REDHOOK ALE BREWERY INC
Form 10-K
March 23, 2007

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-K

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2006

or

o **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	**91-1141254**
(State of incorporation)	*(I.R.S. Employer Identification Number)*
14300 NE 145th Street, Suite 210 **Woodinville, Washington**	**98072-6950**
(Address of principal executive offices)	*(Zip Code)*

(425) 483-3232
(Registrant s telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, Par Value $0.005 Per Share	The NASDAQ Stock Market LLC

Securities registered pursuant to Section 12(g) of the Act:
None.
(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No þ

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No þ

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 þ No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. þ

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 o Accelerated Filer o Non-accelerated Filer þ

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ

The aggregate market value of the Common Stock held by non-affiliates of the registrant as of the last day of the registrant s most recently completed second quarter on June 30, 2006 (based upon the closing sale price of the registrant s Common Stock, as reported by The NASDAQ Stock Market) was $18,493,409.(1)

The number of shares of the registrant s Common Stock outstanding as of March 20, 2007 was 8,304,639.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant s Proxy Statement relating to the registrant s 2007 Annual Meeting of Stockholders to be held on May 22, 2007 are incorporated by reference into Part III of this Report.

(1) Excludes shares held of record on that date by directors and executive officers and greater than 10% shareholders of the registrant. Exclusion of such shares should not be construed to indicate that any such person directly or indirectly possesses the power to direct or cause the direction of the management of the policies of the registrant.

REDHOOK ALE BREWERY, INCORPORATED

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PART I.

Item 1. *Business*

Redhook Ale Brewery, Incorporated (Redhook or the Company) has been an independent brewer of craft beers in the U.S. since the Company s formation in 1981 and is considered to be one of the pioneers of the domestic craft brewing segment. Redhook 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). By operating its own small-batch breweries, the Company believes that it is better able to control the quantities, types and flavors of beer produced, while optimizing the quality and consistency of its products. Management believes that the Company s production capacity is of high quality and that Redhook is the only domestic craft brewer that owns and operates substantial production facilities in both the western region and eastern region of the U.S.

The Company currently produces nine styles of beer, marketed under distinct brand names. The Company s flagship brand is *Redhook ESB* and its other principal products include *Redhook Long Hammer IPA*, *Redhook Blonde Ale*, *Blackhook Porter*, and its seasonal offerings *Nut Brown*, *Sunrye*, *Late Harvest Autumn*, *Winterhook* and *Copperhook Ales.* The Company also sells *Widmer Hefeweizen* in the midwest and eastern U.S. under a 2003 licensing agreement with Widmer Brothers Brewing Company (Widmer). In addition to its principal products, the Company periodically develops and markets new products to test and measure consumer response to varying styles and flavors.

Since July 2004, the Company has distributed its products in the western U.S. through Craft Brands Alliance LLC (Craft Brands or CBA), a joint venture between the Company and Widmer. See Product Distribution Relationship with Craft Brands Alliance LLC below. In the midwest and eastern U.S., the Company has continued to distribute its products through a distribution agreement with Anheuser-Busch, Incorporated (A-B). See Product Distribution Relationship with Anheuser-Busch, Incorporated below.

Industry Background

The Company is a brewer in the relatively small craft brewing segment of the U.S. brewing industry. The domestic beer market is comprised of ales and lagers produced by large domestic brewers, international brewers and craft brewers. Although 2006 production and 2005 production of craft beer is estimated by industry sources to have increased by approximately 12% and 9%, respectively, over the previous year s production, the share of the domestic beer sales market held by the craft beer segment remains small. Craft beer shipments in 2006, 2005 and 2004 were approximately 3.2%, 3.5% and 3.2%, respectively, of total beer shipped in the U.S. Approximately 6.7 million, 6.0 million and 5.6 million barrels were shipped in the U.S. by the craft beer segment during 2006, 2005 and 2004, while total beer sold in the U.S., including imported beer, was approximately 209 million, 205 million and 206 million barrels, respectively. The number of craft brewers in the U.S. grew dramatically between 1994 and 2000, increasing from 627 participants at the end of 1994 and peaking at nearly 1,500 in 2000. At the end of 2006 and 2005, the number of craft brewers was estimated to be 1,400.

From a peak in 1873 of 4,131 U.S. breweries, the number of breweries had dropped to 1,500 by 1910 as a result of improved production and distribution. Approximately 760 of these breweries reopened following Prohibition. During the ensuing decades, the beer industry concentrated its resources primarily on marketing pale lagers and pilsners for various reasons, including: the desire to appeal to the broadest possible segment of the population; to benefit from economies of scale through large-scale production techniques; to prolong shelf life through use of pasteurization processes; and to take advantage of mass media advertising reaching consumers nationwide. At the same time that the beer industry was narrowing its product offerings to compete more effectively, there was also extensive consolidation occurring in the industry, still apparent in today s market composition. According to industry sources, the three largest domestic brewers accounted for approximately 78% of total beer shipped in the U.S., including imports, in 2006.

Annual per capita domestic beer consumption has declined from the highs experienced in the early 1980s, a result of an elevated concern over health and safety issues, changing tastes, and evolving affluence and consumption attitudes of a maturing generation of beer drinkers born after World War II. Since the early 1980s, a sizable number of consumers have migrated away from the major domestic products toward a broader taste and variety in their malt beverages, mirroring similar trends in other beverage and cuisine categories. Foreign brewers initially benefited from these evolving consumption patterns. Despite also being produced by large brewers, European, Canadian and Mexican imported beers offered a fuller-flavored alternative to the national brands produced in the U.S.

