Analyst
Jonathan Snape 613 9235 1601

Authorisation
Sam Haddad 612 8224 2819

The a2 Milk company (A2M)

Easy to stomach

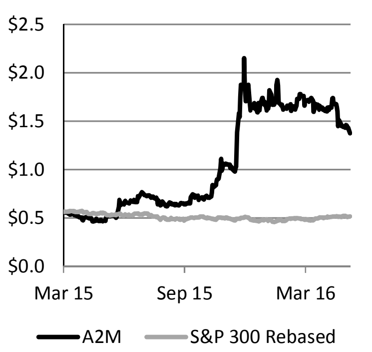
Recommendation
Buy (Initiation)
Price
A$1.38
Target (12 months)
A$1.81 (Initiation)

Expected Return	
Capital growth	**31.9%**
Dividend yield	**0.0%**
Total expected return	**31.9%**
Company Data & Ratios	
Enterprise value	**A$943.7m**
Market cap	**A$978.0m**
Issued capital	**711.3m**
Free float	**100%**
Avg. daily val. (52wk)	**$11.6m**
12 month price range	**$0.46-2.36**
GICS sector	**Food Beverage and Tobacco**

Price Performance

	(1m)	(3m)	(12m)
Price (A$)	1.64	1.64	0.47
Absolute (%)	-16.16	-15.90	192.55
Rel market (%)	-16.36	-24.88	197.15

Absolute Price



SOURCE: IRESS

Background and investment view

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. We initiate on A2M with a Buy rating and a $1.81ps price target. Our favourable view on A2M is supported by: (1) a favourable margin shift as sales evolve in IMF; (2) exposure to growing demand for imported IMF products in China; (3) transition of the US and UK businesses from losses to profits; (4) a change in the NZ business model post 2017 to the advantage of A2M; (5) the potential expansion of the product portfolio into new products across all regions; and (6) undemanding valuation metrics relative to other FMCG companies with functional properties or leverage to infant nutrition markets.

Offshore growth options

In the last three years A2M has entered the fast growing Chinese IMF market, restructured its UK operations and re-entered the US market. The size of these market opportunities is large with; (1) the Chinese IMF market worth US$17.8Bn in 2014 (vs. Australia at A$780m) and growing (+18% pa FY14-19e); and (2) the UK and US fresh milk markets worth US$48Bn with a premium segment worth $4Bn annually, rivalling the size of the entire Australian market (worth ~A$4.6Bn). The earnings upside to A2M from gaining relatively modest market share in these markets is material in our view.

Investment view: Initiate coverage with a Buy rating

A2M looks a business operating within its competitive advantage period, benefiting from being a first mover in a new functional food category with a degree of IP and brand protection. In our view A2M is at the infancy of its earnings growth profile, generating an exception ROIC (44% in FY16e) and strong operating cashflows (from FY17e) and we initiate coverage on A2M with a Buy rating and a $1.81ps target price.

Earnings Forecast

Year end June	2015	2016e	2017e	2018e
Sales (NZ$m)	155.1	343.0	457.4	526.1
EBITDA (NZ$m)	4.8	47.1	82.8	102.7
NPAT (adjusted) (NZ$m)	(0.4)	29.6	55.6	70.0
NPAT (reported) (NZ$m)	(2.1)	27.6	55.6	70.0
EPS (adjusted) (NZ cps)	(0.1)	4.2	7.5	9.4
EPS growth (%)	n.a.	n.a.	78.0	26.0
PER (x)	n.a.	34.7	19.5	15.5
FCF Yield (%)	-1.2	-2.0	3.4	5.7
EV/EBITDA (x)	208.5	21.2	12.1	9.7
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 (%)	5.4	44.1	65.4	73.7

SOURCE: BELL POTTER SECURITIES ESTIMATES

Contents

Background and Investment view

COMPANY BACKGROUND

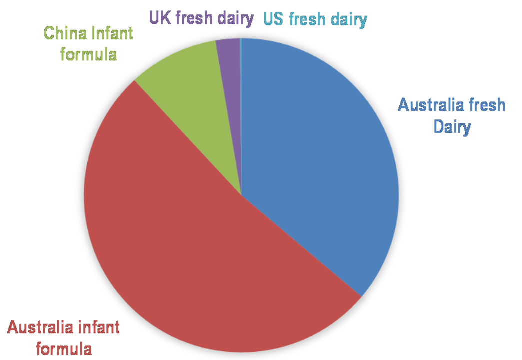
The a2 Milk Company (A2M) was established in NZ in 2000 by Corran McLachlan and is in the business of producing, marketing and selling branded dairy and infant formula products in Australia, New Zealand, China, US and UK. A2M branded milk contains only A2 Protein rather than both A1 Protein and A2 Protein which are found in Regular Cows' Milk, with a body of research purporting to support claims that A2 protein is easier to digest and reduces discomfort of consumers. The A2M business model is to focus on consumer facing products which tend to be higher margin with a target on the functional foods market where a premium can be generated. A2M is a pioneer in its field and there are a number of patents protecting herd testing and branding. A brief divisional overview of A2M is summarised below.

Figure 1 - A2M operational overview

Division	1H16 Sales	1H16 EBITDA	Category	Product	Market Entry	Market size Volume	Value	10yr CAGR	Estimated 2015 Market share
Australia & NZ	127.90	34.50	Fresh dairy	Fresh & long life milk, cream & yoghurt (under licence to jalna)	2003	~2,500mL	~A$4.6Bn ~NZ$1.4Bn	+2.0%	2.2%
			IMF	Infant and follow on formulas		~25,000t	~A$750m	+5.0% pa	11.4%
China	8.40	1.10	IMF	Infant and follow on formulas	2013	~800,000t	~US$19.9Bn	+24.0% pa	>0.1%
UK	2.90	(8.10)	Fresh dairy	Fresh and long life milk	2012	~5,500mL	GBP3.1Bn	+2.5%	>0.1%
US			Fresh dairy	Fresh and long life milk	2015	~50,000mL	US$44.0Bn	(0.7%) pa	n.a.

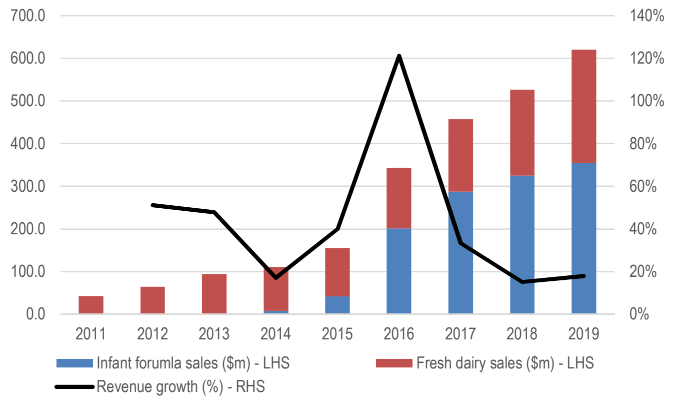
SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

Figure 2 - FY16e revenue by region



SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

Figure 3 - Revenue growth by product segment



SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

INVESTMENT THESIS

A2M looks a business still within its competitive advantage period, with the advantage of being a first mover in a new functional food category and still holding IP and brand protection. This creates a unique set of circumstances with a company achieving significant growth in revenues and earnings, while sustaining a ROIC (~45% in FY16e) well in excess of its cost capital and an exceptionally high level of operating cash generation. In our view A2M is still in the infancy of its growth profile and as such we initiate coverage on A2M with a Buy rating and a $1.81ps target price. Our favourable view on A2M is predicated on:

1.0 Favourable margin shift as sales evolve in IMF: Infant formula sales have grown from 7% of revenues in FY14 to an estimated 59% in FY16e. We estimate that infant formula will make up in excess of 60% of revenue in FY17-18e despite growth in the US & UK milk revenue base and in doing so result in a favourable gross margin shift in the Australian and Asian businesses where we estimate gross margins can be 30-40% higher than those generated in fresh milk sales.

2.0 China market opportunity: The Chinese IMF market was worth US$17.8Bn in 2014 and had been growing at +24% pa in the five years preceding this. This growth is expected to continue with compound growth in demand forecast at +18% pa through to 2019e and A2M is leveraged to this thematic. A2M already operates aa profitable business on a modest sales base ($8.6m in 1H16) and even achieving modest market share (in a market where 30% of product is imported) offers a sizeable opportunity for A2M.

3.0 Evolution of the US and UK businesses: The UK business is expected to be EBIT cash breakeven status in 4Q16 while the investment in expanding the US market presence has been accelerated due to the increasing cash generation of the Australian and China businesses. Combined, these two markets have annual milk sales volumes of 55.6BnL worth an estimated US$48Bn in turnover and developed premium market segments with annual turnover of US$4Bn or a figure broadly comparable to the size of the entire Australian market. Even achieving modest market shares of 1.5% would imply a $20-25m EBITDA opportunity, a figure we project by FY21e.

