

Silkbush Management Report

August 24, 2017

Tom Fish, my old partner, used to say “a late report is a bad report;” perhaps this is not be a bad report, but it certainly is tardy and somewhat discouraging. Most importantly, the lack of rain in the Western Cape is quite severe. They have experienced drought for several years and so far this year appears no better. A normal year is 700 mm of rain and so far they have received only 150 mm. Our upper dam is 30% full, the lower dam is 40%, and the winter season is 50% complete. Both can fill up completely with a good 50mm, two day rainstorm but we have not seen one this season. The cities are rationing water, and all water for agriculture will be turned off as of the end of August if conditions do not markedly improve; only water for residences will be supplied and then in short supply. Because we are high on the mountain, we will likely still be able to use all our water runoff but it will not be enough for maximum crops.



We have replanted 4.7 Ha (almost 12 acres) to Cabernet Sauvignon and Sauvignon Blanc, and the young vines are doing well. There is strong and continuing demand for both varieties. We are improving our domestic wine sales and hope to establish more direct relationships with hospitality industry operators, such as described below, where “every night is Saturday night” for less price sensitive wine sales.

We would also like to highlight the continuing success of Flagstone Winery’s Writers Block Pinotage, sourced entirely from the highest block of grapes planted on Silkbush. Writers Block won its 5th Absa Top 10 award and three in a row this year, by the way. (See: <http://flagstonewines.com/blog/flagstone-makes-it-3-in-a-row-as-absa-top-10-pinotage-winner/>) This is indelible proof that Silkbush produces exceptional Pinotage grapes, at least equal the best in South Africa, irrespective of our relative inability to obtain traction for the varietel in the US.

2017 HARVEST REPORT

Our 2017 harvest came in at 821.1 tons, down almost exactly 100 tons from the year prior. Although not as badly as many other growers, the drought has impacted us. Anton believes the past harvest will be remembered as one of exceptional quality all round. All our buyers are extremely happy with the quality received and this is mainly due to the excellent ripening conditions and early season we had.

We anticipate 948.4 tons in 2018, predicated on more normal yields and some 16 tons from newer plantings of Pinot Noir, Grenache, and Durif. By the way, we are now growing some 14 different cultivars (varieties) and delivering to 8 different wineries. We are actually selling 70% of the crop to 6 different wineries, delivering 22% to Wabooms (our former cooperative that still operates like a coop), to be paid God knows when, and 8% to Bergsig (6 cultivars totaling 73 tons) to be made into Silkbush wine. We still have a few virus-impacted blocks which we are steadily replanting. When we are fully replanted and at vineyard maturities, we should be producing about 1200 metric tons/year.

Dialogue Started with VWE, Potential Distribution and/or Joint Venture Partner

We have been acquainted with Pat Roney, CEO/Founder of Vintage Wine Estates (VWE), for more than five years and have been impressed with his entrepreneurial creativity and success in the wine business. Vintage Wine Estates (www.vintagewineestates.com) at present owns 28 wineries, only one of which is outside the US; they are a privately held

company with plans to go public in another two years or more when their sales have increased from \$170 million to at least \$250 million. They presently produce for their accounts and clients, including Costco, over 5 million cases/year. About three years ago, VWE gave serious consideration to acquiring our Chiles Valley Vineyard in Napa County, liked the fruit, but could not obtain sufficient bank financing. They are also now keen to acquire the balance of our Napa Valley holdings in Wooden Valley, although we are not prepared to sell those 330 planted acres.

In recent days we have provided samples of Silkbush Viognier and Altitude Cuvee for consideration for US distribution and possible JV involvement. VWE has a developing relationship with Hillhouse Capital, Beijing China, a 12 year old company with \$30 Billion under management. ZHANG LEI, the founder/CEO is a Yale MBA and believer in long term projects. If Hillhouse takes a financial position with VWE, we will be considered very seriously for an additional diversification investment. This is a long shot but definitely worth the effort.

Wine Marketing: US and abroad

Suzanne, our rep in Natal, has gotten us a good contract with Kazuko Lodge for private label, entry level red and white wines, approximately 30 cases/month, and additional supplies of our higher priced wines. Kazuko is a 10 year old game camp operator in the East Cape, not on the beaten path around Kruger Park in the NE of the country; It is an innovative eco-tourism and empowerment project, having rehabilitated around 39,000 acres of land and creating employment in an area with a 70% unemployment rate. Kuzuko Lodge, (www.kuzuko.com) a five star, luxury resort based in the spectacular Eastern Cape Province which combines job creation, conservation and transformation. This safari park, offering the “Big 5” in a Malaria free area, is managed by Legacy Hotels and Resorts International and has been contractually incorporated into the Addo Elephant National Park.

