13 June 2018

Warpaint London PLC

Painting a bright future

Warpaint is a UK-based, colour cosmetics specialist that sells creative, design-focused and high-quality cosmetics at affordable prices. Warpaint's flagship brand, W7, has established a loyal customer base, and brand awareness is growing rapidly. The company believes that, with Retra Holdings (Retra) now being well integrated into the group, it is well placed for the next phase of development – namely new product development and increasing market share, both domestically and internationally, particularly in its two key markets, the USA and China. Warpaint has never made a loss and has a very healthy profit margin; it is also net debt-free.

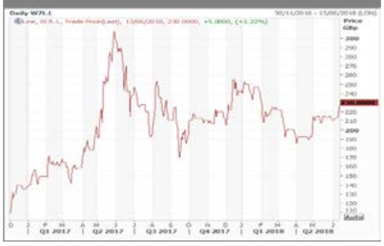
- **Strategy:** In the near term, Warpaint will be focusing on continuing to develop the W7 brand and on the integration of Retra, as well as maximising any possible synergies. The company will also concentrate on increasing its product offerings and expanding brand awareness across the globe.
- **Forecasts:** We forecast sales to grow ca.69% to ca.£55m in 2018, given the boost from Retra. On a like-for-like basis, we expect W7 to grow 11.6%. 2H'18 order books for both W7 and Retra are ahead of the previous year. We are expecting a slight increase in the gross margin in FY18, from 38.8% to 39.5%, and to 40% in FY19.
- **Valuation:** The Retra acquisition fits well with the company's growth strategy: it enhances client access and provides cost savings for both sides of the businesses. Our DCF model indicates a share price range between 219.5p and 276.7p. Warpaint also has a highly competitive dividend yield versus the sector.
- **Risks:** For Warpaint to remain successful, several key factors have to be considered: i) the continuing growth in the discount retail sector; ii) the full effect of the integration of Retra has yet to be analysed; iii) the company's ability to deliver new and innovative products.
- **Investment summary:** Warpaint has made considerable progress in the last six months, since the acquisition of Retra. The company is well positioned to maximise the benefit of the additional assets. It also has a much faster growth rate than the colour cosmetics sector, and has a very attractive RoE. Warpaint offers the opportunity to invest in the fast-growing colour cosmetics sector, with a highly experienced management team.

Financial summary and valuation

Year-end Dec (£m)	2016	2017	2018E	2019E	2020E
Sales	22.5	32.5	55.1	62.3	69.4
EBITDA (adj.)	6.3	8.0	13.2	15.4	17.4
Operating profit (adj.)	6.2	7.3	10.7	13.0	14.9
PBT (adj.)*	6.1	7.7	12.7	15.1	17.1
Adj. basic EPS (p)*	7.9	9.7	13.9	16.5	18.5
DPS (p)	1.5	4.0	5.5	6.6	7.9
P/E (x)*	28.6	23.2	16.2	13.7	12.1
EV/EBITDA (x)	27.2	21.4	12.9	11.1	9.8
Dividend yield (%)	0.7%	1.8%	2.4%	2.9%	3.5%
RoE (%)	-	20.0%	19.6%	21.2%	21.5%

**excludes amortisation of intangible assets*
Source: Hardman & Co Research

Personal Products



Source: Eikon Thomson Reuters

Market data

EPIC/TKR	W7L
Price (p)	225
12m High (p)	294.4
12m Low (p)	150.0
Shares (m)	76.8
Mkt Cap (£m)	172.7
EV (£m)	170.7
Free Float*	34.7%
Market	AIM

**As defined by AIM Rule 26*

Description

Warpaint is a UK-based colour cosmetics specialist that sells creative, design-focused and high-quality cosmetics at affordable prices. The company comprises of two divisions: own-brand (W7, Retra and others) and close-out. It has a presence in more than 60 countries worldwide.

Company information

Joint CEO	Sam Bazini
Joint CEO	Eoin Macleod
CFO	Neil Rodol
Chairman	Clive Garston

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Key shareholders

Directors*	53.5%
Schroder Inv. Mgmt.	10.1%
BlackRock Inv. Mgmt.	9.9%
Hargreave Hale	3.1%
J O Hambro Capital Mgmt.	2.0%
Columbia Threadneedle	1.8%

**includes shares held by directors' wives*

Diary

Sep'18	Interim results

Analyst

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Business model

History

Mr Sam Bazini and Mr Eoin Macleod, founders of the business, started working together in 1992. The business started out by buying and selling close-out and excess stock of cosmetics and fragrances from around the world, particularly from the US. The main customer base for the close-out cosmetics is mostly high-street outlets, wholesalers and discount mass-market retailers. As the business developed, Warpaint's management team built some excellent working relationships with famous cosmetics and fragrance houses.

In 2002, Warpaint decided to venture into creating its first own-brand product – W7 – named after its then postcode in west London. W7 was created in response to the growing customer base and its requirements for a more complete range of cosmetics across both colourways and formats.

In 2008, Warpaint's management team started focusing on the development of its own-brand business, creating an extensive range of high-quality cosmetics for eyes, lips, nails and face at affordable prices. W7's brand development also benefited from the management team's experience on the close-out business. By 2017, sales from the W7 brand accounted for some 81% of the group's total revenue, at £25.5m.

In November 2016, Warpaint London PLC raised a total of £23m on AIM, with the objective of raising the company's brand awareness and providing investment to accelerate the growth of the business. In November 2017, the company raised a further £21.2m to fund the acquisition of Retra Holdings (Retra).

Earlier this year, Warpaint Cosmetics (2014) Ltd, a trading subsidiary of the company, was awarded the Queen's Award for International Trade for outstanding growth in overseas sales over the last three years.

1992	• Business was founded by Mr Sam Bazini and Mr Eoin Macleod • Started out by buying and selling close-out and excess stock of cosmetics and fragrances
2002	• Creation of first own-brand products, W7
2008	• Started focusing on development of W7
2016	• Warpaint admitted to AIM, raising £23m, with a market capitalisation of £62.6m
2017	• Raised a further £21.2m for the acquistion of Retra • Acquisition of Retra for a total consideration of £18.2m (£16.2m cash and £2.0m of shares)
2018	• Warpaint Cosmetics (2014) Ltd was awarded the Queen's Award for International Trade

Own-brand division

Warpaint has a number of cosmetics brands in its portfolio; however, the management team has been focusing mainly on the development of its flagship W7 range. The W7 brand was created to fulfil the ever-increasing demand for creative, design-focused and high-quality cosmetics at affordable prices. The W7 range of products is characterised by an eye-catching design, bold packaging and creative product names – a trend that has been picked up by other high-street brands in recent years.

W7

W7's key target customers are the younger generation, aged 15 to 30, who are more adventurous in exploring different products and bolder colours, yet have a lower spending budget. W7, as Warpaint's flagship brand, focuses on developing a creative, design-focused cosmetics brand proposition, as well as the delivery of these high-quality cosmetics to its consumers at affordable prices.

Warpaint does not have its own factory; instead, the company outsources manufacturing (in the Far East and Eastern Europe), which ensures competitive pricing and rapid production for its customers. Warpaint also prides itself in being quick to respond to market trends, and its ability to bring products to the market with a short lead time and at competitive prices, while also ensuring the quality of its products. The 'Fast-track' launches are achieved in a three- to six-month timeframe.

