FORSYTH BARR

NEW ZEALAND EQUITY RESEARCH | FOOD, BEVS, & AGRI | DAIRY NUTRITION COMPANY
28 FEBRUARY 2020

The a2 Milk Company
1H20 Result — ATM Machine Delivers

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OUTPERFORM

The a2 Milk Company (ATM) reported a strong 1H20 result, modestly ahead of our expectations, with market share gains evident across all products and markets, and another lift in its cash position. Highlights were (1) strength in sales in-market in China, with a further broadening in sales channels; (2) gross margin momentum; (3) supportive brand and demand indicators. We have upgraded our EBITDA forecasts by +2–4%. We continue to see the risk/reward as favourable with valuation metrics (EV/EBIT 17x, PE 25x adjusted for US losses/cash) attractive vs peers, history and the market, particularly given ATM's strong free cashflow and growth outlook. OUTPERFORM.

NZX Code	ATM
Share price	NZ$16.42
Target price	NZ$18.50
Risk rating	High
Issued shares	733.1m
Market cap	NZ$12,038m
Avg daily turnover	716.6k (NZ$10,678k)

Financials: Jun/	19A	20E	21E	22E
NPAT* (NZ$m)	287.7	354.1	438.4	529.0
EPS* (NZc)	38.8	47.7	59.1	71.3
EPS growth* (%)	47.4	23.1	23.8	20.7
DPS (NZc)	0.0	0.0	0.0	21.4
Imputation (%)	100	100	100	100
*Based on normalised profits				

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	27.6	21.9	17.6	14.6
EV/EBIT	27.7	22.1	17.7	14.7
PE	42.3	34.4	27.8	23.0
Price / NTA	15.5	10.7	7.7	5.9
Cash div yld (%)	0.0	0.0	0.0	1.3
Gross div yld (%)	0.0	0.0	0.0	1.8

1H20 result — strong report card

1H20 EBITDA was up +20.5% on the prior year and modestly ahead of guidance and our expectations. Strong revenue growth across all products and markets, coupled with gross margin expansion (+173bp) outweighed a well-signalled step-change in costs. Underlying EBITDA growth was better than the headline suggests given some 'one-off' cost lifts (FX loss of -NZ$4m, introduction of carbon costs -NZ$5m) and greater US losses in the period (to -NZ$30m from -NZ$17m).

Market share and store distribution continues to grow across both key markets (US and China). The key infant formula (IF) segment reported +33% revenue growth, with in-market China sales momentum (+77%) particularly encouraging. China IF 12m rolling market share (Kantar Tier 1 & Key A-D cities) sits at 6.6% (vs 6.4% at June 2019 and 5.4% at 1H19) and ~7.5% for the month of December.

Outlook appears conservative given strong 1H and early momentum in 2H, however, heightened uncertainty with coronavirus

Outlook is the key focus of any ATM result. Comments, margin guidance and strategic priorities are broadly consistent with prior indications to the market. The key change is coronavirus which has supported a strong start to 2H20 (ahead of ATM expectations). We have modestly lifted our earnings forecasts (+2–4%) after the strong 1H20 result. In light of the recent trajectory, guidance appears conservative and hence we see additional risk to the upside for our forecasts, although acknowledge the level of uncertainty is heightened given coronavirus and the evolving impact on both Chinese demand and inventory movements.

Cash is king with ample optionality around its supply chain and/or capital management

ATM's net cash position lifted to NZ$618m in 1H20. While retaining some cash is prudent, the current level (which continues to accelerate) offers ample optionality. ATM has been clear that growth comes first and indicated it is presently assessing "participation in manufacturing capacity and capability to complement existing supply chain relationships". While the rationale appears sensible (risk mitigation and acknowledging no IF manufacturing expertise) it is not clear how this may evolve which makes it difficult to draw any firm conclusions given a number of potential different scenarios. It looks highly unlikely that its large (and growing) cash position will be fully utilised by organic growth initiatives (i.e. continual ramp in marketing spend) and any participation in manufacturing, leaving room for capital management in the medium-term.

