CRAFT BREWERS ALLIANCE, INC.
Form 10-Q
May 14, 2010

Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For The Quarterly Period Ended March 31, 2010

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 BREWERS 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 þ 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 o 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 larger accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act). Check one:

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

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

The number of shares of the registrant s common stock outstanding as of May 5, 2010 was 17,074,063.

CRAFT BREWERS ALLIANCE, INC.
FORM 10-Q
For the Quarterly Period Ended March 31, 2010
TABLE OF CONTENTS

Table of Contents

PART I.
ITEM 1. Financial Statements

CRAFT BREWERS ALLIANCE, INC.
BALANCE SHEETS

	(Unaudited) March 31, 2010	December 31, 2009
	(Dollars in thousands except per share amounts)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 753	$ 11
Accounts receivable, net of allowance for doubtful accounts of $50 at March 31, 2010 and December 31, 2009	11,473	11,122
Inventories	10,173	9,487
Deferred income tax asset, net	843	970
Other current assets	3,531	3,941
Total current assets	26,773	25,531
Property, equipment and leasehold improvements, net	96,364	97,339
Equity investments	5,787	5,702
Intangible and other assets, net	12,889	13,013
Total assets	$ 141,813	$ 141,585
LIABILITIES AND COMMON STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 15,825	$ 14,672
Accrued salaries, wages, severance and payroll taxes	4,055	4,432
Refundable deposits	6,175	6,288
Other accrued expenses	1,623	1,185
Current portion of long-term debt and capital lease obligations	1,504	1,481
Total current liabilities	29,182	28,058
Long-term debt and capital lease obligations, net of current portion	23,581	24,685
Fair value of derivative financial instruments	890	842
Deferred income tax liability, net	6,994	7,015
Other liabilities	366	353
Commitments and Contingencies		
Common stockholders equity:		
Common stock, par value $0.005 per share, 50,000,000 shares authorized; 17,074,063 shares at March 31, 2010 and December 31, 2009 issued and outstanding	85	85
Additional paid-in capital	122,684	122,682

Accumulated other comprehensive loss	(521)	(478)
Retained deficit	(41,448)	(41,657)
Total common stockholders equity	80,800	80,632
Total liabilities and common stockholders equity	$ 141,813	$ 141,585

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

Table of Contents

CRAFT BREWERS ALLIANCE, INC.
STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended March 31,	
	2010	2009
	(In thousands, except per share amounts)	
Sales	$ 29,323	$ 29,721
Less excise taxes	1,871	1,983
Net sales	27,452	27,738
Cost of sales	20,605	22,481
Gross profit	6,847	5,257
Selling, general and administrative expenses	6,205	5,767
Merger-related expenses		112
Operating income (loss)	642	(622)
Income from equity investments	85	29
Interest expense	(399)	(566)
Interest and other income, net	53	91
Income (loss) before income taxes	381	(1,068)
Income tax provision	172	7
Net income (loss)	$ 209	$ (1,075)
Basic and diluted earnings (loss) per share	$ 0.01	$ (0.06)

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

Table of Contents

CRAFT BREWERS ALLIANCE, INC.
STATEMENTS OF CASH FLOWS
(Unaudited)

	Three Months Ended March 31, 2010	Three Months Ended March 31, 2009
	(In thousands)	
Operating Activities		
Net income (loss)	$ 209	$ (1,075)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	1,837	1,819
Income from equity investments	(85)	(29)
Deferred income taxes	131	
Provision for inventory obsolescence	47	122
Loss (gain) on sale or disposal of property, equipment and leasehold improvements	29	(3)
Other	(22)	14
Changes in operating assets and liabilities:		
Accounts receivable	(351)	(673)
Inventories	(879)	(1,447)
Income tax receivable and other current assets	364	(362)
Other assets	38	(61)
Accounts payable and other accrued expenses	1,639	2,534
Accrued salaries, wages, severance and payroll taxes	(377)	86
Refundable deposits	(84)	103
Net cash provided by operating activities	2,496	1,028
Investing Activities		
Expenditures for property, equipment and leasehold improvements	(733)	(715)
Proceeds from sale of property, equipment and leasehold improvements	44	28
Net cash used in investing activities	(689)	(687)
Financing Activities		
Principal payments on debt and capital lease obligations	(365)	(341)
Net repayments under revolving line of credit	(700)	
Net cash used in financing activities	(1,065)	(341)
Increase in cash and cash equivalents	742	
Cash and cash equivalents:		
Beginning of period	11	11

