CRAFT BREW ALLIANCE, INC.
Form 10-Q
November 07, 2018

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, 2018
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	91-1141254
(State or other jurisdiction of incorporation or organization)	(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 every Interactive Data File required to be submitted 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 such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer", "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act.
Large accelerated filer
Accelerated filer
Non-accelerated filer
Smaller reporting company
Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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 1, 2018 was 19,381,762.

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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, 2018	December 31, 2017
Assets		
Current assets:		
Cash, cash equivalents and restricted cash	$ 12,156	$ 579
Accounts receivable, net	28,460	27,784
Inventory, net	17,271	13,844
Assets held for sale	—	22,946
Other current assets	1,275	4,335
Total current assets	59,162	69,488
Property, equipment and leasehold improvements, net	104,225	106,283
Goodwill	12,917	12,917
Intangible, equity method investment and other assets, net	20,244	20,949
Total assets	$ 196,548	$ 209,637
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	$ 18,899	$ 14,338
Accrued salaries, wages and payroll taxes	4,749	5,877
Refundable deposits	4,029	4,816
Deferred revenue	5,335	3,385
Other accrued expenses	2,415	2,368
Current portion of long-term debt and capital lease obligations	816	699
Total current liabilities	36,243	31,483
Long-term debt and capital lease obligations, net of current portion	9,763	32,599
Deferred income tax liability, net	12,271	12,886
Other liabilities	1,639	1,878
Total liabilities	59,916	78,846
Commitments and contingencies (Note 12)		
Common shareholders' equity:		
Common stock, $0.005 par value. Authorized 50,000,000 shares; issued and outstanding 19,381,762 and 19,309,829	97	96
Additional paid-in capital	143,589	142,196
Accumulated other comprehensive income (loss)	3	(164)
Accumulated deficit	(7,057)	(11,337)
Total common shareholders' equity	136,632	130,791
Total liabilities and common shareholders' equity	$ 196,548	$ 209,637

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,	
	2018	2017	2018	2017
Sales	$55,639	$60,040	$170,977	$171,010
Less excise taxes	2,750	3,402	8,778	9,520
Net sales	52,889	56,638	162,199	161,490
Cost of sales	36,190	37,254	108,302	111,108
Gross profit	16,699	19,384	53,897	50,382
Selling, general and administrative expenses	16,712	16,328	47,317	47,357
Operating income (loss)	(13)	3,056	6,580	3,025
Interest expense	(107)	(179)	(348)	(533)
Other income (expense), net	(13)	(59)	42	(46)
Income (loss) before income taxes	(133)	2,818	6,274	2,446
Income tax provision (benefit)	(194)	1,067	1,600	758
Net income	$61	$1,751	$4,674	$1,688
Basic and diluted net income per share	$—	$0.09	$0.24	$0.09
Shares used in basic per share calculations	19,370	19,296	19,338	19,278
Shares used in diluted per share calculations	19,545	19,443	19,525	19,401

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,	
	2018	2017	2018	2017
Net income	$61	$1,751	$4,674	$1,688
Unrealized gain on derivative hedge transactions, net of tax	38	15	167	63
Comprehensive income	$99	$1,766	$4,841	$1,751

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,	
	2018	2017
Cash flows from operating activities:		
Net income	$4,674	$1,688
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	7,985	7,904
(Gain) loss on sale or disposal of Property, equipment and leasehold improvements	(549)	164
Deferred income taxes	(673)	(168)
Stock-based compensation	1,058	945
Other	206	906
Changes in operating assets and liabilities:		
Accounts receivable, net	(676)	(4,886)
Inventories	(2,905)	1,371
Other current assets	2,360	1,124
Accounts payable and other accrued expenses	6,872	13,096
Accrued salaries, wages and payroll taxes	(1,128)	1,203
Refundable deposits	(560)	(884)
Net cash provided by operating activities	16,664	22,463
Cash flows from investing activities:		
Expenditures for Property, equipment and leasehold improvements	(6,216)	(16,170)
Proceeds from sale of Property, equipment and leasehold improvements	22,998	95
Investment in Wynwood	—	(2,101)
Restricted cash from sale of Property, equipment and leasehold improvements	515	—
Net cash provided by (used in) investing activities	17,297	(18,176)
Cash flows from financing activities:		
Principal payments on debt and capital lease obligations	(520)	(483)
Net repayments under revolving line of credit	(22,199)	(3,922)
Proceeds from issuances of common stock	427	98
Tax payments related to stock-based awards	(92)	(17)
Net cash used in financing activities	(22,384)	(4,324)
Increase (decrease) in Cash, cash equivalents and restricted cash	11,577	(37)
Cash, cash equivalents and restricted cash:		
Beginning of period	579	442
End of period	$12,156	$405
Supplemental disclosure of cash flow information:		
Cash paid for interest	$396	$540
Cash paid for income taxes, net	450	216
Supplemental disclosure of non-cash information:		
Purchases of Property, equipment and leasehold improvements with capital leases	$—	$400
	205	285

Purchases of Property, equipment and leasehold improvements included in Accounts payable at end of period

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, 2017 (“2017 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.

Reclassifications
Certain reclassifications have been made to the prior year's data to conform to the current year's presentation. None of the changes affect our previously reported consolidated Net sales, Gross profit, Operating income (loss), Net income or Basic or diluted net income per share.

