

Ag & Vet Weekly



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All the news on ASX-listed agriculture and veterinary companies

Dr Boreham's Crucible: Synlait Milk

By TIM BOREHAM

ASX code: SM1; **NZX code:** SML

Share price: \$6.48; **Shares on issue:** 179,306,908; **Market cap:** \$1,161.9 million

Chief executive officer: Leon Clement

Board: Graeme Milne (chairman)*, Willem Jan (Bill) Roest**, Dr John Penno, Sam Knowles, Min Ben, Qikai (Albert) Lu, Sihang Yang and former National Party MP Ruth Richardson***

* Mr Milne will step down at the end of the 2020-'21 year (Jul 31, 2021)

** Mr Roest will step down at the end of the 2019-'20 year

*** The last four directors listed are Bright Group representatives

Financials (half year to January 31, 2020)*: revenue \$559 million (up 19%), earnings before interest tax depreciation and amortization \$67.6 million (down 4%), net profit after tax \$26.2 million (down 30%), earnings per share 14.61 cents (down 30%), net debt \$447.4 million (up 55%)

* All figures are in New Zealand dollars. \$NZ1.00 equals \$A0.93

Major identifiable holders: Bright Dairy Holdings 39%, A2 Milk Company 17.39%, Dr Penno 2.85%.

At the risk of offending trans-Tasman relations and jeopardizing the prospect of a Covid-19 free travel 'bubble' between the Anzac** nations, Synlait is not well known by investors on this side of the ditch.

(** Australia and New Zealand Army Corps)

The company - NZ's biggest infant formula maker and the fourth biggest dairy processor - graces the Kiwi bourse but has a secondary ASX listing.

What's better known here is the similarly dual-listed A2 Milk Co, which markets infant milk powder produced by Synlait. Measured by market capitalization, A2 is more than 10 times the size of Synlait.

But Synlait is seeking to change its behind-the-scenes status with a recent acquisition that delivers a portfolio of well-known consumer brands.

On April 1, the company settled the acquisition of Dairyworks, after the Office of Overseas Investment (OOI) - the equivalent of Australia's Foreign Investment Review Board - gave the nod.

OOI permission was needed because Synlait is majority foreign owned, with China's Bright Dairy accounting for 39 percent of the register and the Sydney-headquartered A2 another 17 percent.

Unveiled in October last year, the \$NZ112 million (\$AUD104 million) Dairyworks purchase delivers more than 500 cheese, butter, ice cream and milk powder products under the Dairyworks, Deep South, Alpine and Rolling Meadow names.

The operations of the Christchurch-based Dairyworks dovetail with key assets of the primary cheese processor Talbot Forest, which Synlait bought last year.

CEO Leon Clement says the rationale for buying Dairyworks is udderly clear: "to come closer to the consumer and own more of the value chain".

Dairyworks accounts for half the Kiwi cheese market and half the butter market and has a presence on Australian supermarket shelves.

Synlait has been in expansionary mode on other fronts as well, having acquired 28 hectares of land at Pokeno in the Waikato district on the upper North Island for \$NZ156 million in early 2018.

Happily, the site now houses a \$NZ260 million, state-of-the-art formula plant. Sadly, Synlait is in the midst of a legal dispute over restrictive covenants attached to the property, which the company presumed would be removed.

In fact, the country's High Court DID remove them, but at the behest of a neighbor who was protecting quarrying interests, the Court of Appeal overturned the 'de-covenanting' in May 2019.

Synlait then won leave to appeal in the Supreme Court, which after a coronavirus related delay, will hear the case on June 3.

If Australian readers are puzzled, the Kiwi Supreme Court - not the High Court - indeed is the supreme court in the land.

But let's get track on back.

Mooving with the times

Founded by thirty-something dairy scientists, John Penno and dairy farming couple Ben Dingle and Juliet Maclean in 2000, Synlait was based on one 3,000-cow dairy property, Robindale Farm.

The 2007 acquisition of Dunsandel Dairies moved the company into processing, with the first milk produced in 2008.

In 2012, Chinese mob Shanghai Pengxin struck a deal to buy the original farming operation Synlait Farms from the founders. The Overseas Investment Office approved the deal in early 2015 and the business now operates as Purata Farms.

Synlait listed on the New Zealand bourse in July 2013 and the ASX in November 2017.

In 2013, signed its first supply contract with A2 Milk.

In 2015, Synlait acquired 25 percent of Sichuan New Hope Nutritionals and later signed a deal to supply infant formula exclusively for New Hope's Akara brand.

Synlait's next great leg-up came in 2017 when it bought the Auckland based NZ Dairy Company, which delivered the company's second blending and packing plant.

A former senior honcho with Fonterra - the world's biggest dairy company - Mr Clement replaced Dr Penno as CEO in August 2018.

Dr Penno remains on the board.

A2 strategy remains on track

As well as strengthening its brand presence in its current pursuits, Synlait is interested in expanding into sports nutrition and "functional creams" (those providing a health benefit).

But the A2 aspect remains a key differentiator.

For the uninitiated, specially bred A2 cows produce milk without the A1 beta-casein protein, with (disputed) health benefits including easier digestion.

