

REDHOOK ALE BREWERY INC

Form 10-K

March 23, 2007

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-K

- 1** **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)**
OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2006
- or**
- 2** **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 of incorporation)

91-1141254
*(I.R.S. Employer
Identification Number)*

14300 NE 145th Street, Suite 210
Woodinville, Washington
(Address of principal executive offices)

98072-6950
(Zip Code)

(425) 483-3232
(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, Par Value \$0.005 Per Share	The NASDAQ Stock Market LLC

Securities registered pursuant to Section 12(g) of the Act:
None.
(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ☐ No ☒

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Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ☐ No ☒

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☒

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 aggregate market value of the Common Stock held by non-affiliates of the registrant as of the last day of the registrant's most recently completed second quarter on June 30, 2006 (based upon the closing sale price of the registrant's Common Stock, as reported by The NASDAQ Stock Market) was \$18,493,409.(1)

The number of shares of the registrant's Common Stock outstanding as of March 20, 2007 was 8,304,639.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's Proxy Statement relating to the registrant's 2007 Annual Meeting of Stockholders to be held on May 22, 2007 are incorporated by reference into Part III of this Report.

- (1) Excludes shares held of record on that date by directors and executive officers and greater than 10% shareholders of the registrant. Exclusion of such shares should not be construed to indicate that any such person directly or indirectly possesses the power to direct or cause the direction of the management of the policies of the registrant.
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REDHOOK ALE BREWERY, INCORPORATED

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PART I.

Item 1. Business

Redhook Ale Brewery, Incorporated (Redhook or the Company) has been an independent brewer of craft beers in the U.S. since the Company's formation in 1981 and is considered to be one of the pioneers of the domestic craft brewing segment. Redhook 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). By operating its own small-batch breweries, the Company believes that it is better able to control the quantities, types and flavors of beer produced, while optimizing the quality and consistency of its products. Management believes that the Company's production capacity is of high quality and that Redhook is the only domestic craft brewer that owns and operates substantial production facilities in both the western region and eastern region of the U.S.

The Company currently produces nine styles of beer, marketed under distinct brand names. The Company's flagship brand is *Redhook ESB* and its other principal products include *Redhook Long Hammer IPA*, *Redhook Blonde Ale*, *Blackhook Porter*, and its seasonal offerings *Nut Brown*, *Sunrye*, *Late Harvest Autumn*, *Winterhook* and *Copperhook Ales*. The Company also sells *Widmer Hefeweizen* in the midwest and eastern U.S. under a 2003 licensing agreement with Widmer Brothers Brewing Company (Widmer). In addition to its principal products, the Company periodically develops and markets new products to test and measure consumer response to varying styles and flavors.

Since July 2004, the Company has distributed its products in the western U.S. through Craft Brands Alliance LLC (Craft Brands or CBA), a joint venture between the Company and Widmer. See Product Distribution Relationship with Craft Brands Alliance LLC below. In the midwest and eastern U.S., the Company has continued to distribute its products through a distribution agreement with Anheuser-Busch, Incorporated (A-B). See Product Distribution Relationship with Anheuser-Busch, Incorporated below.

Industry Background

The Company is a brewer in the relatively small craft brewing segment of the U.S. brewing industry. The domestic beer market is comprised of ales and lagers produced by large domestic brewers, international brewers and craft brewers. Although 2006 production and 2005 production of craft beer is estimated by industry sources to have increased by approximately 12% and 9%, respectively, over the previous year's production, the share of the domestic beer sales market held by the craft beer segment remains small. Craft beer shipments in 2006, 2005 and 2004 were approximately 3.2%, 3.5% and 3.2%, respectively, of total beer shipped in the U.S. Approximately 6.7 million, 6.0 million and 5.6 million barrels were shipped in the U.S. by the craft beer segment during 2006, 2005 and 2004, while total beer sold in the U.S., including imported beer, was approximately 209 million, 205 million and 206 million barrels, respectively. The number of craft brewers in the U.S. grew dramatically between 1994 and 2000, increasing from 627 participants at the end of 1994 and peaking at nearly 1,500 in 2000. At the end of 2006 and 2005, the number of craft brewers was estimated to be 1,400.

From a peak in 1873 of 4,131 U.S. breweries, the number of breweries had dropped to 1,500 by 1910 as a result of improved production and distribution. Approximately 760 of these breweries reopened following Prohibition. During the ensuing decades, the beer industry concentrated its resources primarily on marketing pale lagers and pilsners for various reasons, including: the desire to appeal to the broadest possible segment of the population; to benefit from economies of scale through large-scale production techniques; to prolong shelf life through use of pasteurization processes; and to take advantage of mass media advertising reaching consumers nationwide. At the same time that the

beer industry was narrowing its product offerings to compete more effectively, there was also extensive consolidation occurring in the industry, still apparent in today's market composition. According to industry sources, the three largest domestic brewers accounted for approximately 78% of total beer shipped in the U.S., including imports, in 2006.

Annual per capita domestic beer consumption has declined from the highs experienced in the early 1980s, a result of an elevated concern over health and safety issues, changing tastes, and evolving affluence and consumption attitudes of a maturing generation of beer drinkers born after World War II. Since the early 1980s, a sizable number

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of consumers have migrated away from the major domestic products toward a broader taste and variety in their malt beverages, mirroring similar trends in other beverage and cuisine categories. Foreign brewers initially benefited from these evolving consumption patterns. Despite also being produced by large brewers, European, Canadian and Mexican imported beers offered a fuller-flavored alternative to the national brands produced in the U.S.

By the latter half of the 1980s, a substantial new domestic industry segment had developed in response to the increasing consumer demand for specialty beers. Across the country, a proliferation of regional specialty brewers (annually selling more than 15,000 barrels but less than two million barrels of craft beer brewed at their own facilities), contract brewers (selling craft beer brewed by a third party to the contract brewer's specifications), microbreweries (selling less than 15,000 barrels per year), and brewpubs (combination restaurant-breweries) emerged to form the craft beer industry. This new segment was able to deliver the fuller flavored products presented by the imported beers while still offering a fresher product than most imports and one that could appeal to local taste preferences. Craft beer producers tend to concentrate on fuller flavors and less on appealing to mass markets. The strength of consumer demand has enabled certain craft brewers, such as the Company, to evolve from microbreweries into regional and national specialty brewers by constructing larger breweries while still adhering to the traditional European brewing methods that typically characterize the craft brewing segment. Industry sources estimate that craft beer produced by regional specialty brewers, such as the Company, accounts for approximately two thirds of total craft beer sales. Other craft brewers have sought to take advantage of growing consumer demand and excess industry capacity, when available, by contract brewing at underutilized facilities.

Since its formation in the 1980s, the rate at which the craft beer segment has grown has fluctuated. The late 1980s and early 1990s were years of significant growth for the segment, only to be followed by several years of minimal growth in the late 1990s and early 2000s. Recent industry reports for 2004, 2005 and 2006 performance, however, indicate favorable trends once again. The craft beer segment's success has been impacted, both positively and negatively, by the success of the larger specialty beer category as well as the domestic alcoholic beverage market. Imported beers have enjoyed resurgence in demand since the mid-1990s. Certain national domestic brewers have increased the competition by producing their own fuller-flavored products to compete against craft beers. In 2001 and 2002, flavored malt beverages were introduced to the market, initially gaining significant interest but recently experiencing smaller returns. Finally, the wine and spirits market has seen a surge in recent years, attributable to competitive pricing, television advertising, increased merchandising, and increased consumer interest in wine and spirits.

Business Strategy

Redhook strives to be the preeminent specialty craft brewing company in the U.S., producing the highest quality ale products in company-owned facilities, and marketing and selling them responsibly through its three-tier distribution system.

The central elements of the Company's business strategy include:

Production of High-Quality Craft Beers. The Company is committed to the production of a variety of distinctive, flavorful craft beers. The Company brews its craft beers according to traditional European brewing styles and methods, using only high-quality ingredients to brew in company-owned and operated brewing facilities. As a symbol of quality, the Company's products are Kosher certified by the Orthodox Union, a certification rarely sought by other brewers. The Company does not intend to compete directly in terms of production style, pricing or extensive mass-media advertising typical of large national brands.

Control of Production in Company-Owned Breweries. The Company builds, owns and operates its own brewing facilities to optimize the quality and consistency of its products and to achieve the greatest control over its production costs. Management believes that its ability to engage in ongoing product innovation and to control product quality

provides critical competitive advantages. The Company's highly automated breweries are designed to produce beer in small batches, while attaining production economies through automation rather than scale. The Company believes that its investment in technology enables it to optimize employee productivity, to contain related operating costs, to produce innovative beer styles and tastes, and to achieve the production flexibility afforded by small-batch brewing, with minimal loss of efficiency and process reliability.

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Strategic Distribution Relationship with Industry Leader. Since October 1994, the Company has benefited from a distribution relationship with A-B, pursuant to which Redhook distributes its products in substantially all of its markets through A-B's wholesale distribution network. A-B's domestic network consists of more than 560 independent wholesale distributors, most of which are geographically contiguous and independently owned and operated, and 13 branches owned and operated by A-B. This distribution relationship with A-B has offered efficiencies in delivery of product, state reporting and licensing, billing and collections. The Company believes that the existence of the distribution relationship with A-B has also provided the Company with access to A-B distributors at A-B's distributor conventions, communications about Redhook in printed distributor materials, and A-B-supported opportunities for Redhook to educate A-B distributors about the Company's specialty products. The Company believes that the opportunities to access A-B distributors has benefited the Company by creating increased awareness of and demand for Redhook products among A-B distributors. The Company is able to reap the benefits of this distribution relationship with A-B while, as an independent company, maintaining control over the production and marketing of its products.

Sales and Marketing Relationship with Craft Brands Alliance LLC. On July 1, 2004, the Company entered into agreements with Widmer, headquartered in Portland, Oregon, to form a joint sales and marketing organization that serves both companies' operations in the western U.S. The joint organization, named Craft Brands Alliance LLC, advertises, markets, sells and distributes both Redhook's and Widmer's products to wholesale outlets through a distribution agreement between Craft Brands and A-B. Management believes that, in addition to achieving certain synergies, Craft Brands capitalizes on both companies' sales and marketing skills and complementary product portfolios. The Company believes that the combination of the two brewers' complementary brand portfolios, led by one focused sales and marketing organization, will not only deliver financial benefits, but will also deliver greater impact at the point of sale.

Operation of Regional Brewing Facilities. Management believes that, by locating its production facilities in proximity to the key regional markets it serves, the Company is able to enjoy distinct competitive advantages. Shortened delivery times maximize product freshness and reduce shipping costs. Established brand awareness of the Company's products and enhanced familiarity with local consumer tastes enable the Company to offer select products that appeal to regional preferences. By pursuing this strategy, Redhook believes that it will be able to preserve its reputation and prestige as a regional craft brewer.

Promotion of Products. The Company promotes its products through a variety of advertising programs with its wholesalers, by training and educating wholesalers and retailers about the Company's products, through promotions at local festivals, venues, and pubs, by utilizing its pubs located at the Company's two breweries, through price discounting, and, more recently, through Craft Brands. In the midwest and eastern U.S., the Company's principal advertising programs include radio, billboards and print advertising (magazines, newspapers, industry publications). The Company also markets its products to distributors, retailers and consumers through a variety of specialized training and promotional methods, including training sessions for distributors and retailers in understanding the brewing process, the craft beer segment and Redhook products. Promotional methods directed towards consumers include introducing Redhook products on draft in pubs and restaurants, using promotional items including tap handles, glassware and coasters, and participating in local festivals and sports venues to increase brand name recognition. In addition, the Company's prominently located breweries feature pubs and retail outlets and offer guided tours to further increase consumer awareness of Redhook. Craft Brands is responsible for promotion, advertising and marketing in the western U.S. and uses methods similar to the Company in its promotion of Redhook products.

The Company will occasionally enter into advertising and promotion programs where the entire program is funded by the Company but, in recent years, has favored co-operative programs where the Company's spending is matched with an investment by a local distributor. Co-operative programs align the interests of the Company with those of the

wholesaler whose local market knowledge contributes to more effective promotions. Sharing these efforts with a wholesaler helps the Company to leverage the investment made on programs where the participating wholesaler has a vested interest in the program's success.

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Products

The Company produces a variety of specialty craft beers using traditional European brewing methods. The Company brews its beers using only high-quality hops, malted barley, wheat, rye and other natural ingredients, and does not use any rice, corn, sugar, syrups or other adjuncts. The Company's beers are marketed on the basis of freshness and distinctive flavor profiles. To help maintain full flavor, the Company's products are not pasteurized. As a result, it is appropriate that they be kept cool so that oxidation and heat-induced aging will not adversely affect the original taste, and that they be distributed and served as soon as possible, generally within three months after packaging, to maximize freshness and flavor. The Company distributes its products only in glass bottles and kegs, and its products are freshness dated for the benefit of wholesalers and consumers.

The Company presently produces nine principal brands, each with its own distinctive combination of flavor, color and clarity:

Redhook ESB (*ESB*). The Company's flagship brand, *ESB*, which accounted for approximately 36%, 47% and 50% of the Company's shipments in 2006, 2005 and 2004, respectively, is full, rich, well-rounded, amber-colored ale with a sweet toasted malt flavor balanced by a pleasant floral liveliness derived from German Tettnang hops. *ESB* has declined as a percentage of total sales over the past three years due to increases in sales of Redhook's other products, particularly *Redhook Long Hammer IPA*, seasonal offerings, and variety packs, and licensed *Widmer*.

Redhook Long Hammer IPA (*Long Hammer*). A premium English, pub-style bitter ale, *Long Hammer*, accounted for approximately 16%, 17% and 16% of the Company's shipments in 2006, 2005 and 2004, respectively. *Long Hammer* is pale and aggressively hopped, has a brassy color imparted by caramelized malt, an herbal aroma characteristic of Northwest Cascade hops and a crisp finish.

Redhook Blonde Ale. A delicious, thirst-quenching golden ale, the combination of lightly roasted barley, subtle hops, and a touch of wheat creates a perfectly balanced and distinctively drinkable ale.

Blackhook Porter (*Blackhook*). A London-style porter, *Blackhook* has an ebony tone, a pleasant toasted character produced by highly roasted barley, and a dark malt flavor suggesting coffee and chocolate, balanced by lively hopping.

Copperhook Ale (*Copperhook*). This ale is cold fermented so beer drinkers can enjoy the full flavor characteristics. *Copperhook* is appetizingly fruity with light maltiness and a very pleasant piney hint in the aroma.

Nut Brown Ale. A malty ale with a hint of sweetness in the finish. The combination of six barley malts and two hop varieties results in a surprisingly smooth, well-balanced dark beer. *Nut Brown Ale* is available in the Company's midwest and eastern markets in late winter and early spring.

Redhook Sunrye Ale (*Sunrye*). Gently roasted barley, delicate hops and a touch of rye combine for a very balanced lighter style ale. Slightly unfiltered to exude a pearl glow, *Sunrye* is styled for warm weather refreshment. *Sunrye* is available from April through September in western markets and April through July in midwest and eastern markets.

Late Harvest Autumn Ale (*Autumn Ale*). A roasted malt aroma and distinct flavors of the Northern Brewer and Saaz hops mark this full-bodied ale. The two row barley foundation malt gives *Autumn Ale* its full body. The specialty malts Crystal, German Smoked Munich, Caramel and Roasted give it a rich complexity. *Autumn Ale* is available August to September in midwest and eastern markets.

Winterhook. A rich, seasonal holiday ale formulated specially each year for cold-weather enjoyment, *Winterhook* typically is deep in color and rich in flavor, with complex flavors and a warm finish. Typically, the Company changes the style of this ale each year. *Winterhook* is available during fall and winter months.

The Company also sells *Widmer Hefeweizen* in the midwest and eastern U.S. under license from Widmer. *Widmer Hefeweizen* is a golden unfiltered wheat beer and is one of the leading American style Hefeweizens sold in the U.S. In 2003, the Company entered into a licensing agreement with Widmer to produce and sell the *Widmer Hefeweizen* brand in states east of the Mississippi River. In March 2005, the *Widmer Hefeweizen* distribution

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territory was expanded to include all of the Company's midwest and eastern markets. Brewing of this product is conducted at the New Hampshire Brewery under the supervision and assistance of Widmer's brewing staff to insure their brand's quality and matching taste profile. The term of this agreement expires February 1, 2008, with additional one-year automatic renewals unless either party notifies the other of its desire to have the term expire at the end of the then existing term at least 150 days prior to such expiration. The agreement may be terminated by either party at any time without cause pursuant to 150 days notice or for cause by either party under certain conditions. Additionally, Redhook and Widmer have entered into a side agreement providing that if Widmer terminates the licensing agreement or causes it to expire before December 31, 2009, Widmer will pay the Company a lump sum payment to partially compensate the Company for capital equipment expenditures made at the New Hampshire Brewery to support Widmer's growth. During the term of this agreement, Redhook will not brew, advertise, market, or distribute any product that is labeled or advertised as a Hefeweizen or any similar product in the agreed upon midwest and eastern territory. Brewing and selling of Redhook's Hefe-weizen was discontinued in conjunction with this agreement. The Company believes that the agreement increases capacity utilization and has strengthened the Company's product portfolio. The Company shipped 30,600, 25,600 and 17,800 barrels of *Widmer Hefeweizen* during the years ended December 31, 2006, 2005 and 2004, respectively. A licensing fee of \$437,000, \$399,000 and \$266,000 due to Widmer is reflected in the Company's statement of operations for the years ended December 31, 2006, 2005 and 2004, respectively. If the Widmer Licensing Agreement were terminated early, or if Widmer gave notice of its election to terminate the agreement according to its term on February 1, 2008, the Company would need to look to replace the lost volume, either through new and existing Redhook products or alternative brewing relationships. If the Company is unable to replace the lost Widmer volume, the loss of revenue and the resulting excess capacity in the New Hampshire Brewery would have an adverse effect on the Company's financial performance.

The Company also sells *Pacific Ridge* in the western U.S. In 2003, the Company entered into a purchase and sale agreement with A-B for the purchase of the *Pacific Ridge* brand, trademark and related intellectual property. In consideration, the Company agreed to pay A-B a fee for 20 years based upon the Company's sales of the brand. The Company shipped 5,900, 6,000, and 5,400 barrels of *Pacific Ridge* during 2006, 2005 and 2004, respectively. A fee of \$80,000, \$83,000 and \$80,000 due to A-B is reflected in the Company's statement of operations for the years ended December 31, 2006, 2005 and 2004, respectively.

In an effort to be responsive to varying consumer style and flavor preferences, the Company periodically engages in the development and testing of new products. The Company believes that the continued success of craft brewers will be affected by their ability to be innovative and attentive to consumer desires for new and distinctive taste experiences while maintaining consistently high product quality. The Company's breweries allow it to produce small-batch experimental ales within three weeks. Experimental products are periodically developed and typically produced in draft form only for on-premise test marketing at the Company's pubs and selected retail sites. If the initial consumer reception of an experimental brew is sufficiently positive, then its taste and formula are refined, as necessary, and a new Redhook brand may be created. *Long Hammer*, *Redhook Blonde Ale* and many of the Company's seasonal offerings are examples of products that were developed in this manner.

Brewing Operations

The Brewing Process. Beer is made primarily from four natural ingredients: malted grain, hops, yeast and water. The grain most commonly used in brewing is barley, owing to its distinctive germination characteristics that make it easy to ferment. The Company uses the finest barley malt, using strains of barley having two rows of grain in each ear. A wide variety of hops may be used to add seasoning to the brew; some varieties best confer bitterness, while others are chosen for their ability to impart distinctive aromas to the beer. Nearly all the yeasts used to induce or augment fermentation of beer are of the species *Saccharomyces cerevisiae*, which includes both the top-fermenting yeasts used in ale production and the bottom-fermenting yeasts associated with lagers.