Note 2. Recent Accounting Pronouncements

ASU 2018-15
In August 2018, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2018-15, "Intangibles—Goodwill and Other—Internal-Use Software (Subtopic 350-40): Customer’s Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract." ASU 2018-15 aligns the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software. ASU 2018-15 is effective for fiscal years, including interim periods within those fiscal years, beginning after December 15, 2019, with early adoption permitted. We are still evaluating the effect of the adoption of ASU 2018-15.

ASU 2018-13
In August 2018, the FASB issued ASU 2018-13, "Fair Value Measurement (Topic 820): Disclosure Framework—Changes to the Disclosure Requirements for Fair Value Measurement." ASU 2018-13 removes, modifies and adds certain disclosure requirements on fair value measurements. ASU 2018-13 is effective for fiscal years, including interim periods within those fiscal years, beginning after December 15, 2019, with early adoption permitted. We are still evaluating the effect of the adoption of ASU 2018-13.

ASU 2018-02
In February 2018, the FASB issued ASU 2018-02, "Income Statement - Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income." ASU 2018-02 allows entities to reclassify accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Cuts and Jobs Act (the “Act”). This update is effective for interim and annual reporting periods beginning after December 15, 2018, with early adoption permitted. The update should be applied either in the period of adoption or retrospectively to each period (or periods) in which the effect of the income tax rate change resulting from the Act is recognized. The early adoption of ASU 2018-02 on January 1, 2018 did not have a material effect on our financial position, results of operations or cash flows.

ASU 2017-12
In August 2017, the FASB issued ASU 2017-12, "Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities." ASU 2017-12 refines and expands hedge accounting for both financial and commodity risks. Its provisions create more transparency around how economic results are presented, both on the face of the financial statements and in the footnotes. It also makes certain targeted improvements to simplify the application of hedge accounting guidance. ASU 2017-12 is effective for fiscal years, including interim periods within those fiscal years, beginning after December 15, 2018, on a prospective basis. We do not expect the adoption of ASU 2017-12 to have a material effect on our financial position, results of operations or cash flows.

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ASU 2017-09
In May 2017, the FASB issued ASU 2017-09, "Compensation - Stock Compensation (Topic 718) - Scope of Modification Accounting." ASU 2017-09 provides clarity and is expected to reduce both diversity in practice and the cost and complexity when accounting for a change to the terms of a stock-based award. ASU 2017-09 is effective for fiscal years, including interim periods within those fiscal years, beginning after December 15, 2017, on a prospective basis. The adoption of ASU 2017-09 on January 1, 2018 did not have a material effect on our financial position, results of operations or cash flows.

ASU 2017-04
In January 2017, the FASB issued ASU 2017-04, "Intangibles - Goodwill and Other (Topic 350) - Simplifying the Test for Goodwill Impairment." ASU 2017-04 simplifies the subsequent measurement of goodwill by eliminating Step 2 from the goodwill impairment test. An entity should perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount, and recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value, if applicable. The loss recognized should not exceed the total amount of goodwill allocated to the reporting unit. The same impairment test also applies to any reporting unit with a zero or negative carrying amount. An entity still has the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. ASU 2017-04 is effective for fiscal years, including interim periods within those fiscal years, beginning after December 15, 2019, on a prospective basis. Early adoption is permitted for interim or annual goodwill impairment tests performed after January 1, 2017. We do not expect the adoption of ASU 2017-04 to have a material effect on our financial position, results of operations or cash flows.

ASU 2016-18
In August 2016, the FASB issued ASU 2016-18, "Statement of Cash Flows (Topic 230) - Restricted Cash." ASU 2016-18 reduces the diversity in practice in the classification and the presentation of restricted cash within an entity's statement of cash flows. ASU 2016-18 is effective for annual periods beginning after December 15, 2017, and interim periods within those annual periods, with early adoption permitted. The adoption of ASU 2016-18 on January 1, 2018 did not have a material effect on our financial position, results of operations or cash flows.

ASU 2016-15
In August 2016, the FASB issued ASU 2016-15, "Statement of Cash Flows (Topic 230) - Classification of Certain Cash Receipts and Cash Payments." ASU 2016-15 addresses eight specific cash flow issues and how they should be reported on the statement of cash flows. ASU 2016-15 is effective for annual periods beginning after December 15, 2017, and interim periods within those annual periods, with early adoption permitted. The adoption of ASU 2016-15 on January 1, 2018 did not have a material effect on our financial position, results of operations or cash flows.

ASU 2016-13
In June 2016, the FASB issued ASU 2016-13, "Financial Instruments - Credit Losses (Topic 326)." ASU 2016-13 addresses accounting for credit losses for assets that are not measured at fair value through net income on a recurring basis. ASU 2016-13 is effective for annual periods beginning after December 15, 2019, and interim periods within those annual periods, with early adoption permitted for fiscal years beginning after December 15, 2018. We do not expect the adoption of ASU 2016-13 to have a material effect on our financial position, results of operations or cash flows.

ASU 2016-02, ASU2018-10 and ASU 2018-11
In February 2016, the FASB issued ASU 2016-02, "Leases." ASU 2016-02 increases transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and requires disclosing key information about leasing arrangements. ASU 2016-02 is effective for annual periods beginning after December 15, 2018, and interim periods within those annual periods. We are currently evaluating the potential impact of the

adoption of ASU 2016-02 on our consolidated financial statements. We currently expect the adoption of this standard to result in a material increase to the assets and liabilities on our consolidated balance sheets.

