

Synlait Milk

NEUTRAL

Doubling Down in Everyday Dairy

Synlait Milk (SML) announced the conditional acquisition of Dairyworks for NZ\$112m, providing an avenue to accelerate its growth plans in the Everyday Dairy segment. Strategically it is on message, multiples aren't demanding and we can see some synergy opportunities. However, we remain to be convinced on the overall merits of SML's diversification into Everyday Dairy.

Acquisition of Dairyworks

SML has entered a conditional agreement for NZ\$112m to acquire Dairyworks, a key player in NZ's Everyday Dairy segment. The company is a contract packer and owns an array of consumer brands, with a small amount of manufacturing (for ice cream). The transaction is subject to Overseas Investment Office (OIO) approval and likely to complete in early 2020.

At this stage we have not incorporated the acquisition of Dairyworks in our forecasts in light of the uncertain timeframe for completion (reliant on OIO).

Key points to note

- **Multiple paid doesn't appear demanding:** EV/EBITDA of c. 7.5x is at the lower end of dairy comparatives and meaningfully below SML itself, although we note Dairyworks is materially smaller.
- **Modest EPS accretion:** We estimate c. +5% in Year 1, pre any synergies.
- **Synergy potential:** There are available synergies which will help to improve the return profile. While difficult to pre-empt timing and quantum, meeting SML's return hurdles for growth capex (20%) appears challenging.
- **Debt funded acquisition, lifts gearing:** We derive pro forma FY20 net debt to EBITDA of 2.4x. SML's cashflow profile should enable deleveraging at a reasonable pace, albeit SML's growth mind-set means we cannot rule out further capital investment projects (M&A and/or organic).

A platform to accelerate its Everyday Dairy strategy; proving up required

Strategically the acquisition ticks a number of boxes and aligns with the company's recent entry into Everyday Dairy and desire to move into consumer brands. However, this diversification strategy is still unproven — with considerable management effort for modest diversification in highly competitive (and lower returning) categories.

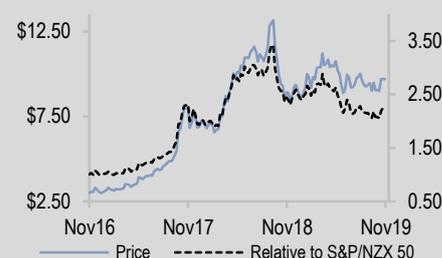
- **Opportunities / Positives:** (1) Solid business on a standalone basis; (2) Synergies, particularly in cheese production; (3) Accelerating Everyday Dairy plans — ability to offer a broader product range to customers.
- **Risks / Negatives:** (1) A different skill-set to SML's raison d'être as a dairy processor; (2) A lot of growth avenues for management to juggle; (3) Moving deeper into competitive categories with customers that have high bargaining power — thereby providing lower returns.

Investment View

SML is a growth-focussed niche dairy processor. Success to date has been underpinned by key customer, The a2 Milk Company, which we also expect to support strong near-term earnings growth. The long-term trajectory is less clear and we expect to see at least some reversion in returns, albeit the extent is unlikely to be known near-term. NEUTRAL.

NZX Code	SML
Share price	NZ\$9.70
Target price	NZ\$9.50
Risk rating	High
Issued shares	179.2m
Market cap	NZ\$1,738m
Average daily turnover	93.0k (NZ\$900k)

Share Price Performance



Financials: July	19A	20E	21E	22E
NPAT* (NZ\$m)	82.2	91.9	108.9	129.0
EPS* (NZc)	45.9	51.3	60.8	72.0
EPS growth* (%)	10.3	11.7	18.5	18.5
DPS (NZc)	0.0	0.0	0.0	0.0
Imputation (%)	100	100	100	100

