

The a2 Milk Company

1H21 — Third Strike; Downgrade to NEUTRAL

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NEUTRAL

The a2 Milk Company (ATM) reported a 1H21 result in-line with recent guidance and materially below the prior year (primarily due to COVID-19 related headwinds), but disappointingly further downgraded FY21 guidance. This is the third downgrade since September 2020 and a further unwelcome reminder of ATM's opaque channels to market, with very limited visibility (including for management). The downgrade cycle has materially dented our (and market) confidence in the near-term outlook which will take time to rebuild. We remain confident in ATM's longer-term brand positioning and growth potential, particularly in large offline channels in China where ATM under-indexes. However, at this juncture there is too much uncertainty to have conviction in a directional call and FY21 guidance is not risk-free. Downgrade to NEUTRAL.

NZX Code	ATM	Financials: Jun/	20A	21E	22E	23E	Valuation (x)	20A	21E	22E	23E
Share price	NZ\$9.34	NPAT* (NZ\$m)	385.8	231.6	271.0	357.6	PE	17.9	29.9	25.6	19.4
Target price	NZ\$11.00	EPS* (NZc)	52.1	31.2	36.5	48.2	EV/EBIT	11.0	17.9	15.8	12.0
Risk rating	High	EPS growth* (%)	34.4	-40.2	17.0	31.9	EV/EBITDA	11.0	17.5	14.9	11.4
Issued shares	742.6m	DPS (NZc)	0.0	0.0	0.0	14.4	Price / NTA	6.1	5.2	4.3	3.6
Market cap	NZ\$6,936m	Imputation (%)	100	100	100	100	Cash div yld (%)	0.0	0.0	0.0	1.5
Avg daily turnover	877.0k (NZ\$14,020k)	*Based on normalised profits					Gross div yld (%)	0.0	0.0	0.0	2.1

What's changed?

- **Earnings:** Materially lowered – EBITDA revised -10% to -15%.
- **Target price:** NZ\$11.00. Material downgrade due to: earnings revisions, impact of Synlait price decline & the MVM acquisition.
- **Rating:** Downgraded to NEUTRAL (from OUTPERFORM).

Key areas of interest

- **FY21 guidance cut; not risk-free:** Guidance is for FY21 revenue of ~NZ\$1.4bn (prior NZ\$1.4–1.55bn) and EBITDA margins of 24–26% (prior 26–29%). This includes a "significant improvement in quarter-on-quarter growth from 3Q21 to 4Q21" for the under-pressure daigou channel. While this is one feasible scenario, we can't rule out the possibility of a further downgrade.
- **Infant Formula (IF) – a tale of two labels:** A material contraction in English Label IF (-39%) outweighed strength in China Label (+45%) in 1H21. English Label challenges stemmed from COVID-19 (availability of daigou, margin squeeze & excess inventory). Anecdotes suggest monthly volatility, however, it continues to take longer than expected to stabilise/improve in a sustainable way.
- **Removal of medium-term EBITDA margin target (30%):** Gives the new CEO (<3 weeks into the role) time to make an informed re-assessment. While understandable, particularly in light of the rapid material shift in business mix, it adds further uncertainty.
- **Inventory challenges stem from COVID-19:** Inventory levels were sensibly built up in the initial stages of COVID-19, however, the materially lower demand profile since has resulted in a spike in 1H21 inventory despite a provision. This will take time to work through, with a fine-balance required while ATM is actively working to lift English Label pricing.
- **Mataura Valley Milk (MVM) – to be a near-term drag on earnings:** This aligns with our prior expectations. The acquisition is strategically sensible, particularly increasing strategic ties with its key China distribution partner and risk mitigation. There is no change to our view that an adequate payback/return is at least five years away while the facility is set-up to be able to supply IF.
- **Valuation metrics:** ATM is trading on a cash-adjusted 12m forward PE of 23.5x, or 21.9x also adjusting for US losses. This is below the NZ market, with a material contraction over the past six months on what we view as suppressed EPS. We view the issues as largely temporary (stemming from COVID-19) and expect growth to return from FY22E. If ATM delivers on our growth profile, valuation is attractive particularly given high returns. However risks remain and there is a high margin of error in any ATM forecast.

