



25 September, 2013

Equity Focus  
 Sector Rating:  
**OVERWEIGHT**

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**Key Data**

Avg.13E P/E (x)	31.64
Avg.13E P/B (x)	5.41
Avg.13E Dividend Yield (%)	0.95

Source(s): Company, Bloomberg, ABCI Securities

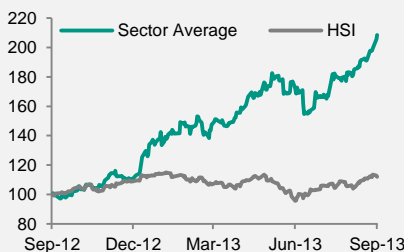
**Sector performance (%)**

	Absolute	Relative*
1-mth	13.8	7.9
3-mth	21.0	4.1
6-mth	39.4	35.3

\*Relative to HSI

Source(s): Bloomberg, ABCI Securities

**1-Year Sector performance (HK\$)**



Source(s): Bloomberg

## Dairy Industry

### Favor Mengniu and CMD on higher ASP and M&A

- Dairy sector is currently trading at premium to the market (represented by HSI) at 31.3x FY13E P/E (HSI: 11.1x FY13E P/E), partly due to funds being redirected from consumer discretionary sector
- After incorporating recent price hikes, we revise up Mengniu TP by 11.8% to HK\$ 38.9 and China Modern Dairy (CMD)'s TP by 9.6% to HK\$ 3.32. Maintain BUY for both counters
- We believe Biostime's current share price has already factored in the potential control premium. Thus, we downgrade the counter to SELL

**Funds continue to flow into the dairy sector.** The consumer discretionary sector, including the apparel and footwear industry (e.g. women's shoes and sportswear), has been suffering from slowed retail sales growth, redirecting funds into consumer staples sector. Dairy companies, with increasing support from the government and recent price hikes, are favored by investors. The sector is currently trading at a premium to the market at 31.3x FY13E P/E (HSI: 11.1x FY13E P/E).

**Favor Mengniu on its expanding dairy empire and ability to transfer costs. Maintain BUY.** Mengniu raised ASP of low-end UHT milk products by 11% in Sep. That was the third round of price hike by the Group in 2013, following the 5% price hike for high-end liquid milk products in Aug. In 1H13, Mengniu ASP increased by 7%/2% as a result of product mix upgrade and ASP hike. The stock has outperformed the market since the beginning of this year, thanks to the series of M&A that allow Mengniu to fully utilize its cash surplus and bring in inorganic growth. The Chinese government intensified its effort to consolidate the dairy industry, encouraging large corporations to acquire smaller ones. This in turn would provide further upside to the Group given its financial strength. Mengniu's organic growth will be mainly driven by upgrade in product mix; the series of price hikes also illustrated the Group's ability to transfer rising raw milk costs to consumers, alleviating concerns about narrowing GP margin. Taking the latest price hike into consideration, we raise our FY13E EPS by 2.2% and FY14E EPS by 11.6%. We revise our TP up by 11.8% to HK\$38.9, pegged to 25.0x FY14E P/E. Maintain BUY.

**Higher-than-expected ASP hike in 4Q13 and JV formation prompt us to maintain BUY on CMD.** Mengniu's ability to transfer costs to customers is positive to CMD as sustainability of Mengniu's profitability might lead to increasing orders for CMD. In Sep, CMD raised the 4Q13 ASP of raw milk sold to Mengniu to RMB 4.75/L, up 11% YoY. Separately, on Sep 24, CMD announced the formation of JV with Success Dairy in which CMD will contribute US\$ 5.4mn and be entitled to 18% of the JV ownership. The move will improve CMD's working capital as the JV will purchase ~6,600 dairy cows from CMD (equivalent to 3.7% of total dairy cows of CMD as at June 30, 2013) at fair value. Based on the slightly higher-than-expected price hike (11% YoY vs. our assumed 9.5% YoY) and the formation of new JV, we raise our FY14E EPS by 8.0%. Applying a 7.9% WACC in our DCF model, we value the stock at HK\$ 3.32 (9.6% higher than previous TP of HK\$ 3.03), representing 26.5x FY14E P/E or 2.17x FY14E P/B. Maintain BUY.

**Biostime: Current price has factored in potential control premium; downgrade to SELL.** Stimulated by government's target to lower the number of formula milk producers from 127 to 45, Biostime has risen by 35.7% since the beginning of July this year as the market expects the Group to be a potential M&A target. Current share price represents 30x FY14E P/E, exceeding our target valuation at 25x FY14E P/E. We believe the potential control premium has already been factored into its current price. Thus, we downgrade the counter to SELL with TP at HK\$ 49.2.

**Risk factors:** 1) Decline in pricing premium if consumer discretionary sectors signals a turnaround; 2) Food safety risks; 3) Increase in raw milk costs; 4) Post-M&A business; 5) Funds might be partially diverted to new entrant stocks, including Huishan Dairy (6863 HK).

**Sector Valuation Summary (pricing at Sep 24, 2013)**

Company	Ticker	Rating	Price (HK\$)	TP (HK\$)	FY13E P/E(x)	FY14E P/E (x)	FY13E P/B (x)	FY14E P/B (x)	FY13E Yield (%)	FY14E Yield (%)
Mengniu	2319 HK	BUY	35.45	38.9	30.14	22.78	3.11	2.76	0.73	0.97
CMD*	1117 HK	BUY	3.02	3.32	23.70	16.51	1.95	1.75	0.34	0.50
Biostime	1112 HK	SELL	59.05	49.20	41.07	29.98	11.18	9.40	1.78	2.44
HSI					11.10	10.31	1.38	1.28	3.49	-

\*CMD FY ended June 30; data represent FY14E/15E forecasts

Source(s): Companies, ABCI Securities estimates, Bloomberg



## Disclosures

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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 from 2007-2011

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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