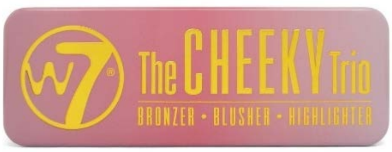
Products

Warpaint's own-brand focuses mainly on four categories of colour cosmetics:

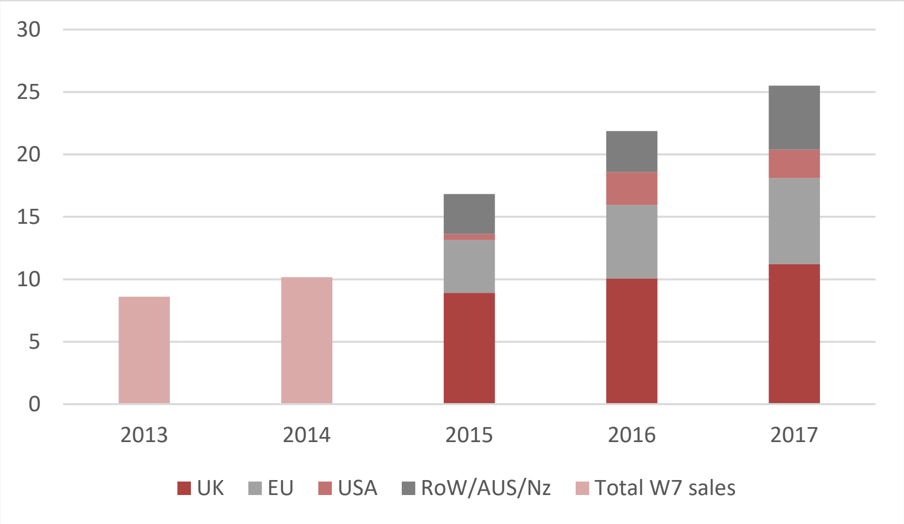
- **Face make-up:** foundation, blushers, illuminators, face-bronzing lotions, creams, and loose, pressed and mineral powders.
- **Eye make-up:** eye shadows, eyeliners, eyebrow pencils, mascara and mineral powders.
- **Lip make-up:** lipsticks and glosses, lip pencils, lip plumpers and palettes.
- **Nail make-up:** nail varnishes and polishes, hardeners and strengtheners, base and top coats.

The company also has a range of accessories and set products, including cosmetics bags and brushes, etc.

In July 2017, W7 launched a new range of products – 'Very Vegan'. This range was developed specifically for vegans and others supporting an animal-friendly lifestyle. To date, the Very Vegan range has 21 product lines. The company has seen encouraging growth in sales since the launch.



W7's sales by geographical regions (£m)



Source: Company

UK remains biggest market for W7

A CAGR of 31% in the W7 brand since 2013

The W7 brand has enjoyed a CAGR of 31% since 2013, a much higher growth rate than that achieved by the global cosmetics market, which grew 6% in 2017. The UK remains the biggest market for the W7 range, accounting for 44% of W7's FY17 sales.

Retra Holdings Limited

In November 2017, Warpaint completed the acquisition of Retra Holdings Limited (Retra) for a total consideration of £18.2m, of which £16.2m was satisfied in cash, with the remaining £2.0m in shares. Retra is a UK colour cosmetics business with a particular focus on the gifting market, as well as products and accessories in bathing ranges, tanning and men's grooming.

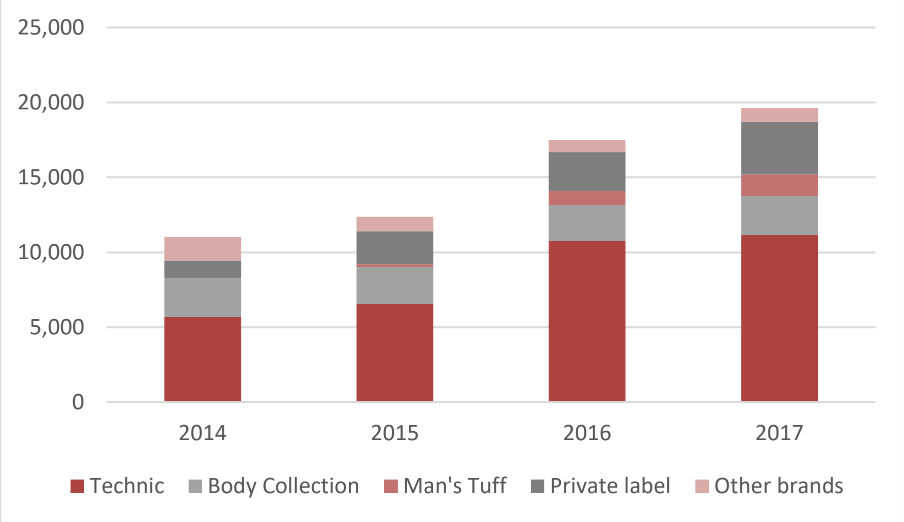
Retra has three core brands in its portfolio:

Different products and different consumer bases

- **Technic:** flagship colour cosmetics and make-up accessories brand, with over 300 products in its range.
- **Body Collection:** more traditional cosmetics and body ranges.
- **Man's Stuff:** new male grooming range covering products from shower gels and shampoo to beard oils and shaving gels – this expands Warpaint's customer segments to men and older consumers.

Retra, based in Silsden, Yorkshire, was acquired by its previous owner in 2006. In 10 years, sales grew from ca.£5m in 2007 to ca.£17.5m in 2016. Retra has a total of 37 employees in Yorkshire, as well as 10 staff members in its three overseas offices, based in Germany, Hong Kong and China. In 2016, sales of gift sets accounted for more than 51% of the company's total revenue. Over 42% of Retra's sales were exports, mainly to the European market, but Retra currently has no presence in Australia and the USA. Warpaint's management believes this presents significant opportunities to accelerate the growth of Retra, given Warpaint's existing presence in both Australia (the company's largest export market) and the USA (the world's largest colour cosmetics market).

Retra's sales by brands (£m)



Source: Company

Warpaint also benefits from cross-selling to Retra's existing customer base, in particular Retra's network into UK supermarkets, grocery stores and high-street health and beauty shops, including Boots, Superdrug and Asda.

Retra also produces white-label cosmetics and toiletry products for several major high-street retailers, including Asda and Matalan.

W7 and Retra synergies

Gifting market

Growing in the gifting sector, providing good revenue visibility

Retra, compared with W7, has traditionally been very strong in the gifting sector (54% of its 2017 sales). Gift sets comprise packaged cosmetics and bath & body collections, with a significant focus on the Christmas market. Warpaint has also seen strong growth in the gifting sector. Orders for Christmas gift sets are typically placed in 1Q and 2Q each year, providing visibility over trading in the second half. Warpaint's management team is expecting this sector to continue to grow and, so far, the gifting sector has provided good revenue visibility.

Expanded customer base

Access to a much larger customer base

There is very little overlap in the customer base between Warpaint and Retra. Retra's customers include high-street retailers such as Boots and Superdrug, and big supermarkets such as Asda and Morrisons, while Warpaint's customers are mainly discount retailers. Warpaint's management believes the acquisition has provided both companies with a much larger customer base, in both the UK and overseas.

Furthermore, Warpaint is selling in over 60 countries, while Retra was selling to only 26 countries (FY16) prior to the acquisition. Retra was not trading in two of Warpaint's biggest-selling countries, namely the USA (the world's largest cosmetics market) and Australia. This presents significant potential opportunities to leapfrog Retra into these regions.

Cost savings

As part of the operation, Retra has an office in Hong Kong for sourcing and quality checks. With the integration of the two businesses, this office provides cost-saving opportunities for both operations. The Hong Kong office will help with quality checks for products from the suppliers in Asia. The acquisition also widens the group's supply chain, which is more cost-effective in some cases. With the integration, bigger orders will drive down unit costs and achieve cost savings in freight.

Other brands

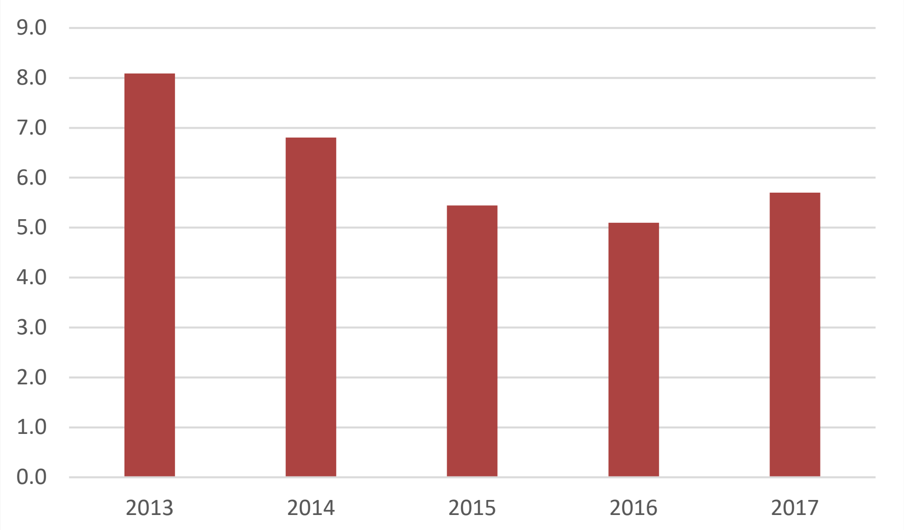
Along with W7 and the brands under Retra, Warpaint has also registered/acquired a portfolio of brands, although they have not been management's focus thus far:

- **Outdoor Girl:** purchased in 2014. This is being developed at a lower price point. So far, sales have been small, but encouraging.
- **CopyCat:** registered in 2015. The company is expecting to develop this into a premium product range that targets the large health and beauty retailers.
- **Smooch:** registered in 2010. This is to be developed as a prestige brand at a higher recommended retail price. Target customers will be department stores.
- **Taxi:** purchased in 2008 as part of a close-out opportunity. This has enabled Warpaint to satisfy bespoke, ad-hoc orders from the value sector.

