

Synlait Milk

FY20 Result — Growing Pains

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NEUTRAL

Synlait Milk (SML) reported an FY20 result below our forecasts, with first-time FY21 guidance materially disappointing. The investment phase to support diversification, and the next step-change in capacity, has been costlier than anticipated; while FY21 is also not helped by a surprisingly weak period of infant formula (IF) demand from key customer, The a2 Milk Company (ATM). Our visibility on earnings drivers is low (reinforced by recent material earnings shocks) which makes gaining confidence on earnings and valuation difficult — leverage can work both ways. Accordingly, we require a higher margin of safety for a directional stock call. NEUTRAL.

NZX Code	SML	Financials: Jul/	20A	21E	22E	23E	Valuation (x)	20A	21E	22E	23E
Share price	NZ\$5.60	NPAT* (NZ\$m)	75.2	77.7	94.8	111.1	PE	13.3	12.9	10.6	9.0
Target price	NZ\$6.00	EPS* (NZc)	42.0	43.4	52.8	62.0	EV/EBIT	11.6	10.6	9.3	8.5
Risk rating	High	EPS growth* (%)	-7.9	3.3	21.9	17.2	EV/EBITDA	8.4	7.8	7.0	6.4
Issued shares	179.3m	DPS (NZc)	0.0	0.0	0.0	25.0	Price / NTA	2.0	1.7	1.5	1.3
Market cap	NZ\$1,004m	Imputation (%)	100	100	100	100	Cash div yld (%)	0.0	0.0	0.0	4.5
Avg daily turnover	165.8k (NZ\$1,139k)	*Based on normalised profits					Gross div yld (%)	0.0	0.0	0.0	6.2

Whats changed?

- **NPAT revisions:** Material near-term downgrades (FY21E -17%; FY22E -14%) pushing out growth profile by one year.
- **Target price:** NZ\$6.00 (from NZ\$5.65), with cost of capital input changes offsetting the near-term earnings downgrades.

FY20 result in the middle of its guidance, albeit below market expectations; FY21 guidance materially below forecasts

FY20 NPAT of NZ\$75m was down -9% on the prior year and weaker than our forecasts (NZ\$80m). EBITDA growth (+13%) did not translate to profit growth given the cost drag of recent investment. Guidance for “similar, or a slight improvement” in FY21 was also materially below our (and market) prior forecasts. We now assume the contribution of recent acquisitions (namely Dairyworks) is offset by higher funding costs and a negative result for finished IF. The latter is a material change, with the unfavourable combination of flat volumes (ATM daigou pressure; not helped by SML carrying higher than usual IF base inventory at year end) and margin pressure from the recent ATM contract renewal (efficiencies to mitigate this are likely difficult without volume growth).

Gearing elevated and likely to remain so for longer than anticipated before the free cashflow profile improves

FY20 net debt of NZ\$527m increased materially on FY19 and was modestly ahead of our forecasts. The majority of SML's large scale capital investment is complete (with some hangover into 1H21) and we are expecting an improved free cashflow/gearing profile from here. However, gearing is likely to be elevated for longer than previously thought given the weaker FY21 earnings outlook. An additional banking facility has been put in place to assist near-term, while SML doesn't appear to be ruling out other options (“in the current environment we recognise the need to assess our balance sheet and capital management options”).

Where to from here? Still a lot we don't know; return to NPAT growth (and improved returns) pushed out to FY22E+

We went into SML's result with a number of questions; many of which are still outstanding. The costly part of the expansion phase is almost behind it and we should begin to see an improved return/profit profile, however, the extent of the prize remains unclear and is dependent on further execution on new customers, which has been slow to date. SML did signal a new multi-national packaging customer which is expected to benefit from FY23+, however, we have no visibility on materiality.

