

CRAFT BREWERS ALLIANCE, INC.
Form 10-Q
August 15, 2011

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 June 30, 2011

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

Washington
(State or other jurisdiction of incorporation or
organization)

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

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

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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

Accelerated Filer

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

Smaller Reporting Company

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

The number of shares of the registrant’s common stock outstanding as of August 2, 2011 was 18,844,817.

CRAFT BREWERS ALLIANCE, INC.
FORM 10-Q
For the Quarterly Period Ended June 30, 2011

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PART I.

ITEM 1. Financial Statements

CRAFT BREWERS ALLIANCE, INC.
CONSOLIDATED BALANCE SHEETS

| | (unaudited) June 30, 2011 | December 31, 2010 |
|---|---|----------------------|
| | (dollars in thousands, except per share amounts) | |
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 6,474 | \$ 164 |
| Accounts receivable, net | 13,078 | 10,514 |
| Inventories | 9,855 | 8,729 |
| Deferred income tax asset, net | 596 | 932 |
| Other current assets | 3,305 | 3,233 |
| Total current assets | 33,308 | 23,572 |
| Property, equipment and leasehold improvements, net | 98,540 | 98,778 |
| Equity method investment in Fulton Street Brewery, LLC | — | 5,240 |
| Goodwill | 12,917 | 12,917 |
| Intangible and other assets, net | 18,233 | 17,759 |
| Total assets | \$ 162,998 | \$ 158,266 |
| LIABILITIES AND COMMON STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 14,762 | \$ 13,825 |
| Accrued salaries, wages, severance and payroll taxes | 4,080 | 4,053 |
| Refundable deposits | 6,486 | 6,291 |
| Other accrued expenses | 1,479 | 1,378 |
| Current portion of long-term debt and capital lease obligations | 2,116 | 2,460 |
| Total current liabilities | 28,923 | 28,007 |
| Long-term debt and capital lease obligations, net of current portion | 16,213 | 24,675 |
| Fair value of derivative financial instruments | 737 | 849 |
| Deferred income tax liability, net | 13,991 | 10,118 |
| Other liabilities | 452 | 421 |
| Commitments and Contingencies | | |
| Common stockholders' equity: | | |
| Common stock, \$0.005 par value, authorized 50,000,000 shares; issued and outstanding 18,839,217 shares and 18,819,053 shares at June 30, 2011 and December 31, 2010, respectively | 94 | 94 |
| Additional paid-in capital | 134,842 | 134,601 |
| Accumulated other comprehensive loss | (459) | (528) |

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| | | |
|---|------------|------------|
| Retained deficit | (31,795) | (39,971) |
| Total common stockholders' equity | 102,682 | 94,196 |
| Total liabilities and common stockholders' equity | \$ 162,998 | \$ 158,266 |

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

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CRAFT BREWERS ALLIANCE, INC.
CONSOLIDATED STATEMENTS OF INCOME
(unaudited)

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--|----------|------------------------------|----------|
| | 2011 | 2010 | 2011 | 2010 |
| | (in thousands, except per share amounts) | | | |
| Sales | \$44,849 | \$39,645 | \$79,809 | \$68,967 |
| Less excise taxes | 3,353 | 2,406 | 6,016 | 4,276 |
| Net sales | 41,496 | 37,239 | 73,793 | 64,691 |
| Cost of sales | 28,038 | 26,841 | 51,107 | 47,446 |
| Gross profit | 13,458 | 10,398 | 22,686 | 17,245 |
| Selling, general and administrative expenses | 10,670 | 7,545 | 19,959 | 13,750 |
| Operating income | 2,788 | 2,853 | 2,727 | 3,495 |
| Income from equity method investments | 335 | 338 | 691 | 423 |
| Gain on sale of Fulton Street Brewery, LLC | 10,398 | — | 10,398 | — |
| Interest expense | (260) | (409) | (542) | (808) |
| Interest and other income, net | 7 | 75 | 20 | 128 |
| Income before income taxes | 13,268 | 2,857 | 13,294 | 3,238 |
| Income tax provision | 5,108 | 1,123 | 5,118 | 1,295 |
| Net income | \$8,160 | \$1,734 | \$8,176 | \$1,943 |
| Basic and diluted earnings per share | \$0.43 | \$0.10 | \$0.43 | \$0.11 |

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

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

| | Six Months Ended June 30, | |
|---|------------------------------|----------|
| | 2011 | 2010 |
| | (in thousands) | |
| Operating Activities | | |
| Net income | \$8,176 | \$1,943 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 3,651 | 3,589 |
| Income from equity method investments, net of distributions received | (691) | (404) |
| Gain on sale of Fulton Street Brewery, LLC | (10,398) | — |
| Deferred income taxes | 4,166 | 1,109 |
| Stock-based compensation | 249 | 74 |
| Loss on sale or disposal of property, equipment and leasehold improvements | — | 34 |
| Other | (49) | 223 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (1,727) | (4,397) |
| Inventories | (1,111) | (257) |
| Income tax receivable and other current assets | (72) | 1,713 |
| Other assets | (221) | 39 |
| Accounts payable and other accrued expenses | 1,017 | 4,816 |
| Accrued salaries, wages, severance and payroll taxes | 27 | (1,111) |
| Refundable deposits and other liabilities | 606 | (538) |
| Net cash provided by operating activities | 3,623 | 6,833 |
| Investing Activities | | |
| Expenditures for property, equipment and leasehold improvements | (3,694) | (1,090) |
| Proceeds from sale of property, equipment and leasehold improvements | 49 | 65 |
| Proceeds from the sale of Fulton Street Brewery, LLC | 15,075 | — |
| Net cash provided by (used in) investing activities | 11,430 | (1,025) |
| Financing Activities | | |
| Principal payments on debt and capital lease obligations | (1,256) | (731) |
| Net repayments under revolving line of credit | (7,500) | (5,100) |
| Issuance of common stock | 13 | 23 |
| Net cash used in financing activities | (8,743) | (5,808) |
| Increase in cash and cash equivalents | 6,310 | — |
| Cash and cash equivalents: | | |
| Beginning of period | 164 | 11 |
| End of period | \$6,474 | \$11 |
| Supplemental Disclosures | | |

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| | | |
|----------------------------|-------|-------|
| Cash paid for interest | \$605 | \$870 |
| Cash paid for income taxes | \$211 | \$205 |

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

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

1. Basis of Presentation

The accompanying financial statements and related notes of the Company should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2010 ("2010 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 the consolidated financial position, results of operations and cash flows of the Company for the periods presented. All such adjustments were of a normal, recurring nature. The results of operations for such interim periods are not necessarily indicative of the results of operations for the full year.

Reclassifications

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

Recent Accounting Pronouncements

In June 2011, the Financial Accounting Standards Board, or FASB, issued ASU No. 2011-05, "Comprehensive Income: Presentation of Comprehensive Income." This new standard requires the presentation of comprehensive income, the components of net income and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The new standard also requires presentation of adjustments for items that are reclassified from other comprehensive income to net income in the statement where the components of net income and the components of other comprehensive income are presented. The updated guidance is effective on a retrospective basis for financial statements issued for interim and annual periods beginning after December 15, 2011. This guidance affects presentation only and will have no effect on our financial condition, results of operations or cash flows.

In May 2011, the FASB amended ASC 820, "Fair Value Measurement." This amendment is intended to result in convergence between U.S. GAAP and International Financial Reporting Standards ("IFRS") requirements for measurement of and disclosures about fair value. This guidance clarifies the application of existing fair value measurements and disclosures, and changes certain principles or requirements for fair value measurements and disclosures. The updated guidance is effective on a prospective basis for financial statements issued for interim and annual periods beginning after December 15, 2011. The adoption of this guidance will not have a material impact on our consolidated financial statements.

In December 2010, the FASB issued ASU No. 2010-29, "Supplementary Pro Forma Information for Business Combinations" ("ASU 2010-29"). ASU 2010-29 clarifies provisions of FASB ASC Topic 805, "Business Combinations" ("ASC 805") relating to the acquisition date that should be used for disclosing the pro forma financial information required by ASC 805 when comparative financial statements are presented. As of December 31, 2010, the Company adopted the provisions of ASU 2010-29, and implemented its provisions in preparing the pro forma information presented regarding the October 1, 2010 merger with Kona Brewing Co., Inc. ("KBC") and related entities ("KBC Merger"). See Note 9, Merger with KBC.

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CRAFT BREWERS ALLIANCE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (continued)
(unaudited)

2. Inventories

Inventories consist of the following:

| | June 30, 2011 | December 31, 2010 |
|----------------------------------|------------------|-------------------------|
| (in thousands) | | |
| Raw materials | \$ 2,179 | \$ 2,870 |
| Work in process | 3,370 | 2,244 |
| Finished goods | 2,760 | 1,933 |
| Packaging materials | 355 | 343 |
| Promotional merchandise | 1,021 | 1,184 |
| Pub food, beverages and supplies | 170 | 155 |
| | \$ 9,855 | \$ 8,729 |

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

3. Equity Method Investments

Fulton Street Brewery, LLC (“FSB”)

On May 2, 2011 (the “Closing Date”), the Company, Anheuser-Busch, Incorporated (“A-B”), and Goose Holdings, Inc. (“GHI”) completed the transaction contemplated by the equity purchase agreement (the “Purchase Agreement”) dated as of February 18, 2011, pursuant to which the Company and GHI (collectively, the “Sellers”) sold all of the equity in FSB to A-B. The aggregate consideration paid by A-B was approximately \$38.9 million (“Purchase Consideration”), net of transaction fees paid by A-B on the Sellers’ behalf, and was determined by arm’s length negotiations among the parties. The Company became a party to the Purchase Agreement pursuant to the Joinder to Equity Purchase Agreement (the “Joinder Agreement”) dated May 2, 2011, by and among A–B, GHI and the Company. A copy of the Joinder Agreement was filed as exhibit 2.1 to the Company’s Form 8-K filed with the SEC on May 4, 2011.

