

# Synlait Milk

## FY20 Guidance — Spilt Milk

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**NEUTRAL** 

Synlait Milk (SML) downgraded FY20 profit guidance — with the rapid pace and magnitude of the change materially surprising both us and the market. The company's update leaves us with more questions than answers. It also provides an untimely reminder of (1) the lack of external visibility for key drivers, (2) the pace at which outlook can change, (3) SML's dependence on things outside of its direct control (e.g. customer decision making) and (4) leverage in the business, which is currently magnified by investment to support capacity growth. The share price reaction was broadly consistent with our earnings and valuation downgrade; retain NEUTRAL.

NZX Code	SML	Financials: Jul/	19A	20E	21E	22E	Valuation (x)	19A	20E	21E	22E
Share price	NZ\$6.80	NPAT* (NZ\$m)	81.7	77.3	92.6	109.2	EV/EBITDA	9.5	9.1	8.0	7.4
Target price	NZ\$7.20	EPS* (NZc)	45.6	43.1	51.7	60.9	EV/EBIT	11.6	12.3	10.5	9.5
Risk rating	High	EPS growth* (%)	8.9	-5.3	19.8	17.9	PE	14.9	15.8	13.2	11.2
Issued shares	179.2m	DPS (NZc)	0.0	0.0	0.0	0.0	Price / NTA	2.6	2.2	1.9	1.6
Market cap	NZ\$1,219m	Imputation (%)	100	100	100	100	Cash div yld (%)	0.0	0.0	0.0	0.0
Avg daily turnover	108.4k (NZ\$1,026k)	*Based on normalised profits					Gross div yld (%)	0.0	0.0	0.0	0.0

### Material FY20 guidance downgrade

FY20 NPAT guidance of NZ\$70–85m (or c. NZ\$75–85m pre SML adding some caution for Coronavirus risk) compares to SML's prior indications of ~+10% NPAT growth (or NZ\$90m). We make ~-15% earnings cuts to our near-term forecasts. The guidance change reflects three (broadly evenly split) drivers:

- Significantly lower infant formula base (IFB) sales in China: This is a marked and rapid turnaround from prior expectations for some increase in IFB volumes. We now forecast IFB volumes of ~3k/MT (prior ~8k/MT and FY19 at ~7k/MT). This reflects (1) internalisation of manufacturing by a key multi-national customer, (2) lower demand from Tier 2/3 customers (consolidation of brands in China and lower birth rate). We view this as a new base level.
- Lactoferrin price volatility: ~50% of SML's lactoferrin volume is exposed to the spot market. There is no publicly available pricing data; however, SML called out a material contraction (of c. -50%) — significantly faster and steeper than originally expected.
- Lower growth in consumer packaged sales vs prior expectations: SML explicitly indicated no change to growth from key customer, The a2 Milk Company.

### Medium-term even less clear; much higher margin of safety required

SML has material capacity to fill, with no further colour on new customers. SML's commentary around IFB also adds further uncertainty for Pokeno (in addition to the covenant issue) given the ramp-up phase was predicated on shifting from initial (low margin) ingredients production to higher margin IFB — which now looks unlikely.

Our visibility on key earnings drivers (namely contract specifics and changes with key customers) for SML is limited; hence, gaining confidence on earnings and valuation is difficult. The rapid deterioration of FY20 reinforces how quickly things can change, however, leverage can work both ways — where any new customer announcement could also quickly change the picture. Nonetheless, a more positive investment view requires a much higher margin of safety in our view.

## Synlait Milk Ltd (SML)

Priced as at 13 Feb 2020 (NZ\$)

6.80

### 12-month target price (NZ\$)\*

7.20

Expected share price return

5.9%

Net dividend yield

0.0%

Estimated 12-month return

5.9%

### Spot valuations (NZ\$)

1. DCF

6.53

n/a

n/a

n/a

n/a

### Key WACC assumptions

Risk free rate

2.00%

Equity beta

1.08

WACC

7.7%

Terminal growth

1.5%

### DCF valuation summary (NZ\$m)

Total firm value

1,517

(Net debt)/cash

(333)

