

# Yowie Group

## An inflection point after a year of challenges?

After a year of internal and external challenges, we believe Yowie has built a strong and reliable operational base and business plan that will support continued sales growth and a move to profitability by the end of fiscal 2018. With US\$1.25/ADR in cash, no debt and modest working investment needs, we see Yowie shares as compelling value for long-term growth investors.

Year end	Revenue (US\$m)	PTP* (US\$m)	EPADR (US\$)	DPADR (\$)	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	31.8	(0.9)	(0.04)	0.0	N/A	N/A
06/19e	42.1	1.2	0.05	0.0	32.0	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.

## New markets help flattish June quarter sales

June quarterly sales of US\$4.2m rose 23% from a year ago, including US\$0.8m in sales from Australia. Sales in the US were up a mere 1%, helped by expansion in the convenience and grocery markets. Sales to Walmart were down c 15% due to a delay in the launches of Series 3, and Discovery World, which have begun and will continue through Q2 of FY18.

## FY18 will start slow and build

Q1 sales are shaping up to be flattish on a sequential basis. Sales may take a hit from hurricanes Harvey and Irma, which hit the south-east US in late August-early September. In Texas, Harvey forced the closure of at least 134 stores and three distribution centers, however many reopened within a week. In Florida, one Walmart and two Winn-Dixies (a new account) remain shut.

## Valuation: DCF US\$3.25 on modest assumptions

Yowie's share price dropped nearly 50% since our [update note](#) published on 17 May 2017. Investors appear overly focused on the quarterly sales trajectory, which for start-up companies can be very volatile driven by one-off aberrations such as initial order channel fill, supply/distribution chain disruptions, and inventory management at the customer level. Yowie has grown sales 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 US\$1.25 cash supporting its US\$1.60/ADR price. Our target value of US\$3.70/ADR is based on a 10% WACC, a sales CAGR of 36% through FY20, tapering to 2%, and an undemanding EBIT margin of 8%.

## Food & beverages

22 September 2017

**Price\*** **US\$1.60**
**Market cap** **US\$34m**

\*Calculated at ADR/Ord conversion ratio 1:10  
US\$0.80/A\$

Net cash (US\$m) at 30 June 2017 26.9

ADRs in issue 21.5m

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

September results October 2017

December results January 2018

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## Looking ahead to a positive turn in FY18

Call it the “sophomore slump”. As a headline, Yowie has achieved much in a short period of time: rolled out into 4,500 Walmart stores, expanded into drug, grocery, big-box retailers and convenience stores – getting a 0.5% market share according to the Nielsen xAOC plus convenience (eXtended all outlet combined) – and made its initial sales in Australia while finalizing its entry in Canada. In two years, sales have increased nearly tenfold from US\$2.4m in FY15 to US\$19.9m in FY17. Gross margins are already in line with those of larger confectioners, such as Hershey (HSY), and the company has US\$1.25/ADR in cash and no debt. Yet the shares are down 50% in three months and 80% from its price when we initiated coverage in September 2015.

So what has gone wrong? In our view, nothing inconsistent with a start-up: a weather-related supply chain imbalance, longer-than-expected sales cycles for some customers and less-than-optimal merchandising at some accounts. We see much of the decline driven by initial investor enthusiasm, coupled with limited data, leaving investors to extrapolate future results off data that often contains a number of one-time positive (channel filling) or negative (store roll-out delay) factors. Layer these nuances on a largely retail shareholder base, many of whom were likely expecting Yowie confectionary to replicate the rapid success achieved in Australia 20 years ago, and we now have expectations that may have swung too far to the negative.

We are setting our FY18 revenue estimate at US\$31.8m (+64%), roughly at the midpoint of Yowie's guidance of 55-70% growth. Company's guidance includes additional sales from Walmart, as well as sales from new customers, increased sales in Australia, and expansion into Canada and the UK. At Walmart, sales gains are expected from the introduction of Yowie's lower-priced Discovery World line, end-cap shelving displays to support holiday promotions, a likely move into the main candy aisle. We have seen a strong improvement in the company's planning and execution standards as well as a more measured approach to communicating goals to the investor community. We believe these changes will begin to have a measureable impact in both results and investor perception, starting in the second or third fiscal quarters.

**Exhibit 1: Yowie Group estimate revisions**

	Revenues (US\$m)			PTP (US\$m)			EPADR (US\$)		
	Old	New	% chg.	Old	New	% chg.	Old	New	% chg.
2017	22.1e	19.9	(10.0)	(3.9)	(7.9)	NM	(0.18)	(0.35)	NM
2018e	37.1	31.8	(14.2)	5.8	(0.9)	NM	0.27	(0.04)	NM
2019e	51.0	42.1	(17.4)	10.1	1.2	(88.8)	0.48	0.05	(90.0)
2020e	NE	49.9	NM	NE	4.2	NM	NE	0.16	NM

Source: Yowie Group reports, Edison Investment Research estimates FY17 old numbers are estimates, NE = no estimate.

