



July 2, 2014  
Company Report  
Rating: BUY  
TP: HK\$ 3.93

Share price (HK\$)	3.05
Est. share price return	28.85%
Est. dividend yield	-
Est. total return	28.85%

Previous Rating & TP	(Resume coverage)
Previous Report Date	N/A

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**Key Data**

52Wk H/L(HK\$)	4.40/1.95
Issued shares (mn)	4,827
Market cap (HK\$ mn)	14,722
3-mth avg daily turnover (HK\$ mn)	55.08
Major shareholder(s) (%):	
Mengniu Group (2319 HK)	27.99

Source(s): Company, Bloomberg, ABCI Securities

**Key operating data in 2013**

Number of dairy cows (head)	186,838
Milkable cows	98,791
Calves and heifers	88,047
Raw milk production volume (tonnes)	678,762
Milk yield (tonnes)	8.51
Raw milk ASP (RMB / kg)	4.57

Source(s): Company, ABCI Securities

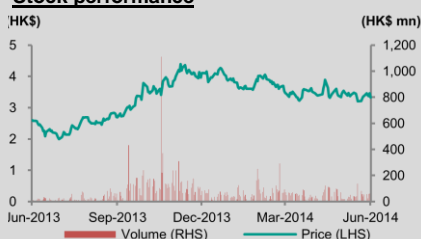
**Share performance (%)**

	Absolute	Relative*
1-mth	(1.88)	(3.54)
3-mth	(12.04)	(15.47)
6-mth	(25.24)	(25.79)

\*Relative to HSI

Source(s): Bloomberg, ABCI Securities

**Stock performance**



Source(s): Bloomberg, ABCI Securities

**Modern Dairy (1117 HK)**  
**Upstream dairy queen at bargain;**  
**reinitiate with BUY**

Modern Dairy is the largest raw milk producer based on herd size and production volume of raw milk in 2013. Its well-diversified production base, together with the Group's substantial operating track record and listing history, has enabled the counter to trade at premium to peers. Mengniu, its largest shareholder, has entered into a long-term strategic agreement with the Group till 2018. We believe the alliance would raise the Group's earnings visibility. The rising premium milk market will deliver another strong push to the Group's business in the medium and long term. We resume our coverage on Modern Dairy with a **BUY** rating. TP is set at HK\$ 3.93, representing 17.42x FY14E P/E, or 12.34x FY15E P/E. Recent negative sentiment in the dairy sector has weighed on the Group's share price; however, its impressive interim results are enhancing the likelihood of the counter's re-rating.

**Leading player with a diversified production base.** The herd size of Modern Dairy was over 186,000 at end-2013, which was ~4.5 /1.3 times of those in YST Dairy (1431 HK) / Huishan Dairy (6863 HK). The Group's raw milk production of Modern Dairy was over 678,000 tonnes in 2013, which was ~3.6 times/1.4 times of those in YST Dairy/Huishan Dairy. The Group has 22 dairy farms (including four farms under construction) located in northern, eastern and central China. Its geographical diversification is better than YST Dairy and Huishan, whose dairy farms are concentrated in northeast China and Liaoning, respectively.

**High product quality; long-term strategic alliance with Mengniu.** In 2013, the Group's ASP was RMB 4.57/kg, 26.38% higher than the industry average, thanks to its superior product quality comparable to the international standard. Its quality product has driven Mengniu to invest in the Group to become the largest single shareholder and establish a long-term supply agreement with the Group till 2018. In 2013, the Group accounted for ~20% of Mengniu's milk supply and over 70% of total supply for Mengniu's premium dairy brand – the Milk Deluxe series.

**Benefit from strong growth in premium milk market.** With the westernization of dietary habits in China, we expect that consumption of premium milk products to stay fast and grow at 17.54% CAGR over 2012-17E. Together with the supply shortfall of raw milk in China supporting the milk price, we expect the Group's earnings growth to turn swift in the next few years.

**Recommend BUY with TP at HK\$3.93.** Our target valuation at 17.42x FY14E P/E reflects the lower quartile of Modern Dairy's historical P/E since 2012. We believe the milk price is turning stable in June with raw milk production entering off-season in 3Q14. Considering that milk price is bottoming out, the downside risk is limited. According to Modern Farm, the Group's subsidiary as its farms operation arm, its net income was up 177% YoY in 1Q14. We expect the re-rating on the Group is likely to occur in August when 1H results are released. We resume our coverage on Modern Dairy with a **BUY** rating.

**Risk factors:** 1) High customer concentration; 2) Risk of disease outbreak; 3) Fluctuation in beef price affecting the raw milk price; 4) Fluctuation in fair value gains or losses of biological assets; 5) No dividend payout record.

**Results and Valuation**

FY ended Dec 31	2012A^	2013A^	2014E	2015E	2016E
<b>Revenue (RMB mn)</b>	<b>2,035</b>	<b>3,289</b>	<b>4,590</b>	<b>5,491</b>	<b>6,437</b>
Chg (% YoY)		61.67	39.54	19.63	17.22
<b>Net Income (RMB mn)</b>	<b>409</b>	<b>481</b>	<b>879</b>	<b>1,241</b>	<b>1,645</b>
Chg (% YoY)		17.67	82.74	41.22	32.50
<b>EPS (RMB)</b>	<b>0.084</b>	<b>0.100</b>	<b>0.182</b>	<b>0.257</b>	<b>0.341</b>
P/E (x)		24.68	13.51	9.56	7.22
<b>BVPS (RMB)</b>	1.080	1.190	1.372	1.629	1.970
P/B (x)		2.07	1.79	1.51	1.25
<b>DPS (RMB)</b>	-	-	-	-	-
Yield (%)		-	-	-	-
<b>ROAE (%)</b>	8.25	8.76	14.22	17.14	18.94
<b>Net gearing (%)*</b>	53.25	70.79	59.26	42.52	27.08

^ Rearrange to consist with the new financial year end at Dec

\* Net gearing=Net debt/Total equity

Source(s): Bloomberg, ABCI Securities estimates



## Valuation analysis

To assess the value of Modern Dairy, we apply the comparative method with reference to the stock's historical valuation in the market. We have identified YST Dairy and Huishan Dairy as the Group's closest peers because of their similar business models and income sources. Mengniu, the Group's largest single shareholder, is also the Group's major customer accounting for over 70% of revenue.

However, considering Modern Dairy's longer listing history and operating track record, we believe Modern Dairy deserves a premium valuation. Besides, its more diversified farm base than peers means the Group bears a lower business risk.

Please note that the Group has changed the financial year end from June to Dec starting from 2013. We have rearranged the financial and operating data so that FY12 and FY13 indicate the 12-month period from Jan till Dec. For FY08-11, the financial year end refers to June and therefore each year reflects the 12-month period from July till June in the following year.

### Historical valuation of Modern Dairy

Modern Dairy is trading at 13.51x FY14E P/E, below the lower quartile of its historical P/E since 2012 at 17.42x. We believe the depressed valuation primarily reflects the concern on tumbling raw milk ASP in 2014 after it had rallied by over 25% in 2013. According to the weekly survey of raw milk prices in China by the Ministry of Agriculture, raw milk ASP among the 10 major raw milk-producing provinces, including Inner Mongolia, Heilongjiang, Xinjiang, etc., declined by 4.45% since the peak in Feb 2014. However, we believe the price is bottoming.

### Milk price is bottoming out

Since milk yield usually peaks in spring, we expect raw milk prices would stay weak on the abundant supply in the short run. Provided that demand for raw milk stays at a similar level, raw milk price is likely to stabilize when milk yield drops in hot summer.

### Profitability to improve in FY14E

According to Ministry of Agriculture, average raw milk prices in 1H14 were 22.34% / 11.02% higher than those in 1H13 / 2H13. We believe the market sentiment would improve by 3Q14 with the stabilizing milk price, and the Group's margin is expected to rise in FY14 on a YoY basis. Modern Farm, a 97.87%-owned subsidiary of the Group, delivered impressive 1Q14 results with net profit soaring by 177.19% YoY.

### BUY Modern Dairy on cheap valuation and stabilizing milk price

Valuation of dairy sector should bottom out soon as the milk price stabilizes. Our target FY14E P/E for Modern Dairy is set at 17.42x, representing the lower quartile of Modern Dairy's historical P/E since 2012. We resume our coverage on Modern Dairy with a **BUY** rating with TP at HK\$ 3.93, representing an upside of 28.85% based on the current trading price.



## Five-year outlook of the Group

### Challenges to the Group

#### Vertical integration of downstream players may pose threat

Downstream dairy product sellers, such as Mengniu and Yili, are seeking to vertically integrate by expanding into upstream segment. Mengniu, the Group's largest customer accounting for over 70% of its revenue in 2013, is building its own ranches.

Raw milk prices driven up by supply shortage is posing an increasing challenge to the downstream dairy enterprises in China. Meanwhile, demand for dairy products is increasing on the gradual recovery of consumer confidence, aggravating the supply shortfall and inflating raw milk prices further. To alleviate the mounting cost pressure induced by higher raw milk prices, Mengniu have started constructing its own raw milk production base. Eight ranches have commenced operation, of which 4 have started milk production. The remaining four will follow suit to start production in 2H14.

