Comvita

Initiation of coverage

Manuka honey: health and well-being play

Food & beverages

Comvita is a natural health products manufacturer and marketer focused on manuka honey, bee products and fresh olive leaf extract. It sells a range of manuka honey-based health products via a range of distribution and sales channels, and has an exclusive licensing agreement with Derma Sciences for medical-grade manuka honey based products to the professional wound care market. Our valuation of the company is NZ$4.57 per share, 23.5% above the current share price.

Year end	Revenue (NZ$m)	PBT* (NZ$m)	EPS* (c)	DPS (c)	P/E (x)	Yield (%)
03/13	104	10.4	25.7	13.0	14.4	3.5
03/14	115	10.6	25.0	12.0	14.8	3.2
03/15e	151	14.3	31.8	16.0	11.6	4.3
03/16e	171	16.2	35.5	18.0	10.4	4.9

Note: *PBT and EPS are normalised, excluding intangible amortisation, exceptional items and share-based payments.

Manuka honey marketer and manufacturer

Manuka honey is used in health and medical products and commands a significant price premium over regular honey due to its unique anti-bacterial qualities. Comvita is the largest manufacturer of manuka honey in New Zealand (also worldwide) and has an exclusive licensing agreement with Derma Sciences for a range of manuka honey based products sold to the professional wound care market. Comvita also owns 865k shares and 233k warrants in Derma Sciences with all warrants being in the money. Note that Derma Sciences also owns 2.272m Comvita shares.

The company also has a fresh olive leaf extract business based in Australia.

Focusing on top-line growth

Comvita is now focusing on revenue growth after a period of 'upstream' investment in apiaries and manufacturing facilities. The company has also invested in its e-commerce back end and on new product development.

The company is exposed to climatic and agricultural risks in its honey business that are not easily diversifiable, although Comvita now owns apiary businesses across the country lowering its geographic and volume risks. This also has the benefit of lowering its raw honey costs. Comvita is also heavily invested in research and development to improve hive and manuka tree yields and quality.

Valuation: Upside potential

Our DCF valuation of Comvita is NZ$4.28 per share using a WACC of 10.5%, in line with management's view of its cost of capital, and a 2% terminal growth rate. The net value of Comvita's shareholding in Derma Sciences adds another NZ$0.29 per share for a total valuation of NZ$4.57 or 23.5% above the current price. Compared to its health and well-being peers, Comvita is trading at a discount to the market price and our valuation. We think this discount can reduce assuming more stable raw honey pricing and the company extracting operational leverage.

28 August 2014

Price	**NZ$3.70**
Market cap	**NZ$120m**

US$0.8390 / £0.5054 / NZ$1

Net debt (NZ$m) at March 2014	26.5
Shares in issue (m)	32.5
Free float	83.4%
Code	CVT
Primary exchange	NZX
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	(1.9)	1.7	(8.1)
Rel (local)	(2.8)	0.2	(17.1)
52-week high/low		NZ$4.24	NZ$3.00

Business description

Comvita is a manufacturer and marketer of manuka honey-based products and fresh olive leaf extract products. The company sells honey and olive leaf extract products for health, skin care and medical uses, with approximately 80% of its products exported to Asia, North America, Australia and the UK.

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Investor newsletter	Sept/Oct 2014

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Comvita is a research client of Edison Investment Research Limited

Investment summary

Manuka honey and natural health products

Comvita is a manufacturer and marketer of natural health and medical products focused around manuka honey, a high value premium honey found only in New Zealand. Comvita has a licensing agreement with Derma Sciences (DSCI.US) for the sale of medical-grade manuka honey to medical professionals worldwide as a wound care product, although this made up only 5.2% of revenue in FY14. Comvita also markets and sells a range of over-the-counter health and well-being products based on manuka honey, propolis, a range of table honey and fresh olive leaf extract, which make up the bulk of its revenue. The company listed on NZX in 2003 and was founded in 1974 in the Bay of Plenty, New Zealand.

Valuation: Upside potential

The company has generated revenue growth of 10% per year over the past five years, which we expect to continue, although the acquisition of NZ Honey will boost revenue by NZ$23m in FY15. Historically the company has not demonstrated much in the way of operational leverage from increasing scale, with increases in gross margin largely being absorbed by rising sales, marketing and administration costs. However, the investment in its upstream supply chain over the past few years, and increased focus on sales growth going forward should see the rate of sales growth lift, resulting in flow on benefits to the gross margin, operating margin and shareholder returns.

Our DCF valuation is NZ$4.28, plus an additional NZ$0.29 for the value of Comvita's shareholding in DSCI. Compared to its peers, Comvita is trading at a discount on the current market price and at our valuation.

Financials: A conservative approach with potential upside

Excluding the impact of the acquisition of NZ Honey we expect earnings growth of 13% per year over the forecast period, in line with our forecast sales growth. Sales of medical honey are expected to grow at 35% per year with a very high margin, but are coming off a low base of NZ$6m per year for FY14.

Including NZ Honey the revenue growth rate is expected to be 19.1% CAGR between FY14 and FY16, with earnings growing at 23.7%.The acquisition of NZ Honey should allow the company to deliver faster earnings growth compared with revenue growth reflecting some operational leverage.

We are adopting a conservative stance with our forecasts, implying that management has to deliver on its strategy before we adopt a more growth-orientated approach.

Sensitivities

Comvita's primary raw material is honey, which is subject to noticeable climatic and agricultural variation each year. To manage these issues the company has acquired apiary businesses over the past four years and developed its own apiaries to increase its security of supply and improve its geographic diversification.

