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Redhook Ale Brewery (Abridged)

For almost 15 years, Paul Shipman, CEO of Redhook Ale Brewery, and his team had steadily developed their premium-quality handmade ales in Seattle, Washington. By August 1995, Shipman and his management team were prepared to enter uncharted territory and go public. A craft brewing operation had never before been taken public in the United States. Redhook embodied the ethos and grassroots beginnings of the microbrew movement, and Shipman was confident that widespread market demand for craft beer was set to explode. In the past year alone, Redhook had forged an alliance with Starbucks to co-brand a coffee-flavored brew, and another with Anheuser-Busch, which had purchased a capped 25% interest in Redhook in exchange for access to its national distribution networks and accounting systems. Shipman had overseen significant capacity increases and plans for another brewery in Portsmouth, New Hampshire. He had worked hard to position Redhook favorably for expansion, and a public offering would provide the necessary capital. Still, he wondered if the microbrew feel of Redhook would translate to the commercialization and growth pressures of the mainstream open market.

Revolutionary Beginning

Shipman remembered the beginning of the company he had helped to start after graduating from the Darden School of Business in 1980. Redhook was founded in 1981 in Seattle by Shipman and his friend Gordon Bowker, who, after founding and running Starbucks for 12 years, had wanted try his hand at producing beer. Their first investor was Bowker's acquaintance Jerry Jones, who contributed $30 million in exchange for a seat on the board of directors as vice president. Because Redhook was founded without its own brewery or even its own beer recipes, the founders immediately hired Charles McElevey, an award-winning Seattle brewmaster, to develop the first Redhook ales. And Shipman and Bowker were able to reach their $350,000 goal to purchase an old transmission shop in Seattle and some recycled brewing equipment that McElevey had located, imported from Germany, and painstakingly reconstructed. Many test batches and recipes later, the trio were happy with their first product, and they planned a grand opening on August 11, 1982, to be attended by Seattle's mayor and Washington State's governor.

Brewing Redhook beer involved adding fresh hops to freshly milled grain, fermenting it with proprietary yeast in a temperature-controlled vat, and employing a filtration process. The bottled beer was not exposed to the air until it was opened by the consumer, and it was hand-dated to promote consumption within 14 days. Redhook's attention to the highest-quality, traditional European brewing methods, and locally sourced

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ingredients helped it build a strong regional reputation and loyal consumer following. Shipman was highly involved in the entire process.[1]

Although Redhook's distinctive offering was the consistent, premium quality of its product, its primary focus was managing the relationship between its sales growth projections and increased capacity needs and balancing it with growing a strong brand presence. At first, Redhook sold directly to restaurants, pubs, and retailers in the Seattle area using mostly a word-of-mouth advertising strategy. It was truly a start-up story, complete with humble beginnings in a renovated old trolley shop and a quality-obsessed management team. Shipman even found a sculptor to design custom ceramic taps when Redhook began distributing kegs to local restaurants.

In addition to brewing, in 1985, Bowker and Shipman started a bottling line. They had some difficulty for many months as they attempted to establish a bottling process that captured the freshness and flavor to which Redhook's customers had grown accustomed. During this time, they lost their full-time brewmaster but also successfully increased the compensation packages of Redhook's 13 employees and warded off a looming union threat.

Through a series of calculated capacity expansions in the Northeast, Redhook had managed the sales-growth-versus-capital-investment tradeoff, with a capacity of 250,000 barrels within reach. Shipman knew that the capacity expansions represented yet another major identity shift, this time from a local Seattle brand to a nationally recognized one. Indeed, in 1994, an arrangement with Anheuser-Busch had resulted in Redhook issuing Series B preferred stock to Anheuser-Busch, giving it a 25% stake in the company.

The Craft-Beer Phenomenon

Beer trends

Craft beer had been around since humans began fermenting grains and grapes, but after prohibition, grassroots microbrewing had been limited to garage and basement operations. Until the mid-1980s, most U.S. beer consumption was of either first- or second-tier national brands or imports, which were imported primarily from Europe. Available retail beer offerings became increasingly homogeneous as the large U.S. brewers consolidated their businesses to achieve economies of scale. By some standards, this was achieved in part by reducing quality, including product pasteurization using stale ingredients, and by generally shortcutting the process of making beer. The first-tier brands by 1985 were Anheuser Busch (34.5% market share), Miller Brewing Company (20.2% market share), and Coors (7% market share); the second tier (28% market share) consisted of about 10 smaller competitors such as Stroh, Heileman, Pabst, and Genesee.[2]

