BELL POTTER

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The a2 Milk Company (A2M)

Tomorrow's sky

Recommendation
Buy (unchanged)
Price
A$5.49
Target (12 months)
A$6.80 (previously A$6.60)

GICS Sector

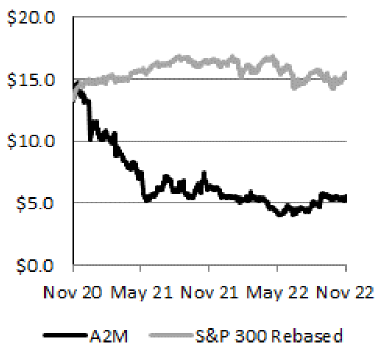
Food Beverage and Tobacco

Expected Return	
Capital growth	23.9%
Dividend yield	0.0%
Total expected return	23.9%
Company Data & Ratios	
Enterprise value	A$3,259m
Market cap	A$4,083m
Issued capital	743.7m
Free float	100%
Avg. daily val. (52wk)	$4.4m
12 month price range	A$3.90-6.49

Price Performance

	(1m)	(3m)	(12m)
Price (A$)	5.40	4.54	6.25
Absolute (%)	3.70	23.35	-10.40
Rel market (%)	-2.11	24.80	-3.50

Absolute Price



SOURCE: IRESS

Moving up the value equation in the US

A2M announced the USFDA has approved its application for enforcement discretion to import, sell and distribute IMF product (Stages 1-2) through to Jan'23 (though we note the USFDA in Sep'22, provided new guidance providing a pathway for products operating under enforcement discretion to remain within the market). Key points:

A2M sales targets: A2M has stated that through its manufacturing partner, SM1, it has access to ~9m tins of IMF capacity. However, A2M's initial expectations are for the supply of up to ~1m tins in 2H23e. This does not appear an egregious forecast, given we estimate BUB sold ~0.45m tins into the US over 4Q22-1Q23 with 6,500 distribution points and A2M has 27,400 existing distribution points for its fresh portfolio.

Earnings impact: A2M expects US gross margins to be lower than average, distribution costs to be higher (initially air freighted), some rework costs, and incremental marketing and trade investment to enter the category. The prevalence of slotting fees, tariffs (once a certain import quota has been met) and higher marketing (as a proportion of sales) in our view are likely to result in more modest margins than those generated in Australian IMF channels.

We have adjusted our forecasts to incorporate modest sales volumes in the US IMF category through to FY25e (assuming sustained market access) and also updated for 1H23 NZD movements. The net effect is NPAT upgrades of +2% in FY23e, +1% in FY24e and +3% in FY25e. Our target price lifts to A$6.80 (prev. A$6.60ps) following these changes and adjusting for movements in the AUDNZD.

Investment view: Buy rating unchanged

Our Buy rating is unchanged. If A2M can execute on its strategy to achieve ~NZ$2Bn in FY26e revenues and EBITDA margins in the teens, then it would imply compound double digit EPS growth through to FY26e. We view the initial entry into the US IMF category as incrementally positive, though note the scale of A2M's existing US fresh distribution footprint implies this could be a more meaningful contributor should sales velocities approach levels seen in other markets.

Earnings Forecast

Year end June	2022	2023e	2024e	2025e
Sales (NZ$m)	1446.2	1630.5	1729.2	1883.7
EBITDA (NZ$m)	196.2	217.1	238.1	274.3
NPAT (adjusted) (NZ$m)	122.6	139.3	160.1	188.9
NPAT (reported) (NZ$m)	98.2	139.3	160.1	188.9
EPS (adjusted) (NZ cps)	16.4	18.7	21.4	25.3
EPS growth (%)	51.6	13.6	14.9	18.0
PER (x)	36.4	32.1	27.9	23.7
FCF Yield (%)	5.5	1.9	4.5	5.4
EV/EBITDA (x)	18.1	16.4	14.9	13.0
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	10.5	10.9	11.4

SOURCE: BELL POTTER SECURITIES ESTIMATES

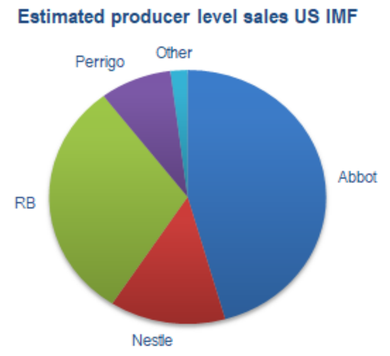
US market at a glance

US MARKET SNAPSHOT

The US market is estimated to have a retail sales value of US$5.6Bn and when we view existing suppliers we see a supplier revenue base of ~US$4.7Bn. Our key observations of the market are detailed below:

