

Using Bankruptcy to Kill the Narrative of the “Craft Beer Bubble.”

BY JACK O'CONNOR

Last December, San Francisco-based Magnolia Brewing filed for Chapter 11 bankruptcy protection. Being a corporate bankruptcy attorney (and an optimistic beer geek), I view this positively. You should, too.

Why? Because it's good evidence that the craft beer industry is ready to move past the tired narrative of the dreaded “craft beer bubble.”

First, let's talk about the bubble, and how it's been speculatively applied to the current craft beer boom, for better or worse. Then we can talk about why a bankruptcy filing in northern California may be important to ending this narrative.

HOW THE “BUBBLE” CONCEPT IS APPLIED TO THE CURRENT CRAFT BEER BOOM

What exactly does it mean when we talk about a bubble in the craft beer industry? Why is it relevant? Should I be concerned about bubbles? What about bubbles in my bath? Are you going to keep asking rhetorical questions? BUBBLES!

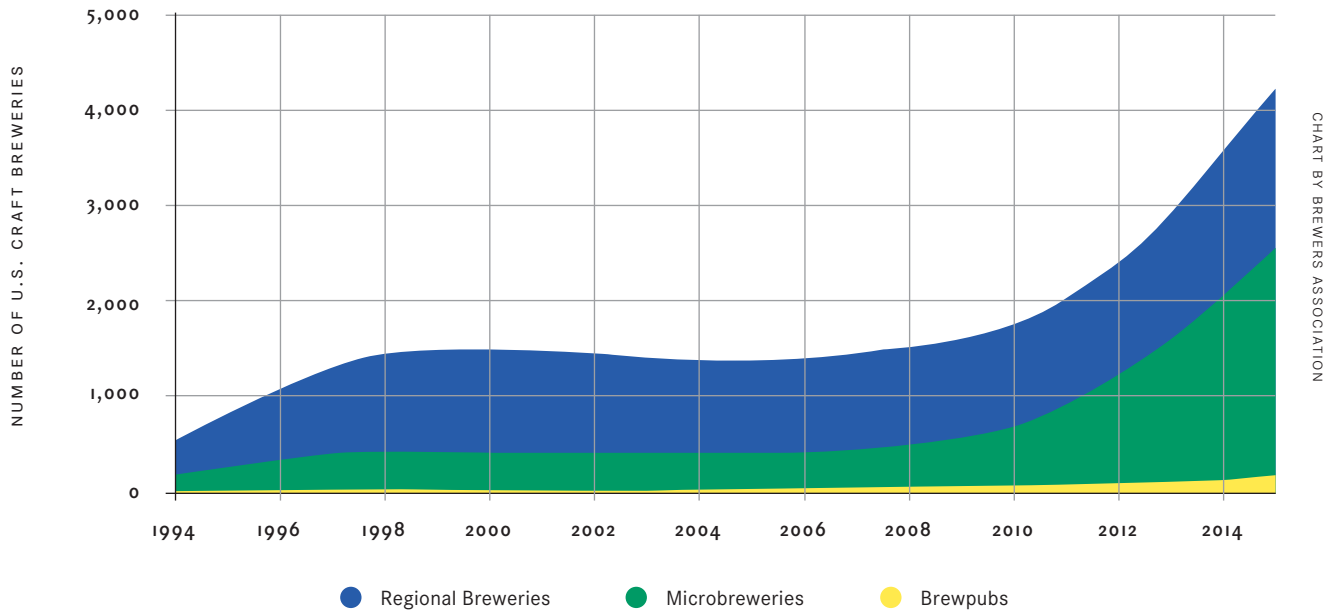
The term “bubble” seems ubiquitous these days when discussing the growth of the craft beer industry—but it's rarely

defined in a clear way. Most often, people seem to use the term “bubble” to refer to the very broad economic concept of an economic cycle, characterized by rapid expansion in a market, which is followed by severe contraction.

The most commonly cited example of a past bubble in the craft beer industry was the rise and fall of microbreweries in the late 90s and early 2000s. According to data from the Brewers Association, the total number of breweries in the U.S. grew by over 500% between 1990 and 2000, ultimately stalling out and slightly declining between 2001 and 2006. Since 2006, however, the total number of breweries in the U.S. has grown again by almost 300%, from 1,511 total breweries in 2007 to current estimates exceeding 4,300 total breweries, more than have ever existed in U.S. history.

Along with the growth in number of breweries, the market share of craft beer has also grown significantly over this time,

U.S. Craft Brewery Count by Category



both in terms of total sales and production volume relative to the overall beer market. This rapid growth of craft beer in such a short time is constantly narrative fodder for journalists, bloggers, and forum commenters (trolls), speculating that we're in the midst of another bubble that's ready to burst any day. The argument usually employs the following logic:

New breweries are opening and current breweries are expanding at an unsustainable rate. Since the rate of growth is unsustainable, the growth of the craft beer industry will suddenly halt, or reverse just like it did 20 years ago.

While craft beer is, indeed, undergoing a booming period of growth, bubble apologists ignore a number of market factors in making their case. Namely, they miss the idea that craft beer is entering a state of maturity. Calling this stage of growth a bubble

is misleading and ultimately harmful for a couple of reasons.

