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NZX/ASX Market Release

Challenging year impacted by COVID-19
Channel inventory dynamics improving and growth strategy review underway

The a2 Milk Company experienced a very challenging year in FY21 impacted by unprecedented levels of uncertainty and volatility due to the prolonged impact of COVID-19 and a rapidly changing China infant nutrition market. Over the past year China market growth has reduced significantly from globally high rates to be flat, and cross-border trade has been disrupted significantly which has had a profound impact on the Company's results.

While certain areas of the business performed well, with market share gains in China label infant nutrition and Australian fresh milk, the Company was impacted by a significant decline in cross-border English label infant nutrition and other nutritional sales through daigou/reseller and e-commerce channels. This created substantial demand and supply volatility, which caused material excess inventory issues that exacerbated the impact.

In response to the dramatic change in circumstances, the Company took significant action, particularly from 4Q21, to address excess inventory issues, rebuild the management team, increase brand investment to drive demand, commence a review of its growth strategy and review options to deploy available capital. These actions have put the Company in a far better position now than it would have been otherwise to navigate the challenges ahead and enable it to return to growth in the medium-term.

The Board and management are confident in the underlying fundamentals of the business and that the growth opportunity in core markets remains strong. Coupled with opportunities for product innovation, category expansion and new markets, and supported by a healthy brand and strong balance sheet, the long-term outlook is positive. However, the outlook for FY22 remains challenging and uncertain and it will take time to recover.

Key points in relation to the Company's full year results are summarised below with more detailed analysis and commentary following in the release.

Key points[1]

- Revenue and EBITDA[2] margin was within the guidance range provided in May
  - Revenue down 30.3% to $1.21 billion
  - Earnings before interest tax depreciation and amortisation (EBITDA) down 77.6% to $123 million inclusive of $109 million in stock write-downs and $10 million in Mataura Valley Milk (MVM) acquisition costs
  - EBITDA to sales margin of 10.2% or 11.1% excluding MVM acquisition costs
- Net profit after tax down 79.1% to $80.7 million (including discontinued operations)
- Actions taken from 4Q21 to address excess inventory are proving effective with channel inventory levels reducing, product freshness improving and market pricing increasing – rebalancing of channel inventory is expected to continue through 1Q22
- Executive Leadership Team appointments and Asia Pacific division reorganisation to build capability and provide more dedicated management focus completed
- Brand health metrics remain strong overall with some improvements in recent tracking research following a significant 4Q21 marketing campaign in China
- MVM acquisition and strategic partnership with China Animal Husbandry Group completed in July

[1] All figures are in New Zealand Dollars (NZ$) and based on continuing operations of the Group, unless otherwise stated.

[2] 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.

- Growth strategy review underway to respond to rapidly changing China market dynamics – update to be provided at the investor strategy day in October
- The Board has carefully considered capital management initiatives and has decided not to return capital to shareholders at this point in time, preferring instead to preserve balance sheet strength having regard to market volatility and potential opportunities to reinvest in growth and supply chain

Group financial performance[3,4,5]

The a2 Milk Company experienced a challenging year with **revenue** for the Group declining 30.3% to $1.21 billion which was within the guidance range provided in May. As stated in the Company's announcement on 10 May 2021, a2MC's performance was impacted by unprecedented levels of uncertainty and volatility due to COVID-19, challenges experienced in the English label infant nutrition channels, and the actions then required in the second half to rebalance channel inventory.

Gross margin percentage[6] decreased to 42.3%. This was significantly lower than the prior year primarily due to recognising stock write-downs of $108.6 million. Gross margin was also impacted by higher cost of goods sold driven by an increase in raw milk prices, lower volumes and adverse mix driven by a higher proportion of liquid milk to infant nutrition sales and a relative increase in China label sales as a proportion of overall infant nutrition sales. Foreign currency movements also negatively impacted gross margin, particularly in 2H21. Excluding the stock write-downs, the full year gross margin was 51.3%.

