Synlait Milk
1H20 Result — Cost and Capacity Bite

CHELSEA LEADBETTER CFA
chelsea.leadbetter@forsythbarr.co.nz
+64 4 495 5262

NEUTRAL

Synlait Milk (SML) reported a material 1H20 profit decline, as pre-guided, and retained recently downgraded FY20 guidance — with its step-change in manufacturing capacity (and associated costs) creating a larger near-term EPS drag than previously anticipated. SML has invested, and is well positioned, for growth; however, there was nothing in the result to provide greater clarity on the medium to longer-term earnings/returns profile. The recent material de-rate in SML sees us more confident in the assumption set this implies. Given the wide magnitude of long-term returns outcomes, recent comments from its key customer, a2 Milk, on diversification and SML's elevated gearing levels, we require a high margin of safety to be confident in a more positive investment view.

NZX Code	SML
Share price	NZ$4.40
Target price	NZ$5.65
Risk rating	High
Issued shares	179.2m
Market cap	NZ$789m
Avg daily turnover	117.2k (NZ$995k)

Financials: Jul/	19A	20E	21E	22E
NPAT* (NZ$m)	81.7	79.9	93.6	110.0
EPS* (NZc)	45.6	44.6	52.2	61.4
EPS growth* (%)	8.9	-2.2	17.1	17.6
DPS (NZc)	0.0	0.0	0.0	0.0
Imputation (%)	100	100	100	100
*Based on normalised profits				

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	6.7	6.9	6.3	5.7
EV/EBIT	8.1	9.0	8.1	7.3
PE	9.7	9.9	8.4	7.2
Price / NTA	1.7	1.9	1.5	1.3
Cash div yld (%)	0.0	0.0	0.0	0.0
Gross div yld (%)	0.0	0.0	0.0	0.0

Key take-outs

- **1H20 result all about the cost drag:** SML reported a -3.5% decline in 1H20 gross profit (with a large step-change in overheads offsetting a +22% sales lift for infant formula [IF]), which when combined with materially higher costs (opex +27%, interest more than doubling) led to NPAT down -30% to NZ$25m. Material investment in opex and capex primarily reflects capacity expansion underway, with investment ahead of being operational.

- **No new customer announcements:** SML has material capacity to fill and indicated it is well progressed on new customers, although did not announce anything. The range of feasible outcomes remains very wide in terms of the potential return profile.

- **COVID-19:** Minimal impact to date. SML is well positioned given products manufactured are largely consumer staples.

- **Elevated gearing:** Net debt lifted to NZ$447m in 1H20 (from NZ$288m in 1H19) and we forecast net debt to EBITDA of 2.9x in FY20E, above the company's long-term target of <2.5x. The company is nearing the end of material investment (in capacity and diversification), focus now turns to driving efficiencies and utilisation of existing assets.

Key revisions — incorporating Dairyworks (+ve), outweighed by lower long-term IF volume assumptions (-ve)

The 1H20 result provided better colour on the near-term path. Our EPS forecasts lift +1–3% over the near-term, primarily due to incorporating Dairyworks (higher EBITDA which outweighs a lift in funding costs and depreciation). However, a reduction in long-term finished IF volumes for key customer, a2 Milk (ATM), materially lowers our DCF. We view SML as the key long-term partner for ATM, however, now assume 25% of its volumes from FY26E are not manufactured by SML (prior 10%) following ATM's recent commentary on risk mitigation/diversification. This is the key driver of our lower target price at NZ$5.65.

There is a high margin of error in any SML forecasts or valuation, with our visibility on key earnings drivers minimal — particularly contract specifics and the new customer pipeline.

