Blackmores Limited (BKL)

Table 1: Blackmores Corporate History 1938 - 2010

Year	Event
1938	Maurice Blackmore, English immigrant establishes first health food store in Brisbane.
1962	Feb - Blackmores Naturopathic Organisation Pty Limited incorporated.
1973	Marcus Blackmore son of Maurice joins Board of Directors.
1975	Sales top one million dollars for year.
1976	Blackmores launches in Singapore and Malaysia.
1982	July - Blackmores acquires Vita Glow, marketer of a range of vitamins and mineral supplements.
1984	Sales top ten million dollars for year.
1985	Blackmores establishes first naturopathic advisory service.
1985	May - Company name changed to Blackmores Laboratories converted to public company and lists on Australian Stock Exchange.
1986	June – Blackmores acquires Abundant Earth, Biogenic Health Foods and Russell's Natural Food Markets to form Blackmores Food Division.
1986	Blackmores acquires the 55 store Healthy Life retail chain.
1987	Blackmores establishes its first naturopathic clinic in Sydney.
1987	June – Blackmores launches skin and haircare products into Japanese markets.
1988	June – Blackmores Sponsors Kay Cottee, first woman in history to sail single handed, non–stop around world.
1988	Healthy Life restructured from franchise group to a licence / banner group.
1989	April – Name changed to Blackmores Limited.
1989	July – Blackmores launches in Thailand.
1990	June – Blackmores launches a skincare range in the United States.
1992	May – Sale of Russell's Natural Foods Markets.
1995	Blackmores launches in Indonesia.
1995	July – Blackmores closes US subsidiary / completes management buyout UK subsidiary.
1997	July – Blackmores launches website.
2000	July – Blackmores expands into Coles grocery outlets.
2003	May – Pan Pharmaceuticals faces largest ever recall of medicines in Australia / Blackmores having never used Pan as a manufacturer remained unaffected, experiencing a significant sales lift.
2004	July – Marcus Blackmore becomes Chairman of Heart Research Institute.
2005	Blackmores announces shift to new manufacturing facilities at Warriewood Sydney.
2005	Blackmores ceases marketing skin and haircare products to focus on supplements.
2006	December – Blackmores free online e-newsletter grows past 100,000 subscribers.
2007	November – Blackmores launches products into Watson's stores in Taiwan.
2008	October – Blackmores free online e-newsletter subscriber base passes 230,000.
2008	November – Christine Holgate appointed CEO.
2009	November – Blackmores relocates to new campus at Warriewood.
2009	May – Blackmores donates to Macular Degeneration Foundation as sales of Macu–Vision hit $2M.
2009	June – Sales reach $200 million, NPAT $20.8M
2010	April – Company updates market at 3rd quarter, expects NPAT lift of 10%-15% for FY10.

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Table 2: Blackmores Financial Snapshot

$'M	2000	2005	2006	2007	2008	2009	2010(e)
Revenue	79.6	135.2	148.9	172.9	180.2	201.2	225.0
Operating Expenses	69.8	115.9	125.9	146.2	150.4	167.7	184.7
EBIT	8.6	17.4	21.1	25.1	27.9	31.0	35.8
NPAT	5.4	11.3	14.5	16.7	19.1	20.8	24.1
EBIT Margins (%)	10.8	12.9	14.2	14.5	15.5	15.4	15.9
Shareholders' Equity	17.4	30.6	36.8	43.5	50.4	58.6	65.7
Net Debt / (net cash)	2.7	5.1	3.5	5.3	25.8	33.6	29.4
Market Capitalisation	85.8	205.9	221.0	328.9	265.7	262.4	379.9
Enterprise Value	88.5	211.0	224.5	334.3	291.5	296.0	409.3
Buyout (%) **	9.7	8.3	9.4	7.5	9.6	10.5	8.8
ROCE (%) *	58.5	48.7	52.4	51.4	36.6	33.6	37.6
GOCF / EBITDA (%)	71	95	95	93	109	97	98
Underlying Earnings per share (¢)	36.5	71.1	91.2	104.4	117.9	126.8	144.3
PER	15.9	18.2	15.2	19.7	13.9	12.6	15.8
Dividend per share (¢)	33.0	58.0	69.0	81.0	90.0	96.0	105.0
Dividend Yield %	5.7	4.5	5.0	3.9	5.5	6.0	4.6
Share Price 30 June ($)	5.80	12.95	13.90	20.56	16.40	16.00	22.75
Issued shares (m)	14.8	15.9	15.9	16.0	16.2	16.4	16.7

* ROCE = EBIT / (Shareholders Equity + debt – cash)
** Buyout represents EBIT / EV as a percentage

History

They say a change is as good as a holiday, well in the case of Australia's most trusted and recognised vitamin and supplement brand, Blackmores has certainly seen plenty of change over the past few years. Whilst its origins date back some 70 years, when English immigrant and founder Maurice Blackmore landed on our shores, establishing Australia's first health food store in 1938, it has been Marcus Blackmore, Maurice's son, that has led the business since 1973.