4.0 Changing NZ business model: The NZ license with Frescha Valley runs until May 2017 and it is intended that this structure will be collapsed and a similar operating model to that of Australia be adopted. Sales of a2 branded milk in NZ are the equivalent of 1-2% of those achieved in Australia and it could be argued that the opportunity for A2M could be material if the success in Australia could be replicated. The NZ fresh milk market is worth ~NZ$1.4Bn annually and capturing 4-5% market share would translate to sales of NZ$55-70m and EBITDA of $6.5-11.0m assuming similar margins to those achieved in Australia.

5.0 Expansion of the product portfolio: The portfolio offering of A2M is currently rather narrow though expanding in the Australian business. In the future we see the potential for A2M to expand into the $850m sports nutrition market or adult dairy supplements market. In addition to the scope for new product lines in the Australian business we see the scope for the existing product range (infant formula, UHT milk, yoghurt and ice cream) to be expanded into new territories as the core fresh milk market product reaches scale and brand awareness is achieved.

6.0 Favourable valuation relative to peers: At the headline A2M is trading on a FY17e EV/EBITDA multiple of 12.1x though excluding the losses generated in the US the multiple falls to 9.9x. This compares to an average multiple for dairy processors of 10.5x and the average for FMCG business with organic or functional properties and infant formula capability of closer to 14.3x. In effect we see the market as capitalising losses in a business that to our mind is essentially development capex, with the US business EBIT positive with the exception of the investment currently being made to expand brand awareness.

TARGET PRICE DETERMINATION

It is rare to find a business generating the level of returns, earnings growth and cash generation of a stock like A2M. The business is still very much in a competitive advantage period where earnings growth and returns expansion are strong and as such we see the stock as still having material earnings growth ahead. In deriving our $1.81ps target price we have utilised a single stage ROIC model, which looks to capitalise returns twelve months forward. Major assumptions in this model are:

WACC Drivers: We have assumed an asset beta of 0.75x in line with what we employ in other listed and dairy processors and consistent with the average for listed FMCG exposures. Incorporating this with an MRP of 5.5% and risk free rate of 5.0% (with a borrowing margin of 2.5%) derives a pre-tax WACC of 9.1%.

Growth rate: Our long range earnings forecasts project A2M is capable of generating compound EBITDA growth of 10% pa for the next 10 years. This is predicated on A2M achieving market share of 0.2% in the China IMF market, 1.5% market share in the UK fresh milk market and 1.5% market share in the Californian fresh milk market. Given the above sector medium term growth rate we have adopted a long-term growth forecast of 3.5% in deriving our EV/EBITDA multiple. This exceeds the traditional 3.0% we use for dairy stocks, which we see as appropriate given we are utilising a single stage growth model in determining our target price.

Share base and net debt: We have adjusted both our projected FY17e net cash balance and share capital base to reflect the dilutionary impact of partly paid shares on issue.

A summary of our target price model is summarised below, highlighting a derived target price of NZ$1.92ps based on FY17e forecasts, or A$1.81ps when translated at the spot AUDNZD cross rate of 1.06.

Figure 4 - A2M price target derivation

Risk Free Rate	5.00%	Equity Beta	0.75	Current Share Price	$ 1.38
Borrowing Margin	2.50%	Terminal Growth Rate	3.5%	Equity (MV $m)	1022.5
Mkt Risk Premium	5.50%	Cost of Debt	7.5%	1H16 net debt (cash) ($m)	(6.1)
Asset Beta	0.75	Cost Of Equity	9.1%	Shares On Issue	743.6
1H16 Net debt/(net debt+equity)	-0.60%	WACC	9.1%		

ROIC based methodolgy	2015	2016	2017	2018	2019
EBIT	2.9	44.3	80.0	99.9	134.6
Invested Capital	52.5	100.6	122.2	135.5	147.2
ROIC (%)	5.4%	44.1%	65.4%	73.7%	91.4%
long-term growth rate	3.0%	3.5%	3.5%	3.5%	3.5%
Pre-tax WACC (%)	9.1%	9.1%	9.1%	9.1%	9.1%
Depreciation	1.9	2.8	2.8	2.8	2.8
EBITDA	4.8	47.1	82.8	102.7	137.3
Derived EV/EBITDA	4.35	15.44	16.30	16.52	16.79
Implied Enterprise Value	**20.9**	**727.5**	**1349.1**	**1695.7**	**2306.6**
Net cash (debt)		27.2	61.2	117.9	202.0
Cash due from options & PPS		20.4	20.4	20.4	20.4
Implied market value		**775.1**	**1430.6**	**1834.0**	**2529.0**
Adjusted shares on issue		743.6	743.6	743.6	743.6
Valuation per share (A$ps)		**1.04**	**1.92**	**2.47**	**3.40**
AUDNZD		1.06	1.06	1.06	1.06
Target price (A$ps)		**0.98**	**1.81**	**2.33**	**3.21**

SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

As a cross check we have also looked at A2M relative to its peer group. While we note the Australian agricultural and FMCG sector is trading at 9.8x FY17e EBITDA, we note global dairy stocks are trading at 10.4x and global infant nutrition and function food exposures are trading at an average of 14.3x.

Figure 5 - A2M peer group comparison

	Stock Code	Share Price ($ps)	Shares Out (m)	Market Cap ($m)	Net Debt/(Cash)	Enterprise Value ($m)	EBITDA ($m)			EV/EBITDA (x)		
							2016	2017	2018	2016	2017	2018
Bellamy's Australia Ltd	BAL.AU	10.97	97	1,060	(38)	1,023	52	90	119	19.7	11.3	8.6
Bega Cheese	BGA.AU	6	153	916	75	990	64	79	87	15.4	12.5	11.4
Capilano Honey	CZZ.AU	21.1	9	200	16	216	18	21	23	12.2	10.5	9.5
Freedom Foods	FNP.AU	3.86	181	697	(12)	685	24	35	47	29.1	19.4	14.6
Fonterra Shareholders Fund	FSF.AU	5.3	1,599	8,475	6,119	14,595	1,944	1,954	2,106	7.5	7.5	6.9
Huon Acquaculture	HUO.AU	3.2	87	279	76	356	18	51	65	20.1	7.0	5.5
MG Unit Trust	MGC.AU	1.00	555	555	392	947	143.4	156.3	166.3	6.6	6.1	5.7
Ridley Corporation	RIC AU	1.37	308	422	59	480	56	63	66	8.6	7.7	7.2
Select Harvests	SHV.AU	7.28	73	531	52	583	57.2	55.1	58.5	10.2	10.6	10.0
Synlait	SML NZ	3.05	146	446	268	714	80	91	98	9.0	7.9	7.3
Tassal Group	TGR.AU	4.21	147	620	128	748	87.5	96.7	106.3	8.5	7.7	7.0
Austrlian & NZ FMCG and agri-processors										**13.4**	**9.8**	**8.5**
Abbott Laboratories	ABT US	39.18	1,469	57,561	3,099	60,661	5,229	5,627	6,077	11.6	10.8	10.0
Bega Cheese	BGA AU	6	153	916	60	976	67	79	89	14.5	12.4	11.0
Beingmate Baby & Child Food Co	002570 CH	13.16	1,023	13,456	(444)	13,012	380	432	708	34.3	30.1	18.4
Bellamy's Australia	BAL AU	10.97	97	1,060	(38)	1,023	52	90	119	19.7	11.3	8.6
Biostime International Holdings	1112 HK	24.75	630	15,600	4,370	19,970	1,648	1,772	1,936	12.1	11.3	10.3
China Mengnui Dairy Co	2319 HK	13.32	3,919	52,205	886	53,090	4,391	4,848	5,351	12.1	11.0	9.9
Danone SA	BN FP	62.87	656	41,236	7,028	48,264	3,863	4,120	4,385	12.5	11.7	11.0
Mead Johnson Nutrition Co	MJN US	83.21	187	15,532	1,501	17,033	1,061	1,126	1,193	16.1	15.1	14.3
Nestle SA	NESN VX	73.35	3,188	233,869	13,954	247,823	17,391	18,347	19,319	14.2	13.5	12.8
Yashili International Holdings	1230 HK	1.71	4,746	8,115	(2,476)	5,639	315.9	456.2	577.4	17.9	12.4	9.8
Global Infant nutrition exposures										**16.5**	**13.9**	**11.6**
Bellamy's Australia Ltd	BAL AU	10.97	97	1,060	(38)	1,023	52	90.5	119.0	19.7	11.3	8.6
Freedom Foods	FNP AU	3.86	181	697	(12)	685	24	35.4	46.8	29.1	19.4	14.6
Mead Johnson Nutrition Co	MJN US	83.21	187	15,532	1,501	17,033	1,061	1,126.2	1,193.0	16.1	15.1	14.3
WhiteWave Foods Co	WWAV US	45.87	177	8,115	2,015	10,130	581	658.8	746.7	17.4	15.4	13.6
Global functional Food exposures										**20.6**	**15.3**	**12.8**
Austrlian & NZ FMCG and agri-processors										**13.4**	**9.8**	**8.5**
Global Dairy										**12.1**	**10.5**	**9.7**
Global Infant nutrition exposures										**17.7**	**14.3**	**11.9**

SOURCE: BELL POTTER SECURITIES, BLOOMBERG AND IBESS

Based on our FY17e forecasts we see A2M trading at a headline discount of 15% to global IMF and functional food stocks, though note that this discount expands to 30% when we adjust for losses currently being generated in the US and European operations. As we essentially view these losses as capex (i.e. investment to grow the business) this discount would look excessive.

