PROGRESSIVE EQUITY RESEARCH

7 June 2017

DISTIL BEVERAGES

DIS.L

3.45p

Market Cap: £17.2m

SHARE PRICE (p)

12m high/low	1.0p/3.7p

Source: LSE Data

KEY INFORMATION

Enterprise value	£16.2m
Index/market	FTSE AIM
Next news	AGM - July 2017
Gearing	N/A
Interest cover	N/A

DISTIL IS A RESEARCH CLIENT OF PROGRESSIVE

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A breakthrough year……

…..delivering maiden profit on owned brands

Distil has had another strong year of sales and volume progression, which has culminated in the company delivering a maiden profit from its owned brands. This has been driven once again primarily through the RedLeg Spiced Rum and Blackwoods Gin and Vodka brands, which have benefited from achieving further listing gains in both the supermarket and pub channels. These brands have capitalised on the continuing growth of premium spirits and the rise of the cocktail phenomenon across an ever broader spectrum of on-trade formats. Distil is well-positioned to benefit from these trends in the UK and export markets from its existing brand portfolio and potential new product development. On the basis of FY17's forecast beat, we have raised our FY18 and FY19 PBT forecasts, and we also initiate on FY20.

- **Into the black**: Distil delivered a full-year PBT of £10K, compared with last year's loss of £98K and our forecast of a £40K loss. This was driven by a very strong H2, and in particular the key Q3 peak trading period, which resulted in an H2 PBT of £89K, compared with last year's H2 loss of £9K. Full year revenues rose by 40%, with cash gross profit rising by a similar quantum on an unchanged gross margin percentage. Advertising and promotional costs marginally reduced as a percentage of sales, delivering a 20bps improvement in the contribution margin to 34.5%. While headcount increase drove an 11% increase in other administrative costs, the aggregate total cost increase was lower than we had anticipated, hence the forecast beat.
- **Compounding volume growth**: Across the year as a whole, volumes increased by 31%, compounding on FY16's volume growth of 35%. This was delivered from the continuing benefits of FY16 listing gains, and further gains made in FY17. FY18 is set to benefit from the gain of a major pub chain listing towards the end of FY17 and a further listing win with another major UK superstore operator. RedLeg delivered a volume gain of 62% across the year, with Blackwoods gin volumes up by 46%, both well ahead of the overall market in their respective segments.
- **Consolidating progress**: FY18 should see further consolidation of volume and revenue increases from Distil's listing gains in the UK. In addition, the launch of RedLeg in the USA should also support sentiment. Our forecast increases broadly roll forward the FY17 beat.

FYE MAR	2016	2017	2018E	2019E	2020E
Revenue	1.2	1.6	2.1	2.5	3.0
Adjusted EBITDA	-0.1	0.0	0.2	0.4	0.5
Adjusted PBT	-0.1	0.0	0.2	0.4	0.5
Adjusted EPS (p)	0.0	0.0	0.0	0.1	0.1
EV/Sales (x)	13.9x	9.9x	7.9x	6.6x	5.4x
EV/Adj. EBITDA (x)	n.a.	1190.1x	103.4x	45.5x	34.9x
P/E (x)	n.a.	1785.1x	114.8x	49.2x	37.4x

Source: Company Information and Progressive Equity Research estimates

Gaining from changing consumer preferences

Summary

Distil to benefit from ongoing changes in consumer drinking preferences

Distil has continued to benefit from the ongoing changes in consumer drinking preferences. This can clearly be illustrated in the UK with the high growth of specialty and premium spirits and the emergence of cocktails as a competitor to the more traditional and long-established beer sector, notwithstanding the growing interest in and growth of craft beers. It is now commonplace for pubs to offer a range of cocktails, often with a preference for specific brands, a trend which Distil has also played into and benefits from. We would expect this trend to continue, notwithstanding potential pressures on disposable incomes as wage inflation lags cost price inflation, just as we expect Distil to continue to grow market share from its brand portfolio.

