

Desautels Capital Management

November 24th, 2015

Ten Peaks Coffee (TSE:TPK)

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Consumers Industry Review

Desautels Capital Management

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Ten Peaks Coffee

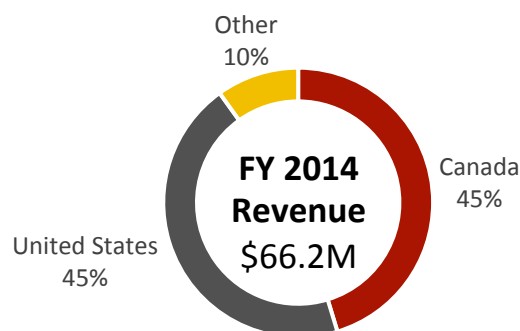
King of decaffeination



Company Description

- TPK is a premium green coffee decaffeinator
- Uses the Swiss Water Process, the only 100% chemical-free water process for third-party decaffeination and the world's only consumer branded process
- Located in Burnaby, British Columbia

Revenue by Geography and Segment



Source: Bloomberg as of 11/20/2015

Public Market Overview

Ten Peaks Coffee Company Inc (CAD\$)	
Current Price (CAD\$/Share)	\$10.84
Dividend Yield	2.3%
52-Week High	\$11.00
52-Week Low	\$4.20
Diluted Shares Outstanding (mm)	9.0
Market Cap (mm)	97.4
Add: Total Debt (mm)	0.0
Add: Value of Preferred Shares	-
Add: Minority Interest	0.0
Less: Cash & ST Investments (mm)	9.3
Enterprise Value	88.1

	Valuation Summary			
	2013A	2014A	2015E	2016E
Revenue	53.9	66.2	80.4	90.6
YOY Growth %	-9.8%	22.8%	21.5%	12.7%
EBITDA	2.9	7.0	9.7	9.9
YOY Growth %	78.5%	143.7%	37.9%	1.6%
EV/Revenue	1.6x	1.3x	1.1x	1.0x
EV/EBITDA	30.5x	12.5x	9.1x	8.9x

