PROGRESSIVE EQUITY RESEARCH

8 June 2016

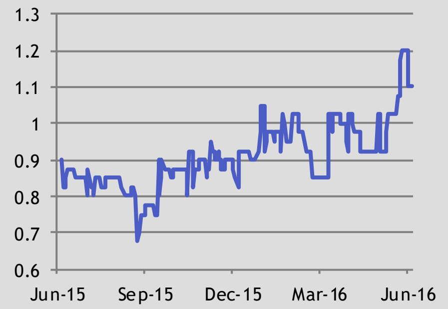
DISTIL BEVERAGES

DIS.L

1.1p

Market Cap: £5.5m

SHARE PRICE (p)



12m high/low	1.2p/0.7p

Source: LSE Data

KEY INFORMATION

Enterprise value	£4.5m
Index/market	FTSE AIM
Next news	AGM - July 16
Gearing	N/A
Interest cover	N/A

DISTIL IS A RESEARCH CLIENT OF PROGRESSIVE

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A year of significant progress in the UK…

…with a substantial reduction in operating loss

FY16 marks a year of major progression for Distil with a substantial increase in turnover and a dramatic reduction in the operating loss, despite a marked step up in brand marketing costs and difficult trading conditions in Eastern Europe continuing to adversely impact sales of Blavod, the black vodka brand. Following its TTB approval, shipments of Blavod have been resumed into the USA, after an absence of several years. RedLeg Spiced Rum achieved a significant breakthrough in the UK, winning listings at two of the Big Four supermarket chains in the UK. These gains contributed to a 350% volume increase for RedLeg in its domestic market. The March placing has further bolstered the balance sheet and introduced the highly regarded Miton investment group to the shareholder list.

- **Prelims results**: Turnover and gross profit rose by 76% and 68% respectively, primarily due to the listing gains at two of the Big Four UK supermarket chains. The company invested in a higher level of advertising and promotion to support top line growth, such that contribution growth was 55% to £401K. With other costs coming in around £100K lower than last year, from savings and efficiencies, the reported pre-tax loss fell by 66% (£191K) to £98K. Net cash at the year-end was £982K after the March placing, which raised £626K gross.
- **Speaking volumes**: Total volumes rose 35%, with RedLeg the star with a 350% increase. Blackwoods Gin were up 3%, led by a 62% increase in UK volumes of the Limited Edition product.
- **TTB approval for RedLeg**: Following the US Alcohol and Tobacco Tax and Trade Bureau (TTB) granting full approval to Blackwoods gins and vodka along with Blavod black vodka in the early months of 2015, the long- and eagerly awaited TTB approval for RedLeg was granted last month. This will allow shipments to the USA ahead of the Christmas period, but it will take time and investment to build the brand in the USA.
- **A year of investment ahead**: FY17's priorities will be increasing distribution for RedLeg and opening new export markets for the brand portfolio – rather than new product development. This will require increased marketing and human resources, as Distil continues to invest in top line growth, with a similar forecast pre-tax loss to FY16.

FYE MAR	2015	2016	2017E	2018E	2019E
Revenue	0.7	1.2	1.5	1.9	2.3
Adjusted EBITDA	**-0.3**	**-0.1**	**-0.1**	**0.1**	**0.3**
Adjusted PBT	-0.3	-0.1	-0.1	0.1	0.3
Adjusted EPS (p)	**-0.1**	**0.0**	**0.0**	**0.0**	**0.1**
EV/Sales (x)	6.8x	3.9x	3.0x	2.4x	2.0x
EV/Adj. EBITDA (x)	n.a.	n.a.	n.a.	76.5x	17.1x
P/E (x)	**n.a.**	**n.a.**	**n.a.**	**92.3x**	**20.8x**

Source: Company Information and Progressive Equity Research estimates

Investing for growth

Summary

FY16 was a transformational year, with listing gains at two of the UK's Big Four supermarket chains

FY16 has in our view been a transformational year for Distil, breaking the £1m revenue threshold for its owned brands for the first time. The stand-out achievement for Distil in our view was winning listings at two of the Big Four UK supermarket chains for its RedLeg Spiced Rum brand, which will raise consumer awareness of the brand to a completely new level.