EBITDA decreased by 77.6% during the period to $123.4 million ($133.8 million excluding MVM acquisition costs). This reflected lower revenue and gross margins, one-off costs of $9.7 million associated with the implementation of a new cloud-based enterprise resource planning (ERP) system, and $10.4 million of MVM acquisition costs. This was partially offset by lower employee incentive payments, lower consulting costs and a reduction in discretionary costs, whilst continuing to invest in brand marketing and internal capability building.

This resulted in an **EBITDA to sales margin** of 10.2%. Excluding MVM acquisition costs, EBITDA to sales margin was within the guidance range provided in May at 11.1%.

The **effective tax rate** of 32.4% was marginally higher than the prior year due to the proportional increase in USA losses (which are not tax effected) to the overall Group profit and the MVM acquisition costs being non-deductible for tax purposes, partly offset by a prior period adjustment. **Net profit after tax** was $80.7 million, a decrease of 79.1% on the prior year including discontinued operations.

The **balance sheet** remains in a strong position with closing **net cash** of $875.2 million. **Operating cash flow** of $89.4 million was significantly lower than the prior year primarily due to lower earnings combined with a marginal reduction in net working capital. The Company also invested in the Kyvalley Dairy Group (Kyvalley) acquisition and lease-back, the Synlait capital raising and the ERP implementation. Post year end, the Company completed the acquisition of MVM for $268.5 million.

Inventory at the end of the period was $112.2 million, reflecting the impact of the $108.6 million stock write-down which includes associated disposal costs. As stated in the Company's announcement on 10 May 2021, this write-down was a result of the Board-initiated inventory review undertaken by management in 2H21, which indicated that the level of channel inventory was higher than anticipated. The elevated inventory was a consequence of managing the uncertainties and complexities of COVID-19 impacting supply chains, compounded by lower sales, particularly in English label infant nutrition. Actions were taken in 4Q21 to address excess inventory which included a reduction in planned sell-in across the daigou/reseller, CBEC and China label channels, as well as working with customers and distributors to improve the dating of inventory to improve freshness across all labels and channels. These actions are proving to be effective with early signs of price stabilisation in the CBEC channel and some recovery in the daigou/reseller channel. Channel inventory in CBEC and daigou/reseller channels are now at target levels, with China label expected to reach target levels by the end of 1Q22.

China infant nutrition market dynamics

As noted in the Company's announcement on 10 May 2021, the China infant nutrition market structure is changing rapidly. In volume terms, the overall infant nutrition market in China decreased[7] in FY21 in volume driven by a significant reduction in the birth rate impacting early-stage products, partially offset by increased product penetration.

Although market performance varied by channel and segment, overall, value growth was flat[8] as the impact of premiumisation (driven primarily through consumers trading-up and new product innovation) was partially offset by increased promotional activity resulting from heightened competitive intensity. Local players continue to gain share against the traditional multinational brands, driven both by the strength of local brands in domestic channels, as well as an overall mix shift from cross-border to domestic channels.

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[3] All figures are in New Zealand Dollars (NZ$) unless otherwise stated.

[4] All comparisons are with the 12 months ended 30 June 2020 (FY20), unless otherwise stated.

[5] All figures are quoted based on continuing operations of the Group, unless otherwise stated.

[6] Gross margin percentage is calculated as sales less cost of goods sold, divided by sales.

[7] Kantar Worldpanel 0-6 years old Baby & Kids panel: National IMF market tracking (Key & A + BCD cities) for the 52 weeks ending 18 June 2021.

[8] Kantar Worldpanel 0-6 years old Baby & Kids panel: National IMF market tracking (Key & A + BCD cities) for the 52 weeks ending 18 June 2021.

The increasingly competitive environment compounded by macro factors and evolving market dynamics reiterates the importance of the Company's current growth strategy review.

Regional performance

1. China & Other Asia

China & Other Asia revenue of $583.4 million was down 16.6%, with EBITDA of $75.6 million, down 66.4%. Lower revenue was primarily due to challenges experienced in the CBEC channel and a rebalancing of inventory with distributors.

The reduction in EBITDA margin was due to the higher proportion of China label sales relative to CBEC sales with the former being a higher cost to serve channel, resulting in a lower gross margin. It also reflected the continued investment in brand and capability. The proportion of the inventory write-down allocated to the China & Other Asia segment was $50.3 million.

