

CRAFT BREW ALLIANCE, INC.  
Form 10-Q  
November 05, 2014

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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, 2014

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 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  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:

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  
o No x

The number of shares of the registrant's common stock outstanding as of October 28, 2014 was 19,074,222.

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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<br>30,<br>2014 | December<br>31,<br>2013 |
|---|--------------------------|-------------------------|
| Assets  |                          |                         |
| Current assets:   |                          |                         |
| Cash and cash equivalents   | \$ 1,469                 | \$ 2,726                |
| Accounts receivable, net  | 11,069                   | 11,370                  |
| Inventories   | 19,152                   | 16,639                  |
| Deferred income tax asset, net  | 1,686                    | 1,345                   |
| Other current assets  | 3,297                    | 3,403                   |
| Total current assets  | 36,673                   | 35,483                  |
| Property, equipment and leasehold improvements, net   | 109,577                  | 104,193                 |
| Goodwill  | 12,917                   | 12,917                  |
| Intangible and other assets, net  | 17,568                   | 17,693                  |
| Total assets  | \$ 176,735               | \$ 170,286              |
| Liabilities and Shareholders' Equity  |                          |                         |
| Current liabilities:  |                          |                         |
| Accounts payable  | \$ 14,657                | \$ 14,742               |
| Accrued salaries, wages and payroll taxes   | 5,677                    | 4,616                   |
| Refundable deposits   | 8,449                    | 8,252                   |
| Other accrued expenses  | 2,256                    | 1,381                   |
| Current portion of long-term debt and capital lease obligations   | 1,208                    | 710                     |
| Total current liabilities   | 32,247                   | 29,701                  |
| Long-term debt and capital lease obligations, net of current portion  | 10,845                   | 11,050                  |
| Fair value of derivative financial instruments  | 340                      | -                       |
| Deferred income tax liability, net  | 18,247                   | 17,719                  |
| Other liabilities   | 629                      | 584                     |
| Total liabilities   | 62,308                   | 59,054                  |
| Commitments and contingencies   |                          |                         |
| Common shareholders' equity:  |                          |                         |
| Common stock, \$0.005 par value. Authorized 50,000,000 shares; issued and outstanding 19,074,222 and 18,972,247 | 95                       | 95                      |
| Additional paid-in capital  | 138,018                  | 136,972                 |
| Accumulated other comprehensive loss  | (210 )                   | -                       |
| Accumulated deficit   | (23,476 )                | (25,835 )               |

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|   |            |            |
|---|------------|------------|
| Total common shareholders' equity                 | 114,427    | 111,232    |
| Total liabilities and common shareholders' equity | \$ 176,735 | \$ 170,286 |

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

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CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

(In thousands, except per share amounts)

|   | Three Months<br>Ended September<br>30, |          | Nine Months Ended<br>September 30, |           |
|---|--|----------|------------------------------------|-----------|
|   | 2014                                   | 2013     | 2014                               | 2013      |
| Sales   | \$55,871                               | \$53,022 | \$163,616                          | \$145,113 |
| Less excise taxes                             | 3,798                                  | 3,668    | 11,031                             | 10,143    |
| Net sales                                     | 52,073                                 | 49,354   | 152,585                            | 134,970   |
| Cost of sales                                 | 37,428                                 | 34,512   | 107,526                            | 96,221    |
| Gross profit                                  | 14,645                                 | 14,842   | 45,059                             | 38,749    |
| Selling, general and administrative expenses  | 13,554                                 | 11,602   | 40,824                             | 36,312    |
| Operating income                              | 1,091                                  | 3,240    | 4,235                              | 2,437     |
| Interest expense                              | (111 )                                 | (62 )    | (317 )                             | (374 )    |
| Other income (expense), net                   | (54 )                                  | (58 )    | (51 )                              | (75 )     |
| Income before income taxes                    | 926                                    | 3,120    | 3,867                              | 1,988     |
| Income tax provision                          | 361                                    | 1,228    | 1,508                              | 775       |
| Net income                                    | \$565                                  | \$1,892  | \$2,359                            | \$1,213   |
| Basic and diluted net income per share        | \$0.03                                 | \$0.10   | \$0.12                             | \$0.06    |
| Shares used in basic per share calculations   | 19,052                                 | 18,937   | 19,019                             | 18,916    |
| Shares used in diluted per share calculations | 19,103                                 | 19,067   | 19,086                             | 19,010    |

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<br>Months<br>Ended<br>September 30, |         | For the Nine<br>Months Ended<br>September 30, |         |
|---|---|---------|---|---------|
|   | 2014  | 2013    | 2014  | 2013    |
| Net income  | \$565   | \$1,892 | \$2,359                                       | \$1,213 |
| Unrealized gain (loss) on derivative hedge transactions, net of tax | 19  | 18      | (210 )  | 135     |
| Comprehensive income  | \$584   | \$1,910 | \$2,149                                       | \$1,348 |

