CRAFT BREW ALLIANCE, INC.
Form 10-Q
August 06, 2014

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

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For The Quarterly Period Ended June 30, 2014

OR

o 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	91-1141254
(State or other jurisdiction of incorporation or organization)	(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 x No o

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 x No o

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:

Large Accelerated Filer o	Accelerated Filer x
Non-accelerated Filer o (Do not check if a smaller reporting company)	Smaller Reporting Company o

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

The number of shares of the registrant’s common stock outstanding as of July 29, 2014 was 19,044,297.

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)

	June 30, 2014	December 31, 2013
Assets		
Current assets:		
Cash and cash equivalents	$6,424	$2,726
Accounts receivable, net	13,330	11,370
Inventories	20,133	16,639
Deferred income tax asset, net	1,775	1,345
Other current assets	3,749	3,403
Total current assets	45,411	35,483
Property, equipment and leasehold improvements, net	106,050	104,193
Goodwill	12,917	12,917
Intangible and other assets, net	17,337	17,693
Total assets	$181,715	$170,286
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	$20,977	$14,742
Accrued salaries, wages and payroll taxes	6,251	4,616
Refundable deposits	7,971	8,252
Other accrued expenses	1,940	1,381
Current portion of long-term debt and capital lease obligations	557	710
Total current liabilities	37,696	29,701
Long-term debt and capital lease obligations, net of current portion	11,693	11,050
Fair value of derivative financial instruments	370	-
Deferred income tax liability, net	18,074	17,719
Other liabilities	614	584
Total liabilities	68,447	59,054
Commitments and contingencies		
Common shareholders' equity:		
Common stock, $0.005 par value. Authorized 50,000,000 shares; issued and outstanding 19,036,378 and 18,972,247	95	95
Additional paid-in capital	137,443	136,972
Accumulated other comprehensive loss	(229)	-
Accumulated deficit	(24,041)	(25,835)
Total common shareholders' equity	113,268	111,232
Total liabilities and common shareholders' equity	$181,715	$170,286

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Sales	$60,728	$52,710	$107,745	$92,091
Less excise taxes	4,042	3,703	7,233	6,475
Net sales	56,686	49,007	100,512	85,616
Cost of sales	38,112	34,043	70,098	61,709
Gross profit	18,574	14,964	30,414	23,907
Selling, general and administrative expenses	15,208	12,950	27,270	24,710
Operating income (loss)	3,366	2,014	3,144	(803)
Interest expense	(105)	(156)	(206)	(312)
Other income (expense), net	9	6	3	(17)
Income (loss) before income taxes	3,270	1,864	2,941	(1,132)
Income tax provision (benefit)	1,275	769	1,147	(453)
Net income (loss)	$1,995	$1,095	$1,794	$(679)
Basic and diluted net income (loss) per share	$0.10	$0.06	$0.09	$(0.04)
Shares used in basic per share calculations	19,029	18,926	19,002	18,905
Shares used in diluted per share calculations	19,087	18,992	19,077	18,905

The accompanying notes are an integral part of these financial statements.
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CRAFT BREW ALLIANCE, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(Unaudited)

(In thousands)

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2014	2013	2014	2013
Net income (loss)	$1,995	$1,095	$1,794	$(679)
Unrealized gain (loss) on derivative hedge transactions, net of tax	(81)	60	(229)	117
Comprehensive income (loss)	$1,914	$1,155	$1,565	$(562)

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)

	Six Months Ended June 30, 2014	Six Months Ended June 30, 2013
Cash flows from operating activities:		
Net income (loss)	$1,794	$(679)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	4,255	3,991
Deferred income taxes	66	(475)
Stock-based compensation	444	348
Excess tax benefit from employee stock plans	(176)	-
Other	(363)	290
Changes in operating assets and liabilities:		
Accounts receivable, net	(1,959)	(868)
Inventories	(2,909)	(3,111)
Other current assets	(347)	191
Accounts payable and other accrued expenses	5,232	3,959
Accrued salaries, wages and payroll taxes	1,635	159
Refundable deposits	446	583
Net cash provided by operating activities	8,118	4,388
Cash flows from investing activities:		
Expenditures for property, equipment and leasehold improvements	(5,074)	(5,313)
Proceeds from sale of property, equipment and leasehold improvements	15	-
Net cash used in investing activities	(5,059)	(5,313)
Cash flows from financing activities:		
Principal payments on debt and capital lease obligations	(291)	(316)
Proceeds from capital lease financing	841	-
Proceeds from issuances of common stock	63	114
Tax payments related to performance shares issued	(150)	-
Excess tax benefit from employee stock plans	176	-
Net cash provided by (used in) financing activities	639	(202)
Increase (decrease) in cash and cash equivalents	3,698	(1,127)
Cash and cash equivalents:		
Beginning of period	2,726	5,013
End of period	$6,424	$3,886
Supplemental disclosure of cash flow information:		
Cash paid for interest	$260	$372
Cash paid for income taxes, net	246	20
Supplemental disclosure of non-cash information:		
Purchases of Property, equipment and leasehold improvements included in Accounts payable	$2,008	$753

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

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, 2013 (“2013 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.

