

CRAFT BREW ALLIANCE, INC.
Form 10-Q
November 07, 2012

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For The Quarterly Period Ended September 30, 2012

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from _____ to _____

Commission File Number 0-26542

CRAFT BREW ALLIANCE, INC.
(Exact name of registrant as specified in its charter)

Washington
(State or other jurisdiction of incorporation or organization)

91-1141254
(I.R.S. Employer Identification No.)

929 North Russell Street
Portland, Oregon 97227
(Address of principal executive offices)

(503) 331-7270
(Registrant's telephone number, including Area Code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company (See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act). Check one:

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Large Accelerated Filer

Accelerated Filer

Non-accelerated Filer (Do not check if a smaller reporting company)

Smaller Reporting Company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

The number of shares of the registrant's common stock outstanding as of October 30, 2012 was 18,874,256.

CRAFT BREW ALLIANCE, INC.
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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

CRAFT BREW ALLIANCE, INC.
CONSOLIDATED BALANCE SHEETS
(Unaudited)
(Dollars in thousands, except per share amounts)

| | September 30, 2012 | December 31, 2011 |
|---|--------------------------|-------------------------|
| Assets | | |
| Current assets: | | |
| Cash | \$3,475 | \$795 |
| Accounts receivable, net | 11,712 | 13,326 |
| Inventories | 11,409 | 9,446 |
| Deferred income tax asset, net | 1,469 | 894 |
| Other current assets | 3,414 | 2,816 |
| Total current assets | 31,479 | 27,277 |
| Property, equipment and leasehold improvements, net | 103,581 | 100,725 |
| Goodwill | 12,917 | 12,917 |
| Intangible and other assets, net | 18,011 | 17,989 |
| Total assets | \$165,988 | \$158,908 |
| Liabilities and Shareholders' Equity | | |
| Current liabilities: | | |
| Accounts payable | \$13,362 | \$10,994 |
| Accrued salaries, wages and payroll taxes | 4,445 | 4,524 |
| Refundable deposits | 8,551 | 7,400 |
| Other accrued expenses | 877 | 1,436 |
| Current portion of long-term debt and capital lease obligations | 632 | 596 |
| Total current liabilities | 27,867 | 24,950 |
| Long-term debt and capital lease obligations, net of current portion | 12,633 | 13,188 |
| Fair value of derivative financial instruments | 313 | 572 |
| Deferred income tax liability, net | 16,874 | 15,210 |
| Other liabilities | 519 | 479 |
| Total liabilities | 58,206 | 54,399 |
| Commitments and contingencies | | |
| Common shareholders' equity: | | |
| Common stock, \$0.005 par value. Authorized 50,000,000 shares; issued and outstanding 18,874,256 and 18,844,817 | 94 | 94 |
| Additional paid-in capital | 135,998 | 135,091 |
| Accumulated other comprehensive loss | (195) | (356) |

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| | | |
|---|-----------|-----------|
| Accumulated deficit | (28,115) | (30,320) |
| Total common shareholders' equity | 107,782 | 104,509 |
| Total liabilities and common shareholders' equity | \$165,988 | \$158,908 |

The accompanying notes are an integral part of these financial statements.

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CRAFT BREW ALLIANCE, INC.
CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)
(In thousands, except per share amounts)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|-----------|------------------------------------|------------|
| | 2012 | 2011 | 2012 | 2011 |
| Sales | \$ 47,951 | \$ 43,633 | \$ 137,121 | \$ 123,442 |
| Less excise taxes | 3,363 | 3,156 | 9,770 | 9,172 |
| Net sales | 44,588 | 40,477 | 127,351 | 114,270 |
| Cost of sales | 30,964 | 27,762 | 88,682 | 78,869 |
| Gross profit | 13,624 | 12,715 | 38,669 | 35,401 |
| Selling, general and administrative expenses | 11,907 | 10,530 | 34,502 | 30,489 |
| Operating income | 1,717 | 2,185 | 4,167 | 4,912 |
| Income from equity method investment | - | - | - | 691 |
| Gain on sale of Fulton Street Brewery, LLC | - | - | - | 10,398 |
| Interest expense | (165) | (205) | (496) | (747) |
| Interest income and other, net | 10 | 22 | 4 | 42 |
| Income before income taxes | 1,562 | 2,002 | 3,675 | 15,296 |
| Income tax provision | 614 | 771 | 1,470 | 5,889 |
| Net income | \$ 948 | \$ 1,231 | \$ 2,205 | \$ 9,407 |
| Basic and diluted net income per share | \$ 0.05 | \$ 0.07 | \$ 0.12 | \$ 0.50 |
| Shares used in basic per share calculations | 18,872 | 18,843 | 18,858 | 18,831 |
| Shares used in diluted per share calculations | 18,954 | 18,935 | 18,932 | 18,936 |

The accompanying notes are an integral part of these financial statements.

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CRAFT BREW ALLIANCE, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited)
(In thousands)

| | For the Three Months Ended September 30, | | For the Nine Months Ended September 30, | |
|--|---|----------|--|----------|
| | 2012 | 2011 | 2012 | 2011 |
| Net income | \$ 948 | \$ 1,231 | \$ 2,205 | \$ 9,407 |
| Unrealized gains on derivative hedge transactions, net of tax | 57 | 39 | 161 | 108 |
| Comprehensive income | \$ 1,005 | \$ 1,270 | \$ 2,366 | \$ 9,515 |

The accompanying notes are an integral part of these financial statements.

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CRAFT BREW ALLIANCE, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(In thousands)

For the Nine Months
Ended September 30,
2012 2011

| | | |
|---|----------|-----------|
| Cash flows from operating activities: | | |
| Net income | \$2,205 | \$9,407 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 5,518 | 5,375 |
| Income from equity method investments, net of distributions received | - | (691) |
| Gain on sale of Fulton Street Brewery, LLC | - | (10,398) |
| Deferred income taxes | 992 | 4,905 |
| Stock-based compensation | 529 | 337 |
| Excess tax benefit from employee stock plans | (379) | - |
| Other | (235) | (3) |
| Changes in operating assets and liabilities: | | |
| Accounts receivable, net | 1,196 | (1,320) |
| Inventories | (1,962) | (1,441) |
| Other current assets | (598) | 739 |
| Other assets | - | (382) |
| Accounts payable and other accrued expenses | 2,173 | (2,024) |
| Accrued salaries, wages and payroll taxes | (79) | (144) |
| Refundable deposits | 682 | 637 |
| Net cash provided by operating activities | 10,042 | 4,997 |
| Cash flows from investing activities: | | |
| Expenditures for property, equipment and leasehold improvements | (7,769) | (6,637) |
| Proceeds from sale of property, equipment and leasehold improvements | 37 | 101 |
| Proceeds from the sale of Fulton Street Brewery, LLC | 418 | 15,075 |
| Net cash provided by (used in) investing activities | (7,314) | 8,539 |
| Cash flows from financing activities: | | |
| Principal payments on debt and capital lease obligations | (440) | (5,605) |
| Net repayments under revolving line of credit | - | (7,500) |
| Proceeds from issuances of common stock | 13 | 23 |
| Excess tax benefit from employee stock plans | 379 | - |
| Net cash used in financing activities | (48) | (13,082) |
| Increase in cash | 2,680 | 454 |
| Cash: | | |
| Beginning of period | 795 | 164 |
| End of period | \$3,475 | \$618 |
| Supplemental disclosure of cash flow information: | | |

| | | |
|---------------------------------|-------|-------|
| Cash paid for interest | \$583 | \$835 |
| Cash paid for income taxes, net | 476 | 473 |

The accompanying notes are an integral part of these financial statements.

