Long: MGP Ingredients (Ticker: MGPI) | June 2016
Investment Update

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Apis Capital is a New-York based, SEC registered investment advisor that invests in value equity opportunities around the globe.
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THESIS OVERVIEW

Per our original report on MGP Ingredients (ticker: MGPI), we believe the company is at the early stages of a multi-year, management-led turnaround of America's largest white-label distiller. In the coming years, we expect significant margin expansion as the company shifts towards higher-margin alcohol and ingredients products and, most importantly, sells alcohols under an MGP brand. Our original report "MGP Ingredients: Whiskey, Management, and Margins Drive Upside" (December 22, 2015) can be accessed on Harvest here: **https://www.hvst.com/posts/55667-mgp-ingredients-whiskey-management-and-margins-drive-upside**

Since our initial report, we have begun to see a number of catalysts play out as we had expected. Below, we provide an update on each of the catalysts we outlined. Following this update, we provide a few incremental notes on MGPI which we believe further underscore the feasibility of the current turnaround.

CATALYSTS PLAYING OUT

Raise corporate turnaround target of "4X = 5Y" – or increasing adjusted operating income by 4x over 5 years.

- **Operating Income guidance was raised 30-50%, and pulled a year forward, to $43.7M-$49.9M by 2018.**

- As we expected, the company came quite close to reaching its 4X = 5Y target in 2015, with Operating Income at 32.8M vs. the 33.2M target by 2019. In response, the company's YE 2015 10K included updated operating guidance: **"Operating income is expected to increase by a compound annual growth rate in the 10-15% range over the next three years."**

Management guidance on quarterly margin expectations, or longer-term targets.

MGP also released other guidance in the 10K, as outlined below. The company has committed to providing quarterly guidance which, judging from the guidance in Q1, will be small modifications to the longer-term outlook for the company.

- **Net Sales Guidance:** "2016 net sales percentage growth is expected to accelerate into the high single digits." This guidance was subsequently brought down to mid-single digits in Q1 due to operational issues at downstream, low-margin white spirit customers, and weakness in the fuel grade alcohol segment. That said, despite a -4.4% YoY decrease in Q1, gross margins still expanded 27% YoY and held around 20% given strong underlying mix shift.

- **Gross Margin Guidance:** "2016 gross margin gains are expected to be moderate following strong 2015 improvement." While gross margins gains are expected to moderate, we note that gross profit increased more than 100% YoY in 2015 vs. 2014. Additionally, we are glad to see two consecutive quarters of gross margins around 20% – clearly, there has been a level change from the high-single digit gross margins seen in 2014.

- **Tax Rate Guidance:** "2016 effective tax rate is forecast to be 35% and shares outstanding are expected to be approximately 16.7M reflecting the benefit of the 2015 share repurchase."

- **Ethanol Market Impact on ICP:** "Due to challenging and volatile conditions in the fuel ethanol markets, ICP's 2015 level of profitability may not be sustainable in 2016."

Branded product launches under the liquor business.

- We remain confident in MGP's ability to execute on its branded strategy and believe the company has pursued a thoughtful **"Test and Invest"** approach. The management team has made it clear that they needn't "swing for the fences" to significantly impact the bottom-line and, instead, will test brand concepts and marketing strategies before investing incremental capital. We believe this is prudent and helps to reduce execution risk.

- Over the coming years, we believe MGP will have a handful of solid, national brands to address various consumer "need states." We give MGP credit for their unique ability to identify white space in the marketplace.

Metze's Select

- We believe the Metze's Select launch was a solid first step on MGP's path to a strong branded whiskey business. The brand was well-received by trade publications, at trade events, and in downstream retail locations. Importantly, Metze's Select has been able to showcase MGP's various capabilities, flavors, and blending prowess. The label is also extremely transparent – refreshing to see given recent controversies around this subject. MGP was also able to continue stress testing its distribution and bottling relationships. Metze's Select is now sold out.

- While Greg Metze unexpectedly announced his departure from MGP, Metze has been regarded as a good mentor to the "bench" of talent that MGP has thoughtfully built up. Additionally, customers have had line of sight on such a scenario, and see his departure as a limited impact event.

Till Vodka

- In March, MGP released Till Vodka, a 40% alcohol by volume product "distilled by the proud men and women of Atchison, Kansas." A 750mL bottle will carry a suggested retail price of $24.99.