The Company’s share of the Purchase Consideration in exchange for its 42 percent interest in FSB was \$16.3 million, net of the Company’s share of transaction fees paid by A-B on the Sellers’ behalf, and consisted of \$15.1 million received in cash and \$1.3 million placed in escrow. The escrow balance is to satisfy valid claims, if any, that may be asserted by A-B in connection with breaches of representations and warranties made by the Sellers in the Purchase Agreement. The escrow balance will be released to the Company in three payments ratably, every six months, beginning six months following the Closing Date, subject to indemnification claims, as applicable. The Company also received reimbursement from A-B for legal and professional fees the Company separately incurred in evaluation of the transaction. In the second quarter of 2011, the Company recorded a gain of approximately \$10.4 million associated with the sale of its equity interest in FSB.

The Company recognized \$691,000 in 2011 for its share of FSB’s earnings through the Closing Date, of which \$335,000 was recognized in the second quarter of 2011. For the three and six month periods ended June 30, 2010, the Company’s share of FSB’s net income totaled \$332,000 and \$378,000, respectively. The book value of the Company’s

equity investment in FSB was \$5.9 million as of the Closing Date and \$5.2 million at December 31, 2010.

The consolidated statements of income for the six month periods ended June 30 include the results of FSB for the six month periods ended May 31. Due to the timing of receipt of FSB's financial statements, the Company accounted for its share of net earnings of FSB on a one-month lag. If the Company had instead recorded the equity in FSB's earnings for the six months ended June 30, the Company would have recorded a decrease of \$248,000 and an increase of \$50,000 to its consolidated statements of income for the six months ended June 30, 2011 and 2010, respectively. There is no lag impact related to the month of June 2011 as the sale of FSB was effective May 2, 2011 and all earnings were captured as of that date.

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CRAFT BREWERS ALLIANCE, INC.
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (continued)
 (unaudited)

At June 30, 2011, the Company had net outstanding receivables due from FSB of \$381,000. At December 31, 2010, the Company had recorded a payable to FSB of \$3.3 million, primarily for amounts owing for purchases of Goose Island-branded product.

Kona Brewery, LLC (“Kona”)

For the three and six month periods ended June 30, 2010, the Company’s share of Kona’s net income was \$6,000 and \$45,000, respectively. As a result of the closing of the KBC Merger on October 1, 2010, Kona became a wholly owned subsidiary of the Company. As such, the operations of KBC are included in our consolidated financial statements for the three and six month periods ended June 30, 2011. See Note 9, Merger with KBC for a discussion of the KBC Merger.

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 a five-year interest rate swap contract with Bank of America, N.A. (“BofA”) with a total notional value of \$9.3 million (as of June 30, 2011) to hedge the variability of interest payments associated with its variable-rate borrowings under its term loan with BofA (“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 Topic 815, Derivatives and Hedging (“ASC 815”). As of June 30, 2011, unrealized net losses of \$737,000 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 and six month periods ended June 30, 2011, respectively.

| Balance Sheet Location | June 30, 2011 | December 31, 2010 |
|------------------------|------------------|-------------------------|
| | (in thousands) | |

Derivative instruments in liability positions:

Derivatives designated as hedging instruments under ASC 815

| | | | |
|-----------------------------|--|-------|-------|
| | Non-current liabilities - derivative financial instruments | \$737 | \$849 |
| Interest rate swap contract | | | |

| | | |
|-------------------|-------|-------|
| Total derivatives | \$737 | \$849 |
|-------------------|-------|-------|

The interest rate swap contract is 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 ("collateral") under the loan agreement with BofA. The Company's subsidiaries, Kona and Kona Brewing Co., LLC, have unconditionally guaranteed the Company's obligations to BofA arising under the interest rate swap agreement.

Fair Value Measurements

The recorded values of the Company's financial instruments, with the exception of its debt obligations, are considered to approximate the fair values of the financial instruments, in all material respects, as the Company's receivables and payables are recorded at amounts expected to be realized and paid and the Company's derivative financial instruments are carried at fair value. At June 30, 2011 the total carrying value and fair value of the Company's debt obligations, including the current portion, was \$18.3 million and \$18.6 million, respectively. At December 31, 2010, the total carrying value and fair value of the Company's debt obligations, including the current portion, was \$27.1 million and \$27.7 million, respectively.

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CRAFT BREWERS ALLIANCE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (continued)
(unaudited)

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:

| | Level 1 | Fair Value Hierarchy Assessment | | Total |
|---|---------|---------------------------------|---------|--------|
| | | Level 2 | Level 3 | |
| | | (in thousands) | | |
| June 30, 2011 | | | | |
| Derivative financial instruments - interest rate swap contracts | \$ - | \$ 737 | \$ - | \$ 737 |
| December 31, 2010 | | | | |
| Derivative financial instruments - interest rate swap contracts | \$ - | \$ 849 | \$ - | \$ 849 |

5. Debt and Capital Lease Obligations

Long-term debt and capital lease obligations consist of the following:

| | June 30, 2011 | December 31, 2010 |
|--|------------------|----------------------|
| | (in thousands) | |
| Term loan payable to bank, due July 1, 2018 | \$ 12,442 | \$ 12,639 |
| Line of credit payable to bank, due September 30, 2015 | — | 7,500 |
| Promissory notes payable to individual lenders, all due July 1, 2015 | 600 | 600 |
| Premium on promissory notes | 455 | 504 |
| Note with affiliated party | 928 | 1,403 |
| Capital lease obligations on equipment | 3,904 | 4,489 |
| | 18,329 | 27,135 |
| Less current portion of long-term debt | 2,116 | 2,460 |

\$ 16,213 \$ 24,675

Since June 2008, the Company has maintained a loan agreement (as amended, the “Loan Agreement”) with BofA, which is presently comprised of a \$22.0 million revolving line of credit (“Line of Credit”), including provisions for cash borrowings and up to \$2.5 million notional amount of letters of credit, and a Term Loan with an original balance of \$13.5 million. The Company may draw upon the Line of Credit for working capital and general corporate purposes.

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CRAFT BREWERS ALLIANCE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (continued)
(unaudited)

With the May 2, 2011 receipt of \$15.3 million in cash, including reimbursements, the Company repaid the outstanding borrowings under the Line of Credit and had no borrowings outstanding under the Line of Credit at June 30, 2011.

Under the Loan Agreement, the Company may select either the London Inter-Bank Offered Rate ("LIBOR") or the Inter-Bank Offered Rate ("IBOR") (each, a "Benchmark Rate") as the basis for calculating interest on the outstanding principal balance of the Line of Credit. Interest accrues at an annual rate equal to the Benchmark Rate plus a marginal rate. The Company may select different Benchmark Rates for different tranches of its borrowings under the Line of Credit. The marginal rate varies from 1.00% to 2.25% based on the ratio of the Company's funded debt to earnings before interest, taxes, depreciation and amortization ("EBITDA"), as defined ("funded debt ratio"). LIBOR rates may be selected for one, two, three, or six month periods, and IBOR rates may be selected for no shorter than 14 days and no longer than six months. Accrued interest for the Line of Credit is due and payable monthly.

Under the Loan Agreement a quarterly fee on the unused portion of the Line of Credit, including the undrawn amount of the related standby letter of credit, varies from 0.15% to 0.30% based upon the Company's funded debt ratio. At June 30, 2011, the quarterly fee was 0.15%. An annual fee is payable in advance on the notional amount of each standby letter of credit issued and outstanding multiplied by an applicable rate ranging from 1.00% to 2.00%.

Interest on the Term Loan will accrue on the outstanding principal balance in the same manner as provided for under the Line of Credit, as established under the LIBOR one-month Benchmark Rate. At June 30, 2011 and December 31, 2010, the principal balance outstanding under the Term Loan was \$12.4 million and \$12.6 million, respectively. The interest rate on the Term Loan was 1.44% as of June 30, 2011. Accrued interest for the Term Loan is due and payable monthly. Principal payments are due monthly in accordance with an agreed-upon schedule set forth in the Loan Agreement, with any unpaid principal balance and unpaid accrued interest due and payable on July 1, 2018.

The Company is in compliance with all applicable contractual financial covenants at June 30, 2011. These financial covenants under the Loan Agreement are measured on a trailing four-quarter basis. For all periods ending June 30, 2011 and thereafter, the Company is required to maintain a funded debt ratio of up to 3.0 to 1 and a fixed charge coverage ratio above 1.25 to 1.

Pursuant to the KBC Merger, the Company assumed an obligation for a promissory note payable ("related party note") to a counterparty that was a significant Kona shareholder. The related party note is secured by the equipment comprising a photovoltaic cell generation system ("photovoltaic system") installed at the Company's brewery located in Kailua-Kona, Hawaii. The balance of the related party note payable as of June 30, 2011 and December 31, 2010 was \$928,000 and \$1.4 million, respectively. Accrued interest on the related party note is due and payable monthly at a fixed interest rate of 4.75%, with monthly loan payments of \$16,129. Any unpaid principal balance and unpaid accrued interest under the related party note will be due and payable on November 15, 2014. The photovoltaic system was eligible for certain federal grants and state tax credits, which were applied for and collected by the Company and remitted to the creditor as a reduction of principal.

The Company was obligated under a capital equipment lease to BofA secured by substantially all of the brewery equipment and restaurant furniture and fixtures located in Portland, Oregon. The outstanding balance for the capital lease as of June 30, 2011 and December 31, 2010 was \$3.9 million and \$4.5 million, respectively, with monthly loan payments of \$119,020 required through the maturity date of June 30, 2014. The capital lease carried an effective interest rate of 6.56% and was subject to a prepayment penalty equal to a specified percentage multiplied by the amount prepaid which terminated in July 2011. The specified percentage was 1% as of June 30, 2011. On July 20,

2011, the Company paid off the remaining balance on the capital lease without penalty.

