

JPM-pp1

Asia Pacific Equity Research

17 March 2015

Want Want China Holdings Ltd (151 HK)

Underweight

Price: HK\$7.99

16 Mar 2015

Price Target: HK\$7.00

PT End Date: 31 Dec 2015

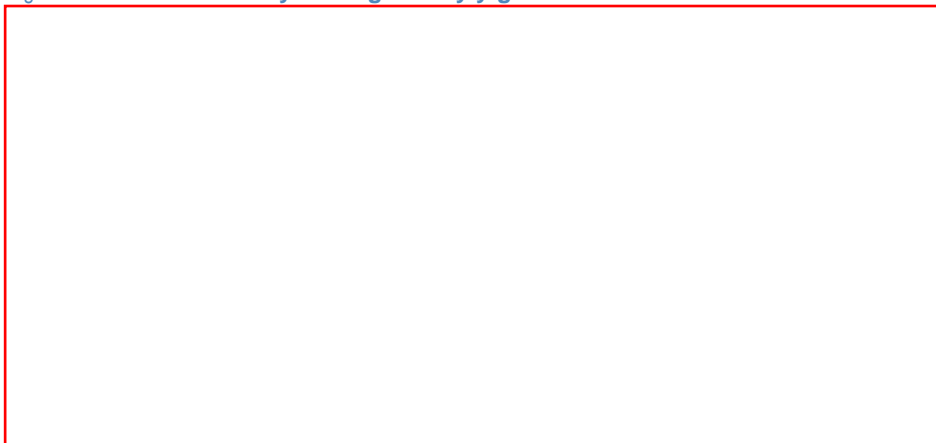
Expecting deterioration to continue; in-line results

Want Want announced US\$619mn net profit for FY14, down 10% y/y in line with our estimate of 9% y/y decline. Weak results should be a non-event given that the company had issued a profit warning earlier. However, it is worth highlighting some interesting points from the results.

- Dairy revenue was down 5% y/y in 2H14 (vs 5% y/y growth in 1H14 and c17% growth in FY13). Want Want tried to lower channel inventory and improve sales after a weak 1H performance; it seems that efforts have not paid in the dairy division and competition continues to impact WW's dairy segment performance.
- Snacks revenue was down 2% y/y in 2H14 following a strong 14% y/y growth in 1H14. Snacks slowdown in 2H seems alarming as this is not a product that has a lot of gifting related sales (such as rice crackers). And in fact during the same period Orion posted c5% y/y growth in its China confectionary and snacks business, which likely shows WW underperformed in this segment.
- On the margin front (with low WMP cost not yet helping WW) operating margin for the entire company came at 19.9% in 2H14 down 370bps on y/y basis.
- The dividend payout in FY14 was c52% which compares to c67% in FY13.

Post the profit warning we downgraded Want Want (WW) to UW as we believe further de-rating is on the way as potential margin recovery on the back of input cost correction takes the back seat and focus is now on top line slowdown. WW used to be a core holding among China consumer names given its: i) dominant market share in niche categories with little competitive pressure, ii) strong pricing power, which meant that it was able to pass on input cost increases via ASP increase and reported strong margin expansion when input costs corrected as it had little need to boost A&P, and iii) on the back of all these had strong top line driven both by volume and ASP. We believe all these pillars have cracked. With a structural slowdown in top line growth (due to high penetration and tough competition) and almost no pricing power left (which likely means not benefitting from input costs correction as it used to do) we believe the stock's de-rating which just started will continue.

Figure 1: Want Want dairy sales growth y/y growth



Source: Company reports.

Table 1: Want Want 2H14 results vs JPM estimates

USDmn	2H13	2H14A	% chg y/y	2H14E	Actual/Est
Sales revenue	2,063	1,923	-7%	1,914	0.5%
Gross profit	862	772	-10%	746	3.5%
Gross margin	41.8%	40.2%		39.0%	
Other income	37	33	-11%	53	-38.9%
Total operating expenses	-413	-423	2%	-413	2.4%
EBIT	486	382	-21%	387	-1.2%
EBIT margin	23.6%	19.9%		20.2%	
Net interest income (expense)	27	22	-19%	24	-9.8%
Associates	1	0		2	
Pretax profit	514	403	-21%	412	-2.2%
Tax	-135	-102	-24%	-106	-3.6%
Effective tax rate	-26%	-25%		-26%	
Minority interests	-1	0		1	
Net profit	378	301	-20%	307	-1.9%
Net margin	18.3%	15.7%		16.0%	

