BOCOM International Research

Sector Primer

China Consumer Dairy Sector

August 9, 2023



# Got (Fresh) Milk?

## Finding **Future Winners** in an Evolving Dairy Sector

**By Edward Lui | Kay Tan**

- **Dairy industry** to undergo evolution with emerging sub-categories
- **Fresh milk** to outperform due to risen health awareness post-pandemic
- **Raw milk cost decline** to drive downstream GPM expansion
- Near-term trends present both **opportunities** (ice-cream) and **challenges** (cheese, yoghurt).
- **Infant milk formula** to remain challenged
- Initiate coverage on **6** companies: **Diversified > niche players**

Image: Unsplash

**Initiation of Coverage**

| | | |
|---|---|---|
| **Yili** 600887 CH | **Mengniu** 2319 HK | **Bright Dairy** 600597 CH |
| **China Feihe** 6186 HK | **H&H** 1112 HK | **Milk-ground** 600882 CH |

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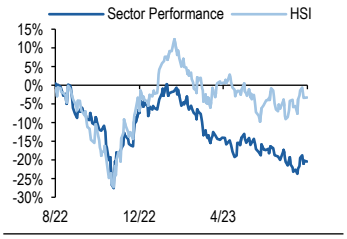
9 August 2023

# Consumer Sector - Dairy

## Got (fresh) milk? Finding future winners in an evolving dairy sector

- **Dairy industry to undergo evolution with emerging sub-categories:** Dairy is one of the largest consumer sectors in China with the fastest pace of consolidation, both vertically and horizontally, led by diversified dairy producers. While overall growth will only be 3.7% CAGR in the next five years (2023-27E), there is more exciting growth outlook for emerging categories, e.g. fresh milk (13% CAGR), cheese (12%) and ice-cream (6%). We look for players that are positioning themselves for long-term success while navigating around near-term cyclical weakness.
- **Fresh milk to outperform due to risen health awareness post-pandemic:** With increased health awareness after the pandemic, we expect categories with clear nutritional benefits, e.g. fresh milk (**Yili/Mengniu/Bright**), to outperform in 2023. Fresh milk will benefit from a drinking milk premiumization trend given its low penetration (30% in China vs. >90% in developed countries), with the keys to growth being (1) nationwide upstream access to premium milk, (2) cold-chain logistics. We also expect demand for immunity boost to lift vitamin/supplements sales (**H&H**).
- **Raw milk cost decline to drive downstream GPM expansion:** The dairy upstream is undergoing consolidation by large dairy farms and becoming more vertically-integrated, meaning: (1) near-term excess supply, and better economies of scale and yield in the long term, would lower raw milk price (-6% YoY in 1H23, -9% in July), positive for downstream GPM (**Mengniu/Yili**); (2) raw milk price cycles to be less pronounced as supply-demand become more aligned, leading to more stable supply chain profitability, (3) downstream players' competitiveness will be tied to their upstream partners' efficiency and products (e.g. organic, Jersey milk).
- **Near-term trends present both opportunities (ice-cream) and challenges (cheese, yoghurt):** A record number of "hot days" in China YTD would likely boost ice-cream sales (**Yili**). On the other hand, given a lackluster consumer sentiment this year, other categories with more discretionary, "snack-like" nature would underperform under consumers' tighter wallets, including cheese sticks (**Milkground**) and yoghurt.
- **Infant milk formula ("IMF") to remain challenged:** While some expect the IMF market to stabilize given consolidation accelerated by new product registration and a likely uptick in new births in the Year of the Dragon (2024), we think it is still too early, given the accumulated new birth decline in the past 3 years. Diversifying into adult milk formula and probiotics/supplements (**H&H**) may buffer this headwind.
- **Initiate coverage on 6 companies: Diversified > niche players:** Considering sub-sector trends as well as raw milk price decline, we initiate with **Buy** on three diversified dairy players: Our top pick is **Yili** (global/beyond-dairy expansion, high ROE) over **Mengniu** (balanced portfolio) and **Bright** (fresh milk leader, but low ROE of self-owned farms). We initiate with **Neutral** on **Feihe** (high ROE but IMF industry headwinds), **H&H** (weak credit profile) and **Milkground** (cheese cyclical weakness).

**1-year sector performance**




*Source: FactSet*

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### Valuation summary

| Company name | Stock code | Rating | TP (local ccy) | CP (local ccy) | EPS FY23E (rpt ccy) | EPS FY24E (rpt ccy) | P/E FY23E (x) | P/E FY24E (x) | P/B FY23E (x) | P/B FY24E (x) | Yield FY23E (%) |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Yili Group | 600887 CH | Buy | 34.70 | 28.11 | 1.728 | 2.039 | 16.3 | 13.8 | 3.34 | 3.04 | 4.4 |
| Mengniu | 2319 HK | Buy | 37.10 | 27.95 | 1.621 | 1.858 | 15.9 | 13.8 | 2.26 | 2.02 | 1.9 |
| Bright Dairy | 600597 CH | Buy | 14.50 | 10.98 | 0.485 | 0.563 | 22.6 | 19.5 | 1.79 | 1.68 | 1.4 |
| China Feihe | 6186 HK | Neutral | 5.00 | 4.88 | 0.600 | 0.649 | 7.5 | 6.9 | 1.48 | 1.32 | 6.1 |
| Milkground | 600882 CH | Neutral | 19.20 | 22.21 | 0.223 | 0.438 | 99.6 | 50.7 | 2.51 | 2.39 | 0.0 |
| H&H | 1112 HK | Neutral | 10.10 | 10.48 | 1.124 | 1.468 | 8.6 | 6.6 | 0.95 | 0.86 | 4.7 |
| **Average** | | | | | | | **28.4** | **18.6** | **2.05** | **1.89** | **3.1** |

*Source: FactSet (consensus for NR stocks), BOCOM Int'l estimates (for covered stocks) *As of 7 August 2023*

***Note:*** *This is the revised version (Original report was published on 9 August 2023).*

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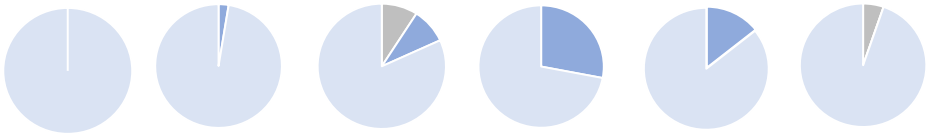
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## Investment Preference in China's Dairy Sector

**Figure 1: BOCOM's dairy sector stock coverage – order of investment preference**

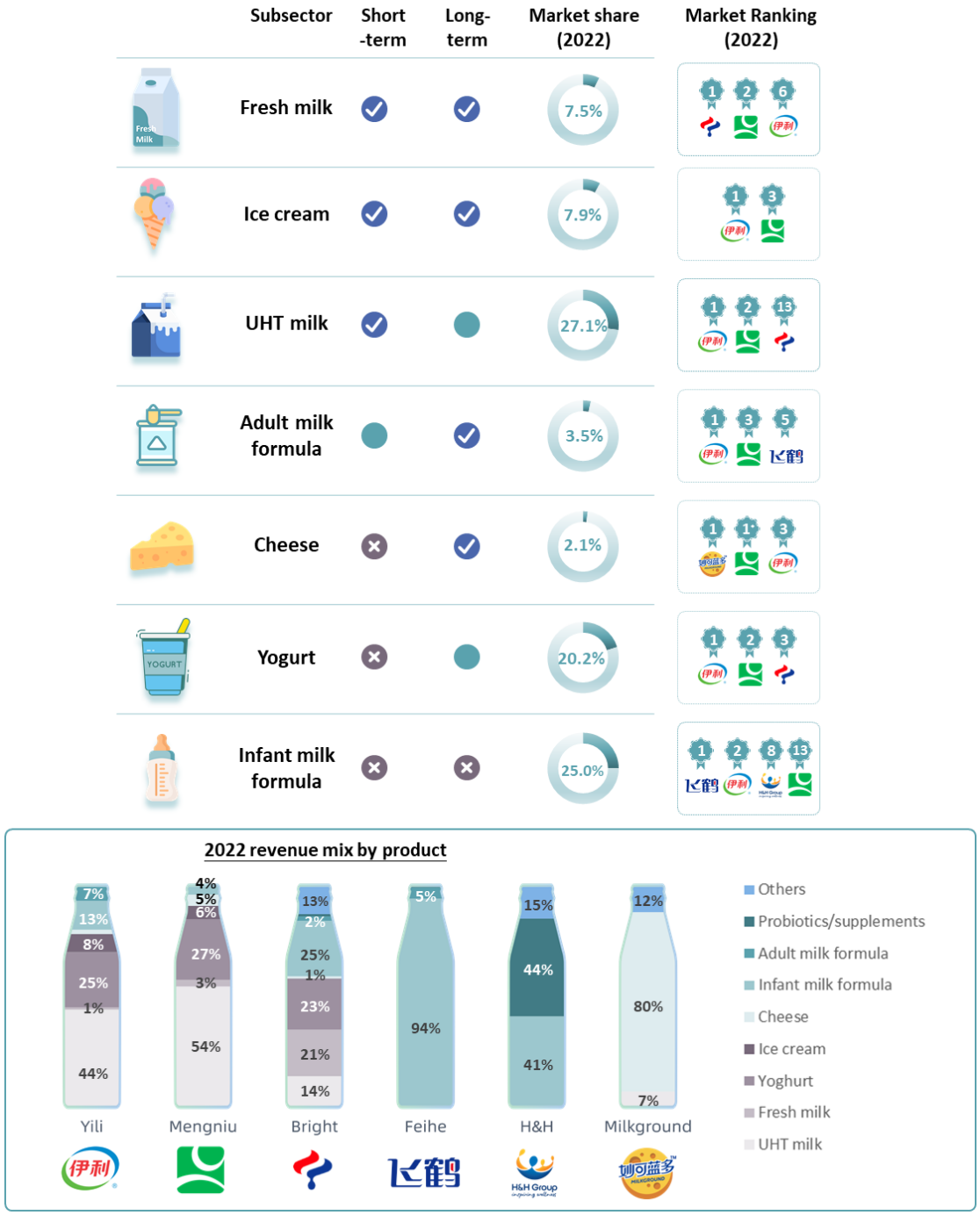
| | More preferred | | | Less preferred | | |
|---|---|---|---|---|---|---|
| Company | Yili | Mengniu | Bright Dairy | Feihe | H&H | Milkground |
| Ticker | 600887 CH | 2319 HK | 600597 CH | 6186 HK | 1112 HK | 600882 CH |
| Pricing currency | RMB | HKD | RMB | HKD | HKD | RMB |
| Share price | 28.11 | 27.95 | 10.98 | 4.88 | 10.48 | 22.21 |
| Mkt cap (US$bn) | **24.9** | **14.1** | **2.1** | **5.7** | **0.9** | **1.6** |
| BOCOM rating | Buy | Buy | Buy | Neutral | Neutral | Neutral |
| Market rating (%) |  | | | | | |
| # brokers | 47 | 39 | 11 | 25 | 14 | 19 |
| 2023 fiscal YE | Dec'23 | Dec'23 | Dec'23 | Dec'23 | Dec'23 | Dec'23 |
| **EPS growth (% YoY)** | | | | | | |
| 2023E | 15.3 | 18.1 | 80.0 | 10.9 | 34.3 | 112.0 |
| 2024E | 15.9 | 16.3 | 15.0 | 13.0 | 25.5 | 61.1 |
| 2025E | 13.8 | 14.3 | 12.8 | 11.5 | 18.4 | 36.8 |
| **CAGR (%, '23-25E)** | **15.0** | **16.2** | **32.7** | **11.8** | **25.9** | **67.2** |
| **P/E** | | | | | | |
| 2023E | 16.5x | 16.3x | 23.5x | 7.4x | 7.6x | 39.2x |
| 2024E | 14.2x | 14.0x | 20.4x | 6.5x | 6.0x | 24.4x |
| 2025E | 12.5x | 12.3x | 18.1x | 5.8x | 5.1x | 17.8x |
| **PEG** | **0.9x** | **0.9x** | **0.6x** | **0.6x** | **0.2x** | **0.4x** |
| **P/B** | | | | | | |
| 2023E | 3.3x | 2.3x | 1.7x | 1.5x | 0.9x | 2.4x |
| 2024E | 3.0x | 1.9x | 1.6x | 1.3x | 0.9x | 2.1x |
| **ROE (%)** | | | | | | |
| 2023E | 20.0 | 13.9 | 8.0 | 21.1 | 12.9 | 6.4 |
| 2024E | 21.2 | 14.5 | 8.5 | 20.5 | 14.6 | 9.4 |
| **Dividend yield (%)** | | | | | | |
| 2023E | 4.2 | 1.8 | 1.2 | 5.9 | 7.2 | 0.0 |
| 2024E | 4.8 | 2.0 | 0.8 | 6.4 | 8.8 | 0.7 |



*Source: Bloomberg consensus, BOCOM Int'l updated as of 7 August 2023*

## Overall Dairy Sector View

**Figure 2: Ranking dairy sub-sectors based on short/long-term prospects, with companies' product mix**




*Source: Various companies, Euromonitor, BOCOM Int'l estimates * Mengniu is ranked first in cheese after including 35%-owned Milkground*

### Figure 3: BOCOM thesis on China's dairy sector

| Key issues | Our view |
|---|---|
| **Sector view** | **Long-term drivers for China's dairy industry:**<br>(1) Emerging dairy categories (ice-cream, cheese) on the back of rising income and changing consumer tastes;<br>(2) Premiumization of drinking milk (fresh, organic milk): Key #1 Access to a steady upstream supply of high-quality, organic milk; Key #2 Development of cold chain industry to penetrate lower-tier cities.<br>**Near-term view:**<br>(1) Increased health awareness post-pandemic to drive sales of fresh milk and vitamin/supplement;<br>(2) Ice-cream sales to be strong given the unusually hot weather this year;<br>(3) Slow recovery of consumption sentiment to affect discretionary, snack-like categories, such as cheese and yoghurt. |
| **Fresh milk**  | Fresh milk accounted for 30% of all drinking milk in China in 2022 (rest being room-temperature, UHT milk) vs. >90% in the US, Japan and South Korea, so it has great upside potential from a sector development point of view.<br>The main hinderances to penetration uptick are (1) higher pricing, but consumers have shown a willingness to trade-up to more nutritious products as their health awareness rises, especially post-pandemic, in-line with China Milk Quotient surveys; (2) cold-chain logistics for distribution in lower-tier cities given short shelf-life of 5-7 days. |
| **Ice-cream**  | Ice-cream sales should be robust this year given a record number of "hot days" (>35 degrees Celsius) in 1H23 and an emerging El Nino effect. Ice-cream market is undergoing premiumization, e.g. Zhong Xue Gao, Moutai-infused ice-cream. |
| **UHT milk**  | Liquid drinking milk as a whole (UHT + fresh milk) is 35% of China's dairy market, higher than those in more developed countries (17-32%), but fresh milk is a much lower mix. We expect UHT milk would fall in share, and fresh milk to rise in the long-run. We expect UHT milk (including milk beverages, flavored milk) to grow at 3% CAGR in the next 5 years. |
| **Adult milk formula (AMF)**  | In the backdrop of a fallen birth rate and an ageing population, we expect AMF market (including milk powder for nursing women as well as elderly consumers) to grow at a 4.0% CAGR in the next 5 years. IMF players that can effectively diversify itself from IMF to AMF can help buffer the demographic headwinds. |
| **Cheese, yoghurt**   | Cheese (e.g. cheese sticks) and yoghurt are all more snack-like and discretionary in nature, which does not bode well as consumers become more value conscious. We expect sales of these categories to be sluggish in 2023. |
| **Infant milk formula (IMF)**  | We expect the IMF industry to see sales decline of 8%/3% YoY in 2023/24E on the back of birth rate decline. However, accelerated market consolidation in the wake of new National Standards for IMF product licensing should help market leaders Feihe and Yili to post better sales growth (>10% YoY in 2023E) while smaller players (H&H) may post weaker growth. 2024, being the Year of Dragon and a year after China's reopening, may also provide an uptick to new births. |
| **Raw milk price**  | The surge in supply driven by large dairy farms, coupled with lackluster demand from consumers in the near term, will likely put continued downward pressure on raw milk price.<br>We expect raw milk price to decline by 8% YoY in 2023E and 3% YoY in 2024E. |
| **Upstream dairy farms**  | Dairy upstream farms are becoming more consolidated by large-scale farms (>1000 heads of dairy cow), driven by policy and necessity (downstream producers' demand for food safety). As a result, the entire supply chain is becoming more vertically integrated, with each dairy farm partnering near-exclusively with a downstream producer, e.g. Youran/Saikexing/Zhongdi with Yili, Modern Dairy/Shengmu with Mengniu, YuanShengTai with Feihe, while Bright has self-owned farms that provide 40% of its raw milk.<br>**Short- and long-term implications:**<br>(1) Decline in raw milk price in both the near-term (due to over-supply from large-scale dairy farm's rapid expansion); and long-term (due to economies of scale and better milk yield). Raw milk price -6% YoY in 1H23, -9% YoY in Jul'23;<br>(2) less pronounced raw milk price cycle, given better demand-supply alignment, leading to more stable GPM for both upstream and downstream;<br>(3) bigger cost differences among downstream producers, as their procurement is no longer guided by market price, but by negotiations with their own exclusive suppliers, which means competitiveness of downstream players will be increasingly tied to their suppliers, including their cost efficiency (yield, feed costs, economies of scale) and product quality (availability and supply quantity of premium milk, e.g. organic milk, Jersey cattle milk). |

