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Toboggan Brewing company: Sliding to Success

Carly Armstrong wrote this case under the supervision of [Colin McDougall](https://iveypubs.my.salesforce.com/003A000001CqXBz) solely to provide material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The authors may have disguised certain names and other identifying information to protect confidentiality.

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It was almost midnight on January 5, 2017, when Mike Smith sat in the backroom of his brew pub, Toboggan Brewing Company (Toboggan), in London, Ontario. It had been a year since Smith had introduced his craft beer, Lunatic Fridge, into Liquor Control Board of Ontario (LCBO) and the Beer Store locations. The release of Lunatic Fridge had been an outstanding success, with product stocking out week to week due to high demand. Although Smith was pleased with the success of his company, he needed to address the fact that the 10-hectolitre (hl)[[1]](#footnote-1) brewing facility built in the basement of Toboggan had reached its maximum brewing capacity. Although he knew that building a new brewery would be the most obvious solution, he was unwilling to make that financial commitment; thus, he began to research less costly ways of producing more product.

In his research, Smith came across the option of contracting the business of producing the beer to other breweries. In Canada, the number of microbreweries had risen exponentially, with as many as 50 new breweries beginning operations in 2016.[[2]](#footnote-2) Many of the independent players were inexperienced and struggled to turn a profit and stay operational. In order to offset their own struggles with growing their brands, breweries would contract their excess capacity out to other players. Over the past few weeks, Smith had found a few viable options for contracting his product, but there were logistical constraints with all of them.

Overall, Smith wanted to grow Lunatic Fridge and capitalize on the rapidly expanding Ontario market for craft beer. Lunatic Fridge had already proven that it was a desired product in the market; however, the high markups and cost of production meant that a significant increase in production would be needed in order for the brand to become truly profitable; therefore, any contracting option he chose would need not only to keep Lunatic Fridge profitable but also to help to grow the brand.

Considering the problem at hand, Smith sat back in his chair, sipped a light lager, and got down to work comparing the contracting options.

THE CRAFT BEER MARKET

Traditionally, the beer market in Canada had been dominated by Anheuser-Busch InBev SA/NV and Molson Coors Brewing Company. Canadians were large consumers, drinking an average of 74.6 litres per capita in 2018. In Ontario, specifically, consumers drank 8.1 million hl in 2015.[[3]](#footnote-3) In recent years, the “big three” biggest breweries in Canada (i.e., Labatt Brewing Company Limited, Sleeman Breweries, and Molson Coors Brewing Company) had seen heightened competition from craft beer producers. Consumers began demanding more craft product—a segment of beer geared towards creating unique beer flavours and brands. Sales of craft brands reflected changing consumer preferences, with year-to-year growth of over 20 per cent, despite a decline in total beer sales of 0.4 per cent annually.[[4]](#footnote-4) In order to capitalize on this profitable trend, business owners had been rapidly opening up craft brewery establishments. In Ontario alone, the number of licensed breweries had grown from 70 in 2010 to over 200 in 2016.[[5]](#footnote-5)

Despite the rapid growth of craft beer drinkers, there were also many barriers to opening a brewery. The capital investment for brewing equipment and facilities was extremely high. Furthermore, the regulatory standards for alcohol were difficult and restrictive, with the entire landscape controlled by the LCBO and the Alcohol and Gaming Commission of Ontario.

The CRAFT BREWING PROCESS

Brewing beer involved a very high initial capital investment due to all the equipment required. At the very least, brewing beer commercially involved the purchase of a brewing tank, a fermentation tank, cleaning and testing supplies, and kegs to store the product in. A 10 hl system (the average for a microbrewery) could cost upwards of $750,000. Furthermore, every brewery required a brew master to take care of the production and operations of the brewery.

It took only a few hours to prepare ingredients and brew each batch of beer. However, once a batch was brewed, it would have to ferment for between two to five weeks. Then, the beer was either canned, bottled, or left in a keg for use in restaurants and other outlets. For craft beer, the average can—often referred to as a “tall boy”—was 473 millilitres.[[6]](#footnote-6) Once produced, craft beer would remain fresh for between two to three months.

ONTARIO RETAIL CHANNELS

The Liquor Control Board of Ontario

Acquiring a product listing with the LCBO was a difficult and time-consuming process. In order for a brewery to gain approval and get its product into LCBO stores, every product had to undergo a series of taste tests, chemical analyses, and marketing strategy evaluations. Also, there were strict labelling conditions that had to be met in order for product to be considered. Once a product was approved, a representative from the brewery, or a salesperson, had to approach each individual LCBO about listing product at that location. Due to limited shelf space, individual LCBO locations would often wait until they had delisted a poorly performing product before they would decide to let another one in. From there, the breweries were also responsible for distributing the product to all of the LCBO locations. While some would drop the product off themselves, it was industry standard to hire a distributor to make weekly store drop-offs.