In July 2018, the FASB issued ASU 2018-10, "Codification Improvements to Topic 842, Leases." ASU 2018-10 provides narrow amendments that clarify how to apply certain aspects of the guidance in ASU 2016-02. ASU 2018-10 is effective for annual periods beginning after December 15, 2018, and interim periods within those annual periods. We are still evaluating the effect of the adoption of ASU 2018-10.

In July 2018, the FASB issued ASU 2018-11, "Leases (Topic 842): Targeted Improvements." ASU 2018-11 provides an optional transition method, that allows entities to initially apply the new leases standard at the adoption date and recognize a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. ASU 2018-11 is effective for annual periods beginning after December 15, 2018, and interim periods within those annual periods. We are still evaluating the effect of the adoption of ASU 2018-11.

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ASU 2016-01

In January 2016, the FASB issued ASU 2016-01, “Financial Instruments - Overall (Subtopic 825-10).” ASU 2016-01 enhances the reporting model for financial instruments to provide users of financial statements with more decision-useful information by addressing certain aspects of recognition, measurement, presentation and disclosure of financial instruments. The amendments simplify certain requirements and also reduce diversity in current practice for other requirements. ASU 2016-01 is effective for public companies for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The adoption of ASU 2016-01 on January 1, 2018 did not have a material effect on our financial position, results of operations or cash flows.

ASU 2014-09, ASU 2016-10 and ASU 2016-12

In May 2014, the FASB issued ASU 2014-09, “Revenue from Contracts with Customers (Topic 606).” ASU 2014-09, as amended, affects any entity using U.S. GAAP that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (e.g., insurance contracts or lease contracts). ASU 2014-09, as amended, is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017.

In April 2016, the FASB issued ASU 2016-10, "Revenue from Contracts with Customers (Topic 606) - Identifying Performance Obligations and Licensing." ASU 2016-10 clarifies aspects of Topic 606 related to identifying performance obligations and the licensing implementation guidance, while retaining the related core principles for those areas. The effective date and transition requirements for ASU 2016-10 are the same as the effective date and transition requirements in ASU 2014-09.

In May 2016, the FASB issued ASU 2016-12, "Revenue from Contracts with Customers (Topic 606) - Narrow-Scope Improvements and Practical Expedients." ASU 2016-12 clarifies aspects of Topic 606 related to the guidance on assessing collectibility, presentation of sales taxes, non-cash consideration, and completed contracts and contract modifications. The effective date and transition requirements for ASU 2016-12 are the same as the effective date and transition requirements in ASU 2014-09.

The standards permit either the retrospective or the modified retrospective (cumulative effect) transition method. On January 1, 2018, we adopted the new accounting standard Accounting Standards Codification ("ASC") 606, "Revenue from Contracts with Customers" and all the related amendments to all contracts using the modified retrospective method. We recognized the cumulative effect of initially applying the new revenue standard as an adjustment to the opening balance of accumulated deficit. We expect the impact of the adoption of the new standard to be immaterial to our net income on an ongoing basis.

See also Note 8.

Note 3. Cash, Cash Equivalents and Restricted Cash

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, 2018 and December 31, 2017, we did not have any cash equivalents.

As part of our cash management system, we use 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, 2018 and December 31, 2017, 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.

Cash and cash equivalents that are restricted as to withdrawal or use under terms of certain contractual agreements are recorded in Cash, cash equivalents and restricted cash on our Consolidated Balance Sheets. Restricted cash of $0.5 million at September 30, 2018 represents funds held in an escrow account from the sale of our Woodinville brewery related to a lien; we expect that the lien will be resolved in our favor and the restriction will be removed. We did not have any restricted cash at December 31, 2017.

Note 4. Inventories

Inventories are stated at the lower of standard cost or net realizable value.

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, equity method investment and other assets, net on our Consolidated Balance Sheets.

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Inventories consisted of the following (in thousands):

	September 30, 2018	December 31, 2017
Raw materials	$ 7,801	$ 4,290
Work in process	2,803	1,960
Finished goods	4,354	5,009
Packaging materials	960	956
Promotional merchandise	831	1,161
Brewpub food, beverages and supplies	522	468
	$ 17,271	$ 13,844

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

Note 5. Related Party Transactions

As of September 30, 2018 and December 31, 2017, Anheuser-Busch, LLC ("A-B") owned approximately 31.3% and 31.4%, respectively, of our outstanding common stock.

Transactions with A-B, Ambev and Anheuser-Busch Worldwide Investments, LLC (“ABWI”)
In December 2015, we partnered with Ambev, the Brazilian subsidiary of Anheuser-Busch InBev SA, to distribute Kona beers into Brazil. In August 2016, we also entered into an International Distribution Agreement with ABWI, an affiliate of A-B, pursuant to which ABWI distributes our malt beverage products in jurisdictions outside the United States, subject to the terms and conditions of our prior agreement with our other international distributor, CraftCan Travel LLC, and certain other limitations.

Contract Brewing Arrangement with Anheuser-Busch Companies, LLC ("ABC")
On January 30, 2018, we entered into a Contract Brewing Agreement (the “Brewing Agreement”) with ABC, an affiliate of A-B, pursuant to which we brew, package, and palletize certain malt beverage products of A-B's craft breweries at our Portland, Oregon, and Portsmouth, New Hampshire, breweries as selected by ABC. Under the terms of the Brewing Agreement, ABC pays us a per barrel fee that varies based on the annual volume of the specified product brewed by us, plus (a) our actual incremental costs of brewing the product and (b) certain capital costs and costs of graphics and labeling that we incur in connection with the brewed products.

