CRAFT BREW ALLIANCE, INC.
Form 10-Q
November 04, 2015

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 September 30, 2015
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 BREW 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

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 "large 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 October 27, 2015 was 19,171,887.

CRAFT BREW ALLIANCE, INC.
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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

CRAFT BREW ALLIANCE, INC.
CONSOLIDATED BALANCE SHEETS
(Unaudited)
(Dollars in thousands, except per share amounts)

	September 30, 2015	December 31, 2014
Assets		
Current assets:		
Cash and cash equivalents	$1,816	$981
Accounts receivable, net	18,719	11,741
Inventory, net	18,276	18,971
Deferred income tax asset, net	1,802	1,670
Other current assets	3,831	4,413
Total current assets	44,444	37,776
Property, equipment and leasehold improvements, net	112,964	110,350
Goodwill	12,917	12,917
Intangible and other assets, net	16,914	17,558
Total assets	$187,239	$178,601
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	$17,420	$12,987
Accrued salaries, wages and payroll taxes	5,775	5,114
Refundable deposits	7,934	8,152
Other accrued expenses	2,008	2,316
Current portion of long-term debt and capital lease obligations	503	1,157
Total current liabilities	33,640	29,726
Long-term debt and capital lease obligations, net of current portion	16,242	13,720
Fair value of derivative financial instruments	641	503
Deferred income tax liability, net	18,865	18,570
Other liabilities	717	665
Total liabilities	70,105	63,184
Commitments and contingencies		
Common shareholders' equity:		
Common stock, $0.005 par value. Authorized 50,000,000 shares; issued and outstanding 19,171,887 and 19,115,396	96	96
Additional paid-in capital	139,234	138,391
Accumulated other comprehensive loss	(397)	(312)
Accumulated deficit	(21,799)	(22,758)
Total common shareholders' equity	117,134	115,417
Total liabilities and common shareholders' equity	$187,239	$178,601

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

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CRAFT BREW ALLIANCE, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)
(In thousands, except per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Sales	$58,460	$55,871	$165,717	$163,616
Less excise taxes	3,771	3,798	10,788	11,031
Net sales	54,689	52,073	154,929	152,585
Cost of sales	37,830	37,428	108,218	107,526
Gross profit	16,859	14,645	46,711	45,059
Selling, general and administrative expenses	15,497	13,554	44,713	40,824
Operating income	1,362	1,091	1,998	4,235
Interest expense	(148)	(111)	(419)	(317)
Other income (expense), net	7	(54)	20	(51)
Income before income taxes	1,221	926	1,599	3,867
Income tax expense	489	361	640	1,508
Net income	$732	$565	$959	$2,359
Basic and diluted net income per share	$0.04	$0.03	$0.05	$0.12
Shares used in basic per share calculations	19,171	19,052	19,144	19,019
Shares used in diluted per share calculations	19,180	19,103	19,171	19,086

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

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CRAFT BREW ALLIANCE, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited)
(In thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Net income	$732	$565	$959	$2,359
Unrealized gain (loss) on derivative hedge transactions, net of tax	(117)	19	(85)	(210)
Comprehensive income	$615	$584	$874	$2,149

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

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CRAFT BREW ALLIANCE, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(In thousands)

