26 October 2023

A2 Milk Limited (ATM)

The company will hold its Annual Shareholders Meeting at **11.00am Thursday 16 November 2023.**

The location is **The Pullman, Corner Waterloo Quadrant & Princes Street, Auckland.**

You can also join the meeting online at this link.

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 19.8% shareholding in Synlait Milk (NZX: SML) and a 75% shareholding in Mataura Valley Milk. In recent times it has experienced some difficulties, with resulting changes in its CEO and senior management and a significant reduction in sales within China.

In October 2021, the company announced it was facing a class action by shareholders around its disclosures between August 2020 and May 2021. Its share price fell from $21.50 to $5.56 during that period. In May 2022, the company advised it is facing a second class action over this matter.

In September 2023, the company cancelled the exclusive manufacturing and supply agreement with Synlait Milk, citing Synlait's failure to meet the requirement levels for exclusive manufacturing and supply. In October, the company announced it had entered into arbitration on the matter.

The Chair, David Hearn, will retire at the ASM having served on the Board since 2014 and will be replaced by Pip Greenwood. Kate Mitchell was appointed to the Board as an Independent Director in June 2023.

Current Strategy

The strategy is to enrich people's 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

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Governance

NZSA assessment against its key policy criteria is summarised below:

Policy Theme	Assessment	Notes
Directors Fees	G	See below.
Director share ownership	A	See below.
Executive Remuneration	G	See below.
Golden parachutes/handshakes	A	See below.
Director Independence	G	A majority of Directors are independent
Board Composition	A	See below.
Director Tenure	G	See below.
ASM Format	G	Hybrid. See below.
Independent Advice for the Board and Risk Management	G	See below.

Directors Fees: Generally good disclosure and in line with NZSA policy, although it is not disclosed if retirement benefits are offered.

Director Share Ownership: Directors are required to acquire one year's worth of Director Fees in shares in their first three years as a Director.

NZSA does not favour a compulsory requirement for shareholding. While we encourage share ownership by independent Directors, we do not support compulsion as this reduces the pool of available Directors, may compromise independence, and removes the 'market signal' associated with share purchases. This requirement would mean a Director holding approximately $200,000 in shares, equivalent to a 33% accumulation rate.

It is not clear whether there is any Chair discretion as regards waiving this requirement in certain circumstances.

Executive Remuneration: The CEO is paid a base salary and a short-term incentive (STI), both paid in cash, and a long-term incentive (LTI) paid by way of performance share rights.

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 each component associated with any awards.

- For STI, the company offers excellent disclosure of the metrics, weightings and achievement vs target for the 'high-level' components that lead to the STI outcome (overall outcome = 95%).

- We note that the 'target' STI payment related to group performance is at 120% of base salary – with a maximum of 144%. The CEO also receives an "individual multiplier" with a range between 0-130%, potentially allowing the CEO to earn double his fixed remuneration in STI. For FY23, the amount earned was a company score of 95% (see above) multiplied by an individual performance factor of 100% = 95%. When multiplied by the STI target of 120% of fixed remuneration, the CEO will receive 114% of his base salary in STI (or AU$2.13m).

For the LTI, the CEO will be issued 690k performance rights (the subject of a non-binding shareholder vote at the ASM) during FY24, based on the target relationship to fixed annual remuneration and FY23 outcomes. NZSA appreciates the disclosure of an additional table that allows this to be calculated.

During FY23, he was issued 501k rights with a vesting date of August 2025.

We note that the company clearly discloses the vesting conditions of the performance rights issued, including both an EPS and Revenue CAGR hurdle. In theory, it is still possible for an LTI award to vest when total shareholder return has been negative, a position not supported by NZSA.

We note and appreciate the improvement in overall remuneration disclosure versus FY22.

At target rates, this implies the ability for the CEO to earn approximately three times his fixed remuneration in incentives, a level not common amongst New Zealand companies. While NZSA does not consider this best practice, it does acknowledge the 'Australian' nature of ATM's recruitment market for its CEO and the market practices common in Australia.