#### Competition in dairy sector to increase

More leading dairy farmers have raised funds in order to expand their operations. YST Dairy and Huishan Dairy conducted their IPOs in 4Q13 to expand their herd size and market share. We expect market competition in the dairy sector would intensify in the future.

### Strategies of the Group

#### Diversifying income sources

As the Group's downstream customers are extending into the upstream segment to pursue vertical integration, we expect the Group would allocate more resources to expand its downstream business to reduce the impacts of possible reduction in demand.

#### Broaden customer base

We believe the Group would actively develop strategic relationship with more new customers in the future. Modern Dairy has entered into various co-operation agreements with renowned dairy manufacturers, such as Shanxi Yinqiao, New Hope and Jule, and international players including Nestle. We think the strategic alliance between Nestle and the Group will help the latter garner more credibility and attract more international customers.



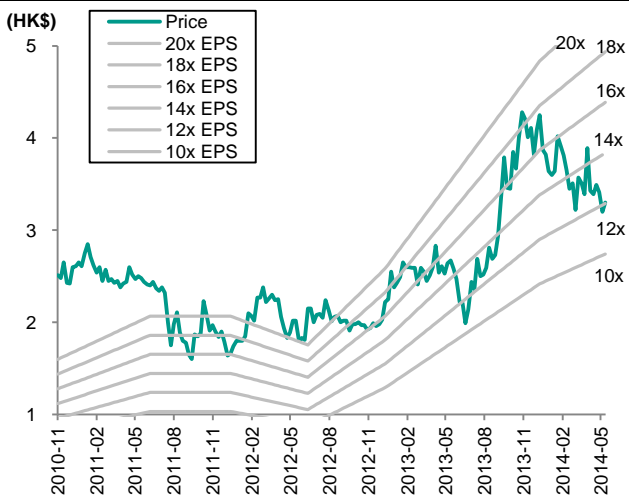
Sector valuation

Exhibit 1: Peer valuation of F&B sector & dairy sector

Company	Ticker	Mkt cap (HK\$ mn)	As of 1/7/2014 CRY	Share Price	P/E (x)		EPS Growth (%YoY)		P/B (x)		ROAE (%)	
					FY14E	FY15E	FY14E	FY15E	FY14E	FY15E	FY14E	FY15E
<b>Large-cap F&amp;B stocks in Hang Seng Index</b>												
WANT WANT CHINA	151 HK	147,184	HKD	11.14	24.78	21.45	11.54	15.52	8.46	7.19	36.76	37.11
TINGYI	322 HK	121,488	HKD	21.70	29.47	24.35	30.14	21.05	4.96	4.43	15.96	16.55
CHINA MENGNIU DA	2319 HK	70,198	HKD	35.85	26.74	21.46	19.58	24.61	2.82	2.51	11.39	11.50
CHINA RES ENTERP	291 HK	51,686	HKD	21.50	29.33	24.97	(7.22)	17.46	1.10	1.06	3.37	3.43
<b>Sector Weighted Average</b>					<b>27.20</b>	<b>22.82</b>	<b>16.29</b>	<b>19.13</b>	<b>5.38</b>	<b>4.68</b>	<b>21.31</b>	<b>21.65</b>
<b>HK-listed dairy stocks</b>												
CHINA MENGNIU DA	2319 HK	70,198	HKD	35.85	26.74	21.46	19.58	24.61	2.82	2.51	11.39	11.50
HUIZHAN DAIRY	6863 HK	24,493	HKD	1.70	11.33	8.41	79.80	34.71	1.36	1.23	13.56	13.23
<b>CHINA MODERN DAI</b>	<b>1117 HK</b>	<b>14,722</b>	<b>HKD</b>	<b>3.05</b>	<b>13.51</b>	<b>9.56</b>	<b>82.74</b>	<b>41.22</b>	<b>1.79</b>	<b>1.51</b>	<b>14.22</b>	<b>17.14</b>
YUANSHENGTAI DAI	1431 HK	4,808	HKD	1.23	9.34	6.47	90.67	44.45	0.90	0.79	10.08	12.96
BIOSIME INTERNA	1112 HK	25,967	HKD	43.00	19.10	15.22	32.55	25.44	7.05	5.83	42.63	48.22
YASHILI INTERNAT	1230 HK	10,037	HKD	2.82	18.34	15.47	0.81	18.55	2.45	2.29	13.21	15.15
<b>Sector Weighted Average</b>					<b>20.49</b>	<b>16.21</b>	<b>38.85</b>	<b>28.26</b>	<b>3.13</b>	<b>2.71</b>	<b>17.50</b>	<b>18.97</b>
<b>A-share market dairy stocks</b>												
INNER MONG YIL-A	600887 CH	84,631	RMB	33.15	18.06	14.79	11.27	22.11	3.61	2.99	22.11	22.90
BRIGHT DAIRY-A	600597 CH	24,376	RMB	15.93	30.81	21.64	56.67	42.36	4.15	3.63	14.50	17.89
GUANGXI ROYAL-A	002329 CH	4,405	RMB	16.47	60.11	43.12	61.18	39.42	4.31	4.02	8.39	9.65
BEINGMATE BABY-A	002570 CH	18,349	RMB	14.36	19.43	15.63	4.64	24.36	3.23	2.79	17.44	18.77
<b>Sector Weighted Average</b>					<b>22.01</b>	<b>17.12</b>	<b>20.41</b>	<b>26.75</b>	<b>3.68</b>	<b>3.11</b>	<b>19.60</b>	<b>20.95</b>
<b>International dairy product producers with business in China</b>												
NESTLE SA-REG	NESN VX	1,946,024	CHF	69.05	19.81	18.47	11.02	7.26	3.24	3.15	16.68	16.35
ABBOTT LABS	ABT US	476,083	USD	40.90	18.52	16.43	34.70	12.68	2.52	2.34	13.71	15.02
DANONE	BN FP	376,664	EUR	55.16	20.04	18.09	13.72	10.79	2.68	2.54	14.20	14.45
MEAD JOHNSON	MJN US	145,932	USD	93.17	25.15	22.50	15.78	11.74	30.11	18.58	158.40	100.54
FONTERRA-SHAR FD	FSF NZ	61,988	NZD	5.70	38.26	18.45	(66.14)	107.38	1.91	1.86	3.69	7.46
<b>Sector Weighted Average</b>					<b>20.27</b>	<b>18.29</b>	<b>13.75</b>	<b>10.84</b>	<b>4.34</b>	<b>3.66</b>	<b>22.51</b>	<b>19.81</b>
<b>Overall Weighted Average</b>					<b>21.08</b>	<b>18.65</b>	<b>15.28</b>	<b>13.00</b>	<b>4.37</b>	<b>3.71</b>	<b>22.08</b>	<b>20.01</b>

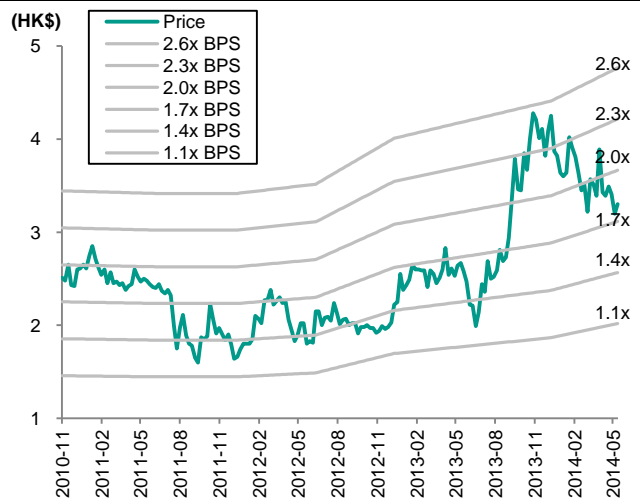
Source(s): Bloomberg, ABCI Securities estimates

