CRAFT BREWERS ALLIANCE, INC.
Form 10-Q
May 15, 2009

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For The Quarterly Period Ended March 31, 2009

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

CRAFT BREWERS ALLIANCE, INC.

(Exact name of registrant as specified in its charter)

Washington	**91-1141254**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

929 North Russell Street
Portland, Oregon 97227
(Address of principal executive offices)
(503) 331-7270
(Registrant s telephone number, including Area Code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company 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 number of shares of the registrant s common stock outstanding as of May 5, 2009 was 16,959,763.

CRAFT BREWERS ALLIANCE, INC.
FORM 10-Q
For the Quarterly Period Ended March 31, 2009
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PART I.
ITEM 1. Financial Statements

CRAFT BREWERS ALLIANCE, INC.
BALANCE SHEETS

	(Unaudited) March 31, 2009	December 31, 2008
	(Dollars in thousands except per share amounts)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 11	$ 11
Accounts receivable, net of allowance for doubtful accounts of $100 and $64 at March 31, 2009 and December 31, 2008, respectively	13,137	12,499
Inventories, net	10,952	9,729
Income tax receivable	722	724
Deferred income tax asset, net	776	767
Other	4,314	3,951
Total current assets	29,912	27,681
Property, equipment and leasehold improvements, net	100,784	101,389
Equity investments	5,218	5,189
Intangible and other assets, net	13,462	13,546
Total assets	$ 149,376	$ 147,805
LIABILITIES AND COMMON STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 17,194	$ 15,000
Accrued salaries, wages, severance and payroll taxes	3,483	3,630
Refundable deposits	6,804	6,191
Other accrued expenses	2,732	2,393
Current portion of long-term debt and capital lease obligations	1,419	1,394
Total current liabilities	31,632	28,608
Long-term debt and capital lease obligations, net of current portion	31,452	31,834
Fair value of derivative financial instruments	1,199	1,252
Deferred income tax liability, net	6,574	6,552
Other liabilities	292	278

Common stock, par value $0.005 per share, 50,000,000 shares authorized; 16,948,063 shares at March 31, 2009 and December 31, 2008 issued and outstanding	85	85
Additional paid-in capital	122,433	122,433
Accumulated other comprehensive income	(672)	(693)
Retained deficit	(43,619)	(42,544)
Total common stockholders equity	78,227	79,281
Total liabilities and common stockholders equity	$ 149,376	$ 147,805

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

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CRAFT BREWERS ALLIANCE, INC.
STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended March 31,	
	2009	**2008**
	(In thousands, except per share amounts)	
Sales	$ 29,229	$ 10,446
Less excise taxes	1,983	1,073
Net sales	27,246	9,373
Cost of sales	21,848	8,995
Gross profit	5,398	378
Selling, general and administrative expenses	5,908	1,901
Merger-related expenses	112	78
Income from equity investment in Craft Brands		753
Operating loss	(622)	(848)
Income from equity investments in Kona and FSB	29	
Interest expense	(566)	(2)
Interest and other income, net	91	44
Loss before income taxes	(1,068)	(806)
Income tax provision (benefit)	7	(262)
Net loss	$ (1,075)	$ (544)
Basic and diluted loss per share	$ (0.06)	$ (0.07)

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

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CRAFT BREWERS ALLIANCE, INC.
STATEMENTS OF CASH FLOWS
(Unaudited)

	Three Months Ended March 31,	
	2009	**2008**
	(In thousands)	
Operating Activities		
Net loss	$ (1,075)	$ (544)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	1,819	703
Income from equity investments in excess of cash distributions	(29)	(234)
Deferred income taxes		(267)
Reserve for obsolete inventory	122	12
Gain on disposition of property, equipment and leasehold improvements	(3)	
Other	14	22
Changes in operating assets and liabilities:		
Accounts receivable	(673)	1,031
Trade receivables from Craft Brands		206
Inventories	(1,447)	(135)
Income taxes receivable and other current assets	(362)	(89)
Other assets	(61)	(46)
Accounts payable and other accrued expenses	2,534	233
Trade payable to Craft Brands		472
Accrued salaries, wages, severance and payroll taxes	86	(255)
Refundable deposits	103	558
Net cash provided by operating activities	1,028	1,667
Investing Activities		
Expenditures for fixed assets	(715)	(1,131)
Proceeds from disposition of fixed assets	28	33
Net cash used in investing activities	(687)	(1,098)
Financing Activities		
Principal payments on debt and capital lease obligations	(341)	(4)
Issuance of common stock		20
Net cash provided by (used in) financing activities	(341)	16
Increase in cash and cash equivalents		585
Cash and cash equivalents:		
Beginning of period	11	5,527
End of period	$ 11	$ 6,112

