

Private Client Research

18 September 2019

a2 Milk Company

Investor strategy day

a2 Milk Company (A2M) released a detailed presentation as part of its investor strategy day and China market immersion event in Shanghai, and in this note Ord Minnett provides a summary of the key points.

The company remains in a significant investment phase, based on a now deep understanding of the consumer, to access the significant opportunity in China infant formula and US milk. This investment appears sound, although it is likely to weigh on operating earnings (EBITDA) margins as the company takes a longer-term approach, which could see recent downgrades continue.

We maintain our Lighten recommendation on a2 Milk with a \$12.92 target price.

- Strategy day** – We note the following key points from the presentation: 1) The consumer is the basis for all decisions, with a significant revenue opportunity. 2) No financial targets were provided, as expected, but management outlined four criteria on which a2 Milk would be judged: a) brand awareness, trial and loyalty conversion; b) share of category consumption; c) absolute revenue growth; and d) healthy underlying gross margins by product categories. 3) The increase in investment in 4Q19 post deep dive in 2Q19 and 3Q19 drove brand awareness and consumption share. 4) Technology development (requiring operating and capital expenditure) will take two to three years, with current systems limited. 5) Incentives are being changed for the long-term incentive plan (from EPS to revenue as well as profit growth), and the short-term incentive plan (to strategic goals across China, the US, brand and people). 6) China Mengniu's proposed acquisition of Bellamy's Australia (BAL, Hold) was not a surprise as it was on market for a few years and the pairing had been suggested for some time, although the multiple did highlight the appeal of the growing China infant formula industry.
- Australian liquid milk** – Key points: 1) Growth has been achieved in the past 10 years in a competitive category. 2) Further market share growth (11.2% in FY19) is possible due to high loyalty and a young consumer skew. 3) The product has been a driver of brand awareness for the China infant formula business.
- China** – Key points: 1) Infant formula remains attractive against other fast-moving consumer goods (FMCG) markets. 2) Market share gain opportunities exist for a2 Milk across all channels and geographies, with consolidation expected (as has occurred in Australian and US markets). 3) Consolidation is expected in the mother and baby store (MBS) channel from current low level (top 5 = 10%). 4) a2 Milk is channel-agnostic with the same gross margins, although it is silent on EBITDA margins and we see this as another driver of EBITDA margin compression. 5) Investment is required to access the opportunity, with ongoing deep dives possibly required as the consumer is changing rapidly. 6) Investment rather than channel mix derisks revenue outlook. 7) The Hong Kong label is a means to access southern China and complements English-label product.
- US milk** – Key points: 1) Brand awareness is key as that drives household penetration, with national penetration evident only in the past year. 2) Loyalty is higher than for peers. 3) Velocity by channel is higher in Club and Natural stores. 4) If a2 Milk had not removed its FY21 breakeven target (in favour of revenue growth), spending on brand would have pulled back faster. 5) The coffee creamer market is distinctive to the US and a growing category, with liquid milk brand awareness driving a faster uptake. 6) There remains significant potential for ranging in more stores and the offering of more products, with a2 Milk confident this business could be a second growth pillar.

Recommendation

Lighten

Risk

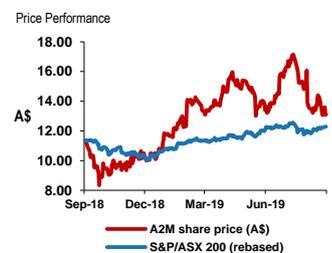
Higher

Target price

\$12.92

Last price

\$13.10

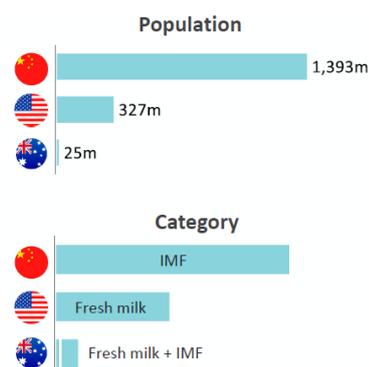


Key charts from A2M investor strategy day

a2 Milk Company (A2M) is hosting its investor strategy day and China market immersion event in Shanghai on 17-18 September. The detailed presentation released contained no financial data, as expected, with the focus on the China market, channels and customer segmentations, as well as the US milk market and growth opportunity.

