

November 4<sup>th</sup> 2021

## **A2 Milk Limited (ATM)**

The company will hold its Annual Shareholders Meeting at **11.00am Wednesday 17 November 2021**.

Due to the uncertainty around Covid restrictions it will be a virtual meeting.

You can join the meeting online at <https://meetings.linkgroup.com/agm/a2MC21/register>

### ***Company Overview***

The a2 Milk Company was founded in New Zealand in 2000 by Dr. Corran McLachlan. While studying at Cambridge University, he learned that proteins in milk affect people differently. He also learned that ordinary cows produce milk with different beta-casein protein types, called A1 and A2. Research over the years has demonstrated that many people who have digestive discomfort when drinking ordinary cows' milk find a2 milk easier on digestion. That is because a2 milk contains only the A2 protein and no A1.

The Company listed on the NZX in 2004 and is also listed on the ASX. It has a 19.84% shareholding in Synlait Milk. Over the past two years it has experienced some difficulties with changes in its CEO and senior management and a significant reduction in its sales to China.

In October 2021 the company announced it was facing a class action by shareholders around its disclosure between August 2020 and May 2021. Its share price fall from \$21.50 to \$5.56 during that period.

### ***Current Strategy***

The strategy is to enrich peoples lives through the provision of a2 milk.

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**Key**

The following sections calculate an objective rating against criteria contained within NZSA policies.

Colour	Meaning
G	Strong adherence to NZSA policies
A	Part adherence or a lack of disclosure as to adherence with NZSA policies
R	A clear gap in expectations compared with NZSA policies
n/a	Not applicable for the company

## Governance

NZSA assessment against its key policy criteria is summarised below:

Policy Theme	Assessment	Notes
Directors Fees	G	See comments below.
Director share ownership	A	Not disclosed if Directors are required to own shares.
Executive Remuneration	A	See below
Golden parachutes/handshakes	R	See comments below.
Director Independence	G	There are a majority of Independent Directors.
Board Composition	A	See comments below.
Director Tenure	G	See comments below.
ASM Format	G	Virtual due to Covid uncertainty.
Company Sec independence	G	Generally good disclosure but not disclosed whether a profit-based incentive is paid.

**Directors Fees:** While disclosure is generally good, there is no disclosure as to whether retirement benefits or share options are available for Directors. NZSA policy is that neither should be offered, and companies should disclose their position in the interests of transparency.

**Executive Remuneration:** NZSA encourages fulsome disclosure in relation to any incentive payments made to the CEO, including disclosure of measures (or measure ‘groups’), weightings, targets and the level of achievement associated with any awards.

The company offers excellent disclosure of the metrics and weightings in its remuneration report for both STI and LTI, although does not specifically disclose the level of achievement for each ‘measure group’ that has led to the CEO incentive payment. The company notes that overall STI was paid to the CEO at 30% of target. In discussion with the company, A2 indicated that the CEO remuneration structure was supported by external recruitment processes.

At A2 Milk, the CEO is paid a base salary, a short-term incentive (STI) and a long-term incentive (LTI). We note that the ‘target’ STI payment is at 120% of base salary, with a maximum opportunity of 156% of base salary. For LTI, the CEO was awarded performance rights equivalent to 150% of base salary. This was subsequently deferred to FY22, due to market volatility, subject to any shareholder approval. We note that the decline in share price in the interim will result in a greater number of performance rights being issued to the CEO. The company also notes that entitlement will be assessed over a 2-year (rather than 3-year) period.

This implies a total incentive opportunity of up to 306% of base salary. NZSA prefers total incentives to be less than base salary, with a greater weighting towards LTI than that implied at A2 Milk.

We appreciate the disclosure of termination and notice periods in the annual report.

**Golden Handshakes and Parachutes:** We note that that the CEO received one-off ‘transition payments’ on joining A2 Milk, to compensate for the loss of entitlement from his previous employer.

This comprise of an AU\$1.27m cash payment and shares in A2 to the value of AU\$3.7m (at the time of joining).

