

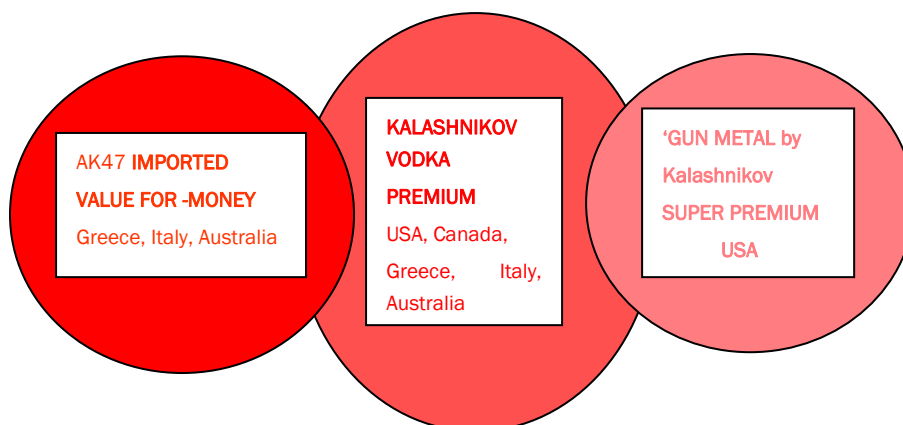
# The Kalashnikov Joint Stock Vodka Co. (1947) plc

The Kalashnikov Joint Stock Vodka Company (1947) plc owns two vodka brands, 'Kalashnikov' and 'AK47'. The former is distilled in Russia, imported into the UK in bulk, and bottled under contract. It is distilled to a strength 1% above the standard 40% alcohol by volume (ABV), and is positioned as a premium brand.

'AK47' is distilled in the UK, to 37.5% ABV, and competes in the value for money market.

A third brand, 'Gun Metal', is being developed – initially for the American market, to compete at the top end of the super premium segment (which started to develop in the late nineties, led by Absolut), and potentially in the ultra premium segment (referred to later in this note).

Both the Kalashnikov and AK47 (Automatic Kalashnikov 1947) names refer to the Russian WW2 veteran, and then distinguished engineer, General Mikhail T. Kalashnikov, who designed the eponymous weapon, and the company believes that the wide international recognition and obvious close association with Russia (one of the sources of perceived "real" vodka) of the two brand names provide an outstanding global marketing opportunity. The General is Honorary Chairman of the company.



**Product Positioning in the Target Markets**

Like any international branded business, the company is involved in a number of trade mark disputes. Information on these disputes is shown in Appendix 3 to this note, but, in a nutshell, the company has no concerns at all in North America or Australasia, none in Europe that cannot be resolved, and problems only in China and Malaysia.

## Investment Summary:

The company owns two vodka brands, Kalashnikov and AK47, which are positioned in the premium and value for money segments of the market. A third brand, Gun Metal, is being developed to compete in the super premium segment, initially in the US.

Since incorporation in 2003, the company has raised £1.3m through six share issues, which has enabled it to invest in marketing and stocks and in acquiring intellectual property rights. Case sales are currently running at over 5,000 per annum, mainly in the US and a few European countries.

The company is now seeking £6.6m, to be spent over three years in expanding business in existing markets, most importantly America, and in penetrating two new markets, Australia and Canada.

75% of the new money is to go on marketing, of which more than two-thirds will be spent in America. Vodka is now the largest spirits brand in America, and premium and super-premium brands are expected to grow at a rate in mid-to-high single digits. America accounts for 61% of global consumption of these two segments.

The company estimates that total case sales of its three brands can reach around 35,000 in Year 1 post-funding, 150,000+ in Year 2 and 250,000+ in Year 3. On this basis it would still be loss-making in Year 2, but would thereafter move into significant profit. On the company's profit projections and our assumptions as to the

terms of the current fund-raising, we would estimate EPS in Year 3 of 4.25p.

The company's long-term profit projections, based – inter alia - on a significant slowing of volume growth after Year 3, would still lead to EPS more than doubling over the following three years. Thus if by early 2011 4.25p is looking a realistic estimate, and the long-term targets are looking achievable, the shares could well reach 80-90p – a PER of around 20, coming down to between 8 and 9 over three years.

Some new vodka brands have grown faster than Kalashnikov is projecting, but others considerably more slowly: thus Ciroc and 42 Below were still slightly short of 100,000 cases in Year 3, against Kalashnikov's hope of 250,000+.for its three brands. At that lower level of sales the company would still be substantially in the red (as was the independent 42 Below, and, for all we know, the Diageo-owned Ciroc, too).

In a sector, however, where brands regularly change hands, the 42 Below story is very cheering; for it was bought in 2006 for an enterprise value of £37m (equivalent), representing a price per case by no means out of line with other vodka brand trade sales. The same case valuation applied to Kalashnikov on the basis of its own Year 3 volume target would equate to 296p per share, while just the same total consideration as was paid for 42 Below, with its prospective 107,000 cases, would be worth 126p.