*Source: Various companies, Euromonitor, BOCOM Int'l*

## Fundamental View on Key Dairy Stocks

**Figure 4: BOCOM's fundamental view and investment recommendation on key dairy stocks**

| Company (stock ticker) | Key positives | Key concerns |
|---|---|---|
| **Yili (600887 CH)** | | |
| **BUY** ☆<br>**TP:** RMB 34.7 based on 17.0x 2024 P/E, 1.0x PEG<br>**CP:** RMB28.11<br>**Upside:** +23.4% | ⊖ Leading dairy conglomerate in China with no. 1 market share in most key categories (liquid milk, yoghurt, ice-cream, adult milk formula) and no. 2 position in infant formula. As market becomes more competitive or consolidates, Yili tends to be the one that benefits and gain share.<br>⊖ Compared to Mengniu that uses horizontal M&A to acquire segment expertise (Yashili, Milkground, Bellamy, etc), Yili has a solid track record of successfully grooming star product series (e.g. Ambrosial, Satine, QiaoLeZi) complemented by a strong pipeline of innovative new products. New products regularly account for 10-15% of its sales, providing impetus for growth .<br>⊖ Yili's milk powder business is comprised of its no.2 ranked infant milk formula, and its no.1 ranked adult formula (30% of total), likely a beneficiary of a consolidating sector.<br>⊖ Making headways into "beyond dairy" category expansion, e.g. bottled water and chocolate cakes (under AMX), and international expansion with ice-cream in Thailand, Indonesia (factory built) and potentially also Middle East and Africa.<br>⊖ Enjoys high ROE of c.20%, more than that of peers Mengniu (mid-teens %) or Bright (mid single-digit). | ⊖ Sales recovery slower than expected given a weak consumer sentiment, in segments like yoghurt, but full year pretax profit guidance still on track.<br>⊖ Infant formula business accounted for c.13% of 2022 sales, which we expect to see falling industry volume. |
| **Mengniu (2319 HK)** | | |
| **BUY**<br>**TP:** HK$37.1 based on 17.3x 2024 P/E, 1.0x PEG<br>**CP:** HK$ 27.95<br>**Upside:** +32.7% | ⊖ Well-balanced portfolio and alliances make a formidable team with ability to defend (43% share in defensive segments like UHT milk) and attack (fast-growing segments like fresh milk, cheese, ice-cream).<br>⊖ UHT milk: Deluxe is hugely successful, accounting for >30% of sales with >10% growth last year.<br>⊖ Fresh milk: 30%-owned Shengmu provides it with stable supply for differentiated organic milk that charges 40-140% premium to peers in a segment undergoing premiumization.<br>⊖ Ice-cream: Partnership with Moutai enhances brand equity. No. 1 in Indonesia (through Aice acquisition) with presence also in the Philippines and Vietnam.<br>⊖ Cheese: Control over 35%-owned Milkground positions Mengniu well for future growth in this high potential category, although near-term sales may be challenging.<br>⊖ Benign cost pressure (China Modern Dairy -4% in 1H), pricing competition positive for GPM. | ⊖ Potentially weak 2Q23 sales especially in segments with more discretionary buying behavior, e.g. room-temperature yoghurt.<br>⊖ Infant formula business remains a drag (loss-making in 2022) on the business with Yashili and Bellamy brands. |
| **Bright Dairy (600597 CH)** | | |
| **BUY**<br>**TP:** RMB14.5 based on 22.0x 2024 P/E, 0.6x PEG<br>**CP:** RMB10.98<br>**Upside:** +32.1% | ⊖ Fresh milk is poised for strong growth and take a much higher proportion of China's drinking milk consumption (currently 30%, vs. >90% in developed countries). Bright is the current leader nationally in fresh milk (#1 with 20% market share, 2x that of #2 player), and has a stranglehold in Eastern China with a >70% market share in Shanghai.<br>⊖ Vertically-integrated model positions Bright better than peers to penetrate lower-tier cities for fresh milk, given its self-owned dairy farms, self-owned cold-chain logistics fleet, R&D center to extend product shelf-life to 15-days and SuiXinDing app to lock in repeat purchasing for fresh milk.<br>⊖ Faces more favorable base effect than peers in 2023 given disproportionately large sales impact in Shanghai in 2022.<br>⊖ It sells baby milk formula to overseas market (25% of sales) via its 39%-owned Synlait but only adult milk formula in China, helping it ride on China's ageing demographic trend. | ⊖ Fresh milk growth to lower-tier cities will be tied to the development of cold-chain logistics, which could take time.<br>⊖ Bright's sales is concentrated in Shanghai (27% of sales) but lacks a nationwide presence.<br>⊖ Bright's strength is in chilled products, especially fresh milk, but is less competitive in other products.<br>⊖ Bright's NPM of 2-3% has been stable in the past but lacks an uptrend, compared to higher margins and continued expansion as seen in Yili and Mengniu. |

☆ *Is our top pick. Source: Various companies, Euromonitor, BOCOM Int'l estimates*

**Figure 5: BOCOM's fundamental view and investment recommendation on key dairy stocks (continued)**

| Company (stock ticker) | Key positives | Key concerns |
|---|---|---|
| **China Feihe (6186 HK)** | | |
| **NEUTRAL**<br><br>**TP:** HK$5.0 based on 7.1x 2024 P/E, 0.85 x PEG<br>**CP:** HK$ 4.88<br><br>**Upside:** +2.5% | ⊖ Feihe has been phenomenal champion in IMF space with a successful localized strategy (market share rose from 4% in 2013 to 20% in 2022). Its strategy of using local raw milk and turning them into powder within 2 hours at its self-owned dairy farms in Heilongjiang, thus ensuring freshness and nutrition, coupled with effective marketing that its formula is tailored for Chinese babies, has been instrumental.<br>⊖ IMF industry weakness, due to a decline in new births, is well known. However, roll-out of new national standards for product registration should accelerate market consolidation, which helps Feihe.<br>⊖ GPM recovery hinges on growth of high-end Astrobaby ZhuoRui, which charges RMB270-280/can and high margins. The sale of super-premium ZhuoRui, however, may also face discounting pressure, which is typical when market consolidation takes place. | ⊖ Sales and GPM pressure from a shrinking market.<br>⊖ Consensus is high, pricing in a blue-sky scenario, with Feihe growing by 9% 2023-25E CAGR (vs. industry decline of 1-2% CAGR) and flattish margins (despite its 7ppt fall in the past 2 years).<br>⊖ Feihe is not as focused on adult milk formula as some of its peers, missing out on potential opportunities from an ageing demographic trend. |
| **Health & Happiness (1112 HK)** | | |
| **NEUTRAL**<br><br>**TP:** HK$10.1 based on 6.0x 2024 P/E, 0.23x PEG<br>**CP:** HK$10.48<br><br>**Upside:** -3.6% | ⊖ Pure play on China's expanding middle-income group via fast-growing nutritional supplements and pet care markets, despite IMF still being its large segment (77% of 2022 sales).<br>⊖ Credit profile overshadows equity growth story for now, but investor attention should shift back to equity story as H&H gradually deleverages in the next 1-2 years. Mgmt vowed to halt further M&As, targeting 3x/2x deb/EBITDA by end-2023/24.<br>⊖ Strong brand portfolio of premium nutritional and wellness brands that are synergistic and with plenty of white spaces for international growth. Swisse and Solid Gold continue to grow in China, Zesty Paws in the US with China/Europe next.<br>⊖ IMF market challenging but Biostime is less affected as it focuses on the super-premium segment that is more resilient. | ⊖ H&H's credit profile has dominated its share price, not without reason, given its Ba2 credit rating (Moody's) and a rising rate environment<br>⊖ Still need to refinance a US$1,125m term loan in 1H24, so it is not out of the woods yet. Interest cost may also rise after refinancing existing debt.<br>⊖ IMF is still its largest sales contributor (37%) and its GPM has been declining with weak sales.<br>⊖ High dividend yield could fall if deleveraging is prioritized. |
| **Milkground (600882 CH)** | | |
| **NEUTRAL**<br><br>TP: RMB19.2 based on 44.0x 2024 P/E, 1.0x PEG<br>**CP:** RMB22.21<br><br>**Upside:** -13.6% | ⊖ Milkground ("MG") rose to the top, overtaking international peers, to become the clear leader in cheese with 20% market share (2022), and the recent investment by Mengniu may further strengthen its supply chain and distribution ability.<br>⊖ Cheese is an emerging category with bright long-term prospects, which have more nutritional value than milk, and its acceptance has grown rapidly in the past few years as consumers' taste also become more varied and open to westernized food that contains cheese.<br>⊖ Expansion into restaurants (B2B) and at-home channels could pave way for longer-term growth. Within cheese sticks, MG is also grooming room-temperature cheese sticks in order to penetrate into lower-tier cities. | ⊖ While cheese is considered to have more nutritional value, MG's current sales are mostly in the form of cheese sticks, which are more snack-like and discretionary in nature, making it vulnerable amid a weak consumer sentiment.<br>⊖ 2023 may see high base effect given international peers were partly shut out of the China market last year. |

*Source: Various companies, Euromonitor, BOCOM Int'l estimates*

## Why Invest in China's Dairy Industry?

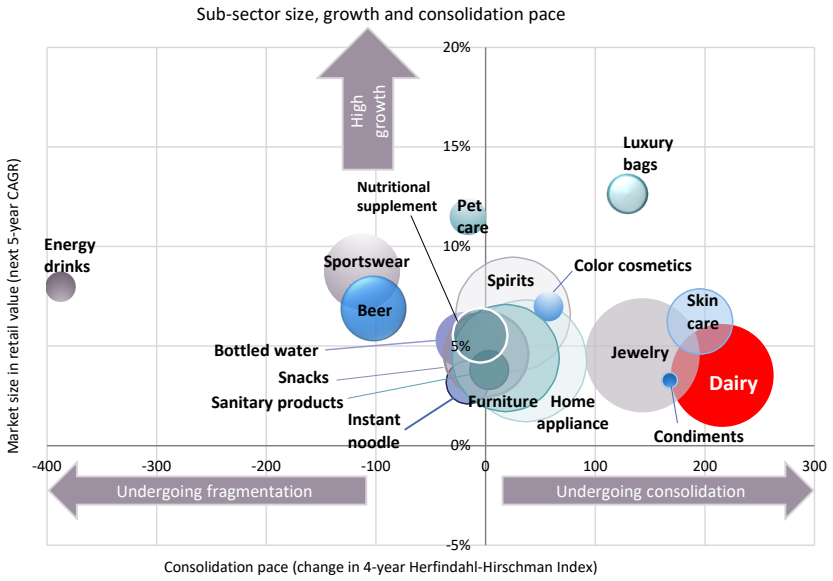
**Dairy sector has large size, fast consolidation but only moderate growth prospects. But certain sub-categories do offer higher growth:** We assess a consumer sub-sector's attractiveness by searching for (1) large industry size, (2) fast pace of consolidation, (3) high industry growth.

**(1) Dairy is a large sector, allowing its leaders to be consolidators of smaller players in its ecosystem:** China's dairy goods market is valued at RMB686bn as of 2022, making it one of the largest consumer sub-sectors. Currently, three consumer sub-sectors are larger: spirits (RMB894bn), home appliances (RMB835bn) and jewelry (RMB816bn). Large market size matters because leading players tend to have the scale and "war chest" to be consolidators, e.g. acquiring players in adjacent categories (horizontal acquisition) or along the supply chain (vertical integration). E.g. Dairy conglomerates have been active in acquiring niche category leaders (Yili acquiring Ausnutria, Mengniu acquiring Yashili and Milkground), and expanding upwards to dairy farms (Yili investing in Youran and Westland, Mengniu investing in China Modern Dairy, Shengmu).

**(2) Dairy has the fastest pace of consolidation among consumer sub-sectors:** A fast consolidation pace also allows market leaders to gain share and post above-industry-average growth. A more concentrated market also tends to lead to reduced competition and increased bargaining power for leaders, which usually results in better margins.

**(3) Overall dairy growth is not high, but certain emerging categories see faster growth:** While dairy industry's overall growth is not the fastest (3.7% CAGR in the next five years), certain product categories are expected to grow faster, e.g. cheese, ice-cream, fresh milk.

**Figure 6: Consumer sub-sector market growth (Y) vs. consolidation pace (X) vs. market size (bubble size). Top-right quadrant is the most attractive**

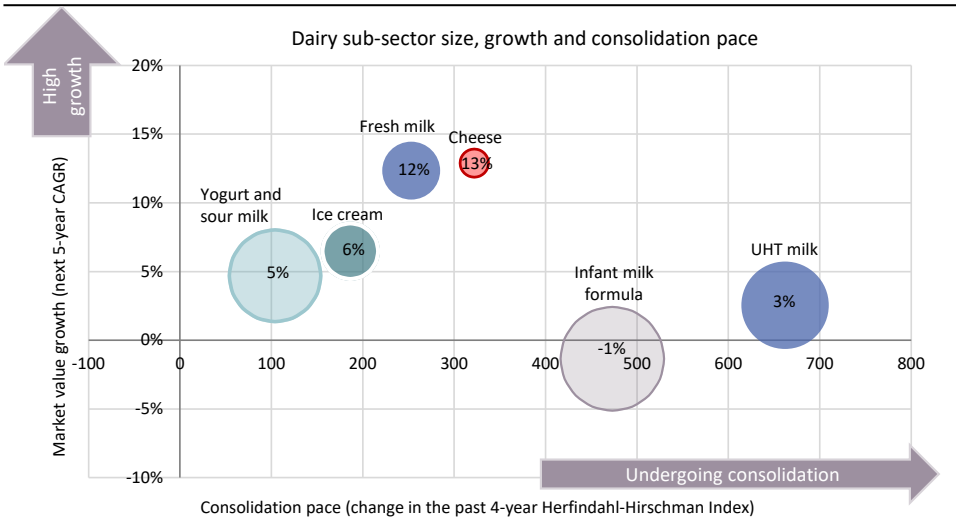



*Source: Euromonitor, BOCOM Int'l*

**Fresh milk, cheese will post the fastest growth:** Within dairy, growth is expected to be divergent. Emerging categories like fresh milk/cheese/ice-cream are expected to have above-average growth of 12%/13%/6% CAGR (2022-27E); on the flipside, UHT milk is expected to lag, with a slower pace of 3% CAGR (2022-27E), as well as yoghurt (5%) and IMF (-1%), according to Euromonitor. Already the largest category, we expect drinking milk to undergo a premiumization trend and a shift from UHT to fresh milk, as drinking milk as a whole still has ample upside in terms of volume and ASP. Volume-wise, China's per capita consumption of drinking milk is only 14-16% of the level in the European Union and the US. ASP-wise, we expect consumers' trade-up from UHT to fresh and premium (organic, Jersey cattle, A2 beta-casein) milk to drive higher ASP in the long run.

**Diversified dairy players to extend their growth through horizontal acquisitions:** To quickly tap into emerging categories with stronger growth prospects, industry leaders Mengniu and Yili have relied on M&A. e.g. **In cheese,** Mengniu acquired controlling stake in category leader Milkground. **In baby food,** Yili acquired IMF player Ausnutria while Mengniu acquired both Yashili and Bellamy's. **In ice-cream,** Yili acquired Chomthana, the largest ice-cream manufacturer in Thailand while Mengniu acquired Aice, a leading ice-cream brand in Southeast Asia. These allow the dairy giants to extend their growth and solidify their dominance in the dairy industry for years to come.

