Brewing up some March Madness $BREW

I generally try not to write updates on ideas (except for Charter (CHTR; disclosure: long); there you get an update basically every quarter!), but I figured an update on my March 2017 post on Craft Brew Alliance (BREW; disclosure: long) was topical because 1) it's March Madness, and they'll be airing some nationwide Kona ads, 2) there was a recent short thesis on VIC, and 3) someone on twitter asked nicely.

The original thesis on BREW was pretty simple (and this post is going to rely heavily on the background from that post; so I'd encourage you to read that first). Kona was growing quickly, and that growth plus the company's most recent partnership deal with AB created strong incentives for BREW and AB to reach a merger agreement (in fact, their distribution agreement laid out the terms of a potential offer). Even if an offer didn't come, as Kona continued to grow and the company stablized their other brands, Craft Brew would likely prove to be undervalued as a standalone company.

Let's fast forward to today. The Kona piece of the thesis has proven relatively accurate- Kona depletions grew ~10% in 2017 & 2018, and shipments grew ~15%+. The rest of the thesis has proven a bit spottier: the non-Kona brands (Widmer and Redhook) have not shown any signs of stabilization, and despite the new AB contract and the increase in Kona shipments, BREW hasn't shown any real signs of operating leverage: EBITDA remains stubbornly in the same $15m/year range it's been at since 2014 and barely covers annual capex (the company's averaged ~$15m/year for the past three years).

That's a relatively high level overview, but it does a decent job of bringing us up to today. At today's share price, BREW has an EV of ~$350m and trades for ~20x LTM EBITDA (and an insane free cash flow multiple given EBITDA and capex basically match up. Note that BREW's EBITDA / revenue includes ~$3.4m of revenue recognition of the AB fee that had already been paid(see p. 62); normally I'd say that should be adjusted out be AB is still making annual payments so I think that's a wash).

BREW Cap Structure

Diluted Shares	19.38	LTM Rev	$ 206.19
Current Price	$ 15.50	LTM Adj. EBITDA	$ 17.56
Market Cap	$ 300		
			LTM
Total Cash	$ 1	EV / Rev	1.7x
		EV / EBITDA	19.7x
Total Debt	$ 46		
EV	$ 346		

Still, despite the ostensibly high multiple, I think BREW remains interesting today. As I'll explain in this article, while I think the odds of AB buying out BREW have come down over the past two years, I think BREW's standalone value has likely improved.

Let's start with the obvious: a trailing look at the financials fails to capture four important things about BREW.

1. BREW made three acquisitions in Q4'2018. In total, they spent ~$38m on these acquisitions in Q4 (the actual value was likely a bit higher as BREW owned a piece of the one of the brewers and one of the agreements included an incentive payout based on growing shipments; see p. 52). All of those acquisitions closed in Q4, so when you look at BREW's trailing financials you're getting basically zero value for these three acquisitions which, at cost, make up ~10% of BREW's EV.
2. If AB doesn't make an offer to buy BREW this year, they will owe BREW a $20m international distribution payment.

That payment is pure profit to BREW and is >5% of their EV; it seems silly to exclude that from BREW's EV given it's coming this year.

    - Spreaking of that international payment, AB is making it because they plan on ramping up Kona international sales. Kona does

3. BREW is making a significant investment into their brands, particularly Kona. For example (and as mentioned above), they're doing a national ad buy for Kona during March Madness. National ad buys are expensive. This type of brand marketing immediately impacts BREW's income statement, but it's probably better though of as a capitalized asset (if you get someone to try your beer, there's a chance they like it and become a habitual drinker / brand loyal, etc.).
4. Capex should come down significantly post 2019. Take this one with a grain or three of salt; I've been saying capex should come down since 2017, and management has been hinting at that too and we haven't seen any results so far. Still, management suggests their big growth projects are ending in 2019, and I see no reason why this business should take >$15m/year in capex to support when AB plants are handling a significant amount of production. Management previously guided maintenance capex of ~$3m/year; I'm not sure I believe that number but <$10m/year seems easily reasonable. Combined with "growth" from some of the estimates above, and it's not hard to see this businesses spitting off a decent bit of free cash flow.