Close-out business

The close-out division's original business started in 1992. It trades close-out and excess stock of branded cosmetics and fragrances from around the world, which it sells to high-street outlets, wholesalers and the discount mass-market retailers. These are primarily in the UK, such as B&M and TK Maxx. Close-out will continue as opportunities arise. The company believes the key is to concentrate on deals that offer good margins and have low working capital requirements. Close-out will not be the management team's main focus area, so it should take very little of management's time to manage this business.

Close-out business revenue (£m)



Source: Company

Route to market

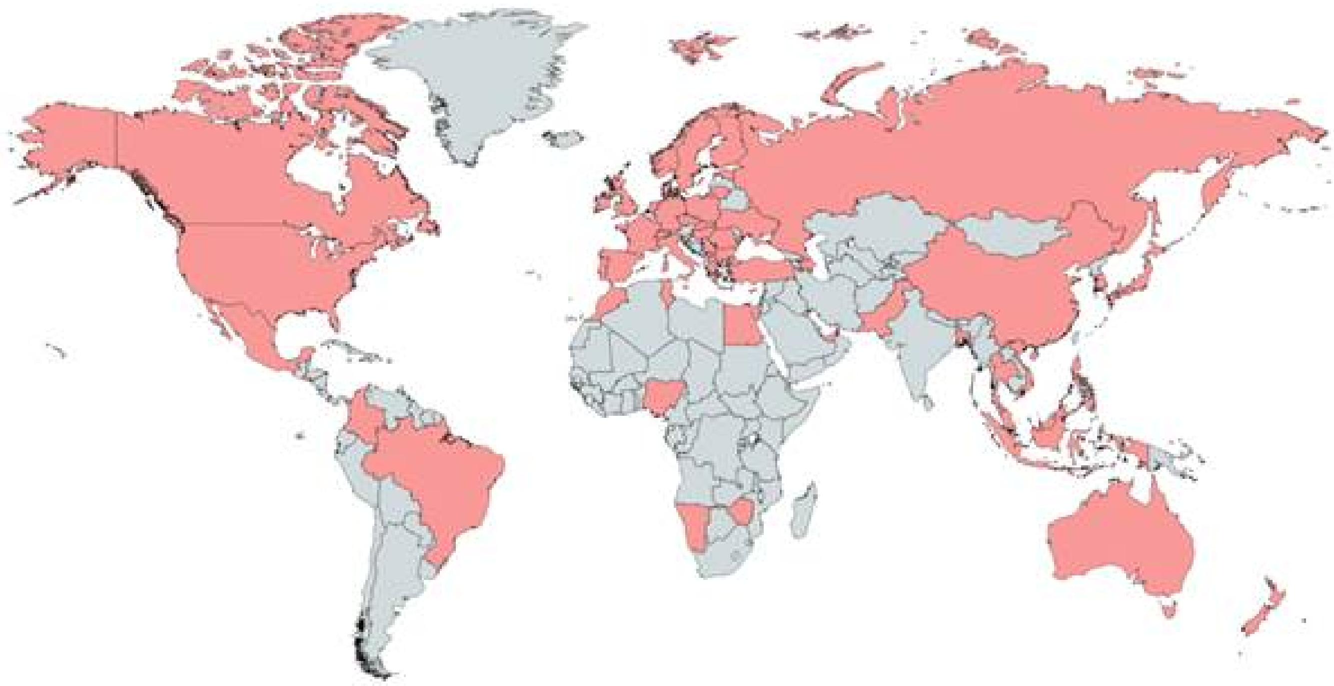
Through the long trading records from the close-out business, Warpaint has developed a very strong customer base for both its own-brand products and the close-out business. The main sales channels for the W7 range have been through trade shows, as well as partnerships with local distributors in different geographical regions.

Products are sold in 60+ countries

Over 700 products in the portfolio

The W7 range is now sold in 60 countries and has over 700 products in its portfolio. In the UK, Warpaint, through its own extensive network, engages with the retailers directly. In the overseas markets, Warpaint engages directly with the local retailers or via distributors. The company has 12 exclusive distribution agreements (from 13 previously) for its W7 brand in countries where it is commercially attractive to have agreements. Most of these exclusive distribution agreements are based on a minimum sales threshold. This allows the company to seek other opportunities in these particular regions in the event of these thresholds not being achieved.

W7's global reach



Source: Company

In the overseas markets, some of the bigger distributors initiated their own marketing for the W7 product range; as a result, marketing costs for Warpaint have been kept to a minimum.

Some overseas distributors initiated their own marketing

W7 advert commissioned by one of its clients in Australia

Source: YouTube

Marketing initiatives

One of the key focuses of the management team following the admission to AIM is to increase brand awareness. Prior to 2016, it had very few marketing activities, e.g. magazine advertisements, targeting the end-users of the products, i.e. the consumers. In 2016, Warpaint launched a series of marketing efforts, but not by the traditional route of mass-market TV or radio advertising. Instead, the management team focused on its marketing efforts by engaging its audience on social media, using bloggers and vloggers with a large following on their respective media platforms, such as YouTube, Facebook, Instagram and Twitter.

Social media platforms for marketing

Millennial consumers pay increasingly more attention to social media and blogs. According to Mintel, 66% of UK women aged 16-24 use the internet to learn new beauty techniques. This is evident from the number of followings from the more successful influential vloggers.

This is especially relevant for Warpaint, given its target consumers, who are more likely to be influenced by the use of social media platforms and celebrity representatives. We note that, as part of its marketing effort, W7 has engaged with a couple of celebrities as brand ambassadors. In addition, through its local distributers, W7 engages with vloggers that have a large following on YouTube to promote W7 products. This is very effective, and the associated costs are very low.

As part of the advertising effort, in August 2016, the company invested in a Beauty Taxi and a Beauty Bus to tour around UK retail outlets, offering makeovers.

W7 beauty taxi

Source: Warpaint

In 2017, W7 initiated a series of online marketing efforts through the engagement of celebrity brand ambassadors.

W7 beauty bus

Source: Warpaint

Strategic plan

Warpaint's management team has identified six key strategic priorities for the next five years. With the recent additions of a product development manager and a PR & marketing manager, Warpaint is well positioned to implement its five-year strategic plan.

