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SodaStream

27.02.2017

A Sparkling future: Initiating coverage of Soda Stream with an Outperform rating

SodaStream has experienced mixed fortunes in recent years, with impressive double – digit growth lasting from 2007 through 2013, followed by a dramatic downturn in 2014 – 2015. The strategic decision by management to rebrand and change the company's long – term business objectives brought about a turnaround that saw it return to growth in 2016 and drove a corresponding recovery in the stock, which gained 200% over the year.

Target market is enormous and there is still plenty of room for SodaStream to realize its potential

The carbonated beverages market is estimated at 300 million households, 17% of which consume carbonated water (soda). In terms of market share, this means that the specific segment SodaStream is targeting comes to 50 million households. Environmental trends, and the increasing controversy surrounding the health risk that carbonated beverages (both regular and sugar free) now pose, constitute drivers that are pushing consumers to switch to plain soda instead, thus growing the size of SodaStream's potential market share.

Change in strategy will continue to drive growth in 2017 too

The company's performance in 2016 was the result of management's strategic decision to rebrand SodaStream as the world's largest maker of home soda drinks dispensers. We think the huge potential that the carbonated beverages market holds will continue to drive the company forward and that the trend towards healthier life style choices worldwide is to set to become even more pronounced than ever. So it is critical that SodaStream seizes the moment and redoubles its efforts to extend household penetration and entrench brand loyalty among consumers before the real competition appears on the horizon.

Not too late to board the train

SodaStream has gained 200% over the past year but we don't think that investors should allow themselves to be deterred by a rise as steep as this. The company still has quite a way to go before it exhausts its potential in the carbonated beverages market and the stock is underpriced relative to the company's fair value. We also believe the stock will enjoy a further uptick in price once the exposure of the company's share to the Israeli market is more meaningful and that because of this it is an interesting investment at this point in time.

Bottom line

We are initiating of SodaStream with an Outperform rating and a $56.5 price target.

Our valuation is based on a multiple of 11x 2017 EV/EBITDAe vs. a historical average of 11.8x. With the company currently enjoying its most successful period ever, we think the stock is fairly priced and, assuming the EV/EBITDA multiples remains around the historical average (11.8x), it constitutes an attractive risk/reward proposition and therefore deserves to be an integral component in any portfolio.

Key data	
Recommendation:	Outperform
Previous:	N/A
Price target:	$56.5
Previous:	N/A
Market price:	$48.7
Upside:	16%
Sector:	Food
Symbol:	SODA
Market:	TLV
Market cap (NIS M):	3,762
52 – week high:	$49.5
52 – week low:	$14.5
TTM return:	190%

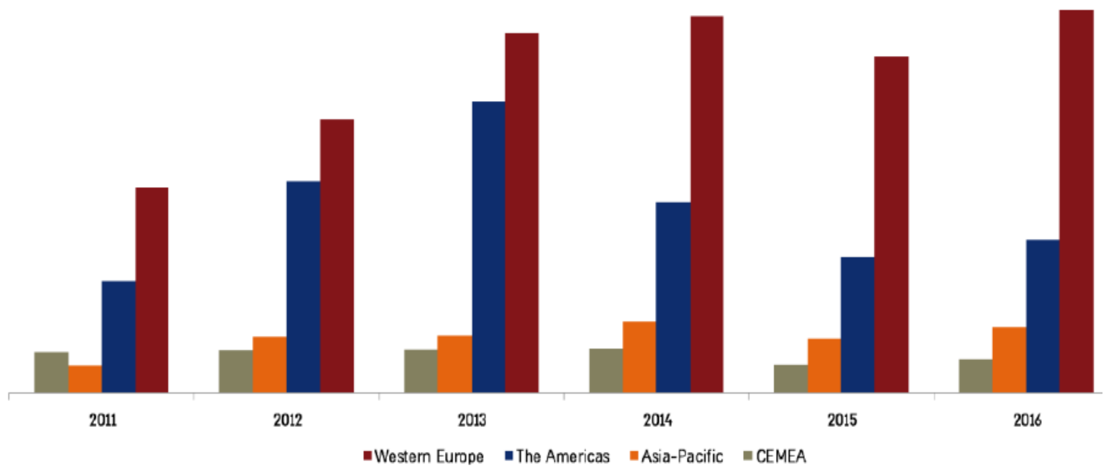
Investment thesis

SodaStream has experienced mixed fortunes in recent years, with impressive double – digit growth lasting from 2007 through 2013, followed by a dramatic downturn in 2014 – 2015. The strategic decision by management to rebrand and change the company's long – term business objectives brought about a turnaround that saw it return to growth in 2016 and drove a corresponding recovery in the stock, which gained 200% over the year.

