

# China Dairy Sector

## Multiple growth drivers ahead; sector consolidation to continue

Low per capita consumption, premiumization, production innovation and segmentation are growth drivers of China dairy sector. We expect Mengniu and Yili to gain market share further given their niches and unrivalled A&P spending. We prefer Mengniu (2319.HK, Buy) to Yili (600887.CH, Buy) on stronger profit growth outlook. We give Outperform rating to China Dairy Sector.

■ **Multiple growth drivers.** (1) **Low consumption level:** China's dairy consumption per capita is just 1/3 of global average. Low consumption level and B2B development (such as 1<sup>st</sup>.1688.com) would promote growth in lower tier cities. (2) **Product innovation and segmentation:** By employing technologies and upgrading flavor, function and packaging to create new product categories and develop new markets. (3) **Premiumization:** As income level increases, consumers are seeking quality and healthy products. Mengniu and Yili's high-end UHT milk (Milk Deluxe and Satine) recorded better sales growth than liquid milk segment in FY18 and 1H19. (4) **Rising product categories:** Chilled fresh milk, cheese and plant-based milk beverages have low penetration in China.

■ **Top two leaders continue to gain market share.** Market share of Yili and Mengniu has risen to 40% in 2018 (vs 32.2% in 2013). Distribution network, brand equity, raw milk supply, capital and R&D are barriers to competitors. Top two players have established many key product brands to grab market share through product innovation and intensive marketing. They reinvested certain gain from market share in A&P so their A&P spending gap between small players has been widening. Smaller players, whose NPM are thin, find it difficult to afford sponsoring major events and top entertainment programs.

■ **Mengniu (2319 HK, Buy).** MN's revenue growth accelerated in 3Q19 (vs 2Q19) driven by Milk Deluxe and Just Yoghurt. Management expects revenue growth in FY19E could beat guidance of low-teens growth but it could be challenging to achieve 0.5ppt OPM expansion due to stronger-than-expected raw milk price in 2H19E. That said, we think the guidance change should have been priced in. We forecast Mengniu to post 22% adjusted EPS CAGR (ex-Junlebao basis) from FY19E to FY21E led by above-group level growth of Milk Deluxe and Just Yoghurt, product mix upgrade, GPM improvement of ice-cream and infant milk formula segments, more disciplined discount promotion and decrease of non-A&P selling expenses ratio. Our TP of HK\$37.00 is based on 28.0x FY20E P/E, in the high-end of 18-30x 1-yr forward P/E range since Mengniu resumed double-digit revenue growth in FY16.

■ **Yili (600887 CH, Buy).** Yili is the market leader with good execution track record. The sales of its high-margin, key product brand Ambrosial grew from launch in FY13 to RMB14bn in FY18. The restricted share award scheme could keep a stable management team for next five years to develop new businesses and overseas markets. We forecast Yili to post 12% adjusted EPS CAGR from FY19E to FY21E, led by 11% revenue CAGR but stable adjusted OPM. Our TP of RMB34.04 is based on 28.0x FY20E P/E, the mid end of its 1-yr forward P/E range of 21x-36x since A-share was said to be included in MSCI Emerging Markets Index in Jun 2017.

### Valuation Table

Name	Ticker	Rating	Mkt Cap (US\$ mn)	Price (LC)	TP (LC)	P/E (x) FY19E	P/E (x) FY20E	P/B (x) FY19E	ROE (%) FY19E
Mengniu	2319 HK	Buy	14,653	29.15	37.00	26.3	22.1	3.4	14.1
Yili	600887 CH	Buy	25,214	29.00	34.04	26.9	23.9	6.3	23.3
Bright Dairy	600597 CH	NR	2,080	11.91	na	30.9	27.6	2.6	8.6
Ausnutria	1717 HK	NR	2,049	9.95	na	15.9	12.2	4.1	22.5
H&H	1112 HK	NR	2,543	31.00	na	14.2	11.9	3.1	23.7

Source: Company data, CMBIS estimates

## OUTPERFORM (Initiation)

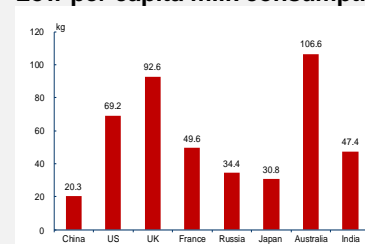
### China Dairy Sector

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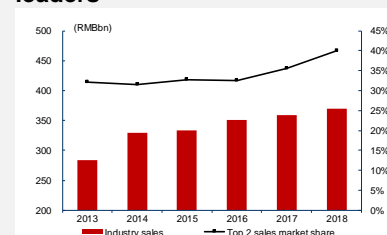
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### Low per capita milk consumption



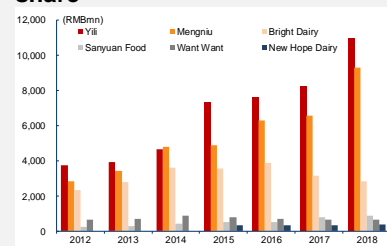
Source: China Dairy Yearbook

### Rising market share of top two leaders



Source: Company data, China Dairy Statistics Summary 2018, 2019 China Dairy Industry Sales Development White Paper

### Top two leaders had unrivalled A&P spending to gain market share



Source: Company data, CMBIS estimates

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## Investment Thesis

### Multiple growth drivers

We think the following are growth drivers of dairy sector: (1) **Low consumption level:** China's dairy consumption is just 1/3 of global average. Low consumption level, increasing brand awareness and B2B development (such as 1st.1688.com or huixiadian) would promote growth in lower tier cities. (2) **Product innovation and segmentation:** By employing technologies and upgrading flavor, function and packaging to create new product categories and develop new markets. (3) **Premiumization:** As income level increases, consumers are seeking quality and healthy products. Mengniu and Yili's high-end UHT milk (Milk Deluxe and Satine) recorded better sales growth than liquid milk segment in FY18 and 1H19. (4) **Rising product categories:** Chilled fresh milk, cheese and plant-based milk beverages are underpenetrated in China.

### Top two leaders continue to gain market share

Market share of Yili and Mengniu has risen to 40% in 2018. Barriers to entry are high for dairy sector. Distribution network, brand equity, raw milk supply, capital and R&D are barriers to competitors.

#### ■ Establish and expand key product brands portfolio

Top two players have established many key product brands to grab market share through product innovation and intensive marketing. The successful build-up of these key product brands is a major reason that top two leaders can widen their market share gap between small players.

#### ■ Top two leaders had unrivalled A&P spending

They reinvested certain gain from market share in A&P so their A&P spending gap between small players has been widened. Sponsorship fees of major events (Olympic Games, World Cup and World Expo) and top entertainment programs (《奔跑吧》) are expensive. Small players, whose NPM are thin, find it difficult to afford these sponsorships.

### Mengniu (2319 HK, Buy) - Margin expansion ahead

#### ■ Milk Deluxe a key growth driver

Milk Deluxe is MN's largest product category, contributing ~19% of revenue in FY18. Thanks to its successful product segmentation strategy and comprehensive advertising campaigns, revenue growth of Milk Deluxe reached ~22% in 1H19 (vs MN organic growth of 13%) and accelerated to 25-30% in 3Q19, according to our channel checks. We think Milk Deluxe will remain MN's key growth driver driven by its strong brand equity, consumption upgrade trend and organic milk demand.

#### ■ Momentum accelerated in 3Q19 but raw milk under cost pressure

Given momentum of both Milk Deluxe and Just Yoghurt (contributed ~30% of total revenue in FY18) accelerated in 3Q19, management expects revenue growth in FY19E could beat guidance of low-teens growth. However, due to stronger-than-expected raw milk price in 2H19E (8% YoY vs 5-6% YoY in 1H19), management thinks it is challenging to achieve a flat GPM in 2H19E and 0.5ppt OPM expansion in FY19E. That said, we think the guidance change should have been priced in (share price has fallen 9% since 5 Nov). We forecast Mengniu to post 32% adjusted net profit growth in FY19E on 15% revenue growth.

### ■ Margin expansion trend

We expect Mengniu to deliver OPM expansion in FY20-21E, led by GPM and non-A&P expenses ratio improvement. The GPM expansion is driven by strong growth of high-margin Milk Deluxe and Just Yoghurt, continuing product mix enhancement and innovation, GPM improvement of IMF and ice-cream segments and more disciplined discount promotion activities. Mengniu had a higher non-A&P related selling expenses ratio than Yili (~13.8% vs 11.2% in FY18). We expect Mengniu would gradually squeeze non-A&P expenses ratio by efficiency enhancement.

### ■ Initiate at Buy

We estimate MN to post 22% adjusted EPS CAGR (ex-Junlebao basis) from FY19E to FY21E, driven by 13% revenue CAGR and 1.0ppt adjusted OPM improvement. Our TP of HK\$37.00 is based on 28.0x FY20E P/E, which is in the high-end of 18-30x 1-yr forward P/E range since Mengniu resumed double-digit revenue growth in 2016. **Catalysts:** better-than-expected revenue and margins. **Risks:** intensifying competition, raw milk cost pressure (net profit drops 4% per 1% increase of raw milk price), food safety issues.

## Yili (600887 CH, Buy) - Market leader with good execution track record

### ■ Market leader with good execution track record

Ambrosial (安慕希), launched in Jan 2014, is Yili's largest products in terms of sales (around 18% of revenue in FY18). Although this UHT yogurt product was launched later than its key competitors, its sales in FY18 was much greater than them. Leveraging on marketing campaigns of Beijing 2008 Olympic Games and Shanghai 2010 World Expo, Yili's revenue surpassed Mengniu in FY12. Yili's strong nationwide network penetration, especially in lower tier cities where per capita consumption is catching up, also contributed to its market leadership.

### ■ 3Q19 net profit +18%

Yili reported 11% YoY revenue growth in 3Q19, better than 9% growth in 2Q19 but behind Mengniu's >15.6% growth in 3Q19. Growth of both Ambrosial and Satine underperformed Mengniu's Just Yoghurt and Milk Deluxe in 3Q19. 3Q19 GPM slightly improved 0.2ppt on product mix enhancement and reduced discount promotion activities. 3Q19 net profit rose 18% YoY led by 2.4ppt decrease of selling expenses ratio due to better economies of scale and healthy revenue growth. We estimate 13% revenue growth and 9% net profit growth in FY19E.

### ■ 12% adjusted net profit CAGR from FY19E to FY21E

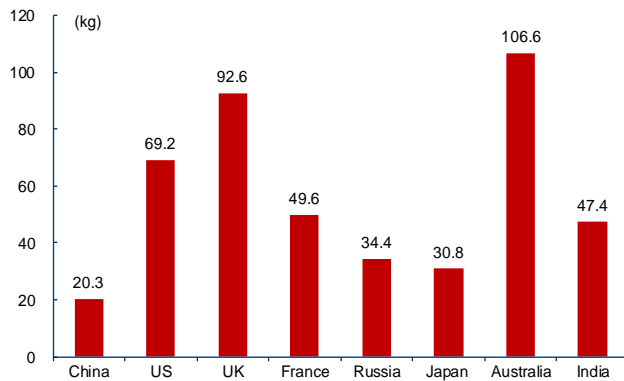
We forecast the growth is led by 11% CAGR of revenue. We expect its OPM to remain stable in 9.1-9.2% in FY19E-21E. Amid rising raw milk cost, we think Yili could be more disciplined in discount promotion activities to achieve the required 8.2% CAGR of adjusted net profit specified by the restricted share award scheme.

### ■ Initiate at Buy

We set our TP of HK\$34.04, based on 28x FY20E P/E, the mid end of its 1-yr forward P/E range of 21x-36x since A-share was said to be included in MSCI Emerging Markets Index in Jun 2017. Our 12% adjusted EPS CAGR from FY19E to FY21E is within 10-17% adjusted EPS growth in FY17-18. Therefore, we think our target P/E of 28.0x is fair. **Catalysts:** better-than-expected revenue and margins; **Risks:** intensifying competition, raw milk cost pressure and food safety.

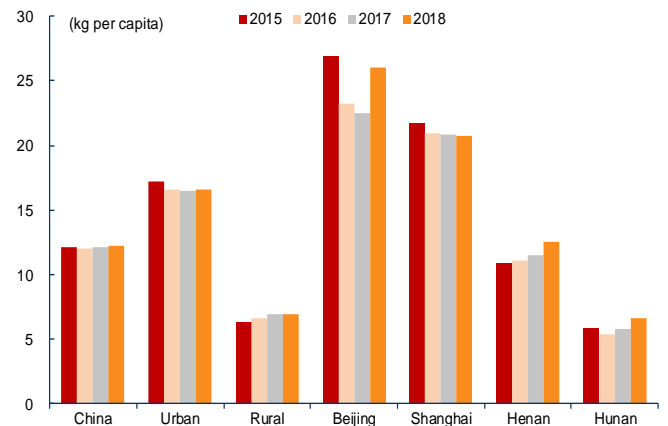
## Focus Charts

**Figure 1: China's milk consumption per capita lower than developed countries and Asian countries, 2016**



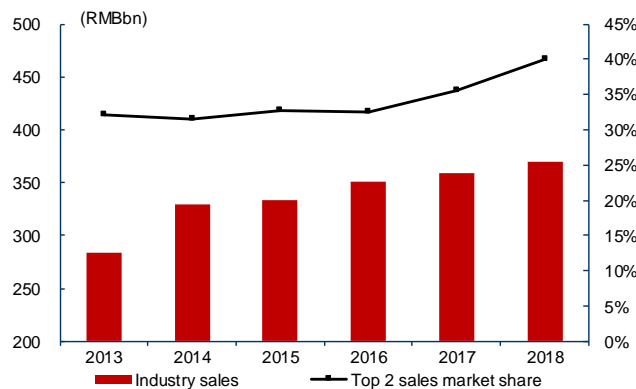
Source: China Dairy Yearbook

**Figure 2: Rural household's milk consumption per capita was 42% of urban household's level in 2018**



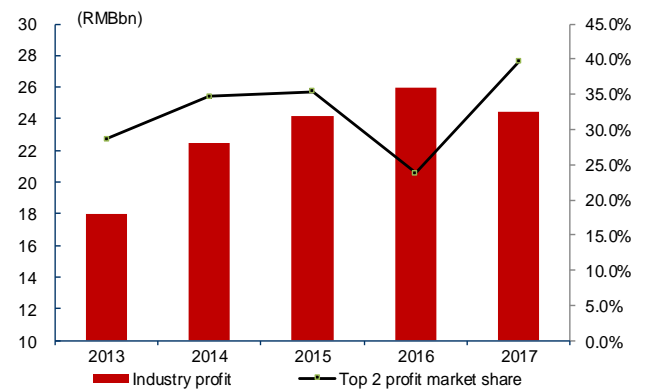
Source: Wind

**Figure 3: Top two leaders are expanding their market share in terms of revenue in dairy products industry**



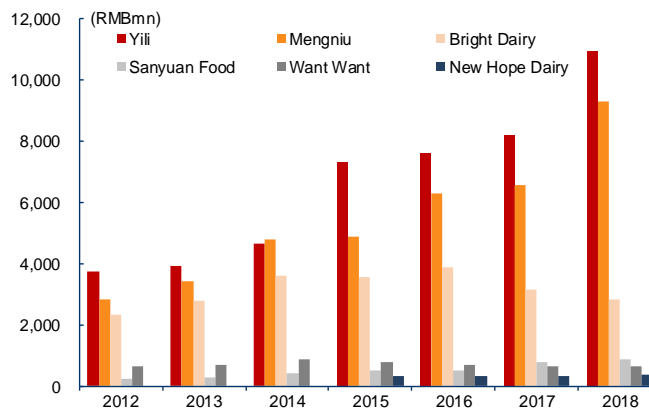
Source: Company data, China Dairy Statistics Summary 2018, 2019  
China Dairy Industry Sales Development White Paper

**Figure 4: Market share of their profits is increasing as well**



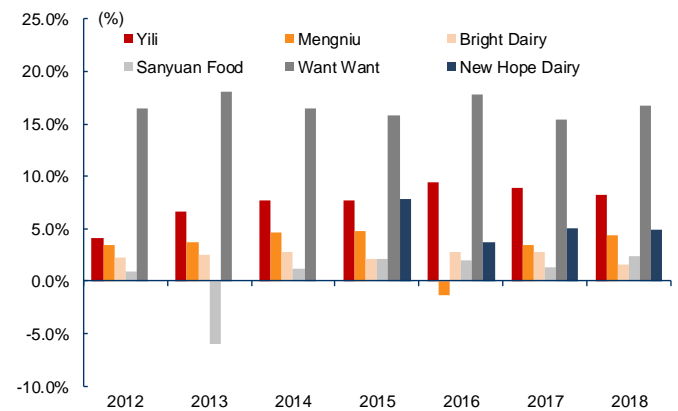
Source: Company data, China Dairy Statistics Summary 2018

**Figure 5: Top two leaders had unrivalled A&P spending to gain market share**



Source: Company data, CMBIS estimates  
Mengniu's FY18 A&P expenses is CMBIS estimates

**Figure 6: Small players had thin NPM, which limited their spending on A&P**



Source: Company data, CMBIS estimates

## Growth drivers of China dairy sector

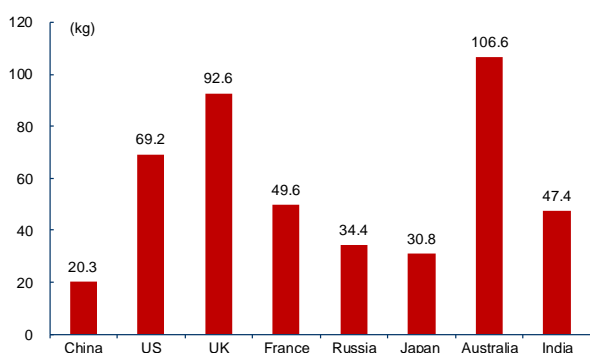
### China's dairy consumption per capita was only 1/3 of global average

According to Dairy Association of China, China's dairy products consumption per capita was 36.9kg in 2017, representing around 100g/day, which is below the Chinese Dietary Guidelines' recommendation of 300g/day. The consumption level was only around 1/3 of global average level, suggesting exciting growth potential of China's dairy sector as its income and living standard increase.

According to China Dairy Yearbook, China's liquid dairy consumption per capita was 20.3kg in 2016, which was far below US, UK and Australia's consumption level and only 66% and 43% of Japan and India's consumption level (Figure 7).

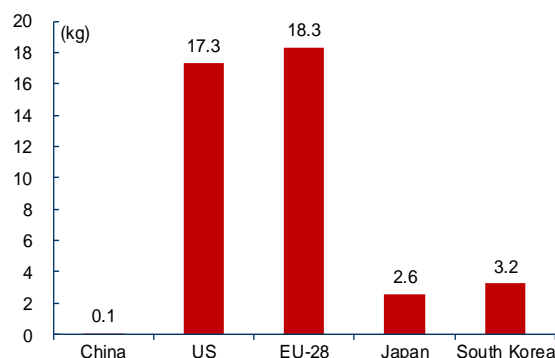
Cheese is a common food used in burgers and sandwiches in Western countries. However, in China, cheese is an emerging product category. According to Agricultural Information Institute of CAAS's "2019-2028 China Dairy Product Market Development Outlook Report", China's cheese consumption per capita was 0.1kg in 2016. This consumption level is even way below Japan and Korea (Figure 8). The report estimated that China's cheese consumption per capita will increase four times to 0.5kg in 2028.

**Figure 7: China's liquid dairy consumption per capita lower than Asian countries, 2016**



Source: China Dairy Yearbook

**Figure 8: China's cheese consumption per capita has huge growth potential, 2018**



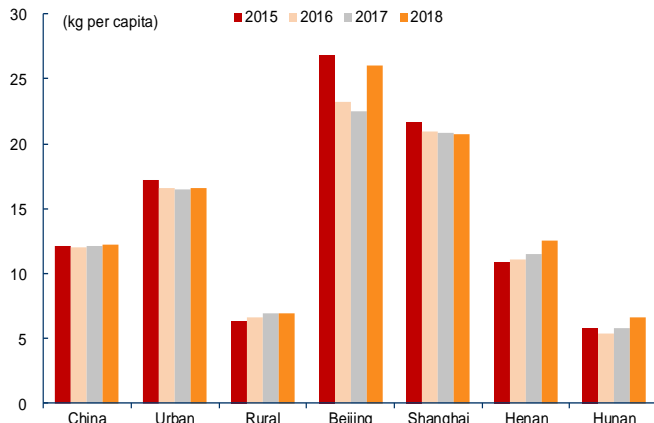
Source: Agricultural Information Institute of CAAS, CLAL  
 \*China's consumption was less than 0.1kg in 2016

### ■ Much penetration upside potential at lower tier cities

According to National Bureau of Statistics, rural household's milk consumption per capita was 6.91kg, only 42% of urban household's 16.53kg in 2018 (Figure 9). Tier 1 cities such as Beijing and Shanghai's level was even higher at 26.02kg and 20.78kg, respectively.

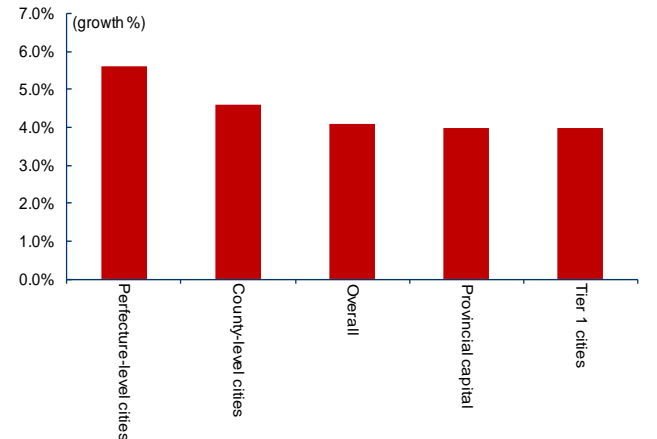
Given that income level increases, consumers in lower tier cities would look for consumption upgrade, such as switching to reputable brands. On the other hand, the development of B2B has enhanced distribution channel efficiency in lower-tier cities. For examples, through "1st.1688.com" or "huixiadian" app, distributors can collect orders from many couple stores (夫妻店) in towns and villages. Mengniu also launched its "镇村通" model to improve network penetration in rural areas. As at end of Jun 2019, this model had covered >4,000 towns and villages and increased Mengniu's POS by 200,000. Overall, we think consumption upgrade trend, continuous urbanization and further channel penetration could drive sales growth in lower tier cities.