The six key strategic priorities are set out as follows:

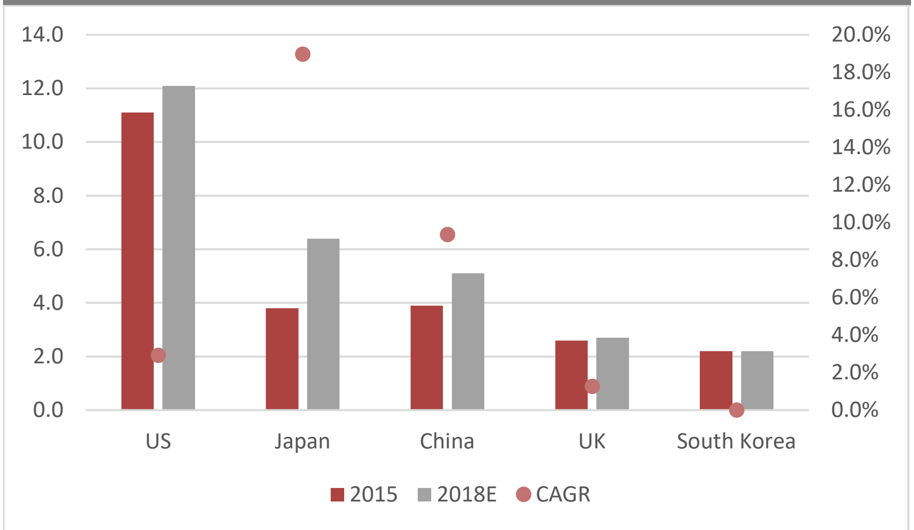
- Continue to develop and build existing brands in the portfolio.
- Provide new product development that meets consumers' changing needs and tastes.
  - As part of the strategy, Warpaint has expanded the team, employing a dedicated product development officer (see bio on page 26).
- Continue to grow market share in the UK.
  - The company estimates that it has less than a 2% market share in the UK. We believe there is plenty of room for growth for the company's own brands in the UK.
- International focus – continue to grow the W7 brand in the US market and launch in China.
  - New marketing personnel has been added to the team.
  - The company's brand is yet to be pushed into China, the fastest-growing market in the world, with a CAGR of 9.4% between 2015 and 2018 in the colour cosmetics sector. The recent acquisition should help facilitate this process, given that Retra already has an established office in the country.
- Reduce costs.
- Drive shareholder values, chiefly through financial performance.

Colour cosmetics market

Cosmetics has been part of human history for millennia, from body arts for rituals in ancient cultures to widely available, day-to-day make-up. Cosmetics products are used by people of all ages to enhance appearance. Global sales of colour cosmetics are expected to reach $48.3bn[1] in 2018, according to Mintel – a 6% increase from $45.5bn in 2017. The USA is the world's largest colour cosmetics market, with estimated 2018 sales of $12.1bn, followed by Japan and China, with estimated sales of $6.4bn and $5.1bn, respectively. Japan and China are estimated to have the fastest CAGRs, of 19% and 9.4%, respectively, over 2015-18. The global colour cosmetics market is expected to reach a value of $77.7bn by 2020, with a CAGR of 5.7%.[2]

The USA is the world's largest colour cosmetics market

Top five colour cosmetics markets in sales ($bn)



Source: Mintel, Hardman & Co Research

According to a press release by Mintel on the 28th edition of 'In-cosmetics Global', it suggested that:

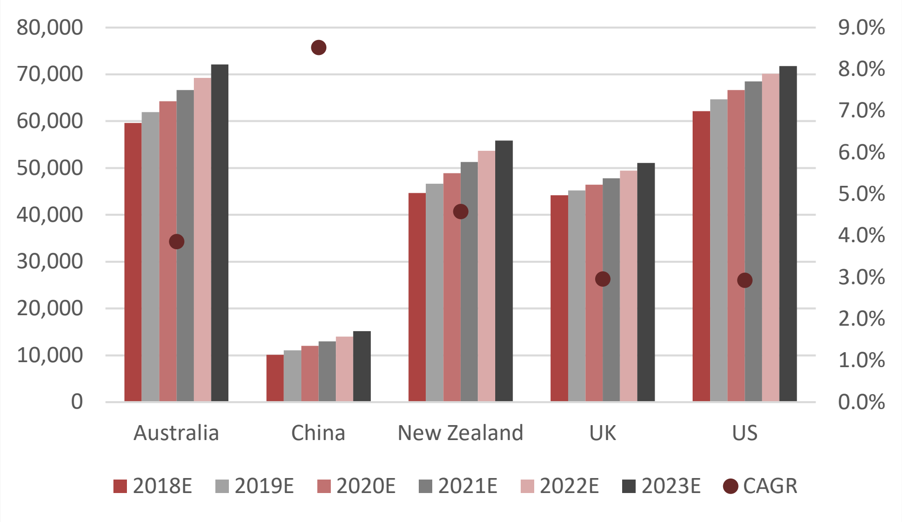
- 41% of Chinese colour cosmetics users are influenced by celebrity beauty bloggers and vloggers to buy products.
- 31% of German make-up users aged 16-24 wear make-up to feel fashionable.
- 66% of UK women aged 16-24 say it is easy to learn new beauty techniques from the internet.

New ways of marketing and advertising are growing in importance, such as celebrity influences and well-followed bloggers and vloggers using various social media channels.

[1] http://www.mintel.com/press-centre/beauty-and-personal-care/global-colour-cosmetics-sales-to-exceed-us-48bn-as-mintel-identifies-4-growth-areas

[2] https://www.marketsandmarkets.com/Market-Reports/color-cosmetic-market-159636154.html

GDP per capita ($) and CAGR (%)



Source: Hardman & Co Research, IMF

In most of the developing markets, the more affordably-priced products are capturing the attention of consumers with the desire to always be 'camera-ready'. The appetite for beauty products is increasing all the time.

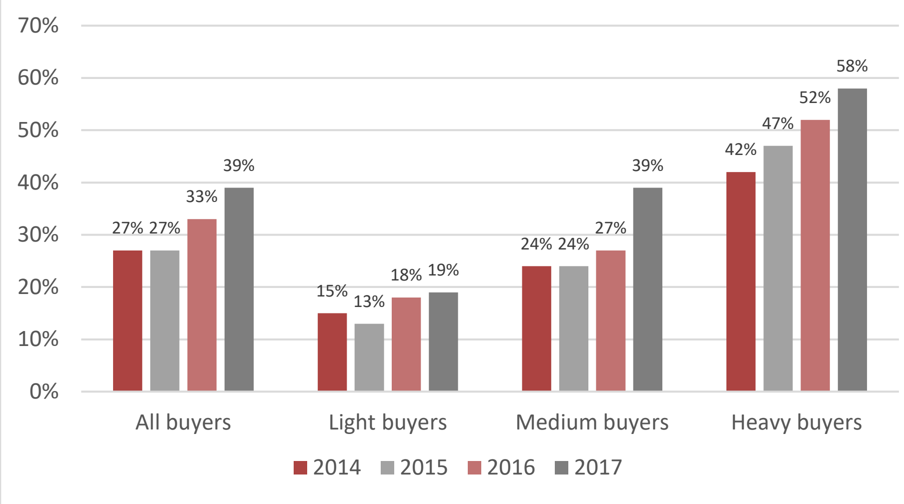
Market trends

Social media influencers

With the advanced network infrastructure and easy access to mobile devices, people are turning to the internet to learn about new cosmetics products and make-up techniques. YouTube, Facebook, beauty blogs and other social media platforms are of increasing importance when women/men are deciding which cosmetics to purchase. There is a deluge of beauty bloggers and vloggers across various social media platforms. YouTube is the go-to place for 'tween and teen', where they can learn the secrets of make-up and hair styling, etc. Some of the more popular vloggers have over 10m subscribers; to put this into perspective, Justin Bieber has 38.9m subscribers, whereas the CNN news channel has only 3.6m.

The chart below shows that, among all buyers, 39% said social media was 'very important'. TABS Analytics' survey indicated that 58% of heavy cosmetics buyers, who buy 10 or more different products, rate social media a very important way to help them to determine which cosmetics products to buy; this is a 16 percentage point increase from 2014.

Percentage of buyers indicating social media as 'very important'



Source: TABS Analytics

Major players are catching on to the increasing importance of online influencers:

- In 2016, L'Oréal launched a 'Beauty Squad', consisting of five of the UK's most influential bloggers, with a combined reach of more than 5 million viewers, to create digital content on a range of beauty topics, in the hope of creating a different way of engaging with consumers, as well as reaching out to new audiences. The company has seen a direct sales uplift since the launch of the Squad. The Squad has made such a big impact for L'Oréal that the company expanded the Squad by adding three more beauty bloggers in July 2017.
- In January 2017, Rimmel teamed up with 12 popular UK beauty influencers to create a new YouTube series – Rimmel Road Trip.
- In January 2017, MAC Cosmetics collaborated with 10 beauty influencers around the world to create its own custom shades of lipsticks for a new collection. The company has continued with the collaboration, with an even bigger team of influencers for lipstick shades launched in spring 2018.

