

28 August 2014

CHINA SHENGMU ORGANIC MILK (1432.HK)

Organic liquid milk the next focus

HONG KONG | DAIRY | COMPANY RESULTS

- Shengmu's 1H14 revenue increased 96.2% yoy. Operating profit rose 202% yoy while profit attributable to owners surged 171% yoy. EPS doubled to RMB 4.9 cents.
- Revenue from organic milk products, including raw milk and liquid milk obtained rapid growth of 141% and 132% yoy in revenue respectively.
- The company scheduled to shift to liquid milk production to obtain the highest gross profit margin. Management plans to double its liquid milk proportion to revenue to 60-70% in the next 3-5 years.
- We initiate a rating of "Accumulate" with target price HK\$ 2.79, equivalent to 22x of 2014 forecasted EPS.

Financial Highlights

Shengmu announced its 2014 interim results that the revenue increased 96.2% yoy to RMB 906 mn, mainly due to the rapid growth of 141% and 132% yoy in organic raw milk and liquid milk revenue respectively. Gross profit surged 165% yoy to RMB 444 mn with gross profit margin up 12.7 percentage points to 49%. Operating income rose 202% yoy to RMB 356 mn while excluding the fair value adjustment income from biological assets, adjusted operating income soared 205% yoy. Profit attributable to owners for 1H surged 171% yoy to RMB 279 mn. Earnings per share amounted as RMB 0.049.

How we view this

The revenue in 1H has already reached around 79% of the total revenue in 2013. We expect the growth will continue in the 2H, since 1) management mentioned that the sales of liquid milk obtained rapid growth in both price and volume after its listing in HKEx which many distributors reported out of stock, 2) not just Shengmu, some milk producers also predicted the average milk price to go up in the 2H, and 3) the company is actively switching its product mix to liquid milk which has the highest GPM and planned to double its proportion to revenue to 60-70% in the 3-5 years.

Investment Action

Although we found that the PE and PB of Shengmu are quite high when comparing with the upstream dairy companies, we tend to put it a bit towards the downstream manufacturer Mengniu due to the company's future direction in liquid milk. Thus, we believe the valuation is still reasonable in this heavy investment stage. And we are quite confident with the company's operation due to the strong background of the management. Thus, we initiate a rating of "Accumulate" with target price HK\$ 2.79, equivalent to 22x of 2014 forecasted EPS.

Key Financial Summary

FYE Dec	FY11	FY12	FY13	FY14E
Revenue (RMB mn)	389	701	1,144	1,830
Net Profit (RMB mn)	223	196	327	586
EPS (HKD)	0.064	0.056	0.094	0.127
P/E (X)	39.2	44.7	26.7	22.0
BVPS (HKD)	0.202	0.281	0.394	0.492
P/B (X)	12.4	8.9	6.4	5.1
DPS (HKD)	0.00	0.00	0.00	0.00
Div. Yield (%)	0.0%	0.0%	0.0%	0.0%

Source: PSR est.

*All multiples & yields based on current market price

Rating:

Accumulate

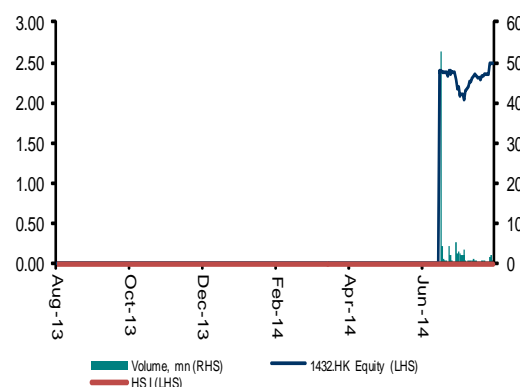
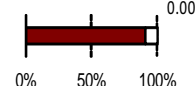
Target Price (HKD)	2.79
Forecast Dividend (HKD)	0.00
Closing Price (HKD)	2.50
Potential Upside	11.6%

Company Description

Shengmu is an organic dairy company operates in Inner Mongolia, producing both the raw milk and liquid milk. It ranks No. 1 in terms of organic milk production and is the only vertically integrated organic dairy company obtained the EU organic certification.

