Daiwa Capital Markets

Sector

Consumer Staples / China
2 May 2014

The 10-second briefing

Initiation: the cream is upstream

- Upstream: should benefit from China's structural quality raw milk shortage, high sales volume growth and price visibility
- Downstream: likely to see competition intensify, cannibalisation by new products and raw-material cost pressures
- Top pick Modern Dairy (Buy); Buy on Huishan, Hold on Mengniu

China Dairy Sector

- **Positive** (initiation)
- Neutral
- Negative

How do we justify our view?

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■ Investment case

We initiate coverage of the China Dairy Sector with a Positive rating.

Upstream players should benefit from structural shortage of raw milk. We expect the scarcity of quality raw milk in China to persist over 2014-16, supporting milk prices and robust sales-volume growth for the upstream players (ie, the dairy-farm operators), and drive a 22-38% revenue CAGR for 2013-16. Also, we look for operating margins for the dairy farms to trend up over the next 3 years, on improvements in economies of scale and milk yields.

Downstream players are price-takers. The dairy brands (downstream players) are competing heavily for market share by launching new products and enhancing their product mixes. We believe they are still price-takers in the face of upward raw-milk cost pressure, and that they are facing fierce competition from international and domestic peers.

Policy support. We believe the government's policies to upgrade food safety and the quality of dairy products are driving demand growth for quality raw milk from large-scale farms and spurring consolidation among dairy farms.

How we differ. Our 2015 EPS forecasts for the dairy farms are on average 8% above those of the Bloomberg consensus, reflecting our belief that the structural milk shortage will last longer than the market expects. We believe the YTD share-price pullback of upstream dairy-farm stocks, due to the recent decline in raw-milk prices, is unwarranted. 1) The decline represents only a slight drop from the peak level in 2013, and applies only to mid- and low-grade raw milk. In 1Q14, raw-milk prices were 24% above their average level of 1Q13. 2) Our discussions with dairy-farm operators suggest ex-factory prices of quality raw milk should be stable for the rest of the year due to the shortage.

■ Catalysts

We see government policy changes to support upstream consolidation, further improvements in milk yields, new expansion plans for dairy farms as the key catalysts for the upstream companies. For downstream players, product mix upgrades are the key earnings catalyst, in our view.

■ Valuation

Our top pick is **China Modern Dairy Holdings (CMD)** (1117 HK, HKD3.32, Buy [1]), for its favourable upstream positioning, with a DCF-based target price of HKD4.60 (WACC: 9.6%, terminal growth rate: 1%). We also like China **Huishan Dairy Holdings (Huishan)** (6863 HK, HKD1.83, Buy [1]), a vertically integrated player, and have a target price of HKD2.48 (DCF value of HKD2.32 for its upstream operation and 12x FY15E [year-end March 2015] PER value of HKD0.16 for its downstream business). **China Mengniu Dairy Holdings (Mengniu)** (2319 HK, HKD39.85, Hold [3]) is our least-preferred stock given its pure downstream exposure and stretched valuation. Our target price is HKD40.7, based on a 30x 2014E PER.

■ Risks

The main sector risks include food safety scandals and competition from imports. We view the upstream-specific risks as rising feed costs, changes to their favourable tax status and other policies, and bovine diseases. Downstream-specific risks would be competition, and a lack of control over raw-material costs and quality.

Key stock calls

	New	Prev.
China Modern Dairy Holdings (1117 HK)		
Rating	Buy	
Target	4.60	
Upside	▲ 38.6%	
China Mengniu Dairy (2319 HK)		
Rating	Hold	
Target	40.70	
Upside	▲ 2.1%	

Source: Daiwa forecasts.

■ Positive (initiation)
■ Neutral
■ Negative

How do we justify our view?

- Growth outlook ✓ ✓ ✓ ✓ ✓
- Valuation ✓ ✓ ✓ ✓ ✓
- Earnings revisions ✓ ✓ ✓ ✓ ✓

■ Growth outlook ✓ ✓ ✓ ✓ ✓

We expect the upstream companies see rapid earnings growth over 2014-16, thanks to visible demand growth for quality raw milk and a likely persistent supply shortage of this product. Thus, for CMD and Huishan, we forecast respective CAGRs of 22% and 38% for revenue, and 47% and 42% for reported net profit over the next 3 fiscal years. For downstream company Mengniu, we forecast a 24% reported net-profit CAGR for 2013-16, due mainly to its acquisition in August 2013 of Yashili (Not rated), and its purchase of a 28% stake in CMD in May 2013.

■ China Dairy universe: revenue and reported net profit growth

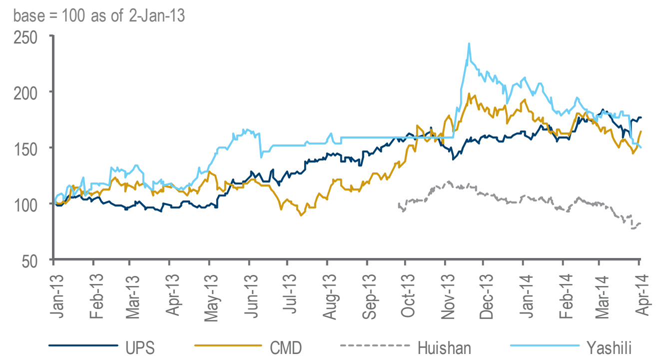
	Reported net profit growth					Revenue growth				
(YoY%)	2012	2013	2014E	2015E	2016E	2012	2013	2014E	2015E	2016E
CMD	32	24	97	30	25	46	62	34	20	14
Huishan*	37	106	36	53	37	256	92	40	33	41
Mengniu	-13	16	28	23	23	-4	20	19	11	11

Source: Company, Daiwa forecasts
**Data for Huisan is for FY12-16E, ie, fiscal year ends 31 March*

■ Valuation ✓ ✓ ✓ ✓ ✓

The share prices of CMD, Huishan and Mengniu are down 17%, 31% and 3%, respectively, from their 2013 peaks on: 1) profit-taking post their 64-89% share-price rises last year, and 2) concerns about the sustainability of raw-milk prices. CMD and Huishan are trading at 2014E PERs of 13.1x and 10.6x, at a discount to Mengniu and other major F&B players (trading at 22-29x 2014E PERs, based on Bloomberg forecasts). We see a limited rerating opportunity for pure downstream player Mengniu due to the risk to its profit margins from rising raw-milk costs and the stock's high valuation. On the other hand, we see good rerating scope for CMD and Huishan, for which we project strong earnings growth and market-share gains.

■ Relative share-price performance of HK-listed dairy companies since 2013

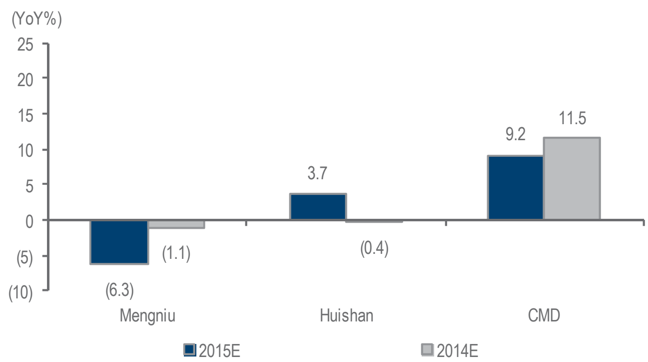


Source: Bloomberg

■ Earnings revisions ✓ ✓ ✓ ✓ ✓

For CMD and Huishan, our EPS forecasts for the next fiscal year are above the Bloomberg consensus, reflecting our higher raw-milk price and profit-margin assumptions. Our sensitivity analysis shows that for CMD a 1% rise in raw-milk prices would lift our 2014E EPS by 5%. For Huishan, a 1% rise in upstream milk prices would raise our FY15E EPS by 0.6%. Our 2014-15E EPS for Mengniu are 1-6% below the consensus. Ex-Yashili, we forecast revenue growth for Mengniu of 13% YoY for 2014 and 9% YoY for 2015, as we believe our assumptions for UHT milk sales (about half of Mengniu's 2014E revenue), are lower than the consensus.

■ Daiwa EPS forecasts vs. consensus



Source: Bloomberg, Daiwa forecasts

Sector stocks: key indicators

Company Name	Stock code	Share Price	Rating		Target price (local curr.)			EPS (local curr.) FY1			EPS (local curr.) FY2		
			New	Prev.	New	Prev.	% chg	New	Prev.	% chg	New	Prev.	% chg
China Huishan Dairy Holdings	6863 HK	1.76	Buy		2.48			0.097			0.133		
China Mengniu Dairy	2319 HK	39.85	Hold		40.70			1.094			1.300		
China Modern Dairy Holdings	1117 HK	3.32	Buy		4.60			0.204			0.264		

Source: Daiwa forecasts

Contents

Company Section

Structural support for raw-milk prices

Increasing demand for quality raw milk and the exit of small dairy-farm operators should drive a 5-10% YoY increase in raw liquid-milk prices for our coverage universe in 2014-15

Raw-milk prices should trend higher, until at least 2016

We analyse the dairy industry in China by dividing it into 2 segments:

Dairy farm operations (upstream companies): These companies raise dairy cows and supply raw milk to dairy product manufacturers directly or through milk stations. Some of them have gone further by vertically integrating into feed production, through managing/running plantations for forage. The upstream segment is highly fragmented, with the top-4 players accounting for only about 4% of the supply in 2013E.

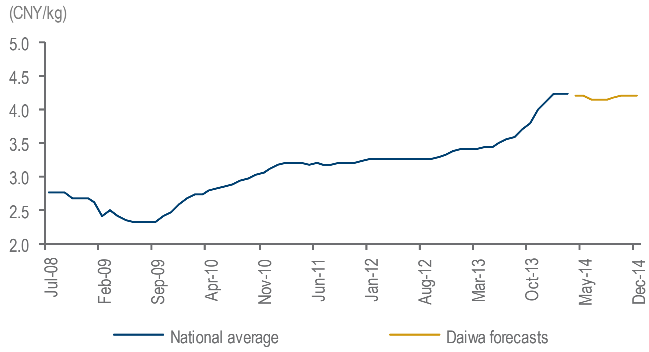
The production and sale of dairy items (downstream companies): This segment includes the production and distribution of liquid or solid dairy products, such as UHT milk, infant formula, yoghurt and pasteurized milk. Domestic enterprises dominate the domestic liquid milk market, accounting for around 50% of the infant formula market in 2013.

Downstream producers source their milk either directly from large farms and intermediaries, or alternatively use imported milk powder to produce dairy beverages. China imported 0.85m tonnes of bulk-pack milk powder in 2013. We estimate that about 12% of the dairy products in China are produced from imported bulk-pack milk.

In 2013, raw-milk prices in China rose by about 10% YoY to CNY3.6/kg, according to the Ministry of Agriculture, and reached a high of CNY4.13/kg in December. They rose further in 1Q14 to CNY4.23/kg, some 24% higher than the average level in 1Q13.

This price strength has been driven largely by a reduction in supply, as a large number of individual farmers (with cow herds comprising fewer than 10 dairy cows on average) have withdrawn from the industry since 2011 in response to high feedstock costs and shrinking profit margins. As a result, individual farmers' proportion of China's total cow herd count declined from 80% in 2007 to 61% in 2012, according to the Ministry of Agriculture.

■ China: raw-milk price trend



Source: Company, Daiwa forecasts for 2Q-4Q14 trend

According to market research and consulting company Frost and Sullivan, the raw-milk volume produced from small farms (with herd sizes of fewer than 1,000 dairy cows) declined by 7% in total from 2008-12. These statistics suggest to us that the number of dairy cows in small farms contracted by more than 6% over the same period.

Meanwhile, large-scale dairy farms expanded their herds rapidly over 2008-12. As can be seen in the table below, the proportion of China's total dairy-milk output supplied by dairy farms with herd sizes of 5,000-9,999 and more than 10,000 increased sharply by a total of 151% and 400%, respectively, over the period. However, in aggregate these large-scale dairy farms still accounted for less than 13.6% of the country's total raw-milk supply in 2012. Raw-milk prices increased by 49% in total over 2009-13, illustrating an ongoing raw-milk shortage over the period.

■ China: raw-milk output by dairy cow herd size

Herd size	Proportion of output %		Implied production volume (m tonnes)		
(No. of dairy cows)	2008	2012	2008	2012	Total change %
<1,000	94	83.9	33.42	31.41	-6.0
1,000-4,999	0.7	2.5	0.25	0.94	276.0
5,000-9,999	4.9	11.7	1.74	4.38	151.4
>10,000	0.4	1.9	0.14	0.71	400.1
Total	100	100	35.56	37.44	5.3

Source: Frost and Sullivan, Daiwa estimates for volume

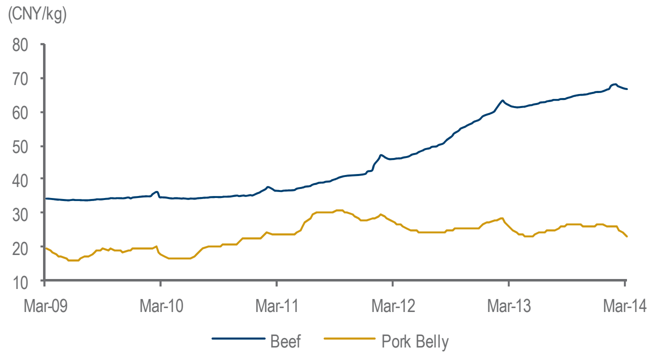
We expect this shortage to continue, at least through to 2016, and as a result we forecast average raw-milk price increases for our coverage companies of 10% YoY for 2014, and 5% YoY for each of 2015 and 2016.

Supply shortage compounded by higher beef costs and hot weather

The elimination of low-yielding cows (ie, local species) by small-scale farms accelerated in 2013 due to adverse weather conditions in the summer and higher beef prices throughout the year. Hot weather is not favourable for milk cow yields and increases the risk of bovine disease.

Beef prices were up 25% YoY on average in 2013, which led to increased slaughtering of low-yielding dairy cows by small farms. Many farmers chose to slaughter dairy cows and sell the beef immediately for a higher cash income than they would obtain if keeping inefficient cows to produce milk.

■ Pork and beef retail price in China's top-50 cities



Source: Ministry of Finance and Commerce, China

Large-scale dairy farms are expanding …

The rising trend in raw-milk prices and increasing demand for high-quality raw milk (high in protein and fat, but low in bacteria content, as opposed to plain raw milk, which has a low protein and fat content but higher bacteria content) has attracted investment in China's dairy-farm industry from domestic and overseas operators, and also from financial investors since 2008.

Among the top-10 dairy enterprises in China in terms of number of dairy cows (shown in the next table), 3 have listed on the Hong Kong Stock Exchange through IPOs over the past 5 years to raise funds for expansion. The 5th-largest, Shengmu High-tech, is reported to be planning an IPO in Hong Kong this year, according to a report in *IFR Asia Magazine*.

■ Top-10 dairy enterprises in China by number of dairy cows (2012)

Company	'000	Company	'000
CMD	176.3	Jilin Guangze	31.3
Huishan	119.0	Tianjin Jialihe	23.8
Bright Dairy (+Shanghai Dairy Group)	56.3	Yuanshengtai Dairy Farm	37.0
Sanyuan	48.0	Dongying Aoya	17.4
Shengmu High-tech	45.0	Nanjing Dairy	17.4
Top-10 total	571.5		
Total number of dairy cows in China	14,400		

Source: Prospectus of Yuansengtai Dairy Farm (listed in Hong Kong)

International companies are also investing in dairy farms in China. For example, New Zealand's Fonterra expects demand for raw milk to reach 70bn litres (70m tonnes) per year by 2020. Fonterra targets to increase its output in China to 1bn litres (1m tonnes) by then, which it estimates would be equivalent to 1.4% of the demand in China in 2020.

■ Some upstream projects in China dairy farms announced by international companies

	Location	Investment (CNYm)	Est. date of completion	No. of cows	Est. production (tpa)	Per unit investment (CNY/t)
Fonterra	Hebei	1,030	Before 2013	15,000	300,000	3,433
	Shanxi	1,500	3Q15	30,000	200,000	7500
Nestle	Heilongjiang	180	Not disclosed			
RRJ Capital	Shanghai Holstan JV	1,525	Not disclosed			

Source: Daiwa

… but they have not filled the supply gap

We believe the market's concerns about large-scale farm expansion are overplayed. Looking at dairy cow imports, we argue that such projects are replacing small-scale farms and will not lead to oversupply, at least until 2016.

Dairy farms expand typically via the following two ways:

- **Organically by increasing their herd sizes:** The industry rate for herd expansion averages between 15% and 20% per year. The organic growth rate of some farms may be lower due to a higher rate of culling dairy cows to boost milk yields.
- **Importing dairy cows:** Imports amounted to around 80,000-100,000 head per year in China between 2011 and 2013. China imports Hesitan dairy cows mainly from Australia and New Zealand.

The statistics on imports of dairy cows allow us to gauge the expansion pace of large-scale dairy farms in China, as this is the only way to speed up expansion, aside from expanding organically.

China imported around 91,000 dairy cows and heifers in 2010, 99,000 in 2011, 78,000 in 2012 and 93,000 in 2013. We conservatively assume China will import

100,000 heifers per year (the high end of the range over the past 3 years) from 2014 until 2016. However, actual imports may be lower given that large dairy farms are gradually becoming self-sufficient through in-house production. We also assume the overall herd size expands organically by 15% per year. As such, we estimate the total number of dairy cows derived from the imports from 2011-2016 would only be about 820,000 head. This represents less than just 6% of the dairy cow count in China in 2012.

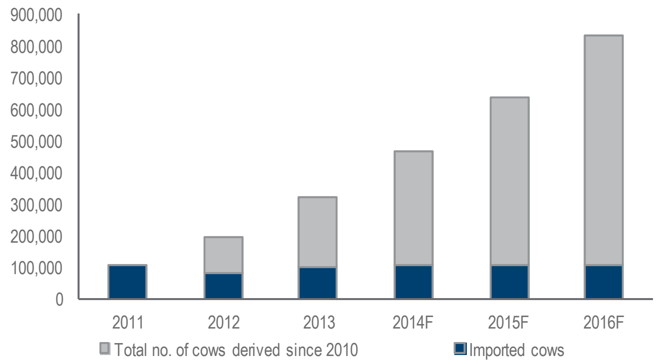
Our forecast of 820,000 cows derived also implies that the proportion of mid-scale or above dairy farms (with more than 1,000 dairy cows) would not exceed 20% by 2016 (from 13.7% in 2012). As a result the market would still be highly fragmented.

■ **Number of dairy cows imported per year and the derived herd sizes**

	No. of cows imported	Organic growth rate assumption 15%	20%	Implied herd size 15%	20%
2011	99,361	n.a.	n.a.	99,361	99,361
2012	78,109	14,904	19,872	192,374	197,342
2013	92,779	28,856	39,468	314,009	329,590
2014E	100,000	47,101	65,918	461,111	495,508
2015E	100,000	69,167	99,102	630,277	694,609
2016E	100,000	94,542	138,922	824,819	933,531

Source: China Customs, Hesitan.com, Daiwa forecasts

■ **Number of imported dairy cows per year and the derived herd sizes**



Source: China Custom, Daiwa estimates

Milk demand could exceed supply by around 13.6m tonnes in 2016

According to Frost and Sullivan, raw-milk demand in China is expected to grow at a CAGR of 8% between 2012 and 2016, against a 7% supply CAGR. As such, the shortage of liquid raw milk in China would exceed 10m tonnes per year over 2014-16. While most of the shortage has been satisfied by imported milk powder in the past, we believe dairy processors will favour domestic sources more in the future as the dairy processors move into high-end pasteurised and other fresh products, which cannot be made from powder substitutes.

■ **Milk supply and demand in China**

m tonnes	Supply	Demand	Shortage	Imported milk (powder)	Implied liquid milk imports*
2009	35.2	40.5	5.3	0.2	2.0
2010	35.8	42.5	6.7	0.4	3.3
2011	36.6	44.8	8.2	0.4	3.6
2012	37.4	46.6	9.2	0.6	4.6
2013	35.3	50.3E	14.9E	1.0E	7.8E
2014E	43.8	54.9	11.1	n.a.	n.a.
2015E	48.1	60.4	12.3	n.a.	n.a.
2016E	50.5	64.1	13.6	n.a.	n.a.
2017E	53.2	68.3	15.1	n.a.	n.a.
Implied CAGR (%) (2012-17E)	7.3	7.9			

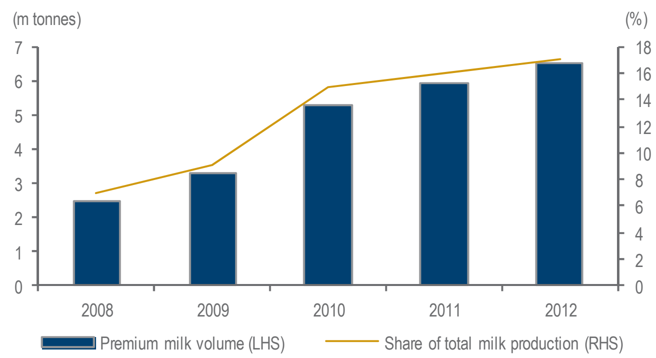
Source: Frost and Sullivan estimates, Huishan prospectus, China Custom for import data
** Implied liquid milk imports = imported milk powder x 8.*

The contribution of quality raw milk to total raw-milk production in China is still low. High quality raw milk, with its high protein levels, still accounted for less than 18% the total supply in 2012.

Although most large-scale dairy farms import high-quality, high-yielding dairy cows and focus on quality milk production, we believe quality raw milk will remain in undersupply in China for at least the next few years.

To put it into context, if we assume that: 1) 1m head of cows are derived from those imported since 2011 (discussed earlier in this section), and 2) they can achieve an average milk yield of 9tpa, this would result in quality raw-milk output in China increasing by 9m tonnes from 2012 to 2016. This is still lower than Frost and Sullivan's forecast of demand of 64m tonnes of total demand for raw milk by 2016.

■ **Supply of quality milk**

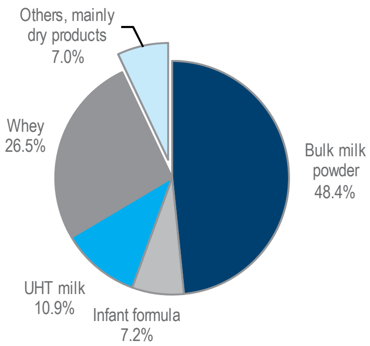


Source: Yuanshengtai Dairy Farm prospectus

Imports not a good substitute for domestic raw milk

Imported milk (mainly in powder form, and used for producing domestic dairy beverages and infant formula) could alleviate upward milk cost pressure in China. Both Mengniu and Yili Industrial (Not rated) have established strategic tie-ups with international players in Europe and New Zealand to secure quality milk sources. Milk powder and other dry products accounted for over 80% of the milk imported into China in the first 11 months of 2013.

■ Breakdown of China dairy imports (January – November 2013)



Source: China Custom, hesitan.com

However, in our view imports are not a good substitute for raw liquid milk, as: 1) powdered milk cannot be used to produce pure liquid milk under Chinese regulations; and pure liquid milk accounts for about half of the dairy product consumption in China, and 2) imports of liquid milk are not cost-efficient due to logistical constraints.

We believe imported raw milk poses less of a threat to domestic large-scale farms than to small-scale players, thanks to the larger farms' focus on the premium milk segment. The quality of the milk produced by large-scale farms is superior to that made by most smaller local players, and is usually used to produce premium UHT milk, pasteurized milk or other dairy products, which cannot be produced using imported powdered milk.

Latest government policy has turned more restrictive on imported milk powder as the raw material for the production of infant formula. Imports of bulk-pack infant milk powder for repackaging into canned infant formula products have been prohibited from April 2014 onwards. As such, many domestic infant formula producers will have to turn to domestic raw-milk sources to continue their production, and demand for raw liquid milk from domestic milk powder players will likely increase.

The government's intention is to improve the overall standard of food raw materials in China and upgrade food safety in China.

The supply shortage favours upstream producers

The earnings and growth visibility for large-scale dairy farms is better than that for smaller players and downstream processors due to the scarcity of quality raw milk, scale advantages and improving pricing power.

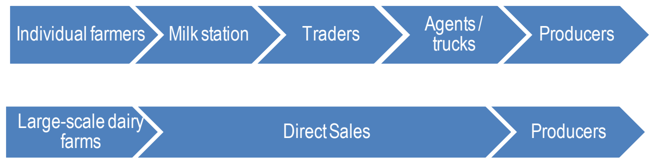
Large players gaining pricing power and cost advantages

Raw-milk prices have been trending up since 2009. The national average price reached CNY4.13/kg in December 2013, up 22% YoY, and 70% higher than the 2009 level. By March 2014 it had reached CNY 4.23/kg. The pricing mechanism between individual farmers and dairy producers is different from that between large-scale dairy farms and dairy producers.

Individual farmers either bring dairy cows to a milking station for milking, or send their finished products to the dairy producers. Milk stations and agents then transport the milk by truck to the downstream producers. The price is set by traders and agents, by taking reference to the price set by the government, which varies in different provinces. The government price is usually set quarterly. Moreover, as there is usually only 1 buyer or trader within the vicinity of the farms, small farmers are usually just price-takers.

For large-scale dairy farms, they often enter into long-term supply agreements with downstream players to secure a visible order book. For example, in 2008 CMD entered into a supply agreement with Mengniu to supply at least 70% of Mengniu's output until 2018. Prices are usually is set on a monthly or quarterly basis, and are based on a premium to the average price of nearby large-scale and individual dairy farms, according to the quality of the raw milk. Most dairy farms are flexible to sell into other buyers who are willing to pay a higher price.

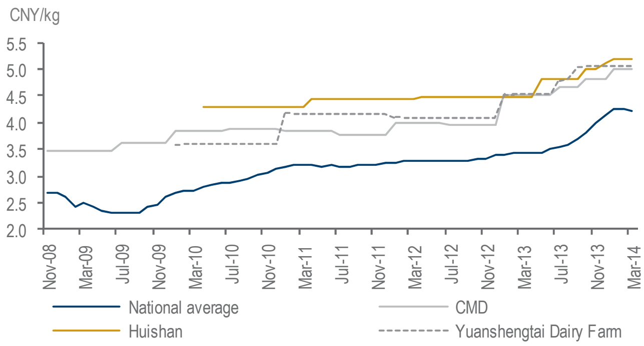
■ Pricing mechanism of raw milk – large vs. small players



Source: CMD, Daiwa

The result is that the raw-milk prices large-scale farms receive are typically at least 20% above general market prices, based on our estimates. The spread is also supported by the high quality of milk produced by large-scale farms.

■ Raw-milk prices in China, from general and premium (large-scale) sources



Source: Ministry of Agriculture, Company

Positive profit margin outlook for large-scale dairy farms

Going forward, we believe the large-scale dairy farms' margins will be driven by:

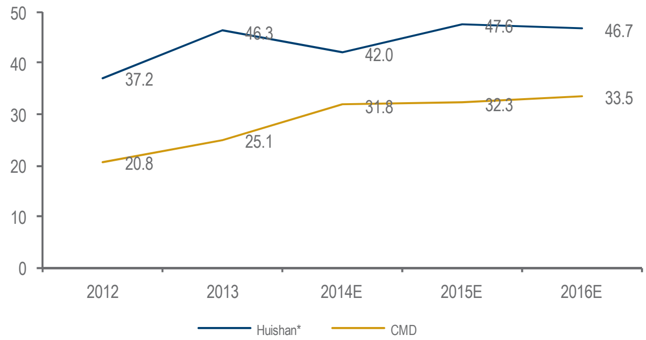
1) **Rising raw-milk prices:** As mentioned above, we estimate that a continued shortage of raw milk through to 2016 would support a 5% increase in quality raw-milk ASPs from the 2013 average level. Quality raw-milk prices charged by listed dairy farms in China were stable in 1Q14, remaining at a level of 13% above their ex-factory price level in 1Q13.

2) **On feed costs:** Feed costs account for 70-80% of a dairy farm's operating costs. According to the United States Department of Agriculture (USDA) and the Ministry of Agriculture of China, the global and domestic supply of grain is in abundance, in particular corn (whose harvest rose by 4.6% YoY in China for 2013). We estimate corn, which in general accounts for 20-40% of a dairy farm's feed costs, will see a price hike of less than 5% in 2014 in China, in line with the increase in the government's official auction price announced in 4Q13. For dairy

farm operators with an in-house supply of alfafa or other feeds, such as Huishan, we expect their cost control to be better than peers.

With a likely improvement in milk yields, we expect the operating margins for the dairy farm operators to continue to trend up. For CMD, we forecast a 7.4pp YoY expansion for 2014, 1.8pp rise for 2015, and a 1.3pp expansion for 2016. For Huishan, we look for its operating margin to expand by 5.5pp YoY for FY15E, followed by a slight decline in FY16E due to increasing selling expenses for its downstream operation.

■ **Operating margin of our upstream coverage companies**

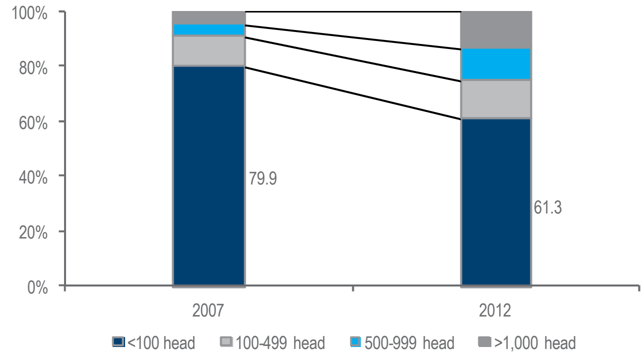


Source: Company, Daiwa forecasts
**FY13-16E data used as Huishan's fiscal year ending on 31 March 2014*

Consolidation continues in the upstream segment

Another theme driving margin expansion is consolidation. The upstream dairy segment in China is still highly fragmented with over 1m dairy farms (including individual famers with 1-2 cows) raising 14m dairy cows as of 2012. Large-scale farms (1,000 head or above) accounted for 13.7% of the total herd size in China in 2012, up from 4.8% in 2007. Given the small average dairy farm size, we believe a secular consolidation story is taking place, underpinned by supportive government policy.

■ **Proportion of dairy farms in China by herd size**



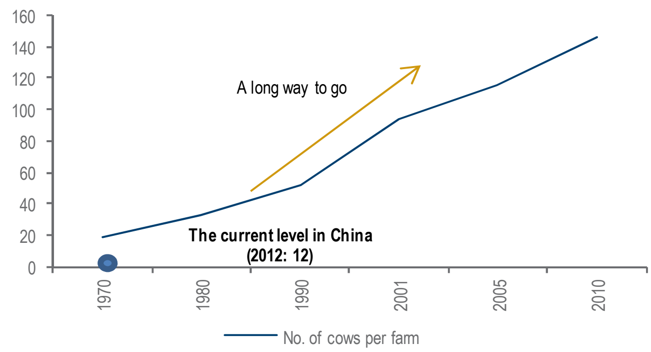
Source: Ministry of Agriculture

The consolidation trajectory of dairy farms in the US can provide some insights on where China's dairy industry will go.

Similar to China, over the past 40-odd years, the US has developed large-scale farms and aimed to improve milk yields per cow rather than expand herd sizes. As a result, the total number of dairy cows declined from 12m in 1970 to 9.1m in 2010, while total milk output increasing from about 60m tonnes to 90m tonnes over the same period.

According to the USDA, milk yields have doubled from 4.4tpa in 1970 to 8.6tpa in 2007. We believe China is at US's level in the 1970s in terms of milk yields and average farm size and will go through a similar consolidation process in the years to come.

■ **Number of cows per dairy farm in the US, and where China stands at present**



Source: National Agricultural Statistics Service (NASS), US

Policy-driven growth and the speeding up of industry consolidation

We believe government policies to consolidate the industry and improve raw-milk quality are positive for the industry.

Driving demand for quality raw milk: In our view, policies to improve product quality and the safety of downstream food products will eventually drive demand for milk from large-scale farms. For example, the government has continued to raise the standard and quality requirements for infant formulas. From April 2014 onwards, the outsourcing of production of infant formulas was prohibited. Producers must also have in-house raw liquid milk production or buy their raw materials from traceable sources to ensure product safety. Some dairy enterprises have also started to produce UHT milk which allows the traceability of the milk source. Such production is also favourable for large dairy farms that can provide traceable raw materials in bulk.

Financial subsidies: imports of dairy cows are supported by financial subsidies. Some provincial governments have offered subsidies of about CNY1,500 to CNY2,000 per cow in the past.

Latest policy for infant formula producers

Since the melamine scandal in 2008, consumers' confidence in domestic dairy products, in particular in infant formula, has declined substantially and consumers have shifted to source baby milk powder worldwide. At the same time, foreign brands continued to raise their ASPs between 2009 and 2012 in China on better brand and product safety recognition.

