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SodaStream International – bubbling to the top

Investment thesis

SodaStream offers investors exposure to what must surely be one of the fastest growing beverage brands in the world today. Off a fairly small base, this business is rapidly gaining traction in the group's chosen markets, driven by the following key themes:

- An increasing tendency among consumers—especially in developed markets—to choose **healthier beverage options** over traditional sugary carbonated soft drinks (CSDs). While it could be argued whether SodaStream's products are that much healthier, the consumer perception is likely to be that they are better for one's health.
- Increasingly **environmentally conscious** consumers—again led by developed markets such as the US. SodaStream's products, by definition, result in less waste in the form of disposed-of bottles and cans.
- **Value for money,** convenience and the 'fun factor' - SodaStream believes its beverage solutions offer a cheaper alternative for consumers, while also providing the user a fun 'DIY' process for making drinks (especially appealing to kids, we would imagine).

This has translated into explosive growth, albeit off a very low base: in FY08, SodaStream generated revenue of only $130mn globally, growing to $436mn in FY12 (35% p.a.) and likely exceeding $550mn in FY13 (the group has forecast 30% growth). However, even these figures represent miniscule penetration of key beverage markets.

Figure 1: SodaStream forecasts

Sodastream International				
Dec y/e	FY12	FY13	FY14	FY15
Diluted HEPS (US$)	2.09	2.68	3.83	5.00
% growth		*28%*	*43%*	*31%*
DPS	0	0	0	0
PE	30.x	23.3x	16.4x	12.5x
DY	0.0%	0.0%	0.0%	0.0%
Share price (US$)	62.65			
12-mnth fwd PE	18.6x			

Source: Bloomberg, Anchor Capital estimates

According to estimates from *IRI* (formerly *SymphonyIRI Group)* the market size of the CSD industry in the US is worth c. $29bn in annual sales, and SodaStream generated only $143mn of revenue in FY12 in the US, or a market share of only c. 0.5%. While we think the group's products will likely remain fairly niche, the potential for further penetration off this base is very strong. This view is perhaps best reflected in management's target of $1bn in revenue by 2016 at a group level (i.e. all regions) as communicated in a recent investor day presentation (May 2013). If achieved, this would mean >20% p.a. growth in turnover and profit growth well ahead of this run-rate. Given the group's delivery in recent years and increased guidance at its 2Q results (PAT rose 35% in 2Q13), we have little reason to doubt these targets at this stage.

This growth does not come for free: the share price has risen 39% YTD and trades at 23x our FY13 (Dec) EPS forecast. However, if growth expectations are delivered on, we expect continued ~20% annual total returns from the share. We rate the SodaStream a **BUY**, but note that risk is above average given the high growth expectation and rating.

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Who are SodaStream and what do they do?

SodaStream is the world's leading manufacturer of home beverage carbonation systems, with an estimated 6mn households using the group's products at least once every two weeks. They sell their products through 60,000 retail locations in 45 countries. Of these countries, 30 were entered into since 2007, highlighting the steep growth curve the company has been on. For example, SodaStream added 10,000 new stores in 2012, of which 5,000 were in the US alone (US retail locations now total 15,000).

SodaStream is headquartered in Airport City, Israel and its shares are listed on the NASDAQ stock exchange under the symbol SODA:US.

The following time-line provides an indication of the group's operating history:

Figure 2: SodaStream timeline

1903:	SodaStream founded in the U.K.
1955:	Pioneers the world's first home soda maker
1985:	Acquired by Cadbury Schweppes PLC
1992:	Israel distributor establishes Soda-Club
1998:	Soda-Club acquires SodaStream
2002:	Soda-Club begins selling in US online
2007:	**Fortissimo Capital acquires Soda-Club**
2010:	**SodaStream International lists on NASDAQ**
2011:	**Worldwide retail locations surpass 45,000 including 7,000 in US**
2012:	**Launches Source and Revolution soda makers and first co-branded flavors. Annual sales reach $436 million.**