The brewing process begins when the malt supplier soaks the barley grain in water, thereby initiating germination, and then dries and cures the grain through kilning. This process, known as malting, breaks down complex carbohydrates and proteins so that they can be easily extracted. The malting process also imparts color and flavor characteristics to the grain. The cured grain, referred to as malt, is then sold to the brewery. At the brewery, various malts are cracked by milling, and mixed with warm water. This mixture, or mash, is heated and stirred in the

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mash tun, allowing the simple carbohydrates and proteins to be converted into fermentable sugars. Naturally occurring enzymes help facilitate this process. The mash is then strained and rinsed in the lauter tun to produce a residual liquid, high in fermentable sugars, called wort, which then flows into a brew kettle to be boiled and concentrated. Hops are added during the boil to impart bitterness, balance and aroma. The specific mixture of hops and the brewing time and temperature further affect the flavor of the beer. After the boil, the wort is strained and cooled before it is moved to a fermentation cellar, where specially cultured yeast is added to induce fermentation. During fermentation, the wort's sugars are metabolized by the yeast, producing carbon dioxide and alcohol. Some of the carbon dioxide is recaptured and absorbed back into the beer, providing a natural source of carbonation. After fermentation, the beer is cooled for several days while the beer is clarified and full flavor develops. Filtration, the final step for a filtered beer, removes unwanted yeast. At this point, the beer is in its peak condition and ready for bottling or keg racking. The entire brewing process of ales, from mashing through filtration, is typically completed in 14 to 21 days, depending on the formulation and style of the product being brewed.

Brewing Equipment. The Company uses highly automated small-batch brewing equipment. The Washington Brewery employs a 100-barrel mash tun, lauter tun, wort receiver, wort kettle, whirlpool kettle, five 70,000-pound, one 35,000-pound and two 25,000-pound grain silos, two 100-barrel, fifty-four 200-barrel, and ten 600-barrel fermenters, and two 300-barrel and four 400-barrel bright tanks. The New Hampshire Brewery employs a 100-barrel mash tun, lauter tun, wort receiver, wort kettle, whirlpool kettle, three 70,000-pound and two 35,000-pound grain silos, nine 100-barrel, two 200 barrel and twenty-two 400-barrel fermenters, two 200-barrel and two 400-barrel bright tanks, and an anaerobic waste-water treatment facility which completes the process cycle. Both breweries use advanced micro filtration technology, including a diatomaceous earth pad filter and sterile filtration. During the spring of 2007 the Company plans to add four additional 400-barrel fermenters, one 70,000 pound grain silo and make process control automation upgrades to the New Hampshire brewery. Installation is expected to be completed by May 2007 and cost approximately \$1,000,000. This expansion will add approximately 25,000 barrels of capacity to the New Hampshire brewery.

Packaging. The Company packages its craft beers in both bottles and kegs. Both of the Company's breweries have fully automated bottling and keg lines. The bottle filler at both breweries utilizes a carbon dioxide environment during bottling that is designed to ensure that minimal oxygen is dissolved in the beer, thereby extending product shelf life.

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Quality Control. The Company monitors production and quality control at both of its breweries, with central coordination at the Washington Brewery. Both the Washington and New Hampshire breweries have an on-site laboratory where microbiologists and lab technicians supervise on-site yeast propagation, monitor product quality, test products, measure color and bitterness, and test for oxidation and unwanted bacteria. The Company also regularly utilizes outside laboratories for independent product analysis.

Ingredients and Raw Materials. The Company currently purchases a significant portion of its malted barley from a single supplier and its premium-quality select hops, grown in the Pacific Northwest, Germany and Czech Republic, from competitive sources. The Company periodically purchases small lots of European hops that it uses to achieve a special hop character in certain of its beers. In order to ensure the supply of the hop varieties used in its products, the Company enters into supply contracts for its hop requirements. Redhook believes that comparable quality malted barley and hops are available from alternate sources at competitive prices, although there can be no assurance that pricing would be consistent with the Company's current arrangements. The Company currently cultivates its own *Saccharomyces cerevisiae* yeast supply and maintains a separate, secure supply in-house. The Company has access to multiple competitive sources for packing materials, such as bottles, labels, six-pack carriers, crowns and shipping cases.

Product Distribution

The Company's products are available for sale directly to consumers in draft and bottles at restaurants, bars and liquor stores, as well as in bottles at supermarkets, warehouse clubs, convenience stores and drug stores. Like substantially all craft brewers, the Company's products are delivered to these retail outlets through a network of local distributors whose principal business is the distribution of beer and, in some cases, other alcoholic beverages, and who traditionally have distribution relationships with one or more national beer brands. To promote and educate the public on the Company's products, Redhook also offers its products directly to consumers at the Company's two on-premise retail establishments located at the Company's breweries, the Forecasters Public House in Woodinville, Washington and the Cataqua Public House in Portsmouth, New Hampshire.

Prior to establishing a distribution relationship with A-B in 1994, the Company distributed its products regionally through distributors, many of which were part of the A-B distribution network, in eight western states: Washington, California (northern), Oregon, Idaho, Montana, Wyoming, Colorado and Alaska. In October 1994, the Company entered into a distribution agreement with A-B (the "Distribution Alliance" or the "Alliance") pursuant to which the Company began distributing its products, for any new markets entered, exclusively through this agreement. Existing wholesalers continued to distribute the Company's products outside of the Distribution Alliance. By 2003, 72% of the Company's sales volume was through Alliance distributors.

On July 1, 2004, the Company entered into a new distribution agreement with A-B (the "A-B Distribution Agreement") pursuant to which the Company continues to sell its product in the midwest and eastern U.S. through sales to A-B and distribute its product through the A-B distribution network.

On July 1, 2004, the Company also entered into agreements with Widmer with respect to the operation of their joint venture sales and marketing entity, Craft Brands. Under their agreements with Craft Brands, 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 U.S. through a distribution agreement between Craft Brands and A-B.

Currently, there are no Company products distributed in the U.S. by a wholesaler that are not distributed pursuant to the A-B Distribution Agreement or the distribution agreement between Craft Brands and A-B.

For additional information regarding the Company's relationship with A-B and Craft Brands, see Relationship with Anheuser-Busch, Incorporated and Relationship with Craft Brands Alliance LLC below.

A-B, whose products accounted for approximately 48% of total beer shipped by volume in the U.S. in 2006, including imports, distributes its products throughout the U.S. through a network of more than 560 independent wholesale distributors, most of whom are geographically contiguous and independently owned and operated, and 13 branches owned and operated by A-B. The Company believes that the typical A-B distributor is financially stable and has both a long-standing presence and a substantial market share of beer sales in its territory.

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Redhook chose to align itself with A-B through the 1994 Distribution Alliance, and again through the 2004 A-B Distribution Agreement and Craft Brands' distribution agreement with A-B, to gain access to quality distribution throughout the U.S. The Company was the first and is the largest independent craft brewer to have a formal distribution agreement with a major U.S. brewer. Management believes that the Company's competitors in the craft beer segment generally negotiate distribution relationships separately with distributors in each locality and, as a result, typically distribute through a variety of wholesalers representing differing national beer brands with uncoordinated territorial boundaries. Because A-B's distributors are assigned territories that generally are contiguous, the distribution relationship with A-B enables the Company to reduce the gaps and overlaps in distribution coverage often experienced by the Company's competitors.

In 2006 and 2005, the Company sold approximately 101,400 and 85,100 barrels to A-B through the A-B Distribution Agreement, accounting for approximately 37% and 38% of the Company's sales volume for the period. During these same periods, the Company shipped approximately 122,600 and 126,500 barrels, or 45% and 56% of the Company's sales volume, to Craft Brands.

During the last six months of 2004, the Company sold approximately 38,000 barrels to A-B through the A-B Distribution Agreement, accounting for approximately 36% of the Company's sales volume for the same period. Also during this same period, the Company shipped approximately 63,600 barrels, or 61% of the Company's sales volume, to Craft Brands.

For the six months ended June 30, 2004, the Company shipped its products to 495 Alliance distribution points, accounting for 84,000 barrels, or 74% of the Company's total sales volume for the same period. In addition, sales through wholesalers that were part of the A-B distribution network but that were not part of the Alliance accounted for an additional 22%, or 24,000 barrels, of the Company's sales volume.

The Company's most significant wholesaler, K&L Distributors, Inc. ("K&L"), is responsible for distribution of the Company's products in most of King County, Washington, including Seattle, Washington. K&L accounted for approximately 11%, 12% and 13% of total sales volume in 2006, 2005 and 2004, respectively. Shipments of the Company's product to K&L during all of 2006, 2005 and the last six months of 2004 were made through Craft Brands. 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.

Relationship with Anheuser-Busch, Incorporated

On July 1, 2004, the Company completed the restructuring of its ongoing relationship with A-B. Pursuant to an exchange and recapitalization agreement between the Company and A-B (the "Exchange and Recapitalization Agreement"), the Company issued 1,808,243 shares of its common stock ("Common Stock") to A-B in exchange for 1,289,872 shares of Series B Preferred Stock held by A-B. The Series B Preferred Stock, reflected in the Company's July 1, 2004 balance sheet at approximately \$16.3 million, was subsequently cancelled. In connection with the exchange, the Company also paid \$2.0 million to A-B in November 2004. A-B was also granted certain contractual registration rights with respect to its shares of the Company's Common Stock. As of December 31, 2006 and 2005, A-B owned approximately 33.3% and 33.6%, respectively, of the Company's Common Stock.

Additionally, pursuant to the Exchange and Recapitalization Agreement, A-B is entitled to designate two members of the board of directors of the Company. A-B also generally has the contractual right to have one of its designees sit on each committee of the board of directors of the Company. The Exchange and Recapitalization Agreement contains limitations on, among other matters, the Company's ability to issue equity securities or acquire or sell assets or stock, amend its Articles of Incorporation or bylaws, grant board representation rights, enter into certain transactions with

affiliates, distribute its products in the U.S. other than through A-B, Craft Brands or as provided in the A-B Distribution Agreement, voluntarily delist or terminate its listing on the NASDAQ Stock Market, or dispose any of its interest in Craft Brands, without the prior consent of A-B. Further, if the new A-B Distribution Agreement described below or the distribution agreement between Craft Brands and A-B is terminated, or the distribution of Redhook products is terminated by Craft Brands under the distribution agreement between Craft Brands and A-B, A-B has the right to solicit and negotiate offers from third parties to purchase all or

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substantially all of the assets or securities of the Company or to enter into a merger or consolidation transaction with the Company and the right to cause the board of directors of the Company to consider any such offer.

On July 1, 2004, the Company also entered into a new A-B Distribution Agreement. The A-B Distribution Agreement provides for the distribution of the Company's products in the midwest and eastern U.S. (the Eastern Territory), which represents those states not covered by the Supply, Distribution and Licensing Agreement between the Company and Craft Brands. The structure of the new A-B Distribution Agreement is substantially similar to the Company's prior arrangement with A-B. Under the A-B Distribution Agreement, the Company has granted A-B the first right to distribute Redhook products, including future new products, in the Eastern Territory. The Company is responsible for marketing its products to A-B's distributors in the Eastern Territory, as well as to retailers and consumers. The A-B distributors then place orders with the Company, through A-B, for Redhook products. The Company separately packages and ships the orders in refrigerated trucks to the A-B distribution center nearest to the distributor or, under certain circumstances, directly to the distributor.

The new A-B Distribution Agreement has a term that expires on December 31, 2014, subject to automatic renewal for an additional ten-year period unless A-B provides written notice of non-renewal to the Company on or prior to June 30, 2014. The A-B Distribution Agreement is also subject to early termination, by either party, upon the occurrence of certain events. The A-B Distribution Agreement may be terminated immediately, by either party, upon the occurrence of any one or more of the following events:

1) a material default by the other party in the performance of any of the provisions of the A-B Distribution Agreement or any other agreement between the parties, which default is either:

i) curable within 30 days, but is not cured within 30 days following written notice of default; or

ii) not curable within 30 days and either:

(1) the defaulting party fails to take reasonable steps to cure as soon as reasonably possible following written notice of such default; or

(2) such default is not cured within 90 days following written notice of such default;

2) default by the other party in the performance of any of the provisions of the A-B Distribution Agreement or any other agreement between the parties, which default is not described in (1) above and which is not cured within 180 days following written notice of such default;

3) the making by the other party of an assignment for the benefit of creditors; or the commencement by the other party of a voluntary case or proceeding or the other party's consent to or acquiescence in the entry of an order for relief against such other party in an involuntary case or proceeding under any bankruptcy, reorganization, insolvency or similar law;

4) the appointment of a trustee or receiver or similar officer of any court for the other party or for a substantial part of the property of the other party, whether with or without the consent of the other party, which is not terminated within 60 days from the date of appointment thereof;

5) the institution of bankruptcy, reorganization, insolvency or liquidation proceedings by or against the other party without such proceedings being dismissed within 90 days from the date of the institution thereof;

6) any representation or warranty made by the other party under or in the course of performance of the A-B Distribution Agreement that is false in material respects; or

7) the distribution agreement between Craft Brands and A-B is terminated or the distribution thereunder of the products of Redhook is terminated pursuant to its terms.

Additionally, the A-B Distribution Agreement may be terminated by A-B, upon six months prior written notice to the Company, in the event:

1) the Company engages in certain Incompatible Conduct which is not curable or is not cured to A-B's satisfaction (in A-B's sole opinion) within 30 days. Incompatible Conduct is defined as any act or omission of the Company that, in A-B's determination, damages the reputation or image of A-B or the brewing industry;

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- 2) any A-B competitor or affiliate thereof acquires 10% or more of the outstanding equity securities of the Company, and one or more designees of such person becomes a member of the board of directors of the Company;
- 3) the current chief executive officer of the Company ceases to function as chief executive officer and within six months of such cessation a successor satisfactory in the sole, good faith discretion of A-B is not appointed;
- 4) the Company is merged or consolidated into or with any other person or any other person merges or consolidates into or with the Company; or
- 5) A-B or its corporate affiliates incur any liability or expense as a result of any claim asserted against them by or in the name of the Company or any shareholder of the Company as a result of the equity ownership of A-B or its affiliates in the Company, or any equity transaction or exchange between A-B or its affiliates and the Company, and the Company does not reimburse and indemnify A-B and its corporate affiliates on demand for the entire amount of such liability and expense.

Fees

Generally, the Company pays the following fees to A-B in connection with the sale of the Company's products:

Margin. In connection with all sales through the Distribution Alliance prior to July 1, 2004, the Company paid a Margin fee to A-B. The Margin did not apply to sales to wholesalers and others that were part of the A-B distribution network but that were not part of the Distribution Alliance, including most sales to Washington State wholesalers, sales to non-A-B wholesalers, sales by the Company's retail operations and dock sales. The July 1, 2004 A-B Distribution Agreement modified the Margin fee structure such that the Margin per barrel shipped increased and is paid on all sales through the new A-B Distribution Agreement. The Margin does not apply to sales to the Company's retail operations or to dock sales. The Margin also does not apply to the Company's sales to Craft Brands because Craft Brands pays a comparable fee on its resale of the product. The A-B Distribution Agreement also provides that the Company shall pay an additional fee on shipments that exceed shipments for the same territory during fiscal 2003 (the Additional Margin). In addition, the Exchange and Recapitalization Agreement provided that the Margin be retroactively increased to the rate provided in the A-B Distribution Agreement for all shipments in June 2004.

For the years ended December 31, 2006 and 2005, the Margin was paid to A-B on shipments totaling 101,400 and 85,100 barrels to 503 and 472 distribution points, respectively. Because 2006 and 2005 shipments in the midwest and eastern U.S. exceeded 2003 shipments in the same territory, the Company paid A-B the Additional Margin on 23,000 and 7,000 barrels, respectively. For the six month period ended December 31, 2004, the Margin was paid to A-B on shipments totaling 38,000 barrels to 371 distribution points, and the retroactive increase on June 2004 shipments was paid on approximately 20,000 barrels. For the six months ended June 30, 2004, the Margin was paid to A-B on shipments totaling 84,000 barrels to 495 Alliance distribution points. The Margin paid is reflected as a reduction of sales in the Company's statements of operations.

Invoicing Cost. Through June 30, 2004, the invoicing cost was paid on sales through the Distribution Alliance when the wholesaler placed the order through the A-B order management system and payment to the Company was processed through A-B. This cost did not apply to sales to wholesalers that were part of the A-B distribution network but that were not part of the Distribution Alliance. The basis for this charge was the number of pallet lifts.

Since July 1, 2004, the invoicing cost is payable on sales through the new A-B Distribution Agreement. The fee does not apply to sales by the Company's retail operations or to dock sales. The fee also does not apply to the Company's sales to Craft Brands because Craft Brands pays a comparable fee to A-B.

According to the terms of the A-B Distribution Agreement, the fee per pallet lift increased on January 1, 2006.

Staging Cost and Cooperage Handling Charge. The Staging Cost was paid on all sales through the Distribution Alliance and is payable on all sales through the A-B Distribution Agreement that are delivered to an A-B brewery or A-B distribution facility. The fee does not apply to product shipped directly to a wholesaler or

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wholesaler support center. The Cooperage Handling Charge was paid on all draft beer sales through the Distribution Alliance and is payable on all draft sales through the A-B Distribution Agreement that are delivered to a wholesaler support center or directly to a wholesaler. The basis for these fees is number of pallet lifts. According to the terms of the A-B Distribution Agreement, the staging cost and cooperage handling charge fees increased on January 1, 2006.

Inventory Manager Fee. The Inventory Manager Fee is paid to reimburse A-B for a portion of the salary of a corporate inventory management employee, a substantial portion of whose responsibilities are to coordinate and administer logistics of the Company's product distribution to wholesalers. This fee decreased in the second half of 2004 because Craft Brands assumed a portion of the fee.

The Invoicing Cost, Staging Cost, Cooperage Handling Charge and Inventory Manager Fee are reflected in cost of sales in the Company's statement of operations. These fees totaled approximately \$129,000, \$249,000 and \$406,000 for the years ended December 31, 2006, 2005 and 2004, respectively. These fees were lower in 2006 compared to prior years as the Company recognized a refund of \$124,000 from A-B in 2006 from over billed invoicing costs from 1995 through 2005.

Management believes that the benefits of the distribution arrangement with A-B, particularly the increased sales volume and efficiencies in delivery, state reporting and licensing, billing and collections, are significant to the Company's business. The Company believes that the existence of the A-B Distribution Agreement, presentations by Redhook's management at A-B's distributor conventions, A-B communications about Redhook in printed distributor materials, and A-B-supported opportunities for Redhook to educate A-B distributors about its specialty products have resulted in increased awareness of and demand for Redhook products among A-B's distributors.

If the A-B Distribution Agreement were terminated early, as described above, it would be extremely difficult for the Company to rebuild its distribution network without a severe negative impact on the Company's sales and results of operations. It is likely that the Company would need to raise additional funds to develop a new distribution network. There cannot be any guarantee that the Company would be able to successfully rebuild all, or part, of its distribution network or that any additional financing would be available when needed, or that any such financing would be on commercially reasonable terms.

The termination of the A-B Distribution Agreement for any reason would also constitute an event of default under the Company's bank credit agreement. Upon default, the bank may declare the entire outstanding term loan balance immediately due and payable. The Company could seek to refinance its term loan with one or more banks or obtain additional equity capital; however, there can be no assurance the Company would be able to access additional capital to meet its needs or that such additional capital would be on commercially reasonable terms.

Relationship with Craft Brands Alliance LLC

On July 1, 2004, the Company entered into agreements with Widmer with respect to the operation of Craft Brands. Craft Brands is a joint venture between the Company and Widmer that purchases products from the Company and Widmer and markets, advertises, sells and distributes these products in the Western Territory pursuant to a distribution agreement with A-B (the "Craft Brands Distribution Agreement"). The Western Territory includes the following western states: Alaska, Arizona, California, Colorado, Hawaii, Idaho, Montana, New Mexico, Nevada, Oregon, Washington and Wyoming. The Company and Widmer are each a 50% member of Craft Brands and each has the right to designate two directors to its six member board. A-B is entitled to designate the remaining two directors.