Figure 6 - A2M EV/EBITDA metrics relative to the peer group

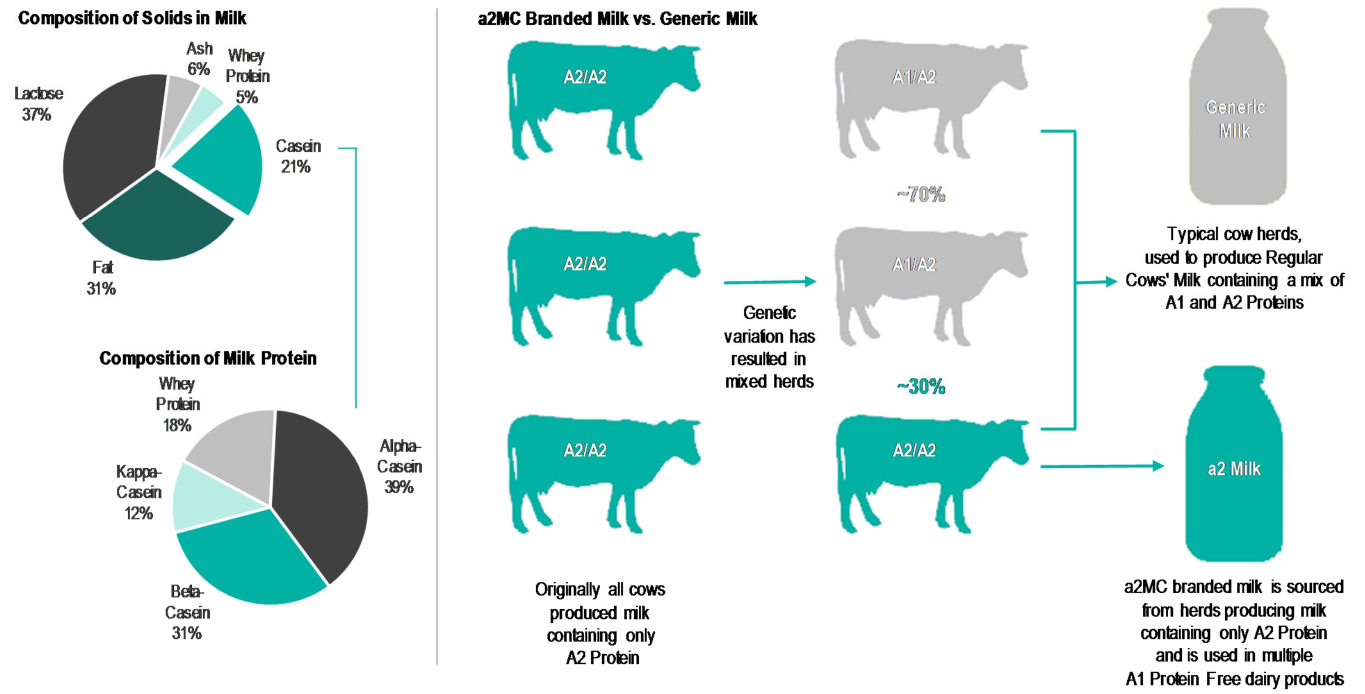
	2012	2013	2014	2015	2016e	2017e	2018e
A2M EV/EBITDA (x)	218.8	164.1	454.9	208.5	21.2	12.1	9.7
EV/EBITDA ex-US (x)	218.8	164.1	231.6	78.7	15.5	9.9	8.4
EV/EBITDA Global dairy					12.1	10.5	9.7
EV/EBITDA Global IMF & functional foods					17.7	14.3	11.9
A2M Discount (%)					**20.0%**	**-15.4%**	**-18.1%**
A2M discount - US adjusted (%)					**-12.3%**	**-30.4%**	**-29.2%**

SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

What is a2 Milk and what's the difference?

Regular cows milk contains two main types of beta-casein proteins (~30% of the total protein content of milk), A2 Protein and A1 Protein. A2 branded milk is comparable to generic milk in all regards with the exception that it contains only A2 Protein.

Figure 7 - a2 Milk vs. generic white milk



SOURCE: COMPANY DATA

Research has shown that A1 and A2 proteins digest differently, with studies showing that a seven-amino peptide (beta-casomorphin-7 or BCM-7) can be cut away from the A1 protein by digestive enzymes. There have been several studies attempting to link BCM-7 with a number of illnesses such as: Type 1 diabetes, heart disease, SIDS and autism, though none have proved conclusive. However, there is growing evidence that A1 protein may effect digestive function and cause digestive discomfort.

In 2014 Curtin University conducted the first human digestion clinical trial testing the A1 and A2 proteins. The Nature Publishing Group published the research in the Journal of Clinical Nutrition. The results showed people who consumed the A2 protein were less susceptible to bloating and other stomach aches than those who consumed the A1 protein and this would look consistent with the marketing claim of a2 Milk.

Supply Chain

A2M products are produced through a scalable supply chain model, which commences with milk supply. The supply chain model has been developed in Australia for fresh milk and in New Zealand for infant formula and is the template which will be rolled out globally. A2M has focused its investment in sales, marketing and brand development and typically looks to outsource the processing aspect of the supply chain, unless there is a strategic rational for the investment (ie. the Smeaton Grange facility in NSW).

Figure 8 - a2 Milk supply chain in Australian fresh milk

SOURCE: COMPANY DATA

Australia & NZ Supply chain model: A2M sources milk for the Australian market from certified local dairy farms. The cows are tested by an A2M certified genetic testing laboratory and only those animals that test positive to naturally producing milk containing A2 Protein and not A1 Protein are isolated to form a herd. The cows' genotyping result is recorded and monitored through an A2M implemented cow tracking system which follows their movements in and out of the herd. Testing of the milk from the farm is conducted to validate that it is A1 Protein Free prior to a2MC certifying that the herd is fit for production. Milk is transported by contractors to either A2M's processing facility, Smeaton Grange, or one of A2M's third party contracted processing facilities.

The Smeaton Grange facility commenced operation in February 2012 and was designed as a purpose built liquid fresh milk facility. In addition, A2M uses a number of independent milk processors who process and pack a proportion of A2M's total Australian requirements under formal contract packing agreements. a2 Platinum infant formula is processed and packaged by Synlait in New Zealand. It is then distributed by contractors to retailer warehouses and pharmacy wholesalers for distribution to individual stores.

China supply chain model: a2 Platinum infant formula is processed and packaged by Synlait under a formal manufacturing agreement that utilises milk sourced from A2M certified dairy farms in New Zealand. Synlait operates a facility in Canterbury (New

Zealand) that allows full manufacturing and packaging control from sourcing and collection of certified A1 Protein Free milk through to manufacturing and packaging of a2 Platinum infant formula. In 2012, A2M appointed China State Farm (CSF) as the exclusive distributor of a2 Platinum for China. In November 2014, this relationship was amended so that CSF became the exclusive import agent for a2 Platinum into mainland China. A2M does not operate a trading subsidiary in China and receives payment for products imported into China in USD or NZD.

UK Supply chain: A2M sources its supply of A1 Protein Free milk from certified farms in the UK. A2m has achieved a growing distribution network throughout the UK with a2MC branded milk being sold in leading supermarkets including Tesco, Waitrose, Morrisons, Ocado (online supermarket) and more recently J Sainsbury. Products will also commence being sold in Wholefoods and with an additional wholesaler and distributor, Marigold, from early 2015. The Company is currently selling solely fresh milk in the UK

Patent Protection

A2M's intellectual property portfolio consists of a numbers of rights in trademarks, patents, proprietary processes and know-how which together interlock and provide protection to a2 branded products and processes. A2M has brand and trademark registrations or applications across 57 territories (as at Dec'15). In addition A2M has 14 families of patents which cover a number of activities including herd testing, herd formation, beneficial uses and physical properties associated with A2 products. The table below details all publically disclosed patents by A2M, though we note there are ~5 new families of patent applications lodged since this list was provided where details have not been released. Our understanding is these patents are largely focused around the benefits of A1 protein free products.

