EDISON

Comvita

Looking sweet

Full-year results

Food & beverages

1 June 2015

Comvita (CVT) has locked up about half its requisite honey supply through acquisitions and investments in apiaries. This, together with investment in augmented production facilities, the rationalisation of its channels to market, and optimising the product mix, should see CVT continue to expand its margins and lift its return on invested capital (ROCE) above the current level of ~12%. Our valuation of NZ$4.73 would increase to NZ$5.96 if the EBITDA margin was to rise from the current level of 14.9% to 18% over the next three years.

Year end	Revenue (NZ$m)	PBT* (NZ$m)	EPS* (c)	DPS (c)	P/E (x)	Yield (%)
03/14	115.3	12.6	25.5	12.0	16.8	2.8
03/15	152.7	16.3	29.9	13.0	14.3	3.0
03/16e	176.3	20.9	34.0	14.0	12.6	3.3
03/17e	204.0	26.4	43.7	16.0	9.8	3.7

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

Demand is not the issue for honey products

CVT's honey products are supply- rather than demand-constrained. This, together with the special qualities of manuka honey, allows CVT to be a honey product price-maker and to focus on improving the yield. The available yield ranges from NZ$5 per 250g for generic unbranded honey to NZ$500 per 250g for skincare products. In FY15, 64% of revenue was generated from the functional food market where branded manuka honey brings from NZ$14-104 per 250g. Healthcare, which includes olive leaf extract, cough and cold remedies and dietary supplements, accounted for 29% of revenue. In this category the manuka-based honey lozenges yield NZ$250 per 250g. Medicinal honey, now 4% of revenue, yields NZ$500.

Improvement in ROCE

The board and management's focus is on restoring ROCE to acceptable long-term sustainable levels. FY15 results provided some early evidence of operating leverage leading to an improved ROCE. The company disclosed ROCE of 12% in FY15 compared with 10.8% in FY14. Our forecasts show ROCE improving to 17.6% by FY18 with EBITDA margins of ~16% (FY15 EBITDA margin of 14.9%).

Valuation: Upside from more runs on the board

The upside in our valuation of NZ$4.73/share (DCF of NZ$4.47 plus NZ$0.26 for Derma Sciences shares) should be reflected in the share price as CVT continues to demonstrate that pricing power for honey products and operating leverage result in higher margins and increasing ROCE. Shareholders should also continue to be rewarded with an increased dividend pay-out ratio.

Price NZ$4.29

Market cap NZ$169m

Net debt (NZ$m) at 31 March 2015	26.1
Shares in issue	39.4m
Free float	58.6%
Code	CVT
Primary exchange	NZX
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	5.7	4.4	23.0
Rel (local)	4.0	6.7	14.0
52-week high/low		NZ$4.3	NZ$3.5

Business description

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

Next event

AGM	23 July 2015

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FY15 results say better days to come

The key messages from the FY15 results were (we refer to results as reported):

- Results were comfortably ahead of guidance provided in the H115 results in November 2014; revenue was 7.2% and NPAT 7.8% ahead of guidance.
- Revenue growth (excluding estimated revenue from NZ Honey) was better than the previous year's growth rate – from 11.4% in FY14 to ~16% in FY15.
- Revenue from Asia was flat year-on-year but the contribution increase of 16% reflects the positive impact of price rises and some changes made in channels to market.
- Internet-based sales, albeit only ~2% of revenue grew by 55%; the company expects internet sales to continue to grow in importance, particularly in China where CVT employs a 'click and collect' model.
- The contribution from medical sales increased by 61% on flat revenue due to the impact of increasing royalties from Derma Sciences (NASDAQ.DSCI) where CVT's wound product continues to gain traction. In the year ended 31 December 2014, Derma Sciences MEDIHONEY sales increased by 16%. We forecast FY15 sales of MEDIHONEY to increase by 12%.
- The NZ and Australian businesses reported strong results, in part because of the strength of the tourism markets in both countries where the highest growth market was China. Asian tourists are the highest spenders of all the tourism markets and have demonstrated a propensity to purchase locally-produced foodstuffs, particularly those with perceived health benefits.
- The NZ and Australian segments included the July 2014 acquisition of NZ Honey. NZ Honey products are not premium-branded products and therefore are lower margin. For the NZ and Australian segments the inclusion of NZ Honey has meant increased sales but a reduced contribution margin.
- There was evidence of operational leverage in the improved EBITDA margin; the underlying margin increased from 13.2% in FY14 to 14.9% in FY15 in spite of the impact of the inclusion in FY15 of the lower-margin NZ Honey business.
- NPAT would have been NZ$0.76 (7.4%) more if not for the net loss in the fair value of derivatives relating to the Derma Science warrants. This increased financial expenses by NZ$1.013m (last year's comparative was NZ$0.03m).
- There was a 14.4% increase in earnings per share and an 8.3% increase in dividends.
- Increased ROCE from 10.8% in FY14 to 12% in FY15.[1]
- There was an increase in raw material inventory levels of NZ$13m to NZ$28m at 31 March 2015; additional honey inventory provides CVT with the potential to value-add because manuka honey increases in value as it matures due to a natural process that increases its antibacterial effectiveness.
- Net debt of NZ$26m with an improved net debt to EBITDA ratio of 1.1x (1.6x[2] at 31 March 2014).

