The a2 Milk Company

OUTPERFORM

Another Tick for the Formula

The a2 Milk Company (ATM)'s Annual Meeting was positive — with first time 1H20 guidance confirming strong revenue momentum, particularly in Infant Formula (IF), and upgraded FY20 margin guidance. Highlights were (1) a further broadening in sales channels in China; (2) signs of success in extending customer tenure and (3) gross margin momentum. Despite a share price reaction ahead of our earnings upgrades, we continue to view risk/reward as positive. Valuation metrics (EV/EBIT 16x, PE 23x adjusted for US losses/cash) are attractive vs peers, history and the market, particularly given ATM's strong free cashflow and growth outlook.

What's changed?

- **Earnings:** EBITDA revised +5%/+3% in FY20/21E — primarily due to higher gross margin assumptions (product mix and price benefits).
- **Target Price and Rating:** NZ$17.50 (+3%); OUTPERFORM retained.

Positive ASM — sales momentum continues and margin guidance lifted

- **First time 1H20 guidance:** Revenue of NZ$780–800m, reflecting growth of +27–31%, and 1H20 EBITDA margin guidance of 31–32%.
  - **1H revenue run-rate modestly ahead of market FY expectations:** The key highlight was standout results in Mother & Baby Stores (MBS) and cross border ecommerce (CBEC), with IF revenue growth ~+84% and ~+54% respectively – marking further progress in ATM broadening its sales channels (these channels contribute 45% of IF revenue vs 35% in 1H19). Growth in ANZ IF was the key positive versus our expectations (growth ~+9%), while US milk sales velocity disappointed.
  - **Margin contraction vs a strong comparative — well signalled:** The mid-point of guidance implies EBITDA growth of ~+14%, with the step-change in cost investment (people, systems, marketing) taking some of the shine off headline revenue momentum.
- **Upgraded FY20 margin guidance:** 29–30% (prior ~28.2%), primarily due to improved gross margins from a combination of price increases (and there is further upside risk near-term) and a reduction in COGS.

Other areas of interest

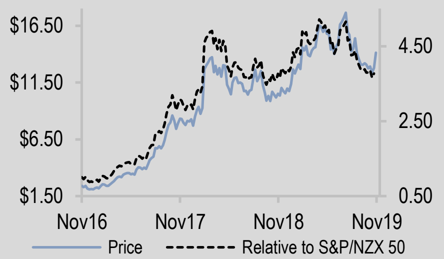
- **More new products in 2H20:** Including China label Stage 4 and Smart Nutrition (4–12yrs), Hong Kong label IF and relaunched Manuka Honey IF.
- **Early positive signs on extending customer tenure:** 1H20 commentary shows strong momentum in products for toddlers / young children (i.e. Stage 4 and Smart Nutrition).
- **Channel checking getting more opaque:** ATM provided some insight into the extent of data and sources it triangulates to track performance, with no one point representative in isolation. Channel checking is becoming more challenging as its product/supply chain is diversified further.
- **At NZ$14, the market is pricing a low single-digit profit growth outlook of +2–4%.** This is well below our expectations (and ATM LTI hurdle rates).

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$14.12
Target price	NZ$17.50
Risk rating	High
Issued shares	733.1m
Market cap	NZ$10,352m
Average daily turnover	809.9k (NZ$11,128k)

Share Price Performance



Financials: June	19A	20E	21E	22E
NPAT* (NZ$m)	287.7	342.4	423.9	521.2
EPS* (NZc)	38.8	46.1	57.1	70.3
EPS growth* (%)	47.4	19.0	23.8	23.0
DPS (NZc)	0.0	0.0	17.1	21.1
Imputation (%)	100	100	100	100

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	23.5	19.3	15.4	12.6
EV/EBIT	23.6	19.4	15.5	12.6
PE	36.4	30.6	24.7	20.1
Price / NTA	13.4	9.3	6.9	n/a
Cash dividend yield (%)	0.0	0.0	1.2	1.5
Gross dividend yield (%)	0.0	0.0	1.7	2.1

*Historic and forecast numbers based on underlying profits

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The a2 Milk Company (ATM)	Priced as at 19 Nov 2019: NZ$14.12		June year end

