



Rating  
**Buy**

Asia  
China

Consumer  
Food & Beverage

Company  
**Dali Foods**

Reuters  
3799.HK

Bloomberg  
3799 HK

Exchange Ticker  
HSI 3799

Date  
11 July 2018

Company Update

Price at 10 Jul 2018 (HKD)	6.16
Price target - 12mth (HKD)	8.80
52-week range (HKD)	7.81 - 4.41
HANG SENG INDEX	28,688

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## The great potential of fresh bread; reiterating Buy

### To create another Toly Bread in the next three years

Dali Foods launched its "Daliyuan quality breakfast" brand in July 2017 and will launch short shelf-life bread ("fresh bread") from September 2018. Helped by booming industry demand and Dali's strength in production and the channel, we forecast Dali's fresh bread to generate Rmb4bn sales in 2020, representing 14% of sales. This will be a similar sales scale to A-share listed Toly Bread (603866.SS). We think the current share price has not factored in this potential growth. We raise our TP to HK\$8.8 and reiterate Buy.

### Fresh bread: a booming sector due to consumers' upgrade demand

According to Euromonitor, baked goods will maintain strong growth, at a 13% CAGR in 2017-20E, to Rmb280bn in 2020. Meanwhile, driven by consumers' increasing preference for more fresh food, short life-shelf bread ("fresh bread") will be the main growth segment with a 16% CAGR in 2017-20E. Additionally, the baked goods sector is still highly fragmented: Dali is the No.1 player with 4.6% market share (mainly long shelf-life products) and Toly is the No.2 player with 2.9% market share (mainly fresh bread).

### Dali: well positioned to penetrate the fresh bread market

Similar to pasteurized milk, the core factors for running a successful fresh bread business are fast production, fast delivery and quality control. Dali has nationwide factories, a strong distribution network, and well-established brands in baked goods. Meanwhile, we expect Dali to achieve a lower operating expense ratio in fresh bread, helped by its large scale in the baked goods segment and bigger production network. We expect Dali to achieve Rmb1bn/3bn/4bn annual sales in 2018/19/20E.

### Revising up TP to HK\$8.8; Buy

We are revising up our TP to HK\$8.8 from HK\$8.4 based on a DCF approach (factoring in 9.5% WACC and 2% terminal growth). We believe its share price has not factored in the potential contribution from fresh bread (bearing in mind that A-share listed Toly Bread has Rmb25bn market cap). We expect the recovery in launches of fresh bread to be the catalyst. We reiterate Buy. Downside risks: lower-than-expected bread sales; higher-than-expected costs.

### Forecasts And Ratios

Year End Dec 31	2016A	2017A	2018E	2019E	2020E
Sales (CNYm)	17,841.9	19,799.1	22,326.4	25,392.7	28,494.2
EBITDA (CNYm)	4,526.9	4,922.2	5,584.7	6,284.5	7,216.0
Reported NPAT (CNYm)	3,136.8	3,433.7	3,903.6	4,464.6	5,090.4
Reported EPS FD(CNY)	0.23	0.25	0.29	0.33	0.37
DB EPS FD (CNY)	0.23	0.25	0.29	0.33	0.37
% Change					
DB EPS growth (%)	-5.0	9.5	13.7	14.4	14.0
PER (x)	16.0	17.4	18.2	15.9	14.0
EV/EBITDA (x)	8.9	10.5	10.7	9.5	7.8
Yield (net) (%)	4.4	3.8	3.6	4.1	4.7

Source: Deutsche Bank estimates, company data

<sup>1</sup> DB EPS is fully diluted and excludes non-recurring items

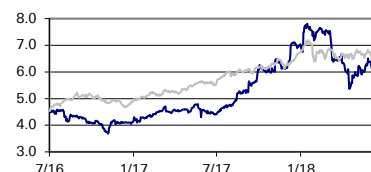
<sup>2</sup> Multiples and yields calculations use average historical prices for past years and spot prices for current and future years, except P/B which uses