## Background

The company was incorporated in 2003, and since March of that year it has raised just over £1.3m through share issues, as shown in the following table:

**Table 1: Issues of Kalashnikov shares since incorporation**

Date	Number of shares	Price per share	Gross proceeds	Shares to date	Proceeds to date	Ave. price to date
Mar-Sep 2003	1,000,000	5p	£50,000	1,000,000	£50,000	5p
January 2004	681,819	55p	£375,000	1,681,819	£425,000	25p
July 2005	150,000	40p	£60,000	1,831,819	£485,000	26p
September 2006	1,761,500	30p	£528,450	3,593,319	£1,013,450	28p
August 2007	121,000	100p	£121,000	3,714,319	£1,134,450	31p
October 2007*	1,808,000	10p	£180,800	<b>5,522,319</b>	<b>£1,315,250</b>	24p

**Source:** Company

The 1 million shares issued in 2003 are classified as 5p Ordinary Shares and the rest as 5p Participating Shares, but both classes rank *pari passu* in all respects. There are 1.157m outstanding warrants, exercisable at between 30p and 55p, and the directors have options over 745,000 shares, exercisable at 30p. The authorised but unissued capital amounts to 50,000 Ordinary Shares and around 4.43m Participating Shares.

There are just over 100 shareholders in all, of whom the largest three hold 20.8%, 20.2% and 9.1%. The three executive directors – John Florey, David Bromige and Michael Davenhill - together hold 553,500 shares, representing fractionally over 10% of the total issued capital. Information on the executive directors appear in Appendix (2) of this note.

The company and the shares qualify under the government's Enterprise Investment Scheme, and future share issues have provisional approval under both this scheme and the Venture Capital Trust regulations.

## Developments since incorporation

The cash raised to date has been used as shown below:

**Table 2: Use of funds, 2002/03-2006/07**

Year-end July	2003	2004	2005	2006	2007	Total
<b>£</b>						
Stock	475	208,597	16,280	38,075	116,983	<b>380,410</b>
Intellectual property rights	27,200	67,414	8,368	14,298	59,331	<b>176,611</b>
Marketing	1,579	45,473	90,145	15,432	171,985	<b>324,614</b>
Wages,fees, overheads	15,704	110,017	80,151	72,089	220,538	<b>498,499</b>
<b>Total</b>	<b>44,958</b>	<b>431,501</b>	<b>194,944</b>	<b>139,894</b>	<b>568,837</b>	<b>1,380,134</b>

**Source:** Company

<sup>1</sup> Plus 2 warrants exercisable on a formula tied to turnover

\* Underwritten rights issue

In the Spring of 2004 the Kalashnikov brand started to be sold in style venues in London, and in September it underwent a formal launch, prompting enquiries from both domestic and overseas distributors. The following month, however, the Portman Group, a body set up to promote responsible behaviour by drinks companies and funded by the industry itself, upheld a complaint by Alcohol Focus Scotland that Kalashnikov was an inappropriate name for an alcoholic drinks brand since consumers would associate it with violence and terrorism.

The ruling was made final in April 2005, and although not legally binding, the company had little choice - with Portman recommending that retailers should not stock the brand - but to withdraw it from the domestic market (although, as shown below, a small volume continues to be sold). The Portman Group's independent advisory service has subsequently stated in writing that it believes the company's suggested new name for the brand, 'General Kalashnikov's Russian Vodka', is acceptable, but this does not guarantee protection against any further complaint, or even the Group's support in the event of such a complaint. None of the Portman Group's recommendations are binding on itself.

In response to all this, over the next few months the company devised an export strategy, which got under way in March 2005, and which, in order not to put undue strain on the company's systems or on its contractors, was initially directed mainly – though not exclusively – towards the smaller markets. Then in 2007 the company started exporting to the USA, and in certain markets introduced its AK47 brand to complement Kalashnikov. As shown below, there were successes and failures, but sales overall grew rapidly from a tiny base.

**Table 3: Case sales, 2004-2007**

<b>Years*</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2007</b>	<b>2007</b>
<b>Cases</b>	<b>Kalashn.</b>	<b>Kalashn.</b>	<b>Kalashn.</b>	<b>Kalashn.</b>	<b>AK47</b>	<b>Total</b>
USA				2,000		2,000
Greece		480	320	1,300		1,300
Italy		80	480	200	400	600
Cyprus	80	320	480	160	160	320
Germany			160	300		300
Jordan		400	400	200		200
Netherlands		40	160	40	160	200
France					160	160
Other export		259	80			
<b>Total exports</b>	<b>80</b>	<b>1,579</b>	<b>2,080</b>	<b>4,200</b>	<b>880</b>	<b>5,080</b>
UK	132	50	58	150		150
<b>Total sales</b>	<b>212</b>	<b>1,629</b>	<b>2,138</b>	<b>4,350</b>	<b>880</b>	<b>5,230</b>
Exports share of total	38%	97%	97%	97%	100%	97%

**Source:** Company

\* The years 2004-06 are calendar years and 2007 is the company's financial year to July.

As a result of the temporary removal of Kalashnikov from the home market and the subsequent increased emphasis on overseas markets, exports have thus risen from 38% of case sales in calendar 2004 to 97% in the year to July 2007. The global vodka market amounts to 388 million cases, of which the USA accounts for 10.8% and the company's other existing areas of operation, as listed above, for 2.1%.