Early years were challenging…

Up until 2014, the US was SodaStream's primary market. Take up at stores and by consumers was impressive at the beginning and the resulting growth in sales boded well for the company's prospects in the global market. But by the end of 2013 the company sensed that there was a problem in the US market. Stores that had ordered huge quantities of SodaStream devices found that they couldn't sell them even after cutting prices and putting on promotions in the form of discounts and coupons. The immediate outcome of these measures was an erosion in SodaStream's gross margin and an inventory glut that led to a pullback in sales to the US market.

Figure 1: Sales by geography



At the same time as the build – up in oversupply it became clear that SodaStream's strategy of branding itself as an alternative to beverage giants such as Coca Cola and Pepsi wasn't working and that the decision to focus exclusively on the US flavored beverages market was wrong. This mistake was made all the more evident by the fact that the company had hardly dedicated any promotions at all to the European market, where consumers are accustomed to drinking carbonated water (rather than flavored drinks). And if that weren't enough, SodaStream became embroiled in a political row over the advertisement that appeared at the Super Bowl featuring the actress Scarlett Johansson, with an accompanying endorsement from the Israeli prime minister. That endorsement seemed to imply that by locating its main manufacturing plant in Israel in the Meshor Adumim industrial park in the town of Maaleh

Adumim outside Jerusalem, the company was tacitly supporting the incumbent government's settlement policy beyond the green line. Needless to say, this wasn't exactly the kind of publicity the business needed.

And then came the change….

Management's solution to the problem was to reallocate marketing spend and move over to an ROI – based model. SodaStream scaled back its spending on marketing in the US, focusing instead on the established market in Europe and on new markets such as Japan and South Korea. Against the backdrop of the growing trend worldwide towards healthier eating it then changed the message underpinning its marketing, stopped branding itself as an alternative to bottled soft drinks, and set itself the goal of achieving control of the carbonated water market.

Lifestyle trends worldwide show that more and more people prefer to drink water rather than sugary drinks and that many of these new consumers are switching to soda. The growth in consumption of soda has come mainly at the expense of diet drinks and is supported by research conducted in the US and in Europe on the damage that can be caused by artificial sweeteners. In monetary terms, the research (conducted by Euromonitor and a Canadian institute) reveals that an additional $2.5bn a year is being spent on soda water instead of sugary/diet drinks.

The change in consumer tastes coupled with SodaStream's strategic turnaround have meant that the company's sales of soda water to households, in terms of liters, are now the highest in the sector, with the number of active consumers (i.e. people who drink over 150 liters of water a year) now estimated to be in excess of 10 million.

Company description

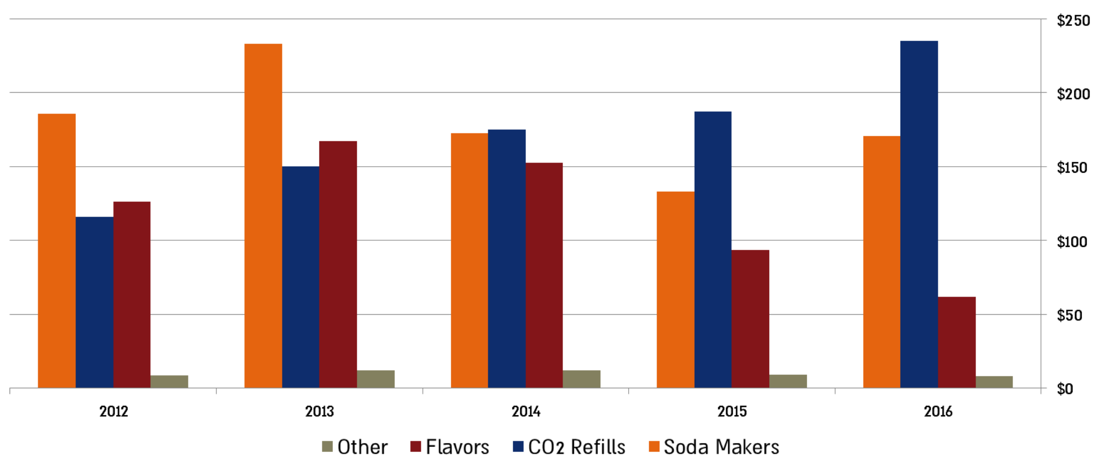
Two core businesses and a business model conducive to continuity

