

**July 20, 2015**  
**Company Report**  
**Reinitiate: BUY**  
**TP: HK\$ 30.72**

Share price (HK\$) 21.75  
Est. share price return 41.25%  
Est. dividend yield 3.25%  
Est. total return 44.50%

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

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**Key Data**

52Wk H/L(HK\$) 42/14.62  
Outstanding shares (mn) 609.34  
Market cap (HK\$ mn) 13,284  
3-mth avg daily turnover (HK\$ mn) 51.75  
Major shareholder(s) (%):  
Biostime Pharma China Ltd. 73.85  
Franklin Templeton Investments 2.2  
Janus Ccapital Management LLC 1.37  
Artisan Partners Ltd Partnership 1.02  
Source(s): Bloomberg, ABCI Securities

**Revenue contribution of business**

**segments**

(%)	FY13	FY14
Infant formula	82.26	84.15
Probiotic supplements	10.04	8.98
Dried bay food & nutrition supplements	4.36	3.20
Baby care products	3.34	3.67

Source(s): Company, ABCI Securities

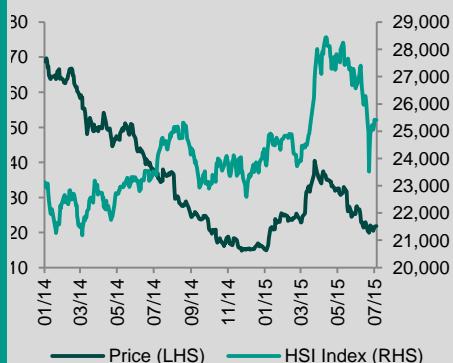
**Share price performance (%)**

	Absolute	Relative*
1-mth	(18.54)	(13.47)
3-mth	(36.63)	(30.39)
6-mth	40.10	34.03

\*Relative to HSI

Source(s): Bloomberg, ABCI Securities

**Stock performance (HK\$)**



Source(s): Bloomberg, ABCI Securities

# Biostime International (1112 HK)

## A leading infant milk formula player

- Biostime has a diversified product portfolio. Apart from its core business of infant milk formula (IMF) products, the Group also sells probiotic supplements, dried baby food, nutritional products, and baby care products
- The Group has been expanding its sales and marketing channels. Its integrated membership reward program, the Mama100 platform, incorporates e-commerce, mobile applications, and an official WeChat account. As of end-1Q15, membership of Mama100 reached 2.24mn. It also operates an O2O business that utilizes its physical sales network to facilitate online sales, and a B2C business that expands its e-commerce presence
- Biostime launched a new product line, Adimil IMF, in 4Q14, which contributed to 17.9% of the Group's IMF sales in FY14. It also ventured into the baby care product business with the "BMcare" brand
- We estimate the Group's GPM, OPM, and NPM in FY15E to be 61.7%, 23.80%, and 17.47%. We set the TP for Biostime at HK\$ 30.72, which represents a 41.25% upside and 16.66x FY15E P/E. Re-Initiate with **BUY**

**Market dynamic is changing.** Competition in China's IMF market has been stiff. More specifically, foreign brands are competing fiercely with the domestic ones, and diverging price trends have been observed. Average price of domestic brands' have been pressured. Nonetheless, opportunities arising from the emergence of e-commerce and changing consumer behaviors would allow domestic brands to expand in the long term.

**Declining costs would be beneficial to the Group.** The industry condition and depreciation of Euro would lower the cost of production for Biostime, which in turn would improve its profit. We expect the Group's GPM, OPM, and NPM to be 61.7%, 23.80%, and 17.47%, respectively, in FY15E.

**Potential foreign partnerships.** A number of foreign IMF brands have partnered with the domestic ones. We believe the Group may form similar partnerships in the future, considering its existing cooperation with foreign IMF manufacturers and its knowledge of the Chinese market. Such partnership would serve as a potential catalyst for its share price.

**Product portfolio needs further optimization.** To stay competitive, the Group would have more new product launches in the future. We believe the Group would need to strengthen its development in the non-infant formula segment to cultivate new growth drivers. In the medium term, we expect the infant formula product segment would remain as the major contributor, accounting for 84.62% of total revenue in FY15E; revenue growth for the segment would be 9.28% YoY in FY15E.

**Re-initiate with BUY; TP at HK\$ 30.72.** Our DCF-derived price range is HK\$ 20.95 – 33.27, representing 12.51x – 19.87x FY15E P/E. By referencing the current peer valuation and the DCF model, we set the TP for Biostime at HK\$ 30.72, which represents a 41.25% increase from its current price level and 16.66x FY15E P/E.

**Risk factors:** 1) Supplier concentration risk; 2) Regulatory risk; 3) Product quality and food safety risk; 4) Domestic economic growth risk.

**Results and Valuation**

FY ended Dec 31	FY13A	FY14A	FY15E	FY16E	FY17E
<b>Revenue (RMB mn)</b>	<b>4,561</b>	<b>4,732</b>	<b>5,142</b>	<b>5,756</b>	<b>6,938</b>
Chg (% YoY)	34.87	3.73	8.67	11.95	20.54
<b>Net Income (RMB mn)</b>	<b>821</b>	<b>807</b>	<b>898</b>	<b>1,047</b>	<b>1,446</b>
Chg (% YoY)	10.44	(1.70)	11.32	16.55	38.16
<b>Basic EPS (RMB cent)</b>	<b>1.37</b>	<b>1.34</b>	<b>1.47</b>	<b>1.72</b>	<b>2.37</b>
P/E (x)	21.55	19.17	11.80	10.13	7.28
BVPS (RMB)	4.20	4.85	5.71	6.79	8.39
P/B (x)	4.04	3.59	3.04	2.56	2.06
DPS (RMB)	1.21	0.67	0.77	0.92	1.31
Yield (%)	1.90	4.23	3.53	4.24	6.03
ROAA (%)	20.08	14.31	13.16	13.59	16.50
ROAE (%)	33.93	29.70	28.08	27.49	31.28

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

## Company overview

Biostime manufactures, markets, distributes, and sells infant milk formula products, probiotic supplements, baby care products, and other baby food and supplements products. Founded in 1999, Biostime has advanced over the years. According to the Group's annual report for FY14, in terms of offline sales, the Group was ranked third in the Chinese infant milk formula (IMF) market.

