

REDHOOK ALE BREWERY INC

Form 10-Q

November 13, 2007

**Table of Contents**

**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, 2007**  
**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**  
**REDHOOK ALE BREWERY, INCORPORATED**  
**(Exact name of registrant as specified in its charter)**

**Washington**  
(State or other jurisdiction of  
incorporation or organization)

**91-1141254**  
(I.R.S. Employer  
Identification No.)

**14300 NE 145<sup>th</sup> Street, Suite 210**  
**Woodinville, Washington 98072-9045**  
(Address of principal executive offices)  
**(425) 483-3232**

(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 is a large accelerated filer, an accelerated filer or a non-accelerated filer. Check one:

Large Accelerated Filer  Accelerated Filer  Non-accelerated Filer

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 November 9, 2007 was 8,354,239.

**REDHOOK ALE BREWERY, INCORPORATED**  
**FORM 10-Q**  
**For The Quarterly Period Ended September 30, 2007**  
**TABLE OF CONTENTS**

|  | <b>Page</b> |
|--|-------------|
| <b><u>PART I. Financial Information</u></b>  |             |
| <u>ITEM 1. Financial Statements</u>  |             |
| <u>Balance Sheets as of September 30, 2007 and December 31, 2006</u>                                 | 3           |
| <u>Statements of Operations for the Three and Nine Months Ended September 30, 2007 and 2006</u>      | 4           |
| <u>Statements of Cash Flows for the Nine Months Ended September 30, 2007 and 2006</u>                | 5           |
| <u>Notes to Financial Statements</u>   | 6           |
| <u>ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 14          |
| <u>ITEM 3. Quantitative and Qualitative Disclosures about Market Risk</u>                            | 34          |
| <u>ITEM 4. Controls and Procedures</u>   | 34          |
| <b><u>PART II. Other Information</u></b>   |             |
| <u>ITEM 1. Legal Proceedings</u>   | 34          |
| <u>ITEM 1A. Risk Factors</u>   | 34          |
| <u>ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>                           | 35          |
| <u>ITEM 3. Defaults Upon Senior Securities</u>   | 35          |
| <u>ITEM 4. Submission of Matters to a Vote of Security Holders</u>                                   | 36          |
| <u>ITEM 5. Other Information</u>   | 36          |
| <u>ITEM 6. Exhibits</u>  | 36          |
| <u>EXHIBIT 31.1</u>  |             |
| <u>EXHIBIT 31.2</u>  |             |
| <u>EXHIBIT 31.3</u>  |             |
| <u>EXHIBIT 32.1</u>  |             |
| <u>EXHIBIT 32.2</u>  |             |
| <u>EXHIBIT 32.3</u>  |             |

**Table of Contents****PART I.****ITEM 1. Financial Statements**

**REDHOOK ALE BREWERY, INCORPORATED**  
**BALANCE SHEETS**

|   | <b>September<br/>30,<br/>2007</b> | <b>December 31,<br/>2006</b> |
|---|-----------------------------------|------------------------------|
|   | (Unaudited)                       |                              |
| <b>ASSETS</b>   |                                   |                              |
| Current assets:   |                                   |                              |
| Cash and cash equivalents   | \$ 10,593,862                     | \$ 9,435,073                 |
| Accounts receivable, net of allowance for doubtful accounts of \$34,854 and \$68,808 in 2007 and 2006, respectively                                     | 2,545,910                         | 1,842,388                    |
| Trade receivable from Craft Brands  | 846,391                           | 854,507                      |
| Inventories, net  | 2,662,172                         | 2,571,732                    |
| Deferred income tax asset, net  | 722,688                           | 506,886                      |
| Other   | 321,614                           | 203,594                      |
| Total current assets  | 17,692,637                        | 15,414,180                   |
| Fixed assets, net   | 56,815,550                        | 58,076,434                   |
| Investment in Craft Brands  | 115,868                           | 127,555                      |
| Other assets  | 496,227                           | 222,573                      |
| Total assets  | \$ 75,120,282                     | \$ 73,840,742                |
| <b>LIABILITIES AND COMMON STOCKHOLDERS EQUITY</b>   |                                   |                              |
| Current liabilities:  |                                   |                              |
| Accounts payable  | \$ 2,403,103                      | \$ 2,233,689                 |
| Trade payable to Craft Brands   | 478,156                           | 324,900                      |
| Accrued salaries, wages and payroll taxes   | 1,397,277                         | 1,547,482                    |
| Refundable deposits   | 2,705,032                         | 2,153,127                    |
| Other accrued expenses  | 770,318                           | 380,394                      |
| Current portion of long-term debt and capital lease obligations   | 465,281                           | 464,648                      |
| Total current liabilities   | 8,219,167                         | 7,104,240                    |
| Long-term debt and capital lease obligations, net of current portion  | 3,972,667                         | 4,321,616                    |
| Deferred income tax liability, net  | 1,776,229                         | 1,548,699                    |
| Other liabilities   | 213,034                           | 173,768                      |
| Common stockholders equity:   |                                   |                              |
| Common stock, par value \$0.005 per share, authorized, 50,000,000 shares; issued and outstanding, 8,354,239 shares in 2007 and 8,281,489 shares in 2006 | 41,771                            | 41,407                       |
| Additional paid-in capital  | 69,303,848                        | 68,977,402                   |

Edgar Filing: REDHOOK ALE BREWERY INC - Form 10-Q

|   |               |               |
|---|---------------|---------------|
| Retained earnings (deficit)                       | (8,406,434)   | (8,326,390)   |
| Total common stockholders' equity                 | 60,939,185    | 60,692,419    |
| Total liabilities and common stockholders' equity | \$ 75,120,282 | \$ 73,840,742 |

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

3

---

**Table of Contents****REDHOOK ALE BREWERY, INCORPORATED**  
**STATEMENTS OF OPERATIONS**

(Unaudited)

|   | <b>Three Months Ended</b> |               | <b>Nine Months Ended</b> |               |
|---|---------------------------|---------------|--------------------------|---------------|
|   | <b>September 30,</b>      |               | <b>September 30,</b>     |               |
|   | <b>2007</b>               | <b>2006</b>   | <b>2007</b>              | <b>2006</b>   |
| Sales   | \$ 12,357,004             | \$ 10,813,132 | \$ 35,383,514            | \$ 30,625,893 |
| Less excise taxes                             | 1,285,374                 | 1,169,670     | 3,866,318                | 3,246,259     |
| Net sales                                     | 11,071,630                | 9,643,462     | 31,517,196               | 27,379,634    |
| Cost of sales                                 | 9,653,674                 | 8,011,838     | 27,307,237               | 23,364,532    |
| Gross profit                                  | 1,417,956                 | 1,631,624     | 4,209,959                | 4,015,102     |
| Selling, general and administrative expenses  | 2,429,821                 | 1,776,501     | 6,609,990                | 5,289,971     |
| Income from equity investment in Craft Brands | 562,210                   | 743,245       | 2,210,336                | 2,076,168     |
| Operating income (loss)                       | (449,655)                 | 598,368       | (189,695)                | 801,299       |
| Interest expense                              | 80,875                    | 92,094        | 246,093                  | 259,239       |
| Other income, net                             | 120,589                   | 56,783        | 404,996                  | 198,844       |
| Income (loss) before income taxes             | (409,941)                 | 563,057       | (30,792)                 | 740,904       |
| Income tax provision (benefit)                | (121,373)                 | 199,197       | 49,252                   | 218,245       |
| Net income (loss)                             | \$ (288,568)              | \$ 363,860    | \$ (80,044)              | \$ 522,659    |
| Basic earnings (loss) per share               | \$ (0.03)                 | \$ 0.04       | \$ (0.01)                | \$ 0.06       |
| Diluted earnings (loss) per share             | \$ (0.03)                 | \$ 0.04       | \$ (0.01)                | \$ 0.06       |

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

**Table of Contents**

**REDHOOK ALE BREWERY, INCORPORATED**  
**STATEMENTS OF CASH FLOWS**  
(Unaudited)

|   | <b>Nine Months Ended</b> |              |
|---|--------------------------|--------------|
|   | <b>September 30,</b>     |              |
|   | <b>2007</b>              | <b>2006</b>  |
| <b>Operating Activities</b>   |                          |              |
| Net income  | \$ (80,044)              | \$ 522,659   |
| Adjustments to reconcile net income to net cash provided by operating activities:         |                          |              |
| (Gain) loss on disposition of fixed assets  | (2,757)                  |              |
| Depreciation and amortization   | 2,133,764                | 2,256,996    |
| Income from equity investment in Craft Brands less than (in excess of) cash distributions | 11,687                   | (81,382)     |
| Stock-based compensation  | 169,400                  | 53,760       |
| Deferred income taxes   | 11,728                   | 218,245      |
| Changes in operating assets and liabilities   | (159,295)                | 455,790      |
| Net cash provided by operating activities   | 2,084,483                | 3,426,068    |
| <b>Investing Activities</b>   |                          |              |
| Expenditures for fixed assets   | (1,092,385)              | (811,868)    |
| Proceeds from disposition of fixed assets   | 357,597                  |              |
| Net cash used in investing activities   | (734,788)                | (811,868)    |
| <b>Financing Activities</b>   |                          |              |
| Principal payments on debt and capital lease obligations                                  | (348,316)                | (345,267)    |
| Issuance of common stock  | 157,410                  | 55,183       |
| Net cash used in financing activities   | (190,906)                | (290,084)    |
| Increase (decrease) in cash and cash equivalents  | 1,158,789                | 2,324,116    |
| Cash and cash equivalents:  |                          |              |
| Beginning of period   | 9,435,073                | 6,435,609    |
| End of period   | \$ 10,593,862            | \$ 8,759,725 |

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

**Table of Contents**

**REDHOOK ALE BREWERY, INCORPORATED**  
**NOTES TO FINANCIAL STATEMENTS**  
(Unaudited)

**1. Basis of Presentation**

The accompanying financial statements and related notes of Redhook Ale Brewery, Incorporated (the Company or the Redhook ) should be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2006. These financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Accordingly, certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted pursuant to such rules and regulations. These financial statements are unaudited but, in the opinion of management, reflect all material adjustments necessary to present fairly the financial position, results of operations and cash flows of the Company for the periods presented. All such adjustments were of a normal, recurring nature. The results of operations for such interim periods are not necessarily indicative of the results of operations for the full year.

**2. Agreement and Plan of Merger**

On November 13, 2007, the Company entered into an Agreement and Plan of Merger (the Merger Agreement ) with Widmer Brothers Brewing Company, an Oregon corporation ( Widmer ), pursuant to which Widmer will merge with and into Redhook, and each outstanding share of capital stock of Widmer (other than any dissenting shares entitled to statutory appraisal rights under Oregon law) will be converted into the right to receive 2.1551 shares of Redhook common stock. The merger will result in Widmer shareholders and existing Redhook shareholders each holding approximately 50% of the outstanding shares of the combined company (assuming that no Widmer shareholder exercises statutory appraisal rights). In connection with the merger, Redhook will change its name to Craft Brewers Alliance, Inc.

Redhook and Widmer have made customary representations, warranties and covenants in the Merger Agreement, including, among others, a covenant by Redhook to cause a meeting of Redhook shareholders to be held to approve issuance of the shares of common stock issuable in the merger. Redhook has also agreed to use commercially reasonable efforts to cause the following individuals to be appointed to the following indicated positions immediately after consummation of the merger: Kurt Widmer, Chairman of the Board; Paul Shipman, Chairman Emeritus and Consultant to the Board; David Mickelson, current President and Chief Operating Officer of Redhook, as Co-Chief Executive Officer; and Terry Michaelson, current President of Craft Brands Alliance LLC, as Co-Chief Executive Officer. Redhook has also agreed to appoint certain other officers of Widmer as officers of Redhook following consummation of the merger.

The merger is subject to customary conditions to closing, including (i) regulatory approval from the Alcohol and Tobacco Tax and Trade Bureau and state licensing agencies, (ii) approval of Anheuser-Busch, Incorporated, (iii) approval by the requisite vote of Redhook shareholders of the issuance of the shares of common stock issuable in the merger, (iv) approval of the merger by the requisite vote of Widmer shareholders, (v) accuracy of the representations and warranties made by the parties under the Merger Agreement, (vi) compliance by the parties with their covenants, and (vii) the absence of any material adverse change to either Redhook or Widmer.

The Merger Agreement was filed as Exhibit 2.1 to the Form 8-K filed on November 13, 2007.

In connection with the discussions leading up to the Merger Agreement, the Company has incurred approximately \$282,000 and \$452,000 in legal, consulting and meeting costs during the three and nine months ended September 30, 2007, respectively. These costs are reflected in the statement of operations as selling, general and administrative expenses.

The Company adopted a Company-wide severance plan that permits the payment of severance benefits to all full-time employees, other than executive officers, in the event that an employee's employment is terminated as a result of a merger or other business combination with Widmer Brothers Brewing Company.



**Table of Contents**

**REDHOOK ALE BREWERY, INCORPORATED**  
**NOTES TO FINANCIAL STATEMENTS (continued)**  
(Unaudited)

**3. Inventories**

Inventories consist of the following:

|                              | <b>September<br/>30,<br/>2007</b> | <b>December<br/>31,<br/>2006</b> |
|------------------------------|-----------------------------------|----------------------------------|
| Raw materials                | \$ 344,114                        | \$ 666,938                       |
| Work in process              | 913,287                           | 622,352                          |
| Finished goods, net          | 381,155                           | 247,333                          |
| Promotional merchandise, net | 420,621                           | 538,339                          |
| Packaging materials          | 602,995                           | 496,770                          |
|                              | <b>\$ 2,662,172</b>               | <b>\$ 2,571,732</b>              |

Work in process is beer held in fermentation tanks prior to the filtration and packaging process. As of September 30, 2007, finished goods and promotional merchandise are net of a \$64,000 valuation reserve.

**4. Craft Brands Alliance LLC**

On July 1, 2004, the Company entered into agreements with Widmer with respect to the operation of a joint venture sales and marketing entity, Craft Brands Alliance LLC ( Craft Brands ). Pursuant to these agreements, the Company manufactures and sells its product to Craft Brands at a price substantially below wholesale pricing levels; Craft Brands, in turn, advertises, markets, sells and distributes the product to wholesale outlets in the western United States pursuant to a distribution agreement between Craft Brands and Anheuser-Busch, Incorporated ( A-B ).

The Company and Widmer have entered into a restated operating agreement with Craft Brands, as amended (the Operating Agreement ), that governs the operations of Craft Brands and the obligations of its members, including capital contributions, loans and allocation of profits and losses.