Company Data

Raw Beta (Past 2yrs weekly data)	N/A
Market Cap. (HKD bn)	15,886
Enterprise Value (HKD mn)	17,172.00
52 week range (HKD)	2.01 - 2.55
Closing Price in 52 week range	0.00



Major Shareholders

1. World Shining Investment Limited	56.56%
2. Jiang Jin Zhi	8.09%
3. The Goldman Sachs Group, Inc.	6.22%
4. Baring Private Equity Asia GPV Limited	6.22%

Valuation Method

PE

Analyst

Kay Ng

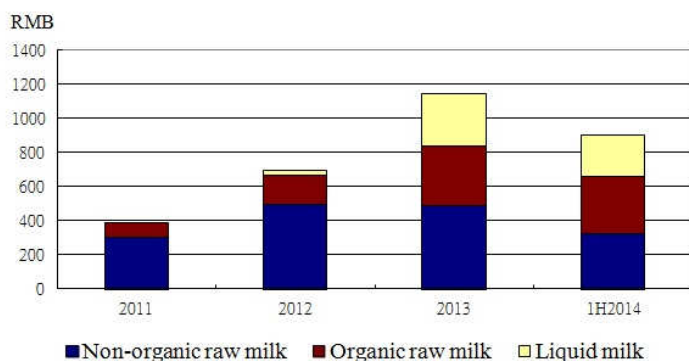
kayng@phillip.com.hk

+852 2277 6751

Revenue on organic milk grew rapidly

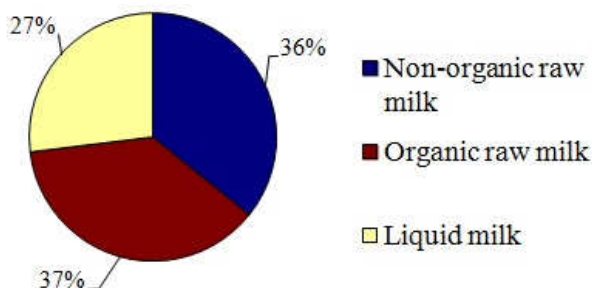
The 1H14 revenue increased 96.2% yoy to RMB 906 mn, among which the organic milk products, including raw milk and liquid milk obtained rapid growth of 141% and 132% yoy in revenue respectively. This is the first time the organic raw milk passed over the non-organic raw milk to be the largest revenue contributor. According to the company's information, it obtained 54.2% market share and ranked as no.1 in the organic milk market in term of production volume. The management is confident at further expanding the business since the proportion of organic milk products to the whole dairy market is still low. They believe the ever-growing customers' concerns on milk quality and healthy issue would drive up the future demand.

Fig 1 Revenue breakdown



Source: Company report

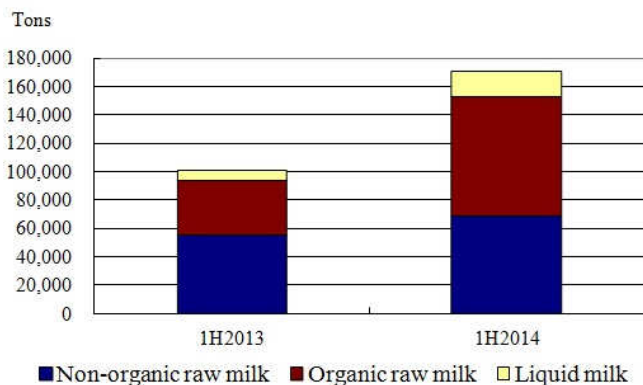
Fig 2 Product mix as at 1H14



Source: Company report

The production volume also shifted to organic milk products, which raw milk production soared 118% to 83,921 tons and liquid milk production surged 141% to 18,210 tons.

Fig 3 Production volume as at 1H14

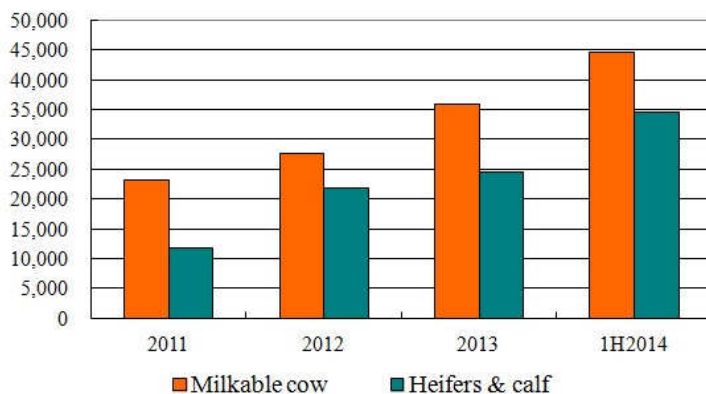


Source: Company report

As at 1H14, there were a total of 25 farms in Inner Mongolia, of 12 non-organic farms located at Hohhot and 13 organic farms located at Ulan Buh Desert. The company plans to set up 6 new organic farms by the end of 2014 and an additional 18 organic and 3 non-organic farms in the next 3 years.