The Group has four major product segments—infant formula, probiotic supplement, dried baby food & nutrition supplements, and baby care products. Infant formula is the core business that contributed to 84.15% of total sales in FY14. To ensure the product quality, the Group sources and/or produces infant milk formula, probiotic supplements, and baby care products through overseas suppliers such as Laiterie De Montaignu, Arla Foods, Isigny Sainte-Mere, and Lallemand.

Since the restructuring in 1H14, the Group has streamlined its operations and operates by business units. Currently the Group has the long-standing “Biostime” that houses a series of infant milk formula and baby food/nutrition/probiotic supplement products. In 4Q14, the Group launched a new brand of infant formula product called Adimil. Under “BM care”, the Group sells a wide range of baby care products. In addition, the Group has extended the Mama100 membership program from a customer reward scheme to a multi-functional servicing platform that includes the mama100.com and several mobile apps. Moreover, the Group is venturing into the pre-school education (早教) business under the Parenting Power unit.

**Exhibit 1 : Different business units of the Group**



Source(s): Company

To expand its customer reach and broaden distribution channels, Biostime has built an integrated online marketing and sales platform that includes an official WeChat account, online stores on major e-commerce sites, and the Mama100 membership platform. The expansion of the platform has been accelerating in recent years. The number of average active Mama100 members (including

WeChat followers) grew from 1.2mn~ in 2012 to 2.0mn~ in 2014.

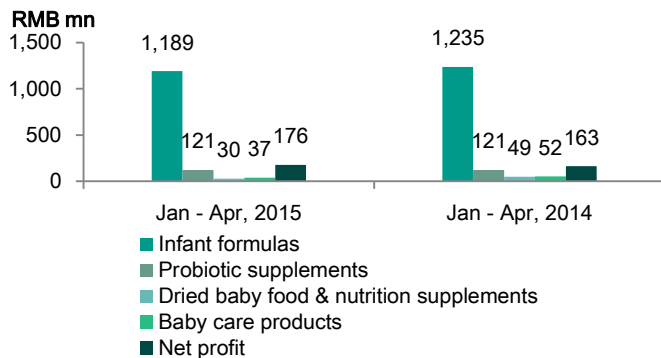
## Operating performance update

Biostime released the operating results for 4M15 in early June. Total revenue declined by 5.45% YoY to RMB 1,377.33mn, while total net profit grew 7.53% YoY to RMB 175.54mn. During the same period, revenue from the infant milk formula segment dropped by 3.69% YoY, which we believe to be the result of online and offline sales promotions conducted to facilitate destocking process upon new product launch.

As of end-1Q15, the Group's Mama100 membership increased to 2.24 mn, up 22.4% from the end-2014 and 16.6% from end-1Q14. Also, the expansion of sales network was on track. The number of VIP baby specialty stores, retail sales organizations, and VIP pharmacies increased from 24,615, 6,659, and 2,824 by the end-2014 to 26,707, 6,918, and 4,358 by end-1Q15.

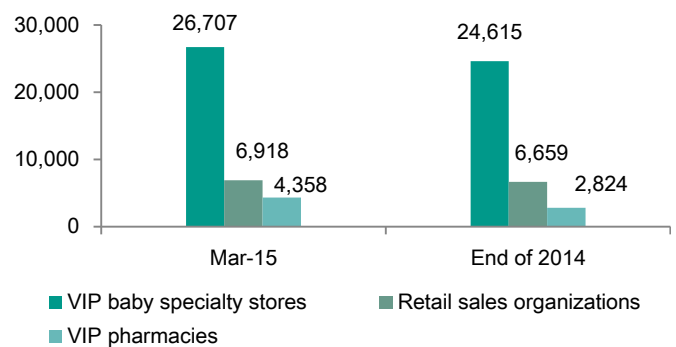
We believe the industry condition is affecting the performance of Biostime and its peers. One example is Beingmate, whose revenue declined by 17.64% YoY and net profit declined by 29.17% YoY in 1Q15. This suggests that the industry is currently under stress and the competition has escalated. Nonetheless, 1Q15 data show the Group is weathering the downturn better than peers as the decline in revenue was less significant while its net profit margin is still relatively high.

**Exhibit 2: Revenue and net profit of Biostime for Jan-Apr**



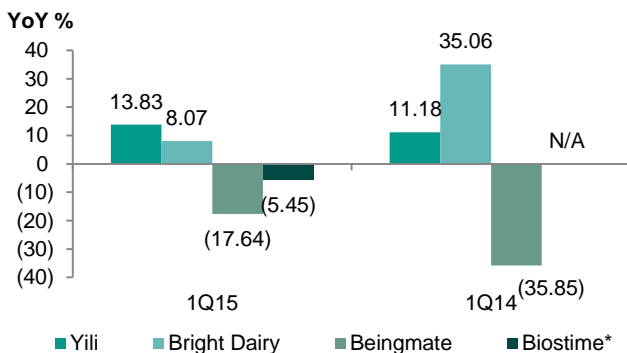
Source(s): Company, ABCI Securities

**Exhibit 3: Biostime's sales network expansion in 1Q15**



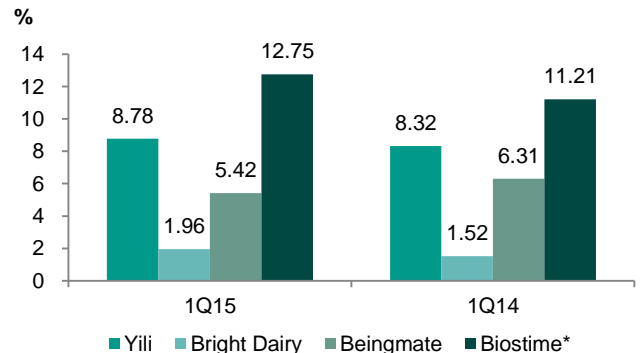
Source(s): Company, ABCI Securities

**Exhibit 4: Revenue growth in 1Q15**



\* Biostime data is for Jan - Apr 2015  
 Source(s): Companies, ABCI Securities

**Exhibit 5: Net profit margin comparison in 1Q15**



\* Biostime data is for Jan - Apr 2015  
 Source(s): Companies, ABCI Securities

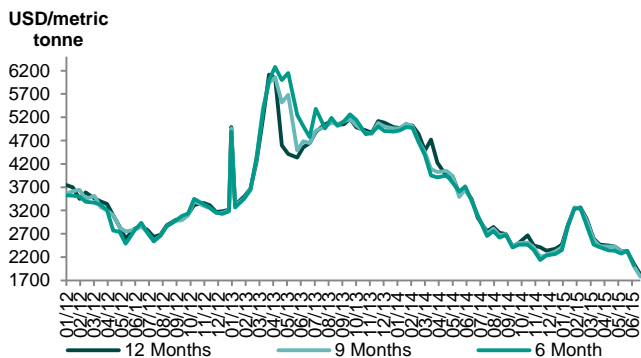
## Industry overview: declining cost and intensifying competition

