

The a2 Milk Company

Short-Term Pain? Digesting Daigou Disruption

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The a2 Milk Company's (ATM) trading update is a blemish to its consistent track record of profit growth, with the company signalling a revenue decline in 1H21 as a result of major disruption to the daigou channel. The key question now – is this a temporary issue, or something more permanent? Although there is a lot we still don't know (not uncommon with ATM), we view this as temporary. While the short-term pain is worse than anticipated, this appears to be a one channel, one product problem (admittedly its most material), with other areas still growing strongly and meaningful growth avenues remaining.

NZX Code	ATM	Financials: Jun/	20A	21E	22E	23E	Valuation (x)	20A	21E	22E	23E
Share price	NZ\$16.65	NPAT* (NZ\$m)	385.8	406.7	498.2	573.1	PE	31.9	30.3	24.7	21.5
Target price	NZ\$23.00	EPS* (NZc)	52.1	54.9	67.3	77.4	EV/EBIT	20.8	19.2	15.5	13.5
Risk rating	High	EPS growth* (%)	34.4	5.4	22.5	15.0	EV/EBITDA	20.6	19.0	15.2	13.2
Issued shares	736.5m	DPS (NZc)	0.0	0.0	0.0	23.2	Price / NTA	10.9	8.1	6.1	4.9
Market cap	NZ\$12,262m	Imputation (%)	100	100	100	100	Cash div yld (%)	0.0	0.0	0.0	1.4
Avg daily turnover	740.1k (NZ\$12,615k)	*Based on normalised profits					Gross div yld (%)	0.0	0.0	0.0	1.9

Key changes

- **EBITDA revisions:** FY21E -11%, FY22E -7%, FY23E -5%. Solely due to lower revenue growth assumptions through daigou. We have assumed a return to growth in daigou in FY22, albeit not fully recovering to where it was, hence modest medium-term downgrades.
- **Target price:** Revised to NZ\$23.00, due to earnings revisions and a lower share price for its stake in Synlait Milk.

ATM FY21 guidance points to a game of two halves, with the 1H weakness meaningfully worse than anticipated

ATM provided FY21 revenue guidance (NZ\$1.8–1.9bn; +4% to +10% YoY) meaningfully below our (and market) expectations. This incorporates a very weak 1H21 (-4% to -10%), albeit a return to strong growth in 2H21. This leaves a number of questions, namely:

- **What is the problem?** ATM has referenced IF demand weakness in its Australasian segment, predominantly due to a decline in retail and corporate daigou as a result of COVID-19 related issues (lack of tourists, international students and lockdowns). These themes are not new, albeit the magnitude negatively surprised. The key acceleration in the issue appears to have been the lockdown in Victoria, which has limited the incremental demand from corporate daigou for replenishment inventory. We understand the weakness is less pronounced in New South Wales, although this is difficult to verify.
- **What is ATM doing about it?** Running a range of daigou incentive programmes and ATM recently hosted a live streaming event.
- **What does guidance incorporate for daigou?** No specifics provided, however, ATM indicated it includes disruption for the balance of 1H21 and stabilisation/some improvement thereafter. What actually plays out is contingent on daigou response to ATM's efforts, and may also be influenced by government restrictions. ATM's assumptions do not appear unreasonable. A daigou recovery is also not inconceivable (things can change quickly) but we believe the channel is unlikely to ever return to its prior peak.
- **EBITDA margin implications from the substantial channel shift signalled:** No. ATM updated its guidance to ~31% (prior 30–31%) helped by some cost initiatives, improved input prices and the release of an inventory provision (conservatively taken in FY20).
- **Is this indicative of a more permanent issue?** Not in our view. ATM signalled its 2H21 budget is broadly unchanged (with some mix differences), brand health metrics are at record levels (including awareness, purchase intent and loyalty) and other channels continue to deliver strong growth (China label year-to-date revenue to August up +77%). The latter remains particularly encouraging given the large offline channel is the key medium-term growth avenue for ATM (market share is growing through Mother & Baby Stores, however at c. 2% there remains ample runway for growth to continue over the medium-term).