### Key changes

TP 8.40 to 8.80 ↑ 4.8%

Source: Deutsche Bank

### Price/price relative



Performance (%)	1m	3m	12m
Absolute	-3.3	-7.6	39.1
HANG SENG INDEX	-7.3	-6.6	12.5

Source: Deutsche Bank

Deutsche Bank AG/Hong Kong

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Model updated: 10 July 2018

Running the numbers

Asia  
China  
Food & Beverage

Dali Foods

Reuters: 3799.HK Bloomberg: 3799.HK

Buy

Price (10 Jul 18) HKD 6.16  
Target Price HKD 8.80  
52 Week range HKD 4.41 - 7.81  
Market Cap (m) HKDm 84,356  
USDm 10,748

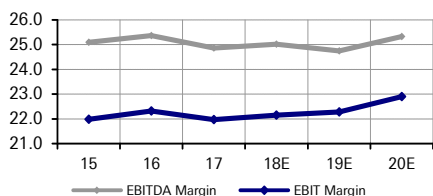
Company Profile

Dali Foods is a snack food and beverage company in China with a diversified multi-brand product portfolio focusing on high-growth product categories. The company has six core product categories of bread, cakes and pastries; chips, fries and others; biscuits; herbal tea; plant-based dairy beverage; and energy drinks, which are marketed under five core brands: Daliyuan, Copico, Haochidian, Heqizheng and Hi-Tiger.

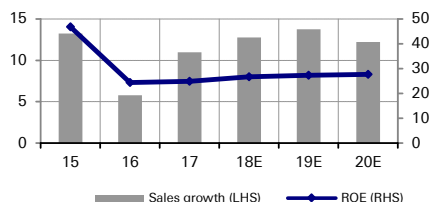
Price Performance



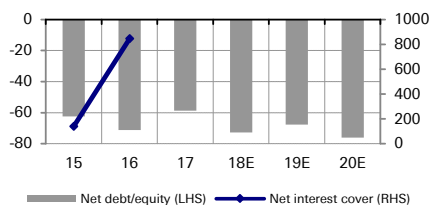
Margin Trends



Growth & Profitability



Solvency



Fiscal year end 31-Dec

Financial Summary

	2015	2016	2017	2018E	2019E	2020E
DB EPS (CNY)	0.24	0.23	0.25	0.29	0.33	0.37
Reported EPS (CNY)	0.24	0.23	0.25	0.29	0.33	0.37
DPS (CNY)	0.11	0.16	0.16	0.19	0.21	0.24
BVPS (CNY)	0.9	1.0	1.0	1.1	1.3	1.4
Weighted average shares (m)	12,077	13,694	13,694	13,694	13,694	13,694
Average market cap (CNYm)	44,409	50,036	59,647	71,156	71,156	71,156
Enterprise value (CNYm)	36,973	40,176	51,551	59,931	59,425	56,349

Valuation Metrics

P/E (DB) (x)	15.2	16.0	17.4	18.2	15.9	14.0
P/E (Reported) (x)	15.2	16.0	17.4	18.2	15.9	14.0
P/BV (x)	4.10	3.47	6.12	4.61	4.11	3.65
FCF Yield (%)	8.1	5.9	3.1	7.2	4.3	8.5
Dividend Yield (%)	2.9	4.4	3.8	3.6	4.1	4.7
EV/Sales (x)	2.2	2.3	2.6	2.7	2.3	2.0
EV/EBITDA (x)	8.7	8.9	10.5	10.7	9.5	7.8
EV/EBIT (x)	10.0	10.1	11.8	12.1	10.5	8.6

Income Statement (CNYm)

Sales revenue	16,865	17,842	19,799	22,326	25,393	28,494
Gross profit	5,816	6,840	7,458	8,647	9,929	11,399
EBITDA	4,233	4,527	4,922	5,585	6,284	7,216
Depreciation	512	531	555	623	609	674
Amortisation	13	14	15	15	17	16
EBIT	3,708	3,982	4,352	4,947	5,658	6,526
Net interest income/(expense)	-27	-5	0	0	0	0
Associates/affiliates	0	0	0	0	0	0
Exceptionals/extraordinaries	0	0	0	0	0	0
Other pre-tax income/(expense)	0	0	0	0	0	0
Profit before tax	3,681	3,977	4,352	4,947	5,658	6,526
Income tax expense	769	840	918	1,043	1,193	1,436
Minorities	0	0	0	0	0	0
Other post-tax income/(expense)	0	0	0	0	0	0
Net profit	2,912	3,137	3,434	3,904	4,465	5,090
DB adjustments (including dilution)	0	0	0	0	0	0
DB Net profit	2,912	3,137	3,434	3,904	4,465	5,090

