Franchise Laws and the Craft Brewer

Milton Friedman, the American Nobel Laureate economist and the most influential economist of the 2nd half of the 20th Century, wrote a book called Free to Choose. As the title suggests, Friedman explained his view of how free markets work in solving all kinds of problems. That's what the beer business is all about...especially the craft segment: Finding Better Beer. It's about risk-taking. It's about investing scarce capital to earn returns high enough to keep small brewers in the business long-term. And it's about innovating and developing new products for demanding consumers…"Off center beer for off center people." That's a quote from the playbook of Dogfish Head Brewery. I could use any number of craft brewers as a "poster boy" but I chose Dogfish Head because Sam Calagione is a fine spokesperson for the craft brewing industry.

Now you ask, what does any of this have to do with valuing beverage enterprises or beer distribution rights? The answer is everything!

A student of Friedman at the Univ. of Chicago went on to become the leading proponent of a valuation methodology referred to as the "FCF Methodology" (an income approach), widely accepted and used by investment bankers, investors, some breweries, and sophisticated buyers including distributors to value a business.

Since 1986 Ippolito/Christon has used this method to value over 400 businesses. I like to refer to the method as "the cigar box" approach to valuing a business. In other words, all that really matters is how much cash comes in, how much goes out, and how much is left over at the end of the day (or month, or year, or however long it takes to produce positive FCF!) Isn't that really how you run your local brewery?

There is tremendous value being created right now in the craft segment, by the brewers and distributors who have the resources and the assets to market, sell and distribute craft beers. Craft brewers are investing real money and there is a significant expansion of capacity going on. Consumers are increasingly aware of craft brands and demanding them. Distributors recognize this development. I believe that there will be continued sustained craft growth of the craft segment compared to mainstream domestic beer for the foreseeable future.

We are in an era of brand realignment in which the perceived fairness of price will become a paramount issue in arranging the transfer of distribution rights. For fast-growing, high-margined brands like craft beers, a small part of a distributor's portfolio, as little as 5%, may account for a substantial part of the profits. We call these add-on cases "bolt-on" brands or 'Golden Cases.' The loss of just 5% of the total case volume of a mainstream distributor, due to brand realignment, could wipe out one-third of the bottom line of a previously healthy distributor. Distributors and suppliers are keenly focused on the issue of "bolt-on" brands and marginal value. Most of the gross profit of bolt-on brands falls to the bottom line, so they are therefore worth more to buyers and sellers.

The value of a craft brand to a distributor can equal or exceed five times gross profit. However, that may not be the price at which the brand changes hands.

Factors such as supplier prohibition of public trading of beer distributorships, the limited pool of buyers,

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Since co-founding Ippolito Christon & Co. in 1986, Andy Christon has focused on brokering transactions and valuing distribution rights in the beverage industry nationwide. The firm's professionals have prepared nearly 500 valuations of beverage companies and distribution rights. Andy closed the first beer distributor transaction priced in excess of $100 million, with the southern California sale of Gate City Beverage to Reyes. Also, in a landmark arbitration case, Ippolito/Christon obtained a $103 per case award concerning Fiji Water, setting the "gold standard" for the value of beverage distribution rights. Prior to 1986, Andy headed a group at Coca-Cola in the historic re-franchising of the U.S. bottler system. He holds a B.A. in Economics and an MBA in Finance from the Wharton School.

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a restrictive brewery approval process, and the unequal bargaining power between a large brewer and distributor can cause the price to be less than the value.

For most of you, the bargaining position versus a distributor is much more equal. In my view, the appropriate objective in any brand transfer is to strike a price that is fair and reasonable.

Discounted brand transaction prices that are not fair and reasonable should be avoided even by the buyer who gets a bargain, because the shoe may be on the other foot one day.

Beer franchise laws differ from state to state. Most contain provisions that prohibit a supplier from terminating a contract for "arbitrary" reasons. The laws mandate that a brewery must have just cause for terminating and, usually, that the distributor be allowed time to remedy any problem before the brands are pulled.

Some statutes, as in Ohio, Illinois, and New Jersey, allow for termination without cause upon the occurrence of certain events, provided the distributor is compensated "fairly" for the distribution rights taken.

The distributor agreement binds a brewery to its distributor until and unless the distributor relinquishes its rights to the brand; the brand is purchased from the current distributor or the brewery withdraws from the market. A distributor can also sell or trade the brand to another distributor or include its rights should it be itself sold or acquired. Legislation, such as that in Indiana, Kentucky and New Jersey, contains provisions for the transfer of brands at a "Fair Market price."