End of period	$	753	$	11
Supplemental Disclosures				
Cash paid for interest	$	427	$	608
Cash paid for income taxes	$	91	$	7

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

5

Table of Contents

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

1. Basis of Presentation

The accompanying financial statements and related notes of the Company should be read in conjunction with the financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2009 (2009 Annual Report). These 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 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 financial statements are unaudited but, in the opinion of management, reflect all material adjustments necessary to present fairly the financial position, results of operations and cash flows of the Company for the periods presented. All such adjustments were of a normal, recurring nature. Certain reclassifications have been made to the prior year s financial statements to conform to the current year presentation. The results of operations for such interim periods are not necessarily indicative of the results of operations for the full year.

Recent Accounting Pronouncements

On January 1, 2010, the Company adopted the guidance in Accounting Standards Update 2009-17, which was incorporated into Accounting Standards Codification (ASC) Topic 810-10, *Consolidation Overall.* This standard requires a qualitative approach to identifying a controlling financial interest in a variable interest entity (VIE) and requires ongoing assessments of whether an entity qualifies as a VIE and if a holder of an interest in a VIE qualifies as the primary beneficiary of the VIE. The adoption of this new accounting standard did not have a material impact on the Company s financial position, results of operations or cash flows.

2. Inventories

Inventories consist of the following:

	March 31, 2010	December 31, 2009
	(In thousands)	
Raw materials	$ 3,934	$ 3,660
Work in process	2,240	2,023
Finished goods	2,400	1,647
Packaging materials	438	892
Promotional merchandise	1,081	1,184
Pub food, beverages and supplies	80	81
	$ 10,173	$ 9,487

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

3. Equity Investments

Equity investments consist of the following:

	March 31, 2010	December 31, 2009
	(In thousands)	
Fulton Street Brewery, LLC (FSB)	$ 4,590	$ 4,544
Kona Brewery LLC (Kona)	1,197	1,158

	$ 5,787	$ 5,702

6

CRAFT BREWERS ALLIANCE, INC.
NOTES TO FINANCIAL STATEMENTS (continued)
(Unaudited)

FSB

For the three months ended March 31, 2010 and 2009, the Company s share of FSB s net income totaled $46,000 and $38,000, respectively. The Company s investment in FSB was $4.6 million at March 31, 2010 and $4.5 million at December 31, 2009, and the Company s portion of equity as reported on FSB s financial statement was $2.3 million as of the corresponding dates. The Company has not received any cash capital distributions associated with FSB during its ownership period. At March 31, 2010 and December 31, 2009, the Company has recorded a payable to FSB of $2.7 million and $2.3 million, respectively, primarily for amounts owing for purchases of Goose Island-branded product.

Kona

For the three months ended March 31, 2010, the Company s share of Kona s net income was $39,000. For the three months ended March 31, 2009, the Company s share of Kona s net loss was $9,000. The Company s investment in Kona was $1.2 million at March 31, 2010 and December 31, 2009 and the Company s portion of equity as reported on Kona s financial statement was $458,000 and $419,000, respectively, as of the corresponding dates. The Company has not received cash capital distributions associated with Kona during the three months ended March 31, 2010 and 2009. At March 31, 2010 and December 31, 2009, the Company has recorded a receivable from Kona of $2.3 million and $1.9 million, respectively, primarily related to amounts owing under the alternating proprietorship and distribution agreements. As of March 31, 2010 and December 31, 2009, the Company has recorded a payable to Kona of $2.4 million and $2.3 million, respectively, primarily for amounts owing for purchases of Kona-branded product.

At March 31, 2010 and December 31, 2009, the Company had net outstanding receivables due from Kona Brewing Co. (KBC) of $86,000 and $57,000, respectively. KBC and the Company are the only members of Kona.

4. Derivative Financial Instruments and Fair Value Measurement

Interest Rate Swap Contracts

The Company s 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.

