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SAM.N - Q3 2021 Boston Beer Company Inc Earnings Call

EVENT DATE/TIME: OCTOBER 21, 2021 / 9:00PM GMT

OVERVIEW:

Co. reported 3Q21 net loss of $58.4m or $4.76 per diluted share. Expects 2021 diluted EPS to be $2-6.

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PRESENTATION

Operator

Greetings, and welcome to The Boston Beer Company Third Quarter 2021 Earnings Call. (Operator Instructions) As a reminder, this conference is being recorded.

I will now turn the conference over to our host, Mike Andrews, Associate General Counsel and Corporate Secretary. Thank you. You may begin.

Michael G. Andrews - *The Boston Beer Company, Inc. - Associate General Counsel & Corporate Secretary*

Thank you. Good afternoon, and welcome. This is Mike Andrews, Associate General Counsel and Corporate Secretary of The Boston Beer Company. I'm pleased to kick off the 2021 Third Quarter Earnings Call for The Boston Beer Company. Joining the call from Boston Beer are Jim Koch, Founder and Chairman; Dave Burwick, our CEO; and Frank Smalla, our CFO.

Before we discuss our business, I'll start with our disclaimer. As we state in our earnings release, some of the information we discuss and that may come up on this call reflect the company's or management's expectations or predictions of the future. Such predictions are forward-looking statements. It's important to note that the company's actual results could differ materially from those projected in these forward-looking statements. Additional information concerning factors that could cause actual results to differ materially from those in the forward-looking statements is contained in the company's most recent 10-Q and 10-K. The company does not undertake to publicly update the forward-looking statements whether as a result of new information, future events or otherwise.

I will now pass it over to Jim for some introductory comments.

C. James Koch - *The Boston Beer Company, Inc. - Founder & Chairman of the Board*

Thanks, Mike. Our intent today is to provide some additional context around our third quarter earnings, discuss our views on trends we see driving results at Boston Beer and in our industry and talk about how we see performance going forward. After I discuss a few highlights from the third quarter, I'll hand it over to Dave, who will provide an overview of our business. Frank will then provide details of the third quarter financial results and how these results have been impacted by slower-than-anticipated hard seltzer growth as well as our outlook for the remainder of 2021 and 2022. Then I will share with you our longer-term view of the business. Finally, we'll open the line up for questions.

I'll begin with some context in measured off-premise channels year-to-date through October 10, where our brand portfolio represents only 4.4 of the total industry volume. We've delivered more than 41% of the total industry volume growth, the highest by far of all brewers. 4 of our 5 major brands are growing depletions and gaining share in off-premise measured channels over the last 13 weeks. We have a broad portfolio of healthy brands, which we will further build in 2022 to continue driving our growth.

Our success has been recognized by our most important customers, our distributors, who recently voted us the top beer supplier in 2021 in the latest Tamarron survey. This is the 10th time in the last 12 years that our most important customers have recognized us as the top supplier in our industry. We are thankful to our outstanding coworkers, distributors and retailers whose continued support is helping grow our business to achieve our 14th consecutive quarter of double-digit growth.

But despite these ongoing strengths, we experienced very large unanticipated costs as the result of the sudden unexpected slowing of growth in hard seltzer. Based on our growth projections, we moved aggressively to build inventory to try to avoid the out of stocks that we experienced in 2019 and in 2020 and to secure capacity, both short term and long term, to be ready for growth through 2023. Dave will share our perspective on the decisions that led to these unanticipated costs, and Frank will share a fuller accounting of them.

I'll now pass it over to Dave for a more detailed overview of our business.

David A. Burwick - *The Boston Beer Company, Inc. - President, CEO & Director*

Thanks, Jim. Good afternoon, everybody. Let me start by addressing where we are strategically, how we're viewing the future of the hard seltzer category and how we plan to grow our portfolio going forward, even without high double-digit hard seltzer category growth.

There's no question that hard seltzers have generated tremendous growth for the beer category over the last 5 years and will remain a very important beer industry segment in the future. Hard seltzers are 11% of total beer dollars year-to-date, up from 9% during the same period in 2020. Consumer metrics remain favorable. Social media sentiment continues to trend positively, and household penetration, frequency and buy rate, all are increasing over the past 13 weeks. Volume growth has slowed this year, but we continue to believe that hard seltzers can reach 15% to 20% of total beer dollars in the next 5 years.

We believe the ability to create alcoholic beverages from a beer base with a range and variety of flavors previously only available to mixed drinks, coupled with the convenience and affordability of beer and beer's tax and distribution levels, will be a platform for long-term growth for Boston Beer. We've been playing to win, and we've reaped many benefits.

So far this year, Truly has achieved the second highest household penetration in all of beer, behind only Bud Light beer and ahead of all its other hard seltzer and beer industry competitors. Truly has generated 54% of all hard seltzer category growth so far in 2021, 2.3x the next highest brand. We've gained 23 share points against the category leader since January 2020. We've led the category in innovation and brand building and have outgrown the category for 13 straight months.

We also believe that Truly is blazing its own path and not following the category like so many other entries. Thus, we believe we are well positioned to succeed in the future when it will be much harder for new entrants to gain share. We've created a $1 billion brand in only 5 years, and we're confident we'll continue to grow it going forward.

Slowing hard seltzer category growth has certainly impacted our business. Earlier in the year, we had expected the category to grow at over 70% and Truly to gain share. The Truly brand did gain share, but the category did not grow as we had expected. Now we expect Truly, thanks to its share gains, to finish the year up between 20% and 25% in volume.

Because of our higher demand projections earlier in the year and our commitment to avoid the out of stocks that we experienced during the summers of 2019 and 2020, we added significant capacity and prebuilt inventories of cans and finished goods to levels that ended up exceeding actual needs as the category slowed down. As a result, we are currently faced with significant temporary costs as we adjust to the new category trends. These cost impacts are reflected in our third quarter financials.

