

The a2 Milk Company

OUTPERFORM

Conviction List stock

Growing Pains — the Revenue / Margin Conundrum

The recent de-rate in The a2 Milk Company (ATM) reflects a deterioration in market confidence and re-base in costs, however looking through the 'digestion period' we continue to see a favourable risk/reward profile. We expect volatility to continue to be a feature for investors. Stepping back from this, we are attracted to ATM's long-term growth opportunity, strong free cashflow and undemanding valuation metrics. **OUTPERFORM.**

What's changed?

- **Earnings:** FY20/21/22E NPAT revised -4%/-9%/-5% underpinned by a flatter EBITDA margin profile (FY21E amplified by FX) and slightly slower near-term revenue growth path.
- **Target Price:** NZ\$17.00 (from NZ\$17.50).
- **Rating:** OUTPERFORM.

Another look at the ATM investment case; retain OUTPERFORM

- At current levels, we don't believe valuation is overly challenging given:
 - Valuation attraction vs the NZ market and peers – with ATM trading at a 12m forward EV/EBIT of ~15x (ex. cash, SML stake and US losses).
 - Recent Bellamy's takeover at a significant premium.
 - Our analysis indicates the market is only pricing a low single-digit profit growth outlook and 10yr market share reaching c. 6.5% in the China Infant Formula (IF) market.
 - ATM penetration still low in a large (and growing) addressable market.
- ATM remains a newsflow driven stock. We see modest downside risk to consensus expectations in the short-term due to:
 - An ongoing 'digestion period' as consensus expectations reset to reflect the shift in strategy and re-set in the cost base.
 - Resurgence in domestic brands, particularly Feihe.
 - Risk ATM's 4m20 revenue growth is below market FY20 expectations following our recent channel checks. While supportive to growth, the quantum of growth varies considerably across sources and there are signs of slowing ahead of the key Singles Day period (November). We acknowledge there is a high margin of error and wholesale price growth (c. +9%), revenue recognition timing and other avenues (Stage 4, Smart Nutrition and the US) also helps to provide some buffer.

We would see any share price weakness as an attractive entry opportunity. The vacuum of information and targets from management has not helped share price volatility or investment sentiment.

Investment View

We are attracted to the opportunity for ATM in existing markets in addition to new markets and products — with ATM currently only scratching the surface of a material market opportunity. Valuation outcomes are wide, but in our view current valuation metrics offer a favourable risk/reward, particularly when adjusted for loss-making markets. **OUTPERFORM.**

NZX Code	ATM
Share price	NZ\$12.93
Target price	NZ\$17.00
Risk rating	High
Issued shares	733.1m
Market cap	NZ\$9,480m
Average daily turnover	806.1k (NZ\$10,947k)

Share Price Performance



Financials: June	19A	20E	21E	22E
NPAT* (NZ\$m)	287.7	325.8	410.5	505.0
EPS* (NZc)	38.8	43.9	55.3	68.1
EPS growth* (%)	47.4	13.2	26.0	23.0
DPS (NZc)	0.0	0.0	16.6	20.4
Imputation (%)	100	100	100	100
Valuation (x)	19A	20E	21E	22E
EV/EBITDA	21.4	18.5	14.5	11.8
EV/EBIT	21.5	18.6	14.5	11.8
PE	33.3	29.4	23.4	19.0
Price / NTA	12.2	8.6	6.5	n/a
Cash dividend yield (%)	0.0	0.0	1.3	1.6
Gross dividend yield (%)	0.0	0.0	1.8	2.2

*Historic and forecast numbers based on underlying profits

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The Revenue / Margin Conundrum

ATM's Investor Day in Shanghai made three things clear:

- **Management's focus on the long-term**, not chasing short-term profit or managing to a margin outcome.
- The **magnitude of the opportunity** for the brand — with ATM currently only scratching the surface of its potential market.
- **“Stepping it up” around costs** — which will constrain margins near-term.

However, the lack of specifics has created more uncertainty with a dislocation between market confidence and that of management.

Long-term: revenue prize material; recently re-based margin outlook

We believe there is a material opportunity for ATM over the medium to longer-term and that the company is putting in the right strategy/tools to execute on this.

- **Revenue:** Large addressable market and ATM is still only scratching the surface.
- **Margins — a new base:** The recent re-base in cost/margin expectations has flattened our near-term EBITDA margin outlook to ~28%. Interestingly this level is consistent with our original long-term expectations for margins (pre ATM's new management) – with the cost re-base simply earlier than we anticipated. From here, our analysis points to a broadly flat medium-term margin profile – with upside risk from IF gross margins and US scale; downside risk from product mix and a continued step-up in marketing, technology and people.

Short-term – positive growth, albeit risk to consensus appears downside skewed

Short-term indicators are supportive to growth, albeit quantum varies considerably across sources and there are signs of slowing ahead of the key Singles Day period (November). Acknowledging a high margin of error, based on recent channel checks we see risk as downside skewed to near-term consensus expectations.

Recapping the investment case: look through ‘digestion period’; OUTPERFORM

ATM is a unique growth story in the NZ market with material optionality and runway ahead, a large (and growing) cash position and highly attractive returns. Nonetheless, the market remains focussed on the near-term trajectory and we are going through a period of ‘digestion’ as consensus expectations reset to reflect the shift in strategy. Recent revenue indicators are mixed and we see risk the next newsflow (ASM on 19 November) may disappoint vs expectations. The vacuum of information and targets from management has also not helped share price volatility or investment sentiment. Nonetheless, looking through any volatility we view current valuation metrics as undemanding in light of an attractive structural growth story with material optionality, even without adjusting for the loss-making US market (an option on future growth). Management's decision to focus on building its brand and future-proofing growth should also yield dividends long-term.

What is the market pricing?

Low single-digit profit growth

Back-solving market expectations from the current price implies future growth of +2–4% for ATM, detailed in Figure 1. While we can debate at length what an ‘appropriate’ growth profile is, our expectation is well ahead of what is being factored in by the market.

Figure 1. Implied future growth using current market pricing (NZ\$m)

	FY19A	FY20E	FY21E	FY22E
NPAT - as reported	288	326	411	505
NPAT - ex US losses	319	361	442	532
Adj. market cap*	8,728	8,728	8,728	8,728
Ke	8.1%	8.1%	8.1%	8.1%
Implied future growth	4.8%	4.4%	3.4%	2.3%
Implied future growth (ex US)	4.5%	4.0%	3.1%	2.0%

Source: Forsyth Barr analysis *Current market cap less its cash balance and stake in Synlait Milk (SML NZ)

6.5% IF market share in 10yrs

Taking this one step further — assuming flat EBITDA margins (28.2%) and using implied future growth from Figure 1, our analysis suggests the market is pricing IF market share of ~6.5% in 10 years, vs. ATM's current share of ~4%.

Figure 2. Implied long-term market share of China IF market at current price

	FY19A	FY20E	Growth CAGR*	Yr 10
EBITDA	414	465	4.4%	714
Margin	31.7%	28.2%		28.2%
Revenue	1,304	1,648		2,532
...IF revenue (total)	1,064	1,349		2,168
...Other revenue	240	299	2.0%	364
China IF market - NZ\$	38,462	40,385	2.0%	49,229
ATM IF (China) - retail revenue	1,545	1,958		3,147
Implied ATM market share	4.0%	4.8%		6.5%

Source: Forsyth Barr analysis *Derived from Figure 2

Valuation attractive versus peers

Valuation metrics are attractive vs peers, history and an expensive market, particularly given strong free cashflow, a large net cash position and its growth potential. ATM is trading at a 12 month forward PE of 27x. This lowers to 22x adjusting for ATM's cash position, stake in Synlait Milk and US losses, which compares favourably to the NZ market weighted average of 23.2x.

