

# The a2 Milk Company

## Baby Steps Forward

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### OUTPERFORM

The a2 Milk Company's (ATM) Annual Meeting provided little in the way of new information, reiterating its FY21 guidance. A positive takeaway was indications of "early green shoots" in the under-pressure daigou channel. ATM's channel mix is shifting rapidly, with strong performance in direct channels being overshadowed by daigou pressure. We view this as temporary and expect a return to growth from 2H21. Current investor focus appears firmly centered on FY21 earnings downgrade risk, which is unlikely to be resolved until the timeline of daigou re-ordering and realignment of channels is clearer. Looking through short-term earnings volatility, we see an attractive medium-term growth runway, with our confidence boosted by recent proprietary channel checks in the key offline market. Valuation metrics remain attractive (PE of ~25x, or ~21x adjusted for cash and US losses), particularly given ATM's strong free cashflow generation and high returns. OUTPERFORM.

NZX Code	ATM	Financials: Jun/	20A	21E	22E	23E	Valuation (x)	20A	21E	22E	23E
Share price	NZ\$14.82	NPAT* (NZ\$m)	385.8	400.2	487.0	566.9	PE	28.4	27.4	22.5	19.4
Target price	NZ\$23.00	EPS* (NZc)	52.1	54.1	65.8	76.6	EV/EBIT	18.3	17.2	13.9	12.0
Risk rating	High	EPS growth* (%)	34.4	3.7	21.7	16.4	EV/EBITDA	18.2	16.9	13.7	11.7
Issued shares	736.5m	DPS (NZc)	0.0	0.0	0.0	23.0	Price / NTA	9.7	7.3	5.5	4.4
Market cap	NZ\$10,914m	Imputation (%)	100	100	100	100	Cash div yld (%)	0.0	0.0	0.0	1.6
Avg daily turnover	795.8k (NZ\$13,664k)	*Based on normalised profits					Gross div yld (%)	0.0	0.0	0.0	2.2

### What's changed?

- **Earnings & target price:** Small revisions, EBITDA -2% in FY21/22E, -1% in FY23E (mix changes, FX). No change to target price.

### What did we learn from the Annual Meeting?

- **"Early green shoots" in the Daigou channel:** The pressure in the daigou channel is now well known, from a suite of compounding issues including COVID-19 border restrictions, surplus channel inventory, pantry de-stocking, high freight costs, low reseller margins, packaging concerns (due to COVID-19). We expect the disruption to moderate gradually over time, with early positive signals of turning a corner (channel inventory lower, pricing stabilised), however, do not factor a full recovery in the channel.
- **No change to Mother & Baby Store trajectory; the key growth engine:** ATM reiterated growth is "strong", albeit without specifics. Rolling 12m market share of 2.2% to September (vs 2.0% to June and 1.7% to Dec 2019) highlights the ample runway still remaining. Our recent offline channel checks saw strong performance for ATM & high quality perception for NZ sourced product.
- **Encouraging performance in key Singles Day Shopping Festival:** +24% English label growth "consistent with plan". Discounting was moderate, implying value growth was also strong. IF category growth was lacklustre, suggesting ATM outperformed.
- **Other areas of the business delivering growth:** Including other nutritional products, liquid milk in Australia, and gross revenue in the US (albeit offset by the planned reallocation of marketing spend to in-trade spend which nets off against revenue).

### Key issue creating debate — when will growth return and is there a downgrade still to come?

Market attention appears centered on one over-arching question — will ATM downgrade its FY21 (particularly 2H21) guidance? Despite the reiteration of guidance and channel commentary, which if anything was incrementally more positive than the last update, this question will likely remain an overhang until the 2H21 outlook is clearer. ATM is going through a dramatic, rapid shift in channel mix which makes forecasting more challenging than usual. The issues are well known, however, the timeline (particularly of daigou re-ordering) is less clear. Our analysis suggests the share price is already factoring in some of the risk (c. 70%). Even under our downgrade scenario we see attractive value (valuation multiples lift by c. 2x).

