EDISON

ADR research

Yowie Group

Business update

Regrouping and reprioritising, or a new path?

Food & beverages

Following a period of excessive volatility in results from Yowie, there has been a change in management, with the resignations of the CEO and two founding board members. Global COO, Mark Schuessler, was promoted to CEO. Additionally, the company now expects flat revenues in FY18 after initially cutting its FY18 revenue growth rate to 17% from previous guidance of 55-70%. We see the second half of FY18 as a transition period, which should create the conditions for a renewed growth path in FY19 at a lower level than before.

Year end	Revenue (US$m)	PTP* (US$m)	EPADR (US$)	DPADR (US$)	P/E (x)	Gross yield (%)
06/16	13.1	(6.7)	(0.41)	0.0	N/A	N/A
06/17	19.9	(7.9)	(0.35)	0.0	N/A	N/A
06/18e	18.0	(3.4)	(0.17)	0.0	N/A	N/A
06/19e	24.9	0.6	0.02	0.0	36.0	N/A

Note: PTP and EPADR are normalized, excluding intangible amortization and exceptional items. Investors should consult their tax advisor regarding the application of any domestic and foreign tax laws. Revenues include both product sales and licensing income.

Whither Yowie?

In its December results, Yowie's chairman, Louis Carroll, announced significant cost cuts for marketing and administrative overhead for the rest of FY18, despite the company having US$22.7m in net cash on its balance sheet. We believe the board may be signaling a shift in strategy, emphasizing near-term profitability over investing in the brand for long-term growth.

A leaner, but slower trajectory for FY18-19

Based on management's guidance, we are cutting our revenue estimate for FY18 to US$18.0m (including a US$1.95m adjustment to previously reported sales) from US$31.8m. Our new FY18 EPADR estimate is -US$0.17, down from -US$0.04. Our FY19 revenue estimate drops to US$24.9m from US$42.1m. We expect Yowie to report modest profitability of US$0.02/ADR in FY19, compared with our previous estimate of US$0.05/ADR.

Valuation: Trading at 70% of net cash

The market appears to have adopted a wait-and-see approach to Yowie. We believe it will take consistent forecast delivery to regain investor trust and so realize valuation upside. Our valuation assumes that Yowie uses the remainder of FY18 as a transition to reset shareholder expectations before reaccelerating its brand investment and sales expansion. At this point, management has not indicated any change in its previous strategy of growing sales at an aggressive rate (+30%). Therefore, for the purposes of this report and using our new estimates for FY18-19, our target value of US$1.78/ADR (previously US$3.25) is based on a 10% WACC, a sales CAGR of 15% for FY17-20, tapering to 2%, and an undemanding EBIT margin of 8%.

29 March 2018

Price	**$0.72***
Market cap	**$16m**

Calculated at ADR/ORD conversion ratio 1:10
US$0.79/A$

Net cash (US$m) at 31 Dec 2017	22.7
ADRs in issue	21.6m
ADR code	YWRPY
ADR exchange	OTC
Underlying exchange	ASX
Depository	BNY

Business description

Yowie Group, listed in Australia, is engaged in brand development of the Yowie chocolate confectionery product, digital platform and licensed consumer products. Yowie's brand vision includes distribution in North America, Australia and Canada with further expansion planned.

Next events

March results	April 2018
June results	August 2018

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Investment summary

Yowie has met with a number of challenges in the past 24 months: several management restructurings, an unexpected change in distributors at its largest customer (which created some volatility in order timing/size versus plan), supply chain upgrades, formalizing internal financial and operational controls and processes, two hurricanes and a prolonged legal battle with its original contract manufacturer. These challenges have taken their toll on shareholder patience and Yowie's share price.

In our September update note, we cautioned that Yowie's largely Australian retail shareholder base might be overly sensitive to its short-term sales trajectory, because those investors have been waiting for the Yowie brand to have the same impact in the US as it did in Australia in the 1990s. However, we also believed that the US$1.25/ADR in net cash would more than support the US$1.68/ADR price at the time. However, since September, the ADR price has dropped an additional 57% and now trades at a c 30% discount to net cash.

Following the December results, Yowie's chairman, Louis Carroll, cut sales guidance for FY18, announced a cost-cutting program targeting Yowie's marketing and administrative spend, and the promotion of global COO, Mark Schuessler, to the position of CEO. The former CEO and two long-time board members resigned shortly thereafter. The company has yet to articulate whether it will change strategy with less aggressive sales growth and lower marketing spend beyond FY18, leaving some uncertainty on the outlook for the Yowie franchise in terms of geographic and product line growth.

Yowie's quarterly performance issues are not particularly unusual for an emerging confectionary brand, although it is unusual for a food company with such modest (c US$20m) product sales to be publicly traded. More traditionally, start-up food companies are privately held (with/without venture capital) before completing an initial public offering. As a result, Yowie's investors are exposed to early-stage trading volatility.

