

## Australian Equity Research

4 July 2017

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## SPECULATIVE BUY↓

from BUY

PRICE TARGET A\$0.52↓

from A\$0.93

Price (3-Jul) A\$0.33

Ticker YOW-ASX

52-Week Range (A\$):	0.40 - 1.06
Avg Daily Vol (000s) :	433.2
Market Cap (A\$M):	70.4
Dividend /Shr (AUC):	0.0
Dividend Yield (%) :	0.0
Shares Out., FD (M) :	213.2
Enterprise Value (A\$M):	53.5
ADR Ticker:	YWRPY

FYE Jun	2016A	2017E	2018E	2019E
Sales (US\$m)	12.9	20.0↓	31.7↓	42.8↓
Previous	-	24.1	50.9	86.0
EBITDA (US\$m)	(3.6)	(2.7)↓	1.4↓	5.1↓
Previous	-	0.4	12.0	26.4
Net Income Adj (US\$m)	(3.5)	(2.5)↓	1.5↓	5.2↓
Previous	-	0.3	8.4	18.1
EPS Adj&Dil (AUC)	(3.03)	(1.61)↓	1.0↓	3.3↓
Previous	-	0.2	5.6	12.2
DPS (AUC)	0.00	0.00	0.00	0.00↓
Previous	-	-	-	7.00
P/E (x)	(10.9)	(20.5)	34.3	9.9
EV/EBITDA (x)	(8.1)	(12.2)	24.9	8.4
Div. Yield (%)	0.0	0.0	0.0	0.0



Priced as of close of business 3 July 2017

Yowie Group (ASX: YOW) is a chocolate novelty branding and manufacturing company, selling a chocolate with a surprise toy inside to major retailers in the USA and Middle East.

## Rating and Target Price Changes

## Unwrapping our numbers

Following a change of analyst, we have recut our numbers on YOW, taking a more conservative approach to the outlook. Since we last published, YOW has revised FY17 guidance with a number of factors impacting momentum including: (i) a distributor change by Walmart; (ii) production issues affecting order fulfilment; and (iii), timing issues around entry into Canada and the launch of its new brand, Discovery World. Similarly, FY18 guidance has been revised also.

Despite the challenges and revised guidance, we retain a positive rating on YOW. We estimate that YOW has greater than US\$25m in cash and therefore has an EV of ~US\$25m. This is against forecast FY17 revenue of ~US\$20m, which is expected to grow at +50% in FY18. We also expect that YOW should shift into profitability in FY18. This should leave YOW well capitalized to continue to build the brand, which management sees as a two- to three-year process rather than an overnight success. Our estimates now reflect this.

There are still some question marks, however, including underlying momentum in the US, and we suspect investors will take a wait-and-see approach. However, at these levels we believe the risk-reward is to the upside. We reinstate coverage on YOW with a Speculative BUY rating and a \$0.52 price target.

## Key points

**What's changed?** Quite a lot has changed since we last published on YOW. Guidance around net sales growth has been revised lower for FY17 and FY18. This is despite a somewhat successful launch in Australia, a pending launch in Canada and the launch of a second brand, Discovery World, now scheduled for 1Q18. YOW has guided to FY17 revenue growth of 55% – this is down from 85% earlier in the year – and FY18 revenue growth of between 55%-70% – previously 70%. This points to moderating momentum in the US and until there is evidence to suggest the opposite, this is likely to continue to weigh on sentiment in our view.

**How has this affected our numbers?** We've taken a more conservative approach to our estimates with FY18E net sales of US\$31.7m implying 58.5% growth, which is toward the bottom end of the range of 55%-70%. This encompasses a conservative estimate for sales into Australia and Canada. Management has noted that profitability at the NPAT level is achieved if growth is delivered at the top end of the range, which implies a breakeven level of ~US\$34m. However, we note that profitability will be impacted by share-based compensation. We have not included this share-based compensation in our adjusted earnings estimates and therefore we are forecasting profitability is reached in FY18 on our lower revenue estimate.