The Operating Agreement requires the Company to make certain capital contributions to support the operations of Craft Brands. Contemporaneous with the execution of the Operating Agreement, the Company made a 2004 sales and marketing capital contribution in the amount of \$250,000. The agreement designated that this sales and marketing capital contribution be used by Craft Brands for expenses related to the marketing, advertising and promotion of the Company s products. The Operating Agreement also requires an additional sales and marketing contribution in 2008 if the volume of sales of Redhook products in 2007 in the Craft Brands territory is less than 92% of the volume of sales of Redhook products in 2003 in the Craft Brands territory. In 2007, Widmer and Redhook entered into an amendment to the Operating Agreement to reduce the Redhook 2008 sales and marketing contribution to reflect the Company s commitment to expand the production capacity of its Washington and New Hampshire breweries to produce more Widmer products. Redhook s 2008 sales and marketing contribution, if one is required, cannot exceed \$310,000 and will be required to be paid by the Company in no more than three equal installments made on or before February 1, 2008, April 1, 2008 and July 1, 2008. If the contemplated merger with Widmer does not occur, the Company believes that it will be required to pay the 2008 sales and marketing contribution of \$310,000 in accordance with the terms of the agreement. Because sales in the craft beer industry generally reflect a degree of seasonality and the Company has historically operated with little or no backlog, the Company s ability to predict sales for future periods is limited. Accordingly, the Company cannot predict to what degree, if at all, the Company will be required to make a 2008 sales and marketing contribution. Widmer has a similar obligation under the Operating Agreement with respect to a 2008 sales and marketing capital contribution that is capped at \$750,000. The Operating Agreement also obligates the Company and Widmer to make other additional capital contributions only upon the request and consent of the Craft Brands board of directors.



**Table of Contents**

**REDHOOK ALE BREWERY, INCORPORATED**  
**NOTES TO FINANCIAL STATEMENTS (continued)**  
(Unaudited)

The Operating Agreement also requires the Company and Widmer to make loans to Craft Brands to assist Craft Brands in conducting its operations and meeting its obligations. To the extent that cash flow from operations and borrowings from financial institutions is not sufficient for Craft Brands to meet its obligations, the Company and Widmer are obligated to lend to Craft Brands the funds the president of Craft Brands deems necessary to meet such obligations. As of September 30, 2007 and December 31, 2006, there were no loan obligations due to the Company. The Operating Agreement also addresses the allocation of profits and losses of Craft Brands. After giving effect to the allocation of the sales and marketing capital contribution, if any, and after giving effect to income attributable to the shipments of the Kona brand, which was shared differently between the Company and Widmer through 2006, the remaining profits and losses of Craft Brands are allocated between the Company and Widmer based on the cash flow percentages of 42% and 58%, respectively. Net cash flow, if any, will generally be distributed monthly to the Company and Widmer based upon these cash flow percentages. No distribution will be made to the Company or Widmer unless, after the distribution is made, the assets of Craft Brands will be in excess of its liabilities, with the exception of liabilities to members, and Craft Brands will be able to pay its debts as they become due in the ordinary course of business.

The Company has assessed its investment in Craft Brands pursuant to the provisions of Financial Accounting Standards Board ( FASB ) Interpretation No. 46 Revised, *Consolidation of Variable Interest Entities an Interpretation of ARB No. 51* ( FIN No. 46R ). FIN No. 46R clarifies the application of consolidation accounting for certain entities that do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties or in which equity investors do not have the characteristics of a controlling financial interest; these entities are referred to as variable interest entities. Variable interest entities within the scope of FIN No. 46R are required to be consolidated by their primary beneficiary. The primary beneficiary of a variable interest entity is determined to be the party that absorbs a majority of the entity's expected losses, receives a majority of its expected returns, or both. FIN No. 46R also requires disclosure of significant variable interests in variable interest entities for which a company is not the primary beneficiary. The Company has concluded that its investment in Craft Brands meets the definition of a variable interest entity but that the Company is not the primary beneficiary. In accordance with FIN No. 46R, the Company has not consolidated the financial statements of Craft Brands with the financial statements of the Company, but instead accounted for its investment in Craft Brands under the equity method, as outlined by Accounting Principle Board Opinion ( APB ) No. 18, *The Equity Method of Accounting for Investments in Common Stock*. The equity method requires that the Company recognize its share of the net earnings of Craft Brands by increasing its investment in Craft Brands on the Company's balance sheet and recognizing income from equity investment in the Company's statement of operations. A cash distribution or the Company's share of a net loss reported by Craft Brands is reflected as a decrease in investment in Craft Brands on the Company's balance sheet. The Company does not control the amount or timing of cash distributions by Craft Brands. The Company will periodically review its investment in Craft Brands to ensure that it complies with the guidelines prescribed by FIN No. 46R.

For the three months ended September 30, 2007 and 2006, the Company's share of Craft Brands' net income totaled \$562,000 and \$743,000, respectively. During the three months ended September 30, 2007 and 2006, the Company received cash distributions of \$1,185,000 and \$930,000, respectively, representing its share of the net cash flow of Craft Brands.

For the nine months ended September 30, 2007 and 2006, the Company's share of Craft Brands' net income totaled \$2,210,000 and \$2,076,000, respectively. During the nine months ended September 30, 2007 and 2006, the Company received cash distributions of \$2,222,000 and \$1,995,000, respectively, representing its share of the net cash flow of Craft Brands.

As of September 30, 2007 and December 31, 2006, the Company's investment in Craft Brands totaled \$116,000 and \$128,000, respectively.



**Table of Contents**

**REDHOOK ALE BREWERY, INCORPORATED**  
**NOTES TO FINANCIAL STATEMENTS (continued)**  
(Unaudited)

For the three months ended September 30, 2007, shipments of the Company's products to Craft Brands represented approximately 39% of total Company shipments, or 31,300 barrels. For the three months ended September 30, 2006, shipments of the Company's products to Craft Brands represented 42% of total Company shipments, or 30,600 barrels. For the nine months ended September 30, 2007, shipments of the Company's products to Craft Brands represented approximately 38% of total Company shipments, or 92,700 barrels. For the nine months ended September 30, 2006, shipments of the Company's products to Craft Brands represented 46% of total Company shipments, or 94,700 barrels. In conjunction with the sale of Redhook product to Craft Brands, the Company's balance sheets as of September 30, 2007 and December 31, 2006 reflect a trade receivable due from Craft Brands of approximately \$846,000 and \$855,000, respectively. In conjunction with the sale of Redhook products in Washington state, where state liquor regulations require that the Company sell its product directly to third-party beer distributors, the Company's balance sheets as of September 30, 2007 and December 31, 2006 reflect a trade payable to Craft Brands, based upon a contractually determined formula, of approximately \$478,000 and \$325,000, respectively.

**5. Common Stockholders' Equity**

In conjunction with the exercise of stock options granted under the Company's stock option plans, the Company issued 48,600 shares of the Company's common stock (Common Stock) and received proceeds on exercise totaling \$157,000 during the nine months ended September 30, 2007. During the nine months ended September 30, 2006, the Company issued 42,400 shares of Common Stock and received proceeds on exercise totaling \$55,000.

Following shareholder approval of the Redhook Ale Brewery, Incorporated 2007 Stock Incentive Plan (the 2007 Plan) at the May 22, 2007 Annual Meeting of Shareholders, the board of directors approved the following fully-vested stock grants under the 2007 Plan: 2,300 shares of Common Stock to each independent, non-employee director, 10,000 shares of Common Stock to the Chief Executive Officer Paul Shipman, and 5,000 shares of Common Stock to President David Mickelson. In conjunction with these stock grants, the Company issued 24,200 shares of Common Stock and recognized stock-based compensation expense of \$169,400 in the nine months ended September 30, 2007.

**6. Earnings (Loss) per Share**

The Company follows FASB Statement of Financial Accounting Standard (SFAS) No. 128, *Earnings per Share*. Basic earnings (loss) per share is calculated using the weighted average number of shares of Common Stock outstanding. The calculation of adjusted weighted average shares outstanding for purposes of computing diluted earnings (loss) per share includes the dilutive effect of all outstanding stock options for periods when the Company reports net income. The calculation uses the treasury stock method and the as if converted method in determining the resulting incremental average equivalent shares outstanding as applicable.

**Table of Contents**

**REDHOOK ALE BREWERY, INCORPORATED**  
**NOTES TO FINANCIAL STATEMENTS (continued)**

(Unaudited)

The following table sets forth the computation of basic and diluted earnings (loss) per common share:

|  | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |             |
|--|---------------------------|-------------|--------------------------|-------------|
|  | <b>September 30,</b>      |             | <b>September 30,</b>     |             |
|  | <b>2007</b>               | <b>2006</b> | <b>2007</b>              | <b>2006</b> |
| Numerator for basic and diluted net income (loss) per share net income (loss)                | \$ (288,568)              | \$ 363,860  | \$ (80,044)              | \$ 522,659  |
| Denominator for basic net income (loss) per share weighted average common shares outstanding | 8,349,976                 | 8,260,167   | 8,323,764                | 8,242,628   |
| Dilutive effect of stock options on weighted average common shares                           |                           | 267,011     |                          | 260,974     |
| Denominator for diluted net income (loss) per share  | 8,349,976                 | 8,527,178   | 8,323,764                | 8,503,602   |
| Basic net income (loss) per share  | \$ (0.03)                 | \$ 0.04     | \$ (0.01)                | \$ 0.06     |
| Diluted net income (loss) per share  | \$ (0.03)                 | \$ 0.04     | \$ (0.01)                | \$ 0.06     |

**7. Stock-Based Compensation**

In 2007, the board of directors adopted and the shareholders approved the Redhook Ale Brewery, Incorporated 2007 Stock Incentive Plan. The 2007 Plan provides for stock options, restricted stock, restricted stock units, performance awards and stock appreciation rights. While incentive stock options may only be granted to employees, awards other than incentive stock options may be granted to employees and directors. The 2007 Plan is administered by the compensation committee of the board of directors. A maximum of 100,000 shares of Common Stock are authorized for issuance under the 2007 Plan. As of September 30, 2007, 75,800 shares of Common Stock are available for future issuance under the 2007 Plan.

The compensation committee may also grant non-qualified stock options and incentive stock options to employees, non-employee directors and independent consultants or advisors under the 2002 Stock Option Plan (the 2002 Plan ). As of September 30, 2007, 97,559 options were available for future grant under the 2002 Plan. The Company issues new shares of Common Stock upon exercise of stock options.

The Company also maintains the 1992 Stock Incentive Plan (the 1992 Plan ) and the Directors Stock Option Plan (the Directors Plan ) under which non-qualified stock options and incentive stock options were granted to employees and non-employee directors through October 2002. Although the 1992 Plan and the Directors Plan both expired in October 2002, preventing further option grants, the provisions of these plans remain in effect until all options terminate or are exercised.

Prior to the January 1, 2006 adoption of SFAS No. 123R, *Share-Based Payment*, the Company accounted for its employee and director stock-based compensation plans using the intrinsic value method, as prescribed by APB No. 25, *Accounting for Stock Issued to Employees*. Under the intrinsic value method, no stock-based compensation

expense had been recognized in the Company's statement of operations because the exercise price of the Company's stock options granted to employees and directors equaled the fair market value of the underlying Common Stock on the date of grant. As permitted, for all periods prior to January 1, 2006, the Company elected to adopt the disclosure only provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*, as amended by SFAS No. 148.

**Table of Contents**

**REDHOOK ALE BREWERY, INCORPORATED**  
**NOTES TO FINANCIAL STATEMENTS (continued)**  
(Unaudited)

On November 29, 2005, the board of directors of the Company approved an acceleration of vesting of all of the Company's unvested stock options (the "Acceleration"). The Acceleration was effective for stock options outstanding as of December 30, 2005. These options were granted under the 1992 Plan and 2002 Plan. As a result of the Acceleration, options to acquire approximately 136,000 shares of the Company's Common Stock, or 16% of total outstanding options, became exercisable on December 30, 2005. Of the approximately 136,000 shares subject to the Acceleration, options to acquire approximately 70,000 shares of the Company's Common Stock at an exercise price of \$1.865 would have otherwise fully vested in August 2006, and options to acquire approximately 66,000 shares of the Company's Common Stock at an exercise price of \$2.019 would have otherwise vested in August 2006 and August 2007. The Acceleration did not have a material impact on 2006 or 2007 results of operations.

On January 1, 2006, the Company adopted SFAS No. 123R, *Share-Based Payment*, which revises SFAS No. 123 and supersedes APB No. 25. SFAS No. 123R requires all share-based payments to employees and directors be recognized as expense in the statement of operations based on their fair values and vesting periods. The Company is required to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in the Company's statement of operations. The Company elected to follow the "modified prospective" transition method, one of two methods prescribed by the standard, for implementing SFAS No. 123R. Under the modified prospective method, compensation cost is recognized beginning with the effective date (i) based on the requirements of SFAS No. 123R for all share-based payments granted after the effective date and (ii) based on the requirements of SFAS No. 123 for all awards granted to employees prior to the effective date of SFAS No. 123R that remain unvested on the effective date.

On May 22, 2007, the board of directors approved a grant of 2,300 shares of fully-vested Common Stock to each independent, non-employee director, 10,000 shares of fully-vested Common Stock to the Chief Executive Officer Paul Shipman, and 5,000 shares of fully-vested Common Stock to President David Mickelson under the 2007 Plan. In conjunction with these stock grants, the Company issued 24,200 shares of Common Stock and recognized stock-based compensation expense of \$169,400 in the Company's statement of operations for the nine months ended September 30, 2007. Because no stock options were granted during the nine months ended September 30, 2007, no stock-based compensation expense related to stock options was recognized in the Company's statement of operations for the nine months ended September 30, 2007.

Stock-based compensation expense recognized in the Company's statement of operations for the nine months ended September 30, 2006 totaled \$54,000 and is attributable to stock options granted to non-employee directors (other than A-B designated directors).

No stock-based compensation expense was recognized in 2007 or 2006 for stock options outstanding as of December 31, 2005 because these options were fully vested prior to the January 1, 2006 adoption of SFAS No. 123R.



**Table of Contents**

**REDHOOK ALE BREWERY, INCORPORATED**  
**NOTES TO FINANCIAL STATEMENTS (continued)**  
(Unaudited)

Presented below is a summary of stock option plans activity for the nine months ended September 30, 2007:

|                                   | Shares<br>Subject to<br>Options | Weighted<br>Average<br>Exercise<br>Price per<br>Share | Weighted<br>Average<br>Remaining<br>Contractual<br>Life (Yrs) | Aggregate<br>Intrinsic<br>Value |
|-----------------------------------|---------------------------------|---|---|---------------------------------|
| Outstanding at January 1, 2007    | 783,440                         | \$2.89  | 4.10  | \$1,950,534                     |
| Granted                           |                                 |   |   |                                 |
| Exercised                         | (48,550)                        | \$3.24  |   |                                 |
| Canceled                          | (39,050)                        | \$7.99  |   |                                 |
| Outstanding at September 30, 2007 | 695,840                         | \$2.58  | 3.58  | \$2,570,786                     |
| Exercisable at September 30, 2007 | 695,840                         | \$2.58  | 3.58  | \$2,570,786                     |

The aggregate intrinsic value of options outstanding and exercisable at September 30, 2007 and January 1, 2007 is calculated based on the difference between the stock closing price as reported by NASDAQ for those dates and the exercise price of the shares. The applicable stock closing prices as of September 30, 2007 and January 1, 2007 were \$6.27 and \$5.20, respectively. As of September 30, 2007 and 2006, there was no unrecognized stock-based compensation expense related to unvested stock options. During the nine months ended September 30, 2007 and 2006, the total intrinsic value of stock options exercised was \$168,000 and \$106,000, respectively.