Synlait Milk Ltd (SML)

Priced as at 19 Mar 2020 (NZ$)	**4.40**

12-month target price (NZ$)*	**5.65**
Expected share price return	28.4%
Net dividend yield	0.0%
Estimated 12-month return	28.4%

Spot valuations (NZ$)	
1. DCF	5.33
n/a	n/a
n/a	n/a

Key WACC assumptions	
Risk free rate	2.00%
Equity beta	1.08
WACC	8.0%
Terminal growth	1.5%

DCF valuation summary (NZ$m)	
Total firm value	1,288
(Net debt)/cash	(333)
Less: Capitalised operating leases	0
Value of equity	955

Profit and Loss Account (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Sales revenue	879.0	1,024.3	1,150.2	1,395.0	1,516.5
Normalised EBITDA	**138.6**	**152.1**	**176.6**	**206.5**	**229.2**
Depreciation and amortisation	(25.6)	(27.6)	(42.0)	(45.5)	(51.7)
Normalised EBIT	**113.1**	**124.5**	**134.6**	**161.0**	**177.5**
Net interest	(9.3)	(9.4)	(23.7)	(31.0)	(24.7)
Associate income	0.4	(0.6)	0	0	0
Tax	(29.3)	(32.8)	(31.1)	(36.4)	(42.8)
Minority interests	0	0	0	0	0
Normalised NPAT	**75.0**	**81.7**	**79.9**	**93.6**	**110.0**
Abnormals/other	0	0	0	0	0
Reported NPAT	**75.0**	**81.7**	**79.9**	**93.6**	**110.0**
Normalised EPS (cps)	41.8	45.6	44.6	52.2	61.4
DPS (cps)	0	0	0	0	0

Valuation Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EV/EBITDA (x)	6.4	6.7	6.9	6.3	5.7
EV/EBIT (x)	7.8	8.1	9.0	8.1	7.3
PE (x)	10.5	9.7	9.9	8.4	7.2
Price/NTA (x)	1.9	1.7	1.9	1.5	1.3
Free cash flow yield (%)	-4.1	-27.7	-5.3	12.6	15.2
Net dividend yield (%)	0.0	0.0	0.0	0.0	0.0
Gross dividend yield (%)	0.0	0.0	0.0	0.0	0.0

Capital Structure	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Interest cover EBIT (x)	12.2	13.2	5.7	5.2	7.2
Interest cover EBITDA (x)	14.9	16.1	7.5	6.7	9.3
Net debt/ND+E (%)	21.2	40.4	47.3	38.3	27.4
Net debt/EBITDA (x)	0.8	2.2	2.9	2.0	1.3

Growth Rates	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Revenue (%)	15.8	16.5	12.3	21.3	8.7
EBITDA (%)	56.1	9.7	16.1	16.9	11.0
EBIT (%)	67.3	10.1	8.1	19.6	10.2
Normalised NPAT (%)	92.4	8.9	-2.2	17.1	17.6
Normalised EPS (%)	92.4	8.9	-2.2	17.1	17.6
Ordinary DPS (%)	n/a	n/a	n/a	n/a	n/a

Key Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Return on assets (%)	14.2	10.8	9.5	11.0	12.0
Return on equity (%)	17.7	16.6	14.0	14.1	14.2
Return on funds employed (%)	15.8	12.6	9.5	9.9	11.3
EBITDA margin (%)	15.8	14.9	15.4	14.8	15.1
EBIT margin (%)	12.9	12.2	11.7	11.5	11.7
Capex to sales (%)	13.7	33.0	12.9	2.4	2.6
Capex to depreciation (%)	471	1,224	354	75	75
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	0	0	0	0	0

Cash Flow (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EBITDA	**138.6**	**152.1**	**176.6**	**206.5**	**229.2**
Working capital change	(14.1)	12.1	(15.1)	(5.5)	(2.7)
Interest & tax paid	(24.1)	(43.5)	(54.7)	(67.4)	(67.5)
Other	(12.2)	(0.9)	0.0	0.0	(0.0)
Operating cash flow	**88.2**	**119.9**	**106.8**	**133.6**	**158.9**
Capital expenditure	(120.5)	(338.3)	(148.7)	(34.1)	(38.8)
(Acquisitions)/divestments	(9.7)	(11.1)	(137.7)	0	0
Other	0	(0.3)	0	0	0
Funding available/(required)	**(42.0)**	**(229.9)**	**(179.6)**	**99.4**	**120.2**
Dividends paid	0	0	0	0	0
Equity raised/(returned)	0	0	0	0	0
(Increase)/decrease in net debt	**(42.0)**	**(229.9)**	**(179.6)**	**99.4**	**120.2**