Supplemental Disclosures		
Cash paid for interest	$ 608	$ 2

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

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CRAFT BRANDS ALLIANCE, INC.
NOTES TO FINANCIAL STATEMENTS
(Unaudited)

1. Basis of Presentation

The accompanying financial statements and related notes of the Company 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, 2008 (2008 Annual Report). These financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Accordingly, certain information and footnote disclosures normally included in 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. Certain reclassifications have been made to the prior year s financial statements to conform to the current year presentation. The results of operations for such interim periods are not necessarily indicative of the results of operations for the full year.

The financial statements as of and for the three months ended March 31, 2009 reflect the July 1, 2008 merger of Widmer Brothers Brewing Company (Widmer) with and into the Company, as more fully described in Note 2 below. These financial statements as of and for the three months ended March 31, 2009 reflect the effect of the July 1, 2008 merger on the termination of the agreements between the Company and Craft Brands Alliance LLC (Craft Brands), and the resulting merger of Craft Brands with and into the Company. See Note 2 for further discussion of Craft Brands.

2. Merger Activities

Merger with Widmer

On November 13, 2007, the Company entered into an Agreement and Plan of Merger with Widmer, which was subsequently amended on April 30, 2008 (Merger Agreement). The Merger Agreement provided, subject to customary conditions to closing, for a merger (the Merger) of Widmer with and into the Company. A copy of the Merger Agreement was included as an exhibit to the Company s current report on Form 8-K filed with the SEC on November 13, 2007. A copy of Amendment No. 1 to the Merger Agreement was included as an exhibit to the Company s registration statement on Form S-4/A filed with the SEC on May 2, 2008.

The Company believes that the combined entity has the potential to secure efficiencies beyond those that had already been achieved by its existing relationships with Widmer in utilizing the two companies production facilities and a national sales force, as well as by reducing duplicate functions. Utilizing the combined breweries offers a greater opportunity to rationalize production capacity in line with product demand. The sales force of the combined entity will support further promotion of the products of its corporate investments, Kona Brewery LLC (Kona), which brews Kona malt beverage products, and, to a lesser extent, Fulton Street Brewery, LLC (FSB), which brews Goose Island malt beverage products.

On July 1, 2008, the Merger was consummated. Pursuant to the Merger Agreement and by operation of law, upon the merger of Widmer with and into the Company, the Company acquired all of the assets, rights, privileges, properties, franchises, liabilities and obligations of Widmer. Each outstanding share of capital stock of Widmer was converted into the right to receive 2.1551 shares of Company common stock, or 8,361,514 shares. The Merger resulted in Widmer shareholders and existing Company shareholders each holding approximately 50% of the outstanding shares of the Company. No Widmer shareholder exercised statutory appraisal rights in connection with the Merger.

In connection with the Merger, the name of the Company was changed from Redhook Ale Brewery, Incorporated to Craft Brewers Alliance, Inc. The common stock of the Company continues to trade on the Nasdaq Stock Market under the trading symbol HOOK.

Merger-Related Costs

In connection with the Merger, the Company incurred merger-related expenditures, including legal, consulting, meeting, filing, printing and severance costs. Certain of the merger-related expenses have been reflected in the

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CRAFT BRANDS ALLIANCE, INC.
NOTES TO FINANCIAL STATEMENTS (continued)
(Unaudited)

statements of operations as incurred, while certain of the other direct merger-related costs have been capitalized in accordance with Financial Accounting Standards Board s (FASB) Statement of Financial Accounting Standards (SFAS) No. 141, *Business Combinations (SFAS 141).* All capitalized merger costs were reclassified to goodwill upon the closing of the Merger. As discussed in the 2008 Annual Report, the Company recorded a full impairment of its goodwill asset. All costs capitalized to goodwill, including any capitalized merger costs, were charged to earnings for the year ended December 31, 2008 as a result.