From 1975 to 1995, U.S. beer consumption per capita varied only somewhat, rising from a range between 17 to 19 gallons per year to a peak in the early 1980s of around 24 gallons, and then declining slightly to settle in a range between 22 to 23 gallons per year. Industry volume had seen essentially zero growth since the early 1980s, and between 1984 and 1994, the U.S. beer industry shipped approximately 180 million barrels per year. The weak performances of the second-tier brands might have been due to their less competitive economies of scale and lower margins, which in a fixed or declining market would result in the decreased ability to sufficiently reinvest in capital equipment and the promotion of new brands. The second-tier brewers began to lose their

[1] Peter Krebs, *Redhook: Beer Pioneer* (New York: Four Walls Eight Windows, 1998), 2.
[2] "Redhook Analyst Report," Smith Barney, September 15, 1995.

relevancy during this 10-year span (13.4% market share in 1994), allowing the major players to consolidate their positions.

Since 1984, craft beer was primarily a regional phenomenon. Craft beers were typically higher in price than their mass-produced counterparts and closer in price to the super-premium mass-produced beverages and European imports. Because U.S. craft brewers were building their locally supported presence in the American beer market just as the mainstream industry stopped expanding, consumer substitution primarily affected the European imports. "While total domestic beer sales slumped 0.6% in 1994, craft brews grew by 44%. The industry should grow more than 50% this year…Industry watchers see the segment grabbing a 7% to 10% market share by 2000."[3]

Demographics

Craft-brew drinkers tended to be highly educated with high incomes; the largest income bracket of craft-beer consumers by far was the over-$75,000 tier. But over time, a broader cross-section of people discovered the product. A 1994 national survey of beer drinkers that focused on microbrew drinking habits indicated that the greatest concentration of exposure was in the 20- to 30-year-old range, with 36% of adults aged 25 to 34 years having tried a microbrew, compared to 27% of adults aged 35 to 44 years, and only 20% of adults over 45. Men were more likely than women to have tried a microbrew, and people of Caucasian descent were twice as likely to have tried a microbrew than individuals of African American descent. Geography also played a role. The most pronounced regional preference was in the West, with 32% of beer drinkers reporting that they had tried a microbrew, compared to 29% in the Northeast, 25% in the Midwest, and only 18% in the South. Interestingly, consumption and exposure data from New York, Los Angeles, and Chicago revealed low market penetration in each of these populous metropolitan areas.

Shipman knew that Redhook's success was similar in some ways to that of Starbucks: the craft-beer value proposition was not just about finely crafted beer, but also about selling the identity of a particular product. Drinking craft beer said something about the consumer such as: "I support local business," "I care about quality," and, ultimately, "I am unique too." This reality was echoed in the affinity scores earned by top-tier beer manufacturers in a 1995 study conducted by BBDO, a New York advertising agency. Budweiser's affinity score was 42%, Coors was 43%, and Miller was 66%.[4]

In contrast, craft beers invoked their microbrew roots to entice consumers to buy an emblem of authenticity, uniqueness, and local cache. Even their labels and packaging were often designed to invoke a localized, contrarian aesthetic intended to appeal to a younger, increasingly affluent generation of customers.

Craft beer, unpacked

The craft-brew segment included small regional specialty brewers producing from 15,000 barrels to 1°million barrels per year, and microbrews producing fewer than 15,000 barrels per year. Brewpubs or restaurants that produced and sold in-house brands of beer were sometimes considered part of this segment but were other times considered to be essentially a restaurant concept. These craft-brew, special-brew, and brewpub subsegments owned and operated their own equipment, which was capital intensive and involved close attention to building and maintaining production capacity relative to current and projected production needs, in addition to brand development and sales responsibilities. A fourth segment, the contract brewer,

[3] Eileen P. Gunn, "Microbrew Party on Wall Street," *Fortune*, December 11, 1995.

[4] Affinity scores were determined by showing photographs of a variety of people to a random sample of test subjects and asking them which beer each photographed individual was likely to drink. Then, test subjects were asked whether they related well to (or had affinity for) the person in the photograph. Patricia Sellers, "A Whole New Ballgame in Beer," *Fortune*, September 19, 1994.

outsourced brewing to other brewers but provided a recipe and brew specifications. The benefit of this model was that capacity utilization was theoretically always at 100%, and it was sometimes possible to take advantage of the contract brewers' economies of scale for sourcing ingredients.