**Figure 7: Within dairy, cheese and fresh milk are expected to have the highest growth in the next few years, while UHT milk and infant milk formula have seen the fastest pace of consolidation**



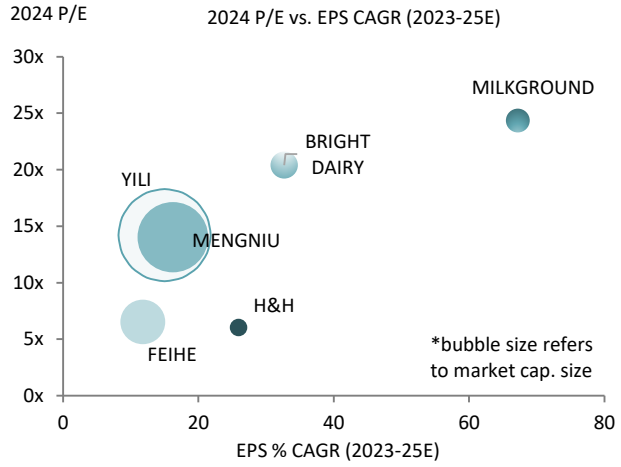

*Source: Euromonitor estimates, BOCOM Int'l*

## Valuation – Underperformed YTD, good long-term value on PEG basis

**Dairy has been one of the under-performing sub-sectors within consumer YTD, but that also represents an opportunity given our long-term constructive view:** Out of 14 consumer sub-sectors that we track, dairy is ranked 10th in terms of YTD share price performance (down 16% YTD vs. HSI -1%, as of 7 August). Its underperformance could be attributed to cyclically weak sales in 1H23 (see Near-Term View section), but given our constructive view longer-term (see Long-Term View section), we think current valuation represents a good opportunity to accumulate. We use PEG (forward P/E vs. 3-year EPS CAGR) as a benchmark for valuation, where our dairy coverage trades at an average of 0.60x PEG, a 36% discount to the 0.93x PEG for 84 key China consumer stocks.

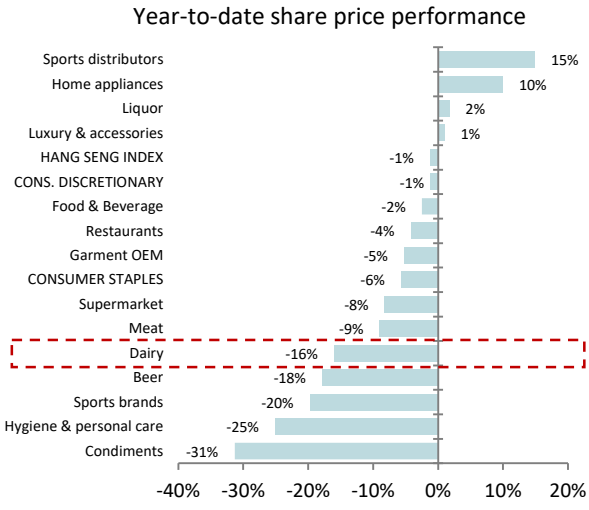
In Figure 8 below, X- and Y- axes represent EPS growth (next three years, 2023-25E) and 2024E P/E valuation respectively, based on Bloomberg consensus estimates, while bubble size presents market cap. As such, the right bottom corner are usually considered more attractive (high earnings growth, low P/E), assuming all things equal. However, this does not take into account fundamental views on the companies that reflect the companies' quality, as low valuation could also be a value trap.

**Figure 8: Earnings growth vs. valuation (2023-25E EPS CAGR vs. 2024 P/E) within our dairy coverage**




*Source: Bloomberg, BOCOM Int'l, updated as of 7 August 2023*

**Figure 9: Dairy's share price has underperformed YTD, ranking 10 out of 14 consumer sub-sectors**




*Source: Bloomberg, BOCOM Int'l, as of 7 August 2023*

## Figure 10: Valuation comps – Dairy goods producers and dairy farms universe

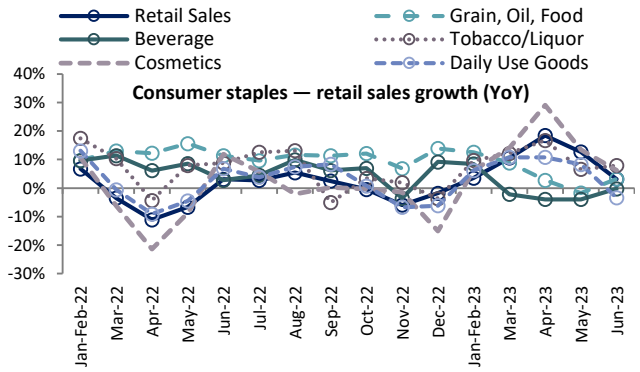
| Ticker | Company | Px | Price | Mkt cap | Beta | 3M ADTV* | EPS growth (%YoY) | | | 3-yr CAGR | PEG | ——P/E—— | | —ROE (%)— | | ——P/B—— | | Div yield (%) | | EV/EBITDA | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | ccy | 7-Aug | (US$bn) | | (US$m) | '23E | '24E | '25E | '23-25E | | '23E | '24E | '23E | '24E | '23E | '24E | '23E | '24E | '23E | '24E |
| **Chinese dairy goods producers** | | | | | | | **51.9** | **33.0** | **23.4** | **30.4** | **0.6** | **27.2** | **19.7** | **11.9** | **13.5** | **2.9** | **2.5** | **1.5** | **1.8** | **11.1** | **9.2** |
| 2319 HK | Mengniu | HKD | 27.95 | 14.1 | 0.89 | 40.6 | 18.1 | 16.3 | 14.3 | 16.2 | 0.9 | 16.3 | 14.0 | 13.9 | 14.5 | 2.3 | 1.9 | 1.8 | 2.0 | 11.7 | 10.2 |
| 600887 CH | Yili | CNY | 28.11 | 24.9 | 0.98 | 148.1 | 15.3 | 15.9 | 13.8 | 15.0 | 0.9 | 16.5 | 14.2 | 20.0 | 21.2 | 3.3 | 3.0 | 4.2 | 4.8 | 9.4 | 8.2 |
| 600597 CH | Bright Dairy | CNY | 10.98 | 2.1 | 0.80 | 14.3 | 80.0 | 15.0 | 12.8 | 32.7 | 0.6 | 23.5 | 20.4 | 8.0 | 8.5 | 1.7 | 1.6 | 1.2 | 0.8 | n/a | n/a |
| 002946 CH | New Hope Dairy | CNY | 15.52 | 1.9 | 0.78 | 10.0 | 39.5 | 27.1 | 23.2 | 29.8 | 0.7 | 26.5 | 20.8 | 16.7 | 17.8 | 4.4 | 3.7 | 0.8 | 1.0 | n/a | n/a |
| 600419 CH | Xinjiang Tianrun | CNY | 16 | 0.7 | 0.88 | 13.7 | 28.5 | 21.8 | 20.4 | 23.5 | 0.7 | 20.1 | 16.5 | 10.1 | 11.0 | 2.0 | 1.8 | 1.4 | 1.6 | n/a | n/a |
| 605179 CH | Zhejiang Yiming | CNY | 12.41 | 0.7 | 0.79 | 3.4 | n/a | 95.7 | 53.3 | n/a | n/m | 54.0 | 27.6 | 7.8 | 13.5 | 4.3 | 3.8 | n/a | n/a | n/a | n/a |
| 002732 CH | GD Yantang | CNY | 23.12 | 0.5 | 0.79 | 5.9 | 69.8 | 11.2 | 12.6 | 28.6 | 0.7 | 21.6 | 19.4 | 12.1 | 11.9 | 2.6 | 2.3 | n/a | n/a | n/a | n/a |
| 600882 CH | Milkground | CNY | 22.21 | 1.6 | 1.23 | 17.1 | 112.0 | 61.1 | 36.8 | 67.2 | 0.4 | 39.2 | 24.4 | 6.4 | 9.4 | 2.4 | 2.1 | 0.0 | 0.7 | 12.3 | 9.1 |
| **Chinese infant milk formula (IMF) producers** | | | | | | | **82.6** | **27.0** | **23.4** | **31.5** | **0.2** | **10.3** | **7.9** | **15.0** | **16.5** | **1.1** | **1.0** | **6.0** | **6.9** | **3.9** | **3.5** |
| 6186 HK | China Feihe | HKD | 4.88 | 5.7 | 1.08 | 10.1 | 10.9 | 13.0 | 11.5 | 11.8 | 0.6 | 7.4 | 6.5 | 21.1 | 20.5 | 1.5 | 1.3 | 5.9 | 6.4 | 3.0 | 2.4 |
| 1112 HK | H&H | HKD | 10.48 | 0.9 | 1.18 | 0.8 | 34.3 | 25.5 | 18.4 | 25.9 | 0.2 | 7.6 | 6.0 | 12.9 | 14.6 | 0.9 | 0.9 | 7.2 | 8.8 | 4.8 | 4.5 |
| 1717 HK | Ausnutria | HKD | 3.52 | 0.8 | 0.69 | 0.1 | 202.5 | 13.7 | 12.5 | 57.0 | 0.1 | 8.9 | 7.8 | 11.3 | 11.7 | 0.9 | 0.8 | 4.9 | 5.5 | n/a | n/a |
| 002570 CH | Beingmate | CNY | 4.36 | 0.7 | 0.64 | 6.6 | n/a | 56.0 | 51.3 | n/a | n/m | 17.4 | 11.2 | 14.7 | 19.1 | n/a | n/a | n/a | n/a | n/a | n/a |
| **Chinese dairy farms (upstream)** | | | | | | | **100.0** | **54.2** | **27.3** | **56.4** | **0.1** | **6.1** | **4.0** | **7.5** | **10.7** | **0.5** | **0.5** | **1.5** | **1.7** | **4.5** | **3.5** |
| 9858 HK | Youran | HKD | 1.63 | 0.8 | 0.89 | 0.5 | 147.3 | 41.2 | 30.7 | 65.9 | 0.1 | 5.5 | 3.9 | 7.3 | 9.6 | 0.4 | 0.5 | 0.0 | 0.0 | n/a | n/a |
| 1117 HK | China Modern Dairy | HKD | 0.8 | 0.8 | 0.78 | 0.5 | 52.8 | 67.3 | 23.9 | 46.8 | 0.1 | 6.7 | 4.0 | 7.7 | 11.8 | 0.5 | 0.4 | 3.0 | 3.4 | 4.5 | 3.5 |
| **Global dairy goods producers** | | | | | | | **(1.6)** | **9.1** | **6.5** | **4.4** | **3.6** | **17.4** | **16.0** | **17.7** | **18.2** | **3.2** | **3.0** | **3.2** | **3.4** | **10.4** | **9.7** |
| NESN SW | Nestle | CHF | 104.06 | 317.8 | 0.83 | 359.9 | 3.4 | 7.1 | 7.7 | 6.1 | 3.2 | 21.0 | 19.6 | 31.4 | 33.8 | 6.6 | 6.6 | 3.0 | 3.1 | 15.5 | 14.5 |
| ULVR LN | Unilever | GBp | 4071.5 | 130.5 | 0.71 | 134.3 | 2.0 | 7.2 | 6.6 | 5.3 | 3.2 | 18.0 | 16.8 | 34.0 | 34.0 | 6.0 | 5.7 | 3.7 | 3.9 | 11.5 | 10.8 |
| RKT LN | Reckitt Benckiser | GBp | 5616 | 51.3 | 0.69 | 75.8 | (1.3) | 6.8 | 8.1 | 4.4 | 3.5 | 16.6 | 15.6 | 24.2 | 23.7 | 3.9 | 3.5 | 3.4 | 3.5 | 11.3 | 10.5 |
| KHC US | Kraft Heinz | USD | 35.28 | 43.3 | 0.51 | 275.3 | 4.2 | 2.8 | 5.8 | 4.3 | 2.8 | 12.2 | 11.8 | 7.2 | 7.2 | 0.9 | 0.8 | 4.6 | 4.6 | 9.3 | 8.8 |
| BN FP | Danone | EUR | 54.34 | 40.5 | 0.67 | 80.0 | 0.9 | 5.2 | 7.0 | 4.3 | 3.5 | 15.7 | 14.9 | 11.7 | 11.9 | 1.9 | 1.7 | 3.8 | 4.0 | 9.5 | 8.8 |
| SAP CN | Saputo | CAD | 27.79 | 8.8 | 0.64 | 20.3 | (0.1) | 22.7 | 9.2 | 10.2 | 1.2 | 15.5 | 12.6 | 10.4 | 11.7 | 1.5 | 1.4 | 2.6 | 2.8 | 7.8 | 6.9 |
| 2269 JP | Meiji | JPY | 3306 | 6.8 | 0.41 | 19.5 | (26.5) | 8.2 | 3.4 | (6.3) | n/m | 18.2 | 16.8 | 7.1 | 7.4 | 1.3 | 1.2 | 2.8 | 2.9 | 7.2 | 6.8 |
| EMMN SW | Emmi | CHF | 851 | 5.2 | 0.80 | 2.1 | 4.7 | 12.8 | 4.1 | 7.1 | 2.8 | 22.2 | 19.7 | 15.5 | 15.5 | 3.5 | 3.1 | 1.8 | 2.0 | 11.3 | 10.6 |
| **Global IMF producers** | | | | | | | **(6.0)** | **10.4** | **11.5** | **2.4** | **7.8** | **21.1** | **19.0** | **16.9** | **17.2** | **3.5** | **3.2** | **2.3** | **2.5** | **12.5** | **11.0** |
| RKT LN | Reckitt Benckiser | GBp | 5616 | 51.3 | 0.69 | 75.8 | (1.3) | 6.8 | 8.1 | 4.4 | 3.5 | 16.6 | 15.6 | 24.2 | 23.7 | 3.9 | 3.5 | 3.4 | 3.5 | 11.3 | 10.5 |
| ABT US | Abbott Labs | USD | 107.65 | 186.8 | 0.84 | 534.3 | (17.7) | 5.0 | 10.8 | (1.5) | n/m | 24.5 | 23.3 | 19.6 | 19.7 | 4.9 | 4.5 | 1.9 | 2.0 | 16.9 | 14.9 |
| BN FP | Danone | EUR | 54.34 | 40.5 | 0.67 | 80.0 | 0.9 | 5.2 | 7.0 | 4.3 | 3.5 | 15.7 | 14.9 | 11.7 | 11.9 | 1.9 | 1.7 | 3.8 | 4.0 | 9.5 | 8.8 |
| A2M AT | A2 Milk Co. | AUD | 5.12 | 2.4 | 0.63 | 8.8 | n/a | 24.6 | 20.2 | n/a | n/m | 27.7 | 22.2 | 12.3 | 13.5 | 3.3 | 2.9 | 0.0 | 0.6 | 12.3 | 10.0 |
| **Global dairy farms (upstream)** | | | | | | | **0.5** | **296.1** | **40.0** | **10.2** | **1.2** | **88.9** | **12.2** | **8.3** | **6.8** | **0.6** | **0.6** | **5.9** | **4.7** | **5.3** | **4.8** |
| SML NZ | Synlait | NZD | 1.6 | 0.2 | 0.85 | 0.3 | (88.5) | 627.8 | 87.8 | 16.4 | 0.7 | 88.9 | 12.2 | 0.5 | 3.6 | 0.5 | 0.4 | 0.0 | 0.0 | 5.4 | 4.2 |
| FSF NZ | Fonterra | NZD | 3.65 | 3.6 | 0.60 | 0.1 | 89.5 | (35.6) | (7.8) | 4.0 | 0.0 | n/a | n/a | 16.0 | 10.1 | 0.7 | 0.8 | 11.9 | 9.5 | 5.3 | 5.4 |

*Source: Bloomberg consensus, BOCOM Int'l, updated as of 7 August 2023*
*Note:*
*ADTV = average daily trading volume.*
*n/a = not available; n/m = not meaningful.*

## Near-term View: Non-essential Dairy Categories (Cheese, Yoghurt) to Underperform in 2023

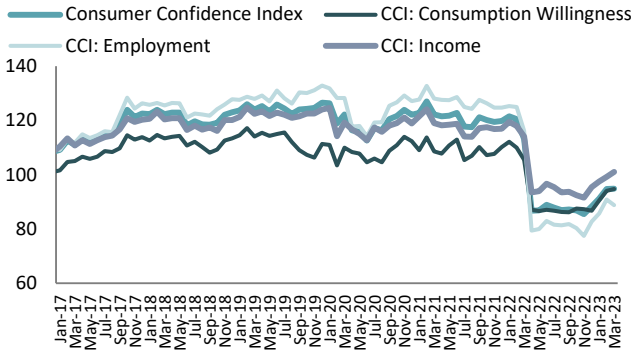
**Consumption recovery gradual:** The recovery of consumption sentiment so far in 2023 has been slower than expected, as written about in our 2H23 consumer sector outlook, where consumers are also becoming more price sensitive. As the charts below show, the YoY recovery in retail sales for staples categories has slowed, consumer confidence has yet to fully rebound, while employment for youth is relatively difficult.

