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# Synlait Milk
## FY21 Guidance Withdrawn — As Clear As Milk


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## NEUTRAL

Synlait Milk (SML) has withdrawn its FY21 guidance, signalling prior guidance (for NPAT down ~-50%) is no longer attainable; the third downgrade in five months. SML will see a profit crunch in FY21E, primarily due to substantially lower Infant Formula (IF) volumes and accordingly a much higher weighting to low margin commodity Ingredients production. Detail is lacking and the backdrop volatile; accordingly there is a high margin of error in forecasts. Valuation metrics are undemanding (and marginally below Fonterra) — trading at ~1.05x FY21E book value. We believe a modest premium to book is justified, particularly to factor in the value of its China license. Confidence has been dented by the recent downgrade cycle — we expect this will take time to rebuild, reliant on improved clarity on the near-term earnings path, gearing and levers available to help offset any sustained pressure/volatility. We require a higher margin of safety for a directional call. NEUTRAL.

| NZX Code | SML |
|---|---|
| Share price | NZ$3.46 |
| Target price | NZ$3.90 |
| Risk rating | High |
| Issued shares | 218.5m |
| Market cap | NZ$756m |
| Avg daily turnover | 175.5k (NZ$1,015k) |

| Financials: Jul/ | 20A | 21E | 22E | 23E |
|---|---|---|---|---|
| NPAT* (NZ$m) | 75.2 | 29.3 | 52.8 | 78.2 |
| EPS* (NZc) | 42.0 | 14.0 | 24.1 | 35.8 |
| EPS growth* (%) | -7.9 | -66.6 | 72.2 | 48.2 |
| DPS (NZc) | 0.0 | 0.0 | 0.0 | 0.0 |
| Imputation (%) | 100 | 100 | 100 | 100 |
| *Based on normalised profits | | | | |

| Valuation (x) | 20A | 21E | 22E | 23E |
|---|---|---|---|---|
| PE | 8.2 | 24.7 | 14.3 | 9.7 |
| EV/EBIT | 9.7 | 17.6 | 12.0 | 9.1 |
| EV/EBITDA | 7.0 | 10.2 | 7.6 | 6.2 |
| Price / NTA | 1.2 | 1.0 | 1.0 | 0.9 |
| Cash div yld (%) | 0.0 | 0.0 | 0.0 | 0.0 |
| Gross div yld (%) | 0.0 | 0.0 | 0.0 | 0.0 |

### What's changed?

- **Earnings:** Materially lowered — FY21E NPAT down -24%, FY22E -12%, FY23E -13%.
- **Target price:** NZ$3.90; downgraded due to earnings revisions, revised cost of capital inputs and lower price to book multiple.

### Prior FY21 guidance pulled

FY21E profit will be substantially below historic levels, and we expect near-term returns will be well below WACC. Key drivers include: (1) lower demand from key customer The a2 Milk Company (ATM), due to COVID-19 headwinds for its English label IF, and excess inventory levels which will take time to run-down; (2) global shipping delays; (3) volatile commodity prices. Detail is lacking, particularly around the magnitude of each driver. We will be looking for better clarity at the 1H21 result on Monday 29 March.

### Where to from here?

There are a lot of unknowns, with visibility low and accordingly a high margin of error in earnings forecasts. This is only amplified by a volatile backdrop and high operating leverage given a large fixed cost base. Our base case is for some recovery in FY22E, factoring in a return to growth for ATM and normalisation in inventory ordering, coupled with a reversal of temporary phasing issues from global supply chain challenges. We assume a more meaningful step-up in FY23E, aligned to our ATM volume growth expectations and the first-time impact of SML's new multi-national customer contract.

### Gearing returns to elevated levels near-term

We expect gearing to return into focus — with questions likely until we have improved clarity on the near-term earnings profile. Our revised forecast is for net debt to EBITDA of ~3.2x in FY21E, above its internal long-term target (~2.5x) albeit well within covenants (total leverage ratio ~4x). 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 medium-term.