**Figure 9: Rural household's milk consumption per capita was only 42% of urban household's level in 2018**



Source: Wind

**Figure 10: Growth in lower tier cities outpaced tier 1 and 2 cities in 1H19**



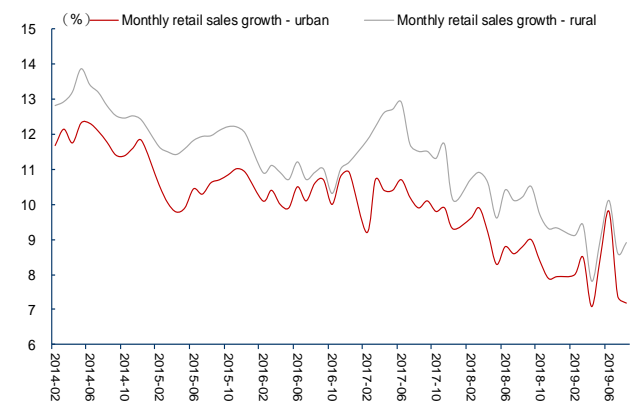
Source: Kantor

**Figure 11: Mengniu launched its “镇村通” model in Henan in 2018**



Source: Company

**Figure 12: Retail sales growth in rural area has been faster than urban area**



Source: Wind



## Premiumization, product innovation and segmentation are key growth drivers

Growth of China dairy sector is driven by continuing product innovation and upgrade by employing latest technologies and aligning with industry's highest standards in upgrading product packaging, flavor and function, creating new product categories and developing new markets. With the aid of big data analytics, companies can optimize consumer research, member management and supply chain operation system and more accurately observe consumer demand through O2O interaction and information cooperation strategy across different industry enterprises.

As income level increases, Chinese consumers are becoming more health conscious and willing to pay for quality, healthy products. Premiumization, such as consumption upgrade from pure milk to high-end milk or organic milk, boosted revenue growth of dairy industry. For examples, Mengniu's high-end milk brand, Milk Deluxe, recorded teens and 22% sales growth in FY18 and 1H19, higher than liquid milk segment's revenue growth of 12% and 14%, respectively. Yili's Satine achieved 20%+ and 17% revenue growth in FY18 and 1H19, stronger than its liquid milk segment's 18% and 13% growth, respectively.

Yili's ASP growth from product mix enhancement contributed 3-6ppt YoY revenue growth each financial period between FY15 and 1H19.

### ■ Typical example of product innovation: UHT yogurt

Launched in 2013, both Yili's Ambrosial and Mengniu's Just Yoghurt have become star products.

#### 1) Just Yoghurt (纯甄) reached ~RMB8bn sales in 2018

Mengniu launched its first kind of UHT yogurt, Just Yogurt, in May 2013, targeting mid to high income consumers. It is manufactured by quality milk source and fermented with lactobacillus without additives, artificial color or preservatives. Advanced Danish production technology is adopted to ensure safe preservation under room temperature.

#### 2) Ambrosial (安慕希) reached ~RMB14bn sales in 2018

Ambrosial is a high-end yogurt product manufactured by quality milk source and fermented with Greek bacteria. Its protein nutrition is greater than other yogurt products. Its flavor is natural without addition of preservatives, sweeteners and artificial color. We estimate its sales exceeded RMB14bn in 2018, representing around 18% of Yili's revenue in FY18.

Figure 13: Yili's Ambrosial



Source: Tmall.com

Figure 14: Mengniu's Just Yoghurt



Source: Tmall.com



### ■ Product innovation - “须尽欢” ice-cream

Yili has introduced a high-end ice-cream brand “须尽欢” (retail price around RMB20 per bar) in May 2019. The product is made with 100% fruit juice and yogurt, with traditional Chinese (国潮) packing design. The product received a good inception as it was recommended by many online KOLs and included in “Tmall V list”.

Figure 15: Yili's 须尽欢 ice-cream



Source: sohu.com

Figure 16: 须尽欢 was selected by “Tmall V list”



Source: sohu.com

### ■ Premiumization: High-end UHT milk grows faster than liquid milk

High-end UHT milk is one of growth drivers of both Mengniu and Yili, reflecting consumption upgrade trend as more consumers prefer premium quality milk products (organic and high nutrition).

#### 1) Satine (金典) reached ~RMB10bn sales in 2018

Satine is the high-end brand of Yili's UHT milk. Its protein concentration of 3.6g/100mL is higher than general UHT milk. It also has a more premium organic milk series, which is certified by China and EU. Satine achieved stronger revenue growth than Yili's liquid milk segment in FY18 (20%+ vs 18%) and 1H19 (17% vs 13%). In Aug 2019, Yili further upgraded its Satine milk protein content from 3.6g/100mL to 3.8g/100mL.

#### 2) Milk Deluxe (特仑苏) reached ~RMB13bn sales in 2018

Milk Deluxe has been Mengniu's star product. The product has garnered the gold award at BioFach for six consecutive years. Milk Deluxe Organic is certified by China and EU and each pack is traceable by an anti-fake product number check system. Milk Deluxe saw better revenue growth than Mengniu's liquid milk segment in FY18 (teens growth vs 12%) and 1H19 (22% vs 14%).

Figure 17: Yili's Satine organic milk



Source: Tmall.com

Figure 18: Mengniu's Milk Deluxe organic milk



Source: Tmall.com

### ■ Product segmentation example – UHT milk

The differentiation of existing products can lead to slightly different product lines catering for different groups of customers. For example, pure UHT milk can be differentiated into various kinds of milk products such as organic, low-fat, skimmed, high-calcium, high-protein, lactose-free, heart-protection, eye-protection, different packages etc.

Mengniu launched skimmed milk for its Milk Deluxe brand by crossover with fine tea brand Lelecha. The packaging of the product adopts three different kinds of tradition Beijing embroidery, namely crane, butterfly and mandarin duck. Its retail price is set at higher than Milk Deluxe organic milk.

Yili introduced its premium UHT milk, Satine Jersey (金典娟姗) in 2019. In 19th century, the milk produced by British Jersey cattle was consumed by British Royal Family.

**Figure 19: Yili's premium Satine Jersey milk**



Source: Tmall.com

**Figure 20: Mengniu's Milk Deluxe skimmed milk**



Source: Tmall.com

## Rising product categories

Certain emerging product categories such as cheese, chilled fresh milk and plant-based beverages could be growth drivers in long term because of their low penetration in China.

### ■ Cheese is underdeveloped in China

Cheese is a high value-added product with rich nutrition value (protein and calcium), because the production of 1kg cheese requires input of 10kg milk. Given consumers' increasing health consciousness, we expect rising consumption from elderly and kids. The increasing acceptance of Western-style food and the promotion of cheese in schools by the MOARA also are growth drivers. China's cheese consumption per capita was 0.1kg in 2016 according to Agricultural Information Institute of CAAS, much below Japan and Korea's 2.6-3.2kg.

Leveraging on the relationship with its strategic shareholder, Arla Foods, Mengniu introduced the professional catering brand Arla Pro, with Arla shredded mozzarella as the debut product in 2018. This product is manufactured in Mengniu's cheese factory. Mengniu also launched kids' cheese cup and sticks under the children dairy product brand Arla Little Explorer. On the other hand, Yili set up cheese as a separate business unit to develop this category in 2018.

Both Mengniu and Yili have their own branded cheese sticks. Because cheese provides rich nutrition (protein and calcium), we think cheese has strong growth potential as consumers are increasingly educated about its nutrition value.

Figure 21: Yili's Wonderful Cheese



Source: Tmall.com

Figure 22: Mengniu's kids cheese sticks



Source: Tmall.com

### ■ Chilled fresh milk is a rising category

Chilled fresh milk is heated up to 70-75 degrees Celsius for 15 seconds to remove all harmful bacteria. Compared to UHT milk, which is heated to 150 degrees Celsius for 5 seconds to kill all harmful micro-organisms, chilled fresh milk could preserve higher nutrition value. In China, market share of chilled fresh milk was below 30%, far below >90% market share in Europe and US. According to the "2019 Fresh Living White Paper" jointly published by New Hope Dairy, Nielsen, Kantar and Toutiaohao, sales of chilled fresh milk jumped 19.5% YoY for the 12 months ended Jul 2019. The penetration rate was low, only at 33.6% for the 12 months ended Aug 2019, suggesting huge growth potential. The growth was driven by consumers' demand for quality and nutrition fresh milk as well as improvement of cold chain logistics.

For Mengniu, its chilled fresh milk sales doubled in 1H19 but contributed less than 1% of total revenue. Its market share expanded from 2.4% in 1H18 to 5.1% in 1H19 according to Nielsen. It has invested in several raw milk suppliers (China Modern Dairy, China Shengmu and Fuyuan Farming) to have control in raw milk supply to develop its chilled fresh milk business. Its distribution network currently covers Eastern China and extends to other major cities such as Beijing, Tianjin and Guangzhou.

**Figure 23: New Hope Dairy's Timing Milk sold at RMB9.50 per 480mL at AEON eshop**



Source: AEON eshop, as of 14 Nov 2019

**Figure 24: Mengniu's Shiny Meadow sold at RMB89.90 per 250mL \* 12 bottles**



Source: Tmall.com, as of 14 Nov 2019

### ■ Plant-based milk beverages

Compared to cow milk, most of plant-based milk beverages are rich in protein, vitamins and minerals but are low in fat and without cholesterol. Also, plant-based milk is a good lactose free substitute to cow milk. People who do not have enough of enzyme lactase cannot digest lactose. Their digestive system could react by causing indigestion, bloating and diarrhea.

China's plant-based milk per capita consumption was only around 1L, way below Hong Kong's 12L in 2018. Through major brands' promotion and continuous consumer education about the advantages of plant-based milk beverages, we expect the penetration of plant-based milk beverages will gradually increase.

Yili's plant-based milk beverages (soy milk and “谷粒多”) recorded around RMB1bn sales in FY18 (1% of total revenue). The segment saw a healthy ~40% revenue growth in 1H19, according to management.

**Figure 25: Soy milk products of major brands**

Brand	Yili's Planted Selected	Mengniu's ZhiPuMoFang	Vitasoy
			
Retail price (RMB)	RMB48 for 250mL * 12 RMB4.00 per 250mL	RMB34.9 for 245mL * 15 RMB2.32 per 245mL	RMB39.9 for 250mL * 16 RMB2.49 per 250mL

Source: Tmall.com, as of 14 Nov 2019

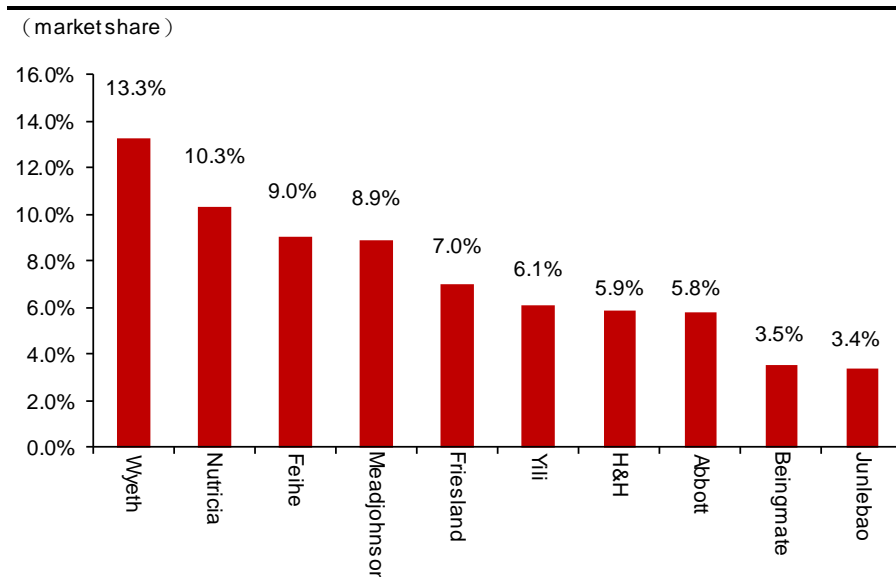
## Consolidation and premiumization of infant milk formula industry

Though China's number of new births peaked at 17.86mn in 2016 as impact of two-child policy faded, we think the growth of IMF players would be led by premiumization and consolidation. Super-premium and premium categories, such as organic and goat milk products, are growing fast driven by increasing health awareness and income level. Furthermore, favorable government policies would drive the upgrade and consolidation of the industry.

Yashili's (51% owned by Mengniu) sales mix of high-end IMF was low at 34.7% in FY18, far below peers' proportion (Feihe: 64.1%, Yili: 50-60% from “金领冠”). Given that it has a diversified high-end brand portfolio covering imported organic, cow and goat milk, we expect Yashili can raise its high-end milk sales mix by strengthening marketing and network development.

Yili is the second largest domestic IMF company in terms of market share for the past 12 months ended 30 Jun 2019. In FY18, IMF contributed around RMB5.6bn sales or 7% of Yili's total revenue. Its high-end brand “金领冠” has organic and New Zealand-imported products.

**Figure 26: IMF market share by the Company for the past 12 months as of 30 Jun 2019**



Source: Nielsen

### ■ Industry consolidation to carry on led by policies

The Administrative Measures for the Registration of Product Formulas of Infant Formula Milk Powder (“婴幼儿配方乳粉产品配方注册管理办法”) was promulgated by the CFDA on 6 Jun 2016 and became effective on 1 Oct 2016. According to the Measures, the product formulas of the infant formula milk powder produced, sold and imported to China shall be approved and registered with CFDA. If the same enterprise applies for the registration of two or more product formulas for the same age group, there shall be a significant difference between the product formulas and the difference shall be scientifically proved.

The Measures requires IMF companies to provide details of the product formula, safety standard of raw materials, production technologies, product quality inspection report, proof of capabilities of R&D, production and quality inspection etc. In addition, each licensed factory is limited to three approved recipes. Given such limitations, licensed factories would



only keep top three approved recipes in terms of sales and terminate the production of remaining recipes, we expect the Measures will accelerate the rising of market concentration ratio. Before the Measures took effect, there were more than 3,000 brands (domestic and foreign manufacturers). As at 30 Jun 2019, 423 brands and 1,253 recipes were totally approved, according to Euromonitor and CITIC Agricultural Fund.

Major IMF brands can lift their investment in raw milk sources and R&D to expand their number of approved recipes and strengthen marketing initiatives and channel penetration to increase sales, further squeezing the market shares of smaller IMF players.

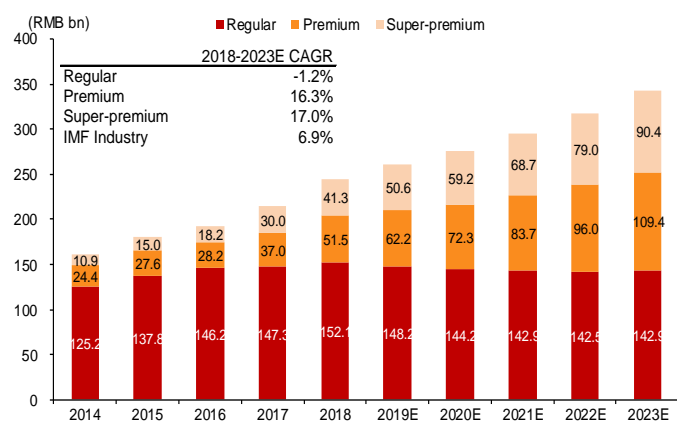
The NDRC published the Action Plan for the Promotion of Domestic IMF (“国产婴幼儿配方乳粉提升行动方案”) in May 2019, targeting to improve the quality of domestic IMF brands and keep self-sufficiency ratio at >60%, enhance market shares of domestic IMF brands and promote industry consolidation. The Plan will strictly review the attributes of new IMF manufacturers and encourage enterprises to merge or acquire outdated production capacities, accelerate the upgrade of production technologies and facilities of enterprises whose annual production capacities less than 1,000 tonnes or annual sales less than RMB50mn for three consecutive years.

### ■ Premiumization

After the dividend of two-child policy was fully released, China's number of babies born dropped from 17.23mn in 2017 to 15.23mn in 2018. Growth of retail sales volume of IMF is forecast to slow from 8.4% in 2014-2018 to 3.8% in 2018-2023E, according to Frost & Sullivan. However, driven by consumers' growing health awareness, increasing income level and urbanization, retail sales value of premium and super-premium IMF are estimated to grow at CAGR of 16.3% and 17.0%, respectively, in 2018-2023E.

We think organic IMF and goat milk are two fast-growing categories that could benefit from consumption upgrade. According to Nielsen, sales of organic IMF jumped 42.4% in 2018. Goat milk IMF, which has been proven to be more easily digested and has lower allergic reactions than cow milk IMF, also saw imported volume growth of around 30% in 2018 according to The General Administration of Customs of PRC. The growth rates of these two categories were faster than China IMF industry's 14% retail sales growth (Frost & Sullivan data) in 2018.

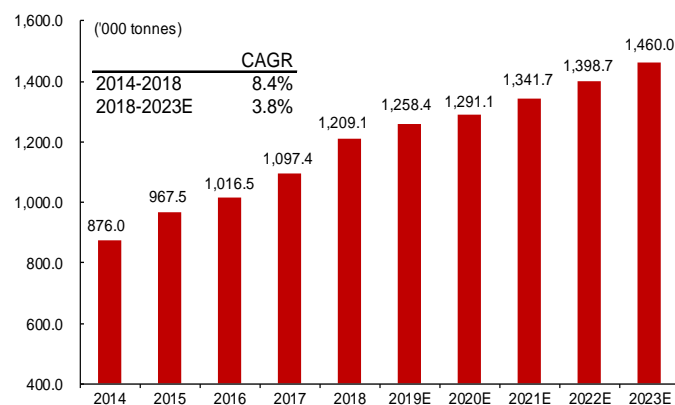
**Figure 27: China's IMF industry is forecast to grow by 6.9% from 2018 to 2023E, led by premium and super-premium IMF**



Source: Frost & Sullivan

Super-premium/premium/regular IMF products are priced at or above RMB450 per kg/from RMB350-449 per kg/below RMB350 per kg for average retail price of Stage 1 to Stage 3, respectively

**Figure 28: China's IMF retail sales volume CAGR is expected to moderate to 3.8% CAGR from 2018 to 2023E**



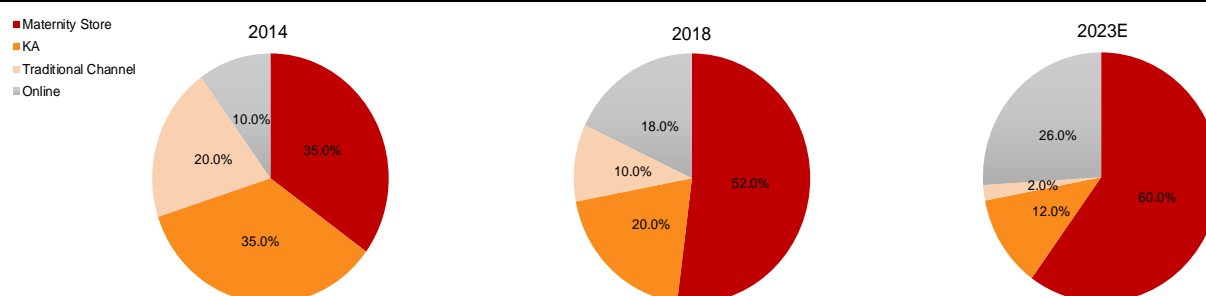
Source: Frost & Sullivan



### ■ Baby & maternity stores and e-commerce channels gaining market share

There are four major distribution channels for consumers to purchase IMF, namely baby & maternity stores, e-commerce, KA (hypermarket & supermarket) and traditional channel. In 2018, baby & maternity stores accounted for 52% of retail sales value of IMF industry. Market share of e-commerce's market increased significantly from 10% in 2014 to 18% in 2018, and is estimated to climb to 26% in 2023E, according to Frost & Sullivan. On the contrary, market share of KA and traditional channel dropped from 35% and 20% in 2014 to 20% and 10% in 2018, respectively. Their market share is estimated to fall further to 12% and 2% in 2023E, respectively.

**Figure 29: Baby & maternity stores and e-commerce channels are expected to gain market share of IMF retail sales**



Source: Frost & Sullivan

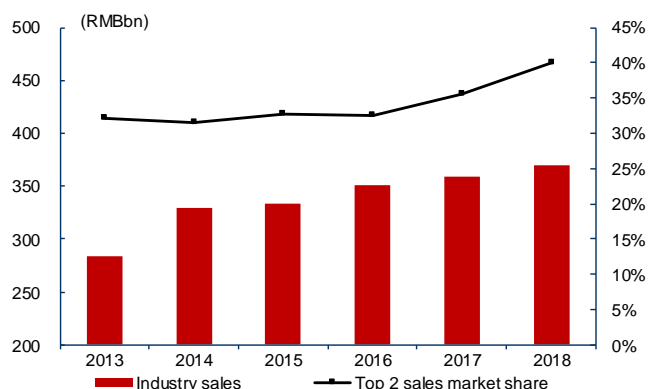
## Top two leaders continue to gain market share

### Top two leaders' market share increased in terms of revenue and profit

China's dairy products industry revenue grew at 5.5% CAGR between 2013 and 2018, reaching RMB370bn in 2018. During the period, we observed a clear industry consolidation trend. Total market share of the top two leaders, Yili and Mengniu, climbed from 32.2% in 2013 to 40.0% in 2018. Number of enterprises dropped from 638 in 2015 to 587 in 2018.