Despite the disruption and challenges experienced during the year, the Company continued to record strong brand health metrics in China overall – China label metrics improved consistently while English label metrics weakened somewhat but improved partially in 4Q21 following the marketing campaign and other initiatives.

Infant nutrition – China label channels

Sales in *a2 至初®* China label infant nutrition of $389.9 million were achieved, an increase of 15.4% which was an encouraging result in a challenging market. The growth rate relative to FY20 was reflective of the substantial uplift in the prior period due to COVID-19 related pantry stocking, a reduction in the birth rate, and the increasing competition from domestic brands. Foreign currency movements (stronger NZD relative to USD/RMB) also created headwinds, particularly in 2H21. The 2H21 decrease in sales of 7.4% was also impacted by the actions taken in 4Q21 to reduce channel inventory.

As measured by Nielsen, retail sales for mother and baby stores (ie sales from stores to consumers by value) for the overall market were up 9% for the year and up 13% for 2H21[9]. a2MC's 12-month rolling market value share in MBS was 2.5% at the end of June 2021, versus 2.4% at the end of December 2020 and 2.0% at the end of June 2020[8]. Distribution increased to 22.8k stores, from 21.8k at the end of December 2020 and 18.2k stores at the end of June 2020[10]. Importantly, *a2 至初®* was one of a few international brands that gained share in the year, providing a solid base to build on in the future.

As measured by Smart Path, retail sales for domestic online ("DOL") platforms (by value) for the overall market were up 19% for the year and up 11% for 2H21[11]. The Company's 12-month rolling market value share in DOL was 2.0% at the end of June 2021, versus 2.0% at the end of December 2020 and 1.9% at the end of June 2020[10].

Channel inventory was slightly higher than target levels at the end of the period and will be further reduced in 1Q22 by careful on-going stock management. The actions taken to replace distributor inventory with fresher stock is well progressed with the impact in store starting to be seen. It is expected that inventory freshness will improve significantly in FY22 compared to FY21.

The Company continued to invest behind the brand to drive consumer demand. For FY21, this was weighted to the second half, including a significant marketing campaign in China in 4Q21.

The strategic importance and size of the channel, and the strong resonance the brand has with consumers, means the mother and baby store channel remains the Company's biggest opportunity to gain market share. A key element of the growth strategy review is focussing on maximising this opportunity as well as gaining share in domestic online channels.

Infant nutrition – Cross-border e-commerce (CBEC)

a2 Platinum® English and other label infant nutrition revenue of $166.9 million was down 51.1%. First half sales were impacted by pantry destocking from 2H20. In the second half, sales of $63.4 million were down 64.9% on 2H20 primarily as a result of cycling a high comparative period and as a result of the actions taken in 2H21 to rebalance inventory within the channel. Foreign currency movements also created headwinds for CBEC sales, which are denominated in US dollars. The second half result also reflected limited price discounting during the "618" sales promotion event and no sales of Hong Kong label, which has ceased due to COVID-19 restrictions.

As measured by Smart Path, retail sales (by value) for the overall CBEC market were up 3% for the year and down 5% for 2H21[12]. The Company's 12-month rolling market value share in CBEC was marginally down at 21.1% at the end of June, versus 22.2% at the end of December 2020 and 21.7% at the end of June 2020[11]. This performance reflected actions taken in 2H21 as referenced above, as well as a significant amount of cross selling and reselling from the daigou/reseller and retail channels. These dynamics may continue to put pressure on a2MC's short-term CBEC market share, as measured by Smart Path.

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[9] Nielsen MBS retail measurement service: mother and baby stores only retail sales (by value). FY21 versus FY20 and 2H21 versus 2H20.

[10] a2MC internal data tracking of stores with active sales in the past 6 months. Restated store numbers for December 2020 and June 2020 reflecting enhanced data capture and updated internal tracking methodology.

[11] Smart Path China IMF online market tracking: domestic online platform sales (by value). FY21 versus FY20 and 2H21 versus 2H20.

[12] Smart Path China IMF online market tracking: for CBEC only retail sales (by value). FY21 versus FY20 and 2H21 versus 2H20. (Prior periods restated for updated data.)

