NEW ZEALAND EQUITY RESEARCH | FOOD, BEVS, & AGRI | DAIRY NUTRITION COMPANY
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The a2 Milk Company
1H20 Preview — China Check

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We expect a strong 1H20 result from The a2 Milk Company (ATM) on 27 February, as another period of positive revenue momentum (from market share gains in China) outpaces margin decline from a step-change in key costs. We forecast 1H20 EBITDA of NZ$252.5m, up +16%. The key area of focus is any insights on outlook.

NZX Code	ATM
Share price	NZ$15.87
Target price	NZ$17.50
Risk rating	High
Issued shares	733.1m
Market cap	NZ$11,635m
Avg daily turnover	708.9k (NZ$10,538k)

Financials: Jun/	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
*Based on normalised profits				

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	26.6	22.0	17.6	14.3
EV/EBIT	26.7	22.1	17.6	14.4
PE	40.9	34.4	27.8	22.6
Price / NTA	15.0	10.4	7.8	6.2
Cash div yld (%)	0.0	0.0	1.1	1.3
Gross div yld (%)	0.0	0.0	1.5	1.8

Key points of interest

- **Outlook:** The key focus of any ATM result. Our channel checking bodes well for outlook given signs of growing demand, particularly in lower tier cities, and further wholesale price increases in December 2019. The key unknown is any impact from Coronavirus, particularly on inventory movement. Feedback from China-exposed corporates has been mixed, although of relevance to ATM recent commentary from other infant formula (IF) players points to no material impact from Coronavirus to date.
- **Key market insights:** We expect evidence of growing market share and distribution in both China and the US.
  - IF in China: We expect a strong result. Channel anecdotes and demand indicators are positive and our ATM Kantar market share data has been particularly strong in recent periods (~7.5% in December 2019 vs rolling six month share of 6.6%), although recent port data has been weaker. We look for outlook comments, growing China label sales and any update to distribution.
  - US: We look for any further distribution expansion and growing sell through rates. We view liquid milk as a platform for building brand awareness, ahead of launching more profitable products in the market.
- **Margin update and outlook:** In 1H20 we forecast gross margin expansion, yet EBITDA margin contraction as a step-up in cost investment (particularly marketing) outweighs favourable product mix (strength in IF) and price increases in July 2019. Of key interest will be outlook. ATM's latest guidance was FY20E EBITDA margins of 29–30% and medium-term margins of >30%. We see upside risk to our current expectations, primarily due to higher IF gross margins given recent price increases in December 2019.
- **Updated cash balance and inventory position**.

Conference call — Thursday 27 February, 11am NZ time

Dial in details are 0800 452 782 (New Zealand), 1800 123 296 (Australia). Conference ID: 7897276.

Figure 1. 1H20 result expectations

NZ$m	1H19	1H20E	% chg
Revenue	613.1	792.5	29.3%
EBITDA	**218.4**	**252.5**	**15.6%**
EBITDA margin	35.6%	31.9%	-376bp
Underlying profit	**152.7**	**176.8**	**15.8%**
Underlying EPS (cps)	20.9	24.2	15.8%
Dividend (cps)	0.0	0.0	n/a

Source: Forsyth Barr analysis, Company reports

Figure 2. Divisional expectations

NZ$m	1H19	1H20E	% chg
Revenue by product			
Infant Formula	495.5	643.2	29.8%
Liquid Milk	83.4	100.8	20.9%
Other	34.2	48.5	41.8%
Total revenue	**613.1**	**792.5**	**29.3%**
Gross margin	55.6%	57.0%	140bp

Source: Forsyth Barr analysis, Company reports

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The a2 Milk Company (ATM)

Priced as at 24 Feb 2020 (NZ$)	**15.87**

12-month target price (NZ$)*	**17.50**
Expected share price return	10.3%
Net dividend yield	0.7%
Estimated 12-month return	11.0%

Key WACC assumptions	
Risk free rate	2.00%
Equity beta	0.88
WACC	8.8%
Terminal growth	2.0%

