SONOMA COUNTY EDB ECONOMIC DEVELOPMENT BOARD

# WINE & CRAFT BEVERAGE

INDUSTRY INSIDER | 2022

# ECONOMIC DEVELOPMENT BOARD

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# EXECUTIVE SUMMARY

August 2022

The Sonoma County Economic Development Board (EDB), in partnership with the Workforce Investment Board (WIB), is pleased to present this 2022 Local Industry Insider Report. For additional information, questions, comments, or suggestions, please contact us at (707) 565-7170 or visit www.sonomaedb.org.

**Disclaimer to the Reader**: *The forthcoming details in this report reflect trends sourced from data gathered during the novel COVID-19 pandemic. Figures, such as employment rates, have been susceptible to great variability and are ever-changing.*

## HIGHLIGHTS

**Wine:** 2021 brought some much-needed relief to Sonoma County vintners, as travel resumed and tasting rooms and restaurants reopened. Total sales of wine in restaurants grew 20% from 2020, but are still down 9% compared to pre-pandemic levels. The pandemic accelerated a shift towards off-premises sales. Sonoma has had significant success with shipping direct-to-consumers and to grocery stores. Sonoma accounts for the largest share of wines shipped by volume in the nation at around 31.7 percent and ranks second to Napa in total value shipped. Wines and Vines analytics reported a 10% increase in total wine sales for 2021. Sales show a preference for higher quality wines. Bottles below $11 have declined in popularity, while bottles around $30, a key market for Sonoma County, are growing in popularity.

**Craft Beverage:** The large millennial cohort is turning increasingly towards beer and spirits. Overall beer sales grew 1% in 2021, but craft beer sales grew 30%. Since craft beer sales are so dependent on in-person sales, including restaurants and taprooms, reopening boosted their sales more than larger breweries. The market for craft beer is becoming increasingly saturated nationwide, but Sonoma County's head start and reputation in the industry will aid continued growth. Craft spirits are more expensive than craft beer or retail spirits, but these products will appeal to millennials as they become more confident spenders and value drinking high quality beverages rather than higher volumes. The craft spirit market is relatively young and although it is already growing saturated, Sonoma County's early entry will aid its growth.

**Outlook**: The baby boomer cohort makes up about one-third of wine consumption. As this cohort ages, they decline both in number and per capita consumption. Millennials, who make up another third of the market, are aging into their prime spending years and are turning away from wine and towards beer and spirits. This shift provides opportunity for the craft beer and spirit market, but will dampen growth of the wine industry. Wineries may need to be more creative in their marketing to younger consumers. Those that promote brand origin and environmental stewardship should continue to find success. Additionally, increasingly volatile climate conditions create uncertainty for the future of Sonoma County's wine and craft beverage industries.


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## WINE & CRAFT BEVERAGE » Sonoma County

**Recent Performance.** Sonoma County vintners, brewers and spirit makers enjoyed much smoother sailing in 2021 compared with the previous year. Wineries had been able to adjust in the wake of widespread business closures and shelter-in-place orders, but the beginning of the vaccination rollout, a recovery in travel, and the reopening of tasting rooms and restaurants provided much-needed respite for the wine industry, which was battered during the COVID-19 pandemic.

Overall U.S. consumer spending on adult beverages continues to tick higher, and the trend toward spirits and away from wine appears to be growing stronger. Throughout the reopening, wine lost market share to spirits. Total wine sold through wholesale channels declined through most of 2011 even though tasting rooms, restaurants, hotels and travel resumed business. Total sales through restaurants rebounded nearly 20% in 2021 but were still down 9% compared with pre-pandemic levels. The pandemic and the slow reopening have also accelerated the shift to off-premises markets through either the direct-to-consumer channel or increased shipments to grocery stores, two key sales avenues in which Sonoma has typically thrived. Sonoma County accounts for the largest share of wines shipped by volume: 31.7% of the overall channel. While growth trailed Napa, Sonoma has maintained its lead in total volume of shipments and ranks second in total value.

