

Analyst

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Authorisation

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The a2Milk Company (A2M)

FX, interest and trade flows

Recommendation

Hold (unchanged)

Price

A\$5.16

Target (12 months)

A\$5.70 (previously A\$5.95)

GICS Sector

Food Beverage and Tobacco

Expected Return

Capital growth	10.5%
Dividend yield	0.0%
Total expected return	10.5%

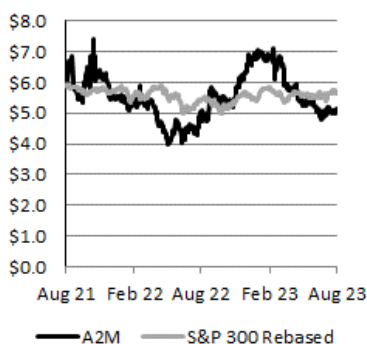
Company Data & Ratios

Enterprise value	A\$3,005m
Market cap	A\$3,725m
Issued capital	722.0m
Free float	100%
Avg. daily val. (52wk)	A\$21.3m
12 month price range	A\$4.60-7.14

Price Performance

	(1m)	(3m)	(12m)
Price (A\$)	4.95	5.40	4.90
Absolute (%)	3.01	-5.00	4.50
Rel market (%)	2.49	-5.67	0.54

Absolute Price



SOURCE: IRESS

BELL POTTER SECURITIES LIMITED
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Adjusting ahead of FY23 results

The following is main takeaways from monthly data points we monitor for A2M:

Australia China exports: Exports from Australia (to China and HK) continue to remain subdued, down -44% YOY through 4Q22 and compares to inbound shipments from NZ (where the three leading brands are manufactured) down -32% YOY. While supply chains are constantly evolving there does not appear to be any material sustained recovery as yet in trade flows.

China IMF imports: Total landed IMF volumes in China fell -9% YOY in 4Q22, though this follows a period of material inventory accumulation (volumes up +38% YOY in 3Q23) ahead of new GB standards. We would expect a period of dislocation in China shipments and revenue generation as channels are destocked and restocked. Direct shipments to China and HK from SM1 centric ports (i.e. A2M volume proxy) were up +88% YOY in volume terms and +130% YOY in value terms in 2H23 (with a +140% YOY uplift in HK bound shipment values in 4Q23).

COGS: Commodity based COG's in IMF continued the downdraft visible in 1H23, on average down -22% YOY in 2H23. Given the timing of inventory accumulation in China we would expect any benefit from lower ingredient costs to be more likely realised from 2Q24e.

We have updated our forecasts to reflect movements in FX, interest rates and export pricing outcomes. The net effect is upgrades to NPAT of +3% in FY23e, +9% in FY24e and +8% in FY25e, the majority being higher interest income. Target price is reduced to \$5.70ps (prev. \$5.95ps) on a higher WACC hurdle with higher base rates.

Investment view: Hold rating unchanged

With the inventory build and unwind in China around new GB standards and change in how platforms are doing business, reading individual patterns in the data variables for A2M is incredibly complex in 2H23-1H24e. On face value HK trends looked to have improved in 4Q23 (from historically low levels) while China data is reflective of upcoming label transitions. We would expect FY24e revenue growth to be 2H biased.

Earnings Forecast

Year end June	2022	2023e	2024e	2025e
Sales (NZ\$m)	1446.2	1587.3	1671.9	1756.0
EBITDA (NZ\$m)	196.2	215.4	242.0	270.0
NPAT (adjusted) (NZ\$m)	122.6	147.5	175.2	200.7
NPAT (reported) (NZ\$m)	98.2	147.5	175.2	200.7
EPS (adjusted) (NZ cps)	16.4	20.0	24.2	27.7
EPS growth (%)	51.6	22.0	20.6	14.6
PER (x)	33.8	27.7	23.0	20.1
FCF Yield (%)	6.0	2.5	5.5	6.3
EV/EBITDA (x)	16.5	15.0	13.4	12.0
Dividend (NZ Cps)	0.0	0.0	0.0	0.0
Franking (%)	0.0	0.0	0.0	0.0
Yield (%)	0.0	0.0	0.0	0.0
ROE (%)	10.3	12.5	13.0	13.0

