Date
24 September 2019

Theme
Initiating Coverage

WILSONS

Company
Bubs Australia Limited (BUB)

Initiation of coverage

We initiate coverage on BUB with a HOLD rating and a 12-mth target of $1.30p/share. BUB is well positioned to capitalise on the IF (infant formula) demand in China, supported by its niche goat IF product positioning and various key relationships (i.e. Chemist warehouse, Alibaba, Beingmate) in the ecosystem. While we see significant growth opportunity, the industry remains highly competitive and building brand awareness remains a key challenge for BUB. Therefore, we see the current share price as broadly fair for this outlook.

Key points

Business overview. Bubs Australia is a premium brand for goat milk products and organic baby food. It outsources majority of the manufacturing. Following the acquisition of Deloraine in 2019, BUB now internalises canning and blending.

Solid foundation, need to deliver now. The IF market in China remains a key growth driver for BUB. It is well positioned with its niche goat IF product with functional benefits of "easier to digest". BUB is also supported by various key partnerships in the ecosystem, which helps with market access. We note challenge for BUB remains building brand awareness amongst intensifying competition in the goat IF market, noting Chinese consumers are relatively sticky unless the product no longer able to deliver certain functional needs.

Strong balance sheet. We forecast FY20 net cash at $16M and BUB to achieve a positive operating cash flow run-rate by the end of FY21.

Forecasts broadly reflect management expectations. We forecast FY20 NPAT of $1.0M, broadly in line with management guidance of "a full-year profit".

Valuation broadly fair. We value BUB at $1.30p/share. This is based on an FY20 EV / Revenue of 8.0x. We expect ~60% sales growth over the next 3 years. A2M has been trading at 6-8x 1 year forward revenue over the last 2 years, re-rated from ~3x in FY14-15 when IF sales were at a similar run-rate to BUB's current level as the market becomes more aware of the significant growth opportunity.

Risks and catalysts

Risks. Product quality, supply constraints, market access, intellectual property, key customer / supplier risk.
Catalyst. Takeover, registration approval.

Earnings forecasts					
Year-end June (AUD)	**FY18A**	**FY19A**	**FY20F**	**FY21F**	**FY22F**
NPAT rep ($m)	-64.5	-35.5	1.0	7.4	15.0
NPAT norm ($m)	-5.2	-6.4	1.0	7.4	15.0
Consensus NPAT ($m)					
EPS norm (cps)	-1.6	-1.4	0.2	1.6	3.2
EPS growth (%)	-16.2	11.8	115.4	664.0	96.7
P/E norm (x)	-84.1	-95.3	618.3	80.9	41.1
EV/EBITDA (x)	-105.2	-113.7	210.2	53.8	28.7
FCF yield (%)	-1.9	-3.7	-0.8	0.1	0.5
DPS (cps)	0.0	0.0	0.0	0.0	0.0
Dividend yield (%)	0.0	0.0	0.0	0.0	0.0
Franking (%)	0	0	0	0	0

Source: Company data, Wilsons estimates, S&P Capital IQ

Recommendation	**HOLD**
12-mth target price (AUD)	**$1.30**
Share price @ 23-Sep-19 (AUD)	$1.34
Forecast 12-mth capital return	-2.6%
Forecast 12-mth dividend yield	0.0%
12-mth total shareholder return	**-2.6%**

Market cap	$686m
Enterprise value	$670m
Shares on issue	514m
Sold short	2.0%
ASX 300 weight	n/a
Median turnover/day	$3.9m

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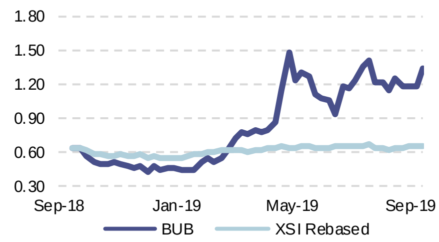
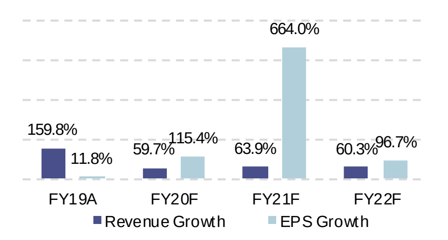
FUNDAMENTAL INSIGHTS

12-mth price performance ($)

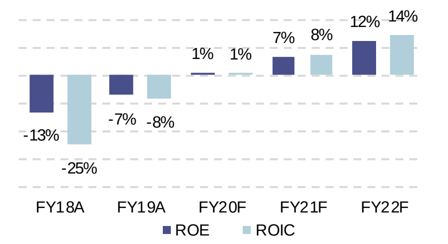


	1-mth	**6-mth**	**12-mth**
Abs return (%)	14.1	74.5	113.6
Rel return (%)	11.6	68.4	109.2

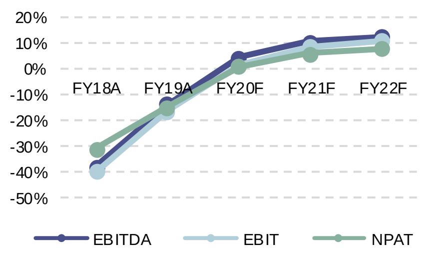
Growth rates



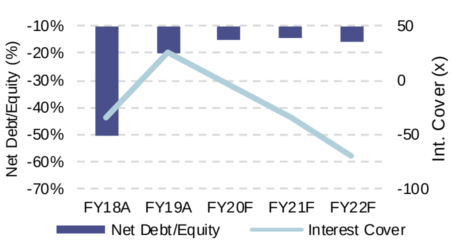
Returns



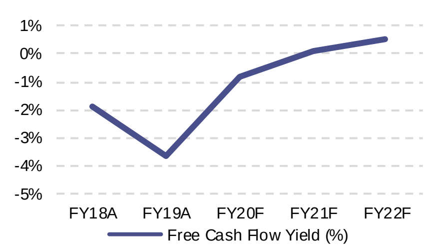
Margin trends



Solvency



Free cash flow yield



Interims ($m)