2. ANZ

Revenue in the ANZ segment was impacted by the infant and other nutrition challenges experienced in the daigou/reseller and retail channels but was partly offset by strong performance in liquid milk in Australia. ANZ segment revenue of $559.7 million was down 42.0%, with EBITDA of $148.8 million, down 68.0%. ANZ segment revenue of $242.5 million for 2H21 was down 52.0%, with EBITDA of $31.4 million for 2H21, down 86.8% primarily due to the actions taken in 4Q21 to rebalance the daigou/reseller channel partly offset by growth in Australian fresh milk.

Infant nutrition – daigou/resellers and retail

Infant nutrition revenue in ANZ decreased by 52.1% to $357.0 million for the year. This significant decrease was due mainly to prolonged impacts emanating from COVID-19 volatility.

In July and August 2020, the business was impacted by the unwinding of pantry loading that had occurred in early 2020 due to COVID-19, initially impacting retail daigou sales. At the end of September, it was evident that daigou/reseller customers were also being impacted by COVID-19 related restrictions. Measures were taken to address the prevailing situation and there were initial signs of improvement. However, there was further impact to CBEC sales later in 2Q21 which had a flow on impact on demand, reflecting the interrelationship between the daigou/reseller and CBEC channels. Actions taken in 3Q21 and in April to address the challenges in the daigou/reseller and CBEC channels had limited impact. Following a Board-initiated comprehensive review by management of inventory in the trade in 2H21, it was clear that the level of channel inventory was higher than had been anticipated and there were difficulties with channel inventory visibility and demand and supply planning.

A number of initiatives were put in place to address this decline in performance and, importantly to put the business on a firmer footing. These included:

- Incurring a significant stock write-down to reduce excess and ageing inventory
- Swapping out older distributor inventory with more recent stock to improve on-shelf product freshness
- Reducing channel inventory levels by restricting sales in 4Q21 to stabilise pricing and improve inventory flow
- Increasing wholesale prices to rebalance pricing across channels and mitigate margin loss due to higher cost of goods sold pressures

The initial results of these actions have been encouraging with product freshness and market pricing starting to improve. English label product freshness is expected to improve significantly in FY22 compared with FY21. Although market pricing is improving, CY21 English label inventory remaining in the market and being sold by certain wholesale traders and online players is depressing visible pricing in the market. The amount of this inventory remaining in the market is difficult to quantify, but it is expected that it will have largely cleared by the end of the "11/11" peak trading period.

Notwithstanding these actions, the Company estimates it lost market share in the daigou channel during the year, particularly in Stage 1 infant nutrition. Kantar data has recently been expanded and a more representative consumer age range now being captured[13]. Whilst there are still some inherent limitations for measuring the Company's performance using Kantar data, it remains the only single source for tracking daigou consumer sales. Kantar data suggests daigou consumer sales in the market were down 42% for FY21 and down 35% for 2H21[14] and that a2MC's daigou share declined but less dramatically to 22% at the end of June 2021 compared to 24% at the end of June 2020[12].

Given the role of the daigou/reseller channel, including in new user recruitment in an increasingly competitive market, some continued pressure on consumer demand is expected. A key focus is working with distribution partners to increase distribution and new user activation, as well as optimising CBEC execution. In addition, a key element of the Company's growth strategy review is considering the route-to-market and management model of English label infant nutrition.

Liquid milk

Australian fresh milk revenue increased by 10.8% to $169.0 million. The business also achieved a record market value share of 12.2% at the end of June 2021[15], primarily driven by increased levels of in-home consumption during 1H21 lockdowns associated with COVID-19. Growth moderated in 2H21 to 5.5% as restrictions eased and a greater amount of out-of-home consumption was experienced prior to recent lockdowns in Australia. During the year the Company acquired the manufacturing facilities of Kyvalley. The purchase and upgrade of Kyvalley is a strategic investment to ensure quality of products and processing capacity.

Other nutritional products

[13] Kantar data based on a panel of 9,000 consumers covering 0-6 year olds and only seeks to project ~40% of the population.

[14] Kantar Worldpanel 0-6 years old Baby & Kids panel: National IMF market tracking (Key & A + BCD cities) for the 52 weeks ending 18 June 2021.