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CRAFT BREW ALLIANCE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 1. Basis of Presentation

General

The accompanying consolidated financial statements and related notes should be read in conjunction with the consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2011 (“2011 Annual Report”). These consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”). Accordingly, certain information and footnote disclosures normally included in consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted pursuant to such rules and regulations. These consolidated financial statements are unaudited but, in the opinion of management, reflect all material adjustments necessary to present fairly our consolidated financial position, results of operations and cash flows for the periods presented. All such adjustments were of a normal, recurring nature. The results of operations for such interim periods are not necessarily indicative of the results of operations for the full year.

Reclassifications

Certain immaterial amounts in the prior periods’ Consolidated Financial Statements have been reclassified to conform to the current period’s presentation.

Note 2. Recent Accounting Pronouncements

In July 2012, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2012-02, “Intangibles – Goodwill and Other: Testing Indefinite-Lived Intangible Assets for Impairment,” which permits an entity to make a qualitative assessment to determine whether it is more likely than not that an indefinite-lived intangible asset, other than goodwill, is impaired. Entities are required to test indefinite-lived intangible assets for impairment at least annually and more frequently if indicators of impairment exist. If an entity concludes, based on an evaluation of all relevant qualitative factors, that it is not more likely than not that the fair value of an indefinite-lived intangible asset is less than its carrying amount, it is not required to perform the quantitative impairment test for that asset. Because the qualitative assessment is optional, an entity is permitted to bypass it for any indefinite-lived intangible asset in any period and apply the quantitative test. ASU 2012-02 also permits the entity to resume performing the qualitative assessment in any subsequent period. ASU 2012-02 is effective for impairment tests performed for fiscal years beginning after September 15, 2012 and early adoption is permitted. We do not expect the adoption of ASU 2012-02 to have any effect on our financial position, results of operations or cash flows.

Note 3. Inventories

Inventories, except for pub food, beverages and supplies, are stated at the lower of standard cost or market. Pub food, beverages and supplies are stated at the lower of cost or market.

We regularly review our inventories for the presence of obsolete product attributed to age, seasonality and quality. If our review indicates a reduction in utility below the product’s carrying value, we reduce the product to a new cost basis. We record the cost of inventory for which we estimate we have more than a twelve-month supply as a component of Intangible and other assets on our Consolidated Balance Sheets.

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Inventories consisted of the following (in thousands):

| | September 30, 2012 | December 31, 2011 |
|------------------------------------|--------------------------|-------------------------|
| Raw materials | \$ 2,150 | \$ 2,778 |
| Work in process | 3,599 | 2,829 |
| Finished goods | 4,457 | 2,128 |
| Packaging materials | 581 | 558 |
| Promotional merchandise | 281 | 967 |
| Pub food, beverages and supplies.. | 341 | 186 |
| | \$ 11,409 | \$ 9,446 |

Work in process is beer held in fermentation tanks prior to the filtration and packaging process.

Note 4.

Related Party Transactions

Note Payable

In connection with our merger with Kona Brewing Company in 2010 (the "KBC Merger"), we assumed an obligation for a promissory note payable ("Related Party Note") to a counterparty that was a significant KBC shareholder and remains a shareholder of Craft Brew Alliance, Inc. The Related Party Note is secured by the equipment comprising a photovoltaic cell generation system ("photovoltaic system") installed at our brewery located in Kailua-Kona, Hawaii. Accrued interest on the Related Party Note is due and payable monthly at a fixed interest rate of 4.75%, with monthly loan payments of \$16,129. Any unpaid principal balance and unpaid accrued interest under the Related Party Note will be due and payable on November 15, 2014. The balance on the Related Party Note was \$390,000 and \$519,000 as of September 30, 2012 and December 31, 2011, respectively.

Transactions with Anheuser-Busch, LLC ("A-B")

Transactions with A-B consisted of the following (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|----------|------------------------------------|-----------|
| | 2012 | 2011 | 2012 | 2011 |
| Gross sales to A-B | \$39,369 | \$35,072 | \$112,317 | \$102,019 |
| Margin fee paid to A-B, classified as a reduction of Sales | 496 | 496 | 1,431 | 2,398 |
| Sales to Fulton Street Brewery, LLC ("FSB"), through a contract brewing arrangement, classified in Sales(1) | 720 | 1,213 | 3,205 | 2,506 |
| Handling, inventory management, royalty and other fees paid to A-B, classified in Cost of sales | 109 | 105 | 339 | 379 |
| Amounts received from A-B for lost keg fees and forfeited deposits, included as a reduction of Property, equipment and leasehold improvements, net | 90 | 120 | 122 | 240 |

(1) We owned 42% of FSB prior to it becoming a wholly owned subsidiary of A-B in May 2011 and, accordingly, transactions with FSB are considered to be related party transactions in all periods.

Executed on October 3, 2012, but effective September 1, 2012, in the best interest of both parties, we mutually agreed with FSB to end our contract brewing arrangement. Under the termination agreement, we will phase out production of FSB branded beers utilizing remaining inventory on-hand. In consideration, FSB will pay us \$70,000 per month

through September 2013, reduced by an agreed upon margin for any beer delivered to FSB based on the remaining inventory levels. We recorded \$57,000 in Sales in September 2012 under the terms of the termination agreement.

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Amounts due to or from A-B were as follows (in thousands):

| | September 30, 2012 | December 31, 2011 |
|---|-----------------------|----------------------|
| Amounts due from A-B related to beer sales pursuant to the A-B distributor agreement | \$ 7,650 | \$ 8,310 |
| Amounts due from FSB related to beer sales pursuant to a contract brewing arrangement | 422 | 585 |
| Refundable deposits due to A-B | (2,598) | (1,746) |
| Amounts due to A-B for services rendered | (1,930) | (2,482) |
| Net amount due from A-B | \$ 3,544 | \$ 4,667 |

Operating Leases

We lease our headquarters office space, restaurant and storage facilities located in Portland, Oregon, as well as the land and certain equipment from two limited liability companies, both of whose members include our current Board Chair and a nonexecutive officer. Lease payments to these lessors were as follows (in thousands):

| Three Months Ended September 30, | | Nine Months Ended September 30, | |
|-------------------------------------|-------|------------------------------------|-------|
| 2012 | 2011 | 2012 | 2011 |
| \$ 32 | \$ 30 | \$ 94 | \$ 91 |

We hold lease and sublease obligations for certain office space and the land underlying the brewery and pub location in Kona, Hawaii, with a company whose owners include a shareholder who owns more than 5% of our common stock and a nonexecutive officer. The sublease contracts expire on various dates through 2020, with an extension at our option for two five-year periods. Lease payments to this lessor were as follows (in thousands):

| Three Months Ended September 30, | | Nine Months Ended September 30, | |
|-------------------------------------|-------|------------------------------------|--------|
| 2012 | 2011 | 2012 | 2011 |
| \$ 102 | \$ 93 | \$ 301 | \$ 296 |

Note 5.

