

May 27, 2015

# Tingyi (Cayman Islands)

## Transition Starts Off; Execution Is Key

Industry View

Stock Rating

**In-Line****Underweight**

**Quick Comment:** Tingyi unveiled its transitional plan and introduced the new generation of the management team on Corporate Day – this is the first showcase since Mr. Wei Ing-Chou stepped down as CEO and Mr. James Wei assumed the role at the end of 2014. We understand new management's ambition is to transform Tingyi into a system-based and data-driven FMCG company, building on the model in which Mr. Wei Ing Chou managed the business by his strong leadership and entrepreneurship. While we believe a "new" Tingyi is heading in the right direction, we think earnings volatility for the rest of year will be high, and there are challenges facing management's double-digit earnings growth target for 2015 amid the transformation.

### Highlights of key strategic changes:

- **Sell-through vs. Sell-in:** Company now will put much more effort on retail takeoff vs. channel take-in, especially for beverages, creating more focus on targeted consumer demand and less on inventory issues in the channel.
- **System-based vs. Intuition/Experience:** New management will adopt more science-based methodologies for setting product portfolio (wider range of consumer surveys, more precise sales forecasts, etc) and channel management (relying more on sales data via digitalizing 20,000+ sales force)
- **Value vs. Volume:** The target consumer group will expand from students and migrant workers to middle-class and white-collar. Thus, management aims to accelerate process of product mix upgrade, to drive value growth.

**1Q15 Result Missed:** Net income came in at US\$107mn, down 17% yoy and lower than our/consensus estimates by 20+%. Total sales were down 17% yoy, with noodle declining 13%, beverages ex. Pepsi declining 27% and Pepsi increasing 15%. Overall gross margin improved by 1.3ppt yoy to 31.7%, but it was a miss, given PET being ~20% cheaper yoy, mid-single-digit price hike in bowl noodles and cutback on sausage promotion. SG&A/sales ratio went up 1.3ppt to 23.7% as sales decline triggered operating leverage.

**What drove result miss:** Beverage sales were affected by the scale-back on pre-peak-season channel sell-in this year (change of sales behavior created a difficult comparison in 1Q). Management indicated the magnitude of pre sell-in this year was roughly 60-70% of that in 2014. Noodle sales were still affected by edible oil scandal that happened to its sisterco in Taiwan. Management estimated the impact was negative 10-15%, based on market survey (i.e., noodle sales could have declined at single-digit rate in 1Q without the incident). It also implies that negative impact is fading out. GPM came in lower than expected, mainly due to low utilization rate in beverages.

MORGAN STANLEY ASIA LIMITED+

**Lillian Lou**

Lillian.Lou@morganstanley.com

+852 2848-6502

**Dustin Wei**

Dustin.Wei@morganstanley.com

+852 2239-7823

**Angela Moh**

Angela.Moh@morganstanley.com

+852 2848-5405

Tingyi (Cayman Islands) ( 0322.HK, 322 HK )

China Consumer Staples / China

**Stock Rating****Underweight****Industry View****In-Line**

Shr price, close (May 26, 2015)

HK\$15.94

52-Week Range

HK\$23.25-15.90

Sh out, dil, curr (mn)

5,615

Mkt cap, curr (mn)

US\$11,547

EV, curr (mn)

US\$13,142

Avg daily trading value (mn)

HK\$130

**Fiscal Year Ending****12/14****12/15e****12/16e****12/17e**

ModelWare EPS (US\$)

0.07

0.09

0.11

0.13

Prior ModelWare EPS (US\$)

-

-

-

-

EPS (US\$)\*\*

0.07

0.09

0.11

0.13

Consensus EPS (US\$)§

0.08

0.09

0.10

0.11

Revenue, net (US\$ mn)

10,238

10,504

11,534

12,823

EBITDA (US\$ mn)

