

The a2 Milk Company

Short-Term Pain? Digesting Daigou Disruption

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The a2 Milk Company's (ATM) trading update is a blemish to its consistent track record of profit growth, with the company signalling a revenue decline in 1H21 as a result of major disruption to the daigou channel. The key question now – is this a temporary issue, or something more permanent? Although there is a lot we still don't know (not uncommon with ATM), we view this as temporary. While the short-term pain is worse than anticipated, this appears to be a one channel, one product problem (admittedly its most material), with other areas still growing strongly and meaningful growth avenues remaining.

NZX Code	ATM	Financials: Jun/	20A	21E	22E	23E	Valuation (x)	20A	21E	22E	23E
Share price	NZ\$16.65	NPAT* (NZ\$m)	385.8	406.7	498.2	573.1	PE	31.9	30.3	24.7	21.5
Target price	NZ\$23.00	EPS* (NZc)	52.1	54.9	67.3	77.4	EV/EBIT	20.8	19.2	15.5	13.5
Risk rating	High	EPS growth* (%)	34.4	5.4	22.5	15.0	EV/EBITDA	20.6	19.0	15.2	13.2
Issued shares	736.5m	DPS (NZc)	0.0	0.0	0.0	23.2	Price / NTA	10.9	8.1	6.1	4.9
Market cap	NZ\$12,262m	Imputation (%)	100	100	100	100	Cash div yld (%)	0.0	0.0	0.0	1.4
Avg daily turnover	740.1k (NZ\$12,615k)	*Based on normalised profits					Gross div yld (%)	0.0	0.0	0.0	1.9

Key changes

- **EBITDA revisions:** FY21E -11%, FY22E -7%, FY23E -5%. Solely due to lower revenue growth assumptions through daigou. We have assumed a return to growth in daigou in FY22, albeit not fully recovering to where it was, hence modest medium-term downgrades.
- **Target price:** Revised to NZ\$23.00, due to earnings revisions and a lower share price for its stake in Synlait Milk.

ATM FY21 guidance points to a game of two halves, with the 1H weakness meaningfully worse than anticipated

ATM provided FY21 revenue guidance (NZ\$1.8–1.9bn; +4% to +10% YoY) meaningfully below our (and market) expectations. This incorporates a very weak 1H21 (-4% to -10%), albeit a return to strong growth in 2H21. This leaves a number of questions, namely:

- **What is the problem?** ATM has referenced IF demand weakness in its Australasian segment, predominantly due to a decline in retail and corporate daigou as a result of COVID-19 related issues (lack of tourists, international students and lockdowns). These themes are not new, albeit the magnitude negatively surprised. The key acceleration in the issue appears to have been the lockdown in Victoria, which has limited the incremental demand from corporate daigou for replenishment inventory. We understand the weakness is less pronounced in New South Wales, although this is difficult to verify.
- **What is ATM doing about it?** Running a range of daigou incentive programmes and ATM recently hosted a live streaming event.
- **What does guidance incorporate for daigou?** No specifics provided, however, ATM indicated it includes disruption for the balance of 1H21 and stabilisation/some improvement thereafter. What actually plays out is contingent on daigou response to ATM's efforts, and may also be influenced by government restrictions. ATM's assumptions do not appear unreasonable. A daigou recovery is also not inconceivable (things can change quickly) but we believe the channel is unlikely to ever return to its prior peak.
- **EBITDA margin implications from the substantial channel shift signalled:** No. ATM updated its guidance to ~31% (prior 30–31%) helped by some cost initiatives, improved input prices and the release of an inventory provision (conservatively taken in FY20).
- **Is this indicative of a more permanent issue?** Not in our view. ATM signalled its 2H21 budget is broadly unchanged (with some mix differences), brand health metrics are at record levels (including awareness, purchase intent and loyalty) and other channels continue to deliver strong growth (China label year-to-date revenue to August up +77%). The latter remains particularly encouraging given the large offline channel is the key medium-term growth avenue for ATM (market share is growing through Mother & Baby Stores, however at c. 2% there remains ample runway for growth to continue over the medium-term).