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)

|   | Nine Months<br>Ended September<br>30, |         |
|---|---------------------------------------|---------|
|   | 2014                                  | 2013    |
| Cash flows from operating activities:   |                                       |         |
| Net income  | \$2,359                               | \$1,213 |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                       |         |
| Depreciation and amortization   | 6,432                                 | 6,079   |
| Deferred income taxes   | 316                                   | 224     |
| Stock-based compensation  | 805                                   | 632     |
| Excess tax benefit from employee stock plans                                      | (191 )                                | (42 )   |
| Other   | (253 )                                | 514     |
| Changes in operating assets and liabilities:                                      |                                       |         |
| Accounts receivable, net  | 301                                   | (1,501) |
| Inventories   | (2,287 )                              | (4,084) |
| Other current assets  | 106                                   | 638     |
| Accounts payable and other accrued expenses                                       | 861                                   | 3,263   |
| Accrued salaries, wages and payroll taxes   | 1,061                                 | (503 )  |
| Refundable deposits   | 1,188                                 | 1,129   |
| Net cash provided by operating activities   | 10,698                                | 7,562   |
| Cash flows from investing activities:   |                                       |         |
| Expenditures for property, equipment and leasehold improvements                   | (12,936)                              | (7,361) |
| Proceeds from sale of property, equipment and leasehold improvements              | 236                                   | -       |
| Net cash used in investing activities   | (12,700)                              | (7,361) |
| Cash flows from financing activities:   |                                       |         |
| Principal payments on debt and capital lease obligations                          | (458 )                                | (475 )  |
| Proceeds from capital lease financing   | 841                                   | -       |
| Proceeds from issuances of common stock   | 321                                   | 119     |
| Tax payments related to performance shares issued                                 | (150 )                                | -       |
| Excess tax benefit from employee stock plans                                      | 191                                   | 42      |
| Net cash provided by (used in) financing activities                               | 745                                   | (314 )  |
| Decrease in cash and cash equivalents   | (1,257 )                              | (113 )  |
| Cash and cash equivalents:  |                                       |         |
| Beginning of period   | 2,726                                 | 5,013   |
| End of period   | \$1,469                               | \$4,900 |
| Supplemental disclosure of cash flow information:                                 |                                       |         |
| Cash paid for interest  | \$401                                 | \$494   |
| Cash paid for income taxes, net   | 889                                   | 30      |



Supplemental disclosure of non-cash information:

|  |       |       |
|--|-------|-------|
| Purchases of Property, equipment and leasehold improvements included in Accounts payable | \$331 | \$679 |
|--|-------|-------|

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 2014-15

In August 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-15, "Presentation of Financial Statements - Going Concern (Subtopic 205-40)". ASU 2014-15 provides guidance related to management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related footnote disclosure. ASU 2014-15 is effective for annual periods ending after December 15, 2016, and for interim and annual periods thereafter. Early application is permitted. We do not expect the adoption of ASU 2014-15 to have a material effect on our financial position, results of operations or cash flows.

ASU 2014-12

In June 2014, the FASB issued 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 amending 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.

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## 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.

## 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 September 30, 2014, and December 31, 2013, bank overdrafts of \$0.4 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):

|                                  | September<br>30,<br>2014 | December<br>31,<br>2013 |
|----------------------------------|--------------------------|-------------------------|
| Raw materials                    | \$ 3,191                 | \$ 4,934                |
| Work in process                  | 3,595                    | 3,313                   |
| Finished goods                   | 9,047                    | 5,927                   |
| Packaging materials              | 1,016                    | 442                     |
| Promotional merchandise          | 1,713                    | 1,539                   |
| Pub food, beverages and supplies | 590                      | 484                     |
|                                  | \$ 19,152                | \$ 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 \$24,000 and \$165,000 as of September 30, 2014 and December 31, 2013, respectively.

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

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

|   | Three Months  |               | Nine Months Ended |               |
|---|---------------|---------------|-------------------|---------------|
|   | Ended         |               | September 30,     |               |
|   | September 30, | September 30, | September 30,     | September 30, |
|   | 2014          | 2013          | 2014              | 2013          |
| Gross sales to A-B  | \$45,905      | \$44,054      | \$136,155         | \$121,181     |
| Margin fee paid to A-B, classified as a reduction of Sales                                      | 670           | 501           | 2,031             | 1,422         |
| Handling, inventory management, royalty and other fees paid to A-B, classified in Cost of sales | 116           | 101           | 296               | 312           |

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

|  | September |          |
|--|-----------|----------|
|  | 30,       | December |
|  | 2014      | 31, 2013 |
| Amounts due from A-B related to beer sales pursuant to the A-B distributor agreement | \$ 7,740  | \$ 8,457 |
| Refundable deposits due to A-B   | (2,804 )  | (2,728 ) |
| Amounts due to A-B for services rendered   | (2,005 )  | (1,852 ) |
| Net amount due from A-B  | \$ 2,931  | \$ 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     | Nine      |      |      |
|-----------|-----------|------|------|
| Months    | Months    |      |      |
| Ended     | Ended     |      |      |
| September | September |      |      |
| 30,       | 30,       |      |      |
| 2014      | 2013      | 2014 | 2013 |
| \$31      | \$32      | \$95 | \$95 |

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     | Nine      |       |       |
|-----------|-----------|-------|-------|
| Months    | Months    |       |       |
| Ended     | Ended     |       |       |
| September | September |       |       |
| 30,       | 30,       |       |       |
| 2014      | 2013      | 2014  | 2013  |
| \$120     | \$111     | \$351 | \$322 |

## 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. On July 1, 2013 our previous swap contract terminated. The current swap contract terminates on September 29, 2023, and had a total notional value of \$7.9 million as of September 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 September 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 September 30, 2014, unrealized net losses of \$340,000 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 nine 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

|                                  | September<br>30,<br>2014 | December<br>31,<br>2013 |
|----------------------------------|--------------------------|-------------------------|
| Fair value of interest rate swap | \$ (340 )                | \$ -                    |