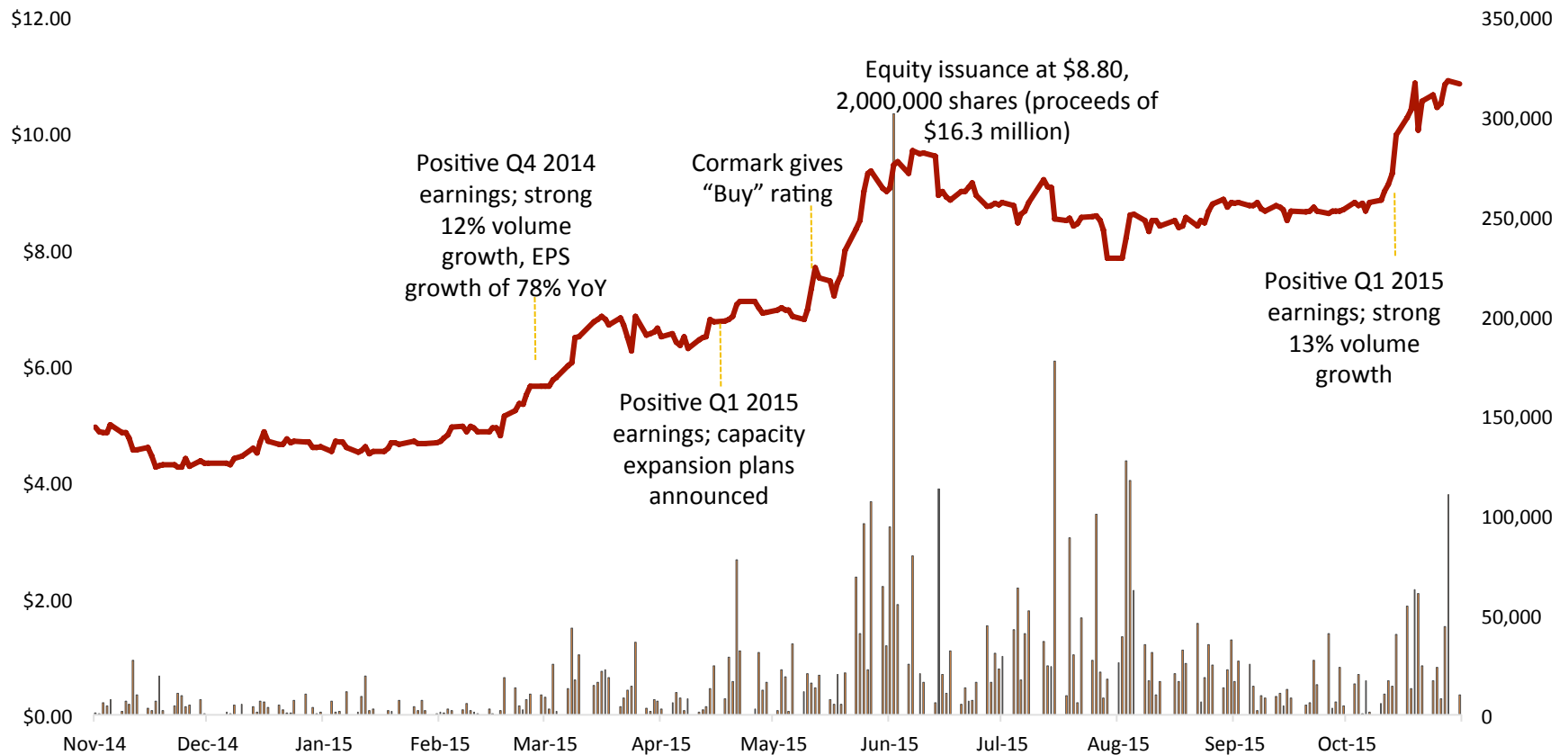


Ten Peaks Coffee

Annotated Price Chart



Recent Run-up In Price with Positive Numbers



Source: Bloomberg as of 10/9/2015



Investment Thesis

“I like myself a good monopoly.”- D. Kraminer, Bcom 2015



1. Premium position in decaffeination with strong growth runway

- Patented Swiss Water Process is the only 100% chemical-free, consumer branded decaffeination process
- Processing volumes up 39% over past five years; improving gross margins and strong ROIC
- Expansion plans in place for plant capacity, given growing U.S. and international volumes

2. Third wave of coffee to increase demand and expand TAM

- Specialty coffee growth is promoting a shift from lower-quality chemical decaffeination methods to premium methods
- TPK currently has approximately 70% market share in Canadian decaf; U.S. market is ~10x the size, providing a large, growing TAM

3. Valuation is attractive given growth prospects

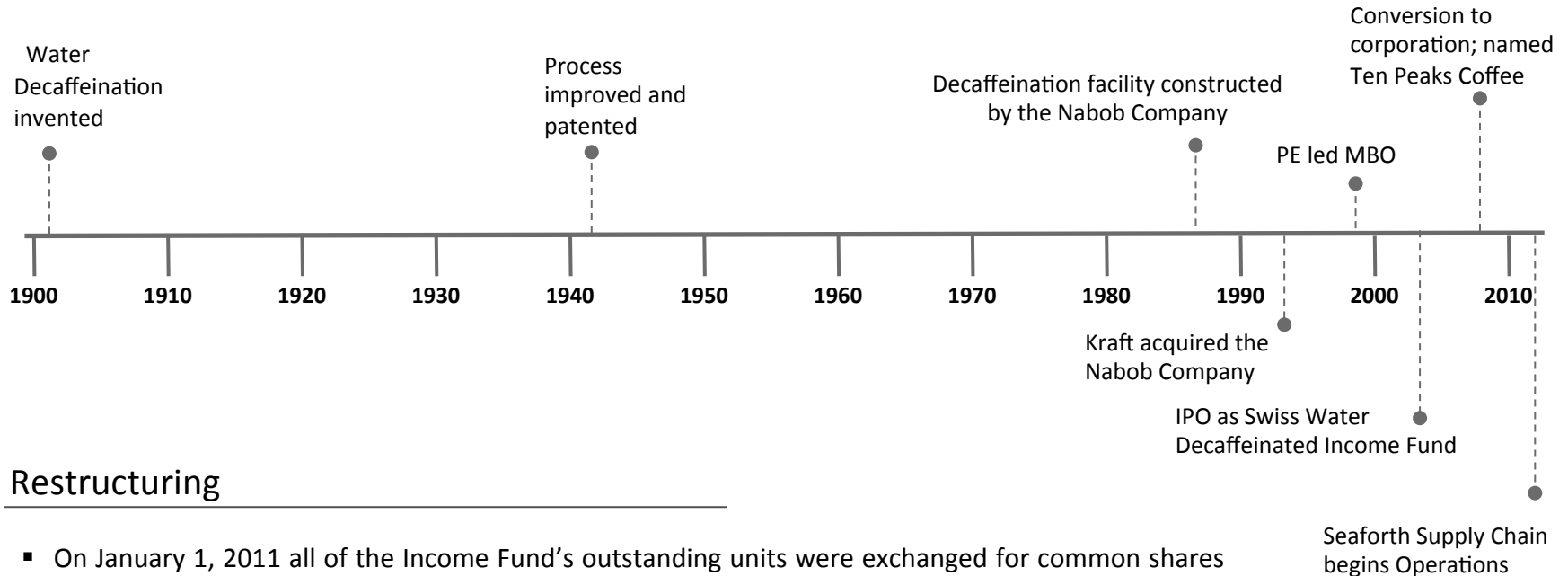
- Unwarranted discount to high-growth consumer plays on current and forward EV/EBTIDA
- DCF base case yields ~25% upside

Bonus: Strong management team (CEO was ex-Director of Kraft Foods Coffee)



Ten Peaks Coffee

Company History & Restructuring



Restructuring

- On January 1, 2011 all of the Income Fund's outstanding units were exchanged for common shares of a company which was created by the fund to transition into a corporation
- The fund was amalgamated into the Company and all of the Fund's assets and liabilities were assumed by the company and the common shares began trading on the TSX.
- Up until December 31, 2010, the Fund was an unincorporated, open-ended, limited purpose trust established under the laws of British Columbia by a declaration of trust.
- The Fund was established to acquire all of the interests in Swiss Water Decaffeinated Coffee Company (SWDCC), a chemical free, premium green coffee decaffeination business.

Source: Street research



Experienced Management

CEO has Been There Since the Beginning



Frank Dennis
President and
CEO

- 20 years of coffee industry experience
- 1990's: led \$300mn Kraft Foods Coffee business
- Led Swiss Water Division sale to PE interests in 2000

Source: Company filings



Sherry Tryssenaar
CFO

- Since 2009
- Previously:
- CFO QuestAir Technologies
- Director-Corporate Finance by RBC Technology Ventures, Inc.



