# CRAFT BEER IS GOING FLAT. CAN CRAFT SPIRITS CONTINUE THE INSURGENCY?

**As Big Beer finally learns the mantra: *if you identify a trend, ride it, don't fight it*, the growth path for craft brewers and distillers becomes more difficult, though not impossible.**

August 2017


## KEY TAKEAWAYS

- The craft beer movement in the US has enjoyed extraordinary success at the expense of Big Beer, rising from 3.6% market share by volume in 2006 to 12.3% in 2016.
- This growth occurred for five main reasons: growing consumer interest in all things artisanal, lackluster national and regional beer brands, a more favorable regulatory environment, the relative low cost and ease of brewing on a small scale, and the social nature of beer consumption providing market momentum for "in" craft brands.
- Craft breweries are now becoming victims of their own success as market maturation causes growth to tap out. Also, Big Beer has finally learned the mantra: *If you identify a trend, ride it, don't fight it*, and acquired a number of craft breweries accordingly, further dampening independent craft beer's growth.
- Craft beer's success in the US has encouraged new craft brewers to challenge beer conglomerates in markets from China to Ireland. In an analogous trend, craft spirits are gaining popularity due to many of the factors that allowed craft beer to first flourish in the US, leading some to predict that craft spirits could achieve similar market share.
- The big alcohol conglomerates, however, will likely not again be passive in response to the threat, making the growth path for independent craft beer and spirits harder, though not impossible.

Craft. Beer. Seldom do two things go so well together. In recent years, the potential of this pairing has been much more than gustatory; many beer-loving entrepreneurs have realized the economic potential of this pairing as well. In fact, the growth of craft beer in the US over the last decade has been nothing short of extraordinary—in a US$100+ billion industry that had been consolidating for decades, craft breweries rose from a paltry 3.4% market share (by volume) in 2006 to 12.3% in 2016. The surge was so pronounced that, in 2016, a new craft brewery opened in the US on average every 11 hours. There are now around 5,500 craft breweries in the US and, though some of their names flout beer branding convention—Cellar Rats, Evil Twin, Rogue Ales, Dogfish Head, Against the Grain, Brew Cult, Hopping Gnome, and Wooden Robot are a few examples—they mean business.

Though "craft" beer may be here to stay, the vibrant independent craft breweries that have reshaped the industry may have a shorter shelf life. Despite their phenomenal success thus far, American craft brewers today face three major impediments to growth: the move of "Big Beer" into their market, limits to their natural consumer base, and, perversely, the curse of their own success. With these challenges coming to the fore, some beer industry analysts have declared that "peak craft" is now behind us, at least in the US.

Unfortunately for independent craft brewers, this thesis is beginning to be borne out in industry production data. Whereas craft beer enjoyed year-on-year sales growth of 21.3% in 2014, this declined to 14.3% in 2015, then to 6.2% in 2016, and in 2017 looks likely to fall further still. The number of microbrewery and brewpub openings has also been tapering off since 2014, albeit more slowly. In addition, in 2016, existing beers accounted for more of overall volume growth than new beers, a sign that new breweries are struggling to gain a foothold.

Though these trends seem to bode poorly for both established and newer craft breweries in the US, global consumer appetite for craft alcohol—that is, high-quality, niche beverages produced by independent, small-scale operations—is spreading, as craft brewers in countries such as Japan, the UK, South Africa, New Zealand, and India begin to establish a foothold in their respective markets.

Similarly, craft spirit distilleries in both the US and foreign markets are poised to gain market share at the expense of major global distillers such as Diageo (brands include Smirnoff, Johnnie Walker, and Captain Morgan), Pernod Ricard (Absolut, Jameson, Beefeater), Beam Suntory (Jim Beam, Maker's Mark, Yamazaki), and Bacardi Limited (Bacardi, Bombay Sapphire, Grey Goose) due to recent regulatory relaxation and growing consumer interest in "craftier" beverages of all types.

While it may be premature to declare the American craft beer uprising of the early twenty-first century over—keep in mind there are still far more craft breweries opening than shutting—an examination of the factors that have contributed to its rise and its current challenges can help illuminate the potential of craft beers in other markets, as well as craft spirits both in the US and abroad, to continue to shake up their respective industries.