The a2 Milk Company (ATM)

Priced as at 25 Feb 2021 (NZ\$) **9.34**

12-month target price (NZ\$)*	11.00
Expected share price return	17.8%
Net dividend yield	0.0%
Estimated 12-month return	17.8%

Spot valuations (NZ\$)	
1. DCF	10.22
2. Peer multiple	9.94
n/a	n/a

Key WACC assumptions	
Risk free rate	2.30%
Equity beta	0.95
WACC	8.2%
Terminal growth	1.5%

DCF valuation summary (NZ\$m)	
Total firm value	6,719
(Net debt)/cash	854
Less: Capitalised operating leases	(17)
Value of equity	7,556

Profit and Loss Account (NZ\$m)	2019A	2020A	2021E	2022E	2023E
Sales revenue	1,300.8	1,731.1	1,381.0	1,599.1	1,912.4
Normalised EBITDA	413.6	549.7	340.6	407.5	530.5
Depreciation and amortisation	(2.2)	(4.4)	(8.3)	(23.8)	(24.6)
Normalised EBIT	411.4	545.3	332.3	383.7	505.9
Net interest	4.3	5.7	3.4	3.5	5.0
Associate income	0	0	0	0	0
Tax	(128.0)	(165.2)	(104.1)	(116.2)	(153.2)
Minority interests	0	0	0	0	0
Normalised NPAT	287.7	385.8	231.6	271.0	357.6
Abnormals/other	0	0	0	0	0
Reported NPAT	287.7	385.8	231.6	271.0	357.6
Normalised EPS (cps)	38.8	52.1	31.2	36.5	48.2
DPS (cps)	0	0	0	0	14.4

Valuation Ratios	2019A	2020A	2021E	2022E	2023E
EV/EBITDA (x)	15.2	10.9	17.5	14.9	11.4
EV/EBIT (x)	15.3	11.0	17.9	15.8	12.0
PE (x)	24.1	17.9	29.9	25.6	19.4
Price/NTA (x)	8.8	6.1	5.2	4.3	3.6
Free cash flow yield (%)	4.1	6.1	-2.2	4.0	5.0
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	-91.2	-131.7	-172.6
Net debt/EBITDA (x)	n/a	n/a	n/a	n/a	n/a

Growth Rates	2019A	2020A	2021E	2022E	2023E
Revenue (%)	41.0	33.1	-20.2	15.8	19.6
EBITDA (%)	46.1	32.9	-38.0	19.6	30.2
EBIT (%)	46.5	32.5	-39.1	15.5	31.9
Normalised NPAT (%)	47.0	34.1	-40.0	17.0	31.9
Normalised EPS (%)	47.4	34.4	-40.2	17.0	31.9
Ordinary DPS (%)	n/a	n/a	n/a	n/a	n/a

Key Ratios	2019A	2020A	2021E	2022E	2023E
Return on assets (%)	40.9	37.5	21.1	20.5	22.7
Return on equity (%)	36.5	34.0	17.1	16.7	18.4
Return on funds employed (%)	106.3	127.2	46.6	38.2	50.3
EBITDA margin (%)	31.8	31.8	24.7	25.5	27.7
EBIT margin (%)	31.6	31.5	24.1	24.0	26.5
Capex to sales (%)	0.3	0.4	20.0	1.9	2.1
Capex to depreciation (%)	155	164	3,343	126	162
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	0	0	0	0	30

Cash Flow (NZ\$m)	2019A	2020A	2021E	2022E	2023E
EBITDA	413.6	549.7	340.6	407.5	530.5
Working capital change	(6.5)	33.6	(102.8)	14.7	7.1
Interest & tax paid	(129.6)	(192.2)	(100.7)	(112.6)	(148.3)
Other	11.6	35.9	(10.0)	0	0
Operating cash flow	289.1	427.0	127.1	309.6	389.3
Capital expenditure	(3.4)	(7.2)	(276.5)	(30.0)	(40.0)
(Acquisitions)/divestments	(162.3)	(21.9)	(56.2)	0	0
Other	0	(3.6)	(3.5)	(3.7)	(3.8)
Funding available/(required)	123.4	394.3	(209.1)	275.9	345.5
Dividends paid	0	0	0	0	(42.9)
Equity raised/(returned)	2.9	2.4	0	0	0
(Increase)/decrease in net debt	126.3	396.8	(209.1)	275.9	302.6