For many craft brewers the issue with franchising has varied from the basic problem of limited access to the marketplace to the ultimate desperation of being stuck, and sometimes virtually abandoned, in a distributor that has little interest in, or knowledge of how to handle specialty brands.

However, many distributors who viewed crafts cautiously a few years ago are now aggressively seeking to take them on. Far-sighted ones are setting up craft beer divisions, promoting craft brands and competing with one another for them.

Craft brewers who are expanding must build partnerships with strong local distributors who have the resources and the assets to market, sell and distribute the craft beers in their local territory. In order to get a distributor to take on a brand, craft brewers will have to be willing to provide an exclusive, perpetual franchise. This will allow for incentives for both the brewer and distributor to progress.

However, another crucial provision of the distributor agreement is the exit mechanism. In the future, the parties may seek to terminate the relationship.

I don't think either side should rely on state law as a solution. Rather, brewer and distributor should look to the terms and conditions set forth in the brewer-distributor agreement, and to the economics of the situation.

You, the brewer, should draft a contract that you

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believe meets the needs of supplier and distributor. There are many agreements you could model. The old industry standard was the A-B Distributor Equity Agreement, but you can draft your own version.

Don't make your contract read like a "landlord lease," which invites litigation in the event of a future dispute. You don't have the big brewery legal departments and budgets to fight those kinds of battles with distributors, some of whom are larger than the largest craft brewer! Be fair and wise in the agreements that you reach with distributors.

The contract between the distributor and the craft brewer should provide for the brewer's ability to terminate the relationship with little or no compensation in non-performance situations. No contract or law should force the brewer to continue supplying a distributor with beer if the distributor is not doing the job.

If, on the other hand, the distributor is performing under the contract and the brewer nevertheless wants to transfer the brand rights to another distributor, the transferee should be willing to offer payment for the rights that is a fair value for the brands to be transferred. State law should be invoked only as a last resort.

Harry Schuhmacher of *Beer Business Daily* basically agrees. "If you are going to have a franchise law, there needs to be a provision in it that allows a brewery to move its brands if it has just cause to do so. You can add that the distributor must receive fair market value for those brands or whatever you want, but you have to give the breweries some options. I don't think it should be too easy to do this, however, because distributors, the good ones, do put a lot of money behind small brands when they take them on. When you've invested in a brand, you should be compensated for it if the brand moves."

Current policy of the Brewers Association is that where franchise laws exist, "any brewer contributing less than 20% of a distributor's volume should be exempted from those

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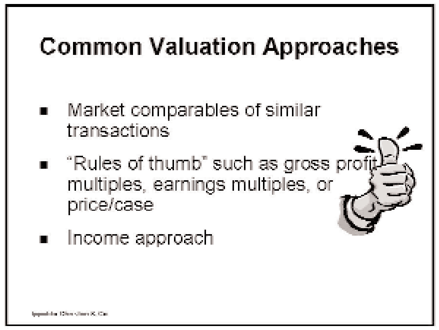
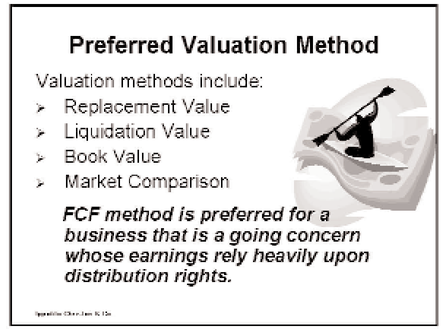
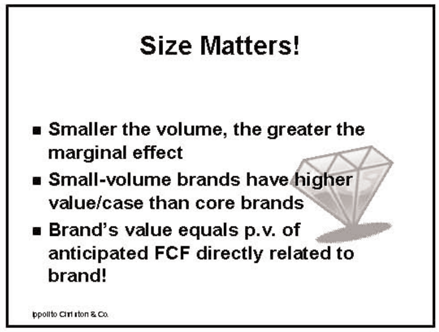
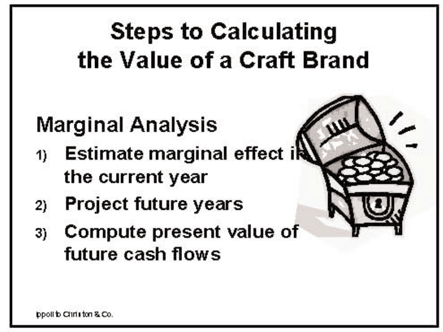
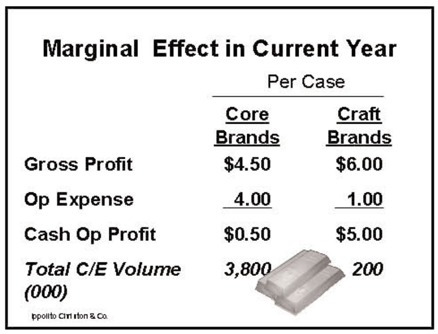