Synlait Milk Ltd (SML)

Priced as at 28 Sep 2020 (NZ\$)

5.60

12-month target price (NZ\$)*

6.00

Expected share price return

7.1%

Net dividend yield

0.0%

Estimated 12-month return

7.1%

Spot valuations (NZ\$)

1. DCF

5.92

2. Price to book

5.42

n/a

n/a

Key WACC assumptions

Risk free rate

1.30%

Equity beta

1.08

WACC

7.0%

Terminal growth

1.3%

DCF valuation summary (NZ\$m)

Total firm value

1,698

(Net debt)/cash

(524)

Less: Capitalised operating leases

(112)

Value of equity

1,062

Profit and Loss Account (NZ\$m)	2019A	2020A	2021E	2022E	2023E
Sales revenue	1,024.3	1,302.0	1,458.6	1,602.0	1,703.4
Normalised EBITDA	152.1	171.4	191.7	212.0	229.8
Depreciation and amortisation	(27.6)	(48.1)	(50.1)	(54.1)	(55.9)
Normalised EBIT	124.5	123.3	141.6	157.9	174.0
Net interest	(9.4)	(21.4)	(33.6)	(26.3)	(19.7)
Associate income	(0.6)	0.0	0	0	0
Tax	(32.8)	(26.7)	(30.2)	(36.9)	(43.2)
Minority interests	0	0	0	0	0
Normalised NPAT	81.7	75.2	77.7	94.8	111.1
Abnormals/other	0	0	0	0	0
Reported NPAT	81.7	75.2	77.7	94.8	111.1
Normalised EPS (cps)	45.6	42.0	43.4	52.8	62.0
DPS (cps)	0	0	0	0	25.0

Growth Rates	2019A	2020A	2021E	2022E	2023E
Revenue (%)	16.5	27.1	12.0	9.8	6.3
EBITDA (%)	9.7	12.6	11.9	10.6	8.4
EBIT (%)	10.1	-1.0	14.8	11.5	10.2
Normalised NPAT (%)	8.9	-7.9	3.3	21.9	17.2
Normalised EPS (%)	8.9	-7.9	3.3	21.9	17.2
Ordinary DPS (%)	n/a	n/a	n/a	n/a	n/a

Cash Flow (NZ\$m)	2019A	2020A	2021E	2022E	2023E
EBITDA	152.1	171.4	191.7	212.0	229.8
Working capital change	12.1	(51.1)	19.3	1.5	4.7
Interest & tax paid	(43.5)	(50.0)	(63.9)	(63.2)	(62.9)
Other	(0.9)	12.3	(0.0)	(0.0)	0.0
Operating cash flow	119.9	82.6	147.2	150.3	171.7
Capital expenditure	(320.6)	(152.2)	(63.1)	(37.3)	(38.8)
(Acquisitions)/divestments	(17.8)	(72.9)	(27.5)	0	0
Other	0	(4.2)	(3.5)	(3.5)	(3.5)
Funding available/(required)	(218.5)	(146.7)	53.1	109.5	129.4
Dividends paid	0	0	0	0	(17.9)
Equity raised/(returned)	0	0	0	0	0
(Increase)/decrease in net debt	(218.5)	(146.7)	53.1	109.5	111.5

Balance Sheet (NZ\$m)	2019A	2020A	2021E	2022E	2023E
Working capital	10.8	93.7	74.3	72.9	68.1
Fixed assets	845.2	965.1	1,011.1	999.7	987.8
Intangibles	22.5	108.0	107.1	106.1	105.1
Right of use asset	0	18.5	17.6	16.7	15.9
Other assets	39.9	62.3	62.3	62.3	62.3
Total funds employed	918.4	1,247.6	1,272.5	1,257.7	1,239.2
Net debt/(cash)	333.1	523.7	470.6	361.0	249.6
Lease liability	0	19.3	19.5	19.5	19.3
Other liabilities	92.9	98.2	98.2	98.2	98.2
Shareholder's funds	492.4	606.5	684.2	779.0	872.1
Minority interests	0	0	0	0	0
Total funding sources	918.4	1,247.6	1,272.5	1,257.7	1,239.2

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

Valuation Ratios	2019A	2020A	2021E	2022E	2023E
EV/EBITDA (x)	8.1	8.4	7.8	7.0	6.4
EV/EBIT (x)	9.9	11.6	10.6	9.3	8.5
PE (x)	12.3	13.3	12.9	10.6	9.0
Price/NTA (x)	2.1	2.0	1.7	1.5	1.3
Free cash flow yield (%)	-20.0	-6.9	8.4	11.3	13.2
Net dividend yield (%)	0.0	0.0	0.0	0.0	4.5
Gross dividend yield (%)	0.0	0.0	0.0	0.0	6.2