The a2 Milk Company (ATM)

 Priced as at 28 Sep 2020 (NZ\$) **16.65**

12-month target price (NZ\$)*						Spot valuations (NZ\$)					
Expected share price return	23.00					1. DCF	24.13				
Net dividend yield	38.1%					2. Peer multiple	20.00				
Estimated 12-month return	38.1%					n/a	n/a				
Key WACC assumptions						DCF valuation summary (NZ\$m)					
Risk free rate	1.30%					Total firm value	16,935				
Equity beta	0.90					(Net debt)/cash	854				
WACC	6.4%					Less: Capitalised operating leases	(17)				
Terminal growth	1.5%					Value of equity	17,772				
Profit and Loss Account (NZ\$m)						Valuation Ratios					
Sales revenue	2019A	2020A	2021E	2022E	2023E	EV/EBITDA (x)	2019A	2020A	2021E	2022E	2023E
Normalised EBITDA	1,300.8	1,731.1	1,853.2	2,274.5	2,616.2	EV/EBIT (x)	28.1	20.6	19.0	15.2	13.2
Depreciation and amortisation	413.6	549.7	579.9	711.5	818.5	PE (x)	28.2	20.8	19.2	15.5	13.5
Normalised EBIT	(2.2)	(4.4)	(7.3)	(11.6)	(15.5)	Price/NTA (x)	42.9	31.9	30.3	24.7	21.5
Net interest	411.4	545.3	572.6	699.9	803.0	Free cash flow yield (%)	15.8	10.9	8.1	6.1	4.9
Associate income	4.3	5.7	8.3	11.6	15.6	Net dividend yield (%)	2.3	3.4	2.8	3.7	4.4
Tax	0	0	0	0	0	Gross dividend yield (%)	0.0	0.0	0.0	0.0	1.4
Minority interests	(128.0)	(165.2)	(174.2)	(213.4)	(245.5)	Interest cover EBIT (x)	0.0	0.0	0.0	0.0	1.9
Normalised NPAT	0	0	0	0	0	Interest cover EBITDA (x)	n/a	n/a	n/a	n/a	n/a
Reported NPAT	287.7	385.8	406.7	498.2	573.1	Net debt/ND+E (%)	n/a	n/a	n/a	n/a	n/a
Normalised EPS (cps)	0	0	0	0	0	Net debt/EBITDA (x)	-143.9	-305.2	-318.1	-393.2	-463.6
DPS (cps)	287.7	385.8	406.7	498.2	573.1	Key Ratios	2019A	2020A	2021E	2022E	2023E
	38.8	52.1	54.9	67.3	77.4	Return on assets (%)	40.9	37.5	31.2	29.2	27.2
	0	0	0	0	23.2	Return on equity (%)	36.5	34.0	26.4	24.4	22.5
						Return on funds employed (%)	106.3	127.2	124.4	126.2	131.1
						EBITDA margin (%)	31.8	31.8	31.3	31.3	31.3
						EBIT margin (%)	31.6	31.5	30.9	30.8	30.7
						Capex to sales (%)	0.3	0.4	1.6	2.2	1.9
						Capex to depreciation (%)	155	164	397	431	323
						Imputation (%)	100	100	100	100	100
						Pay-out ratio (%)	0	0	0	0	30
						Operating Performance	2019A	2020A	2021E	2022E	2023E
						Revenue (breakdown by product)					
						Total Infant Formula	1,064	1,424	1,510	1,873	2,157
						Total Fresh Milk	171	222	243	281	317
						Other	66	85	101	120	142
						Total	1,301	1,731	1,853	2,274	2,616
						Revenue (breakdown by country)					
						Australia & NZ	843	965	779	845	874
						China & Other Asia	423	699	1,007	1,328	1,608
						US	35	66	67	101	134
						Other	0	0	0	0	0
						Total	1,301	1,731	1,853	2,274	2,616
						EBITDA insights					
						Gross margin	55	56	57	57	56
						Gross profit	713	969	1,048	1,286	1,472
						Total SG&A expenses	(300)	(419)	(468)	(575)	(654)
						incl marketing expenses	(134)	(194)	(208)	(257)	(301)
						Total SG&A as % of revenue	23.0	24.2	25.2	25.3	25.0
						Group EBITDA	414	550	580	711	818
						US - EBITDA losses	(44)	(51)	(42)	(35)	(28)
						EBITDA excluding US losses	458	600	622	746	846
Balance Sheet (NZ\$m)											
Working capital	2019A	2020A	2021E	2022E	2023E						
Fixed assets	50.6	(7.6)	37.8	46.4	51.2						
Intangibles	10.3	14.2	37.4	78.2	115.2						
Right of use asset	13.0	13.6	35.5	35.3	35.1						
Other assets	0	16.1	16.3	16.4	16.6						
Total funds employed	368.4	317.2	407.7	457.1	498.9						
Net debt/(cash)	(464.8)	(854.2)	(1,172.3)	(1,625.5)	(2,092.3)						
Lease liability	0	16.8	17.5	18.1	18.7						
Other liabilities	45.4	20.5	21.6	25.6	28.8						
Shareholder's funds	787.9	1,134.1	1,540.8	2,038.9	2,543.6						
Minority interests	0	0	0	0	0						
Total funding sources	368.4	317.2	407.7	457.1	498.9						