One encouraging step forward has been Selena Cuffe’s sales efforts in the US with Southern Glazer Wines (the largest wine distributor in the US). She has us now being carried in New York, Illinois and the Washington DC areas, and has us sold out of the the roughly 2.5 pallets we imported for her in the First Quarter. We have just shipped a container load (10 pallets) of Viognier and Altitude Cuvee and will see how fast that supply is absorbed. Selling RSA wine in the US is clearly an uphill battle; Silkbush may be able to obtain a foothold but I hold little hope for significant South African wine sales increases in general in the US.

Since I returned from RSA in early May from the Cape, much of my time has been spent in researching the international wine markets where where we might be successful with greater sales volumes. It is also important to be able to factually represent the potential to prospective joint venture partners who can provide both capital and market access in certain regions. I have “published” much of my findings on our Silkbush blog (<http://silkbush.com/blog/>) as a three part series, starting on June 14, 2017) entitled *Selling More South African Wine Overseas*. This was a continuation of my efforts of interviewing about 10 RSA winery owners/winemakers about their degree of interest in increasing sales, largely in Hong Kong (HK) and mainland China (PRC). All the producers are enthusiastic but it is clear unless there is joint industry coordination of promotional efforts, lead by Wines of South Africa (WOSA), little is going to be accomplished. Too many other countries are effectively working such programs and several have obtained excise tax exemption in China, a major benefit for wine importers to the mainland. (There already are no taxes whatsoever imposed on wine imported to Hong Kong.)

WOSA has a talented local rep in HK, Michaela Stander, who I met with last year, and she is having developed an electronic guide for would-be RSA producers interested in the Chinese market; recently Michaela solicited my critique of the guide outline, that will be completed by a respected wine consultancy. However, that is not enough. There has to be an “on the ground” tasting and promotional program, starting in HK, to raise the profile of RSA producers with retail and hotel staff. The “Imported China Wine Queen,” Debra Meiberg, has been a friend for several years and her company was instrumental in obtaining an almost 100 fold increase in Georgian wine sales in the past four years. She is a long standing fan of RSA wine and is interested in a similar assignment from the South African wine industry. We will see if that is forthcoming.

Other China Market Insights

Other areas of Chinese wine marketing are interesting to note, and also require an overall “exporting wine region” strategy. Internet wine sales are becoming increasingly important in China, especially for convenience, dissemination of information to consumers, and avoiding counterfeit wines. With four times the population of the US, and over 50% of the population actively on the Internet, this is a natural way to both spread the word about your wines and assure purchasers the wine they order is legitimate.

The Online Market in China

It's important to distinguish ecommerce from new media channels. In China, ecommerce refers to specialist or comprehensive websites that have a long-standing history of wine distribution. The most influential of these includes retailers such as JD.com, Taobao.com, Tmall.com, and Amazon. ‘New media’, on the other hand, refers to emerging channels that are based on WeChat public accounts, mobile websites, or apps. Typically they have only been in operation for two to three years, but while they are young, they can be very influential, particularly when it comes to younger consumers. The ENJOY and Red apps and Kaola.com are among the most prominent, along with a few key opinion leaders on the WeChat platform. “But Taobao is still by far the largest channel. It is definitely the trendsetter,” said a new media channel sales director from an importer of premium sweet wines.

China Is Facing An Epidemic Of Counterfeit And Contraband Wine

(according to Forbes Magazine)

The **Interprofessional Council of Bordeaux Wine** estimates that 30,000 bottles of fake imported wine are sold per hour in China. (If correct, that would be 21.9 million cases of counterfeit wine/year.) Jeremy Oliver, an Australian wine critic was quoted by The Weekly Times saying he was told stories that the average bottle of Champagne in China is filled seven times. He estimates that 50% of wines retailing for \$35 or more in China are bogus. While such estimates are reportedly way too high, it dramatizes the importance of assuring wine consumers that what they order is what they get, especially as one moves up the pricing scale. Direct to Consumer internet wine sales is certainly one major way to address this problem.

Smart Phones Replacing Cash in China

A **NY Times** article from a China based reporter chronicles a phenomenon of the past three years: Almost everyone in major Chinese cities is using a smartphone to pay for just about everything.

