

JPM-pp1

Asia Pacific Equity Research

26 March 2015

China Mengniu Dairy Co. Ltd. (2319 HK)

Overweight

Price: HK\$35.25

25 Mar 2015

Price Target: HK\$41.50

PT End Date: 31 Dec 2015

Strong 2H14 results; A&P is a big tailwind this time vs. being a drag in 1H

For FY14 Mengniu announced a very strong net profit figure of RMB2.35bn at consolidated level which is up 46% y/y and 11% better than our estimates. For the core Mengniu business (exc Yashili) results were stellar. Mengniu core business reported RMB2.23bn net profit for FY14, up 45% y/y and 15% better than our estimate.

For 2H14 standalone net profit for core Mengniu business (exc Yashili) came at RMB1.32bn up 57% y/y and 30% better than our estimate mainly due to strong control on A&P spending which led to flat opex to sales ratio.

Strong 2H14 core business were driven by three pillars i) continuing sales growth at 8% y/y (though admittedly at a slower pace than 1H) ii) continuing GPM expansion up 250bps y/y in 2H14 and iii) great control on operating expenses mainly A&P. Operating expense to sales ratio in 2H14 came at 22.5% which was almost flat on a y/y basis. (A&P spending was well controlled at c5% of sales in 2H14 vs 11% in 1H14 and 6% in 2H13.) Therefore EBIT margin in 2H14 expanded 210bps driving 64% growth at EBIT level in 2H14.

We expect the results to surprise the market positively as well. With its strong execution on product mix improvement which is driving the margins, Mengniu is one of our top picks in China consumer space.

Table 1: Mengniu standalone 2H14 results vs JPM estimates

Standalone Mengniu (RMB mn)	2H13	2H14A	% chg y/y	2H14E	Actual/Est
Sales	21,190	22,943	8.3%	22,889	0.2%
COGS	(15,790)	(16,516)	4.6%	(16,499)	0.1%
Gross profit	5,400	6,421	18.9%	6,403	0.3%
Gross margin	25.5%	28.0%	up 250bps	28.0%	
Opex	-4,720	-5,154	9.2%	-5,530	-6.8%
Opex to sales	-22.3%	-22.5%	up 20bps		
EBIT	849	1,389	63.6%	1,045	32.9%
EBIT margin	4.0%	6.1%	up 200bps	4.6%	
Net interest	71	121		108	12.5%
Associates	124	95		170	-44.3%
Pretax profit	1,044	1,605	53.7%	1,323	21.3%
Tax	(107)	(141)	31.9%	(191)	-26.4%
Effective tax rate	-10.2%	-8.8%		-14.5%	
Minority interests	(99)	(145)	46.2%	(122)	19.3%
Net profit	838	1,319	57.4%	1,010	30.6%
Net margin	4.0%	5.7%		4.4%	

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

Table 2: Mengniu standalone FY14 results vs JPM estimates

Standalone Mengniu (RMB mn)	FY13	FY14A	% chg y/y	FY14E	Actual/Est
Sales	41,858	47,233	12.8%	47,179	0.1%
COGS	(30,939)	(33,244)	7.4%	(33,228)	0.1%
Gross profit	10,918	13,970	27.9%	13,952	0.1%
Gross margin	26.1%	29.6%	up 350 bps	29.6%	
Opex	(9,464)	(11,870)	25.4%	(12,247)	-3.1%
Opex to sales	-22.6%	-25.1%		-26.0%	
EBIT	1,743	2,393	37.3%	2,080	15.1%
EBIT margin	4.2%	5.1%	up 90bps	4.4%	
Net interest	169	183		159	15.1%
Associates	154	278		353	-21.3%
Pretax profit	2,066	2,854	38.1%	2,592	10.1%
Tax	(293)	(364)	24.5%	(415)	-12.2%

<i>Effective tax rate</i>	-14.2%	-16.0%		-16.0%	
Minority interests	(200)	(260)	30.2%	(237)	9.9%
Net profit	1,536	2,229	45.2%	1,940	14.9%
<i>Net margin</i>	3.7%	4.7%		4.1%	

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

Table 3: Mengniu 2H14 consolidated results vs JPM estimates

Consolidated (RMB mn)	2H13	2H14A	% chg y/y	2H14E	Actual/Est	Miss/Beat from Standalone Mengniu	Miss/Beat from Yashili
Sales	22,689	24,213	6.7%	24,368	-0.6%	0.2%	-0.9%
COGS	(16,511)	(17,162)	3.9%	(17,252)	-0.5%	0.1%	-0.6%
Gross profit	6,178	7,052	14.1%	7,130	-1.1%	0.3%	-1.4%
<i>Gross margin</i>	27.2%	29.1%		29.3%			
EBIT	958	1,444	50.8%	1,059	36.3%	32.9%	3.4%
<i>EBIT margin</i>	4.0%	6.0%		4.3%			
Net interest	100	130		161	-19.0%	12.5%	-31.5%
Associates	124	95		170	-44.3%	-44.3%	0.0%
Pretax profit	1,182	1,669	41.1%	1,390	20.0%	21.3%	-1.3%
Tax	(181)	(207)	14.2%	(200)	3.2%	-26.4%	29.6%
<i>Effective tax rate</i>	-15.3%	-12.4%		-14.4%			
Minority interests	(130)	(160)	22.5%	(143)	11.5%	19.3%	-7.7%
Net profit	871	1,302	49.5%	1,046	24.4%	30.6%	-6.1%
<i>Net margin</i>	3.8%	5.4%		4.3%			

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

Table 4: Mengniu FY14 consolidated results vs JPM estimates

Consolidated (RMB mn)	FY13	FY14A	% chg y/y	FY14E	Actual/Est	Miss/Beat from Standalone Mengniu	Miss/Beat from Yashili
Sales	43,357	50,049	15.4%	50,204	-0.3%	0.1%	-0.4%
COGS	(31,660)	(34,616)	9.3%	(34,706)	-0.3%	0.1%	-0.3%
Gross profit	11,697	15,434	31.9%	15,499	-0.4%	0.1%	-0.5%
<i>Gross margin</i>	27.0%	30.8%		30.9%			
EBIT	1,852	2,665	43.9%	2,306	15.5%	15.1%	0.5%
<i>EBIT margin</i>	4.3%	5.3%		4.6%			
Net interest	199	208		238	-12.8%	15.1%	-27.9%
Associates	154	278		353	-21.3%	-21.3%	0.0%
Pretax profit	2,205	3,150	42.9%	2,898	8.7%	10.1%	-1.4%
Tax	(367)	(459)	25.2%	(453)	1.4%	-12.2%	13.6%
<i>Effective tax rate</i>	-16.6%	-14.6%		-15.6%			
Minority interests	(231)	(340)	47.1%	(323)	5.1%	9.9%	-4.8%
Net profit	1,607	2,351	46.3%	2,121	10.8%	14.9%	-4.1%
<i>Net margin</i>	3.7%	4.7%		4.2%			

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

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	24.25	30.00
01-Sep-10	OW	21.50	26.00
02-May-11	OW	24.25	30.00
31-Aug-11	OW	26.60	35.00
12-Oct-11	OW	24.70	33.00
10-Jan-12	OW	20.20	24.00
10-Feb-12	OW	22.40	27.00
27-Mar-12	OW	21.95	26.00
02-Jul-12	OW	21.35	25.00
28-Aug-12	OW	23.10	28.00
13-Dec-12	OW	20.50	24.00
19-Jun-13	OW	26.85	30.50
29-Aug-13	OW	29.85	36.00
04-Nov-13	OW	33.70	38.10
26-Mar-14	OW	38.60	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

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

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