The point I'm trying to drive home is that valuing BREW on a trailing basis probably isn't the right way to look at the company; there are a lot of things that should result in future growth that are getting full credit in Brew's financials. I think once you adjust for all of those points, Brew's valuation today looks, at a minimum, undemanding. For example, if we give them credit for $15m in AB payments in

August ($20m less ~$5m in taxes) and the net cost of their acquisitions, their implied EV would drop to a shade under $300m. If we assume they grow by 5% in 2019 while expanding EBITDA margins to 10%, the company would be trading at ~13.5x forward EBITDA (and, with capex about to fall off, a reasonable free cash flow multiple).

BREW Adj. Cap Structure					
Diluted Shares		19.38	LTM Rev	$	206.19
Current Price	$	15.50	LTM Adj. EBITDA	$	17.56
Market Ca	$	300	EBITDA Margin		8.5%
Current Cash	$	1	Forward Growth		5%
Value of Acquisitions	$	38	Forward EBITDA Margin		10.0%
AB Payment, Net of Tax	$	15			
Total Adj. Cash	$	54	Forward Rev	$	216.50
			Forward EBITDA	$	21.65
Total Debt	$	46			
				Forward Value	
EV	$	293	EV / Rev		1.4x
			EV / EBITDA		13.5x

Maybe saying the valuation looks "undemanding" isn't exactly a vote of confidence. But, at its core, an investment in BREW has always been about Kona, and I think if you can buy BREW at an undemanding current valuation while retaining the call option upside from Kona continuing to perform well, than an investment in Kona is interesting. And all signs point to Kona continuing to do well. Depletions and shipments were strong in 2018, and 2019 appears to be off to a good start (they mentioned strong momentum for Kona in Q1 during their Q4'18 call, and their guide implies good momentum as well). The brand should continue to do well domestically, driven by the national ad buys and continued deepening of the AB partnership, and the international opportunity remains relatively untapped (Kona was up 20% internationally in 2018, though off what seems to be a small base)... AB didn't agree to write a $20m check later this year for Kona's international rights out of the goodness of their hears; they did it because they see huge opportunity for Kona worldwide.

I've pulled the quote below from BREW's Q4'18 call; I think it's a moonshot for Kona to become the "Hawaiian Corona" but I put it here to emphasize that at an "undemanding" valuation you get any continued growth / operating leverage / moonshot potential for Kona for (effectively) free.

<A - Andrew J. Thomas>: Yes. That's a great question, [ph] Steve (01:09:36). I think, if you take a look at it – I think what we've learned is not all brands have the same life cycle. So if I were going to look at a brand like Kona, I would basically look at a reference brand like you just mentioned in Corona. And so if you look at, where was the Corona brand after 25 years relative to its growth trajectory and where is the Kona brand, I think you'll find some validity for what I'm about to say, because, I think we're in early innings. The reason I say that is, I think if you've got a brand that's rooted in a locale that has less universal appeal that has products that are more polarizing and might not have universal appeal. You will see an acceleration in the life cycle, we're living that with Redhook, right. A brand that was all about the Northwest, it was early on, its flagship was ESB, all of those things had a life cycle, but they were probably more finite. If I adjust the position that with Kona, we're blessed with the fact that the Kona brand is rooted here where many of us are today in Hawaii, which has universal appeal. The concept of kind of that liquid sunshine that Liquid Aloha we call it, kind of in the bottle is something that is resonant with a lot of consumers and as such, we think the brand has a longer trajectory, a longer arc of growth, than a lot of other brands will, because, it's rooted in something that has a pretty long arc in terms of a lifecycle.

Secondly, if you take a look at the brands, as Ken said, Longboard Island Lager and Big Wave Golden Ale being the flagships, they're both really accessible, relatively easy drinking brands that deliver on that kind of promise. So the liquids in the bottle, I would say from a functional standpoint, have a longer arc and a trajectory as a life cycle, coupled with a brand that we think has a longer arc. So if I were going to tell you what innings we're, I would say we're in early innings. I don't know if we're in the third inning or the fourth inning, but we're probably in the – somewhere around there. And I think there's a lot of run room for us in – I would say, take a look out of the Corona playbook, I remind people when I joined the beer industry back in – I hesitate to say in 1995, the Heineken brand was bigger than Corona. That was a long time ago, I get it. But if you think about what Corona has done in the decade since then, and how it's distanced itself is something that I think is relevant when we take a look at the life cycle question on the Kona brand.