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	12.9	11.2	9.7	8.8
EV/EBIT	15.7	14.1	12.2	10.9
PE	21.1	18.9	16.0	13.5
Price / NTA	3.7	3.1	2.6	n/a
Cash dividend yield (%)	0.0	0.0	0.0	0.0
Gross dividend yield (%)	0.0	0.0	0.0	0.0

*Historic and forecast numbers based on underlying profits

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Synlait Milk Ltd (SML)

Priced as at 25 Oct 2019: NZ\$9.70

July year end

Forsyth Barr valuation		Valuation Ratios					2018A	2019A	2020E	2021E	2022E	
Valuation methodology		DCF	EV/EBITDA (x)	13.3	12.9	11.2	9.7	8.8				
12-month target price (NZ\$)*		9.50	EV/EBIT (x)	16.3	15.7	14.1	12.2	10.9				
Expected share price return		-2.1%	PE (x)	23.3	21.1	18.9	16.0	13.5				
Net dividend yield		0.0%	Price/NTA (x)	4.2	3.7	3.1	2.6	2.2				
Estimated 12-month return		-2.1%	Free cash flow yield (%)	-1.9	-12.6	-1.8	6.5	7.6				
Key WACC assumptions			Net dividend yield (%)	0.0	0.0	0.0	0.0	0.0				
Risk free rate		2.00%	Gross dividend yield (%)	0.0	0.0	0.0	0.0	0.0				
Equity beta		1.08	Imputation (%)	100	100	100	100	100				
WACC		7.7%	Pay-out ratio (%)	0	0	0	0	0				
Terminal growth		1.5%	Capital Structure	2018A	2019A	2020E	2021E	2022E				
Profit and Loss Account (NZ\$m)		2018A	2019A	2020E	2021E	2022E	Interest cover EBIT (x)	12.1	13.3	7.3	8.0	13.8
Sales revenue		879	1,024	1,202	1,359	1,485	Interest cover EBITDA (x)	14.9	16.1	9.2	10.1	17.0
Normalised EBITDA		138	152	187	218	238	Net debt/ND+E (%)	21.2	40.4	38.5	26.7	12.7
Depreciation and amortisation		(26)	(28)	(40)	(46)	(46)	Net debt/EBITDA (x)	0.8	2.2	2.0	1.2	0.5
Normalised EBIT		113	125	148	173	193	Key Ratios	2018A	2019A	2020E	2021E	2022E
Net interest		(9)	(9)	(20)	(22)	(14)	Return on assets (%)	14.2	10.9	11.4	13.0	14.3
Associate income		0	(1)	-	-	-	Return on equity (%)	17.6	16.7	15.7	15.7	15.7
Tax		(29)	(33)	(36)	(42)	(50)	Return on funds employed (%)	15.7	12.7	11.4	12.5	14.3
Minority interests		-	-	-	-	-	EBITDA margin (%)	15.7	14.8	15.6	16.0	16.0
Normalised NPAT		75	82	92	109	129	EBIT margin (%)	12.8	12.2	12.3	12.7	13.0
Abnormals/other		-	-	-	-	-	Capex to sales (%)	13.7	33.0	12.2	2.9	2.6
Reported NPAT		75	82	92	109	129	Capex to depreciation (%)	471	1,224	366	85	85
Normalised EPS (cps)		41.6	45.9	51.3	60.8	72.0	Operating Performance	2018A	2019A	2020E	2021E	2022E
DPS (cps)		-	-	-	-	-	Sales volume (000 MT)					
Growth Rates		2018A	2019A	2020E	2021E	2022E	Powders & Cream	93,042	106,802	115,840	119,497	120,218
Revenue (%)		15.8	16.5	17.4	13.1	9.3	Consumer Packaged	35,580	42,907	50,184	56,469	61,246
EBITDA (%)		55.4	10.2	23.3	16.3	9.2	Specialty Ingredients	12	21	32	34	36
EBIT (%)		65.3	11.0	18.2	16.9	11.8	Total volume	128,634	149,730	166,056	176,000	181,500
Normalised NPAT (%)		88.6	10.3	11.7	18.5	18.5	Liquid milk volumes (m L)	-	-	35	50	66
Normalised EPS (%)		88.6	10.3	11.7	18.5	18.5	Gross Profit (GP) breakdown					
DPS (%)		n/a	n/a	n/a	n/a	n/a	Powders & Cream	134	142	153	168	177
Cash Flow (NZ\$m)		2018A	2019A	2020E	2021E	2022E	Consumer Packaged	28	34	41	48	52
EBITDA		138	152	187	218	238	Liquid Milk	-	(4)	5	13	22
Working capital change		(14)	12	(17)	(4)	(3)	Specialty Ingredients	4	13	19	19	19
Interest & tax paid		(24)	(44)	(56)	(64)	(64)	Total Gross Profit	166	186	219	247	270
Other		(11)	(1)	1	1	1	Milk supply, m kgMS	61	66	74	80	83
Operating cash flow		88	120	115	151	172	Gross Profit	166	186	219	247	270
Capital expenditure		(120)	(338)	(147)	(39)	(39)	Operating Costs (incl D&A)	(54)	(61)	(71)	(74)	(77)
(Acquisitions)/divestments		(10)	(11)	-	-	-	EBIT	113	125	148	173	193
Other		-	(0)	-	-	-	Depreciation & Amortisation	(26)	(28)	(40)	(46)	(46)
Funding available/(required)		(42)	(230)	(32)	112	133	EBITDA	138	152	187	218	238
Dividends paid		-	-	-	-	-						
Equity raised/(returned)		-	-	-	-	-						
Increase/(decrease) in net debt		42	230	32	(112)	(133)						
Balance Sheet (NZ\$m)		2018A	2019A	2020E	2021E	2022E						
Working capital		40	11	28	31	34						
Fixed assets		538	845	953	947	941						
Intangibles		12	20	19	18	17						
Other assets		20	40	40	40	40						
Total funds employed		609	916	1,040	1,036	1,033						
Net debt/(cash)		114	333	365	253	120						
Other non current liabilities		70	91	91	91	91						
Shareholder's funds		425	492	584	693	822						
Minority interests		-	-	-	-	-						
Total funding sources		609	916	1,040	1,036	1,033						