Building our capacity and inventory levels was an essential part of Playing to Win. In that strategic context, we believe the risk of undersupply was bigger than that of oversupply. So we resourced against a high-growth scenario, securing supply constrained materials and capacity to gain market share in a highly competitive and fast-growing category.

Having said this, we've updated and evolved our own category growth model and believe the category could be flat to plus 10% growth in our most likely 2022 scenarios. Clarity will probably not increase until we start to lap June and July 2021 when the category started to decelerate rapidly, especially in the 2-year volume stack, which we look at closely.

Regardless of which scenarios prove most accurate, we fully intend to extend our streak of outgrowing the category throughout the year, driven by innovation, continued brand building and superior retail execution and distributor support. As Jim mentioned, we have a balanced portfolio of healthy, well-positioned brands. As we look towards 2022 and beyond, our aim is to continue double-digit depletions growth on the foundation of this portfolio, especially as consumers drink more beyond beer products. We are the #2 player in beyond beer with a 26% share, driven by the #1 FMB in Twisted Tea, the strong #2 hard seltzer in Truly and the #1 hard cider in Angry Orchard.

Twisted Tea has overcome this past summer supply chain issues and out of stocks and has grown 22% in the last 13 weeks in measured off-premise channels. Twisted Tea is the second fastest-growing brand year-to-date among the top 25 in beer, while Truly remains #1 in percentage and absolute volume growth. We will have industry-leading innovation again with Truly, starting with a holiday party pack next month and followed by the January 2022 launch of Truly Margarita Style, which has received a terrific response in initial discussions with our distributor partners and retailers. As Twisted Tea expands its consumer base, we're launching a new Twisted Tea Light with only 109 calories.

But our innovations go beyond Truly and Twisted Tea. For 2022, we're introducing new brands, the Bevy Long Drink, Sauza Agave Cocktails and HARD MTN DEW. We're also expanding our lineup of award-winning Dogfish Head Canned Cocktails with new vodka and gin crush styles, and we're launching a new tropical fruit extension for Angry Orchard in addition to adding Angry Orchard HardCore and 8% ABV products.

Meanwhile, our Sam Adams Your Cousin from Boston campaign is paying dividends as Sam Adams grew double digits in the third quarter, fueled by both on-premise and off-premise gains, while also gaining share of crafts in the off-premise.

Now I'll hand it over to Frank to discuss our third quarter financials as well as our outlook for 2021 and our initial thoughts on 2022.

Frank H. Smalla - *The Boston Beer Company, Inc. - CFO & Treasurer*

Thanks, Dave. Good afternoon, everyone. Before I get into the financial review of our third quarter results and financial outlook, I'd like to provide more detail on the third quarter charges and other costs related to the hard seltzer slowdown.

As Dave explained, we strategically resourced against the high side of our internal category growth and market share projections to ensure we would not be constrained in our efforts to build our share position in the hyper growth hard seltzer category. Resourcing against our high side scenario included adding internal and external capacity, prebuilding distributor and internal inventory ahead of the peak summer season and securing tight supply materials such as cans and flavors. This strategy enabled us to gain share in 2020 and 2021 in a supply-constrained environment.

Following the rapid slowdown this summer, actual hard seltzer category growth fell below our internal low side projections and resulted in excess capacity and higher-than-planned inventory levels of input materials and finished goods. As a result, we have taken $102.4 million third quarter charge related to direct costs of the hard seltzer slowdown, consisting of inventory obsolescence and destruction -- and related destruction costs of $54.3 million; contract termination costs, primarily for excess third-party contract production of $35.4 million; and equipment impairment of $12.7 million.

In addition, the third quarter results include indirect costs resulting from the slowing hard seltzer category growth of $30.6 million. These costs include negative absorption impacts at company-owned breweries and downtime charges at third-party breweries of $11.4 million, increased raw material sourcing and warehousing costs of $11.8 million and distributor return provisions for out of code or damaged products of $5.4 million and other costs of $2 million.

The negative absorption impacts are the result of shipments lagging depletions to reduce distributor inventories to target levels and production lagging shipments to reduce internal inventory levels. With this background and the third quarter financial impact of the slowdown in hard seltzer, I will now turn to our overall third quarter results and our current outlook for full year 2021 and 2022.

For the third quarter, we reported a net loss of $58.4 million, a decrease of $139.2 million from the third quarter of 2020. Loss per diluted share was $4.76, a decrease of $11.27 per diluted share from the third quarter of 2020. This decrease was due to the combined direct and indirect costs related to slowing hard seltzer category growth of $133 million or $7.73 per diluted share net of the related tax benefit and higher operating expenses, partially offset by increased net revenue.

Depletions for the quarter increased 11% from the prior year, reflecting increases in our Twisted Tea, Truly Hard Seltzer, Samuel Adams and Dogfish Head brands, partially offset by decreases in our Angry Orchard brand. Shipment volume for the quarter was approximately 2.3 million barrels, an 11.2% increase from the prior year, reflecting increase in our Twisted Tea, Samuel Adams and Angry Orchard brands, partially offset by decreases in our Truly Hard Seltzer and Dogfish Head brands.

We believe distributor inventory as of September 25, 2021, averaged approximately 6 weeks on hand and was at an appropriate level for each of our brands except for Truly, which has significantly higher-than-planned distributor inventory levels for certain styles and packages. To address the slowing demand and continued volatility of future volume projections for Truly, we are working closely with our distributors to reduce Truly distributor inventory levels. We adjusted production and shipments during the third quarter and expect to continue to do so during the remainder of the year.

Our third quarter gross margin of 30.7% decreased from the 48.8% margin realized in the third quarter of 2020, primarily due to the $84.9 million direct and indirect volume adjustment costs as a result of slowing hard seltzer growth described above and higher material costs, partially offset by price increases.

