NEW ZEALAND EQUITY RESEARCH | FOOD, BEVS, & AGRI | DAIRY NUTRITION COMPANY
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The a2 Milk Company
Taking a Step into Processing

CHELSEA LEADBETTER CFA
chelsea.leadbetter@forsythbarr.co.nz
+64 4 495 5262

MATT MONTGOMERIE
matt.montgomerie@forsythbarr.co.nz
+64 9 368 0124

OUTPERFORM

The a2 Milk Company (ATM) has entered into exclusive due diligence and filed a non-binding indicative offer to purchase a 75% interest in NZ dairy processor, Mataura Valley Milk (MVM). Strategically the transaction makes sense, particularly for risk mitigation over the longer-term. Importantly it provides manufacturing diversification, future proofing in case of regulatory change (requiring integrated manufacturing) and a stronger relationship with China State Farms. However, we expect it to take time to provide an adequate payback / return, with risk of a (small) operating loss near-term, depending how much volume is able to be shifted. Using Synlait Milk (SML.NZ) as a benchmark suggests returns above WACC (albeit unsurprisingly well below ATM's current ROIC) is achievable in time, particularly should the facility get Chinese regulatory approval.

NZX Code	ATM
Share price	NZ$20.27
Target price	NZ$25.00
Risk rating	High
Issued shares	736.5m
Market cap	NZ$14,928m
Avg daily turnover	728.4k (NZ$12,068k)

Financials: Jun/	20A	21E	22E	23E
NPAT* (NZ$m)	385.8	456.1	537.9	609.9
EPS* (NZc)	52.1	61.6	72.7	82.4
EPS growth* (%)	34.4	18.2	17.9	13.4
DPS (NZc)	0.0	0.0	0.0	24.7
Imputation (%)	100	100	100	100

*Based on normalised profits

Valuation (x)	20A	21E	22E	23E
EV/EBITDA	25.5	21.0	17.6	15.6
EV/EBIT	25.7	21.2	17.8	15.8
PE	38.9	32.9	27.9	24.6
Price / NTA	13.3	9.6	7.1	5.7
Cash div yld (%)	0.0	0.0	0.0	1.2
Gross div yld (%)	0.0	0.0	0.0	1.7

Transaction key points of note

- **Non-binding indicative offer for 75% interest in MVM:** For NZ$270m, as part of ATM's long-term strategy to "participate in manufacturing". This implies an enterprise value of ~NZ$360m for MVM (~1.4x build cost; ~1.3x total assets). China Animal Husbandry Group, who is directly linked to China State Farms (ATM's main China distributor), will retain a 25% holding in MVM.
- **What is ATM buying**: MVM owns a new, high spec, processing facility in Gore, New Zealand. The plant commenced production in November 2018, cost ~NZ$258m, and is designed for manufacturing nutritional grade milk powders with a 30,000MT capacity. MVM reported an EBIT loss of -NZ$36m (FY19) given low plant utilisation and a skew towards commodity ingredients.
- **Additional investment likely:** Including a blending & canning facility and the potential need to move the plant away from coal. We estimate this could cost an additional c. NZ$100m.
- **Timing:** The transaction is subject to further due diligence, among other things, albeit expected to settle towards the end of FY21.
- **Funding:** Solely cash reserves. The transaction, and likely additional investment, will only utilise c. 30% of ATM's FY21E cash.

What do we think — ticks a number of boxes strategically; may take time to deliver reasonable returns

Strategically the acquisition ticks a number of boxes, particularly taking a long-term view. Namely (1) manufacturing diversification, (2) high quality facility in a strong farming area, (3) vertical integration; risk mitigation in case of any shift in Chinese regulation, (4) strengthening its relationship with China State Farms. However, it will take time (and some investment) for MVM to be capable of producing finished infant formula (IF) for ATM, including herd conversion for an a2 milk pool and adding a blending & canning line. For China label product it also requires China factory registration (GACC) and China brand registration (SAMR).

