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NZX/ASX Market Release

## Trading update and revised FY21 outlook

### Growth strategy and capital management review commenced

The a2 Milk Company ("the Company", "a2MC") today provides a trading update and a revised outlook for FY21.

#### Key points

- The trading dynamics in the China infant nutrition market have been and continue to be challenging for a2MC and many international competitors
- While a2MC's 3Q21 trading was broadly in line with plan, it is clear that the actions taken to address challenges in the daigou/reseller and CBEC channels will not result in sufficient improvement on 3Q21 in pricing, sales and inventory levels to meet our previous guidance based on April sales being well below plan
- The Board tasked management to undertake a comprehensive review of inventory in the trade and this work has indicated that the level of channel inventory is higher than had been anticipated
- As a result of the inventory review, it is clear that the challenges in the daigou/reseller and CBEC channels have been exacerbated by excess inventory and difficulties with visibility
- In the interest of the long-term health of the a2 brand and the medium-term trading outlook of the business, more aggressive actions to address excess inventory will be taken which will impact FY21 revenue and EBITDA, and potentially 1Q22
- The inventory management actions being taken will provide Chinese mothers with the freshest infant milk formula and benefit the Company's customers, distributors and partners
- The Company will also increase marketing investment in 4Q21 and into FY22 to drive consumer demand
- Despite these short-term setbacks, the Company remains confident in the long-term opportunity that the infant nutrition market in China represents, and is determined to build on the strong position which the Company has built within this market over the past five years
- However, the Company recognises that the China market and channel structure is changing rapidly and has therefore commenced a comprehensive process to review its growth strategy and executional plans to respond to this new environment
- In addition, the Board is actively considering capital management initiatives, including a potential share buy-back and an update will be provided at the full year results in August

#### Background

As noted throughout the past year, globally there continues to be unprecedented levels of uncertainty and volatility due to COVID-19 which has significantly impacted markets in which the Company trades and consequently the performance of both a2MC and many competitors.

In February, a2MC outlined the actions it was taking in 2H21 to address the challenges it was facing, particularly in the daigou/reseller and cross border e-commerce (CBEC) channels.

The Company indicated that to re-activate the daigou/reseller channel it was aiming to rebalance inventory levels, implement a new traceability system, provide temporary support to key daigou/reseller customers and work with corporate daigou to drive distribution innovation.

In the CBEC channel, the Company indicated it was aiming to rebalance inventory levels, refine its promotional approach and invest in building enhanced digital and e-commerce capability.

The 2H21 plan also included continuing to invest behind the brand to drive growth in the China label infant nutrition business.

The outlook assumed these actions would deliver a significant improvement in quarter-on-quarter growth from 3Q21 to 4Q21.

### **Trading update**

While 3Q21 Group sales performance was broadly in line with the revised plan at \$295.0 million, it is emerging that actions to address the challenges have not resulted in sufficient improvement in pricing, sales and inventory levels in the daigou/reseller and CBEC channels required to deliver the forecast significant uplift in 4Q21 sales.

### **English label infant nutrition**

Infant nutrition sales in the ANZ segment of \$99.5 million and in the CBEC channel<sup>1</sup> of \$22.1 million were recorded for 3Q21. This represents a 11% and 57% respective decline on 2Q21 and a 56% and 77% respective decline on 3Q20, which was in line with the revised plan for the period. It should be noted that these declines compared to 3Q20 reflect the extraordinary uplift in sales last year as the initial effects of the pandemic were beginning to be felt. Sales were down compared to 2Q21 in the CBEC channel due to actions taken to reduce distributor inventory levels as planned, and ANZ segment sales were down reflecting lower daigou/reseller offtake.

The actions taken in 3Q21 and in April to address the challenges in the daigou/reseller and CBEC channels have had limited impact (ie temporary support to key daigou/reseller customers and reducing CBEC sales) or are expected to have a delayed impact (ie traceability system and distribution innovation). Consequently, the April sales result and outlook for 4Q21 are significantly below plan.

As a result of the inventory review, it is clear that the challenges in the daigou/reseller and CBEC channels have been exacerbated by excess channel inventory and difficulties with visibility.

### **China label infant nutrition**

China label infant nutrition sales of \$98.0 million were recorded for 3Q21 representing 5% growth on 3Q20 and 18% decline on 2Q21. The reduced rate of growth relative to 3Q20 is reflective of the substantial uplift in the prior period due to COVID-related pantry stocking. The rate of decline relative to 2Q21 was mainly due to increasing distributor inventory to mitigate the risk of the potential of a second wave of COVID-19 in China in 1H21.

