10 June 2019

DISTIL

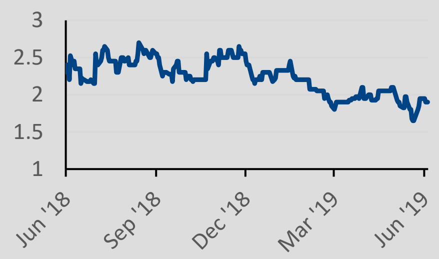
BEVERAGES

DIS.L

1.9p

Market Cap: £9.5m

SHARE PRICE (p)



12m high/low	2.7p/1.7p

Source: LSE Data

KEY INFORMATION

Enterprise value	£8.5m
Index/market	AIM
Next news	AGM - July '19
Gearing	N/A
Interest cover	N/A

DISTIL IS A RESEARCH CLIENT OF PROGRESSIVE

ANALYSTS

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Another year of progress…..

…but with faltering short-term UK consumer outlook

Distil delivered results in line with our forecast expectation at EBITDA and PBT level. FY19 saw a 19% turnover increase, supported by gross margin expansion, with EBITDA and PBT marginally ahead after a 48% increase in brand investment through its advertising and promotional activities. Net cash advanced by almost £40K (+4%) over the year on the back of an operating cash inflow of £85K. Innovation continues apace, with the recent launch of RedLeg Caramelised Pineapple Spiced Rum, along with new gift packaging and miniature bottle formats for RedLeg and Blackwoods Gin. We are reflecting our more cautious outlook on short-term UK consumer spending prospects in our new forecasts, primarily for the current FY20E year.

- **FY19 results:** Distil's results were in line with our unchanged forecasts following the Q4 trading update in May. A slight shortfall in turnover was mitigated by a better than forecast gross margin expansion of 130bps. Total operating cost growth of 28% outpaced turnover and gross profit growth of 19% and 22% respectively, with EBITDA, EBIT and PBT therefore only marginally ahead of last year. Cash generation was again positive, with year-end net cash increasing by just under 4% to £1068K.

- **Volume growth against a more challenging backdrop:** Despite a highly competitive drinks market and an increasingly difficult consumer backdrop, Distil delivered overall volume growth of 15%, led by a 45% increase for RedLeg, which gained market share in this growth segment. Gin continues to gain share from most spirits, led by the growth of coloured, flavoured and sweetened gins, with dry gins also up, driven by new brand launches. The vodka segment continues to shrink. Distil's volumes fell in both the gin and vodka segments, although Blackwoods 2017 Vintage Dry Gin made good underlying progress when performance is adjusted for the pipeline fill last year for the launch of the new vintage and its new packaging.

- **Forecasts tempered on short-term outlook:** With consumer confidence and spending faltering, we have adopted a more cautious stance in the shape of our forecasts, most notably for the current year. Our forecasts continue to show profit progression and cash generation each year across the period, but with the equivalent of a year's lag to the shape of our previous forecasts.

FYE MAR (£M)	2018	2019	2020E	2021E	2022E
Revenue	2.01	2.40	2.50	3.00	3.51
Adj EBITDA	0.16	0.17	0.22	0.36	0.51
Fully Adj PBT	0.16	0.16	0.21	0.35	0.50
Fully Adj EPS (p)	0.03	0.03	0.04	0.07	0.10
EV/Sales (x)	4.2x	3.5x	3.4x	2.8x	2.4x
EV/EBITDA (x)	51.8x	50.1x	38.5x	23.4x	16.5x
PER (x)	60.2x	59.3x	45.2x	27.1x	19.0x

Source: Company Information and Progressive Equity Research estimates

Remaining focussed on key growth drivers

A clear route map to help steer a path through less certain times

The key message emerging from the FY19 results is in our view that Distil has a clear route map for growing its business and its core brands and that it will not be deflected from this, even against a backdrop of "increasingly competitive and crowded markets". Indeed, this market backdrop looks unlikely to change, certainly in the near future, with Brexit still looming and the emergence of more protectionist trade policies and their accompanying tariffs. Such factors increase uncertainty and undermine consumer confidence and propensity to spend, with retailers and businesses in general becoming more promotional to encourage the more reluctant consumer to spend – hence our more cautious stance on near-term prospects for the company.

Promotional activity has greatly increased within the drinks market

Within the drinks market specifically, as can clearly be seen in the still buoyant gin segment, this has led to a large number of new market entrants, many of which are in essence micro distilleries. In turn, this has resulted in increased competition for finite "shelf space" within both the on-trade and off-trade sectors, resulting in increased promotional activity and price decreases. The multiple grocers for example can rotate among competing drinks suppliers, as there will be a queue of producers willing to pay listing fees and/or to offer compelling promotional offers to gain shelf space and visibility for their brand(s). Against this background of a significant increase in promotional offers, Distil has seen Blackwoods Gin's market share decline, notwithstanding the new vintage and the new packaging being well received by trade customers and end-consumers alike. It does however serve to emphasise the increased importance of brand investment and gaining trade support, as has been the case for the fast-growing RedLeg brand.