	1H19A	2H19A	1H20E	2H20E
Sales revenue	19.5	24.4	33.8	36.3
EBITDA	-3.5	-2.4	1.3	1.9
EBIT	-3.7	-3.3	0.2	0.9
Net profit	**-3.5**	**-2.8**	**0.3**	**0.7**
Norm EPS	**-0.8**	**-0.6**	**0.1**	**0.2**
EBIT/sales (%)	-19.1	-13.7	0.6	2.3
Dividend (c)	0.0	0.0	0.0	0.0
Franking (%)	0.0	0.0	0.0	0.0
Payout ratio (%)	0.0	0.0	0.0	0.0
Adj payout (%)	0.0	0.0	0.0	0.0

Key assumptions

	FY17A	FY18A	FY19A	FY20F	FY21F	FY22F
Revenue Growth (%)		329.9	159.8	59.7	63.9	60.3
EBIT Growth (%)		139.0	6.0	-115.1	862.4	105.1
EPS Growth (%)		16.2	-11.8	-115.4	664.0	96.7
ROA (%)	-31.0	-7.5	-4.6	0.6	5.5	9.5
ROE (%)	-36.9	-7.1	-6.0	0.9	6.5	11.6
Infant formula sales ($m)		5.0	18.9	41.7	83.3	150.0
Baby Organic Food sales		1.7	2.7	3.5	4.6	6.0
Caprilac Powder sales ($m)		6.7	15.6	18.0	19.7	20.7
Fresh Dairy Products sales		3.4	5.9	6.2	6.5	6.9
Raw materials sales ($m)		0.1	0.3	0.4	0.4	0.4
Canning services income		0.0	0.4	0.4	0.4	0.4
Gross margin (%)		12.6	20.8	32.1	35.1	35.1

Financial ratios

	FY17A	FY18A	FY19A	FY20F	FY21F	FY22F
PE (x)	-97.7	-84.1	-95.3	618.3	80.9	41.1
EV/EBITDA (x)	-250.4	-105.2	-113.7	210.2	53.8	28.7
Dividend yield (%)	0.0	0.0	0.0	0.0	0.0	0.0
FCF yield (%)	-0.3	-1.9	-3.7	-0.8	0.1	0.5
Payout ratio (%)	0.0	0.0	0.0	0.0	0.0	0.0
Adj payout (%)	0.0	0.0	0.0	0.0	0.0	0.0

Profit and loss ($m)

	FY17A	FY18A	FY19A	FY20F	FY21F	FY22F
Sales revenue	3.9	16.9	43.9	70.1	115.0	184.3
EBITDA	-2.7	-6.4	-5.9	3.2	12.5	23.3
Depn & amort	0.1	0.3	1.2	2.1	2.2	2.3
EBIT	**-2.8**	**-6.7**	**-7.1**	**1.1**	**10.3**	**21.1**
Net interest expense	0.0	0.2	-0.3	-0.3	-0.3	-0.3
Tax	0.0	-1.7	-0.4	0.4	3.2	6.4
Minorities/pref divs	0.0	0.0	0.0	0.0	0.0	0.0
Equity accounted NPAT	0.0	0.0	0.0	0.0	0.0	0.0
Net profit (pre-sig items)	**-2.8**	**-5.2**	**-6.4**	**1.0**	**7.4**	**15.0**
Abns/exts/signif	-2.3	-59.3	-29.1	0.0	0.0	0.0
Reported net profit	**-5.1**	**-64.5**	**-35.5**	**1.0**	**7.4**	**15.0**

Cash flow ($m)

	FY17A	FY18A	FY19A	FY20F	FY21F	FY22F
EBITDA	-2.7	-6.4	-5.9	3.2	12.5	23.3
Interest & tax	0.0	0.0	0.2	0.3	-0.1	-3.0
Working cap/other	0.6	-6.4	-19.4	-8.6	-10.4	-15.1
Operating cash flow	**-2.1**	**-12.8**	**-25.1**	**-5.1**	**1.9**	**5.2**
Maintenance capex	0.0	0.0	-0.1	-0.5	-1.1	-1.5
Free cash flow	**-2.1**	**-12.8**	**-25.2**	**-5.6**	**0.8**	**3.7**
Dividends paid	0.0	0.0	0.0	0.0	0.0	0.0
Growth capex	0.0	0.0	0.0	0.0	0.0	0.0
Invest/disposals	5.5	-25.0	-14.9	0.0	0.0	0.0
Oth investing/finance flows	0.0	0.0	0.8	0.0	0.0	0.0
Cash flow pre-financing	**3.4**	**-37.8**	**-39.3**	**-5.6**	**0.8**	**3.7**
Funded by equity	-0.1	71.7	32.7	0.0	0.0	0.0
Funded by debt	0.0	-0.6	-8.8	0.0	0.0	0.0
Funded by cash	-3.2	-33.3	15.4	5.6	-0.8	-3.7

Balance sheet summary ($m)

	FY17A	FY18A	FY19A	FY20F	FY21F	FY22F
Cash	5.3	38.6	23.3	17.7	18.4	22.1
Current receivables	0.9	4.0	15.6	22.8	28.7	36.9
Current inventories	1.0	6.0	14.6	24.5	40.2	64.5
Net PPE	0.1	0.0	4.2	2.6	1.5	0.8
Intangibles/capitalised	1.3	33.0	91.8	91.8	91.8	91.8
Total assets	**9.0**	**89.0**	**154.6**	**164.6**	**185.9**	**221.3**
Current payables	1.1	5.3	8.9	17.5	28.7	46.1
Total debt	0.0	2.0	2.0	2.0	2.0	2.0
Total liabilities	**1.5**	**16.5**	**48.9**	**58.0**	**71.9**	**92.3**
Shareholder equity	**7.5**	**72.5**	**105.7**	**106.6**	**114.0**	**129.0**
Total funds employed	**7.5**	**74.5**	**107.7**	**108.6**	**116.0**	**131.0**

Investment view

Summary view

We initiative coverage on Bubs Australia (BUB) with a HOLD rating and a 12-month target price of 1.30 p/share. We assess the IF market in China remains the key growth driver for BUB.

We see headwinds from declining birth rate, potentially further regulatory reforms on the social e-commerce channel, and increased competition. However, we see opportunities for brands with the right product positioning and effective channel management.

