

Comvita

RESEARCH INSIGHTS[#]

FY19 — Clearing the Cupboard

Comvita (CVT) delivered an FY19 operating loss, as previously signalled, along with a range of goodwill impairments. Operating earnings declined materially following a third consecutive poor honey season, weak sales growth, and a ramp up in opex. CVT is undertaking a CEO search and comprehensive strategic review — with more details expected at its ASM in October. In the interim, while the stock appears *prima facie* cheap, the past three years have emphasised the high degree of leverage and risk inherent in the business. Until we see any evidence of a turnaround and more insight into the path forward, we would tread carefully.

What's changed?

- Earnings:** EBITDA FY20E/21E lowered -6%.

Key take-outs from FY19 result

- Key markets mixed:** Sales growth over FY19 was mixed in CVT's key markets. ANZ declined -16% as daigou sales slowed due to pricing realignments and Chinese regulatory changes. Europe also lagged as adoption of new MPI standards remains a headwind. Conversely, China performance was solid, and Asia grew strongly with Japan, Korea, and Hong Kong all improving (the Hong Kong protests to impact 1Q20).
- Another poor honey season pressures margins:** FY19 saw CVT's third poor honey harvest, this time with solid yields but sub-par honey quality due to adverse weather and site overcrowding. This led to a sharp decline in gross margin, down c.-400bps to 37%, and drove another operating loss for its Supply business (of -NZ\$6.9m). The Brand business was also pressured, with a ramp up in marketing spend and costs against a decline in sales, driving operating profit down to an -NZ\$0.7m loss.
- Gearing remains elevated:** Debt levels have remained high over FY18/19. Thus, gearing metrics deteriorated significantly in FY19 on lower earnings. CVT reiterated that debt is backing an inventory build which is necessary after several poor honey seasons, and that stored honey increases in value over time. However, we lack visibility into the mix of honey held in inventory, and this exacerbates already material leverage in the business.

Outlook unclear until strategic review reveal

CVT provided no official FY20 guidance, highlighting only that 4Q19 was behind expectations, and that 1Q20 is tracking ahead of the prior year (albeit 1Q is its seasonally slowest quarter). The outlook is made less clear by the board's strategic review underway and the company's pending new executive hires (currently without a permanent CEO or CFO), which we will receive an update on in October. While we recognise CVT appears cheap on headline metrics, particularly for a brand, the stock requires a significant margin of safety given very high operating and financial leverage, poor historic free cash flow and return on capital, and an uncertain outlook.

Investment View

CVT has a leading natural healthcare brand supported by its Manuka Honey operations. It is in the early stages of material strategic change after recent profit pressure, not helped by consecutive weak honey harvests. A streamlined product focus, lowering the apiary risk and greater focus on earnings (rather than revenue) targets makes sense. However, visibility on key targets and the profit trajectory remain limited.

NZX Code	CVT
Share price	NZ\$2.75
Issued shares	45.2m
Market cap	NZ\$124m
Average daily turnover	30.4k (NZ\$133k)

Share Price Performance



Financials: June	19A	20E	21E	22E
NPAT* (NZ\$m)	-7.6	8.3	12.0	15.7
EPS* (NZc)	-16.7	17.9	25.9	34.0
EPS growth* (%)	n/a	n/a	44.6	31.2
DPS (NZc)	0.0	0.0	6.5	8.0
Imputation (%)	100	100	100	100

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	n/a	9.8	8.0	6.7
EV/EBIT	n/a	14.5	10.9	8.7
PE	n/a	15.4	10.6	8.1
Price / NTA	0.9	0.9	0.8	n/a
Cash dividend yield (%)	0.0	0.0	2.4	2.9
Gross dividend yield (%)	0.0	0.0	3.3	4.0

