

CRAFT BREWERS ALLIANCE, INC.

Form 10-Q

November 13, 2009

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**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, 2009  
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 BREWERS 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  Smaller Reporting Company   
○ (Do not check if a 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 November 5, 2009 was 17,074,063.



**CRAFT BREWERS ALLIANCE, INC.**  
**FORM 10-Q**  
**For the Quarterly Period Ended September 30, 2009**  
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**Table of Contents****PART I.****ITEM 1. Financial Statements****CRAFT BREWERS ALLIANCE, INC.  
BALANCE SHEETS**

	(Unaudited) <b>September 30, 2009</b>	<b>December 31, 2008</b>
	(Dollars in thousands except per share amounts)	
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 723	\$ 11
Accounts receivable, net of allowance for doubtful accounts of \$100 and \$64 at September 30, 2009 and December 31, 2008, respectively	9,937	12,499
Inventories, net	10,203	9,729
Income tax receivable	62	724
Deferred income tax asset, net	931	767
Other current assets	3,808	3,951
Total current assets	25,664	27,681
Property, equipment and leasehold improvements, net	98,891	101,389
Equity investments	5,513	5,189
Intangible and other assets, net	13,187	13,546
Total assets	\$ 143,255	\$ 147,805

**LIABILITIES AND COMMON STOCKHOLDERS EQUITY**

Current liabilities:		
Accounts payable	\$ 12,532	\$ 15,000
Accrued salaries, wages, severance and payroll taxes	3,994	3,630
Refundable deposits	6,575	6,191
Other accrued expenses	1,248	2,393
Current portion of long-term debt and capital lease obligations	1,460	1,394
Total current liabilities	25,809	28,608
Long-term debt and capital lease obligations, net of current portion	28,182	31,834
Fair value of derivative financial instruments	949	1,252
Deferred income tax liability, net	7,529	6,552
Other liabilities	340	278

Common Stockholders Equity:

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Common stock, par value \$0.005 per share, 50,000,000 shares authorized; 17,074,063 shares at September 30, 2009 and 16,948,063 at December 31, 2008 issued and outstanding	85	85
Additional paid-in capital	122,680	122,433
Accumulated other comprehensive loss	(533)	(693)
Retained deficit	(41,786)	(42,544)
Total common stockholders' equity	80,446	79,281
Total liabilities and common stockholders' equity	\$ 143,255	\$ 147,805

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

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**CRAFT BREWERS ALLIANCE, INC.**  
**STATEMENTS OF OPERATIONS**  
(Unaudited)

	<b>Three Months Ended</b>		<b>Nine Months Ended September</b>	
	<b>September 30,</b>		<b>30,</b>	
	<b>2009</b>	<b>2008</b>	<b>2009</b>	<b>2008</b>
	(In thousands, except per share amounts)			
Sales	\$ 33,899	\$ 33,498	\$ 100,593	\$ 55,937
Less excise taxes	2,216	2,031	6,522	4,319
Net sales	31,683	31,467	94,071	51,618
Cost of sales	24,373	24,846	72,354	43,863
Gross profit	7,310	6,621	21,717	7,755
Selling, general and administrative expenses	6,722	7,632	19,028	11,984
Merger-related expenses		474	225	1,643
Income from equity investment in Craft Brands				1,390
Operating income (loss)	588	(1,485)	2,464	(4,482)
Income from equity investments in Kona and FSB	196	1	324	1
Interest expense	(531)	(447)	(1,668)	(452)
Interest and other income, net	88	41	258	98
Income (loss) before income taxes	341	(1,890)	1,378	(4,835)
Income tax provision (benefit)	247	(641)	620	(1,658)
Net income (loss)	\$ 94	\$ (1,249)	\$ 758	\$ (3,177)
Basic and diluted earnings (loss) per share	\$ 0.01	\$ (0.07)	\$ 0.04	\$ (0.28)

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

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**CRAFT BREWERS ALLIANCE, INC.**  
**STATEMENTS OF CASH FLOWS**  
(Unaudited)