The premium pricing and popularity of manuka honey has led to a number of 'me too' products appearing that risks undermining the value of the product and brand. New Zealand's Ministry for Primary Industries is in the process of formulating standards to clearly classify manuka honey, although this process is in its early stages.

Comvita has significant seasonality between its H1 and H2 results, with the H1 delivering losses, while H2 has all the profits. This is due to the annual honey production (NZ summer) and sales cycle (Northern Hemisphere winter) both occurring in H2.

Company description

Comvita is a manufacturer and marketer of natural health and medical products in four ingredient 'platforms':

- manuka honey, its largest business;
- propolis, a bee product;
- fresh olive leaf extract, its Australian business; and
- omega-3, a nascent business that remains small.

The company had a turnover of NZ$115m in FY14. We estimate NZ$90m of sales came from manuka honey, propolis and other bee-related products, NZ$20m from olive leaf extract and a small amount from omega-3. We also estimate the company exported/generated offshore around $90m from its operations in Australia and New Zealand, representing c 78% of its revenue in FY14. NZ$47m of this revenue came from Asia, $28m from Australia and $7m each from the UK and North America respectively.

Over the past five years revenue has grown at 10% pa CAGR, from $71.4m in FY09 to $114.9m in FY14, while EBITDA has grown at 18.5% pa CAGR from $6.5m in FY09 to $15.2m in FY14.

The company was founded in 1974 in the Bay of Plenty, New Zealand, and is still located in Paengaroa, where it was founded. One of the co-founders of the company and former managing director, Alan Bougen, is on the board and holds a 9.2% stake. Comvita listed on NZX in 2003.

Strategy

The company's core strategy is focused around three areas:

- Controlled distribution with a focus on Asian markets, particularly north Asian markets such as Korea, Japan, Hong Kong and China;
- Growth in company branded retail distribution and on-line sales; and
- Vertical integration for supply side security and product development.

Comvita estimates that a standard manuka honey in pot form can retail for NZ$100/kg, rising to over NZ$500/kg for more high factor UMF[1] manuka honey. Medical-grade honey can command NZ$1,300/kg while skincare/cosmetic products can achieve NZ$2,000/kg (see Exhibit 4). These price ranges indicate the value of developing health and well-being products from manuka honey as opposed to just selling pots of honey as a food product.

The secondary strategy is to diversify its revenue base into other natural health/medical products to diversify its product base and reduce the seasonality inherent in its earnings. The company has done this with its investment into a fresh olive leaf extract business in Australia; however, it remains on the lookout for acquisitions to broaden its portfolio.

Manuka honey is the key driver

Comvita's founders were focused on the promotion of honey as a natural health/medical product rather than as a food. Over the past 20 years the medical benefits of manuka honey have been clinically researched and the company has become the largest seller of manuka honey in New Zealand, and by extension the world.

Comvita has a licensing and marketing agreement with Derma Sciences[2] (DSCI.US) where Derma Sciences has the global rights to Comvita's medical-grade honey under the MEDIHONEY brand.

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1 Unique Manuka Factor (UMF) is a measure of the unique antibacterial activity naturally present at varying levels in manuka honey.

2 Derma Sciences is a research client of Edison Investment Research.

Comvita has the rights to the brand for a range of over-the-counter consumer products. Comvita also sells a range of manuka honey in pots as a food and manufactures a range of well-being (cough/cold) products and skincare products based on manuka honey. Outside of the medical market the biggest growth for manuka honey is in Asian markets.

Asian consumers see honey as a health/medical product rather than as a food per se, whereas Anglo-Saxons tend to have the opposite view. The largest buyers of Comvita products in New Zealand and other Western countries are also Asian.

Manuka honey

Manuka honey is derived from the manuka bush (*leptospermum scoparium*), a scrub-like tree widespread in New Zealand. It is a member of the myrtle family and generally grows to around 2-5m in height. The tree has coarse leaves, five point pink/white flowers and is an evergreen. It is generally one of the first plants to populate cleared land and is found in areas around farms and near forests in New Zealand. To date, manuka has not been grown in a plantation setting as it has been traditionally seen as a low value/nuisance plant. However, Comvita is conducting research to develop improved strains of the plant to improve its yield and growth cycle based on its value via manuka honey.

The rise of manuka honey as a consumer and medical product has been driven by the discovery of unique medical properties in the honey. Typically most honeys carry hydrogen peroxide, a naturally occurring antiseptic; however, humans break down hydrogen peroxide via enzymes in the saliva and blood relatively quickly, limiting its effectiveness. Manuka honey also has hydrogen peroxide and in addition it contains methylglyoxal, another antibacterial agent not subject to degradation by enzymes in the body.

A number of clinical studies and trials over the past 20 years have proven the wound healing effectiveness of manuka honey, particularly in wound care and combating antibiotic-resistant strains of bacteria. A recent study has shown that manuka honey can be effective for up to 24 hours against a number of bacteria with 40 times the effectiveness of hydrogen peroxide-based honey treatments at 24 hours.[3]

What is the consumer buying?

The medical benefits of manuka honey have seen its price, both for apiarists and consumers, rise significantly above other honey products. Apiarists in New Zealand can earn around NZ$5/kg for white clover honey; however, apiarists can sell manuka honey an average price of around NZ$25/kg and up to NZ$70/kg for very active blends.

The price wedge that has developed has seen a significant increase in the number of hives in New Zealand over the past decade and a proliferation of brands claiming to be manuka honey and offering various ratings as to their effectiveness.

Most manuka honey (including Comvita's) is sold under the Unique Manuka Factor trademark (UMF).[4] The popularity of manuka honey has seen a number of other ratings systems appear using a variety of measures and often misleading claims. This includes manuka honeys marketed based on 'total activity', where the level of such 'activity' has actually been based solely on the levels of hydrogen peroxide in the honey.

