

The Artisanal Spirits Company



Unique heritage and global opportunity

16 September 2021

The Artisanal Spirits Company, through its ownership of the Scotch Malt Whisky Society is well positioned to enjoy sustainable growth. The company boasts growing membership numbers, rising spend per member and a unique approach to sourcing some of the world's most cherished super-premium malt whiskies. In our view, these qualities are not reflected in the current share price which implies scope for a re-rating of the shares as the growth proposition becomes better understood.

Artisanal Spirits released interim 2021 results today which reported a 31% increase in gross profits to £5.1m and a sharp increase in gross margin from 59% to 65%. Moreover, there was a 24% increase in adjusted EBITDA to £0.2m. A 20% increase in first half sales was already announced in the company's interim trading statement, published on 19th July 2021.

The investment case for Artisanal Spirits Company (ASC) is high quality and sustainable growth. The company's Scotch Malt Whisky Society (SMWS) membership model keeps it in constant touch with its core customer base, which grew to **29,400 members by end-August** 2021 H1 after a 5% compound annual growth rate in the previous 4 years. Implied revenue growth per member in H1 was close to 20%. Membership is central to SMWS as an organisation.

A sizable total addressable Scotch whisky market of around **US\$4.2bn** suggests substantial headroom for the company to grow its business. ASC estimates that SMWS's current global market share is minimal at only around 0.4% in 2019 with a 1.1% share in the UK. Importantly, SMWS only operates in super-premium products which is the fastest growing part of the market.

ASC is already a high gross margin business and appears likely to become more so. The company is confident it can increase gross margins in the next decade from their current year expected 63% level to nearer **70%** as the cost of its purchases of whisky stock drop by around £2 per bottle. In our view gross margin strength should offset investor concerns about the current lack of bottom-line profitability. Moreover, EBITDA was positive in H1. SMWS enjoys a substantial asset backing in terms of maturing whisky stock. The company estimates that on 31st August 2021 the realisable retail value of its inventory of in-cask super premium whisky is of the order of £350m. We think investors should note the value of these Scotch whisky assets in the context of the current ASC market capitalisation.

Material undervaluation

We conclude that a fair value for The Artisanal Spirits Company is 150p / share based on relative value analysis covering not only EV/sales, but also comparative gross margins.

Summary financials							
Year to 31st December	2019A	2020A	2021E	2022E	2023E	2024E	2025E
Revenue (£m)	14.6	15.0	17.5	21.6	24.8	28.6	32.7
Revenue growth (%)	20.6	2.6	16.5	23.2	15.1	15.3	14.2
EV/sales (x)	4.5	4.4	3.8	3.1	2.7	2.3	2.0

Source: ED estimates, company historic data

Company Data

EPIC	ART
Price (last close)	81p
52 weeks Hi/Lo	122p/80p
Market cap	£56m
ED Fair Value/share	150p

Share price since IPO, p



Source: ADVFN

Description

SMWS is focused on providing premium single cask spirits. With an average whisky cask yielding around 250 bottles each time, each release is by its very nature a limited edition with exclusive characteristics.

The Group's objective is to bring together spirits from some of the world's best spirits producers, add value by managing the maturation process and provide exclusive access to a vast and unique range of outstanding single cask Scotch malt whisky and other spirits to The Scotch Malt Whisky Society's global membership.

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Interim results announcement

ASC announced interim 2021 results which confirmed the sales growth figures that were included in the company's trading update released on 19th July 2021. Key announcements included a **31% increase in gross profits** and a **24% rise in EBITDA**. Moreover, after-tax losses of £1.1m in 2021 H1 represented a slight improvement versus management's expectations at the time of the June 2021 IPO.

The company's net debt position benefited from the £15m raised at the time of its IPO to support the company's growth strategy. Indeed, by the end of August the company had already **invested £2m in new Scotch whisky stocks** to raise its inventory of casks. We highlight the benefits of such investment later in this report.

Figure 1: 2021 Interim results - financial highlights

6m to end June, £m	2020 H1	2021 H1	Change
Total sales	6.6	7.9	20%
Gross profit	3.9	5.1	31%
Gross margin	59%	65%	6ppt
Adjusted gross profit	4.3	5.1	20%
Adjusted gross margin	65%	65%	-
EBITDA - adjusted	0.0	0.2	24%
Net debt	-13.7	-1.9	20%

Source: Company

International Scotch Malt Whisky Society membership numbers, which include some of the company's highest spend per member jurisdictions, rose by a useful 4% in the first half and more than offset a 2% domestic decline to generate overall 1% growth. Moreover, the year-to-date August number for the UK is +2% and its numbers now stand 9% above their Q1 low point.

It should be noted that a significant component of UK membership recruitment comes via the company's physical venues, which suffered Covid-19 related closures. Indeed, membership growth has accelerated materially at the start of the second half, with now a 4% advance in overall membership recorded in the first 8 months of the year.

Figure 2: 2021 Interim results - operational highlights

6m to end June, £'000s	2020 H1	2021 H1	Change
UK members	13.7	13.4	-2%
International members	14.6	15.3	4%
Total members	28.3	28.7	1%

Source: Company

Outlook

In terms of the full year, the company reiterated its confidence in its ability to meet market expectations for 2021, citing growing demand and trading momentum in international markets as well as a continuation of strong progressive recovery in UK venue activity and events.

Investment case

The simple investment case for ASC is brisk, sustainable growth in both sales and gross profits.