NZSA does not support these types of payments. We note that A2 has previously paid similar transition payments to an incoming CEO. We do understand that the company needs to compete effectively in recruiting an appropriate individual as CEO.

**Board Composition:** The company discloses a ‘collective’ skills matrix outlining how the Board matches the skills required to govern the company, although ‘individual’ matrix is not disclosed. We note the Annual Report does not include a full list of Directors other Directorships and governance roles, although these are clearly disclosed on the company’s website.

It is disappointing that the company does not participate in the IoD’s “Future Director Programme”; given the scale of and status of ATM, we feel that the company would be in a good position to offer an effective experience to emerging directors.

**Director Tenure:** NZSA looks for evidence of ongoing succession or ‘staggered’ appointment dates that reduce the risks associated with effective knowledge transfer in the event of succession. We note that A2 Milk has a range of appointment dates between 2013-2021, indicating an ongoing focus on governance sustainability.

**ASM Format:** The shareholder meeting has been planned as a virtual-only meeting, a decision supported by NZSA in this context. Normally, NZSA favours a hybrid meeting, to maximise shareholder attendance and engagement through both virtual and physical means.

***Audit***

NZSA assessment against its key policy criteria is summarised below:

Policy Theme	Assessment	Notes
Audit independence	G	Good disclosure.
Audit rotation	A	See below.

**Audit Rotation:** Whilst the company ensures the Lead Audit Partner is rotated at 5 years it does not disclose whether the Audit Firm is rotated at 10 years. In common with many other NZX-listed companies, it also does not disclose the appointment date of the Audit Firm or the Lead Audit Partner.

***Ethical and Social***

NZSA assessment against its key policy criteria is summarised below:

Policy Theme	Assessment	Notes
Whistleblowing	G	Good disclosure

Policy Theme	Assessment	Notes
Political donations	A	Not disclosed if donations were made.

Political Donations: NZSA policy is that companies should not make donations to political parties. We expect disclosure to this effect, even if none have been made.

### Financial & Performance

Policy Theme	Assessment	Notes
Dividends and Imputation	n/a	There was no dividend paid.
Capital Raise process	n/a	There was no capital raising

A2 Milk Company's share price fell from \$15.46 to \$7.68 (as of October 21<sup>st</sup>) over the last 12 months – a 50% decline. This compares unfavourably with the NZX 50 which increased by 5% in the same period. The Performance Factor for ATM is -9.62.

Metric	2021	2020	Change
Revenue	\$1,205m	\$1,731m	-30%
Gross Profit	\$510m	\$969m	-47%
NPAT	\$80.6m	\$385.8m	-79%
Gross Profit Margin	42%	56%	-24%
EPS <sup>1</sup>	\$0.11	\$0.52	-79%
PE Ratio	70	30	
Current Ratio	3.99	3.69	8%
Debt Equity	0.27	0.28	-6%
Operating CF	\$89.4m	\$427.4m	-79%
NTA Per Share <sup>1</sup>	\$1.46	\$1.51	-4%
Dividend Per Share <sup>1</sup>	\$1,273	\$521	

<sup>1</sup> per share figures based off actual shares at balance date (not weighted average)

2021 has been a difficult year for ATM, with revenues declining by 30% to \$1,205m, gross profit margin falling from 56% to 42%, leading to a 47% fall in gross profit to \$510m. This led to a large 79% fall in NPAT to \$80.6m delivering EPS of \$0.11 and places the company on a high PE of 70.

Operating cashflow also fell by 79% from \$427.4m to \$89.4m. However, the company is in extremely sound financial position with a current ratio of 3.99 and a debt equity ratio of 0.27. The only non-current liability ATM has is a small lease liability of \$12.9m.

