

Aug 28, 2015

Company Report

Rating: HOLD

TP: HK\$ 2.59

Share price (HK\$)	2.19
Est. share price return	18.33%
Est. dividend yield	0.46%
Est. total return	18.79%

Previous Rating	BUY
Previous TP	HK\$ 3.8

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Key Data

52Wk H/L(HK\$)	4.19/1.77
Outstanding shares (mn)	5,304.77
Market cap (HK\$ mn)	11,617.44
3-mth avg daily turnover (HK\$ mn)	31.73
Major shareholder(s) (%):	
China Mengniu Dairy CO LTD	25.41
Xinmu Holdings Co LTD	12.65
Kohlberg Kravis Roberts & Co LP	9.00
Yinmu Holdings Co LTD	8.42

Source(s): Bloomberg, ABCI Securities

Revenue contribution of business segments

(%)	1H15	FY14
Dairy farming	67.61	83.43
Liquid milk product	32.39	16.57

Source(s): The Group, ABCI Securities

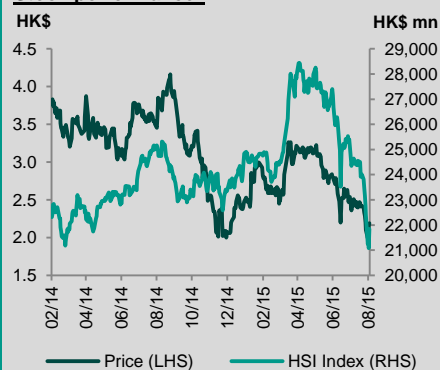
Share price performance (%)

	Absolute	Relative*
1-mth	(7.20)	2.88
3-mth	(32.11)	(11.14)
6-mth	(21.72)	(11.88)

*Relative to HSI

Source(s): Bloomberg, ABCI Securities

Stock performance



Source(s): Bloomberg, ABCI Securities

* All market data and related figures in the report are based on the closing price on Aug. 27

Modern Dairy (1117 HK)

Dismal 1H15 results and a challenging outlook; downgrade to HOLD

- 1H15 sales, gross profit, operating profit, and net profit declined by 5.7% YoY, 11.58% YoY, 1.59% YoY, and 8.83% YoY, respectively; GPM and NPM dropped to 36.47% and 19.57% in 1H15; OPM edged up to 27.08%
- GPM of dairy farming business remained stable at ~40% but the segment's ASP and volume declined. Liquid milk products' GPM rose to 28.53%, and the substantial growth in volume helped offset the decline in ASP and drove up revenue by 177.37% YoY
- Cash EBITDA decreased from RMB 966.69mn in 1H14 to RMB 857.93mn in 1H15 and cash EBITDA margin declined to 35.2%, signaling a decline in earnings quality
- Downgrade to **HOLD**; TP is revised down on uncertain industry environment and dismal performance outlook in FY15E/FY16E

Diversification effort has been effective. Modern Dairy's effort in diversifying has been reflected in its 1H15 results. Revenue contribution from the liquid milk product segment increased from 11.01% in 1H14 to 32.39% in 1H15. As the Group expands its geographical coverage, we expect revenue contribution from its downstream business to increase.

Revenue growth faltered as raw milk business was under pressure. The Group's 1H15 revenue fell by 5.7% YoY as compared to the 86.20% YoY growth in 1H14. The revenue decline was mainly attributable to the upstream business, whose revenue dropped 28.35% YoY. Contributing to the decline in the raw milk business was the fallen ASP (-11.67% YoY to RMB 4.54/Kg) and volume(- 17.09% YoY to 363,271 tons). The upstream business was still under immense pressure in 1H15 because of the declining milk powder price, oversupply of raw milk, and change in industrial customers' product structure. Looking forward, price is unlikely to recover as national raw milk price would maintain at the current level with minor fluctuations. Sales volume of raw milk may continue to decline in coming months on faltering domestic demand and continuous shift in downstream product structure that extends into 2H.

