

The a2 Milk Company

The Grinch Stole Christmas

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OUTPERFORM

The a2 Milk Company (ATM) provided a disappointing pre-Christmas update, materially downgrading FY21 guidance with a sharp and protracted decline in daigou not made up for by other channels. Since August, ATM's cash-adjusted 12 month forward PE has contracted to ~24x, from 32x, on what we view as suppressed EPS (down ~40%). The market now appears to be pricing some combination of (1) daigou not recovering or getting worse (geopolitical tensions and/or changed behaviour), (2) Chinese consumer demand moderating for the brand and/or (3) inventory issues. We view the issues as largely temporary (stemmed from COVID-19), with brand metrics and end demand seemingly positive, and expect growth to return from FY22. It will likely take time to rebuild market confidence. At current levels we see favourable risk/reward, with re-set expectations.

NZX Code	ATM	Financials: Jun/	20A	21E	22E	23E	Valuation (x)	20A	21E	22E	23E
Share price	NZ\$11.00	NPAT* (NZ\$m)	385.8	265.0	335.1	420.0	PE	21.1	30.7	24.3	19.4
Target price	NZ\$15.50	EPS* (NZc)	52.1	35.8	45.3	56.7	EV/EBIT	13.2	18.7	14.6	11.7
Risk rating	High	EPS growth* (%)	34.4	-31.3	26.4	25.4	EV/EBITDA	13.1	18.3	14.3	11.4
Issued shares	736.5m	DPS (NZc)	0.0	0.0	0.0	17.0	Price / NTA	7.2	5.9	4.8	3.9
Market cap	NZ\$8,101m	Imputation (%)	100	100	100	100	Cash div yld (%)	0.0	0.0	0.0	1.5
Avg daily turnover	807.7k (NZ\$13,717k)	*Based on normalised profits					Gross div yld (%)	0.0	0.0	0.0	2.1

What's changed?

- **Earnings:** Materially lowered by -26% to -34%. FY21E forecasts near the bottom of ATM's guidance range.
- **Target price:** Lowered to NZ\$15.50 primarily due to earnings revisions.

Guidance cut a further ~30%; FY21 a year to forget

The magnitude of ATM's FY21 (and 1H21) guidance downgrade was a shock. Revenue is now expected to be NZ\$1.40–1.55bn, -10% to -19% against the prior year. Data and anecdotes suggest the brand is still in demand by Chinese consumers and market share within channels maintained. However, the sharp decline in daigou (where ATM over-indexed), has not been made up for by other channels. ATM's update disappointed across the board, with a revenue decline for English label IF (daigou pressure and recent contagion into cross border ecommerce) while 1H21E growth in China label IF of >+40% was below our forecasts, despite further market share gains and a slowdown on recent trends. The latter wasn't well explained and is only partly attributable to currency. Guidance is also for FY21 EBITDA margin contraction of -275 to -575bp; given operating de-leverage and unfavourable channel mix.

Where to from here?

There is a lot of unknowns, with recent announcements a stark reminder visibility is low and the high margin of error in earnings forecasts. ATM does appear to be prioritising longer-term brand positioning and brand health, rather than short-term profit. Our base case is daigou pressure is largely temporary and it recovers slowly when daigou margins improve (to ~70% of prior levels by FY24E), and ATM continues to take market share (off what is still a low base) in Mother & Baby Stores, with its China label IF. This supports a return to growth from FY22E. If we did assume no recovery in the daigou channel our DCF would fall to ~NZ\$12.70, and if we assumed a further material decline, to ~NZ\$11.90. The path forward is unlikely to be smooth. FY21 is not risk-free, channels to market are opaque with very limited visibility (including for management), geopolitical risk heightened and ATM credibility materially dented; hence, it will take time for any rebuild in market confidence. The company does have a large cash balance which provides the option to help market confidence with a share buyback — this is “being considered”.

