

China Mengniu

DBS Group Research . Equity

3 Jun 2020

BUY

Last Traded Price (2 Jun 2020):HK\$29.00(HSI : 23,996)

Price Target 12-mth:HK\$33.10 (14.1% upside) (Prev HK\$30.50)

Analyst

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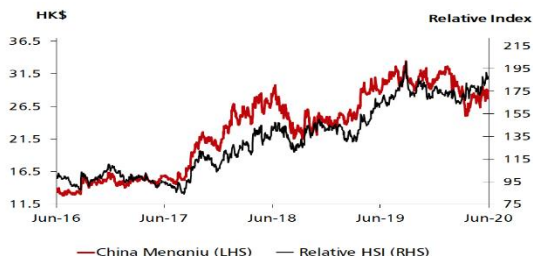
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What's New

- **April's sales recovery; destocking on track; steady recovery in 2H20**
- **Margin expansion in the medium term driven by product mix enhancement and recent M&As**
- **TP lifted to HK\$33.1, maintain BUY**

Price Relative



Forecasts and Valuation

FY Dec (RMBm)	2018A	2019A	2020F	2021F
Turnover	68,977	79,030	72,732	83,551
EBITDA	5,274	7,091	4,798	7,018
Pre-tax Profit	3,853	5,605	3,954	5,873
Net Profit	3,043	4,105	3,055	4,539
Net Profit Gth (Pre-ex) (%)	48.6	34.9	(25.6)	48.6
EPS (RMB)	0.77	1.05	0.78	1.16
EPS (HK\$)	0.85	1.14	0.85	1.26
EPS Gth (%)	47.4	34.9	(25.6)	48.6
Diluted EPS (HK\$)	0.85	1.14	0.85	1.26
DPS (HK\$)	0.20	0.20	0.15	0.22
BV Per Share (HK\$)	7.01	8.10	8.75	9.86
PE (X)	34.3	25.4	34.2	23.0
P/Cash Flow (X)	16.4	16.5	40.0	15.4
P/Free CF (X)	36.0	71.4	nm	26.8
EV/EBITDA (X)	22.1	17.7	26.0	17.1
Net Div Yield (%)	0.7	0.7	0.5	0.8
P/Book Value (X)	4.1	3.6	3.3	2.9
Net Debt/Equity (X)	0.2	0.5	0.5	0.3
ROAE (%)	12.7	15.1	10.1	13.6
Earnings Rev (%)			(26)	(15)
Consensus EPS (RMB)			0.89	1.27
Other Broker Recs:		B:25	S:1	H:6

Source of all data on this page: Company, DBS Bank (Hong Kong) Limited ("DBS HK"), Thomson Reuters

Enhanced product mix to drive margins

One of China's largest dairy processors. We reiterate our BUY rating on China Mengniu with TP raised to HK\$33.1 as we shift our valuation base to FY21F earnings. We expect stronger margins in FY21F driven by enhanced product mix especially higher valued items such as Bellamy's Organic, and star SKUs (Milk Deluxe, Chun Zhen). Excluding Junlebao and Bellamy impact, sales has resumed on its double-digit growth trend since April to ensure that retailers are carrying fresh products. With most stocks now cleared, we expect pricing will stabilise for key products. Near-term, overall margins will continue to face pressure due to higher price of spray dried milk powder in 1Q20, in addition to one-off ~Rmb700m expense on reliefs related to COVID-19.

Where we differ: We forecast earnings growth of 49% in FY21F against consensus' 44% as we anticipate stronger margin expansion from key products, particularly UHT milk.

Potential catalysts: Margins to play catch-up with Yili. Mengniu has lagged Yili in terms of weaker margins in certain product categories such as ice-cream and milk powder. With its recent acquisition of Bellamy's Organic, we expect the group to catch up with Yili's margins and profitability. Second, we expect its market leadership in new food categories such as fresh, plant-based protein, cheese and butter to cement the group's dominant positioning in the dairy sector. Lastly, the development of low-temperature products could leverage on Mengniu's strategic farm locations. Any positive progress in the above areas could prompt a further valuation re-rating.

Valuation:

Our TP of HK\$33.1 is pegged to 26.3x FY21F PE (previously FY20F), equivalent to +1 SD of its average PE, to reflect Mengniu's decent earnings growth outlook.

Key Risks to Our View:

Demand slowdown, raw material cost fluctuations, intense competition, and food safety concerns.

