A2 Milk Company Ltd: Don't Buy

ASX:A2M

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The Automated Bare Knuckle Compounder

Date of analysis: 5/30/2020.

Date of financials: 6/30/2015. Note that this may be a historical report and financials may be from years ago.

Idea source: Serendipity, (more than 50M shares).

Analysis date price: AUD0.64.

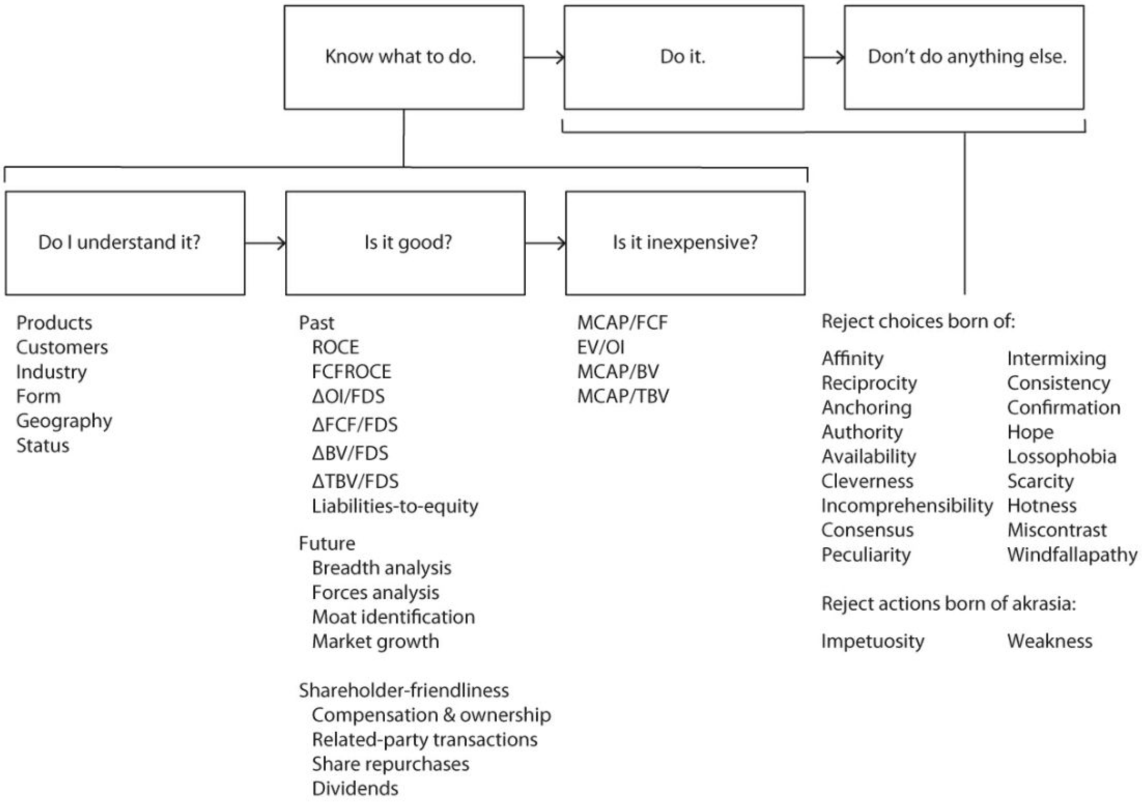
Framework outcomes

Good Stocks Cheap: The price needs to drop -96% to AUD0.02 in order to be cheap.

Growth With Value: The price needs to drop -105% to AUD-0.03 in order to be cheap.

Contents

Framework



Marshall (2017), p. 188.

Do I Understand It? Yes:

Understanding Statement

Packaged foods and meats industry corporation A2 Milk Company sells fresh and powdered milk products with A2 protein to the Western World and Chinese customers, of significance to the latter who are more likely to have a bad reaction to A1 protein, the company's products are patented and are just beginning their US and China expansions after being granted permission to export to China late 2014.

Is it Good? No, poor past performance:

To determine if A2 Milk Company Ltd is good, it was analysed from three perspectives:

1. Past performance, to see if they've been good stewards of their capital.
2. If the company's future is bright, considering breadth, forces, monopolies and market.
3. If the company is shareholder friendly, such as whether leaders behave like owners.