The following table summarizes information for options currently outstanding and exercisable at September 30, 2007:

| Range of Exercise<br>Prices | Number<br>Outstanding<br>& Exercisable | Average<br>Remaining<br>Contractual<br>Life (Yrs) | Weighted<br>Average<br>Exercise<br>Price |
|-----------------------------|--|---|--|
| \$1.485 to \$1.815          | 8,000                                  | 3.14  | \$1.650                                  |
| \$1.816 to \$1.865          | 324,840                                | 3.84  | \$1.865                                  |
| \$1.866 to \$2.180          | 144,834                                | 4.95  | \$2.028                                  |
| \$2.181 to \$3.150          | 34,666                                 | 6.72  | \$2.768                                  |
| \$3.151 to \$5.730          | 183,500                                | 1.47  | \$4.269                                  |
| \$1.485 to \$5.730          | 695,840                                | 3.58  | \$2.575                                  |

**Table of Contents**

**REDHOOK ALE BREWERY, INCORPORATED**  
**NOTES TO FINANCIAL STATEMENTS (continued)**  
(Unaudited)

**8. Income Taxes**

The Company records federal and state income taxes in accordance with SFAS No. 109, *Accounting for Income Taxes*. Deferred income taxes or tax benefits reflect the tax effect of temporary differences between the amounts of assets and liabilities for financial reporting purposes and amounts as measured for tax purposes as well as for tax net operating loss and credit carryforwards.

In June 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes-an interpretation of FASB Statement No. 109*, ( FIN No. 48 ). FIN No. 48 clarifies the accounting and disclosure requirements for uncertainty in income taxes recognized in an entity's financial statements in accordance with SFAS No. 109. The interpretation prescribes the minimum recognition threshold and measurement attribute required to be met before a tax position that has been taken or is expected to be taken is recognized in the financial statements. FIN No. 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition, and clearly excludes uncertainty in income taxes from guidance prescribed by FASB No. 5, *Accounting for Contingencies*. FIN No. 48 is effective for fiscal years beginning after December 15, 2006. The Company adopted this interpretation on January 1, 2007. The adoption of FIN No. 48 did not have a material impact on the Company's balance sheet or statement of operations.

As of September 30, 2007 and December 31, 2006, the Company's deferred tax assets were primarily comprised of federal net operating loss carryforwards ( NOLs ), federal and state alternative minimum tax credit carryforwards, and state NOL carryforwards. In assessing the realizability of the deferred tax assets, the Company considered both positive and negative evidence when measuring the need for a valuation allowance. The ultimate realization of deferred tax assets is dependent upon the existence of, or generation of, taxable income during the periods in which those temporary differences become deductible. The Company considered the scheduled reversal of deferred tax liabilities, projected future taxable income and other factors in making this assessment. The Company's estimates of future taxable income take into consideration, among other items, estimates of future taxable income related to depreciation. Based upon the available evidence, the Company does not believe that all of the deferred tax assets will be realized. Accordingly, the Company's balance sheet as of September 30, 2007 and December 31, 2006 includes a valuation allowance of \$1,059,000 to cover certain federal and state NOLs that may expire before the Company is able to utilize the tax benefit. To the extent that the Company continues to be unable to generate adequate taxable income in future periods, the Company will not be able to recognize additional tax benefits and may be required to record a greater valuation allowance covering potentially expiring NOLs.

There were no unrecognized tax benefits as of January 1, 2007 or September 30, 2007.

Historically, the Company has not incurred any interest or penalties associated with tax matters and no interest or penalties were recognized during the three and nine months ended September 30, 2007. However, the Company has adopted a policy whereby penalties incurred in connection with tax matters will be classified as general and administrative expenses, and interest assessments incurred in connection with tax matters will be classified as interest expense.

Tax years that remain open for examination by federal and state taxing authorities include 2003, 2004, 2005, and 2006. In addition, tax years from 1996 to 2002 may be subject to examination to the extent that the Company utilizes the NOLs from those years in its current year or future year tax returns.

**Table of Contents****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 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 the Company believes are reasonable, but are by their nature inherently uncertain. Many possible events or factors could affect the Company's 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 the Company's Annual Report on Form 10-K for the year ended December 31, 2006, and those described from time to time in the Company's future reports filed with the Securities and Exchange Commission. 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 Financial Statements and Notes thereto of Redhook Ale Brewery, Incorporated (the Company or Redhook) included herein, as well as the audited Financial Statements and Notes and Management's Discussion and Analysis of Financial Condition and Results of Operations contained in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2006. The discussion and analysis includes period-to-period comparisons of the Company's financial results. Although period-to-period comparisons may be helpful in understanding the Company's financial results, the Company believes that they should not be relied upon as an accurate indicator of future performance.*

**Overview**

Since its formation, the Company has focused its business activities on the brewing, marketing and selling of craft beers in the United States. The Company produces its specialty bottled and draft products in two Company-owned breweries, one in the Seattle suburb of Woodinville, Washington (the Washington Brewery) and the other in Portsmouth, New Hampshire (the New Hampshire Brewery). Prior to July 1, 2004, the Company's sales consisted predominantly of sales of beer to third-party distributors and Anheuser-Busch, Incorporated (A-B) through the Company's Distribution Alliance with A-B (the Alliance). Since July 1, 2004, the Company's sales have consisted of sales of product to Craft Brands Alliance LLC (Craft Brands) and A-B. Craft Brands is a joint venture sales and marketing entity formed by the Company and Widmer Brothers Brewing Company (Widmer). The Company and Widmer manufacture and sell their product to Craft Brands at a price substantially below wholesale pricing levels; Craft Brands, in turn, advertises, markets, sells and distributes the product to wholesale outlets in the western United States through a distribution agreement between Craft Brands and A-B. (Due to state liquor regulations, the Company sells its product in Washington state directly to third-party beer distributors and returns a portion of the revenue to Craft Brands based upon a contractually determined formula.) Profits and losses of Craft Brands are generally shared between the Company and Widmer based on the cash flow percentages of 42% and 58%, respectively. The Company continues to sell its product in the midwest and eastern U.S. through sales to A-B pursuant to the July 1, 2004 A-B Distribution Agreement (the A-B Distribution Agreement). For additional information regarding Craft Brands and the A-B Distribution Agreement, see Part 1, Item 1, Business Product Distribution Relationship with Anheuser-Busch, Incorporated and Relationship with Craft Brands Alliance LLC of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2006 and Craft Brands Alliance LLC below. In addition to sales of beer, the Company derives other revenues from sources including the sale of retail beer, food, apparel and other retail items in its two brewery pubs.

On November 13, 2007, the Company entered into an Agreement and Plan of Merger (the Merger Agreement) with Widmer, pursuant to which Widmer will merge with and into Redhook, and each outstanding share of capital stock of Widmer (other than any dissenting shares entitled to statutory appraisal rights under Oregon law) will be converted into the right to receive 2.1551 shares of Redhook common stock. The merger will result in Widmer shareholders and existing Redhook shareholders each holding approximately 50% of the outstanding shares of the combined company (assuming that no Widmer shareholder exercises statutory appraisal rights). In connection with the merger, Redhook will change its name to Craft Brewers Alliance, Inc.

Redhook and Widmer have made customary representations, warranties and covenants in the Merger Agreement, including, among others, a covenant by Redhook to cause a meeting of Redhook shareholders to be held to approve

issuance of the shares of common stock issuable in the merger. Redhook has also agreed to use commercially

**Table of Contents**

reasonable efforts to cause the following individuals to be appointed to the following indicated positions immediately after consummation of the merger: Kurt Widmer, Chairman of the Board; Paul Shipman, Chairman Emeritus and Consultant to the Board; David Mickelson, current President and Chief Operating Officer of Redhook, as Co-Chief Executive Officer; and Terry Michaelson, current President of Craft Brands Alliance LLC, as Co-Chief Executive Officer. Redhook has also agreed to appoint certain other officers of Widmer as officers of Redhook following consummation of the merger.

The merger is subject to customary conditions to closing, including (i) regulatory approval from the Alcohol and Tobacco Tax and Trade Bureau, (ii) approval of Anheuser-Busch, Incorporated, (iii) approval by the requisite vote of Redhook shareholders of the issuance of the shares of common stock issuable in the merger, (iv) approval of the merger by the requisite vote of Widmer shareholders, (v) accuracy of the representations and warranties made by the parties under the Merger Agreement, (vi) compliance by the parties with their covenants, and (vii) the absence of any material adverse change to either Redhook or Widmer.

The Merger Agreement was filed as Exhibit 2.1 to the Form 8-K filed on November 13, 2007.

The Company's gross sales and net loss for the nine months ended September 30, 2007 totaled \$35,384,000 and \$80,000, respectively, compared to gross sales and a net income of \$30,626,000 and \$523,000, respectively, for the same period in 2006. Sales in the craft beer industry generally reflect a degree of seasonality, with the first and fourth quarters historically being the slowest and the rest of the year typically demonstrating stronger sales. The Company has historically operated with little or no backlog, and, therefore, its ability to predict sales for future periods is limited.

The Company's sales are affected by several factors, including consumer demand, price discounting and competitive considerations. The Company competes in the highly competitive craft brewing market as well as in the much larger specialty beer market, which encompasses producers of import beers, major national brewers that produce fuller-flavored products, and large spirit companies and national brewers that produce flavored alcohol beverages. Beyond the beer and flavored alcohol markets, craft brewers also face competition from producers of wines and spirits. The craft beer segment is highly competitive due to the proliferation of small craft brewers, including contract brewers, and the large number of products offered by such brewers. Imported products from foreign brewers have enjoyed resurgence in demand since the mid-1990s. Certain national domestic brewers have also sought to appeal to this growing demand for craft beers by producing their own fuller-flavored products. In recent years, the specialty segment has seen the introduction of flavored alcohol beverages, the consumers of which, industry sources generally believe, correlate closely with the consumers of the import and craft beer products. Sales of these flavored alcohol beverages were initially very strong, but growth rates have slowed in subsequent years. While there appears to be fewer participants in this category than at its peak, there is still significant volume associated with these beverages. The wine and spirits market has also experienced a surge in the past several years, attributable to competitive pricing, increased merchandising, and increased consumer interest in wine and spirits. Because the number of participants and number of different products offered in this segment have increased significantly in the past ten years, the competition for bottled product placements and especially for draft beer placements has intensified.

The Company is required to pay federal excise taxes on the sale of its beer. The excise tax burden on beer sales increases from \$7 to \$18 per barrel on annual sales over 60,000 barrels and thus, if sales volume increases, federal excise taxes would increase as a percentage of sales.

Under normal circumstances, the Company operates its brewing facilities up to seven days per week with multiple shifts per day. Under ideal brewing conditions (which would include, among other factors, production of a single brand in a single package), the theoretical production capacity is approximately 250,000 barrels per year at the Washington Brewery and 235,000 barrels per year at the New Hampshire Brewery. Because of various factors, including the following two, the Company does not believe that it is likely that actual production volume will approximate theoretical production capacity: (1) the Company's brewing process, which management believes is similar to its competitors' brewing processes, inherently results in some level of beer loss attributable to filtering, bottling, and keg filling; and (2) the Company routinely brews and packages various brands and package sizes during the year.

In order to accommodate volume growth in the markets served by the New Hampshire Brewery, the Company has expanded fermentation capacity during the last several years. In May 2007, the Company completed process control

**Table of Contents**

automation upgrades to the brewery and added one 70,000 pound grain silo. In June 2007, the Company completed the installation of four additional 400-barrel fermenters. Installation cost for this expansion totaled \$1.3 million and added approximately 25,000 barrels of capacity to the New Hampshire Brewery, bringing the brewery's theoretical production capacity to approximately 235,000 barrels per year. As with the previous expansions, production capacity at the New Hampshire Brewery can be added in phases until the facility reaches its maximum designed production capacity of approximately 250,000 barrels per year, under ideal brewing conditions. Driven by various considerations including seasonality, production schedules of various draft products and bottled products and packages, and losses attributable to filtering, bottling and keg filling, actual production capacity will be less than theoretical production capacity. In order to reduce the spread between actual and theoretical production capacity, additional capital expenditures will be required. The decision to add capacity is affected by the availability of capital, construction constraints and anticipated sales in new and existing markets.

The Company's capacity utilization has a significant impact on gross profit. Generally, when facilities are operating at their maximum designed production capacities, profitability is favorably affected because fixed and semi-variable operating costs, such as depreciation and production salaries, are spread over a larger sales base. Because current period production levels have been below the Company's current production capacity, gross margins have been negatively impacted. This negative impact could be reduced if actual production increases.

In addition to capacity utilization, other factors that could affect cost of sales and gross margin include sales to Craft Brands at a price substantially below wholesale pricing levels, sales of contract beer at a pre-determined contract price, changes in freight charges, the availability and prices of raw materials and packaging materials, the mix between draft and bottled product sales, the sales mix of various bottled product packages, and fees related to the A-B Distribution Agreement.

See Part I, Item 1A. Risk Factors in the Company's Annual Report on Form 10-K for the year ended December 31, 2006 for additional matters which could materially affect the Company's business, financial condition or future results.