UK tax and duty revenues from spirits exceeded that from beer for the first time last year

Quantitative proof of this trend emerged this week with news that tax revenues in 2016/17 from spirits exceeded those from beer for the first time ever in the UK. This saw the government raise £3.4bn of tax revenues from spirits, an increase of 7% over the year, compared with £3.3bn from beer, an increase of just 1% over the prior year. Wine still remains the overall biggest revenue generator, with £4bn raised last year.

Specialty and premium products driving growth in spirits……

While duty and VAT account for a higher percentage of the price of a bottle of spirits than a pint of beer, the trend away from beer and towards spirits is undeniable and encapsulated well within these figures. According to the Wine and Spirits Trade Association (WSTA), gin sales rose by 12% over the past year, with around 43 million bottles sold across the country. Within this, specialty and premium gins will have delivered a much higher level of growth. Since 2010, the WSTA cited the number of gin brands growing from 37 to more than 80 in 2016. The market is both dynamic and competitive, and has been mirrored by the emergence of specialty and premium mixers, most notably, though not exclusively, Fevertree.

…which is a global phenomenon, with Distil set to make further headway in both domestic and export markets

The growth of premium spirits, in most drink categories, is a global phenomenon, as also shown by statistics from other sources, such as IWSR. This trend should play to Distil's brand portfolio (and future developments within it), despite the implied intensification of competition, in that it underlines the importance of developing brands and brand recognition. Distil's track record in the UK over recent years shows how it is reaping the benefits of sustained marketing and brand investment, along with of course the requisite quality of product, most notably with RedLeg and Blackwoods. We expect to see Distil make further gains made in the UK, which will be complemented in export markets as distribution is built out over time.

Key events FY16 and FY17

Before looking in more detail at the FY17 prelims, the following table summarises the backdrop of key events in FY16 and FY17:

Key newsflow and company events – FY16 and FY17

FY16	**Event**
April '15	Full TTB approval for Blackwoods Limited Edition 60% Gin granted
	RedLeg Spiced Rum obtains major listing with J Sainsbury
June '15	Publication of FY15 prelims results
July '15	AGM statement confirms company has resumed shipments of Blavod Black Vodka to USA
September '15	Reports YTD sales volumes and revenues up 26% and 76% respectively
October '15	Announces listing of RedLeg in 700 Tesco stores
January '16	Q3 year-on-year revenue up 71% from 31% volume increase
March '16	Proposed share placing announced to raise £626K gross
	Miton UK Microcap Trust becomes 10% shareholder through the placing
April '16	Q4 year-on-year revenue up 66% from 76% volume increase
FY17	**Event**
May '16	Group receives TTB approval for RedLeg Spiced Rum
June '16	Publication of FY16 prelims results
Aug '16	RedLeg obtains listing in Waitrose
	Q1 revenue up 5% from 1% volume increase
Sept '16	RedLeg and Blackwoods Vintage Dry Gin obtain listings in Morrisons
Oct'16	Interim results deliver 26% reduction in operating loss
	TTB label approval for RedLeg obtained; US shipments planned for Q4
	H1 revenues up 26% from 16% volume increase
January '17	Q3 year-on-year revenue up 71% from 56% volume increase
	Anticipates that full year results "will be ahead of current market expectations"
April '17	Q4 year-on-year revenue up 23% from 25% volume increase
	Further UK supermarket listing for RedLeg announced, with effect from May 2017

Source: Distil; Progressive Equity Research

FY 17 Prelims – another year of marked progress

FY17 most significant for move into profit

As highlighted on the front page, the key event and major development of these results was the delivery of a maiden profit on its owned brands portfolio. Achieving an initial breakeven position has been the long-held ambition of Distil, and this has now been achieved. This was almost achieved in H2 of FY16, but a very strong H2 result in FY17 has been more than sufficient to overturn the operating loss delivered in H1. While FY17 PBT of £10K may be seen as modest, it remains a significant milestone and foundation for future profitable growth. This result beat our forecast by some £50K, albeit the Q3 trading update had pointed to beating market expectations, and beats our expectation of profit attainment by a year.

