

# Synlait Milk

## Christmas Grinch — Part Two

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NEUTRAL 

Key customer The a2 Milk Company (ATM) blindsided the market and Synlait Milk (SML) with a substantial downgrade to its near-term volume expectations; which has flowed through to a sharp contraction in FY21 profit guidance for SML. 2020 has been an eventful year for SML, including: a key new customer win, settlement of its Pokeno dispute, a capital raise, and three material cuts to near-term earnings. It has reinforced (1) the pace at which the outlook can change, (2) SML's dependence on external factors outside of its control (e.g. customer decision making & demand), (3) lack of external visibility on key drivers, and (4) operating leverage given a large fixed cost base — painful in FY21, although leverage can work both ways. Valuation metrics are attractive assuming it executes on our near-term growth expectations, however, we require a higher margin of safety. NEUTRAL.

NZX Code	SML	Financials: Jul/	20A	21E	22E	23E	Valuation (x)	20A	21E	22E	23E
Share price	NZ\$4.85	NPAT* (NZ\$m)	75.2	38.4	59.7	89.7	PE	11.6	22.7	14.6	9.7
Target price	NZ\$5.50	EPS* (NZc)	42.0	21.4	33.3	50.0	EV/EBIT	12.1	18.7	13.7	10.0
Risk rating	High	EPS growth* (%)	-7.9	-49.0	55.7	50.3	EV/EBITDA	8.7	11.5	8.8	7.0
Issued shares	218.5m	DPS (NZc)	0.0	0.0	0.0	14.0	Price / NTA	1.7	1.4	1.3	1.2
Market cap	NZ\$1,060m	Imputation (%)	100	100	100	100	Cash div yld (%)	0.0	0.0	0.0	2.9
Avg daily turnover	177.6k (NZ\$1,112k)	*Based on normalised profits					Gross div yld (%)	0.0	0.0	0.0	4.0

### What's changed?

- **Earnings:** Material NPAT downgrades. FY21E -49%, FY22E -40% and FY23E -28%.
- **Target price:** NZ\$5.50 (prior NZ\$6.30) — materially lower DCF (earnings revisions), while price to book is only moderately lower.

### SML's guidance cut follows ATM's disappointing updated outlook; although the magnitude is larger given fixed cost base

SML materially lowered its FY21 guidance, with NPAT now expected to be "approximately half" that of FY20, or c.NZ\$38m. This compares to prior guidance provided on 10 November 2020, for NPAT "at or slightly below FY20". The downgrade follows the material reduction in volume expectations from ATM (SML is forecasting volumes down ~-35%) given its slower than anticipated recovery in the under-pressure daigou channel, which has not been made up for by other channels — refer our note *The a2 Milk Company: The Grinch Stole Christmas*, 21 December, for more detail. The impact of a material decline in Infant Formula (IF) volumes is significant on SML given operational de-leverage and as IF is its highest margin product, by some magnitude.

### Where to from here?

There are a lot of unknowns, with visibility low and accordingly a high margin of error in earnings forecasts. While FY21 is a much larger than expected step-back, we are forecasting an attractive medium-term growth profile as SML begins to leverage recent investment, ATM volumes return to growth, and its new customer starts from FY23E. Focus will be on execution, particularly leveraging recent investment / initiatives, to drive an improved return on capital following a disappointing FY21.

### Gearing returns to levels we were forecasting pre the recent capital raise

Our revised gearing expectations are for net debt to EBITDA of ~2.6x in FY21E. The profit contraction returns gearing near its internal long-term target (~2.5x) and levels we were forecasting pre capital raise. While disappointing, there is still reasonable headroom in its covenants. SML is nearing the end of its expansionary capex phase and this, coupled with expected earnings growth from FY22E, should see leverage reduce in the short to medium-term.