The a2 Milk Company (ATM)

Prised as at 18 Dec 2020 (NZ\$) **11.00**

12-month target price (NZ\$)*	15.50
Expected share price return	40.9%
Net dividend yield	0.0%
Estimated 12-month return	40.9%

Key WACC assumptions	
Risk free rate	1.30%
Equity beta	0.95
WACC	7.8%
Terminal growth	1.5%

Spot valuations (NZ\$)	
1. DCF	14.16
2. Peer multiple	15.22
n/a	n/a

DCF valuation summary (NZ\$m)	
Total firm value	9,598
(Net debt)/cash	854
Less: Capitalised operating leases	(17)
Value of equity	10,436

Profit and Loss Account (NZ\$m)	2019A	2020A	2021E	2022E	2023E
Sales revenue	1,300.8	1,731.1	1,433.9	1,697.6	1,995.7
Normalised EBITDA	413.6	549.7	378.2	480.6	603.2
Depreciation and amortisation	(2.2)	(4.4)	(7.3)	(11.6)	(15.5)
Normalised EBIT	411.4	545.3	370.9	469.0	587.7
Net interest	4.3	5.7	7.6	9.5	12.2
Associate income	0	0	0	0	0
Tax	(128.0)	(165.2)	(113.5)	(143.5)	(179.9)
Minority interests	0	0	0	0	0
Normalised NPAT	287.7	385.8	265.0	335.1	420.0
Abnormals/other	0	0	0	0	0
Reported NPAT	287.7	385.8	265.0	335.1	420.0
Normalised EPS (cps)	38.8	52.1	35.8	45.3	56.7
DPS (cps)	0	0	0	0	17.0

Growth Rates	2019A	2020A	2021E	2022E	2023E
Revenue (%)	41.0	33.1	-17.2	18.4	17.6
EBITDA (%)	46.1	32.9	-31.2	27.1	25.5
EBIT (%)	46.5	32.5	-32.0	26.5	25.3
Normalised NPAT (%)	47.0	34.1	-31.3	26.4	25.4
Normalised EPS (%)	47.4	34.4	-31.3	26.4	25.4
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	378.2	480.6	603.2
Working capital change	(6.5)	33.6	(65.8)	(2.6)	(10.4)
Interest & tax paid	(129.6)	(192.2)	(105.9)	(134.0)	(167.7)
Other	11.6	35.9	0	0	0
Operating cash flow	289.1	427.0	206.5	344.1	425.2
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)
Funding available/(required)	123.4	394.3	153.0	290.4	371.3
Dividends paid	0	0	0	0	(50.1)
Equity raised/(returned)	2.9	2.4	0	0	0
(Increase)/decrease in net debt	126.3	396.8	153.0	290.4	321.2

Balance Sheet (NZ\$m)	2019A	2020A	2021E	2022E	2023E
Working capital	50.6	(7.6)	55.5	60.5	73.7
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
Total funds employed	368.4	317.2	425.4	471.2	521.4
Net debt/(cash)	(464.8)	(854.2)	(1,008.9)	(1,301.2)	(1,624.3)
Lease liability	0	16.8	17.5	18.1	18.7
Other liabilities	45.4	20.5	17.7	20.2	23.0
Shareholder's funds	787.9	1,134.1	1,399.1	1,734.1	2,104.0
Minority interests	0	0	0	0	0
Total funding sources	368.4	317.2	425.4	471.2	521.4

Valuation Ratios	2019A	2020A	2021E	2022E	2023E
EV/EBITDA (x)	18.0	13.1	18.3	14.3	11.4
EV/EBIT (x)	18.1	13.2	18.7	14.6	11.7
PE (x)	28.4	21.1	30.7	24.3	19.4
Price/NTA (x)	10.4	7.2	5.9	4.8	3.9
Free cash flow yield (%)	3.5	5.2	2.2	3.6	4.6
Net dividend yield (%)	0.0	0.0	0.0	0.0	1.5
Gross dividend yield (%)	0.0	0.0	0.0	0.0	2.1

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	-258.6	-300.5	-338.6
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	22.9	23.6	24.6
Return on equity (%)	36.5	34.0	18.9	19.3	20.0
Return on funds employed (%)	106.3	127.2	78.2	80.5	91.0
EBITDA margin (%)	31.8	31.8	26.4	28.3	30.2
EBIT margin (%)	31.6	31.5	25.9	27.6	29.4
Capex to sales (%)	0.3	0.4	2.0	2.9	2.5
Capex to depreciation (%)	155	164	397	431	323
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)					
IF - ANZ (primarily daigou)	653	745	333	367	458
IF - CBEC	243	341	298	323	348
Total English Label	896	1,086	631	690	806
IF - China Label	168	338	485	645	778
Total Infant Formula	1,064	1,424	1,116	1,336	1,584
Total Fresh Milk	171	222	237	275	316
Other	66	85	80	87	95
Total revenue	1,301	1,731	1,434	1,697	1,995

