



# Company Report

## China Mengniu (2319 HK)

February 26, 2013

Initiation

**Rating: Buy**  
**TP: HK\$25.8**

### Key data

Share price (HK\$)	21.3
Upside potential (%)	21.1
52Wk H/L(HK\$)	24.4 / 19.5
Issued shares (mn)	1,768
Market cap (HK\$m)	41,199
30-day avg vol (HK\$m)	146.5
Auditors	Ernst & Young
Major shareholder (%):	
COFCO	28.0
Arla Foods	5.9

Source: Company & Bloomberg

### Revenue composition in 1H FY12 (%)

Liquid milk products	86.8
Ice cream products	11.8
Other dairy products	1.4

Source: Company

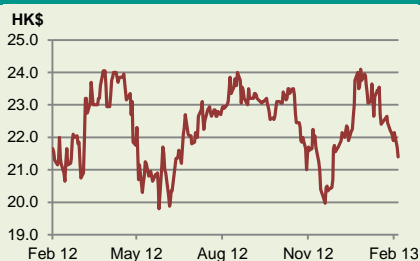
### Share performance (%)

	Absolute	Relative*
1-mth	(7.2)	(3.7)
3-mth	(2.5)	(6.9)
6-mth	(7.4)	(19.3)

\*Relative to Hang Seng Index

Source: Bloomberg

### 1 year share price performance



Source: Bloomberg

### Analyst

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## Waiting for breakthrough

Food safety issues have been negatively affecting the group's performance in 2012. However, the group is putting efforts into product quality control through integrating upwards and cooperating with Arla Foods. Backed by strong shareholder structure and balance sheets, we expect the efforts will take effect soon. We are expecting a recovery in 2013 and possible margin expansion will serve as a breakthrough catalyst. We therefore initiate our research coverage with a BUY recommendation. Our TP is HK\$25.8, based on 20.0x FY13 PER.

**Margin expansion through integrating upstream and better product mix:** To gain a better quality control in milk sources, the group planned to invest a total of Rmb3-3.5bn in the upstream. We estimated that the self-processed raw milk will be accounted for 10% of the group's consumption by FY15. In addition, better product mix will enhance profit margin and become the group's revenue driver. We forecast GP margin of the group to expand from 25.7% in FY12 to 26.7% in FY14.

**Strategic shareholder structure and better quality control:** The increasing involvement of COFCO and recent strategic investment by Arla Foods, the world's fifth largest dairy products enterprise, will benefit the group in terms of more stable raw material supply, better product quality control and ability to develop high end products.

**Strong bargaining power in supply chain leading to strong balance sheet:** As the largest liquid milk producer in China, which accounted for 15.9% of the market share of the domestic dairy products industry, the group has a negative cash conversion cycle of -21.8days. As at the end of 1HFY12, the group had a net cash balance of Rmb5,107.8mn. The strong balance sheet supports the group to implement its five-year plan at low cost.

**Valuation:** Using PER valuation method, we value the stock at HK\$25.8, based on 20.0x FY13 PER. Our appraised share value provides 21.1% of upside potential and we initiate coverage with BUY rating.

**Risk factors:** Food safety risks, market competition, management risks

## Results and valuation

(FY ended Dec 31)	FY10A	FY11A	FY12E	FY13E	FY14E
<b>Revenue (Rmb mn)</b>	30,265	37,388	38,838	42,616	47,431
Chg (%YoY)	17.7%	23.5%	3.9%	9.7%	11.3%
<b>Net Income (Rmb mn)</b>	1,237	1,589	1,373	1,913	2,207
Chg (%YoY)	10.9%	28.4%	-13.6%	39.3%	15.4%
<b>EPS (Rmb)</b>	0.71	0.91	0.74	1.04	1.19
Chg (%YoY)	4.4%	27.3%	-17.8%	39.3%	15.3%
<b>NBV (Rmb/share)</b>	5.61	6.49	7.07	7.98	8.99
<b>PE (x)</b>	-	18.9	22.1	16.5	14.2
<b>PB (x)</b>	-	2.6	2.4	2.1	1.9
<b>ROAA (%)</b>	7.9%	8.5%	6.7%	8.4%	8.7%
<b>ROAE (%)</b>	13.5%	15.0%	11.5%	14.4%	14.7%
<b>Net D/E (%)</b>	Net cash	Net cash	Net cash	Net cash	Net cash

\*We assume HK\$1 = Rmb0.8031

Source: Company, ABCI Securities estimates



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## Investment Themes

Since business commencement in 1999, China Mengniu Dairy (“the group” or “Mengniu”) has become one of the market leaders in the dairy product industry and the largest liquid milk manufacturer in China. With 13 years of operating history, the group has built strong brand name recognition.

However, food safety issues have been negatively affecting the group’s performance recently. The group posted negative sales growth of 1.2% YoY in 1HFY12, mostly due to the Flavacin M1 incident happened in the end of 2011. We see that the management is putting efforts into quality control through a series of restructuring in business operations. In our view, successful execution of the business plan focusing on supply chain control and development of high quality products will help restoring consumer confidence and more importantly, alleviating the market’s major concerns on food safety risks.

The growth potential of the group has attracted Arla Foods to invest in the group as the second largest shareholder in Jun 2012. Supported by the strong shareholder background and financial position, we believe the well-aimed efforts will start to take effect soon. The group’s shareholders are cautiously waiting for the appearance of positive catalysts which will lead to a breakthrough of its share price that was range trading in between HK\$20 and HK\$24 last twelve months. We expect that a recovery in 2013 and possible margin expansion will serve as breakthrough catalysts. Below are the 3 major investment themes we would like to emphasize:

1. Margin expansion through integrating upstream and streamlining products
2. Strategic shareholder structure with synergies effect and better quality control
3. Strong bargaining power in supply chain leading to strong balance sheet

### Margin expansion through integrating upstream and streamlining products

The new business plan of the group focuses on quality control and products SKU. To gain a better quality control in milk sources, the group planned to invest a total of Rmb3-3.5bn in the upstream, of which Rmb2-2.4bn will be used to build six wholly-owned ranches and Rmb1-1.5bn will be invested in cattle ranches as minority stakes (10-20% stakes). We estimated that the self-processed raw milk will be accounted for 10% of the group’s consumption by FY15. In our view, integrating upwards not only allow the group to secure a stable supply of the most essential raw materials (raw milk accounted for 47% of the total costs of sales in 1HFY12), but also enhance the profit margin of the group if ranches are operated efficiently.

*Arla Foods is a global dairy company and is also the second largest shareholder of the group*

Modern Dairy (1117 HK), the largest raw milk producer in China and one of the raw milk suppliers of the group, achieved EBITDA margin of over 20% during FY09 to FY11 as compared to below 10% of the group for the same period. Although the group might lack of the experiences in operating ranches, we believe the participation of Arla Foods in the daily operations of the group enables the group to operate efficiently. In particular, Arla Foods will introduce new technologies to the group to enhance the yield rate per dairy cattle and to cultivate a professional ranch management team. Therefore, we believe the move of integrating upwards will allow the group

to enjoy a higher profit margin. However, this might come at the expense of lower ROAA and ROAE in the short term due to high initial assets investment required.

**Exhibit: Profitability comparison with Modern Dairy (1117 HK)**

Modern Dairy	FY09	FY10	FY11	Mengniu	FY09	FY10	FY11
EBITDA margin	20.0%	31.1%	25.7%	EBITDA margin	7.8%	7.3%	7.5%
NP margin	9.0%	20.2%	23.8%	NP margin	4.3%	4.1%	4.3%
ROAA	1.4%	4.0%	5.1%	ROAA	8.8%	7.9%	8.5%
ROAE	3.8%	7.4%	8.2%	ROAE	17.1%	13.5%	15.0%

Source: The group, company reports

*Major drawback of integrating upwards is a possible downward pressure on ROAA.*

From the group's shareholders' point of view, higher ROAA is more important than profit margins. Upward vertical integration will drag down the return rate of Mengniu's shareholders, unless the profitability of Mengniu's raw milk production assets are as high as its downstream dairy products production and distribution businesses. We believe the group's management knows the drawback of upward vertical integration to shareholders return rate. However, this strategic move is inevitable if the group intends to secure stable supply of consistent high quality raw milk to fulfill the increasing demand for raw milk in its downstream dairy products production and distribution business.

