Statement
of
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Before the
Senate Judiciary Subcommittee on Antitrust,
Competition Policy, and Consumer Rights

Ensuring Competition Remains on Tap:
The AB InBev/SABMiller Merger and the State
of Competition in the Beer Industry
Hearing
December 8, 2015

Chairman Lee, Ranking Member Klobuchar and distinguished members of the Subcommittee, on behalf of the nation's independent beer distributors (wholesalers) and their 130,000 employees, thank you for the opportunity to testify today.

I am here to discuss the proposed acquisition of SABMiller (SAB) by Anheuser-Busch InBev (ABI) – the number one and number two brewers in the world – as well as the sale of the MillerCoors joint venture to Molson Coors.

I will provide insight into how these two business deals could have competitive implications for the American independent beer distribution system, today's competitive marketplace and the vast choice and variety of beer available to consumers.

There's no question that America has entered a new golden age for beer, with unprecedented variety and quality offered by more than 4,000 breweries, compared to less than 50 in the 1980s. Sales by craft brewers grew nearly 18 percent in 2014, representing more than 11 percent of the overall beer market. You would be hard pressed to identify another industry that has experienced the same explosive growth in such a relatively short period of time.

But the true winner is the American consumer, who now enjoys an incredibly broad spectrum of innovative, independently produced beer products for every taste.

What makes this consumer choice possible? The evidence points to a robust and competitive system of *independent* distribution which reduces barriers to market for brewers of all sizes, creates a competitive playing field for brewers of all sizes and keeps pricing competitive for consumers.

A critical issue before this Subcommittee, and the full Judiciary Committee, as you consider these transactions is how to preserve America's golden age of beer – which is fueled by the *independent* beer distribution system.

The Proposed Transactions Lead to Further Industry Concentration

Consumer advocates, craft breweries, retailers and independent distributors have expressed concern that ABI's increased leverage and anticompetitive aspects of the proposed MillerCoors divestiture may reduce access to distribution – reducing choice and raising prices for consumers.

One understandable source of this concern is the sheer magnitude of the two transactions being proposed, which cannot be ignored. ABI, the largest brewer in the world, is attempting to acquire SAB, the second largest. Additionally, in the U.S., Molson Coors has agreed to purchase, from ABI, SABMiller's 58 percent stake in the MillerCoors joint venture and the global rights to both Miller and Coors legacy brands. Currently, ABI and the MillerCoors joint venture account for nearly 71 percent of beer sold in the U.S.

If the proposed deal closes, 57 percent of the world's global beer profit would fall within the ABI and SAB combination. By comparison, Heineken, the next largest *global competitor*, is at 11 percent, and Molson Coors, the largest *U.S. competitor* to ABI-SABMiller, would be just under 3 percent of that same global profit pool.[1]

The resulting concentration could upset the equilibrium of the current U.S. beer market, which today can be fairly characterized as a "consumer pull" marketplace, where the consumer possesses the power to create market demand for popular beer brands. Through coordination with local retailers and local, independent beer distributors, the market responds to that demand.

The scale and market power being proposed in this merger could lead to a "supplier push" method, where brewers possess the scale and market power to dictate brand choices and beer sales. The most likely way this happens is if the large brewers exert pressure on independent distributors not to carry rival brands and on retailers to design their shelves to disfavor or remove rival brands. Just a few days ago, the *Wall Street Journal* reported on distributor incentive deals that could greatly disadvantage craft and other brewers.

The Role of Independent Beer Distributors in the American Marketplace

In particular, these transactions could disrupt a critical component to the success of the industry: the combination of an open and independent distribution system with a state-based regulatory system that has worked so well for so many over the years.

The U.S. beer market is thriving because of a robust and competitive system of independent distribution that reduces barriers to entry, reduces brewer and consumer costs, and fosters the explosion of choice and variety desired by consumers.

