

# Not Your GrandMother's Coffee Roasters

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# Table of Contents

Spinoff Situation .....	3-6
Background and Business .....	7-15
Bear/Bull Case .....	16-27
Sarista Rollout .....	28-33
Patent Issues .....	34-38
Taxes About to Drop .....	39-42
Transformation .....	43-46
Conclusion .....	47-49

# Spinoff Situation

# Spinoff Situation

- D.E Master Blenders 1753 (D.E) was spun out of Sara Lee (now Hillshire Brands) in June 2012
- Parent company shareholders received one share of D.E for each share of Sara Lee owned
- Unlike its parent, D.E is not a component of the S&P 500 Index nor is it listed on a US stock exchange
- D.E trades on the pink sheets (DEMBF) and on Euronext Amsterdam (DE)

# Spinoff Situation

- Management told us they have no plans to list DEMBF on a US exchange
- As of May 1, 2012, only 0.022% of Sara Lee's outstanding shares were held by residents of the Netherlands
- 97.10% of Sara Lee's outstanding shares were held by residents of the United States
- We suspect that over 10 million shares may be owned by motivated sellers

# Spinoff Situation



D.E shares have performed surprisingly well since the spinoff. Management has hosted roadshows with several European banks.

# Background and Business

# Background and Business

- Douwe Egberts Master Blenders 1753 is headquartered in Amsterdam, Netherlands
- D.E was founded in 1753 as a grocery store selling coffee, tobacco and tea
- From the 1940s to 1970s D.E acquired leading coffee makers in Western Europe; as well as the British tea maker, Hornimans



# Background and Business

- In 1978 D.E was acquired by Sara Lee and began to expand outside of Europe, in fast-growing markets such as Brazil
- The Away from Home business also expanded rapidly during the 1990s, with the Cafitesse liquid coffee system becoming popular in offices, hospitals, hotels, and other public buildings

# Background and Business

- D.E operates in two main segments
  - At Home: roast and ground multi-serve coffee/single serve coffee capsules, instant coffee and tea
  - Away from Home: products are sold either directly to businesses, hotels, hospitals and restaurants or to foodservice distributors for distribution to the customer

# Background and Business

## Leading Brands



**Senseo**  
Global



**L'OR Espresso**  
France



**Marcilla**  
Spain



**Hornimans**  
Spain



**Merrild**  
Denmark



**Prima**  
Poland



**Pilão**  
Brazil



**Moccona**  
Australia



**Douwe Egberts**  
Global



**Pickwick**  
Global

# Background and Business



Cafitesse:  
unique liquid  
coffee system,  
serving fresh  
coffee – quickly



Fresh Brew and filter  
coffee: traditional filter  
coffee machines and  
coffee vending machine  
concepts for small,  
medium and large  
locations with Roast &  
Ground Fresh Brew  
coffee



Instant: From  
small instant  
machines to full  
automatic  
machines with  
Douwe Egberts  
quality instant  
ingredients



Espresso: Espresso  
coffee machines for  
restaurants, cafés,  
and hotels, who want  
to provide their  
customers with top  
quality espressos

# Background and Business

- In 2001 D.E formed a 50-50 joint venture with Philips Electronics to launch the Senseo single serve coffee system (one year before Keurig's brewer)
- In January 2012 D.E purchased the remaining 50% stake in Senseo from Philips for €170 million
- D.E now owns full rights to the global Senseo trademark; Philips will continue to design, manufacture and distribute all Senseo machines until 2020

# Background and Business

Fiscal Year Ending July				
<i>in millions of €</i>	2009	2010	2011	2012
Total Revenue	2,234.50	2,315.50	2,601.60	2,795.00
<i>Growth y/y</i>	n/a	3.62%	12.36%	7.43%
COGS	1,333.90	1,346.10	1,616.60	1,787.10
Gross Profit	900.60	969.40	985.00	1,007.90
<i>Gross Margin %</i>	40.30%	41.87%	37.86%	36.06%
Total SG&A	554.1	622.7	653.7	898.2
Operating Income	346.50	346.70	331.30	109.70
<i>Operating Margin %</i>	15.51%	14.97%	12.73%	3.92%
Financial Income and Other	119.4	72.7	48.7	149.8
Pre-Tax Profit	465.90	419.40	380.00	259.50
Income Taxes	127.4	179.4	104	127.3
Net Income	338.50	240.00	276.00	132.20