Roland W. Veit
Board Member

- Principal owner and Chairman of Paragon Coffee Trading Company Ltd. (Paragon), a large US green coffee trading house
- Previously: Nestle Switzerland



David J. Rowntree
Chairman of Board

- Founder and Managing Director of Highland West Capital Ltd., a Vancouver based merchant bank
- Previously: Tricor Pacific Capital, private equity investment firm



Ten Peaks Coffee

Basic Business Model (Pun Intended)

What is the Swiss Water Process?

Step 1.

Green beans are cleaned AND hydrated with pure water preparing them for caffeine extraction.



time



temp.

Step 2.

An internally developed and maintained GCE is introduced and counter current extraction begins.*



time



temp.

Step 3.

Our carbon filtering system continually traps caffeine until the beans are 99.9% caffeine free.



100% chemical free

* GCE (Green Coffee Extract)

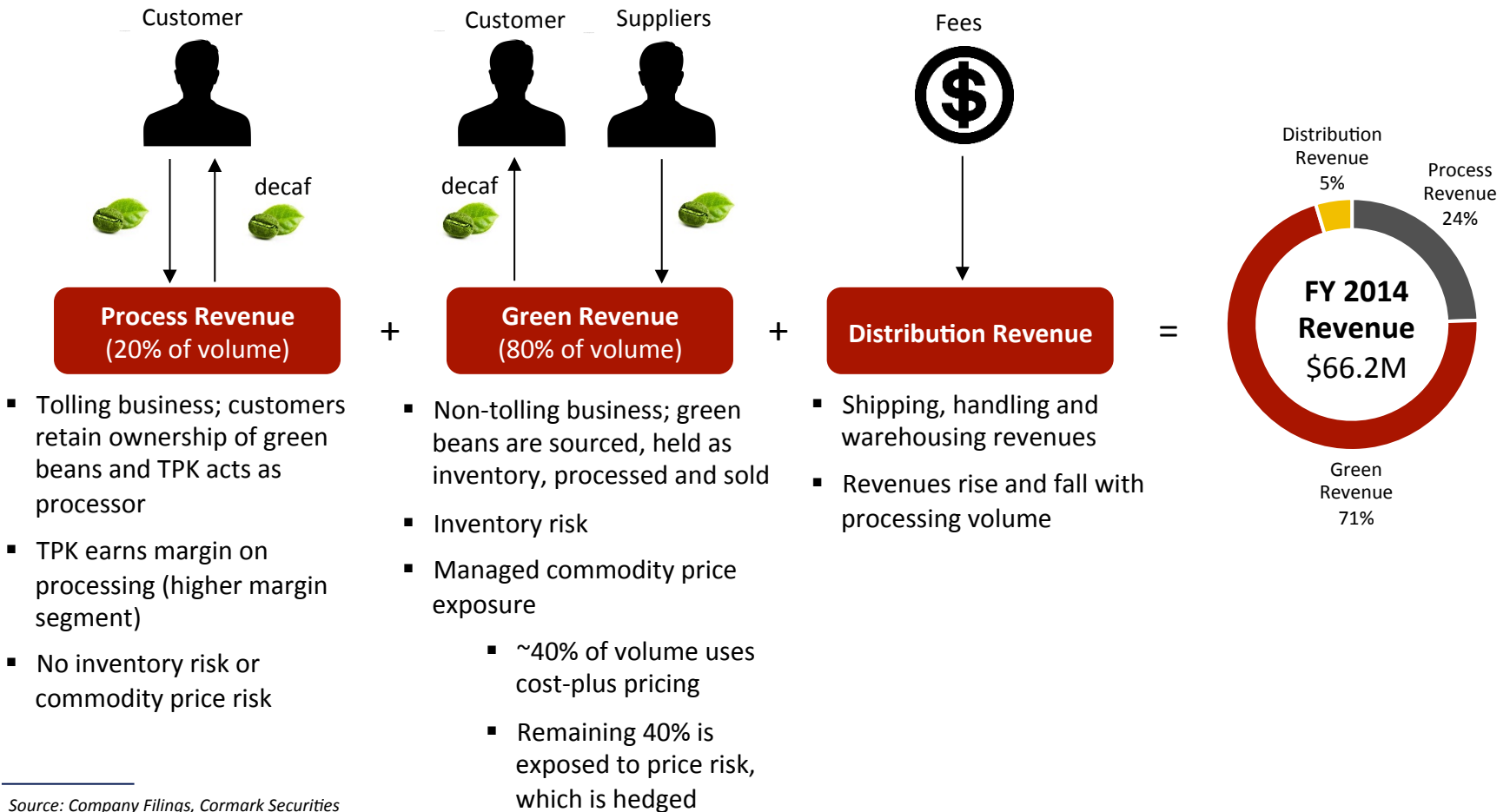
A batch of green (unroasted) beans is soaked in hot water, releasing caffeine and coffee solids. When all the caffeine and coffee solids are released into the water, the beans get discarded. The water then passes through a carbon filter that traps the caffeine but lets the coffee solids through. The solution left over is called GCE or green coffee extract.