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The a2 Milk Company (ATM)

Priced as at 27 Feb 2020 (NZ$)	**16.42**

12-month target price (NZ$)*	**18.50**
Expected share price return	12.7%
Net dividend yield	0.0%
Estimated 12-month return	12.7%

Spot valuations (NZ$)	
1. DCF	16.80
2. Peer multiple	17.65
n/a	n/a

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

DCF valuation summary (NZ$m)	
Total firm value	11,871
(Net debt)/cash	465
Less: Capitalised operating leases	(18)
Value of equity	12,317

Profit and Loss Account (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Sales revenue	922.7	1,304.5	1,673.7	2,062.8	2,478.5
Normalised EBITDA	**283.0**	**413.6**	**507.0**	**624.5**	**750.5**
Depreciation and amortisation	(2.2)	(2.2)	(3.8)	(4.0)	(4.2)
Normalised EBIT	**280.9**	**411.4**	**503.2**	**620.5**	**746.3**
Net interest	2.4	4.3	6.3	10.3	14.9
Associate income	0	0	0	0	0
Tax	(87.5)	(128.0)	(155.4)	(192.4)	(232.2)
Minority interests	0	0	0	0	0
Normalised NPAT	**195.7**	**287.7**	**354.1**	**438.4**	**529.0**
Abnormals/other	0	0	0	0	0
Reported NPAT	**195.7**	**287.7**	**354.1**	**438.4**	**529.0**
Normalised EPS (cps)	26.3	38.8	47.7	59.1	71.3
DPS (cps)	0	0	0	0	21.4

Valuation Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EV/EBITDA (x)	41.3	27.6	21.9	17.6	14.6
EV/EBIT (x)	41.6	27.7	22.1	17.7	14.7
PE (x)	62.4	42.3	34.4	27.8	23.0
Price/NTA (x)	22.0	15.5	10.7	7.7	5.9
Free cash flow yield (%)	1.9	2.4	2.7	3.5	4.3
Net dividend yield (%)	0.0	0.0	0.0	0.0	1.3
Gross dividend yield (%)	0.0	0.0	0.0	0.0	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	-223.9	-333.4	-450.2
Net debt/EBITDA (x)	n/a	n/a	n/a	n/a	n/a

Growth Rates	**2018A**	**2019A**	**2020A**	**2021A**	**2022A**
Revenue (%)	67.9	41.4	28.3	23.2	20.2
EBITDA (%)	>100	46.1	22.6	23.2	20.2
EBIT (%)	>100	46.5	22.3	23.3	20.3
Normalised NPAT (%)	>100	47.0	23.1	23.8	20.7
Normalised EPS (%)	>100	47.4	23.1	23.8	20.7
Ordinary DPS (%)	n/a	n/a	n/a	n/a	n/a

Key Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Return on assets (%)	39.2	41.4	35.2	32.2	30.3
Return on equity (%)	35.2	36.5	31.0	27.8	25.9
Return on funds employed (%)	116.0	106.3	104.2	121.2	142.1
EBITDA margin (%)	30.7	31.7	30.3	30.3	30.3
EBIT margin (%)	30.4	31.5	30.1	30.1	30.1
Capex to sales (%)	0.5	0.3	0.2	0.2	0.1
Capex to depreciation (%)	223	155	88	83	79
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	0	0	0	0	30

Cash Flow (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EBITDA	**283.0**	**413.6**	**507.0**	**624.5**	**750.5**
Working capital change	36.1	(6.5)	(30.9)	(13.2)	(8.8)
Interest & tax paid	(66.9)	(129.6)	(149.1)	(182.1)	(217.3)
Other	(21.1)	11.6	0	0	0
Operating cash flow	**231.1**	**289.1**	**327.0**	**429.2**	**524.5**
Capital expenditure	(4.8)	(3.4)	(3.4)	(3.4)	(3.4)
(Acquisitions)/divestments	(16.1)	(162.3)	0	0	0
Other	0	0	0.7	0.8	0.9
Funding available/(required)	**210.2**	**123.4**	**324.3**	**426.6**	**522.0**
Dividends paid	0	0	0	0	(62.7)
Equity raised/(returned)	7.3	2.9	0	0	0
(Increase)/decrease in net debt	**217.5**	**126.3**	**324.3**	**426.6**	**459.3**