At A Glance

Issued Capital (m shrs)	3,935
Mkt Cap (HK\$m/US\$m)	114,115 / 14,725
Major Shareholders (%)	
COFCO Dairy Investments Ltd.	23.8
Prominent Achiever Ltd.	7.5
Schroder Investment Management Ltd. (SIM)	5.1
Free Float (%)	63.5
3m Avg. Daily Val. (US\$m)	44.91
GICS Industry: Consumer Staples / Food, Beverage & Tobacco	



Live more, Bank less

China Mengniu

CRITICAL FACTORS TO WATCH

Critical Factors

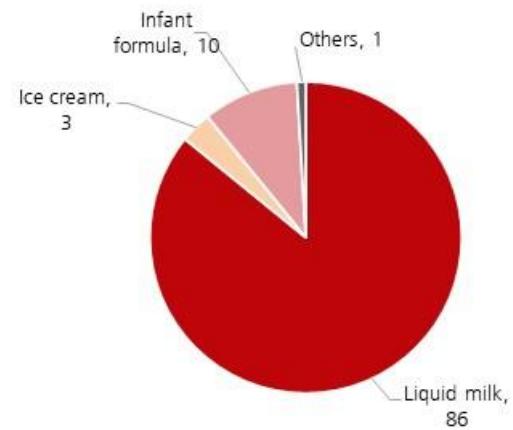
Product mix upgrade in liquid milk category. China dairy sector's growth remains robust, driven by rising consumption demand for high-end dairy products such as chilled fresh milk, room temperature and chilled products, cheese products, organic milk, and goat's milk, which are identified as the key drivers of the industry. We expect Mengniu's strength in developing star products (such as *Milk Deluxe*, *Just Yoghurt*, and *Fruit Milk Drink* within the liquid milk category) to continue to propel the group's sales growth and margin enhancement ahead. Mengniu's largest sales contributor is the liquid milk segment (86% of FY19 sales), which comprises UHT milk, milk beverages, and yogurt. Mengniu's UHT product market share grew steadily by 0.8ppt to 27.2% in FY19.

Infant formula: To capture market share. Mengniu holds a c.51% stake in Yashili International (1230.HK). Under the recent restructuring, Yashili hosts a total of 54 infant milk formula brands under 18 product series, as well as Arla (cooperative brand). There is increasing focus on developing key distribution channels such as mother-and baby stores while adult milk powder distribution is done via Key Account channels. In Dec 2019, Mengniu completed the acquisition of Bellamy's, an Australia organic infant formula and baby food producer for AUD1.46bn (Rmb6.9bn). This should enable Mengniu to capture the huge potential in the organic infant milk formula and baby food market in China. We expect Bellamy Organic to achieve teens growth in FY19-21F.

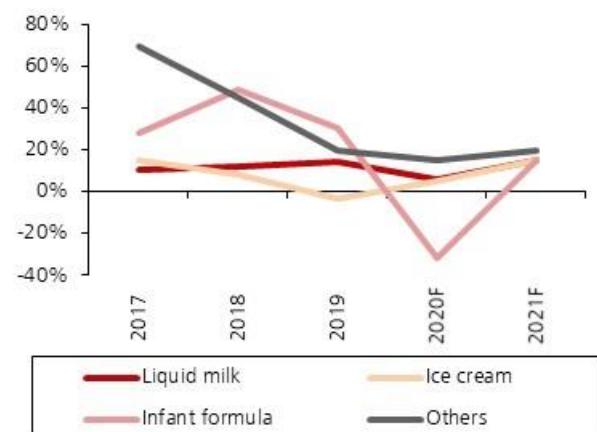
Growing emerging category. Mengniu is developing several emerging categories which will become strong growth areas in the medium term, including fresh dairy, cheese, and overseas businesses. Mengniu currently hosts two fresh milk brands, Shiny Meadow and Modern Meadow, which cover 24 provinces and 50 major cities across China. Meanwhile, cheese consumption has been gaining momentum. With the collaboration with Arla, Mengniu's venture into kid-friendly cheese, and expansion into catering channel should also add to its growth momentum. Lastly, Mengniu's first overseas venture in a liquid milk plant in Indonesia signals the group's ambition to expand in Southeast Asia. With the pending acquisition of Lion Group & Drinks (LDDF) for Rmb2.931bn, this will support its presence in Australia, and provide access to dairy supply to propel its expansion into Southeast Asia and China.