In addition to integrating upstream, the group is planning to streamline its products and it is one of the major development strategies emphasized by the new appointed CEO, Ms Sun. The group has a large product portfolio with 57 sub brands and 456 SKUs. The top 40 SKUs contributed 70% of sales and top 100 SKUs contributed 84% of sales. The group aims to cut down on the less profitable SKUs but will launch new products at the same time, with an objective to enhance profit margin through continuous improvement in product mix. The launch of high end products including Milk Deluxe (特倫蘇) and Future Star Milk (未來星牛奶) and continues improvement in the particular series have proved to be a success in the group's product innovation and the ability to enter high-end market in order to capture the increasing high-end customer group as a result of increasing level of urbanization and income as well as increasing concern in quality of dairy products in China. We forecast GP margin of the group to expand from 25.7% in FY12 to 26.7% in FY14. We view that the GP margin expansion through integrating upwards and improving product mix as a positive catalyst for the group to breakthrough.



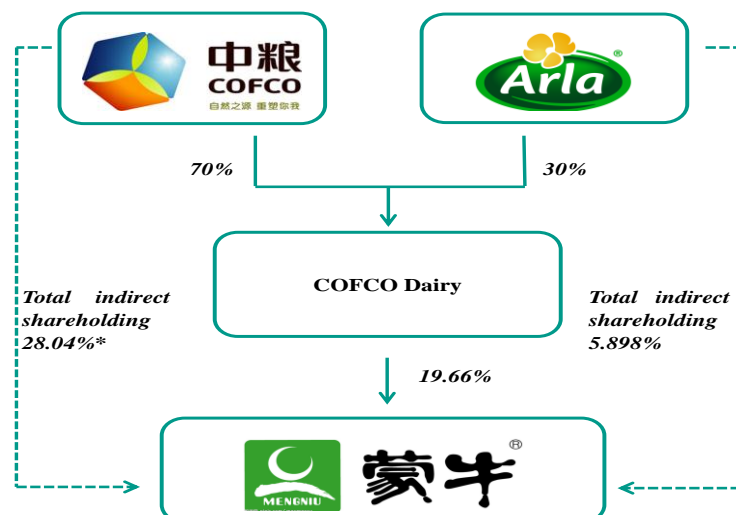
COFCO is the largest oil and food enterprise in China and is also the shareholder of China Foods (506 HK), China Agri-Industries Holdings (606 HK) and COFCO Packaging Holdings (906 HK)

### Strategic shareholder structure with synergies effect and better quality control

In our view, the strategic shareholders of the group have an important role in terms of carrying out the GP margin expansion plan efficiently. China Oil and Food Corporation (“COFCO”) injected capital into the group in Jul 2009 and further increased its stakes in Jul 2011 while Arla Foods Amba (“Arla Foods”), the Danish Dairy Giant and the world’s fifth largest dairy products enterprise, has purchased HOPU Investment Management’s indirect shareholding in the group, representing 5.898% of the group’s total share outstanding, in Jun 2012.

COFCO bought 20.03% of the group for HK\$6.1bn (or HK\$17.6/share) in 2009, making COFCO the largest shareholder of the group since then. In 2011, COFCO bought another 142mn shares of the group for HK\$3.59bn (or HK\$25.28/share) and increased its shareholdings to 28.04%. COFCO is the largest oil and food producers and distributors in China. Leverage on the extensive cooperation with and networks of COFCO customers, we believe the stake investment can create synergy effects to the group in terms of cost effectiveness to source raw materials and to build up a nationwide sales & distribution network. Since COFCO has become a major shareholder to the group in 2009, the selling and distribution (“S&D”) expenses to sales ratio of the group dropped from 18.6% in FY08 to 18.1% in FY09 and 17.9% in FY11. Moreover, COFCO and the group has renewed their S&P agreement in Feb 2012, which allows the group to continue to have a stable supply of raw materials including white sugar and edible oil from COFCO.

In Apr 2012, COFCO stepped up its operational control in the group by appointing Ms Sun Yiping, who was the general manager of COFCO Group (south-west region), as the CEO of the group. We view that the increasing involvement of COFCO, through its long term development strategies and quality control platform, is a move to increase production efficiency and more importantly, food safety and product quality of the group in the long-run.



Source: ABCI Securities



In addition to COFCO, Arla Foods, which has become the second largest shareholder of the group in Jun 2012, has established a strategic cooperation with the group. Arla Foods is 61% bigger than the group in terms of FY11 revenue. However, the group had a higher profitability than Arla Foods in terms of net profit margin, ROAA and ROAE. We expect the group will benefit from the technology and experiences of Arla Foods, more than financial support.

**Exhibit: Financial comparison with Arla Foods**

<b>Arla Foods (US\$ mn)</b>	<b>FY09</b>	<b>FY10</b>	<b>FY11</b>	<b>The group (US\$ mn)</b>	<b>FY09</b>	<b>FY10</b>	<b>FY11</b>
Revenue	8,895	8,805	9,573	Revenue	3,766	4,581	5,939
Net profit	187	225	232	Net profit	163	187	252
Total assets	5,790	5,405	6,087	Total assets	2,065	2,619	3,209
Total equity	1,618	1,562	1,656	Total equity	1,256	1,477	1,822
ROAA	3.3%	4.2%	4.1%	ROAA	8.8%	7.9%	8.5%
ROAE	12.0%	14.7%	14.6%	ROAE	17.1%	13.5%	15.0%
Forex: DKK per US\$	5.1972	5.5684	5.7340	Forex:Rmb/US\$	6.8271	6.6070	6.2950

Source: Arla Foods Amba, Bloomberg

According to the cooperation agreement, the group will be the exclusive distributor of Arla Foods products in China and in turn, Arla Foods will provide technical, management, marketing and innovation advice to the group. Furthermore, appointed by the Ministry of Agriculture of the PRC and the Ministry of Food, Agriculture and Fisheries of the Kingdom of Denmark, the group and Arla Foods will establish the China-Denmark Milk Technology and Cooperation Center with an aim to promote cooperation in the dairy sector facilitating the sharing of relevant experiences, best practices, product development between China and Denmark and to introduce dairy management systems used in Europe into China. We believe the technological support provided by Arla Foods not only allows Mengniu to develop more high-end and higher margin products such as cheese, butter and milk powder, but will also enhance quality control on both raw materials and production process.

We believe the recent move of COFCO and Arla Foods will be a long term positive to the group in terms of continuous improvement in product quality control and food safety issues, which are the major concerns of the group's investors.



### Strong bargaining power in supply chain leading to strong balance sheet

Although the group is losing market shares to its largest competitor, Inner Mongolia Yili (“Yili”), in the dairy products industry in China, the group remains as the largest liquid milk producer in China in terms of revenue. In 1HFY12, the group revenues reached Rmb18,361mn and accounted for 15.9% of the market share in the dairy products market in China as compared to 18.4% of Yili. However, the group’s revenue from the liquid milk business, which accounted for 86.8% of the group’s revenue in 1HFY12, was 1.23x higher than Yili’s and remained as the market leader in the particular segment. Although Mengniu & Yili are two leading players in dairy products production industry, the industry is mainly dominated by other players with market share of approx. 60%. Hence, Mengniu can expand its business by organic growth of the overall industry and by launching new dairy products to displace other players’ market shares.

Exhibit: Sales of top dairy products producers in China

Revenue (Rmb mn)	FY07	FY08	FY09	FY10	FY11	1HFY12
The group	21,318	23,865	25,710	30,265	37,388	18,361
Yili	19,360	21,659	24,324	29,665	37,451	21,181
Bright Dairy	6,158	6,946	7,492	8,994	11,092	6,206
Sanyuan	1,102	1,414	2,380	2,572	3,070	1,693
Others	81,739	96,221	99,013	116,778	142,555	67,975
<b>Market total</b>	<b>129,677</b>	<b>150,104</b>	<b>158,919</b>	<b>188,275</b>	<b>231,556</b>	<b>115,415</b>
<b>Market Share</b>						
Mengniu	16.4%	15.9%	16.2%	16.1%	16.1%	15.9%
Yili	14.9%	14.4%	15.3%	15.8%	16.2%	18.4%
Bright Dairy	4.7%	4.6%	4.7%	4.8%	4.8%	5.4%
Sanyuan	0.9%	0.9%	1.5%	1.4%	1.3%	1.5%
Others	63.0%	64.1%	62.3%	62.0%	61.6%	58.9%
<b>Market total</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>

Source: The group, company reports, Wind

Exhibit: Sales of top dairy products producers in China (Liquid milk segment only)

Revenue (Rmb mn)	FY07	FY08	FY09	FY10	FY11	1HFY12
Mengniu	21,318	23,865	25,710	30,265	37,388	18,361
Yili	19,360	21,659	24,324	29,665	37,451	21,181
Bright Dairy (All dairy products)	6,158	6,946	7,492	8,994	11,092	6,206
Sanyuan	1,102	1,414	2,380	2,572	3,070	1,693
<b>Mengniu/Yili</b>	<b>1.61</b>	<b>1.46</b>	<b>1.45</b>	<b>1.34</b>	<b>1.44</b>	<b>1.23</b>

Source: The group, company reports

The market share of the group and Yili is 3 times the market share of Bright Dairy, the third largest player in the industry, and we believe the leading position of the group and Yili are unlikely to be replaced in the short term. The market leader position of the group gives them a high bargaining power in the supply chain as can be seen in their cash conversion cycle.