	<b>Nine Months Ended</b>	
	<b>September 30,</b>	
	<b>2009</b>	<b>2008</b>
	(In thousands)	
<b>Operating Activities</b>		
Net income (loss)	\$ 758	\$ (3,177)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	5,528	3,462
Income from equity investments less than (in excess of) cash distributions	(324)	75
Deferred income taxes	601	(1,878)
Reserve for obsolete inventory	(8)	140
Loss on sale or disposal of property, equipment and leasehold improvements		24
Stock compensation	40	20
Other	(34)	(27)
Changes in operating assets and liabilities:		
Accounts receivable	2,527	2,557
Trade receivables from Craft Brands		119
Inventories	(849)	(525)
Income tax receivable and other current assets	931	(3,182)
Other assets	(15)	33
Accounts payable and other accrued expenses	(3,613)	100
Trade payable to Craft Brands		60
Accrued salaries, wages, severance and payroll taxes	597	(63)
Refundable deposits and other liabilities	(293)	170
 Net cash provided by (used in) operating activities	 5,846	 (2,092)
<b>Investing Activities</b>		
Expenditures for property, equipment and leasehold improvements	(1,867)	(5,546)
Proceeds from sale of property, equipment and leasehold improvements	61	382
Cash acquired in acquisition of Widmer Brothers Brewing Company, net		2,336
 Net cash used in investing activities	 (1,806)	 (2,828)
<b>Financing Activities</b>		
Principal payments on debt and capital lease obligations	(1,036)	(304)
Net repayments under revolving line of credit	(2,500)	(500)
Issuance of common stock	208	475
Amounts paid for debt issue costs		(25)
 Net cash used in financing activities	 (3,328)	 (354)



Increase (decrease) in cash and cash equivalents	712	(5,274)
Cash and cash equivalents:		
Beginning of period	11	5,527
End of period	\$ 723	\$ 253

**Supplemental Disclosures**

Cash paid for interest	\$ 1,761	\$ 417
Cash paid (received) for income taxes	\$ (771)	\$ 13

Non-cash Transaction

Net assets of Widmer Brothers Brewing Company acquired in exchange for issuance of common stock and assumption of debt (see Note 2)	\$	\$ 82,346
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*The accompanying notes are an integral part of these financial statements.*

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**CRAFT BREWERS ALLIANCE, INC.**  
**NOTES TO FINANCIAL STATEMENTS**  
(Unaudited)

**1. Basis of Presentation**

The accompanying financial statements and related notes of the Company should be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2008 (2008 Annual Report). These 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 financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted pursuant to such rules and regulations. These financial statements are unaudited but, in the opinion of management, reflect all material adjustments necessary to present fairly the financial position, results of operations and cash flows of the Company for the periods presented. All such adjustments were of a normal, recurring nature. Certain reclassifications have been made to the prior year's financial statements to conform to the current year presentation. The results of operations for such interim periods are not necessarily indicative of the results of operations for the full year. Subsequent events were evaluated through November 13, 2009, the date these financial statements were issued.

The financial statements as of and for the three and nine months ended September 30, 2009 are affected by the July 1, 2008 merger of Widmer Brothers Brewing Company (Widmer) with and into the Company, as more fully described in Note 2 below. These financial statements as of and for the three and nine months ended September 30, 2009 reflect the effect of the July 1, 2008 merger on the termination of the agreements between the Company and Craft Brands Alliance LLC (Craft Brands), and the resulting merger of Craft Brands with and into the Company. See Note 2 for further discussion of Craft Brands.

***Recent Accounting Pronouncements***

On January 1, 2009, the Company adopted Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) No. 161, *Disclosures about Derivative Instruments and Hedging Activities - An Amendment of FASB Statement No. 133*, which was incorporated into FASB Accounting Standards Codification (ASC) 815, *Derivatives and Hedging* (ASC 815). This new accounting standard requires enhanced disclosures about an entity's derivative and hedging activities in order to improve the transparency of financial reporting, including providing financial statement users an understanding of (i) how and why an entity uses derivative instruments; (ii) how derivative instruments and related hedged items are accounted for, and (iii) how derivative instruments and related hedged items affect an entity's financial position, results of operations, and cash flows. The adoption of this new accounting standard did not have a material effect on the Company's financial position, results of operations or cash flows; however, the Company was required to expand its disclosures around the use and purpose of its derivative instruments. See Note 7 for these expanded disclosures.

