

JPM-pp1

Asia Pacific Equity Research

24 March 2015

China Foods Ltd (506 HK)

Neutral

Price: HK\$2.89

23 Mar 2015

Price Target: HK\$2.20

PT End Date: 31 Dec 2015

Results 6% better than our estimate

China Foods announced FY14 results with a net loss of HKD225mn, 6% better than our estimates and c20% better than consensus, due to better-than-expected GPM in beverages, better-than-expected results in kitchen goods and government grants. Given that the results beat largely comes from the two major segments (beverages & kitchen foods), we think the market may react positively to the results.

China Foods' sales grew 2% during the year, while gross profit increased by 19% (9% higher than our estimates) thanks to better-than-expected GPM in beverages. In 2H14, the beverage segment's GPM improved 400bps to 35.9% from 31.9% in 1H14 (vs 31.2% in 2H13), benefitting from declining raw material prices, especially for PET. The confectionary and wine segments both saw margin improvement in 2H14 vs 1H14, but kitchen food's GPM slightly declined in 2H vs 1H. On the EBIT front, kitchen foods turned positive in 2H14 after staying in the negative camp for consecutive two years. GPM expansion helped the beverage segment's EBIT advance by 30% y/y in 2H14, despite increased A&P expenses amidst intensifying market competition.

We maintain our Neutral rating as: i) the worst seems to be over for the wine division, and ii) the parent COFCO was one of six state-owned companies picked by the State-Owned Assets Supervision and Administration Commission (SASAC) for "SOE reform trials. However, to turn more positive on the stock we would like to see: i) more evidence of a focus on returns and capital deployment, in particular for its underperforming business (kitchen foods and confectionary), and ii) some recovery in the beverage segment, which is key to the company, accounting for c50% of sales and almost the entire EBIT.

Table 1: China Foods 2H14 results vs JPM estimates

HKD mn	2H13	2H14A	% chg y/y	2H14E	Actual/Est
Sales revenue	12,298	12,975	5.5%	11,344	14%
Gross profit	2,391	3,108	30.0%	2,583	20%
Gross margin	19.4%	24.0%		22.8%	
Other income	222	279	25.5%	199	40%
Total operating expenses	(3,071)	(3,018)	-1.8%	(2,607)	16%
EBIT	(458)	90	-119.7%	(24)	-479%
EBIT margin	-3.7%	0.7%		-0.2%	
Net Interest income	(41)	(18)	-57.2%	(32)	-45%
Associates	66	24	-64.1%	50	-52%
Pretax profit	(433)	96	-122.2%	(6)	
Tax	(83)	(95)	14.6%	(71)	33%
Effective tax rate	19.1%	-98.5%			
Minority interests	(69)	(91)	31.5%	(26)	249%
Net profit	(585)	(90)	-84.7%	(104)	-13%
Net margin	-4.8%	-0.7%		-0.9%	

Source: J.P. Morgan estimates, Company data

Table 2: China Foods FY14 results vs JPM estimates

HKD mn	FY13	FY14A	% chg y/y	FY14E	Actual/Est
Sales revenue	26,218	26,742	2.0%	25,111	6%
Gross profit	5,284	6,305	19.3%	5,780	9%
Gross margin	20.2%	23.6%		23.0%	
Other income	304	393	29.2%	313	25%
Total operating expenses	(6,019)	(6,499)	8.0%	(6,009)	8%
EBIT	(431)	198	-146.0%	84	135%

EBIT margin	-1.6%	0.7%		0.3%	
Net Interest income	(77)	(41)	-46.5%	(56)	-26%
Associates	114	94	-17.6%	120	-22%
Pretax profit	(395)	251	-163.5%	148	69%
Tax	(312)	(224)	-28.3%	(200)	12%
Effective tax rate	79.0%	-89.2%		-80.0%	
Minority interests	(183)	(252)	37.5%	(187)	35%
Net profit	(890)	(225)	-74.7%	(239)	-6%
Net margin	-3.4%	-0.8%		-0.9%	

