

Sep 2, 2015
Company Report
Rating: HOLD
TP: HK\$ 31.13

Share price (HK\$)	25.05
Est. share price return	24.29%
Est. dividend yield	1.51%
Est. total return	25.79%

Previous Rating	BUY
Previous TP	HK\$ 41.63

Analyst: Paul Pan
Tel: (852) 2147 8829
Email: paulpan@abci.com.hk

Key Data

52Wk H/L(HK\$)	51/24
Outstanding shares (mn)	1,961.29
Market cap (HK\$ mn)	49,130.37
3-mth avg daily turnover (HK\$ mn)	216.05
Major shareholder(s) (%):	
COFCO Dairy Investment Ltd.	23.92
Commonwealth Bank of Australia	9.05
Prominent Achiever Ltd.	7.55
JP Morgan Chase & Co.	7.54

Source(s): Bloomberg, ABCI Securities

Revenue contribution of business segments

(%)	1H15	FY14
Liquid milk	85.83	85.99
- UHT milk	41.90	47.36
- Milk beverage	22.13	23.82
- Yogurt	21.80	14.81
Ice cream	6.43	5.43
Milk formula	6.98	7.91
Other revenue	0.01	0.67

Source(s): The Group, ABCI Securities

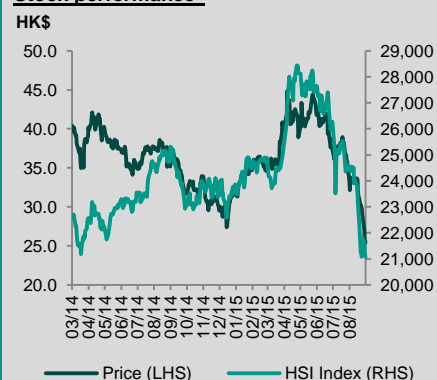
Share price performance (%)

	Absolute	Relative*
1-mth	(28.53)	(13.74)
3-mth	(40.48)	(17.94)
6-mth	(27.50)	(13.72)

*Relative to HSI

Source(s): Bloomberg, ABCI Securities

Stock performance



Source(s): Bloomberg, ABCI Securities

Mengniu (2319 HK)

Reduced competitiveness and challenging business outlook; downgrade to **HOLD**

- 1H15 sales and gross profit fell 1.05% and 2.85% YoY while operating profit and net profit grew 20.57% and 27.66% YoY; GPM dropped to 31.85%, but OPM and NPM increased to 5.76% and 5.24% in 1H15
- Revenue from liquid milk segment grew by a meager 0.81% YoY as UHT milk products sales declined by 13.38% YoY; ice-cream sales dropped 17.31% YoY while milk formula product sales reduced by 7.7% YoY as Yashili's fallen revenue
- Yili, Mengniu's major competitor in China, recorded both revenue and profit growth in 1H15, suggesting that the market still presents growth opportunities
- Downgrade to HOLD; TP revised down to HK\$ 31.13 due to challenging industry environment and muted business outlook for the Group in FY15

Profitability remained stable in 1H15. Mengniu's revenue and gross profit declined by 1.05% YoY and 2.85% YoY in 1H15; GPM declined from 32.44% in 1H14 to 31.85%. EBIT and net profit showed a moderate growth mainly because of the relatively flat SG&A/Sales ratio (1H15: 26.05%; 1H14: 26.55%, FY14: 24.99%) and sizable reduction in net expense in 1H15. Yashili continued to impact the Group's performance negatively. Excluding Yashili's results, Mengniu's revenue grew 0.5% YoY; GPM remained stable at ~31%; NPM improved to 5.31% in 1H15 from 3.83% in 1H14.

Segment performance disappoints but yogurt products see positive development. Revenue from UHT milk and milk beverage declined by 13.38% YoY and 2.89% YoY in 1H15. But, on a positive note, the Group's cooperation with Danone in yogurt products showed encouraging results – revenue growth in the product category accelerated to 55.95% YoY in 1H15. Thus, the sales of liquid milk segment edged up by 0.81% YoY. By revenue, the ice-cream segment recorded a 17.31% YoY decline while milk powder business fell 7.77% YoY in 1H15, mainly dragged by Yashili's revenue that went down by 24.9% YoY in 1H15.

Efforts in sales promotion may have lagged behind peers. The relatively muted performance in 1H15 could be resulted from the lack of swift responses to market changes. Its competitors mostly recorded higher selling and distribution expenses in 1H15 (e.g., Yili: +15.18% YoY); in contrast, Mengniu's selling and distribution expenses declined by 5.63% YoY in 1H15 and is equivalent to 21.77% of sales. This shows that it may have lagged behind peers in promotional efforts.