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[1] http://www.businessinsider.com/sabmiller-ab-inbev-would-dominate-the-beer-market-2015-9

The Justice Department noted in its most recent beer merger review that, "Effective distribution is important for a brewer to be competitive in the beer industry."[2]

A study by the Boston Consulting Group [attachment] underscores that the current system of beer distribution in the U.S. is "open, freely competitive, and driven by consumer choice."

In the most general terms, independent beer distributors purchase beer from a variety of breweries and then sell and deliver beer products to local, licensed retail accounts.[3] Getting a new beer to market is something that beer distributors do every day with tremendous success.

In the current marketplace, independent beer distributors build brands by working with their licensed retail customers to meet consumer demand for choice and variety in products ranging from imported beer from around the world to new American craft beers and other malt-based products and ciders.

Beer distributors provide access to capital and scale for brewers and importers as they can purchase larger quantities of product and also offer warehousing, marketing, promotion, sales and delivery of a heavy, climate-sensitive, perishable product. In addition to these economies of scale, beer distributors also invest in labor, transportation, energy, product integrity and take on other relevant responsibilities related to the selling and transporting of beer.

Independent beer distributors also invest considerable time, energy and resources in developing relationships with both large and small "on-premise" retailers (like restaurants and entertainment venues) and "off-premise" retailers (like grocery stores and convenience stores) in their markets.

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[2] http://www.justice.gov/atr/case-document/file/486551/download

[3] Alcohol is regulated by the states under the 21st Amendment. As a result of this regulation most states have set up a three tier distribution of beer where the brewery sells to a local beer distributors who sells it to local, state licensed alcohol retailers. The United States Supreme Court has repeatedly upheld this system: "*States may also assume direct control of liquor distribution through state-run outlets or funnel sales through the three-tier system. We have previously recognized that the three-tier system itself is unquestionably legitimate*." Granholm v. Heald, 544 U.S. 460 (2005)

These distributor investments and relationships are an intangible value to brewers of all sizes by allowing them to receive the market attention that is necessary to compete, prosper and grow.

The photographs below illustrate the value of the existing system of beer distribution by highlighting the marked distinction between the consumer choice and variety in the beer industry and the state of affairs in the soft drink industry. As reflected in the "on-premise" soft drink photograph, a consumer in a restaurant usually has access to either Coca-Cola or Pepsi products, but not both, while a beer consumer in a restaurant or bar is typically met with a wide variety of brand choices on tap or on the menu.

The same holds true with an "off-premise" retailer account, where the soft drink aisle reflects Coca-Cola products and Pepsi products, whereas often hundreds of brands are found on the beer aisle. This variety is made possible by the independent sales and logistics work of local distributors.

On-premise

On-premise

Off-premise

Off-premise

The result of this open and independent system of distribution has been a beer industry renaissance – the new golden age – where breweries enjoy unrivaled access to market and consumers enjoy unprecedented choice and variety.

ABI/SAB Acquisition: Maintaining Independent Distribution & Consumer Choice

One of several threats the transactions pose to this successful system relates to ABI's relationships with distributors. Concerns have been raised that ABI is seeking to create competitive roadblocks by trying to impose exclusivity, either explicitly or coercively by discouraging its distributors from doing business with competing brands or raising their distribution costs.

Critics have suggested that ABI is pursuing two methods for preventing craft or imported beer brands from getting on a beer distributor's truck and achieving the same economy-of-scale advantages that ABI and MillerCoors enjoy.

First, ABI is purchasing independent beer distributors at such a rapid rate that it is currently the fastest growing beer distributor in the country. Since 2012, ABI has purchased 12 independent distributors in nine states, and ABI-owned distributors are in states that currently represent more than 30 percent of the American beer market. These brewery-owned distribution operations (as opposed to *independent* distributors) limit the access to market for other beer suppliers, particularly independent craft brewers and importers, by imposing limitations on their options for distribution.

Recently, ABI has recognized the competitive concerns raised by these acquisitions. ABI has made several public statements about not increasing its ownership of distribution and acquisition of independent distributors. Several media accounts at the time of the merger announcement quoted North American Zone President Joao Castro-Neves as being comfortable with ABI's current ownership of "around 10 percent" of distribution volume in the U.S. However, the details and nature of this statement remain undetermined.

