

COMPANY NOTE

Initiating Coverage

China | Consumer | China Consumer

8 June 2015

Jefferies

Shengmu (1432 HK) The Pearl in Desert; Initiate with Buy

Key Takeaway

We expect demand for organic food to see rapid growth. Shengmu is the first large-scale organic milk producer in China with a vertically integrated value chain. Its farms' unique location in desert and experienced team offer entry barriers, and it enjoys high growth and margins. We initiate at Buy with at PT of HKD3.2.

Positive on organic milk demand. Organic milk refers to pollution-free and additive-free milk products. As middle class pays more attention to food safety and is willing to pay premium for high-quality foods, we expect rising demand for organic food. Production of organic raw milk grew rapidly at CAGR of 79% in 2009-13, notwithstanding the small scale. Frost & Sullivan forecasts this to grow at 51.5% CAGR in 2014-17e, accounting for 2.5% of 2017e market. Organic raw milk production is undersupplied currently in China with high entry barriers. We expect huge market potential for this sector.

First mover advantage with large scale. Shengmu is, so far, the only largest organic dairy company in China with a fully integrated value chain. Its products meet EU standards for organic milk and have received international awards for premium quality since 2011. Its market share in 2014e organic raw milk production was 62%. All organic farms are located in Ulan Buh desert (Inner Mongolia), creating high entry barriers for potential competitors. Its own-branded liquid milk targets high-end market and is in a fast growth stage. Shengmu's margins and turn ratios are higher vs other key dairy companies.

Earnings forecasts. We forecast sales of Rmb3.4bn in 2015e (+61% yoy), and Rmb4.8bn in 2016e (+40% yoy); and group GP margin to remain stable at 50-51% in 2015-16e vs. 50.2% in 2014. We assume high marketing expenses and promotion to expand the liquid milk business. We forecast core net profit (excluding gain/loss from changes in fair value) of RMB942m (+51% yoy, NM 27.4%) in 2015e and RMB1.3bn (+37% yoy, NM 27.0%) in 2016e.

Valuation/Risks

Our PT of HKD3.2 is based on 13.5x 1-year forward PE, slightly higher than 12x for CMD (1117 HK, Buy) due to Shengmu's unique organic positioning, fast growth and high returns. The stock trades at 9.5x forward P/E (historical median of 12x) and 0.3x forward PEG. Valuation looks compelling. Its share price has outperformed the HSCXI and dairy sector by 11% in the past 1M. Catalysts: significant improvement of dairy cows' productivity; faster expansion of market share in liquid milk. Key risks: Self-supply feeds shortage; strong competition.

RMB	Prev.	2014A	Prev.	2015E	Prev.	2016E	Prev.	2017E
Rev. (MM)	--	2,132.0	--	3,437.0	--	4,799.0	--	6,228.0
Core Earnings (MM)	--	624	--	942	--	1,294	--	1,776
Chg (% YoY)	--	96.4%	--	51.0%	--	37.3%	--	37.2%
BV/Share	--	0.71	--	0.90	--	1.17	--	1.50
P/B	--	2.4x	--	1.9x	--	1.4x	--	1.1x
Dividend	--	0.00	--	0.00	--	0.00	--	0.03
Div. Yield	--	0.00%	--	0.00%	--	0.00%	--	1.79%
Core EPS								
FY Dec	--	0.10	--	0.16	--	0.22	--	0.30
P/Core EPS	--	16.7x	--	10.4x	--	7.6x	--	5.6x

BUY

Price target HK\$3.20
Price HK\$2.09

Bloomberg: 1432 HK
Reuters: 1432.HK

Financial Summary

Book Value (MM):	Rmb4,255.0
Book Value/Share:	Rmb0.70
Net Debt (MM):	Rmb733
Return on Avg. Equity:	23.9%
Net Debt/Capital:	12.8%
Long-Term Debt (MM):	Rmb150.0
Cash & ST Invest. (MM):	HK\$751.0

Market Data

52 Week Range:	HK\$2.55 - HK\$1.89
Total Entprs. Value (MM):	HK\$13,494.2
Market Cap. (MM):	HK\$12,577.8
Insider Ownership:	56.6%
Shares Out. (MM):	6,018.1
Float (MM):	2,199.2
Avg. Daily Vol.:	18,126,560

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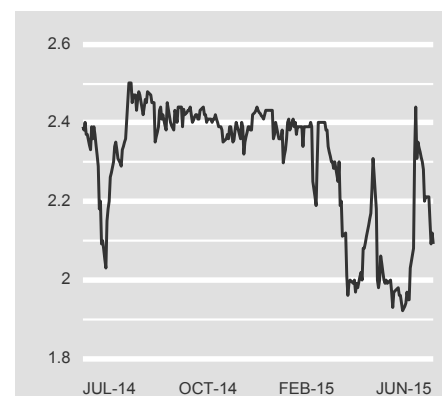
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Price Performance



Scenarios

Target Investment Thesis

- Increasing demand for organic milk.
- Organic raw milk ASP remains stable.
- Strong growth in own-branded organic liquid milk products.
- PT of HKD3.2 based on 13.5x 1-year forward PE and RMB0.186 of 1-year forward EPS

Upside Scenario

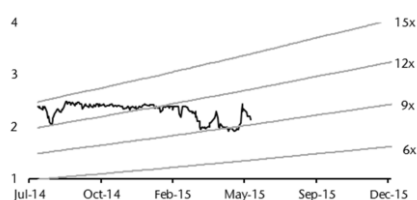
- Stronger-than-expected industry growth in organic dairy products
- Organic raw milk ASP to go up due to undersupply.
- Further increase in ASP and margin expansion on strong own-branded products
- 1-year forward EPS: RMB0.204; Target Multiple: 15x; Target Price HKD3.8

Downside Scenario

- Weaker-than-expected industry growth on organic dairy products
- Organic raw milk ASP to drop due to weak demand and increasing supply.
- Weaker-than-expected own-branded liquid milk
- 1-year forward EPS: RMB0.149; Target Multiple: 11x; Target Price HKD2.0

Long Term Analysis

1 Year Forward P/E



Source: Jefferies estimate

Long Term Financial Model Drivers

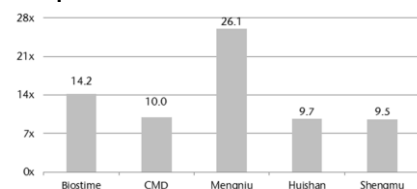
LT Earnings CAGR	42%
Organic Revenue Growth	43%
Acquisition Contribution	0%
Operating Margin Expansion	-4.0 to 1.8ppt.

Other Considerations

- Self-supply feeds shortage
- Strong competition in liquid milk business
- Potential food safety issue
- Potential outbreak of cow disease

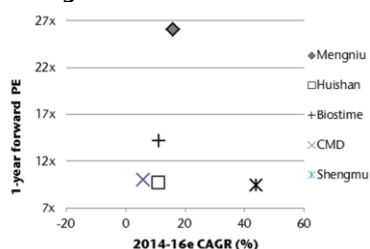
Peer Group

Group P/Es



Source: Jefferies estimates

Earnings Growth vs P/E



Source: Jefferies estimates

Recommendation / Price Target

Ticker	Rec.	PT
6863 HK	Buy	HKD2.1
1117 HK	Buy	HKD3.9
1432 HK	Buy	HKD3.2
2319 HK	Hold	HKD34.8

Catalysts

- Pullback in feed costs
- Faster-than-expected improvement of dairy cows' productivity
- Quicker-than-expected rebound in raw milk price
- Faster expansion of market share in liquid milk

Company Description

Shengmu is the largest organic dairy company in China with a vertically integrated value chain that meets EU organic standards. It supplies organic raw milk to major dairy players in China and also produces own-branded liquid milk for the market, with a dominant market share in the organic milk industry.

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Executive summary

Shengmu is the first large-scale organic milk producer in China with the following key competitive advantages: 1) vertically integrated value chain offers good quality control and lower costs; 2) unique location in Ulan Buh desert, Inner Mongolia, creates high entry barriers for potential competitors; 3) lower competition compared with mass-market dairy products; 4) experienced teams (both upstream and downstream). We expect sales revenue of RMB3.4bn (+61% yoy) and net profit of RMB942mn (+51% yoy) in 2015e. We initiate coverage with a Buy rating and PT of HKD3.2, based on 13.5x forward PE.

Positive on organic milk demand. Organic milk means pollution-free and additive-free milk products. As China's middle class pays more attention to food safety and is willing to pay a premium for high-quality foods, we expect rising demand for organic food. Production of organic raw milk grew rapidly at a CAGR of 79% in 2009-13, notwithstanding its small scale. Frost & Sullivan forecasts this figure to reach 1.08m tons by 2017e, accounting for 2.5% of the market, at 51.5% CAGR in 2014-17e. Organic raw milk production is undersupplied currently in China with high entry barriers. We believe this sector has huge market potential.

First mover advantage with large scale. Shengmu is the largest organic dairy company in China with a fully integrated value chain. Its products meet EU standards for organic milk and have been awarded the Gold Medal of BioFach at China International Organic Trade Fair and Conference, in recognition of its premium quality since 2011. It had a 62% market share in organic raw milk production in 2014E. All organic farms are located in Ulan Buh desert, Inner Mongolia, creating high entry barriers for potential competitors. Its own-branded liquid milk focuses on high-end market and is in a fast-growth phase. Its margins, ROE and ROA ratios are higher vs other dairy companies.

Earnings forecasts. We forecast sales of Rmb3.4bn in 2015e (+61% yoy), and Rmb4.8bn in 16e (+40% yoy). We expect liquid milk's proportion in sales to go up to 47% in 2015e vs. 35% in 2014. We expect organic raw milk price to remain stable in 2015e; and group GP margin to remain stable at 50-51% in 15-16e vs. 50.2% in 2014. We assume high marketing expenses and promotion to expand liquid milk business, Hence, we expect EBIT margin to drop mildly to 36.5% in 2015e from 40.4% in 2014. We forecast core net profit (excluding gain/loss from changes in fair value) of be RMB942m (+51% yoy, NM 27.4%) in 2015e and RMB1.3bn (+37% yoy, NM 27.0%) in 2016e.

Valuation

We arrive at a PT of HKD3.2 based on 13.5x one-year forward PE. This target multiple is slightly higher than the 12x for China Modern Dairy (1117 HK, Buy) due to Shengmu's unique organic positioning, fast growth and high returns. The stock trades at 9.5x forward P/E and 0.3x forward PEG. We believe its valuation looks compelling; we initiate coverage on the stock with a Buy rating. Its share price has outperformed HSCEI by 11% in the past month, as it started receiving further attention from more clients gradually but has underperformed by 23% in the past three months. It has outperformed the dairy sector by 11% in the past month but has underperformed it by 19% in the past three months.

Key Risks and catalysts

Key risks: 1) self-supply feeds shortage; 2) strong competition in liquid milk business; 3) animal pandemic; 4) execution risks;

Key catalysts: 1) pullback in feed costs; 2) faster-than-expected improvement in dairy cows' productivity; 3) quicker-than-expected rebound in raw milk prices; 4) faster expansion of market share in liquid milk.

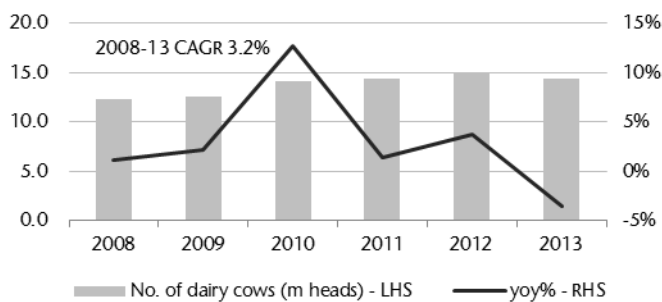
Upstream dairy farming

Industry overview

Farms and herds

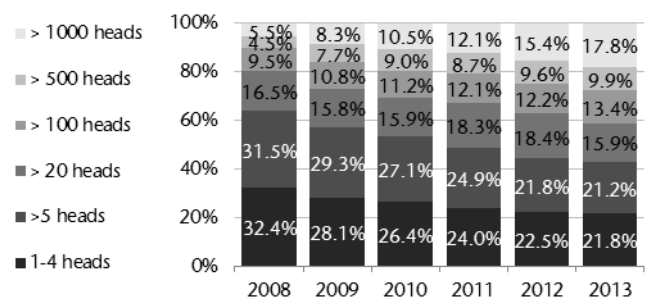
According to the Ministry of Agriculture and DAC, there were 14.4m heads of dairy cows in China as of 2013, a CAGR of 3.2% from 2008-2013. The dairy farming industry in China has been historically highly fragmented and dominated by small-scale individual farmers, with 47% of the dairy cows in China reared by farms with 1-4 cow heads back in 2004. This resulted in low efficiency and higher risk for food safety. As the government encourages large scale farming and provides subsidies and tax exemptions, large scale dairy farms have been gaining traction gradually. The move to large scale farms accelerated after the melamine incident in 2009. Farms with >100 heads of dairy cows accounted for 41% of the market in 2013, up from 7.8% in 2004 and 19.5% in 2008. In particular, large scale farms with >1,000 dairy cows attracted strong investment and accounted for 17.8% of the market in 2013. We expect large scale dairy farms to gradually replace small-sized farms. This pattern suggests fast industry consolidation in the recent decade.

Chart 1: Total number of dairy cows in China, 2007-2013



Source: Ministry of Agriculture, DAC

Chart 2: Rising proportion of large scale farms



Source: Ministry of Agriculture, DAC

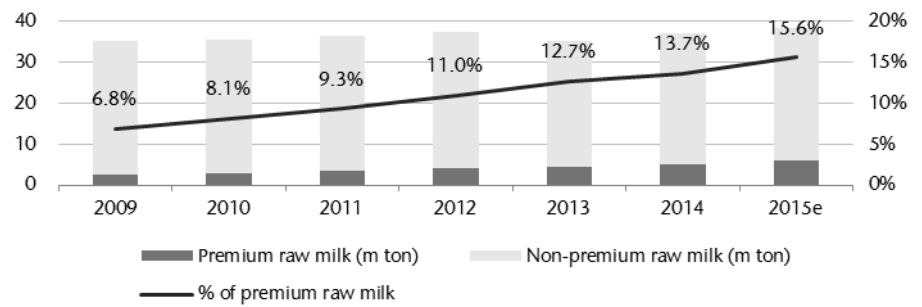
Milk yield

Due to existence of a large number of small-sized farms, China's overall milk yield remains lower than the global average but leading large scale farms in China have achieved a high milk yield of 8-9tons. CMD (1117 HK) reported average milk yield of 8.9tons in 2014 and Huishan (6863 HK) reported average milk yield of 9tons in FY14 (end Mar.14). YST dairy (1431 HK) achieved milk yield of 9.4tons in 2014, while Shengmu (1432 HK) achieved lower milk yield in 2014 (including organic and non-organic), as organic cows generally have lower milk yield. Farms operated by Bright Dairy (600597 CH) in Shanghai had a milk yield of 9.3tons in 2013.

Raw milk production

Raw milk production reached 37.3m tons in 2014, and grew at CAGR of 1.1% in 2009-14. Frost & Sullivan expects raw milk production to reach 38.5m tons in 2015e, up 3.4% yoy.

Premium raw milk, defined as milk with >3.2% protein content, >3.7% fat content, <100k CFU/ml aerobic plate content, and <400k CFC/ml somatic cell content, has grown rapidly in the past few years, driven by strong demand and emergence of large scale farms. Production of premium raw milk reached 5.1m tons in 2014, at a CAGR of 16% in 2009-14, and accounted for 13.7% of total raw milk production in 2014. Frost & Sullivan expects the production of premium raw milk to reach 6m tons (+17.6% yoy) in 15e and accounts for 15.6% of the market.