**Results of Operations**

The following table sets forth, for the periods indicated, certain items from the Company's Statements of Operations expressed as a percentage of net sales:

|   | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |             |
|---|---------------------------|-------------|--------------------------|-------------|
|   | <b>September 30,</b>      |             | <b>September 30,</b>     |             |
|   | <b>2007</b>               | <b>2006</b> | <b>2007</b>              | <b>2006</b> |
| Sales   | 111.6%                    | 112.1%      | 112.3%                   | 111.9%      |
| Less excise taxes                             | 11.6                      | 12.1        | 12.3                     | 11.9        |
| Net sales                                     | 100.0                     | 100.0       | 100.0                    | 100.0       |
| Cost of sales                                 | 87.2                      | 83.1        | 86.6                     | 85.3        |
| Gross profit                                  | 12.8                      | 16.9        | 13.4                     | 14.7        |
| Selling, general and administrative expenses  | 21.9                      | 18.4        | 21.0                     | 19.4        |
| Income from equity investment in Craft Brands | 5.0                       | 7.7         | 7.0                      | 7.6         |
| Operating income (loss)                       | (4.1)                     | 6.2         | (0.6)                    | 2.9         |
| Interest expense                              | 0.7                       | 1.0         | 0.8                      | 0.9         |
| Other income, net                             | 1.1                       | 0.7         | 1.3                      | 0.7         |
| Income (loss) before income taxes             | (3.7)                     | 5.9         | (0.1)                    | 2.7         |
| Income tax provision (benefit)                | (1.1)                     | 2.1         | 0.2                      | 0.8         |
| Net income (loss)                             | (2.6)%                    | 3.8%        | (0.3)%                   | 1.9%        |





**Table of Contents****Three Months Ended September 30, 2007 Compared to Three Months Ended September 30, 2006**

The following table sets forth, for the periods indicated, a comparison of certain items from the Company's Statements of Operations:

|   | Three Months Ended<br>September 30, |               | Increase /<br>(Decrease) | %<br>Change |
|---|-------------------------------------|---------------|--------------------------|-------------|
|   | 2007                                | 2006          |                          |             |
| Sales   | \$ 12,357,004                       | \$ 10,813,132 | \$ 1,543,872             | 14.3%       |
| Less excise taxes                             | 1,285,374                           | 1,169,670     | 115,704                  | 9.9         |
| Net sales                                     | 11,071,630                          | 9,643,462     | 1,428,168                | 14.8        |
| Cost of sales                                 | 9,653,674                           | 8,011,838     | 1,641,836                | 20.5        |
| Gross profit                                  | 1,417,956                           | 1,631,624     | (213,668)                | 13.1        |
| Selling, general and administrative expenses  | 2,429,821                           | 1,776,501     | 653,320                  | 36.8        |
| Income from equity investment in Craft Brands | 562,210                             | 743,245       | (181,035)                | 24.4        |
| Operating income (loss)                       | (449,655)                           | 598,368       | (1,048,023)              | 175.1       |
| Interest expense                              | 80,875                              | 92,094        | (11,219)                 | 12.2        |
| Other income, net                             | 120,589                             | 56,783        | 63,806                   | 112.4       |
| Income (loss) before income taxes             | (409,941)                           | 563,057       | (972,998)                | 172.8       |
| Income tax provision (benefit)                | (121,373)                           | 199,197       | (320,570)                | 160.9       |
| Net income (loss)                             | \$ (288,568)                        | \$ 363,860    | \$ (652,428)             | 179.3%      |

*Sales.* Gross sales increased \$1,544,000 in the third quarter of 2007 as compared to the third quarter of 2006, primarily impacted by the following factors:

An increase in overall pricing and shipments in the midwest and eastern United States resulted in a \$391,000 increase in 2007 third quarter sales;

An increase in overall pricing and shipments in the western United States (not including beer brewed on a contract basis) resulted in a \$120,000 increase in 2007 third quarter sales;

An increase in shipments of beer brewed on a contract basis, slightly offset by a decrease in pricing of these shipments, contributed a \$770,000 increase in 2007 third quarter sales; and

Pub and other sales increased \$321,000 in the third quarter of 2007.

*Shipments.* The following table sets forth a comparison of shipments (in barrels) for the periods indicated:

|                  | Three Months Ended September 30,<br>2007 |                     |                    | 2006               |                     |                    | Increase<br>/<br>(Decrease) | %<br>Change |
|------------------|--|---------------------|--------------------|--------------------|---------------------|--------------------|-----------------------------|-------------|
|                  | Draft<br>Shipments                       | Bottle<br>Shipments | Total<br>Shipments | Draft<br>Shipments | Bottle<br>Shipments | Total<br>Shipments |                             |             |
| A-B              | 12,000                                   | 15,900              | 27,900             | 11,900             | 15,300              | 27,200             | 700                         | 2.6%        |
| Craft Brands     | 9,400                                    | 21,900              | 31,300             | 9,600              | 21,000              | 30,600             | 700                         | 2.3         |
| Contract brewing | 9,600                                    | 9,500               | 19,100             | 13,800             |                     | 13,800             | 5,300                       | 38.4        |

Edgar Filing: REDHOOK ALE BREWERY INC - Form 10-Q

|                |        |        |        |        |        |        |       |      |
|----------------|--------|--------|--------|--------|--------|--------|-------|------|
| Pubs and other | 1,300  | 400    | 1,700  | 1,100  | 200    | 1,300  | 400   | 30.8 |
| Total shipped  | 32,300 | 47,700 | 80,000 | 36,400 | 36,500 | 72,900 | 7,100 | 9.7% |

17

---

**Table of Contents**

Total Company shipments increased 9.7% during the third quarter of 2007 as compared to the third quarter of 2006, primarily driven by a substantial increase in shipments of beer brewed on a contract basis. Total sales volume for the quarter ended September 30, 2007 increased to 80,000 barrels from 72,900 barrels for the same quarter in 2006. Shipments of the Company's packaged products increased 30.7% while shipments of the Company's draft products decreased 11.3%. Excluding the impact of shipments of beer brewed on a contract basis, the Company's shipments of bottled beer have steadily increased as a percentage of total beer shipments since the mid-1990's. In the third quarter of 2007, 62.7% of total shipments, excluding beer brewed under a contract brewing arrangement, were shipments of bottled beer versus 61.8% in the same period in 2006.

Contributing significantly to the 7,100 barrel increase in the Company's total shipments is an increase of 5,300 barrels of beer brewed under contract brewing arrangements with Widmer. In connection with the Supply, Distribution and Licensing Agreement with Craft Brands, if shipments of the Company's products in the Craft Brands territory decrease as compared to the previous year's shipments, the Company has the right to brew Widmer products in an amount equal to the lower of (i) the Company's product shipment decrease or (ii) the Widmer product shipment increase (the Contractual Obligation). In addition, pursuant to a Manufacturing and Licensing Agreement with Widmer, the Company may, at Widmer's request, brew more beer for Widmer than the amount obligated by the Supply, Distribution and Licensing Agreement with Craft Brands. This Manufacturing and Licensing Agreement with Widmer expires December 31, 2007. Under these contract brewing arrangements, the Company brewed and shipped 19,100 barrels and 13,800 barrels of Widmer beer in the third quarter of 2007 and 2006, respectively. Of these shipments, all of third quarter 2007 and 2006 barrels were in excess of the Contractual Obligation. While these contract brewing arrangements have, through 2006, been limited to brewing draft beer at the Washington Brewery, the Company began brewing and shipping packaged beer from the Washington Brewery during the first quarter of 2007; in addition, the New Hampshire Brewery began brewing and shipping draft beer during the second quarter of 2007. During the quarter ended September 30, 2007, approximately 50% of the 19,100 barrels shipped was packaged product and approximately 750 barrels of the 19,100 barrels shipped was brewed and shipped by the New Hampshire Brewery. The Company does not anticipate that the New Hampshire Brewery will be utilized in conjunction with the contract brewing arrangement with Widmer in future periods. Excluding shipments under these contract brewing arrangements, 2007 third quarter shipments of the Company's draft and bottled products increased 3.1% as compared to the same quarter in 2006. Driven by the Contractual Obligation as well as Widmer's production needs, the Company anticipates that beer brewed and shipped in 2007 under the contract brewing arrangements with Widmer will continue to be significantly higher than 2006 levels. The Company expects this level of contract brewing for Widmer to end in the second half of 2008 as Widmer brings its own additional capacity on-line. The Company is evaluating alternatives to utilize the capacity that will become available upon the termination of the contract brewing. If the Company is unable to achieve significant growth through its own products or other alternative products, the Company may have significant unabsorbed overhead that would generate unfavorable financial results.

Included in the Company's total shipments (as shipments through A-B in the table above) are shipments of *Widmer Hefeweizen*, a golden unfiltered wheat beer that is one of the leading American style Hefeweizens sold in the U.S. The Company brews *Widmer Hefeweizen* at the New Hampshire Brewery and distributes the beer through A-B in the midwest and eastern U.S. under license from Widmer. In 2003, the Company entered into a licensing agreement with Widmer to produce and sell the *Widmer Hefeweizen* brand in states east of the Mississippi River. In March 2005, the *Widmer Hefeweizen* distribution territory was expanded to include all of the Company's midwest and eastern markets. The term of this agreement will automatically renew on February 1, 2008 for a one-year term expiring February 1, 2009, with additional one-year automatic renewals unless either party notifies the other of its desire to have the term expire at the end of the then existing term at least 150 days prior to such expiration. The agreement may be terminated by either party at any time without cause pursuant to 150 days notice or for cause by either party under certain conditions. Additionally, Redhook and Widmer have entered into a separate agreement providing that if Widmer terminates the licensing agreement or causes it to expire before December 31, 2009, Widmer will pay the Company a lump sum payment, intended to partially compensate the Company for capital equipment expenditures made at the New Hampshire Brewery to support the sales growth of *Widmer Hefeweizen*. During the term of this agreement, Redhook will not brew, advertise, market, or distribute any product that is labeled or advertised as a Hefeweizen or

any similar product in the agreed upon midwest and eastern territory. Brewing and selling of Redhook's Hefe-weizen was discontinued in conjunction with this agreement. The Company shipped 7,900 barrels and 8,700 barrels of *Widmer Hefeweizen* during the third quarter of 2007 and 2006, respectively. The Company believes that the agreement increases capacity utilization and has strengthened the Company's product portfolio. If the Widmer licensing agreement were terminated, the Company would evaluate alternatives to utilize the capacity, either through new and existing Redhook products or alternative brewing relationships. If the Company is unable to utilize the

**Table of Contents**

capacity, the loss of revenue and the resulting excess capacity in the New Hampshire Brewery would have an adverse effect on the Company's financial performance.

Excluding shipments of beer brewed under the contract brewing arrangement with Widmer and under the *Widmer Hefeweizen* licensing agreement, total Company shipments in the U.S. increased by 2,500 barrels, or 4.9% in the third quarter of 2007 as compared to the same quarter in 2006.

During the quarters ending September 30, 2007 and 2006, the Company's products were distributed in 48 states. Shipments in the midwest and eastern United States increased by 2.6% compared to the same 2006 period, while shipments in the western United States served by Craft Brands increased 2.3% during the same period.

Sales to Craft Brands in the third quarter of 2007 represented approximately 39% of total shipments, or 31,300 barrels, compared to 42%, or 30,600 barrels in the same 2006 quarter. Contributing most significantly to the increase in shipments in the western U.S. were a 45% increase in shipments to New Mexico and a 12% increase in Oregon; in both of these states, Craft Brands offered substantial discounts, reflected in Craft Brands statement of operations, that contributed to notable volume growth. The third quarter 2007 volume increase was also attributable to a 44% increase in shipments to Montana, which supports Idaho and Wyoming wholesalers and may experience fluctuations in demand, and a 2% increase in shipments to Washington, where discounting was flat as compared to the third quarter of 2006. Craft Brands saw an 11% decline in shipments to Colorado, due to highly competitive market pricing. A significant portion of the Company's sales continue to be in the Pacific Northwest region, which the Company believes is one of the most competitive craft beer markets in the U.S., both in terms of number of market participants and consumer awareness. The Company continues to face extreme competitive pressure in Washington state, which is not only the Company's largest market but is also its oldest market. From 2000 through 2006, the Company had experienced a 24% decline in sales volume in Washington state. Pricing of the Company's products has increased and the level of promotion and discounting has declined, allowing the Company to achieve higher revenue per barrel; however, management believes there is a direct correlation to lower sales caused by higher net pricing. During this same period, Craft Brands has continued to experience success in selling Widmer and Kona products. Although the Company enjoys the benefits of those successes through its profit-sharing arrangement with Craft Brands, the Company believes it is critical for Craft Brands to deliver success with the Redhook products in addition to the other products. The Company has communicated this concern to Craft Brands and is working with Craft Brands management to establish new brand management throughout the portfolio of Redhook products. Craft Brands also responded to this concern by re-emphasizing its commitment to Redhook products and focusing its sales efforts on the Company's Long Hammer IPA. This attention has resulted in an increase in shipments of Long Hammer IPA over the prior year's third quarter, but shipments of the Company's other products in the Craft Brands territory have not shown improvement in 2007 over the previous year. The Company is pleased that, while modest, quarterly shipments of Redhook products in the Craft Brands territory have increased over the previous year's comparable quarter. The Company is working with Craft Brands to increase this rate of growth and expand it to include more Redhook products.

Sales in the midwest and eastern United States in the third quarter of 2007 represented approximately 35% of total shipments, or 27,900 barrels, compared to 37%, or 27,200 barrels in the same 2006 quarter. Contributing most significantly to the sales growth in the third quarter of 2007 were increased sales to states in the southeastern U.S., offset by declines in sales in most New England states.

**Pricing and Fees.** The Company sells its product at wholesale pricing levels in the midwest and eastern U.S., at lower than wholesale pricing levels to Craft Brands in the western U.S., and at agreed-upon pricing levels for beer brewed on a contract basis.

Redhook continues to sell its product at wholesale pricing levels in the midwest and eastern U.S. through sales to A-B. Average wholesale revenue per barrel for draft products, net of discounts, improved nearly 6% in the third quarter of 2007 compared to the same quarter in 2006. This increase in pricing accounted for an increase of approximately \$92,000 in total sales. Average wholesale revenue per barrel for bottle products, net of discounts, increased approximately 5% in 2007 compared to 2006. This increase in pricing accounted for an increase of approximately \$158,000 in total sales. Management believes that most, if not all, craft brewers are performing a similar analysis in order to address the cost pressures and to take into account a weak dollar, which may provide price protection against

key import products. Seldom, if ever, have pricing changes

**Table of Contents**

in recent years been driven by an inflationary period. Instead, pricing changes implemented by the Company have generally followed pricing changes initiated by large domestic or import brewing companies. While the Company has implemented modest price increases during the past few years, some of the benefit has been offset by competitive promotions and discounting. Additionally, the Company may experience a decline in sales in certain regions following a price increase.

The Company sells its product to Craft Brands at a price substantially below wholesale pricing levels pursuant to the Supply, Distribution and Licensing Agreement with Craft Brands; Craft Brands, in turn, advertises, markets, sells and distributes the product to wholesale outlets in the western U.S. through a distribution agreement between Craft Brands and A-B. The prices that the Company charges Craft Brands for draft product and for bottled product are determined by contractually defined formulas and are based on the twelve month average pricing ending September of the previous year for all Redhook and Widmer draft product and for all Redhook and Widmer bottled product sold by Craft Brands. The prices are adjusted on January 1<sup>st</sup> of each year. Average revenue per barrel for draft products sold to Craft Brands increased a little more than 2% in the third quarter of 2007 compared to 2006. This increase in pricing accounted for an increase of approximately \$22,000 in total sales. Average revenue per barrel for bottle products sold to Craft Brands decreased less than 1% in 2007 compared to 2006 resulting in a decrease of \$10,000 in total sales.