Group

Figure 1: A2M – Population and category sizes in China, the US and Australia



Source: Company reports.

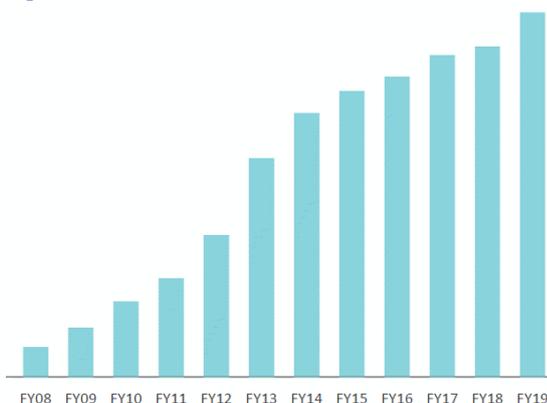
Table 1: A2M – Key ingredients for the ongoing success of the business (according to A2M)

We have sharpened our strategy and increased our focus	<ul style="list-style-type: none"> – Maximise growth from existing products in core markets – Broaden our product portfolio in core markets – Expand into other targeted markets
Accelerate investment to increase and deepen consumer engagement	<ul style="list-style-type: none"> – Deep consumer insights reveals our brand proposition is distinctive and resonating strongly – 'Test and Learn' at the heart of our approach – Market dashboards enable ongoing adjustment to investment settings – Investing in more great people – Step-changing our people experience – Investing in Technology
Our strategic partners enable fast growth and adaptability	<ul style="list-style-type: none"> – Synlait – foundational partnership for infant nutrition – Fonterra – relatively new partnership spanning multiple products & emerging markets – CSFA Holdings – strong partner for infant nutrition products in mainland China since 2013
Preserve our passionate belief and the core values of our culture	<ul style="list-style-type: none"> – Focused on remaining a big "little" company

Source: Company reports.

Australian liquid milk

Figure 2: A2M – Australian fresh milk revenue



Source: Company reports. June year end.

Greater China

Table 2: A2M – Greater China key messages

The infant formula category dynamics remain positive	<ul style="list-style-type: none"> - China's birth rate has declined, although fertility rates are rising - More women are delaying starting a family to prioritize education and a career - The growing middle class in China contributes to category growth - "4-2-1" family structure results in children receiving more attention and care - Category fragmentation provides opportunity for brands that resonate
Our business is consumer-led and we have put in place systems to continue to listen, monitor and adapt	<ul style="list-style-type: none"> - China is a big and complex consumer market with strong regional influences and distinctive city tier dynamics - Global macro factors apply across all consumer segments in Greater China - Chinese consumers have an increased consciousness on health and wellness - The pace of digitalization is supporting the consumer economy - Consumers engaging deeply with content; seamlessly linked into e-commerce - Our research shows five distinct consumer archetypes of mothers in China - Data and analytics allow us to stay ahead of evolving consumer behaviour
We are stepping up our marketing investment – following intensive learnings and data infrastructure development	<ul style="list-style-type: none"> - Consumers engage with multiple and diverse information sources and channels - Our marketing investment is focused on building awareness and conversion - Data infrastructure and consumer insights provides confidence to invest
We are channel-agnostic – able to stay agile and adapt to changing consumer behaviour	<ul style="list-style-type: none"> - Consumers engage with multiple and diverse information sources and channels - In the China IMF market, majority of sales occur in physical stores - China has the biggest, most dynamic retail landscape in the world - Key channel trends and insights: <ul style="list-style-type: none"> - Online – Macro factors enable China to be at the forefront of the digital revolution - Online – China's e-commerce landscape is becoming more and more diverse - Online – CBEC, social e-commerce and daigou are distinctive to China - Online – Top 5 CBEC platforms account for ~80% of market - Online – Viral social e-commerce operators are rewriting the ways to reach shoppers - Online – Social e-commerce is outgrowing overall e-commerce - Online – Daigou is a key channel for certain consumers and will continue to play an important role in our multichannel approach - Online – Daigou retains its personal nature, but is now a modern sophisticated channel - Physical retail – There is a wide variety of physical retail store formats in China - Physical retail – MBS is more than a retail store, and there is significant variation across the MBS channel - Physical retail – The MBS channel is consolidating; Key cities are leading the way - Physical retail – As we grow our store footprint, we are equally focused on in-store execution - Convergence – Pace of retail innovation in China is unprecedented globally - Convergence – Alibaba is leading channel convergence with their new offline Hema Fresh stores
Our growth opportunity remains significant – it will look different to the last 3 years	<ul style="list-style-type: none"> - While growing across all channels, revenue mix is changing and evolving - Significant opportunities to grow within the Greater China infant category - Our broader portfolio of products in China play in very big categories