**Valuation and recommendation.** We have revised our price target on YOW to \$0.52 per share (from \$0.93 previously). Our PT is based on an FY19E PER of 15.5x, which is set at a 10% premium to the Small Industrials average. We believe this is justified given YOW's projected growth rates. We have also changed our recommendation to Speculative BUY (from BUY). Our rating change reflects the guidance revisions and a slower ramp-up in sales, particularly in the US, which poses a risk in our view. That said, YOW is well capitalized and its current valuation isn't baking in much more success from here. While the investment proposition at this stage is not without risk, the risk-reward for investors is to the upside in our view.

Figure 1: Yowie Group Limited (YOW); Canaccord Genuity forecasts

Yowie Group (YOW)					Year end 30 June				
Profit & Loss (US\$m)	2016A	2017F	2018F	2019F	Valuation ratios	2016A	2017F	2018F	2019F
Revenue	12.9	20.0	31.7	42.8	EPS (cps) - A\$	-3.0	-1.6	1.0	3.3
COGS	-6.2	-9.2	-15.1	-20.5	PER (x)	-10.9	-20.5	34.3	9.9
Gross Profit	6.6	10.8	16.6	22.3	PER Rel - All Ind.	-152%	-203%	89%	-40%
EBITDA	-3.6	-2.7	1.4	5.1	PER Rel - Small Ind.	-159%	-217%	128%	-30%
Dep & Amort.	-0.1	-0.2	-0.3	-0.3	Enterprise Value (A\$m)	36.4	41.7	43.3	40.7
EBIT	-3.6	-2.9	1.1	4.8	EV / EBITDA (x)	-7.5	-11.5	23.6	6.0
Net Interest Expense	0.2	0.5	0.4	0.4	EV / EBIT (x)	-7.3	-10.6	29.4	6.4
NPBT	-3.5	-2.4	1.5	5.2	DPS (cps)	0.0	0.0	0.0	0.0
Tax expense	0.0	0.0	0.0	0.0	Dividend Yield (%)	0.0%	0.0%	0.0%	0.0%
NPAT - adjusted	-3.5	-2.5	1.5	5.2	Franking (%)	0%	0%	0%	0%
Cash Flow (US\$m)	2016A	2017F	2018F	2019F	CFPS (cps)	-0.1	-2.9	-0.7	2.0
NPAT	-3.5	-2.5	1.5	5.2	P / CFPS (x)	-378.3	-11.3	-47.5	16.3
+ Depreciation	0.1	0.2	0.2	0.2	Profitability ratios	2016A	2017F	2018F	2019F
+ Amortization	0.0	0.0	0.1	0.1	EBITDA Margin (%)	-27.7%	-13.6%	4.3%	11.9%
+ Other CF from ops	0.0	-0.5	0.0	0.0	EBIT Margin (%)	-28.3%	-14.7%	3.5%	11.2%
- Change in WC/Other	3.3	-1.7	-2.8	-2.3	ROE (%)	-9.5%	-7.1%	4.1%	12.5%
Operating Cashflow	-0.1	-4.5	-1.1	3.1	ROA (%)	-8.9%	-6.8%	3.9%	11.8%
- Capex	-3.1	-0.6	-0.5	-0.5	ROIC (%)	-6.7%	-4.7%	2.8%	9.8%
- Acquisitions	0.0	0.0	0.0	0.0	Balance Sheet ratios	2016A	2017F	2018F	2019F