Source: J.P. Morgan estimates, Company data

Table 3: China Foods revenue, gross profit and EBIT breakdown

HKDmn	1H11	2H11	1H12	2H12	1H13	2H13	1H14	2H14
Revenue								
Wines	1,753	1,941	1,956	1,930	1,131	716	1,084	1,068
Beverages	5,313	5,204	6,134	4,976	5,995	5,394	6,897	5,589
Kitchen foods	6,172	6,968	7,085	7,890	6,411	5,865	5,376	5,855
Confectionary	244	416	308	417	252	183	217	286
Others	0	0	96	86	132	139	193	177
Total revenue	13,482	14,529	15,579	15,300	13,921	12,298	13,767	12,975
Revenue Growth								
Wines	20.4%	17.0%	11.6%	-0.5%	-42.2%	-62.9%	-4.2%	49.1%
Beverages	34.4%	31.1%	15.4%	-4.4%	-2.3%	8.4%	15.0%	3.6%
Kitchen foods	116.3%	26.9%	14.8%	13.2%	-9.5%	-25.7%	-16.1%	-0.2%
Confectionary	33.2%	5.7%	26.6%	0.4%	-18.3%	-56.2%	-13.7%	56.4%
Total revenue	59.7%	26.2%	15.5%	5.3%	-10.6%	-19.6%	-1.1%	5.5%
Gross profit								
Wines	1,120	1,273	1,213	1,201	593	353	442	466
Beverages	1,381	1,396	1,681	1,441	1,813	1,683	2,204	2,008
Kitchen foods	579	604	439	160	368	307	491	508
Confectionary	106	202	126	230	105	61	66	119
Others	0	0	0	0	14	-14	-6	12
Total gross profit	3,187	3,476	3,458	3,031	2,893	2,391	3,197	3,108
Gross margin								
Wines	63.9%	65.6%	62.0%	62.2%	52.4%	49.3%	40.8%	43.6%
Beverages	26.0%	26.8%	27.4%	29.0%	30.2%	31.2%	31.9%	35.9%
Kitchen foods	9.4%	8.7%	6.2%	2.0%	5.7%	5.2%	9.1%	8.7%
Confectionary	43.6%	48.7%	40.8%	55.0%	41.8%	33.5%	30.4%	41.7%
Group gross margin	23.6%	23.9%	22.2%	19.8%	20.8%	19.4%	23.2%	23.9%
EBIT								
Wines	300	334	450	86	-86	-368	-56	-60
Beverages	275	256	311	268	326	170	391	225
Kitchen foods	74	88	46	-276	-126	-26	-61	91
Confectionary	-42	-53	-13	-44	-71	-152	-74	-89
Total EBIT	608	541	761	1	27	-458	108	90
EBIT margin								
Wines	17.1%	17.2%	23.0%	4.4%	-7.6%	-51.4%	-5.2%	-5.6%
Beverages	5.2%	4.9%	5.1%	5.4%	5.4%	3.2%	5.7%	4.0%
Kitchen foods	1.2%	1.3%	0.7%	-3.5%	-2.0%	-0.4%	-1.1%	1.5%
Confectionary	-17.1%	-12.8%	-4.2%	-10.5%	-28.0%	-83.2%	-34.0%	-31.2%
Group EBIT margin	4.5%	3.7%	4.9%	0.0%	0.2%	-3.7%	0.8%	0.7%

Source: Company reports

Investment Thesis

We maintain our Neutral rating, as: 1) the worst seems to be over for the wine division and 2) the parent COFCO was one of six state-owned companies picked by the State-Owned Assets Supervision and Administration Commission (SASAC) for 'SOE reform trials'. However, to turn more positive on the stock we would like to see: 1) more evidence of a focus on returns and capital deployment, in particular for its underperforming business (kitchen foods and confectionary) and 2) some recovery in the beverage segment which is key to the company, accounting for c50% of sales and almost the entire EBIT.

Valuation

Our Dec-15 PT is HK\$2.20. We adopt a PE of 23x (in line with the staple sector average) and have used 2016E EPS (where margins are getting close to normalized levels in our view) and discount that back to Dec-15.

Risks to Rating and Price Target

Key downside risks to our rating and price target include a continuing sharp revenue and margin decline in the wine business in 2014

and a sudden increase in input costs.

Key upside risks to our rating and price target include: improving momentum in wine sales and faster-than-expected sales growth in beverages.

Consumer

AC

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Date	Rating	Share Price (HK\$)	Price Target (HK\$)
11-Oct-06	OW	6.68	7.00
01-Nov-06	OW	7.37	7.65
04-Jun-07	OW	4.97	5.80
08-Aug-07	OW	4.83	6.30
19-Sep-07	OW	5.29	6.00
15-Apr-08	OW	4.25	5.50
23-Sep-08	OW	2.53	4.10
25-Jan-11	N	4.76	5.30
29-Mar-11	N	4.95	5.00
30-Aug-11	N	6.18	6.00
12-Oct-11	N	5.59	5.00
10-Mar-12	OW	6.96	8.00
01-Apr-12	OW	7.78	8.40
29-Aug-12	OW	7.08	8.60
15-Sep-12	OW	7.24	9.20
02-Nov-12	OW	8.01	10.00
16-Jan-13	OW	7.24	11.70
07-Feb-13	N	6.66	5.80
27-Mar-13	N	4.73	5.20
01-May-13	N	3.97	4.20
28-Aug-13	N	3.05	2.50
13-Nov-13	N	3.23	2.70
07-Jul-14	N	2.84	2.50
24-Sep-14	N	3.09	3.30
25-Feb-15	N	2.62	2.20

<http://gps-app.emea.jpmchase.net:6080/server/console/chart/?shareClassId=503726&shareClassServerId=4&chartDesignation=1&actionType=C>

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