Source: Company reports.

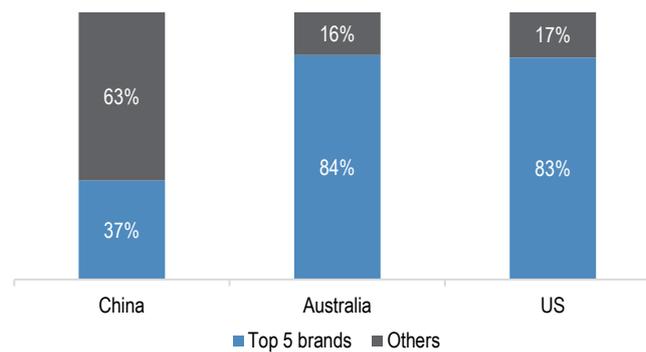
Figure 3: A2M – New births in China vs female population of childbearing age

Number of new births in China (millions)



Source: Company reports.

Figure 4: A2M – Category fragmentation in China provides opportunity for brands that resonate



Source: Company reports, Kantarworld panel, IRI. 12mths ending Jul-19 for China, 12mths ending Aug-19 for Australia and US.

Table 3: A2M – Global macro factors apply across all consumer segments in Greater China

- Growing consumer demand for health and wellness products
- Growing focus on food safety, naturalness and provenance
- Rise of the middle class
- Rapid pace of digitalisation

Source: Company reports.

Figure 5: A2M – Chinese consumers engage with multiple and diverse information sources and channels



Source: Company reports.

Figure 6: A2M – Online channels for infant formula sales in China

	B2C		C2C	
	Domestic online (DOL)	Cross border EC (CBEC)	Social EC	Daigou
Multi-category	Alibaba TMALL天猫 Kaola (CBEC focus) 网易考拉 JD 京东	天猫国际 网易考拉海购 京东全球购	拼多多	淘宝网
Category specialised	babytree 美国妈妈 蜜芽宝贝		小红书 云集	WeChat
Brand specialised	The a2 Milk Company 澳洲高端乳制品品牌 授权母婴官方旗舰店 a2 Milk™ Tmall DOL flagship store	The a2 Milk Company 澳洲乳制品品牌 官方授权海外旗舰店 a2 Milk™ Tmall CBEC flagship store		

Source: Company reports.

Figure 7: A2M – Summary of e-commerce platforms

	B2C			C2C			
	Multi-category	Vertical platform	Brand specialised	Social EC	Daigou		
	 Alibaba Tmall	 Kaola	 JD	 Babytree/Miya	 Brand flagship (Tmall)	 PDD/Red/Yunji	 Taobao/WeChat
Top volume contributor	Full-category platform specialised in CBEC	Proprietary logistics – 90% of orders delivered same or next day	One-stop-shop dedicated for the mum-and-baby category	Supplied and operated by the brands themselves	Content/ community oriented platforms, led by Key Opinion Leaders and Key Opinion Customers	C2C channel for lower price imported goods from overseas	
DOL and CBEC channels co-exist	Quality guaranteed with brands official authorisation	Top volume player driven by frequent discount	Online community for mums to exchange experiences	Brand building; 100% control on product and user experience	Pin Duo Duo leverages personal networks to sell products	Limited visibility by brands	
Frequent platform-wide promotions		Consumers more sensitive to price				Critical channel to build word-of-mouth	

Source: Company reports.