# Background and Business

## Market Valuation

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Stock Price	€9.30
Diluted Shares Out.	595M
Market Cap	€5,533
Net Debt	<u>€337</u>
Enterprise Value	€5,870

## Valuation Multiples

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	€	Multiple
Revenue 2012	€2,793.00	1.86x
Revenue 2013E	€2,904.72	1.79x
EBIT 2012	€321.00	16.19x
EPS 2012	€0.20	46.50x
Normalized EPS	€0.45	20.67x

# Bear Case



# Bear Case

- D.E cannot quickly pass increasing commodity costs (green coffee) on to consumers
- Reported revenue growth of 3.6%, 12.4% and 7.4% in 2010, 2011 and 2012, respectively, is substantially lower than COGS growth
- D.E's gross margins have declined from 42% in 2010 to 36% in 2012
- Two-thirds of D.E's revenue comes from Western Europe

# Bear Case

## New Competitors in Single Serve Category



*Keurig Vue* brews coffee, lattes and cappuccinos, as well as tea, hot cocoa and iced beverages

Brewer price: \$299.99  
Price per serving: 67-92¢



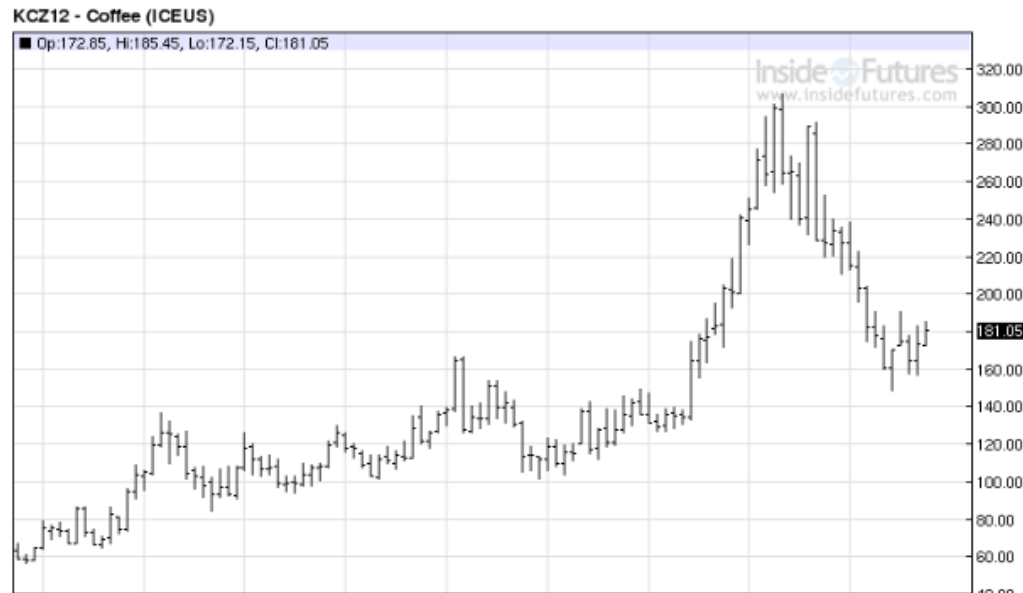
*Starbucks Verismo 580 Brewer* uses pods to create caffè lattes, espresso and steamed milk

Brewer price: \$199.00  
Price per serving: 83-162¢

# Bull Case

# Bull Case

- As green coffee prices surged in 2010-2011, D.E raised prices in line with competitors
- Margins should benefit as coffee prices have dropped almost 50% from their 2011 peak



# Bull Case

Leader in Roast & Ground Market Share (Excludes Single Serve)

