

The a2 Milk Company

Channel Checking

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OUTPERFORM

We have undertaken a mosaic of channel checks across an array of data sources, industry contracts and market participants to look for key takeaways of relevance to The a2 Milk Company (ATM). We appreciate it will never provide a perfect picture, albeit our key conclusions are (1) mixed revenue signals — recent industry growth is attractive, 3Q data points appear strong while 4Q looks weaker in some channels; (2) margin drivers positively skewed; (3) structural trends reinforce ATM is (mostly) well positioned. We make no changes to our earnings growth outlook, although see potential for mix differences. ATM ticks a number of boxes, with an attractive growth outlook, defensive product, a track record of execution and large (and growing) net cash position. Valuation metrics (EV/EBIT ~19x, PE ~27x adjusted for US losses/cash) also seem reasonable relative to other growth companies and the NZ market.

NZX Code	ATM	Financials: Jun/	19A	20E	21E	22E	Valuation (x)	19A	20E	21E	22E
Share price	NZ\$20.58	NPAT* (NZ\$m)	287.7	383.6	456.4	549.0	EV/EBITDA	34.9	25.8	21.6	18.0
Target price	NZ\$24.50	EPS* (NZc)	38.8	51.7	61.5	74.0	EV/EBIT	35.1	26.0	21.7	18.1
Risk rating	High	EPS growth* (%)	47.4	33.3	19.0	20.3	PE	53.1	39.8	33.5	27.8
Issued shares	733.1m	DPS (NZc)	0.0	0.0	0.0	22.2	Price / NTA	19.5	13.0	9.3	7.2
Market cap	NZ\$15,088m	Imputation (%)	100	100	100	100	Cash div yld (%)	0.0	0.0	0.0	1.1
Avg daily turnover	738.3k (NZ\$12,068k)	*Based on normalised profits					Gross div yld (%)	0.0	0.0	0.0	1.5

ATM appointed David Bortolussi as CEO, to start in early 2021, highlighting his "significant skill guiding businesses through periods of significant growth while effectively managing change". We do not expect any material shift in strategy. At face value he seems a reasonable hire, however key will be getting confidence in the cultural fit with, what we consider, a strong senior management team.

Revenue indicators mixed — strong 3Q, while 4Q appears weaker

Channel checking has become increasingly difficult as ATM has expanded its routes to market. We are encouraged by US milk revenue anecdotes, while China IF insights are best described as mixed. Data points and anecdotes suggest ATM's brand sentiment remains strong in China, while market share indicators are weaker than we would like. Piecing together the mosaic supports near-term revenue growth, albeit quantum varies considerably across sources and channels and potentially suggests a weaker run-rate over the past few months. With limited visibility on what is factored into ATM's FY20 revenue guidance, it is difficult to draw firm conclusions.

Margin indicators positively skewed — potential upside risk to our near-term forecasts

Our analysis suggests margin drivers are positively skewed. This reflects recent wholesale price increases, renewed contract terms with Synlait and potential that the continued ramifications of COVID-19 may moderate SG&A cost growth vs our forecasts, which we expect to more than outweigh a recent lift in input costs. Our near-term forecasts assume modest gross margin expansion, albeit EBITDA margin contraction. We view our assumptions as increasingly conservative, and see balance of risk to the upside, albeit acknowledge visibility on the SG&A cost growth outlook is limited.

Trends in China infant formula (IF) sector — ATM (mostly) well positioned

Channel checks reaffirm a number of trends, which appear to have accelerated as a result of COVID-19. Namely: (1) premiumisation, (2) domestic brands winning share, although NZ remains top of the import preference list, (3) digitalisation, and (4) increasing dairy consumption. We see ATM as well positioned, albeit acknowledge the continued resurgence of domestic brands (and consumer patriotism) is an area of risk. Nonetheless, China is a large market and there is nothing at this stage to suggest ATM is out of favour.

The a2 Milk Company (ATM)

Priced as at 11 Aug 2020 (NZ\$) **20.58**

12-month target price (NZ\$)*	24.50
Expected share price return	19.0%
Net dividend yield	0.2%
Estimated 12-month return	19.2%

Key WACC assumptions	
Risk free rate	1.30%
Equity beta	0.91
WACC	6.5%
Terminal growth	1.5%

Spot valuations (NZ\$)	
1. DCF	25.44
2. Peer multiple	21.40
n/a	n/a

DCF valuation summary (NZ\$m)	
Total firm value	18,207
(Net debt)/cash	465
Less: Capitalised operating leases	(18)
Value of equity	18,653

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

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

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

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

Valuation Ratios	2018A	2019A	2020E	2021E	2022E
EV/EBITDA (x)	52.1	34.9	25.8	21.6	18.0
EV/EBIT (x)	52.5	35.1	26.0	21.7	18.1
PE (x)	78.2	53.1	39.8	33.5	27.8
Price/NTA (x)	27.6	19.5	13.0	9.3	7.2
Free cash flow yield (%)	1.5	1.9	2.3	2.9	3.6
Net dividend yield (%)	0.0	0.0	0.0	0.0	1.1
Gross dividend yield (%)	0.0	0.0	0.0	0.0	1.5

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

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

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

Channel checking takeouts and our view

Our analysis and channel checking has yielded mixed results in recent months with COVID-19 causing rapid shifts in activity levels across the various channels in China. In February and March, ATM's strong online presence helped it take market share whilst traditional retail stores were shut, this was evident in a record month on the Tmall & Taobao platforms. However, in recent months anecdotal feedback suggests that offline demand has begun to normalise whilst some Daigou channel constraints have begun to emerge given the challenging international travel and logistics environment. We will never have a direct read through into performance, however, our spectrum of channel checking is predominately supportive of growing demand for ATM, albeit potentially a weaker run-rate over the past few months. Meanwhile, we see risk to the upside to our margin expectations given favourable gross margin drivers and potential the continued ramifications of COVID-19 may moderate cost growth vs our expectations.

Retain OUTPERFORM

ATM ticks a number of boxes with (1) a product in demand, (2) a large (and growing) net cash position, (3) attractive growth outlook and (4) track record of execution. Valuation metrics (EV/EBIT ~19x, PE ~27x adjusted for US losses/cash or 21x and 29x respectively when not adjusted) also seem reasonable relative to other global growth companies (PE average ~30x) and the NZ market (~30x) particularly in light of a superior growth outlook and defensive product characteristics, albeit acknowledging its high reliance on one brand and one market.