The Company and Widmer have entered into a restated operating agreement with Craft Brands (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 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

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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 Redhook's commitment to expand the production capacity of both 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. 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. If the Company is required to make this additional sales and marketing contribution, our available cash will decrease and our income from Craft Brands will decrease by the amount of the contribution, which will be allocated 100% to us.

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 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. Contemporaneous with the execution of the Operating Agreement, the Company made a member loan to Craft Brands of \$150,000. Craft Brands repaid this loan plus accrued interest in December 2004.

The Operating Agreement additionally 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 is 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 the 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 also entered into a Supply, Distribution and Licensing Agreement with Craft Brands (the "Supply and Distribution Agreement"). Under the Supply and Distribution Agreement, the Company is required to manufacture and sell its product directly to Craft Brands (except in states where laws require sales to be made directly from Redhook to wholesalers) and Craft Brands advertises, markets and distributes the products to wholesale outlets in the Western Territory through the Craft Brands Distribution Agreement. The Company has granted Craft Brands a license to use Redhook intellectual property in connection with these efforts to advertise, market, sell and distribute the Company's products in the Western Territory. The Supply and Distribution Agreement also gives the Company the right to manufacture certain products of Widmer for sale to Craft Brands if Widmer is unable to manufacture the quantity ordered by Craft Brands. In addition, if sales of the Company's products decrease as compared to previous year sales, the Company has an option to manufacture Widmer products in an amount equal to the lower of (i) the Company's product decrease or (ii) the Widmer product increase.

The Supply and Distribution Agreement also provides that Craft Brands may elect to discontinue distributing a Redhook product if sales volume of such product declines to less than 20% of the total volume of all Redhook products and the volume of Redhook's product in the prior year decreased by more than 10% as compared to the year prior.

The territory covered by the Supply and Distribution Agreement may be expanded to cover one or more of the following states, at Craft Brands' request: Arkansas, Iowa, Kansas, Louisiana, Minnesota, Missouri, Nebraska, North Dakota, Oklahoma, South Dakota and Texas.

Widmer has also entered into a Supply, Distribution and Licensing Agreement with Craft Brands upon substantially similar terms.

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The Supply and Distribution Agreement has an indefinite term, subject to early termination upon the occurrence of certain events. The Supply and Distribution Agreement may be terminated immediately, by either party, upon the occurrence of any one or more of the following events:

- 1) the other party fails to timely make any payment required under the Supply and Distribution Agreement for a period of 60 days following written notice thereof;
- 2) the other party fails to perform any other material obligation under the Supply and Distribution Agreement and such failure remains uncured for a period of 60 days following written notice thereof;
- 3) the other party becomes the subject of insolvency or bankruptcy proceedings, ceases doing business, makes an assignment of assets for the benefit of creditors, dissolves, or has a trustee appointed for all or a substantial portion of such party's assets;
- 4) any government authority makes a final decision invalidating a substantial portion of the Supply and Distribution Agreement;
- 5) either party finds that complying with any law or regulation relating to fulfilling its obligations under the Supply and Distribution Agreement would be commercially unreasonable and failure to comply with the law or regulation would subject such party or any of its personnel to a monetary or criminal penalty;
- 6) the Craft Brands Distribution Agreement with A-B terminates for any reason; or
- 7) the Operating Agreement terminates for any reason.

Additionally, Craft Brands may, upon notice to Redhook, terminate the Supply and Distribution Agreement if Redhook causes Craft Brands to be in default in its obligations under the Craft Brands Distribution Agreement with A-B and Redhook either (a) fails to take all actions necessary to cause Craft Brands to cure such default or (b) fails to pay on demand certain direct or indirect costs arising out of or related to such default. Craft Brands may also terminate the Supply and Distribution Agreement and cease advertising, marketing, or distributing one or more of the Company's products if an event of default occurs under the Craft Brands Distribution Agreement that gives A-B the right to terminate that agreement and Redhook caused such event of default.

If the Supply and Distribution Agreement were terminated early, as described above, it would be extremely difficult for the Company to rebuild its distribution network and re-launch its marketing and advertising activities in the Western Territory without a severe negative impact on the Company's sales and results of operations. It is likely that the Company would need to raise additional funds to develop a new distribution network. There cannot be any guarantee that the Company would be able to successfully rebuild all, or part, of its distribution network or that any additional financing would be available when needed, or that any such financing would be on commercially reasonable terms. Additionally, termination of the Supply and Distribution Agreement could cause a default under the Craft Brands Distribution Agreement, which could in turn cause the Company to be in default under the A-B Distribution Agreement.

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* and *an Interpretation of ARB No. 51*, (FIN No. 46R) and 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 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 (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*. The Company recognized \$2,655,000, \$2,392,000 and \$1,123,000 of undistributed earnings related to its investment in Craft Brands for the years ended December 31, 2006, 2005 and 2004, respectively. The Company received cash distributions of \$2,621,000, \$2,769,000 and \$903,000, representing its share of the net cash flow of Craft Brands for the years ended December 31, 2006, 2005 and 2004, respectively. The Company's share of the earnings of Craft Brands contributed a significant portion of income to the Company's results of operations. Separate financial statements for Craft Brands are filed with this Annual Report on Form 10-K in Part IV., Item 15. *Exhibits and Financial Statement Schedules*, in accordance with Rule 3-09 of Regulation S-X.

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Sales and Marketing

The Company promotes its products through a variety of advertising programs with its wholesalers, by training and educating wholesalers and retailers about the Company's products, through promotions at local festivals, venues, and pubs, by utilizing the pubs located at the Company's two breweries, through price discounting, and, most recently, through Craft Brands.

The Company advertises its products by utilizing radio, billboard and print advertising in key markets and by participating in a co-operative program with its distributors whereby the Company's spending is matched by the distributor. Since 2000, the Company has allocated a larger share of its advertising budget each year to these co-operative programs. The Company believes that the financial commitment as well as the distributor's knowledge of the local market result in an advertising and promotion program that is targeted in a manner that will best promote Redhook and align the Company's interests with those of its wholesalers. In 2005, the Company reduced the co-op advertising, but continued its promotion program and limited media advertising in select eastern U.S. markets. Expenditures for the co-op program and media advertising program totaled \$365,000, \$533,000 and \$728,000 in 2006, 2005 and 2004, respectively. Craft Brands served the operations of Redhook in the Western Territory for advertising and marketing for all of 2006 and 2005 and half of 2004. In addition Redhook invested in new designs for bottles and packaging in 2005 which explains the trend of decline in these expenses for the Company.

The Company's sales and marketing staff offers education, training and other support to wholesale distributors of the Company's products. Because the Company's wholesalers generally also distribute much higher volume national beer brands and commonly distribute other specialty brands, a critical function of the sales and marketing staff is to elevate each distributor's awareness of the Company's products and to maintain the distributor's interest in promoting increased sales of these products. This is accomplished primarily through personal contact with each distributor, including on-site sales training, educational tours of the Company's breweries, and promotional activities and expenditures shared with the distributors. The Company's sales representatives also provide other forms of support to wholesale distributors, such as direct contact with restaurant and grocery chain buyers, direct involvement in the design of grocery store displays, stacking and merchandising of beer inventory and supply of point-of-sale materials.

The Company's sales representatives devote considerable effort to the promotion of on-premise consumption at participating pubs and restaurants. The Company believes that educating retailers about the freshness and quality of the Company's products will in turn allow retailers to assist in educating consumers. The Company considers on-premise product sampling and education to be among its most effective tools for building brand awareness with consumers and establishing word-of-mouth reputation. On-premise marketing is also accomplished through a variety of other point-of-sale tools, such as neon signs, tap handles, coasters, table tents, banners, posters, glassware and menu guidance. The Company seeks to identify its products with local markets by participating in or sponsoring cultural and community events, local music and other entertainment venues, local craft beer festivals and cuisine events, and local sporting events.

The Company's breweries also play a significant role in increasing consumer awareness of the Company's products and enhancing Redhook's image as a craft brewer. Many visitors take tours at the Company's breweries. Both of the Company's breweries have a retail pub on-site where the Company's products are served. In addition, the breweries have meeting rooms that the public can rent for business meetings, parties and holiday events, and that the Company uses to entertain and educate distributors, retailers and the media about the Company's products. See Item 2.

Properties. The Company also sells various items of apparel and memorabilia bearing the Company's trademarks at its pubs, which creates further awareness of the Company's beers and reinforces the Company's quality image.

To further promote retail bottled product sales and in response to local competitive conditions, the Company regularly offers post-offs, or price discounts, to distributors in most of its markets. Distributors and retailers usually participate in the cost of these price discounts.

The Craft Brands joint sales and marketing organization serves the operations of Redhook and Widmer in the Western Territory by advertising, marketing, selling and distributing both companies' products to wholesale outlets through a distribution agreement between Craft Brands and A-B. Similar to the Company, Craft Brands promotes its

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products through a variety of advertising programs with its wholesalers, through training and education of wholesalers and retailers, through promotions at local festivals, venues, and pubs, by utilizing the pubs located at the Company's two breweries, and through price discounting. Management believes that, in addition to achieving certain synergies by combining sales and marketing forces, Craft Brands is able to capitalize on both companies' sales and marketing skills and complementary product portfolios. The Company believes that the combination of the two brewers' complementary brand portfolios, led by one focused sales and marketing organization, will not only deliver financial benefits, but will also deliver greater impact at the point of sale.

Seasonality

Sales of the Company's products are somewhat seasonal, with the first and fourth quarters historically being the slowest and the rest of the year generating stronger sales. The volume of sales may also be affected by weather conditions. Because of the seasonality of the Company's business, results for any one quarter are not necessarily indicative of the results that may be achieved for the full fiscal year.

Competition

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 have introduced fuller-flavored products, and large spirit companies and national brewers that produce flavored alcohol beverages. Beyond the beer market, craft brewers have also faced competition from producers of wines and spirits. See Industry Background.

Competition within the domestic craft beer segment and the specialty beer market is based on product quality, taste, consistency and freshness, ability to differentiate products, promotional methods and product support, transportation costs, distribution coverage, local appeal and price.

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. Craft brewers have also encountered more competition as their peers expand distribution. Just as Redhook expanded distribution of its products to markets outside of its home in the Pacific Northwest, so have other craft brewers expanded distribution of their products to other regions of the country, leading to an increase in the number of craft brewers in any given market. Competition varies by regional market. Depending on the local market preferences and distribution, Redhook has encountered strong competition from microbreweries, from other regional specialty brewers such as Sierra Nevada Brewing Company, Deschutes Brewery, Pyramid Breweries and New Belgium Brewing Company, as well as from contract brewers such as Boston Beer Company. Because of the large number of participants and number of different products offered in this segment, the competition for bottled product placements and especially for draft beer placements has intensified. Although certain of these competitors distribute their products nationally and may have greater financial and other resources than the Company, management believes that the Company possesses certain competitive advantages, including its Company-owned production facilities and its relationships with A-B and Craft Brands.

The Company also competes against producers of imported beers, such as Heineken, Corona Extra, Bass and Guinness. Most of these foreign brewers have significantly greater financial resources than the Company. Although imported beers currently account for a greater share of the U.S. beer market than craft beers, the Company believes that craft brewers possess certain competitive advantages over some importers, including lower transportation costs, no importation costs, proximity to and familiarity with local consumers, a higher degree of product freshness, eligibility for lower federal excise taxes and absence of currency fluctuations.

In response to the growth of the craft beer segment, most of the major domestic brewers have introduced fuller-flavored beers. While these product offerings are intended to compete with craft beers, many of them are

brewed according to methods used by the major national brewers. Although increased participation by the major national brewers increases competition for market share and can heighten price sensitivity within the craft beer segment, the Company believes that their participation tends to increase advertising, distribution and consumer education and awareness of craft beers, and thus may contribute to further growth of this industry segment.

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In the past few years, several major distilled spirits producers and national brewers have introduced flavored alcohol beverages. Products such as Smirnoff Ice, Bacardi Silver and Mike's Hard Lemonade demonstrate continued growth. The Company believes sales of these products along with strong growth in the imported and craft beer segments of the malt beverage industry increased the overall U.S. alcohol market by nearly 5% in 2006. The producers of these products have significantly greater financial resources than the Company and these products appear to draw a portion of overlapping consumers away from imports and craft beers. The success of the flavored alcohol beverages will likely subject the Company to increased competition.

Competition for consumers of craft beers has also come from wine and spirits. Some of the growth in the past five years in the wine and spirits market, industry sources believe, has been drawn from the beer market. This growth appears to be attributable to competitive pricing, television advertising, increased merchandising, and increased consumer interest in wine and spirits.

A significant portion of the Company's sales continue to be in the Pacific Northwest region, which the Company believes is one of the most competitive craft beer markets in the U.S., both in terms of number of participants and consumer awareness. The Company faces extreme competitive pressure in Washington State, which is not only the Company's largest market, but is also its oldest market. Since 2000, the Company has experienced a decline in sales volume in Washington State of approximately 24%, significantly impacted by a 12% decline in 2004 volume over 2003 volume. The Company believes that the Pacific Northwest, and Washington State in particular, offers significant competition to its products, not only from other craft brewers but also from the growing wine market and from flavored alcohol beverages. This intense competition is magnified because the Company's brand is viewed as being relatively mature. Focus studies in late 2004 indicated that, while the Company's brand does possess brand awareness among target consumers, it also appeared to not attract key consumers who seem to be more interested in experimenting with new products. These focus studies resulted in Craft Brands focusing its 2005 marketing efforts on updating the Redhook brand image to stimulate demand. In the first half of 2005, Craft Brands introduced in the western U.S. several major marketing initiatives, including a proprietary Redhook bottle and new packaging design combined with a new marketing campaign, aimed at updating the Redhook brand image. In the second half of 2005, the new packaging design was introduced in the midwest and eastern U.S.

Management believes that the beer industry is influenced, both positively and negatively, by individual relationships. In Washington State, where some of those relationships have existed for many years, the transition to Craft Brands appears to have had some negative impact on those relationships. The transition took longer than anticipated, and in 2004 nearly all Company sales staff responsible for the Washington State market left the Company. In 2006, sales in the CBA territory of the Company's products have declined by 3% compared to 2005. Pricing of the company's products has increased and the level of promotion and discounting has declined, allowing the Company to achieve higher revenue per barrel, however, management believes there is a direct correlation to lower sales caused by higher net pricing. During this same period, CBA has been very successful selling the Widmer and Kona products. Although the Company enjoys the benefits of those successes through its profit-sharing arrangement with CBA, the Company believes it is critical for CBA to deliver success with the Redhook products in addition to the others. The Company has communicated this concern to CBA, and is working with CBA management to establish new brand management throughout the portfolio of Redhook products. CBA also responded to this concern by re-emphasizing their commitment to Redhook products and CBA has set goals and objectives to improve performance of the Redhook products in 2007.

Regulation

The Company's business is highly regulated at federal, state and local levels. Various permits, licenses and approvals necessary to the Company's brewery and pub operations and the sale of alcoholic beverages are required from various

agencies, including the U.S. Treasury Department, Alcohol and Tobacco Tax and Trade Bureau (the TTB) (formerly the Bureau of Alcohol, Tobacco and Firearms) the U.S. Department of Agriculture, the U.S. Food and Drug Administration, state alcohol regulatory agencies in the states in which the Company sells its products, and state and local health, sanitation, safety, fire and environmental agencies. In addition, the beer industry is subject to substantial federal and state excise taxes, although the Company benefits from favorable treatment granted to brewers producing less than two million barrels per year.

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Management believes that the Company currently has all licenses, permits and approvals necessary for its current operations. However, existing permits or licenses could be revoked if the Company failed to comply with the terms of such permits or licenses. Additional permits or licenses could be required in the future for the Company's existing or expanded operations. If licenses, permits or approvals necessary for the Company's brewery or pub operations were unavailable or unduly delayed, or if any such permits or licenses were revoked, the Company's ability to conduct its business could be substantially and adversely affected.

Alcoholic Beverage Regulation and Taxation

Both of the Company's breweries and pubs are subject to licensing and regulation by a number of governmental authorities. The Company operates its breweries under federal licensing requirements imposed by the TTB. The TTB requires the filing of a Brewer's Notice upon the establishment of a commercial brewery. In addition, commercial brewers are required to file an amended Brewer's Notice every time there is a material change in the brewing process or brewing equipment, change in the brewery's location, change in the brewery's management or a material change in the brewery's ownership. The Company's operations are subject to audit and inspection by the TTB at any time.

In addition to the regulations imposed by the TTB, the Company's breweries are subject to various regulations concerning retail sales, pub operations, deliveries and selling practices in states in which the Company sells its products. Failure of the Company to comply with applicable federal or state regulations could result in limitations on the Company's ability to conduct its business. TTB permits can be revoked for failure to pay taxes, to keep proper accounts, to pay fees, to bond premises, to abide by federal alcoholic beverage production and distribution regulations, or if holders of 10% or more of the Company's equity securities are found to be of questionable character. Permits from state regulatory agencies can be revoked for many of the same reasons.

The U.S. federal government currently imposes an excise tax of \$18 per barrel on beer sold for consumption in the U.S. However, any brewer with annual production under two million barrels instead pays federal excise tax in the amount of \$7 per barrel on sales of the first 60,000 barrels. While the Company is not aware of any plans by the federal government to reduce or eliminate this benefit to small brewers, any such reduction in a material amount could have an adverse effect on the Company. In addition, the Company would lose the benefit of this rate structure if it exceeded the two million barrel production threshold. Individual states also impose excise taxes on alcoholic beverages in varying amounts, which have also been subject to change. It is possible that excise taxes will be increased in the future by both the federal government and several states. In addition, increased excise taxes on alcoholic beverages have in the past been considered in connection with various governmental budget-balancing or funding proposals. Any such increases in excise taxes, if enacted, could adversely affect the Company.

State and Federal Environmental Regulation

The Company's brewery operations are subject to environmental regulations and local permitting requirements and agreements regarding, among other things, air emissions, water discharges and the handling and disposal of wastes. While the Company has no reason to believe the operations of its facilities violate any such regulation or requirement, if such a violation were to occur, or if environmental regulations were to become more stringent in the future, the Company could be adversely affected.

Dram Shop Laws

The serving of alcoholic beverages to a person known to be intoxicated may, under certain circumstances, result in the server being held liable to third parties for injuries caused by the intoxicated customer. The Company's pubs have addressed this concern by establishing early closing hours and regularly scheduled employee training. Large uninsured

damage awards against the Company could adversely affect the Company's financial condition.

Subsequent Events

On January 3, 2007 the Company publicly disseminated a press release announcing it is entering into preliminary discussions with Widmer Brothers Brewing Company regarding the possibility of combining the two companies. These negotiations are continuing. As a result of these discussions, on January 2, 2007, the

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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 an employee's employment is terminated as a result of a merger or other business combination with Widmer Brothers Brewing Company.

Trademarks

The Company has obtained U.S. trademark registrations for its numerous products including its proprietary bottle design. Trademark registrations generally include specific product names, marks and label designs. The Redhook mark and certain other Company marks are also registered in various foreign countries. The Company regards its Redhook and other trademarks as having substantial value and as being an important factor in the marketing of its products. The Company is not aware of any infringing uses that could materially affect its current business or any prior claim to the trademarks that would prevent the Company from using such trademarks in its business. The Company's policy is to pursue registration of its marks in its markets whenever possible and to oppose vigorously any infringement of its marks.

Employees

At December 31, 2006, the Company had 205 employees, including 63 in production, 100 in the pubs, 24 in sales and marketing, and 18 in administration. Of these, 69 in the pubs, 1 in administration and 1 in production were part-time employees. The Company believes its relations with its employees to be good.