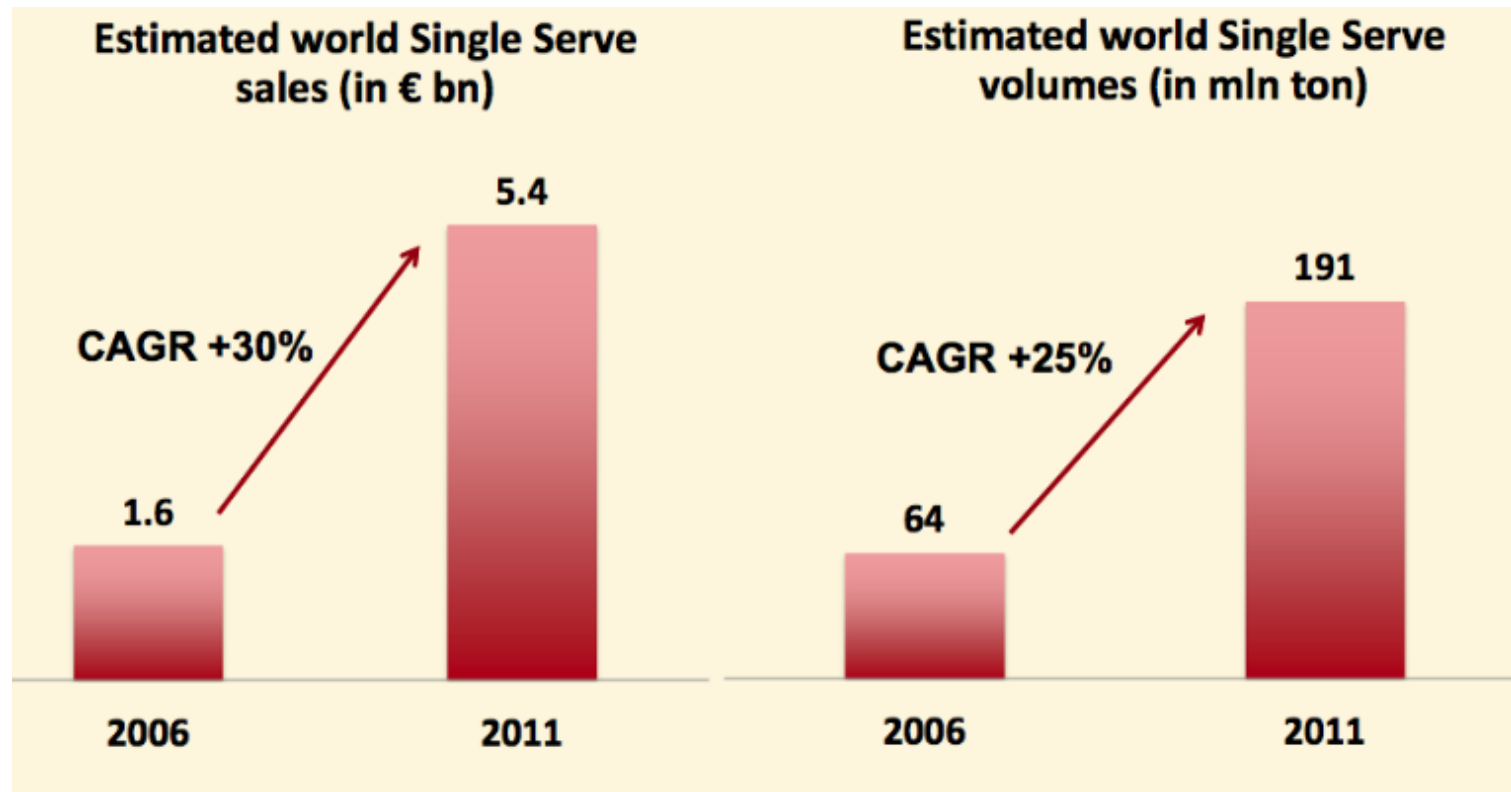
Country	D.E Share	D.E Position
Netherlands	60%	#1
Belgium	52%	#1
Hungary	35%	#1
Denmark	31%	#1
Brazil	22%	#1
Spain	20%	#2
France	15%	#3
Poland	18%	#4

# Bull Case

- 72% of D.E's revenue comes from markets where it has a No. 1 or No. 2 position
- Senseo has share of mind, with over 33 million brewers sold since 2001
- We estimate that global Senseo brewer sales have outpaced Keurig (though GMCR stopped disclosing Keurig brewer sales after fiscal year 2009)

