# Boston Beer Co Inc Class A SAM



## Boston Beer's market share losses continue, but profitability improvement opportunity remains.

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Morningstar's Editorial Policies

**Analyst Note** 04/22/2016

Narrow-moat Boston Beer continues to lose market share even faster than we originally anticipated. We still believe the firm holds a margin expansion opportunity, but with a product portfolio that's increasingly failing to resonate with consumers, and new products not making up the difference, the resulting volume declines suggest our long-run market share assumptions (which contemplate Boston's market share in beer falling to about 8% of craft beer in 2020, from an estimated 12.5% in 2015) are too optimistic. As such, we've reduced our $209 fair value estimate to $180. Shares look undervalued, but we recommend a sizeable margin of safety before investing to account for the uncertainty surrounding the firm's slate of new product introductions and the timing of a rebound in hard cider volumes.

The largest change in our outlook stems from reduced 2016 top-line assumptions. Boston's volume declined 6% in the quarter from a year ago, a far cry from the mid-single-digit volume growth we had anticipated for the full year. Given Sam Adams' share loss and the unexceptional performance of new products, management reduced its full-year forecast to a range of negative 4% to positive 2%. We have lowered our own expectation to a 2% decline. While we remain comfortable with our medium-term outlook for mid-single-digit volume growth--given continued growth in the overall craft beer space, renewed cider growth, and new product development--our updated forecast implies Boston's share of the craft beer space falling to about 7.5% by 2020.

Along with declining volume, Boston's gross margins fell year over year in the first quarter for the first time since late 2014. Although we still think the company can improve its brewery efficiency, these efforts will be overshadowed in the near term by deleveraging from lower volumes. As such, we've reduced our full-year gross margin forecast to 51% from 52%. Our $7.10 EPS expectation is in line with management's $6.50-$7.30 estimate.

**Investment Thesis** 02/25/2015

Boston Beer has separated itself as the pre-eminent U.S. craft brewer, and we think the firm has carved a narrow economic moat based on its brand intangible assets. Craft beer has grown at an impressive rate over the past two decades at the expense of traditional value and premium offerings, with Boston Beer's above-premium Sam Adams brand a key driver. We believe the company has an opportunity to further expand its national distribution, but the category's success has drawn more competition, which could limit pricing power and share gains in the longer term. Nonetheless, we expect Boston Beer to enjoy mid- to high-single-digit growth over the next five years, with benefits of additional scale making their way to the bottom line.

The craft beer, cider, and flavored malt beverage market in the U.S. (96% of Boston's revenue) is highly fragmented, with nearly 4,000 breweries (both distribution-based and brewpub models), but we expect Boston Beer's leading

### Morningstar's Take SAM

**Analyst**

| **Price** 05-20-2016 | **Fair Value Estimate** | **Uncertainty** |
|---|---|---|
| 150.6 USD | 180 USD | Medium |
| **Consider Buy** | **Consider Sell** | **Economic Moat** |
| 126 USD | 243 USD | Narrow |

**Stewardship Rating**
Standard

**Bulls Say**

- Boston Beer's cider brand, Angry Orchard, is the largest in the U.S. by dollars, and despite recent slowing, the category has grown extremely quickly.
- Boston Beer's opportunities on the U.S. West Coast and internationally support our view that it will continue above-category growth over the next several years.
- The company plans to implement efficiency programs to expand margins as top-line growth slows.

**Bears Say**

- Boston Beer has approximately 1.5% of the U.S. beer market. MillerCoors and Anheuser-Busch have significantly larger shares, at 26% and 45%, respectively.
- The company brews about 10% of its core brand product at facilities it does not own. If the contract breweries the firm uses were bought by a competitor, Boston Beer could face short-term capacity issues.
- With a significant number of breweries opening, it is possible that the fight to grow volumes and for shelf space could lead to market fragmentation, price competition, and further share losses for Boston Beer.