Exhibit 2: Historical forward P/E of Modern Dairy in Nov 2010 – June 2014



Source(s): Bloomberg, ABCI Securities

Exhibit 3: Historical forward P/B of Modern Dairy in Nov 2010 – June 2014



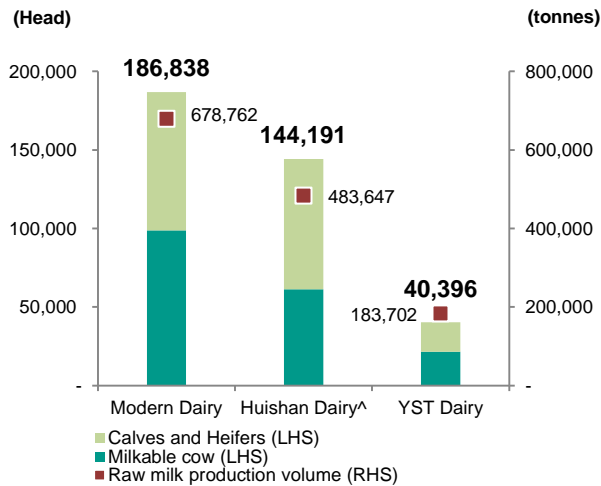
Source(s): Bloomberg, ABCI Securities



## Leading premium milk player with good product quality

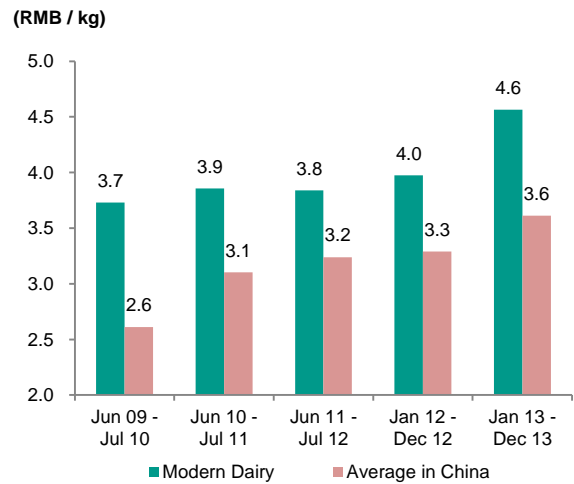
The Group is one of the leading premium milk players in China with a more geographically diversified farm base. Production volume of raw milk (including the volume for intersegment sales) in 2013 was 678,762 tonnes. The Group has a herd size of over 186,000 dairy cows, and it is the largest raw milk producer in China based on herd size and production volume of raw milk in 2013.

**Exhibit 4: Herd size and raw milk production volume of the Group and the peers at end-2013**



<sup>^</sup> Herd size of Huishan Dairy as at end-Mar 2014  
Source(s): The companies, ABCI Securities

**Exhibit 5: Raw milk ASP of Modern Dairy and average raw milk ASP in China during June 09 – Dec 13**



Note: The Group changed the financial reporting year end from June to Dec in 2013  
Source(s): The Company, ABCI Securities

In 2013, the Group's ASP was RMB 4.57 per kg, 26.38% higher than the national raw milk ASP in China during the year. The Group is able to charge more for its milk based on its finer quality. It supplies premium raw milk to the leading dairy product manufacturers such as Mengniu and the international food companies including Nestle.

The protein and fat contents of Modern Dairy are comparable to the international standard. Meanwhile, the safety standard of Modern Dairy exceeds both the domestic and international benchmarks.

**Exhibit 6: Product quality of Modern Dairy and the standards in China, EU, and the U.S. in 2013**

	Modern Dairy	China Standard	E.U. Standard	U.S. Standard
<b>Safety Standard (CFU/mL)</b>				
Microbe count	< 50,000	<= 2,000,000	< 100,000	< 100,000
Somatic Cell Count	< 250,000	N/A	< 400,000	< 750,000
<b>Nutritional Standard (%)</b>				
Protein	>= 3.1	>= 2.8	N/A	>= 3.2
Fat	>= 3.7	>= 3.1	N/A	>= 3.5

Source(s): F&S Report, ABCI Securities



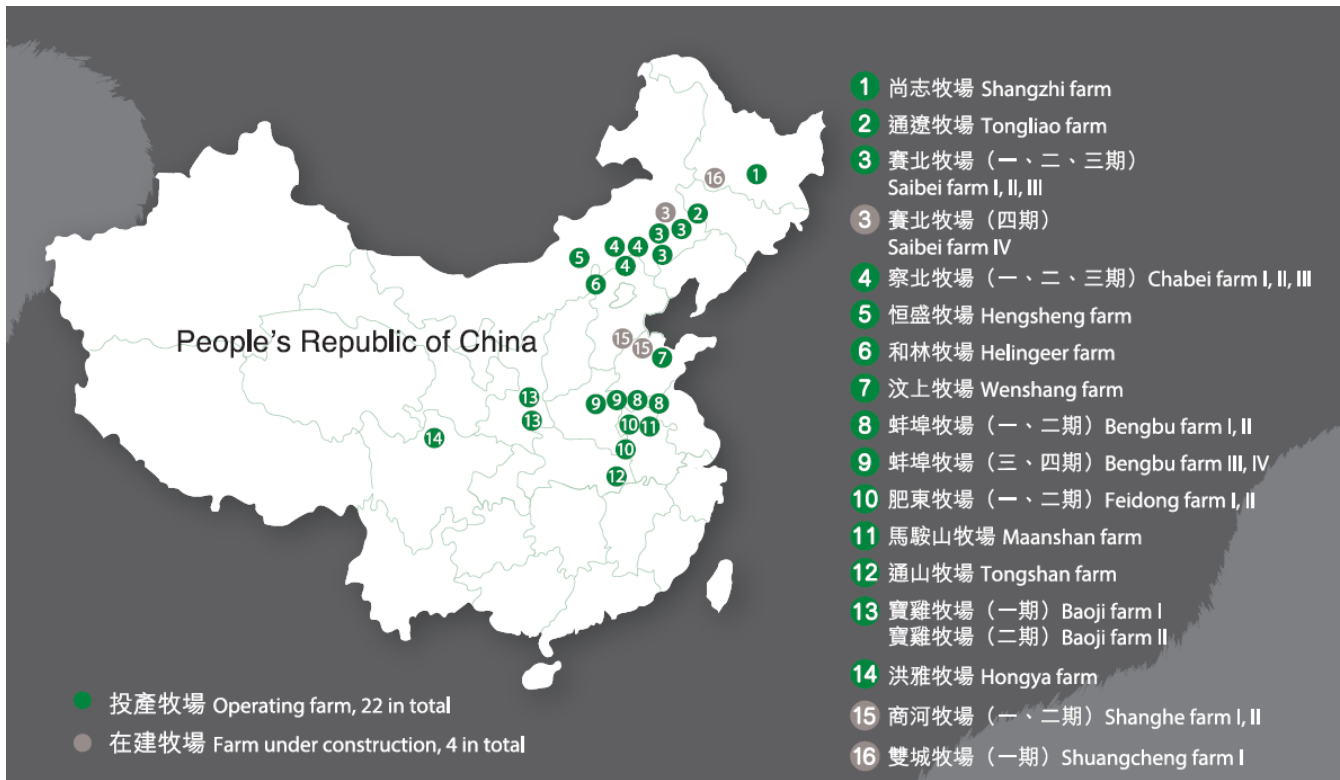
Since Mengniu became the largest single shareholder of Modern Dairy, strategic cooperation between the two has strengthened. Back in 2008, the Group entered into a 10-year raw milk supply agreement with Mengniu. In 2013, the Group accounted for ~20% of Mengniu's milk supply, and more than 70% of the milk supply for the Milk Deluxe series - Mengniu's premium milk brand.

### Geographical diversification

By end-2013, Modern Dairy had 26 farms in China. 22 of the farms were in operation while four were under construction. The Group had 186,838 dairy cows in total, of which 98,791 were milkable, representing an increase of 6% and 26.7% YoY. The 4 dairy farms under construction will supply raw milk exclusively to Nestle.

The Group's dairy farms are located across China. Thus, its geographical concentration risk is relatively lower than YST Dairy and Huishan Dairy, whose dairy farms are concentrated in northern China.

Exhibit 7: Modern Dairy's operating farms and farms under construction



Source(s): The Company

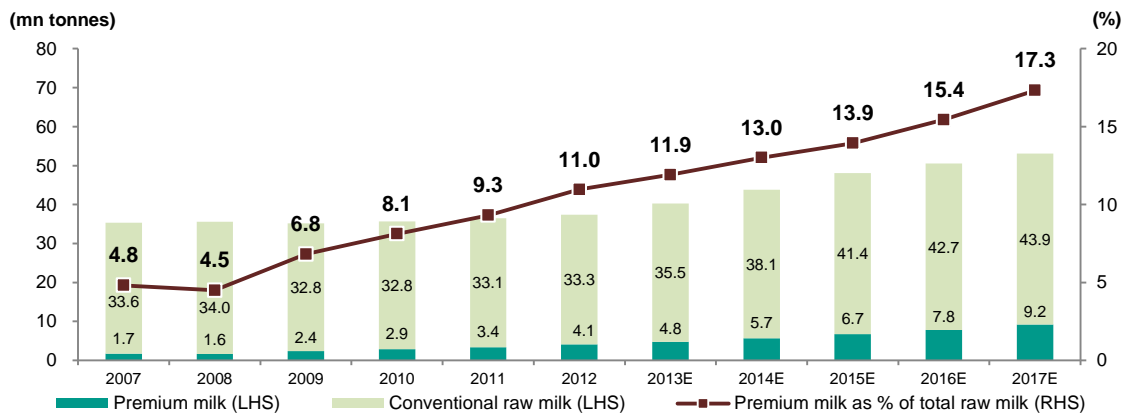


## Earnings outlook

### Strong volume growth in raw milk production in 2014E-17E

As dietary habits in China continue to westernize, consumption of dairy products has grown steadily. China's raw milk demand increased at 4.2% CAGR from 38.0 mn tonnes in 2007 to 46.6mn tonnes in 2012. Driven by the growing health awareness among the public and rising household income over the past few years, demand growth for premium milk outpaced that of the raw milk. Production volume of premium milk climbed at 19.25% CAGR from 1.7mn tonnes in 2007 to 4.1mn tonnes in 2012. Thanks to the increase in household disposable income and accelerating urbanization, growth in premium milk demand is expected to stay high over 2012-17. Production volume of premium milk is estimated to increase at 17.54% CAGR from 4.1mn tonnes in 2012 to 9.2mn tonnes in 2017.

