

Letter to Black Sheep shareholders – Mid January 2019

Dear Fellow Shareholder,

Well these are certainly exciting times, but Brexit or not, I'm sure people will continue to enjoy Black Sheep's excellent beers.

Some cautious congratulations to Andy Slee

I've no idea whether my recent criticisms may have played any part in prodding our Black Sheep board ("Board") out of their slumbers, but hopefully all credit to chairman Andy Slee ("Andy") for energising our company with the opportunistic pre-Christmas acquisition of the York Brewery from the administrators of Mitchell's of Lancaster. Obviously we should all wish the Black Sheep team great success with this acquisition.

Some questions about the York Brewery acquisition

However, while their forecast of an "*earnings enhancing turnover of £2.1 million*" sounds good, we have been given no indication of:

- (a) Whether despite its cashflow pressures, York Brewery was itself viable, but sunk by the problems at Mitchell's of Lancaster, or whether it too has/had serious financial shortcomings;
- (b) What we've paid the administrators, Duff & Phelps, for York Brewery, its interesting range of brands and four leased retail outlets (very little I imagine);
- (c) With an already heavily indebted balance sheet and a market cap of just £3.18 million what if any additional debt has been assumed by Black Sheep (hopefully very little, in which case why not say so?);
- (d) What additional working capital is required to make a business work that the Mitchell's team clearly couldn't and how that's going to be sourced;
- (e) How the existing Black Sheep management team are going to cope with the extra workload;
- (f) What additional brewing capacity (in hectolitres) we've acquired (surely not a state secret!); and
- (g) What proportion of that additional £2.1 million of revenues is attributable to (a) actual beer production, (b) to Beer Duty, and (c) how much comes from on-sales from York Brewery's four leased outlets? We are not told, but a very rough calculation might suggest that as each of the four outlets would be unlikely to be generating top-line revenues of less than £125,000 a year (say £2,400 per week), or say a total of £500,000 p.a., that with the benefit of a 50% reduction in Beer Duty for low volume, actual York Brewery's beer production might be generating circa £1.3 million p.a.

We should all “*look forward to [Andy] sharing more details of this acquisition in the New Year*”, hopefully early in 2019.

The Packaging Project

On the “Packaging Project Update” we’re told our Board is delighted this development “*is now supported by a credit backed offer from RBS*”. Well I hope RBS know what they’re doing by proffering their “*significant vote of confidence*” in Black Sheep purely with debt.

In 2015 and 2016 Black Sheep’s bankers were HSBC in Ripon. In 2017 and 2018 they were Lloyd’s in Thirsk, while during 2017 part of Black Sheep’s banking requirements were also provided by Close Brothers. For a business the size of Black Sheep to be constantly changing their bankers is to say the least unusual!

We may well ask just exactly which bank is now Black Sheep’s primary source of banking support?

New Equity fundraising

On 19th July last year, Andy wrote that “*the Company has not issued any new equity since 1993 and has funded its expansion through debt. The Board is looking at the best way to finance our diversification plans*” and “*it is our belief that this will undoubtedly involve some form of new equity fundraising as part of the process.*” And then we will “*keep shareholders abreast of these developments as appropriate.*”

That intention was reiterated verbally at last September’s AGM in Masham. Then in his last month’s December 2018 Half Year Shareholders’ Update, which strangely is not available on Black Sheep’s supposedly more open and communicative web-site!, Andy stated that “*a review of the long-term funding and capital structure of the business is under way and will hopefully be completed in the early part of 2019.*” It’s now mid-January and we’ve heard nothing on the subject yet.

In well more than forty years of working with and investing in public companies, I have never known any company that took six months between stating an intention to raise new equity and actually doing so. Quite extraordinary. And because shareholders have no idea of the “right” price for this proposed equity raise by Black Sheep, dealings in its shares have to the detriment of shareholders, been minimal. A total of 4,697 shares (0.22% of Black Sheep’s issued equity) have traded since Andy’s letter of 19th July 2018, while the share price has fallen by 25% to £1.50, and there are currently a total of 20,658 shares (almost 1% of the issued equity), on offer at various prices between £1.50 and £2.45 but not a single bid/buyer in sight.

That’s certainly not a good way of looking after shareholders’ best interests.

The Balance Sheet

Andy's has, in my view wrongly, consistently linked Black Sheep's proposed fundraising only to the Packaging Project and proposed retail expansion. I suggest that correcting Black Sheep's existing and growing balance sheet imbalance is fundamental to the sound future development and growth of our company and our Board's failure to advance appropriate proposals in a timely manner is a disgrace and dereliction of their fiduciary duties.

Performance

Andy's explanation of performance for the first six months of the current year would be laughable were it not so embarrassing.

He claims that "*the underlying performance of the business is strong*", but the increase in underlying EBITDA of £173k was only achieved through a £290k increase in third-party packaging costs! You can't sell beer without packaging it, so what on earth is he talking about and just who does he think he's kidding? His rosy sentiments are belied by the next paragraph when he tells the truth, that "*actual underlying EBITDA for H1 was £308k, a drop of 39% when compared to FY (full year) 2017 – 18.*"

And how extraordinary to compare this year's half year figures to last year's full year figures! An accounting sleight of hand that is inconsistent, intellectually incoherent and dangerously misleading.

Shareholders with long memories can refer back to Andy's letter of 6th November 2017, and will soon realise why he has not provided the appropriate financial comparables. For the first half of the year to 31st March 2017, the numbers must have been so embarrassing that under the heading "First Half Performance", Andy conveniently avoided the subject altogether, providing no numbers at all and simply stating "*Our firm objective this financial year is to return Black Sheep to profitability. To the half year, we are on track to do exactly that, which represents a significant improvement versus last year.*" Wow. Subsequently, as we now know, last full year's (to 31st March 2018) contrived and phony profit figure of just £1,281 was only achieved by reducing directors remuneration by £110,194 or 19.9%!

The real story

Reading between the lines, it looks as though in the current year, Black Sheep is heading for both a reduction in overall margins and yet another significant pre-tax loss and we will all doubtless be encouraged to give this useless management team yet one more year to perform. Good luck RBS!

Significant unplanned expenditure

And then, unbelievably, our Board managed to spend £44,000 (presumably £36,667 plus VAT) of our shareholders' money taking so-called professional advice relating to my allegation that the board, under Paul Theakston's ("Paul") chairmanship, had rebutted an informal approach from the Wolverhampton-based Marston's Brewery, originally at £5 and subsequently reduced to £4 per share, without consulting shareholders. Not only was that a disgraceful abuse of shareholders' capital and best interests, particularly in the light of the subsequent persistent decline in Black Sheep's share price to its most recently traded price of £1.50 per share and in the interim at even lower prices, but Paul actually had the decency, and my ears did not deceive me, to publicly admit at last September's AGM that I was/am correct.

Andy and Paul Nolan's assertion that they found my "allegations to be without foundation" is simply rubbish and shareholders should rightly be incandescent with this denial of the truth and the current Board's utter waste of our moneys. We should be asking in detail just exactly how this spendthrift sum was spent. Shame on you Andy and the rest of the Board.

Conclusion

In sum, it remains manifest that we have the wrong executive management team and the wrong Board either to guide the good ship Black Sheep forward or communicate effectively with us the shareholders.

You will hear further from me in the near future, so please keep an eye on our www.buildingabetterblacksheep.com web-site. Thank you.

In the meantime, I wish you all a healthy, successful, contented, prosperous and Happy New Year.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'David Nabarro', with a stylized flourish at the end.

David Nabarro
Activist shareholder in Black Sheep Brewery PLC