Unsustainable growth momentum of downstream business. Revenue of the liquid milk product segment rose by 177.37% YoY; volume increased by 220.39% YoY while ASP declined by 13.44% YoY. We remain doubtful if such volume growth could be sustained in 2H15 given the intensifying market competition. Certain domestic players have already taken up a large market share while numerous foreign brands are entering the Chinese market with competitive pricing. In addition, the high volume growth could mean a higher inventory level among the distributors and consumers, thus sales growth may slow in 2H15.

Profitability saw partial improvement. Modern Dairy recorded GPM, OPM, and NPM of 36.47%, 27.08%, and 19.57% in 1H15 vs. 38.9%, 25.59%, and 20.24% in 1H14. It is worth noting that the Group's GPM in the liquid milk business improved from 23.95% in 1H14 to 28.53% in 1H15. Meanwhile, GPM of raw milk business remained steady at ~40%. For 2H15, however, GPM for the liquid milk business could be stalled or slashed as competition intensifies and bigger discount to distributors becomes necessary. As for the upstream business, we expect the sufficient supply in the market in 2H15, as well as the depressed international milk powder price, would exert further pressure on the segment's margins.

Results and Valuation

FY ended Dec 31	FY13A	FY14A	FY15E	FY16E	FY17E
Revenue (RMB mn)	3,289.28	5,026.71	4,781.04	5,482.12	6,024.76
Chg (% YoY)	61.67	52.82	-4.89	14.66	9.90
Net Income (RMB mn)	506.99	762.89	755.35	797.96	888.14
Chg (% YoY)	17.67	52.86	-1.32	5.37	11.66
Basic EPS (RMB cent)	9.99	15.23	13.68	14.41	16.09
P/E (x)	32.91	11.61	12.80	12.16	10.81
BVPS (RMB)	1.13	1.28	1.31	1.45	1.61
P/B (x)	1.44	1.60	1.63	1.81	2.03
DPS(RMB cent)	N/A	1.00	1.00	1.05	1.17
Yield (%)	N/A	0.45	0.46	0.48	0.54
ROAA (%)	4.25	5.51	4.90	4.70	4.83
ROAE (%)	8.60	11.75	10.32	9.79	9.87

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



Longer receivable turnover days could mean worsening industry condition. The Group's receivable turnover days increased by ~20 days in 1H15 compared to that in 1H14. While manageable at the current level, the longer receivable turnover suggests that the Group's change in business structure has a unfavorable impact on the Group's working capital efficiency, and the Group may have extended its credits to customers amid a worsening industry environment.

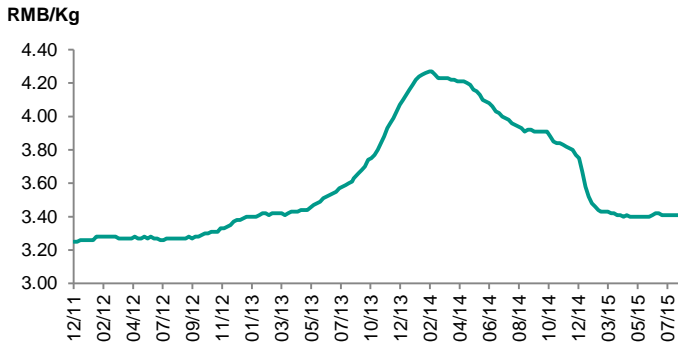
Potential biological asset revaluation could be a concern. The number of milkable cows owned by the Group decreased to 102,593 at end-1H15 from 107,578 at end-FY14; the number of heifers and calves increased from 93,929 at end-FY14 to 95,240 at end-1H15. Hence, total herd size decreased from 201,507 at end-FY14 to 197,833 at end-1H15. However, the value of the Group's biological assets increased from RMB 6,530.81mn by end-FY14 to RMB 6,762.22mn at end-1H15. Given that raw milk price is still low and the milk yield per cow only increased in a gradual pace, there could be write-downs on biological asset value in the future, which would impair the Group's profitability. We do not expect the total herd size to increase substantially in FY15E and FY16E as oversupply in the industry persists.