There is a lot we don't know, particularly on production plans and thereby earnings profile. At this stage we leave our forecasts unchanged. We assume ATM would look to move some volumes to the facility initially (some share of whole milk powder, skim milk powder, Smart Nutrition and/or Stage 4). However, to generate an adequate return is reliant on MVM being able to supply IF — with a circa five year time horizon seemingly more realistic.

The a2 Milk Company (ATM)

Priced as at 21 Aug 2020 (NZ$)	20.27

12-month target price (NZ$)*	25.00
Expected share price return	23.3%
Net dividend yield	0.0%
Estimated 12-month return	23.3%

Key WACC assumptions	
Risk free rate	1.30%
Equity beta	0.90
WACC	6.4%
Terminal growth	1.5%

Profit and Loss Account (NZ$m)	2019A	2020A	2021E	2022E	2023E
Sales revenue	1,300.8	1,731.1	2,078.1	2,478.8	2,790.3
Normalised EBITDA	**413.6**	**549.7**	**650.2**	**765.6**	**864.2**
Depreciation and amortisation	(2.2)	(4.4)	(7.3)	(9.7)	(10.0)
Normalised EBIT	**411.4**	**545.3**	**642.9**	**755.9**	**854.2**
Net interest	4.3	5.7	8.5	12.4	17.0
Associate income	0	0	0	0	0
Tax	(128.0)	(165.2)	(195.3)	(230.4)	(261.2)
Minority interests	0	0	0	0	0
Normalised NPAT	**287.7**	**385.8**	**456.1**	**537.9**	**609.9**
Abnormals/other	0	0	0	0	0
Reported NPAT	**287.7**	**385.8**	**456.1**	**537.9**	**609.9**
Normalised EPS (cps)	38.8	52.1	61.6	72.7	82.4
DPS (cps)	0	0	0	0	24.7

Growth Rates	2019A	2020A	2021E	2022E	2023E
Revenue (%)	41.0	33.1	20.0	19.3	12.6
EBITDA (%)	46.1	32.9	18.3	17.8	12.9
EBIT (%)	46.5	32.5	17.9	17.6	13.0
Normalised NPAT (%)	47.0	34.1	18.2	17.9	13.4
Normalised EPS (%)	47.4	34.4	18.2	17.9	13.4
Ordinary DPS (%)	n/a	n/a	n/a	n/a	n/a

Cash Flow (NZ$m)	2019A	2020A	2021E	2022E	2023E
EBITDA	**413.6**	**549.7**	**650.2**	**765.6**	**864.2**
Working capital change	(6.5)	33.6	(47.1)	(3.7)	(1.3)
Interest & tax paid	(129.6)	(192.2)	(186.8)	(218.0)	(244.3)
Other	11.6	35.9	0	0	0
Operating cash flow	**289.1**	**427.0**	**416.3**	**543.9**	**618.6**
Capital expenditure	(3.4)	(7.2)	(29.0)	(10.0)	(10.0)
(Acquisitions)/divestments	(162.3)	(21.9)	(21.0)	0	0
Other	0	(3.6)	(3.5)	(3.7)	(3.8)
Funding available/(required)	**123.4**	**394.3**	**362.7**	**530.2**	**604.8**
Dividends paid	0	0	0	0	(72.8)
Equity raised/(returned)	2.9	2.4	0	0	0
(Increase)/decrease in net debt	**126.3**	**396.8**	**362.7**	**530.2**	**532.0**