### Competitors SAM

More...

| Name | Price | % Chg | TTM Sales $ mil |
|---|---|---|---|
| **Boston Beer Co Inc Class A** | **$150.60** | **1.94** | **949** |
| Anheuser-Busch Inbev SA | $122.25 | -0.16 | 43,604 |
| Anheuser-Busch Inbev SA ADR | $121.99 | -0.29 | 43,604 |
| SABMiller PLC | $61.70 | 0.90 | 20,754 |
| SABMiller PLC ADR | $61.51 | 0.21 | 20,754 |
| Fomento Economico Mexicano SAB de CV ADR | $87.97 | 0.38 | 18,057 |

position and strong brands to help the firm maintain wider distribution and better cost leverage than the vast majority of smaller peers. However, Boston remains a much smaller brewer than major producers such as SABMiller and AB Inbev (Boston brewed 5 million total hectoliters in 2015, compared with 245 million for SABMiller and 457 million for AB Inbev globally). Although we believe Boston Beer can be more nimble in its flavor offerings--the company's Angry Orchard is the top-selling cider in dollars in the United States, for instance--the company also generates slimmer profitability than these behemoths given lower economies of scale.

Moreover, increased competition has dented results, and further challenges seem inevitable. Larger players have added to their own craft-style offerings (such as MillerCoors' Blue Moon and AB InBev's Goose Island), while the number of craft breweries has increased at a double-digit annual clip over the past decade. Although pricing has remained rational and at a premium to mainstream beers (Boston Beer's average price per hectoliter was roughly $192 in 2015, compared with $109 for MillerCoors), the industry may see pressure if craft beer demand wanes from its recent torrid pace.

**Economic Moat** 02/25/2015

In our view, Boston Beer has carved a narrow economic moat, stemming from the company's strong brand, better distribution network, and better negotiating power than other craft brewers. While the U.S. beer market has seen declining volumes in recent years, the above-premium (craft) portfolio has been one of the few areas of growth. We believe Boston Beer's moat stems from its brand intangible assets as the largest independent craft brewer in the U.S. It owns the iconic Sam Adams brand, which remains one of the top-selling craft brands by volume, as well as market-leading cider brand Angry Orchard. Boston Beer's products remain in high demand; the firm's volumes have grown at a five-year compound annual rate north of 13% compared with a negative 0.4% volume CAGR for the industry, enabling it to demand space at retailers and tap handles in bars. The firm has also established relationships with a number of national distributors, which gives it better exposure and negotiating power with bars and distributors than smaller craft players. The company was an early player in the cider industry and is now the best-selling cider brand in the U.S. (by dollars), according to IRI, at $208 million in 2014. While this product has lower margins, and is slowing from its rapid growth (the category grew 75% in 2014 before slipping to roughly the low double digits in 2015), the firm had held its share of the U.S. market (nearly 60%). The company has been struggling to keep up with growth, but management has suggested that lower growth would present an opportunity to invest in optimization and drive down product costs. This could expand returns on invested capital, which have averaged 32% (with goodwill and excess cash removed) over the past five years, materially better than the firm's 9% weighted average cost of capital.

However, for a variety of reasons, we do not believe the firm is worthy of a wide moat. The number of craft breweries in the industry has materially increased in recent years to nearly 4,000 in 2015 from 1,896 in 2008, which has increased competition as new breweries expand their brand names and distribution out of local markets. While pricing has been largely rational, as the number of craft brewers grows, it is more likely that some will struggle and pricing will deteriorate as they attempt to boost sales. Additionally, in the U.S. (Boston Beer's primary market) alcoholic consumption has been slowly moving to wine and spirits. While above-premium beer consumption has been largely unaffected, an economic downturn could prompt a return to value brands. Finally, Boston Beer still boasts less than 2% of the U.S. beer market, and several larger breweries such as SABMiller and MillerCoors have significant craft brands in the U.S. (Blue Moon, Leinenkugel, Shock Top, and others). These firms have significantly more resources to promote their brands and often have more business with the same distributors used by Boston Beer, which might allow them to put pressure on distributors to ensure they have the lowest-cost distribution and that their products have better positioning at retail outlets.