Capital Structure	2019A	2020A	2021E	2022E	2023E
Interest cover EBIT (x)	13.2	5.8	4.2	6.0	8.8
Interest cover EBITDA (x)	16.1	8.0	5.7	8.1	11.7
Net debt/ND+E (%)	40.4	46.3	40.8	31.7	22.2
Net debt/EBITDA (x)	2.2	3.1	2.5	1.7	1.1

Key Ratios	2019A	2020A	2021E	2022E	2023E
Return on assets (%)	10.8	8.3	9.1	10.0	11.0
Return on equity (%)	16.6	12.4	11.4	12.2	12.7
Return on funds employed (%)	12.6	8.7	8.1	9.3	10.6
EBITDA margin (%)	14.9	13.2	13.1	13.2	13.5
EBIT margin (%)	12.2	9.5	9.7	9.9	10.2
Capex to sales (%)	31.3	11.7	4.3	2.3	2.3
Capex to depreciation (%)	1,160	317	126	69	69
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	0	0	0	0	40

Operating Performance	2019A	2020A	2021E	2022E	2023E
Sales volume					
Powders & Cream (k MT)	106.8	101.2	125.0	122.8	118.5
Consumer Packaged (k MT)	42.9	49.2	49.2	56.5	60.8
Specialty Ingredients (MT)	21.0	30.0	31.5	32.0	32.5
Total volume (k MT)	149.7	150.4	174.2	179.3	179.3

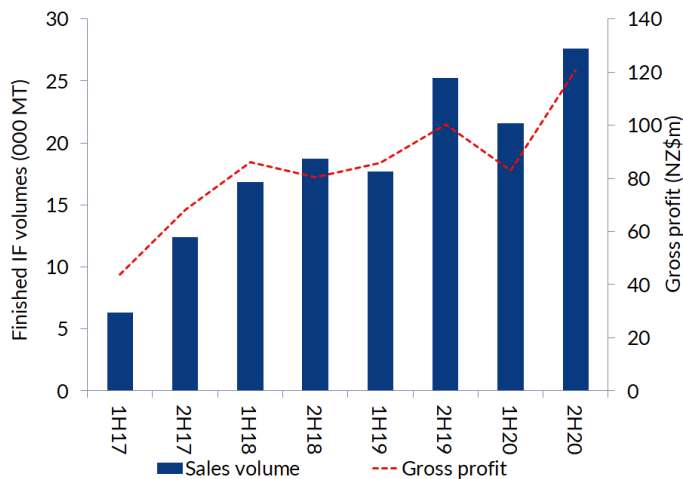
Gross Profit (GP) breakdown	2019A	2020A	2021E	2022E	2023E
Powders & Cream	142.2	134.4	135.2	146.4	151.7
Consumer Packaged	34.3	40.5	41.8	48.0	51.7
Everyday Dairy	0	0.4	29.6	36.8	45.7
Specialty Ingredients	9.8	28.4	26.8	25.1	23.4
Total Gross Profit	186.3	203.7	233.4	256.3	272.5

Operating Costs (incl D&A)	2019A	2020A	2021E	2022E	2023E
EBIT	124.5	123.3	141.6	157.9	174.0
Depreciation & Amortisation	(27.6)	(48.1)	(50.1)	(54.1)	(55.9)
EBITDA	152.1	171.4	191.7	212.0	229.8

ROCE (pre tax) %	2019A	2020A	2021E	2022E	2023E
	18.3	12.6	12.4	13.8	15.4

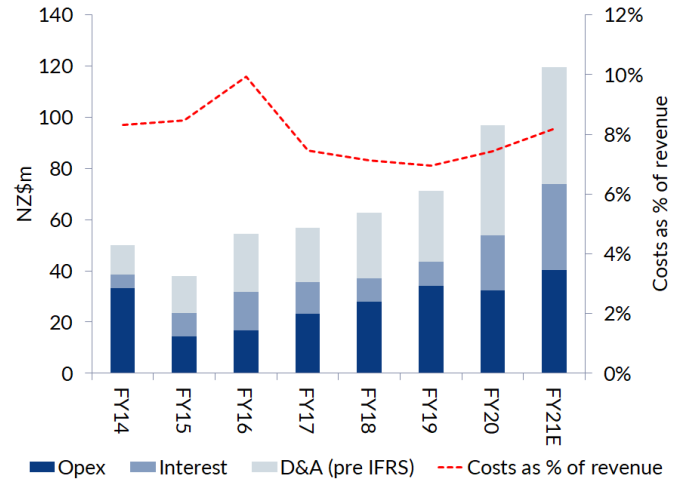
Key tables and charts

Figure 1. Gross profit still tracking finished IF volumes albeit likely to partly decouple in future given diversification