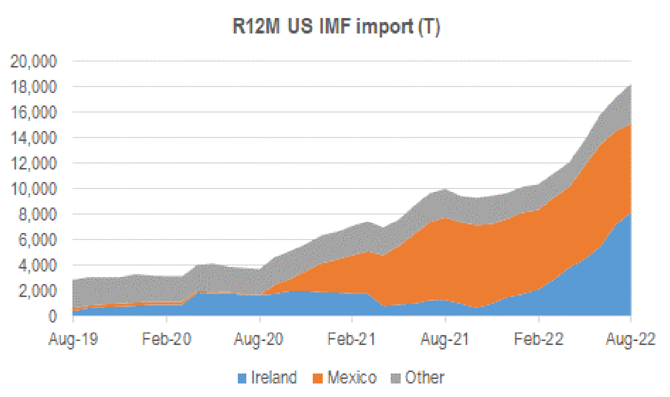
Competitive landscape evolving: In CY21 three branded producers in Abbott, RB and Nestle dominated the market with ~90% of the share, with Perrigo providing formula for retailer housebrands. Since the closure of the Abbott facility and product recall there has been a rapid transition in revenues from Abbott, which to 3QCY22 witnessed a -32% YOY fall in US IMF revenues, towards the other participants. In its recent quarter, RB highlighted +40% YOY growth in US IMF sales (with +20% YOY coming from competitor supply issues) and Nestle highlighted continued strong growth in US IMF revenues.

Figure 1 - Estimated US market share by producer (CY21)



SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

Figure 2 – R12M US imports of finished MF



SOURCE: US CUSTOMS DATA

In addition to local supply shifts, we have observed a material step change in US imports of finished IMF since Dec'31, with large gains from Ireland and Mexico. Note both Nestle and RB have manufacturing capabilities in Mexico and Nestle and Abbott has manufacturing capabilities in Ireland (along with Danone).

New brands: Under the FDA easing of import restrictions, 18 brands covering >19m tins of IMF have been approved for entry into the US. Note there were no volume comments made in regard to the recent approval of A2M and Aptimal Care, though A2M indicated a desire to supply up to 1m tins in 2H23e.

Figure 3 - Brands that have been approved

Date	Brand	Company	Location	Tins (m)
2-Nov	Aptimal Care	Danone	Ireland	n.a.
2-Nov	a2 Platinum	A2M	New Zealand	n.a.
10-Aug	PurAmino (Base powder)	RB/MJN	Mexico	469,000
5-Aug	Althera	Nestle	Netherlands	37,500
29-Jul	Pepticate	Danone	Netherlands	74,000
8-Jul	Care A2+	Care A2 Plus	Australia	4,875,000
6-Jul	PKU Start	Vitaflo	Netherlands	3,192
30-Jun	Aptimal Gold Plus	Danone	New Zealand	550,000
28-Jun	Similac Advance 2	Abbott Nutrition	Ireland	18,677
27-Jun	Bellamy's Organic	Bellamy's Organic	Australia	696,000
17-Jun	Aptimal Frist	Danone	Ireland	750,000
15-Jun	Enfamil Stage 1	Mead Jonson		5,700,000
10-Jun	Similac Total comfort	Abbott Nutrition	Spain	686,530
9-Jun	NAN Expert Pro Sensi	Nestle	Germany	28,200
3-Jun	Gerber Good Start gentle	Nestle	Mexico	1,300,000
2-Jun	NAN Supreme	Nestle	Germany	249,500
27-May	BUB (Full range)	BUB's Australia	Australia	1,250,000
24-May	Kendamil	Kendal Nutricare	United Kingdom	2,000,000
Total				**18,687,599**

SOURCE: US FDA

At face value the volume that has been approved would look to represent >15% of the annual consumption of US IMF and when viewed in conjunction with the sales uplifts being reported from existing US suppliers would suggest a material change in supply side dynamics is emerging. Being granted access is the first step in the process, with suppliers who are granted access having to gain distribution and sell through to hold shelf space.

It is important to note that while the initial term of the access for A2M is until Jan'23, the USFDA has in September 2022, provided new guidance that helps provide a pathway for infant formulas operating under enforcement discretion in the US to remain on the market. In this regard we see the prospect of A2M remaining in market as high.

WIC: Around half the US market is sold via the WIC program, which is highly subsidised (up to 92%) by suppliers. In general companies that hold WIC contracts in any given State have a market leading position in said State, given the preferential facings in retailers. We do not assume that A2M has a desire to participate in WIC as those typically involved have a multi-SKU offering, which A2M currently does not.