The Company has assessed its vulnerability to certain business and financial risks, including interest rate risk associated with its variable-rate long-term debt. To mitigate this risk, the Company entered into with Bank of America, N.A. (BofA) a five-year interest rate swap agreement with a total notional value of $9.7 million (as of March 31, 2010) to hedge the variability of interest payments associated with its variable-rate borrowings under its Term Loan. Through this swap agreement, the Company pays interest at a fixed rate of 4.48% and receives interest at a floating-rate of the one-month LIBOR. 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 under ASC 815. As of March 31, 2010, unrealized net losses of $836,000 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 the Company records interest expense associated with the Term Loan. There was no hedge ineffectiveness recognized for the three months ended March 31, 2010.

As a result of the merger with Widmer Brothers Brewing Company (WBBC), the Company assumed WBBC s contract with BofA for a $7.0 million notional interest rate swap agreement. On the effective date of the Merger, the Company entered into with BofA an equal and offsetting interest rate swap contract. Neither swap contract qualifies for hedge accounting under ASC 815. The assumed contract requires the Company to pay interest at a fixed rate of 4.60% and receive interest at a floating rate of the one-month LIBOR, while the offsetting contract requires the Company to pay interest at a floating rate of the one-month LIBOR and receive interest at a fixed rate of 3.47%. Both contracts expire on November 1, 2010. The Company recorded a net gain on the contracts of $20,000 and $19,000 for the three months ended March 31, 2010 and 2009, respectively, which was recorded to other income.

CRAFT BREWERS ALLIANCE, INC.
NOTES TO FINANCIAL STATEMENTS (continued)
(Unaudited)

	Liability Derivatives at March 31, 2010	
	Balance Sheet Location	**Fair Value** (in thousands)
Derivatives designated as hedging instruments under ASC 815		
Interest rate swap contracts	Non-current liabilities derivative financial instruments	$ 836
Derivatives not designated as hedging instruments under ASC 815		
Interest rate swap contracts	Non-current liabilities derivative financial instruments	54
Total derivatives		$ 890

All interest rate swap contracts are secured by substantially all of the Company s personal property and by the real properties located at 924 North Russell Street, Portland, Oregon and 14300 NE 145th Street, Woodinville, Washington under the loan agreement with BofA.

Fair Value Measurements

The recorded value of the Company s financial instruments is considered to approximate the fair value of the instruments, in all material respects, because the Company s receivables and payables are recorded at amounts expected to be realized and paid, the Company s derivative financial instruments are carried at fair value, and approximately 75% of the Company s debt obligations are at variable rates of relatively short duration. The Company s analysis of the remaining debt obligations, which were adjusted to their respective fair values as of the effective date of the Merger, indicates that their fair values approximate their carrying values.

Under the three-tier fair value hierarchy established in ASC 820, *Fair Value Measurements and Disclosures*, the inputs used in measuring fair value are prioritized as follows:

Level 1: Observable inputs (unadjusted) in active markets for identical assets and liabilities;

Level 2: Inputs other than quoted prices included within Level 1 that are either directly or indirectly observable for the asset or liability, including quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in inactive markets and inputs other than quoted prices that are observable for the asset or liability;

Level 3: Unobservable inputs for the asset or liability, including situations where there is little, if any, market activity or data for the asset or liability.

The Company has assessed its assets and liabilities that are measured and recorded at fair value within the above hierarchy and that assessment is as follows:

	Fair Value Hierarchy Assessment			
	Level 1	**Level 2**	**Level 3**	**Total**
		(in thousands)		
Derivative financial instruments interest rate swap contracts	$	$ 890	$	$ 890

5. Common Stockholders Equity

Stock Plans

The Company maintains several stock incentive plans, including those discussed below, under which non-qualified stock options, incentive stock options and restricted stock are granted to employees and non-employee directors. The Company issues new shares of common stock upon exercise of stock options. Under the terms of the

CRAFT BREWERS ALLIANCE, INC.
NOTES TO FINANCIAL STATEMENTS (continued)
(Unaudited)

Company s stock option plans, subject to certain limitations, employees and directors may be granted options to purchase the Company s common stock at the market price on the date the option is granted.

