

China Mengniu Dairy

2319 HK

Target (HKD): 37.30 → 41.60

Upside: 18.0%

25 Mar price (HKD): 35.25

- 1 Buy
- 2 Outperform (unchanged)
- 3 Hold
- 4 Underperform
- 5 Sell

Starting from a better 2014

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- We revise up our 2015-16E EPS on better selling-cost controls and product-mix upgrades
- Management is confident it can balance revenue growth and profitability in 2015
- Reiterate Outperform (2); raising TP to HKD41.60

■ What's new

China Mengniu's (Mengniu) 2014 net profit was up 44% YoY, beating our and Bloomberg consensus estimates, on well-controlled selling costs and higher-than-2013 interest income. After a post-results talk with management, we are more confident in Mengniu's 2015 strategy to upgrade its product mix to improve its gross margin against price competition in the mass-market segment. Considering this, and earnings-growth recovery for Yashili (1230 HK, NR), its infant-formula subsidiary, we are optimistic about its 2015-16 outlook.

■ What's the impact

Gross-margin improvement, well-controlled expenses. We expect Mengniu's gross margin to expand by 0.7pp YoY to 31.5% in 2015, due to higher sales of star products such as UHT-yogurt, Milk Deluxe, probiotic drinks and Danone's chilled products. Management said it plans to leverage the low raw-milk price in 2015 to expand its market share in

the mass-market segment. It aims to enlarge its customer mix and later promote more high-margin products to new customers. It is confident that Mengniu's revenue growth will exceed the industry average of high-single-digit levels in 2015.

Also, by assuming steady selling costs (maintained at 21% as a ratio of revenue over 2015-17E), we expect Mengniu's operating margin to improve from 5.1% in 2014, to 5.6-5.8% in 2015-17.

Regaining market share in 2015. Mengniu's liquid-milk market share declined slightly, from 27.3% in 2013 to 26.9% in 2014 (AC Nielsen data). But Mengniu believes this will pick up due to the product and packaging design revamp, which drove volume growth from 4Q14. We believe its market share will continue to improve in 2015, particularly in the chilled product segment due to the launches of new products.

Unlocking the benefits of its global network. Yogurt revenue was up 49% YoY in 2H14 as Mengniu continued to focus on pushing its star products such as Danone - Biyou, and its own UHT brand Just Yogurt. Management believes it can continue to grow its premium-business revenue faster than Danone did prior to the JV in 2014, because Mengniu has a more efficient distribution network and management system in China.

■ What we recommend

We raise our 12-month target price to HKD41.60 from HKD37.30, on our EPS revisions (we raise our 2015-16E EPS by 2-3%) and higher 2015E PER of 24x (formerly 22.1x, the stock's past-5-year average 12-month forward PER). We have a

higher target PER on Mengniu's largely complete corporate restructuring and on M&A activity (June 2013 until March 2015). We also introduce our 2017 forecasts. The key risk to our call would be a sharp rise in selling expenses.

■ How we differ

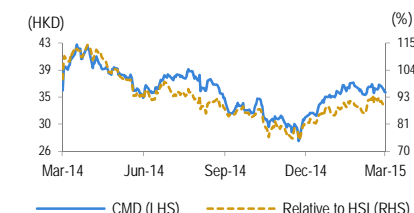
Our 2015-16E EPS are 9-13% above the Bloomberg consensus due to our higher gross-margin assumptions, supported by Mengniu's planned product-mix upgrades.

Forecast revisions (%)

Year to 31 Dec	15E	16E	17E
Revenue change	(2.6)	(2.9)	n.a.
Net profit change	1.8	2.5	n.a.
Core EPS (FD) change	1.8	2.5	n.a.

Source: Daiwa forecasts

Share price performance



12-month range	27.60-42.75
Market cap (USDbn)	8.83
3m avg daily turnover (USDm)	21.99
Shares outstanding (m)	1,942
Major shareholder	COFCO (16.3%)

Financial summary (CNY)

Year to 31 Dec	15E	16E	17E
Revenue (m)	54,935	60,405	66,126
Operating profit (m)	3,288	4,003	4,320
Net profit (m)	2,757	3,413	3,816
Core EPS (fully-diluted)	1.420	1.758	1.966
EPS change (%)	19.4	23.8	11.8
Daiwa vs Cons. EPS (%)	9.1	13.3	n.a.
PER (x)	19.9	16.1	14.4
Dividend yield (%)	1.0	1.2	1.4
DPS	0.284	0.352	0.393
PBR (x)	2.3	2.1	1.8
EV/EBITDA (x)	12.2	10.0	8.9
ROE (%)	12.2	13.6	13.6