Working capital management weakened. The Group's inventory turnover days increased to 45 days in 1H15 from 36 days in FY14. Receivable turnover days increased from 7 days in FY14 to 11 days in 1H15. The figures suggest the Group's products have been moving more slowly and bargaining power with distributors has deteriorated on lower product competitiveness.

Distribution network development needs to be intensified. Through its sales performance, we believe Mengniu has adopted a conservative approach in developing its channels. Mengniu will emphasize on consolidating distributors and developing sales companies in 2H15, but expanding non-traditional sales channels, including e-commerce and baby stores, would provide room for growth in our view.

Results and Valuation

FY ended Dec 31	FY13A	FY14A	FY15E	FY16E	FY17E
Revenue (RMB mn)	43,356.91	50,049.24	51,648.56	57,678.86	66,930.12
Chg (% YoY)	20.44	15.44	3.20	11.68	16.04
Net Income (RMB mn)	1,861.99	2,690.65	2,864.10	3,418.75	4,776.41
Chg (% YoY)	25.16	44.14	7.08	18.97	39.74
Basic EPS (RMB cent)	0.90	1.21	1.28	1.53	2.13
P/E (x)	31.58	21.16	15.57	13.10	9.31
BVPS (RMB)	5.51	8.68	9.67	10.83	12.44
P/B (x)	5.18	2.95	2.07	1.85	1.60
DPS (RMB cent)	0.27	0.35	0.38	0.45	0.62
Yield (%)	0.73	1.08	1.51	1.80	2.50
ROAA (%)	5.33	5.38	5.07	5.47	6.54
ROAE (%)	11.71	12.76	11.26	12.35	15.68

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

Downward pressure in the milk formula segment to continue. We remain cautious on the Group's milk formula segment. It would become quite difficult to achieve a high growth over the next few quarters given that competition has increased substantially in 1H15. Moreover, a turnaround in Yashili is unlikely in 2H15. The acquisition of Dumex, a Chinese infant formula brand, from Danone would not result in a higher organic growth under the tough industry environment, especially given that Dumex is not a particularly strong player in the Chinese IMF market. Nonetheless, Yashili's expansion into the adult milk formula business may help boost its sales.

Yili's results painted a different picture. Yili, another major dairy player in China, presented a surprising 1H15 results. Its core revenue, core gross profit, and net profit grew by 8.04% YoY, 15.05% YoY, and 15.95% YoY; core GPM and NPM also improved to 35.31% and 8.92% in 1H15 from 33.16% and 8.4% in 1H14. Yili maintained a decent growth momentum (+8.28% YoY) in the liquid milk segment, as opposed to the meager growth (+0.81% YoY) in Mengniu's liquid milk product segment. This suggests Yili's sales distribution network could be more developed than that of Mengniu and employed more effective sales promotional campaign. In addition, Yili's diversified business portfolio includes a milk formula segment whose revenue size is twice that of Mengniu's milk formula segment and provided additional revenue from its financing arms in 1H15. Yili's results suggest its superiority in product and sales management.

Potential revenue drivers. Even though the changing industry environment has exerted pressure on the Group's performance, we believe revenue/profit growth drivers may emerge. E.g. successful expansion of its yogurt business would rev up growth momentum in 2H15. Moreover, potential cost reduction resulted from consolidation of sales network would help improve margins and its sales performance in 2H15. From a longer-term perspective, Mengniu's diversification into other product categories, such as plant protein drinks, would also help boost revenue growth in coming years.

Earnings outlook. As the Group becomes less competitive and faces a larger number of strong competitors, we expect Mengniu would target to boost volume growth in the short term. A higher S&D cost/revenue ratio could be expected for FY15 as the Group intensify its promotional efforts and channel development. Based on our estimates, the Group's financial performance would improve starting from FY16E. For FY15E, we expect revenue, gross profit, and net profit to grow by 3.20% YoY, 4.48% YoY, and 7.08% YoY; the respective figures would improve to 11.68% YoY, 12.78% YoY, and 18.97% YoY in FY16E. We believe its cost management capability and the low-cost environment would help stabilize profitability ratios, and GPM, OPM, and NPM in FY15E would be 31.22%, 5.53%, and 4.87%, respectively. ROAA and ROAE would be 5.07% and 11.26% in FY15E, and 5.47% and 12.35% in FY16E.

Downgrade to HOLD; TP at HK\$ 31.13. While recent decline in Mengniu' share price has been partly induced by the overall market sell-off, limited synergies observed between Mengniu and Yashili, as well as the Group's weakened growth potential, have curbed investors' enthusiasm. Based on the disappointing interim results and the uncertain industry outlook, we downgrade the counter from Buy to **HOLD**. Our revised target price of HK\$ 31.13 is equivalent to 13.13x FY16 P/E and 1.85x FY16 P/B and entails a 24.29% upside.