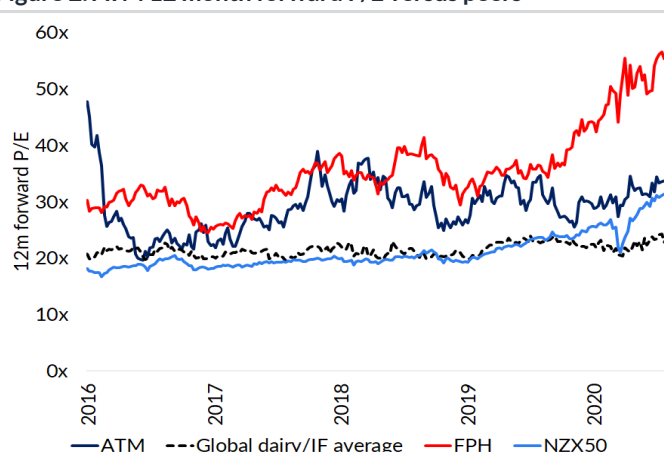
We lift our ATM target price to NZ\$24.50, following revisions to our team cost of capital inputs (risk free to 1.3%; market risk premium to 6.0%) which lifts our DCF by +32% (50% weighting in our target price) – refer the note, *"The Cost of Capital Conundrum: When TINA Came to Our Shores"*, published 7 August 2020 for more detail. Our revised weighted average cost of capital (WACC) for ATM is now 6.5% (prior 8.5%).

Figure 1. ATM near-term expectations

NZ\$m	Forsyth Barr	Consensus	YoY growth	ATM guidance
FY20				
Revenue	1.74bn	1.75bn	34%	1.7-1.75bn
EBITDA	549	557	35%	527-560
NPAT	384	390	36%	n/a
FY21				
Revenue	2.10	2.08	19%	
EBITDA	650	640	15%	
NPAT	456	450	15%	

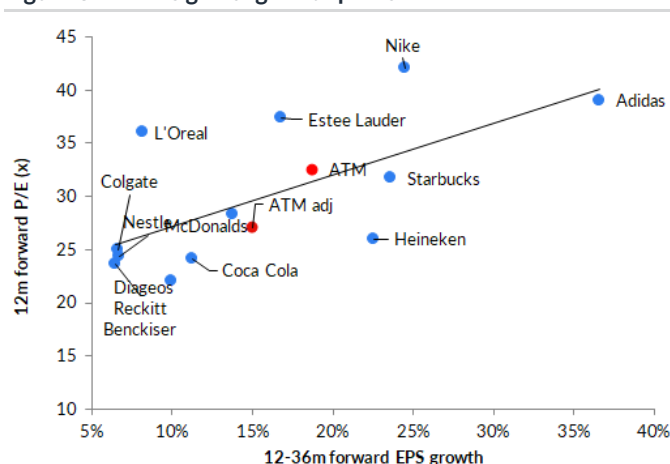
Source: Forsyth Barr analysis, Eikon

Figure 2. ATM 12 month forward P/E versus peers



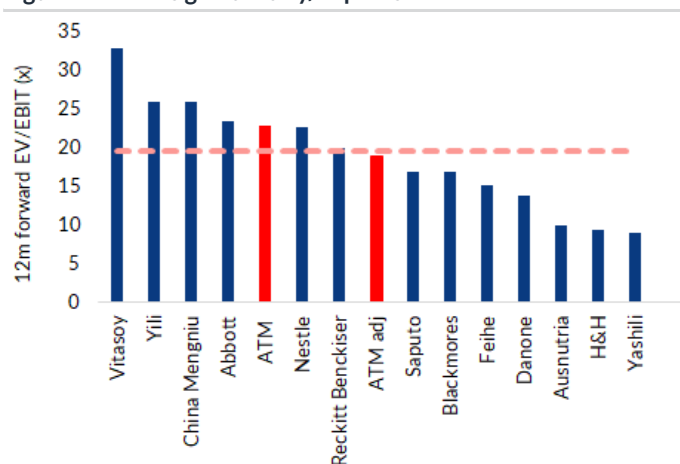
Source: Forsyth Barr analysis, Bloomberg

Figure 3. ATM vs global growth peers



Source: Forsyth Barr analysis, Bloomberg

Figure 4. ATM vs global dairy/IF peers



Source: Forsyth Barr analysis, Bloomberg

Revenue indicators mixed

Channel checking has become increasingly difficult as ATM has expanded its routes to market (both channels and export port). We are encouraged by US liquid milk revenue anecdotes, while data points for China IF are best described as mixed (and sometimes conflicting!), likely not helped by a rapid change in channel mix. Our mosaic of data points and anecdotes support a strong 3Q for ATM (helped by its strong positioning in online channels), while 4Q appears weaker. With limited visibility on what is factored into ATM revenue guidance, it is difficult to draw firm conclusions.

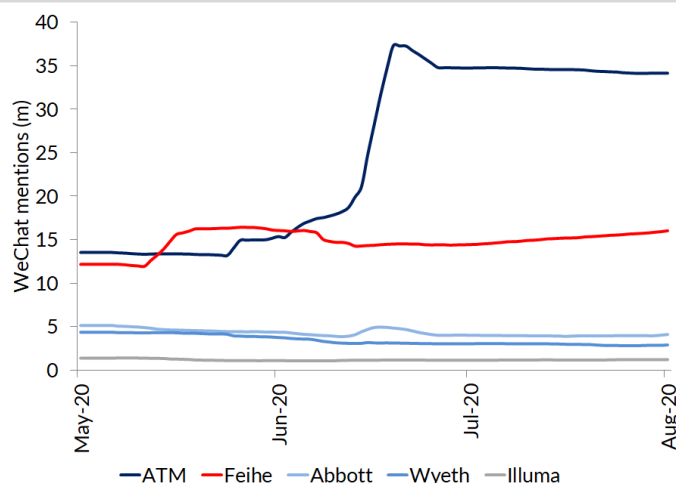
China IF – sentiment strong; market share indicators surprisingly soft

Data points and anecdotes suggest ATM's brand sentiment remains strong in China, while market share indicators are weaker than we would like. Channel checking is becoming more challenging as ATM expands further into offline MBS stores and as the company's product/supply chain becomes more diversified. The key trends evident in our channel checks are (1) a resurgence in momentum for domestic brands (particularly Feihe), which looks to be at the expense of the large multinationals and smaller brands, (2) a material rapid channel shift in favour of online. For ATM channel checks and anecdotes are supportive of growth, although indicators are mixed by channels and showing considerable monthly volatility.

Baidu and WeChat sentiment encouraging

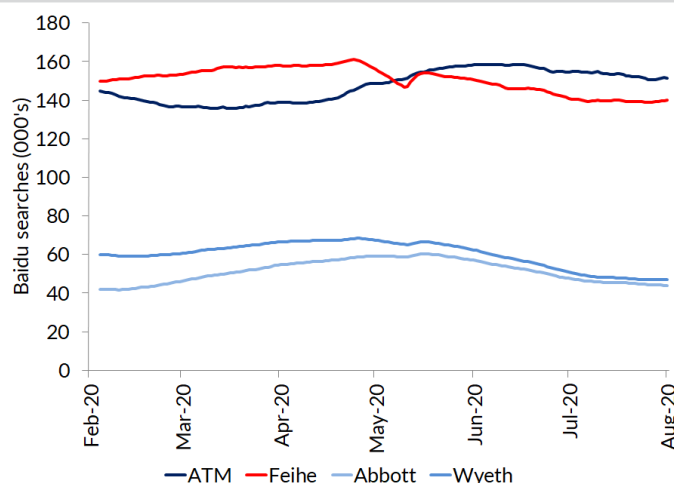
Sentiment tracking data on two of China's leading market trend tools (WeChat and Baidu) shows some signs of growth for ATM in recent months. ATM also continues to screen well versus both foreign and domestic competitors (including key 'in vogue' brand, Feihe). ATM has performed particularly well on WeChat reflecting a strong uplift in mentions throughout the 618 shopping festival period (China's 2nd largest e-commerce festival spanning from June 1 to June 20) where ATM ranked brand #4 on the Tmall platform.

