Progressive EQUITY RESEARCH

DISTIL
BEVERAGES

19 October 2021

DIS.L

2.05p

Market Cap: £13.6m

SHARE PRICE (p)

12m high/low	3.1p/1.2p

Source: LSE Data

KEY DATA

Net (Debt)/Cash	£4.2m *(at 30/09/21)*
Enterprise value	£9.4m
Index/market	AIM
Next news	Trading update - Jan '22
Shares in Issue (m)	662.7
Executive Chairman	Don Goulding
Finance Director	Shaun Claydon

COMPANY DESCRIPTION

Distil develops and markets internationally drinks brands, including RedLeg Spiced Rum and Blackwoods Vintage Gins.

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DISTIL IS A RESEARCH CLIENT OF PROGRESSIVE

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Interim results

Strategic investment in Ardgowan

Distil faced very tough sales comparatives in H1 against the exceptional prior year performance (+128%), driven by the extraordinary circumstances arising from the pandemic. While reflected in the current year performance, Distil delivered strong underlying growth on a two-year view against its pre-Covid sales base (+74%). Turnover declined by 24% in H1 to £1.44m, with gross margin up 40bps to 55.3%. Adjusting for share-based payments and one-off costs related to the Ardgowan investment, Distil delivered an operating profit of £58k, compared with £159k last year. Distil will provide market guidance after the key Christmas trading period, given ongoing disruption to the supply chain and associated cost pressures.

- **Interim results**: Trading volumes decreased by 21% behind the turnover decline but rose 49% on a two-year view. Negative operational leverage, along with combined costs of just over £100k from a higher share-based payment expense and one-off transaction costs relating to the Ardgowan investment, drove a reported operating loss of (£44K) against prior year profit of £154k. An operating cash inflow and the equity raise proceeds saw period end cash of £4.215m against £570k at the period end last year.
- **Operational developments**: RedLeg Spiced Rum made good progress by securing further listings and launching a fourth flavour variant, RedLeg Tropical Rum. TRØVE, the latest brand launch, a botanical vodka in three flavour variants, has been listed by a premium prestige UK retailer and successfully registered its trademark in the US.
- **Ardgowan investment**: The major strategic development of H1 saw Distil raise £3m net through an equity raise to fund investment in Ardgowan Distillery Company. This will broaden Distil's brand portfolio with entry into the premium malt whisky market, as well as providing a physical and spiritual base, together with its own distillery, gin school and visitor centre, for its Blackwoods Gin brand.
- **Forecasts:** With Christmas being the key trading period for Distil and in light of ongoing supply chain challenges, forecasting the outturn for the rest of the financial year remains difficult. This should become clearer once the key trading period has been delivered, with the company therefore looking to provide guidance in the New Year.

FYE MAR (£M)	2018	2019	2020	2021
Revenue	2.01	2.40	2.44	3.62
Adj EBITDA	0.16	0.17	0.25	0.27
Fully Adj PBT	0.16	0.16	0.18	0.24
Fully Adj EPS (p)	0.03	0.03	0.05	0.07
EV/Sales (x)	4.7x	3.9x	3.8x	2.6x
EV/EBITDA (x)	57.3x	55.4x	38.1x	34.8x
PER (x)	65.0x	64.0x	39.9x	30.0x

Source: Company Information and Progressive Equity Research estimates.

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A comparative-ly challenging trading period…

…alongside a broadening of the strategic base

The extraordinary events of last year and their knock-on effect on trading patterns were always going to cast a shadow over H1 trading, throwing up an extremely challenging sales comparative, that was always going to be tough to match. And so it has proven to be, with Distil's H1 revenue down 24% to £1.44m against the £1.88m achieved last year. H1 sales last year rose 128%, with Q2 sales, covering the summer July to September period, rising by an unprecedented 265% within this figure. The pattern of H1 in FY22E saw Q1 sales up 10%, as previously reported, with Q2 sales seeing an estimated decline of almost 40% against last year's substantial uplift. It should be noted that on a two-year view the H1 sales figure is still some 75% higher than in the equivalent H1 period of FY20 before the arrival of the Covid-19 pandemic in early 2020, delivering a two-year compound turnover growth rate (CAGR) of 32%.