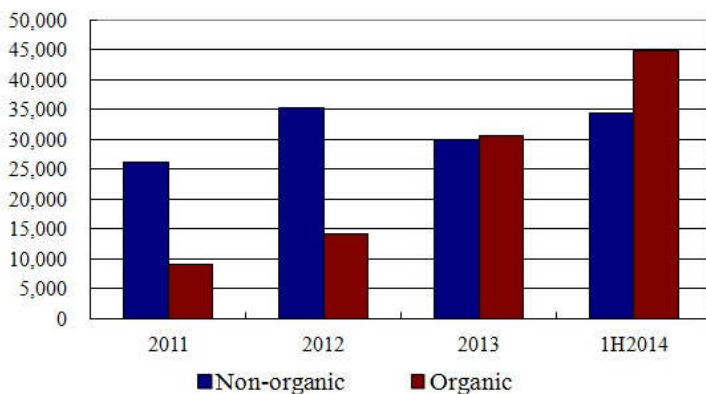
As at 1H14, there were 79,253 cows, among which 44,619 were milkable. The other 34,634 heifers & calf provide productivity in the future. With the same 79,253 cows, 44,779 are organic which shows a sharp increase of 117% of organic cows from 2012 to 2013 and another 46% growth in the 1H14.

Fig 4 Cow classified by milkable



Source: Company report

Fig 5 Cow classified by organic



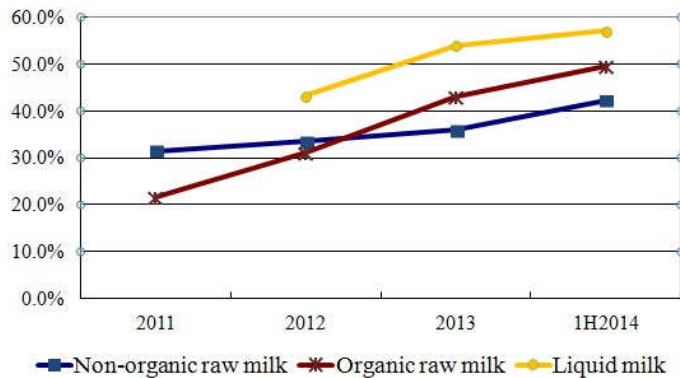
Source: Company report

Liquid milk the next focus

Shengmu's main focus in the next 3-5 years is to transform itself from an upstream raw milk supplier into a milk product manufacturer, with its vertical operation of organic raw milk supply, which lowers the cost of production and confirms the raw milk quality. Management plans to double its liquid milk proportion to revenue to 60-70% during the period.

We see this as an appropriate direction of further expanding since the liquid milk obtains the highest gross profit margin among the three categories of product.

Fig 6 Gross profit margin summary



Source: Company report

Currently the company has 4 different types of organic liquid milk, namely: organic whole milk, organic low-fat milk, organic milk for children and organic yogurt. The company is now distributing its liquid milk by different channels, such as supermarkets, department stores, convenient stores, corporate wholesale and VIP membership. Currently there are around 100,000 VIP members and its plans to have a total of 1 million loyal members in the future. It also schedules to develop the O2O network by Internet direct sales portal in the future.

Concern to company's financial status

Shengmu is aggressively investing in the production facilities these year. As at 1H14, net current asset/ liability was still negative indicates heavy finance burden in the current liabilities, which interest-bearing bank loans amounted to RMB 944 mn while the cash balance was only RMB 326 mn. Currently the company is still able to get fund in financing its investment activities, we see the net change in cash flow maintains positive in 2013 and 1H14. And the cash from operation is ramping up which we forecast to have around RMB 500 mn net cash flow into the company in 2014.

Potential Risks

The company cannot maintain the quality of its organic milk products;
 Selling price of Chinese organic milk not able to upgrade;
 Confident on Chinese milk are low no matter in mainland or the global market.