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

Dairyworks acquisition

Synlait Milk (SML) announced it has entered into a conditional agreement to acquire Dairyworks — a key player in NZ's Everyday Dairy segment. The acquisition, which is subject to Overseas Investment Office (OIO) approval, is expected to close in early CY20.

Strategically the acquisition ticks a number of boxes, although forms part of a yet to be proven up diversification strategy and we are surprised at the timing. While consistent with SML's stated strategy, the reality of consumer brands is different to a dairy processor at a time where management's plate is already full.

At this stage we do not incorporate Dairyworks into our forecasts given the uncertainty around timing of completion (reliant on OIO).

Acquisition details

The key acquisition details are:

- **Price:** SML will pay NZ\$112m.
- **Funding:** The acquisition will be fully debt funded. This would lift FY20 net debt to EBITDA to 2.4x (41% geared), up from 2.0x (38.5%) on a pro forma basis.
- **Acquisition conditions:** The key condition is OIO approval. We expect the transaction to settle around the first quarter of CY20.
- **Multiple paid:** The headline EV/EBITDA multiple of c. 7.5x which compared to SML's current multiple of c. 11x and Fonterra at c. 9x doesn't appear demanding, although Dairyworks is materially smaller.
- **Structure:** Operationally, Dairyworks will be standalone, with current CEO Tim Carter reporting directly to SML's senior management team.

Modest EPS accretion

We derive Dairyworks EBITDA of c. NZ\$15m from SML's disclosure. Using our assumptions around depreciation (NZ\$3m) and the cost of debt (3.5%), we derive NPAT of NZ\$6m for Dairyworks. On a pro forma basis this would lift our SML NPAT by c. +5% and provides EPS accretion of c. +5% pre synergies.