The receivable turnover days of the group is low in comparison to its payable turnover days and is relatively low as opposed to Bright Dairy and Sanyuan, meaning the group has a strong bargaining power in determining the credit terms given to its customers. Although the group has receivable turnover days higher than Yili, the figures of within 7 days are considerably low and the effect is more than compensated by a much lower inventory turnover days. The inventory turnover days of the group are the lowest amongst the industry which can be attributable to its long-established relationship with its



suppliers and also strategic locations of production plants (Please refer to appendix). To maintain relatively low inventory turnover days and to contain business risk of supply interruption, the group has to secure stable supply of raw milk in the production lines.

As a result of its market leading position, the group has a negative cash conversion cycle of -21.8 days as compared to 12.5 days of Yili's. In contrast, other well-known F&B players, apart from Tingyi, have a positive cash conversion cycle. As at the end of 1HFY12, the group had a net cash balance of Rmb5,107.8mn. The strong balance sheet allows the group to continue to support its market development and capacity expansion plans at low financing cost.

**Exhibit: Working capital management of top dairy products producers in China**

	FY08	FY09	FY10	FY11
<b>Mengniu</b>				
Receivables turnover days	5.5	6.6	7.0	6.9
Inventory turnover days	16.2	14.9	15.4	18.8
Payables turnover days	37.7	45.8	47.8	47.5
Cash conversion cycle (days)	(16.0)	(24.3)	(25.5)	(21.8)
<b>Yili</b>				
Receivables turnover days	3.4	3.1	2.9	2.6
Inventory turnover days	43.3	44.6	39.0	40.6
Payables turnover days	57.8	72.6	62.7	55.7
Cash conversion cycle (days)	(11.2)	(24.9)	(20.8)	(12.5)
<b>Bright Dairy</b>				
Receivables turnover days	27.4	25.0	28.3	32.5
Inventory turnover days	42.8	41.4	38.6	44.3
Payables turnover days	46.5	51.7	56.4	55.1
Cash conversion cycle (days)	23.7	14.8	10.4	21.7
<b>Sanyuan</b>				
Receivables turnover days	34.5	22.4	20.9	20.8
Inventory turnover days	51.4	44.2	40.4	37.0
Payables turnover days	38.2	31.7	34.7	37.8
Cash conversion cycle (days)	47.7	34.9	26.6	20.0
Cash conversion cycle (days)	5.5	6.6	7.0	6.9

Source: The group, company reports

**Exhibit: Working capital management comparison with other well-known F&B players**

			Receivables Turnover days	Inventory Turnover days	Payable turnover days	Cash conversion days
<b>2319 HK</b>	<b>Mengniu</b>	<b>FY11</b>	<b>6.9</b>	<b>18.8</b>	<b>47.5</b>	<b>-21.8</b>
322 HK	Tingyi	FY11	6.6	19.7	65.0	-38.7
151 HK	Want Want	FY11	16.2	71.2	36.2	51.2
220 HK	Uni-President	FY11	9.9	36.7	33.3	13.3
1044 HK	Hengan	FY11	35.2	101.4	56.0	80.6
168 HK	Tsingtao Brewery	FY11	2.5	63.4	37.6	28.3

Source: The group, company reports, Bloomberg



## Financial Analysis

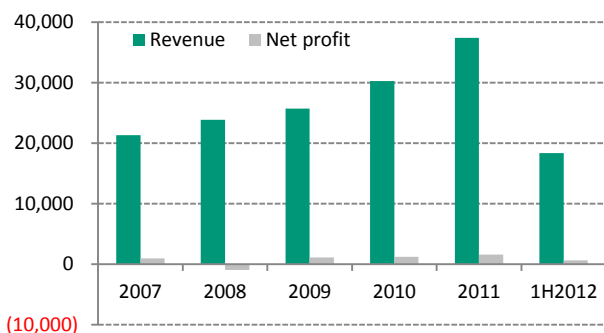
### Revenue Analysis

Although the group posted impressive growth in revenue and net profit from FY07 to FY11, its revenue and net profit declined by 1.2% YoY and 18.4% YoY for 1HFY12 respectively due to 5% fall in sales volume as a result of Flacavin M1 incident occurred in the end of 2011. In regards to food safety concerns, the management of the group is putting effort into product quality control through integrating upwards and cooperating with Arla Foods, the international dairy giant. In view of a shift of customer taste into higher quality products, the group continues to improve its product mix and the 5% fall in sales volume in 1HFY12 was offset by a 4% increase in ASP. We believe revenue will be more ASP-driven during FY12-FY14 as opposed to volume-driven during FY07 to FY11. The group's revenue increased at a CAGR of 15.1% from FY07 to FY11, while production capacity increased at CAGR of 10.2% growth during the same period.

**Exhibit: Production capacity (mn tons)**

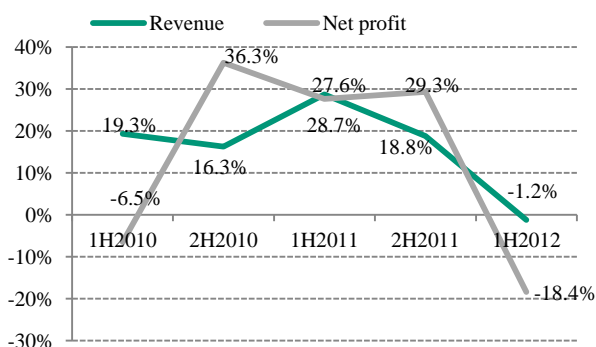
	FY07	FY08	FY09	FY10	FY11
Production capacity	4.78	5.57	5.76	6.50	7.05
YoY Growth		16.5%	3.4%	12.8%	8.5%

**Exhibit: Group's revenue and earnings**



Source: The group

**Exhibit: Group's revenue and earnings YoY growth**

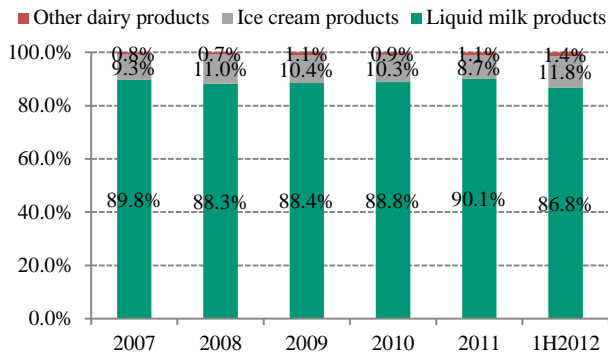


The group's business can be divided into 3 major segments including liquid milk products, ice cream products and other dairy products. In particular, liquid milk products accounted for 88.8%, 90.1% and 86.8% of the group's total revenue in FY10, FY11 and 1HFY12 respectively; and ice cream products accounted for 10.3%, 8.7% and 11.8% of the group's total revenue for the same period.

Liquid milk products comprise of UHT milk, milk beverages and yoghurt. Within the liquid milk products segment, UHT milk constituted the largest single item and accounted for 60.4% of the liquid milk revenue in 1HFY12, while milk beverages and yoghurt accounted for 25.0% and 14.6% respectively.