We are reducing our FY18 revenue estimate to US$18.0m (-41%), including a US$1.95m downward previous period sales adjustment. Our reduction reflects disappointing sales in the December quarter stemming from a poorly executed end-cap promotion at Walmart and the slow uptake of Yowie's lower-priced Discovery World product. December's stumble aside, Yowie has improved internal controls, formalized planning and execution standards, as well as taking a more measured approach to communicating goals to the investor community. We believe these changes should begin to have a measurable impact on both results and investor perception over the next six to 12 months.

Exhibit 1: Yowie Group estimate revision

	Revenues (US$m)			PTP (US$m)			EPADR (US$)		
	Old	New	% chg.	Old	New	% chg.	Old	New	% chg.
FY18e	31.8	18.0*	(43.4)	(0.9)	(3.4)	(277.8)	(0.04)	(0.17)	(325.0)
FY19e	42.1	24.9	(40.9)	1.2	0.6	(50.0)	0.05	0.02	(60.0)
FY20e	49.9	30.6	(61.3)	4.2	3.8	(50.0)	0.16	0.14	(12.5)

Source: Yowie Group reports, Edison Investment Research estimates. Note: *FY18 revenues include a prior period sales adjustment of -US$1.95m.

Valuation

At its core, Yowie has many positive investment features. Sales rose from US$2.4m at the end of FY15 to nearly US$20m in two years, with no brand recognition and limited promotion in the US. The company has healthy gross margins of c 50%, administrative expenses that will benefit from increased economies of scale and current US$1.05 net cash/ADR exceeding its US$0.73/ADR price. However, as we have seen over the past two years, small setbacks in sales timing or expenses can have a large impact on reported results and investor sentiment. It will take consistent forecast delivery to regain investor trust and hence valuation upside. Our valuation assumes that Yowie uses the remainder of FY18 as a transition to reset expectations, before reaccelerating its brand investment and sales expansion. Using our new estimates for FY18-19, our target value of US$1.78/ADR is based on a 10% WACC, a four-year sales CAGR of 15% through FY20, tapering to 2%, and an undemanding EBIT margin of 8%.

Financials

Profit and loss

Yowie's net sales in the first half of FY18 fell 16% to US$8m over the prior year period. Net sales include a downward prior period sales adjustment of US$1.95m. The company attributes the delayed roll-out of Series 3, disappointing early adoption of its lower-priced Discovery World line, a decline in chocolate sales in the novelty confectionary statement and pressures from newly introduced competitive products. Product gross margins for the first half (excluding the sales adjustment) improved by 80bp to 54.7%, from 53.9% in FY17. This is above the company's long-term target of c 50% in the confectionary business and primarily reflects improved commodity costs (the company does not hedge its commodity purchases but does buy forward), and economies of scale in both production and supplies (such as packaging). Including the prior period sales adjustment, product gross margins fell to 43.6%.

We estimate revenues of US$18.0m in FY18, climbing to US$30.6m by FY20, including US$0.6m of licensing revenues, a three-year compound average annual increase of 25%. We lowered our licensing forecast from US$2.1m to US$0.6m to reflect management's focus on the core confectionary products and a more modest timeline for developing the characters so they are well positioned for licensing opportunities.

For FY18, our gross margin estimate (as reported) is 54.8%, compared with our previous estimate of 50.0% and based on the 50bp increase reported in H118, and reflects increased emphasis on sales outside Yowie's key customer (where distribution expenses are absorbed by the customer in exchange for a slightly lower net price). We look for sales and distribution expenses to be largely unchanged in H218 compared with H118, totaling c US$3.8m for the full year.

The most significant change is marketing expense. Management is guiding to marketing expense in H218 to be 50% lower than in H118 – or approximately US$3.7m compared with our previous estimate of US$5.3m. We now forecast administrative expense for the year (as reported) of US$5.8m, down from our previous estimate of US$7.7m.

We forecast EBITDA margins to move from -16.9% in FY18 to 14.0% by FY20, primarily through savings in marketing spend and better economies in administrative expense. The company has had litigation and product development expenses (related to moving production from Whetstone to Madelaine in January 2016, and the creation and patent of the new capsule), which will continue into FY18 as Whetstone continues to challenge unfavorable decisions on its production contract with Yowie, along with professional expenses to set up transfer pricing/intercompany arrangements and ASX filing costs. As a start-up, Yowie is required to file quarterly financials, compared with semi-annually for established companies. Share-based expense was a credit of US$0.8m in the first half of FY18, compared with a debit of US$3.2m in the prior year period. The drop in share-based expense stems from unvested share-based compensation.

Cash flow

At this early stage, Yowie is not operating cash flow positive. The company used US$4.3m in operating and investing cash in the first half of FY18, compared with US$2.6m in the prior year period. The additional cash used in the first half of FY18 reflects the prior period sales adjustment plus investment in intangible assets.