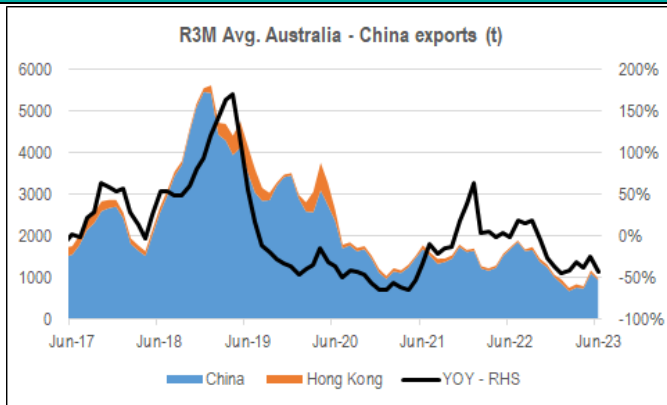
SOURCE: BELL POTTER SECURITIES ESTIMATES

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A2M variable earnings drivers

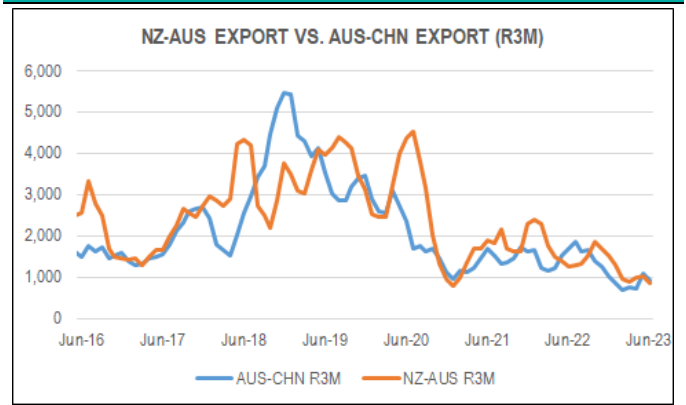
Australian Shipments: Export activity ex-Australia into China has picked up from the lows seen earlier in the year and demonstrating reasonable YOY growth on a R3M basis.

Figure 1 –Finished IMF exports Australia - China



SOURCE: BASED ON ABS DATA

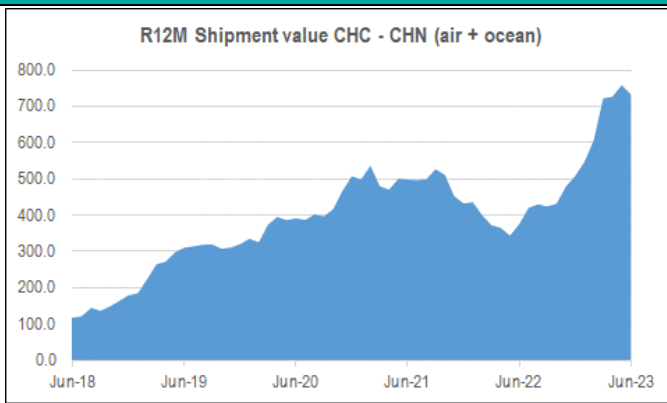
Figure 2 - R3M AUS-CHN exports vs. imports from NZ (t)



SOURCE: BASED ON STATS NZ AND ABS DATA

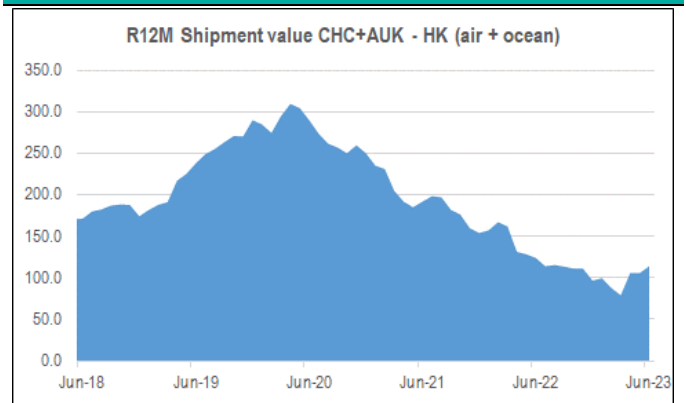
China shipment values: HK revenue trends (CBEC) have bounced off the bottom. China shipments are likely distorted by product movements ahead of GB standard changes. Average shipment values (per Kg) were up +14% YOY to China and +8% YOY to HK.