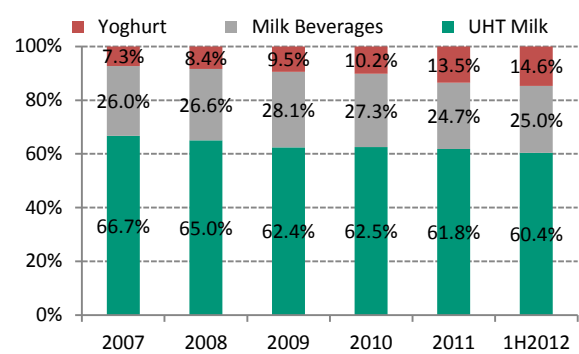


**Exhibit: Group's revenue mix**



Source: The group

**Exhibit: Liquid milk products segment**



**Exhibit: Segment revenue breakdown (Rmb mn)**

Segment revenue	FY07	FY08	FY09	FY10	FY11	1HFY12
Liquid milk products	19,148.9	21,068.1	22,736.2	26,871.8	33,701.2	15,940.8
UHT Milk	12,772.3	13,694.3	14,196.2	16,790.4	20,837.6	9,621.0
Milk Beverages	4,978.7	5,604.1	6,387.3	7,336.2	8,309.6	3,987.6
Yoghurt	1,397.9	1,769.7	2,152.7	2,745.2	4,554.0	2,332.2
Ice cream products	1,991.7	2,626.5	2,685.1	3,111.5	3,258.6	2,158.3
Other dairy products	177.5	170.4	289.2	282.1	428.0	261.5
<b>Total</b>	<b>21,318.1</b>	<b>23,865.0</b>	<b>25,710.5</b>	<b>30,265.4</b>	<b>37,387.8</b>	<b>18,360.6</b>
<b>% of segment revenue</b>						
Liquid milk products	89.8%	88.3%	88.4%	88.8%	90.1%	86.8%
UHT Milk	59.9%	57.4%	55.2%	55.5%	55.7%	52.4%
Milk Beverages	23.4%	23.5%	24.8%	24.2%	22.2%	21.7%
Yoghurt	6.6%	7.4%	8.4%	9.1%	12.2%	12.7%
Ice cream products	9.3%	11.0%	10.4%	10.3%	8.7%	11.8%
Other dairy products	0.8%	0.7%	1.1%	0.9%	1.1%	1.4%
<b>Total</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>
<b>Growth</b>						
Liquid milk products		10.0%	7.9%	18.2%	25.4%	-2.2%
UHT Milk		7.2%	3.7%	18.3%	24.1%	-1.8%
Milk Beverages		12.6%	14.0%	14.9%	13.3%	-6.1%
Yoghurt		26.6%	21.6%	27.5%	65.9%	3.5%
Ice cream products		31.9%	2.2%	15.9%	4.7%	3.6%
Other dairy products		-4.0%	69.8%	-2.5%	51.8%	30.3%
<b>Total</b>		<b>11.9%</b>	<b>7.7%</b>	<b>17.7%</b>	<b>23.5%</b>	<b>-1.2%</b>

Source: The group



Milk Deluxe and Future Star Milk are one of the key liquid milk products of the group.

Profit Margin Analysis

Gross profit of the group increased from Rmb4,803.5mn in FY07 to Rmb9,592mn in FY11. Cost of goods mainly comprised of raw milk and packaging, which accounted for 47% and 22% of total cost of goods sold in 1HFY12. Raw milk price increased by 19.6% YoY in FY10, 11.3% YoY in FY11 and 2.7% YoY in FY12 but the group managed to maintain a steady GP margin throughout the period. GP margin of the group maintained at 25.7% in FY10, FY11 and 1HFY12. The figures indicated that the market leader position gives the group a certain degree of pricing power and a gradual shift into high end products especially through continuous expansion in Milk Deluxe and Future Star Milk series helps offset cost pressures brought from rising raw milk prices.

Exhibit: Group's Gross Profit and GP margin

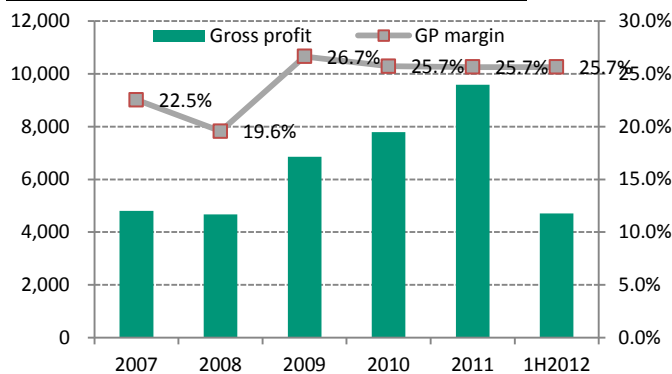
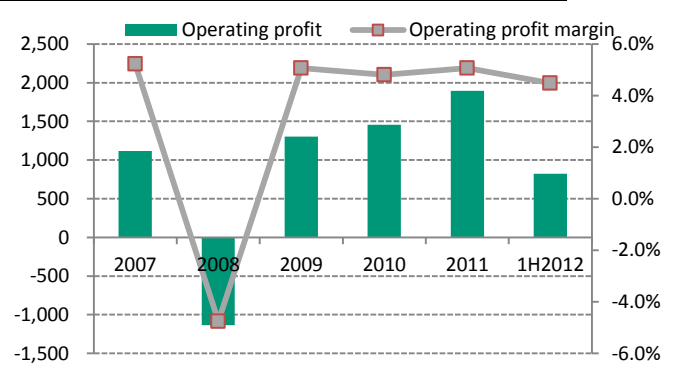


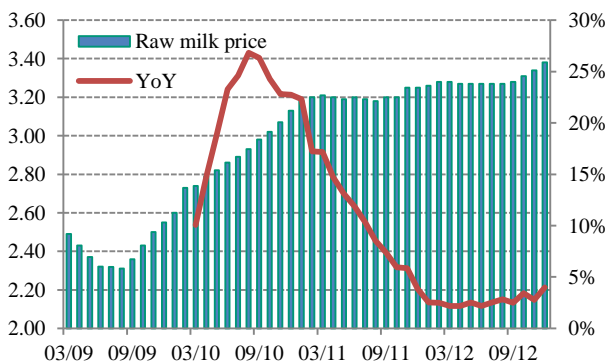
Exhibit: Group's Operating profit and OP margin



Source: The group

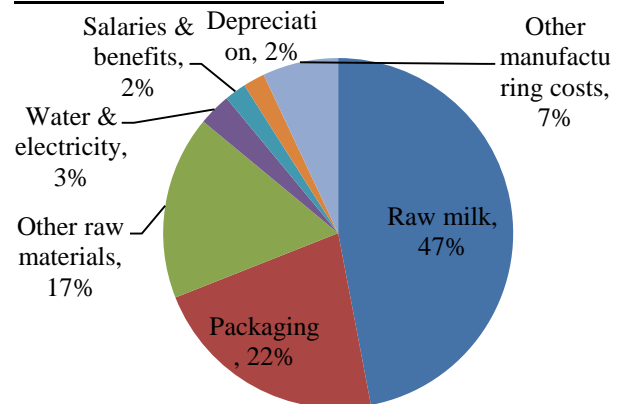
Operating profit of the group increased from Rmb1,115.9mn in FY07 to Rmb1,827mn in FY11, representing a CAGR of 14.2%. Selling and distribution costs (including A&P) accounted for over 80% of the group's operating expenses during FY09 to FY11. S&D to sales ratio dropped slightly from 18.1% in FY09 to 17.9% in FY11, partly because of less A&P spent after Melamine incident in 2HFY08. Operating profit of the group was 4.8%, 5.5% and 4.5% in FY10, FY11 and 1HFY12 respectively.

Exhibit: Raw milk weekly price and YoY



Source: The group

Exhibit: COGs breakdown in 1H2012





#### Working capital analysis

Inventory of the group mainly consists of packaging material and finished good but not raw milk due to its perishable nature. Inventory turnover days of the group increased slightly from 14.9 days in FY09 to 18.8 days in FY11. However, the market leader position of the group allows the group to enjoy a longer payable days in comparison to the group's receivables turnover days. Payable turnover days of the group were over 45 days during FY09-FY11 while receivables day of the group were within a week even though the group normally allows a credit period of not more than 30 days to its customers. Hence, the group had a negative cash conversion cycle throughout FY08-FY11.

The healthy financial position of the group can also be proved by a positive cash flow from operating activities and net cash position during FY08 to FY11. As at 1HFY12, the group had a net cash position of Rmb5,107.8mn.

#### Exhibit: Working capital cycle

	FY08	FY09	FY10	FY11
Receivables turnover days	5.5	6.6	7.0	6.9
Inventory turnover days	16.2	14.9	15.4	18.8
Payables turnover days	37.7	45.8	47.8	47.5
Cash conversion cycle (days)	-16.0	-24.3	-25.5	-21.8

#### Exhibit: Cash flow and Gearing

	FY08	FY09	FY10	FY11
CF from operating activities	2,058.1	586.9	2,131.6	2,485.1
Net cash	1,911.7	1,240.4	5,369.5	5,857.0

Source: The group



## Financial projections

Our earnings model is based on various assumptions. In particular, sales volume growth, ASP growth, raw milk price growth and S&D as a % of sales are the four major assumptions we made in our profit forecasts.