Figure 5. WeChat mentions – three month rolling



Source: Forsyth Barr analysis, WeChat Index

Figure 6. Baidu searches – three month rolling



Source: Forsyth Barr analysis, Baidu Index

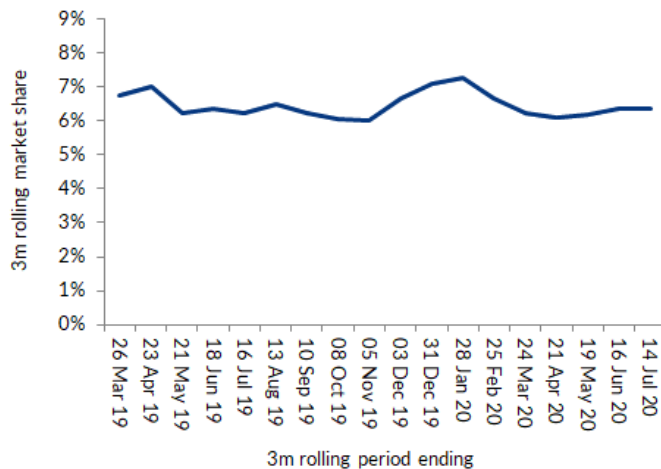
Kantar data – ATM market share has moderated and weaker than we would like

Kantar market share provides an indicator of brand strength for ATM and its key competitors in the IF segment, capturing purchasing habits for a sample of 2,000 consumers across Urban China (Tier 1 and Key A-D cities). The survey only captures babies aged 0 to 36 months. Our analysis suggests the Kantar data covers a market of ~US\$10bn versus the Chinese IF market of >US\$25bn.

Monthly/quarterly trends are volatile, however, ATM's 3m rolling market share in recent months has surprisingly moderated and has been weaker than we would have expected following a period of strong growth in late CY19. Over the past 6 months, ATM has ranked brand #5 with monthly market share ranging between 5.7% and 6.9% (ATM last reported rolling 12m share of 6.6% at December 2019). We expect Kantar data to understate consumption trends given ATM's growing sales in later stage products (i.e. Stage 4 / Smart Nutrition). Nonetheless the Kantar data also doesn't appear to align with ATM's strong April trading update, providing another reminder of the difficulty in drawing firm conclusions from any one data point for the Chinese market.

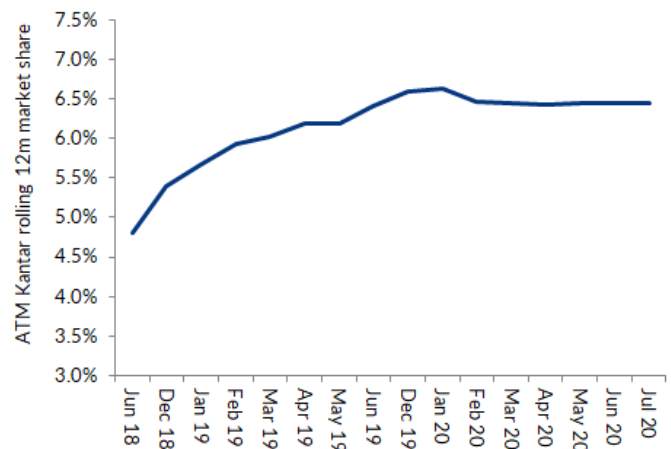
The industry remains fragmented. Kantar data also supports that domestic brands, particularly Feihe, continue to take market share. Feihe reached #1 in the IF category (according to Kantar data) in Q2 CY20, with rolling 3m market share of 13.8% (+600bp YoY and +330bp to date in 2020). Aptamil (Danone), which has historically been #1, is now sitting at #2, with steady market share loss in recent periods (-270bp YoY and -130bp to date in 2020).

Figure 7. ATM Kantar 3m rolling market share



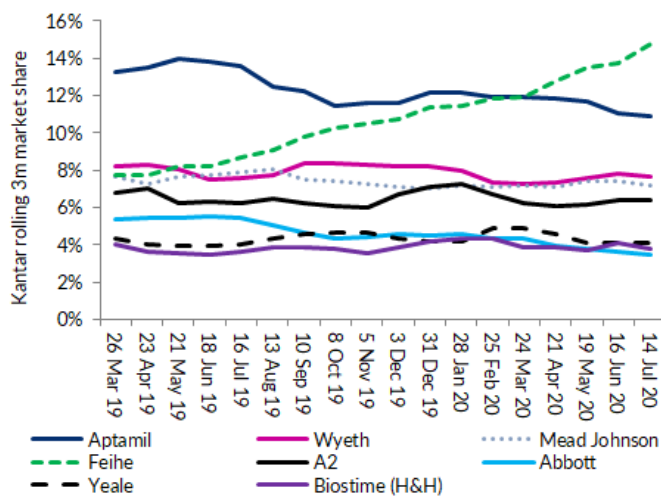
Source: Forsyth Barr analysis, Kantar Baby Panel

Figure 8. ATM Kantar 12m rolling market share



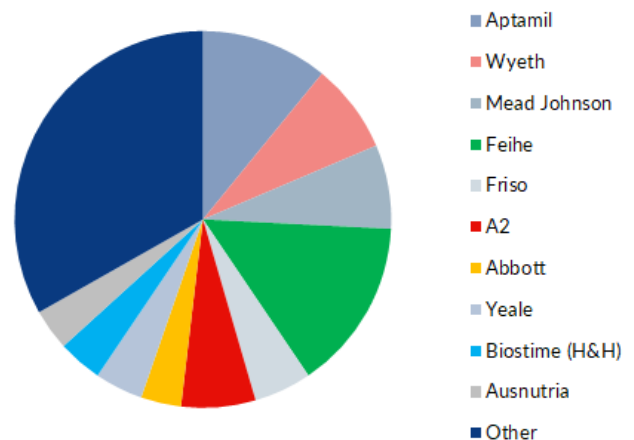
Source: Forsyth Barr analysis, Kantar Baby Panel