Profit and Loss Account (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Sales revenue	922.7	1,304.5	1,658.6	2,062.4	2,491.9
Normalised EBITDA	**283.0**	**413.6**	**488.4**	**602.3**	**738.5**
Depreciation and amortisation	(2.2)	(2.2)	(2.3)	(2.5)	(2.7)
Normalised EBIT	**280.9**	**411.4**	**486.0**	**599.7**	**735.8**
Net interest	2.4	4.3	6.6	10.2	14.1
Associate income	0	0	0	0	0
Tax	(87.5)	(128.0)	(150.3)	(186.0)	(228.7)
Minority interests	0	0	0	0	0
Normalised NPAT	**195.7**	**287.7**	**342.4**	**423.9**	**521.2**
Abnormals/other	0	0	0	0	0
Reported NPAT	**195.7**	**287.7**	**342.4**	**423.9**	**521.2**
Normalised EPS (cps)	26.3	38.8	46.1	57.1	70.3
DPS (cps)	0	0	0	17.1	21.1

Growth Rates	**2018A**	**2019A**	**2020A**	**2021A**	**2022A**
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
Ordinary DPS (%)	n/a	n/a	n/a	n/a	23.0

Cash Flow (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EBITDA	**283.0**	**413.6**	**488.4**	**602.3**	**738.5**
Working capital change	36.1	(6.5)	(28.4)	(8.6)	(7.8)
Interest & tax paid	(66.9)	(129.6)	(143.7)	(175.8)	(214.6)
Other	(21.1)	11.6	0	0	0
Operating cash flow	**231.1**	**289.1**	**316.3**	**417.9**	**516.1**
Capital expenditure	(4.8)	(3.4)	(3.4)	(3.4)	(3.4)
(Acquisitions)/divestments	(16.1)	(162.3)	0	0	0
Other	0	0	0	0	0
Funding available/(required)	**210.2**	**123.4**	**312.9**	**414.5**	**512.8**
Dividends paid	0	0	0	(50.3)	(137.2)
Equity raised/(returned)	7.3	2.9	0	0	0
(Increase)/decrease in net debt	**217.5**	**126.3**	**312.9**	**364.3**	**375.5**

Balance Sheet (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Working capital	14.3	1.0	35.4	43.9	51.7
Fixed assets	9.7	10.3	11.3	12.1	12.7
Intangibles	15.1	13.0	13.0	13.0	13.0
Right of use asset	0	0	0	0	0
Other assets	227.7	344.2	362.6	379.2	396.9
Total funds employed	**266.8**	**368.4**	**422.3**	**448.3**	**474.4**
Net debt/(cash)	(340.5)	(464.8)	(777.7)	(1,142.0)	(1,517.5)
Lease liability	0	0	0	0	0
Other liabilities	51.6	45.4	69.8	86.4	104.1
Shareholder's funds	555.7	787.9	1,130.2	1,503.9	1,887.9
Minority interests	0	0	0	0	0
Total funding sources	**266.8**	**368.4**	**422.3**	**448.3**	**474.4**

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

Spot valuations (NZ$)	
1. DCF	16.58
2. Peer multiple	16.94
n/a	n/a

DCF valuation summary (NZ$m)	
Total firm value	11,403
(Net debt)/cash	465
Less: Capitalised operating leases	0
Value of equity	11,868

Valuation Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EV/EBITDA (x)	39.9	26.6	22.0	17.6	14.3
EV/EBIT (x)	40.2	26.7	22.1	17.6	14.4
PE (x)	60.3	40.9	34.4	27.8	22.6
Price/NTA (x)	21.3	15.0	10.4	7.8	6.2
Free cash flow yield (%)	1.9	2.5	2.7	3.6	4.4
Net dividend yield (%)	0.0	0.0	0.0	1.1	1.3
Gross dividend yield (%)	0.0	0.0	0.0	1.5	1.8

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
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	0	0	0	30	30

Operating Performance	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Revenue (breakdown by product)					
Total Infant Formula	724	1,064	1,358	1,697	2,042
Total Fresh Milk	142	175	222	275	346
Other	56	66	78	90	104
Total	**923**	**1,304**	**1,658**	**2,062**	**2,492**
Revenue (breakdown by country)					
Australia & NZ	656	843	915	940	968
China & Other Asia	234	406	674	1,006	1,341
US	13	35	69	116	183
Other	19	22	0	0	0
Total	**923**	**1,304**	**1,658**	**2,062**	**2,492**
EBITDA insights					
Gross margin	50	55	56	56	56
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**

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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.

