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Themes in the California Wine Industry: Exploring Paso Robles AVA

When assessing investment opportunities in permanent crops, there are typically two fundamental dynamics we look for: strong, consistent demand trends and somewhat constrained supply growth of the crop. We see both of these play out in certain pockets of the California wine industry.

In this report, we update you on the state of the California wine grape industry and regions that may be well-positioned to take advantage of market tailwinds.

Key Takeaways

- The premiumization trend in consumer wine preferences continues to hold as \$15+ bottle sales grow.
- The Central Coast, specifically Paso Robles AVA, has drawn industry attention due its renowned cabernet sauvignon-growing climate.
- Land value growth in the Paso Robles region is supported by limited supply of vineyard acreage due to water supply constraints.

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State of the California Wine Industry

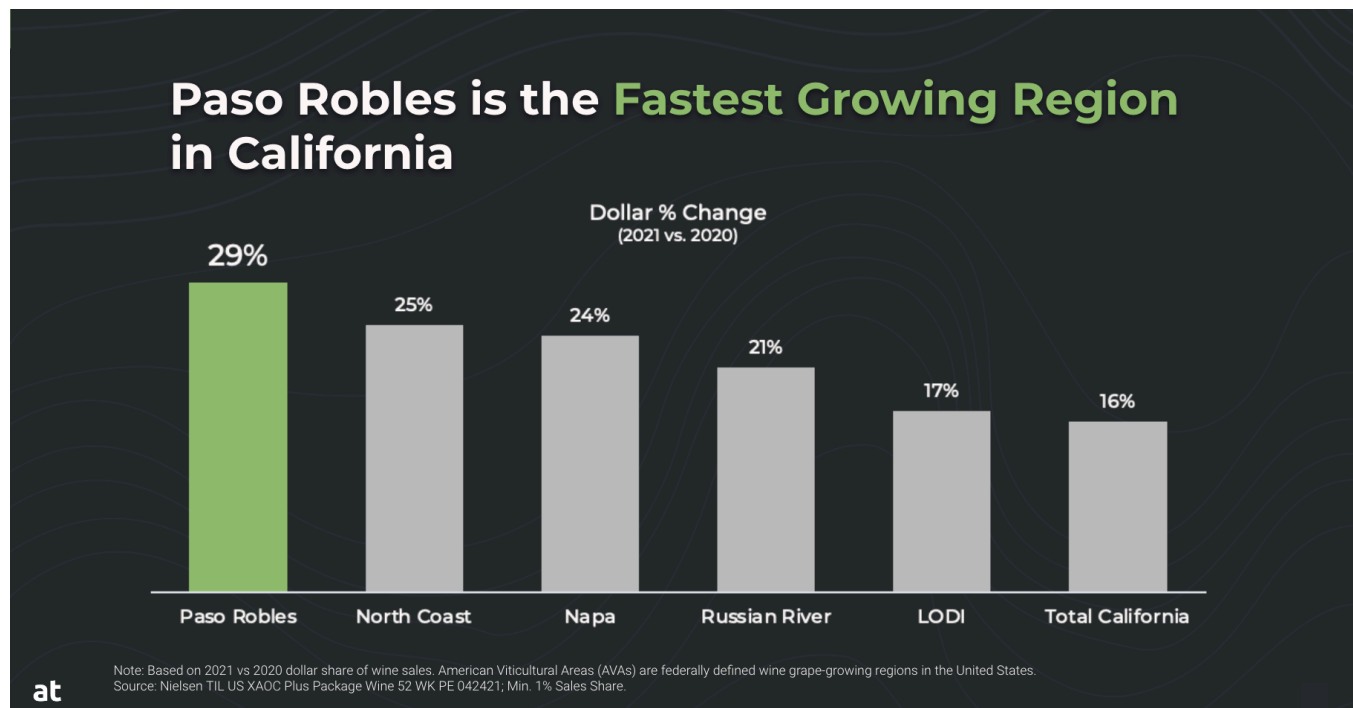
Compared to the “old world” wines of Europe, the United States is relatively new at the winemaking craft. Yet in the less than 100 years that the U.S. has been producing commercially marketable wine, it has made a name for itself on the global wine stage.

