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Haypp Group AB (HAYPP.SE)

Q3 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: Welcome to Haypp Group's Quarter Three Presentation 2022. Throughout the call, all participants will be in listen-only mode. Afterwards, there will be a question-and-answer session. [Operator Instructions]

I will now hand over the word to CEO, Gavin O'Dowd; and CFO, Svante Andersson. Please begin your meeting.

Gavin O'Dowd

Chief Executive Officer, Haypp Group AB

Good morning, everybody, and welcome to Haypp Group's presentation of the interim report for the third quarter of 2022. Today, we will walk you through a brief overview of our business and comment on the operational and financial performance for the third quarter. The interim report and the results presentation is available at the Investor Relations section of our corporate website. Presenting today, in addition to myself is, Svante Andersson, our CFO.

Moving to slide 3 in our results presentation, here, we state our higher purpose of inspiring healthier enjoyment to millions, which is about moving people from cigarettes to safe alternatives. Traditionally, this was more so to snus, but in more recent years, this is very much towards nicotine pouches.

On slide 4, we have a chart presenting the spectrum of nicotine products and the relative level of harm versus cigarettes. Haypp Group's current focus on nicotine pouches and snus lies in the extreme lower end of the spectrum. The scientific body of research around modern harm reduction alternatives to cigarettes has come a long way in recent years. In addition to nicotine pouches and snus, products such as tobacco heating devices and vapor are widely accepted as carrying significantly lower levels of harm than traditional cigarettes and other tobacco smoking products.

On slide 5, we can see what smoking rates are like across a broad range of European countries. Sweden, with a strong tradition of oral nicotine is below one-third of the European average for smoking rates. In Norway, where oral nicotine products were introduced some 20 years ago, smoking rates are at similarly low levels to Sweden. And on the right-hand side, we can see how the smoking rates collapsed between 2005 and 2020 in Norway

especially among the younger part of the population and there is an almost perfect correlation between that and the uptake of nicotine pouches and snus among the same age groups. It is this impact on public health that we wish to bring to other countries.

Turning to slide 6, we can see the outlook for the market that we laid out last year in connection with our IPO which we believe is equally as valid today. We see a global market size for nicotine pouches and snus, which will increase from SEK 27 billion in 2020 to SEK 60 billion in 2025. All of this growth is going to be driven by nicotine pouches, which will increase from a share of the market of 30% in 2020 to 80% in 2025.

Since the market outlook was prepared, nicotine pouches has been tracking in line with expected CAGR of 41%. It is also worth noting that Haypp Group has been growing significantly faster in the nicotine pouch category. Due to the harm reduced nature of this category, it carries relatively low excise taxes, and hence there is quite a significant profit pool to be divided between the manufacturers and the retailers of SEK 48 billion. Furthermore, the category is very well-suited for online and we see online penetration increasing for every quarter that goes by, and we continue to expect online to increase at healthy levels.

On slide 7, we lay out the key factors behind the growth of nicotine pouches. The primary driver is strong consumer demand for less harmful products, which is greatly supported by regulators in general, adopting the principle of harm reduction in their legislative approach to nicotine products. This, in turn, has led to significant investment from the category – sorry, in the category from industry players, both large tobacco companies and many credible new entries – entrants driving innovation. These are the drivers for the growth that we see on the right-hand side.

On slide 8, we have a picture of our competitive landscape online for our category. While there is a significant number of players, many who come and go over time, they never reach the scale that we are at and we are currently circa 10 times the size of our largest competitor online.

On slide 9, starting off with Sweden, we are continuing to grow market share within nicotine pouches and as nicotine pouches continues to grow share of the total market, our share in the total Swedish market has lifted from 10% as we stated in 2020 up to the early to mid-teens.

In Norway, we have struggled since the border and the duty-free channels reopened post-COVID and contracted the size of the domestic market in Norway. What we can see is that our share within the domestic market has been holding strong and we believe that we are growing share in Norway domestically again especially within nicotine pouches.

In our growth markets in Europe and US, we continue to grow share both of the total market and within the online channel.

