

The a2 Milk Company

OUTPERFORM

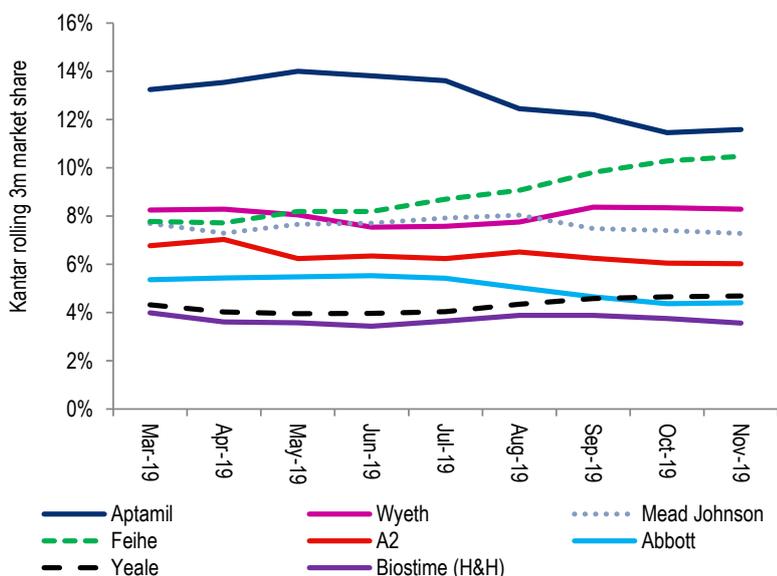
Kantar Data Check

Kantar market share provides an indicator of brand strength for The a2 Milk Company (ATM) and its key competitors in the infant formula (IF) segment, capturing purchasing habits for a sample of consumers across Urban China (Tier 1 and Key A–D cities). The latest market share of ATM is 6.4% — a lift on recent months, broadly stable vs. ATM’s disclosure in June 2019 and ahead of the prior year. The brand remains strong in China; particularly given Kantar data likely understates consumption trends, given ATM’s growing sales in later stage products (i.e. Stage 4 / Smart Nutrition).

Key data points / trends

- ATM Kantar market share of 6.4% (by value) for the four weeks ended 5 November 2019.
 - This compares to 6.0% in the prior four week period, 3m rolling ~6.0% and 12m 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.
- Feihe has taken significant market share over the past six months, with meaningful declines evident in Aptamil and Mead Johnson (Figure 1).
- Our analysis suggests Kantar’s China Baby Panel covers a market of ~US\$10bn versus the Chinese IF market of ~US\$25bn.

Figure 1. Kantar – rolling 3m market share for key infant formula brands



Source: Forsyth Barr analysis, Kantar China Baby Panel

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\$15.46
Target price	NZ\$17.50
Risk rating	High
Share price	NZ\$15.46
Market cap	NZ\$11,334m
Average daily turnover	771.4k (NZ\$10,852k)

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	25.9	21.3	17.1	13.9
EV/EBIT	26.0	21.5	17.1	14.0
PE	39.9	33.5	27.1	22.0
Price / NTA	14.6	10.1	7.6	n/a
Cash dividend yield (%)	0.0	0.0	1.1	1.4
Gross dividend yield (%)	0.0	0.0	1.5	1.9