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[1] Comvita FY15 results presentation 22 May 2015

[2] Comvita FY15 results presentation 22 May 2015

Exhibit 1: CVT – year-on-year comparison of reported results

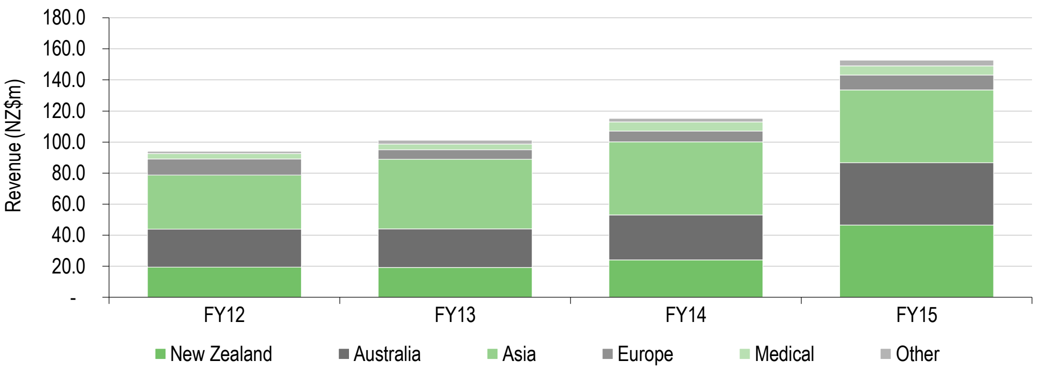
NZ$m	FY14*	FY15	Variance
Revenue	115.3	152.7	32.5%
Cost of goods sold	-54.9	-81.2	47.7%
Gross Margin	60.4	71.6	18.5%
Other income	2.8	6.1	119.9%
Selling and marketing	28.5	34.4	20.7%
Administrative	15.0	17.0	13.4%
Distribution	5.6	6.1	8.9%
Research and Development	2.9	2.8	-3.1%
Depreciation	-2.6	-3.8	44.3%
Amortisation	-1.5	-1.8	16.4%
EBITDA	15.2	22.8	49.7%
Depreciation	-2.6	-3.8	44.3%
EBITA	12.6	19.0	50.8%
Amortisation	-1.5	-1.8	16.4%
EBIT	11.1	17.3	55.5%
Associates	0.0	0.9	NM
EBIT (after associates)	11.1	18.2	63.4%
Interest	-0.6	-3.7	550.4%
NPBT	10.6	14.5	37.3%
Income tax	-3.0	-4.2	41.9%
NPAT	7.6	10.2	35.5%
EPS (cps)	25.5	29.6	16.0%
DPS (cps)	12.0	13.0	8.3%
Margins			
Gross margin	52.4%	46.9%	
EBITDA	13.2%	14.9%	
EBITA	11.0%	12.5%	
EBIT	9.6%	11.3%	
NPAT	6.6%	6.7%	

Source: Comvita financial statements. Note: *Restated.

