NEW ZEALAND

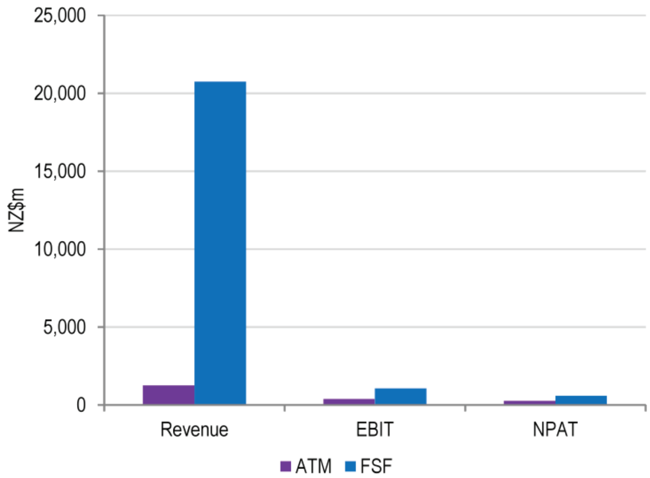
MILK SHAKE-UP

The dairy industry is synonymous with New Zealand, accounting for ~3.5% of GDP. New Zealand's dairy industry has been defined by one monopoly, Fonterra; however that narrative has been changing over the last couple of years with the rise of the a2 Milk Company (ATM) and to a lesser extent Synlait (SML).

ATM is now the most valuable dairy product producer in New Zealand (based on market capitalisation) surpassing Fonterra in February. It is a high-growth, brand driven company attempting to bring change to an industry that has seemingly lacked innovation, while Fonterra is a heavily scrutinised conglomerate in relative turmoil in part due to poor investment decisions and a restrictive governance structure. The differences between the two organisations have been shown by investor sentiment with the share price of ATM rising an astonishing +428% over the last two years while Fonterra units/shares have declined -17% over the same period. Growth expectations and return on invested capital (ROIC) are two factors driving the valuations of ATM and Fonterra in opposite directions and explain why ATM trades on a ~33x forward PE multiple compared to Fonterra trading at ~13x.

However, comparing Fonterra and ATM is not a straightforward exercise. Fonterra's mix of vertical integration, regulation, commodity price reliance and co-operative structure make it a complex business to manage compared to the asset-light, flexible approach of ATM. Operating scale is also a separator of the two businesses with Fonterra's supply chain collecting ~70x more milk solids, driving revenue of 17x more yet only generating EBIT and NPAT of 2.8x and 2.2x more than ATM.

FIGURE 1. CONSENSUS FY19 ESTIMATES



Source: Forsyth Barr analysis, Bloomberg

So how can ATM have a larger market capitalisation than Fonterra despite generating lower profits? A large portion of the discrepancy lies within the growth and ROIC profile of both organisations. Companies that generate high growth and high ROIC tend to trade at higher valuation multiples. ATM has experienced meteoric growth over the last couple of years which is expected to continue with a consensus FY19 revenue growth estimate of +36% compared to the +3% consensus FY19 revenue growth estimate for Fonterra. ATM also generates a vastly superior ROIC compared to Fonterra.

After years of delay in recognising the value in a2 Milk Fonterra decided in February to partner with ATM. Fonterra is now holding conversations with farmers regarding herd conversions to a2 Milk while its Anchor brand launched pure a2 Milk to select North Island supermarkets in July ahead of a planned national rollout.

We recently reinstated full coverage on ATM in August ***(6/08/18 The a2 Milk Company: Not a 1 Trick Pony – Reinstate as OUTPERFORM)*** which should be viewed for additional information.

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