

March 20, 2015

China Resources Enterprise

Execution Is Key for the Loss-reduction Target in 2015

Industry View

In-Line

Stock Rating

Equal-weight

Quick Comment: The efficiency improvement and thus loss-cutting in retail is the major focus for CRE and is the key catalyst for the stock. Management maintained its target to achieve break-even for food retail segment by 2H17, but it recognized challenges ahead in 2015 for reducing meaningful portion of loss from 2014. We estimate retail will turn profitable by 2018, and the amount of loss reduction will be back-end loaded. We think retail earnings bottomed in 2014. With the stock trading at 0.7x 2015E P/B, a record low, and other segments helping hedge the volatility in retail, we think the downside to the stock is limited in the near term.

2014 Review: CRE reported 15% sales growth and an underlying loss of HK\$794mn. Excluding the impact of the Tecso consolidation at end-May 2014, the like-for-like sales growth was 8% and there was an underlying profit of HK\$112mn (vs. underlying profit of HK\$1.64bn in 2013). By segment:

- **Retail:** Excluding Tesco and the store provision, own retail made a HK\$187mn underlying gain and a ~HK\$170mn loss in 2014 and 4Q14, respectively, compared to net income of HK\$734mn and HK\$35mn in 2013 and 4Q13, respectively. It was mainly due to the difficulties in N+NE+HK markets under declining SSSG. Management implied the operations in these areas are under strategic review.
- **Beer:** Market share expanded 1ppt YoY to 24%, while net margin (post MI) was down to 2.2% from 2.9% in 2013 under a challenging market. Loss in 4Q widened yoy due to operating deleverage (weak sales with more promotions).
- **Food:** Management keeps the target to breakeven by 2016-17.
- **Beverage:** Strong net margin of 5.1% in 4Q14 was due to lower PET cost and 1H-skewed ad spending in 2014.

Jan/Feb 2015 trend: 1) Retail SSSG (excluding Tesco) declined at a magnitude similar to 2014's average, but the overall loss reduction was better than expected. 2) Beer volume growth at 3-4% with ASP up 3-4% from mix improvement.

2015 Outlook/Plans 1) Retail: Loss reduction for Tesco on a annualized basis. 2) Beer: 1-2% volume growth if market remains slow with some ASP improvement. 3) Beverage: Continued margin improvement with above-20% top-line growth. 4) The eCommerce platform will be launched by mid- 2015. The initial capex is roughly HK\$200mn. The operation will largely leverage off the existing retail facilities to minimize the capex; management does not intend to add much profit burden from this effort.

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China Resources Enterprise (0291.HK , 291 HK)

China Consumer Staples / China

Stock Rating

Industry View

Equal-weight

In-Line

Shr price, close (Mar 20, 2015)

HK\$15.08

52-Week Range

HK\$24.55-14.04

Sh out, dil, curr (mn)

2,410

Mkt cap, curr (mn)

HK\$36,347

EV, curr (mn)

HK\$58,036

Avg daily trading value (mn)

HK\$70

Fiscal Year Ending	12/14	12/15e	12/16e	12/17e
ModelWare EPS (HK\$)	(0.33)	0.17	0.39	0.68
Prior ModelWare EPS (HK\$)	(0.17)	0.18	0.41	-
EPS, basic (HK\$)**	(0.33)	0.17	0.39	0.68
Consensus EPS (HK\$)§	0.18	0.38	0.52	-
Revenue, net (HK\$ mn)	168,864	185,596	200,440	216,159
EBITDA (HK\$ mn)	6,286	7,629	9,457	9,631
Net income (HK\$ mn)**	(794)	411	950	1,629
P/E, basic**	NM	88.5	38.2	22.3
P/BV	0.8	0.7	0.7	0.7
EV/EBITDA	9.7	7.8	6.5	6.5
ROE (%)**	(1.8)	0.8	1.9	3.2
RNOA (%)**	1.3	2.0	3.6	3.4
Div yld (%)	1.7	0.3	0.8	2.2
FCF yld ratio (%)	(4.4)	(3.3)	(3.5)	(1.9)
Leverage (EOP) (%)	4.1	5.4	6.6	7.7

Unless otherwise noted, all metrics are based on Morgan Stanley ModelWare framework

§ = Consensus data is provided by Thomson Reuters Estimates

** = Based on consensus methodology

e = Morgan Stanley Research estimates

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Key Takeaways from Analyst Briefing

Tesco: The progress of integration went “above-expectation” in Jan/Feb 2015.