As a reminder, H1 FY21 sales were driven by several factors, including consumer and retail lockdowns, retailer panic buying, with an echo effect into the distribution channel, which was fearful of being unable to secure sufficient stocks for the peak Christmas season. This served to pull forward some demand into Q2 last year from Q3, distorting historical sales patterns.

The current year has seen further progress being made by the existing brand portfolio with:

- The UK launch of RedLeg Tropical Rum, the fourth flavour variant for the brand
- Additional listings secured for the RedLeg Spiced Rum range
- The registration of the TRØVE Botanical Vodka trademark in the US
- The listing of TRØVE at a premium UK retailer
- A new export market opened in Ukraine

In addition, H1 also saw an equity fund raise of £3.2m gross completed in August to broaden the base of the group, acquiring a stake in the Ardgowan Distillery Company Limited. Based in Scotland, this strategic investment delivers new revenue streams through entry into the premium malt Scotch market and the establishment of a home base for the Blackwoods Gin brand, together with its own distillery, gin school and visitor centre. We describe this transaction and the subsequent commercial opportunities in more detail later in this note, following a review of the interim results.

Interim results analysis

The following table summarises Distil's H1 profit and loss account (P&L) performance, compared with that delivered last year. Many of the key headlines have already been highlighted in the preceding text. In terms of volume (litres), this decreased by 21% over last year, but was up 49% on a two-year view.

It should be noted that the P&L presented below is as reported by the company. We have however added two lines at the bottom of the table to present an adjusted operating profit figure for both years, covering the share-based payment expense and other exceptional costs.

With regard to the former, this increased to £30k in FY22E from £5k last year. In addition, the current year saw £72k of one-off transaction costs in relation to the Ardgowan investment, making a total adjustment of £102k. This swings the reported operating loss of £44k to an adjusted operating profit of £58k, compared with last year's adjusted operating profit of £159k. The adjusted operating margin delivered was 4.4%, which gives a better representation of the company's underlying trading performance in the period.

FY22 Interim results summary – P&L summary

(£'000 unless stated)	H1 FY21	H1 FY22	Change	% change
Turnover	1,878	1,435	-443	-24%
Gross profit	1031	794	-237	-23%
Gross margin (%)	*54.9%*	*55.3%*	*0.4%*	
Advertising and promotion	-565	-398	167	-30%
Other administrative costs	-300	-402	-102	34%
Depreciation and amortisation	-7	-8	-1	14%
Other costs	-5	-30	-25	n.a.
Total operating costs	-877	-838	39	-4%
Operating profit/(loss)	154	-44	-198	-129%
Finance charge	0	-1	-1	n.a.
Pre-exceptional profit/(loss) before tax	154	-45	-199	-129%
Exceptional charge	0	0	0	n.c.
Reported loss before tax	154	-45	-199	-129%
Operating costs to sales ratio	*-46.7%*	*-58.4%*	*-11.7%*	
Operating margin (%)	*8.2%*	*-3.1%*	*-11.3%*	
Adjusted operating profit	159	58	-101	-64%
Adjusted operating margin (%)	*8.5%*	*4.0%*	*-4.4%*	

Source: Distil, Progressive Equity Research

Despite the widely reported pressures on businesses in many industries from supply chain pressures and rising raw material costs, resulting in increased production costs, Distil has managed to deliver a 40bps increase to 55.3% in its gross margin compared with last year. This does however lag the full-year gross margins seen in recent years, with management stressing that maintaining margins around that delivered in H1 is its priority. This reflects Distil's anticipation of continuing costs pressures around goods and energy over the foreseeable future.

The increase in reported Other administrative costs primarily reflects the inclusion of the one-off transaction costs relating to the Ardgowan investment. The other major cost line relates to advertising and promotion, with management reining this back to reflect the turnover dynamic.

As can be seen in the next table, advertising and promotion costs were 30% lower than last year's brand support and investment, compared with the declines in turnover (24%) and gross profit (23%). This resulted in a smaller decline of 15% at the contribution level to £396k, with the contribution margin increasing by 280bps to 27.6%.