[15] IRI Australian Grocery Weighted Scan 12-months ending 30 June 2021.

The disruption experienced in the daigou/reseller channel also impacted all products in this segment with revenue decreasing 50.5% to $33.7 million. As with infant nutrition products, the Company is examining the product and channel approach as part of the growth strategy review to drive demand and ensure other opportunities are explored to maximise the full potential of the segment.

3. North America

USA revenue decreased 3.7% to $63.6 million. An improved EBITDA result was delivered, with a significantly reduced loss of $33.5 million, representing a $17.0 million improvement on FY20. USA segment revenue of $29.4 million for 2H21 was down 22.8%, with an EBITDA loss of $21.9 million for 2H21 representing a $1.4 million improvement compared to 2H20.

FY21 represented a shift in execution approach for the USA business with lower marketing investment and increased price investment to improve conversion and household penetration. The business leveraged trade investment to bring price to an affordable premium as well as increasing range, facings and improving overall shelf positioning. This resulted in a significant percentage of key accounts increasing product facings and improving shelf position which is expected to benefit the business over time.

The decline in FY21 revenue reflects higher planned trade spend in line with the businesses revised pricing strategy, the loss of certain regions of a major club channel customer, and unfavourable foreign exchange, with each of these factors more heavily weighted to 2H21. Additionally, the US business benefited from a lift in in-home consumption related to COVID-19 lockdowns during 2H20, presenting a more challenging 2H21 comparative. On a constant currency basis, net revenue increased 5.5% to $69.7 million during the year. Underlying volume growth for the year was 13%, or 26% excluding the major club channel customer. The improved EBITDA loss in FY21 reflected a substantial reduction in marketing investment associated with the above noted shift in execution, along with the positive benefits of currency exchange on business expenditure.

Average velocities grew within key accounts and distribution grew to 26.8k stores, from 24.0k stores at the end of June 2020[16]. In 2H21[17], a2 Milk™ grew ahead of the premium liquid milk category and was the strongest performing premium brand over the period.

While marketing investment in FY21 was lower than the prior year, key marketing and public relations activities continued which resulted in driving improvements in brand health metrics, with prompted awareness demonstrating a significant increase. Additionally, the a2 Milk™ brand was one of the top two leading brands in the category for brand loyalty.

The USA is an important market, and the Company continues to evaluate product, distribution and supply chain opportunities to increase the scale and profitability of the business.

In Canada, products were first launched in July 2020, initially focusing on Western Canada with subsequent distribution expansion. The Company continues to work closely with Agrifoods, leveraging the Company's intellectual property and marketing assets as well as proprietary systems and know-how relating to local milk sourcing and processing.

Completion of acquisition of Mataura Valley Milk

On 30 July 2021, the Company completed the acquisition of a 75% interest in Mataura Valley Milk (MVM), a dairy nutrition business located in Southland, New Zealand, in partnership with China Animal Husbandry Group.

The strategic intent of the acquisition remains intact. The acquisition provides the opportunity to participate in nutritional products manufacturing and the potential to pursue additional China label registrations and product innovation opportunities in the future. It strengthens relationships with key strategic partners in China, achieves supplier and geographic diversification, and over time will offer access to insourced manufacturing margins.

It had previously been expected that post acquisition, MVM would process additional third-party volumes which is now uncertain in terms of execution and timing. In addition, a2MC has now revised down its volume assumptions for product to be transferred to MVM during the transitional period (FY22-24). Consequently, MVM is exploring further business development opportunities and will seek to work with additional third parties to improve the financial performance of MVM during the transitional period. The Company still expects MVM will return a positive EBITDA during FY25. Additional financial details for FY22 are provided in the outlook section.

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[16] Updated prior year comparison due to expanded data set now being supplied.

[17] Based on data available to 15 May 2021.

Growth strategy review

Whilst the actions taken have undoubtedly given the business a stronger platform going forward, the dynamic and challenging market conditions over the past year have highlighted the need to review and adapt elements of the Company's long-term strategy and execution going forward.