Average revenue per barrel on beer brewed on a contract basis for Widmer pursuant to the Supply, Distribution and Licensing Agreement with Craft Brands is generally at a price substantially lower than wholesale pricing levels. After the Contractual Obligation has been fulfilled pursuant to the Supply, Distribution and Licensing Agreement with Craft Brands, the price charged Widmer for any additional barrels brewed declines pursuant to the Manufacturing and Licensing Agreement with Widmer. Average revenue per barrel for draft beer brewed on a contract basis decreased approximately 1% in the third quarter of 2007 compared to 2006 resulting in a decrease of \$11,000 in total sales. In the first quarter of 2007, the Company began shipping bottled beer under this contract brewing arrangement.

In connection with all sales through the July 1, 2004 A-B Distribution Agreement, the Company pays a Margin fee to A-B. The Margin does not apply to sales to the Company's retail operations or to dock sales. The Margin also does not apply to the Company's sales to Craft Brands because Craft Brands pays a comparable fee to A-B on its resale of the product. The A-B Distribution Agreement also provides that the Company shall pay an additional fee on shipments that exceed shipments in the same territory during fiscal 2003 (the Additional Margin). For the three months ended September 30, 2007, the Margin was paid to A-B on shipments totaling 27,900 barrels to approximately 507 distribution points. For the three months ended September 30, 2006, the Margin was paid to A-B on shipments totaling 26,800 barrels to approximately 480 distribution points. Because third quarter 2007 and 2006 shipments in the midwest and eastern U.S. exceeded 2003 third quarter shipments in the same territory, the Company paid the Additional Margin on 8,100 and 7,200 barrels, respectively. The Margin is reflected as a reduction of sales in the Company's statements of operations.

**Retail Operations and Other Sales.** Sales in the Company's retail operations and other sales increased \$321,000 to \$2,146,000 in the third quarter of 2007 from \$1,826,000 in the same period in 2006, primarily as the result of an increase in beer and food sales.

**Excise Taxes.** Excise taxes increased \$116,000 to \$1,285,000 for the third quarter of 2007 compared to \$1,170,000 for the same 2006 period, primarily the result of the overall increase in shipments. The Company continues to be responsible for federal and state excise taxes for all shipments, including those to Craft Brands and brewed under contract. The comparability of excise taxes as a percentage of net sales is impacted by: average revenue per barrel; the mix of sales in the midwest and eastern United States, sales to Craft Brands, sales of beer brewed on contract basis, and pub sales; and the estimated annual average federal and state excise tax rates.

**Cost of Sales.** Cost of sales is comprised of direct and overhead costs incurred to produce the Company's package and draft products, as well as expenses associated with the Company's pub operations. Comparing the third quarter of 2007 to the third quarter of 2006, cost of sales increased by \$1,642,000, and increased as a percentage of net sales and on a per barrel basis. The increase in cost of sales was driven by an increase in the production of lower margin beer brewed on a contract basis, an increase in the cost of some raw materials and packaging materials, a higher proportion of packaged product, an increase in the absorption of overhead expenses, and an increase in production losses.

In the third quarter of 2007, the Company shipped an additional 5,300 barrels of beer brewed on a contract basis. In addition to the overall increase in shipments of contract beer, approximately 50% of the 2007 quarter's shipments

---



**Table of Contents**

were packaged product while 2006 third quarter shipments were entirely draft product. The combination of these two factors contributed approximately \$664,000 in additional costs to the 2007 third quarter cost of sales.

While the 2007 cost of packaging increased over 2006 costs and led to a \$208,000 increase in cost of sales over the third quarter of 2006, this per barrel cost increase was compounded by an increase in 2007 third quarter shipments of packaged product relative to total shipments. Shipments of packaged product increased to 59.6% in the third quarter of 2007 from 50.1% in the same quarter of 2006, leading to a \$101,000 increase in cost of sales over the third quarter of 2006.

According to industry and media sources, the price of barley, a primary ingredient in most beers, has increased 48% over the last year. The significant price increase is apparently driven by a lower supply of barley as farmers shift their focus to growing corn, a key component of biofuels. While the Company has experienced an increase in the cost of barley over the past year, the Company's fixed price contracts had limited that increase through August 2007 to less than 10%. The Company's existing barley purchase contracts expired during the third quarter of 2007 and the Company entered into new barley supply contracts that reflect current market pricing that is significantly higher than the pricing in the expired contracts. In addition to a decline in the supply of barley, the beer industry appears to also be experiencing a decline in the supply of hops, driven by a number of factors: excess supply in the 1990s led some growers to switch to more lucrative crops, resulting in an estimated 40% decrease in worldwide hop-growing acreage; poor weather in eastern Europe and Germany caused substantial hops crop losses in 2007; hops crop production in England has declined approximately 85% since the mid-1970's; and 2007 U.S., New Zealand, and Australia hops crop yields were only average. As with malted barley, the Company has fixed price purchase contracts for its specialty hops, both to insure that the Company has the necessary supply for current and future production needs, but also to obtain favorable pricing. In October 2007, the Company entered into a fixed price purchase contract for one of the Company's specialty hops; the Company believes that this contract will provide a substantial portion of the requirements for this hop for the next five years. While the cost of this hop is significantly higher than the Company's cost in prior years, management believes that securing an adequate supply is crucial in the current environment. The Company will likely enter into fixed price purchase contracts for its other significant hops. These increases in the cost of barley and hops had a modest impact of approximately \$80,000 on the Company's cost of sales and gross profit for the third quarter of 2007 and will likely have a significant impact on future cost of sales.

The Company's cost of sales includes a licensing fee of \$131,000 and \$149,000 for the third quarters of 2007 and 2006, respectively, in connection with the Company's shipment of 7,900 barrels and 8,700 barrels of *Widmer Hefeweizen* in the midwest and eastern United States pursuant to a licensing agreement with Widmer.

Based upon the breweries' combined theoretical production capacity under optimal year-round brewing conditions of 121,000 barrels and 113,000 barrels for the third quarter of 2007 and 2006, the utilization rates were 66% and 65%, respectively. Capacity utilization rates are calculated by dividing the Company's total shipments by the combined theoretical production capacity.

*Selling, General and Administrative Expenses.* Selling, general and administrative expenses for the third quarter of 2007 increased \$653,000 to \$2,430,000 from expenses of \$1,777,000 in the same 2006 quarter. The increase is primarily attributable to increases in Sarbanes-Oxley implementation costs, merger-related costs, and sales and marketing salaries and promotional expenditures. Driven by the 2007 deadline for implementation of Sarbanes-Oxley Section 404, the Company has incurred additional consulting and accounting-related fees of approximately \$91,000 in the third quarter of 2007. Additionally, the Company has incurred approximately \$282,000 in legal, consulting and meeting costs in connection with merger discussions. Sales and marketing salaries and related expenses also increased \$102,000 for the quarter ended September 30, 2007 as compared to the same period in 2006, and sales and marketing promotional expenditures are up \$246,000 for the same 2007 quarter.

*Income from Equity Investment in Craft Brands.* After giving effect to income attributable to the Kona brand, which was shared differently between the Company and Widmer through 2006, the Craft Brands operating agreement dictates that remaining profits and losses of Craft Brands are allocated between the Company and Widmer based on the cash flow percentages of 42% and 58%, respectively. For the quarter ended September 30, 2007, the Company's share of Craft Brands' net income totaled \$562,000. For the quarter ended September 30, 2006, the Company's share of Craft Brands' net income totaled \$743,000. Net cash flow of Craft Brands, if any, is generally distributed monthly to

the Company based on the Company's cash flow percentage of 42%. In the third quarter of 2007, the Company

**Table of Contents**

received cash distributions of \$1,185,000, representing its share of the net cash flow of Craft Brands. In the third quarter of 2006, the Company received cash distributions of \$930,000.

*Interest Expense.* Interest expense declined to \$81,000 for the third quarter of 2007 from \$92,000 for the third quarter of 2006. Slightly lower average interest rates in the third quarter of 2007 combined with a declining term loan balance resulted in a decline in interest expense.

*Other Income, net.* Other income, net increased by \$64,000 to \$121,000 for the third quarter of 2007 from \$57,000 for the third quarter of 2006. The 2007 third quarter is primarily comprised of interest income on interest-bearing deposits totaling \$109,000. The 2006 third quarter is primarily comprised of interest income totaling \$88,000 partially offset by \$34,000 in late payment penalties.

*Income Taxes.* The Company's effective income tax rate was a 29.6% benefit for the quarter ending September 30, 2007 and a 35.4% expense for the quarter ending September 30, 2006. Both periods include a provision for current state taxes. The Company has estimated its tax provision to be approximately \$90,000 for the 2007 full year, driven by projected pre-tax results relative to other components of the tax provision calculation, such as the exclusion of a portion of meals and entertainment expenses from tax return deductions. In 2006, the Company decreased the valuation allowance that covers net tax operating loss carryforwards and other net deferred tax assets. The valuation allowance covers a portion of the Company's deferred tax assets, specifically certain federal and state NOLs that may expire before the Company is able to utilize the tax benefit. Realization of the benefit is dependent on the Company's ability to generate future U.S. taxable income. To the extent that the Company is unable to generate adequate taxable income in future periods, the Company will not be able to recognize additional tax benefits and may be required to record a greater valuation allowance covering potentially expiring NOLs.

***Craft Brands Alliance LLC***

The Company has accounted for its investment in Craft Brands under the equity method, as outlined by Accounting Principle Board Opinion ( APB ) No. 18, *The Equity Method of Accounting for Investments in Common Stock*. Pursuant to APB No. 18, the Company has recorded its share of Craft Brands' net income in the Company's statement of operations as income from equity investment in Craft Brands. The following discussion should be read in conjunction with the financial statements and notes thereto of Craft Brands Alliance LLC, filed with the Company's Annual Report on Form 10-K for the year ended December 31, 2006, in Item 15. *Exhibits and Financial Statement Schedules* in accordance with Rule 3-09 of Regulation S-X.

The following summarizes a comparison of certain items included in Craft Brands' statement of operations for the quarters ended September 30, 2007 and 2006. Certain reclassifications have been made to the prior year's financial statements to conform to the current year presentation. The effects of the reclassifications did not affect net income or the profit allocation.

*Sales.* Craft Brands' sales totaled \$19,637,000 for the third quarter of 2007 compared to \$18,120,000 for the third quarter of 2006. In addition to selling 31,300 barrels of the Company's product to wholesalers in the western United States in the third quarter of 2007 and 30,600 barrels in the third quarter of 2006, Craft Brands also sold Widmer and Kona products. Total Craft Brands shipments increased approximately 4.7% as compared to shipments in the three-month period of 2006. Average wholesale revenue per barrel for all draft products sold by Craft Brands, net of discounts, increased 3% in the third quarter of 2007 as compared to the same quarter in 2006. Average wholesale revenue per barrel for all bottle products sold by Craft Brands, net of discounts, increased slightly less than 2% in the third quarter of 2007 as compared to the same period in 2006. For the quarter ended September 30, 2007, average wholesale revenue per barrel for all products sold by Craft Brands was approximately 1% lower than average wholesale revenue per barrel on direct sales to wholesalers by the Company during the same period. Craft Brands also pays fees to A-B in connection with sales to A-B that are comparable to fees paid by the Company.

*Cost of Sales.* Cost of sales of Craft Brands totaled \$14,021,000 for the third quarter of 2007 compared to \$13,267,000 for the third quarter of 2006. The increase in cost of sales over the 2006 quarter is attributable to higher sales volume, an increase in prices charged by the Company and Widmer for draft product sold to Craft Brands and a modest increase in freight costs, slightly offset by a decrease in prices charged by the Company for bottled product sold to Craft Brands. Craft Brands purchases product from the Company and Widmer at a price substantially below



**Table of Contents**

wholesale pricing levels pursuant to the Supply, Distribution, and Licensing Agreement between Craft Brands and each of the Company and Widmer.

*Selling, General and Administrative Expenses.* Craft Brands' selling, general and administrative expenses totaled \$4,092,000 for the third quarter of 2007 compared to \$2,989,000 for the third quarter of 2006, reflecting all advertising, marketing and promotion efforts for the Redhook, Widmer and Kona brands. During the quarter ended September 30, 2007, sales and marketing costs increased approximately \$933,000, attributable to a \$475,000 reduction in the value at which Craft Brands' promotional inventories are stated, the addition of several new positions, and an expansion of the use of promotional materials and media in certain markets. Administrative expenses were approximately \$170,000 higher than the third quarter of 2006, largely driven by a change in the presentation of the Additional Margin paid to A-B; in 2007, the Additional Margin is reflected in the statement of operations as selling, general and administrative expense, while in 2006, the Additional Margin is reflected as a reduction of sales. The effects of the change in presentation did not affect net income or the profit allocation to Redhook.

*Net Income.* Craft Brands' net income totaled \$1,339,000 for the third quarter of 2007 compared to \$1,775,000 for the third quarter of 2006. The Company's share of Craft Brands' net income totaled \$562,000 for the third quarter of 2007 compared to \$743,000 for the third quarter of 2006. After giving effect to income attributable to the Kona brand, which was shared differently between the Company and Widmer through 2006, the Craft Brands operating agreement dictates that remaining profits and losses of Craft Brands are allocated between the Company and Widmer based on the cash flow percentages of 42% and 58%, respectively.

***Nine Months Ended September 30, 2007 Compared to Nine Months Ended September 30, 2006***

The following table sets forth, for the periods indicated, a comparison of certain items from the Company's Statements of Operations:

|   | <b>Nine Months Ended<br/>September 30,</b> |               | <b>Increase /<br/>(Decrease)</b> | <b>%<br/>Change</b> |
|---|--|---------------|----------------------------------|---------------------|
|   | <b>2007</b>                                | <b>2006</b>   |                                  |                     |
| Sales   | \$ 35,383,514                              | \$ 30,625,893 | \$ 4,757,621                     | 15.5%               |
| Less excise taxes                             | 3,866,318                                  | 3,246,259     | 620,059                          | 19.1                |
| Net sales                                     | 31,517,196                                 | 27,379,634    | 4,137,562                        | 15.1                |
| Cost of sales                                 | 27,307,237                                 | 23,364,532    | 3,942,705                        | 16.9                |
| Gross profit                                  | 4,209,959                                  | 4,015,102     | 194,857                          | 4.9                 |
| Selling, general and administrative expenses  | 6,609,990                                  | 5,289,971     | 1,320,019                        | 25.0                |
| Income from equity investment in Craft Brands | 2,210,336                                  | 2,076,168     | 134,168                          | 6.5                 |
| Operating income (loss)                       | (189,695)                                  | 801,299       | (990,994)                        | 123.7               |
| Interest expense                              | 246,093                                    | 259,239       | (13,146)                         | 5.1                 |
| Other income, net                             | 404,996                                    | 198,844       | 206,152                          | 103.7               |
| Income (loss) before income taxes             | (30,792)                                   | 740,904       | (771,696)                        | 104.2               |
| Income tax provision (benefit)                | 49,252                                     | 218,245       | (168,993)                        | 77.4                |
| Net income (loss)                             | \$ (80,044)                                | \$ 522,659    | \$ (602,703)                     | 115.3%              |

**Table of Contents**

**Sales.** Gross sales increased \$4,758,000 in the first nine months of 2007 as compared to the first nine months of 2006, primarily impacted by the following factors:

An increase in overall pricing and shipments in the midwest and eastern United States resulted in a \$1,425,000 increase in 2007 year-to-date sales;

A decrease in overall pricing and shipments in the western United States (not including beer brewed on a contract basis) resulted in a \$203,000 decrease in 2007 year-to-date sales;

An increase in shipments of beer brewed on a contract basis, partially offset by a decrease in pricing of these shipments, contributed a \$3,128,000 increase in 2007 year-to-date sales; and

Pub and other sales increased \$576,000 in the first nine months of 2007.