First, the term "bubble" itself is probably not the right term to describe what happened in the 90s and what people are speculating will happen now. When used by financial professionals, the concept of a bubble focuses on trade pricing for assets in a specific market that strongly deviates from the actual value of those assets (think stock prices, home values, etc.). The dotcom bubble in the late 90s and early 2000s, for example—which happens to coincide with craft beer's last boom-and-bust cycle—was characterized by investors buying tech stocks at artificially high prices, believing they could sell those stocks at even higher prices in the future. This speculation proved untrue, causing the bubble to burst when the value of tech stocks took a nosedive.

What we saw in the 90s was probably better described as a boom-and-bust period within the craft beer industry. The number of

breweries expanded rapidly, then suddenly stopped, resulting in a general shrinking of the industry. This distinction is important to note because, regardless of the rate of industry growth, the industry has never completely fallen off a cliff. The trend over time has continued upward. Thus, the use of the term "bubble," can be detrimental to the industry. It assumes a cataclysmic event in which the industry as a whole goes belly-up.

Rather than focusing on the bubble narrative, our attention should be focused on how the industry is maturing in the midst of a boom period. Expansion, financing, and acquisition rates are high right now, and likely to slow over time, meaning, at the very least, fewer new breweries will open on such a rapid basis. With increased competition between existing breweries that have undergone significant expansions and need to sell more and more beer to stay in business, some breweries will inevitably be forced out of the marketplace.

Some breweries won't be able to compete on quality; others won't be able to compete from an operational efficiency standpoint. More than a few experienced craft players have adopted this view, including Dogfish Head's Sam Calagione, Victory's Bill Covaleski, Stone's Greg Koch, and Founders' Mike Stevens. All four have recently indicated that they think the industry is heading toward a "shakeout" or "fall-out," where breweries will have to close, and the number of new brewery openings will inevitably slow. But none of them seems to think that the craft beer industry is about to experience a complete bust.

I think Van Havig of Gigantic Brewing Co. said it best when interviewed in 2014 for NPR's Strange Brews podcast: "If you think that every brewery out there is going to make it . . . no," because every industry has "bad operators," who will go out of business.

So even during a boom, industry turnover is natural and expected. It doesn't mean that a magical pin is about to fall from the sky and pop an imaginary bubble, causing the industry as a whole to disappear overnight. More likely, it means that the market is maturing. And there's at least one overlooked factor that points to its continuing maturity: Bankruptcy.

BANKRUPTCY AS A FACTOR IN IDENTIFYING THE CRAFT BEER INDUSTRY'S MATURITY

Bankruptcy filings—especially Chapter 11 bankruptcy filings—do not signal the death of a company, much less an industry. They should be viewed as a sign of industry maturity. Businesses that have no intrinsic value do not file for bankruptcy. It can be an expensive process that really only makes sense if there is an industry and marketplace capable of supporting that business's continued operations. When a company files for bankruptcy, an automatic stay is triggered which generally prevents creditors from taking action against the company to

collect outstanding debts while the company reorganizes. In some cases, Chapter 11 is used to sell a business as a going concern or run an orderly liquidation of the business's assets.

The Magnolia bankruptcy presents a good example of how an established brewery in a competitive market views the long-term viability of the craft beer industry. As a San Francisco based brewery and brewpub, Magnolia, like so many other breweries across the country, recently undertook a dramatic expansion plan, which likely cost more than they could return in the short term. As a result, Magnolia filed for Chapter 11 in the Northern District of California. The filings in the Bankruptcy Court show that the brewery and its restaurants are profitable, but that the company needs an opportunity to work with its secured lenders and vendors on terms that will keep moving the business forward.

Magnolia didn't have to try to reorganize. If no market existed for its beers, it could have shut its doors and allowed the bank to liquidate its assets piecemeal. By filing Chapter 11, the brewery gives itself time and breathing room to reorganize its debt, reach agreements with creditors, and develop a plan to profitably continue operations.

This is not a bad thing. Bankruptcy filings, especially Chapter 11 reorganizations, should be viewed as a sign of industry maturity. Rather than simply closing its doors and allowing the bank to liquidate its assets piecemeal, Magnolia is seeking to work its way through a difficult time, in the anticipation that a market exists for its future success.

WHAT TO EXPECT IN THE FUTURE

Now, let me make my own wild speculations about where the industry is heading: if I'm right, we shouldn't be surprised to see more breweries file for bankruptcy in the future. Small and mid-sized breweries across the

country have been rapidly expanding to meet consumer demand. When breweries expand to larger facilities and add capacity, they almost always have to finance that growth through debt or private equity. And with markets becoming increasingly crowded and competitive, breweries may face challenges servicing their debt or making distributions to investors. When this happens, bankruptcy is a likely consequence.

But should this mean we're about to see a bubble burst? No. Simply put, fewer craft breweries does not equate to less good beer. We're seeing signs every day that craft beer as an industry is becoming more sophisticated, and maturing as an industry. Craft brewery bankruptcy filings, even if they're rare, should be a factor considered when determining whether the industry is maturing or preparing for a cataclysmic downturn.♦

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