On June 30, 2009, the Company adopted FASB Staff Position Financial Accounting Standards No. 107-1 and Accounting Principles Board No. 28-1, *Interim Disclosures about Fair Value of Financial Instruments*, which was incorporated into FASB ASC 825, *Financial Instruments*. This new accounting standard requires disclosures about the fair value of financial instruments in interim financial statements in addition to the current requirement for disclosure in annual financial statements. The adoption of this new accounting standard did not have an impact on the Company's financial position, results of operations, or cash flows; however, the Company was required to expand its disclosures around the use and purpose of its derivative instruments. See Note 7 for these expanded disclosures.

On June 30, 2009, the Company adopted SFAS No. 165, *Subsequent Events*, which was incorporated into ASC 855, *Subsequent Events*. This new accounting standard provides guidance on the recognition and disclosure of events that occur after the balance sheet date but before financial statements are issued. The adoption of this new accounting standard did not have an impact on the Company's financial position, results of operations, or cash flows.

On July 1, 2009, the Company adopted SFAS No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles - a replacement of FASB Statement No. 162*, which was incorporated into ASC 105, *Generally Accepted Accounting Principles*. This new accounting standard identifies the ASC as the authoritative source of generally accepted accounting principles (GAAP) in the United States. Rules and

interpretive releases of the SEC under federal securities laws are also sources of authoritative GAAP for SEC registrants, including the Company. The adoption of this new accounting standard did not have an impact on the

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**CRAFT BREWERS ALLIANCE, INC.**  
**NOTES TO FINANCIAL STATEMENTS (continued)**  
(Unaudited)

Company's financial position, results of operations, or cash flows; however the Company has included references to the ASC within the financial statements.

**2. Merger Activities**

***Merger with Widmer***

On November 13, 2007, the Company entered into an Agreement and Plan of Merger with Widmer, which was subsequently amended on April 30, 2008 ( *Merger Agreement* ). The Merger Agreement provided, subject to customary conditions to closing, for a merger (the *Merger* ) of Widmer with and into the Company.

On July 1, 2008, the Merger was consummated. Pursuant to the Merger Agreement and by operation of law, upon the merger of Widmer with and into the Company, the Company acquired all of the assets, rights, privileges, properties, franchises, liabilities and obligations of Widmer. Each outstanding share of capital stock of Widmer was converted into the right to receive 2.1551 shares of Company common stock, or 8,361,514 shares. The Merger resulted in Widmer shareholders and existing Company shareholders each holding approximately 50% of the outstanding shares of the Company. No Widmer shareholder exercised statutory appraisal rights in connection with the Merger.

The Company believes that the combined entity is able to secure efficiencies beyond those that had already been achieved in its prior relationships with Widmer by utilizing the two companies' production facilities and a national sales force, as well as by reducing duplicate functions. Utilizing the combined breweries offers a greater opportunity to rationalize production capacity in line with product demand. The sales force of the combined entity is able to support further promotion of the products of its corporate investments, Kona Brewery LLC ( *Kona* ), which brews Kona malt beverage products, and, to a lesser extent, Fulton Street Brewery, LLC ( *FSB* ), which brews Goose Island malt beverage products.

In connection with the Merger, the name of the Company was changed from Redhook Ale Brewery, Incorporated to Craft Brewers Alliance, Inc. The common stock of the Company continues to trade on the Nasdaq Stock Market under the trading symbol *HOOK*.

***Merger-Related Costs***

In connection with the Merger, the Company incurred merger-related expenditures, including legal, consulting, meeting, filing, printing and severance costs. Certain of the merger-related expenses have been reflected in the statements of operations as incurred, while certain of the other direct merger-related costs have been capitalized in accordance with ASC 805, *Business Combinations* (formerly referenced as SFAS No. 141, *Business Combinations*). All capitalized merger costs were reclassified to goodwill upon the closing of the Merger. As discussed in the 2008 Annual Report, the Company recorded a full impairment of its goodwill asset. All costs capitalized to goodwill, including any capitalized merger costs, were charged to earnings for the year ended December 31, 2008 as a result.

Severance costs include payments to employees and officers whose employment was terminated as a result of the Merger. The Company estimates that merger-related severance benefits totaling approximately \$506,000 will be paid from the remainder of 2009 to 2011 to all affected former Redhook employees and officers, and affected former Widmer employees. The Company has recognized all costs associated with its merger-related severance benefits, including these, in accordance with ASC 420, *Exit or Disposal Cost Obligations* (formerly referenced as SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*). As of September 30, 2009, the Company does not anticipate that any additional costs will be recognized in future periods associated with the Merger.