Balance Sheet (NZ$m)	2019A	2020A	2021E	2022E	2023E
Working capital	50.6	(7.6)	42.8	50.4	54.6
Fixed assets	10.3	14.2	37.4	40.1	42.7
Intangibles	13.0	13.6	35.5	35.3	35.1
Right of use asset	0	16.1	16.3	16.4	16.6
Other assets	294.5	280.8	280.8	280.8	280.8
Total funds employed	**368.4**	**317.2**	**412.7**	**423.0**	**429.7**
Net debt/(cash)	(464.8)	(854.2)	(1,218.7)	(1,750.7)	(2,284.6)
Lease liability	0	16.8	17.5	18.1	18.7
Other liabilities	45.4	20.5	23.8	27.5	30.5
Shareholder's funds	787.9	1,134.1	1,590.1	2,128.0	2,665.1
Minority interests	0	0	0	0	0
Total funding sources	**368.4**	**317.2**	**412.7**	**423.0**	**429.7**

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

Spot valuations (NZ$)	
1. DCF	25.02
2. Peer multiple	22.60
n/a	n/a

DCF valuation summary (NZ$m)	
Total firm value	17,593
(Net debt)/cash	854
Less: Capitalised operating leases	(17)
Value of equity	18,430

Valuation Ratios	2019A	2020A	2021E	2022E	2023E
EV/EBITDA (x)	34.5	25.5	21.0	17.6	15.6
EV/EBIT (x)	34.7	25.7	21.2	17.8	15.8
PE (x)	52.3	38.9	32.9	27.9	24.6
Price/NTA (x)	19.2	13.3	9.6	7.1	5.7
Free cash flow yield (%)	1.9	2.8	2.6	3.6	4.1
Net dividend yield (%)	0.0	0.0	0.0	0.0	1.2
Gross dividend yield (%)	0.0	0.0	0.0	0.0	1.7

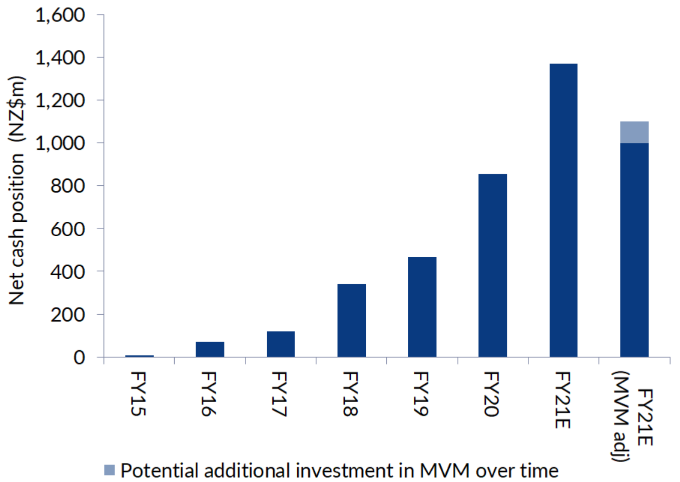
Capital Structure	2019A	2020A	2021E	2022E	2023E
Interest cover EBIT (x)	n/a	n/a	n/a	n/a	n/a
Interest cover EBITDA (x)	n/a	n/a	n/a	n/a	n/a
Net debt/ND+E (%)	-143.9	-305.2	-328.1	-464.0	-600.3
Net debt/EBITDA (x)	n/a	n/a	n/a	n/a	n/a

Key Ratios	2019A	2020A	2021E	2022E	2023E
Return on assets (%)	40.9	37.5	33.6	30.1	27.6
Return on equity (%)	36.5	34.0	28.7	25.3	22.9
Return on funds employed (%)	106.3	127.2	139.0	142.3	159.2
EBITDA margin (%)	31.8	31.8	31.3	30.9	31.0
EBIT margin (%)	31.6	31.5	30.9	30.5	30.6
Capex to sales (%)	0.3	0.4	1.4	0.4	0.4
Capex to depreciation (%)	155	164	397	103	100
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	0	0	0	0	30