By the latter half of the 1980s, a substantial new domestic industry segment had developed in response to the increasing consumer demand for specialty beers. Across the country, a proliferation of regional specialty brewers (annually selling more than 15,000 barrels but less than two million barrels of craft beer brewed at their own facilities), contract brewers (selling craft beer brewed by a third party to the contract brewer s specifications), microbreweries (selling less than 15,000 barrels per year), and brewpubs (combination restaurant-breweries) emerged to form the craft beer industry. This new segment was able to deliver the fuller flavored products presented by the imported beers while still offering a fresher product than most imports and one that could appeal to local taste preferences. Craft beer producers tend to concentrate on fuller flavors and less on appealing to mass markets. The strength of consumer demand has enabled certain craft brewers, such as the Company, to evolve from microbreweries into regional and national specialty brewers by constructing larger breweries while still adhering to the traditional European brewing methods that typically characterize the craft brewing segment. Industry sources estimate that craft beer produced by regional specialty brewers, such as the Company, accounts for approximately two thirds of total craft beer sales. Other craft brewers have sought to take advantage of growing consumer demand and excess industry capacity, when available, by contract brewing at underutilized facilities.

Since its formation in the 1980s, the rate at which the craft beer segment has grown has fluctuated. The late 1980s and early 1990s were years of significant growth for the segment, only to be followed by several years of minimal growth in the late 1990s and early 2000s. Recent industry reports for 2004, 2005 and 2006 performance, however, indicate favorable trends once again. The craft beer segment s success has been impacted, both positively and negatively, by the success of the larger specialty beer category as well as the domestic alcoholic beverage market. Imported beers have enjoyed resurgence in demand since the mid-1990s. Certain national domestic brewers have increased the competition by producing their own fuller-flavored products to compete against craft beers. In 2001 and 2002, flavored malt beverages were introduced to the market, initially gaining significant interest but recently experiencing smaller returns. Finally, the wine and spirits market has seen a surge in recent years, attributable to competitive pricing, television advertising, increased merchandising, and increased consumer interest in wine and spirits.

Business Strategy

Redhook strives to be the preeminent specialty craft brewing company in the U.S., producing the highest quality ale products in company-owned facilities, and marketing and selling them responsibly through its three-tier distribution system.

The central elements of the Company s business strategy include:

Production of High-Quality Craft Beers. The Company is committed to the production of a variety of distinctive, flavorful craft beers. The Company brews its craft beers according to traditional European brewing styles and methods, using only high-quality ingredients to brew in company-owned and operated brewing facilities. As a symbol of quality, the Company s products are Kosher certified by the Orthodox Union, a certification rarely sought by other brewers. The Company does not intend to compete directly in terms of production style, pricing or extensive mass-media advertising typical of large national brands.

Control of Production in Company-Owned Breweries. The Company builds, owns and operates its own brewing facilities to optimize the quality and consistency of its products and to achieve the greatest control over its production costs. Management believes that its ability to engage in ongoing product innovation and to control product quality provides critical competitive advantages. The Company s highly automated breweries are designed to produce beer in small batches, while attaining production economies through automation rather than scale. The Company believes that its investment in technology enables it to optimize employee productivity, to contain related operating costs, to produce innovative beer styles and tastes, and to achieve the production flexibility afforded by small-batch brewing, with minimal loss of efficiency and process reliability.

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Strategic Distribution Relationship with Industry Leader. Since October 1994, the Company has benefited from a distribution relationship with A-B, pursuant to which Redhook distributes its products in substantially all of its markets through A-B s wholesale distribution network. A-B s domestic network consists of more than 560 independent wholesale distributors, most of which are geographically contiguous and independently owned and operated, and 13 branches owned and operated by A-B. This distribution relationship with A-B has offered efficiencies in delivery of product, state reporting and licensing, billing and collections. The Company believes that the existence of the distribution relationship with A-B has also provided the Company with access to A-B distributors at A-B s distributor conventions, communications about Redhook in printed distributor materials, and A-B-supported opportunities for Redhook to educate A-B distributors about the Company s specialty products. The Company believes that the opportunities to access A-B distributors has benefited the Company by creating increased awareness of and demand for Redhook products among A-B distributors. The Company is able to reap the benefits of this distribution relationship with A-B while, as an independent company, maintaining control over the production and marketing of its products.

Sales and Marketing Relationship with Craft Brands Alliance LLC. On July 1, 2004, the Company entered into agreements with Widmer, headquartered in Portland, Oregon, to form a joint sales and marketing organization that serves both companies operations in the western U.S. The joint organization, named Craft Brands Alliance LLC, advertises, markets, sells and distributes both Redhook s and Widmer s products to wholesale outlets through a distribution agreement between Craft Brands and A-B. Management believes that, in addition to achieving certain synergies, Craft Brands capitalizes on both companies sales and marketing skills and complementary product portfolios. The Company believes that the combination of the two brewers complementary brand portfolios, led by one focused sales and marketing organization, will not only deliver financial benefits, but will also deliver greater impact at the point of sale.

