

Synlait Milk

1H20 Preview – Pre-Released Pressure Points

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Synlait Milk (SML) pre-signalled a material 1H20 profit decline (and downgraded FY20 expectations) on 13 February, however, the wide guidance range still leaves room for differences when SML reports its 1H20 result on Thursday 19 March. The rapid pace and magnitude of recent earnings pressure has seen a material dent in our (and market) confidence and raises questions, particularly on progress / greater clarity to support recent expansionary capex decisions.

NZX Code	SML	Financials: Jul/	19A	20E	21E	22E	Valuation (x)	19A	20E	21E	22E
Share price	NZ\$5.55	NPAT* (NZ\$m)	81.7	77.3	92.6	109.2	EV/EBITDA	8.0	7.8	6.9	6.3
Target price	NZ\$7.20	EPS* (NZc)	45.6	43.1	51.7	60.9	EV/EBIT	9.8	10.5	9.0	8.1
Risk rating	High	EPS growth* (%)	8.9	-5.3	19.8	17.9	PE	12.2	12.9	10.7	9.1
Issued shares	179.2m	DPS (NZc)	0.0	0.0	0.0	0.0	Price / NTA	2.1	1.8	1.5	1.3
Market cap	NZ\$995m	Imputation (%)	100	100	100	100	Cash div yld (%)	0.0	0.0	0.0	0.0
Avg daily turnover	110.1k (NZ\$985k)	*Based on normalised profits					Gross div yld (%)	0.0	0.0	0.0	0.0

Key points of interest

- **Any update to, or narrowing of, FY20 guidance:** SML downgraded expectations on 13 February, with current NPAT guidance of NZ \$70m to NZ\$85m. The wide range implies growth of +3% to -15% versus FY19.
- **Any insights around the key contract with a2 Milk (ATM):** We do not expect granularity given it is a commercial contract, however, we look for any insights SML can provide, particularly following ATM's recent commentary on assessing 'participation' in manufacturing capacity. Our valuation is highly sensitive to long-term assumptions on finished infant formula (namely for ATM), particularly a view on the margin SML earns. We forecast downside to current margins over the long-term as ATM continues to grow, although the quantum and timing of this is difficult to pin-point. We see downside risk to our current forecast trajectory.
- **Capacity and customers:** Recent expansionary capex is weighing on near-term returns, with cost investment a drag in the early stages until utilisation ramps up. SML has material capacity to fill. We want to see progress with new customers to de-risk recent capital investment, narrow the potential earnings outcomes and show SML can replicate success on its larger asset base.
- **An update on Pokeno:** How SML utilises capacity can dictate the feasible returns / margin profile. We look for updated insight on how to think about product mix for the site in both the short and longer-term, particularly given recent commentary from SML on pressures in infant base powder. SML's legal issues at Pokeno also need resolution. The Supreme Court hearing is set for 29/30 April so we expect it will likely be too early for any new insights.

Result call – 10am NZ time; pre-registration required

 SML will host a call at 10am on 19 March. Pre-registration is required <https://s1.c-conf.com/diamondpass/10003443-invite.html>
Figure 1. Interim result expectations 1H20E

NZ\$m	1H18	2H18	1H19	2H19	1H20E	% growth	
						1H20 vs 1H19	SML guidance
Gross profit	86.0	80.5	85.9	100.4	81.5	-5.1%	
EBIT	61.9	50.8	57.0	68.1	47.6	-16.6%	
Underlying NPAT	41.3	33.2	37.3	44.9	27.3	-26.9%	26.5-28.5
Underlying EPS (cps)	23.1	18.5	20.8	25.1	15.2	-26.9%	
Dividend (cps)	0.0	0.0	0.0	0.0	0.0	n/a	

Source: Forsyth Barr analysis, Company reports

Synlait Milk Ltd (SML)

Priced as at 11 Mar 2020 (NZ\$)

5.55

12-month target price (NZ\$)*

7.20

Expected share price return	29.7%
Net dividend yield	0.0%
Estimated 12-month return	29.7%

Spot valuations (NZ\$)

1. DCF	6.58
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	1,512
(Net debt)/cash	(333)
Less: Capitalised operating leases	0
Value of equity	1,179