*Historic and forecast numbers based on underlying profits

Chelsea Leadbetter, CFA

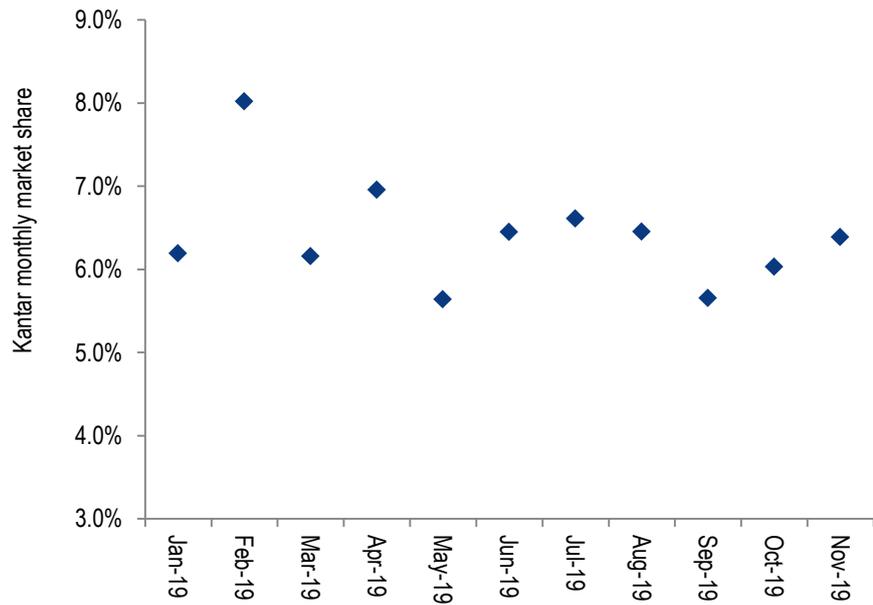
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The a2 Milk Company (ATM)		Priced as at 03 Dec 2019: NZ\$15.46					June year end				
Forsyth Barr valuation						Valuation Ratios	2018A	2019A	2020E	2021E	2022E
Valuation methodology	Weighted DCF and sum of the parts valuation					EV/EBITDA (x)	38.8	25.9	21.3	17.1	13.9
12-month target price (NZ\$)*	17.50	Spot valuations (NZ\$)				EV/EBIT (x)	39.1	26.0	21.5	17.1	14.0
Expected share price return	13.2%	1. DCF	16.29			PE (x)	58.8	39.9	33.5	27.1	22.0
Net dividend yield	0.6%	2. Peer multiple	16.94			Price/NTA (x)	20.7	14.6	10.1	7.6	6.0
Estimated 12-month return	13.7%	n/a	n/a			Free cash flow yield (%)	2.0	2.5	2.8	3.7	4.5
Key WACC assumptions	DCF valuation summary (NZ\$m)					Net dividend yield (%)	0.0	0.0	0.0	1.1	1.4
Risk free rate	2.00%	Total firm value	11,476			Gross dividend yield (%)	0.0	0.0	0.0	1.5	1.9
Equity beta	0.88	(Net debt)/cash	465			Imputation (%)	100	100	100	100	100
WACC	8.8%	Value of equity	11,940			Pay-out ratio (%)	0	0	0	30	30
Terminal growth	2.0%	Shares (m)	733			Capital Structure	2018A	2019A	2020E	2021E	2022E
Profit and Loss Account (NZ\$m)	2018A	2019A	2020E	2021E	2022E	Interest cover EBIT (x)	n/a	n/a	n/a	n/a	n/a
Sales revenue	923	1,304	1,659	2,062	2,492	Interest cover EBITDA (x)	n/a	n/a	n/a	n/a	n/a
Normalised EBITDA	283	414	488	602	739	Net debt/ND+E (%)	-158.2	-143.9	-220.6	-315.6	-409.8
Depreciation and amortisation	(2)	(2)	(2)	(3)	(3)	Net debt/EBITDA (x)	n/a	n/a	n/a	n/a	n/a
Normalised EBIT	281	411	486	600	736	Key Ratios	2018A	2019A	2020E	2021E	2022E
Net interest	2	4	7	10	14	Return on assets (%)	39.2	41.4	34.7	32.6	32.1
Associate income	-	-	-	-	-	Return on equity (%)	35.2	36.5	30.3	28.2	27.6
Tax	(88)	(128)	(150)	(186)	(229)	Return on funds employed (%)	116.0	106.3	100.6	117.6	140.9
Minority interests	-	-	-	-	-	EBITDA margin (%)	30.7	31.7	29.4	29.2	29.6
Normalised NPAT	196	288	342	424	521	EBIT margin (%)	30.4	31.5	29.3	29.1	29.5
Abnormals/other	-	-	-	-	-	Capex to sales (%)	0.5	0.3	0.2	0.2	0.1
Reported NPAT	196	288	342	424	521	Capex to depreciation (%)	223	155	143	132	124
Normalised EPS (cps)	26.3	38.8	46.1	57.1	70.3	Operating Performance	2018A	2019A	2020E	2021E	2022E
DPS (cps)	-	-	-	17.1	21.1	Revenue (breakdown by product)	2018A	2019A	2020E	2021E	2022E
Growth Rates	2018A	2019A	2020E	2021E	2022E	Total Infant Formula	724	1,064	1,358	1,697	2,042
Revenue (%)	67.9	41.4	27.1	24.3	20.8	Growth (%)	83.8	46.9	27.7	24.9	20.3
EBITDA (%)	>100	46.1	18.1	23.3	22.6	Total Fresh Milk	142	175	222	275	346
EBIT (%)	>100	46.5	18.1	23.4	22.7	Growth (%)	13.1	22.9	26.9	23.8	26.0
Normalised NPAT (%)	>100	47.0	19.0	23.8	23.0	Other	56	66	78	90	104
Normalised EPS (%)	>100	47.4	19.0	23.8	23.0	Growth (%)	89.2	17.3	18.7	15.5	15.0
DPS (%)	n/a	n/a	n/a	n/a	23.0	Total	923	1,304	1,658	2,062	2,492
Cash Flow (NZ\$m)	2018A	2019A	2020E	2021E	2022E	Revenue (breakdown by country)	2018A	2019A	2020E	2021E	2022E
EBITDA	283	414	488	602	739	Australia & NZ	656	843	915	940	968
Working capital change	36	(7)	(28)	(9)	(8)	Growth (%)	49.4	28.4	8.6	2.8	2.9
Interest & tax paid	(67)	(130)	(144)	(176)	(215)	China & Other Asia	234	406	674	1,006	1,341
Other	(21)	12	-	-	-	Growth (%)	162.9	73.6	66.2	49.2	33.3
Operating cash flow	231	289	316	418	516	US	13	35	69	116	183
Capital expenditure	(5)	(3)	(3)	(3)	(3)	Growth (%)	n/a	160.7	100.0	67.8	57.4
(Acquisitions)/divestments	(16)	(162)	-	-	-	Other	19	22	0	0	0
Other	-	-	-	-	-	Total	923	1,304	1,658	2,062	2,492
Funding available/(required)	210	123	313	415	513	Key currency assumptions	2018A	2019A	2020E	2021E	2022E
Dividends paid	-	-	-	(50)	(137)	NZDAUD	0.92	0.94	0.93	0.93	0.93
Equity raised/(returned)	7	3	-	-	-	NZDUSD	0.71	0.67	0.63	0.65	0.65
Increase/(decrease) in net debt	(217)	(126)	(313)	(364)	(376)	NZDCNY	4.62	4.59	4.46	4.63	4.63
Balance Sheet (NZ\$m)	2018A	2019A	2020E	2021E	2022E	EBITDA insights	2018A	2019A	2020E	2021E	2022E
Working capital	14	1	35	44	52	Gross margin	50.3	54.7	55.8	55.8	55.6
Fixed assets	10	10	11	12	13	Gross profit	464	714	925	1,150	1,385
Intangibles	15	13	13	13	13	Total SG&A expenses	(181)	(300)	(437)	(548)	(646)
Other assets	228	344	363	379	397	incl marketing expenses	(74)	(135)	(199)	(258)	(311)
Total funds employed	267	368	422	448	474	Total SG&A as % of revenue	19.7	23.0	26.3	26.6	25.9
Net debt/(cash)	(340)	(465)	(778)	(1,142)	(1,518)	Group EBITDA	283	414	488	602	739
Other non current liabilities	52	45	70	86	104	US - EBITDA losses	(29)	(44)	(51)	(48)	(40)
Shareholder's funds	556	788	1,130	1,504	1,888	EBITDA excluding US losses	312	458	539	650	779
Minority interests	-	-	-	-	-						
Total funding sources	267	368	422	448	474						