So I think the standalone case for BREW has probably slightly improved over the past two years, mainly driven by continued performance of Kona. Slightly offseting the standalone upside, I think the buyout case has probably gotten slightly worse.

The case for a buyout happening is still rather simple. There would be decent synergies if AB bought all of BREW; they could cut out a ton of overhead + public company costs (I would guess synergies run $10-15m/year, a not insignificant amount for a ~$300m EV company!), and tighter integration of Kona would probably allow AB to push the brand a bit harder and keep all of the upside from doing so for themselves. And if AB doesn't buyout BREW, then they'll need to pay BREW $20m for their international rights plus run the risk someone else could buy BREW and possibly leveraging their AB contract in ways AB might not 100% be comfortable with. Here's what BREW's

CEO said about the possibility of a buyout on BREW's Q4 call.

> Before I wrap up, a few words about our biggest known, unknown, that will they or won't they question with respect to ABI and the qualified offer deadline. Let me begin by unequivocally stating that our relationship with ABI continues to be healthy, productive and mutually beneficial. When I hosted a call with many of you 2.5 years ago to share details of our new enhanced agreements with ABI, I characterized the relationship between ABI and CBA as collaborative independence. And I believe that still holds today, from our work together in bringing the Kona brand and the rest of our strengthening and outstanding portfolio to retailers through the shared ABI wholesaler network.
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> So the cross-brewing benefits for us in Fort Collins and for ABI in Portsmouth and Portland, so the work and planning for more global expansion most concretely evidenced by the recent actions towards local production in Brazil. And with that healthy well-functioning relationship as a backdrop, I'll remind our shareholders of our protection in the absence of a qualified offer from ABI. If ABI has not made a qualifying offer for CBA then CBA would be entitled to $20 million international incentive payment after the 2019 deadline and ABI could not force the termination of any of these new agreements.
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> Further, again, if ABI has not made a qualifying offer, CBA could continue to operate independently or could then undergo a change in control and ABI would still be required to respect the terms of all agreements, including payment of the $20 million international incentive, continuation of the master distribution agreement at $0.25 a case, continuation of the international distribution agreement and fulfillment of the contract brewing agreement.
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> So, as explicitly as I have ever said it before, I believe the future is bright for CBA, regardless of whether that future leads to a qualified offer from ABI or if that future leads to continued collaborative independents. In either case, our shareholders can look forward to the security of the existing ABI agreements, an accelerated top line, a healthier portfolio anchored by Kona that 25-year young brand with lots of room to run and emerging stronger Plus portfolio of flanking brands and continued progress in the financial performance and financial health of the company.

So why do I think the odds of a buyout have gone down? Mostly it has to do with BREW's most recent acquisitions. If AB is going to buy BREW, it's for Kona. By buying all of those smaller brands in Q4'18, BREW is diluting their exposure to Kona and thus their value to AB- AB doesn't care about those brands and probably wouldn't give BREW full credit for them; in fact, AB might be forced to divest all non-Kona brands as part of a merger condition if they did attempt a merger, so adding more small brands to BREW's portfolio really only adds to the potential regulatory headache in a merger.

Of course, it's possible I'm reading too much into those acquisitions, or that BREW is buying some standalone brands because they're prepping to sell Kona to AB and wanted to have enough brands to spin off into a standalone company as part of a Kona deal. But I can't help but look at those deals and think they're the work of a company looking to remain a standalone company, not a company prepping for a sale to a large strategic buyer.

Just to wrap this follow up up: ~two years ago I wrote BREW up. Since then, Kona has continued to perform well, but I think the odds of an acquisition have come down a bit. With the stock up a bit since the last write up and the odds of an acquisition seemingly haven dropped, I think BREW is interesting today but a lot less so than a few years ago. Sorry for the wishy-washy post / conclusion, but I got the idea of an update in my mind and figured it was interesting to go through.

Enjoy March Madness (preferably with a Kona).