*Historic and forecast numbers based on underlying profits

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Comvita (CVT)		Priced as at 23 Aug 2019: NZ\$2.75					June year end					
Research Insights		Valuation Ratios					2018A	2019A	2020E	2021E	2022E	
Forsyth Barr Research Insights focuses on qualitative rather than quantitative assessments of an equity investment.		EV/EBITDA (x)	11.5	n/a	9.8	8.0	6.7					
We do not provide valuation, target prices or investment ratings for companies in the Research Insights series. It is targeted at selected smaller cap stocks with typically higher risk attributes, or those under transitional coverage.		EV/EBIT (x)	19.2	n/a	14.5	10.9	8.7					
Our earnings and cashflow forecasts, together with key valuation and ratios provided on this page should assist investors in determining the relative valuation merits of the company.		PE (x)	13.4	n/a	15.4	10.6	8.1					
		Price/NTA (x)	0.8	0.9	0.9	0.8	0.7					
		Free cash flow yield (%)	-22.3	3.6	1.7	8.1	6.8					
		Net dividend yield (%)	2.2	0.0	0.0	2.4	2.9					
		Gross dividend yield (%)	3.0	0.0	0.0	3.3	4.0					
		Imputation (%)	100	100	100	100	100					
		Pay-out ratio (%)	29	0	0	25	24					
Profit and Loss Account (NZ\$m)		Capital Structure					2018A	2019A	2020E	2021E	2022E	
Sales revenue	178.5	171.1	217.8	233.1	247.1		Interest cover EBIT (x)	2.9	n/a	3.7	5.7	7.8
Normalised EBITDA	15.5	(2.0)	20.5	25.0	29.8		Interest cover EBITDA (x)	4.8	n/a	5.5	7.8	10.1
Depreciation and amortisation	(6.2)	(6.4)	(6.6)	(6.7)	(6.7)		Net debt/ND+E (%)	32.6	33.9	32.3	28.7	26.2
Normalised EBIT	9.3	(8.5)	13.9	18.3	23.1		Net debt/EBITDA (x)	5.9	n/a	4.2	3.1	2.4
Net interest	(3.2)	(6.1)	(3.8)	(3.2)	(3.0)							
Associate income	1.2	(2.0)	1.0	1.1	1.2							
Tax	(2.9)	3.4	(2.8)	(4.2)	(5.6)							
Minority interests	-	-	-	-	-							
Normalised NPAT	9.3	(7.6)	8.3	12.0	15.7							
Abnormals/other	(3.8)	14.6	-	-	-							
Reported NPAT	8.2	(27.7)	8.3	12.0	15.7							
Normalised EPS (cps)	20.6	(16.7)	17.9	25.9	34.0							
DPS (cps)	6.0	-	-	6.5	8.0							
Growth Rates		Key Ratios					2018A	2019A	2020E	2021E	2022E	
Revenue (%)	14.5	-4.1	27.3	7.1	6.0		Return on assets (%)	2.9	-2.7	4.3	5.6	6.9
EBITDA (%)	87.6	n/a	n/a	21.9	19.2		Return on equity (%)	4.9	-4.4	4.6	6.2	7.7
EBIT (%)	>100	n/a	n/a	31.9	26.2		Return on funds employed (%)	1.3	-2.9	3.4	4.6	5.8
Normalised NPAT (%)	>100	n/a	n/a	44.6	31.2		EBITDA margin (%)	8.7	-1.2	9.4	10.7	12.1
Normalised EPS (%)	>100	n/a	n/a	44.6	31.2		EBIT margin (%)	5.2	-4.9	6.4	7.9	9.4
DPS (%)	>100	-100.0	n/a	n/a	23.6		Capex to sales (%)	3.1	9.7	2.0	1.0	1.0
							Capex to depn + amort (%)	90	260	66	35	37
Cash Flow (NZ\$m)		Operating Performance					2018A	2019A	2020E	2021E	2022E	
EBITDA	15.5	(2.0)	20.5	25.0	29.8		Revenue					
Working capital change	(37.1)	17.3	(7.5)	(5.2)	(10.3)		New Zealand	37	34	33	32	32
Interest & tax paid	(5.5)	(6.3)	(6.6)	(7.4)	(8.6)		Australia	45	36	35	34	33
Other	5.0	12.1	-	-	-		China	12	27	61	71	78
Operating cash flow	(22.1)	21.1	6.5	12.4	10.9		Asia	37	41	45	51	57
Capital expenditure	(5.5)	(16.7)	(4.4)	(2.3)	(2.5)		North America	27	13	22	23	24
(Acquisitions)/divestments	0.5	0.4	-	-	-		Europe	9	6	7	7	7
Other	0.2	(0.1)	-	-	-		Other	12	14	14	15	16
Funding available/(required)	(27.0)	4.7	2.1	10.0	8.4		Total revenue	178	171	218	233	247
Dividends paid	(1.8)	(0.9)	-	(0.9)	(3.5)	Revenue % chg						
Equity raised/(returned)	1.0	0.6	-	-	-	New Zealand	11.9	(8.3)	(3.0)	(2.0)	(2.0)	
Increase/(decrease) in net debt	27.8	(4.4)	(2.1)	(9.1)	(5.0)	Australia	43.0	(21.8)	(3.0)	(2.0)	(2.0)	
Balance Sheet (NZ\$m)		Operating expenses					China	(57.8)	122.4	-	-	-
Working capital	149.4	133.6	136.5	143.4	152.6	Selling and marketing	13.8	12.1	10.0	12.0	12.0	
Fixed assets	47.5	56.9	55.9	53.3	50.8	Administrative	597.7	(50.2)	65.4	5.0	5.0	
Intangibles	33.4	38.7	37.4	35.7	33.9	Europe	17.2	(28.3)	10.0	3.0	3.0	
Other assets	60.4	41.7	47.2	46.6	49.0	Other	(38.4)	19.8	5.0	5.0	5.0	
Total funds employed	290.7	270.9	277.0	279.0	286.3	Total revenue	14.5	(4.1)	27.3	7.1	6.0	
Net debt/(cash)	91.8	88.9	86.8	77.7	72.7	Revenue % chg	(38)	(44)	(46)	(48)	(50)	
Other non current liabilities	9.2	8.6	8.6	8.6	8.6	Selling and marketing	(16)	(20)	(21)	(22)	(22)	
Shareholder's funds	189.7	173.4	181.6	192.7	205.0	Administrative	(8)	(8)	(9)	(9)	(9)	
Minority interests	-	-	-	-	-	Distribution	(3)	(2)	(2)	(2)	(2)	
Total funding sources	290.7	270.9	277.0	279.0	286.3	Research and development	(65)	(74)	(77)	(81)	(83)	