Less: Capitalised operating leases

0

Value of equity

1,184

Profit and Loss Account (NZ\$m)	2018A	2019A	2020E	2021E	2022E	Valuation Ratios	2018A	2019A	2020E	2021E	2022E
Sales revenue	879.0	1,024.3	1,092.2	1,250.0	1,356.8	EV/EBITDA (x)	9.5	9.5	9.1	8.0	7.4
<b>Normalised EBITDA</b>	<b>138.6</b>	<b>152.1</b>	<b>172.9</b>	<b>199.1</b>	<b>216.4</b>	EV/EBIT (x)	11.6	11.6	12.3	10.5	9.5
Depreciation and amortisation	(25.6)	(27.6)	(45.0)	(47.5)	(48.0)	PE (x)	16.3	14.9	15.8	13.2	11.2
<b>Normalised EBIT</b>	<b>113.1</b>	<b>124.5</b>	<b>127.9</b>	<b>151.6</b>	<b>168.4</b>	Price/NTA (x)	3.0	2.6	2.2	1.9	1.6
Net interest	(9.3)	(9.4)	(20.6)	(23.0)	(16.7)	Free cash flow yield (%)	-2.6	-17.9	-3.5	7.9	9.3
Associate income	0.4	(0.6)	0	0	0	Net dividend yield (%)	0.0	0.0	0.0	0.0	0.0
Tax	(29.3)	(32.8)	(30.1)	(36.0)	(42.5)	Gross dividend yield (%)	0.0	0.0	0.0	0.0	0.0
Minority interests	0	0	0	0	0						
<b>Normalised NPAT</b>	<b>75.0</b>	<b>81.7</b>	<b>77.3</b>	<b>92.6</b>	<b>109.2</b>	<b>Capital Structure</b>	<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>
Abnormals/other	0	0	0	0	0	Interest cover EBIT (x)	12.2	13.2	6.2	6.6	10.1
<b>Reported NPAT</b>	<b>75.0</b>	<b>81.7</b>	<b>77.3</b>	<b>92.6</b>	<b>109.2</b>	Interest cover EBITDA (x)	14.9	16.1	8.4	8.7	12.9
Normalised EPS (cps)	41.8	45.6	43.1	51.7	60.9	Net debt/ND+E (%)	21.2	40.4	39.8	29.7	17.7
DPS (cps)	0	0	0	0	0	Net debt/EBITDA (x)	0.8	2.2	2.2	1.4	0.8
<b>Growth Rates</b>	<b>2018A</b>	<b>2019A</b>	<b>2020A</b>	<b>2021A</b>	<b>2022A</b>	<b>Key Ratios</b>	<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>
Revenue (%)	15.8	16.5	6.6	14.5	8.5	Return on assets (%)	14.2	10.8	10.0	11.7	12.8
EBITDA (%)	56.1	9.7	13.6	15.1	8.7	Return on equity (%)	17.7	16.6	13.6	14.0	14.2
EBIT (%)	67.3	10.1	2.7	18.5	11.1	Return on funds employed (%)	15.8	12.6	9.7	10.9	12.4
Normalised NPAT (%)	92.4	8.9	-5.3	19.8	17.9	EBITDA margin (%)	15.8	14.9	15.8	15.9	15.9
Normalised EPS (%)	92.4	8.9	-5.3	19.8	17.9	EBIT margin (%)	12.9	12.2	11.7	12.1	12.4
Ordinary DPS (%)	n/a	n/a	n/a	n/a	n/a	Capex to sales (%)	13.7	33.0	13.8	3.2	3.0
						Capex to depreciation (%)	471	1,224	336	85	85
<b>Cash Flow (NZ\$m)</b>	<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>	Imputation (%)	100	100	100	100	100
<b>EBITDA</b>	<b>138.6</b>	<b>152.1</b>	<b>172.9</b>	<b>199.1</b>	<b>216.4</b>	Pay-out ratio (%)	0	0	0	0	0
Working capital change	(14.1)	12.1	(14.3)	(3.6)	(2.4)						
