The a2 Milk Company

OUTPERFORM

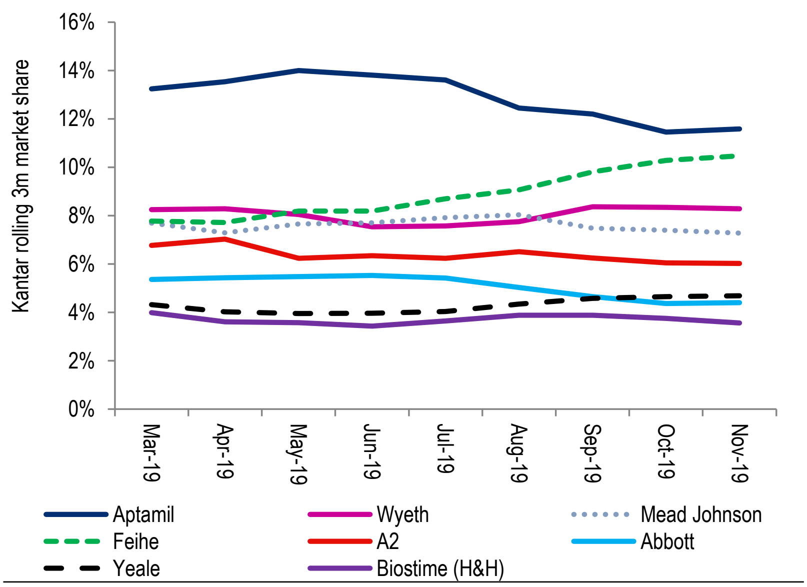
Kantar Data Check

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



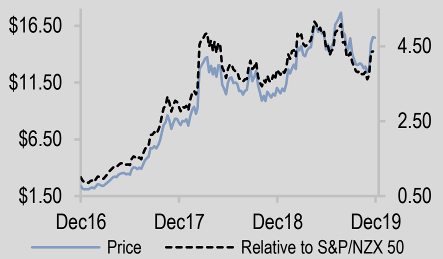
Source: Forsyth Barr analysis, Kantar China Baby Panel

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

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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 methodology	Weighted DCF and sum of the parts valuation		
12-month target price (NZ$)*	**17.50**	**Spot valuations (NZ$)**	
Expected share price return	13.2%	1. DCF	16.29
Net dividend yield	0.6%	2. Peer multiple	16.94
Estimated 12-month return	13.7%	n/a	n/a
Key WACC assumptions		**DCF valuation summary (NZ$m)**	
Risk free rate	2.00%	Total firm value	11,476
Equity beta	0.88	(Net debt)/cash	465
WACC	8.8%	Value of equity	11,940
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)	38.8	25.9	21.3	17.1	13.9
EV/EBIT (x)	39.1	26.0	21.5	17.1	14.0
PE (x)	58.8	39.9	33.5	27.1	22.0
Price/NTA (x)	20.7	14.6	10.1	7.6	6.0
Free cash flow yield (%)	2.0	2.5	2.8	3.7	4.5
Net dividend yield (%)	0.0	0.0	0.0	1.1	1.4
Gross dividend yield (%)	0.0	0.0	0.0	1.5	1.9
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	0	0	0	30	30

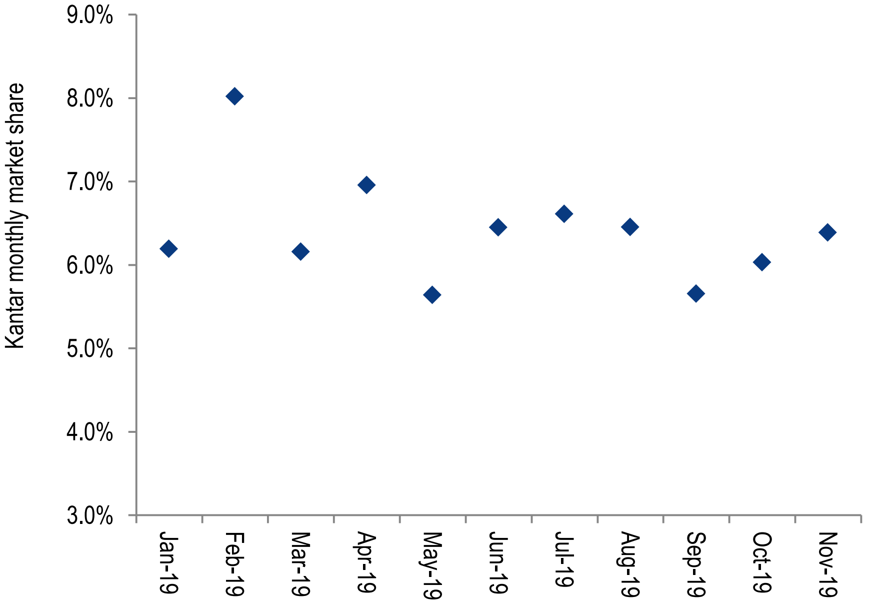
Capital Structure	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Interest cover EBIT (x)	n/a	n/a	n/a	n/a	n/a
Interest cover EBITDA (x)	n/a	n/a	n/a	n/a	n/a
Net debt/ND+E (%)	-158.2	-143.9	-220.6	-315.6	-409.8
Net debt/EBITDA (x)	n/a	n/a	n/a	n/a	n/a

