

Synlait Milk

A Lot Can Change in a Week

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 NEUTRAL 

Over the past week, Synlait Milk (SML) has provided a lot for the market to digest — a new customer announcement, settlement of its Pokeno dispute, and a capital raise. In combination this has helped to de-risk the investment case and resolved some of our questions and concerns. However, there is still a number of unknowns. The pathway to higher returns is becoming clearer after SML's expansionary capex phase, albeit, execution on targets and market expectations is key. Low visibility on key earnings drivers and a wide range of feasible scenarios for longer-term returns (key value driver), means while valuation metrics are not demanding we require a higher margin of safety to be confident in a directional call. NEUTRAL.

NZX Code	SML	Financials: Jul/	20A	21E	22E	23E	Valuation (x)	20A	21E	22E	23E
Share price	NZ\$5.93	NPAT* (NZ\$m)	75.2	75.5	100.4	123.9	PE	14.1	14.1	10.6	8.6
Target price	NZ\$6.30	EPS* (NZc)	42.0	42.1	56.0	69.1	EV/EBIT	14.0	13.0	10.2	8.7
Risk rating	High	EPS growth* (%)	-7.9	0.3	33.0	23.4	EV/EBITDA	10.1	9.4	7.5	6.6
Issued shares	218.5m	DPS (NZc)	0.0	0.0	0.0	20.0	Price / NTA	2.1	1.6	1.5	1.3
Market cap	NZ\$1,296m	Imputation (%)	100	100	100	100	Cash div yld (%)	0.0	0.0	0.0	3.4
Avg daily turnover	166.5k (NZ\$1,098k)	*Based on normalised profits					Gross div yld (%)	0.0	0.0	0.0	4.7

What's changed?

- Earnings:** Gross profit revised -4% in FY21E, minor changes thereafter. Incorporating the capital raise materially lifts our NPAT forecasts, albeit weighs on EPS.
- Target price:** NZ\$6.30. Small increase given positive recent developments, which outweighs modest dilution from the capital raise.

FY21 guidance lowered

SML lowered its FY21 guidance, predominantly due to lower expectations around finished Infant Formula (IF) volumes in 1H21. Guidance is now for NPAT "at or slightly below" FY20 levels, vs prior indications of a "similar or slight improvement". Our updated forecasts assume solid EBITDA growth (albeit weaker than prior expectations), helped by recent acquisitions, outweighed by the cost drag of the recent investment (namely depreciation and interest). Key customer, The a2 Milk Company (ATM), is experiencing material headwinds through the daigou channel, which is flowing through to SML. We view this as a temporary issue, particularly as channel mix readjusts, hence, expect to see a return to growth in finished IF from 2H21 as inventory levels and demand 'normalises'.

Three key announcements in a week — new customer confirmed, Pokeno settled, and capital raise

The last week has been busy for SML — with three notable announcements which help to de-risk the investment case. Namely:

- New multi-national customer confirmed:** Details are scarce, however, this should help to underwrite the investment made in Pokeno (in place of original plans for infant formula base powder) and further diversify earnings. Further capital is being deployed (NZ\$70m), with indications of an attractive ROIC for Pokeno (as a whole) suggesting SML may be taking some volume risk.
- Pokeno dispute settled:** This removes a key overhang and area of uncertainty for investors which was a difficult risk to quantify. No settlement details were provided, except "the price was reasonable and not material to SML". We had assumed a small settlement in our valuation, hence, it appears broadly consistent with our prior expectations.
- Capital raise:** NZ\$200m via an NZ\$180m placement and NZ\$20m Share Purchase Plan. The placement has been underwritten at NZ\$5.10/share — a meaningful discount to our DCF, and helped by the recent price spike. Post raise, net debt to EBITDA lowers to a more comfortable level of ~2x (vs 3.2x at FY20). Both SML's cornerstone shareholders are supporting the raise.

Synlait Milk Ltd (SML)

