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Zacks Small-Cap Research

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Swiss Water Decaffeinated Coffee Inc. (SWP.TO-TSX)

SWP.TO: Industry Outlook Shows Expected Catalysts for Swiss Water Growth Continuing

Industry sources suggest positive catalysts for Swiss Water's growth will continue, as SWP benefits from rising consumption of decaf coffee, consumers' growing preference for healthful beverages (its decaffeination process is 100% chemical-free) and expanding decaf choices within the premium coffee beverage niche, among other drivers. A 2025 report from Nestle notes expanding demand for specialty coffees, which we see as a positive for Swiss Water.

Current Price (12/5/24)	$4.03
Valuation	**$6.10**

OUTLOOK

With consumption of decaffeinated coffee rising at a faster pace than that of the overall coffee beverage category, we expect substantial growth opportunities for Swiss Water. In our view, SWP's natural decaffeination process is a key factor that helps drive demand for its coffee, particularly given the positive tailwind from coffee consumption trends. We note, however, that rising coffee futures prices potentially signal that coffee prices will rise. In turn, this could have a temporary negative impact on demand & constrain SWP's sales in the short-term. If so, we view the impact as short-term.

SUMMARY DATA

52-Week High	**$4.29**
52-Week Low	**$2.49**
One-Year Return (%)	**43**
Beta	**1.77**
Average Daily Volume (sh)	**6,382**
Shares Outstanding (mil)	**10**
Market Capitalization ($mil)	**$38**
Short Interest Ratio (days)	**1**
Institutional Ownership (%)	**N/A**
Insider Ownership (%)	**N/A**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**N/A**
Earnings Per Share (%)	**N/A**
Dividend (%)	**N/A**
P/E using TTM EPS	**N/A**
P/E using 2024 Estimate	**N/A**
P/E using 2025 Estimate	**N/A**

Type of Stock	**Small-Value**
Industry	**N/A**

ZACKS ESTIMATES

Revenue
(in millions of C$)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2022	38 A	48 A	46 A	44 A	177 A
2023	49 A	43 A	33 A	41 A	166 A
2024	39 A	43 A	42 A	41 E	165 E
2025					174 E

Loss/share or EPS (C$)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2022	$0.15 A	$0.16 A	-$0.02 A	-$0.03 A	$0.26 A
2023	-$0.08 A	-$0.06 A	-$0.05 A	$0.10 A	-$0.06 A
2024	-$0.10 A	$0.07 A	-$0.08 A	$0.05 E	-$0.06 E
2025					$0.12 E

Quarters might not sum due to rounding & share count

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KEY POINTS

- **Recent industry outlook pieces suggest that positive catalysts for Swiss Water Decaffeinated Coffee growth will continue.** We believe Swiss Water Decaffeinated Coffee is poised to benefit from several factors, including rising consumption of decaffeinated coffee and, reflecting its 100% chemical-free decaffeination process, the growing consumer trend towards natural and more healthful food and beverages (F&B) and expanding decaf choices within the premium or specialty coffee beverage niche.

- Industry consultancy Ripples expects, "Health and wellness trends will influence coffee consumption. As people become more health-conscious, they will seek healthier options."

- A 2025 outlook report from food conglomerate Nestle points out that about "82% of U.S. consumers currently view wellness as a top or important priority in their lives." This is a likely factor behind why demand for organic coffee continues to rise. Reflecting that the company's proprietary decaffeination process is 100% chemical-free, we see this as a positive for Swiss Water.

- The Nestle report cited above also anticipates a growing focus on specialty coffee, which it notes "is increasingly considered a "little treat," especially among Gen Z consumers. Decaffeinated choices within the premium segment are expanding, which we see as another positive for Swiss Water.

- Reflecting numerous factors including more healthful consumer choices and expansion of the specialty coffee niche, the decaf segment is growing and that trend is expected to continue. Te decaf category has room to gain market share, as it currently comprises only roughly 15% of coffee consumed in the U.S. and about 12% in Western Europe.

- Price increases could have a temporary negative impact on demand. Coffee futures price for Arabica coffee have been volatile, signaling potential increases in coffee prices that could constrain sales in the short-term. If so, we view the impact as short-term.