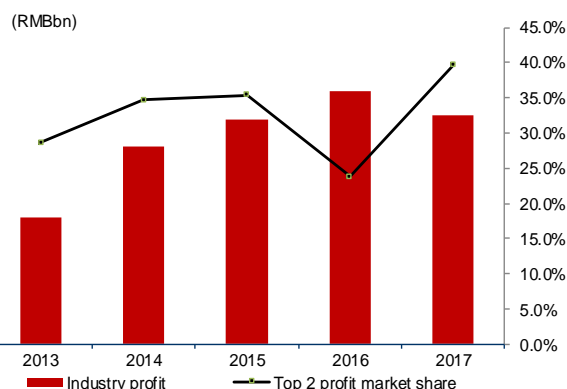
From 2013 to 2017, profit of the industry increased at 8% CAGR with profit margin slightly widened from 6.4% to 6.8%. Total market share of top two leaders expanded from 28.6% in 2013 to 39.6% in 2017, in terms of profit.

**Figure 30: Top two leaders' revenue market share gained in dairy products industry**



Source: Company data, China Dairy Statistics Summary 2018, 2019 China Dairy Industry Sales Development White Paper

**Figure 31: Top two leaders' profit market share gained in dairy products industry**



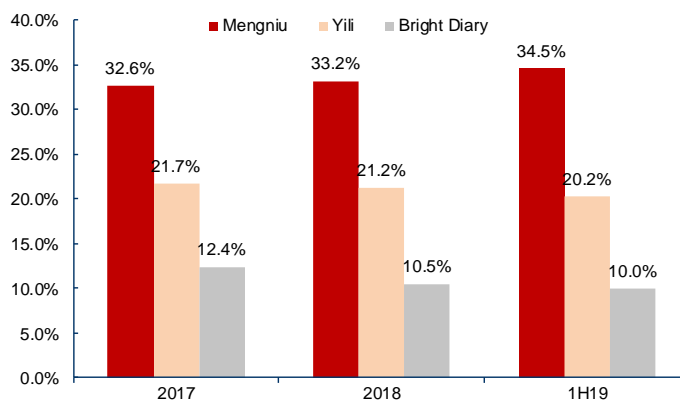
Source: Company data, China Dairy Statistics Summary 2018

### ■ Yili and Mengniu have different niches

According to Nielsen, Yili is the leader of offline liquid milk market (UHT milk, yogurt and milk beverage). Both Yili and Mengniu had a combined market share of 67.3% in 1H19. Market share of top two players has been expanding. Yili was also the number two domestic IMF brand with market share of 5.8% in 2018.

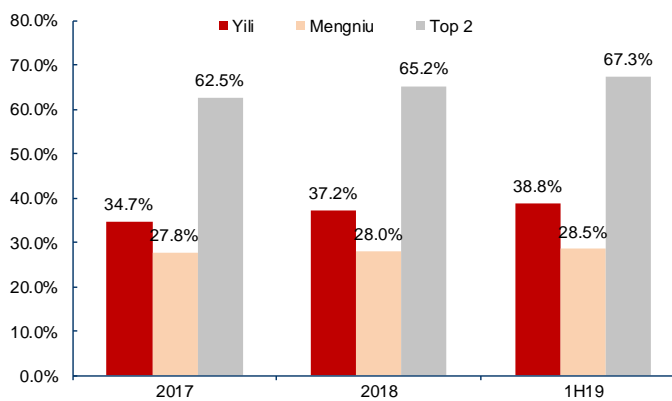
On the other hand, Mengniu was market leader of offline chilled yogurt market in 1H19 with market share of 34.5%. Its market share of UHT and chilled liquid milk was also slightly greater than Yili in online channel in 1H19 (26.5% vs 24.3%).

**Figure 32: Mengniu is market leader of offline chilled yogurt market**



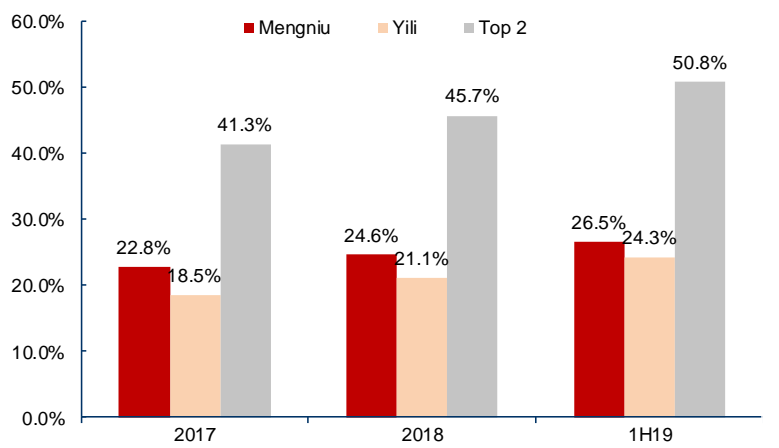
Source: Nielsen

**Figure 33: Yili is market leader of offline liquid milk market**



Source: Nielsen

**Figure 34: Mengniu has greater market share than Yili in online UHT and chilled liquid milk market**



Source: Nielsen

#### ■ Pace of industry consolidation in online channel is faster than offline channel

Like offline channel, market share of top two players has been expanding in online channel. The consolidation pace of top two players in online market (+9.5ppt from 2017 to 1H19) was even faster than offline market (+4.8ppt from 2017 to 1H19). We think (1) top two leaders have absolute advantages in scale and capital to develop new retail and online channel, and they are preferred strategic partners of internet giants, compared to smaller players. This should help top two leaders to further gain market share in online channel; (2) consumers have been increasingly recognizing the brand names of top two leaders, compared to foreign brands and smaller brands.

### High entry barriers to dairy sector

There are three kinds of dairy products players in China:

- Nationwide players: Yili, Mengniu and Bright Dairy. These players have established good brand equity and nationwide distribution network
- Regional players: Sanyuan Food and New Hope Dairy are examples. These players have leading status in certain markets.
- Local players: These players usually operate in single province or city and are difficult to compete with nationwide or regional players.

We expect Yili and Mengniu will continue to expand market shares given their advantages in brand equity, capital, raw milk supply, nationwide distribution network and R&D.

#### ■ Capital

A new player is required to have certain resources advantage and capital strength to enter dairy products industry. The investment in raw milk, production plant, distribution channel and logistics is large and the payback period is long. Yili and Mengniu have established nationwide network and integrated industry value chain. Their revenue and net profit base is much greater than other players. They have absolute economies of scale advantage.

#### ■ Raw milk supply

In China, most of the dairy farms are located in Northern region. The supply of raw milk in Southern region is relatively limited so raw milk price in Southern region is higher than Northern region in general. Both Yili and Mengniu, are founded in Inner Mongolia, have established good business relationship with dairy farms in Northern region. Therefore, they have rich supply of raw milk to expand their UHT milk businesses.

In addition, Yili and Mengniu invest in raw milk suppliers to secure sufficient supply of raw milk. Without securing raw milk source, a dairy company cannot produce high-end products such as chilled fresh milk and yogurt, and high-end UHT milk.

For examples, New Hope Dairy has made two investments since its listing in 2018. In Apr 2019, it announced to purchase 55% equity interests of Fuzhou Auscow, which is a vertically integrated dairy company (from dairy cow farming to production and distribution of pure milk, yogurt, chilled fresh milk). In Jul 2019, New Hope Dairy announced to spend HK\$374mn to purchase 9.3% enlarged issued shares of China Modern Dairy.

Yili announced to acquire 100% equity interest of Westland Co-operative Dairy Company in Mar 2019. The consideration was NZD244mn. This acquisition further expanded its raw milk supply in New Zealand.

**Figure 35: Raw milk suppliers invested by dairy companies**

Companies	Investment in raw milk suppliers
Mengniu	China Modern Dairy, China Shengmu, Fuyuan Farming
Yili	Youyuan Dairy, Westland Co-operative Dairy Company
New Hope Dairy	China Modern Dairy, Fuzhou Auscow

Source: CMBIS

### ■ Brand equity

It requires long and large investment to establish consumers' recognition of a dairy brand. Apart from brand advertising, a player is required to invest in product innovation to make its products differentiating from other brands and promote consumers to switch from other brands.

### ■ Distribution network

It is difficult for a player to enter into a new market. For examples, it could take long time or sacrifice profit margins to convince distributors or get into modern channels.

According to Kantar research, Yili and Mengniu were the top 1 and 2 FMCG brands in China in terms of consumers reached in 2018 with penetration rates of 90.9% and 88.1%, respectively. The top two players' penetration rate was far ahead of Bright Dairy (38.4%), the third largest dairy name.

### ■ R&D

To compete among domestic and international players, a player should invest in R&D such as production technology, IMF, yogurt bacteria, raw materials etc to produce differentiated or patented products to establish its competitive advantages. We think Yili and Mengniu have built up significant advantages in R&D.

Yili has established R&D centers in the Netherlands, New Zealand and the US to cooperate with overseas advanced research institutes to update latest production technologies and new products information to accelerate its own product innovation and globalization.

Mengniu has global dairy leading players, Danone and Arla Food, as its strategic shareholders. These partners can provide support in production technologies and product innovation for Mengniu. For example, Danone cooperates with Mengniu to work on product R&D and production techniques in chilled product business. Arla China Innovation Center, which was set up in the COFCO Nutrition and Health Research Institute in Beijing in 2014, focuses on development of cheese products for Chinese consumers.

## Establish and expand key product brands portfolio

Yili and Mengniu have been expanding their key product brands portfolio through innovation, intensive marketing campaigns and channel penetration. We think the successful build-up of these key product brands is a major reason that top two leaders can widen their market share gap between small players.

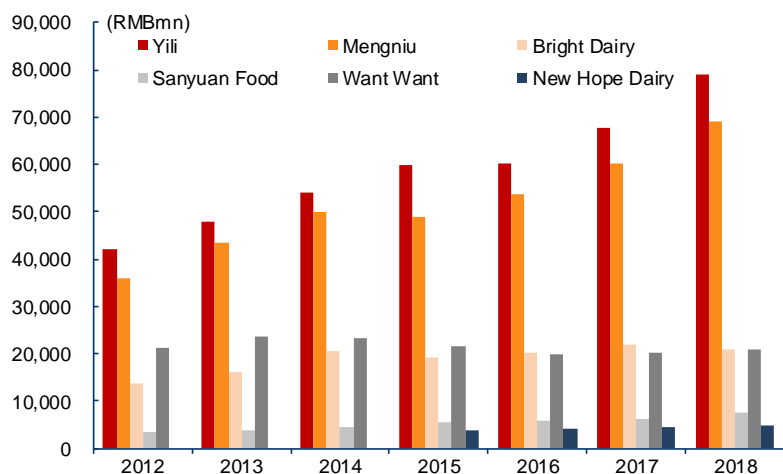
In FY18, Yili had more than 20 sub-brands. Among which, 11 key product brands had contributed annual sales of more than RMB1bn. The top 3 key product brands were Ambrosial, Satine and Yili Pure Milk. For Mengniu, we estimate it had at least six key product brands whose annual revenue was over RMB1bn in 2018. The top 3 key product brands were Milk Deluxe, Mengniu Pure Milk and Just Yoghurt.

In future, we think chilled fresh milk, cheese, plant-based milk beverages and butter are potential key product brands given that the penetration of these categories are low in China.

### Top two leaders had unrivalled A&P spending

Yili and Mengniu has been sponsoring in major events (Olympic Games, World Cup, World Expo) and top entertainment programs to promote their brands and products. Though their revenue gap between other players widened, they continued to spend on A&P which helped them to gain more market share.

**Figure 36: Top two leaders' revenue gap between other players expanded between FY12 and FY18**



Source: Company data

### ■ Small players find it difficult to afford sponsoring major events and top entertainment programs

Major events' advertising campaign is expensive and this sets a high entry barrier to small players. News said Mengniu spent RMB2bn in 2018 World Cup promotion campaign. Rumor said Bank of China paid RMB1.8bn to become official partner of 2022 Beijing Winter Olympic Games. We believe BOC's fee could be a rough estimate for Yili's payment for becoming official partner of 2022 Beijing Winter Olympic Games.

**Figure 37: Top two leaders major events advertising campaign**

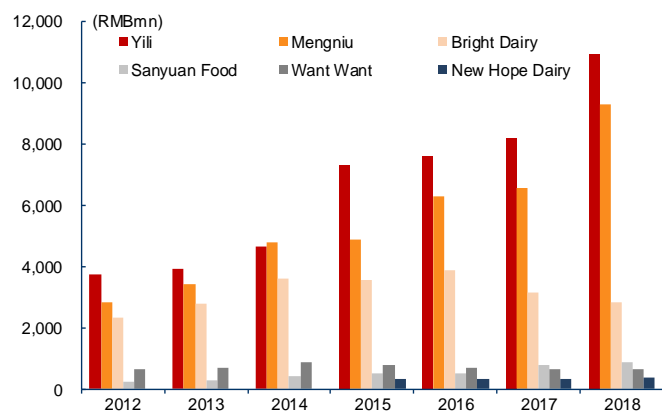
Yili	Mengniu
2008 Beijing Olympic Games	2003 Milk for China's astronauts
2010 Shanghai World Expo	2018 World Cup
2022 Beijing Winter Olympic Games	

Source: CMBIS

Sponsoring fees for top entertainment programs are not cheap too. Top entertainment programs can access to huge pool of audience. Mengniu's sponsorship of 《超级女声》 in 2005 was a good example. News said Mengniu spent around RMB100mn to promote its Suan Suan Ru. 《超级女声》 successfully attracted 300-400mn audience. Suan Suan Ru achieved sales growth from RMB700mn in 2004 to RMB2.5bn sales in 2005. Another example is Yili's Ambrosial. It sponsored several seasons of 《奔跑吧》 and its sales rocketed to RMB14bn in 2018 after its launch in 2013. News said Yili's Ambrosial paid

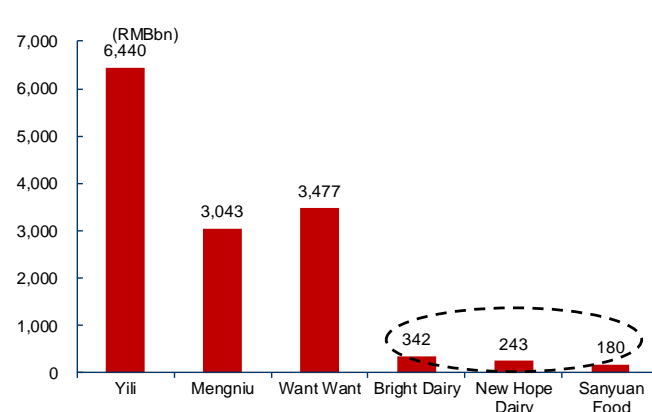
RMB610mn for sponsorship fee of Season 5 of 《奔跑吧》 in 2018. Given that small players' A&P budget was quite limited (below RMB1bn) and their net profit was less than RMB400mn in FY18, they could find it difficult to afford these kinds of sponsorships.

**Figure 38: Top two leaders had unrivalled A&P expenses**



Source: Company data, CMBIS  
 Mengniu's FY18 A&P expenses is CMBIS estimates

**Figure 39: Small players' net profit in FY18 was less than sponsorship fee of top entertainment programs**



Source: Company data

#### ■ Top two leaders kept investing in A&P

From FY12 to FY18, top two leaders gradually raised their A&P expenses ratio from 8-9% in FY12 to around 13-14% in FY18. They sponsored entertainment programs each for a single product and tried to establish these products to become large key product brands. For example, top two leaders' high-end milk brands (Satine and Milk Deluxe) and UHT yogurt brands (Ambrosial and Just Yoghurt) are their largest key product brands (in terms of sales) which enjoy >40% GPM, higher than companies' GPM. The successes of these key product brands helped top two leaders to expand GPM and NPM.

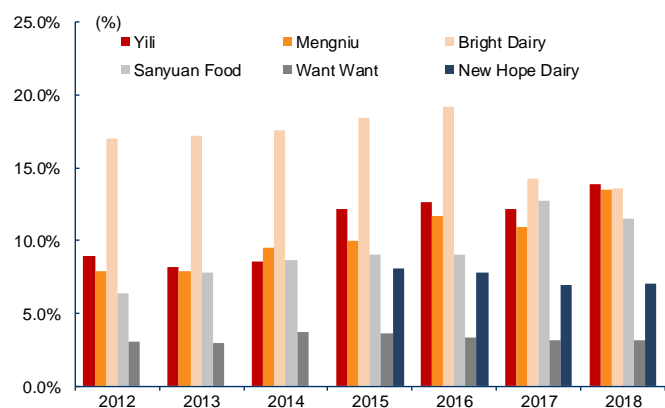
On the other hand, small players usually have lower GPM and NPM than top two leaders. Their thin NPM has limited their spending power in A&P to promote their products.

**Figure 40: Top two leaders' major entertainment program sponsorships in 2019**

Brand	Product	Entertainment program sponsorship
Yili	安慕希	奔跑吧3
	金典	歌手2019
	畅轻	青春环游记
	植选	以团之名
	果果昔	乐队的夏天
	甄稀	拜托了冰箱5
	舒化	我们是真正的朋友
	金领冠	妻子的浪漫旅行2
	特仑苏	向往的生活3
	特仑苏	声入人心2
Mengniu	真果粒	青春有你
	纯甄	创造营2019
	纯甄	中餐厅3
	优益C	王牌对王牌4

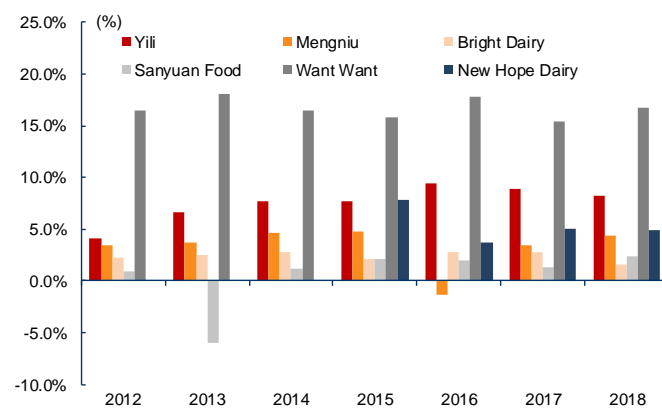
Source: CMBIS



**Figure 41: Top two leaders' A&P expenses ratio increased from FY12 to FY18**


Source: Company data, CMBIS

Mengniu's FY18 A&amp;P expenses ratio is CMBIS estimates

**Figure 42: Small players had thin NPM, which limited their spending on A&P expenses**


Source: Company data, CMBIS

## Valuation

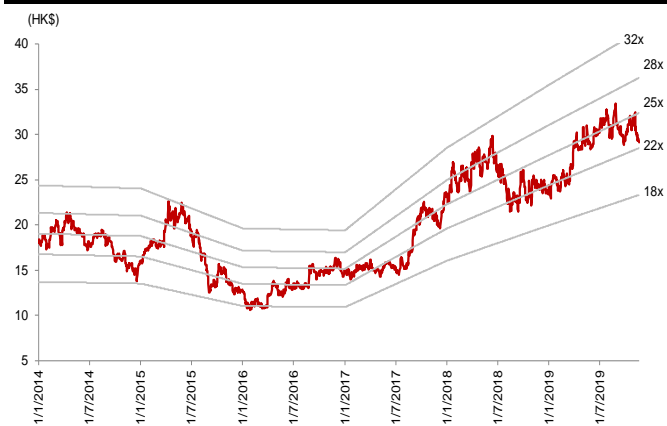
### Mengniu (2319 HK, Buy; TP: HK\$37.00)

In FY15, Mengniu recorded 2% drop in revenue due to macro slowdown and keen competition, its net profit was flat YoY. Its valuation reached the trough of 18x forward P/E in Jan 2016 and then began re-rating because revenue growth resumed double-digit growth in FY16. We set our TP of Mengniu at HK\$37.00 based on 28.0x FY20E adjusted P/E, in the high-end of 18-30x 1-yr forward P/E range. We expect Mengniu can maintain its double-digit revenue growth trend and have OPM expansion from FY19E to FY21E.

### Yili (600887 CH, Buy; TP: HK\$34.04)

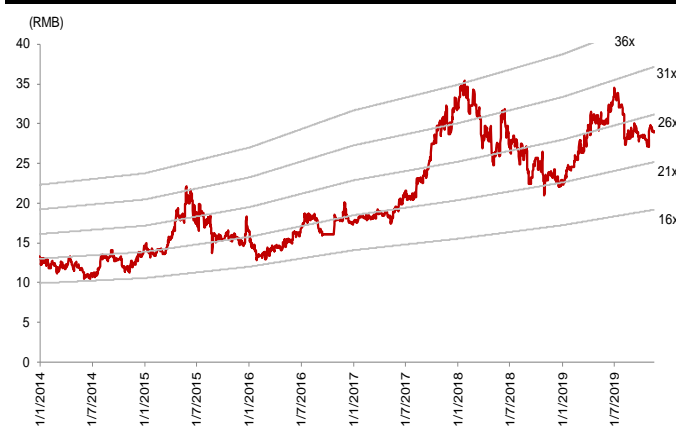
We set our TP of Yili at HK\$34.04 based on 28.0x FY20E P/E, representing the mid end of its 1-yr forward P/E range of 21x-36x since A-share was announced to be included in MSCI Emerging Markets Index. On 21 Jun 2017, MSCI announced that it will include China A shares in the MSCI Emerging Markets Index. We think this news triggered A shares re-rating in 2H17. The trough valuation of Yili moved up from 16x before the announcement on 21 Jun 2017 to 21x post the announcement. Our 12% adjusted EPS CAGR from FY19E to FY21E is within 10-17% adjusted EPS growth in FY17-18. Therefore, we think our target P/E of 28.0x is fair.