The Brewing Agreement will expire on December 31, 2018, unless the arrangement is extended at the mutual agreement of the parties. The Brewing Agreement contains specified termination rights, including, among other things, the right of either party to terminate the Brewing Agreement if (i) the other party fails to perform any material obligation under the Brewing Agreement or any other agreement between the parties, subject to certain cure rights, or (ii) the Master Distributor Agreement is terminated.

Transactions with A-B, Ambev, ABWI and ABC consisted of the following (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Gross sales to A-B and Ambev	$41,737	$46,147	$129,588	$127,932
International distribution fee earned from ABWI	850	850	2,550	2,550
International distribution fee from ABWI, recorded in Deferred revenue	650	400	1,950	1,200
Contract Brewing fee earned from ABC	821	—	1,679	—

Margin fee paid to A-B, classified as a reduction of Sales	601	649	1,806	1,806
Inventory management and other fees paid to A-B, classified in Cost of sales	97	97	287	289
Media and other reimbursement from A-B, classified as a reduction of Selling, general and administrative expenses	192	221	192	295

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

	September 30, 2018	December 31, 2017
Amounts due from A-B related to beer sales pursuant to the A-B distributor agreement	$ 15,667	$ 15,663
Amounts due from ABWI and A-B related to international distribution fee	4,500	5,000
Refundable deposits due to A-B	(2,483)	(1,619)
Amounts due to A-B for services rendered	(9,109)	(4,836)
Net amount due from A-B and ABWI	$ 8,575	$ 14,208

Transactions with Wynwood Brewing Co. ("Wynwood")

As of September 30, 2018 and December 31, 2017, we owned a 24.5% interest in Wynwood. The carrying value of our investment was $2.0 million as of September 30, 2018.

Transactions with Wynwood consisted of the following (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Master distributor fee earned	$ 3	$ 3	$ 22	$ 3
Royalty fee paid	—	31	—	31
Brewery representative reimbursement, classified as a reduction of Selling, general and administrative expenses	—	42	—	42
Share of loss, classified as a component of Other income (expense), net	22	37	44	37
Refund of investment, classified as a reduction in the carrying value of the equity method investment	—	—	23	—

Amounts due to or from Wynwood were as follows (in thousands):

	September 30, 2018	December 31, 2017
Amounts receivable related to raw materials and alternating proprietorship fees	$ 277	$ 148
Amounts receivable related to Brewery representative reimbursements	—	32
Amounts due related to purchases of beer pursuant to the distributor agreement	(206)	(116)
Amounts due related to Royalty fees	—	(4)
Net amount receivable	$ 71	$ 60

Operating Leases

We lease our headquarters office space, restaurant and storage facilities located in Portland, land and certain equipment from two limited liability companies, both of whose members include our former Board Chair, who is also a significant shareholder, and his brother, who continues to be employed by us. Lease payments to these lessors were as follows (in thousands) and are included in the Rent expense under all operating leases above:

Three Months Ended September 30,	Nine Months Ended September 30,

2018	2017	2018	2017
$41	$ 26	$123	$ 87

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We hold lease and sublease obligations for certain office space and the land underlying the brewery and pub location in 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) and are included in the Rent expense under all operating leases above:

Three Months Ended September 30,		Nine Months Ended September 30,	
2018	2017	2018	2017
$145	$143	$435	$431

Note 6. Derivative Financial Instruments

Interest Rate Swap Contracts

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 Term Loan contract and the interest rate swap terminate on September 30, 2023. The Term Loan contract had a total notional value of $6.7 million as of September 30, 2018. 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 2.18% at September 30, 2018.

Effective January 4, 2016, we entered into a $9.1 million notional amount interest rate swap contract with BofA, which was set to expire January 1, 2019, to hedge the variability of interest payments associated with our variable-rate borrowings on our line of credit. The notional amount fluctuated based on a predefined schedule based on our anticipated borrowings. This swap agreement was terminated effective January 18, 2018 as we paid off our line of credit, and we received interest of $27,000.

Since the interest rate swaps hedge the variability of interest payments on variable rate debt with similar terms, they qualify for cash flow hedge accounting treatment.

As of September 30, 2018, unrealized net gains of $4,000 were recorded in Accumulated other comprehensive income (loss) as a result of these hedges. The effective portion of the gain or loss on the derivatives is reclassified into Interest expense in the same period during which we record Interest expense associated with the related debt. There was no hedge ineffectiveness during the first nine months of 2018 or 2017.

The fair value of our derivative instruments are recorded as a component of Other liabilities on our consolidated balance sheets was as follows (in thousands):

	September 30, 2018	December 31, 2017
Fair value of interest rate swaps - asset (liability)	$ 4	$ (221)

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The effect of our interest rate swap contracts that were accounted for as a derivative instrument on our Consolidated Statements of Operations was as follows (in thousands):

Derivatives in Cash Flow Hedging Relationships	Amount of Gain 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,			
2018	$ 52	Interest expense	$ 13
2017	$ 24	Interest expense	$ 30
Nine Months Ended September 30,			
2018	$ 225	Interest expense	$ 52
2017	$ 101	Interest expense	$ 123

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 table summarizes assets and (liabilities) measured at fair value on a recurring basis (in thousands):

Fair Value at September 30, 2018	Level 1	Level 2	Level 3	Total
Interest rate swap	$ —	$ 4	$ —	$ 4
Fair Value at December 31, 2017				
Interest rate swaps	$ —	$ (221)	$ —	$ (221)

The fair value of our interest rate swaps was based on quarterly statements from the issuing bank. There were no changes to our valuation techniques during the nine months ended September 30, 2018.