Operation of Regional Brewing Facilities. Management believes that, by locating its production facilities in proximity to the key regional markets it serves, the Company is able to enjoy distinct competitive advantages. Shortened delivery times maximize product freshness and reduce shipping costs. Established brand awareness of the Company s products and enhanced familiarity with local consumer tastes enable the Company to offer select products that appeal to regional preferences. By pursuing this strategy, Redhook believes that it will be able to preserve its reputation and prestige as a regional craft brewer.

Promotion of Products. The Company promotes its products through a variety of advertising programs with its wholesalers, by training and educating wholesalers and retailers about the Company s products, through promotions at local festivals, venues, and pubs, by utilizing its pubs located at the Company s two breweries, through price discounting, and, more recently, through Craft Brands. In the midwest and eastern U.S., the Company s principal advertising programs include radio, billboards and print advertising (magazines, newspapers, industry publications). The Company also markets its products to distributors, retailers and consumers through a variety of specialized training and promotional methods, including training sessions for distributors and retailers in understanding the brewing process, the craft beer segment and Redhook products. Promotional methods directed towards consumers include introducing Redhook products on draft in pubs and restaurants, using promotional items including tap handles, glassware and coasters, and participating in local festivals and sports venues to increase brand name recognition. In addition, the Company s prominently located breweries feature pubs and retail outlets and offer guided tours to further increase consumer awareness of Redhook. Craft Brands is responsible for promotion, advertising and marketing in the western U.S. and uses methods similar to the Company in its promotion of Redhook products.

The Company will occasionally enter into advertising and promotion programs where the entire program is funded by the Company but, in recent years, has favored co-operative programs where the Company s spending is matched with an investment by a local distributor. Co-operative programs align the interests of the Company with those of the wholesaler whose local market knowledge contributes to more effective promotions. Sharing these efforts with a wholesaler helps the Company to leverage the investment made on programs where the participating wholesaler has a vested interest in the program s success.

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Products

The Company produces a variety of specialty craft beers using traditional European brewing methods. The Company brews its beers using only high-quality hops, malted barley, wheat, rye and other natural ingredients, and does not use any rice, corn, sugar, syrups or other adjuncts. The Company s beers are marketed on the basis of freshness and distinctive flavor profiles. To help maintain full flavor, the Company s products are not pasteurized. As a result, it is appropriate that they be kept cool so that oxidation and heat-induced aging will not adversely affect the original taste, and that they be distributed and served as soon as possible, generally within three months after packaging, to maximize freshness and flavor. The Company distributes its products only in glass bottles and kegs, and its products are freshness dated for the benefit of wholesalers and consumers.

The Company presently produces nine principal brands, each with its own distinctive combination of flavor, color and clarity:

Redhook ESB (ESB). The Company s flagship brand, *ESB*, which accounted for approximately 36%, 47% and 50% of the Company s shipments in 2006, 2005 and 2004, respectively, is full, rich, well-rounded, amber-colored ale with a sweet toasted malt flavor balanced by a pleasant floral liveliness derived from German Tettnang hops. *ESB* has declined as a percentage of total sales over the past three years due to increases in sales of Redhook s other products, particularly *Redhook Long Hammer IPA*, seasonal offerings, and variety packs, and licensed *Widmer.*

Redhook Long Hammer IPA (Long Hammer). A premium English, pub-style bitter ale, *Long Hammer*, accounted for approximately 16%, 17% and 16% of the Company s shipments in 2006, 2005 and 2004, respectively. *Long Hammer* is pale and aggressively hopped, has a brassy color imparted by caramelized malt, an herbal aroma characteristic of Northwest Cascade hops and a crisp finish.

Redhook Blonde Ale. A delicious, thirst-quenching golden ale, the combination of lightly roasted barley, subtle hops, and a touch of wheat creates a perfectly balanced and distinctively drinkable ale.

Blackhook Porter (Blackhook). A London-style porter, *Blackhook* has an ebony tone, a pleasant toasted character produced by highly roasted barley, and a dark malt flavor suggesting coffee and chocolate, balanced by lively hopping.

Copperhook Ale (Copperhook). This ale is cold fermented so beer drinkers can enjoy the full flavor characteristics. *Copperhook* is appetizingly fruity with light maltiness and a very pleasant piney hint in the aroma.

Nut Brown Ale. A malty ale with a hint of sweetness in the finish. The combination of six barley malts and two hop varieties results in a surprisingly smooth, well-balanced dark beer. *Nut Brown Ale* is available in the Company s midwest and eastern markets in late winter and early spring.

Redhook Sunrye Ale (Sunrye). Gently roasted barley, delicate hops and a touch of rye combine for a very balanced lighter style ale. Slightly unfiltered to exude a pearl glow, *Sunrye* is styled for warm weather refreshment. *Sunrye* is available from April through September in western markets and April through July in midwest and eastern markets.

Late Harvest Autumn Ale (Autumn Ale). A roasted malt aroma and distinct flavors of the Northern Brewer and Saaz hops mark this full-bodied ale. The two row barley foundation malt gives *Autumn Ale* its full body. The specialty malts Crystal, German Smoked Munich, Caramel and Roasted give it a rich complexity. *Autumn Ale* is available August to September in midwest and eastern markets.

Winterhook. A rich, seasonal holiday ale formulated specially each year for cold-weather enjoyment, *Winterhook* typically is deep in color and rich in flavor, with complex flavors and a warm finish. Typically, the Company changes the style of this ale each year. *Winterhook* is available during fall and winter months.