6. Common Stockholders' Equity

Stock Plans

The Company maintains several stock incentive plans, including those described 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 Company's stock incentive plans, subject to certain limitations, employees and directors may be granted options to purchase the Company's common stock at an exercise price equal to the market price on the date the option is granted.

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CRAFT BREWERS ALLIANCE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (continued)
(unaudited)

On May 26, 2010, the shareholders approved the 2010 Stock Incentive Plan (the “2010 Plan”), as recommended by the Company’s board of directors. The 2010 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 2010 Plan is administered by the compensation committee of the board of directors (“Compensation Committee”), which determines the grantees, the number of shares of common stock for which options are exercisable and the exercise prices of such options, and the terms and conditions of other equity-based awards under the 2010 Plan. Options granted to the Company’s employees generally vest over a five-year period and remain exercisable until ten years from the date of grant. Up to 750,000 shares of common stock may be issued under the 2010 Plan. As of June 30, 2011, the 2010 Plan had 645,400 shares available for future stock-based awards.

The Company maintains the 2002 Stock Option Plan (the “2002 Plan”) under which non-qualified stock options and incentive stock options were granted to employees and non-qualified stock options were granted to non-employee directors and independent consultants or advisors. Options granted to the Company’s employees generally vest over four or five years while options granted to the Company’s directors generally became exercisable within three months following the grant date. Vested options generally remain exercisable until ten years from the date of grant. The Compensation Committee administers the 2002 Plan.

The Company also maintains the 2007 Stock Incentive Plan (the “2007 Plan”) under which grants of stock options and restricted stock were made to the Company’s employees and restricted stock grants were made to the Company’s directors. Options granted to the Company’s employees generally vest over a five-year period and remain exercisable until ten years from the date of grant. The 2007 Plan is administered by the Compensation Committee.

With the approval of the 2010 Plan, no further grants of stock options or similar stock awards may be made under either the 2007 Plan or the 2002 Plan, but the provisions of these plans will remain in effect until all outstanding options are terminated or exercised.

Restricted Stock Grant

Beginning with the 2011 Annual Meeting of Shareholders, each non-employee director will receive an annual grant of shares of the Company’s common stock with a fair value equivalent to \$25,000 upon election at the Annual Meeting of Shareholders. On May 25, 2011, the board of directors approved, under the 2010 Plan, an annual grant of 2,700 shares of fully-vested Common Stock to each non-employee director. On May 26, 2010, the board of directors approved, under the 2007 Plan, an annual grant of 3,000 shares of fully-vested Common Stock to each non-employee director. In conjunction with these stock grants, the Company issued 16,200 and 18,000 shares of Common Stock in 2011 and 2010, respectively. The Company recognized stock-based compensation of \$164,000 and \$61,000 during the three months ended June 30, 2011 and 2010, respectively, related to these awards.

Stock Option Activity

The Company recognized stock-based compensation associated with its stock option grants of \$29,000 and \$11,000 for the three months ended June 30, 2011 and 2010, respectively, and \$68,000 and \$13,000 for the six month periods ended June 30, 2011 and 2010, respectively. At June 30, 2011, the total unrecognized stock-based compensation associated with unvested option grants was approximately \$525,000, which is expected to be recognized over a period of approximately 4.0 years.

Presented below is a summary of the Company’s stock option plan activity:

| | Options (in thousands) | Weighted Average Exercise Price (per share) | Aggregate Intrinsic Value (in thousands) |
|----------------------------------|---------------------------|--|---|
| Outstanding at December 31, 2010 | 219 | \$ 3.14 | \$ 931 |
| Granted | 45 | 9.29 | |
| Exercised | (4) | 3.15 | |
| Outstanding at June 30, 2011 | 260 | \$ 4.20 | \$ 1,177 |
| Exercisable at June 30, 2011 | 72 | \$ 2.13 | \$ 467 |

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CRAFT BREWERS ALLIANCE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (continued)
(unaudited)

A total of 21,100 and 28,600 stock options vested in the three and six month periods ended June 30, 2011, respectively. No stock options vested during the three month period ended June 30, 2010, and 7,500 stock options vested during the six month period ended June 30, 2010. The total intrinsic value of stock options exercised during the six month periods ended June 30, 2011 and 2010 was \$25,000 and \$31,000, respectively.

In conjunction with the exercise of stock options under the Company's stock option plans during the six months ended June 30, 2011 and 2010, the Company issued 4,000 shares and 13,000 shares, respectively, of common stock and received proceeds on exercise totaling \$13,000 and \$23,000, respectively.

The following table summarizes information for options outstanding and exercisable at June 30, 2011:

| Range of Exercise Prices | Options (in thousands) | Outstanding | | | Exercisable | | |
|--------------------------|------------------------|---|--|------------------------|---|--|--|
| | | Weighted Average Exercise Price (per share) | Weighted Average Remaining Contractual Life (in years) | Options (in thousands) | Weighted Average Exercise Price (per share) | Weighted Average Remaining Contractual Life (in years) | |
| \$ 1.25 to \$ 2.00 | 37 | \$ 1.37 | 6.1 | 22 | \$ 1.46 | 5.1 | |
| \$ 2.01 to \$ 3.00 | 126 | 2.36 | 7.7 | 42 | 2.36 | 5.4 | |
| \$ 3.01 to \$ 3.15 | 8 | 3.15 | 3.9 | 8 | 3.15 | 3.9 | |
| \$ 6.88 to \$ 6.88 | 44 | 6.88 | 9.4 | — | N/A | N/A | |
| \$ 9.28 to \$ 9.35 | 45 | 9.29 | 9.9 | — | N/A | N/A | |
| \$ 1.25 to \$ 9.35 | 260 | \$ 4.20 | 8.0 | 72 | \$ 2.13 | 5.2 | |

N/A - Not applicable

Performance Share Activity

During the second quarter of 2011, the Compensation Committee approved, under the 2010 Plan, the grant of performance shares to selected executives with vesting contingent upon meeting various Company-wide performance goals. The performance goals are tied to target amounts of the Company's adjusted EBITDA and net sales for the three fiscal years ending December 31, 2013. The awards earned will range from zero to one hundred percent of the targeted number of performance shares for the performance period ending March 31, 2014. Awards, if earned, will be paid in shares of common stock. Compensation expense for performance based shares is estimated based on an assessment of the probability that performance goals will be met during the vesting period. We will re-measure the probability of achieving the performance goals during each reporting period. In future reporting periods, if we determine that performance goals are not probable of occurrence, no compensation expense will be recognized and any previously recognized compensation cost would be reversed.

A summary of the activity for performance share awards as of June 30, 2011 and changes during the six month period then ended is presented below:

| | Shares (in thousands) | Weighted Average Grant- Date Fair Value (per share) |
|---|--------------------------|--|
| Nonvested performance shares at December 31, 2010 | - | \$ - |
| Granted | 68 | \$ 9.29 |
| Nonvested performance shares at June 30, 2011 | 68 | \$ 9.29 |

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CRAFT BREWERS ALLIANCE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (continued)
(unaudited)

The compensation expense for the Company's performance share awards totaled \$17,000 for the three and six month periods ended June 30, 2011. The value of the performance shares granted in 2011 is being amortized as compensation expense over the service period.

At June 30, 2011, the Company had \$551,000 of total unrecognized compensation expense related to performance shares that will be recognized over a period of 2.8 years.

7. Earnings per Share

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--|---------|------------------------------|---------|
| | 2011 | 2010 | 2011 | 2010 |
| | (in thousands, except per share amounts) | | | |
| Numerator for basic and diluted earnings per share: | | | | |
| Net income | \$8,160 | \$1,734 | \$8,176 | \$1,943 |
| Denominator for basic earnings per share: | | | | |
| Weighted average common shares outstanding | 18,829 | 17,084 | 18,824 | 17,079 |
| Dilutive effect of stock options on weighted average common shares | 116 | 47 | 112 | 34 |
| Denominator for diluted earnings per share | 18,945 | 17,131 | 18,936 | 17,113 |
| Basic and diluted earnings per share | \$0.43 | \$0.10 | \$0.43 | \$0.11 |

The potential common shares excluded from the calculation of diluted earnings per share totaled 61,000 and 105,000 for the three month periods ended June 30, 2011 and 2010, respectively, and 52,000 and 69,000 for the six month periods ended June 30, 2011 and 2010, respectively, because their effect would be anti-dilutive.

8. Comprehensive Income

The following table sets forth the Company's comprehensive income for the periods indicated:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|--------------------------------|---------|------------------------------|---------|
| | 2011 | 2010 | 2011 | 2010 |
| | (in thousands) | | | |
| Net income | \$8,160 | \$1,734 | \$8,176 | \$1,943 |
| Other comprehensive income (loss): | | | | |
| Unrealized gains (losses) on derivative financial instruments, net of tax | 7 | (66) | 69 | (108) |
| Comprehensive income | \$8,167 | \$1,668 | \$8,245 | \$1,835 |

9. Merger with KBC

On October 1, 2010, the Company completed its acquisition of KBC and related entities pursuant to an agreement and plan of merger dated July 31, 2010. The Company acquired all outstanding shares of KBC common stock in exchange for \$6.2 million in cash and also issued to the former KBC shareholders 1,667,000 shares of the Company's common stock.

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CRAFT BREWERS ALLIANCE, INC.
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (continued)
 (unaudited)

The Company believes that the combined entity is able to secure advantages beyond those that had already been achieved in its long-term strategic relationship with KBC in supporting its brand family of beers. This acquisition increases the breadth and variety of the Company's brand offerings, creating favorable selling opportunities in a greater number of lucrative markets.

Merger-Related Costs

In connection with the business combination, the Company incurred merger-related expenses, including legal, consulting, accounting and other professional fees, and severance costs. The Company recognized expenses associated with the KBC Merger during the latter half of 2010, but did not recognize any merger-related expenses in the first six months of 2010. The Company did not recognize significant merger-related costs during the six months ended June 30, 2011.