Operating Performance	2019A	2020A	2021E	2022E	2023E
Revenue (breakdown by product)					
Total Infant Formula	1,064	1,424	1,742	2,081	2,343
Total Fresh Milk	171	222	235	277	313
Other	66	85	101	120	134
Total	**1,301**	**1,731**	**2,078**	**2,478**	**2,790**
Revenue (breakdown by country)					
Australia & NZ	843	965	1,036	1,096	1,134
China & Other Asia	423	699	975	1,282	1,522
US	35	66	67	101	134
Other	0	0	0	0	0
Total	**1,301**	**1,731**	**2,078**	**2,478**	**2,790**
EBITDA insights					
Gross margin	55	56	57	57	56
Gross profit	713	969	1,176	1,401	1,570
Total SG&A expenses	(300)	(419)	(526)	(635)	(706)
incl marketing expenses	(134)	(194)	(235)	(285)	(321)
Total SG&A as % of revenue	23.0	24.2	25.3	25.6	25.3
Group EBITDA	**414**	**550**	**650**	**766**	**864**
US - EBITDA losses	(44)	(51)	(42)	(35)	(28)
EBITDA excluding US losses	**458**	**600**	**692**	**800**	**892**

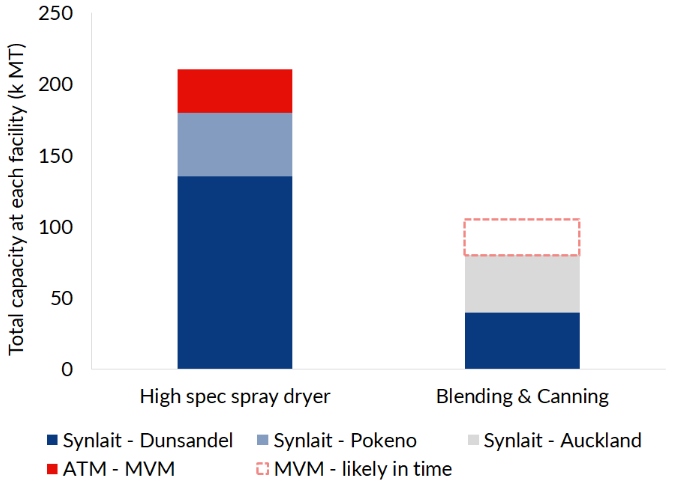
Charts of interest

Figure 1. Net cash position will still be large



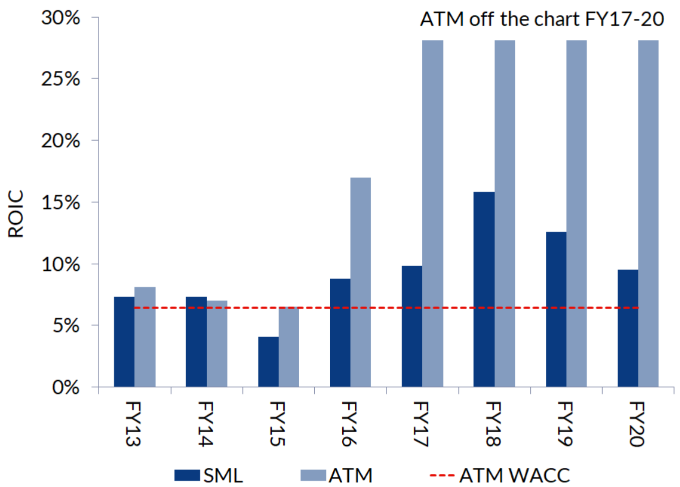
Source: Forsyth Barr analysis, ATM Company reports