Operating Performance	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Revenue (breakdown by product)					
Total Infant Formula	724	1,064	1,375	1,699	2,031
Total Fresh Milk	142	175	220	273	344
Other	56	66	78	90	104
Total	**923**	**1,304**	**1,674**	**2,063**	**2,478**
Revenue (breakdown by country)					
Australia & NZ	656	843	915	943	971
China & Other Asia	234	406	690	1,006	1,328
US	13	35	68	113	180
Other	19	22	0	0	0
Total	**923**	**1,304**	**1,674**	**2,063**	**2,478**
EBITDA insights					
Gross margin	50	55	56	57	57
Gross profit	464	714	942	1,177	1,408
Total SG&A expenses	(181)	(300)	(435)	(552)	(657)
incl marketing expenses	(74)	(135)	(197)	(256)	(307)
Total SG&A as % of revenue	19.7	23.0	26.0	26.8	26.5
Group EBITDA	**283**	**414**	**507**	**625**	**751**
US - EBITDA losses	(29)	(44)	(56)	(54)	(47)
EBITDA excluding US losses	**312**	**458**	**563**	**678**	**797**

Balance Sheet (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Working capital	14.3	1.0	37.9	51.1	59.8
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	15.7	16.2	16.7
Other assets	227.7	344.2	363.3	379.3	396.3
Total funds employed	**266.8**	**368.4**	**441.2**	**471.7**	**498.6**
Net debt/(cash)	(340.5)	(464.8)	(788.8)	(1,215.0)	(1,673.9)
Lease liability	0	0	18.5	20.8	23.3
Other liabilities	51.6	45.4	70.4	86.4	103.5
Shareholder's funds	555.7	787.9	1,141.1	1,579.4	2,045.7
Minority interests	0	0	0	0	0
Total funding sources	**266.8**	**368.4**	**441.2**	**471.7**	**498.6**

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

1H20 Result Takeaways

ATM reported a strong result, with EBITDA of NZ$263m up +20.5% on the prior year and modestly ahead of our forecasts. Free cash flow generation remains impressive and was ahead of our forecasts — ATM finished the year with net cash of NZ$618m.

Figure 1. 1H20 result (including discontinued operations)

NZ$m	1H19	1H20	% chg	Forsyth Barr
Revenue	613.1	806.7	31.6%	792.5
EBITDA	218.4	263.2	20.5%	252.5
EBITDA margin	35.6%	32.6%	-299bp	31.9%
Underlying profit	152.7	184.9	21.1%	176.8
Underlying EPS (cps)	20.9	25.2	20.6%	24.2
Dividend (cps)	0.0	0.0	n/a	0.0

Source: Forsyth Barr analysis, Company reports

Figure 2. 1H20 divisional detail

NZ$m	1H19	1H20	% chg	Forsyth Barr
Revenue by product				
Infant Formula	495.5	659.2	33.0%	643.2
Liquid Milk	83.4	105.8	26.9%	100.8
Other	34.2	41.7	21.8%	48.5
Total revenue	613.1	806.7	31.6%	792.5
Gross margin	55.6%	57.3%	173bp	57.0%

Source: Forsyth Barr analysis, Company reports

Earnings revisions, outlook and our view

ATM reaffirmed recent outlook commentary for "continued strong revenue growth" and previous margin (and marketing spend) guidance (29–30% in FY20 and ~30% in medium-term). Early trading in 2H20 has been stronger than anticipated but it is difficult to know the extent of any pull-forward of demand as a result of coronavirus. We make modest upgrades to our earnings expectations driven by a slight lift in revenue growth assumptions for China IF and higher IF gross margin forecasts (reflecting the recent wholesale price increase). We have also pushed out our expectations for ATM to instate a dividend policy by 12 months, given the company's clear priority on growth and comments it is assessing options around "participation" in manufacturing.