We think BUB is well positioned in the following aspects:

- Product positioning – niche
- Strong relationships with key partners
- Vertical integration helps reduce regulatory risk

We are cautious on:

- Early stage of brand building
- Increased competition in the goat space
- Unable to reach growth pockets (i.e. MBS – mother & baby store, lower tier cities) in the absence of SAMR (State Administration for Market Regulation)

In our ongoing coverage, we will be looking for the following key catalysts:

- Brand penetration via various channels
- SAMR approval
- Performance of new products

Key risks

Brand and reputation

BUB'S key business assets include brand names and related intellectual property of the business. Any damage can erode BUB'S public reputation and adversely affect BUB'S supply streams by decreasing demand for BUB'S products and causing interference with key supply relationships, distributors and employees. Cumulatively this could detrimentally affect the value associated with BUB'S key business assets.

Regulation

There is a continuing risk for BUB that local laws and/or regulations in jurisdictions in which BUB conducts business could unpredictably and radically change. As BUB conducts business across multiple jurisdictions and sources its ingredients internationally, there is a risk that changes to the regulatory environment may materially detrimentally affect the manner in which BUB currently operates (including obligations altering the manufacturing processes, ingredients, shelf life, marketing and export/import processes).

In addition to the above, BUB subscribes to various voluntary codes of conduct, including those relating to being certified "organic", "kosher" and "halal". The standards of these codes are independently regulated by those bodies which provide the certification and can be overlayed by local laws. Changes to these codes could significantly alter BUB'S market and therefore affects its revenues and/or costs.

Competition

BUB'S future financial performance and overall success in the market will rest upon the successful implementation of strategies to compete with highly competitive global businesses. Some of these global competitors have advantageous access to capital and resources, while others are in relationships with, large scale supermarket chains. Those competitors are given both financial and marketing assistance due to their relations. BUB'S strategies may be adversely impacted by the number and size of its competitors who may participate in the market with a more aggressive pricing structure, innovative technologies and/or agile supply and distribution networks more adept than those of BUB.

Manufacturing

BUB'S utilises a number of manufacturers across its product range. Risks in respect of manufacturing hinges upon BUB'S reliance on a concentration of manufacturers. A disruption to this supply chain, or if this manufacturer chooses to discontinue production, would adversely affect BUB'S ability to meet consumer needs and ultimately be of detriment to the business's financial performance and future prospects. Given that there are a number of alternative manufacturers within Australia that the Company could seek production from, the Company considers that it can mitigate this risk.

Failure to grow

The success and potential growth of BUB is dependent on its ability to produce and offer a range of new products to the market. If BUB is unable to do so, the result could be a reduced or negative rate of growth. There is a secondary risk of unprofitability stemming from BUB'S new products incurring operating costs earlier or greater than forecast, greater waste operating costs than anticipated and/or impacts on existing product profitability due to the release of new products. BUB'S may also fail to grow as a result of inadequate marketing or insufficient consumer interest.

Dependence on outside parties

BUB may pursue a strategy that forms strategic business relationships with other organisations in relation to current and potential products, distribution channels and points of sale. There can be no assurance that the Company will be able to attract and retain such organisations and to negotiate appropriate terms and conditions with these organisations or that any potential agreements with such organisations will be complied with.

Given the highly concentrated nature of Australia's FMCG retail market, disruption by any of the major retailers in the Coles-Wesfarmers or Woolworths Group could have a material adverse impact on BUB'Ss financial performance. The diversity of BUB customer base reduces the financial risks to BUB in the event of a delisting by any particular distributor. BUB is focussed on expanding its distribution footprint to further mitigate this risk, as well as to benefit from margin accretive opportunities available outside Australia.

Key issues

IF industry headwinds

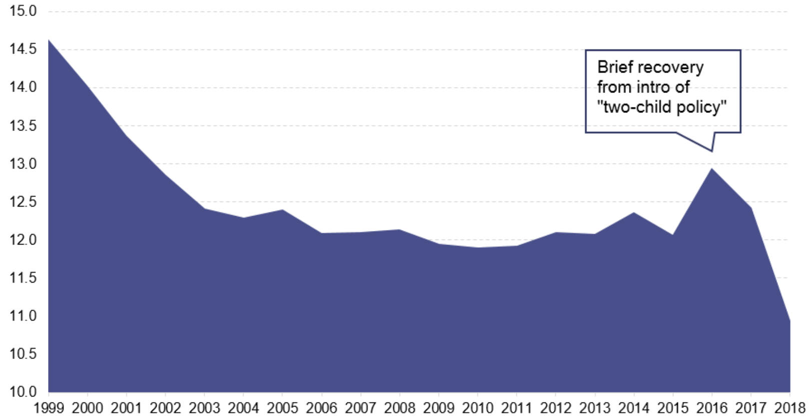
Declining birth rate keeps a lid on demand

China IF sales remain a key growth driver of earnings growth. Birth rate in China is a key indicator of demand for infant formula products. According the National Bureau of Statistics of China, birth rate (i.e. number of births per 1,000 people) returned to a declining trend since 2016, after a short recovery on the back of the introduction of "two-child policy" in 2014.

The introduction of the more relaxed "two-child policy" is encouraging for the industry, but we assess the potential uplift in demand may not be as significant it appears, with cost of living remaining elevated leaving young parents reluctant to have 2nd child.

Further details refer *"Key issue 1: Demographic trends in China"* section on p.6 of the sector report.

Figure 1: Birth rate in China (Number of births per 1,000 people)



Source: National Bureau of Statistics of China

Regulations partly stabilised, but more scrutiny on social e-commerce possible

Regulations on IF sales in China have gone a series of changes over the last 5 years, both in relation to online / CBEC (cross-border e-commerce) and offline sales.

With regards to CBEC/online sales, we assess the overall regulatory environment has now somewhat stabilised. Major e-commerce platforms will player a more important role in supervising. We assess smaller Daigous will likely fade out or consolidate into social e-commerce platforms eventually due to low profitability and regulatory hurdles. Larger corporate Daigous will need to partner with the platforms to stay compliant, or become part of the social e-commerce platforms (e.g. Yunji). Social e-commerce remains one area that may attract further regulatory reforms.

Regulatory environment for products sold offline has always been stricter than that of CBEC. With the MBS channel growing rapidly, and Chinese government's attempt to protect domestic players' turf (as illustrated in the new Action Plan published in June this year), regulatory environment will likely remain strict for offline sales via SAMR registration.

Further details refer *"Key issue 4: Regulatory environment in China"* section on p.22 of the sector report.

