The Second Wave Sell-Off: Private Equity In The Craft Beer Market Spells Upheaval Within A Decade

Tara Nurin/Forbes

It wasn't quite breaking news when Sierra Nevada founder (and newly minted billionaire) Ken Grossman quietly told a group of reporters and industry types in Bethlehem, Pa., last week, "I'm not sure all the people [investing] their money in [craft breweries] are going to get the returns they're hoping for."

Everyone who follows the craft brewing business accepts that the market is or soon will be oversaturated -- not every craft brewer is going to succeed in a world where the number of American breweries is higher than ever. It's also common knowledge to this crowd that 2015 brought an unprecedented number of mergers, acquisitions and private-equity purchases.

But what really got the attention of those at the event was a follow-up comment from Boston Beer founder Jim Koch (according to some measures, craft beer's first billionaire and a Harvard JD/MBA): "Funds have finite lives … when those fund lines get to the end [fund managers] have got to sell those assets."

Sure, each time a craft brewery sells to a private equity firm -- an event that's happened twice this year with the sale of Victory Brewing and Cigar City Brewing -- critics insist on the malevolent intentions of the investment firm du jour.

Online and around the proverbial beer cooler they fret that such a transaction can only mean one thing: despite promises to preserve the management and employee base, culture and quality of its investment, said firm will do whatever it takes to raise the value of the brewery before selling it off to an even more distant and soulless entity hell-bent on global beer domination.

But here's the irony. Most craft beer fans, infamous for crying "sellout" and chastising brewers for any number of perceived offenses, don't realize just how accurate they are. When Koch told the sophisticated beer audience at last week's Brewers of Pennsylvania Meeting of the Malts forum that traditional private equity funds have "got to get a liquidity event," he was probably telling at least half of them something they didn't already know.

So if you're someone who doesn't pay attention to financial news, pay attention to this. Despite what you might have believed, PE investors aren't satisfied to collect off annual profits. A traditional private-equity fund, which pools money from wealthy individual and institutional investors to take equity stakes in companies, has a finite lifespan of usually 10 years. When that fund sunsets, investors expect to get paid out. A lot.

What does this mean for the industry? Of the more than half-dozen high-profile equity deals that have taken place recently, most of the PE firms will look to exit three to five years afterward, launching a rash of the resales and public offerings that the craft community so derides. If a profitable exit doesn't look possible, the firm may hold longer, but something has to happen by the end of the fund's 10-year lifespan, or in some cases a few years afterward if it gets an extension from investors.

"There is a time horizon when PE funds have to wind down or distribute their underlying investments and limited partners get their money," says Townsend Ziebold, managing partner at First Beverage Group, a beverage investment banking and private equity firm that acted as exclusive financial advisor to brands like Firestone Walker, 10 Barrel, Breckenridge, St. Archer, Southern Tier and Boulevard when they each underwent the process of selling to a larger brewery or a PE firm. "For those who sold to PE funds, "There will be a second wave of exits or liquidity events."

Though most breweries don't disclose the terms of their sales, Ziebold says other breweries that he doesn't represent, like Uinta, Dogfish Head and Full Sail, have all entered into traditional PE arrangements. Abita sold a minority share to Enjoy Beer LLC., launched by former Harpoon CEO Rich Doyle and backed by a traditional PE firm. The effects might be mitigated for a company like Dogfish Head, which only sold a 15% stake to LNK Partners. And Victory, which joined Southern Tier in a PE arrangement, and Cigar City, which did the same with Oskar Blues, Perrin and the Utah Brewers Collective, operate under different conditions because they've gone into business with something called a family office, which handles investments for a wealthy family and doesn't need to cut and run after a proscripted period of time.

For the rest, let's look at some likely secondary market scenarios.

IPO:

Because it takes an exhaustive amount of capital to take a company public, only about five major existing craft and former craft breweries and collectives have done it: Boston Beer; Mendocino Brewing; Appalachian Mountain Brewery; Craft Brewers Alliance, partially owned by AB InBev (Redhook, Widmer Brothers, Kona); and North American Breweries (Pyramid, Magic Hat), whose PE firm sold it to a food and beverage conglomerate in Costa Rica two years after buying it. But it is an option, albeit one that sends a strong anti-artisanal message to customers, especially when the word “shareholder” starts getting tossed around.