It is not very helpful at such an early stage in the company's development to try to identify specific trends, but, for the record, the figures show that, leaving aside the first-time contributions from America and France, exports of the Kalashnikov brand alone grew by just under 6% between calendar 2006 and fiscal 2006/07, entirely thanks to a huge leap in sales to Greece; while sales of the two brands combined rose by 40%, with Greece similarly responsible. Of the five export markets other than America, France and Greece, three grew their sales in 2006/07 and two saw a decline.

As stated above, however, none of this detail is important, and what matters is that the company has been gaining footholds in new markets and has been in overall growth. It should be pointed out, however, that where AK47 has been introduced, sales – at least initially – seem to have been achieved at the expense of Kalashnikov (although it should also be said that the premium vodka market in these countries – that is, Italy, Cyprus and the Netherlands - is much smaller than the value for money segment).

## Expansion of the business

The management believes that the company and its brands are now ready for a major expansion of the business and it is seeking to raise £6.6m, to be spent over a three-year period.

The funds will be used to grow sales in the company's existing markets of the USA, Greece, Italy and Cyprus, and to gain entry to Canada and Australia. (The company will continue to sell to its importers in its other European markets and Jordan but will itself not be providing marketing support. It does not regard the UK, notwithstanding the opportunity that exists – as described earlier - to sell a revised brand, as a particularly attractive market.)

Of the total funding requirement of £6.6m, marketing will account for £4.9m, with Kalashnikov taking £3m, AK47 £0.8m and Gun Metal £1.1m. The remainder will be spent on overheads (£1.2m) and stock (£0.5m). Of the planned £6.1m spend excluding stock, £1.3m (including £0.9m on marketing) is earmarked for Year 1, £3m (£2.6m) for Year 2 and £1.8m (£1.4m) for Year 3.

## The American market

Aiko Importers Inc., importers of Kalashnikov in the US, has quoted in its Marketing Plan a survey which describes that country as "the epicenter (*sic*) of global premium and super premium vodka consumption"; and it is the case that these segments account for around 32% of the US vodka market. Premiumisation is, in fact, endemic to the entire US spirits market, with market research suggesting that in recent years sales of all US spirit brands selling at \$10-20 a bottle have been growing over five times faster than those selling at under \$10, while those selling at over \$20 grew over twelve times faster.

Figures collected by Aiko itself indicate that over the period 2002-2006 US sales of vodka priced at \$16.99-23.99 (premium), grew by around 25%, while sales at \$25.99-31.99 (super premium), grew by over 200%. According to the market research company, just-drinks.com, sales of these two categories combined rose by 92% in this same period. Against this background, there has started to emerge over the last couple of years yet another segment, namely, the ultra premiums, which retail for as much as \$80 (for example, Stolichnaya Elit).

The reasons for all this are not hard to find. First, demographic trends mean that in recent years millions of Americans have been reaching legal drinking age (something which will continue for several years to come). Second, America is the land of the cocktail, and vodka's almost total lack of flavour, colour and odour render it ideal for this purpose, in both the bar

and take-home trades. (In 2004 vodka became the largest spirit category in the US - and the second largest vodka market in the world behind Russia). Third, Americans are intensely both aspirational and brand-conscious, with the overwhelming majority of drinks in the on-trade being ordered by brand name. It is estimated that the US accounts for 61% of global consumption of premium or higher brands.

It has to be said that just-drinks.com has also suggested that growth in case sales of premium and super premium brands is set to slow to a rate in mid-to-high single figures, and that a brand shake-out is at some point inevitable. But apart from the fact that even this is the sort of growth of which many industries can only dream, we believe that the provenance and the associations of Kalashnikov (premium) and its derivative brand, Gun Metal (super premium), provide an excellent basis for success in this competitive but potentially very profitable market.

## The company in the US

With so much to play for, it is not surprising that Kalashnikov intends to spend £3.28m, or 71% of its planned three-year marketing budget, in the American market; nor that this is where the first move in the post-funding expansion will take place. The spend will be shared equally between Kalashnikov and Gun Metal, with exactly the same amount being spent on each brand at the same stage in each one's development. The timing and size of the spend will obviously depend crucially on the success of the company's current fund-raising exercise, but the hope is that it will get under way this summer in respect of the Kalashnikov brand and in late 2009 for Gun Metal. For both brands, marketing spend will peak in Year 2 and then fall to its lowest level in Year 3, as shown in the table below (which is inevitably only illustrative as far as timings are concerned):

**Table 4: Planned USA marketing spend**

£000	Year 1	Year 2	Year 3	Year 4	Total
Kalashnikov	540	675	425		
Gun Metal		540	675	425	
<b>Total</b>	<b>540</b>	<b>1,215</b>	<b>1,100</b>	<b>425</b>	<b>3,280</b>

**Source:** Company

The reason for delaying the launch of Gun Metal is to enable the latter to benefit from what is expected by then to be a 'halo effect' of favourable association with the Kalashnikov brand. Indeed, the new brand will be marketed as "Gun Metal by Kalashnikov", and both will be aimed at the same market, since market research shows that consumers tend to have a portfolio of branded drinks for home, bar and gift uses. The company hopes that those consumers, having been won over to the Kalashnikov name, will be tempted to stock, order or make a gift of a special occasion vodka which is self-evidently from the same stable.

## Targeting the American market

The company believes that because Kalashnikov is already a well known "premium" name in America, the brand can be placed directly into the retail market (that is, without first being seeded into selected style bars); and it has decided, on local advice, to target the game hunting fraternity, which is said to number 12.5 million, and gun supporting members of the population (which, in a country that has 900 million registered firearms, would arguably cover everybody).

