NZX: ATM
ASX: A2M

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NZX/ASX Market Release

# RECORD FINANCIAL RESULTS AND MARKET SHARE POSITIONS IN ALL KEY MARKETS, STEP-CHANGING INVESTMENT IN BRAND AND CAPABILITY

**Results highlights for the half-year ended 31 December 2018 (NZ$)[1]**

- Total revenue of $613.1 million – an increase of 41.0%[2]
- EBITDA[3] of $218.4 million – up 52.7%
- Net profit after tax of $152.7 million – up 55.1%
- Basic earnings per share (EPS) of 20.9 cents, an increase of 52.9%
- Operating cash flow of $112.3 million and a closing cash balance of $287.9 million
- Group infant formula revenue of $495.5 million – up 45.3%; China label revenue up 82.6% and China consumption market share of 5.7%[4]; and brand leadership in Australia at 35.7%[5]
- US milk revenue growth of 114.1% and distribution growth to over 10,000 stores
- Australian fresh milk revenue growth of 11.7% and record market share of 10.8%[6]
- Increased strategic investment in consumer insights, brand and organisational capability

[1] All figures are in New Zealand Dollars (NZ$) unless otherwise stated
[2] All comparisons are with the six months ended 31 December 2017 (1H18), unless otherwise stated
[3] Earnings before interest, tax, depreciation and amortisation (EBITDA) is a non-GAAP measure. However, the Company believes that it assists in providing investors with a comprehensive understanding of the underlying performance of the business. A reconciliation of EBITDA to net profit after tax is shown at the end of this document
[4] Kantar Infant Formula market tracking of Tier 1 and Key A cities for 12 months ending 28 December 2018 by value
[5] Aztec Australian Grocery and Pharmacy Scan 12 months ending 30 December 2018
[6] Aztec Australian Grocery Weighted Scan 12 months ending 30 December 2018

**Summary of Group performance**

The Company's increased investment in brand, market development and organisational capability fuelled continued strong sales growth in all key product segments - infant formula, liquid milk and milk powders.

Sales of infant formula totalled $495.5m for the half – an increase of 45.3% on the prior year driven by share gains in China and Australia. The Company also saw pleasing growth in its liquid milk business of 20.2% to $83.4m, particularly in its key markets of Australia and the US. Sales of other nutritional products grew 40.4% to $34.3m, driven predominantly by milk powders and supported by new products launched towards the end of FY18.

Gross margin percentage increased due to the benefits of scale and mix (proportion of infant formula sales now accounting for ~81% of Group sales). This was partially offset by currency movements – most notably a weaker AUD.

*Step-changing investment in brand and capability*

Following a transformative FY18, the Company is focussed on delivering continued and significant growth through step-changing strategic investment in consumer insight, brand development and organisational capability.

The Company is accelerating its investment in building brand equity through enhanced marketing campaigns in its key markets of China, US and Australia, alongside continued investments in R&D and further development of its intellectual property. The Group's investment in marketing in the first half increased by 75.0% to $45.5m primarily as a result of increases in brand building activities in China and the US. The rate of investment in marketing will increase further in the second half as we increase in-market brand building activities.

A number of key senior strategic appointments have recently been completed, including the addition of Lisa Burquest as Chief People Officer, Melanie Kansil as Chief Commercial Officer and Phil Rybinski as Chief Technical Officer. These new roles build upon the existing strong and experienced group of executives and, combined with growth in the broader team and investment in infrastructure will ensure the business is well placed to continue its significant momentum, having the capacity to commercialise further growth opportunities.

We have previously signalled our intention of holding our first investor strategy conference, which will provide an opportunity to present a more comprehensive overview of our strategic focus areas. This remains a priority and will likely occur in the second half of the 2019 calendar year.

*Strong balance sheet*

The Company's closing cash position reflects the growth in revenue and earnings, partially offset by the Company's increased investment in Synlait Milk (August 2018). Net operating cash flow for the half was $112.3m, with cash on hand at 31 December 2018 of $287.9m. Cash conversion was impacted by the timing of tax and supplier payments, and increased debtors and infant formula inventory.

The Company closed the period with $72.8m of inventory, up from $64.1m at 30 June 2018. Owing to the continuing strong demand for *a2 Platinum®* infant formula the closing inventory position for the period was ultimately below target relative to sales. In response, steps have been taken to further enhance our approach to inventory management in market, enabling the business to adjust more quickly to demand changes. This will have the net effect of increasing inventory cover going forward.