Figure 43: P/E band chart of Mengniu



Source: Bloomberg, CMBIS estimates

Figure 44: P/E band chart of Yili



Source: Bloomberg, CMBIS estimates

# Mengniu (2319 HK)

## Margin expansion ahead

- **Milk Deluxe a key growth driver.** Milk Deluxe is MN's largest product category, contributing ~19% of revenue in FY18. Thanks to its successful product segmentation strategy and comprehensive advertising campaigns, revenue growth of Milk Deluxe reached ~22% in 1H19 (vs MN organic growth of 13%) and accelerated in 3Q19 (25-30%) compared to 2Q19, according to our channel checks. We think Milk Deluxe will remain MN's key growth driver (19% CAGR from FY19E to FY21E) backed by its strong brand equity, consumption upgrade trend and organic milk demand.
- **Momentum accelerated in 3Q19 but raw milk under cost pressure.** Given momentum of both Milk Deluxe and Just Yoghurt (~30% of total revenue in FY18) accelerated in 3Q19, we expect revenue growth in FY19E could beat guidance of low-teens growth. However, due to stronger-than-expected raw milk price in 2H19E (8% YoY vs 5-6% YoY in 1H19), management thinks it is challenging to achieve a flat GPM in 2H19E and 0.5ppt OPM expansion in FY19E. That said, we think the guidance change should have been priced in. We forecast Mengniu to post 32% adjusted net profit growth in FY19E on 15% revenue growth. We expect the disposal of 51%-owned Junlebao could be completed in Nov 2019. This is the reason for the 2% drop of revenue in FY20E.
- **Margin expansion trend.** We expect MN to deliver OPM expansion from FY19E to FY21E, led by GPM and non-A&P expenses ratio improvement. The GPM expansion is driven by strong growth of high-margin Milk Deluxe and Just Yoghurt, continuing product mix enhancement and innovation, GPM improvement of IMF and ice-cream segments and more disciplined discount promotion activities. Mengniu had a higher non-A&P related selling expenses ratio than Yili (~13.8% vs 11.2% in FY18). We expect Mengniu would gradually squeeze non-A&P expenses ratio from 14.2% in FY19E to 13.9% in FY21E by efficiency enhancement.
- **Acquire Bellamy's Organic to fill super-premium's void.** The acquisition valuation is not cheap (48.5x FY19 adjusted P/E) but it was due to China's regulatory changes (SAMR registration and E-Commerce Law). Bellamy's organic IMF and baby food would fill Mengniu's void in super-premium segment and improve Mengniu's profit margins. Also, Mengniu and Bellamy's distribution channels can complement each other's. If the acquisition is approved, we estimate earnings impact on Mengniu could be neutral in FY20E, but we think Mengniu could accelerate Bellamy's network penetration and IMF approval process in China.
- **Initiate at Buy.** We estimate MN to post 22% adjusted EPS CAGR (ex-Junlebao basis) from FY19E to FY21E, driven by 13% revenue CAGR and 1.0ppt OPM improvement. Our TP of HK\$37.00 is based on 28.0x FY20E P/E, which is the high-end of 18-30x 1-yr forward P/E range since Mengniu resumed double-digit revenue growth in FY16. **Catalysts:** better-than-expected revenue and margins. **Risks:** raw milk cost pressure (net profit drops 4% per 1% increase of raw milk price), food safety issues.

### Earnings Summary

(YE 31 Dec)	FY17A	FY18A	FY19E	FY20E	FY21E
Revenue (RMB mn)	60,156	68,977	79,792	78,447	87,985
YoY growth (%)	12	15	16	(2)	12
Net profit (RMB mn)	2,048	3,043	6,809	4,661	5,674
Adj. net profit (RMB mn)	2,048	3,043	3,894	4,661	5,674
Adjusted EPS (RMB)	0.526	0.754	0.995	1.185	1.442
YoY growth (%)	0	43	32	19	22
Adjusted P/E (x)	48.1	32.7	26.3	22.1	18.1
P/B (x)	4.4	3.8	3.4	3.0	2.7
Yield (%)	0.5	0.7	0.9	1.0	1.3
ROE (%)	9.4	12.3	14.1	14.6	15.7

Source: Company data, CMBIS estimates

### BUY (Initiation)

Target Price	HK\$37.00
Up/Downside	+27%
Current Price	HK\$29.15

### China F&B Sector

**Albert Yip**  
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### Stock Data

Mkt Cap (HK\$ mn)	114,694
Avg 3 mths t/o (HK\$ mn)	334.5
52w High/Low (HK\$)	34.60/22.45
Total Issued Shares (mn)	3,934.6

Source: Bloomberg

### Shareholding Structure

COFCO	16.3%
Danone	9.9%
Arla	5.3%

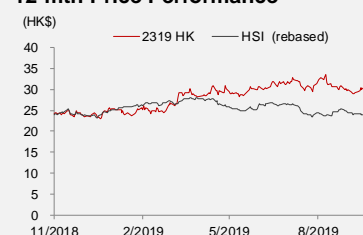
Source: HKEx

### Share Performance

	Absolute	Relative
1-mth	-7.9%	-6.1%
3-mth	-4.4%	-6.5%
6-mth	-2.0%	4.0%

Source: Bloomberg

### 12-mth Price Performance

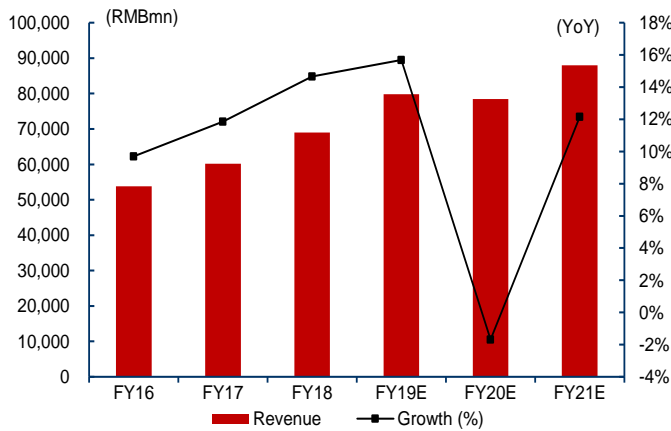


Source: Bloomberg

Auditor: EY

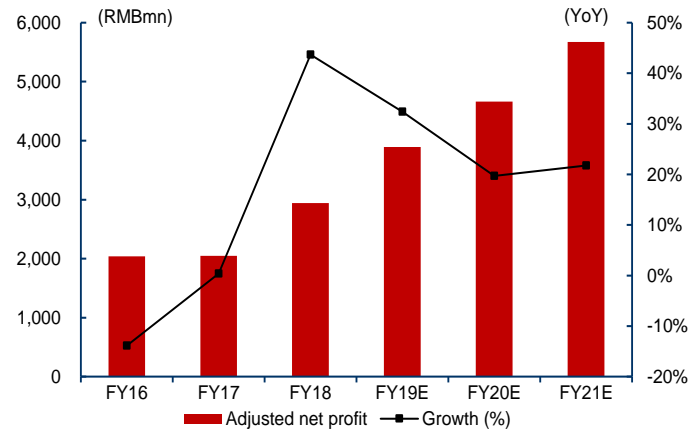
## Focus Charts

**Figure 45: Revenue growth dip in FY20E due to disposal of Junlebao**



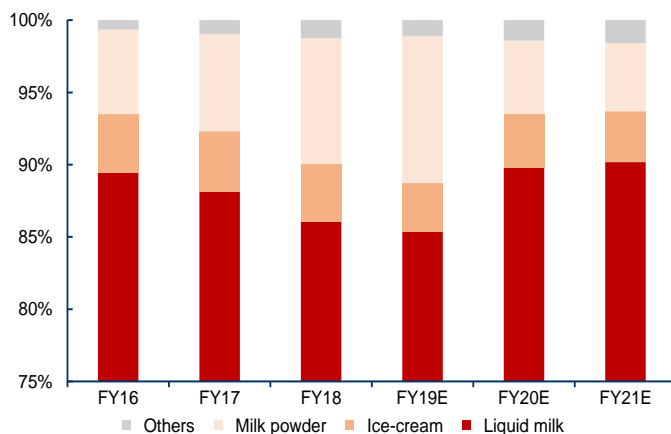
Source: Company data, CMBIS estimates

**Figure 46: Adjusted net profit to grow at 23% CAGR from FY19E to FY21E**



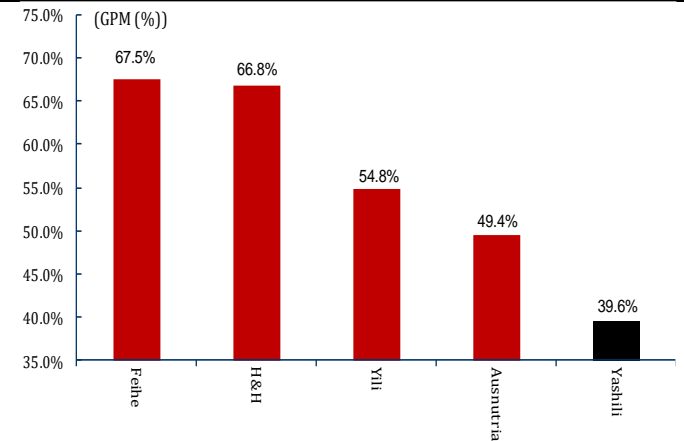
Source: Company data, CMBIS estimates

**Figure 47: Revenue breakdown by segment of Mengniu**



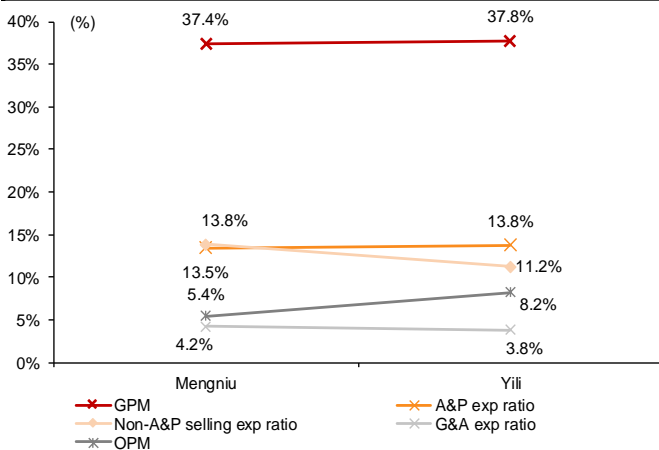
Source: Company data, CMBIS estimates

**Figure 48: GPM of Yashili was lower than IMF peers in FY18**



Source: Company data

**Figure 49: Mengniu margins are less than Yili, suggesting more room to improve**



Source: Company data

**Figure 50: Mengniu's acquisition target, Bellamy's, plans to upgrade its IMF portfolio in 2HFY20E**



Source: Bellamy's organic

## Milk Deluxe a key growth driver

Milk Deluxe (特仑苏) is Mengniu's largest product category in terms of sales, contributing ~19% of revenue in FY18. Its ~22% sales growth in 1H19 widened its market share advantage over Yili's Satine (~17% sales growth in 1H19). Thanks to its successful product segmentation strategy and advertising campaign, Milk Deluxe recorded ~22% revenue growth in 1H19 (vs Mengniu organic growth of 13%). Sales growth of Milk Deluxe accelerated to 25-30% YoY in 3Q19 after a strong 2Q19 (growth in 2Q19 > 1Q19), according to our channel checks. We think Milk Deluxe will remain Mengniu's key growth driver, driven by its strong brand equity, consumption upgrade trend and organic milk demand.

## Product segmentation to accelerate growth

Introduced in 2018, Milk Deluxe organic milk contributed around 13-15% of Milk Deluxe's sales in 1H19. We expect this proportion will increase as consumers' demand for organic food grows. In Apr 2019, Mengniu lowered price of old package of Mike Deluxe by 10%. In Jul 2019, Mengniu launched (1) the Tetra Pak cap package, which is more convenient to consume in outdoor than traditional straw package, at price 25% above the old package, and (2) its skimmed milk category with tradition Beijing Embroidery package at a premium price (RMB7.50 per 250mL), 2% higher than its organic milk.

Figure 51: Mengniu vs Yili high-end UHT milk product matrix

Price positioning	Mengniu Milke Deluxe	Price/pack	Yili Satine	Price/pack
Premium	Skimmed milk Tetra Pak cap; RMB75: 250mL*10	RMB7.50	金典娟姗3.8g protein Tetra Pak cap; RMB106.92: 250mL*12	RMB8.91
				
	Organic Tetra Pak cap; RMB88: 250mL*12	RMB7.33	3.8g protein organic Tetra Pak cap; RMB77.8: 250mL*12	RMB6.48
				
	Pure milk Tetra Pak cap; RMB68: 250mL*10	RMB6.80	3.6g protein organic, RMB136.8: 250mL*24	RMB5.70
				
	Pure milk; RMB65: 250mL * 12	RMB5.42	Pure milk; RMB71.1: 250mL*16	RMB4.44
				

Source: Tmall, as of 14 Nov 2019



## Comprehensive advertising campaigns

Mengniu has stepped up its spending in marketing to promote Milk Deluxe since last year by sponsoring popular Chinese entertainment IPs such as 《声入人心》、《向往的生活》. In Jan 2019, Milk Deluxe endorsed four popular artists (陈道明 x 靳东 x 邓伦 x 张钧甯), aiming at different age groups of consumers. In Jul 2019, Milk Deluxe joined hands with Tmall's domestic brand promotion campaign. It launched three types of skimmed milk products, which adopted three traditional Beijing Embroidery (京绣) designs (butterfly, crane and mandarin duck) on its packages.

**Figure 52: Milk Deluxe sponsored 《声入人心》**



Source: Internet

**Figure 53: Milk Deluxe sponsored 《向往的生活》**



Source: Internet

**Figure 54: Endorsed four popular artists aiming at consumers of different age groups**



Source: Tmall

**Figure 55: Milk Deluxe's skimmed milk crossover with 《天猫国潮》 in Jul 2019**



Source: baijiahao



## Margin expansion trend

We expect Mengniu can deliver OPM expansion thanks to GPM enhancement and selling expenses ratio improvement. We forecast Mengniu to improve its OPM by around 1.1ppt from 5.4% in FY19E to 6.5% in FY21E by enhancing GPM and lowering non-A&P selling expenses ratio.

### GPM enhancement

We think Mengniu has various drivers to enhance its GPM: (1) The above group-level revenue growth of high-margin Milk Deluxe and Just Yoghurt; (2) continuing product mix enhancement and innovation; (3) GPM improvement of IMF and ice-cream segments; (4) more disciplined discount promotion activities or even raise prices; (5) GPM of chilled fresh milk and cheese can improve when their sales reach economies of scale.

#### 1) Milk Deluxe and Just Yoghurt lead the drive

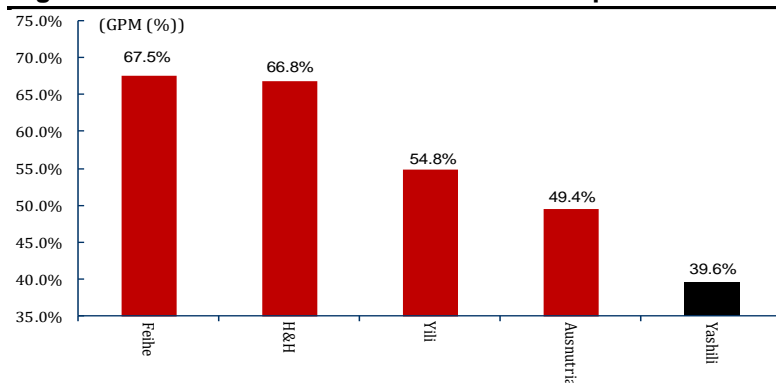
Milk Deluxe and Just Yoghurt are among top three key product brands in terms of sales in FY18, contributing 19% and 12% of total revenue, respectively. In 1H19, Milk Deluxe and Just Yoghurt saw 22% and 24% revenue growth, respectively. The momentum of these two brands in 3Q19 was stronger than 1H19. Given that these two brands enjoy higher GPM than the Company's average (>40% vs 37.4% in FY18), the continuing momentum of Milk Deluxe and Just Yoghurt should improve Mengniu's GPM.

#### 2) IMF and ice-cream GPM has room to improve

Yashili's (51% owned by Mengniu) GPM was only 39.6% in FY18, lower than other peers. In Aug 2019, Yashili launched a new marketing campaign by endorsing Yao Chen (姚晨) and Huang Jingyu (黃景瑜) as spokesperson for Yashili brand and Doraler Goat Milk formula, respectively. Around 80% of sales was from baby & maternity stores. We think Mengniu can help Yashili to expand its supermarket channel network.

Its sales mix of high-end IMF was low at 34.7% in FY18, far below peers' proportion (Feihe: 64.1%, Yili: 50-60% from “金领冠”). Given that it has established a diversified high-end brand portfolio such as Doraler (goat IMF introduced in 2017), Arla Baby & Me (organic IMF introduced in 2016) and Reeborne (organic IMF), we expect Yashili can raise its high-end milk sales mix by strengthening marketing and support from Mengniu (expand penetration into modern channel).

**Figure 56: GPM of Yashili was lower than IMF peers in FY18**



Source: Company data

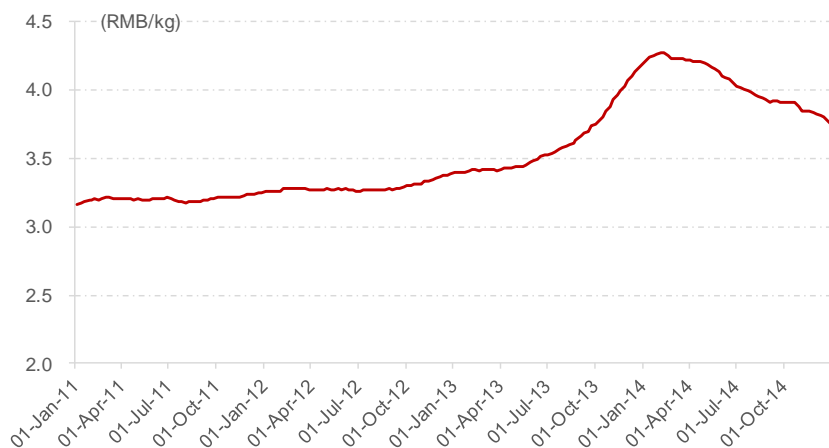
#### 1) Ice-cream

Compared to its closest rival Yili, Mengniu's ice-cream segment was underdeveloped in terms of sales and GPM. In FY18, Mengniu's ice-cream segment recorded RMB2.7bn sales, representing only half of Yili's sales. Mengniu's GPM was below Yili's 45.1% in FY18 though it was above Mengniu's group level (37.4% in FY18). We expect Mengniu will strengthen product innovation to upgrade its product portfolio.

#### ■ More disciplined discount promotion activities or even raise prices

We think the dairy industry could reduce sales promotion activities to improve GPM. For example, Yili reduced its sales promotion to increase ASP by 1-2% and GPM by 0.2ppt to 36.0% in 3Q19. Also, we think the possibility of price hikes cannot be ruled out, though not likely before 2020 CNY. During the previous raw milk price rising cycle, both Mengniu and Yili increased prices in 2013. Coupled with product portfolio adjustment and development of high-end products, GPM of Mengniu increased from 25.1% in FY12 to 30.8% in FY14 despite increased raw milk price.

**Figure 57: Raw milk price peaked in early 2014 during last rising cycle**

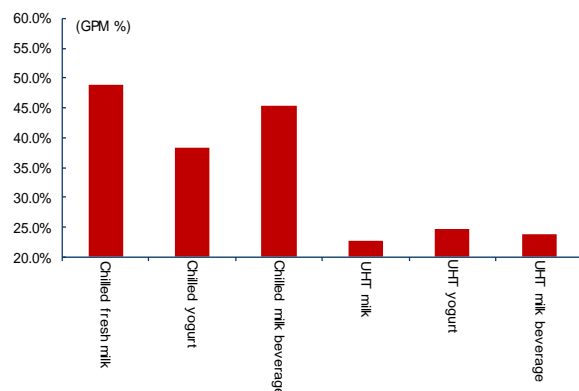


Source: WIND

#### ■ GPM of chilled fresh milk and cheese can improve

In FY17, New Hope Dairy's chilled fresh milk reported 48.8% GPM, which is the highest among its product categories. Such a high GPM is supported by self-owned dairy farms. For Mengniu, sales of chilled fresh milk was around RMB300mn in FY18. However, when its sales reaches economies of scale (sales doubled in 1H19), we expect its GPM could achieve above group's average given its retail price is higher than New Hope Dairy's chilled fresh milk.

We think cheese category has the potential to become a key product category and achieve above group average GPM in long-term. In FY18, Milkground (600882.CH, NR), a cheese product company, achieved RMB456mn revenue and GPM of 34.7% in FY18. In 9M19, revenue increased 46% YoY to RMB445mn and GPM expanded from 25.7% to 30.8%, thanks to better economies of scale. We note Mengniu's kid's cheese retail price is ~47% higher than Milkground's.

