8 June 2018

DISTIL
BEVERAGES

DIS.L

2.57p

Market Cap: £12.8m

SHARE PRICE (p)

12m high/low	3.83p/1.55p

Source: LSE Data

KEY INFORMATION

Enterprise value	£11.8m
Index/market	AIM
Next news	Prelims
Gearing	N/A
Interest cover	N/A

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ANALYSTS

David Jeary

+44 (0) 20 7781 5306

djeary@progressive-research.com

A successful year of both profit growth….

…..and cash generation

Following the substantial reduction in H1 operating loss, Distil had a very strong H2, which resulted in FY18 growing to £157K from £10K in FY17. H2 PBT came in at £178K, some 135% higher than the prior year figure of £76K. Turnover growth of 23% resulted from strong - and broadly similar - volume growth across the core RedLeg spiced rum and Blackwoods gin brands, supported by a return to good growth at Blavod. Total volume growth was 31% and was strong across all trade channels, benefitting from new listings and listing extensions over the past two years. Operating cash flow of £166K saw the year end cash position improve to £1031K (vs £910K last year).

- **Delivering growth and cash:** One of the most pleasing aspects of this year's progress is that Distil has delivered a positive operating cash flow performance on top of an improving bottom line performance. Gross margin improved by around 30bps, and with advertising & promotion (A&P) spend down slightly in relation to turnover, this resulted in a 60bps improvement in the contribution margin. Management's cost discipline saw other administrative expenses held flat, with the overall EBIT margin expanding by 720bps to 7.8%.Year-end net cash of £1031K was up by £121K (+13%) over last year.
- **Volume growth:** The core RedLeg spiced rum and Blackwoods gin brands saw volume growth of 37% and 32% respectively. Having only begun its roll-out from January 2018, we would expect continued strong growth in FY19E from the new Blackwoods 2017 Vintage dry Gin, with its new proprietary bottle and packaging design. Economic recovery in Eastern Europe helped Blavod to a 34% volume increase, albeit largely through licensed sales, where Distil books only commission into turnover. Progress has also been made in opening up new export markets including France and additional Eastern European countries.
- **Increased brand investment in FY19:** Maintaining momentum is key for developing brands, and Distil is to step up its brand investment in FY19E, putting its cash resources to good use by underpinning future growth. Combined with a more considered approach to US distribution, with the company seeking a long-term strategic partner, the lagged impact of the increased marketing effort will hold back profit growth in FY19, before resuming a stronger growth curve from FY20E.

FYE MAR (£M)	2017	2018	2019E	2020E	2021E
Revenue	1.64	2.01	2.50	3.00	3.51
Adj EBITDA	0.01	0.16	0.17	0.41	0.60
Fully Adj PBT	0.01	0.16	0.16	0.40	0.59
Fully Adj EPS (p)	0.00	0.03	0.03	0.08	0.12
EV/Sales (x)	7.2	5.9	4.7	3.9	3.4
EV/EBITDA (x)	865.5	72.3	70.4	28.8	19.7
PER (x)	1,329.8	81.5	80.3	32.1	21.8

Source: Company Information and Progressive Equity Research estimates

A focus on key growth drivers

FY18 delivered both good profit growth and cash generation

While FY17 was a breakthrough year in terms of delivering a small profit, FY18 delivered a reassuring combination of not only good profit growth, with enhanced margins at all levels, but also pleasingly positive cash generation, which has helped to bolster the balance sheet. Having achieved this, management is looking to further underpin the current brand momentum and medium- to long-term growth prospects by stepping up its A&P investment in the current financial year. This will include a greater element of above-the-line (ATL) marketing, focussing primarily on RedLeg. Historically, marketing has been almost entirely invested in below-the line (BTL) activities, and these will still account for the majority of A&P investment over the near term.

Above- and below-the-line marketing, abbreviated to ATL and BTL

As a reminder, the terms above–the-line and below-the-line broadly differentiate between marketing activities with mass penetration (ATL) and more specific penetration (BTL). ATL promotion is considered less targeted than BTL marketing, achieving a wider reach through the use of mass media such as TV, radio, and print advertisements (including trade press). ATL is therefore seen as a vehicle for brand building amongst a wider audience. BTL marketing comprises more specific direct marketing to individuals or a more focused group of customers, with a focus on conversions to the product or service being promoted (brand/product activation). It is often referred to as direct marketing. Examples of BTL activities include brochures at the point of sale by (potential) customers, roadshows and product sampling, and is the tool most frequently used for test marketing a product.

