

The a2 Milk Company

1H21 Preview — Changing of the Guard

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1H21 guidance was provided near period-end, hence, we are expecting little surprise in headline numbers when The a2 Milk Company (ATM) reports on Thursday, 25 February — with devil in the detail. Key focus areas: (1) updated outlook and any recent trading comments, (2) divisional breakdown, (3) market share/brand health indicators. New CEO, David Bortolussi, only started on 8 February, however any early observations or priorities are of interest. FY21 is set to be a disappointing period for ATM, with the magnitude (and pace of change) of recent earnings downgrades surprising us. The path forward is unlikely to be smooth and it will take time to rebuild market confidence, however, we view the issues as largely temporary (stemmed from COVID-19), and expect growth to return from FY22. Our recent channel checks have been supportive.

NZX Code	ATM	Financials: Jun/	20A	21E	22E	23E	Valuation (x)	20A	21E	22E	23E
Share price	NZ\$11.34	NPAT* (NZ\$m)	385.8	265.0	335.1	420.0	PE	21.8	31.7	25.1	20.0
Target price	NZ\$15.50	EPS* (NZc)	52.1	35.8	45.3	56.7	EV/EBIT	13.6	19.4	15.2	12.1
Risk rating	High	EPS growth* (%)	34.4	-31.3	26.4	25.4	EV/EBITDA	13.5	19.0	14.8	11.8
Issued shares	736.5m	DPS (NZc)	0.0	0.0	0.0	17.0	Price / NTA	7.5	6.1	4.9	4.0
Market cap	NZ\$8,352m	Imputation (%)	100	100	100	100	Cash div yld (%)	0.0	0.0	0.0	1.5
Avg daily turnover	852.9k (NZ\$13,835k)	*Based on normalised profits					Gross div yld (%)	0.0	0.0	0.0	2.1

Key areas of interest

- **Outlook — we expect FY21 guidance to be reaffirmed:** Guidance provided in late December is for FY21 revenue of NZ\$1.4–1.55bn (-10% to -19% YoY) and EBITDA margins of 26–29%.
- **Key market insights:** Any recent trading commentary and updated brand share metrics are of most interest.
 - **Infant Formula (IF) in China — mixed trends, with pressure in English Label outweighing growth in China Label:** Key focus: (1) an update on ATM's strategy changes for English Label and any early progress stabilising the under-pressure daigou channel, (2) strong growth in China Label sales — market share gains and increased distribution points — albeit, with better clarity on the growth profile through 1H21 (after confusion in December). The latter is the key medium-term growth opportunity.
 - **US — risk of confusion on underlying growth:** We expect low single-digit net revenue growth, but a meaningfully lower EBITDA loss given the planned shift in marketing from SG&A costs to in-store promotional spend (which is an offset to gross revenue).
- **Balance sheet:** (1) Updated cash balance and intentions for this. ATM's priority is growth, but recent suggestions were that a buyback is "under discussion", (2) Inventory levels and freshness — for ATM and more importantly its channel partners.

Conference call — Thursday 25 February, 11am NZ time

Pre-registration is required: <https://s1.c-conf.com/diamondpass/10011622-02kzls.html>

Figure 1. 1H21 result expectations

NZ\$m	1H20	1H21E	% chg	Guidance
Revenue	806.7	670.7	-16.9%	~670
EBITDA	263.2	181.3	-31.1%	
EBITDA margin	32.6%	27.0%	-560bp	~27%
Underlying profit	184.9	127.3	-31.2%	
Underlying EPS (cps)	25.2	17.2	-31.7%	
Dividend (cps)	0.0	0.0	n/a	

Source: Forsyth Barr analysis, Company reports

Figure 2. Divisional detail

Revenue breakdown (NZ\$m)	1H20	1H21E	% chg
IF - ANZ / daigou	352.0	140.8	-60%
IF - CBEC	158.7	166.6	5%
IF - China Label	146.7	211.2	44%
Liquid Milk	105.8	113.1	7%
Other	41.7	39.0	-6%
Total revenue	806.7	670.7	-17%