***Pro Forma Results of Operations***

The unaudited pro forma combined condensed results of operations are presented below for the nine months ended September 30, 2008 as if the Merger had been completed on January 1, 2008. The unaudited condensed results of operations for the nine months ended September 30, 2009 as reported are presented below for comparative purposes.

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**CRAFT BREWERS ALLIANCE, INC.**  
**NOTES TO FINANCIAL STATEMENTS** (continued)  
(Unaudited)

	<b>Nine Months Ended September</b>	
	<b>2009</b>	<b>2008</b>
	<b>Actual</b>	<b>Pro Forma</b>
	<b>Results</b>	<b>Results</b>
	(In thousands, except per share data)	
Net sales	\$ 94,071	\$ 89,510
Income (loss) before income taxes	\$ 1,378	\$ (5,898)
Net income (loss)	\$ 758	\$ (3,875)
Basic and diluted earnings (loss) per share	\$ 0.04	\$ (0.23)

The unaudited pro forma results of operations are not necessarily indicative of the operating results that would have been achieved had the Merger been consummated as of the dates indicated, or that may be achieved in the future. Rather, the unaudited pro forma combined condensed results of operations presented above are based on estimates and assumptions that have been made solely for the purpose of developing such pro forma results. Historical results of operations were adjusted to give effect to pro forma events that are (1) directly attributable to the acquisition, (2) factually supportable, and (3) expected to have a continuing impact on the combined results. These pro forma results of operations do not give effect to any cost savings, revenue synergies or restructuring costs which may result from the integration of Widmer's operations.

***Merger with Craft Brands***

On July 1, 2004, the Company entered into agreements with Widmer with respect to the operation of a joint venture sales and marketing entity, Craft Brands, including an operating agreement with regards to Craft Brands ( Operating Agreement ) that governed the operations of Craft Brands and the obligations of its members, including capital contributions, loans and allocations of profits and losses. Pursuant to these agreements, and through June 30, 2008, the Company manufactured and sold its product to Craft Brands at prices substantially below wholesale pricing levels; Craft Brands, in turn, advertised, marketed, sold and distributed the product to wholesale outlets in the western United States pursuant to a distribution agreement between Craft Brands and Anheuser-Busch, Inc.

In connection with the Merger, Craft Brands was also merged with and into the Company, effective July 1, 2008. All existing agreements, including all associated future commitments and obligations, between the Company and Craft Brands and between Craft Brands and Widmer terminated as a result of the merger of Craft Brands.

The Operating Agreement addressed the allocation of profits and losses of Craft Brands up to July 1, 2008. Up to this date, the Company was allocated 42% of Craft Brands' profits and losses. Net cash flow, if any, was generally distributed monthly, up through the date of the termination, to the Company based upon that percentage. The Company would not have received a distribution if an event occurred that caused the liabilities of Craft Brands, adjusted for the liabilities to its members, to be in excess of its assets, or Craft Brands to be unable to pay its debts as those debts became due in the ordinary course of business.

The selected financial information presented for Craft Brands represents its activities for the 2008 period up to the date of its termination as follows:

**2008 period  
through  
termination of  
Craft Brands**  
(Dollars in  
thousands)

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Net sales	\$	38,463
Gross profit	\$	12,089
Operating income	\$	3,311
Income before income taxes	\$	3,310
Net income	\$	3,310
Shipments (in barrels)		180,300

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**CRAFT BREWERS ALLIANCE, INC.**  
**NOTES TO FINANCIAL STATEMENTS** (continued)  
(Unaudited)

For the period in 2008 up to the date of termination of its agreements with Craft Brands, the Company's share of Craft Brands' net income totaled \$1.4 million and the Company received cash distributions of \$1.5 million representing its share of the net cash flow of Craft Brands for the corresponding period.

