

## Boston Beer Company, Inc.

NYSE:SAM

**Analyst:** Lionel Krupka

**Sector:** Consumer Disc.

**SELL**

Price Target: \$110

### Key Statistics as of 04/29/2016

|                |                     |
|----------------|---------------------|
| Market Price:  | \$156.08            |
| Industry:      | Alcoholic Beverages |
| Market Cap:    | \$1,982.7 M         |
| 52-Week Range: | \$151.85-266.62     |
| Beta:          | 0.80                |

### Thesis Points:

- Shift in customers interests
- Tremendous increase in competition
- Past focus on volume growth has led to inefficiency

### Company Description:

The Boston Beer Company Incorporation is a brewer that was founded in Boston in 1984 by Jim Koch and Rhonda Kallman. From its modest beginnings, the company has grown into one of the biggest players in the alcoholic beverage industry in the United States today. Its first product was a beer labelled as Samuel Adams Boston Lager, which was named after one of the founding fathers and introduced over Patriot's day. This first product is considered to be the pioneer in the craft beer industry. In 1995, the company went public on the New York Stock Exchange. Nowadays, it sells more than sixty beers under the Samuel or Sam Adams brands, forty beers under the Alchemy & Science tradenames, twelve flavored malt beverages under the Twisted Tea brand and ten hard cider beverages under the Angry Orchard.



## Thesis

Boston Beer Company has brought higher standards to the beer industry for the last 32 years. Between 2010 and 2015, the firm hired more than 650 people. It proved its ability to improve its market shares and revenues thanks to a strategy based on volume growth. However, this strategy has led management to put aside the necessary improvements in efficiency that operations have needed to stay at the same level than the competition. In addition, to the inefficiency of its operations, the company is evolving in a very competitive environment that it has never experienced before. Customers appeal for craft beer products is also shifting towards more local and “authentic” brands. In order to understand all the challenges that the company is facing, it is important to first understand the industry in which it evolved.

## Industry Outlook

According to the Brewer Association and the University of Colorado Boulder, the beer market represented a \$105.9 billion market in 2015, which includes the \$22.3 billion market for craft beer. Craft beer segment reached a level of 24,076,864 barrels last year. In 2014, the craft beer industry accounted for an estimated \$55.7 billion to the U.S economy and for more than 424,000 jobs.

In terms of sales volume growth, the overall beer market increased by 0.2%, at 196,701,792 barrels, last year. Craft beers, Boston Beers’ main market, increased by 12.8% (24,076,864 barrels), while import beers growth was at 6.2% (31,245,124 barrels), and export craft beers grew at 16.3% (446,151 barrels).

There are five different segments in the craft beer market: microbreweries, brewpubs, contract brewing companies, regional craft breweries and large breweries. Microbreweries, breweries that produce less than 15,000 barrels per year, accounted for 16.0% of the U.S production. Brewpubs are defined as restaurant-brewery that sell at least 25% of their production on-site, and represented 5.2% of American craft beer production. Regional craft breweries, defined by an annual production between 15,000 and 6,000,000 barrels, and large breweries accounted for 77.8%. Boston Beer fall in that last segment.

## U.S. Brewery Count

|                             | 2012         | 2013         | 2014         | 2015         |
|-----------------------------|--------------|--------------|--------------|--------------|
| <b>CRAFT</b>                | <b>2,401</b> | <b>2,863</b> | <b>3,676</b> | <b>4,225</b> |
| Regional Craft Breweries    | 97           | 119          | 135          | 178          |
| Microbreweries              | 1,149        | 1,464        | 2,041        | 2,397        |
| Brewpubs                    | 1,155        | 1,280        | 1,500        | 1,650        |
| <b>LARGE NON-CRAFT</b>      | <b>23</b>    | <b>23</b>    | <b>26</b>    | <b>30</b>    |
| <b>OTHER NON-CRAFT</b>      | <b>32</b>    | <b>31</b>    | <b>20</b>    | <b>14</b>    |
| <b>Total U.S. Breweries</b> | <b>2,456</b> | <b>2,917</b> | <b>3,722</b> | <b>4,269</b> |

In the recent years, the craft beers market have seen an exponential growth in the number of competitors. The number of breweries moves from 2,456 breweries in 2012 to 4,269 in 2015 (+73%), and James Koch himself said that “there could be as many as 10,000 craft breweries in the U.S”.

