

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

Expected share price return

6.2%

Net dividend yield

0.0%

Estimated 12-month return

6.2%

Spot valuations (NZ\$)

1. DCF

6.29

2. Price to book

5.47

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

1,810

(Net debt)/cash

(324)

Less: Capitalised operating leases

(112)

Value of equity

1,374

Profit and Loss Account (NZ\$m)	2019A	2020A	2021E	2022E	2023E
Sales revenue	1,024.3	1,302.0	1,393.9	1,594.7	1,774.3
Normalised EBITDA	152.1	171.4	181.4	213.3	242.8
Depreciation and amortisation	(27.6)	(48.1)	(50.1)	(56.6)	(59.3)
Normalised EBIT	124.5	123.3	131.2	156.8	183.4
Net interest	(9.4)	(21.4)	(26.4)	(17.3)	(11.3)
Associate income	(0.6)	0.0	0	0	0
Tax	(32.8)	(26.7)	(29.4)	(39.0)	(48.2)
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
Revenue (%)	16.5	27.1	7.1	14.4	11.3
EBITDA (%)	9.7	12.6	5.8	17.6	13.8
EBIT (%)	10.1	-1.0	6.4	19.4	17.0
Normalised NPAT (%)	8.9	-7.9	0.3	33.0	23.4
Normalised EPS (%)	8.9	-7.9	0.3	33.0	23.4
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	181.4	213.3	242.8
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

* 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)	10.0	10.1	9.4	7.5	6.6
EV/EBIT (x)	12.2	14.0	13.0	10.2	8.7
PE (x)	13.0	14.1	14.1	10.6	8.6
Price/NTA (x)	2.3	2.1	1.6	1.5	1.3
Free cash flow yield (%)	-15.5	-5.4	3.9	6.3	11.1
Net dividend yield (%)	0.0	0.0	0.0	0.0	3.4
Gross dividend yield (%)	0.0	0.0	0.0	0.0	4.7

Capital Structure	2019A	2020A	2021E	2022E	2023E
Interest cover EBIT (x)	13.2	5.8	5.0	9.1	16.2
Interest cover EBITDA (x)	16.1	8.0	6.9	12.3	21.5
Net debt/ND+E (%)	40.4	46.3	25.7	18.8	8.7
Net debt/EBITDA (x)	2.2	3.1	1.7	1.1	0.4

Key Ratios	2019A	2020A	2021E	2022E	2023E
Return on assets (%)	10.8	8.3	8.3	9.5	11.0
Return on equity (%)	16.6	12.4	8.6	10.2	11.4
Return on funds employed (%)	12.6	8.7	7.5	9.0	10.7
EBITDA margin (%)	14.9	13.2	13.0	13.4	13.7
EBIT margin (%)	12.2	9.5	9.4	9.8	10.3
Capex to sales (%)	31.3	11.7	7.0	4.6	2.3
Capex to depreciation (%)	1,160	317	196	131	70
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	0	0	0	0	29

Operating Performance	2019A	2020A	2021E	2022E	2023E
Sales volume					
Powders & Cream (k MT)	107	101	127	123	119
Consumer Packaged (k MT)	43	49	47	56	60
Specialty Ingredients (MT)	21	30	32	32	33
Total volume (k MT)	150	150	174	179	179

Gross Profit (GP) breakdown	2019A	2020A	2021E	2022E	2023E
Powders & Cream	142	134	127	146	151
Consumer Packaged	34	41	40	48	51
Everyday Dairy	0	0	30	37	46
Specialty Ingredients	10	28	27	25	36
Total Gross Profit	186	204	223	255	284

Operating Costs (incl D&A)	-62	-80	-92	-98	-100
EBIT	125	123	131	157	183
Depreciation & Amortisation	-28	-48	-50	-57	-59
EBITDA	152	171	181	213	243

ROCE (pre tax) %	18	13	11	13	15
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Earnings revisions