Source: Sodastream investor day presentation

The products sold by the group can be broken down into the following broad components:

1) **Starter kit**—this includes a soda-maker as well as a CO2 cylinder which can produce between 30-130 litres of carbonated beverages (depending on usage) and some sample syrup flavours. Starter kits are typically sold in the US for as low as $79.95 for a basic model.
2) **Exchangeable CO2 cylinders and refills**. Consumers typically pay $14.99 for a 60-litre refill in the US.
3) **Carbonation bottles**—each plastic bottle costs around $10 in the US, and is designed for repeated usage with a useful life of ~3 years.
4) **Flavours**—a typical 500ml bottle of flavoured syrup will produce ~12 litres of beverage, and these range in price between $4.99-$9.99 each in the US market.

It stands to reason that successful penetration of the group's products relies on consumers having a fair degree of trust in the quality of the tap water supplied by their relevant municipal authority. This is why the company's growth model is well suited to fairly developed markets and first world countries such as the US.

Why is the consumer proposition compelling?

Apart from the novelty associated with producing one's own soda water and flavoured beverages in an almost infinite variety of flavours (>100 in many markets), we believe the cost equation for dedicated, long-term users of the product is pretty compelling.

For the purposes of this exercise, we will use the US market as a proxy and compare a fictitious consumer A, who buys Coca-Cola cans at a retail store, to a consumer B who uses SodaStream as an alternative:

Figure 3: Cost equation: SodaStream vs traditional CSDs

Consumer A:		Note:
Drinks 1 x 355ml (12 oz) CSD per day		
Unit cost per serving:	**$0.42**	1
Consumer B:		
Drinks 1 x 355ml serving of soda using Sodastream system		
NB: Measured over 3 years of usage to amortise initial starter pack cost		
Initial cost of starter pack:	$79.95	2
Cumulative cost of CO2 refills used:	**$97.12**	3
Number of CO2 refills consumed	6.5	4
Number of litres of soda consumed:	388.7	5
Cumulative cost of flavour syrups used:	**$161.97**	6
Number of 500ml flavour syrups used:	32	7
Cumulative total cost of system over 3 years:	**$339.04**	8
Number of individual servings consumed:	1 095	9
Unit cost per serving:	**$0.31**	10
% saving vs Consumer A:	**26%**	

Source: Anchor Capital estimates, SodaStream disclosure

Notes:
1) *Estimated average retail price of $5.00 for a 12 pack of Coca-Cola 12oz cans. However, this varies substantially by region and can be as low as $2.50 when on promotion.*
2) *As per SodaStream disclosure for a "budget" soda maker.*
3) *$14.99 per refill in US.*
4) *Estimated 60 litres per refill.*
5) *1 x 355ml serving daily x 3 years.*
6) *$4.99 per flavour refill—cheapest option.*
7) *~12 litres of beverage per 500ml bottle.*
8) *We ignore the cost of tap water; assumed to be nominal.*
9) *3 years @ 1 x serving daily.*
10) *Cumulative total cost divided by total number of servings.*

