

REDHOOK ALE BREWERY INC

Form 10-Q

August 10, 2007

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

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**  
For The Quarterly Period Ended June 30, 2007

**OR**

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

**Commission File Number 0-26542  
REDHOOK ALE BREWERY, INCORPORATED**  
(Exact name of registrant as specified in its charter)

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

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

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

(Registrant's telephone number, including Area Code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No   
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. Check one:

Large Accelerated Filer  Accelerated Filer  Non-accelerated Filer

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

The number of shares of the registrant's Common Stock outstanding as August 3, 2007 was 8,349,855.

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**REDHOOK ALE BREWERY, INCORPORATED**  
**FORM 10-Q**  
**For The Quarterly Period Ended June 30, 2007**  
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**Table of Contents****PART I.****ITEM 1. Financial Statements****REDHOOK ALE BREWERY, INCORPORATED  
BALANCE SHEETS**

	<b>June 30, 2007</b>	<b>December 31, 2006</b>
	(Unaudited)	
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 9,021,705	\$ 9,435,073
Accounts receivable, net of allowance for doubtful accounts of \$38,325 and \$68,808 in 2007 and 2006, respectively	3,600,922	1,842,388
Trade receivable from Craft Brands	823,779	854,507
Inventories	2,865,673	2,571,732
Deferred income tax asset, net	668,631	506,886
Other	121,101	203,594
Total current assets	17,101,811	15,414,180
Fixed assets, net	57,194,586	58,076,434
Investment in Craft Brands	738,412	127,555
Other assets	288,891	222,573
Total assets	\$ 75,323,700	\$ 73,840,742
 <b>LIABILITIES AND COMMON STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 2,623,249	\$ 2,233,689
Trade payable to Craft Brands	580,270	324,900
Accrued salaries, wages and payroll taxes	1,288,983	1,547,482
Refundable deposits	2,363,690	2,153,127
Other accrued expenses	683,933	380,394
Current portion of long-term debt and capital lease obligations	465,067	464,648
Total current liabilities	8,005,192	7,104,240
Long-term debt and capital lease obligations, net of current portion	4,088,977	4,321,616
Deferred income tax liability, net	1,845,940	1,548,699
Other liabilities	199,945	173,768

Common stockholders' equity:

Common stock, par value \$0.005 per share, authorized, 50,000,000 shares;  
issued and outstanding, 8,344,189 shares in 2007 and 8,281,489 shares in  
2006

	41,721	41,407
Additional paid-in capital	69,259,791	68,977,402
Retained earnings (deficit)	(8,117,866)	(8,326,390)
Total common stockholders' equity	61,183,646	60,692,419
Total liabilities and common stockholders' equity	\$ 75,323,700	\$ 73,840,742

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

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

(Unaudited)

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
Sales	\$ 13,469,578	\$ 11,143,511	\$ 23,026,510	\$ 19,812,761
Less excise taxes	1,566,974	1,186,685	2,580,944	2,076,588
Net sales	11,902,604	9,956,826	20,445,566	17,736,173
Cost of sales	9,847,481	8,110,165	17,653,563	15,352,695
Gross profit	2,055,123	1,846,661	2,792,003	2,383,478
Selling, general and administrative expenses	2,143,707	1,799,664	4,180,169	3,513,470
Income from equity investment in Craft Brands	969,888	818,774	1,648,126	1,332,923
Operating income	881,304	865,771	259,960	202,931
Interest expense	82,031	84,062	165,218	167,145
Other income, net	169,332	88,132	284,407	142,060
Income before income taxes	968,605	869,841	379,149	177,846
Income tax provision	435,881	10,614	170,625	19,048
Net income	\$ 532,724	\$ 859,227	\$ 208,524	\$ 158,798
Basic earnings per share	\$ 0.06	\$ 0.10	\$ 0.03	\$ 0.02
Diluted earnings per share	\$ 0.06	\$ 0.10	\$ 0.02	\$ 0.02

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

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

	<b>Six Months Ended June 30,</b>	
	<b>2007</b>	<b>2006</b>
<b>Operating Activities</b>		
Net income	\$ 208,524	\$ 158,798
Adjustments to reconcile net income to net cash provided by operating activities:		
(Gain) loss on disposition of fixed assets	(2,757)	203
Depreciation and amortization	1,421,121	1,508,289
Income from equity investment in Craft Brands less than (in excess of) cash distributions	(610,857)	(268,029)
Stock-based compensation	169,400	53,760
Deferred income taxes	135,496	
Changes in operating assets and liabilities	(964,261)	83,104
Net cash provided by operating activities	356,666	1,536,125
<b>Investing Activities</b>		
Expenditures for fixed assets	(895,544)	(671,085)
Proceeds from disposition of fixed assets	244,427	
Other, net		(6,188)
Net cash used in investing activities	(651,117)	(677,273)
<b>Financing Activities</b>		
Principal payments on debt and capital lease obligations	(232,220)	(229,546)
Issuance of common stock	113,303	38,894
Net cash used in financing activities	(118,917)	(190,652)
Increase (decrease) in cash and cash equivalents	(413,368)	668,200
Cash and cash equivalents:		
Beginning of period	9,435,073	6,435,609
End of period	\$ 9,021,705	\$ 7,103,809