Priced as at 10 Nov 2020 (NZ\$) **5.93**

12-month target price (NZ\$)*					6.30	Spot valuations (NZ\$)					
Expected share price return					6.2%	1. DCF 6.29					
Net dividend yield					0.0%	2. Price to book 5.47					
Estimated 12-month return					6.2%	n/a					
Key WACC assumptions						DCF valuation summary (NZ\$m)					
Risk free rate						Total firm value 1,810					
Equity beta						(Net debt)/cash (324)					
WACC						Less: Capitalised operating leases (112)					
Terminal growth						Value of equity 1,374					
Profit and Loss Account (NZ\$m)					2019A	2020A	2021E	2022E	2023E	Valuation Ratios	
Sales revenue					1,024.3	1,302.0	1,393.9	1,594.7	1,774.3	EV/EBITDA (x) 10.0	
Normalised EBITDA					152.1	171.4	181.4	213.3	242.8	EV/EBIT (x) 12.2	
Depreciation and amortisation					(27.6)	(48.1)	(50.1)	(56.6)	(59.3)	PE (x) 13.0	
Normalised EBIT					124.5	123.3	131.2	156.8	183.4	Price/NTA (x) 2.3	
Net interest					(9.4)	(21.4)	(26.4)	(17.3)	(11.3)	Free cash flow yield (%) -15.5	
Associate income					(0.6)	0.0	0	0	0	Net dividend yield (%) 0.0	
Tax					(32.8)	(26.7)	(29.4)	(39.0)	(48.2)	Gross dividend yield (%) 0.0	
Minority interests					0	0	0	0	0		
Normalised NPAT					81.7	75.2	75.5	100.4	123.9		
Abnormals/other					0	0	0	0	0		
Reported NPAT					81.7	75.2	75.5	100.4	123.9		
Normalised EPS (cps)					45.6	42.0	42.1	56.0	69.1		
DPS (cps)					0	0	0	0	20.0		
Growth Rates					2019A	2020A	2021E	2022E	2023E	Key Ratios	
Revenue (%)					16.5	27.1	7.1	14.4	11.3	Return on assets (%) 10.8	
EBITDA (%)					9.7	12.6	5.8	17.6	13.8	Return on equity (%) 16.6	
EBIT (%)					10.1	-1.0	6.4	19.4	17.0	Return on funds employed (%) 12.6	
Normalised NPAT (%)					8.9	-7.9	0.3	33.0	23.4	EBITDA margin (%) 14.9	
Normalised EPS (%)					8.9	-7.9	0.3	33.0	23.4	EBIT margin (%) 12.2	
Ordinary DPS (%)					n/a	n/a	n/a	n/a	n/a	Capex to sales (%) 31.3	
										Capex to depreciation (%) 1,160	
Cash Flow (NZ\$m)					2019A	2020A	2021E	2022E	2023E	Imputation (%) 100	
EBITDA					152.1	171.4	181.4	213.3	242.8	Pay-out ratio (%) 0	
Working capital change					12.1	(51.1)	22.6	(1.5)	1.6		
Interest & tax paid					(43.5)	(50.0)	(55.8)	(56.4)	(59.5)		
Other					(0.9)	12.3	0.0	(0.0)	(0.0)		
Operating cash flow					119.9	82.6	148.2	155.5	184.8		
Capital expenditure					(320.6)	(152.2)	(98.1)	(74.1)	(41.4)		
(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)	19.1	77.8	139.9		
Dividends paid					0	0	0	0	(17.5)		
Equity raised/(returned)					0	0	200.0	0	0		
(Increase)/decrease in net debt					(218.5)	(146.7)	219.1	77.8	122.5		
Balance Sheet (NZ\$m)					2019A	2020A	2021E	2022E	2023E		
Working capital					10.8	93.7	71.0	72.5	71.0		
Fixed assets					845.2	965.1	1,046.1	1,069.1	1,056.5		
Intangibles					22.5	108.0	107.1	106.1	105.0		
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	1,304.2	1,326.7	1,310.6		
Net debt/(cash)					333.1	523.7	304.6	226.7	104.2		
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	882.0	982.4	1,088.8		
Minority interests					0	0	0	0	0		
Total funding sources					918.4	1,247.6	1,304.2	1,326.7	1,310.6		
Operating Performance					2019A	2020A	2021E	2022E	2023E		
Sales volume					Powders & Cream (k MT)					107	
					Consumer Packaged (k MT)					101	
					Specialty Ingredients (MT)					127	
					Total volume (k MT)					130	
Gross Profit (GP) breakdown					EBITDA margin (%)					13.0	
					EBIT margin (%)					14.1	
					Capex to sales (%)					1.6	
					Capex to depreciation (%)					1.5	
Operating Costs (incl D&A)					Imputation (%)					100	
EBIT					Pay-out ratio (%)					0	
Depreciation & Amortisation					ROCE (pre tax) %					29	
EBITDA					Total Gross Profit					119	
Operating Costs (incl D&A)					Operating Costs (incl D&A)					12.4	
EBIT					EBIT					8.6	
Depreciation & Amortisation					Depreciation & Amortisation					8.6	
EBITDA					EBITDA					8.6	
ROCE (pre tax) %					ROCE (pre tax) %					11.0	

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

Earnings revisions

We have incorporated SML's capital raise which has a material positive impact on NPAT (lower interest costs), albeit drags on EPS.

We also make modest downgrades to FY21 gross profit forecasts, albeit minor changes thereafter. The former reflects more conservative assumptions on:

- Finished IF volumes: In light of SML's updated guidance for FY21 volumes "to be lower than FY20" (vs prior guidance for "similar volumes year over year")
- Finished IF gross margin: We assume a lower ability to offset recent price negotiations (with ATM) through manufacturing efficiencies – given the lower volumes for finished IF.

