

A2 Milk - Easily digested Milk

Introduction

A2 Milk has enjoyed exceptional growth over the last 8 years. It solves a problem 65% of the population face, milk intolerance. A2 Milk's cows are bred to produce milk only containing the A2 protein and not the A1 protein that has been linked milk intolerance. The herd is located in the pristine environment of New Zealand that adds a further competitive advantage to its products that are deemed safe and well regulated. That is particularly valued by the Chinese where A2 Milk enjoys 6.4% of the infant nutrition market. Growth is now coming mostly from China and emergence in the USA while the company also expands throughout Asia. All production is outsourced enabling high margins and a whopping 40% ROIC with \$296m in cash flows from operations in FY19. These factors led to a strong balance sheet with no debt, \$464m in cash on hand, and \$578m of retained earnings.

Demand for milk is unanimous but not everyone can tolerate it

The demand for cows milk is unanimous amongst nations of the world but not everyone finds it easy to digest. 65% of all people have difficulty, particularly those with Asian, African, Arab, Jewish, Greek, and Italian genetics . Most affected are those of Asian descent with over 90% having difficulty in some communities (Itan et al, 2010).

Traditional milking cows produce milk containing both the A1 and A2 proteins. One of the causes of milk intolerance is an inability to digest A1 b-casein that has been associated with gastrointestinal inflammation, post digestive discomfort, and decreased cognitive processing speed (Jianqin et al, 2016; He et al, 2017). Studies have shown that the consumption of milk only containing A2 protein and not the A1 protein greatly reduces or eliminates digestive discomfort (He et al, 2017).

A2 Milk has bred a herd of cows that produce milk only containing the A2 protein. They have the largest herd of its kind in the world located in the pristine environment of New Zealand. The milk tastes exactly the same as traditional milk which makes it the preferred substitute

for those suffering milk intolerance over Almond, Coconut, or Soy milk which are not nearly as enjoyable.

High quality essential for infants

All parents want the best for their babies. Concern was particularly heightened for Chinese parents where in 2008 contaminants in locally produced infant formula resulted in 300,000 babies being affected with 54,000 hospitalised and 6 fatalities. The disaster resulted in a rush to quality products from overseas, especially New Zealand viewed as a pristine environment with sound regulations.

A2 Milk in high demand

Sales of A2 Milk have grown at 64% CAGR over the last 5 years. In China, demand has been exceptionally strong with A2 Milk now 6.4% of the Chinese infant nutrition market. Revenue growth in China in FY19 was 47%. Entry into the USA market continues to build momentum growing sales by 161% in FY19 and distribution now across 13,100 stores.

Strong balance sheet

The exception growth in sales coupled with premium pricing gives A2 Milk one of the highest growth rates and returns of any company in the world. The company outsources all of its production leaving it acting as mainly a research and marketing platform. This results in an exceptional RIOC of 40% and retained earnings building now to \$578m.

The company has no need for debt or to sell shares as \$295m in funds from operations is more than sufficient to cover costs, even as marketing spend becomes quite significant

In order to continue its growth record, A2 Milk must invest heavily in marketing over the next few years. China and the USA are the largest and fastest growing consumer markets in the world. Competition is rigorous and getting in front of those audiences costs a lot of money. In FY19 A2 Milk spent \$135m on advertising and this is expected to grow over the coming years.

Avenues for future growth

China and USA remain priorities but A2 Milk is also opening new geographies of Thailand, Vietnam, Singapore and Hong Kong. New products are being released such as coffee creamer and a Manuka honey milk drink popular in Asian markets.

Competitors

Nestle has begun selling its own brand of A2 milk in China from a herd being built in Holland however A2 Milk enjoys a competitive advantage of being an established, recognised brand with pure milk from cows grazed in the pristine New Zealand environment. It becomes very hard for competitors to build a herd capable of supplying A2 milk in substantial volumes and no location competes with New Zealand on perceived purity.

Entry points and subsequent market reversal

We completed analysis on A2 Milk in late 2018. The dramatic market downturn of December and January allowed us attractive entry points on 13/12/2018, 17/12/2018, and 03/01/2019. We made a further purchase on 06/03/2019 as shown in Chart One below. A2 Milk was harshly judged by the market on its full year results released on the 21/08/19. It is believed that far too much has been spent on consultants and that margins will come under pressure with significant marketing costs in the future. We've completed our analysis and disagree with the market's views. We remain very optimistic of A2 Milk's future and believe current fair price for the stock is around \$18 at the time of writing.

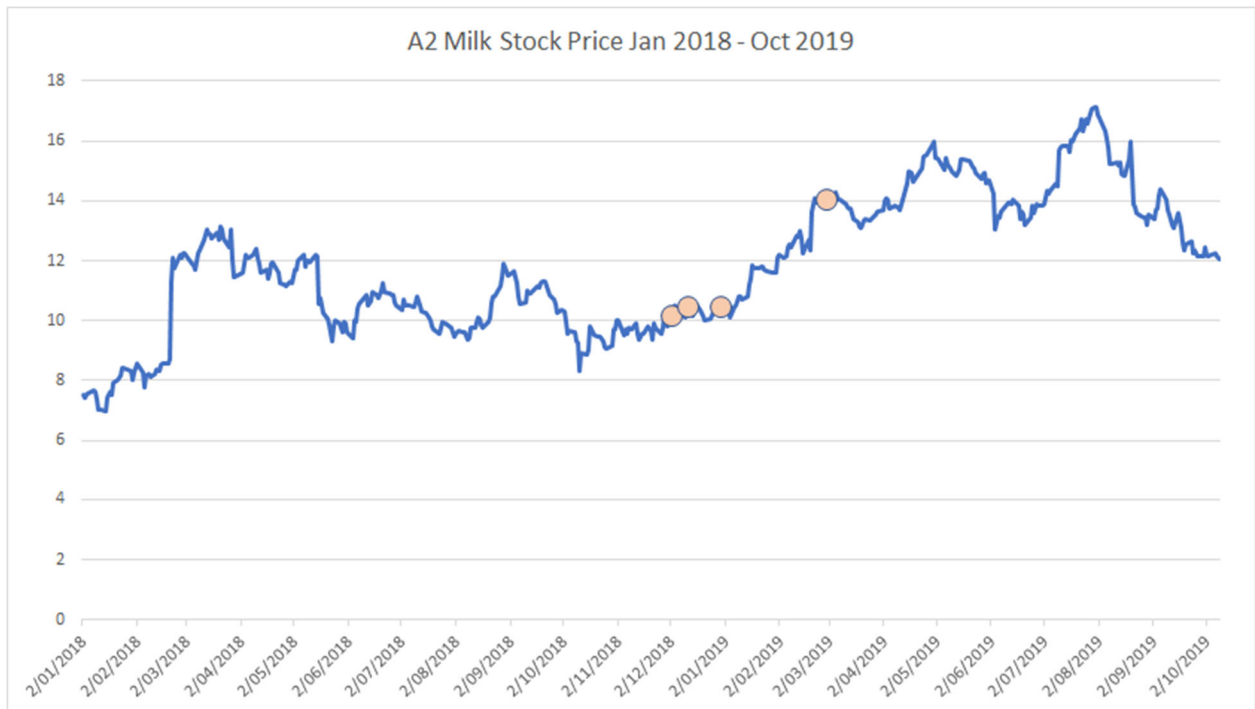


Chart One. A2 Milk stock price, our entry points and subsequent market reversal.

References

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