Fig 7 Peers comparison

Company	Stock Code	Market Cap (HK\$ Mn)	PE	PE (y+1)	PB	ROE	ROA	Debt Ratio
China Modern Dairy	1117 HK	18,682.00	17.42	14.91	2.36	14.6%	7.0%	0.35
Yuanshengtai Dairy	1431 HK	5,472.00	12.62	9.58	1.11	9.7%	5.8%	0.05
China Shengmu Organic Milk	1432 HK	15,886.00	N/A	18.03	N/A	24.6%	13.3%	0.07
Mengniu Dairy	2319 HK	74,418.00	29.82	28.42	3.60	11.7%	5.3%	0.20
China Huishan Dairy	6863 HK	26,078.00	14.35	11.96	1.57	13.1%	7.9%	0.31
source: Bloomberg, as at 08:00 am, Aug 28, 2014								

Valuation Ratios					
P/E (X)	39.2	44.7	26.7	85.1	41.2
P/B (X)	12.4	8.9	6.4	6.4	5.1
EV/EBITDA (X)	0.1	0.1	0.0	0.1	0.0
Dividend Yield (%)	0.0%	0.0%	0.0%	0.0%	0.0%
Per share data (HKD)					
EPS	0.064	0.056	0.094	0.029	0.061
DPS	0.000	0.000	0.000	0.000	0.000
BVPS	0.202	0.281	0.394	0.394	0.492
Outstanding Shares (mn)	4,338.17	4,338.17	4,338.17	4,338.17	5,709.25
Growth & Margins (%)					
Growth					
Revenue	N/A	80.0%	63.2%	N/A	96.2%
EBITDA	N/A	-10.9%	88.7%	N/A	202.0%
Net Income	N/A	-12.3%	67.2%	N/A	171.5%
Margins					
Gross profit margin	29.4%	33.4%	42.9%	36.3%	49.0%
EBITDA margin	57.3%	28.4%	32.8%	25.6%	39.3%
Net Profit Margin	57.3%	27.9%	28.6%	22.3%	30.8%
Key Ratios					
ROE (%)	25.5%	16.3%	21.9%	6.9%	12.7%
ROA (%)	18.9%	10.9%	12.0%	3.8%	8.5%
Income Statement (RMB '000)					
	2011	2012	2013	1H2013	1H2014
Revenue	389,417	700,763	1,143,709	461,543	905,629
Cost of revenue	(274,816)	(466,704)	(653,284)	(294,073)	(461,904)
Gross profit	114,601	234,059	490,425	167,470	443,725
Fair value adjustment of biological assets, net	117,139	4,406	9,484	4,337	10,016
Other income and gains	10,854	7,939	6,868	792	9,235
Selling and distribution expenses	(6,395)	(22,869)	(71,821)	(31,725)	(33,899)
Administrative expenses	(7,845)	(12,563)	(25,436)	(10,212)	(40,490)
Loss on disposal of subsidiary	(444)	0	0	0	0
Finance costs	(4,669)	(12,389)	(32,821)	(12,201)	(28,609)
Share of profits and losses of associates	0	320	(1,349)	(508)	(3,706)
EBIT	223,241	198,903	375,350	117,953	356,272
Income tax expense	0	0	(852)	(9)	(615)
Profit for the year	223,241	198,903	374,498	117,944	355,657
Non-controlling interests	(27)	3,121	47,189	15,142	76,567
Profit attributable to owners	223,268	195,782	327,309	102,802	279,090

Source: Company, PSR

	2011	2012	2013	1H2013	1H2014
Balance Sheet (RMB '000)					
Property, plant and equipment (PPE)	194,875	450,249	922,764	922,764	1,177,784
Prepaid land lease payments	0	3,452	3,381	3,381	5,360
Other intangible assets	15,021	14,466	14,192	14,192	14,784
Investments in associates	14,756	17,576	17,727	17,727	19,620
Biological assets (BA)	713,826	1,029,541	1,510,160	1,510,160	1,997,401
Prepayments for PPE and BA	14,101	26	9,043	9,043	22,359
Deferred tax assets	0	0	187	187	782
Total non-current assets	952,579	1,515,310	2,477,454	2,477,454	3,238,090
Inventories	103,881	204,243	335,218	335,218	239,806
Trade and bills receivables	10,043	24,510	63,470	63,470	173,500
Prepayments, deposits and other receivables	15,893	30,030	94,377	94,377	203,819
Pledged deposits	29,224	12,797	15,030	15,030	8,993
Cash and cash equivalents	69,550	29,838	127,059	127,059	325,586
Total current assets	228,591	301,418	635,154	635,154	951,704
Total assets	1,181,170	1,816,728	3,112,608	3,112,608	4,189,794
Trade and bills payables	83,963	132,151	191,037	191,037	174,726
Receipts in advance	15,473	17,527	82,481	82,481	53,169
Other payables and accruals	82,468	124,581	198,565	198,565	204,959
Interest-bearing bank borrowings	75,000	324,000	932,000	932,000	944,000
Tax payable	0	0	633	633	1,479
Total current liabilities	256,904	598,259	1,404,716	1,404,716	1,378,333
Net current assets (liabilities)	(28,313)	(296,841)	(769,562)	(769,562)	(426,629)
Interest-bearing bank borrowings	49,000	0	0	0	0
Total assets less liabilities	875,266	1,218,469	1,707,892	1,707,892	2,811,461
Issued capital	0	0	0	0	1
Reserves	855,569	1,166,851	1,494,160	1,494,160	2,471,248
	855,569	1,166,851	1,494,160	1,494,160	2,471,249
Non-controlling interest	19,697	51,618	213,732	213,732	340,212
Total Equity	875,266	1,218,469	1,707,892	1,707,892	2,811,461