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[3] "Two Major Medicinal Honeys Have Different Mechanisms of Bacterial Activity", Kwakman, te Velde, de Boer, Vandenbroucke-Grauls and Zaat, PLos ONE, March 2011.

[4] The UMF mark is owned by the Unique Manuka Factor Honey Association, and is registered in 46 countries.

In the UK the claims that sellers of manuka honey have been making have recently come under close scrutiny, with The Grocer[5] magazine recently carrying an article entitled 'The great manuka honey swindle'. The core issue is the competing labelling standards in New Zealand and low level of knowledge by consumers about what they are buying and what the labels mean.

Another challenge is kanuka honey, which until 1983 was considered to be the same as manuka honey, and both were generally referred to as manuka. However, it is now known that they are genetically separate, with kanuka given the species name *kunzea ericoides* and removed from the Leptospermum genus. Kanuka honey does not have any methylglyoxal.

The Ministry for Primary Industries (MPI) in New Zealand is currently consulting with the honey industry on the appropriate standards for defining manuka honey. The current situation with more than one method used to define manuka honey is not satisfactory and risks damaging the manuka honey brand. MPI has recently issued interim guidelines; however, an enforceable standard may be some time off.

Derma Sciences

Comvita has a global licensing arrangement with Derma Sciences (DSCI.US) for the licensing and distribution of medical-grade honey under the MEDIHONEY brand to the professional and medical market. Medical-grade honey is subject to additional processing.

The agreement was announced in February 2010 and replaced a five-year agreement signed in 2007. The agreement gives DSCI global rights to medical-grade manuka honey for these markets in perpetuity, although Comvita has retained all rights to the over-the-counter market for health products based on medical-grade manuka honey. The CEO of Comvita, Brett Hewlett, was appointed to the DSCI board.

DSCI paid Comvita US$2.25m in cash and issued 400,000 shares at US$5.00 per share and 233,333 warrants at an average price of US$5.82, or a total value of NZ$7.5m. At the time Comvita held 458,000 shares in DSCI and 52,000 warrants. It currently holds 864,880 DSCI shares and the 233,333 warrants. The warrants expire on 24 February 2015 and would be expected to be exercised given the current share price of DSCI is over US$11.00.

In September 2013 DSCI took a placement of 2.3m Comvita shares at NZ$3.90 raising NZ$8.86m. At the same time Ed Quilty, the chairman and CEO of DSCI, was appointed to the Comvita board. Currently Comvita holds 3.8% of the fully diluted share of DSCI while DSCI holds 7.0% of the issued shares of Comvita.

We have published three reports on DSCI (September 2013, January 2014 and May 2014) with these reports noting that sales of MEDIHONEY under the agreement are expected to grow at 30-40% per year for the foreseeable future. For FY14 Comvita disclosed Medical revenue of NZ$6.0m. This revenue is broken down as follows:

- $1.0m of amortisation of the $7.5m payment made in FY10;
- $2.0m in royalties; and
- $3.0m in sales of medical-grade honey.

Our estimates assume Comvita's Medical revenue grows at an average rate of 35% per year over the forecast period, excluding the amortising portion.

Exhibit 1 below shows the value of Comvita's holding in DSCI. This is currently worth NZ$9.4m or $0.29 per Comvita share (by comparison, DSCI's holding in Comvita is worth NZ$8.3m).

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5 The Grocer magazine, June 27 2014 issue.

Exhibit 1: Comvita's holding in DSCI

	US$	NZ$
Value of DSCI shares held by CVT	7.23	8.64
Value of DSCI warrants held by CVT	0.65	0.77
Value of DSCI holding	7.88	9.41
Value of DSCI holding per CVT share		0.29
Impact of change in DSCI price by US$0.50		0.02

Source: Edison Investment Research

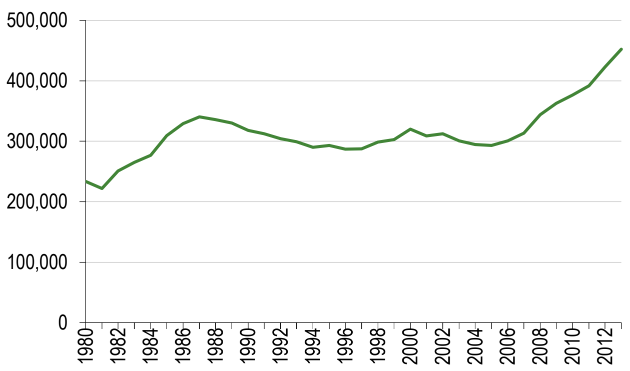
Our current valuation for DSCI is US$15.60 per share on a diluted basis (current share price US$9.90). If that value is achieved it would add an additional NZ$0.28 per share to Comvita's price.

The New Zealand honey market

New Zealand produced some 17,800 tonnes of honey in 2013, from just over 452,000 hives. This was a record crop and significantly higher than the annual average production of 12,554 tonnes over the past five years. Compared to 2003, the average production from the previous five years (1999-2003) was 8,951 tonnes, an increase of 40%.[6]

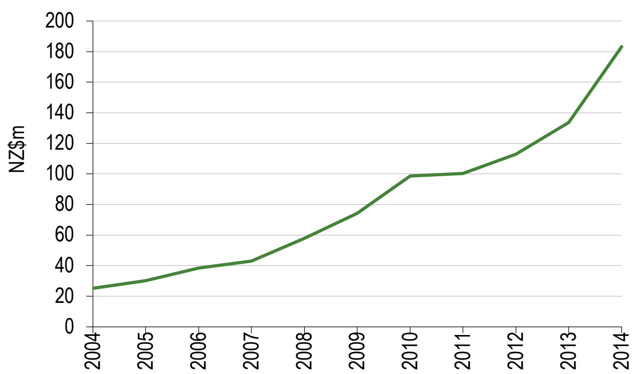
Part of the reason for the increase in production has been the growth in the number of hives and the best climatic conditions for three years. Over the past decade the number of hives has also increased by 50% as New Zealand honey, and in particular, manuka honey, has become more popular in overseas markets. Not only has the number of hives increased, but also hives have been relocated to increase the level of manuka-dominant production.