Concerned parties also note ABI has been purchasing smaller competitors in the craft segment. Since 2014, ABI has purchased five popular craft breweries: 10 Barrel Brewing Co., Blue Point Brewing Co., Elysian Brewing Company, Golden Road Brewing and Virtue Cider. This followed ABI's purchase of Goose Island Brewery in 2011. ABI's purchases of craft breweries have included retail privileges in the form of taprooms, brewpubs and tasting rooms. Many of these retail privileges were granted as “tied-house” exemptions to help smaller brewers get established, yet are now extending ABI’s market power.

ABI’s justification for owning distributors is to better serve the market, but competitors argue that its purchase of competitors, combined with its distributor ownership, allow ABI to favor its own brands – craft labels and otherwise – compromising competition in the marketplace.

For obvious reasons, most brewers prefer to be represented by a distribution operation that is independent and not owned by a competitor; ABI-owned distribution operations focus on selling ABI-owned brands. In addition, it’s been charged that ABI pressures its independent distributors to sell its own brands, such as 10 Barrel, rather than independent, non-ABI products such as Deschutes, Yuengling, Dogfish Head or other growing beers.

Additionally, industry sources charge ABI with various “carrot-and-stick” business tactics that stifle the growth and future business opportunities of an ABI distributor that agrees to sell non-ABI brands or brands that ABI does not approve. These practices can increase costs for brewers and importers who then are forced to find less efficient distribution alternatives. That, in turn, can result in higher prices for consumers.

These practices were the subject of the Department of Justice’s 2013 lawsuit to block the planned merger of ABI and Grupo Modelo. ABI and Modelo’s original proposal called for a third party, Constellation Beer Brands, to hold the importing rights for a period of 10 years. This was an attempt to address market share concerns; at the time, Modelo brands represented only 4 percent of the U.S. market, significantly less than the combined market share reflected by the current merger proposal.

The DOJ investigation in the Modelo case reinforced concerns related to horizontal issues (i.e. increased direct market shares) for Constellation as well as efforts at that time by ABI to use vertical influence (i.e. influence at the distribution and retail levels) to reduce competition.

To resolve the DOJ litigation, the parties agreed to permanently sell the U.S. rights to Modelo, including its newest brewery in Mexico, to Constellation Beer Division. Additionally, out of concern that ABI would use distribution to curb competition by reducing access to market for other brands, the final order also prohibited ABI from discriminating against any distributor that carries the Modelo brands for three years. Specifically, when exercising its contractual right to approve or disapprove a proposed sale of a distributor operation, ABI is prohibited from weighing a distributor's Modelo distribution rights as an "adverse factor." The DOJ also increased oversight of ABI acquisitions of independent beer distributors by substantially lowering the Hart-Scott-Rodino reporting thresholds for new transactions. Finally, the DOJ required that both a divestiture trustee and a monitoring trustee be appointed to oversee the competitive impact and progress of the deal, demonstrating the DOJ's continuing interest in ensuring independence between the parties.

Current Investigations of Alleged Anticompetitive Practices

Given the potential negative impact on competition in the beer marketplace and on consumers, various ABI acquisitions and practices are currently being investigated by the California attorney general as well as the Department of Justice.

According to numerous media accounts, these investigations include claims that ABI penalizes independent distributors that carry non-ABI brands or puts pressure on those distributors to sever existing relationships with competing brewers. DOJ also is investigating non-compliance with the final order of the Modelo case.