Segment results show strength of NZ business

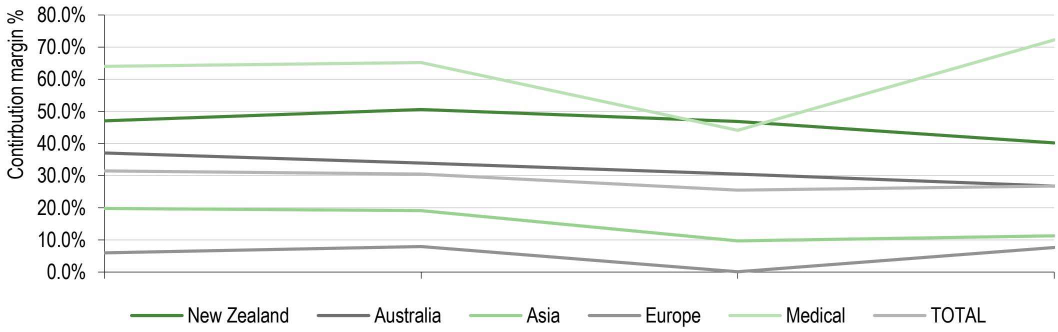
CVT provides a geographic split of revenue and the contribution per segment, measured at the profit before tax and unallocated costs line. Admittedly, this analysis, which appears below, is only partially useful because unallocated costs are significant and range between 16-20% of revenue.

Exhibit 2: CVT – segmental revenue



Source: Comvita financial statements

Exhibit 3: CVT – segmental contribution margin before unallocated costs



Source: Comvita financial statements. Note: Segmental contribution margin % is before unallocated costs.

Exhibit 4: CVT – segmental analysis

NZ$(m)	FY12	FY13	FY14	FY15
Revenue				
New Zealand	19.4	19.3	24.2	46.5
Australia	24.5	24.7	28.9	40.1
Asia	34.8	44.9	47.1	46.9
Europe	10.4	6.2	6.8	9.5
Medical	3.5	3.7	6.0	5.9
Other	1.5	2.4	2.2	3.8
TOTAL	**94.0**	**101.2**	**115.3**	**152.7**
NPBT				
New Zealand	9.1	9.8	11.3	18.7
Australia	9.1	8.4	8.8	10.8
Asia	6.9	8.6	4.6	5.3
Europe	0.6	0.5	0.0	0.7
Medical	2.2	2.4	2.6	4.3
Other	1.7	1.2	2.0	1.2
TOTAL	**29.6**	**30.9**	**29.4**	**41.0**
Unallocated	18.1	20.4	18.3	27.4
NPBT and associates	11.6	10.4	11.1	13.6
Increases in revenue				
New Zealand		-0.5%	25.5%	92.4%
Australia		0.9%	16.9%	38.7%
Asia		29.1%	4.9%	-0.5%
Europe		-40.4%	10.5%	39.8%
Medical		5.6%	63.8%	-2.0%
Other		64.0%	-8.8%	68.4%
TOTAL		**7.7%**	**13.9%**	**32.5%**
NPBT margin (pre unallocated)				
New Zealand	47.1%	50.6%	46.8%	40.2%
Australia	37.1%	33.9%	30.5%	26.8%
Asia	19.8%	19.2%	9.7%	11.3%
Europe	6.0%	7.9%	0.2%	7.7%
Medical	64.0%	65.2%	44.1%	72.3%
Other	113.7%	51.0%	89.6%	32.5%
TOTAL	**31.5%**	**30.5%**	**25.5%**	**26.8%**
Unallocated % of revenue	19.2%	20.2%	15.9%	17.9%
NPBT margin with unallocated	12.3%	10.3%	9.6%	8.9%

Source: Comvita financial statements

The impact of the acquisition of NZ Honey is shown by the increase in the FY15 sales of functional products and the reduction in contribution margin. The lift in the contribution margin from Asia reflects improvement in the channels to market and the medical segment benefited from increased milestone payments from Derma Sciences.

Exhibit 5: CVT – sales by product

	2012	2013	2014	2015
Heatlhcare	40.0%	42.0%	32.0%	29.0%
Functional Foods	49.0%	48.0%	56.0%	64.0%
Personal Care	5.0%	5.0%	4.0%	3.0%
Medical	2.0%	4.0%	7.0%	4.0%
Other	4.0%	1.0%	1.0%	

