Progressive EQUITY RESEARCH

DISTIL
BEVERAGES

25 October 2019

DIS.L

0.7p

Market Cap: £3.5m

SHARE PRICE (p)

12m high/low	2.7p/0.7p

Source: LSE Data

KEY DATA

Net (Debt)/Cash	£1.1m
Enterprise value	£2.4m
Index/market	AIM
Next news	Trading update - Jan '20
Shares in Issue (m)	499.8
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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A challenging first half ……

….though full-year profit forecast maintained

Distil delivered a breakeven result at the interim stage despite challenging trading conditions, particularly in the UK unflavoured gin market. The previous stock overhang, driven by the supply chain ahead of the previous end-March Brexit date and which also contributed to the H1 sales performance, has now been cleared. Distil has also secured the Mardi Gras trademark in Europe and the USA, which will drive further NPD (new product development) initiatives. The core spiced rum market continues to see growth and new RedLeg brand extension launches should underpin a more robust sales performance in the second half. Combined with continued cost management discipline, Distil expects FY20E operating profit to remain in line with previous forecasts. We have revised our outer year forecasts however to remain prudent in light of ongoing market headwinds.

- **Interim results**: Distil delivered a breakeven result, with operating profit of £1K, compared with last year's £101K profit. The H1 29% revenue shortfall was attributed primarily to a weakening of the unflavoured gin market, in which Blackwoods trades, and a listing shrinkage at a retail customer. Costs were tightly managed to offset lost gross profit, enabling breakeven to be achieved, despite the challenging backdrop in the gin market.
- **New launches and NPD**: The second half performance should be underpinned by new product launches in Q3, both of which are brand extensions for RedLeg Spiced Rum. RedLeg Caramelised Pineapple Spiced Rum will launch in five hundred retail outlets, and canned RedLeg & Cola ready-to-drink will launch in three hundred outlets. Distil has indicated its intention to launch a new product in 2020 under the Mardi Gras brand, the trademark which has been secured for the key European and US markets. This underlines the importance of NPD and product innovation.
- **Forecast revisions**: Management has indicated that it does not expect to recover lost revenues in H2, but also that it expects operating profit to remain in line with previous guidance, courtesy of operational efficiencies and tight overhead control. While new initiatives and product launches bed down, we have taken a more conservative approach to outer year forecasts, which broadly move back previous expectations by a year.

FYE MAR (£M)	2018	2019	2020E	2021E	2022E
Revenue	2.01	2.40	2.20	2.53	2.91
Adj EBITDA	0.16	0.17	0.28	0.32	0.42
Fully Adj PBT	0.16	0.16	0.21	0.25	0.35
Fully Adj EPS (p)	0.03	0.03	0.04	0.05	0.07
EV/Sales (x)	1.2x	1.0x	1.1x	1.0x	0.8x
EV/EBITDA (x)	14.9x	14.4x	8.8x	7.7x	5.8x
PER (x)	22.2x	21.8x	16.7x	14.0x	10.0x

Source: Company Information and Progressive Equity Research estimates

Challenging core markets …….

………. driving greater push on NPD

A combination of factors has given rise to a perfect storm of challenging conditions for Distil, reflected in the breakeven result achieved at the interim stage.

First, there was the stock overhang from the first calendar quarter of 2019, as the drinks industry supply chain and customers bought forward to avoid potential disruption around the previous end-March Brexit deadline. This has now unwound, but had the effect of much lower levels of replenishment orders from on- and off-trade customers as they sold down existing stocks.

Second, the gin market remains over-supplied and with growth driven by so-called flavoured gins, as opposed to the unflavoured (or traditional) gin segment within which Blackwoods Vintage Dry Gin is positioned. The unflavoured gin segment has seen volumes falling. There is much anecdotal evidence that major retailers are looking to rationalise their gin offerings and reduce shelf space accordingly. Distil has seen its listings at one major retail customer much reduced in H1.

Third, the spiced rum market continues to show growth, which is of course good news for RedLeg. However the flip side to this is that with much of the broader spirits market stagnant at best, and with some market commentators talking of spiced rum as the new or next gin phenomenon, the market has seen an increase in market entrants in this segment. We believe RedLeg volume shipments were broadly flat in H1, reflecting the broader market overhang position. However, so-called depletions (sales from Distil's customers to their customers) have still been growing at a double-digit rate, in line with the segment. Thus, Distil's RedLeg brand has been holding market share despite increased competition.