Important to stick to principles and key growth drivers

Under such conditions, we believe it is important to stick to the principles that have served the company well over recent years in expanding the distribution of its brands, both domestically and in export markets. This is not to imply an inflexible or rigid approach, as a certain degree of pragmatism or flexibility is always required in business. Therefore it is comforting in our view to see Distil re-iterating the growth drivers it outlined last year, namely:

- Brand activation and marketing at the point of sale
- Innovation in liquid and packaging development
- Route to consumer
- Access to new product and design

We do not intend to re-describe these in more detail, which we did in our prelims note last year ("A successful year of both sales growth and cash generation…" published on 8 June 2018). Rather we will pull out some of the developments of the past year that show these are being actioned to underpin and drive future growth.

All round innovation and brand extensions

On brand activation, the 48% increase in marketing and promotion speaks for itself, notwithstanding the more promotional market backdrop. It has been a significant year in terms of innovation, both in terms of liquid, with the recent soft launch via the on-trade channel of the first RedLeg line extension and flavour variant – RedLeg Caramelised Pineapple Spiced Rum – and in terms of packaging and pack sizes. Blackwoods Gin has enjoyed new packaging, and new gift packaging has been developed, along with a new miniature bottle format for RedLeg and Blackwoods, the latter also potentially facilitating new routes to the consumer. We would anticipate further innovation developments over the medium-term.

Our FY20E forecasts assume no meaningful contribution from the new RedLeg variant. This is due to its launch coming part way through the new financial year, the fact that it is initially a soft launch through the on-trade, and finally that it is difficult at this stage to assess the potential degree of cannibalisation it may have on sales of the original RedLeg Spiced Rum.

International developments

International markets is already another route to consumer that Distil continues to explore. These take time to develop and grow, but progress was made in FY19 in Europe, North America and Asia, more specifically France, Canada and in the latter, Japan, India and China. At this stage, there is no further news to report on Distil's search for a long-term strategic partner and distributor in the US. The company has explored several options and says it will keep shareholders apprised of its progress on this front.

In terms of new production, Distil transitioned the production of RedLeg Spiced Rum to a new supplier over the course of the year, which contributed to the increase in inventories, as stock cover was increased for this period to minimise any potential disruption.

Brexit mitigation factors

With regard to Brexit, Distil has mitigated potential issues in a number of ways. Glass is sourced in the UK for its production in England and Scotland, with glass for Blavod Black Vodka sourced in Europe for its production in Germany. All sales are also invoiced in sterling, thereby minimising exposure to currency fluctuations.

Quality products and healthy balance sheet should counter any short-term pressures

In consideration of the above, and not forgetting first and foremost the quality of the liquids it produces, we believe Distil will continue to grow and prosper over the longer-term. With the added protection of a healthy balance sheet and its net cash position, it is well placed to withstand any short-term pressures in its markets.

FY19 prelims

Turnover growth, gross margin expansion and cash generation

The table below summarises the performance of FY19's P&L results, comparing them with the prior year. FY19 saw further good progress in top line revenues, which increased by 19%. This was driven by a strong performance in the first three quarters, including the key Q3 trading period, and despite a weaker Q4, as outlined in our note, "Q4 trading update…" of 7 May. In turn, the sales performance was driven by a step up in brand investment, with advertising and promotion spend up 48% over the prior year, representing 29% of sales, compared with 23% last year.

Group FY19 profit and loss account

(£'000 unless otherwise stated)	FY18	FY19	Change	% change
Turnover	2,014	2,401	387	19%
Gross profit	1172	1429	257	22%
Gross margin (%)	*58%*	*60%*		
Advertising and promotion	-465	-688	-223	-48%
Contribution	707	741	34	5%
Contribution margin (%)	*35%*	*31%*		
Other administrative costs	-522	-572	-50	-10%
Depreciation and amortisation	-6	-9	-3	-50%
Total operating costs	-993	-1269	-276	-28%
Other income/(charges)	-22	0	22	100%
Operating profit	157	160	3	2%
Finance charge	0	0	0	n.c.
Pre-exceptional loss before tax	157	160	3	2%
Exceptional charge	0	0	0	n.c.
Reported loss before tax	157	160	3	2%

Source: Distil, Progressive Equity Research

Margin performance was more mixed, with gross margin gain not held at contribution and operating levels

Margin performance was more mixed in FY19, compared with increases across the board in FY18. The gross margin expanded by an impressive 130bps to 59.5%, with product costs well managed despite price pressures, thanks to improved planning and procurement. With A&P cost growth outstripping top line and gross profit growth, the contribution margin saw a decline of 420bps to 30.9% from 35.1%. The traditional cost discipline in other areas resulted in all other administrative costs rising by just 5.1%, which mitigated the movement in the operating profit margin, down 110bps to 6.7%. There was however no share based payment charge in FY19, compared with the £22K charge taken in FY18, with underlying administrative expenses rising 9.6%, i.e. around half the level of turnover increase.