Figure 2. Broadening processing options



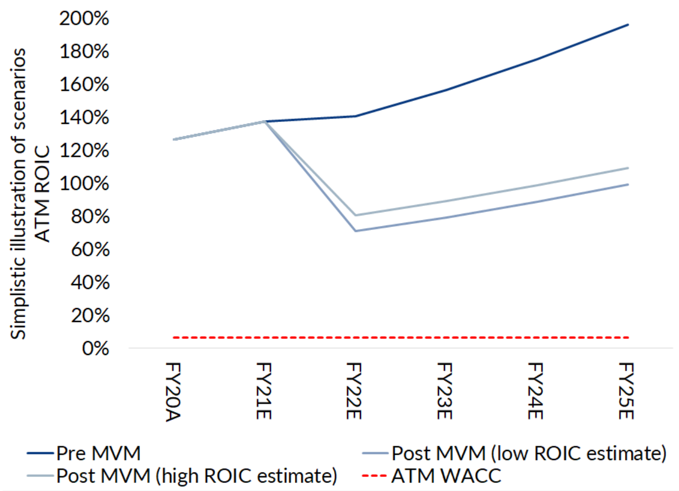
Source: Forsyth Barr analysis, Company disclosures. NB excludes Fonterra and other small processors (e.g. Essence Group) given limited insight

Figure 3. ROIC — ATM versus SML



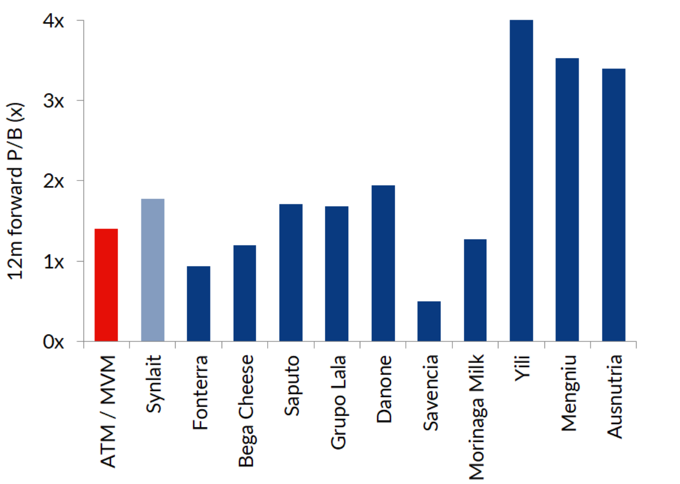
Source: Forsyth Barr analysis, Company reports

Figure 4. Some ROIC dilution likely; however still above WACC



Source: Forsyth Barr analysis and estimates

Figure 5. Price to book multiples for dairy peers



Source: Forsyth Barr analysis, Bloomberg

Figure 6. What volumes could be shifted to MVM?

Category	Product(s)	Potential to move volume to MVM*	Details
Infant Formula	a2 Platinum Stage 1-3	No	SML has exclusivity and China label registration (SAMR and GACC)
Infant Formula	New product, "a2 xxx"	Yes	ATM isn't prevented from a new IF launch under SML contract
Kids formula	a2 Platinum Stage 4; a2 Smart Nutrition	Yes	
Pregnancy formula	a2 Nutrition for mothers	Yes	
Milk powder	a2 Milk full cream and skim milk powder	Yes	
Other	New product	Yes	

Source: Forsyth Barr *Currently. This is our understanding, acknowledging detail is limited

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 is 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.

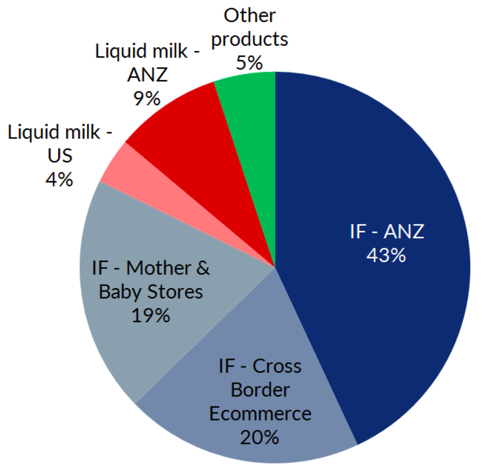
Financial structure

- **Growing net cash position:** ATM's cash balance continues to build, offering options. Growth remains the priority. The planned investment in milk processor, Mataura Valley Milk, will likely utilise c. 30% of ATM's FY21E net cash position.