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.

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.

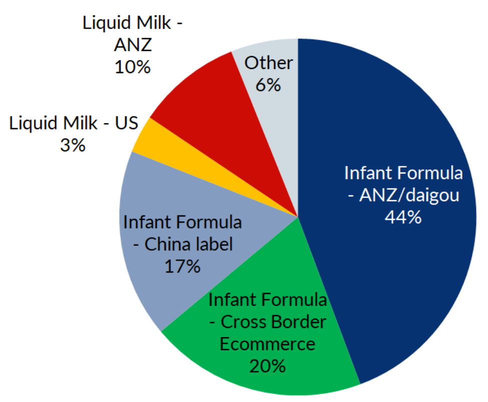
Financial structure

- **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

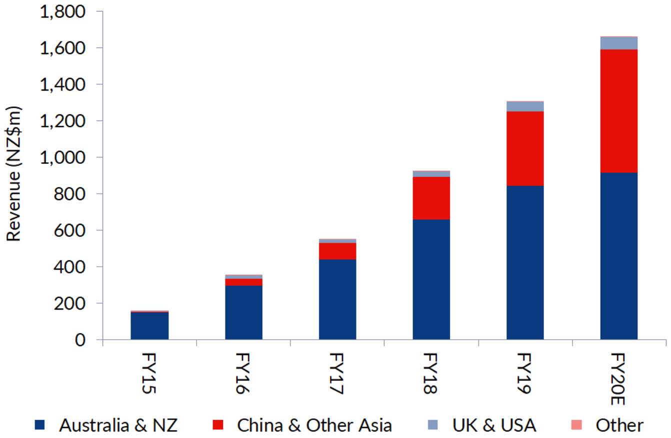
- **Competitive behaviour:** Any discounting or channel stuffing could disrupt the market. Direct competition is also emerging in the a2 / a1-free market.
- **Food safety/quality scare:** ATM's brand and reputation are key pillars to its model. Reliance on third party suppliers adds complexity and risk.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

Figure 3. Revenue breakdown — 1H20E



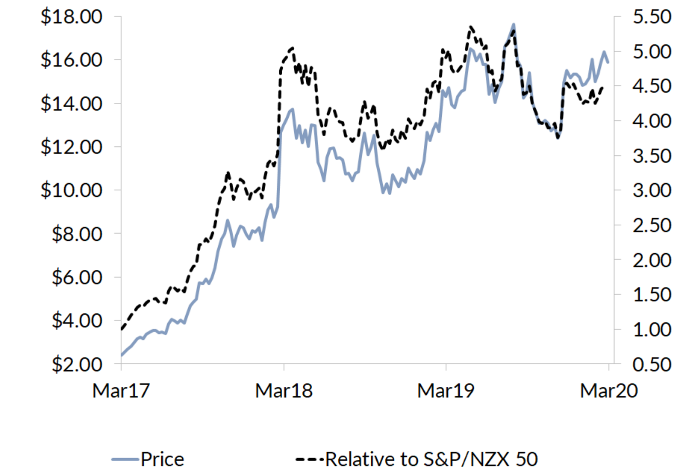
Source: Forsyth Barr analysis, Company reports

Figure 4. Revenue breakdown by market



Source: Forsyth Barr analysis, Company reports

Figure 5. Price performance



Source: Forsyth Barr analysis

Figure 6. Substantial shareholders

Shareholder	Latest Holding
Mitsubishi UFJ Financial Group	10.2%
The Vanguard Group	7.0%
UBS	6.6%
Pendal Group Limited	6.3%
BlackRock Investment Management	5.2%
Morgan Stanley	5.2%