Chart 3: Raw milk production and contribution of premium raw milk

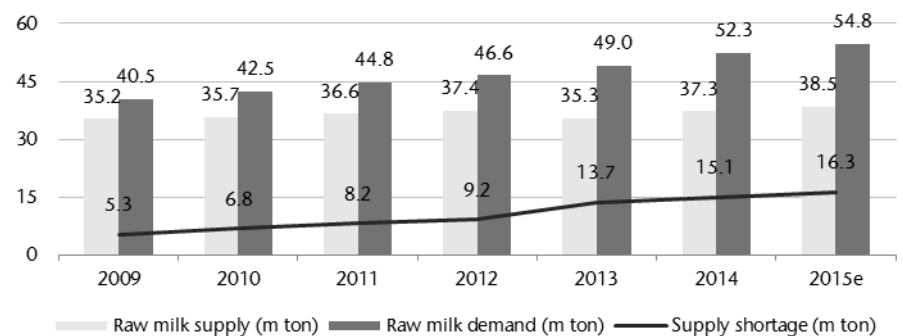
Source: DAC, Frost & Sullivan

Demand

Driven by urbanization, consumption upgrade and rising disposable income, demand for raw milk has risen at a CAGR of 5.2% in 2009-2014. Frost & Sullivan forecasts raw milk demand to reach 54.8m tons (+6.9% yoy) in 2015e.

Supply

China has been experiencing supply shortage for raw milk. It had a supply shortage of 5.3m tons in 2009, which grew to 13.7m tons in 2013 and 15.1m tons in 2014. Frost & Sullivan expects the supply shortage to increase to 16.3m tons in 2015e. The shortage mainly relies upon imports. However, due to the rapid increase in large scale farms, we believe the supply shortage pressure could start to ease off in medium term.

Chart 4: Raw milk demand, supply and shortage

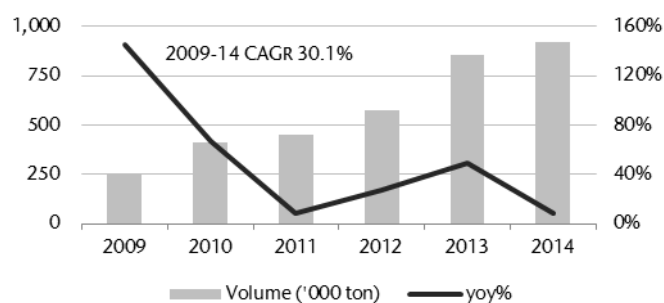
Source: DAC, Frost & Sullivan

Note: Demand for 2014 is estimate from Frost and Sullivan, while supply is the actual reported figure from Ministry of Agriculture

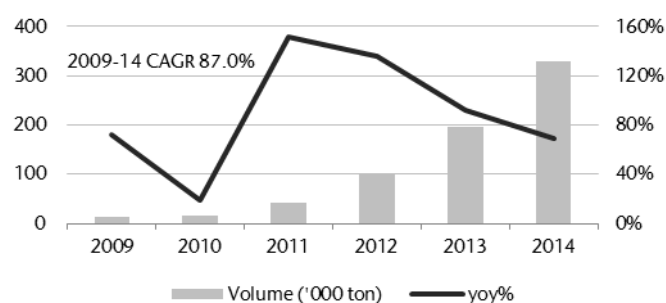
Import

Import of dairy products has been growing rapidly in recent years due to rising demand and cheaper prices overseas (please refer to Chart 10 and 11 for a discussion on pricing). China imported a total of 923k tons of raw milk powder in 2014, up 8.1% yoy and grew at CAGR of 30.1% in 2009-14. Import from New Zealand accounted for 79% of the total import. Total imported raw milk powder accounts for 43% of total milk powder demand in 2014.

Total import of liquid milk reached 329k tons in 2014, up 68.9% yoy and grew at CAGR of 87% in 2009-14; however, it accounts only for <2% of liquid milk demand currently.

Chart 5: Milk powder import volumes

Source: Bloomberg, DAC

Chart 6: Liquid milk import volumes

Source: Bloomberg, DAC

Key players

The dairy farming market in China is highly fragmented. The largest player China Modern Dairy produced 931k tons of raw milk in 2014 and accounted for merely 2.5% of the market. The four leading listed dairy farming companies together accounted for 5.5% of the raw milk production in China in 2014. Huishan Dairy accounted for c1.5% of the market, while Shengmu and YST Dairy accounted for 0.9% and 0.6%, respectively. We expect large farms' contribution to increase.

Chart 7: Production volume of leading listed dairy farming companies, 2014

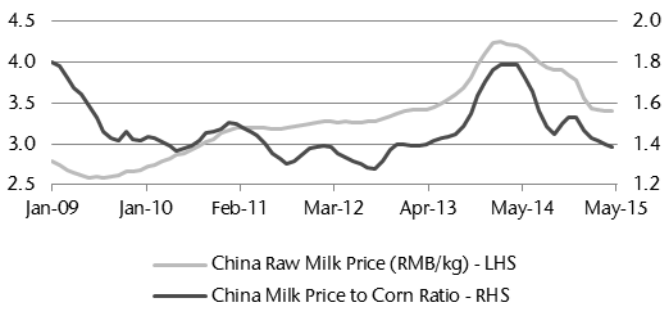
	Raw milk production volume ('000 tons)	% of total market
CMD	931	2.5%
Huishan	573	1.5%
Shengmu	345	0.9%
YST Dairy	230	0.6%
Others	35,311	94.8%
Total	37,250	100.0%

Source: Company data, Ministry of Agriculture, DAC, Jefferies estimates

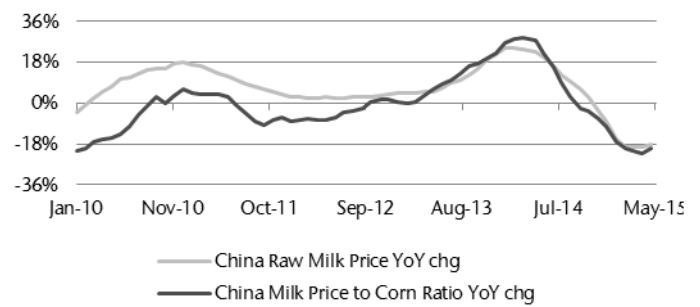
Note: volume for Huishan are interpolated from actual reported results for FY14 (end Mar.2014) and FY15e estimates

Domestic raw milk price

Domestic raw milk price has been on a downward trend since March 2014 due to the substitution effect of milk powder from New Zealand. Domestic raw milk price on average closed at RMB3.40/kg in May 2015, down 0.1% mom and 18% yoy. It has dropped 20% since March 2014. Jefferies' milk-to-corn ratio continued to decline for the fifth consecutive month to 1.4 in April 2015. We expect domestic raw milk price to drop mid to high single digits in 2015 vs 2014. However, as inventory in New Zealand declines and is aided by government's efforts of ensuring farmers' welfare, we expect mild rebound in raw milk prices in 2016.

Chart 8: Raw Milk Price and Jefferies Milk-to-Corn Ratio

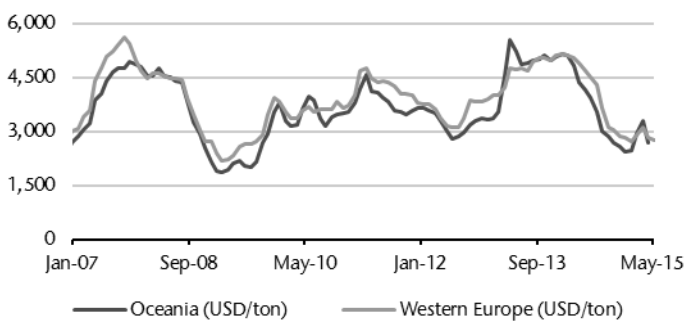
Source: Wind

Chart 9: Raw Milk Price and Milk-to-Corn Ratio Change

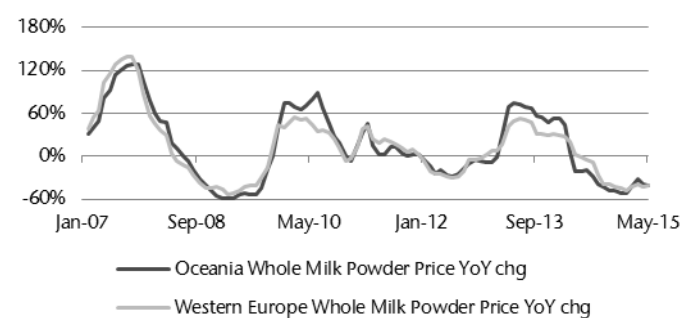
Source: Wind

Global raw milk price

International raw milk powder price fell sharply in Feb-Dec.2014 and rebounded in 1Q15. However, it dropped meaningfully in Apr and May due to better-than-expected production in New Zealand and the removal of export quota for European raw milk powder. Oceania whole milk powder price, on average, closed at USD2,419/ton in May 2015, down 10% mom and 42% yoy. It dropped 52% in 2014 but rebounded 36% in 1Q15. Western Europe whole milk powder price, on average, closed at USD2,756/ton in May 2015, down 3% mom and 41% yoy. It dropped 45% in 2014 but rebounded 10% in 1Q15. The stock to use ratio is low vs. the past two years. We expect Oceania raw milk powder price to rebound in 2015 as the inventory declines, and the current whole milk powder price has been at the historical trough since 2009.

Chart 10: Whole Milk Powder Price

Source: Bloomberg

Chart 11: Whole Milk Powder Price Movement (yoy %)

Source: Bloomberg

Spread between domestic and international prices

Domestic raw milk prices has been higher than international raw milk price due to higher feed cost, lower productivity and supply shortage. Our analysis shows that imported milk is RMB1.3-2.4/kg (39-54%) cheaper than domestic raw milk price. As a result, the sharp fall in New Zealand (79% of China import) raw milk powder price in 2014 has resulted in a decline in domestic raw milk price.

Chart 12: Price comparison: International vs. China raw milk price**Price comparison vs. China domestic liquid milk**

NZ milk powder futures price (USD/ton)	2,325	Jun 2015 futures price
Convert to RMB/kg	14.42	
Convert to liquid milk at 1:7.6 (RMB/kg)	1.90	
Price after Import tax (10% maximum) (RMB/kg)	2.09	
China raw milk price (RMB/kg, mid end)	3.40	As of May.2015
China raw milk price (RMB/kg, high end)	4.50	

Spread (RMB/kg) Range from RMB1.3 to 2.4/kg

Source: Bloomberg, Jefferies

Organic food and organic dairy farming

Organic certification implies high entry barrier

Organic food is generally required to be produced without the use of synthetic pesticides, synthetic fertilizers, synthetic hormones, antibiotics, and genetically modified organisms, and also promote animal welfare.

In general, organic certification for dairy farms requires strict requirements on the farm land, with more than 50% of the feed supplied by self-owned or partnered organic farms, and at least six months of organic breeding before milk production. Please refer to Chart 13 below for a detailed description of the requirements for organic certification in Europe and China.

Chart 13: Organic certification requirement for dairy farms

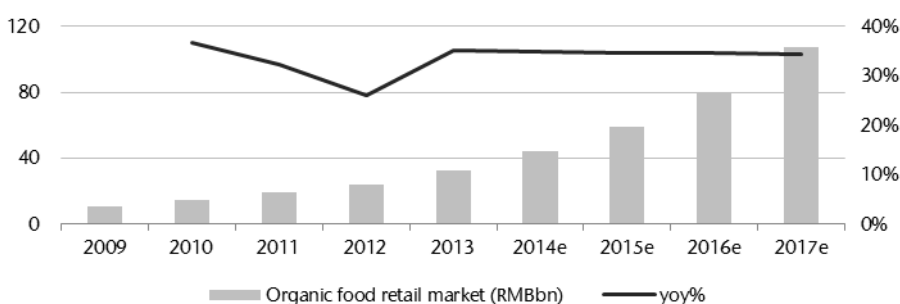
	China	Europe
Farmland	- Far from city, industry/mining area, traffic and other potential pollution. - Requirement for soil, water and air quality	- No pollution risks exist nearby
Feeding	- At least 2 years conversion period - Over 50% feeds from self-owned/partnered organic farms - No synthetic fertilizer	- At least 2 years conversion period before sowing - At least 60% feeds from self-owned/partnered organic farms
Breeding	- At least 6 months conversion period - Natural birth with >3 months suckling period - Active area per cow: 6sqm indorr and 4.5sqm outdoor	- 6 months conversion period - Active area per cow: 6sqm indorr and 4.5sqm outdoor
Production	- Less than 5% non-organic ingredients - No GMO additives	- Less than 5% non-organic ingredients - No GMO additives

Source: Shengmu

Organic food market is small but grows fast

Organic food has a low penetration in China but has been quickly gaining traction in recent years due to the rising awareness on health and food safety, rising living standards, and increasing availability of organic food. The organic food market in China grew from RMB10.6bn in 2009 to RMB32.7bn in 2013, at CAGR of 32.5%. Frost & Sullivan expects the organic food market to grow at CAGR of 34.6% to reach RMB107.5bn in 2017e.

Chart 14: Organic food retail market in China



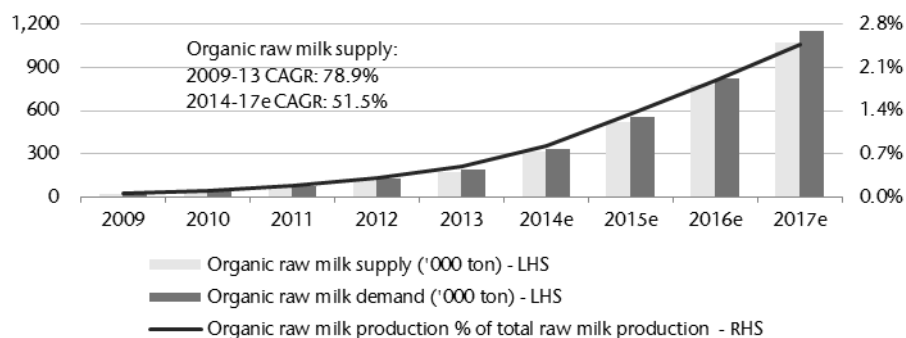
Source: Shengmu, Frost & Sullivan

Organic raw milk production at nascent stage with huge potential

Production of organic raw milk is still in a nascent stage in China. The total organic raw milk production grew from 17k tons in 2009 to 174k ton in 2013, at a CAGR of 78.9%, and accounted for 0.5% of overall raw milk production in China. It is expected to reach 1.08m ton in 2017e and accounts for 2.5% of the market (51.5% CAGR in 2014-17e), according to Frost & Sullivan.

Total demand for organic raw milk follows a similar pattern, reaching 187k tons in 2013, vs. 18k tons in 2009, at CAGR of 79.5%; and is expected to grow at 51.8% CAGR to reach 1.16m tons in 2017e.

Chart 15: Demand and supply of organic raw milk in China



Source: Shengmu, Frost & Sullivan

Key players: Shengmu takes the lead

Organic dairy farming has a high entry barriers due to limited farmland that meets the conditions, long conversion period, limited supply of organic feed, certification and the high capital requirement.

Overall, there were 52,800 heads of organic dairy cows in China in 2013, accounting for 0.4% of the total dairy cow herd size in China. Shengmu has the largest herd size for organic dairy cows, with 30,621 heads in 2013 and 64,769 in 2014. Based on 2013 company data, Shengmu has taken the lead in organic dairy farming with a 58% market share. Yili group has 10,000 heads of organic dairy cows (18.9% of market), while Inner Mongolia Yunhai Qiulin has 4,000 heads (7.6% market share). Other farms have a total of 8,200 heads of organic dairy cows.

In terms of organic raw milk production, Shengmu produced 94,200 tons of organic raw milk in 2013 and accounted for 54.2% of the market. Yili group produced 40,200 tons organic raw milk with 23.1% market share, while Yunhai Qiulin produced 16,700 tons (9.6% market share). Other players produced 22,700 tons and accounted for 13.1% of the market. Shengmu's market share was 62% in organic raw milk production for 2014E.