* Forsyth Barr target prices reflect valuation rolled forward at cost of equity less the next 12-months dividend

FY19 result analysis

Figure 1. FY19 result analysis

NZ\$m	FY18	FY19	% chg	
Revenue				
Australia & NZ	82.6	66.6	-15.7%	Daigou sales impacted by regulatory changes and strategic pricing realignment
China	12.1	26.9	122.4%	Consolidated China business sales +14% to NZ\$52m (prior NZ\$46m)
Asia	36.8	41.3	12.1%	Strong growth in Japan, Korea & Hong Kong. Expect impact from Hong Kong protests in 1Q20
North America	26.8	13.4	-50.2%	Due to Costco inventory build in prior year and delay in recommencing purchasing
Europe	8.7	6.2	-28.3%	Weak year; changes have been made which should see improvements in FY20
Other	11.5	13.8	19.8%	
Total revenue	178.5	171.1	-4.1%	
Cost of sales	(105.3)	(107.3)	1.9%	
Gross profit	73.2	63.8	-12.9%	Gross margin 37.3% (pcp 41.0%) – third consecutive poor honey season with lower quality production (poor weather and site overcrowding) & market pressure
Other income	1.1	1.3	17.9%	
Expenses				
Selling and marketing	(37.9)	(43.7)	15.5%	Planned step up in marketing spend
Administration	(16.0)	(19.7)	23.7%	Marked step-up, with limited visibility on drivers
Distribution	(8.1)	(8.4)	3.7%	
R&D	(3.1)	(1.7)	-45.8%	
Total expenses	(65.0)	(73.5)	13.1%	Cost acceleration materially outpaced revenue, with margins squeezed
EBIT (pre abnormalities)	9.3	(8.5)	na	
Abnormal items	3.8	(14.6)	na	NZ\$19.8m goodwill impairment outweighed gain on sale of China JV during consolidation
EBIT	13.1	(23.0)	na	
Net financing cost	(3.2)	(6.1)	92.2%	FX loss vs FX gain in pcp. Higher average net debt to support inventory build
Net profit before tax	9.9	(29.2)	na	
Tax	(2.9)	3.4	na	
Net profit after tax	7.0	(25.8)	na	
Equity acc'd earnings	1.9	0.4	-76.7%	
Impairment of equity acc'd investments	(0.7)	(2.4)	na	Primarily NZ\$2.3m impairment of Putake Group due to poor honey season and MPI definition change
Reported NPAT	8.2	(27.7)	na	
Underlying NPAT	9.3	(7.6)	na	Split between (1) Brand business NZ\$(0.7)m vs. FY18 NZ\$15.5m, (2) Supply business NZ\$(6.9m) vs. FY18 NZ\$(6.2)m
Underlying EPS (cps)	13.7	(20.4)	na	
Dividend (cps)	6.0	0.0	na	As expected given a weak FY19 result and elevated gearing (net debt NZ\$89m)

Source: Company reports, Forsyth Barr analysis

Earnings revisions

We make small downgrades to our near-term revenue forecasts and account for the China JV consolidation. Operating leverage and higher depreciation & interest drives a more material impact to earnings.