We believe the carrying amounts of Cash, cash equivalents and restricted 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, 2018	December 31, 2017
Fixed-rate debt on Consolidated Balance Sheets	$ 1,648	$ 1,855
Estimated fair value of fixed-rate debt	1,671	1,915

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.

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Note 8. Revenue Recognition

On January 1, 2018, we adopted the Accounting Standards Codification ("ASC") 606, "Revenue from Contracts with Customers" and all the related amendments (the "new revenue standard") for all of our revenue contracts, using the modified retrospective method. We recognized the cumulative effect of initially applying the new revenue standard as an adjustment to the opening balance of Accumulated deficit. The adoption of ASC 606 did not have a material impact on our consolidated financial statements as of January 1, 2018 or for the three and nine-month periods ended September 30, 2018.

The adjustments to our Consolidated Balance Sheets upon adoption of ASC 606, effective January 1, 2018 were as follows (in thousands):

	Balance at December 31, 2017	Adjustments due to ASC 606	Balance at January 1, 2018
Assets:			
Other current assets	$4,335	$ (237)	$4,098
Intangible, equity method investment and other assets, net	20,949	(157)	20,792
Common shareholders' equity:			
Accumulated deficit	$(11,337)	$ (394)	$(11,731)

In accordance with the new revenue standard requirements, the disclosure of the impact of adoption on our Consolidated Balance Sheets and Consolidated Statements of Operations was as follows (in thousands):

	September 30, 2018		
	As Reported	Balance without Adoption of ASC 606	Effect of Change Higher (Lower)
Consolidated Balance Sheets			
Assets:			
Other current assets	$1,275	$1,492	$ (217)
Intangible, equity method investment and other assets, net	20,244	20,244	—
Liabilities:			
Deferred income tax liability, net	12,271	12,316	(45)
Common shareholders' equity:			
Accumulated deficit	$(7,057)	$(7,319)	$ (262)

	Three Months Ended September 30, 2018			Nine Months Ended September 30, 2018		
	As Reported	Balance without Adoption of ASC 606	Effect of Change Higher (Lower)	As Reported	Balance without Adoption of ASC 606	Effect of Change Higher (Lower)
Consolidated Statements of Operations						

Selling, general and administrative expenses	$16,712	$16,771	$ (59)	$47,317	$47,495	$ (178)
Income tax provision (benefit)	(194)	(209)	15	1,600	1,555	45
Net income	61	19	42	4,674	4,546	128

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The following table disaggregates our Sales by major source (in thousands):

	Three Months Ended September 30, 2018			Nine Months Ended September 30, 2018		
	Beer Related[1]	Brewpubs	Total	Beer Related[1]	Brewpubs	Total
Product sold through distributor agreements[2]	$45,326	$ —	$45,326	$139,141	$ —	$139,141
Alternating proprietorship and contract brewing fees	2,863	—	2,863	8,748	—	8,748
International distribution fees	850	—	850	2,550	—	2,550
Brewpubs[3]	—	6,166	6,166	—	18,278	18,278
Other[4]	434	—	434	2,260	—	2,260
	$49,473	$ 6,166	$55,639	$152,699	$ 18,278	$170,977

(1) Beer Related sales include sales to A-B subsidiaries including Ambev, ABWI and ABC. Sales to wholesalers through the A-B distributor agreement in the three and nine-month periods ended September 30, 2018 represented 76.9% and 77.2% of our Sales, respectively.

(2) Product sold through distributor agreements included domestic and international sales of owned and non-owned brands pursuant to terms in our distributor agreements.

(3) Brewpub sales include sales of promotional merchandise and sales of beer directly to customers.

(4) Other sales include sales of beer related merchandise, hops, spent grain and an export manager fee.

Revenue is recognized when obligations under the terms of a contract with our customers are satisfied; generally this occurs when the product arrives at distribution centers or when the wholesaler takes possession. Revenue is measured as the amount of consideration we expect to receive in exchange for transferring goods. We consider customer purchase orders, which in some cases are governed by a master agreement, to be the contracts with a customer. For each contract related to the production of beer, we consider the promise to transfer products, each of which is distinct, to be the identified performance obligation. The transaction price for each performance obligation is specifically identified within the contract with our customer and represents the fair standalone selling price. Discounts are recognized as a reduction to Sales at the time we recognize the revenue. We generally do not grant return privileges, except in limited and specific circumstances.

A performance obligation is a promise in a contract to transfer a distinct good or service to the customer, and is the unit of accounting pursuant to ASC 606. In contracts with multiple performance obligations, we identify each performance obligation and evaluate whether the performance obligation is distinct within the context of the contract at contract inception. Performance obligations that are not distinct at contract inception are combined.

We entered into an International Distribution Agreement ("IDA") with A-B for the rights to serve as our exclusive distributor in international territories defined by the IDA for a 10-year period. The IDA represents a single international license to all territories defined in the IDA. Revenue is recognized on a straight-line basis over the 10-year term of the agreement. In accordance with ASC 606, we evaluate the factors used in our estimates of variable consideration to be received under contracts on a quarterly basis. We estimate variable consideration as the most likely amount to which we expect to be entitled. We have evaluated, on a quarterly basis, the qualitative factors, including current market conditions and our relationship with A-B, and we consider receiving $34.0 million over the 10-year term of the IDA the most likely outcome under the IDA. We believe that the possibility of a significant reversal of cumulative revenue recognized from this agreement under this conclusion is remote. Under the IDA, A-B has the right to issue purchase orders to distribute product in international territories defined by the IDA. Each purchase order placed under the IDA is a distinct performance obligation. The transaction price for each performance obligation is a sales-based royalty, which is recognized as revenue in accordance with the sales-based royalty exception. Accordingly, royalty revenue is recognized as the variability associated with the royalty is resolved, which is upon A-B's subsequent sale of our product.