Cash EBITDA signals lower earnings quality. The Group's cash EBITDA declined from RMB 966.69mn in 1H14 to RMB 857.93mn in 1H15; cash EBITDA margin also declined from 37.4% in 1H14 to 35.2% in 1H15. Combined with the lower operating cash flow, the cash EBITDA reflected that the Group's earnings in 1H15 were slightly inflated by certain non-cash gains. Excluding those non-cash gains, the Group's OPM in 1H15 would be 21.05% as opposed to 27.08%.

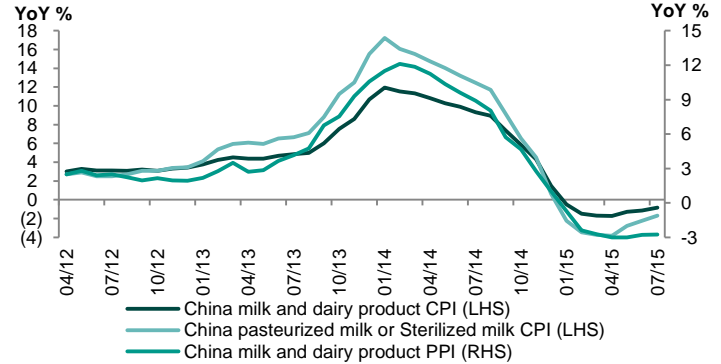
Financial projections. Although we expect the expansion into the pasteurized milk business would help offset the downward pressure partially, the Group would nonetheless face substantial challenges in FY15/16. Earnings would decline in FY15E and recover mildly in FY16E, and we expect GPM, OPM, and NPM to be 35.24%, 21.41%, and 15.18% in FY15E and 16.60%, 20.07%, and 13.95% in FY16E, respectively. As a result, the Group's ROAA and ROAE would also be reduced. The changing industry condition and business structure would lengthen the cash conversion cycles to 54 days in FY15E and 79 days in FY16E.

Downgrade to HOLD; TP at HK\$2.59. We revise down the Group's TP to HK\$ 2.59, which represents 14.39x 2016E P/E and 1.43x 2016E P/B. Based on the closing price on Aug 27 at HK\$ 2.19, which represents 12.16x a 2016E P/E and 1.21x 2016E P/B, the TP has an upside of 18.33%. We downgrade the Group from BUY to **HOLD**.

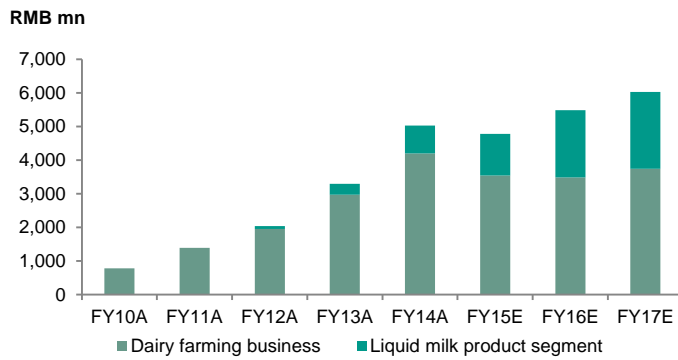
Risk factors: 1) Product quality and food safety risk; 2) Regulatory risk; 3) Domestic economic growth risk; 4) Farm management risk; 5) Customer concentration risk; 6) Potential revaluation loss of biological assets.