Figure 1. Key metrics for Dairyworks acquisition

NZ\$m	SML – FY20E	Dairyworks	Pro forma group
EBITDA	187	15	202
D&A	(40)	(3)	(43)
EBIT	148	12	159
Net interest	(20)	(4)	(24)
PBT	128	8	135
Tax	(36)	(2)	(38)
NPAT	92	6	97
Shares (m)	179		179
EPS (cps)	51.3		54.0
EV		112	
ROIC (post tax)		7.7%	
EV/EBITDA		7.5x	
EPS accretion (pre synergies)		+5%	

Source: Forsyth Barr analysis

Strategic rationale

The acquisition of Dairyworks ticks a number of boxes and fits with SML's plans in Everyday Dairy, however, we remain to be convinced on this diversification strategy.

Key strategic rationale include:

- **Solid business on a standalone basis:** Multiples don't appear demanding and Dairyworks looks to have built a solid business with attractive margins versus peers (using Fonterra and Tip Top).
- **On strategy:** The acquisition aligns with SML's recent move into Everyday Dairy and desire to move into consumer brands. It forms part of the company's diversification strategy as it works to diversify its business away from infant formula (and specifically The a2 Milk Company).
- **Growth avenues:** Limited insight has been provided on the growth potential for Dairyworks. Given the recent entry into Australia (less than 12 months ago) we expect this will be an area of focus, although this is a highly competitive market in our view.
- **Synergies:** Opportunities exist across both businesses to streamline supply chains in key areas of warehousing, transport and inventory holdings. It is difficult to fully quantify the potential synergies; however, this should improve the returns metrics for the acquisition.
 - The main synergy for SML would be supplying some of Dairyworks' cheese requirements using surplus capacity at Talbot Forest Cheese. This also allows SML to re-direct surplus milk from Dunsandel (given the growing volumes of infant formula) potentially at a lower collection cost.
 - Potential benefits from being able to offer a broader range of Everyday Dairy products to customers (supermarkets and food service).

What is Dairyworks?

Christchurch-based Dairyworks was established in 2001 and is one of the larger operators in NZ's Everyday Dairy category. The founders set-up the business to source product from local dairy manufacturers and transform/pack it into products for consumer and foodservice trade.

- **Business mix:** No visibility was provided. We understand Dairyworks is predominantly a contract packer, with only a small amount of ice cream manufacturing. Dairyworks also owns a variety of consumer brands.
- **Sales channels:** Primarily supermarkets, foodservice and wholesale. It recently entered the Australian market around 12 months ago.
- **Products:** Dairyworks supplies almost 50% of NZ's cheese and 25% of its butter. It also supplies milk powder and ice cream. Dairyworks has an array of consumer brands including Rolling Meadow (Cheese and Butter; Foodstuffs exclusive), Dairyworks (Cheese, Milk powder, Butter), Alpine (Cheese, Milk powder, Butter; Countdown exclusive) and Deep South (Ice Cream).

Figure 2. Selection of Dairyworks products



Source: Forsyth Barr analysis, Company website

Figure 3. Selection of Dairyworks products



Source: Forsyth Barr analysis, Company website

Investment summary

Synlait Milk (SML) is a growth-focussed niche dairy processing company. While we have considerable reservations on the level of long-term returns and price you are paying for SML, we don't expect clarity on the key drivers in the short to medium-term. In the interim, we forecast a healthy near-term earnings growth profile as SML continues to reap the benefits with its key customer, The a2 Milk Company (ATM). NEUTRAL.

Business quality

- **Growth focussed dairy processing company:** SML has been manufacturing a range of products for just over a decade, with a full service offering. SML has seen a remarkable acceleration in profitability, returns and share price over the past three years as it has benefitted from the success of key customer, ATM. The next phase is diversifying its business; deploying capital across a range of new areas.
- **Value in China registration:** SML has registration for its Dunsandel facility which allows three brand slots. One is taken by ATM, with the others committed although still awaiting approval. Given the difficulty and time taken to secure registrations (which are not guaranteed) there is material value not captured in SML's book value.