Derivative Financial Instruments

Interest Rate Swap Contracts

Our risk management objectives are to ensure that business and financial exposures to risk that have been identified and measured are minimized using the most effective and efficient methods to reduce, transfer and, when possible, eliminate such exposures. Operating decisions contemplate associated risks and management strives to structure proposed transactions to avoid or reduce risk whenever possible.

We have assessed our vulnerability to certain business and financial risks, including interest rate risk associated with our variable-rate long-term debt. To mitigate this risk, we entered into a five-year interest rate swap contract with Bank of America, N.A. (“BofA”) with a total notional value of \$8.9 million as of September 30, 2012 to hedge the variability of interest payments associated with our variable-rate borrowings under our Term Loan with BofA. Through this swap agreement, we pay interest at a fixed rate of 4.48% and receive interest at a floating-rate of the one-month LIBOR, which was 0.23% at September 30, 2012. Since the interest rate swap hedges the variability of interest payments on variable rate debt with similar terms, it qualifies for cash flow hedge accounting treatment. As of September 30, 2012, unrealized net losses of \$195,000 were recorded in Accumulated other comprehensive loss (“OCI”) as a result of this hedge. The effective portion of the gain or loss on the derivative is reclassified into interest expense

in the same period during which we record interest expense associated with the Term Loan. There was no hedge ineffectiveness recognized during the three or nine months ended September 30, 2012 or 2011.

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The interest rate swap contract is secured by substantially all of our personal property and by the real properties located at 924 North Russell Street, Portland, Oregon and 14300 NE 145th Street, Woodinville, Washington (“collateral”).

The fair value of our derivative instrument is as follows (in thousands):

| | Fair Value of Liability Derivative September 30, 2012 | December 31, 2011 |
|---|---|----------------------|
| Fair value of derivative financial instrument | \$ 313 | \$ 572 |

The effect of our interest rate swap contract that is accounted for as a derivative instrument on our Consolidated Statements of Income was as follows (in thousands):

| Derivatives in Cash Flow Hedging Relationships | Amount of Gain Recognized in Accumulated OCI (Effective Portion) | Location of Loss Reclassified from Accumulated OCI into Income (Effective Portion) | Amount of Loss Reclassified from Accumulated OCI into Income (Effective Portion) |
|---|---|--|---|
| Three Months Ended September 30, | | | |
| 2012 | \$ 92 | Interest expense | \$ 96 |
| 2011 | \$ 62 | Interest expense | \$ 104 |
| Nine Months Ended September 30, | | | |
| 2012 | \$ 259 | Interest expense | \$ 289 |
| 2011 | \$ 174 | Interest expense | \$ 301 |

See also Note 6.

Note 6.

Fair Value Measurements

Factors used in determining the fair value of our financial assets and liabilities are summarized into three broad categories:

- Level 1 – quoted prices in active markets for identical securities as of the reporting date;
- Level 2 – other significant directly or indirectly observable inputs, including quoted prices for similar securities, interest rates, prepayment speeds and credit risk; and
- Level 3 – significant inputs that are generally less observable than objective sources, including our own assumptions in determining fair value.

The factors or methodology used for valuing securities are not necessarily an indication of the risk associated with investing in those securities.

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Following are the disclosures related to our financial liability that is recorded at fair value on a recurring basis (in thousands):

| Fair Value at September 30, 2012 | Level 1 | Level 2 | Level 3 | Total |
|----------------------------------|---------|---------|---------|--------|
| Derivative financial instrument | \$ - | \$ 313 | \$ - | \$ 313 |

Fair Value at December 31, 2011

| | | | | |
|---------------------------------|------|--------|------|--------|
| Derivative financial instrument | \$ - | \$ 572 | \$ - | \$ 572 |
|---------------------------------|------|--------|------|--------|

There were no changes to our valuation techniques during the nine months ended September 30, 2012 or 2011.

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We believe the carrying amounts of cash, accounts receivable, accounts payable and other accrued expenses are a reasonable approximation of the fair value of those financial instruments because of the nature of the underlying transactions and the short-term maturities involved.

Note 7. Segment Results and Concentrations

Our Chief Operating Decision Maker monitors net sales and gross margins of our Beer Related operations and our Pubs operations. Beer Related operations include the brewing operations and related beer sales of our Widmer Brothers, Redhook, Kona and Omission beer brands, both domestically and internationally. Pubs operations include our pubs, some of which are located adjacent to our Beer Related operations, other merchandise sales and sales of our beers directly to customers. We do not track operating results beyond the gross margin level or our assets on a segment level.

Net sales, gross profit and gross margin by segment were as follows (dollars in thousands):

Three Months Ended September 30,

| | Beer | | Pubs | | Total | |
|--------------|-----------|---|----------|---|-----------|---|
| 2012 | Related | | | | | |
| Net sales | \$ 37,880 | | \$ 6,708 | | \$ 44,588 | |
| Gross profit | \$ 12,321 | | \$ 1,303 | | \$ 13,624 | |
| Gross margin | 32.5 | % | 19.4 | % | 30.6 | % |

2011

| | | | | | | |
|--------------|-----------|---|----------|---|-----------|---|
| Net sales | \$ 34,262 | | \$ 6,215 | | \$ 40,477 | |
| Gross profit | \$ 11,533 | | \$ 1,182 | | \$ 12,715 | |
| Gross margin | 33.7 | % | 19.0 | % | 31.4 | % |

Nine Months Ended September 30,

| | Beer | | Pubs | | Total | |
|--------------|------------|---|-----------|---|------------|---|
| 2012 | Related | | | | | |
| Net sales | \$ 109,364 | | \$ 17,987 | | \$ 127,351 | |
| Gross profit | \$ 35,679 | | \$ 2,990 | | \$ 38,669 | |
| Gross margin | 32.6 | % | 16.6 | % | 30.4 | % |

2011

| | | | | | | |
|--------------|-----------|---|-----------|---|------------|---|
| Net sales | \$ 97,583 | | \$ 16,687 | | \$ 114,270 | |
| Gross profit | \$ 32,477 | | \$ 2,924 | | \$ 35,401 | |
| Gross margin | 33.3 | % | 17.5 | % | 31.0 | % |

The segments use many of the same assets. For internal reporting purposes, we do not allocate assets by segment and, therefore, no asset by segment information is provided to our chief operating decision maker.

