

Feb 29, 2016  
Company Report  
Reinitiate: HOLD  
TP: HK\$ 1.64

Share price (HK\$)	1.53
Est. share price return	7.25%
Est. dividend yield	0.59%
Est. total return	7.84%

Previous Rating	HOLD
Previous TP	HK\$ 2.59

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**Key Data**

52Wk H/L(HK\$)	3.5/1.25
Outstanding shares (mn)	5,304.77
Market cap (HK\$ mn)	8,116.29
3-mth avg daily turnover (HK\$ mn)	14.49
Major shareholder(s) (%)	
China Mengniu Dairy CO LTD	25.41
Xinmu Holdings Co LTD	12.65
Kohlberg Kravis Roberts & Co LP	9.00
Yinmu Holdings Co LTD	8.42

Source(s): Bloomberg, ABCI Securities

**Revenue contribution of business segments**

(%)	1H15	FY14
Dairy farming	67.61	83.43
Liquid milk product	32.39	16.57

Source(s): Company, ABCI Securities

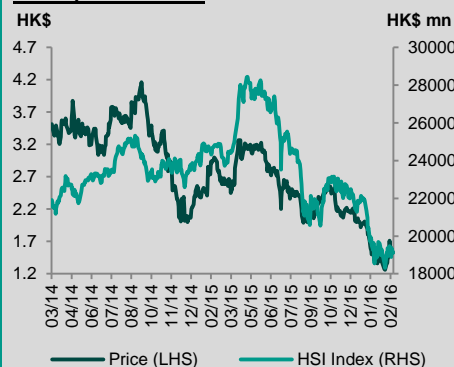
**Share price performance (%)**

	Absolute	Relative*
1-mth	7.75	10.61
3-mth	(28.84)	(15.77)
6-mth	(24.26)	(13.33)

\*Relative to HSI

Source(s): Bloomberg, ABCI Securities

**Stock performance**



Source(s): Bloomberg, ABCI Securities

**Modern Dairy (1117 HK)**

**FY15 result preview; maintain HOLD, TP revised to HK\$ 1.64**

- The Group's profit warning announcement stated that raw milk selling price for July-Nov 2015 decreased by 4.6% compared to 1H15, or 13.6% compared to FY14. FY15E cash EBITDA would decrease by 15% YoY. Performance of its subsidiary also worsened in 3Q15
- We project the Group's raw milk and liquid milk sales contribution would be 69.29% and 30.71% for FY15E; sales from liquid milk segment would grow by 74.58% YoY; in contrast, sales from raw milk segment would decline by 21.80% YoY
- Due to the declining revenue, increasing financing costs, and higher loss in biological fair value, the Group's profits would contract, albeit only slightly. For FY15, GPM, OPM, and NPM would be 33.83%, 19.92%, and 13.84%, respectively
- Maintain **HOLD**; TP revised down to HK\$ 1.64 due to the recent share price adjustment and lower valuation level

**Profit warning issued.** According to the Group's profit warning announcement, its raw milk price for July-Nov 2015 decreased by 4.6% compared to 1H15 and 13.6% compared to FY14, meaning that external selling price of raw milk declined to RMB 4.24/kg in FY15. Accordingly, cash EBITDA for FY15E would decrease by 15% compared to FY14, or RMB 1,502mn. In addition, the Group's non-wholly-owned subsidiary, Modern Farming (MF), recorded a 4.99% YoY decline in 9M15 total sales. While MF's 9M15 GPM and OPM remained stable, NPM declined from 23.41% in 9M14 to 14.69% and inventory days increased from ~91 in 9M14 to ~106. As shown, the Group's growth, profitability, liquidity and working capital management are under pressure.

**Product portfolio would continue to diversify, but growth momentum would falter.** We project that the Group's revenue from raw milk sales and liquid milk product sales would be 69.29% and 30.71% in FY15 vs. 67.61% and 32.39% in 1H15, and 83.43% and 16.57% in FY14. Our projections mean that the Group's raw milk sales would decline by 21.80% YoY while its liquid milk sales would grow by 74.58% YoY, hence the overall sales would decline by 5.84% YoY. These imply an across-the-board decline in sales for 4Q15.