Figure 9 - a2 Milk supply chain in Australian fresh milk

Patent title	Expiry	Territories
Method of Selecting Non-Diabetogenic Milk or Milk Products and Milk or Milk Products so Selected	3 November 2015	Australia, Canada, Finland, Ireland, Netherlands, New Zealand, Norway, UK, USA
Food Product and Process, Bovine Genotype Testing for Beta-Caseins Breeding and Milking Cows for Milk Free of Beta-Casein A1	9 May 2016	Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Netherlands, New Zealand, Sweden, Switzerland, UK, USA
Prophylactic Dietary Supplement Based on Milk	29 June 2020	Australia, China, New Zealand
Animal Genotyping Method	23 May 2023	Australia, Canada, China, Hong Kong, India, Japan, New Zealand, Singapore, South Korea, USA, Vietnam
Method for Altering Fatty Acid Composition of Milk	3 July 2023	Australia, Canada, China, Hong Kong, India, Japan, New Zealand, Singapore, South Korea, USA, Vietnam
Therapeutic Uses of Beta-Casein A2 and Dietary Supplement Containing Beta-Casein A2 A Composition Comprising Beta-Casein	3 October 2023	Canada, China, Czech Republic, Denmark, Finland, France, Germany, Hong Kong, India, Ireland, Italy, Japan, the Netherlands, New Zealand, Singapore, South Korea, Spain, Sweden, Switzerland, UK, Vietnam
Beta-Casein A2 and Prevention of Inflammation of the Bowel	20 May 2034	International (PCT) Application – Territories to be nominated
Beta-Casein A2 and Reducing or Preventing Symptoms of Lactose Intolerance	10 July 2034	International (PCT) Application – Territories to be nominated
Beta-Casein A2 and Blood Glucose Levels	22 August 2034	International (PCT) Application – Territories to be nominated

SOURCE: COMPANY DATA

In Nov'15 arguably one of the more important elements of the patent protection expired in New Zealand, which was the method for testing milk for the presence of A1 Protein, this patent will remain in place in the US until 2017. In practice the patent was co-owned with Fonterra and the fact that Fonterra had never pursued an A1 protein free product range suggests that there is more protection in place for the a2 range than simply one patent. We suspect the more important element of the protection is likely around the herd testing and selection protections, with one of these patents lasting through to 2023.

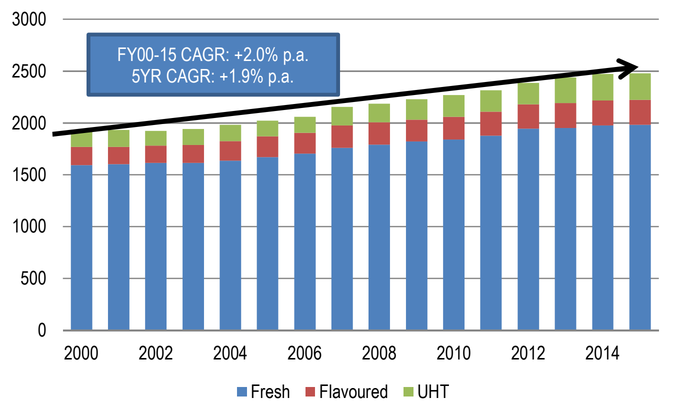
Regional and divisional overview

AUSTRALIA AND NEW ZEALAND

Australia and New Zealand represents ~90% of group revenues with the majority of this derived in the Australian market, with the A2M's NZ presence hamstrung by a licensing agreement with Fresha Valley that remains in place until May'17 (and generates less than $200k in annual royalties for the group). The Australian operations were established in 2003, initially via license distribution agreements (with Freedom Foods in 2007 and Jalna for yoghurt products in 2009) before A2M commissioned its own production facility in Sydney in 2012. In 2013 A2M launched infant nutrition products under the 'a2 Platinum brand' with an extension into cream shortly after in 2014. The products have been incredibly successful in Australia with A2M now accounting for 9.3% of the fresh milk market (supermarket sales) and 16.7% of the infant nutrition market (supermarket and pharmacy sales).

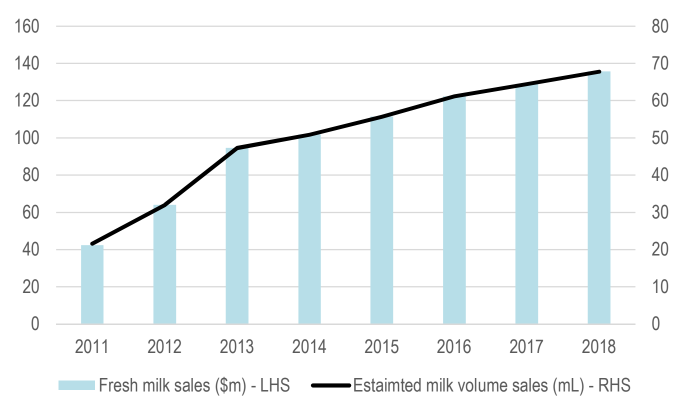
Australian Fresh milk: The milk market in Australia is estimated to be worth ~$4.6Bn annually and been experiencing compound growth of +2%pa over the last decade (in volume terms). The majority of milk is sold via supermarkets (~53% of sales) with private label products making up ~28% of the market (in volume terms). Since its inception we estimate that A2M has managed to capture ~2.2% of the market by volume and ~4.5% by value. A2M products typically attracting ~5% premium to other branded products on shelf and ~145% to private label and are targeted at a market quite distinct from generic milk buyers. After early success, market share growth has slowed to 10-20bp annually over the last three years. In essence A2M branded products are exceeding system growth and we expect that to remain a feature in the near term.

Figure 10 - Drinking milk sales volumes by category (mL)



SOURCE: DAIRY AUSTRALIA

Figure 11 - a2 branded milk sales

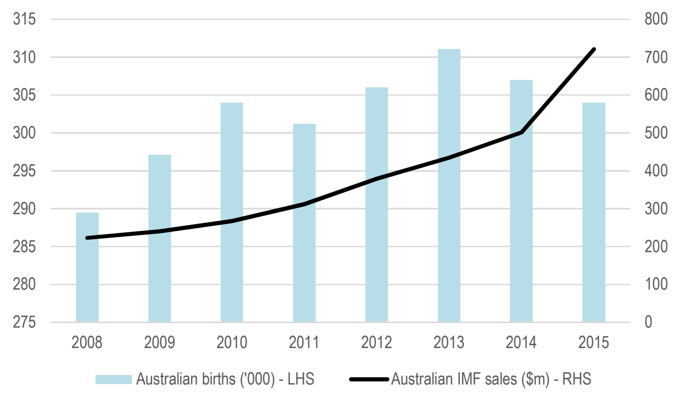


SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

Infant Nutrition: The Australian infant nutrition (IMF) market is estimated to be worth ~$780m in retail sales value annually and has been growing at a compound rate of +17.5%pa since 2008. This growth rate is well in excess of what we would consider the underlying growth rate in demand as dictated by the combination of: the birth rate (+0.7% pa); inflation (+2.5% pa) and declining breast feeding rates (~6% decline between the 2008-10 breastfeeding surveys). The emergence of C2C trading in China has facilitated a grey market in IMF products which we estimate now makes up just under 30% of demand at ~A$200m annually and looked to grow almost four fold in 2015.

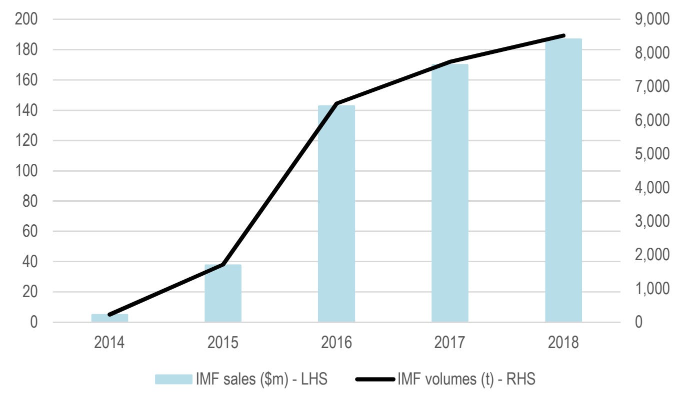
From a standing start in 2013 A2M has grown to ~16.7% market share in the supermarket and pharmacy channels, with estimated annualised sales of $150m in 1H16 (and a Dec'15 annualised rate of ~$240m). Moving forward we expect the rate of growth to slow from current rates, resulting in more modest revenue gains for the business.

Figure 12 – Australian infant formula sales vs. the birth rate



SOURCE: DAIRY AUSTRALIA

Figure 13 - a2 branded milk sales



SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

The biggest risk facing the Australian business is the potential for C2C restrictions being implemented in China that could result in a reduction in demand in the domestic market by up to 30%. Our view is that when such an event occurs (as we believe it is only a matter of time) we will see a substitution of domestic sales into China sales, which are both at a higher price point and gross margin. In the long run this will be positive for companies like A2M, but will likely require a transition period.