Distil has historically focused on BTL activities and will continue to do so, but with add some ATL activity for brand building of RedLeg

Distil to date has focused almost exclusively on a variety BTL activities, interacting directly with consumers at the point-of-sale to introduce its products and brands eg the mobile Rum Shack concept for RedLeg. It is important to stress that the introduction of some ATL promotion of RedLeg will not use elements of mass media such as TV or radio, which are largely becoming less effective as media audiences fragment with the impact of a plethora of digital channels and widespread usage of social media, but will remain more focused, for example with trade advertising and well-placed public relations (PR) articles, in order to deliver better returns on investment.

Above- and below-the-line marketing, abbreviated to ATL and BTL

Management has highlighted its plans for increased investment in four key growth levers, namely:

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

Brand activation has been the cornerstone of promotional activities

The first of these has been a cornerstone – and will continue to be a cornerstone – of Distil's promotional activities. Given the quality and taste of its products, product sampling is the most effective way of introducing consumers to its products, stimulating purchases and driving brand recognition.

Brand extensions through new liquids and flavours

The second driver will include different pack sizes and formats, with new liquids and flavours. We would view this as a brand extension activity into new customer segments and/or for different usage occasions, but based on the current core brands. It will also include new liquids and brands, probably over a more medium-term view, given the traction and momentum of the stars within the current brand portfolio.

Increasing routes to market, including international expansion

The third driver comprises a number of activities to develop more routes to consumers, including new territories and new trade channels. As mentioned above, Distil successfully entered the French rum market early in 2018 and has achieved listings with one of the major hypermarket and supermarket operators. It has also achieved wider penetration within Eastern Europe for RedLeg and Blackwoods, and we would expect further new international markets to be opened in the near-term.

Importance of finding the right distributors as strategic partners, especially in the US. Talks underway, but this may take time and suggests…

Distil also talks specifically about the importance of building long-term distributor relationships in key markets. Given its size, no market is arguably more important than the US in terms of brand development and potential. Distil is currently in talks and negotiations with potential US distributors for its brands (with the exception of Blavod, which already has an appointed distributor). It has emphasised its objective of finding a long-term strategic partner, able to provide market coverage and activation support. This emphasis on both long-term and strategic implies two things to us. First, this may take longer than previously anticipated with a specific objective of finding the right and supportive partner, rather than rushing to achieve distribution, which may not be actively supported by distributors with a substantial brand portfolio.

….Distil is seeking a deeper and closer distributor relationship

Second, the term strategic partner, linked with the phrase activation support, suggests a deeper and closer relationship with a distributor than is often the case. There are some examples within the US drinks industry of strategic investments by distributor trade partners into new and growing brands. One recent example was the 2017 acquisition of Bulldog Gin by Campari, which had been distributing the brand in the US through its own distribution network since 2014 on the back of an exclusive agreement with an option to purchase the brand in 2020. On a broader international basis, another fledgling gin brand, Sipsmith, was acquired at the end of 2016 by the Japanese company, Beam Suntory. Whether Distil is looking to achieve a potentially similar deal is moot at this point, but it is clear that it is looking for a more actively involved and committed distributor partner than a straightforward plain vanilla agreement.

The fourth driver specifies all aspects of distilling, bottling and packaging, but is less specific on details and what this might potentially mean at this stage in terms of partnerships or investments.

The lagged benefit of this year's step up in brand investment will hold back profit growth in FY19

There will be a lagged effect before the benefits of this increased marketing effort are delivered to the bottom line, although the step up in investment will impact the operating costs in the current year. This, combined with the cost of resourcing development within the Asia region, will see profits broadly flat in FY19, before resuming a strong growth curve in outer years. While this may disappoint some investors and observers, we view this as a timing and phasing issue of the strategic investment for the longer-term development and growth of Distil's core brands. We have detailed our forecast revisions in a later section of this note.

FY18 prelims – a year of profit growth and cash generation

Margin improvements, strong profit growth and cash generation

The following table summarises the strong performance of FY18's P&L results, comparing them with the prior year. Margin performance has improved at all levels, namely gross, contribution and operating profit, by around 35bps, 60bps and 720bps respectively. Advertising cost growth of 21% was slightly behind the rate of sales growth of 23%, which accounted for the incremental expansion of the contribution margin over and above the gross margin benefit.