Figure 9. Rolling 3m market share for key brands



Source: Forsyth Barr analysis, Kantar

Figure 10. Industry remains highly fragmented



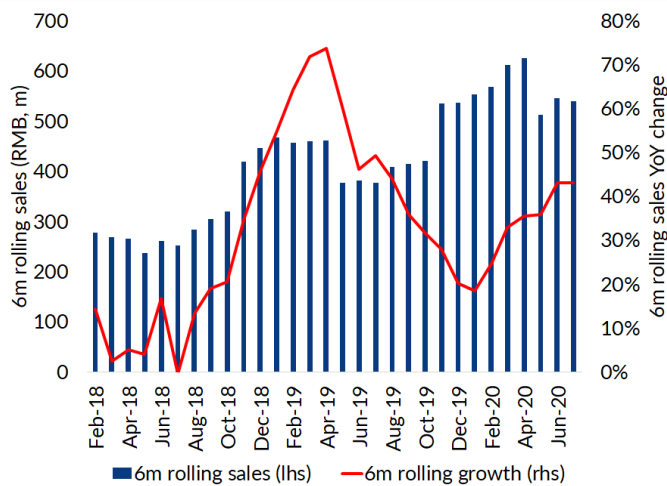
Source: Forsyth Barr analysis, Kantar Baby Panel

Spike in online data for the industry; data also shows strong outperformance for ATM in 3Q, less so in 4Q

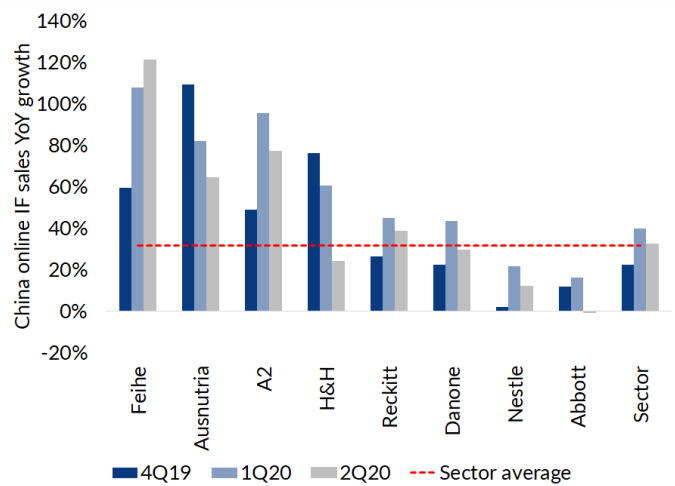
Online data we monitor for the Alibaba e-commerce platform (Tmall & Taobao sites) suggests trends remain positive for a2 Platinum, with signs of a particularly strong 3Q20, albeit less so for 4Q20. The data only captures a sample of China ecommerce sales across a selection of channels to market (daigou, CBEC and direct ecommerce) and is inherently volatile from month-to-month. Other data we gathered also shows very strong YoY growth for ATM through online channels, reinforcing a particular strong 3Q20 (Figure 12).

Tmall and Taobao data to June 2020 shows rolling 3m value growth for ATM of +27% YoY, rolling 6m +43% and rolling 12m +31%. Data shows signs of a very strong 3Q20 for ATM, materially ahead of industry growth, while 4Q20 was weaker (and below industry growth) albeit still materially higher than the prior year. Since balance-date, July data shows +20% YoY growth.

IF industry growth has also been very strong through 2020, +40% year-to-date (January to July YoY), showing a clear step-up in demand which we expect can be attributed to trends as a result of COVID-19, namely, changing channel mix (in favour of online platforms) and pantry stocking.

Figure 11. ATM Tmall and Taobao sales (6m rolling)


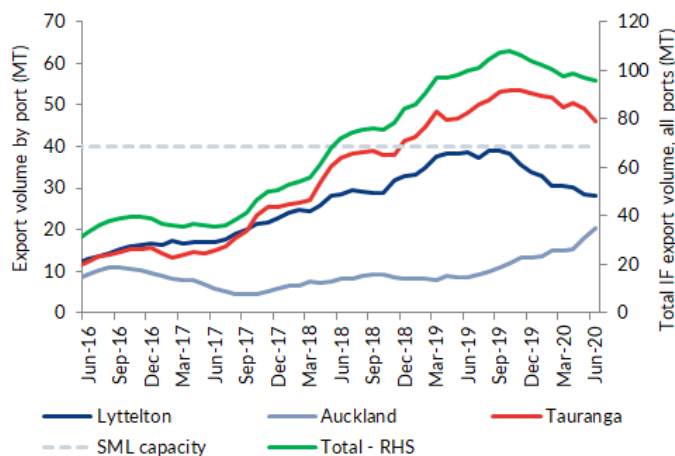
Source: Forsyth Barr analysis, Taosj

Figure 12. Step change in online sales momentum


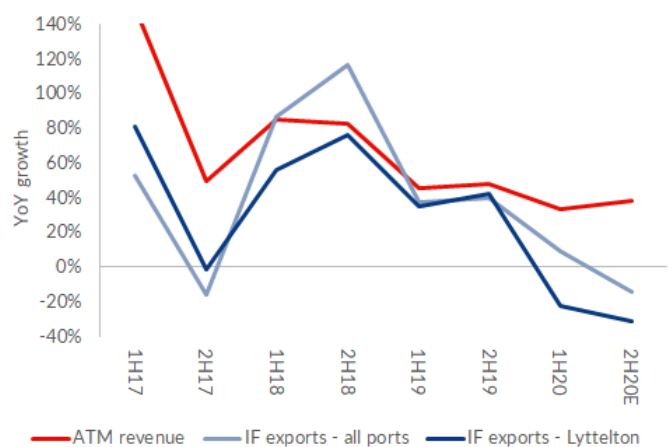
Source: Forsyth Barr analysis, China online spending report

New Zealand export data

Trends in export data for the IF category continue to show strong growth through Auckland, while Lyttelton volumes are down YoY. The relevance of monthly port data as a direct read-through for ATM volume growth has diminished in recent periods as its key manufacturer, Synlait (SML) utilises both its Lyttelton and Auckland facilities to varying degrees on a monthly basis which will influence growth rates. Two interesting features in the recent June data: (1) another month of a strong spike in air freight, (2) a strong June for Lyttelton export volumes destined for China – encouraging for ATM's China label revenue.

Figure 13. IF export volumes by port — destined for ATM's key markets (Australia, China and Hong Kong)


Source: Forsyth Barr analysis

Figure 14. Relationship between ATM and IF export data has broken down


Source: Forsyth Barr analysis

Other market anecdotes

- Industry anecdotes suggest a weaker 618 sales period for ATM than expected, not helped by higher levels of competitor discounting while ATM was less aggressive although this raises the potential of higher quality sales.
- Rapid channel shifts in favour of online/CBEC (cross border ecommerce). Mother & Baby Stores also appear to have done well since re-opening.
- Mixed commentary on the daigou channel ranging from "under pressure" to "weathered COVID-19 well". The market continues to see consolidation/churn as smaller players struggle to compete. This trend may have also been accelerated by COVID-19. We understand January and February were stellar, while anecdotes suggest weakness since then.
- We understand ATM is performing particularly well on JD.com (no public data), which is outperforming Alibaba platforms.
- Our anecdotes suggest ATM continues to report strong growth and market share in Tier 1 and 2 cities, while lower Tier cities have been more volatile and challenging. We expect supply chain disruption from COVID-19 hasn't helped, although this appears to have eased in recent months.