We continue to be very well supported by our infant formula supply partner Synlait Milk, in meeting increased demand, and both teams continue to work closely together to grow our respective businesses.

**Regional performance**

*Australia and New Zealand segment goes from strength to strength*

The ANZ business segment revenues were up 37.5% to $418.4m, and EBITDA was up 64.9% to $192.0m.

The Australian fresh milk business has further strengthened with 11.7% revenue growth and a record 10.8% market share[7], up from 10.0% for the same period a year ago. *a2 Milk™* was the fastest growing major liquid milk brand in Australian supermarkets and remains the leading premium milk brand and the only brand ranged in all major Australian supermarkets.

*a2 Platinum®* infant formula remains a significant growth brand in grocery, pharmacy and daigou channels – it is the market brand leader with 35.7% value share, up from 32.0% at the end of FY18[8].

The business continued to be the highest brand advertiser within both the milk and infant formula categories with growing brand awareness and loyalty benefitting the portfolio as a whole.

The *a2 Milk*™ brand under licence to Fonterra was launched in New Zealand early August with national advertising and distribution from late September and is performing to plan.

*China performing well*

China segment revenue rose to $171.7m, up 50.1%, with EBITDA up 41.6% to $68.4m as a result of strong distribution and market share gains.

Our Kantar infant formula consumption value share increased to 5.7%[9] in the latest 12 month data for Tier 1 and Key A cities, up from 4.4% in the same period prior year, and up from 5.1% as at end June 2018[10]. The Company recently invested in expanded market share coverage to include city tiers B, C and D and is pleased to report a market share position of 5.4% in the latest 12 month data up from 4.7% as at June 2018[11] for the composite of Tier 1 and Key A, B, C and D cities. This result demonstrates considerable momentum in lower tier cities. The positive velocity growth in store combined with the Company's stronger distribution footprint is supporting an increase in sales of China label infant formula with growth of 82.6% relative to first half a year ago.

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[7] Aztec Australian Grocery Weighted Scan 12 months ending 30 December 2018 vs YA. Note, the latest market share reporting database has been updated in current period and prior year to include Costco, Aldi (SA and WA) sales

[8] Aztec Australian Grocery and Pharmacy Scan 12 months ending 30 December 2018 vs June 2018

[9] Kantar Infant Formula market tracking of Tier 1 and Key A cities for 12 months ending 28 December 2018 by value, vs 12 months ending December 2017

[10] Kantar Infant Formula market tracking of Tier 1 and Key A cities for 12 months ending 30 June 2018

[11] Kantar Infant Formula market tracking of Tier 1, Key A, B, C and D cities for 12 months ending 28 December 2018 by value vs 12 months ending 30 June 2018

Our multi-channel strategy remains important to our success. Through the eyes of the consumer each channel plays an important role and the combined effect is beneficial. Progress made during the period by the Company in each channel has been significant.

The cross border e-commerce channel (CBEC) remains a strong pathway to the Chinese consumer for the infant formula category, enabling consumers across all regions (including those in lower tier cities) to more easily access international brands. The Company performed well during the online seasonal events and continues to perform strongly across all CBEC platforms.

Mother and Baby Stores (MBS) provide Chinese parents with a more interactive shopping experience to view brands on offer and receive information about selected products, in particular for Stages 1 and 2. This channel continues to be an important priority. During the half, focus was added to improving in-store productivity within the channel, with impressive results. Pleasingly, sales velocity growth within existing stores was a stronger contributor than growth coming from new store additions. The MBS network comprised ~12,250 stores as at the end of December. Improving in-store productivity and increasing store distribution will both continue to be an important focus in the second half as we work to lift channel share.

Modern supermarkets and Chinese label e-commerce retail channels are lesser contributors at this stage relative to CBEC and MBS but also play important roles for target consumer segments.

Our growing consumer insights gives us confidence that the Company will benefit from accelerated investment in brand building and marketing generally. Our consumers are typically deeply loyal with high trust for the brand, yet there is significant scope to build our in-market brand awareness. The business is now well positioned with strong offline and online distribution in place to benefit from step-changing marketing investment, which is expected to build further brand awareness and trial purchase within the China market. This will be a priority investment focus for the remainder of FY19 and into FY20.