Source: FactSet, Daiwa forecasts

■ 2014 results at a glance

(CNYm, FYE Dec)	2013	2014	YoY (%)	Our est.	Var. (%)	2H14	YoY (%)	1H14	YoY (%)
(A) Liquid milk	37,903	43,036	14	44,759	-4	21,272	8	21,764	19
(1) UHT	22,053	23,702	7	25,472	-7	10,964	-1	12,737	16
(2) Milk beverage	10,426	11,921	14	12,511	-5	6,094	7	5,826	23
(3) Yogurt	5,424	7,414	37	6,777	9	4,213	49	3,201	24
(B) Ice cream	3,023	2,716	-10	3,207	-15	728	-32	1,988	2
(C) Other dairy products	253	336	33	350	-4	187	-5	149	161
(D) Infant formula	2,177	3,961	82	2,782	42	2,027	-7	1,934	391
Sales	43,357	50,049	15	51,099	-2	24,213	7	25,836	25
Gross profit	11,697	15,434	32	16,169	-5	7,052	12	8,382	52
Other income and gains	289	449	56	365	23	195	34	254	78
Government grants	91	172	88	150	14	96	-44	76	151
FX gain / loss	155	17	-89	0	N/A	17	-79	0	N/A
Selling & distribution costs	-8,168	-10,564	29	-11,395	-7	-4,667	7	-5,897	55
Advertising and promotion	-2,710	-4,177	54	-5,915	-29	-1,317	-3	-2,861	112
Others	-5,458	-6,386	17	-5,480	17	-3,350	12	-3,037	24
Administrative expense	-1,606	-1,941	21	-1,942	-0	-979	23	-962	19
Other operating expenses	-360	-713	98	-711	0	-157	-30	-556	306
Operating profit	1,852	2,665	44	2,486	7	1,444	53	1,221	34
Net finance income (costs)	199	208	4	-16	N/A	130	30	78	-21
Associates/JV	154	278	81	326	-15	95	-24	183	518
PBT	2,205	3,150	43	2,796	13	1,669	43	1,481	43
Income tax expense	-367	-459	25	-475	-3	-207	14	-253	36
Profit after tax	1,838	2,691	46	2,321	16	1,462	48	1,229	44
MI	-231	-340	47	-323	5	-160	23	-180	79
Reported net profit	1,631	2,351	44	1,998	18	1,302	48	1,049	40
Recurring net profit *	1,606	2,233	39	1,880	19	1,302	52	931	24
Recurring EPS (CNY)	0.913	1.252	37	1.064	18	0.699	42	0.553	32
Margins and Ratios	2013	2014	YoY (ppt)	Our est.	Var. (ppt)	2H14	YoY (ppt)	1H14	YoY (ppt)
S&D as % of sales	18.8	21.1	2.3	22.3	(1.2)	19.3	0.0	22.8	4.4
A&P as % of sales	6.3	8.3	2.1	11.6	(3.2)	5.4	(0.6)	11.1	4.5
Admin costs as % of sales	3.7	3.9	0.2	3.8	0.1	4.0	0.5	3.7	(0.2)
SG&A as % of sales	22.5	25.0	2.4	26.1	(1.1)	23.3	0.6	26.5	4.2
Effective tax rate	16.6	14.6	(2.1)	17.0	(2.4)	12.4	(3.1)	17.0	(0.9)
Gross Margin	27.0	30.8	3.9	31.6	(0.8)	29.1	1.4	32.4	5.8
Gross margin ex-Yashili	24.9	26.1	1.2	26.1	0.0	28.3	2.8	30.8	n.a.
Operating Margin	4.3	5.3	1.1	4.9	0.5	6.0	1.8	4.7	0.3
Net Margin	3.8	4.7	0.9	3.9	0.8	5.4	1.5	4.1	0.4

Source: Company

■ Revenue breakdown by product categories and revenue growth YoY %

Category	2012	2013	2014	YoY%
Star brands (e.g. Milk Deluxe, Yoyi C, Fruit milk)	30.5	34.9	34.5	10.6
Backbone brands (e.g. Prime Ranch, Suan Suan Ru)	49.2	44	41.9	6.6
Profit contributors (e.g. Ice+ ice cream)	10.2	8.3	6.3	-15.0
Opportunity brands (Just yogurt, Latte, fresh milk)	1.5	3.1	5.2	87.7
Others	8.6	9.7	12.1	39.6

Source: Company, Daiwa estimates for YoY growth

■ Market share in China

	Liquid milk		UHT products		Chilled products	
	2013	2014	2013	2014	2013	2014
Mengniu	27.3	26.9	27.2	27	28.2	28
Yili	22.7	23.7	25.7	27.2	20.6	20
Bright Dairy	11.7	9.7	15.2	12.7	12.98	13.6
Others	61.7	60.3	68.1	66.9	61.78	61.6