Figure 3 - R12M China shipments value ex-CHC (NZ\$m)



SOURCE: STATS NZ

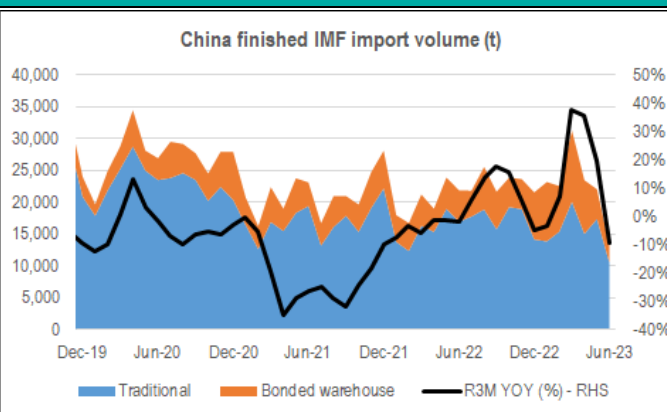
Figure 4 – R12M HK shipments value ex-CHC + AUK (NZ\$m)



SOURCE: STATS NZ

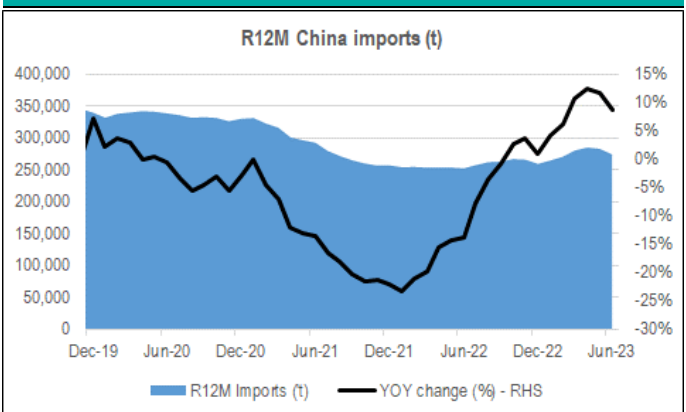
China overall activity: Total China imports of finished IMF have weakened following the surge seen heading into regulatory changes in Feb'23.

Figure 5 – Total China landed imports (t)



SOURCE: STATS NZ

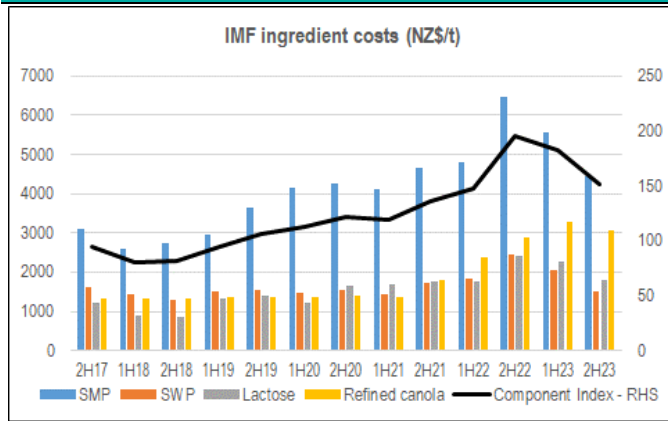
Figure 6 –R12M total landed IMF volumes – China (t)



SOURCE: STATS NZ

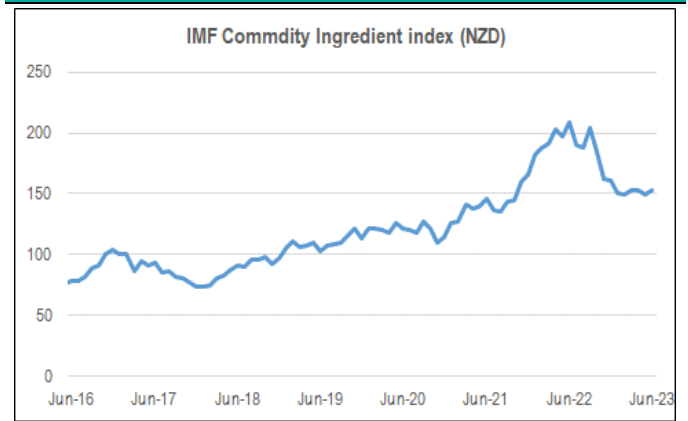
Ingredient input costs: Commodity derived COGS in the IMF supply chain have bottomed in recent months.

