Sep 26, 2016
Company Report
Rating: HOLD
TP: HK$ 14.53

Share price (HK$)	14.32
Est. share price return	1.47%
Est. dividend yield	0.78%
Est. total return	2.25%
Previous Rating	HOLD
Previous TP	HK$ 13.78

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Key Data

52Wk H/L(HK$)	16.08/10.5
Outstanding shares (mn)	3,922.23
Market cap (HK$ mn)	56,166.35
3-mth avg daily turnover (HK$ mn)	143.53
Major shareholder(s) (%):	
COFCO Dairy Investment Ltd.	23.91
Commonwealth Bank of Australia	13.97
Prominent Achiever Ltd.	7.55
JP Morgan Chase & Co.	6.88

Source(s): Bloomberg, ABCI Securities

Revenue contribution of business segments

(%)	1H15	1H16
Liquid milk	85.83	87.18
- UHT milk	41.90	42.24
- Milk beverage	22.13	18.04
- Yogurt	21.80	26.90
Ice cream	6.43	6.25
Milk formula	6.98	6.09
Other revenue	0.01	0.00

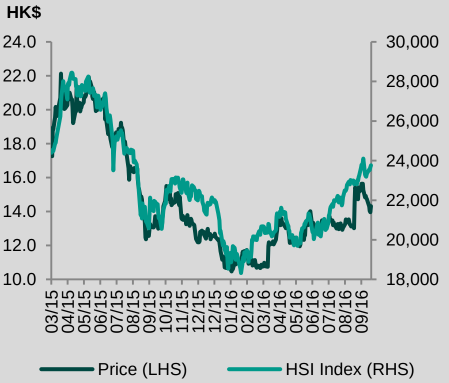
Source(s): The Group, ABCI Securities

Share price performance (%)

	Absolute	Relative*
1-mth	8.65	4.85
3-mth	8.32	(7.19)
6-mth	32.72	14.24

*Relative to HSI
Source(s): Bloomberg, ABCI Securities

Stock performance



Source(s): Bloomberg, ABCI Securities

* All market data as of closing of Sep 22, 2016

Mengniu (2319 HK)

Topline growth beat Yili's at the expense of profitability

- Mengniu's 1H16 revenue growth improved significantly with liquid milk as the biggest growth driver. The Group's leadership position has been consolidated further
- Bottom line suffered due to increased S&D expenses, showing the Group's topline growth was partially driven by heavier promotions. This casts doubts on the sustainability of growth momentum
- The lack of new product innovation, underwhelming performance of the milk powder segment, and the lackluster consumer market environment would continue to weigh on the Group's share price
- TP adjusted to HK$ 14.53 to reflect higher revenue growth; maintain **HOLD**

Growth at the expense of profitability. Mengniu's 1H16 revenue grew by 6.62% YoY, with liquid milk as the major growth driver (+8.30% YoY). However, the Group's profitability declined with its OPM and NPM falling from 5.76% YoY and 5.24% YoY in 1H15 to 5.60% YoY and 3.95% YoY in 1H16. We believe the Group was trading profitability for higher growth and a bigger market share, which is damaging to shareholders in the long term.

Overreliance on liquid milk segment presents risk. In 1H16, the Group's liquid milk products contributed to 87.18% of total sales (1H15: 85.83%), and the UHT milk product contributed to 42.24% of total sales (1H15: 41.90%). According to the Group, its market share of liquid milk and UHT milk improved to 27.4% and 28.4% in 1H16 from 27.1% and 27.5% in 2H15. Yet, the milk formula segment, whose revenue declined by 6.92% YoY and contributed to 6.09% to total, continued to disappoint due to the lack of a turnaround in Yashili's business amid unfavorable industry sentiment. Higher reliance on liquid milk, especially the UHT milk, presents a major risk to the Group.

Working capital management – a mixed picture. Management of working capital improved as CCC declined to -3.39 days compared to 1.95 days in 1H15. However, the Group's payable turnover days increased to 58.03 in 1H16 from 54.02 in 1H15, showing difficulties in making on-time payment to suppliers amid the tough market condition. The extension of receivable turnover days to 15.22 may mean increased leniency to distributors to boost product sales.

A mixed outlook with uncertainties. We believe intensifying competition in the dairy product markets would dampen the growth outlook for industry players. The practice of trading profitability for growth is risky and the limited, short-term gain would not compensate for the downside associated with the lack of progress in balancing product portfolio or reforming distribution channels. In addition, the recent management change would be a risk factor as the new CEO, Mr. Minfang Lu, who was the former CEO of Yashili, has a rather short and, in our opinion, lackluster track record.