Figure 3. Earnings revisions (NZ$m)

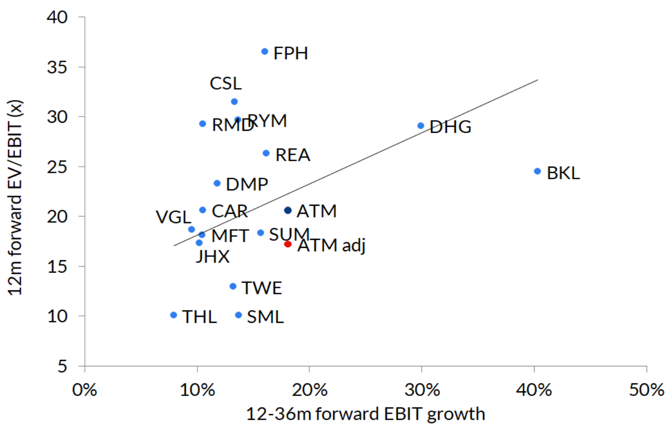
	FY20E			FY21E			FY22E		
NZ$m	Old	New	% chg	Old	New	% chg	Old	New	% chg
Revenue	1,658.6	1,673.7	0.9%	2,062.4	2,062.8	0.0%	2,491.9	2,478.5	-0.5%
EBITDA	488.4	507.0	3.8%	602.3	624.5	3.7%	738.5	750.5	1.6%
Underlying profit	342.4	354.1	3.4%	423.9	438.4	3.4%	521.2	529.0	1.5%
Underlying EPS (cps)	46.1	47.7	3.4%	57.1	59.1	3.4%	70.3	71.3	1.5%
Dividend (cps)	0.0	0.0	n/a	17.1	0.0	n/a	21.1	21.4	1.5%

Source: Forsyth Barr analysis

OUTPERFORM retained; NZ$18.50

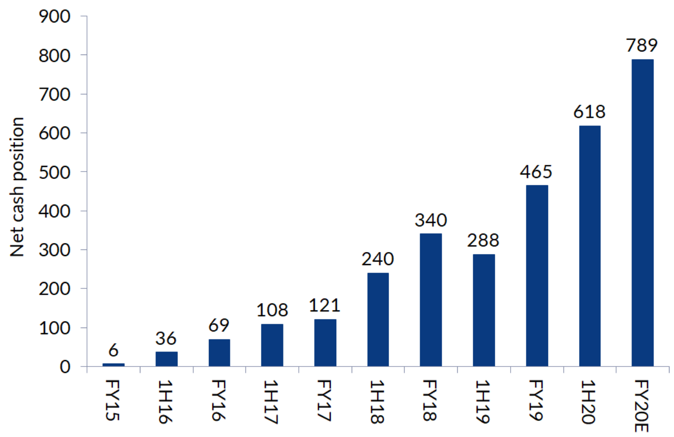
We lift our target price to NZ$18.50 (prior NZ$17.50), given earnings changes discussed above, and retain OUTPERFORM. ATM's 1H20 result once again reinforces the attraction of the model — with a product in high demand, strong free cash flow and attractive profit margins. Recent insights remain positive to growing demand/revenue, while investment should support longer-term growth. Valuation metrics offer a favourable risk/reward, particularly when adjusted for material US losses and its net cash position (adjusted 12m forward PE of ~25x, EV/EBIT ~17x) vs the NZ market and other Australasian growth stocks.

Figure 4. EV/EBIT vs growth for Australasian growth companies



Source: Forsyth Barr analysis, Bloomberg

Figure 5. Net cash position provides ample optionality



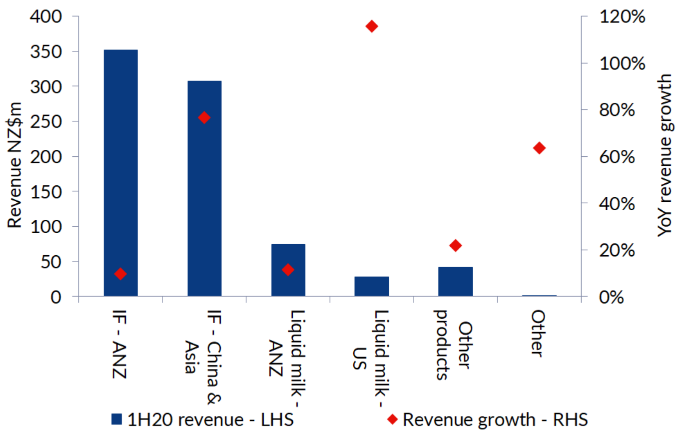
Source: Forsyth Barr analysis, Company reports