Exhibit 2: Number of hives, 1980-2013



Source: Ministry of Primary Industries

Exhibit 3: New Zealand honey exports



Source: Statistics New Zealand

10 years ago exports of honey from New Zealand amounted to just NZ$25.3m per year compared to NZ$183.3m now, a CAGR of over 21% per year. Further, the average export price has increased from $NZ10.70/kg to NZ$19.90/kg over the same period.

Official statistics on the blends on honey produced are not kept; however, manuka honey production was estimated at around 1,700-1,800 tonnes in 2013, with almost all of this exported.

The manuka market

Comvita is recognised as the largest manuka honey business in New Zealand, with Manuka Health Ltd the second largest 'corporate' business. Two other family-owned apiarists have some scale in manuka production with the balance of the market populated by small family owned operators. Comvita annual supply is around 1,400 tonnes of manuka honey per year, with the company processing around 2,500 tonnes of honey per year. The acquisition of NZ Honey comprises 2,400

[6] Five-year averages have been used to smooth out changes that can occur from year to year.

tonnes of honey, including 600 tonnes of manuka honey. This gives the company total processing of almost 5,000 tonnes per annum.

Comvita and Manuka Health have different purchase strategies. Comvita has chosen to invest directly in apiary businesses and has acquired some 25,000 hives over the past few years in a number of transactions, with an additional 5,000 planned to be added in FY15. The acquisitions have been made across the country, with the most recent acquisition being NZ Honey based in the South Island. Each acquisition, apart from NZ Honey has been paid for with cash. Comvita issued 571,429 shares as part payment for NZ Honey.

In contrast, Manuka Health has more or less stayed away from direct investment into hives and instead buys almost all its honey from third-party suppliers. The honey procurement market is highly competitive with larger local players such as Comtiva, Manuka Heath and Honey New Zealand competing with smaller local firm and offshore buyers.

Comvita now controls around 30% of its honey supply (50% of its manuka supply) from its own hives, and is continuing to invest in new hives to expand its own production base. NZ Honey is a slightly different case as it is not an apiarist in its own right but has multi-year supply arrangements with beekeepers in the South Island. This gives the company a secure source of supply, although the price to be paid for the raw honey is subject to negotiation each season. While Comvita produces 30% of its supply, and with the NZ Honey acquisition adds a further 20% of supply control, it still has 70% of its demand subject to annual price negotiations.

Comvita's products

Comvita's products can be broken down into the following groups:

- Healthcare – 32% of sales;
- Functional foods – 56% of sales;
- Medical – 7% of sales; and
- Personal care – 4% of sales.

Healthcare includes fresh olive leaf extract, propolis,[7] cough and cold remedies, and dietary supplements. Functional foods includes manuka honey pots, other honeys (such as rewarewa), milk powders and health snacks. Medical includes MEDIHONEY sold to DSCI, while Personal care includes skincare, first aid and oral care products.

The value added by these products compared to generic honey is set out in Exhibit 4.

Exhibit 4: Honey value added – retail per kg equivalent of raw manuka honey

	NZ$/kg
Generic – non-manuka honey	$30.00
UMF 5+ manuka honey	$98.00
UMF 20+ manuka honey	$536.00
Medical-grade manuka honey	$1,320.00
Skincare	$2,000.00

Source: Comvita

Comvita's strategy is to generate sales growth of the higher value products at a faster rate than its standard honey offering – UMF 5+ honey. However, to date success appears to have been mixed. Sales of MEDIHONEY are expanding quickly, but still represent only 7.0% of total revenue. Sales of skincare and personal care products remain less than 5% of the total, despite continued investment

[7] Propolis is a resinous substance collected from trees and is used by bees in the hive to seal small open spaces (it is distinct from bees wax). It is thought to offer a number of medical benefits; however, conclusive medical evidence is waiting on a number of research projects to be completed.

into these ranges. We estimate that a significant majority of Comvita's revenue comes from the sale of pots of branded honey, with most of this revenue coming from its entry-level UMF 5+ honey.

Sales strategy

Comvita has a mixed selling model. In some markets it sells via its own distribution channels; in some other markets it sells to a national distributor, while in others it operates its own retail stores.

- **Retail stores.** The company owns 78 retail stores in Hong Kong, Japan, Taiwan, Korea and New Zealand, and one in London. Some of these stores are standalone, while others are stores-within-stores inside department stores and other high foot traffic areas. At the same time Comvita's products are available through other retailers in each market.
- **Third-party distribution.** Comvita has a sole distributor in China, with that party operating 400 Comvita-branded stores across the country. This arrangement was set up in 2004 when Comvita first launched in the China market and still has two years to run. The China market is growing quickly (up 50% in the past two years); however, Comvita does not have direct control of these stores carrying its name. The China distributor owns between 4% and 5% of Comvita's stock.
- **Own distribution.** In New Zealand, Australia, the US and UK the company operates its own distribution businesses without any branded retail presence. In FY08 Comvita acquired its Hong Kong distributor, and continues to operate that business.
- **Internet.** Comvita reports that sales over the internet made up only 3% of turnover in FY14, although it invested in a new 'back end' during FY14 to help grow this part of its business. Comvita's products are ideal for a 'click and pick' Internet sales model. This model is proving increasingly popular in markets such as Hong Kong.