To this end the company has already reached what it expects to be an extremely significant agreement with the National Rifle Association, which has 4 million members. General Kalashnikov is a Life Member of the NRA, and the latter has agreed to support the brand by carrying advertisements in its monthly magazine, which has 1.3 million subscribers, consisting of a letter from the General, with an attached "Request Purchase Coupon" which readers can use to order the brand from their local liquor store. The advertising will be along the lines that the man who created the best rifle in the world has now created the best vodka in the world.

## US case sales

There have been two significant vodka brand launches in the USA since 2000, both in the super premium segment, namely, Three Olives and Ciroc. The former grew to 420,000 case sales in its first three years and the latter to 95,000. As mentioned earlier, premium brands have generally not been growing as quickly as super premiums in recent years, but this is probably not a relevant consideration in the case of new product launches.

Be that as it may, the Kalashnikov management, in setting its growth targets, has veered towards the Ciroc example, rather than claiming to be able to emulate the spectacular success of Three Olives, and is budgeting for Year-3 sales of the Kalashnikov brand in the USA of 120,000 cases. For Gun Metal, at the top of the super premium segment, the company is budgeting – very cautiously, it seems – for case sales of just 30,000 in Year 3: less than a third of what Ciroc achieved.

## Other markets

The company intends to give itself six months after embarking on its American marketing plan before starting to further implement its export marketing strategy, as shown below:

**Table 5: Planned marketing spend outside the USA**

Market - brands £000	Start*	Year 1 spend	Year 2 spend	Year 3 spend
Greece - Kalashnikov	6 months	150	95	35
Italy - Kalashnikov and AK47	6 months	94	70	70
Australia - Kalashnikov and AK47	10 months	43	584	162
Canada - Kalashnikov	14 months		327	152
Australia - Gun Metal	26 months			126

**Source:** Company

\* "Start" refers to the number of months after the beginning of the American marketing spend

## Canada

The push into Canada, by far the largest of the company's target markets after the US, with annual vodka consumption of 9.4 million cases, is planned to begin a year or so on from the start of the US campaign. The company intends to concentrate its efforts exclusively on the Eastern provinces of Ontario and Quebec and the Western provinces of British Columbia and Alberta, which account, respectively, for case sales of 3.6 million, 2.3 million, 1.3 million and 1

million – together representing 87% of the Canadian market. Only the Kalashnikov brand will be sold in Canada.

The import of alcohol into the Eastern provinces is strictly controlled, and the regulation of the industry is particularly stringent in Quebec, where both the advertising and retailing of spirits are controlled by state monopolies. The Kalashnikov management met a senior representative of the Quebec controlling body in autumn 2007 and has appointed a local agent to liaise with that body on importing and advertising the company's products.

The Canadian vodka market is not as segmentalised as the American market. There are two super premium brands, Grey Goose (owned by Bacardi) and Belvedere (LVMH/Millennium) and a host of premiums, including such as Smirnoff, Finlandia, Absolut and Stolichnaya, with which Kalashnikov will compete head-on. The company is budgeting for case sales of 85,000 in Year 3.

## Australia

Along with Canada, Australia represents a new challenge for the company, and it believes there is an opportunity to sell all three of its brands there.

The Australian vodka market amounts to just over 1 million cases, and although vodka is the fastest growing category in the local spirits market, consumption per head is low by international standards, and in fact just under a third of what it is in the US, which obviously provides scope for significant growth. Perhaps reflecting this, there is no lack of brands at all levels of the market. The Kalashnikov brand will be competing with Absolut, Smirnoff Black and Stolichnaya, and AK47 with Finlandia and Wyborowa. Looking much further ahead, Gun Metal is likely to be up against Ciroc, Grey Goose and Belvedere at the top of the market. Around two-thirds of the three-year marketing spend in Australia will be put behind the lower-end AK47 brand.

The company intends to begin operations there within a year of the fund-raising and it believes that AK47 can achieve sales of 30,000 cases in Year 3 of its development, Kalashnikov 10,000 and Gun Metal 8,000.

## Europe: Greece

Western European markets were where the company first turned in the wake of the Portman decision, and, as illustrated earlier (Table 3), Greece, Italy and Cyprus, in that order, are its most important markets in the region, followed by Germany, the Netherlands and France. Because the premium vodka segment is not as well developed in Europe as in the US, AK47 will play a more important role than Kalashnikov in many – though not all - of these markets. As shown in Table 5, Greece and Italy will be the company's next focus of attention once the American marketing programme is up and running.

The Greek vodka market comprises 900,000 cases, and is relatively unfragmented, with just four brands accounting for 83% of the market. These are Absolut, Smirnoff and Stolichnaya, all marketed as standard brands, and a value for money offering, namely, Serkova. The company will be selling only its Kalashnikov brand, which will be priced in line with the three mentioned above. Against sales in the year to July of 2007 of 1,300 cases, the company is estimating sales in Year 1 after the enhanced marketing spend gets under way of a little over 3,000 cases, and in Year 3 close to 16,000 cases.

Greece has already started to develop as a base for sales into Crete, the Balkans and Romania, and the company believes, looking further ahead, that Hungary, as well as North African markets, can also be brought into the net.

