# Boston Beer Co Inc Class A SAM



## The continued growth of craft beer in the U.S. should support continued gains at Boston Beer.

by
Adam Fleck
Sector Director

Authors can be reached at Analyst Feedback

Morningstar's Editorial Policies

**Investment Thesis** 02/25/2015

Boston Beer has separated itself as the preeminent 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 we also expect the category's success to draw more competition, which could limit pricing power and share gains longer term. Nonetheless, we expect Boston Beer to enjoy further double-digit top-line growth over the next five years, with benefits of additional scale making their way to the bottom line.

The craft beer market in the U.S. (96% of Boston's revenue) is highly fragmented, with close to 3,000 breweries (both distribution-based and brewpub models), but we expect Boston Beer's leading position and strong resulting brand 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 4.8 million total hectoliters in 2014, compared with 245 million for SABMiller and 426 million for AB-Inbev (2013) 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 U.S., for instance—the company also generates slimmer profitability than these behemoths given lower economies of scale.

Moreover, increased competition seems inevitable. Larger players have added to their own craft-style offerings (such as MillerCoors' Blue Moon and AB-InBev's Goose Island); MillerCoors alone represented 29% of U.S. craft growth in 2013. The number of craft breweries has increased at a 95% clip over the past eight years, and although pricing has remained rational and at a premium to mainstream beers (Boston Beer's average price per hectoliter was roughly $187 in 2014 compared with $126 for SABMiller in 2013), 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 its 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 was the top-selling craft brand by volume in 2013. Sam Adams remains in high demand (Boston Beer volumes have grown at a five-year compound annual rate of 7.8% compared with a negative 0.4% volume CAGR for the industry), and that helps

### Morningstar's Take SAM

**Analyst**

| | | |
|---|---|---|
| **Price** 02-12-2016 | **Fair Value Estimate** | **Uncertainty** |
| 185.04 USD | 210 USD | Medium |
| **Consider Buy** | **Consider Sell** | **Economic Moat** |
| 147 USD | 283.5 USD | Narrow |
| **Stewardship Rating** | | |
| Standard | | |

**Bulls Say**

- Boston Beer's cider brand, Angry Orchard, is the largest in the U.S. by dollars, and the category is growing extremely quickly (100% in 2013).
- Boston Beer's opportunities on the U.S. West Coast and internationally support our view that it will continue double-digit growth over the next several years.
- Management has mentioned that when growth slows, the company plans to implement efficiency programs to expand margins.

**Bears Say**

- Boston Beer has approximately 1.5% of the U.S. beer market. MillerCoors and Anheuser-Busch have significantly larger shares at 27% and 47%, 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 (304 in 2013), it is possible that the fight to grow volumes and for shelf space could lead to market fragmentation, price competition, and margin deterioration.

### Competitors SAM

More...

| Name | Price | % Chg | TTM Sales $ mil |
|---|---|---|---|
| **Boston Beer Co Inc Class A** | **$185.04** | **3.03** | **963** |
| Anheuser-Busch Inbev SA | $115.67 | 0.87 | 45,762 |
| Anheuser-Busch Inbev SA ADR | $115.42 | 0.70 | 45,762 |
| SABMiller PLC ADR | $59.90 | 0.33 | 20,754 |
| SABMiller PLC | $59.40 | -0.75 | 20,754 |
| Fomento Economico Mexicano SAB de CV ADR | $88.67 | 1.28 | 14,387 |

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. Additionally, 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 Information Resources, at $13 million in 2012. While this product has lower margins, the category is growing rapidly (100% in 2013) and the firm had 59% of the U.S. market in 2012 (Woodchuck has the second most at 11%). 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 40% (with goodwill and excess cash removed) over the past five years, materially better than the firm’s 10% weighted average cost of capital.

However, we do not believe the firm is worthy of a wide moat for a variety of reasons. The number of craft breweries in the industry has materially increased in recent years to 2,751 in 2012 from 1,896 in 2008, which could increase 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 continues to have 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** 10/29/2015

We maintain our $210 per share fair value estimate for Boston Beer after the third quarter as a weaker outlook for 2015 was offset time value of money gains. Our updated valuation implies a multiple of 25.5 times our estimated 2016 EPS and an enterprise value/EBITDA multiple of 12.6 times. Boston Beer has enjoyed double-digit top-line growth in the past three years, including a 22% gain in 2014. We expect growth to slow in the near term, with a five-year projected 9.3% average rate driven by continued share gains within the U.S. beer market (though we expect share loss in the craft market), growth from the tea and cider products, and further rational pricing among craft brewers. We estimate that during the next 10 years, the company’s market share will grow to about 4% of the total U.S. beer market from below 2% currently. Alongside this higher revenue, we expect continued profitability gains as the firm leverages an increased volume base across its cost of goods sold and administrative expenses. We also expect efficiency gains as the firm's growth slows from its torrid pace. We anticipate operating margins climbing to 23% by the end of our explicit 10-year forecast period, versus 16.2% in 2014.

**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. Boston Beer’s largest risk 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.

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 , 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** 02/25/2015

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 2013 he was paid a salary of $395,000, with a bonus target of up to 100% (he received 80% or $316,000).

The firm also has a small share buyback program. In 2014, the firm bought back approximately 30 thousand Class A shares for approximately $8 million. Given our view that shares trade at a premium to our fair value estimate, we think this capital could be put to better use by investing behind brands or returned to investors as a dividend.

**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.