The Company estimates that merger-related severance benefits associated with the KBC Merger totaling \$92,000 will be paid during the second half of 2011 to affected Kona employees.

Unaudited Pro Forma Results of Operations

The unaudited pro forma results of operations data are being furnished solely for informational purposes and are not intended to represent or be indicative of the consolidated results of operations that the Company would have reported had the KBC Merger and related transactions been completed as of the dates and for the periods presented, nor are they necessarily indicative of future results.

The unaudited pro forma results of operations data are derived from the consolidated financial statements of the Company and KBC and reflect pro forma adjustments relating to the KBC Merger and associated borrowing that are of a recurring nature consisting of pro forma amortization of intangible assets, primarily non-compete agreements, and pro forma effects of increased excise taxes associated with the loss of the lower rate benefit to KBC as a separate company, and of interest expense on the associated borrowing. Certain nonrecurring expenses assessed by the Company to be directly related to the KBC Merger have been included in the pro forma results presented for the six months ended June 30, 2010. These nonrecurring expenses are the merger-related expenses of \$559,000 and certain incentive compensation costs that were triggered as a result of the KBC Merger totaling \$449,000. These pro forma results of operations do not give effect to any cost savings, revenue synergies or restructuring costs which may result from the integration of KBC's or Kona's operations.

Consistent with ASU 2010-29, the unaudited pro forma combined condensed results of operations are presented below as if the KBC Merger had occurred on January 1, 2010.

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--------------|----------------------------------|------------------------------|------------------------------|------------------------------|
| | 2011 Actual Results | 2010 Pro forma Results | 2011 Actual Results | 2010 Pro forma Results |
| | (in thousands, except per share) | | | |
| Net sales | \$ 41,496 | \$ 35,505 | \$ 73,793 | \$ 63,001 |
| Gross profit | \$ 13,458 | \$ 11,961 | \$ 22,686 | \$ 21,156 |

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| | | | | |
|--------------------------------------|-----------|----------|-----------|----------|
| Income before income tax provision | \$ 13,268 | \$ 2,813 | \$ 13,294 | \$ 2,256 |
| Net income | \$ 8,160 | \$ 1,707 | \$ 8,176 | \$ 1,350 |
| Basic and diluted earnings per share | \$ 0.43 | \$ 0.09 | \$ 0.43 | \$ 0.07 |

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10. Income Taxes

As of June 30, 2011, the Company's deferred tax assets were primarily comprised of federal net operating loss carryforwards ("NOLs") of \$7.2 million, or \$2.5 million tax-effected; state NOL carryforwards of \$136,000 tax-effected; and federal and state alternative minimum tax credit carryforwards of \$658,000 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. Based upon the available evidence, the Company believed that it was more likely than not that all of the deferred tax assets would be realized, and therefore no valuation allowance was established at December 31, 2010 and June 30, 2011.

The effective tax rates for the first six months of 2011 and 2010 were affected by the impact of the Company's non-deductible expenses, primarily meals and entertainment expenses, and state and local taxes.

Significant components of the Company's deferred tax liabilities and assets are as follows:

| | June 30, 2011 | December 31, 2010 |
|---|------------------|----------------------|
| | (in thousands) | |
| Deferred tax liabilities: | | |
| Property, equipment and leasehold improvements | \$ 10,985 | \$ 11,462 |
| Intangible assets | 6,490 | 6,539 |
| Equity investments | 474 | 1,093 |
| Other | 103 | 52 |
| Total deferred tax liabilities | 18,052 | 19,146 |
| Deferred tax assets: | | |
| Net operating losses and alternative minimum tax credit carryforwards | 2,920 | 8,310 |
| Accrued salaries and severance | 833 | 828 |
| Other | 904 | 822 |
| Total deferred tax assets | 4,657 | 9,960 |
| Net deferred tax liability | \$ 13,395 | \$ 9,186 |
| As Presented on the Balance Sheet: | | |
| Long-term deferred income tax liability, net | \$ 13,991 | \$ 10,118 |
| Current deferred income tax asset, net | 596 | 932 |
| Net deferred tax liability | \$ 13,395 | \$ 9,186 |

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

This quarterly report on Form 10-Q includes forward-looking statements. Generally, the words “believe,” “expect,” “intend,” “estimate,” “anticipate,” “project,” “will,” “may,” “plan” and similar expressions or their negatives identify forward-looking statements, which generally are not historical in nature. These statements are based upon assumptions and projections that 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, 2010 (“2010 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 Consolidated Financial Statements and Notes thereto of the Company 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 the Company’s 2010 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 net sales and net income of \$41.5 million and \$8.2 million, respectively, for the three months ended June 30, 2011, compared with net sales and net income of \$37.2 million and \$1.7 million, respectively, for the corresponding period in 2010. The Company generated fully-diluted earnings per share of \$0.43 on 18.9 million shares for the second quarter of 2011 compared with \$0.10 per share on 17.1 million shares for the corresponding period of 2010. The Company generated an operating profit of \$2.8 million during the quarter ended June 30, 2011 compared with \$2.9 million during the quarter ended June 30, 2010, reflecting an improved gross margin of 450 basis points offset by an increase in selling, general and administrative expenses for the 2011 period. Net income increased \$6.4 million from \$1.7 million in the second quarter of 2010 to \$8.2 million in the second quarter of 2011, primarily due to the gain on sale of Fulton Street Brewery, LLC. The Company’s sales volume (shipments) totaled 191,100 barrels in the second quarter of 2011 as compared with 170,900 barrels in the second quarter of 2010, an increase of 11.8%.

The Company reported net sales and net income of \$73.8 million and \$8.2 million, respectively, for the first six months ended June 30, 2011, compared with net sales and net income of \$64.7 million and \$1.9 million, respectively, for the corresponding period in 2010. The Company generated fully-diluted earnings per share of \$0.43 on 18.9 million shares for the first six months of 2011 compared with \$0.11 per share on 17.1 million shares for the corresponding period of 2010. The Company generated operating profit of \$2.7 million during the first six months ended June 30, 2011 compared with \$3.5 million during the corresponding period of 2010, reflecting an improved gross margin of 410 basis points offset by an increase in selling, general and administrative expenses for the 2011 period. The Company’s sales volume totaled 339,000 barrels in the first six months of 2011 as compared with 299,600 barrels in the corresponding period of 2010, an increase of 13.2%.

The comparability of the Company’s results for the three and six month periods ended June 30, 2011 relative to the results for the same periods in 2010 is significantly impacted by the merger with Kona Brewing Co., Inc. (“KBC”) and related entities (“KBC Merger”), which closed October 1, 2010 (the “effective date”) and by the sale of the Company’s equity interest in Fulton Street Brewery, LLC (“FSB”) during the second quarter of 2011.

Management believes that the Company, as it is currently constituted, should be able to secure advantages beyond those that have already been achieved in its long-term strategic relationship with KBC in supporting the Kona Brewing brand family of beers with increased financial, marketing and operating capabilities and reaching more consumers in both Hawaii and the U.S. mainland. The KBC acquisition increases the breadth and variety of the Company's brand offerings, creating favorable selling opportunities in lucrative markets.

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The Company brews its specialty bottled and draft Widmer Brothers-, Redhook- and Kona Brewing-branded beers in its four Company-owned production breweries. The Company brews its beers at a brewery in Portsmouth, New Hampshire (“New Hampshire Brewery”); a brewery located in Portland, Oregon (the “Oregon Brewery”), which is the Company’s largest brewery; a brewery in the Seattle suburb of Woodinville, Washington (“Washington Brewery”); and a brewery located in Kailua-Kona, Hawaii. The Company also owns and operates a small manual style brewery at the Rose Quarter in Portland, Oregon. The Company sells these beers primarily to Anheuser-Busch, Incorporated (“A-B”) and its network of wholesalers pursuant to a Master Distributor Agreement. Redhook- and Widmer Brothers-branded beers are distributed in 49 of the 50 states, and Kona Brewing-branded beers are distributed in more than half of the 50 states.

On May 2, 2011 (the “Closing Date”), the Company, A-B, and Goose Holdings, Inc. (“GHI”) completed the sale of FSB to A-B as contemplated by the equity purchase agreement (the “Purchase Agreement”) dated as of February 18, 2011. The consideration received by the Company in exchange for its 42 percent interest in FSB was \$16.3 million, net of the Company’s share of transaction fees, and consisted of \$15.1 million in cash, and \$1.3 million placed in escrow to satisfy valid claims, if any, that may be asserted by A-B in connection with breaches of representations and warranties made by GHI and the Company in the Purchase Agreement. The Company also received \$350,000 from A-B as reimbursement for legal and professional fees the Company separately incurred in evaluation of the transaction. A copy of the Purchase Agreement was filed as exhibit 2.2 to the Company’s Annual Report on Form 10-K for the year ended December 31, 2010.

On the Closing Date, in connection with the Company’s sale of its interest in FSB, the Company and A-B modified two agreements that the parties had originally executed in 2004, the Master Distributor Agreement (as amended and restated, the “A-B Distributor Agreement”), and the Exchange and Recapitalization Agreement (as amended and restated, the “Exchange Agreement”).

The Company and A-B modified the A-B Distributor Agreement principally to set the Margin fees (“Margin fees”) to be paid to A-B for all draft or bottled beer sold through A-B or the associated A-B distribution network, except for beer sold in qualifying territories, as defined, from May 1, 2011 (the “Commencement Date”) until December 31, 2018, at \$0.25 per case equivalent. Beer sold through A-B or the associated A-B distribution network in qualifying territories, as defined, until September 30, 2013, will be exempt from Margin fees, and thereafter will be assessed Margin fees at the \$0.25 per case equivalent through December 31, 2018. The exemption from Margin fees for beer sold in the qualifying territories is subject to certain conditions, including the Company incurring sales and marketing expenses in the qualifying territories at or above specified amounts. The A-B Distributor Agreement sets Margin fees to be paid to A-B for the renewal period, beginning January 1, 2019 and ending December 31, 2028, at \$0.75 per case equivalent, in the event the A-B Distributor Agreement is renewed. The A-B Distributor Agreement no longer provides for the incremental fees that were previously paid to A-B for shipments above the volume of shipments during 2003.