Potential Control of Commodity Access and Cost

An additional concern among many brewers and importers is that ABI's increased global market power could position the new, larger company to have increased control over critical commodities markets worldwide. The acquisition could lead to increased market pressure for essential materials like hops, barley, rice and corn, as well as the aluminum and glass commodities, resulting in higher prices for consumers. A brewer with a relationship with ABI recently acknowledged a current hop shortage as well as strains on global commodities used to make beer.[4]

Limitations of the MillerCoors Joint Venture Divestiture

Many in the industry also have cast doubt on ABI's assertions that the proposed sale of SABMiller's 58 percent stake in the MillerCoors joint venture would alleviate any competitive problems. Recent studies have shown that mergers often fail to deliver true consumer benefits, and the Modelo deal underscored the

[4] http://www.brewsnews.com.au/2015/11/malts-time-to-shine-says-brewer/

limitations even of judicial intervention to reach a reasonable remedy that included vertical restraints. The law requires that any merger remedy "fully restore competition" in order to permit an otherwise anticompetitive merger to go forward. A remedy must be simple to administer and prevent any future anticompetitive conduct.

Several reasons have been raised explaining why the divestiture of the joint venture by itself may fail to serve as an effective remedy.

1. <u>The New Molson Coors' Potential Weakness as a Competitor</u>

It has been suggested that MillerCoors may be a less effective U.S. competitor when owned by Molson Coors, as the smaller second-largest brewer in the U.S. may be at a significant disadvantage in areas such as marketing, distribution, cost of goods produced and other scale-related business issues.

SABMiller currently is a major force as part of an international system that provides substantial economies of scale and a structure fostering long-term investment and innovation. The combined ABI-SABMiller entity would control 58 percent of the global profit pool, Molson Coors would have only 2.9 percent. The new number one brewer would be 20 times more profitable than Molson Coors, which will be paying off debt from a few markets. Additionally, important details about the transaction between ABI and Molson Coors remain unknown with regard to the specific beers imported into the U.S. by MillerCoors, such as the identity of the brands, country of production and how independent production will be maintained in the future, as was required in the ABI-Modelo merger.

2. <u>Concerns to Independent Distribution</u>

In addition to the competitive threats already discussed to independent distribution on the part of an even larger ABI, the industry will need assurance that Molson Coors will not replicate ABI's actions to compromise distributor independence either through vertical integration (brewery ownership of distribution) or programs that would restrict independent distributors from carrying the beers of other brewers.

3. <u>Lack of Protection for Innovation</u>

Independent distribution has been vital to the explosion of innovation in the market. With 4,000 breweries in the U.S. and more opening on a daily basis, a single entity in the market with significantly disproportionate power may stifle further growth and innovation in a dynamic and robust U.S. beer industry.

4. Lack of Protection of Consumer Choice and Price

Academic studies have reported that the past beer mergers have resulted in higher prices to the consumer. More power at the top levels of the beer industry heightens this concern. Due to its increased global market power, critics of the merger have charged that ABI will be in an even more dominant position to continue to increase prices and stifle choice. Molson Coors could follow in the wake of any price increase instituted by ABI.

5. Failure to Address Commodity Access and Cost

The proposed divestiture in and of itself will not address the concerns that ABI's increased global market power will allow it to control access to commodities and products needed in the U.S. beer market.

What Should Congress and the Department of Justice Do?

For reasons that have been stated above, regulators and policymakers should ensure that the American market renaissance – and in particular, the independent distribution system that enabled it – is not adversely affected by an increase in global market power created by a combination of the two largest brewers.

To achieve that goal, we encourage this Subcommittee and the full Committee to conduct a thoughtful and careful review of the proposed transactions, with the objectives of preventing anticompetitive conduct in the beer market and providing insight and information to the Department of Justice. Likewise, the DOJ should conduct a thorough document review, including making available those documents and materials that have not yet been made available to the public.

Specifically, the Department of Justice should consider the following:

1. Restrictions on Termination of Beer Distributors by ABI, Molson Coors, MillerCoors Joint Venture, or NEWCO (successor entity)

With the number of breweries in America reaching historic levels, not only is the need for strong, independent distributors of scale greater than ever, but so are the economic incentives to make it difficult for new entrants to access the open distribution system. DOJ should seek to ensure that the successful American system of open and independent distribution is not undermined by efforts on the part of ABI, Molson Coors, or their successor entities to use these proposed transactions to reshuffle or eliminate distributors. The parties have asserted that this merger would have no effect on the American marketplace. Ensuring that the parties cannot utilize this global transaction to make American distribution changes as a statement under oath, as part of a consent decree or final order would provide additional stability in the marketplace.