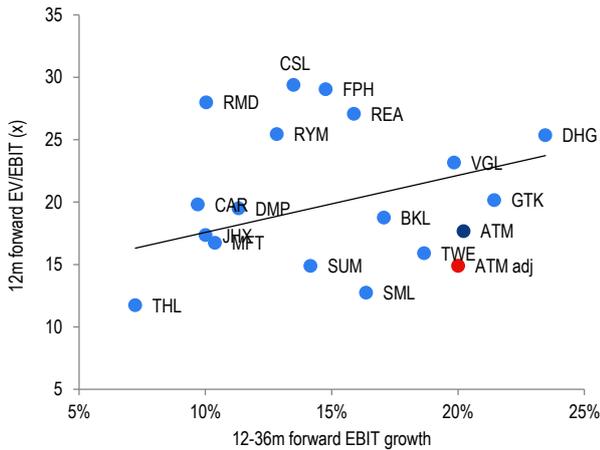
The recent takeover offer for peer Bellamy's (at FY20E/21E bid multiples: EV/EBITDA 27x/21x and PE 46x/36x) also provides support and reinforces the attractiveness/value of the a2 brand, particularly given further industry consolidation is likely in China.

Figure 3. Adjusted valuation metrics

	As reported	Ex US	Ex cash, SML & US
12m fwd EV/EBITDA	17.2x	15.8x	15.2x
12m fwd EV/EBIT	17.3x	15.8x	15.3x
12m fwd PE	27.4x	24.7x	22.1x

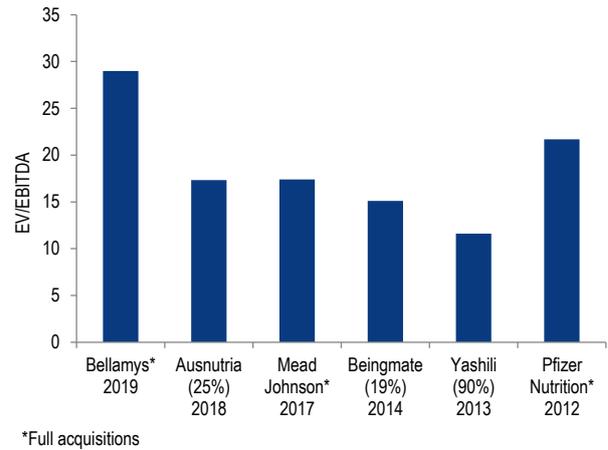
Source: Forsyth Barr analysis

Figure 4. EV/EBIT versus growth – Australasian growth peers



Source: Forsyth Barr analysis, Bloomberg *ATM adj for US losses, cash and SML stake

Figure 5. EV/EBITDA implied multiples from recent M&A



Source: Forsyth Barr analysis, Bloomberg

Earnings revisions

We have made modest downgrades to our near-term forecasts, underpinned by lower margins and taking a slightly more conservative view on near-term revenue. FY21E is amplified by some currency movements.

Over our longer-term explicit forecast horizon more modest expectations around new markets is largely offset by higher expectations for core markets. We retain our view that ATM can achieve 10% market share of the China IF market longer-term, however, expect the company to spend more in the near-term before we see economies of scale.

Figure 6. Earnings revisions

NZ\$m	FY20E			FY21E			FY22E		
	Old	New	% chg	Old	New	% chg	Old	New	% chg
Revenue	1,683.6	1,647.9	-2.1%	2,153.2	2,061.9	-4.2%	2,495.7	2,491.2	-0.2%
EBITDA	485.5	464.6	-4.3%	643.7	583.2	-9.4%	755.8	715.5	-5.3%
Underlying profit	340.4	325.8	-4.3%	452.8	410.5	-9.3%	533.5	505.0	-5.3%
Underlying EPS (cps)	45.9	43.9	-4.3%	61.0	55.3	-9.3%	71.9	68.1	-5.3%
Dividend (cps)	0.0	0.0	n/a	18.3	16.6	-9.3%	21.6	20.4	-5.3%

Source: Forsyth Barr analysis

Delving into revenue indicators / opportunity

ATM's recent investor messaging shows a growing focus on revenue over margins. The range of scenarios for ATM to leverage its brand is extensive, however, near-term priorities are its 'core business', namely:

- **China/ANZ IF:** Underpenetrated in a large and growing market, particularly in the offline / MBS (Mother & Baby Stores) channel. ATM's market share of total China IF is c. 4%, predominantly built through daigou and online channels.
- **US:** An underappreciated opportunity. We expect it to remain a drag on group EBITDA in the short to medium-term as scale is built; however, the prize is meaningful and upside risk exists from any new product introduction/success.

Looking at near-term indicators, our analysis and channel checking is supportive of growth for ATM - although indicators are mixed by channels and showing considerable monthly volatility. We see risk ATM's 4m19 trading update is below market expectations, although wholesale price growth (c. +8%), revenue recognition timing and other avenues (Stage 4 / Smart Nutrition) help to provide some buffer.

ATM's defined 'success measures' revenue centric

Three of ATM's four 'success measures' are centered on top-line drivers (absolute revenue growth, brand awareness, share of category), with only one around profit / margin (high gross margins by category). Quantums or targets are not disclosed.

China/ANZ IF — still plenty of room to grow

Channel checking is becoming more challenging as ATM expands further into offline MBS stores and as the company's product/supply chain becomes more diversified.

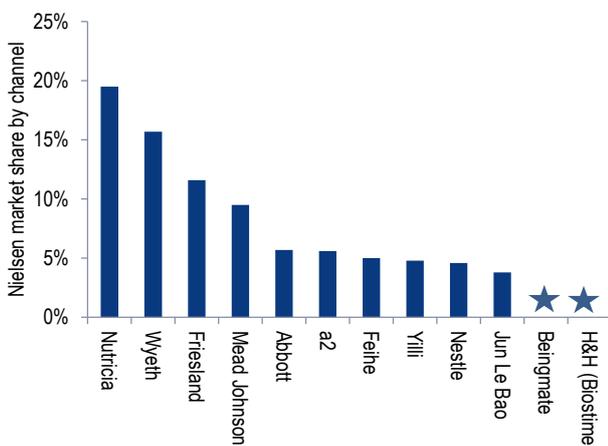
The key trend that is evident in our channel checks is a resurgence in momentum for domestic brands (particularly Feihe), which looks to be at the expense of the large multi-nationals and smaller brands. We also note that Alibaba platforms are potentially seeing some pressure from heightened discounting by smaller platform, Pinduoduo.

Recent data points for ATM show growth, albeit some signs of slower growth.

Still underpenetrated, particularly in MBS

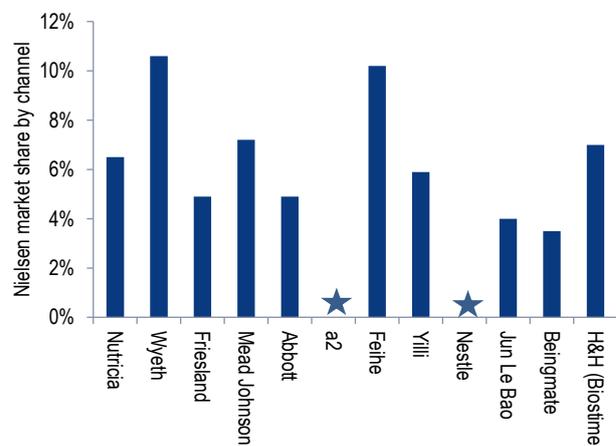
MBS remains the key channel for IF (c. 55–60% of the market) and continues to grow strongly. Comparisons to other IF brands suggest opportunities for ATM through both broader store rollout and sales per store. Nielsen data suggests its market share is <2% in MBS. Market penetration is higher in other channels (including online at 5.6%), however, these still also offer opportunity in our view.