## Europe: Italy

The Italian vodka market is around 400,000 cases, and is considerably more fragmented than the Greek market, with little differentiation in terms of price or market segment. Kalashnikov and AK47, however, are clearly positioned as premium and value for money, and the company believes that this, and the absence of any really dominant brands, provide an excellent opportunity to grow its own brands. Accordingly, it is budgeting for sales of Kalashnikov to grow from just 200 cases in the year to July 2007 to 3,000 in Year 3, and AK47 from 400 to 9,500 over the same period.

## Total case sales

The sales targets mentioned above in respect of the various markets total 312,000 cases in Year 3, but with the new countries coming on stream and enhanced marketing spends cutting in at different times, this is clearly an artificial figure. In the table below we bring together the various sales targets by country and brand, allocated on an estimated real time basis:

**Table 6: Estimated real time case sales by country and brand**

Cases	Year 1	Year 2	Year 3
<b>USA:</b>			
Kalashnikov	22,000	80,000	120,000
Gun Metal		10,000	23,000
<b>Canada:</b>			
Kalashnikov		20,000	40,000
<b>Australia:</b>			
Kalashnikov	3,000	5,000	8,000
AK47	3,000	12,000	12,000
Gun Metal			
<b>Greece:</b>			
Kalashnikov	1,500	5,600	12,000
<b>Italy:</b>			
Kalashnikov	1,040	2,540	3,730
AK47	3,250	7,500	8,250
<b>Other:</b>			
Kalashnikov	630	7,900	16,350
AK47	320	2,880	11,370
<b>TOTAL</b>	<b>34,740</b>	<b>153,420</b>	<b>254,700</b>

Source: Company

**Note:** Gun Metal in Australia is included in the table because the company has a firm intention of introducing it there, but since the marketing spend is not expected to go in until Year 3, no sales are being assumed for that year.

The information shown on the previous page is presented below in a different format, that is, by country and brand totals:

**Table 7: Estimated real time sales by country and brand totals**

Cases	Year 1	Year 2	Year 3
USA	22,000	90,000	143,000
Canada		20,000	40,000
Australia	6,000	17,000	20,000
Greece	1,500	5,600	12,000
Italy	4,290	10,040	11,980
Other	950	10,780	27,720
<b>TOTAL</b>	<b>34,740</b>	<b>153,420</b>	<b>254,700</b>
Kalashnikov	28,170	121,040	200,080
AK47	6,570	22,380	31,620
Gun Metal		10,000	23,000
<b>TOTAL</b>	<b>34,740</b>	<b>153,420</b>	<b>254,700</b>

Source: Company



## Financial forecasts

On the basis of these volume projections the company believes that it will move into profit in Year 3, as set out in the following tables. We first show price and revenue assumptions, and it will be noted that there are two sizes of the Kalashnikov brand, the larger (75cl.) bottle size being the product which is sold in the USA and Canada.

**Table 8: Estimated gross revenue**

Gross revenue (£)	Year 1	Year 2	Year 3
<b>Per case</b>			
Kalashnikov - 70cl.	20.90	21.57	21.09
Kalashnikov - 75cl.	25.00	25.00	25.00
AK47	9.21	9.59	10.16
Gun Metal		35.00	35.00
<b>Total</b>			
Kalashnikov - 70cl.	128,980	453,780	845,230
Kalashnikov - 75cl.	550,000	2,500,000	4,000,000
AK47	60,534	214,675	321,213
Gun Metal		350,000	805,000
<b>TOTAL</b>	<b>739,514</b>	<b>3,518,455</b>	<b>5,971,443</b>

**Source:** Company

The company puts the cost of goods sold, at current production levels – in other words, before taking account of any economies of scale - at around £15 per case for Kalashnikov, £5 per case for AK47 and between £16 and £17 for Gun Metal. Applying these cost figures would produce gross profits as shown below:

**Table 9: Estimated gross profits**

£	Year 1	Year 2	Year 3
Gross revenue (from above)	739,514	3,518,455	5,971,443
Cost of goods sold	462,822	2,096,469	3,532,712
Gross profit	276,692	1,421,986	2,438,731

**Source:** Company:

Although changes in volume make no difference to raw material costs, significant benefits accrue in respect of lower filling and packaging costs as output rises. Thus the company estimates that gross margin should benefit to the tune of around £5.70 a case at an output level of 100,000 cases as compared with the current 5,000 or so. Further economies of scale beyond this level of output are not at this stage being predicated, but on the basis of these numbers we are still able, at least in theory, to add around £690k and £1,140k to the above gross profit projections for Years 2 and 3; and, indeed, there should be a not insignificant benefit in Year 1.

In the following table we show estimated full P&L accounts for Years 1-3 following the fund-raising, based on the above gross profits, the company's estimates for Head Office costs and depreciation, and the enhanced marketing spend described earlier in this note. The putative economies of scale, which the company management conservatively prefers not to include till Year 3, are shown separately. We also show indicative profits for Years 4-6, as described following the table.