**Profitability to worsen.** Due to decline in revenue, the Group's gross profit, operating profit and net profit would decline by 14.16% YoY, 6.97% YoY, and 10.92% YoY, respectively. The downward pressure on pricing, higher selling expenses, and higher financing costs would result in a slight margin contraction. For FY15E, GPM, OPM, and NPM would be 33.83%, 19.92%, and 13.84%, respectively. GPM of raw milk would also decrease to 39.22%, while GPM of liquid milk would rise to 21.66%.

**TP revised to HKD 1.64, maintain HOLD.** According to our projections, the Group's FY15E EPS would decline to RMB 12.35 cents from RMB 15.23 cents in FY14. Based on our DCF and multiple models, we set our TP at HK\$ 1.64, which represents 10.79x FY15E P/E and 1.03x FY15E P/B. Compared to peers, this valuation level is relatively low.

**Risk factors:** 1) Product quality and food safety risk; 2) Regulatory risk; 3) Domestic economic growth risk; 4) Farm management risk; 5) Customer concentration risk; 6) Biological revaluation risk.

**Results and Valuation**

FY ended Dec 31	FY13A	FY14A	FY15E	FY16E	FY17E
<b>Revenue (RMB mn)</b>	<b>3,289.28</b>	<b>5,026.71</b>	<b>4,733.36</b>	<b>5,165.94</b>	<b>5,525.19</b>
Chg (% YoY)	61.67	52.82	-5.84	9.14	6.95
<b>Net Income (RMB mn)</b>	<b>506.99</b>	<b>762.89</b>	<b>681.90</b>	<b>670.31</b>	<b>714.25</b>
Chg (% YoY)	17.67	52.86	-10.92	-1.95	6.90
<b>Basic EPS (RMB cent)</b>	<b>9.99</b>	<b>15.23</b>	<b>12.35</b>	<b>12.11</b>	<b>12.94</b>
P/E (x)	11.99	8.04	10.06	10.84	10.34
BVPS (RMB)	1.13	1.28	1.29	1.41	1.54
P/B (x)	1.44	1.60	1.59	1.65	1.76
DPS (RMB cent)	N/A	1.00	0.90	0.88	0.94
Yield (%)	N/A	0.65	0.59	0.58	0.62
ROAA (%)	4.25	5.51	4.45	4.07	4.06
ROAE (%)	8.60	11.75	9.36	8.37	8.21