### International dairy market in long-term depression

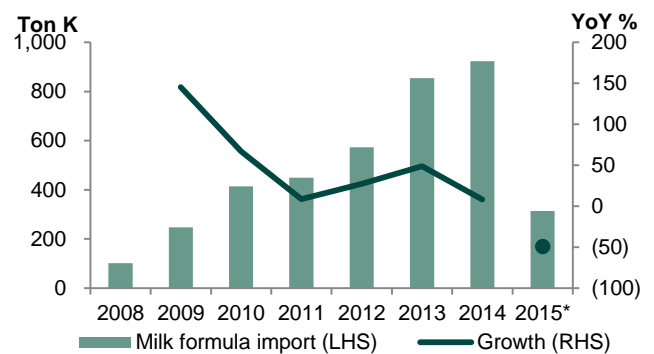
Since 2013, the New Zealand milk powder price has started to weaken. Price fell by 54% in 2014, followed by a less severe downturn in 2015. Milk production in New Zealand has not been severely impacted by the drought and is forecasted to be stable for the next production season. However, China's economy has not shown signs of a sustainable recovery and consumption growth has been slower than expected. Increasing supply, accompanied by a falling demand, results in excess supply in the market.

In addition, the removal of EU milk production quota in Apr 2015 has driven up milk production in European countries, such as Netherlands and the U.K. The increased supply would create additional pressure on the global dairy market.

The current market condition indicates a rebound in the international milk powder price may occur by late-2015 the earliest. Since demand is unlikely to improve in the short term, we believe milk powder price would rise only if there is a reduction in overall supply by means of voluntary reduction of milk delivery or dairy cow slaughtering. For domestic dairy product manufacturers using imported ingredients, the falling production cost would increase their profitability.

**Exhibit 6: New Zealand milk powder futures price**


Source(s): Bloomberg, ABCI Securities

**Exhibit 7: Milk powder imports in China**

 \* 2015 data is for Jan – May  
 Source(s): Bloomberg, ABCI Securities

### Competition intensifies

Competition in China's IMF products market is fierce. The domestic market is currently dominated by foreign brands. We believe the quality of foreign-branded products, especially the imported ones, are still perceived to be superior due to the food safety issues in China.

In addition, the growth in milk powder imports has been declining from 145.54% YoY in 2009 to 8.20% YoY in 2014. In Jan-May 2015, milk powder imports declined by 49.20% YoY, reflecting that domestic demand may not be as strong as expected. Hence, market competition may increase even further on weakening demand.

To stay competitive, many domestic brands use discounts, bundled sales, or free-giveaways to attract customers. In our view, competition intensified in 1H15 on economic slowdown in China and high inventory levels of certain brands. Brands have been strengthening promotional campaigns online and offline over the past few months. On tmall.com, Alibaba's online shopping portal selling qualified branded products, many domestic brands have revved up promotional efforts. Also, some domestic brands are launching low-price products to attract a wider demographics. Yashili launched a new line of IMF

product, Newwit, which is only sold for RMB 99 per tin; the New Hope Group also launched a new line of imported IMF product that is sold for RMB 99 per tin.

**Exhibit 8: Promotions conducted by domestic brands on the online shopping portals**


Product Name	Price	Total Sales	Rating
【买一赠二】金装3段900g 1-3岁较大婴儿配方奶粉 超值包邮	¥268.00	378	95
【买一赠二】金装2段900g 6-12个月较大婴儿配方奶粉 超值包邮	¥278.00	171	43
【辉山直售】金皇后3段900g*3罐900g 1-3岁幼儿配方奶粉 包邮	¥1164.00	15	7
【辉山直售】5A系列3段900g1-3岁幼儿配方奶粉	¥165.00	112	35



**精选4段 聚划算首降**

精选新品4段奶粉，聚划算首次参团，超值体验，囤货比选，给宝宝的全新营养体验！

Product Name	聚划算价	立即抢购
呵护学龄前儿童配方奶粉4段*2罐 满足大宝宝成长所需的全面均衡营养	¥388	立即抢购
金装学龄前儿童配方奶粉4段*2罐 欧洲鲜乳 脱脂后加配方营养	¥491	立即抢购



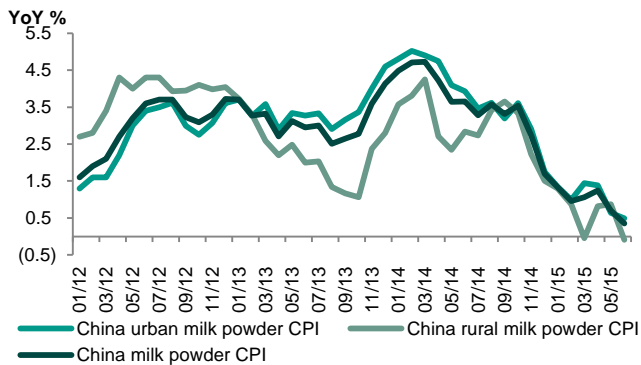
**有机买一送一**

有机发+买一送一 真奶粉

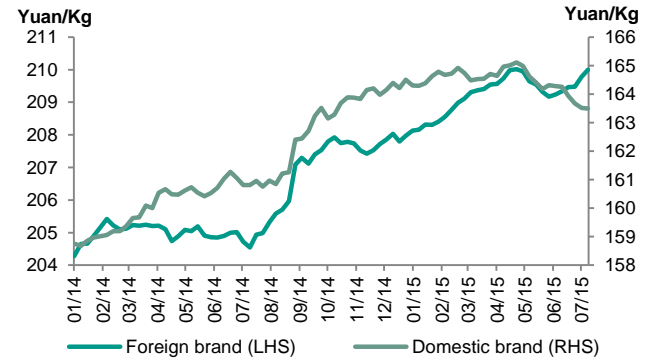
Source(s): tmall.com

**Domestic milk powder price is pressured**

Continued decline in international milk powder price, moderating economic growth, high inventory level, and fierce competition have dragged down the overall prices in the industry. The national milk powder CPI in China dropped from its peak at 4.73% YoY in Mar 2014 to 0.35% YoY in Jun 2015.

