



15 February 2017

NZX/ASX Market Release

## **Continuing strong growth in infant formula drives record results for The a2 Milk Company Half-year earnings exceed those for the full financial year 2016**

### **Overview – financial results for the half-year ended 31 December 2016 (NZ\$m)**

- Total revenue of \$256.1 million – an increase of 84% over the prior corresponding period (pcp)
- Operating EBITDA<sup>1</sup> of \$64.1 million – 243% ahead of the pcp
- Net profit after tax of \$39.4 million – 290% ahead of the pcp
- Continuing strong growth in sales and market share for a2 Platinum<sup>®</sup> infant formula in Australia and China
- Sales growth for fresh milk and whole milk powder in Australia
- Broader distribution and growing sales of fresh milk in the United States
- Increased sales and positive operating earnings in the United Kingdom
- Operating cash flow of \$38.1 million – \$48.1 million more than in the pcp
- Conservative management of infant formula inventory

The a2 Milk Company (“a2MC” or the “Company”) delivered a further step upward in performance in the first half of the 2017 financial year, with operating earnings and net profit at higher levels than those for the full 2016 financial year.

The half-year performance reflects outstanding results from the Australia/New Zealand (ANZ) and China businesses, driven primarily by continuing strong growth in demand for a2 Platinum<sup>®</sup> infant formula. Revenues increased by 62% and 348% in Australia and China respectively, and Operating EBITDA by 104% and 1,021% respectively. The growth rate in part reflects inventory shortages experienced during the pcp.

Results in the United Kingdom and United States also improved. The UK business increased sales and achieved positive operating earnings in the period, while the USA business achieved increased distribution and higher rates of sale in a number of key accounts.

Managing Director Geoffrey Babidge said: “The half-year results show continued progress against the Company’s objective of building a global brand based on the health and digestive benefits of nutritional products containing only the A2 beta casein protein – free of the A1 protein.

“This has involved continuing to grow the established positions in fresh milk and infant formula in Australia while also investing in the key international growth initiatives in China, the United States and the United Kingdom.

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<sup>1</sup> Operating 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



“The outstanding aspect of our half-year performance was the continuing growth in a2 Platinum® infant formula in both Australia and China, through a multi-channel strategy involving a combination of local distribution, e-commerce and overseas shopping (‘Daigou’) traders. The growth is driven predominantly by the growing recognition and trust of the a2™ brand amongst Chinese consumers, reflecting a strong communications platform that speaks directly to mothers and to health care professionals in both Australia and China.

“Whilst the growth in demand was evident across the half-year, there was a marked increase in infant formula sales in the 2<sup>nd</sup> quarter corresponding with the phasing of key sales events in China and an increase in market share in both Australia and China. This was achieved whilst maintaining a prudent approach to the management of production and inventory in recognition of foreshadowed changes in regulations for infant formula sold in China.”

The first half FY17 result included:

- ANZ EBITDA of \$70.4 million
- China EBITDA of \$13.7 million
- UK and USA EBITDA of (\$7.7) million
- Corporate and other costs of \$12.3 million
- Basic earnings per share (EPS) of 5.51c; and diluted EPS of 5.37c

The increase in corporate and other costs in the half is primarily a result of increased spend on business development and research and development costs associated with a higher level of business activity.

Cash on hand at 31 December 2016 increased significantly to \$108.4 million, reflecting the increased earnings, together with pro-active management of working capital, particularly infant formula inventory levels, during the period.

As advised at the Annual Meeting in November 2016, provided that current trends in earnings and cash flow continue and there is no need for significant capital expenditure, the Board expects to adopt a dividend policy following the completion of FY17.

### **Board of Directors**

In line with the Company’s previously announced policy of board renewal, Warwick Every-Burns was appointed an independent non-executive Director of the Company on 23 August 2016. Mr Every-Burns has been a career Consumer Packaged Goods (CPG) executive with relevant global experience, including senior roles with The Clorox Company of the USA, NationalPak (the Glad Products Company), Unilever and Treasury Wine Estates, and is currently a non-executive Director of Treasury Wine Estates.

