



21 February 2018

NZX/ASX Market Release

## **Revenue, earnings and cash flow continue to grow strongly Half-year earnings exceed those for the 2017 full financial year**

### **Overview for the half-year ended 31 December 2017 (NZ\$)**

- Total revenue of \$434.7 million – an increase of 70% over the prior corresponding period (pcp)
- EBITDA<sup>1</sup> of \$143.0 million – 123% ahead of the pcp
- Net profit after tax of \$98.5 million – 150% ahead of the pcp
- Basic earnings per share (EPS) of 13.6 cents, an increase of 147%
- Operating cash flow of \$116.4 million and a cash balance of \$240.2 million at the end of the period
- Continued strong growth in a2 Platinum<sup>®</sup> infant formula sales and market share in China and Australia
- Expansion in fresh milk distribution and sales in the United States
- Progress in new product development and expansion into emerging markets
- Admission to the S&P/ASX 100 and S&P/NZX 10 indices, effective December 2017

The Company made further substantial gains in revenue, earnings and cash flow in the first half of the 2018 financial year. Growth continued at a very strong rate in the infant formula business, and liquid milk sales were again higher in each of the Company's core markets.

Sales of *a2 Platinum*<sup>®</sup> infant formula again grew substantially in Australia and China supported by an increase in market share in those regions. Key first half sales events in China have also contributed to a strong 1H18 result, particularly in November and December. *a2 Platinum*<sup>®</sup> sales revenue was \$341.0 million, 78% of the Company's total revenue for the half-year. Investment continued in building brand awareness and consumer engagement, expanding distribution for *a2 Platinum*<sup>®</sup> in multiple channels and adapting to new regulatory requirements in China.

Significant progress was achieved in the United States, with further growth in brand awareness, sales velocities and store numbers within the established footprint of California and the Southeast. The US business also further

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<sup>1</sup> 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



expanded geographically, culminating in the announcement in January 2018 that the *a2 Milk™* brand would become available through major retailers across the Northeast region.

Fresh milk sales in the United Kingdom continued to build, driven by further improvement in sales velocities in-store and gains in distribution.

Total Group marketing investment increased by \$10.0 million over the pcp, due primarily to programmes supporting growth in the United States and China.

The Company's cash position continued to increase along with growth in revenue and earnings. Net operating cash flow was \$116.4 million, compared with \$38.1 million in the pcp. Cash on hand at 31 December 2017 was \$240.2 million, compared with \$121.0 million at the end of June 2017. Working capital benefited from improved debtor days and timing of payments with suppliers. This has been partially offset by an increase in infant formula inventory of \$25.2 million as the Company seeks to build progressively to more sustainable levels during the year. This included an increase in China label inventory in response to regulatory changes from January 2018 and increasing demand.

The Board continues to consider the appropriate use of the Company's available capital in the best long-term interest of shareholders. This includes a review of opportunities to invest directly in blending and canning capability as part of our longer-term nutritional products sourcing plan, as well as continued consideration of an on-market share buyback and implementation of a dividend policy.

Managing Director Geoffrey Babidge said: "Our financial performance reflects the growing strength of our brand proposition, the successful execution of in-market growth strategies and the continued strong performance of our supply chain.

"Consumer interest in the benefits of dairy-based products free of the A1 beta-casein protein type continues to grow. We invest strategically in this aspect of the business through marketing, promotion and education programmes in each market.

"Our distribution networks grew significantly in the first half of the year – particularly in China and the United States – and the foundations were laid for further strong expansion in the second half," Mr Babidge said.

"An especially pleasing aspect of our performance was the continuing strong growth in market share and sales of *a2 Platinum®* infant formula in China, along with our success in adapting to the evolving regulatory environment in that market.

"The successful growth and evolution of our management capability and depth was also pleasing – particularly in the newly-implemented Asia Pacific structure and the development to support our expansion in China and in emerging markets.

"A further significant development was the announcement today of the formation of a comprehensive strategic relationship with Fonterra Co-operative Group Limited. The arrangements complement the Company's successful ongoing partnership with Synlait Milk, enhancing the Company's ability to enter new priority markets and providing exciting growth opportunities in new A1 protein-free products.

"Continuing strong performance and the consequent strength of our financial position mean the Company is very well positioned to continue to execute its growth strategy in both existing and targeted markets."