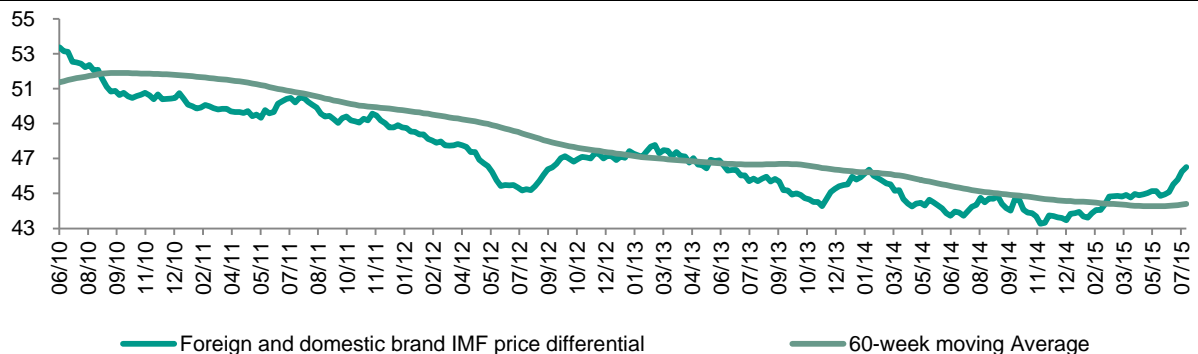
**Exhibit 9: China milk powder CPI**


Source(s): Bloomberg, ABCI Securities

**Exhibit 10: Infant milk formula price of foreign and domestic brands**


Source(s): Wind, ABCI Securities estimates

A diverging price trend is evident between the domestic and foreign IMF products in China. First, the average retail price of domestic infant milk formula has started to decrease since Apr 2015 and fell to RMB 163.49/Kg in the week of July 10. However, the average price of foreign brands bounced back to RMB 210.00/Kg after reaching its temporary low of RMB 209.17/Kg in the week of May 29. What's more, the price difference between the foreign and domestic brands has been increasing since Nov 2014 and has breached the 60-week average level since Feb 2015, meaning that the downward price pressure is more significant for domestic milk formula products than foreign ones.

**Exhibit 11: Price difference between domestic brands and foreign brands in China**


Source(s): Wind, ABCI Securities

### Changing customer behavior

Foreign IMF products are still dominating the Chinese market, as consumer confidence in domestic products has been hampered by a series of food safety scandals. Rapid development of e-commerce also means that Chinese consumers are also enjoying foreign IMF products at lower prices and have better access to overseas products through online purchase agents, or "Daigou" (代购). Nonetheless, as the production techniques and quality control measures improve, Chinese consumers may develop more confidence in domestic milk formula products.

Currently, some domestic IMF brands are competing neck to neck with foreign brands. Beingmate, one of the top-selling brands of IMF products, has a 10.8% market share in the Chinese IMF market. Market shares of other brands such as Yili and Biostime are also rising. As stated in the annual report for FY24, Biostime's market share in both the online and offline channels rose during the year. We believe the relatively higher prices of foreign products and their lack of penetration into the lower-tier cities would give domestic brands additional room to grow.

## Declining costs help offset competitive pressure

The depressed milk powder price in the international market is favorable to Biostime. Since the raw materials of Biostime's IMF products are imported, the COGS of Biostime would continue to decline in FY15. In addition, Euro has been weakening due to recent political instability in the Eurozone. The Euro depreciation would further reduce the production cost, which in turn will give the Group more room for sales promotion in 2015.

Also, removal of the milk quota in EU countries and the resulting increase in output would increase the region's dairy product supply. This would give Biostime more leverage in sourcing from alternative suppliers and negotiate with its current suppliers in the medium term. Overall, the reducing cost of production would help increase the Group's profitability.

## Modernizing sales and marketing tactics

### Expanding membership platform

Biostime's Mama100 membership platform has developed from a simple membership reward mechanism to a comprehensive platform combining customer interaction, education, e-commerce, and membership reward. The number of active Mama100 members (including WeChat followers) reached a new high of almost 2.24mn by end-1Q15. In addition, sales generated by Mama100 active member, as a percentage of total sales, reached 76.8% and 88.9% in FY14 and FY13. We believe that platform would help enhance customer loyalty and establish a clear brand identity for the Group.

### E-commerce – a new growth driver

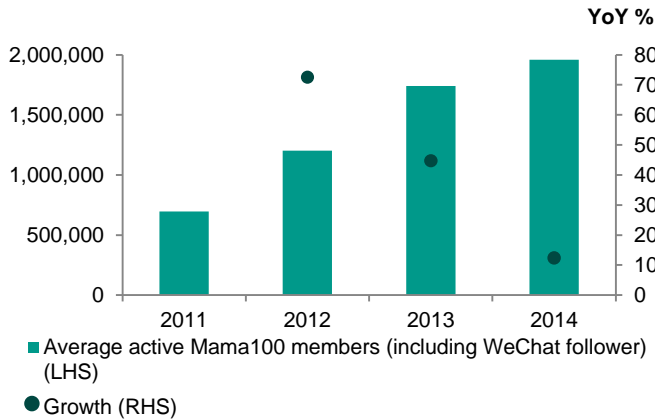
Biostime has developed a comprehensive e-commerce platform to adapt to evolving customer behavior and boost online sales. Currently, the Group adopts the "B2C" business model with official stores in major e-commerce sites such as jd.com and tmall.com. There are also online member stores at taobao.com. Through these channels, the Group could gain direct access and provide a comprehensive service package to its customers while marketing its products in a more targeted manner.

### Seamless integration of online and offline business

The Group has been integrating its online and offline businesses. Its online platform and the vast physical sales network enable Biostime to smoothly execute the "O2O" (online-to-offline) business strategy. Once customers place their orders online, Biostime can notify the nearest baby specialty store to complete the relevant delivery. This could shorten the delivery time while increasing the inventory turnover of the physical stores. In our opinion, continuous expansion of physical sales location would propel its O2O development, thus enabling the Group to enhance its working capital efficiency, and improve customers' shopping experience.