Item 1A. Risk Factors

The risks described below, together with all of the other information included in this report, should be carefully considered in evaluating our business and prospects. The risks and uncertainties described herein are not the only ones facing us. Additional risks and uncertainties not presently known or deemed insignificant may also impair our business operations. Solely for purposes of the risk factors in this Item 1A., the terms *we*, *our* and *us* refer to Redhook Ale Brewery, Incorporated.

We are dependent upon our continuing relationship with Anheuser-Busch, Incorporated. Substantially all of our future sales are expected to be made through the A-B Distribution Agreement and through sales to Craft Brands. Craft Brands will distribute Redhook products through a separate distribution arrangement with A-B. If our relationship with A-B, our relationship with Craft Brands or the relationship between A-B and Craft Brands were to deteriorate, distribution of our products would suffer significant disruption and such event would have a long-term severe negative impact on our sales and results of operations, as it would be extremely difficult for us to rebuild our own distribution network. We believe that the benefits of the Distribution Agreement and our relationship with A-B and Craft Brands, in particular distribution and material cost efficiencies, offset the costs associated with the relationship. However, there can be no assurance that these costs will not have a negative impact on our profit margins in the future.

Additionally, the termination of the A-B Distribution Agreement for any reason would constitute an event of default under our bank credit agreement, and the bank may declare the entire outstanding loan balance immediately due and payable. If this were to occur, we could seek to refinance our term loan with one or more banks or obtain additional equity capital; however, there can be no assurance we would be able to access additional capital to meet our needs or that such additional capital would be available at commercially reasonable terms.

Our agreement with A-B contains limitations on our ability to engage in or reject certain transactions, including acquisitions and changes of control. The Exchange and Recapitalization Agreement with A-B contains limitations on, among other matters, our ability to, without the prior consent of A-B:

issue equity securities;

acquire or sell assets or stock;

amend our Articles of Incorporation or bylaws;

grant board representation rights;

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enter into certain transactions with affiliates;

distribute our products in the U.S. other than through A-B, Craft Brands or as provided in the A-B Distribution Agreement;

voluntarily delist or terminate our listing on the NASDAQ Stock Market; or

dispose of any of our interest in Craft Brands.

Further, if the A-B Distribution Agreement is terminated, or the distribution of Redhook products is terminated by Craft Brands, A-B has the right to solicit and negotiate offers from third parties to purchase all or substantially all of the assets or securities of Redhook or to enter into a merger or consolidation transaction with our Company and the right to cause our board of directors to consider any such offer.

Additionally, as of December 31, 2006 and 2005, A-B owned approximately 33.3% and 33.6%, respectively, of our Common Stock. As long as A-B owns a substantial portion of our outstanding common stock, it may have the ability to approve or block actions requiring the approval of our shareholders.

Our investment in Craft Brands Alliance LLC may not provide anticipated benefits. We believe that Craft Brands combined sales and marketing organization creates synergies and capitalizes on both Redhook's and Widmer's sales and marketing experience and complementary product portfolios. We have realized a decrease in selling, general and administrative expenses and recognized income of \$2,655,000 in 2006, \$2,392,000 in 2005 and \$1,123,000 in 2004 from our investment in Craft Brands; however, Craft Brands has only been operational since July 2004 and predicting future benefits from Crafts Brands is difficult. There can be no assurance that we will see any further or anticipated benefits from the joint venture. In 2006, sales of our products in the CBA territory declined by 3% compared to 2005. Pricing of our products has increased and the level of promotion and discounting has declined, allowing us to achieve higher revenue per barrel, however, management believes there is a direct correlation to lower sales caused by higher net pricing. During this same period, CBA has been very successful selling the Widmer and Kona products. Although we enjoy the benefits of those successes through our profit-sharing arrangement with CBA, we believe it is critical for CBA to deliver success with the Redhook products in addition to the others. We have communicated this concern to CBA, and is working with CBA management to establish new brand management throughout the portfolio of Redhook products. CBA also responded to this concern by re-emphasizing their commitment to Redhook products and CBA has set goals and objectives to improve performance of the Redhook products in 2007. If CBA is unable to increase shipments of our products in the west, our operations will become more dependent on lower margin contract brewing, and profit margins will suffer.

The Operating Agreement requires us to make certain capital contributions to support the operations of Craft Brands. Contemporaneous with the execution of the Operating Agreement, we made a 2004 sales and marketing capital contribution in the amount of \$250,000. The agreement designated this sales and marketing capital contribution be used by Craft Brands for expenses related to the marketing, advertising and promotion of Redhook 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 Redhook's commitment to expand the production capacity of both our Washington and New Hampshire Breweries to produce more Widmer products. Our 2008 contribution, if one is required, cannot exceed \$310,000 and will be required to be paid in no more than three equal installments made on or before February 1, 2008, April 1, 2008 and July 1, 2008. 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 us and Widmer to make other additional capital contributions only upon the request and consent of the Craft Brands board of directors. If we are required to make this additional sales and marketing contribution, our available cash will decrease and our income from Craft Brands will decrease by the amount of the contribution, which will be allocated 100% to us.

Our potential transaction with Widmer Brothers Brewing Company may not occur, and failure to complete the transaction may have a negative impact on our stock price or our future business and financial results. On January 3, 2007, we publicly disseminated a press release announcing that we were entering into preliminary

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discussions with Widmer Brothers Brewing Company regarding the possibility of combining the two companies. These negotiations are continuing, and are still in the preliminary stage. If the transaction with Widmer is not completed for any reason, our business may be adversely affected and will be subject to a number of risks, including:

failure to pursue other beneficial opportunities as a result of the focus of management on the potential transaction, without realizing any of the anticipated benefits of completing the transaction;

the market price of our common stock might decline to the extent that the current market price reflects a market assumption that a transaction between the two companies will be completed; and

our costs related to a potential transaction with Widmer must be paid even if a transaction is not completed, and these costs could be significant.

Additionally, our current employees may experience uncertainty about their future as employees of the combined company until strategies with regard to the combined company are announced or executed. This may adversely affect our ability to attract and retain key personnel, and may affect their performance during the period of uncertainty. We have attempted to address this concern through the adoption of a Company-wide severance plan that permits the payment of 6 months of severance benefits to all full-time employees, other than executive officers, in the event an employee's employment is terminated as a result of a combination with Widmer. However, this severance plan does not apply to executive officers, and it may not be sufficient to adequately address employee concerns.

We are dependent on our distributors for the sale of our products. Although substantially all of our future sales are expected to be made through the A-B Distribution Agreement and through sales to Craft Brands, we continue to rely heavily on distributors, most of which are independent wholesalers, for the sale of our products to retailers. K&L is responsible for distribution of our products in one of our largest markets—Seattle, Washington. K&L accounted for approximately 11%, 12% and 13% of total sales volume in 2006, 2005 and 2004, respectively. A disruption of Craft Brands, the wholesalers, A-B's or our ability to distribute products efficiently due to any significant operational problems, such as wide-spread labor union strikes, the loss of K&L as a customer, or the termination of the A-B Distribution Agreement or the Craft Brands Supply and Distribution Agreement could hinder our ability to get our products to retailers and could have a material adverse impact on our sales and results of operations.

Changes in state laws regarding distribution arrangements may adversely impact our operations. In 2006, the Washington State legislature passed a bill that will remove the long-standing requirement that small producers of wine and beer distribute their products through wholesale distributors, thus permitting these small producers to distribute their products directly to retailers. The law further provides that any in-state or out-of-state brewery that produces more than 2,500 barrels annually may distribute its products directly to retailers if it does so from a facility located in the state that is physically separate and distinct from its production facilities. The new legislation stipulates that prices charged by a brewery must be uniform to all distributors and retailers, but does not restrict prices retailers may charge consumers. While it is too soon to predict what impact, if any, this law will have on our operations, the beer and wine market may experience an increase in competition and cause our future sales and results of operations to be adversely affected. This law may also impact the financial stability of Washington State wholesalers on which we rely.

Increased competition could adversely affect sales and results of operations. We compete 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. Beyond the beer market, craft brewers also face competition from producers of wines and spirits. Primarily as a result of this increased competition, we experienced declining sales volumes ranging from 2.3% to 5.7% for the years 1997 through 1999. Our sales volume for the years 1999 to 2003 increased when compared to the corresponding prior year's volumes, but decreased again in 2004. Although our 2005 sales

volume increased compared to 2004, the increase was a modest 4%, while industry sources estimate that the craft brewing segment in total increased approximately 9%. For 2006 sales volume increased 21% over 2005, while industry sources estimate that the craft brewing segment in total increased approximately 12%.

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Increasing competition could cause our future sales and results of operations to be adversely affected. We have historically operated with little or no backlog and, therefore, our ability to predict sales for future periods is limited.

Future price promotions to generate demand for our products may be unsuccessful. Future prices we charge for our products may decrease from historical levels, depending on competitive factors in our various markets. In order to stimulate demand for our products, we have participated in price promotions with our wholesalers and retail customers in most of our markets. The number of markets in which we participate in price promotions and the frequency of such promotions may increase in the future. There can be no assurance however that our price promotions will be successful in increasing demand for our products.

Due to our concentration of sales in the Pacific Northwest, our results of operations and financial condition are subject to fluctuations in regional economic conditions. A significant portion of our sales continue to be in the Pacific Northwest region. Our business may be adversely affected by changes in economic and business conditions nationally and particularly within the Northwest region. Additionally, we believe this region is one of the most competitive craft beer markets in the U.S., both in terms of number of market participants and consumer awareness. We face extreme competitive pressure in Washington State which is our largest and oldest market. Since 2000, we have experienced a decline in sales volume in Washington State of approximately 24%, significantly impacted by a 12% decline in 2004 volume over 2003 volume. We believe that the Pacific Northwest, and Washington State in particular, offers significant competition to our products, not only from other craft brewers but also from the growing wine market and from flavored alcohol beverages. This intense competition is magnified because our brand is viewed as being relatively mature. Focus studies in late 2004 indicated that, while our brand possesses brand awareness among target consumers, it also appears to not attract key consumers who seem to be more interested in experimenting with new products. These focus studies have resulted in Craft Brands focusing its 2005 marketing efforts on updating the Redhook brand image to stimulate demand. However, in 2006, sales in the Pacific Northwest continued to decline. CBA has informed us they are committed to addressing this negative trend in the western territory, but there can be no assurance that CBA will be successful in increasing shipments and sales of Redhook product. If CBA is unable to increase shipments of our products in the highly competitive Pacific Northwest markets, our market share and profit margins will continue to suffer.

Our business is seasonal in nature, and we are likely to experience fluctuations in our results of operations and financial condition. Sales of our products are somewhat seasonal, with the first and fourth quarters historically being the slowest and the rest of the year generating stronger sales. Our sales volume may also be affected by weather conditions. Therefore, our results for any quarter may not be indicative of the results that may be achieved for the full fiscal year. If an adverse event such as a regional economic downturn or poor weather conditions should occur during the second and third quarters, the adverse impact to our revenues could likely be greater as a result of our seasonal business.

Our gross margins may fluctuate while our expenses remain constant. We anticipate that our future gross margins will fluctuate and may decline as a result of many factors, including shipments to Craft Brands at a fixed price substantially below wholesale pricing levels, disproportionate depreciation and other fixed and semivariable operating costs, and the level of production at our breweries in relation to current production capacity. Our high level of fixed and semivariable operating costs causes gross margin to be especially sensitive to relatively small increases or decreases in sales volume. In addition, other factors beyond our control that could affect cost of sales include changes in freight charges, the availability and prices of raw materials and packaging materials, the mix between draft and bottled product sales, the sales mix of various bottled product packages, and federal or state excise taxes.

An increase in lower margin contract brewing could negatively impact our overall profit margins. In connection with our Supply and Distribution Agreement with Craft Brands, if shipments of Redhook products in the Craft Brands territory decrease as compared to the previous year's shipments, we have the contractual right to brew Widmer

products in an amount equal to the lower of (i) our product shipment decrease or (ii) the Widmer product shipment increase (the Contractual Obligation). In 2006, we brewed and shipped 10,000 barrels of Widmer draft beer under this Contractual Obligation. In addition, we may, pursuant to a Manufacturing and Licensing Agreement with Widmer, brew more beer for Widmer than the amount obligated by the Supply, Distribution and Licensing Agreement with Craft Brands. Our Manufacturing and Licensing Agreement with Widmer expires December 31,

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2007. In 2006, we brewed and shipped 33,000 barrels of Widmer under our Manufacturing and Licensing Agreement with Widmer. Driven by the Contractual Obligation, as well as Widmer's production needs, we anticipate that beer brewed and shipped in 2007 under the contract brewing arrangement with Widmer will increase significantly over 2006 levels. Contract brewing has lower margins compared to sales of Redhook products.

We are dependent on contract brewing to keep our production facilities operating at an efficient capacity; a decrease in contract brewing could have an unfavorable and significant financial impact on our financial statements and results of operations. Widmer has notified us that they will be bringing additional capacity on-line in the first half of 2008, which will significantly reduce our level of contract brewing for Widmer out of our Washington Brewery. Our Manufacturing and Licensing Agreement with Widmer, under which we contract brew for Widmer at our Washington Brewery expires on December 31, 2007. We are currently evaluating alternatives to utilize the capacity that will become available upon the termination of the contract brewing, including entering into new contract brewing arrangements with other parties. If we are unable to replace the Widmer contract brewing, or achieve significant growth through our own products, the resulting loss of revenue and the resulting excess capacity and unabsorbed overhead in the Washington Brewery would have an adverse effect on our financial performance.

Changes in consumer preferences or public attitudes about our products could reduce demand. If consumers were unwilling to accept our products or if general consumer trends caused a decrease in the demand for beer, including craft beer, it would adversely impact our sales and results of operations. If the flavored alcohol beverage market, the wine market, or the spirits market continue to grow, they could draw consumers away from our products and have an adverse effect on our sales and results of operations. Further, the alcoholic beverage industry has become the subject of considerable societal and political attention in recent years due to increasing public concern over alcohol-related social problems, including drunk driving, underage drinking and health consequences from the misuse of alcohol. If beer consumption in general were to come into disfavor among domestic consumers, or if the domestic beer industry were subjected to significant additional governmental regulation, our operations could be adversely affected.

We are subject to governmental regulations affecting our breweries and pubs; the costs of complying with governmental regulations, or our failure to comply with such regulations, could affect our financial condition and results of operations. Our breweries and our pubs are subject to licensing and regulation by a number of governmental authorities, including the U.S. Treasury Department, Alcohol and Tobacco Tax and Trade Bureau, the U.S. Department of Agriculture, the U.S. Food and Drug Administration, state alcohol regulatory agencies in the states in which we sell our products, and state and local health, sanitation, safety, fire and environmental agencies. Our failure to comply with applicable federal, state or local regulations could result in limitations on our ability to conduct business. TTB permits can be revoked for failure to pay taxes, to keep proper accounts, to pay fees, to bond premises, to abide by federal alcoholic beverage production and distribution regulations, or if holders of 10% or more of our equity securities are found to be of questionable character. Other permits or licenses could be revoked if we fail to comply with the terms of such permits or licenses, and additional permits or licenses could be required in the future for our existing or expanded operations. If licenses, permits or approvals necessary for our brewery or pub operations were unavailable or unduly delayed, or if any such permits or licenses were revoked, our ability to conduct business could be substantially and adversely affected.

Our brewery operations are also subject to environmental regulations and local permitting requirements and agreements regarding, among other things, air emissions, water discharges, and the handling and disposal of wastes. While we have no reason to believe the operations of our facilities violate any such regulation or requirement, if such a violation were to occur, or if environmental regulations were to become more stringent in the future, our business could be adversely affected.

We are also subject to dram shop laws, which generally provide a person injured by an intoxicated person the right to recover damages from an establishment that wrongfully served alcoholic beverages to the intoxicated person. Our

pubs have addressed this concern by establishing early closing hours and regularly scheduled employee training, however, large uninsured damage awards against our Company could adversely affect our financial condition.

We may experience material losses in excess of insurance coverage. We believe we maintain insurance coverage that is customary for businesses of our size and type. There are, however, certain types of catastrophic

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losses that are not generally insured because it is not economically feasible to insure against such losses. Should an uninsured loss or a loss in excess of insured limits occur, such loss could have an adverse effect on our results of operations and financial condition.

Declining sales trends could adversely affect brewery efficiency and our financial results. Our breweries have been operating at production levels substantially below their current and maximum designed capacities. Operating our breweries at low capacity utilization rates negatively impacts our gross margins and operating cash flows generated by the production facilities. We periodically evaluate whether we expect to recover the costs of our production facilities over the course of their useful lives. If facts and circumstances indicate that the carrying value of these long-lived assets may be impaired, an evaluation of recoverability will be performed in accordance with FASB Statement of Financial Accounting Standard (SFAS) No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, by comparing the carrying value of the assets to projected future undiscounted cash flows in addition to other quantitative and qualitative analyses. If our management believes that the carrying value of such assets may not be recoverable, we will recognize an impairment loss by a charge against current operations.

An increase in excise taxes could adversely affect our financial condition. The U.S. federal government currently imposes an excise tax of \$18 per barrel on beer sold for consumption in the U.S. However, any brewer with annual production under two million barrels instead pays federal excise tax in the amount of \$7 per barrel on sales of the first 60,000 barrels. While we are not aware of any plans by the federal government to reduce or eliminate this benefit to small brewers, any such reduction in a material amount could have an adverse effect on our financial condition and results of operations. In addition, we would lose the benefit of this rate structure if we exceeded the two million barrel production threshold. Individual states also impose excise taxes on alcoholic beverages in varying amounts, which have also been subject to change. It is possible that excise taxes will be increased in the future by both federal and state governments. In addition, increased excise taxes on alcoholic beverages have in the past been considered in connection with various governmental budget-balancing or funding proposals. Any such increases in excise taxes, if enacted, could adversely affect our financial condition.

Loss of income tax benefits could negatively impact results of operations. As of December 31, 2006, our Company's deferred tax assets were primarily comprised of NOLs of \$26.5 million, or \$9.0 million tax-effected; federal and state alternative minimum tax credit carry forwards of \$166,000; and state NOL carry forwards of \$219,000 tax-effected. In assessing the realizability of the deferred tax assets, we considered whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. 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. We considered the scheduled reversal of deferred tax liabilities, projected future taxable income and other factors in making this assessment. Our estimates of future taxable income takes into consideration, among other items, estimates of future taxable income related to depreciation. Based upon the available evidence, we do not believe it is more likely than not that all of the deferred tax assets will be realized. Accordingly, we established a valuation allowance in 2002, increased it further in 2003, 2004, and 2005 and decreased it in 2006 to cover certain federal and state NOLs that may expire before we are able to utilize the tax benefit. As of December 31, 2006 and 2005, we had a valuation allowance of \$1,059,000 and \$1,656,000, respectively. To the extent that we continue to be unable to generate adequate taxable income in future periods, we will not be able to recognize additional tax benefits and may be required to record a greater valuation allowance covering potentially expiring NOLs.

We are dependent upon the services of our key personnel. We depend on the services of our key management personnel, including Paul Shipman, our chief executive officer, and David Mickelson, our president. If we lose the services of any members of our senior management or key personnel for any reason, we may be unable to replace them with qualified personnel, which could have a material adverse effect on our operations. Additionally, the loss of Paul Shipman as our chief executive officer, and our failure to find a replacement satisfactory to A-B, would be a default under the A-B Distribution Agreement. We do not carry key person life insurance on any of our executive

officers.

We are subject to the risks of litigation. At any given time, we are subject to claims and actions incidental to the operation of our business. The outcome of these proceedings cannot be predicted. If a plaintiff were successful

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in a claim against our Company, we could be faced with the payment of a material sum of money. If this were to occur, it could have an adverse effect on our financial condition.

