

## Inner Mongolia Yili Industrial Group (600887.CH)

### Solid leading position maintained

#### China | Food and beverage | Company report

In the first three quarters of 2015, Yili recorded a total revenue of RMB 45.88 billion, which increased by 9.1% yoy; net profit attributable to shareholders reached RMB 3.64 billion, which grew by 2.2% yoy, and thus earnings per share reached 0.59 yuan. The performance less than expected was mainly due to the weakening of market-end demand causing the significant yoy increase of marketing expenses and promotion expenses. The rate of marketing expenses to sales in the first three quarters rose by 3 ppts to 21.1%, which totally offset the 2.3 ppts increase in gross profit margin brought by the lowered cost of raw milk.

Even though the Company's business results did not meet expectation, the Company's solid leading position in the Chinese dairy products industry maintained in the first three quarters of 2015. According to the statistics by AC Nielsen, the market share of sales turnover of dairy products of Yili rose by 1.1 ppts yoy in the first nine months of 2015, reaching 20.4%, and kept the first rank in the industry. In addition, the Company announced in June the plan of acquiring Sanlian Dairy in Guizhou Province. Such acquisition marked the initial step of Yili's merger and restructuring, and thus future outward expansion is worth expecting. This may speed up the increase of the Company's market share, and also lead the Company to enter new growth stage.

Its profitability may improve. In Q3, the rate of marketing expenses to sales significantly increased by 6.9 ppts to 23.2%, which was the main reason for the downturn of the Company's business. However, we expect such uptrend would not persist. Since 2002, the average rate of marketing expense to sales reached 21.5%, and its hikes mainly occurred during 2008 when the global economy was under the threat of financial crisis, which was much more serious than the current economic slowdown. It is because the current round of economic structural transformation would focus more on the growth of consumption. Moreover, the price of raw milk would still keep at low level in short-/medium- term, and thus the gross profit margin of the Company would maintain at a higher level.

### Moving towards a global leader of healthy diet products

Yili has further consolidated her rank-one status in the dairy product industry in China, and the Company has comparative advantages on capital, brand name, cost control and sales channels etc. Yili will further outstrip competitors in the market, and may develop towards a global leader of healthy diet products through acquisition consolidation and globalized business arrangement. In Q3, China Securities Finance Corporation Limited has become the fourth largest shareholder of the Company and holds 3.03% of the Company's equity. Yili also constantly purchase its shares from the market, demonstrating confidence on the Company's development. We temporarily set the target price as 20 yuan based on a valuation of 26.25X of EPS in 2015e, and maintain the rating of "Buy". (Closing price as at 4 December 2015)

8 December 2015

### BUY (Maintain)

CMP: CNY 15.08

(Closing price as at 4 Dec 2015)

TARGET: CNY 20.00 (+33%)

#### COMPANY DATA

O/S SHARES (MN) :	6.065
MARKET CAP (CNYMN) :	91,460
52 - WK HI/LO (CNY):	44.95/ 13.31

#### SHARE HOLDING PATTERN , %

Hohhot Investment Limited :	8.70
Pan Gang	3.85

#### PRICE PERFORMANCE , %

	1M	3M	1Y
YILI	1.12	-4.13	-41.27
SCI	-6.96	-17.56	-70.24

#### PRICE VS. SCI



Source: Phillip Securities (HK) Research

#### KEY FINANCIALS

CNY mn	FY13	FY14	FY15E	FY16E
Net Sales	47545	54251	60062	67954
Net Profit	3187	4144	4675	5266
EPS, CNY	0.55	0.68	0.76	0.86
PER, x	27.42	22.18	19.77	17.55
BVPS, CNY	2.63	3.04	3.42	3.85
P/BV, x	5.73	4.96	4.41	3.92
ROE, %	27.17	23.72	23.61	23.63
Debt/Equity (%)	101.54	111.95	110.53	110.53

Source: Company reports, Phillip Securities Est.

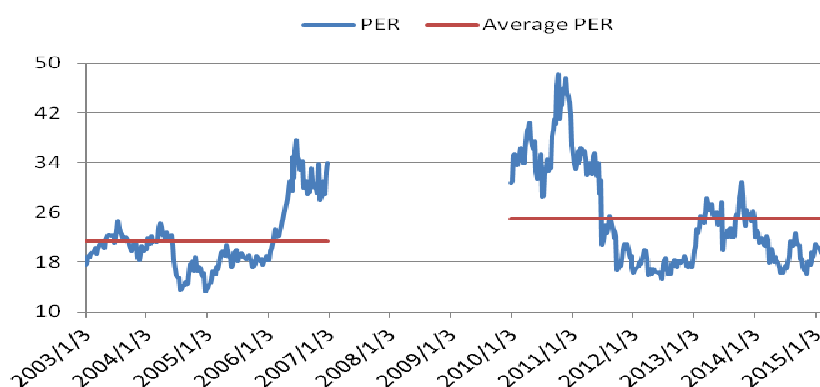
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## Historical P/E Valuation



Source: Bloomberg, Phillip Securities (HK) Research

## Increase of expenses in Q3 dragged down business growth

In the first three quarters of 2015, Yili recorded a total revenue of RMB 45.88 billion, which increased by 9.1% yoy; net profit attributable to shareholders reached RMB 3.64 billion, which grew by 2.2% yoy, and thus earnings per share reached 0.59 yuan.