Generating operational leverage

Over the past five years Comvita has seen its EBITDA grow at 18.5% per annum while its revenue has grown at 10% per annum. At first sight this shows good operational leverage; however, its selling costs (sales, marketing and distribution) have grown at almost the same rate as revenue over the same period.

This suggests that the company has generated operational leverage in its manufacturing and upstream operations, but has not yet seen the benefits of greater scale in its 'downstream' retailing and distribution operations. Comvita is now focusing on growing its sales operation in anticipation of the greater honey volumes the company is going to produce from its apiary businesses.

The company is also re-launching its cosmetics and skin care ranges in the December quarter with new formulations and packaging to lift the sales performance of these product ranges. The company is seeing strong growth in China and is optimising its sales platform in Asia to improve its per store earnings.

We have taken a conservative approach with our earnings estimates. Although the company has a clear strategy to increase its sales of high value/margin health, medical and skin care products we have assumed more or less the same mix over the forecast period. This implies that more than 50% of its revenue will continue to come from lower-margin honey sales, although we expect strong growth in sales of medical honey. We estimate that by FY17 Comvita will sell NZ$15m of medical honey, representing 8.6% of total revenue, compared to 7% now.

Further we assume little change in the cost structure of Comvita, and if anything, sales and marketing and distribution expenses could grow marginally faster than revenue, at least in the short term as the company expands its retail presence in Asian markets. We do not include any changes that may be made to the China contract as the maturity date of this contract is too far in the future.

The sensitivity of our forecasts to the components of operational leverage is material. By way of illustration, if the growth rates in sales, marketing and distribution expenses is half the rate of sales growth between FY15 and FY16, our EBITDA forecast for FY16 increases by 14.5% and NPAT increases from NZ$11.6m to NZ$13.6m (+17.2%).

Management and board

Comvita has a board of seven, although the CEO, Brett Hewlett, is not a director of the company.

Neil Craig, chairman. Neil is the executive chairman of Craigs Investment Partners (CIP), a New Zealand based share broking and investment advisory firm. CIP undertook the IPO of Comvita in 2003 and Neil Craig holds a beneficial interest in 900,000 Comvita shares (2.8%)

Alan Bougen, deputy chair. Alan was the CEO of Comvita from the company's founding in 1976 until 1998 and provides consultancy services to the natural healthcare and apiculture industries. Alan has a beneficial interest in 3,038,649 Comvita shares (9.2%).

Brett Hewlett, chief executive officer. Brett was appointed in September 2005 following 15 years with Tetra Pak in Europe and the Middle East in senior management and marketing roles.

Scott Coulter, chief operating officer. Scott joined Comvita in 2002 as Sales & Marketing Manager. His role covers Comvita's global sales and responsibility for all offshore entities.

Peter Moran, chief financial officer (until 29 August 2014). Peter joined Comvita in 2008 following a number of senior finance roles in a number of industries including oil products/downstream and telecommunications.

Roy Ong, chief marketing officer. Roy joined Comvita in June 2104 from Kirin Holdings where he was global market development director. He will be responsible for the global marketing strategy.

Mark Sadd, chief commercial officer (acting CFO from 29 August 2014). Mark joined Comvita in December 2013. His role covers cost optimisation and assessing new opportunities.

Dr Ralf Schlothauer, CTO. Ralf joined Comvita in 2006 and has overall strategic and functional responsibility for research and development. He is also adjunct professor of biological sciences at the University of Auckland.

Sensitivities

- **Honey price/volume**. The price of manuka honey has been rising in recent years on increasing demand and weather events that have resulted in lower than expected production. Comvita has addressed this by acquiring apiaries and ensuring its has geographic diversification for its honey requirements. However, the company remains exposed to the spot honey price.
- **Exchange rates.** As an exporter, with production costs largely based in NZ, fluctuations in FX rates can have a negative impact on earnings and asset values. Comvita's comprehensive income for FY14 included a NZ$5.8m negative impact from changes in exchange rates arising from the translation of the financial statements of its subsidiaries into NZ dollars. Given the continued relative strength of the NZ dollar against the US$ and A$, further negative effects from exchange rates cannot be ruled out, although a fall in the NZ dollar would have a positive effect.
- **Seasonality.** Comvita's financial reporting periods show that the company generated a loss in H114, and all of its profits in H214. Over the past five years only 30% of its EBITDA has been generated in H1. This is due to the honey harvesting season and selling season for honey

products in the northern hemisphere both occurring in H2. The company has indicated that its H1 15 loss will be greater than its H114 loss, although total earnings for FY15 are expected to be 30% higher than FY14. This increased seasonality for FY15 is partly due to the acquisition of NZ Honey and the increased investment in its upstream supply chain.

Valuation

DCF

We have assessed Comvita using a discounted cash flow (DCF) valuation and comparison to its peer group. Comvita has a significantly lower asset beta that its peer group (0.40), which likely reflects its smaller market cap and lower levels of liquidity; thus for valuation purposes we have adopted the asset beta of its peer group (1.12). An asset beta of around 0.4 would be suitable for a regulated utility, which Comvita is clearly not. From this we derive a WACC of 10.5%, which is in line with management's view of the company's cost of capital. Exhibit 5 sets out our DCF valuation.