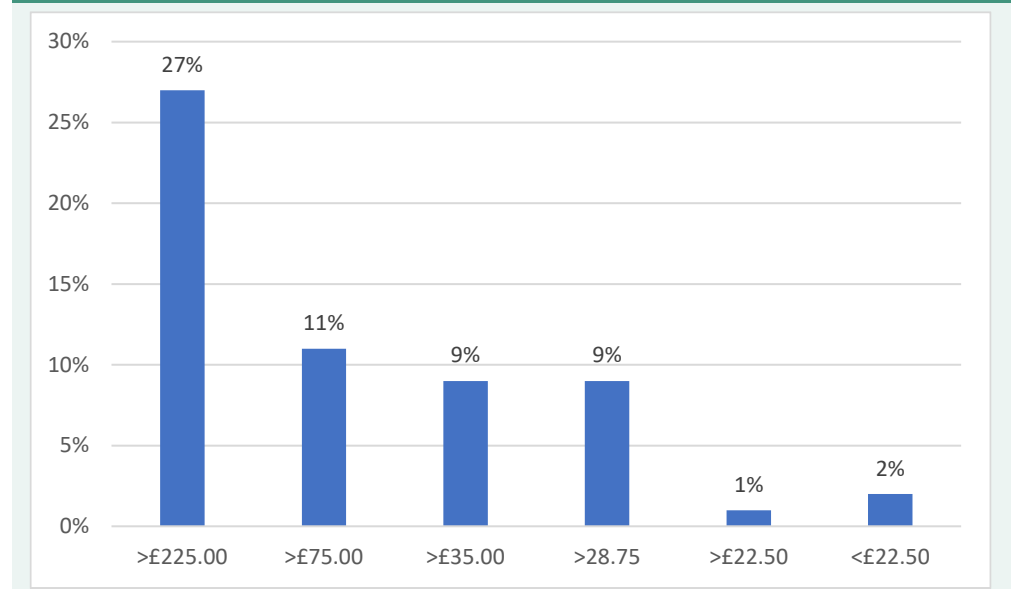
This growth is fuelled by three important metrics: growth in membership numbers, increases in average spend per member and the potential to expand gross margins significantly. The long-term implications for both bottom line profitability and free cash flow are clearly positive.

ASC's core asset is the Scotch Malt Whisky Society (SMWS) which markets bottles of premium single cask Scotch malt whisky to its expanding membership base, currently 28,700 individuals. Membership growth is driven not only by the company's effective marketing, but also by an observable desire for distilled spirits drinkers to substitute volume consumption with higher quality – '**premiumisation**'. Members are central to the business.

The "drink less but better" mantra is central to sustainable growth in average spend by member. Scotch malt whisky is a unique asset within distilled spirits, not just due to the size of the Scotch whisky market overall, but in how it lends itself to connoisseurship and the pursuit of variety. The SMWS offering goes one step further because all its bottles are derived from single, unique casks of Scotch malt whisky. **The SMWS brand is synonymous a high degree of selectivity and prestige for its membership.**

Despite the age and tradition of Scotch whisky, ASC is a modern business with a heavy **online focus**. The company's members receive their communication updates, including the SMWS monthly magazine, virtually and order via the company's website.

Figure 3: Scotch whisky sales growth by price point (CAGR) 2010 to 2019



Source: IWSR

Furthermore, ASC is a global business. The company's online presence enables it to distribute its products internationally with material and growing presences in China, Japan, the USA and Continental Europe, all of which benefit from its firm domestic foothold in the UK. International should provide an opportunity for new product lines to develop – potentially American whiskey.

ASC is a capital-light business, which has positive financial implications for both returns on assets and free cash flow. In particular, the company does not distil – i.e. manufacture - any Scotch whisky itself. Rather, it sources single casks of malt whisky which it identifies and purchases before taking direct control of the maturation process. Bottling and distribution are also outsourced.

ASC owns a substantial amount of maturing malt whisky stock, a product which consistently sees demand outstrip supply.

While such inventory is necessarily under accounting standards valued at the lower of cost and net realisable value, the true value of the company's maturing Scotch whisky stocks should be noted. Right now, the potential net of duty retail value of ASC's inventory considerably exceeds its stockmarket capitalisation. The company estimates that on 31st August 2021 the retail value – i.e. including duty - of SMWS's maturing stock to be **£350m**, which would generate around **£220m in gross profit**.

Margin accretion should be a further feature of ASC's business performance in coming years. As the company grows it will be able to purchase casks for a lower price - with the direct result that gross margins will expand. Based on our calculations an increase from around 60% to closer to 70% is feasible within the current decade.

Financial forecasts support a robust investment case. We project healthy revenue growth not only by extrapolating recent trends in membership from the 29,400 end August 2021 figure, but also by factoring in premiumisation. Moreover, the quality of that growth is enhanced by online and international markets.

In our view the current fair value for ASC's shares is significantly higher than the current share price. Relative valuation metrics fail to reflect the company's unique business model and its status as a high gross margin play on premiumisation internationally. This report argues that fair value for ASC is 150p per share.

Figure 4: The Scotch Malt Whisky Society at work



Source: [Artisanal Spirits Company Admissions Document June 2021](#)

Unique heritage and global opportunity

Overview

While the holding company is relatively young and recently listed on AIM, the core business has been in place since 1983 and prospering for almost 40 years. Ongoing revenue and profit growth should be delivered by a combination of a sizable addressable market, premiumisation or trading up, online marketing, further international expansion, and margin accretion. Moreover, the business is underpinned by a sizable membership base of almost 30,000 and substantial stocks of maturing whisky.

This report outlines the history of ASC and SMWS as well as briefly looking at the evolution of Scotch whisky as an industry. We discuss the core online premium whisky business model in detail before analysing the expansive total addressable market and its implications for brisk sales revenue growth for ASC. In addition, we look at the business and its margin model in detail as well as the depth and relevant experience of the senior management team. Valuation and financials are covered off in a separate section.

The central message is growth in terms of sales revenue, profitability, and cash generation - which in our view are not currently captured in the group's stockmarket valuation.

Scotch Malt Whisky Society – aspirational spirits online

About SMWS

The Scotch Malt Whisky Society is ASC's core business activity as well as being its flagship brand. The division's core competence is the delivery of premium single cask malt whiskies online exclusively to its members, who pay an annual subscription currently priced at £65 in the UK (with attractive discounts available for shareholders in ASC). Membership numbers since 2016 have grown at a compound annual rate of around 7%.

