EDISON

ADR research

Yowie Group

Business update

Growing expectations

Food & beverages

Yowie Group's retail revenues rose 29% on a sequential basis in the December quarter to an estimated US$6.2m as the company completed its roll-out to 4,300 Walmart stores in the US. December quarter numbers include both retail and stock-building sales, so we are maintaining our top-line expectations for now. However, based on the company's recent move to a new contract manufacturer and the resulting discontinuation of patent royalty fees, we believe there may be upside to our estimates.

Year end	Revenue ($m)	PTP* ($m)	EPADR ($)	DPADR ($)	P/E (x)	Gross yield (%)
06/14	0.0	(3.2)	(0.35)	0.0	N/A	N/A
06/15	1.9	(2.4)	(0.19)	0.0	N/A	N/A
06/16e	15.5	(0.7)	(0.04)	0.0	N/A	N/A
06/17e	33.5	4.1	0.24	0.0	20.0	N/A

Note: *PTP and EPADR are normalized, excluding intangible amortization, exceptional items and share-based payments. Converted at A$/US$1.38. Investors should consult their tax advisor regarding the application of any domestic and foreign tax laws.

Quarterly retail sales rise 29% sequentially

Yowie Group posted another strong quarter of retail sales as the company completed its roll-out to all 4,300 Walmart stores. Management comments that it achieved $6.2m in retail sales value in the quarter. With retail sales prices for Yowies typically ranging from a low of $2.48 (at Walmart) to a high of $3.99 (at specialty candy retailers), we estimate that the company sold c 2.2m units in the quarter, right in line with our base case expectation of 2.2m units for the quarter.

Profit upside potential from manufacturing move

Yowie announced that it has moved to a new manufacturer and has started to use its own FDA-approved and patent pending capsule design for its Yowie candies. We believe the move to a new manufacturer may signal better than expected unit sales and a need to ramp up capacity. The move is also likely to reduce production costs as the company begins to use its own proprietary capsule, thereby eliminating royalty fees paid for its previous capsule design. We expect to reduce our forecast for total input costs, but have not done so at present. We will hold our estimates until there is better visibility of total costs under the new structure.

Valuation: Modest expectations implied

The shares have dropped about 42% since our initiation in September 2015, which we believe reflects overall market weakness, along with the 16% increase in shares outstanding. A reverse DCF at the current price with a WACC of 10% implies compound average revenue growth from FY16 to FY18 of 70%, fading to terminal growth of 2% and a terminal EBIT margin of 14%, a margin we believe may be achievable by FY18. There is nothing in our forecasts for roll-out to other geographies, which would present further upside. We also believe that there is a real opportunity for investors as Yowie demonstrates that it can move beyond confectionery into licensing the brand for other products.

26 February 2016

Price	**US$4.81***
Market cap	**US$82m**

*Calculated ADR/Ord conversion ratio 1:10

A$/US$1.38

Net cash ($m) at December 2015	11.6
ADRs in issue	17.1m
ADR Code	YWRPY
ADR exchange	OTC
Underlying exchange	ASX
Depository	BNY

Business description

Yowie Group, listed in Australia, is engaged in brand development of the Yowie chocolate confectionery product, digital platform, and licensed consumer products. The company's brand vision includes distribution in North America, with further expansion planned into Australia, New Zealand and Asia, where Yowie's brand equity remains strong. Expansions into Europe and the Middle East are strategic priorities for a second-stage brand roll-out.

Next events

Q316 results	May 2016
FY16 results	September 2016

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Edison profile page

Yowie Group is a research client of Edison Investment Research Limited

Sales on target – upside to estimates on cost reductions

Yowie Group is an emerging growth, brand development and marketing company. It is launching a unique and patented chocolate/toy novelty in the US market as the first step in reviving a highly successful Australian children's brand that teaches environmental awareness and conservation through whimsical cartoon characters and stories.