For craft breweries, selling to the LCBO could be an expensive process. Because the distribution costs were so high, many producers could only afford to sell at LCBO locations in the general vicinity of their breweries. Despite this, selling through the LCBO was the most lucrative way to sell craft beer.

The Beer Store

The Beer Store was a 447-outlet retail chain selling beer in Ontario. The Beer Store was the only entity in Ontario licensed to sell 24- and 12-packs of beer. In 2014, the big three breweries were strongly criticized for their role in a scandal that saw them accused of monopolizing the Beer Store. Amid unrest from microbreweries in Ontario, the Beer Store was forced to accept more microbrewery options. In 2016, an ambitious plan was unveiled: 25 per cent of all shelf space in the Beer Store stores would have to be occupied by microbrewery beer. Furthermore, all microbreweries would be granted shelf space in seven stores before having to adhere to the listing fee of $2,440 per store. In contrast to the LCBO, the listing payment guaranteed shelving space for a product.

Although the Beer Store was a far more appealing retail outlet for craft beer from a regulatory standpoint, the in-store sales tended to be less lucrative. Most consumers who purchased beer from the Beer Store purchased in the bulk 12- or 24-packs due to cost savings. Craft beers were sold at a premium, usually by the can instead of in a pack. Craft brewers often complained that low sales in the Beer Store made it difficult to justify the cost of delivery. On average, the pace of sales was about 85 per cent lower in the Beer Store locations than the same craft beer product would experience in LCBO stores.

TOBOGGAN BREWING COMPANY

History

Smith had owned and operated businesses in London, Ontario, for over 30 years. Some of the popular establishments he had created were Joe Kool’s, Jim Bob Ray’s, the Runt Club, and Fellini Koolini’s. Smith was well known and liked in the London community and would often frequent peak hours at his establishments to socialize with the locals. For many years, Smith had toyed with the idea of opening a brew pub. He enjoyed the idea of challenging himself with the creation of a beer brand while also acting upon his core competency as a restaurateur. When Smith noticed the rapid expansion of the consumer market for craft beer over the past decade, he made his move.

Toboggan opened in 2015 to rave reviews. Smith hired the award-winning brew master Tom Schmidt, and together they carefully crafted a portfolio of products. Toboggan’s beer brands quickly grew in popularity around the London community. Schmidt would brew specialized, seasonal, and easy-drinking beers, making his products favourable to a wide variety of consumers.

In order to brew on the premises, Smith built a 10 hl microbrewery in the basement of the restaurant. Toboggan’s product was sold not only on tap but also through a retail store at the front of the restaurant, which operated seven days a week. The retail element was especially appealing to brew pub owners, as selling on the premises afforded brewers higher margins over selling the same product through the LCBO or the Beer Store. However, as demand increased for Toboggan beers, Smith knew he had to make a move beyond his retail store.

Lunatic Fridge

In early 2016, Smith approached the LCBO with several products in an attempt to get something listed. The LCBO chose which products could enter their stores, and they chose an India pale ale called Lunatic Fridge from Toboggan’s portfolio (see Exhibit 1). Smith began distributing Lunatic Fridge to LCBO locations around the London area, retailing his product for $3.00 a can (see Exhibit 2). Due to the variable costs associated with selling through the LCBO (see Exhibit 3), Smith quickly noticed the margins were very low. Selling a full case (24 cans) of Lunatic Fridge at the LCBO would return only about $6.00 of margin, or $0.25 per can. No matter where he produced his product, Smith would still have to sell to the LCBO at a cost of $1.20 per can. As such, Smith knew that, in order to make this a truly profitable venture, he would have to sell a high volume of product to make up for the low margins.

Sales Management

In December of 2016, Smith found the sales process to be too burdensome and thus hired local wines sales manager Rick Doyle to take care of the sales process. Doyle had a business called Direct Cellars Beverage Company (Direct Cellars), based out of London. Direct Cellars distributed a portfolio of products, and Doyle had already built a rapport with many of the LCBO managers around London, Stratford, Port Stanley, and Dorchester. Although Doyle was capable of getting Lunatic Fridge into stores further from London, Smith believed that the cost of transporting a small amount of product would eat away at the margin he was generating through LCBO sales. The distribution cost was accounted for as variable cost of production, but it represented an average of $0.10 per can distributed.