In preparing this financial information, certain expenses were allocated between the segments based on management estimates, while others were based on specific factors such as headcount. These factors can have a significant impact on the amount of gross profit for each segment. While we believe we have applied a reasonable methodology, assignment of other reasonable cost allocations to each segment could result in materially different segment gross profit.

Sales to wholesalers through the A-B distributor agreement were as follows as a percentage of Sales:

| Three Months Ended | | | | Nine Months Ended | | | |
|--------------------|---|------|---|-------------------|---|------|---|
| September 30, | | | | September 30, | | | |
| 2012 | | 2011 | | 2012 | | 2011 | |
| 81.1 | % | 79.2 | % | 80.9 | % | 80.7 | % |

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Receivables from A-B represented the following percentage of our accounts receivable balance:

| September 30, 2012 | | December 31, 2011 | |
|-----------------------|---|----------------------|---|
| 65.3 | % | 62.4 | % |

Note 8. Significant Stock-Based Plan Activity and Stock-Based Compensation

Stock-Based Compensation Expense

Total stock-based compensation expense, recognized as a component of Selling, general and administrative expense on our Consolidated Statements of Income, was as follows (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|-------|------------------------------------|--------|
| | 2012 | 2011 | 2012 | 2011 |
| Selling, general and administrative | \$ 218 | \$ 88 | \$ 529 | \$ 337 |

At September 30, 2012, we had total unrecognized stock-based compensation expense of \$1.8 million, which will be recognized over the weighted average remaining vesting period of 3.1 years.

Note 9. Earnings Per Share

The following table reconciles shares used for basic and diluted earnings per share ("EPS") and provides certain other information (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|--------|------------------------------------|--------|
| | 2012 | 2011 | 2012 | 2011 |
| Shares used for basic EPS | 18,872 | 18,843 | 18,858 | 18,831 |
| Dilutive effect of stock-based awards | 82 | 92 | 74 | 105 |
| Shares used for diluted EPS | 18,954 | 18,935 | 18,932 | 18,936 |
| Stock-based awards not included in diluted per share calculations as they would be anti-dilutive | 46 | 92 | 109 | 66 |

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

This quarterly report on Form 10-Q includes forward-looking statements. Generally, the words “believe,” “expect,” “intend,” “estimate,” “anticipate,” “project,” “will,” “may,” “plan” and similar expressions or their negatives identify forward-looking statements, which generally are not historical in nature. These statements are based upon assumptions and projections that we believe are reasonable, but are by their nature inherently uncertain. Many possible events or factors could affect the Company’s future financial results and performance, and could cause actual results or performance to differ materially from those expressed, including those risks and uncertainties described in Part I, Item 1A. “Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2011 (“2011 Annual Report”), and those described from time to time in our future reports filed with the Securities and Exchange Commission (the “SEC”). Caution should be taken not to place undue reliance on these forward-looking statements, which speak only as of the date of this quarterly report.

The following discussion and analysis should be read in conjunction with the Consolidated Financial Statements and Notes thereto included herein, as well as the audited Consolidated Financial Statements and Notes and Management’s Discussion and Analysis of Financial Condition and Results of Operations contained in our 2011 Annual Report. The discussion and analysis includes period-to-period comparisons of our financial results. Although period-to-period comparisons may be helpful in understanding our financial results, we believe that they should not be relied upon as an accurate indicator of future performance.

Overview

Craft Brew Alliance is the union of four unique and pioneering craft beer brands:

- Redhook Ale Brewery founded by Gordon Bowker and Paul Shipman in 1981 in Seattle, Washington;
- Widmer Brothers Brewery founded by brothers Kurt and Rob Widmer in 1984 in Portland, Oregon;
- Kona Brewing Co. founded by father and son team Cameron Healy and Spoon Khalsa in 1994 in Kona, Hawaii; and
 - Omission Beer internally developed by CBA’s brewing team in 2012 in Portland, Oregon.

Since our formation, we have focused our business activities on satisfying consumers through the brewing, marketing and selling of high-quality craft beers in the United States. Today, as an independent craft brewer, we possess several distinct advantages, unique in the craft beer category. These advantages are rooted and leveraged through the combination of our innovative quality craft beers; the strength of our distinct, authentic brand portfolio; our seamless national distribution and national sales and marketing reach; our financial capabilities as a public company; our owned brew pubs; and our bi-coastal breweries.

We proudly brew our craft beers in four company-owned breweries including three mainland breweries located in Portsmouth, New Hampshire; Portland, Oregon; and the Seattle suburb of Woodinville, Washington; and one Hawaii brewery located in Kailua-Kona, Hawaii. We also own and operate a small pilot brewery, primarily used for small batch production and innovative brews, at the Rose Quarter in Portland, Oregon.

We sell our beers primarily to wholesalers via a Master Distributor Agreement (the “A-B Distributor Agreement”) with Anheuser-Busch, LLC (“A-B”). Redhook and Widmer Brothers beers are distributed in all 50 states and Kona beers are distributed in 31 states. Omission Beer recently became available nationally and we continue to expand into new markets. Separate from our A-B wholesalers, we maintain an independent sales and marketing organization complete with resources across the key functions of brand management, field marketing, field sales, and national retail sales.

We operate in two segments: Beer Related operations and Pubs. Beer Related operations include the brewing and sale of craft beers from our five breweries, both domestically and internationally. Pubs operations primarily include our

five pubs, four of which are located adjacent to our Beer Related operations, other merchandise sales, and sales of our beers directly to customers.

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New Brands and Packaging

During the second quarter of 2012, we introduced Omission Beer, the first craft beer brand in the United States focused exclusively on brewing great tasting craft beers with traditional beer ingredients, including malted barley, that are specially crafted to remove gluten. The brand includes two styles: Omission Lager and Omission Pale Ale. Unlike many other beers in the fast-growing gluten-free category, Omission beers have flavor profiles that consumers would expect from traditionally brewed lagers and pale ales. Our innovative brewing process, which allows us to reduce the gluten levels to well below the widely accepted international Codex gluten-free standard of 20 parts per million for food and beverages, is unique to Omission Beer.

In March and April 2012, we began offering Kona Longboard Island Lager and Redhook Long Hammer IPA, respectively, in 12 oz. cans on a national basis. These new packages allow Kona Brewing and Redhook fans to enjoy our craft beers during more occasions – especially those where glass bottles may not be the best option, such as on the beach, in the ballpark or at the pool.

In August 2012, Kona Big Wave Golden Ale, which had previously only been available in Hawaii, joined Kona's portfolio on the mainland that includes its flagship Longboard Island Lager, Fire Rock Pale Ale and the trio of Aloha Series seasonals. Big Wave Golden Ale is one of Kona's original beers, first brewed at our Kailua-Kona home brewery in 1995, and is a great session beer with a bright, quenching finish. Like Longboard, Big Wave Golden Ale is a year-round offering and is available in all of Kona's markets.

Results of Operations

Following is a summary of our financial results:

| | Nine Months Ended September 30, | Net Sales | Net Income | Number of Barrels Sold |
|------|---------------------------------------|---------------------|----------------------------------|------------------------------|
| 2012 | | 127.4 \$ million | 2.2 \$ million | 549,700 |
| 2011 | | 114.3 \$ million | 9.4 \$ million ⁽¹⁾ | 520,500 |

(1) Includes the one-time gain on sale of Fulton Street Brewery, LLC of \$6.5 million, net of tax.