	Nine Months Ended September 30,	
	2015	2014
Cash flows from operating activities:		
Net income	$959	$2,359
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	7,221	6,432
Loss on sale or disposal of Property, equipment and leasehold improvements	318	74
Deferred income taxes	217	316
Stock-based compensation	880	805
Excess tax benefit from employee stock plans	(50)	(191)
Other	(227)	(327)
Changes in operating assets and liabilities:		
Accounts receivable, net	(6,978)	301
Inventories	1,375	(2,287)
Other current assets	581	106
Accounts payable and other accrued expenses	2,893	861
Accrued salaries, wages and payroll taxes	661	1,061
Refundable deposits	452	1,188
Net cash provided by operating activities	8,302	10,698
Cash flows from investing activities:		
Expenditures for Property, equipment and leasehold improvements	(9,772)	(12,936)
Proceeds from sale of Property, equipment and leasehold improvements	410	236
Net cash used in investing activities	(9,362)	(12,700)
Cash flows from financing activities:		
Principal payments on debt and capital lease obligations	(968)	(458)
Proceeds from capital lease financing	—	841
Net borrowings under revolving line of credit	2,900	—
Proceeds from issuances of common stock	64	321
Tax payments related to performance shares issued	(151)	(150)
Excess tax benefit from employee stock plans	50	191
Net cash provided by financing activities	1,895	745
Increase (decrease) in Cash and cash equivalents	835	(1,257)
Cash and cash equivalents:		
Beginning of period	981	2,726
End of period	$1,816	$1,469
Supplemental disclosure of cash flow information:		
Cash paid for interest	$482	$401
Cash paid for income taxes, net	58	889
Supplemental disclosure of non-cash information:		
Purchases of Property, equipment and leasehold improvements included in Accounts payable at end of period	$1,917	$331

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

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CRAFT BREW ALLIANCE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 1. Basis of Presentation

The accompanying consolidated financial statements and related notes should be read in conjunction with the consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2014 (“2014 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 ("U.S. GAAP") 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 our consolidated financial position, results of operations and cash flows 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.

Note 2. Recent Accounting Pronouncements

ASU 2015-15
In August 2015, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update (“ASU”) 2015-15, “Interest - Imputation of Interest (Subtopic 835-30).” ASU 2015-15 provides guidance as to the presentation and subsequent measurement of debt issuance costs associated with line of credit arrangements. We do not expect the adoption of ASU 2015-15 to have a material effect on our financial position, results of operations or cash flows.

ASU 2015-14
In August 2015, the FASB issued ASU No. 2015-14, Revenue From Contracts With Customers (Topic 606)." The amendments in this ASU defer the effective date of ASU 2014-09. Public business entities should apply the guidance in ASU 2014-09 to annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. Earlier application is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period. We are still evaluating the effect of the adoption of ASU 2014-09.

ASU 2015-11
In July 2015, the FASB issued ASU No. 2015-11, "Simplifying the Measurement of Inventory (Topic 330)." ASU 2015-11 simplifies the accounting for the valuation of all inventory not accounted for using the last-in, first-out ("LIFO") method by prescribing that inventory be valued at the lower of cost and net realizable value. ASU 2015-11 is effective for financial statements issued for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016 on a prospective basis. We do not expect the adoption of ASU 2015-11 to have a material effect on our financial position, results of operations or cash flows.

ASU 2015-05
In April 2015, the FASB issued ASU 2015-05, "Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40)." ASU 2015-05 provides guidance regarding the accounting for a customer's fees paid in a cloud computing arrangement; specifically about whether a cloud computing arrangement includes a software license, and if so, how to account for the software license. ASU 2015-05 is effective for public companies' annual periods, including interim periods within those fiscal years, beginning after December 15, 2015 on either a prospective or retrospective basis. Early adoption is permitted. We do not expect the adoption of ASU 2015-05 to have a material effect on our financial position, results of operations or cash flows.

ASU 2015-03

In April 2015, the FASB issued ASU No. 2015-03, "Interest - Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs." The amendments in this ASU require that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. The recognition and measurement guidance for debt issuance costs are not affected by the amendments in this ASU. The amendments are effective for financial statements issued for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. The amendments are to be applied on a retrospective basis, wherein the balance sheet of each individual period presented is adjusted to reflect the period-specific effects of applying the new guidance. We do not expect the adoption of ASU 2015-03 to have a material effect on our financial position, results of operations or cash flows.