Figure 7. Market share by channel for key players – online*



Source: Forsyth Barr analysis, Nielsen * NB: A 0% means the brand is outside of top 10 and <3% share

Figure 8. Market share by channel for key players – MBS*



Source: Forsyth Barr analysis, Nielsen * NB: A 0% means the brand is outside of top 10 and <3% share

Dissecting port data

Lyttelton Port IF export data provides one insight into ATM volumes given principal supplier, Synlait (SML), is the key IF manufacturer exporting through Lyttelton and we estimate ATM is ~90–95% of Lyttelton volume. However, read through is becoming even more opaque as ATM diversifies its products (Stage 4 and Smart Nutrition are included in a different category which is more crowded) and SML continues to package more from its Auckland facility (the mix can vary in any given month and ATM is not the only IF brand shipped from Auckland).

The other key consideration is channel mix revenue recognition timing — particularly as ATM continues to see strong growth in MBS. Our understanding is that ATM reports a sale FOB (free on board; i.e. when on the ship) for both the daigou and cross border ecommerce (CEBC) channels. In contrast, for MBS China label the lag time is considerably longer — we estimate c. two months from when the ship leaves port to revenue recognition. This is particularly important given a very strong May 2019 for shipments to China.

Putting this altogether, our analysis suggests volume growth is tracking ~16% depending on revenue recognition. History has shown this analysis has been far from perfect (and the time period chosen does currently make a material difference), but the addition of Stage 4 products and/or Auckland help to provide a buffer.

Figure 9. Export volumes for ATM's YTD (FB estimates)

Destination	Time period	Lyttelton Port Stage 1-3	Lyttelton Port Stage 4	Auckland Port Stage 1-3	Auckland Port Stage 4
<u>Volume (000 MT)</u>					
Australia (daigou proxy)	Jul - Sep 19	3,501	682	4,386	59
Hong Kong (CEBC proxy)	Jul - Sep 19	2,246	216	0	1
China – no lag	Jul - Sep 19	1,969	1,901	23	18
China – 2m lag	May - Sep 19	3,761	3,564	23	31
<u>YoY growth</u>					
Australia (daigou proxy)	Jul - Sep 19	5.5%	904.2%	305.3%	-92.1%
Hong Kong (CEBC proxy)	Jul - Sep 19	31.0%	301.3%	n/a (0 in pcp)	n/a (0 in pcp)
China – no lag	Jul - Sep 19	4.5%	-9.0%	n/a (0 in pcp)	n/a (0 in pcp)
China – 2m lag	May - Sep 19	51.2%	6.1%	1438.7%	n/a (0 in pcp)
Weighted average growth (by ATM channel mix)		~16%*			

Source: Forsyth Barr analysis, Statistics NZ *Depends on China revenue recognition

Channel checks and recent data points for ATM — positive growth, mixed across channels

- **Wholesale price increases for FY20 of c. +6%.** 4m20 will be cycling a period with only partial contribution from the 2018 price increase, hence, will benefit from average price increases of c. +9%.
 - 2019: Weighted price increase of +6.1% (ranging from +4–7% across Stages 1–4), effective from 1 July 2019.
 - 2018: Weighted price increase of +5.1% (flat for Stages 1 & 2, +7% for Stage 3, +4% for Stage 4), effective from 1 September 2018.
- **Category growth c. +4–5%, with outperformance in premium segment.**
 - Multi-national results remain mixed within the IF category (Figure 10). Within the disclosures, various comments reinforce premium brands are outperforming. Comments also point to a resurgence in local brands (particularly Feihe).
 - Commentary reinforces a competitive market backdrop. Premiumisation continues to outweigh pressure from lower birth rates — industry participants are quoting category growth of c. +3–5% (Danone) or c. +4–6% (Ausnutria).
 - The daigou channel is under pressure; however, strong growth is being signalled in CBEC and MBS.

Figure 10. Recent quarterly YoY revenue growth – IF segment only

Company	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19
Danone	7%	4%	-6%	-2%	1%	2%	11%
Nestle	3%	8%	7%	6%	2%	-4%	-3%
Ausnutria	80%	70%	20%	85%	54%	10%	42%
Abbott	1%	13%	4%	0%	2%	1%	2%

Source: Forsyth Barr analysis, Company releases

■ **Retail pricing broadly stable; Pinduoduo's loss-leading pricing is concerning.**

- Tightly managing retail pricing is critical to success to ensure various channel economics are maintained and that all players through the supply chain are making sufficient margin to continue pushing a product.
- Pinduoduo (PDD) is China's third largest ecommerce platform, which has seen rapid growth since creation in 2015 — now with 483m active users (vs. Alibaba at 700m). However, this has been built on material price discounting (helped by group buying). PDD is offering a2 Platinum at c. 20% discount to other platform prices. While we expect this is supportive to volumes (and it does not impact ATM's wholesale price), it does raise concerns given pricing is now cheaper than master daigou — creating channel imbalance. We understand ATM is addressing this (starving PDD of inventory), however, will be watching closely to ensure this does not become an issue.
- Pricing is broadly stable elsewhere over the past quarter. Our pricing analysis also shows a number of out of stock points across various ecommerce platforms for English label product.

Figure 11. FB pricing analysis by channel / platform

English label (A\$/tin)	Stage 1	Stage 2	Stage 3
Daigou (Taobao avge)	51.0	51.0	48.2
Master Daigou - Andy	37.5	39.0	33.5
Pinduoduo	33.8	37.6	33.8
Other ecommerce platforms	43.8	45.4	43.3

Source: Forsyth Barr analysis, Various websites

■ **MBS feedback — strong results in Bebemax.**

- Bebemax (Aiyingshi) is a listed MBS chain store owner, with ~270 stores predominantly in Tier 1 and 2 cities. It is growing rapidly, although is still small in the context of China (100,000 MBS stores).
- Our checks suggest ATM is now offering an attractive margin (vs. not doing so around one year earlier) to the MBS owner and particularly relative to the 'big 4 brands'. We expect this is a key factor in revenue outperformance for a2 in Bebemax at +120% YoY growth versus IF category growth of +18% (Figure 15).

■ **Sentiment / social trends favourable.**

- A2 Platinum in the three top selling products on master daigou, Andy's, website.
- Wechat index shows interest remains attractive/high for a2 (Figure 14). This index integrates search and browsing behaviour data on Wechat.
- "Indexing at more than 20x any other IF on social networks" according to ATM.

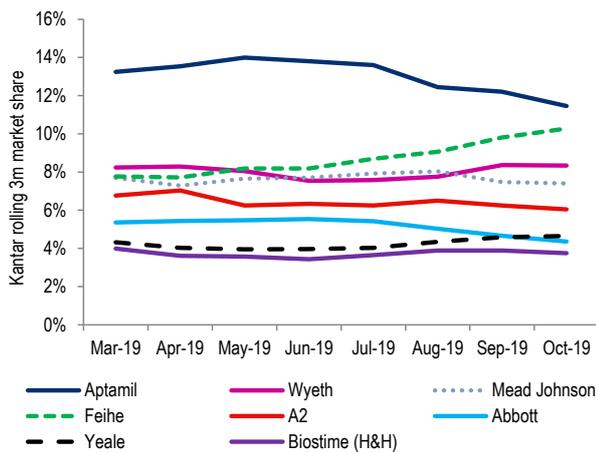
■ **Kantar — surge in local brands clear, ATM broadly stable (Figure 12).**

- October market share ~6.0% (by value), 3m rolling ~6.0%, 10m rolling ~6.4%. The data is volatile from month to month, albeit is broadly stable vs. ATM's disclosure of 6.4% as at June 2019 (rolling 12m), although recent months have been slightly weaker.
- Kantar's China Baby Panel monitors shopper patterns across a sample of 2,000 young mothers across Tier 1 and Key A–D cities. It should capture IF purchases regardless of the channel, however, is still a small sample size (2,000 consumers vs China's birth rate of 15m in 2018, or 3yr cumulative of 50.9m).
- Our analysis suggests the Kantar data covers a market of ~US\$10bn versus the Chinese IF market of ~US\$25bn.