Item 1B. *Unresolved Staff Comments*

None.

Item 2. *Properties*

The Company currently operates two highly automated small-batch breweries, one in the Seattle suburb of Woodinville, Washington and the other in Portsmouth, New Hampshire. See Notes 5 and 11 to the Financial Statements included elsewhere herein.

The Washington Brewery. The Washington Brewery, located on approximately 22 acres (17 of which are developable) in Woodinville, Washington, a suburb of Seattle, is across the street from the Chateau Ste. Michelle Winery, next to the Columbia Winery and visible from a popular bicycle path. The Washington Brewery is comprised of an approximately 88,000 square-foot building, a 40,000 square-foot building and an outdoor tank farm. The two buildings house a 100-barrel brewhouse, fermentation cellars, filter rooms, grain storage silos, a bottling line, a keg filling line, dry storage, two coolers and loading docks. The brewery includes a retail merchandise outlet and the Forecasters Public House, a 4,000 square-foot family-oriented pub that seats 200 and features an outdoor beer garden that seats an additional 200. Additional entertainment facilities include a 4,000 square-foot special events room accommodating up to 250 people. The brewery also houses office space, a portion of which is occupied by the Company's corporate office and the remainder of which is leased through October 2009. The Company purchased the land in 1993 and believes that its value has appreciated. The brewery's theoretical production capacity as of year end 2006 is approximately 250,000 barrels per year, which would be under ideal brewing conditions. An example of ideal brewing conditions would be brewing one particular flavor seven days a week during the whole year with minimal filtration loss. The theoretical production capacity in 2007 is also expected to be approximately 250,000 barrels per year.

The New Hampshire Brewery. The New Hampshire Brewery is located on approximately 23 acres in Portsmouth, New Hampshire. The land is subleased, the term of which expires in 2047, and contains two seven-year extension options. The New Hampshire Brewery is modeled after the Washington Brewery and is similarly equipped, but is larger in design, covering 125,000 square feet to accommodate all phases of the Company's brewing operations under one roof. Also included is a retail merchandise outlet, the Cataqua Public House, a 4,000 square-foot family-oriented pub with an outdoor beer garden, and a special events room accommodating up to 250 people. Production began in late October 1996, with an initial brewing capacity of approximately 100,000 barrels per year. In order to accommodate anticipated sales growth, additional brewing capacity was installed in 2002, 2003 and 2006, bringing the total theoretical production capacity as of year end 2006 to approximately 210,000 barrels per year. The theoretical production capacity as of May 2007 is expected to be approximately 235,000 barrels per year. During the spring of 2007 the Company plans to add four additional 400-barrel fermenters, one 70,000 pound grain silo and make process control automation upgrades to the New Hampshire brewery. Installation is expected to be completed by May 2007 and cost approximately \$1,000,000. This expansion will add approximately 25,000 barrels of capacity to the New Hampshire brewery. The theoretical production capacity as of May 2007 is expected to be approximately 235,000 barrels per year. The Company has the ability to phase in additional brewing capacity as needed, up to the maximum designed production capacity of approximately 250,000 barrels per year under ideal brewing conditions.

Item 3. *Legal Proceedings*

The Company is involved from time to time in claims, proceedings and litigation arising in the normal course of business. The Company believes that, to the extent that it exists, any pending or threatened litigation involving the Company or its properties will not likely have a material adverse effect on the Company's financial condition or results of operations.

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Item 4. *Submission of Matters to a Vote of Security Holders*

None.

Item 4A. *Executive Officers of the Company*

Paul S. Shipman (54) Chief Executive Officer and Chairman of the Board

Mr. Shipman is one of the Company's founders and has served as the Company's Chairman of the Board since November 1992 and Chief Executive Officer since June 1993. From September 1981 to November 2005, Mr. Shipman served as the Company's President. Prior to founding the Company, Mr. Shipman was a marketing analyst for the Chateau Ste. Michelle Winery from 1978 to 1981. Mr. Shipman received his Bachelor's degree in English from Bucknell University in 1975 and his Master's degree in Business Administration from the Darden Business School, University of Virginia, in 1978. Since July 2004, Mr. Shipman has served as a director of Craft Brands.

David J. Mickelson (47) President

Mr. Mickelson has served as President of the Company since December 2005. From December 2005 until March 2007, he also served as Chief Financial Officer. From August 2000 through November 2005, Mr. Mickelson served as Executive Vice President and Chief Financial Officer, and from March 1995 to November 2005, Mr. Mickelson also served as the Company's Chief Operating Officer. From April 1994 to March 1995, he was the Company's Vice President and General Manager. From July 1992 to December 1994, he served as its Chief Financial Officer, and was also named General Manager in January 1994. He served as the Company's Controller from 1987 to July 1992, and additionally was elected Treasurer in 1989. From 1985 to 1987, he was the Controller for Certified Foods, Inc. and from 1981 to 1985, he served as a loan officer with Barclays Bank PLC. Mr. Mickelson received his Bachelor's degree in Business Administration from the University of Washington in 1981.

Gerard C. Prial (52) Vice President, Sales and Eastern Operations

Mr. Prial has served as the Company's Vice President, Sales and Eastern Operations since December 2005. Mr. Prial served as Vice President, East Coast Operations from November 2001 through November 2005. From 1996 to November 2001, Mr. Prial served as the General Manager of the Company's New Hampshire Brewery. He served as the Company's Southern California Field Sales Manager from August 1994 to March 1996. From April 1993 to April 1994, Mr. Prial served as Vice President of Sales for Brewski Brewing Company of Culver City, California. From 1979 to 1993, he served in various positions for Wisdom Import Sales Company in Irvine, California. From 1977 to 1979, Mr. Prial worked for the Miller Brewing Company as an Area Manager in the Pacific Northwest. He received his Bachelor's degree in Management and Economics from Marietta College in Marietta, Ohio in 1977.

Allen L. Triplett (48) Vice President, Brewing

Mr. Triplett has served as Vice President, Brewing since March 1995. From 1987 to March 1995, he was the Company's Production Manager. He has worked in virtually every facet of production since joining the Company in 1985. Mr. Triplett has taken coursework at the Siebel Institute of Brewing and the University of California at Davis. He is a member of the Master Brewers Association of America and is currently serving as its Vice President in the Northwest district and formerly as its Secretary and Treasurer. He is also a member of the American Society of Brewing Chemists and a past and founding board member of National Ambassadors at the University of Wyoming.

He received his Bachelor's degree in Petroleum Engineering from the University of Wyoming in 1985.

Jay T. Caldwell (54) Chief Financial Officer and Treasurer

Mr. Caldwell has served as the Controller, Treasurer and Principal Accounting Officer since June 2006 prior to being selected as Chief Financial Officer in March 2007. During the first half of 2006 he performed financial consulting for Captaris, Inc. in Bellevue, WA. For the five years previous to that, he served as the General Manager of Arena Sports in Redmond, WA, where his primary responsibilities were running all aspects of retail arena

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operations. From 1997 to 2003, he owned Caldwell Resource Group, a consulting firm focused on evaluating acquisitions and negotiating service contracts in the telecommunications industry. Since beginning his career as a CPA with Haskins & Sells in 1977, Mr. Caldwell has also served in high level finance and accounting roles with manufacturing and software companies.

There is no family relationship between any directors or executive officers of the Company.

PART II.**Item 5. *Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities***

The Company's Common Stock trades on the NASDAQ Stock Market under the trading symbol HOOK. The table below sets forth, for the fiscal quarters indicated, the reported high and low sale prices of the Company's Common Stock, as reported on the NASDAQ Stock Market:

	High	Low
2006		
First quarter	\$ 3.74	\$ 3.10
Second quarter	\$ 4.00	\$ 3.43
Third quarter	\$ 4.18	\$ 3.31
Fourth quarter	\$ 5.31	\$ 3.76
2005		
First quarter	\$ 4.20	\$ 3.05
Second quarter	\$ 3.75	\$ 2.86
Third quarter	\$ 3.34	\$ 2.75
Fourth quarter	\$ 3.42	\$ 2.90

As of March 20, 2007, there were 700 Common Stockholders of record, although the Company believes that the number of beneficial owners of its Common Stock is substantially greater.

The Company has not paid any dividends since 1994. The Company anticipates that for the foreseeable future, all earnings, if any, will be retained for the operation and expansion of its business and that it will not pay cash dividends. The payment of dividends, if any, in the future will be at the discretion of the board of directors and will depend upon, among other things, future earnings, capital requirements, restrictions in future financing agreements, the general financial condition of the Company and general business conditions.

Table of Contents**Comparative Performance Graph**

Set forth below is a graph comparing the cumulative total return to shareholders on the Company's Common Stock with the cumulative total return of the Russell 2000 Index and an index comprised of other publicly-traded craft beer companies (the Peer Group) for the period beginning on December 31, 2001 and ended on December 31, 2006. The total return on the Company's Common Stock, the Russell 2000 Index and the Peer Group Index assumes the value of each investment was \$100 on December 31, 2001, and that any dividends were reinvested. The points represent fiscal year-end index levels based on the last trading day in each fiscal year. Return information is historical and not necessarily indicative of future performance.

	2001	2002	2003	2004	2005	2006
Redhook	\$ 100	\$ 123	\$ 155	\$ 209	\$ 189	\$ 310
Peer Group Index	\$ 100	\$ 90	\$ 124	\$ 152	\$ 173	\$ 228
Russell 2000 Index	\$ 100	\$ 78	\$ 114	\$ 133	\$ 138	\$ 168

The Company's Peer Group is comprised of three publicly traded craft beer companies. As required, the returns of each of the component companies in the Peer Group return are calculated and weighted according to their respective market capitalization at the beginning of the period. The Peer Group is composed of: Big Rock Brewery Income Trust (formerly Big Rock Brewery Ltd.) (Toronto Stock Exchange: BR.UN-T); The Boston Beer Company, Inc. (NYSE: SAM); and Pyramid Breweries Inc. (NASDAQ: PMID).

Table of Contents**Item 6. Selected Financial Data**

The following selected financial data should be read in conjunction with the Company's Financial Statements and the Notes thereto and *Management's Discussion and Analysis of Financial Condition and Results of Operations* included elsewhere in this Form 10-K. The selected statement of operations and balance sheet data for, and as of the end of, each of the five years in the period ended December 31, 2006, are derived from the financial statements of the Company. The operating data are derived from unaudited information maintained by the Company.

	Year Ended December 31,				
	2006	2005	2004	2003	2002
Statement of Operations Data (in thousands except earnings (loss) per share):					
Sales	\$ 40,007	\$ 34,520	\$ 36,640	\$ 42,213	\$ 40,913
Less excise taxes	4,292	3,421	3,268	3,498	3,465
Net sales	35,715	31,099	33,372	38,715	37,448
Cost of sales	30,918	27,544	27,171	28,702	27,597
Gross profit	4,797	3,555	6,201	10,013	9,851
Selling, general and administrative expenses	6,848	6,784	7,639	11,689	10,910
Income from equity investment in Craft Brands	2,655	2,392	1,123		
Craft Brands shared formation expenses			535		
Operating income (loss)	604	(837)	(850)	(1,676)	(1,059)
Interest expense	347	271	189	192	230
Other income, net	384	125	116	59	30
Income (loss) before income taxes	641	(983)	(923)	(1,809)	(1,259)
Income tax provision (benefit)	125	217	331	30	(126)
Net income (loss)	\$ 516	\$ (1,200)	\$ (1,254)	\$ (1,839)	\$ (1,133)
Basic earnings (loss) per share	\$ 0.06	\$ (0.15)	\$ (0.18)	\$ (0.30)	\$ (0.18)
Diluted earnings (loss) per share	\$ 0.06	\$ (0.15)	\$ (0.18)	\$ (0.30)	\$ (0.18)
Operating Data (in barrels):					
Beer shipped	271,600	225,300	216,400	228,800	225,900
Production capacity, end of period(1)	460,000	375,000	375,000	375,000	360,000
Balance Sheet Data (in thousands):					
Cash and cash equivalents	\$ 9,435	\$ 6,436	\$ 5,590	\$ 6,123	\$ 7,007
Working capital	8,310	5,232	3,661	4,511	4,346

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Total assets	73,841	72,578	74,128	77,131	79,982
Long-term debt, net of current portion(2)	4,322	4,752	5,175	5,625	6,075
Convertible preferred stock				16,233	16,188
Common stockholders' equity	60,692	60,027	61,161	47,916	50,027

- (1) Based on the Company's estimate of theoretical production capacity of equipment, assuming ideal brewing conditions, installed as of the end of such period. Amounts do not reflect maximum designed production capacity. See *Management's Discussion and Analysis of Financial Condition and Results of Operations*.
- (2) Includes term loan and capital lease Obligations. See Note 7 to the Financial Statements included elsewhere herein.

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Item 7. *Management's Discussion and Analysis of Financial Condition and Results of Operations*

The following discussion and analysis should be read in conjunction with the Company's Financial Statements and Notes thereto included herein. 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 U.S. The Company produces its specialty bottled and draft products in two Company-owned breweries, one in the Seattle suburb of Woodinville, Washington and the other in Portsmouth, New Hampshire. Prior to July 1, 2004, the Company's sales consisted predominantly of sales of beer to third-party distributors and A-B through the Company's Distribution Alliance with A-B. Since July 1, 2004, the Company's sales have consisted of sales of product to Craft Brands and A-B. 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 U.S. 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. For additional information regarding Craft Brands and the A-B Distribution Agreement, see Item 1., Product Distribution Relationship with Anheuser-Busch, Incorporated and Relationship with Craft Brands Alliance LLC. See also Management's Discussion and Analysis of Financial Condition and Results of Operations Results of Operations *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.

For the year ended December 31, 2006, the Company had gross sales and a net income of \$40,007,000 and \$516,000, respectively, compared to gross sales and a net loss of \$34,520,000 and \$1,200,000, respectively, for the year ended December 31, 2005.

The Company's sales volume (shipments) increased 21% to 271,600 barrels in 2006 as compared to 225,300 barrels in 2005. 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 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. Beyond 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 from 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

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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 sales 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. Most states also collect an excise tax on the sale of beer.

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 210,000 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 expanded fermentation capacity during the 2002, 2003 and 2006, bringing the brewery's theoretical production capacity to approximately 210,000 barrels per year. During the spring of 2007 the Company plans to add four additional 400-barrel fermenters, one 70,000 pound grain silo and make process control automation upgrades to the New Hampshire brewery. Installation is expected to be completed by May 2007 and cost approximately \$1,000,000. This expansion will add approximately 25,000 barrels of capacity to the New Hampshire brewery. As with the 2003 and 2006 expansions, production capacity at the New Hampshire Brewery can be added in phases until the facility reaches its maximum designed production capacity of approximately 250,000 barrels per year, under ideal brewing conditions. Such increase will require additional capital expenditures, primarily for fermentation equipment, and production personnel. The decision to add capacity is affected by the availability of capital, construction constraints and anticipated sales in new and existing markets.

The Company's capacity utilization has a significant impact on gross profit. Generally, when facilities are operating at their maximum designed production capacities, profitability is favorably affected because fixed and semi-variable operating costs, such as depreciation and production salaries, are spread over a larger sales base. Because current period production levels have been below the Company's current production capacity, gross margins have been negatively impacted. This negative impact could be reduced if actual production increases.

In addition to capacity utilization, other factors that could affect cost of sales and gross margin include sales to Craft Brands at a price substantially below wholesale pricing levels, sales of contract beer at a pre-determined contract price, changes in freight charges, the availability and prices of raw materials and packaging materials, the mix between draft and bottled product sales, the sales mix of various bottled product packages, and fees related to the Distribution Agreement with A-B.

For additional information about risks and uncertainties facing the Company, see Item 1A. *Risk Factors* above.

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The following table sets forth, for the periods indicated, certain items from the Company's Statements of Operations expressed as a percentage of net sales:

	Year Ended December 31,		
	2006	2005	2004
Sales	112.0%	111.0%	109.8%
Less excise taxes	12.0%	11.0%	9.8%
Net sales	100.0%	100.0%	100.0%
Cost of sales	86.6%	88.6%	81.4%
Gross profit	13.4%	11.4%	18.6%
Selling, general and administrative expenses	19.2%	21.8%	22.9%
Income from equity investment in Craft Brands	7.4%	7.7%	3.4%
Craft Brands shared formation expenses			1.6%
Operating income (loss)	1.6%	(2.7)%	(2.5)%
Interest expense	1.0%	0.9%	0.6%
Other income, net	1.1%	0.4%	0.3%
Income (loss) before income taxes	1.7%	(3.2)%	(2.8)%
Income tax provision	0.3%	0.7%	1.0%
Net income (loss)	1.4%	(3.9)%	(3.8)%

Year Ended December 31, 2006 Compared to Year Ended December 31, 2005

The following table sets forth, for the periods indicated, a comparison of certain items from the Company's Statements of Operations (dollars are in thousands):

	Year Ended December 31,		Increase /	%
	2006	2005	(Decrease)	Change
Sales	\$ 40,007	\$ 34,520	\$ 5,487	15.9%
Less excise taxes	4,292	3,421	871	25.5%
Net sales	35,715	31,099	4,616	14.8%
Cost of sales	30,918	27,544	3,374	12.2%
Gross profit	4,797	3,555	1,242	34.9%

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Selling, general and administrative expenses	6,848	6,784	64	0.9%
Income from equity investment in Craft Brands	2,655	2,392	263	11.0%
Operating income (loss)	604	(837)	1,441	172.2%
Interest expense	347	271	76	28.0%
Other income, net	384	125	259	207.2%
Income (loss) before income taxes	641	(983)	1,624	165.2%
Income tax provision	125	217	(92)	42.4%
Net income (loss)	\$ 516	\$ (1,200)	\$ 1,716	143.0%
Beer shipped (in barrels)	271,600	225,300	46,300	20.6%

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Sales. Total sales increased \$5,487,000 in 2006 compared to 2005, impacted primarily by the following factors:

An increase in pricing and increase in shipments in the midwest and eastern U.S. resulted in a \$3,035,000 increase in sales in 2006;

An increase in pricing and decrease in shipments in the western U.S. (not including beer brewed on a contract basis) resulted in a \$345,000 decrease in sales in 2006;

An increase in shipments of beer brewed on a contract basis, partially offset by a decrease in pricing of these shipments, contributed to a \$2,483,000 increase in sales in 2006; and

Pub and other sales increased \$204,000 in 2006.

Shipments. The following table sets forth a comparison of shipments (in barrels) for the periods indicated:

	Year Ended December 31,						Increase / %	Change
	2006			2005				
	Draft	Bottles	Total	Draft	Bottles	Total		
	Shipped	Shipped	Shipped	Shipped	Shipped	Shipped		
A-B	44,600	56,800	101,400	39,700	45,400	85,100	16,300	19%
Craft Brands								
Alliance	37,200	85,400	122,600	39,900	86,600	126,500	(3,900)	(3%)
Contract brewing	43,000		43,000	8,900		8,900	34,100	383%
Pubs and other	3,400	1,200	4,600	3,500	1,300	4,800	(200)	(4%)
Total shipped	128,200	143,400	271,600	92,000	133,300	225,300	46,300	21%

At December 31, 2006 and 2005, the Company's products were distributed in 48 states. Shipments in the midwest and eastern U.S. Total sales volume in 2006 increased 21% to 271,600 barrels from 225,300 barrels in 2005, primarily driven by a substantial increase in beer brewed on a contract basis and an increase in shipments of Redhook products and *Widmer Hefeweizen* in the midwest and eastern U.S. Shipments of the Company's packaged products increased 8% while shipments of the Company's draft products increased 39%. Since the mid 1990s, the Company's sales of bottled beer have steadily increased as a percentage of total beer sales, excluding sales related to contract brewing. This migration toward increasing bottled beer sales has continued over the past two years, with 63% of total shipments, excluding contract brewing shipments, as bottle shipments versus 62% in 2005.

