

Mengniu (2319 HK)

Acquisition to access raw milk supply and become regional player

Mengniu announced to purchase 100% equity interest of Lion-Dairy & Drinks Pty Ltd, an Australian-based branded dairy and beverage company, from Kirin Foods at an initial consideration of AUD600mn (RMB2.9bn). Overall, we think the acquisition can meet Mengniu's pursuits in overseas raw milk source and distribution network in Southeast Asian market. The acquisition consideration is undemanding and there are synergies to be explored.

- Low-cost milk supply for Milk Deluxe.** Australia farmgate milk price is estimated at RMB2.44/litre (RMB2.37/kg) in FY19/20E, cheaper than China's current RMB3.83/kg. After investing some modification capex, Mengniu can transfer the production of Milk Deluxe from an OEM in New Zealand (around 800,000 litres) to Lion-Dairy and can gain the OEM margin. Furthermore, Mengniu plans to raise the production volume of Milk Deluxe in Lion-Dairy to more than 200mn litres in future. These are the major synergies of the acquisition.
- Other synergies.** We think there are further synergies from (1) sharing of distribution network, infrastructure and back office systems in Australia across Lion Dairy, Bellamy's and Burra Foods; (2) sharing of R&D, collaboration of sales and marketing and cross-selling across brands and products among the group. Lion-Dairy's top milk beverage brand "dare" and yogurt brand "Farmers Union" could be introduced into China and Southeast Asian markets. Mengniu can become a regional player with multi-brand portfolio in Asia Pacific.
- Room to improve margins.** In FY18, Lion Dairy achieved 6.6% EBITDA margin, less than Mengniu's 7.8%. However, management targets to lift the EBITDA margin of Lion Dairy to above 10% through synergies and turnaround of white milk business (contributed around 30% of revenue but negative net profit margin).
- Undemanding valuation** According to management, Lion Dairy's revenue was flat over the past 3 to 4 years given that Kirin cannot provide synergies for Lion-Dairy and Australia is a stable market. The consideration represents 13.1x historical P/E and 1x P/B. Management added that the capex required to build a new UHT plant in Australia is at least AUD300mn. Therefore, we think the consideration is undemanding. Based on FY18 results, we estimate the acquisition could enhance Mengniu's adjusted NP by 5%. The deal, subject to FIRB's approval, is expected to be completed in 1H of 2020.
- Maintain Buy.** 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	79,603	78,057	87,348
YoY growth (%)	12	15	15	(2)	12
Net profit (RMB mn)	2,048	3,043	6,801	4,641	5,637
Adj. net profit (RMB mn)	2,048	3,043	3,886	4,641	5,637
Adjusted EPS (RMB)	0.526	0.779	0.993	1.179	1.433
YoY growth (%)	0	48	32	19	21
Adjusted P/E (x)	48.9	33.2	26.7	22.5	18.5
P/B (x)	4.5	3.9	3.5	3.1	2.7
Yield (%)	0.5	0.7	0.9	1.0	1.2
ROE (%)	9.4	12.7	14.1	14.5	15.6

Source: Company data, CMBIS estimates

BUY (Maintain)

Target Price **HK\$37.00**
 Up/Downside **+25%**
 Current Price **HK\$29.65**

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Stock Data

Mkt Cap (HK\$ mn) 116,661
 Avg 3 mths t/o (HK\$ mn) 332.03
 52w High/Low (HK\$) 34.60/ 22.45
 Total Issued Shares (mn) 3,927.7