■ **Alibaba data shows October weakness, aligning with PDD pricing behaviour.**

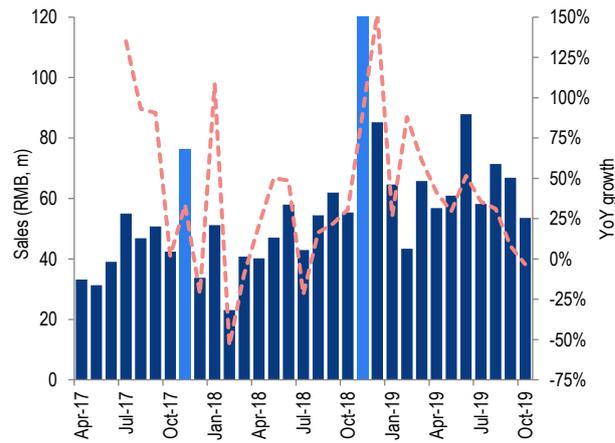
- ATM sales through Alibaba platforms continue to outpace the market. Monthly data can be highly volatile (and only captures a sample of China ecommerce sales), however, October was particularly weak (ATM -3%, IF category -8% YoY). Interestingly this aligns with PDD's pricing behaviour, however, it is difficult to discern if these are correlated and it is a one month data point.
- ATM sales are up +17% (in value) YoY from June to October or +12% from July to October and market share is tracking at 8–9%. This is weaker than we would like. Taking aside November (Singles Day), June 2019 was the strongest month on record, with August and September also in the top 5, however, October was weak and YoY growth is showing a weakening trend.

Figure 12. Kantar rolling 3m market share for key players



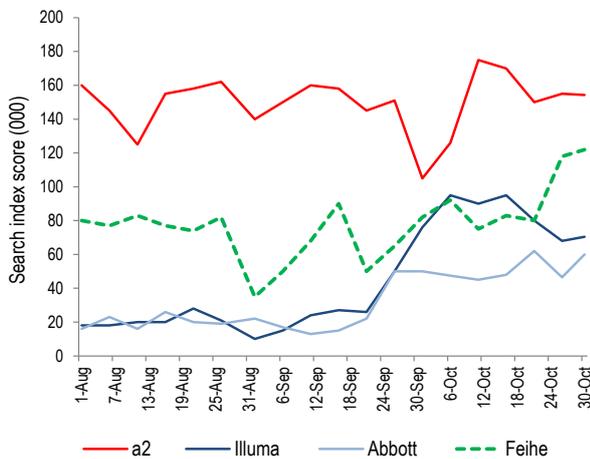
Source: Forsyth Barr analysis, Kantar

Figure 13. Alibaba platform sales



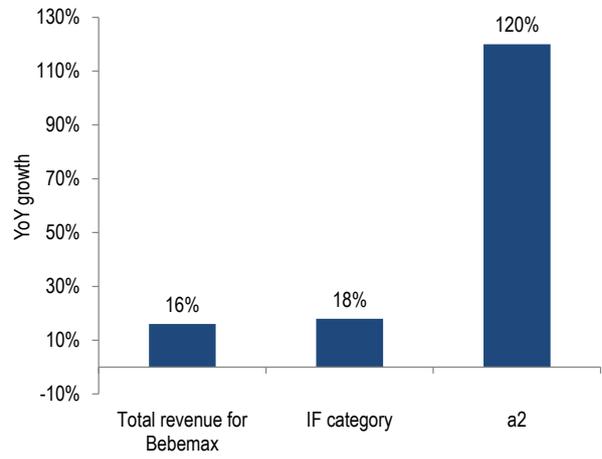
Source: Forsyth Barr analysis, Alibaba (Tmall and Taobao)

Figure 14. WeChat sentiment index



Source: Forsyth Barr analysis, WeChat

Figure 15. Revenue growth for Bebemax (~300 MBS stores)



Source: Forsyth Barr analysis, Bebemax

US — building a liquid milk platform into households

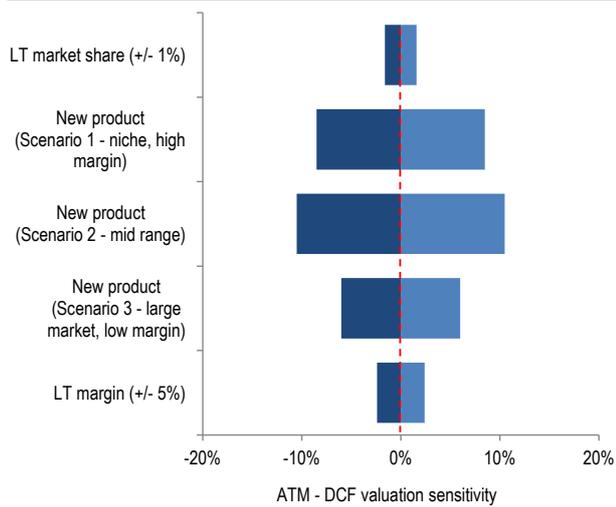
The US is a material opportunity for ATM, in our view, and one we continue to believe investors may underappreciate. While we appreciate its foray into liquid milk is best described as mixed, recent indicators, anecdotes and market attributes in the US appear more comparable to the successful Australian market versus the unsuccessful UK, in our view. Nonetheless, we expect it to remain a drag on group profitability in the short to medium-term (with this accelerating in FY20E), while the company focusses on increasing penetration.

Clear focus on revenue; unlikely to change any time soon

ATM is in a ramp-up phase, with the key priorities being to increase its points of presence and sales velocity (via increased awareness). While a drag to profitability near term, as penetration improves these costs will be fractionalised. It is unclear when the trigger point will be, however, we don't forecast break-even until FY25E.

We see the key area of upside risk to our base case would be ATM introducing any new product to better leverage costs, particularly brand investment (Figure 16).