These factors underline two things to our mind – first the importance of fostering and ideally strengthening end-customer loyalty to your brand and second the importance of product innovation (and speed to market) to capitalise on emerging trends through product innovation. Here, with a view to the future, there is good news on both fronts.

Q3 sees the retail launch of two brand extensions to Distil's flagship RedLeg Spiced Rum brand in two distinct forms. A new flavour, RedLeg Caramelised Pineapple Spiced Rum, will launch shortly into 500 retail outlets, giving incremental shelf space and presence to the RedLeg brand. This will be supported at the point-of-sale with consumer tastings in larger, selected outlets. The second initiative is a 250ml can with a ready-to-drink (RTD) blend of the original RedLeg Spiced Rum, pre-mixed with cola and a twist of lime, in partnership with Franklin & Sons, which is owned by Global Brands Ltd. This launches in 300 outlets. We would expect the number of outlets for each brand extension to grow over time. While the cannibalisation effect of these launches, in particular the full strength Caramelised Pineapple variant, is unknown at this stage, it is difficult to see the impact of these launches being anything other than a net positive for Distil in terms of both sales and brand loyalty.

On the innovation front, Distil has secured the trademark for the name Mardi Gras in both Europe and the US. The company says it intends to launch a Mardi Gras product in 2020, but without a specific date or product type. Given the Mardi Gras name, a spirit with a strong linkage to the Mardi Gras carnival phenomenon would resonate most strongly with consumers. This could potentially incur some extraordinary (and ongoing) marketing and development costs, but shows that Distil is keen to innovate and expand its product portfolio.

The interim results once again underlined the group's careful and disciplined management of its cost base, both on the promotional and administrative front. To the latter point, the group has recently amalgamated and relocated its blending and bottling activities to a single site. This should render future operational scale efficiencies as the business grows.

The H1 breakeven result was a commendable outturn in our view, given the quantum of top line shortfall. In summary, with the stock overhang now cleared, new products launched and in the pipeline, and with a healthy net cash balance, we believe there are many reasons to be optimistic on future developments and prospects, despite the challenging first half.

Interim results analysis

Distil's interim results are summarised in the table below. Before further commentary, it should be noted that the FY20E interim figures, and our revised forecasts, are stated on the basis of the implementation of IFRS 16 with regard specifically to lease accounting. Distil has recognised right-of-use assets on its balance sheet, representing its rights to use the underlying assets, as well as lease liabilities representing its obligation to make lease payments. The IFRS 16 changes impact the P&L account through an amortisation charge of the leased assets and a finance expense within the interest line. The approach adopted by the group means that it has not restated its FY19 interims or prelims, which are reported under the previous IAS 17 reporting methodology.

FY20 interim results – P&L account

(£'000 unless stated)	H1 FY19	H1 FY20	Change	% change
Turnover	1,164	824	-340	-29%
Gross profit	710	499	-211	-30%
Gross margin (%)	61.0%	60.6%	-0.4%	
Advertising and promotion	-312	-219	93	-30%
Other administrative costs	-293	-248	45	-15%
Depreciation and amortisation	-4	-31	-27	675%
Other costs	0	0	0	n.c.
Total operating costs	-609	-498	111	-18%
Operating profit/(loss)	101	1	-100	-99%
Finance charge	0	-2	-2	n.a.
Pre-exceptional profit/(loss) before tax	101	-1	-102	-101%
Exceptional charge	0	0	0	n.c.
Reported loss before tax	101	-1	-102	-101%
Operating costs to sales ratio	-52.3%	-60.4%	-8.1%	
Operating margin (%)	8.7%	0.1%	-8.6%	

Source: Distil, Progressive Equity Research

The key financial elements of these results and the market conditions driving them have already been outlined above. The decline in absolute advertising and promotional spend was in line with the overall revenue decline. While administrative costs were tightly managed, they reduced at a lower rate, which combined with the higher IFRS 16-driven total depreciation and amortisation charge, resulted in an 810bps increase in the operating cost ratio and a commensurate decline in the operating margin to 0.1% in the period. Given the scale of the revenue and gross profit shortfall against last year, we consider the attainment of a breakeven result for H1 to be a highly commendable result.