Figure 7 – IMF constituent index



SOURCE: SOURCE: BASED ON GDT AND STATSCAN DATA

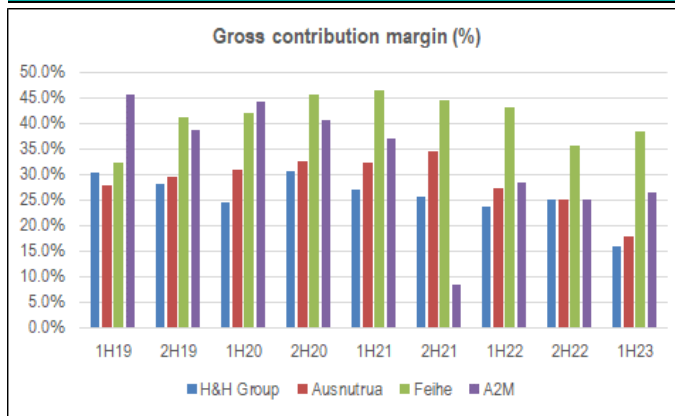
Figure 8 – IMF ingredient index



SOURCE: SOURCE: BASED ON GDT AND STATSCAN DATA

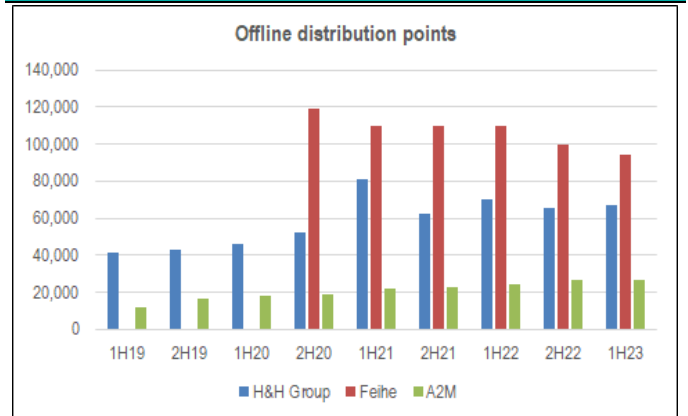
China metrics: A2M is relatively underexposed in offline distribution points relative to peers. A2M gross contribution margins (GM-Marketing-Distribution) is broadly comparable to the peer group.

Figure 9 - Gross contribution margin China IMF



SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

Figure 10 - Offline distribution points



SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

A2M Overview

COMPANY DESCRIPTION

The a2 Milk Company (A2M) is in the business of producing, marketing and selling branded dairy and infant milk formula (IMF) products in Australia, New Zealand, China, US and UK. A2M branded milk contains only A2 Protein rather than both A1 and A2 proteins which are found in Regular Cows' Milk. The business model of A2M is to focus on consumer facing products with a target on the functional food markets where a premium can be generated.

TARGET PRICE

Our target price for A2M is A\$5.70ps and derived utilising our ROIC based methodology. In deriving our target price we have utilised: (1) FY23e ROIC pre-US losses of 56.5% lifting to 63.1% in FY25e; (2) a pre-tax WACC of 11.4%; and (3) AUDNZD cross rate consistent with the spot. To this we incorporate a value for A2M's holding in SM1 at market.

RISKS

A2M is a high growth FMCG business with exposures to an agricultural supply chain. Risks associated in an investment in A2M include but are not isolated to:

COVID-19: The substantial impact of COVID-19 on the global and domestic economies is creating enormous volatility and uncertainty in global share markets. The forecasts in the report may be subjected to significant changes if this situation continues for an extended period of time.

Scientific risk: The A2M brand proposition is built primarily on the potential digestive well-being benefits of A1 Protein Free milk products compared to Regular Cows' Milk products which contain both A1 Protein and A2 Protein. There is the risk of research or information being published that diminishes or rejects the scientific arguments or consumers' experiences as to the benefits of the consumption of A1 Protein Free dairy products. As a result, the A2M brand may lose its differentiated position and it may become difficult for A2M to continue to position its products as premium products sold at a premium price.