## The a2 Milk Company (ATM)

Priced as at 18 Nov 2020 (NZ\$) **14.82**

<b>12-month target price (NZ\$)*</b>	<b>23.00</b>
Expected share price return	55.2%
Net dividend yield	0.0%
Estimated 12-month return	55.2%

<b>Key WACC assumptions</b>	
Risk free rate	1.30%
Equity beta	0.90
WACC	6.4%
Terminal growth	1.5%

<b>Spot valuations (NZ\$)</b>	
1. DCF	23.05
2. Peer multiple	20.00
n/a	n/a

<b>DCF valuation summary (NZ\$m)</b>	
Total firm value	16,002
(Net debt)/cash	854
Less: Capitalised operating leases	(17)
Value of equity	16,839

<b>Profit and Loss Account (NZ\$m)</b>	<b>2019A</b>	<b>2020A</b>	<b>2021E</b>	<b>2022E</b>	<b>2023E</b>
Sales revenue	1,300.8	1,731.1	1,825.0	2,230.6	2,579.7
<b>Normalised EBITDA</b>	<b>413.6</b>	<b>549.7</b>	<b>570.6</b>	<b>695.7</b>	<b>809.8</b>
Depreciation and amortisation	(2.2)	(4.4)	(7.3)	(11.6)	(15.5)
<b>Normalised EBIT</b>	<b>411.4</b>	<b>545.3</b>	<b>563.3</b>	<b>684.1</b>	<b>794.3</b>
Net interest	4.3	5.7	8.3	11.5	15.4
Associate income	0	0	0	0	0
Tax	(128.0)	(165.2)	(171.4)	(208.6)	(242.8)
Minority interests	0	0	0	0	0
<b>Normalised NPAT</b>	<b>287.7</b>	<b>385.8</b>	<b>400.2</b>	<b>487.0</b>	<b>566.9</b>
Abnormals/other	0	0	0	0	0
<b>Reported NPAT</b>	<b>287.7</b>	<b>385.8</b>	<b>400.2</b>	<b>487.0</b>	<b>566.9</b>
Normalised EPS (cps)	38.8	52.1	54.1	65.8	76.6
DPS (cps)	0	0	0	0	23.0

<b>Growth Rates</b>	<b>2019A</b>	<b>2020A</b>	<b>2021E</b>	<b>2022E</b>	<b>2023E</b>
Revenue (%)	41.0	33.1	5.4	22.2	15.6
EBITDA (%)	46.1	32.9	3.8	21.9	16.4
EBIT (%)	46.5	32.5	3.3	21.4	16.1
Normalised NPAT (%)	47.0	34.1	3.7	21.7	16.4
Normalised EPS (%)	47.4	34.4	3.7	21.7	16.4
Ordinary DPS (%)	n/a	n/a	n/a	n/a	n/a

<b>Cash Flow (NZ\$m)</b>	<b>2019A</b>	<b>2020A</b>	<b>2021E</b>	<b>2022E</b>	<b>2023E</b>
<b>EBITDA</b>	<b>413.6</b>	<b>549.7</b>	<b>570.6</b>	<b>695.7</b>	<b>809.8</b>
Working capital change	(6.5)	33.6	(42.9)	(4.6)	(1.6)
Interest & tax paid	(129.6)	(192.2)	(163.1)	(197.1)	(227.4)
Other	11.6	35.9	0	0	0
<b>Operating cash flow</b>	<b>289.1</b>	<b>427.0</b>	<b>364.6</b>	<b>494.0</b>	<b>580.8</b>
Capital expenditure	(3.4)	(7.2)	(29.0)	(50.0)	(50.0)
(Acquisitions)/divestments	(162.3)	(21.9)	(21.0)	0	0
Other	0	(3.6)	(3.5)	(3.7)	(3.8)
<b>Funding available/(required)</b>	<b>123.4</b>	<b>394.3</b>	<b>311.1</b>	<b>440.3</b>	<b>527.0</b>
Dividends paid	0	0	0	0	(67.7)
Equity raised/(returned)	2.9	2.4	0	0	0
<b>(Increase)/decrease in net debt</b>	<b>126.3</b>	<b>396.8</b>	<b>311.1</b>	<b>440.3</b>	<b>459.3</b>

