Consumer & Retail
Food Products
Equity – China

China Mengniu Dairy (2319 HK)

Buy Margin expansion likely to be intact

- **Mix improvement and lower raw milk price should remain the key drivers for margin expansion this year**
- **Compared with peers, Mengniu Dairy's operating margin is still low and we see potential for the company to further enhance its operational efficiency in the long run**
- **Reiterate Buy with an unchanged target price of HKD48.00**

Buy

Target price (HKD)	**48.00**
Share price (HKD)	**44.75**
Upside/Downside (%)	**7.3**

Performance	1M	3M	12M
Absolute (%)	4.3	26.4	15.5
Relative^ (%)	3.6	11.4	-6.1

Index^	HANG SENG INDEX
RIC	2319.HK
Bloomberg	2319 HK
Market cap (USDm)	11,318
Market cap (HKDm)	87,745
Enterprise value (CNYm)	71637
Free float (%)	68

Margin expansion likely to be intact: While Mengniu Dairy does not report quarterly financials, we believe it should have achieved a strong margin improvement in 1Q 2015 given that the average raw milk price in China has fallen 9% year-to-date and our recent store visits in Beijing and Shanghai also suggested that its higher-margin products like Milk Deluxe, Just Yogurt, and Yoyi C continued to outperform the low-end UHT and flavoured milk products. In addition, its peer Bright Dairy (600597 CH, RMB19.56, not rated), whose 1Q 2015 results were released in April-2015, also improved its net margin by 0.4ppt in the first quarter, which we believe is a positive read-across for Mengniu Dairy. In terms of sales by products, Milk Deluxe achieved high-teen sales growth in 2014 (16% of sales), and we expect it to grow by 8-9% this year. Just Yogurt had RMB900m sales in 2014, and we believe it could exceed RMB1,500m sales this year (3% of sales). Yoyi C revenue was up over 50% in 2014 (4% of sales), and we think it could achieve 30% growth this year, thanks to higher market share on the back of new product offering.

Room for further margin improvement: In addition to mix improvement and lower input cost, we believe there is still room for the company to expand its market share further and enhance its operational efficiency. Compared with the operating margin of its international peers like Danone, Mengniu Dairy's liquid milk margin is still 4-5ppt lower, and we believe there is potential for the company to further improve its operating margin through more stringent cost control and scale benefits, especially for the chilled yogurt business, which has a partnership with Danone. Danone's yogurt sales contributed around RMB200m revenue in 2014 due to consolidation in 2H 2014, and we expect the overall chilled yogurt business to account for 18% of total revenue in 2015e, up from 16% in 2014.

Earnings, valuation, and risks: Our earnings estimates for 2015-17e are 3-10% above consensus. Our target price of HKD48.0 is based on a sum-of-the-parts valuation and implies a 2015e PE of 26x, which is c8% higher than the historical average of 24x since January 2013. **Key downside risks:** 1) lower-than-expected sales volume due to a slowdown in dairy consumption or competition; 2) higher-than-expected raw milk costs; and 3) food safety risk.

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Financials & valuation

Financial statements

Year to	12/2014a	12/2015e	12/2016e	12/2017e
Profit & loss summary (CNYm)				
Revenue	50,049	55,644	62,672	70,010
EBITDA	4,006	4,595	5,624	6,227
Depreciation & amortisation	-1,342	-1,238	-1,294	-1,356
Operating profit/EBIT	2,665	3,356	4,330	4,871
Net interest	208	284	317	453
PBT	3,150	3,957	4,982	5,665
HSBC PBT	3,150	3,957	4,982	5,665
Taxation	-459	-645	-856	-1,028
Net profit	2,351	2,855	3,605	4,042
HSBC net profit	2,351	2,855	3,605	4,042
Cash flow summary (CNYm)				
Cash flow from operations	-3,632	4,286	4,709	5,152
Capex	-2,813	-2,900	-2,900	-2,900
Cash flow from investment	-4,202	-2,361	-2,314	-2,179
Dividends	-548	-714	-901	-1,011
Change in net debt	605	-1,211	-1,494	-1,963
FCF equity	-6,175	1,708	2,160	2,732
Balance sheet summary (CNYm)				
Intangible fixed assets	8,936	9,014	9,089	9,164
Tangible fixed assets	11,697	13,382	15,012	16,581
Current assets	20,333	21,627	23,771	26,454
Cash & others	4,650	5,861	7,354	9,317
Total assets	47,081	50,137	53,987	58,314
Operating liabilities	12,553	13,011	13,637	14,338
Gross debt	9,943	9,943	9,943	9,943
Net debt	5,293	4,082	2,589	626
Shareholders funds	21,489	23,630	26,334	29,366
Invested capital	23,764	25,152	26,883	28,547

Ratio, growth and per share analysis

Year to	12/2014a	12/2015e	12/2016e	12/2017e
Y-o-y % change				
Revenue	15.4	11.2	12.6	11.7
EBITDA	30.5	14.7	22.4	10.7
Operating profit	43.9	26.0	29.0	12.5
PBT	42.9	25.6	25.9	13.7
HSBC EPS	36.7	20.8	26.3	12.1
Ratios (%)				
Revenue/IC (x)	2.4	2.3	2.4	2.5
ROIC	10.9	11.5	13.8	14.4
ROE	12.8	12.7	14.4	14.5
ROA	6.8	7.4	8.5	8.8
EBITDA margin	8.0	8.3	9.0	8.9
Operating profit margin	5.3	6.0	6.9	7.0
Net debt/equity	21.6	15.1	8.5	1.8
Net debt/EBITDA (x)	1.3	0.9	0.5	0.1
Per share data (CNY)				
EPS reported (fully diluted)	1.21	1.46	1.84	2.07
HSBC EPS (fully diluted)	1.21	1.46	1.84	2.07
DPS	0.28	0.36	0.46	0.52
Book value	11.03	12.07	13.45	15.00