1. Does A2 Milk Company Ltd Have Good Average Past Performance? No:

Judgement of past performance is based on averages over the past however many periods the analyst chooses to input. Table of averages:

Summary	**Benchmark**	**Average**
OIROCE with cash, start of period	Should be at least 15%	16.57%
OIROCE with cash, end of period	Should be at least 15%	0.07%
OIROCE without cash, start of period	Should be at least 15%	22.64%
OIROCE without cash, end of period	Should be at least 15%	-30.07%
FCFROCE end of period, with cash	Should be at least 8%	-8.54%
FCFROCE end of period, without cash	Should be at least 8%	-36.48%
Δ OI/FDS	Should keep up with inflation, aim for 4%	10.97%
Δ FCF/FDS	Should keep up with inflation, aim for 4%	5.66%
Δ BV/FDS	Should keep up with inflation, aim for 4%	20.34%
Δ TBV/FDS	Should keep up with inflation, aim for 4%	13.56%
L/E	Should be no higher than 2, 7 if otherwise great.	51.58%

Was the performance in the most recent period good? No. Further detail by year is available in the next table.

	A	B	C	H	I	J	K	L	M	N
2	**Category**	**Item**	**Average**	**2015**	**2014**	**2013**	**2012**	**2011**	**2010**	**2009**
3	Past performance	OIROCE, cash, beginning	16.6%	2.9%	7.0%	40.1%	37.0%	37.4%	-24.9%	
4	Past performance	OIROCE, cash, end	0.1%	2.8%	7.3%	25.1%	18.3%	17.3%	-30.2%	-40.2%
5	Past performance	OIROCE, no cash, beginning	22.6%	4.4%	11.6%	50.5%	70.6%	132.5%	-133.7%	
6	Past performance	OIROCE, no cash, end	-30.1%	3.2%	10.9%	41.8%	23.1%	33.0%	-107.0%	-215.6%
7	Past performance	FCFROCE, cash, beginning	-1.6%	-17.8%	-0.1%	10.6%	-0.1%	19.6%	-21.7%	
8	Past performance	FCFROCE, cash, end	-8.5%	-17.3%	-0.1%	6.7%	-0.1%	9.1%	-26.3%	-31.8%
9	Past performance	FCFROCE, no cash, beginning	-10.0%	-26.6%	-0.1%	13.4%	-0.2%	69.5%	-116.2%	
10	Past performance	FCFROCE, no cash, end	-36.5%	-19.7%	-0.1%	11.1%	-0.1%	17.3%	-93.0%	-170.9%
11	Past performance	Δ OI/FDS	11.0%	-59.3%	-73.5%	107.4%	90.4%	188.2%	51.7%	
12	Past performance	Δ FCF/FDS	5.7%	-21653.8%	-101.1%	15858.2	-101.3%	153.2%	47.0%	
13	Past performance	Δ BV/FDS	20.3%	1.7%	-6.2%	51.9%	32.1%	146.8%	-35.7%	
14	Past performance	Δ TBV/FDS	13.6%	-4.0%	-11.5%	71.4%	58.1%	45.0%	-35.7%	
15	Past performance	L/E	N/A	52%	N/A	N/A	N/A	N/A	N/A	N/A
16	Shareholder friendli	Highest paid employee salary	N/A	576						
17	Shareholder friendli	Highest paid employee salary c	N/A	-6.7%						
18	Shareholder friendli	Highest paid outside director	N/A	101,250						
19	Inexpensiveness	MCAP/FCF	N/A	-48.118						
20	Inexpensiveness	EV/OI with cash and cash equiv	N/A	291.684						
21	Inexpensiveness	EV/OI without cash and cash ec	N/A	287.367						
22	Inexpensiveness	MCAP/BV	N/A	7.020						
23	Inexpensiveness	MCAP/TBV	N/A	9.940						