**Shipments.** The following table sets forth a comparison of shipments (in barrels) for the periods indicated:

|                  | Nine Months Ended September 30, |                     |                    |                    |                     |                    | Increase<br>/ %<br>(Decrease) Change |       |
|------------------|---------------------------------|---------------------|--------------------|--------------------|---------------------|--------------------|--------------------------------------|-------|
|                  | 2007                            |                     |                    | 2006               |                     |                    |                                      |       |
|                  | Draft<br>Shipments              | Bottle<br>Shipments | Total<br>Shipments | Draft<br>Shipments | Bottle<br>Shipments | Total<br>Shipments |                                      |       |
| A-B              | 35,700                          | 47,000              | 82,700             | 35,200             | 43,200              | 78,400             | 4,300                                | 5.5%  |
| Craft Brands     | 27,900                          | 64,800              | 92,700             | 29,000             | 65,700              | 94,700             | (2,000)                              | (2.1) |
| Contract brewing | 37,400                          | 24,200              | 61,600             | 30,600             |                     | 30,600             | 31,000                               | 101.3 |
| Pubs and other   | 3,200                           | 900                 | 4,100              | 2,700              | 600                 | 3,300              | 800                                  | 24.2  |
| Total shipped    | 104,200                         | 136,900             | 241,100            | 97,500             | 109,500             | 207,000            | 34,100                               | 16.5% |

Total Company shipments increased 16.5% during the first nine months of 2007 as compared to the first nine months of 2006, primarily driven by a substantial increase in shipments of beer brewed on a contact basis. Total sales volume for the nine months ended September 30, 2007 increased to 241,100 barrels from 207,000 barrels for the same period in 2006. Shipments of the Company's packaged products increased 25.0% while shipments of the Company's draft products increased 6.9%. Excluding the impact of shipments of beer brewed on a contract basis, the Company's shipments of bottled beer have steadily increased as a percentage of total beer shipments since the mid-1990's. In the nine months ended September 30, 2007, 62.8% of total shipments, excluding beer brewed under a contract brewing arrangement, were shipments of bottled beer versus 62.1% in the same period in 2006.

Contributing significantly to the 34,100 barrel increase in the Company's total shipments is an increase of 31,000 barrels of beer brewed under contract brewing arrangements with Widmer. In connection with the Supply, Distribution and Licensing Agreement with Craft Brands, if shipments of the Company's products in the Craft Brands territory decrease as compared to the previous year's shipments, the Company has the right to brew Widmer products in an amount equal to the lower of (i) the Company's product shipment decrease or (ii) the Widmer product shipment increase (the Contractual Obligation). In addition, pursuant to a Manufacturing and Licensing Agreement with Widmer, the Company may, at Widmer's request, brew more beer for Widmer than the amount obligated by the Supply, Distribution and Licensing Agreement with Craft Brands. This Manufacturing and Licensing Agreement with Widmer expires December 31, 2007. Under these contract brewing arrangements, the Company brewed and shipped 61,600 barrels and 30,600 barrels of Widmer beer in the first nine months of 2007 and 2006, respectively. Of these shipments, 94% of the year-to-date 2007 barrels were in excess of the Contractual Obligation and 67% of the year-to-date 2006 barrels were in excess of the Contractual Obligation. While these contract brewing arrangements have, through 2006, been limited to brewing draft beer at the Washington Brewery, the Company began brewing and shipping packaged beer from the Washington Brewery during the first quarter of 2007; in addition, the New Hampshire Brewery began brewing and shipping draft beer during the second quarter of 2007. During the first nine

months of 2007, approximately 39% of the 61,600 barrels shipped was packaged product and approximately 4,400 barrels of the total 61,600 barrels shipped was brewed and shipped by the New Hampshire Brewery. The Company does not anticipate that the New Hampshire Brewery will be utilized in conjunction with the contract brewing arrangement with Widmer in future periods. Excluding shipments under these contract brewing arrangements, 2007 year-to-date shipments of the Company's draft and bottled products increased modestly, or 1.9%, as compared to the same period in 2006. Driven by the Contractual Obligation as well as Widmer's production needs, the Company

**Table of Contents**

anticipates that beer brewed and shipped in 2007 under the contract brewing arrangements with Widmer will continue to be significantly higher than 2006 levels. The Company expects this level of contract brewing for Widmer to end in the second half of 2008 as Widmer brings its own additional capacity on-line. The Company is evaluating alternatives to utilize the capacity that will become available upon the termination of the contract brewing. If the Company is unable to achieve significant growth through its own products or other alternative products, the Company may have significant unabsorbed overhead that would generate unfavorable financial results.

Included in the Company's total shipments (as shipments through A-B in the table above) are shipments of *Widmer Hefeweizen*, a golden unfiltered wheat beer that is one of the leading American style Hefeweizens sold in the U.S. The Company brews *Widmer Hefeweizen* at the New Hampshire Brewery and distributes the beer through A-B in the midwest and eastern U.S. under license from Widmer. In 2003, the Company entered into a licensing agreement with Widmer to produce and sell the *Widmer Hefeweizen* brand in states east of the Mississippi River. In March 2005, the *Widmer Hefeweizen* distribution territory was expanded to include all of the Company's midwest and eastern markets. The term of this agreement will automatically renew on February 1, 2008 for a one-year term expiring February 1, 2009, with additional one-year automatic renewals unless either party notifies the other of its desire to have the term expire at the end of the then existing term at least 150 days prior to such expiration. The agreement may be terminated by either party at any time without cause pursuant to 150 days notice or for cause by either party under certain conditions. Additionally, Redhook and Widmer have entered into a separate agreement providing that if Widmer terminates the licensing agreement or causes it to expire before December 31, 2009, Widmer will pay the Company a lump sum payment, intended to partially compensate the Company for capital equipment expenditures made at the New Hampshire Brewery to support the sales growth of *Widmer Hefeweizen*. During the term of this agreement, Redhook will not brew, advertise, market, or distribute any product that is labeled or advertised as a Hefeweizen or any similar product in the agreed upon midwest and eastern territory. Brewing and selling of Redhook's Hefe-weizen was discontinued in conjunction with this agreement. The Company shipped 23,200 barrels and 24,900 barrels of *Widmer Hefeweizen* during the first nine months of 2007 and 2006, respectively. The Company believes that the agreement increases capacity utilization and has strengthened the Company's product portfolio. If the Widmer licensing agreement were terminated, the Company would evaluate alternatives to utilize the capacity, either through new and existing Redhook products or alternative brewing relationships. If the Company is unable to utilize the capacity, the loss of revenue and the resulting excess capacity in the New Hampshire Brewery would have an adverse effect on the Company's financial performance.

Excluding shipments of beer brewed under the contract brewing arrangement with Widmer and under the *Widmer Hefeweizen* licensing agreement, total Company shipments in the U.S. increased nearly 4,900 barrels, or 3.2% in 2007 as compared to 2006.

During the nine months ended September 30, 2007 and 2006, the Company's products were distributed in 48 states. Shipments in the midwest and eastern United States increased by 5.5% compared to the nine month 2006 period while shipments in the western United States served by Craft Brands decreased 2.1% during the same period.

Sales to Craft Brands in the first nine months represented approximately 38% of total shipments, or 92,700 barrels, compared to 46%, or 94,700 barrels in the nine months of 2006. Contributing most significantly to the decline in shipments in the western U.S. were a 13% decline in shipments to Oregon, attributable in part to a reduction in discounting, a 17% decline in shipments to Colorado, due to highly competitive market pricing, and slightly less than a 2% decline in shipments to California, where an increase in pricing appears to have negatively impacted sales. Shipments in Washington state were up a modest 0.5% for the first nine months of 2007 as compared to the same period in 2006. A significant portion of the Company's sales continue to be in the Pacific Northwest region, which the Company believes is one of the most competitive craft beer markets in the U.S., both in terms of number of market participants and consumer awareness. The Company continues to face extreme competitive pressure in Washington state, which is not only the Company's largest market but is also its oldest market. From 2000 through 2006, the Company experienced a 24% decline in sales volume in Washington state. Pricing of the Company's products has increased and the level of promotion and discounting has declined, allowing the Company to achieve higher revenue per barrel; however, management believes there is a direct correlation to lower sales caused by higher net pricing. During this same period, Craft Brands has continued to experience success in selling Widmer and Kona products.



Although the Company enjoys the benefits of those successes through its profit-sharing arrangement with Craft Brands, the Company believes it is critical for Craft Brands to deliver success with Redhook products in addition to other products. The Company has communicated this concern to Craft Brands and is working with Craft Brands management to establish new brand management throughout the portfolio of Redhook products. Craft Brands

**Table of Contents**

also responded to this concern by re-emphasizing its commitment to Redhook products and focusing its sales efforts on the Company's Long Hammer IPA. Although this attention has resulted in an increase in shipments of Long Hammer IPA over the prior year's nine-month period, shipments of the Company's other products in the Craft Brands territory have not shown improvement in 2007 over the previous year. The Company continues to work with Craft Brands management to improve performance.

Sales in the midwest and eastern United States in the nine months of 2007 represented approximately 34% of total shipments, or 82,700 barrels, compared to 38%, or 78,400 barrels in the same 2006 period. Contributing most significantly to the sales growth in the nine months of 2007 were increased sales to states in the southeastern U.S., offset by declines in sales in several New England and midwestern states.

Pricing and Fees. The Company sells its product at wholesale pricing levels in the midwest and eastern U.S., at lower than wholesale pricing levels to Craft Brands in the western U.S., and at agreed-upon pricing levels for beer brewed on a contract basis.

Redhook continues to sell its product at wholesale pricing levels in the midwest and eastern U.S. through sales to A-B. Average wholesale revenue per barrel for draft products, net of discounts, improved more than 4% in the first nine months of 2007 compared to the first nine months of 2006. This increase in pricing accounted for an increase of approximately \$204,000 in total sales. Average wholesale revenue per barrel for bottle products, net of discounts, increased nearly 4% in 2007 compared to 2006. This increase in pricing accounted for an increase of approximately \$333,000 in total sales. Management believes that most, if not all, craft brewers are performing a similar analysis in order to address the cost pressures and to take into account a weak dollar, which may provide price protection against key import products. Seldom, if ever, have pricing changes in recent years been driven by an inflationary period. Instead, pricing changes implemented by the Company have generally followed pricing changes initiated by large domestic or import brewing companies. While the Company has implemented modest price increases during the past few years, some of the benefit has been offset by competitive promotions and discounting. Additionally, the Company may experience a decline in sales in certain regions following a price increase.

The Company sells its product to Craft Brands at a price substantially below wholesale pricing levels pursuant to the Supply, Distribution and Licensing Agreement with Craft Brands; Craft Brands, in turn, advertises, markets, sells and distributes the product to wholesale outlets in the western U.S. through a distribution agreement between Craft Brands and A-B. The prices that the Company charges Craft Brands for draft product and for bottled product are determined by contractually defined formulas and are based on the twelve month average pricing ending September of the previous year for all Redhook and Widmer draft product and for all Redhook and Widmer bottled product sold by Craft Brands. The prices are adjusted on January 1<sup>st</sup> of each year. Average revenue per barrel for draft products sold to Craft Brands increased nearly 2% for the nine months ended September 30, 2007 compared to the same period in 2006. This increase in pricing accounted for an increase of approximately \$50,000 in total sales. Average revenue per barrel for bottle products sold to Craft Brands decreased nearly 1% for the same period in 2007 compared to 2006 resulting in a decrease of \$70,000 in total sales.

Average revenue per barrel on beer brewed on a contract basis for Widmer pursuant to the Supply, Distribution and Licensing Agreement with Craft Brands is generally at a price substantially lower than wholesale pricing levels. After the Contractual Obligation has been fulfilled pursuant to the Supply, Distribution and Licensing Agreement with Craft Brands, the price charged Widmer for any additional barrels brewed declines pursuant to the Manufacturing and Licensing Agreement with Widmer. Average revenue per barrel for draft beer brewed on a contract basis decreased slightly less than 6% in the first nine months of 2007 compared to 2006 resulting in a decrease of \$133,000 in total sales. In the first quarter of 2007, the Company began shipping bottled beer under this contract brewing arrangement. In connection with all sales through the July 1, 2004 A-B Distribution Agreement, the Company pays a Margin fee to A-B. The Margin does not apply to sales to the Company's retail operations or to dock sales. The Margin also does not apply to the Company's sales to Craft Brands because Craft Brands pays a comparable fee to A-B on its resale of the product. The A-B Distribution Agreement also provides that the Company shall pay an additional fee on shipments that exceed shipments in the same territory during fiscal 2003 (the Additional Margin). For the nine months ended September 30, 2007, the Margin was paid to A-B on shipments totaling 82,700 barrels to approximately 532 distribution points. For the nine months ended September 30, 2006, the Margin was paid to A-B



**Table of Contents**

on shipments totaling 78,400 barrels to approximately 510 distribution points. Because 2007 and 2006 shipments in the midwest and eastern U.S. exceeded 2003 third quarter shipments in the same territory, the Company paid the Additional Margin on 23,500 and 18,600 barrels, respectively. The Margin is reflected as a reduction of sales in the Company's statement of operations.

**Retail Operations and Other Sales.** Sales in the Company's retail operations and other sales increased \$576,000 to \$4,882,000 in the first nine months of 2007 from \$4,306,000 in the same period in 2006, primarily as the result of an increase in beer and food sales.

**Excise Taxes.** Excise taxes increased \$620,000 to \$3,866,000 for the nine months ended September 30, 2007 compared to \$3,246,000 for the nine months ended September 30, 2006, primarily as a result of the overall increase in shipments. The Company continues to be responsible for federal and state excise taxes for all shipments, including those to Craft Brands and brewed under contract. The comparability of excise taxes as a percentage of net sales is impacted by: average revenue per barrel; the mix of sales in the midwest and eastern United States, sales to Craft Brands, sales of beer brewed on contract basis, and pub sales; and the estimated annual average federal and state excise tax rates.

