Australian Vintage 28/10/2014 **FAT-AUS-696**

AVG AUD $0.400 Special **HIGH** B

Hitting the spot

As evidenced by the company's share price over the past five years, Australian Vintage (ASX, AVG) operates in an industry that is inherently volatile. There are two key reasons for this. The first is that by virtue of being an agricultural producer, the supply of grapes/wine in any given period is determined to a large extent by environmental factors and net new investments, the latter of which typically requires a five-year lead time to supply. The second reason is the emergence of large supermarket chains as a key distribution channel for wine producers, particularly white label brands.

These issues aside, we expect the company's focus on cost control, asset utilisation, and branded sales in export markets to translate to above average earnings growth over the medium-term, with the potential for this to be supplemented by currency tailwinds.

The shares are currently trading on a price to earnings ratio of 8.4 times FY15 earnings and yielding 6.4%, which we believe is undemanding, given the winds of change that may be blowing, operationally.

Accordingly we recommend Australian Vintage as a high risk buy. Members should note the smaller cap nature of the company's shares, with patience to be exercised when buying.

Background

Aussie Vintage's heritage traces back to the McGuigan family who started up some of the country's premier wine brands. The business was supercharged in 2002 with the merger of McGuigan and Simeon Wines to create Australia's fourth largest listed wine business, with six modern wineries, direct management of 3,860 hectares and a production capacity of 127 million litres of wine per annum.

The company's vineyards crush 9 percent of total Australian annual production, and it is also a major wine exporter, shipping cases to 20 countries worldwide.

The company's branded portfolio was further bolstered by the acquisition of Miranda Wines in 2003 and Nepenthe in 2007. The enlarged entity was re-branded as Australian Vintage Limited in 2008. Today Australian Vintage now boasts eight major Australian wine brands.

Source: Australian Vintage

Trading snapshot

While the company's share price has recently rallied around 25% off its 52-week low, it remains comfortably below its five-year high in October 2012. In our view, this is interesting given that since then (i) the broader market (ASX 200) has rallied 19%, thereby outperforming Australian Vintage by 38.6%, and (ii) the company's investment fundamentals have actually improved. This is evidenced by the 49% increase in FY14 net profit despite continued difficult trading conditions, a marked reduction in borrowings, albeit through new equity (rather than internal cash flow).

FY14 result

The key takeaway from Australian Vintage's FY14 result is the strong growth in reported net profit from $7.1m to $10.5m. Encouragingly for investors, this was achieved despite the vintage for the period of 124,000 tonnes (which is about 10% of domestic production) being 19% lower than FY13.

	12 months to		Change	
	30/06/14	30/06/13	$'000	%
Australasia / North America Packaged	7,956	5,214	2,742	53
UK / Europe	3,903	3,350	553	17
Cellar Door	1,213	708	505	71
Australasia / North America bulk and processing	3,384	8,000	(4,616)	(58)
Vineyards	3,237	3,485	(248)	(7)
Total	**19,693**	**20,757**	**(1,064)**	**(5)**
Finance costs	(9,139)	(13,910)	4,771	(34)
Interest received	447	312	135	43
Profit Before Tax	11,001	7,159	3,842	54
Tax	(3,331)	(2,144)	(1,187)	(55)
Net Profit	**7,670**	**5,015**	**2,655**	**53**
Impairment of water licences		(901)	901	(100)
Adjustment to provision for onerous contracts *(note)*	4,106	4,223	(117)	(3)
Tax	(1,232)	(1,267)	35	(3)
Total impairment and provision for onerous contracts adjustments	**2,874**	**2,055**	**819**	**40**
Total Net Profit	**10,544**	**7,070**	**3,474**	**49**
EBIT before impairment and provision for onerous contracts adjustment	19,693	20,757	(1,064)	(5)
EBIT after impairment and provision for onerous contracts adjustment	23,799	24,079	(280)	(1)