## WHY CRAFT EXPLODED

According to Analyst Richard Schmidt, CFA, there are five primary reasons why craft beer was able to explode onto the US beer scene: changing consumer tastes, lackluster existing offerings, a more favorable regulatory environment, the relative ease of beer production, and momentum generated by social drinking and social media. First among these, the growing consumer trends of "premiumization," "affordable luxury,"

**BIG BEER'S CRAFTY ACQUISITIONS AS OF AUGUST 2017**

and "bespoke" established that high-income consumers were willing to part with a few extra dollars for higher-quality and more-sophisticated brews, while the "hipster" and "foodie" penchant for all things "local" and "artisanal" added to the growing demand for smaller-batch beers with distinct flavors. In short, craft beer, like farm-to-table restaurants, ticked the "high quality," "local," and "authentic" boxes that well-heeled consumers increasingly sought.

**"You don't say you're a Fat Tire drinker, you say you're a craft beer drinker. That's a problem for Fat Tire."**

Second, existing domestic offerings were not only homogenous but considered bland by many. Ubiquitous American beers such as Budweiser, Miller, and Coors have been long-regarded as characterless by discerning beer lovers, and cheaper regional brands such as Rheingold, Iron City, Narragansett, Olympia, and Schlitz did not offer high or even uniform quality. And while American consumers, increasingly well-travelled, began to appreciate good-quality beer (just as they were discovering the joys of a decent cup of coffee), major American beer brands paid little heed to some of their customers' newly enlivened taste buds, choosing instead to coast on the decades-old recipes that had brought them success in the first place. (Indeed, Anheuser-Busch InBev's Bud Light still manages to outsell the entire craft beer category.) Though flavorful imported beers such as Heineken and Becks remained widely available, the impulse to try something new and different, together with effective marketing focusing on "freshness" from the "better beer" pioneers like Samuel Adams and Anchor Brewing breweries, brought many onto the craft beer-wagon.

Third, changes in the legal and regulatory environment over recent decades lowered barriers to entry for new breweries. Post-prohibition-era laws in the US to control distribution that are still in effect today mandate, with few exceptions, that breweries (and distilleries) must sell their product through independent distributors, rather than directly to retailers. This post-prohibition three-tier system of producers, distributors, and retailers undercuts a traditional advantage of large incumbents who, if left unchecked, could use their market power to vertically integrate, thereby curtailing opportunities for newcomers to get on retail shelves. President Jimmy Carter signed legislation in 1978 that effectively legalized non-commercial home brewing, generating interest in craft beer amongst the general public. Yet the development of brewpubs—defined as restaurant-breweries that sell at least 25% of their product on-site—in the 1980s that were exempted from the three-tier distribution system was even more critical to the rise of craft beer as it provided a platform for home brewing enthusiasts to sell commercially and build a following. These legal and regulatory shifts built a craft beer-enthusiast base that gave the microbreweries established in the 1990s—many of which had started as brewpubs—a chance to compete regionally and even nationally.

Fourth, compared to some alcohols, fresh, quality beer is relatively easy to make on a small scale—the ingredients (grain, yeast, hops, and water) are both cheap and accessible, and the brewing equipment is relatively simple to operate and affordable. More importantly, brewing time is measured in weeks, unlike months or even years for wine and some spirits, allowing independent breweries to set up and scale up quickly to meet budding demand. In sum, a thirst for fresh, flavorful beer was going unquenched in a market ripe for new entrants.

**"When I already have 50 craft beers in my inventory, do I really need the 51st?"**

The final factor that catalyzed the American craft beer explosion of the mid-to-late 2000s is the momentum that can be generated by trendy, publicly consumed products. Unlike most consumer goods—indeed, unlike most food and beverage products—alcohol, and beer in particular, is inherently *social*, consumed on display amongst peers. It is also, like music, a product where quality and taste are inherently *subjective*—a "good" beer, just like a "good" song, cannot be easily nor objectively defined. Products that are both social and subjective, therefore, tend to become indicators of cultural cachet—who wants to be seen drinking a passé beer? For this reason, a craft beer that catches on can gain momentum quickly. This process, hypercharged by beer blogs, mobile apps, and social media, played directly into the hands of craft beer makers whose brands were highly differentiated from the lackluster on-tap standards, magnifying the popularity of the "it" beer of the moment.

## CRAFT BEER'S TIPPING POINT?

Yet for all their competitive advantages, craft brewers now face daunting challenges. For one, the groundswell of newcomers resulting from lower barriers to entry has fragmented the market, making it increasingly difficult for craft breweries to stand out from their peers and grow their brand. With new craft breweries opening at a pace of more than one per day in the US, many craft beer consumers now make purchasing decisions based on name, label design, and locality alone, showing loyalty to the category of craft beer rather than to particular brands. "You don't say you're a Fat Tire drinker, you say you're a craft beer drinker" says Schmidt. "That's a problem for Fat Tire." So while market share of the craft beer category has grown, the share of most individual craft beer brands has been capped as that growth is shared among a larger pool of competitors.