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

**Table of Contents****REDHOOK ALE BREWERY, INCORPORATED**  
**NOTES TO FINANCIAL STATEMENTS**

(Unaudited)

**1. Basis of Presentation**

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

**2. Merger Discussions**

On January 3, 2007, the Company publicly disseminated a press release announcing that it was entering into preliminary discussions with Widmer Brothers Brewing Company regarding the possibility of combining the two companies. These negotiations are continuing. In connection with these discussions, the Company has incurred approximately \$110,000 and \$170,000 in legal, consulting and meeting costs during the three and six months ended June 30, 2007, respectively. These costs are reflected in the statement of operations as selling, general and administrative expenses.

As a result of these discussions, on January 2, 2007, the Company adopted a Company-wide severance plan that permits the payment of severance benefits to all full-time employees, other than executive officers, in the event that an employee's employment is terminated as a result of a merger or other business combination with Widmer Brothers Brewing Company.

**3. Inventories**

Inventories consist of the following:

	<b>June 30, 2007</b>	<b>December 31, 2006</b>
Raw materials	\$ 400,868	\$ 666,938
Work in process	829,607	622,352
Finished goods	446,002	247,333
Promotional merchandise	556,267	538,339
Packaging materials	632,929	496,770
	<b>\$ 2,865,673</b>	<b>\$ 2,571,732</b>

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

**4. Craft Brands Alliance LLC**

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





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

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

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

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

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

accordance with FIN No. 46R, the Company has not consolidated the financial statements of Craft

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NOTES TO FINANCIAL STATEMENTS (continued)**

(Unaudited)

Brands with the financial statements of the Company, but instead accounted for its investment in Craft Brands under the equity method, as outlined by Accounting Principle Board Opinion ( APB ) No. 18, *The Equity Method of Accounting for Investments in Common Stock*. The equity method requires that the Company recognize its share of the net earnings of Craft Brands by increasing its investment in Craft Brands on the Company's balance sheet and recognizing income from equity investment in the Company's statement of operations. A cash distribution or the Company's share of a net loss reported by Craft Brands is reflected as a decrease in investment in Craft Brands on the Company's balance sheet. The Company does not control the amount or timing of cash distributions by Craft Brands. The Company will periodically review its investment in Craft Brands to ensure that it complies with the guidelines prescribed by FIN No. 46R.

For the three months ended June 30, 2007 and 2006, the Company's share of Craft Brands' net income totaled \$970,000 and \$819,000, respectively. During the three months ended June 30, 2007 and 2006, the Company received cash distributions of \$721,000 and \$665,000, respectively, representing its share of the net cash flow of Craft Brands.

For the six months ended June 30, 2007 and 2006, the Company's share of Craft Brands' net income totaled \$1,648,000 and \$1,333,000, respectively. During the six months ended June 30, 2007 and 2006, the Company received cash distributions of \$1,037,000 and \$1,065,000, respectively, representing its share of the net cash flow of Craft Brands.

As of June 30, 2007 and December 31, 2006, the Company's investment in Craft Brands totaled \$738,000 and \$128,000, respectively.

For the three months ended June 30, 2007, shipments of the Company's products to Craft Brands represented approximately 34% of total Company shipments, or 32,600 barrels. For the three months ended June 30, 2006, shipments of the Company's products to Craft Brands represented 45% of total Company shipments, or 34,400 barrels.

For the six months ended June 30, 2007, shipments of the Company's products to Craft Brands represented approximately 38% of total Company shipments, or 61,300 barrels. For the six months ended June 30, 2006, shipments of the Company's products to Craft Brands represented 48% of total Company shipments, or 64,000 barrels.

In conjunction with the sale of Redhook product to Craft Brands, the Company's balance sheets as of June 30, 2007 and December 31, 2006 reflect a trade receivable due from Craft Brands of approximately \$824,000 and \$855,000, respectively. In conjunction with the sale of Redhook products in Washington state, where state liquor regulations require that the Company sells its product directly to third-party beer distributors, the Company's balance sheets as of June 30, 2007 and December 31, 2006 reflect a trade payable to Craft Brands, based upon a contractually determined formula, of approximately \$580,000 and \$325,000, respectively.

