



Mengniu (2319 HK)

Racing against stronger competitors

- Topline growth accelerated in 2H16 on strong growth of liquid milk segment and the recovery of ice cream segment
- Competitors are getting stronger, as evidenced by their growing market shares that catch up with that of Mengniu
- Impairment of goodwill led to a net loss in FY16, but decline of core profitability reflects increasing SG&A expenses
- Downgrade to **SELL**; current TP represents FY17E/18E P/E of 35.92x/31.46x, and FY17E/18E P/B of 2.27x/2.16x

Topline growth accelerated in 2H16. The Group's FY16 revenue was up 9.69% YoY, higher than the 6.62% YoY increase in 1H16. This result is mostly in line with our estimated growth of 9.08% YoY. Revenue from the liquid milk segment was up 11% YoY while growth of the ice cream segment recovered to 1.81% YoY. Dependence on the liquid milk product segment increased as it contributed to 89.4% of FY16 revenue (FY15: 88.4%).

Racing against stronger competitors. The Group's market share was stable in FY16 but competitors have been catching up fast. The Chinese dairy market was consolidating in FY16. According to data cited by Mengniu, its liquid milk market share in 2016 stayed flat at 27.4% while Yili's share edged up from 25.7% to 26.8%. The Group's UHT product market share increased slightly to 27.9%; for Yili, the figure rose from 29.6% to 31.3%; the cluster of brands other than the top 4 had a joint share of 32% in the liquid milk market vs. 30.9% in FY15. We expect industry competition would intensify, assuming that growth in the Chinese dairy product market would slow.

Declining profitability can be attributed partially to goodwill impairment. In FY16, Mengniu recorded a goodwill impairment of RMB 2,253.76mn due to the underperforming business of Yashili. This resulted in a net loss (to owners of the Company) of RMB 751.16mn. According to the Group, its core net profit (excluding Yashili and impairment of goodwill) was RMB 1,686.9mn, down 27.6% YoY; core EBITDA (excluding Yashili and impairment of goodwill) was RMB 3,524.7mn, down 6.8% YoY. The decline in core profitability was driven by the increase in S&D and admin expenses, which rose by 22.3% YoY and 32.1% YoY in FY16, more than the gross profit growth of 14.7% YoY. The resulting core GPM, EBITDA margin, and NPM (for owners of the Company) were 32.2%, 6.8%, 3.3% in FY16 vs. 30.4%, 9.0% and 5.0% in FY15. We believe intensifying competition has driven up marketing and promotional expenses.

Downgrade to SELL, TP at HK\$ 14.16. With the Group's core profitability declining in FY16, our concerns over its product competitiveness increase. Our future earnings projection also indicates the Group is currently overvalued. Downgrade to **SELL** and lower TP to HK\$14.16 as we expect the rising market competition would lead to higher SG&A expense and margin contraction. Current TP represents FY17E/18E P/E of 35.92x/31.46x, and FY17E/18E P/B of 2.27x/2.16x.

Risk factors: 1) Macroeconomic risk; 2) Commodity price risk; 3) Food safety risk; 4) M&A risk, 5) Product concentration risk; 6) Product competitiveness risk

Results and Valuation

FY ended Dec 31	2015A	2016A	2017E	2018E	2019E
Revenue (RMB mn)	49,027	53,779	57,754	63,182	68,400
Chg (% YoY)	(2.04)	9.69	7.39	9.40	8.26
Net Profit (RMB mn)	2,367	(751)	1,372	1,568	1,665
Chg (% YoY)	0.70	(131.73)	N/A	14.23	6.22
Basic EPS (RMB)	0.61	(0.19)	0.35	0.40	0.42
Chg (% YoY)	0.66	(131.69)	N/A	14.17	6.22
P/E (x)	20.50	N/A	39.62	34.70	32.67
BVPS (RMB)	5.63	5.30	5.54	5.80	6.06
P/B (x)	2.22	2.62	2.50	2.39	2.29
DPS (RMB)	0.14	0.09	0.07	0.08	0.09
Yield (%)	0.90	0.57	0.48	0.54	0.58
ROAA (%)	4.84	(1.51)	2.70	2.88	2.89
ROAE (%)	10.85	(3.50)	6.44	7.04	7.15

Source(s): Bloomberg, ABCI Securities estimates

Company Report

Apr 10, 2017

Rating: **SELL**

TP: HK\$ 14.16

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Share price (HK\$)	15.26
Est. share price return	(7.21%)
Est. dividend yield	0.48%
Est. total return	(6.73%)
Previous Rating&TP	HOLD;HK\$14.53
Previous report date	Sep 26, 2016

