

Sep 4, 2015
Company Report
Rating: HOLD
TP: HK\$ 1.72

Share price (HK\$)	1.62
Est. share price return	6.25%
Est. dividend yield	0
Est. total return	6.25%

Previous Rating	2.17
Previous TP	HOLD

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Key Data

52Wk H/L(HK\$)	2.53/1.25
Outstanding shares (mn)	6,354.40
Market cap (HK\$ mn)	10,294.13
3-mth avg daily turnover (HK\$ mn)	7.68
Major shareholder(s) (%)	
World Shining Investment Ltd.,	56.56
Greenbelt Global Ltd.,	6.22
Goldman Sachs Group Inc.	6.22
Sequoia Capital 2010 CGF	5.95

Source(s): Bloomberg, ABCI Securities

Revenue contribution of business segments

(%)	1H15	FY14
Dairy farming business	51.23	65.33
- Organic raw milk	25.79	34.32
- Non-organic raw milk	25.45	31.01
Liquid milk business	48.77	34.67

Source(s): The Group, ABCI Securities

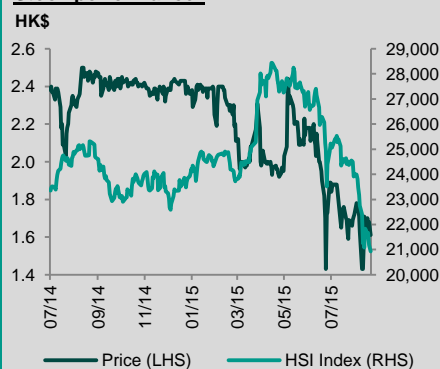
Share price performance (%)

	Absolute	Relative*
1-mth	(4.14)	10.36
3-mth	(23.58)	(0.14)
6-mth	(29.57)	(16.74)

*Relative to HSI

Source(s): Bloomberg, ABCI Securities

Stock performance



Source(s): Bloomberg, ABCI Securities

Shengmu (1432 HK)

Mediocre growth outlook; maintain HOLD

- 1H15 sales, gross profit, and net profit grew by 52.78% YoY, 43.66% YoY, and 19.53% YoY; ASP decline was seen in the dairy farming and liquid milk segments
- The Group has sold more raw milk to its internal division than liquid milk products to its downstream customers; the downstream market might not be able to absorb the Group's liquid milk product in a pace that matches the Group's expansion
- Less efficient working capital management suggests weakened relationships with suppliers and customers
- Mediocre growth outlook prompt us to maintain **HOLD** with TP revised down to HK\$ 1.72

Above average growth in 1H15. Shengmu recorded an above-average-growth in 1H15, with sales, gross profit, and net profit rising by 52.78% YoY, 43.66% YoY, and 19.53% YoY, respectively. Sales in dairy farming segment only expanded by 7.07% YoY as raw milk sales was dragged by ASP decline. Sales in its liquid milk segment, contrary to most industry peers, surged 177.02% YoY. While ASP of the segment also fell by 23.71% YoY in 1H15, strong volume growth of 263.11% YoY offset the price decline and contributed to the strong growth.

Potential decline in sales efficiency. The Group's sales volume of internal organic raw milk amounted to 103,109 tonnes in 1H15 vs. 21,356 tonnes in 1H14. Sales volume of liquid milk reached 59,550 tonnes in 1H15 vs. 16,400 tonnes in 1H14. According to our calculation, the Group's internal raw milk-to-liquid milk conversion rate was 57.75% in 1H15 vs. 76.79% in 1H14, which could imply that the Group's production efficiency in the liquid milk segment has declined significantly. An alternative interpretation is that the Group has sold more raw milk to its liquid milk division than liquid milk products to its downstream customers. Considering the industry condition in 1H15, we believe the latter view is more plausible and this points to possible decline in earnings quality.

Less efficient working capital management. The Group's inventory turnover days declined from 227 days in 1H14 to 165 days in 1H15. However, receivable turnover days increased from 48 days in 1H14 to 68 days in 1H15, and payable turnover days decreased from 150 days to 102 days in 1H15. These changes suggest the Group's bargaining power with its suppliers may have weakened and more credits were extended to distributors, while payments to suppliers had to be settled sooner.

Questionable growth strategy. Even though the Group's organic milk products are unique in the market at present, we believe it would not be difficult for major dairy companies to launch new, similar products. In addition, the low entry barrier of the Group's "Blue Ocean" strategy, which involves the development of large chain community stores, can be easily emulated by competitors in our view.