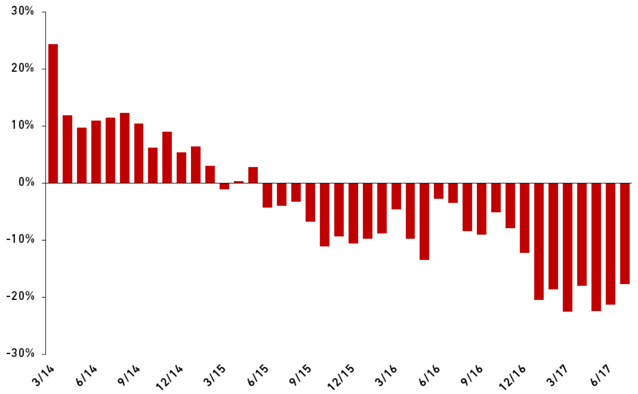
Additionally, distributors had initially found it in their interest to offer retailers promising new brands early in the craft revolution when demand for the latest hip brew was high—granting them an easy road from brewery to bar. In the current saturated market, this is no longer the case. "If I were a beer distributor 10 years ago, of course I would want to stock the latest craft offering as they had all been flying off retailers' shelves," says Schmidt. "But today, when I already have 50 craft beers in my inventory, do I really need the 51st?"

**"Craft beer probably would not have taken as much market share as it did if the big players had made different decisions in the early stages of the movement."**

Besides brand saturation, an arguably larger reason for the current slowdown is simply market maturation. The US Brewers Association maintains an optimistic outlook for future growth, reporting that in 2014 the bottom 60% of households by income accounted for 40% of craft beer sales and the proportion of sales to young women and Hispanics was rising. Still, there are natural limits to how much of the market will pay $17.49 per six-pack (the current retail price of a Dogfish Head "Flesh and Blood IPA" on Craftshack.com). With craft beer at around 12% market share, and with an estimated 75% of the US drinking age population now residing within 10 miles of a brewery, it is not unlikely that the consumer base has been all-but tapped.

For the few brands that have managed to break through, a further challenge is an echo of Yogi Berra's saying that "No one goes there anymore; it's too crowded"—namely, the phenomena in which an outsider who gains popularity *because* of their status as an outsider can quickly lose this newfound popularity as they become mainstream. "Craft must be insurgent to be craft," says Analyst Alec Walsh, CFA. Yet, when craft beer brands become popular, they no longer seem sufficiently insurgent—and therefore not sufficiently "craft"— to sustain their popularity. The trajectory of Samuel Adams, exemplifies this curse of success. After becoming one of the bestselling craft beer brands in the US, sales have been in sharp decline since early 2014. Samuel Adams has launched "craftier" beer labels and brands, such as "Rebel IPA," "Nitro Coffee Stout," and "Coney Island Brewery" in an attempt to regain popularity and shore up sales.

**SAMUEL ADAMS SALES GROWTH, 2014-2017**




*SOURCES: THE NIELSEN COMPANY, GOLDMAN SACHS GLOBAL INVESTMENT RESEARCH*

## BIG BEER AWAKENS

Another significant contributor to the current decline of craft is the response, albeit belated, of Big Beer. Major beer and alcohol conglomerates Anheuser-Busch InBev, MolsonCoors, Heineken, Diageo, and Carlsberg did not initially take action against surging craft breweries due to a combination of underestimating consumer demand for craft beer, believing their advertising and market strength could steer trends, and not wanting to disrupt their core brands. This inaction proved costly; new craft beer entrants probably would not have taken as much market share as they did if the big players had made different decisions in the early stages of the movement. By now, however, they have learned the mantra: "if you identify a trend, ride it, don't fight it." Or, in this case: if you identify a trend, buy it. While it may not be apparent to the casual beer drinker, many craft beer brands of the last decade have now been acquired by the Big Beer giants, adding some of the movement's most recognizable names to their shelves (Ballast Point, Blue Point, and Breckenridge come to mind—and those are just the B's).