- Other Investing.	-0.1	0.0	0.0	0.0	Net Debt (cash)	-31.7	-26.4	-24.8	-27.4
Investing Cashflow	-3.2	-0.6	-0.5	-0.5	Net Gearing (%)	nm	nm	nm	nm
Free Cashflow	-3.3	-5.1	-1.6	2.6	Interest Cover (x)	0.0	0.0	0.0	0.0
Loans - Drawn/(Repayment)	0.0	0.0	0.0	0.0	NTA per share (\$)	\$0.18	\$0.16	\$0.17	\$0.19
Shares - Issues/(Buybacks)	26.3	0.0	0.0	0.0	Price / NTA (x)	1.9	2.0	2.0	1.7
Dividends - (Payments)	0.0	0.0	0.0	0.0	Growth ratios	2016A	2017F	2018F	2019F
Other Financing	0.0	0.0	0.0	0.0	Sales revenue (\$m)	324%	55%	58%	35%
Financing Cashflow	26.3	0.0	0.0	0.0	EBITDA (\$m)	-47%	-24%	-151%	270%
Net Cashflow	22.9	-5.1	-1.6	2.6	EBIT (\$m)	-46%	-19%	-138%	335%
Cash at beginning of period	8.5	31.7	26.4	24.8	NPAT (\$m)	-48%	-29%	-160%	248%
Cash at end of period	31.7	26.4	24.8	27.4	EPS (cps)	-55%	-47%	-160%	248%
Balance Sheet (US\$m)	2016A	2017F	2018F	2019F	DPS (cps)	0%	0%	0%	nm
Cash	31.7	26.4	24.8	27.4	Interim Analysis	1H16A	2H16A	1H17A	2H17F
Receivables/Debtors	1.3	1.9	4.5	6.6	Revenues	5.7	7.2	9.3	10.7
Inventories	1.1	2.7	3.6	4.3	EBITDA - reported	-2.7	-0.9	-1.3	-1.4
PP&E	3.1	3.3	3.3	3.3	EBITA - reported	-2.7	-1.0	-1.4	-1.6
Intangibles	0.8	1.0	1.2	1.4	NPAT -adjusted	-2.6	-0.9	-1.1	-1.4
Deferred Tax	0.0	0.0	0.0	0.0	EPS (cps) - adjusted	-2.4	-0.6	-0.7	-0.9
Other assets	3.0	3.0	5.5	7.6	DPS	0.0	0.0	0.0	0.0
Total Assets	39.7	36.4	38.4	44.1	Valuation	2019F			
Borrowings	0.0	0.0	0.0	0.0	Normalised EBITDA multiple (x)				
Payables/Creditors	2.7	1.9	2.5	3.0	EBITDA (A\$m)	6.8			
Other Liabilities	0.0	0.1	0.1	0.1	Target EBITDA multiple (x)	11.0x			
Total Liabilities	2.7	2.0	2.6	3.0	Add cash (A\$m)	33.1			
NET ASSETS	37.0	34.4	35.9	41.0	Implied Valuation	107.6			
Board of Directors / Substantial Shareholders					Per Share (A\$/sh)	\$0.52			
Board of Directors	Shareholding (m) %				Target PE Multiple				
Trevor Allen - Chairman	0.1 0.0%				EPS (c) - cash	3.3			
Bert Alphonso - MD	0.3 0.1%				PER Target (x)	15.5x			
Patricia Fields - Exec Director	4.2 2.0%				Per Share - A\$	\$0.52			
Substantial Shareholders	Shareholding (m) %				Discounted Cash Flow				
FIL Limited	20.1 9.4%				Cost of equity	10.6%	WACC	14.4%	
Pie Funds Management	11.7 5.5%				Cost of debt	7.3%	Terminal GR	0.0%	
					Net Debt/ ND + equity	-147%	Per Share Val A\$	\$0.54	
					Description				