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# Synlait Milk Ltd (SML)

| | |
|---|---|
| Priced as at 04 Mar 2021 (NZ$) | 3.46 |

| 12-month target price (NZ$)* | 3.90 |
|---|---|
| Expected share price return | 12.7% |
| Net dividend yield | 0.0% |
| Estimated 12-month return | 12.7% |

| Key WACC assumptions | |
|---|---|
| Risk free rate | 2.30% |
| Equity beta | 1.08 |
| WACC | 7.3% |
| Terminal growth | 1.5% |

| Profit and Loss Account (NZ$m) | 2019A | 2020A | 2021E | 2022E | 2023E |
|---|---|---|---|---|---|
| Sales revenue | 1,024 | 1,302 | 1,010 | 1,205 | 1,422 |
| **Normalised EBITDA** | **152** | **171** | **120** | **153** | **188** |
| Depreciation and amortisation | (28) | (48) | (50) | (57) | (60) |
| **Normalised EBIT** | **125** | **123** | **70** | **96** | **128** |
| Net interest | (9) | (21) | (29) | (23) | (19) |
| Associate income | (1) | 0 | 0 | 0 | 0 |
| Tax | (33) | (27) | (11) | (21) | (30) |
| Minority interests | 0 | 0 | 0 | 0 | 0 |
| **Normalised NPAT** | **82** | **75** | **29** | **53** | **78** |
| Abnormals/other | 0 | 0 | 0 | 0 | 0 |
| **Reported NPAT** | **82** | **75** | **29** | **53** | **78** |
| Normalised EPS (cps) | 45.6 | 42.0 | 14.0 | 24.1 | 35.8 |
| DPS (cps) | 0 | 0 | 0 | 0 | 0 |

| Growth Rates | 2019A | 2020A | 2021E | 2022E | 2023E |
|---|---|---|---|---|---|
| Revenue (%) | 16.5 | 27.1 | -22.4 | 19.3 | 18.0 |
| EBITDA (%) | 9.7 | 12.6 | -30.0 | 27.4 | 23.1 |
| EBIT (%) | 10.1 | -1.0 | -43.3 | 37.8 | 33.0 |
| Normalised NPAT (%) | 8.9 | -7.9 | -61.1 | 80.3 | 48.2 |
| Normalised EPS (%) | 8.9 | -7.9 | -66.6 | 72.2 | 48.2 |
| Ordinary DPS (%) | n/a | n/a | n/a | n/a | n/a |

| Cash Flow (NZ$m) | 2019A | 2020A | 2021E | 2022E | 2023E |
|---|---|---|---|---|---|
| **EBITDA** | **152** | **171** | **120** | **153** | **188** |
| Working capital change | 12 | (51) | (11) | 17 | 11 |
| Interest & tax paid | (44) | (50) | (41) | (43) | (50) |
| Other | (1) | 12 | 0 | 0 | (0) |
| **Operating cash flow** | **120** | **83** | **68** | **126** | **150** |
| Capital expenditure | (321) | (152) | (98) | (74) | (77) |
| (Acquisitions)/divestments | (18) | (73) | (28) | 0 | 0 |
| Other | 0 | (4) | (3) | (4) | (4) |
| **Funding available/(required)** | **(218)** | **(147)** | **(61)** | **49** | **69** |
| Dividends paid | 0 | 0 | 0 | 0 | 0 |
| Equity raised/(returned) | 0 | 0 | 200 | 0 | 0 |
| **(Increase)/decrease in net debt** | **(218)** | **(147)** | **139** | **49** | **69** |

| Balance Sheet (NZ$m) | 2019A | 2020A | 2021E | 2022E | 2023E |
|---|---|---|---|---|---|
| Working capital | 11 | 94 | 105 | 88 | 76 |
| Fixed assets | 845 | 965 | 1,046 | 1,069 | 1,091 |
| Intangibles | 22 | 108 | 107 | 106 | 105 |
| Right of use asset | 0 | 18 | 18 | 17 | 16 |
| Other assets | 40 | 62 | 62 | 62 | 62 |
| **Total funds employed** | **918** | **1,248** | **1,338** | **1,342** | **1,351** |
| Net debt/(cash) | 333 | 524 | 384 | 336 | 267 |
| Lease liability | 0 | 19 | 19 | 19 | 19 |
| Other liabilities | 93 | 98 | 98 | 98 | 98 |
| Shareholder's funds | 492 | 606 | 836 | 889 | 967 |
| Minority interests | 0 | 0 | 0 | 0 | 0 |
| **Total funding sources** | **918** | **1,248** | **1,338** | **1,342** | **1,351** |

