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Covid-19 and the US Premium Wine Market, Part I: The Challenges

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Summary

In Part I of our two-part series, we look at the challenges currently facing the US wine industry (hardly 'breaking news' at this point) and argue that the recovery of this channel will take years. The Covid-19 pandemic has created massive disruption to on-premise channels in the US (as it has in other markets), and this is creating significant revenue losses for wineries. The on premise is an important channel for small, premium wine brands, so these challenges are weighing on winery revenues. Some in the industry are hopeful for a quick recovery of the on-premise channel, but Rabobank believes that sales in full-service restaurants and bars will not return to 2019 levels until after 2022. This will create a great deal of pressure for small, premium wholesalers in this market (who over-index on this channel) and, by default, for the wineries they serve.

With the challenges facing the on premise, premium wineries will need to find new ways to engage consumers. Digital strategies will become an increasingly critical component of success but must go beyond traditional direct-to-consumer models to engage the consumer across channels.

Many of the wineries we've spoken with agree that e-commerce must be an increasingly important part of their strategy moving forward, but even those willing to make the investment have a myriad of questions about how to proceed. How do we create it (buy or build)? How should this new structure fit in the organization? If these are the questions your winery is struggling with, stay tuned for Part II of this series, which we will publish shortly.

Covid-19 Has Disrupted Premium Wine Sales

Covid-19 containment measures, such as shelter-in-place and lockdown orders, have pummeled the on-premise channel. Over March and April 2020 combined, an estimated USD 47bn YOY (-75%) reduction in total sales occurred in US foodservice and drinking establishment channels (*see Figure 1*). Accounting for early year-on-year sales growth in January and February, total sales for the first four months of 2020 are down an estimated USD68bn (-22%). The percentage decline in wine sales in the on-premise channel is even higher, given its exposure to full-service bars and restaurants, which performed even more poorly than limited-service restaurants.

Retail Picks up Some (but Not All) of the Slack

Increased retail sales have somewhat compensated the wine sector for reductions in foodservice and bar sales. Over the period from late March to late May 2020, Nielsen reported off-premise wine sales rose by more than 30% in value year on year. But it is important to note that this somewhat overstates the sales shift to off premise, as scan data does not capture sales via smaller, local, independent retail stores and smaller-scale retail chains, which tend to skew much higher in average prices (relative to scanner-measured channels) but do not appear to have seen the same lift in sales.

The On-Premise Channel Is Small Volumetrically but Very Important for Access and for Margins

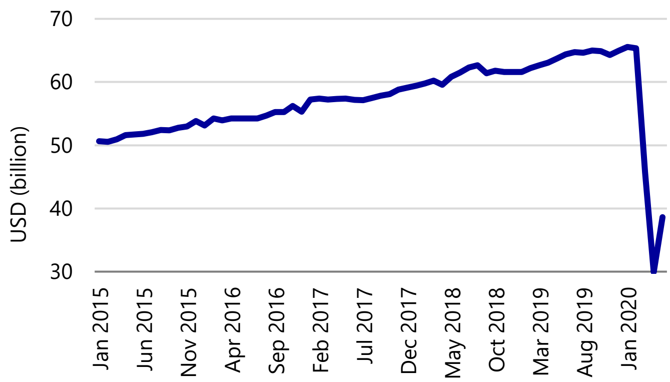
On-premise sales in the US normally account for less than 20% of annual wine sales volume, but, as with the independent retail channel, average sales price and average margin per case for wineries tend to be much higher than scanner-measured channels, such as large chain or 'big box' retail (45% of US sales by volume in 2019).[1]

For small premium brands, accessing major retail chains was difficult going into this crisis, and we expect the penetration gap is likely to get worse for small brands. Nielsen reports that the top 100 brands in the pre-Covid-19 era accounted for 65% of off-premise sales, but by May 2020, this had risen to 70%. Many retailers and wholesalers were already complaining of SKU overcrowding, and the current crisis is giving them an opportunity to reduce SKUs and simplify operations.