We have also lowered our dividend expectations, given CVT's elevated gearing position and while the board works through material strategic change.

Figure 2. Earnings revisions (NZ\$m)

	FY20E			FY21E			FY22E
	Old	New	% chg	Old	New	% chg	New
Revenue	223.5	217.8	-2.6%	241.0	233.1	-3.3%	247.1
EBITDA	21.9	20.5	-6.0%	26.7	25.0	-6.1%	29.8
Normalised NPAT	10.3	8.3	-19.1%	14.5	12.0	-17.1%	15.7
Adjusted EPS (cps)	22.7	17.9	-20.9%	32.0	25.9	-19.0%	34.0
Dividend (cps)	4.5	0.0	na	8.0	6.5	-19.2%	8.0

Source: Forsyth Barr analysis

Investment summary

Comvita (CVT) has a leading natural healthcare brand supported by its Manuka Honey apiary operations. Recent results have seen considerable challenges, not helped by three consecutive poor harvests. This has led to a suite of strategic changes which are still in their infancy. This, combined with high operating and financial leverage, makes CVT a high risk investment. We look for any early signs of progress and greater clarity on the medium-term profit trajectory / opportunity.

Earnings and cash flow outlook

- **Key earnings drivers:** Profit results are driven by (1) Honey harvest — a key driver of supply and quality (which impacts honey grade and thereby price achievement), (2) sales performance across key markets (China, US) and (3) gross margins.
- **Earnings volatility:** Honey supply volatility, due to climatic conditions, has significantly impacted earnings historically. Work has been undertaken to lower the risk for future results, but volatility has remained evident through FY19. New disclosure from FY18 helps to separate apiary earnings ('Supply') and the branded business ('Brand') for investors to more appropriately value CVT.

Business quality

- **Revised strategy:** CVT is in the early stages of strategic changes, with a more streamlined focus on its Manuka Honey and Propolis based products. Detail remains scarce and revised targets / benchmarks have yet to be provided, but we understand it will be more profit-orientated rather than revenue-based.

Financial structure

- **Inventory and gearing:** CVT has elevated gearing metrics following a debt-funded inventory build over FY18 and FY19. While inventory levels cover net debt, it adds financial leverage and risk to an already volatile business.

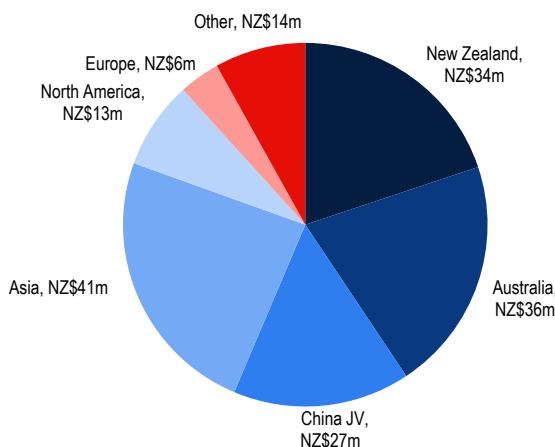
Risks factors

- **Food safety, product quality:** Critical for CVT to maintain its quality reputation and brand value which enables a premium price.
- **Fraud:** Fraudulent Manuka Honey products such as those highlighted in the UK recently have the potential to erode Manuka Honey brand value.