Chart 16: Organic dairy farming herd size, 2013

	Organic dairy farming company	Organic dairy cow herd size ('000 heads)	% market share
1	Shengmu	30.6	58.0%
2	Yili group	10	18.9%
3	Yunhai Qiulin	4	7.6%
	Others	8.2	15.5%
	Total	52.8	100.0%

Source: Shengmu

Chart 17: Production volume of leading organic dairy farming companies, 2013

	Organic dairy farming company	Organic raw milk production ('000 ton)	% market share
1	Shengmu	94.2	54.2%
2	Yili group	40.2	23.1%
3	Yunhai Qiulin	16.7	9.6%
	Others	22.7	13.1%
	Total	173.8	100.0%

Source: Shengmu

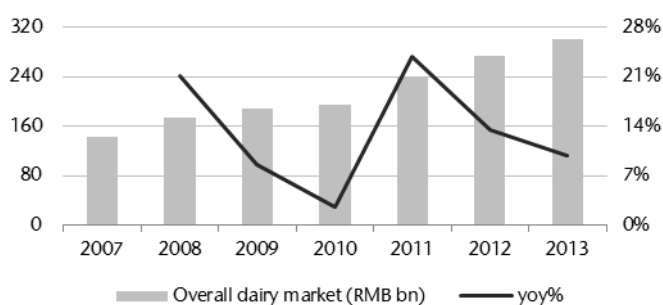
Downstream dairy market

Market overview

Overall retail market for dairy products grew at 12.2% CAGR in 2009-2013 and reached RMB300bn in 2013. Milk powder is the largest sub-category and accounted for 44% of the market. UHT and fresh milk accounted for 36% of the market, followed by yogurt (12%). Other dairy products such as cheese, cream and condensed milk accounted for 8% of the market.

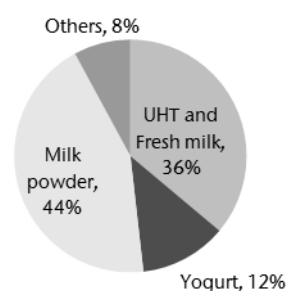
Frost & Sullivan forecasts the overall dairy market will grow at 11.3% CAGR and reach RMB513bn in 2018e, mainly driven by 10.2% CAGR growth for UHT and fresh milk, 11.2% CAGR growth for yogurt, 12.1% for milk powder and 11.8% for other dairy products.

Chart 18: Retail sales value of dairy products in China



Source: Frost & Sullivan

Chart 19: Dairy retail sales breakdown by products, 2013



Source: Frost & Sullivan

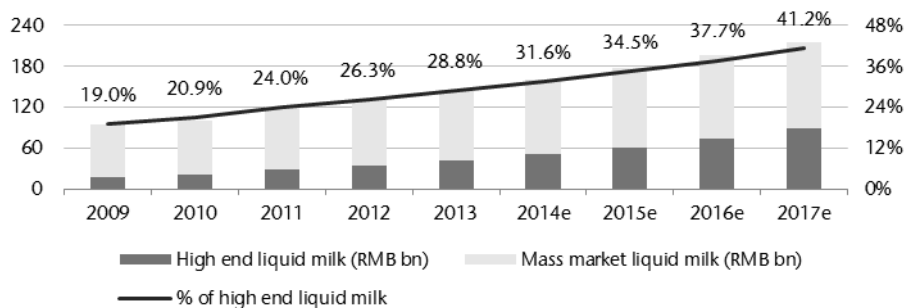
Liquid milk market

Demand

Retail sales of liquid milk (including UHT milk, fresh milk and yogurt) grew at 11.4% CAGR from 2009 to 2013 and reached RMB145bn in 2013. Frost & Sullivan forecast this to grow at 10.4% CAGR in 2014-17e and reach RMB216bn in 2017e.

Driven by the rising awareness for health and food safety, demand for high end liquid milk (retail price >RMB12/liter) enjoyed rapid growth in recent years with a CAGR of 23.5% in 2009-2013. Total retail sales of high end liquid milk reached RMB41.7bn in 2013 and accounted for 28.8% of the liquid milk market in 2013, up from 19% in 2009. Sales of high-end liquid milk is expected to grow at 20.7% CAGR in 2014-17e to reach RMB89m in 17e, and account for 41.2% of the market, according to Frost & Sullivan.

Chart 20: Retail sales of liquid milk

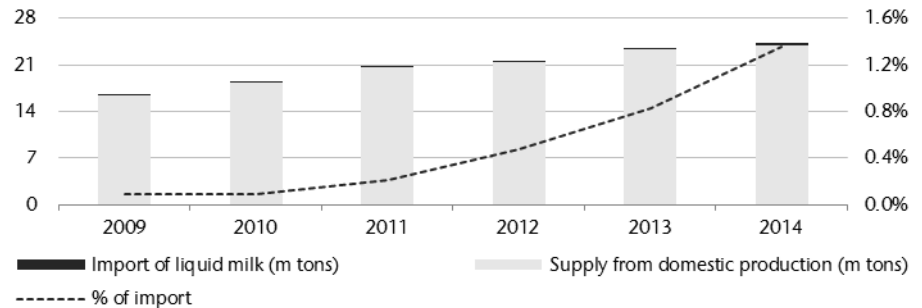


Source: Frost & Sullivan

Supply

The supply of liquid milk in China is mostly met by domestic production. Direct import of liquid milk accounted for 1.4% of liquid milk market by volume in 2014, up from 0.8% in 2013.

Chart 21: Total supply of liquid milk



Source: DAC, Wind, Jefferies

Organic liquid milk market

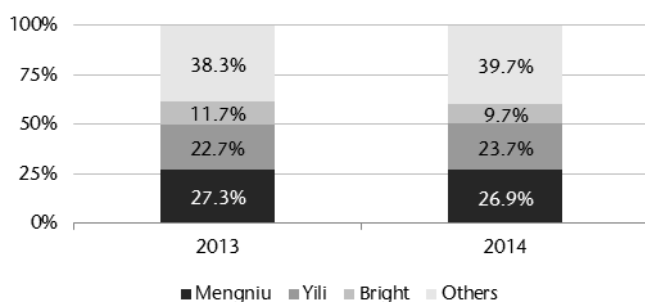
Organic liquid milk is still in a nascent stage in China. The total market size for organic liquid milk reached RMB1.3bn in 2013. It accounted for 1.3% of the liquid milk market and 4.6% of the high end liquid milk market in 2013. Shengmu is becoming a leading player in organic liquid milk market.

Key players and market share

Mengniu (2319 HK, Hold) is the largest liquid milk producer in China with a market share of 26.9% in 2014, vs. 27.3% in 2013. Its strongest rival Yili (600887 CH, NC) has a market share of 23.7% in 2014, up 1ppt from 22.7% in 2013. Bright Dairy (600597 CH) accounted for 9.7% of the market in 2014.

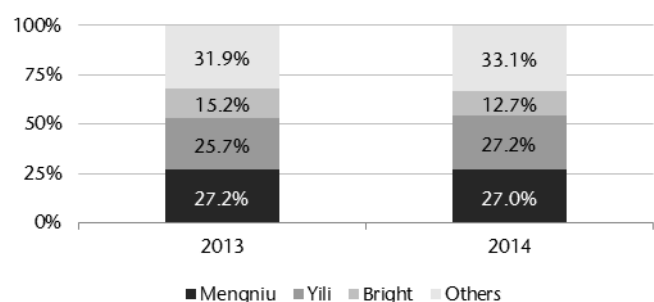
In terms of the UHT milk market, Mengniu's market share was 27% in 2014, vs. 27.2% in 2013. Yili's market share rose 1.5ppt to 27.2% in 2014 from 25.7% in 2013, while that for Bright Dairy was 12.7% in 2014, vs. 15.2% in 2013. It is worth noting that as many upstream players started to expand into downstream dairy market, and imported UHT milk gained popularity (particularly in the ecommerce channel), the total market share for top-three players has decreased from 68.1% in 2013 to 66.9% in 2014.

Chart 22: Liquid milk market share breakdown



Source: Nielsen, Mengniu, Jefferies

Chart 23: UHT milk market share breakdown



Source: Nielsen, Mengniu, Jefferies

Raw materials

Alfalfa

Alfalfa is a key feedstock for dairy cows, providing nutrients and fiber. It is mainly used in large-scale farms with more than 1,000 heads of dairy cows. It typically accounts for c20% of the feedstock costs of dairy cows, according to industry experts.

Domestic production and import

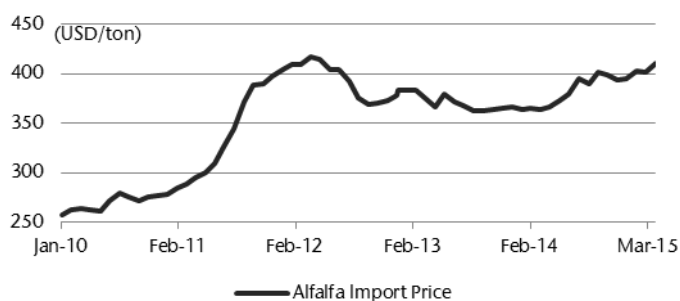
In order to support the domestic plantation of alfalfa, the Ministry of Agriculture and Ministry of Finance jointly implemented the “Development Plan for Alfalfa” with a budget of RMB525m p.a. to support development of 500,000 mu of alfalfa plantation field in 2012-15. Total domestic production of alfalfa in China reached c800,000 tons in 2013, and 1m tons in 2014, according to DAC.

In addition to domestic production, China is also the largest alfalfa importer globally, accounting for 41% of the global import market in 2014. China imported 755,598 tons of alfalfa in 2013 (+70.9% yoy), accounting for c50% of the total supply of alfalfa in China in 2013. Due to the fast expansion of large scale farms, import of alfalfa continued to rise and reached 884,000tons (+17% yoy) in 2014. The US is the largest import source and accounts for 96% of the total imports.

Pricing

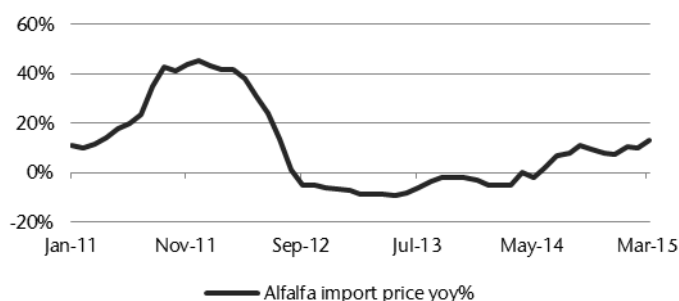
On average, the cost of importing alfalfa into China was USD382/ton in 2014, up 3% yoy. It was on an uptrend in 2H14 and closed at an average of USD396/ton, up 7% hoh and 8% yoy, mainly due to drought in the US alfalfa production region and inventory stocking of US dairy farmers. However, industry experts expect US alfalfa price to decline in 2H15, mainly due to high inventory and lower milk price in US. The domestic alfalfa price is about 30% cheaper lower than imported alfalfa price.

Chart 24: Alfalfa import price to China



Source: DAC

Chart 25: Alfalfa import price movement (yoy %)



Source: DAC

Corn and soybean

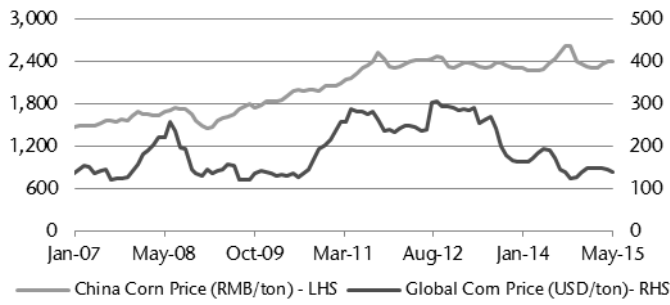
Corn, corn silage, soybean and cotton meal are used as feed for dairy cows to provide proteins, carbohydrates and vitamins for better nutritional quality. These account for about c40% of the cows' daily feed consumption.

Corn price

Global corn price, on average, closed at USD138/ton in May, down 4% mom and 27% yoy, mainly due to a good harvest in the US, which is a major exporter of corn. USDA estimates the stock-to-use ratio for 2014/15e at 19.3% (equivalent to 2.3 months of inventory), above the five-year historical average of 16.3%.

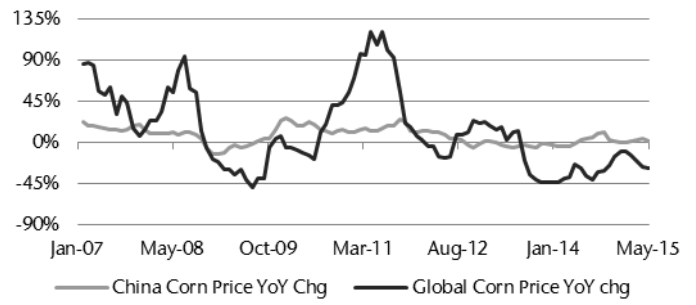
Domestic corn price closed at an average RMB2,414/ton in May, up 0.4% mom and 1% yoy. USDA estimated the stock-to-use ratio for 2014/15e at 36.9% (equivalent to 4.4 months of inventory), above the five-year historical average of 32.1%. China is self-sufficient in corn.

Chart 26: Corn Price – China vs. Global



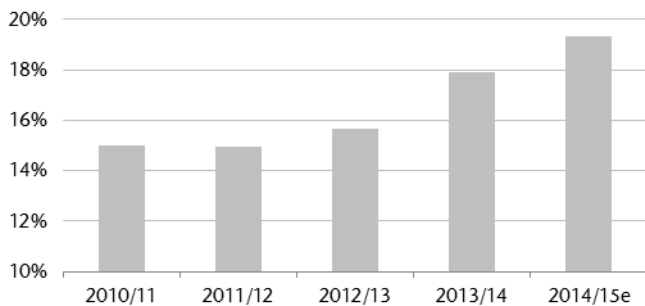
Source: Bloomberg

Chart 27: Corn Price Movement (yoy %)



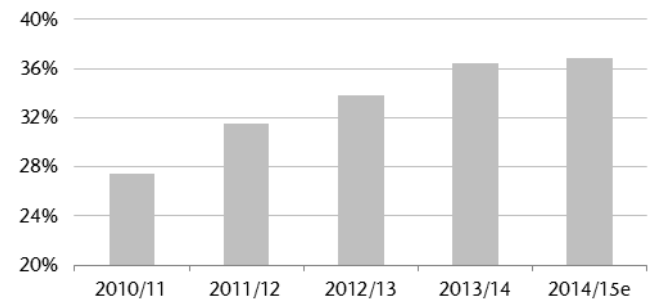
Source: Bloomberg

Chart 28: World Corn Stock to Use Ratio



Source: USDA

Chart 29: China Corn Stock to Use Ratio



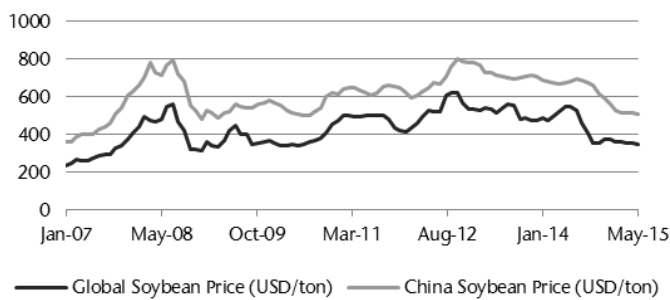
Source: USDA

Soybean price

Global soybean price, on average, closed at USD352/ton in April, down 1% mom and down 36% yoy, due to good harvest in the US. It has been on a downtrend since Jan.2015; USDA estimates the stock-to-use ratio for 2014/15e at 35.3% (equivalent to 4.2 months of inventory), above the five-year historical average of 27.5%. We think it is likely to stay weak before the next plantation season in Spring 2015.