Our takeouts from recent competitor releases

Commentary from IF competitors in recent weeks is mixed, with further evidence large domestic IF players continue to take share, likely at the expense of smaller brands and multi-nationals. However, demand for premium+super-premium and differentiated products (the bucket we believe ATM fits) remains strong, outpacing other categories.

Figure 15. Recent competitor snippets

Competitor	Release	Comments of interest
Ausnutria	1H20 guidance (31 July)	<ul style="list-style-type: none"> Cow IF forecast growth of +22.7% to +24.8% vs 1H19 Implied growth in 2Q of +14% to +17% has materially slowed relative to Q1 (+36%) predominately reflecting the impact of pantry stocking in Q1 "In late May, Ausnutria became aware of overstocking in distribution channel which decelerated Q2 growth and will have a temporary impact on the remainder of 2020"
Reckitt Benckiser	1H20 earnings (27 July)	<ul style="list-style-type: none"> Enfamil was earmarked as one of the key brands impacted by pantry stocking. IF pantry stocking has "unwound quickly" Premium product 'Enfinitas' experienced +237 bps market share growth in super high premium China segment YTD Experienced "solid growth in mainland China" but Hong Kong remains a challenge
Nestle	2Q20 earnings (30 July)	<ul style="list-style-type: none"> Wyeth launched new super-premium brand "Belsol". It is Wyeth's first launch since Illuma in 2011 Sales in key product series Wyeth struggled through April & May but the "contraction moderated in June" Nestle will now focus on 3 products in the China market under the Wyeth series; Illuma, S-26 and Belsol
Feihe	1H20 guidance (8 July)	<ul style="list-style-type: none"> 1H20 revenue will be "no less than +40% growth", with growth primarily coming from super premium products "Foreign brands losing market share was very evident in 1H20, however, there are still 2-3 foreign brands performing well"
Bubs	4Q20 earnings (27 July)	<ul style="list-style-type: none"> Q4 IF sales +20% YoY — a deceleration from recent growth rates, albeit cycling a high prior year period (4Q19 +341% growth on pcg) China direct quarterly sales +26% YoY driven by strong CBEC growth Australia sales -15% YoY with strong domestic demand being more than offset by "daigou channel constraints" Group revenue down YoY in Q4 due to Q3 pantry stocking effectively bringing forward Q4 revenue
Danone	2Q20 earnings (30 July)	<ul style="list-style-type: none"> Release of Aptamil Essensis (organic a2 protein milk product; at a recommended retail price of A\$50) Total sales in China were "broadly flat", however, challenges were experienced in Hong Kong A small impact was incurred from "partial destocking" Premium brand (Aptamil Platinum) "grew double digit in Q2 and gained market share" Danone's introduction of "rare" IF products in late CY19 like a2 have grown significantly in 1H

Source: Forsyth Barr analysis, Company releases

Stockpiling evident in competitor commentary, but magnitude of the impact varies materially

ATM did not provide 3Q sales data this year, however, did indicate revenue was ahead of expectations due to consumer pantry stocking. The company provided FY20 revenue guidance (NZ\$1.7–1.75bn), however, we have no clarity on the extent this incorporates an unwind in pantry stocks. In light of recent competitor commentary we expect some impact in 4Q, however, are assuming this was already encapsulated in FY20 guidance.

Recent commentary from competitors is mixed with some suggesting IF pantry stocking has unwound quickly (and ahead of expectations) but still had a small impact on sales in the May to June quarter with no impacts foreseen thereafter. Meanwhile, other competitor commentary implies the unwinding of pantry stocking has had a material impact on 2Q revenue with growth rates decelerating materially from Q1 and pcg. Other unlisted industry participants have suggested "no material" evidence of stockpiling and that IF is already a category where consumers buy multiple cans.

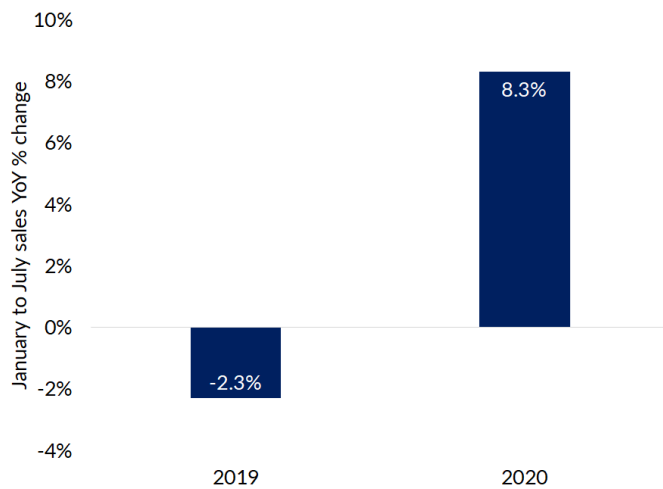
US liquid milk trends supportive of growth

We have minimal regular insight into ATM's performance in the US milk market, however, COVID-19 related demand for milk/dairy products appears strong — likely benefiting from an increased focus on nutrition and people spending more time at home. We expect ATM to be materially outperforming industry growth rates.

The US milk market has been in decline over the past five years (material decline in regular milk outweighing strong growth in specialty) – however, COVID-19 appears to have driven a resurgence in the category. Online interest has surged, and sales are showing positive growth.

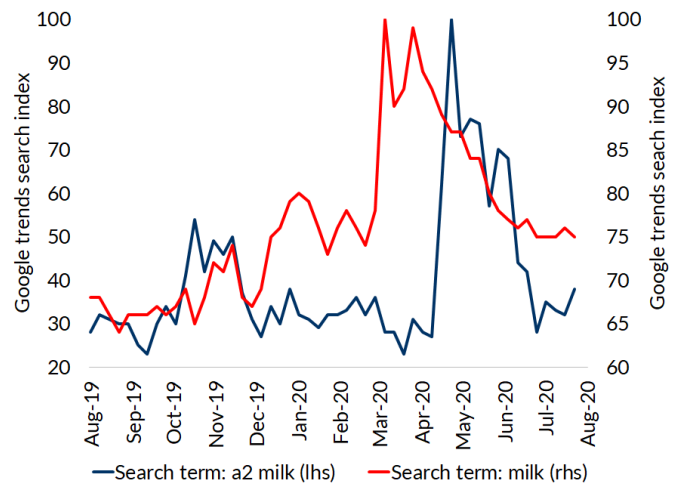
- Sales data points: US milk retail sales were up +8.3% from January to July 2020, a material lift on the same period last year when milk retail sales were down -2.3%. Milk sales saw their biggest year on year jump of +21% in March and remain positive in June (up +2%).
- Online interest: Google trends show a material spike in interest for both 'milk' and 'a2 milk' across March and April. Social media research also indicates a +40% increase in positive mentions about milk in 2020.