Additional terms of the A-B Distributor Agreement allow the Company, in the event the Company purchases additional beer brands, to elect to use a distribution network other than A-B’s for such brands, and for A-B to provide enhanced selling support for the Company’s brands. A copy of the A-B Distributor Agreement was filed as exhibit 10.2 to the Company’s May 4, 2011 Form 8-K.

The Company estimates that, had the modification to the A-B Distributor Agreement been in place throughout 2010, the increase in 2010 sales revenues resulting from the reduced distribution fees would have been approximately \$3.3 million. The amount of increase in sales revenues realized for future periods may differ from this estimate due to the level, timing and geographic distribution of the Company’s shipments to A-B in the future. The loss of the Company’s share of earnings from FSB will partially offset any increase in sales revenues resulting from the reduced distribution fees. The Company’s share of FSB’s earnings was \$696,000 for the year ended December 31, 2010.

For additional information regarding the A-B Distributor Agreement and the Company's relationship with A-B, see Part 1, Item 1, Business "—Distribution," and "— Relationship with Anheuser-Busch, Incorporated" in the Company's 2010 Annual Report.

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Results of Operations

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | | | |
|--|--------------------------------|---------|------------------------------|---------|------|------|
| | 2011 | 2010 | 2011 | 2010 | 2011 | 2010 |
| Sales | 108.1 | % 106.5 | % 108.2 | % 106.6 | | |
| Less excise taxes | 8.1 | 6.5 | 8.2 | 6.6 | | |
| Net sales | 100.0 | 100.0 | 100.0 | 100.0 | | |
| Cost of sales | 67.6 | 72.1 | 69.3 | 73.3 | | |
| Gross profit | 32.4 | 27.9 | 30.7 | 26.7 | | |
| Selling, general and administrative expenses | 25.7 | 20.3 | 27.0 | 21.3 | | |
| Operating income (loss) | 6.7 | 7.6 | 3.7 | 5.4 | | |
| Income from equity method investments | 0.8 | 0.9 | 0.9 | 0.7 | | |
| Gain on sale of Fulton Street Brewery, LLC | 25.1 | — | 14.1 | — | | |
| Interest expense | (0.6) | (1.0) | (0.7) | (1.3) | | |
| Interest and other income, net | — | 0.2 | — | 0.2 | | |
| Income before income taxes | 32.0 | 7.7 | 18.0 | 5.0 | | |
| Income tax provision | 12.3 | 3.0 | 6.9 | 2.0 | | |
| Net income | 19.7 | % 4.7 | % 11.1 | % 3.0 | | |

Three months ended June 30, 2011 compared with three months ended June 30, 2010

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

| | Three Months Ended June 30, | | Increase / (Decrease) | % Change |
|--|--------------------------------|----------|--------------------------|----------|
| | 2011 | 2010 | | |
| | (dollars in thousands) | | | |
| Sales | \$44,849 | \$39,645 | \$5,204 | 13.1 % |
| Less excise taxes | 3,353 | 2,406 | 947 | 39.4 |
| Net sales | 41,496 | 37,239 | 4,257 | 11.4 |
| Cost of sales | 28,038 | 26,841 | 1,197 | 4.5 |
| Gross profit | 13,458 | 10,398 | 3,060 | 29.4 |
| Selling, general and administrative expenses | 10,670 | 7,545 | 3,125 | 41.4 |
| Operating income | 2,788 | 2,853 | (65) | (2.3) |
| Income from equity method investments | 335 | 338 | (3) | (0.9) |
| Gain on sale of Fulton Street Brewery, LLC | 10,398 | — | 10,398 | — |
| Interest expense | (260) | (409) | (149) | (36.4) |
| Interest and other income, net | 7 | 75 | (68) | (90.7) |
| Income before income taxes | 13,268 | 2,857 | 10,411 | 364.4 |
| Income tax provision | 5,108 | 1,123 | 3,985 | 354.9 |
| Net income | \$8,160 | \$1,734 | \$6,426 | 370.6 % |

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The following table sets forth a comparison of sales revenues for the periods indicated:

| | Three Months Ended June 30, | | Increase / (Decrease) | % Change |
|----------------------------|--------------------------------|----------|--------------------------|----------|
| | 2011 | 2010 | | |
| | (dollars in thousands) | | | |
| Sales Revenues by Category | | | | |
| A-B and A-B related (1) | \$36,598 | \$32,234 | \$4,364 | 13.5 % |
| Pubs and other (2) | 6,347 | 2,975 | 3,372 | 113.3 |
| Contract brewing | 1,904 | 695 | 1,209 | 174.0 |
| Alternating proprietorship | — | 3,741 | (3,741) | (100.0) |
| Total Sales | \$44,849 | \$39,645 | \$5,204 | 13.1 % |

Note 1 - A-B related revenues include fees earned on wholesaler or distributor sales made via a non-wholesaler.

Note 2 - Other revenues include international sales, sales of promotional merchandise and other.

Gross Sales. Gross sales increased \$5.2 million, or 13.1%, from \$39.6 million for the second quarter of 2010 to \$44.9 million for the second quarter of 2011 primarily due to an increase in shipments to A-B resulting in increased revenues of \$4.4 million and higher selling prices for the Company's products. Gross sales were also favorably impacted by a decrease in the per barrel fee associated with sales to A-B, which is netted against revenue.

Revenues from pub and other sales increased by \$3.4 million for the second quarter of 2011 primarily due to the addition of the restaurant and pub operations acquired in the KBC Merger.

The increase in contract revenues of \$1.2 million was primarily due to an increase in shipments under a third-party contract and the contribution of shipments under a new contract brewing arrangement with FSB.

Prior to the KBC Merger, the Company earned revenue in connection with an alternating proprietorship agreement with Kona, including fees for leasing the Oregon Brewery and sales of raw materials. After the effective date, any such intercompany activities are eliminated, including the revenues associated with the alternating proprietorship agreement, which represented \$3.7 million for the second quarter ended June 30, 2010.

Shipments – Customer. The following table sets forth a comparison of shipments by customer (in barrels) for the periods indicated:

| | Three Months Ended June 30, | | | | | | Increase / (Decrease) | % Change |
|--------------------|-----------------------------|---------|---------|----------------|---------|---------|--------------------------|----------|
| | 2011 Shipments | | | 2010 Shipments | | | | |
| | Draft | Bottle | Total | Draft | Bottle | Total | | |
| | (in barrels) | | | | | | | |
| A-B | 57,200 | 115,800 | 173,000 | 60,000 | 102,500 | 162,500 | 10,500 | 6.5 % |
| Contract brewing | 10,600 | 3,400 | 14,000 | 5,900 | — | 5,900 | 8,100 | 137.3 |
| Pubs and other (1) | 2,500 | 1,600 | 4,100 | 2,000 | 500 | 2,500 | 1,600 | 64.0 |
| | 70,300 | 120,800 | 191,100 | 67,900 | 103,000 | 170,900 | 20,200 | 11.8 % |

Total
shipped

Note 1 - Other includes international, pubs and other.

Total Company shipments increased 11.8% to 191,100 barrels for the second quarter of 2011 as compared with 170,900 barrels in the corresponding period of 2010, primarily driven by an increase in shipments to A-B of 10,500 barrels, increased shipments under its contract brewing arrangements and increased sales through its pubs and restaurants due to the Hawaiian operations following the KBC Merger. Shipments to A-B for the second quarter of 2011 as compared with the corresponding period one year ago were impacted by the Company's increased sales and marketing efforts beginning in the fourth quarter of 2010. The rate of change in depletions, or sales by the wholesalers to retailers, for the Redhook-, Widmer Brothers- and Kona Brewing-branded beers for the second quarter of 2011 increased at a 6.2% rate from the same quarter a year ago, reflecting the increased sales and marketing efforts.

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Pricing and Fees. The average revenue per barrel on shipments of beer through the A-B distribution network for the second quarter of 2011 increased by 3.8% as compared with the average revenue per barrel for the corresponding period of 2010. The 3.8% increase also included the effect of the mix shift from draft to bottle sales, as the barrel equivalent of bottle sales is priced higher than draft. During the second quarters of 2011 and 2010, the Company sold 90.5% and 95.1%, respectively, of its beer through A-B at wholesale pricing levels. Pricing changes implemented by the Company have generally followed pricing changes initiated by large domestic or import brewing companies. While the Company has implemented modest price increases during the past few years, some of the benefit has been offset by competitive promotions and discounting which was done to increase the visibility of our brands. The Company expects that product pricing will continue to demonstrate modest increases in the near term as tempered by the current competitive climate. The Company's pricing is expected to follow the general trend in the industry.

In connection with all sales through the A-B Distributor Agreement, the Company pays a Margin fee to A-B ("Margin"). The Margin does not apply to sales under the Company's contract brewing arrangement or from its retail operations and dock sales. The A-B Distributor Agreement also previously provided for payment of Additional Margin for shipments that exceeded a specified level (together with Margin, "Total Margin"). For the three months ended June 30, 2011 and 2010, the Company recognized expense of \$741,000 and \$1.6 million, respectively, related to Total Margin associated with sales to A-B. These fees are reflected as a reduction of sales in the Company's consolidated statements of income. The decrease in Total Margin is the result of changes to the A-B Distributor Agreement. The first modification exempts certain product sales from Total Margin effective as of the fourth quarter of 2010. The second modification, effective May 1, 2011, lowered the rate per barrel paid for Margin and eliminated fees associated with Additional Margin. The Company estimates that had the second modification been effective as of the beginning of the 2011 second quarter, the increase in sales revenues for that quarter would have been approximately \$250,000. The increase in sales revenues realized in future periods may differ from this estimate based on the level, timing and geographic distribution of the Company's shipments to A-B.