In response to the increasing concerns from the public about pricing and quality issues relating to infant formula products, government officials have over the past 2 years: 1) issued guidelines for industry development, 2) investigated pricing and production plants for malpractices, and 3) held 2 press conferences to promote selected domestic infant formula brands.

The government expects:

- The number of infant formula producers to be reduced from 127 at present to around 80 by 2015 and to 50 by 2018, through mergers and acquisitions. The government expects there to be 10 infant formula producers with annual sales exceeding CNY2bn each by 2018.
- The top-10 domestic infant formula brands to account for 65% of the market share in 2015 and 80% in 2018.
- Continuous upgrades of production facilities of the domestic players to good manufacturing practices (GMP) standards and increased sourcing from in-house or large-scale raw-milk suppliers.

Moreover, repackaging of large bulk imported baby milk powder into small packages is prohibited from April 2014 onwards. Nutrient and other details of the product must be labelled in Chinese on the smallest package available before being imported to the mainland. Companies exporting baby formula to the mainland must register with the Chinese authorities before 1 May this year.

Support a national league of players

In September 2013, the Ministry of Industry and Information (MII) held a press conference to introduce new baby milk powder businesses from 6 enterprises, including Yashili (which became a subsidiary of Mengniu in August 2013), Yili Industrial and 4 other domestic brands. Another similar press conference was held in January 2014, promoting regional brands such as Sanyuan (Not rated), Huishan, Yinqiao, etc. Media reports refer to such companies as the "national league" and have claimed that they should become major acquirers or market share gainers in the future.

Looking forward, we expect more regional players to be supported by the government which in turn would increase the overall supply of dairy products in China, in particular for the upstream players.

Financial support

In a June 2013 policy release, the government targeted CNY30bn in support for large dairy enterprises to consolidate the industry. Rather than direct cash subsidy to enterprises, we believe that such financial support, if it materialises, would mainly be in the form of research and facility upgrade support, low-interest and policy loans.

■ **Summary of policy release and government actions in the dairy industry since 2013**

Time	Policy	Official Parties in Charge
May-13	Release of "Inspection Rules for Quarantine of Import and Export of Dairy Products" (进出口乳品检验检疫监督管理办法)	AQSIQ
Jun-13	Release of "The Action Plan for upgrade of milk powder quality and enhancement of consumer confidence" (提高乳粉质量水平 提振社会消费信心行动方案)	MII
	CFDA released the "Further Suggestions to Strengthen the Safety and Quality of Pediatric Formula" (进一步加强婴幼儿配方乳粉质量安全工作的意见), which detailed inspection requirements for whey, raw-milk powder; restrictions on production in the form of OEM and repackaging into small cans, etc.	CFDA
	A budget of CNY30bn to support the restructure of the whole dairy industry, encourage M&A among domestic players	
	Price Antitrust Investigation against infant formula producers by the NDRC	NDRC
Jul-13	Anti-trust investigation on Tetrapak China	SAIC
Aug-13	Penalty action against some baby formula producers for price manipulation, who were fined at 3-6% of their baby milk powder sales in China in 2012, totalling CNY670m.	NDRC
Sep-13	Press conference for new infant formula launch from 6 local enterprises, including Mengniu, Yili Industrial, Wondersun, Mingyi, Feihe and Treasure of Plateau	MII
14-Oct	Pilot test of sales of infant formula through pharmacies in Beijing and Jiangsu	
Dec-13	Release of "Detailed Rules of Inspection for Pediatric Formula Production" 婴幼儿配方乳粉生产许可审查细则（2013版）- which specify product and packaging quality and label etc requirements. Enterprises were granted a 1-year transition period to upgrade their facilities.	CFDA
Jan-14	Press conference for new infant formula launch from 6 local enterprises (second group), including Huishan, Yinqiao, Sanyuan, Beingmate, Baiyue, and Shanghai Chenguan.	MII
2014E	Formal Restructure Proposal of the Baby Milk Powder Industry to be released. The proposal will aim to: 1) enhance consolidation of the industry, aimed at building 3-5 large dairy enterprises and 5 mid-size ones, which together with the top-10 will account for 65% of the market share in 2015, rising to 80% by 2018E, 2) cut the number of infant formula producers from 127 to c80-90, 3) impose more regulatory requirements on raw material sources, inspection and quality assurance.	State Council, MII

Source: Daiwa
Note:
MII= Ministry of Industry and Information
SAIC = State Administration for Industry & Commerce; AQSIQ = General Administration of Quality Supervision, Inspection and Quarantine of the PRC; NDRC = National Development and Reform Commission; CFDA = China Food and Drug Administration

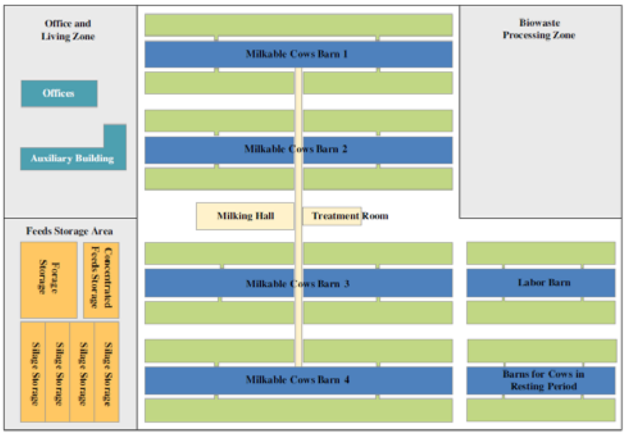
High entry barriers for upstream companies

Large-scale dairy farms have high entry barriers in terms of capital investment and technology know-how. This favours the large and existing operators due to their greater experience and technology levels, and financial strength.

Technology and knowledge: Large-scale dairy farming requires sophisticated technical know-how, as well as steady product demand and investment. Milking is carried out in 3 shifts each day through a highly automated and hygienic process. Raw milk is usually stored in central storage tanks before being piped into thermo-insulated delivery trucks. The whole process normally takes less than 48 hours under hygienic and controlled temperature conditions (4-8°C). Given the short processing time allowed for the whole process (milking, cooling, central collection and delivery), dairy farm operators require steady product demand, which in turn calls for long-term contracts or co-operation relationships with downstream players.

On the other hand, such barriers are positive for experienced market leaders with expertise (construction and farm operation), as they can copy their standard dairy farms in different areas. An example of Huishan's is shown below. The reputation of large-scale farms' product quality also helps them secure contracts with new farms. For example, CMD has already entered into a contract with Mengniu that the latter will take up at least 70% of CMD's production up to 2018. We believe renewal afterwards is likely due to Mengniu's huge need for raw milk.

■ **Layout of a standard Huishan dairy farm**



Source: Huishan Dairy

Capital and long investment period: An industrialized pure-bred Holstein dairy cow farm with 6,000 head of imported cows costs CNY320m-350m to build, of which around CNY140m (~40% of the total cost) is for cow purchases (~CNY20,000/cow), around CNY90m (30%) is for farm construction, and the remainder for procurement of production facilities such as milking systems and feed-processing machinery. The whole build-out process takes 6-12 months and milk production can only begin 12-18 months after the initial investment.

Regulations: Imports of livestock and the setting up of dairy farms require careful disease and pollution control. Bio-waste and waste water are key pollution concerns for dairy farm operations. But if processed, they can be turned into fertilizers and fuel gas for sales. We estimate that in mega-size dairy farms, about 10% of the investment cost (around CNY30-35m) is used on related infrastructure development. Huishan estimates that it will spend CNY54.5m in FY14 to become compliant with environmental protection rules and regulations. Huishan has also engaged its chairman's associate company to provide bio-waste treatment services (see our company section for details).

Moreover, regulatory requirements for product traceability (ie, the ability for the source of the raw material of food to be traced back to the upstream industry) in the future will encourage dairy processors to source from large-scale dairy farms, rather than from fragmented sources that can hardly be traced.

Domestic-gene cows are inefficient

The average milk production yield per cow in China stood at around 4.12tpa in 2013 and is one of the lowest among major milk consumption countries, according to the USDA and Department for Environment Food and Rural Affairs (DEFRA) of the UK. We believe species and technology are the key differences.

■ Fluid milk production per cow (tonnes/cow/year)

	2009	2010	2011	2012	2013P	2014E
US	9.33	9.59	9.68	9.84	9.92	n.a.
EU-28	5.53	5.75	5.98	6.03	6.03	6.07
New Zealand*	3.69	3.67	3.94	4.1	3.9	4.02
Japan	9.33	9.3	9.28	9.39	9.47	9.48
China	4.00	4.00	4.03	4.08	4.12	4.16

Source: USDA. P: preliminary figures, E: estimates

**New Zealand's reported milk yield per cow is low at 4tpa but it is due to their free-range breeding model that incurs low feed costs. New Zealand is suitable for free-range breeding as it is rich in land and natural grass resources.*

The milk yield of China domestic breeds was below 5tpa in 2013, versus 7tpa or above for imported species such as Holstein and Jersey cows. In our view, China will catch up with the US and Japan in terms of raising its milk yields by upgrading milk cow genes and milking techniques.

But, as mentioned above, only large operators can afford to import large numbers of dairy cows and construct large-scale dairy farms. Hence, milk yields at large-scale dairy farms in China are much higher than for small peers through importing high-yielding cows, a better feed mix and scale advantages. As shown below, the milk yields for large-scale dairy farms are much higher than the industry average.

■ Milk yield of selected large dairy farm operators in China

Name	Milk yield (tpa)*	Name	Milk yield (tpa)*
CMD	8.5	Tianjin Jialihe	10
Huishan	9.1	Yuanshengtai Dairy Farm	9
Shanghai Dairy Group	9.4	Dongying Aoya	>9
Beijing Sanyuan	10	Shengmu High-tech	~7

Source: Companies, hesitan.com, Daiwa

** 2012 or 2013 statistics, based on latest information available*

Scale and efficiency translate into cost advantages

Although operational statistics and the financials of small-scale dairy farms are not available, we estimate that the profit margins for large-scale farms are higher than those for smaller peers on average. The cost savings come from:

Higher unit output: Although large-scale farms in general use more expensive feeds than small farms, the unit milk feed cost for large-scale farms is lower. According to CMD, about 80% of its farm operating costs comprise feed, and about 20% of its feed costs comprise alfafa, which is important to increase the milk yield of cows because it boosts the protein content and nutrient value in the milk. If we simply assume that feed costs per cow at a large-scale farm are 25% higher than those at a small farm because of alfafa, the unit milk cost for the large farm would still be 20% lower than that for small farms due to their much greater milk output. And this calculation does not even include the further potential cost savings from in-house production, more sophisticated feed formulation and bulk purchases.

■ Feed cost per unit – CMD versus industry average (2013)

	CMD	Industry average	Difference (%)
Milk yield (tonne/cow/day)	8.6	5.5	56%
Feed cost per cow per day (CNY)	68.7	54.2	25%
Feed cost per tonne of milk (CNY)	2,435	3,006	-20%

Source: Daiwa estimates

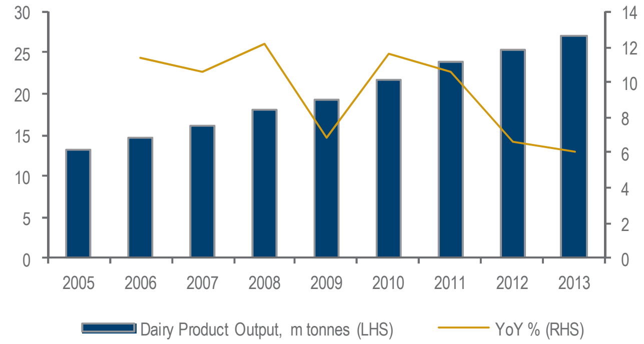
Labour costs: It takes about 150 labourers to run a 10,000-head dairy farm, implying that 1 staff can take care of about 67 head of cows. It is significantly more efficient than family-based farms, in which a family (3-5 persons) may only take care of fewer than 10 cows.

Increasing reliance on quality raw-milk sources

Volume growth for China's dairy industry has slowed over the past few years. Industrial output volume growth decelerated from double-digit growth YoY in 2010/11 to 7% YoY and 6% YoY for 2012 and 2013, respectively, according to the Bureau of Statistics.

Euromonitor estimates that retail sales of dairy products in China rose by 15% YoY for 2012 and 14% YoY for 2013, suggesting that ASPs are trending up. We believe such an uptrend will be supported by product quality upgrades as well as increasing raw-milk costs.

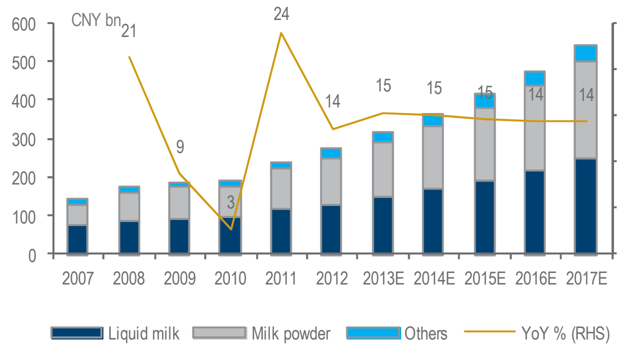
■ Dairy product output by volume and YoY growth



Source: CEIC

According to Euromonitor, liquid milk (UHT milk, pasteurized milk, yoghurt and dairy beverages) accounted for 48% of the dairy product market in China in 2013E in terms of value. The high-end liquid milk market (retail price of more than CNY12 per litre) is growing faster than the mass market, and Euromonitor forecasts it to rise at a 25% CAGR over 2013-17E, versus an 8% CAGR for mass market products.

■ China dairy market breakdown



Source: Euromonitor

The development of high-end products requires high-quality raw materials, either milk powder or raw milk. As shown below, raw-milk standards in China are generally lower than international standards in terms of nutrient content (protein and fat) and hygiene (bacterial limit and somatic cell count). However, large-scale dairy farms in China are able to achieve higher quality (hence higher ASPs) than their smaller domestic peers, due to their use of imported milk cow species, better feed and large-scale operations.

■ Milk quality standards of different farms and countries

	%		/ml	
	Protein	Fat Content	Bacterial Limits	Somatic Cell Count
Huishan	≥ 3.2	≥ 4.1	<50K	<200K
CMD	≥3.2	≥3.8	<20K	<250K
Yuanshengtai Dairy Farm	3.4	4.2	4K	162K
Top-10 players	3.2	3.8	143K	370K
PRC standard	≥ 2.8	≥ 3.1	<2000K	N/A
EU standard	n.a.	n.a.	<100K	<400K
US standard	≥ 3.5	≥ 3.5	<100K	<750K

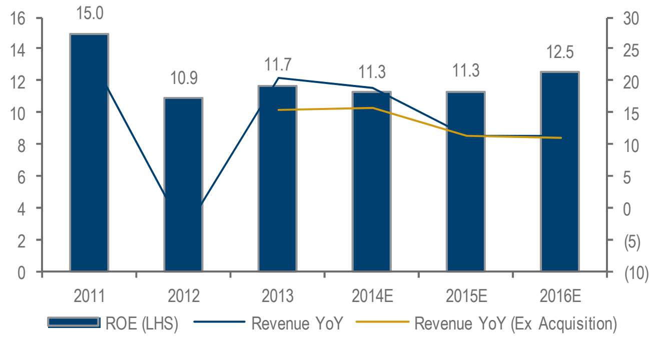
Source: Huishan and Yuanshengtai Dairy Farm prospectus, CMD

Downstream revenue growth susceptible to competition

Downstream dairy leaders are fighting competition from foreign brands and domestic regional peers.

We see revenue growth slowing down and ROE remaining low for downstream processors as competition intensifies and market growth slows down. For example, we forecast Mengniu's revenue growth to slow to 19% YoY for 2014, 11% YoY for 2015, and 11% YoY for 2016, from 20% YoY for 2013. We forecast the company's ROE to drop to 12% over the next 3 years from its peak of 15% in 2011. Ex-acquisition, Mengniu's revenue CAGR should rise at only 12% over 2013-16E, down from 16% YoY in 2013, on our forecasts.

■ **Mengniu: revenue YoY % (RHS) and ROE % (LHS)**



Source: Company, Daiwa forecasts

Market growth slowing down

Sales growth for the overall dairy product market has slowed down since the melamine scandal in 2008. Dairy market revenue grew by only 15% YoY and 11% YoY for 2011 and 2012, according to Mengniu and a McKinsey report as shown below, and growth looks likely to slow further to an 11% CAGR after 2013. Going forward, we believe price will be the key market determinant rather than volume.

■ **Dairy sub-segment market sales growth**

	Fast growth?*	As % of dairy market in China				CAGR (%)	
		2010	2011	2012	2017F	2010-11	2011-17F
UHT Milk	N	27	27	26	23	15	9
Milk Beverage	N	25	23	23	23	8	12
Fresh milk	Y	2	3	3	4	36	21
Probiotic milk	Y	1	1	1	2	55	17
Yoghurt	Y	7	8	9	10	30	15
Ice cream	N	12	12	11	10	7	9
Infant milk formula	Y	19	20	20	22	23	13
Milk powder	N	4	4	4	3	7	8
Cheese	Y	2	2	2	2	21	22
Soy milk	N	0-1	0-1	0-1	1	12	11
Dairy market size (CNYbn)		160	185	205	353	16	12

Source: McKinsey Report
** fast growth defined as CAGR in 2011-17E of greater than the industry average of 12%*

Other key growth drivers for downstream players are product mix upgrades and diversification as shown below where we highlight a number of new product initiatives by various downstream companies. Note that first-movers have a larger market share in many of the categories: for example Mengniu in premium UHT milk (Milk Deluxe accounts for a more than 60% market share), Want Want in dairy beverages (~40% in dairy beverage).

■ **Strategies to grow in different downstream segments**

How?	Examples (and leading market players)	Entry Barriers	First-mover, if any
New or premium categories	Cheese, ice-cream (Mengniu Arla)	Production technology	
	Room temperature yoghurt - Mosilian (Bright), Just Yoghurt (Mengniu)	Production technology	Bright
	Pasteurized milk - Modern Farm (Mengniu), Bright, Huishan	Access to quality milk sources, efficient logistics system	
New flavours	Banana flavoured milk (Bingaree, Labixiaoxin);	Brand building and marketing capability	Bingaree
	Peanut milk (Yinlu)	Research and study of market needs	Yinlu
Specific age groups	Children: Hot Kids Milk (Want Want), Future Star (Mengniu)	Brand building and marketing capability	Want Want
	Office Lady and young adults : Xiaoxinyuguo (Labixiaoxin), Suan Suan Ru (Mengniu)	Brand building and marketing capability	
Rich nutritional	Flavoured milk with additives (herbs/nutrients)	Brand building and marketing capability	Wahaha
	Breakfast milk (Mengniu, Yili Industrial)	Research and study of market needs	
	Nutritional Express (Wahaha)		
	Low Lactose Milk (Yili Industrial)		
Premium UHT Milk	Imported UHT milk	Access to quality milk sources	Mengniu
	Milk Deluxe (Mengniu), Satine (Yili Industrial), Jersey (Huishan), Shengmu	Research and study of market needs	

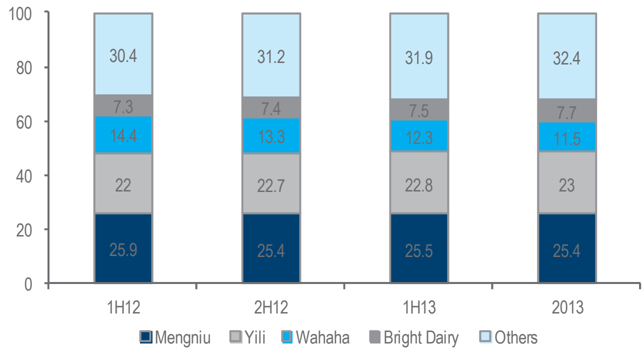
Source: Daiwa

Liquid milk market: consolidated and competitive

As of 2013, the top-4 players accounted for more than 68% of the liquid milk market share in China, according to AC Nielsen. It is much more consolidated than the raw-milk market. There are two well-established national players in China, Mengniu and Yili Industrial, followed by some smaller players that are either regional in focus or concentrated in a few sub-categories. Examples include Bright Dairy (Not rated) which dominates the Shanghai market, with a focus on yoghurt and pasteurized milk, Sanyuan (Not rated) (Beijing), Want Want (Not rated) (dairy beverages) etc.

We note that the market shares of the top-4 players have been slowly coming down over the past 2 years, which we believe is attributable to some small players' gaining market share in regional markets through product differentiation.

■ Liquid milk market share breakdown (2012-13)



Source: AC Nielsen

Regional players can take market share from national players

As shown above, players outside of the top-4 in the liquid milk market in China are slowly taking up market share. We believe that many regional players are more competitive than national players in their homeland provinces. They have a longer history, strong brand recognition and are usually a proxy for quality raw-milk sources in their respective regions. Some of them even emerge into national players in certain product categories. We do not see market leaders being able to grow their market shares (and hence revenue) significantly due to the threat of regional key players.

For example, Bright Dairy (Not rated), which has been established in Shanghai since 1952, has gained a dominant market share in room-temperature yoghurt products since it first launched its brand, Mosilian (莫斯利安), 5 years ago. Bright Dairy has maintained a dominant market share (more than 60%) in the Shanghai liquid milk market. For Guangdong, many suppliers such as Chenguang, have been established for more than 30 years and export their products to Hong Kong, which has high quality requirements and ASPs.

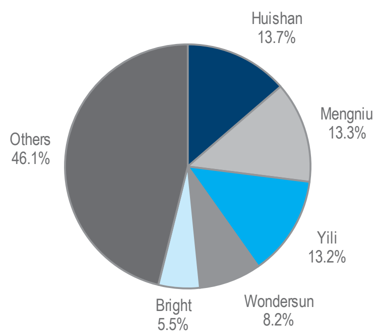
■ Selected dairy players (ex-infant formula) with significant presence in regional markets

Province	Regional brands
Guangdong	Chengguang (晨光), Xiang Man Lao(香滿樓), Yangtang(燕塘)
Shaanxi	Yinqiao (銀橋)
North-eastern China	Huishan (輝山), Wondersun (完達山)
Beijing	Sanyuan (三元)
Hebei	Junlebao (君樂寶)(acquired by Mengniu in 2011)
Chongqing	Tianyue (天友) Dairy
Guangxi	Huangxi (皇氏) Dairy
Hunan	Taizi (太子奶)
Hubei	Youzhiyou (友芝友) – (acquired by Mengniu in 2007)
Shanxi	Gucheng (古城)

Source: Daiwa

Some regional brands are well-recognized by local consumers, and some of them even have higher market share than the national players. Take Northeastern China (Liaoning, Jilin, Heilogjiang provinces) as an example. As shown below, in 2012, Huishan had the highest market share in UHT milk at 13.7%, according to Frost and Sullivan, slightly ahead of Mengniu and Yili Industrial, and even much higher than another national yoghurt brand, Bright Dairy.

■ North-eastern China: liquid milk market share breakdown (2012)

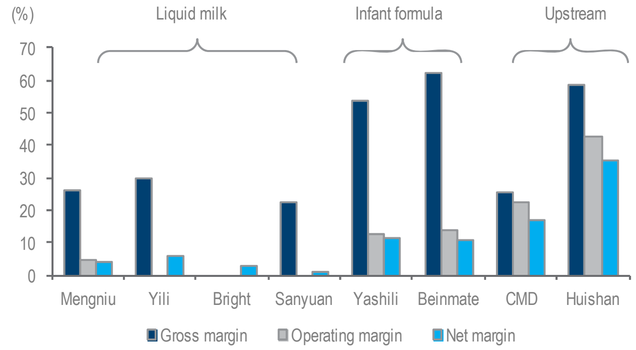


Source: Frost and Sullivan

Operating/net margins on downstream liquid milk lower than that from dairy farms

We believe the intensiveness of the competition in the liquid milk market is evidenced by its low profit margins. As shown below, liquid milk players' net and operating margins are the lowest along the dairy industry chain. We attribute this to: 1) the weak pricing power and commodity nature of mass-market UHT milk products. They account for most of the revenue for the milk players and retail market in China, and result in a lower gross margin, and 2) the lack of tax benefits that upstream companies enjoy.

■ **Profit margins of dairy companies based on their latest audited annual results (2013 or FY13)**

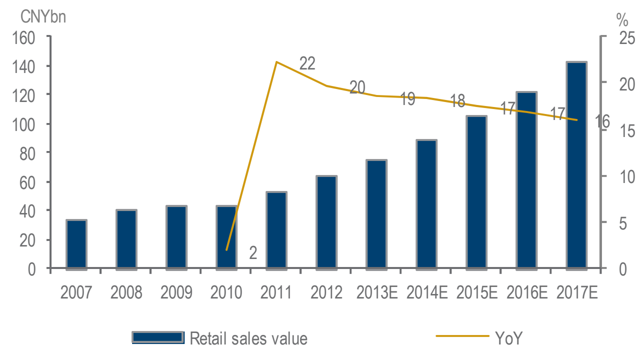


Source: Companies' annual reports

Infant formula – dominated by foreign brands

Infant formula accounted for about 80% of the retail sales of consumer milk powder products in China in 2013, according to Huishan. Total retail sales of infant formula will grow at a 17% CAGR over 2012-17, based on Frost and Sullivan forecasts, faster than the liquid milk market. Growth could accelerate further on the relaxation of the 1-child policy in the future.

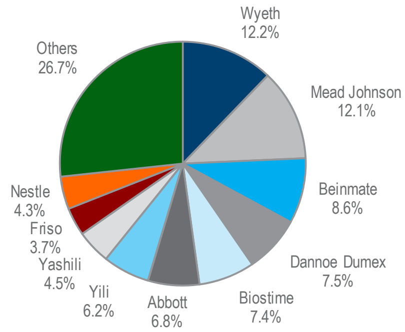
■ **Retail market value of infant formula in China (2007-17E)**



Source: Frost and Sullivan

As shown below, foreign brands accounted for about 50% of the infant formula market in China from January 2013 to January 2014, with 3 out of the top-5 brands being foreign, according to ACNielsen. Foreign brands usually focus on the mid- and high-end markets, as evidenced by their higher retail ASPs in general.

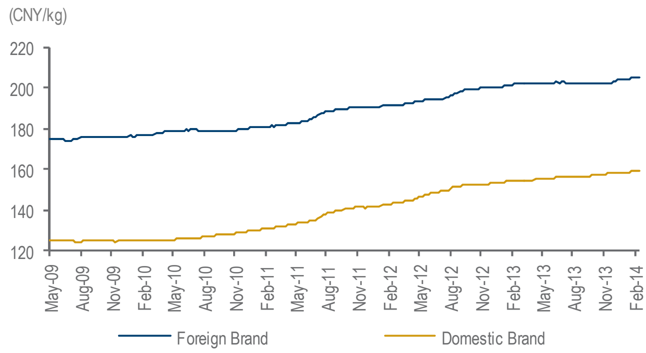
■ **Infant formula market share breakdown in China January 2013 – January 2014**



Source: AC Nielsen, sinanews.com

Based on Ministry of Commerce data shown below, we estimate that the average retail price for foreign brands was 30% above that for domestic brands in 2013. Consumers have turned sceptical about domestic brands, evidenced by a shift to international brands since the melamine scandal in 2008. And the perception held of domestic brands has remained weak, as evidenced by Mainland Chinese tourists purchasing large amounts of milk powder in Hong Kong and overseas.

■ **Average retail price of infant formula**



Source: CEIC, Ministry of Commerce

Lack of differentiation among small domestic brands

Small domestic infant formula brands usually focus on the under-penetrated lower-tier cities. Most of them mainly rely on TV advertising and promotions, which are effective tools of promotion for consumers in lower-tier cities. However, we see little brand differentiation among most of the small domestic brands. There is no major difference in the formulations or ingredients that can differentiate them from each other.

International brands, on the other hand, have strong R&D support and quality raw materials to support product and new formulation development. When foreign brands gradually enter the lower-tier cities in China through modern channels and e-commerce, we believe the market share of smaller domestic brands will shrink further, and consolidation will speed up over the next 3 years.

Relaxation of the 1-child policy – positive for the dairy sector

In November 2013, the China Government announced the relaxation of the 1-child policy, which has been in force in the country for 30 years. Under the old policy, most households were banned from having a second child (the only exceptions were if the parents were only children, and households in select rural areas and provinces, etc).

Under the new policy, which has not been put into effect, families where one parent is an only-child will be allowed to have a second child. The major impact of this will be on urban households. According to a spokesman for the National Health and Family Planning Commission, Mao Qunan, the number of new births due to the relaxation will rise by 1-2m a year in the first few years. This will mean a 6-12% increase in the number of births from the 2013 level (16.4m of births), based on our estimates.

The central government has not fixed a timeline for regional governments to implement the change in policy. But we would note that many provincial governments have announced plans to implement it in 2014, and some announced the related regulatory changes in January 2014.

We have read the news flow and official statements by the Population and Family Planning Commissions of the different provinces, and summarised them, as shown in the table on the right. For the provinces where news flow or official comment is available, we note that most officials target to implement the relaxation policy in 2014.

According to official surveys from these cities and provinces, 50-80% of the households interviewed want to have a second child. Most officials expect a mild increase in the number of births over the next few years (an increase of 0-20% in the number of births), and for it to then normalise at a level that is slightly higher than it was before.

We believe this change is positive for the dairy segment. If the forecast increase in the number of births (6-12%) from the current level materialises in 2015, this would immediately benefit infant-formula brands such as Yashili. Mengniu and the other food and beverage players would also benefit over the longer term, as the babies grow up and consume different milk-powder products. The boost in demand for overall dairy products would also benefit upstream players.

■ Daiwa's assessment of when the time of the 1-child policy will be relaxed and the potential impact in different provinces

		Estimate increase in number of births/year			
Expected date of implementation	Province	In the first few years of launch	After trend normalises	Birth rate before policy was implemented (per year)	Implied increase (%)
Jan-14	Zhejiang	100,000		554,000	18%
	Anhui	Not significant as policy was implemented in rural areas in 1984			
	Beijing	30,000 – 50,000		190,000	15-26%
Mar-14	Jiangsu	110,000-180,000		700,000	15-26%
	Shanghai	10,000-20,000	80,000	200,000	5-10%
	Chongqing	70,000		318,7000	20-22%
	Hainan	3,000		129,000	2-3%
	Guangxi	n.a.		740,000	n.a.
Apr-14	Hubei	40,000-80,000		630,000	6-12%
Jun-14	Hebei	200,000		1,000,000	20%
	Shandong	250,000		1,140,000	22%
1H14	Qinhai	Not significant			n.m.
	Tianjin	Not significant		121,100	n.m.
	Hunan	270,000 potential mothers as of 2013		900,000	n.a.
	Henan	50,000-80,000		1,250,000	6-7%
	Shandong	200,000			20%
	Sichuan	1,280,000 potential mothers		797,300	n.a.
	Shanxi	25,000-29,000		385,300	6-7%
	Guizhou	n.a.			n.a.
2014	Guangdong	100,000-130,000 (2011 estimates)		1,300, 000	7-10%
	Shenzhen	25,000 over 3 years		61,000	13-14%
	Shaanxi	40,000		400,000	10%

Source: Population and Family Planning Commission of different provinces
Note: Provinces for which data is not available: Inner Mongolia, Fujian, Jilin, Liaoning and Heilongjiang

Valuation and recommendations

We have a Buy rating on CMD, which is our top sector pick. We prefer Huishan to Mengniu, as Huishan has more exposure to the upstream business.

Upstream players are likely to be rerated

The China dairy farms are trading at average PERs of 10.2x for 2014E and 7.7x for 2015E, versus 29x and 25x for the downstream Chinese dairy players, respectively (based on the Bloomberg-consensus forecasts). They are also trading at a significant discounts to other China F&B players (as they do not have a strong and national consumer brand), which are trading at average PERs of 27x for 2014E and 22x for 2015E PER (also based on the Bloomberg forecasts).

We expect the upstream players to be rerated over the next 3 years on the back of their continuous and consistent earnings-growth track records and improving balance sheets. We estimate that CMD's net gearing peaked at 72% for 2013 and expect it to slowly decline. We also expect its free cash flow to turn positive from 2015E. As the company's dairy cows continue to mature and produce more milk, we expect its ROE to improve from 9.2% for 2013 to 15.9% for 2014, 17.5% for 2015 and 18.3% for 2016.

Valuations of the downstream players look stretched

The valuations of the downstream players look stretched to us, in the face of growing competition and slowing market growth. For example, we forecast Mengniu's EPS growth to slow from 22% YoY for 2014 to 19% for 2015. The stock has been rerated from a 12-month forward PER of 20x to 30x over the past 12 months as investors have priced in its earnings-growth prospects from the large-scale M&A activities it undertook in 2013.

