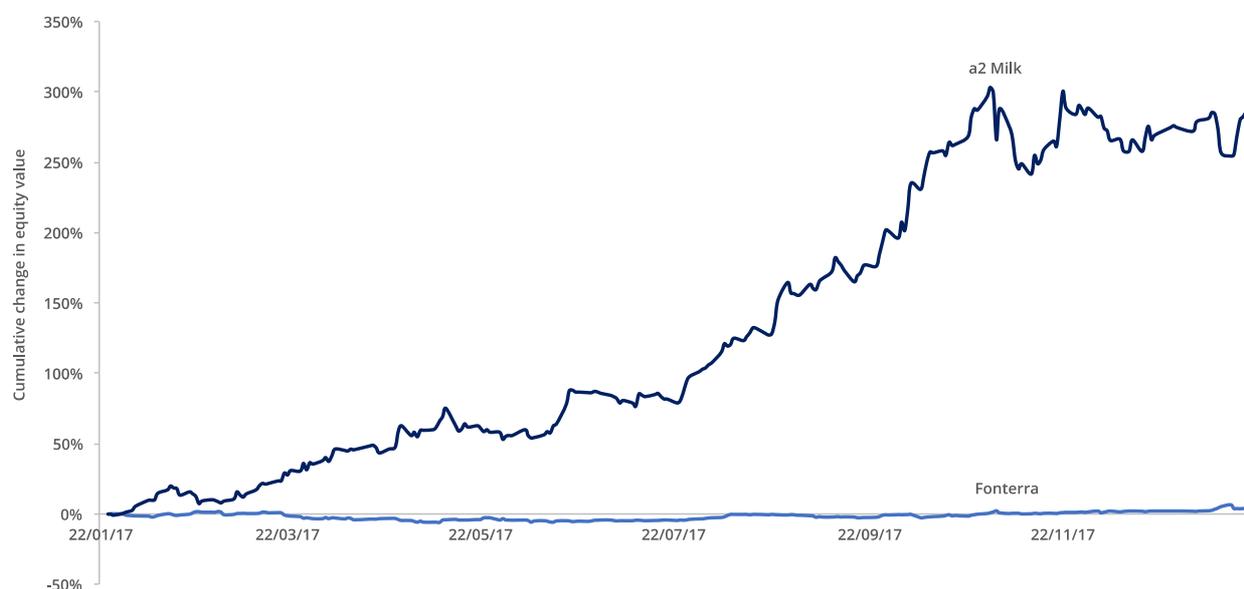


The a2 Milk Company Story – An Overview

January 24, 2018

The market value of Fonterra's equity is \$10.6 billion. Its NPAT in FY17 was \$745 million. That gives it a P/E multiple of 14. The market value of The a2 Milk Company's (ATM) equity is \$6.1 billion – almost 60% of Fonterra's. Its NPAT in FY17 was \$91 million. That gives it a P/E multiple of 66. See Figure 1 below. So what? Clearly investors like ATM's story. It is a dairy industry participant but it is not at all typical.

Figure 1: Percentage change in the equity value of The a2 Milk Company versus Fonterra Cooperative Group



One look at its balance sheet confirms that: total assets of \$344 million (as at 30 June 2017) including cash of \$121 million, property, plant, and equipment of only \$8.4 million, no debt, and total equity of \$241 million. It doesn't collect milk, it doesn't process milk, and it doesn't even have milk supply agreements with farmers. It contracts other entities to do all of that. In New Zealand, that other entity is Synlait Milk (SML).

TDB BRIEFING NOTE

ATM's story is based on the benefits of consuming A1 protein-free milk. In its 2017 annual report, ATM does not state that it has been scientifically proven that A2 protein milk is better for you than A1 protein milk but it does state that scientific research has demonstrated a structural difference between the A1 and A2 protein types and the way in which the digestive system breaks them down. It also states that many consumers and healthcare professionals report that certain people who experience challenges drinking conventional cows' milk experience benefits when they switch to A2 protein milk.

The story is gaining international traction. ATM's sales increased by 56% to \$550 million in the year to 30 June 2017 and its NPAT increased by almost 200% to \$91 million.

Without implying that one is over-valued or that one is under-valued but to put some context around the relative equity value of the ATM and Fonterra, we note the following:

- ATM sells 225 million litres of New Zealand A2 protein milk in various product forms per year. Those 225 million litres represent 65% of certified A2 protein milk globally, which means that the global supply of A2 protein certified milk is 345 million litres;
- Fonterra sells approximately 18 billion litres of New Zealand milk in various product forms per year. That's 80 times more than ATM. Some of that milk could actually be A2 protein certified but Fonterra doesn't separate it from the rest of its milk collections; and
- Back in the day, cows originally produced milk containing only the A2 protein. Genetic variations over time mean that cows now produce milk containing the A2 protein or the A1 protein or both. The general thinking is that approximately one third of the current New Zealand herd produces milk with just the A2 protein. If that's correct, Fonterra is selling something like 6 billion litres of milk containing just the A2 protein – that's more than 25 times ATM's volumes.

As ATM reports in its 2017 annual report, it continues to support further research into understanding the potential benefits of consuming A1 protein-free milk products.

It has been reported in the media over recent times that the science behind the benefits of A1 versus A2 is inconclusive and that Fonterra is sceptical with Theo Spierings having reportedly said in an interview that A2 milk is just a "marketing concept"¹.

Regardless, from a risk management perspective, given that no one is arguing that A1 protein milk is better than A2 protein milk, there doesn't seem to be any downside to farmers breeding for only A2 protein milk from this point forward.

¹ <https://www.stuff.co.nz/business/farming/dairy/77418974/the-a2-milk-company-is-rocking-the-dairy-world>