Contribution and margin performance – H1 FY22 vs H1 FY21

(£'000 unless otherwise stated)	H1 FY21	H1 FY22	Change	% change
Turnover	1,878	1,435	-443	-24%
Gross profit	1,031	794	-237	-23%
Gross margin (%)	*54.9%*	*55.3%*	*0.4%*	
Advertising and promotion	-565	-398	167	-30%
Contribution	466	396	-70	-15%
Contribution margin (%)	*24.8%*	*27.6%*	*2.8%*	
Advertising to sales ratio (%)	*-30.1%*	*-27.7%*	*2.4%*	

Source: Distil, Progressive Equity Research

In terms of cashflow, Distil performed strongly, with £93k generated from operating activities, compared with a £274k outflow in the prior year. The principal driver of this improvement was working capital management, which delivered a £100k inflow, compared with last year's £440k outflow.

Period end net cash stood at £4.215m against £570k at the equivalent stage last year. This balance includes the net proceeds of just over £3m arising from the equity fund raise for the Ardgowan investment, which is due to be drawn down in January 2022.

Ardgowan - broadening the strategic base

Distil's £3m investment in the Ardgowan distillery project serves to broaden and strengthen the strategic base of the company in several important ways:

1) It ***provides an in-house manufacturing base***, together with a physical and spiritual home, to the Blackwoods (and TRØVE) brand(s).

2) It includes ***access to 10% of Ardgowan's annual production of malt whisky***, thereby providing diversification of Distil's branded portfolio into the lucrative premium malt whisky market, which has universal appeal.

3) Distil has an ***option to provide a further £2m convertible loan***, theoretically covered by the placing warrants included within the initial equity raise, which would increase Distil's stake in Ardgowan to 14.3% (compared with 10% for the first tranche) if exercised in full.

4) The 5% yield on the convertible ***loan will provide Distil with an initial income of £150k per annum, potentially increasing to £250k per annum*** upon provision of the second loan. This will be used primarily to increase brand advertising and to develop an online Direct to Consumer (DTC) marketing and sales fulfilment capability.

5) ***Incremental revenue streams will accrue from a number of complementary activities*** arising from the Ardgowan distillery investment. These include revenues and product sales from visitors participating in distillery tours and/or visiting the onsite retail facility; access to the onsite bottling facility will enable limited runs of current or new liquids for gifting occasions, potentially also including personalisation; faster development and bringing to market of new products, by dint of the New Product Development (NPD) kitchen onsite and the services of Ardgowan's Master Distiller, Max Macfarlane.

Ardgowan investment

Ardgowan history and background

Ardgowan House and its estate are situated near Inverkip, around 30 miles west of Glasgow, with the house standing on a promontory overlooking the River Clyde. The estate is steeped in history, with a connection to Robert the Bruce, and also has a castle within its grounds. It is in easy reach of Glasgow and its airport, the Inverkip Marina and the cruise ship terminal at Greenock. It also abuts the Clyde Muirshiel Regional Park, Scotland's largest regional park, which houses a reservoir and a long aqueduct known as The Cut. This is very popular with tourists and hikers, having formally provided water for the heavy industries based in Greenock and fresh water to the original Ardgowan distillery. The distillery operated until 1952, having been converted to produce industrial alcohol before World War II and almost destroyed by bombing in 1941.

Ardgowan Distillery Company Limited was founded to create a new distillery and re-establish Ardgowan's link with the whisky industry. The distillery, when built and functional will produce a classic Lowland single malt whisky, using water sourced from a local spring. The watchwords for this new whisky will be quality and excellence of flavour, created under the watchful eyes of industry veteran, Willie Phillips, the man behind The Macallan Single Malt, and Max McFarlane, responsible for the success of Highland Park Single Malt. Mr Phillips is currently Chairman of Ardgowan and Mr McFarlane is its Master Distiller.

With malt whisky having to remain in barrel for a minimum of three years before bottling, Ardgowan has to date focused on building up a trading business, to establish both its name and to build a customer base for its future products. As of July 2021, this customer database stood at 28,000, with a returning customer rate thus far of 25%. The business has been based upon the purchase of quality malt whiskies from other distilleries, then blending and bottling them for sale under the Ardgowan "Clydebuilt" brand. These are sold both online and through an international network of distribution partners. Further specialised products sold include the Ardgowan "Discovery" series, based on interesting "discovered" casks. One creation, Clydebuilt Coppersmith, has won medals at various industry awards events, including a gold medal at the 2021 Spirits Business Whisky Masters.

