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Haypp Group AB (HAYPP.SE)

Q2 2022 Earnings Call

CORPORATE PARTICIPANTS

Gavin O'Dowd

Chief Executive Officer, Haypp Group AB

Svante Andersson

Chief Financial Officer, Haypp Group AB

OTHER PARTICIPANTS

Niklas Ekman

Analyst, Carnegie Investment Bank AB

MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and welcome to the Haypp Group's Q2 2022 Earnings Conference Call. All participants will be in listen-only mode. [Operator Instructions] After today's presentation, there will be an opportunity to ask questions. [Operator Instructions] Please note this event has been recorded. I would now like to turn the conference over to Gavin O'Dowd. Please go ahead, sir.

Gavin O'Dowd

Chief Executive Officer, Haypp Group AB

Good morning. Welcome to our Q2 earnings release. Today, in addition to myself, Gavin O'Dowd, we will also have our CFO, Svante Andersson.

I'm going to – today's presentation is available on our Haypp Group investor presentation segment, and today I'm going to be following through the slides which are on that site. Moving on that presentation, moving to slide 3, we clearly sort of state our higher purpose here of inspiring healthier enjoyment to millions, which is predominantly moving people from cigarettes to traditionally foods, and in more recent years, to nicotine pouches.

Moving along to slide 4, you can see the space that we operate in relative to the harm reduction spectrum. So, the products which we sell are very much at the lower end of the harm reduction spectrum that we deal with here.

Moving along to slide 5, you can get a summary of what smoking rates are like in Sweden and what they have become in Norway in recent years, and how this compares to being below one-third of the European average and how this ties into our objective to reducing the amount of smoking and hence smoking-related illnesses and deaths across a broad range of countries currently within Europe and North America.

Moving along to slide 6, we can see the outlook for the market, which we laid out in 2020, and we believe it to be equally as consistent today. So, we see a market size which will have increased from SEK 27 billion then to just over SEK 60 billion in 2025. All of this market increase is coming from nicotine pouches, which will move from 30% of the global market to roughly 80% of the global market. I think it's worth highlighting here that the market is

tracking pretty much online with expectation with 41% CAGR year-on-year. And I think it's also worth noting, as you look to our presentation, that we are continuing to grow significantly above and beyond this.

Moving along also, we can see that we anticipate due to the harm-reduced nature of this category, relatively low taxes, and hence quite a significant profit pool to be divided between the manufacturers and the retailers of SEK 48 billion. We recognize the category as being very suitable for online and we see further online penetration as each quarter goes past. And, in turn, we expect a very strong growth for online sales for this business.

Moving along to slide 7 for looking at the key underlying factors for this, the primary underlying factor for this is the consumer demand for less harmful products. This has been greatly supported by regulatory support for harm reduction, and this, in turn, is introducing a lot more players into the industry and significant investment from all of the large tobacco and nicotine companies, but also from many small and credible incumbent players. And this is what's generating the growth that we see on the right-hand side of slide 7.

Moving along to slide 8, we take a look at the competitive landscape for online in this space. What we can see here is that while there is significant players which come and go over time, they never reach the level of scale that we are, and we currently operate at a roughly 10 times the size of our largest competitors.

Moving along to slide 9, regarding our share of the market, what we can see if we start off first of all here with Sweden is that we continue to grow market share within nicotine pouches. And as nicotine pouches continue to grow overall market share, our total share within the Swedish market has been lifting from the 10% we have classified here for 2020 up into the early- to mid-teens.

Looking at Norway, we have struggled with Norway over the past 18 months or the past six quarters where the borders reopening on the back of COVID and the reopening of duty free has contracted the total size of the domestic market in Norway. However, what we can see is that our share of the market is holding relatively strong, and we believe we are back into growing share positions in Norway again. Regarding Europe, we continue to grow share for both total overall market share and for channel share within Europe, as is equally valid for the US.

Moving along to slide 10 and taking a quick look at our logistics landscape. Convenience remains one of our key USPs. Our ability to offer consumers fast and reliable delivery sets us apart. We have continued to execute on our warehouse expansion plan, and we now have six warehouses in our core and growth markets, while we continue to maintain rapidly – when we're managing this while we continue to maintain rapid inventory turnover, which is roughly in line with our 2021 turnover of 18 tonnes per annum.