**3. Inventories**

Inventories consist of the following:

	<b>September 30, 2009</b>	<b>December 31, 2008</b>
	(In thousands)	
Raw materials	\$ 3,662	\$ 4,258
Work in process	1,971	1,921
Finished goods	2,125	1,624
Packaging materials, net	1,258	950
Promotional merchandise, net	1,117	907
Pub food, beverages and supplies	70	69
	<b>\$ 10,203</b>	<b>\$ 9,729</b>

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

**4. Other Current Assets**

Other current assets consist of the following:

	<b>September 30, 2009</b>	<b>December 31, 2008</b>
	(In thousands)	
Deposits paid to keg lessor	\$ 3,514	\$ 3,182
Prepaid property taxes		177
Prepaid insurance	100	201
Other	194	391
	<b>\$ 3,808</b>	<b>\$ 3,951</b>

**5. Equity Investments**

Equity investments consist of the following:

	<b>September 30, 2009</b>	<b>December 31, 2008</b>
	(In thousands)	
Fulton Street Brewery, LLC ( FSB )	\$ 4,315	\$ 4,103
Kona Brewery LLC ( Kona )	1,198	1,086
	<b>\$ 5,513</b>	<b>\$ 5,189</b>





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**CRAFT BREWERS ALLIANCE, INC.**  
**NOTES TO FINANCIAL STATEMENTS** (continued)  
(Unaudited)

**FSB**

For the three and nine months ended September 30, 2009, the Company's share of FSB's net income totaled \$132,000 and \$212,000, respectively. The Company's share of FSB's net loss totaled \$25,000 for the three and nine months ended September 30, 2008. The Company's investment in FSB was \$4.3 million at September 30, 2009 and \$4.1 million at December 31, 2008, and the Company's portion of equity as reported on FSB's financial statement was \$2.1 million and \$1.9 million, respectively, as of the corresponding dates. The Company has not received any cash capital distributions associated with FSB during its ownership period. At September 30, 2009 and December 31, 2008, the Company has recorded a payable to FSB of \$1.6 million and \$1.1 million, respectively, primarily for amounts owing for purchases of Goose Island-branded product. The Company has recorded a receivable from FSB of \$36,000 at December 31, 2008 primarily for marketing fees associated with sales of Goose Island-branded product in the Company's distribution area.

**Kona**

For the three and nine months ended September 30, 2009, the Company's share of Kona's net income totaled \$64,000 and \$112,000, respectively. The Company's share of Kona's net income totaled \$26,000 for the three and nine months ended September 30, 2008. The Company's investment in Kona was \$1.2 million and \$1.1 million at September 30, 2009 and December 31, 2008, respectively, and the Company's portion of equity as reported on Kona's financial statement was \$459,000 and \$347,000, respectively, as of the corresponding dates. The Company has not received any cash capital distributions associated with Kona during its ownership period. At September 30, 2009 and December 31, 2008, the Company has recorded a receivable from Kona of \$2.0 million and \$3.0 million, respectively, primarily related to amounts owing under the alternating proprietorship and distribution agreements. As of September 30, 2009 and December 31, 2008, the Company has recorded a payable to Kona of \$2.0 million and \$1.9 million, respectively, primarily for amounts owing for purchases of Kona-branded product.

At September 30, 2009 and December 31, 2008, the Company had outstanding receivables due from Kona Brewing Co. ( KBC ) of \$68,000 and \$107,000, respectively. KBC and the Company are the only members of Kona.

**6. Debt and Capital Lease Obligations**

The Company refinanced borrowings assumed as a result of the Merger by concurrently entering into a loan agreement (the Loan Agreement ) with Bank of America, N.A. ( BofA ) during July 2008. The Loan Agreement is comprised of a \$15.0 million revolving line of credit ( Line of Credit ), including provisions for cash borrowings and up to \$2.5 million notional amount of letters of credit, and a \$13.5 million term loan ( Term Loan ). The Company may draw upon the Line of Credit for working capital and general corporate purposes. The Line of Credit matures on January 1, 2013 at which time the outstanding principal balance and any accrued but unpaid interest will be due. At September 30, 2009, the Company had \$9.5 million outstanding under the Line of Credit with \$5.5 million of availability for further cash borrowing.

The Company is in compliance with all applicable contractual financial covenants at September 30, 2009. The Company and BofA executed a loan modification to its loan agreement effective November 14, 2008 ( Modification Agreement ), as a result of the Company's inability to meet its covenants as of September 30, 2008. BofA permanently waived the noncompliance effective September 30, 2008, restoring the Company's borrowing capacity pursuant to the Loan Agreement.

