Q&A WITH Geoffrey Babidge

Alan Deans talks to the CEO of The a2 Milk Company about wellness, growth plans and the company's success to date.

BURGEONING TRADE WITH ASIA IS CREATING momentus opportunities for Australian food producers. New free trade agreements (FTAs) with China, Japan and South Korea are delivering on their promise of opening markets for agricultural goodies including dairy, wine, fruit, beef, vitamins, fish and honey. Many companies are counting their good fortune. Others have yet to show how they will cash in. A few are struggling.

Disgruntled shareholders at infant formula group Bellamy's Australia, for instance, recently staged a board coup. The chairman resigned and two other directors were voted off. The company also faces two shareholder class actions based on allegations of misleading and deceptive conduct and continuous disclosure obligations. But the company continues to make money. Other food groups have faced management upheavals, supply chain problems, issues with establishing reliable sales channels and regulatory challenges. Over-inflated share prices have waned.

Department of Foreign Affairs and Trade figures show, however, that there is considerable underlying strength. Exports are up by more than $1.5 billion in six core food commodities since the FTAs came into force in 2015. This should climb higher as living standards in Asia improve. It helps that Australia has an enviable reputation for its clean and diverse food.

The a2 Milk Company spotted its opportunity early, and in 2011 embarked on a strategy to become a major player in Asia and far beyond. Since listing its shares on the ASX in March 2015 from its New Zealand homeland, its price has soared nearly fivefold. In contrast to the woes of some dairy competitors, a2 Milk's latest half-year net profits to December 2016 were up 290 per cent to $39.4 million on revenues that jumped by 84 per cent.

Geoffrey Babidge, a2 Milk's managing director and CEO, set his plan in train six years ago by negotiating a long-term agreement with a company in New Zealand to make infant formula. If the Asian food boom is sprinkled with gold dust, then that dust is baby formula. He then signed generous supply agreements with dairy farmers to secure a reliable supply. All the while, Babidge was plotting a major export move into China. That market accounts for half of the global market for infant formula, and in his view any serious player has to be there.

The next step was into Australian fresh milk production, and more recently into the US, the UK and Southeast Asia. For Babidge, the opportunity is not just China. It is the world. He is aiming high, but his company has major points of difference to its competitors. Its milk is marketed as being nutritional, without the issues of lactose intolerance and other health troubles levelled at suppliers of traditional milk (see accompanying story). It isn't burdened by legacy assets which,

Photo: Studio Commercial

in his words, make it capital light. That could speed growth and provide higher returns than rival companies, so long as he can steer clear of any shoals.

Below is Listed@ASX's interview with Geoffrey Babidge:

Listed@ASX: *How does a2 Milk's business model differ from other dairy companies in Australia and NZ?*

Geoffrey Babidge (GB): We now don't categorise ourselves as a dairy company, per se. We have evolved. The core proposition is around A2, and we are only engaged in products that are pure A2 beta-casein protein-based. That is a key distinction. There is no other dairy company of scale engaged in A1 beta-casein-free dairy products.

Secondly, compared to the majority of dairy companies that have some value-added and some commodity products, we are all about value-added. Thirdly, we have minimal fixed assets, which therefore converts into an attractive return on assets.

The other issue is that we have moved our business from traditional dairy to nutritional products, particularly around infant formula. In our most recent half-year report, to December 2016, infant formula represented 72 per cent of group revenue whereas in the 2015 financial year that was 27 per cent. Until then our business primarily comprised of liquid milk, which was the basis on which we established in Australia. Liquid milk is still very important – we are expanding our liquid milk activities in the US and UK.

Listed@ASX: *So you don't have your own herd of cows producing A2 milk? You are focused on developing markets?*

GB: Correct. This company identified the significance of the opportunity to take this proposition forward – initially in New Zealand, then in Australia and globally. Why New Zealand? It's a major dairy country. The concept and relevance of the proteins and the difference between A2 and A1 were discovered by scientists, and then a promoter in New Zealand started the ball rolling. The company was incorporated in 2000, and the initial business model was to develop the science and intellectual property (IP) and license that to a number of players.

I became involved in early 2007 when, as CEO of Freedom Foods Group, we became aware of the company, then called A2 Corporation. In early 2007, a joint venture for the Australian business was formed between Freedom Foods and A2 Corporation. That involved establishing a sales and marketing operating company, so the business model evolved from being focused primarily on IP to a more traditional fast moving consumer goods approach.

In 2010, the joint venture was merged into A2 Corporation and I transitioned from Freedom Foods to A2 Corporation. It has since evolved from having what was a very important focus on the science and IP to a fully-fledged operating company.