Source: Bloomberg

Shareholding Structure

COFCO 16.3%
 Danone 9.9%
 Arla 5.3%

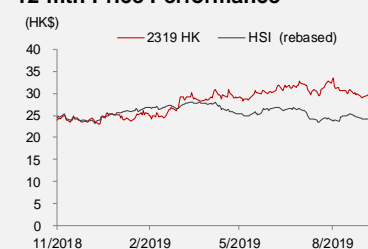
Source: HKEx

Share Performance

	Absolute	Relative
1-mth	-5.2%	-4.4%
3-mth	-10.2%	-11.6%
6-mth	1.2%	4.1%

Source: Bloomberg

12-mth Price Performance



Source: Bloomberg

Auditor: EY

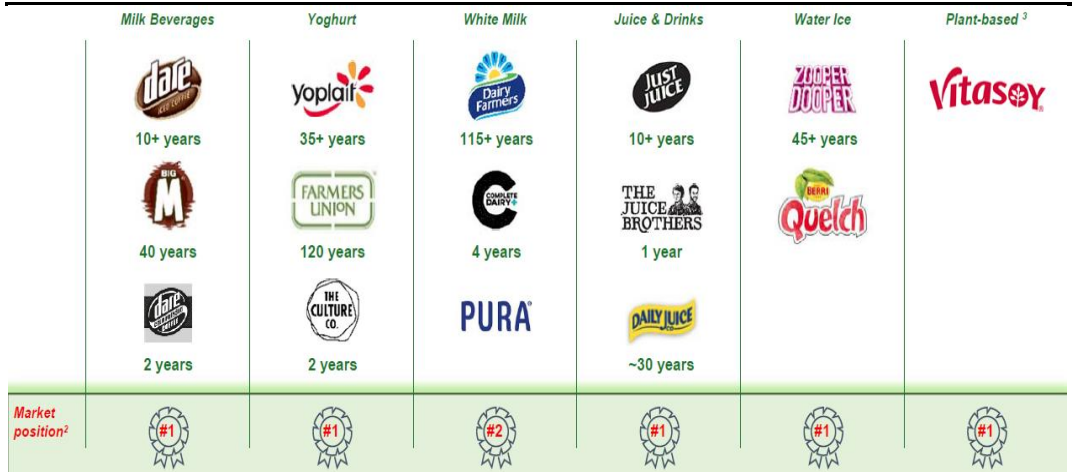
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A leading player in Australia

Lion-Dairy & Drinks is a leading Australia-based branded dairy and beverage company. Its market shares in milk beverages, yogurt, juice, water ice and plant-based categories are No. 1. It is also the No. 2 player in white milk category. Lion-Dairy procures around 825mn litres of milk equivalents and 50mn kg of fresh fruit from around 280 farmers and 85 fruit growers annually. Lion-Dairy had a total of 13 manufacturing facilities (inclusive of two facilities operating as JV) and a cold chain distribution network reaching 35,000 customers in Australia.

Figure 1: Brand portfolio of Lion-Dairy & Drinks



Source: Mengniu

Undemanding valuation

Kirin announced that they had commenced a sales process of Lion-Dairy in Oct 2018. According to management, Lion Dairy's revenue was flat over the past 3 to 4 years as Kirin cannot provide synergies for Lion-Dairy and Australia is a stable market. Lion Dairy recorded AUD45.8mn profit after tax (represents 7% of Mengniu's adj. net profit in FY18) in FY18 and its net assets value was AUD596mn as at 30 Aug 2019. The consideration represents 13.1x historical P/E and 1x P/B. Management added that the capex required to build a new UHT milk plant in Australia is at least AUD300mn. Therefore, we think the consideration is undemanding.

Mengniu plans to finance the acquisition 70% by internal resources and 30% by borrowing. Mengniu had RMB5.1bn cash balance as at 30 Jun 2019. After considering the RMB4.0bn cash proceeds from disposal and RMB4.2bn cash for acquisition of Bellamy, Mengniu still has RMB4.9bn internal cash to make the deal. We estimate the acquisition could enhance Mengniu's adjusted net profit by 5% based on FY18 results.

Figure 2: Historical financial results of Lion-Dairy & Drinks

YE 31 Dec (AUDmn)	FY17	FY18	Change YoY (%)
Revenue	1,779	1,756	(1)
Normalized OP	62	63	2
Profit before tax	69	66	(5)
Profit after tax	48	46	(5)
EBTIDA margin	na	6.6%	na

Source: Mengniu, Kirin

Regulatory approvals

The completion of the deal requires the approvals by Foreign Investment Review Board of Australia as well as Australian Competition and Consumer Commission (may be waived by written consent of the purchaser and seller). Management is confident to get approval because it is a normal commercial deal and the ownership is transferred from a foreign investor to another foreign investor. The deal is expected to be completed in 1H of 2020.

Become an integrated player in Asia Pacific

Lion Dairy has integrated capability from procurement, processing, sales and marketing to distribution. Lion-Dairy has yogurt export sales (around 2-3% of total revenue) to Asian markets with No. 1 market share in Singapore and top 5 market shares in Indonesia and Philippines (Figure 3). The combination of Lion-Dairy, Bellamy's and Burra Foods can better serve Southeast Asia and China markets. Regarding Southeast Asia market development, Mengniu will put Indonesia market as top priority and develop other countries step by step.