Moving along from here into the second segment of the report, looking at the performance for Q2. And if I start off, first of all, on slide 12, taking a look at the operational highlights. We continue to see consumer demand for safer nicotine products, combined with a favorable regulation, and this is the two main factors which is driving Haypp Group's growth.

Growth rates for nicotine pouches, which is our primary growth focus, as I touched upon earlier, has accelerated in the quarter to 55% year-on-year, of which 50% is organic. Nicotine pouches have now gone from just under 40% of our sales in Q1 to just over 41% of our sales in Q2, and this compares to 33% of our sales for Q2 last year.

Moving along further to slide 13, and I'd like to start off, first of all, with pulling together all of the messages we've given over the last couple of quarters on our warehouse expansion. And so, let me sort of see if I can group it together. First of all, potentially on a US basis. So earlier on this year, we opened our Colorado warehouse to

service the West Coast of the US. And then, in the latter part of Q2, we also migrated our own warehouse from Pennsylvania over to Houston, Dallas. So, this now gives us a US footprint where we have a East Coast, a Central and a West Coast warehouse.

Within Europe, in Norway, we in-house our own logistics at the latter part of last year to a warehouse in the edge of Oslo to provide improved convenience for the consumers. And for the rest of Europe, we firstly increased our capacity within our Stockholm warehouse. We then migrated our warehouse that covered the German-speaking part of Europe from Southern Denmark into our Stockholm warehouse. And since then, we have also opened a warehouse in the UK to service our UK consumers.

All of this is a great improvement to convenience for our consumers. But in addition to the improvements in convenience, we also have increased our capacity and we've set a very strong landscape for further efficiency.

Then you look at the regulation. Governments in Europe and the US continue to adopt and support the principle of harm reduction. In Sweden, we saw the introduction of new legislation for nicotine pouches, which supports this principle and improves the overall dynamics of the market. Among the elements in this legislation are age verification and limitations to more aggressive marketing behaviors and setting a basis for product standards. Haypp Group has self-regulated in these areas for many years and welcome the legislation which will bring other retailers closer to our standards. In addition to securing the category in Sweden, this regulation is also an excellent precedent for the upcoming EU regulation.

With that, I will hand over to Svante to walk through some of the financial overview.

Svante Andersson

Chief Financial Officer, Haypp Group AB

Thank you, Gavin. And good morning, everybody. So starting on slide 14 and the financial overview for the group, we continue to show strong growth across all the segments, with the exception of Norway during the second quarter, driven by our progress within the nicotine pouch category. Our reported net sales increased by 16% to SEK 628 million, and organically, when we exclude the acquisitions in Sweden, our sales growth was 6%. When also excluding Norway, the organic growth for the remaining segments was 32% combined.

Our gross margin continued to improve both versus last year and sequentially versus Q1 and amounted to 12.5% during the quarter. This improvement is driven by a stronger gross margin in our core markets. And if we look at our adjusted EBIT for the quarter, we grew the adjusted EBIT by 57% versus last year and it amounted to SEK 14.6 million, which corresponds to an adjusted EBIT margin of 2.3%, which is up by 0.6 percentage points versus last year.

The key driver behind the margin uplift is higher volume and gross margin, partially offset by higher adjusted OpEx from investments that we've done in our organization to support further growth. Our cash flow from operating activities during the period increased to SEK 32 million, implying a strong cash conversion of 71% for the period.

Now if I turn to page 15 and our core markets, we reported a net sales increase in the core markets of 8% during the quarter and the net sales amounted to SEK 525 million. Our nicotine pouch volume grew substantially more at 43%, with Sweden growing even more than that and Norway being a drag on the performance for the segment.

In Sweden, net sales for the quarter increased by 43%, driven by continued strong organic performance in the nicotine pouch category, coupled with acquisitions of Nettotobak and Snusnetto which contributed SEK 56 million to net sales in the quarter.