Risk factors: 1) Product quality and food safety risk; 2) Regulatory risk, 3) Domestic economic growth risk; 4) Risks related to cooperation with new business partners; 5) New product and sales strategy implementation risk; 6) Political risk.

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	43,356.91	50,049.24	51,648.56	57,678.86	66,930.12	25,835.83	25,564.41
- Liquid milk	37,902.83	43,036.16	45,280.66	50,448.23	58,894.25	21,764.84	21,940.95
- Ice cream	3,023.37	2,716.10	2,763.87	2,979.70	3,170.05	1,988.38	1,644.27
- Milk formula	2,177.25	3,960.96	3,123.52	3,588.84	3,936.27	1,933.84	1,783.49
- Other revenue	253.45	336.02	480.51	662.10	929.55	148.77	195.71
COGS	(31,659.66)	(34,615.63)	(35,523.88)	(39,492.72)	(45,873.91)	(17,454.02)	(17,421.60)
Gross profit	11,697.25	15,433.61	16,124.68	18,186.14	21,056.22	8,381.82	8,142.81
Other income	288.63	449.07	393.51	435.06	515.22	250.87	177.61
SG&A	(9,774.03)	(12,504.93)	(13,340.73)	(15,280.86)	(17,115.82)	(6,859.18)	(6,658.93)
Other expenses	(360.13)	(713.21)	(322.10)	(349.67)	(529.33)	(556.20)	(182.84)
EBIT	1,851.72	2,664.55	2,855.35	2,990.67	3,926.28	1,220.66	1,471.75
Net interest expense(-)/income(+)	198.92	207.73	479.50	962.21	1,544.88	77.62	139.15
Income from associate/JV	153.86	277.73	163.26	235.69	285.49	183.18	143.31
Profit before tax	2,204.50	3,150.01	3,498.11	4,188.57	5,756.65	1,481.46	1,754.20
Tax	(366.71)	(459.29)	(634.01)	(769.82)	(980.25)	(252.50)	(321.34)
Profit from discontinued operation	24.20	(0.06)	-	-	-	(0.02)	(0.01)
Total net profit	1,861.99	2,690.65	2,864.10	3,418.75	4,776.41	1,228.93	1,432.85
- Profit to shareholders	1,630.93	2,350.80	2,517.14	2,994.58	4,184.59	1,048.61	1,338.67
- Minority interest	231.06	339.85	346.96	424.17	591.82	180.33	94.18
EPS (RMB)							
- Basic	0.904	1.210	1.283	1.527	2.134	0.540	0.689
- Diluted	0.896	1.203	1.283	1.527	2.133	0.534	0.686
DPS	0.267	0.347	0.377	0.451	0.625	0	0

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 equivalent	7,102	4,650	12,507	16,898	26,379	8,677	8,607
Accounts receivables	754	1,148	1,707	1,099	1,903	1,262	1,864
Inventory	2,577	4,342	4,201	4,507	6,069	4,460	4,289
Other current assets	5,888	10,193	5,529	5,951	6,479	5,294	7,797
Total current assets	16,321	20,333	23,944	28,456	40,830	19,693	22,557
PP&E and construction in progress	10,522	11,697	12,013	12,086	11,823	10,962	11,776
Land use rights	1,049	1,051	1,104	1,209	1,297	1,095	1,096
Goodwill & intangibles	7,307	7,458	7,452	7,445	7,437	7,301	7,454
Other non-current assets	5,140	6,542	7,715	8,108	9,218	7,211	7,222
Total non-current assets	24,018	26,748	28,285	28,848	29,774	26,568	27,548
Total assets	40,339	47,081	52,228	57,303	70,605	46,261	50,105
Accounts payables	4,761	4,992	5,550	5,625	8,101	5,121	5,161
Short-term debt	8,462	4,361	5,882	6,835	8,145	5,169	5,052
Other current liabilities	4,841	4,999	6,494	7,983	13,665	5,888	5,451
Total current liabilities	18,063	14,351	17,926	20,443	29,911	16,178	15,664
Long-term debt	3,236	5,464	4,982	4,976	4,970	4,816	5,417
Other non-current liabilities	1,029	2,773	2,900	3,202	3,875	2,036	2,790
Total non-current liabilities	4,265	8,237	7,882	8,178	8,845	6,852	8,206
Total liabilities	22,328	22,588	25,807	28,621	38,756	23,030	23,871
Equity attributable to shareholders	15,361	21,489	23,234	25,266	28,119	20,274	21,419
Minority interest	2,650	3,003	3,187	3,416	3,731	2,957	4,815
Equities	18,011	24,493	26,421	28,682	31,849	23,230	26,234
Total liabilities and equity	40,339	47,081	52,228	57,303	70,605	46,261	50,105

