

China Modern Dairy (1117 HK)

Takeaways from reverse roadshow

We joined the reverse roadshow in Anhui Bengbu. Management lifted raw milk price forecast in FY20E from 3% to not less than 4% and mentioned to add one farm each year during FY20-22E by asset-light approach. We think market should not be too bearish on dairy product companies' GPM because they have prepared for raising prices. Trading at 0.9x P/B in FY20E, valuation is undemanding compared to historical average of 1.4x.

- Raw milk price outlook.** Raw milk ASP rose 4% to RMB4.13/kg in 3Q19. Management expects ASP to increase by 4% in FY19E and not less than 4% in FY20E. The milk shortage was due to exit of small farms arising from low milk price in 2018, stringent environmental protection requirements and high beef price in 2019 (led by ASF). Since it takes around three years from investing a new dairy farm to producing milk, management expects raw milk price to grow slightly in 2021 and 2022.
- Implications to dairy products companies.** Management stated that Mengniu and Yili have prepared for raising prices if their margins are hurt by raw milk prices. We think market should not be too bearish on their GPM. When raw milk price increased 10%/12% in FY13/14, Mengniu managed to expand GPM by 1.9/3.9ppt, respectively, by raising prices and enhancing product mix. We have Buy rating on Mengniu (2319 HK) and Yili (600887 CH).
- 3Q19 operation data continued improving trend.** Production volume growth accelerated from 7% in 1H19 to 11% in 3Q19. Raw milk ASP growth improved from 3% in 1H19 to 4% in 3Q19. Unit cost decline remained at 4.5% in 3Q19. (see Figure 1).
- Multiple growth drivers.** Besides milk price, CMD outlined several growth drivers ahead: (1) **Raise milk yield:** Management is confident to improve annualized milk yield continuously through genetics (10.4 ton/year in 9M19 vs the breed of its cow semen can produce 13.5 ton/year); (2) **Increase cow farms:** Add one farm (10,000 cows capacity) each year during FY20-22E by asset-light model; (3) **Lower feed cost:** Gradually increase usage of low-cost corn silage to replace high-cost alfafa; (4) **Expand branded milk business:** CMD targets to double its sales from RMB1.05bn in FY19E to RMB2bn in FY22E on further penetration into lower-tier cities and launch of new products (low-fat high-calcium and A2 milk in FY20E); (5) **Reduce finance cost:** CMD plans to reduce borrowings from current RMB6.5bn to RMB5.5bn by 2022.
- Undemanding valuation.** Management guided a 5-8% volume growth and not less than 4% ASP growth in FY20E, implying a 9-12% revenue growth. We think consensus' 7% revenue growth in FY20E is conservative. The stock trades at 10.7x P/E and 0.9x P/B in FY20E, according to consensus. Its P/B is lower than historical average of 1.4x.

Earnings Summary

(YE 31 Dec)	FY16A	FY17A	FY18A
Revenue (RMB mn)	4,862	4,784	4,957
YoY growth (%)	1	(2)	4
Net profit (RMB mn)	(742)	(975)	(496)
EPS (RMB)	(0.14)	(0.16)	(0.08)
YoY growth (%)	(320)	16	(50)
P/E (x)	na	na	na
P/B (x)	0.9	1.0	1.1
Yield (%)	na	na	na
ROE (%)	(10.0)	(13.9)	(7.4)

Source: Company data, CMBIS estimates

NOT RATED

Current Price

HK\$1.19

China F&B Sector

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Stock Data

Mkt Cap (HK\$ mn)	7,625
Avg 3 mths t/o (HK\$ mn)	3.99
52w High/Low (HK\$)	1.43/ 0.71
Total Issued Shares (mn)	6,131.4

Source: Bloomberg

Shareholding Structure

Mengniu	58.15%
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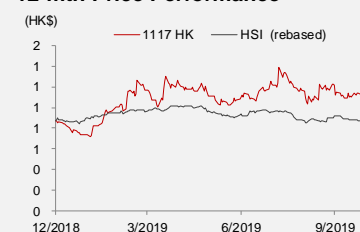
Source: HKEx

Share Performance

	Absolute	Relative
1-mth	-0.8%	3.5%
3-mth	1.7%	2.4%
6-mth	11.2%	13.2%

Source: Bloomberg

12-mth Price Performance



Source: Bloomberg

Auditor: Deloitte

Related reports

"China Dairy Sector - Multiple growth drivers ahead; sector consolidation to continue" – 19 Nov 2019

Figure 1: 9M19 operation data

	1H18	1H19	YoY	9M18	9M19	YoY	3Q18	3Q19	YoY
Milk production volume (10,000 tons)	63.9	68.2	6.7%	94.3	101.8	8.0%	30.4	33.6	10.5%
Milk sales volume (10,000 tons)	62.3	66.8	7.2%	92.2	99.8	8.2%	29.9	33.0	10.4%
ASP (RMB/kg)	3.73	3.85	3.2%	3.81	3.94	3.4%	3.96	4.13	4.3%
Annualized milk yield (ton/head)	10.3	10.6	2.9%	10.1	10.4	3.0%	na	na	na
Unit cost (RMB/kg)	2.42	2.31	-4.5%	2.45	2.34	-4.5%	na	na	na
Feed cost (RMB/kg)	1.89	1.78	-5.8%	1.79	1.78	-0.6%	na	na	na
Dairy cows (heads)	225,782	226,861	0.5%	227,212	233,159	2.6%	na	na	na
Milkable cow proportion	55.9%	58.0%	+2.1ppt	57.1%	58.3%	+1.2ppt	na	na	na
Milkable cow	126,212	131,579	4.3%	129,738	135,932	4.8%	na	na	na