Operating Performance	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Sales volume (k MT)					
Powders & Cream	93.0	106.8	96.0	96.4	96.4
Consumer Packaged	35.6	42.9	48.9	57.1	65.2
Specialty Ingredients	0	0	0	0	0
Total volume	**128.6**	**149.7**	**144.9**	**153.6**	**161.7**
Liquid milk volumes (m L)	**0**	**0**	**35.0**	**37.8**	**39.7**
Gross Profit (GP) breakdown					
Powders & Cream	134.4	142.2	145.9	156.5	166.3
Consumer Packaged	27.6	34.3	40.3	48.6	55.5
Everyday Dairy	0	(3.5)	5.4	30.2	36.3
Specialty Ingredients	4.5	13.3	15.5	15.8	15.0
Total Gross Profit	**166.5**	**186.3**	**207.0**	**251.1**	**273.0**
Gross Profit	**166.5**	**186.3**	**207.0**	**251.1**	**273.0**
Operating Costs (incl D&A)	(53.4)	(61.8)	(72.4)	(90.1)	(95.5)
EBIT	**113.1**	**124.5**	**134.6**	**161.0**	**177.5**
Depreciation & Amortisation	(25.6)	(27.6)	(42.0)	(45.5)	(51.7)
EBITDA	**138.6**	**152.1**	**176.6**	**206.5**	**229.2**

Balance Sheet (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Working capital	40.4	10.8	25.8	31.3	34.1
Fixed assets	537.7	845.2	952.7	942.3	930.4
Intangibles	11.7	20.1	156.9	156.0	155.0
Right of use asset	0	0	0	0	0
Other assets	19.6	39.9	39.9	39.9	39.9
Total funds employed	**609.4**	**916.0**	**1,175.5**	**1,169.6**	**1,159.4**
Net debt/(cash)	114.3	333.1	512.7	413.3	293.1
Lease liability	0	0	0	0	0
Other liabilities	70.4	90.5	90.5	90.5	90.5
Shareholder's funds	424.7	492.4	572.3	665.8	775.8
Minority interests	0	0	0	0	0
Total funding sources	**609.4**	**916.0**	**1,175.5**	**1,169.6**	**1,159.4**

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

FORSYTH BARR

Key result snapshot

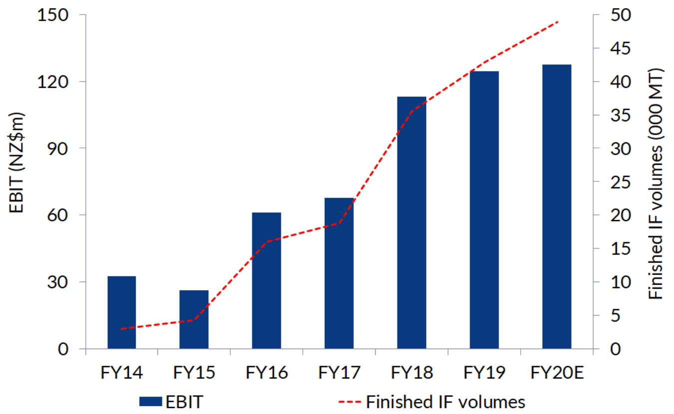
Synlait Milk reported a material 1H20 profit decline, as pre-guided, with strong growth in infant formula volumes outweighed by the step-change across all key cost lines.