Figure 16. DCF sensitivity to key assumption set in US



Source: Forsyth Barr analysis

Figure 17. New packaging – standard milk

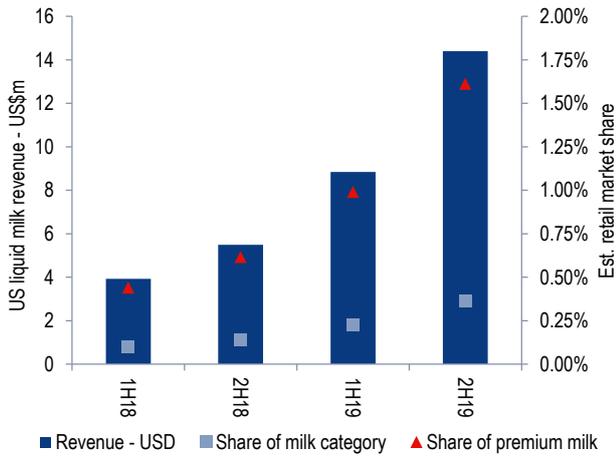


Source: Forsyth Barr analysis

Key features of the US — early days but favourable characteristics

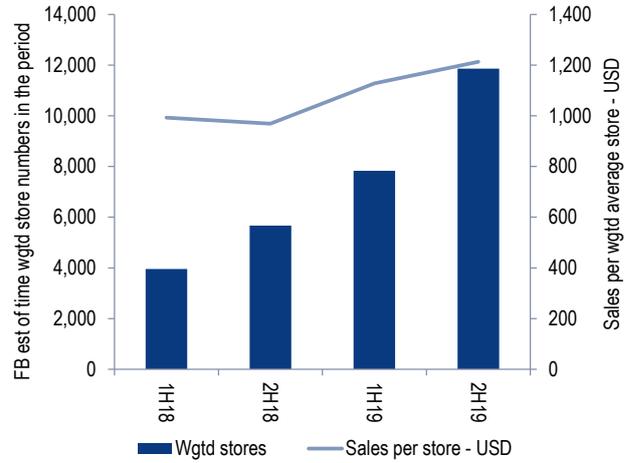
- **Progress to date:** We derive estimated market share for ATM at c. 0.35% of the US\$13bn US milk market (c.1.6% of the premium segment). This has been largely built over the last two years, following market re-entry in mid-2015. US revenue has seen a >+100% CAGR over the past three years driven by:
 - Distribution gains: This has been the key driver to date — with a rapid lift over the past two years (Figure 19). We expect this to remain the case near-term.
 - Sales velocity: This is difficult to assess given the rapid pace of distribution. Our analysis suggests velocity is still low on a per store basis, albeit has seen a pick-up over FY19. While unlikely to be exact, we derive +14/+25% growth in 1H19/2H19. ATM discloses "gains of up to +45% in established stores".
- **New packaging to hit shelves:** Alongside a new communication campaign, to launch during FY20.
- **Recent coffee creamer introduction is a natural extension:** Coffee creamer (launched July 2019) is a natural extension to leverage a liquid milk offering in the US, opening access to a c. US\$3bn market.
- **Specialty category outperforming:** Like most dairy markets globally, the specialty segment is strongly outperforming other liquid milk categories.
- **Further new products:** It is evident other products will be launched in time to better leverage the brand and platform into households created by liquid milk. While infant formula or everyday dairy products may seem obvious next steps, we view nutritional powders as more attractive.
- **Favourable brand indicators:**
 - Strong loyalty rates: >50% won't buy another product when a2 is not available.
 - Favourable social media engagement: ATM measures this to be 10x its nearest competitor.
 - Growing distribution presence: Having met retailer targets "in every case" which has seen expanded distribution.
 - Drawing people from all milk categories.

Figure 18. US liquid milk revenue and est. market share



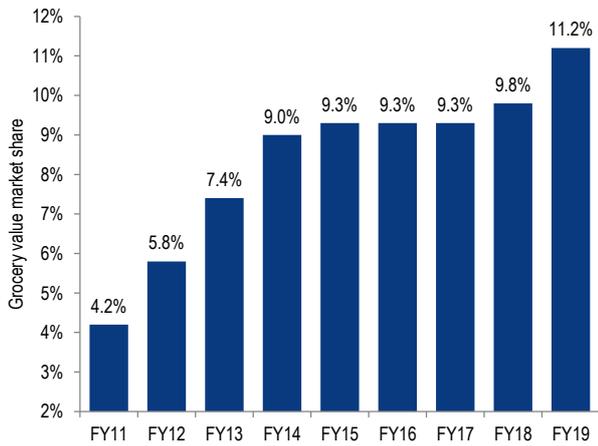
Source: Forsyth Barr analysis, Company reports

Figure 19. Wgtd average store distribution & sales velocity



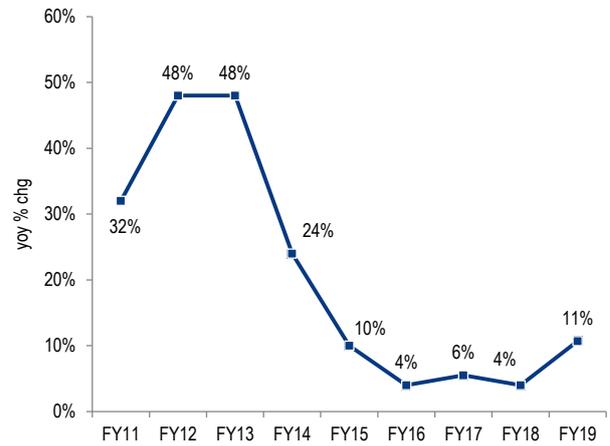
Source: Forsyth Barr analysis

Figure 20. ATM grocery market share gains continue in Australian fresh milk



Source: Company reports, Forsyth Barr analysis

Figure 21. Successful AU market keeps on giving - a recent uptick in fresh milk revenue growth



Source: Company reports, Forsyth Barr analysis

Costing more or accelerating the prize?

ATM's message of "stepping it up" around costs is clear — with the company investing aggressively across a number of areas including marketing, terms to customers, loyalty schemes, IT and online. The objective is (1) strengthening the brand, (2) expanding reach / distribution and (3) lifting throughput. Data-driven and market-specific decision making provides some comfort in the step-change being made.

What is less clear — is the cost to do business rising or will this accelerate the prize? We believe the answer is a combination; however, the market is only focussed on the lift in costs, without considering any benefit to revenue, particularly from a lift in marketing.

The recent re-base in cost/margin expectations has flattened our near-term EBITDA margin outlook to ~28%. From here, our analysis points to a broadly flat medium-term margin profile – with upside risk from IF gross margins and US scale; downside risk from product mix and a continued step-up in marketing, technology and people.

ATM FY20 guidance

ATM has guided to flat gross margins YoY (~54.7%) and a ~350bp contraction in EBITDA margins (to ~28.2%). Of this, just under half (~160bp) reflects a step-change in marketing spend, with the balance less clear.

Figure 22 runs through our estimated breakdown of key cost lines.

Figure 22. Breaking down FY20

NZ\$m	1H19	2H19	FY19	FY20 consensus*			Using consensus average		
				Low	Mean	High	\$ chg	Growth on pcp	Growth on 2H run-rate
Revenue	613.1	691.4	1,304.5	1,600.0	1,671.0	1,743.0	366.5	28.1%	20.8%
Gross Profit	340.6	373.1	713.8	875.2	914.0	953.4	200.3	28.1%	22.5%
Gross Margin	55.6%	54.0%	54.7%	54.7%	54.7%	54.7%			
Marketing	(45.5)	(89.8)	(135.3)	(192.0)	(200.5)	(209.2)	(65.2)	48.2%	11.7%
as % of revenue	-7.4%	-13.0%	-10.4%	-12.0%	-12.0%	-12.0%			
Distribution	(14.8)	(16.5)	(31.3)	(38.4)	(40.1)	(41.8)	(8.8)	28.1%	21.8%
as % of revenue	-2.4%	-2.4%	-2.4%	-2.4%	-2.4%	-2.4%			
Gross contribution	280.3	266.9	547.2	644.8	673.4	702.5	126.3		
as % of revenue	45.7%	38.6%	41.9%	40.3%	40.3%	40.3%			
Total overheads	(61.9)	(71.7)	(133.6)	(193.6)	(202.2)	(210.9)	(68.7)	51.4%	41.1%
EBITDA	218.4	195.2	413.6	451.2	471.2	491.5	57.6	13.9%	20.7%
as % of revenue	35.6%	28.2%	31.7%	28.2%	28.2%	28.2%			
<u>Breaking down overheads</u>									
Professional services	(10.3)	(17.3)	(27.6)						
Legal fees	(1.4)	(3.5)	(4.9)						
Admin employees	(21.5)	(24.2)	(45.7)						
Variable employee & services	(33.2)	(45.1)	(78.3)	(128.0)	(133.7)	(139.4)	(55.4)	70.8%	48.3%
as % of revenue	-5.4%	-6.5%	-6.0%	-8.0%	-8.0%	-8.0%			
Other overheads (pre abn)	(21.8)	(23.5)	(45.2)	(60.6)	(63.5)	(66.5)	(18.3)	40.4%	35.3%
as % of revenue	-3.6%	-3.4%	-3.5%						
Abnormals	(6.9)	(3.1)	(10.0)						