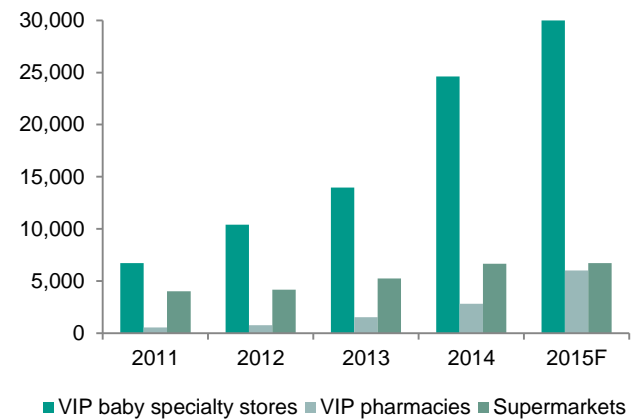


Exhibit 12: Expansion of membership program



Source(s): Company, ABCI Securities

Exhibit 13: Expansion of physical sales location



\* 2015 data estimated by the Group  
Source(s): Company, ABCI Securities

## Potential partnerships with major foreign brands

In the past year, several partnerships between the foreign and domestic brands have been formed in the IMF product market. On Mar 18, 2015, Fonterra announced that it would acquire an 18.8% stake in Beingmate through its Hong Kong subsidiary; Huishan Dairy's transaction with FrieslandCampina to establish an IMF product JV was also completed on Apr 1, 2015; Danone acquired a 25% stake in Yashili back in Oct 2014. We believe the series of transactions reflect strong interest of foreign IMF manufacturers in entering the Chinese IMF product market.

We believe such partnerships are mutually beneficial. The local partners would provide better access to the Chinese market with their local knowledge and market acumen, while the foreign partners may offer technical expertise in dairy product production and their brand equity as a stamp of quality assurance.

Since Biostime has a solid business in China and the experience in cooperating with multiple foreign partners, it is possible for the Group to form similar partnerships in the future. We believe such an announcement would help enhance Biostime's brand value and boost its share price.

## Product portfolio needs to be optimized

### New product launch: A matter of differentiation

Biostime launched the Adimil product line in 4Q14. While Adimil was sold for a quarter in 2014, its revenue contributed to 17.9% of the Group's IMF product sales for the year. The Group also launched an enhanced formula called SN-2 Plus in July 2015.

In our opinion, Biostime's new products would help differentiate itself from its competitors. Staying innovative with frequent new product launch becomes necessary for a brand to survive in the Chinese markets. In light of the intensifying competition, the Group would need to carefully calibrate the positioning and pricing of new products to ensure adequate differentiation and success.

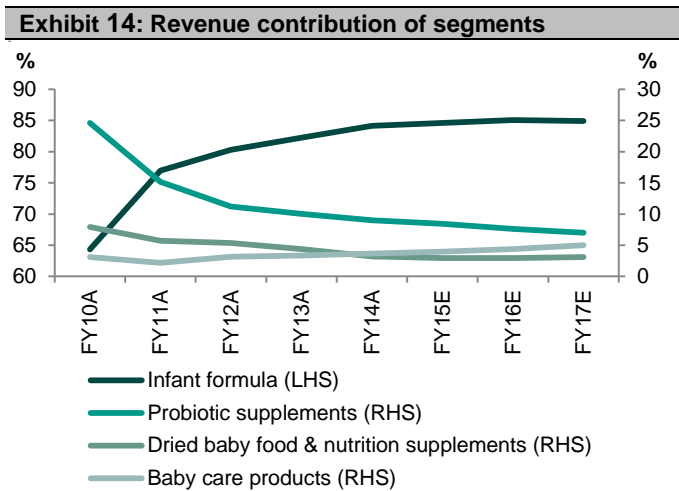


### The need to diversify away from IMF products

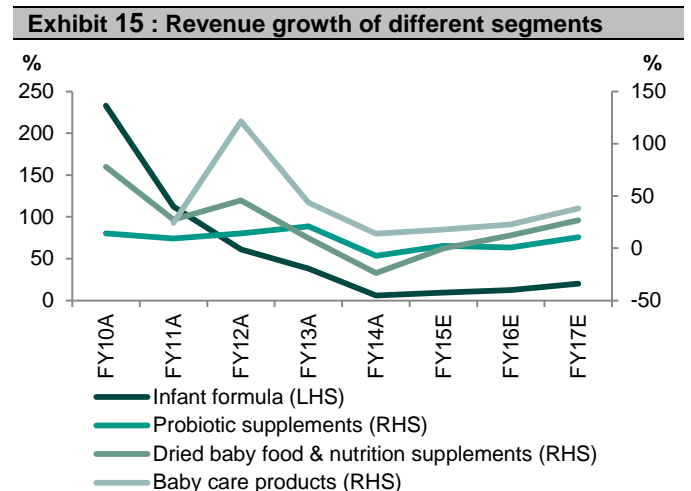
In FY14, the Group's revenue contributions of "infant formula", "probiotic supplements", "dried baby food & nutrition supplements", and "baby care products" were 84.15%, 8.98%, 3.2%, and 3.67%, respectively. It shows that the Group is heavily concentrated on the IMF product segment.

As competition in the IMF product segment intensifies, revenue growth of the segment faltered in FY14. Yet, the development of non-IMF product categories has not seen much progress, with their revenue contribution declining or staying flat over the past few years.

The Group is also diversifying its product portfolio, as evidenced by its launch of the BMcare brand. Nonetheless, the diversification process would take place over the long term. We project the growth of the non-IMF segments would increase gradually in the coming years; however, we do not expect drastic changes in the Group's revenue composition.