Cash Flow (CNYm)

Cash flow from operations	4,057	3,412	2,682	5,849	4,023	7,076
Net Capex	-467	-464	-809	-710	-949	-1,062
Free cash flow	3,590	2,947	1,873	5,138	3,074	6,014
Equity raised/(bought back)	8,432	0	0	0	0	0
Dividends paid	-1,126	-1,460	-3,349	-2,259	-2,568	-2,938
Net inc/(dec) in borrowings	0	0	0	0	0	0
Other investing/financing cash flows	-2,590	-2,455	-289	250	0	0
Net cash flow	8,307	-967	-1,765	3,129	505	3,076
Change in working capital	577	-213	-1,371	1,428	-1,046	1,442

Balance Sheet (CNYm)

Cash and other liquid assets	8,935	9,861	8,096	11,225	11,730	14,807
Tangible fixed assets	4,134	3,896	4,273	4,318	4,595	4,915
Goodwill/intangible assets	594	594	580	606	649	698
Associates/investments	844	250	250	0	0	0
Other assets	1,289	1,879	3,127	2,309	3,506	2,667
Total assets	15,797	16,480	16,326	18,458	20,481	23,087
Interest bearing debt	1,500	0	0	0	0	0
Other liabilities	2,395	2,615	2,540	3,027	3,154	3,607
Total liabilities	3,895	2,615	2,540	3,027	3,154	3,607
Shareholders' equity	11,902	13,866	13,786	15,430	17,327	19,480
Minorities	0	0	0	0	0	0
Total shareholders' equity	11,902	13,866	13,786	15,430	17,327	19,480
Net debt	-7,435	-9,861	-8,096	-11,225	-11,730	-14,807

Key Company Metrics

Sales growth (%)	13.2	5.8	11.0	12.8	13.7	12.2
DB EPS growth (%)	35.2	-5.0	9.5	13.7	14.4	14.0
EBITDA Margin (%)	25.1	25.4	24.9	25.0	24.7	25.3
EBIT Margin (%)	22.0	22.3	22.0	22.2	22.3	22.9
Payout ratio (%)	44.2	69.9	65.8	65.8	65.8	65.8
ROE (%)	46.8	24.3	24.8	26.7	27.3	27.7
Capex/sales (%)	2.8	2.6	4.1	3.2	3.7	3.7
Capex/depreciation (x)	0.9	0.9	1.4	1.1	1.5	1.5
Net debt/equity (%)	-62.5	-71.1	-58.7	-72.7	-67.7	-76.0
Net interest cover (x)	138.7	846.3	nm	nm	nm	nm

Source: Company data, Deutsche Bank estimates

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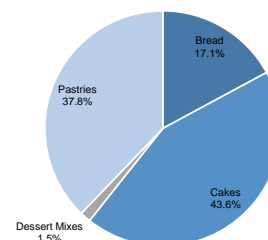
## Fresh bread – a potential fast-growth area for lead players

### Industry demand to post 16% CAGR in next five years

China's baked goods segment (i.e. bread, cakes, and pastries) posted a 12% sales CAGR in 2014-17 to Rmb200bn in 2017 (Figure 2). **According to Euromonitor, baked goods will maintain strong growth, at a 13% CAGR in 2017-20E, to Rmb280bn in 2020**, driven by consumers' growing income, urbanization and an increasing adaption to western diets.