Raw material cost volatility. Mengniu's cost of sales is made up of domestic raw milk, imported bulk powder, sugar, packaging materials, and others. We expect Mengniu's gross margin to contract by 0.9ppts in FY20F due to the increase in usage of bulk powder, and weaker sales volume as a result of the COVID-19 outbreak, with mild recovery in 2H20, and by 0.5ppt in FY21F.

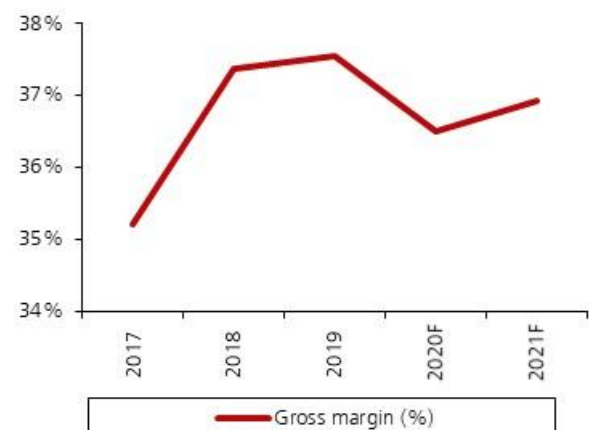
Sales breakdown (%) – FY19



Sales trend by product segment (% yoy)



Gross profit margin (%)

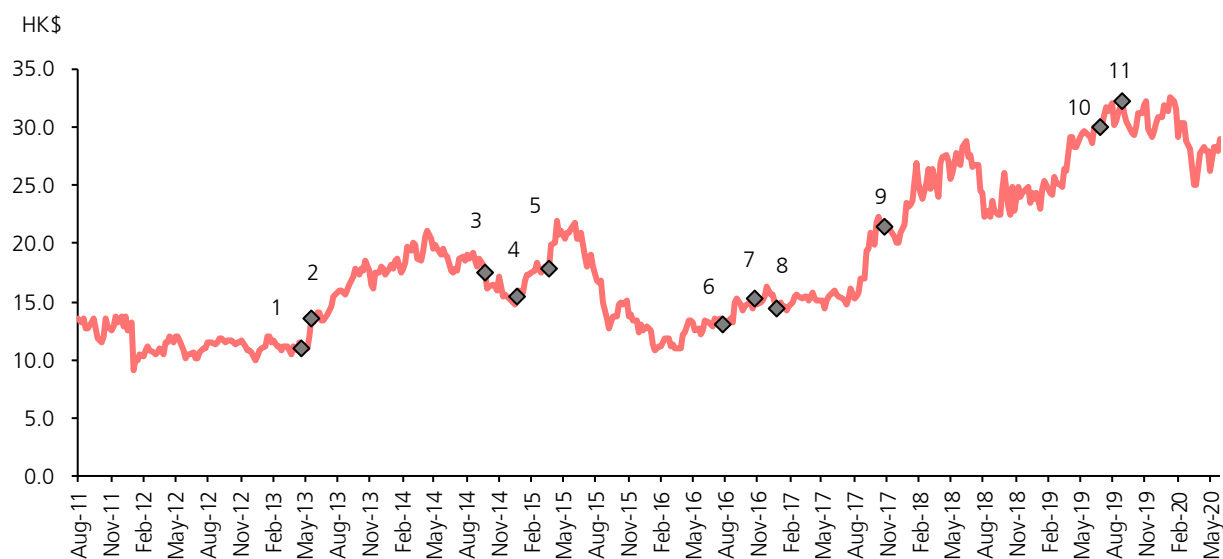


Source: Company, DBS HK

China Mengniu

Appendix 1: A look at Company's listed history – what drives its share price?

Share price performance



Date	Events
May-13	Subsequent to Danone becoming a strategic shareholder of Mengniu in May 2013, the latter's share price rallied with the increase in stake in Yashili (1230.HK)
Jun-13	Mengniu introduces a change in shareholding structure, with strategic alliances with Danone and Arla
Oct-14	Mengniu sold 25% of its Yashili stake to Danone and other shareholders to comply with free-float requirement to maintain its listing status
Jan-15	Imported milk powder volume dropped 41% y-o-y – investors cautious on a supply glut
Apr-15	Weaker-than-expected FY15 results expected
Aug-16	Mengniu saw a surprising overhaul of the management of Sun-Yi-ping, who was replaced by Yashili's CEO Jeffrey Lu
Nov-16	Profit warning announced, primarily due to a one-off provision write-off on Yashili, weaker profits from China Modern Dairy, and booking bulk powder losses
Jan-17	Mengniu announces an increase in stake in China Modern Dairy
Nov-17	Strong sales initiative to drive growth in core categories and the anticipation of World Cup Series
Jul-19	Mengniu announced the proposed disposal of Junlebao Dairy for a disposal gain of Rmb3.4bn
Sep-19	China Mengniu agrees to buy Bellamy's Organic for Rmb6.7bn

Source: Thomson Reuters, Company data

China Mengniu

Balance Sheet:

Manageable financial position. As of Dec 2019, the group's net gearing increased to 58% with the recent acquisition of Bellamy's Organic and Lion's Dairy & Drink (Dec 2018: 29.4%).