**Valuation** 04/22/2016

We've reduced our fair value estimate for Boston Beer to $180 per share from $209, as we now expect short-term market share losses at a greater rate than previously, with these lower volumes also leading to reduced profitability. Our valuation implies a multiple of 25.4 times our estimated 2016 EPS and an enterprise value/EBITDA multiple of 12.6 times. Boston Beer has enjoyed solid top-line growth in the past three years, including a 22% gain in 2014, but slowing results recently (revenue grew about 6% in 2015), as the firm has seen its share of the craft beer category slip and headwinds in the cider business. In our projections, we assume that craft beer and cider continue to climb as a percentage of the overall U.S. beer market (to about 23% and 2%, respectively, from an estimated 13% and 1% in 2015) as consumers continue to flock to these products (the products' respective shares have risen from 6% and 0.2% in 2010). However, we also assume that Boston's Sam Adams and Angry Orchard beer and cider products grow more slowly (including negative results in 2016), owing to rising competition from both small local brewers and large mega beer conglomerates. While we expect pricing to remain relatively rational (contributing about 2% annually to Boston Beer's revenue), we now project revenue will grow at about 5.3% annually over the next five years, versus our prior 7.7% forecast and 16% over the past five years. Our reduced revenue forecast for 2016 also leads to reduced profitability, given deleverage from lower volumes; we now expect operating margins of roughly 15.5% for the full year, versus 16.3% previously. Over the longer term, however, we continue to expect profitability gains as the firm leverages renewed volume increases across its cost of goods sold and administrative expenses. We also expect efficiency gains as the firm's growth slows from its torrid pace. In the near term, we expect the firm to reinvest most of its gross-margin savings into marketing and other brand-development efforts, but we still anticipate operating margins climbing to 23% by the end of our explicit 10-year forecast period, versus 16.3% in 2015.

**Risk** 02/25/2015

Despite increased competition (larger brewers entering the craft space, new craft breweries, imports, wines, and spirits), pricing in the beer market has remained largely rational. One of Boston Beer's largest risks is that too much additional capacity could cause irrational pricing, with larger brewers or struggling craft breweries competing on price. This would likely limit the firm's growth and could pressure margins. As another risk, further shifts in consumer preferences could drive additional market share losses for Sam Adams, Boston's largest brand.

Additionally, an economic slowdown in the U.S. could pressure the firm by limiting consumers' willingness to pay a premium to consume better beer. Another risk is that, as consumers' tastes change (for example to ciders or India pale ales) the firm could face margin pressures as some products require more expensive raw material inputs (apples and more expensive hops). If other craft players follow into new categories, this could further drive up raw material prices.

**Management** 04/22/2016

We rate Boston Beer's management team as Standard stewards of shareholder capital. We support the firm's focus on the long term and the willingness to forgo short-term profitability to build its brands. This focus has contributed to the company's average double-digit revenue growth since 2010 and high returns on invested capital. However, the firm remains controlled by founder and chairman James Koch through his 100% ownership of the Class B shares. While Koch's high level of ownership should align his interests with shareholders, minority interests are unable to strongly influence the company's direction. We do appreciate that, while Koch is a full-time employee, his salary is not excessive. In 2015, he was paid a salary of $405,000, with a bonus target of up to 100% (he received 20%, or $81,000).

The firm has also increased its share buyback program. In 2015, the firm bought back approximately 617 thousand Class A shares for approximately $139 million (versus 30 thousand for $8 million in 2014). The firm continued to repurchase stock in early 2016, and given our view that shares now trade at a slight discount to our fair value estimate, we think this endeavor is a decent use of capital.

**Overview**

**Profile:**

Boston Beer is the largest publicly traded domestic craft brewer in the U.S. and is best known for its flagship brand, Samuel Adams. Sam Adams competes in the above-premium end of the beer market against imports, domestic craft brews, and specialty beers. The company also markets Twisted Tea (a flavored malt beverage) and Angry Orchard ciders. The overall Better Beer category accounts for roughly one fourth of U.S. consumption, and Boston Beer controls roughly 1.5% of the overall U.S. beer and cider market.