Stable margin performance at gross and contribution level

The following table shows a summary of FY17's P&L results, comparing them with last year. Margin performance has been very stable in terms of both gross margin (58%) and indeed contribution margin (around 34%).Indeed with advertising cost growth of 37% slightly behind the rate of sales growth at 40%, there has been a small improvement of 20bps in the contribution margin.

Group FY17 profit & loss account

(£'000 unless otherwise stated)	FY16	FY17	Change	% change
Turnover	1,169	1,642	473	40%
Gross profit	681	950	269	40%
Gross margin (%)	*58%*	*58%*		
Advertising and promotion	-280	-384	-104	-37%
Contribution	401	566	165	41%
Contribution margin (%)	*34%*	*34%*		
Other administrative costs	-470	-520	-50	-11%
Depreciation and amortisation	-3	-4	-1	-33%
Total operating costs	-753	-908	-155	-21%
Other income/(charges)	-25	-32	-7	-28%
Operating profit/(loss)	-97	10	107	110%
Finance charge	-1	0	1	100%
Pre-exceptional loss before tax	-98	10	108	110%
Exceptional charge	0	0	0	n.c.
Reported loss before tax	-98	10	108	110%

Source: Distil; Progressive Equity Research

Total operating cost growth of 21% was significantly below revenue growth

The swing in operating profit and PBT arises from a lower level of increase of just 11% from other administrative costs. This increase primarily reflects a small increase in headcount to support the growing sales base, in both back office and front office functions. In total, including share based payments, the total cost base rose by some 21% (£162K), compared with the £269K increase in gross profit. The net difference of £107K has been sufficient to drive the move from last year's operating loss to FY17's operating profit.

Domestic UK sales growth of 70% achieved

The domestic UK sales channel showed very high growth with revenue up 70%, driven by the listing gains made in FY16 and the early sales benefits from some of the listings gained in FY17. The latter will continue to underpin sales growth in FY18, especially with the addition of another national supermarket operator listing for RedLeg, which is effective from May 2017. FY18 is also set to benefit from the gain of a major pub chain listing towards the end of FY17.

Compounding volume growth from all major brands; Blavod down but up in Q4 in Eastern Europe

Across the year as a whole, volumes increased by 31%, compounding on FY16's volume growth of 35%. RedLeg delivered a volume gain of 62% across the year with revenues up 63% and Blackwoods gin volumes were up by 46% with sales up 41% - both well ahead of the overall market in their respective segments. Blackwoods Vodka also saw a commendable 66% volume uplift in the currently less exciting vodka market, with sales up by 82%, driven largely by increased listings in the pub channel. Blavod volumes were down across the year, despite repeat purchases in the USA, but delivered a welcome return to volume growth in Q4 in Eastern Europe

The following chart shows a summary of the last three years of sales and contribution evolution, showing the important role that investment in marketing and promotion has played in driving incremental sales, gross profit and contribution.

Own brand sales and contribution evolution

(£'000 unless otherwise stated)	FY15	FY16	FY17	Change	% change
Turnover	666	1,169	1,642	473	40%
Gross profit	406	681	950	269	40%
Gross margin (%)	61.0%	58.3%	57.9%		
Advertising and promotion	-148	-280	-384	-104	-37%
Contribution	258	401	566	165	41%
Contribution margin (%)	38.7%	34.3%	34.5%		

Source: Distil; Progressive Equity Research

Good cash flow performance

Distil also had a good performance in terms of cash flow. Year end net cash was £910K at the year-end, down from last year's £982K. However, this is broadly accounted for by capex spend of £65K, the two largest components of which relate to bottle moulds for the new proprietary RedLeg bottle and a new RedLeg Rum Shack promotional vehicle. This tours festivals and other venues, including some larger pubs, to promote the RedLeg brand. Cash flow from operating activities was broadly flat, compared with last year's outflow of £116K.The working capital outflow showed a small improvement compared with last year, despite another year of strong sales growth, showing good management of cash resources.