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

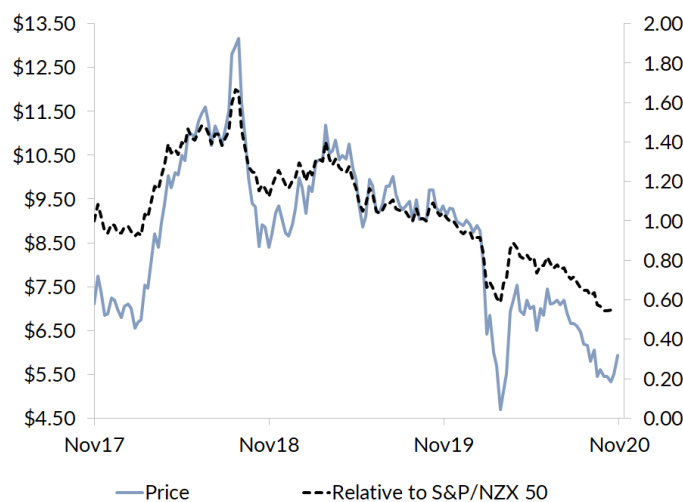
We also make modest downgrades to FY21 gross profit forecasts, albeit minor changes thereafter. The former reflects more conservative assumptions on:

- 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


Source: Forsyth Barr analysis

Figure 3. Substantial shareholders

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

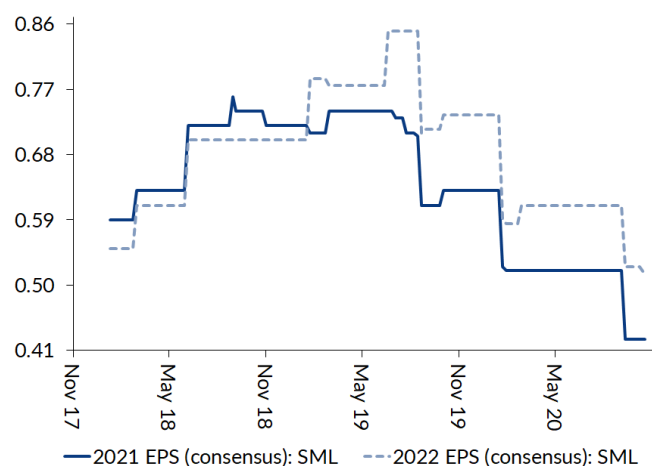
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

Figure 4. International valuation comparisons

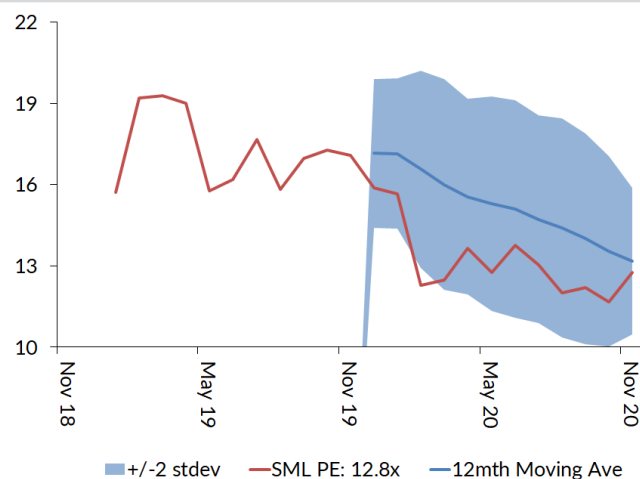
Company	Code	Price	Mkt Cap (m)	PE 2021E	PE 2022E	EV/EBITDA 2021E	EV/EBITDA 2022E	EV/EBIT 2021E	EV/EBIT 2022E	Cash Yld 2022E
(metrics re-weighted to reflect SML's balance date - July)										
Synlait Milk	SML NZ	NZ\$5.93	NZ\$1,296	14.1x	10.6x	10.0x	8.5x	13.9x	11.6x	0.0%
FONTERRA *	FSF NZ	NZ\$4.31	NZ\$6,954	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	CN¥39.44	CN¥239,922	30.3x	26.0x	19.6x	16.8x	24.7x	21.4x	2.5%
CHINA MENGNIU DAIRY CO	2319 HK	CN¥40.85	CN¥161,210	37.7x	28.6x	23.0x	18.3x	34.8x	25.2x	0.8%
AUSNUTRIA DAIRY CORP	1717 HK	CN¥11.28	CN¥19,350	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\$)


Source: Forsyth Barr analysis

Figure 6. One year forward PE (x)


Source: Forsyth Barr analysis

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