EXPECTED COFFEE TRENDS SUPPORT POSITIVE OUTLOOK FOR SWISS WATER

Rising consumption of 'decaf' & specialty coffees important are growth drivers that are expected to continue…

British Columbia-based Swiss Water Decaffeinated Coffee Inc. (OTC:SWSSF, TSX: SWP) is a leading specialty coffee company and premium green coffee decaffeinator focused on producing chemical-free decaffeinated coffee. Swiss Water owns the Swiss Water® trademark exclusively and operates a decaffeination business using this proprietary process, which is a chemical-free way to decaffeinate coffee and simultaneously maintain the full flavor of the green coffee beans.

Key expected catalysts for Swiss Water growth

- Rising consumption of coffee generally
- Market share gains of the decaf category
- Growing popularity of specialty coffee beverages and company focus on premium category
- Consumer concerns around drinking caffeine later in the day
- Growing consumer interest in natural, chemical free food and beverages

We believe Swiss Water is poised to benefit from several factors, including rising consumption of decaffeinated coffee and – reflecting its 100% chemical-free decaffeination process – the growing consumer trend towards natural and more healthful food and beverages (F&B). In fact, several F&B industry studies expect 2025 trends that we see as positive for the company. For example, according to beverage industry consultancy Ripples, "Health and wellness trends will influence coffee consumption.

As people become more health-conscious, they will seek healthier options." Moreover, Ripple notes that with specialty coffee "gaining popularity,"…. When heading out to a cafe, more coffee drinkers are looking for unique flavors and an unparalleled experience. In 2025… expect a rise in artisanal roasters..."

Moreover, reflecting consumer demand for more healthful ingredients and products, among other factors, it appears that many roasters incorporate that they rely on the use of the Swiss Water process in their brand advertising to consumers, using words such as "cleanest," and "healthiest" and "flavorful" in their branding.

We believe that as the overall market for decaffeinated coffee expands, the market for chemical free decaffeination will continue to grow, particularly given people's continued trend towards health consciousness and awareness of environmentally friendly practices. A 2025 outlook report from food conglomerate Nestle points out that about "82% of U.S. consumers currently view wellness as a top or important priority in their lives." This is a likely factor behind why demand for organic coffee continues to rise. About 39% of consumers indicate that they are more likely to purchase coffee that is certified organic, and 59% are more likely to purchase coffee if it is grown in an environmentally sustainable way. on. According to Coffee Intelligence, the 2021 global organic coffee market was valued at $133 billion, which represented a 24.6% year-over-year advance. Demand for organic coffee is highest in North America, followed by Germany and France.

A 2022 NIH-published study notes that "[i]n recognition of the growing concerns around public health, the types of food and beverage products sold through the hospitality sector are experiencing major changes..." According to Forbes, "Consumers continue to expand their awareness of the impact their food and beverage choices have on both their own bodies and our planet"

The publication Coffee Intelligence notes that despite the price premium, organic coffee is recording steady growth. It places the 2021 value of the global organic coffee market at $133 billion and notes that demand for organic coffee is highest in North America, Germany and France. Coffee Intelligence further notes that organic coffee sales saw the highest annual growth in 2021 compared to 2020, with a 24.6% year-over-year advance.

The Nestle report cited above also anticipates a growing focus on specialty coffee, which it notes "is increasingly considered a "little treat," especially among Gen Z consumers. Decaffeinated choices within the premium segment are expanding, which we believe is another positive for Swiss Water.

Specifically, decaffeinated coffee continues to play a role in the growing 'specialty coffee' category, which gives consumers more choices within the premium coffee segment (see below). A growing focus on specialty decaffeinated coffee – or premiumization – is an important factor contributing to the expansion of the decaf category and Swiss Water's strategic focus is largely on the premium specialty coffee segment. Specialty coffees are premium varieties of coffees and include coffee brewed from high-quality beans, particularly Arabica, as well as coffee drinks such as espressos, cappuccinos, and lattes, among others. A recent NCA study indicates that 41% of U.S. consumers responded that they had enjoyed a specialty coffee "in the past day."