The sales picture improved in 2021, with Wines & Vines Analytics reporting a 10% increase in total U.S. wine sales, reversing the 9% decline seen in 2020. There is a clear bifurcation in both sales and consumption in the wine market, with consumers further proving they are happy to drink less but more expensive wine. Wines below the $11 price point are losing out, but Sonoma's key market segments are performing well, with sales of bottles around $30 showing robust growth.

**Macro drivers.** Odds are that the current economic recovery will evolve into a self-sustaining expansion. That is, by late this year, the economy will return to full employment. This is consistent with an unemployment rate in the low 3s and an employment-to-population ratio for prime-age workers over 80%. Real GDP growth will throttle back to the economy's potential growth rate of near 2%. Inflation should also moderate back to the Federal Reserve's target of close to 2%, but this will take longer, until late 2023. For this sanguine outlook to come to pass, the pandemic must continue to fade—with each new wave of the virus less disruptive to the economy than the one before it—and the U.S. economy has already experienced the worst of the fallout from the Russian invasion of Ukraine on oil and other commodity prices. It is critical that the Fed gets monetary policy more or less right, which means quickly normalizing interest rates over the next 18 months. We also need to catch a break, so that nothing else goes materially wrong for the economy.

While worries about the pandemic—and precautionary efforts to contain the virus—have receded, the economy is still struggling with its fallout. It stands to reason that as the pandemic winds down, people will get back to work, positions will be filled, and wage growth will moderate. Scrambled supply chains will also untangle, easing shortages and prices. Some of the worst bottlenecks have already been ironed out, but things have gotten more complicated with the re-emergence of the virus in China and other parts of Asia, where pandemic responses are more restrictive. The fallout of the invasion of Ukraine has also roiled supply chains.

The rebound in consumer spending has been inconsistent. However, the trend will become favorable after the drags from fading stimulus and supply constraints lessen. Growth will stabilize at more sustainable levels later in the year. Excess saving is coming to an end and is shifting to below-trend saving. Changes in the composition of spending will reverse slowly and incompletely.

TSA traveler volumes are improving and will continue to trend higher as contagion fears ease. Average traveler volumes are up 60% compared with 2020 through March, but still down about 12% compared with 2019 levels. Data from OpenTable, which charts seated diners at restaurants, show a similar rapid improvement, growing from 20% below 2019 levels at the end of January to roughly even by the beginning of April. Consumers are growing more comfortable with traveling and dining, and this will improve further as contagion fears ease.

**Industry drivers.** The rise of the millennial consumer continues to grow in importance to Sonoma vintners, craft brewers and spirit makers. Sonoma vintners have enjoyed several years of rapid growth accompanied by modest price increases across varietals, but the aging baby boomer cohort will put a speed limit on the sales of premium and fine wines. This cohort makes up about one-third of total wine consumption, is moving into retirement, and declining in both numbers and per capita consumption.

Excess savings and pent-up demand, coupled with rising wages and a surging stock market, especially for higher-income households, allowed for the premiumization of wine to return after a brief hiatus amid the worst of the COVID-19 pandemic. Despite a decline in total volume of wine sold, wineries reported a higher volume sold at higher prices in 2021, and this will likely continue.

Millennials, who by their sheer size make up nearly one-third of the market, are increasingly turning to craft beer and spirits, and vintners will need to persuade a new generation of wine enthusiasts to take up the mantle from the aging boomer cohort. Although millennials will migrate to higher-priced bottles as they enter their prime earning years, consumer preferences are shifting toward spirits, making millennials less reliable sources of revenue for fine and luxury wines produced by the county's small and midsize wineries.

The shifting demographic landscape provides opportunities for the county's craft beer and spirit makers. Overall beer sales rose 1% in 2021, bucking the trend of five consecutive declines. However, craft beer sales reversed course to post near 30% in 2021. Craft beverage sales rely heavily on on-premises sales, and the reopening of restaurants and taprooms boosted craft sales more so than large brewery sales. Though the national market is increasingly saturated, Sonoma's early entry and reputation will provide an avenue for modest growth.

