The a2 Milk Company
FY20 Guidance — Healthy Demand

CHELSEA LEADBETTER CFA
chelsea.leadbetter@forsythbarr.co.nz
+64 4 495 5262

OUTPERFORM

The a2 Milk Company (ATM) provided FY20 guidance for another stellar year, ahead of prior expectations, as demand remains strong for its products. In what has been a highly dynamic environment, with no shortage of challenges, ATM and its supply chain partners have navigated impressively. In the current uncertain backdrop, ATM ticks a number of boxes with (1) a product in strong demand, (2) a large (and growing) net cash position, (3) attractive growth outlook with a long runway still remaining, in our view and (4) track record of execution. Despite recent share price strength, valuation metrics (EV/EBIT ~19x, PE ~28x adjusted for US losses/cash) still seem reasonable relative to other Australasian growth companies, particularly given ATM's growth outlook, recent earnings upgrades and defensive product characteristics. OUTPERFORM.

NZX Code	ATM
Share price	NZ$19.75
Target price	NZ$21.50
Risk rating	High
Issued shares	733.1m
Market cap	NZ$14,480m
Avg daily turnover	779.1k (NZ$11,973k)

Financials: Jun/	19A	20E	21E	22E
NPAT* (NZ$m)	287.7	383.6	456.4	549.0
EPS* (NZc)	38.8	51.7	61.5	74.0
EPS growth* (%)	47.4	33.3	19.0	20.3
DPS (NZc)	0.0	0.0	0.0	22.2
Imputation (%)	100	100	100	100

*Based on normalised profits

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	33.5	24.7	20.6	17.2
EV/EBIT	33.6	24.9	20.7	17.3
PE	n/a	38.2	32.1	26.7
Price / NTA	18.7	12.5	9.0	6.9
Cash div yld (%)	0.0	0.0	0.0	1.1
Gross div yld (%)	0.0	0.0	0.0	1.6

FY20 guidance ahead of prior consensus and confirms strong recent trading

ATM provided FY20 guidance ahead of our expectations, although at least partially due to some temporary factors. Guidance implies EBITDA of NZ$527–560m; growth of +27–35% on the prior year.

- **Modest revenue beat:** FY20 guidance of NZ$1.7–1.75bn (+30–34% YoY growth), modestly ahead of prior market expectations. 3Q revenue was above ATM's expectations, primarily attributed to changes in consumer purchasing behaviour due to COVID-19.
- **EBITDA margin guidance lifted:** ATM also revised its EBITDA margin guidance higher to 31–32% (prior 29–30%), predominantly helped by temporary factors (including travel restrictions, delay to some recruitment and FX), albeit also benefitting from strong revenue momentum. There is no change to ATM's medium-term EBITDA margin target of "in the order of 30%".

Aligns with our recent channel checks; we still see further runway for 'Brand NZ'

ATM's update aligns with our channel checks in recent weeks suggesting (1) demand is strong for NZ-sourced products helped by the favourable global perception of NZ's management of COVID-19, particularly vs other countries, (2) increased demand for consumer staple and health & wellness related product categories, and (3) an acceleration in online penetration. ATM is well positioned to benefit from all these trends. Industry trends and market anecdotes are supportive to growing demand continuing in the near-term.

Brand momentum remains strong, with no signs of slowing; upgrade to our EPS forecasts +4–8%

ATM's outlook commentary confirms strong recent trading, however, little detail makes it difficult to judge what is factored in for the balance of the year. The key near-term unknown is consumer 'pantry stocking', and the extent that it has driven a strong 3Q. There is some risk near-term demand could ease as pantry stocks unwind and it is unclear if this has been factored into FY20 guidance; we expect it has. While longer-term EBITDA margin guidance has been retained, we see scope for this to continue to be exceeded in the near-term in light of favourable product mix (growing Stage 4) and an easing in input costs which should benefit 1H21. We upgrade our forecasts +4–8% and lift our target price to NZ$21.50.