Group FY18 profit & loss account

(£'000 unless otherwise stated)	FY17	FY18	Change	% change
Turnover	1,642	2,014	372	23%
Gross profit	950	1172	222	23%
Gross margin (%)	*58%*	*58%*		
Advertising and promotion	-384	-465	-81	-21%
Contribution	566	707	141	25%
Contribution margin (%)	*34%*	*35%*		
Other administrative costs	-520	-522	-2	0%
Depreciation and amortisation	-4	-6	-2	-50%
Total operating costs	-908	-993	-85	-9%
Other income/(charges)	-32	-22	10	31%
Operating loss	10	157	147	1470%
Finance charge	0	0	0	n.c.
Pre-exceptional loss before tax	10	157	147	1470%
Exceptional charge	0	0	0	n.c.
Reported loss before tax	10	157	147	1470%

Source: Distil; Progressive Equity Research

Operating cost growth of 8% was significantly below revenue growth

Total operating cost growth, excluding the non-cash share-based payment charge, came in at just 9%, significantly below the rate of sales growth and giving a very positive gearing boost to operating profit (and margin). Including the share-based payment charge, which came in £10K lower at £22K in FY18, operating costs increased by just under 8%. Other administrative expenses were once again very tightly managed and effectively held flat year-on-year, and reducing significantly therefore as a percentage of sales. We would expect to see some increase in this area of the P&L in FY19, as Distil invests in resource to support channel growth and new market development.

Total volume growth in excess of 130% over the past three years

Across the year as a whole, total volume increased by 31%, compounding on the similar level of volume growth delivered in FY17. Over the past three years, volumes have increased by over 130%. RedLeg delivered a volume gain of 37% across the year with revenues up 32%. Blackwoods (Vintage Dry 40%) gin volumes were up by 32% with sales up 22%. Blavod continued the trend of the welcome return to volume growth seen in Q4 FY17. Volume increased by 34%, driven primarily by strong growth in licensed sales in Eastern Europe on the back of improved economic activity and recovery. With only commission on licensed sales booked to revenue, this translated into a 13% sales increase. The vodka market remains out of favour, and against very tough comparatives in FY17, delivered by increased listings in the pub channel, Blackwoods Vodka saw volume decline and listings contract, resulting in a sales decrease of 41%, albeit off a small base within the context of total group sales.

The following chart shows a summary of the last four years of sales and contribution evolution. The year-on-year monetary and percentage growth changes refer to FY18 compared with FY17. 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.

Own brand sales and contribution evolution

(£'000 unless otherwise stated)	FY15	FY16	FY17	FY18	Change	% change
Turnover	666	1,169	1,642	2,014	372	23%
Gross profit	406	681	950	1172	222	23%
Gross margin (%)	61.0%	58.3%	57.9%	58.2%		
Advertising and promotion	-148	-280	-384	-465	-81	-21%
Contribution	258	401	566	707	141	25%
Contribution margin (%)	38.7%	34.3%	34.5%	35.1%		

Source: Distil; Progressive Equity Research

Operating cash inflow of £166K

Distil has enjoyed a very good year in terms of cash flow. Year-end net cash was £1031K at the year-end, an increase of 13% (£121K) from the £910K at the end of FY17. Distil generated a net operating cash inflow of £166K, compared with the £2K outflow of FY17. The main driver of this was the increase in EBITDA, with a small reduction in the working capital outflow. Following FY17's investment in a new RedLeg Rum Shack promotional vehicle, FY18 saw capex drop back to £37K, compared with the £65K spent in FY17. Distil has seen a dramatic improvement in its operating cash flow. This has moved from a £116K outflow in FY16, through a broadly neutral position in FY17 to the £166K inflow of FY18, an overall improvement of just over £280K over the period.

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	Management currently in negotiations, looking for appropriate long-term strategic partners
Heavy reliance on key customers for owned brands	This reflects the transition of the business model, but 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, which are already coming through. Share placings have strengthened the balance sheet, allowing continued investment in growing the top line, as shown with recent listing gains. Distil has moved back into profit and is generating cash.

Source: Progressive Equity Research

Forecast revisions

Top line growth rates broadly unchanged; with lagged impact of increased brand investment reflected in broadly flat profit in FY19 before resumption of good growth curve

The following table summarises our headline forecast changes, reflecting the lagged benefit of planned step change in brand investment spend outlined above, along with our forecast initiation for FY21. The main impact therefore comes through in a higher level of operating costs, primarily but not exclusively A&P investment, which brings down operating profits. We have left our overall turnover estimates unchanged, with the impact of the strategic step up in marketing spend to underpin long-term growth effectively delaying the projected bottom line growth curve by a year, albeit with a small reduction in our FY20 profit forecast as well.