**Figure 11: China retail sales growth (% YoY) for consumer staples has slowed in May/June**




*Source: NBS, BOCOM Int'l*

**Figure 12: Consumer Confidence index is gradually recovering, although the pace is only gradual**

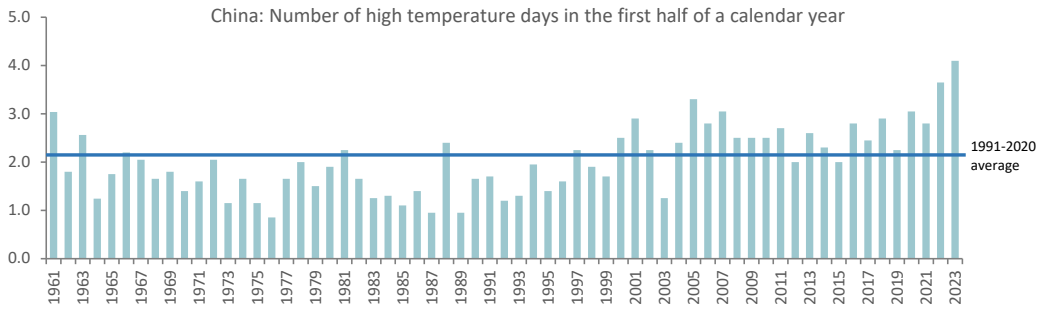



*Source: NBS, BOCOM Int'l*

**Dairy categories with more discretionary nature to underperform this year:** Under such macro backdrop, we believe categories with a higher degree of discretionary consumption nature would face short-term headwinds, such as **yoghurt** and **cheese**, which are more snack-like with purchases often made on impulse. **Ice-cream,** on the other hand, could benefit from unusually hot weather in 2023 as China has recorded the most hot days (defined as >35 degrees Celsius) in the first half of the year since 1961.

**Dairy categories with more rigid demand will be more resilient this year: Liquid milk** (UHT, fresh milk) are more staples-like with more rigid demand, as they are often part of consumers' staple diet and regular shopping cart. **Infant milk formula,** while defensive through economic cycles, will likely remain underwhelming given continued demographic headwinds from declining birth rate, as suggested by recent birth rate data.

**Figure 13: There is a record high number of high-temperature days (>35 degrees Celsius) in 2023**

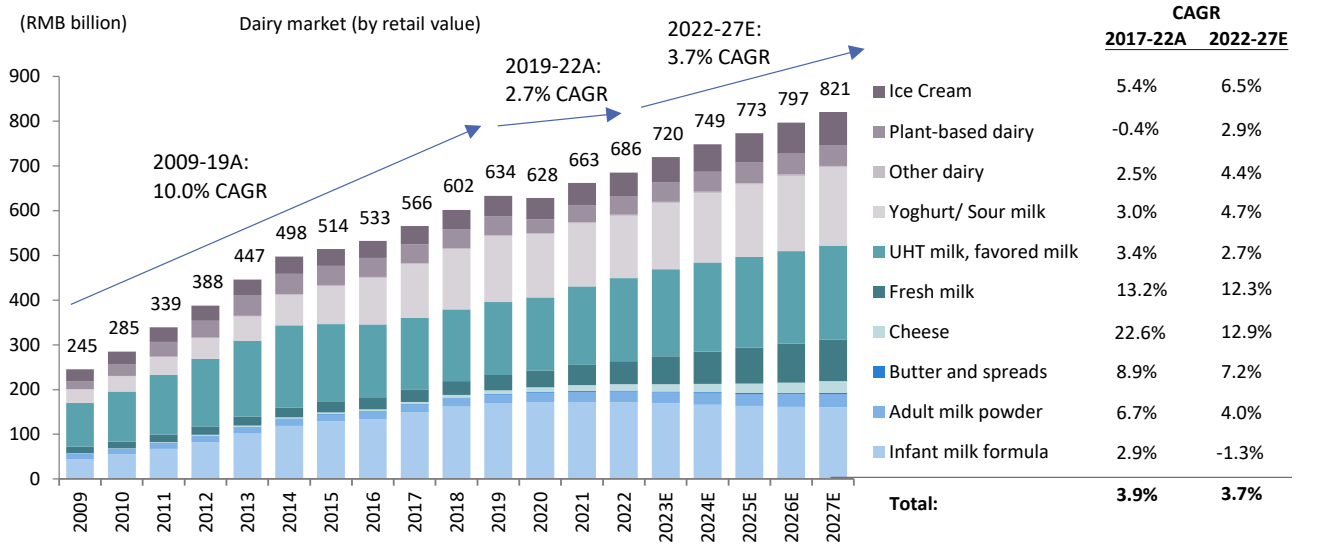



*Source: National Climate Centre, BOCOM Int'l*

## Long-term View: Emerging Categories and Drinking Milk Premiumization to Drive Future Growth

**Industry growth to be driven by emerging categories (cheese, ice-cream, butter) and premiumization of drinking milk (fresh, organic milk)**: China's dairy market is the largest in the world, having grown at a 3.9% CAGR in the past five years to reach a retail value of RMB686bn in 2022, despite slower growth in the past two years due to the pandemic (2.7% CAGR in 2019-21). The market is expected to maintain its growth in the next five years at 3.7% CAGR (2022-27E), according to Euromonitor. This will be driven by emerging dairy product categories (e.g. cheese, ice-cream) and consumption upgrade (e.g. for more mature categories like drinking milk, upgrade from UHT to fresh milk and organic milk), amid rising disposable income, health awareness and demand for more nutritional intake.

**Figure 14: China's dairy industry grew at a 3.9% CAGR in the past few years, despite slowing during the pandemic. It is expected to grow at a similar pace (3.7% CAGR) in the next five years**

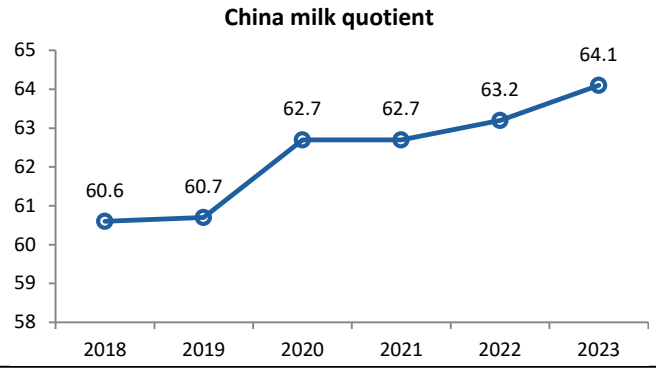



| | CAGR 2017-22A | CAGR 2022-27E |
|---|---|---|
| Ice Cream | 5.4% | 6.5% |
| Plant-based dairy | -0.4% | 2.9% |
| Other dairy | 2.5% | 4.4% |
| Yoghurt/ Sour milk | 3.0% | 4.7% |
| UHT milk, favored milk | 3.4% | 2.7% |
| Fresh milk | 13.2% | 12.3% |
| Cheese | 22.6% | 12.9% |
| Butter and spreads | 8.9% | 7.2% |
| Adult milk powder | 6.7% | 4.0% |
| Infant milk formula | 2.9% | -1.3% |
| **Total:** | **3.9%** | **3.7%** |

*Source: Euromonitor estimates, BOCOM Int'l*

**"Green and healthy" is the new trend:** Since the pandemic, there is rising awareness on healthy food and nutritional intake. According to the latest "Milk Quotient" survey conducted in 2023 by China Dairy Industry Association and Royal FrieslandCampina, there is a steady trend of premiumization where Chinese consumers pursue high-quality food that is green and healthy. Out of some 4,000 respondents in 20 cities across the nation, 78.4% said they would check the labels of dairy products while making purchases. Rich nutrition, high-quality source region of milk, low sugar, low fat, zero additives, and organic certification have all become important factors when Chinese consumers choose dairy products. The concept of Milk Quotient was first proposed in 2018, and it is used to evaluate the ability of Chinese consumers to correctly understand and consume dairy products, reflecting the level of national health literacy.

**Figure 15: "China Milk Quotient", which reflects Chinese consumers' national health literacy on dairy products, has risen 6 years in a row**

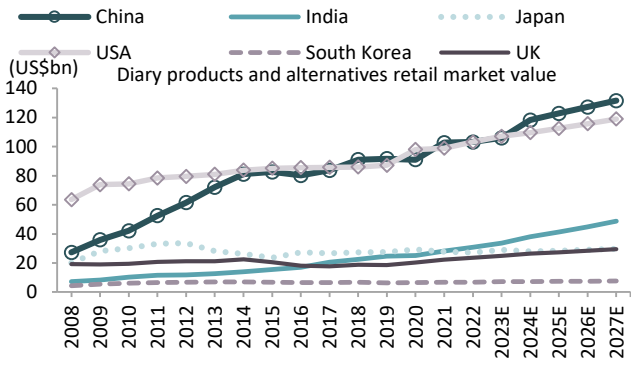



*Source: China Dairy Industry Association and Royal FrieslandCampina, BOCOM Int'l*

**China has the world's largest dairy market despite still-low per capita consumption, shows upside potential:** Despite being the world's largest dairy market (US$103bn) together with the US (same size) in 2022, China's dairy market still has low per-capita consumption compared to developed markets, at 42.29kg in 2021 (in terms of the equivalent of liquid milk), which is only 14-16% of the level in the Europe Union and the US. According to the "China Agricultural Outlook Report (2022-2031)", China's Ministry of Agriculture and Rural Affairs expects per-capita consumption of dairy to reach 63.2kg/year in 2031, up from 42.29kg/year in 2021 (a CAGR of 4.1%).

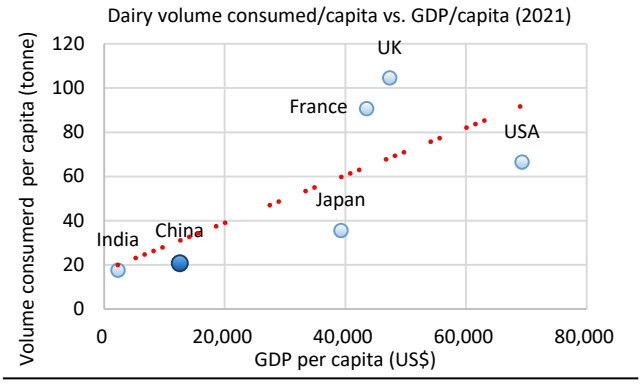
In recent years, with the improvement of national nutrition and health awareness, the milk consumption structure has undergone significant changes. The most prominent change is that the proportion of liquid milk consumption has dropped from 94.9% in 1995 to 74.3% in 2021, replaced by other dairy products. This suggests that there is still tremendous upside for growth from emerging product categories.

**Figure 16: China's dairy market is the largest in the world, valued at US$103bn in 2022**




*Source: Euromonitor estimates, BOCOM Int'l *this data excludes ice-cream*

**Figure 17: Dairy volume consumed per capita in China is still very low compared to other countries**




*Source: Euromonitor, BOCOM Int'l*

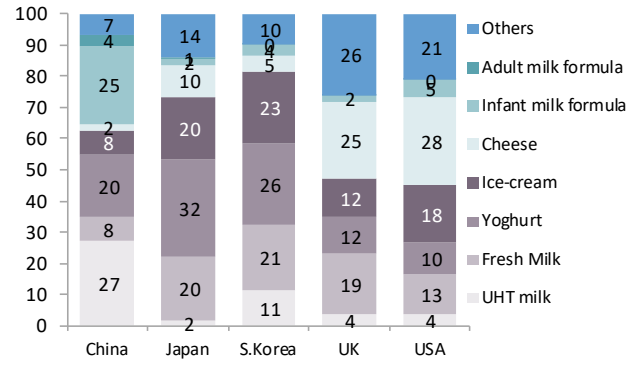
## Evolution of dairy categories around the world

The composition of China's dairy product consumption has undergone immense evolution in the past 30 years, most notably in the proportion of drinking milk, which fell from 94.9% in 1995 to 74.3% in 2021. In fact, using the US as a reference, liquid milk consumption per capita has fallen in the past 20 years, from 196 pounds/capita in 2000 to 134 pounds/capita in 2021, i.e. a steady volume decline of 1.8% CAGR, or a reduction of 60 pounds/capita in the last 21 years.

Liquid drinking milk as a whole (UHT + fresh milk) in China is 35% of total dairy consumption, higher than those in more developed countries (22% in Japan, 32% in S.Korea, 23% in the UK and 17% in the US) in 2022. However, within drinking milk, fresh milk is a much lower share (8% in China, vs. 13-21% in more developed countries). We expect UHT milk would fall in share, while fresh milk will continue to rise in mix as long as it can resolve its development bottlenecks, namely (1) access to supply of quality raw milk in the proximity, and (2) cold-chain logistics to lower-tier cities, which we will discuss more in the Fresh Milk/UHT Milk section in our report.

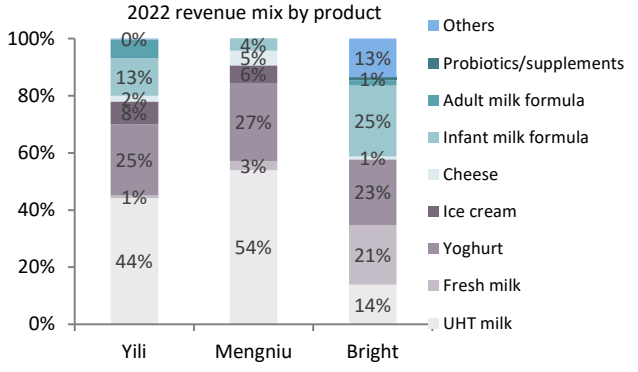
As China's dairy market develops and increasingly affluent consumers' tastes evolve, the adoption rate of new dairy products would also increase, such as ice-cream and cheese, bringing China's dairy industry category mix closer to that in developed markets. Cheese has been the fastest growing in the past five years (23% CAGR), while ice-cream has been growing steadily (5% CAGR in the past five years) and expected to grow by 6% in the next 5 years. The share of yoghurt/sour milk has risen from 12% 10 years ago to 20% in 2022, while butter and spread are growing the second fastest off a small scale. Infant milk formula is already a large share in China and will likely lag due to unfavorable demographics trend, but adult milk formula could rise as demand for such products increases as the proportion of elderly consumers rises in the Chinese society.

**Figure 18: China vs. other countries – Dairy market make-up (% of retail market size, 2022)**




*Source: Euromonitor, BOCOM Int'l*

**Figure 19: Chinese dairy companies, sales mix by product category**

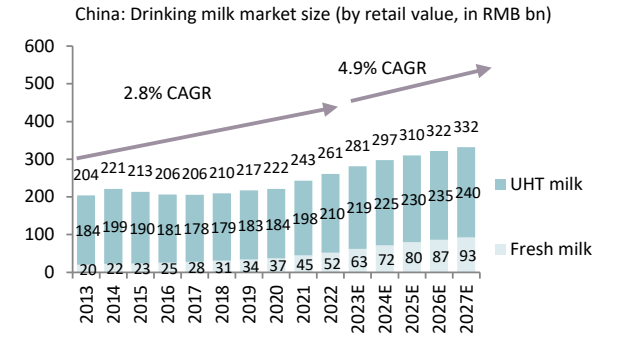



*Source: Various companies, BOCOM Int'l*

## (1) Fresh/UHT Milk – Drinking Milk Premiumization to Drive Fresh Milk Growth

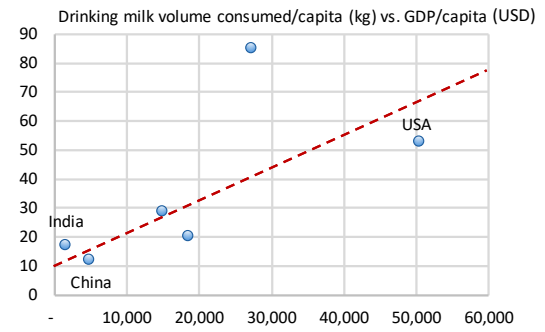
Drinking milk is the largest category within China's dairy sector. Fresh milk accounted for 20% of the drinking milk market in 2022 and is expected to grow at a 12% CAGR in the next five years, vs. a slower 3% CAGR for UHT milk and flavored milk.