However, we see Mengniu's valuation as being increasingly unattractive, given that it is trading at the high-end of its 5-year 12-month forward PER range. We believe the stock would need to see a continuous improvement in its raw-material cost control and successful execution of more M&A transactions to be rerated further.

■ CMD versus Mengniu: 12-Month forward PER comparison

Source: Bloomberg

Valuation and recommendations

Upstream players

We value the dairy farms using a DCF methodology, as we believe this is the best way to value companies with capital-intensive operations but which also generate steady cash flow.

We have a Buy (1) rating for CMD, which is our top sector top pick, for its favourable upstream positioning. Our DCF-derived 6-month target price of HKD4.60 assumes a WACC of 9.6% and a terminal growth rate of 1%. It implies a 2014E PER of 18.8x and 2015E PER of 14.5x 2015E.

We have a Buy (1) rating for Huishan, given what we see as its fast earnings growth and cheap valuation, and a DCF-derived 6-month target price of HKD2.48. We assume a WACC of 11.5% and terminal growth rate of 1% to value its upstream business, which is equivalent to HKD2.32/share. We value its downstream business at a 12x FY15E PER (HKD0.16/share), which is at a 60% discount to its upstream peers to reflect its larger execution risk and current small market share base. Our target price implies PERs of 21.3x for FY14E and 15.5x for FY15E.

Downstream players

We value the downstream dairy business using a PER methodology, which we think is the most appropriate, as well as the most commonly used for a branded-consumer business.

We have a Hold (3) rating on Mengniu, given its pure downstream exposure and stretched-looking valuation, and a 6-month target price of HKD40.7, based on a 30x 2014E PER. We have calculated our target price by applying a 12% premium (a slightly higher earnings growth rate to the sector average) to the average PERs of the major China food and beverage companies, as we expect Mengniu to see faster EPS growth of 22% YoY for 2014E versus the average of its peers' of 10% YoY .

■ China Dairy Sector: our ratings and target prices

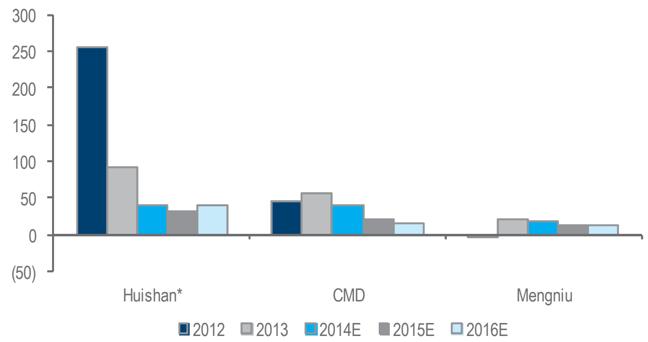
				Implied PER (x)		EPS growth (% YOY)	
Company		Rating	Target price (HKD)	2014E	2015E	2014E	2015E
CMD	1117.HK	Buy (1)	4.6	18.8	14.5	97	30
Huishan*	6863.HK	Buy (1)	2.48	15.5	11.3	21	38
Mengniu	2319.HK	Hold (3)	39.4	30.0	25.2	22	19

Source: Daiwa forecasts
**FY15, FY16E PER and EPS growth used as at fiscal year of 31 March*

Earnings-growth forecasts

Based on our market research, we believe dairy farms are seeing fast earnings growth, driven by both ASP hikes and volume increases. We forecast ASP growth of 5-10% YoY for the 2 dairy farms under our coverage for 2014E, representing a 22-33% sales CAGR over 2013-16E. We forecast slower revenue growth for Mengniu (2013-16E revenue CAGR: 14%) on sluggish market-share gains.

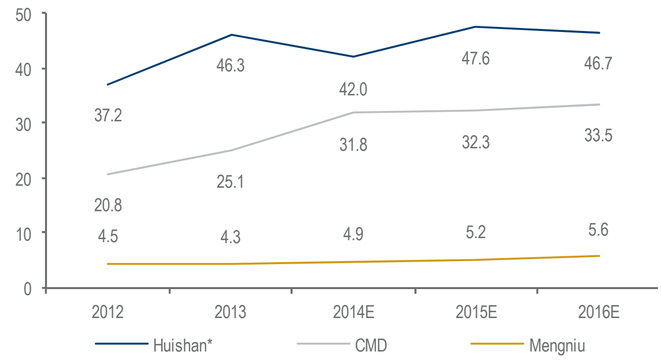
■ China Dairy Sector: revenue growth rates (YoY%)



Source: Company, Daiwa forecasts
*Note: *FY12-16E data (year-ended 31 March)*

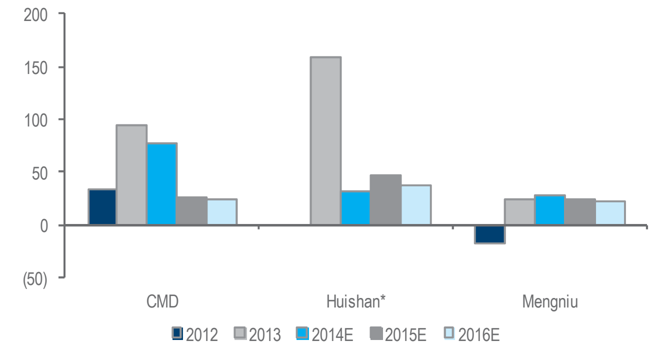
Large-scale dairy farms enjoy higher operating margins than the downstream companies due to: 1) the ongoing scarcity of quality raw milk, which gives the upstream players better pricing power, 2) high entry barriers in terms of the technology needed and the availability of high-yielding cows, and 3) less of a need for advertising and promotional expenses. The dairy farms' higher net margins are also attributable to their tax-free status.

■ China Dairy Sector: operating margin (%)



Source: Company, Daiwa forecasts
*Note:; *FY12-16E data (year-ended 31 March)*

■ China Dairy Sector: recurring net profit growth rate (YoY %)



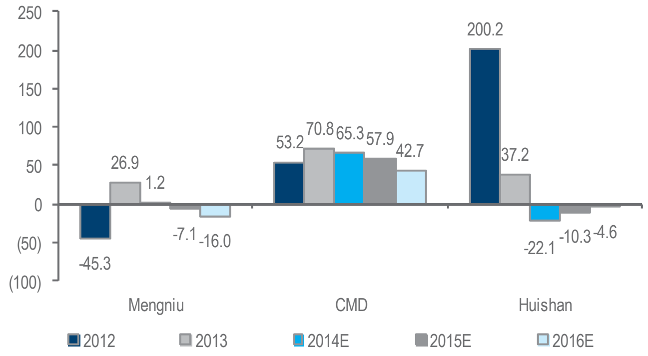
Source: Company, Daiwa forecasts
*Note: *FY12-16 data (year-ended 31 March)*

Balance-sheet analysis

The upstream companies have more capital-intensive operations than do the downstream companies, as the large-scale dairy farms have long investment periods and require more capex. But as the operating cash flow increases substantially after a farm has been operating for more than 3 years (as milk yields pick up), we expect the net gearing of the dairy farms to improve substantially on the increasing cash flow generated.

Compared with CMD, Huishan's net gearing is lower, as it has just raised HKD7bn in proceeds from its IPO in 2013. However, we expect its net gearing to increase gradually as it is still targeting fast capacity expansion.

■ China Dairy Sector: net debt (net cash)/ equity ratio (%)



Source: Company, Daiwa forecasts
*Note: *FY12-16 data (year-ended 31 March)*

Sensitivity analysis: upside to our earnings estimates

In conclusion, we would see upside potential to our 2014-16 earnings forecasts for the upstream companies in China if the price of raw milk were to rise further. We estimate a 1% increase in raw-milk prices would lead to a 5.3% increase in CMD's 2014 net profit, and a 0.7% rise for Huishan in FY14.

On the other hand, a 1% raw-milk price increase would lead to slight margin pressure for Mengniu, as raw milk accounts for about 50% of the COGS for its UHT milk products.

■ CDM: earnings sensitivity analysis

		Impact of change			
		Operating margin (%)		Cash profit (CNYm)	
	Change	2014E	2015E	2014E	2015E
Base case		31.8	32.3	1,074	1,348
		+/- pp		+/- %	
Milk yield	+0.1tonne/year	0.83	0.92	5.0	5.4
Unit feed cost	- 1%	0.48	0.48	2.0	1.9
Raw milk ASP	+ 1%	0.68	0.67	4.1	3.9
Number of milking cows	+ 1%	0.06	0.05	1.3	1.1

Source: Daiwa estimates

■ Huishan: earnings sensitivity analysis

		Impact of change					
		Operating margin (%)			Cash profit (CNYm)		
	Change	FY14E	FY15E	FY16E	FY14E	FY15E	FY16E
Base case		42.0	47.6	46.7	1,309	1,922	2,628
		+/- pp			+/- %		
Milk yield	+0.1tonne/year	0.36	0.75	0.55	2.0	3.7	2.7
Unit feed cost	- 1%	0.15	0.29	0.30	0.4	0.7	0.8
Raw milk ASP	+ 1%	0.14	0.12	0.11	0.7	0.6	0.6
Processed milk ASP	+ 1%	0.31	0.29	0.28	1.3	1.2	1.2
Number of milking cows	+ 1%	n.a.	0.34	0.3	n.a.	2.2	2.1

Source: Daiwa estimates

■ Mengniu: earnings sensitivity analysis

	2014E	2015E
1. ASP (assuming stable costs) +1%		
(A) Liquid milk	*13.8%*	*12.1%*
(1) UHT	*7.7%*	*6.5%*
(2) Milk beverages	*4.1%*	*3.8%*
(3) Yoghurt	*2.0%*	*1.8%*
(B) Ice cream	*1.0%*	*0.8%*
(C) Other dairy products	*0.1%*	*0.1%*
2. Costs (assuming stable price) +1%		
Raw milk	*-6.7%*	*-5.8%*
Packaging	*-2.5%*	*-2.1%*
A&P	*-1.5%*	*-1.4%*

Source: Daiwa estimates

■ China: downstream peers' valuation comparison:

	Bloomberg			Mkt.Cap.	Price	Stock Δ %		PER (x)				EPS growth(%)				EV/EBITDA (x)		Revenue YoY %			EBIT margin (%)		
Name	**Code**	**Rating**	**CRY**	**USDm**	**4/30/14**	**3M**	**1M**	***FY13***	***14E***	***15E***	***16E***	***FY13***	***14E***	***15E***	***16E***	***FY14***	***FY15E***	***FY13***	***14E***	***15E***	***FY13***	***14E***	***15E***
Mengniu Dairy*	2319 HK	Hold	HKD	9,980	39.85	11	1	35.3	29.4	24.7	20.2	14	22	19	23	16.1	13.5	20	19	11	4.3	4.9	5.2
Want Want China	151 HK	NR	HKD	20,597	12.16	16	2	30.0	26.4	22.6	19.5	24	13	17	16	17.8	15.1	14	17	16	21.2	22.2	22.7
Tingyi	322 HK	NR	HKD	15,462	21.55	7	-5	37.8	28.8	24.0	20.6	-11	32	20	17	12.1	10.4	19	12	13	6.1	7.5	8.2
Tsingtao Brewery	168 HK	NR	HKD	9,174	56.45	-1	-1	30.8	26.9	22.7	n.a.	12	15	18	1	14.5	12.5	11	25	13	7.2	8.5	9.2
CRE	291 HK	NR	HKD	6,795	22.05	-5	0	27.9	27.7	23.5	20.3	-52	1	18	15	7.8	6.8	16	15	15	3.0	3.0	3.1
Huiyuan	1886 HK	NR	HKD	1,303	5.08	15	-11	30.0	21.6	16.2	12.9	n.a.	n.a.	34	25	11.1	9.0	13	31	26	(1.8)	12.4	13.0
Uni-President China	220 HK	NR	HKD	2,963	6.42	-9	-5	20.1	26.2	22.0	19.7	7	-23	19	12	11.8	9.9	9	12	13	1.9	2.7	3.0
Average (ex-Mengniu):								**30.3**	**26.7**	**22.2**	**18.9**	***(1)***	***10***	***21***	***16***	**13.0**	**11.0**	***15***	***19***	***15***	**6.0**	**8.7**	**9.2**

*Source: Bloomberg, * denotes Daiwa forecasts*

■ A-share peers' valuation comparison

	Bloomberg			Mkt.Cap.	Price	Stock Δ %		PER (x)				EPS Growth				EV/EBITDA (x)		Revenue YoY %			EBIT margin		
Name	**Code**	**Rating**	**CRY**	**USDm**	**4/30/14**	**3M**	**1M**	***FY13***	***14E***	***15E***	***16E***	***FY13***	***14E***	***15E***	***16E***	***FY14E***	***FY15E***	***FY13***	***14E***	***15E***	***FY13***	***14E***	***15E***
Yili Industrial	600887 CH	NR	CNY	12,204	37.10	5	2	21.0	16.9	13.5	n.a.	54	7	24	25	14.3	11.5	14	14	13	5.3	7.6	8.6
Bright Dairy	600597 CH	NR	CNY	3,624	18.38	4	15	55.7	33.5	23.7	19.6	18	66	41	21	n.a.	n.a.	18	22	20	4.2	4.6	5.5
Beijing Sanyuan Food	600429 CH	NR	CNY	1,066	7.48	4	-9	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	7	n.a.	n.a.	(5.9)	n.a.	n.a.
Average:								**38.3**	**25.2**	**18.6**	**19.6**	***36***	***37***	***33***	***23***	**14.3**	**11.5**	***16***	***18***	***17***	**4.8**	**6.1**	**7.1**

Source: Bloomberg

■ China upstream peers' valuation comparison

	Bloomberg			Mkt.Cap.	Price	Stock Δ %		PER (x)				EPS Growth				EV/EBITDA (x)		Revenue YoY %			EBIT margin		
Name	**Code**	**Rating**	**CRY**	**USDm**	**4/30/14**	**3M**	**1M**	***FY13***	***14E***	***15E***	***16E***	***FY13***	***14E***	***15E***	***16E***	***FY14E***	***FY15E***	***FY13***	***14E***	***15E***	***FY13***	***14E***	***15E***
CMD*	1117 HK	Buy	HKD	2,055	3.32	-8	-8	25.5	13.1	10.1	8.1	23	97	30	25	11.0	9.2	62	34	20	25.1	31.8	32.3
Huishan Dairy*	6863 HK	Buy	HKD	3,270	1.76	-32	-21	14.6	10.6	7.8	n.a.	106	21	38	37	10.9	7.8	92	40	33	46.0	42.0	48.0
Yuanshengtai Dairy Farm	1431 HK	NR	HKD	646	1.29	-32	-2	9.3	6.9	5.1	4.4	n.a.	35	34	17	7.4	5.5	28	37	31	27.0	39.8	40.2
Average:								**16.5**	**10.2**	**7.7**	**6.2**	***65***	***51***	***34***	***26***	**9.8**	**7.5**	***60***	***37***	***28***	***32.7***	**37.9**	**40.2**

*Source: Bloomberg, * denotes Daiwa forecasts.*
Note: For Huishan, FY13-16E PERs is used as its year- end, which is 31 March

Risks

Food safety, commodity prices and adverse government policy changes are the key investment risks for the sector.

Food-safety scandal

The main risk to our positive sector call is the ever-present possibility that another food-related scandal will erupt in China. While food-safety issues have been a continuous systematic risk to the country's food and beverage industry, the dairy sector is exposed to a relatively higher raw-material risk due to the very nature of the industry – the upstream segment is fragmented, and the short shelf-life of raw milk and some selected products.

Although there is now a lot more control over product and raw-material quality since the melamine scandal hit the industry in 2008 (through more checks and severe punishments), there are still occasional media reports on food-quality issues.

There are 2 major risks associated with food safety: 1) the intentional addition of unsafe additives to increase the protein content or to pass various parameter checks, and 2) accidents that happen during feed procurement, collection, treatment, production, storage, etc. the contamination of products or health issues relating to the products may lead to product-liability claims, brand damage and regulatory action.

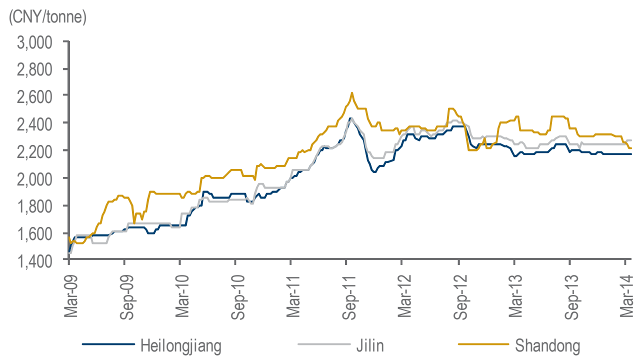
Outbreak of bovine diseases

An outbreak of a bovine disease in a single dairy farm could affect the raw-milk output or even lead to a shutdown of that farm, affecting its profit/return as well as the operations of its customers. A large-scale outbreak of such a disease in China could result in a short-term drop in the demand for dairy products. An outbreak of a serious bovine disease overseas (eg, bovine tuberculosis) could result in a shortage of heifers available for import into China.

Increasing production costs

Production costs of dairy goods are highly correlated to agricultural input prices, including grains (corn, wheat and more) and raw milk (input for the downstream segments). Due to the increasing demand for agricultural products worldwide currently, the price of grains and raw milk has increased continuously, as shown in the following chart. We expect these input costs to continue to increase mildly in the long term due to the Chinese Government's intention to raise farmers' incomes, leading to an increase in the purchase price of food (3-5% per year on average). But if costs increase faster than we expect, these cost hikes may not be fully offset by ASP increases and product-mix upgrades.

■ **Cost of corn (a major feed grain) in the 3 major corn-producing provinces in China**



Source: Bloomberg

■ **Global cost of whey powder (a key raw material for infant milk powder)**

Source: USDA

Competition from imported and foreign brands

For basic liquid milk and milk powder products, we believe there is little differentiation in terms of product quality and taste among the different brands. Milk beverages and high-end dairy products are better positioned, as new products and flavours can help differentiate them from competitors. However, this also implies continuous investment in marketing, promotion and product development.

Moreover, there are new rivals in the industry, such as Coca-Cola, which are able to leverage their strong distribution networks and capital established in other

F&B segments. We expect the industry's competitive landscape to continue to intensify and believe the profit-margin upside for the downstream segment is limited.

Regulatory and policy changes

More stringent and stricter regulatory changes in China are a double-edged sword for dairy manufacturers. We believe the major risks they are facing include: 1) changes in the list of food additives allowed in dairy products, which may require producers to change their recipes frequently, 2) a change to currently favourable policies (such as subsidies), particularly for the upstream segment, and 3) changes in environmental-protection laws as well as quality or nutrient requirements, which would force the industry leaders (who are able to afford such upgrades) to upgrade their facilities. Having to upgrade facilities could also incur extra investment and maintenance costs.

Appendix: industry landscape

■ **Summary of our investment thesis**

	Dairy farming	Dairy product manufacturing	Infant-milk powder manufacturing
Long-term theme	Rapid consolidation	Competiting for sources of raw milk	Domestic players taking on international rivals
Key earnings drivers	1) Milk yield improvement 2) Premium pricing 3) Vertical integration	1) Product-mix upgrades and diversification	1) Premiumisation trend 2) Stable raw-milk costs
Favourable factors	1) Strong demand for quality milk 2) Stable orders from the main downstream players	Sub-standard players are being forced out of the market	1) Preference for good brands 2) Relaxation of the 1-child policy
Unfavourable factors	1) Competition for quality farmland 2) Reliance on imported feed	International rivals in the dairy drinks segment	1) Intense competition from leading international players 2) High A&P expenditure needed to maintain a nationwide presence

Our preferred segment

Source: Daiwa

■ China Dairy Sector: summary of the value chain

	(1) Upstream	(2) Downstream			
	(A) Raw milk	(B) Liquid milk/milk beverages	(C) Infant milk powder	(D) Other milk powder *(eg, adult, functional)*	(E) Other milk products *(eg, ice-cream, cheese)*
Market size (2013)					
- Value (CNYbn)	~130	~190^	Retail sales value: 45-50^	Retail sales value: ~10-15^	N/A
- Production Vol. (million tonnes)	35.31	23	Retail sales volume: 0.55#	Retail sales volume: 0.3***	N/A
	Number of milking cows: 12m*				
Volume growth YoY (2013)	-5.7%	6.4%	~15%#	13%#	N/A
Market structure	**Highly fragmented:-**	**Consolidated:-**	**Fragmented:-**	**Fragmented:-**	**Consolidated:-**
	Represented by small-scale farms (herd size < 100 cows: ~65% of market)	*Dominated by a few domestic and national players; some regional players in China's lower-tier cities*	*Well-established international brands vs. up-and-coming domestic brands*	*No clear industry leader in this underpenetrated segment in China*	
			Domestic brands are usually regional players		
- Top-4's total market share	~4%	70%^ (UHT Milk: 80%)	40%	N/A	
- Largest player	CMD	Mengniu	Wyeth Nutrition	Nestle	
Entry barriers	(1) Large initial capital (2) Long return period (3) Know-how/experience of breeding and farm management (4) has high milk-yield cows (5) Short plant-to-market distance	(1) Brand awareness (2) Distribution network (3) The availability of a safe and abundant raw milk supply (4) Policy entry barriers in terms of scale, hygiene and other regulatory requirements			
Import/domestic supply (%)	Primarily domestic	Primarily domestic	>50% import (by milk source)	N/A	N/A
Key players (market share)^ (2013)	CMD (1.6%)^^	Mengniu (28.1%) - (UHT)^	**International ^:** Wyeth (12.2%), Mead Johnson (12.1%), Dumex (7.5%),	**International:** Nestle, Anlene	
	Huishan (0.9%)	Yili Industrial (26.8%) - (UHT)	**Domestic^:** Beingmate (8.6%), Yili Industrial (6.2%), Biostime (7.4%), Yashili (4.5%)	**Domestic:** Yili Industrial, Wondersun	
	Beijing Sanyuan Luhe Dairy (0.7%)	Bright Dairy (15.4%) - (UHT)			
	Shengmu (0.5%)	Sanyuan (7.2%) - (UHT)			
Key catalysts	(1) Vertical integration (2) Increasing demand for quality raw milk	(1) Launch of premium/new products (yoghurt drinks, high-value products) (2) Increasing consumption level	(1) Demand for quality and safe products (2) Launching products with high ASPs	(1) Aging population (2) Increasing government spending on healthcare	(1) Revenue growing from a low base (2) New product launches
	(3) Improving production technology				
	(4) Supportive government policies for large-scale dairy farms				
	(5) Cost reductions - lowered to international levels				
Key risks	(1) Cow diseases (2) Rising feed costs (3) Product contamination/quality deterioration during transportation	(1) Increasing A&P and other costs (2) Rising raw-milk costs (3) Food safety hazards (4) Slowdown in industry revenue growth	(1) Competition from imported substitutes (2) Food-safety hazards (3) Impact of unfavourable media reports (4) Lack of product and brand differentiation	(1) Competition from other healthcare products (eg, calcium tablets, DHA capsules)	(1) Food-safety hazards (2) Relatively small market size
Key cost items	(1) Feed	(1) Raw milk	(1) Raw milk/ milk powder	(1) Raw milk/milk powder	(1) Raw milk/ milk powder
	(2) Imported calves	(2) Packaging	(2) Packaging	(2) Packaging	(2) Sugar, (3) Packaging

Source: Daiwa, ACNielsen, Frost and Sullivan, CEIC, Statistics Bureau of China
*Notes: ^ denotes AC Nielsen, # denotes Daiwa estimates, *denotes Statistics Bureau of China, ^^denotes Frost and Sullivan, *** denotes CEIC*

■ China Dairy Sector: summary of the value chain

	Upstream		Hybrid	Downstream			
Products	Raw milk		Liquid milk / milk beverages				
Company	CMD	Yuanshengai Dairy Farm	Huishan	Mengniu	Yili Industrial	Bright Dairy	Want Want
Chinese name	現代牧業	原生態	輝山	蒙牛乳業	伊利	光明乳業	旺旺
Key brand logo							
Market data							
Stock code	1117 HK	1431 HK	6863 HK	2319 HK	600887 CH	600597 CH	151 HK
Rating	Buy	Not rated	Buy	Hold	Not rated	Not rated	Not rated
Market cap. (USDm) as of 28 April 2014	2,247	661	3,380	9,811	11,313	3,307	20,530
Strategic shareholders and partners	Mengniu	Mengniu, OCBC, Ares	Chow Tai Fook, Yili Industrial, Investec	Arla, Danone	N/A	N/A	Iwatsuka (2221.JP)
Auditor	Deloitte	Ernst & Young	KPMG	Ernst & Young	BDO	Deloitte	PWC
Company background							
Year established	2005	2008	2002	1999	1993	1952	1994
Key brands	Modern Farm	n.a.	Huishan, Jiexi, Queen	Mengniu, Telunsu, Future Star, Yashili, Junlebao	Yili Industrial, Jindian, Shuhua, QQ, Grain More	Bright, Mosilian	Want Want, Lonely God, Puppy etc
Market share in China (%)		***By herd size^***			**Liquid milk***		**Dairy beverages^^**
	~1.6	<0.5	~0.9	25.4	23.0	11.5	~40
		Liquid milk^			***Yoghurt****		***Rice crackers^^***
	n.a.	n.a.	~13.7% (North Eastern China)	19.4+7.1(Junlebao)	18.9	13.4	~70%
Operation statistics	2013A	2013A	(FY14E data)	2013A	2013E	2013A	2013A
Revenue (CNYm)	3,276	881	3,576	43,357	47,474	16,291	23,479
Net profit (CNYm)	606	300	1,309	1,631	2,886	475	4,223
Gross margin (%)	27.0	42.6	58.4	27.0	29.5	34.2	41.5
EBIT margin (%)	22.1	35.8	42.4	4.3	n.a.	4.2	
Net margin (%)	18.0	34.1	36.6	3.8	6.1	2.9	17.9
SG&A ratio (%)	4.4	6.7	16.4	22.5	23.4	30.0	20.5
A&P ratio (%)	n.a.	n..a	6	6.3	2012A: 8.9	17.1	3.0
ROE (%)	8.8	11.9	13.3	11.7	21.4	11.0	38.6
Net debt/equity (%)		76	net cash	net cash	27	net cash	net cash
Revenue breakdown (%) – 2012			(FY13 data)	(Including Yashilil)	77.2		
(1) Raw and pure milk	Raw milk: 90	Raw milk: 100	Raw/UHT: ~27/28	51		63	n.a.
(2) Milk beverage/yoghurt	N/A	N/A	38	37		27	50.9
(3) Milk powder	N/A	N/A	3	5	10.7	6	n.a.
(4) Ice-cream	N/A	N/A	0	6	10.8	N/A	n.a.
(5) Others	N/A	N/A	4	1	<1	4	49
Revenue growth (%, YoY)							
FY13	*55*	*28*	*29*	*20*	*14*	*18*	*14*
FY12	*45*	*363*	*144*	*24*	*12*	*19*	*14*
FY11	*78*	*4405x*	*192*	*18*	*22*	*21*	*31*
Net-profit growth (%, YoY)							
FY13	*94*	*45*	*30*	*23*	*68*	*28*	*23*
FY12	*33*	*11*	*158*	*(21)*	*29*	*18*	*33*
FY11	*293*	*22x*	*10.6x*	*28*	*20*	*18*	*16*

Source: Company, Daiwa, Bloomberg consensus for the financials for Yuanshengtai Dairy Farm, Bright Dairy and Yili Industrial
Note: For Huishan we use FY14E data instead of 2013E data as its fiscal year ends on 31 March.
** denotes AC Nielsen 2013 data, ^^ denotes AC Nielsen 2010 data, ^denotes Frost and Sullivan 2012 data*

The 10-second briefing

China Modern Dairy Holdings
1117 HK

Target (HKD): **4.60**
Upside: **38.6%**
30 Apr price (HKD): **3.32**

Initiation: cash cow

- Mature milk cow herd and ties with Mengniu should underpin strong sales-volume CAGR of 18% for 2013-16E
- Milk scarcity and scale advantages should drive operating-margin expansion and a stock rerating
- Expect 47% EPS CAGR for 2013-16E; top sector pick, initiating with Buy rating and DCF-based target price of HKD4.60

1 Buy (initiation)
2 Outperform
3 Hold
4 Underperform
5 Sell

How do we justify our view?

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■ Investment case

China Modern Dairy Holdings (CMD) is the top pick in our China dairy universe and we initiate coverage with a Buy (1) rating. CMD is the largest dairy-farm operator in China, with about 187,000 dairy cows as at 31 December 2013.

High sales-volume visibility. CMD is China Mengniu Dairy's (Mengniu) largest supplier of raw milk (about 15% of its needs in 2013, on our estimates). Based on its contract with Mengniu, CMD must sell at least 70% of its raw milk to Mengniu each year before 2018, and the rest to other clients (5-10% higher ASP vs. milk sold to Mengniu).

Now in a harvesting period. CMD has entered a harvesting period after its heavy investment since its IPO (2010). We project the number of milking cows to reach 60% of its total herd by 2016 (up from 53% in 2013), driving a milk-yield improvement to 8.7 tonnes/cow for 2014E and 8.9 tonnes/cow for 2015E (vs. 8.5 in 2H13). We expect its FCF to turn positive from 2015E on reduced capex needs after it stops having to import dairy cows.

How we are different. Our 2014-15E EPS are 9-12% above the Bloomberg consensus, as we expect the scarcity of quality raw milk in China to persist over the next 3 years, keeping the price of milk high.

■ Catalysts

Upside to our earnings forecasts could come from: 1) a rise in the price of milk, with an extra 1% rise in the price vs. our current forecasts, implying 4% and 5% net-profit upside for 2014E and 2015E, and 2) declining alfalfa (feed) costs from Qiushi (an 18%-owned associate) when Qiushi gains economies of scale. Also, CMD's dairy expansion plan beyond 2015 and diversification into new high-end products (eg, pasteurised milk) could be earnings and share-price catalysts.

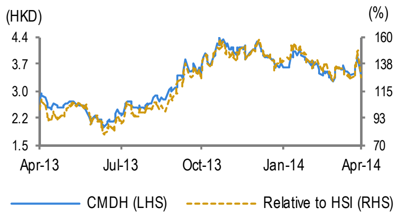
■ Valuation

Our DCF-derived 6-month target price of HKD4.60 (assuming a 9.6% WACC and a 1% long-term growth rate), implies 39% upside potential.

■ Risks

We see the main risks to our call as bovine diseases, CMD's high customer concentration in Mengniu, and share disposals by CMD's founding shareholders.

Share price performance



12-month range	1.99-4.39
Market cap (USDbn)	2.06
3m avg daily turnover (USDm)	9.10
Shares outstanding (m)	4,821
Major shareholder	Mengniu (28.0%)

Financial summary (CNY)

Year to 31 Dec	14E	15E	16E
Revenue (m)	4,410	5,287	6,042
Operating profit (m)	1,404	1,705	2,027
Net profit (m)	994	1,288	1,612
Core EPS (fully-diluted)	0.204	0.264	0.331
EPS change (%)	96.8	29.6	25.2
Daiwa vs Cons. EPS (%)	11.5	9.2	8.5
PER (x)	13.1	10.1	8.1
Dividend yield (%)	0.0	0.0	0.0
DPS	0.000	0.000	0.000
PBR (x)	1.9	1.6	1.3
EV/EBITDA (x)	11.0	9.2	7.6
ROE (%)	15.9	17.5	18.3

Source: FactSet, Daiwa forecasts

1 Buy (initiation)
2 Outperform
3 Hold
4 Underperform
5 Sell

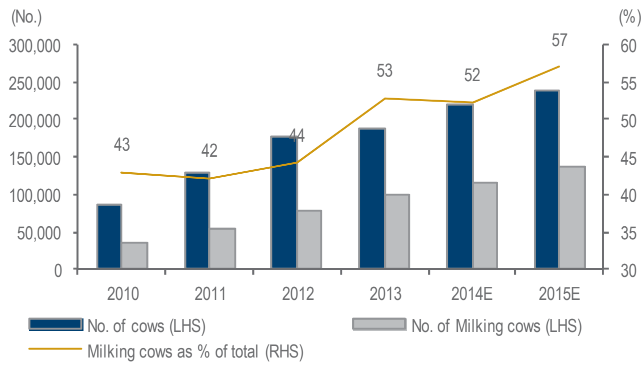
How do we justify our view?