The SMWS was founded in 1983 by malt whisky enthusiast Philip "Pip" Hills who had gained some experience of forming syndicates, starting with a group of close acquaintances, to purchase single casks of malt whisky for maturation and bottling. He later made the decision to broaden the process by forming a membership group, which had its first premises in the Vaults in Leith, Edinburgh.

The SMWS was acquired by malt whisky distiller Glenmorangie in 2004, which was itself taken over by international luxury goods and drinks company LVMH in the same year. Having been taken private in 2015, SMWS returned to public ownership with the flotation of Artisanal Spirits in 2021. SMWS is a 30-year strong business with membership at its core. Its owner ASC was listed publicly on AIM on 4th June 2021.

About whisky

Whisky – frequently spelt "whiskey" outside of the UK – **is the most consumed of the major distilled spirits categories in the world by value.** Excluding duty free, Scotch whisky sales at retail were estimated to be **US\$27bn** in 2019, out of a total spirits spend of **US\$74bn**.

In essence, whisky is a beer which has been distilled twice and aged in a wooden cask for a minimum period of time. The name derives from the gaelic *uisge beatha* which means "water of life." A Scotch whisky which is made purely from a brew of malted (germinated) barley is referred to as a malt whisky and, if from one distillery only, **single malt**.

Commercially the most common form of whisky is blended whiskies, which include some of the best-known retail brands for the product such as Bell's, Famous Grouse, Grant's, Johnnie Walker and Teacher's. Typically, these brands are marketed with the support of heavy advertising campaigns. Moreover, the brand owners go to great lengths to ensure that all bottles carry an identical flavour.

In recent decades malt whiskies have become more popular. In contrast to blended whiskies, which include aged, distilled spirits made out of grains other than malted barleys, malt whiskies are made purely from malted barley. Moreover, their output is linked to one specific distillery with some of the best-known names being Glenfiddich, Glenlivet, Glenmorangie and Macallan. Again, the aim is to produce a consistent flavour in all bottles and as with blended whiskies the better known of these products are also marketed with significant brand marketing campaigns.

Importantly, commercially marketed malt whiskies – no matter how premium priced they are – are sold as blends which, while the product of single distilleries, contain whiskies from different casks. Moreover, they may contain whiskies of different maturity so long as all the liquid inside the bottle has been cask matured for at least the number of years displayed on the label. The aim for even these malts is flavour consistency.

The SMWS difference

SMWS's products are markedly different from other whiskies because their bottles not only contain liquid from one distillery but also from one single cask. Furthermore, in contrast to whiskies (both blended and malt) which have been blended by experts always to ensure the same taste experience, each of SMWS's whiskies has its own distinct flavour. A flavour which is limited solely to the roughly 250 bottles extracted from each cask.

SMWS sources its whiskies from around 100 Scotch whisky distilleries out of a total number of 130 active malt whisky distilleries (estimated by the [Scotch Whisky Association](#)). The company identifies leading distilleries and is actively involved in the process of specific cask selection. Once the company has identified a cask to be purchased it takes **full control** of the ageing process and subsequently the bottling of that cask.

The SMWS brand

The singularity of the SMWS offering and its unique selling proposition of the company through its scale and first mover advantage supports our belief that **ASC is a brand in its own right**. Moreover, the franchise is significantly supported through both its membership communications and specialist venues rather than traditional forms of “above the line” advertising.

As a result of consumer recognition of the SMWS brand, the company can offer its single cask malt whiskies to its members on an anonymous basis. While the bottles themselves are coded to allow identification of the relevant distillery, bottling year and cask number, no further information is given. The reasoning behind this distillery anonymity is to avoid prejudicing members appreciation of the distinct products ahead of them initially being sampled.

Investors should be fully aware of what this ability to market effectively **anonymous products at premium prices** implies for the strength of the SMWS brand itself. SMWS's product stewardship contributes materially to the ability to secure premium prices for its whiskies. This should be recognised as having significant goodwill value.

SMWS enhances this value by providing an illustrated guide to flavour profiling for its products, which are colour coded for key taste markers which we illustrate in Figure 5. The company's membership places trust in the company to accurately categorise its single malt whiskies in accordance with key tasting markers. The members can learn even more about the whiskies by attending the company's venues and purchasing tasting packs. However, it is important to remember that each cask is unique. Once all bottles have been sold, that particular whisky's distinct characteristics can never be reproduced.

Figure 5: SMWS Flavour profiling



Source: Company

Selling into a sizable addressable market

The establishment of a sizable and growing addressable market is a core component of the investment case for a growth company. A simple statistical analysis of SMWS's addressable markets suggests not only substantial headroom for domestic growth but also significant international potential.

Whisky data in the raw

In its [Admission Document](#), ASC estimated the global market for Scotch whisky to be US\$4.2 billion based on IWSR published data. The company's SMWS was therefore estimated to have an overall market share of just 0.4%. The most evolved market is the United Kingdom where it currently estimates its market share to be 1.1%.

Internationally, there is clear scope to grow the business into a sizable addressable market. In particular, while the company is also nearing a 1.0% share in China, its current position in key markets such as France and the United States is fairly minimal.

The position is summarised in Figure 6. With reference to the data, we emphasise that the company's definition of addressable market is tightly defined. It refers to Scotch whisky only, ultra premium and above price points and only those markets where SMWS already has a presence. Moreover, these are the domestic markets and as such exclude duty free.