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)	7.9	8.0	7.8	6.9	6.3
Normalised EBITDA	138.6	152.1	172.9	199.1	216.4	EV/EBIT (x)	9.7	9.8	10.5	9.0	8.1
Depreciation and amortisation	(25.6)	(27.6)	(45.0)	(47.5)	(48.0)	PE (x)	13.3	12.2	12.9	10.7	9.1
Normalised EBIT	113.1	124.5	127.9	151.6	168.4	Price/NTA (x)	2.4	2.1	1.8	1.5	1.3
Net interest	(9.3)	(9.4)	(20.6)	(23.0)	(16.7)	Free cash flow yield (%)	-3.2	-22.0	-4.3	9.7	11.5
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						
Normalised NPAT	75.0	81.7	77.3	92.6	109.2	Capital Structure	2018A	2019A	2020E	2021E	2022E
Abnormals/other	0	0	0	0	0	Interest cover EBIT (x)	12.2	13.2	6.2	6.6	10.1
Reported NPAT	75.0	81.7	77.3	92.6	109.2	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
Growth Rates	2018A	2019A	2020A	2021A	2022A	Key Ratios	2018A	2019A	2020E	2021E	2022E
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
Cash Flow (NZ\$m)	2018A	2019A	2020E	2021E	2022E	Imputation (%)	100	100	100	100	100
EBITDA	138.6	152.1	172.9	199.1	216.4	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)	Operating Performance	2018A	2019A	2020E	2021E	2022E
Other	(12.2)	(0.9)	0.0	(0.0)	(0.0)	Sales volume (m MT)					
Operating cash flow	88.2	119.9	108.0	136.5	154.7	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	Total volume	128.6	149.7	161.9	171.0	180.0
Funding available/(required)	(42.0)	(229.9)	(43.2)	96.1	113.9						
Dividends paid	0	0	0	0	0	Liquid milk volumes (m L)	0	0	35.0	45.0	63.0
Equity raised/(returned)	0	0	0	0	0						
(Increase)/decrease in net debt	(42.0)	(229.9)	(43.2)	96.1	113.9	Gross Profit (GP) breakdown					
						Powders & Cream	134.4	142.2	147.4	163.0	171.3
Balance Sheet (NZ\$m)	2018A	2019A	2020E	2021E	2022E	Consumer Packaged	27.6	34.3	38.3	48.0	52.1
Working capital	40.4	10.8	25.0	28.7	31.1	Liquid Milk	0	(3.5)	1.8	4.5	11.3
Fixed assets	537.7	845.2	952.4	946.2	939.9	Specialty Ingredients	4.5	13.3	11.2	11.9	12.1
Intangibles	11.7	20.1	19.2	18.2	17.3	Total Gross Profit	166.5	186.3	198.6	227.4	246.8
Right of use asset	0	0	0	0	0						
Other assets	19.6	39.9	39.9	39.9	39.9	Milk supply, m kgMS	60.8	66.1	78.0	80.0	80.0
Total funds employed	609.4	916.0	1,036.5	1,033.0	1,028.2						
Net debt/(cash)	114.3	333.1	376.3	280.3	166.3	Gross Profit	166.5	186.3	198.6	227.4	246.8
Lease liability	0	0	0	0	0	Operating Costs (incl D&A)	(53.4)	(61.8)	(70.7)	(75.8)	(78.4)
Other liabilities	70.4	90.5	90.5	90.5	90.5	EBIT	113.1	124.5	127.9	151.6	168.4
Shareholder's funds	424.7	492.4	569.7	662.2	771.4	Depreciation & Amortisation	(25.6)	(27.6)	(45.0)	(47.5)	(48.0)
Minority interests	0	0	0	0	0	EBITDA	138.6	152.1	172.9	199.1	216.4
Total funding sources	609.4	916.0	1,036.5	1,033.0	1,028.2						

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

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, 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 saw a remarkable acceleration in profitability and returns in recent history, 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. This is seeing pressure on near-term results, evidenced by recent FY20 guidance.
- **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.