Yowie Group is a chocolate novelty branding and manufacturing company, selling chocolate with a surprise toy inside to major retailers in the USA, Australia, Canada and the Middle East

Source: Company reports, Canaccord Genuity estimates

## What has changed?

A number of things have occurred since we last published on YOW. The most pertinent issues relating to the investment thesis are as follows:

- **FY17 net sales guidance has been revised down....twice** - In mid-April, YOW reduced its net sales growth guidance to 70% from 85% previously. Management attributed the miss to Walmart's decision to make a US western region distributor change that was implemented in early March, and to manufacturing issues earlier in the year that impacted fulfilment of orders during the 3Q17. The impact of these issues was estimated to be US\$1.0m. Then more recently on 21 June, just two months later, YOW revised the projected growth rate again to 55%. In this instance, the main drivers were the timing of the entry into Canada and the launch of its new brand, Discovery World (see below), which will now fall into 1Q18. Management flagged an estimated US\$1.5m impact of these two delays. On a combined basis, the issues driving the revised guidance totaled an estimated US\$2.5m; however, the actual downgrade was closer to ~US\$4.0m. We suspect the balance reflects a slowdown in US demand or some conservatism by management or potentially a combination of the two.
- **FY18 growth rates revised as well** - Similarly to the above, YOW also revised its FY18 net sales growth outlook, guiding to 70% in April before providing a range in June of 55-70%. With the delay in the launch of Discovery World and the Canada entry falling into 1Q18, we would have thought that this would have made it easier to hit the original guidance. Management, however, said that the revision related to there being more rigor put around forecasting. We also think that there could be an element of conservatism in the guidance to ensure that the company is better placed to deliver or beat expectations. We estimate that based on the revised guidance, the implied organic growth for the US is between 30% and 45%.
- **Discovery World adds another string to YOW's bow** - YOW announced in April the launch of a new brand, Discovery World, which expands its brand portfolio. Discovery World is a complementary offering at a lower price point with the product being a smaller chocolate portion with a collectable. The first series of Discovery World consists of 24 collectible dinosaurs together with educational material. The launch into Walmart is expected in 1Q18 and will be initially trialed at 2,000 stores. Management estimate that the initial sales into Walmart will be ~US\$0.5m.
- **Australia has come into the picture** - YOW was relaunched back into Australia in May and the initial response has been positive. Series one has been rolled out to convenience, petrol, department and toy store channels including Kmart, Toys R Us and Big W. Net sales are expected to be US\$1.6m in FY17 and more distribution is expected to come through in FY18. Management believe sales should more than double into FY18, which would make Australia ~10% of net sales. The RRP was \$3.80 per unit; however, we've seen prices of between \$4.50-\$4.80. We would expect that the addition of a major retailer could see price closer to the RRP and this may result in a lowering of prices across the board and an increase in sales.
- **Canada launch set for 1Q18** - The launch in Canada is to take place in 1Q18. That market is similar to Australia in that it is dominated by large retailers with 50% of the market tied up by Loblaws under the Lobaws supermarket chain and pharmacy chain, Shoppers Drug Mart. It is anticipated that initial sales will be US\$1.0m with the market potential being similar to the Australian market. It will be interesting to see what the response is, given Canada has Kinder Surprise. We

note that Ferrero has announced the launch of the Kinder Joy into the US in April 2018. This may be a challenge for YOW although it is expected that the price point will be higher than a Yowie and may grow the category.

## How have our estimates changed?

We've taken a more conservative approach to our estimates with forecasted FY18 net sales of US\$31.7m implying 58.5% growth, which is toward the bottom end of the range of 55%-70%. This encompasses a conservative estimate for sales into Australia and Canada.

Management has noted that profitability at the NPAT level is achieved if growth is delivered at the top end of the range, which implies a breakeven level of ~US\$34m. However, we note that profitability will be impacted by share-based compensation. We have not included this share-based compensation in our adjusted earnings estimates as it is non-cash.

We haven't made significant changes to our gross margin assumptions although expansion into Australia and Canada will cause a small dilution. This should be offset by a decline in cocoa prices and renegotiated wrapping costs.

We outline our main estimate changes in Figure 2 below.

**Figure 2: Revised earnings estimates FY17-FY19**

	FY17			FY18			FY19		
	Old	New	% Change	Old	New	% Change	Old	New	% Change
US (US\$m)	23.5	18.5	-21.2	49.5	28.0	-43.4	83.8	37.2	-55.6
Australia (US\$m)	0.00	1.2	nm	0.0	2.0	nm	0	3.0	nm
Canada (US\$m)	0.00	0.0	0.0	0.0	1.7	nm	0	2.6	nm
Other (US\$m)	0.6	0.6	0.0	1.4	1.1	-20.0	2.2	1.8	-19.6
<b>Total revenue (US\$m)</b>	<b>24.1</b>	<b>20.0</b>	<b>-17.0</b>	<b>50.9</b>	<b>31.7</b>	<b>-37.7</b>	<b>86.0</b>	<b>42.8</b>	<b>-50.3</b>
EBITDA (US\$m)	0.4	-2.7	nm	12.0	1.4	-88.6	26.4	5.1	-80.8
NPAT (US\$m)	0.5	-2.5	nm	12.1	1.5	-87.6	21.2	5.2	-75.6
EPS (AU¢) –normalised	0.4	-1.6	nm	8.1	1.0	-88.1	14.3	3.3	-76.6
DPS (AU¢)	0.0	0.0	0.0	0.0	0.0	0.0	8.0	0.0	-100.0

Source: Canaccord Genuity estimates

## Outlook and recommendation

Despite the challenges and revised guidance, we retain a positive rating on YOW. We estimate that YOW has greater than US\$25m in cash and therefore has an EV of ~US\$25m. This is against a forecast FY17 revenue of ~US\$20m+, which is expected to grow at +50% in FY18 to between US\$31m and US\$34m. Our estimates now reflect a more conservative expectation around growth, and at these levels, relative to these estimates, the current valuation looks quite appealing.