Figure 6: Global addressable market (GAM)				
	GAM	GAM Growth rate	SMWS sales (whisky)	SMWS market share
All figures in US\$m	2019	2010 to 2019	2020	
United States	1502	323%	3.1	0.2%
Taiwan	424	116%	0.3	0.1%
China	412	120%	3.8	0.9%
UK	327	157%	3.7	1.1%
Germany	156	239%	0.9	0.6%
Japan	147	158%	0.9	0.6%
Australia	140	354%	0.7	0.5%
France	113	81%	0.2	0.2%
Top 8 markets	3222	203%	13.4	0.4%
Other current markets	604	206%	2.0	0.3%
Top current markets	3826	204%	15.4	0.4%
Markets within reach	397	190%	-	0.0%
Total addressable market	4222	202%	15.4	0.4%

Source: IWSR Database, Company

In addition to the available market headroom, the data reveal **significant growth in the past decade for Scotch whisky**. So, investors should note the benefit not only of having a share of one percent of a total addressable market, but also one that is growing at a rapid pace.

The implied annual compound growth rate of a 202% increase is mid-teens %, which is unusually rapid by fast moving consumer goods company standards, especially for one with a heavy orientation towards mature markets.

The importance of trading up

Importantly, raw Scotch whisky market data fail to capture the importance of trading up.

While the overall market for Scotch whisky might be growing at a brisk pace it is the premium and super-premium categories of the product which are growing fastest. Furthermore, ASC through SMWS operates in the discrete super premium category of single cask malt whiskies.

The growth implications should be clear. We illustrate the significantly faster growth of super-premium products in Figure 7. What is striking is that in an overall market where the past decade experienced 4% overall growth in the whisky market and standard Scotch grew at a 2% pace, super premium advanced at a 27% pace.

SMWS is clearly positioned in by far the fastest growing segment of the world whisky market.

Figure 7: Global Scotch Whisky market by price band

Segment	£/70cl bottle	Market size 2019 (US\$bn)	CAGR (2010 to 2019)
Prestige-Plus	225.00+	0.7	27%
Prestige	75.00 to 224.99	1.1	11%
Ultra-Premium	35.00 to 74.99	3.8	9%
Subtotal, Ultra-Premium+		5.5	10%
Super-Premium	28.75 to 34.99	3.2	9%
Premium	22.50 to 28.74	5.0	1%
Standard and below	Up to 22.49	12.9	2%
Total		26.7	4%

Source: IWSR

International and the online model

The presence and brisk growth of international markets in the premium end of the whisky market further underscores the importance of SMWS's online presence and the ability to communicate with members on a direct to customer basis electronically. Online arguably places SMWS at a clear marketing advantage for its super premium products relative to other producers which operate through traditional retail channels.

ASC and SMWS in more detail

Core franchise

The core franchise of the Scotch Malt Whisky Society comprises its ability to source single cask malt whisky, management of the maturation process, its online platform, the membership magazine, the group's venues and overall management of the membership system.

In addition, the company is building other alcoholic beverage brands (notably J G Thomson & Co) and is exploring the potential for other society to expand further into other alcohols.

Sourcing whisky

SMWS sources its whiskies directly from an eclectic mix of over 100 distilleries which results in the company having around 200 makes of whisky to offer its membership. The selection of these whiskies is carefully curated by the company's own expert tasting panel.

Whiskies sold by SMWS fall exclusively within the IWSR Ultra-Premium or higher retail sales price bands, which tends to endorse the quality of the selection process.

Whisky sourcing is an important part of the gross margin story which we discuss in our financial forecasts section of this report. As the company grows in age it should be able to reduce cask purchasing costs through the procurement of younger casks. In the earlier stages of development, the SMWS required a higher proportion of maturing stock which was ready to be bottled and consumed sooner rather than later.

In terms of product quality – a direct function of sourcing – the company has received **multiple endorsements** which include in the past 3 years The Luxury Masters, The Scotch Whisky Masters, The International Wine and Spirits Competition, The International Spirits Challenge, The Ultimate Spirits Challenge and The San Francisco World Spirits Competition.

Managing maturation

The Group's objective is to bring together spirits from some of the world's best spirits producers, add value by managing the maturation process and provide exclusive access to a vast and unique range of outstanding single cask Scotch malt whisky and other spirits to The Scotch Malt Whisky Society's global membership.

Central to the SMWS offering is the uniqueness of each cask offering and the scope for each bottle purchased to deliver serendipity to the company's members. As a result, the company actively manages the maturation process to enhance the flavour differentiation of its whiskies.

A significant part of the cask management process involves decisions about in which wood the SMWS's whiskies should be maturing. For example, switching the contents of a cask from fresh wood casks into sherry casks alters the flavour profile. SMWS makes that kind of switching decision directly itself. Moreover, it is SMWS which decides when the cask is ready to be bottled and not the individual distiller.

