

China Resources Enterprise, Ltd.

## 2014 net loss as expected; Retail and Food turnaround will take time

**CRE reported a 2014 recurring net loss of HK\$794mn, mainly due to a drag from the Retail division's HK\$1.36bn net loss. Excluding the HK\$640mn one-off provisions made for Retail stores closures amid Tesco-JV integration, the overall recurring net loss would have been HK\$154mn. While Retail provisions and divisional losses were well flagged to market on the company's profit warning (click [here](#) to see our note of Mar-3), the Food division loss was also expected given 4Q14 was the fifth consecutive quarter that it has incurred losses due to initial investment in the rice distribution business. Management guided that it will take time for both Retail and Food divisions to turn around. We fine-tune our forecasts and trim our PT by 7% to HK\$17.0.**

**Key management guidance:** It will take time for Retail and Food divisions to turnaround – three to five years for Retail and two to three years for Food, according to management. Yet we believe the company is taking the necessary steps to lay a good foundation for growth for both divisions. For Retail, the company is launching e-commerce in 1H15, as well as closing down under-performing stores and expanding smaller convenience stores. For Food, the company has established a nationwide presence and enhanced the 'Ng Fung' brand for rice to win market share and improve profitability. For Beer, management hopes the division can secure growth through product premiumisation and solidifying its market-leading position. Lastly, for Beverage, growth is to be driven by higher sales volume.

**Revised estimates:** We cut our 2015E / 2016E revenue estimates by 2% each; and 2015E and 2016E net profits by 15% and 25% respectively, given that the turnaround for the Retail and Food divisions is likely to take time. Specifically, for our 2015 HK\$850mn earnings forecast, we assume 20-25% y/y growth in Beer and Beverage profits to HK\$300mn and HK\$950mn. For Retail and Food, we assume losses of HK\$300mn and HK\$100mn. Our forecasts are predicated on no further write-offs in Retail.

**Valuation and risks:** Our new PT of HK\$17.0 is based on a rich forward multiple of 30x applied to 2016E EPS (rolled forward from an average of 2015E and 2016E EPS), as we expect the company's business to normalise in the next one to two years. Key downside risks include a prolonged ramp-up of the Tesco JV, a worsening competitive landscape for Beer, commodity cost and wage inflation. Meanwhile, key upside risks include Tesco JV profits being achieved sooner than expected, better-than-expected growth in the beer and beverage divisions due to its acquisition of Kingway and JV partnership with Kirin.

### 0291.HK: Financial and Valuation Metrics EPS HKD

FY Dec	2013	2014	2015	2016	2017
EPS	0.68A	-0.33A	0.35E	0.57E	0.77E
Previous EPS	0.68A	0.04E	0.42E	0.76E	N/A
P/E	22.1	N/A	42.7	26.5	19.5

Source: Barclays Research.

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PLEASE SEE ANALYST CERTIFICATION(S) AND IMPORTANT DISCLOSURES BEGINNING ON PAGE 6.

Stock Rating **EQUAL WEIGHT**  
Unchanged

Industry View **NEUTRAL**  
Unchanged

Price Target **HKD 17.00**  
lowered -7% from HKD 18.30

Price (20-Mar-2015) HKD 15.08  
Potential Upside/Downside +13%  
Tickers 291 HK / 0291.HK

Market Cap (USD mn) 4706  
Shares Outstanding (mn) 2421.37  
Free Float (%) 49.00  
52 Wk Avg Daily Volume (mn) 3.6  
52 Wk Avg Daily Value (USD mn) 0.00  
Dividend Yield (%) 1.7  
Return on Equity TTM (%) 3.95  
Current BVPS (HKD) 21.01

Source: Thomson Reuters

Price Performance Exchange-HKG  
52 Week range HKD 24.55-14.04



[Link to Barclays Live for interactive charting](#)

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Asia ex-Japan Staples Industry View: NEUTRAL