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

Figure 2. Kantar China Baby Panel – a2 monthly market share



Source: Forsyth Barr analysis, Kantar China Baby Panel

What is Kantar?

Kantar provides consumer panel data, which monitors shopper and usage patterns where full details of every purchase are recorded. More specifically, Kantar’s China Baby Panel monitors a sample of 2,000 young mothers across China’s top tier cities, where panellists are on the panel until their babies reach 36 months.

- **Key benefit:** It should capture infant formula (IF) purchases regardless of the channel.
- **Key limitations:** (1) It is a sample of 2,000 consumers — while large in the context of surveys, this is only a small fraction of the potential market; (2) It only covers babies up to 36 months — this misses any baby that consumes a2 products beyond this timeframe (this includes Stage 4, Smart Nutrition and some Stage 3 product).

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. **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. Its success to date has been primarily driven by IF in China, leveraging a strong position in fresh milk in Australia. Considerable runway remains in existing markets while a key long-term opportunity as evolving to a global dairy nutrition company
- **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.

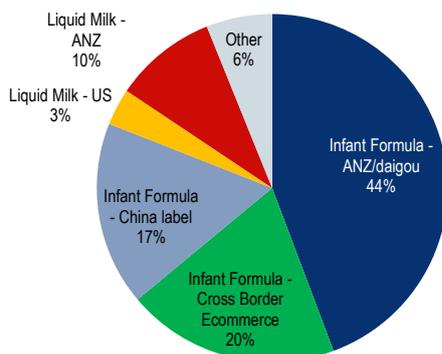
Risk factors

- **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 score:** ATM's brand and reputation are key pillars to its model. Reliance on third party suppliers adds complexity and risk.
- **Regulatory change:** Particularly in China.