### Exhibit: Major assumptions for FY12-FY14

	FY12F	FY13F	FY14F
Sales volume YoY growth (%)	-2.0%	5.0%	5.0%
ASP YoY growth (%)	6.0%	4.5%	6.0%
Raw milk price YoY growth (%)	3.0%	3.0%	3.0%
S&D as a % of sales	18.0%	17.8%	17.6%

Source: ABCI Securities estimates

**Revenue:** Assuming better food quality control and regarding food incidents that occurred in FY08 and FY11 as non-recurrent events, we assume the group's sales volume to recover and increase by 5% YoY in FY13 and FY14. With the support from Arla Foods, we expect the group to launch more high-end products and we assume ASP to increase by 4.5% YoY in FY13 and 6.0% YoY in FY14. We forecast revenue to increase by 3.0% YoY to Rmb38,838.5mn in FY12 and 12.0% YoY to Rmb42,615.5mn in FY13.

**Cost of sales:** Raw milk, which accounted for 47% of the group's total cost of goods sold in 1HFY12, is the major components of raw material costs. The group currently processes 10k tons of raw milk per day. We estimate that the upstream investment plan of Rmb3-3.5bn in FY13-FY15 can secure the group with up to 1.5k tons of raw milk per day by FY15. We expect the upstream investment can lower the group's cost pressure from raw milk. We assume raw milk cost to increase by 3% YoY in FY13 and FY14.

**Gross profit:** With a better product mix and steady raw milk price growth, we estimate GP margin of the group to expand gradually from 25.7% in FY12 to 26.7% in 2014. Gross profit is expected to increase by 6.9% YoY to Rmb10,254.2mn in FY12 and 10.2% YoY to Rmb11,303.0mn in FY13.

**S&G expenses:** We believe the objective to streamline products will lower overall A&P but at the same time, more resources can be allocated to profitable products. With such assumption, we estimate S&G expenses as a percentage of sales to decrease from 18.0% in 2012 to 17.6% in FY14.

**Earnings:** With 17% of effective tax rate, we forecast FY12-FY14 net profit of the group to be Rmb1,372.8mn, 1,913.0mn and Rmb2,207.2mn; FY12-FY14 FD EPS to be Rmb0.743 (down 17.8% YoY), Rmb 1.036 (up 393.3% YoY) and Rmb1.195 (up 15.3% YoY). Our sensitivity analysis indicates that group is easy to mitigate the adverse impact of raw milk cost hike by slightly raising the ASP.

### Exhibit: Sensitivity Analysis – Net profit change

	FY13F
Net profit	1,913.0
Sales volume +/-5%	+/-4.8%
ASP +/-1%	+/-16.2%
Raw milk price +/-5%	-/+6.7%

Source: ABCI Securities estimates



## Sector Comparison

In terms of profit margin, ROAA and ROAE, the liquid milk producers on average have a lower profitability than the F&B sector. However, raw milk producer, China Modern Dairy, and milk powder producers, Biotimes and Yashili enjoyed a much higher profit margin than the liquid milk producers. Within the liquid milk producers, the market leaders including the group and Yili, which accounted for 15.9% and 18.4% of the market share in 1HFY12 (in terms of revenue), achieved a relatively higher margin compared to their peers.

The direct competitor of the group, Yili, achieved NP margin of 4.86% and ROAA of 8.94% in FY11 which was very similar to the result achieved by the group. However, Yili's ROAE in FY11 was 12.9%ppts higher than the group. We believe the relatively high ROAE of Yili is leveraged through a higher level of debt as compared to the group, which can be seen in their net D/E level. In our view, since the group has a strong balance sheet with a large net cash position, cost of debt would be considerably low and it would be beneficial to the group to make better use of the cash or increase its level of debt in order to produce a greater return to equity holders.

### Peers: Profitability comparison, FY11

Ticker	Stock name	Latest FY end	GP margin (%)	NP margin (%)	ROAA (%)	ROAE (%)	Net D/E (%)
<b>Dairy products producers listed in HK</b>							
2319 HK	<b>Mengniu</b>	<b>12/2011</b>	25.66	4.25	8.47	14.97	(51.14)
1117 HK	China Modern Dairy	06/2012	-	23.75	5.12	8.19	40.38
1112 HK	Biotime	12/2011	66.52	24.09	25.60	32.95	(91.73)
1230 HK	Yashili	12/2011	52.01	10.35	8.27	10.05	(70.98)
	<b>Simple average</b>		48.06	15.61	11.56	16.03	-
	Max		66.52	24.09	25.60	32.95	-
	Min		25.66	4.25	5.12	8.19	-
<b>Dairy product producers in A-share markets</b>							
600887 CH	Inner Mongolia Yili	12/2011	28.82	4.86	8.94	27.84	(12.36)
600597 CH	Bright Dairy	12/2011	32.94	2.03	3.74	9.51	26.61
600429 CH	Beijing Sanyuan	12/2011	19.94	1.59	1.38	2.48	16.49
	<b>Simple average</b>		27.23	2.83	4.68	13.28	-
	Max		32.94	4.86	8.94	27.84	-
	Min		19.94	1.59	1.38	2.48	-
<b>F&amp;B Sector – HK listed companies</b>							
322 HK	Tingyi	12/2011	26.54	5.33	7.31	22.15	24.54
151 HK	Want Want	12/2011	34.78	14.24	16.64	38.99	(30.97)
168 HK	Tsingtao Brewery	12/2011	36.51	8.22	7.48	14.98	(36.09)
220 HK	Uni-president	12/2011	29.19	1.84	4.58	9.16	10.70
606 HK	China Agri Industries	12/2011	8.24	2.88	1.72	5.88	95.37
506 HK	China Foods	12/2011	23.79	2.30	4.64	12.09	(0.54)
1068 HK	China Yurun	12/2011	8.62	5.57	1.19	1.85	5.88
829 HK	Shenguan	12/2011	61.94	45.89	29.08	34.44	(30.39)
345 HK	Vitasoy	03/2012	47.35	7.56	10.14	21.03	11.41
1115 HK	Tibet 5100	12/2011	78.78	58.92	21.23	23.23	(68.63)
1886 HK	China Huiyuan Juice	12/2011	26.94	8.12	3.20	6.04	55.77
	<b>Simple average</b>		34.79	14.62	9.75	17.26	-
	Max		78.78	58.92	29.08	38.99	-
	Min		8.24	1.84	1.19	1.85	-

Net D/E= Net debt/Total equity

Source: The group, Bloomberg, ABCI Securities



## Valuation

Using PER valuation method, we value the stock at HK\$25.8, based on 20.0x FY13 PER. Our appraised share value provides 21.1% of upside potential and we initiate coverage with BUY rating.

The F&B sector of the HK-listed companies are trading at 19.0x FY13 PER. But since none of the stocks in the F&B sector can be considered as a direct comparable to the group, we will take the average PER as a reference rather than a benchmark valuation to the group. On the other hand, Yili, which have similar business operations as well as profitability of the group can be considered as a direct comparable to the group. However, as Yili is trading in the A-share market, its historical PER (FY09-FY12: 29.2x) was on average 11% higher than the group's PER (FY09-FY12: 26.3x).

We believe our valuation of 20.0x FY13 PER is conservative, as it is 24% lower than the group's historical average (FY09-FY12). We believe the market is giving a discount to the group mainly due to concerns on further food safety issues, but better food quality control and cooperation with strategic shareholders may lead to potential re-rating.