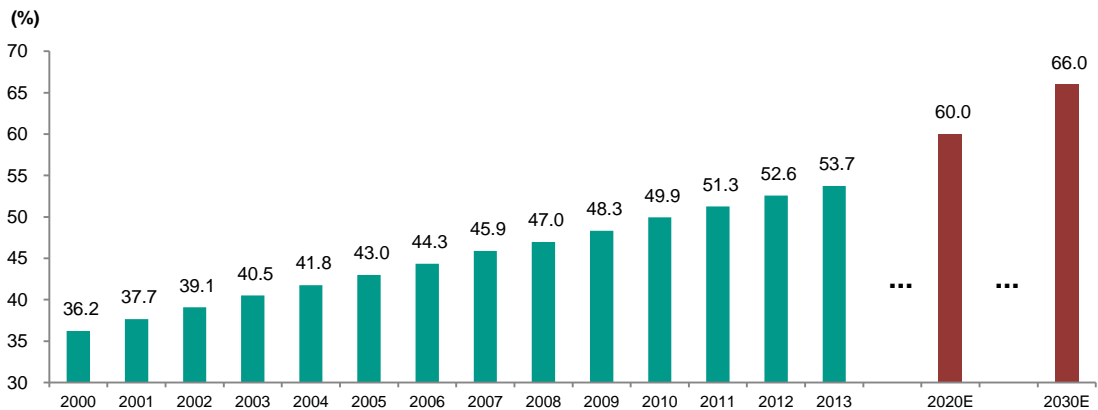
Exhibit 8: Production volume of premium milk and conventional raw milk in China in 2007-17E



Source(s): Prospectus of Huishan Dairy, NBS, ABCI Securities

Urbanization (urban population as a percentage of total population) was increasing from 36.2% at end-2000 to 53.7% at end-2013. According to Development Research Center of the State Council (国务院发展研究中心), it is expected that urbanization would reach 60% by 2020 and 66% by 2030. The expanding urban population is enlarging the potential customer base of downstream dairy product market, which in turn propels growth in the upstream raw milk industry.

Exhibit 9: Urbanization of China in 2000-2030E

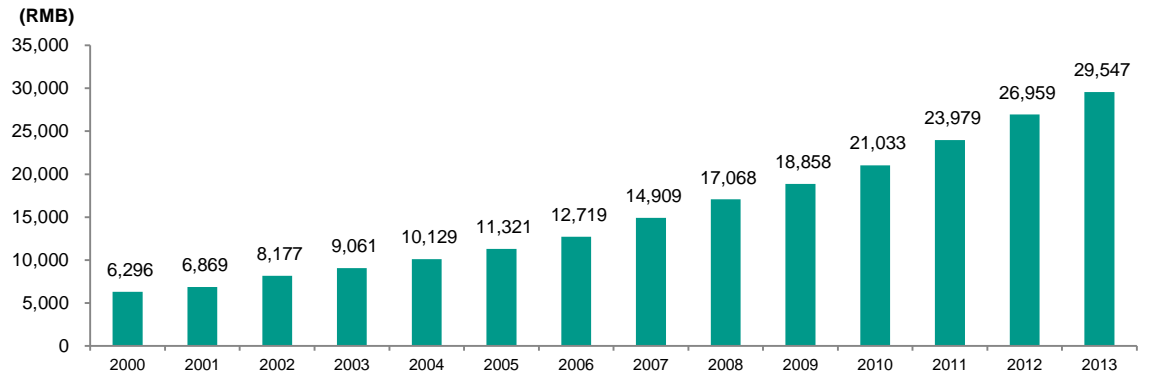


Source(s): NBS, Development Research Center of the State Council, ABCI Securities



Furthermore, disposable household income in China has been increasing by leaps and bounds since 2000. The annual income per capita in urban area increased fourfold from RMB 6,296 in 2000 to RMB 29,547 in 2013. The increasing wealth of the public will spur consumption of premium milk products in the future. We believe the Group, as one of the leading premium milk players, will benefit from such rise.

**Exhibit 10: Urban annual income per capita in China during 2000-13**



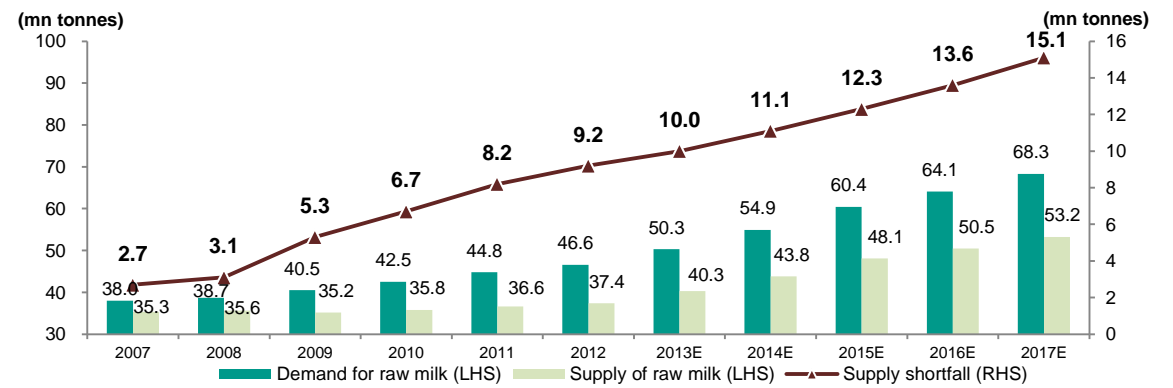
Source(s): NBS, ABCI Securities

**Supply shortfall supportive milk price growth**

Aside from the rising demand, it is expected ASP of premium milk will be elevated by raw milk shortage. Raw milk production in China is dominated by small dairy farms with a herd size of 1,000 dairy cows or less. Since it usually takes 14 months for a calf to turn milkable, small farmers are less willing to ramp up their capacities due to the long investment period. Thus, supply of raw milk has fallen short with its growth lagging behind the increase in demand.

The supply shortfall widened from 2.7mn tonnes in 2007 to 9.2mn tonnes in 2012. It is expected that the figure would arrive at 15.1mn tonnes in 2017. Nonetheless, the increasing divergence between demand and supply is beneficial to the dairy farming industry.

**Exhibit 11: Demand and supply of raw milk in China (2007-17E)**



Source(s): Prospectus of Huishan Dairy, NBS, ABCI Securities

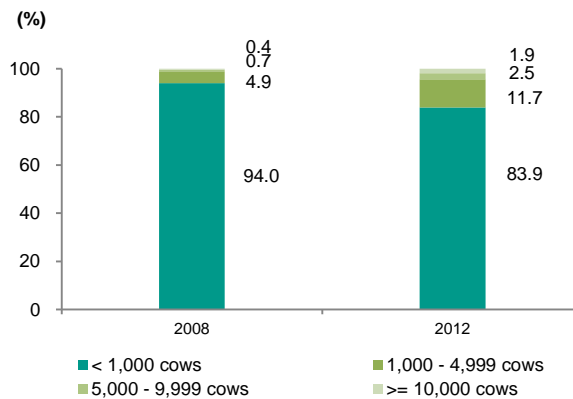




**Market consolidation to benefit the leading players**

The Chinese milk scandal in 2008 has triggered a restructuring in the dairy industry. Since then, the Chinese government has been expediting consolidation in the dairy sector. According to Euromonitor International, raw milk produced by large-scale farms accounted for 6.0% of China's total raw milk in 2008. By 2012, this number increased to 16.1%. The charts below illustrate the proportion of raw milk in China produced by farms of various sizes in 2008 and 2012. In general, we believe the market consolidation would create opportunities for the Group to capture additional market share from the small players.