Figure 1. 1H20 result vs expectations

NZ$m	1H19	1H20	% chg	Forsyth Barr
Gross profit	85.9	82.9	-3.5%	81.5
Underlying EBIT	56.7	45.8	-19.3%	47.1
Underlying NPAT	37.3	24.6	-34.0%	27.3
Underlying EPS (cps)	20.8	14.6	-29.8%	15.2
Dividend (cps)	0.0	0.0	n/a	0.0

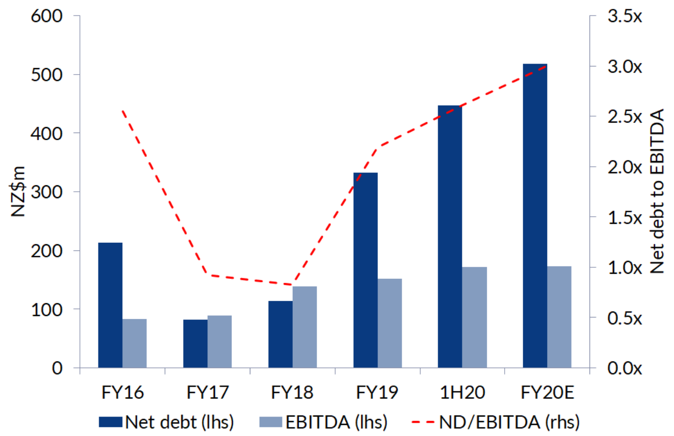
Source: Forsyth Barr analysis, Company reports

Figure 2. EBIT versus finished infant formula volumes



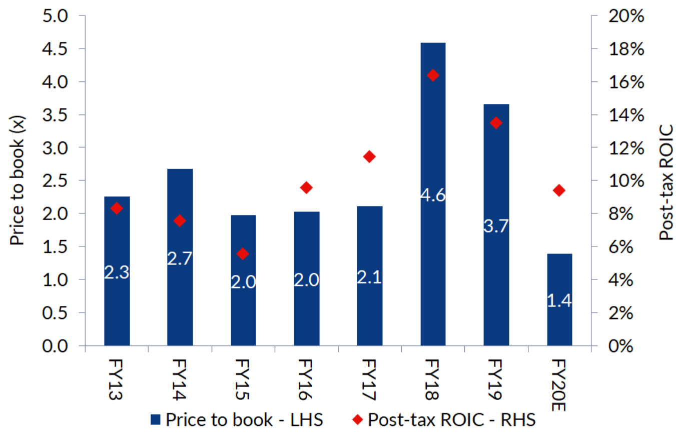
Source: Forsyth Barr analysis, Company reports

Figure 3. Elevated gearing given recent investment cycle



Source: Forsyth Barr analysis

Figure 4. Price to book versus ROIC trajectory



Source: Forsyth Barr analysis

Earnings and valuation revisions

The key near-term earnings changes we have made are to incorporate the Dairyworks acquisition with the higher earnings base partially offset by funding costs and depreciation. Our underlying near-term earnings revisions are small.

We have revisited our longer-term margin and volume assumptions for SML's contract with key customer, The a2 Milk Company (ATM), following ATM's recent result signalling interest in diversifying and 'participation' in manufacturing. We continue to view SML as the key manufacturer for ATM over the longer-term, however, have lowered our longer-term expectations for SML's share of ATM volume (from 90% to 75%). This has a meaningful negative impact on our target price. Our target price is now NZ$5.65 (prior NZ $7.00).

Figure 5. Earnings revisions (NZ$m)

	FY20E			FY21E			FY22E		
NZ$m	Old	New	% chg	Old	New	% chg	Old	New	% chg
Gross profit	199	207	4.2%	227	251	10.4%	247	273	10.6%
EBIT	128	135	5.3%	152	161	6.2%	168	177	5.4%
Underlying NPAT	77	80	3.4%	93	94	1.1%	109	110	0.7%
Underlying EPS (cps)	43.1	44.6	3.4%	51.7	52.2	1.1%	60.9	61.4	0.7%

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, 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 associated value in this 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:** (1) growing global demand for dairy, (2) focus on quality, sustainability and premium products.