Pivoting Supply to Other Channels Is Not So Easy

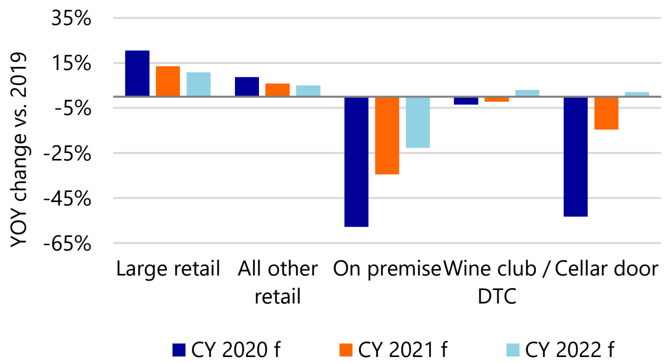
Covid-19's disruption of direct-to-consumer sales accentuates the problem of where and how to sell for smaller wineries. In the pre-Covid-19 era, smaller premium brands held the ability to extract a high margin from their direct sales channels. Disruption will continue to occur in this channel from containment measures, followed by lingering concerns over travel/contagion, as well as recessionary impacts. It is expected that in the next two to three years at least, on-premise and direct-to-consumer channels will remain disrupted components of the small winery trade (*see Figure 2*).

Figure 1: US advance retail sales in foodservice and drinking establishments, 2015-2020



Source: US Census, Rabobank 2020

Figure 2: Changes in wine sales volume by sales channel, 2020f-2022f



Note: 123
Source: 123

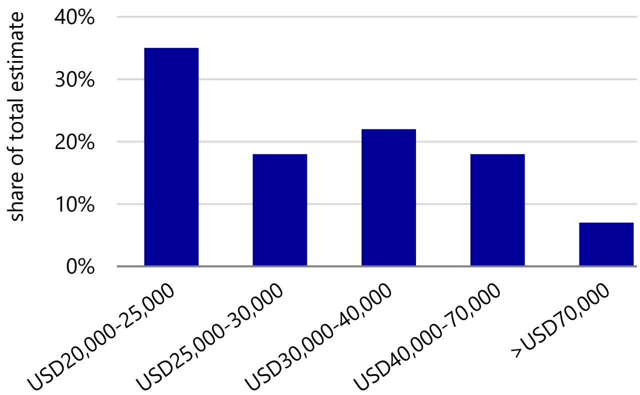
[1] According to bw166 estimates, average winery revenue per case sold to the on premise is ~50% higher than in scanner-measured channels, and in independent retail channels, it is ~75% higher.

Rising Optimism From Initial Moves to Open Up

Signs that some confidence is slowly returning to the US job market emerged in May, as the US added 2.5m jobs – a much quicker rebound than economists had predicted, though still a long way off from replacing all of the 47m jobs lost during the pandemic. Of the jobs added, 1.5m were in the hospitality and leisure sectors, which were hit hard and early in the pandemic.

The rebound in on-premise sales in recent months has been encouraging, but the sector remains under extreme duress. A true recovery will only occur when affluent consumers have both the means and the confidence to go out again. In terms of having the means, the good news for wineries is that more affluent consumers were less affected by the recent spike in unemployment with forecasts highlighting this is expected to remain the case (*see Figure 3*).

Figure 3: Estimated vulnerable US jobs by annual income band



Source: McKinsey & Company April 2020, Rabobank 2020
Note: Vulnerable jobs are considered to be those subject to furlough or layoff or to becoming unproductive during periods of high social distancing.

Barring a Vaccine, the On Premise Will Likely Take Years to Recover

That said, we believe that a recovery in the higher end of the on premise will take more time. A recent Nielsen survey of those that have returned to the on premise since reopening began indicates that 88% have had a positive experience. However, the survey also suggests that older consumers (more vulnerable to the virus and a key demographic of luxury wine buyers) may be more reluctant to return to the on premise; only an estimated 6% of consumers that are +55 years have returned to the on premise for food or drink, compared to 27% of 21- to 34-year-olds.

But the Covid-19 pandemic will also weigh on traffic to bars and restaurants in other ways, as business travel and tourism are expected to decline and as more people will be working from home rather than commuting in to city centers (and eating meals there).

Between government enforcement of social distancing measures, the reluctance of some segments of consumers to return to the on premise due to fears of contagion, and reduced business and tourism travel, many bars and restaurants will be forced to permanently shut their doors unless a vaccine is made available sooner than most experts expect. These businesses run on very thin margins and generally must function at 70% capacity or more just to break even. This is looking increasingly difficult to achieve for many operators.