Risks and challenges

Risks and challenges are broadly unchanged for Distil

Distil, as with all businesses, faces a number of risks and challenges that could affect its growth prospects. It is Progressive Equity Research policy to include a table of identified risks and challenges within any large research note, along with management's responses to the matters raised. Therefore, in the table below we have identified what we believe are the mains risks, while also allowing management the opportunity to give their responses, outlining the actions being taken to minimise and mitigate these risk factors.

Business risks and management response

Risks	**Management response**
Economic downturns can result in lower customer spending	Management can react to this through its pricing policy, with the development of differentiated products encouraging consumer spending and market share gains in a falling market
Brand portfolio falls out of consumer favour	Distil undertakes regular consumer research to stay abreast of taste and drinking trends
Relative lack of sales in the world's largest market, the USA	Distributor appointments made, but revenue generation held back by unforeseen delays in TTB approvals (now all received)
Heavy reliance on key customers for owned brands	This reflects the transition of the business model, and establishing wider distribution of our brands will result in a more balanced customer base, thereby diversifying risk
Drinks marketplace is very competitive, exerting pressure on margins	Management has a policy of constant price monitoring in order to react and adjust pricing where necessary
Financial uncertainty given historical losses and transition of business model	The focus on owned brand should deliver higher margins and better quality of earnings. Share placings have strengthened the balance sheet, allowing continued investment in growing the top line, as shown with recent listing gains, and moving towards break even as critical mass delivers better operating metrics.

Source: Progressive Equity Research

Forecast revisions – PBT upgrades

Top line growth rates broadly unchanged; we assume further good cost management

The following table summarises our headline forecast changes, along with our forecast initiation for FY20. For FY18 and FY19, we have kept with our previous forecast estimates, reflecting sales growth of just over 25% for the current year and 20% for FY19. On the basis of the better than forecast cost management and consequent operational gearing, we have assumed a continuation of this trend, which results in the FY17 forecast beat rolling through into our FY18 and FY19 forecasts.

Summary of forecast changes and FY20 initiation

	FY18E			FY19E			FY20E
£m unless stated	Old	New	Change (%)	Old	New	Change (%)	New
Revenue	2.063	2.063	0%	2.475	2.475	0%	3.002
Adj EBITDA	0.099	0.157	59%	0.299	0.357	19%	0.466
Reported PBT	0.100	0.150	50%	0.300	0.350	17%	0.460
Fully adj PBT	0.100	0.150	50%	0.300	0.350	17%	0.460
Reported EPS (p)	0.02	0.03	50%	0.06	0.07	17%	0.092
Fully adj EPS (p)	0.02	0.03	50%	0.06	0.07	17%	0.092

Source: Progressive Equity Research estimates

Sales growth to pick up in FY20 as US RedLeg sales come through on greater brand recognition and distribution

Our FY20 forecasts sees a small pick-up in the projected sales growth rate to just over 21%, reflecting our view of greater brand recognition and distribution of RedLeg in the US market. Management is currently reviewing its proposed distribution arrangements in the US and in negotiations in order to optimise the launch process. Distil has said it will update the market once it has concluded these negotiations.