Key issues and charts

(1) Strong revenue momentum across the board

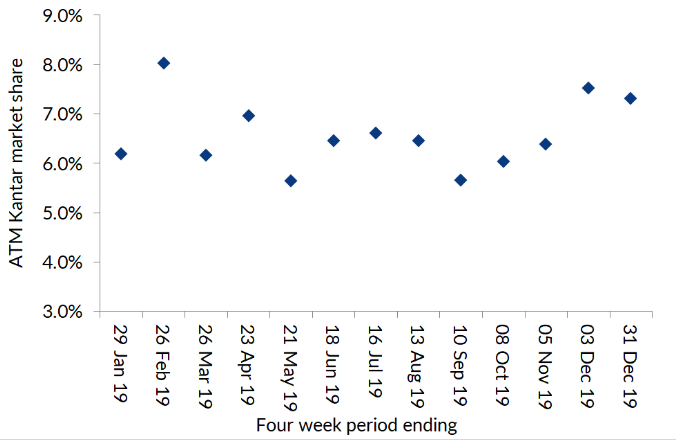
1H20 revenue of NZ$806.7m was up +32% on the prior year and modestly ahead of recent company guidance (NZ$780–800m). Growth was strong across all products, channels and markets, however, the particular standout was on the ground sales in China (IF revenue +77%). Distribution points continue to increase (18,300 in China vs 16,400 in June 2019; 17,500 in the US vs 13,100 in June), wholesale prices in the key IF segment have recently been increased (again) and market share gains are evident. However, there is ample opportunity remaining, with ATM still <5% of the total retail market in both China and the US.

Figure 6. Revenue and growth by product



Source: Forsyth Barr analysis, Company reports

Figure 7. ATM Kantar market share shows recent increase



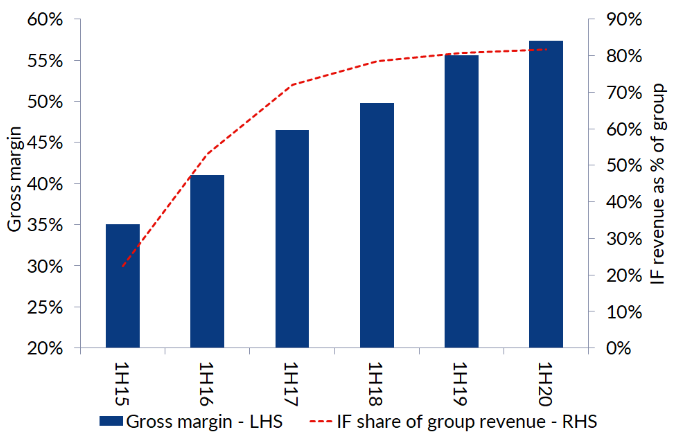
Source: Forsyth Barr analysis, Company reports

(2) Impressive gross margin expansion, outweighed by a step-change in costs

ATM reported EBITDA growth of +21% YoY to NZ$266.5m (continuing operations) or growth of +26% adjusting for a further lift in US losses (to -NZ$30m from -NZ$17.3m, as ATM continues to prioritise revenue and building critical mass). An impressive lift in gross margins was outpaced by a step-change across key SG&A expense lines.

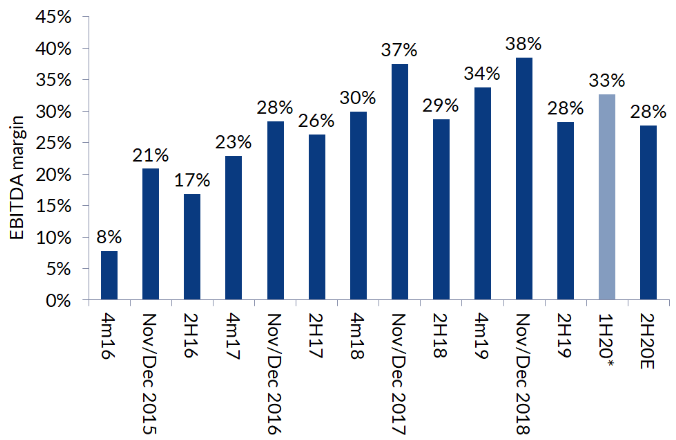
- **Gross margin:** 57.3% in 1H20, ahead of the prior year and modestly above our forecasts. This reflects (1) product mix benefits (i.e. strong growth in IF) and (2) price increases — most notable in IF with wholesales price lifts implemented in around July and December 2019.
- **Marketing:** The critical investment line for the a2 brand. 1H20 spend of NZ$84m was materially ahead of the prior year (+88% YoY) although modestly lower than 2H19 and our expectations. ATM has retained FY20 guidance to spend NZ$200m, although acknowledged risk this may be lower depending on what is feasible in China as a result of coronavirus.
- **SG&A ex marketing:** +63% YoY in 1H20 with a step-change in most key cost lines a function of investing to support business growth.