RedLeg remains the star, high growth brand

RedLeg remains the highest growth brand, delivering sales and volume growth of some 350%. Its growth has been in both the UK and international markets, where it continues to perform strongly in Australia. We estimate that RedLeg must now account for almost half of the group's turnover. The recent granting of TTB approval for sale in the US market is a major boost for RedLeg's long-term global sales potential. Despite increased competition in the maturing UK gin market, the Blackwood's gin family has seen modest volume and revenue growth across the totality of its markets. Blavod has re-commenced shipments back into the US after several years of absence, and despite the difficult macro-economic environment in Eastern Europe, and particularly in Russia and Ukraine, there were also some signs of (relative) recovery for Blavod in Q4.

H2 almost at breakeven

FY16 saw further good progress being made in reducing operating losses, with H2 almost trading at breakeven, delivering a small loss of just £9K.

A portfolio approach to international growth

The principal brand drivers going forward will continue to be the Blackwoods family of gin products and RedLeg Spiced Rum in both international and UK markets, supported by the specialist vodka brands (Blavod, Blackwoods and Diva).

A further step up in A&P costs will see FY17 deliver a similar level of pre-tax loss as FY16

FY17's priorities are firstly to further increase RedLeg's distribution and secondly to open new export markets for the brand portfolio. These will take precedence over (but not preclude) new product development at this stage. These priorities will require increased marketing and human resources, as Distil continues to invest in top line growth, with another substantial step up in advertising & promotion costs. We now forecast a similar level of pre-tax loss to that achieved in FY16.

Placing saw Miton take 10% stake; some further cash depletion forecast for FY17, with inflows thereafter

A further equity placing saw the arrival of respected institutional investor, Miton, on the shareholder list, with a stake of 10%, underpinning the group's cash resources while it develops and extends distribution of its brands. We see no need for further equity placings to support the balance sheet on the basis of our revised forecasts. These see some cash depletion in FY17, with a modest move into the black in FY18, and more substantively in FY19, generating cash inflows for the company.

Key events FY16

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

Key newsflow and company events – FY16

FY16	Event
April '15	Full TTB approval for Blackwoods Limited Edition 60% Gin granted
	RedLeg Spiced Rum obtains major listing with J Sainsbury supermarket chain
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

Source: Distil; Progressive Equity Research

Prelims progress

Second consecutive year of significant loss reduction, with a substantial increase in turnover

FY16 was in effect the second full-year of Distil operating with a pure focus on the development and sale of owned brands. In that context, the financial results delivered in FY16 over FY15 is a true reflection of the progress Distil has made under its new strategic focus. The substantial increase in turnover, accompanied by a significant reduction in the group's operating and pre-tax losses, bear testament to the company's success in changing both the trading and financial models. The cost model and accompanying operating cost ratios continue to evolve, and FY16's considerable improvement at the bottom line was achieved against a backdrop of an almost 90% increase in marketing & promotional costs to £280K. This has of course been instrumental in driving and supporting the top line growth, and we expect a similar pattern for FY17, on which more later when we discuss our forecast revisions.

Pre-tax loss cut by two thirds to £98K……

The following table shows a summary of FY16's P&L results, comparing them with last year. FY16 has in our view been a year of more significant progress than FY15, at both the top and bottom line level. In terms of bottom line progress, Distil delivered a £103K (26%) reduction to £289K in FY15. In FY16, Distil has delivered a £191K (66%) reduction in its pre-tax loss to £98K., some 75% lower than that reported in FY14, which was the final year of operating as a distributor of third party brands as well as developing its owned brands.