Risk factors

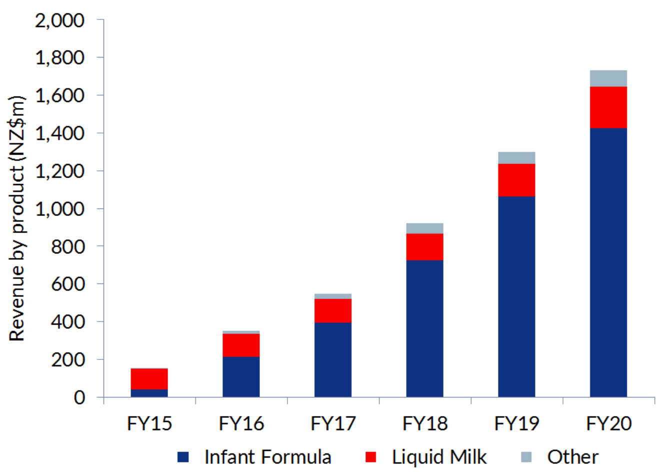
- **Competitive behaviour:** Any discounting or channel stuffing could disrupt the market. Direct competition is also emerging in the a2/a1-free market.
- **Food safety/quality scare:** ATM's brand and reputation are key pillars to its model. Reliance on third party suppliers adds complexity and risk
- **New CEO to start in early 2021:** David Bortolussi appears a reasonable hire at face value, albeit we look for greater insight in duecourse, particularly around cultural fit. We are not expecting any material change in strategic priorities.
- **Regulatory change:** Particularly in China.

Figure 7. Revenue breakdown by product and market



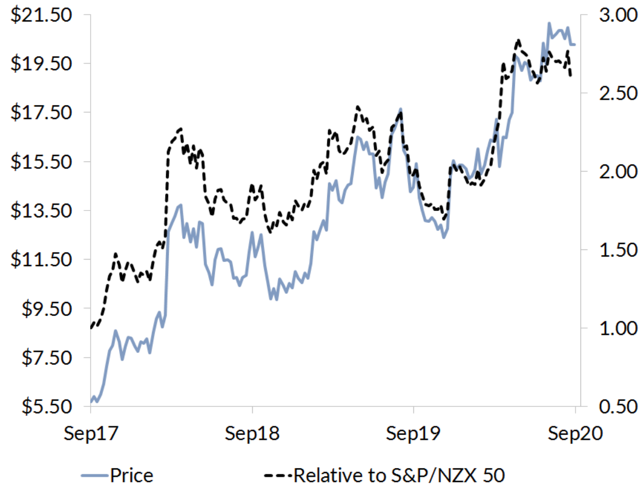
Source: Forsyth Barr analysis, Company reports

Figure 8. Revenue by product through time



, Source: Forsyth Barr analysis, Company reports

Figure 9. Price performance



Source: Forsyth Barr analysis

Figure 10. Substantial shareholders

Shareholder	Latest Holding
The Vanguard Group	7.0%
Mitsubishi UFJ Financial Group	6.4%
Commonwealth Bank of Australia	6.3%
BlackRock Investment Management	5.2%

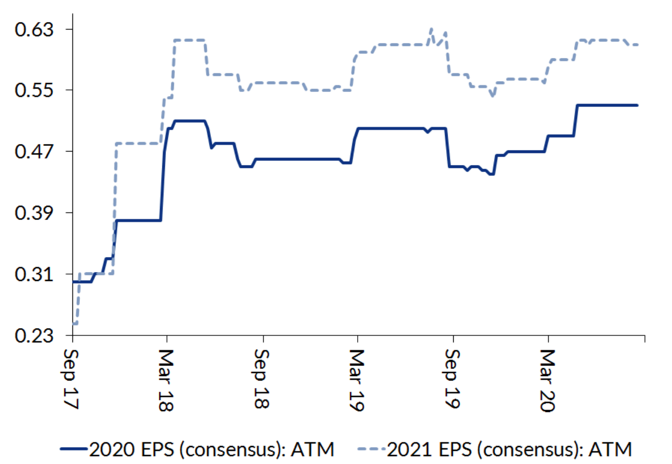
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