Forsyth Barr valuation

Valuation methodology	Weighted DCF and sum of the parts valuation		
12-month target price (NZ$)*	**17.50**	**Spot valuations (NZ$)**	
Expected share price return	23.9%	1. DCF	16.24
Net dividend yield	0.5%	2. Peer multiple	16.94
Estimated 12-month return	24.4%	n/a	n/a
Key WACC assumptions		**DCF valuation summary (NZ$m)**	
Risk free rate	2.00%	Total firm value	11,442
Equity beta	0.88	(Net debt)/cash	465
WACC	8.8%	Value of equity	11,907
Terminal growth	2.0%	Shares (m)	733

Profit and Loss Account (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Sales revenue	923	1,304	1,659	2,062	2,492
Normalised EBITDA	**283**	**414**	**488**	**602**	**739**
Depreciation and amortisation	(2)	(2)	(2)	(3)	(3)
Normalised EBIT	**281**	**411**	**486**	**600**	**736**
Net interest	2	4	7	10	14
Associate income	-	-	-	-	-
Tax	(88)	(128)	(150)	(186)	(229)
Minority interests	-	-	-	-	-
Normalised NPAT	**196**	**288**	**342**	**424**	**521**
Abnormals/other	-	-	-	-	-
Reported NPAT	**196**	**288**	**342**	**424**	**521**
Normalised EPS (cps)	26.3	38.8	46.1	57.1	70.3
DPS (cps)	-	-	-	17.1	21.1

Growth Rates	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Revenue (%)	67.9	41.4	27.1	24.3	20.8
EBITDA (%)	>100	46.1	18.1	23.3	22.6
EBIT (%)	>100	46.5	18.1	23.4	22.7
Normalised NPAT (%)	>100	47.0	19.0	23.8	23.0
Normalised EPS (%)	>100	47.4	19.0	23.8	23.0
DPS (%)	n/a	n/a	n/a	n/a	23.0

Cash Flow (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EBITDA	**283**	**414**	**488**	**602**	**739**
Working capital change	36	(7)	(28)	(9)	(8)
Interest & tax paid	(67)	(130)	(144)	(176)	(215)
Other	(21)	12	-	-	-
Operating cash flow	**231**	**289**	**316**	**418**	**516**
Capital expenditure	(5)	(3)	(3)	(3)	(3)
(Acquisitions)/divestments	(16)	(162)	-	-	-
Other	-	-	-	-	-
Funding available/(required)	**210**	**123**	**313**	**415**	**513**
Dividends paid	-	-	-	(50)	(137)
Equity raised/(returned)	7	3	-	-	-
Increase/(decrease) in net debt	**(217)**	**(126)**	**(313)**	**(364)**	**(376)**

Balance Sheet (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Working capital	14	1	35	44	52
Fixed assets	10	10	11	12	13
Intangibles	15	13	13	13	13
Other assets	228	344	363	379	397
Total funds employed	**267**	**368**	**422**	**448**	**474**
Net debt/(cash)	(340)	(465)	(778)	(1,142)	(1,518)
Other non current liabilities	52	45	70	86	104
Shareholder's funds	556	788	1,130	1,504	1,888
Minority interests	-	-	-	-	-
Total funding sources	**267**	**368**	**422**	**448**	**474**

Valuation Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EV/EBITDA (x)	35.3	23.5	19.3	15.4	12.6
EV/EBIT (x)	35.6	23.6	19.4	15.5	12.6
PE (x)	53.7	36.4	30.6	24.7	20.1
Price/NTA (x)	18.9	13.4	9.3	6.9	5.5
Free cash flow yield (%)	2.2	2.8	3.0	4.0	5.0
Net dividend yield (%)	0.0	0.0	0.0	1.2	1.5
Gross dividend yield (%)	0.0	0.0	0.0	1.7	2.1
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	0	0	0	30	30

Capital Structure	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Interest cover EBIT (x)	n/a	n/a	n/a	n/a	n/a
Interest cover EBITDA (x)	n/a	n/a	n/a	n/a	n/a
Net debt/ND+E (%)	-158.2	-143.9	-220.6	-315.6	-409.8
Net debt/EBITDA (x)	n/a	n/a	n/a	n/a	n/a