The US craft industry is not taking the threat from Big Beer lying down, however. In an attempt to "out" Big Beer–owned brands masquerading as craft, the US Brewers Association launched an independent craft brewer's certification seal on June 27, 2017. Almost 2,000 breweries had adopted the seal as of August 27, 2017. In a similar vein, an app called "Craft Check"[1] (tag line "Drink craft, not crafty,") that launched in 2014 allows consumers to discern "whether the beer you're looking at is from an authentic craft brewery or just a mass-market imitation" simply by scanning the label. A class action lawsuit was even filed against MillerCoors in 2015 in reference to its Blue Moon brand; plaintiffs complained that "through its false and deceptive marketing, Defendant [MillerCoors] misleads consumers to believe that Blue Moon is an independently brewed, hand-crafted beer," especially as "MillerCoors does not appear anywhere on the Blue Moon bottle" and "uses the registered trademark 'Artfully Crafted.'"[2] The suit was ultimately dismissed by a federal judge in 2016.

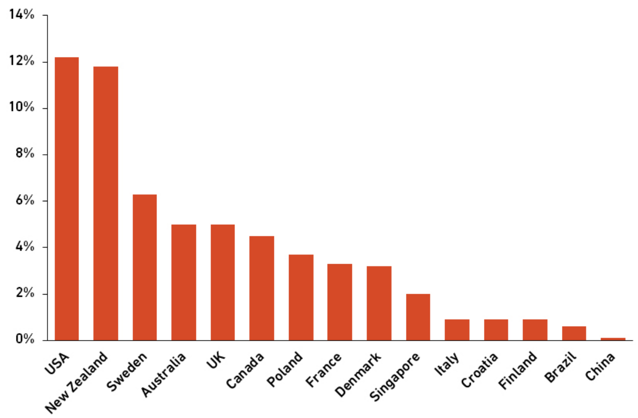
As Walsh notes, "Blue Moon and Goose Island, owned by MillerCoors and Anheuser-Busch InBev respectively, are Big Beer's imposters, trying to prove they are hip. It is a bit like watching dads dance—it is amusing for a little while, but shortly becomes cringe-worthy." But while some cringe, more are oblivious, or simply unfazed. For now, it seems many are perfectly willing to swallow Big Beer's crafted offerings.

Big Beer has similarly begun to take a more aggressive approach to craft competitors in Europe, Asia, Latin America, and Africa, both by acquiring successful craft startups early and by establishing their own "craft" brands. As a result, while the craft beer "style" is growing in markets from Japan to

[1] "Craft Check" is a free app available on iTunes App Store and Google Play. It is not affiliated with, or endorsed by, Harding Loevner.
[2] Class Action Complaint document: http://www.winelawonreserve.com/wp-content/uploads/2015/04/Parent-v.-MillerCoors-Blue-Moon.pdf

South Africa, the major beer conglomerates have managed to retain much of their market share. Nonetheless, there are still instances of independent craft breweries achieving success domestically and even beginning to establish a global presence. Bira 91, which launched in India in 2015, is a prime example. Having quickly established itself as one of the leading craft beers in India, the brewery has since gained some initial traction on the East Coast of the US, in part by becoming the official beer of the Tribeca Film Festival in New York in April 2016—during which it sold twice as much beer in New York as it did in New Delhi. Bira 91's ambitious expansion plans also include Singapore and the wider Asian market.