Figure 16. Return to growth for US milk retail sales



Source: Forsyth Barr analysis, Nielsen

Figure 17. Google trends search interest



Source: Forsyth Barr analysis, Google trends

Margin indicators — upside risk to our forecasts

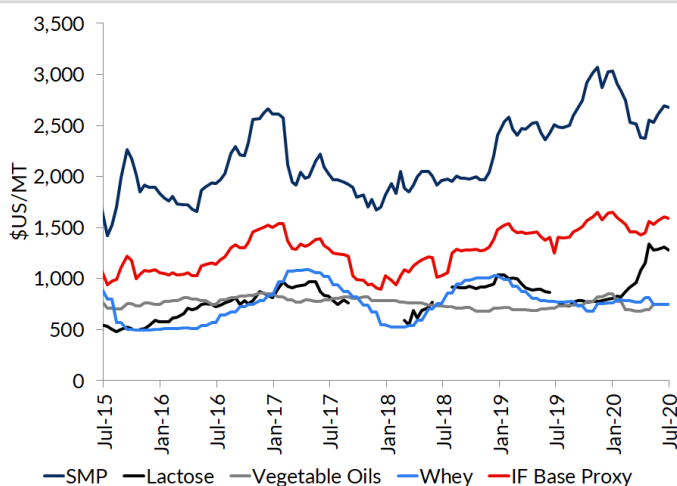
Our analysis suggests indicators are favourable for gross margins, with a recent wholesale price increase and renewed contract terms with SML likely to more than offset the recent uptick in input costs. Visibility is non-existent on SG&A costs, however, there is also some risk cost growth is below our expectations (FY20E +44%; FY21E +27%) as COVID-19 looks likely to limit/restrict travel for longer and may also delay/lower other investment. We do however expect marketing to remain a key area of strong growth, to continue to build brand awareness and trial and reinforce product differentiation in a competitive market.

Our forecasts already assume modest near-term gross margin expansion, albeit EBITDA margin contraction. We make no changes at this point, although view our assumptions as conservative and see balance of risk to the upside.

Key data points of interest

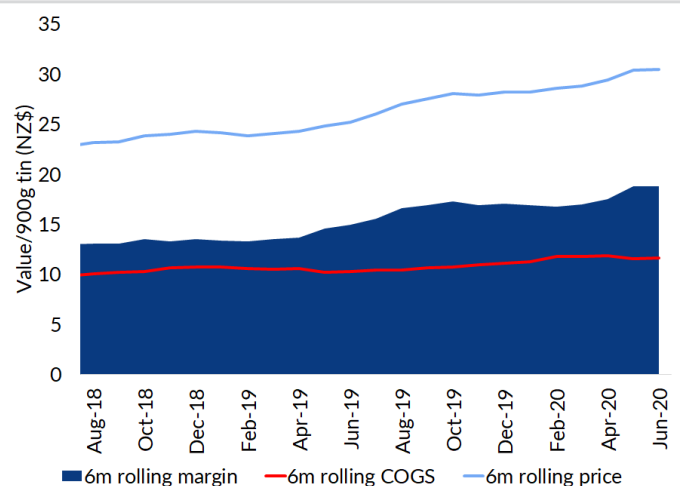
- **Wholesale prices (+ve):** According to the wholesale channel, ATM has circulated a further increase in its price from August 2020. We estimate the weighted average lift to be c. +6%. This follows a lift of a similar magnitude in December 2019. In combination this points to price growth of c. +12% for 1H21. A price increase appears timely following the release of competing a2 protein products by Danone (Aptamil) and Bellamys with a retail price of ~A\$50 and ~A\$42 per 900g tin respectively versus ATM at ~A\$37. We understand Danone is also lifting prices on a similar timetable. While we expect the market to be able to take the price rise, and higher prices can be seen as a signal of quality in China, ATM will need to be careful in managing continued price increases given it is not introducing new features or ingredients.
- **SML contract renewal (+ve):** ATM and SML announced the renewal of their supply agreement in November 2019. This included a tenure extension, volume lift and revised pricing terms with SML signalling its "historical margins can be protected, with manufacturing efficiencies" and that the companies are sharing "the benefits of scale". We have no visibility on magnitude, however, view the contract renewal as positive for ATM's IF gross margins.
- **Input costs (-ve):** Key IF input costs have begun to increase in recent months following a sharp dive during late CY19/early CY20 to date, reflecting a material uplift in both Skim Milk Powder (SMP) and Lactose prices at recent GDT auctions. Our analysis suggests SMP and Lactose makes up ~60% of total IF input costs. Our IF base proxy tracker suggests YoY growth of c. +8% through CY20, although input costs are volatile and move quickly, and there will also be a lag before any change impacts ATM.

Figure 18. Infant formula ingredient mix



Source: Forsyth Barr analysis, GDT, FRED, USDA

Figure 19. Implied margin movements from export data



Source: Forsyth Barr analysis, Stats NZ

China IF industry trends – mostly supportive

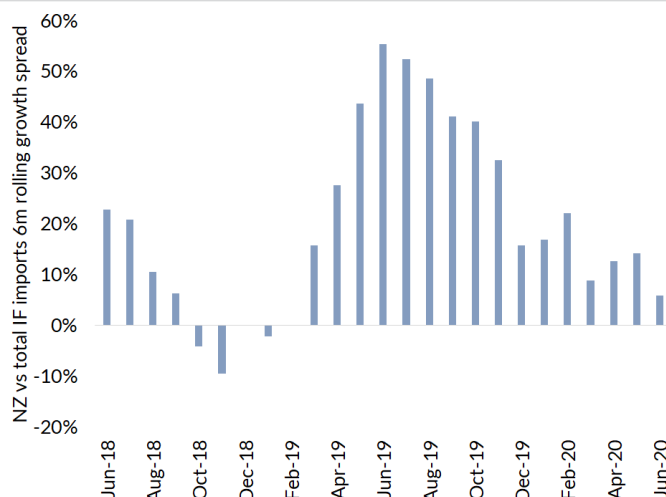
Various data points and anecdotal feedback suggests that COVID-19 has accelerated a number of structural trends in the China IF sector. Namely: (1) premiumisation, (2) domestic brands winning share, although NZ remains top of the preference list for imported product, (3) digitalisation, and (4) increasing dairy consumption. We see ATM as well positioned, particularly vs international peers, given its premium & differentiated product offering, NZ product origin and established brand strength in online platforms. The key area of risk is the continued resurgence of domestic brands, however, China is a large market and there is room for more than one brand/category to be successful. Things are moving fast in China (as usual) – to date ATM has managed rapid change and channel preferences well, however this is an area of risk and requires continued investment.