**Exhibit 12: Breakdown of dairy farms in China by herd size in 2008 and 2012**

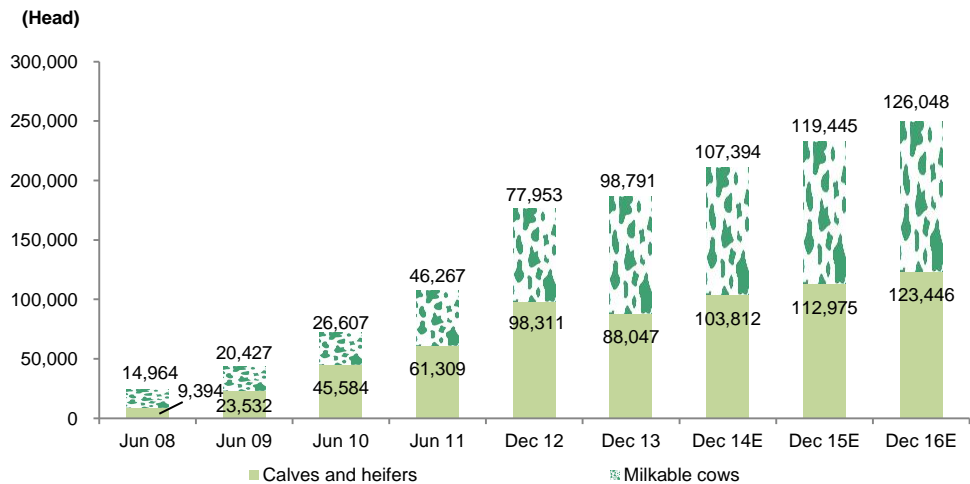


Source(s): Euromonitor International, ABCI Securities

**Expanding herd size**

Based on our discussion with the Group's management, we expect growth in the Group's herd size would remain steady in 2014E-16E after the expansion in 2011-12 driven by the post-IPO procurement of heifers. We estimate the number of milkable cows would increase from 98,791 at end-2013 to 126,048 at end-2016E, and the total herd size would increase from 186,838 at end-2013 to 249,494 at end-2016E.

**Exhibit 13: Milkable cows of Modern Dairy at period-end (2010-16E)**



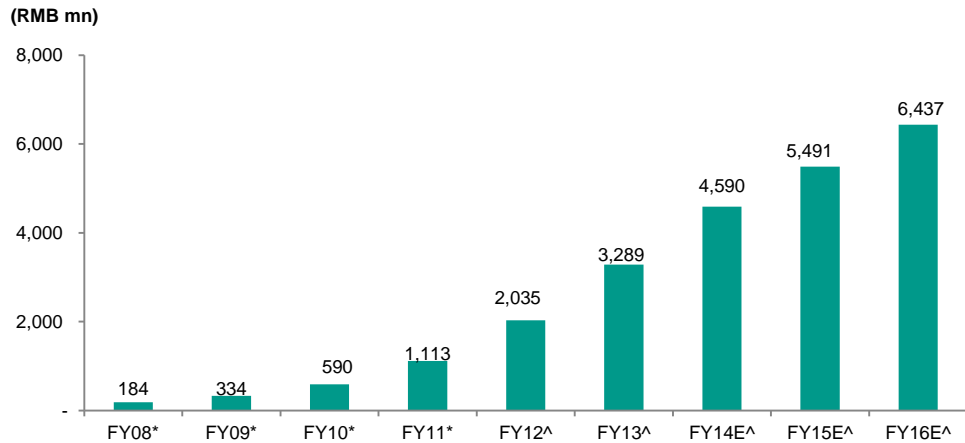
Source(s): The Company, ABCI Securities estimates



High revenue growth going forward

The Group's revenue jumped from RMB 184mn in FY08 to RMB 3,289mn in 2013. Looking forward, based on the growing downstream liquid milk industry and the Group's expanding herd size, we expect revenue to increase to RMB 6,437mn in 2016E, representing a growth of 25.08% CAGR over 2013-16E.

Exhibit 14: Revenue of Modern Dairy in FY08-16E

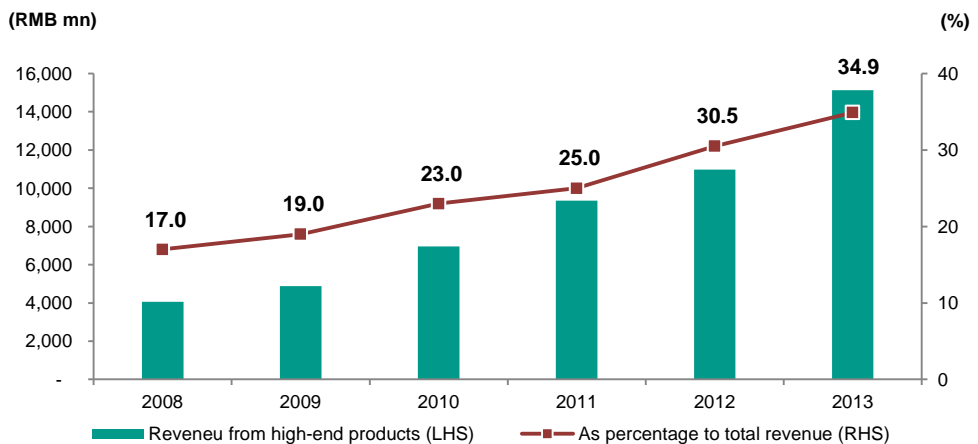


\* Financial year ended in June for 2008-11  
^ Financial year ended in Dec for 2012-16E  
Source(s): The Company, ABCI Securities estimates

Rising demand for high-end milk products may present positive surprise

Mengniu accounted for 70.8% of the Group's turnover for the 6 months ended in Dec 2013. (12 months ended in June 2013: 79.1%). The Group's raw milk was mainly supplied for Mengniu's high-end brands such as the Milk Deluxe. Contribution of Mengniu's high-end products to its total revenue increased from 17.0% in 2008 to 34.9% in 2013. The Group, as a major supplier of Mengniu's high-end products, will benefit from the latter's increasing emphasis on high-end product development.

Exhibit 15: Revenue of Mengniu's high-end products and respective contribution to total revenue in FY08-13



Source(s): Mengniu, ABCI Securities



## Profitability and net profit projections

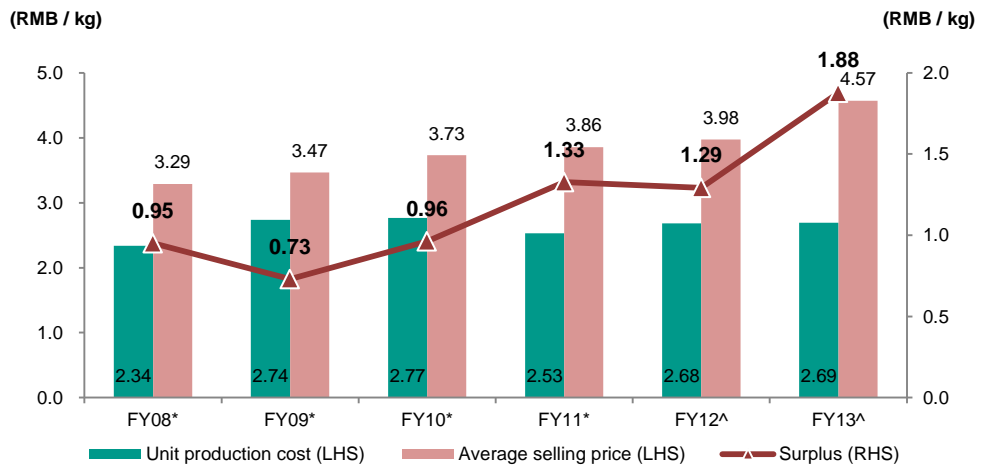
### Profitability improved

Gross profit margin (GPM) of the Group improved from 28.88% in FY08 (July 07 – June 08) to 38.22% in FY13 (Jan 13 – Dec 13). The rising GPM was attributed to the rising milk yield and the surging ASP.

Unit production cost increased mildly by 14.96% from RMB 2.34/kg in FY08 to RMB 2.69/kg in FY13, while raw milk ASP increased by 38.91% from RMB 3.29/kg in FY08 to RMB 4.57/kg in FY13. The surplus increased by 97.89% from RMB 0.95/kg in FY08 to RMB 1.88/kg in FY13.

Milk yield increased from 6.1 tonnes in FY08 to 8.51 tonnes in FY13. We estimate the milk yield to reach 9 tonnes in FY14E as a larger proportion of dairy cows becomes mature and feeds quality improved.

**Exhibit 16: The Group's unit production cost and raw milk ASP in FY08-13**



\* Financial year ended in June for 2008-11  
^ Financial year ended in Dec for 2012-13  
Source(s): The Company, ABCI Securities

**Exhibit 17: Breakdown of cost of sales in the Group**

	FY08*		FY09*		FY10*		FY11*		FY12^		FY13^	
	(RMB mn)	(%)	(RMB mn)	(%)	(RMB mn)	(%)	(RMB mn)	(%)	(RMB mn)	(%)	(RMB mn)	(%)
Feed	116	88.98	245	93.07	396	90.54	648	88.76	1,213	87.77	1,653	81.33
Utility	4	3.40	11	4.06	15	3.54	25	3.46	47	3.40	71	3.47
Other costs	10	7.62	8	2.87	26	5.92	57	7.78	122	8.83	309	15.20
<b>Total</b>	<b>131</b>		<b>264</b>		<b>438</b>		<b>730</b>		<b>1,382</b>		<b>2,032</b>	

\* Financial year ended in June for 2008-11

^ Financial year ended in Dec for 2012-13

Based on our sensitivity analysis, for a 10% increase (decrease) in average feeding cost, net profit would decrease (increase) by 34% FY13.