995

1,273

1,487

1,712

Net income (US\$ mn)\*\*

400

517

596

718

P/E, basic\*\*

32.0

22.3

19.3

16.0

P/BV

4.2

3.4

3.1

2.8

EV/EBITDA

14.5

10.0

8.3

6.8

ROE (%)\*\*

13.9

17.0

17.8

19.5

RNOA (%)

9.7

12.3

15.6

19.6

Div yld (%)

1.6

2.2

2.6

3.4

FCF yld ratio (%)

(7.1)

5.0

7.1

9.2

Leverage (EOP) (%)

41.9

22.6

2.1

(19.6)

Unless otherwise noted, all metrics are based on Morgan Stanley ModelWare framework

§ = Consensus data is provided by Thomson Reuters Estimates

\*\* = Based on consensus methodology

e = Morgan Stanley Research estimates

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## Key Takeaways

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### Key Takeaways from Tingyi's 2015 Corporate Day

**2015 Target and recent trend:** Single-digit top-line growth (mid-high-SD% for beverages and low- SD% for noodle) and double-digit earnings growth. Management reiterates that sales and earnings trends YTD are largely on track with the plan. Management has seen some stabilization in P&L in April/May.

**Noodles:** Management thinks there is further room for product mix upgrade as noodle ASP increase is still far behind cumulative CPI in the past 10 years. Premiumization is almost the only measure to revive the value growth for this category, while management admits the upgrade along with price hike could dampen sales volume. Management does not exclude the possibility of rolling out some substantial upgrading for the core noodle products in 2015.

**Beverages:** Tingyi will still concentrate resources on "big-item" categories (tea, water) instead of niche/trendy products (referring to pear juice, salty juice).

- Tea: Management is relatively confident of tea's momentum after the impact of doing less pre- sell-in fades away.
- Water: Tingyi increased retail price for its purified water to Rmb1.5/bottle in early April from Rmb1/bottle, after making the plastic bottle thicker and more attractive. Now the water is labeled with a new sub-brand name, and its profit sharing to the channel has increased after price hike. Management attributed the sales and market share drop for water in 1Q15 to this product upgrade
- Juice: Management thinks the new products Honey Pomelo and Salty Lemonade will be able to mitigate the weakness in Pear Juice.
- Pepsi: Sales growth of 15% in 1Q was due to favorable CNY calendar shift and better coordination with distributors to prepare for CNY sales peak.

**Tingyi and Wei Chuan's cross licensing** (covering China market only): The new agreement between the two parties allows Tingyi to produce Wei Chuan's product for an ambient version (room temperature). Vice versa, Wei Chuan is allowed to produce Tingyi and Pepsi's products for a low-temperature version. As such, Tingyi will soon launch Wei Chuan branded ambient probiotics drinks, and Wei Chuan, in the future, will be able to produce Tropicana branded 100% low-temperature juice in China.

**Simplified Executive Management for cost saving and better efficiency:** Tingyi has combined most of the headquarters functions which previously were separated for noodle and beverage. For example, there is just one CFO at the group level, whereas in the past noodle BU and beverage BU had their respective CFOs and finance teams.

**Pepsi Restructuring and Integration:** Management expects Pepsi will start to see good margin improvement in one more year after a number of accomplishments recently.

- The system for financial/operating metrics for Pepsi has had visibility into different promotional activities and different channel/distributors. Thus, Tingyi is now able to identify issues in waste in budget/ineffective campaigns, etc.
- Personnel Adjustment: The management level has pretty much stabilized. There will still be some changes at the working level this year, but Tingyi is enhancing the training and recruiting to mitigate the hiccups. Company is also offering an improved package to retain talent. Tingyi estimates the "termination benefit" will be likely be US\$60-70mn in 2015 and 2016, vs. US\$73mn in 2014.
- Pepsi's GPM is over 40% now, and Pepsi China will share more than 50% of total marketing expenses. Hence, Tingyi expects Pepsi bottling to become a high-margin business after the cost-cutting effort is