## Valuation

Our primary valuation metric for Yowie is DCF, since the full value of the current opportunity is likely to become apparent over a number of years rather than in near-term results. We have previously used a reverse DCF to gauge valuation; however, with a 50% drop in valuation in the past three months, coupled with a large cash balance, we believe a reverse DCF suggests unsustainably low margins and revenue growth based on current and forecast trends. With US\$1.25 net cash for each ADR, we believe Yowie offers significant upside to investors over the next several years.

Our 10-year DCF model builds to sales of approximately US\$111m by FY27. We assume a terminal growth rate of 2% and use a WACC of 10.0% (reflecting 10% gearing), an equity risk premium of 5.4% and a beta of 1.2. We selected these to reflect what we view as conservative earnings forecasts, a once strong and proven children's franchise and a business model that is not capital intensive. Our DCF applies a terminal EBIT margin of 8%, a level that we regard as achievable on

the confectionary business alone – where net profit margins for established players can reach the mid-teens. On this basis, we derive an ADR price of US\$3.25, double the current price of US\$1.60.

If the brand continues to prove itself, we expect the WACC and relative risks to the story will more closely reflect a consumer goods story, albeit one with very high growth. As we saw in FY17, investors have been very sensitive to even slight changes to the implied sales trajectory, making brand acceptance and day-to-day execution key investment sensitivities.

There is a real opportunity for investors should Yowie move significantly beyond confectionery into other products and out-licensing – in essence becoming a “brand” as opposed to a pure confectionary play. Evidence of success here would lead us to adjust our sales and margin forecasts to more accurately reflect the impact of the increased license income. Catalysts would include the planned launch of Yowie children’s books (which are being rewritten to better suit a contemporary American audience), the animated web series (in planning stages) and additional potential projects such as video/web games. It is too early to gauge the impact of these projects on confectionary and licensing income, but management has included an unspecified level of marketing spend in its FY18 estimates to cover brand development.

## Financials

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The opportunity for Yowie is significant; however, we are still at the very early stages of what management sees as a global brand across multiple product classes. In addition, apart from Walmart sales performance, we have relatively limited sales data. In our view, there remains a fair amount of uncertainty as to how revenues will trend beyond FY19, especially as confectionary sales to Walmart mature and the company becomes dependent on growth from multiple smaller retailers, new products and new geographies.

## Profit and loss

Yowie has proven success at the checkout stands at Walmart, but even at checkout, Yowie management sees opportunity for growth with better merchandising. Additionally in FY18, Yowie may finally move to the main candy aisle at Walmart after several iterations of package design. We also expect Yowie to move into Canada and the UK in FY18. We expect the US to contribute more than 80% of revenues through FY19; however, there is further opportunity as Yowie renews its existing brand franchise in Australia, New Zealand and Asia, and extends into Europe and the Middle East. Management announced that sales began in Australia and New Zealand on 10 April.

Yowie’s net sales in FY17 rose 51% to US\$19.9m, somewhat behind our US\$22.1m expectation. The company attributes the delayed roll-out of Series 3, Discovery World and entry into Canada for much of the difference. Gross margins for the year expanded to 55.8%, from 52.2% in FY16. 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).

Our model calls for revenues of US\$31.8m in FY18, climbing to US\$49.9m by FY20, including US\$0.6m of licensing revenues, a 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.

Our FY18 model keeps gross margins closer to long-term guidance of 50%, down 580bp from FY17. Gross margins in FY17 benefited to some extent from favorable commodity costs and running production of a single product (US-edition Yowies) on a single line for the bulk of the year. In FY18, Yowie will make product for the US, Australia/NZ, Canada and likely the UK. In addition,

Yowie will manufacture its new Discovery World product on a separate line at Madelaine. This diversification will add incremental manufacturing costs to set up the production line (changing wrappers and display packaging).

We forecast EBITDA margins to move from -38% in FY17 to 9% by FY20, primarily through better economies of scale 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, 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. We forecast share-based compensation to total c 7% of revenues in FY18, down from 23% in FY17. Senior management is fully staffed, so we do not anticipate large share grants related to new hires.

Our margin forecasts could turn out to be conservative should the company not accelerate its marketing spend to 19% of product sales from our forecast level of 17% in FY18. We anticipate economies of scale in production, sales and distribution and in administrative overhead to largely offset any major step up in marketing expenditures.