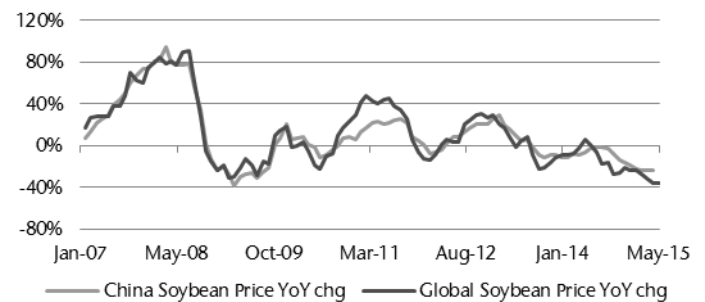
Domestically, soybean price, on average, closed at USD510/ton in May, down 1% mom and 26% yoy. USDA estimates the 2014/15e stock-to-use ratio at 19.3% (equivalent to 2.3 months of inventory), below the five-year historical average of 23.9%. We expect domestic soybean price to be stable or weak in near term albeit a lower inventory since 75% of domestic demand for soybeans is met by imports.

Chart 30: Soybean Price – China vs. Global.

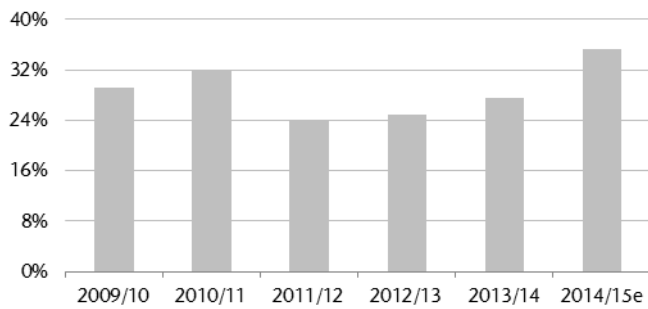


Source: Bloomberg

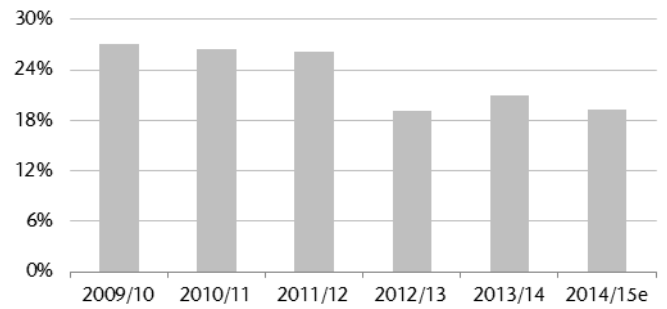
Chart 31: Soybean Price Movement (yoy %)



Source: Bloomberg

Chart 32: World Soybean Stock to Use Ratio

Source: USDA

Chart 33: China Soybean Stock to Use Ratio

Source: USDA

Packaging materials

The main packaging material used for liquid milk products is aseptic paper packaging. The leading suppliers of aseptic paper packaging are Tetra Pak, Greatview Aseptic (468 HK, NC) and SIC Combibloc. Tetra Pak is the largest player in China with c67% market share in 2012, followed by Greatview Aseptic (c13% market share).

Pricing

The market price of aseptic paper packaging has been stable in the past few years. The average market price for 250ml packaging increased from RMB0.205/pack in 2009 to RMB0.215 in 2013, at CAGR of 1.2%. Prices for Tetra Pak's products are generally 30-40% more expensive than other players' due to better quality, patent technology and strong reputation.

Regulations and policies

Dairy farming and import of cows

Policies and regulation

As a key agriculture product, the central government has framed several policies to promote and support the development of the dairy farming industry, including the “Development Plan of Major Dairy Cow farming regions (2008-2015)”, and “Several Opinions of MOA Concerning the Acceleration of the Work of Promoting Standardized Large Scale Raising and Breeding of Livestock and Poultry” issued by MOA in Jan 2010.

The breeding of dairy cows is governed by the “Husbandry Law of PRC”, which requires dairy farms to submit records to the county government. In the case of an animal epidemic, the “Law on Animal Epidemic Prevention” requires dairy farms to report the incident to the relevant authorities and take measures to prevent its spread. The county level government or above compensate the farms if the herd is eradicated.

Government grants

The government provides various subsidies to encourage large-scale farming and modernization of farming technology.

The government provided a total RMB1.5bn in subsidies to improve the breed of dairy cows in 2005-2012. The subsidy varies by province, but on an average the government provides a subsidy of cRMB1,500/head for each heifer imported, which translates to about 8% of the average import cost per heifer (cUSD3,000/head in 2012).

To encourage the setting up of large-scale farms, the government also provides a subsidy of RMB500k for dairy farms with >200 dairy cows. The government also spent RMB556m on machinery subsidies for dairy farms in 2009-2012.

In order to improve the dairy cow breed, the government also provides subsidy of RMB10 per tube of imported frozen semen. Local governments also provide various grants to attract investment in large-scale farms.

Downstream dairy production

Policies and regulation

The downstream dairy production industry is mainly governed by the “Dairy Product Industrial Policies (2009)”. It specifies certain admission conditions for new dairy producers, e.g. requiring new dairy product processing projects to secure over 40% of raw milk from stable and controllable sources, while that for milk powder should be over 50%.

The safety of dairy products is governed by the “Regulation on the Supervision and Administration of the Quality Safety of Dairy Products”, which specifies that the dairy primary responsibility for the quality and safety of dairy products rests on the producer. The “Food Safety law of the PRC” also regulates the industry via various measures to improve food safety.

Waste control and pollution

As dairy farms produce a large amount of waste, they are regulated by the environmental protection law, including “The Environment Protection Law of the PRC”, and “The Law of the PRC on Prevention and Control of Water Pollution/Atmospheric Pollution/Pollution by Solid Wastes”. In addition, the “Environmental Impact Appraisal Law” requires construction projects to engage professional institutions and provide assessment reports on their environmental impact.

These laws and regulations require enterprises engaged in manufacturing and construction activities that may produce environmental waste to adopt measures to effectively control and properly dispose of waste gases, waste water, industrial waste, dust

and other environmental waste materials, as well as require fee payments from producers discharging waste substances.

The administrative department for environmental protection can levy fines if the company breaches these laws. For serious breaches, the PRC government may suspend or close any operation failing to comply with such laws or regulations.

Large-scale farms need to invest in waste processing facilities to avoid pollution. Dairy farms with 1,000-4,000 dairy cows are more cost-effective in waste processing and controlling the environmental impact.

Business Model: Vanguard in organic segment aided by vertical integration

Shengmu is one of the only two large scale domestic dairy companies with a vertical integrated business model (the other being Huishan Dairy 6863 HK), sourcing a majority of its feed from associate company Shengmu Forage (9% owned by Shengmu listco with >20% voting power), and producing its own branded organic liquid milk.

Shengmu is the largest organic dairy farming company in China with 62% market share in organic raw milk production in 2014E. The unique environment in Ulan Buh desert in Inner Mongolia enables the company to build organic dairy farms (please refer to Page 19 for a detailed discussion).

Chart 34 analyses the company's strengths, weaknesses, opportunities and threats. Chart 35 illustrates the major players in each of the value chain of the dairy production business

Chart 34: SWOT Analysis of Shengmu

Strengths	Opportunities
1) Vertical integration enable strong quality control and lower costs 2) Unique location helps building of organic farms 3) Unique positioning as the only vertically integrated organic milk producer in China	1) Rising demand for organic liquid milk 2) Rising demand for high quality raw milk 3) Expansion into organic infant formula business 4) Market share expansion in downstream liquid milk
Weaknesses	Threats
1) Short track record 2) Lower brand recognition nationally compared to large players 3) Regulatory risks	1) Decline in domestic raw milk price 2) Rising raw milk supply from other large scale farms 3) Rising competition in downstream dairy market 4) Animal pandemic 5) Potential food safety scandal

Source: Jefferies

Chart 35: Industry value chain integration by companies

	Forage growing	Dairy farming	Downstream dairy production and sales
Shengmu (1432 HK)	√	√	√
Huishan (6863 HK)	√	√	√
Bright (600597 CH)		√	√
China Modern Dairy (1117 HK)		√	√
New Hope (Not listed)		√	√
Weigang (Not listed)		√	√
YuanShengTai (1431 HK)		√	√
Mengniu (2319 HK)			√
Yili (600887 CH)			√
Sanyuan (600429 CH)			√
Wondersun (Not listed)			√

Source: Shengmu, Jefferies

Note: √ indicates > 50% of feed from own/controllable sources or >50% of raw milk supplied by own/controllable farms

Unique location is a key competitive advantage

Shengmu's organic dairy farms are located in the Ulan Buh desert in Inner Mongolia. The Ulan Buh desert (乌兰布和沙漠) has the following desirable factors that make it suitable for organic farming. These features are not easy to be substituted by other competitors or in other locations.

- It is located within the Golden Raw Milk Belt (between 40° and 47° north latitude). The Golden Raw Milk Belt in China (the Northeast, Inner Mongolia and Xinjiang Autonomous regions) is the key raw milk production region due to its cool and dry weather that suits dairy farming. Ulan Buh desert has an annual average temperature of 7.8°C (vs. the favourable temperature of 0°C to 15°C for dairy cows) and annual average rainfall of 103mm.
- Pangu Group, controlled by the family of Shengmu's president Mr. Wu Jianye, has been rolling out large scale greening effort in the Ulan Buh desert since 1997 and has planted tens of million trees the region, which reduced dust storms, improving the overall environment and enabling large scale plantation of organic forage.
- The Ulan Buh desert has limited human activity, little pollution and very low levels of bacteria, viruses and pests.
- The land underneath the sandy surface of Ulan Buh desert is formed by the alluviation of the Yellow River. Thus there is rich soil and abundant shallow underground water underneath the sandy surface.
- It has ample sunlight of 3,200 hours p.a. with solar radiation of 6,280 MJ/sqm, which aids the growth of forage crops and helps cows produce a higher level of calcium in the milk produced.
- Due to the limited human activities in the Ulan Buh desert, there is ample room for expansion for both organic dairy farms and organic forage fields.
- The soft and breathable desert sand provides comfortable lying ground for cows to rest, reducing their chances of developing limping disease.
- Shengmu has gained strong support from the local government and has secured sufficient amount of land for its medium expansion blueprint.

Chart 36: Location of Ulan Buh Desert

Source: Jefferies

Vertical integration ensures better control and high margin

In-house feed processing plant

Shengmu Dairy (listco) set up a concentrated feed processing plant in 2013, which is located within c80km to its organic dairy farms. All the organic concentrated feed used in feeding are supplied from this in-house plant. It has an annual production capacity of c50,000 tons of organic concentrated feed, and a maximum annual production capacity of 200,000 tons which can provide supplies to 120,000 dairy cows.

Chart 37: Raw material supply

Organic feed	Suppliers
- Corn silage and alfalfa	Shengmu Forage
- Guinea grass	Several local suppliers
- Concentrated feed	Shengmu Forage and other local suppliers
Non-organic feed	Suppliers
- Corn silage, alfalfa and guinea grass	Several local suppliers and import
- Concentrated feed	Several local suppliers
Others	Suppliers
- Packaging materials	Tetra Pak and several local suppliers
- Frozen Semen	Import from North America

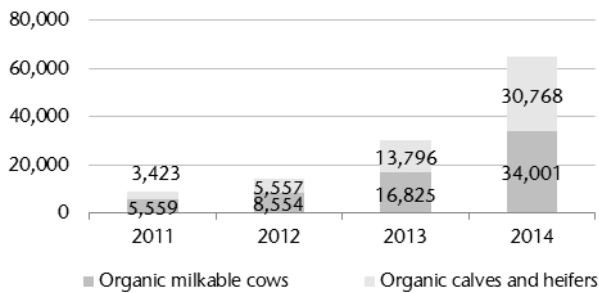
Source: Company data

Dairy farming

Shengmu had 19 organic dairy farms located in the Ulan Buh desert and 12 non-organic dairy farms located in Huhhot, Inner Mongolia as of December 2014. A majority of its dairy farms have a capacity to house 2,500-4,500 dairy cows, vs. >5,000 heads per farm for China Modern Dairy and c3,000 heads per farm for Huishan.

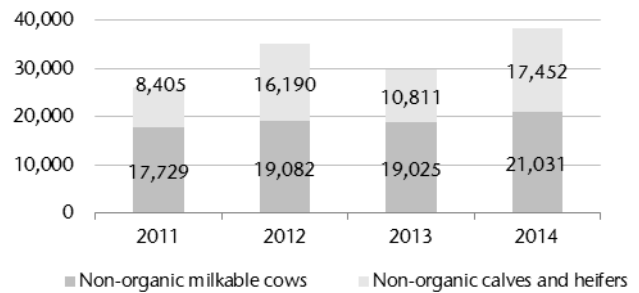
Shengmu had 103,252 dairy cows (64,769 organic dairy cows and 38,483 non-organic dairy cows), of which 55,032 (53.2% of herd size) were milkable cows (34,001 organic milkable cows and 21,031 non-organic milkable cow). All of the dairy cows are Holsteins, which generally have higher milk yield than other breeds. The company will rely on internal herd growth and does not plan to import heifers.

Chart 38: Organic dairy cow herd size



Source: Company data

Chart 39: Non-organic dairy cow herd size

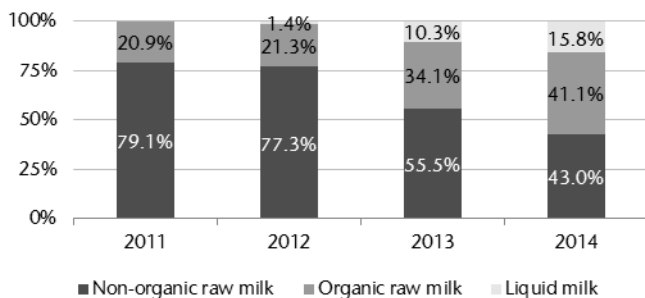


Source: Company data

Raw milk production and sales

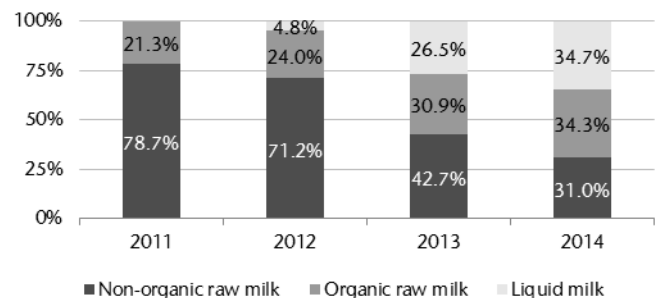
Shengmu Dairy engages in the sale of both upstream raw milk and downstream organic liquid milk. Its organic liquid milk business has been growing rapidly since its entry in the market in 2012, and accounted for 18.0% of sales volume and 34.7% of group revenue in 2014. Organic raw milk accounted for 41.1% of sales volumes and 34.3% of group revenue in 2014, while non-organic raw milk accounted for 42% of sales volumes and 31% of revenue.

Chart 40: Sales volume breakdown



Source: Company data

Chart 41: Revenue breakdown



Source: Company data

Raw milk delivery, key customers and relationship with Mengniu

Shengmu employs third-party logistic providers to transport raw milk produced to its customers. There is a strict requirement on the number of trucks, sanitary conditions, and delivery time-frame. In addition, trucks that have been used to deliver milk with antibiotic residuals are prohibited to deliver its raw milk.