….with H2 EBITDA loss of just £8K

The full year result disguises the strength of Distil's performance in H2, achieving an EBITDA loss of just £8K, benefitting from positive operational gearing effects. While the group fell shy of its initial goal of achieving monthly breakeven across the year as a whole, it came pretty close to that goal in H2. We would however caution that further investments in top line growth in FY17 defer attaining that goal until during the course of FY18 within our new forecasts.

Group FY16 profit & loss account

(£'000 unless otherwise stated)	FY15	FY16	Change	% change
Turnover	666	1,169	503	76%
Gross profit	406	681	275	68%
Gross margin (%)	*61%*	*58%*		
Advertising and promotion	-148	-280	-132	-89%
Contribution	**258**	**401**	**143**	**55%**
Contribution margin (%)	*39%*	*34%*		
Employee costs	-305	-297	8	3%
Other administrative costs	-258	-173	85	33%
Depreciation and amortisation	-4	-3	1	25%
Total operating costs	-715	-753	-38	-5%
Other income/(charges)	23	-25	-48	-209%
Operating loss	-286	-97	189	66%
Finance charge	-3	-1	2	67%
Pre-exceptional loss before tax	**-289**	**-98**	**191**	**66%**
Exceptional charge	0	0	0	n.c.
Reported loss before tax	-289	-98	191	66%

Source: Distil; Progressive Equity Research

Underlying gross margin holding up well

The group's gross margin saw a reduction of just under 300bps to 58.3%. However, this is more a reflection of last year, when the gross margin benefitted from a one-off credit to cost of sales. Management describes underlying gross margin as having held up well, despite the backdrop of competitive pricing pressures in the spirits market. Cash gross profit rose for each of the key brands, and most notably for RedLeg given its two significant listing gains in the UK supermarket sector.

The following table shows the development of Distil's owned brands since FY13. It should of course be remembered that Distil was also acting as a distributor of third party brands in FY13 and FY14, but the figures extracted below are on a like for like basis. The FY15 and FY16 figures are in effect the group's ongoing business activities. The % change column shows the movement for FY16 over FY15, with the final columns showing the 2-year and 3-year compound annual growth for selected revenue and cost lines.

FY16 growth metrics dwarf the 3-year CAGR figures

The percentage change increases achieved in FY16, while obviously part of the compound growth figures, dwarf these on all lines, underlining the step change achieved in FY16. While advertising & promotion (A&P) costs rose substantially in cash terms, expressed as a percentage of turnover, this cost to sales ratio only increased by 170bps to 24.0%. Combined with the gross margin change, discussed above, the contribution margin was some 450bps below last year. This still stands at 34%, but more importantly Distil delivered an incremental £143K of cash contribution.

Owned brand development, export sales and customer concentration (£K unless otherwise stated)

	FY13	FY14	FY15	FY16	Ch'ge	3-yr CAGR	2-yr CAGR
Revenue	681	730	665	1169	75.8%	19.7%	17.0%
Gross profit	326	338	406	681	67.7%	27.8%	26.3%
Gross margin (%)	*47.9%*	*46.3%*	*61.1%*	*58.3%*			
A&P costs	-97	-203	-148	-280	89.2%	42.4%	11.3%
A&P (%)	14.2%	27.8%	22.3%	24.0%			
Contribution	229	135	258	401	55.4%	20.5%	43.7%
Contribution margin (%)	*33.6%*	*18.5%*	*38.8%*	*34.3%*			
Export as % of sales	61%	53%	46%	32%			
Export as % of gross profit	65%	68%	51%	38%			
Biggest customer (% of sales)	31%	44%	54%	66%			
2nd biggest customer (% of sales)	11%	20%	8%	n.a.			

Source: Distil; Progressive Equity Research

Export sales have been on a declining mix trend, for several reasons, but………..