Source(s): The Group, Bloomberg, ABCI Securities estimates

## Appendix I: Financial Statements of the Group

### Consolidated income statement (FY13A-FY17E)

As of Dec 31 (RMB mn, except per share data)	FY13A	FY14A	FY15E	FY16E	FY17E	1H14	1H15
<b>Revenue</b>	<b>3,289.28</b>	<b>5,026.71</b>	<b>4,733.36</b>	<b>5,165.94</b>	<b>5,525.19</b>	<b>2,584.54</b>	<b>2,437.32</b>
- Dairy farming business	2,967.96	4,194.02	3,279.69	3,338.56	3,451.69	2,299.90	1,647.83
- Liquid milk business	321.32	832.69	1,453.67	1,827.38	2,073.50	284.64	789.49
COGS	(2,304.02)	(3,161.35)	(3,132.12)	(3,452.98)	(3,653.47)	(1,579.19)	(1,548.43)
<b>Gross profit - pre bio-adj</b>	<b>985.26</b>	<b>1,865.36</b>	<b>1,601.24</b>	<b>1,712.96</b>	<b>1,871.72</b>	<b>1,005.35</b>	<b>888.89</b>
Biological fair value adjustment included in cost of sales	(860.26)	(1,666.24)	(1,410.14)	(1,554.60)	(1,644.87)	(903.70)	(636.94)
<b>Gross profit - post bio-adj</b>	<b>125.00</b>	<b>199.12</b>	<b>191.10</b>	<b>158.36</b>	<b>226.86</b>	<b>101.65</b>	<b>251.95</b>
SG&A	(208.67)	(326.47)	(357.30)	(382.81)	(451.93)	(156.02)	(179.17)
Loss arising from changes in fair value less costs to sell of dairy cows	(82.75)	(329.07)	(346.85)	(321.62)	(308.79)	(84.56)	(199.27)
Gains arising on initial recognition of raw milk at fair value less costs to sell at the point of harvest	860.26	1,666.24	1,410.14	1,554.60	1,644.87	903.70	636.94
Other net income/(expenses)	17.75	(196.15)	45.96	(71.81)	(103.06)	(93.96)	149.69
<b>Operating profit</b>	<b>711.59</b>	<b>1,013.67</b>	<b>943.05</b>	<b>936.72</b>	<b>1,007.94</b>	<b>670.81</b>	<b>660.14</b>
Share of profit from associates & JV	(0.31)	0.21	0.23	0.26	0.28	4.74	4.00
Net finance costs	(193.71)	(243.52)	(254.78)	(258.54)	(284.62)	(123.58)	(142.23)
Pretax profit	517.57	770.36	688.50	678.44	723.60	551.98	521.91
Tax	(10.57)	(7.48)	(6.60)	(8.13)	(9.35)	(6.60)	(14.60)
<b>Net profits</b>	<b>506.99</b>	<b>762.89</b>	<b>681.90</b>	<b>670.31</b>	<b>714.25</b>	<b>545.38</b>	<b>507.31</b>
- Owners of the Company	481.05	735.32	655.03	642.24	686.56	523.16	476.95
- Minority interest	25.94	27.57	26.87	28.06	27.69	22.21	30.36
Dividend	0.00	48.27	47.73	46.92	50.00	0.00	0.00
EPS (RMB cent)							
- Basic	9.99	15.23	12.35	12.11	12.94	10.84	9.88
- Dilute	9.89	15.08	11.94	11.71	12.52	10.72	9.80
DPS (RMB cent)	0.00	1.00	0.90	0.88	0.94	0.00	0.00

Source(s): The Group, ABCI Securities estimates

### Consolidated balance sheet (FY13A-FY17E)

As of Dec 31 (RMB mn)	FY13A	FY14A	FY15E	FY16E	FY17E	1H14	1H15
Cash and bank balances	369.04	556.96	1,420.66	2,204.24	3,231.57	457.84	605.22
Accounts receivables	544.71	826.77	988.67	1,044.03	889.53	599.71	1,006.38
Inventories	691.11	640.58	853.16	953.00	668.20	558.29	463.25
Others	432.20	614.58	268.10	466.79	513.11	558.81	130.59
<b>Current assets</b>	<b>2,037.06</b>	<b>2,638.89</b>	<b>3,530.60</b>	<b>4,668.06</b>	<b>5,302.42</b>	<b>2,174.65</b>	<b>2,205.44</b>
PP&E	4,032.64	4,457.97	4,448.97	4,378.39	4,818.66	4,113.61	4,484.90
Biological assets	5,954.36	6,530.81	6,645.45	6,647.57	6,681.14	6,297.96	6,762.22
Land use rights	66.26	64.87	70.80	69.65	76.67	65.50	69.94
Others	403.49	518.31	553.39	579.87	615.47	527.38	496.23
<b>Non-current assets</b>	<b>10,456.76</b>	<b>11,571.96</b>	<b>11,718.61</b>	<b>11,675.49</b>	<b>12,191.94</b>	<b>11,004.44</b>	<b>11,813.29</b>
<b>Total assets</b>	<b>12,493.82</b>	<b>14,210.85</b>	<b>15,249.21</b>	<b>16,343.55</b>	<b>17,494.36</b>	<b>13,179.09</b>	<b>14,018.73</b>
Accounts payables	1,474.25	1,403.00	1,980.16	1,613.51	1,953.73	1,161.23	1,220.43
Short-term debt	2,988.80	2,958.40	2,644.22	2,480.49	2,625.27	3,741.12	2,309.26
Others	20.07	14.28	4.57	18.71	8.61	136.02	17.36
<b>Current liabilities</b>	<b>4,483.12</b>	<b>4,375.68</b>	<b>4,628.94</b>	<b>4,112.71</b>	<b>4,587.61</b>	<b>5,038.37</b>	<b>3,547.05</b>
Long-term debt	1,959.87	2,829.45	2,800.77	3,612.70	3,702.87	1,384.16	3,025.17
Others	190.10	349.77	481.65	609.98	481.47	333.48	315.18
<b>Non-current liabilities</b>	<b>2,149.96</b>	<b>3,179.22</b>	<b>3,282.42</b>	<b>4,222.68</b>	<b>4,184.34</b>	<b>1,717.64</b>	<b>3,340.35</b>
Equity attributable to shareholders	5,743.02	6,510.24	7,165.27	7,807.52	8,494.08	6,283.16	6,955.25
Minority interest	117.71	145.71	172.58	200.64	228.33	139.92	176.08
<b>Equity</b>	<b>5,860.73</b>	<b>6,655.95</b>	<b>7,337.85</b>	<b>8,008.16</b>	<b>8,722.41</b>	<b>6,423.08</b>	<b>7,131.33</b>
<b>Total liabilities and Equity</b>	<b>12,493.82</b>	<b>14,210.85</b>	<b>15,249.21</b>	<b>16,343.55</b>	<b>17,494.36</b>	<b>13,179.09</b>	<b>14,018.73</b>