Source: AC Nielsen, Daiwa

Financial summary

■ Key assumptions

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Sales growth YoY % - Liquid Milk	n.a.	25	(4)	17	14	10	11	10
Sales growth YoY % - Infant formula	n.a.	n.a.	n.a.	6	82	13	4	3
ASP hike %	n.a.	3.2	2.0	4.5	9.5	4.5	2.0	2.0
SG&A cost ratio %	n.a.	20.9	20.5	22.5	25.0	25.0	25.0	25.0

■ Profit and loss (CNYm)

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Liquid Milk	26,872	33,701	32,336	37,903	43,036	47,156	52,167	57,445
Ice-cream	3,112	3,259	3,171	3,023	2,716	2,852	3,137	3,451
Other Revenue	282	428	572	2,431	4,297	4,928	5,100	5,231
Total Revenue	30,265	37,388	36,079	43,357	50,049	54,935	60,405	66,126
Other income	193	296	249	289	449	432	217	217
COGS	(22,479)	(27,796)	(27,050)	(31,660)	(34,616)	(37,995)	(41,167)	(45,141)
SG&A	(6,465)	(7,805)	(7,398)	(9,774)	(12,505)	(13,734)	(15,101)	(16,531)
Other op. expenses	(1,063)	(1,224)	(1,254)	(1,732)	(2,054)	(1,830)	(1,955)	(2,080)
Operating profit	1,455	1,896	1,687	1,852	2,665	3,288	4,003	4,320
Net-interest inc./(exp.)	43	112	179	199	208	137	301	328
Assoc/forex/extraord./others	40	52	(53)	154	160	310	423	574
Pre-tax profit	1,538	2,061	1,813	2,205	3,032	3,735	4,728	5,222
Tax	(182)	(276)	(245)	(367)	(459)	(747)	(993)	(1,097)
Min. int./pref. div./others	(119)	(195)	(186)	(231)	(340)	(231)	(322)	(309)
Net profit (reported)	1,237	1,589	1,382	1,607	2,233	2,757	3,413	3,816
Net profit (adjusted)	1,237	1,589	1,382	1,607	2,233	2,757	3,413	3,816
EPS (reported)(CNY)	0.712	0.908	0.789	0.899	1.189	1.420	1.758	1.966
EPS (adjusted)(CNY)	0.712	0.908	0.789	0.899	1.189	1.420	1.758	1.966
EPS (adjusted fully-diluted)(CNY)	0.712	0.908	0.789	0.899	1.189	1.420	1.758	1.966
DPS (CNY)	0.160	0.198	0.160	0.202	0.282	0.284	0.352	0.393
EBIT	1,455	1,896	1,687	1,852	2,547	3,288	4,003	4,320
EBITDA	2,168	2,760	2,728	3,069	3,956	4,718	5,558	6,000

■ Cash flow (CNYm)

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Profit before tax	1,538	2,061	1,813	2,205	3,032	3,735	4,728	5,222
Depreciation and amortisation	713	864	1,041	1,218	1,291	1,430	1,555	1,680
Tax paid	(49)	(218)	(285)	(307)	(351)	(747)	(993)	(1,097)
Change in working capital	193	300	(133)	(1,106)	(6,410)	1,592	(43)	(28)
Other operational CF items	(83)	(164)	(126)	(353)	(485)	(447)	(725)	(902)
Cash flow from operations	2,312	2,842	2,310	1,656	(2,922)	5,563	4,522	4,875
Capex	(1,426)	(2,696)	(2,267)	(3,101)	(2,906)	(2,500)	(2,500)	(2,500)
Net (acquisitions)/disposals	0	0	0	(9,495)	(372)	(2,500)	0	0
Other investing CF items	0	0	0	0	0	0	0	0
Cash flow from investing	(1,426)	(2,696)	(2,267)	(12,597)	(3,278)	(5,000)	(2,500)	(2,500)
Change in debt	60	(184)	(58)	11,191	(1,847)	(2,986)	(1,497)	(487)
Net share issues/(repurchases)	0	0	0	0	4,089	0	0	0
Dividends paid	(245)	(278)	(350)	(283)	(367)	(548)	(551)	(683)
Other financing CF items	(282)	317	(12)	1,350	1,446	281	(2)	34
Cash flow from financing	(467)	(145)	(420)	12,258	3,321	(3,254)	(2,050)	(1,136)
Forex effect/others	0	0	0	0	0	0	0	0
Change in cash	419	1	(376)	1,318	(2,879)	(2,691)	(29)	1,239
Free cash flow	886	146	43	(1,445)	(5,829)	3,063	2,022	2,375

Source: FactSet, Daiwa forecasts

Financial summary continued ...