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The following table sets forth, for the periods indicated, certain information from our Consolidated Statements of Income expressed as a percentage of Net sales(1):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|---------|------------------------------------|---------|
| | 2012 | 2011 | 2012 | 2011 |
| Sales | 107.5 % | 107.8 % | 107.7 % | 108.0 % |
| Less excise tax | 7.5 | 7.8 | 7.7 | 8.0 |
| Net sales | 100.0 | 100.0 | 100.0 | 100.0 |
| Cost of sales | 69.4 | 68.6 | 69.6 | 69.0 |
| Gross profit | 30.6 | 31.4 | 30.4 | 31.0 |
| Selling, general and administrative expenses | 26.7 | 26.0 | 27.1 | 26.7 |
| Operating income | 3.9 | 5.4 | 3.3 | 4.3 |
| Income from equity method investment | - | - | - | 0.6 |
| Gain on sale of Fulton Street Brewery, LLC | - | - | - | 9.1 |
| Interest expense | (0.4) | (0.5) | (0.4) | (0.7) |
| Interest income and other, net | - | 0.1 | - | - |
| Income before income taxes | 3.5 | 4.9 | 2.9 | 13.4 |
| Income tax provision | 1.4 | 1.9 | 1.2 | 5.2 |
| Net income | 2.1 % | 3.0 % | 1.7 % | 8.2 % |

(1) Percentages may not add due to rounding.

Segment Information

Net sales, Gross profit and gross margin information by segment was as follows (dollars in thousands):

Three Months Ended September 30,

| 2012 | Beer | | Total |
|--------------|-----------|----------|-----------|
| | Related | Pubs | |
| Net sales | \$ 37,880 | \$ 6,708 | \$ 44,588 |
| Gross profit | \$ 12,321 | \$ 1,303 | \$ 13,624 |
| Gross margin | 32.5 % | 19.4 % | 30.6 % |

2011

| | | | |
|--------------|-----------|----------|-----------|
| Net sales | \$ 34,262 | \$ 6,215 | \$ 40,477 |
| Gross profit | \$ 11,533 | \$ 1,182 | \$ 12,715 |
| Gross margin | 33.7 % | 19.0 % | 31.4 % |

Nine Months Ended September 30,

| 2012 | Beer | | Total |
|--------------|------------|-----------|------------|
| | Related | Pubs | |
| Net sales | \$ 109,364 | \$ 17,987 | \$ 127,351 |
| Gross profit | \$ 35,679 | \$ 2,990 | \$ 38,669 |
| Gross margin | 32.6 % | 16.6 % | 30.4 % |

2011

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| | | | | | | | |
|--------------|----|--------|----|--------|----|---------|---|
| Net sales | \$ | 97,583 | \$ | 16,687 | \$ | 114,270 | |
| Gross profit | \$ | 32,477 | \$ | 2,924 | \$ | 35,401 | |
| Gross margin | | 33.3 | % | 17.5 | % | 31.0 | % |

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Sales by Category

The following tables set forth a comparison of sales by category (dollars in thousands):

| Sales by Category | Three Months Ended | | Dollar Change | % Change | |
|--------------------------------------|--------------------|----------|---------------|----------|----|
| | Sept. 30, 2012 | 2011 | | | |
| A-B and A-B related | \$38,872 | \$34,576 | \$4,296 | 12.4 | % |
| Contract brewing and beer related(1) | 2,371 | 2,842 | (471) | (16.6 |)% |
| Excise taxes | (3,363) | (3,156) | (207) | 6.6 | % |
| Net beer related sales | 37,880 | 34,262 | 3,618 | 10.6 | % |
| Pubs(2) | 6,708 | 6,215 | 493 | 7.9 | % |
| Net sales | \$44,588 | \$40,477 | \$4,111 | 10.2 | % |

| Sales by Category | Nine Months Ended Sept. 30, | | Dollar Change | % Change | |
|--------------------------------------|-----------------------------|-----------|---------------|----------|---|
| | 2012 | 2011 | | | |
| A-B and A-B related | \$110,885 | \$99,621 | \$11,264 | 11.3 | % |
| Contract brewing and beer related(1) | 8,249 | 7,134 | 1,115 | 15.6 | % |
| Excise taxes | (9,770) | (9,172) | (598) | 6.5 | % |
| Net beer related sales | 109,364 | 97,583 | 11,781 | 12.1 | % |
| Pubs(2) | 17,987 | 16,687 | 1,300 | 7.8 | % |
| Net sales | \$127,351 | \$114,270 | \$13,081 | 11.4 | % |

(1) Beer related includes international beer sales.

(2) Pubs sales include sales of promotional merchandise and sales of beer directly to customers.

Shipments by Category

Shipments by category were as follows (in barrels):

| Three Months Ended September 30, | 2012 | 2011 | Increase | % | Change in Depletions(1) |
|--------------------------------------|-----------|-----------|------------|----------|-------------------------|
| | Shipments | Shipments | (Decrease) | Change | |
| A-B and A-B related | 173,700 | 161,000 | 12,700 | 7.9 % | 4 % |
| Contract brewing and beer related(2) | 12,100 | 16,700 | (4,600) | (27.5)% | |
| Pubs | 3,500 | 3,800 | (300) | (7.9)% | |
| Total | 189,300 | 181,500 | 7,800 | 4.3 % | |

| Nine Months Ended September 30, | 2012 | 2011 | Increase | % | Change in Depletions(1) |
|--------------------------------------|-----------|-----------|------------|---------|-------------------------|
| | Shipments | Shipments | (Decrease) | Change | |
| A-B and A-B related | 496,300 | 470,900 | 25,400 | 5.4 % | 5 % |
| Contract brewing and beer related(2) | 44,600 | 40,300 | 4,300 | 10.7 % | |
| Pubs | 8,800 | 9,300 | (500) | (5.4)% | |
| Total | 549,700 | 520,500 | 29,200 | 5.6 % | |

(1) Change in depletions reflects the year-over-year change in barrel volume sales of beer by wholesalers to retailers.

(2) Contract brewing and beer related includes international shipments of our beers.

The increases in sales to A-B and A-B related in the three and nine-month periods ended September 30, 2012 compared to the same periods of 2011 were primarily due to increases in volume, higher selling prices for our beers, and a shift in product mix towards bottle and high-end product, both of which carry a higher price per unit. Gross sales

in the nine-month period were also favorably impacted by a decrease in the per barrel fee associated with sales to A-B as a result of an amendment to our A-B Distributor Agreement in May 2011. This lower fee level for the period of January 2012 through April 2012 generated approximate savings of \$1.2 million as compared to the same period in 2011.