## Actual vs. Estimate

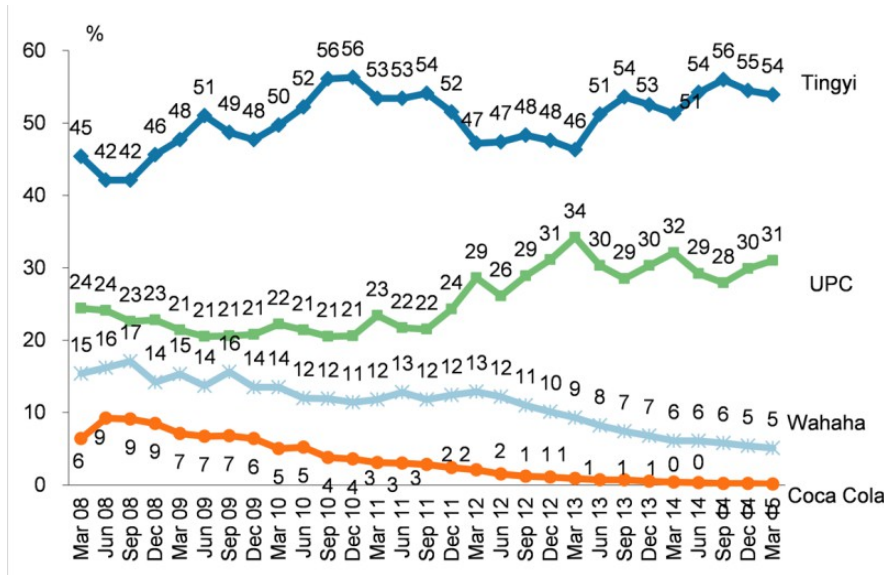
Exhibit 1: Tingyi 1Q15: Actual vs. Estimates