According to an NIH study, "Specialty coffee and tea houses and beverages have become a cultural phenomenon." The NCA notes that specialty coffee has recorded "significant growth." Based on NCA's Spring 2024 National Coffee Data Trends report, some 57% of U.S. adults reported having a specialty coffee in the past week. This represented a 7.5% year-on-year increase. The annual increase was highest for the espresso-based category, which advanced 10% compared to the same period of 2023. Lattes lead this category; about 18% of U.S. adults responded that they had a latte in the past week, followed by espresso (16%) and cappuccinos (14%).

Moreover, many people opt for limiting their caffeine intake later in the day in order to maintain healthy sleep patterns, as they manage their caffeine intake while maintaining coffee consumption. The company's data suggest that about 62% of coffee consumers believe that limiting their caffeine

consumption is important. According to the NCA, 66% of coffee drinking consumers believe that “it is important to limit my caffeine intake.” Consumer awareness of health-related issues is increasing the appreciation for food safety, food provenance, and healthier or “better for you” food options. According to UC Davis, “the small amount of caffeine [in decaffeinated coffee] isn’t really enough to affect most people... But that also depends on a few factors: Those include caffeine sensitivity (which is largely genetic) and caffeine tolerance (which develops with regular intake). People who are “mildly or moderately sensitive to caffeine and/or consume caffeine regularly are unlikely to be affected by the small amount of caffeine in decaf…”

The growth of the premium or specialty coffee category would also align with growing willingness to pay for both specialty drinks and healthier options, we believe. For example, studies examining the results of multiple experiments conducted in the F&B sector concluded that consumers are generally willing to pay for healthier food products across a range of food retail environments, presumably including coffee bars and retailers. Specifically, 23, or 88.5% of a total of 26 experiments included in the review, found that consumers were willing to pay a price premium for healthier options. The premium ranged from 5.6% to 91.5%, with a mean of 30.7%.

Reflecting the factors noted above, the decaf segment is growing and that trend is expected to continue, which we view as growth driver for Swiss Water. According to consumer research from StudyLogic, the amount of decaffeinated coffee consumed has grown annually since 2017 in both the U.S. and Western Europe. This growth was temporarily interrupted in 2020, but that disruption is primarily attributed to the impact of the pandemic. Research suggests that the key demographic driving growth is the young adult consumer market. The US National Coffee Association (NCA) conducted a study in 2017 that found that the largest demographic consuming decaffeinated coffee in the U.S. was comprised of adults aged 18 to 24, which represented roughly 19% of total decaf consumers in the U.S. market.

Moreover, there is significant upside opportunity for the decaf category to gain market share, as decaf currently comprises only roughly 15% of coffee consumed in the U.S. and about 12% of coffee consumed in Western Europe, according to the NCA, but is gaining market share. North America and Europe are key markets for coffee consumption generally and therefore for Swiss Water. Based on data aggregated by UC Davis, the overall decaffeinated coffee market is expected to grow at CAGR of 5-7% in the 2021 to 2031 period.

At the same time, the growth in consumption of decaffeinated coffee comes as coffee consumption generally is rising. The NCA places the number of U.S. adults who have had coffee in the past day “at its highest level in more than 20 years,” and up about 37% since 2004. NCA’s Spring 2024 National Coffee Data Trends (NCDT) report reveals that 67% of American adults had coffee in the past day (more than any other beverage, including tap or bottled water), which compares to 49% in 2004. The spring 2024 study also found that 75% of U.S. adults had consumed coffee in the past week, which represents a 4% year-over-year advance compared to their Spring 2023 study.