- Growth outlook ✔✔✔✔✔
- Valuation ✔✔✔✔✔
- Earnings revisions ✔✔✔✔✔

Growth outlook ✔✔✔✔✔

We forecast a 47% EPS CAGR on an 18% sales-volume CAGR for CMD over 2013-16, driven primarily by 3 factors. 1) We forecast the company's milk yield to improve gradually from 8.5 tonnes/cow in 2013 to 8.7 tonnes/cow in 2014, 8.9 tonnes/cow in 2015 and 9.1 tonnes/cow in 2016, as we expect the number of mature cows to account for about 60% of its total herd by 2016 (vs. 53% in 2013). 2) We forecast its herd size to increase at a 9% CAGR to 252,000 cows by 2016. 3) We project operating-margin improvements of 6.7pp YoY in 2014, 0.5.pp YoY in 2015, and 1.2pp YoY in 2016, thanks to efficient feed-cost control and operating leverage.

CMD: number of milking cows and as % of total herd



Source: Company, Daiwa forecasts

Valuation ✔✔✔✔✔

CMD is trading currently at a PER of 13.1x for 2014E, compared to China Huishan Dairy Holdings (Huishan) (6863 HK, HKD1.76, Buy [1]) on 10.6x for its fiscal year ending March 2015 (both on our EPS forecasts) and Yuanshengtai (Not rated) of 6.9x (on the Bloomberg consensus forecast). Yet we believe CMD's execution risk for expansion is lower compared with Huishan. Bearing in mind the EPS CAGR of 47% for CMD for 2013-16E, our DCF-derived 6-month target price of HKD4.60 implies a 18.8x 2014E PER and a 0.4x PEG, which looks attractive compared with the current trading PERs of downstream dairy companies shown in the opposite table.

CMD: valuation comparison alongside China upstream and downstream peers

Company	Bloomberg Code	Rating	Mkt.cap. USDm	Share price 30-Apr-14	PER (x) 2014E	15E	16E
Upstream - Dairy Farm Operators							
China Modern Dairy*	1117 HK	Buy	2,055	3.32	13.1	10.1	8.1
Huishan Dairy*	6863 HK	Buy	3,270	1.83	14.6	10.6	7.8
Yuanshengtai Dairy	1431 HK	NR	646	1.29	6.9	5.1	4.4
Average (ex-CMD)					**10.7**	**7.9**	**6.1**
Liquid Milk/Dairy Products							
Mengniu Dairy*	2319 HK	Hold	9,980	39.85	29.4	24.7	20.2
Want Want China	151 HK	NR	20,530	12.12	26.4	22.6	19.5
Yili Industries	600887 CH	NR	11,313	34.39	21.0	16.9	13.5
Bright Dairy	600597 CH	NR	3,307	16.77	33.5	23.7	19.6
Average - Downstream companies:					**27.6**	**22.0**	**18.2**

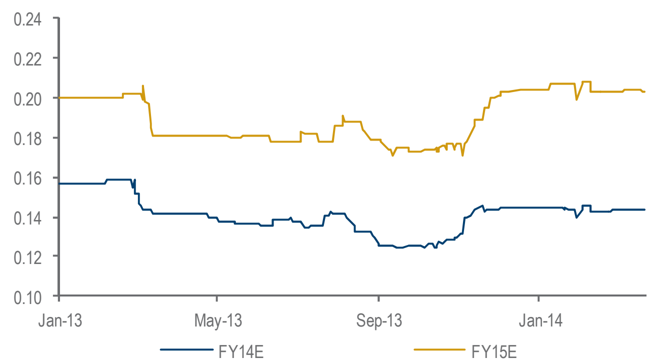
Source: Bloomberg,
** Daiwa estimates. For Huishan Dairy, FY14-16E PER are used as its year end is on 31 March.*

Earnings revisions ✔✔✔✔✔

The Bloomberg consensus recently restated its earnings forecasts for CMD to 31 December. This is to factor in the changes the company made to bring it in line with its major shareholder Mengniu.

The consensus has been raising its EPS forecasts for CMD for FY14-15 since 3Q13, as the company has been reporting fast earnings growth and increasing ASPs. We see upside potential to the consensus forecasts for the same period, on the back of further increases in the price of raw milk and an improving milk yield at CMD.

Change of consensus EPS estimates (for 12 months ended 30 June)



Source: Bloomberg forec asts
Note: the consensus changed the year-end for CMD a couple of weeks ago and only for its latest EPS forecasts. As such, to see the consensus trend for what was FY14-15 (now 2014-15), we take the fiscal year-end numbers previously published

Financial summary

■ Key assumptions

Year to 31 Dec	2009	2010	2011	2012	2013	2014E	2015E	2016E
Milk Yield	n.a.	n.a.	7.8	8.0	8.5	8.7	8.9	9.1
Sales volume of raw milk	n.a.	201,958	366,656	496,979	678,762	855,542	1,007,043	1,129,382
Raw milk ASP	n.a.	3.9	3.8	4.1	4.8	5.1	5.3	5.4
Number of cows	n.a.	87,496	128,759	176,264	186,838	220,134	239,262	241,982

■ Profit and loss (CNYm)

Year to 31 Dec	2009	2010	2011	2012	2013	2014E	2015E	2016E
Raw milk	n.a.	782	1,384	1,971	2,968	3,832	4,564	5,175
Self-own brand	n.a.	0	7	64	321	578	723	867
Other Revenue	n.a.	0	0	0	0	0	0	0
Total Revenue	**n.a.**	**782**	**1,392**	**2,035**	**3,289**	**4,410**	**5,287**	**6,042**
Other income	n.a.	56	127	124	70	95	40	40
COGS	n.a.	(587)	(1,065)	(1,531)	(2,241)	(2,773)	(3,263)	(3,669)
SG&A	n.a.	(53)	(45)	(94)	(144)	(147)	(150)	(152)
Other op.expenses	n.a.	(58)	(78)	(111)	(150)	(182)	(210)	(234)
Operating profit	**n.a.**	**140**	**331**	**423**	**825**	**1,404**	**1,705**	**2,027**
Net-interest inc./(exp.)	n.a.	(47)	(60)	(101)	(208)	(303)	(329)	(327)
Assoc/forex/extraord./others	n.a.	62	50	105	(79)	(65)	(40)	(40)
Pre-tax profit	**n.a.**	**155**	**320**	**426**	**537**	**1,035**	**1,336**	**1,660**
Tax	n.a.	(0)	0	(3)	(11)	(20)	(20)	(20)
Min. int./pref. div./others	n.a.	(50)	(10)	(14)	(21)	(21)	(28)	(28)
Net profit (reported)	**n.a.**	**105**	**311**	**409**	**505**	**994**	**1,288**	**1,612**
Net profit (adjusted)	**n.a.**	**105**	**311**	**409**	**505**	**994**	**1,288**	**1,612**
EPS (reported)(CNY)	**n.a.**	**0.025**	**0.064**	**0.084**	**0.104**	**0.204**	**0.264**	**0.331**
EPS (adjusted)(CNY)	**n.a.**	**0.025**	**0.064**	**0.084**	**0.104**	**0.204**	**0.264**	**0.331**
EPS (adjusted fully-diluted)(CNY)	**n.a.**	**0.025**	**0.064**	**0.084**	**0.104**	**0.204**	**0.264**	**0.331**
DPS (CNY)	**n.a.**	**0.000**	**0.000**	**0.000**	**0.000**	**0.000**	**0.000**	**0.000**
EBIT	**n.a.**	**140**	**331**	**423**	**825**	**1,404**	**1,705**	**2,027**
EBITDA	**n.a.**	**198**	**409**	**533**	**974**	**1,586**	**1,915**	**2,261**

■ Cash flow (CNYm)

Year to 31 Dec	2009	2010	2011	2012	2013	2014E	2015E	2016E
Profit before tax	n.a.	155	320	426	537	1,035	1,336	1,660
Depreciation and amortisation	n.a.	67	95	135	150	182	210	234
Tax paid	n.a.	(0)	(0)	(8)	(11)	(20)	(20)	(20)
Change in working capital	n.a.	(3)	253	177	(441)	106	21	179
Other operational CF items	n.a.	(8)	(45)	131	288	368	369	367
Cash flow from operations	**n.a.**	**211**	**623**	**861**	**523**	**1,672**	**1,916**	**2,419**
Capex	n.a.	(1,498)	(2,258)	(2,271)	(1,960)	(1,702)	(1,757)	(1,473)
Net (acquisitions)/disposals	n.a.	(5)	(18)	(3)	(80)	(1)	0	0
Other investing CF items	n.a.	(5)	(4)	(3)	(2)	(1)	0	0
Cash flow from investing	**n.a.**	**(1,508)**	**(2,280)**	**(2,277)**	**(2,042)**	**(1,704)**	**(1,757)**	**(1,473)**
Change in debt	n.a.	(212)	680	1,104	1,641	540	111	(400)
Net share issues/(repurchases)	n.a.	2,876	0	0	0	0	0	0
Dividends paid	n.a.	0	0	0	0	0	0	0
Other financing CF items	n.a.	(953)	(137)	(44)	220	(320)	(419)	(417)
Cash flow from financing	**n.a.**	**1,711**	**544**	**1,061**	**1,861**	**220**	**(308)**	**(817)**
Forex effect/others	n.a.	0	0	0	0	0	0	0
Change in cash	**n.a.**	**414**	**(1,113)**	**(355)**	**341**	**187**	**(149)**	**130**
Free cash flow	n.a.	(1,287)	(1,635)	(1,410)	(1,438)	(30)	159	946

Source: FactSet, Daiwa forecasts

Financial summary continued ...

■ Balance sheet (CNYm)

As at 31 Dec	2009	2010	2011	2012	2013	2014E	2015E	2016E
Cash & short-term investment	n.a.	2,069	1,017	470	800	1,004	875	1,024
Inventory	n.a.	319	338	440	691	841	1,012	1,157
Accounts receivable	n.a.	132	211	283	545	599	659	725
Other current assets	n.a.	1	2	2	2	2	2	2
Total current assets	**n.a.**	**2,521**	**1,568**	**1,195**	**2,037**	**2,446**	**2,548**	**2,908**
Fixed assets	n.a.	1,924	2,660	3,583	4,033	4,451	4,741	4,707
Goodwill & intangibles	n.a.	310	310	310	310	310	310	310
Other non-current assets	n.a.	2,256	3,378	5,070	6,114	7,128	8,397	9,682
Total assets	**n.a.**	**7,011**	**7,916**	**10,159**	**12,494**	**14,334**	**15,996**	**17,608**
Short-term debt	n.a.	559	510	1,666	2,989	2,989	3,000	2,600
Accounts payable	n.a.	206	354	716	725	870	957	1,149
Other current liabilities	n.a.	316	397	706	769	934	1,099	1,298
Total current liabilities	**n.a.**	**1,081**	**1,261**	**3,089**	**4,483**	**4,793**	**5,057**	**5,047**
Long-term debt	n.a.	1,176	1,693	1,641	1,960	2,500	2,600	2,600
Other non-current liabilities	n.a.	188	73	100	190	176	176	176
Total liabilities	**n.a.**	**2,445**	**3,028**	**4,830**	**6,633**	**7,470**	**7,833**	**7,823**
Share capital	n.a.	415	413	415	415	415	415	415
Reserves/R.E./others	n.a.	4,096	4,415	4,822	5,328	6,323	7,611	9,223
Shareholders' equity	**n.a.**	**4,511**	**4,828**	**5,237**	**5,743**	**6,737**	**8,025**	**9,637**
Minority interests	n.a.	56	61	92	118	128	138	148
Total equity & liabilities	**n.a.**	**7,011**	**7,916**	**10,159**	**12,494**	**14,334**	**15,996**	**17,608**
EV	n.a.	12,643	14,155	15,824	17,095	17,441	17,691	17,152
Net debt/(cash)	**n.a.**	**(333)**	**1,186**	**2,837**	**4,149**	**4,485**	**4,725**	**4,176**
BVPS (CNY)	**n.a.**	**0.940**	**1.006**	**1.091**	**1.191**	**1.398**	**1.665**	**1.999**

■ Key ratios (%)

Year to 31 Dec	2009	2010	2011	2012	2013	2014E	2015E	2016E
Sales (YoY)	n.a.	n.a.	78.0	46.2	61.7	34.1	19.9	14.3
EBITDA (YoY)	n.a.	n.a.	106.8	30.4	82.7	62.8	20.8	18.1
Operating profit (YoY)	n.a.	n.a.	136.9	27.8	95.2	70.2	21.5	18.9
Net profit (YoY)	n.a.	n.a.	195.2	31.6	23.5	96.8	29.6	25.2
Core EPS (fully-diluted) (YoY)	n.a.	n.a.	151.6	31.6	22.9	96.8	29.6	25.2
Gross-profit margin	n.a.	24.9	23.5	24.7	31.9	37.1	38.3	39.3
EBITDA margin	n.a.	25.3	29.4	26.2	29.6	36.0	36.2	37.4
Operating-profit margin	n.a.	17.8	23.7	20.8	25.1	31.8	32.3	33.5
Net profit margin	n.a.	13.5	22.3	20.1	15.4	22.5	24.4	26.7
ROAE	n.a.	4.7	6.7	8.1	9.2	15.9	17.5	18.3
ROAA	n.a.	3.0	4.2	4.5	4.5	7.4	8.5	9.6
ROCE	n.a.	4.4	4.9	5.4	8.5	12.1	13.1	14.1
ROIC	n.a.	3.3	6.4	5.9	8.9	12.9	13.9	14.9
Net debt to equity	net cash	net cash	24.6	54.2	72.2	66.6	58.9	43.3
Effective tax rate	n.a.	0.0	0.0	0.8	2.0	1.9	1.5	1.2
Accounts receivable (days)	n.a.	30.8	44.9	44.3	45.9	47.3	43.4	41.8
Current ratio (x)	n.a.	2.3	1.2	0.4	0.5	0.5	0.5	0.6
Net interest cover (x)	n.a.	3.0	5.5	4.2	4.0	4.6	5.2	6.2
Net dividend payout	n.a.	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Free cash flow yield	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1.2	7.3

Source: FactSet, Daiwa forecasts

■ Company profile

China Modern Dairy (CMD) is the largest dairy-farm operator in China and the first in the country to operate large-scale dairy farms (herd size: 10,000 heads). More than 70% of its raw milk is sold to Mengniu, while the remainder is sold to regional milk-powder producers, and as fresh milk under CMD's own brand. A group of individual shareholders (including management) and Mengniu own 31% and 28% of CMD, respectively.

Initiation: cash cow

CMD is enjoying highly visible and fast earnings growth (CAGR of 47% for 2013-16E), driven by an increasing sales volume and more mature cows. Mengniu has undertaken to buy at least 70% of CMD's output before 2018.

High order-book visibility

CMD's fast sales volume growth is supported by Mengniu's huge demand for fresh milk. CMD has signed a 10-year sales contract with Mengniu, which has undertaken to buy at least 70% of CMD's milk between 2008 and 2018 – sales to Mengniu accounted for 85-98% of CMD's sales volume over the past 5 years. CMD cannot sell to Yili Industrial (not rated) or Bright Dairy (not rated), Mengniu's key national competitors. Such strong order-book visibility has significantly lowered CMD's expansion risk, in our view.

CMD builds dairy farms comprising 10,000 dairy cows close to Mengniu's production plants to ensure the safety and timely delivery of its milk, as shown in the following map. We note that there are still places in central China where CMD has not yet built a farm to supply Mengniu, which implies further room for expansion in the future.

■Location of Mengniu's milk-processing plants and CMD's farms (2013)

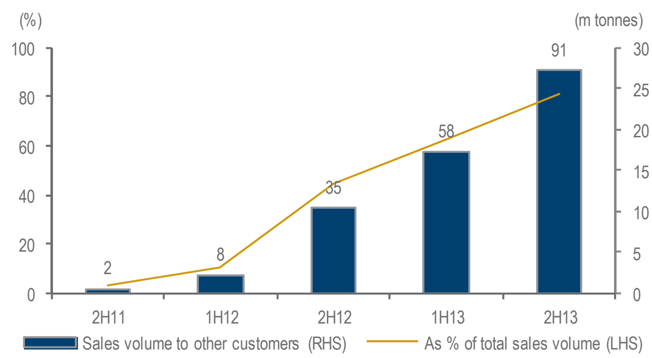
Source: Mengniu, CMD

More than a proxy for Mengniu's growth

We believe CMD's earnings growth for 2014-16E will be faster than Mengniu's, as we see a better net-profit margin for CMD, for the following reasons:

First, the price of raw milk has been on an uptrend since 2H09. Second, CMD's ASP premium over the market price is also expanding, due to CMD's better product quality (in terms of protein, fat, and process hygiene). We believe the increase in the premium is being supported by: 1) a scarcity of quality raw milk in China, 2) increasing transparency of pricing after Mengniu took up a 28% stake in CMD in May 2013, and 3) increasing sales to non-Mengniu customers, which carry a higher ASP (5-10%). Sales to customers other than Mengniu have increased rapidly, to about 24% of CMD's sales in 2H13, versus 1% in 2H11.

■ CMD: sales to non-Mengniu customers



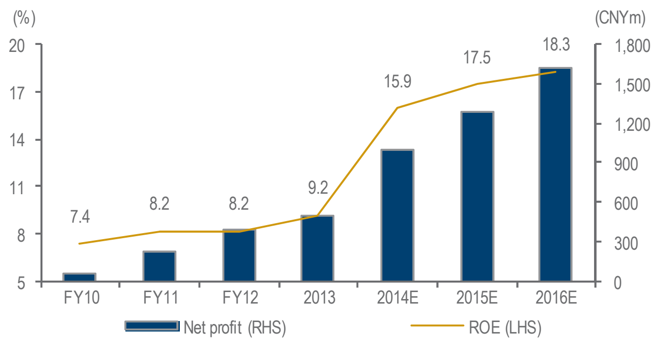
Source: Company

Entering a harvest period

We estimate that CMD has invested more than CNY6bn since 2008 to build 22 dairy farms in China. Each 10,000-dairy-cow farm requires capex of CNY300-350m. The company receives no cash income in the first 2 years of operation, before the cows give birth for the first time and start producing milk.

As more cows become milkable and the milk yield increases, the net profit starts to take off, and we see significant improvement in the ROE, rising from 6.7% for end-December 2012 on our estimates to 15.9% for 2014E and 17.5% for 2015E. (The company changed its financial year-end to 31 December from 30 June at the end of 2013 to bring it in line with Mengniu, its major shareholder.)

■ CMD: net profit and ROE

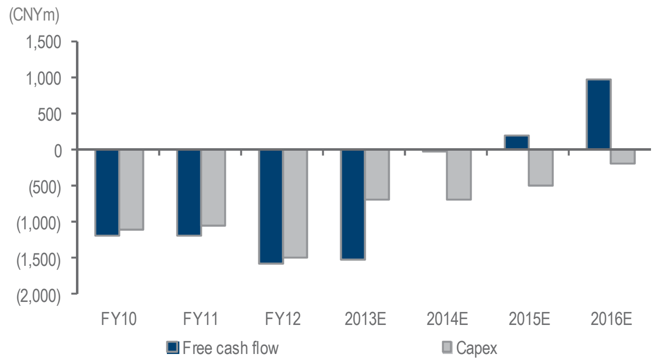


Source: Company, Daiwa
Note: FY10-12 are years ended 30 June (before the company changed its year-end to 31 December)

Moreover, CMD used to import 10,000-20,000 dairy cows a year but stopped in 2013, after reaching a critical herd size of about 187,000 dairy cows in December 2013. We estimate that such a herd size could generate more than 30,000 heifers (young cows that have not yet given birth) a year, which would be sufficient to operate 3 new dairy farms a year as well as an improving the milk yield because the farm would have enough cows to cull.

We expect CMD to import 10,000 dairy cows from New Zealand in 2014E, after which we think it will stop importing cows as it should have a sufficient number. As a result, we expect the company to cut its annual capex significantly, to less than CNY700m a year for 2014 and 2015 (excluding feed costs for heifers which the China companies book as capex until the heifers give birth, usually in their third year), and that the free cash flow will turn positive from 2015.

■ CMD: free cash flow and capex



Source: Company, Daiwa forecasts
Note: FY10-12 are years ended 30 June (before the company changed its year-end to 31 December)
Note: a negative number denotes expenditure

In October 2013, CMD entered into a joint-venture agreement with 2 private equity firms Kohlberg Kravis Roberts (KKR) and CDH Investments (CDH) to invest in a dairy-farm operation. CMD has invested USD7.2m in the joint venture, which will be 18% owned by CMD and 82% owned by KKR and CDH, to start and operate a dairy farm in China. CMD has guaranteed that it will buy back the 82% stake in the future at the highest of the following: 1) an EV/EBITDA multiple of 12x, or 2) at CMD's EV/EBITDA multiple of 0.8x at the time of the buyback, or 3) at a 7% compound investment rate of return – we estimate the cost would be USD46m if the dairy farm is bought back in the fifth year after the JV is formed. KKR and CDH were granted put options to sell their stake in the JV to CMD at any time between year 3 and year 7, once the cows start producing milk.

CMD will also sell 13,200 dairy cows to the JV, which we estimate will generate CNY120m in revenue over 2014-15, assuming a price of CNY18,000 per cow. We expect the sales to take place in 2H14 and 1H15.

Operating margin trending up

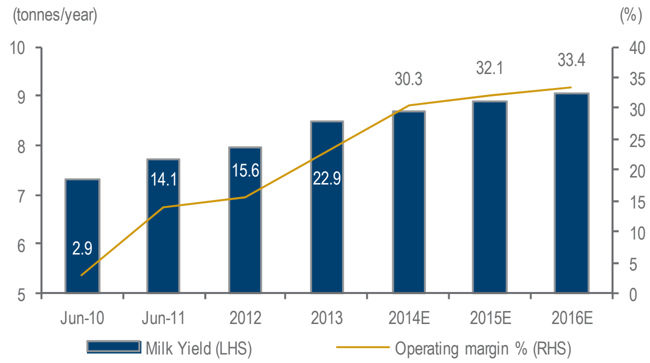
Ample room for the milk yield to improve

We forecast CMD's milk yield to improve to 8.7 and 9 tonnes/year/cow for 2014 and 2015, respectively, from 8.5 tonnes for 2H13. The key drivers are:

1) Milking-cow count and maturity. A cow's milk yield usually reaches its highest level when the cow gets to 7 years old (or after giving birth for the fifth time), after which it gradually declines. We estimate that the number of CMD's milking cows will gradually increase to 57% by 2015, as its total number of cows reaches 136,000 and the average age rises to 4 by 2015 (2012: 44%/3.2 years). For 2014, we forecast 52% and 3.5 years.

2) Improving the genes. CMD has been importing semen from international suppliers to improve the genetic mix of its dairy cows. The milk yield of the Hesitan cow from New Zealand is higher than that of the domestic China dairy cow, but still lower than that of US cows. By using imported semen, CMD believes that the maximum yield for "second-generation" cows (CMD's imported New Zealand cows that are inseminated with sperm from US cattle to produce a second-generation of cow for CMD) will reach more than 10 tonnes/year/cow, versus 8-9 tonnes at present.

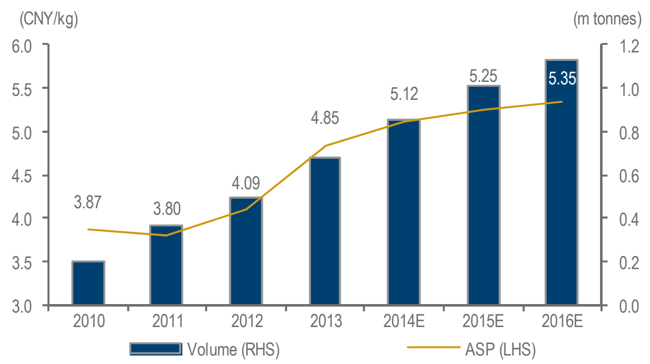
■ CDM: milk yield and operating-margin improvement



Source: Company, Daiwa forecasts

As mentioned in the sector part of this report, we are positive on the raw-milk price trend for 2014-16, which, in turn should support margin expansion for the sector. We assume an 18% sales-volume CAGR for 2013-16E, and that the sales volume will exceed 1m tonnes for 2015E, which will account for about 15-18% of Mengniu's raw-milk needs, based on our estimates.

■ CMD: sales volume and ASP



Source: Company, Daiwa estimates

Our sensitivity analysis shows that the milk yield and price are the most important upside factors in our earnings model. CMD's earnings sensitivity to changes in the price of raw milk is also higher than Huishan's due to CMD's almost 100% exposure to the upstream business.

■ CMD: earnings and operating margin sensitivity analysis

		Impact of change			
		Operating margin (%)		Cash profit (CNYm)	
	Change	2014E	2015E	2014E	2015E
Base case		30.3	32.1	1,072	1,348
		+/- pp		+/- %	
Milk yield	+0.1tonne/year	0.83	0.92	5.0	5.4
Unit feed cost	- 1%	-0.48	-0.48	-2.0	-1.9
Raw milk ASP	+ 1%	0.68	0.67	4.1	3.9
Number of milking cows	+ 1%	0.06	0.05	1.3	1.1

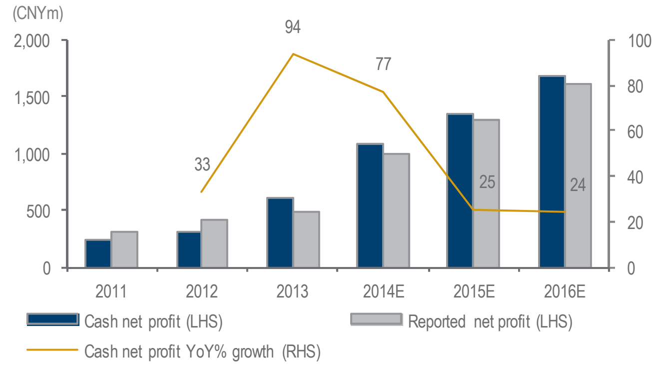
Source: Daiwa estimates

Financials and balance-sheet analysis

We forecast CMD's cash net profit to grow by 77% YoY, 26% YoY and 24% YoY for 2014, 2015 and 2016, to CNY1.07bn, CNY1.35bn and CNY1.67bn, respectively.

We believe CMD's 2014-16E earnings growth will be driven by: 1) an 18% sales-volume CAGR over 2013-16E, 2) a hike in the milk selling price of 6% YoY for 2014E, 3% YoY for 2015E and 2% YoY for 2016E, on the back of a scarcity of premium milk in China and increasing sales of CMD's self-owned branded products, and 3) expansions of 6.7pp, 0.5pp and 1.2pp YoY in the operating margin, to 31.8%, 32.3% and 33.5% for 2014-16E, respectively.

■ CMD: cash profit and reported net profit (YoY growth)



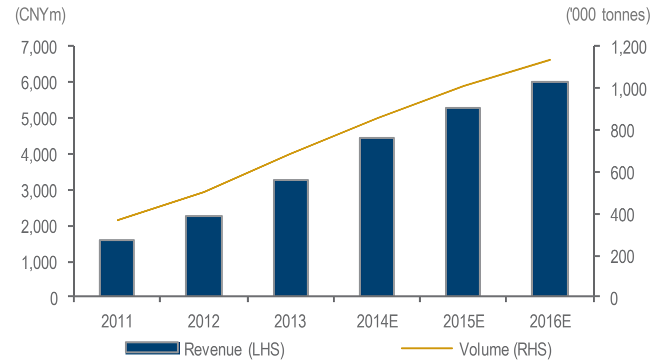
Source: Company, Daiwa forecasts

In terms of CMD's reported net profit, which includes biological asset revaluation gains/losses, we believe the reported net profit will be CNY994m, CNY1.29bn and CNY1.61bn for 2014-16E, respectively. We expect the company to book non-cash valuation losses for its biological assets while its cows mature over the same period. We forecast the company's reported net profit growth to be 97% YoY, 30% YoY and 25% YoY for 2014-16, respectively.

Revenue growth driven by volume

We expect CMD's revenue to grow by 34% YoY, 20% YoY and 14% YoY for 2014-16E, respectively, driven by increases in the sales volume of 26% YoY, 18% YoY and 12% YoY, respectively. Mengniu will remain the key customer, accounting for at least 70% of CMD's sales volume over 2014-16E, in our view.

■ CMD: revenue (CNYm) and sales volume ('000 tonnes)



Source: Company, Daiwa forecasts

Cost analysis

Feed: We estimate that feed accounts for about 70-80% of the operating cost of a dairy farm. About 35-40% of feed costs are made up of corn, while the remainder comprises feed concentrates, grains and forage, etc. As we see a stable supply of corn over 2014-16 in China and increasing availability of domestic high quality forage, we believe feed costs will remain steady over 2014-16E.

Other operating costs and income: 1) Other farm operating costs include utilities, labour and insurance costs, which usually increase in line with the size of the herd size, 2) CMD owns 18% of Qiushi Grass Industry (not listed), the second-largest alfalfa plantation company in China. We estimate associate income of CNY15m, CNY20m and CNY20m for 2014E-16E, up from CNY12m for 2013 as Qiushi expand its plantations.

Financial costs and gearing: We forecast the company's interest expenses to increase to about CNY330m a year for each of 2014-16, up from CNY208m for 2013, as the company's debt has increased on the back of its capex needs. We forecast the company's effective interest rate to remain at 6% for 2014-16.

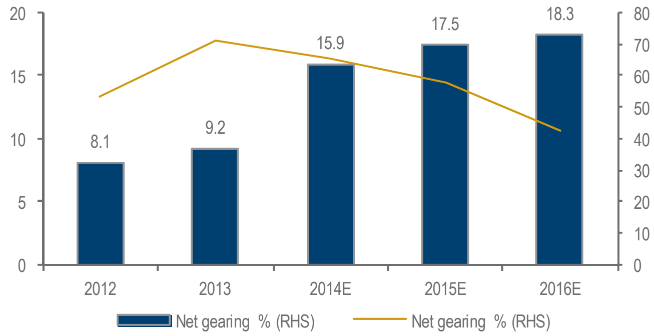
Tax: raw-milk production is not taxed in China and we expect CMD to book very small tax charges over our forecast period, mainly for its branded milk business.

ROE should substantially improve

We expect the net gearing to have peaked in 2013 at 72%, as capex needs are gradually declining since then and the operating cash flow should improve as a result. As discussed earlier in this report, we expect CMD's free cash flow to turn positive from 2014. Its capex for fixed assets should decline significantly, to below CNY700m per year for each of 2014 and 2015, as it will need to import fewer dairy cows.

As a result, we expect the net gearing to slowly decline to 67% and 59% for 2014 and 2015, respectively. At the same time, the ROE is likely to improve sharply, from 9.2% for 2013 to 15.9%, 17.5% and 18.3% for 2014-16, respectively, as CMD's dairy cows mature. This is all in line with our view that CMD has entered a harvesting period.

■ **CMD: net gearing and ROE (%)**



Source: Company, Daiwa forecasts

Valuation and price-target justification

We value CMD at HKD4.60, based on our DCF methodology. This is equivalent to 2014E PER of 18.8x, and an EPS CAGR of 47% for 2013-16E.

We value CMD at HKD4.60, based on our DCF methodology, assuming a terminal growth rate of 1% and a discount rate of 9.6%, as shown in the following table. We believe our terminal growth rate is supported by the demand growth that we expect to see for quality raw milk from large-scale milk farms in China.

We believe that DCF is a suitable methodology to value large-scale dairy farm operators, as these are capital-intensive operations that steadily generate cash once scale is achieved and the cows mature.

Our 6-month target price for CMD translates into 2014E PER of 18.8x and 2015E PER of 14.5x, which is still a 30% and 35% discount to the average PERs of the major downstream China F&B peers (26.7x 2014E PER and 22.2x 2015E PER). As CMD is more vulnerable to changes in commodity prices than the pure brand owners, we believe it deserves to trade at a PER that is lower than that of the downstream players. However, we believe this discount will narrow if CMD can successfully develop a profitable brand business by developing new products that use its premium milk.

■ **CMD: DCF valuation**

Number of farms to be kept at 24 after 2015 — **Tax rate at 0% for the upstream business throughout the period**

Milking cows will account for about 60% of the total no. of cows after 2015E — **Discount rate: 9.6 %**

Culling rate after 2015 will increase from 8-20% to 30-50% to improve the milk yield, keeping the size of the herd at an optimal level.