Operating Performance	2019A	2020A	2021E	2022E	2023E
Revenue (breakdown by product)					
IF - ANZ (primarily daigou)	653	745	440	461	572
IF - CBEC	243	341	183	183	188
Total English Label	896	1,086	623	644	760
IF - China Label	168	338	468	641	807
Total Infant Formula	1,064	1,424	1,091	1,285	1,567
Total Fresh Milk	171	222	242	262	289
Other	66	85	48	52	56
Total revenue	1,301	1,731	1,381	1,599	1,912

Balance Sheet (NZ\$m)	2019A	2020A	2021E	2022E	2023E
Working capital	50.6	(7.6)	91.9	79.2	75.1
Fixed assets	10.3	14.2	333.1	341.7	359.6
Intangibles	13.0	13.6	21.5	21.3	21.1
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	743.6	739.5	753.1
Net debt/(cash)	(464.8)	(854.2)	(646.8)	(924.5)	(1,229.1)
Lease liability	0	16.8	17.5	18.1	18.7
Other liabilities	45.4	20.5	17.2	19.2	22.2
Shareholder's funds	787.9	1,134.1	1,355.7	1,626.7	1,941.4
Minority interests	0	0	0	0	0
Total funding sources	368.4	317.2	743.6	739.5	753.1

Revenue growth (%)					
IF - ANZ (primarily daigou)	35	14	(41)	5	24
IF - CBEC	54	40	(46)	0	3
IF - China Label	100	101	39	37	26
Total Infant Formula	47	34	(23)	18	22
Total Fresh Milk	20	30	9	8	10
Gross profit	713	969	715	841	1,010
Total SG&A expenses	(300)	(419)	(375)	(433)	(480)
incl marketing expenses	(134)	(194)	(173)	(200)	(229)
Group EBITDA	414	550	341	407	530
US - EBITDA losses	(44)	(51)	(27)	(25)	(20)
EBITDA excluding US losses	457.6	600.2	367.1	432.2	550.3

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

1H21 result takeaways

ATM reported 1H21 EBITDA of NZ\$183m, down -30.5% on the prior year, and marginally ahead of our forecasts. Notable features:

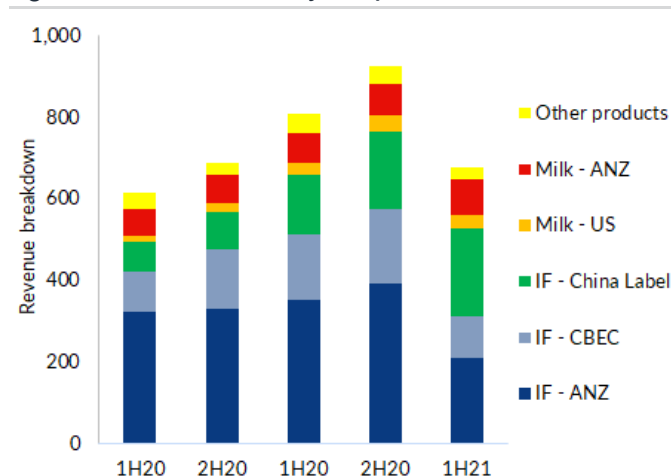
- **Revenue down -16%, albeit marginally better than forecast:** A material contraction in English Label IF outweighed strong double-digit growth in China Label IF and Liquid Milk. Revenue was marginally above our expectations. There were material mix differences, with liquid milk stronger, daigou not as bad as we feared, albeit materially lower sales in cross border ecommerce.
- **Margin pressure:** Gross margin (excluding the stock provision) was down -357bp to 53.7% due to unfavourable business mix and increased in-channel investment. Key positives were materially lower SG&A costs and substantially lower US losses.
- **Inventory levels:** Materially higher, with inventory days jumping to 107 (from 54 in 1H20), despite a provision of NZ\$23m.