**Figure 20: Drinking milk: Market size and growth**



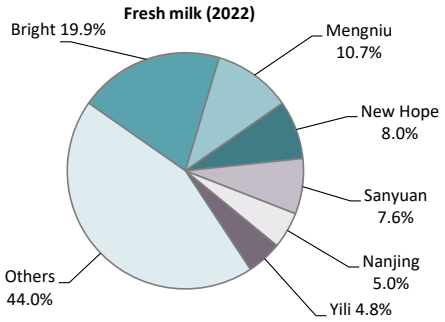

*Source: Euromonitor estimates, BOCOM Int'l*

**Figure 21: Drinking milk: Volume consumed per capita in China vs. other countries (2022)**



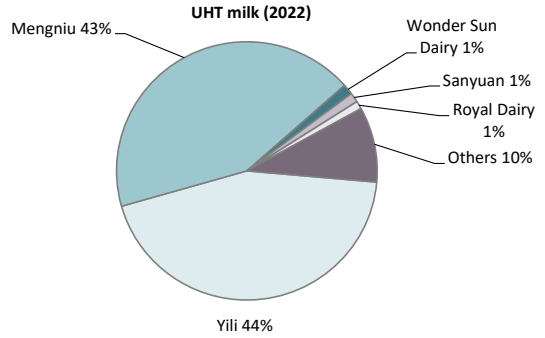

*Source: Euromonitor, BOCOM Int'l*

**Figure 22: Market share in fresh milk**



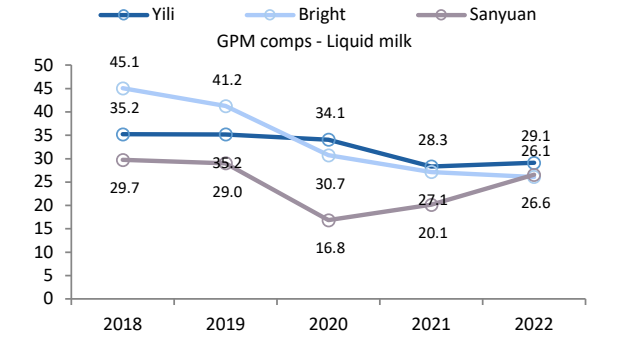

*Source: Euromonitor, BOCOM Int'l*

**Figure 23: Market share in UHT milk**



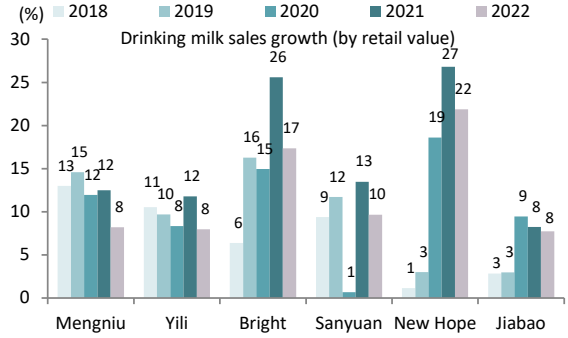

*Source: Euromonitor, BOCOM Int'l*

**Figure 24: Key players' liquid milk* margins**




*Source: Euromonitor, BOCOM Int'l *Liquid milk includes drinking milk (UHT, fresh milk, milk beverages) and yoghurt*

**Figure 25: Key players' sales growth**




*Source: Euromonitor, BOCOM Int'l*

**Drinking milk premiumization:** Premumization is a way for companies to enrich their product portfolio, and a testament of consumers' rising purchasing power. Within drinking milk, premium milk (including fresh milk) has been launched by various companies in recent years, including **Shengmu**'s organic milk (year 2012), **Huishan's** Jersey farm that boasts its Jersey cattle (2014), **Bright Dairy's** Ubest series (2017), **Mengniu's** Shiny Meadow fresh milk (2018), **JunLeBao's** YueXianHuo (2019) and **Yili's** Satine fresh milk (2019). Meanwhile, various novelty concepts such as organic, grass-fed cattle, A2, 3.6g protein, active protein, immunoglobulin, lactoferrin, exotic breeds (e.g. Jersey cattle) and improved cold chain preservation technology continue to extend the ceiling for liquid milk premiumization.

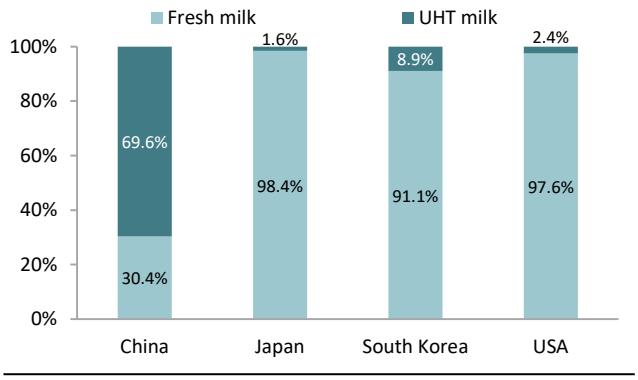
**Figure 26: Drinking milk premiumization has accelerated in recent years**




*Source: BOCOM Int'l*

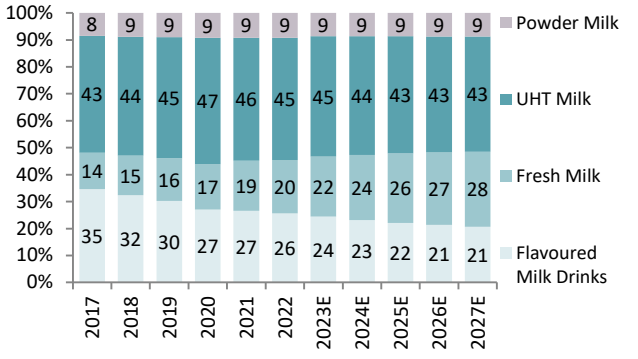
**UHT milk market is split by Mengniu and Yili, but fresh milk is the emerging battleground, currently led by Bright:** Yili and Mengniu are the duopoly in UHT milk, with a combined market share of 87% in 2022. This dominance will likely be stable going forward. However, competition in the fast-growing fresh milk market is more even, where Bright Dairy is currently the market share leader with 30% market share. However, other players are not far behind with 5-10% share each for the next five players.

**Figure 27: Fresh milk is 30% of drinking milk sales in China, but >90% in developed markets**




*Source: Euromonitor, BOCOM Int'l*

**Figure 28: Within liquid milk, fresh milk is expected to increase in sales mix in China**




*Source: Euromonitor estimates, BOCOM Int'l*

## Fresh milk – Key bottlenecks for growth into lower-tier cities

**Fresh milk market growth needs further growth in both demand and supply:** Fresh milk market remains underdeveloped in China, and we think future growth will be determined both by demand (willingness to spend on this premium product), as well as supply (availability of these products in lower tier cities). Companies have voiced that promotions are sometimes still needed to sell the fresh milk products (which have shorter shelf-lives), which means the return for producers is still not high now. E.g. Mengniu's fresh milk business only turned profitable 2 years ago. As consumer adoption rate of fresh and premium milk increases, we expect more companies will shift their capacity from UHT to fresh milk to fill the market void. Therefore, the market share situation could change going forward.

**Key bottlenecks for fresh milk expansion into lower-tier cities/ markets:** We think in order for fresh milk products to be available in lower tier cities and markets, the key bottlenecks to be resolved are:

**(1) Short shelf-life.** Fresh milk's shelf life is typically 5-7 days, or up to 15 days for fresh milk with newer pasteurization techniques. While cold chain can help partly resolve the logistical challenge of delivering them to lower tier cities, the long travel time means the shelf life would be cut even shorter when they are made available on shelves for consumers in lower tier cities. Cold chain also adds to the overall cost of the product, which affects the affordability for consumers and profitability for producers.

**(2) Consumer behavior:** Consumers in lower tier markets may not have the same demand and knowledge about fresh milk as those in tier 1-2 cities, and are used to using milk powder or soy milk as substitutes. Therefore, fresh milk industry's development would require stronger marketing and consumer education, in order to raise consumers' knowledge and trust and groom their habitual consumption for fresh milk.

**(3) Channel construction:** The retail channels in lower tier cities may not be as developed as those in tier 1-2 cities, and fresh milk needs local distributors and retailers (supermarkets, convenience stores) to distribute and increase point of sales. Fresh milk companies also need to use new channels like internet and social media to develop online sales in order to increase adoption of fresh milk.

**Strategy in fresh milk:**

**Bright Dairy:** Bright is currently the market leader in fresh milk, with its Zhiyou, Fresh Pasture and Ubest (Youpei) fresh milk. Sales scale was close to RMB10bn in 2022, but declined YoY due to the pandemic and Bright's sales concentration in Shanghai (27% of 2022 sales). Bright Dairy's self-owned dairy farms (provides 40% of its raw milk supply), own online ordering app (SuiXinDing) and cold-chain logistics company, Speed Fresh, with over 50,000 daily delivery outlets, are also competitive advantages, given cold-chain logistics is a bottleneck for fresh milk distribution to lower-tier cities, and the online ordering app locks in customers for regular repeat purchasing of fresh milk.

**Mengniu:** Mengniu's key products are **Shiny Meadow** and the more economical **Modern Meadow**, with sales scale reaching RMB3bn in 2022 (40%+ from Shiny Meadow, rest from

Modern Meadow) with sales growth of 30% YoY in 2022, helped by its partnership with community group buying platforms that overcame supply chain disruption. Mengniu ranks first in the premium segment of fresh milk. Shiny Meadow also launched a sub-brand, Xiaoxianyu, in June 2022, targeting youngsters with its unique selling point of yummy light fresh milk, mainly sold via the convenience stores channel.

**Yili:** Key products in fresh milk are **Satine (JingDian) fresh milk** and the lower-end **Yili fresh milk**, with sales scale reached more than RMB1bn in 2022. Overall fresh milk sales declined slightly in 2022, affected by sales and cold chain disruption, but sales for its leading brand Satine still grew by >40% YoY. Despite its currently weaker market share position, Yili believes it can easily convert its existing production capacity for UHT to fresh milk whenever it sees a market opportunity to do so, helped by its nationwide upstream dairy farm layout. Yili relies on third-party for cold chain logistics.

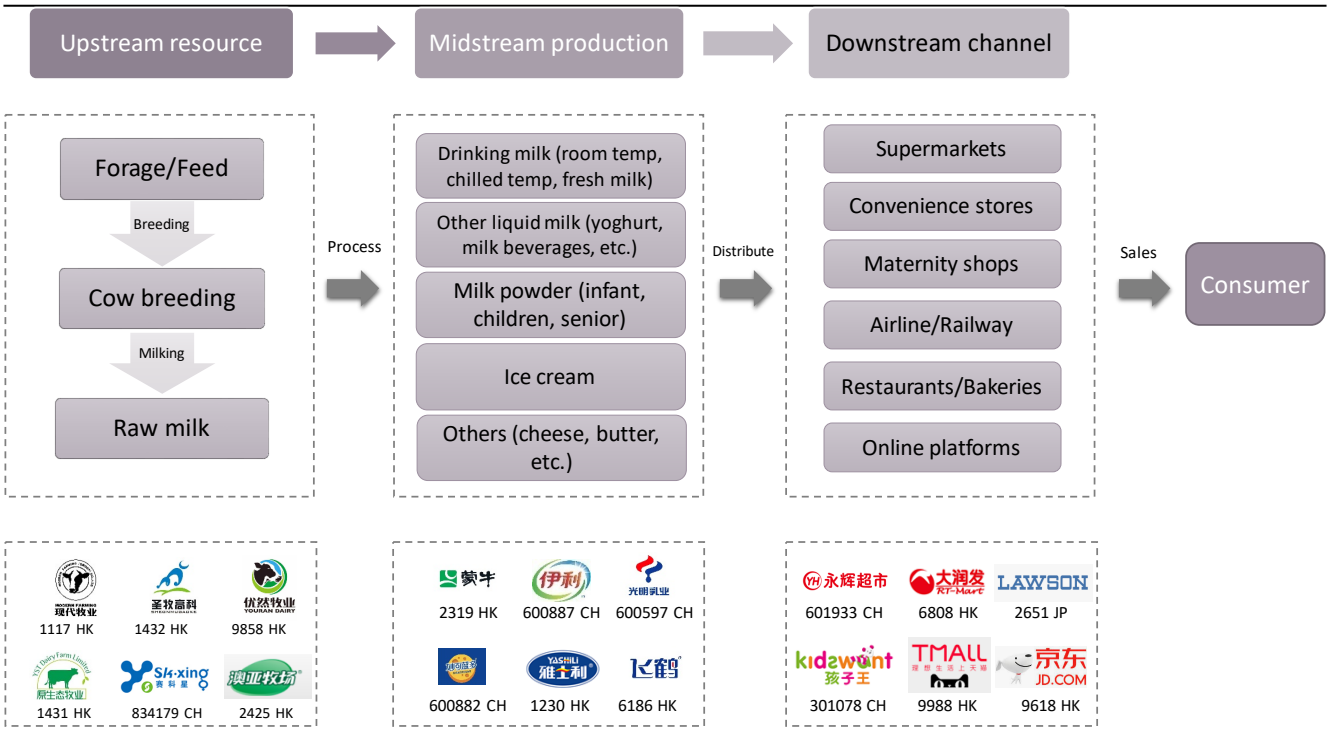
**Figure 29: Product offering by segment – Liquid milk (UHT & fresh milk)**

| Company<br>公司<br>Ticker 股票代号 | Mengniu<br>蒙牛<br>2319 HK | | | | | Yili<br>伊利<br>600887 CH | | Bright Dairy<br>光明<br>600597 CH | | |
|---|---|---|---|---|---|---|---|---|---|---|
| UHT | | | | | | | | | | |
| Product series<br>产品系列 | Milk Deluxe<br>特仑苏 | Mengniu pure milk<br>蒙牛纯牛奶 | Student's Milk<br>蒙牛早餐奶 | Future Star<br>未来星 | Desert organic<br>沙漠有机牛奶 | Satine pure milk<br>金典纯牛奶 | Yili Pure Milk<br>伊利纯牛奶 | Zhiyou<br>优加 | Bright Youji<br>光明有机 | Qiaofeng<br>巧风 |
| Price/ 250ml (Rmb) | 5.4 | 3.1 | 3.2 | 5.0 | 10.0 | 4.1 | 3.2 | 7.2 | 5.2 | 3.7 |
| 鲜奶 | | | | | | | | | | |
| Product series<br>产品系列 | Shiny Meadow<br>每日鲜语 | | Modern Meadow<br>现代牧场 | | | Satine fresh milk<br>金典鲜牛奶 | Yili fresh milk<br>伊利鲜牛奶 | Ubest<br>优倍 | Zhiyou<br>致优 | Fresh pasture<br>新鲜牧场 |
| Price/ 250ml (Rmb) | 11.7 | | 4.9 | | | 8.3 | 6.3 | 2.8 | 11.8 | 7.5 |

*Source: tmall.com, BOCOM Int'l*

## Key #1 to fresh milk growth: nationwide access to supply of high-quality, premium milk

**Figure 30: Dairy supply chain, from dairy farms to dairy goods producers to online/offline retailers**

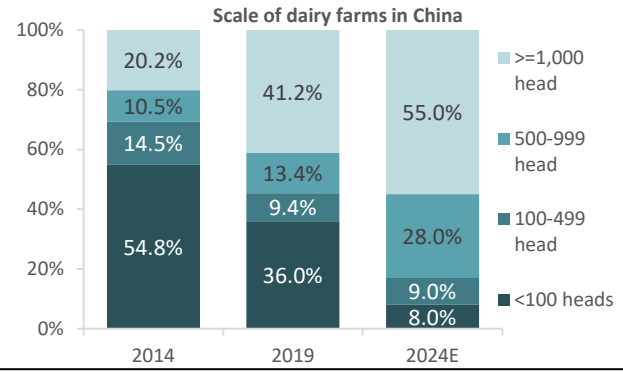



*Source: Various companies, BOCOM Int'l*

**Upstream dairy farm consolidation has accelerated after 2008…** In order to avoid a repeat of the melamine incident in 2008, which was attributed to third-party milk collection stations that collect milk from individual farmers, China's government has launched various policies to reform and develop China's dairy farming industry. The first "Industrial Policy for the Dairy Industry" (乳制品工业产业政策) and "Outlines of the Restructuring and Revitalization Plan for the Dairy Industry" (奶业整顿和振兴规划纲要) were issued in 2008, which encouraged the development, modernization and standardization of large-scale dairy farms in order to improve food safety.