The a2 Milk Company (ATM)

Priced as at 22 Apr 2020 (NZ$)	**19.75**

12-month target price (NZ$)*	**21.50**
Expected share price return	8.9%
Net dividend yield	0.0%
Estimated 12-month return	8.9%

Spot valuations (NZ$)	
1. DCF	19.18
2. Peer multiple	20.20
n/a	n/a

Key WACC assumptions	
Risk free rate	2.00%
Equity beta	0.88
WACC	8.5%
Terminal growth	2.0%

DCF valuation summary (NZ$m)	
Total firm value	13,615
(Net debt)/cash	465
Less: Capitalised operating leases	(18)
Value of equity	14,061

Profit and Loss Account (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Sales revenue	922.7	1,304.5	1,741.9	2,100.6	2,526.5
Normalised EBITDA	**283.0**	**413.6**	**549.3**	**649.9**	**778.5**
Depreciation and amortisation	(2.2)	(2.2)	(3.6)	(3.7)	(3.8)
Normalised EBIT	**280.9**	**411.4**	**545.7**	**646.2**	**774.7**
Net interest	2.4	4.3	6.3	10.4	15.2
Associate income	0	0	0	0	0
Tax	(87.5)	(128.0)	(168.4)	(200.3)	(240.9)
Minority interests	0	0	0	0	0
Normalised NPAT	**195.7**	**287.7**	**383.6**	**456.4**	**549.0**
Abnormals/other	0	0	0	0	0
Reported NPAT	**195.7**	**287.7**	**383.6**	**456.4**	**549.0**
Normalised EPS (cps)	26.3	38.8	51.7	61.5	74.0
DPS (cps)	0	0	0	0	22.2

Valuation Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EV/EBITDA (x)	49.9	33.5	24.7	20.6	17.2
EV/EBIT (x)	50.3	33.6	24.9	20.7	17.3
PE (x)	75.1	50.9	38.2	32.1	26.7
Price/NTA (x)	26.5	18.7	12.5	9.0	6.9
Free cash flow yield (%)	1.6	2.0	2.4	3.1	3.7
Net dividend yield (%)	0.0	0.0	0.0	0.0	1.1
Gross dividend yield (%)	0.0	0.0	0.0	0.0	1.6

Capital Structure	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Interest cover EBIT (x)	n/a	n/a	n/a	n/a	n/a
Interest cover EBITDA (x)	n/a	n/a	n/a	n/a	n/a
Net debt/ND+E (%)	-158.2	-143.9	-211.0	-319.2	-432.4
Net debt/EBITDA (x)	n/a	n/a	n/a	n/a	n/a

Growth Rates	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Revenue (%)	67.9	41.4	33.5	20.6	20.3
EBITDA (%)	>100	46.1	32.8	18.3	19.8
EBIT (%)	>100	46.5	32.6	18.4	19.9
Normalised NPAT (%)	>100	47.0	33.3	19.0	20.3
Normalised EPS (%)	>100	47.4	33.3	19.0	20.3
Ordinary DPS (%)	n/a	n/a	n/a	n/a	n/a

Key Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Return on assets (%)	39.2	41.4	37.1	32.6	30.5
Return on equity (%)	35.2	36.5	32.8	28.1	26.0
Return on funds employed (%)	116.0	106.3	109.0	118.3	138.4
EBITDA margin (%)	30.7	31.7	31.5	30.9	30.8
EBIT margin (%)	30.4	31.5	31.3	30.8	30.7
Capex to sales (%)	0.5	0.3	0.2	0.2	0.1
Capex to depreciation (%)	223	155	93	91	89
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	0	0	0	0	30