**5. Common Stockholders' Equity**

In conjunction with the exercise of stock options granted under the Company's stock option plans, the Company issued 38,500 shares of the Company's common stock ( Common Stock ) totaling \$113,000 during the six months ended June 30, 2007. During the six months ended June 30, 2006, the Company issued 34,900 shares of Common Stock totaling \$39,000.

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

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

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

The Company follows FASB Statement of Financial Accounting Standard ( SFAS ) No. 128, *Earnings per Share*.

Basic earnings (loss) per share is calculated using the weighted average number of shares of Common Stock outstanding. The calculation of adjusted weighted average shares outstanding for purposes of computing diluted earnings (loss) per share includes the dilutive effect of all outstanding stock options for periods when the Company reports net income. The calculation uses the treasury stock method and the as if converted method in determining the resulting incremental average equivalent shares outstanding as applicable.

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

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
Numerator for basic and diluted net income per share net income	\$ 532,724	\$ 859,227	\$ 208,524	\$ 158,798
Denominator for basic net income per share - weighted average common shares outstanding	8,325,438	8,241,602	8,310,440	8,233,713
Dilutive effect of stock options on weighted average common shares	441,863	270,287	437,252	257,468
Denominator for diluted net income per share	8,767,301	8,511,889	8,747,692	8,491,181
Basic net income per share	\$ 0.06	\$ 0.10	\$ 0.03	\$ 0.02
Diluted net income per share	\$ 0.06	\$ 0.10	\$ 0.02	\$ 0.02

**7. Stock-Based Compensation**

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

The compensation committee may also grant non-qualified stock options and incentive stock options to employees, non-employee directors and independent consultants or advisors under the 2002 Stock Option Plan (the 2002 Plan ). As of June 30, 2007, 96,959 options were available for future grant under the 2002 Plan. The Company issues new shares of Common Stock upon exercise of stock options.

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

terminate or are exercised.

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

Prior to the January 1, 2006 adoption of the SFAS No. 123R, *Share-Based Payment*, the Company accounted for its employee and director stock-based compensation plans using the intrinsic value method, as prescribed by APB No. 25, *Accounting for Stock Issued to Employees*. Under the intrinsic value method, no stock-based compensation expense had been recognized in the Company's statement of operations because the exercise price of the Company's stock options granted to employees and directors equaled the fair market value of the underlying Common Stock on the date of grant. As permitted, for all periods prior to January 1, 2006, the Company elected to adopt the disclosure only provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*, as amended by SFAS No. 148. On November 29, 2005, the board of directors of the Company approved an acceleration of vesting of all of the Company's unvested stock options (the Acceleration). The Acceleration was effective for stock options outstanding as of December 30, 2005. These options were granted under the 1992 Plan and 2002 Plan. As a result of the Acceleration, options to acquire approximately 136,000 shares of the Company's Common Stock, or 16% of total outstanding options, became exercisable on December 30, 2005. Of the approximately 136,000 shares subject to the Acceleration, options to acquire approximately 70,000 shares of the Company's Common Stock at an exercise price of \$1.865 would have otherwise fully vested in August 2006, and options to acquire approximately 66,000 shares of the Company's Common Stock at an exercise price of \$2.019 would have otherwise vested in August 2006 and August 2007. The Acceleration did not have a material impact on 2006 or 2007 results of operations. On January 1, 2006, the Company adopted SFAS No. 123R, *Share-Based Payment*, which revises SFAS No. 123 and supersedes APB No. 25. SFAS No. 123R requires all share-based payments to employees and directors be recognized as expense in the statement of operations based on their fair values and vesting periods. The Company is required to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in the Company's statement of operations. The Company elected to follow the modified prospective transition method, one of two methods prescribed by the standard, for implementing SFAS No. 123R. Under the modified prospective method, compensation cost is recognized beginning with the effective date (i) based on the requirements of SFAS No. 123R for all share-based payments granted after the effective date and (ii) based on the requirements of SFAS No. 123 for all awards granted to employees prior to the effective date of SFAS No. 123R that remain unvested on the effective date. On May 22, 2007, the board of directors approved a grant of 2,300 shares of fully-vested Common Stock to each independent, non-employee director, 10,000 shares of fully-vested Common Stock to the Chief Executive Officer Paul Shipman, and 5,000 shares of fully-vested Common Stock to President David Mickelson under the 2007 Plan. In conjunction with these stock grants, the Company issued 24,200 shares of Common Stock and recognized stock-based compensation expense of \$169,400 in the Company's statement of operations for the three and six months ended June 30, 2007. Because no stock options were granted during the six months ended June 30, 2007, no stock-based compensation expense related to stock options was recognized in the Company's statement of operations for the six months ended June 30, 2007. Stock-based compensation expense recognized in the Company's statement of operations for the three and six months ended June 30, 2006 totaled \$54,000 and is attributable to stock options granted to non-employee directors (other than A-B designated directors). No stock-based compensation expense was recognized in 2007 or 2006 for stock options outstanding as of December 31, 2005 because these options were fully vested prior to the January 1, 2006 adoption of SFAS No. 123R.