Source(s): The Group, ABCI Securities estimates

**Consolidated cash flow statement (FY13A-FY17E)**

As of Dec 31 (RMB mn)	FY13A	FY14A	FY15E	FY16E	FY17E	1H14	1H15
Profit before tax	517.57	770.36	688.50	678.44	723.60	551.98	521.91
Depreciation and amortization	168.86	225.54	217.04	224.80	229.16	107.63	132.45
Change in working capital	(363.76)	(187.42)	238.89	(525.84)	754.99	(247.82)	(421.14)
Others	261.50	772.40	286.06	472.47	485.23	625.31	536.38
<b>Cash flow from operating activities</b>	<b>584.16</b>	<b>1,580.89</b>	<b>1,430.49</b>	<b>849.87</b>	<b>2,192.99</b>	<b>1,037.10</b>	<b>769.60</b>
Change in PP&E	(774.08)	(937.82)	9.00	70.58	(440.27)	(375.84)	(26.93)
Changes in biological assets	(909.12)	(735.05)	(114.64)	(2.12)	(33.57)	(409.31)	(231.40)
Others	(241.19)	(221.73)	367.03	(173.29)	(15.52)	(169.45)	(108.48)
<b>Cash flow from investing activities</b>	<b>(1,924.39)</b>	<b>(1,894.60)</b>	<b>261.39</b>	<b>(104.83)</b>	<b>(489.36)</b>	<b>(954.60)</b>	<b>(366.81)</b>
Interest paid	(224.64)	(274.69)	(349.81)	(354.49)	(410.31)	(166.32)	(154.36)
Changes in bank borrowing	1,641.26	821.35	(83.92)	639.49	232.56	176.61	(192.17)
Others	16.00	(45.03)	(394.45)	(246.45)	(498.55)	(4.00)	(8.00)
<b>Cash flow from financing activities</b>	<b>1,432.62</b>	<b>501.63</b>	<b>(828.18)</b>	<b>38.54</b>	<b>(676.30)</b>	<b>6.29</b>	<b>(354.54)</b>
<b>Net change in Cash</b>	<b>92.39</b>	<b>187.92</b>	<b>863.70</b>	<b>783.58</b>	<b>1,027.33</b>	<b>88.80</b>	<b>48.25</b>
Cash and equivalent at beg	276.65	369.04	556.96	1,420.66	2,204.24	369.04	556.96
<b>Cash and equivalent at end</b>	<b>369.04</b>	<b>556.96</b>	<b>1,420.66</b>	<b>2,204.24</b>	<b>3,231.57</b>	<b>457.84</b>	<b>605.22</b>