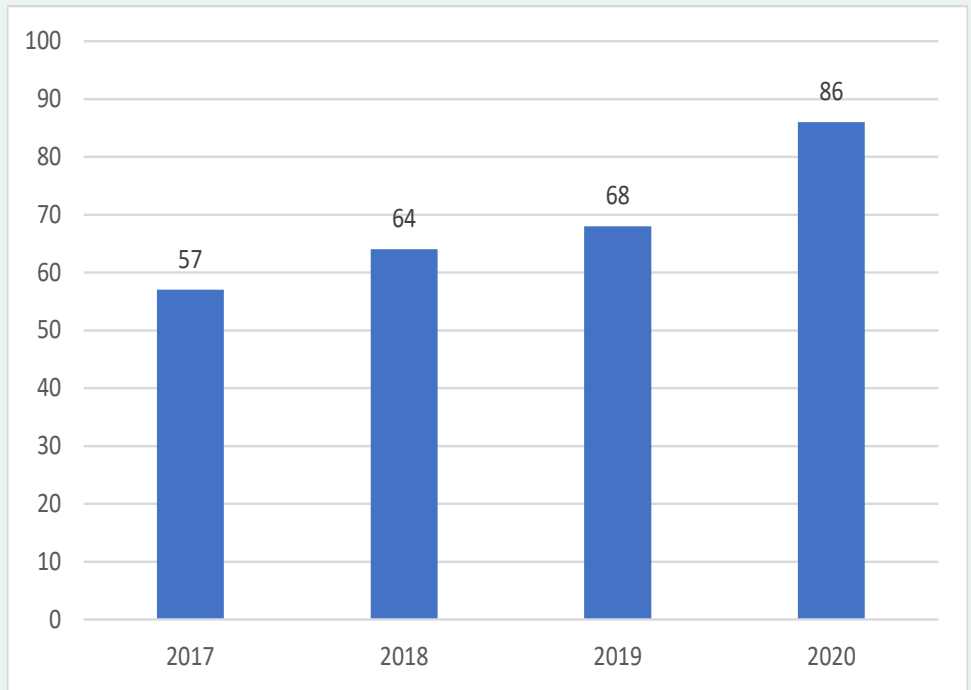
Managing the online platform

Online is central to the SMWS's offering. The company's online platform is managed by Digital Transformation Director Lynne Dickson and Marketing and E-Commerce Director Rebecca Hamilton. The web engine which empowers the commercial capability of the www.smws.com website is built on a [Big Commerce](#) platform. The ERP platform is provided by [Netsuite](#).

The user friendliness and appeal of the online offering tends to be confirmed by the SMWS's continued ability to grow its membership and the brisk pace of sales growth.

Moreover, the company has been successful both in growing the online platform internationally and adapting to change. For example, smws.eu was established specifically for European Union members in the aftermath of the UK's withdrawal.

We show the growth of e-commerce as a portion of total SMWS sales in Figure 8.

Figure 8: E-commerce as % of SMWS sales 2017 to 2020


Source: Company

Specialist membership magazines – “Unfiltered” and “Outturn”

While SMWS’s whiskies are central to the offering it is important to note that the members’ education benefits from exclusive access to the company’s online magazine *Unfiltered*. The magazine discusses key developments in Scotch whisky as well as featuring a number of articles in relation to its heritage.

However, in contrast to other industry publications the SMWS’s magazine directly relates to its own product range in addition to supporting for the Scotch Malt Whisky Society brand as a whole. New releases are featured in the sister magazine “Outturn.”

Unfiltered magazine is run in-house by content manager Richard Goslan. In addition to relevant Scotch whisky articles the magazine aims to be innovative through interactive digital links and video features, notably the ability to offer virtual tours of interesting distilleries.

Examples of front covers are shown in Figure 9:

Figure 9: Unfiltered magazine – some front covers


Source: Google

Venues

SMWS's specialist venues embellish the company's relationship with its members are very much in the DNA of the business given that ownership of the premises in Leith, Edinburgh coincided with the Society's foundation. The venues, which include locations in Glasgow and London, provide a social experience around whisky education. This education in turn enhances member enthusiasm for both the SMWS concept and upcoming product releases.

SMWS both owns and operates its venues as well as employing member facing employees across a range of roles which is important because the venues, as well as events, are virtually the only occasions when the company – being online – has person-to-person contact with its members. This kind of intimacy and opportunity for expert communication is not consistent with hiring agency personnel.

Lifetime value per member

Lifetime value per member is a core contributor to the overall value of the SMWS asset with the Artisanal Spirit's company's shareholders own. The attractiveness of the business model is reflected in the rapid payback of estimated membership acquisition costs.

In addition, the member retention rate appears strong at an estimated 75%.

Annual membership subscriptions to SMWS cost £65 which matches the company's own estimate of a new membership acquisition cost, through marketing and other communications such as events, of £65. Moreover, the average annual spend of a new member is calculated to be of the order of £100.

As a result, the company's analysis demonstrates an **average lifetime value** across ASC's global membership of **£932**, based on an average annual profit per member of £276 and an average member lifetime of 3.4 years. Multiplying lifetime value by the total number of members would imply a **current aggregate lifetime value of £24.6m**. The analysis is summarised in Figure 10.

However, it is important to note that this number, which is effectively an embedded historic value, takes no account of the potential both for membership numbers and aggregate spend per number, which in turn drives SMWS's profitability, to grow.

Figure10: Key membership metrics and lifetime value analysis

	Members ('000s)	Contribution/ member (£)	Retention	Lifetime (years)	Lifetime value (£)
UK	13.7	168	75%	4.1	682
US	4.4	231	54%	2.2	500
Japan	1.4	323	75%	4.0	1,309
Australia	1.1	313	73%	3.8	1,180
Europe	3.3	210	75%	4.0	833
Franchises	3.1	190	81%	5.4	1,018
South-East Asia	0.2	416	58%	2.4	994
China	1.1	2,114	24%	1.3	2,777
Total/average	28.3	276	70%	3.4	932

Note - member numbers are rounded to nearest hundred.
Years calculated as one divided by churn where churn equals one minus retention

Source: Company, ED

The importance of aged stock for intrinsic value

Without maturing whisky stock there is no whisky.

Importantly, this statement cannot be applied to many other significant distilled spirits categories – notably, gin, rum and vodka. All Scotch whisky, including blended products, has to be comprised entirely of product which has **matured for a minimum of 3 years**.

In the case of deluxe blends, premium single malt whiskies and super-premium whiskies the ageing process is significantly longer. Given the pace of market growth for super premium whiskies aged product is necessarily in short supply. As a result, there is constant upward pressure on the value which the whisky industry places on aged malt.

SMWS boasts a substantial stock of maturing in-cask malt whisky. This stock is contained in the designated casks from which the company bottles its super-premium product offering. Typically, one cask will provide enough whisky to fill 250 bottles. It should also be noted that none of SMWS's whiskies are diluted with water which both enhances product quality and alcohol content.

The implication for the value of SMWS's inventory is substantial and positive. Currently, ASC estimates that the online retail sales value of the inventory is of the order of £350m gross of duty and capable of generating of the order of £220m in terms of gross profit.

Both of these numbers are well in excess of the current market cap of the business. This value grew from £330m and over £200m respectively at 31st December 2021 as published in the company's [Admission Document](#) in June 2021.