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

| Spot valuations (NZ$) | |
|---|---|
| 1. DCF | 3.86 |
| 2. Price to book | 3.97 |
| n/a | n/a |

| DCF valuation summary (NZ$m) | |
|---|---|
| Total firm value | 1,258 |
| (Net debt)/cash | (324) |
| Less: Capitalised operating leases | (91) |
| Value of equity | 844 |

| Valuation Ratios | 2019A | 2020A | 2021E | 2022E | 2023E |
|---|---|---|---|---|---|
| EV/EBITDA (x) | 6.4 | 7.0 | 10.2 | 7.6 | 6.2 |
| EV/EBIT (x) | 7.9 | 9.7 | 17.6 | 12.0 | 9.1 |
| PE (x) | 7.6 | 8.2 | 24.7 | 14.3 | 9.7 |
| Price/NTA (x) | 1.3 | 1.2 | 1.0 | 1.0 | 0.9 |
| Free cash flow yield (%) | -26.5 | -9.2 | -3.9 | 6.9 | 9.6 |
| 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 | 2019A | 2020A | 2021E | 2022E | 2023E |
|---|---|---|---|---|---|
| Interest cover EBIT (x) | 13.2 | 5.8 | 2.4 | 4.2 | 6.6 |
| Interest cover EBITDA (x) | 16.1 | 8.0 | 4.1 | 6.7 | 9.7 |
| Net debt/ND+E (%) | 40.4 | 46.3 | 31.5 | 27.4 | 21.6 |
| Net debt/EBITDA (x) | 2.2 | 3.1 | 3.2 | 2.2 | 1.4 |

| Key Ratios | 2019A | 2020A | 2021E | 2022E | 2023E |
|---|---|---|---|---|---|
| Return on assets (%) | 10.8 | 8.3 | 4.6 | 6.1 | 7.8 |
| Return on equity (%) | 16.6 | 12.4 | 3.5 | 5.9 | 8.1 |
| Return on funds employed (%) | 12.6 | 8.7 | 3.6 | 5.1 | 7.1 |
| EBITDA margin (%) | 14.9 | 13.2 | 11.9 | 12.7 | 13.2 |
| EBIT margin (%) | 12.2 | 9.5 | 6.9 | 8.0 | 9.0 |
| Capex to sales (%) | 31.3 | 11.7 | 9.7 | 6.2 | 5.4 |
| Capex to depreciation (%) | 1,160 | 317 | 196 | 131 | 128 |
| Imputation (%) | 100 | 100 | 100 | 100 | 100 |
| Pay-out ratio (%) | 0 | 0 | 0 | 0 | 0 |

| Operating Performance | 2019A | 2020A | 2021E | 2022E | 2023E |
|---|---|---|---|---|---|
| **Sales volume** | | | | | |
| Powders & Cream (k MT) | 107 | 101 | 147 | 146 | 139 |
| Consumer Packaged (k MT) | 43 | 49 | 27 | 33 | 41 |
| Specialty Ingredients (MT) | 21 | 30 | 32 | 32 | 33 |
| **Total volume (k MT)** | **150** | **150** | **174** | **179** | **179** |
| | | | | | |
| **Gross Profit (GP) breakdown** | | | | | |
| Powders & Cream | 142 | 134 | 82 | 101 | 115 |
| Consumer Packaged | 34 | 41 | 23 | 28 | 35 |
| Everyday Dairy | 0 | 0 | 30 | 38 | 46 |
| Specialty Ingredients | 13 | 28 | 27 | 25 | 23 |
| Other | (3) | 0 | 0 | 0 | 8 |
| **Total Gross Profit** | **186** | **204** | **162** | **193** | **228** |
| | | | | | |
| Operating Costs (incl D&A) | (62) | (80) | (92) | (97) | (99) |
| **EBIT** | **125** | **123** | **70** | **96** | **128** |
| Depreciation & Amortisation | (28) | (48) | (50) | (57) | (60) |
| **EBITDA** | **152** | **171** | **120** | **153** | **188** |
| | | | | | |
| ROCE (pre tax) % | 18 | 13 | 6 | 8 | 10 |