Source: Company Presentation

While this put upward pressure on processing margins (i.e. unit costs), the impact was offset by favourable sales mix changes, due to growth in branded sales relative to bulk sales – **global sales for the flagship McGuigan and Tempus brands increased 11%, and 12%, respectively.**

While the company's operating cash flow remains weak (i.e. an outflow), the key drivers of this are expected to subside in FY15. A build-up in inventory is set to stabilise in FY15, and improve in FY16 following the expiry of a number of significant above-market price grower contracts. Also the company is set to enjoy a material decline in interest costs as a result of the recent reduction in borrowings – FY14 interest costs of $8.4m were almost double the gross operating cash flow of $4.3m.

Based on the company's weighted average interest rate of 5.47% for FY14 and debt reduction of around $30 million, this implies an annual interest saving of $1.7 million. In our view, this is reasonably material in the context of the FY14 pre-tax profit of $11 million.

Rosé growth potential

The company's key focus is on growing its branded sales, while at the same time increasing overall exports and reducing costs by optimising asset utilisation and transitioning to less onerous grower contracts as legacy agreements expire. Notwithstanding these initiatives and the recent decline in the AUD, **management expects FY15 net profit to be slightly above FY14,** with further commentary expected at the Annual General Meeting in November 2014.

<u>By virtue of being subject to agricultural risks such as the low 2014 vintage, in our view the key swing factors are the size of the harvest (i.e. the vintage) and the AUD relative to key currencies</u>.

With regards to the latter, we note that Australian Vintage generates around 50% of its annual sales from international markets, with the key regions being the UK, Europe, and the US. With regards to the UK market, it is worth noting that the company's McGuigan brand is ranked as the sixth largest selling still wine in the market.

Geographical Segments

	REVENUE FROM CUSTOMERS	
	2014 $'000	2013 $'000
Australia	107,345	99,091
UK / Europe	87,560	88,847
North America	6,272	7,926
Other	13,576	12,685
	214,753	208,549

The company recently acknowledged this by stating in its 2014 Annual Report that "the wine business is still very tough, and until a significant drop in the dollar occurs, an appropriate return on capital employed will be difficult".

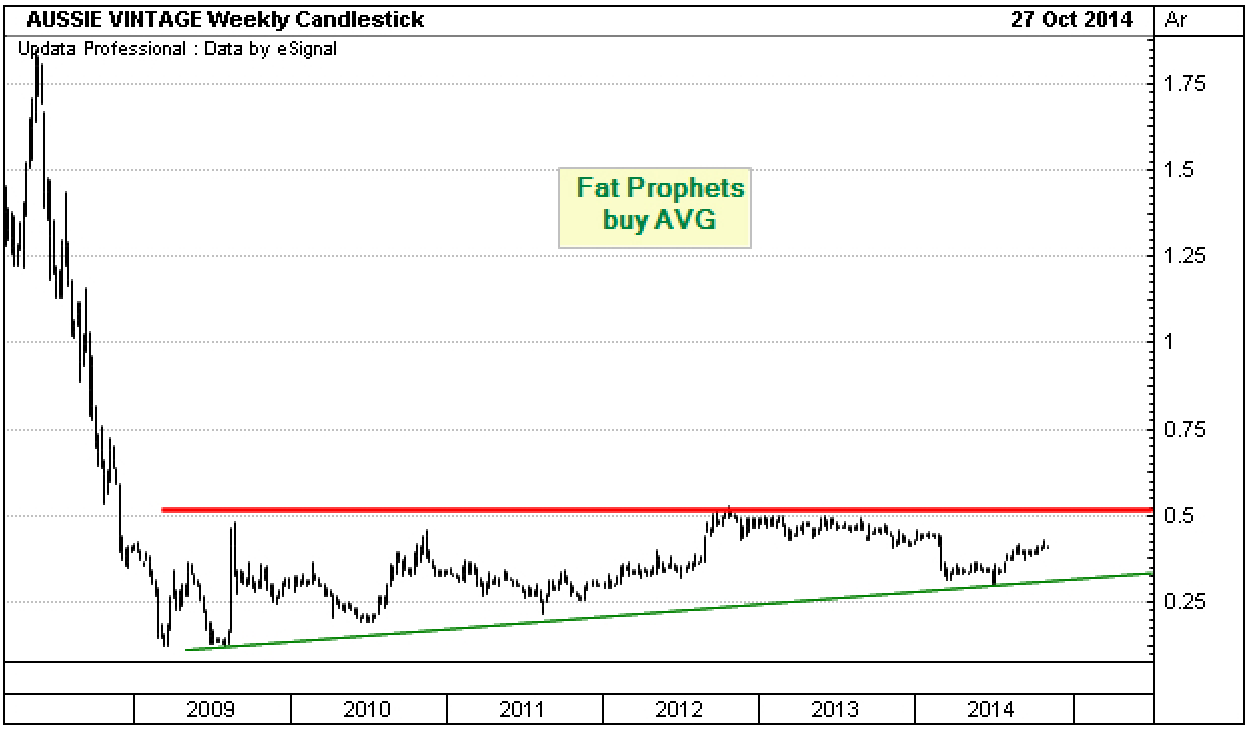
It is our view that both the US dollar and British Pound will appreciate relative to the Australian dollar. This is particularly the case for the latter, based on the view that the UK economy is (i) continuing to recover from the GFC at a reasonable rate, and (ii) should get a boost longer-term from a recovery in the Euro zone.