Moving along to slide 10, you will see an overview of our logistics infrastructure. Convenience remains one of the key USPs and the ability to offer our consumers across all of our markets, fast and reliable deliveries sets us apart. We completed the first phase of our expansion – warehouse expansion plans in Q2. And we are now operating six warehouses across our core and growth markets. We have managed this expansion while continuing to maintain healthy inventory turnover of 17 times in the past 12 months, which is an important element in our strong cash conversion which Svante shall touch upon later.

Moving to the operational highlights for Q3 on slide 12 and starting with our performance in nicotine pouches. The growth in consumer demand for significantly less harmful nicotine products remains elevated and continues to

gain support from regulators. As I touched upon in the earlier slides, effectively all growth for the combined nicotine pouch and snus category is coming from nicotine pouches. With this in mind, nicotine pouch volume is our primary measure of success. In addition to overall nicotine pouch growth, Haypp continues to grow share across all of our markets. In the years prior to COVID, we experienced seasonally slower Q3 as consumers moved to other channels during the summer holiday period. During 2020 and to a certain extent 2021, the normal seasonality pattern was significantly reduced due to COVID-imposed travel restrictions.

In 2022, we saw a return to pre-COVID seasonality patterns, which is particularly evident in the snus volumes in Norway on the right-hand chart. Despite the return to seasonality, we continue to make strong progress in the nicotine pouch volume during the quarter and we grew by 48% year-on-year when excluding Norway. For our growth markets, the increase was even higher. In Norway, we saw a constant improvement in year-on-year growth rates for every month during the quarter. And in total, our volume of nicotine pouches was flat versus the same quarter last year, bringing the overall growth rate for the group to 40%. Nicotine pouches now accounts for 43% of our volume as compared to 34% in the quarter of last year.

Turning to slide 13. Regarding regulation, we continue to see governments adopting the principle of harm reduction as a core pillar of their regulatory strategy. Sweden, for example, adopted new legislation in Q2 that came into effect from the 1st of August, which clearly reflects this perspective. In Europe, we are also noting growing governmental interest for harm reduction and we remain confident that the EU will introduce positive regulation for nicotine pouches in [ph] TPD 3 (00:08:46), which is expected in circa 2024. Since the European Parliament released its Beating Cancer report, we are seeing an increased number of governmental agencies across our markets in Europe advocating for regulations of new nicotine products from a harm reduction perspective.

In September, the German Federal Institute for Risk Assessment released their health assessment on nicotine pouches, concluding that switching from cigarettes to nicotine pouches can significantly reduce the health risks for smokers. Also in September, another harm reduction study commissioned by the UK Department of Health and Social Care encouraged the use of nicotine pouch and vaping products to quit smoking since the risks posed from these products are deemed to be a small fraction of the risks from smoking.

With that, I'll pass the word to Svante, for comments on our financial performance.

Svante Andersson

Chief Financial Officer, Haypp Group AB

Thank you, Gavin. Good morning, everyone. So, starting on page 14, and the financial overview for the group. We continue to see strong growth across all our segments during the third quarter, with the exception of Norway, driven by our progress within the nicotine pouch category. Excluding Norway, our net sales growth was 19% in constant currency and our reported net sales for the group increased by 8% to SEK 631 million for the third quarter. And in constant currency, net sales increased by 4%.

In terms of our gross margin, it continue to improve versus last year and amounted to 12.4% during the quarter. The improvement is driven by a stronger gross margin in our core markets. Our adjusted EBIT for the quarter grew by 35% versus last year and amounted to SEK 14 million, corresponding to an adjusted EBIT margin of 2.2%, up by 0.5 percentage points versus last year. The key driver behind this margin uplift is higher volume and gross margin, partially offset by higher adjusted OpEx from investments in our organization to support further growth. Our cash flow from operating activities during the year-to-date period increased to SEK 55 million, implying a strong cash conversion of 79% for the period.

And if we now turn to page 15, in our core markets, we reported here a net sales for the segment growth – reported a net sales increase for the segment of 3% during the quarter, and the net sales amounted to SEK 514 million. Our nicotine pouch volume, however, grew substantially more at 33% with Sweden growing over 40%, and Norway being flat.

In Sweden, the net sales for the quarter increased by 17%, driven by continued strong organic performance in the nicotine pouch category. In Norway, year-on-year growth was negative during the quarter at 20% with nicotine pouches showing growth at the latter part of the quarter, while snus was declining on the back of seasonality especially in the months of July and the first two weeks of August.