Share Price Drivers:

Maintain market share. We expect Mengniu's key priority to revolve around solidifying its market share. The group remains in a solid position to ride on the overall industry trend.

Stronger-than-expected margin expansion. With a shift in product mix, Mengniu could see stronger-than-expected margin expansion.

Key Risks:

Food safety issues. Mengniu may be affected by dairy-related industry news concerning food safety issues.

Raw material price volatility. Gross profit margin may be affected by raw material cost changes.

Environmental, Social, Governance:

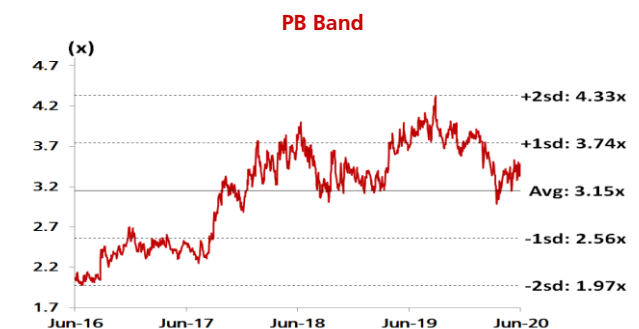
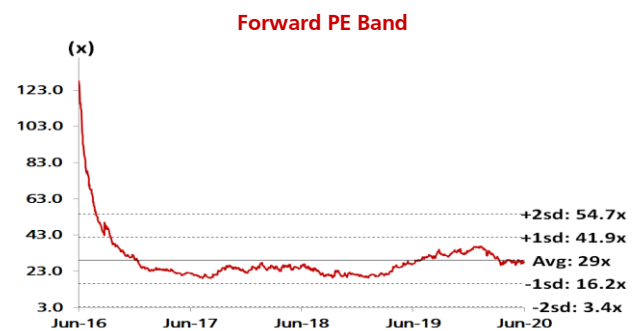
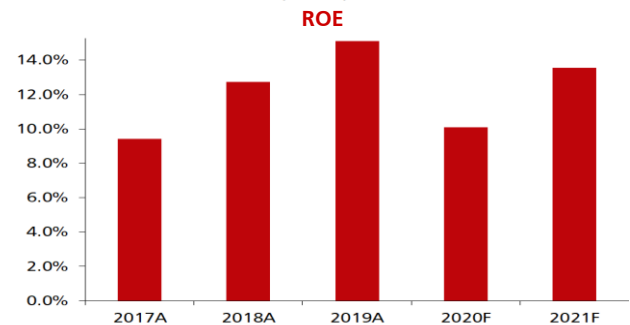
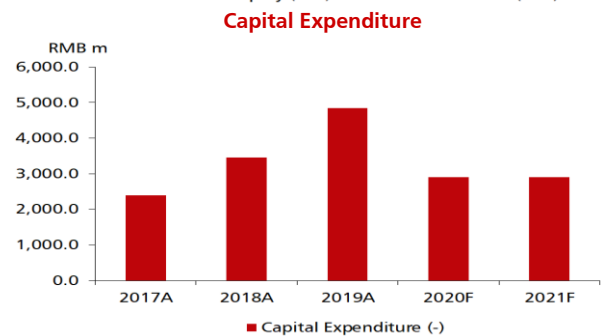
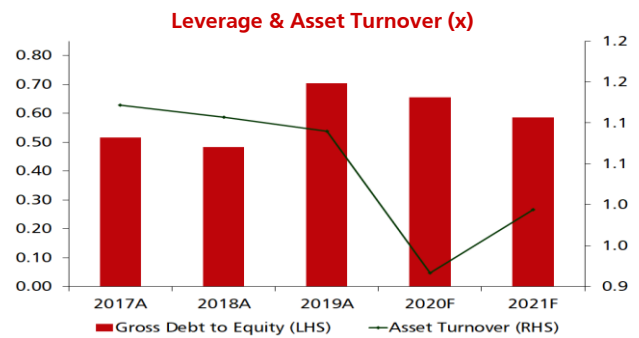
Mengniu has integrated green concepts into its operations. In this respect, the group has conducted independent checks on carbon footprint, carried out accounting greenhouse gas emissions in the production process, and identified opportunities for carbon reduction.