As of June 30, 2011 and December 31, 2010, the net amount due from A-B under all Company agreements with A-B totaled \$4.8 million and \$3.9 million, respectively. In connection with the sale of beer pursuant to the A-B Distributor Agreement, the Company's accounts receivable reflect significant balances due from A-B, and the refundable deposits and accrued expenses reflect significant balances due to A-B. Although the Company considers these balances to be due to or from A-B, the final destination of the Company's products is an A-B wholesaler and payments by the wholesaler are settled through A-B. The Company obtains services from A-B under separate arrangements; balances due to A-B under these arrangements are reflected in accounts payable and accrued expenses. These amounts are also included in the net amount due from A-B presented above.

Shipments – Brand. The following table sets forth a comparison of shipments by brand (in barrels) for the periods indicated:

| | Three Months Ended June 30, | | | | | | Increase / (Decrease) | % Change |
|-------------------|-----------------------------|---------|---------|----------------|---------|---------|--------------------------|-------------|
| | 2011 Shipments | | | 2010 Shipments | | | | |
| | Draft | Bottle | Total | Draft | Bottle | Total | | |
| | (in barrels) | | | | | | | |
| Widmer Brothers | 33,200 | 41,000 | 74,200 | 37,400 | 40,800 | 78,200 | (4,000) | (5.1) % |
| Redhook | 11,800 | 37,600 | 49,400 | 12,500 | 34,800 | 47,300 | 2,100 | 4.4 |
| Kona | 14,700 | 38,800 | 53,500 | 12,100 | 27,400 | 39,500 | 14,000 | 35.4 |
| Total shipped (1) | 59,700 | 117,400 | 177,100 | 62,000 | 103,000 | 165,000 | 12,100 | 7.3 % |

Note 1 - Total shipments by brand exclude shipments produced under the Company's contract brewing arrangements.

Excise Taxes. Excise taxes for the three months ended June 30, 2011 increased \$947,000, or 39.4%, due to a combination of factors, including a) the increase in the Company's shipments for the second quarter of 2011 as compared with the corresponding quarter of 2010, b) the addition of excise taxes relating to shipments of Kona Brewing-branded beers that were previously recognized by Kona prior to the KBC Merger, and c) the marginal tax rate increase after the KBC Merger as the combined companies are eligible for only a single excise tax exemption. Also contributing to the increase in excise tax expense for the second quarter of 2011 was the increase in the marginal tax rate for beer produced in Washington state, which became effective in the second half of 2010.

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Cost of Sales. For the second quarter of 2011, cost of sales as a percentage of net sales fell to 67.6% from 72.1% for the corresponding period in 2010, primarily reflecting a) elimination of alternating proprietorship related costs, b) improved utilization of our brewery facilities and c) an increase in net sales prices for the second quarter of 2011. These factors were partially offset by increased shipping costs as a result of rising fuel prices for the second quarter of 2011 as compared with the same quarter a year ago. Cost of sales increased \$1.2 million, or 4.5%, to \$28.0 million in the second quarter of 2011 from \$26.8 million in the corresponding quarter of 2010, which was primarily due to the increase in shipments, increased costs associated with the acquired Hawaiian restaurant operations and shipping costs. These cost increases were partially offset by the absence of costs associated with the alternating proprietorship during the second quarter of 2011 as a result of the KBC Merger.

The Company's utilization rate improved from 73.6% during the second quarter of 2010 to 84.1% for the second quarter of 2011. Capacity utilization rates are calculated by dividing the Company's total shipments by the working capacity. To improve the balance between expected demand and capacity, the Company has executed two contract brewing agreements. One of the agreements was initiated during the third quarter of 2009, under which shipments are expected to approach 35,000 barrels in 2011, although the third party may designate greater or lesser quantities per the terms of the contract. The second agreement is a three-year contract brewing arrangement with FSB, under which shipments began in the first quarter of 2011. The Company will produce beer in volumes and per specifications as designated by FSB in accordance with the contract terms. The Company anticipates that the volume of this contract may reach 25,000 to 30,000 barrels per year.

Prior to the KBC Merger, cost of sales for 2010 included costs associated with two distinct Kona revenue streams: (i) direct and indirect costs related to the alternating proprietorship arrangements with Kona and (ii) the cost paid to Kona for the Kona Brewing-branded finished goods that are marketed and sold by the Company to wholesalers through the A-B Distributor Agreement. After the effective date, the Company discontinued recognizing the costs related to these activities as they pertain to Kona.

Inventories acquired pursuant to the merger with Widmer Brothers Brewing Company ("WBBC") were recorded at their estimated fair values as of July 1, 2008, resulting in an increase over the cost at which these inventories were stated on the June 30, 2008 WBBC balance sheet (the "Step Up Adjustment"). Substantially all such costs associated with the Step Up Adjustment had been recognized as of December 31, 2010. As of June 30, 2011, all such costs associated with the Step Up Adjustment had been recognized. During the three months ended June 30, 2010, approximately \$58,000 of the Step Up Adjustment was expensed to cost of sales in connection with normal production and sales for the quarter.

Selling, General and Administrative Expenses. Selling, general and administrative ("SG&A") expenses for the three months ended June 30, 2011 increased \$3.1 million, or 41.4%, to \$10.7 million from \$7.6 million for the same period in 2010. The increase in SG&A for the second quarter of 2011 was primarily due to a) an increase in sales and marketing costs, principally packaging design and development, promotions and sponsorship activity, point of sale and related trade merchandise, increased costs associated with a larger sales force during the second quarter of 2011 as compared with the quarter a year ago, and b) the administrative costs associated with the acquired Hawaiian operations.

The Company incurs costs for the promotion of its products through a variety of advertising programs with its wholesalers and downstream retailers. These costs are included in SG&A expenses and frequently involve the local wholesaler sharing in the cost of the program. Reimbursements from wholesalers for advertising and promotion activities are recorded as a reduction to SG&A expenses in the Company's statements of income. Reimbursements for pricing discounts to wholesalers are recorded as a reduction to sales. The wholesalers' contribution toward these activities was an immaterial percentage of net sales for the 2011 second quarter. Depending on the industry and market conditions, the Company may adjust its advertising and promotional efforts in a wholesaler's market if a

change occurs in a cost-sharing arrangement. The timing of these efforts may also be adjusted due to opportunities available to the Company over the course of the fiscal year; however, the Company anticipates that its expenditures associated with its sales and marketing efforts for most periods in 2011 will be significantly greater than its expenditures for SG&A in the corresponding periods of 2010.

Income from Equity Method Investments. For the three months ended June 30, 2011 and 2010, the Company's share of FSB's net income totaled \$335,000 and \$332,000, respectively. For the three months ended June 30, 2010 the Company's share of Kona's net income totaled \$6,000; however, as of October 1, 2010, with the completion of the KBC Merger, the Company discontinued recognizing earnings on an equity basis for Kona.

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With the sale of the Company's investment in FSB to A-B, which closed on May 2, 2011, the Company no longer holds an interest in FSB. As such, the Company has ceased recognizing income for equity method investments after the second quarter of 2011.

Gain on sale of FSB. For the three months ended June 30, 2011, the Company's pre-tax gain on sale of FSB totaled \$10.4 million. The gain was the result of proceeds of \$16.3 million less the investment in FSB of \$5.9 million.

Interest Expense. Interest expense decreased \$149,000 to \$260,000 in the second quarter of 2011 from \$409,000 in the second quarter of 2010 due to the effect of the expiration of the non-qualifying interest rate swap in the fourth quarter of 2010 and to a lower average interest rate on borrowings under the credit agreement and decreased average outstanding borrowings. The reduction in interest rate on the Company's borrowings was due to the modifications the Company negotiated with its primary lender in the latter part of 2010 as a result of its improved financial condition. The decrease in average outstanding borrowings was primarily the result of using the proceeds from the sale of FSB to repay the Company's line of credit.

The Company maintained average outstanding debt for the second quarter of 2010 at \$23.9 million. During the second quarter of 2011, the Company utilized a portion of the proceeds from the sale of FSB to pay down a significant portion of its debt resulting in average outstanding debt of \$23.7 million.

Income Taxes. The Company's provision for income taxes was \$5.1 million and \$1.1 million for the three months ended June 30, 2011 and 2010, respectively. The tax provision for the second quarters of 2011 and 2010 varied from the statutory tax rate due largely to the impact of the Company's non-deductible expenses, primarily meals and entertainment expenses, and state and local taxes.

Six months ended June 30, 2011 compared with six months ended June 30, 2010

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

| | Six Months Ended June 30, | | Increase / (Decrease) | % Change | |
|--|------------------------------|-----------|--------------------------|-------------|---|
| | 2011 | 2010 | | | |
| | (dollars in thousands) | | | | |
| Sales | \$79,809 | \$ 68,967 | \$ 10,842 | 15.7 | % |
| Less excise taxes | 6,016 | 4,276 | 1,740 | 40.7 | |
| Net sales | 73,793 | 64,691 | 9,102 | 14.1 | |
| Cost of sales | 51,107 | 47,446 | 3,661 | 7.7 | |
| Gross profit | 22,686 | 17,245 | 5,441 | 31.6 | |
| Selling, general and administrative expenses | 19,959 | 13,750 | 6,209 | 45.2 | |
| Operating income | 2,727 | 3,495 | (768) | 22.0 | |
| Income from equity method investments | 691 | 423 | 268 | 63.4 | |
| Gain on sale of Fulton Street Brewery, LLC | 10,398 | — | 10,398 | — | |
| Interest expense | (542) | (808) | (266) | (32.9) | |
| Interest and other income, net | 20 | 128 | (108) | (84.4) | |
| Income before income taxes | 13,294 | 3,238 | 10,056 | 310.6 | |
| Income tax provision | 5,118 | 1,295 | 3,823 | 295.2 | |
| Net income | \$8,176 | \$ 1,943 | \$ 6,233 | 320.8 | % |

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The following table sets forth a comparison of sales revenues for the periods indicated:

| | Six Months Ended June 30, | | Increase / (Decrease) | % Change |
|----------------------------|------------------------------|----------|--------------------------|----------|
| | 2011 | 2010 | | |
| (dollars in thousands) | | | | |
| Sales Revenues by Category | | | | |
| A-B and A-B related (1) | \$65,045 | \$56,334 | \$8,711 | 15.5 % |
| Pubs and other (2) | 11,760 | 5,522 | 6,238 | 113.0 |
| Contract brewing | 3,004 | 1,110 | 1,894 | 170.6 |
| Alternating proprietorship | — | 6,001 | (6,001) | (100.0) |
| Total Sales | \$79,809 | \$68,967 | \$10,842 | 15.7 % |

Note 1 - A-B related revenues include fees earned on wholesaler or distributor sales made via a non-wholesaler.

