

Yowie Group

Growing pains, but manageable

After experiencing a drop in sequential sales for the December quarter, Yowie returned to sequential sales growth in the March quarter. However, the company is taking a more modest approach to sales guidance to ensure it can fulfill customer (and investor) expectations. We are maintaining our revenue forecasts, but cutting our profitability estimates for FY17-19 due to higher than expected stock compensation costs in H117. Separately, on 27 February, Wayne Loxton tendered his resignation as executive chairman. With a strong senior team now in place, Loxton had hinted that he would eventually step back from an executive role, however we believed he would wait until FY18 once the publishing and other brand extension businesses had been launched.

Year end	Revenue (US\$m)	PTP* (US\$m)	EPADR (US\$)	DPADR (US\$)	P/E (x)	Gross yield (%)
06/15	2.4	(2.7)	(0.22)	0.0	N/A	N/A
06/16	13.1	(6.7)	(0.41)	0.0	N/A	N/A
06/17e	22.1	(3.9)	(0.18)	0.0	N/A	N/A
06/18e	37.1	5.8	0.27	0.0	11.5	N/A

Note: *PTP and EPADR are normalized, excluding intangible amortization and exceptional items. Dividend yield excludes withholding tax. Investors should consult their tax advisor regarding the application of any domestic and foreign tax laws. Revenue includes both product sales and licensing income.

Sales growth resumes in the March quarter

On 18 April, Yowie announced record quarterly sales of US\$5.9m, up 50% from a year ago, and US\$1.5m sequentially from a disappointing December quarter. At the same time, the company moderated its FY17 revenue growth guidance from 85-90% in early March to 70%. The company attributes its more conservative forecast to slightly weak sales to certain Walmart stores that switched to a new distributor and a more staged rollout in Canada. We are maintaining our revenue estimates, which that imply year-on-year growth of 69% in FY17, 68% in FY18 and 37% in FY19.

Profitability pushed out to FY18 at earliest

We are reducing our profitability estimates for FY17-19 to reflect a higher level of administrative expense (primarily from stock compensation); however, with senior staff largely in place, we do not anticipate further negative surprises on the administrative line associated with the company's expansion plans.

Valuation: Bad news appears largely priced in

At our initiation, Yowie's shares were discounting a terminal EBIT margin of 22% and sales growth of 70% in FY16-18. Since then, the number of shares has increased 43%, our FY18 revenue estimate has fallen by 16% and the Australian dollar has strengthened by 3%, which may explain a significant portion of the 63% drop in the ADR price since our initiation. A reverse DCF at the current price with a WACC of 10% implies compound average annual top-line growth from FY17 to FY19 of 52%, fading to terminal growth of 2% and an undemanding terminal EBIT margin of 15%. With US\$29m in cash, no debt, strong gross margins and growing sales, we believe most of the risks are priced into the shares.

Food & beverages

17 May 2017

Price **US\$3.11**
Market cap **US\$66m**

*Calculated at ADR/Ord conversion ratio 1:10
US\$0.74/A\$

Net cash (US\$m) as of 31 March 2017 29.2

ADRs in issue 21.2m

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

Full year results August 2017

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Investment summary: Easing up on the gas pedal to ensure successful execution

On 18 April, Yowie Group released interim financials for the third quarter of FY17, ended 31 March. Results showed that the company has largely recovered from production implementation issues that prevented it from fulfilling several orders in its December quarter. However, the second quarter issues led the company to take a more conservative approach to both its new market rollout and product line extensions in order to avoid customer fulfillment issues in the future.

The company lowered its FY17 revenue growth goal to 70%, from its previous guidance of 85-90% issued in early March. In our [update note](#) dated 24 January, we lowered our revenue growth and profitability expectations based on December quarter results; our FY17 revenue estimate of US\$22.1m is in line with management's lowered revenue outlook and we are maintaining our revenue estimate for FY17-19 (see Exhibit 1).

On 24 February, Yowie Group released full financials for the first half of FY17, ended 31 December. The report showed strong gross margins (54% vs 52% in H116) and sales, distribution and marketing expenses well within our estimates; however, administrative expenses nearly doubled to US\$6.4m from US\$3.4m in the year-earlier period, with the bulk of the increase coming from stock compensation expenses to directors, executives and staff. We have adjusted our FY17 admin expense estimate to more closely reflect the US\$3.2m stock compensation expense in the first half of FY17. As a result, we now expect to see profitability at both EBITDA and net profit levels in FY18 instead of FY17. We are also increasing our administrative expenses for FY18-19e to include higher stock compensation expenses.

Exhibit 1: Estimate changes

	Revenue (US\$m)			PTP (US\$m)			EPADR (US\$)		
	Estimate	New	Chg	Old	New	Chg	Old	New	Chg
FY17e	22.1	22.1	0.0%	2.5	(3.9)	NM	0.12	(0.18)	NM
FY18e	37.1	37.1	0.0%	7.3	5.8	-20.5%	0.35	0.27	-20.0%
FY19e	51.0	51.0	0.0%	11.6	10.1	-12.9%	0.56	0.48	-12.5%

Source: Edison Investment Research estimates, Yowie Group reports. Note: Revenue includes product sales and licensing fees.