(See: <https://www.nytimes.com/2017/07/16/business/china-cash-smartphone-payments.html>)

Quite interestingly, the journalist had been outside mainland China recently covering Asian technology from Hong Kong, which has a very different internet culture from the mainland. When transferred to Shanghai, he was cut off from his WeChat account for a few weeks and found himself virtually helpless anytime he needed to spend money.

“From a tech standpoint, this is probably one of the single most important innovations that has happened first in China, and at the moment it's only in China,” said Richard Lim, managing director of venture capital firm GSR Ventures. So whether consumers are purchasing wine over the Internet or at a local wine shop, “It has become the default way of life now; literally every business and brand in China is plugged into this ecosystem.” It appears that South Africa has the opportunity to either be on the cutting edge of this change, or be left woefully behind, unaware of its importance.

Please read the following online:

http://drinksretailingnews.co.uk/news/fullstory.php/aid/16857/South_Africa:_conquering_hero.html

Charitable Contribution of Laptop Computers to Local South African Schools

Personally I am quite proud of facilitating the importation and contribution of 22 late model PC laptops to elementary and high schools in Cape Town and near to Silkbush. A year ago a Minnesota teacher's union decided to replace all their laptop computers and had a goodly supply of the slightly older model available. Their head IT manager told me about their situation at a White Oak Winery event and I suggested we bring them to South Africa to use in secondary schools. (Little did I realize what an undertaking this would be!) First, each computer had to have all their proprietary software removed by their staff, an extra hours project taking several months. Finally, all the machines wound up in Patrick's living room, while I asked my niece to figure out how to ship them to Cape Town. The normal courier companies wanted very high prices and were put off by the presence of lithium batteries; what about the same machines in the passenger cabin carried by the vast majority of paying passengers?

Finally, our able Silkbush marketing assistant, Lisa, got into the act, and found a reasonable shipper. One of the founders of Leap Science and Math schools in Cape Town (www.leapschool.org.za) was able to get the needed permit to import used computers without a tariff. With perhaps \$2200 from yours truly, we got the machines boxed up and off to the Cape. We divided the allocation 11 to Leap schools and 11 to the local schools Anton had picked out. Interestingly, most rural schools have Internet service but, at most, only one computer per class room, and the teachers are normally the ones with their hands on the machines. That situation has been improved on significantly, and the students are elated.

We subsequently received this nice accolade from Anthony Galloway:

"From the LEAP Science and Maths Schools we extend our heartfelt thanks to Dave and everyone involved in this project. These machines will provide great benefit on a number of levels to LEAP staff and students, and will make a valuable impact in their new lease of life here in South Africa ! And what better impact than contributing to the upliftment of education of disadvantaged students so that they can become role-models and lead the process of social transformation within their communities in the future?"

And from Anton:

"I can only add that Laerskool Breerivier and Laerskool Petra (the two primary schools in our area) are extremely excited when I delivered them the news of the arrival of the laptop donations. The principal from Petra couldn't stop thanking me; they currently have one old laptop between all classes (probably about 100 pupils) and it caved in yesterday just before I phoned him.... I will be handing them over on Thursday."



And from Patrick Mattocks, who made the computers available:

"Really good news. After lots of work the computers will be put to good use. I'm glad they didn't go to the recycling company."

While the total CA grape acreage is increasing by about 10,000 acres/year, the total production has flattened out. We attribute this to higher producing/lower income acres in the Central Valley, chiefly south of Fresno, being replanted to crops such as almonds, and additional acreage, chiefly in the coastal areas, being planted to lower yielding/higher priced grapes. This all points to steadily increasing prices for CA vineyards and wine grapes (which we are experiencing in Napa and Sonoma) and somewhat higher priced wines.

We are just about to start the 2017 grape harvest in CA and it will be interesting to see how this year's production stacks up with the estimates. Certainly, there is little chance for overproduction, especially for quality grapes, and perhaps the future for more imported wine sales will be more promising.

Nevertheless, the expense and time it takes to build brands, especially from overseas, cannot be discounted.



Our above wine was featured recently in **Wine Industry Insight**, an industry publication by Lewis Perdue, Sonoma CA. Lew is an old friend, but the write up was based strictly on our wine's merits, not on a personal relationship.

Dave Jefferson

Co-Founder and Director

Silkbush Mountain Vineyards