Ten Peaks Coffee

Revenue Model



Revenue Streams



Source: Company Filings, Cormark Securities

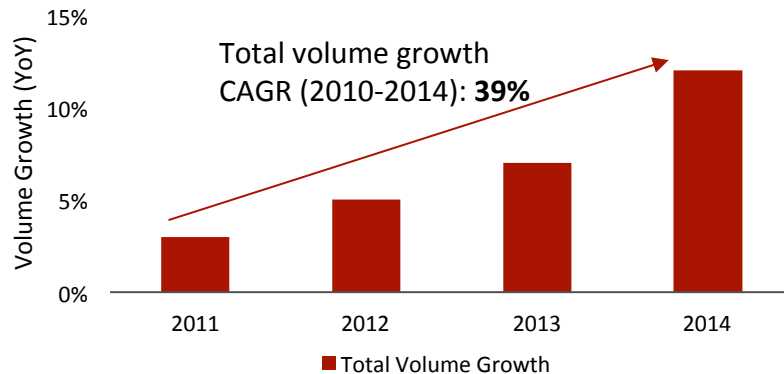


Ten Peaks Coffee

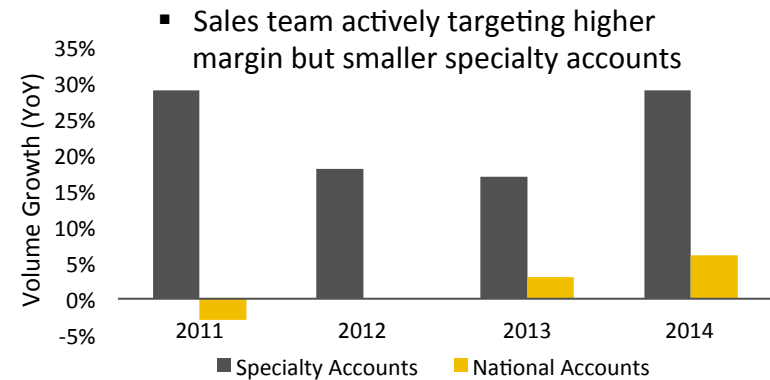
Strong Volume Growth with Room For Expansion



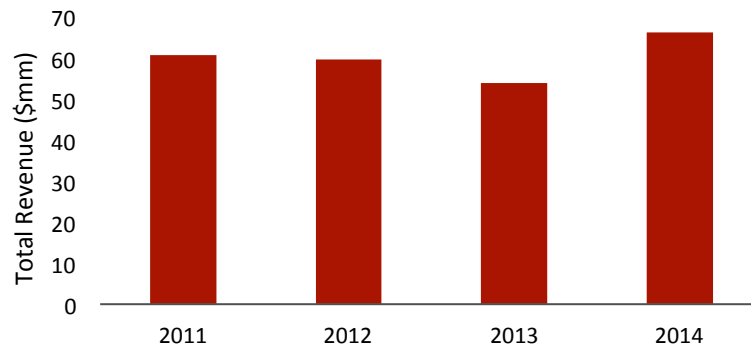
Strong Volume Growth ...



...Driven by Specialty Accounts



Revenue Growth is (Misleadingly) Low...



...Primarily Due to Volatile Coffee Prices

- Declining coffee prices lowers the revenue figures recorded in green revenue segment, as the price beans are sold at are recorded in revenue and the cost is recorded in COGS
 - Green segment is essentially a margin business:
Profit = margin on wholesale + margin on decaffeination
 - Gross profit figures are more indicative, and more closely track volume growth

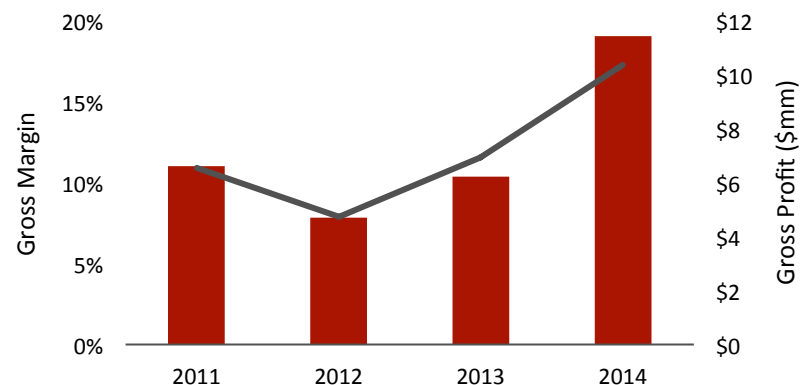
Source: Company filings

Ten Peaks Coffee

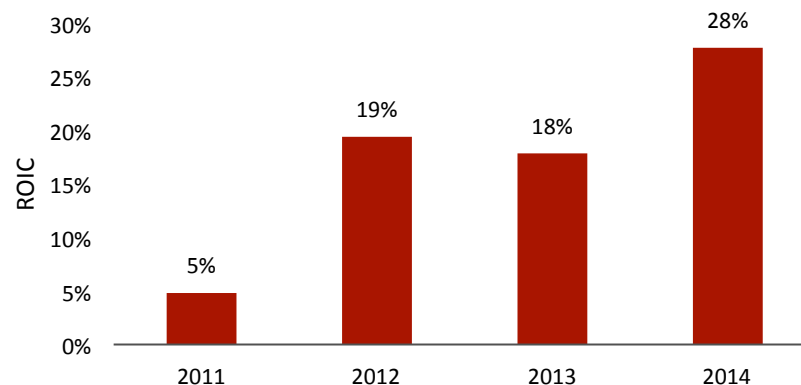
Strong Volume Growth with Room For Expansion



Gross Profit Tells a Different Story



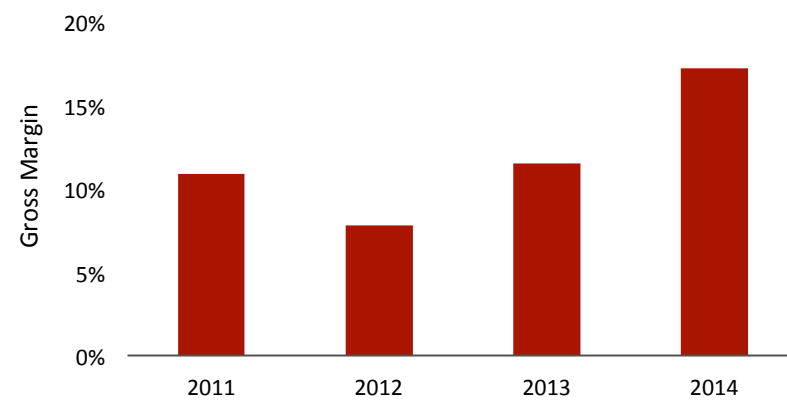
...And So Does ROIC



Expansion Plans Are in Place...