### Market value comparison

Ticker	Stock name	Price* HK\$	FY11 PER (x)	FY12F PER (x)	FY13F PER (x)	Historical P/B (x)
<b>Dairy products producers listed in HK</b>						
2319 HK	<b>Mengniu</b>	21.30	18.9	22.1	16.5	2.64
1117 HK	China Modern Dairy	2.48	23.99	17.62	12.77	1.89
1112 HK	Biostime	32.65	25.96	22.31	17.41	8.19
1230 HK	Yashili	2.82	21.36	15.62	13.72	2.09
<b>Dairy product producers in A-share market</b>						
600887 CH	Inner Mongolia Yili	26.88	24.35	25.58	20.69	6.15
600597 CH	Bright Dairy	12.70	45.45	48.85	35.77	3.95
600429 CH	Beijing Sanyuan	5.97	116.71	-	-	2.86
	<b>Simple average</b>		62.17	37.21	28.23	4.32
	Max		116.71	48.85	35.77	6.15
	Min		24.35	25.58	20.69	2.86
<b>F&amp;B Sector – HK listed companies</b>						
322 HK	Tingyi	20.70	29.85	32.15	25.41	5.89
151 HK	Want Want	10.62	37.40	33.39	26.84	13.16
168 HK	Tsingtao Brewery	47.45	29.30	28.93	24.79	4.15
220 HK	Uni-president	8.95	40.40	28.86	22.18	3.55
606 HK	China Agri Industries	4.30	14.54	12.91	10.17	0.83
506 HK	China Foods	5.12	17.78	20.73	16.00	2.04
1068 HK	China Yurun	5.34	32.76	-	12.39	0.60
829 HK	Shenguan	3.93	15.05	14.03	11.91	5.09
345 HK	Vitasoy	8.70	29.19	28.06	24.86	5.85
1115 HK	Tibet 5100	2.22	11.38	12.29	9.38	2.32
1886 HK	China Huiyuan Juice	3.06	11.70	30.34	23.86	0.69
	<b>Simple average</b>		24.49	24.17	18.89	4.02
	Max		40.40	33.39	26.84	13.16
	Min		11.38	12.29	9.38	0.60

\*: The share prices were dated on 26 Feb, 2013

Source: Bloomberg, ABCI Securities estimates

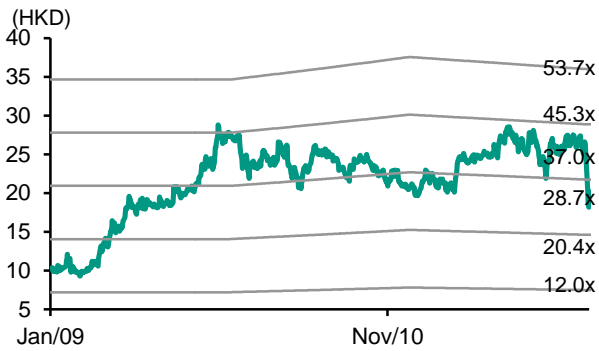


**Exhibit: Financial forecasts vs Consensus (Rmb mn)**

	Our forecast			Consensus			Difference		
	FY12F	FY13F	FY14F	FY12F	FY13F	FY14F	FY12F	FY13F	FY14F
Revenue	38,080	42,584	47,848	38,311	44,422	50,891	-4.1%	-6.0%	-4.1%
Gross Profit	9,787	11,296	12,769	9,800	11,560	13,411	-2.3%	-4.8%	-2.3%
Net profit	1,430	1,913	2,227	1,451	1,844	2,267	3.7%	-1.8%	3.7%
FD EPS (Rmb)	0.775	1.036	1.206	0.814	1.037	1.276	-0.1%	-5.5%	-0.1%

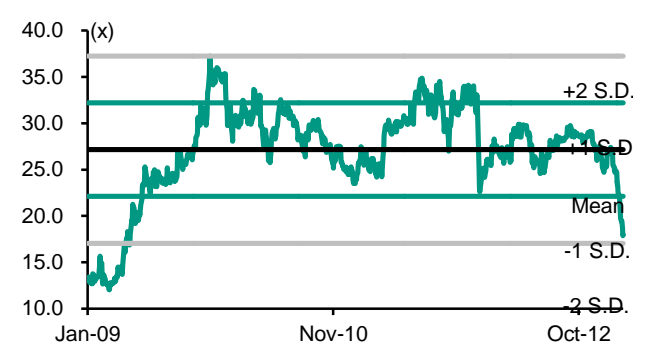
Source: Bloomberg; ABCI Securities estimates

**Exhibit: Historical PE of the group**

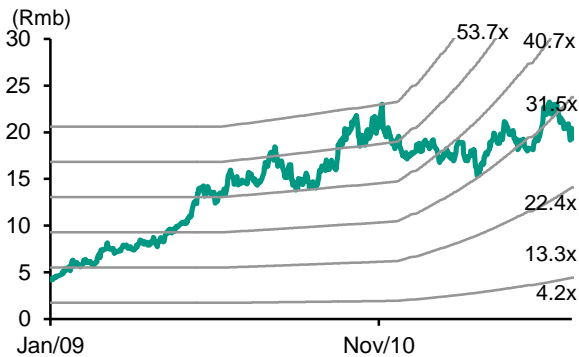


Source: Bloomberg, ABCI Securities

**Exhibit: PE standard deviation of the group**

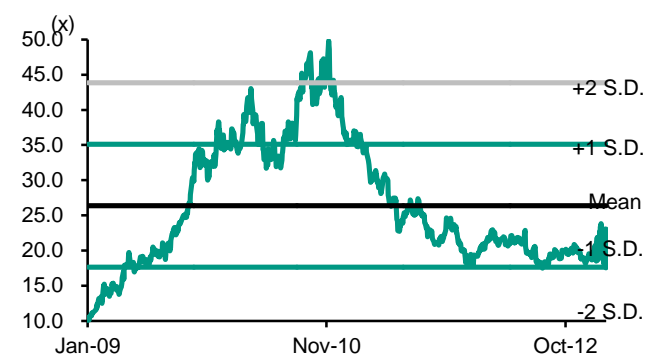


**Exhibit: Historical PE of Yili**



Source: Bloomberg, ABCI Securities

**Exhibit: PE standard deviation of Yili**







## Risk Factors

**Food safety risks:** The group was involved in food safety incidents in 2008 and 2011. In Sep 2008, certain dairy products manufactured by the Group were found to contain Melamine and in Dec 2011, a batch of products from the group's plant at Meishan, Sichuan, was found excessive levels of flavacin M1 upon random inspection. Since raw milk production industry is scattered and are mainly operated in small scale in China, quality control become difficult in examining all the raw materials supplied from over 1000+ milk collection centres. Any contamination of the raw materials for production will affect consumer confidence in the group's products and more A&P is needed to recover the brand image. However, we believe the strategic shareholders including COFCO and Arla Foods and the group's continuous effort in improving its upstream business will lead to stricter quality control on raw materials and production processes.

**Market competition:** Consumers are continuously cautious on the food safety issues in China and tend to favour international brands. The group, especially their high-end products, will face competition to foreign competitors, who might have longer business history and great financial and other resources. In terms of domestic completion, Yili has become increasingly competitive especially after the flavacin M1 incident occurred in 2011. The group may lose market share and its strong bargaining power in the supply chain in view of intensifying market competition.

**Management risks:** Current CEO of the group, Ms Sun, who was appointed in Apr 2012, was the third CEO of the group since the Melamine incident in 2008. Although Ms Sun has extensive experiences in the F&B industry, she has no prior experience in dairy industry. Frequent change in management may lead to inconsistencies in carrying out long term strategies and lower production efficiency.

**Integrating upwards may reduce ROAA and ROAE:** Taking Modern Dairy, the largest raw milk producer in China, as a reference, the group's move to integrate upwards to ensure the quality of milk sources may lower ROAA and ROAE of the group. Modern Dairy achieved ROAA of 5.1% and ROAE of 8.2% in FY11 as compared to the group's ROAA of 8.5% and ROAE of 15.0% for the same period. Integrating upwards may therefore lower the group's ROAA and ROAE in the short term.