# Bull Case

Single Serve is the Fastest Growing Segment in Coffee



# Bull Case

- Unlike its competitors in single serve, D.E does not have a “razor and razor blade” model
- Philips designs, manufactures and distributes all Senseo coffee machines; sells machines above cost instead of at cost
- This sales practice appears to work well in Europe
- We have suggested to management that it tries a “razor and blade” model in the US



# Bull Case

- In the Away from Home segment, 58% of sales are direct to businesses, hotels and restaurants; 42% of sales are to foodservice distributors
- Foodservice distributors are well-established and geographically diverse: Sodexo, Compass, Metro/Makro, Mahou, UCC Japan

# Bull Case

## D.E Generates High Returns on Capital

€ (000,000 omitted)	2011	2010	2009
Net Income	<u>276.00</u>	<u>240.00</u>	<u>338.50</u>
Operating Working Capital	474.80	386.00	350.90
Acquisitions	24.08	n/a	7.36
Net Fixed Assets	369.90	365.60	372.60
CapEx	<u>77.50</u>	<u>65.70</u>	<u>76.60</u>
Total	946.28	817.30	807.46
Return on Capital Invested	29.2%	29.4%	41.9%

# Bull Case

## D.E Generates Significant Free Cash Flow

€ (000,000 omitted)	2011	2010	2009
Operating Cash Flow	281.70	364.80	194.00
CapEx	(77.50)	(65.70)	(76.60)
Acquisitions	<u>(24.08)</u>	<u>n/a</u>	<u>(7.36)</u>
Free Cash Flow	180.12	299.10	110.04

# Sarista Rollout

# Sarista Rollout

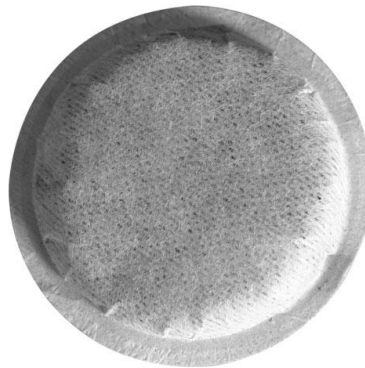
- D.E began selling a new single serve coffee machine, Sarista, in the Netherlands this October
- Unlike other brewers, Sarista starts with unground beans, then grinds them immediately before brewing
- Sarista creates fresher coffee than other machines

# Sarista Rollout

Conventional Single  
Serve (Ground Beans)



K-cups



Coffee Pads

Sarista Funnel  
(Full Beans)



# Sarista Rollout

- Machine is expensive at €249 MSRP
- Cost per serving is €0.24 (\$0.31) – half the price of K-cups and one-third the price of Starbucks Verismo pods



# Sarista Rollout

Brand	Price \$	Servings	Per Serving
<i><u>K-cup - Lower End</u></i>			
Folgers : Black Silk Dark Roast	11.28	18	63¢
GMCR : Breakfast Blend	16.28	24	68¢
Tully's (GMCR) : Kona Blend	11.99	18	67¢
<i><u>K-cup - Higher End</u></i>			
Barista Prima (GMCR) : Coffeehouse Blend	20.49	24	85¢
Café Escapes (GMCR) : Chai Latte	12.99	16	81¢
Dunkin Donuts : Original Blend	11.99	14	86¢
<i><u>D.E Coffee Pod &amp; Sarista Funnel</u></i>			
Senseo Coffee Pods - Dark Roasted	35.99	108	33¢
Senseo Origin Coffee Pods - Colombia	24.99	64	39¢
Sarista Funnels	6.20	20	31¢
<i><u>Verismo Coffee Pod – Higher End</u></i>			
Verismo Caffe Latte Pods	12.95	8	\$1.62
Verismo Espresso Roast	11.95	12	\$1.00
Verismo House Blend Brewed Coffee Pods	11.95	12	\$1.00