Craft spirits command higher prices than craft beer and retail spirit labels, but they are generally less expensive than luxury wines. Such premium spirits will capture a greater share of overall spending on spirits as discerning millennial consumers grow more secure in their economic status and prize drinking better over drinking more.

More volatile climate conditions will be an ever-present challenge for Sonoma vintners and craft beverage makers. Rising ocean surface temperatures have coincided with less-predictable climate events that could put county vineyards, wineries, breweries and distilleries in peril. Vintners are experimenting with different grapes that grow better in hotter conditions, and harvest seasons are moving earlier in some places in response to changing climate conditions.

**Pricing.** A smaller-than-expected crop yield, improving labor market conditions, and the economy's continued reopening all pave the way for better pricing power for Sonoma vintners, brewers and spirit makers. Overall pricing will improve compared with last year, as consumers will act on pent-up demand to celebrate in groups, whether with in-person winery visits or restaurant outings, which will likely boost alcohol consumption throughout the year. According to the preliminary Grape Crush Report, grape prices rebounded roughly 11% in 2021, the effects of back-to-back low-yield seasons.

Craft beer producers face a more challenging pricing environment. While beer enthusiasts have migrated en masse to craft ales, the swell of new breweries has dented pricing power for all but the most coveted brews. Traditional brewers' purchases of independent breweries will bring economies of scale to the craft market and will further dampen the pricing power of smaller producers. Craft brewers will see some respite from restaurant reopenings, however.

Compared with craft beer, the craft spirits movement is relatively young, and demand is swelling. The market is nonetheless also growing more saturated, but growth avenues are more pronounced in Sonoma given its early entry.

**Operating expenses.** Improving prices for wine grapes combined with strong wage growth will have mixed effects on operating expenses. Wage and salary disbursements to California agricultural workers rose nearly 7% in 2021 and are forecast to advance roughly 5% in 2022. Grape prices rose 11% in Sonoma County compared with last year, according to the USDA Grape Crush Report, and another small crop yield should continue to put upward pressure on prices this year.

Craft beverage makers will likewise see an increase in operating expenses. Input prices are substantially higher this year than last; aluminum prices were 36% higher year over year through November and barley prices are up 107% over the same time period. Commodity prices, specifically higher fertilizer and gas prices, will remain elevated as the Russia-Ukraine conflict persists, resulting in increased operating expenses for Sonoma's craft beverage makers.

**Profitability**. Sonoma wineries had a strong year, with those agile enough to switch to off-premises sales channels enjoying stronger sales numbers in 2021 than in the prior year while those that rely heavily on in-person winery visitation struggled, albeit to a much lesser extent than in 2020. With restaurants and tasting rooms reopening, and with lessons learned when restricted business conditions drove innovation and evolution, wineries fared much better over the past year. According to financial statements collected by Silicon Valley Bank, through September 2021, sales growth was up a whopping 21% and pre-tax profits up a similarly strong 19%.

Wineries that rely heavily on tasting room visits will benefit from the continued release of pent-up demand for leisure travel. Sonoma hotel occupancy rates at the end of 2021 are approaching their pre-pandemic level, giving evidence that travelers are still returning en masse as contagion fears ease, and the continued return to normal will likely see winery visitation follow the same path. Profitability will remain strong by historical standards, but the rise in input prices will ensure that it falls below last year's levels.

**Long-term outlook.** Sonoma County's wine and craft beverage industry showed its mettle over the past two years to persevere through the difficult environment. Some of the pain from the COVID-19 pandemic will linger, and it will take some time for small breweries and family-owned wineries to recover from the 2020 recession. Odds are that the economic recovery will take further hold this year, despite the plethora of downside risks, and will provide favorable economic tailwinds to the wine and craft beverage industry as the labor market marches towards full employment.