Exhibit 1: Raw milk price in China


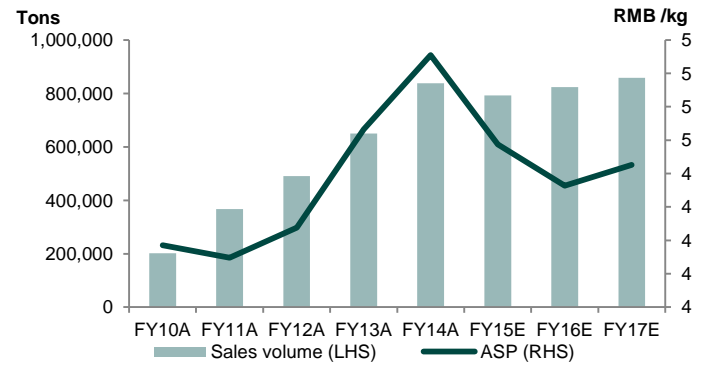
Source(s): Wind, ABCI Securities

Exhibit 2: China's milk CPI and PPI have yet to rebound


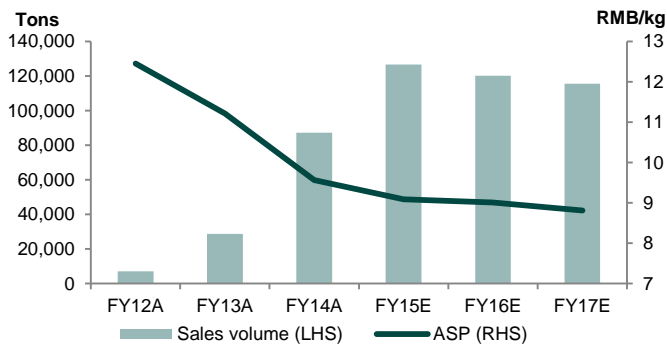
Source(s): The Group, ABCI Securities

Exhibit 3: Modern Dairy's changing revenue composition


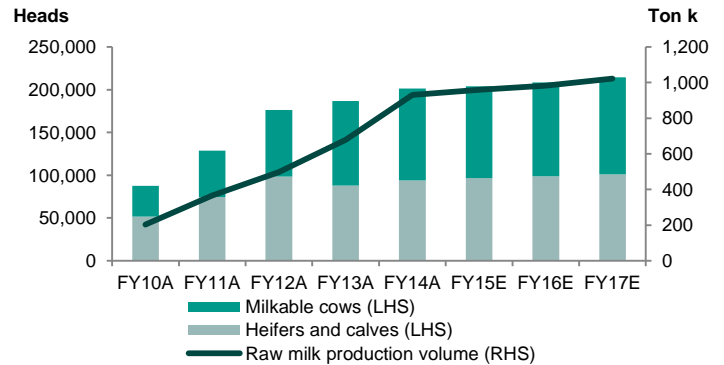
Source(s): The Group, ABCI Securities estimates

Exhibit 4: Modern Dairy's dairy farming business ASP and sales volume


Source(s): The Group, ABCI Securities estimates

Exhibit 5: Modern Dairy's liquid milk product ASP and sales volume


Source(s): The Group, ABCI Securities estimates

Exhibit 6: Modern Dairy's herd size and raw milk production scale


Source(s): The Group, 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	1H14	1H15
Revenue	3,289.28	5,026.71	4,781.04	5,482.12	6,024.76	2,584.54	2,437.32
- Dairy farming business	2,967.96	4,194.02	3,544.27	3,481.74	3,737.07	2,299.90	1,647.83
- Liquid milk business	321.32	832.69	1,236.77	2,000.38	2,287.69	284.64	789.49
COGS	(2,304.02)	(3,161.35)	(3,096.27)	(3,475.59)	(3,788.59)	(1,579.19)	(1,548.43)
Gross profit - pre bio-adj	985.26	1,865.36	1,684.77	2,006.53	2,236.17	1,005.35	888.89
Biological fair value adjustment included in cost of sales	(860.26)	(1,666.24)	(1,394.00)	(1,698.32)	(1,778.49)	(903.70)	(636.94)
Gross profit - post bio-adj	125.00	199.12	290.77	308.21	457.69	101.65	251.95
SG&A	(208.67)	(326.47)	(358.72)	(496.75)	(551.11)	(156.02)	(179.17)
Loss arising from changes in fair value less costs to sell of dairy cows	(82.75)	(329.07)	(348.05)	(332.07)	(350.84)	(84.56)	(199.27)
Gains arising on initial recognition of raw milk at fair value less costs to sell at the point of harvest	860.26	1,666.24	1,394.00	1,698.32	1,778.49	903.70	636.94
Other net income/(expenses)	17.75	(196.15)	45.86	(77.22)	(114.41)	(93.96)	149.69
Operating profit	711.59	1,013.67	1,023.86	1,100.50	1,219.81	670.81	660.14
Share of profit from associates & JV	(0.31)	0.21	0.23	0.26	0.28	4.74	4.00
Net finance costs	(193.71)	(243.52)	(261.43)	(293.12)	(320.33)	(123.58)	(142.23)
Pretax profit	517.57	770.36	762.66	807.63	899.77	551.98	521.91
Tax	(10.57)	(7.48)	(7.31)	(9.68)	(11.63)	(6.60)	(14.60)
Net profits	506.99	762.89	755.35	797.96	888.14	545.38	507.31
- Owners of the Company	481.05	735.32	725.59	764.55	853.71	523.16	476.95
- Minority interest	25.94	27.57	29.76	33.41	34.43	22.21	30.36
Dividend	0.00	48.27	52.87	55.86	62.17	0.00	0.00
EPS (RMB cent)							
- Basic	9.99	15.23	13.68	14.41	16.09	10.84	9.88
- Dilute	9.89	15.08	13.23	13.94	15.56	10.72	9.80
DPS (RMB cent)	0.00	1.00	1.00	1.05	1.17	0.00	0.00