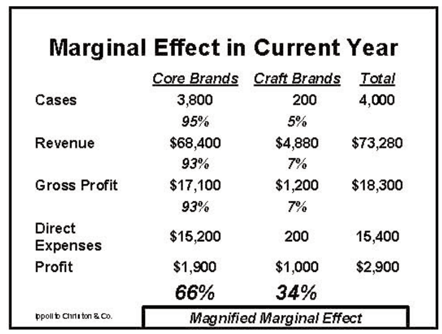




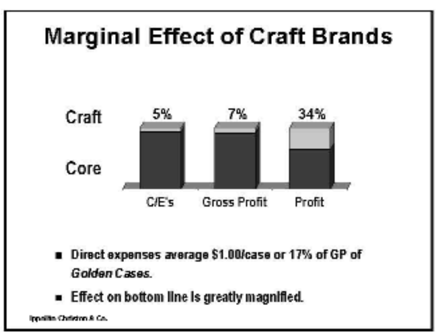


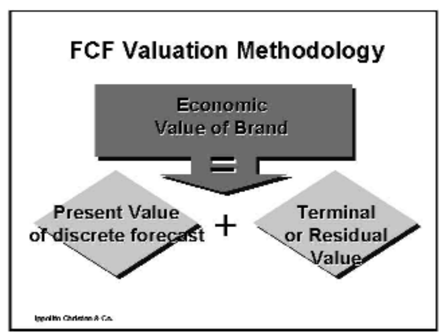


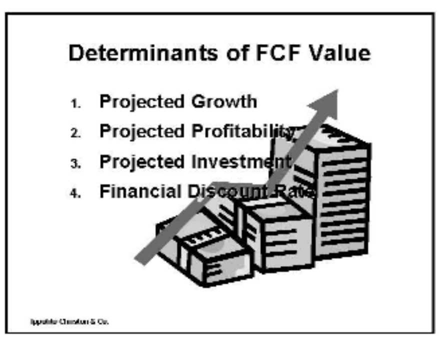
	Per Case	
	Core Brands	Craft Brands
Gross Profit	$4.50	$6.00
Op Expense	4.00	1.00
Cash Op Profit	$0.50	$5.00
Total C/E Volume (000)	*3,800*	*200*

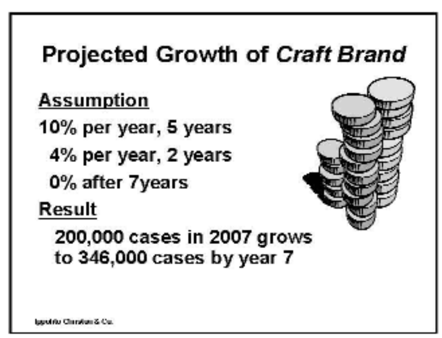


	Core Brands	*Craft Brands*	*Total*
Cases	3,800	200	4,000
	95%	*5%*	
Revenue	$68,400	$4,880	$73,280
	93%	*7%*	
Gross Profit	$17,100	$1,200	$18,300
	93%	*7%*	
Direct Expenses	$15,200	200	15,400
Profit	$1,900	$1,000	$2,900
	66%	*34%*	









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laws and free to establish a mutually beneficial contract with that distributor. Without the leverage inherent in being a large part of a distributor's business, a small brewer and distributor can negotiate a fair contract at arm's length."

I'm not here to opine on the policy or speculate on a size threshold for small craft brewers. I think that most of us acknowledge the need for a way to end unsatisfactory relationships. Distributors have equity in their brands. If a disagreement arises, agreements should have provisions for terminating the relationship. How to do so varies all over the map with regard to how states decide to attach a value to what happens as a result of that termination. Some say fair market value, some say X times annual gross profits. In any case, there are solutions.