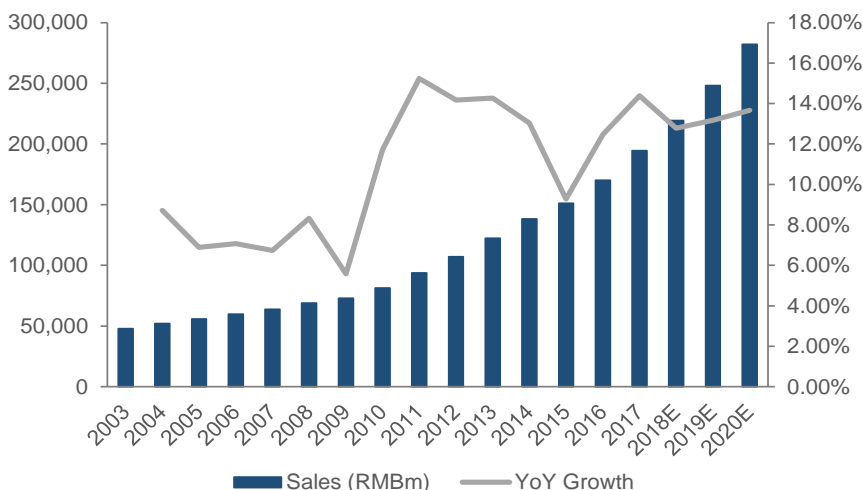
Based on its shelf-life, baked goods can be split into long shelf-life (> 90 days), mid shelf-life (7-60 days), and short shelf-life products (seven days, or "fresh bread"). We estimate that fresh baked goods accounted for less than 30% of baked goods in 2017. Compared to long shelf-life products (3-6 months), fresh bread tastes better and looks healthier, which fits into consumers' growing demand for healthy foods. **We forecast short shelf-life bread to post a 16% sales CAGR in the next five years.**

Figure 1: Baked goods sales breakdown (2017)



Source: Deutsche Bank, Euromonitor

Figure 2: Baked goods industry growth

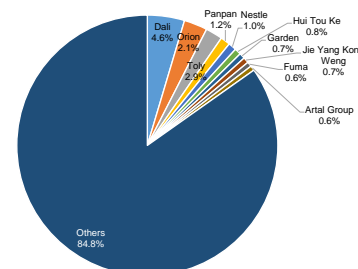


Source: Deutsche Bank, Euromonitor

### The sector is still highly fragmented

The baked segment is one of the most fragmented sectors in packaged foods. Dali and Toly are leading players but with only 4.6% and 2.9% market share respectively (Figure 3). The top 10 players had 15% market share in 2017. The consolidation level has been stable in the past five years, with the market share of the top 10 players growing gradually from 14% in 2012 to 15% in 2017. However, driven by consumers' increasing preference for branded products, lead players' increasing penetration, and increasing industry operating cost, we expect the top 10's market share to rise to 20% in 2020.

Figure 3: Baked goods market share (2017)



Source: Deutsche Bank, Euromonitor

### Experience from Toly: production network and channel execution are key success factors

There are two main business models in fresh bread, the "factory + wholesale" model and the "factory + chain store" model (Figure 4).



- **“Factory + chain store” model:** Manufacturer sells its products through its own or franchised bakery stores. It has more diversified categories, more fresh products, and has higher ASP. As a result, this model has higher gross margin but needs to afford higher rental and labor costs, which result in lower profitability. The listed companies such as 85°C, Bread Talk, and Christine operate on such a model.
- **“Factory + wholesale” model:** Manufacturer sells its products through traditional stores, special channels, and hypermarkets. In this model, a manufacturer has to rely on distributors or its own sales team to react quickly to retail end-demand. It has fewer SKUs compared to the chain store model. It has lower gross margins due to the lower ex-factory price, yet often achieves a higher net margin helped by lower operating expenses. Toly Bread (603866 CH) mainly operates in this model.

Figure 4: Operating model comparison

Operating Model	Characters	Examples	Strength	Weakness
Factory + chain stores	<b>Factory:</b> Produces finished and semi-finished products; <b>Sales channels:</b> Own or franchised bakery stores	Christine, 85°C, Paris Baguette	High freshness; More diversified categories; Higher gross margin; Easy to attract high-end customers.	High operating expenses; Needs more time to expand.
Factory + wholesale	<b>Factory:</b> Produces finished products; <b>Sales channels:</b> Modern channels + traditional channels + distributors	Toly Bread, Garden	Standardized, easy to achieve large scale; Lower operating risk; Flexible and takes less time to expand.	Lower branding; Highly rely on third-party distribution.