The a2 Milk Company (ATM)

 Priced as at 28 Sep 2020 (NZ\$) **16.65**

12-month target price (NZ\$)*					23.00	Spot valuations (NZ\$)				
Expected share price return					38.1%	1. DCF				
Net dividend yield					0.0%	2. Peer multiple				
Estimated 12-month return					38.1%	n/a				
Key WACC assumptions						DCF valuation summary (NZ\$m)				
Risk free rate						Total firm value				16,935
Equity beta						(Net debt)/cash				854
WACC						Less: Capitalised operating leases				(17)
Terminal growth						Value of equity				17,772
Profit and Loss Account (NZ\$m)					2019A	2020A	2021E	2022E	2023E	
Sales revenue					1,300.8	1,731.1	1,853.2	2,274.5	2,616.2	EV/EBITDA (x)
Normalised EBITDA					413.6	549.7	579.9	711.5	818.5	28.1
Depreciation and amortisation					(2.2)	(4.4)	(7.3)	(11.6)	(15.5)	28.2
Normalised EBIT					411.4	545.3	572.6	699.9	803.0	42.9
Net interest					4.3	5.7	8.3	11.6	15.6	15.8
Associate income					0	0	0	0	0	2.3
Tax					(128.0)	(165.2)	(174.2)	(213.4)	(245.5)	3.4
Minority interests					0	0	0	0	0	2.8
Normalised NPAT					287.7	385.8	406.7	498.2	573.1	8.1
Abnormals/other					0	0	0	0	0	6.1
Reported NPAT					287.7	385.8	406.7	498.2	573.1	4.9
Normalised EPS (cps)					38.8	52.1	54.9	67.3	77.4	Free cash flow yield (%)
DPS (cps)					0	0	0	0	23.2	0.0
										Net dividend yield (%)
										Gross dividend yield (%)
Growth Rates					2019A	2020A	2021E	2022E	2023E	
Revenue (%)					41.0	33.1	7.1	22.7	15.0	Return on assets (%)
EBITDA (%)					46.1	32.9	5.5	22.7	15.0	40.9
EBIT (%)					46.5	32.5	5.0	22.2	14.7	37.5
Normalised NPAT (%)					47.0	34.1	5.4	22.5	15.0	31.2
Normalised EPS (%)					47.4	34.4	5.4	22.5	15.0	22.5
Ordinary DPS (%)					n/a	n/a	n/a	n/a	n/a	24.4
										131.1
										31.3
Cash Flow (NZ\$m)					2019A	2020A	2021E	2022E	2023E	
EBITDA					413.6	549.7	579.9	711.5	818.5	Interest cover EBIT (x)
Working capital change					(6.5)	33.6	(44.2)	(4.7)	(1.5)	n/a
Interest & tax paid					(129.6)	(192.2)	(165.9)	(201.7)	(229.9)	n/a
Other					11.6	35.9	0	0	0	n/a
Operating cash flow					289.1	427.0	369.8	505.1	587.1	n/a
Capital expenditure					(3.4)	(7.2)	(29.0)	(50.0)	(50.0)	n/a
(Acquisitions)/divestments					(162.3)	(21.9)	(21.0)	0	0	n/a
Other					0	(3.6)	(3.5)	(3.7)	(3.8)	n/a
Funding available/(required)					123.4	394.3	316.3	451.4	533.3	Capex to sales (%)
Dividends paid					0	0	0	0	(68.4)	Capex to depreciation (%)
Equity raised/(returned)					2.9	2.4	0	0	0	155
(Increase)/decrease in net debt					126.3	396.8	316.3	451.4	464.9	164
										397
										431
										323
Balance Sheet (NZ\$m)					2019A	2020A	2021E	2022E	2023E	
Working capital					50.6	(7.6)	37.8	46.4	51.2	Imputation (%)
Fixed assets					10.3	14.2	37.4	78.2	115.2	Pay-out ratio (%)
Intangibles					13.0	13.6	35.5	35.3	35.1	100
Right of use asset					0	16.1	16.3	16.4	16.6	0
Other assets					294.5	280.8	280.8	280.8	280.8	0
Total funds employed					368.4	317.2	407.7	457.1	498.9	100
Net debt/(cash)					(464.8)	(854.2)	(1,172.3)	(1,625.5)	(2,092.3)	100
Lease liability					0	16.8	17.5	18.1	18.7	100
Other liabilities					45.4	20.5	21.6	25.6	28.8	67
Shareholder's funds					787.9	1,134.1	1,540.8	2,038.9	2,543.6	101
Minority interests					0	0	0	0	0	101
Total funding sources					368.4	317.2	407.7	457.1	498.9	0
EBITDA insights					Total	1,301	1,731	1,853	2,274	2,616
Gross margin						55	56	57	57	56
Gross profit						713	969	1,048	1,286	1,472
Total SG&A expenses						(300)	(419)	(468)	(575)	(654)
incl marketing expenses						(134)	(194)	(208)	(257)	(301)
Total SG&A as % of revenue						23.0	24.2	25.2	25.3	25.0
Group EBITDA						414	550	580	711	818
US - EBITDA losses						(44)	(51)	(42)	(35)	(28)
EBITDA excluding US losses						458	600	622	746	846