**… by large-scale dairy farms:** Driven by policy and food safety needs of dairy producers, there is an accelerated development of large-scale dairy farms in China. To ensure food safety of its milk source, downstream dairy producers have steadily increased their sourcing from large-scale dairy farms (i.e. >1,000 heads of dairy cattle per farm), and have also invested in these dairy farms in order to finance their expansion, which has resulted in increasing vertical integration in the dairy supply chain. For dairy farms, the financial backings helped them modernize their operations, achieve economies of scale and improve yield, which would help to lower production costs in the long run.

**Figure 31: Dairy farms in China are increasingly large-scale, with >1,000 heads of dairy cows**




*Source: Youran IPO prospectus, BOCOM Int'l*

**Increasing vertical integration by downstream dairy conglomerates:** There has been a flurry of M&A and capital raising by upstream dairy farm operators in the past 10 years. Recently, we saw the IPOs of **AustAsia** (2425 HK/NR) in 2022 and **Youran** (9858 HK/NR) in 2021. We note that Youran acquired a majority stake in smaller dairy farm operator **Saikexing** before its IPO, and is a supplier to **Yili** and **Bright Dairy.** Baby formula producer **China Feihe** acquired 71.26% stake in **YuanShengTai Dairy Farm** in September 2020, which supplies most of its raw milk to Feihe. **Mengniu** has gradually increased its stake in **China Modern Dairy** (1117 HK/NR) over the years, while it also increased its stake to 29.99% in **Shengmu**, which provides high-end organic milk to Mengniu.

**Figure 32: Shareholding by dairy conglomerates in dairy farms**

| Acquirer | Stake owned | Target | Stock ticker | Business nature |
|---|---|---|---|---|
| Mengniu | 56.36% | China Modern Dairy | 1117 HK | Dairy farm in China |
| Mengniu | 29.99% | China Shengmu | 1432 HK | Dairy farm in China |
| Yili | 13.72% | Youran | 9858 HK | Dairy farm in China |
| Yili | 16.6% | Zhongdi | 1492 HK | Dairy farm in China |
| Youran (13.7% owned by Yili) | 58.36% | Saikexing | 834179 CH | Dairy farm in China |
| Yili | 100% | Westland | Private | Dairy farm in New Zealand |
| Bright Dairy | 100% of certain assets | Huishan Dairy | 6863 HK | Dairy farm in China |
| Bright Dairy | 60% | Qinghai XiaoXiNiu | Private | Dairy farm in China |
| Bright Dairy | 51.0% | Synlait Milk | Private | Dairy farm in New Zealand |

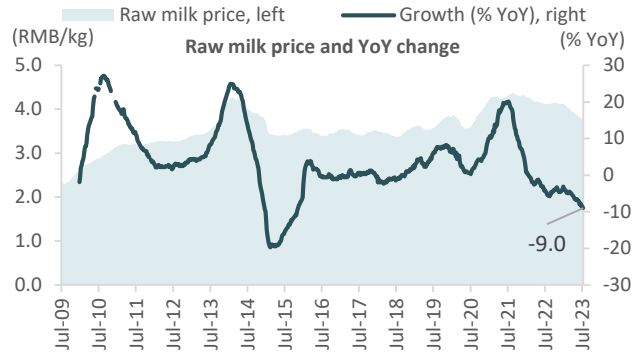
*Source: Various companies, BOCOM Int'l*

**Longer term, raw milk price cycles will be less pronounced:** As the consolidation of upstream dairy farms continues and upstream supply is dominated by large-scale dairy farms that are strategically partnered and near-exclusively supply to one or the other downstream dairy conglomerates, we expect to see less pronounced raw milk price cycles, which are the result of supply-demand mismatches and typically repeat every 3-4 years. We believe supply and demand of raw milk will be more aligned in the long run, and prices would be smoothened out as they are negotiated on a longer-term basis.

**Upstream margins more protected, downstream costs to go down:** As the importance of dairy farms increase for downstream dairy good producers, margins of dairy farms should also be more protected, making them less susceptible to fluctuation in profitability. For dairy goods producers, the improved technology, economies of scale and improved milk yield of dairy farms should lower production costs, and have a deflationary effect on raw milk price in the long run, a positive for downstream producers' margins.

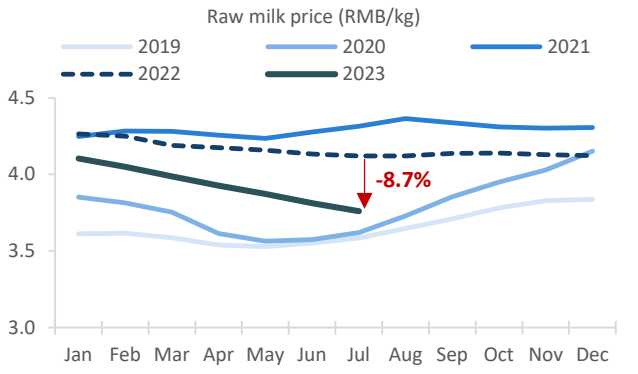
**Long-term, raw milk price should fall given increased supply:** Similar to cotton where domestic cotton is more expensive than imported cotton, domestic raw milk is also more expensive the imported milk (even imported milk powder that is turned back into liquid milk). However, with increased economies of scale, better technology and operating efficiency of large-scale dairy farms, the price of domestic raw milk should decline and may one day fall below the price of imported milk powder (from the likes of Fonterra), which would help to reduce imports of raw milk into China.

**Figure 33: Raw milk price was down 9% YoY in July 2023**



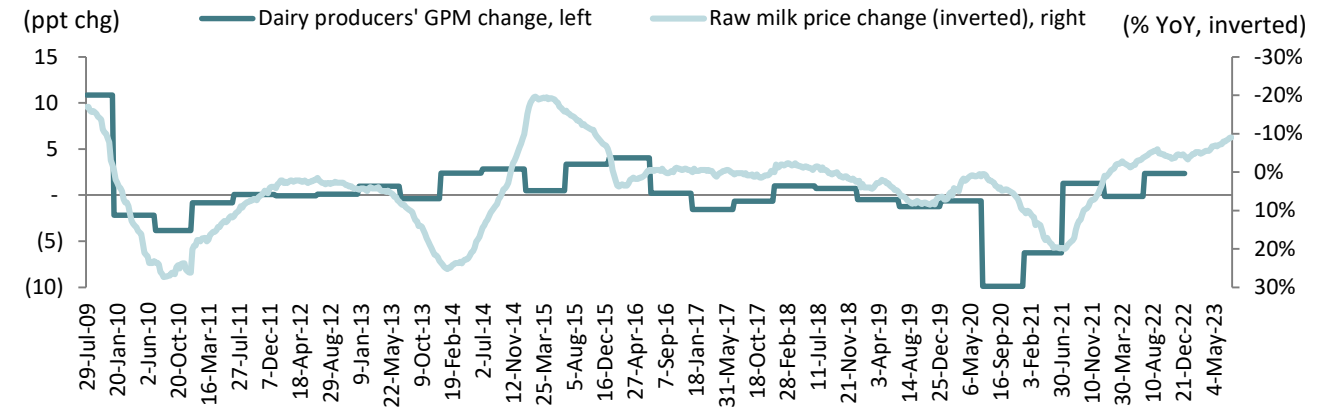

*Source: Ministry of Agriculture and Rural Affairs, BOCOM Int'l*

**Figure 34: Raw milk price is trending lower, down 9% YoY to RMB3.76/kg as of July 2023**




*Source: Ministry of Agriculture and Rural Affairs, BOCOM Int'l*

**Figure 35: Recent decline in raw milk price (-6% YoY in 1H23, -9% in Jul'23) bodes well for the top-3 dairy producers' GPM, as evident from the historically strong correlation between the two**




*Source: Ministry of Agriculture and Rural Affairs, companies, BOCOM Int'l * Dairy producers refer to Yili, Mengniu and Bright Dairy*

**Upstream dairy farms will determine the cost competitiveness of their specific downstream partner in the long run:** Another likely result from the structural consolidation trend is that the raw milk costs for downstream producers will likely be more divergent in the long run, as they procure from their near-exclusive suppliers rather than from the market (at market price). This means the cost competitiveness of downstream players will be tied to the efficiency of upstream suppliers in the long run.

**Mengniu's upstream partner Modern Dairy currently has the lowest costs:** GPM for all three major dairy farm operators were similar, at 31-32%. However, on absolute basis, China Modern Dairy's raw milk COGS was the lowest, at RMB29.4/kg in 2022, while its ASP (i.e. COGS for its customer Mengniu) was also the lowest, at RMB4.3/kg, in 2022. Shengmu, known for its premium organic milk, commands the highest ASP and cost/unit.

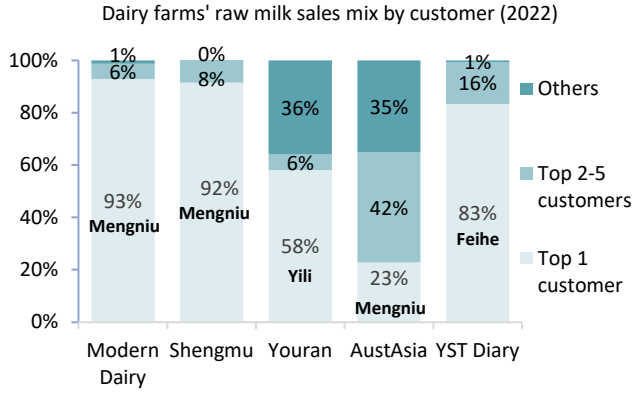
**Figure 36: Upstream dairy farm's raw milk business operating metrics (2022)**

| Raw milk sales | Sales (RMB m) | Volume (0,000 tons) | ASP (RMB/kg) | COGS per kg | Gross profit (RMB m) | GPM (%) |
|---|---|---|---|---|---|---|
| **2022 reported data** | | | | | | |
| Modern Dairy | 9,945 | 232.7 | 4.3 | 29.4 | 3,095 | 31.1% |
| Youran | 10,854 | 232.8 | 4.7 | 32.0 | 3,412 | 31.4% |
| Shengmu | 3,176 | 63.5 | 5.0 | 34.1 | 1,013 | 31.9% |
| **Growth (% YoY)** | | | | | | |
| Modern Dairy | 42.0% | 46.7% | -3.1% | 4.4% | 22.1% | -5.1 |
| Youran | 13.8% | 19.6% | -4.9% | 11.4% | -13.7% | -10.0 |
| Shengmu | 6.4% | 8.5% | -2.0% | 3.8% | -4.9% | -3.8 |

*Source: Companies, BOCOM Int'l*

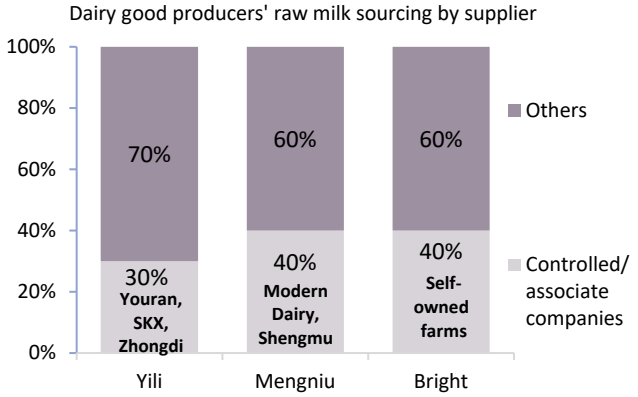
**Securing upstream access to high-quality (organic, jersey cattle) milk will be key to downstream players' premiumization drive:** Shengmu is currently the largest producer of organic milk in China, accounting for >30% of organic certification for raw milk and >40% of organic milk production in China. This gives an advantage to its downstream partner Mengniu, which owns 35% stake in and sources 90% of its organic milk from Shengmu, to have a steadier supply of organic fresh milk to sell to end consumers. Similarly, Yili sources its premium milk (organic, jersey) from its upstream partner Youran.

**Figure 37: Major dairy farms' raw milk sales by customer (2022)**




*Source: Companies, BOCOM Int'l*

**Figure 38: Dairy goods producers' raw milk procurement by dairy farm (2022)**

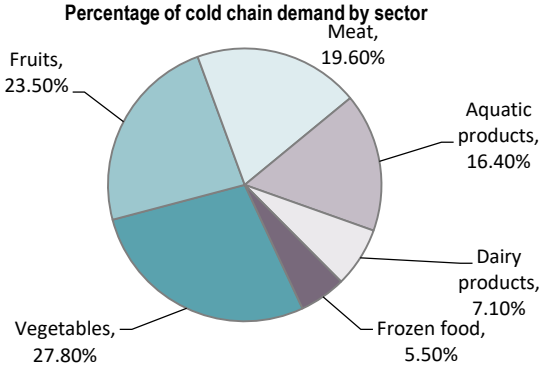



*Source: Companies, BOCOM Int'l Note: Zhongdi (delisted, formerly 1492.HK) was privatized by Yili. Saikexing (SKX) was acquired by Youran.*

## Key #2 to fresh milk growth: development of cold chain logistics to penetrate lower-tier cities

**Demand for fresh food rises, especially in lower-tier cities…** Innovation in pasteurization (e.g. BASF, Ultra High Temperature i.e. UHT) and vacuum packaging (Tetra Pak) has lengthened the shelf life of dairy products and allowed them to be stored and transported in room temperature. However, chilled dairy products are often considered to have more nutritional value than room-temperature ones. As demand for nutritious fresh food continues to rise in China, especially in lower-tier cities where consumers are increasingly affluent, there is an increasing need for cold-chain logistics that can transport, store and distribute fresh food in a chilled or frozen state over a long distance.

**Figure 39: Dairy products to account for 7.1% of the total demand for cold-chain logistics in 2023**




*Source: CCLC, Askci*

**…leads to fast-growing cold-chain industry in recent years.** China's government has introduced several policies to support the development of the cold-chain industry. For example, China's New five-year plan for cold-chain logistics issued in December 2021, aims to initially form a cold-chain logistics network connecting the production side and distribution side, and covering both urban and rural areas by 2025. The overall market size scored double-digit CAGR from 2018 to 2022 and reached RMB239.5bn by 5M23, and is expected to reach RMB561.6bn in 2023.

**Why is ice-cream available in lower tier markets but not fresh milk? Higher requirements for cold chain completeness for chilled food (fresh milk, chilled cheese) compared to frozen food (ice-cream).** Yili has been the ice-cream market leader in China for 28 years, and its ice-cream products have well penetrated lower tier small cities, districts and villages. So one may ask, why are fresh milk and other chilled products not available in the same lower-tier markets yet? The differences with fresh milk are:

- **Different temperature requirement:** Ice-creams are frozen products (temperature controlled at minus 18 degree Celsius), compared to fresh milk being chilled products (temperature controlled at between 2-5 degree Celsius), which means ice-cream has longer shelf life of sometimes up to a year, compared to typically 5-7 days for fresh

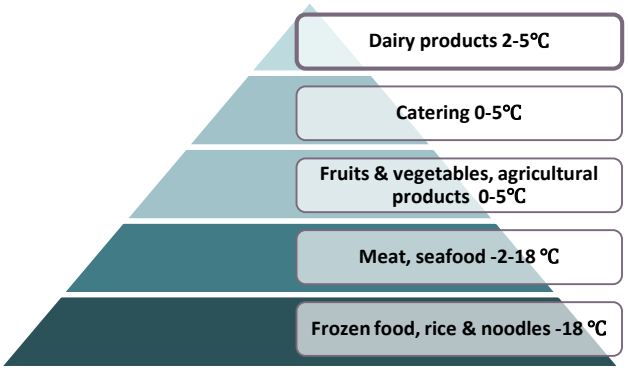
milk and chilled cheese. This means frozen food can afford to have longer transportation time than chilled food.

- **Higher standards in cold chain network completeness:** Gaps in the cold chain network can also be more problematic for chilled food given their delicate temperature requirement. The insufficient development and uneven distribution of cold chain logistics across China is still well behind those in developed countries. There is often unfulfilled demand for cold storage in regions with higher income (Eastern China, Beijing, Guangdong, Sichuan), which can easily result in gap in the cold chain that can lead to higher wastage for chilled food like fresh milk and cheese, but less so for frozen products like ice-cream given the slower rate of bacteria growth in a frozen state.