These severance costs include payments to employees and officers whose employment was or will be terminated as a result of the Merger. The Company estimates that merger-related severance benefits totaling approximately $583,000 will be paid from the remainder of 2009 to 2011 to all affected former Redhook employees and officers, and affected former Widmer employees. These costs were recognized as merger-related expense in the statement of operations in accordance with SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*. The remaining costs for the affected employee group will be recognized as a merger-related expense of approximately $113,000 in the second quarter of 2009.

Pro Forma Results of Operations

The unaudited pro forma combined condensed results of operations are presented below for the three-month period ended March 31, 2008 as if the Merger had been completed on January 1, 2008. The unaudited condensed results of operations for the three-month period ended March 31, 2009 as reported are presented below for comparative purposes.

	Three Months Ended March 31,	
	2009 Actual Results	**2008 Pro Forma Results**
	(In thousands, except per share data)	
Net sales	$ 27,246	$ 25,812
Loss before income taxes	$ (1,068)	$ (1,681)
Net loss	$ (1,075)	$ (1,104)
Basic and diluted loss per share	$ (0.06)	$ (0.07)

The unaudited pro forma results of operations are not necessarily indicative of the operating results that would have been achieved had the Merger been consummated as of the dates indicated, or that may be achieved in the future. Rather, the unaudited pro forma combined condensed results of operations presented above are based on estimates and assumptions that have been made solely for the purpose of developing such pro forma results. Historical results of operations were adjusted to give effect to pro forma events that are (1) directly attributable to the acquisition, (2) factually supportable, and (3) expected to have a continuing impact on the combined results. These pro forma results of operations do not give effect to any cost savings, revenue synergies or restructuring costs which may result from the integration of Widmer s operations.

Merger with Craft Brands

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, including an operating agreement with regards to Craft Brands (Operating Agreement) that governed the operations of Craft Brands and the obligations of its members, including capital contributions, loans and allocations of profits and losses. Pursuant to these agreements, and through June 30, 2008, the Company manufactured and sold its product to Craft Brands at prices substantially below wholesale pricing levels; Craft Brands, in turn, advertised, marketed, sold and distributed the product to wholesale outlets in the western United States pursuant to a distribution agreement between Craft Brands and Anheuser-Busch, Inc.

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CRAFT BRANDS ALLIANCE, INC.
NOTES TO FINANCIAL STATEMENTS (continued)
(Unaudited)

In connection with the Merger, Craft Brands was also merged with and into the Company, effective July 1, 2008. All existing agreements, including all associated future commitments and obligations, between the Company and Craft Brands and between Craft Brands and Widmer terminated as a result of the merger of Craft Brands.

The Operating Agreement addressed the allocation of profits and losses of Craft Brands up to July 1, 2008. During the first three months of 2008, the Company was allocated 42% of Craft Brands profits and losses. Net cash flow, if any, was generally distributed monthly to the Company based upon that percentage. The Company would not have received a distribution if an event occurred that caused the liabilities of Craft Brands, adjusted for the liabilities to its members, to be in excess of its assets, or Craft Brands to be unable to pay its debts as those debts became due in the ordinary course of business.

For the three months ended March 31, 2008, the Company s share of Craft Brands net income totaled $753,000 and during this period the Company received cash distributions of $519,000 representing its share of the net cash flow of Craft Brands.

The selected financial information presented for Craft Brands represents the activities for the entity from January 1, 2008 through March 31, 2008, and is as follows:

	Three Months Ended March 31, 2008
	(Dollars in thousands)
Net sales	$17,070
Gross profit	$ 5,371
Operating income	$ 1,794
Income before income taxes	$ 1,794
Net income	$ 1,794
Shipments (in barrels)	83,100

3. Inventories

Inventories consist of the following:

	March 31, 2009	**December 31, 2008**
	(In thousands)	
Raw materials	$ 4,305	$ 4,258
Work in process	2,005	1,921
Finished goods	2,185	1,624
Packaging materials, net	1,226	950
Promotional merchandise, net	1,165	907
Pub food, beverages and supplies	66	69
	$ 10,952	$ 9,729