Mel Miles retired as a Director on 23 August 2016 after six years on the Board, but continues to advise the Company in a consultancy role.

### **Strategic Agenda Update**

The Company continues to focus on building a portfolio of milk-based nutritional products centred on the unique strengths of the A1 protein-free proposition. The broader nutritional strategy, from infant through to adult products, represents a natural evolution that the Company expects to be more attractive in the medium term than one based purely on traditional dairy.

While fresh milk and infant formula generate most of the revenue and earnings at this stage of the Company’s development, the product portfolio has been broadened through the launches of branded whole milk powder in Australia and China; fresh milk (sourced from Australia) into China; and UHT long life milk and infant formula in the UK.



Growth in the product portfolio will continue with the planned launch of additional nutritional products over the next 12 months.

As an outcome of the Company's growing profile in the USA, an extension of its distribution footprint is progressing through a major retailer in the South East from March 2017. This development is referenced more fully in the relevant section below.

A comprehensive study and strategic review of the infant formula market in China was carried out in conjunction with a leading in-market consultancy during the period. The review has assisted in deepening the Company's understanding of this market at a fundamental level and has confirmed broadly the Company's current approach in China whilst also giving further insight into future opportunities.

The Company also progressed a review of growth opportunities in the South East Asian region.

The Company is strongly focused on building constructive relationships with supply and distribution partners in all markets. A particularly significant development during the half-year was the completion of a new Supply Agreement with our supply partner for a2 Platinum® infant formula, Synlait Milk. This new agreement, for a minimum term of five years, provides access to an agreed level of capacity beyond current requirements, an obligation on Synlait to supply to order, and does not include "take or pay" provisions.

## **ANZ**

The ANZ business has continued to show very strong momentum, with sales and operating earnings in Australia considerably ahead of plan and pcp. Total revenue across all product categories increased by 62% to \$206.6 million and Operating EBITDA by 104% to \$70.4 million.

Growth occurred in all categories, but was driven primarily by rapid expansion in sales of a2 Platinum® infant formula, which registered substantial gains in market share and sales volumes. The brand achieved a ~25% grocery/pharmacy scan market share for the 13 weeks ending 1 January 2017 by value, compared with 16.7% in the comparable period of the prior year.

a2 Platinum® has been the fastest-growing infant formula brand in the Australian market in both the last quarter and the moving annual total, and was the N<sup>o</sup>. 2 brand by market share in the latest quarter.

Close attention has been and will continue to be applied to supply chain and inventory management, taking account of foreshadowed changes in the regulatory environment. Inventory remained at below average levels for the industry in part as a result of the continued expansion in sales. There is also a strong focus on maintaining deep insight into the 'Daigou' channel, including pricing, communication and customer management. The Daigou channel has become a significant and growing sales channel from Australia to consumers in China.

Sales of a2 Milk™ fresh milk increased by 3% over the pcp. Market share by value was stable at approximately 9.3% (Australian Grocery Weighted Scan 18 December 2016 MAT). a2 Milk™ and the a2 Platinum® brands enjoyed the highest level of advertising spend across the fresh milk and infant formula categories respectively for the 12 months ending 31 October 2016.

Sales of a2 Milk™ whole milk powder, launched in June 2015, grew significantly compared with the levels achieved in the pcp.



## China and Other Asia

Sales and earnings from the China business grew very strongly in the half-year. Total revenue increased significantly to \$37.7 million and Operating EBITDA increased to \$13.7 million.

Growth in the half-year was driven by increased consumer demand aided by an increasing understanding of the unique attributes of nutritional products that contain only the A2 beta casein protein – free from A1 protein. The business continues to invest strategically in building that understanding through a promotional programme that includes extensive online activity and events in Mother & Baby stores (MBS).

The business has a flexible multi-channel infant formula strategy to achieve growth – in both China label (predominantly in MBS) and cross-border ANZ label online with major e-retailers. a2 Platinum® achieved ~2.6% value share in the quarter ending 31 December 2016 within the segment of the market as measured by Kantar<sup>2</sup>. This share, while growing at a substantial rate, is modest in the context of the overall market in China and thus highlights a considerable growth opportunity for the Company.

