Australian Vintage 20/03/2018 **FAT-AUS-866**

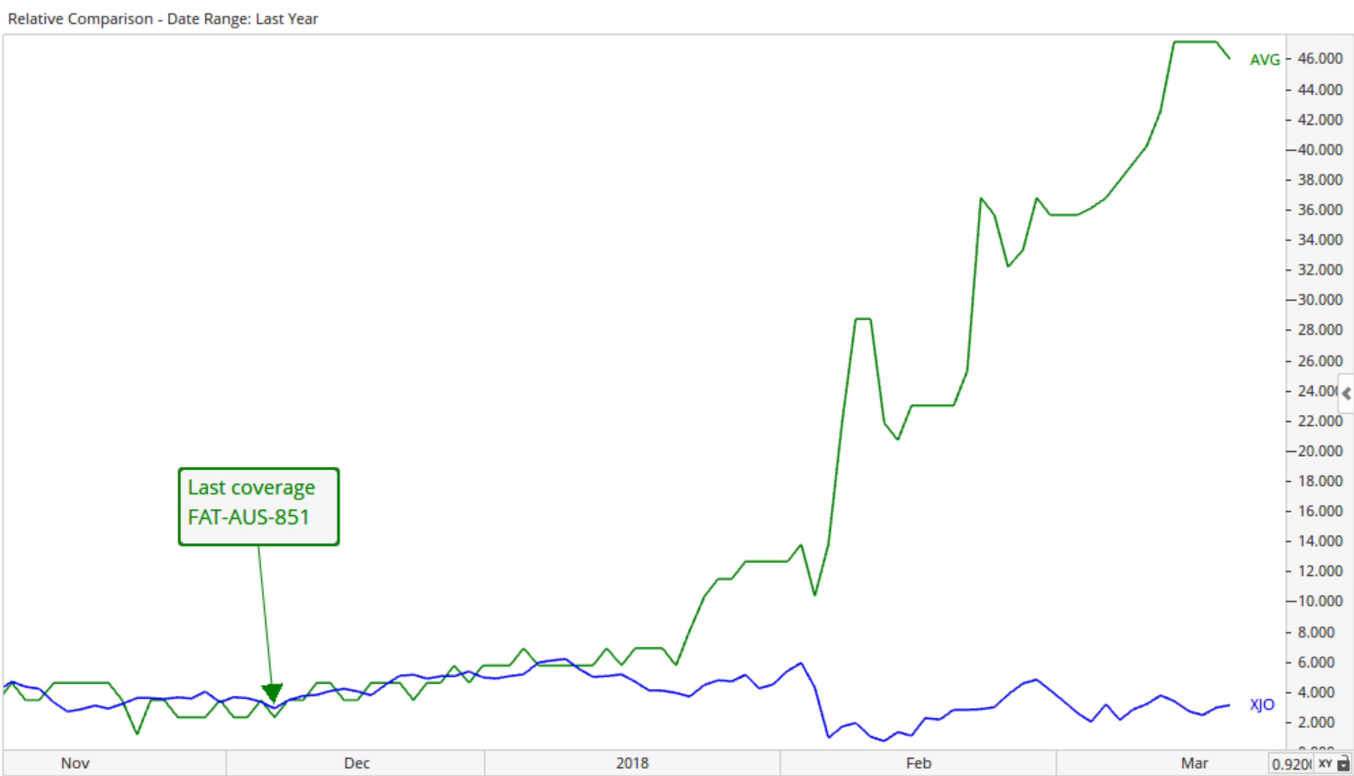
AVG AUD $0.620 Spec. **HIGH** **SH**

Fat Prophets take Profits

Australia's fifth largest winemaker, Australian Vintage (ASX: AVG), recently reported interim results which showed that the company benefitted from an unusually strong harvest domestically amidst weaker global supply. Sales in Europe were particularly strong, though we believe this to be an outlier and that the looming Brexit may reverse these gains. We will closely monitor the developments going forward, **but in the interim we recommend Members take some profits, and sell half their holdings. This will represent a gain of around 55% on our initial recommendation.**

What's New?

The vintner's share price has certainly performed strongly since our last review in December 2017 (FAT-AUS-851), rising around 45% during that time, versus a relatively flat performance for the ASX200. External factors have driven sentiment, along with a solid interim result in February.



Looking at external tailwinds, Australian vintners have benefitted from a particularly difficult season in Europe, with the continent facing an extremely cold spring – along with heavy hailstorms – leading to massive shortfalls in production. The leading wine producers, France, Italy and Spain combined produced 14.5 billion litres of wine, a 16% drop year-on-year and Europe's lowest annual vintage since 1982.Across the Atlantic, the California 2017 wildfire season (April – December) was particularly bad, despite affecting a smaller number of vineyards. According to estimates, between 75% and 90% of the year's vintage was already harvested prior to the wildfires, however, 11 wineries were destroyed which will have significantly impacted the end harvest.