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

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CRAFT BRANDS ALLIANCE, INC.
NOTES TO FINANCIAL STATEMENTS (continued)
(Unaudited)

4. Other Current Assets

Other current assets consist of the following:

	March 31, 2009	December 31, 2008
	(In thousands)	
Deposits paid to keg lessor	$ 3,548	$ 3,182
Prepaid property taxes	88	177
Prepaid insurance	235	201
Other	443	391
	$ 4,314	$ 3,951

5. Equity Investments

Equity investments consist of the following:

	March 31, 2009	December 31, 2008
	(In thousands)	
Fulton Street Brewery, LLC (FSB)	$ 4,141	$ 4,103
Kona Brewery LLC (Kona)	1,077	1,086
	$ 5,218	$ 5,189

FSB

For the three months ended March 31, 2009, the Company s share of FSB s net income totaled $38,000. As the Company acquired its interest in FSB as a result of the Merger, it did not have a share in the earnings for the three months ended March 31, 2008. The Company s investment in FSB was $4.1 million at March 31, 2009 and December 31, 2008 and the Company s portion of equity as reported on FSB s financial statement was $1.9 million as of the corresponding dates. The Company has not received any cash capital distributions associated with FSB during its ownership period. At March 31, 2009 and December 31, 2008, the Company has recorded a payable to FSB of $1.5 million and $1.1 million, respectively, primarily for amounts owing for purchases of Goose Island-branded product. The Company has recorded a receivable from FSB of $34,000 and $36,000 at March 31, 2009 and December 31, 2008, respectively, primarily for marketing fees associated with sales of Goose Island-branded product in the Company s distribution area.

Kona

For the three months ended March 31, 2009, the Company s share of Kona s net loss totaled $9,000. As the Company acquired its interest in Kona as a result of the Merger, it did not have a share in the earnings for the three months ended March 31, 2008. The Company s investment in Kona was $1.1 million at March 31, 2009 and December 31, 2008, and the Company s portion of equity as reported on Kona s financial statement was $338,000 and $347,000 as of the corresponding dates. The Company has not received any cash capital distributions associated with Kona during its ownership period. At March 31, 2009 and December 31, 2008, the Company has recorded a receivable from Kona of $3.5 million and $3.0 million, respectively, primarily related to amounts owing under the alternating proprietorship and distribution agreements. As of March 31, 2009 and December 31, 2008, the Company

has recorded a payable to Kona of $2.4 million and $1.9 million, respectively, primarily for amounts owing for purchases of Kona-branded product.

At March 31, 2009 and December 31, 2008, the Company had outstanding receivables due from Kona Brewing Co. (KBC) of $116,000 and $107,000, respectively. KBC and the Company are the only members of Kona.

CRAFT BRANDS ALLIANCE, INC.
NOTES TO FINANCIAL STATEMENTS (continued)
(Unaudited)

6. Debt and Capital Lease Obligations

The Company refinanced borrowings assumed as a result of the Merger by concurrently entering into a loan agreement (the Loan Agreement) with Bank of America, N.A. (BofA) during July 2008. The Loan Agreement is comprised of a $15.0 million revolving line of credit (Line of Credit), including provisions for cash borrowings and up to $2.5 million notional amount of letters of credit, and a $13.5 million term loan (Term Loan). The Company may draw upon the Line of Credit for working capital and general corporate purposes. The Line of Credit matures on January 1, 2013 at which time the outstanding principal balance and any accrued but unpaid interest will be due. At March 31, 2009, the Company had $12.0 million outstanding under the Line of Credit with $3.0 million of availability for further cash borrowing.

The Company is in compliance with all applicable contractual financial covenants at March 31, 2009, including the covenant pertaining to earnings before interest, taxes, depreciation and amortization (EBITDA). The Company and BofA executed a loan modification to its loan agreement effective November 14, 2008 (Modification Agreement), as a result of the Company s inability to meet its covenants as of September 30, 2008. BofA permanently waived the noncompliance effective September 30, 2008, restoring the Company s borrowing capacity pursuant to the Loan Agreement.