## China Resources Enterprise, Ltd. (0291.HK)

Stock Rating: EQUAL WEIGHT

Income statement (HKDmn)	2014A	2015E	2016E	2017E	CAGR
Revenue	168,864	193,513	215,670	238,440	12.2%
EBITDA	7,278	7,995	9,212	10,382	12.6%
EBIT	2,431	2,848	3,765	4,635	24.0%
Pre-tax income	1,841	2,109	3,021	3,885	28.3%
Net income	-794	850	1,374	1,866	N/A
EPS (reported) (HKD)	-0.33	0.35	0.57	0.77	N/A
Diluted shares (mn)	2,410	2,410	2,410	2,410	0.0%
DPS (HKD)	0.27	0.14	0.23	0.31	4.6%

Price (20-Mar-2015) HKD 15.08  
 Price Target HKD 17.00

**Why Equal Weight?** While we believe there is long-term value in this business, we are concerned by the widening losses of the Tesco JV, business transitions in the company's Food business, keen competition for Beer in China and the continuous threat of e-commerce. Therefore we maintain an EW rating on the stock.

Margin and return data	Average				
EBITDA margin (%)	4.3	4.1	4.3	4.4	4.3
EBIT margin (%)	1.4	1.5	1.7	1.9	1.7
Pre-tax margin (%)	1.1	1.1	1.4	1.6	1.3
Net margin (%)	-0.5	0.4	0.6	0.8	0.3
ROIC (%)	1.4	5.4	6.2	6.8	4.9
ROA (%)	0.7	2.8	3.2	3.4	2.5
ROE (%)	-1.3	1.2	2.0	2.6	1.1

Upside case HKD 20.40

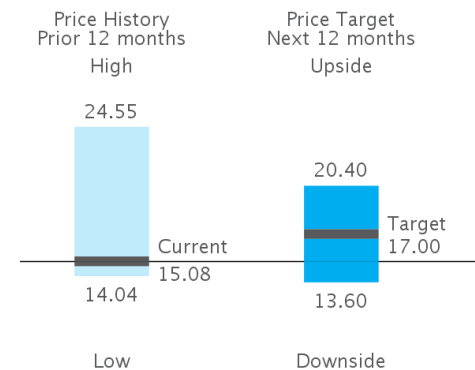
Key upside risks include faster-than-expected Tesco JV profits, better-than-expected growth in beer and beverage divisions with its acquisition of Kingway and JV partnership with Kirin. This case assumes earnings are 20% above our current forecasts.

Downside case HKD 13.60

Key downside risks include prolonged ramp-up of Tesco JV, a worsening competitive landscape for Beer, commodity cost and wage inflation. Downside case assumes earnings being 20% below current projections.

Balance sheet and cash flow (HKDmn)	CAGR				
Tangible fixed assets	56,302	47,487	48,040	48,293	-5.0%
Intangible fixed assets	23,364	23,364	23,364	23,364	0.0%
Cash and equivalents	20,647	23,221	27,208	29,607	12.8%
Total assets	181,364	186,595	197,484	206,691	4.5%
Short and long-term debt	28,897	28,897	28,897	28,897	0.0%
Net debt/(funds)	8,250	5,676	1,689	-710	N/A
Other long-term liabilities	3,270	3,270	3,270	3,270	0.0%
Total liabilities	111,741	116,369	125,665	135,345	6.6%
Shareholders' equity	69,623	70,226	71,819	71,346	0.8%
Change in working capital	4,147	-7,126	2,615	2,737	-12.9%
Cash flow from operations	9,263	-347	10,327	11,358	7.0%
Capital expenditure	-6,000	-6,000	-6,000	-6,000	N/A
Free cash flow	3,263	-6,347	4,327	5,358	18.0%

## Upside/Downside scenarios



Valuation and leverage metrics	Average				
P/E (reported) (x)	N/A	42.7	26.5	19.5	29.6
EV/EBITDA (x)	6.2	5.3	4.2	3.5	4.8
Equity FCF yield (%)	9.0	-17.5	11.9	14.7	4.5
EV/sales (x)	0.3	0.2	0.2	0.2	0.2
P/BV (x)	0.7	0.7	0.7	0.7	0.7
Dividend yield (%)	1.8	0.9	1.5	2.1	1.6
Total debt/capital (%)	29.3	29.2	28.7	28.8	29.0
Net debt/EBITDA (x)	1.1	0.7	0.2	-0.1	0.5