Source: Deutsche Bank

**Toly’s sales posted a 26% CAGR in 2015-17, helped by its efficient execution in the “factory+ wholesale” model.** The key success factor in implementing this model is to build up a fast reaction system and maintain a low inventory return rate. To achieve this, Toly has built up a national factory network and highly efficient logistics system. Specifically:

- **Factory network:** Toly has built factories in 17 areas nationwide, covering Northeast China, East China, North China, Northwest China and Southwest China. With factories as centers, it has over 190,000 POS to support its national sales.
- **Logistics:** Toly mainly uses third-party logistics, supplementing with its own transportation. It divides the logistics into two parts. Tier 1 logistics are used to transport products from factories to KA, city distribution centers and non-local market distributors. Tier 2 logistics are used to transport products from city distribution centers to retail ends such as supermarkets and convenience stores.

## Dali Foods: well positioned to scale up fresh bread

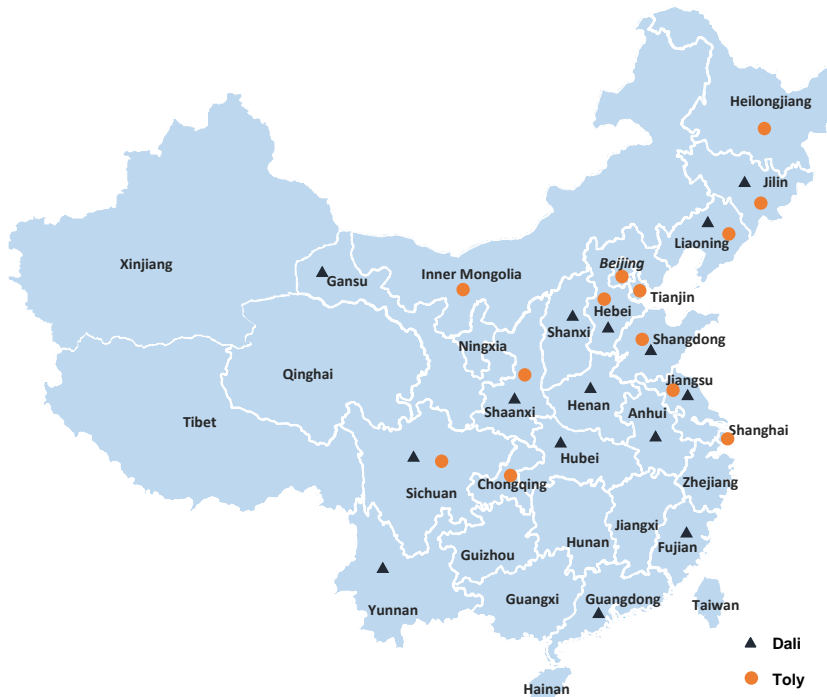
Dali has a strong factory network, solid branding and wide distribution channels



Compared with Toly, Dali has a similar strong factory network, highly efficient distribution channels and good branding (Figure 6). Specifically:

- **Factories network:** Dali has 15 food production facilities across China, which is similar to the 17 factories of Toly. It can cover around 70% of China's population within the 300km logistical circles. As Dali already has long-shelf life bread production lines in its food factory, it is able to install breakfast bread production lines in food factories with limited capex. Helped by its national factory network, Dali should be able to penetrate the short shelf-life bread market nationally.
- **Distribution channels:** Dali has around 4,000 distributors (including 2,300 food distributors and 2,900 beverage distributors) and over 10,000 salespeople nationally, while Toly has 2,905 salespeople and mainly relies on direct sales. Dali has 3 million POS for existing products and it expects that 1 million POS are potential retail ends for breakfast bread. For traditional channels, Dali began to screen out food distributors who are able to sell short-life bread from 2018, and it plans to have the first list by the end of 3Q18. For large chained hypermarkets, Dali will sell from its own factories directly. (Figure 5)
- **Branding:** Dali will use its existing brand "Dali Yuan" as the main brand and new "quality breakfast" sub-brand for short shelf-life breads. "Dali Yuan" is the leading packaged cake and bread brand in China. This will help Dali's fresh bread brand to leverage its existing popular brands.

Figure 5: Production facilities network



Source: Deutsche Bank, company financial reports. Dali production facilities only refer to food production facilities.