The largest regional specialty brewer in terms of total taxable revenues was Sierra Nevada Brewing Co., followed by Anchor Brewing Co., and then Redhook. Hart Brewing Company, makers of Pyramid ales and Thomas Kemper lagers, was fourth (**Exhibit 1**). Hart had shipped 33,000 barrels of Pyramid ales and 7,000 barrels of Thomas Kemper lagers in 1993. But when it reached the limit of its current in-house brewing capacity, Hart's owners decided that contract brewing, outside investment dollars, or an alliance with a mass producer were not for them. In 1995, they were also not looking at an IPO as a desirable option. Hart's marketing was limited to direct consumer product sampling and feedback, and it stayed away from large campaigns. The owners believed that if their beer was nationally available, it would lose its claim to being special.[5]

Another craft-brew category was the contract-brewing company—the largest of which was the Boston Beer Company, makers of the Sam Adams brand. These contract-brewing companies had entirely different capital needs because their brewing was contracted out to a third party, usually a second-tier brewer looking to fill idle capacity. Contract brewers created a recipe and brewing specifications, outsourced the actual brewing and bottling, developed the brands, and managed sales and distribution. Contract-brew production rose from only 9,000 barrels in 1985 to more than 1 million in 1994, while regional specialty brew production rose from around 38,000 barrels to just over 730,000 during that same time, with an average CAGR of 61% and 34%, respectively. Brewpubs represented about 10% of the craft-beer business, growing from approximately 1,400 barrels in 1985 to 260,000 barrels in 1994, with a CAGR of 68%. Microbrews rose from around 25,000 barrels in 1985 to more than 450,000 in 1994, with a CAGR of 33%. Competition was intense and at times lively: Boston Beer President Jim Koch quipped that Redhook should really be called "Budhook." Shipman replied that Koch's contract-brewed Samuel Adams ought to be known as "Scam Adams."[6]

Between 1991 and 1994, both Boston Beer and Redhook grew rapidly, leading their respective subsegments in the growing craft-beer market. Boston Beer was well positioned in 1994, with nearly eight times the sales volume of Redhook, but with much higher advertising costs and lower margins. Boston Beer's marketing and advertising costs were almost 50% of sales, while Redhook's marketing costs were about 20% of sales. Redhook's operating margins had historically fluctuated between 20% and 25% in comparison with the 4% to 7% of Boston Beer. (**Exhibit 2** shows differences in operational spending between Boston Beer and Redhook.)

These comparisons highlight the key differences in business models between the two competitors, and more broadly, the difference between contract and in-house brewing and their implications for scaling up craft-brewing operations. Redhook's position was that contract sourcing violated the entire point of craft brewing and essentially represented consumer deception. In addition, Shipman was skeptical about the stability of the contract-brewer business model. He thought Redhook's approach offered a contrast to mircomarketers who depended on contract brewers. Because pricing stability, availability, and consistent quality of contract capacity relied largely on forces outside of Boston Beer's control, any failure on contractors' parts could translate into production disruption, if not a complete shutdown.[7]

Big beer, interrupted

In 1994, possibly due to flat category volume, demographic changes, and energetic growth in the craft-beer segment, first-tier beer manufacturers began to examine strategies designed to capture some of this emerging

[5] Kristine Portnoy Kelley, "A Strong Hart," *Beverage Industry*, July 1, 1995.
[6] Greg W. Prince, "Though He's Hooked Up with the Biggest One, Shipman Says He'll Still Brew Independently," *Beverage World*, June 30, 1995, 18.
[7] Prince, June 30, 1995.

specialty brew market. Some manufacturers purchased stakes in partnerships or formed them with existing craft-beer manufacturers. After Anheuser-Busch and Redhook disclosed their distribution deal, reports circulated that Miller and Seagram's were doing the same. Others developed a more varied, upscale product line intended to appeal to that same demographic. Some of these new products were intended to be perceived by less-educated buyers as unique and craft brew in nature, while others, such as the "ice" beers, were simply an attempt at novelty and variety (although ice beer held 6% of industry sales).[8]

In mid-1995, to say that the industry was changing would have been an understatement. Shipman wondered: Could the craft brew segment, in particular the regional specialty brewer as compared to the contract brewer, sustain its recent high growth? Would one model win out over the other as industry dynamics continued to surprise? There were other players to consider, too, now that Redhook would be going national. The first- and second-tier players had been caught off-guard by craft beer and were scrambling to claim their piece of the microbrew pie.

Pre-IPO Musings

Shipman knew he had significant growth projections to live up to after his company went public. He thought $17 per share was a fair offering price, and he hoped that Redhook would gain an advantage by being first to tap the craft-brew public-share market. He hoped the scarcity of his product would create even more demand.

Redhook was in great shape: its brewing technology was first-rate, and its equipment was mostly brand new and running well. Redhook's capital structure was strong, with high cash flow and manageable long-term debt. Shipman was aware that the combined experience of his management team built the public's trust and added to Redhook's successful image. The company's fresh, hops-forward brew was still premium, still had the date on each bottle, and still stayed sealed until opened by a consumer.[9]

Shipman understood that Redhook's future primarily depended on the acceptance of a premium product in geographic areas that previously had not been regularly exposed to craft beer as a higher-priced alcoholic beverage option. In fact, the behavioral demographics of craft-beer drinkers in general were still up for debate. Although Shipman had to sell his vision internally to his shareholders and his reliability to suppliers and distributors, he also had to sell his product to consumers; therefore much depended on whether he would be able to accomplish in New Hampshire and Tennessee what he had accomplished in the Pacific Northwest. How much growth potential existed in the craft-brewing industry segment?