## Selected operating metrics

Retail revenue growth (%)	15.1	15.0	10.6	9.2
Beer revenue growth (%)	4.5	11.2	11.2	11.2
Water revenue growth (%)	35.4	22.4	17.3	17.3
Food revenue growth (%)	36.6	13.0	13.0	13.0
Effective tax rate (%)	84.2	36.0	36.0	36.0
Capex/sales (%)	3.6	3.1	2.8	2.5
Number of hypermarkets	678.0	691.0	761.0	821.0

Source: Company data, Barclays Research

Note: FY End Dec

## Changes in estimates

We revise our estimates based on latest management guidance. Revenue for 2015E and 2016E are cut by 2% for each year, while net profits for 2015E and 2016E are cut by 15% and 25% respectively on an anticipated prolonged turnaround for the Retail and Food divisions.

FIGURE 1  
CRE – changes in estimates

	2015E new	2015E old	y/y change	2016E new	2016E old	y/y change
Revenue	193,513	196,962	-1.8%	215,670	220,159	-2.0%
Gross profit	47,923	47,863	0.1%	53,767	54,415	-1.2%
Gross margin	24.8%	24.3%	+0.5 ppts	24.9%	24.7%	+0.2 ppts
EBIT	2,848	2,950	-3.5%	3,765	5,077	-25.8%
EBIT margin	1.5%	1.5%	Flat	1.7%	2.3%	-0.6 ppts
Net profit	850	1,004	-15.4%	1,374	1,829	-24.9%

Source: Barclays Research estimates.

## Results overview

Consistent with company's profit warning announcement on Mar 3 (click [here](#) to see our note), it reported 2014 a net loss of HK\$161mn, which marked a deterioration from net profit of HK\$1,908mn in 2013.

Excluding the after-tax effect of asset revaluation and major disposals, the underlying net loss from continuing operations was HK\$794mn, vs. underlying net profit from continuing operations of HK\$1,642mn in 2013.

Overall 2014 revenue was up by 15.3% y/y to HK\$168.9bn. By division,

- Retail was up by 15.1% y/y to HK\$109,500mn;
- Beer was up by 4.5% y/y to HK\$34,482mn;
- Food was up by 36.6% y/y to HK\$16,486mn; and
- Beverage was up by 35.4% y/y to HK\$9,891mn.

In terms of quarterly results, 4Q14 revenue from

- Retail was up by 17.1% y/y to HK\$27,329mn;
- Beer was down by 8.7% y/y to HK\$5,096mn ;
- Food was up by 5.7% y/y to HK\$4,117mn; and
- Beverage was up by 16.4% y/y to HK\$1,672mn.

2014 Gross margin was down by 0.4 ppts y/y to 25.1%.

Adjusted EBIT was down by 62.8% y/y to HK\$1,809mn and adjusted EBIT margin was down by 2.2 ppts y/y to 1.1%.

2014 underlying net loss was HK\$794mn. By division,

- Retail loss (adjusted after one-off items) was HK\$1,359mn, which included a store closure provision of HK\$640mn, vs. retail profit of HK\$734mn in 2013;
- Beer profit was down by 19.3% y/y to HK\$761mn;

- Food loss was HK\$134mn, vs profit of HK\$53mn in 2013;
- Beverage profit was up by 123.6% y/y to HK\$237mn.

In terms of quarterly results, 4Q14 profit & loss summary is found below:

- Retail loss was at HK\$1,066mn, which included a store closure provision of HK\$640mn (vs. profit of HK\$35mn in 2013); excluding the after-tax revaluation surplus and disposal of non-core assets;
- Beer loss widened to HK\$281mn from loss of HK\$164mn in 2013;
- Food loss narrowed slightly to HK\$43mn from loss of HK\$48mn in 2013;
- Beverage recorded profit of HK\$86mn vs loss of HK\$23mn in 2013.