In Norway, the year-on-year growth was still negative during the quarter at 26%. Comparable figures for Norway remained relatively challenging in Q2. And on top of that, consumers in Norway did to a large extent revert back to border and duty free channels during the second quarter. These are channels which accounted for circa 30% of Norwegian consumption pre-COVID. This has led to a temporary drop for the total domestic market in Norway. We have, as already communicated in previous earnings calls, launched a range of commercial activities to turnaround of developments, and our data is suggesting that, as Gavin mentioned here earlier, that we are taking market share domestically in this quite challenging environment.

In terms of profitability in our core markets, it remains very strong with an EBITDA margin of 8.3% during the second quarter, which is up by 2.2 percentage points versus last year and already close to levels which we're expecting for the total group in the medium- to long-term add to our financial targets that we will discuss in a few moments.

The EBITDA margin increase is mainly attributable to higher gross margin and leverage on operating expenses from higher sales volume, and these profits we generate in our core markets are reinvested back into building our market positions in the growth markets.

So with that, moving on to the growth markets on page 16, we increased net sales in the growth markets by 78% to SEK 102 million for the quarter on the back of strong performance across both the US, DACH, and the UK. The performance is almost solely driven by nicotine pouches where we grew by 86% in volume during the quarter.

EBITDA amounted to negative SEK 19 million versus negative SEK 13 million during the same period of last year as a result of continued commercial investments for growth, mainly impacting the gross margin negatively in the segment. And we continue to invest considerable resources into building strong online market positions in these very significant consumer markets, and we remain confident that with our current growth trajectory, we will over time also be able to deliver healthy profitability from the growth markets.

On my last page here, which is page 17, we're presenting a selection of KPIs, and I'd like to touch upon the balance sheet in particular and our financial position, which remains very strong. We had a net working capital of SEK 112 million as per end of the quarter, which is up from SEK 70 million at year-end. The inventory levels increased somewhat versus the year-end as we built safety stock in our newly opened warehouse facilities, as well as continued to seize opportunities to load inventory at very favorable commercial terms ahead of inbound price increases.

In terms of our net debt, it amounted to SEK 84 million, corresponding to a net debt-to-adjusted EBITDA ratio of 1.0, which is up from 0.6 at the year-end, driven by higher non-current lease liabilities as a result of the warehouse expansions, which we intend to finance with leasing contract.

As per end of the quarter, we also had cash and cash equivalents amounting to SEK 53 million, and we had another SEK 65 million in unutilized credit facilities.

So to wrap up the second quarter performance, we saw a 55% growth in our nicotine pouch volume, which is the most important growth category for us as we have talked about. We saw a 57% growth in the adjusted EBIT and

we're spending off SEK 32 million of cash from operating activities. And I think with that, I'll hand the word back to Gavin.

Gavin O'Dowd

Chief Executive Officer, Haypp Group AB

Thank you. Moving along to slide 19, I would like to reiterate our financial targets. We anticipate to reach net sales of at least SEK 5 billion by 2025, predominantly through organic growth. We will target – we will prioritize growth over profitability in the short-term, but we will also target high-single digit adjusted EBIT margin in the medium- to long-term. And given the current growth potential that we see within the business and the opportunity from reinvesting the cash, which Svante referred to a moment ago, we don't envisage that we're going to be declaring a dividend for the foreseeable future.

Moving along to slide 20, I would like to touch again on some of the key dynamics around the market. Overall growth in nicotine pouches is expected to grow by over 40% year-on-year. Online penetration for nicotine pouches and snus combined is still relatively low and there is strong potential for this to continue to grow. And we will continue to leverage our leading market positions across all of our key markets.

Moving in to slide 21, we take a quick update on current trading. We continue to see growth in nicotine pouches, driven by the consumer demand and the regulatory support. We continue to see intense competition from all the global manufacturers and many credible small manufacturers due to the potential within the category, and this has led to the launches of exciting new brands and strong consumer relevant innovation.

We see ourselves as well positioned for uncertain times. In previous cycles of contraction in consumer spend, nicotine consumption has remained resilient. However, consumers have been known to downgrade to less expensive nicotine categories. For example, after the financial crisis, many consumers in Europe moved from cigarettes to rolling tobacco.