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As the accompanying table and financial records show, the company is, excuse the pun, a picture of health.
The selling of vitamins, herbal & mineral supplements (VHMS) is now big business in this country and Blackmores the most dominant player. Unlike traditional drugs that require scientific testing to gain regulatory approval, the active ingredients in complementary medicines have a long history of use and are generally available for use in self-medication and are obtained from retail outlets such as pharmacists, supermarkets and health food stores. While numbers are hard to quantify, management suggests the market value of complementary medicines is $650M, with complementary therapies attracting another $350M. Blackmores' focus has been in the complementary medicine space, where local sales of $170M imply a market share of roughly 26%.

The growth in preventive medicine use has seen the business undertake significant progress since its public listing in 1985. The group's strength lies in its trusted brand status and management's unwavering commitment to introduce innovative, high quality vitamin products. These products range from the traditional cold and flu vitamins, to specific formulations for men, women and children and extends to areas including age related diseases such as Macu–Vision (to fight against damage to the retina of the eye), Glucosamine (help reduce pain caused by osteoarthritis) and Cholesterol Health (to assist in reducing cholesterol levels) to name just a few.

Business

In total, Blackmores' individual product range now numbers around 150 and closer to 400 if all product sizes and variations are included. This is an area of focus for the new management team as it looks to press home the company's brand strength and increased manufacturing capabilities. The appointment of new CEO Christine Holgate

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in September 2008 was an important catalyst in driving home this advantage. In fact, the appointment of Holgate ended the group's long search for a new chief executive since the resignation of Darin Walters in 2003. In the intervening years, Blackmores has relied on the services of a chief operating officer and its chief financial officer, along with Marcus Blackmore as chairman to run the business.

It is not an ideal situation and one that stopped us investing in the business when we first visited the operations back in May 2007. While we had the highest respect for the brand and the company's financial record, every team needs a leader and in this instance our concerns rested on the belief that the then management team was lacking focus at a critical juncture in company's history, as it undertook a potentially risky and costly property move to new facilities at Warriewood in Sydney. All up, the move cost north of $50M. The 25,000 square metres Blackmores Campus, officially opened in May 2009, now houses the group's entire Australian team of 320 personnel along with production facilities capable of packaging 80,000 vitamins per day, a significant step up from the 50,000 previously. We were fortunate enough to tour the facility in May this year and the look and feel of the new campus speaks volumes to the heritage that backs up the Blackmores brand.

Site Visit

Our meeting with Holgate and newly appointed chief financial officer Chris Last also allayed some of our fears that despite the company's ongoing financial success, the lack of strategic direction was now being addressed. As with any company built by a founder and passed onto the next generation, the chances of a mis-step or even significant damage are ever present. Fortunately, Holgate has set some clear goals and has hit the ground running. While the brand has always enjoyed strong customer loyalty, particularly following the Therapeutic Goods Administration (TGA) recall of drug operator Pan Pharmaceuticals products in April 2003, these two external

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appointments will provide both a fresh and balanced voice in a company, where the chairman Marcus Blackmore controls 27.3% of the issued capital.

Business Operations

Operationally, Blackmores' products are sold throughout Australia and into international markets including New Zealand, Hong Kong, Malaysia, Taiwan, Singapore, Vietnam and the United Kingdom. As noted earlier, Australian operations recorded sales of $167M during 2009 up from $74M in 2000. Over the past nine years, sales have grown at an annual compound rate of 9.4%, while the industry's growth rate has been estimated at 5-6%. The group's sales are predominately directed towards the specialist pharmacy outlets that as a body represent about 66% of revenue, followed by grocery stores with 25% and health food stores bringing up the rear with 9%. Management have indicated a desire to push further into the pharmacy sector, as it provides better brand protection and a customer base supportive of the products offered. At the earnings before interest and tax line, the company's Australian based profits have moved up from $8.9M in 2000 to $26.5M during 2009, reflecting an improving EBIT margin of 15.9%.

New CEO

Holgate has also wasted little time in re-energising the Blackmores culture. Getting new products to market has become a critical component of the group's renewed push to grow. In the 2009 financial year, only nine new products were launched, seven of which took place in the latter stages of the year. In sharp contrast, 2010 is shaping up to be a stellar year with the group launching 67 new products in all markets, made up of varying package sizes. This has been made possible, in large part due to management revisiting staid regulatory procedures that stymied the approval process, leading to long product delays. In addition, new products are now formulated on the basis that they must also meet global standards, allowing for faster market launches. Forming industry partnerships and addressing specific health issues have also become a critical component of new product developments, as evident by the formulation of Macu-Vision, an eye health product endorsed by the Macular Degeneration Foundation that now enjoys a market share of 80%. In a similar vein, the group's targeted pregnancy formulation product has grabbed a 70% market share while discussions continue with other leading institutions including the Heart Foundation.

