



Sector Rating: Overweight

Key Data

Average FY12E PE (x)	20.0
Average FY12E PB (x)	3.58

Source: Bloomberg, ABCI Securities

Results in FY2012

	ROAA(%)	ROAE(%)	D/E(%)
Mengniu	8.7	14.2	Net cash
Modern Dairy	4.8	8.5	54.0
Biostime	22.6	34.8	Net cash
Yashili	9.8	13.5	Net cash

Source: Company

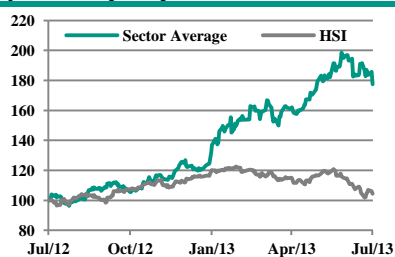
Average share performance (%)

	Absolute	Relative*
1-mth	(9.9)	(1.0)
3-mth	9.4	18.5
6-mth	29.6	42.8

*Relative to Hang Seng Index

Source: Bloomberg

1 year share price performance



Source: Bloomberg

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China Dairy Industry

Infant formula milk: Possible antitrust violations

Biostime (1112 HK) plummeted as its Guangzhou unit, together with five foreign infant formula milk companies, including Nestle SA, Abbott Laboratories, Mead Johnson Nutrition Co, Danone's Dumex brand and Wyeth Nutrition, are under investigation by the NDRC for an alleged violation of Article 14 of China's Anti-Monopoly law. The government's action is a way of breaking down price control on formula milk products as the foreign brands are dominating the local market. Beingmate (002570 CH), after the anti-trust cases shed into light, announced on 2 Jul that it will lower its ex-factory price and details including when and how much it will lower its price are yet to be announced while Wyeth announced on 3 Jul that it will lower its ASP by an average of 11% and will not raise product price in the coming 12 months.

The reason behind: In our view, the government targets its investigation towards high-tier imported formula milk products which have a relatively high ASP, as a way to break down illegal manipulation of retail prices of imported formula milk products, as their ASP have been rising too rapidly in recent years (~30% growth since 2008). Average ASP of foreign brand formula milk is ~Rmb300/kg as compared to Rmb153/kg of domestic brands.

Impact on Biostime: The case of Biostime comes after Kweichow Moutai Co. (600519) and Wuliangye Yibin Co. (000858)'s units were fined in Feb 2013 for setting minimum retail prices. The commission fined Moutai and Wuliangye Rmb247mn and Rmb202mn respectively which represent 0.7-1% of their revenues in 2012. Biostime may therefore face potential fine on possible violation of the anti-monopoly law. If Biostime is charged with a fine of 1% of 2012 revenue or Rmb33.8mn, we estimate est 2013 EPS will be lowered by 3.8% to Rmb1.32. Maximum fine for violating the anti-trust law can reach 10% which we estimate will lower Biostime est 2013 EPS by 39% to Rmb0.84. However, we believe end buyers of high end imported formula milk products are less price-sensitive consumers. The penalty cost may eventually be transferred to consumers by raising wholesale prices to distributors.

Worst scenario: Our major concern is not the one-off potential fine that Biostime may face, but the price war that it may cause. If the outcome of investigation is unable to drive down retail prices of imported formula milk products, the investigation will not benefit consumers and the government will be blamed subsequently. If the investigation ultimately drives down the retail prices of imported formula milk products in the long term, this will bring in negative side effect to local formula milk products producers as the price gap between imported and local brands will be reduced. As 60% of Biostime formula milk revenue come from high-tier market (Rmb200-300/can), substitution effects will kick in and consumers will switch to foreign brands as they become relatively less expensive if retail prices of imported formula milk products are slashed.

Another concern is whether NDRC's action targeting imported formula milk products is just the beginning of the series of government administrative actions

Recommendation: Our top pick in the industry is Mengniu (2319 HK), with TP set at HK\$32.0 (but this does not include any +VE impact from acquisition of Yashili which is subject to final approval by shareholders on 16 Jul). Taken into consideration of trading liquidity, we do not choose China Modern Dairy as our top pick but stick to Buy with TP set at HK\$2.93. We maintain our Hold rating on Yashili (1230 HK), which might go unlisted if over 90% of the shareholders choose to accept the cash offer from Mengniu. We maintain Hold for Biostime despite 17% of upside potential because of short term policy risks. Entry point for Biostime will be subject to further news on anti-monopoly investigation which we will continue to follow up.

Summary and valuation

Company	Code	Rating	Price (HK\$)	TP (HK\$)	Upside (%)	2013F PER (x)	2013F PB (x)	2013F Yield (%)
Mengniu	2319	BUY	27.80	32.0	15.0%	21.7	2.8	1.1
Modern Dairy	1117	BUY	2.25	2.93	30.2%	19.5	1.6	0.0
Biostime	1112	HOLD	37.45	43.8	17.0%	20.8	6.8	3.4
Yashili	1230	HOLD	3.45	3.61	4.6%	17.5	3.0	4.0

Source: Company, Bloomberg, ABCI Securities estimates

Exhibit 1: Anti-monopoly Law of PRC - Article 14

Any of the following agreements among business operators and their trading parties are prohibited:

- (1) fixing the price of commodities for resale to a third party;
 - (2) restricting the minimum price of commodities for resale to a third party;
- or
- (3) other monopoly agreements as determined by the Anti-monopoly Authority under the State Council.

Source: china.org.cn

Exhibit 2: Mead Johnson (MJN US) share price vs Biostime share price



Source: Bloomberg (Jul 2012 – Jul 2013)

Disclosures

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

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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