Store count increased to 22.6k and the 12-month rolling market value share in mother and baby stores (MBS) is stable at 2.4 per cent at the end of March.

### **Liquid milk**

The Australian liquid milk business continued to perform strongly and the liquid milk business in the USA performed in line with plan for 3Q21.

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<sup>1</sup> Excludes sales of non-English label products to Korea and Hong Kong

## **Inventory review**

A Board-initiated comprehensive review by management has been conducted into channel inventory. Although visibility into third party inventory levels is generally challenging and the data is incomplete, the review has indicated that the level of channel inventory is higher than had been anticipated.

In the interest of the long-term health of the a2 brand and the medium-term trading outlook of the business, more aggressive actions to address these issues will be taken which will benefit consumers and the Company's customers, distributors and partners.

The daigou/reseller margin support program will cease and the Company will work with its customers and distributors to improve the dating of inventory. From a consumer perspective, this will improve the freshness of product available in store and online, and should therefore enhance the competitiveness of the a2 offer to consumers, particularly new users. This will take time to flow through to the consumer as inventory turns through the channel.

Rebalancing inventory by further reducing sell-in to the daigou/reseller and CBEC channels will need to continue for the rest of 4Q21 and this may continue into 1Q22. This is also aimed at reducing customer and distributor inventory to target levels. While this is necessary to restore the overall health of these channels, it will result in significantly reduced sales for FY21.

These actions will result in a further stock provision of approximately \$80 million to \$90 million, in addition to the \$23 million stock provision recognised in 1H21. The provision will cover the impact of a2MC's inventory write-offs and associated disposal costs.

The Company is in the process of implementing a wholesale price increase across its English label infant nutrition product range to restore its premium price positioning and mitigate expected cost of goods sold pressures.

The Company is also exploring options to implement additional systems and processes to improve channel inventory visibility and demand and supply planning.

## **Updated outlook**

The more aggressive actions being taken in 4Q21 will impact the FY21 results. The Board believes that it is imperative that the Company takes the necessary action to address these inventory imbalances urgently in order to stabilise the current situation and, more importantly, to create a platform for a return to growth in the future.

It is also critical that the Company continues to invest behind the brand and to drive consumer demand/offtake through this rebalancing phase and into the future. The plan is to further increase the level of marketing in 4Q21 and into FY22. Consequently, a high level of marketing investment is continuing with a significant marketing campaign in China in 4Q21. Marketing investment will be increased, particularly in digital marketing, to help drive consumer demand.

## **FY21 revenue**

The Company is now targeting revenue for FY21 in the order of \$1.20 billion to \$1.25 billion.

The significant decline from the outlook provided in February reflects the impact of the lower than expected sales in 4Q21 versus prior plan and the further actions being taken to rebalance the channels by actively reducing sales in May/June.

It will take some time to rebalance inventory levels and restore channel health. An immediate recovery is not expected and a further update for FY22 will be provided at the Company's results in August.

### FY21 EBITDA

The Company is expecting an earnings before interest, depreciation and amortisation (EBITDA) to sales margin for FY21 in the order of 11% to 12% (excluding MVM transaction costs).

The significantly lower EBITDA margin outlook from that provided in February reflects:

- The lower than expected sales in 4Q21 versus prior plan and the further actions being taken to rebalance the channels by actively reducing sales in May/June
- A stock provision of approximately \$80 million to \$90 million which is in addition to the \$23 million stock provision recognised in 1H21. This includes costs to dispose of excess inventory in a controlled and sustainable manner
- One-off costs of approximately \$8 million associated with the implementation of the Company's new cloud-based enterprise resource planning (ERP) system

The vast majority of these impacts on EBITDA are non-cash as the ERP investment costs have already been paid for.

The first phase of the new cloud-based ERP system has now been successfully implemented. The recently announced interpretation of the accounting standards in relation to cloud-computing arrangements by IFRIC (the interpretations committee for the International Accounting Standards Board) requires that certain project implementation costs be expensed in FY21. This was not incorporated into the prior market guidance as it was expected that the implementation costs could be capitalised and amortised over future periods. The new ERP system will support the business going forward and further investment in systems capability will be required over time.

As previously advised, the Company expects to incur one-off transaction costs of approximately \$10 million for its proposed acquisition of MVM. Completion of the proposed transaction remains subject to approval of the New Zealand Overseas Investment Office (OIO). The OIO consideration is on-going, and completion remains subject to OIO consent. Based on recent discussions, a2MC is now targeting the end of June 2021 for completion. It is expected that an integration and financial update on the acquisition will be provided at the full year results in August.