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

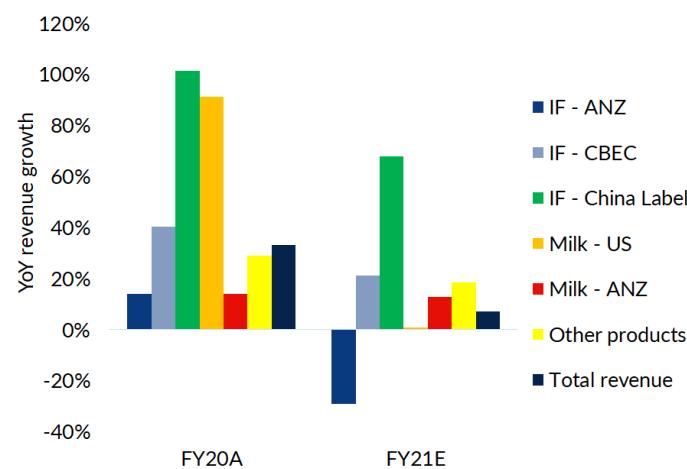
Charts and tables

Figure 1. Earnings revisions (NZ\$m)

NZ\$m	FY21E			FY22E			FY23E		
	Old	New	% chg	Old	New	% chg	Old	New	% chg
Revenue	2,078.1	1,853.2	-10.8%	2,470.7	2,274.5	-7.9%	2,780.3	2,616.2	-5.9%
EBITDA	650.2	579.9	-10.8%	765.6	711.5	-7.1%	864.2	818.5	-5.3%
Underlying profit	456.1	406.7	-10.8%	537.9	498.2	-7.4%	609.9	573.1	-6.0%
Underlying EPS (cps)	61.6	54.9	-10.8%	72.7	67.3	-7.4%	82.4	77.4	-6.0%
Dividend (cps)	0.0	0.0	n/a	0.0	0.0	n/a	24.7	23.2	-6.0%