FIGURE 2

**CRE – Divisional quarterly financial summary**

	1Q13	2Q13	3Q13	4Q13	2013	1Q14	2Q14	3Q14	4Q14	2014
<b>Revenue</b>										
Retail	25,923	21,984	23,920	23,347	95,174	28,081	24,508	29,582	27,329	109,500
Beer	6,548	9,530	11,332	5,584	32,994	7,876	10,599	10,911	5,096	34,482
Beverage	1,453	1,922	2,494	1,436	7,305	2,259	2,798	3,162	1,672	9,891
Food	2,433	2,571	3,171	3,894	12,069	3,942	4,093	4,334	4,117	16,486
- Inter-company transactions	(204)	(303)	(334)	(288)	(1,129)	(346)	(304)	(438)	407	(1,495)
Revenue - Core Businesses	36,153	35,704	40,583	33,973	146,413	41,812	41,694	47,551	37,807	168,864
<b>Net Profit ex. Oneoffs</b>										
Retail	525	99	75	35	734	464	(25)	(732)	(1,066)	(1,359)
Beer	(23)	381	749	(164)	943	6	411	625	(281)	761
Beverage	8	31	90	(23)	106	10	56	85	86	237
Food	57	14	30	(48)	53	(50)	(22)	(19)	(43)	(134)
Total Net Profit ex. one-offs - Core Businesses	567	525	944	(200)	1,836	430	420	(41)	(1,304)	(495)
- net corporate interest and expenses	(55)	(32)	(33)	(74)	(194)	(81)	(101)	(60)	(57)	(299)
Profit attributable to continuing operations	512	493	911	(274)	1,642	349	319	(101)	(1,361)	(794)

Source: Company filings, Barclays Research.

Note: Retail division's underlying net loss for 4Q14 and 2014 included provision of stores closure of HK\$640mn (HK\$800mn \* 80%).

## Divisional development and management guidance

### Retail

Following the formation of the joint venture with Tesco, CRE performed an internal assessment on the company's retail business. As the company identified under-performing stores and assets, it has made provisions of c.HK\$800mn (of which 80% of the amount or HK\$640mn has been included in CRE's retail division net loss), mainly for assets impairments and compensations for early terminations of shop leases. In total, the company expects to close down 38 stores including 36 CRE Vanguard stores and two Tesco stores to control operating loss. Store closures commenced after Chinese New Year (Feb 2015).

Management has guided that short-to-medium term profitability of the division will be negatively affected during the integration process. In 2015, the e-commerce business will be officially launched in 1H and will start in Guangdong initially before rolling out to other

regions. The Retail Division will slow down openings of hypermarkets with 150-200 net stores openings and the emphasis on expansion of smaller stores including supermarkets, specialist stores and convenience stores. Certain existing hypermarkets will be transformed into a new trade-up format 'V+' with a bigger focus on fresh produce (such as fruit) and more spaces available for leasing for lifestyle elements such as restaurants.

The company's brand names of 'CR Vanguard', 'Chinese Arts & Crafts', 'CR Care', 'Vivo Health and Beauty' and 'Pacific Coffee' operated over 4,800 stores in China as of Dec-2014, of which 85% were self-operated and the remaining 15% were franchised. SSS decline for 2014 was 2.6%.

### **Beer**

The company's beer sales volume increased by 1% y/y to 11.8mn kilolitres, thanks to the integration with Kingway. Of note, the 'Snow' brand accounted for 90% of total beer sales volume. In 2014, the company launched promotions to fend off market competition, and optimised its product mix to raise the average selling price to offset pressure from rising costs. As of Dec 31, 2014, the company operated 95 breweries, with annual production capacity of more than 20mn kilolitres.

In 2015, the company will continue to reinforce the promotion of premium beers and optimise its product mix. Management mentioned that there is room for an average selling price hike as the company's beer price is c.30% lower than its competitor Tsingtao on average. It will also aim for organic growth to expand market share.

### **Food**

The Food Division incurred a loss of HK\$134mn in 2014 vs a net profit of HK\$53mn, due to high initial investment and marketing expenses from rice business expansion. Management guided that break-even will take place in the next two to three years.

The Rice business managed to expand into new markets and establish a nationwide presence, via both organic growth and acquisitions. By improving the reputation of 'Ng Fung' branded rice, the company targets a higher market share and improved profitability.