**Table 10: Estimated P&L accounts**

£	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Gross profit	276,692	1,421,986	2,438,731			
Economies of scale		689,928	1,138,508			
	<b>276,692</b>	<b>2,111,914</b>	<b>3,577,239</b>	<b>4,650,411</b>	<b>5,580,493</b>	<b>6,138,543</b>
Head Office, etc.	656,080	445,000	462,250	494,608	529,230	566,276
Marketing	917,000	2,588,275	1,407,000	1,164,431	1,397,318	1,537,049
EBITDA	(1,296,388)	(921,361)	1,707,989	2,991,372	3,653,945	4,035,218
Depreciation	14,959	15,783	19,038	19,038	19,038	19,038
<b>Pre-tax profit</b>	<b>(1,311,346)</b>	<b>(937,144)</b>	<b>1,688,951</b>	<b>2,972,334</b>	<b>3,634,907</b>	<b>4,016,180</b>
Net profit after tax @ 28%	(944,169)	(674,744)	1,216,045	2,140,080	2,617,133	2,891,649

**Source:** Company and VSA Capital

**Notes:**

(1) Excluding anything for economies of scale in Year 2, as referred to above, the estimated pre-tax loss in that year would be £1.63m.

(2) The budgeted decline in Head Office and other costs in Year 2 reflects non-recurrence of the costs of the fund-raising exercise.

As stated above, the figures for Years 4-6 are no more than indicative, but we consider that they are based on conservative assumptions. They assume that, following an increase in volume of 66% in Year 3, growth will slow to 30% in Year 4 and then to 20% and 10% in the next two years. It is further assumed that like-for-like prices will remain unchanged, and that there will be no improvement in the sales mix (notwithstanding the possible success of the super-premium Gun Metal), so that revenue growth will only match volume growth.

The cost of goods sold is also assumed to remain constant, and, as already stated, no additional economies of scale are built in, despite the fact that case sales are budgeted to rise from 255,000 in Year 3 to 437,000 in Year 6. In practice, of course, both the cost of goods sold and selling prices are likely to rise, but either way gross margins are assumed to remain constant. Central costs are assumed to grow at 7% compound. Following the major marketing push in Years 2 and 3, the spend will fall back in Year 4, still to a level comfortably above Year 1, and then grow by 20% and 10% in the next two years.

**Earnings per share**

As shown above, it is expected that there will be nothing available for shareholders in the first two years following the fund-raising. In Year 3 profits should start to benefit significantly from the marketing investment, and then very substantially in Year 4, following which – as just discussed – the growth of the business is assumed to slow, albeit to a still above-average rate.

In estimating future earnings per share we are assuming that the planned £6.6m of new funds will be raised through the sale of new shares at 30p, involving the issue of 22m shares. On this basis the profit figures shown above would produce the following diluted EPS from Year 3 onwards:

**Table 11: Estimated EPS, Years 3-6**

	Year 3	Year 4	Year 5	Year 6
Net profit after tax (£)	1,216,045	2,140,080	2,617,133	2,891,649
Interest on full dilution (£)	35,761	35,761	35,761	35,761
<b>Earnings on full dilution</b>	<b>1,251,806</b>	<b>2,175,841</b>	<b>2,652,894</b>	<b>2,927,410</b>
Existing shares	5,522,379	5,522,379	5,522,379	5,522,379
Shares to be issued	22,000,000	22,000,000	22,000,000	22,000,000
Options and warrants	1,902,000	1,902,000	1,902,000	1,902,000
<b>Total shares, diluted</b>	<b>29,424,379</b>	<b>29,424,379</b>	<b>29,424,379</b>	<b>29,424,379</b>
<b>EPS (p)</b>	<b>4.25</b>	<b>7.39</b>	<b>9.02</b>	<b>9.95</b>

**Source:** Company and VSA Capital

Attributing a value on a price earnings ratio basis to a company with no track record is clearly extremely difficult. We consider, however, that if in two-three years' time the above estimates appear realistic, and we are thus at that stage looking at a company about to make EPS of 4.25p and then more than double those EPS over the following three years, a share price then of 80-90p, based on a prospective multiple (of 4.25p) of around 20, should be achievable. On trading grounds alone a mid-price of 85p would thus be our target, looking out to, say, the first half of 2011. This would put a value on the whole company of £25m.

## Comparable brand launches

The little word "if" looms large in the previous paragraph, and it remains to be seen whether the company's volume – and therefore profit - projections are excessively optimistic. As a reminder, against (in round numbers) 5,000 cases last year and perhaps 7,000 this, the company is looking for 35,000 cases in Year 1 post-fund raising, followed by 155,000 and 255,000.

Mention has already been made in this note of the fortunes in the US market of the two super premiums, Ciroc and Three Olives, which by Year 3 were selling 95,000 and 420,000 cases, respectively. Another brand, Level One, sold 100,000 cases in its first year.

The New Zealand company, 42 Below, started selling its eponymous premium vodka brand in Australasia in 1999, and by 2003, on the back of private equity investment of £1m (equivalent), had reached annual case sales of 5,000 – rather like Kalashnikov now. Towards the end of that year it raised the equivalent of £5.7m in an IPO, and, having invested the new money in international expansion, saw its sales grow to 18,000 cases in the following year, then to 55,000 and then 90,000 (including 50,000 in the US) in 2006. What happened next is described below, but in 2007 the company was expecting to sell 107,000 cases.

The founder of the business put the brand's success down to its unusual provenance, what he has described as "fresh and irreverent" advertising, and the quality of the product. One can hardly claim that the brand was not successful, but its sales over three years fell some way short of what Kalashnikov is aiming for, and if the latter is selling only 90,000 cases in Year 3, it certainly won't be making 4.25p of earnings, but, on the contrary, will still be substantially in the red.