Figure 6: Distribution comparison

Company	No. of covered provinces and municipalities	No. of production facilities	Distribution	No. of POS	Salespeople
Dali	31	15 food and 17 beverage factories	Distributors and direct sales for KA	3 million	over 10,000
Toly	22	17	Distributors and direct sales	190,000	2,905

Source: Deutsche Bank

**Meanwhile, we expect Dali to have a higher operating margin in fresh bread compared to Toly.** On one side, Dali has better capability to keep a low inventory return rate than peers. Different from Toly, Dali has various SKUs including short, mid and long shelf-life bread. It could reduce the impairment rate by adjusting the portion between short and long shelf-life products. On the other side, as most of Dali's distributors sell other food products (including potato chips, biscuits and long shelf-life bread) together, Dali could achieve a lower operating expense ratio in fresh bread compared to Toly.

#### To make a significant contribution in both sales and profit in 2020

Dali launched the "Daliyuan Quality Breakfast Bread" series products from July and achieved Rmb300mn sales in 2H17 (all long shelf-life products). Under this sub-brand, it launched the first batch of mid-shelf-life bread (2 months) in May 2018 and a second batch of mid-shelf-life bread (1 month) in July 2018. It targets to launch the first batch of short shelf-life bread by the end of September.

**Management targets to achieve Rmb1bn and Rmb3bn sales for breakfast bread in 2018 and 2019 respectively, representing 4.5% and 12% of 2018/19 sales.** We believe this target is achievable, helped by its existing strength and good execution tracking record. **We expect Dali to achieve Rmb4bn sales in 2020,** which is at a similar scale of Toly in 2017.

According to management, fresh bread's gross margin is 13-14ppts higher than long shelf-life bread's, due to the higher portion of water in raw materials and less use of paper boxes for packaging. But it will incur higher operating expense due to a higher return rate and impairment rate. At the operating profit level, we forecast breakfast bread to have a similar operating margin as the food segment at around 20% (vs. Toly's OP margin at 16% in 2017). **This implies breakfast bread will contribute Rmb800m operating profit in 2020, representing 12% of its 2020 operating profit.**

#### Revising up target price to HK\$8.8; reiterating Buy

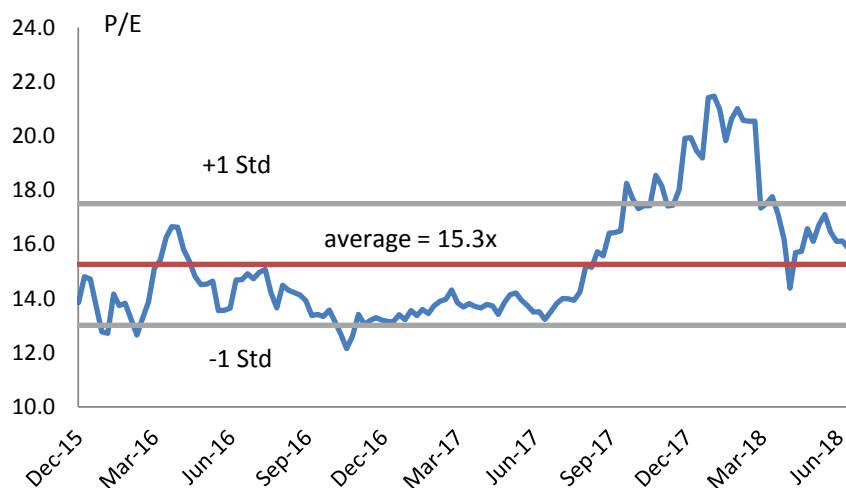
We expect breakfast bread to be a new driver for Dali's sales in 2019-20E. We are revising up our earnings forecasts and our target price to HK\$8.8 to factor in our increasing confidence in its breakfast bread, based on DCF method, factoring in 9.5% WACC and 2% terminal growth rate.

Dali currently trades at 18x 2018 P/E, which is a 30% discount to HK F&B staples at 26x 2018 P/E (Figure 8). **We expect the valuation to rerate with a gradual recovery in soy milk sales and launches of fresh bread. We reiterate Buy.**

Downside risk: 1) lower-than-expected sales in breakfast bread; 2) channel de-stocking of soy milk; 3) higher-than-expected raw material prices.