**Profit Forecast**

FY ended Dec 31 (Rmbmn)	FY10	FY11	FY12F	FY13F	FY14F
Revenue	30,265.4	37,387.8	38,838.5	42,615.5	47,431.1
Cost of sales	(22,479.0)	(27,795.7)	(28,584.3)	(31,312.5)	(34,775.2)
<b>Gross profit</b>	<b>7,786.4</b>	<b>9,592.2</b>	<b>10,254.2</b>	<b>11,303.0</b>	<b>12,655.9</b>
Other income and gains	193.5	296.3	233.0	255.7	284.6
S&D	(5,429.1)	(6,694.7)	(7,379.3)	(7,585.6)	(8,347.9)
Admin expenses	(1,036.0)	(1,110.1)	(1,126.3)	(1,235.9)	(1,375.5)
Other operating expenses	(59.7)	(187.2)	(194.2)	(213.1)	(284.6)
Share of profits and losses of associates	40.4	52.1	0.0	0.0	0.0
<b>EBIT</b>	<b>1,495.4</b>	<b>1,948.5</b>	<b>1,787.4</b>	<b>2,524.2</b>	<b>2,932.5</b>
Interest income	87.9	173.1	129.8	129.8	129.8
Finance costs	(45.2)	(60.9)	(37.6)	(34.9)	(40.3)
<b>EBT</b>	<b>1,538.1</b>	<b>2,060.6</b>	<b>1,879.5</b>	<b>2,619.0</b>	<b>3,022.0</b>
Tax	(182.2)	(276.1)	(319.5)	(445.2)	(513.7)
MI	(118.6)	(195.3)	(187.2)	(260.9)	(301.0)
<b>Net profit attributable to owners</b>	<b>1,237.3</b>	<b>1,589.3</b>	<b>1,372.8</b>	<b>1,913.0</b>	<b>2,207.2</b>
<b>D&amp;A</b>	<b>(718.9)</b>	<b>(851.8)</b>	<b>(1,055.0)</b>	<b>(1,230.6)</b>	<b>(1,406.3)</b>
<b>EBITDA</b>	<b>2,214.3</b>	<b>2,800.3</b>	<b>2,842.4</b>	<b>3,754.8</b>	<b>4,338.7</b>
Dividends	278.1	350.0	302.0	420.8	485.6
No. of issued shares at end of period (mn)	1,738.0	1,767.4	1,768.2	1,768.2	1,768.2
Issuable shares:					
Share options	37.7	51.0	78.3	78.3	79.3
Total issued & issuable shares	<b>1,775.7</b>	<b>1,818.4</b>	<b>1,846.5</b>	<b>1,846.5</b>	<b>1,847.5</b>
<b>Per share value (Rmb)</b>					
FD EPS	0.711	0.905	0.743	1.036	1.195
NBV	5.615	6.490	7.066	7.977	8.987
DPS	0.160	0.198	0.171	0.238	0.275

Source: The group (for historical figures only), ABCI Securities estimates

**Key Financial Ratio**

FY ended Dec 31	FY10	FY11	FY12F	FY13F	FY14F
<b>Profitability ratio</b>					
Gross profit margin	25.7%	25.7%	26.4%	26.5%	26.7%
EBIT margin	4.9%	5.2%	4.6%	5.9%	6.2%
EBITDA margin	7.3%	7.5%	7.3%	8.8%	9.1%
Net profit margin	4.1%	4.3%	3.5%	4.5%	4.7%
ROAA	7.88%	8.47%	6.67%	8.42%	8.67%
ROAE	13.50%	14.97%	11.46%	14.38%	14.72%
<b>Cost ratio</b>					
S&D/revenue	-17.9%	-17.9%	-19.0%	-17.8%	-17.6%
Admin expenses/revenue	-3.4%	-3.0%	-2.9%	-2.9%	-2.9%
Effective tax rate	-11.8%	-13.4%	-17.0%	-17.0%	-17.0%
<b>Leverage</b>					
Current ratio	1.55	1.44	1.50	1.51	1.68
Quick ratio	1.36	1.20	1.29	1.32	1.46
Net debt/total equity	Net cash	Net cash	Net cash	Net cash	Net cash
<b>Working capital cycle</b>					
Receivables turnover days	7.0	6.9	9.0	9.0	9.0
Inventory turnover days	15.4	18.8	20.0	18.0	18.0
Payables turnover days	47.8	47.5	47.5	47.5	47.5

Source: The group (for historical figures only), ABCI Securities estimates



### Balance Sheet Forecast

As of Dec 31 (Rmbmn)	FY10	FY11	FY12F	FY13F	FY14F
PPE	5,380.4	6,806.5	7,766.5	8,750.4	9,558.4
Others	2,261.1	3,008.6	2,994.0	2,979.8	2,965.9
<b>Non-current assets</b>	<b>7,641.5</b>	<b>9,815.2</b>	<b>10,760.5</b>	<b>11,730.2</b>	<b>12,524.2</b>
Inventories	1,176.4	1,685.2	1,447.3	1,641.1	1,788.8
Trades and bills receivable	575.5	835.8	1,079.6	1,022.0	1,317.0
Prepayments and deposits	942.3	774.9	791.4	924.4	981.1
Other receivables	169.9	289.4	136.2	330.8	189.0
Investment deposits	0.0	102.8	102.8	102.8	102.8
Pledged deposits	102.4	175.3	175.3	175.3	175.3
Cash and bank balances	6,697.8	6,523.1	6,476.5	8,545.4	9,358.8
<b>Current assets</b>	<b>9,664.3</b>	<b>10,386.5</b>	<b>10,209.0</b>	<b>12,741.8</b>	<b>13,912.8</b>
Trade and bills payables	3,548.5	3,684.5	3,755.2	4,394.6	4,656.5
Interest-bearing bank loans	550.8	537.5	537.5	537.5	537.5
Others	2,139.0	3,003.7	2,439.6	3,687.6	3,289.7
<b>Current liabilities</b>	<b>6,238.3</b>	<b>7,225.8</b>	<b>6,783.5</b>	<b>8,414.3</b>	<b>8,291.9</b>
Interest-bearing bank loans	150.0	0.0	0.0	0.0	0.0
Others	700.0	927.0	927.0	927.0	927.0
<b>Non-current liabilities</b>	<b>850.0</b>	<b>927.0</b>	<b>927.0</b>	<b>927.0</b>	<b>927.0</b>
<b>Total assets</b>	<b>17,305.8</b>	<b>20,201.7</b>	<b>20,969.5</b>	<b>24,472.0</b>	<b>26,437.1</b>
<b>Net assets</b>	<b>10,217.5</b>	<b>12,048.8</b>	<b>13,258.9</b>	<b>15,130.7</b>	<b>17,218.1</b>
Issued capital	178.7	181.1	181.1	181.1	181.1
Retained earnings	2,050.2	3,074.3	4,097.2	5,708.1	7,494.5
Other reserves	7,529.2	8,215.6	8,215.6	8,215.6	8,215.6
MI	459.4	577.8	765.0	1,025.8	1,326.8
Total equity	10,217.5	12,048.8	13,258.9	15,130.7	17,218.0
<b>Equity attributable to owners</b>	<b>9,758.1</b>	<b>11,471.1</b>	<b>12,493.9</b>	<b>14,104.8</b>	<b>15,891.2</b>