Figure 8. Another period of strong gross margin expansion



Source: Forsyth Barr analysis, Company reports

Figure 9. EBITDA margin



Source: Forsyth Barr analysis, Company reports

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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.

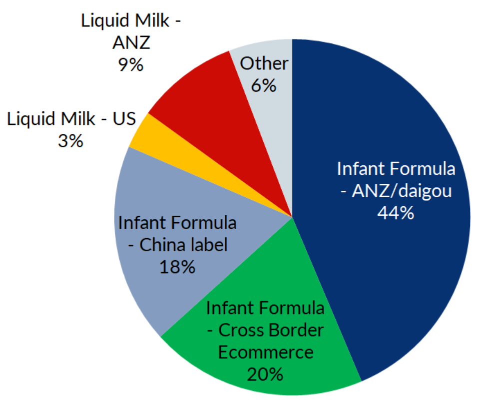
Financial structure

- **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

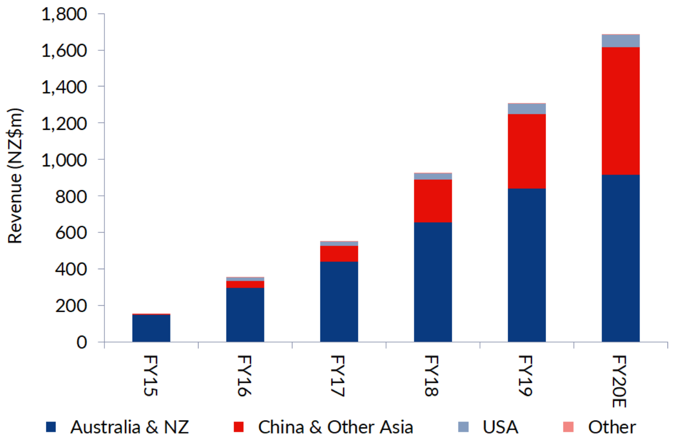
- **Competitive behaviour:** Any discounting or channel stuffing could disrupt the market. Direct competition is also emerging in the a2/a1 free market.
- **Food safety/quality scare:** ATM's brand and reputation are key pillars to its model. Reliance on third party suppliers adds complexity and risk.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

Figure 10. Revenue breakdown by product and channel



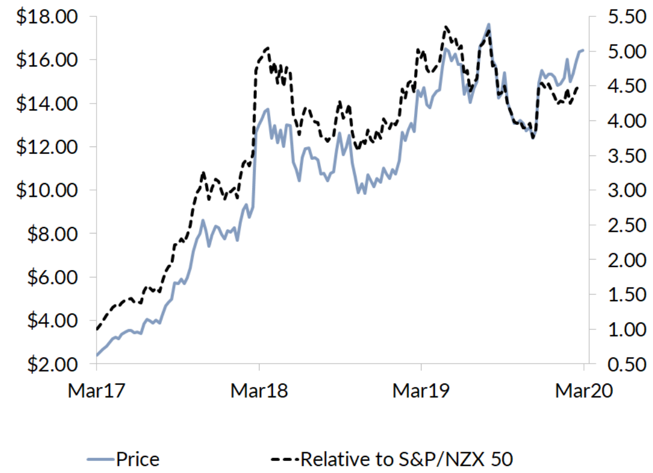
Source: Forsyth Barr analysis, Company reports