On March 17, 2010, the board of directors approved the 2010 Stock Incentive Plan (the 2010 Plan), which will be submitted to the shareholders for approval in the second quarter of 2010, and would provide for grants of stock options, restricted stock, restricted stock units, performance awards and stock appreciation rights to directors and employees, if approved. If the 2010 Plan becomes effective, a maximum of 750,000 shares of common stock would be authorized for issuance under this stock plan.

The Company s shareholders approved the 2002 Stock Option Plan (2002 Plan) in May 2002. The 2002 Plan provides for granting of non-qualified stock options and incentive stock options to employees, non-employee directors and independent consultants or advisors. The compensation committee of the board of directors administers the 2002 Plan, determining the grantees, the number of shares of common stock for which the options are exercisable and the exercise prices of such shares, among other terms and conditions. Under the 2002 Plan, options granted to the Company s employees during the first quarter of 2009 vest over a four-year period, while in periods prior to the 2009 fiscal year, the options granted to the Company s employees vest over a five-year period. Options granted under the 2002 Plan to the Company s directors (excluding the A-B designated directors) have become exercisable beginning from the date of the grant up to three months following the grant date. The maximum number of shares of common stock for which options may be granted prior to expiration of the 2002 Plan on February 25, 2012, is 346,000; however, if the 2010 Plan is approved by the shareholders, the 2002 Plan will terminate and no further grants may be made under the 2002 Plan. As of March 31, 2010, the 2002 Plan had 74,759 shares available for future grants of options.

The 2007 Plan was adopted by the board of directors and approved by the shareholders in May 2007. The 2007 Plan provides for grants of stock options, restricted stock, restricted stock units, performance awards and stock appreciation rights. While incentive stock options may only be granted to employees, awards other than incentive stock options may be granted to employees and directors. The 2007 Plan is administered by the compensation committee of the board of directors. A maximum of 100,000 shares of common stock are authorized for issuance under the 2007 Plan; however, if the 2010 Plan is approved, the 2007 Plan will terminate and no further grants may be made under the 2007 Plan. As of March 31, 2010, the 2007 Plan had 53,240 shares available for future grants of stock-based awards.

6. Earnings (Loss) per Share

The following table sets forth the computation of basic and diluted earnings (loss) per common share:

	Three Months Ended March 31,	
	2010	**2009**
	(In thousands, except per share amounts)	
Numerator for basic and diluted earnings (loss) per share:		
Net income (loss)	$ 209	$ (1,075)
Denominator for basic earnings (loss) per share:		
Weighted average common shares outstanding	17,074	16,948
Dilutive effect of stock options on weighted average common shares	27	
Denominator for diluted earnings (loss) per share	17,101	16,948

Basic and diluted earnings (loss) per share	$ 0.01	$ (0.06)

Certain Company stock options were not included in the computation of diluted earnings (loss) per share because the exercise prices of the options were greater than the average market price of the common shares, or the impact of their inclusion would be anti-dilutive. Such stock options, with an exercise price of $2.43 to $3.15 per share for the three months ended March 31, 2010 and from $1.25 to $3.97 per share for the three months ended March 31, 2009, averaged 31,000 and 447,000 for the three months ended March 31, 2010 and 2009, respectively.

Table of Contents

CRAFT BREWERS ALLIANCE, INC.
NOTES TO FINANCIAL STATEMENTS (continued)
(Unaudited)

7. Comprehensive Income (Loss)

The following table sets forth the Company s comprehensive income (loss) for the periods indicated:

	Three Months Ended March 31, 2010	Three Months Ended March 31, 2009
	(in thousands)	
Net income (loss)	$ 209	$ (1,075)
Other comprehensive income (loss):		
Unrealized gains (losses) on derivative financial instruments, net of tax	(43)	21
Comprehensive income (loss)	$ 166	$ (1,054)

8. Income Taxes

As of March 31, 2010, the Company s deferred tax assets were primarily comprised of federal net operating loss carryforwards (NOLs) of $26.7 million, or $9.1 million tax-effected; state NOL carryforwards of $276,000 tax-effected; and federal and state alternative minimum tax credit carryforwards of $230,000 tax-effected. In assessing the realizability of its deferred tax assets, the Company considered both positive and negative evidence when measuring the need for a valuation allowance. The ultimate realization of deferred tax assets is dependent upon the existence of, or generation of, taxable income during the periods in which those temporary differences become deductible. Among other factors, the Company considered future taxable income generated by the projected differences between financial statement depreciation and tax depreciation. At December 31, 2009, based upon the available evidence, the Company believed that it was not more likely than not that all of the deferred tax assets would be realized. The valuation allowance was $100,000 as of December 31, 2009. Based on the evidence available to it as of March 31, 2010, the Company did not adjust the valuation allowance as of that date.