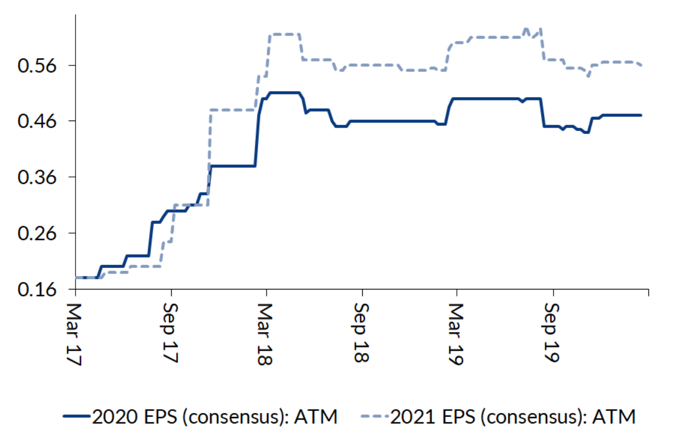
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 7. International valuation comparisons

Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash 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$15.87**	**NZ$11,635**	**34.4x**	**27.8x**	**22.9x**	**18.5x**	**23.0x**	**18.6x**	**1.1%**
CHINA FEIHE	6186 HK	CN¥12.10	CN¥108,093	n/a	21.1x	18.7x	14.6x	19.1x	14.7x	1.7%
Synlait Milk *	SML NZ	NZ$6.52	NZ$1,169	15.1x	12.8x	8.8x	7.6x	11.8x	10.1x	0.0%
BLACKMORES	BKL AT	A$70.24	A$1,222	>50x	30.1x	29.4x	16.1x	37.8x	20.1x	2.4%
HEALTH AND HAPPINESS H&H INT	1112 HK	CN¥35.35	CN¥22,751	18.0x	15.5x	11.4x	10.5x	12.4x	11.3x	1.7%
RECKITT BENCKISER GROUP PLC	RB/ LN	£64.14	£45,523	19.5x	19.3x	15.3x	15.2x	16.9x	16.9x	2.7%
AUSNUTRIA DAIRY CORP	1717 HK	CN¥12.90	CN¥20,816	20.2x	15.6x	14.4x	11.1x	16.3x	12.1x	2.3%
INNER MONGOLIA YILI INDUS-A	600887 CH	CN¥30.71	CN¥187,220	25.4x	22.7x	18.1x	15.8x	22.5x	19.9x	2.8%
DANONE	BN FP	€71.00	€48,715	17.8x	16.5x	12.7x	11.9x	15.8x	14.8x	3.2%
CHINA MENGNIU DAIRY CO	2319 HK	CN¥29.55	CN¥116,299	24.9x	23.4x	16.1x	13.9x	22.5x	19.5x	1.0%
			Compco Average:	**20.1x**	**19.7x**	**16.1x**	**13.0x**	**19.4x**	**15.5x**	**2.0%**
EV = Current Market Cap + Actual Net Debt			**ATM Relative:**	**71%**	**41%**	**42%**	**43%**	**18%**	**20%**	**-46%**

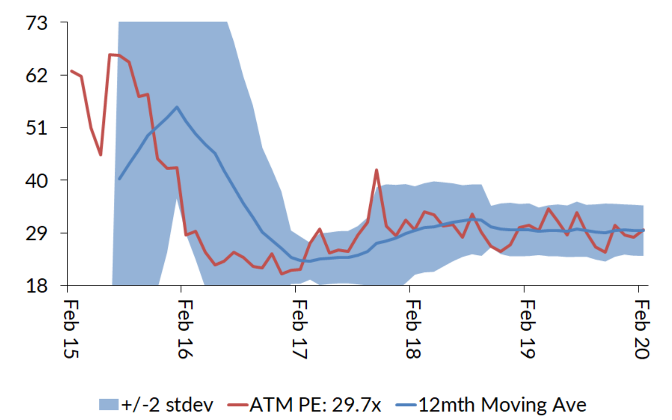
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (ATM) companies fiscal year end

Figure 8. Consensus EPS momentum (NZ$)



Source: Forsyth Barr analysis

Figure 9. One year forward PE (x)



Source: Forsyth Barr analysis

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