Summary of forecast changes and FY21 initiation

	FY19E			FY20E			FY21E
£m unless stated	**Old**	**New**	**Change (%)**	**Old**	**New**	**Change (%)**	**New**
Revenue	2.475	2.500	1%	3.002	3.000	0%	3.510
Adj EBITDA	0.357	0.168	-53%	0.466	0.410	-12%	0.600
Reported PBT	0.350	0.160	-54%	0.460	0.400	-13%	0.590
Fully adj PBT	0.350	0.160	-54%	0.460	0.400	-13%	0.590
Reported EPS (p)	0.070	0.032	-54%	0.092	0.080	-13%	0.118
Fully adj EPS (p)	0.070	0.032	-54%	0.092	0.080	-13%	0.118

Source: Progressive Equity Research estimates

Our revisions see the operating margin fall back to a forecast 6.4% in FY19, down 140bps on FY18, before recovering strongly into double-digit territory with forecasts of 13.3% and 16.8% in FY20 and FY21 respectively.

Detailed forecasts in following chart

The following chart 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	**2017**	**2018**	**2019E**	**2020E**	**2021E**
Revenue	1.64	2.01	2.50	3.00	3.51
Adj EBITDA	0.01	0.16	0.17	0.41	0.60
Adj EBIT	0.01	0.16	0.16	0.40	0.59
Reported PBT	0.01	0.16	0.16	0.40	0.59
Fully Adj PBT	0.01	0.16	0.16	0.40	0.59
NOPAT	0.01	0.16	0.16	0.40	0.59
Reported EPS (p)	0.00	0.03	0.03	0.08	0.12
Fully Adj EPS (p)	0.00	0.03	0.03	0.08	0.12
Dividend per share (p)	0.00	0.00	0.00	0.00	0.00
CASH FLOW & BALANCE SHEET	**2017**	**2018**	**2019E**	**2020E**	**2021E**
Operating cash flow	0.00	0.17	0.14	0.31	0.52
Free Cash flow	-0.07	0.13	0.12	0.31	0.52
FCF per share (p)	-0.01	0.03	0.02	0.06	0.10
Acquisitions	-0.01	-0.02	0.00	0.00	0.00
Disposals	0.00	0.00	0.00	0.00	0.00
Shares issued	0.01	0.01	0.00	0.00	0.00
Net cash flow	-0.07	0.12	0.12	0.31	0.52
Overdrafts / borrowings	0.00	0.00	0.00	0.00	0.00
Cash & equivalents	0.91	1.03	1.15	1.46	1.98
Net (Debt)/Cash	0.91	1.03	1.15	1.46	1.98
NAV AND RETURNS	**2017**	**2018**	**2019E**	**2020E**	**2021E**
Net asset value	2.81	3.01	3.17	3.57	4.16
NAV/share (p)	0.56	0.60	0.64	0.72	0.83
Net Tangible Asset Value	1.27	1.46	1.65	2.05	2.64
NTAV/share (p)	0.26	0.29	0.33	0.41	0.53
Average equity	2.79	2.91	3.09	3.37	3.87
Post-tax ROE (%)	0.3%	5.4%	5.2%	11.9%	15.2%
METRICS	**2017**	**2018**	**2019E**	**2020E**	**2021E**
Revenue growth	40.4%	22.6%	24.2%	20.0%	17.0%
Adj EBITDA growth	(114.6%)	1,097.6%	2.7%	144.3%	46.2%
Adj EBIT growth	(110.0%)	1,531.8%	1.5%	150.2%	47.4%
Adj PBT growth	(109.9%)	1,531.8%	1.5%	150.3%	47.3%
Adj EPS growth	(108.7%)	1,531.8%	1.5%	150.3%	47.3%
Dividend growth	N/A	N/A	N/A	N/A	N/A
Adj EBIT margins	0.6%	7.8%	6.4%	13.3%	16.8%
VALUATION	**2017**	**2018**	**2019E**	**2020E**	**2021E**
EV/Sales (x)	7.2	5.9	4.7	3.9	3.4
EV/EBITDA (x)	865.5	72.3	70.4	28.8	19.7
EV/NOPAT (x)	1,224.3	75.0	73.9	29.5	20.0
PER (x)	1,329.8	81.5	80.3	32.1	21.8
Dividend yield	N/A	N/A	N/A	N/A	N/A
FCF yield	(0.5%)	1.0%	0.9%	2.4%	4.1%

Source: Company information and Progressive Equity Research estimates

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