US\$mnn; YE Dec	1Q13	2Q13	3Q13	4Q13	1Q14	2Q14	3Q14	4Q14	1Q15	1Q15e	YoY	Act:Est
<b>Net Sales</b>	<b>2,648</b>	<b>2,775</b>	<b>3,390</b>	<b>2,128</b>	<b>2,782</b>	<b>2,723</b>	<b>2,954</b>	<b>1,780</b>	<b>2,321</b>	<b>2,557</b>	<b>-17%</b>	<b>-9%</b>
- Instant Noodles	1,105	888	1,153	1,186	1,150	884	1,132	972	1,000	1,035	-13%	-3%
- Instant Food	57	42	55	49	53	36	47	42	38	51	-29%	-25%
- Beverage (Total)	1,462	1,787	2,160	858	1,554	1,778	1,729	739	1,260	1,445	-19%	-13%
- Bev (Ex CSD)	1,069	1,430	1,635	638	1,246	1,408	1,224	549	907	1,115	-27%	-19%
- CSD + Others	393	357	525	220	308	370	505	190	353	330	15%	7%
- Other	24	58	22	35	24	24	46	27	23	27	-6%	-14%
Cost of Goods Sold	1,873	1,930	2,285	1,543	1,937	1,857	2,007	1,319	1,586	1,738	-18%	-9%
<b>Gross Profit</b>	<b>775</b>	<b>845</b>	<b>1,104</b>	<b>586</b>	<b>845</b>	<b>865</b>	<b>947</b>	<b>460</b>	<b>735</b>	<b>819</b>	<b>-13%</b>	<b>-10%</b>
Operating Expenses	605	745	796	635	624	720	702	548	551	557	-12%	-1%
<b>Income from Oper</b>	<b>170</b>	<b>99</b>	<b>308</b>	<b>(49)</b>	<b>221</b>	<b>145</b>	<b>245</b>	<b>(87)</b>	<b>184</b>	<b>262</b>	<b>-17%</b>	<b>-30%</b>
Net Interest Inc/(Exp)	3	0	(0)	12	3	4	1	(0)	(2)	(2)	-164%	-8%
Share of Associates	2	4	9	1	2	8	5	(7)	4	2	140%	85%
Other Income	12	73	43	36	19	63	31	42	12	19	-38%	-38%
<b>Income Before Tax</b>	<b>187</b>	<b>177</b>	<b>360</b>	<b>(1)</b>	<b>245</b>	<b>220</b>	<b>282</b>	<b>(53)</b>	<b>197</b>	<b>282</b>	<b>-19%</b>	<b>-30%</b>
Provision for Inc Tax	70	50	82	28	72	56	76	5	64	87	-12%	-27%
<b>Income Before MI</b>	<b>117</b>	<b>127</b>	<b>278</b>	<b>(29)</b>	<b>173</b>	<b>164</b>	<b>206</b>	<b>(58)</b>	<b>134</b>	<b>194</b>	<b>-23%</b>	<b>-31%</b>
Minority Interest	(12)	(36)	(93)	55	(45)	(61)	(46)	67	(27)	(49)	-40%	-45%
Net Income	105	92	186	26	128	104	160	9	107	145	-17%	-26%
<b>Net Income (recur)</b>	<b>105</b>	<b>81</b>	<b>186</b>	<b>27</b>	<b>128</b>	<b>104</b>	<b>160</b>	<b>9</b>	<b>107</b>	<b>145</b>	<b>-17%</b>	<b>-26%</b>
<b>Margins</b>												
Gross Margin	29.3%	30.4%	32.6%	27.5%	30.4%	31.8%	32.1%	25.9%	31.7%	32.0%	1.3%	-0.4%
Instant Noodles	30.2%	28.0%	29.8%	28.8%	28.0%	26.3%	29.8%	28.8%	30.8%	28.5%	2.8%	2.3%
Instant Food	38.2%	35.1%	38.4%	40.2%	36.5%	33.4%	36.2%	38.1%	35.1%	39.0%	-1.4%	-3.9%
Beverages	28.4%	31.7%	34.1%	24.5%	32.1%	34.6%	33.4%	21.5%	32.5%	34.6%	0.5%	-2.1%
Operating Margin	6.4%	3.6%	9.1%	-2.3%	8.0%	5.3%	8.3%	-4.9%	7.9%	10.3%	0.0%	-2.3%
SG&A/Sales	22.8%	26.9%	23.5%	29.8%	22.4%	26.5%	23.8%	30.8%	23.7%	21.8%	1.3%	2.0%
Selling & Distribut'n	19.0%	22.6%	20.4%	23.0%	18.5%	21.7%	20.2%	24.4%	18.6%	17.8%	0.1%	0.8%
Admin	3.3%	3.2%	2.8%	3.9%	3.0%	3.2%	2.3%	3.5%	3.5%	2.6%	0.6%	0.9%
EBIT Margin	7.0%	6.4%	10.6%	-0.6%	8.7%	7.9%	9.5%	-3.0%	8.6%	11.1%	-0.1%	-2.5%
EBITDA Margin	11.1%	10.4%	13.9%	5.0%	13.1%	12.5%	13.6%	2.5%	14.2%		1.1%	
Tax Rate	37.3%	28.0%	22.7%	NM	29.4%	25.4%	27.1%	NM	32.3%	31.0%	2.9%	1.3%
Net Margin (recurring)	4.0%	2.9%	5.5%	1.3%	4.6%	3.8%	5.4%	0.5%	4.6%	5.7%	0.0%	-1.1%
Net Margin	4.0%	3.3%	5.5%	1.2%	4.6%	3.8%	5.4%	0.5%	4.6%	5.7%	0.0%	-1.1%
Noodle	8.8%	6.5%	9.4%	6.2%	9.0%	6.6%	10.5%	8.2%	9.4%			
Instant Food	1.4%	-16.1%	-6.1%	-9.8%	-7.1%	-18.9%	-8.7%	-6.4%	-13.3%			
Beverage	0.6%	1.8%	3.7%	-5.8%	2.5%	3.0%	2.2%	-8.1%	1.6%			
Beverage (Pre MI)	1.5%	3.7%	8.3%	-13.0%	5.4%	6.4%	4.8%	-17.0%	3.7%			