Source(s): The Company, ABCI Securities

**Exhibit 18: Milk yield of the milking cow in the Group**

	FY08*	FY09*	FY10*	FY11*	FY12^	FY13^
Production volume (tonnes)	55,888	96,306	158,081	288,620	496,979	678,762
Milk yield (tonnes)	6.10	6.90	7.30	7.73	7.94	8.51
<b>Estimated effective milking cow (head)</b>	<b>9,162</b>	<b>13,957</b>	<b>21,655</b>	<b>37,338</b>	<b>62,592</b>	<b>79,761</b>

\* Financial year ended in June for 2008-11

^ Financial year ended in Dec for 2012-13

Source(s): The Company, ABCI Securities

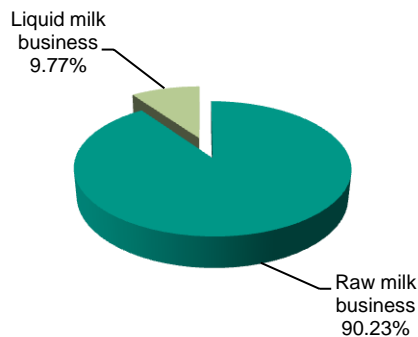


**Benefiting from changes in product-mix**

The Group has utilized its upstream raw milk production capability to vertically integrate with the downstream business since FY12. Its revenue sources have been broadened to include incomes from raw milk and liquid milk businesses. Revenue of liquid milk business increased from RMB 86mn in FY12 to RMB 321mn in FY13, equivalent to 4.24% and 9.77% of total revenue in FY12 and FY13.

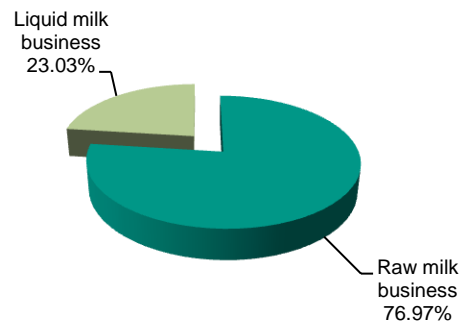
Based on our discussion with management, we estimate ~6%-7% of production volume of raw milk would be used for proprietary liquid milk products in FY14E; the ratio is expected to surge to 10% in FY16E. Contribution of its liquid milk business would increase in FY14E-16E.

**Exhibit 19: Revenue mix of the Group in FY13**



Source(s): The Company, ABCI Securities

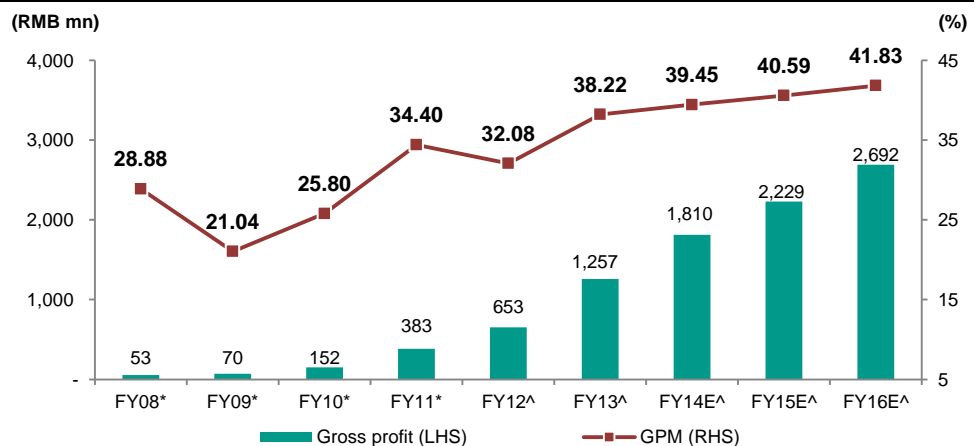
**Exhibit 20: Projected revenue mix of the Group in FY16E**



Source(s): ABCI Securities estimates

Raw milk takes up about 50% of the cost of sales in the liquid milk segment. With the vertical integration, the Group would be able to leverage on its raw milk production upstream and improve its profit margin. We estimate GPM of liquid milk business (after the inter-segment sales elimination) to have been 50%-55% in FY12 and FY13, while that of raw milk business to have been 30%-40%. As we expect contribution of liquid milk business would increase, overall GPM would climb further in FY14E-16E.

**Exhibit 21: Gross profit and gross profit margins of the Group in FY08-16E**



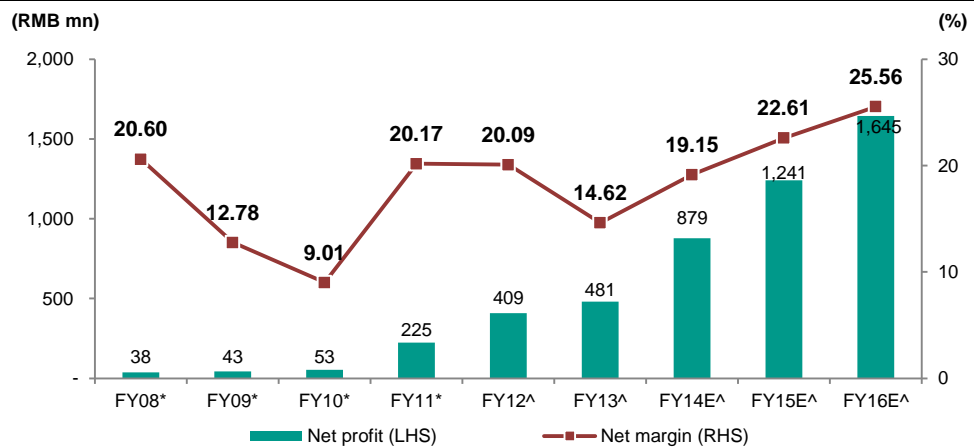
\* Financial year ended in June for 2008-11  
^ Financial year ended in Dec for 2012-16E  
Source(s): The Company, ABCI Securities estimates



Net income margin to increase

Because of the distortion resulted from changes in biological assets (i.e. dairy cows), net margin dropped from 20.09% in FY12 to 14.62% in FY13. By excluding the biological gains and losses, the Group's core net profit rose from RMB 316mn in FY12 to RMB 555mn in FY13, and core net margin grew from 15.55% to 16.87%.

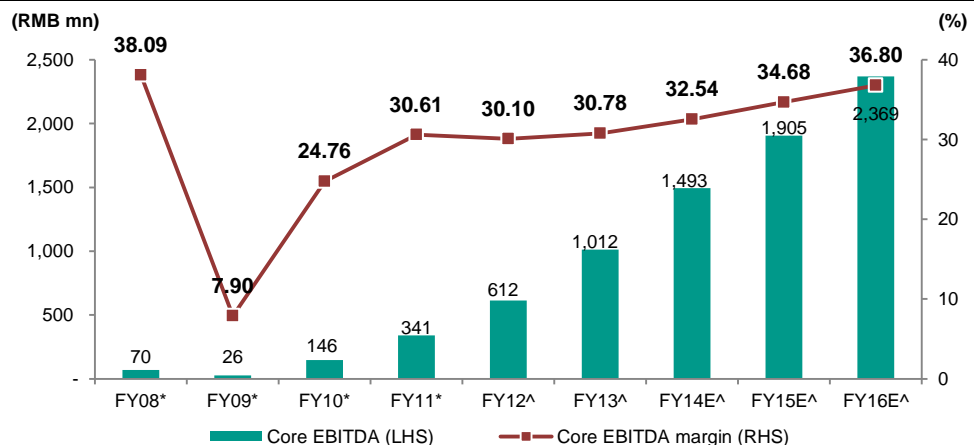
Exhibit 22: Net profit and net profit margin of the Group in FY08-16E



\* Financial year ended in June for 2008-11  
^ Financial year ended in Dec for 2012-16E  
Source(s): The Company, ABCI Securities estimates

The core EBITDA (EBITDA of the Group excluding biological gains and losses) margin was stable at ~30% in FY11-13. Benefiting from greater economies of scale, we expect the SG&A-to-revenue ratio would trend down and core EBITDA margin would increase to ~35% by 2016E.

Exhibit 23: Core EBITDA and core EBITDA margin of the Group in FY08-16E



\* Financial year ended in June for 2008-11  
^ Financial year ended in Dec for 2012-16E  
Source(s): The Company, ABCI Securities estimates



## Risk factors

### High customer concentration

Modern Dairy relies heavily on a single customer. Most of the Group's raw milk is supplied to its largest customer, Mengniu, which accounted for over 95% of its revenues during FY08-12. Mengniu's contribution, however, dropped to 75.7% as of the 6 months ended Dec 2013 as the Group acquired new customers and expanded market share of its proprietary brand. It is obvious that the Group is proactively diversifying its customer base to mitigate risk.