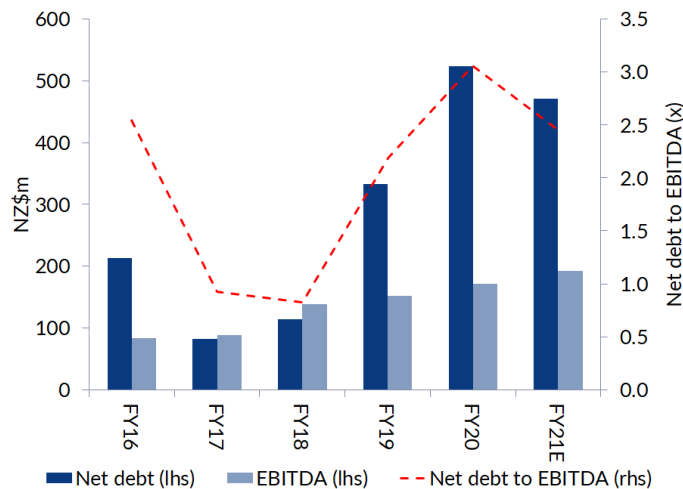
Source: Forsyth Barr analysis, Company reports

Figure 2. EBITDA growth not translating to NPAT growth due to the cost drag (particularly interest) of the recent investment



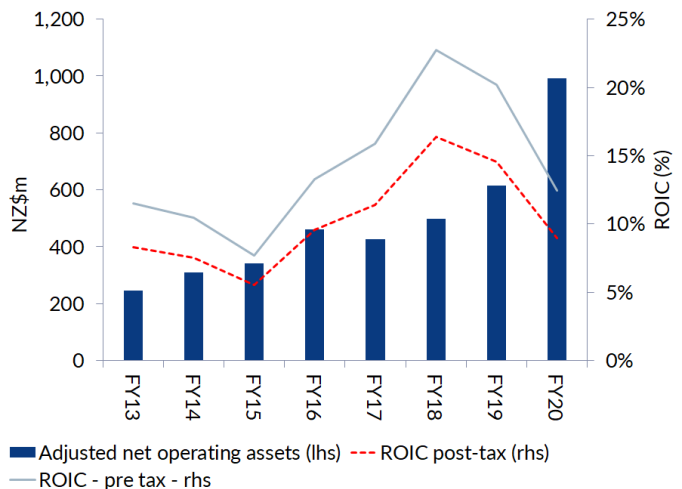
Source: Forsyth Barr analysis, Company reports

Figure 3. Gearing elevated but nearing peak? We think so



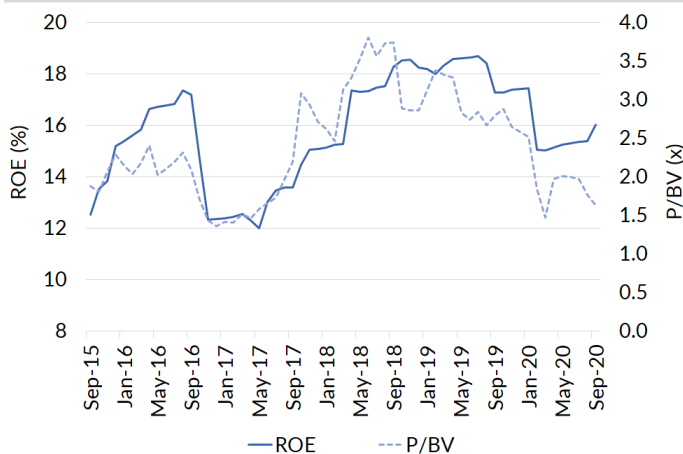
Source: Forsyth Barr analysis, Company reports