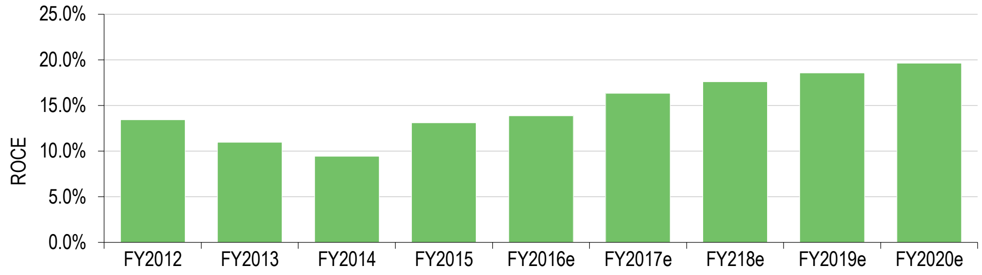
Source: Comvita financial statements

Strategy to drive ROCE

The company expects to achieve year-on-year increases in ROCE through implementation of the following strategies:

- continuing to work on securing the supply of honey. CVT currently has control of 30,000 hives, which produce about 30% of honey requirements. A further 20% is secured by contracts;
- rationalisation of channels to market to achieve the most cost-effective outcome;
- increasing the production of value-added products;
- achieving EBITDA margin expansion through operating leverage;
- maintaining the Comvita brand as a premium brand;
- increasing the market penetration of the olive leaf extract products; these extract products are neither constrained by a lack of supply nor by a lack of productive capacity. It is estimated that the current spare capacity is between 60-70%; and
- no increase in annual capital expenditure.

Exhibit 6: CVT – ROCE



Source: Comvita financial statements, Edison Investment Research

Forecast changes

We have reviewed our forecasts for FY16 and beyond. The changes made to our FY16 forecasts include stronger revenue increases and an improved EBITDA margin.

Exhibit 7: FY16 forecast changes

NZ$m	Previous	Revised	Variance
Revenue	168.2	176.3	4.8%
EBITDA	23.5	26.6	13.2%
EBITA	17.7	21.6	22.3%
Amortisation	-	-1.2	N/A
Associate	-	1.1	N/A
Interest	-1.4	-1.8	31.8%
NPBT	16.3	19.7	20.9%
NPAT	11.7	13.4	14.5%
EPS	29.5	34.0	15.3%
DPS	14.0	14.0	0.0%
Revenue growth	12%	14%	
EBITDA %	14.0%	14.7%	

Source: Edison Investment Research

Valuation

Most relevant comparative – Capilano Honey (CZZ.ASX)

The most relevant peer for CVT is Australia-based Capilano Honey. Capilano is the leading local honey brand in the packaged honey category in Australia. About 80% of its product is directed at the local market where it has >51% market share. Unlike CVT, CZZ experiences pricing pressure. Its primary customers are the large supermarket chains, which are aggressively executing their private label strategy and are competing with CZZ for scarce local honey (honey volumes in Australia have declined at a CAGR of 2.7% since 1980). The other limitation on the margins that can be achieved by CZZ comes from CZZ being a packager only and not a producer. In FY14 the EBITDA margin comparison was 13.2% for CVT and 9.4% for CZZ. CZZ sells 325t of higher-margin Jarrah and active manuka honey, and has plans to double this volume in two years. This should result in overall margin improvement.

CVT is forecast to achieve higher sales growth and an EBITDA margin 400bp better than CZZ because CVT operates a business model that is, in the main, vertically integrated. CVT is already achieving ROCE of 13.1%, which is more than WACC and therefore does not deserve to trade at lower multiples than CZZ. CZZ achieved a ROCE of 5.5% in FY14 and is forecast to achieve a ROCE of 9.4% in FY15. Our DCF valuation of NZ$4.47 plus NZ$0.26 for the Derma Sciences investment implies a FY16e P/E of 13.9x and an EV/EBIT multiple of 9.8x.

Exhibit 8: Comparative data – Comvita (CVT) and Capilano (CZZ)

	2013	2014	2015e*	2016e	2017e
PE (x)					
CVT	17.5	16.8	14.5	12.6	9.8
CZZ	30.2	22.3	15.5	14.9	13.9
EV/EBIT (x)					
CVT	25.6	16.9	10.8	8.9	7.1
CZZ	23.3	17.8	10.6	9.5	8.5
Yield (%)					
CVT	3.0%	2.8%	3.0%	3.3%	3.7%
CZZ	1.3%	1.3%	1.9%	2.2%	2.3%
EBITDA margin (%)					
CVT	12.7%	13.7%	14.9%	15.1%	15.8%
CZZ	9.7%	9.4%	1.6%	11.0%	11.2%
Sales growth (%)					
CVT		13.9%	32.5%	15.5%	15.7%
CZZ		19.3%	28.1%	2.9%	2.9%
ROCE					
CVT	11.5%	10.3%	13.1%	15.0%	18.0%
CZZ		5.4%	9.2%	10.1%	11.3%

Source: CVT and CZZ financial data, Edison Investment Research, consensus data Thomson Reuters. Note: *Actual for CVT for year-end 31 March 2015; forecast for CZZ for year ending 30 June 2015. **P/E based on diluted EPS. Priced at 29 May 2015.