Earnings and cashflow outlook

- **Volumes and gross margin — primary drivers of earnings and value:** Key influencers include customer mix and growth, product mix and facility utilisation. We forecast strong near-term growth, driven by volume growth from ATM at healthy margins. We forecast margin contraction in the longer-term — a key area of DCF sensitivity.
- **Macro backdrop:** Currently supportive with (1) growing global demand for dairy, (2) focus on quality, sustainability and premium products.

Financial structure

- **Capacity expansion:** New customer contracts are required to support debt-funded capital investment underway through increasing utilisation of available capacity. Progress with higher margin opportunities is of interest.

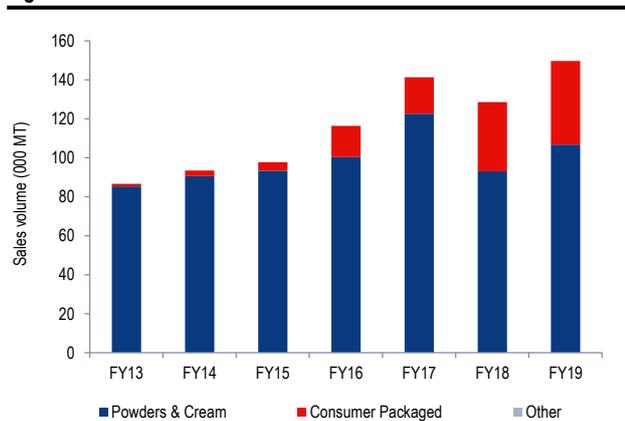
Risk factors

- **Food safety / quality scare:** This could have a number of material consequences. There is contagion risk from any scare relating to brand NZ.
- **Pokeno development:** A recent unfavourable court decision brings into question the feasibility of its new (near completed) manufacturing site which is set to provide capacity expansion and geographic diversification.

Company description

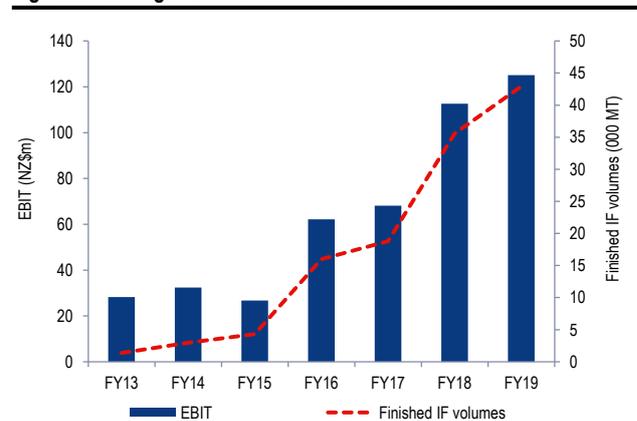
Synlait is a manufacturer of milk powder and milk powder related products. Its recent success has been underpinned by Infant Formula (IF) and ultimately its mutually dependent relationship with The a2 Milk Company (ATM). The company is actively working to diversify its business in terms of customers, products and geographies to fill capacity expansion underway.