2. <u>Vertical Restraints on ABI-Owned Distribution and Retail Expansion</u>

The Department of Justice has acknowledged the importance of an independent distribution system to a robust beer marketplace, and already is investigating whether ABI's increasingly aggressive efforts to acquire distribution operations is being implemented to foreclose their competitors' distribution options and limit their access to market. Having identified concerns with ABI-owned distribution in the Grupo Modelo/Constellation transaction, the DOJ should consider whether various restraints on vertical integration are needed to support an open and independent distribution system including:

<u>Limitation of Ownership of ABI Distribution Assets</u>

ABI has recently indicated a willingness to sell some assets, including Peroni and Grolsch, to satisfy concerns in the European Union. In a similar fashion, exiting ownership of distribution should be considered as a remedy in the U.S. Limiting ownership of distributor operations by ABI could help maintain access to market as well as scale for other brewers while promoting competition for all market participants.

The DOJ put provisions into the ABI-Modelo order to require more oversight and notice for ABI expansion of distribution via a lower Hart-Scott-Rodino filing threshold. The DOJ should consider going further and preventing further distributor purchases by ABI.

<u>Prevention of Expansion into Retail</u>

ABI's recent purchases of craft breweries have included retail privileges in the form of taprooms, brewpubs, and tasting rooms. As a result the power of ABI reaches into greater levels of market penetration when the consumer facing aspect of beer sales is also controlled by the ABI.

3. Prevention of Exclusivity Mandates

The proposed transactions represent an opportunity for DOJ and Congress to further consider the effect of exclusivity mandates on the marketplace and consumers and whether their use by a dominant competitor should be allowed to derail the goals of the other breweries and the system that has effectively served the consumer, the marketplace, brewers large and small, importers, distributors and retailers.

4. Prohibiting Interference in Distributors' Sales of Competing Brands

The Justice Department should review business practices that penalize independent distributors from carrying different beer companies' beer and thereby threaten their role in a healthy beer marketplace.

5. Disclosure of All Aspects of the Proposed Acquisition, Including a Potential Divestiture of the MillerCoors Joint Venture

Important questions remain regarding the future of brands, not yet revealed or identified, that are currently sold by distributors in the U.S. For example, Exhibit 3 of the agreement between Molson Coors and ABI has been redacted. Policymakers, regulators and the public should know the specific impact of the proposed deal on all beer brands that will be affected.

Conclusion

Any time the number one and number two global market leaders in any industry combine, it is incumbent on policymakers to ask questions and seek assurances for adequate protections for the marketplace and consumers.

Consumer advocates, craft breweries, independent beer distributors, retailers and others have expressed concern that ABI's proposed acquisition of SABMiller could increase ABI's leverage on the American beer industry. Additionally, questions exist about Molson Coors' plans for distribution in the U.S. and whether ABI or Molson Coors could compromise competition by reducing access to market for other brewers and importers, controlling more distribution, and impacting consumers who may have less choice and pay higher prices as a result of this combination.

Congress and the Department of Justice are encouraged to consider various vertical restraints, such as a requirement that ABI sell some or all of the ABI-owned distribution operations; prohibitions on additional ownership of distribution; and a prohibition against interference with an independent distributor's efforts to sell competing bands.

Maintaining the strength and integrity of the existing open and independent system of beer distribution – that provides access to market for brewers large and small; generates enormous consumer choice; balances the cost to consumers; and generates robust marketplace competition – should be the priority to ensure that America's golden age of beer continues to generate excitement across the country.

On behalf of the nation's 133,000 beer distribution employees, thank you for your interest in the role of independent beer distributors and for your efforts to examine the potential effects these historic transactions could have on brewers, distributors, the marketplace and the consumer.