In anticipation of growth, to expand, as well as upgrade, production capacity, Swiss Water opened a new state-of-the-art production facility in 2020 and expanded capacity in 2023

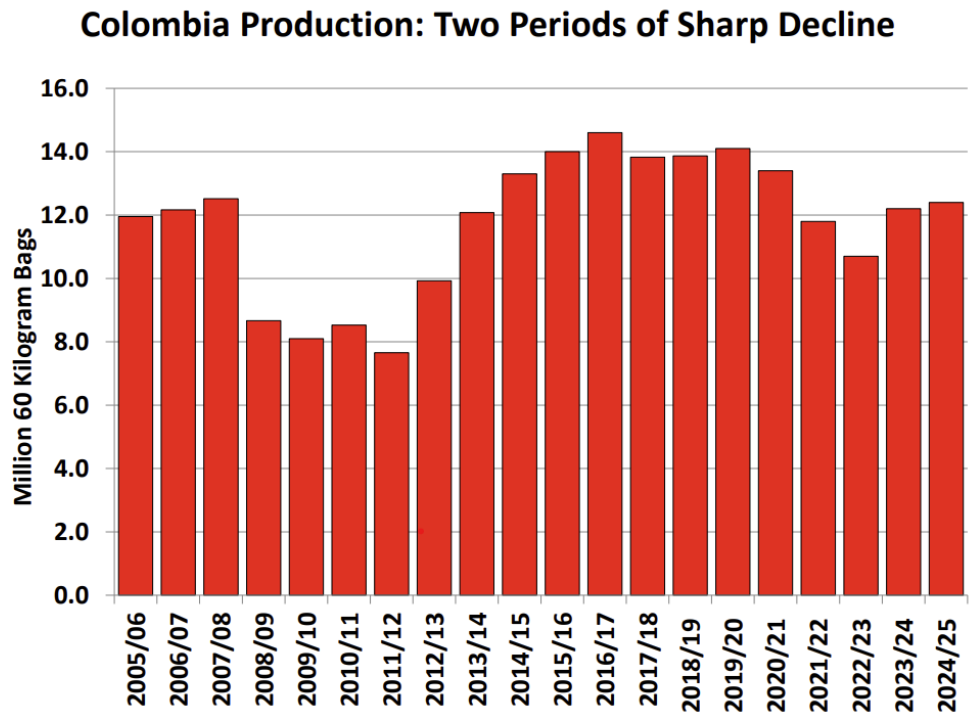
In anticipation of growth and to upgrade and expand production capacity, Swiss Water opened a new state-of-the-art production facility in the city of Delta, British Columbia in 2020 and completed the construction of a 2nd production line in 2023. The consolidation of operations in one location has enabled Swiss Water to obtain some production efficiencies. In addition, the proximity of the facility to its warehouse operations also has led to some operational benefits.

Shifting production from an older facility in the city of Burnaby to the new plant and then installing the second line there has also led to some timing shifts in fulfilling sales. Order backlogs increased during the transition from the Burnaby plant to the Delta facility. Given the short-term disruptions in plant activity, year-over-year sales comparisons have not been apples-to-apples in 2024.

FUTURES TRADING POINTS TO RISING COFFEE PRICES

Coffee futures point to possible price increases, which could have temporary negative impact on demand for Swiss Water decaffeinated coffee…

Commodity prices of the coffee beans, which fluctuate, plays a significant role in prices to consumers. According to CoBank, which provides credit to the U.S. rural and agribusiness sector, prices of U.S. imported coffee increased by a sizable 65% from 2021 to 2023 and have remained volatile in 2024. Factors that explain this include geopolitical tensions and challenging conditions in key growing markets such as Colombia, Brazil and Vietnam and increasing overall global coffee demand, among other factors.



Source: USDA

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Volumes and revenue are returning to normal patterns in 2024 but a short-term interruption could come if coffee prices rise, which is suggested by current trading patterns of coffee futures. Geopolitical pressures and other factors are leading to rising coffee futures price for Arabica coffee, a leading indicator that coffee prices will subsequently rise. In turn, this could hamper consumer demand for coffee and, as a result, constrain SWP's volume shipments in the short-term. The company anticipates that rising futures prices could have a temporary constraining impact on demand.

Coffee futures have been volatile, as noted. In 2Q24, they peaked at US$2.48/lb in mid-April. In 3Q24, the NY'C' coffee futures price for Arabica coffee continued to display volatility, peaking at US$2.74/lb in late September. Over the span of the quarter, pressure on the futures market grew. At the same time, spot availability of coffees remains low.