Nicotine pouches are well positioned for this. Due to the harm reduced nature of the category, there is little or no punitive taxes on the category, which means that it is sold to the consumer at a fraction of the price of the packaged cigarettes. We also believe that in the event of a contraction in consumer spending, consumers will become more aware of the price advantages of buying nicotine pouches online.

Regarding inflation, so far we have not seen any abnormal price increases from our product suppliers. This may be due to either, A, the nature of the component costs of the products, or B, the relatively high product margins available to the manufacturers.

However, we have seen an increase in our fulfillment costs. But we need to bear in mind that these costs relate to less than 10% of our overall revenue and any extra costs will be passed on. We continue to see strong performance in our nicotine pouch growth in Sweden. Our share of nicotine pouches continues to grow.

In Norway, the activities which we initiated in the latter part of 2021 and again – and in early 2022 are gaining traction, and we see strong and consistent growth in the US, Germany, and the UK. We will continue with our existing position – proposition to consumers hinged around a broad assortment, convenient delivery, and good prices. The platforms continue to play a pivotal role in launching new brands, and almost one-third of our current sales in nicotine pouches comes from products which were not on the market a year ago.

We will continue to enhance our digital infrastructure, including our storefronts, our age verification, our consumer insights, and our machine learning. This not only enables us to sustain our growth, but also to further release benefits of scale.

With this, I would like to wrap up with slide 22. We are the global online market leader and we are over 10 times the size of our nearest competitor. There is 1 billion smokers in the world looking for safer alternatives from a product which is perfectly suited for online sales. We have a symbiotic relationship with our suppliers. And we have a track record of benefiting from regulation. Our unit economics continues to improve in markets where we are well established, and we have a highly engaged team to continue to execute on our strategy.

With that, I would like to open up to any questions. Operator?

QUESTION AND ANSWER SECTION

Operator: We will now begin the question-and-answer session. [Operator Instructions] The first question is from Niklas Ekman from Carnegie. Please go ahead.

Niklas Ekman

Analyst, Carnegie Investment Bank AB

Q

Thank you. Yes. A couple of questions, if I may. Firstly, on the Norway, you say that you're back to growing share. And yes, you reported 26% declines. I guess you're referring to the online market specifically. Is that correct?

Svante Andersson

Chief Financial Officer, Haypp Group AB

A

Good morning, Niklas. Yeah, I think – I mean, what we're seeing is that, that overall domestic sales in Norway, so including both online and offline is having a fairly challenging time in Q2, obviously driven by the fact that consumers have reverted back to the non-domestic channels. And I think what we're seeing is that we both for – take a look at the domestic universe in isolation, we are growing share somewhat and we're also growing share within the online part of the domestic universe.

Niklas Ekman

Analyst, Carnegie Investment Bank AB

Q

Okay. And that's very clear. And when do you expect this effect to annualize? I think the borders will reopen in February. But do you face equally tough comparisons throughout the year, or will comparisons gradually ease in the second half of this year, or can you just elaborate on that?

Svante Andersson

Chief Financial Officer, Haypp Group AB

A

Yeah. I mean, it's – we – obviously, these comparisons are getting somewhat easier as we go along here for the rest of this year. But I think we have also seen that there has been a fairly huge effect on – over the border and duty free reopening. So, we anticipate that the remainder of this year might be challenging for returning to growth. But I would expect that the early part of 2023 to be a period of when we can start recording growth rates again in Norway.

Niklas Ekman

Analyst, Carnegie Investment Bank AB

Q

Okay. Thank you. That's very clear. And I'm curious, on a bigger topic here on kind of the migration to from online retail, we see many other online retailers that have reported a slowdown in Q2 due to kind of a revival of physical retail and then there's this ease during the summer that if you kind of disregard on the Norwegian market, have you seen anything similar in your channels? Is there any signs of resumed sales in physical stores and how that has then reverted back to online sales towards the end of Q2 and beginning of Q3 or – and yeah, that's my second question.