Figure 4. Returns dilution from capital investment phase



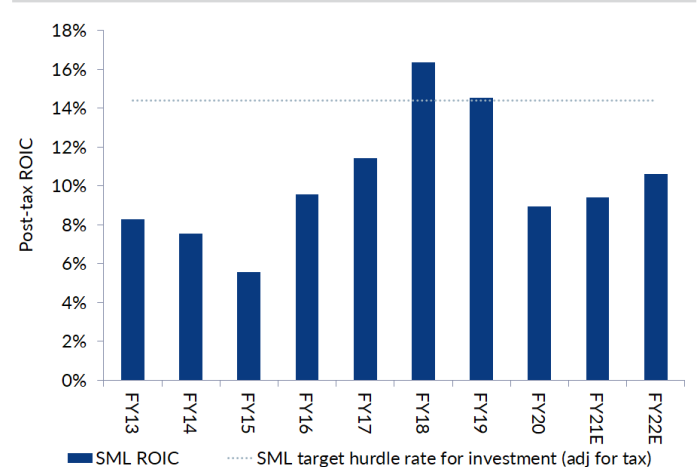
Source: Forsyth Barr analysis, Company reports

Figure 5. Reasonable relationship between SML's price to book and ROE historically; we expect near-term ROE to decline



Source: Forsyth Barr analysis, Eikon

Figure 6. Valuation highly sensitive to long-term assumptions around ROIC profile; feasible range of outcomes remains wide



Source: Forsyth Barr analysis, Company reports

Earnings revisions and our view

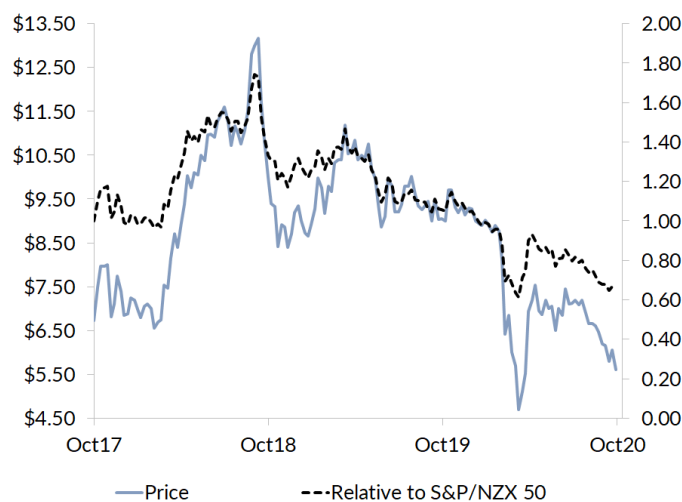
We materially lower our near-term forecasts, reflecting (1) lower near-term demand for finished IF from key customer, ATM, (2) higher cost drag, (3) greater weighting to lower margin categories. Our medium to longer-term changes are less material. Revisions to our team's cost of capital inputs offset earnings downgrades, with our target price modestly higher at NZ\$6.00.

Our long-term ROIC assumptions remain materially below the recent peak, albeit ahead of current levels (giving SML some benefit of the doubt re new customers and shifting to higher value products) and comfortably ahead of WACC. The latter, in combination with the ATM licence, helps to justify some level of premium to book value. The magnitude that is 'appropriate' will remain subject to debate. SML's multiples and premium do not appear demanding versus other processors when mapped against returns; albeit, it is higher risk than others. SML has plenty of options given its recent investment phase, however, the return path is highly contingent on the type of customers (and products) which capacity is deployed to, providing a wide range of feasible outcomes. The rapid deterioration seen through CY20 reinforces how quickly things can change, however, leverage can work both ways. Accordingly, we require a higher margin of safety for a directional stock call. NEUTRAL.

Figure 7. Earnings revisions (NZ\$m)

NZ\$m	FY21E			FY22E			FY23E
	Old	New	% chg	Old	New	% chg	New
Gross profit	251	233	-7.1%	273	256	-6.1%	273
EBIT	161	142	-12.0%	177	158	-11.0%	174
Underlying NPAT	94	78	-16.9%	110	95	-13.8%	111
Underlying EPS (cps)	52.2	43.4	-16.9%	61.4	52.8	-13.9%	62.0
Dividend (cps)	0.0	0.0	n/a	0.0	0.0	n/a	25.0

Source: Forsyth Barr analysis

Figure 8. Price performance


Source: Forsyth Barr analysis

Figure 9. Substantial shareholders

Shareholder	Latest Holding
Bright Dairy Limited	39.1%
The a2 Milk Company	19.8%
FIL Investment Management	5.4%