The effect of the interest rate swap contracts that were accounted for as a derivative instrument on our Consolidated Statements of Operations for the three and nine-month periods ended September 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 September 30, 2014          | \$ 30   | Interest expense   | \$ 55  |
| 2013   | \$ 29   | Interest expense   | \$ -   |
| Nine Months Ended September 30, 2014           | \$ (340 )   | Interest expense   | \$ 151   |
| 2013   | \$ 219  | 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):

|                                  | Level 1 | Level 2 | Level 3 | Total   |
|----------------------------------|---------|---------|---------|---------|
| Fair Value at September 30, 2014 |         |         |         |         |
| Money market funds               | \$1,000 | \$-     | \$ -    | \$1,000 |
| Interest rate swap               | -       | (340)   | -       | (340 )  |
|                                  | \$1,000 | \$(340) | \$ -    | \$660   |
| 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 nine months ended September 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):

|                                  | September<br>30,<br>2014 | December<br>31, 2013 |
|----------------------------------|--------------------------|----------------------|
| Fixed-rate debt on balance sheet | \$ 1,539                 | \$ 960               |
| Fair value of fixed-rate debt    | \$ 1,596                 | \$ 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.

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

## Three Months Ended September 30,

|              | Beer     |         |          |
|--------------|----------|---------|----------|
|              | Related  | Pubs    | Total    |
| 2014         |          |         |          |
| Net sales    | \$44,663 | \$7,410 | \$52,073 |
| Gross profit | \$13,447 | \$1,198 | \$14,645 |
| Gross margin | 30.1 %   | 16.2 %  | 28.1 %   |

## 2013

|              |          |         |          |
|--------------|----------|---------|----------|
| Net sales    | \$42,267 | \$7,087 | \$49,354 |
| Gross profit | \$13,701 | \$1,141 | \$14,842 |
| Gross margin | 32.4 %   | 16.1 %  | 30.1 %   |

## Nine Months Ended September 30,

|              | Beer      |          |           |
|--------------|-----------|----------|-----------|
|              | Related   | Pubs     | Total     |
| 2014         |           |          |           |
| Net sales    | \$132,520 | \$20,065 | \$152,585 |
| Gross profit | \$42,153  | \$2,906  | \$45,059  |
| Gross margin | 31.8 %    | 14.5 %   | 29.5 %    |

## 2013

|              |           |          |           |
|--------------|-----------|----------|-----------|
| Net sales    | \$116,514 | \$18,456 | \$134,970 |
| Gross profit | \$36,319  | \$2,430  | \$38,749  |
| Gross margin | 31.2 %    | 13.2 %   | 28.7 %    |

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 September 30, |       | Nine Months Ended September 30, |       |
|----------------------------------|-------|---------------------------------|-------|
| 2014                             | 2013  | 2014                            | 2013  |
| 81.0%                            | 82.1% | 82.0%                           | 82.5% |

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

| September 30, | December 31, |
|---------------|--------------|
| 2014          | 2013         |

69.9 % 74.4 %

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## 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<br>Months<br>Ended<br>September<br>30,<br>2014 |       | Nine<br>Months<br>Ended<br>September<br>30,<br>2013 |       |
|---|--|-------|---|-------|
| Selling, general and administrative expense | \$320  | \$236 | \$720   | \$514 |
| Cost of sales                               | 41   | 48    | 85  | 118   |
| Total Stock-based compensation expense      | \$361  | \$284 | \$805   | \$632 |

At September 30, 2014, we had total unrecognized stock-based compensation expense of \$2.2 million, which will be recognized over the weighted average remaining vesting period of 3.1 years.

## 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<br>Ended<br>September 30,<br>2014 |        | Nine Months<br>Ended<br>September 30,<br>2013 |        |
|---|--|--------|---|--------|
| Weighted average common shares used for basic EPS   | 19,052   | 18,937 | 19,019  | 18,916 |
| Dilutive effect of stock-based awards   | 51   | 130    | 67  | 94     |
| Shares used for diluted EPS   | 19,103   | 19,067 | 19,086  | 19,010 |
| Stock-based awards not included in diluted per share calculations as they would be antidilutive | 144  | -      | 79  | 38     |

## 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 our 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, 2013 ("2013 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 2013 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.

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Overview

Craft Brew Alliance, Inc. is an independent craft brewing company that was formed through the merger of leading Pacific Northwest craft brewers – Widmer Brothers Brewing and Redhook Ale Brewery – in 2008. Since our formation, we have remained focused on preserving and growing one-of-a-kind craft beers and brands. Today, we are comprised of five unique and pioneering craft beer and cider brands:

- Redhook Ale Brewery founded by Gordon Bowker and Paul Shipman in 1981 in Seattle, Washington;
- Widmer Brothers Brewing 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 Kailua-Kona, Hawaii;
- Omission Beer, internally developed by our brewing team as the first beer brand specially crafted to remove gluten, and launched in 2012 in Portland, Oregon; and
- Square Mile Cider Company, the first non-beer brand family created by Craft Brew Alliance, and launched in 2013.

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 derive from the combination of: i) our innovative portfolio of distinct craft beer and cider brand families; ii) evolving national brewing footprint with national sales and marketing reach; iii) expertise in developing partnerships and new growth strategies; iv) leadership team with significant beer and growth-company expertise; v) proven ability to manage brand lifecycles, from development to turnaround; and vi) successful track record managing mergers, divestitures and acquisitions.