The lower part of the table looks at some other metrics relating to Export markets and customer concentration. Looking first at exports, these have been on a declining mix trend across the period. This reflects a number of factors affecting different geographies, often involving changes of distributors or indeed business model. For example, when Distil decided to change the US distributor of the well-established Blavod black vodka brand, this necessitated seeking a renewal of its TTB approval. Similarly, the group's decision to outsource production and distribution of Blavod into Eastern Europe, Russia and Ukraine through the German manufacturer Behn in 2014 saw the trading model move to one of licence income for Distil, rather than acting as a producer and distributor with all the associated costs.

On the customer front, it should be noted that the biggest customer, accounting for two thirds of group sales in FY16, is in fact Distil's appointed UK distributor, Hi-Spirit, through which the vast majority of UK customers are serviced, rather than a single retail customer.

……….grew by over 20% in FY16. Distil is to invest to exploit the attractive potential of international markets

The table below breaks down the owned brand sales between the domestic UK market and export markets, including the gross profit and gross margins achieved. This clearly shows the greater sales growth achieved in the UK market. It should however be noted that after two years of sales declines, export markets delivered an encouraging rate of growth at 21.5% in FY16. They also deliver a higher percentage gross margin, underlining the attractive potential of international markets. This is an area where Distil is looking to invest in further human resources for FY17, in order to seek to exploit the significant international growth opportunities. We have highlighted the growth in the global spirits market along with the trend to premiumisation in previous research notes, both of which Distil is well positioned to exploit, given its brand positioning and the TTB approvals gained over the past 18 months for the US, the world's largest single market for spirits.

Development of owned brands – UK and export markets – FY13 to FY16 (£K unless otherwise stated)							
	FY13	**FY14**	**FY15**	**FY16**	**Change**	**3-yr CAGR**	**2-yr CAGR**
UK sales	266	345	359	797	122.0%	44.3%	32.2%
UK gross profit	114	108	199	422	112.2%	54.7%	57.7%
UK gross margin (%)	43.0%	31.2%	55.4%	53.0%			
	FY13	**FY14**	**FY15**	**FY16**	**Change**	**3-yr CAGR**	**2-yr CAGR**
Export sales	415	385	306	372	21.5%	-3.6%	-1.2%
Export gross profit	212	230	207	259	25.0%	6.9%	4.0%
Export gross margin	51.0%	59.8%	67.7%	69.6%			

Source: Distil; Progressive Equity Research

Administrative costs down 16%, falling from 85% to 40% of sales

Returning to FY16's P&L performance and moving below the contribution line, total administrative costs fell 16% to £470K, tumbling as a percentage of sales from 85% to 40%. Splitting this into the principal components of employee and other administrative costs, we see that it is the latter component that has driven the fall. Employee costs reduced by 3% to £297K, whereas other administrative costs were 33% lower at £173K. This has come in a number of areas, one example being a Head Office move, which resulted in a £33K saving. The total employee costs include redundancy payments (£16K) and share based payments (£29K) in FY16. Excluding these, underlying staff costs decreased by around 17%.

Year-end net cash of £982K post the March share placing

Distil ended the year with net cash of £982K, compared with £511K at the prior year end. This follows the share placing in March, which raised £626K gross and £602K net. The underlying trading activities of the group therefore saw a cash outflow of £131K in FY16. The main gross components of this were the EBITDA loss and a £50K working capital outflow, as the group continues to invest for growth. FY16 saw an inflow from decreasing inventory, although we are forecasting cash outflows, with inventory rising as the company grows further, over our forecast horizon.

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 PBT loss 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

Forecasts revised on basis of management priorities, with similar loss forecast for FY17 as seen in FY16

We have revised our forecasts following the FY16 prelims to take account of management's priorities of increasing distribution for RedLeg and opening new export markets for the brand portfolio – rather than new product development. These initiatives will require increased marketing and human resources, as Distil continues to invest in top line growth. The net result of this delivers a higher level of sales growth than previously forecast but a broadly similar level of pre-tax loss to that achieved in FY16. We then forecast a move into the black in FY18 with a more meaningful EBITDA and PBT delivered in FY19. Our new (rounded) EBITDA and PBT forecasts are (£0.1m), £0.1m and £0.3m.

