

Boston Beer Co Inc Wages War Against Hard Root Beer, Cider, and Fragmentation

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Boston Beer Co Inc ([NYSE:SAM](#)) reported solid third quarter results in Oct. 2015 with net revenue up 9% year-over-year to \$293.1 million and diluted earnings per share up 2.2% to \$2.85. However, management indicated in the call that the remainder of the year would be "soft" and lowered full-year earnings guidance from a range of \$7.10 to \$7.50 to \$7.00 to \$7.40 per share. Investors were unimpressed as the stock shed 25% over the next three months.

So what exactly lies behind this pivot to reduced guidance? As you will see, it includes a frothy brew of decelerating depletion rates, heavy competition, and a rapidly fragmenting craft brewery market.

Depletions

The links of the supply chain for a brewer include shipping the product to a distributor who then ships the product to either a retail outlet such as a grocery store or an "on-premise" location such as a bar. A bartender then pours a Sam Adams for the customer. The rate at which the beer leaves the distributor's warehouse is known as depletion, and brewers closely monitor this metric in order to gauge the health of its sales.

Boston Beer management indicated in the company's second quarter conference call that its depletions rate for the year would range between 6% to 9% but reduced this estimate to a range of 3% to 6% in its third quarter earnings call. According to founder and Chairman Jim Koch in the earnings call, this is a result of weakness in the Sam Adams flagship brand due to increased craft beer competition and slowdown in the company's cider category.

Crafty competition: hard root beer

Small Town Brewery's Not Your Father's Root Beer exploded this past summer and became the number one selling craft package of 2015 with more than 1.95 million cases sold for a total of over \$85 million in sales according to IRI data. Boston Beer launched its own hard root beer brand this past summer, Coney Island Hard Root Beer, but captured only 18% of the hard root beer category as Small Town Brewery used its first mover advantage to dominate 80% of the market.

In a move to catch this wave, Anheuser Busch released its own hard root beer, Best Damn Root Beer, in December of this past year, but according to Boston Beer CEO Martin F. Roper, the mania may be over:

... Maybe there has been some trial, maybe there has been some stock-up in people's home refrigerators, and at this point in time while the demand is steady, it's not at the level it was in August, and in reaction to the August peaks, or early September peaks, wholesalers and retailers sort of loaded up. So there is some correction there.

In an anticipatory move based on consumers' promiscuous tastes, Boston Beer has rolled out other hard soda flavors such as Hard Ginger Ale and Hard Orange Cream Ale.

Crafty competition: hard cider

Although Boston Beer does not break out its sales by brand, industry analysts estimate that cider represented as much as 20% of the company's total revenue in 2015. Its cider offering, Angry Orchard, received stiff hits from consumers shifting to the aforementioned hard root beer category and cider alternatives like Stella Artois Cidre, which grew 158% last year.

Also, as indicated by Koch in the earnings call, although Angry Orchard accounts for almost 60% of the cider category, it does not get 60% of the shelf space in off-premise locations. The explosion in the cider category resulted in disproportionate shelf space for smaller brewers which should revert to normalized space-to-sales ratios over time. Boston Beer received craft cider shelf crowding from the likes of Two Rivers Cider and Far From The Tree Craft Hard Cider over the past year.

Fragmentation

The crowding out on the shelf that Boston Beer experienced in its cider category is indicative of a broader trend in the beer industry: high volume, spider-web fragmentation as a result of the formation of a record number of craft brewers in the United States. According to the Brewers Association, this number stands at 4,144, the highest level since 1873.

According to Koch, this extreme fragmentation results in crowded shelf space and lower sales per line:

Particularly competition for ads, display space, shelf space, but both of them are quite competitive. Just the number of craft brands available on draft continues to grow, probably double digits every year. Similarly, the number of craft brands that show up in our IRI numbers, and show up on retailer shelves is also growing double digits. So when you actually look at the numbers, you basically find that even though craft is growing in a quite, almost explosive manner, the average craft brewer is getting smaller, and the average sales per draft line or per SKU on the shelf are going down, because the number of draft lines out there keep going up, and the number of SKUs on the shelf keeps going up.

Nitro

Guinness has been the long-standing champion in beers brewed using a nitrogen process, which creates a smoother beer texture as opposed to a carbon dioxide process and its traditional lager texture. The Irish brewer upped the ante last year with its introduction of Guinness Nitro IPA, and Boston Beer responded in kind with the introduction of its own line of nitrogen crafted beer, available in white ale, IPA, and coffee stout flavors. Similar to its launch of hard sodas, Boston Beer is taking a proactive strategy with nitro products to address the tendency for consumers to constantly try new flavors.

Combating competition

In order to address the increase in competition, Boston Beer has escalated its advertising, promotional, and selling expenses which also adds to the softer outlook in earnings. In the third quarter, these expenses increased by \$13.2 million over the same quarter last year, a 20.3% increase. In part, this escalated budget is being spent on increased investments in media advertising, increased local marketing, and point of sale according to comments from CFO William Ulrich. These expenses represented 27% of net revenue for Boston Beer in the third quarter of 2015. For the same period, megabrewer **Anheuser-Busch InBev** spent 14.8% of its revenue on sales and marketing expenses.

On Feb. 18, Boston Beer will deliver its fourth quarter and full-year earnings results, and we will learn just how significant these headwinds were for the company as it rounded out 2015. Will depletion growth rates trend lower to the 3% to 6% range? Is hard root beer and the craft brewer explosion still taking a bite out of Angry Orchard cider and the flagship Samuel Adams brand? If Boston Beer is fighting against a perfect storm of competition, the landing could be soft indeed.

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