Advertising, promotional and selling expenses increased by $58.8 million or 54.4% from the third quarter of 2020, primarily due to increased brand investments of $37.6 million, mainly driven by higher media, production and local marketing costs and increased freight to distributors of $21.2 million that was primarily due to higher rates and volumes.

Based on information of which we are currently aware, we are now targeting full year 2021 earnings per diluted share of between $2 and $6. However, actual results could vary significantly from this target. This projection excludes the impact of ASU 2016-09 and is highly sensitive to changes in volume projections, particularly related to the hard seltzer category.

Full year 2021 depletions growth is now estimated to be between 18% and 22%. We project increases in revenue per barrel of between 2% and 3%. Full year 2021 gross margins are expected to be between 40% and 42%. The gross margin impact related to the combined full year direct and indirect cost of the hard seltzer slowdown is estimated at $132.6 million, of which $95.8 million have been incurred in the first 9 months and the remainder of $36.8 million are estimated to be incurred in the fourth quarter.

Our full year 2021 investments in advertising, promotion and selling expenses are expected to increase between $80 million and $100 million. This does not include any increases in freight costs for the shipment of products to our distributors.

I will now turn to 2022. We're in the process of completing our 2022 plan, and we'll provide further guidance when we present our full year 2021 results. Based on information of which we are currently aware, we are using the following preliminary assumptions and targets for our 2022 fiscal year, which are highly sensitive to changes in volume projections, particularly related to the hard seltzer category.

We're targeting depletions and shipments percentage increases of between mid-single digits and low double digits. We project increases in revenue per barrel of between 3% and 6%. Full year 2022 gross margins are expected to be between 45% and 48%. We plan increased investments in advertising, promotion and selling expenses of between $10 million and $30 million for the full year 2022, not including any changes in freight costs for the shipment of products to our distributors.

We expect that our cash balance of $86.5 million as of September 25, 2021, along with our future operating cash flow and unused line of credit of $150 million, will be sufficient to fund future cash requirements.

Now I'll hand it back to Jim for some closing remarks.

C. James Koch - *The Boston Beer Company, Inc. - Founder & Chairman of the Board*

Thanks, Frank. Before we open it up for questions, I'd like to share some perspective from someone who's been at Boston Beer Company since the beginning and remind us all, we have a tremendous track record of growth at Boston Beer Company.

For the past 20 years, we've grown our revenue at over a 12% compounded annual growth rate and have increased total shareholder returns at a 20% compounded annual growth rate. That growth doesn't always come in a straight line. The numbers are a beautiful thing, but the actual results sometimes aren't pretty. But it has come over 20 years compounded because we've demonstrated the ability to consistently innovate and grow great brands in our niche, the high end of the beer and beyond category.

That brings us to where we are today. Truly is the #2 hard seltzer and closing the gap this year with the current category leader. Twisted Tea is #1 in hard tea and now the #1 FMB and is continuing to gain share. The Sam Adams brand is gaining share for the first time in several years, and Angry Orchard is #1 in hard cider and maintaining close to a 50% market share. We intend to grow these 4 brands and Dogfish Head as well in 2022 through brand building and executing at retail, the things that we've been doing for decades.

We believe we have the best brewers, the best high-end brands with potential yet to be fully tapped, the best sales force and the best innovation again for 2022. We're fixing our capacity and supply chain issues. Our marketing is hitting its stride, and we have the best distributor network behind us. That's why we've been the fastest-growing company in all of alcohol for the last few years. We have a company and culture that not only delivers double-digit growth but also demonstrates resilience and agility when faced with challenges.

As Dave mentioned, we've been playing to win in the hard seltzer category. We will continue to play to win, to nourish our brands, to exploit their untapped growth potential as we're seeing with our 20-plus-year-old Twisted Tea brand and to innovate with new ones in the months ahead. Today, we hope to put the turbulence of the hard seltzer category slowdown behind us and continue to prove our ability to outgrow the beer category for many years to come.

Now let's open it up for your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Nik Modi with RBC Capital Markets.

Sunil Harshad Modi - *RBC Capital Markets, Research Division - MD of Tobacco, Household Products and Beverages & Lead Consumer Staples Analyst*

Dave, I was hoping maybe you can provide some context on some of your 2022 preliminary guidance that you provided just in terms of the buckets of shelf space allocation, innovation, kind of core category growth. I know the range of the outcome for category growth is pretty wide. But maybe you could just give some context around kind of how you guys came to that conclusion.

David A. Burwick - *The Boston Beer Company, Inc. - President, CEO & Director*

Okay. Nik, thanks for the call. I think without getting into specifics about what we're thinking about each brand, there's a range of growth we see for each brand. We definitely expect all 5 of these brands to grow next year. And as Jim mentioned, we're building momentum as we head into next year. Innovation will definitely play a role. And depending on how you count innovation, it's probably -- it could be 1/3 or more of the growth.

But we're placing a lot of bets, as you heard, across the board, both in just investing in our brands to sustain the growth, whether it be for Twisted Tea or Sam Adams, adding line extensions where it's appropriate, certainly for Truly, Twisted Tea. We added Twisted Tea Light, as I mentioned. Sam Adams Wicked Hazy is on a roll. And also, we actually have 3 new brands next year that we'll put into the marketplace with Beam Suntory, Sauza and obviously HARD MTN DEW with PepsiCo, et cetera. So it's going to be a balanced approach to all of those brands.

By the way, we do expect Truly to grow. And as I mentioned, it's the category -- we kind of came out with -- a lot of folks on this phone came out on the category growth on hard seltzer. And we think that we'll get growth with Truly next year as well.