Maintain HOLD with TP of HK$ 14.53. We revise the Group's valuation based on its mixed performance in revenue growth and profitability. We remain cautiously optimistic on the Group's outlook and set TP at HK$ 14.53, which represents 24.13x 2016E P/E or 25.57x 2017E P/E, and 2.09x 2016E P/B or 1.98x 2017E P/B. Maintain **HOLD**.

Results and Valuation

FY ended Dec 31	FY14A	FY15A	FY16E	FY17E	FY18E
Revenue (RMB mn)	**50,049.24**	**49,026.52**	**53,476.60**	**59,037.65**	**64,649.65**
Chg (%,YoY)	*15.44*	*-2.04*	*9.08*	*10.40*	*9.51*
Net Profit (RMB mn)	**2,350.80**	**2,367.29**	**2,031.23**	**1,916.39**	**2,786.17**
Chg (%,YoY)	*44.14*	*0.70*	*-14.20*	*-5.65*	*45.39*
Basic EPS (RMB)	**0.61**	**0.61**	**0.52**	**0.49**	**0.71**
P/E (x)	*18.94*	*18.80*	*23.78*	*25.20*	*17.33*
BVPS (RMB)	5.52	5.63	5.99	6.31	6.78
P/B (x)	*2.07*	*2.03*	*2.06*	*1.95*	*1.82*
DPS(RMB)	0.14	0.14	0.11	0.10	0.15
Yield (%)	*0.98*	*0.98*	*0.78*	*0.73*	*1.04*
ROAA (%)	5.38	4.84	3.85	3.43	4.62
ROAE (%)	12.76	10.85	8.89	7.93	10.83

Source(s): The Group, Bloomberg, ABCI Securities estimates

Appendix: Financial Statements of the Group

Consolidated income statement (FY14A-FY18E)

FY ends at Dec 31 (RMB mn, excl. EPS & DPS)	FY14A	FY15A	FY16E	FY17E	FY18E	1H15A	1H16A
Revenue	**50,049.24**	**49,026.52**	**53,476.60**	**59,037.65**	**64,649.65**	**25,564.41**	**27,257.15**
- Liquid milk	43,036.16	43,326.64	47,869.40	53,324.95	58,711.91	21,940.95	23,761.52
- Ice cream	2,716.10	2,141.19	2,146.25	2,162.27	2,209.79	1,644.27	1,703.33
- Milk formula	3,960.96	3,228.80	3,146.84	3,226.89	3,388.24	1,783.49	1,660.04
- Other revenue	336.02	329.88	314.11	323.54	339.71	195.71	132.27
COGS	(34,615.63)	(33,651.04)	(36,401.52)	(40,051.14)	(43,282.61)	(17,421.60)	(18,075.75)
Gross profit	**15,433.61**	**15,375.47**	**17,075.08**	**18,986.51**	**21,367.04**	**8,142.81**	**9,181.41**
Other income	449.07	521.27	454.34	513.01	561.78	177.61	169.96
SG&A	(12,504.93)	(12,856.29)	(14,956.52)	(17,148.75)	(18,493.04)	(6,658.93)	(7,584.82)
Other expenses	(713.21)	(392.59)	(427.81)	(472.30)	(517.20)	(182.84)	(218.79)
EBIT	**2,664.55**	**2,647.86**	**2,145.09**	**1,878.47**	**2,918.59**	**1,471.75**	**1,525.47**
Net interest expense(-)/income(+)	207.73	244.64	325.45	428.11	490.82	139.15	126.64
Income from associate/JV	277.73	137.67	150.17	165.78	181.54	143.31	(154.56)
Profit before tax	3,150.01	3,030.17	2,620.70	2,472.36	3,590.95	1,754.20	1,497.55
Tax	(459.29)	(510.04)	(436.59)	(411.72)	(595.07)	(321.34)	(313.03)
Profit from discontinued operation	(0.06)	0.12	0.00	0.00	0.00	(0.01)	-
Total net profit	**2,690.65**	**2,520.25**	**2,184.12**	**2,060.64**	**2,995.88**	**1,432.85**	**1,184.52**
- Profit to shareholders	2,350.80	2,367.29	2,031.23	1,916.39	2,786.17	1,338.67	1,077.29
- Minority interest	339.85	152.96	270.99	255.32	371.06	94.18	107.23
EPS (RMB)							
- Basic	0.61	0.61	0.52	0.49	0.71	0.34	0.28
- Diluted	0.60	0.61	0.52	0.49	0.71	0.34	0.28
DPS (RMB)	0.14	0.14	0.11	0.10	0.15	0.00	0.00

Source(s): The Group, ABCI Securities estimates

Consolidated balance sheet (FY14A-FY18E)