## Synlait Milk Ltd (SML)

Priced as at 21 Dec 2020 (NZ\$)

4.85

### 12-month target price (NZ\$)\*

5.50

Expected share price return

13.4%

Net dividend yield

0.0%

Estimated 12-month return

13.4%

### Spot valuations (NZ\$)

1. DCF

5.00

2. Price to book

5.22

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

1,529

(Net debt)/cash

(324)

Less: Capitalised operating leases

(112)

Value of equity

1,093

Profit and Loss Account (NZ\$m)	2019A	2020A	2021E	2022E	2023E
Sales revenue	1,024	1,302	1,078	1,261	1,511
<b>Normalised EBITDA</b>	<b>152</b>	<b>171</b>	<b>131</b>	<b>160</b>	<b>201</b>
Depreciation and amortisation	(28)	(48)	(50)	(57)	(59)
<b>Normalised EBIT</b>	<b>125</b>	<b>123</b>	<b>81</b>	<b>103</b>	<b>141</b>
Net interest	(9)	(21)	(27)	(20)	(17)
Associate income	(1)	0	0	0	0
Tax	(33)	(27)	(15)	(23)	(35)
Minority interests	0	0	0	0	0
<b>Normalised NPAT</b>	<b>82</b>	<b>75</b>	<b>38</b>	<b>60</b>	<b>90</b>
Abnormals/other	0	0	0	0	0
<b>Reported NPAT</b>	<b>82</b>	<b>75</b>	<b>38</b>	<b>60</b>	<b>90</b>
Normalised EPS (cps)	45.6	42.0	21.4	33.3	50.0
DPS (cps)	0	0	0	0	14.0

Valuation Ratios	2019A	2020A	2021E	2022E	2023E
EV/EBITDA (x)	8.4	8.7	11.5	8.8	7.0
EV/EBIT (x)	10.3	12.1	18.7	13.7	10.0
PE (x)	10.6	11.6	22.7	14.6	9.7
Price/NTA (x)	1.8	1.7	1.4	1.3	1.2
Free cash flow yield (%)	-18.9	-6.6	1.9	3.6	9.7
Net dividend yield (%)	0.0	0.0	0.0	0.0	2.9
Gross dividend yield (%)	0.0	0.0	0.0	0.0	4.0

Capital Structure	2019A	2020A	2021E	2022E	2023E
Interest cover EBIT (x)	13.2	5.8	2.9	5.1	8.4
Interest cover EBITDA (x)	16.1	8.0	4.8	7.8	12.0
Net debt/ND+E (%)	40.4	46.3	28.4	24.9	17.8
Net debt/EBITDA (x)	2.2	3.1	2.6	1.9	1.1

Growth Rates	2019A	2020A	2021E	2022E	2023E
Revenue (%)	16.5	27.1	-17.2	16.9	19.9
EBITDA (%)	9.7	12.6	-23.6	22.2	25.5
EBIT (%)	10.1	-1.0	-34.5	28.0	36.8
Normalised NPAT (%)	8.9	-7.9	-49.0	55.7	50.3
Normalised EPS (%)	8.9	-7.9	-49.0	55.7	50.3
Ordinary DPS (%)	n/a	n/a	n/a	n/a	n/a

Key Ratios	2019A	2020A	2021E	2022E	2023E
Return on assets (%)	10.8	8.3	5.3	6.6	8.8
Return on equity (%)	16.6	12.4	4.5	6.6	9.1
Return on funds employed (%)	12.6	8.7	4.4	5.8	8.1
EBITDA margin (%)	14.9	13.2	12.1	12.7	13.3
EBIT margin (%)	12.2	9.5	7.5	8.2	9.4
Capex to sales (%)	31.3	11.7	9.1	5.9	2.7
Capex to depreciation (%)	1,160	317	196	131	70
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	0	0	0	0	28

Cash Flow (NZ\$m)	2019A	2020A	2021E	2022E	2023E
<b>EBITDA</b>	<b>152</b>	<b>171</b>	<b>131</b>	<b>160</b>	<b>201</b>
Working capital change	12	(51)	30	(4)	(5)
Interest & tax paid	(44)	(50)	(42)	(44)	(52)
Other	(1)	12	(0)	(0)	0
<b>Operating cash flow</b>	<b>120</b>	<b>83</b>	<b>118</b>	<b>112</b>	<b>144</b>
Capital expenditure	(321)	(152)	(98)	(74)	(41)
(Acquisitions)/divestments	(18)	(73)	(28)	0	0
Other	0	(4)	(3)	(4)	(4)
<b>Funding available/(required)</b>	<b>(218)</b>	<b>(147)</b>	<b>(11)</b>	<b>35</b>	<b>99</b>
Dividends paid	0	0	0	0	(12)
Equity raised/(returned)	0	0	200	0	0
<b>(Increase)/decrease in net debt</b>	<b>(218)</b>	<b>(147)</b>	<b>189</b>	<b>35</b>	<b>87</b>