Promotional activities have included a strong focus on communicating the benefits of a2 Platinum® infant formula through a testimonial approach, featuring mothers in China and Australia reporting on their own experiences and on educating health professionals.

The e-commerce strategy is centred on building strong relationships with profile providers such as Tmall, JD.com, Mia, Kaola, VIP and other strategic platforms. The promotional calendar has a strong bias towards the first half of the financial year given sales for the three largest e-retailer events fall predominately within the first six months. Sales on 'Singles Day' more than doubled the levels achieved in the previous year across the top four e-commerce platforms, while a2 Platinum® achieved the N<sup>o</sup>. 1 sales position in its category on JD.com. Sales momentum continued during the "12/12" sales event and the initial build for Chinese New Year.

The offline strategy is based on sustainably driving sales in MBS, growing the number of distribution points and significantly enhancing instore education and shopper marketing activities through investment in increased field resources and point of sale materials.

Sales of a2 Milk™ branded fresh milk sourced from Australia, in key premium retail stores and e-commerce platforms, also continued to grow from a small base.

The Company continues to closely monitor the regulation of infant and other nutritional products in China and in cross-border trade. It believes it is responding satisfactorily to the current phase of regulatory activity, including infant formula registration and labelling guidelines, and is focused on ensuring it remains well-positioned to deal with future developments.

## USA

The USA business made further progress against the objectives set out for its launch phase, with pleasing gains in distribution and sales velocity. The product is positioned in the specialty milk section, which is the fastest-growing segment of the total milk category.

The a2 Milk™ brand was launched in Southern California from April 2015 and Northern California from September 2015. Two major chains, Trader Joe's and Target, began distribution in California during the half year. The business currently has distribution in about 1,800 stores in California, the Pacific Northwest and the home market of Colorado.

The sales focus remains on building unit sales per store per week (UPSW) relevant to the speciality milk category. The business is expected to deliver a progressive improvement in sales velocity in its key accounts during the financial year.

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<sup>2</sup> Kantar tracks China Key and A cities that comprise a substantial proportion of the total China infant formula market



Marketing and communication activity increased during the half-year across digital and social media platforms, through retail promotions and through a public relations programme. The product range has received mainstream media coverage, notably through the *Los Angeles Times Sunday Section*, *Fortune*, *Bloomberg Newsweek*, *Mother Jones*, *Forbes*, *New Nutrition* journal, digital publications and television stations in Southern California, with reach extended further through online media.

Supply chain efficiency was enhanced through the engagement of a second dairy processor, in the Los Angeles basin, allowing the business to ship locally to the California market. The business also entered into a non-exclusive licence with its procurement partner, Prairieland Dairy in Nebraska, to build awareness and distribute fresh milk in the states of Kansas, Missouri and Nebraska under the a2 Milk™ brand.

The market entry strategy for the business has centred on launching primarily in California and building an understanding of the key drivers for growth in this market prior to expansion. The Company considers it now has a clearer view of the key factors for success in this market and other potential state markets. Accordingly, it is progressing an opportunity to expand its footprint significantly with a launch into the South East of the USA, in March, in association with the Publix Group. Publix is a highly-regarded major retailer with about 1,100 stores, primarily in Florida, Georgia and the Carolinas. We anticipate ranging in all stores. To support this launch, the business expects to increase its marketing spend in the second half.

The Company is very pleased with the opportunity to expand the USA business beyond the West Coast. We acknowledge that the timing is ahead of plan and the likely investment in the USA business will consequently be higher than previously assumed. Accordingly, we now estimate that the level of further investment in this business over this year and the subsequent two years prior to positive monthly EBITDA will be approximately US\$30 - 35 million. Given these changes, we have determined it appropriate to writeoff NZ\$2.2 million of capitalised USA intangible assets.

## UK

The United Kingdom business achieved a significant improvement in performance, with increased brand awareness, sales and positive operating earnings for the half-year for the first time.