The Company also sells *Widmer Hefeweizen* in the midwest and eastern U.S. under license from Widmer. *Widmer Hefeweizen* is a golden unfiltered wheat beer and is one of the leading American style Hefeweizens sold in the U.S. 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

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territory was expanded to include all of the Company s midwest and eastern markets. Brewing of this product is conducted at the New Hampshire Brewery under the supervision and assistance of Widmer s brewing staff to insure their brand s quality and matching taste profile. The term of this agreement expires February 1, 2008, 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 side 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 to partially compensate the Company for capital equipment expenditures made at the New Hampshire Brewery to support Widmer s growth. 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 believes that the agreement increases capacity utilization and has strengthened the Company s product portfolio. The Company shipped 30,600, 25,600 and 17,800 barrels of *Widmer Hefeweizen* during the years ended December 31, 2006, 2005 and 2004, respectively. A licensing fee of $437,000, $399,000 and $266,000 due to Widmer is reflected in the Company s statement of operations for the years ended December 31, 2006, 2005 and 2004, respectively. If the Widmer Licensing Agreement were terminated early, or if Widmer gave notice of its election to terminate the agreement according to its term on February 1, 2008, the Company would need to look to replace the lost volume, either through new and existing Redhook products or alternative brewing relationships. If the Company is unable to replace the lost Widmer volume, 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.

The Company also sells *Pacific Ridge* in the western U.S. In 2003, the Company entered into a purchase and sale agreement with A-B for the purchase of the *Pacific Ridge* brand, trademark and related intellectual property. In consideration, the Company agreed to pay A-B a fee for 20 years based upon the Company s sales of the brand. The Company shipped 5,900, 6,000, and 5,400 barrels of *Pacific Ridge* during 2006, 2005 and 2004, respectively. A fee of $80,000, $83,000 and $80,000 due to A-B is reflected in the Company s statement of operations for the years ended December 31, 2006, 2005 and 2004, respectively.

In an effort to be responsive to varying consumer style and flavor preferences, the Company periodically engages in the development and testing of new products. The Company believes that the continued success of craft brewers will be affected by their ability to be innovative and attentive to consumer desires for new and distinctive taste experiences while maintaining consistently high product quality. The Company s breweries allow it to produce small-batch experimental ales within three weeks. Experimental products are periodically developed and typically produced in draft form only for on-premise test marketing at the Company s pubs and selected retail sites. If the initial consumer reception of an experimental brew is sufficiently positive, then its taste and formula are refined, as necessary, and a new Redhook brand may be created. *Long Hammer, Redhook Blonde Ale* and many of the Company s seasonal offerings are examples of products that were developed in this manner.

Brewing Operations

The Brewing Process. Beer is made primarily from four natural ingredients: malted grain, hops, yeast and water. The grain most commonly used in brewing is barley, owing to its distinctive germination characteristics that make it easy to ferment. The Company uses the finest barley malt, using strains of barley having two rows of grain in each ear. A wide variety of hops may be used to add seasoning to the brew; some varieties best confer bitterness, while others are chosen for their ability to impart distinctive aromas to the beer. Nearly all the yeasts used to induce or augment fermentation of beer are of the species *Saccharomyces cerevisiae,* which includes both the top-fermenting yeasts used in ale production and the bottom-fermenting yeasts associated with lagers.

The brewing process begins when the malt supplier soaks the barley grain in water, thereby initiating germination, and then dries and cures the grain through kilning. This process, known as malting, breaks down complex carbohydrates and proteins so that they can be easily extracted. The malting process also imparts color and flavor characteristics to the grain. The cured grain, referred to as malt, is then sold to the brewery. At the brewery, various malts are cracked by milling, and mixed with warm water. This mixture, or mash, is heated and stirred in the mash tun, allowing the simple carbohydrates and proteins to be converted into fermentable sugars. Naturally occurring enzymes help facilitate this process. The mash is then strained and rinsed in the lauter tun to produce a residual liquid, high in fermentable sugars, called wort, which then flows into a brew kettle to be boiled and concentrated. Hops are added during the boil to impart bitterness, balance and aroma. The specific mixture of hops and the brewing time and temperature further affect the flavor of the beer. After the boil, the wort is strained and cooled before it is moved to a fermentation cellar, where specially cultured yeast is added to induce fermentation. During fermentation, the wort s sugars are metabolized by the yeast, producing carbon dioxide and alcohol. Some of the carbon dioxide is recaptured and absorbed back into the beer, providing a natural source of carbonation. After fermentation, the beer is cooled for several days while the beer is clarified and full flavor develops. Filtration, the final step for a filtered beer, removes unwanted yeast. At this point, the beer is in its peak condition and ready for bottling or keg racking. The entire brewing process of ales, from mashing through filtration, is typically completed in 14 to 21 days, depending on the formulation and style of the product being brewed.