Since Boston Beer is one of the biggest producer of craft beers, these numbers should be a positive signal as they indicate a growing interest of customers for that line of products. However, the situation is getting a little bit more complicated than that for the Boston based company. In the last earnings call, James Koch, himself, admitted that “Samuel Adams has lost share due to the increased competition and continued growth of drinker interest in variety and innovation.”

## Shift in customers’ behaviors

As Boston Beer was the pioneer of craft beers in the U.S, it gained a lot of loyalty from customers who enjoyed that type of products in the past. However, it seems that there is a strong demand for variety and innovation in the market right now, as Koch stated it. As it has been observed in some other markets, such as retail food industry with organic food, there is a trend for customers to look for more “better for you” products. Therefore, the perception of Samuel Adams brand does not correspond to the current demand for more authentic and local beers. Microbreweries and brewpubs opening growth, respectively 108% and 43% over the last three years, is the fulfillment of this demand for new brands with different values.

Nonetheless, Boston Beer is an experienced company that has been the face of the craft beer industry for the last 32 years. It has been able to sustain its sales growth thanks to its innovations. For instance, in 2012, it

launched nationwide a hard cider beverage called Angry Orchard. After two mitigated years, sales grew impressively, and Angry Orchard captured more than 50% of the cider category. However, sales in the cider category have also decreased, especially because of the hard soda rising. Boston Beer was not able to address the changes in both the cider and craft beer markets despite the launch of a new line of products called Nitro and IPA beers.



## Financials

Sales growth, which fell from 16.7% to 3.3% over the last twelve months was mainly driven by depletions, the rate at which shipments goes from a distributor to end users, in volume, down by 5% year to year. This trend is not going to reverse soon, as inventory level of distributors are considered to be at appropriate level, and the company forecasts depletions between -4.0% to 2.0% for 2016. Boston Beer reported a net income of \$7 million in the last quarter. Down by 6.7 million year to year, net income declined by 48.9%. This declined was mainly driven by a decrease in revenue, margin and an increase in selling, general and administrative expenses.

Revenue was announced at \$188.8 million for the first quarter, decreasing by 5.0% from the same period last

|             | EBITA Margin |       | COR/Revenue |       |
|-------------|--------------|-------|-------------|-------|
|             | Historic     | LFY   | Historic    | LFY   |
| sam         | 16.3%        | 15.3% | 47.7%       | 48.0% |
| Competitors | 30.6%        | 30.7% | 43.4%       | 41.9% |

year. Historically and in the last fiscal year, EBITA margin is also lower than for the industry, and cost of goods sold to revenue ratio is higher than for the industry. Indeed, the company has focused on increasing volume without taking care of its efficiency. Gross margin was down by 1.5% (from 50% to 48.5%) year to year because processing costs increased, and forecasted gross margin range for 2016 was reviewed to 51%-53% from 52%-54%. The company is also looking at increase in advertising up to \$10 million after being originally forecasted at \$20 million. Even if

management guaranteed that they are focusing on adjusting cost and increase efficiency, it seems very complicated for them to increase short term earnings at the same time. With a free cash flow down by 58.0% year to year, and after buying back \$75.7 million of shares in the first quarter, the company does not have a great margin of error. Management is not particularly enthusiast about acquisitions, whereas competitors have been acquiring regional brands. Furthermore, Boston Beer forecasted way higher growth for the first quarter, and it put in place 24 hours shift patterns and extra shift on certain lines, hired new employees (both in sales and production force) and planned important investments for each brands. Cancelling or mitigating all of these initiatives will come to a cost.