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ASU 2015-02
In February 2015, the FASB issued ASU No. 2015-02, "Consolidation (Topic 810): Amendments to the Consolidation Analysis," which is intended to improve targeted areas of consolidation guidance for legal entities such as limited partnerships, limited liability corporations, and securitization structures (collateralized debt obligations, collateralized loan obligations, and mortgage-backed security transactions). The ASU focuses on the consolidation evaluation for reporting organizations that are required to evaluate whether they should consolidate certain legal entities. In addition to reducing the number of consolidation models from four to two, the new standard simplifies the FASB Accounting Standards Codification and improves current U.S. GAAP by placing more emphasis on risk of loss when determining a controlling financial interest, reducing the frequency of the application of related-party guidance when determining a controlling financial interest in a variable interest entity ("VIE"), and changing consolidation conclusions for companies in several industries that typically make use of limited partnerships or VIEs. The ASU will be effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. Early adoption is permitted, including adoption in an interim period. We do not expect the adoption of ASU 2015-02 to have a material effect on our financial position, results of operations or cash flows.

Note 3. Cash and Cash Equivalents

We maintain cash balances with financial institutions that may exceed federally insured limits. We consider all highly liquid investments with an original maturity of three months or less to be cash equivalents. As of September 30, 2015 and December 31, 2014, we did not have any cash equivalents.

Under our cash management system, we utilize a controlled disbursement account to fund cash distribution checks presented for payment by the holder. Checks issued but not yet presented to banks may result in overdraft balances for accounting purposes. As of September 30, 2015 and December 31, 2014, there were no bank overdrafts. Changes in bank overdrafts from period to period are reported in the Consolidated Statements of Cash Flows as a component of operating activities within Accounts payable and Other accrued expenses.

Note 4. Inventories

Inventories, except for pub food, beverages and supplies, are stated at the lower of standard cost or market. Pub food, beverages and supplies are stated at the lower of cost or market.

We regularly review our inventories for the presence of obsolete product attributed to age, seasonality and quality. If our review indicates a reduction in utility below the product's carrying value, we reduce the product to a new cost basis. We record the cost of inventory for which we estimate we have more than a twelve-month supply as a component of Intangible and other assets, net on our Consolidated Balance Sheets.

Inventories consisted of the following (in thousands):

	September 30, 2015	December 31, 2014
Raw materials	$4,742	$4,414
Work in process	3,147	2,781
Finished goods	7,430	8,986
Packaging materials	893	627
Promotional merchandise	1,413	1,531
Pub food, beverages and supplies	651	632
	$18,276	$18,971

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

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Note 5. Related Party Transactions

Transactions with Anheuser-Busch, LLC (“A-B”)
Transactions with A-B consisted of the following (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Gross sales to A-B	$47,943	$45,905	$135,890	$136,155
Margin fee paid to A-B, classified as a reduction of Sales	693	670	1,978	2,031
Inventory management and other fees paid to A-B, classified in Cost of sales	102	116	294	296

Amounts due to or from A-B were as follows (in thousands):

	September 30, 2015	December 31, 2014
Amounts due from A-B related to beer sales pursuant to the A-B distributor agreement	$12,960	$7,846
Refundable deposits due to A-B	(2,429)	(2,629)
Amounts due to A-B for services rendered	(2,073)	(1,821)
Net amount due from A-B	$8,458	$3,396

Operating Leases
We lease our headquarters office space, restaurant and storage facilities located in Portland, Oregon, as well as the land and certain equipment, from two limited liability companies, both of whose members include our current Board Chair and a nonexecutive officer. Lease payments to these lessors were as follows (in thousands):

Three Months Ended September 30,		Nine Months Ended September 30,	
2015	2014	2015	2014
$30	$31	$90	$95

We hold lease and sublease obligations for certain office space and the land underlying the brewery and pub location in Kailua-Kona, Hawaii, with a company whose owners include a shareholder who owns more than 5% of our common stock. The sublease contracts expire on various dates through 2020, with an extension at our option for two five-year periods. Lease payments to this lessor were as follows (in thousands):

Three Months Ended September 30,		Nine Months Ended September 30,	
2015	2014	2015	2014
$131	$120	$392	$351

Note 6. Derivative Financial Instruments

Interest Rate Swap Contract
Our 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.