We proudly brew our craft beers in four company-owned breweries located in Portland, Oregon; the Seattle suburb of Woodinville, Washington; Portsmouth, New Hampshire; and Kailua-Kona, Hawaii; and one brewery in Memphis, Tennessee owned by our brewing partner. Additionally, we own and operate two small innovation breweries, primarily used for small batch production and innovative brews, in Portland, Oregon and Portsmouth, New Hampshire.

We distribute our beers to retailers through independent wholesalers that are aligned with the Anheuser-Busch, LLC (“A-B”) network. These sales are made pursuant to a Master Distributor Agreement (the “A-B Distributor Agreement”) with A-B. As a result of this distribution arrangement, we believe that, under alcohol beverage laws in a majority of states, these wholesalers would own the exclusive right to distribute our beers in their respective markets if the A-B Distributor Agreement expires or is terminated. Redhook and Widmer Brothers beers are distributed in all 50 states and Kona beers are distributed in 40 states. Omission Beer continues to expand into new markets in the U.S. and internationally. Square Mile is currently available in 10 states in the West. Separate from our A-B wholesalers, we maintain an internal independent sales and marketing organization 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 operations. Beer Related operations include the brewing and sale of craft beers and cider from our breweries, both domestically and internationally. Pubs operations primarily include our five pubs, four of which are located adjacent to our Beer Related operations, as well as other merchandise sales, and sales of our beers directly to customers.

Following is a summary of our financial results:

|   |            |                        |
|---|------------|------------------------|
| Nine Months Ended September 30, Net Sales | Net Income | Number of Barrels Sold |
|---|------------|------------------------|

|      |                 |               |         |
|------|-----------------|---------------|---------|
| 2014 | \$152.6 million | \$2.4 million | 632,400 |
| 2013 | \$135.0 million | \$1.2 million | 569,900 |

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## Results of Operations

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

|  | Three Months Ended |                    | Nine Months Ended  |                    |
|--|--------------------|--------------------|--------------------|--------------------|
|  | September 30, 2014 | September 30, 2013 | September 30, 2014 | September 30, 2013 |
| Sales  | 107.3%             | 107.4%             | 107.2%             | 107.5%             |
| Less excise tax                              | 7.3                | 7.4                | 7.2                | 7.5                |
| Net sales                                    | 100.0              | 100.0              | 100.0              | 100.0              |
| Cost of sales                                | 71.9               | 69.9               | 70.5               | 71.3               |
| Gross profit                                 | 28.1               | 30.1               | 29.5               | 28.7               |
| Selling, general and administrative expenses | 26.0               | 23.5               | 26.8               | 26.9               |
| Operating income                             | 2.1                | 6.6                | 2.8                | 1.8                |
| Interest expense                             | (0.2 )             | (0.1 )             | (0.2 )             | (0.3 )             |
| Other income (expense), net                  | (0.1 )             | (0.1 )             | (0.0 )             | (0.1 )             |
| Income before income taxes                   | 1.8                | 6.3                | 2.5                | 1.5                |
| Income tax provision                         | 0.7                | 2.5                | 1.0                | 0.6                |
| Net income                                   | 1.1 %              | 3.8 %              | 1.5 %              | 0.9 %              |

(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,

| 2014         | Beer     |         |          |
|--------------|----------|---------|----------|
|              | Related  | Pubs    | Total    |
| Net sales    | \$44,663 | \$7,410 | \$52,073 |
| Gross profit | \$13,447 | \$1,198 | \$14,645 |
| Gross margin | 30.1 %   | 16.2 %  | 28.1 %   |

## 2013

|              |          |         |          |
|--------------|----------|---------|----------|
| Net sales    | \$42,267 | \$7,087 | \$49,354 |
| Gross profit | \$13,701 | \$1,141 | \$14,842 |
| Gross margin | 32.4 %   | 16.1 %  | 30.1 %   |

## Nine Months Ended September 30,

| 2014         | Beer      |          |           |
|--------------|-----------|----------|-----------|
|              | Related   | Pubs     | Total     |
| Net sales    | \$132,520 | \$20,065 | \$152,585 |
| Gross profit | \$42,153  | \$2,906  | \$45,059  |
| Gross margin | 31.8 %    | 14.5 %   | 29.5 %    |

## 2013

|              |           |          |           |
|--------------|-----------|----------|-----------|
| Net sales    | \$116,514 | \$18,456 | \$134,970 |
| Gross profit | \$36,319  | \$2,430  | \$38,749  |
| Gross margin | 31.2 %    | 13.2 %   | 28.7 %    |