Source: Company Data, Morgan Stanley Research Estimates

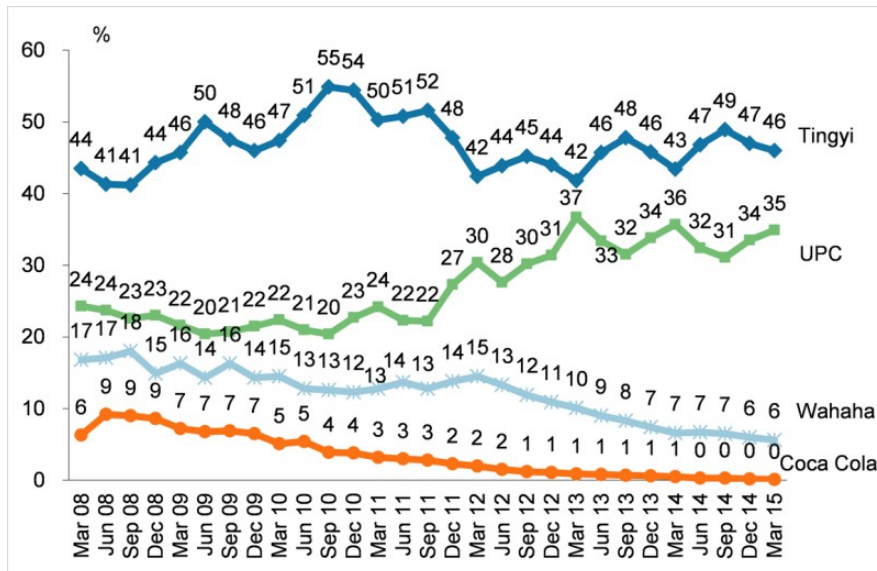
Market Share

Exhibit 2: RTD Tea (Incl Milk Tea) Market Share by Volume



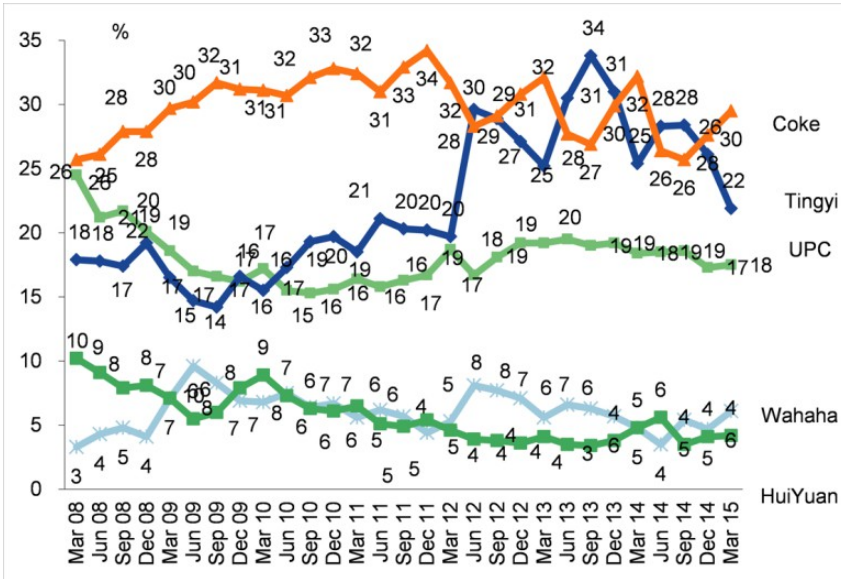
Source: Company Data, Nielsen, Morgan Stanley Research