Source(s): Company, ABCI Securities estimates



Source(s): Company, ABCI Securities estimates

## Financial analysis, earnings outlook, and valuation

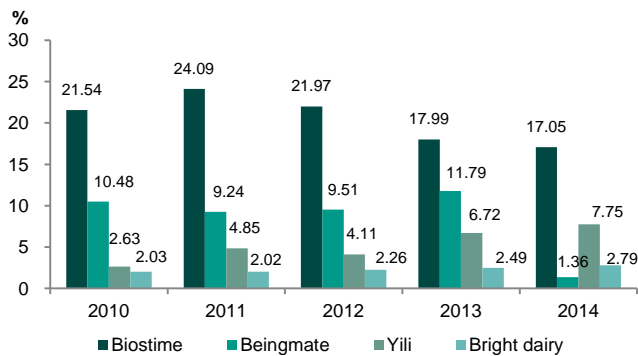
### Industry condition is suppressing revenue growth

The Group's sales growth declined to 3.73% YoY in FY14 from 34.87% YoY in FY13. In FY14, revenue of infant formula and baby care product segment only grew by 6.12% YoY and 13.95% YoY, while probiotic supplement and dried baby food and nutrition supplements witnessed a revenue decline of 7.22% YoY and 23.82% YoY. Such a situation would be alleviated in the coming years as demand improves and the Group's new product lines gain more traction.

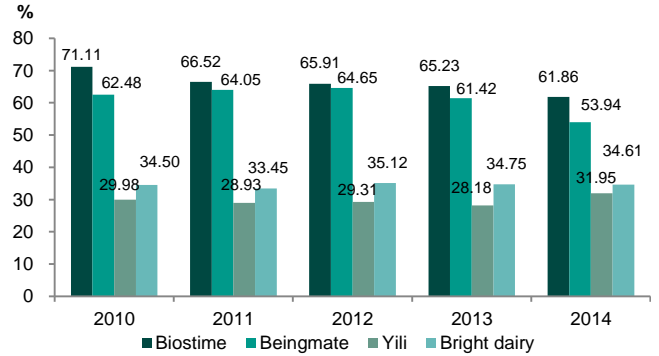
Based on our estimates, the Group's total revenue in FY15E/16E would grow by 8.67%/11.95% YoY. The infant formula segment would remain the major business segment and would not recover soon. We project that the IMF segment would contribute to 84.62%/85.07% of FY15/16E revenue; the segment's revenue growth would be 9.28%/12.55% YoY in FY15E/ FY16E. Revenue contribution of other segments would remain at similar levels, although their revenue growth would improve in coming years as we project the Group to diversify its product portfolio.

### Profit margins to improve after 2015

Unlike its direct competitor, Beingmate, whose profitability has deteriorated over time, Bioptime has consistently outperformed its peers in the IMF sector and the dairy sector in terms of profitability amid the deteriorating industry condition. This reflects the Group's ability to manage costs.

**Exhibit 16: Net profit margins**


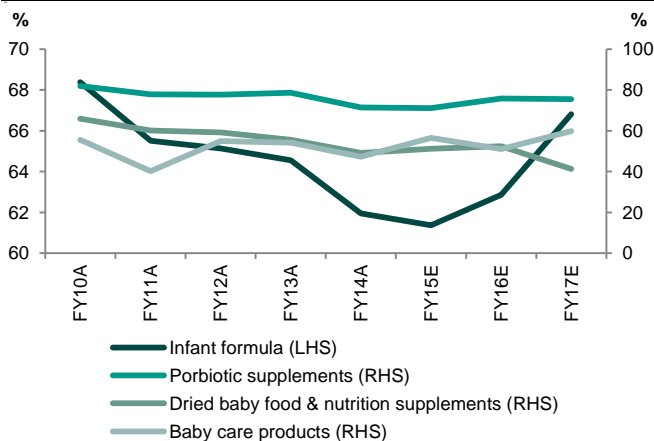
Source(s): Wind, ABCI Securities

**Exhibit 17: Gross profit margins**


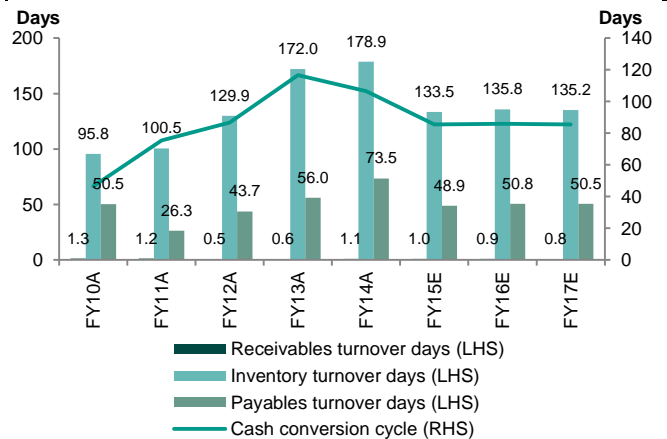
Source(s): Bloomberg, ABCI Securities

While the GPMs of non-IMF segments remain stable, profitability of IMF products has been declining in the past few years due to stiff competition in the Chinese market and the shift to selling more low-price products. Bioptime also reported a higher proportion of IMF sales were generated from high-tier segment (FY14: 63%; FY13: 60.5%) rather than supreme-tier segment (FY14: 37%; FY13: 39.5%). The high reliance on the IMF product segment and the declining profitability would inevitably hurt the Group's bottom line. This matter is worsened by the fact that contributions from other segments to sales and profits have been limited.

We estimate the Group's GPM, OPM, and NPM to be 61.7%, 23.80%, and 17.47%, respectively, in FY15. GPM of infant formula segment would be 61.38%, while GPMs of other segments would be similar to previous years. Intensifying industry competition would impact the Group's return ratios. ROAA and ROAE would edge down to 13.16% and 28.08% in FY15E.

**Exhibit 18: GPM of product segments**


Source(s): Company, ABCI Securities estimates

**Exhibit 19: Working capital**


Source(s): Company, ABCI Securities estimates

### Working capital efficiency would improve

Working capital efficiency of Bioptime has been less than optimal. Its inventory turnover days, payable turnover days, and overall cash conversion cycle were 178.9 / 172 days, 73.5 days/ 56 days, and 106.5 days /116.6 days in FY14/



FY13. The high amount of inventory turnover day would imply higher inventory management costs and a greater chance of inventory turning obsolete. However, we expect the Group's cash conversion cycle would stabilize in the coming years at ~85-86 days as inventory management becomes more efficient.

#### Capital structure would be stable

The Group's debt-to-equity ratio increased to 82.63% at end-FY14 from 11.65% at end-FY13. The significant increase in leverage was due to the issuance of convertible bonds of HK\$ 3,100 mn in Feb 2014. We believe the amount raised would be sufficient for its financing needs in the next few years and therefore, we do not expect any major increase in leverage going forward.