In addition to the currency thematic, we believe there are three fundamental drivers of the company's medium-term outlook. The first being the likelihood that global wine production and consumption are becoming more balanced – while wine demand in 2012 exceeded production, there was a modest oversupply in 2013.

We are also buoyed by the company's focus on increasing branded sales in export markets. This will be assisted by the recent signing of a long-term distribution agreement with COFCO Wine and Spirits, which will enhance prospects within Asia markets.

We are also encouraged by the recent sale of an underutilised asset, which will bolster returns on capital employed. In July 2014, the company announced that it had reached an agreement to sell its 10,000 tonne Yaldara Winery and the Yaldara brand to 1847 Winery.

Turning to the charts, the share price appears to have begun bottoming out following the eighteen months of a bearish spell. Evidently from a daily chart, the technical outlook started improving following the rotation higher and a decisive break above the 50-day moving average. Furthermore, the subsequent retest of these levels is suggestive of a changing momentum, which bodes well on the overall recovery. Therefore, with the 14-day RSI nearly neutral there is an ample scope for further upside in the near term.



Summary

While the global wine industry continues to face challenges with markets and margins generally under pressure, the company's response to these issues in recent times has been positive, as evidenced by the FY14 results. Having regard for the fact that agricultural companies can be notoriously unpredictable over the short-term, we expect the company's focus on cost control, asset utilisation, and branded sales in export markets to translate to above average earnings growth over the medium-term, with the potential for this to be supplemented by currency tailwinds.

We believe the shares hold significant appeal. This is as the company has recently reduced its borrowings (albeit gearing is still a risk at circa 39% net debt to equity) and the shares currently trade on a price to earnings ratio of 8.4 times FY15 earnings and yield 6.4% (with the dividend covered 1.8 times by prospective earnings). Note that the ex-dividend date is tomorrow, 29 October 2014.

While operating cash flow has been weak over the past several years, we expect improvements to become apparent through FY15, and particularly FY16.

Accordingly we recommend Australian Vintage as a high risk buy. Members should note the smaller cap nature of the company's shares, with patience to be exercised when buying.

Snapshot AVG

Australian Vintage

Latest Closing Price: $0.400

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:$94m

	FY1	FY2
Price to Earnings	8.4375	7.5
Dividend Yield (%)	6.42	6.91
Price to Book	0.22	0.23
Return on Equity (%)	5.5	5.8