Source: Forsyth Barr analysis, Company reports

The a2 Milk Company (ATM)

Prised as at 22 Feb 2021 (NZ\$) **11.34**

12-month target price (NZ\$)*	15.50
Expected share price return	36.7%
Net dividend yield	0.0%
Estimated 12-month return	36.7%

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

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

DCF valuation summary (NZ\$m)	
Total firm value	9,721
(Net debt)/cash	854
Less: Capitalised operating leases	(17)
Value of equity	10,559

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

Valuation Ratios	2019A	2020A	2021E	2022E	2023E
EV/EBITDA (x)	18.6	13.5	19.0	14.8	11.8
EV/EBIT (x)	18.7	13.6	19.4	15.2	12.1
PE (x)	29.2	21.8	31.7	25.1	20.0
Price/NTA (x)	10.7	7.5	6.1	4.9	4.0
Free cash flow yield (%)	3.4	5.0	2.1	3.5	4.5
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

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

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

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

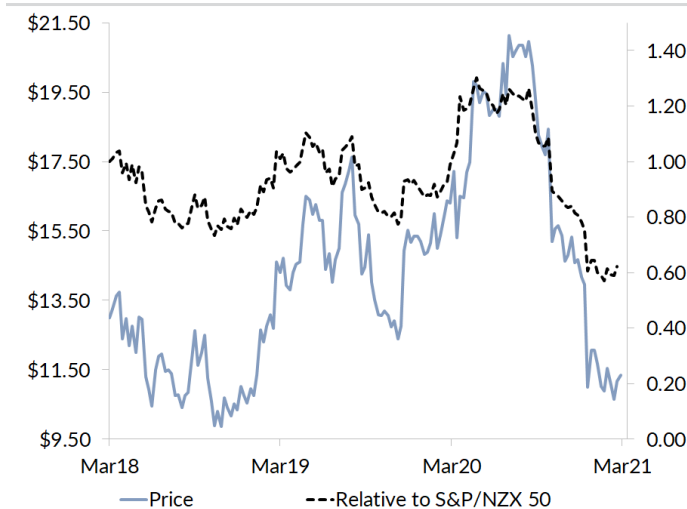
Key Ratios	2019A	2020A	2021E	2022E	2023E
Return on assets (%)	40.9	37.5	22.9	23.6	24.6
Return on equity (%)	36.5	34.0	18.9	19.3	20.0
Return on funds employed (%)	106.3	127.2	78.2	80.5	91.0
EBITDA margin (%)	31.8	31.8	26.4	28.3	30.2
EBIT margin (%)	31.6	31.5	25.9	27.6	29.4
Capex to sales (%)	0.3	0.4	2.0	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

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

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 (%)					
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

Figure 3. Price performance


Source: Forsyth Barr analysis

Figure 4. Substantial shareholders

Shareholder	Latest Holding
Mitsubishi UFJ Financial Group	8.5%
The Vanguard Group	7.0%
Commonwealth Bank of Australia	6.3%
BlackRock Investment Management	6.2%
UBS	5.7%
Pendal Group Limited	5.2%

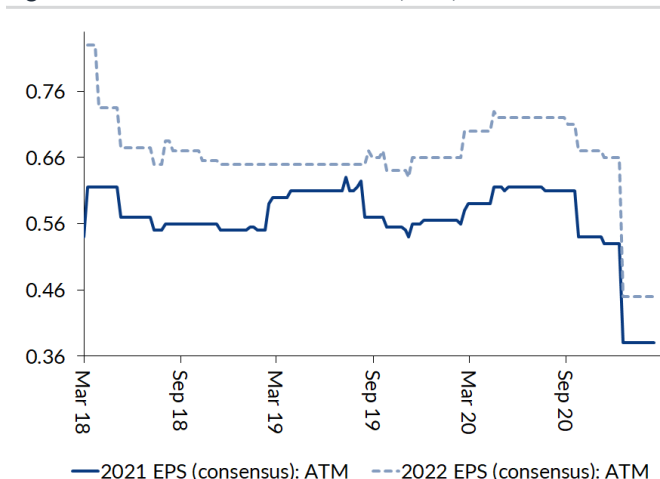
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