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For Small and Large Brewers, the U.S. Market Is Open

JUNE 19, 2014by Neil Houghton, Jr. and Marin Gjaja

- **IN THIS ARTICLE**
- Demand for craft beers, and the rise of small brewers, is fundamentally driven by consumer preference.
- The open distribution system for beer in the U.S. has helped small brewers gain access to the market because they do not have to build their own networks.
- Given the open distribution system, both small and large brewers must compete for consumers in order to survive.

The U.S. beer market is open, freely competitive, and driven by consumer choice. Brewers who capture the hearts of consumers are the most likely to succeed. Those who miss shifts in consumer identities, norms, attitudes, and tastes will suffer.

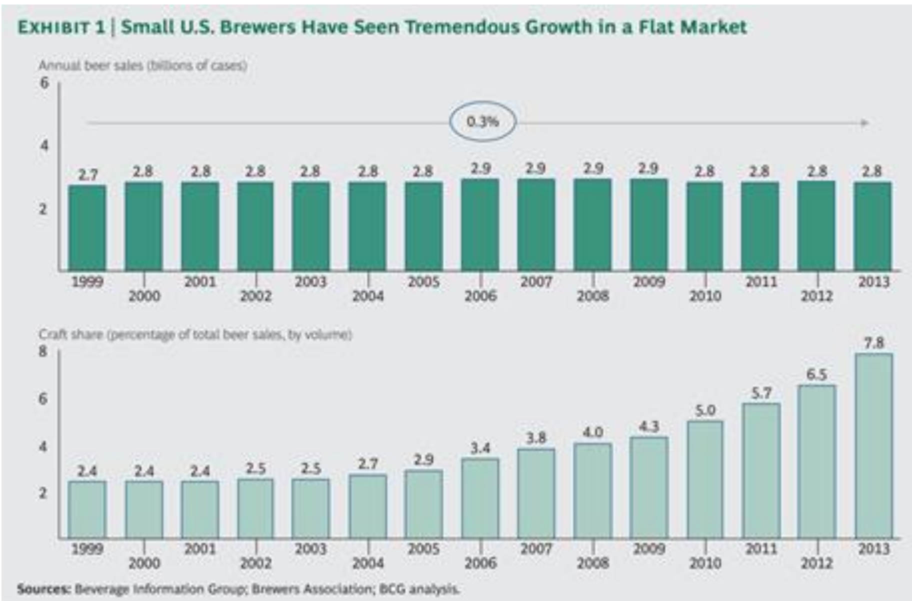
The success of small brewers making craft beers is proof of these points. Despite fears that small brewers can't compete against the scale and reach of large, mass-market brewers, the opposite has proved to be true. The popularity of craft beers supplied by small brewers has exploded, rising on the strength of consumer demand. Ironically, small brewers' ability to reach more drinkers has been enabled by the open U.S. beer-distribution system—a system that was once thought to lock out smaller players.

The economics of the U.S. beer business conveys significant advantages to those with scale. But, as it turns out, subscale small brewers are also (unexpectedly) the beneficiaries of the advantages afforded major domestic brewers. The reason: they can leverage an effective route-to-market distribution system that was built by distributors and larger brewers over the decades. This open distribution system enables small brewers to avoid significant, if not prohibitive, costs to entry, while also gaining deep access to large and small retailers.

Our findings have implications for all U.S. brewers. All brewers need to attract consumers, of course. Even incumbents with strong distribution networks are not insulated from the changing tastes and demands of consumers and retailers. Small brewers seeking to break into the market must recognize that they ultimately depend on consumer loyalty and that the distribution costs are not the impediment they seem to think they are. In fact, thanks to piggybacking on independent distribution networks supported largely by the economics of large domestic and import brewers, small brewers avoid much higher distribution costs. And regulators need not worry about the barriers to entry for market newcomers given their recent success and ability to leverage the industry distribution system.

The Rise of Small Brewers

Consumption of imported and domestic beer in the U.S. has remained relatively flat since 1999. Total U.S. sales volumes rose just 0.3 percent year-over-year over the full period, with a mild decline during the past five years. (See Exhibit 1.)