Source(s): The Group, ABCI Securities estimates

**Key operating and financial ratios (FY13A-FY16E)**

As of Dec 31	FY13A	FY14A	FY15E	FY16E	FY17E	1H14	1H15
<b>Revenue composition (%)</b>							
- Dairy farming business	90.23	83.43	69.29	64.63	62.47	88.99	67.61
- Liquid milk business	9.77	16.57	30.71	35.37	37.53	11.01	32.39
<b>Profitability ratios (%)</b>							
Gross margin – pre bio-adj	29.95	37.11	33.83	33.16	33.88	38.90	36.47
- Dairy farming business	30.27	41.22	39.22	34.04	32.73	40.75	40.28
- Liquid milk business	27.00	16.42	21.66	31.55	35.79	23.95	28.53
Gross margin – post bio-adj	3.80	3.96	4.04	3.07	4.11	3.93	10.34
EBIT margin	21.63	20.17	19.92	18.13	18.24	25.95	27.08
EBITDA margin	26.77	24.65	24.51	22.48	22.39	30.12	32.52
Pre-tax margin	15.73	15.33	14.55	13.13	13.10	21.36	21.41
Net margin	14.62	14.63	13.84	12.43	12.43	20.24	19.57
<b>Growth (YoY %)</b>							
Sales growth	61.67	52.82	-5.84	9.14	6.95	86.20	-5.70
- Raw milk sales	52.34	41.31	-21.80	1.80	3.39	80.95	-28.35
- Liquid milk sales	272.49	159.14	74.58	25.71	13.47	143.28	177.37
Gross profit	84.84	89.33	-14.16	6.98	9.27	175.93	-11.58
EBIT	37.18	42.45	-6.97	-0.67	7.60	155.58	-1.59
Net profit	17.67	52.86	-10.92	-1.95	6.90	240.68	-8.83
<b>Return ratios (%)</b>							
ROAA	4.25	5.51	4.45	4.07	4.06	4.08	3.38
ROAE	8.60	11.75	9.36	8.37	8.21	8.52	6.92
ROIC	5.28	6.88	5.79	5.59	5.94	5.37	4.26
<b>Liquidity ratio (%)</b>							
Current ratio	45.44	60.31	76.27	113.50	115.58	43.16	62.18
Quick ratio	30.02	45.67	57.84	90.33	101.02	32.08	49.12
Cash ratio	17.84	26.74	36.45	64.90	81.59	20.15	20.69
<b>Cash conversion cycle (days)</b>							
Days of outstanding receivable	38.10	39.92	73.24	90.76	115.55	34.44	54.33
Days of inventory on hand	89.62	76.88	87.04	95.46	80.98	72.19	65.05
Days of outstanding payable	102.77	97.11	103.63	100.61	104.19	91.69	106.80
CCC	24.95	19.68	56.65	85.61	92.35	14.95	12.58
<b>Leverage ratios (%)</b>							
Total debt/Equity	84.44	83.03	76.93	78.58	74.84	79.79	77.61
Total debt/Total assets	39.61	38.89	37.02	38.51	37.32	38.89	39.48