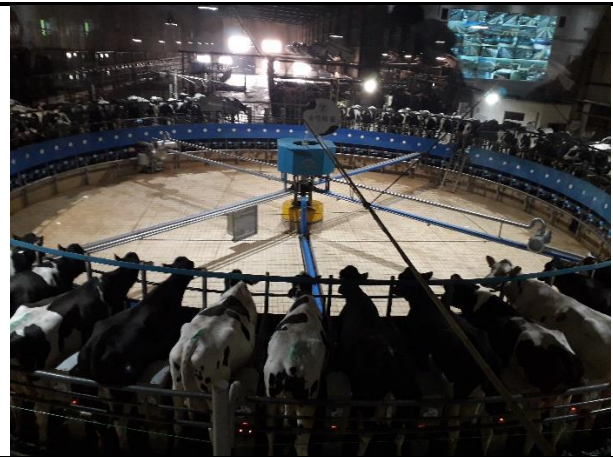
Source: Company data

Figure 2: CMD's Bengbu Farm in Anhui



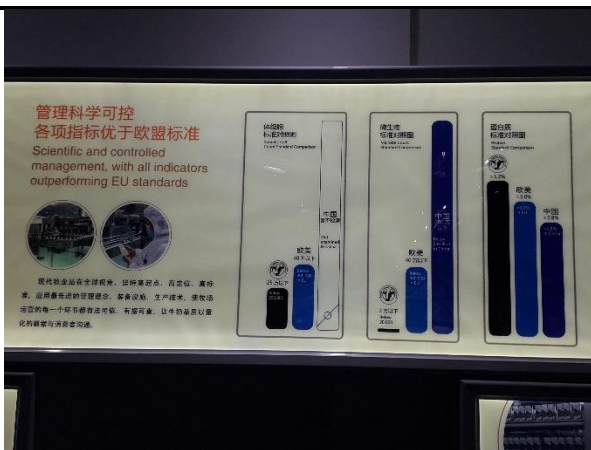
Source: CMBIS

Figure 3: Automated milking of cows



Source: CMBIS

Figure 4: CMD's milk is above European and Chinese standard



Source: CMBIS

Figure 5: Branded milk is produced within two hours



Source: CMBIS

Figure 6: Packaging of branded milk



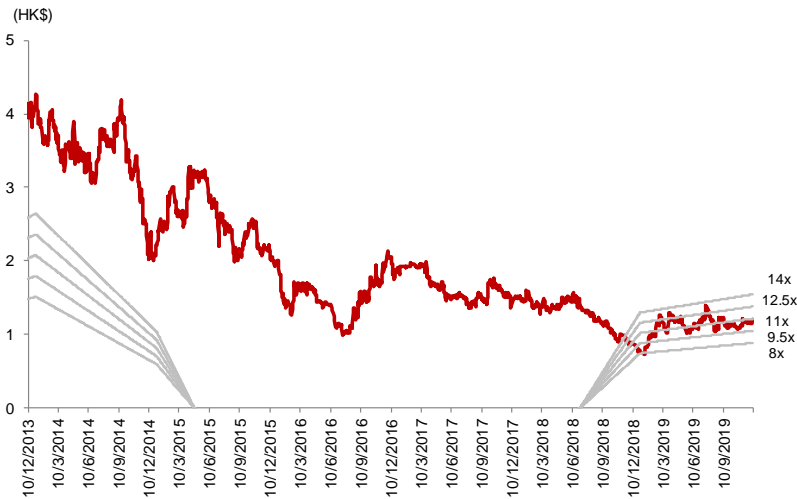
Source: CMBIS

Figure 7: CMD has around 230,000 milk cows



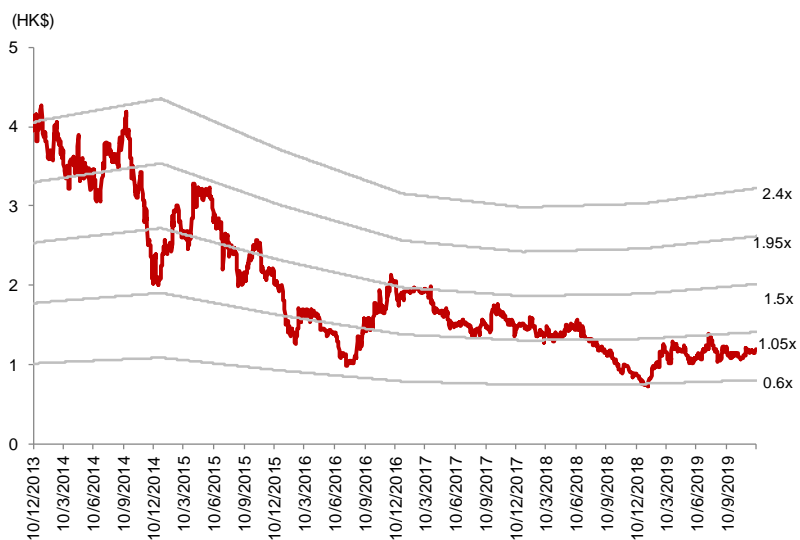
Source: CMBIS

Figure 8: P/E band chart



Source: Bloomberg estimates, CMBIS

Figure 9: P/B band chart



Source: Bloomberg estimates, CMBIS

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