In cases where all conditions to a sale are not met at the time of sale, revenue recognition is deferred until all conditions are met. As of January 1, 2018, Deferred revenue on our Consolidated Balance Sheets included $3.4 million related to the IDA. As of September 30, 2018, we earned the right to receive an additional $4.5 million pursuant to the IDA, of which we have recognized $2.6 million as Sales, resulting in Deferred revenue of $5.3 million at September 30, 2018. We will earn the right to receive an additional $1.5 million in the fourth quarter of 2018 and we expect to earn the right to receive an additional $20.0 million in 2019. We expect to recognize an additional $0.9 million of Deferred revenue as Sales in the remainder of 2018, $3.2 million in 2019, and $22.7 million thereafter.

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Note 9. Segment Results and Concentrations

Our chief operating decision maker monitors Net sales and gross margins of our Beer Related operations and our Brewpubs operations. Beer Related operations include the brewing operations and related domestic and international beer and cider sales of our Kona, Widmer Brothers, Redhook and Omission beer brands and Square Mile cider brand. Brewpubs operations primarily include our brewpubs, 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,		
2018	Beer Related	Brewpubs	Total
Net sales	$46,723	$6,166	$52,889
Gross profit	$16,261	$438	$16,699
Gross margin	34.8 %	7.1 %	31.6 %
2017			
Net sales	$49,073	$7,565	$56,638
Gross profit	$18,679	$705	$19,384
Gross margin	38.1 %	9.3 %	34.2 %

	Nine Months Ended September 30,		
2018	Beer Related	Brewpubs	Total
Net sales	$143,921	$18,278	$162,199
Gross profit	$52,913	$984	$53,897
Gross margin	36.8 %	5.4 %	33.2 %
2017			
Net sales	$140,359	$21,131	$161,490
Gross profit	$48,569	$1,813	$50,382
Gross margin	34.6 %	8.6 %	31.2 %

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,	
2018	2017	2018	2017
76.9%	77.2%	77.2%	75.2%

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

September 30, 2018	December 31, 2017
70.9%	74.4 %

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Note 10. Significant Stock-Based Plan Activity and Stock-Based Compensation

Stock-Based Compensation
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,	
	2018	2017	2018	2017
Cost of sales	$42	$50	$108	$86
Selling, general and administrative expense	329	341	950	859
Total stock-based compensation expense	$371	$391	$1,058	$945

At September 30, 2018, we had total unrecognized stock-based compensation expense of $2.0 million, which will be recognized over the weighted average remaining vesting period of 1.8 years.

Note 11. Earnings Per Share

The reconciliation between the number of shares used for the basic and diluted per share calculations, as well as other related information, is as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Weighted average common shares used for basic EPS	19,370	19,296	19,338	19,278
Dilutive effect of stock-based awards	175	147	187	123
Shares used for diluted EPS	19,545	19,443	19,525	19,401
Stock-based awards not included in diluted per share calculations as they would be antidilutive	—	—	—	—

Note 12. Commitments and Contingencies

General
We are subject to various claims and pending or threatened lawsuits in the normal course of business. Although we do not anticipate that the resolution of legal proceedings arising in the normal course of business or the proceeding described below will have a material adverse effect on our financial position, results of operations or cash flows, we cannot predict this with certainty.

Legal
On February 28, 2017 and March 6, 2017, respectively, two lawsuits, Sara Cilloni and Simone Zimmer v. Craft Brew Alliance, Inc., and Theodore Broomfield v. Kona Brewing Co. LLC, Kona Brew Enterprises, LLP, Kona Brewery LLC, and Craft Brew Alliance, Inc., were filed in the United States District Court for the Northern Division of California. On April 7, 2017, the two lawsuits were consolidated into a single complaint under the Broomfield case. The lawsuit alleges that the defendants misled customers regarding the state in which Kona Brewing Company beers are manufactured. On April 28, 2017, we filed a motion to dismiss the complaint, which was granted in part and denied in part on September 1, 2017. On September 26, 2018, the court granted Plaintiffs' motion for class

certification, forming a class of persons within the state of California who purchased certain Kona Brewing Company products within the relevant statute of limitations period. Our motion for reconsideration was denied on October 16, 2018. A trial date has been set for August of 2020. We have not recorded any liabilities with respect to the claims.

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Note 13. Termination of Pabst Agreements

Termination of Agreements with Pabst

Effective May 1, 2017, we reached an agreement with Pabst Brewing Company, LLC, and Pabst Northwest Brewing Company, LLC (collectively, "Pabst") to terminate the brewing agreements that provided for brewing selected brands owned by Pabst at our brewery in Woodinville, Washington, through December 31, 2018. In conjunction with the termination of the brewing arrangements, Pabst's option to purchase the Woodinville brewery and adjacent pub pursuant to the Option and Agreement of Purchase and Sale dated as of January 8, 2016 (the "Option Agreement") was also terminated. Pabst agreed to pay us \$2.7 million in connection with the termination of the brewing agreements and Option Agreement. This payment is in addition to the \$1.6 million of contract brewing volume shortfall fees for the 2016 calendar year recognized in the fourth quarter of 2016 and \$1.7 million related to remaining volume shortfalls for the 2016 - 2017 contract year ended March 31, 2017, recognized in the first quarter of 2017. All payments had been received from Pabst by the end of the second quarter of 2017.