Source: Company, PSR

	2011	2012	2013	1H2013	1H2014
Cashflow Statements (RMB '000)					
Net cash flows from operating activities	141,204	177,942	363,630	152,269	258,793
Net cash flows used in investing activities	(408,376)	(535,215)	(934,299)	(234,125)	(788,470)
Net cash flows from financing activities	269,550	317,427	667,890	97,674	717,138
Net change in cash	2,378	(39,846)	97,221	15,818	187,461
Cash and cash equivalents at beginning of period	67,980	69,550	29,838	29,838	127,059
Effects of exchange rates, net	(808)	134	0	0	11,066
Cash and cash equivalents at end of period	69,550	29,838	127,059	45,656	325,586

Source: Company, PSR

PHILLIP RESEARCH STOCK SELECTION SYSTEMS

Total Return	Recommendation	Rating	Remarks
>+20%	Buy	1	>20% upside from the current price
+5% to +20%	Accumulate	2	+5% to +20% upside from the current price
-5% to +5%	Neutral	3	Trade within \pm 5% from the current price
-5% to -20%	Reduce	4	-5% to -20% downside from the current price
<-20%	Sell	5	>20% downside from the current price

We do not base our recommendations entirely on the above quantitative return bands. We consider qualitative factors like (but not limited to) a stock's risk reward profile, market sentiment, recent rate of share price appreciation, presence or absence of stock price catalysts, and speculative undertones surrounding the stock, before making our final recommendation

GENERAL DISCLAIMER

This publication is prepared by Phillip Securities (Hong Kong) Ltd ("Phillip Securities"). By receiving or reading this publication, you agree to be bound by the terms and limitations set out below.

This publication shall not be reproduced in whole or in part, distributed or published by you for any purpose. Phillip Securities shall not be liable for any direct or consequential loss arising from any use of material contained in this publication.

The information contained in this publication has been obtained from public sources which Phillip Securities has no reason to believe are unreliable and any analysis, forecasts, projections, expectations and opinions (collectively the "Research") contained in this publication are based on such information and are expressions of belief only. Phillip Securities has not verified this information and no representation or warranty, express or implied, is made that such information or Research is accurate, complete or verified or should be relied upon as such. Any such information or Research contained in this publication is subject to change, and Phillip Securities shall not have any responsibility to maintain the information or Research made available or to supply any corrections, updates or releases in connection therewith. In no event will Phillip Securities be liable for any special, indirect, incidental or consequential damages which may be incurred from the use of the information or Research made available, even if it has been advised of the possibility of such damages.

Any opinions, forecasts, assumptions, estimates, valuations and prices contained in this material are as of the date indicated and are subject to change at any time without prior notice.

This material is intended for general circulation only and does not take into account the specific investment objectives, financial situation or particular needs of any particular person. The products mentioned in this material may not be suitable for all investors and a person receiving or reading this material should seek advice from a financial adviser regarding the suitability of such products, taking into account the specific investment objectives, financial situation or particular needs of that person, before making a commitment to invest in any of such products.

This publication should not be relied upon as authoritative without further being subject to the recipient's own independent verification and exercise of judgment. The fact that this publication has been made available constitutes neither a recommendation to enter into a particular transaction nor a representation that any product described in this material is suitable or appropriate for the recipient. Recipients should be aware that many of the products which may be described in this publication involve significant risks and may not be suitable for all investors, and that any decision to enter into transactions involving such products should not be made unless all such risks are understood and an independent determination has been made that such transactions would be appropriate. Any discussion of the risks contained herein with respect to any product should not be considered to be a disclosure of all risks or a complete discussion of such risks.