Benchmark
Should be at least 15%
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Should be at least 8%
Should be at least 8%
Should be at least 8%
Should be at least 8%
Should keep up with inflation, aim for 4%
Should keep up with inflation, aim for 4%
Should keep up with inflation, aim for 4%
Should keep up with inflation, aim for 4%
Should be no higher than 200%, 700% if otherwise great.
For US companies, should be less than $USD30,000,000
Should be 5% of the lower of FCF or NI
For US companies, preferably less than $USD250,000 and not more than $USD500,000
Should be no higher than 8
Should be no higher than 7, sell if >25
Should be no higher than 7, sell if >25
Should be no higher than 3
Should be no higher than 3

Subtracted goodwill from capital employed as it has been stable ever since the initial acquisition. Because they have poor past performance in terms of stewarding capital, they're not a buy. They have poor return on capital employed in terms of operating income and free cash flow.

2. Does A2 Milk Company Ltd Have a Bright Future? Yes:

Does A2 Milk Company Ltd Have Enough Breadth? Yes:

Does this company have breadth of customers? Yes:

Broadening: "Over 67% of milk and infant formula sales come from three customers. (2014: over 86% from three customers)". "The Group has credit risk exposure as a large portion of sales are to three customers. However this risk is mitigated as these customers are all creditworthy, have sufficient collateral and are not related entities."

Does this company have breadth of suppliers? Yes:

"•We work with approximately 14 quality certified processing sites across our markets"

Does A2 Milk Company Ltd Confront Maximum 1 Strong Force? Yes:

The number of strong forces this company confronts is 1. To consider it further, there should not be more than 1.

The bargaining power of customers is Weak:

Number of customers: At least 3! No statements on this in annual report apart from "Over 60k visitors to our T-mall virtual store in China in the first 4 weeks of trading." This is just China, which accounts for a negligible proportion of total revenue. So in terms of people buying the product they have hundreds of thousands. Actual customers like supermarkets would be the big supermarkets in Australia such as Woolies, Coles, IGA, Foodland. Since those supermarkets dominate, that's why they account for such a large proportion of sales but the risk remains that if one of these supermarkets decides to stop buying, a huge proportion of sales will disappear. This eventuality would be offset by their overseas expansion plans and the potential for online sales. The chances of being dropped by the supermarkets can be considered against their sales growth - 4.5x globally and their platinum product has the second highest selling sku in one of these leading chains this year. So overall they have enough customers and protection against losing them. They also have 1 distributor, China State Farm, in China, which in turn has 25 distributors to get the product to customers.

Improbability of backward integration: Supermarkets are not going to start making an own brand specialty milk product like A2. They do own brands for potatoes, sugar, and other bulk necessities. Also, A2M has patents on their products.

Switching costs: If they swich they will be losing the second highest selling sku, therefore will lose money.

Summary: Bargaining power of customers is low since there are very many customers and overseas expansion plans are gaining steam therefore this situation will only get worse in terms of bargaining power, switching costs are high as they would lose a very popular product and patents mean it would be very difficult if not impossible for supermarkets to make their own versions of this very popular product. With regard to China, however, the bargaining power of customers is high as China State Farm has an exclusive distribution agreement. GIven the size of sales to China presently, this means overall the bargaining power of customers is low presently but may be an issue going forward. It is noted they already sell on JD.com and T-mall so they are at least getting exposure in all the right places.

The bargaining power of suppliers is Weak:

Number of suppliers: They appear to have 14 processing sites as suppliers but only one manufacturing partner, Synlait Milk, is certified for export to China. It is unclear if Synlait is their sole manufacturing partner or if there are 14. On P. 13 they mention 77 farms in one bullet point followed by 14 processing sites. It seems sensible that the 14 are not farms but factories like Synlait. Perhaps processing site and manufacturing partner are synonymous.

Improbability of forward integration: Given that A2M has patents and spends all its time on branding, research and building relationships in overseas markets, a mom and pop dairy or processing partner is going to struggle to match this when they have thousands of cows to herd and milk to process. Synlait Milk is closer to being able to do away with A2M since they actually manufacture the powder and other products. It is unclear if their 14 processing partners also do this or merely put the milk from the cows into trucks. Presumably there would be a legal protections in place to prevent this but also Synlait faces the same challenges as the dairies and 'processing sites'. They have to do something complicated and different to their main line of business and may have their hands full already.