Golden parachutes/handshakes: 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 comprised of an AU$1.27m cash payment and shares in a2 to the value of AU$3.7m (at the time of joining).

While we do understand that the company needs to compete effectively in recruiting an appropriate individual as CEO, NZSA does not support these types of payments as we do not believe they correlate to performance.

We appreciate the disclosure of termination and notice periods in the annual report, essentially placing a 'cap' on the potential value of any termination payment.

Board Composition: Whilst the company includes a skills matrix in the Annual Report it does not attribute skill sets to individual Directors to demonstrate how they contribute to the governance of the company.

The company does not participate in any Future Director programme designed to develop and mentor the next generation of Directors. NZSA expects NZX50 companies to participate as part of a responsibility to develop and mentor the next generation of Directors.

The nature of the company's Board indicates a commitment to thought, experiential and social diversity, with relevant experience for a2.

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 also prefer a term maximum of 9-12 years, unless there are exceptional circumstances that may apply.

Directors' appointment ranges from 2016 to 2023 indicating appropriate succession planning.

Independent Advice for the Board & Risk Management: NZSA looks for evidence, through disclosures, that a Board has access to appropriate internal and external expertise to support board assurance activities. We also look for evidence that Boards are across their risk management responsibilities.

The Board Charter states that Directors are entitled to seek independent external advice at a2's expense, with the prior approval of the Chair. Board members are also able to access the Company Secretary. KPMG acts as the Company's independent internal auditor, reporting to the Company's Head of Internal Audit.

a2 offers comprehensive disclosure of the key strategic, business, climate-related and financial risks that impact the business, as well as mitigations. There is also thorough disclosure of its risk management and governance processes.

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 as required by the NZX Listing Rules, it does not disclose if the Audit Firm is rotated at 10 years. NZSA also expects disclosure of the appointment dates of the Lead Audit Partner and Audit Firm to improve transparency for investors.

Environmental Sustainability

NZSA assessment against its key policy criteria is summarised below:

Policy Theme	Assessment
Approach	G
Sustainability Governance	G
Strategy and Impacts	G
Risk and Opportunity	G
Metrics and Targets	G
Assurance	A

Overall approach: The a2 Milk Company (ATM) has been providing sustainability commentary within their Annual Report since 2018. a2 Milk increased the scope of their sustainability reporting in 2023, having produced their inaugural GHG Emissions Inventory Report, Net Zero Roadmap, GRI Index, and TFCD document, among others. They acknowledge the importance of Environmental, Social and Governance (ESG) reporting, referring to the XRB Climate Standards and the Australian Treasury climate-related disclosure requirements. This assessment demonstrates that a2 Milk is indeed prepared for meeting future environmental reporting requirements.

Sustainability Governance: ATM discloses a Board skills matrix that shows the number of Directors with High or Medium levels of capability in 11 skill areas, including sustainability. While not having a formal sustainability committee, a2 Milk does have 'Green Teams' across each of its locations to promote sustainability initiatives, as well as a Chief Sustainability Officer.

Strategy and Impact: A2 Milk note that they "*recognise that climate change and pressures on agricultural and food systems present a systemic challenge for our world*". Their growth strategy has five key priorities, one of which is investing in people and planet leadership. They have identified the climate and other risks the Company faces and have also prepared their inaugural carbon Net Zero Roadmap.

Risk and Opportunity: ATM provides a comprehensive overview of their risks and opportunities. They identify nine key sources of risk, including climate and nature and social licence to operate. Within these two sources, a2 Milk specifies their mitigation strategies as well as potential opportunities.

Metrics and Targets: A2 Milk disclose their GHG emissions From Scope 1 to 3 in their GHG Emissions Inventory Report, together with comparative data from FY21. In addition to disclosing their environmental performance targets, a2 Milk also include environmental performance in their STI performance scorecard.

Assurance: The a2 Milk Company has provided a limited ESG Assurance Report from EY. While they have provided assurance for a2 Milk's sustainability performance data, it appears that not all of a2 Milk's environmental sustainability claims were subject to assurance.