In many ways, Yowie Group has achieved the Holy Grail for new consumer products. Without any real sales track record in the US, Walmart came on as a beachhead customer in 2014, based on what Walmart's buyers see as strong potential for Yowie's chocolate encapsulated/toy product in their stores. Due to a successful trial in 50 stores in fall 2014, followed by a preliminary roll-out to 1,500 stores in early 2015, Yowies are currently available in all 4,300 US Walmart stores.

December quarter volumes on target with our expectations

According to the company's press release, Yowie Group reported record sales in the December quarter. An estimated US$6.2m of retail sales value was achieved, up 29% sequentially. Consistent with ASX practices, Yowie Group does not file an income statement on a quarterly basis, so we have to infer unit sales from management's comments and its 4C filing.

- **Retail value US$6.2m:** management comments that it achieved $6.2m in retail sales value in the December quarter. Retail sales prices for Yowies typically range from a low of $2.48 (at Walmart) to a high of $3.99 (at specialty candy retailers). We estimate that the company sold c 2.2m units in the quarter, right in line with our base case expectation of 2.2m units for the quarter.
- **Cash receipts US$3.6m:** Yowie reports customer receipts on a cash basis, which reflects sales to customers at wholesale, but excludes any increase in accounts receivable. Customer receipts totalled US$3.6m in the December quarter versus US$1.8m in the September quarter. Using an average wholesale price of US$1.70-1.80 suggests the company shipped 2.0-2.1m units in the quarter.

Unlike the September quarter, where there was a sizeable difference between management's retail sales estimate and cash receipts, retail sales and cash receipts were very close in the December quarter, suggesting that the company is quickly converting orders into cash.

Management has set its sights high for the potential target market in the US, with a fairly aggressive peak sales target based on Yowie's success in Australia in the late 1990s (where annual sales were an estimated 3.6 units per capita), as well as versus Kinder Surprise, which averages 1-2 units per capita each year in the EU. At a penetration of 2-3 units per head of population, the 320 million US market would represent a sales volume of some 750m units, around 30 times higher than our 2018 base case forecast volumes in Exhibit 1 below. Our forecast scenarios were discussed in detail in our 21 September 2015 initiation.

While management's unit sales targets may be achievable over the long term, we believe that the real opportunity for investors will be as Yowie moves beyond confectionery into other products and licensing. Merchandise and other licensing agreements would likely be structured as royalty revenues to the company, with some level of guarantee. Licensing revenue would likely be highly profitable and drop almost entirely to the operating line, after some level of administrative costs. However, we have not built this into our earnings model for FY16-17 and we have a modest licensing revenue assumption of US$1m for 2018.

Exhibit 1: Store and volume penetration scenarios

	FY16e	FY17e	FY18e
Base case			
Store penetration at year end	12,281	18,481	20,481
Total units (m)	9.5	20.7	27.2
Product sales (US$000)	15,210	33,128	43,527
Moderately higher growth (10% in stores and volume)			
Store penetration at year end	13,509	20,329	25,279
Total units (m)	11.5	25.1	32.9
Product sales (US$000)	18,401	40,085	52,668
Moderately lower growth (10% in stores and volume)			
Store penetration at year end	11,053	16,633	20,683
Total units (m)	7.7	16.8	22.0
Product sales (US$000s)	12,318	26,834	35,257

Source: Edison Investment Research. Note: Product sales and units refer to sales into stores. Sales numbers do not include royalties.

Yowies come to New York and bring potentially higher margins

On 30 December, Yowie announced that it entered into a long-term manufacturing agreement for its product with Madelaine Chocolate Company in New York. In addition, it has begun to use its own FDA-approved and patent pending capsule for its Yowie confectionary. Yowie ended its manufacturing agreement with Atlantic Candy Company, along with its agreement to pay royalties to the owner of its earlier capsule design patent, Hank Whetstone.