As for the convertible bond liability, we believe that it would not post any constraint on the Group's cash position and future contingent liabilities. We project the Group's debt-to-equity ratio to be 70.23%/59.14% in FY15E/FY16E.

#### EPS and dividend projections

The Groups stock option schemes and convertible bond would dilute the EPS going forward. We take into account of the full dilution impact in our EPS calculation and estimate the Group's basic EPS to be RMB 1.47/ RMB 1.72 in FY15E/FY16E, and the diluted EPS to be RMB 1.38 / RMB 1.61 in FY15E/FY16E.

The Group's dividend policy has been generous. Apart from the interim and final dividends, it also distributed a special dividend in FY12 and FY13. In light of the industry environment and the Group's business performance, we believe the Group's dividend payout ratio would be stable at ~46%.

#### Valuation

Our DCF model assumes a WACC of 9.78%, a terminal growth rate of 5% in the best case scenario and a terminal growth rate of 2% in the worst case scenario. The derived price range is HK\$ 20.95 – 33.27, representing 12.51x – 19.87x FY15E P/E.

Yashili, Biostime's comparable peer in the HK Exchange, is trading at 24.47x FY15E P/E. Beingmate, a comparable peer listed in the Shenzhen Stock Exchange, is trading at 50.16x FY15E P/E.

Based on the DCF analysis and the market valuations of peers, we set our TP for Biostime at HK\$ 30.72, which represents an upside of 41.25% from its current price and 16.66x FY15E P/E. We re-initiate our coverage for Biostime with a **BUY** rating.



## Risk factors

### Supplier concentration risk

Currently, Biostime sourced its milk powder from strategic partners in Europe, which include Arla Foods, Isigny Sainte-Mere, and Laiterie De Montaigu. Therefore, any disruptions of milk production in Europe could severely impair the Group's supply.

### Regulatory risk

The authorities in China have been tightening the laws and regulations in the food industry, especially those pertaining to the dairy sector. In 2013, Biostime was fined for price fixing. It is possible that authorities may monitor more closely over the business practices of milk formula manufacturers in the future.

### Product quality and food safety risk

Product quality is a major risk for the Group. The authorities have been conducting random inspections of various products. If the Group's products fail to meet the required standards, its sales could be disrupted; revenue and net profit would be negatively impacted as a result.

Any failure in the quality control process may potentially result in food safety crisis. The Group will be subject to fines and product recalls; also, its brand image would be hampered.

### Domestic economic growth risk

China's macroeconomic environment shows moderating signs in 1H15 with growth slowing in retail and dairy product CPI. If China's stimulus policies could not boost the economic growth, the dairy industry would also be negatively impacted.

## Appendix: Financial Statements of the Group

### Consolidated income statement (2013A-2017E)

FY ends at Dec 31 (RMB mn, except per share data)	2013A	2014A	2015E	2016E	2017E
<b>Revenue</b>	<b>4,561.30</b>	<b>4,731.56</b>	<b>5,141.88</b>	<b>5,756.30</b>	<b>6,938.43</b>
- Infant formula	3,752.12	3,981.58	4,351.07	4,896.99	5,890.85
- Probiotic supplements	458.16	425.09	434.72	437.88	484.45
- Dried baby food and nutrition supplements	198.78	151.42	151.32	169.93	215.42
- Baby care products	152.24	173.47	204.77	251.50	347.72
COGS	(1,586.18)	(1,804.63)	(1,969.56)	(2,128.80)	(2,339.54)
<b>Gross profit</b>	<b>2,975.12</b>	<b>2,926.93</b>	<b>3,172.32</b>	<b>3,627.50</b>	<b>4,598.89</b>
Other income and gains	23.47	23.03	29.45	36.69	49.29
SG&A	(1,690.36)	(1,763.03)	(1,915.64)	(2,139.44)	(2,541.79)
Other expenses	(55.57)	(87.55)	(62.90)	(74.82)	(93.44)
<b>Operating profit</b>	<b>1,252.65</b>	<b>1,099.38</b>	<b>1,223.23</b>	<b>1,449.93</b>	<b>2,012.95</b>
Net interest income/(expense)	72.34	18.36	7.64	11.39	30.19
Fine on violation of anti-monopoly law	(162.90)	0.00	0.00	0.00	0.00
Share of profit of an associate	0.00	0.59	0.71	0.85	1.02
<b>Profit before tax</b>	<b>1,162.10</b>	<b>1,118.34</b>	<b>1,223.94</b>	<b>1,450.78</b>	<b>2,013.97</b>
Tax	(341.38)	(311.55)	(325.82)	(404.05)	(567.83)
<b>Net profits</b>	<b>820.72</b>	<b>806.79</b>	<b>898.12</b>	<b>1,046.73</b>	<b>1,446.14</b>
Dividend	577.42	321.26	430.79	484.62	646.35
EPS (RMB)					
- Basic	1.37	1.34	1.47	1.72	2.37
- Dilute	1.34	1.31	1.38	1.61	2.22
DPS (RMB)	1.21	0.67	0.77	0.92	1.31