Sunil Harshad Modi - *RBC Capital Markets, Research Division - MD of Tobacco, Household Products and Beverages & Lead Consumer Staples Analyst*

And then just a final question on Truly and the marketing now that the Dua Lipa campaign has been out, you have some time under your belt. Any perspective on consumer engagement scores, brand equity scores?

David A. Burwick - *The Boston Beer Company, Inc. - President, CEO & Director*

Yes. I mean I think the thing that we look at most actually for Truly is social media engagement and response because to be fair, we -- initially, several years ago, we weren't that competitive in that space. And we made a lot of progress. So our share of voice in social media is about 50 index to the leader. Right now -- however, 91% of all of our -- all the comments are positive. So we're seeing a lot of positive momentum on social media. And for us, right now, that's the biggest -- I'd say the biggest litmus test for how we're reaching the right consumer in the right way.

Operator

Our next question comes from Eric Serotta with Evercore.

Eric Adam Serotta - *Evercore ISI Institutional Equities, Research Division - MD*

First, a clarification. In terms of the '22 preliminary look, is the range of scenarios that you're looking at, does that have Truly growing in excess of the category or gaining shelf space? Wasn't clear on that from your previous comments. And then if you could talk a bit about shelf space more broadly. Clearly, shelf space gains have been a major driver of both your and the hard seltzer category growth over the past 2 years. With a lot of those brands not really turning, how do you see the shelf space evolving as we get into next year? And is your guidance built on Truly holding shelf space, losing shelf space, gaining overall shelf space? Any color would be appreciated.

David A. Burwick - *The Boston Beer Company, Inc. - President, CEO & Director*

Okay. Great. Thanks, Eric. So as it relates -- first to your first question, as it relates to Truly growth, we put the -- our range right now is 0 to 10% on the category, and we're expecting Truly to outgrow whatever the category comes in at. So it would be north of 0 if it's 0. It would be up -- north of 10% if the category is 10%. So we do expect it to outgrow the category.

As it relates to shelf space, I mean, right now, if you look at it, seltzers are about 10% of total shelf space right now, which is about a little -- maybe a little south of where they should be based on the representation. We do expect, as others have stated, that the long tail -- there will be some paring of the long tail, which should enable certainly the top 2 brands to gain more share of shelf. But right now, we're at 24% share shelf, Truly is.

Again, these are kind of rough numbers, and we do expect to grow it slightly next year, but we're not expecting our growth for Truly to be contingent on growing shelf space. But we do think that our [winning laws] will apply soon, certainly by next spring, and we will have more shelf space. But again, the growth rate that we're expecting to have goes beyond just the shelf space.

Diego, are we still -- do we have more questions coming?

Michael G. Andrews - *The Boston Beer Company, Inc. - Associate General Counsel & Corporate Secretary*

Diego, can you hear us?

David A. Burwick - *The Boston Beer Company, Inc. - President, CEO & Director*

For those who might be able to hear us, don't go anywhere. We're trying to figure out this glitch, and hopefully, we'll fix it quickly.

(technical difficulty)

Operator

Apologies for the technical issue. Please stand by. Our next question comes from Laurent Grandet with Guggenheim.

Laurent Daniel Grandet - *Guggenheim Securities, LLC, Research Division - MD & Senior Analyst*

Yes. First, I mean, a follow-up from the previous question. So you're saying, Dave, that next year, the seltzer category will be growing 0 to 10%. So -- and we've been seeing over the last 3 periods that actually that category has been declining. So what gives you some comfort that, I mean, the category will grow again? And that's probably the question that every investor has got top of their mind. If you can help us bridge that.

David A. Burwick - *The Boston Beer Company, Inc. - President, CEO & Director*

Yes. Sure thing, Laurent. Why don't I just explain a little bit how we got to that number and why we're confident that there will be growth resulting from that? So more time has helped us understand better what's happening in the category. Our model looks at household penetration rates, purchase frequency, buy rates, repeat rates. And we've looked really at the last 13 weeks versus the whole year because obviously, things have changed. So we've done a lot of work with the model. We talked to wholesalers and retailers to get their input as well. We obviously looked at what's out there from other folks that -- many of whom are on the call. And the 0 to 10% range seems to be consistent with what others are arriving at.

Now there's other -- we have new -- there's new consumer information that's very important that gives us confidence that there is growth in the category. Actually, one thing I will mention, if you look at IRI and you look at the 2-year stack over the -- since Labor Day, the 2-year stack has been pretty consistent at about 100% to 110%, somewhere in that range. So we have seen a stabilization of that 2-year stack. So that's another sort of data input that's out there.

From a consumer perspective, again, let's start with numerator data. And I know a number of people look at numerator. Even the latest 13 weeks, you see -- we see household penetration continue to increase about 4%, buy rate about 1.5 points. We look at social media metrics, we see 38% of comments are favorable, 17 are unfavorable, 21-point gap. That gap is bigger than it was a year ago, favorable to unfavorable.

We're just starting to get back results from a consumer test -- I'm sorry, a consumer study we just done with 4,000 people who drink alcohol between the age of 21 and 55. And some of the top line things that we've seen, hard seltzer -- today's hard seltzer drinkers are very eager to increase their consumption. So about 1/3 of them want to consume more hard seltzer, which is more than what beer, wine and spirits, regular drinkers indicated they want to consume of those categories in the future. About 3/4 sort of non-triers or lapsed drinkers are open to try a hard seltzer in the next year. And then importantly, only about 6% of people are truly rejectors. And when we looked at this a year ago, it was about the same.

So the consumer data -- and there's been other work done out there. I know Wendy at Citi did some stuff that also kind of pointed to this as well. The consumer data on top of the quantitative models that we're building all say that this category -- there's still a deep interest in the category.

And I'll give you one other data point which we just got, which might explain some things, and that is penetration is increasing. But when you look -- when you break out new buyers versus either -- versus lapsed buyers or casual buyers, there has been -- there are fewer new buyers coming into the category right now, and they're spending less on average, which has provided some of that downdraft. On the other hand, we also see that there are many more "heavier repeat buyers," and they're buying more.