Figure 1. Result breakdown (1H21)

NZ\$m	1H20	1H21	% chg	Forsyth Barr
Revenue	806.7	677.3	-16.0%	670.7
Underlying EBITDA	263.2	183.0	-30.5%	181.3
EBITDA margin	32.6%	27.0%	-561bp	27.0%
Underlying profit	184.9	124.5	-32.7%	127.3
Reported profit	184.9	120.0	-35.1%	127.3
Underlying EPS (cps)	25.2	16.8	-33.4%	17.2
Dividend (cps)	0.0	0.0	n/a	0.0

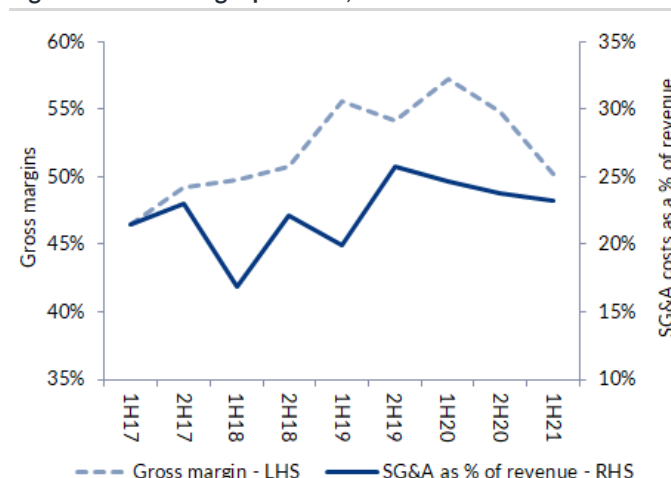
Source: Forsyth Barr analysis, Company reports

Figure 3. Recent revenue trajectory



Source: Forsyth Barr analysis

Figure 5. Gross margin pressure; SG&A well controlled



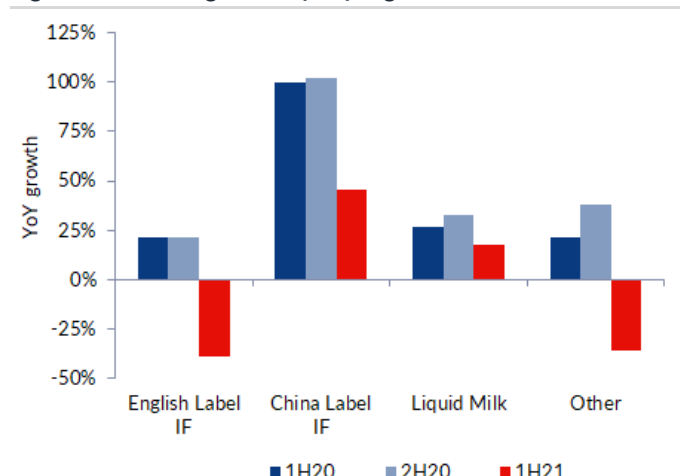
Source: Forsyth Barr analysis, Company reports

Figure 2. Total revenue breakdown

NZ\$m	1H20	1H21	% chg	Forsyth Barr
IF - ANZ / daigou (A)	352.0	209.5	-40%	140.8
IF - CBEC (B)	160.5	103.5	-36%	166.6
IF - total English Label (A+B)	512.5	313.0	-39%	307.4
IF - China Label	146.7	213.1	45%	211.2
Liquid Milk	105.8	124.7	18%	113.1
Other	41.7	26.6	-36%	39.0
Total revenue	806.7	677.3	-16%	670.7