See Note 14 for a discussion of the classification of the assets related to our Woodinville brewery as assets held for sale.

Note 14. Assets Held for Sale and Sale of Woodinville, Washington Brewery

Assets held for sale at December 31, 2017 represented the assets related to our Woodinville, Washington Brewery, which was designated as held for sale on May 1, 2017. At the end of 2017, a \$493,000 impairment charge was recorded, as a component of Selling, general and administrative expenses in our Consolidated Statements of Operations, related to the sale of our Woodinville brewery, which was sold on January 12, 2018 to assignees of Sound Commercial Investment Holdings, LLC, for a total purchase price of \$24.5 million (the "Sale Transaction").

The assets that were sold included the real property, equipment, fixtures, mechanical systems, and certain personal property used in our operation of the brewery and adjacent brewpub. We paid real estate brokerage commissions totaling \$0.6 million from the sale proceeds and recorded a gain of \$0.5 million during the quarter ended March 31, 2018 related to the Sale Transaction, which was recorded as a component of Selling, general and administrative expenses in our Consolidated Statements of Operations.

In contemplation of the sale of certain brewing and bottling equipment included in the Sale Transaction, \$0.5 million of the total purchase price was placed in escrow following the closing. If the purchaser of the equipment had sold it for less than \$3.5 million, the shortfall would have been paid to the purchaser up to the amount held in escrow, with the balance, if any, paid to us. The Woodinville brewing and bottling equipment was sold for more than \$3.5 million in the first quarter of 2018 and, accordingly, the \$0.5 million in escrow was remitted to us.

Note 15. Subsequent Events

Amendment to Credit Agreement

On October 10, 2018, we executed a First Amendment (the "Amendment") to our Amended and Restated Credit Agreement with Bank of America, N.A. dated November 30, 2015 (as amended, the "Credit Agreement"). The Credit Agreement provides for a term loan and a revolving line of credit. The primary changes effected by the Amendment were to increase the maximum amount available under the line of credit from \$40.0 million to \$45.0 million and to extend the maturity date of the line of credit from November 30, 2020 to September 30, 2023, which is also the maturity date of the term loan. The maximum amount of the line of credit is subject to loan commitment reductions in the amount of \$750,000 each quarter beginning March 31, 2020. The Amendment also increased the limit on the total amount of investments that we may make in other craft brewers from \$5.0 million to \$10.0 million.

As amended, the Credit Agreement requires us to satisfy the following financial covenants: (i) a Consolidated Leverage Ratio of 3.50 to 1.00 and (ii) a Fixed Charge Coverage Ratio of 1.20 to 1.00. Failure to maintain compliance with these covenants is an event of default and would give BofA the right to declare the entire outstanding loan balance immediately due and payable.

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Purchase of Intellectual Property of Cisco Brewers, Inc. ("Cisco")
On October 10, 2018, we purchased the intellectual property assets of Cisco, relating to its malt beverage products (the "Products"), including all trademarks, logos, and goodwill, as well as raw materials, finished goods, work in process, packaging materials, specified contract rights, and other assets relating to the manufacture and sale of those Products (the "Purchase Transaction"). We paid $23.0 million in cash (the "Purchase Price"), assumed certain liabilities relating to the acquired assets, and agreed to pay an additional amount as a cash incentive payment based on Product shipments in 2023 in excess of a specified number of barrels. The Purchase Transaction excluded certain assets owned by Cisco, including intellectual property rights associated with its operation of its brewpub in Nantucket and a taproom in Boston, Massachusetts, as well as our brewpub in Portsmouth, New Hampshire, which Cisco began operating in June 2018. Of the Purchase Price, $690,000 was placed in escrow to cover potential liabilities associated with certain third party and direct claims relating to the assets purchased and liabilities assumed in the Purchase Transaction.

We also entered into an agreement permitting Cisco to operate up to three initial brewpubs and any number of “pop-up” locations, royalty-free under a non-exclusive license arrangement, using the intellectual property rights associated with the Products acquired by us in the Purchase Transaction. The license agreement permits Cisco to operate additional brewpubs upon the payment of a $50,000 annual royalty per brewpub.

As of the date of this report, the initial accounting for the Purchase Transaction was incomplete; therefore, we have not disclosed how we accounted for the transaction, including the amounts recognized for the transaction and the line item in the financial statements in which each amount is recognized, the amount of acquisition related costs, amounts recognized as expenses and the line item in the income statement in which each expense is recognized, and the issuance cost not recognized as expense.

Agreement to Acquire Appalachian Mountain Brewery ("AMB")
On October 10, 2018, we entered into an agreement to acquire substantially all the assets of AMB, subject to regulatory approval by the U.S. Alcohol and Tobacco Tax and Trade Bureau and the approval of holders of a majority of the outstanding shares of voting capital stock of AMB.

Increase in Ownership Interest of Wynwood
On October 10, 2018, we increased our ownership interest in Wynwood, which operates a brewery and taproom in Miami, Florida, from 24.5% to 100%. Wynwood is now a wholly owned subsidiary.