Given these (and other) challenges, a recent Rabobank report suggests that the foodservice industry will likely not return to 2019 levels until mid- to late 2022 and that the recovery will be led by limited-service restaurants and take-out/delivery, where wine generally under-indexes. Sales in bars and full-service restaurants – where wine is sold – are not projected to fully recover until after 2022.

Challenges in the On-Premise Trade Will Have Knock-On Effects

The dramatic slowdown in the on premise during the pandemic has led to a dramatic spike in accounts receivable at risk among wholesalers. Larger wholesalers who have a greater proportion of sales in the off premise, as well as more financial muscle, should be better placed to withstand this. Small wholesalers, who often tend to be over-indexed to the on premise as a proportion of their sales, will find this environment more difficult, especially given the doldrums this channel faces in the coming years.

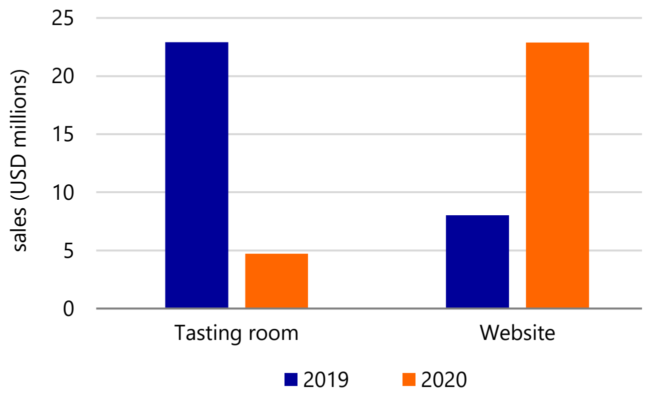
This, in turn, raises the likelihood of a potential increase in consolidation in the wholesale sector, as some smaller wholesalers will be forced to 'throw in the towel.' As a result, smaller premium brands, either domestic or imported, will likely have even fewer options for gaining access to traditional wholesale channels.

The Path Forward Is Increasingly Digital

Given the challenges in the on premise, much of the sentiment in the industry has been understandably pessimistic. The structural challenges facing this critical channel will have unavoidable consequences for the industry. Wineries – not just in the US, but around the world – are going to have to find new pathways to the consumer.

While the on premise is facing monumental challenges, the growth in e-commerce has also been well documented and provides an important opportunity for wineries seeking alternative growth strategies. This process is well underway, as wineries have already begun to offset the decline in tasting room sales with e-commerce.

Figure 4: Tasting room and website sales (USD) for US wineries, 2019 vs. 2020



Source: Wine Direct, Rabobank 2020

While social distancing and shelter-in-place orders have provided a natural lift to e-commerce sales, these incentives are expected to fade as markets begin to reopen. As a recent Rabobank report notes, e-commerce sales will likely experience a palpable decline as consumers revert to more normalized routines, though not all of the e-commerce gains will be lost, and growth rates will likely be slightly faster than pre-Covid-19 rates moving forward.

E-Commerce Beyond Direct-to-Consumer

Perhaps one of the biggest changes required by many wineries will be to think about e-commerce much more broadly than as a means of driving direct-to-consumer sales. Improved direct-to-consumer sales will likely be one result of an effective digital strategy, but sales should only be one goal of a robust e-commerce program. Beverage companies are finding new, innovative ways to connect with consumers, wherever they are, in a digital environment and to help drive sales across channels. Tsingtao, the Chinese beer company, took the lockdown measures as an opportunity to create a network of 'community distributors' (essentially social media influencers working on commission) that has been extremely successful by a number of measures (see here for more details).

Moving forward, the challenge will be for wineries to find ways to engage the consumer that help drive sales via whichever channel the consumer chooses

"OK... but How?"

In conversations we have had with wineries (in the US and abroad), many are reaching the conclusion that e-commerce will indeed be an important component of their strategy moving forward. Once that conclusion is reached, however, there is then a series of pragmatic follow-up questions about how to proceed. How do we think about e-commerce within the organization? Should we buy or build an e-commerce team? Where should it sit within the organization? How do we get started?

These are important questions, and we will lay out our views on them in detail in our upcoming Q3 Wine Quarterly. Stay tuned!

Imprint

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