Ethical and Social

NZSA assessment against its key policy criteria is summarised below:

Policy Theme	Assessment	Notes
Whistleblowing	G	Good disclosure.
Political donations	A	Not disclosed if donations were made.

Financial & Performance

Policy Theme	Assessment	Notes
Capital Management	G	See below.
Takeover or Scheme	n/a	

A2 Milk Company's share price fell from \$6.25 to \$4.56 (as of 4th October 2023) over the last 12 months – a 27% decline. This compares unfavourably with the NZX 50 which rose by 1% in the same period. The capitalisation of ATM is \$3.3b placing it 17th out of 128 companies on the NZX by size and makes it a large company.

Metric	2020	2021	2022	2023	Change
Revenue	$1,731m	$1,205m	$1,443m	$1,591m	10%
Gross Profit	$969m	$510m	$664m	$739m	11%
NPAT[2]	$385.8m	$80.6m	$122.6m	$144.8m	26%
Gross Profit Margin	56%	42%	46%	46%	n/c
EPS[1]	$0.52	$0.11	$0.165	$0.216	40%
PE Ratio	30	70	36	21	
Inventory Turnover	5.96	5.36	6.19	5.11	-17%
Capitalisation	$11.4b	$5.1b	$4.4b	$3.3b	-29%
Current Ratio	3.69	3.99	2.66	2.96	11%
Debt Equity	0.28	0.27	0.44	0.40	-8%
Operating CF	$427.4m	$89.4m	$203.8m	$111.3m	-45%
NTA Per Share[1]	$1.51	$1.46	$1.46	$1.44	-1%
Dividend Per Share[1]	$0.00	$0.00	$0.00	0.00	n/c

[1] *per share figures based off actual shares at balance date (not weighted average)*

[2] *Attributable to shareholders of the company.*

2023 continued to be a good year for ATM with most metrics improving on an-already improved FY22. This was not, however, reflected in the share price which declined 27% against an index that held steady.

As indicated last year, the company embarked on an on-market buyback of its shares to a value of $149m, resulting in cancellation of 21.7m shares.

Revenues increased 10% to $1,591m and *Gross Profit* was up 11% to $739m on a steady *gross profit* margin of 46%. *NPAT* was up 26% to $144.8m. *EPS*, on the back of less shares on issue, was up 40% to $0.216 and this places ATM on a more modest *PE* of 21.

Operating cashflow fell 45% to $111.3m, however we note that inventories increased by $53.4m to sit at $193.4m. *Inventory turnover* fell 17% to 5.11.

The company is in extremely sound financial position with a *current ratio* of 2.96 and a low *debt equity ratio* of 040. The company has a very modest $67m of long-term debt and $15m of current debt.

ATM holds cash balances of $802m and has sufficient resources to return capital to shareholders.

The *NTA* declined slightly to $1.44 and the company trades at a large 216% premium to NTA.

Page 11 of an investor presentation released in conjunction with their Annual results, provides some forward looking statements where ATM is expecting low single digit revenue growth in FY24, gross margin % is expected to be the same and they are expecting the EBITDA margin % to be broadly in line with FY23. In addition, capital expenditure is expected to increase to approximately $26m.

The top 20 shareholders, all institutions, collectively hold 62% of the company.

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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 Kate Mitchell as an Independent Director.**

   Kate Mitchell was appointed to the Board 1 June 2023 and is therefore required to offer herself for election. She is currently Chair of The New Zealand Merino Company and Link Engine Management and a Director of Heartland Group Holdings, FarmRight, and Christchurch International Airport. Prior to moving to New Zealand in 2014, Kate's executive career spanned over 20 years in investment banking in London, which included senior leadership roles across several divisions within global investment banks including Deutsche Bank, Goldman Sachs, and Merrill Lynch.

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

3. **Grant of performance rights to David Bortolussi, Chief Executive Officer, and Managing Director.**

   This resolution relates to the granting of performance rights under the long-term incentive scheme and is a requirement of the ASX Listing Rules. Full details are set out in the Notice of Meeting.

   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 Tuesday 14 November 2023.**

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

The Team at NZSA