Brewing Equipment. The Company uses highly automated small-batch brewing equipment. The Washington Brewery employs a 100-barrel mash tun, lauter tun, wort receiver, wort kettle, whirlpool kettle, five 70,000-pound, one 35,000-pound and two 25,000-pound grain silos, two 100-barrel, fifty-four 200-barrel, and ten 600-barrel fermenters, and two 300-barrel and four 400-barrel bright tanks. The New Hampshire Brewery employs a 100-barrel mash tun, lauter tun, wort receiver, wort kettle, whirlpool kettle, three 70,000-pound and two 35,000-pound grain silos, nine 100-barrel, two 200 barrel and twenty-two 400-barrel fermenters, two 200-barrel and two 400-barrel bright tanks, and an anaerobic waste-water treatment facility which completes the process cycle. Both breweries use advanced micro filtration technology, including a diatomaceous earth pad filter and sterile filtration. During the spring of 2007 the Company plans to add four additional 400-barrel fermenters, one 70,000 pound grain silo and make process control automation upgrades to the New Hampshire brewery. Installation is expected to be completed by May 2007 and cost approximately $1,000,000. This expansion will add approximately 25,000 barrels of capacity to the New Hampshire brewery.

Packaging. The Company packages its craft beers in both bottles and kegs. Both of the Company s breweries have fully automated bottling and keg lines. The bottle filler at both breweries utilizes a carbon dioxide environment during bottling that is designed to ensure that minimal oxygen is dissolved in the beer, thereby extending product shelf life.

Quality Control. The Company monitors production and quality control at both of its breweries, with central coordination at the Washington Brewery. Both the Washington and New Hampshire breweries have an on-site laboratory where microbiologists and lab technicians supervise on-site yeast propagation, monitor product quality, test products, measure color and bitterness, and test for oxidation and unwanted bacteria. The Company also regularly utilizes outside laboratories for independent product analysis.

Ingredients and Raw Materials. The Company currently purchases a significant portion of its malted barley from a single supplier and its premium-quality select hops, grown in the Pacific Northwest, Germany and Czech Republic, from competitive sources. The Company periodically purchases small lots of European hops that it uses to achieve a special hop character in certain of its beers. In order to ensure the supply of the hop varieties used in its products, the Company enters into supply contracts for its hop requirements. Redhook believes that comparable quality malted barley and hops are available from alternate sources at competitive prices, although there can be no assurance that pricing would be consistent with the Company s current arrangements. The Company currently cultivates its own *Saccharomyces cerevisiae* yeast supply and maintains a separate, secure supply in-house. The Company has access to multiple competitive sources for packing materials, such as bottles, labels, six-pack carriers, crowns and shipping cases.

Product Distribution

The Company s products are available for sale directly to consumers in draft and bottles at restaurants, bars and liquor stores, as well as in bottles at supermarkets, warehouse clubs, convenience stores and drug stores. Like substantially all craft brewers, the Company s products are delivered to these retail outlets through a network of local distributors whose principal business is the distribution of beer and, in some cases, other alcoholic beverages, and who traditionally have distribution relationships with one or more national beer brands. To promote and educate the public on the Company s products, Redhook also offers its products directly to consumers at the Company s two on-premise retail establishments located at the Company s breweries, the Forecasters Public House in Woodinville, Washington and the Cataqua Public House in Portsmouth, New Hampshire.

Prior to establishing a distribution relationship with A-B in 1994, the Company distributed its products regionally through distributors, many of which were part of the A-B distribution network, in eight western states: Washington, California (northern), Oregon, Idaho, Montana, Wyoming, Colorado and Alaska. In October 1994, the Company entered into a distribution agreement with A-B (Distribution Alliance or the Alliance) pursuant to which the Company began distributing its products, for any new markets entered, exclusively through this agreement. Existing wholesalers continued to distribute the Company s products outside of the Distribution Alliance. By 2003, 72% of the Company s sales volume was through Alliance distributors.

On July 1, 2004, the Company entered into a new distribution agreement with A-B (the A-B Distribution Agreement) pursuant to which the Company continues to sell its product in the midwest and eastern U.S. through sales to A-B and distribute its product through the A-B distribution network.

On July 1, 2004, the Company also entered into agreements with Widmer with respect to the operation of their joint venture sales and marketing entity, Craft Brands. Under their agreements with Craft Brands, 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 U.S. through a distribution agreement between Craft Brands and A-B.

Currently, there are no Company products distributed in the U.S. by a wholesaler that are not distributed pursuant to the A-B Distribution Agreement or the distribution agreement between Craft Brands and A-B.

For additional information regarding the Company s relationship with A-B and Craft Brands, see Relationship with Anheuser-Busch, Incorporated and Relationship with Craft Brands Alliance LLC below.

A-B, whose products accounted for approximately 48% of total beer shipped by volume in the U.S. in 2006, including imports, distributes its products throughout the U.S. through a network of more than 560 independent wholesale distributors, most of whom are geographically contiguous and independently owned and operated, and 13 branches owned and operated by A-B. The Company believes that the typical A-B distributor is financially stable and has both a long-standing presence and a substantial market share of beer sales in its territory.

Redhook chose to align itself with A-B through the 1994 Distribution Alliance, and again through the 2004 A-B Distribution Agreement and Craft Brands distribution agreement with A-B, to gain access to quality distribution throughout the U.S. The Company was the first and is the largest independent craft brewer to have a formal distribution agreement with a major U.S. brewer. Management believes that the Company s competitors in the craft beer segment generally negotiate distribution relationships separately with distributors in each locality and, as a result, typically distribute through a variety of wholesalers representing differing national beer brands with uncoordinated territorial boundaries. Because A-B s distributors are assigned territories that generally are contiguous, the distribution relationship with A-B enables the Company to reduce the gaps and overlaps in distribution coverage often experienced by the Company s competitors.