Revenue growth (%)	2019A	2020A	2021E	2022E	2023E
IF - ANZ (primarily daigou)	35	14	(55)	10	25
IF - CBEC	54	40	(13)	8	8
IF - China Label	100	101	44	33	21
Total Infant Formula	47	34	(22)	20	19
Total Fresh Milk	20	30	7	16	15
Gross profit	713	969	769	925	1,097
Total SG&A expenses	(300)	(419)	(391)	(445)	(494)
incl marketing expenses	(134)	(194)	(182)	(209)	(239)
Group EBITDA	414	550	378	481	603
US - EBITDA losses	(44)	(51)	(42)	(37)	(28)
EBITDA excluding US losses	457.6	600.2	420.3	517.4	631.2

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

FY21 downgrade; where to from here?

The magnitude of ATM's FY21 (and 1H21) guidance downgrade was a shock. It is clear FY21 has seen a dramatic shift in channel mix, given the material decline in the daigou channel, however, guidance suggests lower revenue growth vs our forecasts across the board for the key Infant Formula (IF) products. Detail is sparse and if anything ATM's conference call added confusion on drivers and trends.

English Label IF — daigou pressure contagion to CBEC; recovery path likely to take time (in our view)

Pressures in the daigou channel are well known, although management was evidently too optimistic on the recovery path. ATM also indicated disruption in daigou “is now having a more significant impact in CBEC”, after what appeared to be a strong start to 1H21. Channels are complex and inter-linked, and a lack of specifics and opaque commentary from ATM hasn't helped.

Our interpretation of the issue is — ATM responded to daigou problems by pushing more inventory into CBEC, however, this looks to have made the situation worse, with price discounting on some platforms creating even more pressure on daigou margins. From here we expect ATM to squeeze inventory to CBEC (i.e. less supply) to attempt to drive prices higher. However, we do not expect daigou to meaningfully recover until freight prices are lower (reliant on commercial flights). We assume daigou recovers to 70% by FY24E.

China Label IF — strong growth, with market share gains evident, however, much weaker than expected

Growth is strong, with ATM still taking market share (rolling 12m share 2.3% to October vs 2.0% to June and 1.7% to Dec 2019). However, guidance for >+40% sales growth in 1H21 vs +77% growth in July/August was a surprise. Our analysis suggests ~15% of the difference can be attributed to unfavourable FX movement but the balance is less clear. ATM commented that demand has been consistently strong, July/August were cycling weaker comparatives and its outlook for the channel is unchanged/slightly improved. This is impossible to verify. Nonetheless, our recent proprietary channel checks and port data reinforce demand is strong and if anything growing. With ATM still under-indexing in this channel, there remains ample opportunity for growth.

Earnings and valuation

We make material downgrades to our IF sales forecasts, across all channels — with our forecasts summarised in Figures 1 and 3. We also assume some near-term gross margin contraction, with ATM likely to support the daigou channel. We lower our target price to NZ\$15.50 from NZ\$23.00, primarily due to earnings revisions.

Figure 1. Forecast earnings changes (NZ\$m)

NZ\$m	FY21E			FY22E			FY23E		
	Old	New	% chg	Old	New	% chg	Old	New	% chg
Revenue	1,825.0	1,433.9	-21%	2,230.6	1,697.6	-24%	2,579.7	1,995.7	-23%
EBITDA	570.6	378.2	-34%	695.7	480.6	-31%	809.8	603.2	-26%
Underlying profit	400.2	265.0	-34%	487.0	335.1	-31%	566.9	420.0	-26%
Underlying EPS (cps)	54.1	35.8	-34%	65.8	45.3	-31%	76.6	56.7	-26%
Dividend (cps)	0.0	0.0	n/a	0.0	0.0	n/a	23.0	17.0	-26%