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	2,229	3,150	3,498	4,189	5,757	1,481	1,754
Depreciation and amortization	1,218	1,342	1,532	1,691	1,902	638	701
Change in working capital	517	(478)	201	1,391	1,580	(221)	(422)
Others	(679)	(934)	(1,343)	(2,027)	(2,845)	(352)	75
Total cash flow from operation	3,284	3,080	3,888	5,243	6,394	1,547	2,107
CapEx	(12,597)	(3,278)	(2,281)	(2,431)	(2,499)	(1,485)	(1,440)
Others	(2,672)	(3,137)	(2,622)	(2,146)	(1,572)	(1,756)	(1,005)
Total Cash Flow From investing	(15,269)	(6,415)	(4,904)	(4,577)	(4,071)	(3,241)	(2,445)
Change in debt	7,840	(1,946)	1,039	948	1,303	(1,818)	644
Dividend paid	(385)	(491)	(680)	(740)	(884)	(463)	(549)
Others	4,876	6,055	(675)	(840)	(1,258)	5,605	(131)
Total Cash Flow From Financing	12,331	3,619	(317)	(632)	(839)	3,323	(36)
Net change in cash	346	283	(1,332)	34	1,484	1,629	(374)
Cash and cash equivalent at beg	2,918	3,355	3,607	2,295	2,349	3,355	3,607
ForEx change	148	(31)	20	20	20	25	12
Cash and cash equivalent at end	3,355	3,607	2,295	2,349	3,853	5,009	3,245
Time deposit - maturity longer than three months	3,747	1,043	10,212	14,549	22,526	3,668	5,362
Cash and cash equivalent on Balance Sheet	7,102	4,650	12,507	16,898	26,379	8,677	8,607

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 measures (%)							
Sales growth	20.44	15.44	3.20	11.68	16.04	25.00	(1.05)
Liquid milk growth	17.22	13.54	5.22	11.41	16.74	19.18	0.81
- UHT milk growth	11.91	7.47	(5.39)	3.60	10.76	13.02	(13.38)
- Milk beverage growth	29.69	14.34	5.80	9.18	11.41	23.12	(2.89)
- Yogurt growth	18.12	36.69	38.18	31.27	32.53	37.99	55.95
Ice cream growth	(4.67)	(10.16)	1.76	7.81	6.39	1.74	(17.31)
Milk powder growth	393.09	81.92	(21.14)	14.90	9.68	390.67	(7.77)
Other product growth	94.46	32.58	43.00	37.79	40.40	161.39	31.55
Gross profit growth	30.70	31.94	4.48	12.78	15.78	51.88	(2.85)
Operating profit growth	15.17	43.90	7.16	4.74	31.28	36.54	20.57
Net profit growth	25.16	44.14	7.08	18.97	39.74	39.91	27.66
Profitability ratios (%)							
Gross margin	26.98	30.84	31.22	31.53	31.46	32.44	31.85
EBIT margin	4.27	5.32	5.53	5.19	5.87	4.72	5.76
EBITDA margin	7.49	8.56	8.49	8.12	8.71	7.90	9.06
Pre-tax margin	5.08	6.29	6.77	7.26	8.60	5.73	6.86
Net margin	3.76	4.70	4.87	5.19	6.25	4.06	5.24
Return ratios (%)							
ROAA	5.33	5.38	5.07	5.47	6.54	2.42	2.75
ROAE	11.71	12.76	11.26	12.35	15.68	5.09	5.28
ROIC	5.84	5.88	5.80	6.88	8.37	5.10	3.23
Liquidity ratio (%)							
Current ratio	90.36	141.68	133.57	139.19	136.51	121.73	144.00
Quick ratio	76.09	111.42	110.14	117.14	116.22	94.16	116.62
Cash ratio	42.42	34.18	71.34	84.17	89.33	54.40	57.76
Cash conversion cycle (days)							
Days of outstanding receivable	6.78	6.94	10.09	8.88	8.19	7.12	10.75
Days of inventory on hand	22.71	36.48	43.89	40.24	42.08	36.79	45.21
Days of outstanding payable	46.58	48.93	54.37	51.25	52.81	46.63	54.02
CCC	(17.09)	(5.51)	(0.40)	(2.13)	(2.55)	(2.72)	1.95
Leverage ratios (%)							
Total debt/Equity	64.94	40.11	41.78	41.86	41.82	43.53	40.57
Total debt/Total assets	29.00	20.87	20.80	20.61	18.57	21.86	21.24

Source(s): The Group, ABCI Securities estimates

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Analyst Certification

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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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**Office address: ABCI Securities Company Limited, 13/F Fairmont House,
8 Cotton Tree Drive, Central, Hong Kong.**

Tel: (852) 2868 2183