Source: Forsyth Barr analysis, Company reports *Consensus revenue used, along with ATM guidance around EBITDA margin and marketing spend

EBITDA margin — an output not an input

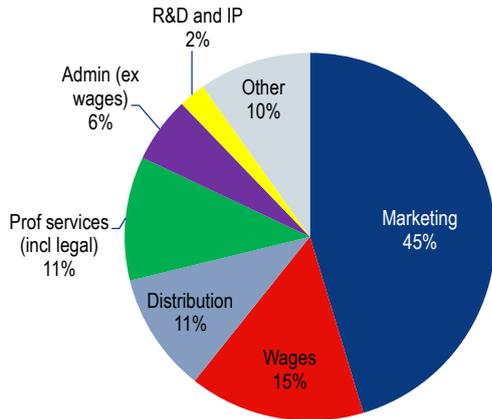
EBITDA margin for any consumer business should be an output as a function of (1) revenue, (2) gross margins (by category and also impacted by mix) and (3) SG&A cost lines. Hence, our surprise at ATM's decision to provide margin guidance in isolation.

Breaking down the key costs

In our view the channels to market in China are not discrete and costs aren't either. Hence, we look at costs in aggregate (or across its IF business where possible).

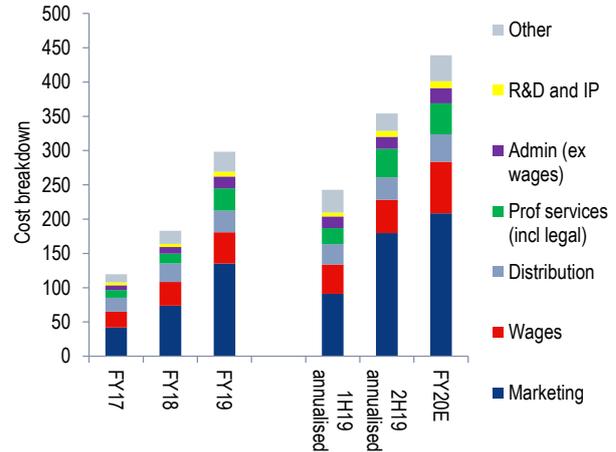
We see upside opportunity in gross margins versus peers, while expect ATM will need to continue to invest in staff and marketing which constrains EBITDA margins near-term.

Figure 23. FY19 SG&A cost breakdown



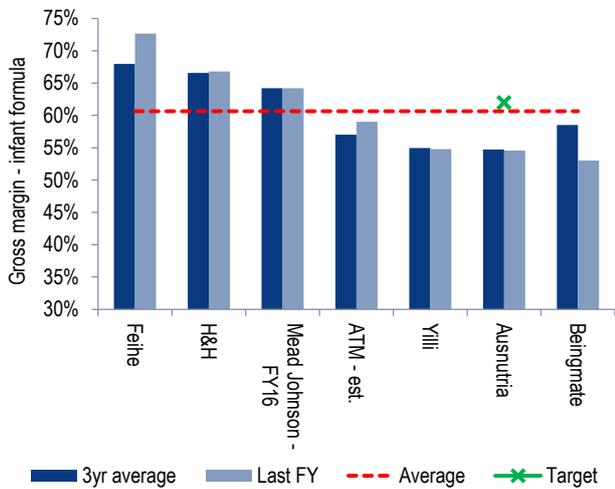
Source: Forsyth Barr analysis, Company reports

Figure 24. SG&A cost trajectory



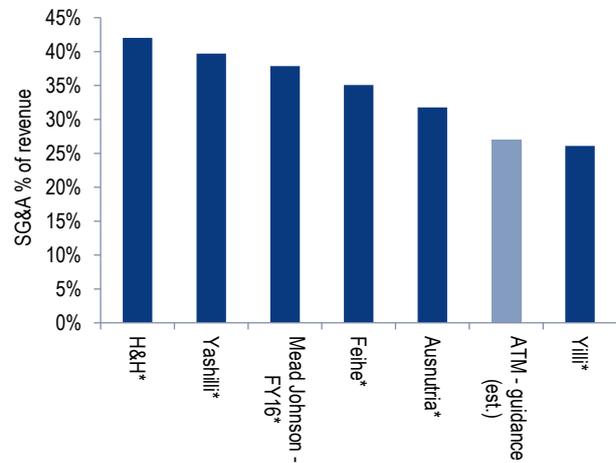
Source: Forsyth Barr analysis, Company reports

Figure 25. Gross margins for listed IF players (IF segment only)



Source: Forsyth Barr analysis, Company reports

Figure 26. SG&A costs as % of revenue – ATM appears low, although comps have different business models (ownership of manufacturing and/or numerous brands)



Source: Forsyth Barr analysis *NB These businesses own part of the manufacturing chain and/or have more brands to spread marketing \$\$ across

We see five key cost areas of materiality:

(1) Cost of sales / gross margin — potential upside runway still

While ATM doesn't disclose category specific margins, our analysis suggests the company has benefited from IF gross margin expansion in recent years — supported by wholesale price increases.

The company has called out 'high gross margins by category' as a key success measure. Group gross margin will be dictated by product mix. Looking at the key IF segment does suggest there is still some modest opportunity in the medium-term.

(2) In-store / trade spend — not visible; likely to increase with MBS growth

ATM revenue is recognised net of trade discounts, volume rebates and customer

promotional allowances. We understand this includes the majority of in-trade activity like banners, front real estate etc. ATM's audit report flags this as a key audit matter given its associated value and judgements required to estimate the variable consideration.

Anecdotes from various FMCG companies suggests this could range anywhere from 5% to 30%. In terms of IF competitors, Feihe is at ~22% and Mead Johnson was ~25% (prior to its 2016 takeover). We have no visibility on where ATM sits, although expect it is below peers and will continue to increase in time along with China label revenue growth. This is another avenue of marketing spend and will influence revenue and growth in China.

(3) Marketing — set to accelerate; key question is by how much?

ATM is building a premium, aspirational brand and marketing is its key investment line. The company has guided to spend at ~12% of revenue for FY20E which totals ~NZ\$205m using our revenue assumptions (+NZ\$70m on pcp or +NZ\$25m using the 2H run-rate). We are broadly comfortable with FY20; the key question is — where to thereafter?

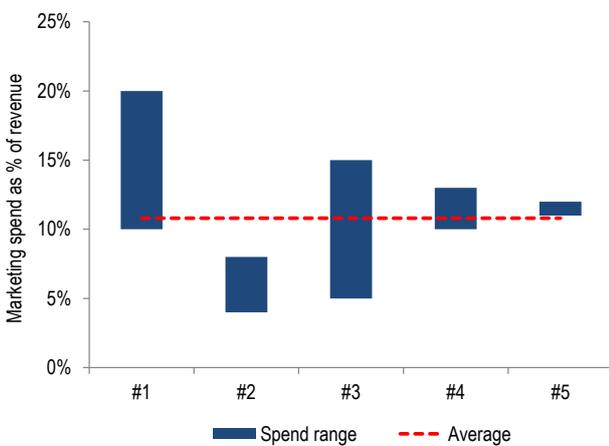
There is no simple answer to this question and comparing marketing expenditure across companies is fraught with difficulty given the influence of (1) product/category mix, (2) number of brands being supported, (3) product positioning, (4) life stage, (5) classification of what costs are/aren't included across companies.