Earnings: Based on visible pricing for new products in market, retail price points appear to be materially higher than the Australian price points for the same products. When determining an NSR we are cognisant that we need to account for traditional levels of trade spend (10-15%), slotting fees (~5%) and tariffs (17.5% above the quota volume) and such we would expect NSR discounts to be higher in the US than in Australia. With this in mind our forecasts for A2M in the US assume modest volumes and EBITDA gains in FY23-25e, with FY23e predicated on ~1m tins. In light of A2M's existing US footprint and what other participants have achieved from a standing start we do not see our volume assumptions as particularly aggressive, with sales velocity rates on a per store basis materially behind Australia and China offline.

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$6.80ps and derived utilising our ROIC based methodology. In deriving our target price we have utilised: (1) FY23e ROIC pre-US losses of 52% lifting to 56% in FY24e; (2) a pre-tax WACC of 10.3%; 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.

The a2 Milk Company
as at 3 November 2022

Recommendation	Buy
Price	A$5.49
Target (12 months)	A$6.80

Table 1 - Financial summary

Year end June	2019	2020	2021	2022	2023e	2024e	2025e
Profit & Loss (NZ$m)							
Sales revenue	1,304.5	1,731.1	1,206.7	1,446.2	1,630.5	1,729.2	1,883.7
. . . Change	41.4%	32.7%	-30.3%	19.8%	12.7%	6.1%	8.9%
EBITDA	413.7	552.0	123.4	196.2	217.1	238.1	274.3
Deprec. & amort.	(2.2)	(4.4)	(7.5)	(18.9)	(21.9)	(21.9)	(21.9)
EBIT	411.6	547.6	116.0	177.3	195.1	216.2	252.4
Interest expense	4.2	5.7	3.3	4.1	7.6	13.6	16.7
Pre-tax profit	415.7	553.4	119.3	181.4	202.8	229.8	269.0
Tax expense	(128.0)	(165.2)	(38.6)	(66.6)	(73.4)	(79.9)	(90.7)
. . . tax rate	31%	30%	32%	37%	36%	35%	34%
Minorities	0.0	0.0	0.0	7.9	9.9	10.2	10.5
Net Profit	**287.7**	**388.1**	**80.7**	**122.6**	**139.3**	**160.1**	**188.9**
Abs. & extras.	(66.7)	(55.5)	(133.5)	(24.5)	0.0	0.0	0.0
Reported Profit	**221.0**	**332.6**	**(52.9)**	**98.2**	**139.3**	**160.1**	**188.9**
Cashflow (NZ$m)							
EBITDA	413.7	552.0	123.4	196.2	217.1	238.1	274.3
Net Interest Expense	4.2	5.7	3.3	3.0	7.6	13.6	16.7
Tax Paid	(133.9)	(197.9)	(97.8)	(23.0)	(70.0)	(76.7)	(85.3)
Change in Wkg Capital	(1.2)	58.2	53.4	37.0	(61.7)	2.2	3.4
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**	**93.0**	**177.2**	**209.1**
Capex	(3.4)	(7.2)	(7.3)	(5.2)	(24.2)	(18.5)	(18.3)
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**	**68.8**	**158.7**	**190.7**
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)	0.0	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)**	**68.8**	**158.7**	**190.7**
Balance Sheet (NZ$m)							
Cash & near cash	464.8	854.2	875.2	887.3	956.1	1,114.8	1,305.5
Receivables	52.7	70.7	65.3	83.5	94.2	99.9	108.8
Inventories	108.5	147.3	112.2	140.0	171.2	181.6	197.8
Other	49.7	56.3	44.3	60.4	62.9	66.4	71.8
Current assets	**675.7**	**1,128.5**	**1,096.9**	**1,171.2**	**1,284.3**	**1,462.6**	**1,683.9**
Fixed assets	10.3	30.4	17.2	240.5	243.9	241.5	239.0
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**	**556.9**	**563.5**	**569.9**
Total assets	**993.5**	**1,453.3**	**1,372.0**	**1,715.9**	**1,841.3**	**2,026.1**	**2,253.8**
Creditors	160.2	281.9	266.3	376.1	358.7	380.4	414.4
Borrowings	0.0	0.0	0.0	43.9	43.9	43.9	43.9
Other	45.1	23.5	8.4	20.2	33.5	46.8	62.2
Current liabilities	**205.4**	**305.4**	**274.7**	**440.2**	**436.2**	**471.2**	**520.5**
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**	**517.9**	**552.9**	**602.2**
Net assets	**787.9**	**1,134.1**	**1,084.0**	**1,194.0**	**1,323.3**	**1,473.2**	**1,651.6**
Share capital	144.5	146.9	149.1	149.2	149.2	149.2	149.2
Reserves	64.9	22.9	(110.1)	(136.3)	(136.3)	(136.3)	(136.3)
Retained earnings	578.4	964.3	1,044.9	1,167.6	1,306.9	1,466.9	1,655.8
Outside equity Interests	0.0	0.0	0.0	13.6	3.7	(6.5)	(17.1)
S/holders' funds	**787.9**	**1,134.1**	**1,084.0**	**1,194.0**	**1,323.3**	**1,473.2**	**1,651.6**
Net Debt (Cash)	(464.8)	(854.2)	(875.2)	(763.0)	(831.7)	(990.4)	(1,181.2)