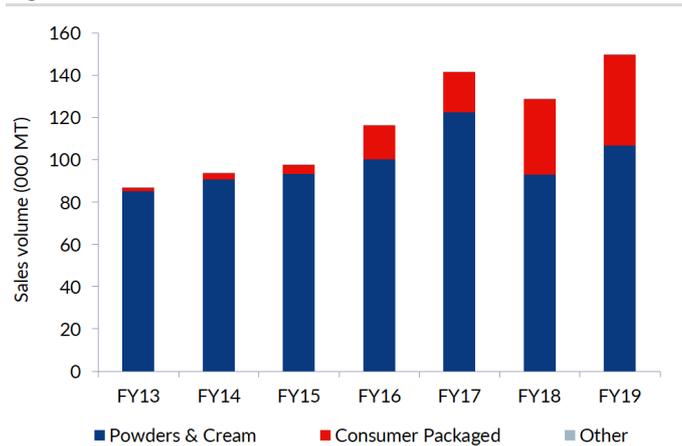
Financial structure

- **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

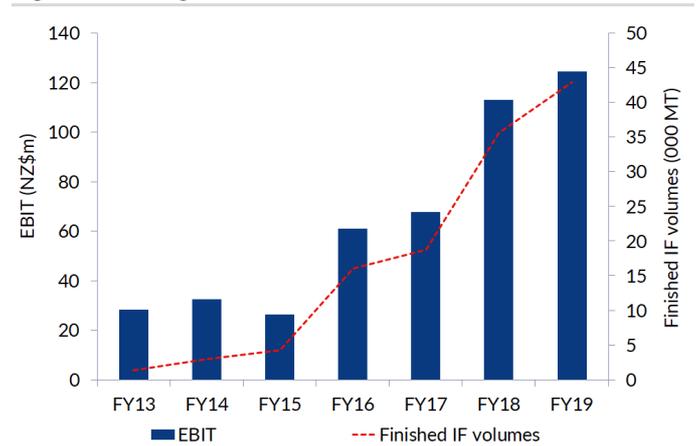
- **Food safety / quality scare:** This could have a number of material consequences. There is contagion risk from any scare relating to brand NZ.
- **Pokeno development:** A recent unfavourable court decision brings into question the feasibility of its new manufacturing site, which provides capacity 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%

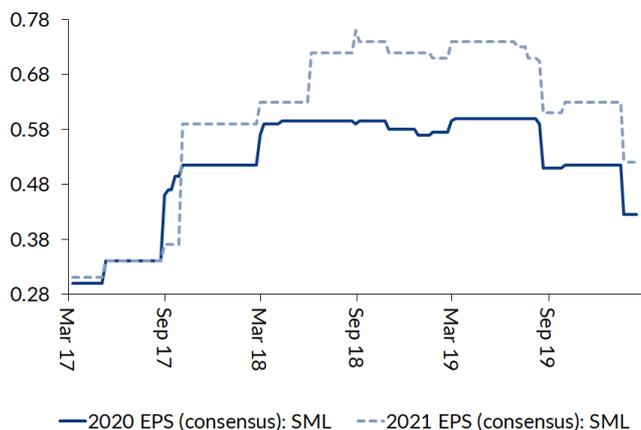
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 6. International valuation comparisons

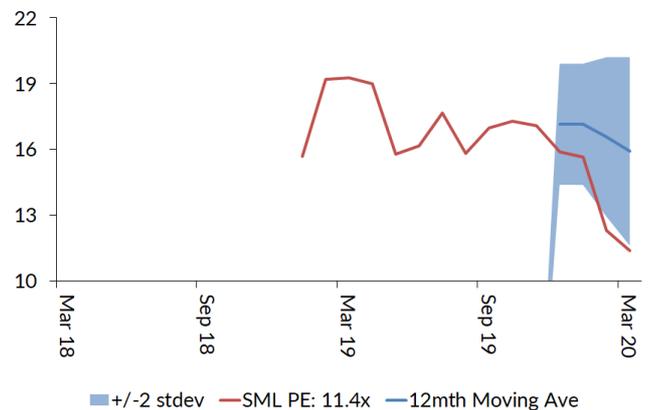
Company	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash Yld 2021E
				2020E	2021E	2020E	2021E	2020E	2021E	
(metrics re-weighted to reflect SML's balance date - July)										
Synlait Milk	SML NZ	NZ\$5.55	NZ\$995	12.9x	10.7x	7.7x	6.7x	10.4x	8.8x	0.0%
Fonterra *	FSF NZ	NZ\$3.73	NZ\$6,011	17.2x	11.8x	9.6x	9.0x	16.5x	14.7x	4.6%
BEGA CHEESE	BGA AU	A\$4.38	A\$938	32.3x	20.0x	12.5x	9.9x	22.3x	15.4x	2.7%
SAPUTO INC	SAP CN	C\$33.75	C\$13,769	18.4x	12.6x	11.4x	10.4x	16.0x	14.0x	n/a
NESTLE SA-REG	NESN SW	CHF96.82	CHF288,136	21.6x	20.1x	15.8x	15.4x	19.7x	19.1x	3.0%
DANONE	BN FP	€57.30	€39,315	16.3x	12.6x	10.8x	10.0x	14.3x	12.5x	4.4%
INNER MONGOLIA YILI INDUS-A	600887 CH	CN¥29.89	CN¥182,221	24.7x	22.0x	17.4x	15.2x	21.7x	19.0x	2.9%
CHINA MENGNIU DAIRY CO	2319 HK	CN¥28.10	CN¥110,592	23.7x	22.1x	15.2x	13.1x	21.2x	18.4x	1.1%
AUSNUTRIA DAIRY CORP	1717 HK	CN¥12.22	CN¥19,686	18.6x	14.4x	13.4x	10.3x	15.0x	11.1x	2.5%
KERRY GROUP PLC-A	KYG ID	€106.10	€18,731	28.2x	23.5x	19.7x	17.0x	24.8x	21.2x	0.9%
Compco Average:				22.3x	17.7x	14.0x	12.3x	19.1x	16.2x	2.7%
SML Relative:				-42%	-39%	-45%	-46%	-46%	-46%	-100%

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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