Figure 8: A2M – Top 5 CBEC platforms account for ~80% of the market in China

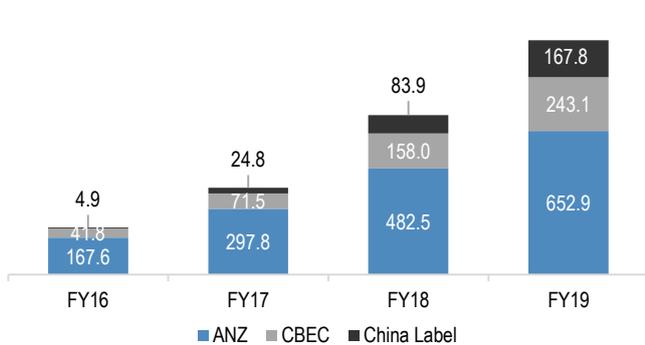
	 Tmall Global	 Kaola	 JD Worldwide	 VIP Global	 Little Red Book
Total CBEC share %	~30%	~25%	~10%	~10%	~5%
Number of bonded warehouses	34	13	17	10	2

Alibaba recently acquired Kaola and plans to integrate it with Tmall, giving Tmall a leading ~55% share of CBEC

Source: Company reports.

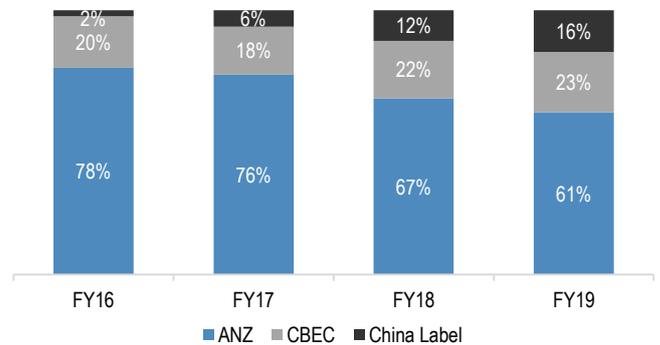
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Figure 9: A2M – Reported IMF Revenue (NZ\$m) by Channel



Source: Company reports. June year end.

Figure 10: A2M – Reported IMF Revenue Contribution (%) by Channel



Source: Company reports. June year end.

Table 4: A2M – Significant opportunities to grow within the Greater China infant category

The category dynamics remain positive, despite declining birth rates

- Household penetration and usage is increasing with growing household wealth
- Premiumisation continues as families prioritize investment in their children
- Brand fragmentation provides an opportunity for brands with a proposition that resonates with consumers

Our business is consumer-led and we have put in place systems to continue to listen, monitor and adapt

- The macro factors that have supported our growth in other markets are just as relevant in China
- We have a deep, proprietary understanding of our consumers which is sharpening our brand proposition and business model
- We have invested in data and analytics to ensure we stay ahead of evolving consumer behaviour

We are stepping up our marketing investment – following intensive learning and data infrastructure development

- The diversity of information channels that consumers engage with along the path to purchase require us to step up our marketing investment
- Primary focus is growing brand awareness – our relatively high loyalty gives us confidence in the ROI of increasing awareness and driving trial
- We are committed to testing, monitoring and iterating our approach to building brand awareness
- Our brand awareness has risen several points over the last 12 months