- Seeing strong growth in U.S. and international markets
- Capacity expansion plans for 2015-2016:
 - Approximately \$5mm investment to increase production capacity in Burnaby facility
- Should allow for incremental volume of 20% and incremental EBITDA of \$1.5mm
- Maintenance capex is at \$400K/year

...Specialty Growth & Scale to Further Aid Margins



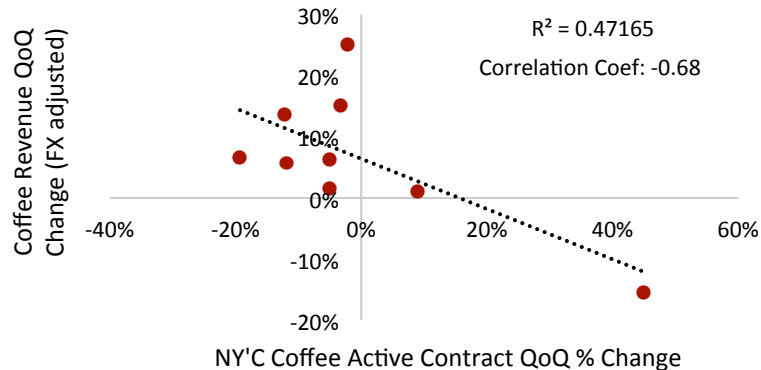
Source: Company filings



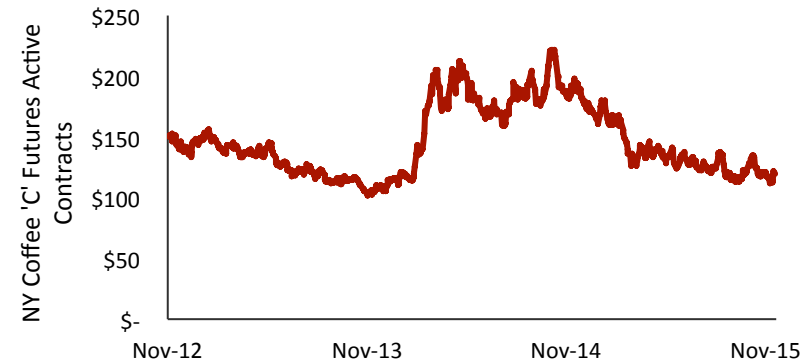
Coffee Price Outlook

Beans and Derivatives

Inverse Relationship: Revenue vs. Coffee Price



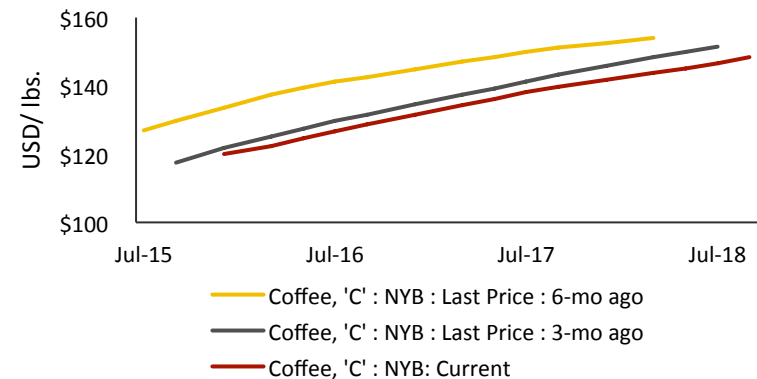
TPK Should Benefit From Lower Coffee Prices



What Drives Coffee Prices?

- Weather
- Production levels vs demand
- Arabica vs. Robusta price differential
- Currency of exporting countries
- Greater macro trends

NY'C Futures Curve



Note: Coffee revenue = Processing Revenue + Green Revenue, Bloomberg as of 11/24/2015



Third Wave of Coffee

A History of Coffee

First Wave

- Traces its roots back to the 1900s, with the commercialization of quick and affordable coffee
- Significant innovation was vacuum packaging, which removed air from coffee tins, resulting in fresher beans
- Advent of the first automatic drip home coffee maker : Mr. Coffee, with over 40,000 being sold per day
- Dominated by instant coffee brands – focus on availability to the masses



Second Wave

- Driving force of the second wave was a reaction to the “bad coffee” being marketed under the first wave
- Starbucks opened its doors in 1971, pioneering the second wave and shifting consumers taste to fresh, premium beans
- Starbucks became the poster child for second wave, not only giving specialty coffee its own language, but making it social by introducing the masses to the coffee shop experience