Figure 11. 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)	2021E	2022E	2021E	2022E	2021E	2022E	2022E
The a2 Milk Company	**ATM NZ**	**NZ$20.27**	**NZ$14,928**	**32.9x**	**27.9x**	**21.6x**	**18.4x**	**21.9x**	**18.6x**	**0.0%**
CHINA FEIHE	6186 HK	CN¥16.26	CN¥145,256	24.2x	19.2x	16.8x	13.4x	17.3x	13.9x	1.9%
SYNLAIT MILK *	SML NZ	NZ$6.79	NZ$1,217	13.2x	11.2x	7.6x	6.8x	9.8x	8.8x	0.0%
BLACKMORES	BKL AT	A$75.04	A$1,452	>50x	39.2x	30.5x	20.4x	48.0x	28.2x	1.8%
HEALTH AND HAPPINESS H&H INT	1112 HK	CN¥31.55	CN¥20,324	16.0x	13.7x	9.5x	8.5x	10.4x	9.3x	3.8%
RECKITT BENCKISER GROUP PLC	RB/ LN	£76.36	£54,310	24.1x	23.2x	17.6x	17.1x	20.1x	19.6x	2.3%
AUSNUTRIA DAIRY CORP	1717 HK	CN¥13.68	CN¥22,099	16.8x	13.4x	11.2x	9.0x	12.1x	9.7x	2.6%
INNER MONGOLIA YILI INDUS-A	600887 CH	CN¥34.99	CN¥212,852	30.8x	24.8x	19.8x	16.2x	25.9x	21.0x	2.6%
DANONE	BN FP	€56.70	€38,932	16.0x	14.9x	11.2x	10.6x	14.4x	13.6x	3.9%
CHINA MENGNIU DAIRY CO	2319 HK	CN¥35.55	CN¥140,258	35.0x	25.7x	21.0x	16.4x	31.5x	22.3x	0.9%
			Compco Average:	**22.0x**	**20.6x**	**16.1x**	**13.2x**	**21.1x**	**16.3x**	**2.2%**
EV = Current Market Cap + Actual Net Debt			**ATM Relative:**	**50%**	**35%**	**34%**	**40%**	**4%**	**14%**	**-100%**

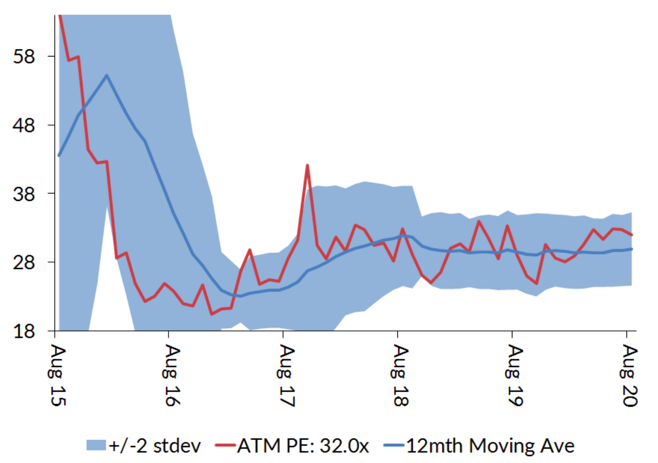
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (ATM) companies fiscal year end

Figure 12. Consensus EPS momentum (NZ$)



Source: Forsyth Barr analysis

Figure 13. One year forward PE (x)



Source: Forsyth Barr analysis

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