## Strategic focus

The Company's growth strategy has three priorities:

- Building a broad portfolio of dairy-based nutritional products based on the A1 protein-free proposition
- Targeting attractive regions globally
- Continuing to invest in proprietary know-how and A2 protein expertise

Stage 4 *a2 Platinum*<sup>®</sup> infant formula, for children three years and over, was launched in Australia and China in August 2017 and has performed above expectations. The launch of a further specialised milk powder product is scheduled to occur by the end of the financial year and additional products are planned for the remainder of calendar 2018.

We progressed our strategy for growth in emerging markets through the launch of *a2 Milk*<sup>™</sup> branded fresh milk in Singapore, and through discussions with potential partners in various other markets. The Singapore launch, in August 2017, achieved positive sales momentum with good in-store velocities. Shipments are now being made weekly from Australia and we are considering the potential to broaden the product range and distribution for this market.

We also established a small test market, for *a2 Milk*<sup>™</sup> branded whole milk powder, with a partner in Vietnam.

The Company remains committed to its low capital model supported by mutually beneficial medium-term relationships with processing and distribution partners, in line with its multi-site, multi-product and geographic diversification strategy. As part of this, the Company is continuing to assess its medium-term manufacturing strategy for nutritional products, including the possible ownership, either in full or in partnership, of blending and canning assets as part of the supply solution.

The agreement with our infant formula supply partner Synlait Milk is operating very well, with increasing order quantities being supplied and both management teams working to achieve efficiencies through increased throughput.

The Company has announced the formation of a comprehensive strategic relationship with Fonterra Co-operative Group Limited ("Fonterra"). The initial scope of the relationship incorporates:

- a Nutritional Products Manufacturing and Supply Agreement under which Fonterra will manufacture A1 protein-free products for certain priority markets in South East Asia and the Middle East exclusively for the Company;
- an exclusive licence to Fonterra for the production, distribution, sale and marketing of *a2 Milk*<sup>™</sup> branded fresh milk in New Zealand;
- the opportunity to leverage Fonterra's sales and distribution capabilities in the priority markets; and
- jointly evaluating opportunities for the sale of certain Company branded dairy products in Australia, New Zealand and China

The arrangements with both Synlait Milk and Fonterra provide the Company with further diversification in the manufacture of nutritional products and the opportunity to expand the portfolio of Company branded products and access new priority markets more quickly than would otherwise be the case.

During the half-year, the Company continued to invest in enhancing and protecting its intellectual property, including support for scientific research and development and investment in brands, trademarks, patents and proprietary know-how across identified markets.

The Company expects broader interest in the A1 protein-free category over time. Given its pioneering heritage, its comprehensive suite of intellectual property and a business model focused solely on products free of the A1 protein type, the Company is well positioned to respond.



## Board and Management

As announced in December 2017, Managing Director and CEO Geoffrey Babidge will retire during calendar 2018 and be succeeded by Jayne Hrdlicka. Ms Hrdlicka was CEO of Jetstar for more than five years before assuming another senior role with Jetstar's parent company Qantas Airways Limited. She has also been a senior partner at Bain & Company, focused on customer-oriented businesses. It is expected that she will join the Company around the commencement of the 2019 financial year. Mr Babidge will be available until December 2018 to assist the transition.

A reorganisation of the senior leadership team announced in June 2017 was completed in August with Peter Nathan appointed to the new role of Chief Executive Asia Pacific and Jane Xu appointed Executive Vice President China. The new structure is focused on maximising opportunities within the ANZ and China markets and across the broader Asia Pacific region over time.

## ANZ

The ANZ business continued to grow strongly, with total revenue across all product categories up by 47% to NZ\$304.3 million and EBITDA by 65% to NZ\$116.4 million.

Revenue growth for *a2 Platinum*<sup>®</sup> infant formula was particularly strong, driven by continued growth in consumer awareness in Australia and China. *a2 Platinum*<sup>®</sup> remains the fastest growing infant formula brand by value in Australia, with market share in mainstream retailers up from ~26%<sup>2</sup> to ~30%<sup>3</sup>.