The future focus of Ardgowan will be on the production of its own premium single malt whiskies, initially a five-year old product, with the first release scheduled for 2028.

Distil investment structure

Distil raised £3.2m gross in an equity raise announced in July, comprising both a placing and subscription offer, at a price of 2p per share. The 160m shares issued represent some 24.1% of the enlarged share capital, now totalling 662.7m shares. The placing comprised 87.5m shares, raising £1.75m gross, with the subscription comprising 72.5m shares, raising gross proceeds of £1.45m. The purchasers of the subscription shares are Roland Grain, a Non-Executive Director of Distil, in the sum of £0.65m, and BERO in the sum of £0.8m. The subsequent holdings of Grain GmbH and BERO in Distil stand at 20.34% and 16.04% respectively, from 20.38% and 13.21% ahead of this equity raise.

In addition, placing warrants were issued on the basis of two warrants for every three placing and subscription shares. These are exercisable at the 2p issue price for a year from admission on 6 August 2021. If fully exercised, these 107.2m warrants would raise gross proceeds of £2.143m. Distil has an option to increase its investment by a further £2m to £5m in total, which has to be exercised by 31 December 2022.

Distil's investment takes the form of a convertible loan, which will pay interest of 5% per annum to Distil, paid quarterly in arrears. The duration of the loan is 10 years, with Distil able to convert into equity in Ardgowan at any time, on the basis of a valuation of £30m for Ardgowan. As part of this agreement, Ardgowan will also pledge 10% of its annual production of malt whisky to Distil during the term of the loan. Distil can require early repayment or conversion of the loan if a change of control event occurs.

Distil can appoint an observer at Ardgowan board meetings under the terms of the loan agreement and can later appoint a Director to the Ardgowan board once it has a shareholding of over 10% (which would be the case upon conversion of Distil's initial investment). These roles are expected to be fulfilled by Don Goulding, Executive Chairman of Distil.

Distillery construction plans and timetable

Ardgowan will be responsible for the construction of the site and the two distilleries, namely for Ardgowan itself and for Distil. Planning permission has already been granted, with an expected build plan of between 20 and 24 months, according to Ardgowan's business plan. Construction started upon the initial £11.4m funding package being secured, comprising £7.2m from Roland Grain (one of Distil's directors), £1.2m from other Ardgowan shareholders and £3.0m from Distil. On completion, the Ardgowan Distillery will have a production capacity of up to 1 million litres of pure alcohol per annum.

Distil facilities

Within the part of the estate leased by Ardgowan Distillery Company Limited, Distil will sub-let one of the buildings forming the totality of the Ardgowan Distillery complex. This will be used to house three specific areas – a distillery, a product development kitchen and a visitor experience area. The latter two areas will both be fitted out and staffed at Distil's expense. In terms of the distillery itself, Ardgowan will install such distilling equipment as specified by Distil at its own cost and will undertake the manufacturing of selected Distil brands for Distil on an agreed pricing structure. These brands will include Blackwoods Gin, Blackwoods Vodka and TRØVE Botanical Spirit, together with other products yet to be agreed.

The two companies will also collaborate in the development of a range of whiskies for Distil. To this end, Ardgowan will help Distil to source and blend wholesale whisky stock. Distil expects to launch a range of its own branded premium malt whiskies in 2022. Ardgowan will also be able to use Distil's product development kitchen until its own is completed on its distillery site. As this suggests, Distil's believes its onsite facilities will be up and running before the completion of Ardgowan's own distillery and associated facilities. While subject to the progress of building and other works, Distil's facilities could be operational next year, with Ardgowan more likely to come onstream in the course of 2023.

Business arrangements

In essence, there are two key agreements to cover the business arrangements between Distil and Ardgowan, namely a Manufacturing Agreement and a Mutual Services Agreement. The former covers the manufacturing arrangements pertaining to Distil's products (and facilities) as broadly laid out above in the section "Distil facilities".