- Tesco's loss contribution was HK\$300-350mn in 4Q14 vs. HK\$600-650mn in Jun-Sep 2015 (four months). Management has started to see some cost saving by combining the headquarter functions.
- Supply chain – the integration has not really started, as most supplier contracts for 2014 were signed before the Tesco deal.
- Private label is another area of focus. Management sees upside on gross margin as CRE's original retail has less than 5% of sales from private labels.

CRE's original retail (ex. Tesco): Underlying net income was HK\$187mn in 2014 (ex. provision) vs. HK\$734mn in 2013.

- The key drag was still the loss-making operations in the North, Northeast and Hong Kong. Management reveals that CRE will focus on improving the return in these areas.
- Gift card sales was another weak point, while the declining trend is narrowing. It went down ~30% yoy in 2014.

Store Closure: CRE booked HK\$800mn provisions (HK\$640mn after minority) for the plan to close 38 supermarkets (most will be closed in 2015).

- Most of the to-be-closed stores will be gradually shut down after CNY.
- Only two are Tesco's stores as Tesco's store locations are better than CRE's.
- Management estimates these stores altogether made roughly HK\$200-300mn loss a year at EBIT level.
- CRE plans to net open less than 250 stores in 2015, with most of them being supermarkets or convenience stores.

eCommerce: The platform will likely be launched in June-July after the system has been built up.

- The kick-start area will be Guangdong province.
- Management does not expect a big loss as CRE will heavily leverage off its existing logistics and warehousing assets.
- Management indicated the development of eCommerce is part of the restructuring plan for the whole retail operation and it will not dedicate too many resources to it before Tesco is fully integrated.

Beer: Management is focused more on market share gains and expects to improve margin slightly in 2015 through mix upgrades.

- Volume growth in Jan/Feb was at 3-4% yoy, above management's 2015 target at 1-2%.
- While management expects the ASP increase trend to continue by launching more premium products, it indicates it is equally important to turn up sales for mid-/low-end products.
- Beer utilization rate was below 60% in 2014.
- Management plans to reinvest most of the gross margin gain into marketing and promotion to further expand market share.

Beverages: Momentum continues with operating leverage.

- CRE achieved 5.1% net margin in 4Q14 vs. loss in 4Q13, due to the major part of ad spending was booked in 1H (e.g., the sponsorship in the film Transformer) and the falling PET price. Management is confident of margin improvement prospect.
- Management expects above 20% sales growth for beverages in 2015.

CRE: 2014 Actual vs. Estimate

Exhibit 1:

HK\$mnn; YE Dec	2013	2014	2014e	2014 YoY	2014 Act:Est	1H13	2H13	1H14	2H14	2H14e	2H14 YoY	2H14 Act:Est
Sales	146,413	168,864	172,636	15%	-2%	71,857	74,556	83,506	85,358	89,130	14%	-4%
Retail	95,174	109,500	110,912	15%	-1%	47,907	47,267	52,589	56,911	58,323	20%	-2%
Beer	32,994	34,482	35,248	5%	-2%	16,078	16,916	18,475	16,007	16,773	-5%	-5%
Food	12,069	16,486	17,690	37%	-7%	5,004	7,065	8,035	8,451	9,655	20%	-12%
Beverage	7,305	9,891	9,995	35%	-1%	3,375	3,930	5,023	4,868	4,972	24%	-2%
Intersegment & Others	(1,129)	(1,495)	(1,208)	32%	24%	(507)	(622)	(616)	(879)	(592)	41%	48%
Cost of goods sold	(109,040)	(126,419)	(129,782)	16%	-3%	(53,822)	(55,218)	(62,124)	(64,295)	(67,658)	16%	-5%
Gross profit	37,373	42,445	42,854	14%	-1%	18,035	19,338	21,382	21,063	21,472	9%	-2%
Other income	2,113	2,755	2,056	30%	34%	794	1,319	1,451	1,304	605	-1%	116%
SG&A cost	(34,697)	(43,483)	(44,540)	25%	-2%	(16,206)	(18,491)	(19,994)	(23,489)	(24,546)	27%	-4%
Underlying Op Profit	4,509	1,084	370	-76%	193%	2,623	2,166	2,839	(1,122)	(2,469)	NM	-55%
Retail	1,973	(1,020)	(1,048)	NM	NM	1,119	854	1,122	(2,142)	(2,170)	NM	-1%
Beer	2,581	2,200	2,296	-15%	-4%	1,135	1,446	1,291	909	1,005	-37%	-10%
Food	208	181	(41)	NM	-544%	160	48	50	131	(91)	NM	NM
Beverage	224	503	274	125%	84%	90	134	34	469	240	250%	95%
Corporate Income/(Exp)	(477)	(780)	(1,111)	NM	NM	119	(316)	342	(489)	(1,453)	NM	NM
Net Finance Income	230	188	118	-18%	59%	(153)	383	(320)	508	438	33%	16%
Equity Income	27	(64)	40	NM	NM	8	19	(22)	(42)	62	-321%	-168%
Profit before tax	5,046	1,841	528	-64%	249%	2,478	2,568	2,497	(656)	(1,969)	NM	NM
Income tax	(1,894)	(1,550)	(229)	NM	NM	(1,002)	(892)	(1,041)	(509)	812	NM	-163%
Profit from conti biz	3,152	291	299	-91%	-3%	1,476	1,676	1,456	(1,165)	(1,157)	NM	NM
Total Profit	3,152	291	299	-91%	-3%	1,476	1,676	1,456	(1,165)	(1,157)	NM	NM
Minority interest	(1,244)	(452)	(715)	NM	NM	(458)	(786)	(527)	75	(188)	-110%	-140%
Net Profit (Reported)	1,908	(161)	(416)	NM	NM	1,018	890	929	(1,090)	(1,345)	NM	NM
Underlying net profit	1,642	(794)	(416)	NM	NM	1,005	637	668	(1,462)	(1,084)	NM	NM
Retail	734	(1,359)	(1,153)	NM	NM	624	110	439	(1,798)	(1,592)	NM	NM
Beer	943	761	891	-15%	-15%	358	585	417	344	474	-41%	-27%
Food	53	(134)	(114)	NM	NM	71	(18)	(72)	(62)	(42)	NM	NM
Beverage	106	237	126	124%	89%	39	67	66	171	60	155%	187%
Corporate Exp	(194)	(299)	(166)	NM	NM	(87)	(107)	(182)	(117)	16	NM	NM
Margins												
Gross margin	25.5%	25.1%	24.8%	1.4%	0.3%	25.1%	25.9%	25.6%	24.7%	24.1%	-1.3%	0.6%
SG&A/sales	23.7%	25.8%	25.8%	1.6%	0.0%	22.6%	24.8%	23.9%	27.5%	27.5%	2.7%	0.0%
Underlying OPM	3.1%	0.6%	0.2%	-0.4%	0.4%	3.7%	2.9%	3.4%	-1.3%	-2.8%	-4.2%	1.5%
Retail	2.1%	-0.9%	-0.9%	0.2%	0.0%	2.3%	1.8%	2.1%	-3.8%	-3.7%	-5.6%	0.0%
Beer	7.8%	6.4%	6.5%	-0.6%	-0.1%	7.1%	8.5%	7.0%	5.7%	6.0%	-2.9%	-0.3%
Food	1.7%	1.1%	-0.2%	-3.2%	1.3%	3.2%	0.7%	0.6%	1.6%	-0.9%	0.9%	2.5%
Beverage	3.1%	5.1%	2.7%	-0.7%	2.3%	2.7%	3.4%	0.7%	9.6%	4.8%	6.2%	4.8%
Effective tax rate	37.5%	84.2%	43.4%	13.0%	40.8%	40.4%	34.7%	41.7%	NM	NM		
Net Margin (Reported)	1.3%	-0.1%	-0.2%	-1.8%	0.1%	1.4%	1.2%	1.1%	-1.3%	-1.5%	-2.5%	0.2%
Underlying Net Margin	1.1%	-0.5%	-0.2%	-0.1%	-0.2%	1.4%	0.9%	0.8%	-1.7%	-1.2%	-2.6%	-0.5%
Retail	0.8%	-1.2%	-1.0%	0.1%	-0.2%	1.3%	0.2%	0.8%	-3.2%	-2.7%	-3.4%	-0.4%
Beer	2.9%	2.2%	2.5%	-0.1%	-0.3%	2.2%	3.5%	2.3%	2.1%	2.8%	-1.3%	-0.7%
Food	0.4%	-0.8%	-0.6%	-2.1%	-0.2%	1.4%	-0.3%	-0.9%	-0.7%	-0.4%	-0.5%	-0.3%
Beverage	1.5%	2.4%	1.3%	-0.4%	1.1%	1.2%	1.7%	1.3%	3.5%	1.2%	1.8%	2.3%
SSSG	4.7%	-2.6%	-2.0%	0.6%	-0.6%	5.6%	3.8%	-1.4%	-3.8%	-2.6%		