Intellectual Property: A2M's business relies in part on its intellectual property portfolio, including brands and trademarks, patents, proprietary processes and know-how. Some forms of registered intellectual property, including patents, are of fixed duration and will expire over time. As any of A2M's registered intellectual property expires, or if it is invalidated or removed from intellectual property registers, this will adversely impact on A2M's ability to claim and enforce exclusive rights in such intellectual property. Because of the importance of its intellectual property, A2M may also need to defend its intellectual property or take action against third parties that infringe or claim rights in its intellectual property. Such action may include litigation, which may be protracted and expensive, and which may result in negative publicity.

Emergence of new competition: A2M's business model relies on A2M branded products being differentiated from other dairy products in each market in which it operates because they consist of, or are made using, A1 Protein Free milk. There is a risk that a competitor or competitors may launch A1 Protein Free milk products, and this risk may increase over time as A2M patents expire. There is also a risk that competitors may develop branding that creates confusion between a2MC branded products and Regular Cows' Milk products or otherwise reduces the perception of A2M branded products as differentiated A1 Protein Free milk products

Supply chain disruption: A2M's business model and supply chain are dependent on contractual arrangements with third parties which provide essential processing, production

or distribution functions for A2M branded products globally. There is the risk that the operations of one or more third parties change in a material and adverse way or that one or more third parties could reduce their support for the A2M brand. This could reduce A2M's ability to maintain supply to its customers in the short to medium term and reduce its ability to maintain its position in existing markets or enter new markets. This may also necessitate the need for A2M to invest in manufacturing capacity that would likely be returns dilutionary.

Brand risk: In common with many other food companies, there is a risk that raw materials may deteriorate or that products may become contaminated, tampered with, adulterated or otherwise unsafe or unfit for sale or consumption within the supply chain due to various factors, including human error and equipment failure. Potential adverse consequences for A2M include regulatory penalties, termination of distribution arrangements, liability associated with adverse health effects on consumers, product recall and disposal costs, loss of stock, delay in supply and financial costs.

Regulatory risk: A2M and its strategic suppliers and contractors require certain licences, approvals and consents in order to conduct their businesses. There is a risk that any such licences, approvals or consents that are material to a2MC in operating its business will not be renewed or will be renewed on more restrictive or onerous terms, or in limited circumstances, revoked.

China regulatory risk: At this stage we are projecting no material change in China C2C law changes which would likely have a detrimental impact on the level of sales in the Australian IMF business, but following a transition would be more than mitigated by faster growth in the China business where gross margins are higher than those achieved in Australia. As such while we are cognisant that a change in Chinese C2C trading regulations can impact near term earnings, we don't necessarily view this as detrimental to the company's longer-term growth trajectory.

Key personnel risk: A2M's performance is dependent on the ability of its senior executives and key personnel to manage and grow its business. Continuity and retention of senior executives and key personnel are important for the ongoing implementation of A2M's strategy.

Execution risk: Part of our optimism centres around management's ability to generate a profitable return in the US and UK fresh dairy markets. Failure to execute this strategy may impact stock performance and its ability to realise our target price.