We assume feed costs and milk ASP will increase by only 1% YoY/remain flat for 2017-30

	2014E	2015E	2016F	2017F	2018F	2019F	2020F	2021F	2022F	2023E	2024E	2025E	2026F	2027F	2028F	2029F	2030F	>2030E
No. of cows	220,134	239,262	241,981	245,884	246,621	245,805	244,821	244,306	244,077	243,870	243,616	243,342	243,071	242,805	242,541	242,276	242,144	
No. of milking cows	115,045	136,303	145,441	147,439	146,578	145,742	145,115	144,832	144,705	144,579	144,425	144,262	144,102	143,944	143,788	143,631	143,552	
Number of milking cows as a % of the total herd	52	57	60	60	59	59	59	59	59	59	59	59	59	59	59	59	59	
Milk volume ('000 tonnes)	856	1,007	1,129	1,330	1,354	1,361	1,368	1,378	1,390	1,403	1,402	1,400	1,399	1,397	1,396	1,394	1,393	
ASP (CNY/kg)	5.12	5.25	5.36	5.46	5.57	5.68	5.80	5.80	5.80	5.80	5.80	5.80	5.80	5.80	5.80	5.80	5.80	
Sales of milk (CNYm)	4,410	5,287	6,044	7,120	7,250	7,286	7,326	7,378	7,443	7,514	7,507	7,499	7,491	7,482	7,474	7,466	7,459	
EBIT (CNYm)	630	807	1,897	3,074	3,095	3,070	3,051	3,040	3,036	3,033	2,991	2,948	2,905	2,862	2,818	2,774	2,731	
Depreciation (CNYm)	182	210	235	247	260	272	285	297	310	322	335	347	360	372	385	397	410	
EBITDA (CNYm)	812	1,017	2,131	3,321	3,355	3,342	3,335	3,337	3,345	3,355	3,326	3,296	3,265	3,234	3,203	3,172	3,141	Terminal Value
Capex CNYm)	-600	-500	-250	-250	-250	-250	-250	-250	-250	-250	-250	-250	-250	-250	-250	-250	-250	
Cash flow (CNYm)	-111	167	1,532	2,771	2,805	2,792	2,805	2,807	2,815	2,825	2,796	2,766	2,735	2,704	2,673	2,642	2,611	29,938
Discount factor	1.097	1.204	1.321	1.449	1.590	1.745	1.914	2.100	2.304	2.528	2.774	3.044	3.340	3.664	4.021	4.411	4.840	5.311
Discounted FCF	-101.4	139.1	1160.0	1911.9	1764.0	1600.3	1465.5	1336.4	1221.7	1117.3	1007.8	908.5	818.9	737.9	664.8	598.8	539.4	5637.4
Total discounted FCF (from 2014E)			22,820					NAV/share (CNY)						3.83				
Net cash as at December 2013			-4,149	Total value		18,671		**NAV/share (HKD)**						**4.60**		@ HK$ 1.20 = CNY 1		

Source: Daiwa

CMD: sensitivity of our target price to changes in our DCF assumptions

Target price (HKD)		WACC (%)				
		8.6	9.1	9.6	10.1	10.6
Terminal growth rate (%)	0.0	5.22	4.82	4.45	4.14	3.85
	0.5	5.32	4.90	4.52	4.20	3.90
	1.0	5.44	5.00	4.60	4.27	3.96
	1.5	5.57	5.11	4.69	4.34	4.02
	2.0	5.73	5.23	4.79	4.42	4.08

Target price (HKD)		Beta (x)				
		0.68	0.73	0.78	0.83	0.88
Risk free rate(%)	3.3	5.61	5.33	5.07	4.82	4.60
	3.8	5.33	5.07	4.82	4.60	4.39
	4.3	5.07	4.82	4.60	4.39	4.19
	4.8	4.82	4.60	4.39	4.19	4.00
	5.3	4.60	4.39	4.19	4.00	3.83

Source: Daiwa estimates

CMD: Daiwa's key WACC assumptions

Assumptions (%)			
Beta (X)	0.78	Terminal growth rate	1
Equity risk premium	10	Cost of debt	7.8
Risk-free rate	4.3	Debt-weighting	40
Cost of equity	12.1	WACC*	9.6

Source: Daiwa

China: downstream peers' valuation comparison:

	Bloomberg			Mkt.Cap.	Price	Stock Δ %		PER (x)				EPS growth(%)				EV/EBITDA (x)		Revenue YoY %			EBIT margin (%)		
Name	Code	Rating	CRY	USDm	4/30/14	3M	1M	FY13	14E	15E	16E	FY13	14E	15E	16E	FY14	FY15E	FY13	14E	15E	FY13	14E	15E
Mengniu Dairy*	2319 HK	Hold	HKD	9,980	39.85	11	1	35.3	29.4	24.7	20.2	14	22	19	23	16.1	13.5	20	19	11	4.3	4.9	5.2
Want Want China	151 HK	NR	HKD	20,597	12.16	16	2	30.0	26.4	22.6	19.5	24	13	17	16	17.8	15.1	14	17	16	21.2	22.2	22.7
Tingyi	322 HK	NR	HKD	15,462	21.55	7	-5	37.8	28.8	24.0	20.6	-11	32	20	17	12.1	10.4	19	12	13	6.1	7.5	8.2
Tsingtao Brewery	168 HK	NR	HKD	9,174	56.45	-1	-1	30.8	26.9	22.7	n.a.	12	15	18	1	14.5	12.5	11	25	13	7.2	8.5	9.2
CRE	291 HK	NR	HKD	6,795	22.05	-5	0	27.9	27.7	23.5	20.3	-52	1	18	15	7.8	6.8	16	15	15	3.0	3.0	3.1
Huiyuan	1886 HK	NR	HKD	1,303	5.08	15	-11	30.0	21.6	16.2	12.9	n.a.	n.a.	34	25	11.1	9.0	13	31	26	(1.8)	12.4	13.0
Uni-President China	220 HK	NR	HKD	2,963	6.42	-9	-5	20.1	26.2	22.0	19.7	7	-23	19	12	11.8	9.9	9	12	13	1.9	2.7	3.0
Average (ex-Mengniu):								**30.3**	**26.7**	**22.2**	**18.9**	***(1)***	***10***	***21***	***16***	**13.0**	**11.0**	***15***	***19***	***15***	**6.0**	**8.7**	**9.2**

*Source: Bloomberg, * denotes Daiwa forecasts*

■ China upstream peers' valuation comparison

	Bloomberg			Mkt.Cap.	Price	Stock Δ %		PER (x)				EPS Growth(%)				EV/EBITDA (x)		Revenue YoY %			EBIT margin(%		
Name	Code	Rating	CRY	USDm	4/30/14	3M	1M	FY13	14E	15E	16E	FY13	14E	15E	16E	FY14E	FY15E	FY13	14E	15E	FY13	14E	15E
CMD*	1117 HK	Buy	HKD	2,055	3.32	-8	-8	25.5	13.1	10.1	8.1	23	97	30	25	11.0	9.2	62	34	20	25.1	31.8	32.3
Huishan Dairy*	6863 HK	Buy	HKD	3,270	1.76	-32	-21	14.6	10.6	7.8	n.a.	106	21	38	37	10.9	7.8	92	40	33	46.0	42.0	48.0
Yuanshengtai Dairy Farm	1431 HK	NR	HKD	646	1.29	-32	-2	9.3	6.9	5.1	4.4	n.a.	35	34	17	7.4	5.5	28	37	31	27.0	39.8	40.2
Average:								**16.5**	**10.2**	**7.7**	**6.2**	***65***	***51***	***34***	***26***	**9.8**	**7.5**	***60***	***37***	***28***	***32.7***	**37.9**	**40.2**

*Source: Bloomberg, * denotes Daiwa forecasts.*

Note: For Huishan, FY13-16E PERs is used as its year- end, which is 31 March

Investment risks

Bovine diseases – the main risk to our rating

Large dairy farms (10,000 dairy cows per farm) are more vulnerable than small farms in the event of disease outbreaks, as illness can easily spread among a large number of cows. That said, CMD has 22 dairy farms in operation and is more geographically diverse in its operations than its listed peers, which we believe makes it less exposed to the outbreak of bovine disease in any single area.

Customer concentration

We forecast Mengniu to account for about 70-75% of CMD's sales in 2014-16E. Any safety issues or operation failures at Mengniu could affect investor sentiment, as well as CMD's sales.

Surge in feed cost

Feed costs account for about 70-80% of a dairy farm's COGS. These costs can be classified into 3 categories: 1) forage (fibrous material), 2) concentrates (grain or milling by-products), and 3) additives. Many of these costs are related to the processing of corn, while some are due to feed costs having to be imported (eg, alfalfa). If the cost of grain were to increase significantly and the price of raw milk cannot be raised in response, CMD's gross profit margin could be affected materially.

Sell-off by original shareholders

Since CDH and KKR's sell-off of their 27% stake in May 2013, about 32% of CMD's stake is owned by a group of about 30 founding shareholders in China, including some of its management executives, such as CEO Ms. Lina Gao and CFO Mr. Sun Yu Gang.

The company's non-management shareholders sold 333m old shares in October 2013, reducing their stake in CMD to 32%, from 38%. As this group are financial investors, it is possible that they might sell more shares on share-price strength in the future, which could create short-term share-policy volatility.

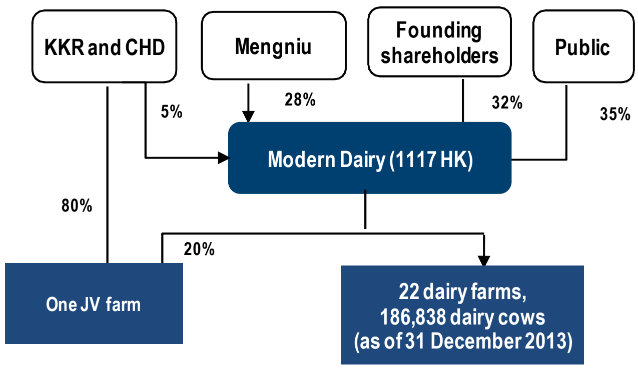
Company background

CMD is China's largest dairy-farm operator, with an approximate 2% share of the country's raw-milk market at present. At least 70% of its sales go to Mengniu, while the rest goes to regional milk powder and dairy product enterprises, as well as for its own consumer brand products.

CMD was founded by a group of former Mengniu management in 2005. There were 3 private equity investors, KKR, CDH and Brightmoon Capital, which together invested CNY1.4bn in 2009 for a 32% stake. The acquisition price was equivalent to HKD0.89/share at the time of the company's IPO in November 2010.

At the time of the IPO, Mengniu and COFCO Group (Not listed) became cornerstone investors. In May 2013, Mengniu acquired a 27% stake from KKR and CDH and became the single largest shareholder of CMD.

■ CMD: shareholding structure (as at 31 December 2013)



Source: Company

The 10-second briefing

China Huishan Dairy Holdings

6863 HK

Target (HKD): **2.48**
Upside: **40.9%**
30 Apr price (HKD): **1.76**

Initiation: land of milk and honey

- Potential feed-cost rises and recent share sales by some pre-IPO investors look priced into 10.6x FY15E PER and 0.5x PEG
- We expect a re-rating on herd size expansion and milk price uptrend, and forecast an 32% EPS CAGR for FY13-16
- Initiating coverage with a Buy rating and SOTP-derived target price of HKD2.48

1 Buy (initiation)
2 Outperform
3 Hold
4 Underperform
5 Sell

How do we justify our view?

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■ Investment case

We initiate coverage of China Huishan Dairy Holdings (Huishan), the second-largest dairy-farm operator in China, with a Buy (1) rating.

Cost leadership. Thanks to its in-house alfalfa production and access to low-cost corn in Liaoning Province, we forecast Huishan's FY14/FY15 operating margin to be 16.9pp/15.8pp higher than peer China Modern Dairy Holding's (CMD). We expect Huishan to retain its cost advantage, supported by operating leverage through sales-volume growth and increasing its self-owned plantations.

High sales-volume growth should capture China's milk scarcity opportunity. Huishan plans to spend HKD4.4bn of its IPO proceeds on dairy-farm expansion, targeting to increase its herd size organically by 15% per year and import 24,000-26,000 dairy cows per year over FY14-16. We expect its milk yields to improve from 9.1tpa in FY13 to 9.3tpa in FY16 and thus forecast CAGRs of 36% for its milk sales volume and 38% for revenue over FY13-16.

How we are different. Though we are less optimistic than most analysts on Huishan's downstream business, we believe its upstream cost advantages and flexibility to raise upstream sales can offset its weak downstream business. Hence, our EPS forecasts are broadly in line with the Bloomberg consensus.

■ Catalysts

We see 3 catalysts: 1) the building-up of a consistent earnings growth record, which would alleviate concerns about short track record (IPO in 3Q13), 2) more initiatives to reduce feed costs by moving further upstream to feed production, and 3) launches of new downstream and differentiated products.

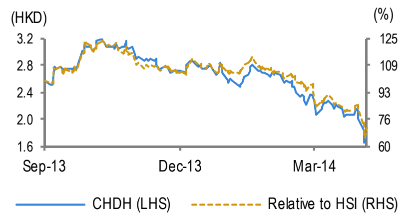
■ Valuation

Our 6-month target price is HKD2.48, which comprises: 1) HKD2.32/share for the upstream operation (DCF), and 2) HKD0.16/share for the downstream operation (12x FY15E PER, 60% discount to peers). Our target price implies a 15.5x FY15E PER and we see good re-rating scope given our 32% EPS CAGR for FY13-16E.

■ Risks

The main risks we see are execution risks for the downstream business, bovine diseases and more share disposals by pre-IPO investors.

Share price performance



12-month range	1.65-3.19
Market cap (USDbn)	3.27
3m avg daily turnover (USDm)	18.93
Shares outstanding (m)	14,408
Major shareholder	Yang Kai (46.7%)

Financial summary (CNY)

Year to 31 Mar	14E	15E	16E
Revenue (m)	3,576	4,742	6,662
Operating profit (m)	1,501	2,257	3,109
Net profit (m)	1,256	1,922	2,630
Core EPS (fully-diluted)	0.097	0.133	0.183
EPS change (%)	20.5	37.6	36.8
Daiwa vs Cons. EPS (%)	3.2	(0.4)	3.7
PER (x)	14.7	10.6	7.8
Dividend yield (%)	0.0	0.0	0.0
DPS	0.000	0.000	0.000
PBR (x)	1.6	1.4	1.2
EV/EBITDA (x)	10.9	7.8	5.9
ROE (%)	13.3	13.8	16.2

Source: FactSet, Daiwa forecasts

1 Buy (initiation)
2 Outperform
3 Hold
4 Underperform
5 Sell

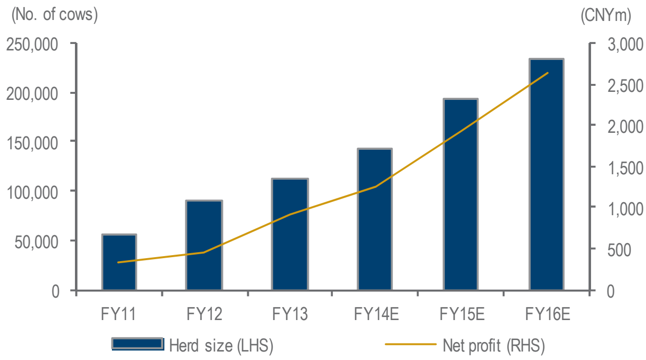
How do we justify our view?

- Growth outlook ✔✔✔✔✔
- Valuation ✔✔✔✔✔
- Earnings revisions ✔✔✔✔✔

Growth outlook ✔✔✔✔✔

We forecast strong net profit growth for Huishan of 36% YoY for FY14, and 53% YoY for FY15 and 37% YoY for FY16, to CNY1.26bn, CNY1.92bn and CNY2.63bn, respectively. We expect its herd size to reach 234,000 dairy cows and 112,000 milking cows by FY16, implying respective CAGRs of 28% and 31% for FY13-16, with an organic increase in the herd size of 15% per year and imports of about 25,000 heifers per year.

Huishan: cow herd size and net profit



Source: Company, Daiwa forecasts

Valuation ✔✔✔✔✔

Huishan is trading currently at PERs of 10.6x for FY15E and 7.8x for FY16E (based on our EPS forecasts), which we believe are not demanding given strong earnings growth we expect over the period. Also, we note that Huishan is trading at a significant PER discount to its downstream peers, such as China Mengniu Dairy (Mengniu). We see long-term re-rating potential for Huishan, driven by its downstream business, through market-share gains outside north-eastern China.

Huishan: valuation comparison with peers

Company	BBG code	Rating	Mkt.Cap. (USDm)	Price 30-Apr-14	PER (x) 14E	15E	16E
Upstream – dairy-farm operators							
China Huishan Dairy*	6863 HK	Buy	3,270	1.83	14.6	10.6	7.8
China Modern Dairy*	1117 HK	Buy	2,055	3.32	13.1	10.1	8.1
Yuanshengtai Dairy	1431 HK	NR	646	1.29	6.9	5.1	4.4
Average (ex-Huishan)					**10.0**	**7.6**	**6.2**
Liquid milk/dairy products							
China Mengniu Dairy*	2319 HK	Hold	9,980	39.85	29.4	24.7	20.2
Want Want China*	151 HK	NR	20,530	12.12	26.4	22.6	19.5
Yili Industries	600887 CH	NR	11,313	34.39	21.0	16.9	13.5
Bright Dairy	600597 CH	NR	3,307	16.77	33.5	23.7	19.6
Average - downstream companies					**27.6**	**22.0**	**18.2**

*Source: Bloomberg, * Daiwa forecasts*
Note: based on share prices as of 30 April 2014

Earnings revisions ✔✔✔✔✔

Our FY14-16 revenue forecasts for Huishan are 12-21%, below the Bloomberg consensus ones, probably due to our lower sales forecasts for the company's downstream operation. However, we have higher operating-profit margin assumptions, and thus our EPS forecasts for the period are broadly in line with the consensus (3% and 4% higher for FY14 and FY16, respectively). Huishan has a short listing history (it was listed only in September 2013), and there have been no significant changes to the consensus EPS forecasts since its listing.

Huishan: Daiwa revenue and earnings forecasts vs. consensus

(Year-end March)	1H FY14	2H FY14E	FY14E	FY15E	FY16E
Revenue (CNYm)	1,534	2,042	3,576	4,742	6,662
YoY growth (%)	48	35	51	33	40
Var. vs. consensus	n.a.	n.a.	-12	-21	-18
Core net profit (CNYm)	584	725	1,309	1,922	2,628
YoY growth (%)	44	23	32	47	37
Var. vs. consensus	n.a.	n.a.	-2	-3	1
Core EPS (CNY, ex-valuation gain)	0.051	0.050	0.101	0.133	0.182
Core EPS growth YoY (%)	44	-2	17	32	37
Var. vs. consensus	n.a.	n.a.	8	0	4

Source: Company, Daiwa forecasts

Financial summary

■ Key assumptions

Year to 31 Mar	2009	2010	2011	2012	2013	2014E	2015E	2016E
Milk Yield (tonne/cow/year)	n.a.	n.a.	8.70	8.60	9.10	9.14	9.18	9.26
Sales volume of Milk (tonnes)	n.a.	n.a.	57,381	213,920	352,411	522,910	671,673	893,332
ASP of raw milk (CNY/kg)	n.a.	n.a.	4.30	4.45	4.51	4.95	5.20	5.40
Number of cows (heads)	n.a.	n.a.	55,570	90,254	112,778	143,686	192,484	234,554
Gross margin of downstream products (%)	n.a.	n.a.	n.a.	38.4	54.0	62.3	68.9	68.2

■ Profit and loss (CNYm)

Year to 31 Mar	2009	2010	2011	2012	2013	2014E	2015E	2016E
Raw Milk	n.a.	n.a.	244	672	681	900	1,134	1,354
Processed milk	n.a.	n.a.	15	564	1,707	2,397	3,240	4,381
Other Revenue	n.a.	n.a.	115	97	165	280	368	926
Total Revenue	**n.a.**	**n.a.**	**374**	**1,333**	**2,552**	**3,576**	**4,742**	**6,662**
Other income	n.a.	n.a.	0	0	0	0	0	0
COGS	n.a.	n.a.	(231)	(732)	(1,082)	(1,368)	(1,770)	(2,582)
SG&A	n.a.	n.a.	(33)	(54)	(197)	(478)	(555)	(740)
Other op.expenses	n.a.	n.a.	(24)	(52)	(92)	(230)	(160)	(231)
Operating profit	**n.a.**	**n.a.**	**87**	**495**	**1,181**	**1,501**	**2,257**	**3,109**
Net-interest inc./(exp.)	n.a.	n.a.	(57)	(103)	(142)	(210)	(179)	(187)
Assoc/forex/extraord./others	n.a.	n.a.	297	67	(28)	82	27	27
Pre-tax profit	**n.a.**	**n.a.**	**327**	**459**	**1,012**	**1,373**	**2,104**	**2,949**
Tax	n.a.	n.a.	0	(11)	(87)	(118)	(182)	(319)
Min. int./pref. div./others	n.a.	n.a.	0	0	0	0	0	0
Net profit (reported)	**n.a.**	**n.a.**	**327**	**448**	**925**	**1,256**	**1,922**	**2,630**
Net profit (adjusted)	**n.a.**	**n.a.**	**327**	**448**	**925**	**1,256**	**1,922**	**2,630**
EPS (reported)(CNY)	**n.a.**	**n.a.**	**0.028**	**0.039**	**0.080**	**0.097**	**0.133**	**0.183**
EPS (adjusted)(CNY)	**n.a.**	**n.a.**	**0.028**	**0.039**	**0.080**	**0.097**	**0.133**	**0.183**
EPS (adjusted fully-diluted)(CNY)	**n.a.**	**n.a.**	**0.028**	**0.039**	**0.080**	**0.097**	**0.133**	**0.183**
DPS (CNY)	**n.a.**	**n.a.**	**0.000**	**0.000**	**0.000**	**0.000**	**0.000**	**0.000**
EBIT	**n.a.**	**n.a.**	**87**	**495**	**1,181**	**1,501**	**2,257**	**3,109**
EBITDA	**n.a.**	**n.a.**	**110**	**547**	**1,273**	**1,622**	**2,417**	**3,340**

■ Cash flow (CNYm)

Year to 31 Mar	2009	2010	2011	2012	2013	2014E	2015E	2016E
Profit before tax	n.a.	n.a.	327	459	1,012	1,373	2,104	2,949
Depreciation and amortisation	n.a.	n.a.	24	37	69	121	160	231
Tax paid	n.a.	n.a.	0	(9)	(116)	(118)	(182)	(319)
Change in working capital	n.a.	n.a.	(64)	(128)	191	(304)	(104)	127
Other operational CF items	n.a.	n.a.	52	101	139	206	176	185
Cash flow from operations	**n.a.**	**n.a.**	**340**	**460**	**1,295**	**1,279**	**2,155**	**3,173**
Capex	n.a.	n.a.	(1,921)	(1,744)	(1,541)	(1,753)	(3,406)	(3,799)
Net (acquisitions)/disposals	n.a.	n.a.	26	8	57	79	68	68
Other investing CF items	n.a.	n.a.	(5)	(4)	(3)	(2)	(1)	0
Cash flow from investing	**n.a.**	**n.a.**	**(1,900)**	**(1,741)**	**(1,488)**	**(1,677)**	**(3,339)**	**(3,731)**
Change in debt	n.a.	n.a.	0	137	732	(11)	0	0
Net share issues/(repurchases)	n.a.	n.a.	243	0	907	5,816	0	0
Dividends paid	n.a.	n.a.	0	0	0	0	0	0
Other financing CF items	n.a.	n.a.	(122)	1,801	(1,363)	(314)	(161)	(171)
Cash flow from financing	**n.a.**	**n.a.**	**121**	**1,938**	**277**	**5,491**	**(161)**	**(171)**
Forex effect/others	n.a.	n.a.	0	0	0	0	0	0
Change in cash	**n.a.**	**n.a.**	**(1,440)**	**657**	**84**	**5,093**	**(1,346)**	**(729)**
Free cash flow	n.a.	n.a.	(1,581)	(1,284)	(247)	(475)	(1,251)	(626)

Source: FactSet, Daiwa forecasts

Financial summary continued ...

Balance sheet (CNYm)

As at 31 Mar	2009	2010	2011	2012	2013	2014E	2015E	2016E
Cash & short-term investment	n.a.	n.a.	48	513	826	5,869	4,527	3,798
Inventory	n.a.	n.a.	203	413	447	566	734	1,070
Accounts receivable	n.a.	n.a.	138	148	173	238	286	343
Other current assets	n.a.	n.a.	1,585	582	696	696	696	696
Total current assets	**n.a.**	**n.a.**	**1,974**	**1,655**	**2,141**	**7,370**	**6,243**	**5,907**
Fixed assets	n.a.	n.a.	1,844	2,840	3,637	3,714	4,923	6,104
Goodwill & intangibles	n.a.	n.a.	384	418	1,453	1,465	1,477	1,489
Other non-current assets	n.a.	n.a.	1,305	2,278	3,280	4,744	6,702	9,009
Total assets	**n.a.**	**n.a.**	**5,507**	**7,190**	**10,511**	**17,293**	**19,345**	**22,509**
Short-term debt	n.a.	n.a.	182	362	909	500	500	500
Accounts payable	n.a.	n.a.	470	524	910	816	920	1,380
Other current liabilities	n.a.	n.a.	2,313	3,280	473	448	456	516
Total current liabilities	**n.a.**	**n.a.**	**2,965**	**4,166**	**2,292**	**1,765**	**1,876**	**2,396**
Long-term debt	n.a.	n.a.	1,961	1,917	2,103	2,500	2,500	2,500
Other non-current liabilities	n.a.	n.a.	193	224	233	74	91	107
Total liabilities	**n.a.**	**n.a.**	**5,119**	**6,307**	**4,628**	**4,338**	**4,467**	**5,003**
Share capital	n.a.	n.a.	0	0	0	1,143	1,143	1,143
Reserves/R.E./others	n.a.	n.a.	388	882	5,883	11,812	13,735	16,363
Shareholders' equity	**n.a.**	**n.a.**	**388**	**882**	**5,883**	**12,955**	**14,877**	**17,506**
Minority interests	n.a.	n.a.	0	0	0	0	0	0
Total equity & liabilities	**n.a.**	**n.a.**	**5,507**	**7,190**	**10,511**	**17,293**	**19,345**	**22,509**
EV	n.a.	n.a.	22,567	22,239	22,658	17,604	18,946	19,675
Net debt/(cash)	**n.a.**	**n.a.**	**2,095**	**1,766**	**2,186**	**(2,869)**	**(1,527)**	**(798)**
BVPS (CNY)	**n.a.**	**n.a.**	**0.034**	**0.077**	**0.512**	**0.899**	**1.033**	**1.215**

Key ratios (%)

Year to 31 Mar	2009	2010	2011	2012	2013	2014E	2015E	2016E
Sales (YoY)	n.a.	n.a.	n.a.	256.3	91.5	40.1	32.6	40.5
EBITDA (YoY)	n.a.	n.a.	n.a.	394.9	132.9	27.4	49.1	38.2
Operating profit (YoY)	n.a.	n.a.	n.a.	470.3	138.5	27.1	50.3	37.8
Net profit (YoY)	n.a.	n.a.	n.a.	36.9	106.4	35.8	53.1	36.8
Core EPS (fully-diluted) (YoY)	n.a.	n.a.	n.a.	36.9	106.4	20.5	37.6	36.8
Gross-profit margin	n.a.	n.a.	38.4	45.1	57.6	61.7	62.7	61.2
EBITDA margin	n.a.	n.a.	29.5	41.0	49.9	45.3	51.0	50.1
Operating-profit margin	n.a.	n.a.	23.2	37.2	46.3	42.0	47.6	46.7
Net profit margin	n.a.	n.a.	87.5	33.6	36.2	35.1	40.5	39.5
ROAE	n.a.	n.a.	168.7	70.6	27.3	13.3	13.8	16.2
ROAA	n.a.	n.a.	11.9	7.1	10.5	9.0	10.5	12.6
ROCE	n.a.	n.a.	6.9	17.4	19.6	12.1	13.3	16.2
ROIC	n.a.	n.a.	3.5	18.8	20.1	15.1	17.6	18.4
Net debt to equity	net cash	net cash	539.8	200.2	37.2	net cash	net cash	net cash
Effective tax rate	n.a.	n.a.	0.0	2.3	8.6	8.6	8.7	10.8
Accounts receivable (days)	n.a.	n.a.	67.5	39.2	22.9	21.0	20.2	17.2
Current ratio (x)	n.a.	n.a.	0.7	0.4	0.9	4.2	3.3	2.5
Net interest cover (x)	n.a.	n.a.	1.5	4.8	8.3	7.2	12.6	16.6
Net dividend payout	n.a.	n.a.	0.0	0.0	0.0	0.0	0.0	0.0
Free cash flow yield	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Source: FactSet, Daiwa forecasts

Company profile

China Huishan Dairy (Huishan) is the second-largest dairy-farm operator in China and is based in Liaoning Province, northeastern China. The company supplies raw milk to third-party dairy processors, as well as produces fresh milk and UHT dairy products under its own brand, Huishan.

Land of milk and honey

Huishan has adopted a vertically integrated dairy-operations model, spanning feed production and consumer products. This significantly reduces its feed costs and should enhance its profitability further over FY14-16.

A cost leader

Thanks to its vertical integration and low land cost in Liaoning Province, Huishan's unit cost of milk production is much lower than those of its peers. We forecast Huishan's reported unit feed cost for its milking cows to be 30-40% below CMD's over FY14-16.

Alfalfa is a forage consumed by livestock, which, because of its high protein content, stimulates milk production in dairy cows, in turn enhancing milk yields for dairy-farm operators. China relies heavily on imports of alfalfa.

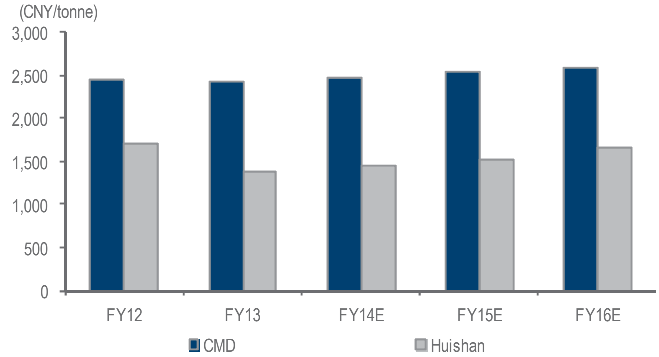
Reflecting its ability to produce large quantities of its own alfalfa on cheap leased land, Huishan's alfalfa costs were 75% below the cost of imported alfalfa (USD90/tonne, compared with USD350/tonne for imported alfalfa) in FY13.

As of September 2013, Huishan leased 140,000mu (1mu = 667m²) of land for its alfalfa plantations at a cost of less than CNY300/mu/year on average. This land area was for the plantations, but was sufficient to support 70,000 milkable cows. The company leased a further 100,000mu in 1H FY14 and is in negotiations to take on a further 200,000mu for grain and alfalfa plantations.

Although the cost of leasing new land has risen to CNY750-800/mu/year in FY14 (ie, Huishan's financial year ended 31 March 2014), which we believe will translate into a total alfalfa cost of about USD160/tonne (more than 70% of the cost is land cost), it still represents a significant discount to imported alfalfa substitutes.

We expect Huishan to continue to enjoy a significant feed cost advantage over its peers, as evidenced by the gap between it and China Modern Dairy Holdings (CMD) in terms of the unit feed cost of milk production, as shown in the chart below. To achieve further vertical integration for its upstream operations, Huishan plans to build its own feed processing plants and use the extra agricultural land obtained for grain feed plantation by the end of FY16.

■ Unit feed cost comparison between Huishan and CMD*



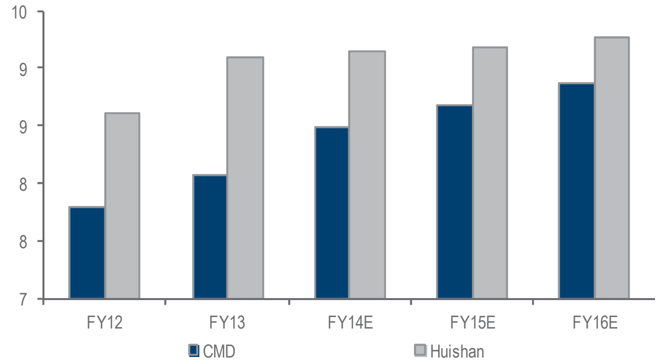
Source: Company, Daiwa forecasts
*Note: *2011-15E data used for CMD as it has a December financial year-end*

Its upstream business should maintain a high gross-profit margin

The availability for Huishan of high-quality feed also means its milk yield is significantly above those of its domestic peers, and hence leads to a high gross-profit margin for the company's upstream business (61% for FY13, 61.7% for FY14E on our forecast) and lower unit costs. We expect the company's milk yield to remain at above 9tpa over FY14-16, as its dairy cows mature and produce more milk, albeit the yield should only rise slowly over the period as it is already high.