Note 2. Recent Accounting Pronouncements

ASU 2014-12
In June 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-12, “Compensation – Stock Compensation (Topic 718): Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period.” This ASU requires that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. ASU 2014-12 is effective for annual periods beginning after December 15, 2015, and interim periods within annual periods beginning after December 15, 2015. We do not expect the adoption of ASU 2014-12 to have a material effect on our financial position, results of operations or cash flows.

ASU 2014-09
In May 2014, the FASB issued ASU No. 2014-09, “Revenue from Contracts with Customers (Topic 606).” ASU 2014-09 affects any entity using U.S. GAAP that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (e.g., insurance contracts or lease contracts). ASU 2014-09 is effective for annual periods beginning after December 15, 2016, and interim periods within annual periods beginning after December 15, 2016. We are still evaluating the effect of the adoption of ASU 2014-09.

ASU 2014-08
In April 2014, the FASB issued ASU No. 2014-08, "Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360) and Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity." ASU 2014-08 amends the definition for what types of asset disposals are to be considered discontinued operations, as well as amends the required disclosures for discontinued operations and assets held for sale. ASU 2014-08 is effective for annual periods beginning on or after December 15, 2014, and interim periods within annual periods beginning on or after December 15, 2014. We do not expect the adoption of ASU 2014-08 to have a material effect on our financial position, results of operations or cash flows.

ASU 2013-11
In July 2013, the FASB issued ASU No. 2013-11, “Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists.” ASU 2013-11 amends the guidance related to the presentation of unrecognized tax benefits and allows for the reduction of a deferred tax asset for a net operating loss (“NOL”) carryforward whenever the NOL or tax credit carryforward would be available to

reduce the additional taxable income or tax due if the tax position is disallowed. ASU 2013-11 is effective for annual and interim periods for fiscal years beginning after December 15, 2013. The adoption of ASU 2013-11 in January 2014 did not have any effect on our financial position, results of operations or cash flows.

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Note 3. Cash and Cash Equivalents

Under our cash management system, we utilize a controlled disbursement account to fund cash distribution checks presented for payment by the holder. Checks issued but not yet presented to banks may result in overdraft balances for accounting purposes. As of June 30, 2014, and December 31, 2013, bank overdrafts of $1.5 million and $0.7 million, respectively, were included in Accounts payable on our Consolidated Balance Sheets. Changes in book overdrafts from period to period are reported in the Consolidated Statements of Cash Flows as a component of operating activities within Accounts payable and Other accrued expenses.

Note 4. 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.

Inventories consisted of the following (in thousands):

	June 30, 2014	December 31, 2013
Raw materials	$4,090	$ 4,934
Work in process	4,222	3,313
Finished goods	8,524	5,927
Packaging materials	1,312	442
Promotional merchandise	1,501	1,539
Pub food, beverages and supplies	484	484
	$20,133	$ 16,639

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

Note 5. Related Party Transactions

Note Payable

In connection with our merger with Kona Brewing Company (“KBC”) in 2010, 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 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 and unpaid accrued interest will be due and payable on November 15, 2014. The balance on the Related Party Note was $72,000 and $165,000 as of June 30, 2014 and December 31, 2013, respectively.

Transactions with Anheuser-Busch, LLC (“A-B”)

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Gross sales to A-B	$51,798	$44,861	$90,250	$77,127
Margin fee paid to A-B, classified as a reduction of Sales	761	517	1,361	921
Handling, inventory management, royalty and other fees paid to A-B, classified in Cost of sales	87	111	180	211

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

	June 30, 2014	December 31, 2013
Amounts due from A-B related to beer sales pursuant to the A-B distributor agreement	$9,953	$ 8,457
Refundable deposits due to A-B	(2,358)	(2,728)
Amounts due to A-B for services rendered	(2,119)	(1,852)
Net amount due from A-B	$5,476	$ 3,877

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 June 30,		Six Months Ended June 30,	
2014	2013	2014	2013
$32	$ 32	$64	$ 64

We hold lease and sublease obligations for certain office space and the land underlying the brewery and pub location in Kailua-Kona, Hawaii, with a company whose owners include a shareholder who owns more than 5.00% of our common stock. 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 June 30,		Six Months Ended June 30,	
2014	2013	2014	2013
$120	$105	$231	$211