'Selfie' effect

Warpaint's target consumers, namely, the Millennials and Generation Z, are a major part of the driving force for the cosmetics sector, always wanting to be 'selfie-ready' and more willing to spend money on beauty products, instead of other retail goods. Millennials are *"the one bright spot in an otherwise challenging environment for retailers and packaged goods companies"*, according to the Financial Post.

Millennials are reported to be the biggest driving force behind the strong growth at specialty retailers, such as Ulta Beauty – which has more than 1,000 stores across the USA – and Sephora, which operates ca.2,300 stores in 33 countries. Kylie Cosmetics, an online retailer set up by American reality TV star Kylie Jenner, reported sales of $420m in only 18 months. It is reported that the company is projected to have $1bn in lifetime sales by 2022. Advertising efforts consist largely of Jenner's Instagram account, which has more than 108 million followers.

24 billion selfies were uploaded to Google in 2016, according to an article by Google. The average millennial is expected to take 25,700 selfies in his/her lifetime, i.e. close

to one selfie a day. Females aged between 16 and 25 spend an average of five hours per week taking selfies. This impact of selfies certainly drives sales, particularly for cosmetics products targeting areas that help to take the most flattering selfies, as well as increasing the demand for accessory products, such as make-up sponges and brushes.

The discount/value retailers

With the availability of shopping channels and social media influences, consumers' shopping habits are changing and becoming increasingly more 'savvy'. While dire headlines about high-street store closures are plaguing news in the retail sector, the discount retailers are reporting fast YoY growth around the world.

According to Feng Global Retail & Technology, there is a polarisation of growth in the US beauty retail market, for both lower-price retailers and specialist chains.

- Lower-price retailers have grown their shares of beauty shoppers, and younger shoppers are much more likely than older generations to shop for beauty products in lower-price retailers. Readers should note that Warpaint's target consumers are younger shoppers between the ages of 15 and 30, who have lower spending budgets.

The lower prices of mass-market cosmetics products are a strong motivator for shopping in discount retailers. For the younger consumers, price is one of the most important factors when deciding where to buy such products.

B&M UK Stores (of B&M European Value Retail SA) and TK Maxx (of TJX Companies), two of Warpaint's retail customers, have been reporting growth and new store openings YoY, despite the fierce competition with online services such as Amazon. It remains difficult to replicate the bargain-hunt shopping experience these retailers offer. Warpaint, with a high penetration rate in its stores, also enjoys the growth in orders from these customers.

B&M European Value Retail SA (BME.L)

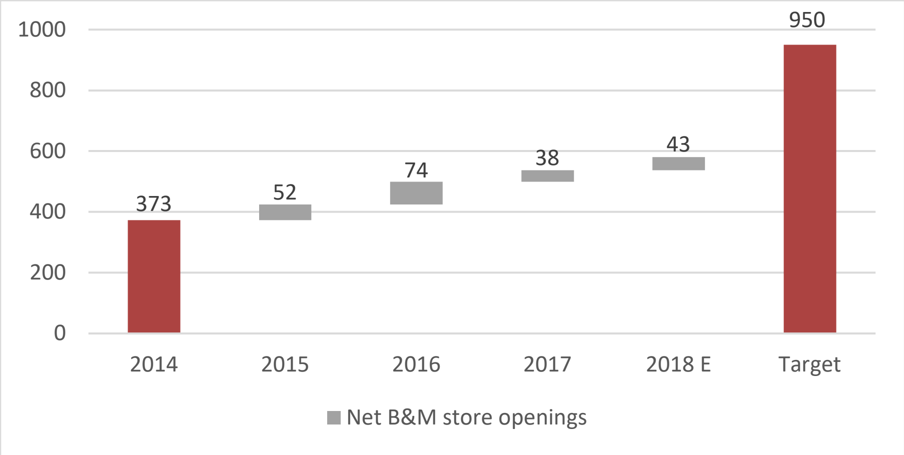
B&M European Value Retail SA's 3Q'17/'18 trading update reported a 12.9% sales increase in its B&M stores for the quarter, with like-for-like sales up by 3.9%. The company, which sells everything from garden furniture, household electricals to cosmetics products, believes this reflected the *"continued robust performance… and the recognition of value offer by consumers generally"*.

Contrary to news reported on the UK high-street stores, B&M has opened a net total of 32 stores in the first three-quarters of FY17/18. The retailer has set itself a target of opening 950 stores in the UK, up from its previous target of 850.

B&M stores roll out target in the UK

Warpaint has high penetration rate in B&M's stores across the UK

B&M UK store openings and target store numbers



Source: B&M

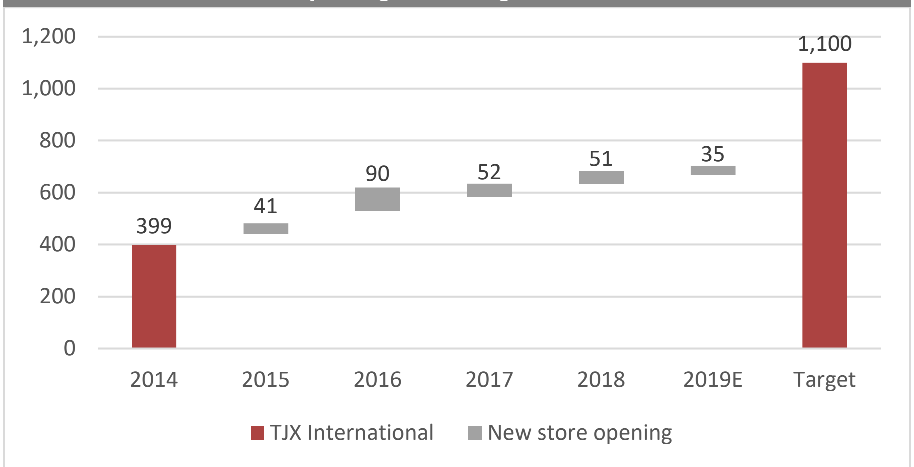
TJX Companies Inc (TJX.NYSE)

TJX Companies Inc is an off-price apparel and home fashion retailer, which operates over 4,000 stores selling an assortment of quality, fashionable, brand-name and designer merchandise *"at prices generally 20% to 60% below full-price retailers' regular prices on comparable merchandise, every day"*. The company has reported consecutive 1Q revenue growth in sales since 1998, registering a CAGR of 8.2%.

TJX emphasises the extreme diversity of its merchandise and the treasure-hunt shopping experience it offers, as well as the non-predictability of its inventory, which runs across the company's multiple brands: TJ Maxx, Marshalls, HomeGoods, Homesense, TK Maxx and Sierra Trading Post. The company prides itself on its opportunistic buying practices – a similar philosophy to Warpaint's close-out business.

In a statement in its 2017 annual report, the company said: *"We see tremendous opportunity to expand our retail chains around the world. We believe we can increase out store base by more than 2,000 stores, or about 50%, to 6,100 stores long term…in just our current countries alone"*.

TJX International store openings and target store numbers



Source: Company reports, Hardman & Co Research

2017 financials and forecasts

2017 full-year results

Profit & Loss

At the end of April 2018, Warpaint announced its second set of full-year results since its admission to AIM. The company has reported eight years of consecutive growth in revenue. In the results for 2017, it reported a 15.6% rise in revenue on a like-for-like basis (taking the full-year sales of the close-out business into account in 2016, while not including the one-month sales contribution from Retra in 2017 and costs associated with the acquisition). Adjusted EBITDA increased 27.2% to ca.£8.0m.