Rating	Buy
Share price (A$ps)	$5.49
Target price (A$ps)	$6.80
Shares on issue (m)	743.7
Market cap (A$m)	4082.7
Enterprise Value (A$m)	3259.2
Converted at AUDNZD of: 1.09	**EV: MKt cap less cash and SM1 holding**

Year end June	2019	2020	2021	2022	2023e	2024e	2025e
Valuation Ratios							
Adjusted EPS (¢ps)	38.9	52.4	10.8	16.4	18.7	21.4	25.3
Change (%)	46.9%	34.5%	-79.3%	51.6%	13.6%	14.9%	18.0%
Adjusted PE (x)	15.4	11.4	55.3	36.4	32.1	27.9	23.7
EV/Sales (x)	2.7	2.1	2.9	2.5	2.2	2.1	1.9
EV/EBITDA (x)	8.6	6.4	28.8	18.1	16.4	14.9	13.0
EV/EBIT (x)	8.6	6.5	30.6	20.0	18.2	16.4	14.1
NTA ($ps)	1.05	1.52	1.44	1.59	1.76	1.96	2.21
P/NTA (x)	5.2	3.6	3.8	3.5	3.1	2.8	2.5
Book Value ($ps)	1.07	1.53	1.46	1.61	1.78	1.98	2.22
Price/Book (x)	5.6	3.9	4.1	3.7	3.4	3.0	2.7
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%	13.3%	13.8%	14.6%
EBIT/sales (%)	31.5%	31.6%	9.6%	12.3%	12.0%	12.5%	13.4%
OCF Realisation (%)	100%	108%	75%	141%	58%	97%	99%
FCF Realisation (%)	99%	108%	73%	159%	49%	99%	101%
ROE (%)	36.5%	34.2%	7.4%	10.3%	10.5%	10.9%	11.4%
ROIC (%)	127.4%	195.7%	55.5%	41.1%	39.7%	44.8%	53.7%
Asset turn (years)	190.13	125.66	16.56	10.37	9.90	10.86	12.51
Capex/Depn (x)	1.55	1.64	0.98	0.27	1.10	0.84	0.84
Interest cover (x)	(98.95)	(95.31)	(35.25)	(43.22)	(25.53)	(15.88)	(15.14)
Net Debt/EBITDA (x)	(1.12)	(1.55)	(7.09)	(3.89)	(3.83)	(4.16)	(4.31)
Net debt/equity (%)	-59%	-75%	-81%	-64%	-63%	-67%	-72%
Segmentals							
Australia/NZ	842.7	965.7	559.7	532.7	567.2	584.8	606.8
China	405.7	699.4	583.4	726.5	834.0	904.1	1018.8
US & UK	56.1	66.1	63.6	82.7	126.0	137.0	154.7
Processing				108.9	112.8	112.8	112.8
Corporate and other	0.0	0.0	0.0	(4.5)	(9.4)	(9.4)	(9.4)
Revenue	**1,304.5**	**1,731.1**	**1,206.7**	**1,446.2**	**1,630.5**	**1,729.2**	**1,883.7**
Australia/NZ	388.2	465.6	148.8	173.2	171.0	182.0	191.8
China	123.9	224.9	75.6	145.1	163.3	171.5	195.5
US & UK	(39.5)	(50.5)	(33.5)	(36.7)	(21.2)	(16.4)	(10.7)
Processing				(18.8)	(22.5)	(23.8)	(25.0)
Corporate & Other	(58.9)	(87.9)	(67.5)	(66.6)	(73.5)	(75.3)	(77.2)
Associates	0.0	0.0	0.0	0.0	0.0	0.0	0.0
EBITDA	**413.7**	**552.0**	**123.4**	**196.2**	**217.1**	**238.1**	**274.3**
IMF rev share (%)	81.5%	82.3%	75.9%	70.5%	71.1%	72.1%	73.4%
Gross Margin (%)	54.7%	56.0%	42.2%	45.9%	46.1%	46.1%	46.5%
GM ex-MVM (%)	54.7%	56.0%	41.4%	48.8%	48.5%	48.3%	48.6%
IMF GM ex-impairments	56.7%	59.3%	59.6%	55.2%	54.2%	53.5%	53.3%
Marketing (NZ$m)	135.3	194.0	168.7	230.0	264.5	286.8	319.0
NZDAUD	0.94	0.95	0.93	0.94	0.90	0.91	0.91
NZDUSD	0.67	0.64	0.70	0.68	0.62	0.64	0.64
NZDCNY	4.59	4.48	4.57	4.40	4.25	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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