Lunatic Fridge had been very well received in the London region. The average total sales volume was consistently four cases per week in the London LCBO store locations—a considerably high sales volume for a craft beer. Beyond London, sales were slightly lower, at between two to three cases per week. In total, Lunatic Fridge was in 31 LCBO and four Beer Store locations.

Smith was sure that this high sales volume in London had to do with brand recognition, loyal friends throughout the London community, and the attachment to Toboggan’s name. However, the lower sales beyond London led him to worry about expanding to communities where Toboggan was less well known. Would it be worth his while to distribute to those stores if he was not receiving an adequate return?

EXPANSION OPTIONS

Toboggan was only able to produce 1,000 hl of beer annually. New orders were coming in every day, and it was clear that they would not be able to fill the demand with their current capacity. As Smith strategized potential partners for contract breweries, he knew that he had only enough funding and energy to work with one of the potential brewery alternatives.

Contract brewing involved partnering with a brewer that had excess capacity on hand. The brew master would hand over their recipe for the beer, which would be replicated at the contracted facility. Any skilled brew master could follow a recipe effectively, and so the quality of the output was not a concern.

Not only would Smith have to set up the brewing operation at his brewery of choice, but he would also have to decide how to distribute his product. Doyle would only be able to help with breweries located in the London region, as anything further would make his services too costly. Therefore, Smith also considered the distribution options available in each respective city. He was willing to find other distributors in each location; however, he wanted to ensure the distributors would be able to represent his brand effectively.

Contract Brewing in London—Springbank

Smith knew the owners of Springbank, and the two businesses had co-operated for many years. Both businesses had served each other’s product at their breweries in an attempt to support other local businesses. Smith had heard that Springbank had excess capacity, and he considered Springbank a viable option as a contracting partner.

Springbank was only 10 kilometres (km) away from Toboggan, making it easy for Smith to drop in to the brewery to keep an eye on operations. Although Springbank did not have much capacity available, they were willing to offer 400 hl to Toboggan at a cost of $0.90 per can.

Another benefit of producing beer with Springbank was that Toboggan could use the same distribution channels currently used with Direct Cellars. Doyle already distributed Springbank’s product, so he could continue to distribute Toboggan products from Springbank’s location for the same cost; hence, Toboggan would still net an average margin of $4.80 per case, or $0.20 per can.

Contract Brewing in Guelph—Dark & Stormy Drafts

Another option under consideration was contracting with Dark & Stormy Drafts (D&S) in Guelph, Ontario—about 120 km from London. D&S was a relatively new brew pub that employed many young, bright individuals who were new to the craft beer business. They had invested heavily in equipment—with a 50 hl system—and thus had a very large facility with a lot of excess capacity. Operationally, they had not turned a profit since their inception in 2014. D&S had struggled with the LCBO’s process, submitting and failing to meet the regulations required for listing product within its stores. After years of trials, D&S finally received a listing in December 2016 and were now in the process of setting up their own distribution channel.

The owner of D&S, Rob Little, was a new graduate of Queen’s University of Kingston, Ontario. Little believed that he could take care of distribution himself. When Smith approached D&S regarding a potential deal for contract brewing, D&S was excited and eager. In regards to price, D&S offered Smith an estimated cost per can of about $0.90 to both produce and distribute the product for Toboggan. They were willing to produce up to 5,000 hl. Smith was pleasantly surprised at the $0.90 cost per can, as it would allow for a far larger margin on a per-can basis than any of the other contractors. Lunatic Fridge had a very limited presence in the Guelph market, and Smith began to wonder if D&S and Lunatic Fridge could grow their brands together.

Guelph was a good option because the proximity to London would make it easy for him to occasionally check in on the brewery. However, he was deeply concerned by the staff’s experience—both operationally, in running and managing the brew pub, and as representatives of his product. Little was bright and outgoing, but he had never worked in a sales role, let alone dealt with the LCBO.

Contract Brewing in Toronto—The Hopping Horse

The Hopping Horse had been in the Toronto area for many years. In late 2014, business was thriving, so the owners built a new, state-of-the-art brewery in Etobicoke, just north of Toronto. They had planned for future demand and purchased enough equipment to have excess capacity for many years. In the interim, they were actively seeking new partners to contract brew for.

The Hopping Horse was currently contract brewing for several different breweries and had set up distribution in the Greater Toronto Area (GTA) for all of them. Partnering with the Hopping Horse would provide Toboggan with access to listings at LCBO and Beer Store locations throughout the GTA. The Hopping Horse was able to offer up to 6,000 hl of production annually but would start at an annual minimum of 1,000 hl. They only accepted already established brands that had seen relative success in their markets. Considering all associated costs, Toboggan would make a margin of only $0.08 per can, as Hopping Horse required approximately $1.12 per can to manufacture and distribute.