Looking at the profitability for our core markets, it remains strong with an EBITDA margin of 8.2% during the third quarter, up by 3 percentage points versus last year and already close to levels which we're expecting for the total group in the medium- to long-term according to our financial targets. The EBITDA in the core markets now amounts to SEK 163 million on an LTM basis. The EBITDA margin increase in the third quarter is mainly attributable to a higher gross margin and operating leverage from higher sales volume.

The profits that we generate here in our core markets are reinvested back into building our market positions in the growth markets. So, with that, turning to page 16 and looking at the growth markets, the net sales here increased by 44% to SEK 116 million for the quarter on the back of strong performance across both the US and Europe. The performance is almost solely driven by nicotine pouches where we grew 55% in volume during the quarter and gain market share.

EBITDA amounted to negative SEK 17 million versus negative SEK 8 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. We continue to invest considerable resources into building strong online market positions in these very significant consumer markets, and we have been gaining market shares. We remain confident that with our current trajectory and market share gains, we will over time also be able to deliver healthy profitability from the growth markets.

On page 17, we're presenting a selection of KPIs, and I would like to focus here on the balance sheet in particular. In an uncertain general economic environment, we are particularly pleased to note that our financial position remains very strong. The net working capital was SEK 113 million as per the end of the quarter, up from SEK 70 million at the year-end. Within the net working capital, we had SEK 161 million of inventories which we turn about 17 times per year, as Gavin mentioned earlier, implying that it's a highly liquid asset.

Versus year ended 2021, we have grown the inventory for two reasons. One, we have built safety stock in our newly opened warehouses throughout the first half of the year, and two, we have continued to seize opportunities to load inventory at favorable commercial terms.

Our net debt amounted to SEK 75 million corresponding to a net debt to adjusted EBITDA ratio of 0.8, up from 0.6 at year-end mainly driven by higher lease liabilities as a result of the warehouse expansions. Cash and cash equivalents amounted to SEK 72 million at the end of the quarter and we had another SEK 54 million in unutilized for these facilities.

Lastly, on page 18, we have a summary here of the third quarter performance. So, first and foremost, we grew our strategically important nicotine pouch volume by 40%. Secondly, we're showing a continued profitability uplift with an adjusted EBIT growth of 35%. And thirdly, we're generating strong cash flow of SEK 55 million so far this year and we have a solid financial position with a net debt ratio of 0.8.

And with that, I'll hand the word back to Gavin.

Gavin O'Dowd

Chief Executive Officer, Haypp Group AB

Thank you, Svante. On slide 20, we reiterate our long-term targets of SEK 5 billion in net sales by 2025 predominantly through organic growth. We also reiterate our profit target of high single-digit adjusted EBIT over the medium- to long-term. As you have seen from Svante's material, we are already rapidly closing on this target in our core markets. Due to the growth potential in the category, the board does not intend to issue a dividend in the foreseeable future and instead utilize our strong cash generation and robust balance sheet to accelerate growth.

On slide 21, we highlight the potential which we see in the overall category growth and also the potential for online to take a larger share of the category, given how suitable the characteristics of the category are for online. We also reiterate our market leading positions in all of our markets.

Moving along to slide 22, and our current trading. Overall market trends for the oral nicotine category remained favorable and we continue to transition our business into the nicotine pouch category. As anticipated, the online channel for this category is benefiting in the current economic environment, as consumers are more sensitive to value and high benefits from the price advantage over traditional offline channels.

In terms of inflationary pressure on inbound costs, we reiterate our previous guidance that inflationary pressure on our cost base remains limited. Given the non-cyclical characteristic of this category, we remain confident that any inflationary pressure can be passed on. In terms of regulatory development, the state of California voted to impose a ban on flavored nicotine products on November 8. The ban prohibits brick-and-mortar retailers and vending machines from selling certain flavored products, including flavored nicotine pouches.

While it is our opinion that the ban is a step back in terms of harm reduction, we do not expect it to have a material impact on the category growth in this stage. There are examples of other states in the US that have regulated against flavors, and in general, they have had a very limited impact on the overall consumption.