FY ends at Dec 31 (RMB mn)	FY14A	FY15A	FY16E	FY17E	FY18E	1H15A	1H16A
Cash and equivalent	4,649.56	7,931.24	11,536.43	11,285.45	14,450.24	8,606.90	5,206.88
Accounts receivables	1,148.19	1,617.76	2,544.58	2,046.78	2,854.96	1,864.04	2,929.61
Inventory	4,342.29	4,339.51	4,051.45	4,581.42	4,418.43	4,289.32	3,468.52
Other current assets	10,192.55	8,531.86	6,661.34	7,580.58	7,404.22	7,796.74	10,106.18
Total current assets	**20,332.59**	**22,420.36**	**24,793.79**	**25,494.23**	**29,127.86**	**22,557.00**	**21,711.19**
PP&E and construction in progress	11,697.41	12,538.92	12,776.45	13,247.63	14,390.83	11,775.95	13,069.53
Land use rights	1,050.57	888.68	1,180.66	1,251.62	1,341.32	1,096.15	967.52
Goodwill & intangibles	7,457.88	7,581.62	7,592.39	7,629.17	7,681.13	7,453.88	8,567.55
Other non-current assets	6,542.35	7,222.97	8,449.19	9,486.33	11,079.05	7,222.35	7,007.13
Total non-current assets	**26,748.20**	**28,232.19**	**29,998.69**	**31,614.75**	**34,492.34**	**27,548.32**	**29,611.73**
Total assets	**47,080.79**	**50,652.54**	**54,792.48**	**57,108.98**	**63,620.19**	**50,105.32**	**51,322.91**
Accounts payables	4,991.85	4,644.30	6,818.50	6,426.09	7,806.15	5,160.71	5,779.87
Short-term debt	4,360.62	6,080.75	5,862.75	6,792.53	8,360.09	5,052.28	6,403.89
Other current liabilities	4,998.68	5,251.33	5,780.56	5,673.31	6,543.59	5,451.43	5,084.28
Total current liabilities	**14,351.15**	**15,976.38**	**18,461.82**	**18,891.93**	**22,709.83**	**15,664.42**	**17,268.04**
Long-term debt	5,464.05	4,969.51	4,968.55	4,975.97	4,980.57	5,416.79	3,768.51
Other non-current liabilities	2,772.72	3,091.50	3,179.13	3,676.24	4,304.50	2,789.70	3,505.03
Total non-current liabilities	**8,236.77**	**8,061.01**	**8,147.68**	**8,652.20**	**9,285.08**	**8,206.49**	**7,273.53**
Total liabilities	**22,587.92**	**24,037.39**	**26,609.50**	**27,544.13**	**31,994.91**	**23,870.91**	**24,541.57**
Equity attributable to shareholders	21,489.40	22,136.24	23,557.76	24,803.79	26,666.31	21,419.09	22,284.23
Minority interest	3,003.47	4,478.92	4,625.22	4,761.06	4,958.97	4,815.32	4,497.11
Equities	**24,492.87**	**26,615.15**	**28,182.98**	**29,564.85**	**31,625.28**	**26,234.41**	**26,781.34**
Total liabilities and equity	**47,080.79**	**50,652.54**	**54,792.48**	**57,108.98**	**63,620.19**	**50,105.32**	**51,322.91**

Source(s): The Group, ABCI Securities estimates

Consolidated cash flow statement (FY14A-FY18E)

FY ends at Dec 31 (RMB mn)	FY14A	FY15A	FY16E	FY17E	FY18E	1H15A	1H16E
Profit before tax	3,149.95	3,030.29	2,620.70	2,472.36	3,590.95	1,754.19	1,497.55
Depreciation and amortization	1,341.72	1,444.29	1,738.83	2,003.29	2,259.99	700.59	784.15
Change in working capital	(478.21)	(1,063.27)	2,145.60	331.93	960.88	455.59	1,059.57
Others	(933.57)	(1,502.12)	(1,263.55)	(1,385.21)	(1,699.66)	(803.10)	(665.97)
Total cash flow from operation	**3,079.89**	**1,909.19**	**5,241.59**	**3,422.37**	**5,112.16**	**2,107.26**	**2,675.30**
CapEx	(3,278.28)	(3,026.92)	(3,113.68)	(3,424.40)	(4,702.77)	(1,439.60)	(2,706.50)
Others	(3,137.08)	3,563.56	3,526.47	3,433.96	3,840.44	2,286.04	3,440.53
Total Cash Flow From investing	**(6,415.36)**	**536.64**	**412.79**	**9.56**	**(862.33)**	**846.44**	**734.03**
Change in debt	(1,945.55)	881.69	(218.96)	937.20	1,572.17	512.08	(877.86)
Dividend paid	(490.95)	(654.72)	(621.54)	(563.67)	(527.60)	(642.19)	0.00
Others	6,055.32	462.07	(148.31)	(239.99)	(248.68)	853.10	(538.69)
Total Cash Flow From Financing	**3,618.83**	**689.05**	**(988.81)**	**133.54**	**795.88**	**722.99**	**(1,416.55)**
Net change in cash	**283.36**	**3,134.88**	**4,665.57**	**3,565.47**	**5,045.72**	**3,676.70**	**1,992.78**
Cash and cash equivalent at beg	**3,354.59**	**3,607.03**	**6,833.61**	**11,421.49**	**14,960.67**	**3,607.03**	**6,833.61**
ForEx change	(30.91)	92.66	(77.68)	(26.29)	(24.18)	207.85	13.86
Cash and cash equivalent at end	**3,607.03**	**6,833.61**	**11,421.49**	**14,960.67**	**19,982.22**	**7,491.58**	**8,840.24**
Time deposit - maturity longer than three months	(1,042.53)	(1,057.40)	114.93	(3,675.22)	(5,531.97)	1,115.32	(3,633.36)
Cash and cash equivalent on Balance Sheet	**4,649.56**	**7,931.24**	**11,536.43**	**11,285.45**	**14,450.24**	**8,606.90**	**5,206.88**