Exhibit 3: RTD Tea (Incl Milk Tea) Market Share by Value



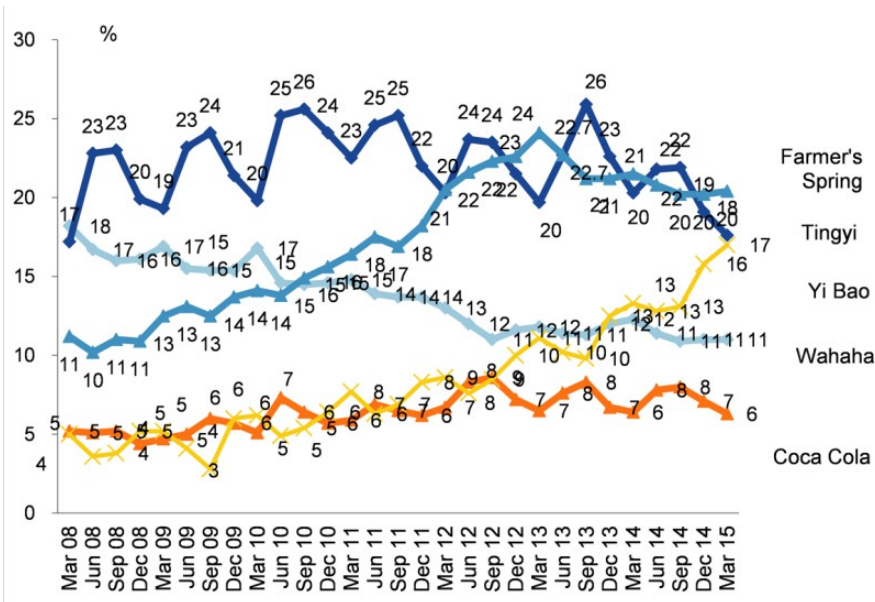
Source: Company Data, Nielsen, Morgan Stanley Research

**Exhibit 4: Juice (diluted) Market Share by Value**



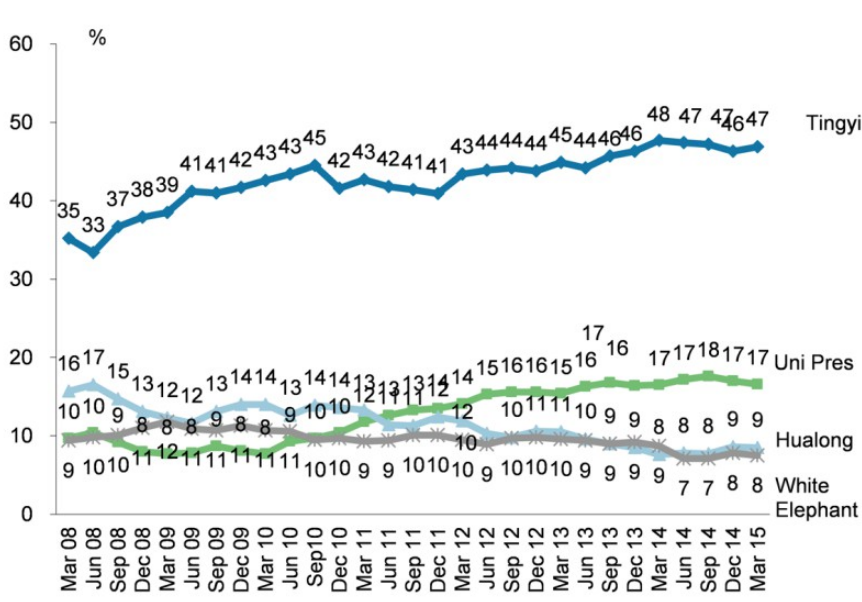
Source: Company Data, Nielsen, Morgan Stanley Research