Sales growth forecasts raised, but predicated on extended distribution in existing markets

As has been our practice, we continue to forecast with a high degree of conservatism. This applies to the all-important turnover line, which is the key driver of the P&L, even though we have increased our growth assumptions. We were previously assuming turnover growth of 20% for both FY17 and FY18. With Distil yet to anniversary or lap its listing within the second supermarket chain, in which it is in more stores than with the first supermarket chain, combined with the recent TTB approval of RedLeg, which should deliver some upside in FY17 and more in FY18, we have raised our sales growth assumptions to 30% in FY17 and 25% in FY18. We initiate our FY19 forecast with an assumption of 20% sales growth. Our forecasts assume no new product launches ie from NPD initiatives over our forecast horizon and no new market entry beyond geographies where distributor arrangements are already in place. We do not preclude this possibility, especially with new human resource investment to open new export markets, but are effectively predicating growth to come from extending distribution and market share gains in existing markets.

Brands driving sales primarily RedLeg and Blackwoods gin family

As discussed in earlier notes, we continue to assume no re-launch revenues for Jago's Vanilla Cream Liqueur across the full three-year forecast horizon. While not formally forecasting for individual brands, we believe revenues from the super-premium Diva vodka line will grow but remain modest, due to its specialised nature and niche appeal. The key brand drivers will continue to be RedLeg and the Blackwoods family of gin products.

Gross margin assumption of 58% over our forecast horizon

We have slightly lowered our gross margin assumption to 58%, in line with that achieved in FY16 in order to be more conservative. Our previous forecasts were predicated on a 60% gross margin. While recognising there could be some further pricing and therefore margin pressure in the UK market, we believe this would be mitigated by a rising sales participation mix of export markets, where gross margins have consistently been higher.

We have raised our A&P costs in particular to reflect ongoing marketing support of the brands

We have raised our overall operating cost forecasts for Distil. The key area of increase is advertising & promotion, where we have assumed another step change in FY17 to £500K, from the £280K in FY16. This is followed by much more modest increases in FY18 and FY19. In contrast, our forecasts for other administrative expenses actually reduce slightly. This primarily reflects the lower achieved cost in FY16 compared with our forecast. The outer year forecasts see modest decreases therefore, even after the assumption of some staff recruitment for Distil's export markets.

Downside risks

We believe that forecast risk remains weighted to the upside, however it would be remiss not to acknowledge potential downside risks. These include distribution de-listings, hikes in excise duties or other applicable taxes and currency fluctuations. Advertising restrictions can also impact on sales of alcoholic beverages, although Distil is not a big above-the-line advertiser.

US regulatory approval delay has pushed back our breakeven forecast into FY17

The delay in obtaining US approvals has had a knock-on impact on the shape of projected turnover growth and also pushed out break-even on a full-year basis until the end of FY17E within our new forecasts, with the group moving into profit in FY18E. Monthly breakeven should be achieved around the middle of FY17E, with the full year result balancing early month losses with later month positive contributions.

No requirement for further equity placings on the basis of our forecasts

On the cash front, following equity placings in both FY15 and FY16, there should be no further need for equity placings to support the balance sheet on the basis of our forecasts. These see some cash depletion in FY17, as the company steps up investment for growth, but the more modest cost increases forecast beyond FY17, in conjunction with operational gearing benefits and our forecast move into the black, should see net cash inflows in FY18 and FY19.

Extended distribution of a largely re-launched product range continues to underpin Distil's medium- and longer-term growth prospects. While the regulatory delays on the US distribution front have been unhelpful, with these now all in place in the world's largest single spirits market, the medium- and longer-term prospects for Distil as a brand incubator remain undiminished in our view.

Our forecasts are summarised on the following Financials page at the back of the note.