Finally, ROIC to WACC ratio of the firm is higher than the industry. A correction towards industry level has started, and the process is most likely to exceed the end of the year.

|            | ROC /WACC |      |
|------------|-----------|------|
|            | Historic  | LFY  |
| sam        | 3.19      | 2.10 |
| Competitor | 1.09      | 1.05 |

## Porter's Five Forces

### Barriers to Entry: LOW

As mentioned before, the competition has increased exponentially over the last years. It is cheap to open a brewery, and there is a low switching cost for customers.

### Bargaining power of suppliers: HIGH

The company is buying its raw materials from a small number of suppliers. For Samuel lagers, the firm has to use "Noble hops", which grow only in specific areas such as Hallertau-Hallertauer, Tettngang-Tettnganger, Hersbruck-Hersbrucker and Spalt-Spalter in Germany and Saaz-Saazer in the Czech Republic.

### Bargaining power of customers: HIGH

Customers have a very high bargaining power because switching costs for consumers are really low and they have more choices than in the past.

### Threat of substitutes: LOW

There are many other options available for customers to choose from: other craft beers, regular beers, wines, liquors.

### Existing rivalry: HIGH

Existing rivalry is high because there are many other regional brands on the market.

## Conclusion

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While there are no doubts that Boston Beers has the experience and expertise to handle changes in the craft beer market in the long-term, I do not believe that management will be able to turn the company around within one year. New brands did not offset the erosion in the craft and cider markets and led to higher spending. Boston Beer has to deal with cost adjustments, lower volume expectations, lack of efficiency and new customers' behaviors. Therefore, I expect the stock price to drop at \$110 within one year, for a gain of 29.0%.

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**The Boston Beer Company, Inc. (SAM)**

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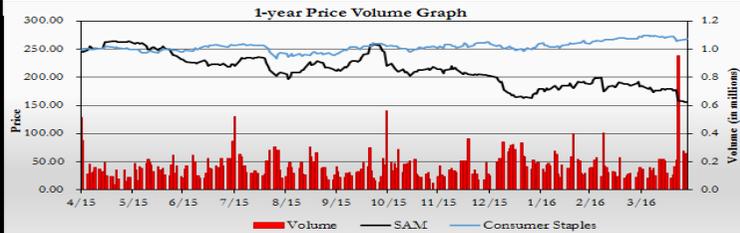
**BEARISH**

Analysis by Lionel Krupka  
4/30/2016

Current Price: **\$156.08**  
Divident Yield: **0.2%**

Intrinsic Value: **\$97.27**  
Target Price: **\$110.43**

Target 1 year Return: **-29.02%**  
Price Increase's probability: **0.8%**

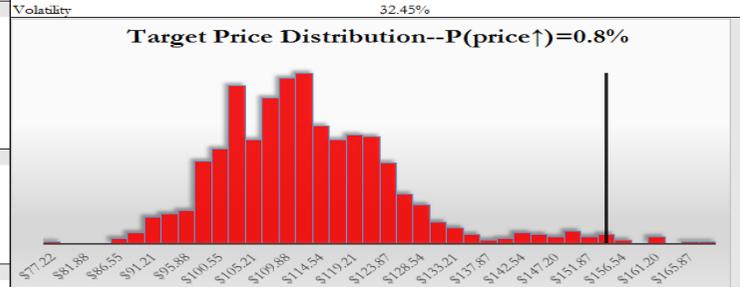


|  |                  |
|--|------------------|
| <b>Description</b>   |                  |
| The Boston Beer Company, Inc. produces and sells alcohol beverages primarily in the United States. |                  |
| <b>General Information</b>   |                  |
| Sector   | Consumer Staples |
| Industry   | Beverages        |
| Last Guidance  | November 3, 2015 |
| Next earnings date   | July 19, 2016    |
| Estimated Country Risk Premium   | 6.00%            |
| Effective Tax rate   | 40%              |
| Effective Operating Tax rate   | 40%              |

|                                       |            |
|---------------------------------------|------------|
| <b>Market Data</b>                    |            |
| Market Capitalization                 | \$1,978.77 |
| Daily volume (mil)                    | 0.12       |
| Shares outstanding (mil)              | 12.68      |
| Diluted shares outstanding (mil)      | 13.38      |
| % shares held by institutions         | 78%        |
| % shares held by investments Managers | 57%        |
| % shares held by hedge funds          | 9%         |
| % shares held by insiders             | 27.99%     |
| Short interest                        | 13.87%     |
| Days to cover short interest          | 10.01      |
| 52 week high                          | \$266.62   |
| 52-week low                           | \$151.85   |
| Levered Beta                          | 0.80       |
| Volatility                            | 32.45%     |