# Earnings revisions

We make material downgrades to our earnings forecasts, due to:

- Lower order 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 recoveries given its high fixed cost base.
- Higher Ingredients volumes: With SML utilising capacity available due to the lower IF volumes. Our assumed gross margin for Ingredients is materially lower than for finished IF (pre COVID we estimated Ingredients margins were ~20% of finished IF).
- Lower Ingredients margins: We assume higher milk price assumptions have a negative impact near-term.
- Short-term pressure from supply chain challenges.

We assume a return to growth from FY22E, off a low base. This reflects an easing of some COVID-19 headwinds and a recovery (and return to growth) for ATM's volumes. SML's new customer begins in FY23E which helps support a further step-up in profitability.

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

| | | FY21E | | | FY22E | | | FY23E | |
|---|---|---|---|---|---|---|---|---|---|
| **NZ$m** | **Old** | **New** | **% chg** | **Old** | **New** | **% chg** | **Old** | **New** | **% chg** |
| Gross profit | 173 | 162 | -6.3% | 202 | 193 | -4.4% | 242 | 228 | -5.9% |
| EBIT | 81 | 70 | -13.5% | 103 | 96 | -6.8% | 141 | 128 | -9.4% |
| **Underlying NPAT** | **38** | **29** | **-23.7%** | **60** | **53** | **-11.6%** | **90** | **78** | **-12.8%** |
| Underlying EPS (cps) | 18.4 | 14.0 | -23.7% | 27.3 | 24.1 | -11.6% | 41.1 | 35.8 | -12.8% |
| Dividend (cps) | 0.0 | 0.0 | n/a | 0.0 | 0.0 | n/a | 14.0 | 0.0 | n/a |

Source: Forsyth Barr analysis

We lower our SML target price to NZ$3.90. This reflects (1) materially lower earnings expectations, (2) lower ROIC profile through our forecast horizon, (3) lower price to book multiple applied — reflecting reduced confidence in the returns profile, and (4) a modest lift in our cost of capital (to 7.3% from 7.0%) following changes to our team inputs, given higher interest rates — refer our strategy report, Still a One Way Bet? — Updated WACC Assumptions, published 12 February 2021.

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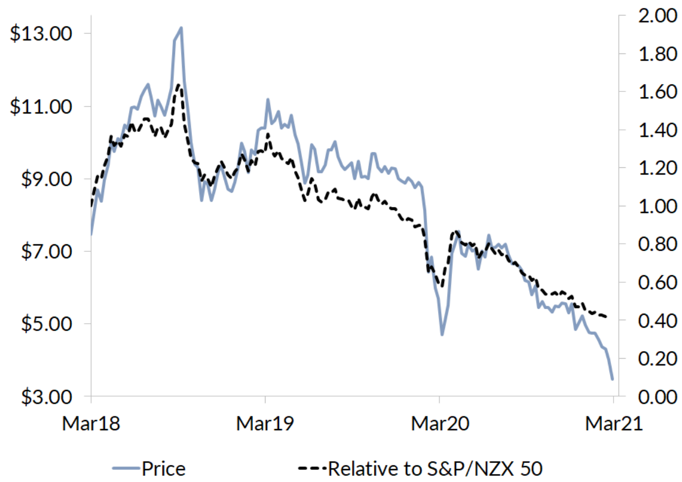
## Figure 2. Price performance