Cash Flow (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EBITDA	**283.0**	**413.6**	**549.3**	**649.9**	**778.5**
Working capital change	36.1	(6.5)	(33.3)	(12.4)	(9.3)
Interest & tax paid	(66.9)	(129.6)	(162.0)	(189.9)	(225.7)
Other	(21.1)	11.6	0	0	0
Operating cash flow	**231.1**	**289.1**	**354.0**	**447.7**	**543.5**
Capital expenditure	(4.8)	(3.4)	(3.4)	(3.4)	(3.4)
(Acquisitions)/divestments	(16.1)	(162.3)	(21.6)	0	0
Other	0	0	0.7	0.8	0.9
Funding available/(required)	**210.2**	**123.4**	**329.7**	**445.1**	**541.1**
Dividends paid	0	0	0	0	(65.1)
Equity raised/(returned)	7.3	2.9	0	0	0
(Increase)/decrease in net debt	**217.5**	**126.3**	**329.7**	**445.1**	**476.0**

Operating Performance	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Revenue (breakdown by product)					
Total Infant Formula	724	1,064	1,443	1,737	2,079
Total Fresh Milk	142	175	220	273	344
Other	56	66	78	90	104
Total	**923**	**1,304**	**1,742**	**2,100**	**2,526**
Revenue (breakdown by country)					
Australia & NZ	656	843	952	962	990
China & Other Asia	234	406	722	1,025	1,356
US	13	35	68	113	180
Other	19	22	0	0	0
Total	**923**	**1,304**	**1,742**	**2,100**	**2,526**
EBITDA insights					
Gross margin	50	55	56	57	57
Gross profit	464	714	983	1,200	1,439
Total SG&A expenses	(181)	(300)	(434)	(550)	(660)
incl marketing expenses	(74)	(135)	(206)	(260)	(313)
Total SG&A as % of revenue	19.7	23.0	24.9	26.2	26.1
Group EBITDA	**283**	**414**	**549**	**650**	**779**
US - EBITDA losses	(29)	(44)	(56)	(54)	(47)
EBITDA excluding US losses	**312**	**458**	**605**	**703**	**825**

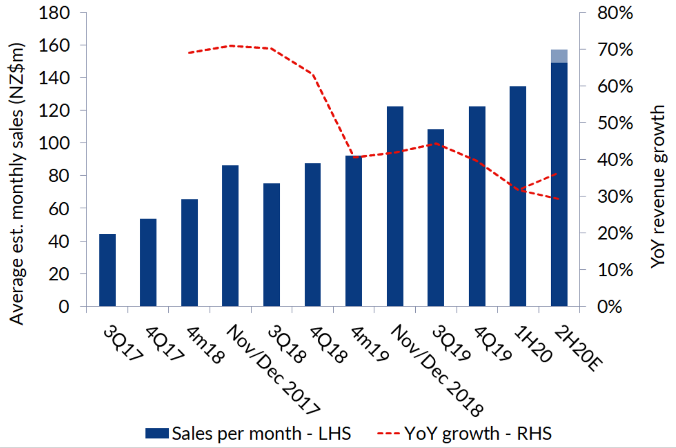
Balance Sheet (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Working capital	14.3	1.0	40.2	52.6	61.9
Fixed assets	9.7	10.3	33.1	34.2	35.3
Intangibles	15.1	13.0	13.0	13.0	13.0
Right of use asset	0	0	15.7	16.2	16.7
Other assets	227.7	344.2	366.1	380.8	398.3
Total funds employed	**266.8**	**368.4**	**468.1**	**496.9**	**525.2**
Net debt/(cash)	(340.5)	(464.8)	(794.2)	(1,238.8)	(1,714.4)
Lease liability	0	0	18.5	20.8	23.3
Other liabilities	51.6	45.4	73.2	88.0	105.5
Shareholder's funds	555.7	787.9	1,170.6	1,626.9	2,110.8
Minority interests	0	0	0	0	0
Total funding sources	**266.8**	**368.4**	**468.1**	**496.9**	**525.2**