Relationships were put in place with farmers attracted to the proposition. We DNA test our farmers' cows and determine which cows are pure A2 producing, and then a separate A2-only herd is established. We contract to purchase milk from that herd at a premium to standard milk prices. We maintain quality control processes to ensure the milk we receive and process is A1 protein free.

We have farmer relationships in Australia, New Zealand and the UK and also now in the US.

Listed@ASX: *Do you take the milk and produce dairy products yourself?*

GB: Generally, we outsource the processing of liquid milk products. The exception is in New South Wales, where we have our own purpose built, state-of-the-art facility in southwest Sydney. We have contract packing arrangements in place with Norco Co-operative, Brownes in Western Australia and a liquid milk processor in Victoria.

In the UK, we have a manufacturing agreement with the second largest liquid milk processor, and in the US we have two medium-sized contract packers.

Our sourcing in New Zealand is focused on manufacturing infant formula for sale primarily in Australia, into China and progressively into other markets in Southeast Asia. We initiated a relationship in 2011 with Synlait Milk in Canterbury, which has developed a state-of-the-art, high quality nutritionals processing facility. In August last year, we negotiated a new processing and supply contract for another five years. They are a high quality manufacturer of what is a very high spec product, so we have outsourced to a world-class manufacturer.

Where we add value is in developing the science, the IP and sales, marketing and distribution. We have a capital light-smart business model. We put medium to long-term relationships in place with outsourced parties that have complementary businesses and where we are satisfied as to the quality of the product that is produced.

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Listed@ASX: *Milk has been around a long time. What makes it such a great business to be in now? Is it just China?*

GB: We have a differentiated proposition to the others in the industry. That proposition and the interest from consumers – initially in Australia and more recently in China – is perhaps the most significant reason for our growth over the past five years.

The China market represents approximately 50 per cent of the global infant formula market. It just so happens that Australia is geographically well positioned to China. We have a proposition that is unique and Chinese consumers are interested in digestive wellbeing. There is a higher proportion of people who are purportedly lactose intolerant.

Listed@ASX: *How much of the infant formula that you export to China comes from New Zealand as opposed to Australia?*

GB: All of our infant formula production is from New Zealand. We built a large milk pool there because our priority was to establish a relationship with a high quality manufacturer. Synlait was keen to get on the journey early so I established a strategic relationship with them.

Listed@ASX: *Why list the a2 Milk Company's shares in Australia?*

GB: The company was growing rapidly. It was incorporated in 2000, and admitted to the Alternative Market in New Zealand in 2004. We initially took the listing onto the NSX Main Board in 2012. But the reality is that, as time went by, the company grew very quickly and the logic was to establish a listing that was more broadly recognised. A number of Australian institutions and other potential shareholders had wanted to invest but has been precluded because of mandates. That was one factor.

The second was that the majority of our business activities had been in Australia with liquid milk and the commencement of infant formula. The ASX listing was therefore about broadening the shareholder base and in consequence of having a significant proportion of business activity in Australia. The dual listing became effective on 31 March 2015.

Listed@ASX: *As you develop markets in China, the US and the UK, will you move into those capital markets too?*

GB: We are very pleased with the listing on the ASX. It has delivered everything and more than what we expected. Our core focus is three-pronged – continue to support the Australian business; support growth into China and other parts of Southeast Asia; and develop a liquid milk business in the US market.

The ASX caters very well for our needs for the foreseeable future. We have a clean balance sheet. There are significant funds on deposit. We are significantly cash flow positive. Initiatives may arise, but even if they do the ASX is sufficiently developed and is a much larger market than was available to us solely within New Zealand.

Listed@ASX: *What is the balance of your shareholder base between Australia and New Zealand, and between institutions and smaller holders?*

GB: Greater than 60 per cent ASX in number of shares, greater than 80 per cent shareholders ASX to NZX and institutions across the two registers would exceed 50 per cent.

Listed@ASX: *That is quite a large move across to the ASX.*

GB: Yes. We are pleased about that. We currently have around 22,000 shareholders.

Listed@ASX: *What investor relations (IR) strategy did you adopt in gaining the ASX listing?*

GB: This was a very considered decision. We started communicating to the market in New Zealand about 12 months in advance of contemplating such a move. We undertook planning to establish our structure moving forward, particularly how we would manage investor relations and what its objectives should be. Part of that was to focus on the information memorandum for the compliance listing. We invested substantial resources to ensure that the memorandum was comprehensive and, in our view best in class, to properly inform Australian investors.

Step two was to develop the appropriate basis to communicate to the market. Obviously, there are guidelines in Australia so we developed our knowledge about them. Then we resourced up in respect of the skill set in the business. We employed, as part of our finance team, a manager of IR who works very closely with our general counsel to ensure we maintain compliance. We take investor communications very seriously, and we believe we have established the right balance. Some companies communicate more regularly than us. We very much focus on key events, around the half year and full year, and we attend one, two or three key investor days with profile investment banks.