**Figure 58: New Hope Dairy's chilled fresh milk achieved 48.8% GPM in FY17**


Source: Company data

**Figure 59: Mengniu's chilled fresh milk sells at higher retail price than New Hope Dairy's**

Brand	New Hope Dairy	Mengniu
		
Retail price (RMB)	RMB9.5 for 480mL RMB1.98 per 100mL	RMB89.9 for 250mL * 12 RMB3.00 per 100mL

Source: AEON eshop, Tmall, as of 14 Nov 2019

**Figure 60: Milkground's cheese reported 34.7% GPM in FY18**

Brand	Milkground	Mengniu
		
Retail price	RMB123 for 1,000g	RMB129.9 for 315g * 3
Unit price (RMB)	RMB0.123/g	RMB0.137/g
FY18 GPM (%)	34.7%	<37%
FY18 Revenue (RMBmn)	456	400-500

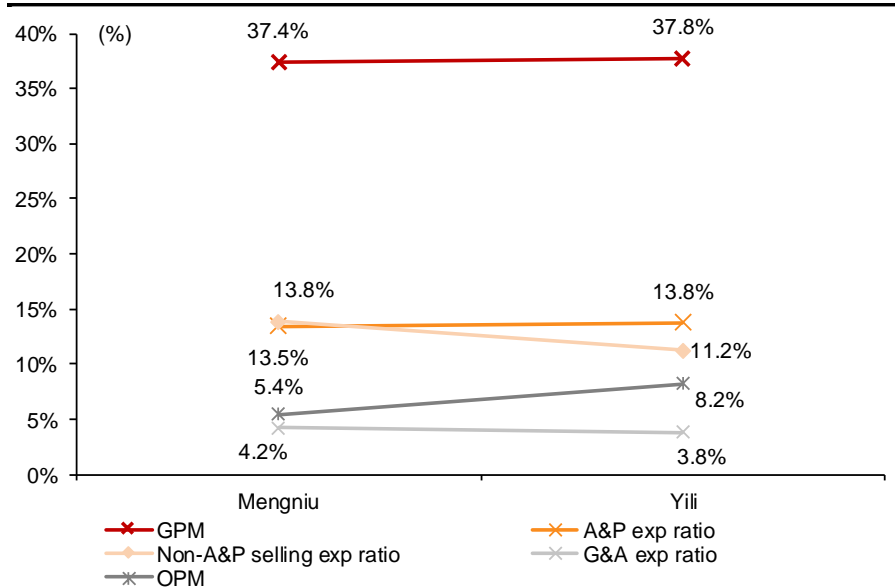
Source: Company data, Tmall, as of 14 Nov 2019

## Lowering non-A&P selling expenses ratio

While both Mengniu and Yili are dairy sector's super giants with roughly similar sales scale, Yili had a more efficient selling expenses ratio than Mengniu (25.0% vs 27.3% in FY18). Advertising and promotion is the largest expense item of both companies under selling expenses (Yili: 13.8% in FY18, Mengniu: ~13.5%).

Going forward, we think both companies will keep their advertising and promotion expenses ratio at relatively high level to expand their market shares at the expenses of smaller brands, which cannot match the top two leaders' spending given their much smaller revenue base (the third largest dairy company, Bright Dairy, recorded sales of RMB21bn in FY18). Mengniu has room to gradually improve its non-A&P related selling expenses ratio (Mengniu: ~13.8%, Yili: 11.2% in FY18), for example, by improving efficiency of transportation and warehouses.

**Figure 61: Mengniu margins are lower than Yili, suggesting more room to improve**



Source: Company data, CMBIS estimates

## Acquire Bellamy's Organic to fill super-premium's void

On 16 Sep 2019, Mengniu announced to acquire all the shares (including outstanding options) of Bellamy's Organic (BAL AU, NR) except for the 3,248,482 shares held by itself, at consideration of AUD12.65/share. Total cash consideration represents around RMB7.0bn, which will be 60% and 40% financed by internal financial resources and borrowing, respectively, according to management. As at 30 Jun 2019, Mengniu had RMB5.1bn cash balance. Coupled with RMB4.0bn cash proceeds from the sale of Junlebao to be received in 2H19, we think Mengniu has sufficient financial resources to make the deal.

### Valuation not cheap due to regulatory changes in China

The acquisition consideration is valued at 48.5x adjusted P/E in FY19 or 31.1x adjusted EV/EBITDA in FY19. However, Bellamy's FY19 results was negatively affected by China's regulatory changes, which caused its revenue and adjusted net profit to fall by 19% and 36%, respectively. Valuation based on FY19 results is not cheap but we think this can be explained:

#### ■ China offline channels sales disrupted by SAMR registration

Due to regulations change, Chinese-label products imported and sold in retail channels in China require SAMR registration post 1 Jan 2018. Bellamy's Organic submitted its SAMR application in late Dec 2017 and is still awaiting the outcome of assessment. As a result, sale of Chinese-label products, accounted for less than 6% of revenue in FY18, in China's offline channels was suspended beginning Jan 2018.

#### ■ Daigou channels affected by E-Commerce Law

The adoption of E-Commerce Law since 1 Jan 2019 has strengthened regulation on e-commerce operators, including Daigous. According to Bellamy, sales of its Australian label products to persons in Australia who on-sell to Chinese consumers via e-commerce and social media platforms is a substantial channel.

#### ■ Mengniu can help Bellamy to grow in China

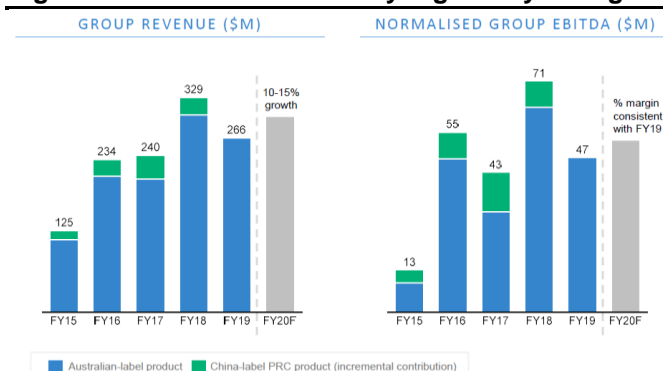
Despite the regulatory changes, Bellamy still achieved 21% and 38% CAGR of revenue and normalized EBITDA from FY15 to FY19. We think Mengniu and Yashili have resources and good track record of securing IMF approvals from SAMR, which could help Bellamy's Organic to break through. Expansion of its distribution network in China is also important to Bellamy's growth outlook. Looking forward, we think Mengniu could leverage on the synergies to help Bellamy's Organic to achieve high growth in future.

**Figure 62: FY18 and FY19 key financials of Bellamy**

(YE - 30 Jun) (AUD'000)	FY18	FY19
Revenue	328.7	266.2
EBITDA	64.6	34.9
Net profit	42.8	21.7
Adjusted EBITDA	70.6	46.9
Adjusted net profit	47.0	30.1
Adjusted EBITDA margin (%)	21.5%	17.6%
Adjusted net profit margin (%)	14.3%	11.3%

Source: Bellamy's Organic

**Figure 63: FY19 results hurt by regulatory changes**

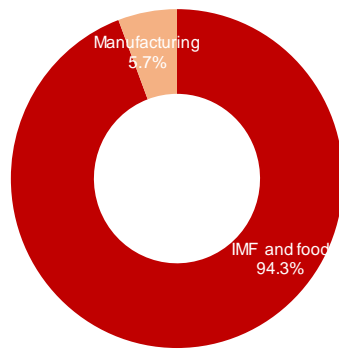


Source: Bellamy's Organic

## Background of Bellamy's Organic

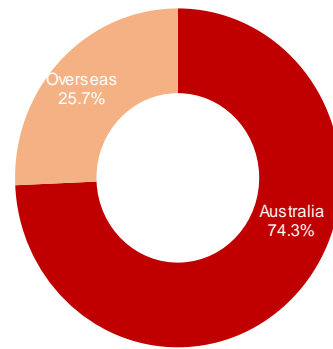
Bellamy's Organic is a leading Australian organic IMF and baby food company. It is the No. 1 organic brand in Australia and No. 2 organic infant brand globally. It has good popularity amongst Chinese consumers with No. 3 organic brand awareness in China. FY19 revenue fell 22% due to AUD18mn loss of China label sales, the CBEC regulation, declining birth rate and increase of competition in China.

**Figure 64: Revenue breakdown by product in FY19**



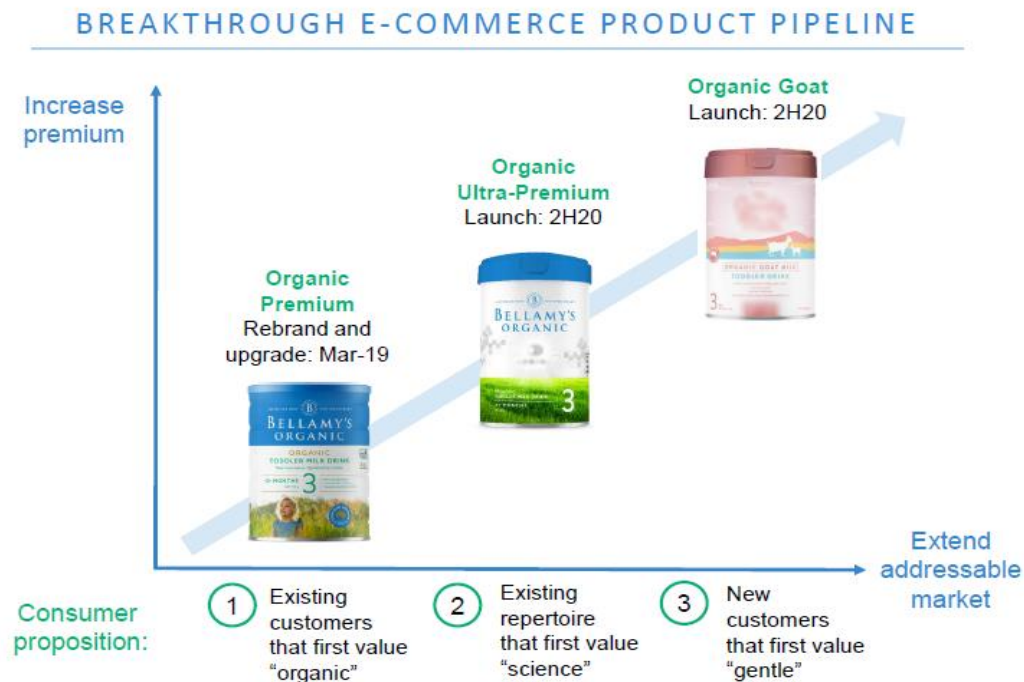
Source: Bellamy's Organic

**Figure 65: Revenue breakdown by region in FY19**



Source: Bellamy's Organic

**Figure 66: Bellamy's plans to upgrade its IMF portfolio in 2HFY20**



Source: Bellamy's Organic



## Synergies of the acquisition

We think the acquisition of Bellamy could provide synergies to Mengniu in following ways:

### ■ Organic IMF and baby food are high growth categories, which complement Mengniu's product portfolio

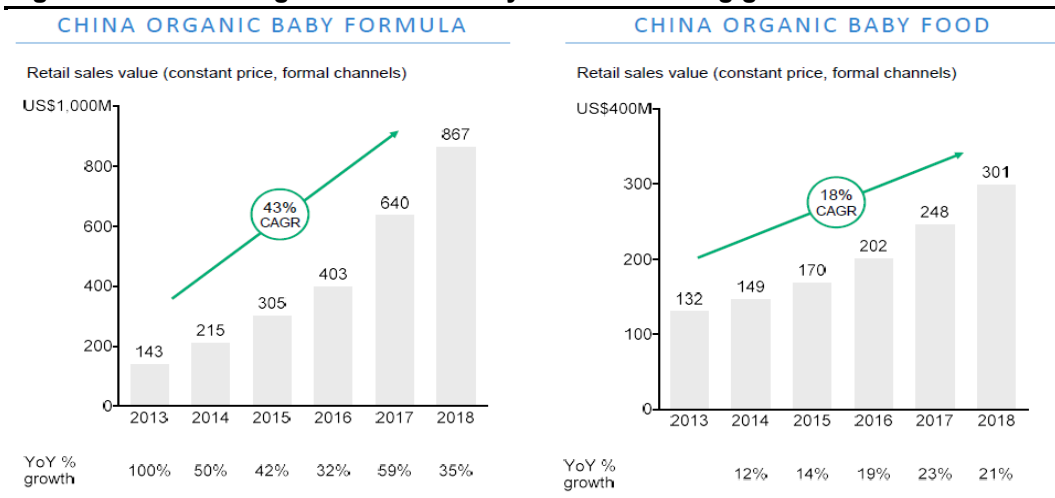
Bellamy's IMF product portfolio is positioned at super-premium segment, which is more high-end than Yashili's premium IMF product portfolio. According to Bellamy's product pipeline, it targets to launch Organic Ultra-Premium and Organic goat IMF products in 2H20. Its organic baby food also enrich Mengniu's product portfolio. According to Euromonitor, retail sales value of organic IMF and baby food recorded 43% and 18% CAGR in China from 2013 to 2018, reaching US\$867mn and US\$301mn, respectively. We expect organic products' market share will increase, led by consumers' perception of higher quality and safety standards of organic ingredients.

**Figure 67: Bellamy's organic IMF complements Mengniu's IMF product portfolio**



Source: Mengniu

**Figure 68: China's organic IMF and baby food saw strong growth from 2013-18**



Source: Bellamy's Organic, Euromonitor

### ■ Both brands complement each other's distribution channels and regions

According to Mengniu's management, Bellamy currently focuses on tier 1 cities and cross border e-commerce channels in China. On the other hand, Mengniu's IMF channel mix are 75%, 15% and 10% from maternity stores, modern trade and e-commerce, respectively. Given Mengniu's strong distribution networks in China, this could help Bellamy to expand into China, especially in lower-tier cities and other channels such as maternity stores and supermarkets, which are weaknesses of Bellamy. On the other hand, Bellamy's operations in Australia, New Zealand and a number of Southeast Asia countries fit Mengniu's strategy to expand into overseas markets with near-term focus on Southeast Asia and Australia.

### ■ Improve Mengniu's profit margin

Thanks to its high-end positioning, Bellamy's Organic recorded 43.5% GPM and 8.1% NPM in FY19, which are higher than Mengniu's 37.4% GPM and 4.4% NPM in FY18. The acquisition of Bellamy will unlock its growth potential which should improve Mengniu's growth and profit margins in future.

## Conditions precedent to the acquisitions

The board of Bellamy's Organic would unanimously recommends its shareholders to vote in favour of the acquisition in the absence of a proposal with better terms and subject to the opinion of independent expert engaged by Bellamy's Organic. Also, the following conditions need to be satisfied or waived: (1) approvals from relevant regulatory authorities in Australia; (2) approval from majority of Bellamy's shareholders on shareholders' meeting on 5 Dec 2019; (3) The Supreme Court of New South Wales approves the acquisition in accordance with the Corporations Act.

On 15 Nov 2019, the Foreign Investment Review Board of Australia approved the acquisition with certain conditions: (1) Majority of Bellamy's directors are Australian citizens; (2) Bellamy must keep its headquarters in Australia for at least a decade; and (3) Bellamy continues to invest AUD12mn in local processing facilities in Victoria.

## Earnings impact on Mengniu could be neutral in short term

Based on 60%/40% of funding from internal financial resources and borrowing and Bellamy's guidance in 2020E (10-15% revenue growth with stable EBITDA margin), we estimate the earnings impact on Mengniu could be neutral in FY20E by considering opportunity cost of internal resources finance income (@1.7% p.a.) and borrowing cost (@3.4% p.a.). However, if Bellamy's acquisition by Mengniu can be completed, we think this could accelerate Bellamy's network penetration in China and the approval process of IMF approvals by SAMR, which should speed up Bellamy's earnings growth.

**Figure 69: Bellamy's FY20E guidance and earnings impact on Mengniu in FY20E**

YE 30 Jun (AUDmn)	FY19	FY20E
<b>Bellamy's FY20E guidance</b>		
Revenue	266.2	306.2
EBITDA	34.9	
Normalized EBITDA	46.9	53.9
Net profit	21.7	
Normalized net profit	30.1	34.6
Normalized EBITDA margin	17.6%	17.6%
Normalized NPM *	11.3%	11.3%

**Earnings impact on Mengniu in FY20E**

Acquisition consideration	1,460.0
Acquisition consideration (RMBmn)	6,993.4
Financing: internal resources (60%) (RMBmn)	4,196.0
Financing: borrowing (40%) (RMBmn)	2,797.4
Shared NP of Bellamy in FY20E @100% owned (RMBmn)	165.7
Less: financial income of internal resources @1.7%p.a. (RMBmn)	71.3
Less: borrowing cost @3.4%p.a. (RMBmn)	95.1
Net impact (RMBmn)	(0.7)

Source: Bellamy's Organic, CMBIS estimates

\*We assume Bellamy's normalized NPM in FY20E is the same as FY19

**Earnings forecast****22% adjusted EPS (ex-Junlebao basis) CAGR from FY19E to FY21E**

We estimate Mengniu to post 21% adjusted net profit CAGR from FY19E to FY21E, led by 5% revenue CAGR and 1.1ppt OPM improvement from FY19E to FY21E. By assuming the disposal of 51% equity interests in Junlebao could be completed in Nov 2019, on ex-Junlebao basis, we estimate revenue and adjusted EPS CAGR are 13% and 22%, respectively, from FY19E to FY21E. The 1.0ppt OPM expansion is led by above-group level revenue growth of high-margin Milk Deluxe and Just Yoghurt, continuing product mix enhancement, GPM improvement of IMF and ice-cream segments, more disciplined discount promotion activities, and non-A&P selling expenses ratio improvement.

**Figure 70: CMBI estimates vs consensus**

US\$ mn	CMBI			Consensus			Diff (%)		
	FY19E	FY20E	FY21E	FY19E	FY20E	FY21E	FY19E	FY20E	FY21E
Revenue	79,792	78,447	87,985	77,587	82,289	90,767	3%	-5%	-3%
Gross Profit	29,703	29,711	33,584	29,366	31,543	35,036	1%	-6%	-4%
Operating Profit	4,329	4,717	5,757	4,534	5,249	6,194	-5%	-10%	-7%
Adjusted Net Profit	3,894	4,661	5,674	3,954	4,635	5,461	-2%	1%	4%
Gross Margin	37.2%	37.9%	38.2%	37.8%	38.3%	38.6%	-0.6ppt	-0.4ppt	-0.4ppt
Operating Margin	5.4%	6.0%	6.5%	5.8%	6.4%	6.8%	-0.4ppt	-0.4ppt	-0.3ppt
Adjusted Net Margin	4.9%	5.9%	6.4%	5.1%	5.6%	6.0%	-0.2ppt	+0.3ppt	+0.4ppt

Source: Company data, CMBIS

**Figure 71: P&L**

<b>Year-end Dec 31 (RMB mn)</b>	<b>FY17</b>	<b>FY18</b>	<b>FY19E</b>	<b>FY20E</b>	<b>FY21E</b>
<b>Revenue</b>	<b>60,156</b>	<b>68,977</b>	<b>79,792</b>	<b>78,447</b>	<b>87,985</b>
Liquid milk	53,015	59,389	68,099	70,448	79,338
Ice-cream	2,513	2,723	2,696	2,912	3,087
Milk powder	4,042	6,017	8,111	3,975	4,173
Others	585	848	886	1,112	1,388
Cost of sales	(38,973)	(43,193)	(50,089)	(48,736)	(54,401)
Gross profit	21,183	25,784	29,703	29,711	33,584
Other income and gains	338	635	471	374	420
Selling expenses	(14,869)	(18,833)	(21,384)	(20,945)	(23,316)
Administrative expenses	(2,497)	(2,915)	(3,431)	(3,530)	(3,959)
Other expenses	(1,182)	(936)	(1,029)	(893)	(972)
EBIT	2,972	3,734	4,329	4,717	5,757
Net finance cost	184	318	324	656	782
One-off items	0	101	3,429	0	0
Share of profit/(loss) of associates	(532)	(300)	185	246	332
Profit before tax	2,625	3,853	8,267	5,619	6,871
Income tax expense	(594)	(649)	(1,305)	(913)	(1,112)
Non-controlling interests	17	(161)	(152)	(44)	(85)
<b>Net profit</b>	<b>2,048</b>	<b>3,043</b>	<b>6,809</b>	<b>4,661</b>	<b>5,674</b>
<b>Adjusted net profit</b>	<b>2,048</b>	<b>2,942</b>	<b>3,894</b>	<b>4,661</b>	<b>5,674</b>

Source: Company data, CMBIS estimates

## Valuation

### Valuation attractive compared to peers

We set our TP of HK\$37.00 based on 28.0x FY20E adjusted P/E, in the high-end of 18-30x 1-yr forward P/E range since revenue growth resumed double-digit growth in FY16. We expect Mengniu can maintain its OPM expansion and double-digit revenue growth trend since FY16, the financial year that the Company resumed double-digit revenue growth.

We think our TP is not aggressive if we compare Mengniu's valuation to peers. We forecast Mengniu to deliver 22% EPS CAGR (ex-Junlebao basis) from FY19E to FY21E, which is faster than sectors' average of 17%. Our TP represents 33.4x FY19E P/E, or 1.5x PEG which is lower than sector's average of 1.9x.