While the actual tonnage lost from the wildfires haven't been disclosed yet, the closest metric on hand comes from California's grape crush report which measures grapes crushed for wine production. The latest count show that red varieties crushed were down 1.4% year-on-year, though this does not include the harvest lost from the smoke damage which may overall be worse year-on-year. Note that California produces over 85% of all US wine so the impact may be worse than initial reports expect.

Combined, this has led to estimates from the International Organisation of Vine and Wine that Global wine production in 2017 hit its lowest level in 56 years, with output expected to be down by 8% to 247 million hectolitres (a hectolitre is the equivalent to 133 standard wine bottles) which implies that there were about 2.9 billion fewer bottles produced. Overall, these are positive signals for the Australian vintages which had a bumper crop given the favourable weather.

Despite the positive developments, we believe that this has already been largely priced in. Australian Vintage's share price also followed the rally of larger rival Treasury Wine Estates which disclosed its earnings figures 3 weeks prior to AVG's. As of now, AVG is trading at a FY18 multiple of 25 times versus the sector median of 20.7 times, a slight premium.

That would be palatable provided that growth can be sustained, however, we have reason to believe that this may be difficult going forward. Note that historically, AVG has a large share of its sales in the UK/Europe region at circa 42%. But the looming Brexit and its negotiation deadline come October 2018 may signal a decline in demand.

In fact, estimates by two Australian economists, Kym Anderson and Glyn Wittwer, point to lower consumption from the UK market. According to the duo, the Brexit will ultimately (by 2025) lead to a 28% decline in sales owing to the devaluation of the GBP. We already saw signs of this during the two years since the referendum, alongside slower-than-usual economic growth which has pushed up costs and simultaneously cut demand.

Management has also indicated that the 2018 vintage (output) will be lower compared to last year's. This is likely due to the unusually strong 2017 vintage while reports from various growers imply a mixed harvest given the fickle spring weather. The looming Brexit, and other issues present an increasingly uncertain environment which we believe, merits some caution, hence our view on taking profits.

With that said we turn towards the results:

1H18 Results Review

Revenues for 1H18 surged ahead 18.1% year-on-year to $140.94 million. Looking at the breakdown of the sales figures, all segments reported year-on-year growth as the business benefitted from weak global supply which was impacted by a mix of events (Europe: adverse weather, US: California Wildfire) as well as prudent execution of the Packaged (branded) strategy.

On that note, **Bulk & Processing (Australasia + North America)** benefitted the most in terms of revenueshaving surged 89.8% year-on-year to $16.64 million though this didn't necessarily translate into higher profit contribution as management took this opportunity to offload inventory not required in future sales.

Source: 21 February 2018 Company Presentation

Contrast with the **Packaged segment** which saw revenues grow 12.6% year-on-year to $114.39 million due to strong growth in Europe which experienced shortages from its worst season.

Breaking this down further across regions and **Australia** sales increased 2.5% year-on-year with branded sales up 2.3% and Bulk sales up 3.4%. The sales mix is also improving as higher margin products, Tempus Two and Nepenthe brands, reported growth of 44% and 35%, respectively. The older McGuigan brand reported flattish sales domestically, however.

Next up, **New Zealand** sales were particularly strong up 49% year-on-year with per capita consumption in alcohol hitting its highest levels since the Sale and Supply of Alcohol Act of 2012 took effect and reversing the weak volume in the year ago period.

This was likely due to the 2017 grape harvest being 9% lower year-on-year at 396k tonnes and the increasing export bent with local producers, leading to possible fears of shortages pushing consumer purchases. This helped the McGuigan brand surge 63% year-on-year.

Sales to **Asia**, on the other hand, grew at a slower than expected pace up 12% year-on-year despite an alliance with YesMyWine. Note that sector sales to China were up 63% year-on-year, implying market share loss.

Nevertheless, management assures that in 2H18 they may make up the expected shortfall in 1H based on the order trends from COFCO, the other major distributor in China, though this isn't entirely conclusive yet.

All in all, revenues from Australasia amounted to $75.06 million, up 17.7% year-on-year.

Following the recent product launch of the McGuigan's "The Plan" and Tempus Two product line, sales in **North America** expanded 23% year-on-year. Momentum, in our view, will likely continue in the region given the California wildfire will lead to shortages in the near term as vineyards are still in recovery mode.

Finally, we take a look at the **UK/Europe**, which is AVG's largest overseas market, historically accounting for circa 42% of revenues. However, more recently, this region's revenue share has hovered below 40% given the unfavourable movements in the GBP since the Brexit referendum back in 2016.

However, the particularly weak Europe vintage led to shortages which in turn raised demand for AVG products, and saw significant growth. Revenues rose 19.5% year-on-year to $56.87 million and now accounts for 40.4% of turnover.