Source: Company data, Morgan Stanley Research, E = Morgan Stanley Research estimates

CRE: Key Financial Summary

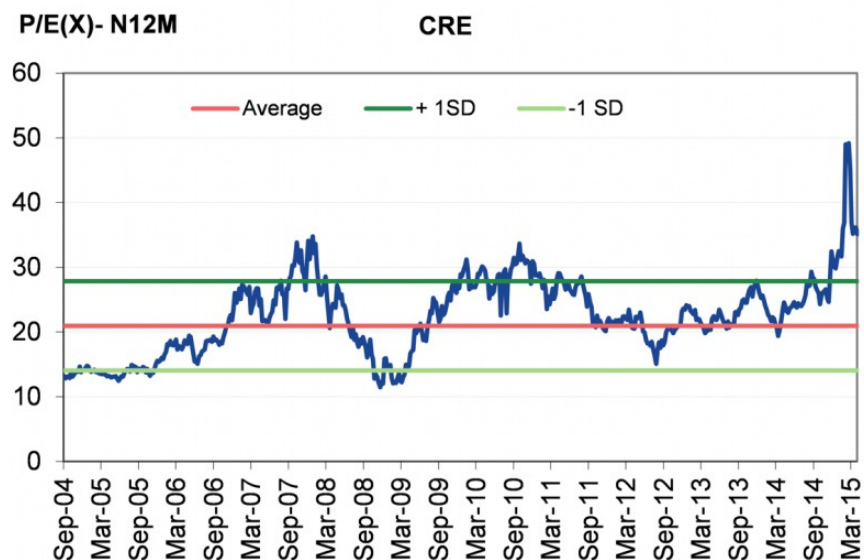
Exhibit 2: CRE: Key Financial Summary

HK\$mn	2013	2014	2015E	2016E	2017E	1Q13	2Q13	3Q13	4Q13	1Q14	2Q14	3Q14	4Q14
Overall													
Core business													
Net Sales	146,413	168,864	185,596	200,440	216,159	36,153	35,704	40,583	33,973	41,812	41,694	47,551	37,807
Intersegment Sales	(1,129)	(1,495)	(1,600)	(1,712)	(1,797)	(204)	(303)	(334)	(288)	(346)	(304)	(438)	(407)
EBITDA	8,708	6,046	7,629	9,457	9,631	1,812	2,405	3,345	1,146	2,027	2,694	2,396	(1,071)
EBITDA - underlying	8,428	5,413	7,629	9,457	9,631	1,812	2,388	3,333	895	2,073	2,440	2,303	(1,403)
Net profit	1,908	(161)	411	950	1,629	512	506	920	(30)	356	573	(71)	(1,019)
Net profit - underlying core	1,642	(794)	411	950	1,629	512	493	911	(274)	349	319	(101)	(1,361)
Margin - core													
EBITDA margin - core	5.9%	3.6%	4.1%	4.7%	4.5%	5.0%	6.7%	8.2%	3.4%	4.8%	6.5%	5.0%	-2.8%
EBITDA margin - underlying core	5.8%	3.2%	4.1%	4.7%	4.5%	5.0%	6.7%	8.2%	2.6%	5.0%	5.9%	4.8%	-3.7%
Net margin - core	1.3%	-0.1%	0.2%	0.5%	0.8%	1.4%	1.4%	2.3%	-0.1%	0.9%	1.4%	-0.1%	-2.7%
Net margin - underlying core	1.1%	-0.5%	0.2%	0.5%	0.8%	1.4%	1.4%	2.2%	-0.8%	0.8%	0.8%	-0.2%	-3.6%
YoY growth - core													
Sales - core	16%	15%	10%	8%	8%	8%	17%	19%	21%	16%	17%	17%	11%
Net profit - core	-52%	-108%	-355%	131%	71%	-61%	-44%	-19%	NM	-30%	13%	NM	NM
Underlying net profit	8%	-148%	-152%	131%	71%	-9%	-14%	36%	NM	-32%	-35%	NM	NM
Retail													
Store # incl. franchised stores	4,614	4,726	4,801	4,956	5,121	4,448	4,494	4,551	4,614	4,625	4,785	4,825	4,866
Sales	95,174	109,500	118,233	122,341	128,373	25,923	21,984	23,920	23,347	28,081	24,508	29,582	27,329
Underlying EBITDA	3,460	690	2,369	2,960	3,561	1,224	725	733	778	1,276	618	(84)	(1,120)
Underlying net profit	734	(1,359)	(780)	(319)	(8)	525	99	75	35	464	(25)	(732)	(1,066)
Margin													
Underlying EBITDA margin	3.6%	0.6%	2.0%	2.4%	2.8%	4.7%	3.3%	3.1%	3.3%	4.5%	2.5%	-0.3%	-4.1%
Underlying net margin	0.8%	-1.2%	-0.7%	-0.3%	0.0%	2.0%	0.5%	0.3%	0.1%	1.7%	-0.1%	-2.5%	-3.9%
Sales Growth													