Mediocre earnings outlook; maintain HOLD. Based on our estimates, sales, gross profit, and net profit would grow by 26.62% YoY, 4.17% YoY, and 2.3% YoY in FY15E. In particular, sales in dairy farming segment sales would maintain a decent growth of 9.6% YoY, but its liquid milk business would expand at a slower rate of 58.68% YoY in FY15E (vs. 177.02% in 1H14). FY15E GPM and NPM would be 41.28% and 26.95%, while ROAA and ROAE would be 9.61% and 15.38%. Based on the Group's business prospect, we adjust the Group's TP down to HK\$ 1.72, which represents 9.90x FY16E P/E and 1.64x FY16E P/B. Maintain **HOLD**.

Results and Valuation

FY ended Dec 31	FY13A	FY14A	FY15E	FY16E	FY17E
Revenue (RMB mn)	1,143.71	2,132.43	2,700.03	3,224.93	3,875.45
Chg (% YoY)	63.21	86.45	26.62	19.44	20.17
Net Income (RMB mn)	327.31	711.23	727.61	883.78	1,161.37
Chg (% YoY)	67.18	117.30	2.30	21.46	31.41
Basic EPS (RMB cent)	7.50	11.80	11.45	13.91	18.28
P/E (x)	N/A	12.08	11.81	9.72	7.35
BVPS (RMB)	N/A	0.59	0.73	0.84	1.02
P/B (x)	N/A	2.89	2.33	2.01	1.65
DPS (RMB cent)	0	0	0	0	0
Yield (%)	0	0	0	0	0
ROAA (%)	13.28	14.81	9.61	9.17	9.86
ROAE (%)	22.37	23.85	15.38	15.72	17.33

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

Appendix: Financial Statements of the Group

Consolidated income statement (FY13A-FY17E)

As of Dec 31 (RMB mn, except per share data)	FY13A	FY14A	FY15E	FY16E	FY17E	1H14A	1H15A
Revenue	1,144	2,132	2,700	3,225	3,875	906	1,384
- Dairy farming segment	841	1,393	1,527	1,626	1,875	785	1,270
- Liquid milk segment	303	739	1,173	1,599	2,001	244	675
COGS	(653)	(1,063)	(1,586)	(1,880)	(2,179)	(462)	(746)
Gross profit	490	1,070	1,114	1,345	1,696	444	637
Other gains and income	16	109	90	170	274	18	36
SG&A	(97)	(230)	(321)	(428)	(504)	(74)	(165)
EBIT	409	949	884	1,086	1,466	387	509
Net finance cost	(33)	(54)	(79)	(86)	(120)	(27)	(41)
Share of profit and losses of associates	(1)	(8)	(8)	(9)	(10)	(4)	(8)
Pre-tax profit	375	888	797	991	1,335	356	461
Tax	(1)	(4)	(3)	(4)	(5)	(1)	(0)
Net profit	374	884	794	987	1,331	356	461
- Profit to shareholders	327	711	728	884	1,161	279	334
- Minority interest	47	173	67	104	169	77	127
EPS (RMB)							
- Basic	0.075	0.118	0.115	0.139	0.183	0.049	0.053
- Diluted	0.075	0.116	0.106	0.129	0.170	0.049	0.052

Source(s): The Group, ABCI Securities estimates

Consolidated balance sheet (2013A-2017E)

As of Dec 31 (RMB mn)	FY13A	FY14A	FY15E	FY16E	FY17E	1H14A	1H15A
Cash and bank balance	127	735	1,316	1,592	2,117	335	791
Trade and bills receivables	63	398	267	469	438	174	633
Inventories	335	701	695	899	984	240	646
Other current assets	109	202	507	618	854	204	269
Total current assets	635	2,035	2,784	3,578	4,394	952	2,339
Biological assets	1,510	2,720	3,609	4,206	4,850	1,997	2,992
PP&E	923	1,658	2,129	2,748	3,520	1,178	1,928
Other non-current assets	45	78	138	79	178	23	77
Total non-current assets	2,477	4,456	5,875	7,033	8,548	3,198	4,997
Total assets	3,113	6,491	8,659	10,611	12,941	4,190	7,336
Trade and bills payables	191	424	220	690	272	175	538
Receipts in advance	82	32	137	82	156	53	23
Short-term debt	932	1,334	2,419	3,150	4,148	944	1,616
Other current liabilities	199	296	524	501	847	206	297
Total current liabilities	1,405	2,086	3,301	4,424	5,424	1,378	2,474
Total non-current liabilities	0	150	150	150	150	0	137
Total liabilities	1,405	2,236	3,451	4,574	5,574	1,378	2,611
Equity attributable to shareholders	1,494	3,722	4,450	5,333	6,495	2,471	4,066
Minority interest	214	533	600	703	873	340	660
Equities	1,708	4,255	5,209	6,037	7,368	2,811	4,727
Total liabilities and equity	3,113	6,491	8,659	10,611	12,941	4,190	7,337