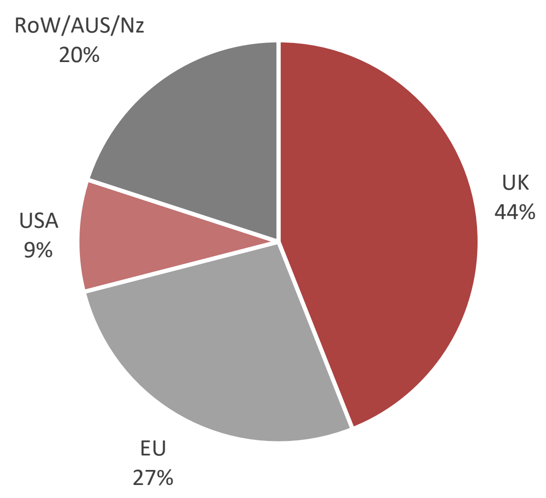
W7 continues to perform strongly

16.4% YoY increase in W7 sales

W7, Warpaint's flagship own-brand, reported sales of £25.5m, a 16.4% YoY increase. This represented ca.82% of the company's pro-forma sales of £31.2m, excluding the sales contribution from Retra. W7 is now sold in more than 60 countries (see W7 global reach map on page 8), with the UK being the brand's biggest market, accounting for 44% of sales in FY17, with YoY growth of 17.1%.

UK is W7's biggest market, representing 44% of W7's sales in 2017

W7's 2017 sales by geography



Source: Company, Hardman & Co Research

At the end of 2017, the top 10 W7 customers accounted for 59.2% of its sales, compared with 56.3% in 2016.

W7's top 10 customers

	2017 sales (£m)	Region
Customer 1	3.7	AUS
Customer 2	2.5	USA
Customer 3	1.7	UK
Customer 4	1.4	EU
Customer 5	1.3	EU
Customer 6	1.1	UK
Customer 7	0.9	EU
Customer 8	0.9	UK
Customer 9	0.7	UK
Customer 10	0.6	UK
Total	**14.8**	**59.2%**

Source: Company

Acquisition of Retra

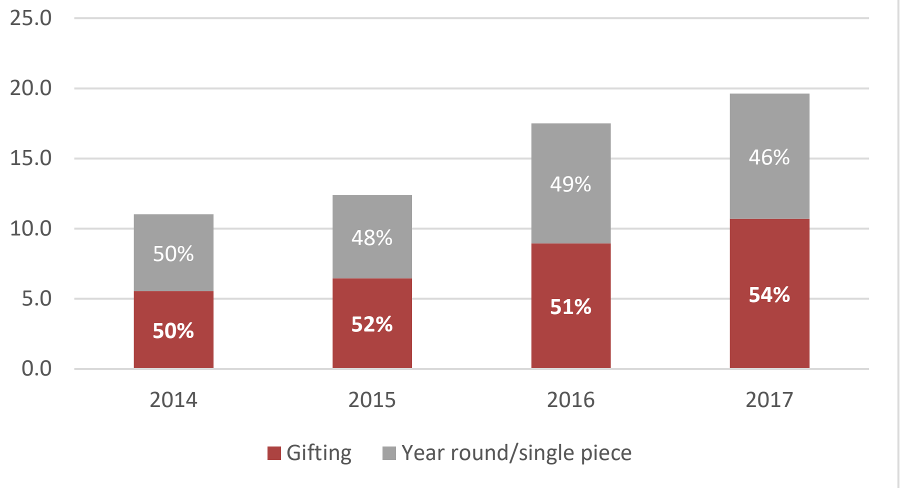
A total consideration of £18.2m

Warpaint listed on AIM in November 2016, and successfully raised £23m from the market, which enabled the joint CEOs, Sam Bazini and Eoin Macleod, to implement their growth strategy to make W7 a global brand. With this goal in mind, Warpaint raised a further £21.2m in November 2017 for the acquisition of Retra. The total consideration was £18.2m, of which £16.2m was satisfied in cash, with the remaining £2.0m in shares. The remainder of the proceeds were used to repay nearly all of Retra's debt.

Retra has a strong product presence in the gifting sector, with ca.51% of Retra's revenue from gifting in 2016, with a heavy 2H bias. Despite the strong seasonality in revenue, there is good forward visibility, because these orders are normally in place before the end of the first half.

Gifting accounts for a substantial portion of Retra's business: ca.54% of FY17 total revenue

Retra has a strong product presence in gifting



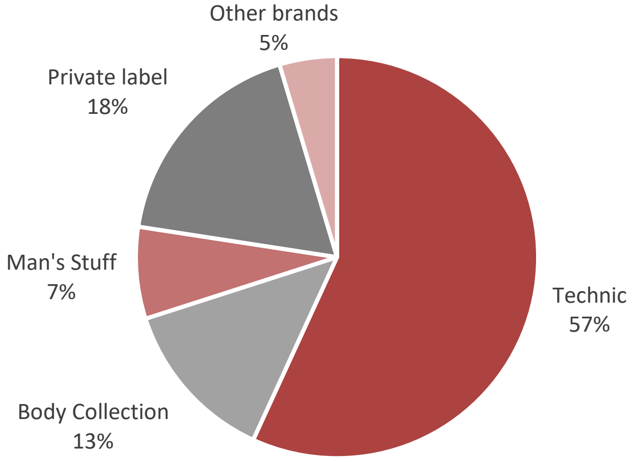
Source: Company, Hardman & Co Research

Little overlapping of clients

Provides access to larger customers

Along with colour cosmetics, Retra also offers personal care ranges such as tanning products, men's grooming kits and bathing products, which are different offerings from Warpaint's own-brand products. Also, Retra's product range is, on average, at a lower price point compared with W7's products, which means there should be no cannibalisation issues when cross-selling to each other's clients. Furthermore, Warpaint currently supplies only five of Retra's top 20 clients and 40 of its total 200 active customers. Additionally, Retra has access to larger customers (in its top 20 customer list), such as health and beauty chains (e.g. Boots and Superdrug) and supermarkets (Asda and Morrisons, etc), with which Warpaint did not previously have relationships.

Retra's 2017 sales by brand (full calendar year)



Source: Company, Hardman & Co Research

Below is a table of Retra's top 10 customers, who accounted for ca.52% of its 2017 pro-forma sales. Retra contributed one month of revenue (£1.3m) to Warpaint's FY17 revenue.

Retra's top 10 customers

	FY17 sales (£m)	Region
Customer 1	2.7	UK
Customer 2	1.2	EU
Customer 3	1.1	EU
Customer 4	1.0	EU
Customer 5	1.0	UK
Customer 6	0.8	UK
Customer 7	0.7	UK
Customer 8	0.5	UK
Customer 9	0.5	UK
Customer 10	0.4	UK
Total	**9.9**	**52.0% of Retra total sales**

Source: Company

Forecasts

Profit & Loss

We are forecasting group revenue in the region of £55m in FY18, representing some 69% YoY growth. The growth will come mainly from the company's own-brand division, for which we estimate 84% growth. Readers should note that, with the addition of Retra, the company's revenue will be more second-half-weighted, and there is strong forward visibility given that most orders are binding and typically placed by the end of 1H. Warpaint is also expecting to increase W7's exposure in gifting substantially. So far, the 2H'18 order books for both W7 and Retra are ahead of the previous year. We are expecting a slight increase in the gross margin in FY18, from 38.8% in FY17, to 39.5%, and then up to 40% in FY19.

Further growth in gross margin

Warpaint does not have its own manufacturing facilities; therefore, its fixed costs requirement is relatively low. The company works closely with its core manufacturers to ensure the quality of its products, as well as their timely delivery. Since the acquisition of Retra, Warpaint has already started utilising the former's offices in Hong Kong and China. The company also expects to achieve cost savings in both unit costs and freight costs. The company now runs a team of 99 people (52 in Iver, Warpaint's HQ, 37 in Retra, UK, and 10 staff members overseas). Its marketing/advertising efforts focus on trade shows, the use of brand ambassadors, and social media influencers. This is relatively low-budget compared with other, more traditional ways of advertising, such as TV and radio adverts.

The company has 12 exclusive distribution agreements (13 previously), covering all the geographical regions outside the UK. Warpaint has terminated its exclusive distribution agreement with its US distributor, which represented 9.6% of the company's own-brand/W7 revenue in 2017 (2016: 12.3%). The company will continue to work closely with this distributor, but it can now seek additional distributors to further expand its presence in the USA.

Market opportunity in China accelerated by Retra's established operations in the country, one of the fastest-growing markets in the world

Furthermore, the company has not yet opened up the market in China, one of the fastest-growing colour cosmetics market in the world, which had a growth rate of 9.4% between 2015 and 2018. With the addition of Retra and its established operations in China, Warpaint's management team is optimistic about the growth potential in the country.