The effective tax rate for the first three months of 2010 was also affected by the impact of the Company s non-deductible expenses, primarily meals and entertainment expenses and a shift in the destination of the Company s shipments resulting in a greater apportionment of earnings and related deferred tax liabilities to states with higher statutory tax rates than in prior periods.

The Company expects to reach a settlement with the Internal Revenue Service during the second quarter of 2010 over outstanding examination issues associated with the income tax returns for 2007 and 2008 filed by WBBC. The amount associated with this settlement is expected to be less than $90,000, most of which the Company provided for in the fourth quarter of 2009.

To the extent that the Company is unable to generate adequate taxable income for either the remainder of 2010 or in future periods, the Company may be required to record an additional valuation allowance to provide for potentially expiring NOLs or other deferred tax assets for which a valuation allowance has not been previously recorded. Any such increase would generally be charged to earnings in the period of increase.

Table of Contents

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 Craft Brewers Alliance, Inc. (the Company) believes are reasonable, but are by their nature inherently uncertain. Many possible events or factors could affect the Company s future financial results and performance, and could cause actual results or performance to differ materially from those expressed, including those risks and uncertainties described in Part I, Item 1A. Risk Factors in the Company s Annual Report on Form 10-K for the year ended December 31, 2009 (2009 Annual Report), and those described from time to time in the Company s future reports filed with the Securities and Exchange Commission. 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 Financial Statements and Notes thereto of the Company included herein, as well as the audited Financial Statements and Notes and Management s Discussion and Analysis of Financial Condition and Results of Operations contained in the Company s 2009 Annual Report. The discussion and analysis includes period-to-period comparisons of the Company s financial results. Although period-to-period comparisons may be helpful in understanding the Company s financial results, the Company believes that they should not be relied upon as an accurate indicator of future performance.

Overview

Since its formation, the Company has focused its business activities on the brewing, marketing and selling of craft beers in the United States. The Company reported gross sales and net income of $29.3 million and $209,000, respectively, for the three months ended March 31, 2010, compared with gross sales and a net loss of $29.7 million and $1.1 million, respectively, for the corresponding period in 2009. The Company generated basic and fully-diluted earnings per share of $0.01 on 17.1 million shares for the first quarter of 2010 compared with a loss per share of $0.06 on 16.9 million shares for the corresponding period of 2009. The Company generated operating profit of $642,000 during the quarter ended March 31, 2010 compared with an operating loss of $622,000 during the quarter ended March 31, 2009, primarily due to an improved margin for the 2010 period and a reduction in merger-related expenses, partially offset by an increase in selling, general and administrative expenses for the 2010 period. The Company s sales volume (shipments) totaled 128,700 barrels in the first quarter of 2010 as compared with 133,800 barrels in the first quarter of 2009, a decrease of 3.8%.

The Company produces its specialty bottled and draft Redhook-branded and Widmer Brothers-branded products in its four Company-owned breweries, one in the Seattle suburb of Woodinville, Washington (Washington Brewery), another in Portsmouth, New Hampshire (New Hampshire Brewery), and two in Portland, Oregon. The two breweries in Portland, Oregon are the Company s largest production facility (Oregon Brewery) and its smallest, a manual brewpub-style brewery at the Rose Quarter. The Company sells these products in addition to the Kona-branded products primarily to Anheuser-Busch, Incorporated (A-B) and its network of wholesalers pursuant to the July 1, 2004 Master Distributor Agreement (the A-B Distribution Agreement), as amended. These products are available in 48 states. The framework for the Company s current operating configuration came about as a result of the Company s merger (Merger) with Widmer Brothers Brewing Company (WBBC), which was consummated July 1, 2008.