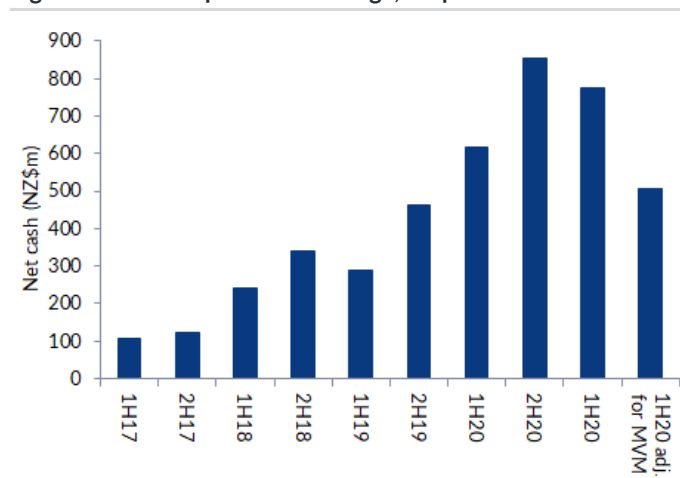
Source: Forsyth Barr analysis, Company reports

Figure 4. Revenue growth by key segment



Source: Forsyth Barr analysis, Company reports

Figure 6. Net cash position still large, despite some investment



Source: Forsyth Barr analysis, Company reports

Earnings revisions and valuation

We have made a number of revisions to our ATM forecasts, with the net result moderate downgrades to revenue and more meaningful cuts to profit expectations over the medium-term. We have also incorporated the acquisition of MVM for the first time, which is initially loss-making. For clarity we include earnings revisions pre and post this to enable like-for-like comparisons. Our FY21 revenue forecast is marginally below ATM guidance (more conservative daigou recovery path), and our EBITDA margin is below the mid-point of guidance.

Key changes include:

- Revised English Label mix, with an upgrade to daigou modestly outweighed by a material downgrade to CBEC.
- Lower China Label IF gross margins. We assume China Label margins are ~5% lower than English label (prior: no difference).
- Lower sales of Other products, primarily linked to daigou channel weakness.
- Lower SG&A costs, across most buckets, following a better than expected 1H21 (even adjusted for some timing benefits).
- Incorporating the acquisition of MVM. We assume a near-term EBITDA loss of -NZ\$10m from FY22E, improving to break-even in FY25E – more conservative than ATM guidance. We also incorporate D&A of ~NZ\$15m per annum.

There are many unknowns, with recent announcements a stark reminder visibility is low and there is a high margin of error in earnings forecasts.

Figure 7. Earnings revisions

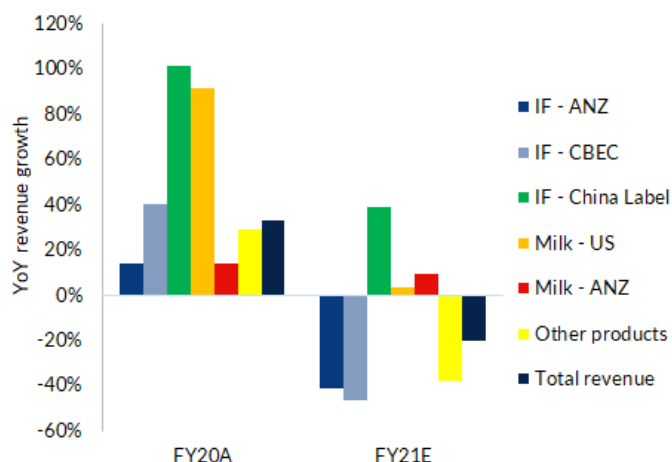
NZ\$m	FY21E			FY22E			FY23E		
	Old	New	% chg	Old	New	% chg	Old	New	% chg
Revenue	1,433.9	1,381.0	-4%	1,697.6	1,599.1	-6%	1,995.7	1,912.4	-4%
EBITDA	378.2	340.6	-10%	480.6	407.5	-15%	603.2	530.5	-12%
EBITDA ex MVM	378.2	340.6	-10%	480.6	417.5	-13%	603.2	539.5	-11%
Underlying profit	265.0	231.6	-13%	335.1	271.0	-19%	420.0	357.6	-15%
Underlying profit ex MVM	265.0	231.6	-13%	335.1	288.5	-14%	420.0	374.4	-11%
Underlying EPS (cps)	35.8	31.2	-13%	45.3	36.5	-19%	56.7	48.2	-15%
Dividend (cps)	0.0	0.0	n/a	0.0	0.0	n/a	17.0	14.4	-15%

