Treasury Wine Estates (TWE.AU)

17 August 2021

Sandstone Insights

Spotlight on Penfolds

New strategy to offset China loss

Buy

The change in strategy by Treasury Wine Estates towards a more premium portfolio is logical and is supported by its shift to a divisional model that separates the valuable Penfolds brand. The punitive duty imposed by China can be worked around but will take time to materialise given TWE's previous over-exposure to the country.

The Penfolds division requires no introduction to Australians who know the legendary status of this famous brand range from the super-premium Grange Hermitage through to the more affordable Koonunga Hill and others.

Treasury America includes the Beringer portfolio and some brands that overlap from Australia like Matua and 19 Crimes.

Treasury Premium Brands division houses TWE's other key commercial brands including Wolf Blass, Seppelt, Wynns and Lindeman's among others.

The Penfolds pivot

Penfolds is TWE's jewel in the crown and could be worth around $6 billion based on its global potential and high brand awareness.

China's decision to impose a draconian duty on Australian wine for five years has necessitated a strategic shift. The Chinese Ministry of Commerce released its final determination on 29 March which imposes a 175.6% anti-dumping and countervailing duty rate on TWE's Australian country of origin wine (<2 litres) imported into China. The economic damage was not insignificant to Australia which exported 11% of its total production (1.2bn litres of wine in 2019) to China prior to the change.

Fortunately, TWE is not short of alternate export markets to offset the change and can realistically achieve this. Exports ex China have been growing at 8% pa, domestic sales have been strong due to the pandemic and overseas vintages are likely to be lower across key regions in 2021.

We expect Penfolds EBITS to fall from a peak of $363 million in FY19 to under $300 million by FY23f. Given half its peak EBITS may have come from China, finding a reallocation solution is crucial for future earnings. TWE's marketing strategy has therefore pivoted towards a global focus on consumers, brand, education and luxury.

TWE sees the opportunity in under-penetrated markets where the Penfolds brand awareness is a low 10% in the Americas and 30% in the UK compared to the 50% recognition in Australia. Supply will be expanded with Penfolds style and quality wines made in the US (Napa, California) and France (Bordeaux) but this multi country-of-origin approach is rare and risky.

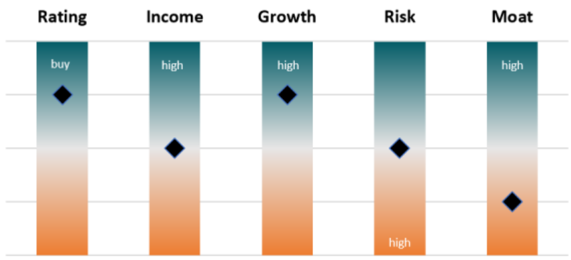
TWE could also delay some sales rather than lower price points to clear inventory as a viable means of redirecting volume away from China. Fortunately, the product will usually get better (and more expensive) with age depending on the vintage.

Penfolds		FY18	FY19	FY20
Volume	m9LE	2.1	2.8	2.5
Net sales revenue	A$m	544.3	816	765.2
NSR/case	A$	255.3	287.3	312.2
EBITS	A$m	225.2	363.3	357.3
margin		41%	45%	47%

Source: TWE

The target for Penfolds EBITS margins is 40-45% including investment to grow its distribution. The elevated marketing spend required may squeeze the margin for some time yet so we would expect outcomes to be at the lower end of that range.

Key Properties



Source: Sandstone Insights

Forecasts

Price: AUD	A$12.25	Mkt Cap:	A$8,805m		
YE June	2019	2020	2021f	2022f	2023f
Revenue	2,883	2,678	2,522	2,381	2,539
EBITDA	766	681	666	688	764
Margin	27%	25%	26%	29%	30%
EBIT	643	492	508	528	604
PBT	599	419	423	448	532
NPAT	478	261	303	319	382
EPS (cps)	0.58	0.44	0.42	0.44	0.53
PE (x)	25.9	23.9	29.2	27.8	23.1
DPS (cps)	0.38	0.28	0.26	0.29	0.35
Div Yield	3.7%	2.3%	2.1%	2.4%	2.8%
Net Debt	746	1,223	1,083	939	847
EV/EBITDA	15.1	12.9	14.8	14.4	12.9
ND/EBITDA	1.0	1.8	1.6	1.4	1.1
	MTD	YTD	YOY		
TWE	2.9%	30.3%	13.4%		
ASX200	3.2%	15.8%	28.7%		

Source: Factset consensus

Share Price

Source: Factset

Less is more in the Americas

Treasury Americas is likely to reset to 8.5-9.0 million annual cases from a peak of 14 million cases in FY19. The mix of business is moving towards premium wines and restructuring its cost base to lift margins towards a sustainable level around 25%.