Under the Modification Agreement, the Company may select from one of the following two interest rate benchmarks as the basis for calculating interest on the outstanding principal balance of the Line of Credit: the London Inter-Bank Offered Rate (LIBOR) or the Inter-Bank Offered Rate (IBOR) (each, a Benchmark Rate). Interest accrues at an annual rate equal to the Benchmark Rate plus a marginal rate. The Company may select different Benchmark Rates for different tranches of its borrowings under the Line of Credit. The marginal rate is fixed at 3.50% until September 30, 2009 at which time it will vary from 1.75% to 3.50% based on the ratio of the Company s funded debt to EBITDA, as defined. LIBOR rates may be selected for one, two, three, or six month periods, and IBOR rates may be selected for no shorter than 14 days and no longer than six months. Under the Modification Agreement, the Company may not draw upon the Line of Credit in increments of less than $1 million. Accrued interest for the Line of Credit is due and payable monthly. At March 31, 2009, the weighted-average interest rate for the borrowings outstanding under the Line of Credit was 3.98%.

Under the Modification Agreement, a quarterly fee on the unused portion of the Line of Credit, including the undrawn amount of the related Standby Letter of Credit, will accrue at a rate of 0.50% payable quarterly. An annual fee will be payable in advance on the notional amount of each standby letter of credit issued and outstanding multiplied by an applicable rate ranging from 1.13% to 1.50%.

Interest on the Term Loan will accrue on the outstanding principal balance in the same manner as provided for under the Line of Credit, as established under the LIBOR one-month Benchmark Rate. The interest rate on the Term Loan was 4.01% as of March 31, 2009. Accrued interest for the Term Loan is due and payable monthly. At March 31, 2009, principal payments are due monthly in accordance with an agreed-upon schedule set forth in the Loan Agreement. Any unpaid principal balance and unpaid accrued interest will be due on July 1, 2018.

Financial Covenants Required by Modification Agreement

Minimum EBITDA, as defined (in thousands) (1)	
For the quarter ending June 30, 2009	$ 2,300
Asset Coverage Ratio	
For the quarter ending March 31, 2009 and thereafter	1.50 to 1
Capital Expenditures (in thousands) (1)	
To spend or incur obligations less than the following:	
For the quarter ending June 30, 2009 (2)	$ 550

Notes:

(1) - Covenant does not apply beginning with the quarter ending September 30, 2009

(2) - Provides for carryover spending of any amount not used in the prior quarter

CRAFT BRANDS ALLIANCE, INC.
NOTES TO FINANCIAL STATEMENTS (continued)
(Unaudited)

The Modification Agreement also revised the types of financial covenants that the Company is required to meet for each quarter through June 30, 2009. The Company generated EBITDA under the Modification Agreement of $1.4 million for the quarter ended March 31, 2009, as compared with the minimum EBITDA covenant of $850,000 for the corresponding period, and was in compliance with the loan covenants under the Modification Agreement as of March 31, 2009. EBITDA under the Modification Agreement is defined as EBITDA as adjusted for certain other items as defined by either the Loan Agreement or the Modification Agreement.

In addition, the Company is restricted in its ability to declare or pay dividends, repurchase any outstanding common stock, incur additional debt or enter into any agreement that would result in a change in control of the Company. Effective September 30, 2009, the Company will be required to meet the financial covenant ratios of funded debt to EBITDA, as defined, and fixed charge coverage in the manner established pursuant to the original Loan Agreement, but at levels specified by the Modification Agreement.

The Loan Agreement is secured by substantially all of the Company s personal property and by the real properties located at 924 North Russell Street, Portland, Oregon and 14300 NE 145th Street, Woodinville, Washington (Collateral), which comprise its larger-scale automated Portland, Oregon brewery and its Woodinville, Washington brewery, respectively.