Fresh milk revenue rose by ~3% over the pcp. Market share by value for *a2 Milk*<sup>™</sup> branded fresh milk rose to ~9.5%<sup>4</sup>. *a2 Milk*<sup>™</sup> remains the only milk brand distributed through all six key grocery retailers in the Australian market.

Total sales of *a2 Milk*<sup>™</sup> branded milk powder products – whole milk powder and skim milk powder (the latter introduced in May 2017) – were significantly higher than in the pcp.

The Company continued to invest strongly in its brands, through the highest national advertising spend in both the infant formula and fresh milk categories in the Australian market and through strong editorial media coverage. Both spontaneous and prompted consumer brand awareness grew sharply in both categories. *a2 Milk*<sup>™</sup> was recently named the top brand of choice for Australian 'millennials'<sup>5</sup>.

Close attention continued on the infant formula supply chain resulting in an improved level of inventory at the end of the half. The Company also introduced an on-line platform to improve access of *a2 Platinum*<sup>®</sup> for Australian consumers.

The Company continues to engage with and closely monitor the personal shopper ("Daigou") channel, recognising its importance as a continuing driver for the business.

As announced in December 2017, a confidential settlement was reached in respect of the legal dispute with Lion Dairy & Drinks Pty Limited whereby the parties agreed not to proceed with their cases against each other.

## China and Other Asia

The China and Other Asia business recorded exceptional growth, with revenue up by 204% to \$114.4 million and EBITDA by 252% to \$48.3 million.

<sup>2</sup> Aztec Australian Grocery and Pharmacy Scan, 30/06/17 MAT (Moving Annual Total)

<sup>3</sup> Aztec Australian Grocery and Pharmacy Scan, 31/12/17 MAT

<sup>4</sup> Aztec Australian Grocery Weighted Scan, 31/12/17 MAT

<sup>5</sup> Number 1 brand on millennial shopping lists, *The Urban List, Food & Drink Survey May 2017*



The business has a flexible multi-channel infant formula strategy in both China label (offline and online) and cross border English label (online) to best position the brand for growth in the medium term.

Total market share for *a2 Platinum*<sup>®</sup> infant formula in the targeted regions continued to grow rapidly. Consumption market share by value grew from ~3.5% (quarter ending 30/06/17) to ~5.4% (quarter ending 31/12/17) as measured by Kantar<sup>6</sup>.

Increased marketing and sales investment remained a key driver of rising brand awareness. The announcement, in November 2017, of the publication of research findings from a major clinical trial conducted in China (see below) provided further impetus.

*a2 Platinum*<sup>®</sup> again participated successfully in key online sales events. In the major '11/11 Singles Day' event it was the top-selling infant formula on Kaola.com, second on JD.com and third on T-mall.

In the offline (bricks and mortar) segment, distribution grew to ~6,700 Mother & Baby Stores supported by an in-store communication programme including deployment of promotional staff who provide consumers with product and category advice. Further expansion is planned for this channel during the second half, backed by an enhanced marketing programme including investment in mainstream media in targeted provinces and in social media.

The China business also launched *a2 Platinum*<sup>®</sup> infant formula in Hong Kong, with distribution through ~350 high-end pharmacy outlets, supported by brand advertising in high-profile outdoor media. Hong Kong presents an attractive opportunity, both in regard to local consumers and as a channel for Mainland China.

The Company continues to strengthen the organisation in China, with further development in the latest period across all key functions including sales, distribution, marketing, quality, regulatory affairs and finance.

Synlait Milk achieved registration of our China label infant formula products with the China Food and Drug Administration (CFDA) in September 2017. Under regulations applying from 1 January 2018, only China label infant formula products (Stages 1, 2 and 3) registered by the CFDA are permitted to be imported into China through traditional channels. The registration process is comprehensive and includes testing of raw materials and finished products, certification of manufacturing standards and formulation assessment, and packaging changes in response to labelling and branding requirements.

The Company continues to monitor changes in the regulatory regime closely and respond as appropriate.

## United States

The US business continued to progress its strategy to build brand awareness and sales velocities while further expanding its distribution footprint.

Investment continued in a multi-media marketing strategy including the *Love Milk Again* advertising campaign, an active editorial media programme, strong digital media and shopper marketing programmes. Sales velocities continued to grow in a number of key accounts.