Source: Forsyth Barr analysis

We lower our ATM target price to NZ\$11.00 (from NZ\$15.50). This reflects (1) materially lower earnings expectations, (2) incorporating the acquisition of MVM which is dilutive, (3) marking to market ATM's stake in Synlait and (4) a modest lift in our cost of capital (to 8.2% from 7.8%) following changes to our team inputs, given higher interest rates – refer our strategy report, *Still a One Way Bet?* – Updated WACC Assumptions, published 12 February 2021.

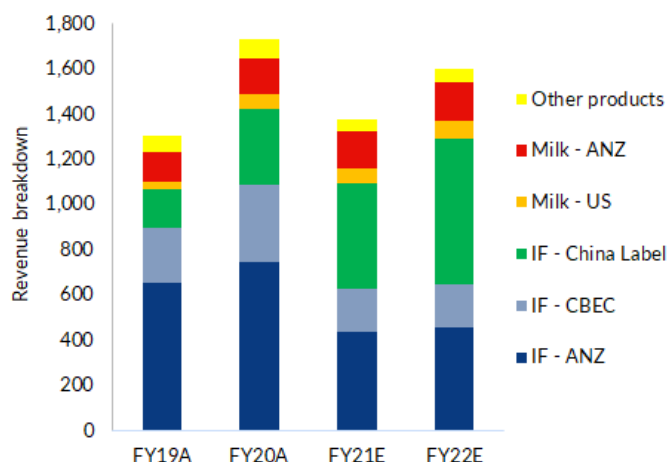
Our valuation assumes a terminal share of ~6% of the China IF market, up from an estimated ~3.6% in FY21E and ~4.6% in FY20 (including daigou). This incorporates a near-term decline in the IF market (following recent birth rate data), followed by a return to growth of +1.5% longer-term.

Figure 8. Our growth expectations built up by the pieces

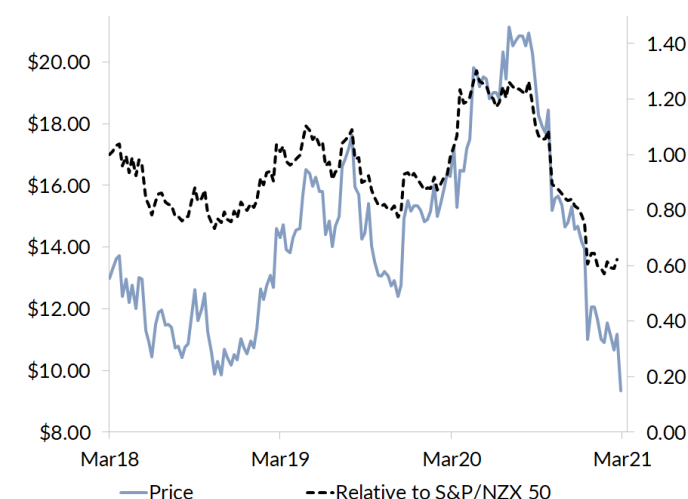


Source: Forsyth Barr analysis, Company reports

Figure 9. Revenue breakdown by key segment



Source: Forsyth Barr analysis, Company reports

Figure 10. Price performance


Source: Forsyth Barr analysis

Figure 11. 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%

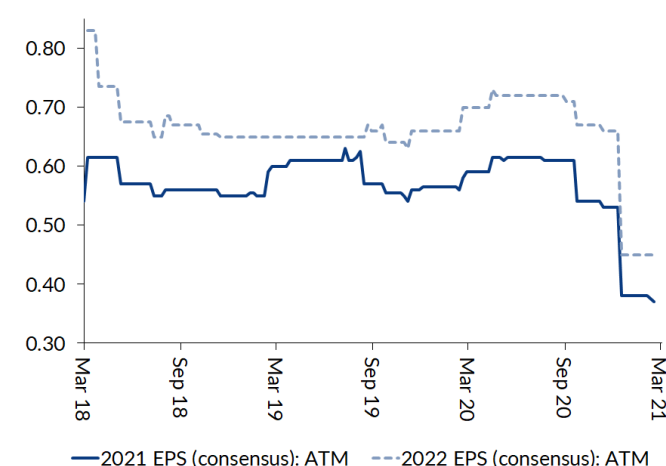
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