The latter Mutual Services Agreement covers a wider range of services between the two companies. A key element of this relates to the sale and distribution of each other's products, including pricing, agreed on an arm's length basis. This relates to both onsite and online sales. With a wider established client base in both the UK and globally, Distil will also assist Ardgowan to distribute its products, again on an agreed financial basis. Another area covered by this agreement would be joint procurement of goods and services to take advantage of their combined buying power, where appropriate.

Visitor experiences

Given the site's location and the popularity of distillery visits, which constitute the third most popular tourist activity in Scotland, Ardgowan should be very attractive as a tourist attraction in its own right, over and above its primary role as a manufacturing distillery. Ardgowan's business plan anticipates some 10,000 visitors to the site in Year 1, rising to 50,000 by Year 6.

Ardgowan's own distillery site will house a retail facility for the combined site, including an area for the sale of Distil products, so that the two distilleries do not compete against each other for retail sales. Ardgowan will have a visitor centre, with Distil housing a visitor experience area, and both sites offering distillery tours, tasting and experiences (such as distilling one's own gin at Distil). We understand visitors will also be able to purchase a combined tour/tasting ticket for both Ardgowan and Distil. There will also be onsite catering facilities to encourage visitor dwell time on the site.

The attraction of onsite retail sales is that the distilleries gain a full retail margin, rather than a wholesale margin. It also offers the possibility of other add-on sales, mementoes and gifting items.

Forecasts

The impact of the pandemic on both total and quarterly trading in FY21 will play a significant part in the shape of FY22E's trading results. Distil delivered a 10% increase in revenues in Q1 FY22E against the 21% Q1 comparative of last year, when the impact of Covid-19 and the first lockdown were initially felt. This prompted a degree of panic-buying last year, which inflated Q1 and most notably Q2 revenues (+265%). The net result was a 128% increase in H1 sales last year, with H2 seeing a 7% increase, driving a total FY21 turnover rise of 48%.

While it would be premature to say that business activity and consumer confidence has returned to pre-Covid levels, it is clear that both have been improving on the back of the vaccination programme and the relaxation of many of the pandemic-related lockdown restrictions. However, as widely reported, there are global pressures emerging on supply chains and raw material costs in many industries, resulting in fragmented product availability within the wholesale and retail sectors. This is obviously an unwelcome and untimely development, which is holding back recovery and has given rise to warnings from the retail industry with regard to Christmas shopping.

It would likewise be premature to say that the on-trade (hospitality sector) has resumed normal levels of activity. There are encouraging signs that reopening is being embraced by consumers, albeit more cautiously by some demographics. The hospitality sector is currently also struggling with staff shortages to the detriment of customer service levels. This could have an adverse impact on the longer-term outlook if unresolved and could potentially hinder even the shorter-term prospects.

In light of all these issues and uncertainties, it is unsurprising that Distil feels unable to provide guidance on the full-year outturn at this stage with a high degree of confidence and accuracy. The company has indicated therefore that it will release market guidance after the Christmas trading period, whereupon we will look to reinitiate forecasts.

Financial Summary: Distil

Year end: March (£m unless shown)