Source(s): Company, ABCI Securities estimates

### Consolidated balance sheet (2013A-2017E)

As of Dec 31 (RMB mn, except per share data)	2013A	2014A	2015E	2016E	2017E
Cash and cash equivalents	1,662.84	3,347.16	3,582.49	3,864.47	4,448.09
Restricted bank deposit	70.00	0.00	0.00	0.00	0.00
Trade and bills receivable	15.18	12.04	14.85	13.01	17.83
Inventories	971.89	797.03	644.19	940.22	793.04
Others	145.96	179.49	124.04	232.64	114.05
<b>Current assets</b>	<b>2,865.87</b>	<b>4,335.72</b>	<b>4,365.57</b>	<b>5,050.33</b>	<b>5,373.01</b>
PP&E	326.19	478.03	614.94	820.27	1,092.40
Prepaid land lease payments	64.72	63.24	62.47	60.23	58.12
Goodwill	76.00	76.00	76.00	76.00	76.00
Intangible assets	109.89	104.11	105.23	105.22	113.74
Bonds and loans receivable	183.59	183.83	250.17	236.59	230.61
Others	1,014.76	1,390.22	1,545.67	2,037.86	2,201.96
<b>Non-current assets</b>	<b>1,775.15</b>	<b>2,295.44</b>	<b>2,654.48</b>	<b>3,336.17</b>	<b>3,772.82</b>
<b>Total assets</b>	<b>4,641.02</b>	<b>6,631.16</b>	<b>7,020.05</b>	<b>8,386.50</b>	<b>9,145.84</b>
Trade and bills payables	361.63	294.54	192.14	482.41	124.19
Other payables and accruals	719.84	737.49	692.07	919.86	1,103.01
Short-term debt	750.61	0.00	0.00	0.00	0.00
Others	212.73	235.59	134.64	324.49	270.78
<b>Current liabilities</b>	<b>2,044.81</b>	<b>1,267.62</b>	<b>1,018.85</b>	<b>1,726.76</b>	<b>1,497.98</b>
Deferred tax liabilities	80.62	35.92	76.43	79.27	90.79
Convertible bonds	0.00	2,410.53	2,444.35	2,445.52	2,446.00
<b>Non-current liabilities</b>	<b>80.62</b>	<b>2,446.45</b>	<b>2,520.77</b>	<b>2,524.79</b>	<b>2,536.78</b>
<b>Equity</b>	<b>2,515.59</b>	<b>2,917.09</b>	<b>3,480.44</b>	<b>4,134.95</b>	<b>5,111.08</b>
<b>Total liabilities and Equity</b>	<b>4,641.02</b>	<b>6,631.16</b>	<b>7,020.05</b>	<b>8,386.50</b>	<b>9,145.84</b>

Source(s): Company, ABCI Securities estimates



**Consolidated cash flow statement (2013A-2017E)**

<b>FY ends at Dec 31 (RMB mn)</b>	<b>2013A</b>	<b>2014E</b>	<b>2015E</b>	<b>2016E</b>	<b>2017E</b>
Profit before tax	1,162.10	1,118.34	1,223.94	1,450.78	2,013.97
Depreciation and amortization	26.56	50.67	41.50	60.28	86.68
Finance costs	10.59	86.67	73.82	73.82	73.82
Income tax paid	(347.47)	(338.38)	(279.37)	(340.46)	(497.68)
Change in working capital	(166.52)	150.98	(334.83)	869.17	(376.18)
Others	(24.79)	(96.10)	(84.81)	(91.69)	(110.37)
<b>Cash flow from operating activities</b>	<b>660.47</b>	<b>972.17</b>	<b>640.25</b>	<b>2,021.90</b>	<b>1,190.25</b>
Change in PP&E	(135.58)	(132.92)	(169.04)	(244.10)	(325.32)
Change in intangible assets	(2.23)	(13.82)	(8.81)	(9.46)	(19.99)
Others	57.06	(313.65)	550.08	920.82	235.74
<b>Cash flow from investing activities</b>	<b>(80.75)</b>	<b>(460.39)</b>	<b>372.23</b>	<b>667.26</b>	<b>(109.57)</b>
Change in bank loans	480.09	(750.61)	0.00	0.00	0.00
Net proceeds from convertible bonds	0.00	2,414.37	0.00	0.00	0.00
Interest paid	(8.76)	(8.69)	(73.82)	(73.82)	(73.82)
Dividends paid	(621.91)	(492.70)	(393.44)	(467.80)	(526.42)
Others	(64.09)	9.48	(0.00)	(0.00)	(0.00)
<b>Cash flow from financing activities</b>	<b>(214.67)</b>	<b>1,171.85</b>	<b>(467.25)</b>	<b>(541.62)</b>	<b>(600.24)</b>
<b>Net change in Cash</b>	<b>365.05</b>	<b>1,683.63</b>	<b>545.23</b>	<b>2,147.54</b>	<b>480.44</b>
Cash and equivalent at beg	400.62	764.84	2,447.16	2,592.49	2,775.47
Forex effect	(0.83)	(1.30)	(399.89)	(1,964.57)	(5.72)
<b>Cash and equivalent at end</b>	<b>764.84</b>	<b>2,447.16</b>	<b>2,592.49</b>	<b>2,775.47</b>	<b>3,250.19</b>

Source(s): Company, ABCI Securities estimates

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

<b>FY ended Dec 31</b>	<b>2013A</b>	<b>2014A</b>	<b>2015E</b>	<b>2016E</b>	<b>2017E</b>
<b>Revenue composition (%)</b>					
- Infant formula	82.26	84.15	84.62	85.07	84.90
- Probiotic supplements	10.04	8.98	8.45	7.61	6.98
- Dried baby food and nutrition supplements	4.36	3.20	2.94	2.95	3.10
- Baby care products	3.34	3.67	3.98	4.37	5.01
<b>Profitability ratios (%)</b>					
Gross margin	65.23	61.86	61.70	63.02	66.28
- Infant formula	64.55	61.96	61.38	62.86	66.81
- Probiotic supplements	78.61	71.44	71.03	75.75	75.52
- Dried baby food and nutrition supplements	55.60	49.10	51.16	52.43	41.29
- Baby care products	54.16	47.25	56.48	50.98	59.87
EBIT margin	27.46	23.24	23.79	25.19	29.01
EBITDA margin	28.05	24.31	23.79	25.19	29.01
Pre-tax margin	25.48	23.64	23.80	25.20	29.03
Total net margin	17.99	17.05	17.47	18.18	20.84
<b>Return ratios (%)</b>					
ROAA	20.08	14.31	13.16	13.59	16.50
ROAE	33.93	29.70	28.08	27.49	31.28
ROIC	36.21	31.08	38.39	45.04	48.11
<b>Liquidity ratio (%)</b>					
Current ratio	1.40	3.42	4.28	2.92	3.59
Quick ratio	0.93	2.79	3.65	2.38	3.06
Cash ratio	0.85	2.64	3.52	2.24	2.97
<b>Cash conversion cycle (days)</b>					
Days of outstanding receivable	0.6	1.1	1.0	0.9	0.8
Days of inventory on hand	172.0	178.9	133.5	135.8	135.2
Days of outstanding payable	56.0	73.5	48.9	50.8	50.5
CCC	116.6	106.5	85.6	85.9	85.5
<b>Leverage ratios (%)</b>					
Total debt/Equity	29.84	82.63	70.23	59.14	47.86
Total debt/Total assets	16.17	36.35	34.82	29.16	26.74

Source(s): Company, ABCI Securities estimates

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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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