Shengmu's raw milk is mainly sold to Mengniu, Yili and Want Want. Mengniu has been its largest external customer, accounting for 94.6%, 58.3% and c50% of its overall revenue in 2012, 2013, 2014, respectively. Shengmu has a long history and deep relationship with

Mengniu. Most of the founders of Shengmu Dairy have been ex-employees of Mengniu. In addition, Mengniu has 4.3% shareholding in Shengmu Dairy. Since 2014, Shengmu has made serious efforts to grow its own-branded organic milk brands and the proportion of raw milk sold internally continues to rise.

Organic liquid milk production and sales

The company entered the organic liquid milk business in June 2012 under the brand “Shengmu 圣牧”. All the organic liquid milk products are made from organic raw milk produced in its own farms, and processed in its own processing plant. Its own processing plant is located within 100km (c.1.5 hour driving distance) from the organic dairy farms, with key equipment purchased from Tetra Pak. It has a liquid milk daily production capacity of 330 tons in early 2014. It targets to expand daily production capacity to 1,150 tons.

It currently has four product series: organic whole milk (launched in Jun.12), organic low fat milk (launched in Jan.13), organic whole milk for children (launched in Jan.13) and organic yogurt (launched in Jul.14). These are UHT milk variants with a six-month shelf life. They were awarded the Gold Medal of BioFach China International Organic Trade Fair and Conference (中國國際有機食品博覽會金獎) in recognition of the premium quality for three consecutive years since 2011.

Chart 42: Shengmu’s organic liquid milk products

	Organic whole milk	Organic low-fat milk	Organic children's milk	Organic yogurt
Launch date	Jun.2012	Jan.2013	Jan.2013	Jul.2014
Suggested retail price per 250ml	RMB6-8.2	RMB7.3-9	RMB7.5	RMB6.6 per 205g

Source: Company data, Jefferies

Liquid milk distribution and marketing

Shengmu’s liquid milk is distributed mostly through regional distributors, while a tiny portion is sold directly to consumers via VIP card membership and corporate wholesale in Huhhot and Beijing. Its products are distributed nationally. In terms of marketing, Shengmu engages in active marketing activities such as television commercials (e.g. on CCTV), in-flight media (e.g. Air China flights), online advertisements. It also plans to open “Shengmu Organic Life Houses” to show the processing techniques of yoghurt to consumers and attract consumer to the organic concept.

Future strategy

On the upstream business, Shengmu plans continuing expansion with the number of organic farms reaching 34 by 2016 (from 19 in 2014). For the liquid milk production, it plans to increase the daily processing capacity to 1,150 tons and introduce more liquid milk products. It will stick to vertical integrated business model with a focus on organic milk production and organic milk brands. Raw milk sold to external clients should reduce gradually.

In addition, it plans to continue expand its distribution channels via engaging more distributors, in particular strengthen its distribution network in tier 3 and tier 4 cities. More marketing activities are planned to increase its brand awareness.

Financial Analysis

Shengmu has experienced rapid growth in the past few years, generating sales revenue of RMB1.1bn in 2013 and RMB2.1bn 2014, and core net profit of RMB 318mn in 2013 and RMB624m in 2014.

We expect sales to increase 61.2% yoy to RMB3.4bn in 2015e and 39.6% yoy to RMB4.8bn in 2016e, mainly driven by strong growth in liquid milk sales and external sales of organic milk.

We expect gross profit margin to remain stable at 50.3% in 2015e and 50.9% in 2016e vs. 50.2% in 2014. We assume high marketing expenses and promotion in order to expand liquid milk business. Thus, EBIT margin is expected to drop mildly to 36.4% in 2015e from 40.4% in 2014. We forecast core net profit (excluding fair value changes on biological assets) to grow 51.0% yoy to RMB942m in 2015e and 37.3% yoy to RMB1.3bn in 2016e. These suggest core net margin to reach 27.4% (-1.8ppt yoy) in 2015e and 27.0% (-0.4ppt yoy) in 2016e. Our 2015e sales forecast is 5.6% higher than consensus median and 2015e core net profit forecast is 2.4% below consensus median.

Shengmu's net gearing was healthy at 17.2% in 2014; we expect this to remain healthy at 22.7% in 2015e. It had been generating negative free cash flow in the past few years. We expect FCF to turn positive in 2017e.

Dairy farming

Number of dairy cows

Shengmu had 103,252 dairy cows (64,769 organic dairy cows and 38,483 non-organic dairy cows), of which 55,032 (53.3% of herd size) were milkable cows (34,001 organic milkable cows and 21,031 non-organic milkable cows).

We expect the non-organic dairy cows herd size to remain stable at 39,922 heads (+3.7% yoy) in 2015e, of which 23,806 heads (59.6% of non-organic cows) are milkable cows. This is mainly due to the continuing conversion of non-organic cows (mainly heifers) to organic cows as the company focuses on the organic business. We expect the company to have 40,888 heads of non-organic dairy cows in 2016e, of which 25,491 heads are milkable cows (62.3% of non-organic cows).

We expect the organic dairy cows herd size to increase to 84,615 heads in 15e, of which 47,077 heads (55.6% of organic cows) are milkable cows. We expect 107,027 heads of organic dairy cows in 2016e with 61,919 heads milkable cows (57.9% of organic cows).

Milk yield

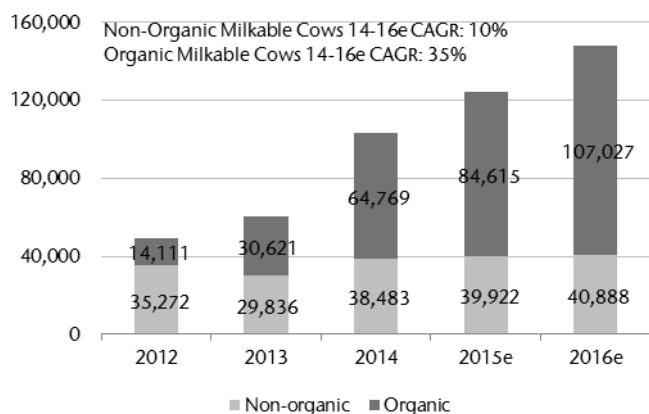
Shengmu reported milk yield of 8.5 tons per lactation period in 2013 and 2014. We expect 1% yoy increase in the milk yield in 2015e and 2016e.

Production volume

Shengmu's non-organic dairy farms produced 139k tons (+24.9% yoy) of non-organic raw milk in 2014. We expect that to reach 159k tons in 2015e (+14.6% yoy) and 177k tons (+11.2% yoy) in 2016e.

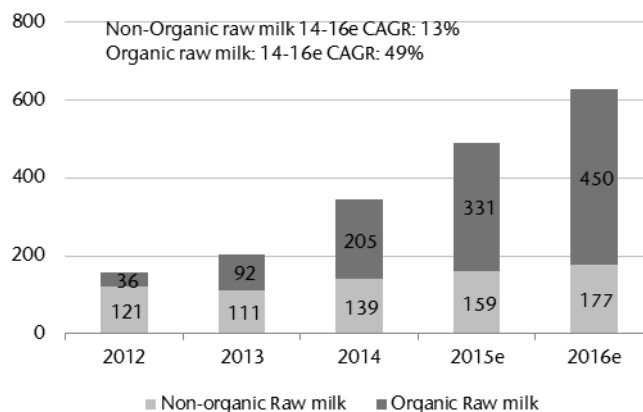
Total production volume for organic raw milk rose 122.6% yoy to 205k tons in 2014. We expect this to reach 331k tons in 2015e (+61.1% yoy) and 450k tons (+35.8% yoy) in 2016e.

Chart 43: Dairy cows herd size (head)



Source: Company data, Jefferies estimates

Chart 44: Production volume ('000 tons)



Source: Company data, Jefferies estimates

Sales revenue

Total sales grew from RMB389m in 2011 to RMB2.1bn in 2014, at a CAGR of 76% during the period, thanks to the growth in herd size, and the buildup of liquid milk business.

As the company continued to develop its organic farming and downstream business, the sales contribution of non-organic raw milk dropped from 71.2% in 2012 to 31% in 2014, while the organic raw milk business contributed 34.3% in 2014 vs. 24% in 2012. Organic liquid milk business emerged as the largest sales contributor, accounting for 34.7% of group sales in 2014, vs. 4.8% in 2012.

We expect group sales to reach RMB3.4bn (+61.2% yoy) in 2015e and RMB4.8bn (+39.6% yoy) in 2016e, driven by the following:

- External sales of non-organic raw milk to reach RMB724m (+9.4% yoy) in 2015e and RMB821m (+13.4% yoy) in 2016e. We expect its contribution to group sales to reach 21.1% in 2015e and 17.1% in 2016e.
- We expect external sales of organic raw milk to reach RMB1.1bn (+48.1% yoy) in 2015e and RMB1.3bn (+19.3% yoy) in 2016e. We expect its contribution to group sales to reach 31.5% in 2015e and 26.9% in 2016e.
- Downstream sales of organic liquid milk to reach RMB1.6bn (+120.3% yoy) in 15e and RMB2.7bn (+64.8% yoy) in 2016e. We expect its contribution to group sales to reach 47.4% in 2015e and 55.9% in 2016e.

Non-organic raw milk sales

The ASP for non-organic raw milk reached RMB4.75/kg in 2014, up 8.5% yoy from RMB4.38/kg in 2013. We expect this to decline 4.5% yoy to RMB4.5/kg in 2015e, in line with the weakening raw milk price trend nationally, but rebound 2% yoy to RMB4.6/kg in 2016e.

Shengmu sold a total of 139k tons (+24.9% yoy) of non-organic raw milk in 2014. Our herd size and milk yield assumptions suggest sales volume of 159k tons (+14.6% yoy) in 2015e and 177k tons (+11.2% yoy) in 2016e.

These suggest sales of RMB724m (+9.4% yoy) in 2015e and RMB821m (+13.4% yoy) in 2016e from external sales of non-organic raw milk.

Organic raw milk sales to external customers

Shengmu's organic raw milk had an ASP of RMB5.51/kg in 2014, up 6.9% yoy from RMB5.15/kg in 2013. We expect this to remain stable at RMB5.51/kg in 2015e-2016e, due to the limited supply of organic raw milk nationally.

Shengmu sold a total of 133k tons (+94.0% yoy) of organic raw milk to external customers in 2014. We expect sales volumes of 197k tons (+48.1% yoy) in 2015e and 235k tons (+19.3% yoy) in 2016e.

These suggest sales of RMB1.1bn (+48.1% yoy) in 15e and RMB1.3bn (+19.3% yoy) in 2016e from external sales of organic raw milk.

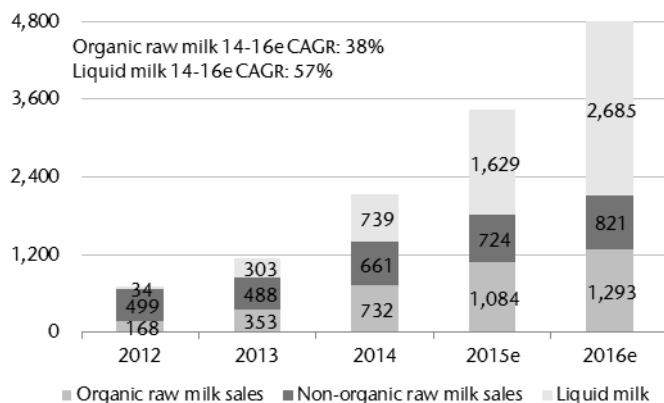
Organic liquid milk sales

Shengmu sold a total of 51k tons (+147.4% yoy) of organic liquid milk in 2014, mainly driven by continuing penetration of its products and the newly launched organic yogurt. We expect sales volumes to grow 123% yoy to 114k tons in 15e, and 60% yoy to 182k tons in 16e.

Its liquid milk had an ASP of RMB14.4/kg in 2014, vs. RMB14.6/kg in 2013. We forecast ASP of RMB14.3/kg (-1% yoy) in 15e and RMB14.7/kg (3% yoy) in 16e.

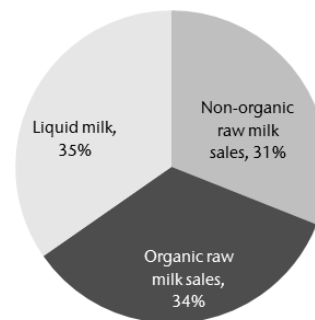
We expect Shengmu to generate sales of RMB1.6bn (+120.3% yoy) in 2015e and RMB2.7bn (+64.8% yoy) in 2016e from downstream sales of organic liquid milk.

Chart 45: Group sales



Source: Company data, Jefferies estimates

Chart 46: Sales contribution breakdown in FY14



Source: Company data, Jefferies estimates

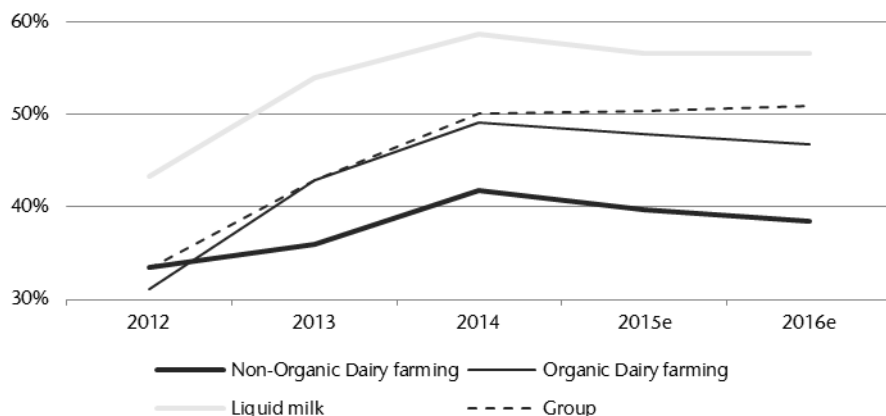
Gross Margin

Group gross margin increased from 33.4% in 2012 to 42.9% in 2013 and 50.2% in 2014, mainly driven by the rising raw milk price and product mix change.

We expect group gross margin to reach 50.3% (+0.1ppt yoy) in 2015e and 50.9% (+0.6ppt yoy) in 2016e vs. 50.2% in 2014.

- We expect gross margin from the external sales of non-organic raw milk to reach 39.7% in 2015e and 38.5% in 2016e, vs. 41.8% in 2014, mainly due to the price drop of raw milk price.
- Gross margin from external sales of organic raw milk is expected to reach 47.9% in 2015e and 46.7% in 2016e, vs. 49.1% in 2014 and 43% in 2013, mainly due to rising organic feeds costs.

- We expect gross margin for liquid milk (taking consideration of vertical integration) to reach 56.7% in 2015e and 2016e, vs. 58.7% in 2014 and 54.0% in 2013, mainly due to rising raw milk costs.

Chart 47: Gross margin of each business segment

Source: Company data, Jefferies estimates

Margin Analysis

Our sensitivity analysis suggests that a 3% increase in ASP, other factors remaining unchanged, could increase GP margin of organic segment by 0.6ppt and group GP margin by 0.5ppt in FY15e. A 1ppt increase in milk yield could increase GP margin of organic segment and group by 0.2ppt in FY15e (see Table below).

Chart 48: Milk yield and ASP sensitivity to GP margin of organic segment, FY15e

ASP yoy%	Milk yield yoy%				
	-1.0%	0.0%	1.0%	2.0%	3.0%
-6.0%	51.6%	51.8%	52.0%	52.3%	52.5%
-3.0%	52.1%	52.4%	52.6%	52.8%	53.1%
0.0%	52.7%	52.9%	53.2%	53.4%	53.6%
3.0%	53.3%	53.5%	53.7%	54.0%	54.2%
6.0%	53.8%	54.0%	54.3%	54.5%	54.8%

Source: Jefferies estimates

Chart 49: Milk yield and ASP sensitivity in the organic segment to group GP margin, FY15e

ASP yoy%	Milk yield yoy%				
	-1.0%	0.0%	1.0%	2.0%	3.0%
-6.0%	49.0%	49.2%	49.4%	49.6%	49.8%
-3.0%	49.5%	49.7%	49.9%	50.1%	50.3%
0.0%	49.9%	50.1%	50.3%	50.5%	50.7%
3.0%	50.4%	50.6%	50.8%	51.0%	51.2%
6.0%	50.8%	51.1%	51.3%	51.5%	51.7%

Source: Jefferies estimates

Operating expenses

Total operating expenses reached RMB230m (+136.3% yoy) in 2014, while operating expenses/sales ratio increased from 8.5% in 2013 to 10.8% in 2014, as Shengmu continued to build dairy farms and expand the downstream business.