We have assessed our vulnerability to certain business and financial risks, including interest rate risk associated with our variable-rate long-term debt. To mitigate this risk, effective January 23, 2014, we entered into an interest rate swap contract with Bank of America, N.A. (“BofA”) for 75% of the Term Loan balance, to hedge the variability of interest payments associated with our variable-rate borrowings under our Term Loan with BofA. The current swap contract terminates on September 29, 2023, and had

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a total notional value of $7.6 million as of September 30, 2015. Through this swap agreement, we pay interest at a fixed rate of 2.86% and receive interest at a floating-rate of the one-month LIBOR, which was 0.20% at September 30, 2015. 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. As of September 30, 2015, unrealized net losses of $641,000 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 we record Interest expense associated with the Term Loan. There was no hedge ineffectiveness during the first three quarters of 2015 or 2014.

The fair value of our derivative instrument is as follows (in thousands):

Fair Value of Derivative Instrument

	September 30, 2015	December 31, 2014
Fair value of interest rate swap	$(641)	$(503)

The effect of our interest rate swap contract that was accounted for as a derivative instrument on our Consolidated Statements of Operations for the three- and nine-month periods ended September 30, 2015 and 2014 was as follows (in thousands):

Derivatives in Cash Flow Hedging Relationships	Amount of Gain (Loss) Recognized in Accumulated OCI (Effective Portion)	Location of Loss Reclassified from Accumulated OCI into Income (Effective Portion)	Amount of Loss Reclassified from Accumulated OCI into Income (Effective Portion)
Three Months Ended September 30,			
2015	$(188)	Interest expense	$52
2014	$30	Interest expense	$55
Nine Months Ended September 30,			
2015	$(137)	Interest expense	$156
2014	$(340)	Interest expense	$151

See also Note 7.

Note 7. Fair Value Measurements

Factors used in determining the fair value of our financial assets and liabilities are summarized into three broad categories:

- Level 1 – quoted prices in active markets for identical securities as of the reporting date;
- Level 2 – other significant directly or indirectly observable inputs, including quoted prices for similar securities, interest rates, prepayment speeds and credit risk; and
- Level 3 – significant inputs that are generally less observable than objective sources, including our own assumptions in determining fair value.

The factors or methodology used for valuing securities are not necessarily an indication of the risk associated with investing in those securities.

The following tables summarize liabilities measured at fair value on a recurring basis (in thousands):

Fair Value at September 30, 2015	Level 1	Level 2	Level 3	Total
Interest rate swap	$—	$(641)	$—	$(641)

Fair Value at December 31, 2014	Level 1	Level 2	Level 3	Total
Interest rate swap	$—	$(503)	$—	$(503)

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We did not have any assets measured at fair value on a recurring basis at September 30, 2015 or December 31, 2014.

The fair value of our interest rate swap was based on quarterly statements from the issuing bank. There were no changes to our valuation techniques during the third quarter of 2015.

We believe the carrying amounts of Cash, Accounts receivable, Other current assets, Accounts payable, Accrued salaries, wages and payroll taxes, and Other accrued expenses are a reasonable approximation of the fair value of those financial instruments because of the nature of the underlying transactions and the short-term maturities involved.

We had fixed-rate debt outstanding as follows (in thousands):

	September 30, 2015	December 31, 2014
Fixed-rate debt on balance sheet	$705	$1,456
Estimated fair value of fixed-rate debt	$740	$1,513

We calculate the estimated fair value of our fixed-rate debt using a discounted cash flow methodology. Using estimated current interest rates based on a similar risk profile and duration (Level 2), the fixed cash flows are discounted and summed to compute the fair value of the debt.

Note 8. Segment Results and Concentrations

Our chief operating decision maker monitors Net sales and gross margins of our Beer Related operations and our Pubs operations. Beer Related operations include the brewing operations and related beer sales of our Widmer Brothers, Redhook, Kona and Omission beer brands, as well as our Square Mile cider brand. Pubs operations primarily include our pubs, some of which are located adjacent to our Beer Related operations. We do not track operating results beyond the gross margin level or our assets on a segment level.