Contribution and margin performance – H1 FY20

(£'000 unless otherwise stated)	H1 FY19	H1 FY20	Change	% change
Turnover	1,164	824	-340	-29%
Gross profit	710	499	-211	-30%
Gross margin (%)	61.0%	60.6%		
Advertising and promotion	-312	-219	93	-30%
Contribution	398	280	-118	-30%
Contribution margin (%)	34.2%	34.0%	-0.2%	
Advertising to sales ratio (%)	-26.8%	-26.6%	0.2%	

Source: Distil, Progressive Equity Research

The table above shows the stability achieved with regard to the contribution margin, delivered after the deduction of advertising and promotion costs. The gross margin achieved was down 40bps year-on-year, but the mitigation of a 20bps improvement in the advertising to sales ratio resulted in a small 20bps decline in the contribution margin.

Forecast revisions

The table below summarises our key forecast changes. As stated above, these changes broadly move previous expectations back by a year, given the reset of expectations for the current FY20E year.

The combination of the new product launches in the second half of FY20E, normalisation of the inventory supply chain and ongoing advertising and promotional support should see a return to top line revenue growth in H2. We are forecasting growth of 11% for the period, achieved at a higher gross margin than in H1 and with the advertising to sales ratio broadly the same as in H1, but below the level invested last year. Combined with further conservative management of other administrative costs, as seen in H1, this delivers an operating profit of £213K and a PBT of £211K in H2. Our full year PBT forecast therefore remains unchanged at £210K, with the year-end net cash position broadly unchanged from previously. As ever, a successful performance over the key Q3 trading period will be key to attaining our full year results.

Summary of key forecast changes – FY20E to FY22E

	FY20E			FY21E			FY22E		
£m unless stated	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)
Revenue	2.497	2.200	-12%	2.996	2.530	-16%	3.506	2.909	-17%
Adj EBITDA	0.220	0.276	25%	0.361	0.316	-12%	0.562	0.416	-26%
Reported PBT	0.210	0.210	0%	0.350	0.250	-29%	0.500	0.350	-30%
Fully adj PBT	0.210	0.210	0%	0.350	0.250	-29%	0.500	0.350	-30%
Reported EPS (p)	0.042	0.042	0%	0.070	0.050	-29%	0.100	0.070	-30%
Fully adj EPS (p)	0.042	0.042	0%	0.070	0.070	0%	0.100	0.070	-30%
Net cash	1.222	1.061	-13%	1.406	1.229	-13%	1.648	1.497	-9%

Source: Progressive Equity Research

Our FY21E and FY22E forecasts are predicated on revenue growth rates of 15% per annum. These are more conservative compared with our previous assumptions of 20% and 17% and are applied to the lower revenue now forecast for FY20E. We assume a similar level of gross margin to both years as forecast for H2 FY20E, namely 61.5%. The advertising to sales ratio remains broadly flat compared with the new level forecast for FY20E. Given the renewed focus on NPD, we have also assumed that general administrative costs will increase to reflect this. Our net cash projections do move back in FY21E and FY22E, directionally following our profit revisions, but still moving ahead on a year-on-year basis.

Financial Summary: Distil

Year end: March (£m unless shown)