Figure 3: Market share of Lion-Dairy's yogurt in Southeast Asia and China



Source: Mengniu

Figure 4: CMBI estimates vs consensus

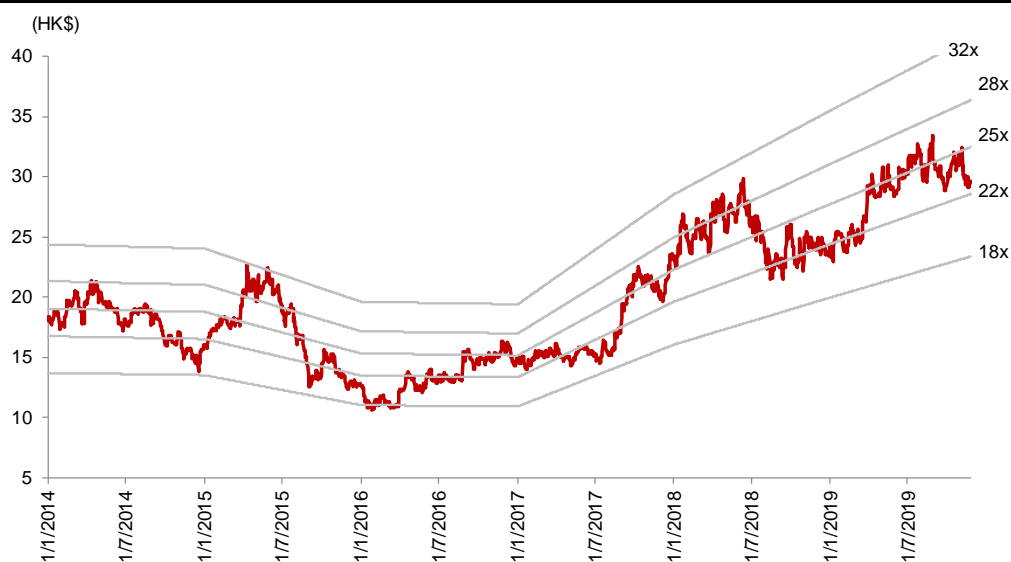
US\$ mn	CMBI			Consensus			Diff (%)		
	FY19E	FY20E	FY21E	FY19E	FY20E	FY21E	FY19E	FY20E	FY21E
Revenue	79,792	78,447	87,985	77,658	82,165	90,664	3%	-5%	-3%
Gross Profit	29,703	29,711	33,584	29,321	31,418	35,002	1%	-5%	-4%
Operating Profit	4,329	4,717	5,757	4,534	5,249	6,194	-5%	-10%	-7%
Adjusted Net Profit	3,894	4,661	5,674	3,952	4,635	5,461	-1%	1%	4%
Gross Margin	37.2%	37.9%	38.2%	37.8%	38.3%	38.7%	-0.6ppt	-0.4ppt	-0.5ppt
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%	6.5%	5.1%	5.6%	6.0%	-0.2ppt	+0.3ppt	+0.5ppt

Source: Company data, CMBIS

Figure 5: P&L

Year-end Dec 31 (RMB mn)	FY17	FY18	FY19E	FY20E	FY21E
Revenue	60,156	68,977	79,603	78,057	87,348
Liquid milk	53,015	59,389	67,910	70,058	78,701
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)	(49,969)	(48,492)	(54,006)
Gross profit	21,183	25,784	29,634	29,564	33,343
Other income and gains	338	635	470	374	419
Selling expenses	(14,869)	(18,833)	(21,334)	(20,841)	(23,147)
Administrative expenses	(2,497)	(2,915)	(3,423)	(3,513)	(3,931)
Other expenses	(1,182)	(936)	(1,028)	(890)	(967)
EBIT	2,972	3,734	4,320	4,694	5,717
Net finance cost	184	318	323	654	778
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	8,257	5,594	6,827
Income tax expense	(594)	(649)	(1,304)	(909)	(1,104)
Non-controlling interests	17	(161)	(152)	(44)	(85)
Net profit	2,048	3,043	6,801	4,641	5,637
Adjusted net profit	2,048	2,942	3,886	4,641	5,637
Adjusted EPS (Rmb)	0.53	0.75	0.99	1.18	1.43