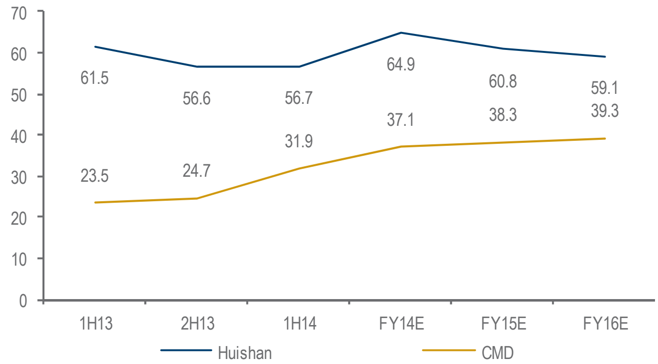
Huishan's milk production volume growth will be driven mainly by expansion of its herd size, in our view. We forecast the company's upstream gross-profit margin to remain high at above 60% for FY14-15, with potential upside if milk prices rise further.

■ **Comparison of milk yields between Huishan and CMD* (tpa)**



Source: Company, Daiwa forecasts
*Note: *2011-15E data used for CMD as it has a December financial year-end*

■ **Comparison of gross margins between CMD* and Huishan's upstream operations**



Source: Company, Daiwa forecasts
*Note: *2011-15E data used for CMD as it has a December-year end*

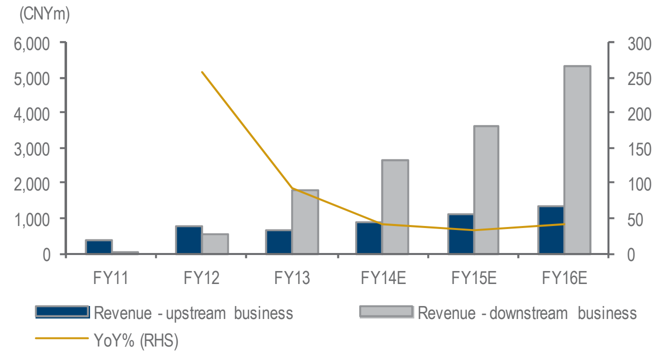
Herd size expansion likely to drive output and revenue growth

With IPO proceeds of HKD7.5bn in hand, Huishan's plan over FY14-16 is to: 1) add 45-50 new farms, 2) import 75,000 heifers at about CNY16,000 per heifer, and 3) build processing facilities for milk powder and liquid products to support downstream development over FY14-16.

Huishan plans to use its upstream output mainly in-house for its downstream products, such as branded fresh products, UHT milk and infant formula. As such, we forecast the company's upstream volume output to increase at a 36% CAGR over FY13-16, from 365,000 tonnes in FY13 to 906,000 tonnes in FY16. We forecast its sales of downstream products rise rapidly by 49% YoY for FY14, 35% YoY for FY15 and 47% YoY for FY16 but expect its raw milk sales to external customers to remain steady over the period.

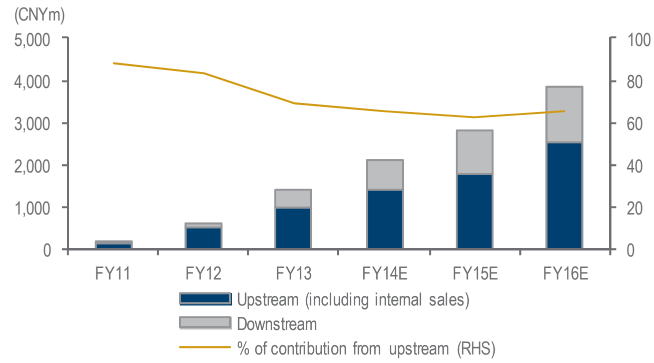
We believe that going forward more than 70% of the company's gross profit will continue to come from its upstream operation, assuming the sales price for its in-house downstream business is the same as that for its sales to external customers.

■ **Huishan: revenue breakdown and total YoY growth**



Source: Company, Daiwa forecasts

■ **Huishan: gross profit breakdown and % from upstream operations**



Source: Company, Daiwa forecasts

Challenging outlook for downstream business

We expect the downstream operation's net profit contribution to remain at 8-10% over FY14-16, with lower profit margins vs. the upstream operation.

Despite Huishan's small market share in China, management believes the company's upstream operations are efficient and bring significant cost and quality advantages over downstream competitors.

To expand its brand business, Huishan plans to do the following. 1) It aims to increase sales of quality fresh products with a short shelf life but high value, in north-eastern China. Given its access to quality milk sources, Huishan is able to differentiate itself from national competitors that do not have such access. 2) It plans to sell high-end UHT milk (which is more expensive than competitor Mengniu's Milk Deluxe high-end product) and yoghurts that have a long shelf life in Shandong and Chongqing provinces. It is logistically feasible to sell such products outside north-eastern China as they do not require cold-chain logistics for transportation.

As at September 2013, Huishan had engaged 330 distributors and 341 supermarkets to sell its branded products. It is now extending its coverage outside north-eastern China and Shandong to central and western China.

Investments in advertising and promotions

In September last year Huishan engaged 4 well-known, celebrity TV hosts from Mainland China, Hong Kong and Taiwan as ambassadors for its product safety. Management believes that Huishan's high-quality raw milk can help the company build a strong downstream brand in the future. Ultimately, management aims for Huishan to be a downstream dairy company with a 100% in-house raw milk supply for its products.

■ **Huishan: examples of pasteurised milk and yoghurt drink (CNY6.5/480g; CNY6.80/290g)**

Source: Daiwa

■ **Huishan: yoghurt made from high-nutrient milk produced by cows that have just given birth (CNY48 per 6 x 135g pack)**

Source: Daiwa

■ **Huishan: premium UHT milk (ASP about CNY100 per 12 x 260g pack)**

Source: Company

▪ **UHT milk – mass-market products (ASP about CNY30 per 12 x 260g pack)**

Source: Daiwa

▪ **Huishan's Golden Queen infant formula (CNY350-400/900g)**

Source: Company

Seeking to gain share in regional markets

We believe Huishan can expand its market share in north-eastern China by selling fresh products with a short shelf-life, such as yoghurt and pasteurised milk. In our view, Huishan's from grass-to-glass business model differentiates the company from most of its peers in terms of product quality and safety, as Huishan can leverage its in-house fresh milk source. At present, however, Huishan lacks brand recognition and a national distribution network in the segments of UHT milk and infant formula.

We see little competitive edge in Huishan's room-temperature products over those of domestic peers such as Mengniu, Yili Industries (Yili), and international players, which have a longer-established presence in the market and more promotional and marketing resources. Competition in the UHT milk segment – in particular in the high-end segment – is already keen, as Mengniu (with its Milk Deluxe brand), Yili (Satine), CMD (Modern Farm), Shengmu have been present in this segment for more than 3 years.

There are at least 4 national players that entered the high-end UHT milk market earlier than Huishan. The company's move into infant formula and UHT milk outside north-eastern China is likely to lead to significant advertising and promotional (A&P) costs and be a drag on its downstream profit margins until it is able to build scale here.

The current context for the company's formula and milk powder business is not satisfactory, in our view. Huishan's Queen product range targets a supreme market segment (retail ASP of more than CNY400/900g can), which we note is still dominated by international brands and Biostime, a domestic pioneer in this segment.

The company's revenue generated from milk powder (infant formula and bulk powder for food processing) increased by 22% in 1H FY14 from 2H FY13. However, the gross-profit margin contracted sharply from 62% to 36.1% over the period, due to the inclusion of milk powder sales for B2B business in 1H FY14, whereas in 2H FY13 Huishan sold only infant formula, which has a much higher gross-profit margin than the B2B products (above 60%, compared with about 20%). We believe the company's infant formula has seen revenue decline further from 2H FY13 level.

Given this context, we believe it will still take a long time for Huishan to establish brand recognition in the infant formula business if it does not spend more on advertising and promotion. Yet higher A&P expenditure would likely lead to a much lower gross-profit margin for the segment, at least until the A&P efforts start to filter through to higher profits. We assume a 21-22% gross-profit margin for Huishan's processing segment, and A&P expenditure to account for about 10-12% of segmental revenue for FY14-16.

B2B operation – low margin but good for diversification over the long term

Huishan is exploring other B2B opportunities, such as providing high-end raw materials to producers of domestic milk-powder. This includes infant-milk-formula base powder, D-90 whey powder and whole-milk powder. Huishan started supplying milk powder to a Taiwanese dairy beverage brand's plant located in China and a domestic infant-formula producer in 1H FY14.

Although the B2B business carries a low operating-profit margin (about 20% on our estimates), we believe it will enable Huishan to build a strong foundation upon which to develop new products in the long run.

Downstream profit contribution likely to remain small

We forecast a 42% revenue CAGR for Huishan's overall downstream business over the next 3 years, driven mainly by market-share gains in north-eastern China. The company had a combined 13.6% share of the dairy product market in Liaoning, Jilin and Heilongjiang Provinces in north-eastern China in 2012 and about a 30% market share in Liaoning Province alone. Management targets for Huishan to garner a 30% market share in the 3 provinces within 3 years, by leveraging its access to quality milk sources and regional brand recognition.

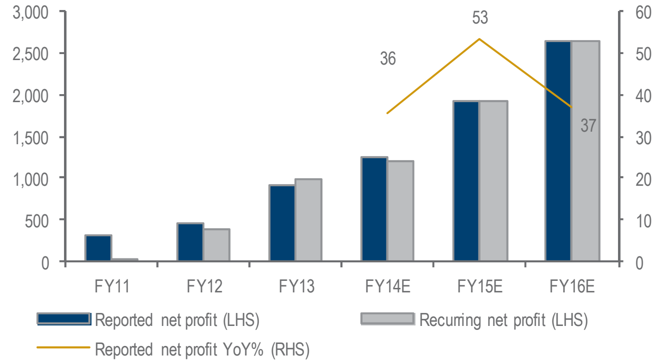
Though we forecast substantial revenue growth for the downstream business over FY14-16, we project it will account for only 8-10% of Huishan's total net profit over this period, given its lower profit margins compared with the company's upstream operation.

Financial analysis

We forecast Huishan's cash net profit to rise strongly over FY14-16.

In terms of the company's reported net profit, which includes any biological asset revaluation gains/losses, we forecast this at CNY1.26bn for FY14, up by 36% YoY from CNY925m reported for FY13. We expect the company to book a non-cash valuation loss of CNY80m for its biological assets in FY14 while its cows mature over the period.

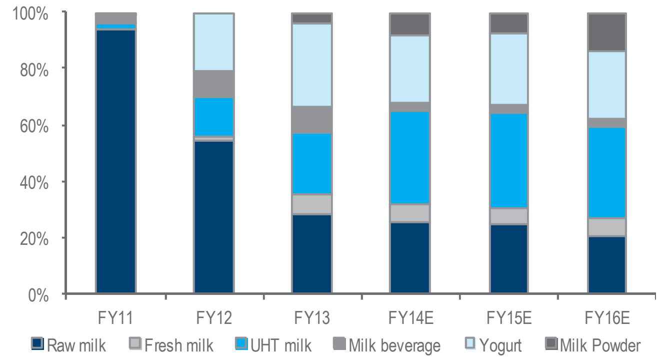
■ Huishan: recurring net profit and YoY growth



Source: Company, Daiwa forecasts

We forecast revenue growth for Huishan of 40% YoY for FY14, 33% YoY for FY15 and 41% YoY for FY16, to respective levels of CNY3.58bn, CNY4.74bn and CNY6.66bn. This reflects sales-volume growth forecasts of 48% YoY, 28% YoY and 33% YoY for the respective years. We forecast the company's raw milk sales to external customers to account for 25%, 24% and 20% of total revenue over FY14-16, respectively, as we expect the proportion of sales to external customers to decline gradually given that Huishan is developing its own brand business.

■ Huishan: revenue contribution by segment (%)



Source: Company, Daiwa forecasts

Cost analysis

Feed. We estimate that feed accounts for about 70-80% of the operating cost of a dairy farm. About 35-40% of feed costs are made up of corn, while the remainder comprises feed concentrates, grains and forage, etc. As we project a stable corn supply in China over 2014-16 and an increase in Huishan's in-house production of feed, we believe its feed costs will remain steady over FY14-16.

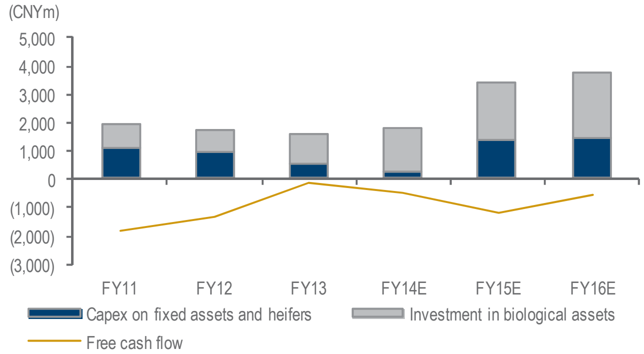
Financial costs and gearing. We forecast interest expenses of CNY210m for FY14, CNY179m for FY15 and CNY187m for FY16. As Huishan raised proceeds of HKD7.5bn from its IPO in September last year, we do not expect its total debt level to rise significantly in the near term.

Tax. Raw-milk production is not taxed in China. As such, we forecast Huishan's effective tax rate to stay low at 8.6% for FY14, 8.7% for FY15 and 10.8% for FY16, reflecting mainly its downstream business (taxed at 25%).

Stronger balance sheet since IPO

After raising HKD7.5bn from its IPO, Huishan had a net cash position of CNY2.6bn at end-September 2013, and we estimate this had risen to about CNY2.8bn at end-March 2014. The company has a capex budget of CNY8.8bn for FY14-16, and we believe it will just about have enough funds to pay for its capex and working-capital needs. We project negative FCF over FY14-16.

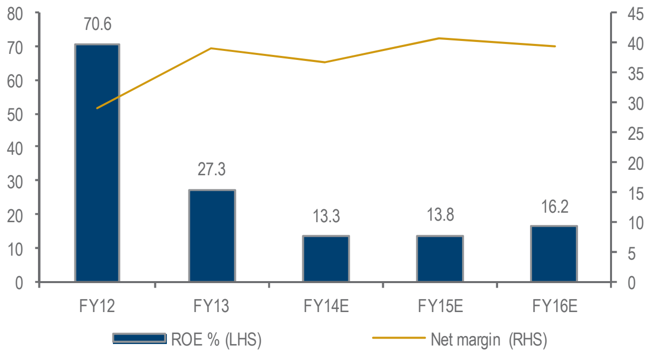
■ Huishan: FCF and investing cash flow



Source: Company, Daiwa forecasts

We forecast Huishan's ROE to decline to 13.3% in FY14, (from 27.3% reported for FY13), due to share dilution from its IPO in September 2013. We project its ROE to improve to 13.8% for FY15 and 16.2% for FY16, as we forecast net-profit margin expansion to about 40% for both FY15 and FY16 and the revenue to trend up strongly. We expect Huishan to maintain a net cash position on its balance sheet throughout FY14-16, as the proceeds from its IPO and its operating cash flow should be sufficient to cover its capex and working capital needs.

■ Huishan: ROE and net-profit margin (%)



Source: Company, Daiwa forecasts

Valuation

We initiate coverage on Huishan with a Buy (1) rating and 6-month target price of HKD2.48.

We have a 6-month target price for Huishan of HKD2.48, using an SOTP methodology, which enables us to capture individual values for the company's upstream and downstream businesses.

We value the upstream business using a DCF methodology, assuming a terminal growth rate of 1% and a WACC of 11.5%, as shown in the subsequent table in this section. We believe a DCF methodology is appropriate to value large-scale dairy farm operators like Huishan, which have capital-intensive operations that generate steady cash flows once scale is achieved and the cows mature. Our beta assumption of 0.83x is higher than our 0.78x beta used in our valuation of CMD (based on the Bloomberg data), reflecting Huishan's share-price volatility since its IPO. We assume that Huishan will not expand its farm business once it reaches 95 dairy farms in operation, targeted by FY16. We value the company's upstream business at HKD2.32/share.

To value the downstream business, we assign a FY15E PER of 12x, which represents a 60% discount to the average PER at current share prices of the company's major food and beverage peers in China (based on Bloomberg consensus data). We believe such a discount is justified given Huishan's weaker market penetration and currently low market share and higher execution risks. We consider PER is a suitable method to value downstream food and beverage operations due to their generally good earnings visibility and stable earnings stream. We value the company's downstream business at HKD0.16/share.

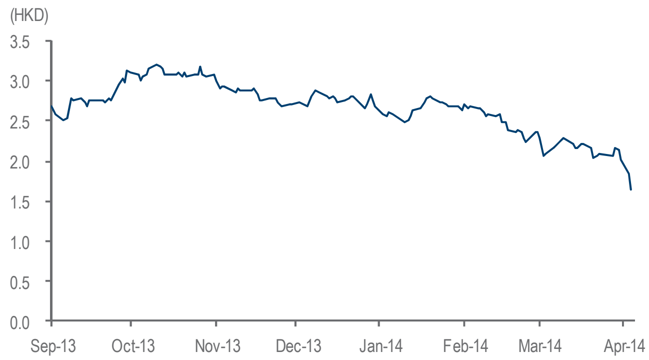
Our target price of HKD2.48 implies PERs of 21.3x for FY14E and 15.5x for FY15E.

We believe Huishan's current valuation is undemanding given our high 32% EPS CAGR for FY13-16E (which translates into PEG of 0.5x).

Overhang from share disposals by pre-IPO investors looks priced in

Year-to-date, Huishan's share price has declined by 37% and underperformed the Hang Seng Index by 32%. In our view, this share-price weakness has been due to share disposals carried out by pre-IPO investors and is not related to the company's business fundamentals. Two investors, Hero Beteiligungen (Hero) and An Yu Capital (An Yu), sold their stakes at a price of between HKD2.0/share and HKD2.21/share over March-April. Both investors have affirmed to Huishan's management recently that these sales had no connection with Huishan's business operations.

■ Huishan: share price performance since listing



Source: Bloomberg

■ Huishan: sales of shares by financial investors

Investor	No. of shares sold (m)	As % of total share capital	Date of share sale	Cost of investment (HKD/share)
An Yu Capital	285	1.98	Apr-14	0.78
Hero Beteiligungen	518	3.6	Mar-14	n.a.

Source: Company

In the following table we show the company's other pre-IPO investors, and cornerstone investors who bought shares at the IPO price. In aggregate, they own about 19% of the company's share capital. While the recent share disposals discussed could still cause some short-term volatility in Huishan's share price, we believe this is priced into the company's current trading PER of 10.6x for FY15E. We highlight that Yili Industries (Yili), which is Huishan's largest customer and China's second-largest liquid milk producer, is one of the cornerstone investors. We believe Yili's presence as a cornerstone investor signals a vote of confidence by an industry leader in the company's operations.

■ Huishan: pre-IPO investors and cornerstone investors

Investor	No. of shares owned (m)	As % of total share capital	Nature	Cost of investment (HKD/share)
CTF Group	1,294	8.98	Pre-IPO	0.73
Investec	285	1.98	Pre-IPO	0.78
Alpha Spring	285	1.98	Pre-IPO	0.78
Yili Industrial	141	1	Cornerstone	2.67
Bao Hua	117	0.8	Cornerstone	2.67
Norges Bank	720	5	Cornerstone & secondary market	2.67-2.782

Source: Company, Hong Kong Stock Exchange

■ Huishan: DCF valuation and key assumptions for upstream business

No. of farms to be kept at 95 after FY16

Milking cows account for about 55-60% of total no. of cows after FY15 **Discount rate 11.5%**

Tax rate at 0% for upstream business throughout period; we assume both feed costs and milk ASP rise at 1% per year after FY16

	FY14E	FY15E	FY16E	FY17E	FY18E	FY19E	FY20E	FY21E	FY22E	FY23E	FY24E
No. of cows	143,686	192,484	234,554	266,447	302,589	308,351	309,432	306,287	304,870	304,404	304,731
No. of milking cows	64,918	84,968	111,953	144,559	173,669	179,184	178,407	176,119	173,423	172,202	172,196
% of milking cows	45	44	48	54	57	58	58	58	57	57	57
Milk volume ('000 tonnes)	523	681	906	1,138	1,429	1,626	1,658	1,646	1,623	1,603	1,595
ASP (CNY/kg)	4.95	5.20	5.40	5.40	5.45	5.51	5.56	5.62	5.68	5.73	5.79
Sales of milk (CNYm)	2,588	3,541	4,895	6,145	7,795	8,957	9,223	9,248	9,213	9,188	9,236
EBIT (CNYm)	684	857	1,301	2,506	3,933	4,659	4,787	4,759	4,664	4,565	4,515
Depreciation(CNYm)	101	140	201	241	278	293	309	324	339	355	371
EBITDA (CNYm)	784	998	1,502	2,747	4,212	4,952	5,095	5,083	5,003	4,920	4,885
Capex (CNYm)	-754	-1,419	-1,614	-1,500	-600	-606	-612	-618	-624	-631	-637
Cash flow (CNYm)	-129	-581	-272	1,088	3,452	4,185	4,321	4,300	4,212	4,121	4,079
Discounted FCF	-129.2	-521.3	-218.6	784.5	2232.4	2427.0	2247.0	2005.6	1761.8	1545.8	1372.0
	FY25E	FY26E	FY27E	FY28E	FY29E	FY30E	FY31E	FY32E	FY33E	FY34E	>FY35E
Milk volume ('000 tonnes)	1,597	1,600	1,602	1,602	1,602	1,601	1,600	1,600	1,599	1,598	
ASP (CNY/kg)	5.85	5.91	5.96	6.02	6.08	6.15	6.21	6.27	6.33	6.40	
Sales of milk (CNYm)	9,336	9,449	9,555	9,652	9,747	9,840	9,934	10,029	10,125	10,223	
EBIT (CNYm)	4,502	4,498	4,487	4,469	4,448	4,423	4,398	4,370	4,341	4,310	
Depreciation (CNYm)	387	403	419	435	452	469	486	299	306	312	
EBITDA (CNYm)	4,888	4,901	4,906	4,905	4,900	4,892	4,883	4,670	4,647	4,622	Terminal value
Capex (CNYm)	-643	-650	-656	-663	-669	-676	-683	-690	-697	-704	
Cash flow (CNYm)	4,074	4,079	4,077	4,069	4,057	4,043	4,028	3,807	3,777	3,746	35,632
Discounted FCF	1228.7	1103.2	988.9	885.1	791.4	707.2	631.8	535.6	476.5	423.7	3614.6
Total discounted FCF (from FY15E)			25,023					NAV/share (CNY)	1.94		
Net cash, FY14E			2,869		Total value	27,892		NAV/share (HKD)	2.32		@ HKD 1.20 = CNY 1

Assumptions (%)			
Beta (x)	0.83	Terminal growth rate	1
Equity-risk premium	10.1	Cost of debt	8.0
Risk-free rate	4.3	Debt-weighting	25
Cost of equity	12.7	WACC*	11.5

Source: Daiwa estimates and forecasts

■ Huishan upstream business valuation – sensitivity to assumptions (HKD/share)

Terminal growth rate (%) \ WACC (%)	10.0	11.0	11.5	12.0	12.5
0.0	2.55	2.42	2.30	2.19	2.09
0.5	2.57	2.43	2.31	2.20	2.10
1.0	2.59	2.45	2.32	2.21	2.11
1.5	2.61	2.47	2.34	2.22	2.12
2.0	2.63	2.49	2.36	2.24	2.13

Risk-free rate (%) \ Beta (x)	0.73	0.78	0.83	0.88	0.93
3.3	2.74	2.62	2.52	2.41	2.32
3.8	2.62	2.52	2.42	2.32	2.24
4.3	2.52	2.42	2.32	2.24	2.15
4.8	2.42	2.32	2.24	2.16	2.08
5.3	2.32	2.24	2.16	2.08	2.01

Source: Daiwa estimates

■ **Huishan: valuation of downstream business and target price**

	Unit	FY14E	FY15E	FY16E
Huishan's total cash earnings	CNYm	1,309	1,922	2,628
Net profit from upstream business	CNYm	1,200	1,766	2,389
Implied net profit for downstream business	CNYm	110	156	240
Implied net margin for downstream business	%	4.1	4.3	4.5
Valuation of downstream business	**@ 12 x FY15E PER**		1,874	
Valuation of downstream business per share	(CNY)		0.13	
Valuation of downstream business per share	**(HKD)**		**0.16**	
Valuation of upstream business per share	(HKD)		2.32	
Target price	**(HKD)**		**2.48**	

Source: Daiwa estimates

■ **China: downstream peers' valuation comparison:**

	Bloomberg			Mkt.Cap.	Price	Stock Δ %		PER (x)				EPS growth(%)				EV/EBITDA (x)		Revenue YoY %			EBIT margin (%)		
Name	Code	Rating	CRY	USDm	4/30/14	3M	1M	FY13	14E	15E	16E	FY13	14E	15E	16E	FY14	FY15E	FY13	14E	15E	FY13	14E	15E
Mengniu Dairy*	2319 HK	Hold	HKD	9,980	39.85	11	1	35.3	29.4	24.7	20.2	14	22	19	23	16.1	13.5	20	19	11	4.3	4.9	5.2
Want Want China	151 HK	NR	HKD	20,597	12.16	16	2	30.0	26.4	22.6	19.5	24	13	17	16	17.8	15.1	14	17	16	21.2	22.2	22.7
Tingyi	322 HK	NR	HKD	15,462	21.55	7	-5	37.8	28.8	24.0	20.6	-11	32	20	17	12.1	10.4	19	12	13	6.1	7.5	8.2
Tsingtao Brewery	168 HK	NR	HKD	9,174	56.45	-1	-1	30.8	26.9	22.7	n.a.	12	15	18	1	14.5	12.5	11	25	13	7.2	8.5	9.2
CRE	291 HK	NR	HKD	6,795	22.05	-5	0	27.9	27.7	23.5	20.3	-52	1	18	15	7.8	6.8	16	15	15	3.0	3.0	3.1
Huiyuan	1886 HK	NR	HKD	1,303	5.08	15	-11	30.0	21.6	16.2	12.9	n.a.	n.a.	34	25	11.1	9.0	13	31	26	(1.8)	12.4	13.0
Uni-President China	220 HK	NR	HKD	2,963	6.42	-9	-5	20.1	26.2	22.0	19.7	7	-23	19	12	11.8	9.9	9	12	13	1.9	2.7	3.0
Average (ex-Mengniu):								**30.3**	**26.7**	**22.2**	**18.9**	***(1)***	***10***	***21***	***16***	**13.0**	**11.0**	***15***	***19***	***15***	**6.0**	**8.7**	**9.2**

*Source: Bloomberg, * denotes Daiwa forecasts*

■ **China upstream peers' valuation comparison**

	Bloomberg			Mkt.Cap.	Price	Stock Δ %		PER (x)				EPS Growth				EV/EBITDA (x)		Revenue YoY %			EBIT margin		
Name	Code	Rating	CRY	USDm	4/30/14	3M	1M	FY13	14E	15E	16E	FY13	14E	15E	16E	FY14E	FY15E	FY13	14E	15E	FY13	14E	15E
CMD*	1117 HK	Buy	HKD	2,055	3.32	-8	-8	25.5	13.1	10.1	8.1	23	97	30	25	11.0	9.2	62	34	20	25.1	31.8	32.3
Huishan Dairy*	6863 HK	Buy	HKD	3,270	1.76	-32	-21	14.6	10.6	7.8	n.a.	106	21	38	37	10.9	7.8	92	40	33	46.0	42.0	48.0
Yuanshengtai Dairy Farm	1431 HK	NR	HKD	646	1.29	-32	-2	9.3	6.9	5.1	4.4	n.a.	35	34	17	7.4	5.5	28	37	31	27.0	39.8	40.2
Average:								**16.5**	**10.2**	**7.7**	**6.2**	***65***	***51***	***34***	***26***	**9.8**	**7.5**	***60***	***37***	***28***	***32.7***	**37.9**	**40.2**

*Source: Bloomberg, * denotes Daiwa forecasts.*
Note: For Huishan, FY13-16E PERs is used as its year- end, which is 31 March

Investment risks

Bovine diseases – the main risk

Huishan has about 2,500-3,000 dairy cows per farm. If a serious bovine disease were to break out at any of its farms, all the cows in that farm might have to stop being milked and even be euthanized, if required by the regulator. Further, as all of Huishan's farms are currently located only in Liaoning Province, this would make Huishan more vulnerable than its peers with farms in different provinces to an outbreak in Liaoning Province, given the company has no farms elsewhere.

Control of A&P costs for downstream business

We have assumed that Huishan's downstream business will account for about 10% of its core net profit over FY14-16, and, as such this business does not represent a significant component of our target price. If the company's A&P costs, in particular for new products, are higher than we expect, this part of Huishan's business could become loss-making, which could disappoint investors and lead to cuts in consensus earnings forecasts.

Sharp rise in feed costs

Feed costs account for about 70-80% of a dairy farm's COGS. If the cost of grain were to rise significantly and Huishan could not raise its raw milk prices in response, its gross profit margin could be adversely affected materially.

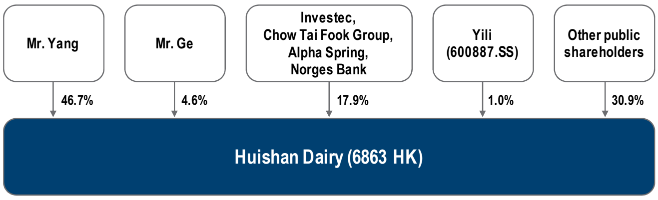
Share sales by financial investors

A group of financial investors invested USD290m to buy convertible bonds in Huishan in June 2011. These bonds were converted into 3bn shares after the company's IPO in 3Q13, an amount equivalent to 17.7% of its issued share capital, and were worth HKD0.78/share. The lock-up period for these investors ended on 26 March this year. Share sales by these investors could cause short-term share-price volatility.

Company background

Mr. Kai Yang, the founder and current chairman of Huishan, has about 20 years of experience in China's food industry. After the melamine scandal which affected several dairy companies in China in 2008 (described in our industry analysis in this sector report), Mr. Yang Kai saw investment opportunities in the upstream dairy sector and started to invest and build dairy farms. The company later acquired the Huishan brand from an SOE that had its roots in the 1950s. Huishan's products were not found to be contaminated with melamine during the 2008 scandal.

■ Huishan: current shareholding structure



Source: Company

Mr. Yang is also been involved in the property development and bio-waste treatment businesses. His 100%-owned associate company, Zhao Ji Investment, owns one of the largest bio-waste gas-generation projects in Asia, according to the Central Government's website. This company provides bio-waste cleaning services to Huishan (free of charge), which helps Huishan to keep its spending on waste-treatment facilities low.

■ One of Chairman Yang's bio-diesel plants in Shenyang used to treat Huishan's cow waste

Source: Daiwa

Hero (Not listed), a provider of infant-nutrition products and fruit-based products based in Switzerland, entered into a joint venture with Mr. Yang to develop infant-formula products in 2010. The business was later injected into Huishan. Hero became an investor in Huishan for a while, buying a 4.3% stake after the IPO, but disposed of its stake at a price of HKD2.21/share in March this year.

Yili was one of the cornerstone investors for Huishan's IPO, and owns a 0.98% stake in the company currently.

Company

Consumer Staples / China
2 May 2014

The 10-second briefing

China Mengniu Dairy
2319 HK

Target (HKD): **40.70**
Upside: **2.1%**
30 Apr price (HKD): **39.85**

Initiation: positives from product mix upgrade priced in

- Gross margin expansion from product mix upgrades and acquisition-led earnings growth look priced into 29x 2014E PER
- We believe we need to see good M&A execution and greater control of raw-material costs to drive a further re-rating
- Initiating coverage with a Hold rating and target price of HKD40.70, based on a 30x 2014E PER

1 Buy
2 Outperform
3 **Hold** (initiation)
4 Underperform
5 Sell

How do we justify our view?

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■ Investment case

We initiate coverage on China Mengniu Dairy (Mengniu), China's largest dairy-product company by revenue, with a Hold (3) rating. We like Mengniu's focus on enhancing its product mix with higher-gross-margin products but believe its risk/reward profile is unappealing.

M&A execution risks appear overlooked. Aside from China Modern Dairy (CMD) (28%-owned), we do not expect major near-term profit contributions from Mengniu's M&A carried out in 2013. For its JV with Danone, we foresee product cannibalisation between Mengniu's original products and Danone's.

Product mix upgrades should mitigate cost pressure. Mengniu continues to launch new flavours and packaging to tap the mid-to-high end segments. We forecast this and its advertising targeting youngsters to help offset rising cost pressures and drive a 13% revenue CAGR for 2013-16 (ex-Yashili). Still, we expect a flat 28% UHT liquid market share for 2014-16, as rivals will likely keep launching similar new products. Also, with China's raw milk shortage likely to persist, we forecast Mengniu's unit milk cost to rise by 5% YoY in 2014, partially offsetting product-mix upgrade benefits.

