EDISON

Spotlight – IPO report

Nightcap

Travel & leisure

13 December 2020

A heady cocktail

With the launch of Nightcap, entrepreneurial management with significant experience in developing successful bar groups is seizing a clear-cut opportunity to build a major drinks-led UK hospitality business. The increased availability of target sites at attractive rents, sharply reduced competition and shifting consumer preferences highlight extensive changes beneficial to Nightcap, which have only been accelerated and enhanced by COVID-19. London Cocktail Club (LCC) looks a strong first move for Nightcap as it is both popular and well-regarded in its own right – and highly scalable. This acquisition is likely to be just the start.

Keeping it simple

Nightcap has a clear and straightforward strategy, which is welcome. It seeks to acquire at relatively low valuations basically sound businesses that do not have the money to grow, and then aims to re-capitalise and develop them. In addition to a low break-even level and high return on investment, their business models should be easily scalable with scope for nationwide rollout and group synergies. Nightcap targets the relative affluence of the millennial market with its taste for social interaction and experiences and the non-formulaic, as epitomised by LCC.

Opportunity knocks

A silver lining of the pandemic's exacerbation of longstanding structural difficulties in UK hospitality is the availability of prime sites at ever cheaper prices and the significant erosion of competition (estimated loss of up to 30% of restaurants) with the consequent supply of high quality staff. This provides an undeniable opportunity for an operator like Nightcap, which should be well-funded after the IPO and has experienced and ambitious leadership, notably CEO Sarah Willingham, a prominent entrepreneur, and CFO Toby Rolph who developed the Be At One cocktail bars before selling to Stonegate.

The perfect starter

LCC fits Nightcap's bill as its experiential offering has proved itself to millennials across London and since 2018 provincially (Bristol). Operating from a small footage (basement bars of 1,200 sq ft) allows for attractive returns and a potentially simple rollout from 10 sites at present to 40 over the next five years.

Valuation

As a base for assessing underlying profit without structural changes and COVID-19, LCC's pro forma EBITDA uses results for FY19, enhanced by efficiencies and site maturity, plus a full year for openings based on trading up to February 2020 and head office/one-off adjustments. For a total consideration of £7.5m, which assuming a pro forma EBITDA of £1.8m gives an exit EV/EBITDA multiple of 4.2x.

LCC's pro forma EBITDA

Year end June						EBITDA (£m)
						1.8

Source: Nightcap

Price	N/A
Market cap	N/A

Share details

Code	NGHT
Listing	AIM
Shares in issue	N/A

Business description

Nightcap is aiming to build a major presence in the UK premium bars sector, initially through the acquisition and proposed expansion of London Cocktail Club, a popular chain of high energy party bars. The company expects further acquisitions of drinks-led concepts.

Bull

- Arguably unprecedented growth opportunity: site availability, reduced competition, changes in consumer behaviour and availability of talent.
- Strategic focus on replicable models with nationwide potential and synergies endorsed by the purchase of the pioneering LCC.
- Strong entrepreneurial and operational management.

Bear

- Execution risk in terms of planned expansion.
- Economic uncertainty, notably regarding the impact of COVID-19 and Brexit.
- Retention of key personnel.

Analysts

Richard Finch +44 (0)20 3077 5700

Russell Pointon +44 (0)20 3077 5700

consumer@edisongroup.com

Edison profile page

Company description: Premium bars operator

Nightcap is newly established to take advantage of significant changes taking place in the premium bars segment and more generally in UK hospitality. Management is confident that it can seize an exceptional opportunity to acquire and grow 'drinks-led' hospitality concepts focused on the social experience of consumers. As its first step in implementing its strategy Nightcap will acquire LCC.

London Cocktail Club

'Behind the iconic red LCC door is a light beckoning you down to the party below! Here's our bar inspired by our appreciation of trendy tattoo parlours and influenced by our love of rum. Sip delicious award-winning cocktails among walls adorned with colourful contemporary artwork & shelves decked in all the eclectic rum antiques! This basement bar is an after work, hair-down, ties-off celebration of consequence-free drinking for an "up for it" crowd. The soundtrack of your youth echoes loudly through the speaker, so don't be surprised to find yourself singing along!'