PROFIT & LOSS	**2018**	**2019**	**2020E**	**2021E**	**2022E**
Revenue	2.01	2.40	2.20	2.53	2.91
Adj EBITDA	0.16	0.17	0.28	0.32	0.42
Adj EBIT	0.16	0.16	0.21	0.25	0.35
Reported PBT	0.16	0.16	0.21	0.25	0.35
Fully Adj PBT	0.16	0.16	0.21	0.25	0.35
NOPAT	0.16	0.16	0.21	0.25	0.35
Reported EPS (p)	0.03	0.03	0.04	0.05	0.07
Fully Adj EPS (p)	0.03	0.03	0.04	0.05	0.07
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	0.01	0.19	0.29
Free Cash flow	0.13	0.04	(0.01)	0.17	0.27
FCF per share (p)	0.03	0.01	0.00	0.03	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	(0.01)	0.17	0.27
Overdrafts / borrowings	0.00	0.00	0.00	0.00	0.00
Cash & equivalents	1.03	1.07	1.06	1.23	1.50
Net (Debt)/Cash	1.03	1.07	1.06	1.23	1.50
NAV AND RETURNS	**2018**	**2019**	**2020E**	**2021E**	**2022E**
Net asset value	3.01	3.17	3.38	3.63	3.98
NAV/share (p)	0.60	0.64	0.68	0.73	0.80
Net Tangible Asset Value	1.46	1.62	1.83	2.08	2.43
NTAV/share (p)	0.29	0.32	0.37	0.42	0.49
Average equity	2.91	3.09	3.28	3.51	3.81
Post-tax ROE (%)	5.4%	5.2%	6.4%	7.1%	9.2%
METRICS	**2018**	**2019**	**2020E**	**2021E**	**2022E**
Revenue growth	22.6%	19.2%	(8.4%)	15.0%	15.0%
Adj EBITDA growth	1097.6%	3.4%	63.1%	14.6%	31.7%
Adj EBIT growth	1531.8%	1.6%	33.5%	18.9%	39.5%
Adj PBT growth	1531.8%	1.6%	31.0%	19.3%	40.1%
Adj EPS growth	1531.8%	1.6%	31.0%	19.3%	40.1%
Dividend growth	N/A	N/A	N/A	N/A	N/A
Adj EBIT margins	7.8%	6.7%	9.7%	10.0%	12.2%
VALUATION	**2018**	**2019**	**2020E**	**2021E**	**2022E**
EV/Sales (x)	1.2	1.0	1.1	1.0	0.8
EV/EBITDA (x)	14.9	14.4	8.8	7.7	5.8
EV/NOPAT (x)	15.4	15.2	11.4	9.6	6.9
PER (x)	22.2	21.8	16.7	14.0	10.0
Dividend yield	N/A	N/A	N/A	N/A	N/A
FCF yield	3.7%	1.2%	(0.2%)	4.8%	7.7%

Source: Company information and Progressive Equity Research estimates

25 October 2019

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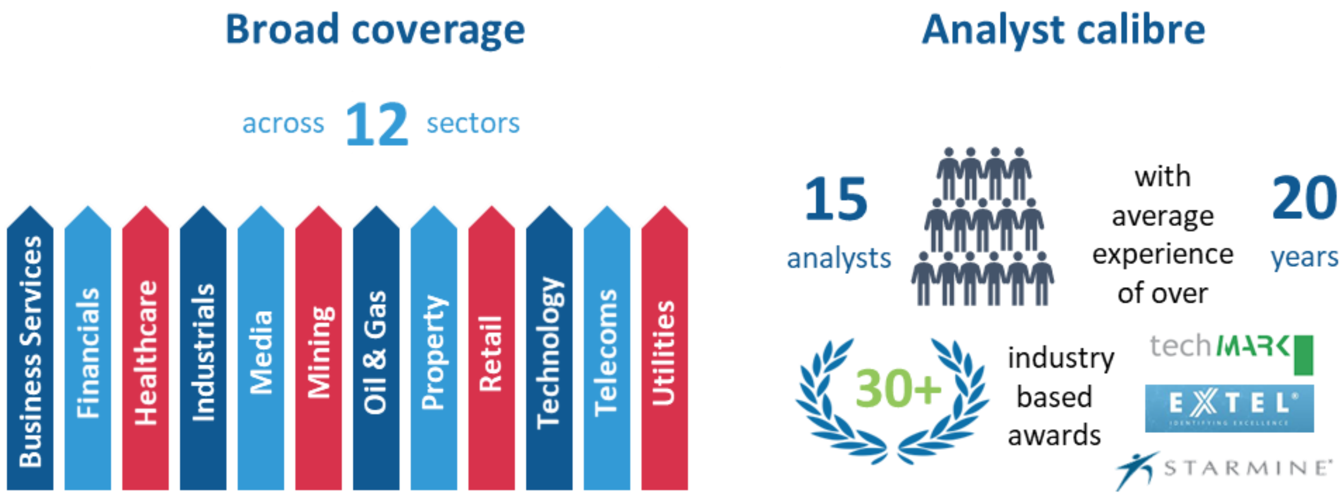

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