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## Sales by Category

The following table sets forth a comparison of sales by category (dollars in thousands):

| Sales by Category                                | Three Months Ended |                    | Dollar  |      |   |
|--|--------------------|--------------------|---------|------|---|
|  | September 30, 2014 | September 30, 2013 | Change  | %    |   |
| A-B and A-B related                              | \$45,235           | \$43,553           | \$1,682 | 3.9  | % |
| Contract brewing and beer related <sup>(1)</sup> | 3,226              | 2,382              | 844     | 35.4 | % |
| Excise taxes                                     | (3,798 )           | (3,668 )           | (130 )  | 3.5  | % |
| Net beer related sales                           | 44,663             | 42,267             | 2,396   | 5.7  | % |
| Pubs <sup>(2)</sup>                              | 7,410              | 7,087              | 323     | 4.6  | % |
| Net sales  | \$52,073           | \$49,354           | \$2,719 | 5.5  | % |

| Sales by Category                                | Nine Months Ended  |                    | Dollar   |      |   |
|--|--------------------|--------------------|----------|------|---|
|  | September 30, 2014 | September 30, 2013 | Change   | %    |   |
| A-B and A-B related                              | \$134,124          | \$119,759          | \$14,365 | 12.0 | % |
| Contract brewing and beer related <sup>(1)</sup> | 9,427              | 6,898              | 2,529    | 36.7 | % |
| Excise taxes                                     | (11,031 )          | (10,143 )          | (888 )   | 8.8  | % |
| Net beer related sales                           | 132,520            | 116,514            | 16,006   | 13.7 | % |
| Pubs <sup>(2)</sup>                              | 20,065             | 18,456             | 1,609    | 8.7  | % |
| Net sales  | \$152,585          | \$134,970          | \$17,615 | 13.1 | % |

(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,                 | 2014      | 2013      | Barrel Change | %      |   | Change in Depletions <sup>(1)</sup> |
|--|-----------|-----------|---------------|--------|---|-------------------------------------|
|  | Shipments | Shipments |               | Change | % |                                     |
| A-B and A-B related                              | 198,300   | 194,100   | 4,200         | 2.2    | % | 6 %                                 |
| Contract brewing and beer related <sup>(2)</sup> | 13,700    | 9,400     | 4,300         | 45.7   | % |                                     |
| Pubs   | 3,300     | 3,500     | (200 )        | (5.7 ) | % |                                     |
| Total  | 215,300   | 207,000   | 8,300         | 4.0    | % |                                     |

  

| Nine Months Ended September 30,                  | 2014      | 2013      | Barrel Change | %      |   | Change in Depletions <sup>(1)</sup> |
|--|-----------|-----------|---------------|--------|---|-------------------------------------|
|  | Shipments | Shipments |               | Change | % |                                     |
| A-B and A-B related                              | 584,000   | 533,800   | 50,200        | 9.4    | % | 8 %                                 |
| Contract brewing and beer related <sup>(2)</sup> | 40,000    | 27,200    | 12,800        | 47.1   | % |                                     |
| Pubs   | 8,400     | 8,900     | (500 )        | (5.6 ) | % |                                     |
| Total  | 632,400   | 569,900   | 62,500        | 11.0   | % |                                     |

(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, 2014 compared to the same periods of 2013 were primarily due to increases in shipments, shifts in package mix towards bottle, which has a higher selling price per barrel than draft, and price increases.

The increases in contract brewing and beer related sales in the three and nine-month periods ended September 30, 2014 compared to the same periods of 2013 were primarily due to increases in international shipments of our beers, which sell at a higher rate per barrel than contract brewing sales, as well as increases in contract brewing shipments.

Pubs sales increased in the three and nine-month periods ended September 30, 2014 compared to the same periods of 2013. This sales growth was driven by higher guest counts combined with higher revenue per guest. The Redhook Pub in Woodinville, Washington was closed for twelve weeks during the nine-month period ended September 30, 2013 for a full remodel and re-opened at the end of May 2013 after being closed for twelve weeks in total.

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The increases in excise taxes in the three and nine-month periods ended September 30, 2014 compared to the same periods of 2013 were due to the increases in shipments.

## Shipments by Brand

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

| Three Months Ended September 30, | 2014 Shipments | 2013 Shipments | Increase (Decrease) | % Change | Change in Depletions |
|----------------------------------|----------------|----------------|---------------------|----------|----------------------|
| Kona                             | 79,700         | 70,000         | 9,700               | 13.9 %   | 15 %                 |
| Widmer Brothers                  | 69,700         | 70,000         | (300 )              | (0.4 )%  | 4 %                  |
| Redhook                          | 55,500         | 60,100         | (4,600 )            | (7.7 )%  | (2 )%                |
| Total <sup>(1)</sup>             | 204,900        | 200,100        | 4,800               | 2.4 %    | 6 %                  |

  

| Nine Months Ended September 30, | 2014 Shipments | 2013 Shipments | Increase (Decrease) | % Change | Change in Depletions |
|---------------------------------|----------------|----------------|---------------------|----------|----------------------|
| Kona                            | 234,400        | 196,300        | 38,100              | 19.4 %   | 14 %                 |
| Widmer Brothers                 | 200,400        | 190,000        | 10,400              | 5.5 %    | 2 %                  |
| Redhook                         | 167,600        | 161,700        | 5,900               | 3.6 %    | 5 %                  |
| Total <sup>(1)</sup>            | 602,400        | 548,000        | 54,400              | 9.9 %    | 8 %                  |

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

The increases in our Kona brand shipments in the three and nine-month periods ended September 30, 2014 compared to the same periods of 2013 were primarily due to the release of Castaway IPA on the mainland and continued sales growth of our Big Wave Golden Ale and Longboard Lager.

The decrease in our Widmer Brothers brand shipments in the three-month period ended September 30, 2014 compared to the same period of 2013 was primarily due to a decline in shipments of Rotator IPA, which was discontinued in the second quarter of 2014, and Hefeweizen; these declines were partially offset by an increase in shipments of Upheaval IPA, a new beer for the Widmer Brothers brand, and Omission beer. The increase in our Widmer Brothers brand shipments in the nine-month period ended September 30, 2014 compared to the same period of 2013 was primarily due to increases in shipments of the Omission brand and Upheaval IPA, partially offset by declines in sales of Rotator IPA and Hefeweizen.