Balance sheet

Yowie remains debt free, with US$22.7m of cash on the balance sheet at 31 December 2017. Trade accounts payable and accruals increased to US$4.0m from US$2.7m in the prior year period, reflecting the prior period sales adjustment. The adjustment will be expensed over the upcoming 12 months.

Exhibit 2: Financial summary

US$000s	2015	2016	2017	2018e	2019e	2020e
Year end June	AGAAP	AGAAP	AGAAP	AGAAP	AGAAP	AGAAP
PROFIT & LOSS						
Revenue	2,377	13,063	19,897	18,023	24,926	30,550
Cost of Sales	(1,043)	(6,245)	(8,789)	(8,141)	(12,382)	(14,968)
Gross Profit	1,334	6,818	11,108	9,883	12,544	15,581
EBITDA	(2,657)	(6,562)	(7,489)	(3,051)	980	4,263
Operating Profit (before amort. and except.)	(2,727)	(6,674)	(7,878)	(3,422)	580	3,839
Intangible Amortisation	0	0	(194)	0	0	0
Exceptionals	(64)	(700)	0	0	0	0
Other	0	0	0	0	0	0
Operating Profit	(2,790)	(7,375)	(8,071)	(3,422)	580	3,839
Net Interest	(1)	(0)	(1)	0	0	0
Pre-tax profit (norm)	(2,727)	(6,674)	(7,879)	(3,422)	580	3,839
Pre-tax profit (FRS 3)	(2,791)	(7,375)	(8,072)	(3,422)	580	3,839
Tax	0	(23)	581	(300)	(87)	(768)
Profit After Tax (norm)	(2,725)	(6,695)	(7,294)	(3,718)	497	3,075
Profit After Tax (FRS 3)	(2,791)	(7,398)	(7,491)	(3,722)	493	3,071
Average Number of ADRs Outstanding (m)	1.3	16.5	20.8	21.5	21.5	21.5
EPADR - normalized (c)	(21.6)	(40.5)	(35.0)	(17.3)	2.3	14.3
EPADR - normalized fully diluted (c)	(21.6)	(40.5)	(34.0)	(16.8)	2.3	14.3
EPADR - (IFRS) (c)	(22.1)	(44.7)	(36.0)	(17.3)	2.3	14.3
Dividend per share (c)	0.00	0.00	0.00	0.00	0.00	0.00
Gross Margin (%)	56.1	52.2	55.8	54.8	50.3	51.0
EBITDA Margin (%)	(111.8)	(50.2)	(37.6)	(16.9)	3.9	14.0
Operating Margin (before GW and except.) (%)	(114.7)	(51.1)	(39.6)	(19.0)	2.3	12.6
BALANCE SHEET						
Fixed Assets	1,572	3,865	4,653	4,931	5,182	5,408
Intangible Assets	385	783	1,140	1,140	1,140	1,140
Tangible Assets	1,187	3,081	3,513	3,792	4,043	4,268
Investments	0	0	0	0	0	0
Current Assets	14,209	35,820	33,293	31,103	34,203	39,376
Stocks	5,197	1,134	3,721	2,524	3,838	4,640
Debtors	319	1,327	1,523	1,379	1,907	2,338
Cash	8,465	31,693	26,878	26,406	27,249	30,938
Other	227	1,666	1,171	794	1,208	1,461
Current Liabilities	(1,516)	(2,708)	(2,794)	(2,605)	(3,962)	(4,790)
Creditors	(1,516)	(2,708)	(2,794)	(2,605)	(3,962)	(4,790)
Short term borrowings	0	0	0	0	0	0
Long Term Liabilities	0	0	0	0	0	0
Long term borrowings	0	0	0	0	0	0
Other long term liabilities	0	0	0	0	0	0
Net Assets	14,264	36,977	35,152	33,429	35,423	39,994
CASH FLOW						
Operating Cash Flow	(6,545)	(109)	(5,652)	478	1,580	5,106
Net Interest	(1)	(0)	(1)	0	0	0
Tax	0	(23)	581	(300)	(87)	(768)
Capex	(317)	(3,211)	(1,083)	(650)	(650)	(650)
Acquisitions/disposals	0	0	0	0	0	0
Financing	7,562	26,571	1,339	0	0	0
Dividends	0	0	0	0	0	0
Net Cash Flow	699	23,228	(4,816)	(472)	843	3,689
Opening net debt/(cash)	(7,767)	(8,465)	(31,693)	(26,878)	(26,406)	(27,249)
HP finance leases initiated	0	0	0	0	0	0
Other	0	0	0	(0)	0	0
Closing net debt/(cash)	(8,465)	(31,693)	(26,878)	(26,406)	(27,249)	(30,938)

Source: Company accounts, Edison Investment Research

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