Under the Modification Agreement, the Company may select from one of the following two interest rate benchmarks as the basis for calculating interest on the outstanding principal balance of the Line of Credit: the London Inter-Bank Offered Rate ( LIBOR ) or the Inter-Bank Offered Rate ( IBOR ) (each, a Benchmark Rate ). Interest accrues at an annual rate equal to the Benchmark Rate plus a marginal rate. The Company may select different Benchmark Rates for different tranches of its borrowings under the Line of Credit. The marginal rate was fixed at 3.50% until September 30, 2009, after which it can vary from 1.75% to 3.50% based on the ratio of the Company's funded debt to earnings before interest, taxes, depreciation and amortization ( EBITDA ), as defined ( funded debt ratio ). LIBOR rates may be selected for one, two, three, or six month periods, and IBOR rates may be selected for no shorter than 14 days

and no longer than nine months. Accrued interest for the Line of Credit is due and payable

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**CRAFT BREWERS ALLIANCE, INC.**  
**NOTES TO FINANCIAL STATEMENTS** (continued)  
(Unaudited)

monthly. At September 30, 2009, the weighted-average interest rate for the borrowings outstanding under the Line of Credit was 3.76%.

Under the Modification Agreement, a quarterly fee on the unused portion of the Line of Credit, including the undrawn amount of the related Standby Letter of Credit, will accrue at a rate of 0.50% payable quarterly; however, beginning September 30, 2009, this fee will also vary from 0.30% to 0.50% based upon the Company's funded debt ratio. An annual fee will be payable in advance on the notional amount of each standby letter of credit issued and outstanding multiplied by an applicable rate ranging from 1.13% to 1.50%.

Interest on the Term Loan will accrue on the outstanding principal balance in the same manner as provided for under the Line of Credit, as established under the LIBOR one-month Benchmark Rate. The interest rate on the Term Loan was 3.76% as of September 30, 2009. Accrued interest for the Term Loan is due and payable monthly. Principal payments are due monthly in accordance with an agreed-upon schedule set forth in the Loan Agreement. Any unpaid principal balance and unpaid accrued interest will be due on July 1, 2018.

Effective September 30, 2009, the Company is required to meet the financial covenants of the funded debt ratio and the fixed charge coverage ratio in the manner established pursuant to the original Loan Agreement, but at levels specified by the Modification Agreement. The Modification Agreement also required the Company to maintain an asset coverage ratio. Beginning with the third quarter of 2009, the financial covenants under the Modification Agreement are measured on a trailing four-quarter basis, as applicable. EBITDA under the Modification Agreement is defined as EBITDA as adjusted for certain other items as defined by either the Loan Agreement or the Modification Agreement. Those covenant requirements are detailed as follows:

**Financial Covenants Required by Loan Agreement  
as Revised by the Modification Agreement**

<u>Ratio of Funded Debt to EBITDA, as defined</u>	
From December 31, 2009 through September 30, 2010	3.50 to 1
From December 31, 2010 and thereafter	3.00 to 1
 Fixed Charge Coverage Ratio	 1.25 to 1
 Asset Coverage Ratio	 1.50 to 1

The Loan Agreement is secured by substantially all of the Company's personal property and by the real properties located at 924 North Russell Street, Portland, Oregon and 14300 NE 145<sup>th</sup> Street, Woodinville, Washington ( Collateral ), which comprise its larger-scale automated Portland, Oregon brewery and its Woodinville, Washington brewery, respectively. In addition, the Company is restricted in its ability to declare or pay dividends, repurchase any outstanding common stock, incur additional debt or enter into any agreement that would result in a change in control of the Company.

As a result of the Merger, the Company assumed Widmer's promissory notes signed in connection with the acquisition of commercial real estate related to the Portland, Oregon brewery. Each promissory note is secured by a deed of trust on the commercial real estate. The outstanding note balance to each lender as of September 30, 2009 was \$200,000, with each note bearing a fixed interest rate of 24% per annum, subject to a one-time adjustment on July 1, 2010 to reflect the change in the consumer price index from the date of issue, July 1, 2005, to the date of adjustment. The promissory notes are carried at the total of stated value plus a premium reflecting the difference between the Company's incremental borrowing rate and the stated note rate. The effective interest rate for each note is 6.31%. Each note matures on the earlier of the individual lender's death or July 1, 2015, but in no event prior to July 1, 2010, with prepayment of principal not allowed under the notes' terms. Interest payments are due and payable monthly.