Our proprietary survey of marketing / brand participants, combined with various comparative companies suggests a range of 5–25% is a realistic starting range. We expect ATM's marketing spend to lift and view a range of 10–15% as appropriate. What is being missed by the market, in our view, is (1) the material lift underway in trade spend, (2) the potential that the lift in spend accelerates revenue growth.

Other considerations we learnt along the way:

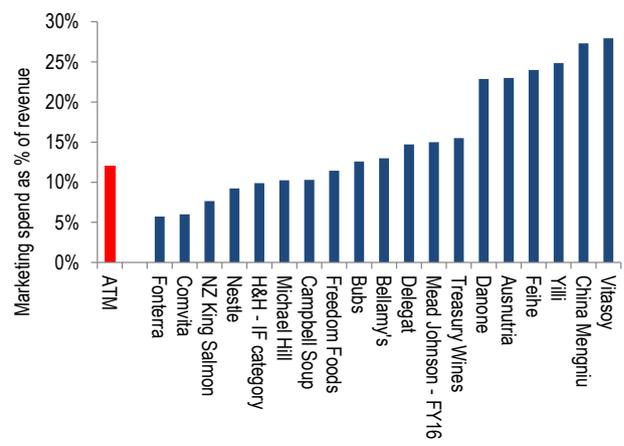
- Classification of expenditure can make a material difference.
- In-store / trade spend is not included in marketing expenses disclosure.
- How you invest is arguably more important than absolute dollars spent.
- In the offline channel, what is given to the channel is arguably most important.
 - Various anecdotes and channel checking suggests the margin provided to the MBS owner is more important than brand advertising.
 - Our checks suggest ATM is now offering an attractive margin to MBS (vs. not doing so around one year earlier), particularly relative to the 'big 4 brands'.
- Competitive market: All the comparable IF companies we follow are planning to continue to invest in marketing, if not accelerating this investment.

Figure 27. Marketing spend – survey



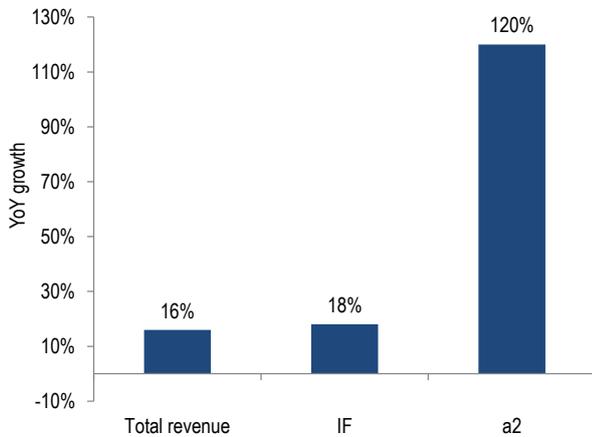
Source: Forsyth Barr analysis, Various industry players

Figure 28. Marketing spend across various brands



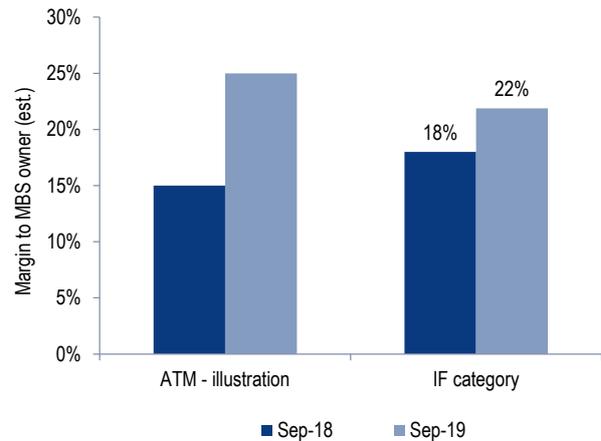
Source: Forsyth Barr analysis, Bloomberg, Company reports

Figure 29. Case study – lifting margins offered to the MBS owner delivering results. YoY revenue growth through Bebemax



Source: Forsyth Barr analysis, Various industry players

Figure 30. Case study – lifting margins offered to the MBS owner delivering results. Our estimate of margin given to Bebemax



Source: Forsyth Barr analysis, Bloomberg, Company reports

(4) Variable employee and services costs – lift in employee numbers likely

Within this we include employee wages, professional service fees and legal expenses — it has varied between 5–7% of ATM revenue to date. We see this, particularly staff numbers, as a key area that will increase materially in the short-term.

- **Wages:** ATM has total staff of 222 as at FY19 including ~50 in China, ~30 in the US and the balance predominantly in Australasia. On the surface this looks low versus peers, but not when digging deeper given various classifications and supply chain differences (outsourcing vs owning facilities), aside from Feihe. Nonetheless, we expect the number of employees in China to increase materially in the short-term — a key driver of margin contraction.
 - Ausnutria (~NZ\$1.2bn revenue): Has a total of 3,800 employees (at December 2018). This includes an estimated ~90 in R&D, ~1,000 in manufacturing (at its facilities), ~2,500 ‘push girls’ (the term for MBS in-store brand marketing agents) which leaves a balance of ~210.
 - ATM (~NZ\$1.3bn revenue): Has ~220 staff (at June 2019). This does not include ATM’s ‘push girls’ which would lift this to >2,500 by our estimates.
 - Feihe (~NZ\$2.3bn revenue): Has 5,300 employees (at March 2019). This includes a massive ~3,200 in sales and marketing (although we don’t believe this includes ‘push girls’), ~1,700 in production/quality control, ~60 in R&D and balance of ~340.
- **Professional services:** The material step-up and quantum raised eyebrows in FY19 with NZ\$32m (+NZ\$18m YoY) spent on ‘professional services’ when we include legal expenses, which are broken out separately. ATM provides limited insight around what is included in this. We expect this is a combination of:
 - External resource investment: Given ATM’s rapid expansion the company has no doubt been playing catch-up across various areas of skills and capacity. We expect at least some of this to be internalised in time.
 - Consultation / costs linked to China offline expansion: Given a high correlation of professional services costs with both China label sales growth and MBS footprint (>85%) there is potential that at least a portion of professional services costs should be captured in costs to serve the offline channel. This would lift ATM’s sales and distribution expense towards that of its regional peer group.

(5) Distribution — variable cost, unlikely to move the dial

We assume this includes logistics, storage and warehousing costs. Detail is sparse; however, we expect the majority is variable.

Various competitor anecdotes and data suggest distribution costs should range between c. 2–3% of revenue. ATM reported distribution costs at 2.4% of revenue in FY19 and we expect a similar level to be appropriate in future.

Investment summary

The a2 Milk Company (ATM) has seen unprecedented success to date, primarily underpinned by infant formula (IF) in China, leveraging a strong market position in Australia. This market alone offers meaningful runway for growth as ATM broadens its routes to market. Our rating is **OUTPERFORM**.