The LCC website introduction to its bar in Shaftesbury Avenue, which opened in 2012, epitomises the experiential destination-led offering that Nightcap is targeting. It is the antithesis of mass-produced hospitality with its emphasis on price as favoured by the likes of Revolution Bars and Wetherspoons, and is instead in tune with a shift in consumer taste towards a more discerning, personalised proposition. Indeed, each of LCC's 10 bars, even in relatively close proximity (seven are in central London), is styled individually, multiplying the opportunity for social experience and interaction sought by its focus market, (mainly female) millennials.

However, a common theme is an intimate, basement location (capacity of up to c 120) with no outside distraction, ie daylight, to encourage dwell time. While peak trading is from 7pm to 10pm, the challenge, evidently addressed by LCC, is to retain the guest who would otherwise move on to a night club (in normal conditions its venues are open broadly until 2am). Happy Hour of 4pm to 7pm with 2–4–1 cocktails for £12 compounds this goal, as does an all-day menu, which drives efficiencies.

The experiential offering and branding are expanded through masterclass courses (£40 per person) on signature company cocktails with the provision of an LCC certificate and a kitchen cocktails book (quarantinis) and 'LCC' radio to allow the re-creation at home of the company's experience.

The growing significance of branding, for example in terms of drinks and music, was recognised early by LCC's co-founder and creative director, JJ Goodman, who is credited with revolutionising London's cocktail scene over the past decade or more. Regarded as one of the leading mixologists and bartenders (a former world champion, no less), importantly, he remains at the heart of LCC under Nightcap as LCC's Head Bartender.

Exhibit 1: Nightcap – overview

Source: Nightcap

Ready to roll

Nightcap is confident that LCC's proven 10-year record across London and, since 2018, provincially (Bristol) and the simplicity of its model (small, low-profile sites) should allow rapid and efficient expansion. With an average site cost of £339,000 and having consistently achieved bumper returns on investment (75% at site EBITDA level after three years), the company's medium-term aim of 40 outlets in major UK cities looks reasonable. Thereafter, up to 120 LCC sites may be on the cards.

Notwithstanding execution risk, the opportunity for expansion appears unusually favourable, ironically as a consequence of the longstanding severity of trading conditions, which were compounded by the advent of COVID-19. Structural difficulties had long bedevilled UK hospitality as a result of excess capacity, the frequency of 'me too' product, rising costs and narrow margins. Economic and political uncertainty following the result of the EU referendum in 2016 only made matters worse as the erosion of consumer confidence led to an increase in vacant retail space being rented out to restaurant and bar operators on historically cheap debt finance. Stagnation in sales and inflationary pressures (notably, business rates, the National Living Wage and food imports thanks to sterling weakness) have proved an especially sorry mix for restaurant groups, which were already highly indebted. High-profile chains entering administration or credit agreements in 2018 and 2019 included Jamie's Italian, Carluccio's, Gaucho and Gourmet Burger Kitchen.

Happily for a well-funded operator such as Nightcap with cash and tradeable equity, this sorry tale appears to have led to a rather more benign environment which its management believes is likely to continue for a number of years:

- **Enhanced availability of sites:** As a result of the aforementioned pressures and landlords' wish to ensure occupancy, the aggressive renegotiation of the terms of existing leases has often yielded material rent reductions. Also, even if LCC is not considering turnover rents, it is widely expected that the performance element of rent, ie linked to tenant operator turnover, will increase, thereby reducing base rents. Overall, in the longer term this could well empower tenants, with potential one-way tenant breaks and downward rent reviews.
- **Reduction in competition:** Market consensus of 20–30% fewer hospitality businesses as a consequence of the economic fallout necessarily works in favour of survivors. In any case there

is at present no direct peer (basement bars) for LCC in management's view and existing operators are likely to be preoccupied with repositioning their estate rather than expanding.

- **Availability of talented staff:** The prospect of a ready supply of well-qualified people from closed businesses should be of particular benefit to LCC as it majors on guest service.
- **Shift in consumer habits:** Away from night clubs (11% fewer venues in 2019, per Alix Partners) to party bars.

Notwithstanding continued uncertainty about the timing of a return to trading normality, the promising news of the development of vaccines should accelerate the reopening of UK hospitality and in particular, LCC's intended rollout.

The cherry on top

Expansion aside, organic growth prospects for LCC appear very positive in view of the popularity of its core ingredient. Cocktails have long been the star of the drinks on-trade with the industry association CGA reporting last year that cocktails 'continue to go from strength to strength' and specifically up 6% y-o-y in Q120. According to Diageo, in 2019 spirits were growing ahead of beer and wine, accounting for almost one in three of total alcohol market serves.