Source: Company data, CMBIS estimates

Figure 6: P/E band chart

Source: CMBIS estimates, Bloomberg, Company data

Financial Summary

Income statement						Cash flow summary					
YE 31 Dec (RMB mn)	FY17A	FY18A	FY19E	FY20E	FY21E	YE 31 Dec (RMB mn)	FY17A	FY18A	FY19E	FY20E	FY21E
Revenue	60,156	68,977	79,603	78,057	87,348	Profit before tax	2,625	3,853	8,257	5,594	6,827
Liquid milk	53,015	59,389	67,910	70,058	78,701	Associates & JV	532	300	(185)	(246)	(332)
Ice-cream	2,513	2,723	2,696	2,912	3,087	D&A	1,704	1,838	2,161	1,768	1,961
Milk powder	4,042	6,017	8,111	3,975	4,173	Change in working capital	1,447	1,653	1,618	861	792
Others	585	848	886	1,112	1,388	Others	(802)	(1,280)	(6,160)	(1,987)	(2,306)
Cost of sales	(38,973)	(43,193)	(49,969)	(48,492)	(54,006)	Operating cash flow	5,505	6,363	5,692	5,990	6,941
Gross profit	21,183	25,784	29,634	29,564	33,343	Capex	(2,152)	(3,149)	(3,800)	(4,000)	(3,000)
Other income and gains	338	635	470	374	419	Acquisitions	(4,250)	(309)	0	0	0
Selling expenses	(14,869)	(18,833)	(21,334)	(20,841)	(23,147)	Others	(5,049)	(773)	4,271	1,078	1,202
Administration expenses	(2,497)	(2,915)	(3,423)	(3,513)	(3,931)	Investing cash flow	(11,450)	(4,232)	471	(2,922)	(1,798)
Other expenses	(1,182)	(936)	(1,028)	(890)	(967)	Change of borrowing	5,778	(383)	245	0	0
EBIT	2,972	3,734	4,320	4,694	5,717	Dividend paid	(399)	(526)	(711)	(899)	(1,067)
Finance income, net	184	318	323	654	778	Others	369	8	52	0	0
Others	0	101	3,429	0	0	Financing cash flow	5,748	(900)	(414)	(899)	(1,067)
JV & associates	(532)	(300)	185	246	332	Net change in cash	(196)	1,231	5,749	2,169	4,076
Pre-tax profit	2,625	3,853	8,257	5,594	6,827	Cash at the beginning	3,356	3,129	4,370	10,119	12,288
Income tax	(594)	(649)	(1,304)	(909)	(1,104)	Forex effect	(31)	10	0	0	0
Less: Minority interests	17	(161)	(152)	(44)	(85)	Cash at disposal groups	1	0	0	0	0
Net profit	2,048	3,043	6,801	4,641	5,637	Cash at the end	3,129	4,370	10,119	12,288	16,364
Adjusted net profit	2,048	3,043	3,886	4,641	5,637	Time deposit	2,829	2,927	2,927	2,927	2,927
						Cash and cash equivalent	5,959	7,298	13,047	15,216	19,292

Balance sheet						Key ratios					
YE 31 Dec (RMB mn)	FY17A	FY18A	FY19E	FY20E	FY21E	YE 31 Dec	FY17A	FY18A	FY19E	FY20E	FY21E
Non-current assets	32,121	36,716	29,954	32,431	33,802	Sales mix (%)					
PPE	12,715	14,734	11,098	13,023	14,127	Liquid milk	88.1	86.1	85.3	89.8	90.1
Goodwill and intangible assets	6,727	6,980	6,108	6,041	5,974	Ice-cream	4.2	3.9	3.4	3.7	3.5
JV & associates	7,194	7,202	7,345	7,591	7,922	Milk powder	6.7	8.7	10.2	5.1	4.8
Others	5,485	7,800	5,403	5,776	5,779	Others	1.0	1.2	1.1	1.4	1.6
Current assets	26,018	29,741	35,257	38,738	44,106	P&L ratios (%)					
Cash	5,959	7,298	13,047	15,216	19,292	Gross margin	35.2	37.4	37.2	37.9	38.2
Pledged deposit	466	623	384	384	384	EBIT margin	4.9	5.4	5.4	6.0	6.5
Inventory	3,510	4,282	4,167	4,727	5,265	Net margin	3.4	4.4	8.5	5.9	6.5
Trade receivables	2,647	2,892	3,092	3,507	3,925	Adjusted net margin	3.4	4.4	4.9	5.9	6.5
Others	13,435	14,646	14,567	14,902	15,240	Payout ratio	22.8	23.2	23.0	23.0	23.0
Current liabilities	22,566	25,109	18,776	20,948	23,033	Balance sheet ratios					
Borrowings	7,935	6,523	1,964	1,964	1,964	Current ratio (x)	1.2	1.2	1.9	1.8	1.9
Trade payables	6,342	7,022	6,636	7,528	8,384	A/C receivables days	15	15	14	15	16
Other payables	7,324	10,889	9,524	10,804	12,033	A/C payables days	55	56	50	53	54
Others	965	675	652	652	652	Inventory days	32	33	31	33	34
Non-current liabilities	8,465	10,884	11,119	11,119	11,119	Asset turnover (x)	1.0	1.0	1.2	1.1	1.1
Borrowings	6,015	8,192	8,493	8,493	8,493	Net gearing ratio (%)	30	22	(8)	(13)	(21)
Deferred revenue	739	856	856	856	856	Returns (%)					
Others	1,711	1,835	1,770	1,770	1,770	Adjusted ROE	9.4	12.7	14.1	14.5	15.6
Total net assets	27,107	30,464	35,316	39,102	43,757	Adjusted ROA	3.8	4.9	5.9	6.8	7.6
Shareholders' equity	22,604	25,212	30,073	33,815	38,385	Per share					
Non-controlling interests	4,503	5,252	5,243	5,287	5,372	EPS (RMB)	0.53	0.78	0.99	1.18	1.43
						DPS (RMB)	0.12	0.18	0.23	0.27	0.33
						BVPS (RMB)	5.76	6.42	7.64	8.59	9.76

Source: Company data, CMBIS estimates

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