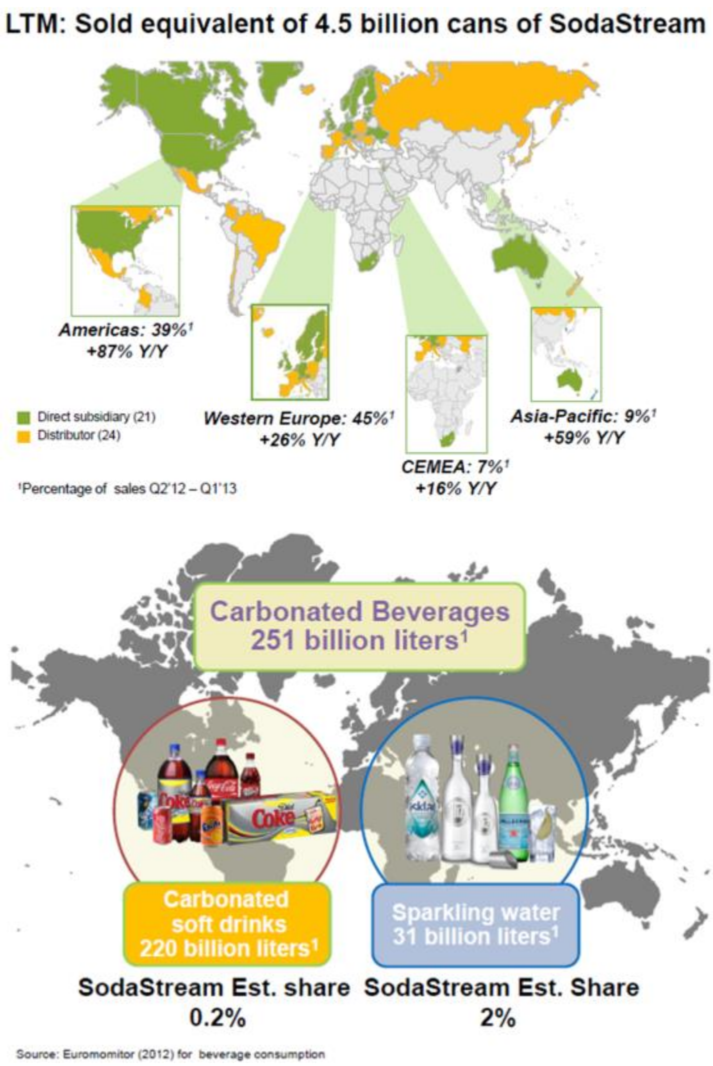
As demonstrated in the analysis above, meaningful cost savings to consumers are possible when using SodaStream products. While these costs are estimates and the price of traditional CSDs may vary from the rough average we have used above (promotions etc.), we think this demonstrates that SodaStream products are at the very least very competitive. However, we think the more important benefit to consumers is one of convenience.

Penetration levels remain very low; huge scope for expansion

As pointed out earlier, SodaStream has experienced significant growth in recent years off a very low base in what is a CSD market that is stagnating or declining in certain countries (*IBIS World* estimates that the soda market will have declined by 2.9% annually in the US between 2008-2013).

According to the company, it sold the equivalent of 4.5bn cans of SodaStream in 2012, with the Americas region demonstrating the fastest growth (87%) as consumer uptake in the US was very successful following the launch of distribution of the SodaStream products in Wal-Mart stores across the country.

Figure 4: SodaStream in 2012

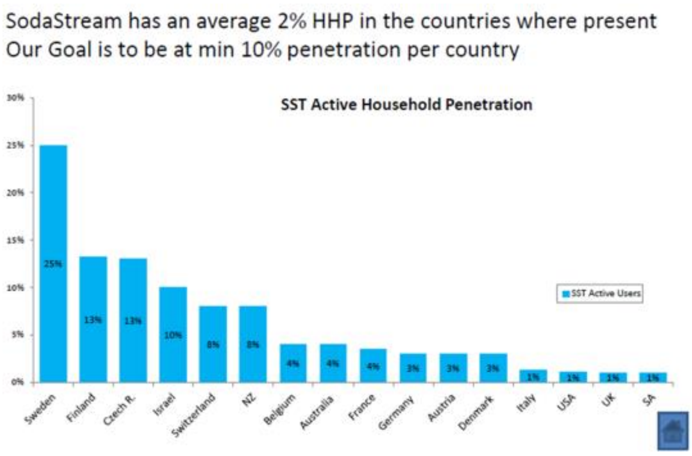


Source: SodaStream May 2013 investor day presentation

However, it is clear from the above pictures that the group has a long road ahead of it in terms of the potential to further penetrate the market for carbonated beverages.

SodaStream believes that it currently has an average household penetration of 2% in those countries it has a presence in—the goal is to increase this to at least 10% in each country in which it operates (many are higher). In some markets, we feel this may be a stretch but if the group is even half successful in this regard, it means strong growth.