SSSG	4.7%	-2.6%	-2.0%	2.0%	2.3%	7.3%	22.3%	14.2%	14.2%	8.3%	11.5%	23.7%	17.1%
Beer													
Volume (mn liters)	11,722	11,842	12,096	12,695	13,331	2,297	3,462	4,072	1,891	2,575	3,726	3,819	1,722
Sales	32,994	34,482	36,670	40,105	43,820	6,548	9,530	11,332	5,584	7,876	10,599	10,911	5,096
EBITDA	4,415	4,353	4,381	4,857	5,390	436	1,492	2,290	197	672	1,619	2,118	(56)
Net profit - Post MI	943	761	856	1,033	1,215	(23)	381	749	(164)	6	411	625	(281)
Margin													
EBITDA margin	13.4%	12.6%	11.9%	12.1%	12.3%	6.7%	15.7%	20.2%	3.5%	8.5%	15.3%	19.4%	-1.1%
Net margin - Post MI	2.9%	2.2%	2.3%	2.6%	2.8%	-0.4%	4.0%	6.6%	-2.9%	0.1%	3.9%	5.7%	-5.5%
YoY growth													
Volume	10%	1%	2%	5%	5%	16.2%	2.1%	10.2%	19.9%	12.1%	7.6%	-6.2%	-8.9%
Sales	18%	5%	6%	9%	9%	13%	8%	24%	31%	20%	11%	-4%	-9%
Net profit	15%	-19%	12%	21%	18%	NM	-7%	49%	NM	NM	8%	-17%	71%
Food													
Sales	12,069	16,486	20,023	24,971	28,641	2,433	2,571	3,171	3,894	3,942	4,093	4,334	4,117
EBITDA	409	257	300	356	427	142	109	134	24	69	98	87	3
Underlying net profit	53	(134)	(84)	(64)	28	57	14	30	(48)	(50)	(22)	(19)	(43)
Margin													
EBITDA margin	3.4%	1.6%	1.5%	1.4%	1.5%	5.8%	4.2%	4.2%	0.6%	1.8%	2.4%	2.0%	0.1%
Underlying net margin	0.4%	-0.8%	-0.4%	-0.3%	0.1%	2.3%	0.5%	0.9%	-1.2%	-1.3%	-0.5%	-0.4%	-1.0%
YoY growth													
Sales	16%	36.6%	21.5%	24.7%	14.7%	-6%	1%	20%	48%	62%	59%	37%	6%
Underlying net profit	-80%	-353%	-37%	-24%	-144%	0%	-84%	-56%	NM	NM	NM	NM	NM
Beverage													
Volume	4,930	6,556	8,112	9,470	10,696	971	1,297	1,687	975	1,400	1,822	2,179	1,155
Sales	7,305	9,891	12,269	14,734	17,123	1,453	1,922	2,494	1,436	2,259	2,798	3,162	1,672
EBITDA	324	673	929	1,079	1,226	42	92	218	(28)	56	156	233	228
Net profit	106	237	328	381	437	8	31	90	(23)	10	56	85	86
Margin													
EBITDA margin	4.4%	6.8%	7.6%	11.4%	11.5%	2.9%	4.8%	8.7%	-1.9%	2.5%	5.6%	7.4%	13.6%
Net margin	1.5%	2.4%	2.7%	2.6%	2.6%	0.6%	1.6%	3.6%	-1.6%	0.4%	2.0%	2.7%	5.1%
YoY growth													
Volume	41%	33%	24%	17%	13%	43%	29%	44%	50%	44%	40%	29%	18%
Sales	53%	35%	24%	20%	16%	56%	41%	54%	67%	55%	46%	27%	16.4%
Net profit	23%	124%	38%	16%	15%	33%	29%	55%	NM	25%	81%	-6%	NM

