23 August 2019

Chairman & Executive Director remarks from results call

Neil Craig:
To recap, we entered the 2018/19 financial year with an optimistic view around the 2019 honey season together with a forecast upward trajectory on sales particularly into the US and China. What transpired was:

Supply
A third poor Manuka honey production season in a row from a combination of weather events impacting production and overstocking of hives by the industry.

Overstocking came from new players entering the 'perceived gold rush' and existing apiary businesses chasing high quality UMF honey. We reduced our fixed cost component of the apiary business (Kiwi Bee) materially but not enough to counter the two impacts mentioned. We incurred a loss of $6m in Kiwi Bee in 2019.

In response and in anticipation of the 2019/20 harvest, which commences in October in Northland and runs through to February in the King Country, we have further reduced our apiary overhead costs, but more importantly analysed our extensive historical production data to limit hives only to sites where honey production is more reliable (season upon season). The first material quantities from our own high UMF Manuka plantings will also start to positively assist the profitability of Kiwi Bee.

A big, but less publicly visible impact on Comvita's cost of goods and hence profitability comes from the MPI (Ministry of Primary Industries) certification standards introduced in early 2018 defining what can be exported as Manuka honey. These standards while not perfect, were materially beneficial for the industry in eliminating 'cowboys' from exporting packed Manuka honey but they also had some unintended consequences that impacted Comvita in FY19. In our view, additional MPI certification must be put in place to remove the definition for Multifloral Manuka honey (as opposed to the genuine Monofloral Manuka honey) and New Zealand needs to enforce the same standard for domestic New Zealand sales as it does for export.

For Non-Manuka honey's, the definition took the heat out of pricing but also brought the Non-Manuka price back to levels more in line with global honey prices. Wholesale prices dropped from $8-12/kg in 2018 to $4-5/kg today as honey's that looked like Manuka honey (but wasn't) could no longer be sold as Manuka. The impact of this change has been significant. All Apiaries targeting Manuka produce non-Manuka honey as 'bycatch', so the profitability of all New Zealand apiaries has fallen as a result.

Fortunately, Comvita has anticipated the wholesale honey price response and acted accordingly in the wholesale market for honey in New Zealand.

We have also anticipated the shortage of MPI compliant honey, with positive action over three years in building high quality UMF Manuka honey inventory and only purchasing non-manuka honey where we need to in order to maintain long standing relationships. Apart from Manuka honey held in markets ready for sale around the world, all of this inventory is now stored in our new state of the art climate-controlled warehouse at Paengaroa, Bay of Plenty.

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Revenue
On the sales side, we expected our fledging North American sales to large supermarket chains, digital through Amazon and various other customers to be circa $25m but ended up being just $13m. This was entirely a function of being optimistic that one supermarket chain in the US would recommence purchasing in the second quarter of the 2019 financial year. What transpired was no orders until around nine months later than expected as a direct result of overstocking of a competing brand. Our first 2019 orders were only delivered in June 2019 and we expect regular orders from now on.

At the same time as we were grappling with no orders from our biggest US customer, we realised early in the 2019 financial year that our own pricing strategies into China were not providing the right signals and incentives to our NZ and Australian diagou customers reselling into China nor our direct customers through our 51%/49% JV in Shenzhen or our cross-border e-commerce platforms (CBEC) we were selling to directly. This exercise of realigning pricing and marketing programmes involved protracted negotiations with a number of parties and wasn't complete until the final quarter of the 2019 financial year. We now have an ongoing tactical approach to maintaining competitive and cohesive pricing in all channels into Asia.

On 1 January 2019, China implemented new regulations on the Diagou traders. This created added costs on diagous and a good deal of uncertainty on them of what other regulatory issues might impact their sales in the future. The impact on Comvita has been a more volatile and less predictable sales pattern through this channel. Long-term, the diagou channel will remain important and valuable outlet for Comvita products, however this volatility has driven Comvita to reduce its reliance on diagou sales in the future.