Interest & tax paid	(24.1)	(43.5)	(50.6)	(59.0)	(59.2)	<b>Operating Performance</b>	<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>
Other	(12.2)	(0.9)	0.0	(0.0)	(0.0)	<b>Sales volume (m MT)</b>					
<b>Operating cash flow</b>	<b>88.2</b>	<b>119.9</b>	<b>108.0</b>	<b>136.5</b>	<b>154.7</b>	Powders & Cream	93.0	106.8	115.4	114.5	118.7
Capital expenditure	(120.5)	(338.3)	(151.3)	(40.4)	(40.8)	Consumer Packaged	35.6	42.9	46.5	56.5	61.2
(Acquisitions)/divestments	(9.7)	(11.1)	0	0	0	Specialty Ingredients	0	0	0	0	0
Other	0	(0.3)	0	0	0	<b>Total volume</b>	<b>128.6</b>	<b>149.7</b>	<b>161.9</b>	<b>171.0</b>	<b>180.0</b>
<b>Funding available/(required)</b>	<b>(42.0)</b>	<b>(229.9)</b>	<b>(43.2)</b>	<b>96.1</b>	<b>113.9</b>	<b>Liquid milk volumes (m L)</b>	<b>0</b>	<b>0</b>	<b>35.0</b>	<b>45.0</b>	<b>63.0</b>
Dividends paid	0	0	0	0	0						
Equity raised/(returned)	0	0	0	0	0	<b>Gross Profit (GP) breakdown</b>					
<b>(Increase)/decrease in net debt</b>	<b>(42.0)</b>	<b>(229.9)</b>	<b>(43.2)</b>	<b>96.1</b>	<b>113.9</b>	Powders & Cream	134.4	142.2	147.4	163.0	171.3
						Consumer Packaged	27.6	34.3	38.3	48.0	52.1
<b>Balance Sheet (NZ\$m)</b>	<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>	Liquid Milk	0	(3.5)	1.8	4.5	11.3
Working capital	40.4	10.8	25.0	28.7	31.1	Specialty Ingredients	4.5	13.3	11.2	11.9	12.1
Fixed assets	537.7	845.2	952.4	946.2	939.9	<b>Total Gross Profit</b>	<b>166.5</b>	<b>186.3</b>	<b>198.6</b>	<b>227.4</b>	<b>246.8</b>
Intangibles	11.7	20.1	19.2	18.2	17.3						
Right of use asset	0	0	0	0	0	<b>Milk supply, m kgMS</b>	<b>60.8</b>	<b>66.1</b>	<b>78.0</b>	<b>80.0</b>	<b>80.0</b>
Other assets	19.6	39.9	39.9	39.9	39.9						
<b>Total funds employed</b>	<b>609.4</b>	<b>916.0</b>	<b>1,036.5</b>	<b>1,033.0</b>	<b>1,028.2</b>	<b>Gross Profit</b>	<b>166.5</b>	<b>186.3</b>	<b>198.6</b>	<b>227.4</b>	<b>246.8</b>
Net debt/(cash)	114.3	333.1	376.3	280.3	166.3	Operating Costs (incl D&A)	(53.4)	(61.8)	(70.7)	(75.8)	(78.4)
Lease liability	0	0	0	0	0	<b>EBIT</b>	<b>113.1</b>	<b>124.5</b>	<b>127.9</b>	<b>151.6</b>	<b>168.4</b>
Other liabilities	70.4	90.5	90.5	90.5	90.5	Depreciation & Amortisation	(25.6)	(27.6)	(45.0)	(47.5)	(48.0)
Shareholder's funds	424.7	492.4	569.7	662.2	771.4	<b>EBITDA</b>	<b>138.6</b>	<b>152.1</b>	<b>172.9</b>	<b>199.1</b>	<b>216.4</b>
Minority interests	0	0	0	0	0						
<b>Total funding sources</b>	<b>609.4</b>	<b>916.0</b>	<b>1,036.5</b>	<b>1,033.0</b>	<b>1,028.2</b>						