Figure 5: SodaStream household penetration



Source: SodaStream May 2013 investor day presentation

The group has its own distribution network, but also distributes its products via third-party retailers and has a number of retail partners globally.

Figure 6: Sodastream global retail partners

Source: SodaStream May 2013 investor day presentation

Ambitious FY16 financial targets set by management publicly: 20%+ topline growth + margin expansion

SodaStream has set its sights very high when it comes to continuing the growth story we have already witnessed to date. We think much of this confidence stems from the early success the group has witnessed in consumer uptake in the all-important US market.

In summary, management is looking to achieve the following:

- **Revenue of $1bn by 2016**—this means 22% p.a. growth off what we believe the group will deliver in FY13 ($550mn; +26% YoY).
- **A gross profit margin of 56% in FY16 vs 54% in FY12**—this improvement will largely arise from increased levels of self-distribution, lower levels of reliance on contract manufacturing (they are investing in capacity to bring some elements of production in-house), offset by higher depreciation.
- **FY16 total operating expenses of 35-48% of revenue vs 42.2% in FY12**—presumably this arises from strong turnover growth leveraging elements of a fixed-cost base.
- **An adjusted operating income margin of 17-20% in FY16 vs 11.8% in FY12.**

It is important to contextualise what these targets and figures all mean. We estimate that, should they be achieved, this would translate into an **EPS figure of >$6.50/share in FY16,** or annualised growth of 32% from the FY12 base of $2.14/share.

Should that be achieved, we think it would not be unreasonable to expect a share price of $120 in 3-4 years time (= forward 15x P/E in 3.5 years time), translating into an annual capital gain of close to 20%. This obviously excludes any prospects of dividend payments, which should come as the group achieves scale in both margins and cash flows.

Fundamentals of the business

We have discussed in reasonable detail SodaStream's growth drivers and prospects. But is this a good business? While the current wide gap between its gross and operating margins suggests it has not yet reached its scale potential, returns are already fairly strong. For example, in FY12 the group had shareholders equity of $275mn, inclusive of $62mn of net cash, and generated bottom-line earnings of $44mn. This equated to an return on average equity of 18%, with a pre-tax return on capital employed of 25%. Clearly, given that margins are below group targets, this return profile has upside potential. We have not incorporated any dividend expectations into our forecasts (for now) given that the group appears to be investing heavily for growth in both capex and working capital. Nevertheless, our projections imply a modest, steady improvement in the group's RoE profile over the next few years:

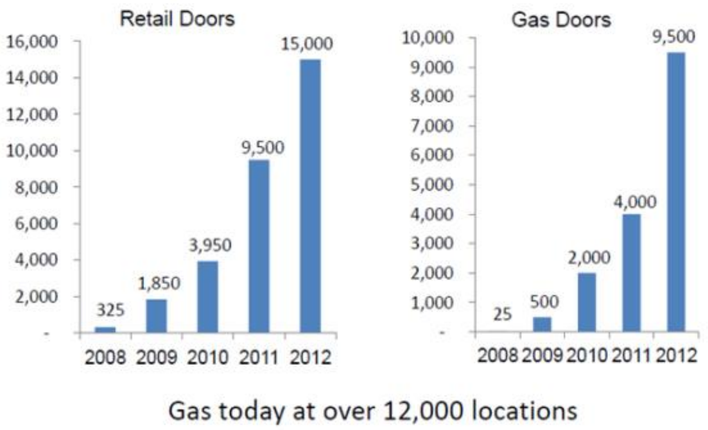
Figure 7: SodaStream forecast EPS and RoE profile; Bloomberg consensus vs our estimates

$	FY13	FY14	FY15	FY16	FY13-16 CAGR
Starting NAV	13.10	15.77	19.66	24.73	
EPS	2.67	3.89	5.07	6.59	35%
DPS	-	-	-	-	
Ending NAV	15.77	19.66	24.73	31.32	
ROE	18.5%	22.0%	22.8%	23.5%	
Bloomberg	2.89	3.49	4.58		
Anchor Capital	2.67	3.89	5.07		
% difference	-8%	12%	11%		