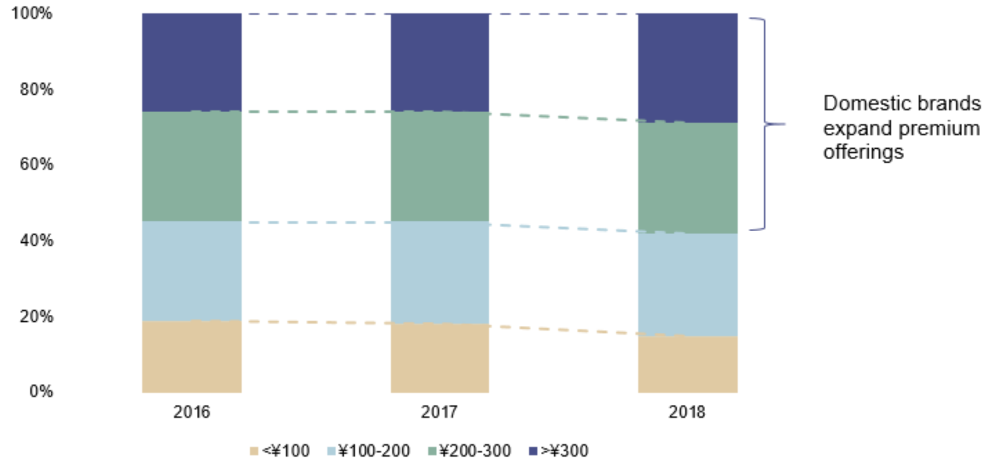
BUB's core goat IF product remains in the SAMR registration process, with application submitted in October 2017. BUB's recently launched a grass-fed cow milk IF product. SAMR registration for this product was submitted in March 18 under a different and will require brand transfer.

Competition increases

Premiumisation has been a major feature of the retail landscape in China with growing "middle class". The share of premium products continue to grow at the expense of lower end products, especially following the 2008 IF scandal. While this trend continues to favour BUB, but competition has also increased in this category. Imports continue to strengthen its presence in China, with large international brands diversify its product portfolio with different price points, functions, and ingredients. In addition, domestic brands have also strengthened their offerings and consumers' confidence has partly been restored due to tighter regulations and brand efforts to compete with imports.

Further details refer *"Key issue 2: Premiumsation in China"* section on p.8 of the sector report.

Figure 2: Share of total number of domestic IF brands by price range



Source: CBNData. Price is based on per 900g tin.

Goat niche offers growth potential

While headline growth is limited, we see opportunities for Australian brands that are positioned in the right sub-categories. We assess products that include niche raw materials and have functional benefits offer the best growth potential.

The goat IF market is dominated by imported products, whether it is an international brand or an offshore farm / company owned by Chinese owners. This is largely due to the constraints around availability and quality of domestically sourced goat milk. Imported products are mainly out of Netherlands (Ausnutria's Kabrita, Primavita) and New Zealand (Danone Nutricia's Karicare, Karihome, Blue River owned by a HK based company Blueriver). Due to the growth and dominance of imported products in recent years, some domestic brands opt to acquire offshore farms / equity holding in offshore companies. For example, Kabrita's parent company Hyproca is owned by Ausnutria (HK-listed), and Feihe invested CAD 225M in North America's first and only goat IF manufacturing facility 1 year ago.

BUB's core goat IF product is an emerging brand, especially in the domestic Chinese market. Following the supply agreement with Central Dairy Goats in NZ in December 18, BUB was able to produce its products entirely with Australian goat milk, a world first. While it is early days to assess consumer response, it will likely be a favourable marketing campaign. Brand awareness and consumer education remain key for BUB in the near-term.

Further details refer *"Strong momentum in niche / premium categories"* section on p.11 of the sector report.

Transition to new distribution model in China

The industry is transitioning from a Daigou driven distribution model to a more active and direct sales model into China. This is driven by a number of factors, being a) growth in offline MBS sales, b) growth in lower tier cities where MBS dominates c) consumer driven and d) e-commerce slowing.

An offline presence is not only important in capturing the growth in MBS network, but also enables touchpoints with consumers in lower tier cities which are seeing growth in excess of the 1st tier cities. This is especially important for mature brands who already have a reasonable presence in online channel and bigger cities to drive further growth beyond the old CBEC / online model.

While BUB's unable to reach certain channels in the absence of SAMR, we do not see a pressing need for the registration. We assess there is still room for BUB to grow in online channels as an emerging brand. Near-term focus remains building brand awareness via multiple channels. Despite it is a shrinking market, Daigou remains an important advocate for the brand especially through the domestic channel. We note BUB started partnering with 1 key corporate Daigou in Australia in 2H19.

Further details refer *"Key issue 3: The evolution of channels in China"* section on p.15 of the sector report.

Vertical integration helps reduce reg risk

The SAMR registration required to sell products in offline channels in China is attached to the canning facility (instead of manufacturing facility). With tighter regulations in China (reflected in the limit of 3 brand slots per facility and extended registration process), the value of canning facilities has increased. Brands are more inclined to own the facility to minimise the risk of losing their brand slot, albeit noting the time consuming process is also costly for the facility if opt to swap brands. We note increased M&A activity implies misalignments between previous brands under SAMR registration and incoming brand. Given it is early days and lacks precedents, we note some risks around swapping brand that has already proved by SAMR into a new brand under new ownership.

BUB is reasonably well positioned following its acquisition of Deloraine canning facility. Capacity does not appear to be an issue currently. The cow milk IF application will require a brand transfer application down the track.

Further details refer *"Canning facility ownership"* section on p.31 of the sector report.

Marketing spend for the industry grows

We assess cost of doing business in China is increasing for fast-moving consumer goods broadly, driven by omni-channel and cost of data. Brands that previously relied on Daigous will see a further step up in the near-term during the transition from Daigou model to a more direct distribution model. For example, the omni-channel implies marketing presence in multiple platforms and requires data analytics capability to understand consumers in various regions. More local expertise is also required as the brands are effectively competing directly in-country with its competitors.

We assess near-term marketing focus for BUB will remain the Daigou and CBEC channels. This compares to some of its more established peers who will switch to a more direct in-country marketing strategy. Ability to invest cash in marketing will remain limited compared to its peers, with BUB only recently turned operating cash flow positive in 4Q19. However, the strategic alignment with key partners is an alternative to cash marketing spend. While it is too early to call the outcome of these strategic partnerships, we are seeing encouraging signs from the early contributions to BUB's operations. Management guided to FY20 marketing spend (as a % of sales) in line with FY19. Our forecasts reflect management guidance.