The first issue, i.e. transportation time (to lower-tier cities) versus shelf life (5-7 days for fresh milk), is difficult to resolve, and one of the solutions is the creation of longer shelf life products. 15-day shelf life fresh milk (compared to the typical 5-7 days for fresh milk) has been developed by various brands, including Bright Dairy who launched its new 15-day shelf-life Ubest fresh milk in 2H22 that boasts about its ability to keep more of its nutritional value compared to competitors' products.

Another solution is to increase the density of dairy farms and processing plant in the vicinity of the end markets, in order to shorten the distance travelled and transportation time. However, this requires time and development and is the reason why chilled food remains largely out of reach for lower-tier cities' residents for now.

**Figure 40: Temperature requirement for storage and transportation of various food categories**




*Source: YunLian Think Tank, LeadLeo, BOCOM Int'l*

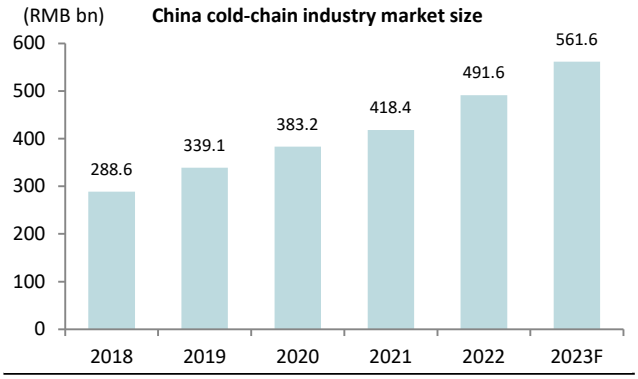
**Figure 41: Unfulfilled demand for cold storage is the highest in Eastern China and Beijing (1H21)**




*Source: YunLian Think Tank, LeadLeo, BOCOM Int'l*

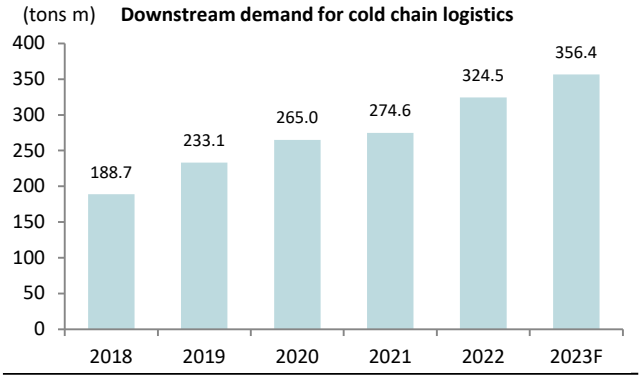
**On the demand side,** the total market demand for cold chain logistics in China is expected to exceed 356m tons in 2023, of which dairy products account for 7.1%. Dairy consumption in smaller cities and rural areas in China is far from the level it could be. Consumption of milk and other dairy products like cheese and butter will keep growing and help to boost total dairy consumption.

**Figure 42: China cold-chain industry grew by around 14% CAGR from 2018 to 2022**




*Source: Cold Chain Logistics Committee (CCLC), Askci, BOCOM Int'l*

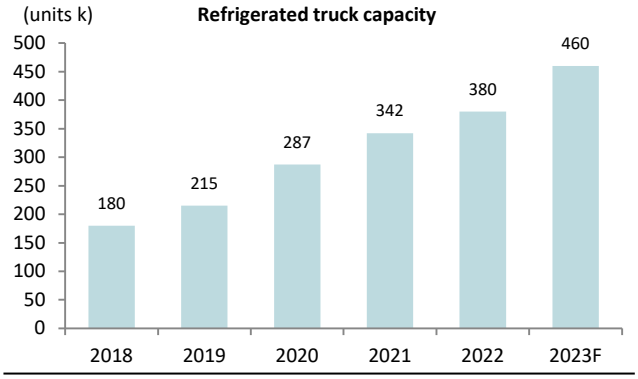
**Figure 43: Demand for cold chain logistics in 2023 will be almost twice as high as in 2018**




*Source: CCA, Askci, BOCOM Int'l*

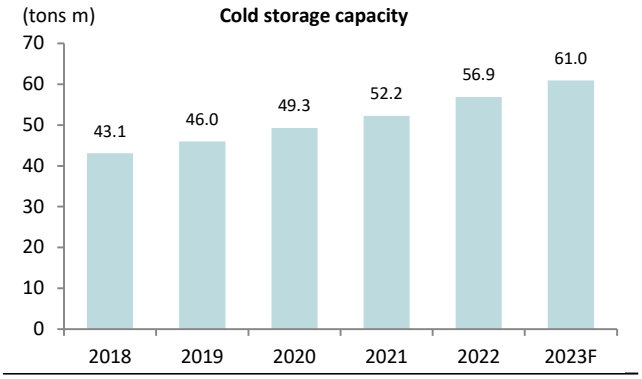
**On the supply side,** cold storage capacity of major enterprises grew from 43m tons to 57m tons from 2018 to 2022, and is expected to further expand to >60m tons in 2023, riding on the continuous cold-chain infrastructure construction by the government and deployment by enterprises. Refrigerated truck, a key determinant of cold chain capacity, reached 380,000 units in 2022, and is expected to grow to 460,000 units in 2023.

**Figure 44: Refrigerated truck capacity has steadily increased in the past, but still has huge need**




*Source: CCLC, Askci, BOCOM Int'l*

**Figure 45: Cold storage capacity is also increasing**



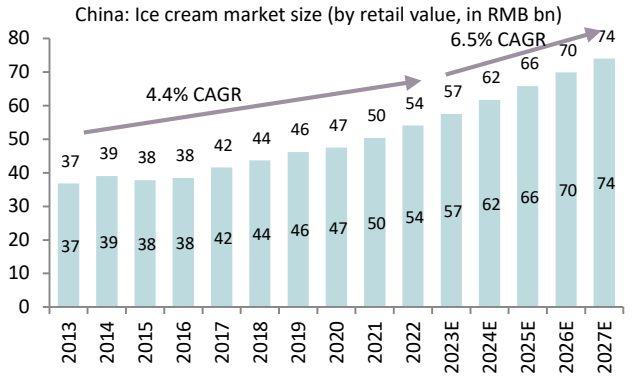

*Source: CCA, Askci, BOCOM Int'l*

**Top dairy players are deploying cold-chain logistics.** For example, **Bright Dairy**'s own cold-chain logistics company, Speed Fresh, has over 50,000 daily delivery outlets. Speed Fresh ranks 9th among China's cold-chain logistics companies, tops the list in terms of urban distribution scale, and is the first in the dairy industry to obtain the five-star cold chain qualification. **Mengniu** has cooperated with Alibaba to develop cold-chain home-delivery services, and **Yili** adopted digitalization in its cold-chain system, keeping the products at 2-6°C throughout the whole process from production to sales terminal to ensure the freshness.

## (2) Ice-cream – Short-term Helped by Hot Weather, Long-term Driven by Rise in Income

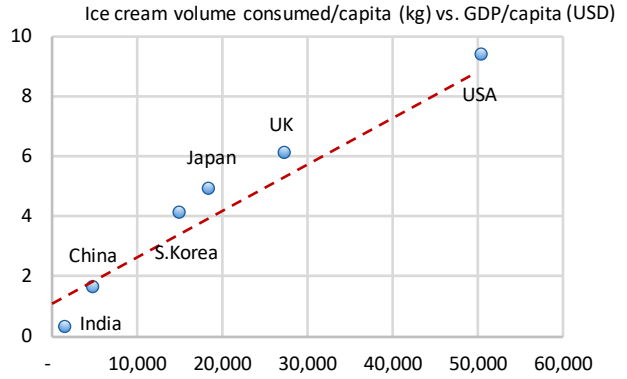
The ice-cream category grew at a 4.4% CAGR from 2013-22, making up 7.9% of China's dairy industry in 2022 (up from 7.2% in 2016), and is expected to grow at 6.5% CAGR in the next five years. Ice-cream per capita consumption in China is currently low compared to more developed countries, but is poised to rise as consumers become more affluent. Yili is the clear market leader in ice-cream, a record it has held for 28 straight years. The only other domestic peer coming close is Mengniu, ranking third.

**Figure 46: Ice cream: Market size and growth**



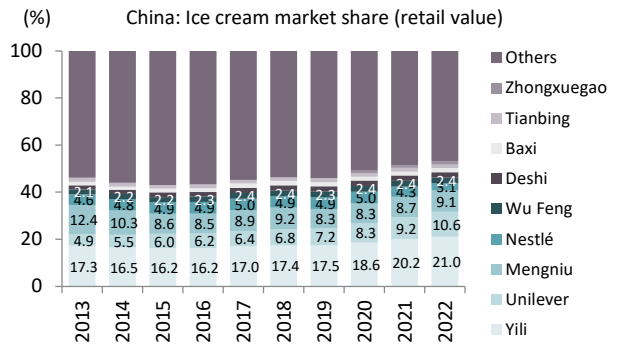

*Source: Euromonitor estimates, BOCOM Int'l*

**Figure 47: Ice cream per capita consumption**



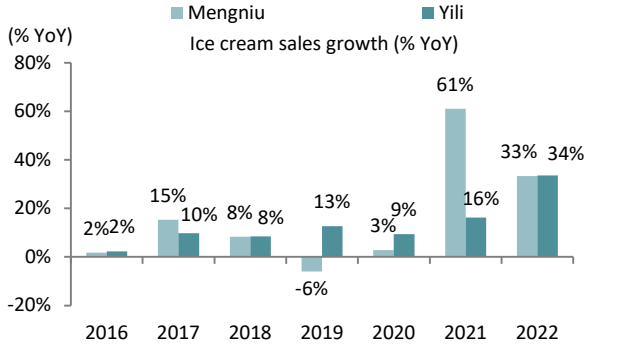

*Source: Euromonitor, BOCOM Int'l*

**Figure 48: Ice-cream: Market share by company**




*Source: Euromonitor, BOCOM Int'l*

**Figure 49: Ice-cream: Key players' sales growth**




*Source: Euromonitor, BOCOM Int'l*

**Ice-cream growth is driven by weather in the short-term, and income in the long-term:** As discussed before, ice-cream has already penetrated into lower tier cities. As a snack or dessert with little health benefits, its demand is based on disposable income and desire to purchase for luxury. On the supply side, its continued growth will be driven by product innovation and premiumization. Sales trends in 1H23 is so far strong, up >30% YoY for Yili (market leader in ice-cream), and will likely to be helped the hot weather and an emerging El Niño effect that can bring hotter weather and more demand for ice-cream.

**Premium ice-cream considered as "affordable luxury":**

**Zhong Xue Gao:** The most well-known example of the premiumization of ice-cream in China is arguably Zhong Xue Gao (or "Chicecream" in English), which was also dubbed the "Hermès of ice-cream" and became popular in early 2018. The customers buying Zhong Xue Gao were often not just paying for the quality of the ice-cream or its exotic tastes, but also for the status symbol of being able to afford the luxury item. Its ice-creams, which weigh 78 grams each, are usually sold for RMB15-20, which is 4-5x the price of most of its competitors, according to SCMP. The most expensive product the company sold, which was called Ecuador Pink, was sold at RMB66 each, and was mainly made of pink cocoa powder extracted from a plant growing in the South American country and Japanese shaddock juice. The product was claimed to cost RMB40 each, according to its owner.

**Mengniu x Moutai:** Mengniu also joined the fray in 1H22, when it teamed up with high-end Chinese liquor maker Kweichow Moutai to launch three flavors of prepackaged ice-cream in Guiyang. The three flavors, plum, vanilla and milk, are spiked with 2% alcohol, and retail for RMB59-66 for 75 grams each, according to China Daily. Mengniu's president Lu Minfang said the combination of baijiu and milk serves as a trans-boundary innovation of food. The product also helps Moutai further promote its brand among young female consumer groups, as the liquor has historically targeted mostly male consumers.

**Figure 50: Zhong Xue Gao, dubbed the Hermès of Ice-cream, are being sold up to RMB66/piece**



*Source: South China Morning Post, BOCOM Int'l*

**Figure 51: Mengniu's Moutai-infused ice-cream, are sold for RMB59-66 each**




*Source: China Daily, BOCOM Int'l*

**Figure 52: Product offering by segment – Ice-cream**

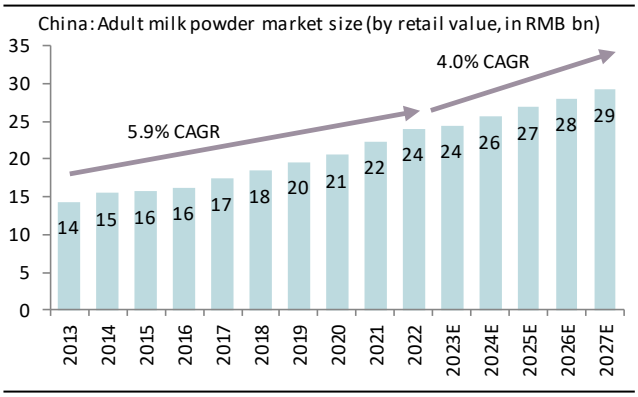
| Company 公司 | Mengniu 蒙牛 | | | | Yili 伊利 | | | | |
|---|---|---|---|---|---|---|---|---|---|
| Ticker 股票代号 | 2319 HK | | | | 600887 CH | | | | |
| Ice cream | | | | | | | | | |
| Product series 产品系列 | Suibian 随便 | Deluxe 蒂兰圣雪 | Mood for Green 绿色心情 | Ice+ 冰+ | Chocliz 巧乐兹 | Gemice 甄稀 | Iceology 冰工厂 | Miao-Qu 妙趣 | Xujinhuan 须尽欢 |
| Price/70g (Rmb) | 2.1 | 2.8 | 3.1 | 2.3 | 3.0 | 5.1 | 6.0 | 3.0 | 11.2 |

*Source: tmall.com, BOCOM Int'l*

## (3) Adult Milk Formula — Turning Demographic Headwind into a Tailwind

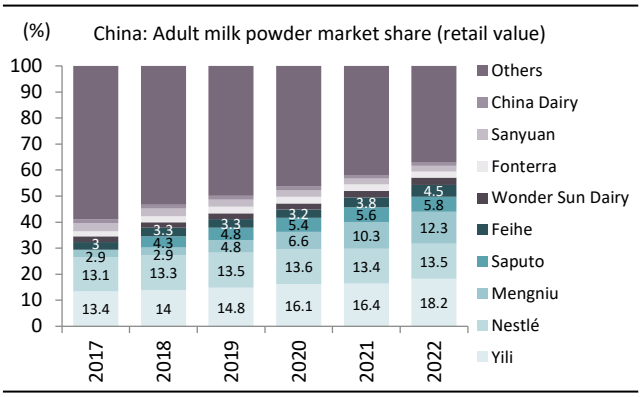
**A way to take advantage of an ageing society:** In the backdrop of a fallen birth rate and an ageing population, the infant milk formula (IMF) market is expected to decline at a 1.3% pace in the next 5 years (2022-25), according to Euromonitor, but adult milk formula (AMF) market (including milk powder for nursing women as well as elderly consumers) to grow at a 4.0% CAGR during the same period. Players that can effectively diversify itself from IMF to AMF can help buffer the demographic headwinds, although we do note that the adult milk formula market size is still relatively small (RMB24m in 2022), so diversification efforts would not be able to fully offset the impact from a declining IMF market (RMB172m in 2022).

**Figure 53: Adult milk powder: Market size and growth**




*Source: Euromonitor estimates, BOCOM Int'l*

**Figure 54: Adult milk powder: Market share**

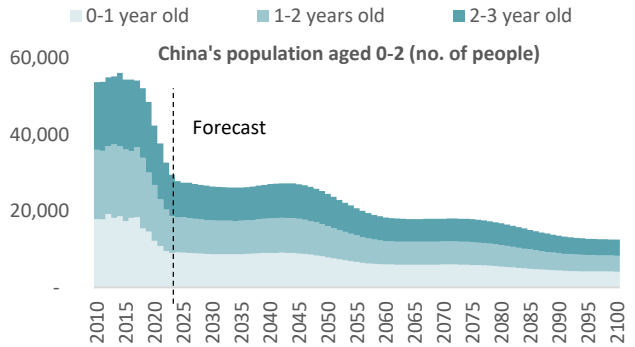



*Source: Euromonitor, BOCOM Int'l*

**Chinese people are living longer.** Life expectancy of Chinese people reached 77.9 in 2022, up remarkably from 67.6 years in 1982 (even higher than that in the US, at 76.4 years in 2022) due to better science and healthcare, healthier lifestyles (e.g. 37.2% of the population regularly took part in physical exercises, up from 33.9% in 2014, according to China's General Administration of Sport), better nutritional intake, and higher living standards in general.

