Boston Beer Company (SAM)

Date: January 30, 2014

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Stock Price: $212
Diluted Shares: 13.5MM
Diluted Market Cap: $2.9BN
Working Capital Surplus: $50MM
Debt: $0
EV: $2.85BN
2013E EBITDA: $150MM
EV / EBITDA Multiple: 19x

I suspect The Boston Beer Company is about to take a dramatic fall. Others – like Off Wall Street – have said similar things. Unfortunately their timing was horrendous as the stock ripped 100 points in the wrong direction. Who says short selling is easy?

But today I believe a fairly significant multiple contraction is underway. **For hedgies looking for alpha shorts, SAM presents a very attractive risk-reward.**

Boston Beer is the maker of Samuel Adams. There are 2 other significant brands in its portfolio - Twisted Tea, which is a hard tea line of beverages and Angry Orchard, which is a hard cider. But for investor purposes, the primary driver of this business is beer – specifically the 39 main types of craft beer under their flagship Sam Adams brand. I am confident in writing this because I can't find anyone that actually believes small niches like cider beer will ever get to more than 1% of total beer volumes. Flavored malt beverages like Twisted Tea maybe someday gets to 2%. So the investment case is centered around craft beer.

So let's take a look at what's been happening in the craft beer market in the US (where +95% of SAM's sales come from).

Long arc first: Over the last 10 years, volume in the domestic beer industry, ex-"Better Beers" AKA craft / specialty beers, has shrunk as more drinkers traded up to higher quality beer beverages or substituted beer with other spirits. The entire sector's growth has been concentrated in the craft / specialty end. This was the opening in the market that SAM positioned itself beautifully to take advantage of. And it paid off with sales increasing double digits in each of the past 3 years. But this shift in the market has not gone unnoticed. And now SAM is facing an all-out assault on its business – from niche local breweries to large international brewers – and consumers are getting saturated with choices. And it's this shift – from wide-open greenfield to fiercely competitive brownfield – that will cause investors to re-price this company. I believe the turning point is at hand and we're about to witness a complete turnover in the shareholder base as momentum traders get replaced by value investors (but only after a severe multiple contraction).

Here are the details that give me conviction in making this call:

1. SAM is no longer buying back its stock. SAM has done a pretty good job keeping it share count low by repurchasing $300MM in stock to date. But this game is over as capital expenditures are increasing dramatically this year (CapEx was est. at $110MM in 2013, were guided to be $115MM in 2014 but were increased to $160MM on the last earnings report). This CapEx is going to suck up all their operating cash and more, leaving no money for repurchases (save a debt offering / recap which would be an awful capital allocation decision at this stock price).
2. In 2012, new craft breweries opened at a record pace of nearly 2 per day. **That's 2. Per. Day.** There were 420 operating craft breweries in 2006; now there are more than 2,483 (as of Jun-13) and there are many more in the planning stages (perhaps 1,000 to 2,000 more). What does this imply about pricing, margins, and company-specific growth given that the definition of a craft beer drinker is "an explorer with non-linear taste preferences"? Page 7. If you guessed that it implies "bad things" you are on the right track. Logic tells me that a few things will happen over the course of the next couple of years: (1) maintaining a beer on the shelf will get more expensive, (2) advertising and promotional efforts will have to be increased, (3) selling expenses (specific to growing SAM's direct salesforce) will likely go higher, (4) capital investments will be increased. Each of these things will put pressure on margins. If all of them happened at once, it would be a disaster to operating margins.
3. Recent insider sales have been extremely heavy – just take a look at the CEO's transactions in the past month: http://www.secform4.com/insider-trading/949870.htm
4. The second derivative of growth appears to have peaked. 2012 shipment volume was up 10.5% from 2011 then in 2013 it is estimated to be up 25% from 2012. My math tells me this acceleration is going to slow in 2014, especially as the numbers get larger (just harder to grow at the same pace). Momentum stocks like SAM tend to get killed when the second order of growth turns negative and that moment is nigh.

Don't get me wrong – SAM has a solid position in a pretty darn good business along with an unlevered balance sheet. But **every business has its price. And SAM's price is way out of whack with the fundamental headwinds it's facing.**

One thing would immediately make me change my mind: if the company spent it's overpriced stock to buy underpriced competitors. Plugging in other brands into their portfolio / wholesale sales channel could be a game-changer for the company, so this is something to keep your eye on.