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

Key charts and tables

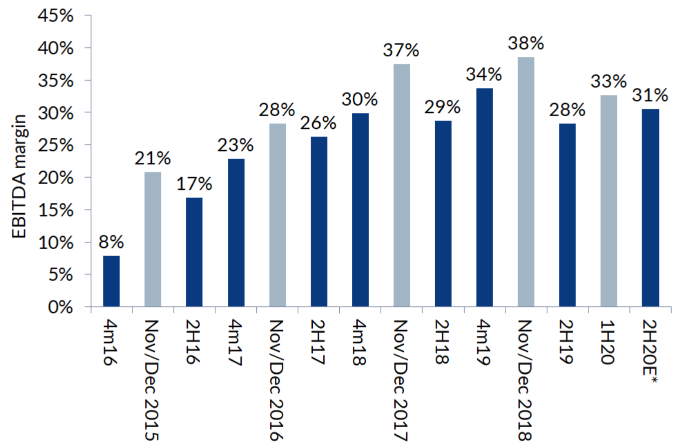
ATM provided FY20 guidance for revenue of NZ$1.7–1.75bn (+30-34% YoY) and EBITDA margins of 31–32%. Trends in both key metrics remain strong, refer Figure 1 and Figure 2.

Figure 1. Revenue growth trajectory



Source: Forsyth Barr analysis, Company reports

Figure 2. Margin trajectory



Source: Forsyth Barr analysis, Company reports *Using ATM guidance mid-point. Light blue bars are boosted by Singles Day volumes in November

We upgrade our FY20 expectations to the upper end of company guidance, predominantly due to higher assumptions for infant formula sales into China and lower costs. We lift forecasts thereafter, reflecting our view that positive revenue momentum/market share gains continue, and modestly higher margin assumptions (benefits of lower input costs and product mix). We also factor in ATM's recent small additional investment in Synlait Milk. We lift our target price to NZ$21.50, primarily underpinned by the earnings revisions across our explicit DCF horizon.

Figure 3. Earnings revisions

		FY20E			FY21E			FY22E	
NZ$m	**Old**	**New**	**% chg**	**Old**	**New**	**% chg**	**Old**	**New**	**% chg**
Revenue	1,673.7	1,741.9	4.1%	2,062.8	2,100.6	1.8%	2,478.5	2,526.5	1.9%
EBITDA	**507.0**	**549.3**	**8.3%**	**624.5**	**649.9**	**4.1%**	**750.5**	**778.5**	**3.8%**
Underlying profit	354.1	383.6	8.3%	438.4	456.4	4.3%	529.0	549.0	3.9%
Underlying EPS (cps)	47.7	51.7	8.3%	59.1	61.5	4.2%	71.3	74.0	3.9%
Dividend (cps)	0.0	0.0	n/a	0.0	0.0	n/a	21.4	22.2	3.9%

Source: Forsyth Barr analysis

Investment Summary

The a2 Milk Company (ATM) has seen unprecedented success to date, primarily underpinned by infant formula (IF) in China, leveraging a strong market position in Australia. This market alone offers meaningful runway for growth as ATM broadens its routes to market. OUTPERFORM.

Business quality

- **Building a brand:** ATM has created a product in demand with little capital investment and highly attractive profit margins. Its success to date has been primarily driven by IF in China, leveraging a strong position in fresh milk in Australia. Considerable runway remains in existing markets while a key long-term opportunity is evolving to a global dairy nutrition company.
- **IP portfolio:** Details are opaque and vary by market. ATM's IP makes it difficult for competing a2 products, particularly on how to market the product and its benefits.

Earnings and cashflow outlook

- **Infant formula (IF):** ATM has established a meaningful market share in China, the largest IF market globally, and is well placed to build on this. Routes to market are complex but to date ATM has executed impressively to support strong growth and adapt to regulatory change. This will remain an area to watch.
- **Liquid milk:** ATM has a strong market share in Australia and is expanding into the US. Expansion has been slower and costlier than expected but distribution/revenue and momentum is building in the US.
- **Other products and markets:** This is a key area of optionality leveraging ATM's brand. Any early signs of progress are likely to be a positive catalyst.