<b>Balance Sheet (NZ\$m)</b>	<b>2019A</b>	<b>2020A</b>	<b>2021E</b>	<b>2022E</b>	<b>2023E</b>
Working capital	50.6	(7.6)	36.2	44.7	49.6
Fixed assets	10.3	14.2	37.4	78.2	115.2
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
<b>Total funds employed</b>	<b>368.4</b>	<b>317.2</b>	<b>406.1</b>	<b>455.4</b>	<b>497.3</b>
Net debt/(cash)	(464.8)	(854.2)	(1,167.1)	(1,609.2)	(2,070.4)
Lease liability	0	16.8	17.5	18.1	18.7
Other liabilities	45.4	20.5	21.4	25.2	28.5
Shareholder's funds	787.9	1,134.1	1,534.3	2,021.3	2,520.5
Minority interests	0	0	0	0	0
<b>Total funding sources</b>	<b>368.4</b>	<b>317.2</b>	<b>406.1</b>	<b>455.4</b>	<b>497.3</b>

<b>Valuation Ratios</b>	<b>2019A</b>	<b>2020A</b>	<b>2021E</b>	<b>2022E</b>	<b>2023E</b>
EV/EBITDA (x)	24.8	18.2	16.9	13.6	11.7
EV/EBIT (x)	25.0	18.3	17.1	13.9	12.0
PE (x)	38.2	28.4	27.4	22.5	19.4
Price/NTA (x)	14.0	9.7	7.3	5.5	4.4
Free cash flow yield (%)	2.6	3.8	3.1	4.1	4.9
Net dividend yield (%)	0.0	0.0	0.0	0.0	1.6
Gross dividend yield (%)	0.0	0.0	0.0	0.0	2.2

<b>Capital Structure</b>	<b>2019A</b>	<b>2020A</b>	<b>2021E</b>	<b>2022E</b>	<b>2023E</b>
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	-317.8	-390.5	-460.0
Net debt/EBITDA (x)	n/a	n/a	n/a	n/a	n/a

<b>Key Ratios</b>	<b>2019A</b>	<b>2020A</b>	<b>2021E</b>	<b>2022E</b>	<b>2023E</b>
Return on assets (%)	40.9	37.5	30.9	28.9	27.2
Return on equity (%)	36.5	34.0	26.1	24.1	22.5
Return on funds employed (%)	106.3	127.2	122.7	123.8	130.1
EBITDA margin (%)	31.8	31.8	31.3	31.2	31.4
EBIT margin (%)	31.6	31.5	30.9	30.7	30.8
Capex to sales (%)	0.3	0.4	1.6	2.2	1.9
Capex to depreciation (%)	155	164	397	431	323
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	0	0	0	0	30

<b>Operating Performance</b>	<b>2019A</b>	<b>2020A</b>	<b>2021E</b>	<b>2022E</b>	<b>2023E</b>
<b>Revenue (breakdown by product)</b>					
Total Infant Formula	1,064	1,424	1,474	1,824	2,114
Total Fresh Milk	171	222	247	281	317
Other	66	85	104	125	149
<b>Total</b>	<b>1,301</b>	<b>1,731</b>	<b>1,825</b>	<b>2,230</b>	<b>2,579</b>

<b>Revenue (breakdown by country)</b>					
Australia & NZ	843	965	733	796	830
China & Other Asia	423	699	1,022	1,334	1,615
US	35	66	69	101	134
Other	0	0	0	0	0
<b>Total</b>	<b>1,301</b>	<b>1,731</b>	<b>1,825</b>	<b>2,230</b>	<b>2,579</b>

<b>EBITDA insights</b>					
Gross margin	55	56	56	56	56
Gross profit	713	969	1,029	1,259	1,449
Total SG&A expenses	(300)	(419)	(458)	(563)	(639)
incl marketing expenses	(134)	(194)	(204)	(252)	(297)
Total SG&A as % of revenue	23.0	24.2	25.1	25.2	24.8
<b>Group EBITDA</b>	<b>414</b>	<b>550</b>	<b>571</b>	<b>696</b>	<b>810</b>
US - EBITDA losses	(44)	(51)	(41)	(35)	(28)
<b>EBITDA excluding US losses</b>	<b>458</b>	<b>600</b>	<b>612</b>	<b>730</b>	<b>837</b>