Company description

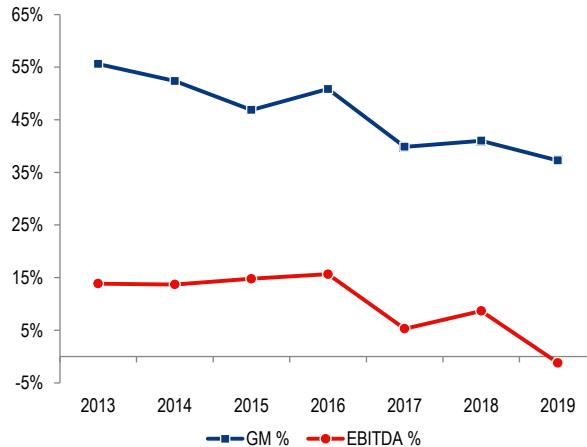
Comvita (CVT) is a vertically integrated natural health product company. It specialises in honey-based products, with a particular focus on Manuka honey. CVT generates sales globally, with Australia, Asia, UK/Europe, and the US amongst key geographies. The company owns or has supply contracts with over 30% of global Manuka honey supply.

Figure 3. Revenue by geography (FY19)



Source: Company reports, Forsyth Barr analysis

Figure 4. Margins over time



Source: Company reports, Forsyth Barr analysis

Figure 5. Substantial Shareholders

Shareholder	Latest Holding
Li Wang	16.8%
Kauri NZ Investment	10.5%
China Resources	10.1%
Hamish Coleman	5.8%

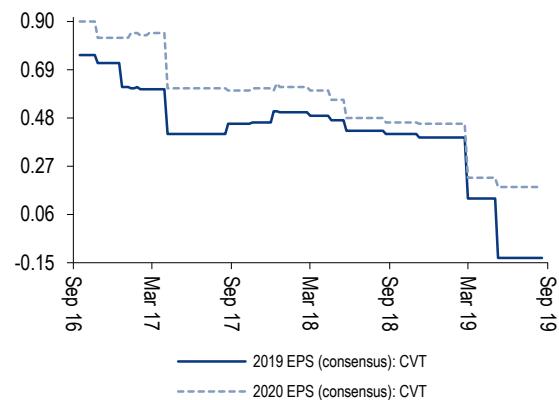
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 6. International Compos

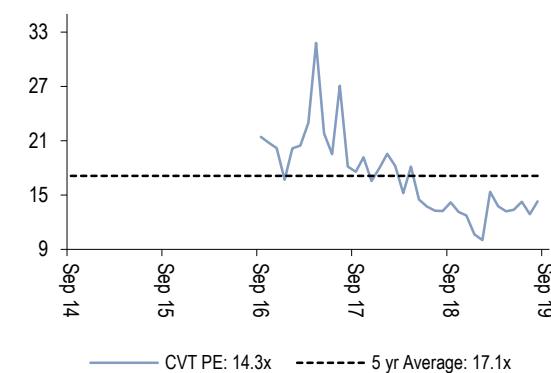
Company (metrics re-weighted to reflect CVT's balance date - June)	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash D/Yld 2021E	
				2020E	2021E	2020E	2021E	2020E	2021E		
Comvita	CVT NZ	NZ\$2.75	NZ\$124	15.4x	10.6x	10.4x	8.5x	15.3x	11.6x	2.4%	
The a2 Milk Company *	ATM NZ	NZ\$14.75	NZ\$10,842	32.2x	24.2x	21.4x	16.1x	21.5x	16.2x	1.2%	
Blackmores	BKL AT	A\$67.44	A\$1,171	21.8x	18.7x	13.2x	11.4x	15.1x	12.8x	3.9%	
Scales *	SCL NZ	NZ\$4.64	NZ\$657	18.1x	16.8x	12.7x	11.9x	15.6x	14.4x	4.2%	
Delegat Group *	DGL NZ	NZ\$11.72	NZ\$1,185	23.0x	19.7x	14.5x	12.8x	17.2x	15.0x	1.7%	
Sanford *	SAN NZ	NZ\$6.87	NZ\$642	13.7x	11.6x	8.0x	6.9x	10.9x	9.4x	3.3%	
New Zealand King Salmon *	NZK NZ	NZ\$2.16	NZ\$299	21.9x	21.7x	11.7x	10.9x	15.6x	15.2x	2.3%	
				Compco Average:	21.8x	18.8x	13.6x	11.7x	16.0x	13.8x	2.8%
				CVT Relative:	-29%	-43%	-24%	-27%	-4%	-16%	-16%

EV = Current Market Cap + Actual Net Debt

Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (CVT) companies fiscal year end

Figure 7. Consensus EPS Momentum


Source: Forsyth Barr analysis

Figure 8. 12 Month Forward PE


Source: Forsyth Barr analysis

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