Source(s): The Group, ABCI Securities estimates

Consolidated balance sheet (FY13A-FY17E)

As of Dec 31 (RMB mn)	FY13A	FY14A	FY15E	FY16E	FY17E	1H14	1H15
Cash and bank balances	369.04	556.96	866.59	1,535.14	1,294.87	457.84	605.22
Accounts receivables	544.71	826.77	1,618.20	1,978.38	2,938.79	599.71	1,006.38
Inventories	691.11	640.58	836.07	981.92	699.24	558.29	463.25
Others	432.20	614.58	270.93	490.84	535.21	558.81	130.59
Current assets	2,037.06	2,638.89	3,591.78	4,986.28	5,468.11	2,174.65	2,205.44
PP&E	4,032.64	4,457.97	4,530.06	4,765.61	5,209.87	4,113.61	4,484.90
Biological assets	5,954.36	6,530.81	6,656.08	6,748.87	6,845.55	6,297.96	6,762.22
Land use rights	66.26	64.87	72.09	75.81	82.89	65.50	69.94
Others	403.49	518.31	553.41	580.03	615.65	527.38	496.23
Non-current assets	10,456.76	11,571.96	11,811.64	12,170.33	12,753.97	11,004.44	11,813.29
Total assets	12,493.82	14,210.85	15,403.42	17,156.61	18,222.08	13,179.09	14,018.73
Accounts payables	1,474.25	1,403.00	2,010.68	1,887.05	2,025.34	1,161.23	1,220.43
Short-term debt	2,988.80	2,958.40	2,165.68	2,345.47	2,628.80	3,741.12	2,309.26
Others	20.07	14.28	5.09	20.03	10.43	136.02	17.36
Current liabilities	4,483.12	4,375.68	4,181.45	4,252.56	4,664.57	5,038.37	3,547.05
Long-term debt	1,959.87	2,829.45	3,336.39	4,060.80	3,970.89	1,384.16	3,025.17
Others	190.10	349.77	474.28	633.99	489.22	333.48	315.18
Non-current liabilities	2,149.96	3,179.22	3,810.66	4,694.79	4,460.11	1,717.64	3,340.35
Equity attributable to shareholders	5,743.02	6,510.24	7,235.83	8,000.38	8,854.09	6,283.16	6,955.25
Minority interest	117.71	145.71	175.47	208.88	243.31	139.92	176.08
Equity	5,860.73	6,655.95	7,411.30	8,209.26	9,097.40	6,423.08	7,131.33
Total liabilities and Equity	12,493.82	14,210.85	15,403.42	17,156.61	18,222.08	13,179.09	14,018.73

Source(s): The Group, ABCI Securities estimates

Consolidated cash flow statement (FY13A-FY17E)