So you have these 2 -- so it's really a normalization of the category where some of these heavy drinkers are now -- are adding to the total volume. So it's not a perfect science, as you guys know. And I know everybody on the phone has been trying to figure this thing out, as have we, 24/7.

But again, we look at our -- and again, I'll give you one more data point at the risk of giving too much. To get to the high end of our growth rate, the 10% growth rate, it assumes household penetration grows by about 2% -- or 2 points, I should say, and buy rate by about 6.5%. So if we can get there -- and the household penetration year-to-date is up 8%. I know it's been going in a different direction. It seems reasonable. So between the model, the consumer work we're doing now, consumer work others have done, numerators data, it points to a category that's got growth in it. And that's why -- and we do believe that there's growth in the category.

Operator

Our next question comes from Nadine Sarwat with Bernstein.

Nadine Sarwat - *Sanford C. Bernstein & Co., LLC., Research Division - Senior Research Associate*

One for me, please. So if volumes continue at this new normal that you are forecasting, are you liable to incur any additional expenses such as shortfall fees in the coming years?

Frank H. Smalla - *The Boston Beer Company, Inc. - CFO & Treasurer*

Yes. This is Frank. Let me take that. So when we looked at the capacity, the way it contracted with our external manufacturers, some of that we canceled, and that is reflected in the charge that we communicated. With the co-manufacturers or the third-party brewers that we still are working with, we have thresholds. And if we fall below those thresholds, we're still liable to shortfall fees. So the contracts that are still in place, we still have that. But it's going to be a much leaner network and much more integrated.

Nadine Sarwat - *Sanford C. Bernstein & Co., LLC., Research Division - Senior Research Associate*

If I could just follow up on that. Could you then explain how the contracts that you have existing that are left compare to your volume forecast that you've expressed for 2022? Is there a gap in there? What could a worst-case scenario be essentially?

Frank H. Smalla - *The Boston Beer Company, Inc. - CFO & Treasurer*

So we have, in our entire network, and that's going to be the first time in quite a while. We have enough -- we have sufficient capacity. And so it's not that, as in previous years, we needed to prebuild inventory to go through the peak. We have sufficient capacity to address that. If you're looking for the risk, the -- depending on the range and the preliminary guidance that we have given, there's clearly a margin risk that's related to shortfall fees. But that should not exceed 0.5 percentage point on the gross margin. It should be below that.

Operator

Our next question comes from Bonnie Herzog with Goldman Sachs.

Bonnie Lee Herzog - *Goldman Sachs Group, Inc., Research Division - Research Analyst*

I had a question on your incremental spend. I guess first, I'm surprised your incremental investment spend remains pretty elevated this year, but then you do have plans to step it down pretty considerably next year. So could you guys talk about the strategy behind this, especially in context of your strategy of playing to win? And then I guess thinking about a step-down next year, does this suggest your pipeline of innovation will be a lot slower and you don't think the hard seltzer category specifically warrants additional spend? And I guess finally, what's the risk in your mind that a pullback on incremental spend next year could result in share losses for you in a category that is decelerating, I guess, with the possibility for growth to turn negative next year?

Frank H. Smalla - *The Boston Beer Company, Inc. - CFO & Treasurer*

So Bonnie, let me start off, and then I'll hand it over to Dave. When you look at 2021, clearly, as you know, we have communicated we had -- when we looked at our range, we were clearly targeting a higher growth scenario than what we're ending up with. And what has worked in 2020 and what we also did in 2021 was spending at the beginning of the year to make sure that we get in before the peak period and maximize that.

Clearly, the volume didn't play out. So you could say we spent more relative to the volume that we expected. So we will increase our spend next year, as we said, but not to the same extent. We just have to take into consideration that the growth isn't as high as we had expected. But I think 2021 might not be a really good comparison because of everything that happened.

But if you look at the AP&S spend that we have -- or that we're projecting for 2021 -- for 2022, I'm sorry, that's going to be close to 30% above 2020 and close to 80% above 2019. So we have invested dramatically into the category. And as we've said before, we did that to make sure that we carve out our market share in the growing category, which is different if you have a category that's stabilizing. It's much harder to steal market share or to gain market share. So I think the dynamics are changing. So we have dramatically increased the spend, and we believe we have enough that we can allocate to where we believe we get the biggest return.

David A. Burwick - *The Boston Beer Company, Inc. - President, CEO & Director*

And Bonnie, I'll just build on what Frank said. I'll just add one other point, which is we feel very confident that the quality of our creative is very strong. We spent a lot of time -- and this is sort of Jim's -- one of his passion, so he can jump in on this one. But we spent a lot of time really with our own sort of model to measure the impact, the effectiveness of our creative. So for Twisted Tea, Sam Adams, all of our brands, Angry Orchard and Truly. And we feel like we're -- we can get more with the same dollar tomorrow when we spend it because of the changes we've made and because of the evolution we've taken on these campaigns.

I think the Sam Adams campaign is a really good example. Your Cousin from Boston is really resonating, and we're bringing in a lot of younger drinkers that we didn't have before. And on top of that, I would say there's a huge PR kind of angle that [good copy] can create, which is worth a lot.

And so for example, this -- we had a number of PR initiatives around the advertising investment we made this year for Sam Adams. One was Super Bowl and the Clydesdale ad. We did sort of a COVID vaccine spot. We did a Say It with Sam wedding vows contest. We did just recently one with Inspiration4 space mission, and we're creating a space craft beer. Those all generated hundreds of millions to literally billions of impressions. So it's just one example of how we can get more. So it's not quite as simple to say look at total dollars and say you're not getting -- you're not being able to support a full portfolio. We think we are.