Golden State of Wine

The U.S. wine industry is largely defined by the state of California, which produces ~80% of the nation’s wine, making it the world’s fourth largest wine producing region. Ever since the first winery was founded in Napa back in 1854, California winemakers have led the way in U.S. wine production. Today, California has over 580,000 acres of vineyards and more than 100 American Viticultural Areas (AVAs), each with its own soil, microclimate, and terroir. Broadly speaking, California can be divided into four large wine regions:

- North Coast
- Central Coast
- South Coast
- Central Valley

While the North Coast’s Napa and Sonoma County AVAs are the most widely recognized, a number of prominent Central Coast regions are now considered to be some of the most exciting and dynamic areas of California wine production. These include the Santa Cruz Mountains AVA and Santa Ynez Valley as well as Paso Robles AVA⁽¹⁾.

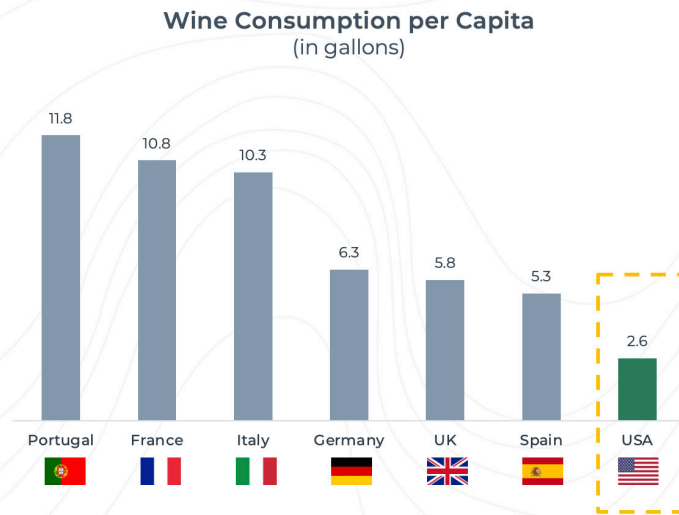


Past performance does not guarantee future results and there is no guarantee this trend will continue.

Theme 1: Consumer Preferences Have Changed

On a global scale, the U.S. is the top country in terms of total wine consumption. This has been steadily increasing since the early 1990s. But looking at consumption on a per capita basis, the U.S. is not even among the top 10. The Portuguese drink about ~12 gallons per person per year (~60 bottles) compared to the American's ~3 gallons per person (~15 bottles)^(2,3). **This suggests that there could be room to grow in terms of future U.S. market capture.**

Opportunity For Growth for US Market Capture



Source: OIV, April 2022.

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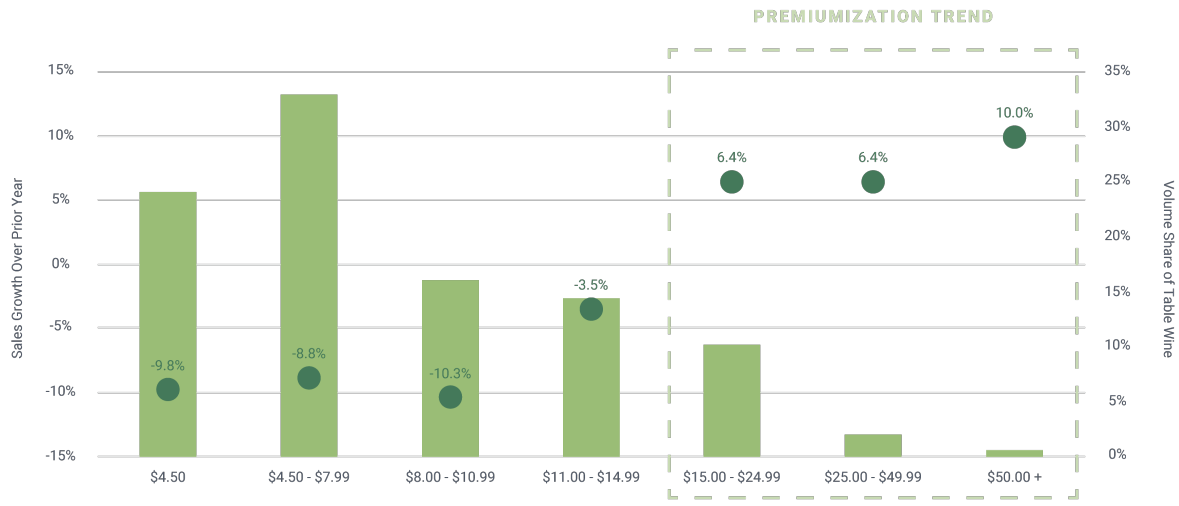
While per capita consumption has increased nearly 40% over the last two decades in the United States⁽⁴⁾, industry volumes are facing a number of headwinds. A variety of factors including the rise of cocktails and increasing alternative health-marketed beverages have slowed some interest from younger demographics in recent years. In a report published by Silicon Valley Bank, data shows that the largest consumer cohort of wine is over the age of 65, and it is key for the industry to capture additional market share with younger consumers.

