

JPM-pp1

Asia Pacific Equity Research

03 March 2015

China Resources Enterprise (291 HK)

Underweight

Price: HK\$16.44

03 Mar 2015

Price Target: HK\$15.50

PT End Date: 31 Dec 2015

CRE profit warning; FY14 underlying bottom line in the red

CRE announced a profit warning for FY14 noting that the Group will announce an underlying consolidated loss for FY14 mainly attributable to weak retail results. Management noted that for FY14 retail operations profitability is likely to decrease around HKD2bn y/y due to i) China's anti-extravagance policy ii) competition from e-commerce and iii) initial stage of integration process with Tesco. This is in line with our expectations as we expect CRE to post HKD1.3bn loss for retail business for FY14 vs HKD734mn profit in FY13 (details below in our earnings preview comment). CRE separately noted that the company booked 800mn provisions during 4Q for the closure of less efficient stores. We had been expecting around 600mn one-off loss during FY14. The provision figure is slightly higher than our estimate which might signal slightly better recurring earnings for FY15. Having said that we have some optimistic assumptions for FY15 such as HKD500mn savings from integration with Tesco and NE China losses narrowing down substantially due to store closures and if these do not materialize there is likely to be some downside risk to our FY15 retail earnings estimates. We continue to rate CRE as UW as we see no catalysts in the future.

- **4Q14 loss to be higher than 3Q14 loss:** As per our understanding from peers 4Q14 continues to be challenging for food retailers. Carrefour recently reported a 7.8% SSSG decline for 4Q14. Therefore, we expect no pick-up in CRE's retail operations in the 4Q14. Moreover, the recent SAB Miller release indicated that CR Snow volume and revenue were down 3% and 7% y/y, respectively in 4Q14. With that we have cut our beer estimates for 4Q14. We now expect CRE to report a HK \$1.2bn recurring net loss during 4Q14 with retail net loss at HK\$1bn (vs HK\$732mn loss in 3Q) and beer net loss at HK \$190mn.
- **FY15 estimates:** For FY15, we expect CRE to report HK\$170mn recurring net loss. We expect HK\$1bn net loss from retail operations in FY15 compared to FY14 retail loss estimate of HK\$1.3bn. CRE will consolidate 12 months of Tesco losses in FY15 but at the same time we have started to build in some savings from: i) integration with Tesco and ii) the closure of some loss-making stores. Hence, we expect overall retail losses to narrow. For the beer segment, we are looking for 9% sales and 17% earnings growth in FY15 as we expect the market to go back to MSD volume growth. *Tesco is covered by our European analyst Borja Olcese.*

Table 1: JPM's estimates on CRE's 2H14E and FY14E results

HK\$m	2H13	2H14E	% chg y/y	FY13	FY14E	% chg y/y
Revenue	74,556	87,420	17.3%	146,413	170,926	16.7%
Gross profit	19,338	22,717	17.5%	37,373	44,099	18.0%
Operating profit	2,355	-847	-136.0%	4,789	1,677	-65.0%
PBT	2,568	-895	-134.8%	5,046	1,602	-68.3%
Net profit	890	-1,268	-242.4%	1,908	-339	-117.8%
Recurring net profit	697	-1,327	-290.4%	1,702	-659	-138.7%
Margins						
Gross margin (%)	25.9%	26.0%		25.5%	25.8%	
Operating margin (%)	3.2%	-1.0%		3.3%	1.0%	
Tax rate (%)	-34.7%	na		-37.5%	-103.0%	
Net margin (%)	1.2%	-1.5%		1.3%	-0.2%	
Recurring net margin (%)	0.9%	-1.5%		1.2%	-0.4%	

Source: J.P. Morgan estimates, Company data.

Table 2: Revenue and net income breakdown by product category

HK\$m	2H13	2H14E	% chg y/y	FY13	FY14E	% chg y/y
Turnover breakdown						
Retail and property	47,267	57,484	21.6%	95,174	110,073	15.7%
Beer	16,916	16,178	-4.4%	32,994	34,653	5.0%
Beverage	3,930	4,914	25.0%	7,305	9,971	36.5%
Food processing and distribution	7,065	9,586	35.7%	12,069	17,621	46.0%
Intersegment	-622	-742	19.3%	-1,129	-1,392	23.3%
Total	74,556	87,420	17.3%	146,413	170,926	16.7%
Recurring net income						

Retail and property	110	-1,765	-1704.4%	734	-1,326	-280.6%
Beer	585	436	-25.4%	943	853	-9.5%
Beverage	67	77	15.2%	106	143	35.1%
Food processing and distribution	42	-47	-211.3%	113	-119	-205.1%
Unallocated corporate expenses	-107	-29	-73.1%	-194	-212	9.2%
Total	697	-1,327	-290.4%	1,702	-660	-138.8%
Recurring net margins						
Retail and property	0.2%	-3.1%		0.8%	-1.2%	
Beer	3.5%	2.7%		2.9%	2.5%	
Beverage	1.7%	1.6%		1.5%	1.4%	
Food processing and distribution	0.6%	-0.5%		0.9%	-0.7%	
Total	0.9%	-1.5%		1.2%	-0.4%	

Source: J.P. Morgan estimates, Company data.