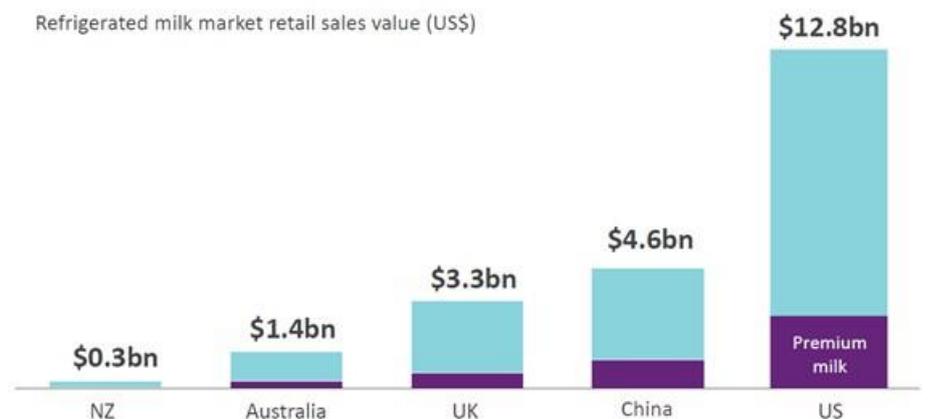
We are channel agnostic – able to stay agile and adapt to changing consumer behaviour

- The pace of change in the China retail landscape is unparalleled; we must continue to be consumer-led and channel agnostic
- Daigou will continue to grow and be an important channel option for consumers; accordingly, it will continue to be important for a2 Platinum
- Other online channels (CBEC, social e-commerce and domestic online) will also continue to collectively grow
- Beyond driving increased physical distribution, we are also focused on improving our offline execution

Source: Company reports.

United States

Figure 11: A2M – The US premium refrigerated milk market is significant



Source: Company reports, Euromonitor, World Bank, Kantar.

Table 5: A2M – Significant and attractive potential in the US market

20-25% of milk category sales are in **premium segment**
 100% of **annual growth** in premium segment driven by non-organic milk brands
 32% of total grocery spend is on **health and wellness products**
 20% of packaged goods growth is coming from **disruptive brands** at average premium of 3.9x

Source: Company reports.

Figure 12: A2M – Diverse US retail landscape creates distinct experiences for consumers



Source: Company reports.

Table 6: A2M – US market metrics improving

- Target consumers represent a significant % of category
- Velocity gains of up to 45% in established stores
- High loyalty rates
- Social media engagement is 10x the nearest competitor
- Sales have increased more than 100% CAGR over the past three years
- Continued store expansion in all major retailers due to positive early performance

The most important objective in the near term is growing brand awareness and converting to trial. This will deliver significant velocity growth and ultimately a scale business in the US.

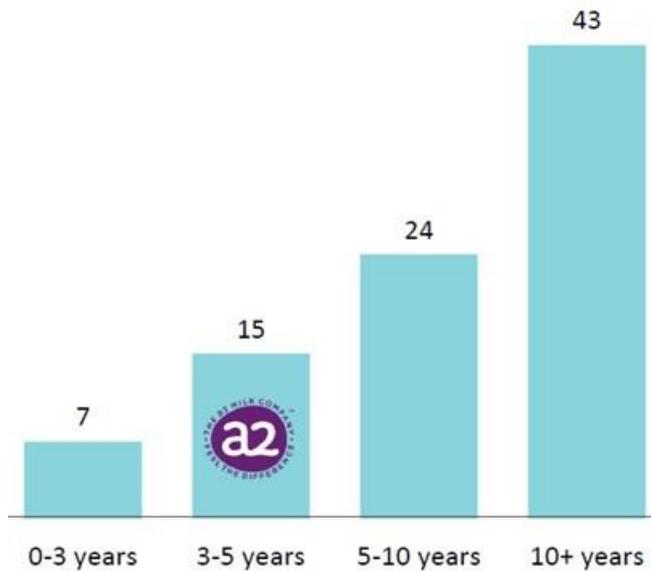
Source: Company reports.

Figure 13: A2M – Expansion of National Footprint in US



Source: Company reports.