Interestingly, wine consumers have shown a consistent trend in recent years of buying higher-priced bottles. Despite lower total volume consumed in 2022, overall sales dollars should be positive. **This trend of sales growth for \$15+ per bottle wines is called "premiumization."**

Theme 2: Continued Premiumization Presents an Opportunity

Industry sales data shows that there are two stories in the wine market: **sales for lower priced wines are decreasing, while there is continued growth for the higher priced bottles.** So while volumes may be stagnant, wine consumers are choosing to spend more.

Bifurcation in Sales Trends Presents an Opportunity



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Source: SiipSource via SVB State of the US Wine Industry 2023

While it is worth noting that sales for bottles priced \$11 and below accounted for ~73% of total wine volume sales in 2022, **the widened gap between preference for higher priced bottles has been gaining momentum since 2015.**

We're seeing winemakers shift their strategy in line with consumer behavior to focus on premium lines, as well as sustainability, and digital commerce. For example, in 2021, Constellation Brands expanded their commitment to scalable, premium wines by acquiring Paso Robles-based Booker Vineyard. Booker Vineyard produces luxury Rhône varietals with bottles ranging from \$30 to \$160.

Cabernet Sauvignon Continues to Reign

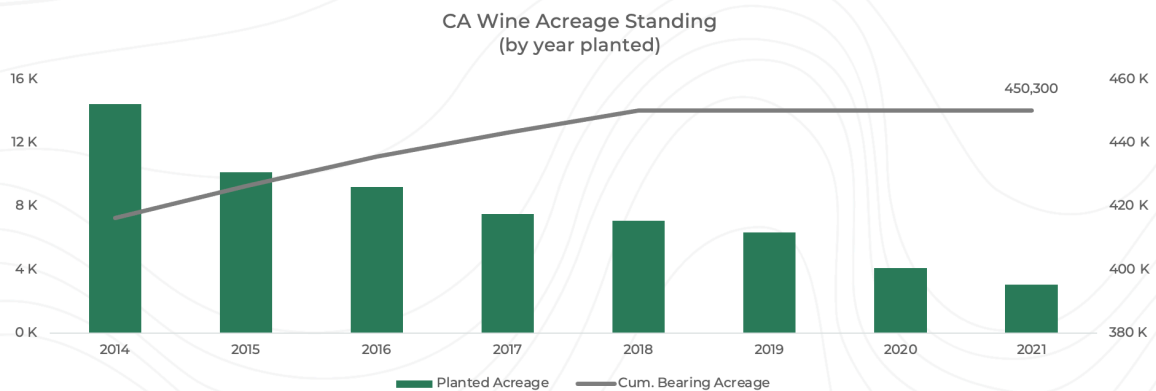
As consumers treat themselves to these higher-priced bottles, cabernet sauvignon remains the primary choice. It is California's most planted grape variety, with most of the state's cabernet acreage located in Napa, San Luis Obispo, Sonoma, and San Joaquin Counties⁽⁵⁾. Out of the total 525,000 acres planted in California, nearly 88,000 are dedicated to chardonnay and 90,000 are dedicated to cabernet sauvignon. An industry saying is, "Cabernet sauvignon is king; chardonnay is queen," and data indicates that still stands true.

According to BevAlc Insights, cabernet sauvignon is the only grape variety to experience share gains since 2019. **"This is tied to premiumization in the red wine category, as cabernet sauvignon has one of the highest average unit prices among the top-selling varietal wines,"** says Liz Paquette, head of consumer insights at Drizly⁽⁶⁾. The majority of top-selling regions in 2021 to date are nearly all from the U.S., specifically California: Napa Valley, Sonoma Coast, Paso Robles, North Coast, and Central Coast.