We expect operating expenses to reach RMB509m (14.8% of sales) in 2015e and RMB768m (16.0% of sales) in 2016e, as the company continues to build organic dairy farm and expand the liquid milk business.

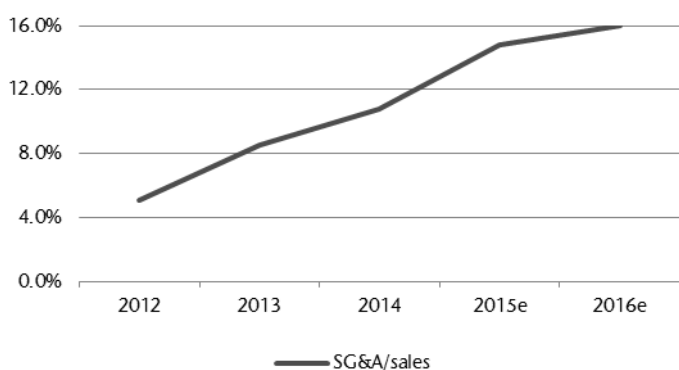
The company recorded other income of RMB22m (1% of sales) in other income (excl. interest income, mainly from RMB16.2m government grant). We forecast other income of RMB31m (0.9% of sales) in 2015e and RMB38m (0.8% of sales) in 2016e.

Operating profit

Operating profit (not including fair value changes in biological assets) rose from RMB205m in 2012 to RMB400m in 2013 (+95.2% yoy) and RMB862m in 2014 (+115.8% yoy). Operating margin expanded from 29.2% in 2012 to 34.9% in 2013 (+5.7ppt yoy) and 40.4% in 2014 (+5.5ppt yoy), as higher operating expenses/sales ratio partly offsets gross margin expansion.

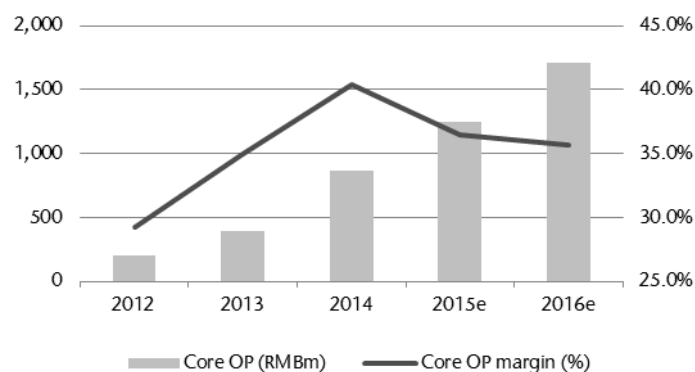
We expect operating profit to grow 45.2% yoy to RMB1.25bn in 2015e and 36.8% yoy to RMB1.7bn in 2016e. This suggests operating margin of 36.4% (-4.0ppt yoy) in 2015e and 35.7% (-0.7ppt yoy) in 2016e.

Chart 50: Operating expenses/sales ratio



Source: Company data, Jefferies estimates

Chart 51: Operating profit and margin



Source: Company data, Jefferies estimates

Gain from changes in fair value of biological assets

Shengmu recorded a gain of RMB87.1m from fair value changes of dairy cows in 2014, vs. gain of RMB9.5m in 2013. This is a non-core gain and we do not include this in our forecast.

Net finance cost

The company recorded interest income of RMB6m in 2014, suggesting an effective interest rate of 1.4%.

Its total debt amounted to RMB1.5bn in 2014, vs. RMB932m in 2013. It incurred interest charges of RMB60m in 2014 vs. RMB33m in 2013, which suggests an interest rate of 5% and 5.2%, respectively.

We forecast net finance cost of RMB76m in 2015e and RMB101m in 2016e, vs. RMB54m in 2014.

Income tax

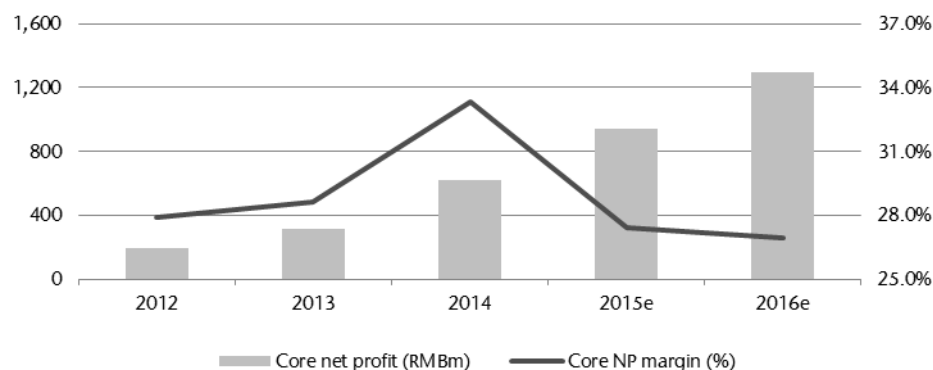
Shengmu paid income tax of RMB4m in 2014 and RMB1m in 2013, suggesting effective tax rate of 0.4% and 0.2%, respectively, as the dairy farming business as well as white milk is tax exempted by the government in an effort to support the agriculture industry.

We expect effective tax rate of 0.5% in 15e and 16e, and forecast income tax of RMB6m in 15e and RMB8m in 16e.

Core net profit

Putting all the analysis above together, we expect core net profit (excluding gain/loss from changes in fair value of biological assets) of RMB942m (+51.0% yoy) in 2015e and RMB1.29bn (+37.3% yoy) in 2016e, vs. RMB624m in 2014 and RMB318m in 2013. This suggests core net margin of 27.4% (-1.8ppt yoy) in 2015e and 27.0% (-0.4ppt yoy) in 2016e, vs. 29.3% in 2014 and 27.8% in 2013. Our 2015-16e core net profit is in line with the consensus'.

Chart 52: Core net profit and margin



Source: Company data, Jefferies estimates

Returns

Shengmu achieved ROE of 23.9% in 2014 and 2013, which is higher than peers mainly due to higher asset turnover ratio. Our forecasts suggest ROE of 22.5% in 2015e and 24.4% in 2016e.

Chart 53: Du Pont Analysis

	2012	2013	2014	2015e	2016e
Net Margin	27.3%	27.8%	29.3%	27.4%	27.0%
Asset Turnover	46.8%	46.4%	44.4%	46.8%	51.4%
Leverage	1.48	1.85	1.84	1.75	1.76
ROE	18.9%	23.9%	23.9%	22.5%	24.4%

Source: Company data, Jefferies estimates

Cash cycle

Inventory turnover days increased from 151 days in 2013 to 178 days in 2014; we expect this to reach 163 days in 2015e.

Trade receivable turnover days increased to 39 days in 2014 from 14 days in 2013; we expect this to reach 43 days in 2015e.

Trade payable turnover days increased to 106 days in 2014 from 90 days in 2013; we expect this to reach 100 days in 2015e.

Overall cash conversion cycle was 112 days in 2014, vs. 74 days in 2013. We expect a cash conversion cycle of 106 days in 15e and 97 days in 16e.

Chart 54: Working capital management

	2012	2013	2014	2015e	2016e
Inventory days	120	151	178	163	153
Receivable days	9	14	39	43	39
Payable days	85	90	106	100	96
Cash cycle	45	74	112	106	97

Source: Company data, Jefferies estimates

Balance sheet and cash flow

Shengmu had a net debt position of RMB733m in 2014 vs. RMB790m in 2013. We forecast net debt of RMB1.2bn in 15e and RMB1.5bn in 16e. It had a net gearing of 17.2% in 2014, which is lower than 46.3% in 2013 after the listing in July 2014. We forecast net gearing of 22.7% in 15e and 21.8% in 16e.

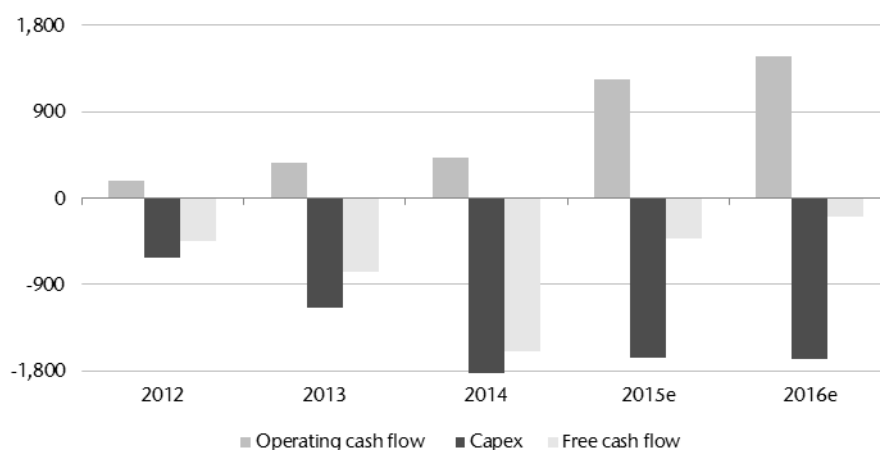
Capital expenditure and free cash flow

Capex

Shengmu's Capex includes addition of property, plant and equipment, purchase of dairy cows and lease prepayments and breeding costs for heifers and calves. It incurred capex of RMB1.1bn in 2013 and RMB2.0bn in 2014. We forecast capex of RMB1.7bn in 2015-16e.

Free cash flow

Due to the capital-intensive nature of dairy farming and the rapid growth of its farm and herd size, Shengmu has been generating negative free cash flow in the past few years, at –RMB772m in 2013 and –RMB1.6bn in 2014. Our forecasts suggest negative free cash flow of RMB423m in 15e and RMB196m in 16e. We expect FCF to turn positive in 17e.

Chart 55: Operating cash flow, Capex and free cash flow (RMBm)

Source: Company data, Jefferies estimates

Peer comparison

Herd size

China Modern Dairy (1117 HK, Buy) is the largest dairy farming company in China with 201,507 heads of dairy cows as of 2014. Huishan (6863 HK, Buy) is the second largest with 144,191 heads as of FY14 (end March 2014), followed by Shengmu with 103,252 heads and YST dairy (1431 HK, NC) with 44,623 heads.

Chart 56: Herd size comparison

	2013	2014	2015e
Shengmu	60,457	103,252	124,538
China Modern Dairy	186,838	201,507	208,461
Huishan	112,851	144,191	186,833
YuanShengTai	40,396	44,623	NA

Source: Company data, Jefferies estimates

Note: Huishan's figures are for the year ended March, i.e. 2013 refer to FY13 ended in Mar.2013.

Milk yield

All listed companies have high milk yield. YST has the highest milk yield of 9.4tons, followed by Huishan (9 tons) and CMD (8.9 tons). Shengmu has the lowest milk yield amongst the listed peers, mainly due to the lower yield for its organic dairy cows.

Raw milk ASP

Shengmu's organic raw milk had the highest ASP of RMB5.5/kg in 2014. CMD, Huishan and YST dairy had ASP of RMB5.0-5.1/kg for their raw milk, while the non-organic raw milk from Shengmu had a slightly lower ASP of RMB4.8/kg.

Sales contribution from upstream

YST purely focuses on upstream farming. While CMD's downstream business has been growing rapidly, its upstream still contributed 83.4% of group sales in 2014. Shengmu's upstream contributed 65.3% of sales, while Huishan's upstream sales contributed only 28%.

Chart 57: Raw milk ASP comparison

	2013	2014	2015e
Shengmu - organic	5.2	5.5	5.5
Shengmu - non-organic	4.4	4.8	4.6
China Modern Dairy	4.6	5.0	4.5
Huishan	4.5	5.0	4.9
YuanShengTai	4.8	5.1	NA

Source: Company data, Jefferies estimates

Note: Huishan's figures are for the year ended March, i.e. 2013 refer to FY13 ended in Mar.2013.

Chart 58: Sales contribution from upstream (external sales of raw milk)

	2013	2014	2015e
Shengmu	73.5%	65.3%	52.6%
China Modern Dairy	90.2%	83.4%	73.4%
Huishan	26.7%	28.0%	29.3%
YuanShengTai	100.0%	100.0%	NA

Source: Company data, Jefferies estimates

Note: Huishan's figures are for the year ended March, i.e. 2013 refer to FY13 ended in Mar.2013.

Group GP margin comparison

Huishan had the highest GP margin of 62.4% in 2014 (both upstream and downstream GPM are the highest amongst peers), partly due to its vertically integrated business model. Shengmu had a GP margin of 50.2%, followed by YST dairy (45.7%) and CMD (37.1%).

Upstream GP margin comparison

Huishan had the highest GP margin of 62% on upstream, partly due to its vertically integrated business model as it produces alfalfa, corn internally. Shengmu and YST dairy had a GPM margin of 45.6-45.7%, while CMD delivered GP margin of 37.9%. We performed a detailed pro-forma analysis as follows for explanations of GP margin difference between Shengmu and CMD, using 2014 figures.

1) Shengmu's GPM is 11.2ppt higher than CMD's, of which 5.7ppt. comes from ASP difference and 5.5ppt comes from ACP difference.

2) Shengmu's raw milk ASP of RMB5.5/kg is 9.9% higher than CMD's ASP of RMB5.0/kg. This results in a 5.7ppt advantage in GP margin as organic liquid milk has a higher standard than the premium milk produced by CMD, thus higher pricing.

3) Shengmu's raw milk ACP of RMB2.8/kg is 12% lower than CMD's ACP of RMB3.2/kg. This results in a 5.5ppt advantage in GP margin. To further break down their cost structure, Shengmu has a lower milk yield at 8.1 ton per organic milkable cow vs. 9.0 ton of CMD. This could result in 4.2ppt disadvantage in GP margin but can be offset by Shengmu's much lower feeds costs as they source their main feeds internally. Advantages from feed costs bring 10.5ppt advantage in GP margin.

Chart 59: Proforma analysis of Shengmu's dairy farming GP margin vs. CMD's GP margin

FY14 (dairy farming)	Shengmu	CMD	Diff	GP margin impact	Comments
GP margin	49.1%	37.9%	11.2%	11.2ppt	Mainly due to ASP difference
- ASP (RMB/kg)	5.5	5.0	9.9%	5.7ppt	Organic liquid milk charges higher price
- ACP (RMB/kg)	2.8	3.2	-11.9%	5.5ppt	Organic cows generally has a lower milk yield given its strict feeding and milking standard while this is offset by the lower cost of feeding due to Shengmu's procurement cost saving from its connected company
- Milk yield (ton per milkable cow, assume others unchanged)	8.1	9.0	-10.4%	-4.2ppt	
- Feed cost per milkable cow ('000 RMB, assume others unchanged)	18	22	-20.7%	10.5ppt	Shengmu procured most of its feeds internally
- Milk yield and feed costs				5.2ppt	

Source: Company data

Chart 60: Group GPM comparison

	2013	2014	2015e
Shengmu	42.9%	50.2%	50.3%
China Modern Dairy	30.0%	37.1%	34.4%
Huishan	54.0%	62.4%	56.8%
YuanShengTai	42.6%	45.7%	NA

Source: Company data, Jefferies estimates

Note: Huishan's figures are for the year ended March, i.e. 2013 refer to FY13 ended in Mar.2013.

