

JPM-pp1

Asia Pacific Corporate Research

23 March 2015

China Mengniu Dairy Co. Ltd. (2319 HK)

Overweight

Price: HK\$35.70

23 Mar 2015

Price Target: HK\$41.50

PT End Date: 31 Dec 2015

Modern Dairy FY14 earnings below consensus; posing slight downside risk to Mengniu estimates

Modern Dairy FY14 earnings were up 53% y/y but 30% below consensus, implying c3% downside to our FY14 earnings forecast for Mengniu. Weaker-than-expected results were due to slightly weaker-than-expected margins as well as doubling losses in fair value loss from derivative financial liabilities.

- China Modern Dairy (1117 HK, not covered) announced FY14 net profit of RMB735mn, up c53% y/y but was c30% below consensus estimates, which we were using to estimate associate's income in our Mengniu model, implying 3% decline in our bottom line estimate.
- Modern Dairy sales increased c53% y/y, driven mainly by volume growth in sales of raw milk (+37%), ASP increase in raw milk (10%), with increase in liquid milk sales accounting for the rest of the sales growth. Raw milk prices increased by double digits in 1H14. However, in 2H14 there was a significant decrease in raw milk prices, which according to the company was due to prices in the overseas market declining significantly, and imported bulk milk powder and imported liquid milk products flooding into the PRC market and disrupting the PRC dairy market leading to notable oversupply.
- Modern Dairy cash EBITDA margin increased 420bps thanks to: i) 9% expansion in milkable cows, ii) 6% increase in milk yield per cow (from 8.4 tons in 2013 to 8.9 tons in 2014, iii) an increase in sales of liquid milk, and iv) effective control of costs and expenses. Cash EBITDA was up 73% y/y.

Investment Thesis

We highlight Mengniu as our top pick in the China Staples space given: 1) Mengniu is positioned in a growth segment with low competitive intensity; 2) product mix is driving margin expansion; 3) strong market share gains expected in the IMF segment; and 4) strong ties with Danone.

We continue to expect DD growth in the dairy sector from 2013-17. Urbanization trends and our deep dive into expenditure patterns show that all food sub-categories are on a decreasing trend as a percentage of average Chinese household consumption expenditure, except for dairy (and dried and fresh fruits and dining out), which is on an increasing trend. We are also positive on the company's strategy to focus on higher-end products (resulting in margin expansion barring any raw milk cost spikes), and continuous improvement in upstream and strong backing by parents.

Valuation

Our Dec-15 PT is HK\$41.5 based on 26x one-year forward P/E, which is pegged to the historical mean.

Risks to Rating and Price Target

Key risks to our rating and price target include higher-than-expected A&P spending, a shortage of raw milk supply in China, and slower momentum in Mengniu's high-end products.

Consumer

AC

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Date	Rating	Share Price (HK\$)	Price Target (HK\$)
10-Apr-08	UW	20.45	18.00
21-Sep-08	UW	20.00	3.80
17-Apr-09	UW	13.02	8.10
28-Jun-09	UW	18.60	14.50
09-Sep-09	OW	20.80	23.00
08-Dec-09	OW	27.50	32.00
29-Apr-10	OW	23.55	30.00
01-Sep-10	OW	22.30	26.00
02-May-11	OW	23.85	30.00
31-Aug-11	OW	25.35	35.00
12-Oct-11	OW	25.65	33.00
10-Jan-12	OW	19.74	24.00
10-Feb-12	OW	22.40	27.00
27-Mar-12	OW	21.95	26.00
02-Jul-12	OW	20.35	25.00
28-Aug-12	OW	23.00	28.00
13-Dec-12	OW	20.35	24.00
19-Jun-13	OW	26.85	30.50
29-Aug-13	OW	31.75	36.00
04-Nov-13	OW	33.00	38.10
26-Mar-14	OW	35.55	43.00
08-Jul-14	OW	35.25	42.50
28-Aug-14	OW	35.45	43.00
25-Nov-14	OW	31.05	40.50
25-Feb-15	OW	35.65	41.50

<http://gps-app.amer.jpmchase.net:6080/server/console/chart/?shareClassId=503709&shareClassServerId=4&chartDesignation=1&actionType=C>

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