Figure 14: A2M – Number of brands to reach US\$25m revenue by length of time from launch



Source: Company reports.

Investment Thesis, Valuation and Risks

a2 Milk Company (*Lighten*; Price Target: \$12.92)

a2 Milk Company (A2M)

Year-end Jun (NZ\$)	FY18A	FY19A	FY20E	FY21E	FY22E
Revenue (NZ\$ mn)	922	1,304	1,658	1,957	2,226
Gross margin	50.3%	54.7%	54.9%	55.4%	55.6%
EBITDA margin	30.7%	31.7%	28.1%	27.8%	27.8%
Adj. net income (NZ\$ mn)	196	288	327	384	437
Adj. EPS (NZ\$)	0.26	0.39	0.44	0.52	0.59
BBG EPS (NZ\$)	-	-	-	-	-
Reported EPS (NZ\$)	0.26	0.39	0.44	0.52	0.59
Dividend yield	0.0%	0.0%	0.0%	0.9%	1.1%
Adj. P/E	54.0	36.6	32.3	27.5	24.2
EV/EBITDA	36.3	24.5	21.2	17.4	14.8

Source: Company data, Bloomberg, Ord Minnett estimates.

Investment Thesis

- Retain Lighten.** The FY19 result was below consensus and OMLf but in-line with FY19 EBITDA margin guidance that factored in a step up in investment in 2H19. As noted in our recent initiation, A2M can expand its addressable market geographically in China infant formula and has been able to do well when competitors have threatened, leveraging the combination of product, brand, ANZ provenance, ANZ usage and deep engagement with core consumers, while it enjoys a nimble route to market. Yet FY20 guidance and surrounding management commentary has changed the shape of EBITDA growth and ROC for A2M and the investment prospects accordingly.
- Investment.** The increased investment (marketing and capability) for FY20 and beyond, without any indication of a revenue/market share target, appears to: (1) reverse a greater than expected underinvestment due to the over-reliance on daigou (and the low cost marketing provided) in China infant formula, (2) incorporate the detailed work done by A2M on how to appropriately engage in the China and US markets, with a much greater size and duration of investment required to be successful, and (3) show the initial signs of quicker than expected change in route to market with more CBEC & MBS and less daigou more EBITDA margin dilutive than expected. Further, the FY21 breakeven target in US milk has been jettisoned, with revenue growth the priority. This is consistent with the broader investment to achieve revenue growth focus, but the prospects of success in the US milk market is less certain and the competitive advantages less established, raising execution risks.
- Earnings and valuation.** Given this backdrop we recently reduced our earnings estimates in FY20 as per EBITDA margin guidance but also beyond as marketing costs are forecast to increase further as a percentage of sales (channel mix), with revenue largely unchanged as it has become more expensive to achieve. Valuation support low on a DCF (\$12.50) and P/E multiple (30.7x FY20 and 26.1x FY21 for 13% and 18% growth, respectively).

Valuation

A2M – DCF Valuation

NZ\$ & \$ in millions

	NZ\$	\$
PV of Cashflows	\$5,402	\$5,132
Terminal Value	\$3,596	\$3,416
Value of Associates	\$289	\$275
Enterprise Value (\$m)	\$9,287	\$8,823
Net debt	(\$502)	(\$477)
Valuation (\$m)	\$9,789	\$9,299
Per Share (\$)	\$13.16	\$12.50

Source: J.P. Ord Minnett.

We retain our 30 June 2020 share price target of \$12.92 per share. Our share price target is derived from our theoretical share price target, which is based on our DCF valuation, rolled forward at the cost of equity (9.7%), less forecast dividends, with a modest discount due to expected volatility in the share price of companies exposed to the China consumer. Our price target implies that A2M will trade at a ~31x FY20E P/E multiple.