## Exit strategy

An obvious possible concern for investors in Kalashnikov is that the action of the Portman Group in the UK in 2004 could be emulated in overseas markets. On the other hand, no such body exists in the vitally important US market – where, moreover, the Colt 45 beer brand and gun ownership are part of the landscape and way of life. Self-regulatory bodies do exist in a few other alcoholic drinks markets, but most do not wield the same degree of influence over the trade as Portman.

### Comparable Brand Case Sales First 3 Years



**Table 12: Vodka brand values**

Brand	Year	Purchaser	Price	Cases (000)	Price per case
Skyy	2001	Campari	\$415m	1,600	\$259
Grey Goose	2004	Bacardi	\$1,742m	1,500	\$1,161
Ursus	2004	Diageo	\$178m	400	\$445
42 Below	2006	Bacardi	\$73m	107	\$679
Ketel One	2008	Diageo	\$1,800m	1,900	\$947

**Source:** 42 Below offer document and VSA Capital research

**Notes:**

(1) The sales of Skyy and Ketel One involved only half of each business, but the figures in the table are in respect of a notional 100%. Diageo in fact has a call option on the remaining 50% at the same price (plus interest).

(2) The total and per case prices shown for 42 Below are based on the value of the offer net of cash within the company (that is, the enterprise value). The figures have been converted from New Zealand dollars at the then current rate against the US\$ of 1.52.

At the end of March Pernod Richard announced that it had prevailed in the auction to purchase from the Swedish government the internationally renowned premium vodka brand, Absolut. The brand sells a massive 10.7m cases a year and fetched \$8.9bn. This implies a price

per case of \$862, that is, somewhere between the per case prices at which the two preceding deals - for 42 Below and Ketel One - were done.

Given the wide disparity amongst the valuations of case sales shown above, it is hard – impossible, in fact – to infer from them with any confidence an appropriate valuation for Kalashnikov. All that can be pointed out is that since the Skyy sale, which was seven years ago, no brand has gone for less than \$445 per case; and that 42 Below fetched the figure of \$679 despite the fact that the business had made a loss in every year of its existence, and, indeed, was forecasting a further loss for the financial year in which it was bought.

On the basis of the Kalashnikov company's hoped-for sales of its three brands in Year 3 of 254,700 cases, the 42 Below per case valuation implies a value for the business of \$173m, or £87m at a rate of \$1.98 to the £. This would equate to a price per share, on the basis of our suggested share capital of 29.4m shares (see Table 11) of 296p –somewhat higher than the 85p reached on the basis of "fundamentals". On a more conservative basis – namely, that AK47 finds itself unwanted and Gun Metal fails to take off – we would still be looking at estimated sales of 200,080 cases (Table 7) and a valuation of \$136m, which is £69m, or 234p a share. And if – to be even more conservative – it were to fall woefully below its targets and achieve only the same case sales as Below 42, and fetched the same price as the latter, shareholders would even then pocket 126p per share.

## APPENDIX 1: Financials

### P&L account summary

Year-end July (£)	2003	2004	2005	2006	2007
Turnover	11	801	50,963	18,781	121,345
Cost of sales	(475)	(604)	(48,921)	(21,447)	(106,880)
Head office	(17,292)	(108,840)	(176,636)	(74,300)	(372,112)
EBITDA	(17,756)	(108,643)	(174,594)	(76,966)	(357,647)
Depn. and amortisation	0	(2,799)	(11,891)	(14,901)	(24,088)
Loss before interest	(17,756)	(111,442)	(186,485)	(91,867)	(381,735)
Interest receivable	0	998	698	161	2,639
Loss before tax	(17,756)	(110,444)	(185,787)	(91,706)	(379,096)

**Source:** Based on the company accounts

### Summary balance sheet

At end-July 2007	£		
Plant and equipment	38,218	Equity funds (£)	222,262
Intellectual property rights	134,044	Issued shares	3.59m
Cash	11,092	Equity funds per share	6p
Working capital	44,908	Net debt (£)	Nil
Short-term loan	(6,000)	Gearing	Nil
Equity funds	222,262		

**Source:** Based on the company accounts

### Cash flow analysis

Year-end July (£)	2003	2004	2005	2006	2007
EBITDA	(17,756)	(108,643)	(174,594)	(76,966)	(357,647)
Working capital	49,221	(87,217)	19,470	128,701	(146,583)
Interest received	0	998	698	161	2,639
Capital spending	(45,231)	(45,882)	(22,999)	(28,410)	(83,419)
Net cash inflow (outflow)	(13,766)	(240,744)	(177,425)	23,486	(585,010)
Opening net cash	N.a.	3,990	164,091	38,166	61,652
Net cash inflow (outflow)	(13,766)	(240,744)	(177,425)	23,486	(585,010)
Shares issued	0	400,845	60,000	0	528,450
Closing net cash	3,990	164,091	38,166	61,652	5,092

**Source:** Based on the company accounts

**Note:** £6,000 of short-term debt in 2006/07 and £8,500 in 2004/05 and 2005/06, which in the accounts are included in working capital, are treated above as debt and netted off against the cash item.