Coffee Futures



Source: Yahoo Finance

The Coffee C futures contract, which is the global benchmark for Arabica coffee, recently reached their highest levels since the early 1970s. Combined with the potential for tariff impositions and greater regulator focus on sustainable sourcing, there could be further upward pressure on coffee prices in 2025. In turn, higher coffee prices could result in lower consumer demand in the immediate aftermath of prices climbing and also pressure Swiss Water volume shipments to coffee roasters.

RECENT RESULTS

Y/Y volumes improve against disrupted seasonality last year

SWP reported revenue of C$41.2 million in 3Q24, up 28% compared to C$32.6 million in 3Q23. Volumes and revenue are returning to normal patterns in 2024, as noted. Total 3Q24 processing volumes advanced by 27% compared to 3Q23, reflecting strong demand for the company's coffee. We note, however, that results are not entirely apples-to-apples, as the distribution of quarterly sales volumes in 2023 did not follow normal seasonal patterns because of the newly opened production line during the year. Short-term capacity limitations during this period in turn led to substantially higher than normal volume growth and financial results during 1Q23 and 4Q23. Thus, customer sales orders were unusually front loaded last year in anticipation of the temporary production constraints resulting from SWP's closing its legacy Burnaby production site in 2Q23. Once this line went operational in 2Q23, 4Q23 orders were also unusually high reflecting timing delays for customers that otherwise would have placed orders in 2Q and 3Q.

Gross profit for 3Q24 was C$6.4 million, up about 80% compared to the same period in 2023. The gross margin of 15% expanded compared to 11% in 3Q23. The improvement reflected efficiencies derived from the consolidation of operations at the company's upgraded new production plant, as well as lower utility rates and a one-time C$2.5 million decrease in depreciation expense on an obsolescence of older infrastructure. This was partially offset by higher operating expenses related to planned headcount and wage increases, as well as higher professional fees and increased stock-based compensation expense on the higher share price. Swiss Water reported a net loss of C$0.8 million, or (C$0.07) compared to a net loss of C$0.4 million or (C$0.05) in 3Q23. One-time costs related to the closure of the Burnaby facility impacted results in both periods.

Balance sheet

The company had cash and equivalents of just shy of C$15 million at September 30, 2024 and combined short-term and long-term borrowings of about C$99 million. Swiss Water targets paying down debt and accumulating cash deposits, while concurrently managing inventory levels to ensure that it has sufficient inventory on hand to support operations. A $15.8 million repayment of debentures with warrants held by Mill Road Capital is scheduled in 4Q24.

VALUATION

We are optimistic about Swiss Water's growth prospects, reflecting the positive trends for consumption of decaffeinated coffee and rising consumer interest in natural food and beverages. As the company has expanded its production capacity with the recent expansion of its plant, we believe the company is well-positioned to benefit from this anticipated growth. We believe it is difficult to compare Swiss Water shares to those of other publicly traded companies, as there are no other public companies that directly compete with Swiss Water Decaffeinated Coffee and therefore there does not seem to be a direct public competitor.

Therefore, we believe using an EV/EBITDA multiple, particularly as the fluctuations in commodity prices of coffee beans impacts the company's revenue, but this impact is generally offset at the adjusted EBITDA level. Over the past few years, the EV/EBITDA for the S&P 500 has generally been a range of about 13x to 17x. We believe, however, that smaller cap companies likely trade at lower average EV/EBITDA multiples and we therefore apply a discount to the above noted S&P 500 average.

Swiss Water generated adjusted EBITDA of C$13.4 million in 2023. We forecast adjusted EBITDA of C$14.4 million in 2025. We believe the shares trade below 8x our 2025E adjusted EBITDA forecast on an EV/EBITDA basis. We expect multiple expansion and derive a near-term valuation of about C$5.65 to C$7.00 (about US$4.00 to US$5.00) per share, or about C$6.30 at the midpoint, which is still well below the multiple the S&P 500 commands. We also believe our forecast could prove conservative, given the trends discussed in this report.