Cocktails also enjoy:

- **Strong margins:** Consumers pay up for the theatre created by the bartenders who prepare beautiful cocktails, made with a few ingredients, fancy eclectic glassware and garnishes to finish. LCC's most popular cocktails are priced between £9 and £12.
- **Broad appeal:** Popular with the increasingly discerning millennial consumer as well as the novice, for whom presentation and taste may alone suffice (notwithstanding the demonstrable flair and expertise of LCC bartenders).
- **Flexibility:** Appropriate at almost any occasion and at any time of the afternoon and evening.
- **An element of show:** This suits LCC's target millennials' desire for social interaction and experience.

COVID-19 resilience

LCC trade has continued to show its mettle despite continuing coronavirus restrictions. In August and September following the phased re-opening in July, LLC reports like-for-like sales up 8% y-o-y.. This is impressive as it is in the face of the Rule of Six and the start of the 10pm curfew and of course was not flattered by the government's Eat Out to Help Out scheme throughout August which did not apply to alcohol. A high spend per head was still achieved with a simplified menu delivered via table service. LCC's demographic remained enthusiastic about social engagement in a safe setting, while arguably feeling more confident about COVID-19 than other groups in society. On reopening on 2 December after the second national lockdown, LCC's London venues are offering a substantial meal to accompany alcoholic drinks in accordance with COVID restrictions.

A by-product of restrictions has been a material paring of costs including supplier prices through bulk ordering for a simplified menu, a move from monthly to hourly pay, the renegotiation of property leases and at head office.

Further expansion

Nightcap has stated its ambition to acquire, re-capitalise and develop or re-position drinks-led concepts across the UK. We may assume these to have similar characteristics to the LCC model, as described, and the potential for economies of scale in terms of increased purchasing power and other operational and head office synergies.

Management

The company's senior management (see below) is backed by the highly experienced operational management of LCC. Overall, the team has been involved in the opening and operation of over a hundred bars and restaurants and achieved a number of successful exits of hospitality companies for investors.

- **Founder and CEO: Sarah Willingham** is a well-known entrepreneur and investor in the hospitality sector. She developed Bombay Bicyle Club, the UK's largest chain of Indian restaurants, in partnership with Clapham House Group, to which she profitably sold her share three years later, and where she continued as an executive director. She is now investor and chair of private equity backed Tonkotsu (modern, hip canteen serving Japanese ramen with homemade noodles in a variety of broths), which has 12 sites in London and one in Birmingham. She is co-founder of LCC. She appeared as a 'Dragon' on BBC's 'Dragons' Den' from 2015 to 2017.
- **CFO: Toby Rolph** helped grow Be At One (premium cocktail bars in high street locations) from 12 sites to 33 and co-led its sale to Stonegate in 2018. After expanding Academy Music Group, the UK's leading owner and operator of nationwide live music and club venues, he co-led its disposal to Live Nation.
- **Founder and executive director: Michael Toxvaerd** is a serial entrepreneur, investor and private equity professional with 15 years' M&A experience. He founded and led AIM-listed start-up NeutralHealth and served as investor and director of AIM-listed asset management group Rasmala.

Financials

Exhibit 2: Summary accounts for LCC (annual and first quarters to September)

Year end 30 June (£m)	2018	2019	2020	Q120	Q121
Sites at year end	7	9	10		
Revenue	5.9	6.6	5.2	1.57	1.25
Gross Profit	4.6	5.2	4.1	1.25	0.99
Operating profit	0.1	0.1	(0.3)	(0.48)	0.06
Add back:					
Property costs	0.5	0.4	0.3	0.58	0.90
Non-recurring costs	0.2	0.4	0.1	-	-
Adjusted EBITDA pre IFRS 16	0.7	0.9	0.1	0.10	0.96

Source: LCC

While the impact of expansion in FY19 and then of COVID-19 in FY20 is clearly evident in the periods' contrasting fortunes, Nightcap believes that historical financials for LCC, shown above in Exhibit 2, are unrepresentative of the underlying business. Consequently, it has prepared a pro forma pre IFRS 16 EBITDA (Exhibit 3), which assumes trading at FY19 levels ie excluding COVID-19, with a substantial uplift for operational efficiencies. These include reducing the size of the cocktail menu, improved purchasing as a result of discontinuing legacy contracts with certain spirits brands, and a streamlined wage structure. The three openings since the start of FY19 are shown for the full period, based on their performance in the eight months to February 2020 before COVID-19 took hold. There is also an adjustment for the expected benefit of maturity of these sites in line with that of other LCC bars.