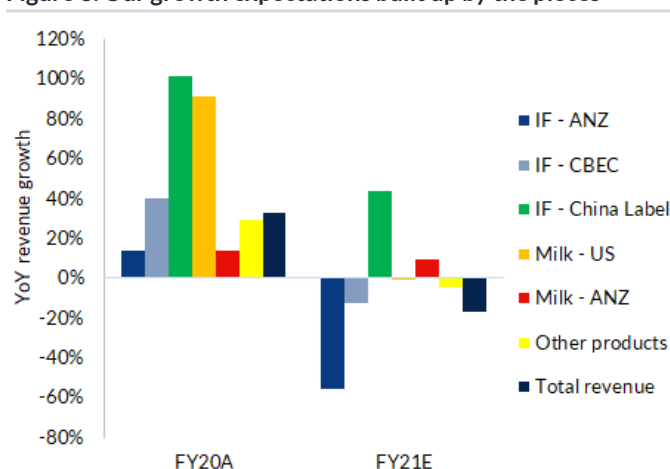
Source: Forsyth Barr analysis

Figure 2. ATM guidance breakdown by half

	FY21 guidance		1H21	2H21 guidance	
	Low	High		Low	High
Revenue	1,400	1,550	670	730	880
YoY growth	-19%	-10%	-17%	-21%	-5%
EBITDA margin	26.0%	29.0%	27.0%	25.1%	30.5%
EBITDA	364	450	181	183	269
YoY growth	-34%	-18%	-31%	-36%	-6%

Source: Forsyth Barr analysis, Company reports

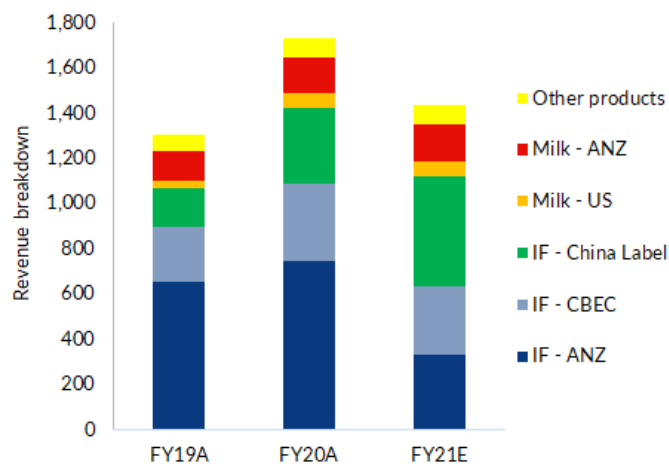
Figure 3. Our growth expectations built up by the pieces