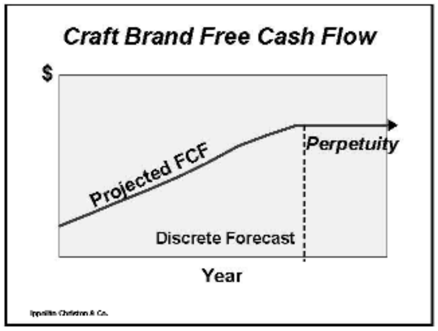
The search for the "perfect distributor agreement" and the "perfect beer franchise law" is never ending. Interestingly, some craft brewers may believe they have unexpected allies in their fight for control over their own destinies.

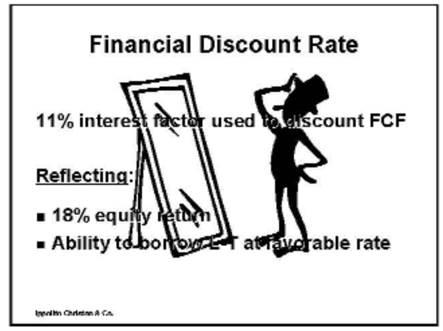
The big brewers seek to realign all of their brands by transferring acquired and alliance brands to their own distributors. Getting brands into their own houses has been problematic, because distributors protected by strong franchise laws are reluctant to give up profitable relationships unless fairly compensated.

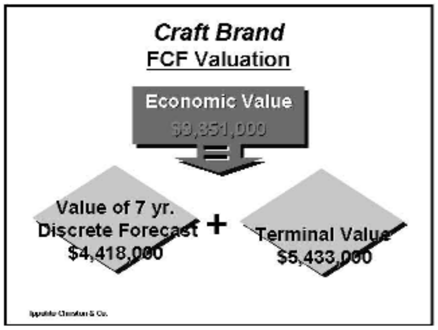
This may lead the big brewers to seek modifications to existing state laws in order to make it easier to terminate a distributor without cause.

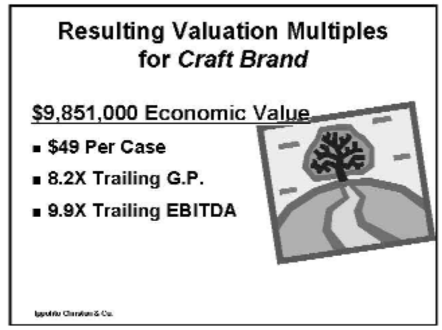
The question then becomes, would changes to the beer franchise laws, if and when they happen, be a boon or a curse to craft brewers?

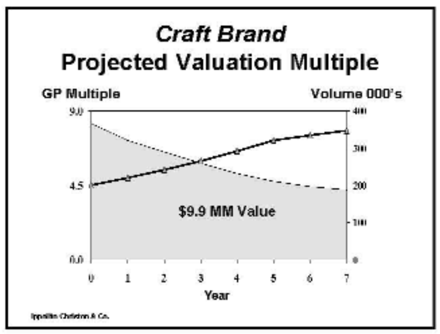
As I stated earlier, we are in an era of brand realignment in which the perceived fairness of price for brand rights will become a paramount issue in arranging the transfer of distribution rights. In the final analysis, it would be difficult to imagine "termination without cause" unless it is accompanied by a "fair" payment for the rights.

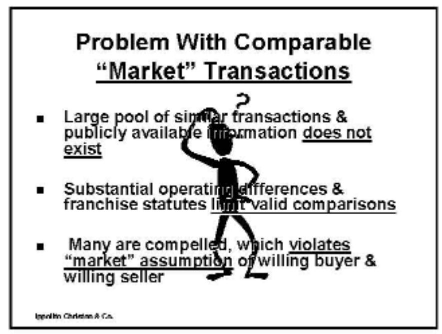


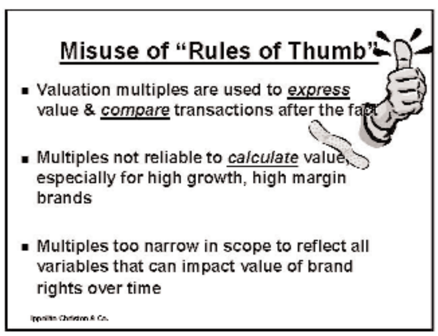


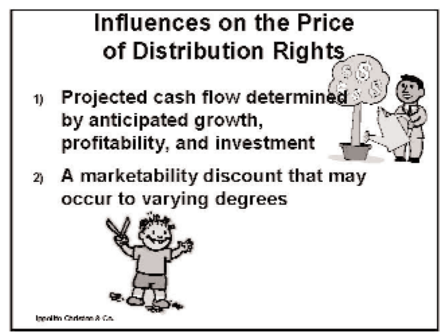












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