Source: Bloomberg as of 10/9/2015, Philippe Riche, Henri St Pierre

Third Wave of Coffee

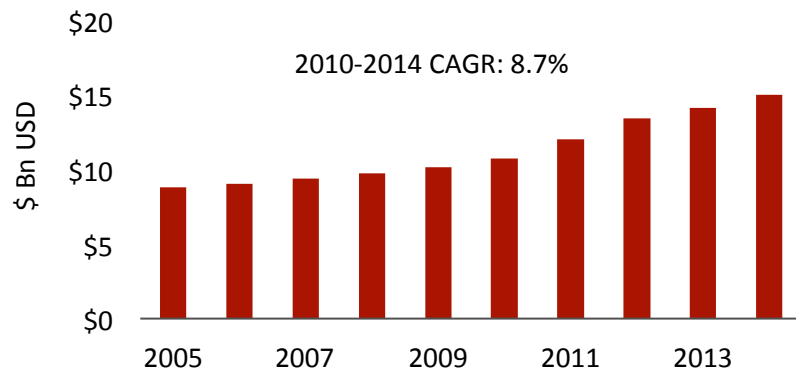
Hipster Revolution

Third Wave

- Focus on local, traceable, sustainable, ultra-premium. artisanal coffee with an interest in the bean itself
- Third Wave roasters cannot sell the lower quality chemical-based decaf product that still is 70% of market
- Larger players Tim Hortons are following as well to stay abreast of trends and consumer desires



Coffee Sales Growth Still Strong

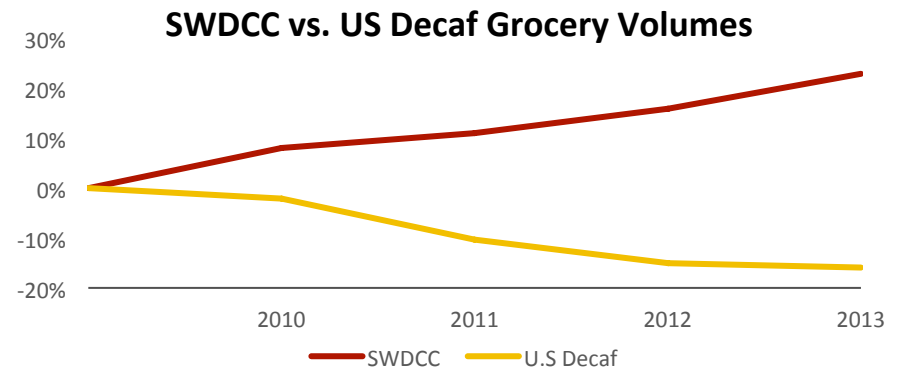


Source: Bloomberg as of 10/9/2015, Philippe Riche, Henri St Pierre

Focus on premium space

- Divergence in traditional non-gourmet segment vs single-cup brewer consumption and gourmet market
- Gourmet market share increased from 40% to 51% from 2010 to 2015
- Driven by broader F&B trends towards food-chain traceability, etc.
- \$120 M of Silicon Valley investment in Premium Coffee

What Premiumization means for Ten Peaks



Competitor Analysis

Threats to the Monopoly



Third-Party Decaffeinators

- Most use chemical methods for high volume, mainstream, commercial coffee market as opposed to the specialty coffee market
- The largest third party chemical decaffeimators are based in Germany and Mexico
- Chemical decaffeimators offer a cheaper alternative to the Swiss Water Process
- Major players include Hamburg-based Coffein/Kaffe Verdelungs Werke, Mexico-based Cafiver S.A. de c.v. and Descamex



Chemical-Free Third-Party Decaffeinators

- Direct competitors to Ten Peaks
- None have established same degree of recognition and scale
- The largest third party chemical free decaffeimators are based in Germany and the United States.
- Major players include Hermesen GMBH, Kraft Foods International Germany and Atlantic Coffee Solutions. Descamex also has a water based decaffeination plant in Mexico
- Atlantic Coffee Solutions uses the CO₂ process, which results in poor tasting beans so is inferior to Swiss Water Process



Ten Peaks Coffee

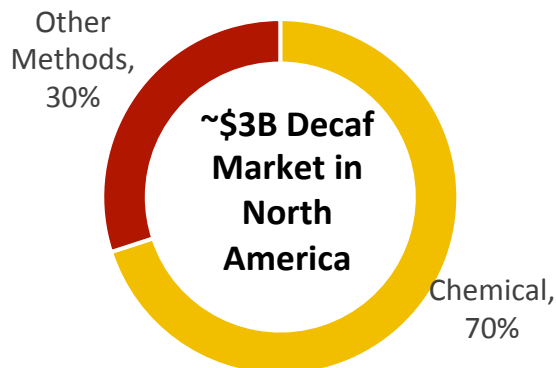
Threats to the Monopoly



Decaffeination Methods

- Methylene Chloride: Most preferred method, leaves low level of caffeine and greatest coffee flavor
- Carbon Dioxide: High pressure forces out flavor
- Ethyl Acetate: Leaves a fruity aftertaste in the coffee
- Water: Pioneered by TPK, leaves lower level of caffeine and even greater coffee flavor (15% premium in price)

Preference of Methods



Source: Company filings, Street research

Barriers to Entry

- Organic accreditation
- Patented process
- Trademark + brand equity
- High quality beans
- Unrivalled experience in industry
- Location –need to be near high-quality, fresh water source (ex. BC mountains, Mexico mountains)

Frank Dennis (CEO)

“We’re flattered to see our competitors introducing “100% water” and “pure water” processes but we have been decaffeinating with pure water using our patented process for a long time - we believe the quality of our product reflects that experience”

Bob Weagle (VP Marketing)

Misconception that “if it’s decaf coffee it must taste bad since if you remove the caffeine you also remove the flavor ... Our internal R&D team created our proprietary carbon regeneration technology that micro-manages the fractal geometry of our carbon. This regeneration allows our carbon to be very specific in capturing caffeine molecules, leaving valuable flavor and body components untouched.”