The decrease in our Redhook brand shipments in the three-month period ended September 30, 2014 compared to the same period of 2013 was primarily the result of cycling the launch of Game Changer Ale and declines in ESB, partially offset by our new KCCO Black Lager, a craft beer developed in partnership with theChive, a photo entertainment website. The increase in shipments in the nine-month period ended September 30, 2014 compared to the same period of 2013 was primarily the result of increased sales of KCCO Black Lager, as well as further penetration into existing markets, particularly by our Long Hammer IPA, partially offset by declines in sales of ESB and Audible Ale.

The differences between the percentage changes in shipments and percentage changes in depletions for the three and nine-month periods ended September 30, 2014 compared to the same periods of 2013 were a result of continuing the optimization of our supply chain processes, including brewing, to more closely align with the seasonality of our beer sales.



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## Shipments by Package

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

| Three Months Ended | 2014      |        | 2013      |        |
|--------------------|-----------|--------|-----------|--------|
|                    |           | % of   |           | % of   |
| September 30,      | Shipments | Total  | Shipments | Total  |
| Draft              | 52,700    | 25.7 % | 58,400    | 29.2 % |
| Packaged           | 152,200   | 74.3 % | 141,700   | 70.8 % |
| Total              | 204,900   | 100.0% | 200,100   | 100.0% |

| Nine Months Ended | 2014      |        | 2013      |        |
|-------------------|-----------|--------|-----------|--------|
|                   |           | % of   |           | % of   |
| September 30,     | Shipments | Total  | Shipments | Total  |
| Draft             | 151,400   | 25.1 % | 160,800   | 29.3 % |
| Packaged          | 451,000   | 74.9 % | 387,200   | 70.7 % |
| Total             | 602,400   | 100.0% | 548,000   | 100.0% |

The shifts in package mix from draft to packaged in the three and nine-month periods ended September 30, 2014 compared to the same periods of 2013 were primarily the result of the increases in volumes on our Kona, Omission and Redhook packaged beers and lower volumes on our Widmer Brothers draft beer. Increased competition across the industry, as a result of both the entry of large, multi-national brewers into the craft beer segment and the significant increase in small, local breweries nationally, is making on premise draft sales more challenging.

## Cost of Sales

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

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

|              | Three Months Ended |          | September 30, |        | Dollar | % |
|--------------|--------------------|----------|---------------|--------|--------|---|
|              | 2014               | 2013     | Change        | Change |        |   |
| Beer Related | \$31,216           | \$28,566 | \$2,650       | 9.3    | %      |   |
| Pubs         | 6,212              | 5,946    | 266           | 4.5    | %      |   |
| Total        | \$37,428           | \$34,512 | \$2,916       | 8.4    | %      |   |

  

|              | Nine Months Ended |          | September 30, |        | Dollar | % |
|--------------|-------------------|----------|---------------|--------|--------|---|
|              | 2014              | 2013     | Change        | Change |        |   |
| Beer Related | \$90,367          | \$80,195 | \$10,172      | 12.7   | %      |   |
| Pubs         | 17,159            | 16,026   | 1,133         | 7.1    | %      |   |
| Total        | \$107,526         | \$96,221 | \$11,305      | 11.7   | %      |   |

The increases in Beer Related Cost of sales in the three and nine-month periods ended September 30, 2014 compared to the same periods of 2013 were primarily due to the increases in shipments discussed above, as well as the mix shift from draft to packaged product as the per barrel equivalent cost of packaged product is higher than draft. In the

nine-month period ended September 30, 2014 compared to the same period in 2013, these cost increases were partially offset by increased efficiencies, primarily through better capacity utilization of our breweries.

Also contributing to the increases in Beer Related Cost of sales were various costs incurred as a result of initiating brewing operations in Memphis, Tennessee. Due to the efficient and successful launch in July 2014, we were able to balance production in the three month period ended September 30, 2014 and meet shipping demands from buffer stock brewed during the three months ended June 30, 2014 to ensure adequate supply in the event our Memphis brewery experienced any initial challenges. This resulted in utilization rates that were slightly lower than typically seen in prior three month periods ended September 30, and significantly lower than the three month period ended September 30, 2013, when we were responding to out-of-stock issues that surfaced during the summer of 2013. We also realized incremental startup costs for initial shipments out of the Memphis brewery as a result of launching during the peak selling season. The impact of decreased production and higher shipment costs represented approximately \$1.4 million, or \$840,000 after tax, reflected in Beer Related Cost of sales in the three-month period ended September 30, 2014. For the nine month period ended September 30, 2014, the additional costs related to initiating brewing in Memphis totaled approximately \$0.7 million, or \$420,000 after tax.



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Pubs Cost of sales increased in the three and nine-month periods ended September 30, 2014 compared to the same periods of 2013, primarily due to the increases in sales and cost increases across various categories, including labor, merchandise and administrative costs.

Capacity utilization is calculated by dividing total shipments from our owned breweries by the approximate working capacity of these breweries and was as follows:

|                      | Three<br>Months<br>Ended<br>September<br>30,<br>2014 |      | Nine<br>Months<br>Ended<br>September<br>30,<br>2013 |      |
|----------------------|--|------|---|------|
| Capacity utilization | 75 %   | 77 % | 77 %  | 71 % |

In June 2014, we initiated full-scale brewing with our brewing partner in Memphis, Tennessee. This partnership provides us scalable capacity and we anticipate producing up to 100,000 barrels at this location over the next 12 months.