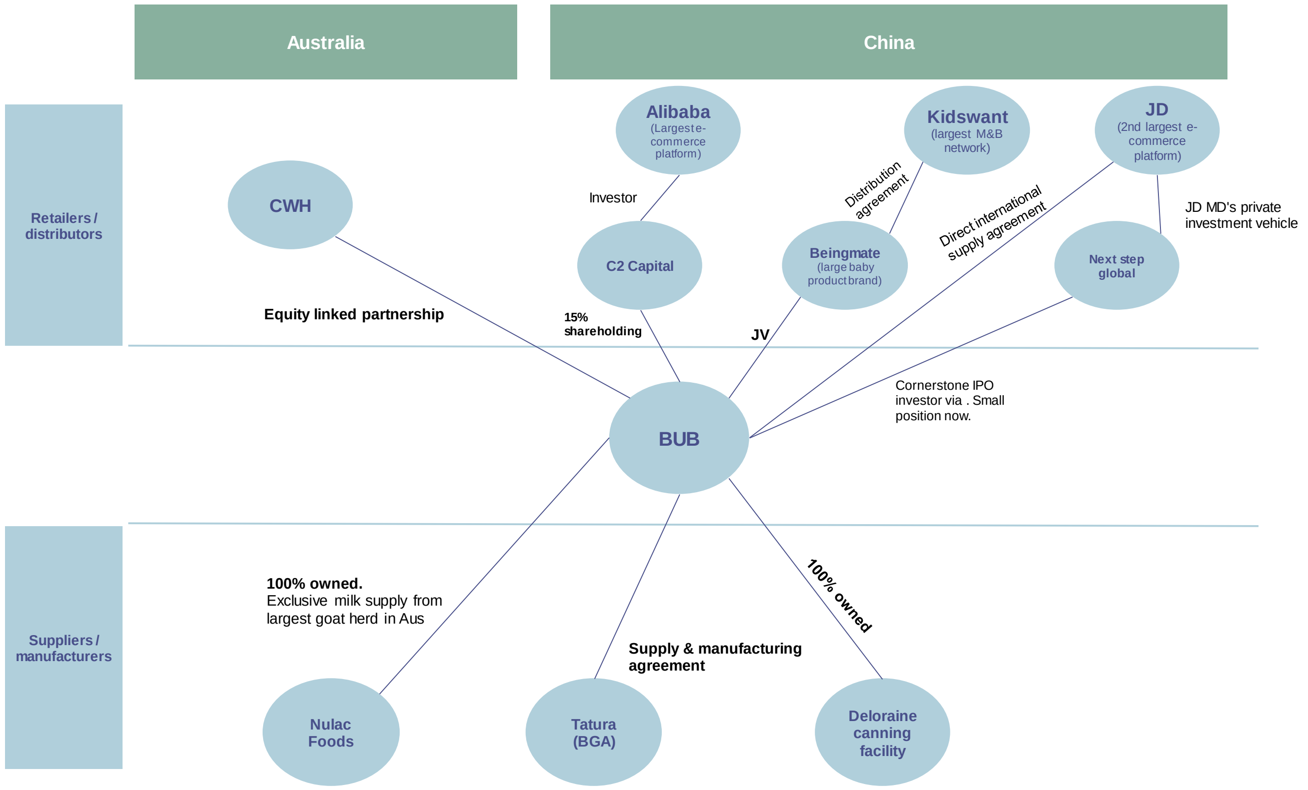
Key relationships build path to growth

BUB positioned itself with a number of key domestic players in China to help navigate through the complexity in the China market. Key strategic partnerships include:

- Alibaba's interest in BUB through its investment vehicle C2 Capital's 15% shareholding in BUB. The relationship here will likely benefit BUB in product positioning, channel penetration and entry into new markets.
- JV arrangement with Beingmate, one of the largest baby product brands in China. Having a local partner responsible for distribution will likely help BUB navigate through the fragmented offline distribution network in China.
- Equity linked partnership with Chemist Warehouse. This will likely help BUB build brand awareness in the domestic market and ultimately the Daigou network.

While these relationships have laid a solid foundation for BUB to pursue growth opportunities both domestically and in China, we see near term focus remain building brand awareness which will take time.

Figure 3: BUB's key relationships



Source: BUB & Wilsons

Business Overview

Introduction

Bubs was founded by Kristy Carr in 2006 in Sydney as a premium organic baby food brand. Bubs launched Australia's first range of organic pouch baby food sold in Australian supermarkets. Since then, it has grown to Australia's largest producer of goat milk products and listed on the ASX in 2017.

Business model

The BUB's business model started as an asset-light, marketer and distributor, which outsources supply and manufacturing. Following the acquisition of Nulac Foods (ie. leading brand of goat milk products and exclusive supply exclusive goats milk supply from Australia's largest herd of milking goats) in 2017 and canning facility Deloraine in 2019, BUB has evolved into a vertically integrated producer in the goat milk infant formula space in order to adapt to the regulatory changes in the industry.

BUB has a number of key strategic partnerships which we include in the relevant sections below.

Marketing & Distribution

In Australia, infant formula is available in supermarkets and selected pharmacies. Some of the products sold in Australia are consumed in China. Some are shipped for personal consumption and the majority are resold through online platforms (Taobao, Wechat etc.). BUB started distributing to 1 Australia based corporate Daigou / exporter in 2H19, who then distribute to their network in China. Chemist warehouse (CWH) is the key equity-linked partner in this channel. BUB entered into a four year agreement in April 2019 with CWH, commencing June 2019. Bubs has an obligation to pay a fee to CWH for marketing support and promotional services. This fee will be payable by the issuance of ordinary shares in BUB, being a maximum of 49,426,508 fully paid ordinary shares.

In China, BUB's IF products are selling directly through cross-border e-commerce channels and the O2O (online to offline) channel. BUB has not been able to distribute IF products in offline channels yet in the absence of SAMR registration. BUB's baby food range is already sold in around 500 stores in China in addition to online channels. Beingmate is the key JV partner in this channel. In Mar 19, BUB formed a JV with Beingmate (SZSE-listed), which will be responsible for the marketing and distribution of BUB products in China. BUB will supply infant formula and organic baby food products to Beingmate's distribution network covering 30,000 Mother and Baby stores throughout China. The JV announced its first project, a strategic partnership with Kidswant who is the largest MBS store chain to distribute BUB's baby food products through its network.