■ Balance sheet (CNYm)

As at 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Cash & short-term investment	6,800	6,801	6,230	7,663	4,902	2,211	2,183	3,422
Inventory	1,176	1,685	1,420	2,577	4,342	4,766	5,164	5,663
Accounts receivable	575	836	801	754	1,148	1,260	1,386	1,517
Other current assets	1,112	1,064	1,310	5,327	9,940	8,573	8,573	8,573
Total current assets	9,664	10,387	9,761	16,321	20,333	16,811	17,305	19,175
Fixed assets	5,915	7,694	8,489	10,522	11,697	12,810	13,798	14,661
Goodwill & intangibles	1,158	1,292	1,516	8,356	8,508	9,708	9,708	9,708
Other non-current assets	568	829	1,225	5,140	6,542	6,833	7,236	7,790
Total assets	17,306	20,202	20,991	40,339	47,081	46,162	48,048	51,334
Short-term debt	691	657	599	8,554	4,479	2,000	1,000	1,000
Accounts payable	3,548	3,685	3,679	4,761	4,992	5,753	6,233	6,835
Other current liabilities	1,999	2,885	2,703	4,748	4,880	4,880	4,880	4,880
Total current liabilities	6,238	7,226	6,981	18,063	14,351	12,633	12,114	12,715
Long-term debt	150	0	0	3,236	5,464	4,957	4,460	3,972
Other non-current liabilities	700	927	938	1,029	2,773	2,773	2,773	2,773
Total liabilities	7,088	8,153	7,919	22,328	22,588	20,363	19,346	19,460
Share capital	179	181	181	181	196	196	196	196
Reserves/R.E./others	9,579	11,290	12,262	15,180	21,293	23,502	26,364	29,497
Shareholders' equity	9,758	11,471	12,443	15,361	21,489	23,698	26,560	29,694
Minority interests	459	578	629	2,650	3,003	2,101	2,142	2,180
Total equity & liabilities	17,306	20,202	20,991	40,339	47,081	46,162	48,048	51,334
EV	49,212	49,106	49,746	58,760	59,030	57,542	55,711	53,468
Net debt/(cash)	(5,959)	(6,145)	(5,631)	4,126	5,041	4,746	3,277	1,550
BVPS (CNY)	5.617	6.490	7.040	8.438	11.068	12.205	13.679	15.293

■ Key ratios (%)

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Sales (YoY)	17.7	23.5	(3.5)	20.2	15.4	9.8	10.0	9.5
EBITDA (YoY)	9.6	27.3	(1.1)	12.5	28.9	19.3	17.8	8.0
Operating profit (YoY)	11.7	30.3	(11.0)	9.8	37.5	29.1	21.7	7.9
Net profit (YoY)	10.9	28.4	(13.0)	16.3	39.0	23.5	23.8	11.8
Core EPS (fully-diluted) (YoY)	4.5	27.5	(13.0)	13.9	32.3	19.4	23.8	11.8
Gross-profit margin	25.7	25.7	25.0	27.0	30.8	30.8	31.8	31.7
EBITDA margin	7.2	7.4	7.6	7.1	7.9	8.6	9.2	9.1
Operating-profit margin	4.8	5.1	4.7	4.3	5.1	6.0	6.6	6.5
Net profit margin	4.1	4.3	3.8	3.7	4.5	5.0	5.7	5.8
ROAE	13.5	15.0	11.6	11.6	12.1	12.2	13.6	13.6
ROAA	7.9	8.5	6.7	5.2	5.1	5.9	7.2	7.7
ROCE	14.0	16.0	12.8	8.5	7.9	9.8	12.0	12.2
ROIC	33.9	32.3	21.9	10.4	8.8	8.8	10.1	10.4
Net debt to equity	n.a.	n.a.	n.a.	26.9	23.5	20.0	12.3	5.2
Effective tax rate	11.8	13.4	13.5	16.6	15.1	20.0	21.0	21.0
Accounts receivable (days)	7.0	6.9	8.3	6.5	6.9	8.0	8.0	8.0
Current ratio (x)	1.5	1.4	1.4	0.9	1.4	1.3	1.4	1.5
Net interest cover (x)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Net dividend payout	22.5	21.8	20.3	22.4	23.8	20.0	20.0	20.0
Free cash flow yield	1.6	0.3	0.1	n.a.	n.a.	5.6	3.7	4.3

Source: FactSet, Daiwa forecasts

■ Company profile

Established in Inner Mongolia in 1999, China Mengniu Dairy (Mengniu) is controlled by COFCO group, a state-owned food conglomerate. Mengniu focuses on the production of UHT milk, milk beverages and ice cream. It is China's largest maker of liquid milk products by revenue, with about a 28% market share in 2013, according to AC Nielsen.

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