Smith liked the idea of being in Toronto but worried about doubling Toboggan’s total production in one year. The risk was that Toboggan would not have the same brand presence in Toronto as it had in London and would therefore not be able to keep up with the annual production minimum. In the LCBO, if a product was not selling, it was delisted from that store forever. Smith wondered if Lunatic Fridge had the ability to carry itself in the new market with such a rapid expansion. Furthermore, he was uncomfortable using a new distributor. He knew and trusted Rick Doyle and his team. Would the Hopping Horse distribution team be able to gain Toboggan entrance into enough of the stores to keep up with production?

Contract Brewing in Ottawa—Bytown Brewery

Ottawa intrigued Smith, as several visitors from the area had lobbied hard for him to make a move to this market. Ottawa had a rapidly expanding craft beer market, as the city had become a more interesting and attractive place for young adults to settle down. After some investigation, Smith had found Bytown Brewery (Bytown). Bytown’s contract brewing partner had recently dropped out, and Bytown was therefore willing to offer a good price in order to quickly regain the revenue. They would offer a production cost of $0.95 per can. However, Bytown would not offer any sort of distribution plan, meaning that Smith would have to travel to Ottawa to coordinate something with a local distributor. He was not concerned about finding a sales manager for Ottawa, but he was uncertain about the price he would have to pay for distribution. Smith knew that he was getting a good deal with Doyle but was uncertain about the industry standard.

A Bytown contract would have no minimum production volume requirement, making this option very viable. Smith liked the idea of being able to grow his product alongside demand in Ottawa, just as he had done in London.

DECISION

As Smith finished his drink, he thought about the consequences of not acting on this issue soon. He knew better than anyone did that consumer beer preferences could change quickly, and if Lunatic Fridge was not feeding customer demand, another beer would. As the early hours of morning approached, Smith set out to choose an alternative to proceed with by daylight.

Exhibit 1: Toboggan Brewing Company—Lunatic Fridge



Source: Company files.

Exhibit 2: Cost per can of comparable beers

|  |  |  |
| --- | --- | --- |
| **Brand** | **Type** | **Price (per 473 ml can)** |
| Corona Extra | Import | $2.75 |
| Lakeport Pilsener | Import | $2.05 |
| Beck’s | Import | $2.80 |
| Collingwood Kingpost Extra Special Bitter | Craft | $2.85 |
| Hop City Barking Squirrel | Craft | $3.00 |
| Toboggan Lunatic Fridge IPA | Craft | $3.00 |
| Moosehead Lager | Domestic | $2.55 |
| Molson Canadian | Domestic | $2.50 |
| Labatt Blue | Domestic | $2.05 |

Note: All dollar amounts are in CAD; ml = millilitres.

Source: Company files.

Exhibit 3: Breakdown of costs per can

|  |  |  |
| --- | --- | --- |
| **Cost Breakdown** | **Price per Component (CAD)** | **Purchasing Price** |
| Raw Material/Production Cost | $0.65 |  |
| Canning Cost | $0.20 |  |
| Distribution Cost | $0.10 |  |
| Markup to LCBO | $0.25 |  |
| **Selling Price To Lcbo** |  | $1.20 |
| LCBO Markup | $0.44 |  |
| Volume Levy | $0.25 |  |
| Environmental Tax | $0.10 |  |
| Tax (Ontario) | $0.40 |  |
| LCBO Cost of Service | $0.61 |  |
| **Retail Price** |  | $3.00 |

Note: LCBO = Liquor Control Board of Ontario.

Source: Company files.

1. A hectolitre (hl) was a metric unit of capacity equal to one hundred litres, used especially for wine, beer, grain, and agricultural produce. [↑](#footnote-ref-1)
2. Ontario Craft Brewers (website), 2018, accessed March 18, 2017, www.ontariocraftbrewers.com/. [↑](#footnote-ref-2)
3. “The Rise of Craft Beer in Canada: An Infographic,” *Financial Post*, September 16, 2015, accessed March 15, 2017, <http://business.financialpost.com/news/retail-marketing/the-rise-of-craft-beer-in-canada-an-infographic>. [↑](#footnote-ref-3)
4. “Industry Trends 2017,” Beer Canada, accessed July 12, 2019, https://industry.beercanada.com/statistics. [↑](#footnote-ref-4)
5. Ontario Craft Brewers, op. cit. [↑](#footnote-ref-5)
6. In production, 1 hl = 200 cans of beer. [↑](#footnote-ref-6)