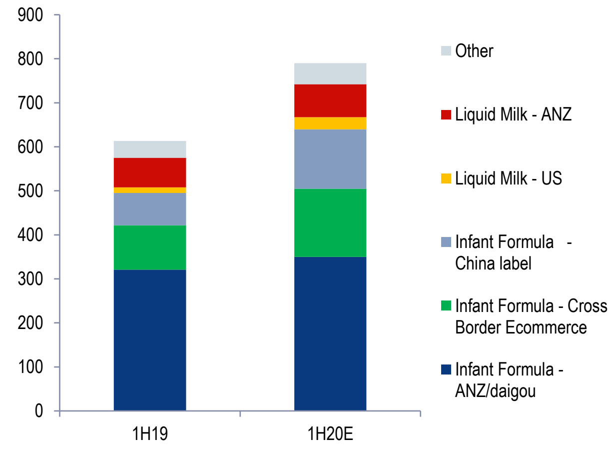
Key Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Return on assets (%)	39.2	41.4	34.7	32.6	32.1
Return on equity (%)	35.2	36.5	30.3	28.2	27.6
Return on funds employed (%)	116.0	106.3	100.6	117.6	140.9
EBITDA margin (%)	30.7	31.7	29.4	29.2	29.6
EBIT margin (%)	30.4	31.5	29.3	29.1	29.5
Capex to sales (%)	0.5	0.3	0.2	0.2	0.1
Capex to depreciation (%)	223	155	143	132	124

Operating Performance	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Revenue (breakdown by product)					
Total Infant Formula	724	1,064	1,358	1,697	2,042
Growth (%)	83.8	46.9	27.7	24.9	20.3
Total Fresh Milk	142	175	222	275	346
Growth (%)	13.1	22.9	26.9	23.8	26.0
Other	56	66	78	90	104
Growth (%)	89.2	17.3	18.7	15.5	15.0
Total	**923**	**1,304**	**1,658**	**2,062**	**2,492**
Revenue (breakdown by country)					
Australia & NZ	656	843	915	940	968
Growth (%)	49.4	28.4	8.6	2.8	2.9
China & Other Asia	234	406	674	1,006	1,341
Growth (%)	162.9	73.6	66.2	49.2	33.3
US	13	35	69	116	183
Growth (%)	n/a	160.7	100.0	67.8	57.4
Other	19	22	0	0	0
Total	**923**	**1,304**	**1,658**	**2,062**	**2,492**
Key currency assumptions					
NZDAUD	0.92	0.94	0.93	0.93	0.93
NZDUSD	0.71	0.67	0.63	0.65	0.65
NZDCNY	4.62	4.59	4.46	4.63	4.63
EBITDA insights					
Gross margin	50.3	54.7	55.8	55.8	55.6
Gross profit	464	714	925	1,150	1,385
Total SG&A expenses	(181)	(300)	(437)	(548)	(646)
incl marketing expenses	(74)	(135)	(199)	(258)	(311)
Total SG&A as % of revenue	19.7	23.0	26.3	26.6	25.9
Group EBITDA	**283**	**414**	**488**	**602**	**739**
US - EBITDA losses	(29)	(44)	(51)	(48)	(40)
EBITDA excluding US losses	**312**	**458**	**539**	**650**	**779**

* Forsyth Barr target prices reflect valuation rolled forward at cost of equity less the next 12-months dividend

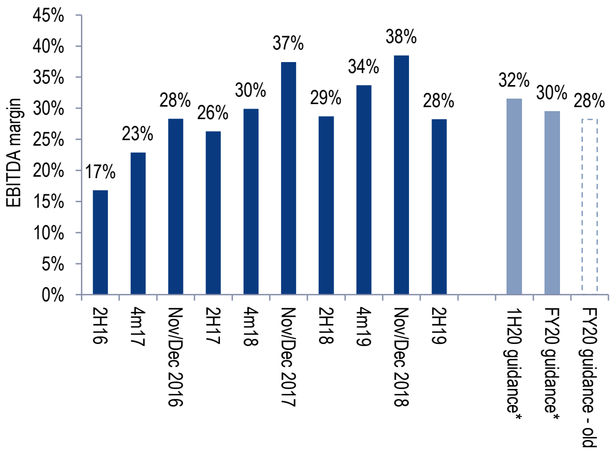
Key charts and tables

Figure 1. Revenue guidance breakdown (NZ$m)