**Exhibit 24: Mengniu's contribution to the Group's revenue in July 07 – Dec 13**

	(July 07 – June 08)	(July 08 – June 09)	(July 09 – June 10)	(July 10 – June 11)	(July 11 – June 12)	(July 12 – June 13)	(July 13 – Dec 13)
Total revenue (RMB mn)	184	334	590	1,113	1,678	2,481	1,901
Of which, revenue from Mengniu (RMB mn)	182	333	576	1,084	1,617	1,962	1,439
<b>As percentage of total revenue (%)</b>	<b>98.9</b>	<b>99.6</b>	<b>97.6</b>	<b>97.4</b>	<b>96.4</b>	<b>79.1</b>	<b>75.7</b>

Source(s): The Company, ABCI Securities

### Risk of major disease outbreak

A major outbreak of any illnesses or diseases at the dairy farms could have a significant impact on the raw milk production capacity and volume.

### Forage price movement

The Group requires a substantial amount of feed for its dairy farms. As a percentage of farm operating expenses, the costs of feed were 87.77% in FY12 (ended on Dec 31, 2012) and 81.33% in FY13 (ended on Dec 31, 2013). The Group purchases the majority of its feed from third-party farmers and producers, some of which are located outside China. The forage price movement will affect the profit margin of the Group significantly.

### Fluctuation in beef prices

Beef prices were highly correlated with raw milk prices. The upsurge in beef prices in 2012-2013 motivated farmers to sell their dairy cows and cash out. Subsequently, raw milk prices climbed in 2013 on reduced supply. We believe the rise in raw milk and beef prices in 4Q13 will motivate farmers to raise dairy cows again. Considering the two-year growing period from calves to heifers and milkable cows, we expect raw milk supply is unlikely to increase substantially in 2014-15. However, a drastic decline in raw milk supply is unlikely to repeat in 2014-15 unless incidents such as a major disease outbreak occurs and disrupts production.

### Fluctuation in biological value

The fair value of dairy cows is determined by two major criteria:

1. Market price at year-end is adjusted with reference to the age and cost of the dairy cows to reflect differences in characteristics and stages of growth of the dairy cows; or
2. When market prices are unavailable, the present value of expected net cash flow from the dairy cows discounted at a current market rate is used.



## Strong 1Q14 results indicates business is right on track

According to the announcement of Modern Farming (Group) Co., Ltd. (Modern Farming) (现代牧业(集团)有限公司), a 97.87%-owned dairy farming operation arm of Modern Dairy.

The revenue of Modern Farming was up 85.70% YoY in and net profit rose 177.19% YoY in 1Q14 mainly due to the risen raw milk price. The revenue and profit of the Group were equivalent to 26.99% and 25.48% of our full-year estimates for 2014. Thus, we believe the Group's performance is right on track.

**Exhibit 25: 1Q14 Results summary of Modern Farming**

	1Q13 (RMB mn)	1Q14 (RMB mn)	Change (% YoY)
<b>Revenue</b>	<b>667</b>	<b>1,239</b>	<b>85.70</b>
Raw milk	614	1,081	75.94
Liquid milk products	47	157	235.88
<b>Operating cost</b>	<b>516</b>	<b>800</b>	<b>55.05</b>
Raw milk	474	678	42.96
Liquid milk products	37	123	231.45
<b>Estimated operating profit margin (%)</b>	<b>22.62</b>	<b>35.39</b>	<b>12.77</b>
Raw milk	22.82	37.28	14.47
Liquid milk products	20.94	21.98	1.04
Net income (ex. MI)	81	224	177.19
<b>Net margin (%)</b>	<b>12.11</b>	<b>18.08</b>	<b>5.97</b>

Source(s): The Company, ABCI Securities



## Comparison of the Group and its major peers

The Group's geographically diversified dairy farm base, together with its larger herd size than peers, justifies the Group's higher valuation than its listed peers in HKEx. The following tables (Exhibit 25 and 26) compare the operational and financial data of the Group and its peers.

### Exhibit 26: The Group's financial and operational data

<b>China Modern Dairy (1117 HK)</b>			
<b>FY ended</b>	<b>Dec*</b>		
Reported currency	RMB		
FY	<u>2011*</u>	<u>2012*</u>	<u>2013*</u>
Revenue (RMB mn)	1,392	2,035	3,289
Net profit (RMB mn)	314	408	481
Total assets	7,917	10,159	12,494
Total equity	4,889	5,329	5,861
Total equity/total assets	61.75	52.46	46.91
<b>Revenue composition (RMB mn)</b>			
Sales of raw milk	1,392	2,005	2,911
Sales of processed milk	-	86	321
<b>Revenue composition (%)</b>			
Sales of raw milk	100.00	98.54	88.51
Sales of processed milk	-	4.23	9.76
<b>Herd size and milk yield</b>			
Milkable cows (Head)	54,338	77,953	98,791
Heifers and calves (Head)	74,421	98,311	88,047
<b>Total dairy cows (Head)</b>	<b>128,759</b>	<b>176,264</b>	<b>186,838</b>
Total sales volume (tonnes)	366,656	496,979	678,762
Total Sales volume per dairy cows (tonnes/head)	2.85	2.82	3.63
<b>Milk yield for (tonnes)</b>	<b>7.80</b>	<b>7.94</b>	<b>8.51</b>
<b>ASP of raw milk (RMB / kg)</b>	<b>3.858</b>	<b>3.976</b>	<b>4.566</b>
<b>Profitability (%)</b>			
Gross profit margin	31.20	32.08	38.19
ROAA		4.51	4.25
ROAE		8.11	8.76

\* Financial year end of Modern Dairy was changed from June to Dec in 2013. The financial data for the company above was adjusted by ABCI Securities

Source(s): The Company, Bloomberg, ABCI Securities





**Exhibit 27: Financial data of the Group's major peers**

YST Dairy (1431 HK)				Huishan Dairy (6863 HK)			
FY ended	Dec			FY ended	Mar		
Reported currency	RMB			Reported currency	RMB		
FY	<u>2011</u>	<u>2012</u>	<u>2013</u>	FY	<u>2012</u>	<u>2013</u>	<u>2014</u>
Revenue (RMB mn)	149	689	881	Revenue (RMB mn)	1,333	2,552	3,530
Net profit (RMB mn)	190	210	218	Net profit (RMB mn)	450	945	1,249
Total assets (RMB mn)	2,387	2,593	4,968	Total assets	7,190	10,511	21,020
Total equity (RMB mn)	381	590	3,911	Total equity	882	5,883	13,195
Total equity/total assets (%)	15.96	22.75	78.72	Total equity/total assets	12.27	55.97	62.77
Revenue composition (RMB mn)				Revenue composition (RMB mn)			
Sales of raw milk	149	689	881	Sales of raw milk	672	681	989
				Liquid milk business	564	1,707	2,288
				Others	97	164	254
Revenue composition (%)				Revenue composition (%)			
Sales of raw milk	100.00	100.00	100.00	Sales of raw milk	50.42	26.68	28.01
				Liquid milk business	42.32	66.88	64.80
				Others	7.26	6.44	7.19
Herd size and milk yield				Herd size and milk yield			
Milkable cows (Head)	14,950	20,643	21,544	Milkable cows (Head)	31,221	49,889	61,286
Heifers and calves (Head)	17,269	16,357	18,852	Heifers and calves (Head)	59,033	62,962	82,905
<b>Total dairy cows (Head)</b>	<b>32,219</b>	<b>37,000</b>	<b>40,396</b>	<b>Total dairy cows (Head)</b>	<b>90,254</b>	<b>112,851</b>	<b>144,191</b>
Total sales volume (tonnes)	35,722	168,070	183,702	Total sales volume (tonnes)	236,190	397,593	483,647
Total Sales volume per dairy cows (tonnes/head)	1.11	4.54	4.55	Total Sales volume per dairy cows (tonnes/head)	2.62	3.52	3.35
<b>Milk yield (tonnes)</b>	<b>8.80</b>	<b>8.90</b>	<b>9.00</b>	<b>Milk yield for (tonnes)</b>	<b>8.60</b>	<b>9.10</b>	<b>9.00</b>
<b>ASP of raw milk (RMB / kg)</b>	<b>4.165</b>	<b>4.100</b>	<b>4.795</b>	<b>ASP of raw milk (RMB / kg)</b>	<b>4.448</b>	<b>4.515</b>	<b>5.017</b>
Profitability (%)				Profitability (%)			
Gross profit margin	34.53	37.80	42.57	Gross profit margin	41.24	53.99	62.45
ROAA		8.42	5.76	ROAA		10.68	7.92
ROAE		43.20	9.67	ROAE		27.95	13.10