Supply and Demand Fundamentals Have Shifted

An additional tailwind in the industry is the decline in production over the last three years due to wildfires, limited water availability, and freeze impact. Lower production, coupled with surge in wine sales during the pandemic, brought stability to the supply-demand gap from 2018/2019.

Decline in Rate of Incremental Planted Acreage



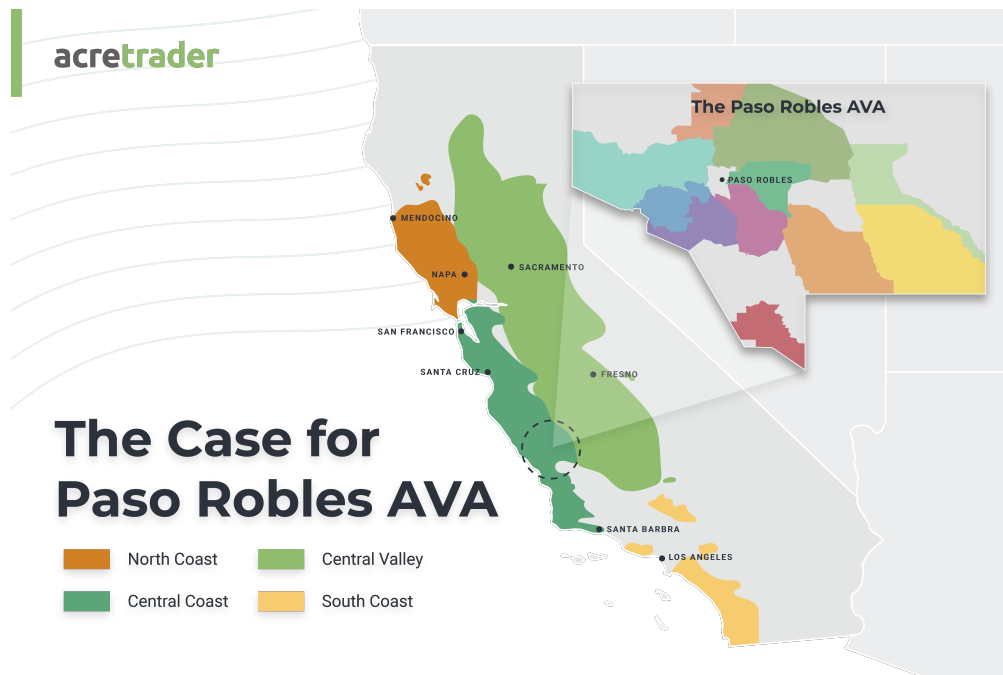
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Note: Non-bearing years are 2019, 2020, 2021.
Source: California Grape Acreage Report, April 2022.

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Declining levels of new plantings indicate that supply growth is constrained and new plantings are targeted rather than speculative. The targets in SGMA (Sustainable Groundwater Management Act) are projected to reduce irrigated crop acreage in the state by 2040, and wine grape growers are feeling the pressure. Regions like Napa and Sonoma are heavily dependent on groundwater for irrigation; valuations for acreage with only one source of water may see declines. Continued pumping restrictions in the next few years will determine which acreage can stay in production and which risks being fallowed. **This means most red varieties are expected to decrease in acreage in the most prestigious wine regions between 2022 and 2025.**

Theme 3: Paso Robles Well Positioned for Current Trends



As we've noted, demand for wine at higher price tiers is still growing at a healthy pace. **However, vineyard land suitable for these higher priced wines is limited.** Rick Tigner, CEO at Jackson Family Wines, said the challenges they face are with the upscale labels' ability to meet demand⁽⁷⁾.

High land costs in Napa and Sonoma have forced some wineries to find equally suitable acreage at a more economical rate elsewhere. Wine companies have found that **Paso Robles provides what they need: prime grape-growing climate, great soils for cabernet sauvignon grapes, and a relatively attractive entry price.**

Paso Robles Overview

Down Highway 101, 50 miles from the Pacific Ocean, behind the Santa Lucia Range is the Paso Robles AVA. An American Viticultural Area, or AVA, is a defined grape-growing region with specific geographic or climatic features that distinguish it from the surrounding regions and affect how grapes are grown. **Well-known AVAs can command premium pricing for their grapes.**

Paso Robles is California's largest geographic appellation covering over 24 square miles and is **California's fastest growing AVA**, growing from 50 wineries in 2000 to over 200 today. The region is known for its red wine grapes: cabernet sauvignon, merlot, zinfandel, syrah, grenache, and petit verdot, among others. In all, more than 60 wine grape varieties are grown in Paso Robles.