Figure 5. International valuation comparisons

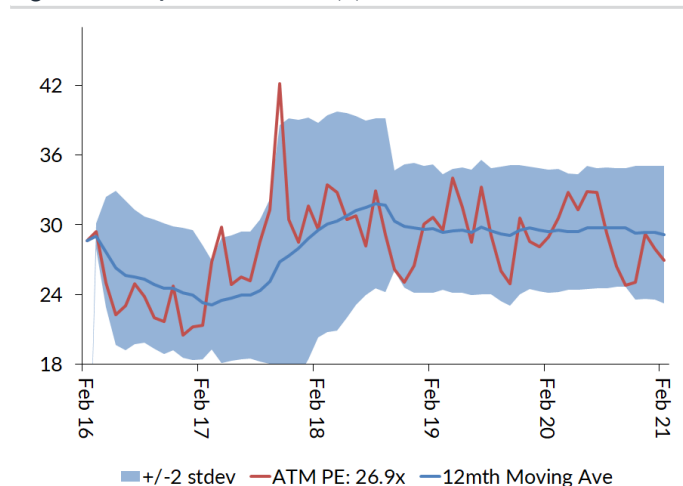
Company	Code	Price	Mkt Cap (m)	PE 2021E 2022E	EV/EBITDA 2021E 2022E	EV/EBIT 2021E 2022E	Cash Yld 2022E
(metrics re-weighted to reflect ATM's balance date - June)							
The a2 Milk Company	ATM NZ	NZ\$11.34	NZ\$8,352	31.7x 25.1x	19.8x 15.6x	20.2x 16.0x	0.0%
CHINA FEIHE	6186 HK	CNY23.00	CNY205,467	31.6x 25.0x	21.9x 17.4x	22.1x 17.5x	1.4%
SYNLAIT MILK *	SML NZ	NZ\$4.30	NZ\$940	19.3x 13.5x	11.0x 9.3x	17.6x 14.5x	0.0%
BLACKMORES	BKL AT	A\$72.06	A\$1,394	41.0x 28.4x	20.2x 16.0x	29.1x 20.3x	2.4%
HEALTH AND HAPPINESS H&H INT	1112 HK	CNY36.30	CNY23,396	18.9x 15.8x	11.2x 9.8x	12.1x 10.5x	3.5%
RECKITT BENCKISER GROUP PLC	RB/ LN	£62.78	£44,748	19.6x 19.1x	14.9x 14.6x	17.0x 16.7x	2.8%
AUSNUTRIA DAIRY CORP	1717 HK	CNY12.34	CNY21,176	17.0x 13.5x	12.2x 9.6x	14.0x 10.7x	2.6%
INNER MONGOLIA YILI INDUS-A	600887 CH	CNY45.80	CNY278,584	35.1x 30.1x	22.9x 19.6x	29.1x 25.2x	2.2%
DANONE	BN FP	€55.58	€38,163	16.9x 15.9x	11.7x 11.2x	15.3x 14.7x	3.9%
CHINA MENGNIU DAIRY CO	2319 HK	CNY47.10	CNY185,960	45.0x 32.9x	27.5x 21.2x	41.8x 29.4x	0.7%
Compco Average:				27.1x 21.6x	17.0x 14.3x	22.0x 17.7x	2.2%
ATM Relative:				17% 16%	16% 9%	-8% -10%	-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 6. Consensus EPS momentum (NZ\$)


Source: Forsyth Barr analysis

Figure 7. One year forward PE (x)


Source: Forsyth Barr analysis

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