The Company recognises that the China infant nutrition market structure is changing rapidly. While consumers still have a strong preference for premium infant nutrition, market growth is being impacted by a more pronounced reduction in the birth rate. In addition, 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, with domestic players continuing to gain market share.

It is also clear that the daigou/reseller channel has been impacted by COVID-19, regulatory and other structural factors. Whilst the daigou/reseller channel will continue to play an important role, the Company needs to further evolve its routes to market and brand marketing programmes in parallel in order to adjust to the changing environment in which it operates.

Accordingly, the Company recognises the need to change its approach in light of the significant market changes and a comprehensive process to review its growth strategy is underway. The scope of this review includes the Company's approach to driving infant nutrition growth in both China label and English label channels; its infant nutrition product portfolio and innovation strategy; adjacent growth opportunities; and its brand positioning to ensure continued resonance and distinctiveness amongst an evolving consumer base.

An update on this review will be provided at an investor strategy day currently scheduled for late October.

Capital management

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.

Capital planning is an ongoing activity of the Board, guided by the Company's strategy and capital allocation framework. This framework prioritises investment in growth initiatives ahead of returning capital to shareholders.

The current capital planning process is considering how to maximise the value of the Company's strong capital position in line with its growth strategy. This includes further investment to strengthen the business as well as potential acquisitions to complement existing operations. The Board also considers it prudent to maintain a conservative cash reserve in uncertain times. This is particularly relevant in the context of volatile consumer markets, which continue to be impacted by COVID-19.

Several mechanisms are available to the Company when considering the return of excess capital to shareholders. The effectiveness of these options is impacted by the Group's ownership structure and taxation profile, which are relevant factors when considering how best to utilise the Group's capital. For any potential on-market share buyback, consideration would need to be given to the Company's available subscribed capital, which at end of FY21 was in the order of NZ$175 million.

Notwithstanding the above considerations, the Board is currently of the view that there is greater opportunity to create value by investing in the business and through potential acquisition than by returning capital to shareholders either via a buyback or by introducing a dividend at this stage in the Company's development. Capital management options will continue to be an important consideration in the broader capital planning process and will continue to be reviewed by the Board on an ongoing basis.

Significant progress in sustainability

In FY20, the Company identified a number of focus areas to enhance its efforts to become a more sustainable business for the future. In FY21, significant progress was made in several focus areas including enhancing its approach to animal welfare and its farm environmental plans; continuing to invest, engage and support local communities; as well as advancing several initiatives under its people strategy, responsible sourcing and ethical supply chain.

The Company is committed to investing in tangible climate-related programmes that will create a positive impact on the planet. In FY21 funding was redeployed to advance and support critical research and projects in the supply chain as follows:

- Progressed a research project to assess the potential of asparagopsis in reducing methane produced by A2/A2 cows
- Contributed to Synlait's conversion of its current coal boiler to biomass fuel
- Committed to converting or replacing MVM's coal boiler in the future
- Installed solar panels at the Smeaton Grange milk processing plant and commenced an energy audit of the site

Further information on the Company's sustainability goals and strategy will be provided at the upcoming investor strategy day in late October.

Executive leadership team and reorganisation

In July 2021 the Company announced it would reorganise its Asia Pacific division. The objectives of this reorganisation are to provide greater leadership and focus on key components of the business, enable holistic management of the English label business, and improve execution going forward.

This reorganisation resulted in two of the Company's existing leaders, Xiao Li, Chief Executive – Greater China, and Kevin Bush, Executive General Manager – ANZ, being promoted to be direct reports to the CEO, demonstrating the depth of talent within the Company, and are both now on the Executive Leadership Team.

Yohan Senaratne was appointed Executive General Manager – International and commenced with the Company in July. Yohan is responsible for leading the Company's cross-border export business, primarily focused on English label infant nutrition products.

The Company also recently appointed Edith Bailey as its new Chief Marketing Officer. Edith will be responsible for managing the strategic and creative direction of the a2™ brand and driving product innovation going forward. Edith will commence in December 2021.

Amanda Hart was also recently appointed as Chief People & Culture Officer in July and will commence her role in September 2021. Amanda will be responsible for driving the people strategy and executing integrated programmes to develop internal capability and evolve the Company's culture.