**Cost of Sales.** Cost of sales is comprised of direct and overhead costs incurred to produce the Company's package and draft products, as well as expenses associated with the Company's pub operations. Comparing the first nine months of 2007 to the same period in 2006, cost of sales increased by \$3,943,000 and increased modestly as a percentage of net sales, but was nearly flat on a per barrel basis. The increase in cost of sales was driven by an increase in the production of lower margin beer brewed on a contract basis, an increase in the cost of some raw materials and packaging materials, a higher proportion of packaged product, an increase in the absorption of overhead expenses, and an increase in production losses.

In the nine months of 2007, the Company shipped an additional 31,000 barrels of beer brewed on a contract basis. In addition to the overall increase in shipments of contract beer, approximately 39% of the 2007 year-to-date shipments were packaged product while 2006 year-to-date shipments were entirely draft product.

While the 2007 cost of packaging increased over 2006 costs, this per barrel cost increase was compounded by an increase in 2007 year-to-date shipments of packaged product relative to total shipments. Shipments of packaged product increased to 56.8% in the third quarter of 2007 from 52.9% in the nine months of 2006.

According to industry and media sources, the price of barley, a primary ingredient in most beers, has increased 48% over the last year. The significant price increase is apparently driven by a lower supply of barley as farmers shift their focus to growing corn, a key component of biofuels. While the Company has experienced an increase in the cost of barley over the past year, the Company's fixed price contracts had limited that increase through August 2007 to less than 10%. The Company's existing barley purchase contracts expired during the third quarter of 2007 and the Company entered into new barley supply contracts that reflect current market pricing that is significantly higher than the pricing in the expired contracts. In addition to a decline in the supply of barley, the beer industry appears to also be experiencing a decline in the supply of hops, driven by a number of factors: excess supply in the 1990s led some growers to switch to more lucrative crops, resulting in an estimated 40% decrease in worldwide hop-growing acreage; poor weather in eastern Europe and Germany caused substantial hops crop losses in 2007; hops crop production in England has declined approximately 85% since the mid-1970s; and 2007 U.S., New Zealand, and Australia hops crop yields were only average. As with malted barley, the Company has fixed price purchase contracts for its specialty hops, both to assure that the Company will have the necessary supply for current and future production needs, but also to obtain favorable pricing. In October 2007, the Company entered into a fixed price purchase contract for one of the Company's specialty hops; the Company believes that this contract will provide a substantial portion of the requirements for this hop for the next five years. While the cost of this hop is significantly higher than the Company's cost in prior years, management believes that securing an adequate supply is crucial in the current environment. The Company will likely enter into fixed price purchase contracts for its other significant hops. These increases in the cost of barley and hops had a modest impact on the Company's cost of sales and gross profit for the first nine months of 2007 and will likely have a significant impact on future cost of sales.

**Table of Contents**

The Company's cost of sales includes a licensing fee of \$339,000 and \$343,000 for the nine months of 2007 and 2006, respectively, in connection with the Company's shipment of 23,200 barrels and 24,900 barrels of *Widmer Hefeweizen* in the midwest and eastern United States pursuant to a licensing agreement with Widmer.

Additionally, cost of sales for the nine months ended September 30, 2006 reflect a payment of \$124,000 from A-B for invoice costs collected by A-B from 1994 through 2005 in excess of amounts due under the 1994 A-B Distribution Alliance and the 2004 A-B Distribution Agreement.

Based upon the breweries' combined theoretical production capacity under optimal year-round brewing conditions of 353,000 barrels and 330,000 barrels for the first nine months of 2007 and 2006, the utilization rates were 68% and 63%, respectively. Capacity utilization rates are calculated by dividing the Company's total shipments by the combined theoretical production capacity.

*Selling, General and Administrative Expenses.* Selling, general and administrative expenses for the nine months ended September 30, 2007 increased \$1,320,000 to \$6,610,000 from expenses of \$5,290,000 for the nine months ended September 30, 2006. The increase is primarily attributable to increases in stock-based compensation expense, complying with Sarbanes-Oxley rules, costs related to the possible business combination with Widmer, salaries, and sales and marketing expenditures. In May 2007, the Company issued 24,200 shares of the Company's common stock to independent, non-employee directors and certain executive officers and recognized stock-based compensation expense of \$169,400. Stock-based compensation expense recognized for the nine months ended September 30, 2006 totaled \$54,000 and is attributable to stock options granted to independent, non-employee directors. Driven by the 2007 deadline for implementation of Sarbanes-Oxley Section 404, the Company has incurred additional consulting and accounting-related fees of approximately \$169,000 in the nine months of 2007. Additionally, the Company has incurred approximately \$452,000 in legal, consulting and meeting costs in connection with merger discussions. Salaries and related expenses also increased \$41,000 for the nine months ended September 30, 2007 as compared to the same period in 2006, and sales and marketing promotional expenditures are up \$507,000 for the same 2007 period.

*Income from Equity Investment in Craft Brands.* After giving effect to income attributable to the Kona brand, which was shared differently between the Company and Widmer through 2006, the Craft Brands operating agreement dictates that remaining profits and losses of Craft Brands are allocated between the Company and Widmer based on the cash flow percentages of 42% and 58%, respectively. For the nine months ended September 30, 2007, the Company's share of Craft Brands' net income totaled \$2,210,000. For the nine months ended September 30, 2006, the Company's share of Craft Brands' net income totaled \$2,076,000. Net cash flow of Craft Brands, if any, is generally distributed monthly to the Company based on the Company's cash flow percentage of 42%. In the nine months of 2007, the Company received cash distributions of \$2,222,000, representing its share of the net cash flow of Craft Brands. In the nine months of 2006, the Company received cash distributions of \$1,995,000.

*Interest Expense.* Interest expense declined approximately \$13,000 to \$246,000 in 2007 from \$259,000 in 2006. Slightly lower average interest rates for the nine months of 2007 combined with a declining term loan balance resulted in a decline in interest expense.

*Other Income, net.* Other income, net increased by \$206,000 to \$405,000 for the nine months ended September 30, 2007 from \$199,000 for the nine months ended September 30, 2006, largely attributable to a \$60,000 insurance recovery for expenses incurred following a December 2006 storm and a \$88,000 increase in interest income earned on interest-bearing deposits.

*Income Taxes.* The Company's provision for income taxes was an expense of \$49,000 for the nine months ended September 30, 2007 and an expense of \$218,000 for the nine months ended September 30, 2006. Both periods include a provision for current state taxes. The Company has estimated its tax provision to be \$90,000 for the 2007 year, driven by projected pre-tax results relative to other components of the tax provision calculation, such as the exclusion of a portion of meals and entertainment expenses from tax return deductions. In 2006, the Company increased the valuation allowance that covers net tax operating loss carryforwards and other net deferred tax assets. The valuation allowance covers a portion of the Company's deferred tax assets, specifically certain federal and state NOLs that may expire before the Company is able to utilize the tax benefit. Realization of the benefit is dependent on the Company's ability to generate future U.S. taxable income. To the extent that the Company is unable to generate adequate taxable



**Table of Contents**

income in future periods, the Company will not be able to recognize additional tax benefits and may be required to record a greater valuation allowance covering potentially expiring NOLs.

***Craft Brands Alliance LLC***

The Company has accounted for its investment in Craft Brands under the equity method, as outlined by Accounting Principle Board Opinion ( APB ) No. 18, *The Equity Method of Accounting for Investments in Common Stock*. Pursuant to APB No. 18, the Company has recorded its share of Craft Brands' net income in the Company's statement of operations as income from equity investment in Craft Brands. The following discussion should be read in conjunction with the financial statements and notes thereto of Craft Brands Alliance LLC, filed with the Company's Annual Report on Form 10-K for the year ended December 31, 2006, in Item 15. *Exhibits and Financial Statement Schedules* in accordance with Rule 3-09 of Regulation S-X.

The following summarizes a comparison of certain items included in Craft Brands' statement of operations for the nine months ended September 30, 2007 and 2006. Certain reclassifications have been made to the prior year's financial statements to conform to the current year presentation. The effects of the reclassifications did not affect net income or the profit allocation.

**Sales.** Craft Brands' sales totaled \$57,794,000 for the nine months of 2007 compared to \$52,751,000 for the nine months of 2006. In addition to selling 92,700 barrels of the Company's product to wholesalers in the western United States in the nine months of 2007 and 94,700 barrels in the nine months of 2006, Craft Brands also sold Widmer and Kona products. Total Craft Brands shipments increased approximately 4.9% as compared to shipments in the nine-month period of 2006. Average wholesale revenue per barrel for all draft products sold by Craft Brands, net of discounts, increased more than 3% in the nine months of 2007 as compared to the same period in 2006. Average wholesale revenue per barrel for all bottle products sold by Craft Brands, net of discounts, increased nearly 3% in the nine months of 2007 as compared to the same period in 2006. For the nine months ended September 30, 2007, average wholesale revenue per barrel for all products sold by Craft Brands was flat as compared to average wholesale revenue per barrel on direct sales to wholesalers by the Company during the same period. Craft Brands also pays fees to A-B in connection with sales to A-B that are comparable to fees paid by the Company.

**Cost of Sales.** Cost of sales of Craft Brands totaled \$40,825,000 for the nine months of 2007 compared to \$38,629,000 for the nine months of 2006. The increase in cost of sales over the comparable 2006 period is attributable to higher sales volume, an increase in prices charged by the Company and Widmer for draft product sold to Craft Brands, and modest increases in freight costs, slightly offset by a decrease in prices charged by the Company for bottled product sold to Craft Brands. Craft Brands purchases product from the Company and Widmer at a price substantially below wholesale pricing levels pursuant to the Supply, Distribution, and Licensing Agreement between Craft Brands and each of the Company and Widmer.

**Selling, General and Administrative Expenses.** Craft Brands' selling, general and administrative expenses totaled \$11,239,000 for the nine months of 2007 compared to \$8,952,000 for the nine months of 2006, reflecting all advertising, marketing and promotion efforts for the Redhook, Widmer and Kona brands. During the nine months ended September 30, 2007, sales and marketing costs increased approximately \$1,703,000, attributable to a \$475,000 reduction in the value at which Craft Brands' promotional inventories are stated, the addition of several new positions, and an expansion of the use of promotional materials and media in certain markets. Administrative expenses were approximately \$585,000 higher than the nine months of 2006, largely driven by a change in the presentation of the Additional Margin paid to A-B; in 2007, the Additional Margin is reflected in the statement of operations as selling, general and administrative expense, while in 2006, the Additional Margin is reflected as a reduction of sales. The effects of the change in presentation did not affect net income or the profit allocation to Redhook.

**Net Income.** Craft Brands' net income totaled \$5,263,000 for the nine months of 2007 compared to \$4,956,000 for the nine months of 2006. The Company's share of Craft Brands' net income totaled \$2,210,000 for the nine months of 2007 compared to \$2,076,000 for the nine months of 2006. After giving effect to income attributable to the Kona brand, which was shared differently between the Company and Widmer through 2006, the Craft Brands operating

**Table of Contents**

agreement dictates that remaining profits and losses of Craft Brands are allocated between the Company and Widmer based on the cash flow percentages of 42% and 58%, respectively.

***Outlook***

Shipments in October 2007, including shipments of beer brewed on a contract basis and shipments of *Widmer Hefeweizen* in the midwest and east under the licensing agreement with Widmer, increased 15% to 27,300 barrels as compared to shipments of 23,700 barrels in October 2006. Excluding shipments of *Widmer Hefeweizen* brewed on a contract basis at the Washington Brewery and shipments of *Widmer Hefeweizen* in the midwest and east under the licensing agreement with Widmer, shipments of Redhook products increased 13% in October 2007 compared to October 2006, reflecting an increase of nearly 14% in shipments in the midwest and eastern United States and an increase of nearly 13% in the Craft Brands territory. The Company believes that sales volume for the first month of a quarter should not be relied upon as an accurate indicator of results for future periods. Sales in the craft beer industry generally reflect a degree of seasonality, with the first and fourth quarters historically being the slowest and the rest of the year typically demonstrating stronger sales. The Company has historically operated with little or no backlog and, therefore, its ability to predict sales for future periods is limited.

**Liquidity and Capital Resources**

The Company has required capital principally for the construction and development of its production facilities. Historically, the Company has financed its capital requirements through cash flow from operations, bank borrowings and the sale of common and preferred stock. The Company expects to meet its future financing needs and working capital and capital expenditure requirements through cash on hand, operating cash flow and bank borrowings, and to the extent required and available, offerings of debt or equity securities.

The Company had \$10,594,000 and \$9,435,000 of cash and cash equivalents at September 30, 2007 and December 31, 2006, respectively. At September 30, 2007, the Company had working capital of \$9,473,000. The Company's long-term debt as a percentage of total capitalization (long-term debt and common stockholders' equity) was 6.1% at September 30, 2007 compared to 6.6% at December 31, 2006. Cash provided by operating activities totaled \$2,084,000 for the nine months ended September 30, 2007 and \$3,426,000 for the same period in 2006. Cash provided by operating activities was lower in 2007 as a result of normal fluctuations in operating assets and liabilities. During the nine months ended September 30, 2007, the Company's capital expenditures totaled \$1,092,000, including approximately \$951,000 related to the expansion of fermentation capacity in the New Hampshire Brewery. Capital expenditures for fiscal year 2007 are expected to total approximately \$1.7 million, including the \$1,092,000 incurred to date. Capital expenditures will be funded with operating cash flows. In June 2007, the Company brought an additional 25,000 barrels of fermentation capacity on-line at the New Hampshire Brewery at a cost of nearly \$1.2 million.

The Company has a credit agreement with a bank under which a term loan (the Term Loan) is provided. In June 2006, the credit agreement was amended to extend the maturity date from June 5, 2007 to June 5, 2012. The Term Loan is secured by substantially all of the Company's assets. Interest on the Term Loan accrues at London Inter Bank Offered Rate (LIBOR) plus 1.75% and the Company has the option to fix the applicable interest rate for up to twelve months by selecting LIBOR for one- to twelve- month periods as a base. As of September 30, 2007, there was \$4,388,000 outstanding on the Term Loan, and the Company's one-month LIBOR-based borrowing rate was 7.3%. The termination of the A-B Distribution Agreement for any reason would constitute an event of default under the credit agreement and the bank may declare the entire outstanding loan balance immediately due and payable. If this were to occur, the Company could seek to refinance its Term Loan with one or more banks or obtain additional equity capital; however, there can be no assurance the Company would be able to access additional capital to meet its needs or that such additional capital would be at commercially reasonable terms. The Company plans to pay off the Term Loan in the fourth quarter of 2007.