Progressive dividend policy

Profit & Loss account					
Year-end Dec (£m)	**2016**	**2017**	**2018E**	**2019E**	**2020E**
Own-brands	*21.9*	*26.9*	*49.5*	*56.7*	*63.7*
Close-out	*0.6*	*5.7*	*5.7*	*5.7*	*5.7*
Sales	**22.5**	**32.5**	**55.1**	**62.3**	**69.4**
Growth rate		*45%*	*69%*	*13%*	*11%*
Cost of sales	-13.7	-19.9	-33.4	-37.4	-41.5
Gross profit	**8.8**	**12.6**	**21.8**	**24.9**	**27.9**
Gross margin	*39.1%*	*38.8%*	*39.5%*	*40.0%*	*40.2%*
SG&A	-2.5	-4.7	-8.5	-9.5	-10.5
Underlying EBITDA	**6.3**	**8.0**	**13.2**	**15.4**	**17.4**
Underlying EBITDA margin	*28%*	*25%*	*24%*	*25%*	*25%*
Share-base payments	0.0	0.0	-0.1	-0.1	-0.1
Depreciation and amortisation	-0.1	-0.7	-2.5	-2.5	-2.4
Underlying EBIT	**6.2**	**7.3**	**10.7**	**13.0**	**14.9**
Underlying EBIT margin	*27%*	*23%*	*19%*	*21%*	*22%*
Exceptional items	-1.7	-0.4	0.0	0.0	0.0
EBIT (as reported)	**4.4**	**6.9**	**10.6**	**12.9**	**14.8**
Finance costs	0.0	0.0	-0.2	0.0	0.0
Adjusted PBT*	**6.1**	**7.7**	**12.7**	**15.1**	**17.1**
Adjusted PBT margin	*27%*	*22%*	*19%*	*21%*	*22%*
Pre-tax profit	**4.4**	**6.9**	**10.5**	**12.9**	**14.8**
Tax	-1.3	-1.4	-2.0	-2.5	-2.8
Adjusted net income*	**4.9**	**6.3**	**10.7**	**12.6**	**14.2**
Adjusted net income margin	*22%*	*20%*	*19%*	*20%*	*21%*
Net income	**3.1**	**5.5**	**8.4**	**10.4**	**12.0**
Net income margin	*14%*	*17%*	*15%*	*17%*	*17%*
Adjusted basic EPS (p)*	7.9	9.7	13.9	16.5	18.5
Growth rate		*23%*	*44%*	*19%*	*13%*
Basic EPS (p)	5.1	8.3	11.0	13.6	15.6
Growth rate		*65%*	*32%*	*23%*	*15%*
Dividend (p)	1.5	4.0	5.5	6.6	7.9

**excludes amortisation of intangible assets*

Source: Hardman & Co Research

Balance sheet

Warpaint has a very active inventory management system, due to the size of its product portfolio. Keeping track of stock levels, as well as colour and fashion trends, is a key part of inventory management. Warpaint does not have its own manufacturing facilities. Capex is kept at a very low level.

As part of the acquisition of Retra, Warpaint has taken on Retra's debt of £8.7m. It has always been management's expectation to pay off this debt. A significant portion of this has already been paid off (some £7.3m), in 2017, and the company expects to pay off the remaining £1.4m in FY18.

Growing cash balance will enable the company to take advantage of potential acquisition opportunities or to increase dividend payments in the future

Debt-free from 2019

Balance sheet

@ 31 Dec (£m)	2016	2017	2018E	2019E	2020E
Non-current assets					
Goodwill	0.5	8.0	8.0	8.0	8.0
Intangibles	1.4	10.7	8.5	6.4	4.3
Property, plant and equipment	0.2	1.5	1.3	1.2	1.1
	2.2	**20.1**	**17.8**	**15.6**	**13.3**
Current assets					
Inventories	7.7	11.5	13.3	14.9	17.0
Trade and other receivables	5.4	13.2	18.1	20.8	23.8
Derivative financial instruments	0.0	0.0	0.0	0.0	0.0
Cash and cash equivalents	3.5	3.4	6.7	11.7	16.7
	16.6	**28.1**	**38.1**	**47.5**	**57.5**
Total assets	**18.7**	**48.3**	**55.9**	**63.0**	**70.8**
Current liabilities					
Trade payables	-2.8	-3.5	-6.9	-7.7	-8.5
Loans and borrowings	0.0	-0.6	0.0	0.0	0.0
Corporate tax liabilities	-1.3	-0.9	-1.5	-1.8	-2.0
Derivative financial instruments	0.0	0.0	0.0	0.0	0.0
	-4.2	**-5.1**	**-8.3**	**-9.5**	**-10.6**
Non-current liabilities					
Bank loans	0.0	-0.8	0.0	0.0	0.0
Deferred tax liabilities	-0.3	-2.0	-1.6	-1.2	-0.8
	-0.3	**-2.8**	**-1.6**	**-1.2**	**-0.8**
Total liabilities	**-4.4**	**-7.8**	**-9.9**	**-10.6**	**-11.3**
Equity	**14.3**	**40.4**	**46.0**	**52.4**	**59.5**

Source: Hardman & Co Research

Cashflow

Cashflow					
Year-end Dec (£m)	**2016**	**2017**	**2018E**	**2019E**	**2020E**
PBT	4.4	6.9	10.5	12.9	14.8
Depreciation	0.1	0.2	0.4	0.3	0.3
Amortisation	0.1	0.5	2.1	2.1	2.1
(Profit)/loss on disposal	0.0	0.0	0.0	0.0	0.0
Share-based payments	0.0	0.0	0.1	0.1	0.1
Change in working capital	-0.1	-0.3	-3.3	-3.6	-4.2
Tax paid	-1.5	-2.1	-1.3	-2.2	-2.6
Net cashflow from operating activities	**3.0**	**5.2**	**8.4**	**9.7**	**10.6**
Purchase of intangible assets	-0.1	-0.1	0.0	0.0	0.0
Purchase of PP&E	-0.2	-0.6	-0.2	-0.2	-0.2
Acquisition of business	0.0	-16.2	0.0	0.0	0.0
Bank balances acquired	0.1	0.2	0.0	0.0	0.0
Sale of investments	0.0	0.0	0.0	0.0	0.0
Proceeds from sale of PP&E	0.0	0.0	0.0	0.0	0.0
Net cashflow from investing activities	**-0.1**	**-16.5**	**-0.2**	**-0.2**	**-0.2**
Proceeds from new share issuance	2.5	21.2	0.0	0.0	0.0
Share issue costs	-0.1	-0.9	0.0	0.0	0.0
Repayment in borrowings	-0.7	-7.3	-1.4	0.0	0.0
Dividend	-2.8	-1.9	-3.5	-4.5	-5.4
Net cashflow from financing activities	**-1.1**	**11.2**	**-4.9**	**-4.5**	**-5.4**
Net increase/(decrease) in cash	1.7	-0.1	3.3	5.0	5.0
Cash B/F	1.8	3.5	3.4	6.7	11.7
Cash C/F	**3.5**	**3.4**	**6.7**	**11.7**	**16.7**

Source: Hardman & Co Research

Valuation

In our DCF model, a discount rate of 11% and a terminal value of 8-12x indicate a share price range of between 219.5p and 276.7p.

Share price range between 219.5p and 276.7p

DCF per share (p)

		Terminal multiple (x)				
		8	9	10	11	12
Discount rate	9.0%	242.3	258.5	274.7	290.9	307.1
	10.0%	230.5	245.7	260.9	276.2	291.4
	11.0%	**219.5**	**233.8**	**248.1**	**262.4**	**276.7**
	12.0%	209.2	222.7	236.1	249.5	262.9
	13.0%	199.6	212.2	224.8	237.4	250.0

Source: Hardman & Co Research

Comparative valuation

Looking at the peer group table below, Warpaint compares favourably with its peers. RoE is very attractive compared with the sector average, with an expected RoE of 19.6% for Warpaint in 2018. The company also offers a highly competitive dividend yield compared with the sector.