The term A2 Milk is patented by the A2 Milk Company - and fiercely protected. But the A2 cows are naturally, rather than genetically, modified and, like 5G, have nothing to do with causing the coronavirus.

The Synlait supply agreement with A2 milk was recently expanded and extended, to July 2025 at the earliest.

Synlait also makes milk and cream for Foodstuffs, a large NZ co-operative retailer, on a white label basis (an appropriate use of the term indeed).

Reducing the carbon hoofprint

Synlait has a dedicated research and development facility at Palmerston North, with a targeted R&D spend of 1.5 percent of revenue.

Synlait's R&D activities have an 'environmental, social and governance' (ESG) focus, with commitments to tree planting, reducing energy and water usage and best-practice employment.

Earlier this year, the company spent \$NZ25.7 million to buy adjacent farmland at Dunsandel, partly to get better control over water rights and partly to do field research on sustainable farming methods.

It's the sort of company where "Saint" Jacinda Arden would be happy to plant a ceremonial tree - and indeed, New Zealand's Labour Prime Minister has done just that.

Recognizing Synlait's sustainability credentials, the ANZ Bank last year agreed to convert an existing \$NZ50 million facility into the country's first environmental social governance (ESG) loan.

An ESG loan offers incentives such as reduced interest for appropriate behavior - such as prime ministerial endorsed tree plantings.

Finances and performance

Synlait saw its half year revenue rise 19 percent to \$NZ559 million in the first half, with output rising 8.5 percent to 46.7 million kilograms of milk solids.

Revenue hit the \$NZ1 billion mark for the first time in the 2018-'19 year.

During the half year to January 31, 2020, sales of consumer-packaged infant formula rose 22 percent to 21,571 tonnes, but with Chinese sales off the pace on the back of "market consolidation".

The company has said it has not seen any Covid-19 supply chain disruption, but was monitoring the situation "very closely".

Sales of powders and creams declined 18 percent to 46,259 tonnes, owing to delayed deliveries.

The most recent purchases aside, Synlait has undertaken \$NZ470 million of "growth projects" over the last 24 months,

The expansions mean that Synlait's net debt has risen to \$NZ447.4 million from \$NZ287.8 million a year ago.

Late last year, the company issued a \$NZ180 million subordinated fixed rate bond listed on the NZ exchange.

The 3.83 percent coupon on these instruments might have seemed a bit mealy then, but no-one would complain now with the official Kiwi cash rate at 0.25 percent.

The increased interest and depreciation costs meant that Synlait's net profit fell 30 percent to \$NZ26.2 million.

In February, management guided full-year net profit to \$NZ70 million to \$NZ85 million, compared with \$NZ82.2 million in 2018-'19.

Given the previous guidance was for earnings to go onwards and upwards, the stock drooped by 20 percent.

Over time, Synlait shares have traded as low as \$2.90 (December 2016) and as high as \$12.22 (September 2018). Over the last year they have drifted from the \$10 level.

Dr Boreham's diagnosis:

Despite the Chinese flavor of Synlait's register, China only accounted for eight percent of revenue during the half year, while NZ and Australia accounted for 35 percent and 24 percent respectively.

While missing out on links in the value chain, there's an argument for Synlait doing most of its China business via A2 Milk, which seems to be doing better than investors expected.

Still, broker Morgans questions the terms of last year's extension deal, which Synlait dubbed as being in line with the "ongoing competitive pricing regime".

The firm says: "We think the market will continue to question Synlait's bargaining power with A2 Milk and this is likely to continue to weigh on investor sentiment."

While infant formula has walked off the shelves during recent panic buying sprees, the China is characterized by tight margins and a consolidating market.

It doesn't help that couples haven't indulged in rampant procreation despite the nation's one child policy being relaxed to allow two kids.

As with Bubs Australia, which we covered last time around, Synlait is waiting on all important product registration for its formula from the State Administrative Market Regulation (SAMR) for the Akara and Pure Canterbury infant formula lines.

Jacinda Arden is not the only visitor to grace Synlait's facilities: late last Chinese minister Xiao Yaqing, the big cheese responsible for the SAMR, popped his head into Pokeno for a look-see.

In early April, broker Select Equities upgraded Synlait from a 'sell' to a 'hold'.

“We remain a little cautious in light of the lack of significant new customers in the short to medium term, although we are reassured by Synlait’s efforts to remedy this and to utilize recently expanded capacity.”

Broker Bell Potter also rates the company a ‘hold’, with an uninspiring \$5 a share valuation.

Your humble columnist reckons it’s all a matter of price:

Synlait stock is trading on a multiple of around 16 times expected current year earnings, compared with A2 milk on roughly 35 times. ASX-listed processor Bega Cheese trades on a multiple of circa 40 times.

In summary, we don’t think investors have milked all the upside already but maybe the cream on top isn’t as fluffy as it once was.

Disclosure: Dr Boreham is not an agronomist and does not possess a relevant – or irrelevant - doctorate of any sort. His childhood dream was to become a dairy farmer in Saudi Arabia so he could be a ... wait for it ...milk sheikh.