In addition, Redhook needed to stay focused on its primary competitor, Boston Beer, which planned to go public soon—as might Pete's Wicked Ale, Hart, and any number of other craft-beer firms. Certainly, Boston Beer, because of its greater economies of scale, would continue to pose a threat to Redhook in the northeastern craft-brew market. Yet Shipman was confident that contract brewers such as Boston Beer and Pete's Wicked Ale could not match the quality or consistency of Redhook's products since those businesses had to grapple with the availability of the idle capacity they needed to keep their own utilization at 100%, forcing them to rely on second-tier brewers to do their manufacturing.

Of course, at the moment, the most pressing matter was the IPO. As Redhook prepared to go public, analysts would ask: What is the value of Redhook's equity? How would the first day of trading turn out? Was

[8] Sellers, 79.
[9] The flower of the hop plant was put into beer to provide bitterness, light aromas (flowery, fruity, or citrus), and longer shelf life.

the implied growth rate of Redhook sustainable? How would first-tier mass brewers react to Redhook's capitalization?

Exhibit 1

Roll Out the Barrels: Redhook Ale Brewery

Regional Specialty Brewers, 1993 and 1994

	1994	1993	% Change
Sierra Nevada Brewing Co	155,942	104,325	49.5%
Anchor Brewing Co.	102,462	92,000	11.4%
Redhook Ale Brewery	93,577	73,000	28.2%
Pyramid Ales/Hart Brewing Co. (includes Thomas Kemper Brewing Co.)	72,416	39,200	84.7%
Full Sail Brewing Co.	52,598	38,159	37.8%
Widmer Brewing Co.	50,000	40,520	23.4%
Portland Brewing Co.	36,994	16,606	122.8%
Stevens Point Brewing Co.	31,000	N/A	N/A
Straub Brewery	27,000	N/A	N/A
Rockies Brewing Co.	26,180	17,900	46.3%

Data source: "Redhook Analyst Report," Smith Barney, September 15, 1995.

Exhibit 2

Roll Out the Barrels: Redhook Ale Brewery

Financial Summary for Redhook and Boston Beer, 1991–94

	Redhook				Boston Beer			
	1991	1992	1993	1994	1991	1992	1993	1994
Percentage margin analysis								
Net sales	100%	100%	100%	100%	100%	100%	100%	100%
COGS	57.4	55.3	53.7	58.2	44.3	45.7	46	46
Gross profit	42.6	44.7	46.3	41.8	55.7	54.3	54	54
SG&A	21.5	19.9	17.4	18.8	48.7	50.6	47.7	46.2
Operating income	21.1	24.8	28.9	23.1	7	3.7	6.3	7.7
Other income	-2.1	-2.4	-1	-0.8	0.1	-0.3	0	0.2
Pretax income	19	22.4	27.9	22.2	7.1	3.4	6.3	7.9
Net income	12.5	15.6	18.3	14.2	4.2	2	3.7	4.6
Per-barrel analysis								
Net sales	$170.50	$164.02	$156.03	$159.50	$169.29	$163.87	$162.42	$160.83
COGS	$97.91	$90.65	$83.74	$92.80	$74.94	$74.93	$74.70	$74.02
Gross profit	$72.59	$73.37	$72.30	$66.70	$94.36	$88.95	$87.73	$86.81
SG&A	$36.65	$32.62	$27.18	$29.93	$82.48	$82.93	$77.46	$74.36
Operating income	$35.94	$40.75	$45.12	$36.77	$11.87	$6.02	$10.27	$12.45
Other income	($3.50)	($3.98)	($1.60)	($1.30)	$0.13	($0.42)	$0.00	$0.28
Pretax income	$32.44	$36.77	$43.52	$35.48	$12.01	$5.60	$10.26	$12.72
Net income	$21.29	$25.56	$28.59	$22.70	$7.07	$3.24	$6.01	$7.45

	Redhook				Boston Beer			
	1991	1992	1993	1994	1991	1992	1993	1994
Financial returns								
EBIDTA to total capital	NA	28.10%	21.40%	13.50%	NA	19.40%	16.80%	72.60%
Net income to common equity	26.70%	25.40%	31.50%	167.40%	20.70%	14.80%	32.20%	80.60%

Data source: "Redhook Analyst Report," Smith Barney, September 15, 1995.