Source: Company Data, Morgan Stanley Research Estimates

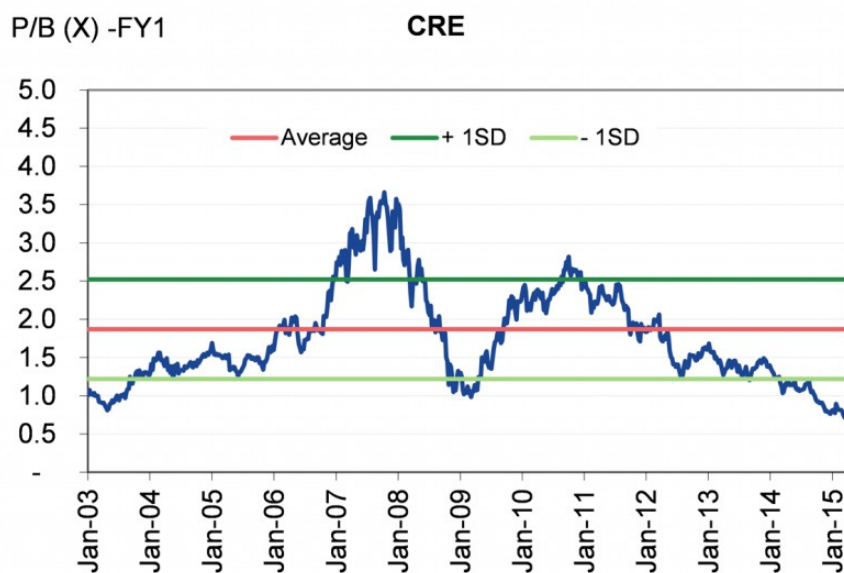
Valuation Charts

Exhibit 3: CRE: Forward P/E



Source: Thomson Reuters, Morgan Stanley Research

Exhibit 4: CRE: Forward P/B



Source: Thomson Reuters, Morgan Stanley Research

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Lillian Lou, Angela Moh, Dustin Wei.

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(as of February 28, 2015)

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STOCK RATING CATEGORY	COVERAGE UNIVERSE		INVESTMENT BANKING CLIENTS (IBC)		
	COUNT	% OF TOTAL	COUNT	% OF TOTAL IBC	% OF RATING CATEGORY
Overweight/Buy	1161	35%	321	41%	28%
Equal-weight/Hold	1459	44%	370	47%	25%
Not-Rated/Hold	101	3%	10	1%	10%
Underweight/Sell	609	18%	88	11%	14%
TOTAL	3,330		789		

Data include common stock and ADRs currently assigned ratings. Investment Banking Clients are companies from whom Morgan Stanley received investment banking compensation in the last 12 months.

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Unless otherwise specified, the time frame for price targets included in Morgan Stanley Research is 12 to 18 months.