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

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

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value
Outstanding at January 1, 2007	783,440	\$ 2.89	4.10	\$1,950,534
Granted				
Exercised	(38,500)	\$ 2.94		
Canceled	(38,150)	\$ 8.13		
Outstanding at June 30, 2007	706,790	\$ 2.60	3.81	\$3,788,040
Exercisable at June 30, 2007	706,790	\$ 2.60	3.81	\$3,788,040

The aggregate intrinsic value of options outstanding and exercisable at June 30, 2007 and January 1, 2007 is the difference between the stock closing price as reported by NASDAQ and the exercise price of the shares. The market values as of June 30, 2007 and January 1, 2007 were \$7.76 and \$5.20, respectively. As of June 30, 2007 and 2006, there was no unrecognized stock-based compensation expense related to unvested stock options. During the three months ended June 30, 2007 and 2006, the total intrinsic value of stock options exercised was \$45,000 and \$140,000, respectively.

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

Range of Exercise Prices	Number Outstanding & Exercisable	Average Remaining Contractual Life (Yrs)	Weighted Average Exercise Price
\$1.485 to \$1.815	8,000	3.40	\$1.650
\$1.816 to \$1.865	325,840	4.09	\$1.865
\$1.866 to \$2.019	138,534	5.16	\$2.019
\$2.020 to \$2.180	8,000	5.89	\$2.180
\$2.181 to \$2.425	6,666	4.89	\$2.425
\$2.426 to \$2.450	12,000	6.88	\$2.450
\$2.451 to \$3.150	16,000	7.90	\$3.150
\$3.151 to \$3.969	156,000	1.89	\$3.969
\$3.970 to \$5.730	35,750	0.88	\$5.730
\$1.485 to \$5.730	706,790	3.81	\$2.601



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

**8. Income Taxes**

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

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

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

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

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

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*This quarterly report on Form 10-Q includes forward-looking statements. Generally, the words believe, expect, intend, estimate, anticipate, project, will and similar expressions or their negatives identify forward-looking statements, which generally are not historical in nature. These statements are based upon assumptions and projections that the Company believes are reasonable, but are by their nature inherently uncertain. Many possible events or factors could affect the Company's future financial results and performance, and could cause actual results or performance to differ materially from those expressed, including those risks and uncertainties described in Part I, Item 1A. Risk Factors in the Company's Annual Report on Form 10-K for the year ended December 31, 2006, and those described from time to time in the Company's future reports filed with the Securities and Exchange Commission. Caution should be taken not to place undue reliance on these forward-looking statements, which speak only as of the date of this quarterly report.*

*The following discussion and analysis should be read in conjunction with the Financial Statements and Notes thereto of Redhook Ale Brewery, Incorporated (the Company or Redhook) included herein, as well as the audited Financial Statements and Notes and Management's Discussion and Analysis of Financial Condition and Results of Operations contained in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2006. The discussion and analysis includes period-to-period comparisons of the Company's financial results. Although period-to-period comparisons may be helpful in understanding the Company's financial results, the Company believes that they should not be relied upon as an accurate indicator of future performance.*

**Overview**

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

The Company's gross sales and net income for the six months ended June 30, 2007 totaled \$23,027,000 and \$209,000, respectively, compared to gross sales and a net income of \$19,813,000 and \$159,000, respectively, for the same period in 2006. Sales in the craft beer industry generally reflect a degree of seasonality, with the first and fourth quarters historically being the slowest and the rest of the year typically demonstrating stronger sales. The Company has historically operated with little or no backlog, and, therefore, its ability to predict sales for future periods is limited. The Company's sales are affected by several factors, including consumer demand, price discounting and competitive considerations. The Company competes in the highly competitive craft brewing market as well as in the much larger specialty beer market, which encompasses producers of import beers, major national brewers that produce fuller-flavored products, and large spirit companies and national brewers that produce flavored alcohol beverages.

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

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

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

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

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