The increase in contract brewing and beer related sales in the nine-month period ended September 30, 2012 compared to the same period of 2011 was due to an increase in shipments under a three-year contract brewing arrangement with FSB, which began production in the first quarter of 2011. The decrease in contract brewing and beer related sales in the three-month period ended September 30, 2012 compared to the same period of 2011 was due to a decrease in shipments under the arrangement with FSB. Executed on October 3, 2012, but effective September 1, 2012, in the best interest of both parties, we mutually agreed with FSB to end our contract brewing arrangement. Under the termination agreement, we will phase out production of FSB branded beers utilizing remaining inventory on-hand. In consideration, FSB will pay us \$70,000 per month through September 2013, reduced by an agreed upon margin for any beer delivered to FSB based on the remaining inventory levels. We recorded \$57,000 in Sales in September 2012 under the terms of the termination agreement.

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Sales to FSB through the contract brewing arrangement, classified in Sales, were as follows (dollars in thousands):

| Three Months Ended September 30, | | Nine Months Ended September 30, | |
|----------------------------------|----------|---------------------------------|----------|
| 2012 | 2011 | 2012 | 2011 |
| \$ 720 | \$ 1,213 | \$ 3,205 | \$ 2,506 |

Pubs sales increased in the three and nine-month periods ended September 30, 2012 compared to the same periods of 2011, primarily due to increased guest counts and pricing in certain markets. The increases were partially offset by decreases in the number of barrels sold, primarily as a result of a decline in event volume.

The increases in excise taxes in the three and nine-month periods ended September 30, 2012 compared to the same periods of 2011 were due to higher shipments in the 2012 periods compared to the same periods of the prior year.

The increases in volume in the three and nine-month periods ended September 30, 2012 compared to the same periods of 2011 were primarily driven by our increased sales and marketing efforts, timing of programs and new brand and package introductions, partially offset by the termination of our contract brewing agreement with FSB as discussed above and a decline in our event volume, which is included in Pubs.

Shipments by Brand

The following table sets forth a comparison of shipments by brand (in barrels):

| Three Months Ended September 30, | 2012 Shipments | 2011 Shipments | Increase (Decrease) | % Change | Change in Depletions |
|----------------------------------|----------------|----------------|---------------------|----------|----------------------|
| Widmer Brothers | 71,800 | 73,000 | (1,200) | (1.6)% | (9)% |
| Kona | 57,100 | 45,300 | 11,800 | 26.0 % | 21 % |
| Redhook | 49,000 | 47,000 | 2,000 | 4.3 % | 6 % |
| Total(1) | 177,900 | 165,300 | 12,600 | 7.6 % | 4 % |

| Nine Months Ended September 30, | 2012 Shipments | 2011 Shipments | Increase (Decrease) | % Change | Change in Depletions |
|---------------------------------|----------------|----------------|---------------------|----------|----------------------|
| Widmer Brothers | 199,500 | 209,600 | (10,100) | (4.8)% | (7)% |
| Kona | 164,900 | 135,900 | 29,000 | 21.3 % | 22 % |
| Redhook | 142,800 | 136,500 | 6,300 | 4.6 % | 5 % |
| Total(1) | 507,200 | 482,000 | 25,200 | 5.2 % | 5 % |

(1) Total shipments by brand include international shipments and exclude shipments produced under our contract brewing arrangements.

The decreases in our Widmer Brothers brand shipments in the three and nine-month periods ended September 30, 2012 compared to the same periods of 2011 were primarily due to pressure on our Hefeweizen beer which is experiencing competition from large, multi-national wheat beer competitors in the southwestern region. Partially offsetting these decreases has been the positive effect of our focus on the core Widmer Brothers brands including our Rotator IPAs and seasonals, and our high-end offerings, which is fueling broader awareness of the overall Widmer Brothers brand.

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The increases in our Kona brand shipments in the three and nine-month periods ended September 30, 2012 compared to the same periods of 2011 were due to the success of our Kona variety packs and the increased velocity of our Kona flagship, Longboard Lager, in existing markets. During the quarter ended September 30, 2012, we launched our Big Wave Golden Ale, previously available only in Hawaii, on the mainland. We continue to successfully introduce our Kona beers to new markets, which has been contributing to the brand's shipment growth. The introduction of our Kona beer in cans in March 2012 also contributed to the increase.

The increases in our Redhook brand shipments in the three and nine-month periods ended September 30, 2012 compared to the same periods of 2011 were the result of our investments in new packaging, brand introductions and marketing initiatives. These investments have resulted in the unique Redhook brand position which we believe is resonating with consumers.

Shipments by Package

The following table sets forth a comparison of our shipments by package, excluding private label shipments produced under our contract brewing arrangements (in barrels):

| Three Months Ended September 30, | 2012 | | 2011 | |
|-------------------------------------|-----------|------------|-----------|------------|
| | Shipments | % of Total | Shipments | % of Total |
| Draft | 55,200 | 31.0 % | 56,400 | 34.1 % |
| Bottle | 122,700 | 69.0 % | 108,900 | 65.9 % |
| Total | 177,900 | 100.0 % | 165,300 | 100.0 % |

| Nine Months Ended September 30, | 2012 | | 2011 | |
|------------------------------------|-----------|------------|-----------|------------|
| | Shipments | % of Total | Shipments | % of Total |
| Draft | 164,600 | 32.5 % | 170,400 | 35.4 % |
| Bottle | 342,600 | 67.5 % | 311,600 | 64.6 % |
| Total | 507,200 | 100.0 % | 482,000 | 100.0 % |

The shift in package mix from draft to bottle in the three and nine-month periods ended September 30, 2012 compared to the same periods of 2011 was primarily the result of the increase in volumes on our Kona bottle beer and lower volumes on our Hefeweizen draft beer. There is also increased general competition across the industry for on-premise draft sales as the large, multi-national brewers enter the craft beer segment.

Cost of Sales

Cost of sales includes purchased raw materials, direct labor, overhead and shipping costs.

Information regarding Cost of sales was as follows (dollars in thousands):

| | Three Months Ended Sept. 30, | | Dollar Change | % Change |
|--------------|------------------------------|-----------|------------------|----------|
| | 2012 | 2011 | | |
| Beer Related | \$ 25,559 | \$ 22,729 | \$ 2,830 | 12.5 % |
| Pubs | 5,405 | 5,033 | 372 | 7.4 % |
| Total | \$ 30,964 | \$ 27,762 | \$ 3,202 | 11.5 % |

| | Nine Months Ended Sept. 30, | | Dollar Change | % Change |
|--------------|-----------------------------|-----------|------------------|----------|
| | 2012 | 2011 | | |
| Beer Related | \$ 73,685 | \$ 65,106 | \$ 8,579 | 13.2 % |
| Pubs | 14,997 | 13,763 | 1,234 | 9.0 % |
| Total | \$ 88,682 | \$ 78,869 | \$ 9,813 | 12.4 % |

The increases in Beer Related Cost of sales in the three and nine-month periods ended September 30, 2012 compared to the same periods of 2011 were due to the increase in shipments discussed above, as well as the mix shift from draft to bottle as the per barrel equivalent cost of bottle is more than draft. In addition, increased distribution costs, including offsite storage and fuel, and higher grain prices, primarily barley, contributed to the increases in both the three and nine-month periods.