The terms of the credit agreement require the Company to meet certain financial covenants. The Company was in compliance with all covenants for the quarter ended September 30, 2007 and expects that it will remain in compliance with its debt covenants for the next twelve months. In December 2001, March 2003, February 2004 and October 2004, the credit agreement was amended to modify several financial covenants. In January 2006, the credit agreement was amended to eliminate the tangible net worth covenant (shareholders' equity less intangible assets) as of the year





**Table of Contents**

ended December 31, 2005. These modifications to the financial covenants have reduced the likelihood that a violation of the covenants by the Company will occur in the future. However, if the Company were to report a significant net loss for one or more quarters within a time period covered by the financial covenants, one or more of the covenants would be negatively impacted and could result in a violation. Failure to meet the covenants required by the credit agreement is an event of default and, at its option, the bank could deny a request for a waiver and declare the entire outstanding loan balance immediately due and payable. In such a case, the Company would seek to refinance the loan with one or more banks, potentially at less desirable terms. However, there can be no guarantee that additional financing would be available at commercially reasonable terms, if at all.

The following table summarizes the financial covenants required by the Term Loan and the Company's current level of compliance with these covenants:

|                             | <b>Required by Term Loan</b> | <b>Quarter Ended<br/>September 30, 2007</b> |
|-----------------------------|------------------------------|---|
| Capital ratio               | Less than: 1.25:1            | 0.23:1                                      |
| Working capital             | Greater than: \$1,900,000    | \$9,473,470                                 |
| Fixed charge coverage ratio | Greater than: 1.15:1         | 1.891:1                                     |

**Critical Accounting Policies and Estimates**

The Company's financial statements are based upon the selection and application of significant accounting policies that require management to make significant estimates and assumptions. Management believes that the following are some of the more critical judgment areas in the application of the Company's accounting policies that currently affect its financial condition and results of operations. Judgments and uncertainties affecting the application of these policies may result in materially different amounts being reported under different conditions or using different assumptions.

*Income Taxes.* The Company records federal and state income taxes in accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standard (SFAS) No. 109, *Accounting for Income Taxes*. Deferred income taxes or tax benefits reflect the tax effect of temporary differences between the amounts of assets and liabilities for financial reporting purposes and amounts as measured for tax purposes as well as for tax net operating loss and credit carryforwards.

In June 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes-an interpretation of FASB Statement No. 109*, (FIN No. 48). FIN No. 48 clarifies the accounting and disclosure requirements for uncertainty in income taxes recognized in an entity's financial statements in accordance with SFAS No. 109. The interpretation prescribes the minimum recognition threshold and measurement attribute required to be met before a tax position that has been taken or is expected to be taken is recognized in the financial statements. FIN No. 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition, and clearly scopes income taxes out of FASB No. 5, *Accounting for Contingencies*. FIN No. 48 is effective for fiscal years beginning after December 15, 2006. The Company adopted this interpretation on January 1, 2007. The adoption of FIN No. 48 did not have a material impact on the Company's balance sheet or statement of operations.

**Table of Contents**

As of September 30, 2007, the Company's deferred tax assets were primarily comprised of federal net operating loss carryforwards ( NOLs ) of \$24.9 million, or \$8.5 million tax-effected; federal and state alternative minimum tax credit carryforwards of \$184,000; and state NOL carryforwards of \$200,000 tax-effected. In assessing the realizability of the deferred tax assets, the Company considered both positive and negative evidence when measuring the need for a valuation allowance. The ultimate realization of deferred tax assets is dependent upon the existence of, or generation of, taxable income during the periods in which those temporary differences become deductible. The Company considered the scheduled reversal of deferred tax liabilities, projected future taxable income and other factors in making this assessment. The Company's estimates of future taxable income takes into consideration, among other items, estimates of future taxable income related to depreciation. Based upon the available evidence, the Company does not believe that all of the deferred tax assets will be realized. Accordingly, the Company's balance sheet includes a valuation allowance to cover certain federal and state NOLs that may expire before the Company is able to utilize the tax benefit. As of September 30, 2007, the Company had a valuation allowance of \$1,059,000. To the extent that the Company continues to be unable to generate adequate taxable income in future periods, the Company will not be able to recognize additional tax benefits and may be required to record a greater valuation allowance covering potentially expiring NOLs.

There were no unrecognized tax benefits as of January 1, 2007 or September 30, 2007.

Historically, the Company has not incurred any interest or penalties associated with tax matters and no interest or penalties were recognized during the three months ended September 30, 2007. However, the Company has adopted a policy whereby penalties incurred in connection with tax matters will be classified as general and administrative expenses, and interest assessments incurred in connection with tax matters will be classified as interest expense. Tax years that remain open for examination by federal and state taxing authorities include 2003, 2004, 2005, and 2006. In addition, tax years from 1996 to 2002 may be subject to examination to the extent that the Company utilizes the NOLs from those years in its current year or future year tax returns.

*Long-Lived Assets.* The Company evaluates potential impairment of long-lived assets in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. SFAS No. 144 establishes procedures for review of recoverability and measurement of impairment, if necessary, of long-lived assets, goodwill and certain identifiable intangibles. When facts and circumstances indicate that the carrying values of long-lived assets may be impaired, an evaluation of recoverability is performed by comparing the carrying value of the assets to projected future undiscounted cash flows in addition to other quantitative and qualitative analyses. Upon indication that the carrying value of such assets may not be recoverable, the Company will recognize an impairment loss by a charge against current operations. Fixed assets are grouped at the lowest level for which there are identifiable cash flows when assessing impairment. During 2006, the Company performed an analysis of its brewery assets to determine if an impairment might exist. The Company's estimate of future undiscounted cash flows indicated that such carrying values were expected to be recovered. Nonetheless, it is possible that the estimate of future undiscounted cash flows may change in the future, resulting in the need to write down those assets to their fair value.

*Investment in Craft Brands Alliance LLC.* The Company has assessed its investment in Craft Brands pursuant to the provisions of FASB Interpretation No. 46 Revised, *Consolidation of Variable Interest Entities - an Interpretation of ARB No. 51* ( FIN No. 46R ). FIN No. 46R clarifies the application of consolidation accounting for certain entities that do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties or in which equity investors do not have the characteristics of a controlling financial interest; these entities are referred to as variable interest entities. Variable interest entities within the scope of FIN No. 46R are required to be consolidated by their primary beneficiary. The primary beneficiary of a variable interest entity is determined to be the party that absorbs a majority of the entity's expected losses, receives a majority of its expected returns, or both. FIN No. 46R also requires disclosure of significant variable interests in variable interest entities for which a company is not the primary beneficiary. The Company has concluded that its investment in Craft Brands meets the definition of a variable interest entity but that the Company is not the primary beneficiary. In accordance with FIN No. 46R, the Company has not consolidated the financial statements of Craft Brands with the financial statements of the Company, but instead accounted for its investment in Craft Brands under the equity method, as outlined by APB No. 18, *The Equity Method of Accounting for Investments in Common Stock*. The equity

method requires that the Company recognize its share of the net earnings of Craft Brands by increasing its investment in Craft Brands on the Company's balance sheet and recognizing income from equity investment in the Company's statement

**Table of Contents**

of operations. A cash distribution or the Company's share of a net loss reported by Craft Brands is reflected as a decrease in investment in Craft Brands on the Company's balance sheet. The Company does not control the amount or timing of cash distributions by Craft Brands. For the nine months ended September 30, 2007 and 2006, the Company recognized \$2,210,000 and \$2,076,000, respectively, of undistributed earnings related to its investment in Craft Brands, and received cash distributions of \$2,222,000 and \$1,995,000, respectively, representing its share of the net cash flow of Craft Brands. The Company's share of the earnings of Craft Brands contributed a significant portion of income to the Company's results of operations. The Company will periodically review its investment in Craft Brands to insure that it complies with the guidelines prescribed by FIN No. 46R.

*Refundable Deposits on Kegs.* The Company distributes its draft beer in kegs that are owned by the Company as well as in kegs that have been leased from third-parties. Kegs that are owned by the Company are reflected in the Company's balance sheets at cost and are depreciated over the estimated useful life of the keg. When draft beer is shipped to the wholesaler, regardless of whether the keg is owned or leased, the Company collects a refundable deposit, reflected as a current liability in the Company's balance sheets. Upon return of the keg to the Company, the deposit is refunded to the wholesaler. When a wholesaler cannot account for some of the Company's kegs for which it is responsible, the wholesaler pays the Company, for each keg determined to be lost, a fixed fee and also forfeits the deposit. The Company reduces its fixed assets for the lost keg fee and the forfeited deposit.

Because of the significant volume of kegs handled by each wholesaler and retailer, the similarities between kegs owned by most brewers, and the relatively low deposit collected on each keg when compared to the market value of the keg, the Company has experienced some loss of kegs and anticipates that some loss will occur in future periods. The Company believes that this is an industry-wide problem and the Company's loss experience is typical of the industry. In order to estimate forfeited deposits attributable to lost kegs, the Company periodically uses internal records, A-B records, other third party records, and historical information to estimate the physical count of kegs held by wholesalers and A-B. These estimates affect the amount recorded as fixed assets and refundable deposits as of the date of the financial statements. The actual liability for refundable deposits could differ from estimates. As of September 30, 2007 and December 31, 2006, the Company's balance sheets include \$2,366,000 and \$1,962,000, respectively, in refundable deposits on kegs and \$1,240,000 and \$1,534,000 in keg fixed assets, net of accumulated depreciation.

*Revenue Recognition.* The Company recognizes revenue from product sales, net of excise taxes, discounts and certain fees the Company must pay in connection with sales to A-B, when the products are shipped to customers. Although title and risk of loss do not transfer until delivery of the Company's products to A-B or the A-B distributor, the Company recognizes revenue upon shipment rather than when title passes because the time between shipment and delivery is short and product damage claims and returns are immaterial. The Company recognizes revenue on retail sales at the time of sale. The Company recognizes revenue from events at the time of the event.

**Recent Accounting Pronouncements**

In June 2006, the FASB ratified the consensus of EITF No. 06-3, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation)*. EITF No. 06-3 indicates that the income statement presentation on either a gross basis or a net basis of the taxes within the scope of the issue is an accounting policy decision. The Company's accounting policy is to present the taxes within the scope of EITF No. 06-3 on a gross basis. In accordance with the guidance presented in EITF No. 06-3, the Company's statements of operations separately disclose excise taxes, thus following the approach described as the gross basis.

In July 2006, the FASB issued FIN No. 48, *Accounting for Uncertainty in Income Taxes*. FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109, *Accounting for Income Taxes*. FIN No. 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN No. 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN No. 48 is effective for fiscal years beginning after December 15, 2006. An enterprise shall disclose the cumulative effect of the change on retained earnings in the statement of financial position as of the date of adoption and such disclosure is required only in the year of adoption. On January 1, 2007,



**Table of Contents**

the Company adopted FIN No. 48; the adoption did not have a material effect on its results of operations or financial condition.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in accordance with GAAP, and expands disclosures about fair value measurements. The standard applies whenever other standards require, or permit, assets or liabilities to be measured at fair value. This statement is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Early adoption is permitted. The adoption of SFAS No. 157 as of December 31, 2006 did not have a material impact on the Company's results of operations or financial condition.

In February 2007, FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115*. SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. Early adoption is permitted. The Company is currently evaluating the requirements of SFAS No. 159 and has not yet determined the impact on the financial statements.

**ITEM 3. *Quantitative and Qualitative Disclosures about Market Risk***

The Company has assessed its vulnerability to certain market risks, including interest rate risk associated with financial instruments included in cash and cash equivalents and long-term debt. Due to the nature of these investments and the Company's investment policies, the Company believes that the risk associated with interest rate fluctuations related to these financial instruments does not pose a material risk.

The Company did not have any derivative financial instruments as of September 30, 2007.

**ITEM 4. *Controls and Procedures***

The Company has carried out an evaluation of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(e) or 15d-15(e)) as of the end of the period covered by this quarterly report on Form 10-Q. Based upon that evaluation, the Chief Executive Officer, President and Chief Operating Officer, and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective.

No changes in the Company's internal control over financial reporting were identified in connection with the evaluation that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**PART II. Other Information**

**ITEM 1. *Legal Proceedings***

The Company is involved from time to time in claims, proceedings and litigation arising in the normal course of business. The Company believes that, to the extent that it exists, any pending or threatened litigation involving the Company or its properties will not likely have a material adverse effect on the Company's financial condition or results of operations.

**ITEM 1A. *Risk Factors***

Information regarding risk factors affecting the Company appears in Part I, Item 1A. *Risk Factors* in the Company's Annual Report on Form 10-K for the year ended December 31, 2006. There have been no material changes to the risk factors previously disclosed in the Company's Annual Report on Form 10-K except as described below:

*We may experience a shortage in kegs necessary to distribute our draft beer.* The Company distributes its draft beer in kegs that are owned by the Company as well as leased from A-B and a third-party vendor. During periods when the Company experiences stronger sales, the Company relies on kegs leased from A-B and the third-party vendor to

**Table of Contents**

address the additional demand. As shipments of draft beer increase, the Company may experience a shortage of available kegs to fill sales orders. If the Company cannot meet its keg requirements through either lease or purchase, the Company may be required to delay some draft shipments. Such delays could have an adverse impact on the Company's sales and relationships with its wholesalers, A-B and Craft Brands. The Company is currently reviewing other alternatives for leasing or purchasing kegs. There is no assurance, though, that the Company will be successful securing additional kegs.

**ITEM 2. *Unregistered Sales of Equity Securities and Use of Proceeds***

None.

**ITEM 3. *Defaults Upon Senior Securities***

None.



**Table of Contents**

**ITEM 4. *Submission of Matters to a Vote of Security Holders***

None.

**ITEM 5. *Other Information***

None.

**ITEM 6. *Exhibits***

The following exhibits are filed as part of this report.

- 31.1 Certification of Chief Executive Officer of Redhook Ale Brewery, Incorporated pursuant to Exchange Act Rule 13a-14(a)
- 31.2 Certification of President and Chief Operating Officer of Redhook Ale Brewery, Incorporated pursuant to Exchange Act Rule 13a-14(a)
- 31.3 Certification of Chief Financial Officer of Redhook Ale Brewery, Incorporated pursuant to Exchange Act Rule 13a-14(a)
- 32.1 Certification of Chief Executive Officer of Redhook Ale Brewery, Incorporated pursuant to Exchange Act 13a-14(b) and 18 U.S.C. Section 1350
- 32.2 Certification of President and Chief Operating Officer of Redhook Ale Brewery, Incorporated pursuant to Exchange Act 13a-14(b) and 18 U.S.C. Section 1350
- 32.3 Certification of Chief Financial Officer of Redhook Ale Brewery, Incorporated pursuant to Exchange Act 13a-14(b) and 18 U.S.C. Section 1350

**Table of Contents**

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**REDHOOK ALE BREWERY, INCORPORATED**

November 13, 2007

BY: /s/ Jay T. Caldwell

Jay T. Caldwell  
*Chief Financial Officer  
and Treasurer*

37