As a result of the Merger, the Company assumed Widmer s promissory notes signed in connection with the acquisition of commercial real estate related to the Portland, Oregon brewery. Each promissory note is secured by a deed of trust on the commercial real estate. The outstanding note balance to each lender as of March 31, 2009 was $200,000, with each note bearing a fixed interest rate of 24% per annum, subject to a one-time adjustment on July 1, 2010 to reflect the change in the consumer price index from the date of issue, July 1, 2005, to the date of adjustment. The promissory notes are carried at the total of stated value plus a premium reflecting the difference between the Company s incremental borrowing rate and the stated note rate. The effective interest rate for each note is 6.31%. Each note matures on the earlier of the individual lender s death or July 1, 2015, but in no event prior to July 1, 2010, with prepayment of principal not allowed under the notes terms. Interest payments are due and payable monthly.

As a result of the Merger, the Company assumed Widmer s capital equipment lease obligation to BofA, which is secured by substantially all of the brewery equipment and restaurant furniture and fixtures located in Portland, Oregon. The outstanding balance for the capital lease as of March 31, 2009 was $6.3 million, with monthly loan payments of $119,020 required through the maturity date of June 30, 2014. The capital lease carries an effective interest rate of 6.56%. The capital lease is subject to a prepayment penalty equal to a specified percentage multiplied by the amount prepaid. This specified percentage began at 4% and, except in the event of acceleration due to an event of default, ratably declines 1% for every year the lease is outstanding until July 31, 2011, at which time the capital lease is not subject to a prepayment penalty. The specified percentage is 3% as of March 31, 2009. In the event of acceleration due to an event of default, the prepayment penalty is restored to 4%.

7. Derivative Financial Instruments

Interest Rate Swap Contracts

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities An Amendment of FASB Statement No. 133* (SFAS 161). SFAS 161 requires enhanced disclosures about an entity s derivative and hedging activities in order to improve the transparency of financial reporting. SFAS 161 amends and expands the disclosure requirements of SFAS No. 133, *Accounting for Derivative Instruments and Hedge Activities* (SFAS 133) to provide users of financial statements with an enhanced understanding of (i) how and why an entity uses derivative instruments; (ii) how derivative instruments and related hedged items are accounted for under SFAS 133 and its related interpretations, and (iii) how derivative instruments and related hedged items affect an entity s financial position, results of operations, and cash flows. SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. SFAS 161 encourages, but does not require, comparative disclosures for earlier periods at initial adoption. On January 1, 2009, the Company adopted SFAS 161, which did not have a material effect on the Company s financial position, results of operations or cash flows;

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CRAFT BRANDS ALLIANCE, INC.
NOTES TO FINANCIAL STATEMENTS (continued)
(Unaudited)

however, the Company was required to expand its disclosures around the use of and purpose for its derivative instruments, which are discussed below.

The Company s risk management objectives are to ensure that business and financial exposures to risk that have been identified and measured are minimized using the most effective and efficient methods to reduce, transfer and, when possible, eliminate such exposures. Operating decisions contemplate associated risks and management strives to structure proposed transactions to avoid or reduce risk whenever possible.

The Company has assessed its vulnerability to certain business and financial risks, including interest rate risk associated with its variable-rate long-term debt. To mitigate this risk, the Company entered into with BofA a five-year interest rate swap agreement with a total notional value of $10.0 million (as of March 31, 2009) to hedge the variability of interest payments associated with its variable-rate borrowings under its Term Loan. Through this swap agreement, the Company pays interest at a fixed rate of 4.48% and receives interest at a floating-rate of the one-month LIBOR. Since the interest rate swap hedges the variability of interest payments on variable rate debt with similar terms, it qualifies for cash flow hedge accounting treatment under SFAS 133. As of March 31, 2009, unrealized net losses of $1.1 million were recorded in accumulated other comprehensive loss as a result of this hedge. The effective portion of the gain or loss on the derivative is reclassified into interest expense in the same period during which the Company records interest expense associated with the Term Loan. There was no hedge ineffectiveness recognized for the three months ended March 31, 2009.

As a result of the Merger, the Company assumed Widmer s contract with BofA for a $7.0 million notional interest rate swap agreement. On the effective date of the Merger, the Company entered into with BofA an equal and offsetting interest rate swap contract. Neither swap contract qualifies for hedge accounting under SFAS 133. The assumed contract requires the Company to pay interest at a fixed rate of 4.60% and receive interest at a floating rate of the one-month LIBOR, while the offsetting contract requires the Company to pay interest at a floating rate of the one-month LIBOR and receive interest at a fixed rate of 3.47%. Both contracts expire on November 1, 2010. The Company recorded a net gain on the contracts of $19,000 for the three months ended March 31, 2009, which was recorded to other income. The Company did not have any similar contracts outstanding during 2008; accordingly, there were no amounts recorded to earnings for the three months ended March 31, 2008.