In 2006 and 2005, the Company sold approximately 101,400 and 85,100 barrels to A-B through the A-B Distribution Agreement, accounting for approximately 37% and 38% of the Company s sales volume for the period. During these same periods, the Company shipped approximately 122,600 and 126,500 barrels, or 45% and 56% of the Company s sales volume, to Craft Brands.

During the last six months of 2004, the Company sold approximately 38,000 barrels to A-B through the A-B Distribution Agreement, accounting for approximately 36% of the Company s sales volume for the same period. Also during this same period, the Company shipped approximately 63,600 barrels, or 61% of the Company s sales volume, to Craft Brands.

For the six months ended June 30, 2004, the Company shipped its products to 495 Alliance distribution points, accounting for 84,000 barrels, or 74% of the Company s total sales volume for the same period. In addition, sales through wholesalers that were part of the A-B distribution network but that were not part of the Alliance accounted for an additional 22%, or 24,000 barrels, of the Company s sales volume.

The Company s most significant wholesaler, K&L Distributors, Inc. (K&L), is responsible for distribution of the Company s products in most of King County, Washington, including Seattle, Washington. K&L accounted for approximately 11%, 12% and 13% of total sales volume in 2006, 2005 and 2004, respectively. Shipments of the Company s product to K&L during all of 2006, 2005 and the last six months of 2004 were made through Craft Brands. 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.

Relationship with Anheuser-Busch, Incorporated

On July 1, 2004, the Company completed the restructuring of its ongoing relationship with A-B. Pursuant to an exchange and recapitalization agreement between the Company and A-B (the Exchange and Recapitalization Agreement), the Company issued 1,808,243 shares of its common stock (Common Stock) to A-B in exchange for 1,289,872 shares of Series B Preferred Stock held by A-B. The Series B Preferred Stock, reflected in the Company s July 1, 2004 balance sheet at approximately $16.3 million, was subsequently cancelled. In connection with the exchange, the Company also paid $2.0 million to A-B in November 2004. A-B was also granted certain contractual registration rights with respect to its shares of the Company s Common Stock. As of December 31, 2006 and 2005, A-B owned approximately 33.3% and 33.6%, respectively, of the Company s Common Stock.

Additionally, pursuant to the Exchange and Recapitalization Agreement, A-B is entitled to designate two members of the board of directors of the Company. A-B also generally has the contractual right to have one of its designees sit on each committee of the board of directors of the Company. The Exchange and Recapitalization Agreement contains limitations on, among other matters, the Company s ability to issue equity securities or acquire or sell assets or stock, amend its Articles of Incorporation or bylaws, grant board representation rights, enter into certain transactions with affiliates, distribute its products in the U.S. other than through A-B, Craft Brands or as provided in the A-B Distribution Agreement, voluntarily delist or terminate its listing on the NASDAQ Stock Market, or dispose any of its interest in Craft Brands, without the prior consent of A-B. Further, if the new A-B Distribution Agreement described below or the distribution agreement between Craft Brands and A-B is terminated, or the distribution of Redhook products is terminated by Craft Brands under the distribution agreement between Craft Brands and A-B, A-B has the right to solicit and negotiate offers from third parties to purchase all or substantially all of the assets or securities of the Company or to enter into a merger or consolidation transaction with the Company and the right to cause the board of directors of the Company to consider any such offer.

On July 1, 2004, the Company also entered into a new A-B Distribution Agreement. The A-B Distribution Agreement provides for the distribution of the Company s products in the midwest and eastern U.S. (the Eastern Territory), which represents those states not covered by the Supply, Distribution and Licensing Agreement between the Company and Craft Brands. The structure of the new A-B Distribution Agreement is substantially similar to the Company s prior arrangement with A-B. Under the A-B Distribution Agreement, the Company has granted A-B the first right to distribute Redhook products, including future new products, in the Eastern Territory. The Company is responsible for marketing its products to A-B s distributors in the Eastern Territory, as well as to retailers and consumers. The A-B distributors then place orders with the Company, through A-B, for Redhook products. The Company separately packages and ships the orders in refrigerated trucks to the A-B distribution center nearest to the distributor or, under certain circumstances, directly to the distributor.

The new A-B Distribution Agreement has a term that expires on December 31, 2014, subject to automatic renewal for an additional ten-year period unless A-B provides written notice of non-renewal to the Company on or prior to June 30, 2014. The A-B Distribution Agreement is also subject to early termination, by either party, upon the occurrence of certain events. The A-B Distribution Agreement may be terminated immediately, by either party, upon the occurrence of any one or more of the following events:

1) a material default by the other party in the performance of any of the provisions of the A-B Distribution Agreement or any other agreement between the parties, which default is either:

i) curable within 30 days, but is not cured within 30 days following written notice of default; or

ii) not curable within 30 days and either:

(1) the defaulting party fails to take reasonable steps to cure as soon as reasonably possible following written notice of such default; or

(2) such default is not cured within 90 days following written notice of such default;

2) default by the other party in the performance of any of the provisions of the A-B Distribution Agreement or any other agreement between the parties, which default is not described in (1) above and which is not cured within 180 days following written notice of such default;

3) the making by the other party of an assignment for the benefit of creditors; or the commencement by the other party of a voluntary case or proceeding or the other party s consent to or acquiescence in the entry of an order for relief against such other party in an involuntary case or proceeding under any bankruptcy, reorganization, insolvency or similar law;

4) the appointment of a trustee or receiver or similar officer of any court for the other party or for a substantial part of the property of the other party, whether with or without the consent of the other party, which is not terminated within 60 days from the date of appointment thereof;

5) the institution of bankruptcy, reorganization, insolvency or liquidation proceedings by or against the other party without such proceedings being dismissed within 90 days from the date of the institution thereof;

6) any representation or warranty made by the other party under or in the course of performance of the A-B Distribution Agreement that is false in material respects; or

7) the distribution agreement between Craft Brands and A-B is terminated or the distribution thereunder of the products of Redhook is terminated pursuant to its terms.