*a2 Milk*<sup>™</sup> is available in four variants (including chocolate) within the specialty milk segment, the fastest growing segment of the total milk category. At the end of the reporting period the Company had distribution in ~3,600 stores, in California and the South East and through natural retail chains including Sprouts Farmers Market (nationally) and Whole Foods Market (in seven of 11 regions).

It was announced in January 2018 that distribution would be expanded to major retailers across the Northeast region, building on a growing presence already in the natural channel in the region. The Northeast is home to ~60

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<sup>6</sup> Kantar Infant Formula market tracking of Tier 1 and Key A cities comprising a substantial proportion of the total China infant formula market



million consumers and accounts for about 20% of the total milk category volume in the US. It includes New York, New Jersey, Pennsylvania, Connecticut, Rhode Island, New Hampshire, Massachusetts, Vermont and Maine. The *Love Milk Again* campaign and associated programmes are being broadened to support the expansion to this region.

Along with prior distribution growth in California, the South-East and the natural channel, the Northeast expansion is expected to increase total distribution numbers to ~5,000 stores across the US.

As previously advised, the financial outlook for the US business assumes investment of approximately US\$25 million over the course of FY18 and FY19 before positive monthly EBITDA is achieved in the 2020 fiscal year. A significant component of this investment relates to building brand awareness and product trial in support of the growth in distribution.

Meanwhile the Company is investigating specific new product opportunities for the US market to further capitalise on the expanded distribution.

### United Kingdom

The United Kingdom business achieved further gains in revenue and positive operating earnings, driven by continuing improvement in sales rates and an expanding distribution footprint.

Volume sales of *a2 Milk™* branded fresh milk increased by more than 50% against the pcp.

Improving sales rates reflect growing brand recognition achieved through the *a2tonishing* marketing campaign and improvements in merchandising, including increased in-store facings and greater point of sale presence.

Distribution grew from ~1,600 stores to more than 2,000, with gains across the three largest supermarket chains – Tesco, Sainsbury and Asda. In the UK's largest retailer, *a2 Milk™* is now sold in stores comprising 70% of its weighted distribution. The distribution gains across all major chains are, in turn, creating new promotional and marketing opportunities.

As in the pcp, results also include a contribution from the sale of *a2 Platinum®* infant formula in the wholesale market.

The Company is continuing to assess opportunities for incremental business in Europe and the Middle East.

### Science, research and development

A recently published clinical trial conducted in China, involving ~600 adult participants with self-reported lactose intolerance, found that those who consumed milk containing only the A2 beta-casein protein type had reduced acute gastrointestinal symptoms compared with those from milk containing the A1 and A2 beta-casein protein types. The authors said their findings demonstrated that, in some individuals, symptoms from consumption of conventional milk may be related to the presence of A1 beta-casein protein rather than lactose.

A pilot human study carried out under the New Zealand Government High Value Nutrition programme is now complete and being submitted for publication. The study compared the digestive effects of lactose-free milk, *a2 Milk™* and conventional milk amongst milk intolerant participants. Subsequent follow-on studies have now commenced.

A clinical study in China amongst pre-school children, examining digestive benefits of milk free of the A1 beta casein protein type has been completed and submitted for publication.

Studies in progress at the end of the period included a clinical examination at Pennington Biomedical Research Centre, in the United States, with regard to digestive function, inflammation and aspects of metabolic function and a clinical study in association with Monash University, in Australia, with regard to irritable bowel syndrome.



## Outlook

The Company has delivered a very strong first half-year, and performance in January 2018 has been pleasing. Continued revenue growth is expected in nutritional products in ANZ and China, along with further growth in fresh milk in the United States in consequence of the Northeast expansion. The focus on growth initiatives in targeted emerging markets and new product development will continue.

Gross margin percentage was higher than expected in the first half primarily due to the higher proportion of infant formula sales, currency movements and favourable net selling prices relative to plan. This was partially offset by product cost increases and margin mix within nutritional products. Subject to currency movements and realisation of throughput efficiencies, the Company expects the gross margin percentage to be broadly consistent in the second half.

As advised at the annual meeting in November 2017, earnings growth in the second half will be tempered by a higher marketing expense, with a half-on-half increase now likely to be in the range of ~NZ\$35 - \$40 million given the timing and scope of marketing programmes in China and the United States. This increased brand investment will further support future growth in these key markets.

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