DCF valuation – NZ$4.47

Our DCF uses forecasts for 10 years, a terminal growth rate of 2.02% and a WACC of 10.7%.

Exhibit 9: CVT – free cash flow

DCF (NZ$m)	2016e	2017e	2018e	2019e	2020e	2021e	2022e	2023e	2024e
EBIT	20.5	25.8	30.8	36.1	42.4	49.3	57.5	58.6	59.8
Tax	6.1	7.5	8.9	10.4	12.1	14.0	16.2	16.6	16.9
Depreciation	4.9	5.3	5.4	5.6	5.9	6.1	6.4	6.4	6.4
Amortisation	1.2	1.1	0.9	0.8	0.7	0.6	0.6	0.6	0.6
Maintenance capex	3.1	3.8	4.1	5.2	5.3	5.4	5.5	6.4	6.4
Expansionary capex	6.0	3.0	3.0	3.0	3.0	3.0	3.0	0.0	0.0
Payment for acquisitions	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Working capital movement	(1.4)	(8.3)	(9.8)	(12.6)	(12.6)	(13.7)	(16.0)	(16.3)	(16.7)
Free cash flow	10.0	9.5	11.4	11.5	16.1	19.9	23.6	26.3	26.8

Source: Edison Investment Research

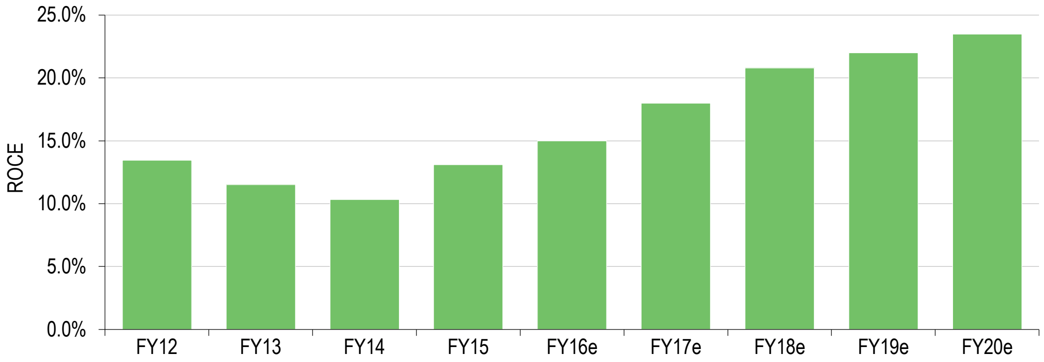
Derma Sciences – value per CVT share NZ$0.26

At 31 March 2015 CVT held 1.098m shares in Derma Sciences (NASDAQ.DSCI). The share price at 25 May 2015 of US$6.71 converts to a market value of NZ$10.1m, which equates to NZ$0.26 per CVT share. CVT has an exclusive licensing agreement with Derma Sciences for medical-grade manuka honey-based products for the professional wound care market.

Sensitivities: What happens if the EBITDA margin reaches 18%?

If CVT lifts its EBITDA margin to 18% through increasing the amount of higher-value products sold, our DCF increases from NZ$4.47 to NZ$5.70, taking our valuation range from NZ$4.73 to NZ$5.96 (including the value of the Derma Sciences shares at current market values). ROCE would increase to 20.8% by FY18 if an EBITDA margin of 18% was achieved by FY18.