Risks to Rating and Price Target

- Changes in the rate of growth in the infant formula industry in China, including volume (birth rates, kilo per capita), the rate premiumisation, competitive dynamics (including any change in terms to access the growing Mother & Baby Store, MBS, channel).
- Changes in regulation of the infant formula industry in China, especially relating to cross-border e-commerce, the daigou channel and efforts to increase domestic production.
- Competitive dynamics within the A1 free dairy category, including new scientific studies and the impact of new entrants.
- Changes in the relative appeal of A2M product to the daigou channel and changes in how inventory levels are managed.
- Any disruption of the infant formula supply chain, especially from Synlait and in the future Fonterra, including product safety.
- Changes in the timing of break even in the United States (FY21) and the quantum of losses in the United Kingdom.
- The effectiveness of how the significant level of organisational change is being managed.

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a2 Milk Company

NZ\$ in millions, year end Jun

Profit And Loss	FY18	FY19	FY20E	FY21E	FY22E	Valuation Summary					\$m	\$ps					
Revenue	922	1,304	1,658	1,957	2,226	Current mkt capitalisation					9,758.92	13.12					
Revenue growth	67.9%	41.4%	27.1%	18.0%	13.8%	Price Target						12.92					
COGS	(458)	(591)	(748)	(873)	(988)	Capital growth to price target						(1.5%)					
Operating Expenses	(182)	(300)	(445)	(538)	(620)	Trading Multiples					FY18	FY19	FY20E	FY21E	FY22E		
EBITDA	283	414	465	545	618	PE Pre-abnormals	54.0	36.6	32.3	27.5	24.2	PE Reported	54.0	36.6	32.3	27.5	24.2
EBITDA growth	100.5%	46.1%	12.5%	17.1%	13.4%	EV/EBITDA	36.3	24.5	21.2	17.4	14.8	EV/EBIT	36.6	24.7	21.3	17.5	14.9
EBITDA margin	30.7%	31.7%	28.1%	27.8%	27.8%	Key Ratios					FY18	FY19	FY20E	FY21E	FY22E		
Amortisation	(1)	(0)	(0)	(0)	(0)	Dividend Yield	0.0%	0.0%	0.0%	0.9%	1.1%	Franking	-	-	-	-	-
Depreciation	(1)	(2)	(2)	(2)	(3)	Return on Assets (%)	36.9%	33.7%	28.3%	25.6%	23.5%	Return on Equity (%)	49.1%	42.8%	34.3%	29.9%	26.9%
EBIT	281	411	463	542	615	ROIC (%)	40.6%	43.0%	47.7%	52.7%	57.4%	Leverage					
Other Income	-	-	-	-	-	Gearing (Net Debt / Equity)	NM	NM	NM	NM	NM	Gearing (ND / (ND + E))	(158.2%)	(143.9%)	(225.5%)	(331.4%)	(444.6%)
Other Expenses	-	-	-	-	-	Net Debt / EBITDA	NM	NM	NM	NM	NM	EBIT Interest Cover (x)	(118.6)	(96.2)	(109.6)	(79.0)	(64.7)
Net Interest	2	4	4	7	10	Balance Sheet					FY18	FY19	FY20E	FY21E	FY22E		
Pre-Tax Profit	283	416	467	549	624	Cash	340	465	774	1,119	1,462	Receivables	59	53	69	71	70
Tax	(88)	(128)	(140)	(165)	(187)	Investments	-	-	-	-	-	Inventories	64	108	103	117	129
Tax Rate	30.9%	30.8%	30.0%	30.0%	30.0%	Other Current Assets	36	50	50	50	50	Total Current Assets	500	676	996	1,358	1,710
Minorities	0	0	0	0	0	Net PPE	10	10	11	12	13	Total Intangibles	15	13	14	15	16
Abnormals (post tax)	0	0	0	0	0	Other Non Current Assets	192	294	297	297	297	Total Non Current Assets	217	318	322	323	325
Reported NPAT	196	288	327	384	437	Total Assets	716	993	1,317	1,681	2,036	Creditors	109	160	155	178	199
Normalised NPAT	196	288	327	384	437	Current Borrowings	0	0	0	0	0	Current Tax Provisions	51	44	44	44	44
Growth	115.9%	47.0%	13.6%	17.6%	13.7%	Other Current Provisions	0	0	0	0	0	Other Current Liabilities	1	1	1	1	1
End of Period Shares	730	735	735	735	735	Total Current Liabilities	160	205	200	224	244	Non Current Creditors	0	0	0	0	0
EFPOWA	744	742	744	744	744	Non Current Borrowings	0	0	0	0	0	Non Current Tax Liabilities	0	0	0	0	0
Reported EPS	0.27	0.39	0.44	0.52	0.59	Other Non Current Provisions	-	-	-	-	-	Other Non Current Liabilities	0	0	0	0	0
Normalised EPS	0.26	0.39	0.44	0.52	0.59	Other Non Current Liabilities	0	0	0	0	0	Total Non Current Liabilities	0	0	0	0	0
Growth	114.0%	47.4%	13.3%	17.6%	13.7%	Total Liabilities	161	206	200	224	244	Equity	142	144	144	144	144
DPS	0.00	0.00	0.00	0.13	0.15	Other Equity	0	0	0	0	0	Reserves	123	65	67	67	67
Growth	-	-	-	-	15.4%	Reserves	123	65	67	67	67	Retained Profits	291	578	905	1,245	1,579
DPS/EPS payout	0.0%	0.0%	0.0%	25.2%	25.5%	Outside Equity Interests	-	-	-	-	-	Total Shareholders Equity	556	788	1,117	1,457	1,791
Cash Flow Statement						FY18	FY19	FY20E	FY21E	FY22E	Net Debt	(340)	(465)	(774)	(1,119)	(1,462)	
Net Profit for Cashflow	196	288	327	384	437	Source: Company reports and Ord Minnett estimates.											
Depreciation & Amortisation	2	2	2	3	3												
Non Cash Items	-	-	-	-	-												
Working Capital Changes	(96)	(3)	(16)	7	11												
Other Operating Cashflows	129	2	0	0	0												
Cashflow from Operating Activities	231	289	313	394	451												
Capex	(5)	(3)	(4)	(4)	(5)												
Net Acquisitions	0	0	0	0	0												
Other Investing cashflows	0	0	0	0	0												
Investing Cash Flow	(21)	(166)	(4)	(4)	(5)												
Inc/(Dec) in Borrowings	0	0	0	0	0												
Equity Issued	7	3	0	0	0												
Dividends Paid	-	-	-	-	-												
Other Financing Cashflows	0	0	0	(44)	(103)												
Financing Cash Flow	7	3	0	(44)	(103)												
Net Cash Flow	219	124	309	345	343												