Earnings and cashflow outlook

- **Infant formula (IF):** ATM has established a meaningful market share in China, the largest IF market globally, and is well placed to build on this. Routes to market are complex but to date ATM has executed impressively to support strong growth and adapt to regulatory change. This will remain an area to watch.
- **Liquid milk:** ATM has a strong market share in Australia and is expanding into the US. Expansion has been slower and costlier than expected but distribution/revenue and momentum is building in the US.
- **Other products and markets:** This is a key area of optionality leveraging ATM's brand. Any early signs of progress are likely to be a positive catalyst.

Business quality

- **Building a brand:** ATM has created a product in demand with little capital investment and highly attractive profit margins. The company's success to date has been primarily underpinned by IF in China, leveraging a strong position in fresh milk in Australia. We see a key long-term opportunity as evolving to a global dairy nutrition company. In the interim, considerable runway remains in existing markets.
- **IP portfolio:** Details are opaque and vary by market. ATM's IP makes it difficult for competing a2 products, particularly on how to market the product and its benefits.

Company description

The a2 Milk Company (ATM) is a premium dairy company marketing and selling products which contain only the a2 protein (i.e. a1-free). The company's success to date has been in Infant Formula in China, leveraging a strong position in Australian fresh milk. Its growth strategy is centred on the expansion of its brand and product portfolio - primarily centred on two markets (US and China). ATM has a capital light model supported by third party supply relationships (most notably Synlait, SML.NZ, which ATM has a 17.4% stake in, and Fonterra, FSF.NZ)

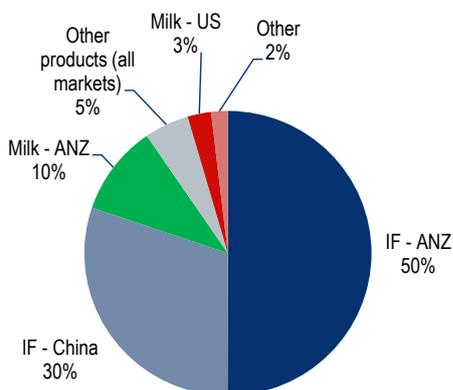
Financial structure

- **Growing net cash position:** There is a fine balance between returning capital to shareholders and ensuring sufficient flexibility to capitalise on growth opportunities. ATM's cash balance continues to build, offering options. Growth remains the priority.

Risk factors

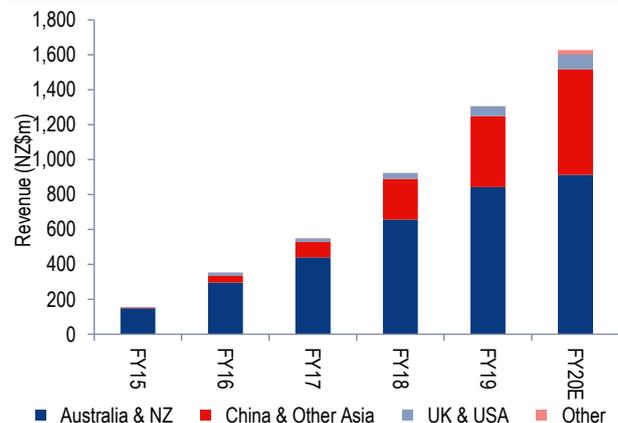
- **Competitive behaviour:** Any discounting or channel stuffing could disrupt the market. Direct competition is also emerging in the a2 / a1-free market.
- **Food safety/quality score:** ATM's brand and reputation are key pillars of its model. Reliance on third party suppliers also adds complexity and risk.
- **Regulatory change:** Particularly in China.

Figure 31. Revenue breakdown – FY19



Source: Forsyth Barr analysis, Company reports

Figure 32. Revenue breakdown by market (NZ\$m)



Source: Forsyth Barr analysis, Company Reports

Figure 33. Substantial Shareholders

Shareholder	Latest Holding
Mitsubishi UFJ Financial Group	9.2%
The Vanguard Group	7.0%
Pendal Group Limited	5.3%
BlackRock Investment Management	5.2%
UBS	5.0%

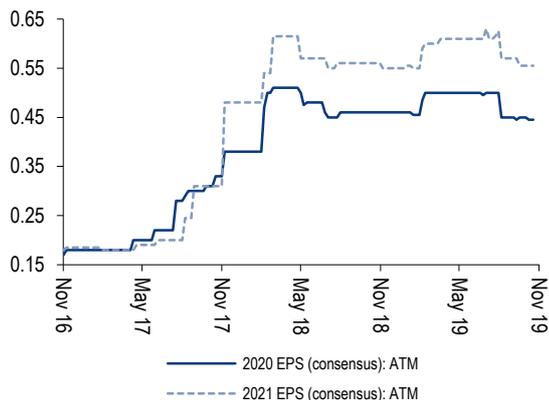
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 34. International Compcos

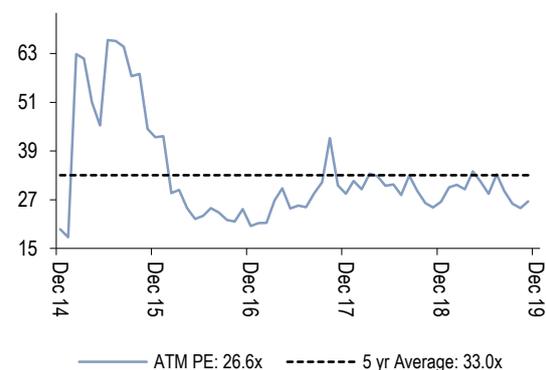
Company <i>(metrics re-weighted to reflect ATM's balance date - June)</i>	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash D/Yld
				2020E	2021E	2020E	2021E	2020E	2021E	2021E
The a2 Milk Company	ATM NZ	NZ\$12.93	NZ\$9,480	29.4x	23.4x	19.4x	15.5x	19.5x	15.5x	1.3%
Bellamy's Australia	BAL AT	A\$12.95	A\$1,468	45.8x	36.2x	26.0x	20.9x	29.5x	23.1x	0.5%
Synlait Milk *	SML NZ	NZ\$9.47	NZ\$1,698	18.7x	15.8x	11.1x	9.5x	13.9x	11.9x	0.0%
Blackmores	BKL AT	A\$84.67	A\$1,473	29.3x	24.2x	17.1x	14.5x	20.0x	16.6x	3.1%
Health & Happiness H&H International Holc	1112 HK	CN¥31.10	CN¥19,971	14.0x	12.2x	9.3x	8.4x	10.1x	9.1x	1.9%
Reckitt Benckiser Group PLC	RB/ LN	£58.94	£41,813	17.5x	17.1x	14.0x	13.8x	15.3x	15.0x	3.0%
Ausnutria Dairy Corp	1717 HK	CN¥11.84	CN¥19,087	18.9x	14.4x	13.3x	9.9x	15.4x	11.1x	2.5%
Inner Mongolia Yili Industrial Group Co	600887 CH	CN¥29.45	CN¥179,560	24.5x	21.8x	17.4x	15.3x	21.9x	19.8x	3.0%
Danone SA	BN FP	€73.62	€50,512	18.4x	17.0x	13.0x	12.3x	16.2x	15.1x	3.1%
China Mengniu Dairy Co	2319 HK	CN¥32.25	CN¥126,825	27.3x	25.1x	17.5x	15.3x	24.4x	20.7x	1.0%
			Compco Average:	23.8x	20.4x	15.4x	13.3x	18.5x	15.8x	2.0%
			ATM Relative:	+24%	+14%	+26%	+16%	+5%	-2%	-36%

EV = Current Market Cap + Actual Net Debt

Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (ATM) companies fiscal year end

Figure 35. Consensus EPS Momentum


Source: Forsyth Barr analysis, Bloomberg

Figure 36. 12 Month Forward PE


Source: Forsyth Barr analysis

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