Total volume growth of 15%, driven by a 45% increase for RedLeg

Total volume growth of 15% was delivered thanks to another strong year from RedLeg Spiced Rum, which saw volume growth of 45%.In a tough year in an increasingly saturated gin market, and with vodka sales declining, the group's Blackwoods Gin and Vodka and its Blavod Black Vodka brands all experienced a year-on-year sales decline. In terms of sales revenues, RedLeg saw a 50% increase, while Blackwoods Gin and Vodka fell by 12% and 39% respectively and Blavod down by 68%, the latter due primarily to a decline in non-licensed sales.

The following chart summarises the last five years of sales and contribution evolution. This clearly shows the important role that investment in marketing and promotion has played - and will continue to play - in driving incremental sales, gross profit and contribution. The year-on-year monetary and percentage growth changes refer to FY19 compared with FY18.

Own brand sales and contribution evolution

(£'000 unless otherwise stated)	FY15	FY16	FY17	FY18	FY19	Change	% change	4-yr CAGR
Turnover	666	1,169	1,642	2,014	2,401	387	19%	37.8%
Gross profit	406	681	950	1172	1429	257	22%	37.0%
Gross margin (%)	61.0%	58.3%	57.9%	58.2%	59.5%			
Advertising and promotion	-148	-280	-384	-465	-688	-223	-48%	46.8%
Contribution	258	401	566	707	741	34	5%	30.2%
Contribution margin (%)	38.7%	34.3%	34.5%	35.1%	30.9%			

Source: Distil, Progressive Equity Research

Contribution CAGR of 30% achieved since FY15

We have also added the four-year compound growth rate (CAGR) of these key variables since FY15, which underline the strong growth delivered by Distil as it develops its brand portfolio. Turnover and gross profit have both risen by around 37% over this period. This has yielded a 30% CAGR at contribution level, with the lower rate accounted for by the strategic brand investment through A&P, which has seen a 47% CAGR over this period.

Net cash increased by £37K to £1.068m at the year end

Distil achieved a net operating cash inflow of £85K in FY19, around half the level of FY18. The lower inflow was due largely to a greater working capital outflow (of £84K) than in the prior year. Capex was broadly similar to FY18, with Distil seeing a £37K increase in net cash to £1.068m at the year end. Net assets rose from £3.01m to stand at £3.17m at the year end.

Forecast revisions

Our revised forecasts show modest sales of 4% for FY20E, before resuming more traditional, stronger growth rates in FY21E and FY22E.

As outlined above, with Brexit and other more global economic uncertainties prevailing at present, there are several reasons to adopt a more cautious stance on the short-term outlook. To that end, we have therefore revised our previous forecasts, as well as initiating our FY22E forecasts, all of which are summarised in the table below. The impact of the lower 4% turnover growth rate we have prudently adopted for FY20E has broadly the equivalent effect of pushing back our previous FY20E and FY21E by a year (to become our FY21E and FY22E forecasts respectively).

Sales growth and gross margin assumptions

It is important to note however that we are forecasting both profit growth and cash generation across the three-year forecast period. Our turnover growth forecasts increase to 20% for FY21E and 17% for FY22E, more in line with that seen in FY19 and the double-digit growth rates of recent years. These equate to a cumulative 45% sales gain over the FY19 figure. Sales growth will be complemented by a higher gross margin, with management confident that further gains can be made in this area. Our forecast assumption is for a gross margin of 62.5% over the period, some 300bps higher than that achieved in FY19.

The shape of operating cost assumptions

In terms of operating costs, we have assumed a flat monetary level of A&P spend in FY20E, before resuming the strategic plan to grow marketing and promotional spend ahead of the rate of turnover increase. While we have held A&P spend flat in FY20E, we have assumed a higher level of increase in other administrative expenses for the current year, reflecting the company's comments on the need to invest in its commercial infrastructure, as well as its brands, in order to "capture new markets and new consumers". Our forecast therefore assumes a 12% increase for FY20, before moderating to low- to mid-single digit increases for FY21E and FY22E.