Within that market, the U.S. craft beer segment has seen tremendous growth. According to the Brewers Association, craft beer production increased more than 80 percent in just the past five years, from 117 million cases in 2008 to 215 million cases in 2013. During that same period, small brewers' volume share of the overall beer market rose from 4.0 percent to 7.8 percent. In addition, according to the National Beer Wholesalers Association, the total number of craft breweries in the U.S. has now reached historic levels—growing from 350 in 1991, to 1,499 in 2001, to more than 2,500 today.

Clearly, consumer preferences have been the main engine driving this growth. Craft beers are riding a wave in which consumers are "trading up" across all consumer categories to brands and products that are perceived as having strong authenticity and higher quality, and as being more relevant to specific consumers' attitudes, values, and lifestyle. This preference for trading up persisted even during the most recent recession.

The Dynamics of Distribution

Demand without distribution, of course, would leave small brewers without sales. Thanks to the open structure of the three-tier distribution system, small brewers can satisfy consumer demand.

The Boston Consulting Group has studied direct store delivery (DSD) across multiple categories for more than 20 years, often in conjunction with the Grocery Manufacturers Association. We have consistently seen that in U.S. categories with supplier-owned DSD systems—such as ice cream, soda, and snacks—suppliers enjoy significant benefits of local scale. And large players have multiple advantages, such as being able to make more frequent deliveries, reach smaller stores, introduce new products more quickly, and set up in-store displays, to name just a few. All these benefits combine into significant competitive advantage for the larger players in DSD categories.

When it comes to beer, however, distributors are independent from brewers. A brewery can demand certain quality standards from its distributors, but it cannot demand absolute product loyalty. In fact, distributors are more than independent—they have certain franchise rights in perpetuity, protected by the state, for the brands they distribute. These protections prevent breweries from using their scale to extract advantages from the distribution system the way that DSD suppliers do.

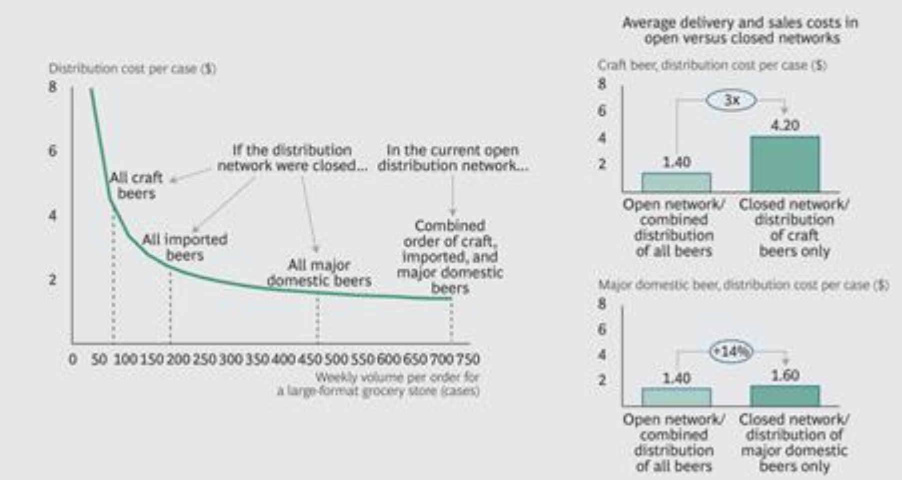
At the same time, the independence of the distributors creates the opportunity for smaller brewers to “get on trucks” and achieve distribution at a much lower cost per unit than they would otherwise have to pay. These distribution costs are considerable. A recent economic impact report from the National Beer Wholesalers Association estimates that the cost of wages and salaries associated with operating the entire U.S. beer distribution system is approximately $10 billion in annual expenses. In total, U.S. beer distributors employ more than 130,000 full-time equivalents and service more than 500,000 retail outlets.