Source: Honne Capital pricing checks on Amazon.com and Starbucks.com



# Sarista Rollout

- Despite their low cost per serving, Sarista bean funnels are high-margin for D.E, as they are just canisters of unground beans
- Capex related to Sarista is minimal, as D.E uses existing facilities to fill funnels with roasted beans
- Philips manufactures, distributes and sells all Senseo coffee machines
- Retailers have ordered twice as many Sarista machines as management expected

# Patent Issues

# Patent Issues

- In 1998 D.E was granted a patent for Senseo and started with a monopoly over high-margin coffee pouches
- Competitors soon entered the market for coffee pouches and delivered copy-cat products in shops
- At the end of 2001 Sara Lee began infringement proceedings against several competitors in Belgium and in the Netherlands

# Patent Issues

- In 2002 the Court of Appeal in Hague held that there was no indirect infringement action
- Dutch competitors were allowed to continue selling their copy-cat products
- In 2006 the European Patent Office completely revoked Sara Lee's patents for lack of "inventive step"

# Patent Issues

- Learning from experience, D.E has built up an extensive patent portfolio to protect Sarista canisters/funnels as well as the coffee brewer, and their interaction
- D.E has filed 10 patent families for Sarista
- Most of these have already been granted in the Netherlands, France and Germany with expiration in 2031
- A few are still pending at the European Patent Office

# Patent Issues

- D.E has focused on preventing patent workarounds
- Patents provide D.E with an exclusive right to manufacture and sell Sarista canisters/funnels
- D.E has ensured that its funnels cannot be refilled

# Taxes About to Drop

# Taxes About to Drop

- Tax rate was abnormally high in 2010 and 2012
- In fiscal 2010, D.E recognized €50.8 million of additional tax expense as a result of its decision to repatriate certain income that will result in recapture taxes and an increase in tax reserves of €31.7 million for a tax claim in Belgium
- D.E also recorded additional tax expense associated with a change in tax reserves recorded in prior years of €30.7 million



# Taxes About to Drop

- **Q: Clearly, the tax rate is above the norm for the year. What do you see as the effective tax rate going forward?**
- **A: We reported an effective tax rate of approximately 53%. If you look at what is the normalized effective tax rate, that is around 32% for 2012. Going forward to 2013, I expect the effective tax rate to be around 30% and from 2014, as I also already announced in March, we expect an effective tax rate of around 25%.**

# Taxes About to Drop

- Applying a 25% effective tax rate, D.E's net income in 2010, 2011, and 2012 would have been higher by 31%, 3.3%, and 58.9%
- Management does not apply the going-forward tax rate in its calculation of adjusted earnings

# Transformation

# Transformation

- Non-recurring charges amount to €221 million in fiscal 2012:
  - Spin-related items
  - Restructuring
  - Termination costs related to prior Senseo contract with Philips
  - New business model
- Normalized EPS is €0.45 vs. reported EPS of €0.20

# Transformation

- In July 2012 D.E began a restructuring program to become simpler and more commercially driven
- 7% of workforce eliminated, with annual savings of €5 million
- 30% of general managers have been given new positions
- Cost saving programs aim to cut expenses €25-30 million in 2013; €55-75 million by 2015

# Transformation

- In 2011 D.E generated approximately 95% of Senseo sales in the Netherlands, Belgium, France and Germany
- D.E plans to expand geographically into Eastern Europe, Asia and Latin America
- As emerging markets grow wealthier, buying will shift away from instant coffee to single serve and roast and ground (where D.E has an advantage)
- Extension of new products and selective acquisitions where appropriate

# Conclusion

# Conclusion

- D.E has been under-managed as a division of Sara Lee, with inconsistent sales execution and a lack of urgency
- After the spinoff, D.E is leaner and more profitable
- D.E is a great business with ~30% return on invested capital
- With Sarista, D.E has a second chance to generate large profits in the single serve category



# Conclusion

- We project that over the next few years D.E will grow the top line in the mid-single digits
- Net income will improve *ceteris paribus* due to lower tax rates going forward
- P/E multiple of 20x 2012 adjusted earnings is misleading due to 49% tax rate
- Applying going-forward tax rate, P/E drops to ~10
- Given the quality and potential of D.E's business, 10x earnings is cheap

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