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

## What's changed?

We have made material earnings cuts underpinned by:

- IFB volumes: We now forecast FY20E volumes of ~3k/MT (prior ~8k/MT). This creates a new base for future years.
- Lower future volume expectations for smaller finished IF customers.
- A material reduction to our Lactoferrin margin assumptions (downgraded ~55%). The material reduction in spot price reflects a combination of both a softening in demand and an increase in global Lactoferrin supply — neither of which seems likely to change in the near-term.

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

NZ\$m	FY20E			FY21E			FY22E		
	Old	New	% chg	Old	New	% chg	Old	New	% chg
Revenue	1,202	1,092	-9.1%	1,359	1,250	-8.0%	1,485	1,357	-8.6%
Gross profit	219	199	-9.1%	247	227	-8.0%	270	247	-8.6%
EBIT	148	128	-13.5%	173	152	-12.3%	193	168	-12.8%
Underlying NPAT	92	77	-15.9%	109	93	-15.0%	129	109	-15.4%
Underlying EPS (cps)	51.3	43.1	-15.9%	60.8	51.7	-15.0%	72.0	60.9	-15.4%

Source: Forsyth Barr analysis

## 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, SML continues to reap the benefits with 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 margin contraction in the longer-term — a key area of DCF sensitivity.
- **Macro backdrop supportive:** (1) growing global demand for dairy, (2) focus on quality, sustainability and premium products.

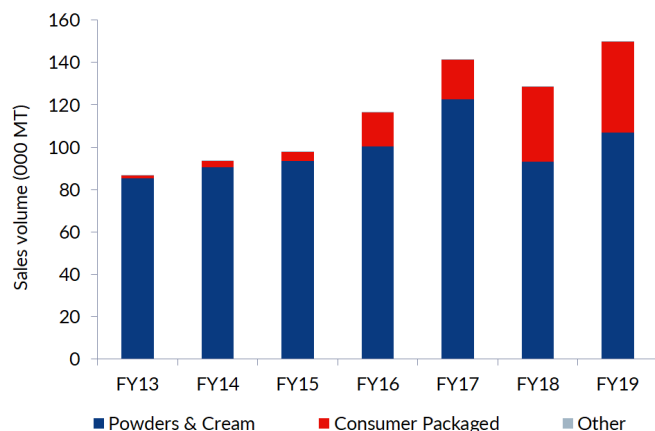
### Financial structure

- **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 particular interest.

### Risk factors

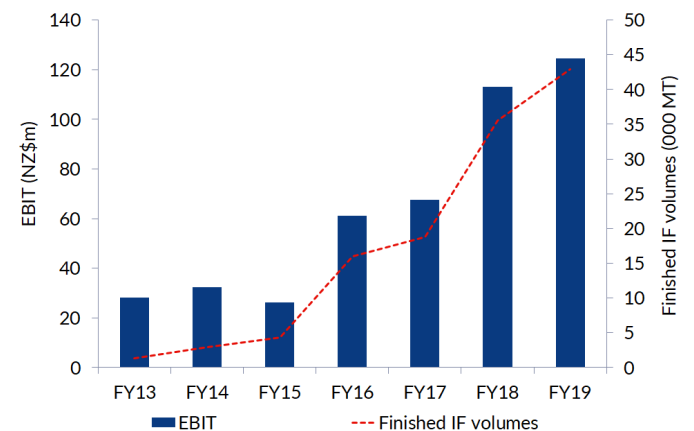
- **Food safety / quality scare:** This could have a number of material consequences. There is contagion risk from any scare relating to brand NZ.
- **Pokeno development:** A recent unfavourable court decision brings into question the feasibility of its new (near completed) manufacturing site, which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