Net sales, Gross profit and gross margin information by segment was as follows (dollars in thousands):

	Three Months Ended September 30,		
2015	Beer Related	Pubs	Total
Net sales	$46,940	$7,749	$54,689
Gross profit	$15,633	$1,226	$16,859
Gross margin	33.3 %	15.8 %	30.8 %
2014			
Net sales	$44,663	$7,410	$52,073
Gross profit	$13,447	$1,198	$14,645
Gross margin	30.1 %	16.2 %	28.1 %

	Nine Months Ended September 30,		
2015	Beer Related	Pubs	Total
Net sales	$133,727	$21,202	$154,929
Gross profit	$43,914	$2,797	$46,711
Gross margin	32.8 %	13.2 %	30.1 %

2014			
Net sales	$132,520	$20,065	$152,585
Gross profit	$42,153	$2,906	$45,059
Gross margin	31.8 %	14.5 %	29.5 %

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The segments use many of the same assets. For internal reporting purposes, we do not allocate assets by segment and, therefore, no asset by segment information is provided to our chief operating decision maker.

In preparing this financial information, certain expenses were allocated between the segments based on management estimates, while others were based on specific factors such as headcount. These factors can have a significant impact on the amount of Gross profit for each segment. While we believe we have applied a reasonable methodology, assignment of other reasonable cost allocations to each segment could result in materially different segment Gross profit.

Sales to wholesalers through the A-B Distributor Agreement represented the following percentage of our Sales:

Three Months Ended September 30,		Nine Months Ended September 30,	
2015	2014	2015	2014
80.8 %	81.0 %	80.8 %	82.0 %

Receivables from A-B represented the following percentage of our Accounts receivable balance:

September 30,	December 31,
2015	2014
69.2 %	66.8 %

Note 9. Significant Stock-Based Plan Activity and Stock-Based Compensation

Stock-Based Compensation Expense

Stock-based compensation expense was recognized in our Consolidated Statements of Operations as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Selling, general and administrative expense	$254	$320	$810	$720
Cost of sales	21	41	70	85
Total stock-based compensation expense	$275	$361	$880	$805

At September 30, 2015, we had total unrecognized stock-based compensation expense of $2.2 million, which will be recognized over the weighted average remaining vesting period of 3.0 years.

Note 10. Earnings Per Share

The following table reconciles shares used for basic and diluted earnings per share ("EPS") and provides other information (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Weighted average common shares used for basic EPS	19,171	19,052	19,144	19,019
Dilutive effect of stock-based awards	9	51	27	67
Shares used for diluted EPS	19,180	19,103	19,171	19,086

Stock-based awards not included in diluted per share calculations as they would be antidilutive (in thousands)	275	144	223	79

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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 we believe are reasonable, but are by their nature inherently uncertain. Many possible events or factors could affect our 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 our Annual Report on Form 10-K for the year ended December 31, 2014 (“2014 Annual Report”), and those described from time to time in our future reports filed with the Securities and Exchange Commission (the “SEC”). 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 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 our 2014 Annual Report. The discussion and analysis includes period-to-period comparisons of our financial results. Although period-to-period comparisons may be helpful in understanding our financial results, we believe that they should not be relied upon as an accurate indicator of future performance.

Overview

Craft Brew Alliance is a leading craft brewing company that brews, brands and markets some of the world’s most respected and best-loved American craft beers.

We are home to three of the earliest pioneers in craft beer: Redhook Ale Brewery, Washington’s largest craft brewery, founded in 1981; Widmer Brothers Brewing, Oregon’s largest craft brewery, founded in 1984; and Kona Brewing Company, Hawaii’s oldest and largest craft brewery, founded in 1994. As part of Craft Brew Alliance, these craft brewing legends have expanded their reach across the U.S. and more than 15 international markets.

In addition to growing and nurturing distinctive brands rooted in local heritage, Craft Brew Alliance is committed to developing innovative new category leaders, such as Omission Beer, which is the #1 beer in the gluten-free beer segment, and Square Mile Cider, a tribute to the early American settlers who purchased the first plots of land in the Pacific Northwest.

Publicly traded on NASDAQ under the ticker symbol BREW, Craft Brew Alliance is headquartered in Portland, Oregon and operates five breweries and five pub restaurants across the U.S.