How we are different. Our 2014-16E revenue and EPS are 1-3% and 1-13%, respectively, below the Bloomberg consensus, as we build in slow market growth amid intensifying competition and are cautious on Mengniu's organic revenue growth.

■ Catalysts

ASP hikes and product mix upgrades would be earnings catalysts. Mengniu continues to seek strategic partners to explore new dairy opportunities, which could be catalysts if they create value and do not over-stretch management resources.

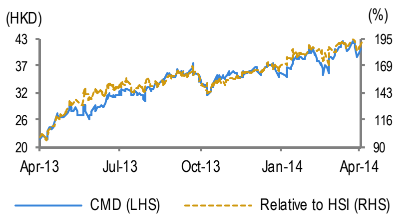
■ Valuation

Our 6-month target price of HKD40.70 is based on a 30x 2014E PER, representing a 12% premium to the major China F&B players' average of 26.7x, given higher prospective earnings growth vs. its peer group. We believe Mengniu's current 29x PER for 2014E prices in our earnings outlook.

■ Risks

We see the key upside risk as value-enhancing investments and/or M&A activity, and the main downside risk as a sharp rise in milk costs.

Share price performance



12-month range	21.75-42.75
Market cap (USDbn)	9.98
3m avg daily turnover (USDm)	40.53
Shares outstanding (m)	1,942
Major shareholder	COFCO (16.3%)

Financial summary (CNY)

Year to 31 Dec	14E	15E	16E
Revenue (m)	51,526	57,304	63,811
Operating profit (m)	2,505	2,952	3,590
Net profit (m)	2,054	2,524	3,098
Core EPS (fully-diluted)	1.094	1.300	1.595
EPS change (%)	21.7	18.8	22.7
Daiwa vs Cons. EPS (%)	(1.1)	(6.3)	(12.8)
PER (x)	29.4	24.7	20.2
Dividend yield (%)	0.5	0.6	0.7
DPS	0.159	0.195	0.239
PBR (x)	3.0	2.7	2.4
EV/EBITDA (x)	16.1	13.5	11.0
ROE (%)	11.3	11.3	12.5

Source: FactSet, Daiwa forecasts

1 Buy
2 Outperform
3 **Hold** (initiation)
4 Underperform
5 Sell

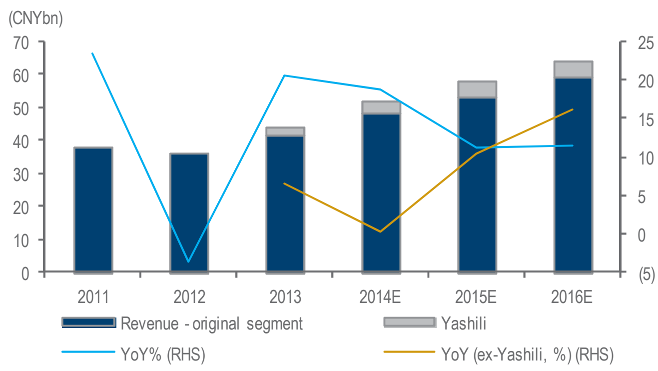
How do we justify our view?

- Growth outlook ✔ ✔ ✔ ✔ ✔
- Valuation ✔ ✔ ✔ ✔ ✔
- Earnings revisions ✔ ✔ ✔ ✔ ✔

Growth outlook ✔ ✔ ✔ ✔ ✔

Reflecting Mengiu's strategy to enhance its product mix amid a structural growth slowdown in China's dairy market, we believe its key revenue driver over 2014-16 will shift to high-margin dairy products, such as infant milk formulae. For 2014, revenue growth should also be driven by the first full year of inclusion of Yashili (75.6% owned), which we forecast will contribute 12-13% to total revenue and 13% to total net profit this year. We forecast organic (ie, excluding M&A) net profit growth of 15% YoY for 2014, and 23% YoY for 2015-16. We expect the ratio of selling expenses to revenue to rise from 17.3% back in 2012 to 19.4% in 2014, including Yashili.

Mengniu: revenue growth YoY ex-Yashili and with Yashili

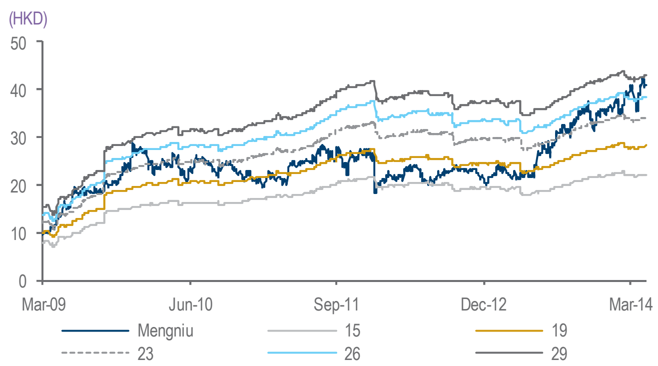


Source: Company, Daiwa forecasts

Valuation ✔ ✔ ✔ ✔ ✔

Mengniu trades at a 2014E PER of 29x (on our EPS). This multiple is at a premium to its major China food and beverage peers (26.7x on average on the Bloomberg consensus EPS) and its China upstream dairy peers (10x), and is at the high end of Mengniu's 12-month forward trading PER range of 17-30x since 2009, ie, after the 2008 melamine scandal. Food conglomerate COFCO's acquisition of an 18% stake in Mengniu in 2009 has triggered a rerating. Leveraging COFCO's network and financial strength, Mengniu has gained access to international expertise and strengthened its balance sheet. But we believe the stock is fairly valued and that we need to see an improvement in raw-material cost control and successful M&A execution for it to re-rate further.

Mengniu: 12-month forward PER bands

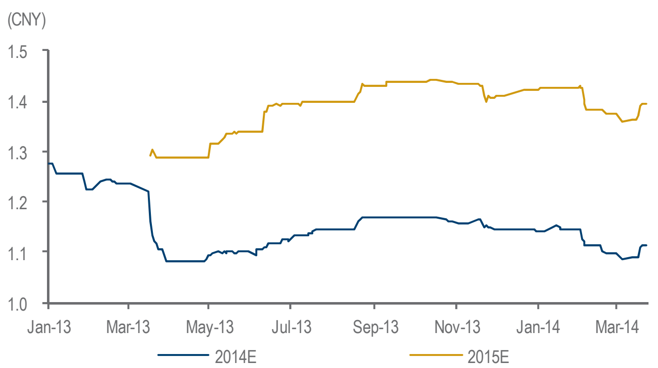


Source: Company, Bloomberg

Earnings revisions ✔ ✔ ✔ ✔ ✔

Our 2014 and 2015 EPS forecasts for Mengniu are 1% and 6% below the respective Bloomberg consensus forecasts, as we build in intensifying competition and slower domestic dairy market growth. The consensus EPS forecasts for both years trended up during 2013, reflecting positive expectations surrounding the company's acquisitions of Yashili and a 28% stake in CMD. Year-to-date, however, the consensus EPS forecasts have been revised down gradually as Yashili's 2013 results missed consensus expectations and the raw-milk price has remained elevated, implying increased cost pressure for Mengniu.

Mengniu: consensus EPS revisions for 2014-15E



Source: Bloomberg

Financial summary

Key assumptions

Year to 31 Dec	2009	2010	2011	2012	2013	2014E	2015E	2016E
Sales growth YoY - Liquid Milk	n.a.	n.a.	25	(4)	17	16	12	11
Sales growth YoY - Yashili pediatric formula	n.a.	n.a.	n.a.	n.a.	6	0	11	16
ASP hike	n.a.	n.a.	3.2	2.0	4.5	4.6	2.8	2.0
SG&A cost ratio	n.a.	n.a.	20.9	20.5	22.5	23.3	23.0	22.7

Profit and loss (CNYm)

Year to 31 Dec	2009	2010	2011	2012	2013	2014E	2015E	2016E
Liquid Milk	22,736	26,872	33,701	32,336	37,903	44,071	49,323	54,759
Ice-cream	2,685	3,112	3,259	3,171	3,023	3,207	3,272	3,599
Other Revenue	289	282	428	572	2,431	4,248	4,709	5,453
Total Revenue	**25,710**	**30,265**	**37,388**	**36,079**	**43,357**	**51,526**	**57,304**	**63,811**
Other income	81	193	296	249	289	145	145	145
COGS	(18,858)	(22,479)	(27,796)	(27,050)	(31,660)	(36,839)	(40,955)	(45,525)
SG&A	(5,517)	(6,465)	(7,805)	(7,398)	(9,774)	(12,007)	(13,192)	(14,490)
Other op.expenses	(1,012)	(1,063)	(1,224)	(1,254)	(1,732)	(1,728)	(1,891)	(1,991)
Operating profit	**1,303**	**1,455**	**1,896**	**1,687**	**1,852**	**2,505**	**2,952**	**3,590**
Net-interest inc./(exp.)	24	43	112	179	199	25	153	280
Assoc/forex/extraord./others	20	40	52	(53)	154	298	381	471
Pre-tax profit	**1,346**	**1,538**	**2,061**	**1,813**	**2,205**	**2,829**	**3,485**	**4,342**
Tax	(126)	(182)	(276)	(245)	(367)	(481)	(662)	(912)
Min. int./pref. div./others	(104)	(119)	(195)	(186)	(231)	(294)	(298)	(333)
Net profit (reported)	**1,116**	**1,237**	**1,589**	**1,382**	**1,607**	**2,054**	**2,524**	**3,098**
Net profit (adjusted)	**1,116**	**1,237**	**1,589**	**1,382**	**1,607**	**2,054**	**2,524**	**3,098**
EPS (reported)(CNY)	**0.681**	**0.712**	**0.908**	**0.789**	**0.899**	**1.094**	**1.300**	**1.595**
EPS (adjusted)(CNY)	**0.681**	**0.712**	**0.908**	**0.789**	**0.899**	**1.094**	**1.300**	**1.595**
EPS (adjusted fully-diluted)(CNY)	**0.681**	**0.712**	**0.908**	**0.789**	**0.899**	**1.094**	**1.300**	**1.595**
DPS (CNY)	**0.141**	**0.160**	**0.198**	**0.160**	**0.202**	**0.159**	**0.195**	**0.239**
EBIT	**1,303**	**1,455**	**1,896**	**1,687**	**1,852**	**2,505**	**2,952**	**3,590**
EBITDA	**1,978**	**2,168**	**2,760**	**2,728**	**3,069**	**3,864**	**4,443**	**5,182**

Cash flow (CNYm)

Year to 31 Dec	2009	2010	2011	2012	2013	2014E	2015E	2016E
Profit before tax	1,346	1,538	2,061	1,813	2,205	2,829	3,485	4,342
Depreciation and amortisation	675	713	864	1,041	1,218	1,358	1,491	1,591
Tax paid	(71)	(49)	(218)	(285)	(307)	(481)	(662)	(912)
Change in working capital	23	193	300	(133)	(1,106)	289	538	650
Other operational CF items	(43)	(83)	(164)	(126)	(353)	(323)	(533)	(752)
Cash flow from operations	**1,930**	**2,312**	**2,842**	**2,310**	**1,656**	**3,672**	**4,319**	**4,920**
Capex	(740)	(1,426)	(2,696)	(2,267)	(3,101)	(3,000)	(2,000)	(2,000)
Net (acquisitions)/disposals	0	0	0	0	(9,495)	(372)	0	0
Other investing CF items	0	0	0	0	0	0	0	0
Cash flow from investing	**(740)**	**(1,426)**	**(2,696)**	**(2,267)**	**(12,597)**	**(3,372)**	**(2,000)**	**(2,000)**
Change in debt	(1,021)	60	(184)	(58)	11,191	(6,118)	(1,452)	(1,444)
Net share issues/(repurchases)	2,696	0	0	0	0	4,089	0	0
Dividends paid	(188)	(245)	(278)	(350)	(283)	(367)	(308)	(379)
Other financing CF items	619	(282)	317	(12)	1,350	(148)	(111)	(6)
Cash flow from financing	**2,107**	**(467)**	**(145)**	**(420)**	**12,258**	**(2,543)**	**(1,872)**	**(1,828)**
Forex effect/others	0	0	0	0	0	0	0	0
Change in cash	**3,297**	**419**	**1**	**(376)**	**1,318**	**(2,244)**	**447**	**1,092**
Free cash flow	1,190	886	146	43	(1,445)	672	2,319	2,920

Source: FactSet, Daiwa forecasts

Financial summary continued …

■ Balance sheet (CNYm)

As at 31 Dec	2009	2010	2011	2012	2013	2014E	2015E	2016E
Cash & short-term investment	6,381	6,800	6,801	6,230	7,663	5,419	5,866	6,958
Inventory	715	1,176	1,685	1,420	2,577	2,999	3,334	3,706
Accounts receivable	580	575	836	801	754	896	997	1,110
Other current assets	339	1,112	1,064	1,310	5,327	5,327	5,327	5,327
Total current assets	**8,014**	**9,664**	**10,387**	**9,761**	**16,321**	**14,641**	**15,523**	**17,101**
Fixed assets	5,246	5,915	7,694	8,489	10,522	12,488	13,020	13,453
Goodwill & intangibles	598	1,158	1,292	1,516	8,356	8,428	8,428	8,428
Other non-current assets	237	568	829	1,225	5,140	5,419	5,779	6,231
Total assets	**14,096**	**17,306**	**20,202**	**20,991**	**40,339**	**40,976**	**42,751**	**45,212**
Short-term debt	431	691	657	599	8,554	3,000	2,000	1,000
Accounts payable	2,340	3,548	3,685	3,679	4,761	5,817	6,791	7,926
Other current liabilities	1,784	1,999	2,885	2,703	4,748	4,545	4,545	4,545
Total current liabilities	**4,554**	**6,238**	**7,226**	**6,981**	**18,063**	**13,362**	**13,335**	**13,470**
Long-term debt	350	150	0	0	3,236	2,672	2,220	1,776
Other non-current liabilities	280	700	927	938	1,029	1,029	1,029	1,029
Total liabilities	**5,184**	**7,088**	**8,153**	**7,919**	**22,328**	**17,063**	**16,584**	**16,276**
Share capital	179	179	181	181	181	181	181	181
Reserves/R.E./others	8,397	9,579	11,290	12,262	15,180	20,956	23,172	25,891
Shareholders' equity	**8,576**	**9,758**	**11,471**	**12,443**	**15,361**	**21,137**	**23,354**	**26,073**
Minority interests	336	459	578	629	2,650	2,775	2,813	2,864
Total equity & liabilities	**14,096**	**17,306**	**20,202**	**20,991**	**40,339**	**40,976**	**42,751**	**45,212**
EV	57,137	56,855	56,748	57,388	66,402	62,374	60,152	57,216
Net debt/(cash)	**(5,600)**	**(5,959)**	**(6,145)**	**(5,631)**	**4,126**	**253**	**(1,646)**	**(4,182)**
BVPS (CNY)	**4.937**	**5.617**	**6.490**	**7.040**	**8.438**	**10.886**	**12.028**	**13.428**

■ Key ratios (%)

Year to 31 Dec	2009	2010	2011	2012	2013	2014E	2015E	2016E
Sales (YoY)	7.7	17.7	23.5	(3.5)	20.2	18.8	11.2	11.4
EBITDA (YoY)	n.a.	9.6	27.3	(1.1)	12.5	25.9	15.0	16.6
Operating profit (YoY)	n.a.	11.7	30.3	(11.0)	9.8	35.3	17.8	21.6
Net profit (YoY)	n.a.	10.9	28.4	(13.0)	16.3	27.9	22.9	22.7
Core EPS (fully-diluted) (YoY)	n.a.	4.5	27.5	(13.0)	13.9	21.7	18.8	22.7
Gross-profit margin	26.7	25.7	25.7	25.0	27.0	28.5	28.5	28.7
EBITDA margin	7.7	7.2	7.4	7.6	7.1	7.5	7.8	8.1
Operating-profit margin	5.1	4.8	5.1	4.7	4.3	4.9	5.2	5.6
Net profit margin	4.3	4.1	4.3	3.8	3.7	4.0	4.4	4.9
ROAE	17.1	13.5	15.0	11.6	11.6	11.3	11.3	12.5
ROAA	8.8	7.9	8.5	6.7	5.2	5.1	6.0	7.0
ROCE	16.1	14.0	16.0	12.8	8.5	8.4	9.8	11.6
ROIC	34.9	33.9	32.3	21.9	10.4	9.0	9.8	11.5
Net debt to equity	net cash	net cash	net cash	net cash	26.9	1.2	net cash	net cash
Effective tax rate	9.4	11.8	13.4	13.5	16.6	17.0	19.0	21.0
Accounts receivable (days)	6.6	7.0	6.9	8.3	6.5	5.8	6.0	6.0
Current ratio (x)	1.8	1.5	1.4	1.4	0.9	1.1	1.2	1.3
Net interest cover (x)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Net dividend payout	20.7	22.5	21.8	20.3	22.4	14.5	15.0	15.0
Free cash flow yield	1.9	1.4	0.2	0.1	n.a.	1.1	3.7	4.7

Source: FactSet, Daiwa forecasts

■ Company profile

Established in Inner Mongolia in 1999, China Mengniu Dairy (Mengniu) is controlled by COFCO group, a state-owned food conglomerate. Mengniu focuses on the production of UHT milk, milk beverages and ice cream. It is China's largest maker of liquid milk products by revenue, with about a 28% market share in 2013, according to AC Nielsen.

Too early to price in M&A potential

We believe the market is pricing in too early the potential positives from Mengniu's product mix upgrades through M&A activity, and is overlooking the prospect of rising raw milk costs, a slowdown in UHT milk revenue growth and execution risks from M&A.

Enhancing product mix through ties with international industry leaders

Over recent years, Mengniu has seen a change of major shareholder which has brought about operational and financial benefits for it and has given it access to international expertise. In addition, Mengniu has been active on the M&A front to enhance its product mix and business growth and complement organic business growth.

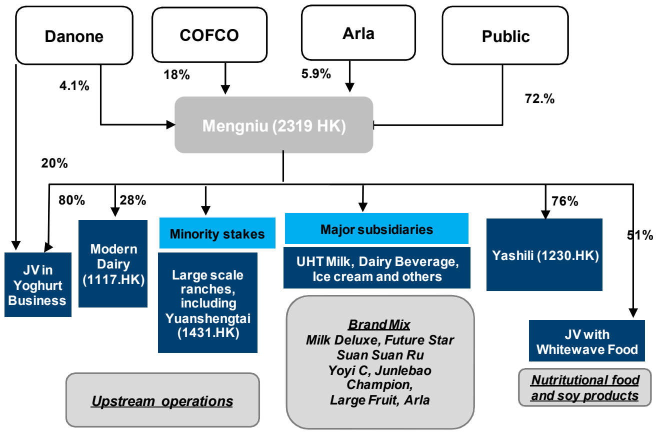
In 2009, COFCO, a state-owned China food conglomerate, became Mengniu's largest shareholder, purchasing 77m new shares issued by Mengniu which gave it an 18% stake at that time. Also, since 2009 the company's founding shareholders, which had included Mr. Genshen Niu, the former CEO, gradually sold down their stakes.

Following the introduction of strategic investors in 2012 and 2013 and new share issuance to Danone in March this year that we go on to discuss, COFCO, Arla Foods and Danone currently own respective shareholdings of 16.3%, 5.4% and 9.9% in Mengniu. Danone is a major France-based group selling dairy products and other food and beverage items worldwide. Arla Foods is a European dairy industry leader based in Denmark and owned by more than 12,000 co-operative dairy farms in Denmark, Sweden and 4 other countries. Both Arla Foods and Danone are contributing to Mengniu's business in the areas of quality, safety control and new product development.

Danone recently raised its stake at a premium to Mengniu's current share price

In March this year, Mengniu issued 121m new shares to Danone at a price of HKD 42.5/share. Following the restructuring also carried out in March of Mengniu's holding vehicle, the stakes held by COFCO, Arla Foods and Danone in Mengniu are now 16.3%, 5.4% and 9.9%, respectively, all held through a jointly-owned holding company. The next chart displays Mengniu's shareholding structure post the above moves.

■ Mengniu: shareholding structure post new share placement to Danone



Source: Company, Daiwa
*Note: * Effective interest in Mengniu*

The funds raised from Mengniu's new shares issued to Danone will help to strengthen Mengniu's balance sheet (which we discuss in the financials section further on) and thus are a slight positive for the company, in our view.

With regards to Danone, based on our discussions with Mengniu's management, we believe the distribution capabilities of Mengniu and its parent COFCO in China are of interest to Danone, as they could help enhance Danone's sales of yoghurt in China. However, given that COFCO is the PRC Government's investment arm in the country's food industry, we believe COFCO is likely to maintain management control of Mengniu, as part of COFCO's aim to maintain a presence in all major food segments in China. Our industry research suggests that Danone's influence on Mengniu's management and daily operations will be mainly in the areas of technology know-how and product development.

Background to Danone's involvement in China dairy business

We note that, aside from its joint venture with Mengniu (discussed later), Danone has had a chequered history of co-operation with Chinese enterprises, which suggests to us that Danone would probably keep its stake in Mengniu at below those of the latter's other 2 strategic shareholders, COFCO and Arla Foods.

Danone started its first yoghurt plant in China in 1987 in Guangzhou. Since 1996, Danone entered into co-operation agreements with well-known domestic food and beverage companies but these forays unfolded as follows:

Bright Dairy (Bright): Danone became a strategic shareholder when it bought a 5% stake in dairy products company Bright in 2001, and increased its stake to 20% in 2006. Danone's own-brand products accounted for about 12% of Bright's net profit in 2006. However, due to a series of restructuring measures in Shanghai SOEs including Bright and Bright's sister companies, led by the local administration, Danone sold its stake to other major shareholders in 2007.

Wahaha: Danone formed a 51%-owned joint venture with Wahaha, a dairy beverage and food company, in 1996. However, there were disputes over the use of the Wahaha trademarks in 2007, and Danone subsequently sold its stake to the Wahaha Group for EUR300m, which was below Danone's EUR380m book value of the stake in 2009.

Mengniu: prior to establishing their current joint venture, Danone and Mengniu first formed a joint venture to develop the yoghurt business in 2006, but the agreement collapsed in 2007. Mengniu was still controlled by its founding shareholder during that period.

Execution risks related to M&A

Since 2013, Mengniu has announced or executed a few major M&A deals, and has spent more than CNY10bn in total on such moves. This has changed the company's balance sheet position from a cash-rich position to slight gearing.

At first sight, the M&A projects have ROEs of above 13%, higher than Mengniu's average ROE over the past 5 years (ie, after the 2008 melamine scandal hit China). However, we see risks from stretching management resources at the initial operating stage of its M&A projects, as well as from potential cannibalisation of different product lines between Mengniu's existing projects and those of its M&A partners.

■ **Mengniu: M&A and major investments in 2013 and 1Q14**

M&A activity	Rationale	Transaction value (CNYm)	ROE (2014E)
Acquired 28% stake in China Modern Dairy (CMD)	Upstream expansion	2,752	13.0
Acquired controlling 75.6% stake in Yashili	Product diversification	7,754	16.9
Formed 80%-owned JV with Danone	Horizontal integration and margin improvements	n.a.	n.a.
Formed 51%- owned JV with Whitewave Food	To drive a focus by Yashili on milk powder	190	n.a.
	Total	10,696	n.a.

Source: Company, Daiwa forecasts for ROE

Yoghurt joint venture with Danone – positioning looks unclear

For example, the current Mengniu-Danone joint venture, which was set up in 2H13, plans to launch new yoghurt brands as well as selling Mengniu's existing ones. Mengniu and Danone will inject their brands and production plants in China by June this year. Mengniu's management expects Danone to upgrade the technology and improve the efficiency of the joint venture's yoghurt operation, which currently generates a lower operating-profit margin than Mengniu's core UHT milk business (the numbers have not been disclosed).

However, we are concerned about the potential execution risks for this joint venture, at least in the near term, which could come from cannibalisation of the 2 brands' similar products. We take an acquisition carried out by Mengniu 4 years ago as an example.

Junlebao (JLB) was the fourth-largest yoghurt brand in China with a 14% market share in 2008. Mengniu acquired a controlling 51% stake in JLB in 2010. JLB has remained independent of Mengniu in terms of operations since the acquisition. However, its market share declined to just 7% in 2012, which we believe was due to Mengniu's more aggressive promotions of its own branded yoghurt products rather than JLB's, and has since remained at that level, according to AC Nielsen. We believe there is a risk that JLB could lose more market share to Danone and Mengniu in the long run, as we are of the view that Mengniu will focus more marketing and research resources on the brands of the joint venture than that of JLB.

Given the unclear positioning of JLB within Mengniu, we are concerned about the execution risks of combining Danone and Mengniu's yoghurt businesses in the future.

Yet to see distribution synergies with Yashili

Yashili – acquisition of a low-PER stock

Founded by the 6 Zhang brothers, of whom 2 are currently executive directors, Yashili has distributed infant formulae in China for more than 20 years under its brand, Yashili, and the later-launched brand, Scient.

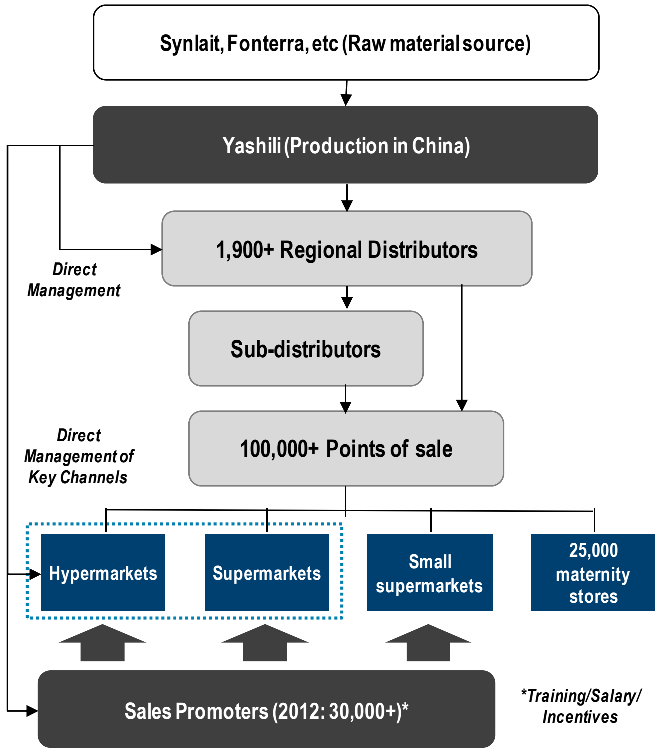
After the melamine scandal in China 2008 (explained in our industry analysis in this sector report), the company switched its raw-material source from domestic milk powder to New Zealand imports and shifted its sales focus to tier-2 and tier-3 cities from tier-1 cities previously. According to AC Nielsen, Yashili accounted for about 6.6% and 7.7% of the infant formula market in China in terms of value and volume, respectively, in 2012.

In June 2013, Mengniu announced its intention to acquire Yashili for HKD3.50/share, equivalent to a 15x 2014E PER for Yashili at the time, based on the Bloomberg consensus EPS forecast. In October that year, Mengniu retained a 75.6% stake in Yashili and sold down the remaining shares to restore Yashili's free float. The Zhang brothers now own about 10% of Yashili. Currently, Yashili remains independently run by its original management and there is no timetable for an asset injection by Mengniu's original milk powder business.

We believe the Yashili acquisition is value-enhancing for Mengniu, as it was acquired at a PER of 15x, which compared with Mengiu's trading 2014E PER at the time of more than 20x. We estimate Yashili will add about 10% to the company's revenue and 13% to its net profit for 2014 (based on the acquisition proceeds of CNY7.5bn). But we see few synergies, in terms of the sales and distribution networks, between the liquid milk and baby products segments in China.

Yashili has rapidly penetrated specialty baby product stores in tier-3 cities since 2013, resulting in a sharp increase in its sales in those areas. However, we believe these are not appropriate channels for Mengniu's Arla series of infant formula, which targets the high-end segment in tier-1 cities.

■ Yashili: distribution channels (December 2013)



Source: Company

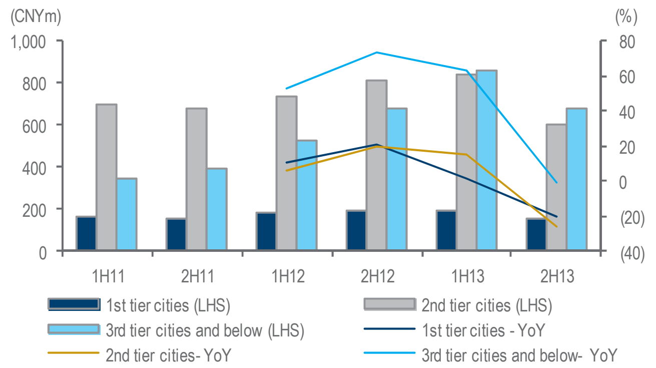
Yashili's weak 2H13 sales could linger in 2014

Yashili's 2013 net profit declined by 6% YoY and came in 14% below the Bloomberg consensus forecast. Its net profit declined by 42% YoY for 2H13, versus an increase of 34% YoY for 1H13. This fall was due to: 1) price competition, and 2) the negative impact of the clostridium botulinum incident relating to Fonterra's milk powder in August 2013. Yashili did not use Fonterra's defective milk powder, but its sales were still affected adversely due to its strong brand association with New Zealand milk sources.

According to management, Yashili's sales have gradually recovered since the clostridium botulinum incident, but management declined to comment as to whether its sales have recovered fully. We forecast Yashili's sales to decline by 7% YoY for 1H14, from a high base in 1H13 and due to the residual impact of the clostridium botulinum incident.

In China's tier-1 and tier-2 cities, where Yashili's sales declined by 21% YoY and 25% YoY, respectively, in 2H13, we are concerned that sales may not fully recover to the pre-incident level, as many consumers can afford other high-end brands, in particular foreign brands, and may not shift back to Yashili's products.

■ Yahili: sales in China by tier of city



Source: Company, Daiwa forecasts

Selling price under pressure

Our market research has revealed that Yashili's shelf-space presence is stronger than that of many other local brands in at modern distribution channels (ie, hypermarket and supermarket chains) but its pricing of about CNY200/900g is cheaper than foreign brands at present. Based on Ministry of Commerce data, we estimate that the average retail price for foreign brands was 30% above that of domestic brands in 2013.

However, China's anti-monopoly investigation into milk powder enterprises last year has triggered price cuts among most foreign brands in China. As shown in the table below, major foreign brands have cut their retail prices by 4-20% as a result. This suggests the price uptrend by foreign brands after the melamine scandal in 2008 has come to a halt since the milk powder investigation.

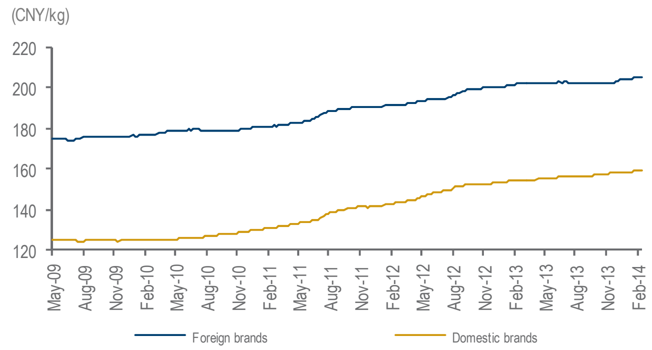
■ Retail price cuts by international brands

Company	3Q13	1Q14
Mead Johnson	7-15%	
Dumex	5-20%	8-18% for new products
Wyeth	11% on average	
Friso	5%	
Abbott	4-12%	
Meiji	5-20%	
Nestle	0-20%	

Source: sina.com

We believe the pricing environment will turn less favourable in 2014 and expect the retail price gap between domestic and foreign brands (the 30% mentioned above) to narrow. This, in turn, would likely lead to pricing pressure for domestic brands such as Yashili.

■ Average retail price of infant formula in China



Source: CEIC, Ministry of Commerce

China Modern Dairy – positive contribution at associate level

We forecast CMD's net profit to rise by 96.8% to CNY994m for 2014 and 29.6% to CNY1,288m for 2015, and account for about 13-14% of Mengniu's net profit. We forecast CMD to account for about 15% of Mengniu's raw milk needs by 2015. In addition, we see long-term synergies between the 2 companies, by Mengniu on CMD's premium milk sources and more launches by Mengniu of high-end products, such as pasteurised milk.

Aside from CMD, Mengniu also bought a 4% stake in Yuanshengtai Dairy (Not rated) in 4Q13 when Yuanghsengtai underwent its IPO on the Hong Kong Stock Exchange. Yuanshengtai is a domestic premium raw milk supplier, which we estimated accounts for less than 2% of Mengniu's raw milk needs.