With the business likely to shift into profitability in FY18, there should be sufficient capital for YOW to continue building the Yowie and Discovery World brands and for further geographical expansion to be pursued. On this basis, the outlook for YOW looks positive.

There are still some question marks, however, including underlying momentum in the US, and in this regard we suspect investors will take a wait-and-see approach to see how this transpires in 1H18, particularly around the launch of Discovery World and Series 3 collectibles.

However, at these levels we believe the risk-reward is to the upside. We re-instate coverage on YOW with a Speculative BUY rating and a \$0.52 price target. Our price target is based on an FY19E PER of 15.5x, which is set at a 10% premium to the Small Industrials average given the strong projected growth rates.



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### Investment Recommendation

Date and time of first dissemination: July 03, 2017, 16:27 ET

Date and time of production: July 03, 2017, 11:24 ET

### Target Price / Valuation Methodology:

Yowie Group Ltd. - YOW

Our price target of is derived by applying a 15.5x multiple to our FY19E PER. The 15.5x multiple is a 10% premium to the Small Industrials average.

### Risks to achieving Target Price / Valuation:

Yowie Group Ltd. - YOW

Risks to achieving our price target include; slower than expected customer volume ramp up, inadequate funding for a larger than expected volume ramp up, competition from multinational chocolate companies, the inability for Yowie to expand beyond the USA market effectively and margins being squeezed as volumes increase. We highlight legal activity as risks, although the company has outlined their belief that the legal claims against it are "without merit".

### Distribution of Ratings:

#### Global Stock Ratings (as of 07/03/17)

Rating	Coverage Universe		IB Clients
	#	%	%
Buy	581	60.97%	40.10%
Hold	271	28.44%	21.03%
Sell	26	2.73%	15.38%
Speculative Buy	75	7.87%	69.33%
	953*	100.0%	

\*Total includes stocks that are Under Review

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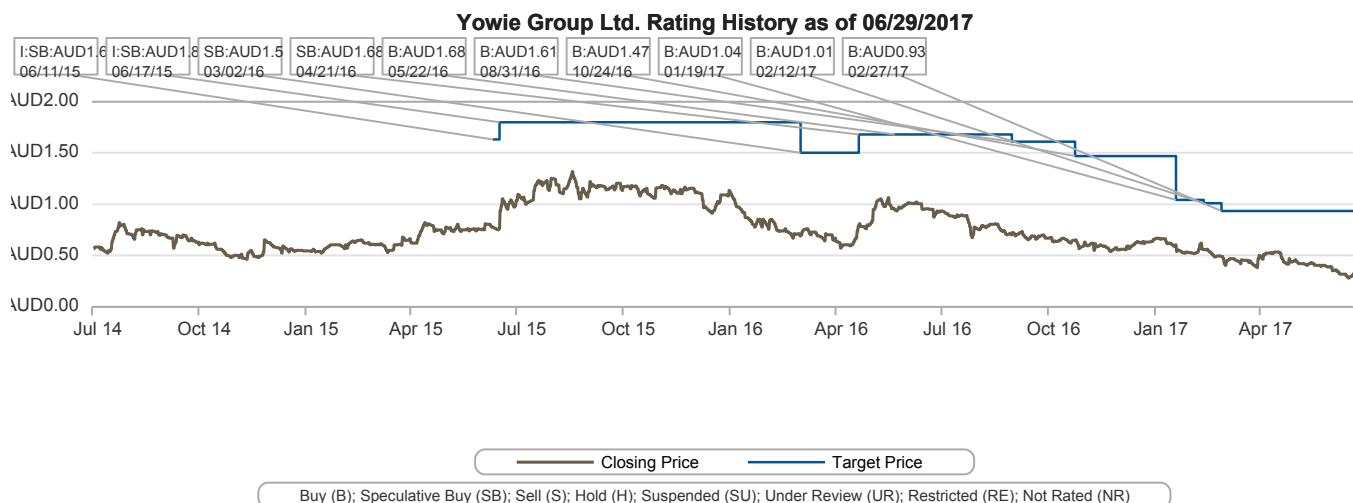
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