Figure 12. International valuation comparisons

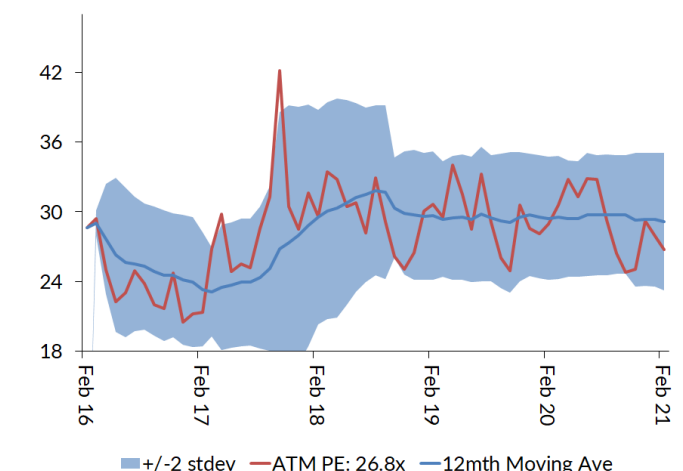
Company	Code	Price	Mkt Cap (m)	PE 2021E	PE 2022E	EV/EBITDA 2021E	EV/EBITDA 2022E	EV/EBIT 2021E	EV/EBIT 2022E	Cash Yld 2022E
(metrics re-weighted to reflect ATM's balance date - June)										
The a2 Milk Company	ATM NZ	NZ\$9.34	NZ\$6,936	29.9x	25.6x	17.9x	14.9x	18.3x	15.9x	0.0%
CHINA FEIHE	6186 HK	CNY22.90	CNY204,573	31.4x	24.8x	21.8x	17.3x	22.0x	17.4x	1.4%
SYNLAIT MILK *	SML NZ	NZ\$4.27	NZ\$933	19.1x	13.4x	10.9x	9.3x	17.5x	14.4x	0.0%
BLACKMORES	BKL AT	A\$74.10	A\$1,434	42.2x	29.2x	20.7x	16.4x	29.9x	20.8x	2.4%
HEALTH AND HAPPINESS H&H INT	1112 HK	CNY33.15	CNY21,366	17.2x	14.4x	10.3x	9.1x	11.2x	9.7x	3.9%
RECKITT BENCKISER GROUP PLC	RB/ LN	£59.70	£42,552	18.6x	18.2x	14.1x	14.0x	16.2x	15.8x	2.9%
AUSNUTRIA DAIRY CORP	1717 HK	CNY12.38	CNY21,245	16.9x	13.5x	12.1x	9.7x	13.9x	10.9x	2.6%
INNER MONGOLIA YILI INDUS-A	600887 CH	CNY45.01	CNY273,779	34.5x	29.5x	22.5x	19.3x	28.5x	24.7x	2.3%
DANONE	BN FP	€57.62	€39,564	18.3x	16.5x	12.2x	11.6x	17.4x	15.3x	3.7%
CHINA MENGNIU DAIRY CO	2319 HK	CNY46.50	CNY183,591	44.4x	32.5x	27.2x	20.9x	41.3x	29.0x	0.7%
Compco Average:				27.0x	21.3x	16.9x	14.2x	22.0x	17.6x	2.2%
ATM Relative:				11%	20%	6%	5%	-17%	-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 13. Consensus EPS momentum (NZ\$)


Source: Forsyth Barr analysis

Figure 14. One year forward PE (x)


Source: Forsyth Barr analysis

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