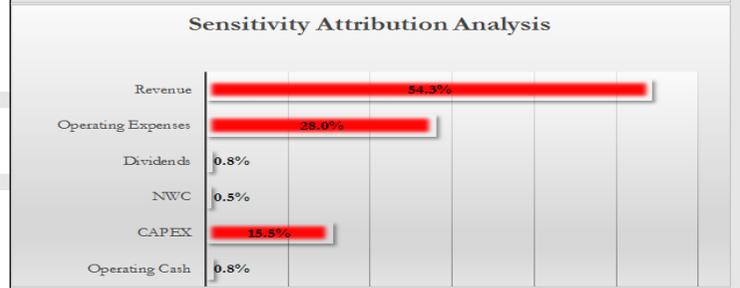
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| <b>Past Earning Surprises</b> |         |
| Quarter ending                | Revenue |
| 3/28/2015                     | -5.49%  |
| 6/27/2015                     | -7.28%  |
| 9/26/2015                     | 0.07%   |
| 12/26/2015                    | -6.46%  |
| 3/26/2016                     | -9.65%  |
| Mean                          | -5.76%  |
| Standard error                | 1.6%    |

|                |         |
|----------------|---------|
| <b>EBITDA</b>  |         |
| 3/28/2015      | 23.85%  |
| 6/27/2015      | 7.48%   |
| 9/26/2015      | 6.21%   |
| 12/26/2015     | 7.36%   |
| 3/26/2016      | -22.70% |
| Mean           | 4.44%   |
| Standard error | 7.5%    |



|                   |                              |
|-------------------|------------------------------|
| <b>Management</b> |                              |
| Koch, C.          | Founder and Chairman of the  |
| Roper, Martin     | Chief Executive Officer, Pre |
| Geist, John       | Chief Sales Officer          |
| Smalla, Frank     | Chief Financial Officer      |
| Murphy, Matthew   | Chief Accounting Officer     |
| Wade, Kathleen    | Vice President of Legal and  |

|                              |  |
|------------------------------|--|
| <b>Peers</b>                 |  |
| Molson Coors Brewing Company |  |
| Brown-Forman Corporation     |  |
| Constellation Brands Inc.    |  |
| Craft Brew Alliance, Inc.    |  |



|                             |       |
|-----------------------------|-------|
| <b>Profitability</b>        |       |
| SAM (LTM)                   | 14.5% |
| ROIC                        | 10%   |
| NOPAT Margin                | 1.47  |
| Revenue/Invested Capital    | 14.4% |
| ROE                         | 10%   |
| Adjusted net margin         | 1.46  |
| Revenue/Adjusted Book Value |       |

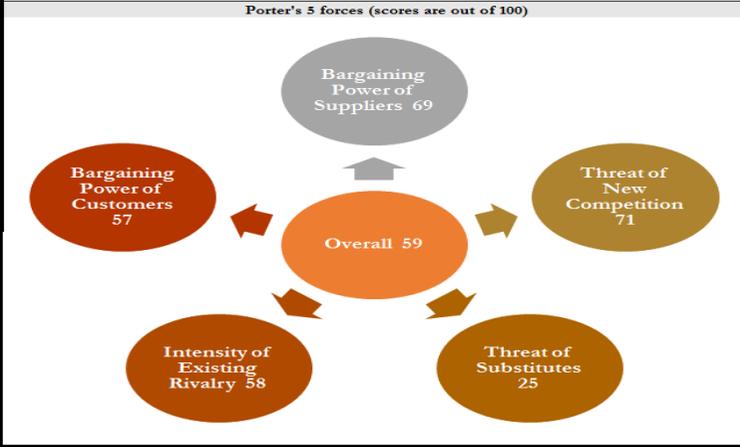
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|-----------------------------------|--|
| <b>Total compensations growth</b> |  |
| -2.09% per annum over 5y          |  |
| -4.11% per annum over 5y          |  |
| 2.67% per annum over 5y           |  |
| N/M                               |  |
| N/M                               |  |
| N/M                               |  |