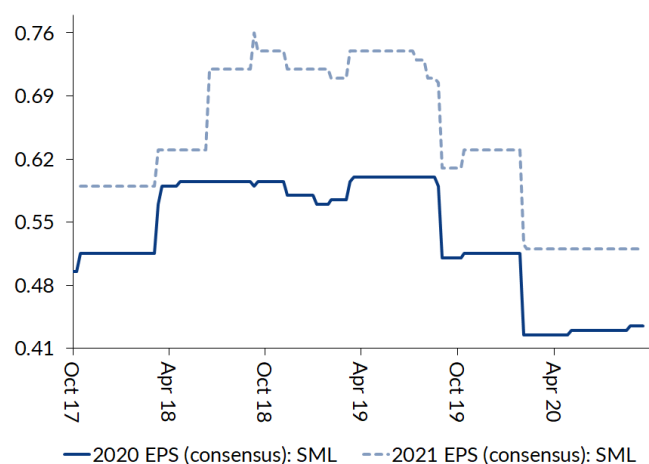
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

Figure 10. International valuation comparisons

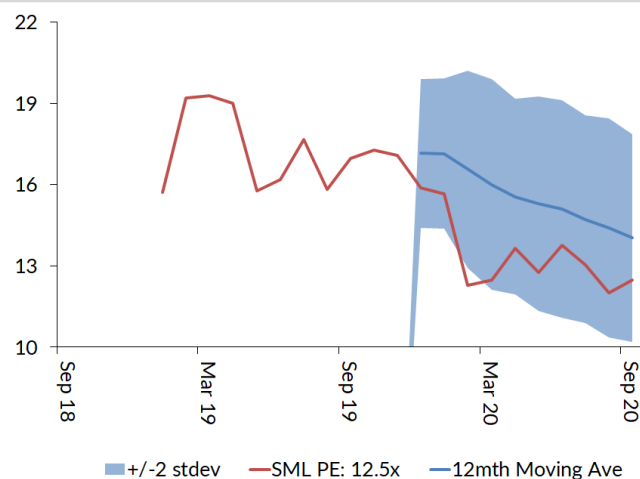
Company	Code	Price	Mkt Cap (m)	PE 2021E	PE 2022E	EV/EBITDA 2021E	EV/EBITDA 2022E	EV/EBIT 2021E	EV/EBIT 2022E	Cash Yld 2022E
(metrics re-weighted to reflect SML's balance date - July)										
Synlait Milk	SML NZ	NZ\$5.60	NZ\$1,004	12.9x	10.6x	8.0x	7.2x	10.8x	9.7x	0.0%
FONTERRA *	FSF NZ	NZ\$4.00	NZ\$6,448	13.8x	12.4x	7.6x	7.4x	13.3x	12.7x	4.0%
BEGA CHEESE	BGA AU	A\$5.23	A\$1,125	24.6x	20.0x	10.9x	9.7x	17.9x	15.0x	2.7%
SAPUTO INC	SAP CN	C\$33.37	C\$13,660	18.7x	n/a	11.1x	10.6x	15.9x	n/a	n/a
NESTLE SA-REG	NESN SW	CHF109.76	CHF316,219	24.9x	23.3x	18.3x	17.6x	23.0x	22.0x	2.7%
DANONE	BN FP	€54.56	€37,463	15.4x	14.4x	10.9x	10.4x	14.1x	13.4x	4.0%
INNER MONGOLIA YILI INDUS-A	600887 CH	CN¥38.11	CN¥231,831	29.6x	25.3x	20.3x	17.5x	25.2x	21.8x	2.6%
CHINA MENGNIU DAIRY CO	2319 HK	CN¥35.90	CN¥141,671	33.2x	25.3x	20.1x	16.0x	30.7x	22.2x	0.9%
AUSNUTRIA DAIRY CORP	1717 HK	CN¥12.16	CN¥20,859	14.6x	11.7x	10.3x	8.4x	11.2x	9.0x	3.0%
KERRY GROUP PLC-A	KYG ID	€109.80	€19,401	29.2x	26.2x	20.2x	18.6x	26.8x	24.3x	0.9%
Compco Average:				22.7x	19.8x	14.4x	12.9x	19.8x	17.5x	2.6%
SML Relative:				-43%	-47%	-45%	-44%	-46%	-45%	-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 11. Consensus EPS momentum (NZ\$)


Source: Forsyth Barr analysis

Figure 12. One year forward PE (x)


Source: Forsyth Barr analysis

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