GLOBAL CRAFT BEER PENETRATION (BY VOLUME), 2015



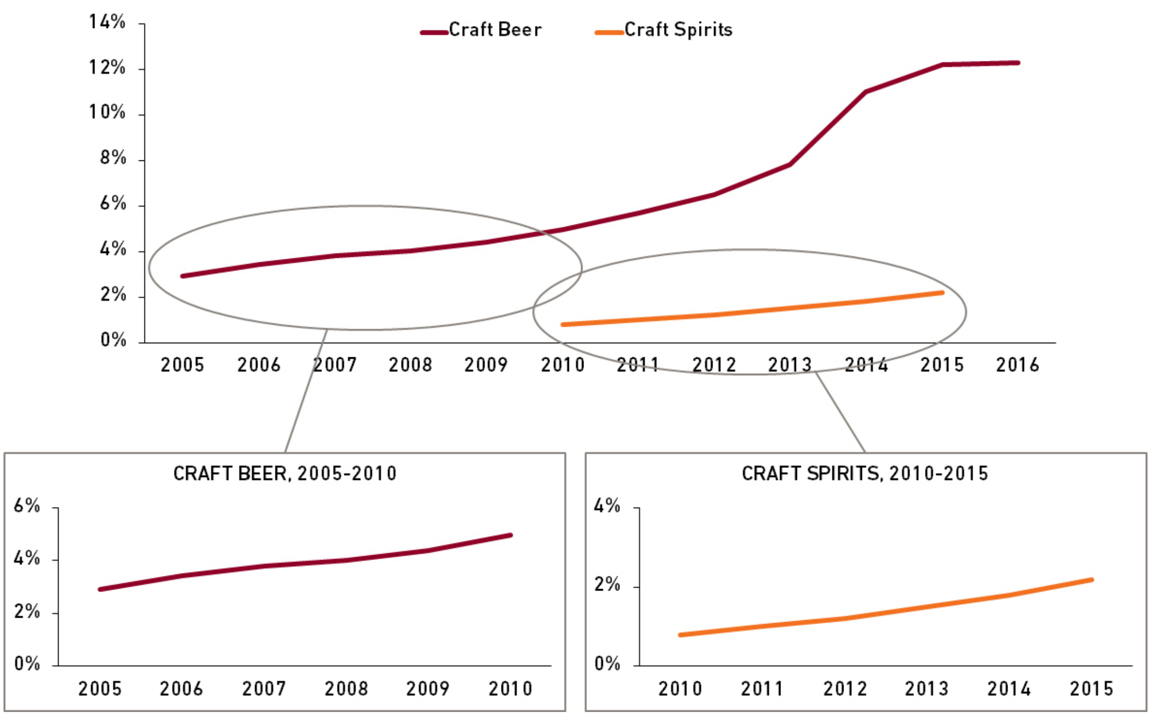

*SOURCES: GLOBALDATA CONSUMER, BANK OF AMERICA MERRILL LYNCH*

## CRAFT SPIRITS: THE NEXT REVOLUCIÓN?

While craft beer growth is falling in the US, the number of craft whiskey, rum, gin, vodka, and tequila distilleries is rising, as is their market share. Besides growing demand for craft-anything, relaxation of many individual state regulations and the separation of the US Bureau of Alcohol, Tobacco, and Firearms' law enforcement functions from its tax and trade functions in 2002—which shifted the tone of the agency from regulatory compliance to promoting revenue generation—has enabled more craft distilleries to enter the market. In fact, craft spirits seem to be in the same position today as craft beer was 15 years ago, poised to take market share on the back of consumer trends and a more favorable regulatory environment. For this reason, some bullish observers are predicting craft spirits could account for 10–20% market share in a decade.

Craft distilleries, however, do not enjoy the same advantages that independent craft breweries enjoyed a decade ago. Spirits can require a greater level of expertise and startup capital than beer, and some require a much longer production time—in the case of whiskey, years for a batch to be aged for consumption—making it more difficult for these distillers to ramp up production to meet demand. Additionally, there is no shortage of high-quality "top shelf" spirits available on the market today catering to a range of tastes and at different price points, leading to a smaller market gap than the one craft beer was able to fill.

MARKET SHARE GROWTH (BY VOLUME), 2005-2016




*SOURCES: BREWERS ASSOCIATION, AMERICAN CRAFT SPIRITS ASSOCIATION*

Most importantly, having internalized the lessons of the American craft beer insurgency, the major spirits industry incumbents have shown they are not averse to buying promising craft spirit startups early, choosing to ride the trend instead of fighting it. The recent (US$1 billion!) acquisition of tequila-maker Casamigos by Diageo, the world's largest spirits company, came just four years after actor George Clooney co-founded the craft distiller with two friends. So, though the premiumization trend and locavore movement will likely buoy craft spirits in the short term, expeditious action by incumbents may soon limit their growth.

Even if variety eventually declines from the current high-water mark in the US beer industry today, the demand for "better" beer has by now been ingrained, and is spilling into other markets. There may be surprises to come in the spirits industry as well if craft distillers can create significant demand for differentiated, premium offerings. "Perhaps the best news in this story is the continuing maturation of the American palette," says Schmidt. "Whatever the eventual outcome for the craft beer and craft spirits movements, the hankering for premium alcohol seems here to stay." And for those who want to support independent craft breweries or are otherwise curious to know whether the latest obnoxiously labelled craft beer in their hands is real or a crafty fake, well, like anything else in modern life, there's an app for that.

## CONTRIBUTORS

Harding Loevner Analysts Richard Schmidt and Alec Walsh contributed research and viewpoints to this article.

## DISCLOSURES