And the last thing I would say to that is when we see that there's positive response, we'll spend more. So we're not going to stop spending just because right now, we gave this kind of -- this isn't even guidance. It's kind of -- it's directional thoughts about 2022. If we feel like there's some heat there, we're going to go hard. So we're never going to back away from investing in our brands if we think we can get a return.

Bonnie Lee Herzog - *Goldman Sachs Group, Inc., Research Division - Research Analyst*

Okay. Yes, that's definitely helpful because I guess I was kind of thinking about it in the context of you really have been the driver of the growth in the category. And if there is any pullback, then I'm just thinking about what that suggests for the outlook for the category. So that's good to hear. If you see something, you'll push harder.

And if I could just squeeze in a second quick question as it relates to the stronger price growth that I guess you're guiding to next year of 3% to 6%. I guess I'm also curious. What gives you guys the confidence that you have that kind of pricing power, especially given what we're talking about, the deceleration of the category, and maybe the eventual shakeout of the category, which could happen early next year? And then I think about that in the context of pricing pressure as that shakeout happens. So just any thoughts there would be helpful.

Frank H. Smalla - *The Boston Beer Company, Inc. - CFO & Treasurer*

Yes. And Bonnie, the same thing. I'm going to kick it off and hand it over to Dave. But our pricing this year and also next year is very much driven by the inflation of input costs that everybody is facing. And so we'll try to price that.

Our confidence is relatively strong because so far, even with like the softening of the growth in the category, price hasn't seemed to be a real decision factor in the purchase decision. What we have seen is really what makes the difference is the brand strength and the quality of the beverage in itself. But we have seen, like across the category, pricing attempts to kind of take price down to gain share. And we haven't really seen that working across the category. We haven't seen it with our own brands. So that's what we believe, that it's not -- that it won't be a pricing game, at least not at this point.

David A. Burwick - *The Boston Beer Company, Inc. - President, CEO & Director*

I don't have much more to add to that other than if there is -- a shakeout does occur in hard seltzer, fewer brands actually would support higher -- support the ability to take more price. But this entire ecosystem from retailer, wholesaler, brewer is impacted by all the input costs, as you know. And I think everybody -- it's in everyone's best interest to try to recoup those costs.

And the last thing I'd say is that we're not the only ones that are -- that have excess raw materials that we have to dispose of. And note, there's no -- nobody has resorted to price in this category to try to flush out product because I think they believe in the sanctity of pricing, and it's an important thing, particularly in the economy that we're in right now.

Operator

Our next question comes from Kaumil Gajrawala with Credit Suisse.

Kaumil S. Gajrawala - *Crédit Suisse AG, Research Division - MD & Research Analyst*

Can we talk about inflation maybe in a little bit more detail as you're thinking about next year? Obviously, you've given us some rough guidance, but you can give us an idea of kind of what you're seeing, where you're hedged if you're not hedged or at least what some of the assumptions are and some of what you've provided us so far? And obviously, not limiting to gross margins. Also maybe including freight, if you can.

Frank H. Smalla - *The Boston Beer Company, Inc. - CFO & Treasurer*

Yes, sure, Kaumil. So the key categories that we're seeing that we have seen this year is clearly aluminum that's going up. That's reflected in the can pricing. That's about -- that's double-digit increases. Freight has gone up significantly. That's in the 30% range. I think everybody is experiencing that. We have seen that really coming up. It's a shortage of drivers. And I think the entire economy sees that. So that has elevated everything.

We don't believe that's going to go down much. We believe we stay at this higher level and have like planned for a single digit -- further single-digit increase for 2022. So those are kind of the key assumptions. And then we have paperboard, linerboard and also sweeteners that are going up. So we see inflation depending on the mix of the different categories, going up to about 5% to 6% for next year for our input materials. And when I talk about inflation, I really mean the underlying commodity and the underlying cost. This is before any productivity savings, volume tiers or anything else. It's just really the underlying commodity.

And to your last question, hedging, we don't hedge. I mean hedging is like you can extend that you're gaining time, but at the end of the day, you are faced with the market realities unless you're in a really up and down market, but major trends. So we just like -- we go through that and we don't have any hedge positions.

Operator

Our next question comes from Sean King with UBS.

Sean Roberts King - *UBS Investment Bank, Research Division - Equity Research Analyst of Beverages*

Thinking about gross margins and just given some of like the rightsizing of the production expectations. Do you see, I guess, a pathway on gross margins getting back above 50% like as it's been historically, sort of excluding some of the inflationary headwinds? Or is there something going on with sort of the beyond beer kind of mix of the portfolio that's going to be a structural headwind longer term?

Frank H. Smalla - *The Boston Beer Company, Inc. - CFO & Treasurer*

So Sean, this is Frank. The -- we don't really see an impact from mix. I mean we have the hiccup that we have this year with the charge and the cost. We have adjustment costs and absorption impact. But medium to long term, the fundamentals haven't really changed.

And as we've communicated before there, like the key drivers where we see the margin improvement happening is that we're building a more integrated and more balanced production network. Like especially this year, at the beginning of the -- with a patch work of like our own breweries, we added quite a number of additional production locations, co-manufacturers. And the focus there was not really to integrate them or to get to the lowest possible cost. The focus was really to add capacity as quickly as possible because that's what has worked in the past years, and that's what we did. But we knew all along, as long as it stabilizes, what we will do is we'll integrate it.

So we're building a network with 4 anchor breweries. And most importantly, there's a really big facility on the West Coast -- or 2, I should say, that will supply that. So that will drive significant freight savings on 2 fronts. One is like outbound freight. So we don't have to ship it from the East Coast anymore to the West Coast. And with the beyond beer categories, especially seltzer, our growth has happened and has built out the West Coast much more than the East Coast. So that's one big bucket.