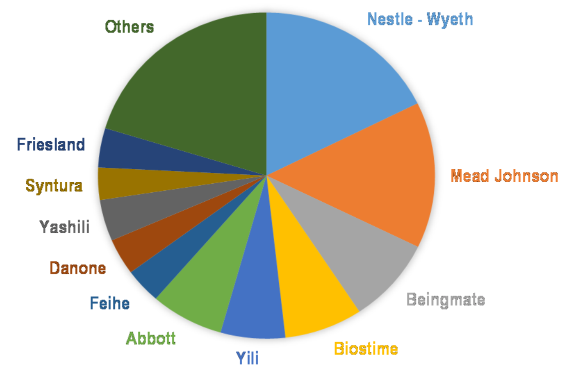
New Zealand fresh milk: In NZ, Auckland processor Fresha Valley has the licence to produce homogenised A2 milk in one and two-litre containers, but has a limited distribution reach. This license runs until May 2017 and it is intended that this structure will be collapsed and a similar operating model to that of Australia be adopted. Sales of a2 branded milk in NZ are the equivalent of 1-2% of those achieved in Australia and it could be argued that the opportunity for A2M could be material if the success in Australia could be replicated. The NZ fresh milk market is worth ~NZ$1.4Bn annually and capturing 4-5% market share would translate to sales of NZ$55-70m and EBITDA of $6.5-11.0m assuming similar gross margins and S,G&A costs that where consistent with levels seen in the Australian business at the same size.

CHINA

A2M entered the Chinese infant nutrition market in 2012. The supply model is such that a2 Platinum is produced under contract by Synlait and then sold to China State Farm, who is the exclusive distributor of the product in China and Hong Kong. The focus of the distribution model is on mother and baby stores which make up 42% of IMF sales and are the fastest growing avenue for distribution, with traditional retail channels in decline.

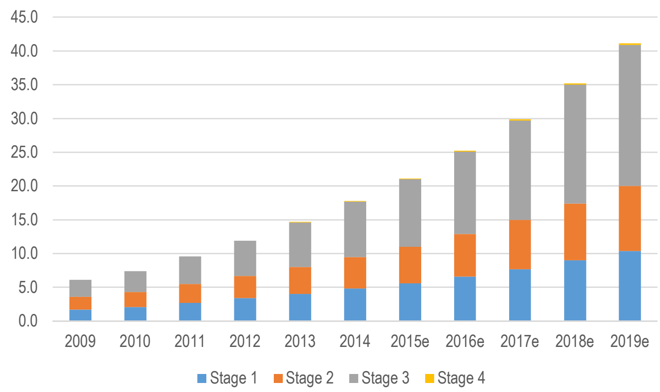
China IMF market: According to Euromonitor Chinese IMF demand totalled 727,000t in 2014 and was worth an estimated US$17.8Bn. Demand has been growing at a compound rate of 24%pa over the last five years and is expected to remain so with 18% pa growth projected through to 2019e. In 2015 ~180kt (+46% YOY) with a value of US$2.5Bn of IMF products were imported into China via authorised channels. Since the Melamine incident of 2008, imported IMF products have been one of the fastest growing categories (+32% pa excluding the impact of Fonterra contamination issues in 2014) and now account for ~13% of the total market. When grey market volumes and IMF products made from imported materials are incorporated into these numbers, this lifts closer to an estimated 30% of the market, a number more closely linked to the total value of IMF and milk powder imports into China.

Figure 14 – China IMF shares - 2014



SOURCE: NIELSON

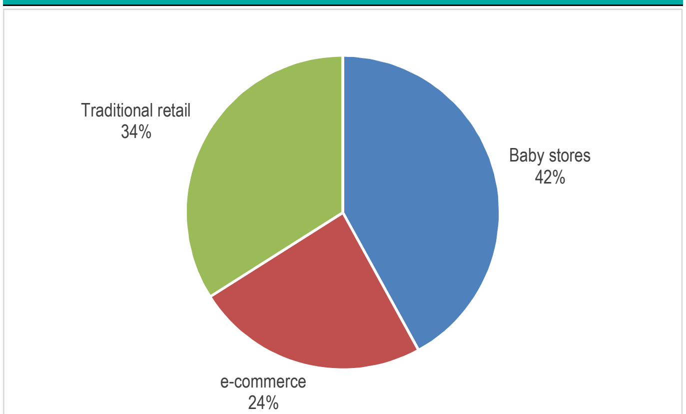
Figure 15 – China demand growth in IMF



SOURCE: EUROMONITOR

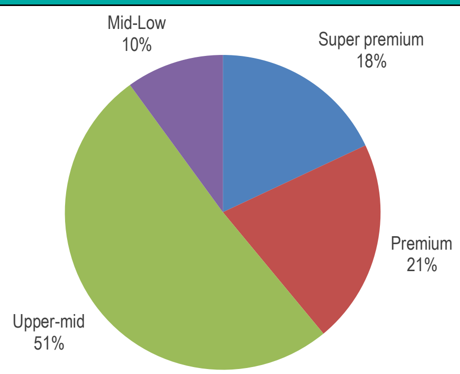
There has been a period of consolidation among Chinese and multi-national producers which now sees the top four producers accounting for 48% of the market (2014) and the top 10 accounting for 80%. Distribution of IMF product is by three main sources with baby stores and e-commerce the fastest growing source of product (at the expense of traditional retailers). A2M has initially targeted baby stores for distribution and this market tends to have a higher exposure to premium priced (>RMB250 per 800 gram tin) IMF products relative to traditional retailers.

Figure 16 – China IMF sales by distribution channel



SOURCE: NIELSON

Figure 17 – Sales mix through baby stores



SOURCE: SYNUTRA

The evolution of the A2M business is in its infancy, yet the business is already profitable at what could be considered a modest level of sales (1H16 sales of $8.6m). Gross margins in china tend to be higher than those generated in the Australian business on the back of higher average price points. In the future A2M plans on marketing milk products from Australia into the China market, with UHT and fresh milk recently launched in the China market.

UK AND US

The UK and US markets represent growth potential for A2M with the operations in both markets commenced in the last five years and only consolidated to 100% company ownership in the last two years. Combined these two markets have annual milk sales volumes of 55.6BnL worth an estimated US$48Bn in turnover. The market positioning of A2M is in the premium end of the markets, a sector worth in excess of US$4Bn annually or comparable to the size of the Australian market in its entirety. At the commencement of its strategy there is in our view a very real chance to double the size of the company.

UK fresh milk market: A2M entered the UK market in 2011, through a JV with Robert Wiseman Dairies (RWD). Following the sale of the RWD in 2012 and a slower than expected market acceptance of the product the agreement was restructured with A2M acquiring the 50% of the UK business it didn't already own. Since that time A2M has entered an agreement with RWD for the processing and distribution of A2M branded products with marketing and promotional activity directly taken on by A2M. In FY14 A2M generated revenue of GBP1.0m and an EBITDA loss of GBP2.2m. Management is targeting a breakeven EBITDA monthly run rate by end FY16e, with a positive earnings contribution from FY17e.

The UK fresh milk market is worth ~GBP3.0Bn annually with ~5.5BnL of milk consumed. Demand growth has been effectively static for the last deade. Since acquiring the operations from RWD A2M has repositioned the brand from conventional dairy to the premium segment of the market, which we estimates is ~13% of the market and worth an estimated GBP390m in annual turnover. Our current forecasts have A2M capturing ~5% of the specialty milk market by FY18 and generating ~A$6m EBITDA at this level. If A2M can capture a similar share to that generated in Australia then this would lift towards a A$30m EBITDA contributor, which would require the business to effectively supplant ~20% of the filtered market segment.

US fresh milk market: Following a false start in 2003, A2M entered the fresh milk market in the US in 2014 via a 100% owned subsidiary. The business entered the west coast, via California, in 2015 and is currently investing to expand the business. The US fresh milk market is a 50.1BnL market, worth an estimated US$44Bn. The Californian market in its own right is a 22BnL market, worth an estimated US$19Bn, with the latter the market that A2M has initially entered. The opportunity in the US market is significant with an approach anywhere near Australian market share levels implying a material uplift in A2M earnings.

Financials

PROFIT AND LOSS

We are projecting a material acceleration in revenues and earnings over the next three years on the back of: a transition in the Australian business towards higher margin IMF products; an acceleration in revenue growth in an already profitable China IMF business; and as losses are reduced in the US & UK businesses (as revenues growth accelerates and overheads are absorbed). In aggregate we are projecting compound revenue growth of +49% pa over FY15-19e, fuelling compound growth in EBITDA of +165% pa and material lift in NPAT from losses. A large portion of this growth is achieved in FY16e with current guidance for revenues of NZ$335-350m and operating EBITDA of NZ$45-49m.