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

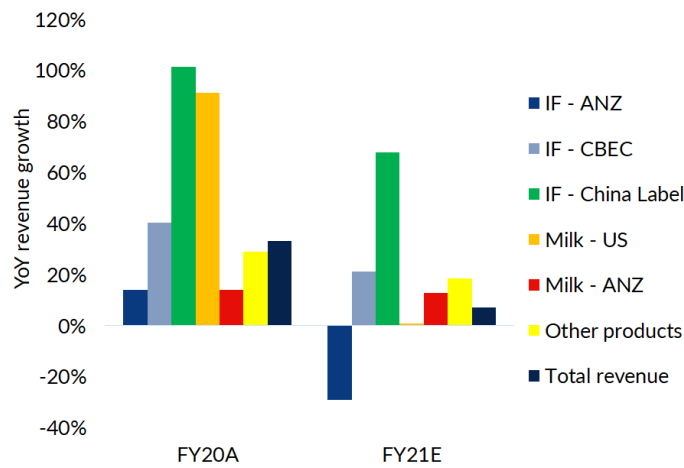
Charts and tables

Figure 1. Earnings revisions (NZ\$m)

NZ\$m	FY21E			FY22E			FY23E		
	Old	New	% chg	Old	New	% chg	Old	New	% chg
Revenue	2,078.1	1,853.2	-10.8%	2,470.7	2,274.5	-7.9%	2,780.3	2,616.2	-5.9%
EBITDA	650.2	579.9	-10.8%	765.6	711.5	-7.1%	864.2	818.5	-5.3%
Underlying profit	456.1	406.7	-10.8%	537.9	498.2	-7.4%	609.9	573.1	-6.0%
Underlying EPS (cps)	61.6	54.9	-10.8%	72.7	67.3	-7.4%	82.4	77.4	-6.0%
Dividend (cps)	0.0	0.0	n/a	0.0	0.0	n/a	24.7	23.2	-6.0%