Source: Forsyth Barr analysis, Company reports

Figure 2. EBITDA margin trajectory



Source: Forsyth Barr analysis, Company reports *Using mid-point of guidance

Figure 3. Earnings revisions

	FY20E			FY21E			FY22E		
NZ$m	**Old**	**New**	**% chg**	**Old**	**New**	**% chg**	**Old**	**New**	**% chg**
Revenue	1,647.9	1,658.6	0.6%	2,061.9	2,062.4	0.0%	2,491.2	2,491.9	0.0%
EBITDA	**464.6**	**488.4**	**5.1%**	**583.2**	**602.3**	**3.3%**	**715.5**	**738.5**	**3.2%**
Underlying profit	**325.8**	**342.4**	**5.1%**	**410.5**	**423.9**	**3.3%**	**505.0**	**521.2**	**3.2%**
Underlying EPS (cps)	43.9	46.1	5.1%	55.3	57.1	3.3%	68.1	70.3	3.2%
Dividend (cps)	0.0	0.0	n/a	16.6	17.1	3.3%	20.4	21.1	3.2%
EBITDA margin	28.2%	29.4%	1.3%	28.3%	29.2%	0.9%	28.7%	29.6%	0.9%

Source: Forsyth Barr analysis

ATM's revised performance framework vs market

ATM has reset its performance framework for both STI and LTIs, with the key change being to incorporate revenue metrics.

Figure 4 details ATM's hurdle rates for its FY20 LTI plan versus market expectations.

Figure 4. ATM revised LTI hurdles versus market expectations

FY20 LTI plan	**FY19-22 CAGR**				**Market expectations**	
% vested	**0%**	**50%**	**85%**	**100%**	**Consensus**	**Forsyth Barr**
Sales CAGR	<15%	15.0%	18.5%	22.0%	21%	24%
and/or	OR	AND	AND	AND		
EPS CAGR	<15%	=>15%	=>15%	=>15%	18%	21%

Source: Forsyth Barr analysis

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.

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.

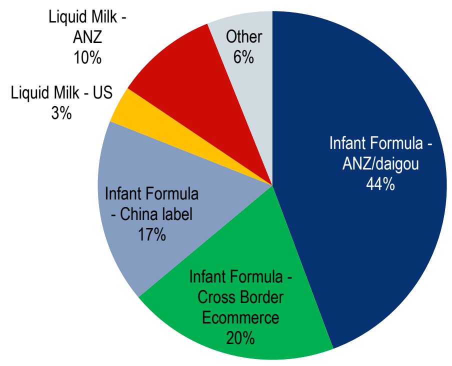
Risk factors

- **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 scare:** ATM's brand and reputation are key pillars of its model. Reliance on third party suppliers also adds complexity and risk.

Company description

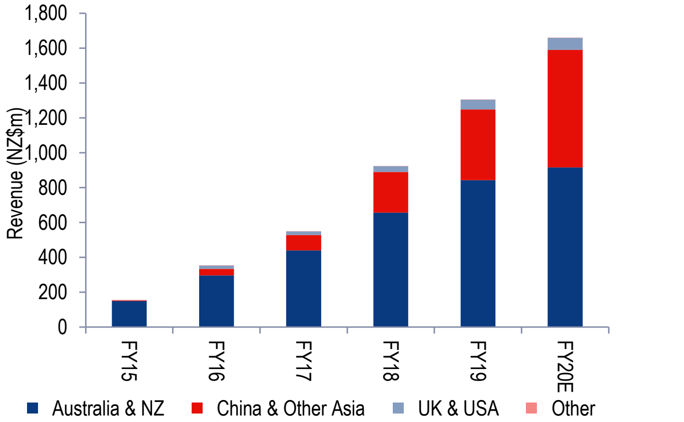
The a2 Milk Company (ATM) is a premium dairy company marketing and selling products which contain only the a2 protein (i.e. a1-free). The company's success to date has been in Infant Formula in China, leveraging a strong position in Australian fresh milk. Its growth strategy is centred on the expansion 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)

Figure 5. Revenue breakdown – 1H20E



Source: Company reports, Forsyth Barr analysis

Figure 6. Revenue breakdown by market (NZ$m)