Figure 1. Earnings revisions (NZ\$m)

NZ\$m	FY21E			FY22E			FY23E		
	Old	New	% chg	Old	New	% chg	Old	New	% chg
Gross profit	233	223	-4.4%	256	255	-0.5%	281	284	1.1%
EBIT	192	181	-5.4%	215	213	-0.5%	240	243	1.3%
Underlying NPAT	77.9	75.5	-3.1%	92.5	100.4	8.6%	112.6	123.9	10.1%
Underlying EPS (cps)	43.4	36.2	-16.7%	51.6	45.9	-10.9%	62.8	56.7	-9.7%
Dividend (cps)	0.0	0.0	n/a	0.0	0.0	n/a	22.0	20.0	-9.1%

Source: Forsyth Barr analysis

Figure 2. Price performance

Figure 3. Substantial shareholders

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

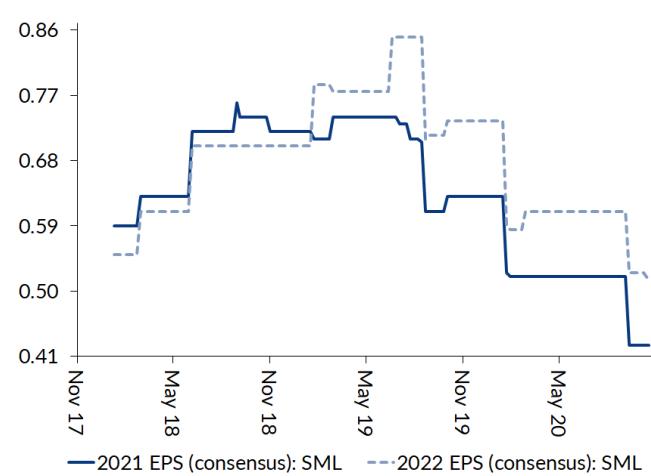
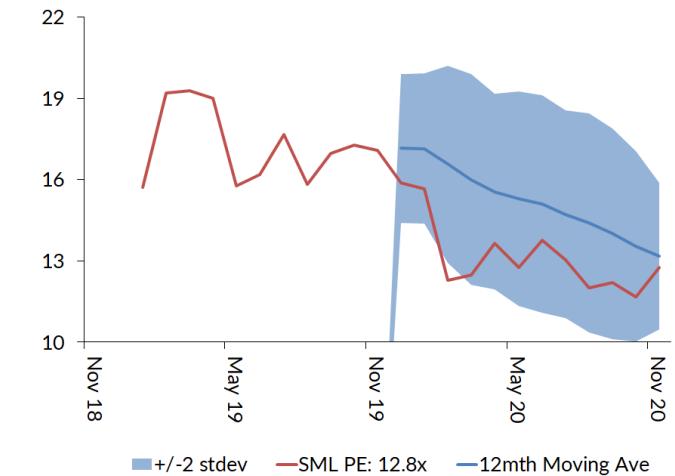
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

Figure 4. International valuation comparisons

Company (metrics re-weighted to reflect SML's balance date - July)	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash Yld 2022E
				2021E	2022E	2021E	2022E	2021E	2022E	
Synlait Milk	SML NZ	NZ\$5.93	NZ\$1,296	14.1x	10.6x	10.0x	8.5x	13.9x	11.6x	0.0%
FONTERRA *	FSF NZ	NZ\$4.31	NZ\$6,954	14.8x	13.3x	8.0x	7.7x	13.9x	13.3x	3.7%
BEGA CHEESE	BGA AU	A\$5.18	A\$1,113	23.9x	19.7x	10.7x	9.6x	17.5x	14.8x	2.8%
SAPUTO INC	SAP CN	C\$32.60	C\$13,347	18.8x	16.3x	10.9x	10.2x	16.2x	14.1x	n/a
NESTLE SA-REG	NESN SW	CHF106.50	CHF306,827	24.3x	22.8x	17.9x	17.2x	22.4x	21.5x	2.8%
DANONE	BN FP	€49.65	€34,091	14.6x	13.7x	10.4x	9.9x	13.6x	12.9x	4.4%
INNER MONGOLIA YILI INDUS-A	600887 CH	CNY39.44	CNY239,922	30.3x	26.0x	19.6x	16.8x	24.7x	21.4x	2.5%
CHINA MENNIU DAIRY CO	2319 HK	CNY40.85	CNY161,210	37.7x	28.6x	23.0x	18.3x	34.8x	25.2x	0.8%
AUSNUTRIA DAIRY CORP	1717 HK	CNY11.28	CNY19,350	13.7x	11.1x	9.8x	8.0x	10.6x	8.5x	3.3%
KERRY GROUP PLC-A	KYG ID	€107.20	€18,942	28.7x	25.7x	20.0x	18.4x	26.2x	23.8x	0.9%
Compco Average:				23.0x	19.7x	14.5x	12.9x	20.0x	17.3x	2.7%
SML Relative:				-39%	-46%	-31%	-34%	-31%	-33%	-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 5. Consensus EPS momentum (NZ\$)

Figure 6. One year forward PE (x)


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