	Liability Derivatives at March 31, 2009	
	Balance Sheet Location	**Fair Value**
		(In thousands)
Derivatives designated as hedging instruments under SFAS 133		
Interest rate swap contracts	Non-current liabilities - derivative financial instruments	$ 1,067
Derivatives not designated as hedging instruments under SFAS 133		
Interest rate swap contracts	Non-current liabilities - derivative financial instruments	$ 132
Total derivatives		$ 1,199

All interest rate swap contracts are secured by the Collateral under the Company s loan agreement with BofA.

Fair Value Measurements

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157). SFAS 157 clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that

should be determined based upon assumptions that market participants would use in pricing an asset or liability. As a basis for considering such assumptions, SFAS 157 establishes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value as follows:

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Level 1: Observable inputs (unadjusted) in active markets for identical assets and liabilities;

Level 2: Inputs other than quoted prices included within Level 1 that are either directly or indirectly observable for the asset or liability, including quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in inactive markets and inputs other than quoted prices that are observable for the asset or liability;

Level 3: Unobservable inputs for the asset or liability, including situations where there is little, if any, market activity or data for the asset or liability.

The Company has assessed its assets and liabilities that are measured and recorded at fair value within the above hierarchy and that assessment is as follows:

	Fair Value Hierarchy Assessment			
	Level 1	Level 2	Level 3	Total
	(In thousands)			
Derivative financial instruments interest rate swap contracts	$	$ 1,199	$	$ 1,199

8. Common Stockholders Equity

In conjunction with the exercise of stock options granted under the Company s stock option plans during the three months ended March 31, 2008, the Company issued 5,000 shares of common stock and received proceeds on exercise totaling $20,000. No options were exercised during the three months ended March 31, 2009.

Stock Plans

The Company maintains several stock incentive plans, including those discussed below, under which non-qualified stock options, incentive stock options and restricted stock are granted to employees and non-employee directors. The Company issues new shares of common stock upon exercise of stock options. Under the terms of the Company s stock option plans, employees and directors may be granted options to purchase the Company s common stock at the market price on the date the option is granted. Under these stock option plans, stock options granted at less than the fair value on the date of grant and stock options granted to non-employee directors are deemed to be non-qualified stock options rather than incentive stock options.

The Company s shareholders approved the 2002 Stock Option Plan (2002 Plan) in May 2002. The 2002 Plan provides for granting of non-qualified stock options and incentive stock options to employees, non-employee directors and independent consultants or advisors. The compensation committee of the board of directors administers the 2002 Plan, determining the grantees, the number of shares of common stock for which the options are exercisable and the exercise prices of such shares, among other terms and conditions. Under the 2002 Plan, options granted to employees of the Company through December 31, 2008 vest over a five-year period while options granted to employees of the Company during the three months ended March 31, 2009 vest over a four-year period. Options granted under the 2002 Plan to the Company s directors (excluding the A-B designated directors) have become exercisable beginning from the date of the grant up to six months following the grant date. The maximum number of shares of common stock for which options may be granted during the term of the 2002 Plan is 346,000. As of March 31, 2009, the 2002 Plan had 70,259 shares available for future grants of options.

The 2007 Stock Incentive Plan (2007 Plan) was adopted by the board of directors and approved by the shareholders in May 2007. 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 March 31, 2009, the 2007 Plan had 71,240 shares available for future grants of stock-based awards.

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Stock Option Plan Activity

Presented below is a summary of the Company s stock option plan activity for the three months ended March 31, 2009:

		Weighted Average	
			Remaining
		Exercise	Contractual
	Options	Price	Life
	(In thousands)	(Per share)	(In years)
Outstanding at December 31, 2008	431	$ 2.61	2.4
Granted	30	1.25	10.0
Exercised			
Canceled	(20)		
Outstanding at March 31, 2009	441	$ 2.46	