Financial structure

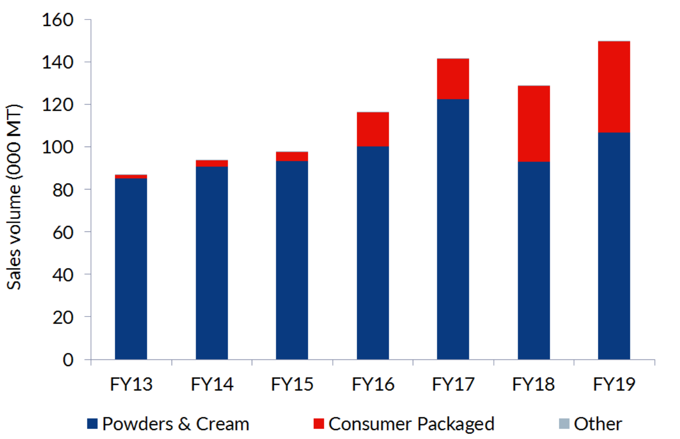
- **Capacity expansion:** New customer contracts are required to support debt-funded capital investment underway through increasing utilisation of available capacity. Progress with higher margin opportunities is of interest.

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.

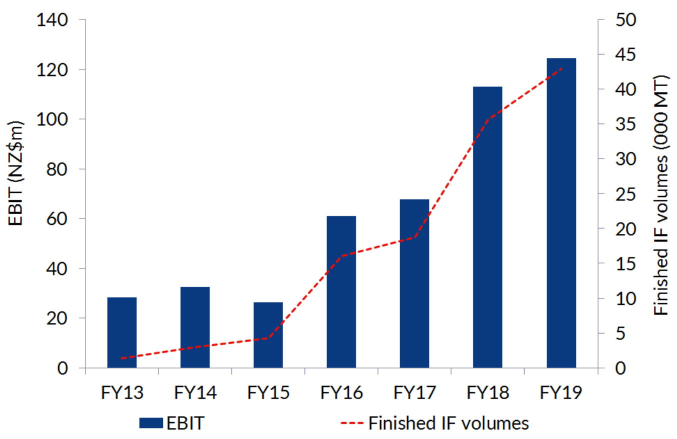
- **Pokeno development:** A recent unfavourable court decision brings into question the feasibility of its new (near completed) manufacturing site which is set to provide capacity expansion and geographic diversification.

Figure 6. Sales volumes



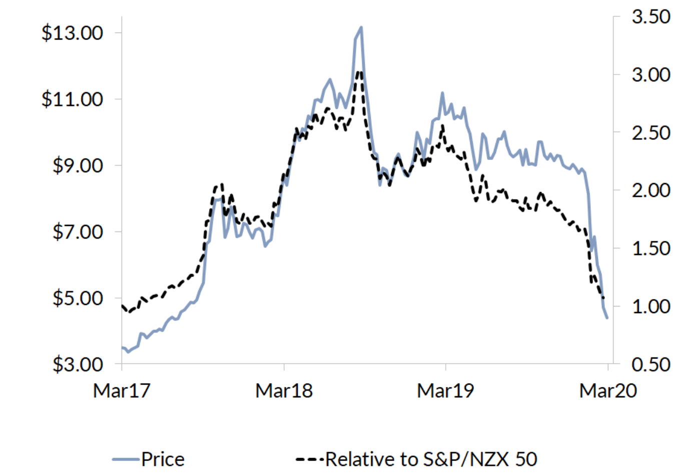
Source: Forsyth Barr analysis, Company reports

Figure 7. Earnings vs. finished infant formula volumes



Source: Forsyth Barr analysis, Company reports

Figure 8. Price performance



Source: Forsyth Barr analysis

Figure 9. Substantial shareholders

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

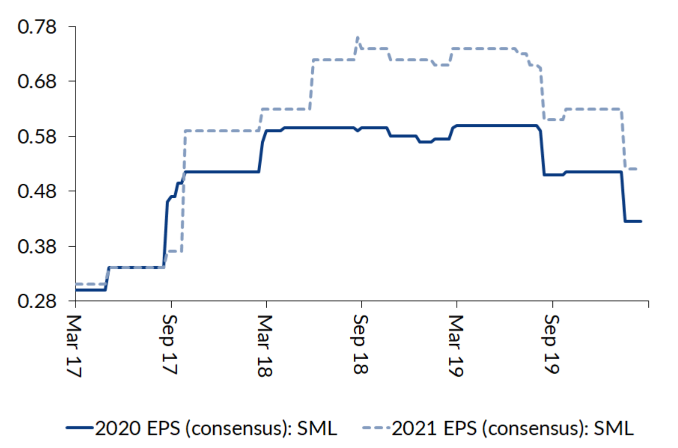
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 10. International valuation comparisons