There is a bridge from site to company EBITDA with the deduction of central costs adjusted for one-off items, head office efficiencies and a discontinued business (pre-made cocktails).

The resultant figure of £1.8m for pro forma normalised EBITDA compares with adjusted reported figures for FY19 and FY20 respectively of £0.9m and £0.1m.

Exhibit 3: Pro forma normalised, adjusted EBITDA (excludes impact of COVID-19)

Year end June/pre IFRS 16	£m
Site EBITDA (FY19)	1.84
Full year effect of openings (Old Street, Bristol and Clapham)*	0.29
Site maturity	0.12
Increased operating margin**	0.31
Adjusted site EBITDA	2.56
Central/one-off costs	-0.77
Company EBITDA	1.79

Source: Nightcap. Note: *Based on trading in the eight months to February 2020 ie pre COVID-19 (estimated £0.3m beneficial impact). **Benefits of new simplified cocktail menu, better pricing on purchasing owing to untying of legacy contracts with spirits brands and a streamlined wage structure (moving certain staff from a monthly to an hourly pay scheme).

Valuation

The lack of direct, listed peers and the trading aberration caused by COVID-19 do not make for easy comparison of Nightcap in terms of rating and profit forecasts. Therefore, we look at City Pub Group which is arguably the closest to Nightcap in view of its portfolio of 48 drinks-led pubs, of which a third are in London. While its current emphasis on outdoor seating areas and lack of reliance on surrounding offices (in contrast to LCC's city-centre, basement premises) is understandable because of COVID-19 restrictions, our assessment assumes a resumption of trading in hopefully normalised conditions. Nonetheless, there is encouragement for LCC that its 8% like-for-like y-o-y sales gain in August and September compares with a Q3 decline of 20% in those pubs (77% of the estate) that City Pub Group had reopened. Its decision not to reopen sites deemed unlikely to trade well during COVID-19 only enhances LCC's outperformance.

In terms of valuation, it appears helpful to base it on the pre-pandemic (2019) performance and also to use pre IFRS 16 numbers. With a current market cap of £93m and bank net debt of £13m at June 2020 following a £22m equity raise, City Pub Group's EV is £106m and is trading on an EV/EBITDA multiple of 11.6x on application of its 2019 EBITDA. By comparison, LCC looks to have been acquired by Nightcap at just 4.2x, given an acquisition consideration of £7.5m (£2.2m cash, £3.5m shares and £1.7m debt) applied to £1.8m pro forma EBITDA.

This agreement by the vendors to take the majority of the consideration in terms of shares should also be a positive for the valuation, given its support for Nightcap's strategy and confidence in its prospects.

Peer comparison aside, in its own right LCC should be recognised for the transparency of its business model (selling premium drinks from very small premises) and consequent high returns, eg a return on investment of 75% after three years, historical site EBITDA margins of 33% and average site capex of c £339,000.

Sensitivities

- Nightcap competes for a share of disposable consumer income, which may be eroded by economic downturn.
- Imminent withdrawal from the European Union may have an economic cost and cause disruption to its drinks supply chain and increased competition for staff.
- Geopolitical events and natural disasters such as COVID-19 can have a significant impact on profitability. LCC has shown operational resilience during the pandemic ie busy when it is allowed to be busy.

- Much of the company's cost base is fixed. This risk can be mitigated by effective yield management and the development of as flexible a business model as possible.
- Execution risk in terms of expansion which is at the heart of the Nightcap investment case. However, for the foreseeable future conditions should continue to be favourable, albeit not guaranteeing successful implementation.
- Retention of key personnel.

EDISON

General disclaimer and copyright

This report has been commissioned by PrimaryBid and prepared and issued by Edison, in consideration of a fee payable by PrimaryBid. Edison Investment Research standard fees are £49,500 pa for the production and broad dissemination of a detailed note (Outlook) following by regular (typically quarterly) update notes. Fees are paid upfront in cash without recourse. Edison may seek additional fees for the provision of roadshows and related IR services for the client but does not get remunerated for any investment banking services. We never take payment in stock, options or warrants for any of our services.