In August 2018 the Company renewed its agreement with China State Farm. This relationship is strong and enduring and an important part of building our business in China for the long term.

The Company is well progressed on the appointment of a CEO for Greater China who will lead the business through its next phase of growth in the region. We have been very focussed on finding a strong leader who has a demonstrated track record in creatively building successful consumer driven businesses in China.

<u>China regulatory dynamic</u>

The Chinese government issued a number of important regulatory updates during the half with respect to e-commerce and cross border trade in general. This included a new e-commerce law to strengthen the compliance obligations for e-commerce operators, and a new CBEC policy framework containing implementation guidance for future CBEC trade.

The new e-commerce law, together with the Chinese Government's continued support of CBEC, will further protect the rights and safety of consumers and the overall integrity of the CBEC channel. We fully support the changes, and the Company and its major trading partners selling English label products to Chinese consumers has been anticipating these changes and will be compliant on all regulatory requirements.

*United States momentum building*

*a2 Milk™* sales momentum continued with sales growth of 114.1% in the half underpinned by increased investment in brand awareness and a stronger distribution base.

By the end of December 2018 US distribution exceeded 10,000 stores. More recently, a further ~2,400 stores have been added, taking the distribution of the brand to ~12,400 stores by the end of January 2019. The increase in store numbers is driven primarily by national distribution within the Kroger supermarket chain, in addition to three new regions within Costco; additional Vons and Safeway stores and further Walmart distribution. Sales velocities continue to improve through both new and established key accounts.

The significant rate of distribution growth in January is driven by building brand awareness and new store planogram reset timings within the respective retail chains. While the second half will continue to focus on increased distribution, there will also be a focus on improving in-store productivity in relatively newer stores.

Pleasingly, recent US research data indicates the US brand development looks a lot like the experience with fresh milk in Australia. The *a2 Milk™* brand in the US is successfully growing category consumption, sourcing volume across multiple product segments and trading up consumers from conventional milk while demonstrating high levels of consumer loyalty once the brand is trialled.

There will be increased investment in 2H19 to support continued velocity growth in market. The planned investment for FY19 is now approximately US$27 million.

*Other markets and further opportunities*

UK liquid milk sales have continued to grow off a modest base. The business successfully transitioned between suppliers early in the half to a new carton packaging form. The delivery of scale remains challenging.

Progress continues to be made in establishing our presence in other Asian markets. Although relatively small contributors to sales growth, these markets offer opportunities for further expansion in the future.

The Company has agreed with Fonterra to build a milk pool in New Zealand that will enable direct ingredient supply to The a2 Milk Company, from second half calendar 2019. In addition, the business will continue to develop a milk pool in Victoria, Australia for raw milk supply. The joint a2MC and Fonterra team is actively working together to commercialise the next wave of opportunities which will come from our partnership and we continue to be encouraged by the potential.

**Outlook**

In the first half the Company has invested strongly in both internal and external capability to better understand our Chinese consumers, channel dynamics and ways of improving brand awareness.

Following a very strong first half performance, and encouraged by growing market share in China, the Company is now in a position to reinvest the benefits of scale into increased marketing activities in the second half. This is intended to drive brand awareness, predominantly in China, and the US. Increased brand and marketing investment is expected to continue into FY20.

The Company expects the Group revenue growth rate in the second half to continue broadly in line with the first half. The increased investment in brand building in 2H19 is expected to support revenue growth in FY20 and beyond.

Second half EBITDA margins will consequently be lower than in the first half, with full year FY19 EBITDA as a percentage of sales expected to be approximately 31-32%. This is due largely to:

- Marketing investment in 2H19 to approximately double 1H19
- Continued investment in building organisational capability

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**Reconciliation of EBITDA to net profit after tax**

| | Half Year Ended 31-Dec-18 NZ$ 000's | Half Year Ended 31-Dec-17 NZ$ 000's |
|---|---|---|
| Segment EBITDA | 218,407 | 142,989 |
| Depreciation & amortisation | (965) | (1,058) |
| **EBIT** | **217,442** | **141,931** |
| Interest income | 1,615 | 795 |
| Income tax expense | (66,362) | (44,257) |
| **Net profit after tax** | **152,695** | **98,469** |