We were surprised by Wayne Loxton's resignation from the position of executive chairman, announced on 27 February. We met with Yowie management on 7 February in New York City and Loxton discussed general plans to pull back from an active operating role in the next year; however, we believed that the timing was an FY18 announcement at the earliest. We have no reason to believe that the timing reflects the board's opinion of Loxton's performance as executive chairman. His departure is likely to reduce administrative overhead while leaving operations in the hands of a strong team of confectionary industry veterans.

Valuation

Our primary valuation metric for Yowie is reverse 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 believe that if the brand continues to prove itself, the WACC and relative risks to the story will more closely reflect a consumer goods story, albeit one with very high growth. The biggest sensitivity we see with the Yowie story is how customer demand evolves as the product is rolled out broadly to stores in the US and across the globe. While sales have increased nearly tenfold from US\$2.4m in FY15 to an estimated US\$22.1m in FY17, the trajectory has been somewhat choppy, consistent with the growth trajectory of many start-up companies.

So far, Yowie has proven success at the checkout stands at Walmart, but it is still early in the game. We see Yowie continuing to increase its sales in Walmart by moving to the main candy aisle and expanding into other retail outlets in both the US and other markets.

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 on 10 April. We expect sales in Canada to start during first quarter of FY18, slightly behind the company's original goal of expanding into two new markets in FY17.

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 2017-18 and we have made only a modest assumption of US\$2.1m for FY19.

Exhibit 2: Current unit and net sales estimates – US and RoW

Fiscal year ended 30 June	2016	2017e	2018e	2019e
Estimated units sold (000s)				
United States	8,600	12,738	21,109	29,065
% growth		48%	66%	38%
RoW	-	2,173	4,346	5,432
% growth		NM	100%	25%
Total units	8,600	14,911	25,455	34,497
% growth		73%	71%	36%
Net effective price/unit (US\$)				
United States	1.50	1.45	1.40	1.40
% change	NA	-3%	-3%	0%
RoW	NM	1.50	1.50	1.50
% change		NA	0%	0%
Blended net effective price/unit	1.50	1.46	1.42	1.42
% change		-3%	-3%	0%
Product net revenues (US\$000)				
United States	12,888	18,470	29,553	40,691
% growth		43%	60%	38%
RoW	0	3,259	6,519	8,149
% growth		NM	100%	25%
Total product net revenues	12,888	21,730	36,072	48,840
% growth		69%	66%	35%

Source: Edison Investment Research estimates and Yowie Group. Note: Product net revenues exclude licensing revenues.

As Yowie is still an emerging growth story, we use a reverse DCF model to gauge long-term EBIT margins based on the current share price and our revenue growth expectations. Our 10-year reverse DCF model builds to sales of approximately US\$117m by FY26. As noted above, we

believe that there is a real opportunity for investors should Yowie move significantly beyond confectionery into other products and out-licensing – in essence becoming a diversified brand as opposed to a pure confectionary play. Evidence of success here would lead us to adjust our forecasts to more accurately reflect the impact of the increased license income.

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. On this basis, our reverse DCF requires a terminal EBIT margin of 15%, a level that we regard as achievable given our forecast of a modest increase in out-licensing income over the next 10 years, to c 9% of total revenue, albeit still significantly short of management's aspirations in this area.

Additionally, using our base case forecasts, we have explored alternative scenarios with a range of WACCs of 7-13% and terminal EBIT margins from 7-23%. This indicates the sensitivity to the terminal EBIT margin, which likely corresponds to the rate of development of licensing income over the period. At the same time, overachievement on revenue growth milestones would be associated with a decrease in perceived execution risk and hence in the WACC.

Exhibit 3: ADR value (US\$/share) scenario analysis based on terminal EBIT margin & WACC

Exhibit 17.1 EBIT Value (Equivalent) Scenario Analysis Based on Terminal EBIT Margin of 10%						
		Terminal EBIT margin				
		7%	11%	15%	19%	23%
WACC	7.0%	2.83	4.16	5.48	6.81	8.13
	8.0%	2.28	3.33	4.37	5.41	6.46
	9.0%	1.89	2.74	3.58	4.43	5.28
	10.0%	1.60	2.30	3.00	3.70	4.40
	11.0%	1.37	1.96	2.55	3.14	3.73
	12.0%	1.18	1.69	2.19	2.70	3.20
	13.0%	1.04	1.47	1.91	2.34	2.78

Source: Edison Investment Research estimates

Financials

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.

March quarter results – production volumes rise, RoW rollout starts

Yowie's net sales rose 50% y-o-y to US\$5.9m in its March quarter. On a sequential basis, net sales rose US\$1.5m from US\$4.4m in the December quarter. Sales in the US continue to outpace its Nielsen data category growth, rising 0.1 point sequentially to 1.0% in the xAOC (eXtended All Outlet Combined) market. The company shipped US\$1.2m worth of product to Australia during the quarter and on its 18 April conference call indicated that a similar size order was set to ship.