Source: The group (for historical figures only), ABCI Securities estimates

### Cash Flow Forecast

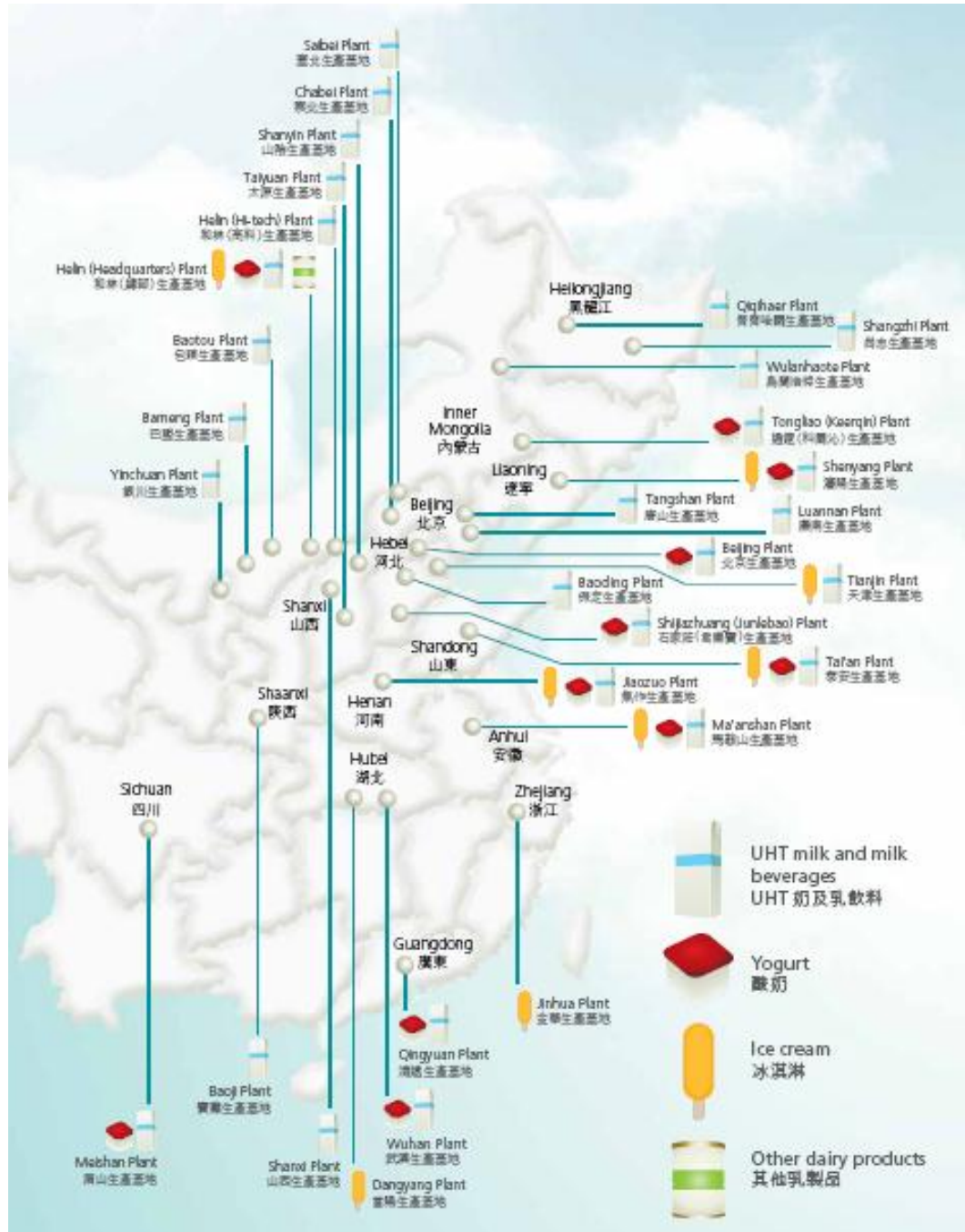
As of Dec 31 (Rmbmn)	FY10	FY11	FY12F	FY13F	FY14F
<b>EBITDA</b>	<b>2,214.3</b>	<b>2,800.3</b>	<b>2,842.4</b>	<b>3,754.8</b>	<b>4,338.7</b>
Change in working capital	151.7	37.9	(311.4)	1,166.8	(479.9)
Others	259.7	(75.3)	92.2	94.9	89.5
<b>Cash (used in)/generated from operations</b>	<b>2,625.7</b>	<b>2,762.9</b>	<b>2,623.2</b>	<b>5,016.5</b>	<b>3,948.3</b>
Interest paid	(38.9)	(46.4)	0.0	0.0	0.0
Income tax paid	(101.8)	(196.4)	(319.5)	(445.2)	(513.7)
<b>CF from operating activities</b>	<b>2,485.1</b>	<b>2,520.1</b>	<b>2,303.7</b>	<b>4,571.3</b>	<b>3,434.5</b>
CAPEX	(1,426.1)	(2,696.3)	(2,000.0)	(2,200.0)	(2,200.0)
Others	(3,263.5)	(1,468.8)	(2,303.7)	(4,571.3)	(3,434.5)
<b>Cash flows from investing activities</b>	<b>(2,204.5)</b>	<b>(1,645.0)</b>	<b>(2,000.0)</b>	<b>(2,200.0)</b>	<b>(2,200.0)</b>
Net borrowing	(130.1)	(277.0)	0.0	0.0	0.0
Proceeds from issue of shares	13.4	520.6	0.0	0.0	0.0
Dividends paid	(272.7)	(331.2)	(350.0)	(302.0)	(420.8)
Interest paid	(38.9)	(46.4)	0.0	0.0	0.0
Others	32.6	(104.2)	(0.3)	(0.3)	(0.3)
<b>Cash flows from financing activities</b>	<b>(395.6)</b>	<b>(238.2)</b>	<b>(350.3)</b>	<b>(302.3)</b>	<b>(421.1)</b>
Net (decrease)/increase in cash and cash equivalents	(114.9)	636.9	(46.6)	2,068.9	813.4
Cash and cash equivalents at beginning of year/period	3,986.6	3,775.3	4,359.9	4,313.3	6,382.2
Effect of foreign exchange rates, net	(96.4)	(52.2)	0.0	0.0	0.0
<b>Cash and cash equivalents at end of year/period</b>	<b>3,775.3</b>	<b>4,359.9</b>	<b>4,313.3</b>	<b>6,382.2</b>	<b>7,195.6</b>

Source: The group (for historical figures only), ABCI Securities estimates



### Appendix – Production plant map

The group has 30 production plants in 14 provinces in China with production capacities of 7.05mn tons as of 31 Dec 2011.



Source: The group

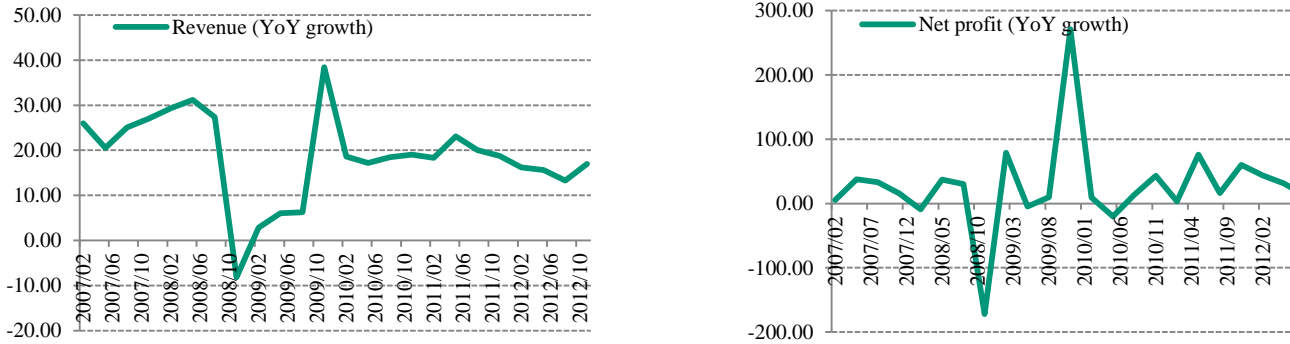


### Appendix - Industry Statistics

For the first 11 months in 2012, revenue of the China's dairy products market increased by 15.5% YoY. GP margin of the industry was 23.8%/24.2%/24.0% for 1Q/2Q/3Q 2012 compared to 25.7% for the group in 1H2012.

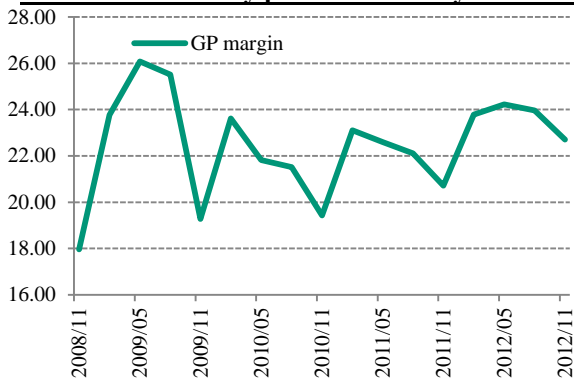
According to the 12th Five Year Plan, raw milk production is planned to increase to 50mn tons, while dairy products production is planned to increase to 27mn tons by 2015, representing a 5-yr CAGR of 15%. The government is encouraging domestic dairy products industry to deepen the supply chain and to enlarge product portfolios from the majority of liquid milk products to other dairy products including high quality milk powder, yoghurt, milk protein and lactose. The government will continue to eliminate inefficient capacities and to develop corporates with more than Rmb2bn revenue through M&A. We believe expanding product range will be one of the key for market leaders to gain market shares.

**Exhibit: China dairy products industry - Revenue and net profit YoY growth (%)**



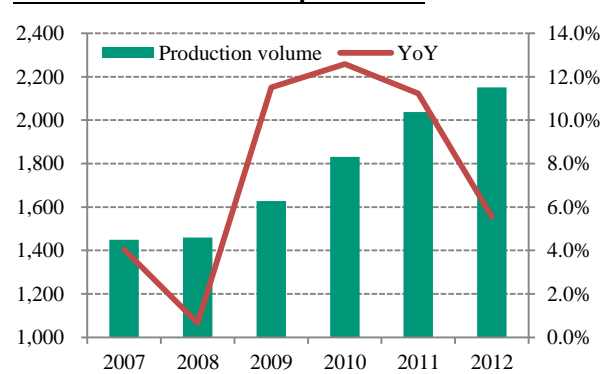
Source: Wind; NSBC

**Exhibit: China dairy products industry - GP margin (%)**



Source: Wind; NBSC

**Exhibit: China raw milk production**





## Disclosures

I, Lee Oi-yee, Lisa, being the person primarily responsible for the content of this research report, in whole or in part, hereby certify that all of the views expressed in this report accurately reflect my personal view about the subject company or companies and its or their securities. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this report.

### 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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