As millennials overtake Gen Xers and baby boomers as the largest wine-consuming cohort, sales of fine and premium wines will slow from the brisk pace of the past four years. The large presence of craft breweries and spirit makers will help Sonoma's economy weather these changes. While enthusiasm for craft beers and spirits is frequently ascribed to millennials, the thirst for craft offerings cuts across generations and will help the beverage industry diversify.

Still, winemaking remains the beating heart of Sonoma's economy, and vintners will need to do better with millennials to ensure a healthy base of demand in the long run. Millennials are entering into their prime spending years, and they will wield significant purchasing power as their careers progress. Wineries that emphasize brand origin and environmental stewardship as well as promote new dining experiences will find success.

The landscape for craft beers will grow increasingly bifurcated. While smaller craft breweries will be able to draw on county residents and tourists seeking an increasingly diverse dining experience, midsize and large breweries with national and global ambitions will face price pressures. Recent downsizing by Lagunitas is just one example, with slowing sales and lower profit margins forcing layoffs at local facilities.

Makers of craft spirits will face similar pressures as the craft spirits movement matures. Foreign markets will grow in importance for craft beer and spirit makers. Replicating the success of winemakers in cultivating a taste for more sophisticated offerings in China, emerging Asia and Latin America will be critical to their long-run success.

**Upside risks.** Consumer spending could exceed expectations and drive faster growth. Last year, a fresh round of fiscal stimulus drove the U.S. saving rate above 20% and excess saving fueled consumption growth. The saving rate declined by the end of last year to close to the pre-pandemic rate and is expected to decline further this year. If baby boomers spend like they have in the past, the saving rate could come down even more. Further, if widespread worker shortages drive wages higher than expected, consumer spending could rise even more. This would disproportionately benefit Sonoma wineries and breweries that depend heavily on visitor traffic. Further, recreation and travel spending could surprise on the upside, as would-be travelers may still have been hesitant to travel in light of numerous COVID-19 variants over the past year.

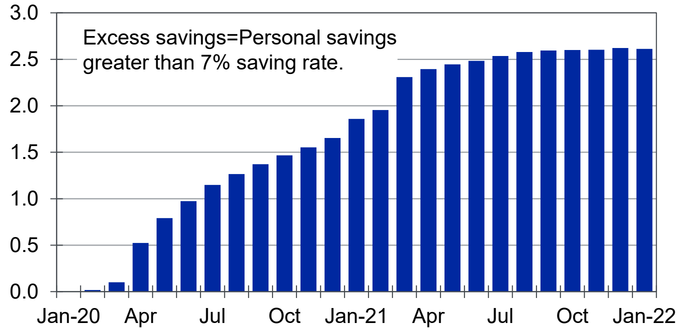
**Downside risks.** Rising long-term U.S. interest rates will tighten financial markets. One risk is that the rise in long-term interest rates will precipitate further correction in equity markets. A prolonged slump and a tighter financial environment would weaken the economy, and especially damage the wine industry given its reliance on high-income earners. Lower equity prices may sting consumer spending via the wealth effect.

Climate change remains a particularly important downside risk for Sonoma County's wine industry. Another severe drought or wildfire could deal a more serious blow to vines and production facilities. The California wildfire season is getting progressively longer, and insurers are growing hesitant to shield county businesses against wildfire risk given the enormous losses suffered in recent years.