Gross margins in the March quarter expanded to 56%, from 54% in the December quarter. This is somewhat 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 both in production and supplies (such as packaging).

Profit and loss

Our model calls for revenues of US\$22.1m in FY17, climbing to US\$51.0m by FY19, including US\$2.1m of licensing revenues, a compound average annual increase of 52%. We forecast EBITDA margins to move from -16.0% in FY17 to 20.6% by FY19. Our margin forecasts could be conservative should the company not plan to accelerate its marketing spend to 19% of product sales, from 16.8% in FY16, a level that is in line with the large confectionery companies. In addition, should the company generate licensing revenues beyond the US\$2.1m we have in FY19, margins could expand further as we would expect licensing revenue to largely fall directly to the operating profit line.

Cash flow

At this early stage, Yowie is not operating cash flow positive. The company generated approximately US\$3.3m in total operating and investing cash flows in FY16, down from US\$6.9m in FY15. Our forecast calls for operating and investing cash use to decrease to approximately US\$5.9m in FY17.

Balance sheet

Yowie remains debt free, with US\$29.2m of cash on the balance sheet at 31 March 2017. 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 rollout in the US and newer ventures in publishing and entertainment. We forecast net cash of US\$25.8m at 30 June 2017.

Exhibit 4: Financial summary

	US\$000s	2015	2016	2017e	2018e	2019e
Year end 30 June		AGAAP	AGAAP	AGAAP	AGAAP	AGAAP
PROFIT & LOSS						
Revenue		2,377	13,063	22,057	37,140	50,976
Cost of Sales		(1,043)	(6,245)	(10,867)	(17,813)	(24,283)
Gross Profit		1,334	6,818	11,190	19,327	26,693
EBITDA		(2,657)	(6,562)	(3,545)	6,119	10,481
Operating Profit (before amort. and except.)		(2,727)	(6,674)	(3,874)	5,764	10,096
Intangible Amortization		0	0	0	0	0
Exceptionals		(64)	(700)	0	0	0
Other		0	0	0	0	0
Operating Profit		(2,790)	(7,375)	(3,874)	5,764	10,096
Net Interest		(1)	(0)	0	0	0
Profit Before Tax (norm)		(2,727)	(6,674)	(3,874)	5,764	10,096
Profit Before Tax (FRS 3)		(2,791)	(7,375)	(3,874)	5,764	10,096
Tax		0	(23)	0	0	0
Profit After Tax (norm)		(2,725)	(6,695)	(3,870)	5,768	10,100
Profit After Tax (FRS 3)		(2,791)	(7,398)	(3,874)	5,764	10,096
Average Number of ADRs Outstanding (m)		1.3	16.5	21.2	21.2	21.2
EPADR - normalised (c)		(21.6)	(40.5)	(18.3)	27.2	47.7
EPADR - normalised fully diluted (c)		(21.6)	(40.5)	(17.7)	26.4	47.7
EPADR - (IFRS) (c)		(22.1)	(44.7)	(18.3)	27.2	47.7
Dividend per share (c)		0.00	0.00	0.00	0.00	0.00
Gross Margin (%)		56.1	52.2	50.7	52.0	52.4
EBITDA Margin (%)		-111.8	-50.2	-16.1	16.5	20.6
Operating Margin (before GW and except.) (%)		-114.7	-51.1	-17.6	15.5	19.8
BALANCE SHEET						
Fixed Assets		1,572	3,865	4,189	4,484	4,749
Intangible Assets		385	783	836	836	836
Tangible Assets		1,187	3,081	3,353	3,648	3,913
Investments		0	0	0	0	0
Current Assets		14,209	35,820	30,785	37,058	47,859
Stocks		5,197	1,134	2,557	5,522	7,528
Debtors		319	1,327	1,376	743	1,020
Cash		8,465	31,693	25,778	28,475	36,152
Other		227	1,666	1,074	2,318	3,160
Current Liabilities		(1,516)	(2,708)	(1,869)	(2,672)	(3,642)
Creditors		(1,516)	(2,708)	(1,869)	(2,672)	(3,642)
Short term borrowings		0	0	0	0	0
Long Term Liabilities		0	0	0	0	0
Long term borrowings		0	0	0	0	0
Other long term liabilities		0	0	0	0	0
Net Assets		14,264	36,977	33,106	38,869	48,966
CASH FLOW						
Operating Cash Flow		(6,545)	(109)	(5,265)	3,347	8,327
Net Interest		(1)	(0)	0	0	0
Tax		0	(23)	0	0	0
Capex		(317)	(3,211)	(650)	(650)	(650)
Acquisitions/disposals		0	0	0	0	0
Financing		7,562	26,571	0	0	0
Dividends		0	0	0	0	0
Net Cash Flow		699	23,228	(5,915)	2,697	7,677
Opening net debt/(cash)		(7,767)	(8,465)	(31,693)	(25,778)	(28,475)
HP finance leases initiated		0	0	0	0	0
Other		0	0	0	(0)	0
Closing net debt/(cash)		(8,465)	(31,693)	(25,778)	(28,475)	(36,152)

Source: Yowie Group reports, Edison Investment Research estimates.

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