Under IFRS, in common with most other accounting conventions, inventories are accounted for using the lower of cost or net realisable value. The true value – i.e. that which is realisable - of the company's maturing whisky stock is therefore not reflected in the company's balance sheet. Moreover, there is no ability for the company to recognise unrealised – proxy marked to market - gains on the value of its maturing whisky.

SMWS brand value

The SMWS brand name is clearly associated with the company's ability to market super-premium category whiskies at some of the industry's highest price points. Importantly, none of the single cask products themselves receive any specific support. **It is all about the SMWS brand.**

This point should be taken in the context of our earlier comments about whisky and other distilled spirits brands which rely heavily on tradition advertising support to promote premium price positions and market share.

Other business opportunities

J G Thomson & Co

J G Thomson & Co is the group's only Scotch whisky offering which carries its own brand name. The primary product will be blended Scotch malt whisky, which is itself a fast-growing market. As Figure 5 showed, all but the standard and premium Scotch whisky categories are growing at close to double digit rates and the higher price brackets significantly faster. Even blended malt whiskies tend towards the higher price points.

The subsidiary's spirits will be marketed to consumers using both a Direct to Consumer (D2C) distribution model as through traditional channels such as specialist retail outlets. While a diversification away from the traditional membership model of SMWS, J G Thomson embraces the overall culture of ASC – i.e. an ability to market heritage products steeped in history using modern e-commerce led methods of distribution.

The Company acquired the legal rights to the J G Thomson & Co. brand in 2017 with the vision of reviving its renowned blended whisky heritage and expanding into other spirits categories with a J G Thomson & Co brand relaunch scheduled for 2021. The original headquarters for J G Thomson & Co are now occupied by the SMWS at its vaults in Leith, Edinburgh.

Management & Strategy

The Artisanal Spirits leadership team appears well positioned to sustain the growth of the business based on their relevant experience at the luxury and premium end of the fast-moving consumer goods industry and a clear grasp of what is required to generate unusually brisk growth in that sector. Investors should note the importance of some of the team's experience working for the world's largest marketer of luxury goods, LVMH.

Board of Directors and Management Team

David Ridley, Executive Managing Director heads up the group with **Andrew Dane as Executive Finance Director**. Their respective experiences in high-end distilled spirits (LVMH) and a disruptive industry such as biodiesel (Argent Energy) is arguably complementary.

Moreover, this combination is highly being relevant for a business which requires deep distilled spirits know-how and material evolution such as Artisanal Spirits which sells a traditional product through an innovative channel. We summarise the Board of Directors in Figure 11.

Figure 11: Board of Directors

Director	Age	Role	Key experiences
Mark Hunter	58	Chairman	Molson Coor's
Paul Skipworth	53	Non-exec Deputy Chairman	LVMH
David Ridley	51	Executive Managing Director	LVMH
Andrew Dane	37	Executive Finance Director	Argent Energy, KPMG
Mark Bedingham	66	Non-executive Director	LVMH
Gavin Hewitt CMG	76	Non-executive Director	Scotch Whisky Association
Lesley Jackson	57	Non-executive Director	Stock Spirits, William Grant
Helen Page	51	Non-executive Director	Virgin Media, Argos

Source: Company

The Management Team members hold important roles in whisky selection, whisky management, the online function, and finance. Qualification to execute these diverse roles is a function of relevant experience which includes roles as diverse as other online driven businesses and pure Scotch whisky experience.

Its members are summarised here:

Figure 12: Management Team

Team member	Age	Role
Kai Ivalo	55	Spirits Director
Jan Damen	50	Operations Director - Europe
Rebecca Hamilton	43	Marketing & E-commerce Director
Douglas Aitken	47	Company Secretary & Legal Counsel

Source: Company

Strategy

Growth drivers

ASC's four stated growth drivers are to grow and develop membership, enhance the e-commerce channel, further improve margins through increased value creation and to establish new and complementary brands.

These four stated growth drivers are important not only because they reflect clear growth ambitions but also because they are consistent with the "DNA" of the company. ASC is able to embrace Scotch whisky heritage and ensure integrity of its product offering while adopting modern business techniques to ensure that it operates its e-commerce platform at best practice.

Moreover, despite SMWS being a membership-based business the company itself has a clear financial direction. **Going forward it can enhance gross margins by purchasing younger casks of maturing whisky stock.** We summarise the key points of what the company articulates as its clear plan for revenue growth in Figure 13.

Figure 13: Business model - growth drivers

Grow and develop membership

- Direct investment towards high growth markets
- Build-out existing channels and focus on digital recruitment initiatives
- Further enhance the member value proposition and increase member retention

Enhance e-commerce channel and digital content

- Further invest in e-commerce platform in UK and roll out to other regions
- Replace existing CRM systems with upgraded and integrated CRM tool
- Continued development of online content and events

Further improve margins through increased value creation

- Buying younger spirit, for in-house maturation
- Supply chain optimisation
- Increasing sherry cask maturation

New and complementary brands

- Develop J G Thomson & Co

Source: Company

Valuation and financial forecasts

Valuation

We include three relative valuation metrics in this report.

We look at a standard comparison between ASC and key listed distilled spirits companies based on EV/sales and EV/EBITDA. What this valuation illustrates is that Artisanal Spirits trades at a significant discount to its international distilled spirits peer group based on EV/sales.

Given the company's relatively early stage as a listed company and its current high gross margin pre-EBITDA status, we argue that EV/sales ratio is the most appropriate first stage comparison. For Artisanal Spirits Company's shares (LON:ART) to trade in line with this peer group the stock price would have to rise to **150p**. We summarise our comparison in Figure 14.