Following the completion of the MVM acquisition, Bernard May has joined a2MC's Executive Leadership Team as Chief Executive Officer – MVM.

During the year Eleanor Khor was promoted to the role of Chief Strategy Officer, and Jaron McVicar's role was expanded to Chief Legal & Sustainability Officer and Company Secretary.

Outlook

The Company is confident in the underlying fundamentals of the business and that the growth opportunity in core markets remains significant. Coupled with opportunities for product innovation, category expansion and new markets, and supported by a healthy brand and strong balance sheet, the long-term outlook is positive.

However, given the continuing uncertainty and volatility in a2MC's consumer markets resulting from issues related to COVID-19 and other rapidly changing market dynamics, particularly in China, the Company has determined not to provide specific guidance regarding anticipated Group revenue or EBITDA margin at this time. Rather, it is providing current observations on key drivers and important issues that may impact its FY22 results.

These observations are based on what the Company is currently aware of, and facts and circumstances may change materially in the future. Accordingly, actual results may vary materially from that indicated by the qualitative outlook provided below.

The outlook also assumes no material changes in macro factors such as cross border trade, changes in the regulatory environment and foreign exchange, and that COVID-19 related impacts continue at broadly current levels.

China infant nutrition market

China's infant nutrition market is being materially impacted by a lower birth rate, especially recently due to COVID-19 and related vaccination programmes causing many people to delay pregnancy. While it is expected that this short-term impact will be cyclical in nature, at this stage it is not possible to accurately predict the extent or timing of the impact or recovery over the medium-term. In the longer-term, it is expected that Government initiatives to address the declining birth rate will have a positive and stabilising impact. The prospect of other potential regulatory impacts on the category, whether they be positive or negative in nature, is unknown and inherently difficult to predict.

In FY22, the Company expects the value of the overall infant nutrition market to decrease due to the lower number of births (during the year, and also as a result of the year prior), an increase in competitive intensity and promotional activity impacting average pricing, partially offset by a continuation of the usage penetration and premiumisation trend.

Based on current market trends, the ultra-premium segment (where the Company's China label product competes) is expected to perform at or above market, and the premium segment is expected to perform at or below market.

The impact of these market dynamics is expected to be felt most in early-stage products, and in Key and A cities where the birth rate reduction is higher than in BCD cities. Market share gains by domestic brands compared to international brands are expected to continue.

Category and business divisions

In **China label infant nutrition,** the Company is expecting to grow sales in FY22, as well as gain moderate share, albeit in a weaker market overall. The focus is on acquiring new users and expanding distribution. Inventory levels are reducing, and product freshness is improving. In 1Q22, the Company is continuing to reduce distributor inventory levels which will impact sales. This is expected to result in a stronger 2H22 compared to 1H22.

In **English label infant nutrition**, with the category under pressure and the challenges experienced by a2MC in FY21, the Company is targeting sales stabilisation in FY22 but a wide range of outcomes is possible. The COVID-19 impacts on the daigou/reseller channel and associated impact on CBEC for English label products are expected to be prolonged. The Company is adapting its strategy and execution to stabilise its English label business and return to growth over time.

Further incremental sales growth is expected in **Australian liquid milk** in FY22. In 1H22, the current COVID-19 restrictions in Australia are likely to support volumes. However, these restrictions are expected to ease in 2H22, with potential volume declines as more out-of-home consumption resumes. Input costs are also higher compared to FY21 partially offset by pricing.

Strong underlying growth in key accounts is expected in **USA liquid milk** in FY22. In-home consumption is expected to remain at similar levels. However, with the loss of certain regions of a major club channel customer due to private label substitution, modest sales growth overall is expected. The higher trade spend in FY21 to reduce retail price points and improve distribution will be rolled back during the year in line with plan with some volume risk. Overall, a marginal improvement in USD losses is expected.