*Colin Seitz*
*April 2022*

## Excess Saving Tops Out

Cumulative excess savings, $ tril, 2020

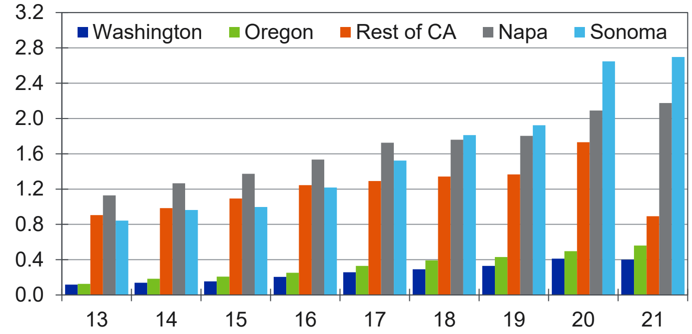



Sources: BEA, Moody's Analytics

The drawdown in excess savings will continue through the year. While income growth should be good given the tightness of the labor market, high inflation will boost nominal spending, as will the recovery in service spending as infections decline and consumers return to pre-pandemic activities. Risks remain high but likely skew toward even lower saving if consumers spend more of the cash in their balance sheets, either out of desire or because events in Europe drive inflation higher than anticipated. The release of excess savings will drive a strong year for Sonoma's wine and craft beverage industry.

## Sonoma Extends Lead in Direct Shipments

Cases, 9 liters, mil

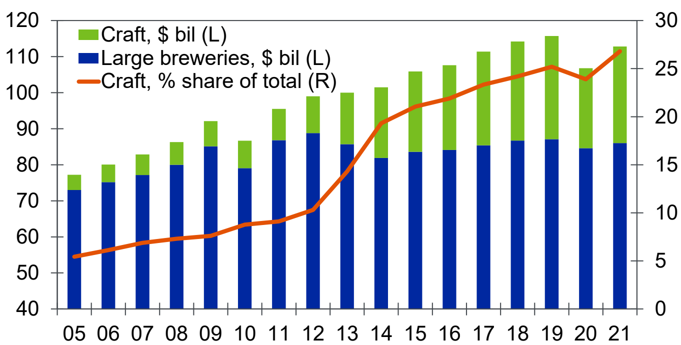



Sources: Wines & Vines Analytics, ShipCompliant, Moody's Analytics

Direct shipments are a crucial avenue of sales for Sonoma County's smaller and midsize wineries. Sonoma has outmuscled fierce competition from within the state and the Pacific Northwest to maintain its lead in shipment volumes, even if 2021 marked a slower pace of growth compared with historical averages. Sales volume still trails that of Napa because of a lower average price point. Sonoma nabs just over 20% of the total value of direct-to-consumer wine shipments, while Napa is nearing 50%.

## Craft Ales Nab More Market Share

Retail sales, beer, U.S.

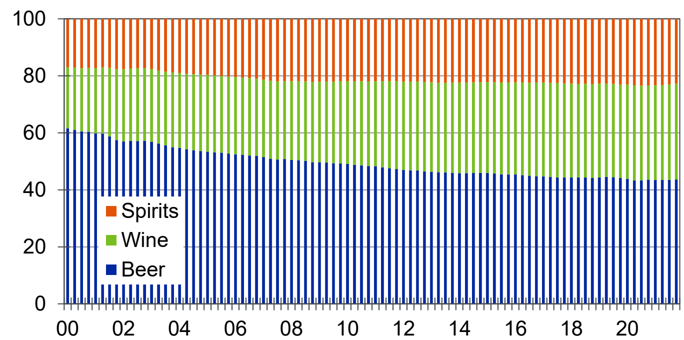



Sources: Brewers Assn., Moody's Analytics

With the return to normal taking hold in 2021, the craft beverage industry saw a more typical year than in 2020. The share of the overall beer market increased yet again, with strong sales growth tied to more on-premises consumption and flush consumers. Local brewers' nationally renowned ales will safeguard sales amid an increasingly concentrated market. Though the market is growing saturated, consumers have a demonstrated preference for craft beer, and we expect this trend to resume in 2022 as the economy reopens.

## Beer Makes Way for Wine and Spirits

Real personal spending on alcoholic beverages, %




Sources: BEA, Moody's Analytics

Total beer sales continue to lose ground to wine and spirits as consumers take a pass on mass-market ales. Although beer still makes up nearly half of total off-premises sales of alcoholic beverages, its market share has steadily eroded as wine and spirit makers have capitalized on consumers' willingness to drink better, if not more. While sales of mass-market beer brands have flagged, growing enthusiasm for craft beer and spirits bodes well for county producers.

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