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

## Key charts and tables

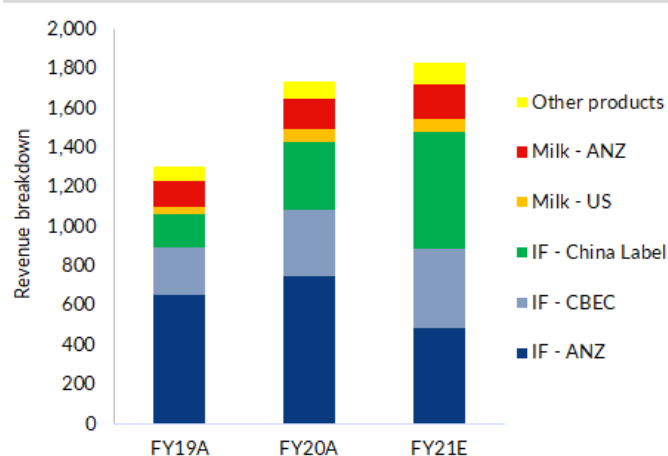
We make minor earnings revisions — with some moderate mix adjustments (stronger liquid milk and China IF revenue, outweighing more conservative daigou assumptions) and updated FX assumptions.

**Figure 1. Earnings revisions (NZ\$m)**

NZ\$m	FY21E			FY22E			FY23E		
	Old	New	% chg	Old	New	% chg	Old	New	% chg
Revenue	1,853.2	1,825.0	-1.5%	2,274.5	2,230.6	-1.9%	2,616.2	2,579.7	-1.4%
EBITDA	579.9	570.6	-1.6%	711.5	695.7	-2.2%	818.5	809.1	-1.2%
Underlying profit	406.7	400.2	-1.6%	498.2	487.0	-2.2%	573.1	566.4	-1.2%
Underlying EPS (cps)	54.9	54.1	-1.6%	67.3	65.8	-2.2%	77.4	76.5	-1.2%
Dividend (cps)	0.0	0.0	n/a	0.0	0.0	n/a	23.2	23.0	-1.2%

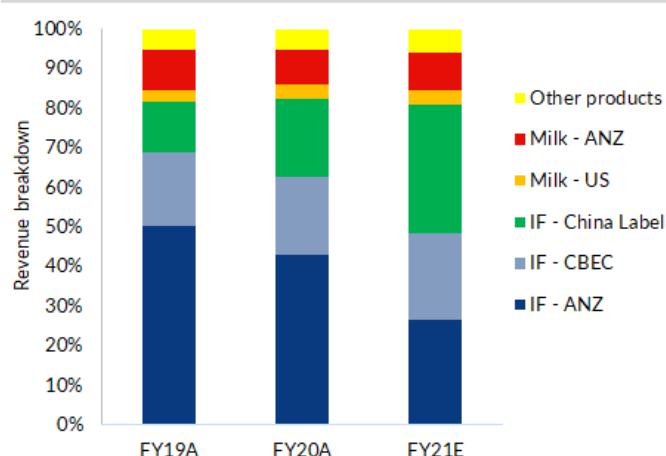
Source: Forsyth Barr analysis

**Figure 2. Revenue breakdown (NZ\$m)**



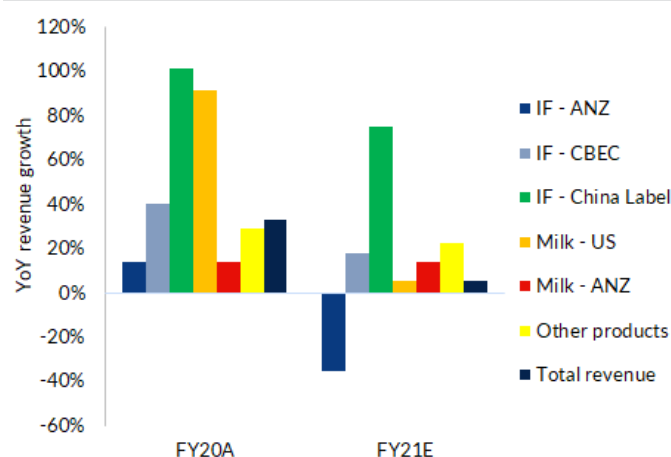
Source: Forsyth Barr analysis, Company reports ; IF = Infant Formula