SodaStream manufactures and markets home beverage carbonation systems (soda water makers) and is the world's top carbonated water brand in terms of sales of water to households. The company's products enable consumers to easily transform ordinary tap water into carbonated water and flavored drinks. SodaStream's business model is based on the lines of the razor and blades business model, meaning that it sells machines for making soda and earns most of its profit from the sales of complementary items – beverage flavors and gas refills. SodaStream's products are sold at over 70,000 stores worldwide (in 45 countries), some of which receive their orders from the company directly (or through a local distributor that the company has acquired), while others are supplied through local retail chains.

Soda water makers – As of 2016, this business accounted for 34% of total sales and contributes an estimated 6% to underlying gross margin, according to our estimate. SodaStream's business model has two principle legs – selling the soda makers at an affordable price in the region of $58, and using the company's extensive geographic reach to gain a foothold in consumers' homes. Gross margin on the company's soda makers is reportedly around 20% and this margin is likely to be pushed up towards 35% with the launch of the latest generation of machines (under the Sprint brand). The big money here comes from the sales of complementary products, mainly CO_2 refills.

Disposable products – The reported revenue in this business comes from the sales of canisters for CO_2 refills and syrups to make flavored beverages. In contrast to the flavorings which are just an additive to the soda water, the refill canisters are integral to the soda preparation process and thus create reliance on the part of the consumers that have bought a maker and therefore have an ongoing customer – supplier relationship with SodaStream. A single canister of CO_2 makes 50 liters of soda, with households using, on average, three canisters a year. In the US gas canisters sell for $15 (stores will occasionally give a discount on this) while in Europe the price is even lower at around €8. Gross margin on the gas canisters is very high and is currently over 70%. According to our estimates, the other item in this category, syrups, accounted for 25% of segment revenue in 2016. Gross margin is high too at 40%.

Figure 2: Sales by product ($M)



Road to the top looks straightforward but the risks are there

Direct competition

There have been a number of attempts in the past by different brands to get a foothold in the home carbonated drinks segment. These efforts generally didn't get very far as a result of either poor technology or a lack of interest on the part of the market in alternative products. The case that instantly comes to mind here is that of Keurig, the US' largest maker and distributor of home coffee machines. It spent over a $1bn on a range of products marketed under the KOLD brand in a joint venture with Coca Cola, but the venture ran out of steam very quickly and in June 2016, faced with a very limited take up and the fact that the overpriced range ($370 for a machine) didn't meet consumers' expectations, Keurig decided to shut it down.

There doesn't seem to be any genuine competition to SodaStream in the soda water maker category. By contrast the cash cow that the company has built up from CO_2 canister refills for machines faces a serious threat from cowboy operators promoting ways of inserting canisters that weren't originally designed for use on soda machines at all (a quick search online will produce a host of guides explaining how to do this). There are also a number of companies offering CO_2 canisters that *are* suitable for use on soda machines.

FX exposure

SodaStream reports its results in dollars even though a considerable portion of its sales are in euros and its operating costs are mainly in shekels, as well as other currencies. As a result, the company is exposed to the strengthening of the dollar against the other currencies in which it sells its products and to the strengthening of the shekel against the dollar.

Moreover, because a sizable portion of the company's revenue is in currencies other than the dollar (~75%), the strengthening of the dollar against these currencies is likely to negatively impact company results. SodaStream has mitigated some of this exposure through currency hedges but part of its results still remains susceptible to foreign currency volatility. This volatility will probably be particularly noticeable this year given that the strength of the shekel vs. the dollar and of the dollar itself against other currencies is expected to continue.