Summary of forecast changes and FY22E initiation

£m unless stated	FY20E Old	FY20E New	FY20E Change (%)	FY21E Old	FY21E New	FY21E Change (%)	FY22E New
Revenue	3.000	2.497	-17%	3.510	2.996	-15%	3.506
Adj EBITDA	0.410	0.220	-46%	0.600	0.361	-40%	0.562
Reported PBT	0.400	0.210	-48%	0.590	0.350	-41%	0.500
Fully adj PBT	0.400	0.210	-48%	0.590	0.350	-41%	0.500
Reported EPS (p)	0.080	0.042	-48%	0.118	0.070	-41%	0.100
Fully adj EPS (p)	0.080	0.042	-48%	0.118	0.070	-41%	0.100

Source: Distil, Progressive Equity Research

Operating margin expands steadily, moving into double-digit territory in FY21

The combined effect of our FY20E revisions actually sees the operating margin recovering to a forecast 8.4%, up some 170bps on FY19 and above that achieved in FY19. It then continues to expand, moving into double-digit territory with forecasts of 11.7% and 14.3% in FY21E and FY22E respectively.

Detailed forecasts in following chart

The following table shows both the recent trading history, including key cash flow and balance sheet metrics, along with our new three-year forecasts.

Financial Summary: Distil

Year end: March (£m unless shown)

PROFIT & LOSS	**2018**	**2019**	**2020E**	**2021E**	**2022E**
Revenue	2.01	2.40	2.50	3.00	3.51
Adj EBITDA	0.16	0.17	0.22	0.36	0.51
Adj EBIT	0.16	0.16	0.21	0.35	0.50
Reported PBT	0.16	0.16	0.21	0.35	0.50
Fully Adj PBT	0.16	0.16	0.21	0.35	0.50
NOPAT	0.16	0.16	0.21	0.35	0.50
Reported EPS (p)	0.03	0.03	0.04	0.07	0.10
Fully Adj EPS (p)	0.03	0.03	0.04	0.07	0.10
Dividend per share (p)	0.00	0.00	0.00	0.00	0.00
CASH FLOW & BALANCE SHEET	**2018**	**2019**	**2020E**	**2021E**	**2022E**
Operating cash flow	0.17	0.09	0.18	0.21	0.27
Free Cash flow	0.13	0.04	0.15	0.18	0.24
FCF per share (p)	0.03	0.01	0.03	0.04	0.05
Acquisitions	(0.02)	(0.01)	0.00	0.00	0.00
Disposals	0.00	0.00	0.00	0.00	0.00
Shares issued	0.01	0.00	0.00	0.00	0.00
Net cash flow	0.12	0.04	0.15	0.18	0.24
Overdrafts / borrowings	0.00	0.00	0.00	0.00	0.00
Cash & equivalents	1.03	1.07	1.22	1.41	1.65
Net (Debt)/Cash	1.03	1.07	1.22	1.41	1.65
NAV AND RETURNS	**2018**	**2019**	**2020E**	**2021E**	**2022E**
Net asset value	3.01	3.17	3.38	3.73	4.23
NAV/share (p)	0.60	0.64	0.68	0.75	0.85
Net Tangible Asset Value	1.46	1.62	1.83	2.18	2.68
NTAV/share (p)	0.29	0.32	0.37	0.44	0.54
Average equity	2.91	3.09	3.28	3.56	3.98
Post-tax ROE (%)	5.4%	5.2%	6.4%	9.8%	12.5%
METRICS	**2018**	**2019**	**2020E**	**2021E**	**2022E**
Revenue growth	22.6%	19.2%	4.0%	20.0%	17.0%
Adj EBITDA growth	1097.6%	3.4%	30.0%	64.4%	41.8%
Adj EBIT growth	1531.8%	1.6%	31.0%	67.0%	42.8%
Adj PBT growth	1531.8%	1.6%	31.1%	66.9%	42.7%
Adj EPS growth	1531.8%	1.6%	31.1%	66.9%	42.7%
Dividend growth	N/A	N/A	N/A	N/A	N/A
Adj EBIT margins	7.8%	6.7%	8.4%	11.7%	14.3%
VALUATION	**2018**	**2019**	**2020E**	**2021E**	**2022E**
EV/Sales (x)	4.2	3.5	3.4	2.8	2.4
EV/EBITDA (x)	51.8	50.1	38.5	23.4	16.5
EV/NOPAT (x)	53.8	52.9	40.4	24.2	16.9
PER (x)	60.2	59.3	45.2	27.1	19.0
Dividend yield	N/A	N/A	N/A	N/A	N/A
FCF yield	1.4%	0.4%	1.6%	1.9%	2.6%

Source: Company information and Progressive Equity Research estimates

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