In this specific case of the California flavor ban, online retail is exempt, implying that the ban could benefit Haypp and other online-based retailers. We continue to see solid performance in our nicotine pouch growth. Performance remains strong in Sweden with continued share growth. The actions taken in previous quarters to turn around our development in Norway have delivered in line with expectation, and the consistent improvements seen during the third quarter has continued so far during the fourth quarter, and we are currently experiencing a year-on-year growth in nicotine pouches.

The strong momentum we have in our growth markets is sustained, and we continue to gain share of the total market. Seasonality effects are expected to be slightly more pronounced in December of this year versus 2021, as December last year still had the degree of COVID restrictions in place. We will continue to fine-tune our existing proposition to consumers hinging around a broad assortment, convenient delivery and good prices. Our platform continues to play a pivotal role in launching new brands with over one-third of the third quarter volume of nicotine pouches coming from products which were launched into the market in the last year.

Lastly, we believe we are very well positioned for the up – for what is becoming a complex period for consumer spending. With a strong balance sheet and non-cyclical product and a capital-light business model, we are able to remain flexible and strengthen our overall market position.

As I wrap up, I would like to guide you to slide 23. In summary, there's over 1 billion smokers in the world looking for healthier alternatives and nicotine pouches is the fastest growing category. The category is perfect for online, and we are an undisputed global online market leader where we are over 10 times the size of our largest competitor. We have a symbiotic relationship with our suppliers. In addition to being the partners of choice for new launches, we are also the largest provider of consumer insights. We continue to welcome proportionate regulation as we often benefit from it. And the unit economics continue to improve as we scale and this is already evident in our core markets. And we have a highly engaged team with core competencies across both the nicotine industry and e-commerce.

Operator, I would now like to open up the line for questions, please.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And our first question comes from Niklas Ekman from Carnegie. Please go ahead. Your line is now open.

Niklas Ekman

Analyst, Carnegie Investment Bank AB

Q

Thank you. Yes. A couple of questions from my end. Firstly on Norway, where you're talking about signs of improvement, what would you attribute these signs to? Is there any signs of reversal of border trade? Is it due to easier comparisons or are you seeing accelerated online migration? Or what would you attribute the signs of improvement on?

Gavin O'Dowd

Chief Executive Officer, Haypp Group AB

A

Good morning, Niklas. So, perhaps, just on this one, to give a little context. So, if we look back a few years and we take a look at how we were operating in the era before COVID, we were showing robust month-on-month growth within the market. Then, as COVID manifested, we saw effectively 300% growth very rapidly within Norway as the market grew quite – as they – as the border shut and – the border shut and the travel duty-free shut down as well. There was also, of course, the boost of lockdown within that space as well.

What we saw over the last six quarters was the reversal of that coming through. Now, what we now see is a return to the underlying trend that we saw going into COVID, where we're seeing that natural migration from offline to online. So, we don't envisage that based on our understanding of the market, the border has returned effectively to the same position as it was before COVID. We don't anticipate that it will reduce. We've seen quite a significant channel to the market for the past couple of decades. We envisage the same for duty-free. It's more within the domestic market where there is that gradual migration that we've been experiencing during 2018 and 2019 from offline to online that we see continuing unabated in 2022, in recent months.

Niklas Ekman

Analyst, Carnegie Investment Bank AB

Q

That makes a lot of sense. Thank you. And on your growth target there of €0.5 billion. You said you're very much in line with reaching this target. But this – on my calculations that requires a CAGR of 24% from here. And, of course, in Q3 specifically, you only grew 4%. And, obviously, a lot of disruptions in the short-term. But what makes you confident that this growth will accelerate so strongly in the coming quarters and coming years?

Gavin O'Dowd

Chief Executive Officer, Haypp Group AB

A

Yes, so absolutely. We need to be getting into the mid-to-high 20s in order to hit our targets on this pace. I think what we need to take a look at here, Niklas, is the underlying component parts of the business. You're right. We we're looking at a 4%. But if you take a look at our growth rates excluding Norway, where we have been experiencing more difficult period in time, we can see that our growth rates are in excess of that target CAGR that we're currently looking for at the moment.

Niklas Ekman

Analyst, Carnegie Investment Bank AB

Q

Yeah, fair enough. And on the short-term margin trend here, we've seen now margins rising 40 basis points, 50 basis points year-over-year in the past three or four quarters here. Are you expecting this to accelerate or do you expect a similar kind of trajectory looking into 2022? I'm again kind of referring to your fairly bullish medium-term target, which requires significantly higher margins. Just trying to see whether you expect these improvements to accelerate or if it's going to be more backend loaded towards 2024, 2025.