**Exhibit 5: Bottled Water Market Share by Volume**



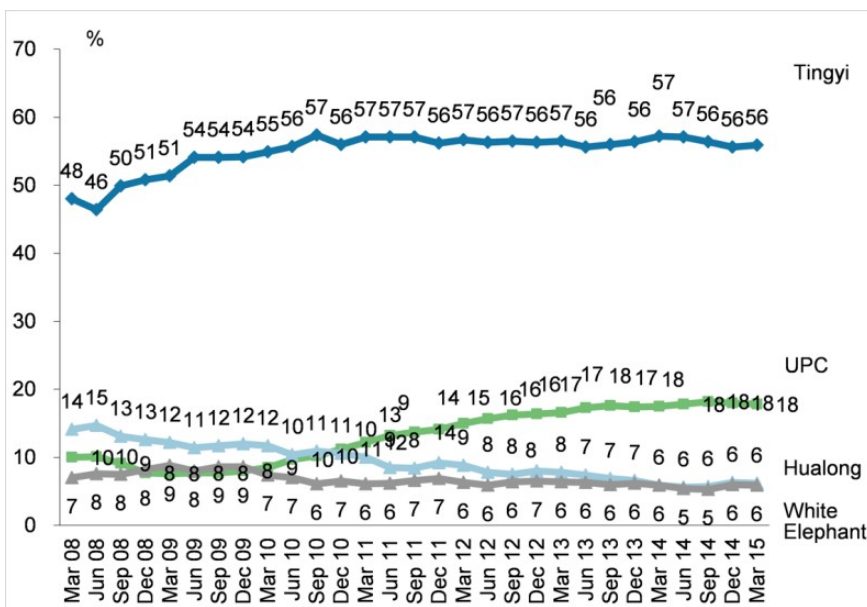
Source: Company Data, Nielsen, Morgan Stanley Research

**Exhibit 6:** Noodle Market Share by Volume



Source: Company Data, Nielsen, Morgan Stanley Research

**Exhibit 7:** Noodle Market Share by Value



Source: Company Data, Nielsen, Morgan Stanley Research

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(as of April 30, 2015)

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STOCK RATING CATEGORY	COVERAGE UNIVERSE		INVESTMENT BANKING CLIENTS (IBC)		
	COUNT	% OF TOTAL	COUNT	% OF TOTAL	% OF RATING CATEGORY
Overweight/Buy	1166	35%	324	43%	28%
Equal-weight/Hold	1449	44%	336	45%	23%
Not-Rated/Hold	102	3%	12	2%	12%
Underweight/Sell	614	18%	78	10%	13%
<b>TOTAL</b>	<b>3,331</b>		<b>750</b>		

Data include common stock and ADRs currently assigned ratings. Investment Banking Clients are companies from whom Morgan Stanley received investment banking compensation in the last 12 months.

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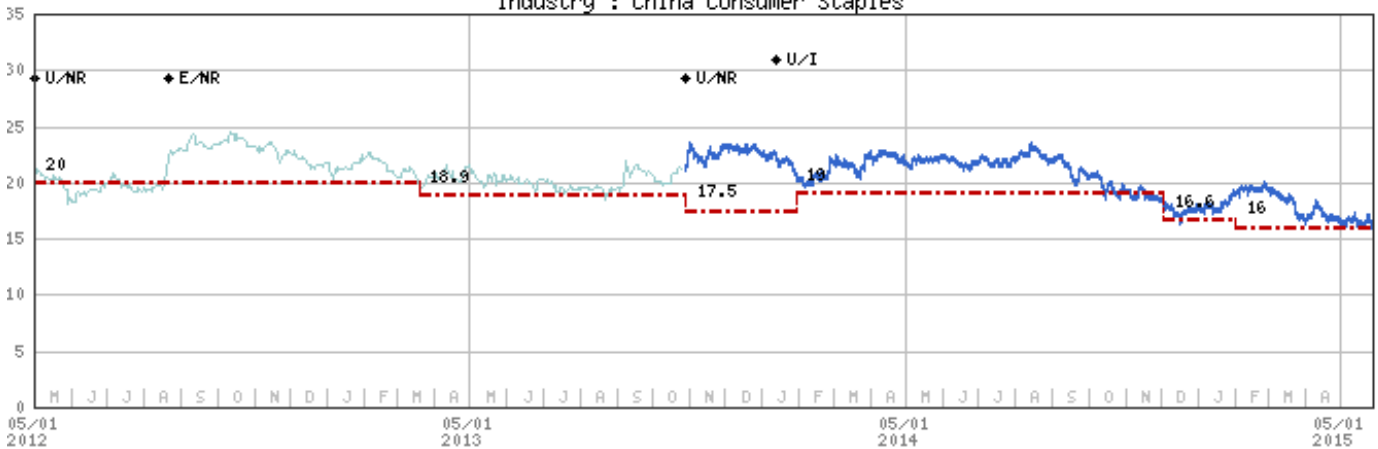
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**Stock Price, Price Target and Rating History (See Rating Definitions)**