Exhibit 5: Comvita DCF valuation

DCF valuation		Valuation parameters	
Forecast period	52.8	Asset beta	1.10
Terminal value	113.1	Equity beta	1.28
NPV to capital	165.9	Gearing	18.0%
Net debt/(cash)	26.5	WACC	10.5%
NPV to equity	139.4	Cost of equity	11.7%
		Terminal growth rate	2.0%
Value per share	$ 4.28	DCF Return over CMP	15.7%
Derma Sciences Value	$0.29		
Valuation	$4.57	Total return	23.5%

Source: Edison Investment Research

Our cash flow projections extend for 10 years with the growth rate trending down to our terminal growth rate in the final year.

Exhibit 6: Free cash flow projection

Free cash flow	FY14	FY15e	FY16e	FY17e	FY18e	FY19e	FY20e	FY21e	FY22e	FY23e	FY24e
EBIT	11.5	16.2	19.1	23.8	26.2	29.5	32.4	35.7	38.4	40.3	41.1
less tax on EBIT	(3.2)	(4.5)	(5.4)	(6.4)	(7.3)	(8.3)	(9.1)	(10.0)	(10.7)	(11.3)	(11.5)
plus depreciation	4.1	4.9	5.6	6.3	7.0	7.0	7.0	7.0	7.0	7.0	7.0
less capex/acquisitions	(16.3)	(10.2)	(10.6)	(11.3)	(7.0)	(7.0)	(7.0)	(7.0)	(7.0)	(7.0)	(7.0)
+/- working capital	(1.9)	(16.7)	(3.0)	(2.3)	(8.5)	(8.2)	(7.4)	(8.1)	(6.7)	(4.8)	(2.0)
Free cash flow	(5.9)	(10.4)	5.8	9.1	10.4	13.1	16.0	17.6	20.9	24.2	27.6

Source: Edison Investment Research

Our DCF valuation derives a value of $4.28 per share with an additional $0.29 per share for the value of Comvita's shareholding in Derma Sciences, for a total valuation of $4.57 per share, or 23.5% above the current share price.

Peer valuation

Exhibit 7 sets out our peer valuation. Comvita is valued at a discount to its peer group at the current market price and at our valuation. This discount can be explained by the smaller size of Comvita to its peers and its reliance on one major product group, which is subject to climatic and agricultural risks and its significant earnings seasonality.

Exhibit 7: Peer valuation

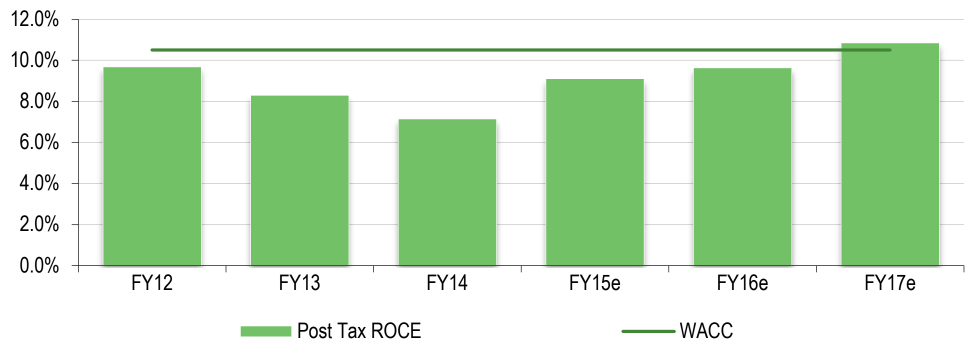
						Prospective 12-month forward				
Company	Country	Currency	Price	Mkt cap m (local)	Mkt cap m (US$)	EV/EBITDA (x)	Revenue / mkt Cap	P/E (x)	EBITDA margin (%)	Operating margin (%)
Comvita market price	**NZ**	**NZ$**	**3.70**	**120**	**101**	**7.3**	**1.32**	**11.0**	**14.1**	**10.9**
Comvita valuation	**NZ**	**NZ$**	**4.57**	**149**	**126**	**8.6**	**1.07**	**13.6**	**14.1**	**10.9**
Blackmores	Australia	A$	29.99	513	478	12.6	0.68	20.0	13.2	11.3
Herbalife	US	US$	49.49	4,542	4,542	5.3	1.22	7.2	17.7	15.2
Nu Skin Enterprises	US	US$	46.75	2,769	2,769	5.4	0.99	10.2	17.2	15.5
USANA Health Sciences	US	US$	74.30	956	956	5.8	0.84	12.0	16.5	11.9
Vitamin Shoppe	US	US$	38.37	1,185	1,185	6.4	1.12	15.1	12.5	9.9
GNC Holdings	US	US$	37.28	3,355	3,355	8.1	0.81	12.1	19.6	17.3
Natural Grocers	US	US$	18.89	425	425	9.1	1.44	29.6	7.6	5.0
Annie's Inc	US	US$	31.12	532	532	17.7	0.41	34.1	13.5	12.9
The Hain Celestial Group	US	US$	97.92	4,908	4,908	17.7	0.46	30.0	14.1	11.5
Mega Lifesciences	Thailand	TB	20.00	17,305	542	13.1	0.53	21.1	12.6	11.2
SunOpta Inc	Canada	C$	14.48	969	887	10.3	1.42	27.5	6.8	4.8
Health companies				**Median excl CVT**	**20,588**	**9.1**	**0.84**	**20.0**	**13.5**	**11.5**
				Weighted average excl CVT		**9.9**	**0.80**	**17.2**	**15.9**	**13.5**

Source: Bloomberg, Edison Investment Research. Note: Priced as at 27 August 2014.