Valuation data

Year to	12/2014a	12/2015e	12/2016e	12/2017e
EV/sales	1.4	1.3	1.1	1.0
EV/EBITDA	18.1	15.6	12.6	11.1
EV/IC	3.0	2.8	2.6	2.4
PE*	29.7	24.5	19.4	17.3
P/Book value	3.2	3.0	2.7	2.4
FCF yield (%)	-9.2	2.5	3.2	4.0
Dividend yield (%)	0.8	1.0	1.3	1.4

Note: * = Based on HSBC EPS (fully diluted)

Price relative

Source: HSBC

Note: price at close of 26 May 2015

Valuation and risks

We use a sum-of-the-parts method to value Mengniu Dairy as it has two distinct main businesses – a liquid milk operation and an infant formula business through Yashili. For the company's core liquid milk business (excluding Yashili), we use a three-stage DCF model:

- Stage one: an explicit period of three years (2015-17e) with a revenue CAGR of 12 % and a NOPLAT CAGR of 21%;
- Stage two: a semi-explicit period of seven years with a NOPLAT CAGR of 9%, driven by a 10% revenue CAGR and a steady EBIT margin of 6.7%; and
- Stage three: a terminal growth rate of 3%.

In our DCF model for the liquid milk business, we use a WACC of 7.7%, which is derived from a risk free rate of 3.5%, a market risk premium of 5.5% and a cost of debt of 5.0%. Our fair value for the liquid milk business is HKD44.5, implying a 24.6x 2015e PE and 19.3x 2016e PE.

For Yashili's (1230 HK, HKD2.60, Hold) equity value, we value its effective stake based on our target price of HKD2.80 for Yashili, which is based on 1.5x 2015e PB. Adding the two, we arrive at a target price for Mengniu Dairy of HKD48.00, representing a 26.3x 2015e PE or 20.9x 2016e PE.

Key risks

Key downside risks: 1) lower-than-expected sales volume due to a slowdown in dairy demand or competition; 2) higher-than-expected raw milk and operating costs; 3) food safety risk; 4) weaker-than-expected Yashili operation; and 5) any earnings dilutive acquisitions or VC-type investment

Disclosure appendix

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From 23rd March 2015 HSBC has assigned ratings on the following basis:

The target price is based on the analyst's assessment of the stock's actual current value, although we expect it to take six to 12 months for the market price to reflect this. When the target price is more than 20% above the current share price, the stock will be classified as a Buy; when it is between 5% and 20% above the current share price, the stock may be classified as a Buy or a Hold; when it is between 5% below and 5% above the current share price, the stock will be classified as a Hold; when it is between 5% and 20% below the current share price, the stock may be classified as a Hold or a Reduce; and when it is more than 20% below the current share price, the stock will be classified as a Reduce.

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Upside/Downside is the percentage difference between the target price and the share price.

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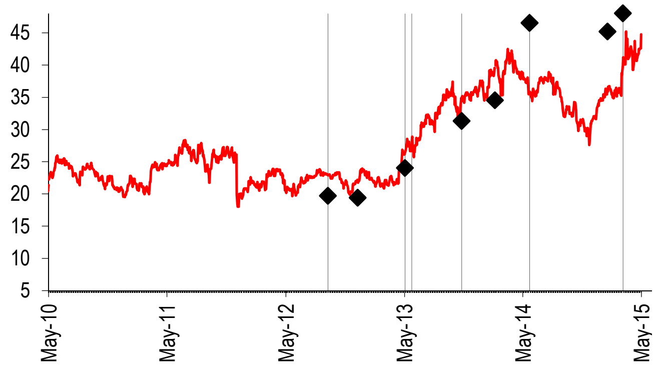
Buy	38%	(29% of these provided with Investment Banking Services)
Hold	44%	(29% of these provided with Investment Banking Services)
Sell	18%	(20% of these provided with Investment Banking Services)

For the purposes of the distribution above the following mapping structure is used during the transition from the previous to current rating models: under our previous model, Overweight = Buy, Neutral = Hold and Underweight = Sell; under our current model Buy = Buy, Hold = Hold and Reduce = Sell. For rating definitions under both models, please see "Stock ratings and basis for financial analysis" above.

Share price and rating changes for long-term investment opportunities

China Mengniu Dairy (2319.HK) Share Price performance HKD Vs HSBC rating history



Source: HSBC

Recommendation & price target history

From	To	Date
N/A	Underweight (V)	03 October 2012
Underweight (V)	Underweight	28 May 2013
Underweight	Restricted	18 June 2013
Restricted	Underweight	19 November 2013
Underweight	Overweight	16 June 2014
Overweight	Buy	31 March 2015
Target Price	**Value**	**Date**
Price 1	19.70	03 October 2012
Price 2	19.40	03 January 2013
Price 3	24.00	28 May 2013
Price 4	Restricted	18 June 2013
Price 5	31.30	19 November 2013
Price 6	34.50	02 March 2014
Price 7	46.50	16 June 2014
Price 8	45.20	11 February 2015
Price 9	48.00	31 March 2015

Source: HSBC

HSBC & Analyst disclosures

Disclosure checklist

Company	Ticker	Recent price	Price Date	Disclosure
CHINA MENGNIU DAIRY	2319.HK	44.75	26-May-2015	4, 6, 11

Source: HSBC

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