Unionization of employees in Israel

The staff at the SodaStream manufacturing plant in Israel are a vital part of the business. They are not unionized although there have been a number of attempts in the past by certain employees to join a union. If such an attempt were finally to prove successful management could find itself having to negotiate with a unionized employees' committee and end up incurring unexpected additional costs for a pay settlement or the disruptions in manufacturing due to strike action.

Growth drivers and the potential therein

The carbonized beverage market is enormous and the share commanded by carbonated water devices and accessories is growing ever larger

The carbonated beverages market is estimated at 300 million households, 17% of which consume carbonated water (soda). In terms of market share, this means that the specific segment SodaStream is targeting comes to 50 million households. Environmental trends, and the increasing controversy surrounding the health risk that carbonated beverages (both regular and sugar free) now pose, constitute drivers that are pushing consumers to switch to plain soda instead, thus growing the size of SodaStream's potential market share.

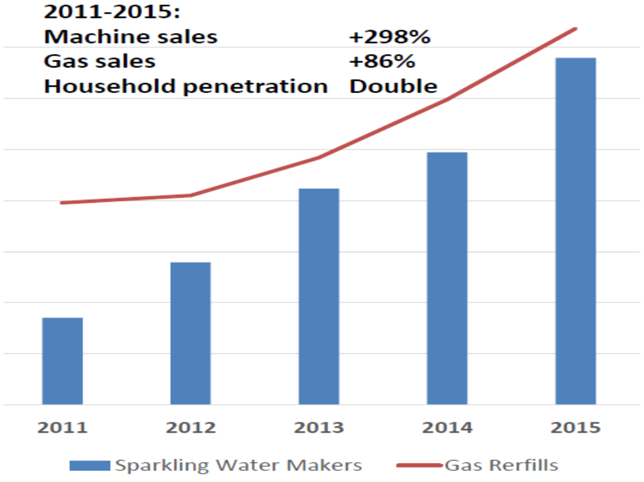
As of year – end 2016, SodaStream's share of this 50 million – strong market stands at just over 20% and our estimates indicate that overall market growth at the same time as SodaStream's own efforts to grow its organic sales should lift this market share to 25% within the next five years.

An interesting question is whether the company can kickstart growth again in the US market. Although momentum in the company business has been positive, the core of its growth continues to be concentrated in the European market (which is large enough in its own right) and the US market evidently is still unable to move away from traditional carbonated beverages. SodaStream's strong 4Q/16 results did provide some cause for cheer in this area too, since the company reported a 46% increase in sales of soda making devices in the US, while sales of CO_2 refills grew 7%.

German market is the front runner

Germany is considered a mature market when it comes to water consumption preferences and most people there drink soda water as a matter of course. SodaStream focused its efforts on this market during 2011 to 2015 and the results were not long in coming: 300% growth in soda machine sales, an 86% increase in sales of CO_2 canisters, and a doubling of the company's rate of household penetration. Also contributing to SodaStream's success in Germany, aside from the fact that it is a mature market, was the marketing strategy it adopted, at the front of which was the triumphant 'No Schlepping' advertising campaign that brought SodaStream onto the store shelves at the country's major grocery chains (such as Lidl, Edeka and the REWE Group). Indeed the campaign was so successful it 'spread the word' to neighboring countries such as Poland and Austria without SodaStream having to build a dedicated campaign for the markets there. Yet despite having made a successful entry (with the company having achieved a 6% market share thus far), the potential in the markets in Germany and neighboring countries is huge and SodaStream has merely touched the tip of the iceberg.

Figure 3: Penetration of German market; 2011 – 2015



Gaining access to more store doors is the key to continued growth

Having seen a steady increase in its customer base, SodaStream can now allow itself to expand its retailer network and move out of large high street stores (such as the DIY chains Home Center and ACE in Israel), by opening additional points in local supermarkets and neighborhood stores.

Convenience is the key word here and it is a hugely important criterion that SodaStream needs to be mindful of as it looks to retain and grow its customer base. If a customer has to make a special journey by car to buy a CO_2 refill for his soda machine he is highly likely to find the travelling a nuisance and eventually get rid of the machine. But if buying the refill is part of a customer's regular shopping and can be added on in the same way as soap or laundry powder, the CO_2 will represent an ideal alternative to plastic bottles. And this is precisely why we are optimistic about SodaStream's growth prospects.