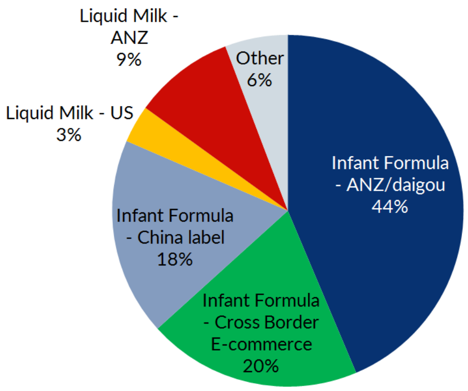
Financial structure

- **Growing net cash position:** There is a fine balance between returning capital to shareholders and ensuring sufficient flexibility to capitalise on growth opportunities. ATM's cash balance continues to build, offering options. Growth remains the priority.

Risk factors

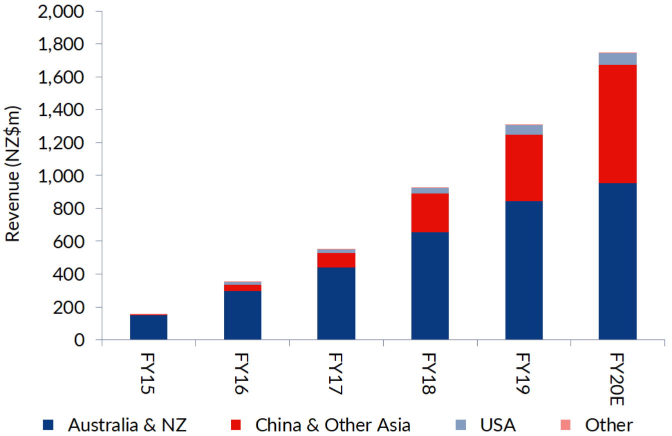
- **Competitive behaviour:** Any discounting or channel stuffing could disrupt the market. Direct competition is also emerging in the a2/a1-free market.
- **Food safety/quality scare:** ATM's brand and reputation are key pillars to its model. Reliance on third party suppliers adds complexity and risk.
- **Regulatory change:** Particularly in China.

Figure 4. Revenue breakdown by product and channel



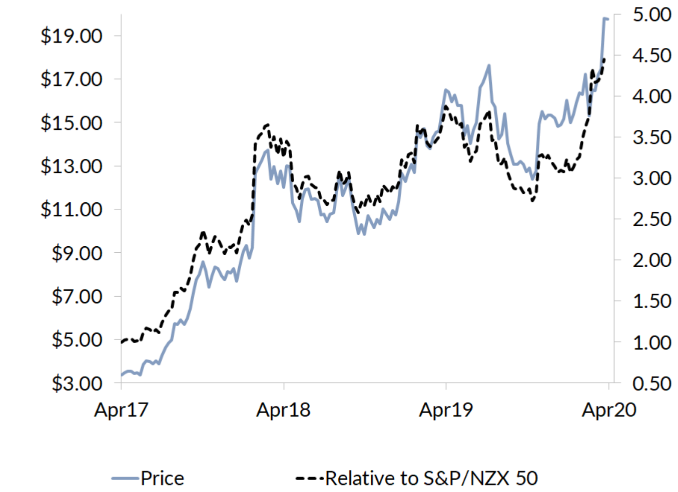
Source: Forsyth Barr analysis, Company reports

Figure 5. Revenue by market



Source: Forsyth Barr analysis

Figure 6. Price performance



Source: Forsyth Barr analysis

Figure 7. Substantial shareholders

Shareholder	Latest Holding
Mitsubishi UFJ Financial Group	9.0%
The Vanguard Group	7.0%
UBS	6.6%
Pendal Group Limited	6.3%
BlackRock Investment Management	5.2%

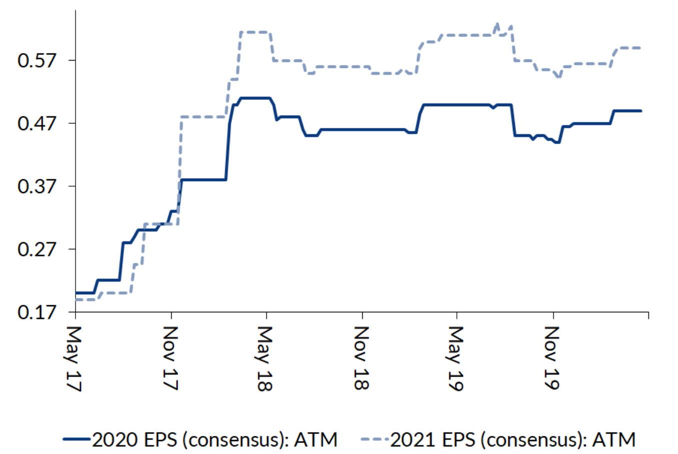
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 8. International valuation comparisons

Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash Yld
(metrics re-weighted to reflect ATM's balance date - June)			(m)	2020E	2021E	2020E	2021E	2020E	2021E	2021E
The a2 Milk Company	**ATM NZ**	**NZ$19.75**	**NZ$14,480**	**38.2x**	**32.1x**	**25.5x**	**21.6x**	**25.7x**	**21.7x**	**0.0%**
CHINA FEIHE	6186 HK	CN¥13.50	CN¥120,600	26.4x	22.1x	18.8x	15.2x	19.2x	15.4x	1.7%
Synlait Milk *	SML NZ	NZ$5.10	NZ$914	11.4x	9.9x	7.2x	6.1x	9.3x	7.9x	0.0%
BLACKMORES	BKL AT	A$66.86	A$1,163	>50x	30.8x	25.7x	15.6x	39.2x	21.2x	2.2%
HEALTH AND HAPPINESS H&H INT	1112 HK	CN¥24.85	CN¥15,993	13.9x	11.2x	8.7x	7.9x	9.6x	8.3x	2.6%
RECKITT BENCKISER GROUP PLC	RB/ LN	£57.59	£40,882	4.0x	18.6x	14.6x	14.6x	<0x	16.3x	3.0%
AUSNUTRIA DAIRY CORP	1717 HK	CN¥11.38	CN¥18,333	18.0x	13.6x	12.0x	9.3x	13.5x	10.1x	2.7%
INNER MONGOLIA YILI INDUS-A	600887 CH	CN¥28.35	CN¥171,968	23.6x	21.2x	16.7x	14.7x	20.8x	18.4x	3.0%
DANONE	BN FP	€54.92	€37,682	16.2x	12.5x	10.5x	9.9x	14.1x	12.3x	4.4%
CHINA MENGNIU DAIRY CO	2319 HK	CN¥26.20	CN¥103,114	21.6x	21.0x	14.3x	12.5x	20.1x	18.1x	1.2%
			Compco Average:	**16.9x**	**17.9x**	**14.3x**	**11.7x**	**18.2x**	**14.2x**	**2.3%**
EV = Current Market Cap + Actual Net Debt			**ATM Relative:**	**126%**	**80%**	**79%**	**84%**	**41%**	**52%**	**-100%**

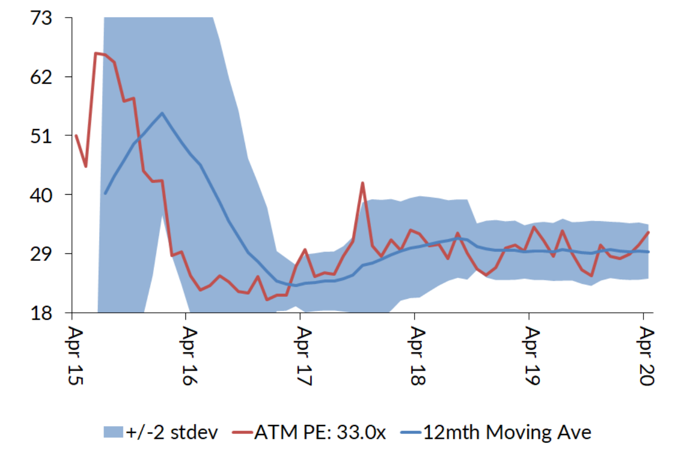
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (ATM) companies fiscal year end

Figure 9. Consensus EPS momentum (NZ$)



Source: Forsyth Barr analysis

Figure 10. One year forward PE (x)



Source: Forsyth Barr analysis

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