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The increases in Pubs Cost of sales in the three and nine-month periods ended September 30, 2012 compared to the same periods of 2011 were primarily due to the increases in guest counts noted above, as well as increased labor, food and beverage costs in certain markets.

Gross Profit

Information regarding Gross profit was as follows (dollars in thousands):

| | Three Months Ended Sept. 30, | | Dollar Change | % | |
|--------------|------------------------------|-----------|------------------|--------|---|
| | 2012 | 2011 | | Change | |
| Beer Related | \$ 12,321 | \$ 11,533 | \$ 788 | 6.8 | % |
| Pubs | 1,303 | 1,182 | 121 | 10.2 | % |
| Total | \$ 13,624 | \$ 12,715 | \$ 909 | 7.1 | % |

| | Nine Months Ended Sept. 30, | | Dollar Change | % | |
|--------------|-----------------------------|-----------|------------------|--------|---|
| | 2012 | 2011 | | Change | |
| Beer Related | \$ 35,679 | \$ 32,477 | \$ 3,202 | 9.9 | % |
| Pubs | 2,990 | 2,924 | 66 | 2.3 | % |
| Total | \$ 38,669 | \$ 35,401 | \$ 3,268 | 9.2 | % |

Gross profit as a percentage of Net sales, or gross margin, was as follows:

| | Three Months Ended September 30, | | | | Nine Months Ended September 30, | | | |
|--------------|-------------------------------------|---|------|---|------------------------------------|---|------|---|
| | 2012 | | 2011 | | 2012 | | 2011 | |
| Beer Related | 32.5 | % | 33.7 | % | 32.6 | % | 33.3 | % |
| Pubs | 19.4 | % | 19.0 | % | 16.6 | % | 17.5 | % |
| Total | 30.6 | % | 31.4 | % | 30.4 | % | 31.0 | % |

The increases in Gross profit in the three and nine-month periods ended September 30, 2012 compared to the same periods of 2011 were due to increases in shipment volumes discussed above, partially offset by declines in beer related and overall gross margin rates. The declines in the beer related gross margin rates were primarily due to higher distribution and grain costs, partially offset by improved brewery performance, increased capacity utilization and a shift in mix to our higher-end beers. The increases in Pubs Gross profit in the three and nine-month periods ended September 30, 2012 compared to the same periods of 2011 were primarily due to increases in guest counts and pricing, partially offset by increases in labor, food and beverage costs.

Total approximate capacity utilization is calculated by dividing total shipments by the approximate working capacity and was as follows:

| | Three Months Ended September 30, | | | | Nine Months Ended September 30, | | | |
|----------------------|-------------------------------------|---|------|---|------------------------------------|---|------|---|
| | 2012 | | 2011 | | 2012 | | 2011 | |
| Capacity utilization | 84.1 | % | 79.9 | % | 81.4 | % | 76.4 | % |

During the second quarter of 2012, we added additional fermentation vessels to our breweries which we expect will increase the combined capacity of our production breweries from approximately 900,000 barrels per year to approximately 1.1 million barrels per year when put into service by the end of 2012.

Selling, General and Administrative Expenses

Selling, general and administrative expenses (“SG&A”) include compensation and related expenses for our sales and marketing activities, management, legal and other professional and administrative support functions.

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Information regarding SG&A was as follows (dollars in thousands):

| | Three Months Ended Sept. 30, | | Dollar | % Change | |
|---------------------|------------------------------|-----------|----------|----------|---|
| | 2012 | 2011 | Change | | |
| | \$ 11,907 | \$ 10,530 | \$ 1,377 | 13.1 | % |
| As a % of Net sales | 26.7 % | 26.0 % | | | |

| | Nine Months Ended Sept. 30, | | Dollar | % Change | |
|---------------------|-----------------------------|-----------|----------|----------|---|
| | 2012 | 2011 | Change | | |
| | \$ 34,502 | \$ 30,489 | \$ 4,013 | 13.2 | % |
| As a % of Net sales | 27.1 % | 26.7 % | | | |

The increases in SG&A for the three and nine-month periods ended September 30, 2012 compared to the same periods of 2011 were primarily due to increases in labor costs as we expand our national footprint into new geographies and increased costs associated with the launch of our Omission and Big Wave brands. Our investments in sales and marketing are consistent with our strategic focus on firmly establishing our brands' national footprint and competitively addressing the varied needs of craft beer consumers. These increases were partially offset by lower packaging design and development costs.

Income from Equity Method Investment

Income from equity method investment included our share of Fulton Street Brewery, LLC's ("FSB") net income through the date of sale in May 2011.

Gain on Sale of Fulton Street Brewery, LLC ("FSB")

Our pre-tax gain on the sale of FSB totaled \$10.4 million, which resulted from proceeds of \$16.3 million less our investment of \$5.9 million.

Interest Expense

Information regarding Interest expense was as follows (dollars in thousands):

| | Three Months Ended Sept. 30, | | Dollar | % Change | |
|------------------|------------------------------|--------|----------|----------|---|
| | 2012 | 2011 | Change | | |
| Interest expense | \$ 165 | \$ 205 | \$ (40) | (19.5) | % |

| | Nine Months Ended Sept. 30, | | Dollar | % Change | |
|------------------|-----------------------------|--------|-----------|----------|---|
| | 2012 | 2011 | Change | | |
| Interest expense | \$ 496 | \$ 747 | \$ (251) | (33.6) | % |

| | Three Months Ended Sept. 30, | | Nine Months Ended Sept. 30, | | | |
|--------------------------|------------------------------|-----------|-----------------------------|-----------|------|--|
| | 2012 | 2011 | 2012 | | 2011 | |
| Average debt outstanding | \$ 13,349 | \$ 15,179 | \$ 13,525 | \$ 22,059 | | |
| Average interest rate | 2.07 % | 2.69 % | 2.04 % | 2.70 % | | |

The decreases in Interest expense in the three and nine-month periods ended September 30, 2012 compared to the same periods of 2011 were due to lower average outstanding borrowings and lower average interest rates. The average interest rates shown in the above table represent cash interest, exclusive of our interest rate swap. The decreases in average outstanding borrowings were primarily the result of using a portion of the proceeds from the sale of FSB in May 2011 to repay the \$8.8 million outstanding on our line of credit and \$4.2 million outstanding related to capital leases.

Income Tax Provision

Our effective income tax rate was 40.0% for the first nine months of 2012 and 38.5% in the first nine months of 2011. The effective income tax rates reflect the impact of non-deductible expenses, primarily meals and entertainment expenses and state and local taxes, and tax credits.

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Liquidity and Capital Resources

We have required capital primarily for the construction and development of our production breweries, to support our expansion and growth plans and to fund our working capital needs. Historically, we have financed our capital requirements through cash flow from operations, bank borrowings and the sale of common and preferred stock. We anticipate meeting our obligations for the twelve months beginning October 1, 2012 primarily from cash flows generated from operations. In addition, we may borrow under our line of credit facility as the need arises. Capital resources available to us at September 30, 2012 included \$3.5 million of cash and \$22.0 million available under our line of credit facility.