Key trends observable in China IF market, which appear to have been accelerated by the pandemic

Premiumisation: Demand for premium and super-premium high quality products remains strong in China (and has potentially accelerated through the COVID-19 pandemic). Various data points and anecdotes show this category continues to outperform, and recent IF product launches have been (unsurprisingly) weighted to this category.

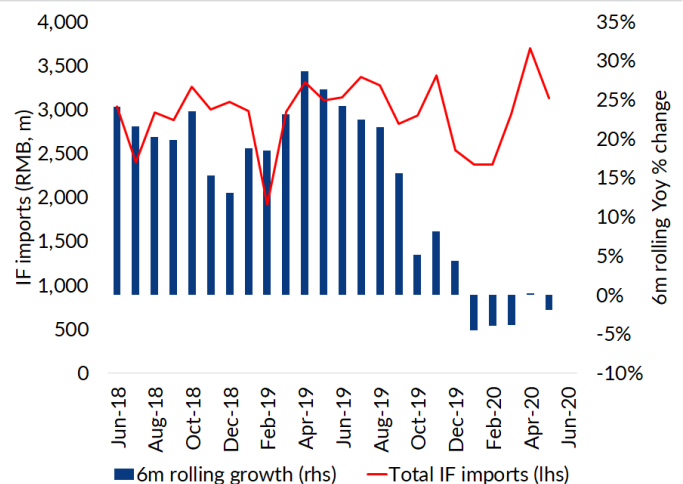
- **Domestic winning share:** Domestic brands and products are taking market share at the expense of foreign in a number of categories, including IF. COVID-19 appears to have accelerated this trend, with growing domestic pride for China's handling of the pandemic.
- **NZ remains top of the preference list for imported product:** Anecdotes suggest NZ has been one of the few countries to not see a decline in recent sentiment/preference, likely helped by our handling of the pandemic and relative positioning in geo-political tension. The latter will remain an area to watch. Australia also continues to rank well, albeit anecdotes suggest some signs of sentiment weakening while other countries, particularly the US, and 'foreign' in general has seen a deterioration according to our channel checks. Whether Chinese consumers view ATM as 'NZ', 'Australian' or 'foreign' will no doubt vary across the market.
- **Digitalisation:** Ecommerce penetration has rapidly accelerated following the virus outbreak, particularly in lower tier cities. It has also accelerated marketing channel shifts, particularly the continued rise of live streaming and short videos. Increased digitalisation may help improve the connectivity between lower tier cities and foreign brands in particular where building brand presence has been historically difficult. However, competition for eyeballs is high and will likely require investment and a differentiated proposition.
- **Increasing dairy consumption:** This has been a longstanding trend, however, further recent government support (suggestions it should be a national strategy to encourage every person to drink at least 300g of milk a day) is helpful. The increasing focus on products with nutritional and immunity benefits, fuelled by the pandemic, are also likely supportive for growing dairy consumption.

Figure 20. Growth in NZ imports continues to outpace industry



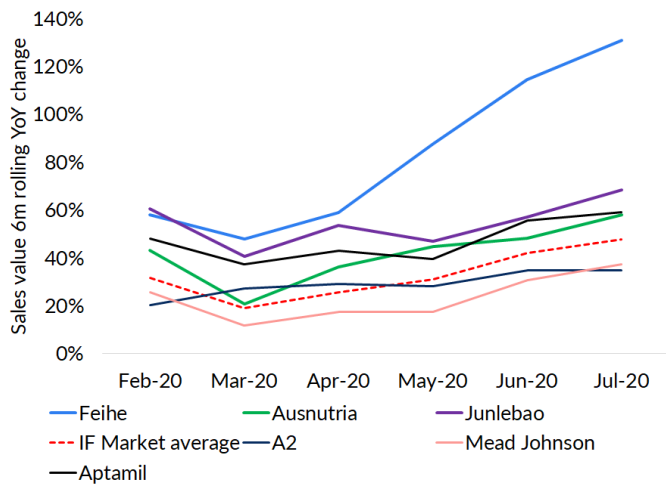
Source: Forsyth Barr analysis, China online spending report

Figure 21. Domestic growth slowing total China IF imports



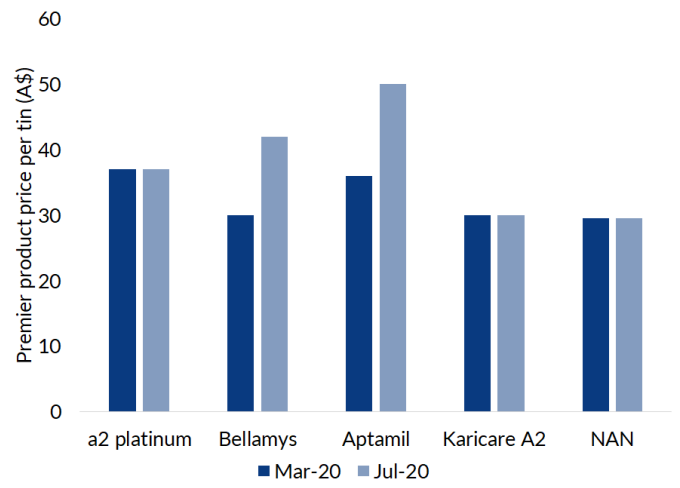
Source: Forsyth Barr analysis, China Customs

Figure 22. Domestic outpacing foreign brands on Alibaba



Source: Forsyth Barr analysis, Taosj

Figure 23. ATM no longer the Australian price premier



Source: Forsyth Barr analysis, Chemist Warehouse

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.

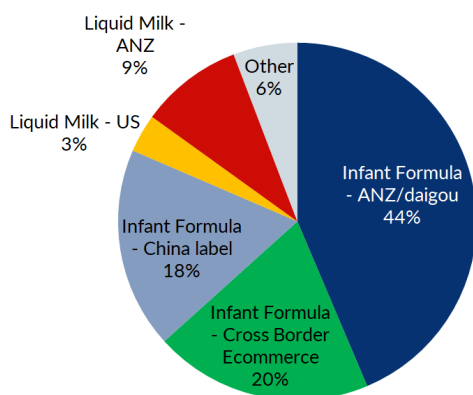
Financial structure

- **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

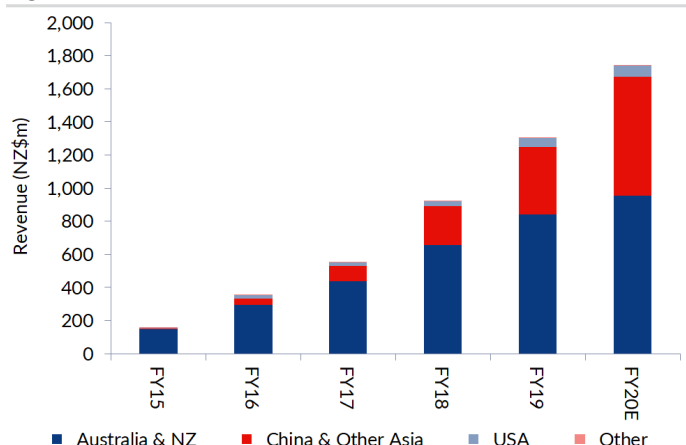
- **Competitive behaviour:** Any discounting or channel stuffing could disrupt the market. Direct competition is also emerging in the a2/a1-free market.
- **Food safety/quality score:** ATM's brand and reputation are key pillars to its model. Reliance on third party suppliers adds complexity and risk.
- **New CEO to start in early 2021:** David Bortolussi appears a reasonable hire at face value, albeit we look for greater insight in due course, particularly around cultural fit. We are not expecting any material change in strategic priorities.
- **Regulatory change:** Particularly in China.