Additionally, the A-B Distribution Agreement may be terminated by A-B, upon six months prior written notice to the Company, in the event:

1) the Company engages in certain Incompatible Conduct which is not curable or is not cured to A-B s satisfaction (in A-B s sole opinion) within 30 days. Incompatible Conduct is defined as any act or omission of the Company that, in A-B s determination, damages the reputation or image of A-B or the brewing industry;

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2) any A-B competitor or affiliate thereof acquires 10% or more of the outstanding equity securities of the Company, and one or more designees of such person becomes a member of the board of directors of the Company;

3) the current chief executive officer of the Company ceases to function as chief executive officer and within six months of such cessation a successor satisfactory in the sole, good faith discretion of A-B is not appointed;

4) the Company is merged or consolidated into or with any other person or any other person merges or consolidates into or with the Company; or

5) A-B or its corporate affiliates incur any liability or expense as a result of any claim asserted against them by or in the name of the Company or any shareholder of the Company as a result of the equity ownership of A-B or its affiliates in the Company, or any equity transaction or exchange between A-B or its affiliates and the Company, and the Company does not reimburse and indemnify A-B and its corporate affiliates on demand for the entire amount of such liability and expense.

Fees

Generally, the Company pays the following fees to A-B in connection with the sale of the Company s products:

Margin. In connection with all sales through the Distribution Alliance prior to July 1, 2004, the Company paid a Margin fee to A-B. The Margin did not apply to sales to wholesalers and others that were part of the A-B distribution network but that were not part of the Distribution Alliance, including most sales to Washington State wholesalers, sales to non-A-B wholesalers, sales by the Company s retail operations and dock sales. The July 1, 2004 A-B Distribution Agreement modified the Margin fee structure such that the Margin per barrel shipped increased and is paid on all sales through the new A-B Distribution Agreement. 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 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 for the same territory during fiscal 2003 (the Additional Margin). In addition, the Exchange and Recapitalization Agreement provided that the Margin be retroactively increased to the rate provided in the A-B Distribution Agreement for all shipments in June 2004.

For the years ended December 31, 2006 and 2005, the Margin was paid to A-B on shipments totaling 101,400 and 85,100 barrels to 503 and 472 distribution points, respectively. Because 2006 and 2005 shipments in the midwest and eastern U.S. exceeded 2003 shipments in the same territory, the Company paid A-B the Additional Margin on 23,000 and 7,000 barrels, respectively. For the six month period ended December 31, 2004, the Margin was paid to A-B on shipments totaling 38,000 barrels to 371 distribution points, and the retroactive increase on June 2004 shipments was paid on approximately 20,000 barrels. For the six months ended June 30, 2004, the Margin was paid to A-B on shipments totaling 84,000 barrels to 495 Alliance distribution points. The Margin paid is reflected as a reduction of sales in the Company s statements of operations.

Invoicing Cost. Through June 30, 2004, the invoicing cost was paid on sales through the Distribution Alliance when the wholesaler placed the order through the A-B order management system and payment to the Company was processed through A-B. This cost did not apply to sales to wholesalers that were part of the A-B distribution network but that were not part of the Distribution Alliance. The basis for this charge was the number of pallet lifts.

Since July 1, 2004, the invoicing cost is payable on sales through the new A-B Distribution Agreement. The fee does not apply to sales by the Company s retail operations or to dock sales. The fee also does not apply to the Company s sales to Craft Brands because Craft Brands pays a comparable fee to A-B.

According to the terms of the A-B Distribution Agreement, the fee per pallet lift increased on January 1, 2006.

Staging Cost and Cooperage Handling Charge. The Staging Cost was paid on all sales through the Distribution Alliance and is payable on all sales through the A-B Distribution Agreement that are delivered to an A-B brewery or A-B distribution facility. The fee does not apply to product shipped directly to a wholesaler or wholesaler support center. The Cooperage Handling Charge was paid on all draft beer sales through the Distribution Alliance and is payable on all draft sales through the A-B Distribution Agreement that are delivered to a wholesaler support center or directly to a wholesaler. The basis for these fees is number of pallet lifts. According to the terms of the A-B Distribution Agreement, the staging cost and cooperage handling charge fees increased on January 1, 2006.

Inventory Manager Fee. The Inventory Manager Fee is paid to reimburse A-B for a portion of the salary of a corporate inventory management employee, a substantial portion of whose responsibilities are to coordinate and administer logistics of the Company s product distribution to wholesalers. This fee decreased in the second half of 2004 because Craft Brands assumed a portion of the fee.