Source: Anchor Capital estimates & calculations

Aside from the hard numbers, the attractiveness of SodaStream's business model can be ascribed to what the company terms the "razor and razor-blade effect." In essence, once a consumer has purchased the Sodastream soda-maker, they are effectively committed to making repeat purchases of flavoured syrups and gas refills (think of Nestle's Nespresso business model). In addition, we believe the group's established brand and network of returnable gas bottles provides a potentially high barrier to entry for new competitors.

Figure 8: SodaStream retail/distribution presence in the US:



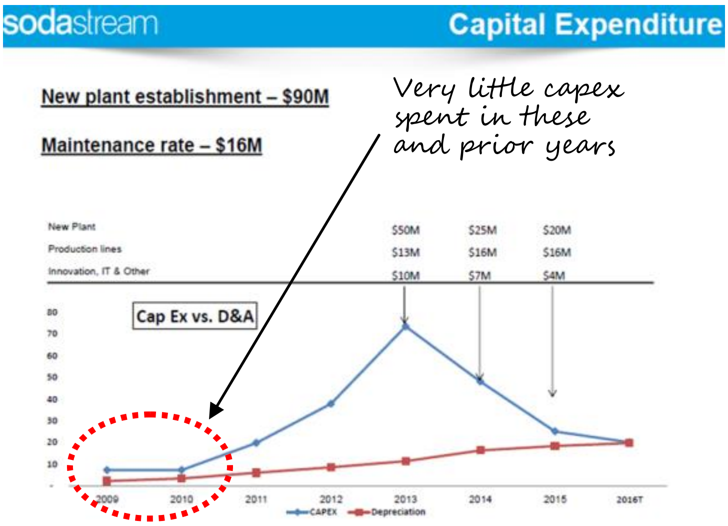
Source: SodaStream May 2013 investor day presentation

Capex for growth

Investors may be asking why SodaStream, after all these years, remains a fairly small-scale business. We think the answer probably lies in the group's historical ownership profile. The group was acquired by Cadbury Schweppes in 1985 and subsequently sold to Soda-Club, its Israeli distributor in 1998. In turn, Soda-Club was then acquired by Fortissimo Capital in 2007. We believe that over these years, the group may not have had sufficient access to capital for expansion and that multiple ownership changes may have resulted in a lack of focus for the group. The company went public in an IPO on the NASDAQ stock exchange in November 2010, raising $110mn for repayment of debt and the funding of capex for expansion.

The group is in the process of building a new manufacturing facility in Israel (cost $90mn) in order to expand capacity and reduce reliance on third-party manufacturers:

Figure 9: SodaStream capex profile



Source: SodaStream May 2013 investor day presentation

An innovative business

SodaStream is not standing still as a business in respect of innovations. In addition to the group's continual development of new flavours (in many instances through co-branding opportunities with other food producers; see Figure 10), the company also partnered with Samsung in early 2013 in producing the world's first refrigerator that dispenses soda water. We cannot predict with any degree of certainty what sales uptake this will have, but it should provide for greater brand recognition for SodaStream amongst consumers, potentially benefitting sales of its traditional products.

Figure 10: SodaStream co-branded flavour products—Kraft Foods example

Source: SodaStream May 2013 investor day presentation

Figure 11: Samsung/SodaStream soda-water dispensing refrigerator

Source: SodaStream May 2013 investor day presentation

Conclusion

The core of our offshore portfolios will typically consist of well-known, big, diversified businesses with well-established track records and fairly predictable growth profiles. SodaStream does not fit this profile, but rather offers a higher risk, higher return profile. We struggle to find companies that possess the growth potential offered by the group given its delivery to date, low product penetration levels and lofty management targets. The share price has risen sharply in recent months and is not a bargain at a **forward 18-19x P/E multiple**, but if management's expectations are delivered on (we think these are achievable) investors will earn handsome returns from these levels when measured over a three year period. Conversely, should the group disappoint relative to their communicated ambitions, the downside could be material given the elevated rating. We find the risk/reward equation fairly attractive for a moderate percentage weighting in portfolios for investors willing to tolerate above-average risk.