While the announcement was unexpected, we appreciate the issues driving Yowie's decision. The Company faced the loss of patent exclusivity on the Whetstone capsule design in 2018. In its press release, Yowie's management notes, "Yowie has developed the new Company-owned capsule and new manufacturing agreement as part of a long term strategic plan designed to mitigate risk and optimize Yowie performance as a sustainable company and brand well equipped to compete successfully in a competitive global market".

The Madelaine contract provides Yowie access to a fully automated plant, which is intended to provide immediately increased manufacturing capability improved efficiency and enhanced quality assurance. Management states that it expects to be able to produce c 100m units per annum, compared with an estimated 18m units that could be produced on a single line at Atlantic Candy.

Yowie manufacturing will commence from the Madelaine factory in early 2016. Yowie believes it has significant product inventory in excess of currently committed customer requirements, which the Company believes is sufficient to cover the production ramp-up at Madelaine plus contingency.

However, we believe that Yowie's decision to prematurely end its contract with Atlantic Candy could expose it to some risk of legal action on two fronts: patent infringement on the new capsule design and contract breach. We understand that the Board is confident of its legal position and that its legal advice formed a significant part of its decision. Yowie worked with patent counsel in developing the new capsule design, and its counsel believes the new design does not infringe on Whetstone's patent. However, according to Confectionery News Hank Whetstone has successfully defended his patent as recently as 2013, making it possible that Whetstone will consider whether he can bring suit against Yowie. On the potential breach of contract issue, Yowie's 2015 annual report lists a minimum payment of $1.37m due to Atlantic Candy covering patent exclusivity from December 2016-2019; however, further details of the contract have not been made public.

On the flip side, its former manufacturer, Atlantic Candy, is now free to use its existing, patented capsule design for other candy manufacturers, which could create near-term competition for Yowie.

Despite these risks, our initial read on this news is largely positive, as Yowie will potentially be reducing its production costs by eliminating both its exclusivity and per unit patent royalties previously paid to Whetstone. Management has not disclosed any anticipated savings from the move; however, we believe it is reasonable to expect a portion of any savings will be reinvested back into marketing and product development.

Sensitivities

In many ways, Yowie Group is a high-risk startup venture. It is still early to know whether consumers will consistently flock to a premium-priced, novelty candy based on little-known characters.

Foreign exchange sensitivity for ADR investors has been mitigated as the company has switched its functional currency from Australian dollars to US dollars as of this current fiscal year (1 July 2015).

Success at Walmart is crucial to our sales forecasts. Walmart not only has 4,300 outlets in the US, but it also tends to have more points of sale (POS) in each store and higher sales per POS than Yowie's other outlets. While management will not break out sales to Walmart specifically (citing confidentiality agreements), we believe that sales from Walmart could drive more than 80% of Yowie's total sales in the next 12-18 months.

In the past, we considered Yowie's reliance on a single manufacturer a sensitivity because of the potential risk for supply disruption. At the same time we saw the capsule design patent exclusivity as a competitive advantage. By creating its own FDA-approved and patent-pending capsule, Yowie has mitigated the single manufacturer risks but as we discussed in the previous section, the Company may have invited legal action from its previous supplier – although Yowie's board and legal counsel are confident in the Company's position.

Finally, with Atlantic Candy able to sell its capsule design to other manufacturers, Yowie may now face competition in the encapsulated toy/candy space if another manufacturer chooses to use Whetstone's design (which is patented until 2018); however, it strikes us that given Yowie's ability to quickly design an FDA-compliant capsule, Ferrero's Kinder Surprise absence in the US market may involve more than capsule design.

Other sensitivities for Yowie Group include commodity pricing and typical regulatory and legal issues.

Valuation

Our primary valuation metric for Yowie is DCF, since the full value of the current opportunity is likely to become apparent over a number of years rather than from near-term results.

In the short term, we see the Yowie story as somewhat binary – either US customers will love the brand or they will not. As a result, we believe that if the brand proves itself in the next year, the WACC and relative risks to the story will more closely reflect a consumer goods story – albeit one with very high growth. In this context, the retail sales data over the past six months are quite encouraging.