Figure 14: Relative valuation - distilled spirits

	Share price	Shares	Mkt cap	Net debt	EV	Sales	EV/sales
All figures in local currency units	(local)	(m)	(m)	(m)		2021	(x)
Artisanal Spirits Company (ART)	81	69.6	56.4	9.6	66.0	14.0	4.7
Brown Forman (BF.B)	70.79	478.7	33,884	1,136	35020	3740	9.4
Campari (CPR)	11.79	1125.3	13,271	985	14256	2097	6.8
Diageo (DGE)	3459	2322	80,319	12,564	92883	13460	6.9
Remy Cointreau (RCO)	162.50	50	8,104	426	8530	1202	7.1
Average							7.0

Note: Brown Forman, Diageo and Remy Cointreau refer to FY2022 data

Share prices are as at 15th September 2021 UK close and 1900 for Brown Forman

Source: MarketScreener, ADVFN and Equity Development estimates

A comparison of ASC's valuation with a selection of luxury goods companies is shown in Figure 15. In our opinion this approach better captures the high price points and exclusivity of the company's products. What is clear is that ASC trades at a valuation discount to these kinds of companies.

Figure 15: Relative valuation – luxury goods

	Share price	Shares	Mkt cap	Net debt	EV	Sales	EV/sales
All figures in local currency units	(local)	(m)	(m)	(m)		2021	(x)
Artisanal Spirits Company (ART)	81	69.6	56.4	9.6	66.0	14.0	4.7
Hermes (RMS)	1248	104.6	130,543	-5,552	124,991	8,655	14.4
LVMH (MC)	621	503.8	312,850	13,073	325,923	61,348	5.3
Average							8.2

Share prices are as at 14th September 2021

Source: ADVFN and MarketScreener

The progressive gross margin story is important

We compare the EV/sales valuations of both Figure 14 and Figure 15 groups with achieved gross margins in Figure 16. Companies with a lower EV/sales valuation in relation to gross margin represent better value in our opinion based on this metric.

In Figure 16, we note that were Artisanal Spirits Company's shares to trade at our 150p fair value they would have an EV/gross profit multiple less than one point above group average. However, given that significant gross profit margin growth is a clear management expectation, as discussed in this report, and that ASC reports its sales gross of duty such a premium would be justifiable in our view.

Figure 16: EV/sales comparatives based on gross margin

All figures in local currency units	EV	Sales 2020	Net/gross	EV/2020 sales (x)	Gross profit 2020 (m)	Gross profit margin (%)	EV/gross profit (x)
Artisanal Spirits Company (ART)	66	15.0	gross	4.4	8.8	58.6%	7.5
Brown Forman (BF.B)	35020	3461	net	10.1	2094	60.5%	16.7
Campari (CPR)	14256	1772	net	8.0	1026	57.9%	13.9
Diageo (DGE)	92883	12733	net	7.3	7695	60.4%	12.1
Hermes (RMS)	124991	6389	n/a	19.6	4376.2	68.5%	28.6
LVMH (MC)	325923	44651	n/a	7.3	28780	64.5%	11.3
Remy Cointreau (RCO)	8530	1012	net	8.4	680.1	67.2%	12.5
Average							14.7

Note: Net/gross refers to whether distilled spirits companies' sales are reported net or gross of duty

Note: Brown Forman, Diageo and Remy Cointreau refer to FY2021 data

Source: MarketScreener

Stocks

ASC's maturing whisky stocks should also be noted in the context of valuation.

A simple comparison is that the current stockmarket valuation places the company at a 70% discount to the £220m estimated realisable gross profit from its whisky stocks.

Even at a 150p share price this discount would still be a substantial 48%. There is clear intrinsic value in the business.

Financial forecasts

The central message from our financial forecasts is one of rapid sales growth combined with higher gross margins. The gross margin story is a direct function of the company's ability to source casks of maturing whisky stock more cheaply as it reduces the average age of whisky stock purchased. A simple ready reckoner calculation for the impact of stock procurement benefits is summarised in Figure 17.

Figure 17: Impact of liquid procurement on gross margin

Period	Liquid cost per 70cl bottle (£)	Gross margin impact	Gross margin
Current financial year	6.00		61%
5 years out	4.00	4%	65%
10 years out	2.00	4%	69%

Source: ED estimates

The revenue numbers which appear in Figure 19 are driven the revenue model data which appear in Figure 18. Our approach is to match senior management focus on revenue by market – i.e. country or region – with the exception being the UK where we separate e-commerce from revenue derived from venues.

Given new members subscribe during the course of a given year we base our membership numbers for modelling purposes on a start-year/end-year average. We then project forward revenue per member based on historic trends and our expectations for high-end consumer spending growth within each market. UK venues are assumed to an extent to move in line with hotel & restaurant trends, most notably when there are forced closures due to Covid19. Underlying spend per member is expected to rise by 3% over the forecasting period.

The salient features of Figure 19 are good sales growth and gross margin progression which will in turn lead to EBITDA growth and a positive net income number. At this stage we assume no dividend payment will be made to shareholders imminently.

A feature of our balance sheet forecasts is the ASC's investment in maturing whisky stocks which are shown separately from other inventories. Investment in these and other assets explains the net indebtedness which we expect to remain in place in 2021 and 2022. Proceeds from the £14.9m fundraising at the time of IPO explain the fall in short term borrowings.