Chart 61: Upstream GPM comparison

	2013	2014	2015e
Shengmu	38.9%	45.6%	44.6%
China Modern Dairy	28.9%	37.9%	30.8%
Huishan	58.7%	62.0%	57.3%
YuanShengTai	42.6%	45.7%	NA

Source: Company data, Jefferies estimates

Note: Huishan's figures are for the year ended March, i.e. 2013 refer to FY13 ended in Mar.2013. Shengmu's upstream includes both organic milk and non-organic milk.

Liquid milk GP margin comparison

Huishan's liquid milk enjoyed a high GP margin of 65.5%, followed by Shengmu at 58.7%, partly due to their higher upstream GP margin as a result of vertically integrated business model. CMD's liquid milk had a GP margin of 39.9% in 2014.

We performed a detailed pro forma analysis as follows to understand GP margin difference between Shengmu and CMD, using 2014 figures.

1) Shengmu's GPM is 18.8ppt higher than CMD's, of which 20.3ppt. comes from ASP difference and -1.5ppt comes from ACP difference.

2) Shengmu's liquid milk ASP of RMB14.4/kg is 50.0% higher than CMD's ASP of RMB9.6/kg. This results in a 20.3ppt advantage in GP margin as organic liquid milk has higher standard than the premium milk produced by CMD thus it charges higher price.

3) Shengmu's liquid milk ACP of RMB6.0/kg is 4% higher than CMD's ACP of RMB5.7/kg. This results in a 1.5ppt disadvantage in GP margin.

Chart 62: Pro forma analysis of Shengmu's liquid milk GP margin vs. CMD's GP margin

FY14 (liquid milk)	Shengmu	CMD	Diff	GP margin impact	Comments
GP margin (assume raw milk at costs)	58.7%	39.9%	18.8%	18.8ppt	Mainly due to ASP difference
- ASP (RMB/kg)	14.4	9.6	50.9%	20.3ppt	Organic liquid milk charges higher price; CMD offers higher discount to distributors
- ACP (RMB/kg)	6.0	5.7	4%	-1.5ppt	

Source: Company data

Taking out the benefit from value chain integration (assume raw milk procured at market price), Shengmu's GP margin would be 34.8%, the highest among peers due to its premium organic positioning. Huishan's liquid milk enjoyed a GP margin of 28.5%. CMD had a GP margin of 16.4% for its liquid milk, much lower than peers, as it offers lower prices to distributors but distributors bear most of the marketing expenses.

Chart 63: Liquid milk GP margin comparison (with benefit from value chain integration)

	2013	2014	2015e
Shengmu	54.0%	58.7%	56.7%
China Modern Dairy	39.4%	39.9%	47.1%
Huishan	54.0%	65.5%	58.1%
YuanShengTai	NA	NA	NA

Source: Company data, Jefferies estimates

Note: Huishan's figures are for the year ended March, i.e. 2013 refer to FY13 ended in Mar.2013.

Chart 64: Liquid milk GP margin comparison (w/o benefit from value chain integration)

	2013	2014	2015e
Shengmu	33.7%	34.8%	33.1%
China Modern Dairy	27.0%	16.4%	22.4%
Huishan	22.1%	28.5%	27.1%
YuanShengTai	NA	NA	NA

Source: Company data, Jefferies estimates

Note: Huishan's figures are for the year ended March, i.e. 2013 refer to FY13 ended in Mar.2013.

Core OP margin comparison

We performed comparison at the core OP margin level to excluding the impact of minority interest, fair value change of biological asset, gain/loss from associates. Huishan and YST had the highest core OP margin of 42.5% in 2014, followed by 40.4% for Shengmu. CMD had the lowest core OP margin of 26.7%.

Core net profit margin comparison

Among peers, YuanshengTai has the highest core net margin (excluding the impact of minority interest, fair value change of biological asset, gain/loss from associates) at 39.7%, followed by Huishan and Shengmu at 35.4% and 29.3% respectively. CMD had the lowest core net margin of 24.1%.

Chart 65: Core OP margin comparison

	2013	2014	2015e
Shengmu	34.9%	40.4%	36.4%
China Modern Dairy	24.1%	26.7%	29.4%
Huishan	47.9%	42.5%	41.4%
YuanShengTai	35.9%	42.5%	NA

Source: Company data, Jefferies estimates

Note: Huishan's figures are for the year ended March, i.e. 2013 refer to FY13 ended in Mar.2013.

Chart 66: Core net profit margin comparison

	2013	2014	2015e
Shengmu	27.8%	29.3%	27.4%
China Modern Dairy	18.4%	24.1%	22.2%
Huishan	39.7%	35.4%	36.3%
YuanShengTai	26.3%	39.7%	NA

Source: Company data, Jefferies estimates

Note: Huishan's figures are for the year ended March, i.e. 2013 refer to FY13 ended in Mar.2013.

ROA and ROE comparison

Shengmu had the highest ROA amongst peers at 19.5% in 2014, while the other three listed peers had a closer ROA at 9.2% for Huishan, 8.7% for YST dairy and 7.5% for CMD.

In term of ROE, Shengmu had the highest ROE of 23.9% in 2014 mainly due to higher asset turnover ratio. CMD had a higher leverage thus its ROE is higher than the other two players at 19.9%. Huishan had a ROE of 13.1%, while that for YST dairy was 10.2%.

Chart 67: ROA comparison

	2013	2014	2015e
Shengmu	16.5%	19.5%	16.9%
China Modern Dairy	6.2%	7.5%	10.0%
Huishan	12.2%	9.2%	8.0%
YuanShengTai	9.3%	8.7%	NA

Source: Company data, Jefferies estimates

Note: Huishan's figures are for the year ended March, i.e. 2013 refer to FY13 ended in Mar.2013.

Chart 68: ROE comparison

	2013	2014	2015e
Shengmu	23.9%	23.9%	22.5%
China Modern Dairy	11.0%	19.9%	17.3%
Huishan	27.9%	13.1%	11.9%
YuanShengTai	9.7%	10.2%	NA

Source: Company data, Jefferies estimates

Note: Huishan's figures are for the year ended March, i.e. 2013 refer to FY13 ended in Mar.2013.

Company background

Company description

Shengmu is a vertically integrated dairy company with a focus on organic milk. It sources organic feed from its associate company. It had 19 organic dairy farms in the Ulan Buh desert with 64,769 heads of organic dairy cows, and 12 non-organic dairy farms in Huhhot with 38,483 heads of non-organic dairy cows in 2014. It is the largest organic dairy farming company in China, with a 54% market share in 2013.

Shengmu generated 31% of its revenue in 2014 from selling non-organic raw milk to large downstream dairy companies (Mengniu, Yili, Want Want), 34.3% from selling organic raw milk to these customers, while 34.7% of its revenue came from downstream organic liquid milk produced. Its downstream organic liquid milk product portfolio includes organic whole milk, organic low fat milk, organic whole milk for children, and organic yogurt. These products are sold under the brand “Shengmu 圣牧” and distributed nationally.

Corporate history

The company was founded by Mr. Yao Tongshan with 21 other parties in October 2009 in Inner Mongolia. Many of the founding members, including Mr. Yao, had relations (i.e. employment, investment or business dealings) with Mengniu. It signed raw milk supply agreement with Mengniu in 2010, with Yili in 2013 and with Want Want in 2014. It received organic certifications under Europe and China standards in 2011.

Shengmu entered downstream dairy business and started producing organic whole milk in Jun.2012. It expanded into organic low fat milk and organic whole milk for children in Jan.2013, and organic yogurt in Jul.2014.

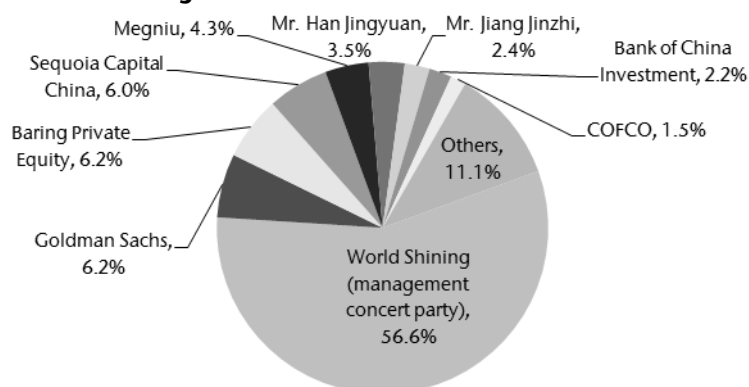
The company was listed in Hong Kong Stock Exchange on July 15, 2014.

Shareholding structure

World Shing, which is the concert party mainly formed by the management and which has agreed to support Mr. Yao Tongshan, has 56.6% shareholding in the listco. Pre-IPO investors Goldman Sachs, Baring Private Equity and Sequoia Capital China have 6.2%, 6.2%, 6%, shareholding in Shengmu, respectively.

Its largest customer, Mengniu, invested in Shengmu in May 2011, and currently holds 4.3% shareholding in the company.

Other pre-IPO investors, Mr. Han Jingyuan, Mr. Jiang Jinzhi, and Bank of China Investment own 3.5%, 2.4% and 2.2%, respectively. COFCO was a cornerstone investor at the IPO and has 1.5% shareholding.

Chart 69: Shareholding structure

Source: Company data, HKEx, Jefferies

Note: Goldman Sachs, Baring Private Equity, Sequoia Capital China, Mengniu, Mr. Han Jingyuan, Mr. Jiang Jinzhi and bank of China Investment are all pre-IPO investors. COFCO was a corner stone investor at IPO.

Management profile

Chart 70: Management profile summary

Executive directors	Position	Responsibility	Joined the group in
Mr. Yao Tongshan	Chairman, CEO and executive director	Strategic planning and overall management	Oct.2009
Mr. Wu Jianye	President and executive director	Operational management	Sep.2010
Ms. Gao Lingfeng	Vice president and executive director	Performance planning and control	Oct.2009
Mr. Cui Ruicheng	Vice president, CFO and executive director	Finance and accounting	Oct.2009
Non-executive directors	Position	Responsibility	Joined the group in
Mr. Wu Jingshui	Non-executive director	Supervision	Apr.2011
Mr. Fan Xiang	Non-executive director	Supervision	Dec.2013
Mr. Cui Guiyong	Non-executive director	Supervision, Audit committee member	Dec.2013
Mr. Sun Qian	Non-executive director	Supervision, Remuneration committee member	Mar.2014
Senior management	Position	Responsibility	Joined the group in
Mr. Li Yundong	Vice president and joint company secretary	On-site supervision and management	Oct.2011

Source: Company data

Senior management details

Mr. Yao Tongshan, is the Chairman and the Chief Executive Officer. He is also the lead founder of the company. He is principally responsible for the overall strategic and long-term business planning, overall business, market development and operation management and annual budgets. Mr. Yao was the CFO for Mengniu listco (2319 HK) in Jul.2008-Mar.2010, and CFO of Inner Mongolia Mengniu (key subsidiary of Mengniu listco) in Oct.2001-Jan.2010.

Mr. Wu Jianye is the President and Executive Director, and responsible for management and operations of the company. He joined the company in September 2010. Prior to that, he was the chairman and president for Inner Mongolia Pangu group (engaged in agricultural business) in May 2003-Aug.2010 and general manager for Inner Mongolia Pangu Cashmere (engaged in cashmere manufacturing) from January 2000 to May 2003.

Ms. Gao Lingfeng, is a Vice President and Executive Director of the company. She is responsible for quality control, setting and implementing key performance indicators, and management, organic certification management, and overall administrative and coordination. She joined the company at inception in Oct.2009 and has >14 years'

experience in the dairy industry. She was the head of quality control department at Inner Mongolia Mengniu in Oct.1999-Apr.2009.

Mr. Cui Ruicheng, is the Chief Financial Officer, Vice President and Executive Director, and principally responsible for the financial management of the group. He has over 10 years of experience in the dairy industry and financial management and joined the company at inception in Oct.2009. Prior to that, he was the finance department head with Inner Mongolia Mengniu Shengwu Zhineng Company in Aug.2006-Sep.2009, and worked in various financial and accounting positions with Inner Mongolia Mengniu between Jul.2003-Aug.2006.

Mr. Li Yundong, is a Vice President and joined as the company secretary of the company. He joined the company in Oct. 2011 and has over 14 years of experience in the dairy industry. Prior to joining the company, he worked for Inner Mongolia Mengniu in Apr.2000-Sep.2011 as Treasurer, Head Of Finance Department, Vice President (finance) of the ice cream business, head of settlement and deputy CFO of operation systems.

Valuation

We arrive at a TP of HKD3.2 based on 13.5x 1-year forward PE. This target multiple is slightly higher than 12x for China Modern Dairy (1117 HK, Buy) due to Shengmu's unique organic positioning, fast growth and high returns. The stock trades at 9.5x forward P/E and 0.3x forward PEG. We believe its valuation looks compelling; we initiate coverage of the stock with a Buy rating. Its share price has outperformed HSCEI by 11% in the past one month as it has started receiving further attention from clients gradually but has underperformed it by 23% in the past three months. It outperformed the dairy sector by 11% in the past month but has underperformed it by 19% in the past three months.

Key catalysts and risks

Key risks: 1) Self-supply feeds shortage; 2) strong competition in liquid milk business; 3) animal pandemic; 4) execution risks.

Key catalysts: 1) Pullback in feed costs; 2) faster-than-expected improvement of dairy cows' productivity; 3) quicker-than-expected rebound in raw milk price; 4) faster expansion of market share in liquid milk.