Warpaint London Plc peer group multiples

	Price	Market cap.	P/E		EV/EBITDA		Dividend yield		RoE	
			2018E	2019E	2018E	2019E	2018E	2019E	2018E	2019E
Warpaint	**225p**	**£172.7m**	16.2	13.7	12.9	11.1	2.4%	2.9%	19.6%	21.2%
Swallowfield	324p	£56m	13.0	11.0	8.3	7.3	1.9%	2.2%	16.5%	16.9%
elf Beauty	$19.5	$931m	31.9	28.0	16.9	14.7	0.0%	0.0%	15.7%	14.2%
Estée Lauder	$155.2	$56.9bn	33.2	29.5	19.9	17.9	1.0%	1.2%	3.8%	3.6%
L'Oréal	EUR207.7	EUR 116.7bn	29.3	27.4	18.8	17.7	1.9%	2.0%	15.1%	15.0%
Shiseido	JPY 9,012	JPY 3,605bn	51.6	42.3	22.1	18.9	0.4%	0.5%	16.4%	18.1%
Weighted avg.			33.5	30.1	19.5	17.9	1.4%	1.6%	12.5%	12.6%

Source: Reuters, Hardman & Co Research

Management team

Directors and senior management team

Sam Bazini – Joint Chief Executive Officer

On leaving school at 16, Sam started work in a cosmetics warehouse, supplementing his income by selling cosmetics directly to the public at numerous London street markets. Selling directly to the public gave Sam an invaluable insight into consumer needs and, in 1981, at the age of 18, using £500 he had saved, he set up his own business, buying and selling close-out and end-of-line cosmetics and fragrances. During the course of the next 10 years, Sam and Eoin's paths crossed on numerous occasions, working intermittently with each other on a joint venture basis until they formally went into business together in 1992.

Eoin Macleod – Joint Chief Executive Officer

Eoin's first introduction to the world of beauty was at the age of 14 through a Saturday job in an indoor market selling cosmetics and perfumes. After leaving college, Eoin decided to set up his own business selling fragrances directly to the public through London street markets, as well as selling into the wholesale sector and then expanding into selling cosmetics. In 1992, he formally went into business with Sam, operating initially in the close-out cosmetics and fragrance industry.

Neil Rodol – Chief Financial Officer

Neil joined the Group in August 2015, having previously been an advisor to the business for several years. He has overseen the introduction of new systems and procedures. Over the last 17 years, he has been involved in several corporate purchases and acquisitions. In 2006, he sold his publishing company to a quoted group and became the group licensing director. In 2014, he completed a management buyout. Neil trained as an accountant at BDO Stoy Hayward and holds an honours degree in Maths and Computer Science.

Clive Garston – Non-executive Chairman

Clive has been a corporate lawyer for over 40 years, specialising in corporate finance and mergers and acquisitions, and he is currently a consultant at DAC Beachcroft LLP. He has been on the boards of a number of public and private companies, and has been the deputy chairman of a fully-listed company and chairman of a number of AIM companies. He has significant experience in small and medium quoted companies. He is a fellow of the Chartered Institute for Securities and Investment (CISI) and chairman of its corporate finance forum. Clive has been closely connected with the Quoted Company Alliance and is one of the authors of its corporate governance guidelines.

Paul Hagon – Non-Executive Director

Having worked in the Grocery Sector for over 30 years in both wholesaling and major branded suppliers, Paul is currently providing consultancy services for a number of retail, manufacturing and wholesale businesses to assist with strategies, change programmes and the implementation of practical business plans. Prior to this, Paul worked in selling, marketing and business management roles with Nestlé and, more recently, Palmer and Harvey, where his latter role was as Group Strategy and Development Director. Paul has also served as Chairman of the Association of Convenience Stores, for which he had also been a Board Member for 20 years.

Keith Sadler – Non-Executive Director

Keith is chief financial officer of A Spokesman Said Limited, a radio station operating under the name Love Sport and an online price comparison site. He is also a non-executive director of TLA Worldwide plc, a global sports management and events business, for which he chairs the audit committee. He was, until December 2014, chief financial officer of Dods Group PLC, a political communications business, and formerly chief operations officer and group finance director of WEARE 2020 plc. Prior to this, he was chief executive and group finance director of SPG Media Group plc, a marketing services business, and group finance director of The Wireless Group and two quoted regional newspaper publishers – News Communication and Media plc and Bristol United Press plc. Before this, he was treasurer of Mirror Group Newspapers plc. Keith is a chartered accountant and holds an honours degree in economics from the University of Kent.

New personnel and Retra management

Michelle Aling-Pope – Product development manager

Michelle Aling-Pope has over 10 years of cosmetics, hair care, skin care and oral care product development experience, as well as experience in sourcing, purchasing and supply chain management. She has worked, both beginning to end, on the brand side (Charlotte Tilbury, Essie, Lippman Collection, TPR Holdings), as well as on the supplier and manufacturing side (LF Beauty, DDD Ltd, HCT). In addition, she has worked in beauty retail for Lancôme and Ulta. She is also a trained make-up artist.

Chris Gatton – Managing Director of Badgequo (Retra)

Chris joined Retra in November 2017 as part of the integration process following the Retra acquisition. Chris has over 17 years' experience as a national sales manager, with an excellent track record in developing and generating new business, while growing and maintaining existing business. He has worked with some of the big supermarkets and discount retailers in the UK.

Matthew Goldstein – Finance Director of Badgequo (Retra)

Prior to joining Retra in November 2012, Matthew spent over 15 years as a finance director in leading teams in both PLC and latterly SME/privately-owned businesses. Matthew has experience in integrating newly acquired businesses, as well as in business reorganisation and JV projects across Europe and the Fast East. He has been instrumental in the completion of the Retra acquisition.

SWOT analysis and risks

Strengths

- An experienced management team, which has demonstrated its ability to break into new markets and focus on the continued growth of W7's brand equity.
- Strong customer and supplier network.
- Fast-track product development process.
- Acquisition of Retra enables larger client base and cost savings.
- Low capex, fixed-cost operating structure.

Weaknesses

- The e-commerce platform could cannibalise the company's relationship with its clients, which are mainly discount retailers.
- The gain or loss of a large client could have a significant impact on the P&L.
- Reliance on outsourced supplies.

Opportunities

- Brands are yet to be pushed into China, one of the fastest-growing colour cosmetics markets in the world.
- Potential to gain a much bigger market share in the UK.
- Growing the company's e-commerce platform.
- Further acquisition opportunities.
- Maximising cross-selling opportunities from the Retra acquisition.

Threats

- The discount retail sector could suffer a downturn.
- Highly competitive budget cosmetics market.

Risks

For Warpaint to continue to be successful, several key factors have to be considered:

- Whether growth in the discount retail sector will continue.
- The fact that the full effect of the integration of Retra is yet to be analysed.
- The company's ability to deliver new and innovative products.

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Status of Hardman & Co's research under MiFID II

Some professional investors, who are subject to the new MiFID II rules from 3rd January, may be unclear about the status of Hardman & Co research and, specifically, whether it can be accepted without a commercial arrangement. Hardman & Co's research is paid for by the companies and legal entities about which we write and, as such, falls within the scope of 'minor non-monetary benefits', as defined in the Markets in Financial Instruments Directive II.

In particular, Article 12(3) of the Directive states: 'The following benefits shall qualify as acceptable minor non-monetary benefits only if they are: (b) 'written material from a third party that is commissioned and paid for by a corporate issuer or potential issuer to promote a new issuance by the company, or where the third party firm is contractually engaged and paid by the issuer to produce such material on an ongoing basis, provided that the relationship is clearly disclosed in the material and that the material is made available at the same time to any investment firms wishing to receive it or to the general public…'

The fact that we are commissioned to write the research is disclosed in the disclaimer, and the research is widely available.

The full detail is on page 26 of the full directive, which can be accessed here: http://ec.europa.eu/finance/docs/level-2-measures/mifid-delegated-regulation-2016-2031.pdf

In addition, it should be noted that MiFID II's main aim is to ensure transparency in the relationship between fund managers and brokers/suppliers, and eliminate what is termed 'inducement', whereby free research is provided to fund managers to encourage them to deal with the broker. Hardman & Co is not inducing the reader of our research to trade through us, since we do not deal in any security or legal entity.

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