Figure 24. Revenue breakdown by product and channel

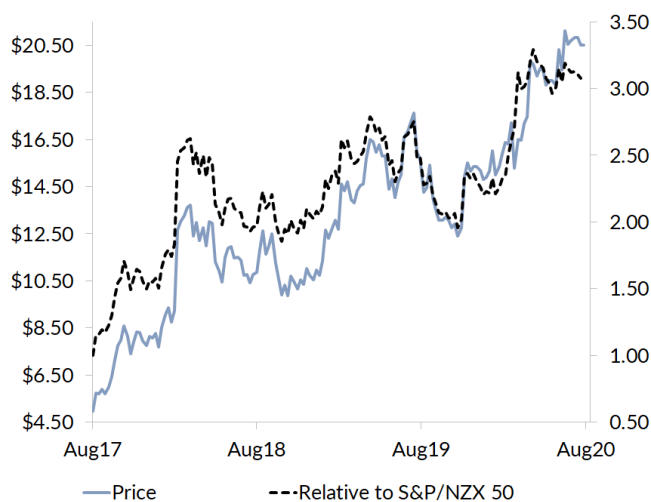


Source: Forsyth Barr analysis, Company reports

Figure 25. Revenue by market



Source: Forsyth Barr analysis, Company reports

Figure 26. Price performance


Source: Forsyth Barr analysis

Figure 27. Substantial shareholders

Shareholder	Latest Holding
The Vanguard Group	7.0%
Mitsubishi UFJ Financial Group	6.4%
Commonwealth Bank of Australia	6.3%
BlackRock Investment Management	5.2%

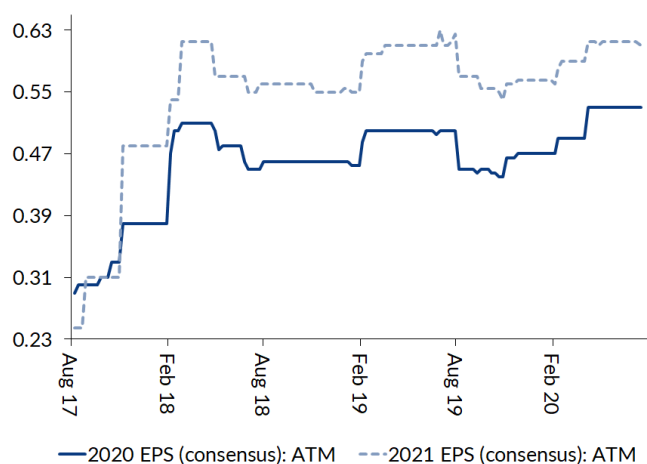
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

Figure 28. International valuation comparisons

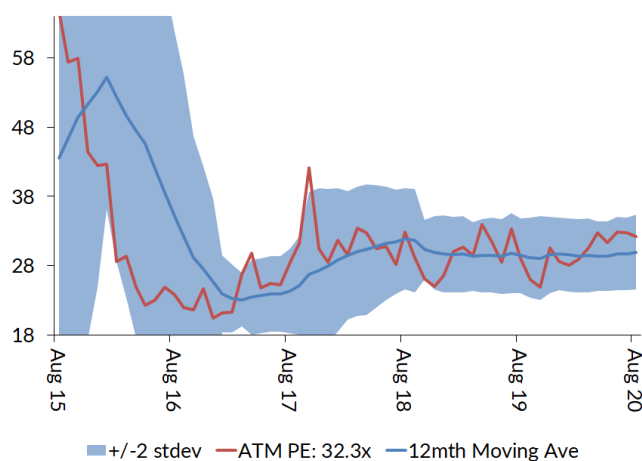
Company	Code	Price	Mkt Cap (m)	PE 2020E	PE 2021E	EV/EBITDA 2020E	EV/EBITDA 2021E	EV/EBIT 2020E	EV/EBIT 2021E	Cash Yld 2021E
(metrics re-weighted to reflect ATM's balance date - June)										
The a2 Milk Company	ATM NZ	NZ\$20.58	NZ\$15,088	39.8x	33.5x	26.6x	22.5x	26.8x	22.6x	0.0%
CHINA FEIHE	6186 HK	CN¥16.40	CN¥146,507	30.8x	24.5x	22.1x	17.1x	22.8x	17.6x	1.5%
SYNLAIT MILK *	SML NZ	NZ\$6.71	NZ\$1,203	15.0x	13.0x	8.8x	7.5x	11.5x	9.7x	0.0%
BLACKMORES	BKL AT	A\$74.50	A\$1,441	>50x	38.9x	30.3x	20.2x	47.7x	28.0x	1.8%
HEALTH AND HAPPINESS H&H INT	1112 HK	CN¥30.85	CN¥19,873	18.3x	15.5x	10.4x	9.4x	11.7x	10.2x	3.2%
RECKITT BENCKISER GROUP PLC	RB/ LN	£74.98	£53,328	4.5x	23.6x	<0x	17.3x	<0x	19.8x	2.3%
AUSNUTRIA DAIRY CORP	1717 HK	CN¥13.34	CN¥21,550	21.2x	16.0x	13.9x	10.5x	15.8x	11.6x	2.2%
INNER MONGOLIA YILI INDUS-A	600887 CH	CN¥36.42	CN¥221,551	34.1x	32.1x	22.8x	20.6x	29.3x	27.1x	2.2%
DANONE	BN FP	€54.80	€37,627	17.3x	15.4x	11.0x	10.8x	14.9x	13.9x	3.8%
CHINA MENGNIU DAIRY CO	2319 HK	CN¥34.90	CN¥137,693	37.3x	34.5x	21.3x	20.6x	32.4x	30.7x	0.6%
Compco Average:				22.3x	23.7x	17.6x	14.9x	23.3x	18.7x	2.0%
ATM Relative:				78%	41%	52%	51%	15%	21%	-100%

EV = Current Market Cap + Actual Net Debt

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

Figure 29. Consensus EPS momentum (NZ\$)


Source: Forsyth Barr analysis

Figure 30. One year forward PE (x)


Source: Forsyth Barr analysis

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