**Figure 3. Substantial acceleration in channel shift**



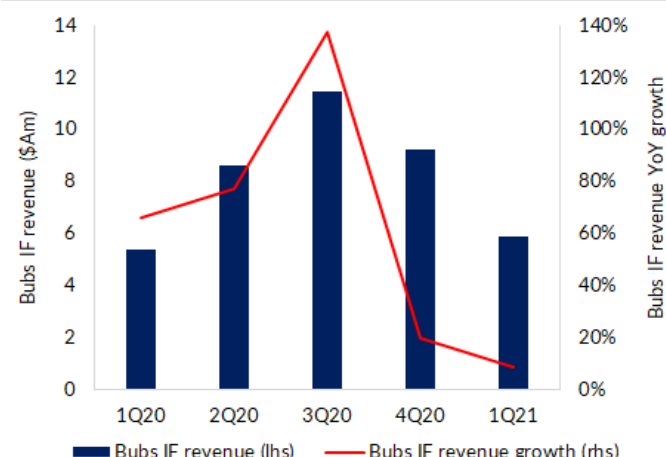
Source: Forsyth Barr analysis, Company reports ; IF = Infant Formula

**Figure 4. Our growth expectations built up by the pieces**



Source: Forsyth Barr analysis, Company reports ; IF = Infant Formula

**Figure 5. ATM not alone in daigou pressure**



Source: Forsyth Barr analysis, Company reports

**Figure 6. FY21 guidance vs market expectations**

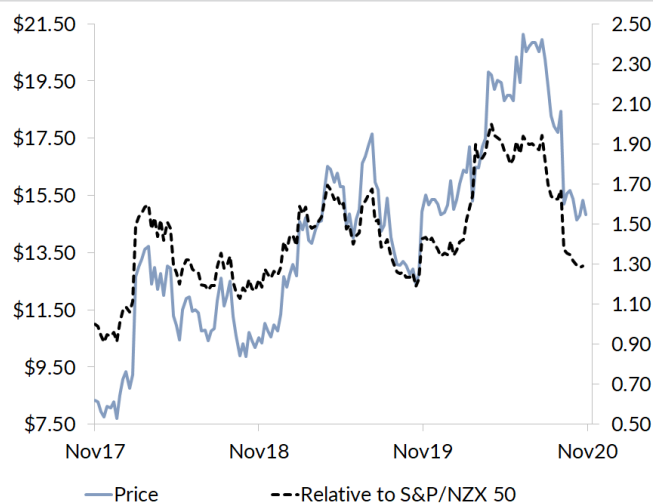
FY21E	ATM guidance		Forsyth Barr
	Low	High	
Revenue	1,800	1,900	1,825
...YoY growth	4%	10%	5%
EBITDA	558	589	571
...YoY growth	2%	7%	4%
EBITDA margin	~31%	~31%	31.3%

Source: Forsyth Barr analysis

**Figure 7. Interim splits**

	ATM guidance (mid point)		Forsyth Barr	
	1H20	2H20	1H21E	2H21E
Revenue	806.7	924.4	776	1,049
% growth	32%	34%	-4%	13%
EBITDA	263.2	286.5	241	330
% growth	21%	47%	-9%	15%
Margin	32.6%	31.0%	31.0%	31.5%

Source: Forsyth Barr analysis

**Figure 8. Price performance**


Source: Forsyth Barr analysis

**Figure 9. Substantial shareholders**

Shareholder	Latest Holding
Mitsubishi UFJ Financial Group	7.5%
The Vanguard Group	7.0%
Commonwealth Bank of Australia	6.3%
BlackRock Investment Management	5.2%
Pendal Group Limited	5.2%