Contributing significantly to the 46,300 barrel increase in the Company's total shipments is an increase of 34,100 barrels of beer brewed at the Washington Brewery under a contract brewing arrangement with Widmer. In connection with the Supply and Distribution Agreement with Craft Brands, if shipments of the Company's products in the Craft Brands territory decrease as compared to the previous year's shipments, the Company has the right to brew Widmer products in an amount equal to the lower of (i) the Company's product shipment decrease or (ii) the Widmer product shipment increase (the "Contractual Obligation"). In addition, the Company may, pursuant to a Manufacturing and Licensing Agreement with Widmer, brew more beer for Widmer than the amount obligated by the Supply, Distribution and Licensing Agreement with Craft Brands. This Manufacturing and Licensing Agreement with Widmer

expires December 31, 2007. Under these contract brewing arrangements, the Company brewed and shipped 43,000 barrels and 8,900 barrels of Widmer draft beer in 2006 and 2005, respectively. Of these shipments, approximately 77% of 2006 barrels were in excess of the contractual obligation and 20% of 2005 barrels were in excess of the obligation. Excluding shipments under this arrangement, shipments of the Company's draft products increased 3% in the 2006 and total Company shipments increased 6%. Driven by the contractual obligation as well as Widmer's production needs, the Company anticipates that beer brewed and shipped in 2007 under the contract brewing arrangement with Widmer will increase significantly over 2006 levels. The Company expects this level of contract brewing for Widmer to end in the first half of 2008 as Widmer brings its own additional capacity on-line. The Company is evaluating alternatives to utilize the capacity that will become available upon the termination of the contract brewing. If the Company is unable to achieve significant growth through its own products or other alternative products, the Company may have significant unabsorbed overhead that would generate unfavorable financial results.

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Also included in the Company's total shipments is *Widmer Hefeweizen* brewed at the New Hampshire Brewery under a licensing arrangement with Widmer and distributed through A-B. The Company also sells *Widmer Hefeweizen* in the midwest and eastern U.S. under license from Widmer. *Widmer Hefeweizen* is a golden unfiltered wheat beer and is one of the leading American style Hefeweizens sold in the U.S. In 2003, the Company entered into a licensing agreement with Widmer to produce and sell the *Widmer Hefeweizen* brand in states east of the Mississippi River. In March 2005, the *Widmer Hefeweizen* distribution territory was expanded to include all of the Company's midwest and eastern markets. Brewing of this product is conducted at the New Hampshire Brewery under the supervision and assistance of *Widmer's* brewing staff to insure their brand's quality and matching taste profile. The term of this agreement expires February 1, 2008, with additional one-year automatic renewals unless either party notifies the other of its desire to have the term expire at the end of the then existing term at least 150 days prior to such expiration. The agreement may be terminated by either party at any time without cause pursuant to 150 days notice or for cause by either party under certain conditions. Additionally, Redhook and Widmer have entered into a side agreement providing that if Widmer terminates the licensing agreement or causes it to expire before December 31, 2009, Widmer will pay the Company a lump sum payment to partially compensate the Company for capital equipment expenditures made at the New Hampshire Brewery to support Widmer's growth. During the term of this agreement, Redhook will not brew, advertise, market, or distribute any product that is labeled or advertised as a Hefeweizen or any similar product in the agreed upon midwest and eastern territory. Brewing and selling of Redhook's Hefe-weizen was discontinued in conjunction with this agreement. The Company believes that the agreement increases capacity utilization and has strengthened the Company's product portfolio. The Company shipped 30,600 barrels and 25,600 barrels of *Widmer Hefeweizen* during 2006 and 2005, respectively; these shipments are included in the A-B and Non-wholesalers line in the table above. In the fourth quarter of 2006 *Widmer* began selling its *Hefeweizen* directly into Texas where the Company had not sold any *Widmer Hefeweizen* during the first nine months of 2006. If the *Widmer Licensing Agreement* were terminated early, or if *Widmer* gave notice of its election to terminate the agreement according to its term on February 1, 2008, the Company would need to look to replace the lost volume, either through new and existing Redhook products or alternative brewing relationships. If the Company is unable to replace the lost *Widmer* volume, the loss of revenue and the resulting excess capacity in the New Hampshire Brewery would have an adverse effect on the Company's financial performance.

Excluding shipments of beer brewed under the contract brewing arrangement with *Widmer* and under the *Widmer Hefeweizen* licensing agreement, total Company shipments, in the U.S., increased by 7,200 barrels, or 4% in 2006 as compared to 2005.

Sales in 2006 to Craft Brands represented approximately 45% of total shipments, or 122,600 barrels, compared to 56%, or 126,500 barrels in 2005. Contributing most significantly to the decline in shipments in the western U.S. were a 7% decline in shipments to California, a 3% decline in shipments to Washington State, and a 14% decline in shipments to Colorado. A significant portion of the Company's sales continue to be in the Pacific Northwest region, which the Company believes is one of the most competitive craft beer markets in the U.S., both in terms of number of market participants and consumer awareness. The Company continues to face extreme competitive pressure in Washington State, which is not only the Company's largest market but is also its oldest market. From 2000 through 2006, the Company has experienced a 24% decline in sales volume in Washington State. In 2006, sales of the Company's products in the CBA territory declined by 3% compared to 2005. Pricing of the company's products has increased and the level of promotion and discounting has declined, allowing the Company to achieve higher revenue per barrel, however, management believes there is a direct correlation to lower sales caused by higher net pricing. During this same period, CBA has been very successful selling the *Widmer* and *Kona* products. Although the Company enjoys the benefits of those successes through its profit-sharing arrangement with CBA, the Company believes it is critical for CBA to deliver success with the Redhook products in addition to the others. The Company has communicated this concern to CBA, and is working with CBA management to establish new brand management throughout the portfolio of Redhook products. CBA also responded to this concern by re-emphasizing their

commitment to Redhook products and CBA has set goals and objectives to improve performance of the Redhook products in 2007.

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Pricing and Fees. The Company sells its product at wholesale pricing levels in the midwest and eastern U.S., at lower than wholesale pricing levels to Craft Brands in the western U.S., and at agreed-upon pricing levels for beer brewed on a contract basis.

Redhook continues to sell its product at wholesale pricing levels in the midwest and eastern U.S. through sales to A-B. Average wholesale revenue per barrel for draft products, net of discounts, increased approximately 1% in 2006 compared to 2005. This increase in pricing accounted for an increase of approximately \$60,000 in total sales. Average wholesale revenue per barrel for bottle products, net of discounts, increased approximately 1% in 2006 compared to 2005. This increase in pricing accounted for an increase of approximately \$74,000 in total sales. Seldom, if ever, are pricing changes driven by an inflationary period. Instead, pricing changes implemented by the Company generally follow pricing changes initiated by large domestic or import brewing companies. While the Company has implemented modest price increases during the past few years, some of the benefit has been offset by competitive promotions and discounting. Additionally, the Company may experience a decline in sales in certain regions following a price increase.

The Company sells its product to Craft Brands at a price substantially below wholesale pricing levels pursuant to the Supply, Distribution and Licensing Agreement with Craft Brands; Craft Brands, in turn, advertises, markets, sells and distributes the product to wholesale outlets in the western U.S. through a distribution agreement between Craft Brands and A-B. The prices that the Company charges Craft Brands for draft product and for bottled product are determined by contractually defined formulas and are based on the twelve month average pricing ending September of the previous year for all Redhook and Widmer draft product and for all Redhook and Widmer bottled product sold by Craft Brands. The prices are adjusted on January 1st of each year. Average revenue per barrel for draft products sold to Craft Brands decreased approximately 2% in 2006 compared to 2005. This decrease in pricing accounted for a decrease of approximately \$81,000 in total sales. Average revenue per barrel for bottle products sold to Craft Brands increased 1% in 2006 compared to 2005 resulting in an increase of \$121,000 in total sales.

Average revenue per barrel on beer brewed on a contract basis for Widmer pursuant to the Supply, Distribution and Licensing Agreement with Craft Brands is generally at a price substantially lower than wholesale pricing levels. After the Contractual Obligation has been fulfilled pursuant to the Supply, Distribution and Licensing Agreement with Craft Brands, the price charged Widmer for any additional barrels brewed declines pursuant to the Manufacturing and Licensing Agreement with Widmer. This decline in price contributed to an overall 14 % decline in price for beer brewed on a contract basis for Widmer in 2006.

In connection with all sales through the July 1, 2004 A-B Distribution Agreement, the Company pays a Margin fee to A-B. The Margin does not apply to sales to the Company's retail operations or to dock sales. The Margin also does not apply to the Company's sales to Craft Brands because Craft Brands pays a comparable fee to A-B on its resale of the product. The A-B Distribution Agreement also provides that the Company shall pay an additional fee on shipments that exceed shipments in the same territory during fiscal 2003 (the Additional Margin). For 2006, the Margin was paid to A-B on shipments totaling 101,400 barrels to approximately 503 distribution points. For 2005, the Margin was paid to A-B on shipments totaling 85,100 barrels to approximately 472 distribution points. The Margin is reflected as a reduction of sales in the Company's statement of operations.

Retail Operations and Other Sales. Sales in the Company's retail operations and other sales increased \$204,000 to \$5,521,000 in 2006 from \$5,317,000 in 2005, primarily the result of an increase in special event and food sales.

Excise Taxes. Excise taxes increased \$871,000 to \$4,292,000 in 2006 compared to \$3,421,000 in 2005, primarily the result of the overall increase in 2006 shipments compared to 2005. The Company continues to be responsible for federal and state excise taxes for all shipments, including those to Craft Brands and those brewed under contract. The

comparability of excise taxes as a percentage of net sales is impacted by average revenue per barrel, the mix of sales in the midwest and eastern U.S., sales to Craft Brands, sales of beer brewed on a contract basis, pub sales, and the estimated annual average federal and state excise tax rates.

Cost of Sales. Comparing 2006 and 2005, cost of sales increased 12%, or \$3,374,000, yet declined on a per barrel basis. The decline on a per barrel basis is primarily attributable to a larger sales volume in 2006 than in 2005 being spread over approximately the same base of fixed and semi-variable costs. The Company's fixed and semi-

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variable costs included in cost of sales are depreciation, insurance, rent on the New Hampshire Brewery, utilities, and repair and maintenance charges.

In January 2003, the Company entered into a licensing agreement with Widmer to produce and sell *Widmer Hefeweizen* in states east of the Mississippi River. Brewing of this product is conducted at the New Hampshire Brewery under the supervision and assistance of Widmer's brewing staff to insure their brand's quality and matching taste profile. The Company's cost of sales includes a licensing fee of \$437,000 and \$399,000 for 2006 and 2005, respectively, in connection with the Company's shipment of 30,600 and 25,600 barrels of Widmer Hefeweizen in the midwest and eastern U.S. pursuant to a licensing agreement with Widmer. Shipments of Widmer Hefeweizen to states that were included in the expanded territory in 2005 are excluded from the computation of the licensing fee due to Widmer.

Based upon the breweries' combined theoretical production capacity under optimal year-round brewing conditions of 460,000 barrels and 375,000 barrels for 2006 and 2005, the utilization rates were 60% for each year. Capacity utilization rates are calculated by dividing the Company's total shipments by the combined theoretical production capacity.

Selling, General and Administrative Expenses. Selling, general and administrative expenses increased \$64,000 to \$6,848,000 for 2006, primarily due to an increase in salary expenses resulting from staff turnover and a highly competitive job market for employers. Selling, general and administrative expenses for 2006 also include \$54,000 for stock-based compensation expense incurred in the second quarter of 2006. On January 1, 2006, the Company adopted SFAS No. 123R, *Share-Based Payment*, which 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. This second quarter 2006 expense is solely attributable to stock options granted to the independent members of the board of directors in May 2006 as part of their director compensation package. No compensation expense was recognized in 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.

Income from Equity Investment in Craft Brands. In accordance with the Craft Brands operating agreement, the Company made a \$250,000 sales and marketing capital contribution to Craft Brands in 2004; the capital contribution was used by Craft Brands for expenses related to the marketing, advertising, and promotion of Redhook products (Special Marketing Expense). After giving effect to the allocation of the Special Marketing Expense, which was allocated 100% to Redhook, and giving effect to income attributable to the Kona brand, which is shared differently between the Company and Widmer through 2006, the operating agreement dictates that 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. For the year ended December 31, 2006, the Company's share of Craft Brands net income totaled \$2,655,000. For the year ended December 31, 2005, the Company's share of Craft Brands net income totaled \$2,392,000. This share of Craft Brands' profit was net of \$135,000 of the Special Marketing Expense that had been incurred by Craft Brands during the same period and was fully allocated to the Company. As of December 31, 2005, the entire \$250,000 2004 sales and marketing capital contribution made by the Company had been used by Craft Brands for designated Special Marketing Expenses and netted against Craft Brands' profits allocated to the Company. Net cash flow of Craft Brands, if any, is generally distributed monthly to the Company based on the Company's cash flow percentage of 42%. During 2006 and 2005, the Company received cash distributions of \$2,621,000 and \$2,769,000, respectively, representing its share of the net cash flow of Craft Brands.

Interest Expense. Interest expense was \$347,000 in 2006, up from \$271,000 in 2005. Higher average interest rates in 2006, partially offset by a declining term loan balance, resulted in an increase in interest expense.

Other Income, Net. Other income, net, increased by \$259,000 to \$384,000 in 2006 compared to income of \$125,000 in 2005. Results for 2006 include approximately \$295,000 of interest income, an increase of \$169,000 over 2005. Results for 2005 include approximately \$126,000 in interest income and \$26,000 resulting from loss on the disposal of brewing equipment.

Income Taxes. The Company's effective income tax rate was a 19.5% expense for 2006 and a 22.0% expense for 2005. Both periods include a provision for current state taxes. In 2006, the Company decreased the valuation

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allowance that covers net tax operating loss carry forwards and other net deferred tax assets by \$597,000. In 2005, the Company increased the valuation allowance by \$502,000. The valuation allowance covers a portion of the Company's deferred tax assets, specifically certain federal and state NOLs that may expire before the Company is able to utilize the tax benefit. Realization of the benefit is dependent on the Company's ability to generate future U.S. taxable income. To the extent that the Company is 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.

Craft Brands Alliance LLC

The Company has accounted for its investment in Craft Brands under the equity method, as outlined by APB No. 18, *The Equity Method of Accounting for Investments in Common Stock*. Pursuant to APB No. 18, the Company has recorded its share of Craft Brands' net income in the Company's statement of operations as income from equity investment in Craft Brands. Separate financial statements for Craft Brands are included in this Annual Report on Form 10-K in Part IV., Item 15. *Exhibits and Financial Statement Schedules*, in accordance with Rule 3-09 of Regulation S-X. The following summarizes a comparison of certain items from Craft Brands' statements of operations for the years ended December 31, 2006 and 2005.

Sales. Craft Brands' sales totaled \$68,703,000 and \$60,784,000 for the years ended December 31, 2006 and 2005. In addition to selling 122,600 barrels of the Company's product to wholesalers in the Western Territory during for the year ended December 31, 2006 and 126,500 barrels for the year ended December 31, 2005, Craft Brands also sold products brewed by Widmer and Kona Brewery LLC (Kona). Average wholesale revenue per barrel for all draft products sold by Craft Brands, net of discounts, increased approximately 3% during the 2006 as compared to 2005. Average wholesale revenue per barrel for all bottle products sold by Craft Brands, net of discounts, in 2006 remained relatively the same as compared to 2005. For 2006, average wholesale revenue per barrel for all products sold by Craft Brands was approximately the same in comparison to 2005. Craft Brands' sales efforts during 2006 and 2005 included a reduction in discounting on the Company's products. Craft Brands also pays a fee to A-B in connection with sales to A-B that are comparable to fees paid by the Company.

Cost of Sales. Cost of sales for Craft Brands totaled \$50,135,000 for the year ended December 31, 2006 and \$44,822,000 for the year ended December 31, 2005. On a per barrel basis, cost of sales decreased modestly due to prices at which Craft Brands purchased product from the Company and Widmer. Craft Brands purchases product from the Company and Widmer at prices substantially below wholesale pricing levels pursuant to the Supply and Distribution Agreement between Craft Brands and each of the Company and Widmer. Craft Brands has realized a slight increase in its average freight cost per barrel over the Company's historical costs, largely as a result of increased fuel costs. This has been somewhat offset by the use of A-B wholesaler support centers and increased Washington shipments of *Widmer Hefeweizen* from the Company's facility.

Selling, General and Administrative Expenses. Craft Brands' selling, general and administrative expenses totaled \$11,879,000 for year ended December 31, 2006 and \$9,708,000 for the year ended December 31, 2005, reflecting all advertising, marketing and promotion efforts for the Company's, Widmer's and Kona's brands. Higher sales and marketing costs contributed to the increase from 2005 to 2006 as a result of the hiring of several new positions, the development and implementation of a web-based ordering system for wholesaler support items, the development of new packaging materials, and increased promotional activities. Selling, general and administrative expenses of Craft Brands for the first quarter of 2005 include approximately \$135,000 of designated Special Marketing Expenses.

Net Income. Craft Brands' net income totaled \$6,339,000 for the year ended December 31, 2006 and \$5,924,000 for the year ended December 31, 2005. The Company's share of Craft Brands' net income totaled \$2,655,000 and \$2,392,000 for these respective periods. After giving effect to the allocation of the Special Marketing Expense, which

is allocated 100% to Redhook, and giving effect to income attributable to the Kona brand, which is shared differently between the Company and Widmer through 2006, the Operating Agreement dictates that 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.

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The following table sets forth, for the periods indicated, a comparison of certain items from the Company's Statements of Operations (dollars are in thousands):

	Year Ended December 31,		Increase /	%
	2005	2004	(Decrease)	Change
Sales	\$ 34,520	\$ 36,640	\$ (2,120)	5.8%
Less excise taxes	3,421	3,268	153	4.7%
Net sales	31,099	33,372	(2,273)	6.8%
Cost of sales	27,544	27,171	373	1.4%
Gross profit	3,555	6,201	(2,646)	42.7%
Selling, general and administrative expenses	6,784	7,639	(855)	11.2%
Income from equity investment in Craft Brands	2,392	1,123	1,269	113.0%
Craft Brands shared formation expenses		535	(535)	
Operating income (loss)	(837)	(850)	13	1.5%
Interest expense	271	189	82	43.4%
Other income, net	125	116	9	7.8%
Income (loss) before income taxes	(983)	(923)	(60)	6.5%
Income tax provision	217	331	(114)	34.4%
Net income (loss)	\$ (1,200)	\$ (1,254)	\$ 54	4.3%
Beer shipped (in barrels)	225,300	216,400	8,900	4.1%

Sales. Total sales declined \$2,120,000 in 2005 as compared to 2004, impacted by the following factors:

While all sales in the western U.S. in 2005 were made to Craft Brands at discounted rates, sales in the western U.S. in 2004 were at two distinct pricing levels – at historical wholesale prices for the first six months of 2004, and at discounted rates for the last six months of 2004. This difference in the pricing structure for 2005 relative to 2004 resulted in a \$3,830,000 decline in total sales in 2005;

Improvements in overall pricing to Craft Brands resulted in a \$245,000 increase in sales in 2005;

A decline in shipments in the western U.S. resulted in an \$855,000 decline in sales in 2005 over 2004;

An increase in shipments of beer brewed on a contract basis as well as an improvement in pricing of these shipments contributed a \$480,000 increase in sales in 2005;

Improvements in overall pricing in the midwest and eastern U.S. resulted in a \$280,000 increase in sales in 2005 over 2004;

An increase in shipments in the midwest and eastern U.S. resulted in a \$995,000 increase in sales in 2005; and

An increase of \$269,000 in pub and other sales in 2005.