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% |

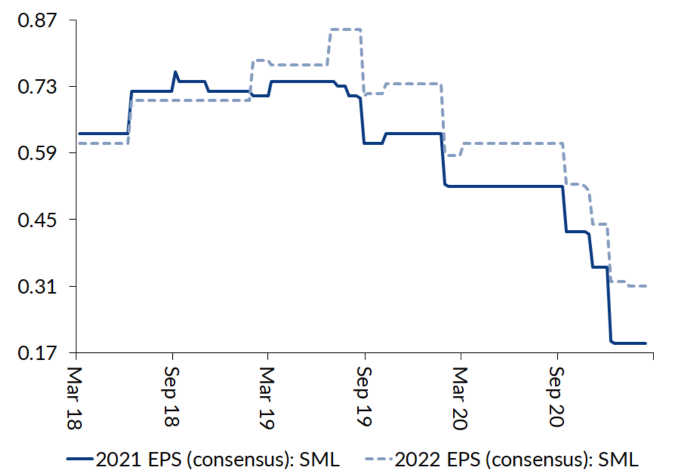
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

## 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) | | | (m) | 2021E | 2022E | 2021E | 2022E | 2021E | 2022E | 2022E |
| **Synlait Milk** | **SML NZ** | **NZ$3.46** | **NZ$756** | **24.7x** | **14.3x** | **10.7x** | **8.4x** | **18.3x** | **13.3x** | **0.0%** |
| FONTERRA * | FSF NZ | NZ$5.09 | NZ$8,212 | 17.5x | 15.7x | 8.8x | 8.6x | 15.4x | 14.7x | 3.1% |
| BEGA CHEESE | BGA AU | A$6.00 | A$1,814 | 35.0x | 19.7x | 14.4x | 8.8x | 25.6x | 13.8x | 2.5% |
| SAPUTO INC | SAP CN | C$36.18 | C$14,869 | 20.5x | 18.0x | 11.8x | 10.8x | 17.4x | 15.1x | n/a |
| NESTLE SA-REG | NESN SW | CHF96.96 | CHF279,342 | 22.3x | 21.3x | 16.8x | 16.2x | 20.7x | 20.0x | 3.0% |
| DANONE | BN FP | €55.32 | €37,984 | 17.4x | 15.7x | 11.8x | 11.2x | 16.6x | 14.7x | 3.8% |
| INNER MONGOLIA YILI INDUS-A | 600887 CH | CN¥41.67 | CN¥253,463 | 31.5x | 27.0x | 20.5x | 17.6x | 26.0x | 22.5x | 2.5% |
| CHINA MENGNIU DAIRY CO | 2319 HK | CN¥40.00 | CN¥157,928 | 36.9x | 27.6x | 22.7x | 17.8x | 34.1x | 24.6x | 0.8% |
| AUSNUTRIA DAIRY CORP | 1717 HK | CN¥12.04 | CN¥20,661 | 16.1x | 13.0x | 11.5x | 9.3x | 13.2x | 10.4x | 2.7% |
| KERRY GROUP PLC-A | KYG ID | €106.00 | €18,732 | 30.1x | 26.0x | 20.6x | 18.2x | 27.0x | 24.1x | 0.9% |
| | | | **Compco Average:** | **25.3x** | **20.4x** | **15.4x** | **13.2x** | **21.8x** | **17.8x** | **2.4%** |
| EV = Current Market Cap + Actual Net Debt | | | **SML Relative:** | **-2%** | **-30%** | **-31%** | **-36%** | **-16%** | **-25%** | **-100%** |

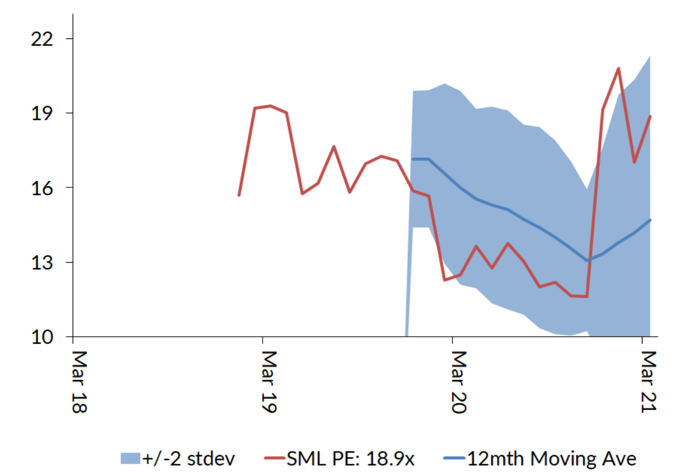
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (SML) companies fiscal year end

## 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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