2019/20
The 2019 financial year finished profitably in the last quarter as most significant marketplace sales issues had been resolved. Even so, further 'hiccups' in Hong Kong (riots) and volatility with diagou sales from some New Zealand regulatory changes resulted in revenues slightly lower than we had projected. Sales in the first quarter in 2020 are tracking higher than in the same quarter of 2019, notwithstanding the quarter is vacation time in the Northern hemisphere and therefore normally our lowest sales period.

Our focus over the next few months will be repositioning Comvita to produce sustainable profits. We will have some relatively small one-off costs as, with the help of some outside consultants, we reposition the business. This will come from:

- Concentration of sales and marketing effort in our core markets of China and greater Asia, and North America, while other markets all continue to contribute to profits.
- Coordinating of our sales approach into China centered on our own China distribution company in Shenzhen, but having regard to all other sales channels into China including Hong Kong, CBEC and diagou.
- Reducing our overhead costs across the board, both in New Zealand and offshore
- Reducing our cost of goods, for our core ingredients of Manuka honey and Propolis.
- As noted earlier, ensuring Kiwi Bee is profitable under all reasonable scenarios.
- Contribution from Manuka planting programmes using our high UMF Manuka cultivars have been developed over 12 years in our breeding programme.

On the same date (6 June 2019), we announced the Strategic Review headed by Brett Hewlett, we also announced that Scott Coulter our CEO will be stepping down. The Board can confirm that a search for a new CEO from outside of Comvita is well underway. The timeframe for announcing a new CEO will mainly be dependent on current employment circumstances of that individual. However, given Brett Hewlett's past role of Comvita for ten years was CEO (early 2016), we have been very fortunate (with the help of some outside specialists) to be able to 'hand through' to any new CEO a business unshackled from legacy assets and legacy issues, and fit to produce sustainable profits. The goodwill write down taken into account in our own 2019 statements in our 2019 result is a direct result of this review.

Shareholders / Share Price

Finally, the Board is very conscious of the sharp decline in the share price from December 2019 until $2.62 today. This share price decline weighs heavily on the Board.

We acknowledge that the share price is a function of our successively missing financial forecasts or expectations of analysts. This decline was exacerbated by our shares being removed from the NZX50 index on 21 December 2018 based on a review of market capitalisation relative to other listed shares by Standard and Poors.

We estimate on that one day (21 December 2018), circa 1.5 million shares were effectively for sale as Comvita shares were mandated by several institutions to be sold simply because Comvita was removed from the S&P/NZX50 Gross Index. At that time of the year (from Christmas to end of January) the stockmarket transaction volumes are very light with virtually no retail investors or institutions in the market. 'The resulting share overhang' combined with successive negative honey season updates has weighed heavily on Comvita shares. Throughout the period from January 2019 through to today, Restricted Persons, (directors and executives) have been restricted by Board Policy from transacting in Comvita shares except for about 20 trading days. There has therefore been very limited "leadership" to the market from those that know most about Comvita.

We are cognisance that a sustained recovery in the share price will occur only when we can gain the confidence of investors that the Company will be trading profitably on a sustainable basis. The Board is committed to achieving this.

<u>Brett Hewlett – Executive Director:</u>

At the beginning of June 2019, the Company announced that it had established a special purpose sub-committee to conduct a review of the under-performing assets of the business, as well as structural, balance sheet, leadership and organisational considerations.

Changes have already started. Early in the process we looked to draw out any skeletons from the balance sheet cupboard and deal quickly to any impediments to improving performance in FY20. Given the recent history of poor honey harvests, adjusting for the recent changes to the regulatory environment, and under the shadow of a languishing share price that undervalues collectively the Groups non-current assets, we have chosen as a Board to act conservatively, and realise impairments to the value of some of those assets, now. The non-operating adjustments of $20.1m, mostly impairments of goodwill intangible assets, has been necessary to clear the way for a more focused reset of our strategy. This will also ensure that we are not unnecessarily hindered as we strive to returning to net positive earnings growth."