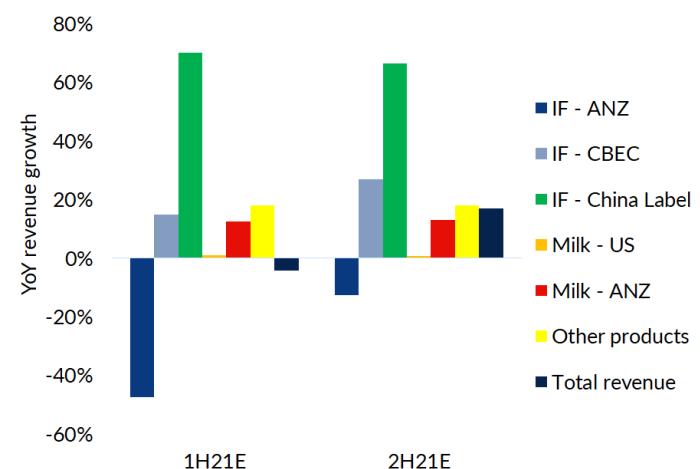
Source: Forsyth Barr analysis

Figure 2. Growth expectations built up by the pieces – FY



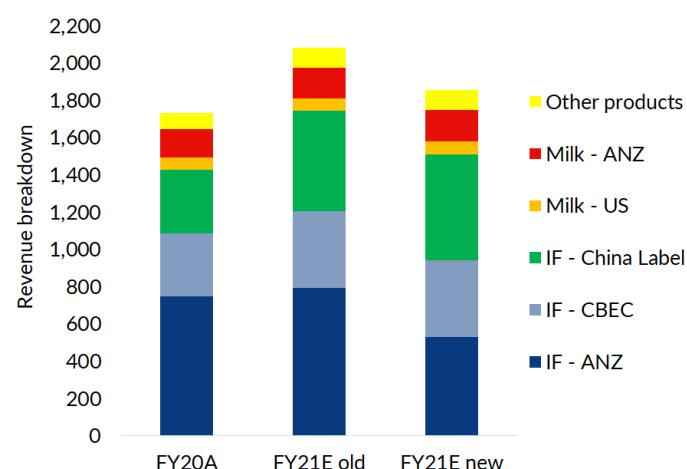
Source: Forsyth Barr analysis, Company reports

Figure 3. Growth expectations built up by the pieces – interims



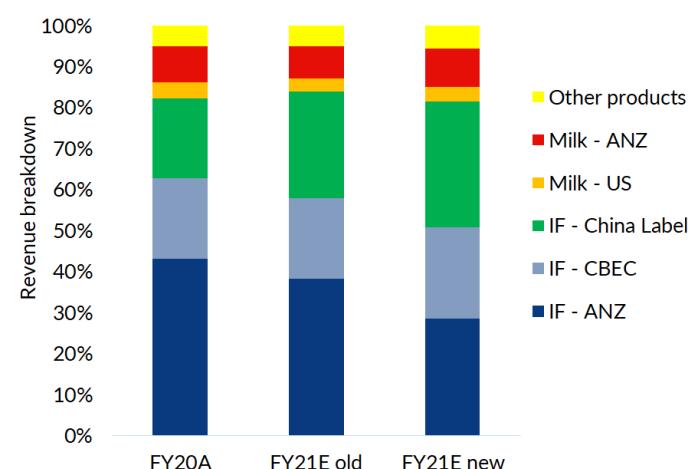
Source: Forsyth Barr analysis, Company reports

Figure 4. Revenue breakdown (NZ\$m)



Source: Forsyth Barr analysis, Company reports

Figure 5. Revenue breakdown by percentage



Source: Forsyth Barr analysis, Company reports

Figure 6. Price performance



Source: Forsyth Barr analysis

Figure 7. 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

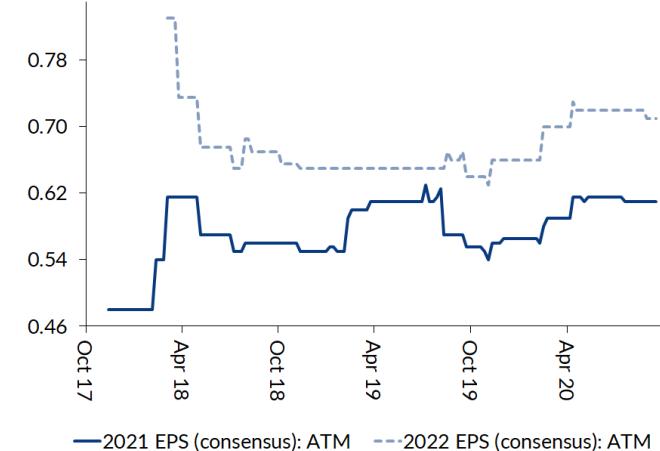
Figure 8. International valuation comparisons