Switching costs: A2M depends on a special cow which is certified for A2 protein. There are only 40k of these cows across the West, as opposed to millions of normal ones. There are 77 dairies they can choose from although it is unknown what proportion they currently use. There would be very strong switching costs if alternative dairies couldn't supply A2 milk, but in this case, there are many potential suppliers so potentially swtiching costs are not significant here. What is unknown is the proportion of total supply that the 14 processing site suppliers currently used constitute of the total available. It's also not clear what the difference is between a dairy and processing site. I presume manufacturer Synlait is different from these to as they feature their own picture annual report of their powdered milk plant. An important recent development was a manufacturing supplier Synlait Milk getting registration Q3 last year to export milk to China. This, however, means they have a great degree of bargaining power as such registrations are hard to get and take a long time. A2M may not be able to easily develop a relationship with another manufacturer with such a registration. Similar to bargaining power of customers though, given the small proportion of total sales in China, this does not affect overall bargaining power of suppliers for now but should be watched in future during their China expansion. What does affect overall bargaining power of suppliers though is it seems their sole manufacturing supplier for the whole business, and all powdered milk products they sell, is Synlait Milk. This affects not only their Chinese sales but all such manufactured product sales. There would be strong switching costs to go to another manufacturer as there would be down time to tool up the new factory. It is possible that they would be able to secure a deal on similar or more favourable terms as that with Sinlait though, but due to disruption of supply or extra costs dealing with two suppliers during a switching over period means Sinlait has the advantage here. What isn't clear from the report is what proportion of total sales is represented by manufactured (i.e. powdered, condensed milk, ice cream, cream etc) vs just fresh milk. If it's most, the switching costs to go to another manufacturing supplier are even higher.

Summary: There are many dairy suppliers and processing suppliers, but only it seems there is only one manufacturing supplier. They have patents to protect against suppliers developing competing products but the switching costs are high. It is therefore tempting to say bargaining power of suppliers is overall high. Note, however, that because they are the sole source of A2 milk products on the market if they leave Synlait Milk and go to another supplier then Synlait will not promptly be able to find another customer. Therefore their bargaining power as supplier is reduced, although they could simply start manufacturing A1 milk products like everyone else. Further research is needed on whether there is specialty equipment they have invested in which can't be used for A1 milk product manufacturing. Similar to bargaining power of customers, China expansion plans could be hampered by high bargaining power of their 1 manufacturing supplier in this context, since their powerdered milk seems very popular in this market. Tempering these observations though is A2M's rampant popularity. They have done a great job finding buyers for the products Synlait manufactures and are far more sought after than regular run of the mill A1 products. Synlait would feel it more I think than A2M if they lost A2M than the other way around and given the popularity of A2M products in China, another manufacturing plant would probably be only too ready to go through the registration process. It's a tie, I'm going on the side of weak

The threat of substitutes is Weak:

Wholly different products that perform the same basic function: Breast milk, plant based milk like oat/rice/soy milk can do the same thing as A2 milk. In the case of breast milk it would be better that the baby was fed with this and government health agencies will promote it. Note, however, that there was a major health scare in China where a number of babies died from poisoned milk. As a result, rich mothers sought a wholly different product - A2M..

Doing without: This is possible, mothers produce their own milk after all. Adults who want milk but react to A1 milk can just use plant based milk or use fruit juice.

Direct substitutes: They are the 1 and only A2 milk brand!

Summary: Since they are the 1 and only A2 milk brand and are protected by patents, there is a minimal threat of substitutes. As such they have a first mover advantage and can use this to establish the impression they are the Nike of milk and an aspirational brand for rich mothers to signal to other mothers that they are better. In fact, they pose a threat of substitution to A1 milk producers because there is research showing that 1/4 of Americans are intolerant of milk and this is not only due to lactose and 85% of Chinese who can't stomach A1 milk have no issues with A2.