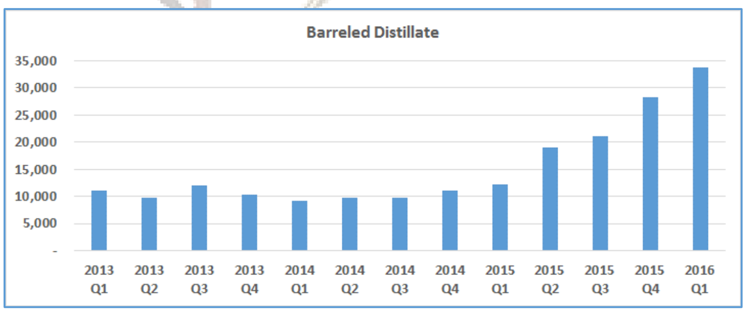
- We are excited about Till not only because it represents a second branded product launch, but also because it demonstrates efforts to drive premiumization across both white and brown spirits.

- In line with its "Test and Invest" strategy, MGP will initially sell Till Vodka in local Kansas and Missouri markets and scale as marketing initiatives prove effective.

Continued ramp of warehousing capacity and "Barreled Distillate" – or MGP-owned and aging distillate.

Barreled Distillate Continues to Ramp, Management Incentivized to Grow Distillate

- Since our initial report, MGP has continued to ramp barreled distillate – or inventory which MGP owns and can be used for MGP brands or other strategic purposes.



- In the most recent proxy, management compensation targets include "the production and warehousing of at least 20,000 barrels of premium whiskey in new white oak barrels for MGP inventory." While the all-in cost for a barrel of whiskey can be difficult to estimate, prior proxy statements and a surveying of the industry can provide some clues here.

- Management incentives are no longer tied to ICP. Management has made it quite clear that ICP is a "non-strategic asset" and the company will not expend cash to support the business. While the company holds a "Shutdown Election", the company has yet to use this right.

Warehouse Expansion Project Nearing Completion

- We believe MGP is nearing the end of its $20M+ capital expenditures on warehousing expansion, facility sustenance, and environmental health and safety projects. Once complete, MGP will have doubled its warehousing capacity, removing a key bottleneck in its ability to supply the booming whiskey market and store its own distillate.

Sell-side initiations on the MGP story. Liquidity should increase as well.

MGP has actively shared their story with good result. Since our initial report, we have been pleased to see a number of sell-side mentions, as well as an initiation by Craig-Hallum.

- **Craig-Hallum, Alex Fuhrman. MGP research initiation:** "MGPI Is An Undervalued Premium Spirits Company Barreling Towards $3.00 In EPS. Initiating Coverage With BUY Rating And $42 Price Target." – May 25, 2016. Additionally, Craig-Hallum sees longer-term potential of $80 per share. Craig-Hallum's initiation was well-received by the market with the stock gaining nearly 13% on the day.

- **Cowen, Vivien Azer.** Cowen Industry Update: "MGP: Flying Under the Radar in a High-Flying Category" – April 11, 2016. Cowen provided a detailed overview of the MGP business after the recent Analyst Day.

- **Barclays, William Marshall.** Equity Research report: "The Next Whiskey Rebellion" – March 14, 2016. To explain how craft distillers are "getting their start", Barclays spotlights MGP – "The Largest Alcohol Company You've (Probably) Never Heard Of".

- **Goldman Sachs.** Equity Research report: "The Rise of Craft Vol. 2, Spirits, Distilling the Impact" – April 14, 2016. Goldman mentions MGP's "unique role as the provider of distillate for both large and craft players."

Continued macro growth in whiskey as a category, and rye and craft whiskey as sub-categories.

- Media headlines continue to highlight the enthusiasm in the whiskey category. In Kentucky, bourbon inventory reached a 40-year high last year. Bardstown Bourbon continues to make progress on its upcoming distillery, former Four Roses Master Distiller Jim Rutledge plans to begin constructing the J.W. Rutledge distillery, and a crop of craft distillers are raising funds to build facilities. Additionally, various major distillers are increasing warehouse investment.

- Various other quantitative and qualitative indicators confirm that the premiumization trend is well under way. A recent and interesting case is the limited release of Booker's Rye which will retail at $300 per bottle.

ADDITIONAL NEWS FROM MGP

- **MGP scale and dominance further highlighted.** At the most recent Analyst Day, MGP broke out its white spirit production to include vodka and gin – this incremental information further elucidates the scale of the Indiana facility. From additional research and management commentary, MGP may be even more dominant in the white label space than we had initially understood.

- **James Bareuther joins the Board of Directors.** Like Gus, Jim Bareuther hails from Brown-Forman, where he last served as Chief Operating Officer from 2003-2010. Jim is clearly an industry veteran with decades of experience; he is also a former three-term chairman of the Distiller Spirits Council of the United States (DISCUS). We believe Jim provides further depth to MGP's high-quality Board.

- **Financial flexibility further expanded.** MGP recently amended its credit facility, including its acquisition covenants. The purpose of such a move is unclear but, generally speaking, we are pleased to see the company gain additional flexibility. While we don't believe the company will require significant capital expenditure to meet its forecasted business targets and market demand, MGP has ready access to capital should the high-class problem of additional capital expenditure requirements arise.