Table 1 - Financial summary

Year end June	2019	2020	2021	2022	2023e	2024e	2025e
Profit & Loss (NZ\$m)							
Sales revenue	1,304.5	1,731.1	1,206.7	1,446.2	1,587.3	1,671.9	1,756.0
... Change	41.4%	32.7%	-30.3%	19.8%	9.8%	5.3%	5.0%
EBITDA	413.7	552.0	123.4	196.2	215.4	242.0	270.0
Deprec. & amort	(2.2)	(4.4)	(7.5)	(18.9)	(19.9)	(21.9)	(21.9)
EBIT	411.6	547.6	116.0	177.3	195.5	220.0	248.1
Interest expense	4.2	5.7	3.3	4.1	23.1	36.3	42.9
Pre-tax profit	415.7	553.4	119.3	181.4	218.6	256.3	291.0
Tax expense	(128.0)	(165.2)	(38.6)	(66.6)	(80.1)	(89.0)	(98.2)
... tax rate	31%	30%	32%	37%	37%	35%	34%
Minorities	0.0	0.0	0.0	7.9	9.0	7.9	8.0
Net Profit	287.7	388.1	80.7	122.6	147.5	175.2	200.7
Abs. & extras	(66.7)	(55.5)	(133.5)	(24.5)	0.0	0.0	0.0
Reported Profit	221.0	332.6	(52.9)	98.2	147.5	175.2	200.7
Cashflow (NZ\$m)							
EBITDA	413.7	552.0	123.4	196.2	215.4	242.0	270.0
Net Interest Expense	4.2	5.7	3.3	3.0	23.1	36.3	42.9
Tax Paid	(133.9)	(197.9)	(97.8)	(23.0)	(73.4)	(84.5)	(93.6)
Change in Wkg Capital	(1.2)	58.2	53.4	37.0	(62.7)	1.9	1.9
Other	6.3	7.6	(16.2)	(13.4)	0.0	0.0	0.0
Operating Cash Flow	289.1	425.6	66.2	199.7	102.5	195.6	221.2
Capex	(3.4)	(7.2)	(7.3)	(5.2)	(20.2)	(18.7)	(18.5)
Dividend paid	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Free Cash Flow	285.7	418.4	58.9	194.5	82.2	177.0	202.7
Acquisitions	(162.3)	(21.9)	(57.1)	(214.8)	0.0	0.0	0.0
Disposals	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Share issues	2.9	0.0	2.2	(13.3)	(150.0)	0.0	0.0
Other	(2.0)	(7.2)	17.0	(78.6)	0.0	0.0	0.0
(Inc.) /dec. in net debt	124.4	389.4	21.0	(112.2)	(67.8)	177.0	202.7
Balance Sheet (NZ\$m)							
Cash & near cash	464.8	854.2	875.2	887.3	819.6	996.5	1,199.2
Receivables	52.7	70.7	65.3	83.5	91.7	96.5	101.4
Inventories	108.5	147.3	112.2	140.0	166.7	175.6	184.4
Other	49.7	56.3	44.3	60.4	61.4	64.4	67.3
Current assets	675.7	1,128.5	1,096.9	1,171.2	1,139.3	1,333.0	1,552.3
Fixed assets	10.3	30.4	17.2	240.5	245.9	243.7	241.3
Intangibles	13.0	13.6	15.1	109.3	108.3	107.2	106.2
Other	294.5	280.8	242.8	194.7	204.7	214.7	224.7
Non current assets	317.8	324.8	275.1	544.6	558.9	565.7	572.2
Total assets	993.5	1,453.3	1,372.0	1,715.9	1,698.2	1,898.6	2,124.5
Creditors	160.2	281.9	266.3	376.1	349.2	367.8	386.3
Borrowings	0.0	0.0	0.0	43.9	43.9	43.9	43.9
Other	45.1	23.5	8.4	20.2	40.0	54.5	69.1
Current liabilities	205.4	305.4	274.7	440.2	433.2	466.2	499.3
Borrowings	0.0	0.0	0.0	80.4	80.4	80.4	80.4
Other	0.2	13.8	13.4	1.3	1.3	1.3	1.3
Non current liabilities	0.2	13.8	13.4	81.7	81.7	81.7	81.7
Total liabilities	205.6	319.3	288.1	521.9	514.9	547.9	581.0
Net assets	787.9	1,134.1	1,084.0	1,194.0	1,183.3	1,350.7	1,543.5
Share capital	144.5	146.9	149.1	149.2	100.0	100.0	100.0
Reserves	64.9	22.9	(110.1)	(136.3)	(236.3)	(236.3)	(236.3)
Retained earnings	578.4	964.3	1,044.9	1,167.6	1,315.1	1,490.3	1,691.0
Outside equity interests	0.0	0.0	0.0	13.6	4.6	(3.3)	(11.2)
S/holders' funds	787.9	1,134.1	1,084.0	1,194.0	1,183.3	1,350.7	1,543.5
Net Debt (Cash)	(464.8)	(854.2)	(875.2)	(763.0)	(695.2)	(872.2)	(1,074.9)
Rating							
Share price (A\$ps)	Hold						
Target price (A\$ps)	A\$5.70						
Shares on issue (m)	722.0						
Market cap (A\$m)	3725.4						
Enterprise Value (A\$m)	3005.8						
Converted at AUDNZD of:	1.08	EV: MKT cap less cash and SM1 holding					