Figure 11. Revenue by market



Source: Forsyth Barr analysis, Company reports

Figure 12. Price performance



Source: Forsyth Barr analysis

Figure 13. 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	5.0%

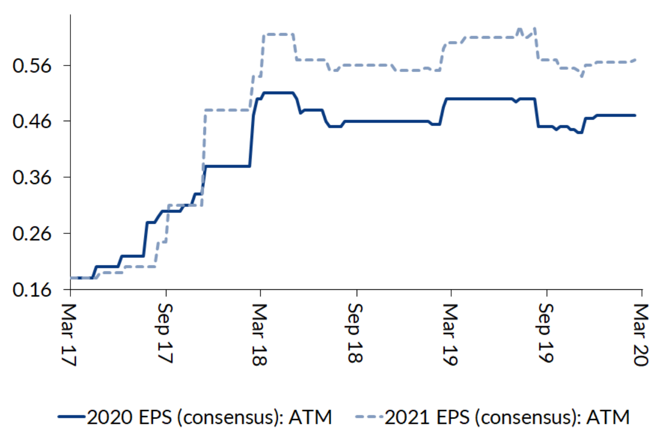
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 14. 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$16.42**	**NZ$12,038**	**34.4x**	**27.8x**	**22.8x**	**18.5x**	**23.0x**	**18.7x**	**0.0%**
CHINA FEIHE	6186 HK	CN¥11.98	CN¥107,021	n/a	20.7x	18.5x	14.5x	18.9x	14.5x	1.7%
Synlait Milk *	SML NZ	NZ$6.15	NZ$1,103	14.2x	12.1x	8.4x	7.3x	11.3x	9.6x	0.0%
BLACKMORES	BKL AT	A$66.59	A$1,158	>50x	29.6x	26.4x	15.5x	36.6x	20.9x	2.4%
HEALTH AND HAPPINESS H&H INT	1112 HK	CN¥34.70	CN¥22,333	17.6x	15.2x	11.2x	10.4x	12.2x	11.1x	1.7%
RECKITT BENCKISER GROUP PLC	RB/ LN	£58.41	£41,457	3.4x	17.6x	14.9x	14.2x	16.6x	15.8x	2.9%
AUSNUTRIA DAIRY CORP	1717 HK	CN¥12.96	CN¥20,913	20.3x	15.7x	14.5x	11.1x	16.4x	12.1x	2.3%
INNER MONGOLIA YILI INDUS-A	600887 CH	CN¥29.95	CN¥182,587	24.8x	22.1x	17.6x	15.4x	22.0x	19.4x	2.9%
DANONE	BN FP	€65.40	€44,872	19.0x	15.4x	11.9x	11.0x	15.9x	13.7x	3.5%
CHINA MENGNIU DAIRY CO	2319 HK	CN¥28.45	CN¥111,970	24.0x	22.5x	15.6x	13.4x	21.6x	18.8x	1.1%
			Compco Average:	**17.6x**	**19.0x**	**15.4x**	**12.5x**	**19.0x**	**15.1x**	**2.1%**
EV = Current Market Cap + Actual Net Debt			**ATM Relative:**	**95%**	**46%**	**48%**	**48%**	**21%**	**23%**	**-100%**

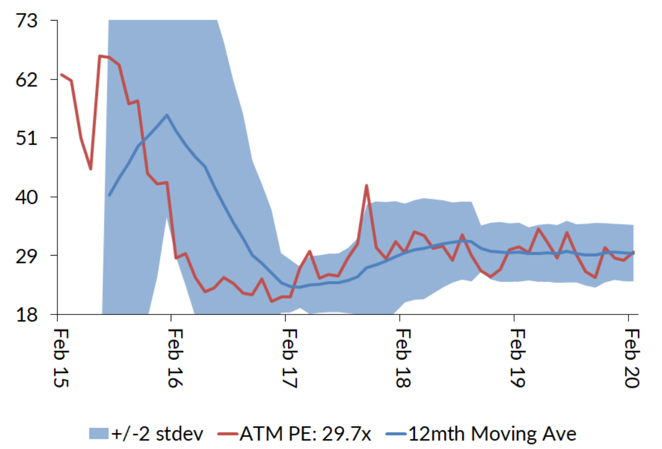
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (ATM) companies fiscal year end

Figure 15. Consensus EPS momentum (NZ$)



Source: Forsyth Barr analysis

Figure 16. One year forward PE (x)



Source: Forsyth Barr analysis

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