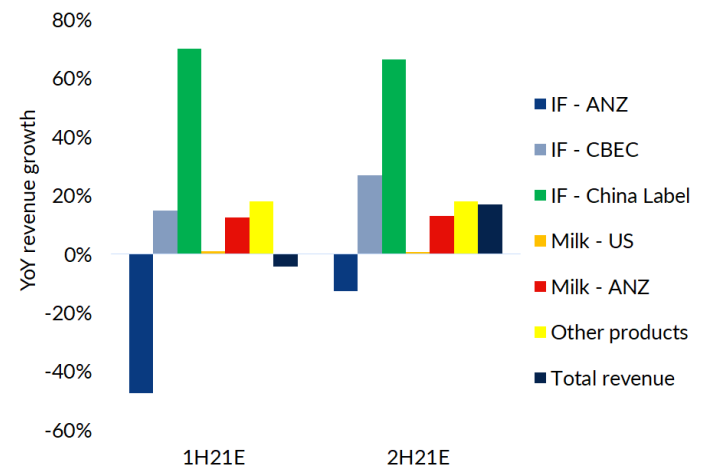
Source: Forsyth Barr analysis

Figure 2. Growth expectations built up by the pieces – FY



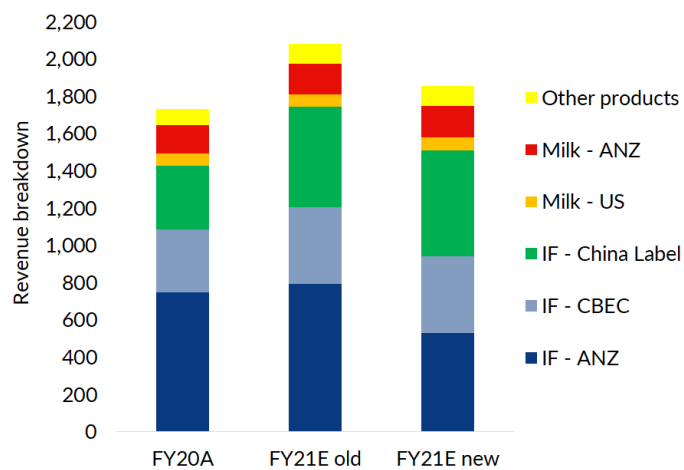
Source: Forsyth Barr analysis, Company reports

Figure 3. Growth expectations built up by the pieces – interims



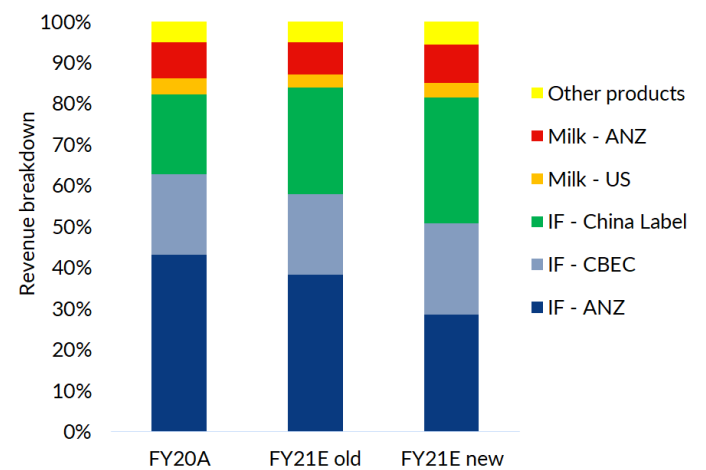
Source: Forsyth Barr analysis, Company reports

Figure 4. Revenue breakdown (NZ\$m)



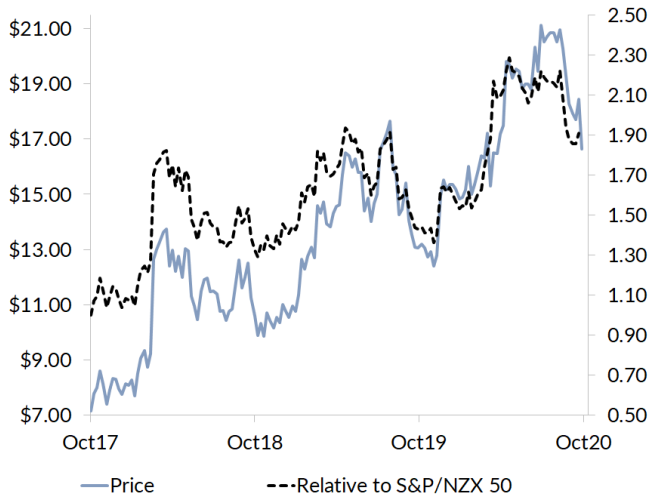
Source: Forsyth Barr analysis, Company reports