The second big bucket was variety pack costs because as you know, the hard seltzer category was kind of unique. It was this tremendous growth, but it was also in a completely new packaging format like slim can variety pack, which didn't exist before. And to produce them at scale and scale economics, that takes some time and some scale. So we have developed that internally. And we're getting -- and we've identified our external costs were extremely high. So that was one area of improvement.

One was to have a higher percentage internally, which we will be achieving because we are reducing our co-manufacturing capacity. The second thing is the co-manufacturers that will be producing variety pack have technology to get them really, really close to where we are internally. So we are achieving that as well. So that was the third -- the second one.

And the third one is the ongoing impact of our supply chain transformation efforts where we are better integrating -- becoming more efficient, and that's supporting the 4 anchor brewery concept, reducing waste and getting to lower inventories. And that will also reduce waste because we don't have to prebuild anymore as much. And that's just like as soon as you put stuff in and out of a warehouse that just increases costs.

So those are the 3 key drivers, and they remain in place, okay? And you will -- I mean you've seen the margin guidance. We're improving. We're getting to margins hopefully that are in the 2020 range or even better. And then we see the first -- we have seen the first benefits this year, quite frankly. They are masked with everything else that's going on. We see more benefits next year than eventually 2023.

Operator

Our next question comes from Kevin Grundy with Jefferies.

Kevin Michael Grundy - *Jefferies LLC, Research Division - Senior VP & Equity Analyst*

Great. Frank, not to belabor the -- I have 2 questions, if you don't mind. First one, just a point of clarification on gross margin. The second one for Jim and Dave on the HARD MTN DEW deal with PepsiCo. So first, just reasonable that this should be a mid-50% gross margin business? I think you made that comment within the past year or so. It sounded like you were kind of heading that way. If so, what's a reasonable time to achieve it? How important is that objective for the company within the context of sort of broader growth initiatives?

And then for Jim and Dave, on the PepsiCo HARD MTN DEW deal, I think it would be helpful just to spend some time on how that agreement came about. You may not want to comment, but what sort of contribution are you expecting this year and how that brand will play within the broader RTD space?

And then, Jim, curious to get your thoughts, and sorry for being verbose here. But just on sort of the broader conversions theme, I think PepsiCo's choice to set up a separate entity and handle the distribution is particularly noteworthy. Would be great to kind of get your thoughts on how you see this playing out more broadly for the industry and what the implications are.

Frank H. Smalla - *The Boston Beer Company, Inc. - CFO & Treasurer*

All right, Kevin. Let me start with gross margin. Gross margin clearly is a big focus area, and that hasn't changed. And we always said, like as long as we have this hyper growth, especially in hard seltzer, where new category is being built, growth and cutting out market share is the #1 priority. Once the growth moderates a little bit, then we will focus more on gross margin. So that is the strategy that hasn't changed.

We see margins above 50%. I don't want to commit to a specific number here. But clearly, we see the runway, and that is important to get it over 50% because as you know, you get the margin up, it applies to the entire volume that you have, and that drives profit and EPS. Having -- and we believe -- we started the project. We have seen progress this year. We'll see further progress next year. So when we get to the final point, it always will go, but we should see major progress at the latest in end of '22, 2023.

I will say, though, it's always a function of the growth. If something hits in the middle and we -- new category is being built and we need to drive growth, we might flip that. But margin is very clearly -- is very high on our agenda.

David A. Burwick - *The Boston Beer Company, Inc. - President, CEO & Director*

Okay. I'll tell you -- it looks like there's one for each of us, Kevin. So I'll do the second one. As it relates to the PepsiCo conversations, I mean, I spent 20 years there. So they still talk to me. And we've been in touch over time for different things. And as you know, with beyond beer -- this beyond beer category that we're calling right now emerging and consumers' desires changing and they're looking for different experiences, we find ourselves pretty quickly competing with everybody, not just other beer companies, beer, wine, spirits, non-alc, et cetera, et cetera.

And so there's been different conversations. They maybe started in different places but ended up with this idea around the HARD MTN DEW. And we went down that path because we do think that we can satisfy consumers' needs with our lineup of brands, and we can innovate as we have, as Jim pointed out, very successfully over time to reach those consumers. But given the different dimensions that beyond beer is taking, we might need to have some partners for certain things like Beam Suntory as well.

And so that sort of -- it kind of ended up with HARD MTN DEW. Our initial -- our preference is to put it through our system. Without question, it always is. And they have a different agenda, which is right for them. And so we had to come to some sort of a compromise on that. And I can -- from that, I can hand it over to Jim, and Jim can talk a little bit more about what this means for us.

C. James Koch - *The Boston Beer Company, Inc. - Founder & Chairman of the Board*

Yes. And Kevin, you mentioned this much larger theme of convergence, and I would add consolidation and blurring of lines. And I see that as a long-term trend. It's not going to change the world tomorrow, but it is something that will be relevant in our future. 10 years from now, it's going to look different. In 20 years, different still. A lot of it is driven by just -- well, by the raw economics of the distribution channel.

I mean basically, your gross margin dollars per stop is the biggest driver of profitability in the distribution channel. And the retailers are encouraging that, too. If you're a 7-Eleven, you don't want to see 3 distributor trucks out in your parking lot, one delivering Bud, one delivering Pepsi and another one maybe from a liquor distributor for your wines. They prefer fewer trucks, fewer salespeople calling on them, if you worry invoices. So there is an underlying pressure from that.

And then at the manufacturer level, everybody is exploring growth beyond their traditional lanes. The consumers are very supportive of that. There is a new consumer who is alcohol agnostic. I mean people don't ask where does the alcohol and Truly come from. It's just not that relevant to them. And that's creating this sort of overlapping category. People are calling it beyond beer, but it's also beyond wine because you're getting wine in the juice box, canned wine, wine in the form of a margarita and things like Rancho Gloria. And it's, in some ways, beyond spirits. It's coming in a beer can. But it happens to, say, Crown Royal on the outside of it.