Return on capital employed

Over the past three years Comvita has not achieved its WACC, although it came close in FY12. The company's ROCE is improving, with our longer-term estimates suggesting that it should generate a return slightly above WACC in FY17.

Exhibit 8: Post tax return on capital employed



Source: Edison Investment Research

Comvita's ROCE is expected to improve as it benefits from the upstream investment in its apiary businesses and from improving operational leverage. Our forecasts assume modest expansion of its EBIT margin from 10.0% in FY14 to 11.1% in FY16.

Financials

Revenue and earnings

Our revenue forecasts are largely based on the trends evident in the company's results over the past five years, with adjustments made for announced acquisitions. The acquisition of NZ Honey in the current financial year should add around NZ$23m to revenue, with the balance of the revenue growth of NZ$14m coming from across its business operations. We expect the largest growth to come from the Asia segment, followed by New Zealand and Australia, although we project the fastest growth to come from Medical, with an expected growth rate of 35% per year over our forecast period.

We make minimal changes to our margin estimates given the small changes in the breakdown between the major product groups over the past few years; the implication being that while these are all growing, the relative growth between each product group as been about the same. As discussed on page 8, our forecast assumes short-term increases in costs that may offset operational leverage benefits, and we have explained the potential upside to our forecasts.

We think NZ Honey will add NZ$2m to NPAT in FY15, implying an acquisition P/E of 6.2x.

The company does have currency exposure; however, the offshore element of its sales and marketing costs offsets this. For each 1% movement of the NZ$ against relevant foreign currencies, we estimate that our FY15e EPS forecast would move by around 1.0%.

Exhibit 9: Earnings estimates

NZ$m	FY13	FY14	FY15e	FY16e
Asia	44.9	47.1	54.2	62.3
Australia	24.7	28.9	31.7	34.7
New Zealand	19.3	24.2	27.1	56.1
Medical	3.7	6.0	8.1	10.9
Other	10.9	9.1	7.0	7.7
FY15 acquisition	0.0	0.0	23.0	0.0
Revenue	**103.5**	**115.3**	**151.0**	**171.4**
Gross profit	57.6	60.4	82.2	93.3
Other income	1.1	2.8	1.3	1.3
Operating costs	(44.3)	(47.9)	(62.4)	(69.9)
EBITDA	**14.4**	**15.2**	**21.1**	**24.7**
Depreciation and amortisation	(3.1)	(4.1)	(4.9)	(5.6)
EBIT	11.3	11.2	16.2	19.1
Interest	(0.8)	(0.6)	(1.9)	(2.9)
PBT	**10.4**	**10.6**	**14.3**	**16.2**
Tax	(3.1)	(3.0)	(4.0)	(4.5)
NPAT	**7.4**	**7.6**	**10.3**	**11.6**

Source: Comvita, Edison Investment Research

Balance sheet

The balance sheet features NZ$41m of intangibles, made up of NZ$33m of goodwill, NZ$4m of brands/trademarks and NZ$4m of software. The goodwill arises largely arises from the acquisition of the olive extract business in Australia and the Hong Kong distribution business. We expect the acquisition of NZ Honey will add a further NZ$1m of goodwill to the balance sheet, with inventories also increasing by $11m, and fixed assets by NZ$0.3m.

The company has plans to continue to invest in its main processing facility in the Bay of Plenty with another $5m of capex scheduled in FY15. This will include expanding warehousing and honey processing capacity. As noted above, the company is also expected to add a further 5,000 beehives at an average value of $400 per hive. We expect the capex spend in FY16 to be the same value, including maintenance capex.

Comvita's net debt was NZ$26.5m at FY14, although we expect this to increase to $43.1m in FY15 as the company funds the acquisition of NZ Honey, further investment in its processing facilities and invests in beehives. In FY16 we expect net debt to increase to $46.2m, largely due to further investment in production capacity and maintenance capex. This translates into a debt/(debt + equity) ratio of 22.5% in FY14, 31.2% in FY15 and 31.4% in FY16.

Although the increase in debt is large on a cash basis, relative to its capital structure the increase is manageable within Comvita's banking lines. The company has recently renewed its banking lines through to September 2017 with total available facilities of NZ$80m. The company should have an interest coverage ratio of 8.6x for FY15 and 6.5x for FY16.