The company is facing a class action lawsuit brought by Slater & Gordon (as per A2's announcement on October 6<sup>th</sup>), and the possibility of another, as has been reported in the media. The company released a [statement on 21<sup>st</sup> October](#) stating that: *The a2 Milk Company ("the Company") is aware of media reporting concerning a potential class action against the Company that is apparently being investigated by Shine Lawyers. The Company is not aware of any legal proceeding having been filed by Shine Lawyers at this time.*

In a forward-looking statement released on page 17 of the Annual Report the company remains cautious: *"Overall, although a2MC believes the business will continue to make significant progress on*

*many fronts, FY22 is expected to continue to be a challenging and volatile year. Due to the actions taken in 4Q21 to address channel inventory and improve product freshness, coupled with strong brand health, the business is well-placed to adapt its strategy and execution to drive growth in the longer term. However, recovery in English label channels is expected to be slow and market growth in China will be subdued for some time”.*

A lengthy 161 page [investor day presentation](#) released on the 27th October was interpreted by the market as a downgrade and the share price reacted accordingly. Nonetheless, the document sets out a longer-term pathway for A2’s future.

## **Resolutions**

### **1. That the Board is authorised to fix the auditor’s remuneration for the coming year.**

This is an administrative resolution.

We will vote undirected proxies **IN FAVOUR** of this resolution.

### **2. To elect David Bortolussi as a Non-Independent Director.**

David Bortolussi was appointed to the Board in February 2021 and is therefore required to offer himself for election. He is also the CEO. He was previously Group President – International Innerwear, HanesBrands. He joined Pacific Brands in 2009 initially as Chief Financial & Operating Officer taking over as Managing Director and CEO of the public company in 2014. Prior to this, he spent five years at Foster’s Group, where he held the role of Chief Strategy Officer responsible for corporate strategy, M&A, business development and performance improvement. He resides in Australia.

NZSA does not favour the CEO also being a Director in a company the size of A2, also considering the short-period of time he has been associated. The governance and management of the company should be separate with the CEO reporting to the Board not being a ‘first amongst equals’.

We recognise that Mr. Bortolussi may have appropriate experience to be considered as a board member of A2 Milk in his own right. However, his foremost responsibility is as CEO, to implement the strategy and operations of A2.

We note that 76% of the NZX Top 50 companies do not appoint the CEO to the Board, a position supported by most leadership research. We are also aware that the opposite is true in Australia, which forms the operational base for A2 Milk. 96% of the 25-largest ASX listed companies have their CEO on the Board. In our view, A2’s operating base does not offer an exception to what would be considered effective governance practice.

Given this, we will vote undirected proxies **AGAINST** this resolution.

### **3. To elect Bessie Lee as an Independent Director.**

Bessie Lee was appointed to the Board in February 2021 and is therefore required to offer herself for election. She is the Greater China CEO of Jones Lang LaSalle and a director on the boards of Electrocomponents and Abcam. She was also previously a director at Ecovacs Robotics. She founded Withinlink Limited in 2015 where she continues to focus on investing and incubating marketing technology start-ups in China, several of which have listed in the past few years. She resides in China.

We will vote undirected proxies **IN FAVOUR** of this resolution.

### **3. To re-elect Warwick Every-Burns as an Independent Director.**

Warwick Every-Burns was appointed to the Board in August 2016. He is a Director of ASX listed Treasury Wine Estates Limited. He background is in consumer-packaged goods including executive roles with The Clorox Company of the USA as Senior Vice President, International, based in the USA and prior to that as VP Asia Pacific, Managing Director of NationalPak Limited and Unilever plc. He resides in Australia.

We will vote undirected proxies **IN FAVOUR** of this resolution.

### ***Proxies***

**You can vote online or appoint a proxy at <https://vote.linkmarketservices.com/ATM/>**

Instructions are on the Proxy/voting paper sent to you.

Voting and proxy appointments close **11.00am Monday 15 November 2021.**

**Please note you can appoint the Association as your proxy. We will have a representative attending the meeting.**



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**Details on the NZSA website.**

<http://www.nzshareholders.co.nz/shareholders-standing-proxies.cfm>

**The Team at NZSA**