The threat of new entrants is Strong:

Barriers to entry; barriers to success: In the end, all you have to do is buy A2 milk from one of the 77 dairies, put a label on it and go to trade fairs and baby equipment conventions with nice signs and slogans. To become successful, you would need patents, a network of large supermarket customers and distributor relationships in countries that will offer many customers. This is possible but would take time and money which larger players with the cash to do this may not be interested in doing because in the end it's a kind of specialty milk with an inherently limited market..

Economies of scale: A2 is the number one, and only, specialty brand selling this product and have a number of dairies on board. The popularity of the product has lead to supply shortages. If anything this means they can raise prices and high product costs due to low economies of scale is not a problem.

Higher switching costs: I know from Matt Joass' assessment that they charge more for their product because they have a monopoly. Customers seem fine with this due to buying so much the supply has run out. This circumstance must be attractive to entrepreneurs who want to replicate A2M's success.

Hard-to-get permits: Their manufacturing supplier Sinlait Milk has a permit to send milk to China, the lack of which interrupted sales in 2014 due to a regulatory change. New entrants would have to find manufacturers with the same permit or use the same manufacturer. The annual report does not say they have an exclusive deal, therefore this may be possible.

Summary: New entrants may perceive an opportunity since the market is dominated by a monopoly charging high prices. There does not seem to be an exclusive deal with their manufacturer, who has the required permit to export to China. New entrants will have to match the scale of 14 dairies worth of production/distribution. I do not know how much this is. Overall it seems new entrants are probable and it is an attractive market since the profits are so high, therefore threat of them is strong.

Does A2 Milk Company Ltd Have a Monopoly? Yes:

Government: No.

Network: No.

Cost: No.

Brand: Yes. "We are the 1 and only brand of cows' milk that is all A2 and completely free of the A1 protein in Australia, NZ, UK, US and China amongst other markets"

Switching costs: No.

Ingrainedness: No.

Market Growing? Yes:

It is growing due to increasing popularity amongst rich Chinese mothers of baby formula products from better regulated countries than China. It is also growing due to increasing awareness of the lack of irritation consuming this milk compared to normal milk.

3. Is A2 Milk Company Ltd Shareholder Friendly? Yes:

Friendly on the Numbers? No:

The CEO's salary is AUD576 per year. This is -6.73% of the lower of free cash flow or net income. The highest paid outside director gets AUD101,250 a year. On the numbers, is this a shareholder friendly company? No.

Material insider buying at market

CEO Babidge holds 11M shares, worth about $7M in 2015 and Chairman Hearn holds 5M shares, $3M in value. Throughout the 2014/15 FY, directors Mair, Le Grice and Hearn all made transactions. Le Grice was a seller of 100k shares, worth $60k in Sept 14 and Mair was a seller in mid 2015 but overall the buys outweighed the sells significantly, indicating insiders like the business.

Share repurchases

None mentioned.

Related party transactions

Consulting fees are charged by Miles, a director and Hearn, the Chairman, when they are already employed and paid a salary by the company. This should not have occurred as their salary should have covered this service. In any event, the total damage of this malfeascence was $98k. Packaging is done by companies in which director Gunner had an interest but he has left the board now. This was also malfeascence but given he's left it's less concerning as is the assurance the rates were normal compared to competitors.

Dividends

None.

Shareholder Friendly Overall? Yes:

They are cash flow negative, so the CEO's half million dollar salary does not seem to be paying off. His salary compares favourably to other businesses this size according to SWS. There is significant ownership by CEO and chairman worth many millions of dollars with purchases outweighing sells in the past year by insiders, signifying managers are incentivised to think like owners and insiders and confident. There are no repurchases or dividends, indicating the business is in a rapid growth phase. There are some consulting related party transactiosn which should not have occurred as it was directors billing time. Overall the amount is minimal. The biggest related party transaction was for packaging and was worth more than a million last year and nearly half a mill this year but the related director has left. Overall it's not like related parties are buying Ferraris from the float in the till.

Is it Cheap? No:

Analysis date price: AUD0.64, cheap price: AUD0.02. The price needs to drop -96% to AUD0.02 in order to be cheap.

Summary	**As at 5/30/2020**	**Benchmark**
MCAP/FCF	-48.12	Should be no higher than 8
EP/OI - cash	287.37	Should be no higher than 7, sell if >25
EP/OI + cash	291.68	
MCAP/BV	7.02	Should be no higher than 3
MCAP/TBV	9.94	Should be no higher than 3

The main reason they aren't cheap appears to be the major drop in revenues in the past two years.