Valuation Ratios							
Adjusted EPS (¢ps)	38.9	52.4	10.8	16.4	20.0	24.2	27.7
Change (%)	46.9%	34.5%	-79.3%	51.6%	22.0%	20.6%	14.6%
Adjusted PE (x)	14.3	10.6	51.3	33.8	27.7	23.0	20.1
EV/Sales (x)	2.5	1.9	2.7	2.2	2.0	1.9	1.8
EV/EBITDA (x)	7.8	5.9	26.2	16.5	15.0	13.4	12.0
EV/EBIT (x)	7.9	5.9	27.9	18.3	16.6	14.7	13.0
NTA (\$ps)	1.06	1.52	1.45	1.59	1.62	1.85	2.12
P/NTA (x)	4.9	3.4	3.6	3.3	3.2	2.8	2.4
Book Value (\$ps)	1.07	1.53	1.46	1.61	1.64	1.87	2.14
Price/Book (x)	5.2	3.6	3.8	3.5	3.4	3.0	2.6
DPS (¢)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Payout (%)	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Yield (%)	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Performance Ratios							
EBITDA/sales (%)	31.7%	31.9%	10.2%	13.6%	13.6%	14.5%	15.4%
EBIT/sales (%)	31.5%	31.6%	9.6%	12.3%	12.3%	13.2%	14.1%
OCF Realisation (%)	100%	108%	75%	141%	61%	99%	99%
FCF Realisation (%)	99%	108%	73%	159%	56%	101%	101%
ROE (%)	36.5%	34.2%	7.4%	10.3%	12.5%	13.0%	13.0%
ROIC (%)	127.4%	195.7%	55.5%	41.1%	40.0%	46.0%	52.9%
Asset turn (years)	190.13	125.66	16.56	10.37	10.81	11.03	12.31
Capex/Deprn (x)	1.55	1.64	0.98	0.27	1.02	0.85	0.84
Interest cover (x)	(98.95)	(95.31)	(35.25)	(43.22)	(8.45)	(6.06)	(5.78)
Net Debt/EBITDA (x)	(1.12)	(1.55)	(7.09)	(3.89)	(3.23)	(3.60)	(3.98)
Net debt/equity (%)	-59%	-75%	-81%	-64%	-59%	-65%	-70%
Segmentals							
Australia/NZ	842.7	965.7	559.7	532.7	417.2	411.7	425.2
China	405.7	699.4	583.4	726.5	975.1	1054.8	1114.8
US & UK	56.1	66.1	63.6	82.7	113.1	123.5	134.1
Processing				108.9	112.8	112.8	112.8
Corporate and other	0.0	0.0	0.0	(4.5)	(30.9)	(30.9)	(30.9)
Revenue	1,304.5	1,731.1	1,206.7	1,446.2	1,587.3	1,671.9	1,756.0
Australia/NZ	388.2	465.6	148.8	173.2	114.1	113.5	119.2
China	123.9	224.9	75.6	145.1	223.3	249.3	270.9
US & UK	(39.5)	(50.5)	(33.5)	(36.7)	(23.1)	(20.5)	(17.3)
Processing				(18.8)	(18.9)	(14.3)	(14.7)
Corporate & Other	(58.9)	(87.9)	(67.5)	(66.6)	(80.0)	(86.0)	(88.2)
Associates	0.0	0.0	0.0	0.0	0.0	0.0	0.0
EBITDA	413.7	552.0	123.4	196.2	215.4	242.0	270.0
IMF rev share (%)	81.5%	82.3%	75.9%	70.5%	70.8%	71.6%	72.1%
Gross Margin (%)	54.7%	56.0%	42.2%	45.9%	46.2%	47.2%	47.4%
GM ex-MVM (%)	54.7%	56.0%	41.4%	49.0%	48.0%	49.0%	49.1%
IMF GM ex-impairments	56.7%	59.3%	59.6%	55.2%	55.5%	56.7%	56.6%
Marketing (NZ\$m)	135.3	194.0	168.7	230.0	274.9	299.8	308.5
NZDAUD	0.94	0.95	0.93	0.94	0.91	0.93	0.93
NZDUSD	0.67	0.64	0.70	0.68	0.61	0.61	0.61
NZDCNY	4.59	4.48	4.57	4.40	4.29	4.30	4.30

SOURCE: BELL POTTER SECURITIES ESTIMATES

Recommendation structure

Buy: Expect >15% total return on a 12 month view. For stocks regarded as 'Speculative' a return of >30% is expected.

Hold: Expect total return between -5% and 15% on a 12 month view

Sell: Expect <-5% total return on a 12 month view

Speculative Investments are either start-up enterprises with nil or only prospective operations or recently commenced operations with only forecast cash flows, or companies that have commenced operations or have been in operation for some time but have only forecast cash flows and/or a stressed balance sheet.

Such investments may carry an exceptionally high level of capital risk and volatility of returns.

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