Divestment leads to premiumisation

In March 2021, TWE entered an agreement with The Wine Group giving TWG a long-term licensing agreement to source and sell several commercial tier brands in the Americas. This will effectively lower TWE's volume but increase its premiumisation and margin from the region. TWE will generate a one-off net cash inflow of at least $300 million as part of the reduction in its commercial wine volumes.

The most positive development for TWE in the Americas is the improvement in industry-wide supply-demand balance following a 26% fall in the 2020 Californian grape harvest compared to the peak in 2018.

Smaller base, lower costs, higher margins

Post divestment, TWE's portfolio will sell around 7.6 million cases with EBITS of about $130 million based on FY20 results which were impacted by COVID-19. Volumes should improve as the US economy recovers but the cost-out program in structural savings and supply chain will be important to generate the margins being targeted. TWE has restructured its operations in the Americas which will save approximately $35 million in FY21f. A second cost-out program to improve the supply chain is expected to save $75 million across the group by FY23f, some of which will flow to the Americas.

Treasury Americas		FY18	FY19	FY20	FY20 pro forma
Volume	m9LE	13.5	13.9	12.3	7.6
NSR	A$m	935.4	1084.4	1014.6	810.8
NSR/case	A$	69.1	78.2	82.6	106.8
EBITS	A$m	188.1	202.5	120.2	130.2
margin		20%	19%	12%	16%

Source: TWE

Treasury Premium Brands

TWE's third division is a large volume, lower margin segment with its two biggest markets in Australia and the UK. The growth outlook is less clear given its large commercial wine portfolio and low return on capital.

Treasury Premium Brands		FY18	FY19	FY20
Volume	m9LE	18.9	18.8	17.6
NSR	A$m	949.2	931.2	869.7
NSR/case	A$	50.2	49.6	49.4
EBITS	A$m	163.6	137.9	78.4
margin		17%	15%	9%

Source: TWE

Investment view

TWE is expecting FY21 EBITS to be in a range of $495-515 million which would be an increase of 33% in 2H21 compared to the same period in FY20 at the mid-point.

Volumes have declined for TWE over the last four years when commercial wines were 45% of sales in FY18 to less than 25% by FY23f. The divestment in the Americas will also see revenue decline and of course, the loss of Chinese sales will linger.

TWE's focus on premium wine brands and broader distribution, supported by more marketing, will create an earnings challenge for a company that is aiming for higher EBITS margins.

The greater focus on Penfolds offers upside in the share price after the disruption from China and the opportunity to lift the brand in the Americas and Europe. Penfolds is worth around 60% of the company's valuation so improvements in this division will be important.

As with any wine company there are plenty of earnings risks from market competition to currency and tariffs as well as production issues (weather, vintage).

Penfolds is the biggest value driver

After a difficult 18 months, we think earnings can stabilise and the greater focus on Penfolds can deliver a valuation re-rate in time.

We begin our coverage of TWE with a Buy recommendation.

Disclosures

Risk Statement	Sandstone Insights outlines that the securities and industries covered in this report, are exposed to broader risks associated with operational, competition, economic, and political factors. Sandstone Insights points out, that these factors carry ongoing risk of change and variation, which cannot be accurately forecast or anticipated in all instances. These risks apply to both earnings forecasts and target price. The price and value of investments mentioned and any income that might accrue could fall or rise or fluctuate. Past performance is not a guide to future performance
Analyst Declaration	This report has been prepared in an independent manner. In uploading the report to the Sandstone Insights webpage, the analysts certify that the views and opinions expressed within this report accurately represent their personal views on the subject matter and securities covered in this report. The analysts have not received direct or indirect compensation related to the views or recommendations contained herein.
Conflict Policy	Sandstone Insights research is published in accordance with our conflict management policy which is available at our website