As a result of the Merger, the Company assumed Widmer's capital equipment lease obligation to BofA, which is secured by substantially all of the brewery equipment and restaurant furniture and fixtures located in Portland, Oregon. The outstanding balance for the capital lease as of September 30, 2009 was \$5.8 million, with monthly loan

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**CRAFT BREWERS ALLIANCE, INC.**  
**NOTES TO FINANCIAL STATEMENTS (continued)**  
(Unaudited)

payments of \$119,020 required through the maturity date of June 30, 2014. The capital lease carries an effective interest rate of 6.56%. The capital lease is subject to a prepayment penalty equal to a specified percentage multiplied by the amount prepaid. This specified percentage began at 4% and, except in the event of acceleration due to an event of default, ratably declines 1% for every year the lease is outstanding until July 31, 2011, at which time the capital lease is not subject to a prepayment penalty. The specified percentage is 2% as of September 30, 2009. In the event of acceleration due to an event of default, the prepayment penalty is restored to 4%.

**7. Derivative Financial Instruments and Fair Value Measurement*****Interest Rate Swap Contracts***

The Company's 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.

The Company has assessed its vulnerability to certain business and financial risks, including interest rate risk associated with its variable-rate long-term debt. To mitigate this risk, the Company entered into with BofA a five-year interest rate swap agreement with a total notional value of \$9.8 million (as of September 30, 2009) to hedge the variability of interest payments associated with its variable-rate borrowings under its Term Loan. Through this swap agreement, the Company pays interest at a fixed rate of 4.48% and receives interest at a floating-rate of the one-month LIBOR. 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 under ASC 815. As of September 30, 2009, unrealized net losses of \$856,000 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 the Company records interest expense associated with the Term Loan. There was no hedge ineffectiveness recognized for the three and nine months ended September 30, 2009.

As a result of the Merger, the Company assumed Widmer's contract with BofA for a \$7.0 million notional interest rate swap agreement. On the effective date of the Merger, the Company entered into with BofA an equal and offsetting interest rate swap contract. Neither swap contract qualifies for hedge accounting under ASC 815. The assumed contract requires the Company to pay interest at a fixed rate of 4.60% and receive interest at a floating rate of the one-month LIBOR, while the offsetting contract requires the Company to pay interest at a floating rate of the one-month LIBOR and receive interest at a fixed rate of 3.47%. Both contracts expire on November 1, 2010. The Company recorded a net gain on the contracts of \$21,000 and \$59,000 for the three and nine months ended September 30, 2009, respectively, which was recorded to other income. The Company recorded a net gain on the contracts of \$18,000 for the three and nine months ended September 30, 2008, which was recorded to other income.

**Liability Derivatives at September 30, 2009**  
**Balance Sheet Location**

**Fair Value**  
(in  
thousands)

***Derivatives designated as hedging instruments >U.S. Federal Tax Consequences***

The following disclosure supplements, and to the extent inconsistent supersedes, the discussion in the product prospectus supplement under "Supplemental Discussion of U.S. Federal Income Tax Consequences."

In the opinion of our counsel, Morrison & Foerster LLP, it would generally be reasonable to treat a Note with terms described herein as a pre-paid cash-settled derivative contract in respect of the Reference Asset for U.S. federal income tax purposes, and the terms of the Notes require a holder and us (in the absence of a change in law or an administrative or judicial ruling to the contrary) to treat the Notes for all tax purposes in accordance with such characterization. However, the U.S. federal income tax consequences of your investment in the Notes are uncertain and the IRS could assert that the Notes should be taxed in a manner that is different from that described in the

preceding sentence.