Summary of 2016 and forecast for the coming year

Strong finish to a record year

SodaStream's results for FY2016 underscore the improvement the company has made across all metrics. Revenue increased 14% vs. 2015 to $476mn, operating profit rose 176% to an all – time of $54.5mn while net profit grew to $44.5mn. The improvement in revenue was matched by a corresponding improvement in FCF, which increased to $57mn.

Broken down by segment, sales of soda makers increased 22% to 2.9mn units, while sales of CO_2 canisters grew 10% to a record 29.4mn units. The growth in soda machine sales implies that SodaStream is set record a potentially large increase in follow – on sales of canisters in 2H/17.

As in previous years, the growth in revenue came mainly Western Europe, in particular Germany in which SodaStream posted double – digit growth for the 20th consecutive quarter amid price rises and stronger sale volumes. Growth has also been robust in other countries across Europe such as Switzerland, Austria and the Scandinavian countries. Looking at the US, sales growth reached an impressive 20%, a result that reversed the decline in SodaStream's sales to this market in 2014 and in 2015.

Margins also improved in 2016 on the back of a more profitable sales mix, the opening of the new manufacturing plant in the Lehavim industrial park in Southern Israel and an increase in the prices of selected products which translated into a 14% increase in sales, a 106% increase in net profit, and EBITDA of $75m for 2016.

Figure 4: SodaStream – FY2016 results snapshot

	FY 2016	% Change Y/Y
Total Revenues	$476.1 million	+14%
Sparkling Water Maker Units	2,941,000	+22%
CO_2 Refill Units	29.4 million	+10%
Flavor Units	22.0 million	-2%
Net Income	$44.5 million	+268%
EPS[(1)]	$2.07	+261%
Net Income vs. 2015 Non-IFRS[(2)]	$44.5 million	+106%
EPS vs. 2015 Non-IFRS[(2)]	$2.07	+102%

Company forecast for 2017: Growth is set to continue

Revenue growth is expected to be in the high single digit range with FX headwinds likely to translate into median single digit revenue growth in dollar terms. Gross margin is expected to reach 52%, up 1% vs. 2015.

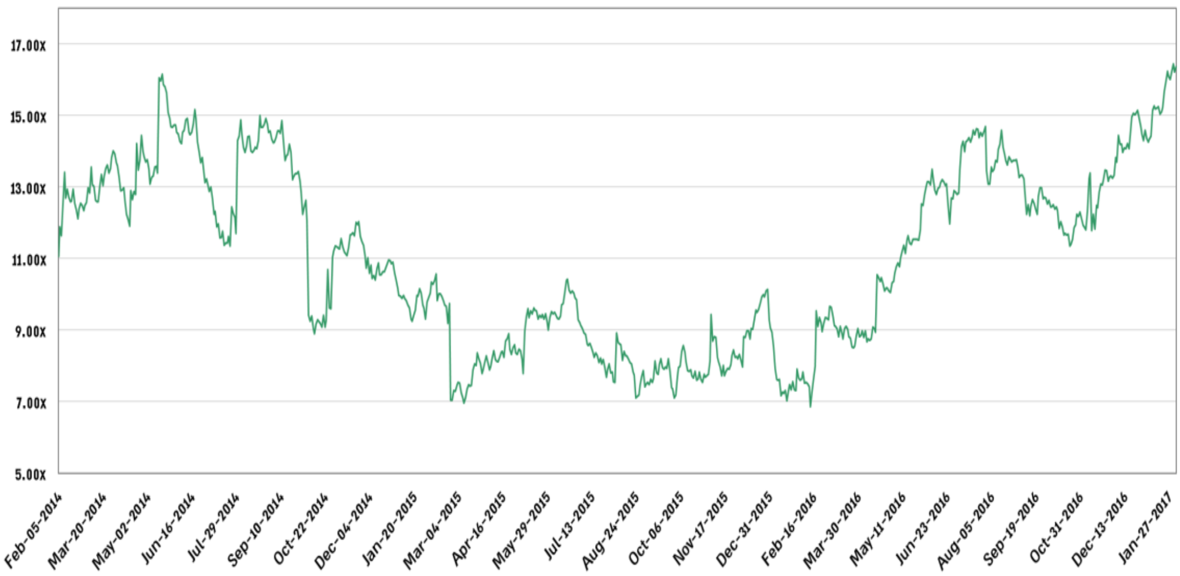
Operating expenditure is forecast to be largely unchanged vs. 2016 with operating margin (assuming a fixed currency exchange rate), growing 30%. FX headwinds are expected to leave their mark here too, with the result that actual operating margin will be in the low double – digit range. Capex is forecast to reach $25mn while depreciation and impairment charges are forecast to total $20mn.