Company (metrics re-weighted to reflect ATM's balance date - June)	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash Yld		
				2021E	2022E	2021E	2022E	2021E	2022E			
The a2 Milk Company	ATM NZ	NZ\$16.65	NZ\$12,262	30.3x	24.7x	19.7x	16.0x	19.9x	16.3x	0.0%		
CHINA FEIHE	6186 HK	CNY17.70	CNY158,120	24.8x	19.8x	16.7x	13.2x	17.6x	13.9x	1.8%		
SYNLAIT MILK*	SML NZ	NZ\$6.05	NZ\$1,085	14.0x	11.7x	8.5x	7.7x	11.5x	10.3x	0.0%		
BLACKMORES	BKL AT	A\$68.85	A\$1,332	40.4x	27.7x	19.6x	15.5x	28.7x	19.8x	2.5%		
HEALTH AND HAPPINESS H&H INT	1112 HK	CNY33.25	CNY21,422	16.7x	14.2x	9.9x	8.8x	10.9x	9.7x	3.7%		
RECKITT BENCKISER GROUP PLC	RB/LN	£74.70	£53,139	23.6x	22.7x	17.3x	16.9x	19.7x	19.3x	2.4%		
AUSNUTRIA DAIRY CORP	1717 HK	CNY12.16	CNY20,859	14.9x	11.9x	10.5x	8.5x	11.4x	9.1x	2.9%		
INNER MONGOLIA YILI INDUS-A	600887 CH	CNY38.11	CNY231,831	30.0x	25.6x	20.5x	17.7x	25.6x	22.1x	2.6%		
DANONE	BN FP	€54.56	€37,463	15.5x	14.5x	10.9x	10.4x	14.2x	13.4x	4.0%		
CHINA MENGNIU DAIRY CO	2319 HK	CNY35.90	CNY141,671	34.3x	25.6x	20.7x	16.2x	32.0x	22.5x	0.9%		
Compco Average:					23.8x	19.3x	15.0x	12.8x	19.1x	15.6x	2.3%	
EV = Current Market Cap + Actual Net Debt					ATM Relative:	27%	28%	32%	26%	5%	5%	-100%

Source: *Forsyth Barr analysis, Bloomberg Consensus

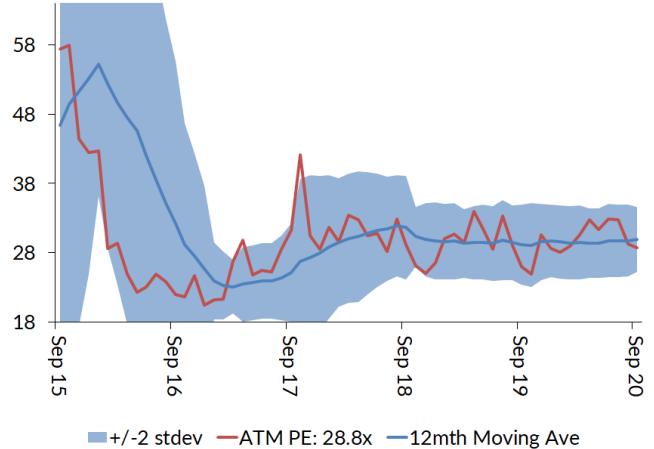
Source: "Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (ATM) companies fiscal year end

Figure 9. Consensus EPS momentum (NZ\$)



Source: Forsyth Barr analysis

Figure 10. One year forward PE (x)



Source: Forsyth Barr analysis

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