Company (metrics re-weighted to reflect SML's balance date - July)	Code	Price	Mkt Cap (m)	PE 2020E	PE 2021E	EV/EBITDA 2020E	EV/EBITDA 2021E	EV/EBIT 2020E	EV/EBIT 2021E	Cash Yld 2021E
Synlait Milk	**SML NZ**	**NZ$4.40**	**NZ$789**	**9.9x**	**8.4x**	**6.4x**	**5.4x**	**8.3x**	**7.0x**	**0.0%**
Fonterra *	FSF NZ	NZ$3.94	NZ$6,350	18.1x	12.5x	9.8x	9.3x	17.0x	15.1x	4.3%
BEGA CHEESE	BGA AU	A$4.23	A$906	31.2x	19.3x	12.2x	9.7x	21.7x	15.0x	2.8%
SAPUTO INC	SAP CN	C$32.97	C$13,451	18.0x	12.3x	11.2x	10.2x	15.7x	13.8x	n/a
NESTLE SA-REG	NESN SW	CHF99.80	CHF297,005	22.4x	20.9x	16.3x	15.8x	20.1x	19.6x	2.9%
DANONE	BN FP	€61.08	€41,908	17.5x	13.5x	11.3x	10.6x	15.0x	13.2x	4.1%
INNER MONGOLIA YILI INDUS-A	600887 CH	CN¥27.84	CN¥169,723	23.0x	20.5x	16.2x	14.2x	20.2x	17.7x	3.1%
CHINA MENGNIU DAIRY CO	2319 HK	CN¥25.70	CN¥101,147	21.4x	20.2x	13.9x	12.0x	19.3x	16.9x	1.2%
AUSNUTRIA DAIRY CORP	1717 HK	CN¥10.30	CN¥16,593	15.9x	12.1x	10.5x	8.2x	11.9x	8.9x	2.9%
KERRY GROUP PLC-A	KYG ID	€107.80	€19,031	28.6x	23.9x	20.0x	17.3x	25.2x	21.5x	0.9%
			Compco Average:	**21.8x**	**17.3x**	**13.5x**	**11.9x**	**18.4x**	**15.7x**	**2.8%**
EV = Current Market Cap + Actual Net Debt			**SML Relative:**	**-55%**	**-51%**	**-53%**	**-54%**	**-55%**	**-56%**	**-100%**

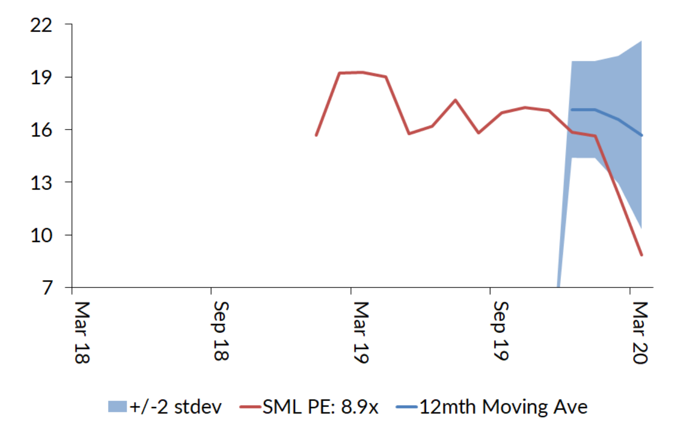
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (SML) companies fiscal year end

Figure 11. Consensus EPS momentum (NZ$)



Source: Forsyth Barr analysis

Figure 12. One year forward PE (x)



—Source: Forsyth Barr analysis

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