Sales of a2 Milk™ branded fresh milk grew in excess of 45% on the pcp. Average rates of sale in-store improved significantly and distribution in key retailer accounts is now approximately 1,400 stocking points.

This performance was achieved by a continuing focus on consumers and retail customers, with particular benefit from the 'a2tonishing' advertising campaign launched in May 2016 and continued into the half-year. The business also sought improved point of sale presence through its out-sourced field team and has recently achieved extra facings in a key account. The in-house digital team continued to build relationships and activities with consumers and the health care professional community.

UHT long life milk was launched in September 2016 in selected channels and grew at a satisfactory rate. The business is pleased with the continued growth of infant formula sales in the non-grocery segment and will assess the opportunity in the retail market during the next 12 months.

## Research and development (R&D) and Intellectual property (IP)

The Company continues to drive and support R&D around the benefits of A1 protein-free products, and to develop its portfolio of intellectual property (including brand assets and proprietary know-how).

The breadth and depth of the IP portfolio, coupled with first mover advantage, continue to support our market position. The patent portfolio covers a range of compositional benefits and therapeutic uses of A1 protein-free products, with protection for some applications through to 2035.



R&D focus in the half-year included:

- Completion of a significant clinical study undertaken in China (600 participants) that has now been submitted for publication. The study builds upon digestive benefit findings from successful China pilot study published in April 2016 and gives further insight into digestive mechanisms;
- Concurrently a study conducted in China amongst pre-schoolers has been completed and the authors are currently preparing for publication. The results are understood to be aligned with adult findings around digestive and cognitive responses;
- A clinical study in association with Monash University, Australia, examining the benefits of a2 Milk™ for IBS (irritable bowel syndrome) sufferers is under way;
- Clinical examination of benefits to gut and systemic inflammation at a leading USA institution, Pennington Biomedical Research Centre is under way, and
- Work pursuant to a New Zealand government grant for research to support benefit claims in international markets has commenced.

In October 2016, UK-based *Nutrition Journal* reported that consumption of a2 Milk™ increases the natural production of the body's key antioxidant – Glutathione (GSH), widely recognised for its association with a range of health benefits – in milk-intolerant consumers.

The Australian Federal Court case with the Lion Group initiated in June 2016 is scheduled to be heard in November 2017. The a2 Milk Company is pursuing Lion over what the Company believes are misleading and deceptive packaging and advertising claims. Lion has filed a cross claim challenging the way the Company promotes a2 Milk™. With the scientific evidence in support of the benefits of a2 Milk™ continuing to strengthen, the Company is confident in its position.

### **Full year FY17 outlook**

An update on the Group's revenue and operating earnings for the four months to October 2016 was provided at the Annual Meeting on 22 November 2016. The Company has since delivered a very strong first half and performance in January 2017 is consistent with plan.

As previously indicated, the Company closely monitors the outlook relating to the regulatory environment for infant formula in China and likely competitor activity in each of our markets and consequently continues to adopt a prudent approach to inventory management.

Given that the timing of major selling events in China is weighted towards the first half, and as a result of our prudent approach to inventory management, the Company is anticipating lower infant formula sales during the second half relative to 1H17, although they will be materially higher than in 2H16. In addition, the investment in marketing will likely be higher in the second half by up to \$15 million, based on the planned phasing of communication and development activities across the year, in particular for the USA and China.

**For further information contact:**

**The a2 Milk Company Limited**

**Geoffrey Babidge**

**Managing Director and CEO**

**+61 2 9697 7000**



## Reconciliation of EBITDA to net profit after tax (NPAT)

	Half year ended 31-Dec-16 NZ\$ 000's	Half year ended 31-Dec-15 NZ\$ 000's	Movement %
Segment EBITDA	64,075	18,683	243%
Depreciation & Amortisation	(1,608)	(1,255)	28%
<b>EBIT</b>	<b>62,467</b>	<b>17,428</b>	258%
Interest income	443	142	212%
Interest expense	-	(38)	(100)%
Income tax expense	(23,528)	(7,425)	217%
<b>Net Profit After Tax (NPAT)</b>	<b>39,382</b>	<b>10,107</b>	290%