PROFIT & LOSS	**2018**	**2019**	**2020**	**2021**
Revenue	2.01	2.40	2.44	3.62
Adj EBITDA	0.16	0.17	0.25	0.27
Adj EBIT	0.16	0.16	0.18	0.25
Reported PBT	0.16	0.16	0.18	0.24
Fully Adj PBT	0.16	0.16	0.18	0.24
NOPAT	0.16	0.16	0.26	0.36
Reported EPS (p)	0.03	0.03	0.05	0.07
Fully Adj EPS (p)	0.03	0.03	0.05	0.07
Dividend per share (p)	0.00	0.00	0.00	0.00
CASH FLOW & BALANCE SHEET	**2018**	**2019**	**2020**	**2021**
Operating cash flow	0.17	0.09	(0.10)	0.25
Free Cash flow	0.13	0.04	(0.14)	0.22
FCF per share (p)	0.03	0.01	(0.03)	0.04
Acquisitions	(0.02)	(0.01)	(0.02)	(0.02)
Disposals	0.00	0.00	0.00	0.00
Shares issued	0.01	0.00	0.00	0.00
Net cash flow	0.12	0.04	(0.21)	0.20
Overdrafts / borrowings	0.00	0.00	0.00	0.00
Cash & equivalents	1.03	1.07	0.86	1.06
Net (Debt)/Cash	1.03	1.07	0.86	1.06
NAV AND RETURNS	**2018**	**2019**	**2020**	**2021**
Net asset value	3.01	3.17	3.43	3.81
NAV/share (p)	0.60	0.64	0.68	0.76
Net Tangible Asset Value	1.46	1.62	1.85	2.21
NTAV/share (p)	0.29	0.32	0.37	0.44
Average equity	2.91	3.09	3.30	3.62
Post-tax ROE (%)	5.4%	5.2%	7.8%	9.5%
METRICS	**2018**	**2019**	**2020**	**2021**
Revenue growth	22.6%	19.2%	1.7%	48.1%
Adj EBITDA growth	1097.6%	3.4%	45.6%	9.3%
Adj EBIT growth	1531.8%	1.6%	15.0%	38.0%
Adj PBT growth	1531.8%	1.6%	13.7%	33.5%
Adj EPS growth	1531.8%	1.6%	60.4%	32.9%
Dividend growth	N/A	N/A	N/A	N/A
Adj EBIT margins	7.8%	6.7%	7.5%	7.0%
VALUATION	**2018**	**2019**	**2020**	**2021**
EV/Sales (x)	4.7	3.9	3.8	2.6
EV/EBITDA (x)	57.3	55.4	38.1	34.8
EV/NOPAT (x)	59.5	58.6	35.9	26.1
PER (x)	65.0	64.0	39.9	30.0
Dividend yield	N/A	N/A	N/A	N/A
FCF yield	1.3%	0.4%	(1.3%)	2.2%

Source: Company information and Progressive Equity Research estimates

Progressive EQUITY RESEARCH

19 October 2021

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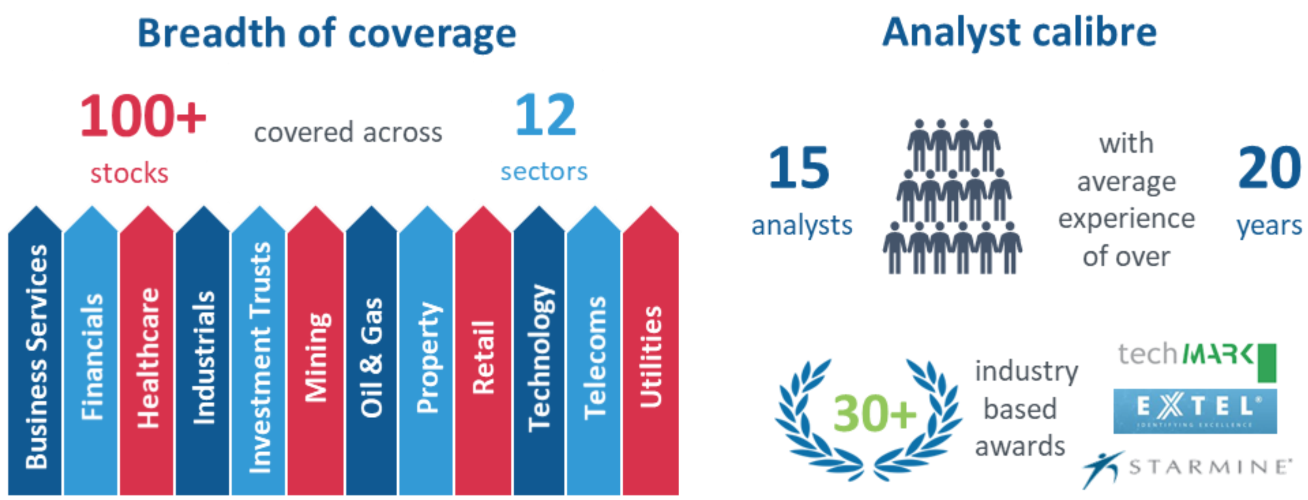

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