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

Table 2: Want Want FY14 results vs JPM estimates

USDmn	FY13	FY14A	% chg y/y	FY14E	Actual/Est
Sales revenue	3,818	3,775	-1%	3,767	0.2%
Gross profit	1,586	1,519	-4%	1,493	1.7%
Gross margin	41.5%	40.2%		39.6%	
Other income	78	73	-6%	94	-22.0%
Total operating expenses	-781	-816	4%	-806	1.2%
EBIT	883	777	-12%	781	-0.6%
EBIT margin	23.1%	20.6%		20.7%	
Net interest income (expense)	49	53	9%	56	-4.3%
Associates	2	-1		2	
Pretax profit	934	830	-11%	839	-1.1%
Tax	-247	-210	-15%	-214	-1.8%
Effective tax rate	-26%	-25%		-26%	
Minority interests	-1	-1		1	
Net profit	686	619	-10%	625	-1.1%
Net margin	18.0%	16.4%		16.6%	

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

Table 3: Want Want 2H14 revenue, gross profit and EBIT breakdown by segment vs JPM estimates

USDmn	2H13	2H14A	% chg y/y	2H14E	Actual/Est
Revenue breakdown					
Rice crackers	590	508	-14%	502	1%
Dairy products & beverages	1,057	1,006	-5%	1,010	0%
Snack foods	412	405	-2%	397	2%
Others	5	4		5	
Total	2,063	1,923	-7%	1,914	0%
Gross profit breakdown					
Rice crackers	257	206	-20%	205	1%
Dairy products & beverages	425	385	-9%	367	5%
Snack foods	178	180	1%	169	6%
Others	2	0		5	
Total	862	772	-10%	746	4%
EBIT breakdown					
Rice crackers	147	102	-30%	95	8%
Dairy products & beverages	287	245	-15%	224	9%
Snack foods	87	77	-12%	83	-7%
Unallocated costs	-35	-43		-16	
Total EBIT	486	382	-21%	387	-1%
Gross profit margin					
Rice crackers	43.6%	40.7%			
Dairy products & beverages	40.2%	38.3%			
Snack foods	43.4%	44.5%			
Total	41.8%	40.2%			
EBIT margin					
Rice crackers	24.9%	20.2%			
Dairy products & beverages	27.2%	24.4%			
Snack foods	21.3%	19.1%			
Total	23.6%	19.9%			

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

Table 4: Want Want FY14 revenue, gross profit and EBIT breakdown by segment vs JPM estimates

USDmn	FY13	FY14A	% chg y/y	FY14E	Actual/Est
Revenue breakdown					
Rice crackers	910	812	-11%	806	1%
Dairy products & beverages	1,999	1,993	0%	1,997	0%
Snack foods	900	963	7%	955	1%
Others	9	8		9	
Total	3,818	3,775	-1%	3,767	0%
Gross profit breakdown					
Rice crackers	371	324	-13%	323	0%
Dairy products & beverages	826	765	-7%	747	3%
Snack foods	387	432	12%	421	3%
Others	2	-2		3	
Total	1,586	1,519	-4%	1,493	2%
EBIT breakdown					
Rice crackers	185	153	-17%	145	5%
Dairy products & beverages	560	488	-13%	467	4%
Snack foods	204	215	5%	221	-3%
Unallocated costs	-65	-79		-52	
Total EBIT	883	777	-12%	781	-1%
Gross profit margin					
Rice crackers	40.8%	39.9%			
Dairy products & beverages	41.3%	38.4%			
Snack foods	43.0%	44.9%			
Total	41.5%	40.2%			
EBIT margin					
Rice crackers	20.3%	18.8%			
Dairy products & beverages	28.0%	24.5%			
Snack foods	22.7%	22.4%			
Total	23.1%	20.6%			