The livestock rearing operation's profitability was under pressure as feed costs remained high and the selling price for live pigs was lower than expected.

The meat operation achieved substantial y/y top-line growth as there was rapid expansion of the first-tier meat wholesale business and carved meat business, as well as an increase in the number of specialised meat retail stores in various cities.

### **Beverage**

Overall the division's sales volume increased by 33% y/y to 6.6mn kilolitres in 2014, mainly on impressive growth of 'C'estbon' purified water. In 2014, the company expanded its sales network from the core regions of Guangdong, Hunan and Sichuan to adjacent regions; and it also launched effective advertising to increase brand awareness and boost sales.

Management commented that the Beverage division achieved its best performance to date in 2014. In 2015, the Beverage Division will ramp up product research and development, as well as promotional campaigns to enhance brand quality and image to meet customer demand.

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China Resources Enterprise, Ltd. (0291.HK, 20-Mar-2015, HKD 15.08), Equal Weight/Neutral, D/I/K/L/M

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Marico Ltd. (MRCO.NS)	Merida Industry (9914.TW)	Nestle India Ltd. (NEST.NS)
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China Resources Enterprise, Ltd. (291 HK / 0291.HK)

Stock Rating

Industry View

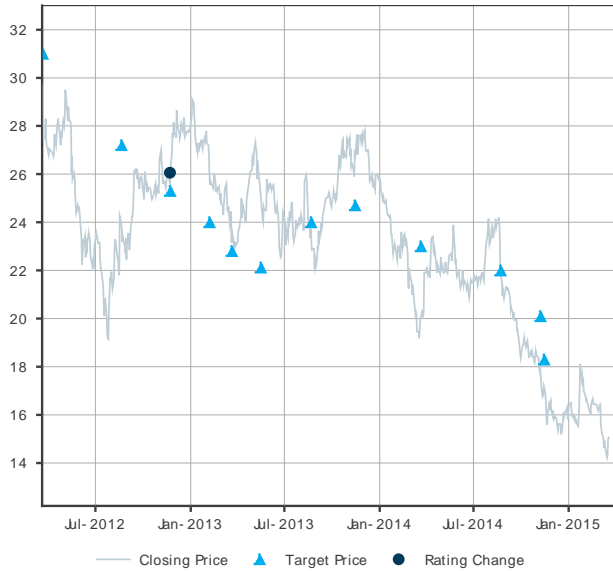
HKD 15.08 (20-Mar-2015)

EQUAL WEIGHT

NEUTRAL

Rating and Price Target Chart - HKD (as of 20-Mar-2015)

Currency=HKD



Date	Closing Price	Rating	Adjusted Price Target
14-Nov-2014	17.18		18.30
07-Nov-2014	17.90		20.10
22-Aug-2014	21.95		22.00
21-Mar-2014	20.00		23.00
14-Nov-2013	27.00		24.70
21-Aug-2013	23.70		24.00
16-May-2013	25.15		22.12
21-Mar-2013	23.15		22.80
06-Feb-2013	26.10		24.00
22-Nov-2012	25.60	Equal Weight	25.30
20-Aug-2012	23.95		27.20
21-Mar-2012	29.45		31.00

Source: Thomson Reuters, Barclays Research

Historical stock prices and price targets may have been adjusted for stock splits and dividends.

Source: IDC, Barclays Research

[Link to Barclays Live for interactive charting](#)

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**Valuation Methodology:** Our price target of HK\$17.0 is based on a target P/E of 30x applied to 2016E EPS, the target P/E multiple is 20% higher than the average of China staples universe but we think market will recognize one-off expenses nature and factor-in initial loss incurred by JV with Tesco. We also think the premium can be justified by the hope of a margin recovery from the very low levels of 2014/2015.

**Risks which May Impede the Achievement of the Barclays Research Price Target:** Key upside risks include faster-than-expected Tesco JV profits, better-than-expected growth in beer and beverage divisions with its acquisition of Kingway and JV partnership with Kirin. Meanwhile, key downside risks include prolonged ramp-up of Tesco JV, a worsening competitive landscape for Beer, commodity cost and wage inflation.

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