Figure 4: Fair value of the shares expected to be issued to CWH as at FY19

	Tranche 1	Tranche 2	Tranche 3	Tranche 4	Tranche 5	Total
Grant Date	18-Apr-19	18-Apr-19	18-Apr-19	18-Apr-19	18-Apr-19	
Share price at grant date	$ 0.87	$ 0.87	$ 0.87	$ 0.87	$ 0.87	
Time to maturity	2 months	5 months - 10 months	1.1 years	2.1 years	3.1 years	
Expected dividend	Nil	Nil	Nil	Nil	Nil	
Value per share ($)	$ 0.87	$ 0.87	$ 0.35	$ 0.26	$ 0.17	
Number of shares	2,974,272	9,382,355	12,356,627	12,356,627	12,356,627	49,426,508
Total value of shares	$ 2,587,616	$ 8,162,649	$ 4,300,106	$ 3,225,080	$ 2,150,053	$ 20,425,504

Source: BUB

Raw material supply & Manufacturing

For the core goat milk IF product, BUB has an exclusive long-term Australian and New Zealand milk supply agreement, which was first entered into in 2017 as part of the Nulac Foods acquisition. While the farmers still own the herd, BUB has a call option over the Australian goat farms. In addition, BUB entered into a long-term supply agreement with Tatura (BGA) to convert fresh goat milk directly from farm gate into IF nutritional base in one step, without intermediate spray dry to whole milk powder. The products are canned at Deloraine which BUB acquired in April 2019. BUB has occupied 2 out of 3 brand slots under SAMR registration at Deloraine.

For the adult goat product, BUB entered into an agreement with Central Dairy Goats (NZ) in Dec 18 for the sourcing and manufacturing of CapriLac range of adult milk powders.

Forecasts

Segment sales

A summary of segment sales is provided below.

Segment sales summary						
Year-end June (AUD)		**FY18**	**FY19**	**FY20e**	**FY21e**	**FY22e**
Infant formula	$M	5.0	18.9	41.7	83.3	150.0
- growth	%	n/a	278.0%	120.0%	100.0%	80.0%
Baby Organic Food	$M	1.7	2.7	3.5	4.6	6.0
- growth	%	n/a	59.5%	30.0%	30.0%	30.0%
Caprilac Powder	$M	6.7	15.6	18.0	19.7	20.7
- growth	%	n/a	133.5%	15.0%	10.0%	5.0%
Fresh Dairy Products	$M	3.4	5.9	6.2	6.5	6.9
- growth	%	n/a	74.9%	5.0%	5.0%	5.0%
Raw materials	$M	0.1	0.3	0.4	0.4	0.4
- growth	%	n/a	187.8%	5.0%	5.0%	5.0%
Canning services	$M	0.0	0.4	0.4	0.4	0.4
- growth	%	n/a	n/a	5.0%	0.0%	0.0%
Group sales revenue	**$M**	**16.9**	**43.9**	**70.1**	**115.0**	**184.3**
- growth	**%**	329.9%	159.8%	59.7%	63.9%	60.3%

Source: BUB & Wilsons.

Infant formula

We assume strong growth to continue, driven by brand penetration and introduction of new channels (i.e. corporate Daigou and offline China upon receipt of SAMR registration).

CapriLac powder

We assume growth at ~10%, with growing demand and initiatives from the partnership with Alibaba.

Group income statement

A summary of BUB's group income statement is provided in the table below.

Earnings summary								
Year-end June (AUD)		**FY16**	**FY17**	**FY18**	**FY19**	**FY20e**	**FY21e**	**FY22e**
Group sales	**$M**	**3.7**	**3.9**	**16.9**	**43.9**	**70.1**	**115.0**	**184.3**
- growth	*%*	*101%*	*7%*	*330%*	*160%*	*60%*	*64%*	*60%*
Gross profit	**$M**	**0.8**	**0.9**	**2.1**	**9.1**	**22.5**	**40.3**	**64.6**
- growth	*%*	*55%*	*3%*	*145%*	*329%*	*147%*	*79%*	*60%*
- margin	*%*	*23.1%*	*22.1%*	*12.6%*	*20.8%*	*32.1%*	*35.1%*	*35.1%*
Distribution & selling	$M	0.2	0.3	0.9	1.5	2.1	3.2	4.8
- growth	*%*	*8%*	*12%*	*216%*	*71%*	*43%*	*53%*	*49%*
- % of sales	*%*	*6.6%*	*6.9%*	*5.1%*	*3.3%*	*3.0%*	*2.8%*	*2.6%*
Employee	$M	0.8	1.3	2.5	4.8	5.5	6.3	9.2
- growth	*%*	*584%*	*62%*	*98%*	*92%*	*15%*	*16%*	*46%*
- % of sales	*%*	*21.2%*	*31.9%*	*14.7%*	*10.8%*	*7.8%*	*5.5%*	*5.0%*
Marketing & promotion	$M	0.4	0.8	0.9	4.1	6.5	11.5	18.4
- growth	*%*	*1862%*	*108%*	*5%*	*374%*	*59%*	*78%*	*60%*
- % of sales	*%*	*10.7%*	*20.6%*	*5.1%*	*9.2%*	*9.2%*	*10.0%*	*10.0%*
Occupancy	$M	0.1	0.1	0.4	0.4	0.4	0.5	0.6
- growth	*%*	*98%*	*101%*	*175%*	*3%*	*10%*	*23%*	*7%*
- % of sales	*%*	*1.8%*	*3.4%*	*2.2%*	*0.9%*	*0.6%*	*0.5%*	*0.3%*
Other	$M	0.4	1.1	3.9	4.3	4.9	6.3	8.3
- growth	*%*	*22%*	*175%*	*266%*	*11%*	*13%*	*29%*	*31%*
- % of sales	*%*	*10.7%*	*27.3%*	*23.2%*	*9.9%*	*7.0%*	*5.5%*	*4.5%*
Total expenses	**$M**	**1.9**	**3.5**	**8.5**	**15.0**	**19.4**	**27.9**	**41.3**
- growth	*%*	*162%*	*90%*	*140%*	*77%*	*29%*	*44%*	*48%*
- margin	*%*	*51.0%*	*90.2%*	*50.2%*	*34.2%*	*27.6%*	*24.3%*	*22.4%*
EBITDA	**$M**	**(1.0)**	**(2.7)**	**(6.4)**	**(5.9)**	**3.2**	**12.5**	**23.3**
- growth	*%*	*510%*	*162%*	*138%*	*(7%)*	*(154%)*	*n/a*	*87%*
- margin	*%*	*n/a*	*n/a*	*n/a*	*n/a*	*4.5%*	*10.8%*	*12.7%*
Depreciation / amortisation	$M	0.1	0.1	0.3	1.2	2.1	2.2	2.3
EBIT	**$M**	**(1.1)**	**(2.8)**	**(6.7)**	**(7.1)**	**1.1**	**10.3**	**21.1**
- growth	*%*	*346%*	*152%*	*139%*	*6%*	*(115%)*	*n/a*	*105%*
- margin	*%*	*n/a*	*n/a*	*n/a*	*n/a*	*1.5%*	*8.9%*	*11.4%*

Source: BUB & Wilsons.