Detailed forecasts in following table

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

SUMMARY FINANCIALS

Year ended March	FY-15A	FY-16A	FY-17A	FY-18E	FY-19E	FY-20E
£m unless stated						
Profit & Loss						
Revenue	**0.67**	**1.17**	**1.64**	**2.06**	**2.48**	**3.00**
Adj EBITDA	-0.28	-0.09	0.01	0.16	0.36	0.47
Adj EBIT	**-0.29**	**-0.10**	**0.01**	**0.15**	**0.35**	**0.46**
Reported PBT	-0.29	-0.10	0.01	0.15	0.35	0.46
PBT before exceptionals and AAG	-0.29	-0.10	0.01	0.15	0.35	0.46
Fully adj PBT	**-0.29**	**-0.10**	**0.01**	**0.15**	**0.35**	**0.46**
NOPAT	-0.29	-0.10	0.01	0.15	0.35	0.46
Reported EPS (p)	-0.08	-0.02	0.00	0.03	0.07	0.09
EPS before exceptionals and AAG (p)	-0.08	-0.02	0.00	0.03	0.07	0.09
Fully adj EPS (p)	**-0.08**	**-0.02**	**0.00**	**0.03**	**0.07**	**0.09**
Dividend per share (p)	0.00	0.00	0.00	0.00	0.00	0.00
Cash flow & Balance sheet						
Operating cash flow	-0.37	-0.11	0.00	0.05	0.27	0.36
Free Cash flow £m	-0.38	-0.12	-0.07	0.05	0.28	0.36
FCF per share p	-0.10	-0.03	-0.01	0.01	0.06	0.07
Acquisitions	-0.02	-0.02	-0.01	0.00	0.00	0.00
Disposals	0.00	0.00	0.00	0.00	0.00	0.00
Shares issued	0.56	0.60	0.01	0.00	0.00	0.00
Net cash flow	**0.17**	**0.47**	**-0.07**	**0.05**	**0.28**	**0.36**
Overdrafts / borrowings	0.00	0.00	0.00	0.00	0.00	0.00
Cash & equivalents	**0.51**	**0.98**	**0.91**	**0.96**	**1.23**	**1.60**
Net (Debt)/Cash	**0.51**	**0.98**	**0.91**	**0.96**	**1.23**	**1.60**
NAV and returns						
Net asset value	2.23	2.76	2.81	2.96	3.31	3.77
NAV/share (p)	**0.51**	**0.55**	**0.56**	**0.59**	**0.66**	**0.76**
Net Tangible Asset Value	0.72	1.24	1.27	1.44	1.79	2.25
NTAV/share (p)	**0.16**	**0.25**	**0.26**	**0.29**	**0.36**	**0.45**
Average equity	2.09	2.50	2.79	2.88	3.14	3.54
Post-tax ROE (%)	**-13.8%**	**-3.9%**	**0.3%**	**5.2%**	**11.2%**	**13.0%**
Metrics	**FY-15A**	**FY-16A**	**FY-17A**	**FY-18E**	**FY-19E**	**FY-20E**
Revenue growth	*-72.3%*	*75.6%*	*40.4%*	*25.6%*	*20.0%*	*21.3%*
Adj EBITDA growth	*21.7%*	*66.8%*	*114.6%*	*1050.7%*	*127.1%*	*30.7%*
Adj EBIT growth	*22.1%*	*66.2%*	*110.0%*	*1431.3%*	*135.0%*	*31.5%*
Adj PBT growth	*26.3%*	*66.2%*	*109.9%*	*1455.5%*	*133.2%*	*31.5%*
Adj EPS growth	*26.3%*	*66.2%*	*109.9%*	*1455.5%*	*133.2%*	*31.5%*
Adj EBIT margins	*-43.0%*	*-8.3%*	*0.6%*	*7.2%*	*14.0%*	*15.2%*
Valuation	**FY-15A**	**FY-16A**	**FY-17A**	**FY-18E**	**FY-19E**	**FY-20E**
EV/Sales	24.4	13.9	9.9	7.9	6.6	5.4
EV/EBITDA	(57.6)	(173.4)	1,190.1	103.4	45.5	34.9
EV/NOPAT	(56.8)	(168.0)	1,683.4	109.9	46.8	35.6
PER	n.a.	n.a.	1,785.1	114.8	49.2	37.4
FCF yield	-2.9%	-0.8%	-0.4%	0.3%	1.6%	2.1%

Source: Company information, Progressive Equity Research estimates

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