Source: Forsyth Barr analysis, Company reports

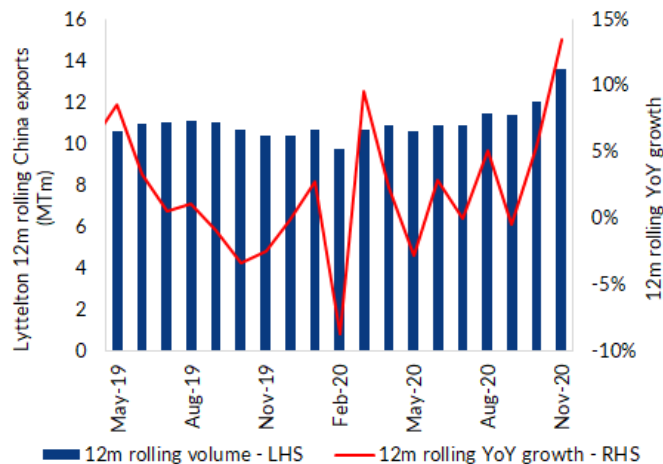
Key charts and tables

Figure 4. Material shift in channel mix



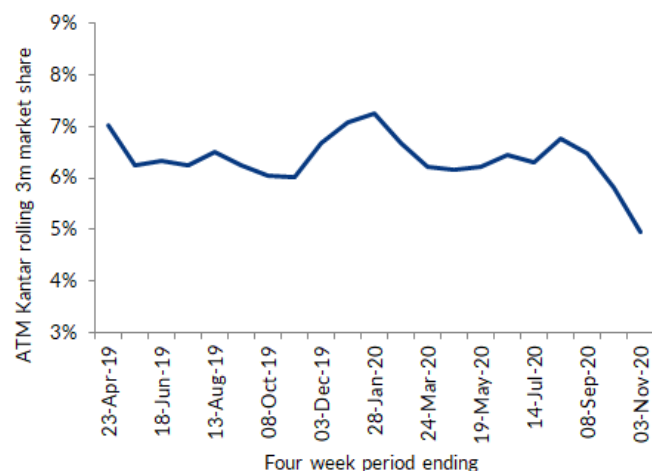
Source: Forsyth Barr analysis

Figure 5. Recent China label port data trends have been strong



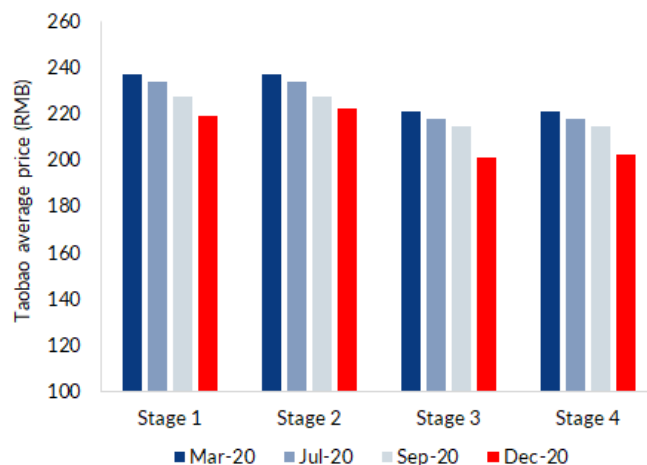
Source: Forsyth Barr analysis, Stats NZ

Figure 6. Kantar market share shows the rapid deterioration



Source: Forsyth Barr analysis, Kantar consumption panel

Figure 7. Retail prices have been under pressure for daigou

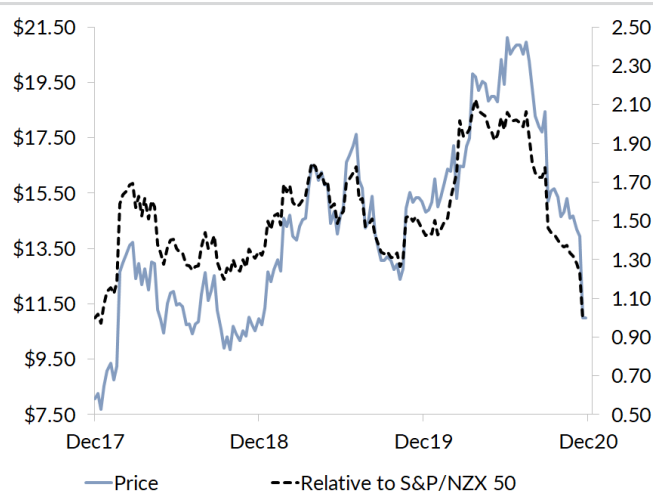


Source: Forsyth Barr analysis, Average from Taobao

Figure 8. Timeline of what has happened

Event	Date	ATM FY21 guidance		ATM FY21E EBITDA*	SML guidance Finished IF volumes	Notable commentary
		Revenue	EBITDA margin			
ATM FY20 result	19-Aug	Strong growth	30-31%	646		<ul style="list-style-type: none"> Expect pantry de-stocking will flow into FY21 Lower than anticipated retail daigou sales
ATM downgrade #1	28-Sep	\$1.8-1.9bn +4% to +10%	31%	565		<ul style="list-style-type: none"> Started to observe disruption in corporate daigou Expecting this to continue for the remainder of 1H21
SML FY20 result	28-Sep	n/a	n/a	n/a	Similar year-on-year	<ul style="list-style-type: none"> Lower demand in 1H21 due to high stock levels A return to growth in 2H once stock levels have cleared
SML capital raise	10-Nov	n/a	n/a	n/a	Lower than FY20	<ul style="list-style-type: none"> Now expect softer demand than previous in 1H21 as ATM reset inventory levels. Still expect volumes to increase in 2H once stock levels have cleared
ATM Annual Meeting	18-Nov	Retained prior guidance		552		<ul style="list-style-type: none"> Reaffirmed guidance and assumptions Emphasised uncertainty
ATM downgrade #2	18-Dec	\$1.4-1.55bn -19% to -10%	26-29%			<ul style="list-style-type: none"> Daigou disruption longer & greater than expected Daigou sales improved in Dec, albeit not to extent expected Daigou disruption has flowed to CBEC channel

Source: Forsyth Barr analysis, Company disclosure, * market consensus post event

Figure 9. Price performance


Source: Forsyth Barr analysis

Figure 10. 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	6.2%
UBS	5.7%
Pendal Group Limited	5.2%