Company Background

One of the leading giants. Mengniu is one of the leading dairy giants in China. Mengniu, through its subsidiaries, manufactures and distributes dairy-related products (UHT milk, yogurt, and milk beverages), ice cream, and other dairy products such as infant formula powder.

Key listed companies. Mengniu has controlling stakes in two listed companies – Yashili (1230.HK) and China Modern Dairy (1117.HK) – which secures Mengniu's upstream supply chain as well as improves its infant formula capabilities. It also holds minor equity stakes in other upstream players such as Shengmu and YST Dairy.

Partnerships with international players. Mengniu has formed partnerships with its stakeholders such as Danone and Arla; Danone holds a 20% stake in Mengniu's cold-chain business that includes yogurt offerings. In addition, Mengniu has also formed a 51%/49% JV with US-based Whitewave Foods, which has launched plant-based products.



Source: Company, DBS HK

China Mengniu

Segmental Breakdown (RMB m)

FY Dec	2017A	2018A	2019A	2020F	2021F
Revenues (RMB m)					
Liquid milk	53,015	59,389	67,878	63,840	73,283
Ice cream	2,513	2,723	2,561	2,689	3,093
Other dairy products	4,042	6,017	7,870	5,374	6,180
Infant formula	585	848	721	829	995
Total	60,156	68,977	79,030	72,732	83,551

Source: Company, DBS HK

Income Statement (RMB m)

FY Dec	2017A	2018A	2019A	2020F	2021F
Revenue	60,156	68,977	79,030	72,732	83,551
Cost of Goods Sold	(38,973)	(43,193)	(49,351)	(46,046)	(52,449)
Gross Profit	21,183	25,784	29,679	26,686	31,101
Other Opng (Exp)/Inc	(18,210)	(21,949)	(24,709)	(23,197)	(25,701)
Operating Profit	2,972	3,835	4,970	3,489	5,400
Other Non Opng (Exp)/Inc	0	0	0	0	0
Associates & JV Inc	(532)	(300)	175	275	303
Net Interest (Exp)/Inc	184	318	461	190	170
Dividend Income	0	0	0	0	0
Exceptional Gain/(Loss)	0	0	0	0	0
Pre-tax Profit	2,625	3,853	5,605	3,954	5,873
Tax	(594)	(649)	(1,310)	(737)	(1,142)
Minority Interest	17	(161)	(190)	(162)	(191)
Preference Dividend	0	0	0	0	0
Net Profit	2,048	3,043	4,105	3,055	4,539
EBITDA	4,180	5,274	7,091	4,798	7,018
Growth					
Revenue Gth (%)	11.9	14.7	14.6	(8.0)	14.9
EBITDA Gth (%)	369.2	26.2	34.4	(32.3)	46.3
Opg Profit Gth (%)	(807.6)	29.0	29.6	(29.8)	54.8
Net Profit Gth (%)	N/A	48.6	34.9	(25.6)	48.6
Margins & Ratio					
Gross Margins (%)	35.2	37.4	37.6	36.7	37.2
Opg Profit Margin (%)	4.9	5.6	6.3	4.8	6.5
Net Profit Margin (%)	3.4	4.4	5.2	4.2	5.4
ROAE (%)	9.4	12.7	15.1	10.1	13.6
ROA (%)	3.8	4.9	5.7	3.8	5.4
ROCE (%)	5.7	7.0	7.0	4.6	6.6
Div Payout Ratio (%)	23.0	23.4	17.3	17.3	17.3
Net Interest Cover (x)	NM	NM	NM	NM	NM

Source: Company, DBS HK

China Mengniu

Balance Sheet (RMB m)