Source(s): The Group, ABCI Securities estimates

## Appendix II: Financial Metrics of the Group's subsidiary, Modern Farming

### Key operating and financial ratios (1Q13A-9M15A)

	1Q13	1H13	9M13	FY13	1Q14	1H14	9M14	FY14	1Q15	1H15	9M15
<b>Revenue composition (%)</b>											
- Dairy farming business	92.10	91.43	91.93	90.15	87.25	87.02	86.58	83.41	67.49	67.61	68.63
- Liquid milk business	7.03	8.42	7.94	9.76	12.71	11.01	13.38	16.56	32.51	32.39	31.37
<b>Profitability ratios (%)</b>											
Gross margin	22.62	26.22	28.46	30.02	35.39	38.89	33.51	37.11	35.09	36.47	35.65
- Dairy farming business	22.82	26.31	28.74	29.53	37.28	41.64	40.85	41.22	41.56	40.28	39.25
- Liquid milk business	20.94	25.64	25.46	34.64	21.98	23.95	18.93	16.42	21.66	28.53	27.78
EBIT margin	16.30	20.26	22.42	24.32	29.47	35.18	28.38	31.03	35.84	29.39	27.84
Pre-tax margin	13.08	14.31	15.44	18.00	18.90	25.62	23.92	18.16	18.82	17.11	15.88
Net margin	12.11	13.52	14.77	17.27	18.08	25.04	23.41	17.86	16.89	15.67	14.69
<b>Growth (YoY %)</b>											
Sales	N/A	N/A	N/A	62.68	85.70	86.05	70.07	52.74	-0.43	-5.76	-4.99
- Raw milk	N/A	N/A	N/A	53.07	75.94	77.07	60.17	41.31	-22.98	-26.78	-24.69
- Liquid milk	N/A	N/A	N/A	281.68	235.88	143.28	186.54	159.14	154.65	177.37	122.74
Gross profit	N/A	N/A	N/A	110.63	190.55	175.97	100.25	88.82	-1.28	-11.63	1.10
Operating profit	N/A	N/A	N/A	156.00	235.76	223.02	115.27	94.86	21.07	-21.27	-6.79
Pretax profit	N/A	N/A	N/A	36.40	168.30	233.19	163.55	54.04	-0.87	-37.07	-36.91
Net profit	N/A	N/A	N/A	35.05	172.07	237.85	166.03	55.55	-4.46	-38.67	-38.25
<b>Return ratios (%)</b>											
ROAA	N/A	N/A	N/A	N/A	1.83	5.23	6.99	6.99	1.50	2.82	3.75
ROAE	N/A	N/A	N/A	N/A	4.70	13.01	17.24	17.60	3.67	6.63	8.98
<b>Liquidity ratio (%)</b>											
Current ratio	N/A	N/A	N/A	45.01	44.02	43.12	54.25	56.35	66.11	54.84	56.41
Quick ratio	N/A	N/A	N/A	29.59	31.60	32.02	40.82	41.95	53.13	42.61	41.14
Cash ratio	N/A	N/A	N/A	17.46	18.18	20.02	21.43	24.15	32.73	17.63	17.90
<b>Cash conversion cycle (days)</b>											
Days of outstanding receivable	N/A	N/A	N/A	N/A	145.82	68.84	56.14	39.90	207.17	108.66	79.48
Days of inventory on hand	N/A	N/A	N/A	N/A	288.18	144.28	91.13	76.85	276.36	131.40	106.72
Days of outstanding payable	N/A	N/A	N/A	N/A	347.41	169.43	106.58	83.61	343.77	184.91	123.32
CCC	N/A	N/A	N/A	N/A	86.59	43.70	40.68	33.14	139.76	55.14	62.87
<b>Leverage ratios (%)</b>											
Total debt/Equity	N/A	N/A	N/A	112.55	110.17	93.53	97.25	80.34	86.20	81.25	81.10
Total debt/Total assets	N/A	N/A	N/A	43.25	43.67	39.15	41.32	32.87	35.07	35.95	34.51

Source(s): The Company, ABCI Securities

## Disclosures

### Analyst Certification

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### Definition of equity rating

Rating	Definition
Buy	Stock return $\geq$ Market return rate
Hold	Market return $- 6\% \leq$ Stock return $<$ Market return rate
Sell	Stock return $<$ Market return $- 6\%$

Stock return is defined as the expected % change of share price plus gross dividend yield over the next 12 months

Market return: 5-year average market return rate from 2010-2014

Time horizon of share price target: 12-month

### Definition of share price risk

Rating	Definition
Very high	$2.6 \leq$ 180 day volatility/180 day benchmark index volatility
High	$1.5 \leq$ 180 day volatility/180 day benchmark index volatility $<$ 2.6
Medium	$1.0 \leq$ 180 day volatility/180 day benchmark index volatility $<$ 1.5
Low	180 day volatility/180 day benchmark index volatility $<$ 1.0

We measure share price risk by its volatility relative to volatility of benchmark index. Benchmark index: Hang Seng Index.

Volatility is calculated from the standard deviation of day to day logarithmic historic price change. The 180-day price volatility equals the annualized standard deviation of the relative price change for the 180 most recent trading days closing price.

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