Figure 72: P/E band chart



Source: CMBIS estimates, Bloomberg, Company data

Figure 73: Peers valuation

Staples	Stock code	Price	Mkt cap (RMBmn)	Y/E	P/E (x)			EPS growth (%)			P/B (x)		ROAE (%)		FY1-3 EPS CAGR	FY1 PEG
					FY1	FY2	FY3	FY1	FY2	FY3	FY1	FY2	FY1	FY2		
Mengniu	2319 HK	29.15	114,694	Dec-18	26.3	22.1	18.1	32	19	22	3.4	3.0	14.1	14.6	20.4	1.3
WH	288 HK	8.39	123,474	Dec-18	11.9	11.0	10.7	26	9	3	1.8	1.7	16.0	15.7	6.0	2.0
Want Want #	151 HK	6.39	79,333	Mar-19	18.7	17.5	16.3	10	7	7	4.4	4.2	24.2	24.4	7.1	2.6
Budweiser Brewing	1876 HK	29.35	388,694	Dec-18	50.0	38.7	31.8	na	29	22	4.4	4.1	9.6	11.5	25.4	2.0
CR Beer	291 HK	44.65	144,852	Dec-18	57.1	40.1	31.4	134	42	28	6.4	5.8	11.6	15.0	34.8	1.6
Tsingdao Beer	168 HK	50.50	75,416	Dec-18	33.2	28.4	24.6	29	17	16	3.2	3.0	9.8	10.7	16.3	2.0
Hengan	1044 HK	50.35	59,900	Dec-18	13.8	12.8	11.8	4	8	8	3.0	2.8	22.6	22.6	8.0	1.7
Vinda	3331 HK	14.28	17,066	Dec-18	17.6	14.9	13.2	58	18	13	1.8	1.6	10.7	11.6	15.4	1.1
Ting Yi	322 HK	12.00	67,481	Dec-18	22.9	20.7	18.8	7	11	10	2.9	2.8	13.1	14.0	10.3	2.2
Uni-President China	220 HK	7.62	32,913	Dec-18	21.5	19.7	18.4	33	9	7	2.2	2.2	10.5	11.1	8.2	2.6
Sun Art	6808 HK	9.00	85,857	Dec-18	28.1	25.8	23.6	6	9	9	3.1	2.8	11.1	11.2	9.2	3.1
Vitasoy #	345 HK	32.30	34,360	Mar-19	43.3	36.5	31.5	14	19	16	9.8	8.9	23.7	25.4	17.3	2.5
Haidilao	6862 HK	35.5	188,150	Dec-18	65.8	45.4	34.5	46	45	32	15.2	11.9	25.4	28.7	38.2	1.7
Yihai	1579 HK	51.25	53,654	Dec-18	65.0	47.7	36.2	32	36	32	17.9	13.6	30.7	31.8	34.0	1.9
Xiabuxiabu	520 HK	9.12	9,856	Dec-18	18.9	15.0	12.6	(0)	26	19	3.5	3.1	19.1	21.5	22.5	0.8
Cafe De Coral #	341 HK	19.62	11,492	Mar-19	19.8	18.0	17.3	(2)	10	4	3.3	3.1	16.4	17.4	7.0	2.8
Ausnutria	1717 HK	9.95	16,040	Dec-18	15.9	12.2	9.6	18	31	27	4.1	3.5	22.5	27.1	29.1	0.5
H&H International	1112 HK	31.00	19,910	Dec-18	14.2	11.9	10.7	48	20	11	3.1	2.6	23.7	23.2	15.1	0.9
Dali Food	3799 HK	5.23	71,620	Dec-18	16.2	15.0	13.9	7	8	7	3.8	3.6	24.4	25.0	7.8	2.1
Average					29.5	23.9	20.3	28	20	15	5.1	4.4	17.8	19.1	17.5	1.9
Ex-Mengniu					29.7	24.0	20.4	28	20	15	5.2	4.5	18.1	19.3	17.3	1.9

Source: CMBIS estimates, Bloomberg

# Year ended in Mar

## Company Overview

### Diversified product portfolio

Mengniu manufactures and distributes diversified dairy products, including UHT milk, chilled fresh milk, milk beverage, yogurt, IMF, milk powder, ice-cream, cheese, soy milk and others, in China. It is the second largest dairy product manufacturer in China with Mengniu as its core brand. As at 31 Dec 2018, Mengniu had 9.75mn tons annual production capacity.

**Figure 74: Mengniu's diversified product portfolio**



Source: CMBIS, Company data

### Investment in quality raw milk sources

Mengniu has invested in three raw milk manufacturers to control more than 2mn annual milk yield in China. These domestic quality raw milk source is important for the manufacture of its liquid milk products, especially Milk Deluxe and chilled fresh milk.

#### ■ China Modern Dairy (1117 HK, NR)

Mengniu currently holds 58.15% equity interests of CMD but classifies CMD as an associate company because it thinks it has less than 50% substantive voting rights over CMD when it adds its voting rights of 11.24% shares underlying the exchangeable bonds when exchanged and the outstanding vested management share options of CMD when exercised.

CMD is the largest dairy farming operator and fresh milk producer in China in terms of herd size and milk yield. It operates 26 dairy farms in China with dairy cows over 230 thousands heads and annual milk yield over 1.3mn tons. CMD's products have been consecutively awarded with the Gold Prize of Monde Selection in the past six years.

#### 3) China Shengmu (1432 HK, NR)

Mengniu holds 23.1% equity interests of Shengmu, according to China Shengmu's 2019 interim report. China Shengmu has 34 dairy farms, including 11 organic farms. Its dairy herd size was 109,610 heads, including 47,054 heads which produce organic milk.



#### 4) Fuyuan Farming

According to management, Mengniu holds 42% equity interests of Fuyuan Farming. Fuyuan is a vertically integrated player covering plantation of forages, trading and processing of feed, operation of cow farms, online dairy big data services platform, consultancy of dairy operation, dairy products processing. According to its website, its dairy herd size was around 50,000 head in Oct 2017.

### Strategic shareholders brings expertise and improves corporate governance

Danone and Arla Food are strategic shareholders of Mengniu, each holding 9.9% and 5.3% equity interest in the Company. Both Danone and Arla Foods are top global dairy companies. Apart from sharing their expertise in dairy products, we think their participation in the board (each Company has one board seat) in Mengniu should enhance corporate governance.

#### ■ Expertise

##### 1) Danone

Danone is a global leader in four businesses, namely essential dairy and plant-based products, early life nutrition, medical nutrition and waters. Danone and Mengniu has established a JV to tap into Chinese yogurt market and upgrade Mengniu's chilled plants with Danone's production and quality control standards. Both companies continued to work on product R&D and production techniques in chilled product business. Mengniu has been the market leader in China's chilled product market for 13th successive years. In addition, Danone invested 25% equity interest of Yashili and shared concepts and experience in international management with Yashili.

##### 2) Arla Foods

Arla Foods is the largest organic dairy producers in the world and has the second largest milk pool in Europe. The cooperation between Mengniu and Arla Foods lies in areas such as import business, advanced ranch technologies and dairy product nutrition studies. As Arla Foods' exclusive distributor in China, Mengniu introduced Arla Foods' cheese and butter products into China. Arla China Innovation Center, which was set up in the COFCO Nutrition and Health Research Institute in Beijing in 2014, focuses on development of cheese products for Chinese consumers. In 2016, Mengniu and Arla Foods formed a JV to tap the high-potential cheese market.

## Financial Summary

### Income statement

YE 31 Dec (RMB mn)	FY17A	FY18A	FY19E	FY20E	FY21E
<b>Revenue</b>	<b>60,156</b>	<b>68,977</b>	<b>79,792</b>	<b>78,447</b>	<b>87,985</b>
Liquid milk	53,015	59,389	68,099	70,448	79,338
Ice-cream	2,513	2,723	2,696	2,912	3,087
Milk powder	4,042	6,017	8,111	3,975	4,173
Others	585	848	886	1,112	1,388
Cost of sales	(38,973)	(43,193)	(50,089)	(48,736)	(54,401)
Gross profit	21,183	25,784	29,703	29,711	33,584
Other income and gains	338	635	471	374	420
Selling expenses	(14,869)	(18,833)	(21,384)	(20,945)	(23,316)
Administration expenses	(2,497)	(2,915)	(3,431)	(3,530)	(3,959)
Other expenses	(1,182)	(936)	(1,029)	(893)	(972)
EBIT	2,972	3,734	4,329	4,717	5,757
Finance income, net	184	318	324	656	782
Others	0	101	3,429	0	0
JV & associates	(532)	(300)	185	246	332
Pre-tax profit	2,625	3,853	8,267	5,619	6,871
Income tax	(594)	(649)	(1,305)	(913)	(1,112)
Less: Minority interests	17	(161)	(152)	(44)	(85)
<b>Net profit</b>	<b>2,048</b>	<b>3,043</b>	<b>6,809</b>	<b>4,661</b>	<b>5,674</b>
<b>Adjusted net profit</b>	<b>2,048</b>	<b>3,043</b>	<b>3,894</b>	<b>4,661</b>	<b>5,674</b>

### Cash flow summary

YE 31 Dec (RMB mn)	FY17A	FY18A	FY19E	FY20E	FY21E
<b>Profit before tax</b>	<b>2,625</b>	<b>3,853</b>	<b>8,267</b>	<b>5,619</b>	<b>6,871</b>
Associates & JV	532	300	(185)	(246)	(332)
D&A	1,704	1,838	2,161	1,768	1,961
Change in working capital	1,447	1,653	1,641	880	815
Others	(802)	(1,280)	(6,162)	(1,994)	(2,318)
<b>Operating cash flow</b>	<b>5,505</b>	<b>6,363</b>	<b>5,722</b>	<b>6,028</b>	<b>6,997</b>
Capex	(2,152)	(3,149)	(3,800)	(4,000)	(3,000)
Acquisitions	(4,250)	(309)	0	0	0
Others	(5,049)	(773)	4,272	1,080	1,206
<b>Investing cash flow</b>	<b>(11,450)</b>	<b>(4,232)</b>	<b>472</b>	<b>(2,920)</b>	<b>(1,794)</b>
Change of borrowing	5,778	(383)	245	0	0
Dividend paid	(399)	(526)	(711)	(901)	(1,072)
Others	369	8	52	0	0
<b>Financing cash flow</b>	<b>5,748</b>	<b>(900)</b>	<b>(414)</b>	<b>(901)</b>	<b>(1,072)</b>
<b>Net change in cash</b>	<b>(196)</b>	<b>1,231</b>	<b>5,780</b>	<b>2,207</b>	<b>4,131</b>
Cash at the beginning	3,356	3,129	4,370	10,150	12,357
Forex effect	(31)	10	0	0	0
Cash at disposal groups	1	0	0	0	0
<b>Cash at the end</b>	<b>3,129</b>	<b>4,370</b>	<b>10,150</b>	<b>12,357</b>	<b>16,488</b>
Time deposit	2,829	2,927	2,927	2,927	2,927
Cash and cash equivalent	5,959	7,298	13,078	15,285	19,416

### Balance sheet

YE 31 Dec (RMB mn)	FY17A	FY18A	FY19E	FY20E	FY21E
<b>Non-current assets</b>	<b>32,121</b>	<b>36,716</b>	<b>29,954</b>	<b>32,431</b>	<b>33,802</b>
PPE	12,715	14,734	11,098	13,023	14,127
Goodwill and intangible assets	6,727	6,980	6,108	6,041	5,974
JV & associates	7,194	7,202	7,345	7,591	7,922
Others	5,485	7,800	5,403	5,776	5,779
<b>Current assets</b>	<b>26,018</b>	<b>29,741</b>	<b>35,315</b>	<b>38,862</b>	<b>44,320</b>
Cash	5,959	7,298	13,078	15,285	19,416
Pledged deposit	466	623	384	384	384
Inventory	3,510	4,282	4,179	4,752	5,304
Trade receivables	2,647	2,892	3,100	3,524	3,953
Others	13,435	14,646	14,574	14,917	15,263
<b>Current liabilities</b>	<b>22,566</b>	<b>25,109</b>	<b>18,826</b>	<b>21,046</b>	<b>23,188</b>
Borrowings	7,935	6,523	1,964	1,964	1,964
Trade payables	6,342	7,022	6,655	7,567	8,447
Other payables	7,324	10,889	9,554	10,863	12,126
Others	965	675	652	652	652
<b>Non-current liabilities</b>	<b>8,465</b>	<b>10,884</b>	<b>11,119</b>	<b>11,119</b>	<b>11,119</b>
Borrowings	6,015	8,192	8,493	8,493	8,493
Deferred revenue	739	856	856	856	856
Others	1,711	1,835	1,770	1,770	1,770
<b>Total net assets</b>	<b>27,107</b>	<b>30,464</b>	<b>35,324</b>	<b>39,128</b>	<b>43,816</b>
<b>Shareholders' equity</b>	<b>22,604</b>	<b>25,212</b>	<b>30,081</b>	<b>33,842</b>	<b>38,444</b>
<b>Non-controlling interests</b>	<b>4,503</b>	<b>5,252</b>	<b>5,243</b>	<b>5,287</b>	<b>5,372</b>

### Key ratios

YE 31 Dec	FY17A	FY18A	FY19E	FY20E	FY21E
<b>Sales mix (%)</b>					
Liquid milk	88.1	86.1	85.3	89.8	90.2
Ice-cream	4.2	3.9	3.4	3.7	3.5
Milk powder	6.7	8.7	10.2	5.1	4.7
Others	1.0	1.2	1.1	1.4	1.6
<b>P&amp;L ratios (%)</b>					
Gross margin	35.2	37.4	37.2	37.9	38.2
EBIT margin	4.9	5.4	5.4	6.0	6.5
Net margin	3.4	4.4	8.5	5.9	6.4
Adjusted net margin	3.4	4.4	4.9	5.9	6.4
Payout ratio	22.8	23.2	23.0	23.0	23.0
<b>Balance sheet ratios</b>					
Current ratio (x)	1.2	1.2	1.9	1.8	1.9
A/C receivables days	15	15	14	15	16
A/C payables days	55	56	50	53	54
Inventory days	32	33	31	33	34
Asset turnover (x)	1.0	1.0	1.2	1.1	1.1
Net gearing ratio (%)	30	22	(9)	(13)	(21)
<b>Returns (%)</b>					
Adjusted ROE	9.4	12.7	14.1	14.6	15.7
Adjusted ROA	3.8	4.9	5.9	6.8	7.6
<b>Per share</b>					
EPS (RMB)	0.53	0.78	1.00	1.18	1.44
DPS (RMB)	0.12	0.18	0.23	0.27	0.33
BVPS (RMB)	5.76	6.42	7.65	8.60	9.77

Source: Company data, CMBIS estimates

# Yili (600887 CH)

## Market leader with good execution track record

- **Market leader with good execution track record.** Ambrosial (安慕希), launched in Jan 2014, is Yili's largest product in terms of sales (~18% of revenue in FY18). Although this UHT yogurt product was launched later than its key competitors, its sales in FY18 was much greater than them. Leveraging on marketing campaigns of Beijing 2008 Olympic Games and Shanghai 2010 World Expo, Yili's revenue surpassed Mengniu in FY12. Yili's strong nationwide network penetration, especially in lower tier cities where per capita consumption is catching up, also contributed to its market leadership. Yili targets to reach RMB100bn revenue and become one of the top five dairy companies in the world in 2020E.
- **3Q19 net profit +18%.** Yili reported 11% YoY revenue growth in 3Q19, better than 9% growth in 2Q19 but behind Mengniu's >15.6% growth in 3Q19. Growth of both Ambrosial and Satine underperformed Mengniu's Just Yoghurt and Milk Deluxe in 3Q19. 3Q19 GPM slightly improved 0.2ppt on product mix enhancement and reduced discount promotion activities. 3Q19 net profit rose 18% YoY led by 2.4ppt decrease of selling expenses ratio due to better economies of scale and healthy revenue growth. We estimate 13% revenue growth and 9% net profit growth in FY19E.
- **Restricted share award scheme to maintain stable management team.** Yili will expand into new businesses (healthy drinks and cheese BUs) and overseas markets. We think the scheme (covered 478 employees) would keep a stable management team for next five years for these expansions. The scheme has set a requirement of 8.2% CAGR of adjusted net profit in FY19-23E for the grant of shares to eligible employees. Amortization cost of RMB1.4bn of the scheme will be amortized in FY19-24E.
- **12% adjusted net profit CAGR from FY19E to FY21E.** We forecast the growth is led by 11% CAGR of revenue. We expect its OPM to remain stable in 9.1-9.2% in FY19E-21E. Amid rising raw milk cost, we think Yili could be more disciplined in discount promotion activities to achieve the required 8.2% CAGR of adjusted net profit specified by the restricted share award scheme.
- **Initiate at Buy.** We set our TP of HK\$34.04, based on 28x FY20E P/E, the mid end of its 1-yr forward P/E range of 21x-36x since A-share was said to be included in MSCI Emerging Markets Index in Jun 2017. Our 12% adjusted EPS CAGR from FY19E to FY21E is within 10-17% adjusted EPS growth in FY17-18. Therefore, we think our target P/E of 28.0x is fair. **Catalysts:** better-than-expected revenue and margins; **Risks:** intensifying competition, raw milk cost pressure and food safety.

### Earnings Summary

(YE 31 Dec)	FY17A	FY18A	FY19E	FY20E	FY21E
Revenue (RMB mn)	67,547	78,976	89,588	100,972	110,638
YoY growth (%)	12	17	13	13	10
Net profit (RMB mn)	6,001	6,440	7,041	7,508	8,607
Adjusted net profit (RMB mn)	5328	5878	6535	7375	8196
Adjusted EPS (RMB)	0.880	0.970	1.076	1.216	1.351
YoY growth (%)	17	10	11	13	11
Adjusted P/E (x)	33.0	29.9	26.9	23.9	21.5
P/B (x)	7.0	6.3	6.3	5.7	5.2
Yield (%)	2.4	2.4	2.8	3.0	3.4
ROE (%)	22.1	22.2	23.3	25.1	25.3

Source: Company data, CMBIS estimates

### BUY (Initiation)

Target Price	HK\$34.04
Up/Downside	+17%
Current Price	HK\$29.00

### China F&B Sector

**Albert Yip**  
(852) 3900 0838  
albertyip@cmbi.com.hk

### Stock Data

Mkt Cap (RMB mn)	176,817
Avg 3 mths t/o (RMB\$ mn)	1,472.44
52w High/Low (RMB)	34.66/ 21.70
Total Issued Shares (mn)	6,064.8

Source: Bloomberg

### Shareholding Structure

Huohuot Investment	8.88%
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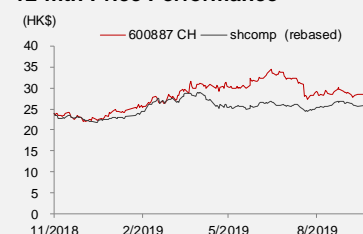
Source: HKEx

### Share Performance

	Absolute	Relative
1-mth	2.7%	5.8%
3-mth	0.9%	-1.5%
6-mth	-4.8%	-5.1%

Source: Bloomberg

### 12-mth Price Performance

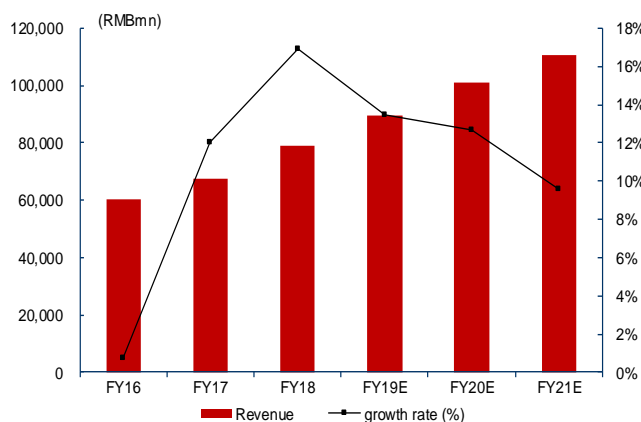


Source: Bloomberg

Auditor: Da Hua

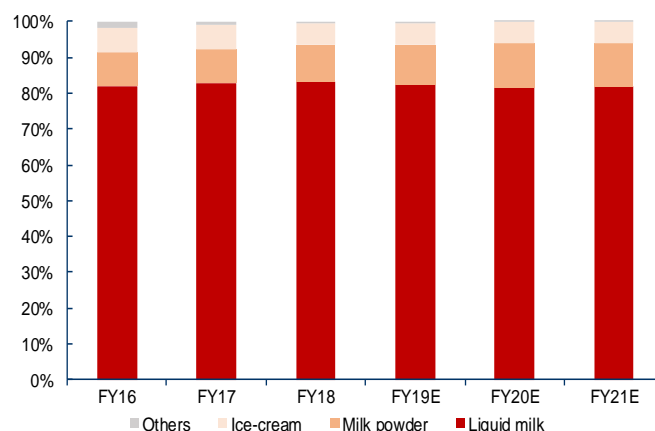
## Focus Charts

**Figure 75: Revenue to grow at 11% CAGR from FY19E to FY21E**



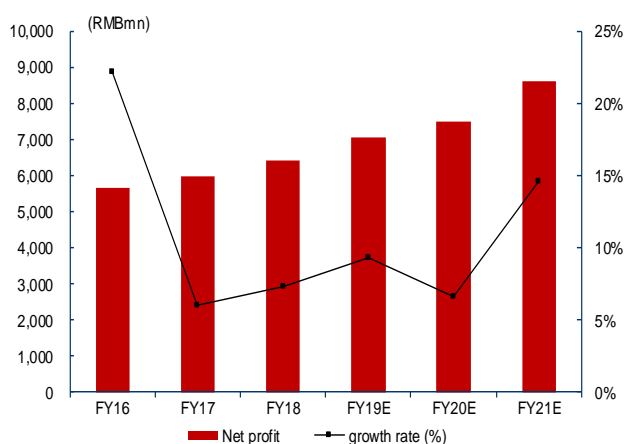
Source: Company data, CMBIS estimates

**Figure 76: Revenue breakdown by segment of Yili**



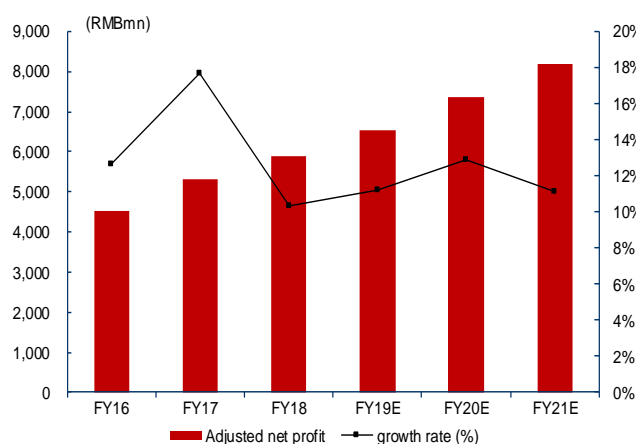
Source: Company data, CMBIS estimates

**Figure 77: Net profit to grow at 11% CAGR from FY19E to FY21E**



Source: Company data, CMBIS estimates

**Figure 78: Adjusted net profit to grow at 12% CAGR from FY19E to FY21E**



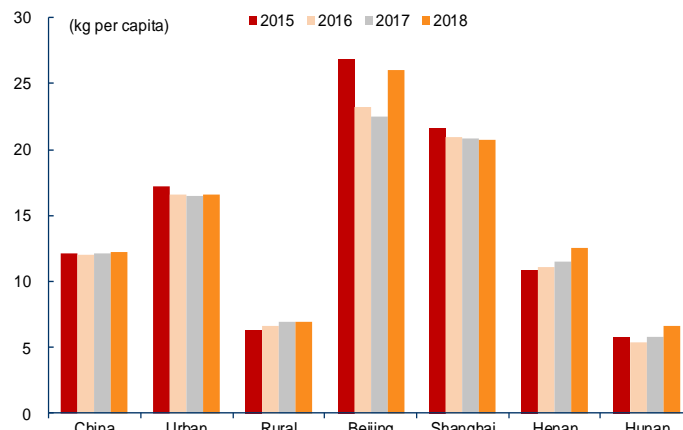
Source: Company data, CMBIS estimates

**Figure 79: Requirements for the release of restricted award shares**

Restriction of sale period	Net profit requirement for financial year	Net profit growth (vs 2018 base)	ROE requirement (%)	Payout ratio (%)
1st	FY19	$\geq 8\%$	$\geq 20$	$\geq 70$
2nd	FY20	$\geq 18\%$	$\geq 20$	$\geq 70$
3rd	FY21	$\geq 28\%$	$\geq 20$	$\geq 70$
4th	FY22	$\geq 38\%$	$\geq 20$	$\geq 70$
5th	FY23	$\geq 48\%$	$\geq 20$	$\geq 70$

Source: Company data

**Figure 80: Rural household's milk consumption per capita was only 42% of urban household's level in 2018**



Source: Wind

## Market leader with good execution track record

Yili is the largest dairy player in China in terms of sales in 2018. Its revenue reached RMB79.5bn, followed by Mengniu's RMB69.0bn and Bright Dairy's RMB21.0bn.