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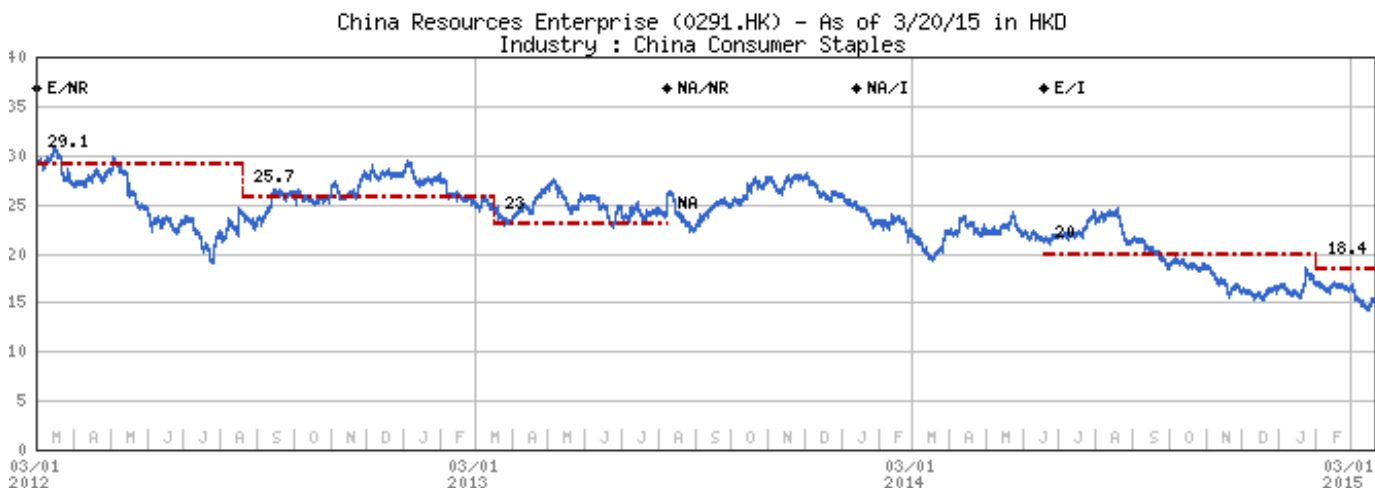
Attractive (A): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be attractive vs. the relevant broad market benchmark, as indicated below.

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Cautious (C): The analyst views the performance of his or her industry coverage universe over the next 12-18 months with caution vs. the relevant broad market benchmark, as indicated below.

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Stock Price, Price Target and Rating History (See Rating Definitions)



Source: Morgan Stanley Research Date Format : MM/DD/YY Price Target -- No Price Target Assigned (NA)
 Stock Price (Not Covered by Current Analyst) — Stock Price (Covered by Current Analyst) —
 Stock and Industry Ratings (abbreviations below) appear as ♦ Stock Ratings/Industry View
 Stock Ratings: Overweight (O) Equal-weight (E) Underweight (U) Not-Rated (NR) No Rating Available (NA)
 Industry View: Attractive (A) In-line (I) Cautious (C) No Rating (NR)

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INDUSTRY COVERAGE: China Consumer Staples

COMPANY (TICKER)	RATING (AS OF)	PRICE* (03/20/2015)
Lou, Lillian		
Bright Dairy (600597.SS)	E (12/08/2014)	Rmb19.85
China Agri-Industries (0606.HK)	E (06/02/2014)	HK\$3.03
China Foods Limited (0506.HK)	U (02/07/2013)	HK\$2.91
China Mengniu Dairy (2319.HK)	O (12/12/2008)	HK\$36.25
China Resources Enterprise (0291.HK)	E (06/19/2014)	HK\$15.08
Kweichow Moutai Company Ltd. (600519.SS)	O (10/17/2014)	Rmb193.50
Luzhou Lao Jiao Co. Ltd (000568.SZ)	U (10/17/2014)	Rmb22.99
Shuanghui Development (000895.SZ)	E (02/01/2015)	Rmb34.66
Tingyi (Cayman Islands) (0322.HK)	U (10/28/2013)	HK\$18.50
Tsingtao Brewery (600600.SS)	E (02/04/2012)	Rmb41.34
Tsingtao Brewery (0168.HK)	E (01/29/2014)	HK\$51.10
Uni-President China (0220.HK)	U (10/28/2013)	HK\$5.42
Want Want China Holdings Ltd (0151.HK)	E (04/11/2013)	HK\$7.98
WH Group (0288.HK)	O (09/08/2014)	HK\$4.20
Wuliangye Yibin Company Ltd. (000858.SZ)	E (01/29/2014)	Rmb22.63
Yantai Changyu Pioneer Wine Company Ltd. (000869.SZ)	E (02/01/2015)	Rmb36.15
Yantai Changyu Pioneer Wine Company Ltd. (200869.SZ)	O (02/01/2015)	HK\$26.65
Yili Industrial (600887.SS)	O (01/29/2014)	Rmb29.50

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