Discount Cash Flow Analysis

A discount cash flow analysis (DCF) is mentioned as a common method in How to Value a Business (Cowley, 2019). The below DCF has High Growth Period and Terminal or Stable Growth Period segments. The intrinsic values of each are summed to calculate the share price of the company that is warranted by the anticipated future cash flow, based on the geometric mean of its growth rate. A comparison between this price and the current price is another way to see how cheap the business is currently. For further details on what the below terms and numbers mean, consult Cowley (2019).

High Growth Period

Table 1. Parameters.

Parameter	**Value**
Investors required return or discount rate	12%
Continuing number of years	4

Arithmetic mean of ending free cashflow	-0.0028 per share
Compound annual growth rate of same	6%

Table 2. Cashflow for high growth period.

Year into the future	Cash flow per share	Intrinsic value
1	0.00	-0.003
2	0.00	-0.003
3	0.00	-0.002
4	0.00	-0.002

Terminal or Stable Growth Period

Table 1. Parameters.

Parameter	Value
Investors required return or discount rate	12%
Constant growth rate for stable period	5%
Cashflow from the last year of high growth	0.00 per share
Starting year of stable growth	5

Table 2. Cashflow for terminal or stable growth period.

From year	Cash flow per share	Intrinsic value
5	0.00	-0.03

Table 3. Intrinsic value of the business.

Parameter	Value
Intrinsic value of the business	AUD-0.04 per share
Share price at 5/30/2020	AUD0.64
Margin of safety	20%
Margin of safety status	The price needs to drop -105% to AUD-0.03 in order to be cheap.

From this calculation we can see that, from the perspective of future cashflows, the intrinsic value of the business supports a price of AUD-0.04 per share. Note that this is only true if the following assumptions are correct:

1. The business grows for the next 4 years at a high rate of 6% per year.
2. The business grows perpetually thereafter at a rate of 5% per year.

The margin of safety should guide buying decisions in case these assumptions are wrong.

Verdict: Don't Buy

The framework says they're not a buy on 2 fronts - past performance and cheapness. They have not been good stewards of capital at all for free cash flow return on capital employed. On average the operating income return on capital employed at the start of the period is great, but end of the periord is terrible. This is a strange outcome which requires further thought. They are also very certainly not cheap at the moment mainly because operating income and free cash flow have died off in the past two years, presumably because of the costs of expanding into new markets and listing on the ASX. Balancing these observations is the bright future. In this particular instance, the bright future came true and they went on to grow free cash flow strongly each year and rode a wave of high popularity in China. The lesson learnt is to consider the significance of the future. If it is bright, it can mean hugely positive outcomes, even when it looks like they have been poor stewards of their capital due to low returns in the past. If that was merely a product of setting up the business for success, then that poor return on capital situation may turn around if the bright future one has identified comes true.

Checklist:

SI	Item	Sub Item	Check
1	**Do I understand it?**		**Yes.**
2	**Is it good?**		**No, poor past performance.**
2.1		**Has there been good past performance?**	**No.**
2.2		**Is the future bright?**	**Yes.**
2.2.1		Is it broad with respect to customers and suppliers?	Yes.
2.2.2		Is there, at most, one strong force?	Yes.
2.2.3		Is there a monopoly?	Yes.
2.2.4		Is the market growing?	Yes.
2.3		**Is it shareholder friendly?**	**Yes.**
2.3.1		On the numbers, is it shareholder friendly?	No.
2.3.2		Overall, is it shareholder friendly?	Yes.
3	**Is it cheap?**		**No.**
3.2	Is it cheap according to Good Stocks Cheap?		No
3.2	Is the price below the margin of safety from a DCF intrinsic value analysis?		No.

References

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2. Wil's Value Investing Tool.
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4. Marshall, Kenneth Jeffrey (2017). Good Stocks Cheap: Value Investing with Confidence for a Lifetime of Stock Market Outperformance. McGraw-Hill Education. Kindle Edition.