COMMENTARY

February 21, 2014

Dear clients and colleagues,

On January 18th, 2013, just a little over a year ago, we profiled Sodastream (SODA US), a name we had just added in the portfolio, the price on that day was US$45.94.

What a year it has been for Sodastream. A first Super Bowl ad in 2013 that was pulled off, then the Scarlett Johansson, controversial Super Bowl 2014 ad with the Oxfam and the Boycott Israel movement.

The stock price went to $77 last June, on strong results and acquisition rumors before going down to $30 on February 2nd 2014, and is now at $40.93.

A disappointing return of -16% since last year compared to +28% for the MSCI World SC index. We sold some shares last June during the acquisition rumors, but purchased them back when the stock dropped earlier this year and Sodastream is now 2% of our Global Portfolio.

When we purchased the company, we knew the stock price would be volatile. There are only 20 million shares outstanding. With a daily volume in excess of 1.5 million shares and 40% of outstanding shares sold short, it means the average holding period is less than a week. Our time horizon is measured in years.

The company's target of achieving US$1 Billion in sales in 2015 or double 2012 sales is very achievable. But even at $1 Billion in sales, Sodastream has the potential to be a much larger company.

Naysayers argue that the Do-it-at-home market will be a very small niche market at best, and probably is just a fad.

In Sweden, the household penetration of Sodastream approaches 25%. In Countries like Germany, the UK and France, it is approaching 5% and still growing. In the US, it is only around 1%.

A significant event happened in February 14, when the stock price dropped to $30. Coca Cola announced they would invest $1.25 Billion to acquire 10% of Green Mountain Coffee, and become an exclusive partner to launch a home system for cold beverages and soft drinks.

We could argue on the merits of Green Mountain vs. Sodastream, but the real news is that Coca Cola has just validated the do-it-at-home market.

Green Mountain has long been a proxy for Sodastream. Similar business models, an upstart in a market dominated by much larger competitors, we thought the news was probably the best piece of news in a long time for Sodastream.

We would much rather see Sodastream have 50% of a US$5 billion pie in the US than 100% of a $200 million pie.

Let us review our thesis for Sodastream.

SodaStream (SODA US - $40.93)
www.sodastream.com

Business Overview
Israel based Sodastream is the World's leading manufacturer of drink makers, carbonators and concentrates for sparkling drinks made at home. It has sold more than 13 million makers and currently has 7 million active customers in 45 countries. It distributes its products via 75K retail stores Worldwide. In the US, it has a presence in more than 18K retail locations, including major retailers such as Bed Bath & Beyond, Williams Sonoma, Macy's, Target, Wal-Mart and Costco Wholesale.

The business model is the razor-razorblade model, like Nespresso, like Keurig. You sell the maker, then you sell the consumables, the CO2 cylinders and the syrups. Over time, revenues should shift from the soda maker to the consumables which increase profitability. To put it in perspective, the Company has been operating in Switzerland for 15 years and currently has about 80% of its revenue coming from consumables and has an EBIT margins higher than 25% in that market.

In January, Sodastream issued a profit warning, blaming mix and increased marketing expenses. Although disappointed by the results, we believe that Sodastream's strategy to rapidly increase its user base and capitalize on its first mover's advantage is the right strategy. In the last quarter, almost 6 million CO2 cylinders were exchanged a business that by itself would justify the current stock price.

History
The company was founded in 1903 and was associated with London Gin Distillers until 1960. The first home soda machine was launched in 1950 with 14 flavors. In 1985 it was purchased by Cadbury Schweppes who sold it in 1997. Fortissimo Capital, a private equity firm, acquired it in 2007. The company went public on November 3, 2010.

Target Market
According to Euromonitor the retail global carbonated beverage market is estimated to be $264B with about 40% in the US. Major brands such as Coke, Pepsi, Dr Pepper and Nestle are the largest players. The market is not growing in developed markets but enjoys solid growth in emerging markets.

The at-home market is still very small and Sodastream with $US 500 million in sales is the largest player.

Competition

The main competition comes from the incumbents which rely on the existing retailer distribution model. AGA, a subsidiary of Linde Gas has been operating for about five years and has approximately 15% market share in Sweden. Green Mountain Coffee, in association with Coca Cola will launch a system in 2015. Finally, Startbucks and Nestle are also rumored to want to enter the industry.

Competitive advantages

Sodastream's main competitive advantage, one that is lost by most people, is its exchangeable CO2 cylinder In the US alone, over 15 000 stores will exchange your used CO2 cylinder. For a 60l capacity, the exchange costs around $15 compared to $30 for a new cylinder. Because of hazardous materials regulations, those cylinders can't be shipped. Our thesis is that retailers will not carry many different type of cylinders in their store. Sodastream has signed licensing agreeements with Samsung and KitchenAid, with probably more to come, to use their CO2 system. Similar to the Intel inside model.

Growth strategy

Sodastream's growth strategy is to increase the installed base of sodamakers. To do so, it will expand to new markets such as Mexico, sign license agreements, as described above. Expand the market to the hospitality industry, launch new products, etc.

An additional vector of growth is to increase the use of its machines. It will do so by increasing the number of flavors available to the consumer, either their own flavors or through partnerships such as those already in place with Campbell Soup (V8 Splash), Kraft (Cool-Aid), Skinnygirl, etc.

Risks

The main risk would be the loss of the cylinder exchange partners.

We do not believe the Company has to sell itself to a larger player. We believe it will be successful on its own.

Market Data

Market Cap $847M, Debt nil, Cash 30M, p/e (2015) 13x.

Have a nice weekend.

The Global Alpha Team