SUMMARY FINANCIALS

Year ended March	FY-15A	FY-16A	FY-17E	FY-18E	FY-19E
£m unless stated					
Profit & Loss					
Revenue	**0.67**	**1.17**	**1.52**	**1.90**	**2.28**
Adj EBITDA	-0.28	-0.09	-0.12	0.06	0.26
Adj EBIT	**-0.29**	**-0.10**	**-0.12**	**0.06**	**0.26**
Reported PBT	-0.29	-0.10	-0.12	0.06	0.26
PBT before exceptionals and AAG	-0.29	-0.10	-0.12	0.06	0.26
Fully adj PBT	**-0.29**	**-0.10**	**-0.12**	**0.06**	**0.26**
NOPAT	-0.29	-0.10	-0.12	0.06	0.26
Reported EPS (p)	-0.08	-0.02	-0.02	0.01	0.05
EPS before exceptionals and AAG (p)	-0.08	-0.02	-0.02	0.01	0.05
Fully adj EPS (p)	**-0.08**	**-0.02**	**-0.02**	**0.01**	**0.05**
Dividend per share (p)	0.00	0.00	0.00	0.00	0.00
Cash flow & Balance sheet					
Operating cash flow	-0.37	-0.11	-0.30	-0.04	0.22
Free Cash flow £m	-0.38	-0.12	-0.30	-0.03	0.23
FCF per share p	-0.10	-0.03	-0.06	-0.01	0.05
Acquisitions	-0.02	-0.02	0.00	0.00	0.00
Disposals	0.00	0.00	0.00	0.00	0.00
Shares issued	0.56	0.60	0.00	0.00	0.00
Net cash flow	**0.17**	**0.47**	**-0.30**	**-0.03**	**0.23**
Overdrafts / borrowings	0.00	0.00	0.00	0.00	0.00
Cash & equivalents	**0.51**	**0.98**	**0.68**	**0.65**	**0.87**
Net (Debt)/Cash	**0.51**	**0.98**	**0.68**	**0.65**	**0.87**
NAV and returns					
Net asset value	2.23	2.76	2.64	2.70	2.97
NAV/share (p)	**0.51**	**0.55**	**0.53**	**0.54**	**0.59**
Net Tangible Asset Value	0.72	1.24	1.12	1.18	1.44
NTAV/share (p)	**0.16**	**0.25**	**0.22**	**0.24**	**0.29**
Average equity	2.09	2.50	2.70	2.67	2.84
Post-tax ROE (%)	**-13.8%**	**-3.9%**	**-4.4%**	**2.2%**	**9.3%**
Metrics	**FY-15A**	**FY-16A**	**FY-17E**	**FY-18E**	**FY-19E**
Revenue growth	*-72.3%*	*75.6%*	*30.0%*	*25.0%*	*20.0%*
Adj EBITDA growth	*21.7%*	*66.8%*	*-28.1%*	*-149.1%*	*347.1%*
Adj EBIT growth	*22.1%*	*66.2%*	*-27.0%*	*-145.7%*	*364.4%*
Adj PBT growth	*26.3%*	*66.2%*	*-21.4%*	*-150.1%*	*344.9%*
Adj EPS growth	*26.3%*	*66.2%*	*-21.4%*	*-150.1%*	*344.9%*
Adj EBIT margins	*-43.0%*	*-8.3%*	*-8.1%*	*3.0%*	*11.4%*
Valuation	**FY-15A**	**FY-16A**	**FY-17E**	**FY-18E**	**FY-19E**
EV/Sales	6.8	3.9	3.0	2.4	2.0
EV/EBITDA	(16.0)	(48.1)	(37.6)	76.5	17.1
EV/NOPAT	(15.8)	(46.6)	(36.7)	80.3	17.3
PER	n.a.	n.a.	n.a.	92.3	20.8
FCF yield	-9.2%	-2.4%	-5.5%	-0.6%	4.1%

Source: Company information, Progressive Equity Research estimates

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