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Shipments. The following table sets forth a comparison of shipments (in barrels) for the periods indicated:

	Year Ended December 31,						Increase/ (Decrease)	% Change
	Draft Shipped	2005 Bottles Shipped	Total Shipped	Draft Shipped	2004 Bottles Shipped	Total Shipped		
A-B	39,700	45,400	85,100	33,600	44,200	77,800	7,300	9%
Craft Brands								
Alliance *	39,900	86,600	126,500	41,100	90,500	131,600	(5,100)	(4%)
Contract brewing	8,900		8,900	2,300		2,300	6,600	287%
Pubs and other	3,500	1,300	4,800	3,400	1,300	4,700	100	2%
Total shipped	92,000	133,300	225,300	80,400	136,000	216,400	8,900	4%

* Distribution through Craft Brands Alliance did not exist prior to July 1, 2004. Shipments from January 1, 2004 to June 30, 2004 were distributed through A-B, however for comparative purposes the Company has included these shipments in this line item. Shipments of products in the pre-Craft Brands Alliance territory for January 1, 2004 to June 30, 2006 were 68,000 barrels.

Total sales volume in 2005 increased 4% to 225,300 barrels from 216,400 barrels in 2004, the result of a 14% increase in shipments of draft products and partially offset by a 2% decrease in shipments of bottled products. Since the mid 1990s, the Company's sales of bottled beer have steadily increased as a percentage of total beer sales, excluding sales related to contract brewing. This migration toward increasing bottled beer sales has continued over the past two years, with 62% of total shipments, excluding contract brewing shipments, as bottle shipments versus 63% in 2004.

Included in the Company's total shipments is beer brewed under a contract brewing arrangement with Widmer. In connection with the Supply and Distribution Agreement with Craft Brands, if shipments of the Company's products in the Craft Brands territory decrease as compared to the previous year's shipments, the Company has the right to brew Widmer products in an amount equal to the lower of (i) the Company's product shipment decrease or (ii) the Widmer product shipment increase. In addition, the Company may, at Widmer's request, agree to brew beer for Widmer in excess of the amount obligated by the contract. Under this contract brewing arrangement, the Company brewed and shipped 8,900 barrels and 2,300 barrels of Widmer draft beer in 2005 and 2004, respectively. Of these shipments, approximately 20% of 2005 barrels were in excess of the contractual obligation and all of the 2004 barrels were in excess of the obligation. Excluding shipments under this arrangement, shipments of the Company's draft products increased 6% and total Company shipments increased 1% compared to 2005.

At December 31, 2005 and 2004, the Company's products were distributed in 48 states. Shipments in the midwest and eastern U.S. increased by 9% in 2005 as compared to the same 2004 period but were partially offset by a 4% decline in shipments in the western U.S. Contributing most significantly to the decline in shipments in the western U.S. were a 5% decrease in shipments to California and an 19% decrease in shipments to Colorado, primarily attributable to a decrease in price discounting. A significant portion of the Company's sales continue to be in the Pacific Northwest region, which the Company believes is one of the most competitive craft beer markets in the U.S., both in terms of number of market participants and consumer awareness. The Company faces extreme competitive pressure in

Washington State, which is not only the Company's largest market but is also its oldest market. From 2000 through 2005, the Company has experienced a decline in sales volume in Washington State of approximately 20%. Shipments to Washington State decreased by 2% in 2005 compared to 2004. Management believes that the decline can be partially attributable to the relative maturity of the brand in this region and, more recently, the formation of Craft Brands. The Company believes that the beer industry is influenced by individual relationships. The transition to Craft Brands impacted its established wholesaler and retailer relationships which, prior to Craft Brands, had existed for many years. Because the transition to Craft Brands took longer than anticipated, and because nearly all the Company's sales staff responsible for Washington State left the Company, the Company and Craft Brands have had to re-establish many of these relationships with wholesalers and retailers. During the second quarter of 2005, Craft Brands introduced in the western U.S. several major marketing initiatives aimed at updating the Redhook brand image, including a proprietary Redhook bottle and new packaging design, combined with a new marketing campaign. Sales have also been impacted by a reduction in the pricing promotions historically offered in these regions.

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Sales to Craft Brands represented approximately 56% of total shipments, or 126,500 barrels in 2005, compared to 29% of total shipments, or 63,600 barrels in 2004.

Pricing and Fees. The Company sells its product at wholesale pricing levels in the midwest and eastern U.S., at lower than historical wholesale pricing levels to Craft Brands in the western U.S., and at agreed-upon pricing levels for beer brewed on a contract basis.

The Company continues to sell its product at wholesale pricing levels in the midwest and eastern U.S. through sales to A-B. Average wholesale revenue per barrel for draft products, net of discounts, increased approximately 6% in 2005 as compared to 2004. Average wholesale revenue per barrel for bottled products, net of discounts, decreased approximately 1% in 2005 as compared to 2004. Seldom, if ever, are pricing changes driven by an inflationary period. Instead, pricing changes implemented by the Company generally follow pricing changes initiated by large domestic or import brewing companies. While the Company has implemented modest pricing increases during the past few years, some of the benefit has been offset by competitive promotions and discounting. Additionally, the Company may experience a decline in sales in certain regions following a price increase.

The Company sells its product to Craft Brands at a price substantially below historical wholesale pricing levels pursuant to a Supply and Distribution Agreement with Craft Brands; Craft Brands, in turn, advertises, markets, sells and distributes the product to wholesale outlets in the western U.S. through a distribution agreement between Craft Brands and A-B. Average revenue per barrel for draft products sold to Craft Brands increased approximately 1% in 2005 as compared to 2004. Average revenue per barrel for bottled products sold to Craft Brands increased approximately 4% in 2005 as compared to 2004. The price charged Craft Brands is generally adjusted annually. Because Craft Brands formation did not occur until July 2004, approximately 68,000 barrels sold in the western U.S. in the first half of 2004 were at historical wholesale pricing levels.

Average revenue per barrel on beer brewed on a contract basis is at agreed upon pricing levels between the Company and its customers and is generally at a price substantially lower than historical wholesale pricing levels.

In connection with all sales through the Distribution Alliance prior to July 1, 2004, the Company paid a Margin fee to A-B. The Margin did not apply to sales to wholesalers and others that were part of the A-B distribution network but that were not part of the Distribution Alliance, including most sales to Washington State wholesalers, sales to non-A-B wholesalers, sales by the Company's retail operations, and dock sales. The July 1, 2004 A-B Distribution Agreement modified the Margin fee structure such that the Margin per barrel shipped increased and is paid on all sales through the new A-B Distribution Agreement. The Margin does not apply to sales to the Company's retail operations or to dock sales. The Margin also does not apply to the Company's sales to Craft Brands because Craft Brands pays a comparable fee to A-B on its resale of the product. The A-B Distribution Agreement also provides that the Company shall pay an additional fee on shipments that exceed shipments for the same territory during fiscal 2003 (the

Additional Margin). In addition, the Exchange and Recapitalization Agreement provided that the Margin be retroactively increased to the rate provided in the A-B Distribution Agreement for all shipments in June 2004. In 2005, the Margin was paid to A-B on shipments totaling 85,100 barrels to 472 distribution points. Because 2005 shipments in the midwest and eastern U.S. exceeded 2003 shipments in the same territory, the Company paid A-B the Additional Margin on 7,000 barrels. For the six month period ended December 31, 2004, the Margin was paid to A-B on shipments totaling 38,000 barrels to 371 distribution points and the retroactive increase on June 2004 shipments was paid on approximately 20,000 barrels. For the six months ended June 30, 2004, the Margin was paid to A-B on shipments totaling 84,000 barrels to 495 Alliance distribution points. The Margin paid is reflected as a reduction of sales in the Company's statements of operations.

Retail Operations and Other Sales. Sales in the Company's retail operations and other sales increased \$465,000 to \$5,317,000 in 2005 from \$4,851,000 for same 2004 period, primarily the result of an increase in special event and food sales.

Excise Taxes. Excise taxes increased \$153,000 to \$3,421,000 in 2005 compared to \$3,268,000 in 2004, primarily the result of the overall increase in 2005 shipments compared to 2004. The Company continues to be responsible for federal and state excise taxes for all shipments, including those to Craft Brands and those brewed under contract. The comparability of excise taxes as a percentage of net sales is impacted by average revenue per barrel, the mix of sales in the midwest and eastern U.S., sales to Craft Brands, sales of beer brewed on a contract basis, pub sales, and the estimated annual average federal and state excise tax rates.

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Cost of Sales. Comparing 2005 and 2004, cost of sales increased 1%, or \$373,000, yet declined on a per barrel basis. The decline on a per barrel basis is primarily attributable to a decrease in freight, offset by a slight increase in the cost of new packaging. Although the Company experienced higher freight costs on shipments to midwest and eastern markets during the second half of 2005, full year freight costs declined by nearly 27% compared to 2004, as the cost of shipping Redhook products in the western U.S. became the responsibility of Craft Brands in the third quarter of 2004. The Company introduced a new packaging and label design in the western U.S. markets in May 2005 and in midwest and eastern U.S. in the fourth quarter of 2005. Based upon the breweries' combined theoretical production capacity of 375,000 barrels for 2005 and 2004, the utilization rates were 60% and 58%, respectively. Capacity utilization rates are calculated by dividing the Company's total shipments by the combined theoretical production capacity.

In January 2003, the Company entered into a licensing agreement with Widmer to produce and sell *Widmer Hefeweizen* in states east of the Mississippi River. Brewing of this product is conducted at the New Hampshire Brewery under the supervision and assistance of Widmer's brewing staff to insure their brand's quality and matching taste profile. The Company shipped 25,600 and 17,800 barrels of *Widmer Hefeweizen* during 2005 and 2004, respectively. A licensing fee of \$399,000 and \$266,000 due to Widmer is reflected in the Company's statement of operations for the years ended December 31, 2005 and 2004, respectively.

Selling, General and Administrative Expenses. Selling, general and administrative expenses decreased \$855,000 to \$6,784,000 from expenses of \$7,639,000 in 2004, significantly impacted by the formation of Craft Brands. A significant reduction in advertising, marketing and selling costs in the western U.S. following the transition to Craft Brands was somewhat offset by an increase in advertising and promotional spending and additional sales personnel in midwest and eastern markets. While the Company and Widmer sought the regulatory approval required for Craft Brands to become fully operational, they agreed to share certain sales-related costs, primarily salaries and overhead. The Company's share of those costs totaled \$554,000 in 2004 and is reflected in the Company's statement of operations as selling, general and administrative expenses.

Income from Equity Investment in Craft Brands. In accordance with the Craft Brands Operating Agreement, the Company made a \$250,000 sales and marketing capital contribution to Craft Brands, which was to be used by Craft Brands for expenses related to the marketing, advertising, and promotion of Redhook products. After giving effect to the allocation of the sales and marketing contribution, which is allocated 100% to Redhook, and giving effect to income attributable to the Kona brand, which is shared differently between the Company and Widmer through 2006, the Operating Agreement dictates that 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. For the year ended December 31, 2005, the Company's share of Craft Brands net income totaled \$2,392,000. This share of Craft Brands profit was net of \$135,000 of the Special Marketing Expense that had been incurred by Craft Brands during the same period and was fully allocated to the Company. As of December 31, 2005, the entire \$250,000 2004 sales and marketing capital contribution made by the Company had been used by Craft Brands for designated Special Marketing Expenses and netted against Craft Brands' profits allocated to the Company. For the six months ended December 31, 2004, the Company's share of Craft Brands' net income totaled \$1,123,000. This share of Craft Brands' profit was net of \$115,000 of the Special Marketing Expense that had been incurred by Craft Brands during the same period and was fully allocated to the Company. Net cash flow of Craft Brands, if any, is generally distributed monthly to the Company based on the Company's cash flow percentage of 42%. During the 2005 and 2004, the Company received cash distributions of \$2,769,000 and \$903,000, respectively, representing its share of the net cash flow of Craft Brands.

Craft Brands Shared Formation Expenses. In conjunction with the formation of Craft Brands, both the Company and Widmer incurred certain start-up expenses, including severance expenses and legal fees. The Company's operating

income (loss) reflects \$535,000 attributable to the Company's share of these expenses for the year ended December 31, 2004.

Interest Expense. Interest expense was \$271,000 in 2005, up from \$189,000 in 2004. Higher average interest rates in 2005, partially offset by a declining term loan balance, resulted in an increase in interest expense.

Other Income, Net. Other income, net increased by \$9,000 to income of \$125,000 in 2005 compared to income of \$116,000 in 2004. Results for 2005 include approximately \$126,000 in interest income earned on

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interest-bearing deposits and \$26,000 resulting from loss on the disposal of brewing equipment. Results for 2004 include approximately \$45,000 in interest income earned on interest-bearing deposits and \$71,000 of other income, primarily consisting of a filing commission from a state taxing authority.

Income Taxes. The Company's effective income tax rate was a 22% expense in 2005 as compared to a 36% expense for in 2004. In 2005 and 2004, the Company increased the valuation allowance by \$502,000 and \$416,000, respectively, to cover net tax operating loss carry forwards and other net deferred tax assets. The valuation allowance covers a portion of the Company's deferred tax assets, specifically certain federal and state NOLs that may expire before the Company is able to utilize the tax benefit. Realization of the benefit is dependent on the Company's ability to generate future U.S. taxable income. 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.

Craft Brands Alliance LLC

The Company has accounted for its investment in Craft Brands under the equity method, as outlined by APB No. 18, *The Equity Method of Accounting for Investments in Common Stock*. Pursuant to APB No. 18, the Company has recorded its share of Craft Brands' net income in the Company's statement of operations as income from equity investment in Craft Brands. Separate financial statements for Craft Brands are included in this Annual Report on Form 10-K in Part IV., Item 15. *Exhibits and Financial Statement Schedules*, in accordance with Rule 3-09 of Regulation S-X. The following summarizes a comparison of certain items from Craft Brands' statements of operations for the year ended December 31, 2005 and the six months ended December 31, 2004.

Sales. Craft Brands' sales totaled \$60,784,000 for the year ended December 31, 2005 and \$27,777,000 for the six months ended December 31, 2004. In addition to selling 126,500 barrels of the Company's product to wholesalers in the Western Territory during the year ended December 31, 2005 and 63,600 barrels during the six months ended December 31, 2004, Craft Brands also sold products brewed by Widmer and Kona Brewery LLC (Kona). Average wholesale revenue per barrel for all draft products sold by Craft Brands, net of discounts, increased approximately 1% during the twelve months of 2005 as compared to the six months of 2004. Average wholesale revenue per barrel for all bottle products sold by Craft Brands, net of discounts, increased approximately 2% during the twelve months of 2005 as compared to the six months of 2004. For the year ended December 31, 2005, average wholesale revenue per barrel for all products sold by Craft Brands was approximately 5% higher than average wholesale revenue per barrel on sales to wholesalers by the Company during the same period. Craft Brands' sales efforts during 2005 and 2004 included a reduction in discounting on the Company's products. Craft Brands also pays a fee to A-B in connection with sales to A-B that are comparable to fees paid by the Company.

Cost of Sales. Cost of sales for Craft Brands totaled \$44,822,000 for the year ended December 31, 2005 and \$20,104,000 for the six months ended December 31, 2004. On a per barrel basis, cost of sales increased modestly due to prices at which Craft Brands purchased product from the Company and Widmer. Craft Brands purchases product from the Company and Widmer at prices substantially below wholesale pricing levels pursuant to the Supply and Distribution Agreement between Craft Brands and each of the Company and Widmer. Craft Brands has realized improvement in its average freight cost per barrel over the Company's historical costs, largely as a result of synergies created by negotiating its shipping relationships as a single larger entity.

Selling, General and Administrative Expenses. Craft Brands' selling, general and administrative expenses totaled \$9,708,000 for year ended December 31, 2005 and \$4,704,000 for the six months ended December 31, 2004, reflecting all advertising, marketing and promotion efforts for the Company's, Widmer's and Kona's brands. During 2005, Craft Brands focused significant effort on advertising and promotion in conjunction with the May 2005 introduction of new packaging for the Company's bottled product. Selling, general and administrative expenses of

Craft Brands for 2005 includes approximately \$135,000 designated as Special Marketing Expense. During the six months ended December 31, 2004, Craft Brands suspended many of the Company's major advertising and promotion efforts while it completed an assessment of the Redhook brand. Selling, general and administrative expenses of Craft Brands for the six months ended December 31, 2004 includes approximately \$115,000 designated as Special Marketing Expense. As of December 31, 2005, the entire \$250,000 2004 sales and marketing capital

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contribution made by the Company had been used by Craft Brands for designated Special Marketing Expenses and netted against Craft Brands' 2004 and 2005 profits allocated to the Company.

Net Income. Craft Brands' net income totaled \$5,924,000 for the year ended December 31, 2005 and \$2,869,000 for the six months ended December 31, 2004. The Company's share of Craft Brands' net income totaled \$2,392,000 and \$1,123,000 for these respective periods. After giving effect to the allocation of the Special Marketing Expense, which is allocated 100% to Redhook, and giving effect to income attributable to the Kona brand, which is shared differently between the Company and Widmer through 2006, the Operating Agreement dictates that 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.

Liquidity and Capital Resources

The Company has required capital principally for the construction and development of its production facilities. Historically, the Company has financed its capital requirements through cash flow from operations, bank borrowings and the sale of common and preferred stock. The Company expects to meet its future financing needs and working capital and capital expenditure requirements through cash on hand, operating cash flow and bank borrowings, and to the extent required and available, offerings of debt or equity securities.

The Company had \$9,435,000 and \$6,436,000 of cash and cash equivalents at December 31, 2006 and 2005, respectively. At December 31, 2006 and 2005, the Company had working capital of \$8,310,000 and \$5,232,000. The Company's long-term debt as a percentage of total capitalization (long-term debt and common stockholders' equity) was 6.6% and 7.3% as of December 31, 2006 and 2005, respectively. Cash provided by operating activities increased by \$3,151,000 in 2006 from \$1,509,000 in 2005. Cash provided by operating activities was higher in 2006 as a result of an increase in overall sales and higher gross margins due to lower cost of sales per barrel compared to 2005. Cost of sales is lower due to certain fixed and semi-variable costs included in cost of sales being spread over a larger sales volume for 2006 compared to 2005.

In 2006, the Company's capital expenditures totaled \$1,332,000. This amount includes \$36,000 of non-cash capital expenditures for capital lease acquisitions made during 2006 for brewery equipment, \$260,000 related to upgrades to brewing equipment at the Washington Brewery and \$540,000 related to the expansion of fermentation capacity in the New Hampshire Brewery that was completed in late July 2006. Capital expenditures for fiscal year 2006 were more than the anticipated \$888,000 due to the additional cost associated with the cellar expansion in New Hampshire in December 2006. This cellar expansion is related to the Company's plans to bring on-line an additional 25,000 barrels of fermentation capacity in 2007 at an estimated cost of \$1,000,000. Capital expenditures will be funded with operating cash flows.

In connection with the shipment of its draft products to wholesalers through the A-B Distribution Agreement, the Company collects refundable deposits on its kegs. Because wholesalers generally hold an inventory of the Company's kegs at their warehouse and in retail establishments, A-B assists in monitoring the inventory of kegs to insure that the wholesaler can account for all kegs shipped. When a wholesaler cannot account for some of the Company's kegs for which it is responsible, the wholesaler pays the Company a fixed fee and also forfeits its deposit for each keg determined to be lost. For the years ended December 31, 2006 and 2005, the Company reduced its brewery equipment by \$643,000 and \$305,000, which consists of lost keg fees and forfeited deposits.