Paso Robles Terroir Provides the Grapes for Great Wine

Terroir is a French term that means "a sense of place." This term is commonly used to describe how a particular region's climate, soils, and terrains should affect the taste of wine. One of the standout characteristics of Paso

Robles is the region's contrasting day and night temperatures that are optimal for wine grape growing. During the growing season, daytime temperatures can exceed 100°F. The heat allows the grapes to fully ripen without introducing unwanted vegetal flavors. **Heat-loving grapes such as cabernet sauvignon, grenache, zinfandel, and syrah thrive in this environment.** At night, temperatures can drop dramatically to ~50°F. This diurnal shift is caused by gaps in the Santa Lucia Range, and the cool climate allows the grapes to maintain high levels of acidity and limits sugar overproduction. Here, the grapes benefit from one of the longest wine-growing seasons in the world.

Due to its location along two tectonic plates, Paso Robles AVA sits in the largest calcareous-based soil formation in all of California. Calcareous soils are desirable for wine grape growers as they simultaneously allow for water retention during dry seasons and drainage during wet periods.

Strategic Institutional Expansion into Paso Robles

We are seeing evidence of this growing presence from large wine companies with the expected launch of a new Paso Robles-based line from Terlato Family Wines, the E&J Gallo acquisition of Denner Vineyards, and JaM Cellars' new tasting room in downtown Paso Robles, among other transactions. As Trinchero Family Estates President and CEO said, "It seems like the Central Coast area is going to be pivotal."

Entrants into the market have been driven by two factors: premiumization and scale. The primary market movers have been established regional brands wanting to expand operations or large-scale brands bolstering their premium labels.

Recent transaction activity has quieted in the Monterey and Santa Barbara Counties as **soaring land prices in those regions have pushed investors down to the Central Coast.**

Andrew Adams, editor for Wine Analytics Report, confirms: "I mean, the number of **winemakers I used to work with in Napa that are now buying vineyards here**, or taking trips down here and just being tourists, I feel like we've tried to talk a big game for a long time, and I think finally we are seeing the fruits of all this and are really kind of breaking through and getting a lot of attention."

Case Study: Duckhorn Acquires \$17 Million Ranch in Paso Robles

An industry bellwether, The Duckhorn Portfolio (NYSE: NAPA) sent the market confirmation of Paso Robles' attractiveness with their May 2022 acquisition of 289 acres for \$17 million. **"There is a reason why Paso Robles has the most cabernet sauvignon acreage of any appellation in California outside of Napa Valley,"** said CEO Alex Ryan, who joined the company as a vineyard manager in the early 1990s.

The farm is exclusively planted with cabernet vines, featuring seven top clones on three drought-tolerant rootstocks. The acquired land will support Duckhorn's premium Decoy and Postmark lines.