Table 3: Quarterly revenue and net income

HK\$m	1Q13	2Q13	3Q13	4Q13	1Q14	2Q14	3Q14	4Q14E
Turnover Breakdown								
Retail and property	25,923	21,984	23,920	23,347	28,081	24,508	29,582	27,452
Beer	6,548	9,530	11,332	5,584	7,876	10,599	10,911	5,267
Beverage	1,453	1,922	2,494	1,436	2,259	2,798	3,162	1,752
Food processing and distribution	2,433	2,571	3,171	3,894	3,942	4,093	4,334	5,252
Intersegment elimination	-204	-303	-334	-288	-346	-304	-438	165
Total	36,153	35,704	40,583	33,973	41,812	41,694	47,551	39,889
Recurring net income								
Retail and property	525	99	75	35	471	-32	-732	-1,033
Beer	-23	381	749	-164	6	411	625	-189
Beverage	8	31	90	-23	10	56	85	-8
Food processing and distribution	57	14	30	12	-50	-22	-19	-28
Unallocated corporate expenses	-55	-32	-33	-74	-81	-101	-60	30
Total	512	493	911	-214	356	312	-101	-1,227

Source: J.P. Morgan estimates, Company data.

Investment Thesis

We believe CRE's weak earnings momentum in 3Q14 is likely to continue in 4Q14 as the food retail segment remains lacklustre and beer numbers are weaker than expected. For FY14, we now expect the company to report HK\$660mn recurring net loss which implies a HK\$1.2bn recurring net loss as of 4Q14, notably above the 3Q14 net loss figure of HK\$101mn as 4Q is a low season for beer (loss making) and retail losses continue to impact overall earnings. We have increased our earnings estimates for FY15 for retail as we are now building some savings on the back of bigger integration with Tesco and we have further assumed that CRE will be looking to close down some its loss-making stores. If these do not materialize we will have downside risk to FY15 earnings estimates. As such as we are expecting HK\$170mn recurring net loss for FY15, out of this HK\$1bn is from retail operations (which will consolidate 12 months of Tesco losses). We continue to rate CRE as UW as we see no catalysts in the future.

Valuation

Our Dec-15 PT is HK\$15.50, based on our sum-of-the-parts valuation, in which we assign: 1) 6x EV/ EBITDA to FY16E Retail discounted to FY15; 2) 22x P/E for Beer, 3) 15x P/E for beverages; 4) 10x P/E for food and 5) 10x P/E for property.

CRE: SOTP Valuation

2015E	Recurring earnings (EBITDA for retail)	Valuation Method	Valuation (HK \$m)	% of Total Valuation
Retail*		6x EV/ EBITDA for FY16E discounted to		
	1,820	FY15E	9,666	26%
Beer	1,052	22x P/E	23,139	62%
Beverage	186	15x P/E	2,791	7%
Food processing and distribution	2	10x P/E	19	0%
Property	400	10x P/E	4,000	11%
Net corporate interest & expenses	-212	discounted at 10%	-2,118	-6%
Total (HK\$m)			37,497	100%
Price Target per share (HK\$)			15.5	

Source: J.P. Morgan estimates, 2016E for Retail

Risks to Rating and Price Target

Key upside risks to our rating and price target include: 1) a faster-than-expected turnaround in NE China retail; 2) a faster-than-expected turnaround in the Tesco JV; 3) better-than-expected margin improvements from product mix in beer; and 4) sizeable M&A.

Key downside risks include: 1) further deterioration in retail margins from extended losses; 2) worsening competition in beverage; and 3) worsening competition in retail.

Consumer

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18-Jul-07	N	32.70	32.80
27-Aug-07	OW	32.00	35.00
31-Mar-08	OW	25.00	30.00
21-Jul-08	OW	19.70	24.80
04-Sep-08	OW	20.20	25.00
20-Nov-08	OW	11.20	18.00
06-Mar-09	OW	11.04	13.80
01-Apr-09	OW	12.00	13.50
22-May-09	UW	16.26	16.00
03-Aug-09	N	20.70	22.30
03-Sep-09	OW	18.60	21.40
30-Oct-09	OW	26.45	27.00
11-Nov-09	N	26.80	27.00
26-Mar-10	N	28.90	29.00
27-Aug-10	N	31.55	32.00
18-Nov-10	N	32.95	34.00
06-Apr-11	N	32.85	28.00
12-Oct-11	N	29.15	26.00
14-Jan-12	N	27.75	24.50
22-Mar-12	N	29.75	25.00
16-May-12	N	26.05	24.50
17-Aug-12	N	24.25	23.00
21-Nov-12	N	26.25	22.50
05-Feb-13	NR	26.90	--
19-Feb-14	N	23.50	21.00
17-Apr-14	N	22.70	22.00
26-May-14	N	23.90	20.00
24-Sep-14	N	19.94	18.40
16-Nov-14	UW	17.18	15.00
25-Feb-15	UW	16.42	15.50

<http://gps-app.emea.jpmchase.net:6080/server/console/chart/?shareClassId=502044&shareClassServerId=4&chartDesignation=1&actionType=C>

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