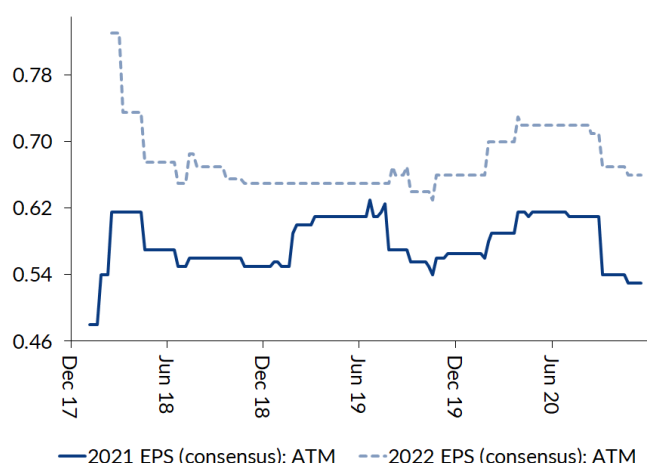
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

Figure 11. International valuation comparisons

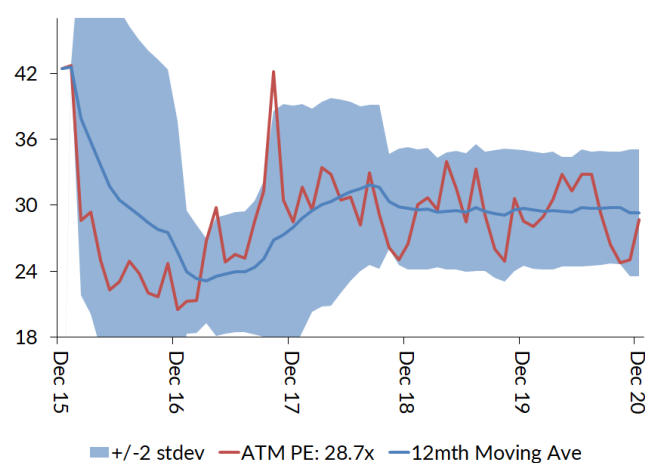
Company	Code	Price	Mkt Cap (m)	PE 2021E 2022E	EV/EBITDA 2021E 2022E	EV/EBIT 2021E 2022E	Cash Yld 2022E
(metrics re-weighted to reflect ATM's balance date - June)							
The a2 Milk Company	ATM NZ	NZ\$11.00	NZ\$8,101	30.7x 24.3x	19.2x 15.1x	19.5x 15.5x	0.0%
CHINA FEIHE	6186 HK	CN¥17.36	CN¥155,083	23.8x 18.9x	16.4x 13.0x	16.5x 13.1x	1.9%
SYNLAIT MILK *	SML NZ	NZ\$5.45	NZ\$1,191	13.0x 10.0x	9.5x 8.2x	13.1x 11.1x	0.0%
BLACKMORES	BKL AT	A\$80.61	A\$1,560	45.9x 31.7x	22.4x 17.8x	32.4x 22.6x	2.2%
HEALTH AND HAPPINESS H&H INT	1112 HK	CN¥31.35	CN¥20,201	16.2x 13.6x	9.8x 8.7x	10.7x 9.3x	4.1%
RECKITT BENCKISER GROUP PLC	RB/ LN	£64.08	£45,628	19.9x 19.3x	15.0x 14.7x	17.0x 16.6x	2.7%
AUSNUTRIA DAIRY CORP	1717 HK	CN¥11.10	CN¥19,041	14.9x 11.8x	10.6x 8.4x	12.1x 9.3x	3.0%
INNER MONGOLIA YILI INDUS-A	600887 CH	CN¥40.40	CN¥245,762	31.4x 26.9x	20.3x 17.4x	25.6x 22.1x	2.5%
DANONE	BN FP	€52.50	€36,048	15.8x 14.7x	11.0x 10.5x	14.4x 13.7x	4.2%
CHINA MENGNIU DAIRY CO	2319 HK	CN¥43.35	CN¥171,112	41.4x 30.4x	25.5x 19.3x	38.3x 27.0x	0.7%
Compco Average:				24.7x 19.7x	15.6x 13.1x	20.0x 16.1x	2.4%
ATM Relative:				24% 23%	23% 15%	-2% -4%	-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 12. Consensus EPS momentum (NZ\$)


Source: Forsyth Barr analysis

Figure 13. One year forward PE (x)


Source: Forsyth Barr analysis

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