Figure 18 - A2M summary profit and loss (NZ$m unless stated otherwise)

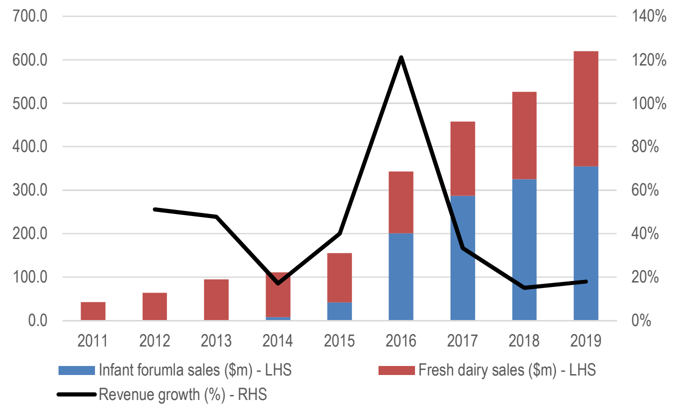
	2011	2012	2013	2014	2015	2016e	2017e	2018e
Australia/NZ	42.4	64.0	94.7	106.9	149.1	314.3	403.3	430.3
China				2.7	4.0	19.8	32.7	45.4
US & UK				1.1	1.9	8.9	21.3	50.4
Corporate and other				0.1	0.0	0.0	0.0	0.0
Revenue	**42.2**	**64.0**	**94.7**	**110.8**	**155.1**	**343.0**	**457.4**	**526.1**
...Growth (%)		51.7%	47.8%	17.1%	39.9%	121.1%	33.3%	15.0%
Australia/NZ	2.6	5.2	10.3	18.7	30.0	81.0	110.2	122.7
China	0.0	0.0	0.0	(3.3)	(3.1)	4.0	8.2	12.5
US & UK	0.0	0.0	(0.2)	(4.3)	(12.1)	(19.8)	(17.4)	(14.1)
Corporate & Other	0.1	0.1	(0.2)	(7.5)	(10.0)	(18.0)	(18.2)	(18.4)
Associates	0.1	(0.7)	(3.7)	(1.4)	0.0	0.0	0.0	0.0
EBITDA	**2.8**	**4.6**	**6.1**	**2.2**	**4.8**	**47.1**	**82.8**	**102.7**
...EBITDA Margin (%)	6.7%	7.1%	6.4%	2.0%	3.1%	13.7%	18.1%	19.5%
Depreciation & Amortisation	(0.1)	(0.4)	(1.1)	(1.9)	(1.9)	(2.8)	(2.8)	(2.8)
EBIT	2.8	4.1	5.0	0.3	2.9	44.3	80.0	99.9
...EBIT Mrgain (%)	6.6%	6.5%	5.3%	0.3%	1.8%	12.9%	17.5%	19.0%
Net Interest Income	0.1	(0.0)	0.2	0.4	0.1	(0.2)	0.4	1.3
Pre-tax profit	2.9	4.1	5.2	0.7	3.0	44.2	80.3	101.2
Tax	(0.7)	0.3	(1.0)	(0.7)	(3.4)	(14.6)	(24.8)	(31.1)
Minorities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Underlying NPAT	**2.1**	**4.4**	**4.1**	**0.0**	**(0.4)**	**29.6**	**55.6**	**70.0**
Non-recurring items (post-tax)	0.4	(0.2)	(2.3)	0.0	(1.7)	(2.0)	0.0	0.0
Reported NPAT	**2.5**	**4.2**	**1.8**	**0.0**	**(2.1)**	**27.6**	**55.6**	**70.0**

SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

Material assumptions in deriving our earnings forecasts are detailed below:

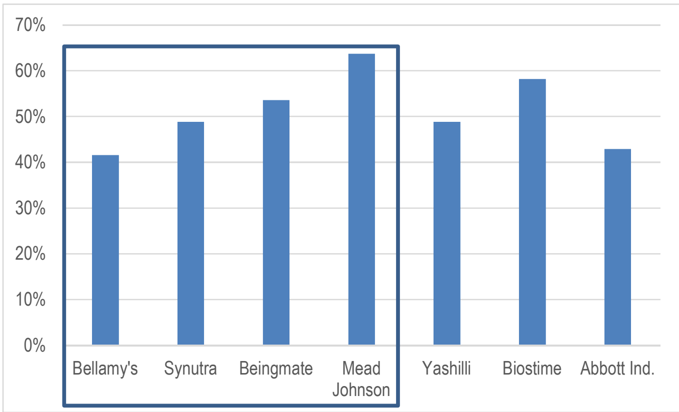
1. Transition to higher margin IMF products in Australia and China: We estimate gross margins in the Australian & China IMF business are ~30-35% higher than those generated in the fresh milk business. As growth in the IMF business units outpaces growth rates in the ANZ fresh milk business we expect to see a favourable shift in EBITDA margins. This transition in gross margin is now clearly on display with the 1H16 gross margin of 41% well in excess of FY15 levels of 35% and in our view entirely reflective of the change in earnings composition from fresh milk to IMF.

Figure 19 – Changing revenue contribution of A2M



SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

Figure 20 – IMF gross margins B2C



SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

At this stage we are projecting no material change in China C2C regulations. If any material change to C2C trading were enacted, it would likely have a detrimental impact on the level of sales in the Australian IMF business. However, following a transition period (as sales migrate from Australia to China direct) lost sales in Australia would more than likely be mitigated by faster growth in the China business where gross margins are higher. 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 A2M's longer-term growth trajectory.

2. Underlying revenue growth above system: In our forecasts we have assumed continued growth in market share of +40bp in the Australian fresh milk business in FY16-17e (in a market growing +2% pa) before reaching terminal market share levels. In the Australian IMF business, we assume A2M grows at double the system growth rate of 5% pa (well below recent growth rates) through to FY18e before normalising to system growth. In China we assume market share growth through to FY19e when critical mass is reached at 0.15%share, with a market growth rate assumed at 10% pa (again an assumption well below recent growth rates and projected growth rates of 18% pa through to FY18e).

3. Execution in the UK: Our UK forecasts assume that A2M reaches profitability in FY17e with market share growth towards 1.5% by FY21e. We assume no material growth in market volumes or average price points, which we have assumed at GBP1.00/litre a 75% premium to the average generic price in the UK.

4. Execution in the US: Our forecasts assume market share gains through to 1.5% of the Californian market by FY21e. Market share gains are non-linear with an assumption of an acceleration from FY18-21e as the brand gains traction. Gross margins are assumed to be at a level below both Australia and the UK (~500bp lower), as we see this as a more competitive market. We assume the US business contributes positively to EBITDA in FY19e as marketing spending is brought down to levels more consistent with other markets. While current sales are modest, the US makes a positive gross margin contribution to the group before the inclusion of start-up marketing costs.

5. Sales and Marketing: we have assumed that sales and marketing costs in Australia grow at 5% pa reflecting that market awareness has now been achieved. In the UK we assume S,G&A spend continues to be 20-30% of sales in the near term and in the US we continue to assume that marketing exceeds sales revenue through to FY19e. In China we assume a high level of investment in S,G&A through to achieving critical mass.

BALANCE SHEET AND CASHFLOW

A2M has sustained a relatively conservative balance sheet position with a net cash position sustained over its listed life, though this has largely been the result of new equity funding with $71.8m in equity raised over FY12-16e. A2M runs a reasonably low production asset base, preferring to utilise contract manufacturing partnership so A2M can focus on brand development, for this reason we note a material deviation historically between operating cashflows and underlying cash NPAT, with a cumulative investment in working capital of $45m over FY12-1H16. Looking forward we anticipate a material uplift in operating cashflows as the business moves into a breakeven position in the UK and expands profitability in the Australian and China operations. This cash generation should also take a material step-up in FY19e once the US is EBITDA breakeven.

Figure 21 - A2M Balance sheet and cashflow summary (NZ$m unless stated otherwise)

	2011	2012	2013	2014	2015	2016e	2017e	2018e
Operating cashflow ($m)		0.1	3.6	0.4	(8.1)	(16.7)	37.7	60.5
Operating cash realisation (%)		2%	70%	23%	-528%	-52%	65%	83%
Free cashflow ($m)		(12.3)	(2.2)	(7.2)	(11.7)	(20.5)	33.9	56.7
Free cash realisation (%)		-280%	-53%	n.a.	n.a.	-69%	61%	81%
Net Debt/(Cash) ($m)		(2.2)	(20.2)	(16.0)	(6.1)	(27.2)	(61.2)	(117.9)
New equity raised ($m)		7.7	20.5	0.0	2.0	41.6	0.0	0.0

SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

The primary investment of A2M in developing the business is in marketing and working capital. Net working capital to sales has averaged 17.2% over FY14-15, however, we expect this to lift to 22.5% over FY16-18e reflecting the change in business mix to IMF where inventory positions are built up in advance of sales. It is worth noting at this level net working capital represents 17-20% of one year forward sales.