So I guess I see those things as fundamental drivers in our business, and we have moved to build relationships with really strong players in terms of Beam Suntory and Pepsi. I mean we're a 4%, 5% share of beer, yet we've been able to build relationships with super high-quality companies with great brands. And I'm not sure where all that's going to go, but I want to -- I think Boston Beer should be better positioned than our other players in the beer industry if we want to win in this converged and consolidated future. It will happen, as I said, slowly. And alcohol is different.

So I think our friends at Pepsi are interested. They're putting their toe in the water. Do they -- will they like it? Yet to be determined. They certainly have great capabilities and make great products. But alcohol is its own different animal. There's no slotting fees. There's all these state-by-state laws. It's a much more complicated equation. But a solid, capable company wants to get into alcohol. They will, just like beer distributors are exploring non-alc and seeing what they can do with energy brands and sports brands and new non-alc brands. So I see this convergence and consolidation not going away, and we want to be well positioned to prosper from it.

Operator

(Operator Instructions) Our next question comes from Steve Powers with Deutsche Bank.

Stephen Robert R. Powers - *Deutsche Bank AG, Research Division - Research Analyst*

Maybe just a cleanup first, Frank, for you, I think, and then a second question kind of cleaning up from a different topic. The first one is on freight. I just want to go back to what you said. If I heard you correctly, I think you said you're making allowances for a few points of inflation further from here. So I guess is that a -- are you saying that's sequential appreciation from here? Or are you saying that's your call for '22 kind of base case, a little bit of inflation for year-over-year in '22?

Because I guess I would just think that on a year-over-year basis, given the appreciation we've seen progressively through '21, that there'd be a bigger year-over-year impact, although maybe that's offset by some of the West Coast build-out that you mentioned and efficiencies there. So just a little bit more clarity on what your base case is, a rough rate.

Frank H. Smalla - *The Boston Beer Company, Inc. - CFO & Treasurer*

Yes. I think if you look at our freight, I think we broke freight out separately, our freight on a rate basis is up higher than inflation. It's roughly 40%. And 2/3 of that is really rate inflation that's line haul that we're experiencing, but then there's a mix impact that we're having as well. And the mix impact is because we're shipping way more to the West Coast.

So what I was trying to say is there's like a significant 25%, 30% increase that we see really in line haul rates that we see this year. We don't see that going down. We see incremental single-digit increases, mid-single digits, mid- to high single digits for 2022 incrementally to 2021.

Stephen Robert R. Powers - *Deutsche Bank AG, Research Division - Research Analyst*

Okay. But then that's partially offset by the fact that you should have less of that long-haul dynamic in '22 versus '21?

Frank H. Smalla - *The Boston Beer Company, Inc. - CFO & Treasurer*

Exactly. Exactly. That's why I said before, what I'm giving you is like just pure rates and pure commodities. There's others that we have productivity initiatives. We have other things like -- so that's a big saving for us.

Stephen Robert R. Powers - *Deutsche Bank AG, Research Division - Research Analyst*

Okay. Great. Great. And then I just wanted to circle back on the pricing conversation and relative to the volume conversation we were having because it felt like there were 2 different conversations almost implying that you saw no elasticity impacts. The volume base -- the volume conversation was based on sort of household penetration and what consumers are saying. And then the pricing conversation was just cost up because costs are going up, we're taking price.

And I just -- in the context of the consumer being asked to bear a lot of price next year from a lot of different categories and in the context of all the convergence that we were just talking about, like how are you thinking about elasticity? Are you really thinking -- did I hear you correctly that sort of like elasticity is not a consideration? You feel like you have that pricing power, you're relatively inelastic? Or is that factored into the volume outlook for '22?

C. James Koch - *The Boston Beer Company, Inc. - Founder & Chairman of the Board*

Well, I'll take that, Steve. I guess the way we're thinking about it is that our -- we will be pricing up, but we're -- in real dollars, we will be probably going down. Now we're not going to fully recover the 5.5% inflation that we're seeing out in the broader economy. So the consumer can probably accept that. Their earnings will go up probably and their disposable income. I'm going to guess we'll go up a little faster than 3% or 4%, but they certainly won't go up much slower than that. And in our categories, I mean, we tend to compete at the high quality end in everything that we do.

So people have already made the decision that they're going to pay more for our brands. All of our brands are priced significantly above the average price per case in the beer category, and they have not traditionally been that price sensitive. I mean if you look at, say, Truly and the hard seltzer category, yes, there is a Natty Light Seltzer. I believe the last time I looked, it had 0.3% share. Yes, it's significantly below the industry leaders, us and White Claw. But it really has not drawn a lot of consumers to it.

And the same thing is kind of true in other categories. We sell craft beer. People -- they know they're going to pay more for it. It's significantly above other beers, and even low-priced craft beers from some of the big players have not gained traction. Cider, everything is more expensive there because it's harder to make and the ingredients are more expensive. And Twisted Tea, there are lower-priced RTs that have come after it, and Twisted Tea still has 90% to 95% market share in the hard tea category.

So I guess I'd say our feeling is that our consumers and our brands are -- while not impervious to price, there's got to be elasticities. We don't see a volume impact from passing on a portion of our costs. We're not going up as much as our costs have, and we think that will not impede the volume growth. It will look reasonable. And in the context of everything else, we're going to be going up less than the CPI.

Operator

There are no further questions at this time. I'll turn it back to Mr. Koch for some closing remarks. Thank you.

C. James Koch - *The Boston Beer Company, Inc. - Founder & Chairman of the Board*

I just want to say thanks, everyone, and we will speak next year.

Operator

Thank you. This concludes today's conference. All parties may disconnect. Have a good day.