General Disclaimer

Information	The information and opinions contained within Sandstone Insights Research were prepared by MST Financial Services Pty Ltd (ABN 54 617 475 180, AFSL 500557) ("us", "our" or "**we**").
Distribution	Sandstone Insights Research is distributed only as may be permitted by law. It is not intended for distribution or use by any person or entity located in a jurisdiction where distribution, publication, availability or use would be prohibited. We make no claim that Sandstone Insights Research content may be lawfully viewed or accessed outside of Australia. Access to Sandstone Insights Research content may not be legal for certain persons and in certain jurisdictions. If you access this service or content from outside of Australia, you are responsible for compliance with the laws of your jurisdiction and/or the jurisdiction of the third party receiving such content. Sandstone Insights Research is provided to our clients through our proprietary research portal and distributed electronically by us to its Sandstone Insights clients. Some Sandstone Insights Research products may also be made available to its clients via third party vendors or distributed through alternative electronic means as a convenience. Such alternative distribution methods are at our discretion.
Access and Use	Any access to or use of Sandstone Insights Research is subject to the Terms and Conditions of Sandstone Insights Research. By accessing or using Sandstone Insights Research you hereby agree to be bound by our Terms and Conditions and hereby liable for any monies due in payment of accessing this service. In addition you consent to us collecting and using your personal data (including cookies) in accordance with our Privacy Policy (https://mstfinancial.com.au/privacy-policy/), including for the purpose of a) setting your preferences and b) collecting readership data so we may deliver an improved and personalised service to you. If you do not agree to our Terms and Conditions and/or if you do not wish to consent to our use of your personal data, please do not access this service.
Other Important Disclosures	Sandstone Insights Research is not intended, nor does it constitute a representation that an investment strategy or recommendation is suitable or appropriate for an investors individual circumstances. Sandstone Insights Research may not it be construed as personal advice or recommendation. We encourage investors to seek independent financial advice regarding the suitability of investments for their individual circumstances and recommends that investments be independently evaluated. Investments involve risks and the value of any investment or income may go down as well as up. Investors may not get back the full amount invested. Past performance is not indicative of future performance, and no representation or warranty, express or implied, is made regarding future performance. Estimates of future performance are based on assumptions that may not be realised. If provided, and unless otherwise stated, the closing price provided is that of the primary exchange for the issuer's securities or investments. Information, opinions and estimates contained in this report reflect a judgment at its original date of publication and are subject to change without notice. The price, value of and income from any of the securities or financial instruments mentioned in this report can fall as well as rise. The value of securities and financial instruments is subject to exchange rate fluctuation that may have a positive or adverse effect on the price or income of such securities or financial instruments. We assume no obligation to update this document or correct any inaccuracy which may become apparent after it is given. The information contained within Sandstone Insights Research is published solely for information purposes and is not a solicitation or offer to buy or sell any financial instrument or participate in any trading or investment strategy. Analysis contained within Sandstone Insights Research publications is based upon publicly available information and may include numerous assumptions. Investors should be aware that different assumptions can and do result in materially different results. Whilst we makes every effort to use reliable, comprehensive information in the construction of its reports, we make no representative, warranty or undertaking of the accuracy, timeliness or completeness of information provided to it by third party providers. Save for any statutory liability that cannot be excluded, we and our employees, representative and agents shall not be liable (whether in negligence or otherwise) for any error or inaccuracy in, or omission from, this advice or any resulting loss suffered by the recipient or any other person. Coverage by Sandstone Insights Research, including whether to initiate, update or cease coverage of an issuer or sector, is at the sole discretion of the Analyst providing the service. Sandstone Insights Research personnel may participate in issuer events such as site visits and are prohibited from accepting payment by the issuer of associated expenses unless pre-authorised by us. The research analysts principally responsible for the preparation of Sandstone Insights Research have received compensation based upon direct client contracting. For important stock specific disclosures, stock price charts and equity rating histories, please see our website.
Copyright	Copyright of the information contained within Sandstone Insights Research (including trademarks and service marks) are the property of their respective owners. Sandstone Insights Research, or any portion thereof, may not be reprinted, sold or redistributed without the prior and written consent of us.