We had \$3.5 million and \$795,000 of cash at September 30, 2012 and December 31, 2011, respectively. At September 30, 2012, we had working capital of \$3.6 million compared to working capital of \$2.3 million at December 31, 2011. Our debt as a percentage of total capitalization (total debt and common shareholders' equity) was 11.0% and 11.7% at September 30, 2012 and December 31, 2011, respectively.

A summary of our cash flow information was as follows (dollars in thousands):

| | Nine Months Ended September 30, | |
|---|------------------------------------|-----------|
| | 2012 | 2011 |
| Cash flows provided by operating activities | \$ 10,042 | \$ 4,997 |
| Cash flows provided by (used in) investing activities | (7,314) | 8,539 |
| Cash flows used in financing activities | (48) | (13,082) |
| Increase in cash | \$ 2,680 | \$ 454 |

Cash provided by operating activities of \$10.0 million in the first nine months of 2012 resulted from our Net income of \$2.2 million, net non-cash expense of \$6.4 million and changes in our operating assets and liabilities as discussed in more detail below.

Accounts receivable, net, decreased \$1.6 million to \$11.7 million at September 30, 2012 compared to \$13.3 million at December 31, 2011. This decrease was primarily due to a \$660,000 decrease in our receivable from A-B, which totaled \$7.7 million at September 30, 2012. Historically, we have not had collection problems related to our accounts receivable.

Inventories increased \$2.0 million to \$11.4 million at September 30, 2012 compared to \$9.4 million at December 31, 2011, primarily to support an increase in shipment volume.

Accounts payable increased \$2.4 million to \$13.4 million at September 30, 2012 compared to \$11.0 million at December 31, 2011, primarily due to increased inventory purchases to support our increased level of sales, partially offset by a \$150,000 decrease in the portion of our payable to A-B that is included in Accounts payable, which totaled \$1.3 million at September 30, 2012.

As of September 30, 2012, we had state net operating loss carryforwards ("NOLs") available to offset payment of future income taxes of \$80,000, tax-effected; and we had no federal NOLs remaining. We also had \$589,000 in federal alternative minimum tax ("AMT") credit carry forwards.

We anticipate that we will utilize the remaining state NOLs and federal AMT credit carry forwards in the near future and, accordingly, once utilized, we will be required to satisfy all of our income tax obligations with cash.

Capital expenditures of \$7.8 million in the first nine months of 2012 were primarily for capacity, efficiency and cooperage purposes. For all of 2012, we anticipate capital expenditures of approximately \$8.5 million to \$9.5 million primarily for investments in capacity and efficiency.

We have a loan agreement (as amended, the “Loan Agreement”) with BofA, which is presently comprised of a \$22.0 million revolving line of credit (“Line of Credit”), including provisions for cash borrowings and up to \$2.5 million notional amount of letters of credit, and a \$11.9 million term loan (“Term Loan”). We may draw upon the Line of Credit for working capital and general corporate purposes. At September 30, 2012, we had no borrowings outstanding under the Line of Credit and we were in compliance with the financial covenants associated with the Loan Agreement.

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Critical Accounting Policies and Estimates

Our financial statements are based upon the selection and application of significant accounting policies that require management to make significant estimates and assumptions. Judgments and uncertainties affecting the application of these policies may result in materially different amounts being reported under different conditions or using different assumptions. Our estimates are based upon historical experience, market trends and financial forecasts and projections, and upon various other assumptions that management believes to be reasonable under the circumstances at various points in time. Actual results may differ, potentially significantly, from these estimates.

Our critical accounting policies, as described in our 2011 Annual Report, relate to goodwill, other intangible assets, long-lived assets, refundable deposits on kegs, revenue recognition and income taxes. There have been no changes to our critical accounting policies since December 31, 2011.

Seasonality

Our sales generally reflect a degree of seasonality, with the first and fourth quarters historically exhibiting low sales levels relative to the second and third quarters. Accordingly, our results for any particular quarter are not likely to be indicative of the results to be achieved for the full year.

Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements that have, or are reasonably likely to have, a material current or future effect on our financial condition, changes in financial condition, revenue or expenses, results of operations, liquidity, capital expenditures or capital resources.

Recent Accounting Pronouncements

See Note 2 of Notes to Consolidated Financial Statements included in Part I, Item 1 of this Form 10-Q.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

There have been no material changes in our reported market risks and risk management policies since the filing of our 2011 Annual Report on Form 10-K, which was filed with the SEC on March 14, 2012.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

Our management, including our Chief Executive Officer and our Chief Financial Officer, carried out an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(e) or 15d-15(e)) under the Securities Exchange Act of 1934 (“Exchange Act”) as of the end of the period covered by this Report. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered by this report, disclosure controls and procedures were effective to ensure that information required to be disclosed in the reports filed or submitted by us under the Exchange Act is recorded, processed, summarized and reported within the time periods specified by the SEC’s rules and forms and that such information is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosures. While reasonable assurance is a high level of assurance, it does not mean absolute assurance. Disclosure controls and internal control over financial reporting cannot prevent or detect all errors, misstatements or fraud. In addition, the design of a control system must recognize that there are resource constraints, and the benefits associated with controls must be

proportionate to their costs.

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Changes in Internal Control Over Financial Reporting

During the third quarter of 2012, no changes in our internal control over financial reporting were identified in connection with the evaluation required by Exchange Act Rule 13a-15 or 15d-15 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II - OTHER INFORMATION

Item 1A. Risk Factors

There have been no changes in our reported risk factors and no new risk factors have been identified since the filing of our 2011 Annual Report on Form 10-K, which was filed with the SEC on March 14, 2012.

Item 6. Exhibits

The following exhibits are filed herewith and this list is intended to constitute the exhibit index:

| | |
|-------------|---|
| <u>31.1</u> | Certification of Chief Executive Officer of Craft Brew Alliance, Inc. pursuant to Exchange Act Rule 13a-14(a) |
| <u>31.2</u> | Certification of Chief Financial Officer of Craft Brew Alliance, Inc. pursuant to Exchange Act Rule 13a-14(a) |
| <u>32.1</u> | Certification pursuant to Exchange Act Rule 13a-14(b) and 18 U.S.C. Section 1350 |
| <u>99.1</u> | Press Release dated November 7, 2012 |
| 101.INS* | XBRL Instance Document |
| 101.SCH* | XBRL Taxonomy Extension Schema Document |
| 101.CAL* | XBRL Taxonomy Extension Calculation Linkbase Document |
| 101.LAB* | XBRL Taxonomy Extension Label Linkbase Document |
| 101.PRE* | XBRL Taxonomy Extension Presentation Linkbase Document |

* Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, or Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

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SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

CRAFT BREW ALLIANCE, INC.

November 7, 2012

BY: /s/ Joseph K. O'Brien
Joseph K. O'Brien
Controller and Chief Accounting Officer