We proudly brew our craft beers in four company-owned breweries located in Portland, Oregon; the Seattle suburb of Woodinville, Washington; Portsmouth, New Hampshire; and Kailua-Kona, Hawaii; and one brewery in Memphis, Tennessee owned by our brewing partner. Additionally, we own and operate two small innovation breweries, primarily used for small batch production and innovative brews, in Portland, Oregon and Portsmouth, New Hampshire.

We distribute our beers to retailers through independent wholesalers that are aligned with the Anheuser-Busch, LLC (“A-B”) network. These sales are made pursuant to a Master Distributor Agreement (the “A-B Distributor Agreement”) with A-B. As a result of this distribution arrangement, we believe that, under alcohol beverage laws in a majority of states, these wholesalers would own the exclusive right to distribute our beers in their respective markets if the A-B Distributor Agreement expires or is terminated. Kona, Redhook and Widmer Brothers beers are distributed in all 50 states. Omission Beer continues to expand into new markets in the U.S. and internationally, while Square Mile Cider is currently available in 12 states in the West. Separate from our A-B wholesalers, we maintain an internal independent sales and marketing organization with resources across the key functions of brand management, field marketing, field sales, and national retail sales.

We operate in two segments: Beer Related operations and Pubs operations. Beer Related operations include the brewing, and domestic and international sales, of craft beers and ciders from our breweries. Pubs operations primarily include our five pubs, four of which are located adjacent to our Beer Related operations, as well as other merchandise sales, and sales of our beers directly to customers.

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Following is a summary of our financial results:

Nine Months Ended September 30,	Net sales	Net income	Number of Barrels Sold
2015	$154.9 million	$1.0 million	626,600
2014	$152.6 million	$2.4 million	632,400

Results of Operations

The following table sets forth, for the periods indicated, certain information from our Consolidated Statements of Operations expressed as a percentage of Net sales[(1)]:

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2015		2014		2015		2014	
Sales	106.9	%	107.3	%	107.0	%	107.2	%
Less excise taxes	(6.9	)	(7.3	)	(7.0	)	(7.2	)
Net sales	100.00		100.0		100.00		100.0	
Cost of sales	69.2		71.9		69.9		70.5	
Gross profit	30.8		28.1		30.1		29.5	
Selling, general and administrative expenses	28.3		26.0		28.9		26.8	
Operating income	2.5		2.1		1.3		2.8	
Interest expense	(0.3	)	(0.2	)	(0.3	)	(0.2	)
Other income (expense), net	0.0		(0.1	)	0.0		0.0	
Income before income taxes	2.2		1.8		1.0		2.5	
Income tax expense	0.9		0.7		0.4		1.0	
Net income	1.3	%	1.1	%	0.6	%	1.5	%

(1) Percentages may not add due to rounding.

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Segment Information

Net sales, Gross profit and gross margin information by segment was as follows (dollars in thousands):

	Three Months Ended September 30,		
2015	Beer Related	Pubs	Total
Net sales	$46,940	$7,749	$54,689
Gross profit	$15,633	$1,226	$16,859
Gross margin	33.3 %	15.8 %	30.8 %
2014			
Net sales	$44,663	$7,410	$52,073
Gross profit	$13,447	$1,198	$14,645
Gross margin	30.1 %	16.2 %	28.1 %

	Nine Months Ended September 30,		
2015	Beer Related	Pubs	Total
Net sales	$133,727	$21,202	$154,929
Gross profit	$43,914	$2,797	$46,711
Gross margin	32.8 %	13.2 %	30.1 %
2014			
Net sales	$132,520	$20,065	$152,585
Gross profit	$42,153	$2,906	$45,059
Gross margin	31.8 %	14.5 %	29.5 %

Sales by Category

The following table sets forth a comparison of sales by category (dollars in thousands):

	Three Months Ended September 30,		Dollar	
Sales by Category	2015	2014	Change	% Change
A-B and A-B related	$47,250	$45,235	$2,015	4.5 %
Contract brewing and beer related[1]	3,461	3,226	235	