Overall, the forecast for 2017 is consistent with the growth SodaStream posted for 2016 and represents an impressive continuation to the change SodaStream has been undergoing in recent years.

Pricing and valuation

We are initiating coverage of SodaStream with an Outperform rating and a $56.5 price target which we derive from the DCF model that follows below. Our model implies a multiple of 11x 2017 EV/EBITDA vs. a historical average of 11.8x. With the company currently enjoying its most successful period ever, we think the stock is fairly priced and, assuming the EV/EBITDA multiples remains around the historical average (11.8x), it constitutes an attractive risk/reward proposition.

Figure 5: SodaStream – Historical EV/EBITDA



Key model assumptions

Strategic change will continue to drive growth in 2017

Our estimates and SodaStream's guidance lead us to forecast that the growth of the past year is set to continue into 2017. The 28% increase in sales of soda makers will generate follow – on sales of CO_2 refills thus providing a tail wind to top line and offsetting the minor hit to revenue from the ongoing slippage in sales of flavored beverages. Overall, after discounting a $510mn hit from FX headwinds, we look for top line growth of 7% in 2017.

We model for operating margin of 13%, which will be aided by the increase in prices of company products and a further reduction in operating costs following the start of manufacturing at the company's new plant in Lehavim. This will be offset by the strengthening of the shekel and the dollar. From this we arrive at our FY2017 EBITDA estimate of $86mn.

With the annual run – rate for capex having now declined to $25mn, we expect SodaStream's cash flow to remain strong. We see this as the representative level of capex at SodaStream in the coming years given that the new manufacturing plant is up and running and can handle the growth in orders in the coming years.

As at year – end 2016 SodaStream has $50mn in cash and zero debt.

Figure 6: SodaStream – DCF model

DCF Model	TY	2020E	2019E	2018E	2017E	2016A	2015A	2014A	2013A	2012A
Total Revenue	667,808	634,238	596,242	557,524	510,465	476,065	413,135	511,774	562,723	436,316
% change Y/Y	5.29%	6.37%	6.94%	9.22%	7.23%	15.23%	-19.27%	-9.05%	28.97%	43.00%
Gross Profit	362,255	340,915	318,464	294,472	267,454	244,978	201,008	261,395	285,570	235,825
% of Revenues	54.25%	53.75%	53.41%	52.82%	52.39%	51.46%	48.65%	51.08%	50.75%	54.05%
Selling General & Admin Exp.	263,784.0	250,524.1	235,515.7	220,221.8	200,935.2	188,179.0	185,899.0	227,463.0	236,642.0	190,776.0
% of Revenues	39.50%	39.50%	39.50%	39.50%	39.36%	39.53%	45.00%	44.45%	42.05%	43.72%
Operating Income	98,471.0	90,390.8	82,948.5	74,249.7	66,518.9	54,471.0	15,109.0	33,932.0	48,928.0	44,767.0
% of Revenues	14.75%	14.25%	13.91%	13.32%	13.03%	11.44%	3.66%	6.63%	8.69%	10.26%
Net Interest Exp.	(200.0)	(200.0)	(200.0)	(200.0)	(200.0)	437.0	(350.0)	(351.0)	(395.0)	193.0
EBT Incl. Unusual Items	98,671.0	90,590.8	83,148.5	74,449.7	66,718.9	52,352.0	15,083.0	16,163.0	46,682.0	44,597.0
Income Tax Expense	15,787.4	14,041.6	12,888.0	11,167.5	10,007.8	7,886.0	3,006.0	3,868.0	4,655.0	737.0
% of Revenues	16.00%	15.50%	15.50%	15.00%	15.00%	15.06%	19.93%	23.93%	9.97%	1.65%
Net Income	82,883.6	76,549.2	70,260.5	63,282.3	56,711.1	44,466.0	12,077.0	12,295.0	42,027.0	43,860.0
EBITDA	120,471.0	109,590.8	102,148.5	93,449.7	86,118.9	73,922.0	29,052.0	48,724.0	62,171.0	53,777.0
% of Revenues	18.04%	17.28%	17.13%	16.76%	16.87%	15.53%	7.03%	9.52%	11.05%	12.33%
CAPEX	(22,000.0)	(20,000.0)	(20,000.0)	(20,000.0)	(25,000.0)	(25,987.0)	(49,466.0)	(55,174.0)	(39,799.0)	(34,080.0)
FCF	82,715.6	75,580.2	69,291.5	62,312.3	51,141.1					