Gross Profit

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

|              | Three Months<br>Ended<br>September 30, |          | Dollar    |        | % |
|--------------|--|----------|-----------|--------|---|
|              | 2014                                   | 2013     | Change    | Change |   |
| Beer Related | \$13,447                               | \$13,701 | \$ (254 ) | (1.9 ) | % |
| Pubs         | 1,198                                  | 1,141    | 57        | 5.0    | % |
| Total        | \$14,645                               | \$14,842 | \$ (197 ) | (1.3 ) | % |

  

|              | Nine Months<br>Ended<br>September 30, |          | Dollar  |        | % |
|--------------|---------------------------------------|----------|---------|--------|---|
|              | 2014                                  | 2013     | Change  | Change |   |
| Beer Related | \$42,153                              | \$36,319 | \$5,834 | 16.1   | % |
| Pubs         | 2,906                                 | 2,430    | 476     | 19.6   | % |
| Total        | \$45,059                              | \$38,749 | \$6,310 | 16.3   | % |

The decrease in gross profit in the three-month period ended September 30, 2014 compared to the same period of 2013 was primarily due to the additional costs incurred related to initiating brewing in Memphis, Tennessee, as discussed above. The increase in gross profit in the nine-month period ended September 30, 2014 compared to the same period of 2013 was primarily due to the increases in shipment volumes, as well as increased pricing, improved operating efficiencies of our breweries and optimization of our supply chain, partially offset by the additional costs incurred related to initiating brewing in Memphis, Tennessee, as discussed above.

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

|              | Three<br>Months<br>Ended<br>September<br>30, |       | Nine Months<br>Ended<br>September<br>30, |       |
|--------------|--|-------|--|-------|
|              | 2014   | 2013  | 2014                                     | 2013  |
| Beer Related | 30.1%  | 32.4% | 31.8%                                    | 31.2% |
| Pubs         | 16.2%  | 16.1% | 14.5%                                    | 13.2% |
| Total        | 28.1%  | 30.1% | 29.5%                                    | 28.7% |

The decrease in the Beer Related gross margin rates in the three-month period ended September 30, 2014 compared to the same period of 2013 was due to the additional costs incurred related to initiating brewing in Memphis, Tennessee, as discussed above, as well as the effect of changes in our product mix. Additionally, the three-month-period ended September 30, 2013 benefited from increased brewing to establish appropriate inventory levels after shortages during the three-month period ended June 30, 2013. The increase in the Beer Related gross margin rates in the nine-month period ended September 30, 2014 compared to the same period of 2013 was due to the improved operating efficiencies of our breweries, as discussed above, optimization of our supply chain, and increases in pricing, partially offset by the effect of changes in product mix and additional costs incurred related to initiating brewing in Memphis, Tennessee. The increases in the Pubs gross margin rates in the three and nine-month periods ended September 30, 2014 compared to the same periods of 2013 were primarily due to the 2013 closure and post renovation ramp up of our Woodinville, Washington Pub, as discussed above.

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## 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.

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

|                     | Three Months<br>Ended<br>September 30, |          | Dollar  | %      |
|---------------------|--|----------|---------|--------|
|                     | 2014                                   | 2013     | Change  | Change |
|                     | \$13,554                               | \$11,602 | \$1,952 | 16.8 % |
| As a % of Net sales | 26.0 %                                 | 23.5 %   |         |        |
|                     | Nine Months Ended<br>September 30,     |          | Dollar  | %      |
|                     | 2014                                   | 2013     | Change  | Change |
|                     | \$40,824                               | \$36,312 | \$4,512 | 12.4 % |
| As a % of Net sales | 26.8 %                                 | 26.9 %   |         |        |

The increases in SG&A for the three and nine-month periods ended September 30, 2014 compared to the same periods of 2013 were primarily due to the planned increases in SG&A spending, primarily for Kona television advertising in select markets, in 2014 when compared to 2013, as well as the timing of certain promotional activity. SG&A increased as a percentage of Net sales in the three-month period ended September 30, 2014 compared to the same period of 2013 primarily due to the planned increases in SG&A spending in 2014 compared to 2013 as discussed above. SG&A decreased as a percentage of Net sales in the nine-month period ended September 30, 2014 compared to the same period of 2013 primarily due to the increase in our Net sales, partially offset by the planned increase in spending.

## Interest Expense

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

|  | Three<br>Months<br>Ended<br>September<br>30, |       | Dollar   | %        |
|--|--|-------|----------|----------|
|  | 2014   | 2013  | Change   | Change   |
|  | \$111  | \$62  | \$49     | 79.0 %   |
|  | Nine<br>Months<br>Ended<br>September<br>30,  |       | Dollar   | %        |
|  | 2014   | 2013  | Change   | Change   |
|  | \$317  | \$374 | \$ (57 ) | (15.2 )% |

|                          | Three Months<br>Ended<br>September 30, |          | Nine Months Ended<br>September 30, |          |
|--------------------------|--|----------|------------------------------------|----------|
|                          | 2014                                   | 2013     | 2014                               | 2013     |
| Average debt outstanding | \$12,152                               | \$12,613 | \$11,826                           | \$12,800 |
| Average interest rate    | 1.85 %                                 | 1.99 %   | 1.88 %                             | 1.95 %   |

The increase in Interest expense in the three-month period ended September 30, 2014 compared to the same period of 2013 was due to the impact of our current interest rate swap contract. The decrease in Interest expense in the nine-month period ended September 30, 2014 compared to the same period of 2013 was due to lower average outstanding borrowings, as well as lower average interest rates.