Tingyi (Cayman Islands) (0322.HK) - As of 5/26/15 in HKD  
Industry : China Consumer Staples



Source: Morgan Stanley Research      Date Format: MM/DD/YY      Price Target ---      No Price Target Assigned (NA)  
 Stock Price (Not Covered by Current Analyst) --- Stock Price (Covered by Current Analyst) ---  
 Stock and Industry Ratings (abbreviations below) appear as ♦ Stock Rating/Industry View  
 Stock Ratings: Overweight (O) Equal-weight (E) Underweight (U) Not-Rated (NR) No Rating Available (NA)  
 Industry View: Attractive (A) In-line (I) Cautious (C) No Rating (NR)

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#### INDUSTRY COVERAGE: China Consumer Staples

COMPANY (TICKER)	RATING (AS OF)	PRICE* (05/26/2015)
<b>Lou, Lillian</b>		
Bright Dairy (600597.SS)	E (12/08/2014)	Rmb19.85
China Agri-Industries (0606.HK)	E (06/02/2014)	HK\$4.87
China Foods Limited (0506.HK)	U (02/07/2013)	HK\$6.08
China Mengniu Dairy (2319.HK)	O (12/12/2008)	HK\$44.75
China Resources Enterprise (0291.HK)	++	HK\$23.85
Kweichow Moutai Company Ltd. (600519.SS)	O (10/17/2014)	Rmb285.54
Luzhou Lao Jiao Co. Ltd (000568.SZ)	E (05/12/2015)	Rmb27.20
Shuanghui Development (000895.SZ)	E (02/01/2015)	Rmb27.24
Tingyi (Cayman Islands) (0322.HK)	U (10/28/2013)	HK\$15.94
Tsingtao Brewery (600600.SS)	E (02/04/2012)	Rmb52.13
Tsingtao Brewery (0168.HK)	E (01/29/2014)	HK\$51.60
Uni-President China (0220.HK)	U (10/28/2013)	HK\$7.63
Want Want China Holdings Ltd (0151.HK)	E (04/11/2013)	HK\$8.70
WH Group (0288.HK)	O (09/08/2014)	HK\$6.01
Wuliangye Yibin Company Ltd. (000858.SZ)	E (01/29/2014)	Rmb27.90
Yanghe Brewery (002304.SZ)	O (05/12/2015)	Rmb99.01
Yanjing Brewery (000729.SZ)	E (05/12/2015)	Rmb12.08
Yantai Changyu Pioneer Wine Company Ltd. (000869.SZ)	E (02/01/2015)	Rmb54.61
Yantai Changyu Pioneer Wine Company Ltd. (200869.SZ)	O (02/01/2015)	HK\$37.05
Yili Industrial (600887.SS)	O (01/29/2014)	Rmb44.16

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\* Historical prices are not split adjusted.