Overall, amid of economic slowdown and consumption downturn, which caused the dairy products industry in domestic Chinese market merely recorded a slight growth of 2.4%, the Company still demonstrated stable growth. This apparently showed its strength on competitiveness in the market. In regard to different products of the Company, the sales turnover of room-temperature yogurt Ambrosial (An Muxi) surged 661% yoy; while the two signature brands of Yili Yoghourt: Chang Qing and Mei Yi Tian grew by 53.9% yoy and 37% yoy respectively. The high-end formula milk powder for infants, namely “Pro-Kido Premium” grew by 24% yoy, while Satine grew by 20% yoy.

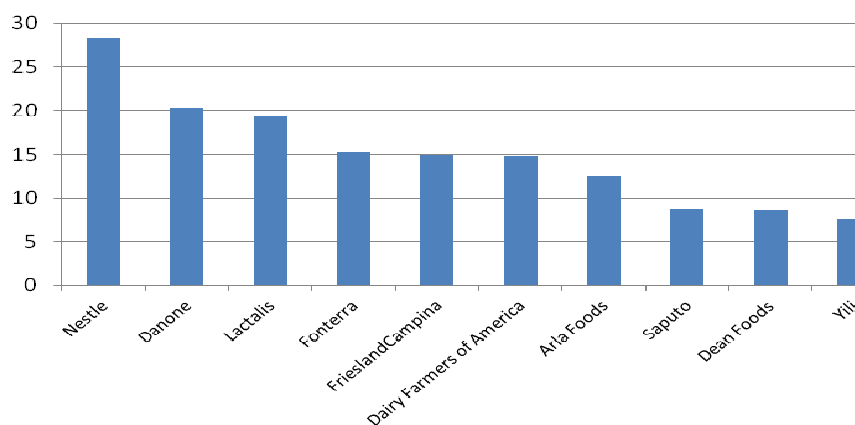
In view of the Company’s quarterly performance, the revenue recorded in 2015Q1, Q2 and Q3 amounted to RMB 14.99 billion, RMB 15.16 billion and RMB 15.73 billion respectively, which grew yoy by 14.4%, 5.6% and 7.7% respectively. Meanwhile, the net profit recorded in the first three quarters amounted to RMB 1.31 billion, RMB 1.36 billion and RMB 0.98 billion respectively, which grew yoy by 20.4%, 12.0% and -22.8% respectively. Based on the above data, we can conclude that the drop of profit in Q3 dragged down the Company’s business growth, which is mainly due to the weakening of market-end demand causing the significant yoy increase of marketing expenses and promotion expenses. The rate of marketing expenses to sales in the first three quarters rose by 3 ppts to 21.1%, which totally offset the 2.3 ppts increase in gross profit margin brought by the lowered cost of raw milk.

## Solid leading position maintained

Even though the Company’s business results did not meet expectation, the Company’s solid leading position in the Chinese dairy products industry maintained in the first three quarters of 2015. According to the statistics by AC Nielsen, the market share of sales turnover of dairy products of Yili rose by 1.1 ppts yoy in the first nine months of 2015, reaching 20.4%, and kept the first rank in the industry. Among Yili’s products, the share of sales turnover of room-temperature liquid milk increased by 2.2 ppts yoy to 29.0%, while basic liquid milk increased by 2.1 ppts yoy to 35.9%. Both of these two products ranked the first in the industry and significantly surpassed peers. Meanwhile, sales turnover of cold drink also ranked the top in the industry for 22 consecutive years.

It is worth to note that the Company announced in June the plan of acquiring Sanlian Dairy in Guizhou Province. Such acquisition marked the initial step of Yili's merger and restructuring, and thus future outward expansion is worth expecting. This may speed up the increase of the Company's market share, and also lead the Company to enter new growth stage. In the annual report of 2014, Yili mentioned for the first time her strategic target of bidding the top five ranks of the global dairy producers, and becoming a high-end healthy food group by 2020. Being the leading dairy giant in China, Yili expands through acquisition and restructuring, which comply with both the norms of development of dairy industry as well as the state policies. In June 2014, the Chinese Government released the restructuring plan for dairy products industry: by the end of 2018, the top 10 domestic dairy brands would hold 80% of the market share.