Our 10-year reverse DCF model builds to sales of approximately US$120m by 2025. There is nothing in our forecast for roll-out to other geographies, which thus represents pure upside. We also believe that there is a real opportunity for investors should Yowie move significantly beyond confectionery into other products and licensing. Evidence of success here would lead us to adjust our forecasts to more accurately reflect the impact of the increased license income.

We assume a terminal growth rate of 2% and use a WACC of 10.0% (reflecting 10% market gearing), an equity risk premium of 5.4% and a beta of 1.2. We selected these to reflect what we view as conservative earnings forecasts, a once strong and proven children's franchise and a business model that is not capital intensive. On this basis, our reverse DCF requires a terminal EBIT margin of 14%, a level that we regard as achievable given our forecast of a modest increase in licensing income over the next ten years, to c 9% of total revenue, albeit still significantly short of management's aspirations in this area.

Exhibit 2: Valuation (US$ per ADR)

		Terminal EBIT Margin				
		6%	10%	14%	18%	22%
WACC	7.0%	4.17	6.49	8.81	11.13	13.45
	8.0%	3.36	5.19	7.02	8.84	10.67
	9.0%	2.79	4.27	5.75	7.23	8.71
	10.0%	2.36	3.58	**4.81**	6.03	7.26
	11.0%	2.02	3.05	4.08	5.11	6.15
	12.0%	1.75	2.63	3.51	4.39	5.27
	13.0%	1.53	2.29	3.05	3.81	4.57

Source: Edison Investment Research. Note: Bold indicates current level.

Financials

Yowie reported $0.9m in operating cash flow in December, its first quarter of positive operating cash flow. The company began working down its inventory in the September quarter as it worked through the initial stocking for its Walmart roll-out. Net cash at December 2015 was US$11.6m, up $3.3m from September, reflecting financing cash flows from listed and unlisted option exercises in addition to the positive operating cash flow.

We expect Yowie to ramp up production and rebuild inventory once it has completed its factory transition, so it seems reasonable to expect that operating cash flow may return to negative territory this year as the company looks to expand distribution and begins to work with retailers that may have a longer accounts payable cycle.

Management indicates there will be lower input costs associated with the move to the new factory and the use of its own capsule design. We believe that most of these lower input costs will come from the discontinuation of royalties paid to Atlantic Candy: a flat annual exclusivity fee and a variable fee based on production volume. At this point, however, we are maintaining our cost estimates until we see (1) evidence of lower manufacturing costs; (2) costs associated with the new patent; (3) any unforeseen costs associated with the new contract or transition costs; and (4) any changes in corporate spending for marketing, product development and the like as a potential use of the lower input costs. However, we are adjusting our EPADR down slightly to reflect the net effect of discontinuing royalties and the increase in ADRs outstanding from 15.5m to 17.1m.

Exhibit 3: Estimate changes

	EPADR ($)			PTP ($m)			EBITDA ($m)		
	Old	New	% chg.	Old	New	% chg.	Old	New	% chg.
2015	(0.19)	(0.19)	N/A	(2,419)	(2,419)	N/A	(2,619)	(2,619)	N/A
2016e	(0.04)	(0.04)	N/A	(660)	(660)	N/A	(785)	(341)	N/A
2017e	0.27	0.24	(11.1)	4,139	4,139	N/A	3,950	3,950	N/A
2018e	0.49	0.44	(11.4)	7,584	7,584	N/A	7,102	7,102	N/A