Company description

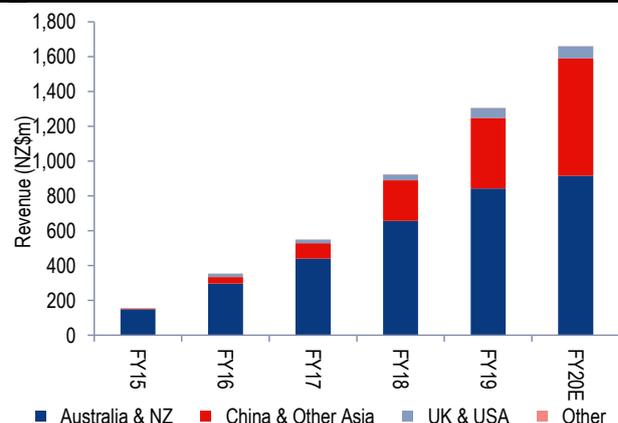
The a2 Milk Company (ATM) is a premium dairy company marketing and selling products which contain only the a2 protein (i.e. a1-free). The company's success to date has been in Infant Formula in China, leveraging a strong position in Australian fresh milk. Its growth strategy is centred on the expansion 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 3. Revenue breakdown – 1H20E



Source: Company reports, Forsyth Barr analysis

Figure 4. Revenue breakdown by market (NZ\$m)



Source: Company reports, Forsyth Barr analysis

Figure 5. Substantial Shareholders

Shareholder	Latest Holding
Mitsubishi UFJ Financial Group	10.2%
The Vanguard Group	7.0%
UBS	6.5%
Pendal Group Limited	6.3%
Morgan Stanley	5.5%
BlackRock Investment Management	5.2%

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

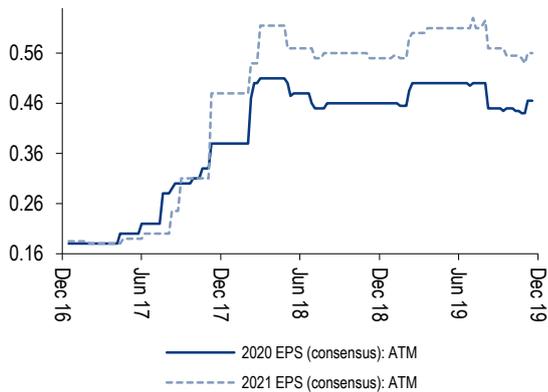
Figure 6. International Compcos

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\$15.46	NZ\$11,334	33.5x	27.1x	22.3x	18.0x	22.4x	18.1x	1.1%
Bellamy's Australia	BAL AT	A\$13.18	A\$1,494	46.6x	36.8x	26.5x	21.3x	30.1x	23.6x	0.5%
Synlait Milk *	SML NZ	NZ\$9.40	NZ\$1,685	18.5x	15.7x	11.0x	9.4x	13.9x	11.8x	0.0%
Blackmores	BKL AT	A\$82.14	A\$1,429	29.0x	23.6x	17.0x	14.1x	20.0x	16.4x	3.1%
Health & Happiness H&H International Holc	1112 HK	CN¥33.95	CN¥21,805	16.0x	13.8x	10.4x	9.5x	11.2x	10.2x	1.7%
Reckitt Benckiser Group PLC	RB/ LN	£60.38	£42,841	18.0x	17.7x	14.4x	14.2x	15.7x	15.5x	2.9%
Ausnutria Dairy Corp	1717 HK	CN¥9.65	CN¥15,557	15.2x	11.8x	10.7x	8.1x	12.2x	8.9x	3.0%
Inner Mongolia Yili Industrial Group Co	600887 CH	CN¥29.67	CN¥180,902	24.5x	21.7x	17.4x	15.3x	21.8x	19.5x	3.0%
Danone SA	BN FP	€73.24	€50,251	18.3x	16.9x	13.0x	12.2x	16.1x	15.1x	3.1%
China Mengniu Dairy Co	2319 HK	CN¥30.30	CN¥119,219	25.5x	23.5x	16.5x	14.3x	23.0x	19.5x	1.0%
Compco Average:				23.5x	20.2x	15.2x	13.2x	18.2x	15.6x	2.0%
ATM Relative:				+43%	+34%	+46%	+37%	+23%	+16%	-46%

EV = Current Market Cap + Actual Net Debt

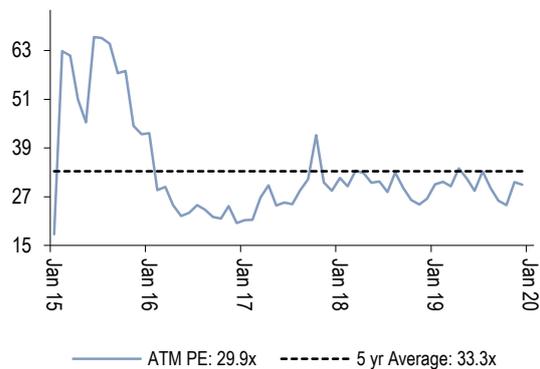
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (ATM) companies fiscal year end

Figure 7. Consensus EPS Momentum



Source: Forsyth Barr analysis, Bloomberg

Figure 8. 12 Month Forward PE



Source: Forsyth Barr analysis

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