Svante Andersson

Chief Financial Officer, Haypp Group AB

A

Yeah, sure. Good morning, Niklas. This is Svante. So, I think I mean, in the shorter-term here, I think we will continue to sort of realize the benefits of scale as we grow and manage our margins in a fairly constant manner upwards as we've done throughout this year. And but I think and if you sort of take the perspective from our financial targets, obviously, reaching the mid to high or sort of the high single-digit EBIT margin in the medium- to long-term, we were – that hinges a lot on us turning around the margin development or increasing the margin, I should say, in the growth markets. And I think that will be – that aspect will be more back loaded versus now and 2025. But I think with that said, as I started off with [indiscernible] (00:25:17), we should see sort of continuous smaller improvements in the margin every quarter from here.

Niklas Ekman

Analyst, Carnegie Investment Bank AB

Q

Okay. Fair enough. And on that topic, your losses in growth markets, they have been increasing now for the past six consecutive quarters. When do you think this could reverse? How far away is the reversal there do you think?

Gavin O'Dowd

Chief Executive Officer, Haypp Group AB

A

Yeah. So, I think here, I mean, we reiterate here I think what we've said before, right? We're first of all very happy with how we have grown so far. We are investing heavily in the growth markets, but we're also generating some serious growth. And the key to improving the margins in the growth market will be to achieve sufficient market scale and market share and scale to really be able to attract even further investment from our suppliers and then sort of apply our commercial model that we operate quite successfully here in Scandinavia. It will likely take another – it's hard to give a specific guidance [indiscernible] (00:26:27) another couple of quarters or so before we start to see some serious improvement here, but we remain very confident that we will. It's a matter of scale and we are definitely on that trajectory.

Niklas Ekman

Analyst, Carnegie Investment Bank AB

Q

Very good. Thanks. And finally, just a small one here, you mentioned a greater seasonality effect in December. Are you talking then about lower volumes overall? Are you talking about a greater shift to physical retail or how should we read this? Is it merely a phasing or is it actually a little bit of lost volume from your end?

Gavin O'Dowd

Chief Executive Officer, Haypp Group AB

A

On this one, I guess there's probably two dynamics to this one. And one of the ones – one of the dynamics we need to bear in mind, although it does feel like sort of a very dim and distant memory, is that when we were in December last year, we were still in the midst of COVID lockdown across Scandinavia. It was the deepest lockdown we experienced within Sweden and it was also the final lockdown that was experienced in Norway in Norway and it manifested through into early to mid-January. So, we're going to be facing that Norway impact, for December, [ph] no significant (00:27:40) we're going to be facing that Norway impact.

There's also another aspect tying in a little bit [indiscernible] (00:27:45) similar to what I sort of highlighted in the messaging around December. We tend to see a two-phase of the seasonality at any given year. So, we tend to see heightened seasonality from mid-July until mid-August and we also tend to see very heightened seasonality from around about the – around about the 20 of December until about the 28 or 29 of December, around the Christmas period, where people will often choose to buy their snus or nicotine pouches via other channels as they're dealing with complexity – other complexities or travel that's going on around Christmas. We didn't see that to a great extent during 2021, nor in 2020, and we expect that normal seasonality that we experienced there to return back for 2022.

So, this would be [ph] lost volume in the same way as the summer is (00:28:33), that we don't get back. I flagged this up as something to be to be aware of, but we don't envisage this is going to be significant. This is not going to impact on – this is not going to have a significant impact on our overall results.

Niklas Ekman

Analyst, Carnegie Investment Bank AB

Q

That's super clear. Thank you for taking my question.

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: Thank you. There are no more questions from the telephone conference. I hand over back to you, Gavin and Svante.

Gavin O'Dowd

Chief Executive Officer, Haypp Group AB

Great. Thank you, all, very much for taking the time to participate in this morning's call, and we look forward to coming back to you on the 15 of February, with our full year results for 2022. Have a wonderful day. Take care.

Svante Andersson

Chief Financial Officer, Haypp Group AB

Thank you.

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