## Success of Ambrosial established execution track record

Launched in 2H13, Ambrosial (安慕希) now is Yili's largest product in terms of revenue, contributing around RMB14bn revenue or 18% of total revenue in FY18. Among the top three dairy names in China, Yili was the last player to launch its UHT yogurt. Mengniu launched its Just Yoghurt (纯甄) in May 2013. Bright Dairy's (600597 CH, NR) Momchilovtsi (莫斯利安) had first mover advantage and was the market leader in UHT yogurt segment in 2014 with sales of RMB6bn. Although the launch of Ambrosial was later than its key competitors, Ambrosial's sales (RMB14bn) was much higher than Just Yoghurt (RMB8bn) and Momchilovtsi in 2018.

**Figure 81: Ambrosial vs Just Yoghurt vs Momchilovtsi**

Brand	Yili's Ambrosial	Mengniu's Just Yoghurt	Bright Dairy's Momchilovtsi
			
Retail price (RMB)	RMB118 for 205g * 24 RMB4.91 per 205g	RMB89.9 for 200g * 24 RMB3.75 per 200g	RMB65.9 for 200g * 12 RMB5.49 per 200g

Source: Tmall as at 3 Oct 2019

## Sound advertising and product segmentation strategy

Ambrosial positioned itself as a high-end, Greek UHT yogurt for young consumers. In 2014, Ambrosial sponsored two popular Chinese entertainment IPs 《中国好声音》 and 《奔跑吧兄弟》, which successfully caught consumers' attention.

In 2015, Ambrosial launched blueberry flavor and strengthened its market campaign. While it continued to sponsor 《奔跑吧兄弟》, it endorsed Angelababy and Li Chen as spokesperson to precisely target young consumers. Revenue surged to RMB3-4bn in its third year. On the other hand, Momchilovtsi's revenue dropped 1% YoY to RMB5.9bn in 2015.

**Figure 82: Angelababy and Li Chen were spokesperson**



Source: Internet

**Figure 83: Ambrosial joined hands with Ning Zetao in (安慕希奥运打气天团) promotion**



Source: Internet



In 2016, Ambrosial further launched vanilla favor. During 2016 Rio Olympics, Ambrosial initiated sports marketing (安慕希奥运打气天团) in mobile social platform such as Weixin and Weibo through joining hands with athletes such as Ning Zetao.

In 2017, Ambrosial released a differentiated product, peach with oat granule favor with cap package. While oat granule offers different consumption enjoyment, customers can consume the product conveniently with the cap package. In the same year, Ambrosial upgraded its package to PET bottle, which was even more convenient for drinking. We estimate revenue of Ambrosial reached RMB10bn in 2017.

**Figure 84: Peach with oat granule favor with cap package.**



Source: Internet

**Figure 85: PET bottle package version launched in 2017**

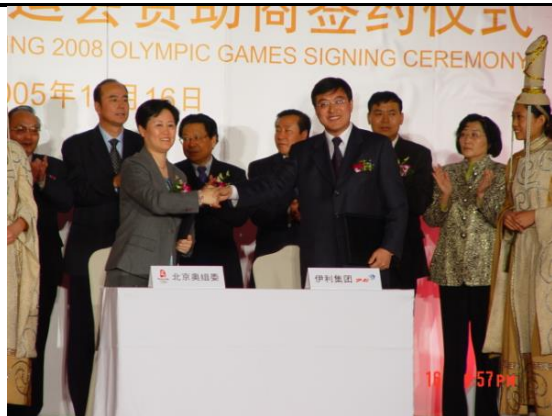


Source: Internet

## Leverage on Olympic Games and World Expo marketing campaigns

Yili is China's first F&B company to sponsor Olympics Games. It has been sponsoring China Olympics Committee (COC) since 2005. On 30 Aug 2017, Yili became the Official Dairy Products Partner of the Olympic and Paralympic Winter Games Beijing. This term of sponsorship will cover Pyeongchang 2018, Tokyo 2020, Beijing 2022 and Paris 2024, which should provide Yili with a great opportunity to promote its brand and products in China and overseas. On the other hand, Yili also was the Official Dairy Products Partner of 2010 Shanghai Expo.

**Figure 86: Yili began its sponsorship of China Olympic Committee in 2005**



Source: Company

**Figure 87: Yili's pure milk product used 2008 Beijing Olympic logo**



Source: Internet



**Figure 88: Yili became the Official Dairy Products Partner of the Beijing 2022**



Source: Company

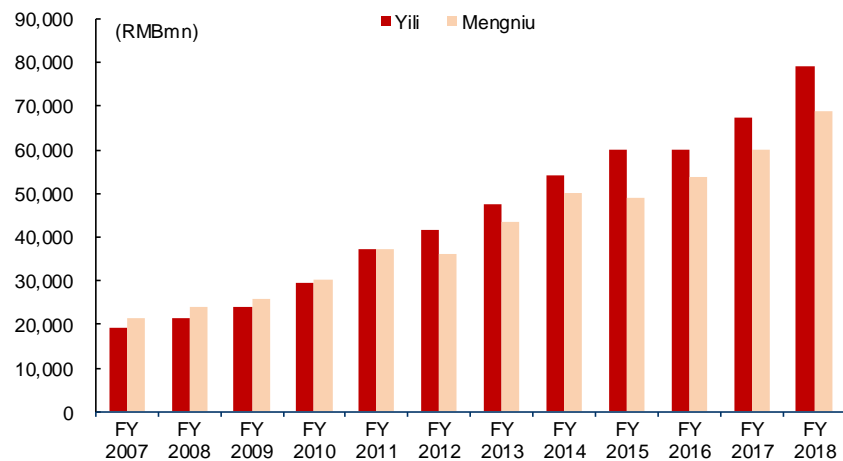
**Figure 89: Yili's pure milk product used 2010 World Expo logo**



Source: Internet

2008 Beijing Olympic Games and 2010 Shanghai World Expo were eye-catching, top national events which attracted massive attention of Chinese consumers. The brand promotion effect would be significant. Although Mengniu's revenue was greater than Yili between 2007 and 2011, Yili's revenue surpassed Mengniu in 2012. We think the enhanced brand equity of Yili, driven by the sponsorships of Beijing Olympic Games and Shanghai World Expo, was a major contributor for Yili's overtaking of Mengniu. We think this impact is similar to Anta's overtaking of Li Ning as number one domestic sportswear brand since Anta became the Official Partner of COC in 2009.

**Figure 90: Yili's sales surpassed Mengniu since 2012**



Source: Company data

## Outstanding network penetration capability

We think Yili's outstanding distribution network penetration, especially in lower-tier cities, is a key contributor to its market leadership.

### 1) No.1 FMCG brand in terms of number of consumers reached

According to Kantar research, Yili has reached 1,275mn Chinese consumers, representing 90.9% penetration rate, in 2018. Its penetration rate was higher than Mengniu and Tingyi.

**Figure 91: Yili was the most consumers reached FMCG brand in 2018**

Ranking	Brand	No. of consumers	Growth (%)	Penetration rate (%)	Shopping frequency
1	Yili	1,275	5.1	90.9	7.5
2	Mengniu	1,053	1.4	88.1	6.5
3	Tingyi	850	(7.3)	80.8	5.6
4	Haitian	520	6.0	73.3	4.0
5	Want Want	453	(4.8)	64.9	3.7
6	Shuanghui	430	0.6	59.7	4.1
7	Bright Dairy	388	(9.0)	38.4	5.4
8	Liby	384	0.7	66.5	3.1
9	Nongfu Spring	368	9.5	59.3	3.5
10	Uni-President	361	(8.4)	57.2	3.5

Source: Kantar

### 2) Nationwide network strategy laid solid foundation

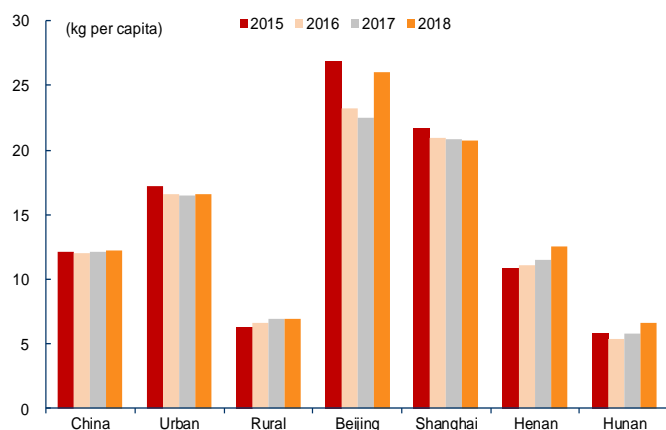
Mr. Pan Gang has been appointed as the Chairman of Yili since 2005. After channel checks, he found the growth opportunities in southern market (high disposable income level but lack of top dairy brands) was huge. Then, in 2006, he initiated nationwide networking strategy to set up production bases in Hubei, Anhui, Sichuan, Shandong, Hebei and Zhejiang as well as establish distribution network.

### 3) Well penetrated in lower-tier cities to capture growth opportunities

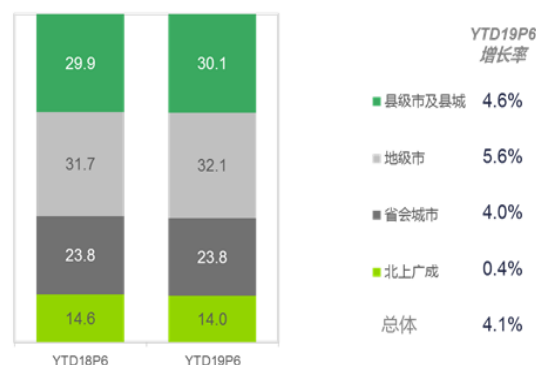
According to Kantar research, revenue growth of dairy products in prefectural-level cities and county-level or below cities was 5.6% and 4.6%, respectively, during the 12 months ended Jun 2019. Such growth rate was stronger than tier 1 cities (0.4% growth) and tier 2 cities (4.0% growth). Thanks to Yili early network penetration strategy, lower-tier cities contributed a major proportion of the Company's revenue. For UHT liquid milk segment, tier 3 and 4 cities contributed over 70% of segment's revenue. For chilled liquid milk segment, tier 3 and 4 cities contributed over 50% of segment revenue.

With reference to Yili's 2019 interim report, its UHT liquid milk market penetration rate increased 2.7ppt to 83.9% in 1H19. Its penetration rate in tier 3 and 4 cities were higher at 86.2% in 1H19 (+2.3ppt), showing Yili has strong penetration in lower tier cities.

According to National Bureau of Statistics, rural household's milk consumption per capita was 6.91kg, only 42% of urban household's 16.53kg in 2018. Tier 1 cities such as Beijing and Shanghai's level was even higher at 26.02kg and 20.78kg, respectively. Given the continuous urbanization, rising income level and consumption upgrade trend, we think lower tier cities will remain as a growth driver of China's dairy sector and Yili should benefit from its well-penetrated distribution network in lower tier cities.

**Figure 92: Rural household's milk consumption per capita was only 42% of urban household's level in 2018**


Source: Wind

**Figure 93: Growth in lower tier cities outpaced tier 1 and 2 cities**


Source: Kantar

### 3Q19 net profit +18%

Yili's reported 11% YoY revenue growth in 3Q19, slightly better than 9% YoY growth in 2Q19. The growth was driven by volume growth, product mix improvement and reduced discount promotion activities. We think the completion of acquisition of Westland Dairy on 2 Aug also contributed 1-2ppt. Yili's 3Q19 revenue growth continued to underperform Mengniu (3Q19 growth > 15.6% in 1H19). GPM slightly improved 0.2ppt to 36.0% as product mix enhancement and reduced discount promotion activities more than offset raw milk cost pressure (+8.5% in 3Q19). Management anticipates raw milk price increased in 4Q19E to be less than 3Q19 because of high base (>6% in 4Q18 vs 4% in 3Q18).

Selling expenses ratio fell 2.4ppt to 21.9%. Management expect selling expenses ratio to drop slightly in FY19E. Administrative expenses ratio increased 1ppt to 4.5% driven by increased staff expenses on establishment of healthy drinks and cheese BUs and increased compensation. Management expects administrative expenses ratio (excluding expenses related to share award scheme) to remain 4-5% in FY19-20E. Net profit rose 18% YoY in 3Q19.

### Sales growth of key product brands still behind Mengniu's

YoY sales growth of Ambrosial, the largest product in terms of sales, moderated from around 20% growth in 1H19 to 17% in 9M19. Yili's high-end UHT milk brand (contributed around RMB10bn sales or 13% of total sales in FY18), Satine, saw momentum maintained at 17.8% in 9M19 vs 17% in 1H19. Growth of both products remained behind Mengniu's Milk Deluxe (25-30% in 3Q19 and Just Yoghurt (>24% in 3Q19).

**Figure 94: Sales growth of Yili's key product brands behind Mengniu's**

	1Q19	1H19	9M19
Ambrosial	30%	20%	17%
Just Yoghurt	1Q<2Q	24%	>24%
Satine	20%	17%	18%
Milk Deluxe	1Q<2Q	22%	>22%

Source: Company data, Nielsen

**Figure 95: 3Q19 results**

Y/E Dec (RMB mn)	3Q19	3Q18	% change	Remarks
<b>Revenue</b>	<b>23,552</b>	<b>21,258</b>	<b>11%</b>	<b>ASP +2%, volume growth and product mix improvement</b>
Cost of sales	(15,075)	(13,648)	10%	
Gross profit	8,477	7,610	11%	
Other income and gains/(losses)	203	332	-39%	
Selling and distribution expenses	(5,149)	(5,164)	0%	
Administrative expenses	(1,060)	(745)	42%	set up new BUs and overseas offices, increased compensation
R&D expenses	(132)	(56)	136%	
Tax & surcharges	(118)	(136)	-14%	
Operating profit	2,221	1,841	21%	
Finance income, net	(101)	33	-409%	
Other gains/(losses)	(12)	(4)	174%	
Share of profit from JV/associate	56	30	84%	
Profit before tax	2,164	1,899	14%	
Tax expense	(314)	(312)	0%	
Profit after tax	1,850	1,587	17%	
Non-controlling interests	0	15	-99%	
<b>Net profit</b>	<b>1,850</b>	<b>1,572</b>	<b>18%</b>	
<b>Adjusted net profit</b>	<b>1,745</b>	<b>1,460</b>	<b>20%</b>	
<b>Margin &amp; Ratio (%)</b>				
Gross margin	36.0	35.8	0.2	the impact of product mix improvement and reduced discount was more than offset raw milk price increase
Operating margin	9.4	8.7	0.8	
Selling expenses ratio	21.9	24.3	(2.4)	dropped due to revenue growth and better economies of scale
Administrative expenses ratio	4.5	3.5	1.0	
R&D expenses ratio	0.6	0.3	0.3	
Net margin	7.9	7.4	0.5	
Adjusted net margin	7.4	6.9	0.5	
Effective tax rate	14.5	16.5	(1.9)	

Source: Company data, CMBIS

## Restricted share award scheme to maintain stable management team for next five years

On 6 Aug 2019, Yili proposed a restricted share award scheme involving the grant of 182.92mn shares, 3% of issued shares, to employees. The share award price is RMB15.46, at 50% discount to closing price of RMB30.81 on 5 Aug 2019. The share award scheme was approved by the board on 30 Sep 2019. The finalized scheme would grant 152.4mn shares (2.5% of issued shares) to 478 senior management on 30 Sep 2019. These shares will be restricted for sale in five lots within 12/24/36/48/60 months since the date of grant, with each lot representing 20% of granted shares.

**Figure 96: Requirements for the release of restricted shares**

Restriction of sale period	Net profit requirement for financial year	Net profit growth (vs 2018 base)	ROE requirement (%)	Payout ratio (%)
1st	FY19	>=8%	>=20	>=70
2nd	FY20	>=18%	>=20	>=70
3rd	FY21	>=28%	>=20	>=70
4th	FY22	>=38%	>=20	>=70
5th	FY23	>=48%	>=20	>=70

Source: Company data

Note: net profit means adjusted net profit. Adjusted net profit is used for calculation of ROE. The calculation of adjusted net profit excludes share award scheme expenses.

**Figure 97: Adjusted net profit growth, adjusted ROE and payout ratio over past five financial years**

Financial year	Adjusted net profit growth	adjusted net profit growth (vs 2013 base)	Adjusted ROE (%)	Payout ratio (%)
FY14	71%	71%	21.7	61
FY15	7%	83%	20.8	59
FY16	13%	106%	21.0	64
FY17	18%	142%	22.1	71
FY18	10%	167%	22.2	66

Source: Company data, CMBIS

## Better align the interests of management and shareholders

Currently, the Chairman and three Vice Presidents totally hold 7.96% of issued shares. If all the shares under the restricted award scheme were granted, the top four senior management would own a combined 9.1% share holdings, greater than the 8.9% shareholding of Yili's largest shareholder, Hohhot Investment. The share award scheme would provide greater incentives to senior management and align the interests of senior management and shareholders, in our view.

**Figure 98: Total share holdings of top four senior management could exceed the largest shareholder**

Name of senior management	Current share holdings (mn)	Shares to be granted under the restricted share award scheme (mn)	Total shares holdings (mn)	% of issued shares
潘剛	236.09	50.66	286.75	4.7%
趙成霞	84.09	8.33	92.42	1.5%
劉春海	83.31	8.33	91.64	1.5%
胡利平	79.34	unknown	79.34	1.3%
Total			550.15	9.1%
Hohhot Investment			538.54	8.9%

Source: Company data

## Maintain a stable management team to develop new products and expand globally

Compared to the previous restricted share award scheme in Oct 2016, the number of employees covered by the current scheme was greater at 478 (vs 277). In addition, the term of current scheme is longer than the previous one (two years). Yili will expand its new businesses such as healthy drinks (energy drink launched in 2018, mineral water scheduled to launch in 2021) and cheese (healthy drinks and cheese business units were established in 2018), and continue its globalization strategy in coming few years. The share award scheme would provide greater incentives to senior management and keep a stable management team for development of new businesses and new markets, in our view.

## Share price fell after the scheme unveiled

Yili's share price fell 9% on 6 Aug 2019 after the restricted share award scheme was unveiled. We think there were two major reasons for the decline:

### ■ Discount of share award price to market price was deep

The discount of share award price of RMB15.46 to market price was deep at 50% and the amortization cost for the scheme was large at RMB1.4bn.

The discount was greater than the previous restricted share award scheme in Oct 2016. On 22 Oct 2016, Yili unveiled a share option scheme (45mn) and restricted share award scheme (15mn). Total number of shares involved was 60mn, represents 1% of issued shares. The share award price of RMB15.33 was only 5% discount to market price. The total amortization cost for the scheme was RMB175mn. Share price jumped 7% next trading day, showing the scheme was well received by investors.