In addition to the sale of Redhook-branded and Widmer Brothers-branded beer, the Company also earns revenue in connection with several operating agreements with Kona Brewery, LLC (Kona), including an alternating proprietorship agreement and a distribution agreement. Pursuant to the alternating proprietorship agreement, Kona produces a portion of its malt beverages at the Oregon Brewery. The Company sells raw materials to Kona prior to production beginning and receives from Kona a facility leasing fee based on the barrels brewed and packaged at the Oregon Brewery. These sales and fees are reflected as revenue in the Company s statements of operations. Under the distribution agreement, the Company distributes Kona-branded product, whether brewed at Kona s facility or the

Table of Contents

Company s breweries, and then markets, sells and distributes the Kona-branded products pursuant to the A-B Distribution Agreement.

The Company also derives other revenues from sources including the sale of retail beer, food, apparel and other retail items in its three brewery pubs.

The Company holds corporate investments, a 20% equity ownership in Kona Brewing LLC and a 42% equity ownership in Fulton Street Brewery, LLC (FSB). Both investments are accounted for under the equity method, as outlined in Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 325, *Investments.*

For additional information regarding A-B and the A-B Distribution Agreement, see Part 1, Item 1, Business under the headings Product Distribution and Relationship with Anheuser-Busch, Incorporated in the Company s 2009 Annual Report.

The U.S. economic recession which began in the fourth quarter of 2008 continued throughout 2009 and into the first quarter of 2010, has negatively affected most segments within the beer industry, which experienced an overall decline in shipment volumes in 2009 as compared with 2008. Domestic shipments of imported beer were particularly hard hit, with industry accounts reporting that imported beer suffered a nearly 10% decline in shipments for 2009 as compared with 2008 shipment levels. Certain channels were negatively affected, which had a greater impact on certain segments of the beer industry than others. These channels included restaurants and dining establishments, and convenience stores. For 2009, the craft beer segment showed moderate to strong growth from 2008 both in volume and total revenues in the face of these challenges. Recent economic data suggests that the worst of the recession may be over, and that improvement in the employment and general economic conditions may occur at some point in 2010. To the degree that the general U.S. economy improves, the channels and segments that previously have been particularly affected by the recession may recover at rates greater than the general beer industry as a whole.

Results of Operations

The following table sets forth, for the periods indicated, certain items from the Company s Statements of Operations expressed as a percentage of net sales:

	Three Months Ended March 31,	
	2010	**2009**
Sales	106.8%	107.1%
Less excise taxes	6.8	7.1
Net sales	100.0	100.0
Cost of sales	75.1	81.0
Gross profit	24.9	19.0
Selling, general and administrative expenses	22.6	20.8
Merger-related expenses		0.4
Operating income (loss)	2.3	(2.2)
Income from equity investments	0.3	0.1
Interest expense	(1.4)	(2.1)
Interest and other income, net	0.2	0.3
Income (loss) before income taxes	1.4	(3.9)
Income tax provision	0.6	
Net income (loss)	0.8%	(3.9)%

12

Table of Contents

Non-GAAP Financial Measures

The Company s loan agreement, as modified, subjects the Company to a financial covenant based on earnings before interest, taxes, depreciation and amortization (EBITDA). See Liquidity and Capital Resources. EBITDA is defined per the Company s loan agreement and requires additional adjustments, among other items, to (a) exclude merger-related expenses, (b) adjust losses (gains) on sale or disposal of assets, and (c) exclude certain other non-cash income and expense items. The financial covenants under the Company s loan agreement are measured on a trailing four-quarter basis. EBITDA as defined was $12.0 million for the trailing four quarters ended March 31, 2010. The following table reconciles net income to EBITDA per the loan agreement for this period:

	For the Trailing Four Quarters Ended March 31, 2010 (In thousands)
Net income	$ 2,171
Interest expense	1,972
Income tax provision	351
Depreciation expense	6,412
Amortization expense	919
Merger-related expenses	113
Other non-cash charges	108
EBITDA per the loan agreement	$ 12,046

Three months ended March 31, 2010 compared with three months ended March 31, 2009

The following table sets forth, for the periods indicated, a comparison of certain items from the Company s Statements of Operations:

Three Months Ended