In view of the stable outlook for SodaStream, and more specifically, the company's CO_2 refill business, we applied a WACC of 9% and set our TY growth at 2.5%, metrics that, we feel, reflect the pace of market expansion and SodaStream's share therein. Using multiples to value the company leads us to the same conclusion that we arrived at through our DCF – based analysis: the company's share is underpriced relative to its fair value. Our implied price objective of $56.5 represents a ~16% upside to the current market price.

Figure 7: SodaStream – Price sensitivity to WACC and terminal growth assumptions

	Price sensitivity to cap rate and terminal growth assumptions							
	7.0%	7.5%	8.0%	8.5%	9.0%	9.5%	10.0%	10.5%
-1.0%	51.0	48.1	45.5	43.2	41.1	39.2	37.5	35.9
-0.5%	53.6	50.3	47.4	44.9	42.6	40.5	38.7	37.0
0.0%	56.5	52.8	49.6	46.8	44.2	42.0	40.0	38.2
0.5%	59.8	55.7	52.1	48.9	46.1	43.6	41.4	39.5
1.0%	63.7	59.0	54.9	51.3	48.2	45.5	43.1	40.9
1.5%	68.4	62.8	58.1	54.1	50.6	47.6	44.9	42.5
2.0%	73.9	67.4	61.9	57.3	53.3	49.9	46.9	44.3
2.5%	80.7	72.8	66.4	61.0	**56.5**	52.6	49.2	46.3
3.0%	89.2	79.5	71.8	65.4	60.2	55.7	51.9	48.6
3.5%	100.1	87.9	78.3	70.7	64.5	59.3	54.9	51.2
4.0%	114.7	98.6	86.6	77.2	69.7	63.6	58.5	54.1
4.5%	135.0	112.9	97.1	85.3	76.1	68.7	62.7	57.6

Conclusion and outlook

Having endured a rocky period during its first few years, SodaStream now appears to have discovered its identity and is making a fresh start.

The results for 2016 attest to the strategic turnaround that management undertook with the aim of rebranding SodaStream as the world's top sparkling water company. We think the huge potential that the carbonated beverages market holds will continue to drive the company forward and that the trend towards healthier life style choices worldwide is to set to become even more pronounced than ever. So it is critical that SodaStream seizes the moment and redoubles its efforts to extend household penetration and entrench brand loyalty among consumers before the real competition appears on the horizon.

Near – term potential is priced in but it's still not too late to board the train

SodaStream has thus far been held mainly by foreign entities and the gains made by the stock (200% over the past 12 months) have won it admission to the TA 35 Index where it will benefit from exposure to institutional investors in Israel too. We therefore expect the stock to be buoyed by the positive momentum resulting from the wider exposure to the Israeli market and aside from the comfortable pricing, the additional demand should provide a tail wind as well.

The gains over the past year have indeed been impressive but we don't think that investors should allow themselves to be deterred by a rise as steep as this. The company still has quite a way to go before it exhausts its potential in the carbonated beverages market and the stock is underpriced relative to the company's fair value. As we have already noted, the turnaround at SodaStream has only just begun and at this point in time we think it is an excellent investment proposition.

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