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

Table 6: Product segment breakdown trends

USD mn	1H11	2H11	1H12	2H12	1H13	2H13	1H14	2H14
Revenue breakdown								
Rice crackers	279	538	277	535	320	590	304	508
Dairy products & beverages	623	770	796	912	942	1,057	987	1,006
Snack foods	369	354	450	380	488	412	558	405
Others	8	5	4	4	4	5	4	4
Total	1,279	1,667	1,528	1,831	1,754	2,063	1,853	1,923
Gross profit breakdown								
Rice crackers	89	218	98	219	114	257	117	206
Dairy products & beverages	211	255	290	385	400	425	380	385
Snack foods	121	128	178	157	208	178	252	180
Others	1	2	1	0	1	2	-2	0
Total	422	603	567	761	724	862	747	772
EBIT breakdown								
Rice crackers	36	125	34	112	38	147	50	102
Dairy products & beverages	127	148	188	246	273	287	243	245
Snack foods	63	70	102	82	117	87	138	77
Unallocated costs	-22	-23	-26	-28	-30	-35	-36	-43
Total EBIT	204	319	298	413	397	486	395	382
% revenue growth								
Rice crackers	18%	37%	0%	-1%	15%	10%	-5%	-14%
Dairy products & beverages	29%	32%	28%	18%	18%	16%	5%	-5%
Snack foods	35%	37%	22%	7%	8%	8%	14%	-2%
Others	-24%	-20%	-54%	-10%	6%	18%	-6%	-26%
Total	28%	34%	19%	10%	15%	13%	6%	-7%
GPM ppt chg								
Rice crackers	(990)	37	310	52	40	266	300	(294)
Dairy products & beverages	(60)	(169)	260	915	610	(200)	(400)	(193)
Snack foods	(920)	(304)	680	509	310	199	250	113
Total	(510)	(111)	410	543	415	22	(92)	(164)
EBIT margin ppt chg								
Rice crackers		(46)	(224)	(60)	398	466	(470)	
Dairy products & beverages		325	780	537	16	(436)	(279)	
Snack foods		560	198	131	(46)	78	(215)	
Total		358	341	315	101	(134)	(368)	
Gross margin by product								

Rice crackers	32.1%	40.4%	35.2%	41.0%	35.6%	43.6%	38.6%	40.7%
Dairy products & beverages	33.8%	33.1%	36.4%	42.2%	42.5%	40.2%	38.5%	38.3%
Snack foods	32.8%	36.3%	39.6%	41.4%	42.7%	43.4%	45.2%	44.5%
Total	33.0%	36.2%	37.1%	41.6%	41.2%	41.8%	40.3%	40.2%
EBIT margin by product								
Rice crackers	12.9%	23.1%	12.4%	20.9%	11.8%	24.9%	16.5%	20.2%
Dairy products & beverages	20.3%	19.2%	23.6%	27.0%	28.9%	27.2%	24.6%	24.4%
Snack foods	17.0%	19.7%	22.6%	21.7%	23.9%	21.3%	24.7%	19.1%
Total	15.9%	19.1%	19.5%	22.5%	22.6%	23.6%	21.3%	19.9%

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

Investment Thesis

We reiterate UW on Want Want (WW). We believe further de-rating is on the way as potential margin recovery on the back of input cost correction takes the back seat and focus is now on top line slowdown. WW used to be a core holding among China consumer names given its: i) dominant market share in niche categories with little competitive pressure; ii) strong pricing power which meant that they were able to pass on input cost increases via ASP increase and reported strong margin expansion when input costs corrected as they had little need to boost A&P; and iii) on the back of all these had strong top line driven both by volume and ASP. We believe all these pillars have cracked. With a structural slowdown in top line growth (due to high penetration and tough competition) and almost no pricing power left (which likely means not benefitting from input costs correction as they used to do), we believe the stock's de-rating which just started will continue.

Valuation

Our Dec-15 PT of HK\$7 is based on 16x one-year forward P/E, 2-standard deviation below the historical mean as growth rates are lower than in the past.

Risks to Rating and Price Target

Risks to our UW rating and price target include: i) a stronger-than-expected margin recovery in 2015 which should kick in after 1Q, thanks to low milk powder price and likely lead to decent earnings growth this year; and ii) seasonal sales momentum, which might mean we are likely to have strong 1Q15 sales given the shift in CNY.

Consumer

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09-Feb-10	N	5.08	5.20
10-Mar-10	N	5.86	5.40
28-Jun-10	N	6.57	5.80
25-Aug-10	N	6.06	5.80
04-Nov-10	OW	7.43	8.80
17-Jul-11	N	7.29	8.00
24-Aug-11	N	6.28	6.50
12-Oct-11	N	6.89	6.00
07-Mar-12	N	7.52	7.00
02-Jul-12	N	9.76	7.60
30-Aug-12	N	9.68	8.50
16-Jan-13	N	10.16	9.00
05-Mar-13	N	11.48	9.50
27-Aug-13	N	11.42	10.00
12-Mar-14	N	11.36	10.50
26-Jul-14	N	10.62	10.20
25-Nov-14	N	10.28	9.90
11-Feb-15	UW	8.68	7.00

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