"We have now got a substantial proportion of the business in nutritionals as opposed to traditional dairy, so we need to be looked at differently."

Listed@ASX: *Since the listing in Australia, a2 Milk has been the subject of takeover overtures, furious interest has developed around China market opportunities, dairy prices have collapsed, and investors have rebased their views. How has that impacted on your IR approach? You must get lots more people calling you than you expected.*

GB: Yes. The issue is, however, that we have to be disciplined in handling communications to the market. We are not a company that responds to market rumour or issues in the press that are not of direct consequence to how our business is operating. We, of course, need to keep the market informed consistent with our continuous disclosure obligations.

Movement in world pricing of dairy products has not been of significance to date either positively or negatively. We pay a high milk price for liquid milk anyway – one that is above world prices. We do not take the benefit of world prices coming down because we want long-term relationships with our liquid milk suppliers.

We have now got a substantial proportion of the business in nutritionals as opposed to traditional dairy, so we need to be looked at differently. We have a mix of business in different markets. All of that means that we are a different company to others. Clearly, however, our share price moves around with sentiment that is relevant to the market.

Listed@ASX: *What IR strategies are you now pursuing in support of your expansion into different markets?*

GB: We would like to continue to build the shareholder base, particularly the institutional base, broader than in Australia and New Zealand. The ASX invites us to participate in conferences in Asia and that is part of the mix. We are undertaking roadshows to the US and Asia as part of our IR process.

Listed@ASX: *Are you using shareholder targeting?*

GB: We haven't needed to do that because we have had a lot of inbound interest from institutional investors.

Listed@ASX: *What is the impact on the structure of the company from the rapid growth? How do you ensure that you keep up with the pace that the board has set?*

GB: It's a very good question. Both the revenue of the company and the market cap have been growing extremely strongly in the past few years. When I came across in 2010, I developed an initial five-year strategic plan that we update regularly.

As part of that plan, I communicated to the board that we needed to recruit and develop an organisational structure to support the growth. The board was very supportive of recruiting high quality people that were beyond the size that the company could justify at that time. The answer is that the organisational strength has provided a substantial benefit to our development. Even with the growth of the past two to three years, we have not encountered the degree of growing pains often associated with issues around structure or management capability. We need to continue to review and invest from here on, but the board acknowledges this has been an important factor in managing the growth we have achieved.

"The reality is our company has invested substantial sums in developing our IP, patents, trademarks and proprietary processes."

Listed@ASX: *Did you plan growth of such a scale?*

GB: We always had views about the potential of the company. It is probably fair to say that it has come a little earlier. Achieving a $2 billion market cap came earlier than we expected, but the senior team and the board always had a very clear view of our growth potential.

Listed@ASX: *There have been pitfalls along the way however, such as occurred within the dairy industry last year.*

GB: When you say pitfalls, there are always challenges. We have attempted to focus on our unique product proposition. We live and breathe that. That's very important in how we build the management team. We are extremely focused on a limited number of strategic opportunities.

We need a capital structure that doesn't put pressure on the business. We have funded growth out of capital or out of cash flow. Because we are quite a new company, we have not had the legacy issues that longer-established companies have to manage.

It's a combination of those factors that allows us to position ourselves to ride through the sorts of market changes you mention.

Listed@ASX: *Can a2's pace of growth continue?*

GB: All I can say is that we are delighted with the performance we have been achieving and we are optimistic that the growth will continue. The question is, how quickly? The potential around the A2 proposition is very strong. The IP that underpins this company is unique and provides a competitive advantage. The consumer interest in the product is what is driving the growth.

Listed@ASX: *Tell me about the US growth potential.*

GB: From 2007, the company focused on premium liquid milk in Australia and built a unique and profitable business here. In infant formula, we are playing in Australia and we are building a position in the largest infant formula market – China.

It is logical that we also see a unique product opportunity in the largest liquid milk market, the US. We launched initially in California, where, as you would expect, consumers are interested in health and wellness. There is clearly a market opportunity there. Our challenge is to communicate the differentiated product offering.

Listed@ASX: *What's to stop another company like yours coming along and focusing on A2?*

GB: The reality is our company has invested substantial sums in developing our IP, patents, trademarks and proprietary processes and know-how. We are the only company that has been involved in it for many, many years. Certainly the patent portfolio has been a very important factor in that. It represents part of the barriers to entry for other players. They are registered across most jurisdictions in western markets and into Asia.

What we are about, however, is building a unique brand proposition based on naturalness and uniqueness. Because of the success of this company, you can expect that others will be looking at how to enter the space.