Source(s): Bloomberg, ABCI Securities

Key Data

52Wk H/L(HK\$)	16.82/12
Issued shares (mn)	3,925.03
Market cap (HK\$ mn)	59,895.91
3-mth ADT (HK\$ mn)	148.87

Major shareholders	(%)
COFCO	31.46
Danone S.A.	31.54
Commonwealth Bank of Australia	10.85
JP Morgan Chase &Co.	6.89

Source(s): Bloomberg, HKEX

% of total revenue	FY17E
Liquid milk	89.97
Ice cream	3.87
Milk formula	5.60

Source(s): ABCI Securities estimates

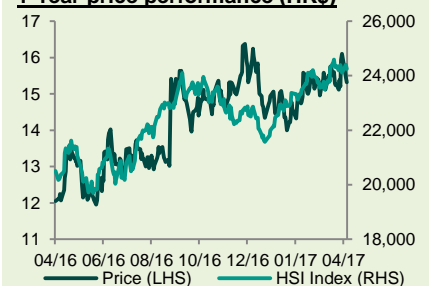
Sector Performance (%)

	Absolute	Relative*
1-mth	0.93	(2.24)
3-mth	3.25	(4.14)
6-mth	2.55	(0.16)

* Relative to HSI

Source(s): Bloomberg, ABCI Securities

1-Year price performance (HK\$)



Source(s): Bloomberg, ABCI Securities

* All pricing and market data as of closing of Apr 7, 2017



Consolidated income statement (2015A-2019E)

FY ends at Dec 31 (MB mn, except per share data)	2015A	2016A	2017E	2018E	2019E
Revenue	49,027	53,779	57,754	63,182	68,400
- Liquid milk	43,327	48,103	51,960	57,203	62,222
- Ice cream	2,141	2,180	2,238	2,245	2,271
- Milk formula	3,229	3,151	3,233	3,394	3,564
- Others	330	314	324	340	343
COGS	(33,651)	(36,144)	(39,181)	(42,932)	(46,283)
Gross profit	15,375	17,635	18,574	20,250	22,117
Other income	521	702	596	652	706
SG&A	(12,856)	(15,907)	(16,892)	(18,326)	(20,043)
Other expenses	(393)	(2,851)	(462)	(505)	(547)
Operating profit	2,648	(420)	1,816	2,071	2,233
Net finance cost	245	184	196	215	200
Share of profits from JV and associates	138	(225)	(242)	(265)	(287)
Pretax profit	3,030	(461)	1,771	2,021	2,146
Tax	(510)	(351)	(295)	(335)	(355)
Profit from discontinued operation	0	0	0	0	0
Net profit	2,520	(813)	1,476	1,686	1,790
- Profit attributable to shareholders	2,367	(751)	1,372	1,568	1,665
- Minority interest	153	(62)	183	209	221
EPS (RMB)					
- Basic	0.61	(0.19)	0.35	0.40	0.42
- Diluted	0.61	(0.19)	0.35	0.40	0.42
DPS (RMB)	0.14	0.09	0.07	0.08	0.09

Source(s): Company, ABCI Securities estimates

Consolidated balance sheet (2015A-2019E)

FY ends at Dec 31 (RMB mn)	2015A	2016A	2017E	2018E	2019E
Cash and cash equivalent	7,931	6,070	8,590	7,994	7,744
Trade and bills receivable	1,618	2,340	2,151	2,639	2,343
Inventory	4,340	3,314	4,975	5,249	5,805
Others	8,532	7,731	7,272	7,664	7,736
Total current assets	22,420	19,456	22,988	23,546	23,629
PP&E	12,539	13,970	13,236	14,376	15,176
Land use rights	889	984	1,252	1,341	1,430
Goodwill	5,851	4,528	4,528	4,528	4,528
Other Intangible assets	1,731	2,086	1,779	1,831	1,866
Others	7,223	10,023	10,712	12,377	14,263
Total non-current assets	28,232	29,504	29,727	32,621	35,396
Total assets	50,653	48,960	52,715	56,167	59,025
Trade and bills payable	4,644	5,406	6,290	6,242	7,342
ST borrowings	6,081	3,045	5,574	6,682	9,812
Others	5,251	6,852	5,649	6,368	6,039
Total current liabilities	15,976	15,303	17,513	19,292	23,192
LT Borrowings	4,970	5,542	4,967	4,969	1,958
Others	3,092	2,776	3,725	4,257	5,091
Total non-current liabilities	8,061	8,318	8,692	9,225	7,049
Shareholders' equity	22,136	20,845	21,755	22,783	23,797
Minority interest	4,479	4,659	4,756	4,867	4,986
Total equity	26,615	25,504	26,511	27,650	28,783
Total liabilities and equity	50,653	49,124	52,715	56,167	59,025