FY Dec	2017A	2018A	2019A	2020F	2021F
Net Fixed Assets	12,715	14,734	11,103	12,969	14,554
Invts in Associates & JVs	7,194	7,202	7,351	7,351	7,351
Other LT Assets	12,212	14,780	22,598	22,598	22,598
Cash & ST Invts	5,959	7,921	6,550	7,236	12,273
Inventory	3,510	4,282	5,090	4,749	5,409
Debtors	14,007	14,760	22,818	22,213	22,656
Other Current Assets	2,541	2,778	3,027	3,057	3,088
Total Assets	58,139	66,457	78,537	80,173	87,929
ST Debt	7,958	6,546	13,843	13,843	13,843
Creditors	6,342	7,022	6,739	7,444	8,479
Other Current Liab	8,266	11,542	11,153	8,870	10,541
LT Debt	6,015	8,192	9,635	9,635	9,635
Other LT Liabilities	2,450	2,691	3,822	4,530	5,380
Shareholder's Equity	22,604	25,212	29,132	31,475	35,484
Minority Interests	4,503	5,252	4,215	4,377	4,568
Total Cap. & Liab.	58,139	66,457	78,537	80,173	87,929
Non-Cash Wkg. Capital	5,450	3,257	13,044	13,705	12,134
Net Cash/(Debt)	(8,014)	(6,817)	(16,927)	(16,241)	(11,204)
Debtors Turn (avg days)	63.3	76.1	86.8	113.0	98.0
Creditors Turn (avg days)	57.6	58.8	53.0	57.5	56.8
Inventory Turn (avg days)	37.8	34.3	36.1	39.9	36.3
Asset Turnover (x)	1.1	1.1	1.1	0.9	1.0
Current Ratio (x)	1.2	1.2	1.2	1.2	1.3
Quick Ratio (x)	0.9	0.9	0.9	1.0	1.1
Net Debt/Equity (X)	0.3	0.2	0.5	0.5	0.3
Net Debt/Equity ex MI (X)	0.4	0.3	0.6	0.5	0.3
Capex to Debt (%)	17.2	23.5	20.6	12.4	12.4
Z-Score (X)	3.1	3.3	2.9	3.1	3.2

Source: Company, DBS HK

Cash Flow Statement (RMB m)

FY Dec	2017A	2018A	2019A	2020F	2021F
Pre-Tax Profit	2,625	3,853	5,605	3,954	5,873
Dep. & Amort.	1,625	1,841	2,160	1,034	1,315
Tax Paid	(638)	(662)	(990)	(1,310)	(737)
Assoc. & JV Inc/(loss)	0	0	0	0	0
(Pft)/ Loss on disposal of FAs	0	0	0	0	0
Chg in Wkg.Cap.	1,229	1,637	600	620	2,016
Other Operating CF	665	(305)	(1,069)	(1,690)	(1,670)
Net Operating CF	5,505	6,363	6,307	2,608	6,797
Capital Exp.(net)	(2,401)	(3,463)	(4,846)	(2,900)	(2,900)
Other Invts.(net)	(9,785)	(1,904)	(14,098)	0	0
Invts in Assoc. & JV	0	0	0	0	0
Div from Assoc & JV	0	0	0	0	0
Other Investing CF	736	1,135	1,414	1,690	1,670
Net Investing CF	(11,450)	(4,232)	(17,530)	(1,210)	(1,230)
Div Paid	(345)	(483)	(709)	(712)	(530)
Chg in Gross Debt	5,023	(300)	5,679	0	0
Capital Issues	48	5	0	0	0
Other Financing CF	1,098	609	4,881	0	0
Net Financing CF	5,824	(169)	9,851	(712)	(530)
Currency Adjustments	10	0	0	0	0
Chg in Cash	(111)	1,963	(1,371)	686	5,037
Opg CFPS (RMB)	1.10	1.20	1.45	0.51	1.22
Free CFPS (RMB)	0.80	0.74	0.37	(0.07)	0.99

Source: Company, DBS HK

China Mengniu

Target Price & Ratings History



	Date	Closing Price	12-mth Target Price	Rating
1:	12-Jun-19	HK\$30.20	HK\$34.30	Buy
2:	15-Nov-19	HK\$29.30	HK\$33.10	Buy
3:	27-Mar-20	HK\$26.60	HK\$30.50	Buy

Source: DBS HK

Analyst: Alison FOK

Mavis HUI

Alice HUI CFA

DBS HK recommendations are based on an Absolute Total Return* Rating system, defined as follows:

STRONG BUY (>20% total return over the next 3 months, with identifiable share price catalysts within this time frame)

BUY (>15% total return over the next 12 months for small caps, >10% for large caps)

HOLD (-10% to +15% total return over the next 12 months for small caps, -10% to +10% for large caps)

FULLY VALUED (negative total return, i.e., > -10% over the next 12 months)

SELL (negative total return of > -20% over the next 3 months, with identifiable share price catalysts within this time frame)

*Share price appreciation + dividends

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Sources for all charts and tables are DBS HK unless otherwise specified.

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China Mengniu

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