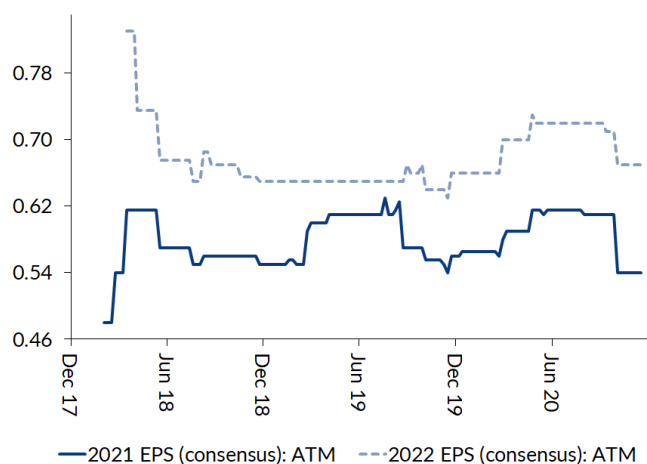
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

**Figure 10. International valuation comparisons**

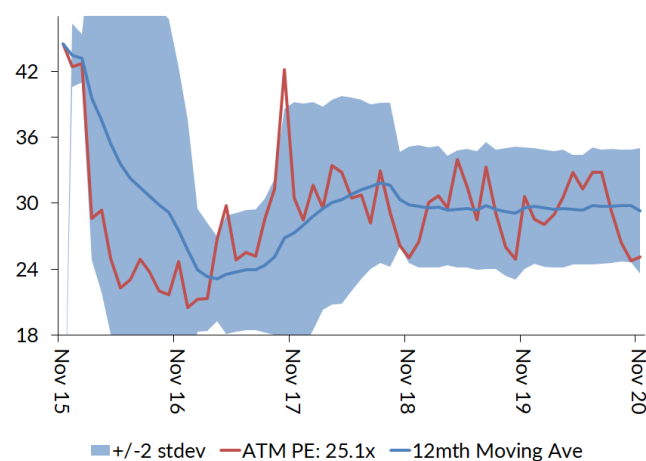
Company	Code	Price	Mkt Cap (m)	PE 2021E	PE 2022E	EV/EBITDA 2021E	EV/EBITDA 2022E	EV/EBIT 2021E	EV/EBIT 2022E	Cash Yld 2022E
(metrics re-weighted to reflect ATM's balance date - June)										
The a2 Milk Company	ATM NZ	NZ\$14.82	NZ\$10,914	27.4x	22.5x	17.6x	14.5x	17.9x	14.7x	0.0%
CHINA FEIHE	6186 HK	CNY¥17.14	CNY¥153,117	23.3x	18.6x	16.2x	12.8x	16.2x	12.9x	1.9%
SYNLAIT MILK *	SML NZ	NZ\$5.61	NZ\$1,190	13.3x	10.3x	9.5x	8.2x	13.1x	11.1x	0.0%
BLACKMORES	BKL AT	A\$78.05	A\$1,510	44.4x	30.7x	21.8x	17.2x	31.5x	21.9x	2.2%
HEALTH AND HAPPINESS H&H INT	1112 HK	CNY¥31.10	CNY¥20,038	16.1x	13.5x	9.8x	8.6x	10.6x	9.2x	4.2%
RECKITT BENCKISER GROUP PLC	RB/ LN	£67.06	£47,724	20.8x	20.0x	15.5x	15.1x	17.6x	17.2x	2.6%
AUSNUTRIA DAIRY CORP	1717 HK	CNY¥10.88	CNY¥18,664	14.3x	11.5x	10.2x	8.2x	11.6x	9.0x	3.2%
INNER MONGOLIA YILI INDUS-A	600887 CH	CNY¥38.33	CNY¥233,170	29.7x	25.5x	19.3x	16.5x	24.2x	20.9x	2.5%
DANONE	BN FP	€54.60	€37,490	16.2x	15.2x	11.2x	10.7x	14.7x	13.9x	4.0%
CHINA MENGNIU DAIRY CO	2319 HK	CNY¥41.55	CNY¥163,979	39.7x	29.2x	24.4x	18.5x	36.7x	25.8x	0.8%
Compco Average:				24.2x	19.4x	15.3x	12.9x	19.6x	15.8x	2.4%
ATM Relative:				13%	16%	15%	12%	-9%	-7%	-100%

EV = Current Market Cap + Actual Net Debt

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

**Figure 11. Consensus EPS momentum (NZ\$)**


Source: Forsyth Barr analysis

**Figure 12. One year forward PE (x)**


Source: Forsyth Barr analysis

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