### Top 10 dairy manufacturers

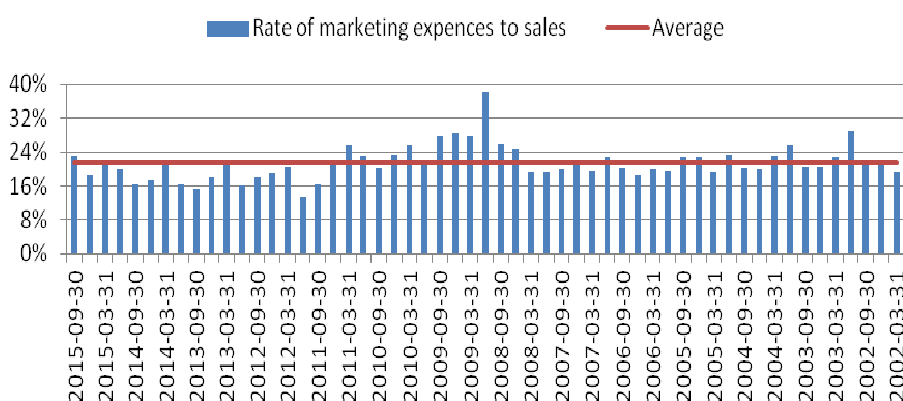


Source: Rabobank, Phillip Securities (HK) Research

### Profitability may improve

In Q3, the rate of marketing expenses to sales significantly increased by 6.9 ppts to 23.2%, which was the main reason for the downturn of the Company's business. However, we expect such uptrend would not persist. Since 2002, the average rate of marketing expense to sales reached 21.5%, and its hikes mainly occurred during 2008 when the global economy was under the threat of financial crisis, which was much more serious than the current economic slowdown. It is because the current round of economic structural transformation would focus more on the growth of consumption.

### Marketing expenses of sales of YILI



Source: Company report, Phillip Securities (HK) Research

Moreover, the price of raw milk would still keep at low level in short-/medium- term, and thus the gross profit margin of the Company would maintain at a higher level.

According to the monitoring data by the Ministry of Agriculture, the current average price of fresh milk in domestic Chinese market still records a yoy decline of about 10%. In addition, the Company's product mix has been enhanced, with proportion of high-end products increase rapidly, and the profitability of high-end products is stronger. The current gross profit margin of the market-dominated room temperature liquid milk is only around 20% to 25%, but the gross profit margins of new high-end products such as Satine and Walnut milk etc was recorded as 35% or even higher than 40%.

### Catalyst

More-than-expected sales of high-end products;  
Faster-than-expected progress of outward expansion;  
Faster-than-expected implementation of internationalized strategy.

### Risks

Intensified competition among dairy product producers;  
Rise of raw material cost;  
Risk of food safety.

## FINANCIALS

Periodicity:	2012	2013	2014	2015F	2016F
<b>Valuation Ratios</b>					
Price Earnings	42.28	27.42	22.18	19.77	17.55
Price to Book	9.86	5.73	4.96	4.41	3.92
Dividend Yield	0.62%	1.77%	2.67%	2.53%	2.85%
<b>Per share data(CNY)</b>					
EPS Adjusted	0.36	0.55	0.68	0.76	0.86
Book Value Per Share	1.53	2.63	3.04	3.42	3.85
Dividends Per Share	0.09	0.27	0.40	0.38	0.43
<b>Growth &amp; Margin</b>					
Revenue growth	-30.50%	13.90%	14.10%	10.71%	13.14%
Gross profit growth	-41.31%	10.11%	32.60%	16.69%	12.54%
Net profit growth	-63.27%	85.61%	30.02%	12.81%	12.63%
Gross Margin	29.29%	28.31%	32.90%	34.68%	34.50%
Operating Margin	3.95%	5.29%	8.46%	8.68%	8.70%
Net Profit Margin	4.11%	6.70%	7.64%	7.78%	7.75%
Dividend Payout Ratio %	26.17%	48.48%	59.15%	50.00%	50.00%
<b>Key ratios</b>					
Return on Assets	8.64%	12.10%	11.45%	11.18%	11.22%
Return on Equity	25.71%	27.17%	23.72%	23.61%	23.63%
Liability ratio	62.02%	50.38%	52.82%	52.50%	52.50%
Effective Tax Rate	16.81%	-	12.93%	14.25%	14.25%
<b>Income Statement(CNY: mn)</b>					
<b>Revenue</b>	<b>41,741</b>	<b>47,545</b>	<b>54,251</b>	<b>60,062</b>	<b>67,954</b>
- Cost of Goods Sold	29,515	34,083	36,400	39,233	44,513
<b>Gross Income</b>	<b>12,226</b>	<b>13,462</b>	<b>17,851</b>	<b>20,830</b>	<b>23,441</b>
- Selling, General & Admin Expense	10,577	10,946	13,260	15,616	17,532
<b>Operating Income</b>	<b>1,649</b>	<b>2,516</b>	<b>4,592</b>	<b>5,213</b>	<b>5,909</b>
- Interest Expense	100	82	183	180	180
- Net Non-Operating Losses (Gain)	-534	-631	-424	-500	-500
Pretax Income	2,087	3,060	4,786	5,483	6,179
- Income Tax Expense	351	-141	619	781	881
Income Before XO Items	1,736	3,201	4,167	4,702	5,299
- Minority Interests	19	14	22	27	33
<b>Net Profit</b>	<b>1,717</b>	<b>3,187</b>	<b>4,144</b>	<b>4,675</b>	<b>5,266</b>

Source: Company, Phillip Securities (HK) Research Estimates

(Financial figures as at 4 Dec 2015)

**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

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