Operating Performance	2019A	2020A	2021E	2022E	2023E
<b>Sales volume</b>					
Powders & Cream (k MT)	107	101	142	143	136
Consumer Packaged (k MT)	43	49	32	37	43
Specialty Ingredients (MT)	21	30	32	32	33
<b>Total volume (k MT)</b>	<b>150</b>	<b>150</b>	<b>174</b>	<b>179</b>	<b>179</b>

Gross Profit (GP) breakdown	2019A	2020A	2021E	2022E	2023E
Powders & Cream	142	134	89	109	122
Consumer Packaged	34	41	27	31	37
Everyday Dairy	0	0	30	37	46
Specialty Ingredients	13	28	27	25	23
Other	(3)	0	0	0	14
<b>Total Gross Profit</b>	<b>186</b>	<b>204</b>	<b>173</b>	<b>202</b>	<b>242</b>

Operating Costs (incl D&A)	2019A	2020A	2021E	2022E	2023E
<b>EBIT</b>	<b>125</b>	<b>123</b>	<b>81</b>	<b>103</b>	<b>141</b>
Depreciation & Amortisation	(28)	(48)	(50)	(57)	(59)
<b>EBITDA</b>	<b>152</b>	<b>171</b>	<b>131</b>	<b>160</b>	<b>201</b>
ROCE (pre tax) %	18	13	7	9	12

Balance Sheet (NZ\$m)	2019A	2020A	2021E	2022E	2023E
Working capital	11	94	64	68	73
Fixed assets	845	965	1,046	1,069	1,056
Intangibles	22	108	107	106	105
Right of use asset	0	18	18	17	16
Other assets	40	62	62	62	62
<b>Total funds employed</b>	<b>918</b>	<b>1,248</b>	<b>1,297</b>	<b>1,322</b>	<b>1,312</b>
Net debt/(cash)	333	524	334	300	213
Lease liability	0	19	19	19	19
Other liabilities	93	98	98	98	98
Shareholder's funds	492	606	845	905	982
Minority interests	0	0	0	0	0
<b>Total funding sources</b>	<b>918</b>	<b>1,248</b>	<b>1,297</b>	<b>1,322</b>	<b>1,312</b>

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

## Earnings changes

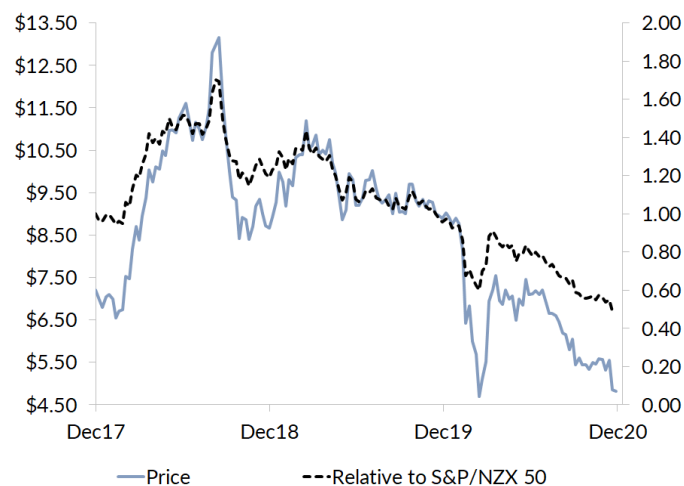
We make material downgrades to our earnings forecasts, due to lower volume expectations for key finished IF customer, ATM. This also negatively impacts margins given (1) negative mix effect – with IF its highest margin product, by some magnitude; and (2) lower manufacturing cost recovery for a high fixed cost base.

We also make some adjustments to working capital – IF base powder inventory will take longer to sell down, while a greater mix of Ingredients production through 2H21 is positive, given the shorter time to sell.