Results Summary ($'000)

	6 Months to		Change	
	31/12/17 $'000	31/12/16 $'000	$'000	%
Australasia / North America Packaged	5,097	4,341	756	17
UK / Europe	4,669	1,043	3,626	348
Cellar Door	1,010	998	12	1
Australasia / North America bulk and processing	(386)	(45)	(341)	(758)
Vineyards	(1,091)	(1,392)	301	22
EBIT	9,299	4,945	4,354	88
Finance costs	(2,900)	(2,627)	(273)	(10)
Interest received	11	7	4	57
Profit Before Tax	6,410	2,325	4,085	176
Tax	(1,977)	(727)	(1,250)	(172)
Net Profit (after tax)	4,433	1,598	2,835	177

Source: 21 February 2018 Company Presentation

Moving on to profitability, **EBIT (Earnings Before Interest and Taxes) saw a significant improvement, up 88% year-on-year to $9.3 million.** This massive surge in year-on-year performance was attributable to UK/Europe growth which contributed 83.3%.

The major detractor, however, was the Bulk business which reported a $386,000 loss as management opted to clear bulk inventories and increase throughput in other Wineries. The Asia segment also detracted from the EBIT as management increased investment in the region to promote sales growth.

All in all, net profit after tax (before one-off items) came in almost 3 times higher at $4.43 million compared to last year's while diluted earnings per share expanded 2.14 times to $1.5 compared to last year's $0.7.

Moving on down, the company's financial position remained sound despite an increase in Finance Costs which were up 10.4% year-on-year to $2.9 million on the back of higher interest rates. Operating cash flows were better ($11m vs $7.8m) while net debt remained flattish at $83 million. Management has also signed an extension for funding to September 2020 and kept net gearing flat at 29%.

Outlook and Takeaways

Going forward, management notes that given the fickle weather and unusual bumper crop last year, 2018 vintage (output) should be lower.

According to management, the residual effects of 2017 shortages, favourable currency exchange (versus GDP) and the price increases may mean that NPAT could end 60% higher from 2017's $4.3 million at $6.88 million, though this growth is slower than we expect and still lower than 2016's NPAT of $7.01 million, a slight disappointment, in our view given, the expansion activities in Asia and unusually strong performance in Europe.

On a more positive note, **the company is making steady progress in its shift from bulk wine to quality-oriented branded products given the solid growth of the Tempus Two (+44% yoy) and Nepenthe (+35% yoy)** though the older McGuigan brand had a more muted growth, up 7% year-on-year. <u>We will continue to monitor the progress going forward especially with looming Brexit negotiations and in the interim we recommend taking profits while we are ahead of the curve</u>.

Turning to the charts and prices in recent months have pushed upward from the long-term uptrend line, and dynamic support. After such a strong rally some consolidation is potentially on the cards, and with overhead resistance around the $0.66 mark.

Australian Vintage Limited - AVG (ASX) - 1 Month CandleStick Chart - AUD

Summary

Australia's fifth largest winemaker, Australian Vintage recently reported interim results which showed that the company benefitted from an unusually strong harvest domestically amidst weaker global supply. Sales in Europe were particularly strong, though we believe this to be an outlier and that the looming Brexit may reverse these gains. We will closely monitor the developments going forward, but in the interim we recommend Members take some profits, and sell half their holdings. This will represent a gain of around 55% on our initial recommendation.

On the valuation front, the company's shares are trading at a price of FY18 multiple of 24 times which, compared to sector multiple of 20.7 times, implies that much growth is already priced in. With that said, **we recommend that Members should take this chance to take profits and SELL HALF their Australian Vintage shares around current prices.**

STV Group, Sylvania Platinum, Tata Motors, Tencent, Tertiary Minerals, Teva Pharamaceutical, Toyota Motor, Tullow Oil, Unilever, Vedanta Resources, Vodafone, Walt Disney, Zillow.

Snapshot AVG

Australian Vintage

Latest Closing Price: $0.62

Australian Vintage Limited is a leading Australian wine company. Championing a fully-integrated wine business model, the breadth of our capabilities extends to vineyards, boutique and bulk wine production, packaging, marketing and distribution. As one of the largest vineyard owners and managers in Australia, with grape supply capacity extends through some of Australia's most captivating and diverse wine regions including the Hunter and Barossa Valleys; the Murray-Darling, Langhorne Creek and Limestone Coast regions; as well as Griffith, Cowra and the Adelaide Hills.

Wines produced by Australian Vintage are recognised and rewarded the world over. The company wine portfolio encompasses both branded, bulk and private label wine, which are distributed in key market around the world.

Market Capitalisation:$173.65M

	FY1	FY2
Price to Earnings	24.4	14.8
Dividend Yield (%)	2.1	3.2
Return on Equity (%)	2.5	4.0
EV/EBITDA	11.1	11.1