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## Income Tax Provision

Our effective income tax rate was 39.0% for the first nine months of 2014 and 2013. The effective income tax rates reflect the impact of non-deductible expenses, primarily state and local taxes, meals and entertainment expenses, and tax credits.

## 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 flows from operations, bank borrowings and the sale of common and preferred stock. We anticipate meeting our obligations for the twelve months beginning October 1, 2014 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, 2014 included \$1.5 million of Cash and cash equivalents and \$22 million available under our line of credit facility.

We had \$4.4 million of working capital and our debt as a percentage of total capitalization (total debt and common shareholders' equity) was 9.5% at September 30, 2014.

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

|   | Nine Months<br>Ended<br>September 30, |          |
|---|---------------------------------------|----------|
|   | 2014                                  | 2013     |
| Cash flows provided by operating activities           | \$ 10,698                             | \$ 7,562 |
| Cash flows used in investing activities               | (12,700)                              | (7,361)  |
| Cash flows provided by (used in) financing activities | 745                                   | (314 )   |
| Decrease in Cash and cash equivalents                 | \$(1,257 )                            | \$(113 ) |

Cash provided by operating activities of \$10.7 million in the first nine months of 2014 resulted from our Net income of \$2.4 million, net non-cash expenses of \$7.1 million and changes in our operating assets and liabilities as discussed in more detail below.

Accounts receivable, net, decreased \$0.3 million to \$11.1 million at September 30, 2014 compared to \$11.4 million at December 31, 2013. This decrease was primarily due to a \$0.7 million decrease in our receivable from A-B, which totaled \$7.7 million at September 30, 2014. Historically, we have not had collection problems related to our accounts receivable.

Inventories increased \$2.6 million to \$19.2 million at September 30, 2014 compared to \$16.6 million at December 31, 2013, primarily to support an expected increase in shipment volume, as well as an updated inventory policy.

As of September 30, 2014, we had the following net operating loss carryforwards ("NOLs") and federal credit carry forwards available to offset payment of future income taxes:

- state NOLs of \$32,000, tax-effected; and
- federal alternative minimum tax ("AMT") credit carry forwards of \$178,000.

We anticipate that we will utilize the remaining NOLs and federal 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 \$12.9 million in the first nine months of 2014 were primarily directed to beer production capacity and efficiency improvements and Pubs remodeling. As of September 30, 2014 we had an additional \$0.3 million of expenditures recorded in Accounts payable on our Consolidated Balance Sheets, level with December 31, 2013. In June 2014, we entered into a capital lease financing arrangement related to equipment already purchased and included in the \$12.9 million above, and received cash proceeds of \$0.8 million. The lease term is 84 months with an effective interest rate of 2.98% per annum and payments due monthly. We anticipate capital expenditures of approximately \$16 million to \$18 million in all of 2014 primarily for capacity and efficiency improvements, quality initiatives and restaurant and retail.

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We have a loan agreement (as amended, the “Loan Agreement”) with Bank of America, N.A., 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 \$10.5 million term loan (“Term Loan”). We may draw upon the Line of Credit for working capital and general corporate purposes. At September 30, 2014, we had no borrowings outstanding under the Line of Credit and we were in compliance with the financial covenants associated with the Loan Agreement.

## 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 2013 Annual Report, relate to goodwill, indefinite-lived intangible assets, long-lived assets, refundable deposits on kegs, revenue recognition and deferred taxes. There have been no changes to our critical accounting policies since December 31, 2013.

## Seasonality

Our sales generally reflect a degree of seasonality, with the first and fourth quarters historically exhibiting low sales levels compared 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 2013 Annual Report on Form 10-K, which was filed with the SEC on March 6, 2014.

## 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 2014, 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 2013 Annual Report on Form 10-K, which was filed with the SEC on March 6, 2014.

Item 6. Exhibits

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

- 10.1 Letter of Agreement between the Registrant and J. Scott Mennen dated August 4, 2014
- 10.2 Letter of Agreement between the Registrant and John W. Glick dated August 5, 2014
- 10.3 Letter of Agreement between the Registrant and Kenneth C. Kunze dated August 5, 2014
- 31.1 Certification of Chief Executive Officer of Craft Brew Alliance, Inc. pursuant to Exchange Act Rule 13a-14(a)
- 31.2 Certification of Chief Financial Officer of Craft Brew Alliance, Inc. pursuant to Exchange Act Rule 13a-14(a)
- 32.1 Certification pursuant to Exchange Act Rule 13a-14(b) and 18 U.S.C. Section 1350
- 99.1 Press Release dated November 5, 2014
- 101.INS XBRL Instance Document
- 101.SCHXBRL Taxonomy Extension Schema Document
- 101.CALXBRL Taxonomy Extension Calculation Linkbase Document
- 101.DEF XBRL Taxonomy Extension Definition Linkbase Document
- 101.LABXBRL Taxonomy Extension Label Linkbase Document
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

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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 5, 2014 BY: /s/ Joseph K. O'Brien  
Joseph K. O'Brien  
Controller and Chief Accounting Officer