The Value of Open Distribution

The ability of small brewers to gain access to the marketplace through independent distributors is a major reason that small brewers are able to exist at all. Considering that only the top ten small brewers generate more than $20 million in revenues annually, according to the Craft Brew Alliance, building a stand-alone distribution system would be cost prohibitive. Without independent distributors, most small brewers would have to cope with far less access to the market and consumers, and far lower growth rates.

How valuable is this access, economically speaking? To illustrate the economics, we applied BCG’s proprietary DSD economic modeling approach to the costs of distributing beer to large-format grocery stores. (See Exhibit 2.) Using an economic model of the costs of distributing and servicing a set of like stores, we estimated the costs for different types of breweries under today’s open distribution system. Then we compared that result to what the costs would be if the distribution system were not open—that is, a system that restricted the types of products permitted on trucks to those produced or sanctioned by a major brewer.

EXHIBIT 2 | Open Networks Offer Economies of Scale in Beer Distribution



Source: BCG analysis.

We found that in today's open distribution system, the average delivery and sales cost for a distributor supplying craft beers, imported beers, and a major national beer company's portfolio to a large-format grocery store is $1.40 a case. If the major national brewer were to build a dedicated closed distribution system, its delivery and sales costs would only increase 14 percent—from $1.40 per case to $1.60 per case.

On the other hand, if craft beer suppliers did not have the benefits of scale afforded by combined distribution of their craft beers with imported beers and the domestic beers of a large national brewer, their distribution costs would be triple what they are today—that is, $4.20 per case. And that's not even including costs such as warehousing, administration, and distributor margin. Given the moderate margins of small brewers, this cost disadvantage would likely get passed through to the consumer—making many craft beers far more expensive and small breweries less competitive.

Ongoing Challenges

This is not to say that all is rosy for small brewers. Open marketplaces, in which consumer choice is king, can be brutal. Small brewers are challenged when their own success invites more entrants. Most consumers aren't looking for the fifteenth version of a strong-tasting hoppy India pale ale. In fact, it is not uncommon for sales to drop off precipitously after the arrival of the first few brands in a particular style or position. This means that most of the me-too craft products deliver low velocity (while taking up valuable shelf space) at retail outlets and low revenues at bars. Once the excitement and newness wears off, retailers, restaurants, and bars may cut their craft beer offerings.

Further, with such an abundance of craft beer options, me-too small brewers face challenges engaging retailers and distributors. Retailers don't want to carry what distributors don't carry—and vice versa. Without a differentiated position, small brewers will find it hard to create the coordinated momentum required to break through.

Distributors are also increasingly challenged by the complexity and costs inherent in handling low-performing items that don't have a meaningful consumer following. In 2007, the average beer distributor carried 262 different SKUs, according to the National Beer Wholesalers Association; by 2013, the average beer distributor carried 657 SKUs.

Beer distributors are starting to be more demanding in terms of what they bring into their warehouses, add to their computer systems, and support in the marketplace.

The Implications

Our view is that success in the beer industry still rests fundamentally with consumer demand. Further, the current open structure of the three-tier distribution system has been a fundamental enabler of growth in the craft beer segment.

Several other key findings also emerged for major players in the industry:

Regulators of the beer industry, which is one of the most highly regulated industries in the U.S., should recognize that the marketplace is working. And they should be skeptical of complaints (legal and otherwise) that the marketplace favors only large players.

Large brewers are also at the mercy of the consumer and retailer. With all the options available, if the brands in large brewers' sizable portfolios don't hit the mark perfectly with today's consumer, sales will decline. History is replete with examples of once-large brands and brewers that have fallen by the wayside because they couldn't keep up with the market.

Small brewers must build their brands in order to generate sufficient demand to win (and retain) the space they occupy in stores and justify the complexity they add to the work of retailers and distributors. Doing so requires strengthening local demand and also offering products that are differentiated enough to cut through the clutter and compelling enough to convert trial drinkers to loyal ones. If they can do that, small brewers—aided by an open distribution system—will continue to enjoy success.

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