Exhibit 10: Financial summary

NZ$000s	2011	2012	2013	2014	2015e	2016e
Year end March	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS						
Revenue	82.0	95.9	103.5	115.3	151.0	171.4
Cost of Sales	(35.7)	(41.4)	(46.0)	(54.9)	(68.8)	(78.1)
Gross Profit	46.3	54.5	57.6	60.4	82.2	93.3
EBITDA	6.4	14.8	14.4	15.2	21.1	24.7
Operating Profit (before amort. and except.)	2.9	12.1	11.3	11.2	16.2	19.1
Intangible Amortisation	0.0	0.0	0.0	0.0	0.0	0.0
Exceptionals	0.0	0.0	0.0	0.0	0.0	0.0
Other	(0.0)	0.0	0.0	0.0	0.0	0.0
Operating Profit	2.9	12.1	11.3	11.2	16.2	19.1
Net Interest	(0.4)	(0.6)	(0.9)	(0.6)	(1.9)	(2.9)
Profit Before Tax (norm)	2.5	11.6	10.4	10.6	14.3	16.2
Profit Before Tax (FRS 3)	2.5	11.6	10.4	10.6	14.3	16.2
Tax	(2.0)	(3.3)	(3.1)	(3.0)	(4.0)	(4.5)
Profit After Tax (norm)	0.5	8.2	7.4	7.6	10.3	11.6
Profit After Tax (FRS 3)	0.5	8.2	7.4	7.6	10.3	11.6
Average Number of Shares Outstanding (m)	29.4	29.2	28.7	30.5	32.3	32.8
EPS - normalised (c)	1.7	28.1	25.7	25.0	31.8	35.5
EPS - normalised and fully diluted (c)	1.7	28.1	25.7	25.0	31.8	35.5
EPS - (IFRS) (c)	1.7	28.1	25.7	25.0	31.8	35.5
Dividend per share (c)	6.0	14.0	13.0	12.0	16.0	18.0
Gross Margin (%)	56.5	56.8	55.6	52.4	54.4	54.4
EBITDA Margin (%)	7.8	15.4	13.9	13.2	13.9	14.4
Operating Margin (before GW and except.) (%)	3.5	12.6	10.9	9.7	10.7	11.1
BALANCE SHEET						
Fixed Assets	73.3	74.3	84.4	92.0	94.5	99.5
Intangible Assets	43.4	41.5	41.6	40.6	41.6	41.6
Tangible Assets	18.9	22.5	30.3	38.7	44.0	49.0
Investments	11.0	10.3	12.6	12.8	8.9	8.9
Current Assets	38.8	41.1	52.3	55.5	73.4	79.7
Stocks	18.5	17.0	20.8	27.2	41.5	45.6
Debtors	17.8	19.8	23.2	22.6	27.9	30.2
Cash	2.5	2.2	6.0	2.9	1.3	1.2
Other	0.0	2.1	2.3	2.8	2.8	2.8
Current Liabilities	(18.0)	(18.2)	(18.0)	(21.3)	(24.1)	(27.6)
Creditors	(11.9)	(16.6)	(16.0)	(20.7)	(23.6)	(27.6)
Short term borrowings	(6.1)	(1.5)	(1.9)	(0.6)	(0.6)	(0.6)
Long Term Liabilities	(21.8)	(21.6)	(36.9)	(35.0)	(49.0)	(51.0)
Long term borrowings	(15.3)	(14.0)	(29.4)	(28.8)	(43.8)	(46.8)
Other long term liabilities	(6.6)	(7.6)	(7.5)	(6.2)	(5.2)	(4.2)
Net Assets	72.3	75.6	81.9	91.2	94.7	100.6
CASH FLOW						
Operating Cash Flow	(0.2)	16.2	7.4	11.3	14.4	20.7
Net Interest	(1.7)	(1.3)	(1.2)	(1.8)	(1.9)	(2.9)
Tax	(1.1)	(2.4)	(3.2)	(1.1)	(4.0)	(4.5)
Capex	(4.2)	(5.7)	(8.2)	(16.2)	(9.9)	(10.6)
Acquisitions/disposals	(0.2)	0.0	(3.2)	(0.3)	(12.3)	0.0
Financing	2.0	0.2	0.7	9.4	2.3	0.0
Dividends	(1.7)	(2.0)	(4.1)	(4.0)	(5.2)	(5.8)
Net Cash Flow	(7.0)	5.0	(11.9)	(2.5)	(16.6)	(3.1)
Opening net debt/(cash)	11.5	18.9	13.4	25.3	26.5	43.1
HP finance leases initiated	1.0	(5.3)	15.2	(0.9)	0.0	0.0
Other	(1.4)	5.8	(15.3)	2.2	0.0	(0.0)
Closing net debt/(cash)	18.9	13.4	25.3	26.5	43.1	46.2

Source: Company accounts, Edison Investment Research

EDISON

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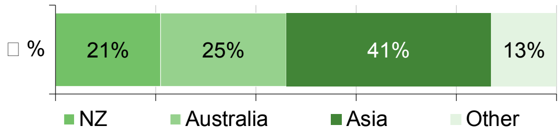
Revenue by geography



CAGR metrics		Profitability metrics		Balance sheet metrics		Sensitivities evaluation	
EPS 12-16e	6.0%	ROCE 15e	10.7%	Gearing 15e	45.5%	Litigation/regulatory	◖
EPS 14-16e	19.3%	Avg ROCE 12-16e	8.7%	Interest cover 15e	8.6x	Pensions	○
EBITDA 12-16e	13.6%	ROE 15e	10.8%	CA/CL 15e	3.0x	Currency	◖
EBITDA 14-16e	27.2%	Gross margin 15e	54.4%	Stock days 15e	100.2	Stock overhang	○
Sales 12-16e	15.6%	Operating margin 15e	10.7%	Debtor days 15e	67.3	Interest rates	○
Sales 14-16e	21.9%	Gr mgn / Op mgn 15e	5.1x	Creditor days 15e	42.8	Oil/commodity prices	◖

Management team

CEO: Brett Hewlett

Brett has been CEO since 2005, following 15 years with Tetra Pak in Europe and the Middle East.

COO: Scott Coulter

Scott joined Comvita in 2002 and is responsible for the global sales and marketing strategy and all offshore entities.

CFO: Peter Moran (to 29 August 2014)

Peter has been CFO since 2008 following a career with a number of New Zealand entities across oil services, telecommunications and bio-tech.

CTO: Dr Ralf Schlothauer

Dr Schlothauer has overall responsibility for Comvita's research and development and is also an Adjunct Professor of Biological Sciences at Auckland University.

Principal shareholders	(%)
Kauri NZ Investments	9.87
A Bougen, L Bougen & G Elvin (associated with A Bougen, Director)	9.20
NZ CSD Ltd	9.33
Derma Sciences, Inc.	6.98
Custodial Services Ltd – Account 3	4.99
Li Wang	4.36
Stapway Nominees	3.74

Companies named in this report
Derma Sciences (DSCI.US)