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

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.

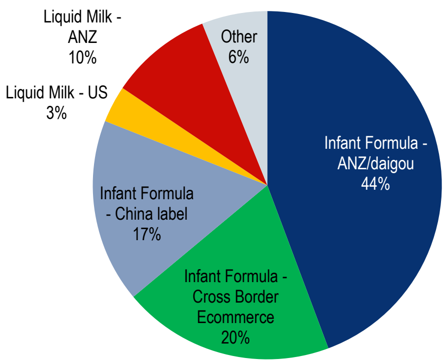
Risk factors

- **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 scare:** 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

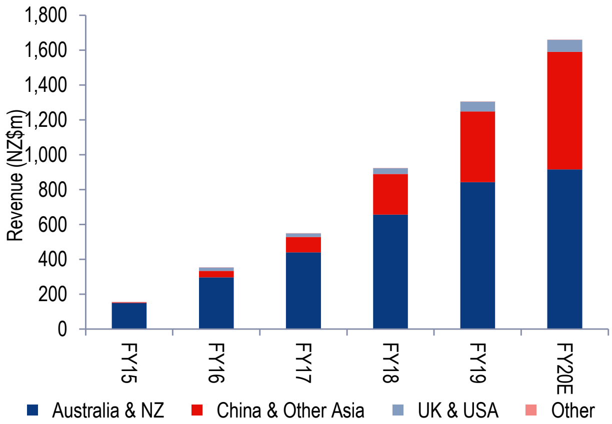
The a2 Milk Company (ATM) is a premium dairy company marketing and selling products which contain only the a2 protein (i.e. a1-free). The company's success to date has been in Infant Formula in China, leveraging a strong position in Australian fresh milk. Its growth strategy is centred on the expansion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

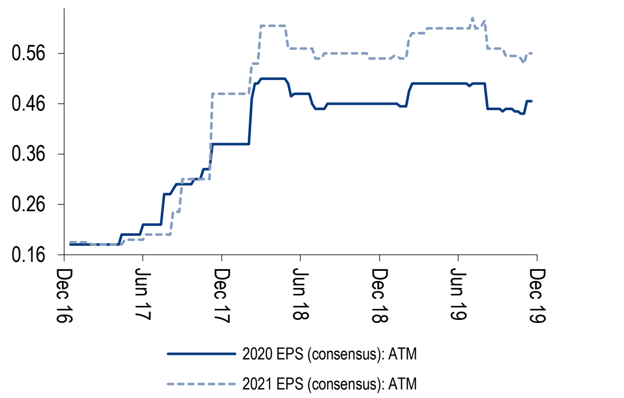
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 6. International Compcos

Company	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$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%**
EV = Current Market Cap + Actual Net Debt			**ATM Relative:**	**+43%**	**+34%**	**+46%**	**+37%**	**+23%**	**+16%**	**-46%**

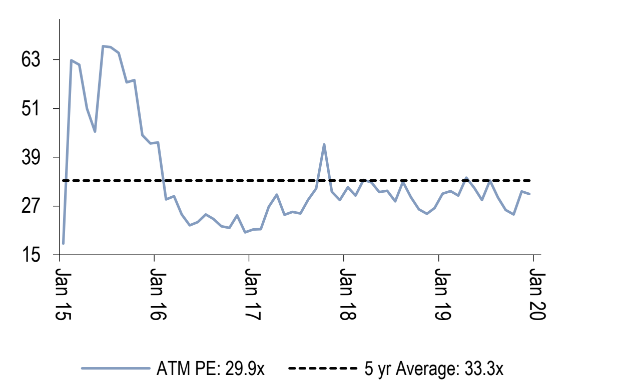
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (ATM) companies fiscal year end

Figure 7. Consensus EPS Momentum



Source: Forsyth Barr analysis, Bloomberg

Figure 8. 12 Month Forward PE



Source: Forsyth Barr analysis