Source: Edison Investment Research

Exhibit 4: Financial summary

	US$000's	2013	2014	2015	2016e	2017e	2018e
Year end June		IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS							
Revenue		11	19	1,917	15,520	33,456	44,595
Cost of Sales		0	(4)	(885)	(9,731)	(19,056)	(24,128)
Gross Profit		11	15	1,032	5,789	14,400	20,467
EBITDA		(810)	(3,283)	(2,619)	(785)	3,950	7,102
Operating Profit (before amort. and except.)		(814)	(3,298)	(2,678)	(903)	3,799	6,911
Intangible Amortisation		0	(0)	(3)	0	0	0
Exceptionals		(912)	(1,441)	(111)	0	0	0
Other		0	0	0	0	0	0
Operating Profit		(1,726)	(4,739)	(2,791)	(903)	3,799	6,911
Net Interest		18	75	258	243	340	672
Profit Before Tax (norm)		(796)	(3,223)	(2,419)	(660)	4,139	7,584
Profit Before Tax (FRS 3)		(1,708)	(4,665)	(2,533)	(660)	4,139	7,584
Tax		0	0	0	0	0	0
Profit After Tax (norm)		(796)	(3,399)	(2,418)	(658)	4,141	7,587
Profit After Tax (FRS 3)		(1,708)	(4,665)	(2,533)	(660)	4,139	7,584
		0.0	0.0	0.0	0.0	0.0	0.0
Average Number of ADRs Outstanding (m)		4.1	9.7	12.7	16.3	17.1	17.1
EPADR - normalized (US$)		(0.19)	(0.35)	(0.19)	(0.04)	0.24	0.44
EPADR - (IFRS) (US$)		(0.41)	(0.48)	(0.20)	(0.04)	0.24	0.44
Dividend per share (US$)		0.00	0.00	0.00	0.00	0.00	0.00
		0	0	0	0	0	0
Gross Margin (%)		100.0	80.3	53.8	37.3	43.0	45.9
EBITDA Margin (%)		-7643.6	-17646.0	-136.7	-5.1	11.8	15.9
Operating Margin (before GW and except.) (%)		-7676.0	-17730.2	-139.7	-5.8	11.4	15.5
		0	0	0	0	0	0
BALANCE SHEET		**0**	**0**	**0**	**0**	**0**	**0**
Fixed Assets		1,100	980	1,488	1,657	2,122	2,402
Intangible Assets		410	173	364	362	362	362
Tangible Assets		690	807	1,123	1,295	1,760	2,041
Investments		0	0	0	0	0	0
Current Assets		2,851	8,907	13,449	12,592	17,664	25,728
Stocks		0	2,019	4,920	5,060	6,670	7,480
Debtors		28	54	302	310	669	892
Cash		2,335	5,975	8,013	7,000	10,034	17,029
Other		488	859	215	221	292	327
Current Liabilities		(352)	(677)	(1,485)	(1,460)	(2,858)	(3,619)
Creditors		(352)	(677)	(1,485)	(1,460)	(2,858)	(3,619)
Short term borrowings		0	0	0	0	0	0
Long Term Liabilities		0	0	0	0	0	0
Long term borrowings		0	0	0	0	0	0
Other long term liabilities		0	0	0	0	0	0
Net Assets		3,598	9,210	13,452	12,789	16,928	24,511
		0	0	0	0	0	0
CASH FLOW		**0**	**0**	**0**	**0**	**0**	**0**
Operating Cash Flow		(1,166)	(5,611)	(5,671)	(723)	3,650	7,467
Net Interest		18	75	0	0	0	0
Tax		0	0	0	0	0	0
Capex		(957)	(911)	(275)	(290)	(616)	(471)
Acquisitions/disposals		(180)	0	0	0	0	0
Financing		3,465	10,088	7,984	0	0	0
Dividends		0	0	0	0	0	0
Net Cash Flow		1,181	3,640	2,038	(1,013)	3,034	6,996
Opening net debt/(cash)		(1,154)	(2,335)	(5,975)	(8,013)	(7,000)	(10,034)
HP finance leases initiated		0	0	0	0	0	0
Other		0	0	0	0	(0)	0
Closing net debt/(cash)		(2,335)	(5,975)	(8,013)	(7,000)	(10,034)	(17,029)

Source: Edison Investment Research. Note: Historic results reflect past results prepared under presentation currency of A$ to June 2015 and translated at US$0.725/A$. Presentation currency for financial reporting changed from A$ to US$ from 1 July 2015.

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