Source(s): The Group, ABCI Securities estimates

Key operating and financial ratios (FY14A-FY18E)

As of Dec 31	FY14A	FY15A	FY16E	FY17E	FY18E	1H15A	1H16A
Growth measures (%)							
Sales growth	15.44	(2.04)	9.08	10.40	9.51	(1.05)	6.62
Liquid milk growth	13.54	0.67	10.48	11.40	10.10	0.81	8.30
- UHT milk growth	7.47	(9.86)	7.48	6.68	4.41	(13.38)	7.50
- Milk beverage growth	14.34	(12.46)	(2.77)	3.79	3.27	(2.89)	(13.11)
- Yogurt growth	36.69	55.48	28.05	23.96	21.66	55.95	31.57
Ice cream growth	(10.16)	(21.17)	0.24	0.75	2.20	(17.31)	3.59
Milk powder growth	81.92	(18.48)	(2.54)	2.54	5.00	(7.77)	(6.92)
Other product growth	32.58	(1.83)	(4.78)	3.00	5.00	31.55	(32.42)
Gross profit growth	31.94	(0.38)	11.05	11.19	12.54	(2.85)	12.75
Operating profit growth	43.90	(0.63)	(18.99)	(12.43)	55.37	20.57	3.65
Net profit growth	44.14	0.70	(14.20)	(5.65)	45.39	27.66	(19.53)
Profitability ratios (%)							
Gross margin	30.84	31.36	31.93	32.16	33.05	31.85	33.68
EBIT margin	5.32	5.40	4.01	3.18	4.51	5.76	5.60
EBITDA margin	8.56	8.63	7.26	6.58	8.01	9.06	7.91
Pre-tax margin	6.29	6.18	4.90	4.19	5.55	6.86	5.49
Net margin	4.70	4.83	3.80	3.25	4.31	5.24	3.95
Return ratios (%)							
ROAA	5.38	4.84	3.85	3.43	4.62	2.75	2.11
ROAE	12.76	10.85	8.89	7.93	10.83	5.28	4.04
ROIC	10.69	9.27	8.62	8.33	11.65	5.42	4.06
Liquidity ratio (x)							
Current ratio	1.42	1.40	1.34	1.35	1.28	1.44	1.26
Quick ratio	1.11	1.13	1.12	1.11	1.09	1.17	1.06
Cash ratio	0.34	0.54	0.67	0.64	0.68	0.58	0.34
Cash conversion cycle (days)							
Days of outstanding receivable	6.94	10.30	14.20	14.19	13.84	10.75	15.22
Days of inventory on hand	36.48	47.08	42.07	39.34	37.95	45.21	39.42
Days of outstanding payable	48.93	52.26	57.93	59.56	60.24	54.02	58.03
CCC	(5.51)	5.12	(1.65)	(6.03)	(8.45)	1.95	(3.39)
Leverage ratios (%)							
Total debt/Equity	40.11	41.52	38.86	40.19	42.52	40.57	38.08
Total debt/Total assets	20.87	21.82	19.77	20.61	20.97	21.24	19.87

Source(s): The Group, ABCI Securities estimates

Disclosures

Analyst Certification
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Definition of equity rating

Rating	Definition
Buy	Stock return ≥ Market return rate
Hold	Market return – 6% ≤ 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 ≤180 day volatility/180 day benchmark index volatility
High	1.5 ≤ 180 day volatility/180 day benchmark index volatility < 2.6
Medium	1.0 ≤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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