Under Section 871(m) of the Code, a “dividend equivalent” payment is treated as a dividend from sources within the United States. Such payments generally would be subject to a 30% U.S. withholding tax if paid to a non-U.S. holder. Under U.S. Treasury Department regulations, payments (including deemed payments) with respect to equity-linked instruments (“ELIs”) that are “specified ELIs” may be treated as dividend equivalents if such specified ELIs reference an interest in an “underlying security,” which is generally any interest in an entity taxable as a corporation for U.S. federal income tax purposes if a payment with respect to such interest could give rise to a U.S. source dividend. However, the IRS has issued guidance that states that the U.S. Treasury Department and the IRS intend to amend the effective dates of the U.S. Treasury Department regulations to provide that withholding on dividend equivalent payments will not apply to specified ELIs that are not delta-one instruments and that are issued before January 1, 2021. Based on our determination that the Notes are not delta-one instruments, non-U.S. holders should not be subject to withholding on dividend equivalent payments, if any, under the Notes. However, it is possible that the Notes could be treated as deemed reissued for U.S. federal income tax purposes upon the occurrence of certain events affecting the Reference Asset or the Notes (for example, upon the Reference Asset rebalancing), and following such occurrence the Notes could be treated as subject to withholding on dividend equivalent payments. Non-U.S. holders that enter, or have entered, into other transactions in respect of the Reference Asset or the Notes should consult their tax advisors as to the application of the dividend equivalent withholding tax in the context of the Notes and their other transactions. If any payments are treated as dividend equivalents subject to withholding, we (or the applicable withholding agent) would be entitled to withhold taxes without being required to pay any additional amounts with respect to amounts so withheld.

The accompanying product prospectus supplement notes that FATCA withholding on payments of gross proceeds from a sale or redemption of Notes will only apply to payments made after December 31, 2018. That discussion is modified to reflect regulations proposed by the U.S. Treasury Department in December 2018 indicating an intent to eliminate the requirement under FATCA of withholding on gross proceeds of the disposition of financial instruments. The U.S. Treasury Department has indicated that taxpayers may rely on these proposed regulations pending their finalization. Prospective investors are urged to consult with their own tax advisors regarding the possible implications of FATCA on their investment in the Notes.

#### Terms Incorporated in the Master Note

All of the terms appearing in the section “Key Terms” (except the item captioned “Estimated Value”) and “U.S. Federal Tax Consequences” in this pricing supplement, and the applicable terms included in the product prospectus supplement, the Series H MTN prospectus supplement and the prospectus are incorporated into the master global note that represents the Notes and is held by the Depository Trust Company.

#### Validity of the Notes

In the opinion of Norton Rose Fulbright Canada LLP, the issue and sale of the Notes has been duly authorized by all necessary corporate action of the Bank in conformity with the Indenture, and when the Notes have been duly executed, authenticated and issued in accordance with the Indenture and delivered against payment therefor, the Notes will be validly issued and, to the extent validity of the Notes is a matter governed by the laws of the Province of Ontario or Québec, or the laws of Canada applicable therein, and will be valid obligations of the Bank, subject to equitable remedies which may only be granted at the discretion of a court of competent authority, subject to applicable bankruptcy, to rights to indemnity and contribution under the Notes or the Indenture which may be limited by applicable law; to insolvency and other laws of general application affecting creditors’ rights, to

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limitations under applicable limitations statutes, and to limitations as to the currency in which judgments in Canada may be rendered, as prescribed by the Currency Act (Canada). This opinion is given as of the date hereof and is limited to the laws of the Provinces of Ontario and Québec and the federal laws of Canada applicable thereto. In addition, this opinion is subject to customary assumptions about the Trustee's authorization, execution and delivery of the Indenture and the genuineness of signatures and certain factual matters, all as stated in the letter of such counsel dated September 7, 2018, which has been filed as Exhibit 5.1 to Royal Bank's Form 6-K filed with the SEC dated September 7, 2018.

In the opinion of Morrison & Foerster LLP, when the Notes have been duly completed in accordance with the Indenture and issued and sold as contemplated by the prospectus supplement and the prospectus, the Notes will be valid, binding and enforceable obligations of Royal Bank, entitled to the benefits of the Indenture, subject to applicable bankruptcy, insolvency and similar laws affecting creditors' rights generally, concepts of reasonableness and equitable principles of general applicability (including, without limitation, concepts of good faith, fair dealing and the lack of bad faith). This opinion is given as of the date hereof and is limited to the laws of the State of New York. This opinion is subject to customary assumptions about the Trustee's authorization, execution and delivery of the Indenture and the genuineness of signatures and to such counsel's reliance on the Bank and other sources as to certain factual matters, all as stated in the legal opinion dated September 7, 2018, which has been filed as Exhibit 5.2 to the Bank's Form 6-K dated September 7, 2018.

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