## APPENDIX 2: Notes on the executive directors

### **John Florey – Managing Director**

Aged 41, John Florey founded the company, in collaboration with General Kalashnikov, in 2003. His academic qualifications include degrees in Law from London University and in Land Economy from Cambridge, and an MBA from Tanaka Business School at Imperial College.

Developing new and varied ventures around the world has been his speciality. He first worked as a property planning consultant in the UK (1990-92), before moving to Southeast Asia as a corporate strategist (1993-95). In 1996 he returned to London, where he established a property management business and took over the running of London Educational Services, a body concerned with the promotion of British higher education around the world. Then in 1999 he set up The London & Oriental Trading Company, which traded commodities, foodstuffs and consumer goods internationally. At the same time he acted as an international financial and business consultant, arranging loans and insurance and mediating between businesses. From 1999 till 2003 he was also chess grand master Garry Kasparov's London representative in brand licensing. He is a founder and non-executive director of the British Russian Institute of Management and an Honorary Professor at the Moscow Business School.

### **David Bromige – Branding and Creative Director**

What David Bromige, aged 57, mainly brings to the party is his experience in the development of premium spirits brands. In 1999 he designed and created Polstar vodka and its flavoured derivative brands for the style bar market. The product has subsequently been sold to the William Grant company. He is also a director of the Reformed Spirits Company, which was formed in 1999 and makes Martin Miller's Gin. This product, distilled in England and then sent to Iceland for blending with spring water, is positioned as a top premium brand, and is exported to Australia, Ireland, Russia and the US. Mr Bromige is a co-founder of The Drinks Consultancy, which was also set up in 1999, and provides an advisory service to both drinks manufacturers and the licensed trade.

### **Michael Davenhill – Finance Director**

Michael Davenhill is 65 and has extensive experience in finance in a wide range of industries. He was for seven years with Unilever and then for ten years was a financial controller at Schlumberger, the Texas-based international oilfield services provider. He has also been Finance Director at the advertising agencies, J. Walter Thompson and D'Arcy Masius Benton & Bowles, and at the partwork publishers, Marshall Cavendish. He has a degree in mathematics and is a Fellow of the Association of Chartered Certified Accountants.

## APPENDIX 3: Trade mark disputes

The company has for some time been in dispute with a Russian spirits company, Glazovsky, and a Chinese company, Qingdao, regarding the registration of the Kalashnikov and AK47 trade marks.

As far as the US and Canada are concerned, there is no dispute with other parties, and the company is well advanced in the process of achieving all necessary registrations in respect of its Kalashnikov and AK47 brands. Registrations in Australasia are at a less advanced stage, but there is no known opposition to the company's applications.

In Europe the company is in dispute with Glazovsky. The latter has an International Registration, which designates protection in relation to several European countries, including France, Germany and Italy. Glazovsky used this International Registration, via a Community Trade Mark, to oppose trade mark registration by Kalashnikov throughout the whole of the EU. Kalashnikov responded by applying for registration on a country-by-country basis and now has registration in all European markets of interest apart from Cyprus, Italy and Poland, where a decision is awaited. Kalashnikov itself filed an application for a Community Trade Mark some eighteen months ago, and believes the application will succeed on the grounds of Glazovsky's failure actually to use the trade marks itself. If it fails, however, the company can again apply for individual registrations, that is, in Portugal, Malta, and the Scandinavian, Baltic and Central European countries of the EU.

The company has been refused registration for AK47 in Malaysia and expects to be refused in respect of China, in both cases because of Qingdao's existing rights.

Qingdao is also applying for registration rights for AK47 in a range of other countries, namely, Denmark, Estonia, Finland, Greece, Ireland, Sweden, Norway, Turkey and Venezuela. In most of these territories Kalashnikov's earlier registrations are almost certain to be – or have already been – cited by the authorities as bars to registration by Qingdao.

## S.W.O.T. Analysis

### Strengths

- A strong internationally recognised Russian brand name, licensed from and supported by General Mikhail T. Kalashnikov, one of the few living national heroes of Russia
- An ideal brand for both the Emerging Markets, in particular for "New Europe" and Africa, as well as the traditional markets of the USA, developed Europe and Australasia
- The vodka has consistently been acknowledged as appealing by consumers and won Silver & Bronze Medals at the International Wine & Spirit Exhibition in 2005 & 2007 in London
- The product design has also been acknowledged as appealing by consumers and won a 'Shine' design award in 2005 in London
- The Company has obtained and registered the trademark for 'Kalashnikov' and 'AK47' in its potential key markets

### Weaknesses

- Main competitors with substantial financial muscle
- Small business dealing with global customers

### Opportunities

- Year on year growth in the Premium & Super Premium vodka sectors in the USA, comprising 11 million of the 34 million annual US vodka case sales, grew by 46.4% from 2000 to 2004
- The initial target market in the USA are the 12.5 million hunters and 4 million National Rifle Association ('NRA') members
- Global vodka sales amount to over 388 million cases annually and account for 25% of all spirit drinks consumed

### Threats

- If the supply of bulk vodka from Russia ceased, it would effect the production of Kalashnikov Vodka, but not the other two brands, 'AK47' and 'Gun Metal'
- A significant increase in duty and excise on alcoholic beverages would impact the Company's ability to deliver on its forecast case sales
- The global increase in the cost of raw materials, especially grain, will affect the price competitiveness of the end product if it persists or worsens

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