Figure 7: Dali one-year forward PE chart



Source: Deutsche Bank, Bloomberg Finance LP

Figure 8: Peer comp

Company	Ticker	Recom	Listing Curr	Price	Mkt Cap US\$m	PE (x)			PB (x)			EV/EBITDA			Div Yield (%)		
						Hist	FY1Y	FY2Y	Hist	FY1Y	FY2Y	Hist	FY1Y	FY2Y	Hist	FY1Y	FY2Y
<b>HK listed</b>																	
Dali	3799.HK	Buy	HKD	6.02	10,765	17.4	17.8	15.6	6.1	4.5	4.0	10.5	10.4	9.2	3.8	3.7	4.2
Want Want	0151.HK	Hold	HKD	6.95	11,119	19.9	20.8	18.3	5.2	4.5	3.8	11.0	11.7	9.9	0.0	0.0	0.0
Tingyi	0322.HK	Hold	HKD	17.92	12,669	27.9	37.0	33.2	4.0	4.4	4.1	8.0	11.8	11.1	1.8	1.3	1.5
Mengniu Dairy	2319.HK	Buy	HKD	26.75	12,935	28.4	27.0	20.6	3.5	3.5	3.1	13.2	14.0	11.4	0.8	0.9	1.1
CRB	0291.HK	Hold	HKD	35.75	14,715	47.4	51.1	39.0	4.3	4.9	4.5	16.0	22.3	18.1	0.8	0.4	0.5
Qingdao Brewery	0168.HK	Sell	HKD	43.20	8,207	31.3	33.2	31.0	2.8	2.7	2.6	12.1	14.8	13.8	1.4	1.4	1.4
Jiashili	1285.HK	NR	HKD	1.86	98	6.2	N/A	N/A	1.0	N/A	N/A	2.7	N/A	N/A	8.1	N/A	N/A
<b>Average</b>						<b>26.9</b>	<b>33.8</b>	<b>28.4</b>	<b>3.5</b>	<b>4.0</b>	<b>3.6</b>	<b>10.5</b>	<b>14.9</b>	<b>12.9</b>	<b>2.2</b>	<b>0.8</b>	<b>0.9</b>
<b>Global peers</b>																	
Yili Dairy	600887.SS	Buy	CNY	28.04	25,653	22.8	24.0	20.7	7.8	6.1	5.4	15.6	16.6	13.9	3.1	2.7	3.1
Lolo	000848.SZ	NR	CNY	10.33	1,516	22.5	21.4	17.9	4.6	4.8	4.3	12.9	13.1	11.2	4.9	2.9	6.0
Qia Qia	002557.SZ	NR	CNY	14.65	1,138	25.1	19.6	17.4	2.6	2.3	2.1	17.7	15.8	13.9	2.4	3.1	3.5
Toly	603866.SS	NR	CNY	53.64	3,989	34.2	39.9	31.6	5.8	7.9	6.6	22.4	34.0	27.2	1.4	0.8	1.0
Haoxiangni Jujube	002582.SZ	NR	CNY	10.82	855	56.6	31.0	21.5	1.8	1.4	1.3	24.8	19.8	16.3	0.6	1.1	2.7
Orion	271560.KS	NR	KRW	149,000	5,195	N/A	25.7	22.7	3.2	3.8	3.3	N/A	13.9	12.9	0.4	0.6	0.7
Pepsico	PEP.N	Hold	USD	107.76	152,787	21.9	19.9	18.9	15.7	12.7	13.5	13.7	13.0	12.5	2.8	3.3	3.6
Mondelez	MDLZ.OQ	Buy	USD	42.17	62,204	20.4	17.8	16.5	2.5	2.4	2.3	16.6	14.8	14.2	1.9	2.2	2.5
Monster Beverage	MNST.O	NR	USD	58.72	33,041	47.3	34.0	30.0	9.2	7.8	7.0	27.8	23.8	21.3	N/A	0.0	0.0
<b>Average</b>						<b>31.3</b>	<b>25.9</b>	<b>21.9</b>	<b>5.9</b>	<b>5.5</b>	<b>5.1</b>	<b>18.9</b>	<b>18.3</b>	<b>15.9</b>	<b>2.2</b>	<b>1.9</b>	<b>2.6</b>

Source: Deutsche Bank, Bloomberg Finance LP. Stock price is on 9 July 2018. We use DB forecasts for those companies we covered and Bloomberg consensus for others.