Accuracy of content: All information used in the publication of this report has been compiled from publicly available sources that are believed to be reliable, however we do not guarantee the accuracy or completeness of this report and have not sought for this information to be independently verified. Opinions contained in this report represent those of the research department of Edison at the time of publication. Forward-looking information or statements in this report contain information that is based on assumptions, forecasts of future results, estimates of amounts not yet determinable, and therefore involve known and unknown risks, uncertainties and other factors which may cause the actual results, performance or achievements of their subject matter to be materially different from current expectations.

Exclusion of Liability: To the fullest extent allowed by law, Edison shall not be liable for any direct, indirect or consequential losses, loss of profits, damages, costs or expenses incurred or suffered by you arising out or in connection with the access to, use of or reliance on any information contained on this note.

No personalised advice: The information that we provide should not be construed in any manner whatsoever as, personalised advice. Also, the information provided by us should not be construed by any subscriber or prospective subscriber as Edison's solicitation to effect, or attempt to effect, any transaction in a security. The securities described in the report may not be eligible for sale in all jurisdictions or to certain categories of investors.

Investment in securities mentioned: Edison has a restrictive policy relating to personal dealing and conflicts of interest. Edison Group does not conduct any investment business and, accordingly, does not itself hold any positions in the securities mentioned in this report. However, the respective directors, officers, employees and contractors of Edison may have a position in any or related securities mentioned in this report, subject to Edison's policies on personal dealing and conflicts of interest.

Australia

Edison Investment Research Pty Ltd (Edison AU) is the Australian subsidiary of Edison. Edison AU is a Corporate Authorised Representative (1252501) of Crown Wealth Group Pty Ltd who holds an Australian Financial Services Licence (Number: 494274). This research is issued in Australia by Edison AU and any access to it, is intended only for "wholesale clients" within the meaning of the Corporations Act 2001 of Australia. Any advice given by Edison AU is general advice only and does not take into account your personal circumstances, needs or objectives. You should, before acting on this advice, consider the appropriateness of the advice, having regard to your objectives, financial situation and needs. If our advice relates to the acquisition, or possible acquisition, of a particular financial product you should read any relevant Product Disclosure Statement or like instrument.

New Zealand

The research in this document is intended for New Zealand resident professional financial advisers or brokers (for use in their roles as financial advisers or brokers) and habitual investors who are "wholesale clients" for the purpose of the Financial Advisers Act 2008 (FAA) (as described in sections 5(c) (1)(a), (b) and (c) of the FAA). This is not a solicitation or inducement to buy, sell, subscribe, or underwrite any securities mentioned or in the topic of this document. For the purpose of the FAA, the content of this report is of a general nature, is intended as a source of general information only and is not intended to constitute a recommendation or opinion in relation to acquiring or disposing (including refraining from acquiring or disposing) of securities. The distribution of this document is not a "personalised service" and, to the extent that it contains any financial advice, is intended only as a "class service" provided by Edison within the meaning of the FAA (i.e. without taking into account the particular financial situation or goals of any person). As such, it should not be relied upon in making an investment decision.

United Kingdom

This document is prepared and provided by Edison for information purposes only and should not be construed as an offer or solicitation for investment in any securities mentioned or in the topic of this document. A marketing communication under FCA Rules, this document has not been prepared in accordance with the legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research.

This Communication is being distributed in the United Kingdom and is directed only at (i) persons having professional experience in matters relating to investments, i.e. investment professionals within the meaning of Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005, as amended (the "FPO") (ii) high net-worth companies, unincorporated associations or other bodies within the meaning of Article 49 of the FPO and (iii) persons to whom it is otherwise lawful to distribute it. The investment or investment activity to which this document relates is available only to such persons. It is not intended that this document be distributed or passed on, directly or indirectly, to any other class of persons and in any event and under no circumstances should persons of any other description rely on or act upon the contents of this document.

This Communication is being supplied to you solely for your information and may not be reproduced by, further distributed to or published in whole or in part by, any other person.

United States

Edison relies upon the "publishers' exclusion" from the definition of investment adviser under Section 202(a)(11) of the Investment Advisers Act of 1940 and corresponding state securities laws. This report is a bona fide publication of general and regular circulation offering impersonal investment-related advice, not tailored to a specific investment portfolio or the needs of current and/or prospective subscribers. As such, Edison does not offer or provide personal advice and the research provided is for informational purposes only. No mention of a particular security in this report constitutes a recommendation to buy, sell or hold that or any security, or that any particular security, portfolio of securities, transaction or investment strategy is suitable for any specific person.