If the company delivers milestones on its growth initiatives earlier than anticipated, it could impact the multiple. Any delay or failure in successful execution of the strategy or short-term constraint in market demand could represent a potential risk to the company's valuation and cause the share price to decline. The company believe the risk / reward ratio could be attractive for investors who have a higher than average risk tolerance and longer time horizon.

RISKS

We believe risks to Swiss Water achieving its goals, and to our valuation, include the following, among others.

- Swiss Water might not gain market share as quickly as the company expects, which could lead to slower than anticipated revenue ramp.
- The company could incur unanticipated costs associated with market initiatives.
- Competition could increase.
- The company might need to raise capital to support its strategy that might be dilutive to current shareholders.
- Demand might exceed the company's production capacity, which would likely impose constraints on revenue growth.
- Commodity bean prices fluctuate. Although the impact is usually offset at the company's adjusted EBITDA level, there could be lags that in the short-term impact results more than anticipated.
- Given that the majority of Swiss Water revenue is generated outside of its home market of Canada, foreign exchange rates might have a greater impact on consolidated revenue and results than anticipated.
- Futures prices and consequently likely increased coffee prices could constrain demand for coffee more than currently anticipated.

RECENT NEWS

- Swiss Water reported 2Q24 results on August 1, 2024.
- On May 9, 2024, the company reported voting results from its annual general meeting.
- Swiss Water reported 1Q24 results on May 2, 2024.
- Swiss Water launched its second production line in the Delta, BC facility on November 6, 2023.
- The company completed its second production line in Delta, BC on August 8, 2023.

PROJECTED FINANCIALS

Swiss Water Decaffeinated Coffee Inc ($000 Canadian except per share amounts)

	1Q23	2Q23	3Q23	4Q23	2023	1Q24	2Q24	3Q24A	4Q24E	2024E	2025E
Revenue	49,045	43,368	32,627	41,237	166,277	38,730	43,372	41,778	41,443	165,323	173,589
COGs	44,151	39,956	29,051	34,321	147,479	33,615	35,707	35,342	35,848	140,512	147,551
Gross profit	4,894	3,412	3,576	6,916	18,798	5,115	7,665	6,436	5,595	24,811	26,038
Administration exp	2,697	2,182	1,865	2,315	9,059	2,837	2,947	2,747	2,279	10,810	10,242
Sales & marketing exp	773	1,154	953	1,229	4,109	914	970	909	622	3,415	3,298
Total OpEx	3,470	3,336	2,818	3,544	13,168	3,751	3,917	3,656	2,901	14,225	13,540
Operating income	1,424	76	758	3,372	5,630	1,364	3,748	2,780	2,694	10,586	12,498
Gain (loss) risk mgmt ac	111	350	(360)	356	457	(149)	(519)	(1,970)			
Gain (loss) fair value em	(968)	860	310	(126)	76	(891)	83	144			
Other gains	-	175	-	-	175	-	-				
Finance income	437	426	274	492	1,629	460	446	509			
Finance expense	(1,837)	(2,075)	(2,027)	(2,326)	(8,265)	(2,288)	(2,293)	(2,294)			
FX gain (loss)	(84)	(38)	265	(377)	(234)	380	206	(269)	-	-	-
Total other	(2,341)	(302)	(1,538)	(1,981)	(6,162)	(2,488)	(2,077)	(3,880)	(2,000)	(10,445)	(10,863)
Pretax income (loss)	(917)	(226)	(780)	1,391	(532)	(1,124)	1,671	(1,100)	694	141	1,636
Taxes	(216)	145	(363)	438	4	(224)	724	(309)	173	364	409
Net income (loss)	(701)	(371)	(417)	953	(536)	(900)	947	(791)	520	(224)	1,227
EPS	($0.08)	($0.06)	($0.05)	$0.10	($0.06)	($0.10)	$0.07	($0.08)	$0.05	($0.06)	$0.12
Avg shares out*	9,186	9,213	9,213	9,213	9,213	9,224	9,502	9,518	9,502	9,436	9,536

Source: Company reports, Zacks estimates *Ex RUSs

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HISTORICAL STOCK PRICE



Source: Yahoo Finance

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