### FY21 cashflow

This year the Company has made investments in the Synlait capital raising, the acquisition of the KyValley milk processing facility and the ERP implementation. Together with a net investment in working capital, including higher inventory and a reduction in trade creditors, means that the Company's cash balance at the end of FY21 is expected to be broadly in line with FY20 (excluding the MVM acquisition impact if it completes in FY21). We expect operating cash flow to be positive for the full year.

### **Underlying business**

It is important to recognise that the revised outlook does not reflect the underlying performance or strength of the business. The Board and Management have determined that it is appropriate to address the inventory imbalances aggressively in order to allow the business to return to growth as quickly as possible and to deliver acceptable margins. Most of the actions that we are taking are non-cash in nature with the result that Company's balance sheet will remain strong, and we would expect to see improved performance during FY22.

Specifically, it is estimated that if the one-off charges and sales reductions to reduce inventory in the trade were backed out for this year, the business would record annual revenues in the order of \$1.3 billion with an EBITDA margin percent in the low to mid-twenties.

### **Growth strategy review**

The dynamic and challenging market conditions over the past year have highlighted the need to review and adapt elements of the Company's strategy and execution going forward.

The Company recognises that the China infant nutrition market structure is changing rapidly. While the premiumisation trend is continuing, market growth is being impacted by a more pronounced decline in birth rates. The shift towards China label infant nutrition continues, the rate of new product innovation has ramped up, channels to market are changing and competitive intensity is increasing.

It is also clear that the daigou/reseller channel has been cyclically impacted by COVID-19, regulatory and other structural factors. Whilst the daigou/reseller channel will continue to play an important role, the Company is evolving its channels to market and brand marketing programs that have benefited in the past from a highly engaged daigou network.

The Board recognises that the Company needs to change its approach and is commencing a comprehensive process to review its growth strategy. The scope of this review will primarily focus on the China infant nutrition market including brand, product and channel strategy to drive demand, but will also consider other opportunities to maximise the full potential of the business.

An update on this review will be provided at an investor strategy day, post the FY21 results, and ahead of the Annual Meeting in November.

### **Capital management opportunities**

The Company's balance sheet remains strong.

Despite the current challenges being faced, the Board is confident in the strength of the brand, the underlying fundamentals of the business, and the Company's long-term growth potential.

The Board is actively reviewing capital management initiatives, including a potential share buy-back. An update will be provided at the full year results in August.

### **Leadership changes**

The Company has today separately announced that Peter Nathan has resigned from his role as Chief Executive Asia Pacific but will remain with the business for some time to ensure a smooth and orderly transition.

The Company further advises that Eleanor Khor has recently been appointed to the newly created position of Chief Strategy Officer and that Jaron McVicar's role has been expanded to Chief Legal and Sustainability Officer & Company Secretary.

Progress is being made towards filling the Chief People Officer and Chief Marketing Officer roles with further updates expected in 4Q21.

The Company continues to invest in capability building and leadership development.

## Quotes for media

*The a2 Milk Company's Managing Director and CEO, David Bortolussi said:*

- *"While our third quarter trading was broadly in line with plan, it is clear that the actions taken to address challenges in the Daigou and CBEC channels will not result in sufficient improvement in pricing, sales and inventory levels to meet our previous guidance*
- *"We have conducted a comprehensive review of inventory in the trade and this work has indicated that channel inventory levels are higher than had been anticipated*
- *"The challenges in the Daigou and CBEC channels have been exacerbated by excess inventory and difficulties with visibility*
- *"In the interest of the long-term health of our brand and the medium-term trading outlook of the business, more aggressive actions to address inventory will be taken which will impact FY21 revenue and EBITDA, and potentially 1Q22*
- *"Despite these short-term setbacks, we are confident in the long-term potential for infant nutrition and other opportunities we have in China, and are determined to build on the strong position we have built in the market over the past five years*
- *"We recognise that the China market and channel structure is changing rapidly and are commencing a comprehensive review of our growth strategy and executional plans to respond to this new environment*
- *"The Board is actively considering capital management initiatives, including a potential share buy-back and we will provide an update at the full year results in August*

**Authorised for release by the Board of Directors**

**David Bortolussi**

**Managing Director and Chief Executive Officer**

**The a2 Milk Company Limited**

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