Gross profit

We expect gross profit margin to improve, reflecting the new manufacturing technology (i.e. one-step conversion from liquid to base powder) and scale benefit.

Opex

We expect opex continue to grow in dollar terms as sales grow, largely driven by marketing spend and employee expenses. But we expect opex as a % of sales to decrease as the business scales up.

Tax expense

We broadly assume an effective group tax rate of ~30%.

FY20 guidance

- Strong sales growth to continue
- A full year profit
- Marketing spend (as a % of sales) in line with pcp

Cash flow statement

A summary of BUB's cash flow and working capital is provided in the tables below.

Cash Flow Summary								
Year-end June (AUD)		**FY16**	**FY17**	**FY18**	**FY19**	**FY20e**	**FY21e**	**FY22e**
EBITDA	$M	(1.0)	(2.7)	(6.4)	(5.9)	3.2	12.5	23.3
Less net interest expense	$M	(0.2)	(0.0)	(0.0)	0.2	0.3	0.3	0.3
Less tax expense	$M	0.0	0.0	0.0	0.0	0.0	(0.4)	(3.3)
Dec / (Inc) working capital	$M	(1.8)	1.3	(3.9)	(16.4)	(8.6)	(10.4)	(15.1)
Other	$M	3.0	(0.7)	(2.4)	(3.0)	0.0	0.0	0.0
Operating Cash Flow	**$M**	**0.0**	**(2.1)**	**(12.8)**	**(25.1)**	**(5.1)**	**1.9**	**5.2**
Capex	$M	(0.1)	(0.0)	(0.0)	(0.1)	(0.5)	(1.1)	(1.5)
Acquisition / divestment	$M	(0.0)	5.5	(25.0)	(14.9)	0.0	0.0	0.0
Investing Cash Flow	**$M**	**(0.1)**	**5.5**	**(25.0)**	**(14.9)**	**(0.5)**	**(1.1)**	**(1.5)**
Equity raised	$M	6.4	(0.1)	71.7	32.7	0.0	0.0	0.0
Inc / (dec) in debt	$M	(1.3)	(0.0)	(0.6)	(8.8)	0.0	0.0	0.0
Dividends paid	$M	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	$M	0.0	0.0	0.0	0.8	0.0	0.0	0.0
Financing Cash Flow	**$M**	**5.2**	**(0.2)**	**71.1**	**24.7**	**0.0**	**0.0**	**0.0**
Net Cash Flow	$M	5.1	3.2	33.3	(15.4)	(5.6)	0.8	3.7

Source: BUB & Wilsons.

Working capital								
Year-end June (AUD)		**FY16**	**FY17**	**FY18**	**FY19**	**FY20e**	**FY21e**	**FY22e**
Receivables	$M	0.8	0.9	4.0	15.6	22.8	28.7	36.9
Inventory	$M	2.5	1.0	6.0	14.6	24.5	40.2	64.5
Payables	$M	(1.1)	(1.1)	(5.3)	(8.9)	(17.5)	(28.7)	(46.1)
Total	**$M**	**2.1**	**0.8**	**4.7**	**21.2**	**29.8**	**40.2**	**55.3**
- growth	*%*	*594%*	*-62%*	*496%*	*348%*	*41%*	*35%*	*37%*
- % of sales	*%*	*57%*	*20%*	*28%*	*48%*	*43%*	*35%*	*30%*

Source: BUB & Wilsons.

Working capital

We assume working capital remains grows in dollar terms as sales grow, but reduce moderately as a % of sales as BUB becomes more efficient at managing WC.

Capex

We assume underlying capex broadly in line with depreciation and amortisation.

Dividends

We assume nil dividend.

Balance sheet

A summary of BUB's balance sheet is provided in the table below.

Balance sheet								
Year-end June (AUD)		**FY16**	**FY17**	**FY18**	**FY19**	**FY20e**	**FY21e**	**FY22e**
Working capital	$M	2.1	0.8	4.7	21.2	29.8	40.2	55.3
Property, Plant & Equipment	$M	0.1	0.1	0.0	4.2	2.6	1.5	0.8
Intangibles	$M	1.3	1.3	33.0	91.8	91.8	91.8	91.8
Other Assets / (Liabilities)	$M	(0.2)	0.1	(1.9)	(32.8)	(33.2)	(36.0)	(39.0)
Total capital employed	**$M**	**3.3**	**2.2**	**35.9**	**84.4**	**90.9**	**97.6**	**108.8**
Net debt / (cash)	**$M**	**(2.0)**	**(5.3)**	**(36.6)**	**(21.3)**	**(15.7)**	**(16.4)**	**(20.1)**
Total equity	$M	5.3	7.5	72.5	105.7	106.6	114.0	129.0
ND / ND + E	**%**	**(61.9%)**	**(239.3%)**	**(102.1%)**	**(25.2%)**	**(17.2%)**	**(16.8%)**	**(18.5%)**
ND / EBITDA	x	2.0x	2.0x	5.8x	3.6x	(4.9x)	(1.3x)	(0.9x)
EBIT / Net interest expense	**x**	**(5.5x)**	**15519.8x**	**(34.2x)**	**25.1x**	**(3.6x)**	**(34.2x)**	**(70.2x)**
NTA p/share	$	$159.60	$0.03	$0.09	$0.03	$0.03	$0.05	$0.08

Source: BUB & Wilsons.

- BUB's balance sheet primarily consists of working capital and intangibles (predominately goodwill associated with acquisitions and license associated with Deloraine).
- We expect BUB to maintain its net cash position over the forecast years.