FY22 will be the first time **MVM** is included in a2MC's financial reporting. As such, the following information regarding MVM is provided to assist the market with revenue and earnings expectations. Based on revised volume assumptions, it is now expected that in FY22 MVM will deliver approximately $80 million in revenue (excluding intercompany revenue) and an EBITDA loss of approximately $20 million for the 11 months post-completion. On an annualised basis the EBITDA loss would be approximately $4 million greater due to July being a seasonally low period. Prior to any further investment in a blending and canning facility and associated infrastructure, it is expected that depreciation and amortisation during the transitional period will be approximately $14 million, subject to finalisation of acquisition accounting. MVM will be fully consolidated into a2MCs accounts going forward on a 100% basis with the non-controlling interest deducted from the Group's net profit after tax. The consolidation of MVM will affect the reported gross margin of the Group. This includes the allocation of direct overheads, including a portion of manufacturing depreciation, to gross margin.

Marketing and capability investment

Based on the continuing strong brand fundamentals, the Company is planning for a significant increase in brand investment, content generation and activation in FY22 to drive awareness and trial in China and to compensate for continued subdued daigou activity which has been effective in the past in building the brand. Overall marketing investment in FY22 is anticipated to return to approximately FY20 levels which is expected to continue to drive improved brand health metrics and future demand. Phasing of marketing investment may be influenced by the growth strategy review underway.

The Company will also continue to invest in capability building in China and in corporate functions to support future growth. It is also expecting a return of short-term and long-term employee incentive programmes in order to retain and attract talent. These investments will offset the reversal of FY21 one-off costs associated with the MVM acquisition and ERP implementation. Accordingly, together with the addition of FY22 operating costs for the MVM business, the Company is anticipating an uplift in employee and administration costs in FY22.

Key financials

The Company is expecting 1H22 **revenue** (including MVM) to be marginally lower than 1H21 due mainly to lower English label infant nutrition sales offset by the addition of MVM revenue. 2H22 revenue (including MVM) is expected to be significantly higher than 2H21 due mainly to actions taken in 2H21 to rebalance channel inventory, increased marketing investment and the inclusion of MVM revenue.

FY22 **gross margin** is expected to be broadly similar to FY21 (excluding FY21 stock write-downs and before consolidating the MVM business in FY22). This reflects the annualisation benefit of FY21 infant nutrition price increases and the product mix benefit from an overall growth in infant nutrition volume. These benefits will be largely offset by COGS headwinds related to increasing milk, ingredient and packaging costs. The Company is also expecting continued adverse infant nutrition mix in FY22 with China label growing ahead of English label.

Given the uncertainty and potential volatility in infant nutrition sales, particularly English label, it is difficult to predict with any precision the wide range of potential **EBITDA** outcomes in FY22 relative to FY21 excluding stock write-downs.

Additionally, with the inclusion of MVM in FY22, **depreciation and amortisation** for the Group is expected to increase to approximately $20 million and, as the MVM losses will not be taken as a deduction for tax purposes, a higher **effective tax rate**, in the order of 37-39%, is anticipated.

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.

Quotes for media

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

- *"It was a challenging year for The a2 Milk Company but we remain confident in the long-term opportunity that the infant nutrition market in China represents.*
- *"The actions taken from the fourth quarter to address excess inventory are proving effective with channel inventory levels reducing, product freshness improving and pricing increasing.*
- *"Our brand health metrics remain strong overall with some improvements in our most recent tracking research following a significant marketing campaign in China in the fourth quarter.*
- *"We recognise that the China market and channel structure is changing rapidly and we are undertaking a comprehensive process to review our growth strategy and executional plans to respond to this new environment.*
- *"Our acquisition of a 75% interest in Mataura Valley Milk further strengthens our New Zealand presence and our relationships with China though another important strategic partner in China Animal Husbandry Group.*
- *"The appointments we have made to bolster our Executive Leadership Team, alongside a reorganisation of our Asia Pacific division, provide more dedicated management focus going forward.*

Reconciliation of EBITDA to net profit after tax

	Year Ended 30-Jun-21 NZ$ 000's	**Year Ended 30-Jun-20 NZ$ 000's**
Group EBITDA	123,428	549,719
Depreciation and amortisation	(7,453)	(4,393)
Group EBIT	**115,975**	**545,326**
Interest income	3,989	6,135
Interest expense	(699)	(389)
Income tax expense	(38,607)	(165,235)
Net profit after tax	**80,658**	**385,837**

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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