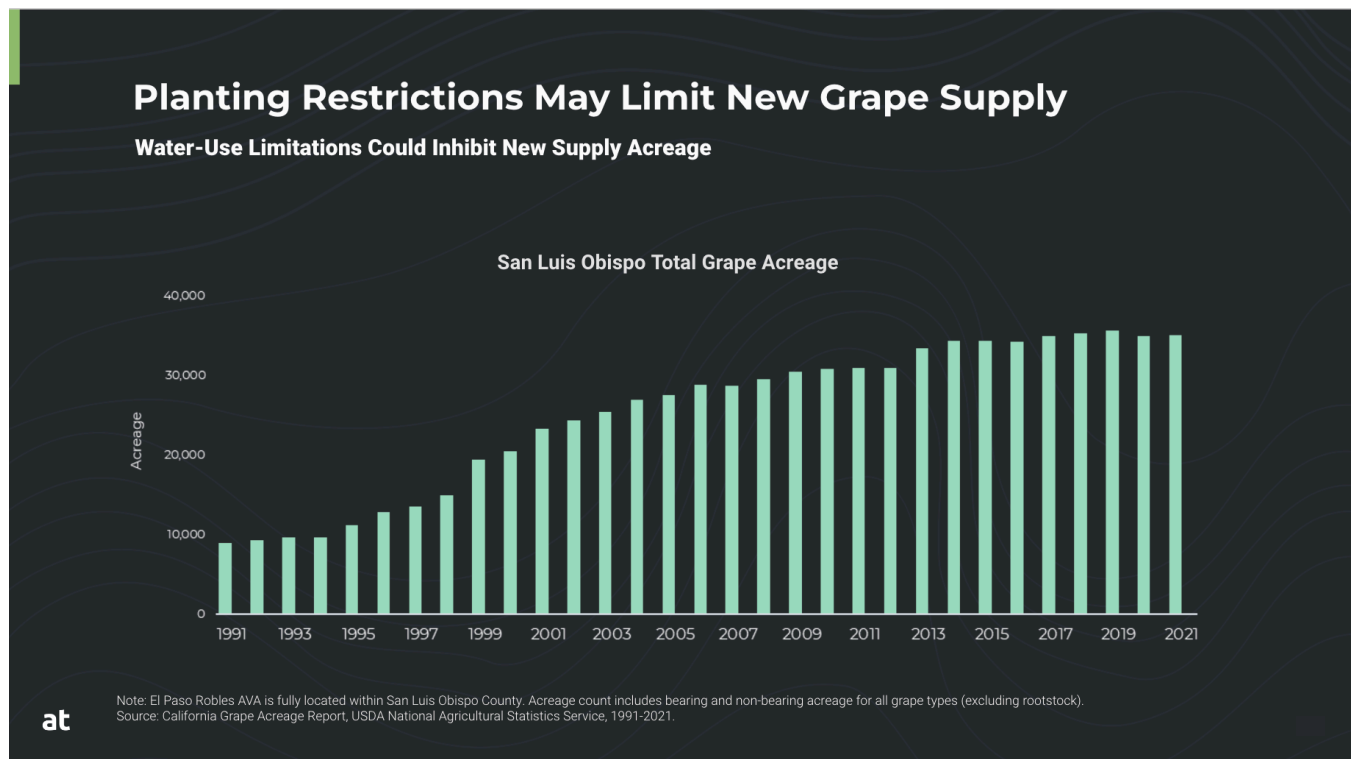
And there are indications there may be further expansions in the future. At the Barclays Global Consumer Conference in September 2022, when asked about brands, outside of Decoy and Duckhorn, that have the potential to scale the portfolio, Ryan responded, "We have a couple of winery brands that we're working with in the Central Coast, down at Paso Robles. **We think that is another up-and-coming wine region.**"

Other Notable Paso Robles Transactions

- E&J Gallo acquires Denner Vineyards⁽⁸⁾
- Riboli Family Wines purchases \$9.1 million vineyard and residence in Paso Robles⁽⁹⁾
- Booker Vineyard acquired by Constellation Brands⁽¹⁰⁾
- Rabble Wines acquired by O'Neill Vintners & Distillers⁽¹¹⁾
- WX Brands acquires portfolio of wines from Niven Family Wine Estates⁽¹²⁾

Narrowing Supply of Quality Acreage

San Luis Obispo County, where Paso Robles sits, passed a planting offset requirement in January 2023 aimed at reducing groundwater usage. Well restrictions highly impede new acreage in a desirable area, further limiting supply of in-demand appellation grapes. Coupled with declining grape market supply, this is likely to put upward pressure on pricing.



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Final Thoughts

The wine industry at large feels a level of apprehension due to a number of factors: high interest rates, inflation and rising costs, the potential for a recession, and shifting attitudes from younger consumers.

Despite the challenges, there are investment opportunities within the industry. Assets in great grape-growing regions continue to appreciate in value and are seen as attractive havens in turbulent macro environments. Demand for high-quality winery and vineyard properties continues to exceed the supply. Given that dynamic, it is likely that transactions will continue into 2023 with wine assets holding their value overall.

When looking for any permanent crop investment opportunities, we always like to start with the combination of restricted supply and strong demand trends. This causes us to be highly selective when identifying vineyard investment opportunities. Wine grape supply for premium varieties in premium regions is often restricted by the AVA and lack of water availability. Demand trends are supported by the premiumization trends we see as clearly evident in wine.

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