**Figure 99: Share award scheme expenses amortization schedule**

Total expenses (RMBmn)	FY19E	FY20E	FY21E	FY22E	FY23E	FY24E
1,393	159	566	323	195	108	42

Source: Company data

**Figure 100: Requirements for the release of restricted shares for the schemes in Oct 2016**

Restriction of sale period	Net profit requirement for financial year	Net profit growth (vs 2015 base)	ROE requirement (%)
1st	FY17	>=30%	>=12
2nd	FY18	>=45%	>=12

Source: Company data

Note: net profit means adjusted net profit. Adjusted net profit is used for calculation of ROE. The calculation of adjusted net profit excludes share award scheme expenses.

**Figure 101: Total share amortization expense for the schemes in Oct 16**

Total expenses (RMBmn)	FY16E	FY17E	FY18E
175	1	93	81

Source: Company data, CMBIS

### ■ It seems that profit target of the scheme can be achieved without difficulty

The restricted share award scheme has specified profit, ROE and payout requirements for the release of restriction for sale. When the adjusted net profit requirement is compared to the financial results of past five years (FY14-18), it seems that it is easy to achieve (167% adjusted net profit growth in FY18 against FY13 base vs 48% adjusted net profit growth in FY23E against FY18 base). The 8.2% CAGR of adjusted net profit requirement is based on the consideration of rising raw milk price, investments in new businesses (healthy drinks and cheese BUs) and globalization strategies.



## Globalization strategies

Yili utilizes the integration of its global raw materials and intelligence resources to produce innovative and upgrade products for Chinese consumers based on big data analytics, and set high quality standards for domestic dairy industry. At the same time, through overseas production base and distribution network, Yili can accelerate its business development under the development of “Belt and Road” in Thailand, Indonesia, New Zealand and other markets.

### Globalized dairy resources

Yili has been working with hundreds of suppliers across various countries and regions, covering raw and auxiliary materials, product packaging, intelligent equipment and other industries to maintain cooperative relations, jointly build “Global Health Ecosystem”, through comprehensively deepening global health industry chain cooperation mechanism, gathering global quality resources, and consolidating dairy industry resource securing capability.

#### ■ Westland Co-operative Dairy Co Ltd

Yili completed the acquisition of the company on 2 Aug 2019 with consideration of NZD244mn. Located in the West Coast of New Zealand, Westland collects quality milk from 429 farms and then produces and distributes various dairy products such as milk powders, proteins, milk fats, cream, butter etc to 40 countries worldwide. For the financial year ended 31 July 2019, Westland recorded NZD693mn revenue, NZD0.6mn net profit and NZD230mn net asset value.

By acquiring Westland, Yili can secure quality raw milk source in New Zealand and overseas distribution network.

### Globalized network

Under the development of “Belt and Road”, Yili continues to promote the global network strategy and business layout across Indonesia, New Zealand, Thailand and other markets. Yili's Joy Day ice-cream entered Indonesia market, the largest ice-cream market in Southeast Asia, in 2018.

#### ■ Chomthana Company Ltd

On 25 Apr 2019, the acquisition of 96.46% equity interests of Chomthana was completed. Chomthana is Thailand's leading ice-cream and frozen food manufacturer. It also exports ice-cream to 13 nearby countries. It also owns cold-chain facilities covering the whole Thailand. Thailand is the second largest ice-cream market in Southeast Asia. The acquisition of Chomthana could help Yili expand its business and distribution network in Southeast Asia.

The acquisition consideration was around US\$80.6mn. For the six months ended 30 Jun 2019, Chomthana recorded US\$18.2mn revenue and net profit of US\$0.9mn. Its net asset value was US\$22.0mn.

#### ■ Indonesia

Indonesia is the largest ice-cream market in Southeast Asia. In Oct 2018, Yili began to sell its Joyday ice-cream to test the market in Indonesia. Meanwhile, it is constructing a chilled yogurt plant for further business expansion there.

## Globalized industry layout

Yili has established overseas R&D centers and production base as part of its globalization strategy.

### ■ R&D centers

Yili has established R&D centers in the Netherlands, New Zealand and the US to cooperate with overseas advanced research institutes to update latest production technologies and new products information to accelerate its own product innovation and globalization.

#### 3) Yili Innovation Center Europe

The center was established in 2014 and is located on the campus of Wageningen University in Food Valley in the Netherlands. It is one of the leading international universities in the field of healthy food and living environment. The center works with partners along the value chain in the fields of nutrition & health, product and process technology, food safety and farm management.

#### 4) Sino-US Food Wisdom Valley

The Valley was established in Seattle, the US. It will effectively promote a wide range of bilateral cooperation between agri-food enterprises, universities and research institutes, focusing nutrition and health, product development, food safety, agricultural technology, animal husbandry, veterinary medicine, ecological environmental protection, enterprise management, and personnel training. The partners in the US includes University of Pennsylvania, Yale University, Cornell University, University of Toronto, UC Davis, Wharton School and University of Minnesota.

#### 5) R&D Center in New Zealand

Yili has placed a R&D center at Lincoln University near Christchurch in New Zealand. Yili and the university collaborates on research activities across all areas of the dairy process, from development to final products.

### ■ Oceania production base

The Oceania production base, located in South Island of New Zealand, commenced operation in Nov 2014. It is an integrated production base covering R&D, in-depth processing, manufacturing and packaging. The production base currently produces Satine New Zealand imported milk, Perfectlands milk and Pro-Kido IMF.

## Earnings forecast

### 12% adjusted net profit CAGR from FY19E to FY21E

On adjusted basis (excluding expenses from restricted share award scheme and government grants), we estimate adjusted net profit to grow at 12% CAGR from FY19E to FY21E, led by 11% revenue CAGR with a stable OPM at 9.1-9.2% from FY19E to FY21E. We think the positive impact from continuing product mix enhancement, less discounted promotion activities and slight decrease of A&P expenses ratio could be large offset by rising raw milk cost and investments in new businesses and overseas market.

We expect its SG&A expenses ratio (excluding expenses from restricted share award scheme) would remain stable at 28.5%-28.7% in FY19E-21E (vs 28.8% in FY18) given such expenditures are necessary because (1) there is still room of growth and consolidation in dairy industry and (2) investments in new businesses and new markets are required. Amid rising raw milk cost, we think Yili could be more disciplined in discount promotion activities to achieve the required 8.2% CAGR of adjusted net profit specified by the restricted share award scheme.

**Figure 102: CMBI estimates vs consensus**

US\$ mn	CMBI			Consensus			Diff (%)		
	FY19E	FY20E	FY21E	FY19E	FY20E	FY21E	FY19E	FY20E	FY21E
Revenue	89,588	100,972	110,638	90,187	100,930	111,831	-1%	0%	-1%
Gross Profit	33,972	38,443	42,307	34,271	38,555	42,943	-1%	0%	-1%
Operating Profit	8,017	8,632	9,884	8,210	9,102	10,580	-2%	-5%	-7%
Adjusted net profit	6,535	7,375	8,196	7,071	7,735	8,971	-8%	-5%	-9%
Gross Margin	37.9%	38.1%	38.2%	38.0%	38.2%	38.4%	-0.1ppt	-0.1ppt	-0.2ppt
Operating Margin	8.9%	8.5%	8.9%	9.1%	9.0%	9.5%	-0.2ppt	-0.5ppt	-0.6ppt
Adjusted net margin	7.3%	7.3%	7.4%	7.8%	7.7%	8.0%	-0.5ppt	-0.4ppt	-0.6ppt

Source: CMBIS estimates

**Figure 103: P&L of Yili**

Year-end Dec 31 (RMB mn)	FY17	FY18	FY19E	FY20E	FY21E
<b>Revenue</b>	<b>67,547</b>	<b>78,976</b>	<b>89,588</b>	<b>100,972</b>	<b>110,638</b>
Liquid milk	55,766	65,679	73,889	82,105	90,540
Milk powder	6,428	8,045	10,043	12,773	13,592
Ice-cream	4,606	4,997	5,401	5,838	6,251
Others	1,258	833	456	456	456
Cost of sales	(42,362)	(49,106)	(55,616)	(62,529)	(68,331)
Gross profit	25,185	29,870	33,972	38,443	42,307
Other income and gains	1,359	1,402	1,098	1,107	1,148
Selling expenses	(15,522)	(19,773)	(21,412)	(24,031)	(26,221)
Admin expenses	(3,108)	(2,980)	(4,414)	(5,413)	(5,633)
Other operating expenses	(771)	(1,033)	(1,228)	(1,473)	(1,716)
Operating profit	7,143	7,486	8,017	8,632	9,884
Net finance cost	(113)	60	134	31	30
Other gains	(42)	(113)	(110)	(110)	(110)
Share of profit/(loss) of associates	87	144	223	255	291
Profit before tax	7,074	7,578	8,264	8,808	10,096
Income tax expense	(1,071)	(1,126)	(1,214)	(1,291)	(1,480)
Non-controlling interests	(2)	(12)	(9)	(9)	(9)
<b>Net profit</b>	<b>6,001</b>	<b>6,440</b>	<b>7,041</b>	<b>7,508</b>	<b>8,607</b>
<b>Adj net profit</b>	<b>5,328</b>	<b>5,878</b>	<b>6,535</b>	<b>7,375</b>	<b>8,195</b>

Source: Company data, CMBIS estimates

## Valuation

### Our 28x target P/E represents mid end of trading range

We set our TP of HK\$34.04 based on 28.0x FY20E P/E, representing the mid end of its 1-yr forward P/E range of 21x-36x since A-share was announced to be included in MSCI Emerging Markets Index. On 21 Jun 2017, MSCI announced that it will include China A shares in the MSCI Emerging Markets Index. We think this news triggered A shares re-rating in 2H17. The trough valuation of Yili moved up from 16x before the announcement on 21 Jun 2017 to 21x post the announcement. Our 12% adjusted EPS CAGR from FY19E to FY21E is within 10-17% adjusted EPS growth in FY17-18. Therefore, we think our target P/E of 28.0x is fair.

We think Yili's valuation is undemanding compared to A shares peers. The stock trades at 24.0x FY20E P/E, at 21% discount to peers' average. Its 5.8x P/B in FY20E is 12% lower than peers but its ROE of 25.1% is greater than peers' average of 21.8%.

Figure 104: P/E band chart



Source: CMBIS estimates, Bloomberg, Company data

Figure 105: Peers valuation

Staples	Stock code	Price	Mkt cap (RMBmn)	Y/E	P/E (x)			EPS growth (%)			P/B (x)		ROAE (%)		FY1-3 EPS CAGR	FY1 PEG
Yili	600887 CH	29.00	176,817	Dec-18	FY1	FY2	FY3	FY1	FY2	FY3	FY1	FY2	FY1	FY2	12.0	2.1
Bright Dairy	600597 CH	11.91	14,584	Dec-18	30.9	27.6	25.2	38	12	10	2.6	2.5	8.6	9.1	10.6	2.9
Haitian Flavouring	603288 CH	112.62	304,116	Dec-18	58.0	48.4	40.8	20	20	19	18.1	15.0	32.9	32.8	19.2	3.0
Teway Food	603317 CH	46.77	19,323	Dec-18	58.2	45.9	37.7	12	27	22	10.6	8.9	19.2	19.7	24.2	2.4
Hengshun Vinegar	600305 CH	14.94	11,706	Dec-18	33.8	30.0	26.2	14	13	15	5.0	4.4	14.5	14.6	13.7	2.5
Jonjee Hi-Tech	600872 CH	46.85	37,322	Dec-18	52.4	41.3	33.8	17	27	22	8.9	7.7	17.5	19.0	24.5	2.1
Qianhe Condiment	603027 CH	23.42	10,906	Dec-18	49.2	38.8	30.1	(9)	27	29	6.4	5.6	14.3	15.9	27.8	1.8
Tsingtao Brewery	600600 CH	54.50	67,564	Dec-18	41.8	35.2	30.0	24	19	17	3.9	3.6	9.6	10.6	18.1	2.3
Chongqing Brewery	600132 CH	51.35	24,852	Dec-18	45.7	43.8	37.9	35	4	15	19.1	17.7	43.9	42.7	9.8	4.7
C&S Paper	002511 CH	13.75	17,997	Dec-18	29.6	23.9	19.7	43	24	21	4.6	4.0	15.8	16.8	22.6	1.3
Moutai	600519 CH	1227.28	1,541,706	Dec-18	35.8	29.9	25.5	22	20	17	11.0	9.0	32.4	31.7	18.5	1.9
Wuliangye	000858 CH	133.00	516,254	Dec-18	29.7	24.0	20.1	29	24	19	6.9	5.8	24.7	25.7	21.4	1.4
Jiangsu Yanghe	002304 CH	97.38	146,750	Dec-18	17.3	15.6	13.7	4	11	14	3.8	3.4	22.7	22.5	12.5	1.4
Luzhou Laojiao	000568 CH	85.06	124,592	Dec-18	26.5	21.3	17.6	35	24	21	6.4	5.5	24.6	27.2	22.8	1.2
Anhui Gujing	000596 CH	111.39	49,438	Dec-18	25.3	20.3	16.6	31	25	22	5.6	4.6	23.4	23.9	23.2	1.1
Yonghui	601933 CH	7.69	73,597	Dec-18	32.6	25.5	20.1	51	28	26	3.5	3.3	10.8	12.9	27.2	1.2
Average					37.0	30.9	25.9	24	20	19	7.7	6.7	21.1	21.9	19.3	2.1
Average - excl Yili					37.8	31.4	26.3	24	20	19	7.8	6.7	21.0	21.7	19.7	2.1

Source: CMBIS estimates, Bloomberg

## Company Overview

### Company's vision

Yili's vision is to be recognized as the most trustworthy healthy food provider around the world. It targets to reach revenue of RMB100bn and become one of the world's top five dairy companies in 2020E.

The Company will expand to non-dairy product portfolio. Apart from the established energy drink ("唤醒源"). It has established a mineral water production base in Changbaishan, Jilin province. Yili's mid to high-end mineral water product is expected to launch in 2021.

### Diversified product portfolio

Yili manufactures and distributes diversified dairy products, including UHT milk, chilled fresh milk, milk beverage, yogurt, IMF, milk powder, ice-cream, cheese, soy milk and cereal drinks etc, in China. It has established six business units, namely liquid milk, milk powder, ice-cream, yogurt, healthy drinks and cheese. Each business unit is responsible for the production, distribution and sales of its product portfolio. It is the largest dairy product manufacturer in China with Yili as its core brand. As at 30 Jun 2019, Yili has a total annual production capacity of 11.3mn tons in China and overseas.

**Figure 106: Yili's diversified product portfolio**



Source: Tmall, Company

## Financial Summary

### Income statement

YE 31 Dec (RMB mn)	FY17A	FY18A	FY19E	FY20E	FY21E
<b>Revenue</b>	<b>67,547</b>	<b>78,976</b>	<b>89,588</b>	<b>100,972</b>	<b>110,638</b>
Liquid milk	55,766	65,679	73,889	82,105	90,540
Milk powder	6,428	8,045	10,043	12,773	13,592
Ice-cream	4,606	4,997	5,401	5,838	6,251
Others	1,258	833	456	456	456
Cost of sales	(42,362)	(49,106)	(55,616)	(62,529)	(68,331)
Gross profit	25,185	29,870	33,972	38,443	42,307
Other income	1,359	1,402	1,098	1,107	1,148
Selling expenses	(15,522)	(19,773)	(21,412)	(24,031)	(26,221)
Admin expenses	(3,108)	(2,980)	(4,414)	(5,413)	(5,633)
Other op expenses	(771)	(1,033)	(1,228)	(1,473)	(1,716)
EBIT	7,143	7,486	8,017	8,632	9,884
Finance income, net	(113)	60	134	31	31
Other gains/(losses)	(42)	(113)	(110)	(110)	(110)
JV & associates	87	144	223	255	291
Pre-tax profit	7,074	7,578	8,264	8,808	10,096
Income tax	(1,071)	(1,126)	(1,214)	(1,291)	(1,480)
Less: Minority interests	(2)	(12)	(9)	(9)	(9)
<b>Net profit</b>	<b>6,001</b>	<b>6,440</b>	<b>7,041</b>	<b>7,508</b>	<b>8,607</b>
<b>Adj net profit</b>	<b>5,328</b>	<b>5,878</b>	<b>6,535</b>	<b>7,375</b>	<b>8,196</b>

### Cash flow summary

YE 31 Dec (RMB mn)	FY17A	FY18A	FY19E	FY20E	FY21E
<b>Profit before tax</b>	<b>7,074</b>	<b>7,578</b>	<b>8,264</b>	<b>8,808</b>	<b>10,096</b>
JV & associates	(87)	(144)	(223)	(255)	(291)
D&A	1,426	1,598	2,021	2,420	3,430
Net finance income	113	(60)	(134)	(31)	(31)
Change in working capital	(23)	313	953	1,024	934
Others	(1,497)	(660)	(1,877)	(1,289)	(1,463)
<b>Operating cash flow</b>	<b>7,006</b>	<b>8,625</b>	<b>9,004</b>	<b>10,676</b>	<b>12,674</b>
Capex	(3,351)	(5,091)	(10,000)	(9,500)	(2,800)
Acquisitions	0	0	(1,640)	0	0
Others	235	(284)	1,165	84	84
<b>Investing cash flow</b>	<b>(3,117)</b>	<b>(5,375)</b>	<b>(10,474)</b>	<b>(9,416)</b>	<b>(2,716)</b>
Change of debt	7,710	(6,337)	1,151	1,500	0
Dividend and interest paid	(3,845)	(4,393)	(4,431)	(5,011)	(5,353)
Others	188	(19)	(2,572)	0	0
<b>Financing cash flow</b>	<b>4,053</b>	<b>(10,749)</b>	<b>(5,852)</b>	<b>(3,511)</b>	<b>(5,353)</b>
<b>Net change in cash</b>	<b>7,942</b>	<b>(7,499)</b>	<b>(7,322)</b>	<b>(2,252)</b>	<b>4,605</b>
<b>Cash at the beginning</b>	<b>13,211</b>	<b>20,756</b>	<b>13,564</b>	<b>6,242</b>	<b>3,990</b>
<b>Exchange difference</b>	<b>(398)</b>	<b>307</b>	<b>0</b>	<b>0</b>	<b>0</b>
<b>Cash at the end</b>	<b>20,756</b>	<b>13,564</b>	<b>6,242</b>	<b>3,990</b>	<b>8,595</b>

### Balance sheet

YE 31 Dec (RMB mn)	FY17A	FY18A	FY19E	FY20E	FY21E
<b>Non-current assets</b>	<b>19,455</b>	<b>23,151</b>	<b>31,902</b>	<b>39,265</b>	<b>38,953</b>
Fixed asset	15,158	17,374	25,192	32,310	31,718
Prepaid lease payments	525	650	1,009	1,009	1,009
Interest in JV	1,765	1,909	2,133	2,388	2,679
Other non-current assets	2,006	3,217	3,569	3,558	3,547
<b>Current assets</b>	<b>29,846</b>	<b>24,455</b>	<b>19,318</b>	<b>18,237</b>	<b>23,827</b>
Inventories	4,640	5,507	6,237	7,012	7,663
Account receivables	950	1,282	1,454	1,639	1,796
Prepayments	1,426	1,614	1,810	2,021	2,199
Others	1,007	5,001	3,574	3,574	3,574
Cash	21,823	11,051	6,242	3,990	8,595
<b>Current liabilities</b>	<b>23,850</b>	<b>19,171</b>	<b>21,866</b>	<b>25,560</b>	<b>27,980</b>
Account payables	7,469	9,116	10,324	11,607	12,685
Other payables	8,081	8,135	8,978	9,889	10,731
Borrowings	7,884	1,556	1,200	3,700	4,200
Tax payables	404	353	353	353	353
Others	12	10	1,010	10	10
<b>Non-current liabilities</b>	<b>211</b>	<b>398</b>	<b>1,105</b>	<b>1,105</b>	<b>605</b>
Borrowings	0	0	508	508	8
Others	210	398	597	597	597
<b>Total net assets</b>	<b>25,240</b>	<b>28,037</b>	<b>28,249</b>	<b>30,837</b>	<b>34,196</b>
<b>Shareholders' equity</b>	<b>25,103</b>	<b>27,916</b>	<b>28,119</b>	<b>30,698</b>	<b>34,049</b>
<b>Non-controlling interests</b>	<b>136</b>	<b>122</b>	<b>130</b>	<b>139</b>	<b>147</b>

### Key ratios

YE 31 Dec	FY17A	FY18A	FY19E	FY20E	FY21E
<b>Sales mix (%)</b>					
Liquid milk	82.6	83.2	82.5	81.3	81.8
Milk powder	9.5	10.2	11.2	12.6	12.3
Ice-cream	6.8	6.3	6.0	5.8	5.6
Others	1.9	1.1	0.5	0.5	0.4
<b>P&amp;L ratios (%)</b>					
Gross margin	37.3	37.8	37.9	38.1	38.2
EBIT margin	10.6	9.5	8.9	8.5	8.9
Net margin	8.9	8.2	7.9	7.4	7.8
Adj. net margin	7.9	7.4	7.3	7.3	7.4
Payout ratio	70.9	66.1	70.0	70.0	70.0
<b>Balance sheet ratios</b>					
Current ratio (x)	1.3	1.3	0.9	0.7	0.9
Quick ratio (x)	1.1	1.0	0.6	0.4	0.6
A/C receivables days	4	5	6	6	6
A/C payables days	63	62	64	64	65
Inventory days	39	38	39	39	39
Net cash (RMB mn)	13,939	9,495	4,534	(217)	4,387
<b>Returns (%)</b>					
Adj. ROE	22.1	22.2	25.1	25.5	26.6
Adj. ROA	12.0	12.1	14.3	13.8	14.3
<b>Per share</b>					
EPS (RMB)	0.99	1.06	1.16	1.24	1.42
DPS (RMB)	0.70	0.70	0.81	0.87	0.99
BVPS (RMB)	4.13	4.59	4.64	5.06	5.61

Source: Company data, CMBIS estimates



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