Board and management

BOARD OF DIRECTORS

David Hearn: Chairman & Executive Director

David has been Chairman of The a2 Milk Company Limited since 30 March 2015. David is also a member of the Nomination and Remuneration Committees. David has experience and skills in executive management, sales and marketing and strategy development in FMCG in international markets. He has held senior executive roles including Chief Executive Officer or Managing Director roles for FMCG companies including Goodman Fielder Limited, UB Snack Foods Europe/Asia, Del Monte UK and Smith's Crisps and for the marketing services group, Cordiant Communications Group. In addition to his a2MC directorship, David is also a Director of Lovat Partners Limited, Robin Partington & Partners Limited, and Committed Capital Limited. David resides in the United Kingdom

Julia Hoare: Deputy Chairman & Non-Executive Director

Julia has been Deputy Chairman of the Company since 30 March 2015. Julia is also Chairman of both the Nomination Committee and the Audit and Risk Management Committee. Prior to joining the Board, Julia had extensive chartered accounting experience in Australia, the UK and New Zealand and was a partner with PwC New Zealand for 20 years. In addition to her Company directorship, Julia is a Director of New Zealand Post Limited, Watercare Services Limited, AWF Group Limited and Port of Tauranga Limited (appointed 20 August 2015). Julia is also a member of the New Zealand External Reporting Advisory Panel (XRAP), a body designed to support the standard setting process of the New Zealand External Reporting Board (XRB), and the New Zealand Institute of Directors National Council. Julia resides in New Zealand.

Geoffrey Babidge: Managing Director & Chief Executive Officer (CEO)

Geoffrey has over 25 years senior management experience working in the Australian FMCG industry. Prior to his appointment as CEO of the Company in 2010, Geoffrey held senior executive roles with a number of companies in Australia including Freedom Foods Group Limited, Bunge Defiance and National Foods. Prior to these roles he was a practicing chartered accountant and Partner at Price Waterhouse. Geoffrey resides in Australia.

Richard Le Grice: Non-Executive Director

Richard has experience in management of, and as a shareholder in, a number of private companies. He brings considerable international experience with these companies operating in a number of countries including Australia. In addition to his Company directorship, Richard is also a Director of several other companies including Energi Advertising Limited, Thode Knife & Saw Limited and The Gravitas Group Limited. Richard is Chairman of the Remuneration Committee and a member of both the Audit and Risk Management Committee and the Nomination Committee. Richard resides in New Zealand.

Melvyn Miles: Non-Executive Director

Melvyn has over 30 years Australian and international senior executive experience in the FMCG industry, and has held Vice President roles in Carlton & United Breweries and Foster's Group and General Manager roles in Visy Industries and Amcor. Melvyn is a member of both the Audit and Risk Management Committee and the Remuneration Committee. Melvyn resides in Australia.

Peter Hinton: Non-executive Director

Mr Hinton is a partner at law firm Simpson Grierson in New Zealand with experience in NZ and international markets. Mr Hinton has provided legal advice to the Company over many years.

SENIOR MANAGEMENT

Craig Louttit: Chief Financial Officer & Company Secretary

Craig joined the Group in April 2014 from ASX listed public company UGL Limited where, since 2007, he had held senior finance roles including as General Manager Finance, Transport and Technology Systems, and Group Financial Controller. Prior to this he held senior finance roles with EMI Group PLC from 1999 in London, UK. Craig is a member of the Institute of Chartered Accountants in Australia.

Susan Massasso: Chief Marketing Officer

Susan has over 18 years' experience in the FMCG industry. She joined the Group in September 2013 as Chief Marketing Officer with oversight of marketing and brand development across all markets. Susan has held several senior leadership positions across the Campbell Arnott's business including most recently Asia Pacific Regional Marketing Director. Prior to this she held a number of commercial roles including Marketing Director Arnott's ANZ, Marketing Director Campbell's ANZ and General Manager Campbell's ANZ. Prior to this Susan spent a number of years at Unilever where she held a number of marketing, consumer insight and logistics roles. Susan attended the University of Sydney under scholarship from accounting firm Price Waterhouse where she also gained undergraduate employment throughout her degree.

Andrew Clarke: Chief Scientific Officer

Andrew joined the Group in 2003. Andrew has over 15 years' experience in private sector pharmaceutical research and agricultural biotechnology. He received a PhD in Biochemistry and Molecular Biology from the University of Auckland. In his role as Chief Scientific Officer, Andrew oversees all aspects of the Group's science-based activities including research and development, scientific communications and the expansion of intellectual property.

Simon Hennessy: General Manager and International Development

Simon joined the Group in 2007 as the Business Unit Manager for the Australian joint venture with Freedom Foods. In 2010 Simon took on the responsibilities for Group operations and development of new markets. Simon has over 25 years' experience in manufacturing operations, sales and marketing, after an early career in research and development and quality management.

Shareef Khan: General Manager Operations

Shareef joined the Group in June 2012. He has over 13 years' senior management experience as a qualified supply chain professional. He is experienced across a number of industries, some of which include FMCG, infant nutrition, office products and construction

Peter Nathan: Chief Executive Australia & New Zealand

Peter joined the Group in 2008 and in 2010 took on the role of Chief Executive of the Australia and New Zealand region. During his time with the Company, Peter has led the successful re-launch of a2MC branded milk in the Australian market. He has over 20 years' experience working the FMCG industry, as evidenced by his previous senior marketing and sales roles for Gillette and Colgate Palmolive in Australia and Asia as well as his involvement with Freedom Foods Group Limited as General Manager.

Major shareholders

A2M has a dual listing, listed on both the Australiana and New Zealand stock exchange. Approximately 65% of shares are domiciled in Australia, 33% in New Zealand and the remainder elsewhere. There are two substantial shareholders in A2M holding a combined 11.6% of the company between them.

Figure 22 - A2M substantial shareholders

Shareholder	Holding (m Shares)	Holding (%)
Greencape	45.3	6.4%
Regal funds management	37.1	5.2%

SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

In addition to the 711.3m ordinary shares on issue there are 20m options with a $0.63ps exercise price, 12m partly paid shares with an average $0.63ps conversion price and 1.6m performance rights. As such the current diluted capital base of A2M sits at 743.6m, with notional cash due of $20.4m if all stock were converted to fully paid ordinary shares. In all valuation work we have assumed both options and partly paid shares are converted given they are deeply in the money.

Risks

ASM 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:

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.

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.

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.

The a2 Milk company

as at 7 June 2016

Recommendation	Buy
Price	A$1.38
Target (12 months)	A$1.81

Table 1 - Financial summary

Year end June	2012	2013	2014	2015	2016e	2017e	2018e
Profit & Loss (NZ$m)							
Sales revenue	64.0	94.7	110.8	155.1	343.0	457.4	526.1
. . . Change		47.8%	17.1%	39.9%	121.1%	33.3%	15.0%
EBITDA	4.6	6.1	2.2	4.8	47.1	82.8	102.7
Deprec. & amort.	(0.4)	(1.1)	(1.9)	(1.9)	(2.8)	(2.8)	(2.8)
EBIT	4.1	5.0	0.3	2.9	44.3	80.0	99.9
Interest expense	(0.0)	0.2	0.4	0.1	(0.2)	0.4	1.3
Pre-tax profit	4.1	5.2	0.7	3.0	44.2	80.3	101.2
Tax expense	0.3	(1.0)	(0.7)	(3.4)	(14.6)	(24.8)	(31.1)
. . . tax rate	-7%	20%	99%	114%	33%	31%	31%
Minorities	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net Profit	**4.4**	**4.1**	**0.0**	**(0.4)**	**29.6**	**55.6**	**70.0**
Abs. & extras.	(0.2)	(2.3)	0.0	(1.7)	(2.0)	0.0	0.0
Reported Profit	**4.2**	**1.8**	**0.0**	**(2.1)**	**27.6**	**55.6**	**70.0**
Cashflow (NZ$m)							
EBITDA	4.6	6.1	2.2	4.8	47.1	82.8	102.7
Net Interest Expense	(0.0)	0.2	0.4	0.1	(0.2)	0.4	1.3
Tax Paid	(0.8)	(0.6)	(0.9)	(2.5)	(14.0)	(19.7)	(28.0)
Change in Wkg Capital	(4.7)	(2.4)	(5.4)	(9.1)	(49.7)	(25.7)	(15.5)
Other	1.0	0.3	4.2	(1.3)	0.0	0.0	0.0
Operating Cash Flow	**0.1**	**3.6**	**0.4**	**(8.1)**	**(16.7)**	**37.7**	**60.5**
Capex	(12.4)	(5.8)	(7.7)	(3.6)	(3.8)	(3.8)	(3.8)
Div Paid (gross of DRP)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Free Cash Flow	**(12.3)**	**(2.2)**	**(7.2)**	**(11.7)**	**(20.5)**	**33.9**	**56.7**
Acquisitions	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Disposals	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Share issues	7.7	20.5	0.0	2.0	41.6	0.0	0.0
Other	(0.0)	(0.3)	3.0	(0.2)	0.0	0.0	0.0
(Inc.) /dec. in net debt	**(4.7)**	**18.0**	**(4.2)**	**(9.9)**	**21.1**	**33.9**	**56.7**
Balance Sheet (NZ$m)							
Cash & near cash	6.6	20.2	16.0	6.1	27.2	61.2	117.9
Receivables	17.2	24.4	27.4	39.9	85.8	114.3	131.5
Inventories	0.7	0.7	5.6	4.8	18.9	25.2	28.9
Other	0.5	2.4	2.2	9.7	32.6	43.4	50.0
Current assets	**24.9**	**47.7**	**51.1**	**60.5**	**164.4**	**244.1**	**328.3**
Fixed assets	10.3	11.0	9.2	9.3	9.3	9.3	9.3
Intangibles	12.4	11.1	14.8	17.2	18.2	19.2	20.2
Other	2.1	2.6	1.6	1.8	1.8	1.8	1.8
Non current assets	**24.8**	**24.7**	**25.5**	**28.3**	**29.3**	**30.3**	**31.3**
Total assets	**49.7**	**72.4**	**76.6**	**88.9**	**193.8**	**274.4**	**359.7**
Creditors	7.2	12.1	16.7	26.9	60.0	80.0	92.1
Borrowings	4.4	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.6	0.3	1.2	2.0	4.6	9.7	12.9
Current liabilities	**12.3**	**12.4**	**17.9**	**29.0**	**64.7**	**89.8**	**105.0**
Borrowings	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.1	0.1	1.3	1.3	1.3	1.3
Non current liabilities	**0.0**	**0.1**	**0.1**	**1.3**	**1.3**	**1.3**	**1.3**
Total liabilities	**12.3**	**12.5**	**18.0**	**30.2**	**65.9**	**91.0**	**106.3**
Net assets	**37.3**	**59.9**	**58.6**	**58.6**	**127.8**	**183.4**	**253.4**
Share capital	63.8	84.3	86.3	86.3	127.9	127.9	127.9
Reserves	1.7	(0.3)	(3.6)	(1.6)	(1.6)	(1.6)	(1.6)
Retained earnings	(28.1)	(24.0)	(24.0)	(26.1)	1.5	57.1	127.1
Outside equity Interests	0.0	0.0	0.0	0.0	0.0	0.0	0.0
S/holders' funds	**37.3**	**59.9**	**58.6**	**58.6**	**127.8**	**183.4**	**253.4**
Net Debt (Cash)	(2.2)	(20.2)	(16.0)	(6.1)	(27.2)	(61.2)	(117.9)