Gavin O' Dowd

Chief Executive Officer, Haypp Group AB

A

I think on that one, Niklas, now so, as you say, if you strip up the exception of all of Norway, our total group growth would have been organically – would have run about 30% and – for Q2 year-on-year. So, we're seeing strong growth across Sweden, US, and continental Europe. We're not seeing any reversion back to offline from our consumers.

I think the reasoning – the underlying drivers for our growth in previous year, it wasn't so much with the exception of Norway, perhaps, wasn't so much driven by COVID, it was more driven by that fundamental trend of harm reduction and the benefits that we, ourselves, could give in the form of assortment and pricing and convenience along the way. So, I don't think that as opposed to many other products, I don't believe we're being that affected relative to offline.

Niklas Ekman

Analyst, Carnegie Investment Bank AB

Q

Yes. That's very clear. Thanks. And...

Gavin O' Dowd

Chief Executive Officer, Haypp Group AB

A

And perhaps, adding onto your question as regards to the trends that we've seen from – during Q2 into the summer, we were pretty comfortable with how it was during Q2 and we haven't seen an uptick in it as we came through the summer either. In fact, what we tend to experience as a business is a slight reduction in sales during the summer as people tend to spend more time on vacation and perhaps more time out of the country. So, I think it's more that seasonality that we tend to see rather than the other way around.

Niklas Ekman

Analyst, Carnegie Investment Bank AB

Q

Okay. That makes sense. I mean, is that seasonality more pronounced this year than last year maybe?

Gavin O' Dowd

Chief Executive Officer, Haypp Group AB

A

Yes. I expect – so I think with this seasonality that we've experienced from we originated as a company in 2009 up until 2019, I think it broke heavily for 2020 during COVID. It reverted partially in 2021. And I think we would probably be back to normal seasonality for 2022.

Niklas Ekman

Analyst, Carnegie Investment Bank AB

Q

Okay. That's very clear. And third and final question, just on the margins here rising quite strongly here, driven mainly by core markets, over the next few quarters, do you think that's still going to be the main margin driver for you, or do you expect any tangible improvements also in your growth markets? And I'm talking kind of the next few quarters, the next two years or so.

Svante Andersson

Chief Financial Officer, Haypp Group AB

A

Yeah, I think when it comes to the margin on the growth markets, Niklas, I – as I alluded to in the commentary here, I mean, we are confident that we will be able to flip these into healthy profitability, but that is going to be – it is down to a matter of sufficient scale. And I mean, we have to keep in mind also that these are quite significant consumer markets where we're building our positioning. But as we get to a certain point of scale, we're quite confident that we can sort of apply the – our media and insights model that we quite – worked quite successfully really for quite a few years in Scandinavia to the growth markets as well. And then that could quite rapidly move these markets into profitability. But it's a little bit hard to speculate on exactly when that will happen. But I mean we remain committed to our financial targets, obviously. So, it's – I think that's pretty much what I can say about the timing of it.

Gavin O'Dowd

Chief Executive Officer, Haypp Group AB

A

I think it's probably also worth noting in this one, Niklas, that you can see the growth in nicotine pouches in our growth markets are close to triple-digit year-on-year growth. And so, as long as we can see this sort of growth and this moving towards sustainability, we will prioritize growth over margins for that period. However, what we can see with this sort of growth coming through is that the benefits of scale are starting to – will start to manifest extremely quickly. And so, I think we will continue to keep to the principle of optimizing for these markets on growth over profitability, but we can see already exactly how we've done this in other markets of how to bring those rapidly into the net contributing markets once that scale is achieved.

Niklas Ekman

Analyst, Carnegie Investment Bank AB

Q

Thank you. That's very helpful. Thanks for taking my questions.

Gavin O'Dowd

Chief Executive Officer, Haypp Group AB

A

Thank you, Niklas.

Svante Andersson

Chief Financial Officer, Haypp Group AB

A

Thank you.

Operator: [Operator Instructions] There are no more questions from the phone.

Gavin O'Dowd

Chief Executive Officer, Haypp Group AB

Great. Thank you very much. I look forward to catching up with you all again for our Q3 results in November. Thank you.

Svante Andersson

Chief Financial Officer, Haypp Group AB

Thank you. Bye-bye.

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