Figure 5. Revenue breakdown by percentage



Source: Forsyth Barr analysis, Company reports

Figure 6. Price performance



Source: Forsyth Barr analysis

Figure 7. 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

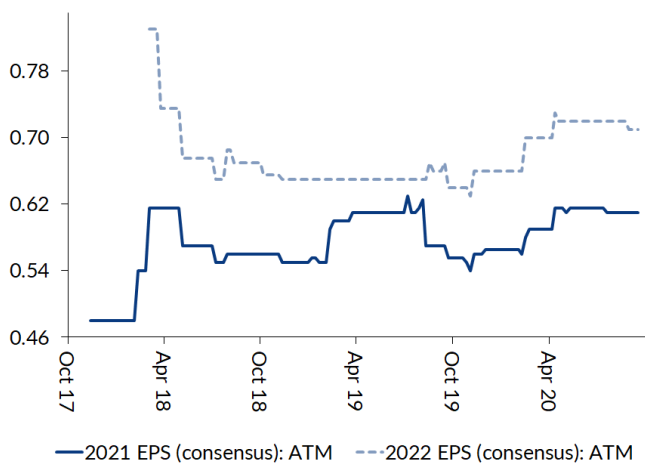
Figure 8. International valuation comparisons

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
The a2 Milk Company	ATM NZ	NZ\$16.65	NZ\$12,262	30.3x	24.7x	19.7x	16.0x	19.9x	16.3x	0.0%
CHINA FEIHE	6186 HK	CN¥17.70	CN¥158,120	24.8x	19.8x	16.7x	13.2x	17.6x	13.9x	1.8%
SYNLAIT MILK *	SML NZ	NZ\$6.05	NZ\$1,085	14.0x	11.7x	8.5x	7.7x	11.5x	10.3x	0.0%
BLACKMORES	BKL AT	A\$68.85	A\$1,332	40.4x	27.7x	19.6x	15.5x	28.7x	19.8x	2.5%
HEALTH AND HAPPINESS H&H INT	1112 HK	CN¥33.25	CN¥21,422	16.7x	14.2x	9.9x	8.8x	10.9x	9.7x	3.7%
RECKITT BENCKISER GROUP PLC	RB/ LN	£74.70	£53,139	23.6x	22.7x	17.3x	16.9x	19.7x	19.3x	2.4%
AUSNUTRIA DAIRY CORP	1717 HK	CN¥12.16	CN¥20,859	14.9x	11.9x	10.5x	8.5x	11.4x	9.1x	2.9%
INNER MONGOLIA YILI INDUS-A	600887 CH	CN¥38.11	CN¥231,831	30.0x	25.6x	20.5x	17.7x	25.6x	22.1x	2.6%
DANONE	BN FP	€54.56	€37,463	15.5x	14.5x	10.9x	10.4x	14.2x	13.4x	4.0%
CHINA MENGNIU DAIRY CO	2319 HK	CN¥35.90	CN¥141,671	34.3x	25.6x	20.7x	16.2x	32.0x	22.5x	0.9%
Compco Average:				23.8x	19.3x	15.0x	12.8x	19.1x	15.6x	2.3%
ATM Relative:				27%	28%	32%	26%	5%	5%	-100%

EV = Current Market Cap + Actual Net Debt

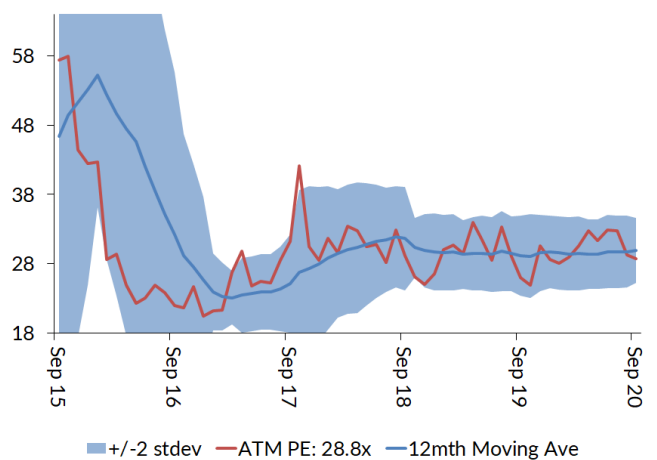
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (ATM) companies fiscal year end

Figure 9. Consensus EPS momentum (NZ\$)



Source: Forsyth Barr analysis

Figure 10. One year forward PE (x)



Source: Forsyth Barr analysis

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