Valuation

Comparable Valuation



November 23, 2015

CAD\$ unless otherwise noted

Company	Market	Balance Sheet		EV/Sales			EV/EBITDA		Debt/EBITDA		Sales Growth		
	Cap.	Debt	EV	LTM	2015E	2016E	2015E	2016E	2015E	2016E	2015E	2016E	2017E
	(\$ mm)	(\$ mm)	(\$ mm)										
Select Peer Group													
Dunkin' Brands Group, Inc.	5,244	3,326	8,138	8.1x	7.5x	7.1x	14.5x	13.7x	5.9x	5.6x	8%	5%	6%
Farmer Brothers Co.	639	7	616	0.8x	0.9x	0.8x	12.1x	9.6x	0.1x	0.1x	-6%	8%	6%
Keurig Green Mountain, Inc.	9,103	601	9,632	1.6x	1.6x	1.6x	6.9x	7.1x	0.4x	0.4x	0%	-1%	4%
Panera Bread Company	6,350	552	6,532	1.8x	1.8x	1.8x	12.5x	12.2x	1.1x	1.0x	1%	4%	10%
Starbucks Corporation	124,347	3,175	125,486	4.9x	4.9x	4.3x	20.8x	17.9x	0.5x	0.5x	1%	13%	9%
Mean	29,137	1,532	30,081	3.5x	3.3x	3.1x	13.4x	12.1x	1.6x	1.5x	1%	6%	7%
Median	6,350	601	8,138	1.8x	1.8x	1.8x	12.5x	12.2x	0.5x	0.5x	1%	5%	6%
Ten Peaks Valuation													
Ten Peaks Coffee Company Inc	97	-	88	1.1x	1.1x	1.0x	9.1x	8.9x	0.0x	0.0x	31%	13%	n/a

Although we do not base our valuation on comparables, TPK is cheap for a high quality, growing, consumer branded company with a leading and premium position in the decaffeination market.



Valuation

DCF Assumptions



Assumptions

Terminal Growth	2.5%
Terminal Multiple	8.0x
Risk-free rate	2.25%
Beta	1.01
MRP	6.0%
Cost of Equity	8.3%
Cost of Debt	N/A
WACC	8.3%

Bear Case

Purpose: Slower growth than expected with declining margins

Revenue

- Mid-single digits, vs. guidance of 10-15%

Gross Margins

- Gross margins decline to 13%

Price Target: **\$9.00**

Downside: **(-16.9%)**

Base Case

Purpose: Growth in line with management estimates and gross margin gains

Revenue

- Growth around guidance of 10-15%

Gross Margins

- +100bps gradually, consistent with CFO commentary

Price Target: **\$13.36**

Upside: **23.3%**

Model Output

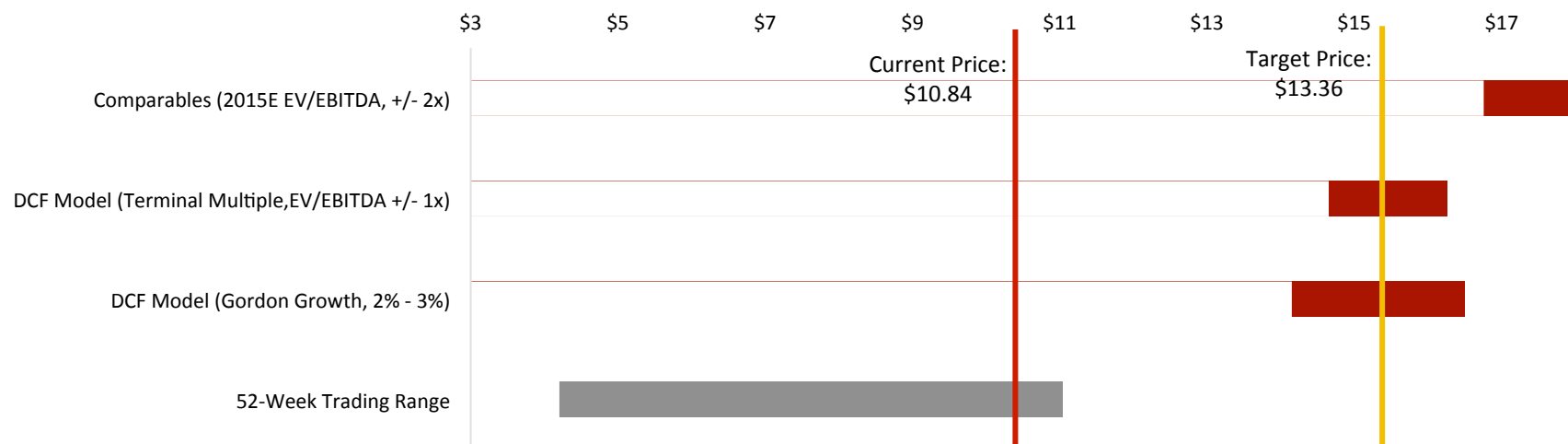
	2013	2014	2015E	2016E	2017E	2018E	2019E	2020E
Unlevered Free Cash Flow	1.71	(2.75)	(5.63)	2.99	6.25	6.98	10.82	8.47
PV of FCF				2.71	5.22	5.39	7.70	5.57
Sum of PV FCF								\$ 29.66
PV terminal value								\$ 98.24
Total Enterprise value								\$ 124.90
Equity Value per Share								13.13
PV terminal value								\$ 102.46
Total Enterprise value								\$ 129.12
Equity Value per Share								\$ 13.60