The Company has a credit agreement with a bank under which a term loan (the "Term Loan") is provided. In June 2006, the credit agreement was amended to extend the maturity date from June 5, 2007 to June 5, 2012. The Term Loan is secured by substantially all of the Company's assets. Interest on the Term Loan accrues at London Inter Bank Offered Rate ("LIBOR") plus 1.75% and the Company has the option to fix the applicable interest rate for up to twelve months

by selecting LIBOR for one- to twelve- month periods as a base. As of December 31, 2006, there was \$4,725,000 outstanding on the Term Loan, and the Company's one-month LIBOR-based borrowing rate was 7.1%. The termination of the A-B Distribution Agreement for any reason would constitute an event of default under the credit agreement and the bank may declare the entire outstanding loan balance immediately due and payable. If this were to occur, the Company could seek to refinance its Term Loan with one or more banks or obtain additional equity capital; however, there can be no assurance the Company would be able to access additional capital to meet its needs or that such additional capital would be at commercially reasonable terms.

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The terms of the credit agreement require the Company to meet certain financial covenants. The Company was in compliance with all covenants at December 31, 2006 and expects that it will remain in compliance with its debt covenants for the next twelve months. In December 2001, March 2003, February 2004 and October 2004, the credit agreement was amended to modify several financial covenants. In January 2006, the credit agreement was amended to eliminate the tangible net worth covenant (shareholders' equity less intangible assets) as of the year ended December 31, 2005. These modifications to the financial covenants have reduced the likelihood that a violation of the covenants by the Company will occur in the future. However, if the Company were to report a significant net loss for one or more quarters within a time period covered by the financial covenants, one or more of the covenants would be negatively impacted and could result in a violation. Failure to meet the covenants required by the credit agreement is an event of default and, at its option, the bank could deny a request for a waiver and declare the entire outstanding loan balance immediately due and payable. In such a case, the Company would seek to refinance the loan with one or more banks, potentially at less desirable terms. However, there can be no guarantee that additional financing would be available at commercially reasonable terms, if at all.

The following table summarizes the financial covenants required by the Term Loan and the Company's current level of compliance with these covenants:

	Required by Term Loan	Quarter Ended December 31, 2006
Capital ratio	Less than: 1.25:1	0.22:1
Working capital	Greater than: \$1,900,000	\$8,309,940
Fixed charge coverage ratio	Greater than: 1.15:1	3.314:1

Contractual Commitments. The Company has certain commitments, contingencies and uncertainties relating to its normal operations. As of December 31, 2006, contractual commitments associated with the Company's long-term debt, operating leases and raw material purchase commitments are as follows:

	Year Ended December 31,						
	2007	2008	2009	2010	2011	Thereafter	Total
Long-term debt(1)	\$ 468	\$ 468	\$ 468	\$ 462	\$ 453	\$ 2,475	\$ 4,794
Operating leases(2)	70	70	102	272	276	11,728	12,518
Malt and hop commitments(3)	2,533	579					3,112
Other operational commitments(4)	138	101	31	21	19	1	311
	\$ 3,209	\$ 1,218	\$ 601	\$ 755	\$ 748	\$ 14,204	\$ 20,735

- (1) Represents annual principal payments required on the Company's Term Loan and annual lease payments (including portion of payments imputed as interest) on capital lease obligations. Interest on the Term Loan accrues at LIBOR plus 1.75% and interest on capital leases are calculated at the Company's incremental borrowing rate at the inception of each lease. Monthly interest payments on the Term Loan are not reflected above. The termination of the A-B Distribution Agreement for any reason would constitute an event of default

under the credit agreement and the bank may declare the entire outstanding loan balance immediately due and payable.

- (2) Represents minimum aggregate future lease payments under noncancelable operating leases.
- (3) Represents purchase commitments to ensure that the Company has the necessary supply of malted barley and specialty hops to meet future production requirements. Payments for malted barley are made as deliveries are received. Hop contracts generally provide for payment upon delivery of the product with the balance due on any unshipped product during the year following the harvest year. The Company believes that, based upon its relationships with its hop suppliers, the risk of non-delivery is low and that if non-delivery of its required supply of hops were to occur, the Company would be able to purchase hops to support its operations from other competitive sources. Malt and hop commitments in excess of future requirements, if any, will not materially affect the Company's financial condition or results of operations.
- (4) Represents legally-binding production and operating purchase commitments.

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Certain Considerations: Issues and Uncertainties

The Company does not provide forecasts of future financial performance or sales volumes, although this Annual Report contains certain other types of forward-looking statements that involve risks and uncertainties. The Company may, in discussions of its future plans, objectives and expected performance in periodic reports filed by the Company with the Securities and Exchange Commission (or documents incorporated by reference therein) and in written and oral presentations made by the Company, include forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, or Section 21E of the Securities Exchange Act of 1934, as amended. Such forward-looking statements are based on assumptions that the Company believes are reasonable, but are by their nature inherently uncertain. In all cases, there can be no assurance that such assumptions will prove correct or that projected events will occur. Actual results could differ materially from those projected depending on a variety of factors, including, but not limited to, the successful execution of market development and other plans, and the availability of financing and the issues discussed in Item 1A. *Risk Factors* above. In the event of a negative outcome of any one these factors, the trading price of the Company's Common Stock could decline and an investment in the Company's Common Stock could be impaired.

Critical Accounting Policies and Estimates

The Company's financial statements are based upon the selection and application of significant accounting policies that require management to make significant estimates and assumptions. Management believes that the following are some of the more critical judgment areas in the application of the Company's accounting policies that currently affect its financial condition and results of operations. Judgments and uncertainties affecting the application of these policies may result in materially different amounts being reported under different conditions or using different assumptions.

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 carry forwards. As of December 31, 2006, the Company's deferred tax assets were primarily comprised of NOLs of \$26.5 million, or \$9.0 million tax-effected; federal and state alternative minimum tax credit carry forwards of \$166,000; and state NOL carry forwards of \$219,000 tax-effected. In assessing the realizability of the deferred tax assets, the Company considered whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. 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 takes into consideration, among other items, estimates of future taxable income related to depreciation. Based upon the available evidence, the Company does not believe it is more likely than not that all of the deferred tax assets will be realized. Accordingly, the Company established a valuation allowance in 2002, increased it further in 2003, 2004, and 2005 and decreased it in 2006 to cover certain federal and state NOLs that may expire before the Company is able to utilize the tax benefit. As of December 31, 2006 and 2005, the Company had a valuation allowance of \$1,059,000 and \$1,656,000, respectively. 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.

Long-Lived Assets. The Company evaluates potential impairment of long-lived assets in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. SFAS No. 144 establishes procedures for review of recoverability and measurement of impairment, if necessary, of long-lived assets, goodwill and certain identifiable intangibles. When facts and circumstances indicate that the carrying values of long-lived

assets may be impaired, an evaluation of recoverability is performed by comparing the carrying value of the assets to projected future undiscounted cash flows in addition to other quantitative and qualitative analyses. Upon indication that the carrying value of such assets may not be recoverable, the Company will recognize an impairment loss by a charge against current operations. Fixed assets are grouped at the lowest level for which there are identifiable cash flows when assessing impairment. During 2006, the Company performed an analysis of its

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brewery assets to determine if an impairment might exist. The Company's estimate of future undiscounted cash flows indicated that such carrying values were expected to be recovered. Nonetheless, it is possible that the estimate of future undiscounted cash flows may change in the future, resulting in the need to write down those assets to their fair value.

Investment in Craft Brands. The Company has assessed its investment in Craft Brands pursuant to the provisions of FIN No. 46R, *Consolidation of Variable Interest Entities – an Interpretation of ARB No. 51*. 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 Brands with the financial statements of the Company, but instead accounted for its investment in Craft Brands under the equity method, as outlined by 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 in 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 in the Company's balance sheet. The Company does not control the amount or timing of cash distributions by Craft Brands. The Company recognized \$2,655,000 and \$2,392,000 of undistributed earnings related to its investment in Craft Brands for the years ended December 31, 2006 and 2005, respectively. The Company received cash distributions of \$2,621,000 and \$2,769,000, representing its share of the net cash flow of Craft Brands for the years ended December 31, 2006 and 2005, respectively. The Company's share of the earnings of Craft Brands contributed a significant portion of income to the Company's results of operations. Separate financial statements for Craft Brands are filed with this Annual Report on Form 10-K in Part IV., Item 15. *Exhibits and Financial Statement Schedules*, in accordance with Rule 3-09 of Regulation S-X. The Company will periodically review its investment in Craft Brands to ensure that it complies with the guidelines prescribed by FIN No. 46R.

Revenue Recognition. The Company recognizes revenue from product sales, net of excise taxes, discounts and certain fees the Company must pay in connection with sales to A-B, when the products are shipped to customers. Although title and risk of loss do not transfer until delivery of the Company's products to A-B or the A-B distributor, the Company recognizes revenue upon shipment rather than when title passes because the time between shipment and delivery is short and product damage claims and returns are immaterial. The Company recognizes revenue on retail sales at the time of sale. The Company recognizes revenue from events at the time of the event.

Recent Accounting Pronouncements

In November 2004, the FASB issued SFAS No. 151, *Inventory Costs – an Amendment of ARB No. 43, Chapter 4*. SFAS No. 151 requires idle facility expenses, abnormal freight, handling costs, and wasted material (spoilage) to be recognized as current-period charges. In addition, SFAS No. 151 requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. SFAS No. 151 will be effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The adoption of this SFAS No. 151 has not had a material effect on the Company's financial condition or 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

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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. Stock-based compensation expense recognized in the Company's statement of operations for the year ended December 31, 2006 totaled \$54,000 and is solely attributable to stock options granted to the board of directors in May 2006. No compensation expense was recognized in 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.

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections*, which is a replacement of APB No. 20, *Accounting Changes*, and SFAS No. 3, *Reporting Accounting Changes in Interim Financial Statements*. Among other changes, SFAS No. 154 requires that a voluntary change in accounting principle be applied retrospectively such that all prior period financial statements are presented in accordance with the new accounting principle, unless impracticable to do so. SFAS No. 154 also provides that (1) a change in method of depreciating or amortizing a long-lived non-financial asset be accounted for as a change in estimate (prospectively) that was effected by a change in accounting principle, and (2) correction of errors in previously issued financial statements should be termed a restatement. SFAS No. 154 is effective for accounting changes and correction of errors made in fiscal years beginning after December 15, 2005. The Company is not currently contemplating an accounting change which would be impacted by SFAS No. 154.

In September 2004, the consensus of Emerging Issues Task Force (EITF) Issue No. 04-10, *Determining Whether to Aggregate Operating Segments That Do Not Meet the Quantitative Thresholds*, was published. EITF No. 04-10 addresses how an enterprise should evaluate the aggregation criteria of SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*, when determining whether operating segments that do not meet the quantitative thresholds may be aggregated in accordance with SFAS No. 131. The consensus in EITF No. 04-10 was applied for fiscal years ending after September 15, 2005. This consensus did not have an impact on the Company's disclosures.

In September 2005, the FASB ratified EITF No. 04-13, *Accounting for Purchases and Sales of Inventory with the Same Counterparty*. EITF No. 04-13 provides guidance on whether two or more inventory purchase and sales transactions with the same counterparty should be viewed as a single exchange transaction within the scope of APB No. 29, *Accounting for Nonmonetary Transactions*. In addition, EITF No. 04-13 indicates whether nonmonetary exchanges of inventory within the same line of business should be recognized at cost or fair value. EITF No. 04-13 was effective as of April 1, 2006. This consensus did not have an impact on the Company's financial statements.

In June 2006, the FASB ratified the consensus of EITF No. 06-3, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation)*. EITF No. 06-3 indicates that the income statement presentation on either a gross basis or a net basis of the taxes within the scope of the issue is an accounting policy decision. The Company's accounting policy is to present the taxes within the scope of EITF No. 06-3 on a gross basis. In accordance with the guidance presented in EITF No. 06-3, the Company's statements of operations separately disclose excise taxes, thus following the approach described as the gross basis.

In July 2006, the FASB issued FIN No. 48, *Accounting for Uncertainty in Income Taxes*. FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109, *Accounting for Income Taxes*. FIN No. 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a

tax return. FIN No. 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN No. 48 is effective for fiscal years beginning after December 15, 2006. An enterprise shall disclose the cumulative effect of the change on retained earnings in the statement of financial position as of the date of adoption and such disclosure is required only in the year of adoption. The Company is in the process of analyzing the implications of FIN No. 48. The Company does not anticipate this statement will have a material effect on its results of operations or financial condition.

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In September 2006, the SEC issued Staff Accounting Bulletin No. 108 (SAB No. 108), *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*. SAB No. 108 clarifies the SEC staff's beliefs regarding the process of quantifying financial statement misstatements and is effective for fiscal years ending after November 15, 2006. The Company does not expect SAB No. 108 to have a material impact on our financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in accordance with GAAP, and expands disclosures about fair value measurements. The standard applies whenever other standards require, or permit, assets or liabilities to be measured at fair value. This statement is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Early adoption is permitted. The Company is currently evaluating the requirements of SFAS No. 157 and has not yet determined the impact on the financial statements.

In February 2007, FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115*. SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. Early adoption is permitted. The Company is currently evaluating the requirements of SFAS No. 159 and has not yet determined the impact on the financial statements.

Item 7A. *Quantitative and Qualitative Disclosures about Market Risk*

The Company has assessed its vulnerability to certain market risks, including interest rate risk associated with financial instruments included in cash and cash equivalents and long-term debt. Due to the nature of these investments and the Company's investment policies, the Company believes that the risk associated with interest rate fluctuations related to these financial instruments does not pose a material risk.

The Company did not have any derivative financial instruments as of December 31, 2006.

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Item 8. *Financial Statements and Supplementary Data*

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of
Redhook Ale Brewery, Incorporated

We have audited the accompanying balance sheets of Redhook Ale Brewery, Incorporated (the Company) as of December 31, 2006 and 2005 and the related statements of operations, common stockholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Redhook Ale Brewery, Incorporated as of December 31, 2006 and 2005, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

As described in Note 3 to the financial statements, the Company adopted a new principle of accounting for share-based payments in accordance with Financial Accounting Standards Board Statement No. 123 R, Share-Based Payment.

Seattle, Washington
March 23, 2006

Table of Contents**REDHOOK ALE BREWERY, INCORPORATED****BALANCE SHEETS**

	December 31,	
	2006	2005
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 9,435,073	\$ 6,435,609
Accounts receivable, net of allowance for doubtful accounts of \$68,808 and \$7,599 in 2006 and 2005, respectively	1,842,388	1,297,404
Trade receivable from Craft Brands	854,507	698,272
Inventories	2,571,732	3,027,720
Deferred income tax asset, net	506,886	
Other	203,594	502,667
Total current assets	15,414,180	11,961,672
Fixed assets, net	58,076,434	60,379,901
Investment in Craft Brands	127,555	92,806
Other assets	222,573	143,326
Total assets	\$ 73,840,742	\$ 72,577,705
LIABILITIES AND COMMON STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 2,233,689	\$ 1,990,627
Trade payable to Craft Brands	324,900	367,590
Accrued salaries, wages and payroll taxes	1,547,482	1,259,823
Refundable deposits	2,153,127	2,440,796
Other accrued expenses	380,394	211,200
Current portion of long-term debt and capital lease obligations	464,648	459,245
Total current liabilities	7,104,240	6,729,281
Long-term debt and capital lease obligations, net of current portion	4,321,616	4,751,920
Deferred income tax liability, net	1,548,699	946,395
Other liabilities	173,768	123,542
Common stockholders equity:		
Common stock, par value \$0.005 per share, authorized, 50,000,000 Shares; issued and outstanding, 8,281,489 shares in 2006 and 8,222,609 shares in 2005	41,407	41,113
Additional paid-in capital	68,977,402	68,828,009
Retained deficit	(8,326,390)	(8,842,555)

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Total common stockholders' equity	60,692,419	60,026,567
Total liabilities and common stockholders' equity	\$ 73,840,742	\$ 72,577,705

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

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

	Year Ended December 31,		
	2006	2005	2004
Sales	\$ 40,006,708	\$ 34,520,401	\$ 36,639,552
Less excise taxes	4,292,324	3,421,494	3,267,513
Net sales	35,714,384	31,098,907	33,372,039
Cost of sales	30,918,137	27,543,639	27,171,255
Gross profit	4,796,247	3,555,268	6,200,784
Selling, general and administrative expenses	6,848,050	6,783,821	7,639,290
Income from equity investment in Craft Brands	2,655,248	2,391,936	1,123,283
Craft Brands shared formation expenses			534,628
Operating income (loss)	603,445	(836,617)	(849,851)
Interest expense	346,455	271,460	189,662
Other income, net	384,025	125,308	115,619
Income (loss) before income taxes	641,015	(982,769)	(923,894)
Income tax provision	124,850	217,674	331,000
Net income (loss)	\$ 516,165	\$ (1,200,443)	\$ (1,254,894)
Basic earnings (loss) per share	\$ 0.06	\$ (0.15)	\$ (0.18)
Diluted earnings (loss) per share	\$ 0.06	\$ (0.15)	\$ (0.18)

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

Table of Contents**REDHOOK ALE BREWERY, INCORPORATED****STATEMENTS OF COMMON STOCKHOLDERS EQUITY**

	Common Stock Shares	Par Value	Additional Paid-In Capital	Retained Deficit	Total Common Stockholders Equity
Balance as of January 1, 2004	6,226,306	\$ 31,132	\$ 54,250,059	\$ (6,365,018)	\$ 47,916,173
Issuance of common stock to A-B in exchange for Series B preferred stock	1,808,243	9,041	14,245,814		14,254,855
Issuance of common stock	153,650	768	265,893		266,661
Other				(22,200)	(22,200)
Net loss				(1,254,894)	(1,254,894)
Balance as of December 31, 2004	8,188,199	40,941	68,761,766	(7,642,112)	61,160,595
Issuance of common stock	34,410	172	66,243		66,415
Net loss				(1,200,443)	(1,200,443)
Balance as of December 31, 2005	8,222,609	41,113	68,828,009	(8,842,555)	60,026,567
Issuance of common stock	58,880	294	149,393		149,687
Net income				516,165	516,165
Balance as of December 31, 2006	8,281,489	\$ 41,407	\$ 68,977,402	\$ (8,326,390)	\$ 60,692,419

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

Table of Contents**REDHOOK ALE BREWERY, INCORPORATED****STATEMENTS OF CASH FLOWS**

	Year Ended December 31,		
	2006	2005	2004
Operating Activities			
Net income (loss)	\$ 516,165	\$ (1,200,443)	\$ (1,254,894)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Depreciation and amortization	2,999,916	2,938,088	2,944,412
Deferred income taxes	95,418	176,597	301,000
Loss on disposition of fixed assets		25,631	
Income from equity investment in Craft Brands less than (in excess of) cash distributions	(34,749)	377,195	(219,901)
Stock-based compensation	53,760		
Changes in operating assets and liabilities:			
Accounts receivable	(544,984)	(173,929)	563,260
Trade receivables from Craft Brands	(156,235)	(299,565)	(398,707)
Inventories	455,988	(27,411)	341,697
Other current assets	299,073	3,661	(259,290)
Other assets	(86,146)	(131,140)	4,400
Accounts payable and other accrued expenses	243,062	(128,676)	(274,059)
Trade payable to Craft Brands	(42,690)	(63,499)	431,089
Accrued salaries, wages and payroll taxes	287,659	39,575	(341,278)
Refundable deposits	354,850	(85,292)	253,760
Other liabilities	219,420	58,639	64,903
Net cash provided by operating activities	4,660,507	1,509,431	2,156,392
Investing Activities			
Expenditures for fixed assets	(1,295,668)	(585,392)	(252,098)
Investment in Craft Brands			(250,100)
Proceeds from disposition of fixed assets		305,260	
Other, net		4,961	(4,583)
Net cash used in investing activities	(1,295,668)	(275,171)	(506,781)
Financing Activities			
Payment to A-B pursuant to exchange and recapitalization agreement			(2,000,000)
Principal payments on debt and capital lease obligations	(461,302)	(454,687)	(450,000)
Issuance of common stock	95,927	66,415	266,661