Figure 18 – Revenue model

Figures in £'000s	2020	2021	2022	2023	2024	2025
	actual	forecast	forecast	forecast	forecast	forecast
<u>Membership growth</u>						
UK	-2.8%	3.6%	2.0%	2.0%	5.0%	10.0%
Europe	17.9%	-9.1%	-2.5%	35.0%	17.5%	15.0%
Australia	-8.3%	18.2%	15.0%	15.0%	10.0%	5.0%
China	22.2%	36.4%	0.0%	10.0%	20.0%	20.0%
Japan	16.7%	14.3%	14.0%	15.0%	10.0%	5.0%
South East Asia	0.0%	0.0%	15.0%	10.0%	5.0%	0.0%
USA	12.8%	15.9%	15.0%	15.0%	10.0%	5.0%
Franchises	3.3%	6.5%	7.0%	5.0%	5.0%	5.0%
Total	3.7%	6.7%	5.5%	9.5%	8.6%	9.0%
<u>Average number of members, k</u>						
UK	13.9	14.0	14.3	14.6	15.1	16.3
Europe	3.1	3.2	3.0	3.4	4.3	5.0
Australia	1.2	1.2	1.4	1.6	1.8	1.9
China	1.0	1.3	1.5	1.6	1.8	2.2
Japan	1.3	1.5	1.7	2.0	2.2	2.4
South-East Asia	0.2	0.2	0.2	0.2	0.3	0.3
USA	4.2	4.8	5.5	6.3	7.1	7.6
Franchises	3.1	3.2	3.4	3.6	3.8	4.0
Total	27.8	29.3	31.0	33.4	36.4	39.6
<u>Revenue per country</u>						
UK - online	3234	3500	3265	3497	3801	4293
Europe	2100	1650	2101	2584	3325	3978
Australia	600	900	774	916	1060	1172
China	3000	3800	4403	5040	6156	7609
Japan	700	800	978	1154	1335	1476
Other	200	206	228	264	292	308
USA	2789	3800	3909	4630	5357	5925
Franchises	900	1000	1069	1167	1262	1365
UK - venues	1503	1850	3839	4376	4595	4825
J G Thomson			1000	1200	1440	1728
Total	15026	17506	21566	24827	28622	32678

Source; ED estimates and company historic data

Figure 19: Income statement

All figures in £'000s	2019	2020	2021	2022	2023	2024	2025
	Actual	Actual	Forecast	Forecast	Forecast	Forecast	Forecast
Revenue	14,645	15,026	17,506	21,566	24,827	28,622	32,678
increase in revenue	20.6%	2.6%	16.5%	23.2%	15.1%	15.3%	14.2%
Gross profit	8,533	8,804	11,029	13,490	15,903	18,620	21,422
Gross margin (%)	58.3%	58.6%	63.0%	62.6%	64.1%	65.1%	65.6%
Selling & distribution expenses	-3,178	-2,979	-3,900	-4,800	-5,526	-6,371	-7,273
Administrative expenses	-5,240	-5,663	-7,200	-8,436	-9,027	-9,297	-9,576
EBITDA - adjusted	115	162	-71	254	1,351	2,952	4,573
Depreciation	-460	-600	-699	-861	-991	-1,143	-1,305
Amortisation of intangible assets	-227	-283	-283	-283	-283	-283	-283
EBIT - adjusted	-572	-721	-1,053	-890	76	1,526	2,985
Exceptional items		-392					
Other income		410					
Other costs (share options)			-400	-200			
Finance costs	-439	-499	-466	-504	-650	-671	-623
Pre-tax profits - adjusted	-1,011	-810	-1,920	-1,593	-774	656	2,162
Taxation	-330	-418		-300	-300	-131	-432
After tax profits - adjusted	-1,341	-1,228	-2,320	-1,893	-1,074	525	1,729
Basic EPS (pence)	-11.6	-9.3	-3.4	-2.8	-1.6	0.7	2.4

Source; ED estimates and company historic data

Figure 20: Balance sheet

All figures in £'000s	2019A	2020A	2021F	2022F
Assets				
Non-current assets				
Investment property	391	391	391	391
Property, plant & equipment	5,700	5,785	10,741	14,470
Intangible assets	2,613	2,599	2,555	2,272
Total non-current assets	8,704	8,775	13,687	17,133
Current assets				
Cask goods	18,824	18,707	22,207	24,207
Other inventories	2,129	2,944	3,430	4,225
Trade & other receivables	2,547	1,956	2,583	2,924
Forward currency contracts	32	83		
Cash & cash equivalents	1,536	2,176	2,176	2,176
Total current assets	25,068	25,866	30,396	33,532
Total assets	33,772	34,641	44,083	50,666
Liabilities				
Current liabilities				
Trade and other payables	3,622	3,157	3,252	3,349
Forward currency contracts				
Current tax liabilities	428	332	418	418
Borrowings	12,940	14,963		
Lease debt	146	139	144	144
Convertible loan notes				
Total current liabilities	17,136	18,591	3,947	4,044
Non-current liabilities				
Borrowings	833	901	11,669	17,595
Lease liability	1,546	1,428	1,354	1,354
Deferred tax liabilities	241	324		
Provisions	264	404		
Total non-current liabilities	2,884	3,057	13,723	19,749
Total	20,020	21,648	17,669	23,794
Called up share capital	131	135	174	174
Share premium account	15,980	99	14,938	14,938
Translation reserve	-48	-15		
Retained earnings	-2,687	12,544	10,224	8,331
Hedging reserve	27	67		
Other reserves			967	3,266
Shareholders' funds	13,403	12,830	26,251	26,709
Minority interest	349	163	163	163
Total liabilities	33,772	34,641	44,083	50,666

Source: ED estimates and company historic data

Figure 21: Free cash flow

All figures in £'000s	2018A	2019A	2020A	2021F	2022F
Profit for year after tax	-1,367	-1,341	-1,620	-2,320	-1,893
Cash flow from operations	-4,680	-2,777	-215	-4,990	-1,393
Income taxes paid	-99	-169	-327		-300
Interest paid	-266	-439	-477		
Net cash flow from operating activities	-5,045	-3,385	-1,019	-5,856	-2,197
Cash flow from investing activities					
Purchase of intangible assets	-215	-167	-437	44	
Purchase of property, plant & equipment	-733	-1,507	-660	-4,956	-3,730
Purchase of investment property	-230	-161			
Proceeds received on sale of fixed assets		13	1		
Interest receivable			19		
Grant income			391		
Net cash used in investing activities	-1,178	-1,822	-686	-4,912	-3,730
Free cash flow before dividends etc	-6,223	-5,207	-1,705	-10,768	-5,927

Source; ED estimates and company historic data



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