Listed@ASX: *So you have a first mover advantage?*

GB: That has been the case.

Listed@ASX: *No other companies have A2 cows as well?*

GB: Other companies may be sourcing milk from a herd that comprises A1, A2 and A1/A2 cows. Over time, can someone else access a supply of A1-free milk? The answer, potentially, is yes. The real challenge then is how do you ensure absolute quality, how do you establish a brand and market position when you haven't done it before? And an additional challenge is that, if you are a traditional dairy company, your portfolio comprises A1/A2.

If others in other jurisdictions think this is a great idea, maybe they should come talk to us. We have a very clear business plan focused on the markets and products I have mentioned. But I am open to talk about opportunities for technology transfer.

Listed@ASX: *Going back to the ructions late last year, you seemed to sail through. Why was that?*

GB: It's a combination of factors. We have been focused on doing a limited number of things, hopefully well. Our focus in China has been about communicating with Chinese consumers, and being agile and flexible on the distribution channels to market, be that through Australia or direct into China. That preparedness to be extremely responsive to changes in distribution channels, being somewhat agnostic and support the ones that work at a given time, was a strategy we adopted a number of years ago.

That doesn't mean that we don't want to develop a stronger in-China business. We have people in Shanghai and we are doing that as well. But, certainly, our team in Australia has developed some smarts and agility in respect to the go-to-market strategy.

Listed@ASX: *What is the pitch to investors now?*

GB: We would like to think that we are demonstrating a unique business model and strategy. We are a dairy-based nutritional company. We are said to be one of the Australian-based companies Gen Y investors are interested in. We are a contemporary brand, highly aligned to what we deem to be the right values – which relate to naturalness. We have a track record of some consistency, particularly since the ASX listing. Also, we have some exciting growth prospects ahead of us.

The dairy debate

Debate surrounds whether dairy products that contain only the A2 form of beta-casein protein are better for people's health than milk that also contains the A1 beta-casein protein. The issue kicked off in the early 1990s when scientists in New Zealand observed correlations between the prevalence in some countries of certain chronic diseases and the prevalence of people in those countries who drank milk containing the A1 protein.

In 2009, a review of the then-current scientific literature on the subject by the European Food Safety Authority found that there was insufficient evidence to prove a "cause and effect" relationship between consuming BCM-7, a peptide released upon digestion of milk which contains the A1 protein, and diseases like diabetes, heart disease and autism. The report did however acknowledge that there was evidence to suggest that BCM-7 could interact with digestive and immune cells and tissue.

Protein is a major nutritional component of milk. Part of that protein is made up of beta-casein, which has two main types – A1 and A2. Its job is to transport nutrients and minerals like phosphorous and calcium to build body tissue. That is why milk is said to be good for you.

The a2 Milk Company got its big start when it patented a procedure for genetically testing cows so it could identify those ones that produced milk containing only the A2 protein. This paved the way for the commercial production of its a2 Milk.

"The history is that, up until approximately 5,000 years ago, all dairy cows in western herds were producing milk with only the A2 form of beta-casein protein," Geoffrey Babidge says. "Around that time, a genetic mutation occurred as herds were being domesticated, and another type of beta-casein protein, now called A1, emerged. The two proteins are identical in their composition other than the nature of one amino acid along the protein chain.

"There are dairy cows today that still produce milk containing only the A2 protein – we would say, as nature originally intended. There are also cows that produce milk that contain both the A1 and A2 proteins, and cows that produce milk with only the A1 protein. Our business is all about taking forward the proposition around A2 only milk or, one could otherwise call it, milk that is A1 protein free," he says.

Babidge continues: "When the company was formed, the initial interest in the difference between A2 and A1 was derived from some research that looked at whether A1 could be a trigger for type one diabetes, and other disease states. The interest into the impact on digestive issues started subsequently.

"When I became involved, we saw the significance of the digestive positioning and the link to naturalness as being the most appropriate positioning to take the company forward. But there still is a growing body of science behind the A2 protein proposition, which does involve looking at any possible negative health effects associated with the A1 protein. At the end of the day, however, when you look at the testimonials and body of science, this product works. People who previously reported having digestive problems when drinking regular cows' milk are now enjoying cows' milk and other dairy products again.

"Many people report to us that they have issues consuming conventional cows' milk because they experience digestive issues often associated with lactose intolerance. The studies we have worked with, and the consumer response, show that these digestive issues may in fact be due to sensitivity or intolerance to the A1 protein in conventional milk.

"We have built our business on the basis that our product is wholly natural, comes straight from the cow as nature intended. So, if you have had some issues regarding dairy intolerance, why not try a2 Milk?"