

Not Your GrandMother's Coffee Roasters

Derek C. Cheung
Amy Zhao



Honne Capital
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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

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

Valuation Multiples

	€	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

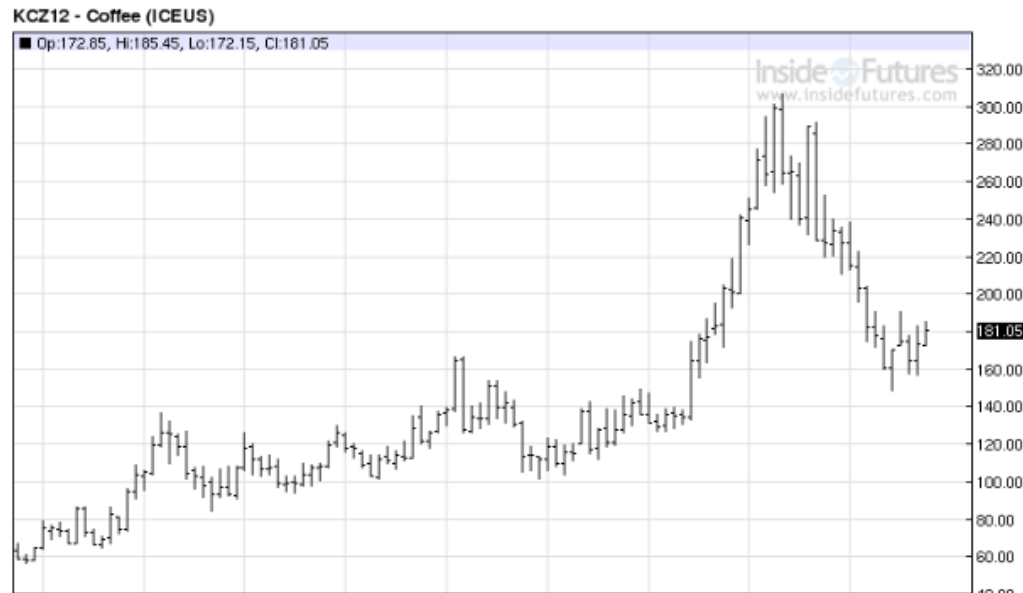
Brewer price: \$199.00

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)

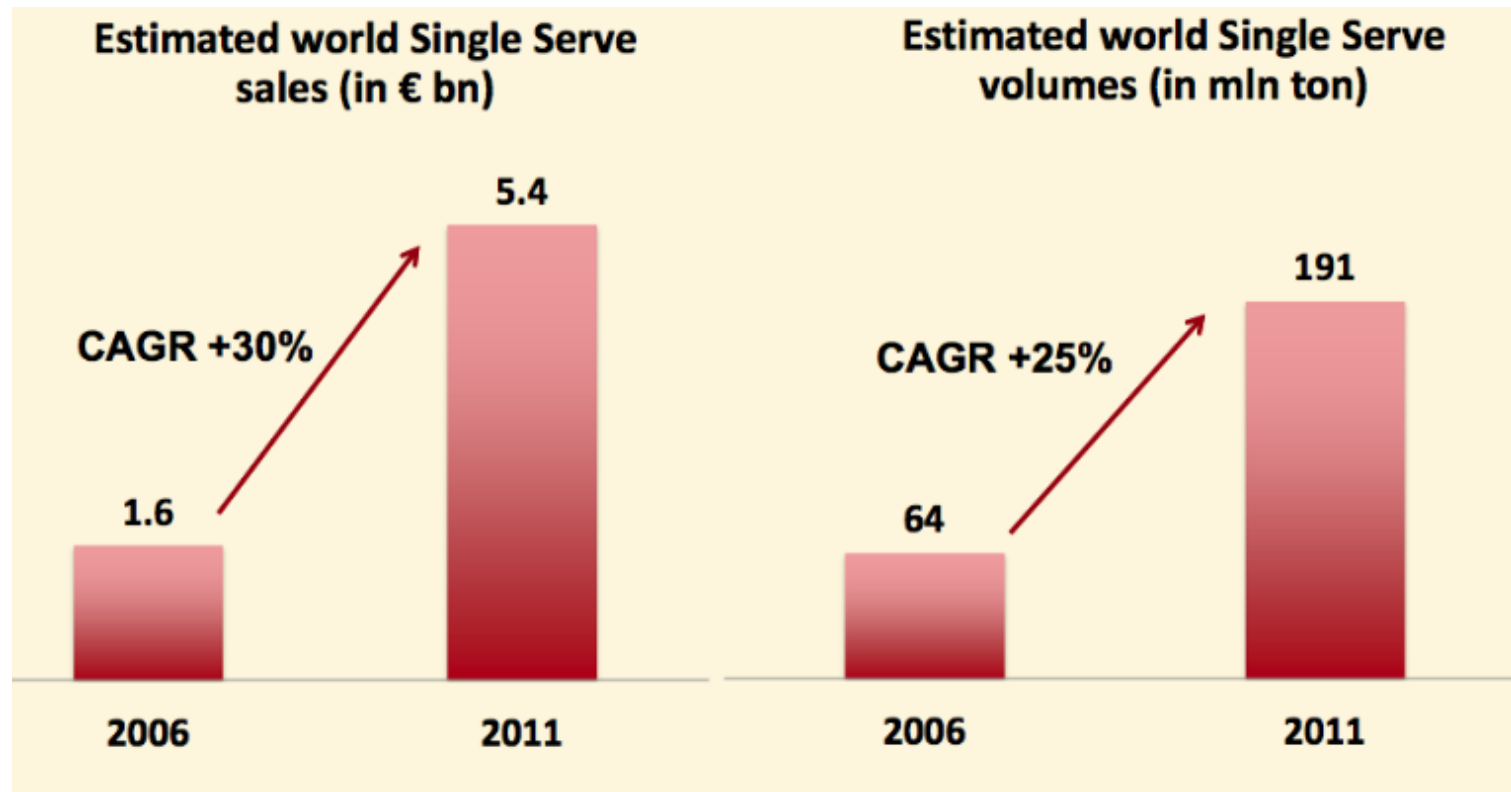
Country	D.E Share	D.E Position
Netherlands	60%	#1
Belgium	52%	#1
Hungary	35%	#1
Denmark	31%	#1
Brazil	22%	#1
Spain	20%	#2
France	15%	#3
Poland	18%	#4

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

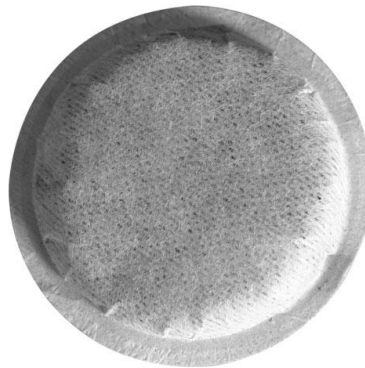
- D.E began selling a new single serve coffee machine, Sarista, in the Netherlands this October
- Unlike other brewers, Sarista starts with unground beans, then grinds them immediately before brewing
- Sarista creates fresher coffee than other machines

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 & 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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