# Appendix 1

## Important Disclosures

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Company	Ticker	Recent price*	Disclosure
Dali Foods	3799.HK	6.16 (HKD) 10 Jul 18	NA

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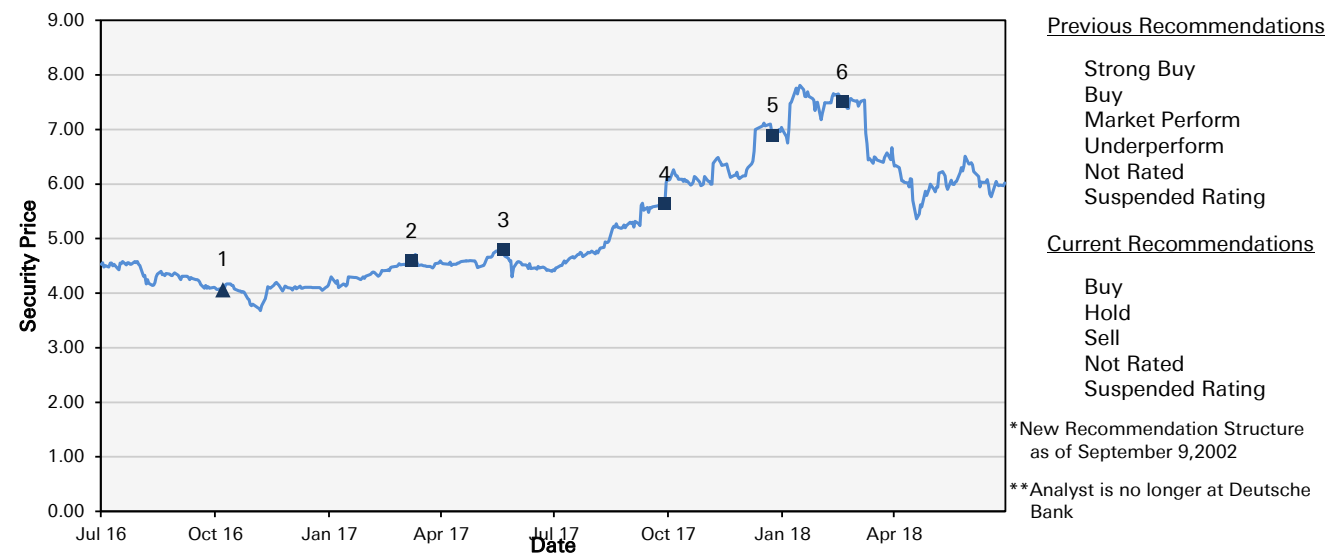
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### Historical recommendations and target price: Dali Foods (3799.HK)

(as of 7/10/2018)



1. 18/10/2016: Upgrade to Buy, Target Price Change HKD4.90 Mark Yuan	4. 09/10/2017: Buy, Target Price Change HKD6.50 Mark Yuan
2. 19/03/2017: Buy, Target Price Change HKD5.40 Mark Yuan	5. 04/01/2018: Buy, Target Price Change HKD7.40 Mark Yuan
3. 01/06/2017: Buy, Target Price Change HKD5.80 Mark Yuan	6. 01/03/2018: Buy, Target Price Change HKD8.40 Mark Yuan





### Equity rating key

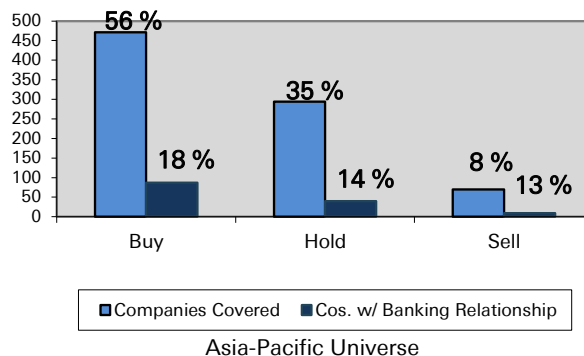
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**Sell:** Based on a current 12-month view of total share-holder return, we recommend that investors sell the stock

**Hold:** We take a neutral view on the stock 12-months out and, based on this time horizon, do not recommend either a Buy or Sell.

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