Valuation Summary



Football Field Analysis



Sensitivity Analysis

WACC	Terminal Growth					
		2.00%	2.25%	2.50%	2.75%	3.00%
	9.25%	10.44	10.76	11.10	11.47	11.86
	8.25%	12.34	12.79	13.28	13.81	14.39
	7.25%	14.98	15.65	16.38	17.20	18.12

WACC	Terminal EV/EBITDA					
		7.50x	7.75x	8.00x	8.25x	8.50x
	9.25%	12.80	13.15	13.51	13.86	14.22
	8.25%	12.89	13.25	13.60	13.96	14.32
	7.25%	12.99	13.35	13.70	14.06	14.42



Investment Thesis

“I like myself a good monopoly.”- D. Kraminer, Bcom 2015



1. Premium position in decaffeination with strong growth runway

- Patented Swiss Water Process is the only 100% chemical-free, consumer branded decaffeination process
- Processing volumes up 39% over past five years; improving gross margins and strong ROIC
- Expansion plans in place for plant capacity, given growing U.S. and international volumes

2. Third wave of coffee to increase demand and expand TAM

- Specialty coffee growth is promoting a shift from lower-quality chemical decaffeination methods to premium methods
- TPK currently has approximately 70% market share in Canadian decaf; U.S. market is ~10x the size, providing a large, growing TAM

3. Valuation is attractive given growth prospects

- Unwarranted discount to high-growth consumer plays on current and forward EV/EBTIDA
- DCF base case yields ~25% upside

Bonus: Strong management team (CEO was ex-Director of Kraft Foods Coffee)



Catalysts and Risks

A Free Option, but Some Risks Too



Catalysts

- Positive volume growth and earnings
- Adoption of IFRS hedge accounting in FY2016
 - Daily hedge book maintained –they are 100% hedged against coffee and FX
 - Will reduce seeming volatility in gross profit and margins and increase transparency of hedging policy
- Increased sell-side coverage
 - Currently only covered by Cormark
- Development of caffeine capture technology, which will act as a supplementary revenue stream
 - Caveat: At least 3 years away, according to CFO

Risks

- Customer concentration
 - Top 3 customers are ~30% of revenues
- Competition
 - Although technology is patented, TPK could face competition from other forms of chemical free and chemical decaffeination methods
- Unionization and strikes
- Coffee prices
 - Volatility in coffee prices leads to customers stocking up on inventory when prices are lower, vice versa
 - Overall inverse relationship between coffee prices sales

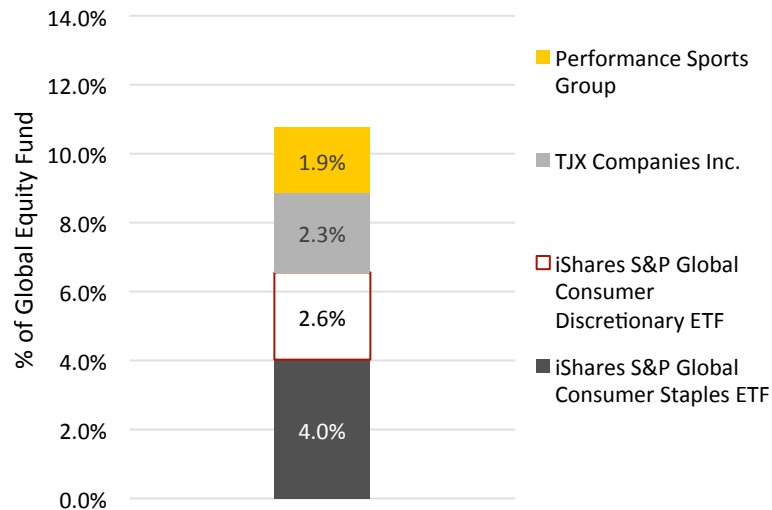
Recommendation: Initiate a 2.0% position in TPK with a 1-2 year price target of \$13.50 (upside of ~25%).



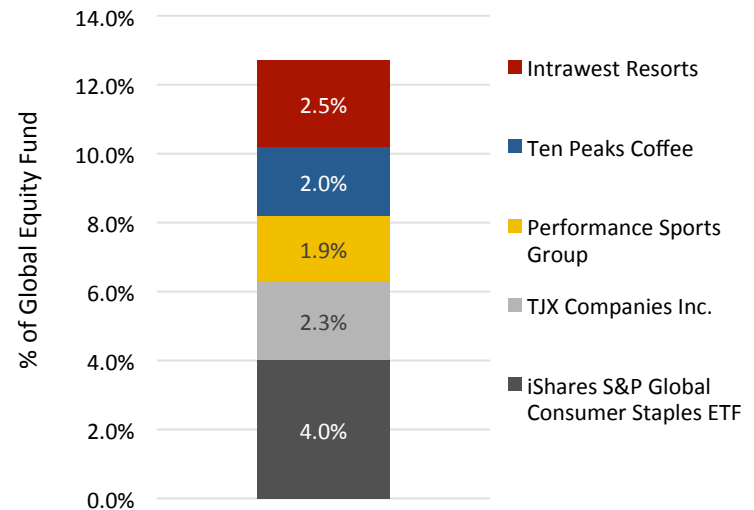
Allocation Decision

Coffee + Ski is Greater than Tea

Current Allocation



Suggested Allocation



Recommendation: Initiate a 2.5% allocation in Intrawest and 2.0% allocation in Ten Peaks Coffee using proceeds from the sale of iShares S&P Global Consumers Discretionary ETF and iShares S&P TSX ETF positions.