Nothing in this report shall be construed to be an offer or solicitation for the purchase or sale of a security. Any decision to purchase securities mentioned in this research should take into account existing public information, including any registered prospectus in respect of such security.

Disclosure of Interest

Analyst Disclosure: Neither the analyst(s) preparing this report nor his associate has any financial interest in or serves as an officer of the listed corporation covered in this report.

Firm's Disclosure: Phillip Securities does not have any investment banking relationship with the listed corporation covered in this report nor any financial interest of 1% or more of the market capitalization in the listed corporation. In addition, no executive staff of Phillip Securities serves as an officer of the listed corporation.

Availability

The information, tools and material presented herein are not directed, intended for distribution to or use by, any person or entity in any jurisdiction or country where such distribution, publication, availability or use would be contrary to the applicable law or regulation or which would subject Phillip Securities to any registration or licensing or other requirement, or penalty for contravention of such requirements within such jurisdiction.

Information contained herein is based on sources that Phillip Securities (Hong Kong) Limited ("PSHK") believed to be accurate. PSHK does not bear responsibility for any loss occasioned by reliance placed upon the contents hereof. PSHK (or its affiliates or employees) may have positions in relevant investment products. For details of different product's risks, please visit the Risk Disclosures Statement on <http://www.phillip.com.hk>.

© 2014 Phillip Securities (Hong Kong) Limited

Contact Information (Regional Member Companies)

SINGAPORE

Phillip Securities Pte Ltd
Raffles City Tower
250, North Bridge Road #06-00
Singapore 179101
Tel : (65) 6533 6001
Fax : (65) 6535 6631
Website: www.poems.com.sg

HONG KONG

Phillip Securities (HK) Ltd
Exchange Participant of the Stock Exchange of Hong Kong
11/F United Centre 95 Queensway
Hong Kong
Tel (852) 22776600
Fax (852) 28685307
Websites: www.phillip.com.hk

INDONESIA

PT Phillip Securities Indonesia
ANZ Tower Level 23B,
Jl Jend Sudirman Kav 33A
Jakarta 10220 – Indonesia
Tel (62-21) 57900800
Fax (62-21) 57900809
Website: www.phillip.co.id

THAILAND

Phillip Securities (Thailand) Public Co. Ltd
15th Floor, Vorawat Building,
849 Silom Road, Silom, Bangrak,
Bangkok 10500 Thailand
Tel (66-2) 6351700 / 22680999
Fax (66-2) 22680921
Website www.phillip.co.th

UNITED KINGDOM

King & Shaxson Capital Limited
6th Floor, Candlewick House,
120 Cannon Street,
London, EC4N 6AS
Tel (44-20) 7426 5950
Fax (44-20) 7626 1757
Website: www.kingandshaxson.com

AUSTRALIA

PhillipCapital Australia
Level 12, 15 William Street,
Melbourne, Victoria 3000, Australia
Tel (613) 96188238
Fax (613) 92002272
Website: www.phillipcapital.com.au

MALAYSIA

Phillip Capital Management Sdn Bhd
B-3-6 Block B Level 3 Megan Avenue II,
No. 12, Jalan Yap Kwan Seng, 50450
Kuala Lumpur
Tel (603) 21628841
Fax (603) 21665099
Website: www.poems.com.my

JAPAN

PhillipCapital Japan K.K.
Nagata-cho Bldg.,
8F, 2-4-3 Nagata-cho,
Chiyoda-ku, Tokyo 100-0014
Tel (81-3) 35953631
Fax (81-3) 35953630
Website: www.phillip.co.jp

CHINA

Phillip Financial Advisory (Shanghai) Co. Ltd
No 436 Hengfeng Road,
Greentech Unit 604,
Postal code 200070
Tel (86-21) 51699400
Fax (86-21) 63532643
Website: www.phillip.com.cn

FRANCE

King & Shaxson Capital Limited
3rd Floor, 35 Rue de la Bienfaisance 75008
Paris France
Tel (33-1) 45633100
Fax (33-1) 45636017
Website: www.kingandshaxson.com

UNITED STATES

Phillip Futures Inc
141 W Jackson Blvd Ste 3050
The Chicago Board of Trade Building
Chicago, IL 60604 USA
Tel +1.312.356.9000
Fax +1.312.356.9005