Valuation

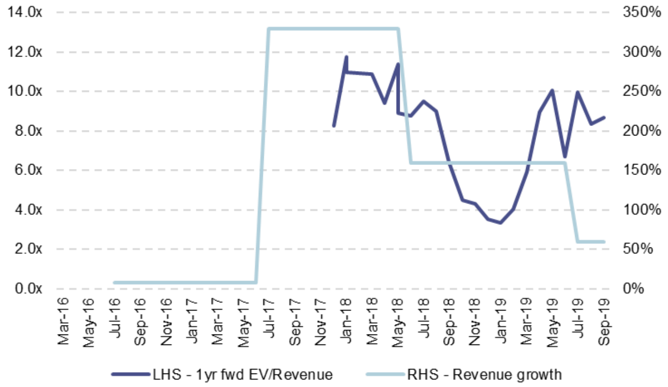
Earnings / revenue capitalisation

We value BUB at $1.30p/share. This is based on an FY20 EV / Revenue of 8.0x. We expect ~60% sales growth over the next 3 years. A2M has been trading at 6-8x 1 year forward revenue over the last 2 years, re-rated from ~3x in FY14-15 when IF sales were at a similar run-rate to BUB's current level as the market becomes more aware of the significant growth opportunity.

Figure 5: Earnings capitalisation valuation

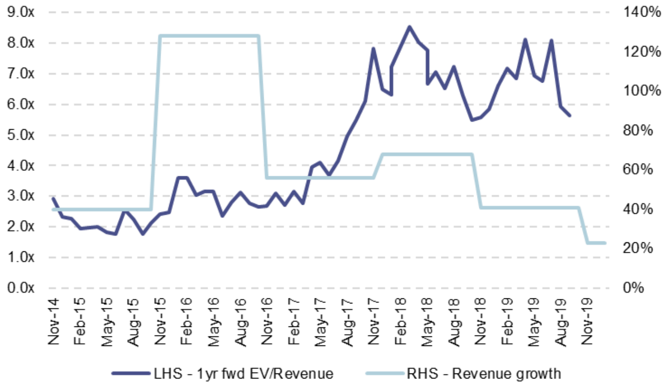
Valuation summary								
Year-end June (AUD)		**BUB**	**FY18**	**FY19**	**FY20e**	**FY21e**	**FY22e**
Share price (current)	**$**	**$1.34**					
- EV / Revenue	x		23.6x	13.4x	8.2x	5.2x	3.3x
- EV / EBITDA	x		(62.6x)	(99.5x)	180.6x	48.0x	26.4x
- EV / EBIT	x		(59.7x)	(82.9x)	539.8x	58.3x	29.2x
- PER	x		(84.1x)	(95.3x)	618.3x	80.9x	41.1x
- PEG	x		(5.2x)	8.1x	(5.4x)	0.1x	0.4x
- Yield	%		-%	-%	-%	-%	-%
Wilsons valuation	**$**	**$1.30**					
- EV / Revenue	x		22.9x	13.0x	**8.0x**	4.9x	3.1x
- EV / EBITDA	x		(60.8x)	(96.8x)	175.8x	45.5x	24.8x
- EV / EBIT	x		(58.0x)	(80.7x)	525.2x	55.2x	27.5x
- PER	x		(81.9x)	(92.8x)	602.0x	78.8x	40.1x
- PEG	x		(5.1x)	7.9x	(5.2x)	0.1x	0.4x
- Yield	%		-%	-%	-%	-%	-%

Figure 6: 1 year forward EV/Revenue vs revenue growth - BUB



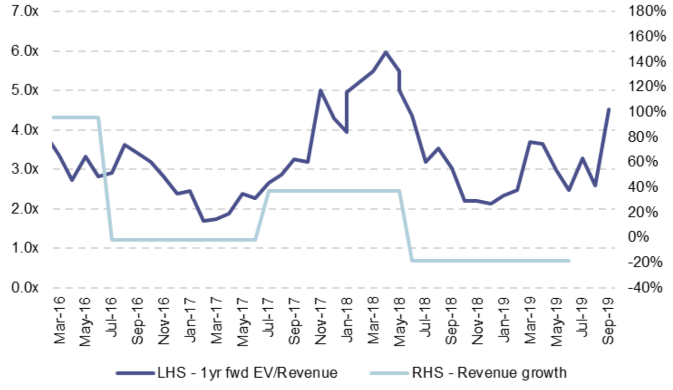
Source: Capital IQ & Wilsons

Figure 7: 1 year forward EV/Revenue vs revenue growth – A2M



Source: Capital IQ & Wilsons

Figure 8: 1 year forward EV/Revenue vs revenue growth - BAL



Source: Capital IQ & Wilsons

Bubs Australia Limited (BUB)

Business description

Bubs Australia is a premium goat milk products and organic baby food brand. It outsources majority of the manufacturing. Following the acquisition of Deloraine in 2019, BUB now internalises canning and blending.

Investment thesis

We initiate coverage on BUB with a HOLD rating and a 12-mth target of $1.30p/share. BUB is well positioned to capitalise on the IF (infant formula) demand in China, supported by its niche goat IF product positioning and various key relationships (i.e. Chemist warehouse, Alibaba, Beingmate) in the ecosystem. While we see significant growth opportunity, the industry remains highly competitive and building brand awareness remains a key challenge for BUB.

Revenue drivers

- Birth rate
- Brand awareness
- Channel penetration
- Registration

Balance sheet

- FY19 Net cash of $21M

Margin drivers

- Sales mix
- Raw material prices
- Marketing spend
- Efficiency of scale

Board

- Dennis Lin – Chainman
- Kristy Carr – Founder CEO, Executive director
- Matthew Reynolds – Non-executive director
- Steve Lin - Non-executive director
- Jay Stephenson – Company secretary

Key issues/catalysts

- Channels / market access
- ROI from increased market spend
- Takeover
- Registration approval

Management

- Kristy Carr – CEO
- Iris Ren – CFO
- Anthony Gualdi – Co-founder and Director of special projects
- David Orton – GM Commercial
- Vivian Zurlo – GM Marketing
- Richard Paine – GM Dairy operations

Risk to view

- Product quality
- Supply constraints
- Market access
- Intellectual property
- Key customer / supplier risk

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Disclaimers and disclosures

Recommendation structure and other definitions

Definitions at wilsonsadvisory.com.au/Disclosures.

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