As of Dec 31 (RMB mn)	FY13A	FY14E	FY15E	FY16E	FY17E	1H14	1H15
Profit before tax	517.57	770.36	762.66	807.63	899.77	551.98	521.91
Depreciation and amortization	168.86	225.54	219.02	236.72	248.56	107.63	132.45
Change in working capital	(363.76)	(187.42)	(351.22)	(606.64)	(580.36)	(247.82)	(421.14)
Others	261.50	772.40	298.73	540.11	611.03	625.31	536.38
Cash flow from operating activities	584.16	1,580.89	929.19	977.83	1,178.99	1,037.10	769.60
Change in PP&E	(774.08)	(937.82)	(72.09)	(235.56)	(444.26)	(375.84)	(26.93)
Changes in biological assets	(909.12)	(735.05)	(125.27)	(92.79)	(96.69)	(409.31)	(231.40)
Others	(241.19)	(221.73)	357.69	(207.07)	(29.19)	(169.45)	(108.48)
Cash flow from investing activities	(1,924.39)	(1,894.60)	160.34	(535.42)	(570.14)	(954.60)	(366.81)
Interest paid	(224.64)	(274.69)	(358.93)	(401.91)	(461.80)	(166.32)	(154.36)
Changes in bank borrowing	1,641.26	821.35	(29.31)	897.33	191.46	176.61	(192.17)
Others	16.00	(45.03)	(391.66)	(269.29)	(578.78)	(4.00)	(8.00)
Cash flow from financing activities	1,432.62	501.63	(779.91)	226.13	(849.11)	6.29	(354.54)
Net change in Cash	92.39	187.92	309.63	668.55	(240.26)	88.80	48.25
Cash and equivalent at beg	276.65	369.04	556.96	866.59	1,535.14	369.04	556.96
Cash and equivalent at end	369.04	556.96	866.59	1,535.14	1,294.87	457.84	605.22

Source(s): The Group, ABCI Securities estimates

Key operating and financial ratios (FY13A-FY16E)

As of Dec 31	FY13A	FY14A	FY15E	FY16E	FY17E	1H14	1H15
Revenue composition (%)							
- Dairy farming business	90.23	83.43	74.13	63.51	62.03	88.99	67.61
- Liquid milk business	9.77	16.57	25.87	36.49	37.97	11.01	32.39
Profitability ratios (%)							
Gross margin – pre bio-adj	29.95	37.11	35.24	36.60	37.12	38.90	36.47
- Dairy farming business	30.27	41.22	42.75	33.91	32.70	40.75	40.28
- Liquid milk business	27.00	16.42	13.72	41.28	44.32	23.95	28.53
Gross margin – post bio-adj	3.80	3.96	6.08	5.62	7.60	3.93	10.34
EBIT margin	21.63	20.17	21.41	20.07	20.25	25.95	27.08
EBITDA margin	26.77	24.65	26.00	24.39	24.37	30.12	32.52
Pre-tax margin	15.73	15.33	15.95	14.73	14.93	21.36	21.41
Net margin	14.62	14.63	15.18	13.95	14.17	20.24	19.57
Return ratios (%)							
ROAA	4.25	5.51	4.90	4.70	4.83	4.08	3.38
ROAE	8.60	11.75	10.32	9.79	9.87	8.52	6.92
ROIC	5.28	6.88	6.23	6.16	6.36	5.37	4.26
Liquidity ratio (%)							
Current ratio	45.44	60.31	85.90	117.25	117.23	43.16	62.18
Quick ratio	30.02	45.67	65.90	94.16	102.24	32.08	49.12
Cash ratio	17.84	26.74	27.16	47.60	39.19	20.15	20.69
Cash conversion cycle (days)							
Days of outstanding receivable	38.10	39.92	73.24	90.76	115.55	34.44	54.33
Days of inventory on hand	89.62	76.88	87.04	95.46	80.98	72.19	65.05
Days of outstanding payable	102.77	97.11	106.20	107.22	110.02	91.69	106.80
CCC	24.95	19.68	54.08	79.00	86.52	14.95	12.58
Leverage ratios (%)							
Total debt/Equity	84.44	83.03	76.94	80.47	74.74	79.79	77.61
Total debt/Total assets	39.61	38.89	37.02	38.51	37.32	38.89	39.48

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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