The group continues to outsource all its manufacturing to accredited TGA organisations, preferring instead to concentrate efforts on product packaging and strengthening its in-house sales and marketing teams. This has allowed the group to actively promote to leading pharmacy chains at a time when competitors have dropped the ball.

Management noted Sanofi-Aventis, following its 2008 $560M acquisition of Symbion's consumer business and owner of consumer brands Nature's Own, Cenovis, Bio-organics and Golden Glow, is Blackmores' largest competitor with a market share half that of the group. Other main competitors include the Australian based Swisse group turning over $65M per annum of natural medicines and the listed Sigma Pharmaceuticals' wholly owned subsidiary Herron Pharmaceuticals.

Growing offshore success

In offshore markets, Blackmores' marketing success has taken second stage to the main game in Australia, with sales growing from $11.6M in 2000 to $37.2M during 2009, on EBIT up from $250,000 to $2.6M. Holgate acknowledges that international markets have not been a high priority of past management teams, noting that some distribution agreements currently in place have hindered growth. However with Holgate now dedicating one third of her time to offshore markets, management is

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firmly targeting this area as a strong source of future growth. Having first launched into the Thailand market in 1989, Blackmores' products are now sold throughout Asia and New Zealand. The Asian market is very accepting of natural medicines and Blackmores' brands are highly regarded, with the group's main contributing markets of Thailand and Malaysia up in local currencies by 29% and 25% respectively for the nine months to March 2010.

Strong Financials

While some may regard the group's progress thus far as a little pedestrian, its financial performance record would be the envy of many in the investment arena. In the nine years, as reflected in Table 2, the numbers are truly worth repeating. In that period, sales have risen 152% to $201M, with EBIT up 260% to $31M, on EBIT margins up 43% to 15.4%. The beauty of the Blackmores business lies in its ability to generate strong cash flows without the need for high capital expenditure. This has allowed the group to focus attention on increased product development and targeted marketing spend. In the period since 2000, return on capital employed has fallen from 58.5% to 33.6%, however it is largely a reflection of new debt the group took on to complete its property move from Balgowlah to Warriewood.

As things stand, net debt at only $33.6M is reflective of management's conservative style. Importantly for shareholders, the group's issued capital has remained largely unchanged over the years, rising from 14.8 million to 16.4 million as at 2009. Earnings per share have, as a result, jumped from $0.36 per share in 2000 to $1.26 per share by 2009. Likewise, dividends have almost tripled from $0.33 per share to $0.96 per share during the same period. Not surprisingly, the Blackmores share price has followed suit, motoring from $5.80 per share to its current level of $22.50 per share, implying a current market value of $376 million for the business. Based on management's market update in April, the group expects to lift net profit by 10% - 15% this year, suggesting a full year net profit range of $22.8M – 23.9M. On our

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numbers, the business is currently trading on an attractive buyout ratio of 8.8% when compared to the risk free bond rate of 6%. Furthermore, the highly desirable defensive qualities of the business and appointment of a new CEO and management team provides us with sufficient confidence that the group's past performance can not only be maintained but built upon.

The share market wobbles of recent months have allowed us to add Blackmores to the portfolio for the first time. The investment made represents 3% of the portfolio at an entry price of $21.50 per share. On this basis, the investment is trading on a PER of 14.9 and a fully franked yield of 4.9%.

There is a lot to like about Blackmores' business and the changes made in recent years but none more so than the reputation earned over seventy years as Australia's leading natural health brand. ***SFM***

Brand Rudd gone...brand Australia damaged, what next?

We highlighted our concerns in our June 2008 and September 2009 quarterlies with Part 1 and 2 of "Governments – Perfecting the art of stealing". We are advocates of tax reform and certainty. The Resources Super Profits Tax (RSPT) delivered neither. Whether one agreed with Peter Costello or not, he was on the money when he said that this was an opportunity squandered. Rather than tax reform it was a tax grab, a drag on growth and a source of uncertainty.

Reform should aim to simplify and reduce the overall burden. Putting the RSPT design flaws aside, rather than delivering a meaningful step forward for industry and country alike, it only served to heightened sovereign risk for local and foreign investors. Uncertainty is the enemy of investment. Investment is the key to job creation and growth. And growth ultimately drives a higher tax base. In the case of the new Minerals Resources Rent Tax (MMRT) it remains complicated and fails to deliver reform or revenue. But industry and investor uncertainty is retained.

Our fear when Rudd was elected was a desire to govern in slow motion, taking advice from expert panels and committees at every turn. As it turned out, we had no cause for concern. Our issue with the Gillard Government is policy architecture. Naturally in the short term it is focused on the desperate bid to be re-elected, but more worryingly is that in the longer term it may have shifted towards the self serving factions responsible for Rudd's departure. From where we sit this is unlikely to deliver reform or certainty. Can Abbott produce sound policy? We don't know. But we wouldn't rule out a change of government. ***SFM***