Figure 4. Sales volumes



Source: Forsyth Barr analysis, Company Reports

Figure 5. Earnings vs. finished infant formula volumes



Source: Forsyth Barr analysis, Company Reports

Figure 6. Substantial Shareholders

Shareholder	Latest Holding
Bright Dairy Limited	39.1%
The a2 Milk Company	17.4%

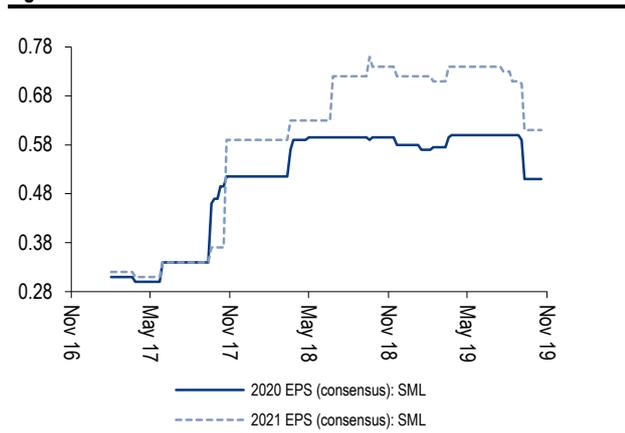
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 7. International Compcos

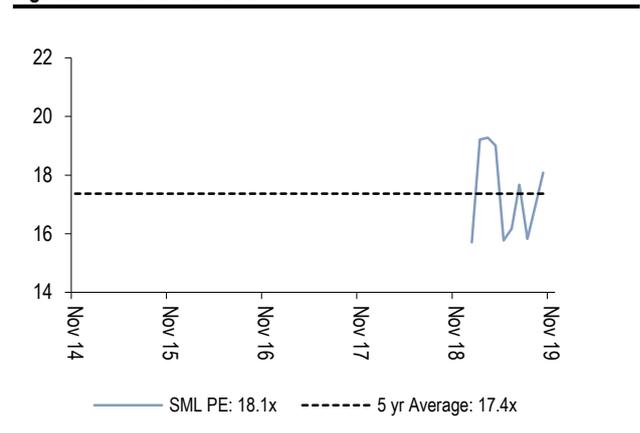
Company <i>(metrics re-weighted to reflect SML's balance date - July)</i>	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash D/Yld
				2020E	2021E	2020E	2021E	2020E	2021E	
Synlait Milk	SML NZ	NZ\$9.70	NZ\$1,738	18.9x	16.0x	11.1x	9.5x	14.0x	12.0x	0.0%
Fonterra *	FSF NZ	NZ\$4.10	NZ\$6,610	18.9x	13.0x	10.1x	9.5x	17.3x	15.4x	4.1%
Bega Cheese	BGA AU	A\$4.42	A\$947	23.5x	17.7x	10.4x	8.9x	16.3x	12.9x	2.8%
Saputo Inc	SAP CN	C\$37.69	C\$15,362	21.0x	14.1x	13.3x	12.0x	17.7x	15.5x	n/a
Nestle SA	NESN SW	CHF104.02	CHF309,564	22.6x	21.0x	17.0x	16.2x	21.0x	20.0x	2.8%
Danone SA	BN FP	€74.02	€50,787	18.3x	16.9x	13.1x	12.2x	16.1x	15.1x	3.2%
Inner Mongolia Yili Industrial Group Co	600887 CH	CN¥27.15	CN¥165,537	22.5x	20.0x	16.6x	14.8x	20.4x	18.4x	3.2%
China Mengniu Dairy Co	2319 HK	CN¥31.00	CN¥121,909	26.2x	23.8x	16.6x	14.5x	23.0x	19.7x	1.0%
Ausnutria Dairy Corp	1717 HK	CN¥10.84	CN¥17,431	16.9x	12.9x	11.8x	8.8x	13.6x	9.9x	2.8%
Kerry Group PLC	KYG ID	€104.70	€18,480	25.3x	23.0x	18.4x	17.0x	23.1x	21.3x	0.9%
Compcos Average:				21.7x	18.1x	14.1x	12.7x	18.7x	16.5x	2.6%
SML Relative:				-13%	-12%	-22%	-25%	-25%	-27%	-100%

EV = Current Market Cap + Actual Net Debt

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

Figure 8. Consensus EPS Momentum


Source: Forsyth Barr analysis, Bloomberg

Figure 9. 12 Month Forward PE


Source: Forsyth Barr analysis

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