Source(s): Companies, Bloomberg, ABCI Securities



## Financial statements of the Group

## Consolidated income statement (2012A-2016E)

FY Ended Dec 31 (RMB mn)	2012A <sup>^</sup>	2013A <sup>^</sup>	2014E	2015E	2016E
<b>Revenue</b>	<b>2,035</b>	<b>3,289</b>	<b>4,590</b>	<b>5,491</b>	<b>6,437</b>
Raw milk	1,948	2,968	3,921	4,433	4,955
Liquid milk products	86	321	669	1,058	1,482
<b>COGS</b>	<b>(1,382)</b>	<b>(2,032)</b>	<b>(2,779)</b>	<b>(3,262)</b>	<b>(3,744)</b>
<b>Gross profit</b>	<b>653</b>	<b>1,257</b>	<b>1,810</b>	<b>2,229</b>	<b>2,692</b>
SG&A	(260)	(378)	(457)	(474)	(491)
Other income (loss)	33	(362)	(423)	(435)	(449)
<b>Pre-tax profit</b>	<b>426</b>	<b>518</b>	<b>931</b>	<b>1,320</b>	<b>1,753</b>
Income tax	(3)	(11)	(33)	(53)	(74)
<b>Net profit*</b>	<b>422</b>	<b>507</b>	<b>897</b>	<b>1,267</b>	<b>1,679</b>
Profit attributable to:					
Minority interests	(14)	(26)	(18)	(25)	(34)
<b>Equity shareholders of the Company</b>	<b>409</b>	<b>481</b>	<b>879</b>	<b>1,241</b>	<b>1,645</b>
<b>EPS (RMB)</b>	<b>0.084</b>	<b>0.100</b>	<b>0.182</b>	<b>0.257</b>	<b>0.341</b>
<b>DPS (RMB)</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>
<b>EBIT</b>	<b>594</b>	<b>770</b>	<b>1,255</b>	<b>1,661</b>	<b>2,120</b>
<b>EBITDA</b>	<b>705</b>	<b>938</b>	<b>1,493</b>	<b>1,905</b>	<b>2,369</b>

<sup>^</sup> Financial year end of Modern Dairy's was changed from June to Dec in 2013. Historical data for 2012 and 2013 was recalculated by ABCI Securities, which reflects the financial of the Group ended in Dec during the corresponding years

\* Our net profit projection refers to net profit from core operation only; fair value changes in biological assets were excluded

Source(s): Company, ABCI Securities estimates

## Consolidated balance sheet (2012A-2016E)

As of Dec 31 (RMB mn)	2012A <sup>^</sup>	2013A <sup>^</sup>	2014E	2015E	2016E
<b>Current assets</b>	<b>1,195</b>	<b>2,037</b>	<b>2,461</b>	<b>3,654</b>	<b>4,926</b>
Cash and equivalent	470	800	1,044	2,037	3,221
Trade and bill receivables	224	463	493	560	498
Inventories	440	691	832	956	1,096
Other current assets	61	84	92	101	111
<b>Non-current assets</b>	<b>8,964</b>	<b>10,457</b>	<b>11,257</b>	<b>12,083</b>	<b>12,856</b>
Property, plant and equipment	3,583	4,033	4,164	4,288	4,406
Intangible assets	377	377	358	340	323
Long term investments	-	59	60	62	64
Biological assets	4,977	5,954	6,622	7,338	7,922
Other non-current assets	26	35	53	55	142
<b>Total assets</b>	<b>10,159</b>	<b>12,494</b>	<b>13,718</b>	<b>15,737</b>	<b>17,783</b>
<b>Current liabilities</b>	<b>3,089</b>	<b>4,483</b>	<b>4,191</b>	<b>4,422</b>	<b>4,266</b>
Trade and bill payables	716	725	798	990	857
Receipts in advance	90	56	120	181	172
Short term borrowings	1,666	2,989	2,489	2,389	2,289
Other current liabilities	616	713	784	863	949
<b>Non-current liabilities</b>	<b>1,742</b>	<b>2,150</b>	<b>2,769</b>	<b>3,290</b>	<b>3,813</b>
Long-term payables	-	-	-	-	-
Long-term borrowings	1,641	1,960	2,560	3,060	3,560
Other non-current liabilities	100	190	209	230	253
<b>Total liabilities</b>	<b>4,830</b>	<b>6,633</b>	<b>6,960</b>	<b>7,712</b>	<b>8,079</b>
<b>Minority interests</b>	<b>92</b>	<b>118</b>	<b>136</b>	<b>161</b>	<b>195</b>
<b>Shareholders' equities</b>	<b>5,237</b>	<b>5,743</b>	<b>6,622</b>	<b>7,864</b>	<b>9,508</b>
<b>BVPS (RMB)</b>	<b>1.080</b>	<b>1.190</b>	<b>1.372</b>	<b>1.629</b>	<b>1.970</b>

<sup>^</sup> Financial year end of Modern Dairy's was changed from June to Dec in 2013. Historical data for 2012 and 2013 was recalculated by ABCI Securities, which reflects the financial of the Group ended in Dec during the corresponding years

Source(s): Company, ABCI Securities estimates



**Consolidated cash flow statement (2012A-2016E)**

FY ended Dec 31 (RMB mn)	2012A <sup>^</sup>	2013A <sup>^</sup>	2014E	2015E	2016E
<b>Profit before tax</b>	<b>426</b>	<b>518</b>	<b>931</b>	<b>1,320</b>	<b>1,753</b>
Changes in depreciation and amortization	85	336	219	226	232
Changes in working capital	207	(672)	(99)	1	(211)
Financial cost	166	137	390	409	441
Income tax paid	(2)	(3)	(33)	(53)	(74)
Others	(153)	273	-	-	-
<b>CF Operating</b>	<b>728</b>	<b>589</b>	<b>1,407</b>	<b>1,903</b>	<b>2,140</b>
Increase in PP&E	(798)	(767)	(350)	(350)	(350)
Increase in intangible assets	(4)	(1)	-	-	-
Increase in biological assets	(1,630)	(1,205)	(1,407)	(1,568)	(1,785)
Others	350	49	503	574	670
<b>CF Investing</b>	<b>(2,082)</b>	<b>(1,924)</b>	<b>(1,254)</b>	<b>(1,345)</b>	<b>(1,465)</b>
Capital injection	18	1	-	-	-
Net debt financing	1,110	436	100	400	400
Dividend payout	-	-	-	-	-
Interest paid	(163)	(212)	(325)	(341)	(367)
Others	(7)	1,202	316	375	477
<b>CF Financing</b>	<b>957</b>	<b>1,427</b>	<b>91</b>	<b>434</b>	<b>510</b>
<b>Net change in cash</b>	<b>(397)</b>	<b>92</b>	<b>244</b>	<b>993</b>	<b>1,184</b>
Cash at the beginning	1,309	470	800	1,044	2,037
Adjustment (Time deposit & FX effect)	(441)	237	-	-	-
<b>Cash at the end</b>	<b>470</b>	<b>800</b>	<b>1,044</b>	<b>2,037</b>	<b>3,221</b>

<sup>^</sup> Financial year end of Modern Dairy's was changed from June to Dec in 2013. Historical data for 2012 and 2013 was recalculated by ABCI Securities, which reflects the financial of the Group ended in Dec during the corresponding years  
Source(s): Company, ABCI Securities estimates

**Key operating and financial ratios (2012A-2016E)**

FY ended Dec 31	2012A <sup>^</sup>	2013A <sup>^</sup>	2014E	2015E	2016E
<b>Sales mixed (%)</b>					
Raw milk	95.76	90.23	85.43	80.73	76.97
Liquid milk products	4.24	9.77	14.57	19.27	23.03
<b>Profit &amp; loss ratios (%)</b>					
Gross margin	32.08	38.22	39.45	40.59	41.83
Net profit margin	20.09	14.62	19.15	22.61	25.56
Effective tax rate	0.82	2.04	3.59	4.01	4.23
<b>Growth (%)</b>					
Revenue		61.67	39.54	19.63	17.22
Gross profit		92.62	44.01	23.11	20.80
EBIT		29.56	63.14	32.30	27.63
EBITDA		33.17	59.14	27.53	24.38
Net profit		17.67	82.74	41.22	32.50
<b>Balance sheet ratios</b>					
Current ratio (x)	0.39	0.45	0.59	0.83	1.15
Quick ratio (x)	0.24	0.30	0.39	0.61	0.90
Cash ratio (x)	0.15	0.18	0.25	0.46	0.75
Trade and bill receivables days	31.85	38.10	38.00	35.00	30.00
Trade and bill payables turnover days	141.39	129.49	100.00	100.00	90.00
Inventory turnover days	102.80	101.61	100.00	100.00	100.00
Total debt / equity ratio (%)	62.07	84.44	74.71	67.90	60.27
Net debt / equity ratio (%)	53.25	70.79	59.26	42.52	27.08
<b>Returns (%)</b>					
ROAE	8.25	8.76	14.22	17.14	18.94
ROAA	4.79	4.25	6.71	8.43	9.81
Payout ratio	-	-	-	-	-

<sup>^</sup> Financial year end of Modern Dairy's was changed from June to Dec in 2013. Historical data for 2012 and 2013 was recalculated by ABCI Securities, which reflects the financial of the Group ended in Dec during the corresponding years  
Source(s): Company, ABCI Securities estimates



## Disclosures

### Analyst Certification

I, Steve Wong, being the person primarily responsible for the content of this research report, in whole or in part, hereby certify that all of the views expressed in this report accurately reflect my personal view about the subject company or companies and its or their securities. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this report. I and/or my associates have no financial interests in relation to the listed company (ies) covered in this report, and I and/or my associates do not serve as officer(s) of the listed company (ies) covered in this report.

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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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