Note 2 - Other revenues include international sales, sales of promotional merchandise and other.

Gross Sales. Gross sales increased \$10.8 million, or 15.7%, from \$69.0 million for the first six months of 2010 to \$79.8 million for the corresponding period in 2011. The primary factor contributing to the increase in sales revenues for the six month period ended June 30, 2011 was the increase in sales to A-B and A-B related revenues of \$8.7 million due to an increase in shipments to A-B and an increase in the net selling price for the Company's products. Gross sales also saw an increase due to a decrease in the per barrel fee associated with sales to A-B.

Revenues from pub and other sales increased by \$6.2 million for the first six months of 2011 primarily due to the addition of the restaurant and pub operations acquired in the KBC Merger.

The increase in contract revenues of \$1.9 million was primarily due to an increase in shipments under a third-party contract and the contribution of shipments under the contract brewing arrangement with FSB.

Prior to the KBC Merger, the Company earned revenue in connection with an alternating proprietorship agreement with Kona, including fees for leasing the Oregon Brewery and sales of raw materials. After the effective date, any such intercompany activities are eliminated, including the revenues associated with the alternating proprietorship agreement, which represented \$6.0 million for the six month period ended June 30, 2010.

Shipments – Customer. The following table sets forth a comparison of shipments by customer (in barrels) for the periods indicated:

| | Six Months Ended June 30, 2011 - Shipments | | | 2010 - Shipments | | | Increase / (Decrease) | % Change |
|--------------------|---|---------|---------|------------------|---------|---------|--------------------------|----------|
| | Draft (in barrels) | Bottle | Total | Draft | Bottle | Total | | |
| A-B | 109,500 | 200,400 | 309,900 | 109,900 | 174,900 | 284,800 | 25,100 | 8.8 % |
| Contract brewing | 18,400 | 3,900 | 22,300 | 10,700 | — | 10,700 | 11,600 | 108.4 |
| Pubs and other (1) | 4,500 | 2,300 | 6,800 | 3,300 | 800 | 4,100 | 2,700 | 65.9 |

| | | | | | | | | |
|---------------|---------|---------|---------|---------|---------|---------|--------|--------|
| Total shipped | 132,400 | 206,600 | 339,000 | 123,900 | 175,700 | 299,600 | 39,400 | 13.2 % |
|---------------|---------|---------|---------|---------|---------|---------|--------|--------|

Note 1 - Other includes international, non-wholesalers, pubs and other.

Total Company shipments increased 13.2% to 339,000 barrels for the six month period ended June 30, 2011 as compared with 299,600 barrels in the corresponding period of 2010, primarily driven by an increase in shipments to A-B of 25,100 barrels, increased shipments under its contract brewing arrangements and increased sales through its pubs and restaurants due to the Hawaiian operations following the KBC Merger. Shipments to A-B for the six months ended June 30, 2011 as compared with the corresponding period one year ago were impacted by the Company's increased sales and marketing efforts beginning in the fourth quarter of 2010. The rate of change in depletions, or sales by the wholesalers to retailers, for the Redhook-, Widmer Brothers- and Kona Brewing-branded beers for the six months ended June 30, 2011 increased at a 6.7% rate from the same period a year ago, reflecting the increased sales and marketing efforts.

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Pricing and Fees. The average revenue per barrel on shipments of beer through the A-B distribution network for the first six months of 2011 increased by 3.8% as compared with the average revenue per barrel for the corresponding period of 2010. The 3.8% increase also included the effect of the mix shift from draft to bottle sales, where the barrel equivalent of bottle sales is priced higher than draft. During the six month periods ended June 30, 2011 and 2010, the Company sold 91.4% and 95.1%, respectively, of its beer through A-B at wholesale pricing levels.

For the six months ended June 30, 2011 and 2010, the Company recognized expense of \$1.9 million and \$3.0 million, respectively, related to Total Margin associated with sales to A-B. These fees are reflected as a reduction of sales in the Company's consolidated statements of income.

The Company estimates that, if the second modification to the A-B Distributor Agreement discussed above had been in place as of January 1, 2011, the increase in sales revenues would have been approximately \$1.0 million for the first six months of 2011.

Shipments – Brand. The following table sets forth a comparison of shipments by brand (in barrels) for the periods indicated:

| | Six Months Ended June 30, 2011 - Shipments | | | 2010 - Shipments | | | Increase / % (Decrease) Change | |
|-------------------|---|---------|---------|------------------|---------|---------|---|----------|
| | Draft (in barrels) | Bottle | Total | Draft | Bottle | Total | | |
| Widmer brand | 63,800 | 72,800 | 136,600 | 68,000 | 71,400 | 139,400 | (2,800) | (2.0) % |
| Redhook brand | 22,600 | 66,900 | 89,500 | 23,500 | 61,800 | 85,300 | 4,200 | 4.9 |
| Kona brand | 27,600 | 63,000 | 90,600 | 21,700 | 42,500 | 64,200 | 26,400 | 41.1 |
| Total shipped (1) | 114,000 | 202,700 | 316,700 | 113,200 | 175,700 | 288,900 | 27,800 | 9.6 % |

Note 1 - Total shipments by brand exclude shipments produced under the Company's contract brewing arrangement.

Excise Taxes. Excise taxes for the six months ended June 30, 2011 increased \$1.7 million, or 40.7%, due to a combination of factors, including a) the increase in the Company's shipments for the first six months of 2011 as compared with the corresponding period of 2010, b) the addition of excise taxes relating to shipments of Kona Brewing-branded beers that were previously recognized by Kona prior to the KBC Merger, and c) the marginal tax rate increase after the KBC Merger as the combined companies are eligible for only a single excise tax exemption. Also contributing to the increase in excise tax expense for the six months ended June 30, 2011 was the increase in the marginal tax rate for beer produced in Washington state, which became effective in the second half of 2010.

Cost of Sales. For the six month period ended June, 30 2011, cost of sales as a percentage of net sales fell to 69.3% from 73.3% for the corresponding period in 2010, primarily reflecting a) elimination of alternating proprietorship related cost, b) improved brewery utilization and c) an increase in net sales prices for the first six months of 2011. These factors were partially offset by increased shipping costs as a result of rising fuel prices for the six months ended June 30, 2011 as compared with the same period a year ago. Cost of sales increased \$3.7 million, or 7.7%, to \$51.1 million in the first six months of 2011 from \$47.4 million in the corresponding period of 2010, which was primarily due to the increase in shipments, increased costs associated with the acquired Hawaiian restaurant operations and shipping costs. These cost increases were partially offset by the absence of costs associated with the alternating proprietorship during the six months ended June 30, 2011 as a result of the KBC Merger.

The Company's utilization rate improved from 64.5% during the first six months of 2010 to 74.6% for the same period in 2011.

Inventories acquired pursuant to the merger with WBBC were recorded at their estimated fair values as of July 1, 2008, resulting in an increase over the cost at which these inventories were stated on the June 30, 2008 WBBC balance sheet. As of June 30, 2011, all such costs associated with the Step Up Adjustment had been recognized. During the six months ended June 30, 2010, approximately \$203,000 of the Step Up Adjustment was expensed to cost of sales in connection with normal production and sales for the quarter.

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Selling, General and Administrative Expenses. SG&A expenses for the six months ended June 30, 2011 increased \$6.2 million, or 45.2%, to \$20.0 million from expenses of \$13.8 million for the same period in 2010. The increase in SG&A for the six month period ended June 30, 2011 was primarily due to a) an increase in sales and marketing costs, principally packaging design and development, promotions and sponsorship activity, point of sale and related trade merchandise, increased costs associated with a larger sales force during the first six months of 2011 as compared with the same period a year ago, and b) the administrative costs associated with the acquired Hawaiian operations.

Income from Equity Method Investments. For the six months ended June 30, 2011 and 2010, the Company's share of FSB's net income totaled \$691,000 and \$378,000, respectively. For the six months ended June 30, 2010 the Company's share of Kona's net income totaled \$45,000; however, as of October 1, 2010, with the completion of the KBC Merger, the Company discontinued recognizing earnings on an equity basis for Kona.

With the sale of the Company's investment in FSB to A-B, which closed on May 2, 2011, the Company no longer holds an interest in FSB. As such, the Company has ceased recognizing income for equity investments after the second quarter of 2011.

Gain on sale of FSB. For the six months ended June 30, 2011, the Company's pre-tax gain on sale of FSB totaled \$10.4 million. The gain was the result of proceeds of \$16.3 million less the investment in FSB of \$5.9 million.

Interest Expense. Interest expense decreased \$266,000 to \$542,000 in the first six months of 2011 from \$808,000 in the same period in 2010 due to the effect of expiration of the non-qualifying interest rate swap in the fourth quarter of 2010, lower average interest rate on borrowings under the credit agreement, and relatively flat average outstanding borrowings.