Figure 2. Sales volumes

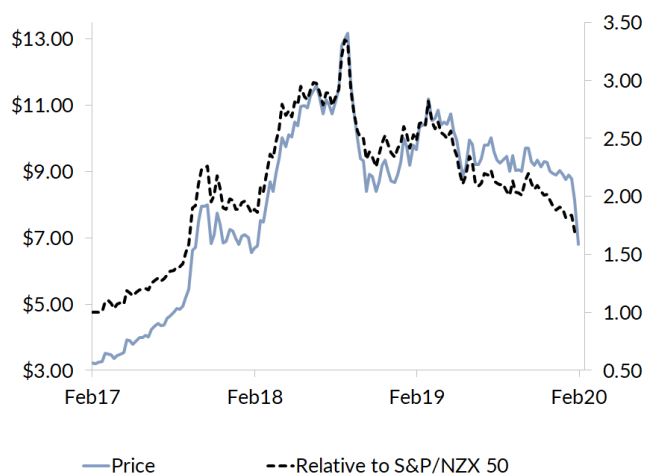


Source: Forsyth Barr analysis, Company reports

Figure 3. Earnings vs. finished infant formula volumes



Source: Forsyth Barr analysis, Company reports

**Figure 4. Price performance**


Source: Forsyth Barr analysis

**Figure 5. Substantial shareholders**

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

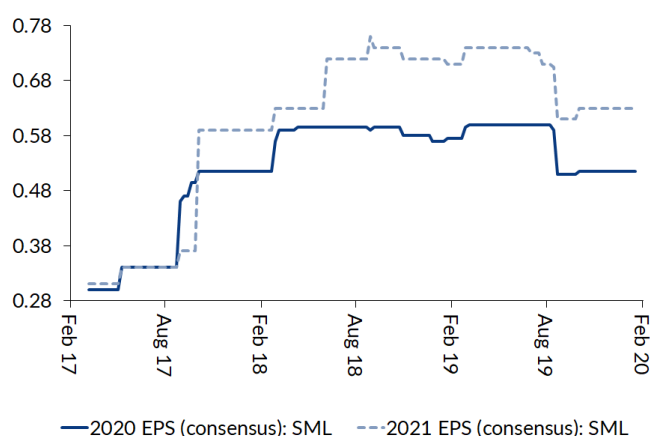
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

**Figure 6. International valuation comparisons**

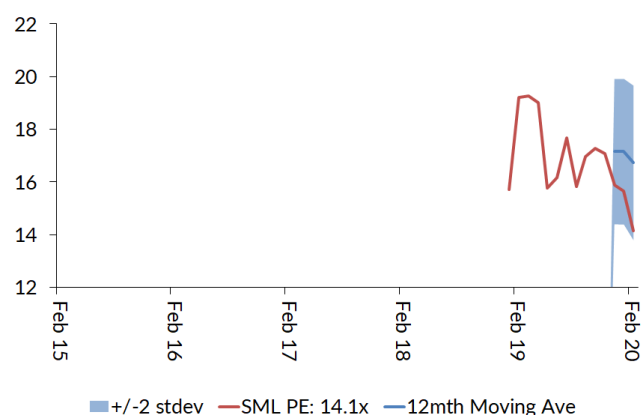
Company	Code	Price	Mkt Cap (m)	PE 2020E	PE 2021E	EV/EBITDA 2020E	EV/EBITDA 2021E	EV/EBIT 2020E	EV/EBIT 2021E	Cash Yld 2021E
(metrics re-weighted to reflect SML's balance date - July)										
Synlait Milk	SML NZ	NZ\$6.80	NZ\$1,219	15.8x	13.2x	9.0x	7.8x	12.1x	10.2x	0.0%
Fonterra *	FSF NZ	NZ\$3.87	NZ\$6,238	17.8x	12.3x	9.8x	9.2x	16.8x	15.0x	4.4%
Bega Cheese	BGA AU	A\$4.36	A\$934	31.8x	20.7x	11.9x	9.8x	20.1x	14.8x	2.5%
Saputo Inc	SAP CN	C\$41.24	C\$16,824	22.5x	15.4x	13.3x	12.1x	18.7x	16.3x	n/a
Nestle SA	NESN SW	CHF107.08	CHF318,670	23.4x	21.9x	17.6x	17.0x	21.5x	20.8x	2.7%
Danone SA	BN FP	€73.42	€50,375	18.2x	16.9x	13.0x	12.2x	16.1x	15.1x	3.2%
Inner Mongolia Yili Industrial Group Co	600887 CH	CN¥30.25	CN¥184,415	24.9x	22.0x	17.6x	15.4x	22.0x	19.3x	2.9%
China Mengniu Dairy Co	2319 HK	CN¥30.20	CN¥118,857	25.3x	23.4x	16.2x	14.0x	23.0x	19.6x	1.0%
Ausnutria Dairy Corp	1717 HK	CN¥10.74	CN¥17,330	16.6x	12.9x	11.9x	9.1x	13.4x	9.8x	2.7%
Kerry Group PLC	KYG ID	€116.30	€20,529	28.2x	25.7x	20.4x	18.8x	25.2x	23.2x	0.8%
<b>Compco Average:</b>				<b>23.2x</b>	<b>19.0x</b>	<b>14.6x</b>	<b>13.1x</b>	<b>19.7x</b>	<b>17.1x</b>	<b>2.5%</b>
<b>SML Relative:</b>				<b>-32%</b>	<b>-31%</b>	<b>-39%</b>	<b>-40%</b>	<b>-38%</b>	<b>-40%</b>	<b>-100%</b>

EV = Current Market Cap + Actual Net Debt

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

**Figure 7. Consensus EPS momentum (NZ\$)**


Source: Forsyth Barr analysis

**Figure 8. One year forward PE (x)**


Source: Forsyth Barr analysis

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