Source(s): The Group, ABCI Securities estimates

Consolidated cash flow statement (2013A-2017E)

As of Dec 31 (RMB mn)	FY13A	FY14A	FY15E	FY16E	FY17E	1H14A	1H15E
Profit before tax	375	888	797	991	1,335	356	461
Depreciation and amortization	29	60	103	137	179	25	30
Change in working capital	(65)	(545)	(193)	(0)	(443)	(143)	(155)
Others	24	24	35	(38)	(106)	20	58
Total cash flow from operation	364	427	742	1,090	966	259	394
Changes in PP&E	(442)	(760)	(556)	(704)	(889)	(300)	(270)
Changes in biological assets	(490)	(1,131)	(676)	(684)	(346)	(479)	(272)
Others	(2)	(24)	(3)	(3)	(3)	(9)	(295)
Total Cash Flow From investing	(934)	(1,915)	(1,235)	(1,391)	(1,237)	(788)	(837)
Net change of debt	586	534	1,031	695	948	(6)	269
Interest paid	(33)	(60)	(110)	(117)	(152)	(28)	(47)
Others	115	1,621	153	0	(0)	751	(3)
Total Cash Flow From Financing	668	2,095	1,074	578	796	717	218
Net change in cash	97	607	581	276	525	187	(225)
Cash and cash equivalent at beg	30	127	735	1,316	1,592	127	735
ForEx change	0	0	0	0	0	11	0
Cash and cash equivalent at end	127	735	1,316	1,592	2,117	326	511

Source(s): The Group, ABCI Securities estimates

Key operating and financial ratios (2013A-2017E)

As of Dec 31	FY13A	FY14A	FY15E	FY16E	FY17E	1H14A	1H15A
Growth (YoY %)							
Dairy farming business	26.08	65.70	9.60	6.52	15.28	85.55	7.07
- Organic raw milk	109.95	107.36	9.54	(9.76)	6.02	140.83	5.58
- Non-organic raw milk	(2.19)	35.56	9.66	24.51	22.70	49.72	8.63
Liquid milk business	792.93	144.03	58.68	36.26	25.15	132.55	177.02
Gross profit	109.53	118.14	4.17	20.65	26.14	164.96	43.66
Net profit	67.18	117.30	2.30	21.46	31.41	171.48	19.53
Revenue composition (%)							
Dairy farming business	73.51	65.33	56.55	50.43	48.38	73.10	51.23
- Organic raw milk	30.86	34.32	29.69	22.43	19.79	37.31	25.79
- Non-organic raw milk	42.65	31.01	26.86	28.00	28.59	35.79	25.45
Liquid milk business	26.49	34.67	43.45	49.57	51.62	26.90	48.77
Profitability ratios (%)							
Gross margin	42.88	50.17	41.28	41.69	43.77	49.00	46.07
EBIT margin	35.76	44.52	32.74	33.69	37.82	42.78	36.78
EBITDA margin	37.39	47.34	36.57	37.93	42.45	45.59	38.95
Pre-tax margin	32.78	41.62	29.51	30.73	34.46	39.34	33.33
Net margin	28.62	33.35	26.95	27.40	29.97	30.82	24.11
Return ratios (%)							
ROAA	13.28	14.81	9.61	9.17	9.86	7.64	4.83
ROAE	22.37	23.85	15.38	15.72	17.33	12.35	7.43
ROIC	46.02	44.35	30.98	31.62	32.26	15.33	13.04
Liquidity ratio (%)							
Current ratio	45.22	97.55	84.36	80.87	81.00	69.05	94.55
Quick ratio	12.11	29.93	35.56	38.08	39.89	51.65	68.43
Cash ratio	9.05	35.22	39.87	35.99	39.03	24.27	31.98
Cash conversion cycle (days)							
Days of outstanding receivable	14.04	39.45	44.90	41.61	42.71	47.75	67.94
Days of inventory on hand	150.70	178.00	160.70	154.75	157.72	227.19	164.79
Days of outstanding payable	75.21	78.57	74.44	79.72	77.58	149.80	102.04
CCC	89.53	138.89	131.15	116.64	122.85	125.14	130.68
Leverage ratios (%)							
Total debt/Equity	54.57	44.07	49.32	54.67	58.34	33.58	37.09
Total debt/Total assets	29.94	22.86	29.67	31.10	33.21	22.53	23.90

Source(s): The Group, ABCI Securities estimates

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 2010-2014

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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