Source: Company reports and Ord Minnett estimates.

Please contact your Ord Minnett Adviser for further information on our document.

Guide to Ord Minnett Recommendations

Our recommendations are based on the total return of a stock – nominal dividend yield plus capital appreciation – and have a 12-month time horizon.

SPECULATIVE BUY	We expect the stock's total return (nominal yield plus capital appreciation) to exceed 20% over 12 months. The investment may have a strong capital appreciation but also has high degree of risk and there is a significant risk of capital loss.
BUY	The stock's total return (nominal dividend yield plus capital appreciation) is expected to exceed 15% over the next 12 months.
ACCUMULATE	We expect a total return of between 5% and 15%. Investors should consider adding to holdings or taking a position in the stock on share price weakness.
HOLD	We expect the stock to return between 0% and 5%, and believe the stock is fairly priced.
LIGHTEN	We expect the stock's return to be between 0% and negative 15%. Investors should consider decreasing their holdings.
SELL	We expect the total return to lose 15% or more.
RISK ASSESSMENT	Classified as Lower, Medium or Higher, the risk assessment denotes the relative assessment of an individual stock's risk based on an appraisal of its disclosed financial information, historical volatility of its share price, nature of its operations and other relevant quantitative and qualitative criteria. Risk is assessed by comparison with other Australian stocks, not across other asset classes such as Cash or Fixed Interest.

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