We believe that the real margin opportunity will be as Yowie moves beyond confectionery into entertainment (books, gaming, media and out-licensing). Merchandise and other licensing agreements would likely be structured as royalty revenues to the company, with some level of guarantee. Licensing revenue would likely be highly profitable and drop almost entirely to the operating line, after some level of administrative costs. However, we have not built this into our earnings model for FY18 and we have made only a modest assumption of US\$0.6m for FY19.

## **Cash flow**

At this early stage, Yowie is not operating cash flow positive. The company used US\$5.3m in operating and investing cash for FY17, compared with US\$3.3m used in FY16. The additional cash used in FY17 went to rebuilding inventories and higher stock compensation expense, partially offset by less investment in plant and equipment.

## **Balance sheet**

Yowie remains debt free, with US\$26.9m of cash on the balance sheet at 30 June 2017, somewhat better than our forecasted net cash of US\$25.8m. In FY16, Yowie raised US\$23m through a private placement of 35.6m shares in addition to US\$4.2m from the exercise of options. These proceeds are being used to fund working capital, the continued roll-out in the US and newer ventures in publishing and entertainment.

**Exhibit 2: Financial summary**

	US\$000s	2015	2016	2017	2018e	2019e	2020e
Year end June		AGAAP	AGAAP	AGAAP	AGAAP	AGAAP	AGAAP
<b>PROFIT &amp; LOSS</b>							
Revenue		2,377	13,063	19,897	31,800	42,112	49,861
Cost of Sales		(1,043)	(6,245)	(8,789)	(15,911)	(21,098)	(24,624)
Gross Profit		1,334	6,818	11,108	15,889	21,014	25,237
EBITDA		(2,657)	(6,562)	(7,489)	(486)	1,609	4,594
Operating Profit (before amort. and except.)		(2,727)	(6,674)	(7,878)	(857)	1,210	4,170
Intangible amortization		0	0	0	0	0	0
Exceptionals		(64)	(700)	0	0	0	0
Other		0	0	0	0	0	0
Operating Profit		(2,790)	(7,375)	(7,878)	(857)	1,210	4,170
Net Interest		(1)	(0)	(1)	0	0	0
Pre-Tax Profit (norm)		(2,727)	(6,674)	(7,879)	(857)	1,210	4,170
Pre-Tax Profit (FRS 3)		(2,791)	(7,375)	(7,879)	(857)	1,210	4,170
Tax		0	(23)	581	0	(181)	(834)
Profit After Tax (norm)		(2,725)	(6,695)	(7,294)	(853)	1,032	3,340
Profit After Tax (FRS 3)		(2,791)	(7,398)	(7,298)	(857)	1,028	3,336
Average Number of ADRs Outstanding (m)		1.3	16.5	21.5	21.5	21.5	21.5
EPADR - normalized (c)		(21.6)	(40.5)	(33.9)	(4.0)	4.8	15.5
EPADR - normalized fully diluted (c)		(21.6)	(40.5)	(32.9)	(3.8)	4.8	15.5
EPADR - (IFRS) (c)		(22.1)	(44.7)	(33.9)	(4.0)	4.8	15.5
Dividend per share (c)		0.00	0.00	0.00	0.00	0.00	0.00
Gross Margin (%)		56.1	52.2	55.8	50.0	49.9	50.6
EBITDA Margin (%)		-111.8	-50.2	-37.6	-1.5	3.8	9.2
Operating Margin (before GW and except.) (%)		-114.7	-51.1	-39.6	-2.7	2.9	8.4
<b>BALANCE SHEET</b>							
Fixed Assets		1,572	3,865	5,695	5,973	6,224	6,450
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
Deferred Tax Assets		0	0	1,042	1,042	1,042	1,042
Current Assets		14,209	35,820	33,293	36,455	40,392	46,130
Stocks		5,197	1,134	3,721	4,933	6,540	7,633
Debtors		319	1,327	1,523	2,433	3,222	3,815
Cash		8,465	31,693	26,878	27,536	28,570	32,278
Other		227	1,666	1,171	1,553	2,059	2,403
Current Liabilities		(1,516)	(2,708)	(2,794)	(5,092)	(6,751)	(7,880)
Creditors		(1,516)	(2,708)	(2,794)	(5,092)	(6,751)	(7,880)
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	36,194	37,336	39,865	44,700
<b>CASH FLOW</b>							
Operating Cash Flow		(6,545)	(109)	(5,652)	1,309	1,866	5,192
Net Interest		(1)	(0)	(1)	0	0	0
Tax		0	(23)	581	0	(181)	(834)
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)	659	1,034	3,708
Opening net debt/(cash)		(7,767)	(8,465)	(31,693)	(26,878)	(27,536)	(28,570)
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)	(27,536)	(28,570)	(32,278)

Source: Yowie Group reports, Edison Investment Research estimates

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