Exhibit 10: ROCE if EBITDA margin increases to 18% by 2018



Source: Comvita Financial Statement, Edison Investment Research

Exhibit 11: CVT sensitivity analysis – improved EBITDA margin and impact on ROCE

	FY18e EBITDA margin	ROCE
Forecasts	15.7%	17.6%
Sensitivity (1)	16.0%	18.0%
Sensitivity (2)	16.5%	18.7%
Sensitivity (3)	17.0%	19.4%
Sensitivity (4)	17.5%	20.1%
Sensitivity (5)	18.0%	20.8%

Source: Edison Investment Research

Exhibit 12: Financial summary

NZ$000s	2014	2015	2016e	2017e	2018e
31 March	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Revenue	115,283	152,702	176,347	204,014	236,432
Cost of Sales	(54,924)	(81,150)	(91,441)	(105,585)	(122,135)
Gross Profit	60,359	71,552	84,906	98,429	114,297
EBITDA	15,785	22,804	26,594	32,135	37,153
Operating Profit (before amort. and except.)	13,192	19,934	22,747	28,134	33,128
Intangible Amortisation	(1,527)	(1,777)	(1,195)	(1,056)	(933)
Exceptionals	0	0	0	0	0
Other	0	0	0	0	0
Operating Profit	11,665	18,157	21,553	27,078	32,195
Net Interest	(564)	(3,668)	(1,845)	(1,753)	(1,737)
Profit Before Tax (norm)	12,628	16,266	20,903	26,381	31,390
Profit Before Tax (FRS 3)	11,101	14,489	19,708	25,325	30,458
Tax	(3,129)	(4,245)	(6,307)	(8,104)	(9,746)
Profit After Tax (norm)	7,972	10,244	13,401	17,221	20,711
Profit After Tax (FRS 3)	7,972	10,244	13,401	17,221	20,711
Average Number of Shares Outstanding (m)	31.3	34.6	39.4	39.4	39.4
EPS - normalised (c)	25.5	29.9	34.0	43.7	52.5
EPS - normalised and fully diluted (c)	25.5	29.6	34.0	43.7	52.5
EPS - (IFRS) (c)	25.5	29.6	34.0	43.7	52.5
Dividend per share (c)	12.0	13.0	14.0	16.0	17.0
Gross Margin (%)	52.4	46.9	48.1	48.2	48.3
EBITDA Margin (%)	13.7	14.9	15.1	15.8	15.7
Operating Margin (before GW and except.) (%)	11.4	13.1	12.9	13.8	14.0
BALANCE SHEET					
Fixed Assets	93,277	106,615	110,644	112,396	114,587
Intangible Assets	40,558	43,112	41,917	40,862	39,929
Tangible Assets	39,174	48,417	52,541	54,057	55,756
Investments	13,545	15,086	16,186	17,478	18,901
Current Assets	55,469	93,107	90,769	102,306	116,905
Stocks	27,156	44,519	39,031	45,086	52,174
Debtors	22,362	28,895	29,635	34,284	39,732
Cash	2,865	19,420	21,831	22,663	24,726
Other	3,086	273	273	273	273
Current Liabilities	(21,276)	(32,418)	(26,228)	(28,605)	(31,386)
Creditors	(20,721)	(30,388)	(24,198)	(26,575)	(29,356)
Short term borrowings	(555)	(2,030)	(2,030)	(2,030)	(2,030)
Long Term Liabilities	(35,388)	(48,625)	(48,625)	(48,625)	(48,625)
Long term borrowings	(28,800)	(43,483)	(43,483)	(43,483)	(43,483)
Other long term liabilities	(6,588)	(5,142)	(5,142)	(5,142)	(5,142)
Net Assets	92,082	118,679	126,560	137,472	151,480
CASH FLOW					
Operating Cash Flow	11,347	19,409	25,153	23,807	27,399
Net Interest	(1,774)	(2,926)	(1,845)	(1,753)	(1,737)
Tax	(1,052)	(4,513)	(6,307)	(8,104)	(9,746)
Capex	(11,301)	(8,897)	(9,071)	(6,809)	(7,148)
Acquisitions/disposals	(5,024)	(23,557)	0	0	0
Financing	9,454	24,723	0	0	0
Dividends	(3,983)	(3,976)	(5,520)	(6,309)	(6,703)
Net Cash Flow	(2,333)	263	2,411	832	2,063
Opening net debt/(cash)	24,157	26,490	26,093	23,682	22,850
HP finance leases initiated	0	0	0	0	0
Other	0	135	0	(0)	0
Closing net debt/(cash)	26,490	26,093	23,682	22,850	20,787

Source: Comvita financial statements, Edison Investment Research

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