Chart 71: Derivation of Shengmu's PT based on PE method

PE valuation	
12-m forward EPS (RMB cents)	18.6
12-m forward EPS (HK cents)	23.4
PE multiple target (X)	13.5
PE based Target price (HKD/share)	3.2
Current market price (HKD/share)	2.2
Up/down-side	47.0%
Dividend yield	0.0%
Total return	47.0%

Source: Bloomberg, Jefferies estimates

Chart 72: DCF analysis of Fair Price as a reference

WACC calculation

Risk free rate	2.0%
Equity risk premium	10.0%
Beta	0.80
Cost of equity	10.0%
Cost of debt	4.5%
Tax rate	0.5%
After tax cost of debt	4.5%
Proportion of debt in the capital structure	26.3%
WACC	8.5%

	2015e	2016e	2017e	2018e	2019e	2020e	2021e	2022e	2023e	2024e	2025e
NOPLAT	1,246	1,705	2,319	2,694	2,977	3,260	3,547	3,860	4,191	4,527	4,888
Depreciation and amortization	102	141	175	207	240	274	307	345	386	427	469
Change in working capital	(107)	(365)	(246)	(255)	(179)	(173)	(154)	(119)	(171)	(172)	(160)
Net capex	(1,664)	(1,676)	(1,636)	(1,868)	(2,004)	(2,140)	(2,298)	(2,594)	(2,715)	(2,859)	(3,088)
Free Cash Flow	(423)	(196)	612	778	1,034	1,221	1,403	1,492	1,691	1,923	2,109
PV of FCF	(423)	(188)	541	634	776	844	893	876	914	958	968
Sum of Forward PV	7,215										

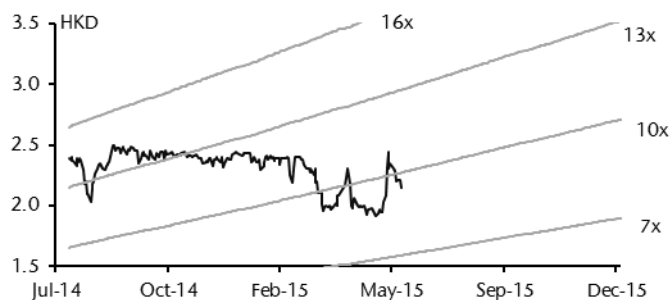
Terminal growth assumption	1.5%
WACC	8.5%
FCF at 2025e	2,141
Terminal value of FCF @ 2025e	30,369
PV of terminal value	13,931

Enterprise Value	21,146
Less: Net debt/(cash)	1,231
Less: Minority interests	754
Intrinsic Market value (RMB mn)	19,161
Intrinsic Market value (HKD mn)	24,143
Shares outstanding (mn)	6,018
Value per share (HKD/share)	4.0

WACC	LT Growth Rate				
	0.5%	1.0%	1.5%	2.0%	2.5%
7.6%	4.3	4.6	4.9	5.2	5.6
8.1%	3.9	4.2	4.4	4.7	5.0
8.6%	3.6	3.8	4.0	4.2	4.5
9.1%	3.3	3.5	3.6	3.8	4.1
9.6%	3.1	3.2	3.3	3.5	3.7

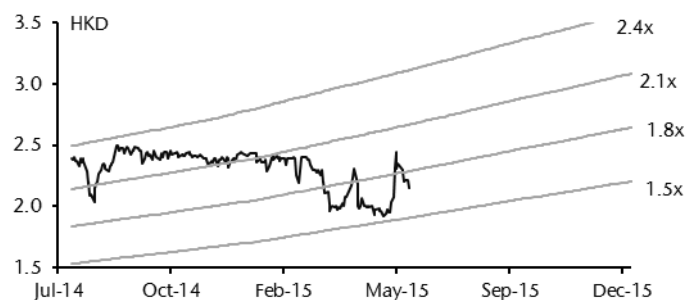
Source: Jefferies, Bloomberg estimates

Chart 73: 1-yr forward PE band



Source: Bloomberg, Jefferies

Chart 74: 1-yr forward PB band



Source: Bloomberg, Jefferies

Chart 75: Valuation comparison of dairy companies

Companies	Bloomberg Ticker	Pricing currency	JEF Rating	Price Jun 05	JEF PT	Mcap (USDm)	EV/EBITDA (x)		P/B (x)		P/E (x)		PEG (x)		ROA (%)		ROE (%)		CAGR2014-16e		Dividend yield		Gearing (%)
							2015e	2016e	2015e	2016e	2015e	2016e	2015e	2016e	2015e	2016e	2015e	2016e	EPS	EBITDA	2015e	2016e	2014
Global Downstream Players																							
Nestle	NESN VX	CHF	Buy	70.8	NA	244,539	13.8	12.9	3.1	3.0	20.9	19.5	NA	2.6	7.4	7.9	15.2	15.7	-10.6	6.5	3.2	3.4	17.1
Abbott	ABT US	USD	Hold	48.7	NA	72,473	13.8	12.5	2.9	2.7	22.5	20.2	0.5	1.8	7.3	8.0	14.4	14.2	26.7	17.0	2.0	2.2	15.6
Danone	BN FP	EUR	Hold	61.5	NA	45,231	12.6	11.5	2.9	2.7	20.8	19.0	0.4	1.9	5.6	5.9	14.3	14.7	31.2	13.9	2.6	2.8	67.5
Mead Johnson	MJN US	USD	NC	95.4	NA	19,324	15.8	14.4	NA	NA	23.9	21.7	1.9	2.1	20.6	20.4	NA	NA	11.3	10.7	1.7	1.9	-
Fonterra	FSF NZ	NZD	NC	4.8	NA	5,413	8.8	8.0	1.1	1.1	14.6	12.2	0.2	0.6	5.3	6.0	8.2	9.7	45.0	23.4	4.9	5.7	-
Meiji	2269 JP	JPY	NC	14,040.0	NA	8,593	11.6	10.6	2.5	2.3	24.8	22.9	1.9	2.7	5.3	6.5	10.5	10.5	10.8	9.6	1.0	1.3	-
Mean							12.3	11.3	2.5	2.4	21.6	19.5	1.0	1.9	8.1	8.6	12.5	12.9	16.3	13.0	2.4	2.7	-
Chinese Milk Powder Producers																							
Biostime	1112 HK	HKD	Buy	27.5	39.2	2,157	7.9	7.2	3.7	3.3	14.2	13.3	0.9	2.1	13.2	12.8	29.0	26.5	11.2	12.8	4.2	4.5	-71.4
Yashili	1230 HK	HKD	NC	2.6	NA	1,579	13.4	11.3	1.5	1.4	26.8	20.8	2.7	0.7	6.5	7.2	7.8	8.3	18.9	72.5	1.3	2.4	-
Mean							10.6	9.2	2.6	2.4	20.5	17.1	1.8	1.4	9.9	10.0	18.4	17.4	15.0	42.7	2.8	3.5	-
Chinese Liquid Milk Producers																							
Mengniu	2319 HK	HKD	Hold	43.0	34.8	10,876	15.9	14.4	2.5	2.4	26.5	24.2	3.6	2.6	6.3	6.4	10.6	10.1	8.3	6.3	0.8	0.9	-13.2
Yili	600887 CH	CNY	NC	20.0	NA	19,777	15.1	12.5	5.6	4.8	20.6	18.2	1.4	1.4	13.5	14.5	25.7	26.6	14.2	21.4	1.7	2.0	-
Mean							15.5	13.4	4.1	3.6	23.5	21.2	2.5	2.0	8.8	9.8	17.6	18.9	20.2	19.7	1.3	1.5	-
Chinese Upstream Dairy Farming Players																							
CMD	1117 HK	HKD	Buy	3.0	3.9	1,849	8.8	8.3	1.5	1.3	9.5	8.5	NA	0.7	10.0	9.8	17.3	16.8	5.8	14.5	1.0	1.8	74.2
Shengmu	1432 HK	HKD	Buy	2.1	3.2	1,713	8.8	6.6	1.9	1.4	10.7	7.8	0.2	0.2	16.9	18.2	22.5	24.4	44.0	41.8	0.0	0.0	17.2
Huishan	6863 HK	HKD	Buy	1.5	2.1	2,789	9.0	8.5	1.1	1.0	9.6	9.0	0.6	1.3	8.4	8.6	12.2	11.8	10.8	14.0	2.1	2.2	7.3
Mean							8.9	8.4	1.3	1.2	9.6	8.7	0.6	1.0	9.2	9.2	14.7	14.3	8.3	14.3	1.6	2.0	40.7
Mean all							12.0	10.9	2.6	2.4	19.9	17.7	1.4	1.7	8.7	9.2	15.1	15.4	15.8	18.8	2.1	2.5	16.6

Source: Bloomberg, Jefferies estimates, close prices as of Jun 05

Note: Calendarized numbers used.

Appendix: Financial Summary

Chart 76: Income Statement (RMB m)

	2012	2013	2014	2015e	2016e	2017e
Sales	701	1,144	2,132	3,437	4,799	6,228
COGS	(467)	(653)	(1,063)	(1,707)	(2,356)	(3,027)
Gross profit	234	490	1,070	1,730	2,443	3,201
SG&A	(35)	(97)	(230)	(509)	(768)	(903)
Other income	6	6	22	31	38	40
Operating profits	205	400	862	1,253	1,714	2,338
Depreciation & Amortization	(12)	(29)	(60)	(102)	(141)	(175)
EBITDA	216	428	922	1,354	1,855	2,513
Gains from changes in fair value	4	9	87	-	-	-
Net finance costs	(10)	(32)	(54)	(76)	(101)	(123)
Profit from associates	0	(1)	(8)	(7)	(6)	(5)
Loss on disposal of a subsidiary	-	-	-	-	-	-
Profit before tax	199	375	888	1,169	1,606	2,210
Tax	-	(1)	(4)	(6)	(8)	(18)
Profit after tax	199	374	884	1,164	1,598	2,192
Minority interests	(3)	(47)	(173)	(221)	(304)	(417)
Reported net profit	196	327	711	942	1,294	1,776
Adj: Non-core income	(4)	(9)	(87)	-	-	-
Core net profit	191	318	624	942	1,294	1,776
EPS and DPS						
EPS (RMB/share)	0.04	0.07	0.10	0.16	0.22	0.30
Diluted EPS (RMB/share)	0.04	0.07	0.10	0.15	0.21	0.29
DPS (RMB/share)	-	-	-	-	-	0.03
EPS and DPS						
EPS (HKD/share)	0.05	0.09	0.13	0.20	0.27	0.37
Diluted EPS (HKD/share)	0.05	0.09	0.13	0.19	0.27	0.36
DPS (HKD/share)	-	-	-	-	-	0.04
Key ratios						
Gross margin (%)	33.4%	42.9%	50.2%	50.3%	50.9%	51.4%
Operating margin (%)	29.2%	34.9%	40.4%	36.4%	35.7%	37.5%
EBITDA margin (%)	30.9%	37.5%	43.3%	39.4%	38.7%	40.4%
Core Net margin (%)	27.3%	27.8%	29.3%	27.4%	27.0%	28.5%
ROE (%)	18.9%	23.9%	23.9%	22.5%	24.4%	26.3%
ROA (%)	14.0%	16.5%	19.5%	16.9%	18.2%	19.6%
ROCE (%)	16.5%	19.5%	22.4%	18.9%	20.1%	21.5%

Source: Company data, Jefferies estimates

Chart 77: Balance sheet (RMB m)

	2012	2013	2014	2015e	2016e	2017e
Cash	30	127	735	736	943	1,747
Pldged bank deposits	13	15	16	16	16	16
Trade receivables	25	63	398	412	624	810
Inventories	204	335	701	825	1,152	1,370
Others	30	94	185	194	204	214
Total current assets	301	635	2,035	2,184	2,939	4,157
Fixed asset	450	923	1,658	2,456	3,134	3,609
Prepaid land lease payments	3	3	5	6	6	6
Other intangible assets	14	14	16	16	16	16
Biological assets	1,030	1,510	2,720	3,484	4,340	5,326
Others	18	27	57	50	44	39
Non- current assets	1,515	2,477	4,456	6,012	7,541	8,997
Total assets	1,817	3,113	6,491	8,196	10,480	13,154
Trade and other payables	257	390	717	758	941	1,110
Short-term loan	324	932	1,334	1,201	1,201	1,201
Others	18	83	35	35	35	35
Current liability	598	1,405	2,086	1,995	2,177	2,346
Long-term loan	-	-	150	783	1,286	1,777
Total long-term liabilities	-	-	150	783	1,286	1,777
Minority interests	52	214	533	754	1,058	1,474
Shareholders' equity	1,167	1,494	3,722	4,664	5,959	7,557
Liability+equity	1,817	3,113	6,491	8,196	10,480	13,154
Key ratios						
Total debt/equity (%)	26.6%	54.6%	34.9%	36.6%	35.4%	33.0%
Total debt/capital employed (%)	21.0%	35.3%	25.9%	26.8%	26.2%	24.8%
Net debt/equity (%)	23.1%	46.3%	17.2%	22.7%	21.8%	13.4%
Net debt/capital employed (%)	18.2%	29.9%	12.8%	16.6%	16.1%	10.1%
BV/share (RMB)	0.3	0.4	0.7	0.9	1.2	1.5

Source: Company data, Jefferies estimates

Chart 78: Cash flow statement (RMB m)

	2012	2013	2014	2015e	2016e	2017e
Cash from operating activities						
Pretax profits	199	375	888	1,169	1,606	2,210
Depreciation & amortization	12	29	60	102	141	175
Interest income	(2)	(0)	(6)	(10)	(10)	(13)
Interest expense	12	33	60	86	112	136
Share of profits from associates	(0)	1	8	7	6	5
Gain from changes in fair value	(4)	(9)	(87)	-	-	-
Change in working capital	(40)	(65)	(545)	(107)	(365)	(246)
Tax paid	-	(1)	(3)	(5)	(8)	(18)
Others	(0)	-	46	-	-	-
Net cash from operating activities	176	363	421	1,242	1,481	2,249
Cash flow from investing activities						
Interest received	2	0	6	10	10	13
Capex	(372)	(760)	(1,510)	(900)	(820)	(650)
Others	(161)	(173)	(386)	(764)	(856)	(986)
Net cash from investing activities	(531)	(932)	(1,890)	(1,654)	(1,666)	(1,623)
Cash flow from financing activities						
Change in borrowings	188	586	534	499	503	491
Interest paid	(14)	(33)	(60)	(86)	(112)	(136)
Others	144	115	833	-	-	(178)
Net cash from financing activities	317	668	1,307	413	391	177

Source: Company data, Jefferies estimates

Note: others in cash flow from financing activities include Capex used for breeding calves and heifers.

Company Description

Shengmu is the largest organic dairy company in China and a vertically integrated organic dairy company in China that meets E.U. organic standards. It supplies organic raw milk to major dairy players in China and also produces own-branded liquid milk to the market. In addition, the company is also among the top eight producers of premium non-organic raw milk.

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Buy - Describes securities that we expect to provide a total return (price appreciation plus yield) of 15% or more within a 12-month period.

Hold - Describes securities that we expect to provide a total return (price appreciation plus yield) of plus 15% or minus 10% within a 12-month period.

Underperform - Describes securities that we expect to provide a total return (price appreciation plus yield) of minus 10% or less within a 12-month period.

The expected total return (price appreciation plus yield) for Buy rated securities with an average security price consistently below \$10 is 20% or more within a 12-month period as these companies are typically more volatile than the overall stock market. For Hold rated securities with an average security price consistently below \$10, the expected total return (price appreciation plus yield) is plus or minus 20% within a 12-month period. For Underperform rated securities with an average security price consistently below \$10, the expected total return (price appreciation plus yield) is minus 20% or less within a 12-month period.

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1432 HK

Initiating Coverage

8 June 2015

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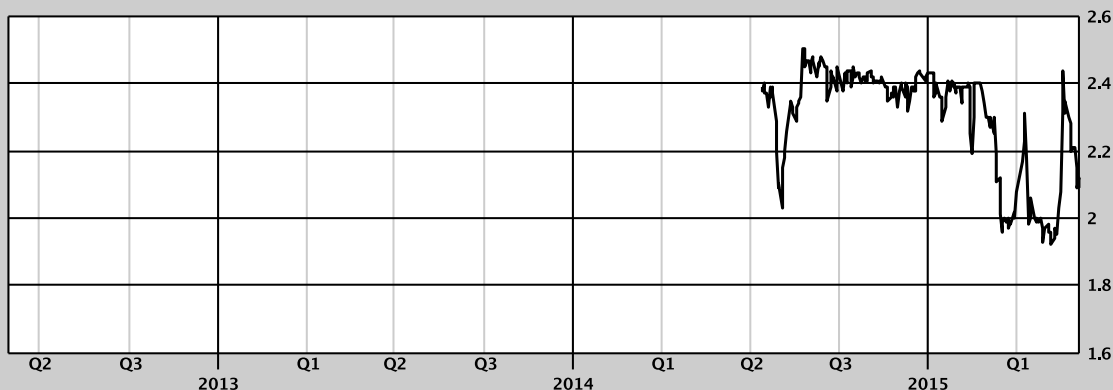
Risks which may impede the achievement of our Price Target

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Other Companies Mentioned in This Report

- Abbott Laboratories (ABT: \$48.68, HOLD)
- Biostime International Holdings (1112 HK: HK\$27.45, BUY)
- China Huishan Dairy (6863 HK: HK\$1.51, BUY)
- China Mengniu Dairy Co. Ltd. (2319 HK: HK\$43.00, HOLD)
- China Modern Dairy Holdings Ltd. (1117 HK: HK\$2.97, BUY)
- Danone (BN FP: €62.38, HOLD)
- Nestle (NESN VX: CHF71.20, BUY)

Rating and Price Target History for: China Shengmu Organic Milk Limited (1432 HK) as of 06-05-2015



Distribution of Ratings

Rating	Count	Percent	IB Serv./Past 12 Mos.	
			Count	Percent
BUY	1072	51.59%	295	27.52%
HOLD	839	40.38%	161	19.19%
UNDERPERFORM	167	8.04%	13	7.78%

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