Demand for Manuka honey

Contrary to rumours and speculation by some industry commentators, the Manuka honey market has not crashed. It is as strong as ever. Demand globally has shown amazing resilience to the reprehensible behavior of a number of NZ and foreign industry players who have sort to capitalise on the golden honey rush. Following the adoption of new standards introduced by MPI and the disruption it has caused to both supply chain as well as market channels, as well as a harsh dose of reality around the challenges involved in building a quality global brand, many of the less capable industry players are retrenching, or exiting all together. Hence the rumours.

Comvita remains the Manuka honey category leader

Comvita has been exporting as a premium foods and health supplements brand for more than 45 years. Over the last 20 years or more we have been leading the story of Manuka honey and in the process built considerable value for the honey industry domestically. We should all be reminded that it was Comvita's role in commercialising the IP for application of Manuka honey as a miraculous healer of wounds that first put Manuka honey on the map, and so started the gold rush. Demand has built steadily over this period and so too has consumers knowledge and appreciation for quality and trust in known brands. Most notably in China, the fastest growing consumer market in the world, the Comvita brand is leading the way, by a considerable margin. While a change in industry standards and shifting regulations have been disruptive leading to a temporary adjustment to product mix and volumes, and availability in certain channels, the consumers desire for Comvita Manuka honey, and willingness to pay a premium for it, has not abated.

The changing nature of global distribution

Very notably, over the last 5 years, there have been a number of trends in how and where global consumers purchase products from brands like Comvita. The explosive growth of new e-commerce platforms, the rise of cross border e-commerce trading, the role of social media and technology in accessing information including prices, cross border trading, to name just a few. Comvita is currently reassessing where and how it sells, market by market, channel by channel. We will review how we are organised in each of our target markets and optimise for consumer intimacy and profitability. We are well on the way to achieving the optimal structure in our newly acquired China distribution business, the first target of our Market reviews.

Supply side review

Coming from a historical environment of chronic supply constraints, Comvita has over the past 10 years and more, invested considerable resources to ensure we have secure supply of our core raw materials (Manuka honey, Propolis and Olive leaf). We have had to manage this in unregulated burgeoning industry environments. It has taken courage, required innovation on many fronts and a real pioneering spirit to achieve as much as we have in a relatively short space of time. Today we have in place enough supply chain initiatives to ensure that we can meet our aspirational demands for the highest quality raw materials for at least the next 5 years.

Having put in place this foundation for supply, we must now ensure that we operate these supply based assets efficiently. We will now evolve our attention on taking costs out of the supply chain, improving harvest yields and productivity. We will also explore new Revenue stream opportunities that can arise from holding scalable supply based assets. e.g. licensing rights to our IP, ingredient sales, shared services etc.

Underperforming assets

To ensure that we are not hindered in our shift of focus, from supply security to supply efficiency, we have taken a hard look at all of our assets on the supply side. Given the recent history of poor honey harvest and changing regulatory environment, and under the shadow of a languishing share price that undervalues collectively the Groups non-current assets, we have chosen to act conservatively and realise impairments, mostly of intangibles, to some of those assets now. This clears the way for a reset of our strategy as outlined above, and is intended to lead us as quickly as possible to reporting on a net earnings growth story. The entire Board are confident that we will be successful in this endeavor.

New structure under Supply and Brand

Comvita will adopt a more focused organisational model for the two complimentary yet disparate parts of the business i.e. Supply and Demand(Brand). We will retain 100% ownership of these two business units but will run them separately under a new leadership structure. We are working with the entire organisation as well as taking on outside advisors where necessary to ensure that we make a successful transition of the business and at the same time do not lose focus on delivering a positive net earnings result in FY20.

We will be able to update our shareholders on the progress we are making at our AGM in October this year, including progress on recruitment of a new CEO.

Ends.

For further information:
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Background information

About Comvita (www.comvita.co.nz)

Comvita (NZX:CVT) is a global natural health company committed to the development of innovative products, backed by ongoing investment in scientific research.