High liquid milk costs could linger

We forecast Mengniu's cost of raw liquid milk to rise by 5% for 2014. Our sensitivity analysis shows a 1% increase in milk costs would lower its 2014E net profit by 7% relative to our current forecast.

Yet to gain upstream cost control

We believe Mengniu is still weak in terms of controlling its raw-milk supply. Although 94% of its raw-milk needs were supplied by ranches (Mengniu's term for co-operative farms) and large-scale farms in 2013, only 24% of the raw milk used by the company was satisfied by related parties (minority stake investments) or in-house sources. We estimate that 70% of its raw-milk supply is based on co-operation agreements with third-party ranches. As such, we believe Mengniu's control over its raw-milk costs is not strong.

To improve its raw-milk supply quality and lower its costs, Mengniu is building a few large-scale (1,000+ cows per farm) and mega-scale (10,000 cows) farms. We estimate that Mengniu invested around CNY1bn in upstream dairy operations in 2013 (in particular, for its USD60m stake purchase in Yuanshengtai in November), and will invest a further CNY700m in 2014, including in the construction of 2 large-scale dairy farms.

Including CMD, these investments (including minority stakes) should still account for less than 25% of Mengniu's needs if completed by 2016, on our forecasts. Moreover, it usually takes 2 years from the time of construction to the start of production for large-scale farms. Consequently, we expect Mengniu to remain heavily dependent on third-party suppliers for raw milk for the next 2-3 years.

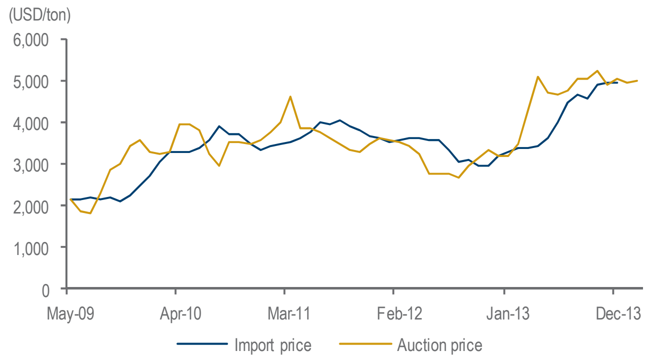
To speed up its in-house dairy farm expansion, in November 2013 Mengniu introduced a third-party investor to its dairy farm operation subsidiary, Fuyuan Farming. As a result, Mengniu's stake in Fuyuan Farming would be reduced from 100% to 45% and the deal should be completed in 2014.

Challenges for infant formula business

Fonterra raised its whole milk-powder price by 48% YoY in 2013, which stands to put gradual pressure on Yashili's gross-profit margin in 2014, as there is usually a 3-6 month delivery time. As such, we forecast a slight 2pp YoY decline in Yashili's gross-profit margin for 2014. We expect international milk powder prices to remain high at the current level this year, on strong demand from China.

In order to improve cost control, Yashili has already started constructing a processing plant in New Zealand, which upon completion in mid-2014, would have an annual capacity of 52,000tpa. This new plant should help lower its raw-material costs and ensure better product quality in the long run. However, the new plant will only account for around of 25% of Yashili's total capacity by the end of 2014, based on our estimates, implying that most of Yashili's products will still be produced in China.

■ Milk-powder prices: Fonterra's import price compared to auction price



Source: China Customs, Fonterra

Product mix upgrades should help offset margin pressure

Mengniu has diversified away from low-end UHT milk and into other high-margin products to offset the rising milk costs; but we do not see significant market-share expansion from these new product launches.

Sales of core products slowing

Mengniu offers a wide range of dairy products, displayed below. Among them, UHT milk is the largest revenue contributor but has a low gross-profit margin.

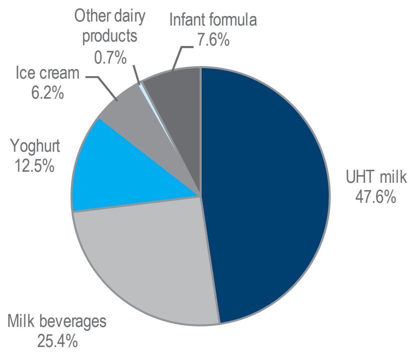
■ Mengniu: product segments

Source: Company, Daiwa estimates for gross margin

As shown in the chart below, we expect UHT milk to remain an important revenue source for Mengniu (48% of total revenue for 2014E), among which about 40% should come from Milk Deluxe, its premium product. We note that the company's revenue growth for UHT milk has been volatile in recent years (up 18% YoY for 2010, up 24% YoY for 2011, down 5% YoY for 2012, and up 12% YoY for 2013), against a backdrop of a slowdown in market growth, reports from time to time of food safety issues that have shaken consumer confidence, and increasing competition in the premium segment.

We forecast revenue growth for UHT milk of 11% YoY for 2014 and 8% YoY for each of 2015 and 2016, driven by high-end products.

■ Mengniu: revenue breakdown by product (2014E)



Source: Daiwa forecasts

Little possibility of differentiation among UHT milk products

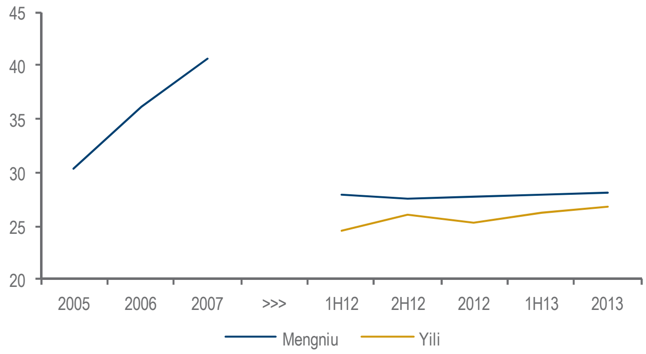
In our view, UHT milk is a basic sub-category in the liquid milk segment and can only be differentiated through milk sources, pricing and availability.

Mengniu was the first to launch a premium milk product in China to tap into the high-end segment, launching its first premium UHT milk product in China, Milk Deluxe, in 2006. However, competition in the premium milk segment has intensified as many peers have launched their own premium UHT products. Many of the company's competitors have attempted to differentiate their products by focusing on regional markets, or highlighting their self-owned raw-milk sources, which Mengniu lacks.

In 1Q14, Mengniu launched a new product, Selected Meadow, which we estimate is priced at around 20% lower than Milk Deluxe. By scanning the QR-barcode printed on the package, consumers can find out the milk source of the milk they consume.

We believe such new UHT products will help raise Mengniu's revenue and gross margin slightly over 2014-16, but at the same time could trigger migration by some consumers between Mengniu's different UHT products and not enhance its market share significantly. As shown below, Mengniu has not seen any significant market-share gains for the past 2 years, according to AC Nielsen. As such, we forecast its market share in UHT milk to remain at about 28% over the next 3 years (2013: 28.1%).

■ **Mengniu: UHT milk market share in China**



Source: AC Nielsen, Company
Note: No market share data was disclosed by the company between 2008 and 2011

Shifting focus to high-margin products to offset high milk costs…

From 2012 onwards, Mengniu's management has divided the company's products into 4 categories: star brands, backbone brands, profit contributors and opportunity brands.

As the following table shows, the company's star brands are its key revenue and revenue growth contributors, posting revenue growth of 32% YoY, based on our estimates. The current revenue contribution of its opportunity brands is small but based on our analysis, these products have potential to grow into star brands, one such product being Just Yoghurt, a room-temperature yoghurt product launched in May 2013.

■ **Mengniu: revenue breakdown by brand cluster, ex Yashili**

Cluster	Example	Highlights	2012 (%)	2013 (%)	Implied YoY growth (%)
Star brands	Milk Deluxe, Yoyi C, Champion	High profit margin, good brand recognition	30.5	34.9	32
Backbone brands	Pure milk	Low profit margin, high volume	49.2	44	3
Profit contributors	Ice-cream	High profit margin, low growth	10.2	8.3	-6
Opportunity brands	Latte, Just Yoghurt	High profit margin, low sales volume	1.5	3.1	139

Source: Company, Daiwa

We believe the strong performance of star brands and some selected opportunity brands is in line with Chinese consumers' shift in consumption patterns. As discussed in our industry section in this sector report, China's dairy industry growth in value terms has been faster than volume growth over the past few years, supported by increasing demand for high-quality, tasty and safe products.

Milk beverages – seeking growth by targeting young consumers

Among all the major product categories, we are most positive on the near-term momentum of Mengniu's milk beverage segment than for its other products. Its milk beverage sales were up by 30% YoY for 2013 and 40% YoY for 2H13. With reference to Want Want China's (151 HK, Not rated) dairy beverage operation, we estimate that Mengniu's segmental gross-profit margin is at least 35%, above its overall gross-profit margin of 27% reported for 2013.

We believe the sales momentum for this segment, as well as for the company's other star brand products, will be supported by effective advertising and promotional campaigns (such as the sponsorship of pop-music programmes) targeting youngsters. As such, we forecast the segment's revenue to increase by 26% YoY for 2014, 18% YoY for 2015 and 15% YoY for 2016, and its contribution to Mengniu's total revenue to rise to 25-28% by 2016, up from 24% in 2013.

However, we believe the entry barriers for milk beverage production are low in terms of technology and raw-material availability, given that milk beverages can be derived from milk powder, which can be imported. The room for taste and flavour differentiation is also limited. As such, successful products can easily be copied by other players.

For example, a number of dairy brands in China (including Mengniu) launched banana-flavoured milk beverages in 2012 and 2013, following the success of Korea's Binggrae (005180 KS, Not rated) with its banana-milk product. Binggrae is the largest banana dairy beverage brand in Korea and was the first to launch the product in China in 2008. Below we show a few examples of the products available in the China market.

■ **Banana beverage products from Mengniu and some competitors**

Source: Daiwa

Yoghurt – cannibalisation between old and new products

Mengniu has launched some successful yoghurt products over the past 3 years. For example, revenue generated by its Champion-branded yoghurt increased by more than 20% YoY for 1H13, according to the company. However, overall revenue from its yoghurt products was up only 11% YoY for 1H13 (2013: 18% YoY growth). We believe new yoghurt products launched by Mengniu have taken market share away from its other products instead of driving the segment's growth.

In terms of chilled yoghurt, Mengniu's market share dipped from 19.7% in 2012 to 19.4% in 2013, according to AC Nielsen and Mengniu's disclosure.

Looking forward, we believe Mengniu's lacklustre market-share record and cannibalisation among its old and new products will keep the company's yoghurt sales growth modest at 18% YoY for 2014 and 13% YoY for 2015.

Infant formula – staying in the mid-tier

Before Mengniui acquired Yashili, infant formula accounted for less than 1% of Mengniu's revenue, mainly from sales of the Arla Mengniu product. Since its launch in 2007, this product has targeted high-end consumers. However, we believe the focus of Mengniu's infant formula business will shift following its acquisition of Yashili, which targets mid-end and low-end products, and tier-2 and tier-3 cities. In our view, volume will be the key growth drivers in this segment.

Ice cream and other products

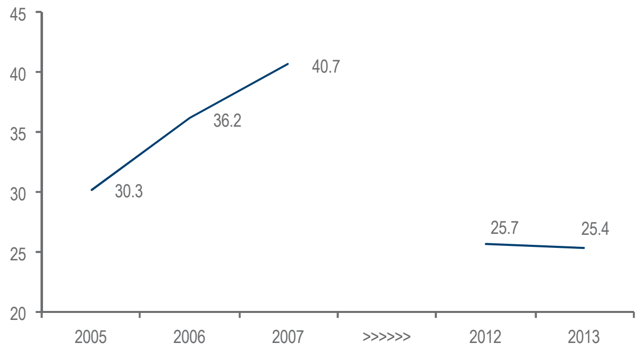
For products such as ice cream and cheese, Mengniu is targeting high-end segments and bringing in pioneer products that have not been available in China before, such as ice-cream sandwiches. However, we believe Mengniu's products are inferior in terms of brand recognition and quality to the major foreign brands in these segments, and as such we expect the segment's revenue contribution to remain low at 5-6% of Mengniu's total revenue over the next few years.

For other dairy products such as cheese, Mengniu plans to introduce high-end products in conjunction with its strategic partner, Arla, in the near future, to satisfy Chinese consumers' predilection for high-quality imported products.

...but market-share gains look challenging to achieve

Data from Mengniu and AC Nielsen show that Mengniu's market share in the liquid milk segment (UHT milk, dairy beverages, yoghurt, etc.) declined from 25.7% in 2012 to 25.4% in 2013, lower than 30-40% before China's melamine scandal in 2008.

■ **Mengniu: liquid-milk market share**



Source: AC Nielsen, company

At the same time, the top-4 liquid milk players' market share declined to 67.6% in 2013, from 69.4% in 2012. We believe this is evidence that it is not easy for Mengniu to take market share from smaller players, despite its fast revenue growth in milk beverages and other star products. Regional players are taking market share in the premium UHT milk segment by launching UHT milk and chilled dairy products, leveraging on their in-house raw milk sources.

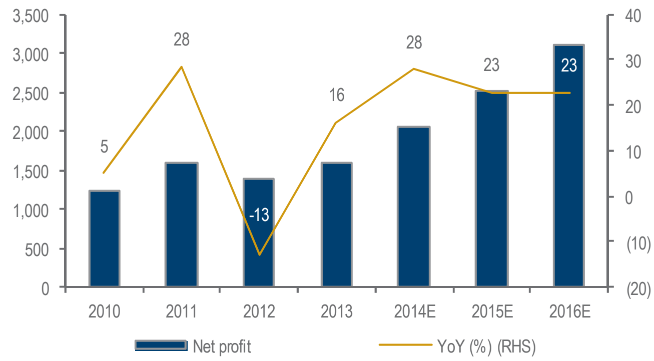
Consumers in China are now paying more attention to raw-milk sources and the product safety of dairy products, and seem more willing to trust regional brands they know have in-house raw-milk sources, such as Bright Dairy. As discussed in our industry section in this sector report, this situation puts the regional players that have access to reliable milk sources in a better position than the national players in their respective regional markets.

Financial analysis

We forecast Mengniu's recurring net profit to rise by 28% for 2014, 23% YoY for 2015 and 23% YoY for 2016, driven mainly by recent acquisitions.

We expect Mengnui's recurring net profit growth over 2014-16 to be driven mainly by revenue growth, which we project at 19% YoY for 2014, and 11% YoY for each of 2015 and 2016. We estimate about 13% of its net profit for 2014 and 2015 will be contributed by Yashili. We forecast EPS growth of 22% YoY for 2014, 19% YoY for 2015 and 23% YoY for 2016, taking into account EPS dilution of 6.6% arising from the new share issuance to Danone carried out in March this year.

■ **Mengniu: net profit (CNYm) and YoY growth**



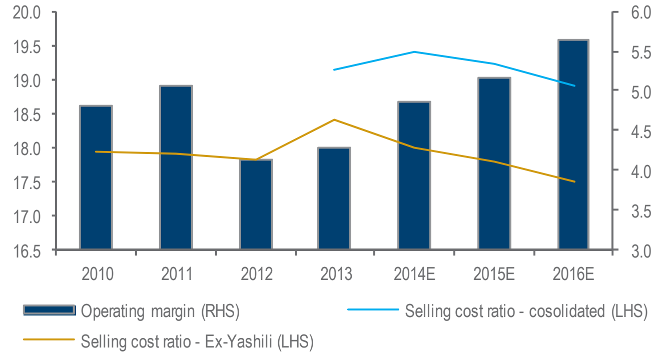
Source: Company, Daiwa forecasts

Selling costs on a rising trend

For operating costs, we expect the selling/cost ratio of the ex-Yashili business to decline only slightly from 18.2% reported for 2013 to 18% in 2014 and 17.8% in 2015. We believe the potential operating margin upside from Mengniu's product mix upgrades (from 2014-16) will be offset partially by higher milk costs and increasing selling expenses. Mengniu expanded its sales force from around 4,500 people in 2012 to 5,500 by June 2013, and by a further 1,000 to 6,500 by December 2013.

For Mengniu as a whole (including Yashili), we forecast a mild increase in selling costs as a ratio of revenue from 19.1% reported for 2013 to 19.4% in 2014, then a slight improvement to 19.2% in 2015, on operating leverage. We forecast Yashili to carry high selling expenses of 36-37% as a ratio of revenue from 2014-15, 25% of which for advertising and promotions (A&P), versus Mengniu's expenditure on A&P of 6% of revenue in 2013.

■ **Mengniu: selling expense ratio – consolidated and ex-Yashili**



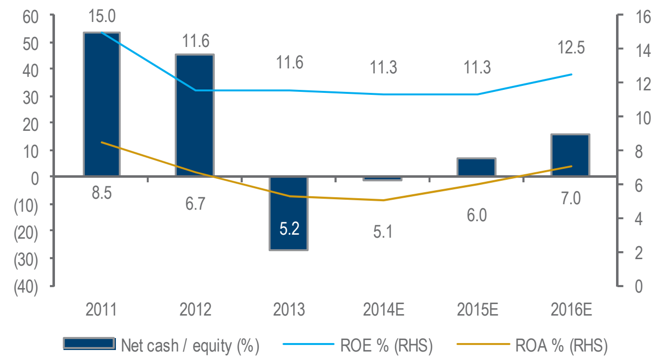
Source: Company, Daiwa forecasts

Balance sheet strengthened on equity issue, but major ROE improvement unlikely

Mengniu's balance sheet was stretched as a result of M&A expenditure in 2013. To rectify this, in November 2013 the company raised USD500m by issuing a 5-year bond with a coupon rate of 3.5%.

Then in March 2014, Mengniu issued 121m shares to Danone at HKD42.5/share to raise HKD5.1bn (CNY4.09bn). As a result, we expect its net gearing to come down to 1.2% in 2014, from 27% reported for 2013. However, we do not project a significant pick-up in the company's ROE for the core business in the near future. We forecast its ROE to decline slightly from 11.6% reported for 2013 to 11.3% for each of 2014 and 2015 as a result of dilution from the above new share issue. Mengniu's ROE will remain below its peak of 15% (2011) post the melamine scandal. We forecast its ROA to improve from 5.1% in 2014 to 6.0% in 2015 and 7.0% in 2016, on a 24% net profit CAGR over 2013-16E.

■ **Mengniu: net gearing and ROE/ROA trends**



Source: Company, Daiwa forecasts

Valuation

We have a Hold (3) rating with a target price of HKD40.70, based on a 30x 2014E PER and implying only 2% upside from the current share price.

To value Mengniu, we use our 2014 EPS forecast and assign a target PER of 30x, which corresponds to a 12% premium to the major China food and beverage companies' average 2014E PER at current share prices of 26.7x (based on the Bloomberg consensus EPS forecasts). In our view, a premium is justified by Mengniu's higher EPS growth of 22% YoY for 2014E and 19% YoY for 2015E, on our forecasts, compared to 10% YoY and 21% YoY on average for its peer group (on the consensus forecasts). We believe PER is a suitable methodology to value Mengniu given its profile as a downstream food and beverage company with what we regard as good earnings visibility and stability.

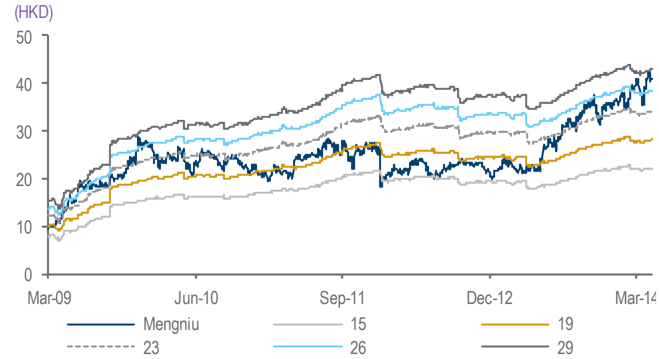
However, we believe Mengniu's current valuation looks unappealing, given that it is trading at the high end of its past-5-year and 12-month forward PER range of 15-30x after the 2008 melamine scandal. We believe the company would need to see an improvement in its raw-material cost control and successful execution of more M&A transactions in order to be re-rated.

■ **Mengniu: revenue and earnings trend and forecasts vs. consensus**

	2012	2013	2014E	2015E	2016E
Revenue (CNYm)	36,000	43,357	51,526	57,304	63,811
YoY (%)	*(4)*	*20*	*19*	*11*	*11*
Var. vs. consensus (%)	*n.a.*	*n.a.*	*(1)*	*(3)*	*(6)*
Net profit (CNYm)	1,303	1,631	2,054	2,524	3,098
YoY (%)	*(18)*	*23*	*28*	*23*	*23*
Var. vs. consensus (%)	*n.a.*	*n.a.*	(3)	(5)	(11)
EPS (CNY)	0.744	0.913	1.094	1.300	1.595
YoY (%)	*(18)*	*23*	*20*	*19*	*23*
Var. vs. consensus (%)	*n.a.*	*n.a.*	*(1)*	*(6)*	*(13)*

Source: Bloomberg, Daiwa forecasts

■ **Mengniu: 12-month forward PER bands**



Source: Bloomberg

■ **Mengiu and peers: valuation summary**

Company	BBG code	Rec	CRY	FY end	Mkt cap. USDm	Price 30-Apr-14	Share price Δ 3M	1M	PER (x) FY13	FY14E	FY15E	FY16E	EPS Growth (%) FY13	FY14E	15E	16E	EV/EBITDA FY14E	FY15E	EBIT margin FY13	FY14E	FY15E
Mengniu Dairy*	**2319 HK**	**Hold**	**HKD**	**Dec**	**9,980**	**39.85**	**11**	**1**	**35.3**	**29.4**	**24.7**	**20.2**	**14**	**22**	**19**	**23**	**16.1**	**13.5**	**4.3**	**4.9**	**5.2**
Key China food and beverage players																					
Want Want China	151 HK	NR	HKD	Dec	20,597	12.16	16	2	30.0	26.4	22.6	19.5	24	13	17	16	17.8	15.1	21.2	22.2	22.7
Tingyi	322 HK	NR	HKD	Dec	15,462	21.55	7	-5	37.8	28.8	24.0	20.6	-11	32	20	17	12.1	10.4	6.1	7.5	8.2
Tsingtao Brewery	168 HK	NR	HKD	Dec	9,174	56.45	-1	-1	30.8	26.9	22.7	n.a.	12	15	18	1	14.5	12.5	7.2	8.5	9.2
CRE	291 HK	NR	HKD	Dec	6,795	22.05	-5	0	27.9	27.7	23.5	20.3	-52	1	18	15	7.8	6.8	3.0	3.0	3.1
Huiyuan	1886 HK	NR	HKD	Dec	1,303	5.08	15	-11	30.0	21.6	16.2	12.9	n.a.	n.a.	34	25	11.1	9.0	(1.8)	12.4	13.0
Uni-President China	220 HK	NR	HKD	Dec	2,963	6.42	-9	-5	20.1	26.2	22.0	19.7	7	-23	19	12	11.8	9.9	1.9	2.7	3.0
Average (ex-Mengniu)									**30.3**	**26.7**	**22.2**	**18.9**	***(1)***	***10***	***21***	***16***	***13.0***	**11.0**	**6.0**	***8.7***	***9.2***
Upstream - Dairy Farm Operators																					
China Modern Dairy*	1117 HK	Buy	HKD	Dec	2,055	3.32	-8	-8	25.5	13.1	10.1	8.1	23	97	30	25	11.0	9.2	25.1	31.8	32.3
Huishan Dairy #	6863 HK	Buy	HKD	Mar	3,270	1.76	-32	-21	14.6	10.6	7.8	n.a.	106	21	38	21	10.9	7.8	46.0	42.0	48.0
Yuanshengtai Dairy	1431 HK	NR	HKD	Dec	646	1.29	-32	-2	9.3	6.9	5.1	4.4	n.a.	35	34	34	7.4	5.5	27.0	39.8	40.2
Average:									**16.5**	**10.2**	**7.7**	**6.2**	***65***	***51***	***34***	***26***	***9.8***	**7.5**	**32.7**	***37.9***	***40.2***
Liquid Milk/Dairy Products - A-share																					
Yili Industries	600887 CH	NR	CNY	Dec	12,204	37.10	5	2	21.0	16.9	13.5	n.a.	54	7	24	25	14.3	11.5	5.3	7.6	8.6
Bright Dairy	600597 CH	NR	CNY	Dec	3,624	18.38	4	15	55.7	33.5	23.7	19.6	18	66	41	21	n.a.	n.a.	4.2	4.6	5.5
Average:									**38.3**	**25.2**	**18.6**	**19.6**	**36**	**37**	**33**	**23**	**14.3**	**11.5**	**4.8**	**6.1**	**7.1**
Pediatric Milk Powder and baby goods																					
Biostime	1112 HK	NR	HKD	Dec	3,977	51.50	-20	8	29.9	21.3	16.9	14.3	10	41	26	18	14.4	11.4	23.5	29.9	30.0
Yashili International	1230 HK	NR	HKD	Dec	1,711	3.75	-4	14	24.3	24.2	14.9	14.2	*(8)*	*26*	*29*	*7*	11.1	8.7	9.6	16.6	18.6
Zhejiang Beingmate	002570 CH	NR	CNY	Dec	2,313	22.48	-2	0	19.9	17.7	14.5	11.6	*112*	*12*	*22*	*24*	11.2	9.1	14.7	14.6	15.1
Average									**24.7**	**21.1**	**15.5**	**13.4**	***38***	***26***	***26***	***16***	***12.3***	**9.7**	**15.9**	**20.4**	**21.2**

Source: Bloomberg, Daiwa forecasts for covered companies*
Note: # data for Huishan data is for its financial years ending 31 March

■ **Valuation summary of major international food and beverage players and dairy companies**

	BBG		Mkt cap.	Price	Stock Δ %		PER (x)				EPS growth				EV/EBITDA (x)		Revenue YoY %			EBIT margin		
Company	code	CRY	USDm	30-Apr-14	3M	1M	2013	2014E	2015E	2016E	2013	2014E	2015E	2016E	2014E	2015E	2013	2014E	2015E	2013	2014E	2015E
Kraft	KRFT US	USD	33,800	56.69	2	7	12.5	17.9	16.5	15.6	64	-30	8	6	11.2	10.6	*(0)*	*2*	*3*	25.8	18.0	18.6
Coca Cola	KO US	USD	179,236	40.78	5	6	21.0	19.5	18.2	16.7	-3	8	7	8	14.9	14.1	*(2)*	*1*	*4*	21.8	24.2	24.9
Pepsi	PEP US	USD	129,729	85.57	3	4	19.6	18.9	17.5	16.2	10	4	8	8	11.8	11.1	*1*	*1*	*4*	14.6	15.2	15.4
General Mills	GIS US	USD	32,371	52.68	2	7	18.4	18.3	17.0	16.0	18	0	8	6	11.5	10.9	*7*	*2*	*3*	16.2	16.4	16.7
Mondelez	MDLZz US	USD	60,529	35.63	3	5	16.1	20.9	18.5	16.4	44	-23	13	12	13.0	11.9	*1*	*2*	*5*	11.9	12.6	13.2
Kellogg	K US	USD	23,480	65.37	7	11	13.1	16.3	15.4	14.3	86	-20	6	7	11.2	10.8	*4*	*2*	*2*	19.2	14.8	15.1
Nestle	NSRGY US	USD	249,148	77.26	1	2	n.a.	21.5	20.1	n.a.	-2	n.a.	8	n.a.	n.a.	n.a.	*3*	*3*	*4*	15.8	16.0	16.7
Average							**16.8**	**19.0**	**17.6**	**15.9**	***31***	***(10)***	***8***	***8***	**12.2**	**11.6**	**2**	**2**	**3**	**17.9**	**16.7**	**17.2**
Global Dairy companies																						
Danone	BN FP	EUR	42,043	53.16	0	4	22.0	19.0	17.3	15.7	-8	16	10	12	11.9	11.0	2	*0*	*6*	13.2	13.0	13.4
Mead Johnson	MJN US	USD	17,716	87.66	5	9	27.4	23.7	21.2	19.3	10	15	12	17	15.8	14.4	*8*	*5*	*7*	22.0	24.1	24.5
ABBOTT	ABT US	USD	59,671	38.67	-1	5	23.6	17.5	15.6	14.1	-60	35	12	13	10.7	9.8	*2*	*3*	*5*	12.0	19.0	20.0
Average:							**24.3**	**20.1**	**18.0**	**16.4**	***(19)***	***22***	***11***	***14***	**12.8**	**11.7**	***11***	***9***	***9***	**1.9**	**3.0**	**3.1**

Source: Bloomberg

Investment catalysts and risks

Upside risks

Product mix upgrades and ASP hikes

Mengniu has enhanced its product mix over the past 2 years by launching a number of new high-margin products. It has also raised the ASPs of some of its popular products following the significant rise in milk costs over the past 16 months. If the ASP hike is sufficient to offset the cost pressure, and Mengniu is successful in promoting its new high-end products, its gross-profit margin may expand more than we currently expect.

Value-accretive M&A activity

Leveraging major shareholder COFCO's network and state-owned background, Mengniu has over the past 2 years acquired various dairy enterprises in China and formed a joint venture with Danone in yoghurt products. We do not see these acquisitions a being value-enhancing in the near term, as it is likely to take time for the partners to optimise their product portfolio and develop new products. However, if Mengniu can acquire further attractive companies at reasonable valuations, this could lift its profitability beyond what we currently forecast. Besides, we believe any news flow on M&A would be a short-term positive catalyst for the share price.

Favourable policy shift

China's government has been increasingly supportive of the development of the dairy industry. In 2H13, a series of policies were issued, targeting the construction of a number of large dairy plants in China that would dominate the market. The government believes the building of these plants will improve the safety and quality of dairy products in China. As Mengniu is the largest dairy enterprise in China and an SOE, we believe it would be a potential beneficiary of any further future policy changes, such as direct financial subsidies for R&D and upstream development. Such support mechanisms could lift Mengniu's net profit beyond our current forecasts.

Downside risks

Milk cost hikes

We forecast raw liquid milk to account for over 50% of the company's liquid milk COGS for 2014, We assume 5% YoY and 3% YoY increases in its unit liquid milk costs in 2014 and 2015, respectively. In the case of a disruption to the raw milk supply and/or a failure to pass on the cost pressure through price hikes, Mengniu's gross-profit margin and earnings would be affected adversely.

Expensive M&A activity

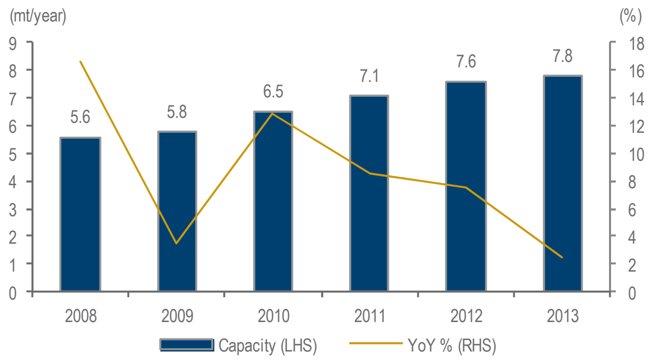
Mengniu is strengthening its product portfolio through acquisitions, such as acquiring Yashili in August 2013. Any sizeable M&A in the future could stretch its balance sheet and lead to the dilution of management resources or other execution risks.

Company background

Mengniu was established in 1999 in Inner Mongolia by veteran Mr. Genshen Niu, the former CEO and chairman, and other founding shareholders. Mengniu has consistently been the leading dairy product producer in China since 2006, and focuses on the production of UHT milk, milk beverages and ice cream.

The company has rolled out various innovative products, such as Milk Deluxe, Future Star Milk and Suan Suan Ru, which have changed radically the China dairy industry's competitive landscape and strengthened Mengniu's leading position. It had expanded its capacity rapidly before the 2008 melamine scandal arose in China.

■ Mengniu: production capacity and YoY



Source: Company

The 2008 melamine scandal had a major impact on the China dairy industry, including on Mengniu, which as a result turned loss-making temporarily. In June 2009, COFCO, the state-owned conglomerate engaged in the food production and distribution business, formed a joint venture with Hopu, a private equity fund in China, to invest in Mengniu. The 2 subscribed new shares and purchased shares from some non-management founding shareholders, effectively owning 20% of the enlarged share capital.

COFCO has gradually taken up key management positions while the original shareholders continued to sell down their stakes between 2009 and 2011. COFCO has also started engaging international partners to strengthen the company's product development and quality-control measures.

In 2012, Denmark's Arla Foods took up Hopu's stake in Mengniu and became a strategic shareholder. In 2013, the board has appointed Ms Yiping Sun, a senior management transferred from other COFCO's businesses, as CEO of Mengniu.

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