Primary Reasons Behind Transactions
We completed the acquisition of Cisco's intellectual property, increased our ownership interest in Wynwood and entered into an agreement to acquire substantially all the assets of AMB to unlock the full potential of each brand. Over the past several years, our partnerships with North Carolina-based AMB, Massachusetts-based Cisco, and Florida-based Wynwood have bolstered our brand portfolio with strong local brands and breweries in key markets, complementing Kona as the anchor of our portfolio strategy. Further, these partners have supported our strategic brewery evolution by leveraging the capability and location of the Portsmouth, New Hampshire brewery to increase production for partner brands as we rebalanced our brewing footprint. We plan to increase marketing spend and resources to fuel each brand's growth and help drive continued innovation and greater levels of support for their local communities.

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, 2017 (“2017 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 2017 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.

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Overview

Craft Brew Alliance, Inc. ("CBA") is the seventh largest craft brewing company in the U.S. and a leader in brewing, branding, and bringing to market world-class American craft beers.

CBA’s distinctive portfolio combines the power of dynamic national lifestyle brands with strong regional craft breweries rooted in community. Our national portfolio is led by Kona Brewing Co., one of the largest craft brands in the U.S., and also includes Omission Brewing Co., which is the leader in the gluten-removed beer segment. Our regional portfolio spans some of the country's largest beer states, with Appalachian Mountain Brewery, Cisco Brewers, Redhook Brewery, Square Mile Cider Co., Widmer Brothers Brewing, and Wynwood Brewing Co. We nurture the growth and development of our brands in today’s increasingly competitive beer market through our state-of-the-art brewing and distribution capability, integrated sales and marketing infrastructure, and strong focus on partnerships, local community and sustainability.

CBA was formed in 2008 through the merger of Redhook Brewery and Widmer Brothers Brewing, the two largest craft brewing pioneers in the Northwest at the time. Following a successful strategic brewing and distribution partnership, Kona Brewing Co. joined CBA in 2010. As part of CBA, Kona has expanded its reach across all 50 U.S. states and approximately 30 international markets, while remaining deeply rooted in its home of Hawaii.

As competition in the craft beer market continues to grow and consumers increasingly demand local offerings, CBA has expanded its portfolio of brands and maximized its brewing footprint, initially through strategic partnerships with Appalachian Mountain Brewery ("AMB"), based in Boone, North Carolina; Cisco Brewers ("Cisco"), based in Nantucket, Massachusetts; and Wynwood Brewing Co. ("Wynwood"), based in Miami, Florida. Through these strategic partnerships, we gained local relevance in select beer geographies, while our partner breweries acquired access to our world-class leadership and national brewing and sales infrastructure to grow their brands. In the third quarter of 2017, we acquired a 24.5% ownership interest in Wynwood and acquired the remaining ownership interest in Wynwood in October 2018. Also in October 2018, we purchased the intellectual property assets of Cisco and entered into an agreement to acquire substantially all the assets of AMB. See Note 15 of Notes to Consolidated Financial Statements included in Part I, Item 1 of this Form 10-Q for additional information regarding these transactions.

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

We proudly brew our craft beers in three company-owned breweries located in Portland, Oregon; Portsmouth, New Hampshire; and Kailua-Kona, Hawaii. In 2016, we entered into a contract brewing agreement with A-B Commercial Strategies, LLC (“ABCS”), an affiliate of Anheuser-Busch, LLC (“A-B”), and have been producing some CBA beers at ABCS's brewery in Fort Collins, Colorado since 2017. Additionally, we own and operate three small innovation breweries, which are primarily used for small batch production and experimental, limited-release beers that could potentially scale for larger production; these innovation breweries are located in Portland, Oregon, Seattle, Washington and Portsmouth, New Hampshire.

We distribute our beers to retailers through wholesalers that are aligned with the A-B network. These sales are made pursuant to a Master Distributor Agreement (the “A-B Distributor Agreement”) with A-B, which extends through 2028. 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. Our Kona and Omission brands are distributed nationally and internationally, while we focus distribution of our regional brands in their respective home markets. 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.

On January 30, 2018, we entered into a Contract Brewing Agreement (the “Brewing Agreement”) with Anheuser-Busch Companies, LLC ("ABC"), an affiliate of A-B, pursuant to which we brew, package, and palletize certain malt beverage products of A-B's craft breweries at our Portland, Oregon, and Portsmouth, New Hampshire, breweries as selected by ABC. Under the terms of the Brewing Agreement, ABC pays us a per barrel fee that varies based on the annual volume of the specified product brewed by us, plus (a) our actual incremental costs of brewing the product and (b) certain capital costs and costs of graphics and labeling that we incur in connection with the brewed products. This Brewing Agreement will expire on December 31, 2018, unless the arrangement is extended at the mutual agreement of the parties.

We operate in two segments: Beer Related operations and Brewpubs operations. Beer Related operations include the brewing, and domestic and international sales, of craft beers and ciders from our breweries. Brewpubs operations primarily include our five brewpubs, three 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
2018	$162.2 million	$4.7 million	587,400
2017	$161.5 million	$1.7 million	586,300

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,	
	2018	2017	2018	2017
Sales	105.2 %	106.0 %	105.4 %	105.9 %
Less excise taxes	(5.2)	(6.0)	(5.4)	(5.9)
Net sales	100.0	100.0	100.0	100.0
Cost of sales	68.4	65.8	66.8	68.8
Gross profit	31.6	34.2	33.2	31.2
Selling, general and administrative expenses	31.6	28.8		