Note 6. Derivative Financial Instruments

Interest Rate Swap Contract

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, effective January 23, 2014, we entered into an interest rate swap contract with Bank of America, N.A. (“BofA”), to hedge the variability of interest payments associated with our variable-rate borrowings under our Term Loan with BofA. The swap contract terminates on September 29, 2023, and had a total notional value of $8.0 million as of June 30, 2014. Through this swap agreement, we pay interest at a fixed rate of 2.86% and receive interest at a floating-rate of the one-month LIBOR, which was 0.15% at June 30, 2014. 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 June 30, 2014, unrealized net losses of $370,000 were recorded in Accumulated other comprehensive loss 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 during the first six months of 2014 or 2013.

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

Fair Value of Derivative Instrument

	June 30, 2014	December 31, 2013
Fair value of interest rate swap	$(370)	$ -

The effect of this interest rate swap contract that was accounted for as a derivative instrument on our Consolidated Statements of Operations for the three and six-month periods ended June 30, 2014 and 2013 was as follows (in thousands):

Derivatives in Cash Flow Hedging Relationships	Amount of Gain (Loss) 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 June 30,			
2014	$ (131)	Interest expense	$ 55
2013	$ 98	Interest expense	$ 94
Six Months Ended June 30,			
2014	$ (370)	Interest expense	$ 96
2013	$ 190	Interest expense	$ 188

See also Note 7.

Note 7. 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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The following tables summarize assets and (liabilities) measured at fair value on a recurring basis (in thousands):

Fair Value at June 30, 2014	Level 1	Level 2	Level 3	Total
Money market funds	$6,200	$-	$ -	$6,200
Interest rate swap	-	(370)	-	(370)
	$6,200	$(370)	$ -	$5,830
Fair Value at December 31, 2013				
Money market funds	$2,650	$-	$ -	$2,650

We did not have any financial liabilities recorded at fair value on a recurring basis at December 31, 2013.

The fair value of our money market funds was based on statements from our financial institution. The fair value of our interest rate swap was based on quarterly statements from the issuing bank. There were no changes to our valuation techniques during the six months ended June 30, 2014.

We believe the carrying amounts of Cash, Accounts receivable, Other current assets, Accounts payable, Accrued salaries, wages and payroll taxes 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.

We had fixed-rate debt outstanding as follows (in thousands):

	June 30, 2014	December 31, 2013
Fixed-rate debt on balance sheet	$1,645	$ 960
Fair value of fixed-rate debt	$1,675	$ 985

We calculate the estimated fair value of our fixed-rate debt using a discounted cash flow methodology. Using estimated current interest rates based on a similar risk profile and duration (Level 2), the fixed cash flows are discounted and summed to compute the fair value of the debt.

Note 8. 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, as well as our Square Mile cider brand. Pubs operations primarily include our pubs, some of which are located adjacent to our Beer Related operations. 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 information by segment was as follows (dollars in thousands):

Three Months Ended June 30,

2014	Beer Related	Pubs	Total
Net sales	$50,043	$6,643	$56,686
Gross profit	$17,659	$915	$18,574
Gross margin	35.3 %	13.8 %	32.8 %

2013

Net sales	$42,997	$6,010	$49,007
Gross profit	$14,292	$672	$14,964
Gross margin	33.2 %	11.2 %	30.5 %

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Six Months Ended June 30,

2014	Beer Related	Pubs	Total
Net sales	$87,857	$12,655	$100,512
Gross profit	$28,706	$1,708	$30,414
Gross margin	32.7 %	13.5 %	30.3 %
2013			
Net sales	$74,247	$11,369	$85,616
Gross profit	$22,618	$1,289	$23,907
Gross margin	30.5 %	11.3 %	27.9 %

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 represented the following percentage of our Sales:

Three Months Ended June 30,		Six Months Ended June 30,	
2014	2013	2014	2013
84.0%	84.1%	82.5%	82.8%

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

June 30, 2014	December 31, 2013
74.7%	74.4 %

Note 9. Significant Stock-Based Plan Activity and Stock-Based Compensation

Stock-Based Compensation Expense

Stock-based compensation expense was recognized in our Consolidated Statements of Operations as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Selling, general and administrative expense	$246	$211	$400	$278

Cost of sales	27	35	44	70
Total Stock-based compensation expense	$273	$246	$444	$348

At June 30, 2014, we had total unrecognized stock-based compensation expense of $2.4 million, which will be recognized over the weighted average remaining vesting period of 3.3 years.

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Note 10. 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 June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Weighted average common shares used for basic EPS	19,029	18,926		