Source: Company reports, Forsyth Barr analysis

Figure 7. 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%

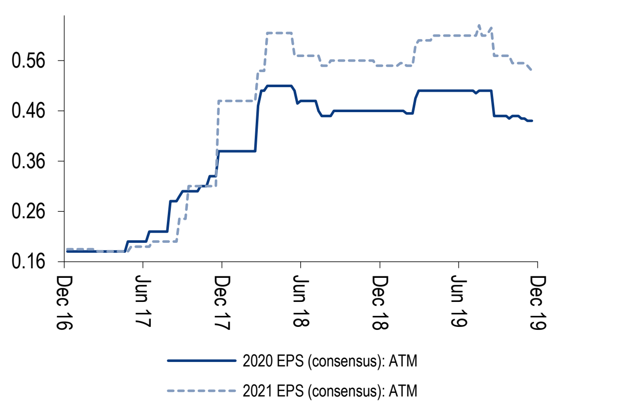
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 8. International Compcos

Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash D/Yld
(metrics re-weighted to reflect ATM's balance date - June)			(m)	2020E	2021E	2020E	2021E	2020E	2021E	2021E
The a2 Milk Company	**ATM NZ**	**NZ$14.12**	**NZ$10,352**	**30.6x**	**24.7x**	**20.2x**	**16.4x**	**20.3x**	**16.5x**	**1.2%**
Bellamy's Australia	BAL AT	A$13.16	A$1,492	46.5x	36.8x	26.4x	21.2x	30.0x	23.5x	0.5%
Synlait Milk *	SML NZ	NZ$9.28	NZ$1,664	18.3x	15.5x	10.9x	9.3x	13.7x	11.7x	0.0%
Blackmores	BKL AT	A$82.30	A$1,432	28.8x	23.6x	16.8x	14.1x	19.7x	16.3x	3.1%
Health & Happiness H&H International Holc	1112 HK	CN¥31.00	CN¥19,910	14.6x	12.6x	9.7x	8.8x	10.4x	9.4x	1.9%
Reckitt Benckiser Group PLC	RB/ LN	£59.15	£41,962	17.6x	17.2x	14.1x	13.9x	15.4x	15.1x	3.0%
Ausnutria Dairy Corp	1717 HK	CN¥9.95	CN¥16,040	15.7x	12.1x	11.0x	8.4x	12.6x	9.2x	3.0%
Inner Mongolia Yili Industrial Group Co	600887 CH	CN¥29.00	CN¥176,817	24.0x	21.2x	17.0x	14.9x	21.4x	19.1x	3.0%
Danone SA	BN FP	€74.92	€51,404	18.7x	17.3x	13.3x	12.4x	16.4x	15.3x	3.1%
China Mengniu Dairy Co	2319 HK	CN¥29.15	CN¥114,694	24.6x	22.7x	15.8x	13.8x	22.0x	18.7x	1.0%
			Compco Average:	**23.2x**	**19.9x**	**15.0x**	**13.0x**	**17.9x**	**15.4x**	**2.1%**
EV = Current Market Cap + Actual Net Debt			**ATM Relative:**	**+32%**	**+24%**	**+35%**	**+27%**	**+13%**	**+7%**	**-41%**

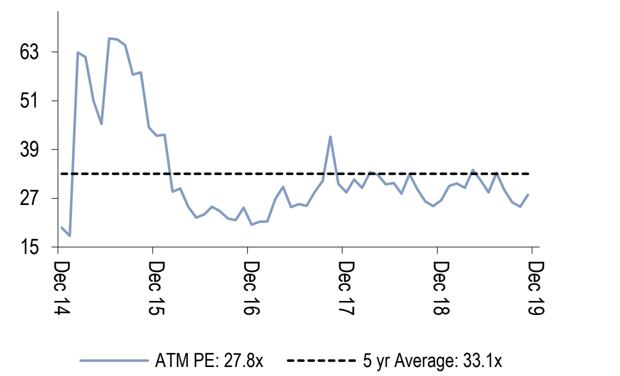
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (ATM) companies fiscal year end

Figure 9. Consensus EPS Momentum



Source: Forsyth Barr analysis, Bloomberg

Figure 10. 12 Month Forward PE



Source: Forsyth Barr analysis