Figure 12: Company financial targets

sodastream 2016 Financial Target

	2016T
Revenues	$1.0B
4 years revenue CAGR	23%
Gross margin	56%
A&P (as % from revenue)	13%-15%
Adjusted Operating income margin	17%-20%
Tax rate	15%-18%
Adjusted Net income	15%-18%

Source: SodaStream

Figure 13: SodaStream products

Source: SodaStream

Key risks

We see the following as the key risks facing SodaStream:

- Potential competitors may seek to develop competing products that are compatible with the group's soda-makers.
- The group's tax rate is low and could be subject to challenges by various revenue authorities to the company's transfer-pricing arrangements.
- SodaStream manufactures the majority of its products in a number of facilities in Israel, including one in the disputed West Bank territory. This poses some risk of loss or disruption should these facilities be affected by terrorism or other geopolitical events.
- From a share price perspective, the elevated rating is indicative of a company in a high growth phase; should the group's growth fall short of management's targets, the share could de-rate significantly and this poses downside risk.

Sean Ashton

Appendix A: SodaStream forecast income statement

$'m	FY08A	FY09A	FY10A	FY11A	FY12A	% ch	FY13E	% ch	FY14E	% ch	FY15E	% ch	FY16E	% ch
Revenue	130	136	208	289	436	51%	567	30%	709	25%	851	20%	1 021	20%
COGS	-59	-60	-96	-131	-200	53%	-261	30%	-326	25%	-383	17%	-449	17%
GP	71	76	112	158	236	50%	306	30%	383	25%	468	22%	572	22%
GP margin %	*54.8%*	*55.6%*	*53.9%*	*54.5%*	*54.0%*		*54.0%*		*54.0%*		*55.0%*		*56.0%*	
Opex	-58	-62	-98	-129	-190	48%	-241	27%	-289	20%	-341	18%	-403	18%
Sales & marketing	-42	-45	-74	-99	-153	54%	-187	22%	-224	20%	-264	18%	-312	18%
G&A	-16	-17	-24	-30	-38	27%	-54	44%	-65	20%	-77	18%	-91	18%
Other income, net	0	0	0	0	0		-		-		-		-	
Operating income	**13**	**14**	**15**	**29**	**46**	**59%**	**65**	**43%**	**93**	**44%**	**126**	**35%**	**169**	**33%**
margin %	9.9%	10.2%	7.0%	9.9%	10.4%		11.5%		13.2%		14.9%		16.5%	
Net finance	-6	-2	0	2	-1		-1		-		-		-	
PBT	**7**	**12**	**15**	**31**	**45**	**45%**	**64**	**44%**	**93**	**46%**	**126**	**35%**	**169**	**33%**
Taxation	-6	-2	-2	-3	-1		-6		-11	**75%**	-19		-29	
effective tax rate	*90.4%*	*20.1%*	*15.4%*	*10.9%*	*1.7%*		*10.0%*		*12.0%*		*15.0%*		*17.0%*	
Net income	**1**	**9**	**13**	**27**	**44**	**60%**	**58**	**32%**	**82**	**43%**	**107**	**31%**	**140**	**30%**
Diluted shares in issue (m)	9.6	13.2	14.7	20.6	21.0		21.5		21.5		21.5		21.5	
Diluted EPS	**0.07**	**0.70**	**0.86**	**1.34**	**2.09**	**57%**	**2.68**	**28%**	**3.83**	**43%**	**5.00**	**31%**	**6.51**	**30%**
Share price	62.65													
PE multiple					**30.0**		**23.3**		**16.4**		**12.5**		**9.6**	

Source: Anchor Capital estimates
A = actual; E = estimate

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