The Invoicing Cost, Staging Cost, Cooperage Handling Charge and Inventory Manager Fee are reflected in cost of sales in the Company s statement of operations. These fees totaled approximately $129,000, $249,000 and $406,000 for the years ended December 31, 2006, 2005 and 2004, respectively. These fees were lower in 2006 compared to prior years as the Company recognized a refund of $124,000 from A-B in 2006 from over billed invoicing costs from 1995 through 2005.

Management believes that the benefits of the distribution arrangement with A-B, particularly the increased sales volume and efficiencies in delivery, state reporting and licensing, billing and collections, are significant to the Company s business. The Company believes that the existence of the A-B Distribution Agreement, presentations by Redhook s management at A-B s distributor conventions, A-B communications about Redhook in printed distributor materials, and A-B-supported opportunities for Redhook to educate A-B distributors about its specialty products have resulted in increased awareness of and demand for Redhook products among A-B s distributors.

If the A-B Distribution Agreement were terminated early, as described above, it would be extremely difficult for the Company to rebuild its distribution network without a severe negative impact on the Company s sales and results of operations. It is likely that the Company would need to raise additional funds to develop a new distribution network. There cannot be any guarantee that the Company would be able to successfully rebuild all, or part, of its distribution network or that any additional financing would be available when needed, or that any such financing would be on commercially reasonable terms.

The termination of the A-B Distribution Agreement for any reason would also constitute an event of default under the Company s bank credit agreement. Upon default, the bank may declare the entire outstanding term loan balance immediately due and payable. 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 on commercially reasonable terms.

Relationship with Craft Brands Alliance LLC

On July 1, 2004, the Company entered into agreements with Widmer with respect to the operation of Craft Brands. Craft Brands is a joint venture between the Company and Widmer that purchases products from the Company and Widmer and markets, advertises, sells and distributes these products in the Western Territory pursuant to a distribution agreement with A-B (the Craft Brands Distribution Agreement). The Western Territory includes the following western states: Alaska, Arizona, California, Colorado, Hawaii, Idaho, Montana, New Mexico, Nevada, Oregon, Washington and Wyoming. The Company and Widmer are each a 50% member of Craft Brands and each has the right to designate two directors to its six member board. A-B is entitled to designate the remaining two directors.

The Company and Widmer have entered into a restated operating agreement with Craft Brands (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 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

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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 Redhook s commitment to expand the production capacity of both 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. 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. If the Company is required to make this additional sales and marketing contribution, our available cash will decrease and our income from Craft Brands will decrease by the amount of the contribution, which will be allocated 100% to us.

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 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. Contemporaneous with the execution of the Operating Agreement, the Company made a member loan to Craft Brands of $150,000. Craft Brands repaid this loan plus accrued interest in December 2004.

The Operating Agreement additionally 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 is 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 the 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 also entered into a Supply, Distribution and Licensing Agreement with Craft Brands (the Supply and Distribution Agreement). Under the Supply and Distribution Agreement, the Company is required to manufacture and sell its product directly to Craft Brands (except in states where laws require sales to be made directly from Redhook to wholesalers) and Craft Brands advertises, markets and distributes the products to wholesale outlets in the Western Territory through the Craft Brands Distribution Agreement. The Company has granted Craft Brands a license to use Redhook intellectual property in connection with these efforts to advertise, market, sell and distribute the Company s products in the Western Territory. The Supply and Distribution Agreement also gives the Company the right to manufacture certain products of Widmer for sale to Craft Brands if Widmer is unable to manufacture the quantity ordered by Craft Brands. In addition, if sales of the Company s products decrease as compared to previous year sales, the Company has an option to manufacture Widmer products in an amount equal to the lower of (i) the Company s product decrease or (ii) the Widmer product increase.

The Supply and Distribution Agreement also provides that Craft Brands may elect to discontinue distributing a Redhook product if sales volume of such product declines to less than 20% of the total volume of all Redhook products and the volume of Redhook s product in the prior year decreased by more than 10% as compared to the year prior.

The territory covered by the Supply and Distribution Agreement may be expanded to cover one or more of the following states, at Craft Brands request: Arkansas, Iowa, Kansas, Louisiana, Minnesota, Missouri, Nebraska, North Dakota, Oklahoma, South Dakota and Texas.

Widmer has also entered into a Supply, Distribution and Licensing Agreement with Craft Brands upon substantially similar terms.

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The Supply and Distribution Agreement has an indefinite term, subject to early termination upon the occurrence of certain events. The Supply and Distribution Agreement may be terminated immediately, by either party, upon the occurrence of any one or more of the following events:

1) the other party fails to timely make any payment required under the Supply and Distribution Agreement for a period of 60 days following written notice thereof;

2) the other party fails to perform any other material obligation under the Supply and Distribution Agreement and such failure remains uncured for a period of 60 days following written notice thereof;

3) the other party becomes the subject of insolvency or bankruptcy proceedings, ceases doing business, makes an assignment of assets for the benefit of creditors, dissolves, or has a trustee appointed for all or a substantial portion of such party s assets;

4) any government authority makes a final decision invalidating a substantial portion of the Supply and Distribution Agreement;

5) either party finds that complying with any law or regulation relating to fulfilling its obligations under the Supply and Distribution Agreement would be commercially unreasonable and failure to comply with the law or regulation would subject such party or any of its personnel to a monetary or criminal penalty;