers in private labels.
4. 70 percent of those surveyed in a Symphony/IRI Group report think store brands represent high quality.

WINNING STRATEGIES AND ACTIONABLE INSIGHTS (CONTINUED)

7. **Manage and control supply sources and costs more tightly.**
   - Consolidate back office support, especially mixed decentralized vineyard and wine operations.
   - If market demand is there, secure growth financing or capital to support growth strategies.
   - Negociant brands: Secure access to the right balance of supply sources through acquisition or strategic partnering.

Figure 5- Next 24 months: Seven Winning Strategies to Leverage Trends and Overcome Hurdles.

[18] See TTB guidance on bailment warehouses,, available at: http://www.ttb.gov/main_pages/bailout-warehouses.shtml.

Retail Opportunity: Retail Players Are Finding Creative Ways to Engage Customers. Some U.S. airports now allow liquor to be sold around the clock. A few provide tastings at terminal locations. Upscale locations at airports where passengers can drink while waiting for flights are also on the rise. CEO Doug Tomlinson founded Vino Volo in September 2005, bringing high-quality wine and food to airports. Says Tomlinson, "Vino Volo has grown rapidly, with 17 stores in operation by Spring 2011 and plans to grow to 50 stores within the next three years."

Retail Opportunity: Wine Bars Are the Coffee Bars of the Twenty-First Century. "Wine and beer bars at grocery stores and coffee shops may become the wave of the future."[19] The retail wine industry is taking advantage of the same trends that are hitting beer and tea. Whole Foods is experimenting with this concept in some stores and if successful will roll it out on a wider scale. Starbucks may begin serving regional wine and beer in at least some of its 16,000 stores around the world if the idea meets with customers' approval in the company's native Seattle, where the concept is being tested. Wine bar concepts in general are exploding around the country, with multiple bottle lists, themes and large numbers of wines by the glass (50 to 100 offerings are common).

Online retailers, despite being hampered by the variety of legal issues that vary from state to state, are continuing to grow. Leveraging more than 10 million online viewers that tune in to their programs, Food Network is launching an online wine club in July and could soon become the largest online retailer in the world.

U.S. MARKET LIBERALIZATION

The influence of the retail tier on wine market liberalization is significant. This tier owns 90 percent of wine inventories and is energizing an increasingly wine-savvy customer base – including a growing number of Millennials. Increasing consumer demand - for variety, convenience, value, personal experience and communication -- is distinctly at odds with a three-tier alcoholic beverage distribution system with its roots in the Prohibition era. How the law evolves to reflect this rapidly transforming marketplace will in part determine the pace at which the wine industry itself can change to meet consumer demand. We are halfway to 2015 – what effect has Granholm had?

Two Steps Forward, One Step Back. Litigation and legislation continue to shape this dynamic.

1. The CARE Act, intended to legislatively reverse the Granholm decision, is a sign of the desperation of the wholesale tier attempting to hold the line against the modernization of the industry. Backed by the Wine and Spirits Wholesalers of America and the National Beer Wholesalers Association and roundly condemned as cynical and unnecessary by every U.S. producer organization in wine, spirits and beer, the CARE Act has yet to find a Senate sponsor in spite of a record level of political spending by distributors hoping to influence politicians.[20] At heart, the CARE Act is an attempt to impose a legislative solution on what is really a commercial issue; i.e., the inability of the large wholesaler to adjust to the new market and consumer reality. We predict that the CARE Act will fail, and that

[19] Scion Advisors' Trend Watch 2011 report.

[20] The Specialty Wine Retailers Association cites public records showing that distributors spent $82 million between 2005 and 2010 on contributions to federal and state political campaigns and federal lobbying efforts. SWRA Report, "Toward Liquor Domination," June 2011.

failure will accomplish exactly the opposite of what was intended by its authors by virtue of the Act's unintended consequence of educating the American consuming public to the inability of the current delivery systems to get them the products they want when they want them. For example, groups such as the American Wine Consumer Coalition are forming through social media to address their frustrations with the current system.[21]

2. The retail tier lost in its effort to apply the Commerce Clause principles of Granholm to interstate shipping by retailers when the Supreme Court declined to hear the Wine Country Gift Baskets case[22] in March 2011. By letting stand the Fifth Circuit's decision to uphold a Texas law allowing in-state wine stores to ship to consumers while prohibiting out-of-state stores from doing the same. The Supreme Court's denial of cert leaves retail-based wine clubs, flash marketing sites, marketplace sellers, specialty wine clubs and purveyors of high-end specialty wines such as auction houses and specialty stores holding older vintages and rare wines, vulnerable to state laws, challenging these retailers' right to ship wine directly to consumers.
3. Despite this defeat, consumers' refusal to accept the restrictions of the three-tier system is confounding regulators across the country, whose only recourse is to arrest their own consumers for unlawful importation of alcoholic beverages, something they are loath to do. The loss of the retail case served to drive more *commerce underground*: Some determined collectors are using every tool at their disposal to obtain the wine they want regardless of where they live, and others are purchasing their wine in the state of the merchant and importing it themselves. We expect the ultimate winner will be the consumer, and we will see significant breakthroughs within the next two years, including the development of legally compliant shipment systems using new technology to decipher the complexities of the three-tier system and 50 different state laws. Consumer demand justifies the cost of system development.
4. Retailers are using their clout with consumers to fight back. Battles over selling wine in grocery stores are raging in New York, Tennessee and Kentucky, and fights over retail license limits have been placed on the ballot in Massachusetts and are the subject of legislative hearings in New Jersey.

A New Tactic – the Initiative Process.

First with court battles[23] and, in 2010, with its failed Initiative 1100, big-box retailer Costco has attempted to overturn laws in Washington state that prohibit restrictive alcohol regulations. In 2011, Costco introduced another measure, Initiative 1183. Potentially less objectionable to anti-alcohol forces, the new measure would allow quantity discounts and central warehousing for wine and spirits (although not for beer), as well as privatizing liquor sales in this currently control

[21] http://www.facebook.com/AmericanWineConsumerCoalition

[22] *Wine Country Gift Baskets.com v. Steen*, 612 F. 3d 809 (5th Cir. 2010).

[23] Costco's initial victory in the Washington district court was largely overturned by the Ninth Circuit when it upheld the state's laws regarding uniform pricing, minimum markups, quantity discount, credit and central warehousing bans. *Costco Wholesale Corp. v. Hoen*, 2006 WL 1075218 (W.D. Wash. April 21, 2006), *overruled by Costco Wholesale Corp. v. Maleng*, 522 F. 3d 874 (9th Cir. 2008).

state. Will Initiative 1183 be successful? In 2011, Costco is NOT being opposed by a competing initiative, as was the case with Initiative 1100, but rather by a combination of wholesaler, public entity unions and anti-alcohol forces who have thus far not stepped in with anywhere near the funding opposition that Initiative 1100 faced.

If Costco wins, this may establish the initiative process as the tool of choice to change laws and reform systems that cannot otherwise be touched because of entrenched (and immovable) political interests in state houses all over the U.S., where the wholesalers have been spending decades building their power base.[24]

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[24] During the past three election cycles, wine, beer and spirits wholesalers have contributed more than $58 million to state political campaigns, as well as spending countless millions in lobbying efforts at the state level. SWRA Report.