The Company maintained average outstanding debt for the six month period ended June 30, 2010 at \$24.9 million, compared to \$25.5 million for the first six months of 2011. Following the sale of FSB, the Company reduced its debt level to \$18.3 million at June 30, 2011.

Income Taxes. The Company's provision for income taxes was \$5.1 million and \$1.3 million for the six month periods ended June 30, 2011 and 2010, respectively. The tax provision for the first six months of 2011 and 2010 varied from the statutory tax rate due largely to the impact of the Company's non-deductible expenses, primarily meals and entertainment expenses, and state and local taxes.

Liquidity and Capital Resources

The Company has required capital primarily for the construction and development of its production breweries, to support its expansion and growth plans, and to fund its working capital needs. Historically, the Company has financed its capital requirements through cash flow from operations, bank borrowings and the sale of common and preferred stock. The Company anticipates meeting its anticipated obligations for the remainder of 2011 through a combination of the proceeds received from the sale of its interest in FSB and cash flows from operations, and may borrow under its short-term bank borrowings as the need arises. The capital resources available to the Company under its loan agreement and capital lease obligations are discussed in greater detail in the 2010 Annual Report, in Item 8, Notes to Financial Statements.

The Company had \$6.5 million and \$164,000 of cash and cash equivalents at June 30, 2011 and December 31, 2010, respectively. At June 30, 2011, the Company had a working capital surplus totaling \$4.4 million, an \$8.8 million improvement from the Company's working capital position at December 31, 2010. The Company's debt as a percentage of total capitalization (total debt and common stockholders' equity) was 15.2% and 22.4% at June 30, 2011 and December 31, 2010, respectively. Cash provided by operating activities totaled \$3.6 million and \$6.8 million for the six months ended June 30, 2011 and 2010, respectively.

Capital expenditures for the first six months of 2011 were \$3.7 million compared with \$1.1 million for the corresponding period in 2010. Major projects in 2011 have included the purchase or retrofitting of equipment to upgrade the Company's breweries and the planning and design of a Company-wide supply chain management system. The capital expenditures for the six month period ended June 30, 2010 were primarily for maintenance projects and continuation of certain projects carried over from the prior year.

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As of June 30, 2011, the Company's available liquidity was \$28.3 million, comprised of accessible cash and cash equivalents and further borrowing capacity. With the May 2, 2011 receipt of \$15.3 million in cash, which represented the Company's share of the cash proceeds of the Purchase Consideration from the sale of its equity interest in FSB to A-B and reimbursement of certain transaction fees, the Company repaid the outstanding borrowings under its revolving line of credit. The Company anticipates that an additional \$1.3 million, which was placed in escrow at May 2, 2011, will be released to the Company in three payments ratably, every six months following the Closing Date, subject to indemnification claims, as applicable. The Company anticipates that it will be able to generate sufficient liquidity for the 2011 fiscal year between the proceeds from the sale of the equity interest in FSB, its operating cash flows and its available borrowing capacity to fund its capital expenditures at necessary levels. The Company's 2011 capital expenditures are planned to include investments in brewing and other production areas, primarily associated with the new contract brewing arrangement with FSB, quality assurance, information technology equipment, and to enhance and target its brand offerings. Certain of these expenditures began in the fourth quarter of 2010, and are expected to continue throughout the remainder of the 2011 fiscal year, during which the Company expects to spend a total of approximately \$2.5 million to \$3.5 million for these capital projects.

The Company previously had a capital equipment lease obligation to BofA secured by substantially all of the brewery equipment and restaurant furniture and fixtures located in Portland, Oregon. On July 20, 2011, the Company paid off the remaining balance on the capital lease without penalty.

Since June 2008, the Company has maintained a loan agreement (as amended, the "Loan Agreement") with Bank of America, N.A. ("BofA"), which is presently comprised of a \$22.0 million revolving line of credit ("Line of Credit"), including provisions for cash borrowings and up to \$2.5 million notional amount of letters of credit, and a \$13.5 million term loan ("Term Loan"). The Company may draw upon the Line of Credit for working capital and general corporate purposes. At June 30, 2011, the Company had no borrowings outstanding under the Line of Credit. As of June 30, 2011, the Company was in compliance with the financial covenants associated with the Loan Agreement.

Under the Loan Agreement, the Company may select either the London Inter-Bank Offered Rate ("LIBOR") or the Inter-Bank Offered Rate ("IBOR") (each, a "Benchmark Rate") as the basis for calculating interest on the outstanding principal balance of the Line of Credit. Interest accrues at an annual rate equal to the Benchmark Rate plus a marginal rate. The Company may select different Benchmark Rates for different tranches of its borrowings under the Line of Credit. The marginal rate varies from 1.00% to 2.25% based on the ratio of the Company's funded debt ratio. LIBOR rates may be selected for one, two, three, or six month periods, and IBOR rates may be selected for no shorter than 14 days and no longer than six months. Accrued interest for the Line of Credit is due and payable monthly.

Under the Loan Agreement a quarterly fee on the unused portion of the Line of Credit, including the undrawn amount of the related standby letter of credit, varies from 0.15% to 0.30% based upon the Company's funded debt ratio. At June 30, 2011, the quarterly fee was 0.15%. An annual fee is payable in advance on the notional amount of each standby letter of credit issued and outstanding multiplied by an applicable rate ranging from 1.00% to 2.00%.

Trend

During the six months ended June 30, 2011, the Company has experienced an \$8.8 million improvement in working capital, due in large part to the proceeds on sale of FSB and the Company's generation of \$3.6 million in cash flows from operating activities adjusted for non-cash activities, partially offset by \$8.8 million in principal payments and \$3.7 million in capital expenditures. On May 2, 2011, the Company received cash proceeds and reimbursement of expenses from A-B totaling \$15.3 million, which it used to pay down all outstanding borrowings under its Line of Credit.

Critical Accounting Policies and Estimates

The Company's 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 2010 Annual Report, related to goodwill, other intangible assets and long lived assets, refundable deposits on kegs, equity investments, revenue recognition and income taxes. There have been no material changes to our critical accounting policies since December 31, 2010, except as discussed below.

Equity Method Investments. On May 2, 2011, the Company sold its interest in FSB in exchange for its share of the consideration specified in the Purchase Agreement. This was the Company's sole equity method investment as of December 31, 2010, and with the sale to A-B, the Company no longer holds an equity method investment after May 2, 2011. Therefore, it is unlikely that the Company will recognize any income associated with equity method investments for the remainder of fiscal year 2011.

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Recent Accounting Pronouncements

See Item 1, Notes to Financial Statements, Note 1 “– Recent Accounting Pronouncements” for discussion of recent changes to the FASB Accounting Standards Codification (“ASC”) and the impact of those changes on the Company’s financial statements.

ITEM 3. Quantitative and Qualitative Disclosures about Market Risk

The Company has assessed its vulnerability to certain market risks, including interest rate risk associated with financial instruments included in cash and cash equivalents and long-term debt. To mitigate this risk, the Company entered into a five-year interest rate swap agreement to hedge the variability of interest payments associated with its variable-rate borrowings. 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, Derivatives and Hedging.

This interest rate swap reduces the Company’s overall interest rate risk. However, due to the remaining outstanding borrowings that continue to have variable interest rates, management believes that interest rate risk to the Company could be material if prevailing interest rates increase materially.

ITEM 4. Controls and Procedures

Disclosure Controls and Procedures

The Company’s management, including the Chief Executive Officer and the Chief Financial Officer, carried out an evaluation of the effectiveness of the design and operation of the Company’s 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, the Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the quarterly 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 the Company under the Exchange Act is recorded, processed, summarized and reported within the time periods specified by the Securities and Exchange Commission’s rules and forms and that such information is accumulated and communicated to management, including the 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.

Changes in Internal Control Over Financial Reporting

During the second quarter of 2011, no changes in the Company’s 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, the Company’s internal control over financial reporting.

PART II. Other Information

ITEM 1. Legal Proceedings

The Company is involved from time to time in claims, proceedings and litigation arising in the normal course of business. The Company believes that, to the extent that it exists, any pending or threatened litigation involving the Company or its properties is not likely to have a material adverse effect on the Company’s financial condition or results of operations.

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ITEM 6. Exhibits

The following exhibits are filed as part of this report.

| | |
|---------------|--|
| <u>10.1</u> * | Form of Performance Award Agreement for the 2010 Stock Incentive Plan |
| <u>10.2</u> | Letter of Agreement between the Registrant and Andrew J. Thomas dated June 1, 2011 |
| <u>10.3</u> | Stock Appreciation Right Agreement between the Registrant and Andrew J. Thomas dated October 12, 2010 |
| <u>10.4</u> | Stock Appreciation Right Agreement between the Registrant and Andrew J. Thomas dated January 1, 2011 |
| <u>31.1</u> | Certification of Chief Executive Officer of Craft Brewers Alliance, Inc. pursuant to Exchange Act Rule 13a-14(a) |
| <u>31.2</u> | Certification of Chief Financial Officer of Craft Brewers Alliance, Inc. pursuant to Exchange Act Rule 13a-14(a) |
| <u>32.1</u> | Certification pursuant to Exchange Act Rule 13a-14(b) and 18 U.S.C. Section 1350 |
| <u>99.1</u> | Press Release dated August 15, 2011 |
| 101.INS** | XBRL Instance Document |
| 101.SCH** | XBRL Taxonomy Extension Schema Document |
| 101.CAL** | XBRL Taxonomy Extension Calculation Linkbase Document |
| 101.LAB** | XBRL Taxonomy Extension Label Linkbase Document |
| 101.PRE** | XBRL Taxonomy Extension Presentation Linkbase Document |

* Confidential treatment has been requested with respect to portions of this exhibit. A complete copy of the agreement, including the redacted terms, has been separately filed with the Securities and Exchange Commission

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

SIGNATURES

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 BREWERS ALLIANCE, INC.

August 15, 2011

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