**Figure 1. Earnings revisions (NZ\$m)**

NZ\$m	FY21E			FY22E			FY23E		
	Old	New	% chg	Old	New	% chg	Old	New	% chg
Gross profit	223	173	-22.6%	255	202	-20.9%	284	242	-14.8%
<b>EBITDA</b>	<b>181</b>	<b>131</b>	<b>-27.8%</b>	<b>213</b>	<b>160</b>	<b>-25.1%</b>	<b>243</b>	<b>201</b>	<b>-17.3%</b>
<b>Underlying NPAT</b>	<b>75</b>	<b>38</b>	<b>-49.2%</b>	<b>100</b>	<b>60</b>	<b>-40.5%</b>	<b>124</b>	<b>90</b>	<b>-27.6%</b>
Underlying EPS (cps)	36.2	18.4	-49.2%	45.9	27.3	-40.5%	56.7	41.1	-27.6%
Dividend (cps)	0.0	0.0	n/a	0.0	0.0	n/a	20.0	14.0	-30.0%

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	6.7%

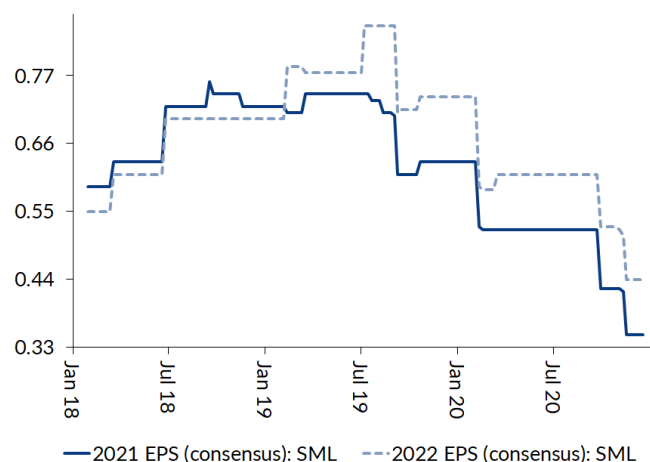
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

**Figure 4. International valuation comparisons**

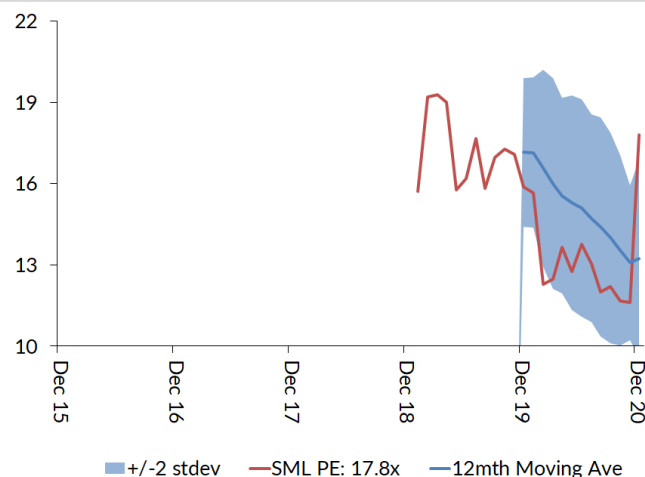
Company	Code	Price	Mkt Cap	PE	EV/EBITDA	EV/EBIT	Cash Yld
(metrics re-weighted to reflect SML's balance date - July)							
Synlait Milk	SML NZ	NZ\$4.85	NZ\$1,060	22.7x	14.6x	12.1x	0.0%
FONTERRA *	FSF NZ	NZ\$4.37	NZ\$7,050	15.0x	13.5x	8.0x	3.7%
BEGA CHEESE	BGA AU	A\$5.36	A\$1,505	25.7x	19.0x	14.6x	2.8%
SAPUTO INC	SAP CN	C\$36.99	C\$15,171	21.4x	18.9x	12.3x	n/a
NESTLE SA-REG	NESN SW	CHF99.62	CHF287,005	22.8x	21.3x	16.9x	2.9%
DANONE	BN FP	€52.50	€36,048	15.7x	14.6x	11.0x	4.2%
INNER MONGOLIA YILI INDUS-A	600887 CH	CNY40.40	CNY245,762	31.0x	26.6x	20.0x	2.5%
CHINA MENGNIU DAIRY CO	2319 HK	CNY43.35	CNY171,112	40.0x	29.9x	24.7x	0.7%
AUSNUTRIA DAIRY CORP	1717 HK	CNY11.10	CNY19,041	14.6x	11.6x	10.4x	3.0%
KERRY GROUP PLC-A	KYG ID	€119.90	€21,186	32.1x	28.8x	22.1x	0.8%
Compco Average:				24.2x	20.5x	15.5x	2.6%
SML Relative:				-6%	-29%	-22%	-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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