“Even larger breweries that may afford the compliance costs avoid going public because an IPO sends a mass-market signal at odds with the goal of maintaining a local image,” writes Kyle Leingang, an attorney who works on brewery consolidations, on the Dorsey & Whitney, LLP website.

Resale to a larger brewery:

These transactions are generally the most common, and we’ve seen international brewers like Anheuser-Busch InBev , Constellation Brands, Heineken, MillerCoors’ Tenth and Blake division, and even Duvel Moortgat display an appetite for gobbling up smaller competitors. As PE firms bolster the value of their brewery investments, expect to see these corporations enter the secondary market as buyers.

“We have all this beer volume and it’s all migrating to a consumer that wants local and artisanal. So one of the reasons the industry is consolidating is that bigger breweries need to buy their growth and innovation,” says Ziebold.

Obviously, this can present a disastrous public relations future for a brewer who cares about craft cred.

“These buyout transactions are often disapproved of by industry insiders and enthusiasts, who criticize them for tarnishing a brand’s local credibility, imposing ‘big corporate’ culture, and leading to sacrificed quality,” writes Leingang.

Employee Stock Ownership Plan (ESOP):

A firm may choose to send the company back to its employees, as could be the case when Full Sail’s partnership with Encore Consumer Capital ends. Last year, the Oregon brewery’s employees, who’d held a controlling interest in their company since 1999, voted to turn their equity over to Encore. Going back to an ESOP may be considered the “feel-good” option, though it generally results in a lower sale price, because there’s no competitive bidding, and a delayed liquidity event, considering that Leingang says most banks don’t want to finance the entire transaction.

However, Leingang thinks a partial ESOP may be the “new frontier for craft beer” and an “untapped structure for craft beer liquidity.” This arrangement would transfer part of the equity to employees while selling the rest to a third party. He says this type of deal has “potential to accelerate the cash event for sellers and make traditional sales more palatable to the industry by ensuring local ownership and protecting craft beer’s culture.”

Sale to other craft breweries:

We've seen this in the Victory and Cigar City deals. Both Southern Tier and Oskar Blues partnered with family offices to fund the purchase of other craft breweries. In what might be the most ideal scenario, management stays in place and holds seats on the board while benefiting from streamlined administrative systems and shared knowledge between relatively equal partners. Again, with family office financing, there is no term limit, which brings it as close as possible to guaranteeing that everyone’s in it together for the long haul.

However, despite the cheerful press releases that come after such transactions, there really is no such thing as a sure thing.

Victory co-founder Bill Covaleski acknowledges that in spite of his confidence that his new PE friends see in Victory “a long runway to grow and succeed,” he and co-founder Ron Barchet wouldn’t necessarily be able to stop an unwanted sale or public offering.

“Ron and I each have a seat on the board but they have majority ownership. If something directed them to want to liquidate they would be able to do so,” he says.

Of course, any talk of capital infusions into craft brewing makes brewers who remember the 1990s shudder. Unprecedented interest from outside investors and a rush for some companies to prematurely go public brought about a shakeout that shuttered around 200 businesses. Yet Ziebold, along with many of his colleagues in the business, agree that comparisons to the '90s aren’t accurate.

For one, there was much less private-equity investment in the industry at that time because PE firms seek to invest in companies with scale and profitability and not too many breweries in the 1990s rose to a level to catch their attention. What’s more, too many breweries were mismanaged and/or producing poor quality beer.

“The industry is much more mature now,” Ziebold says. “It’s not this cottage industry anymore.”

With the Brewers Association craft beer lobbying group reporting U.S. craft production up 13% in 2015 over the previous year and sales up 16% over the same period, there are a few things we can be pretty sure of: as the industry continues to enjoy double digit growth, there’s going to be ongoing consolidation, an increase in outside investment and, as Grossman foresees, some breweries that underperform and close as a result.

“That will be interesting,” Koch surmised during the forum.

Interesting. To say the least.