Rating	Buy
Share price (A$ps)	$1.38
Target price (A$ps)	$1.81
Shares on issue (m)	711.3
Market cap (A$m)	978.0
Enterprise Value (A$m)	943.7

Year end June	2012	2013	2014	2015	2016e	2017e	2018e
Valuation Ratios							
Adjusted EPS (¢ps)	1.35	0.67	0.00	(0.06)	4.20	7.47	9.42
Change (%)		n.a.	n.a.	n.a.	n.a.	78.0%	26.0%
Adjusted PE (x)	n.a.	n.a.	n.a.	n.a.	34.7	19.5	15.5
EV/EBITDA (x)	218.8	164.1	454.9	208.5	21.2	12.1	9.7
EV/EBIT (x)	241.7	200.6	3,335.9	351.0	22.6	12.5	10.0
EV/EBITDA ex-US (x)	218.8	164.1	231.6	78.7	15.5	9.9	8.4
NTA ($ps)	0.05	0.08	0.08	0.08	0.16	0.23	0.34
P/NTA (x)	26.6	17.5	18.7	19.2	9.1	6.3	4.3
Book Value ($ps)	0.07	0.10	0.09	0.09	0.18	0.26	0.36
Price/Book (x)	21.8	15.0	15.7	15.8	8.1	5.7	4.1
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 (%)	7.1%	6.4%	2.0%	3.1%	13.7%	18.1%	19.5%
EBIT/sales (%)	6.5%	5.3%	0.3%	1.8%	12.9%	17.5%	19.0%
OCF Realisation (%)	2%	70%	23%	-528%	-52%	65%	83%
FCF Realisation (%)	-280%	-53%	-144640%	2784%	-69%	61%	81%
ROE (%)	11.8%	6.9%	0.0%	-0.7%	23.1%	30.3%	27.6%
ROIC (%)	11.8%	12.6%	0.7%	5.4%	44.1%	65.4%	73.7%
Asset turn (years)	10.56	5.51	1.16	2.46	16.89	29.66	36.79
Capex/Depn (x)	28.71	5.27	4.04	1.86	1.36	1.36	1.36
Interest cover (x)	188.18	(28.68)	(0.72)	(28.23)	265.68	(208.37)	(77.39)
Net Debt/EBITDA (x)	(0.47)	(3.31)	(7.26)	(1.27)	(0.58)	(0.74)	(1.15)
Net debt/equity (%)	-6%	-34%	-27%	-10%	-21%	-33%	-47%
Segmentals							
Australia/NZ	64.0	94.7	106.9	149.1	314.3	403.3	430.3
China	0.0	0.0	2.7	4.0	19.8	32.7	45.4
US & UK	0.0	0.0	1.1	1.9	8.9	21.3	50.4
Corporate and other	0.0	0.0	0.1	0.0	0.0	0.0	0.0
Revenue	**64.0**	**94.7**	**110.8**	**155.1**	**343.0**	**457.4**	**526.1**
Australia/NZ	5.2	10.3	18.7	30.0	81.0	110.2	122.7
China	0.0	0.0	(3.3)	(3.1)	4.0	8.2	12.5
US & UK	0.0	(0.2)	(4.3)	(12.1)	(19.8)	(17.4)	(14.1)
Corporate & Other	0.1	(0.2)	(7.5)	(10.0)	(18.0)	(18.2)	(18.4)
Associates	(0.7)	(3.7)	(1.4)	0.0	0.0	0.0	0.0
EBITDA	**4.6**	**6.1**	**2.2**	**4.8**	**47.1**	**82.8**	**102.7**

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.

Research Team

Staff Member	Title/Sector	Phone	@bellpotter.com.au
TS Lim	Head of Research	612 8224 2810	tslim
Industrials			
Sam Haddad	Industrials	612 8224 2819	shaddad
John O'Shea	Industrials	613 9235 1633	joshea
Chris Savage	Industrials	612 8224 2835	csavage
Jonathan Snape	Industrials	613 9235 1601	jsnape
Sam Byrnes	Industrials	612 8224 2886	sbyrnes
John Hester	Healthcare	612 8224 2871	jhester
Tanushree Jain	Healthcare/Biotech	612 8224 2849	tnjain
Financials			
TS Lim	Banks/Regionals	612 8224 2810	tslim
Lafitani Sotiriou	Diversified	613 9235 1668	lsotiriou
Resources			
Peter Arden	Resources	613 9235 1833	parden
David Coates	Resources	612 8224 2887	dcoates
Associates			
Hamish Murray	Associate Analyst	613 9256 8761	hmurray
Tim Piper	Associate Analyst	612 8224 2825	tpiper

Bell Potter Securities Limited
ACN 25 006 390 7721
Level 38, Aurora Place
88 Phillip Street, Sydney 2000
Telephone +61 2 9255 7200
www.bellpotter.com.au

The following may affect your legal rights. Important Disclaimer:

This document is a private communication to clients and is not intended for public circulation or for the use of any third party, without the prior approval of Bell Potter Securities Limited. In the USA and the UK this research is only for institutional investors. It is not for release, publication or distribution in whole or in part to any persons in the two specified countries. In Hong Kong this research is being distributed by Bell Potter Securities (HK) Limited which is licensed and regulated by the Securities and Futures Commission, Hong Kong. This is general investment advice only and does not constitute personal advice to any person. Because this document has been prepared without consideration of any specific client's financial situation, particular needs and investment objectives ('relevant personal circumstances'), a Bell Potter Securities Limited investment adviser (or the financial services licensee, or the representative of such licensee, who has provided you with this report by arraignment with Bell Potter Securities Limited) should be made aware of your relevant personal circumstances and consulted before any investment decision is made on the basis of this document.

While this document is based on information from sources which are considered reliable, Bell Potter Securities Limited has not verified independently the information contained in the document and Bell Potter Securities Limited and its directors, employees and consultants do not represent, warrant or guarantee, expressly or impliedly, that the information contained in this document is complete or accurate. Nor does Bell Potter Securities Limited accept any responsibility for updating any advice, views opinions, or recommendations contained in this document or for correcting any error or omission which may become apparent after the document has been issued.

Except insofar as liability under any statute cannot be excluded. Bell Potter Limited and its directors, employees and consultants do not accept any liability (whether arising in contract, in tort or negligence or otherwise) for any error or omission in this document or for any resulting loss or damage (whether direct, indirect, consequential or otherwise) suffered by the recipient of this document or any other person.

Disclosure of interest:

Bell Potter Securities Limited, its employees, consultants and its associates within the meaning of Chapter 7 of the Corporations Law may receive commissions, underwriting and management fees from transactions involving securities referred to in this document (which its representatives may directly share) and may from time to time hold interests in the securities referred to in this document.

Jonathan Snape owns 22,500 shares in A2M.

ANALYST CERTIFICATION

Each research analyst primarily responsible for the content of this research report, in whole or in part, certifies that with respect to each security or issuer that the analyst covered in this report: (1) all of the views expressed accurately reflect his or her personal views about those securities or issuers and were prepared in an independent manner and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by that research analyst in the research report.