|  |        |
|--|--------|
| <b>Invested Funds</b>                  |        |
| SAM (LTM)                              | 8.1%   |
| Total Cash/Total Capital               | 8.1%   |
| Estimated Operating Cash/Total Capital | 4.7%   |
| Non-cash working Capital/Total Capital | 100.0% |
| Invested Capital/Total Capital         |        |

|                                     |  |
|-------------------------------------|--|
| <b>Total return to shareholders</b> |  |
| 4.02% per annum over 5y             |  |
| 4.02% per annum over 5y             |  |
| 4.02% per annum over 5y             |  |
| N/M                                 |  |
| N/M                                 |  |
| N/M                                 |  |

|                                 |       |
|---------------------------------|-------|
| <b>Capital Structure</b>        |       |
| SAM (LTM)                       | 0.00  |
| Total Debt/Common Equity (LTM)  | 2.90% |
| Cost of Existing Debt           | 2.02% |
| Estimated Cost of new Borrowing | AA    |
| CGFS Risk Rating                | 0.80  |
| Unlevered Beta (LTM)            | 8.93% |
| WACC                            |       |

|                  |      |
|------------------|------|
| <b>Valuation</b> |      |
| NOPAT margin     | 3.3% |
| ROIC/WACC        | 9.9% |
|                  | 3.2% |
|                  | 3.1% |
|                  | 3.0% |
|                  | 2.9% |
|                  | 2.8% |
|                  | 2.7% |
|                  | 2.6% |
|                  | 2.5% |
|                  | 2.4% |
|                  | 2.2% |
|                  | 2.1% |
|                  |      |



|                         |          |
|-------------------------|----------|
| <b>Invested Capital</b> |          |
| Base Year               | \$264.59 |
| 3/26/2017               | \$319.81 |
| 3/26/2018               | \$433.14 |
| 3/26/2019               | \$607.06 |
| 3/26/2020               | \$647.51 |
| 3/26/2021               | \$634.06 |
| 3/26/2022               | \$691.60 |
| 3/26/2023               | \$711.60 |
| 3/26/2024               | \$731.18 |
| 3/26/2025               | \$750.27 |
| 3/26/2026               | \$768.84 |
| Continuing Period       |          |

|                   |             |
|-------------------|-------------|
| <b>Net Claims</b> |             |
| Base Year         | \$160.04    |
| 3/26/2017         | \$89.87     |
| 3/26/2018         | -\$23.68    |
| 3/26/2019         | -\$138.22   |
| 3/26/2020         | -\$410.26   |
| 3/26/2021         | -\$526.33   |
| 3/26/2022         | -\$643.20   |
| 3/26/2023         | -\$760.78   |
| 3/26/2024         | -\$878.98   |
| 3/26/2025         | -\$997.75   |
| 3/26/2026         | -\$1,117.01 |
| Continuing Period |             |

|                        |          |
|------------------------|----------|
| <b>Price per share</b> |          |
| Base Year              | \$96.85  |
| 3/26/2017              | \$109.30 |
| 3/26/2018              | \$122.38 |
| 3/26/2019              | \$135.46 |
| 3/26/2020              | \$160.22 |
| 3/26/2021              | \$173.21 |
| 3/26/2022              | \$186.12 |
| 3/26/2023              | \$198.92 |
| 3/26/2024              | \$211.59 |
| 3/26/2025              | \$224.09 |
| 3/26/2026              | \$236.38 |
| Continuing Period      |          |