Source(s): Company, ABCI Securities estimates



Consolidated cash flow statement (2015A-2019E)

FY ends at Dec 31 (RMB mn)	2015A	2016E	2017E	2018E	2019E
Pretax profit	3,030	(461)	1,771	2,021	2,146
Depreciation and amortization	1,444	1,739	2,003	2,259	2,561
Change in working capital	(1,063)	3,010	(1,552)	21	355
Others	(1,502)	2,003	(194)	(256)	(224)
Cash flow from operating activities	1,909	6,289	2,028	4,045	4,838
Capex	(3,027)	(4,353)	(3,532)	(4,854)	(5,324)
Others	3,564	4,648	2,993	3,546	3,672
Cash flow from investing activities	537	295	(539)	(1,308)	(1,653)
Change in borrowings	882	(1,193)	684	1,109	120
Dividends paid	(655)	(622)	(349)	(378)	(427)
Others	462	(186)	(173)	(249)	(228)
Cash flow from financing activities	689	(2,000)	162	483	(535)
Net change in cash	3,135	4,585	1,651	3,220	2,650
Forex effect	93	(82)	(26)	(24)	(52)
Cash and cash equivalent - end	6,834	11,336	12,961	16,157	18,754

Source(s): Company, ABCI Securities estimates

Key operating and financial ratios (2015A-2019E)

FY ends at Dec 31	2015A	2016A	2017E	2018E	2019E
Growth (YoY %)					
Revenue	(2.04)	9.69	7.39	9.40	8.26
Liquid milk	0.67	11.02	8.02	10.09	8.77
- UHT milk	(9.86)	11.64	0.85	4.27	2.75
- Milk beverage	(12.46)	(10.11)	6.00	3.27	0.66
- Yogurt	55.48	29.00	20.80	21.66	19.51
Ice cream	(21.17)	1.81	2.66	0.31	1.16
Milk powder	(18.48)	(2.41)	2.59	5.00	5.00
Other products	(1.83)	4.77	(6.39)	5.00	1.07
Gross profit	(0.38)	14.70	5.32	9.02	9.22
Operating profit	(0.63)	(115.86)	N/A	14.01	7.82
Net profit (to owners of the Group)	0.70	(131.73)	N/A	14.23	6.22
Profitability ratios (%)					
GPM	31.36	32.79	32.16	32.05	32.33
OPM	5.40	(0.78)	3.14	3.28	3.26
EBITDA margin	8.63	1.78	6.61	6.85	7.01
NPM (to owners of the Group)	4.83	(1.40)	2.38	2.48	2.43
Return ratios (%)					
ROAA	4.84	(1.51)	2.70	2.88	2.89
ROAE	10.85	(3.50)	6.44	7.04	7.15
ROIC	9.27	(3.15)	6.02	6.49	6.52
Liquidity ratio (x)					
Current ratio	1.40	1.27	1.31	1.22	1.02
Quick ratio	1.13	1.05	1.03	0.95	0.77
Cash ratio	0.54	0.45	0.54	0.46	0.38
Cash conversion cycle (days)					
Days of outstanding receivable	10.30	13.43	14.19	13.84	13.29
Days of inventory on hand	47.08	38.65	38.61	43.46	43.59
Days of outstanding payable	52.26	52.23	52.26	52.94	52.93
CCC	5.12	(0.15)	0.54	4.36	3.95
Leverage ratios (%)					
Total debt/Equity	41.52	38.86	40.19	42.52	41.36
Total debt/Total assets	21.82	20.13	20.00	20.74	19.94

Source(s): Company, ABCI Securities estimates



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Definition of equity rating

Rating	Definition
Buy	Stock return \geq Market return rate
Hold	Market return - 6% \leq Stock return < Market return rate
Sell	Stock return < Market return - 6%

Stock return is defined as the expected % change of share price plus gross dividend yield over the next 12 months

Market return: 5-year average market return rate

Time horizon of share price target: 12-month

Definition of share price risk

Rating	Definition
Very high	$2.6 \leq 180$ day volatility/180 day benchmark index volatility
High	$1.5 \leq 180$ day volatility/180 day benchmark index volatility < 2.6
Medium	$1.0 \leq 180$ day volatility/180 day benchmark index volatility < 1.5
Low	180 day volatility/180 day benchmark index volatility < 1.0

We measure share price risk by its volatility relative to volatility of benchmark index. Benchmark index: Hang Seng Index. Volatility is calculated from the standard deviation of day to day logarithmic historic price change. The 180-day price volatility equals the annualized standard deviation of the relative price change for the 180 most recent trading days closing price.

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