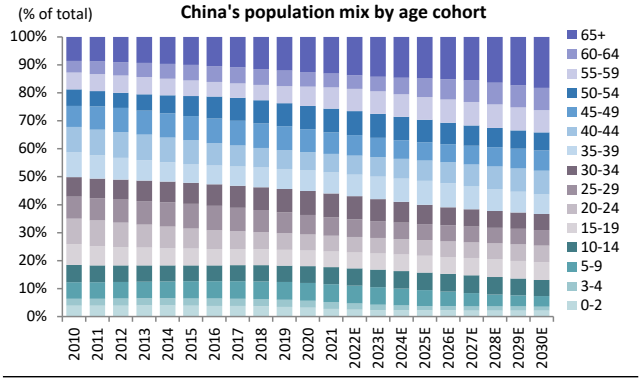
**While new births are falling, people are also living longer, which means China's population is ageing:** As the number of new births falls and people live longer, older people become a bigger mix of the population, which means the average age of China's population rises (i.e. the society is ageing). The number of old (aged 65+) and young (aged 0-14) that depend on the working-age population (aged 15-64) rises, leading to a rise in dependency ratio, which have longer-term negative implications for China's discretionary spending, as people will allocate more spending on healthcare for the elderly, as well as child-bearing, child-raising and education costs. As people care more about the health of elderly people, there will be good opportunity with China's adult milk formula market.

**Figure 55: Chinese IMF firms' target market, children aged 0-3 years old, is expected to fall**




*Source: United Nations estimates, BOCOM Int'l*

**Figure 56: The society is ageing with more senior people | China: Population age distribution**




*Source: United Nations estimates, BOCOM Int'l*

**Strategy in adult milk formula:**

**Yili:** Yili has been the leader in adult milk formula for eight years, with its brands Xinhuo and Beichang (goat milk). It is leading and driving the segment with its strong R&D capabilities. It leverages on its R&D centers and partners with top-notch medical institutions and hospitals in China to develop its products and conduct clinical trials. e.g. its flagship Xinhuo Shutang (欣活纾糖) series (for controlling blood sugar level) was proven to reduce blood sugar level by 6.4% after 2 weeks of consumption. Another product Xinhuo Xinhuo (欣活心活) that targets blood vessel health is able to reduce cholesterol by 13% after 2 months of consumption. In 1H23, Xinhuo's high-end product series has grown by >40% YoY, while its core product Xinhuo ShuTang series has grown by >100%. Given it is already the clear leader, it believes in enlarging the entire category through continued customer education and advertising.

**Feihe:** Feihe is ranked 5th with its Classic 1962 and Aiben brands. Feihe continues to prioritize its infant milk formula business over its adult milk formula business, which only accounts for 3-4% of Feihe's sales vs. 94% sales from IMF.

**Figure 57: Product offering by segment – Adult milk powder**

| Company<br>公司<br>Ticker 股票代号 | Yili<br>伊利<br>600887 CH | | Mengniu<br>蒙牛<br>2319 HK | | Bright Dairy<br>光明<br>600597 CH | | Feihe<br>飞鹤<br>6186 HK | |
|---|---|---|---|---|---|---|---|---|
| Product series<br>产品系列 | Xinhuo<br>欣活 | Goat Milk Powder<br>倍畅 | Platium<br>铂金 | Yourui<br>悠瑞 | High Calcium & Vitamin E Milk Powder for Middle-aged & Senior<br>中老年高钙维生素E调制奶粉 | Youjia<br>优加 | Classic 962<br>经典1962 | Aiben<br>爱本 |
| Price/ 800g (Rmb) | 139 | 258 | 108 | 128 | 78 | 109 | 58 | 141 |

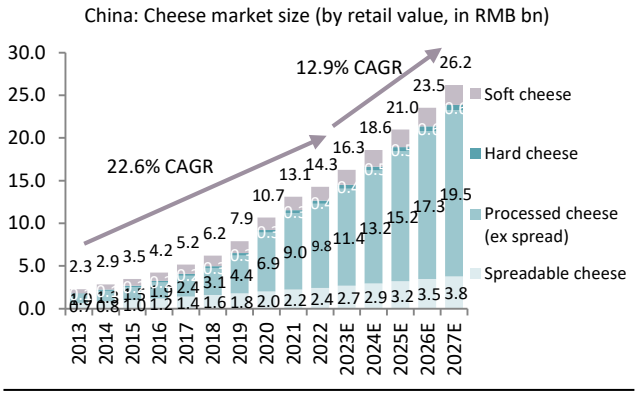
*Source: tmall.com, BOCOM Int'l*

## (4) Cheese – Huge LT Potential Driven by Rise in Adoption, Though Near-term Sales Weak

**Cheese market overview:** China's cheese market grew at a 23% CAGR in 2017-22, making up 2% of China's dairy industry in 2022. Market growth was the highest in 2019/20/21, posting 27%/35%/23% YoY growth respectively, before decelerating in 2022 (9% YoY) mostly on 2H22 market-wide weakness, as well as intensified competition in general. Cheese market is expected to grow at a 13% CAGR from 2022-27E, based on Euromonitor estimates, driven by a long-term increase in cheese consumption per capita in China, which stands at only 0.1kg in 2018, compared to around 18kg in the US and Europe.

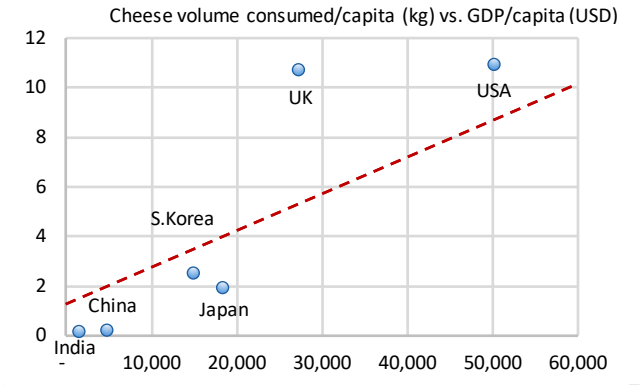
**Market share:** China's cheese market has been fast-growing. It has seen the emergence of Milkground as a clear leader who has been able to grow its market share from nothing to almost 30% as of 2021 (based on Euromonitor), and further to 36% in 1H22, according to the company.

**Figure 58: Cheese: Market size and growth**



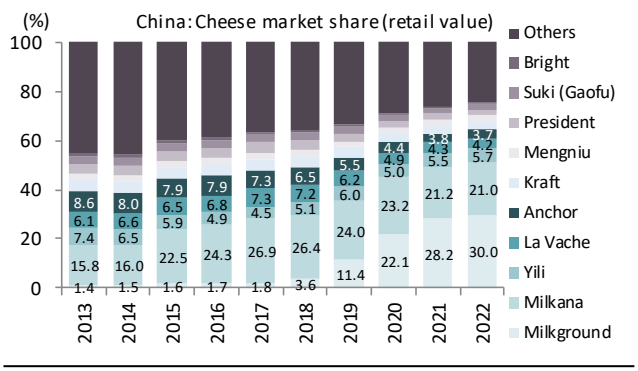

*Source: Euromonitor estimates, BOCOM Int'l*

**Figure 59: Future growth potential: Cheese per capita consumption vs developed countries**



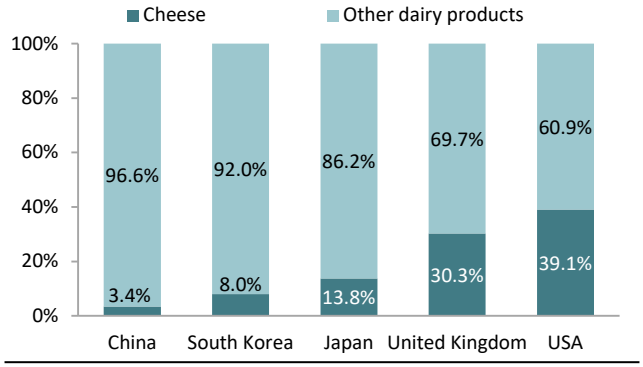

*Source: Euromonitor, BOCOM Int'l*

**Figure 60: Cheese: Market share by company**



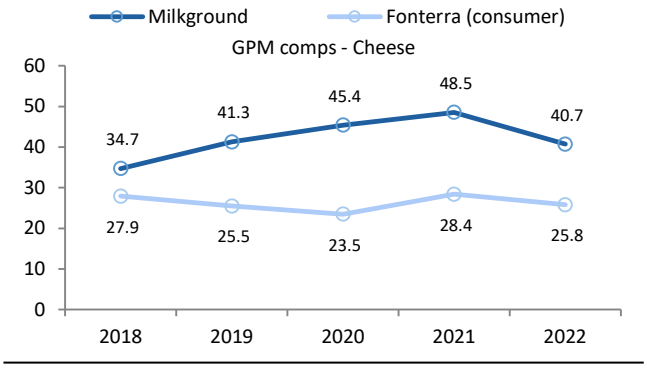

*Source: Euromonitor, BOCOM Int'l*

**Figure 61: Cheese has great upside in China as it continues to rise as % of total dairy consumption**



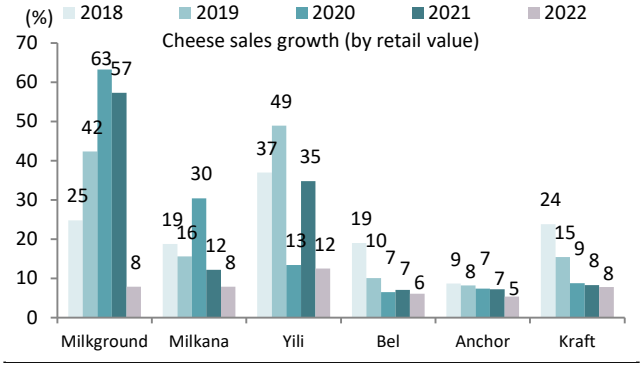

*Source: Euromonitor, BOCOM Int'l*

**Figure 62: Cheese: Key players' margins**




*Source: Company data, BOCOM Int'l*

**Figure 63: Cheese: Key players' sales growth**




*Source: Euromonitor, BOCOM Int'l*

**Cheese is increasingly popular in China:** During the pandemic, consumers have focused on choosing food that can strengthen immunity, while cheese is generally considered to be able to strengthen immunity. The number of Chinese people who like eating cheese will likely rise, due to the growth in popularity of Western food like pizza, spaghetti, cheesecake and sandwiches in China. In addition, cheese has a high nutritional value and the protein from cheese can be fully digested, meaning that lactose-intolerant Chinese consumers do not need to worry about such problems.

**Food safety issues for cheese:** China only allows imports of large packages of cheese or smaller cheese already cut by foreign manufacturers, but does not allow domestic merchants to cut imported cheese into smaller pieces for sale for food safety reasons. The restrictions on repackaging foreign-made cheese into smaller packages, and the fact that smaller packages and snack food like cheese sticks are favored by consumers, creates an entry barrier to competition, and presents an opportunity to domestic cheese producers, such as Milkground, Yili and Mengniu.

**Strategy in cheese:**

**Milkground/Mengniu:** Mengniu became the largest shareholder in cheese market leader Milkground with a 35.01% in Nov'22. Milkground has had a phenomenal rise up the market share ranking, by successfully creating the cheese stick category as a snack for children. However, its sales have abruptly slowed since 4Q22 (sales -25% YoY) that continued into 1Q23 (sales -20% YoY) and 2Q23 (YoY declined narrowed, based on pre-announcement). Its strategy recently has been to diversify away from cheese sticks by creating more usage scenario, in particular for at-home consumption, e.g. cheese slides and as a dessert, e.g. Cup Cheese, as well as expanding into the B2B channel, by selling cheese and butter to restaurant chains like Saizeiriya and tea drinks cafes like Nayuki. With Mengniu as its controlling shareholder, Milkground will likely get a boost in terms of its channel expansion, geographic expansion and organizational capability.

**Yili:** Yili is the third largest player in cheese with a market share of 6% in 2022. Cheese is a relatively small part of Yili's overall product portfolio, and is included within its "milk powder and other dairy products" division. Yili's strategy is similar to Milkground's, to

diversify away from cheese sticks, which has faced a market downturn, although Yili believes it has outperformed its peers. Yili utilizes its strength in R&D to create a wide range of products, e.g. double-layer cheese sticks, chilled cheese eggs, cheese cups, with offerings in both chilled and room-temperature. It is also expanding into the at-home and B2B channels, e.g. by selling to bakeries. It is also investing in its overseas supply chain.

**Bright Dairy:** Cheese is not a strategic priority for Bright right now, but the company agrees that cheese is a high-growth segment with big potential in the future.

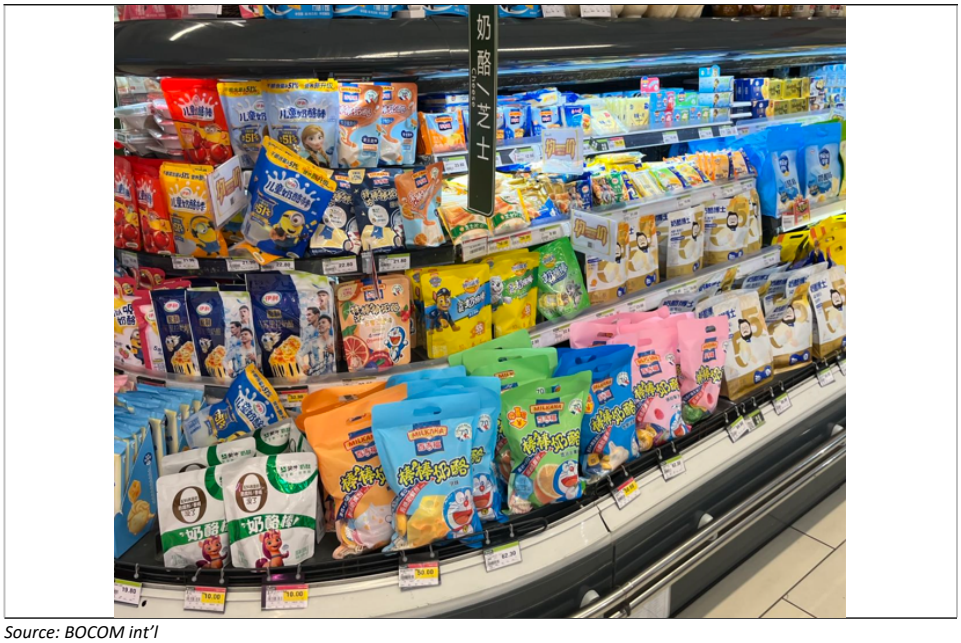
**Figure 64: Product offering by segment – Cheese**

| Company<br>公司<br>Ticker 股票代号 | Mengniu<br>蒙牛<br>2319 HK | | Milkground<br>妙可蓝多<br>600882 CH | | | Yili<br>伊利<br>600887 CH | | Bright dairy<br>光明<br>600597 CH | Milkana<br>百吉福 | Dr. Cheese<br>奶酪博士 | Miaofei<br>妙飞 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 奶酪棒 | | | | | | | | | | | |
| Product series<br>产品系列 | High calcium<br>蒙牛高钙奶酪棒 | Kids cheese stick<br>爱氏晨曦儿童奶酪棒 | Cheese stick<br>妙可蓝多奶酪棒 | High calcium<br>钙多多常温奶酪棒 | PAW Patrol<br>汪汪队常温奶酪棒 | Kids cheese stick<br>伊利儿童奶酪棒 | Suckable cheese<br>可以吸的奶酪 | Jcan<br>健能高钙奶酪棒 | Bangbang<br>棒棒奶酪 | Golden stick<br>金装棒棒 | Cheese stick<br>妙飞奶酪棒 |
| Price/20g (Rmb) | 2.5 | 2.5 | 2.3 | 5.6 | 7.7 | 2.6 | 1.6 | 2.5 | 2.9 | 4.4 | 3.0 |

*Source: tmall.com, BOCOM Int'l*

**Competition is fierce:** A typical cheese counter at a grocery store in China offers many choices of cheese. Therefore, packaging, advertised nutritional benefits, pricing and product quality all play into consumers' purchasing decisions. For example, on packaging, Milkground uses popular children's cartoon characters from Paw Patrol on its packaging, Yili uses Argentina soccer team and Disney movie Frozen, and Milkana uses Japanese cartoon Doraemon, making a tough decision for children choosing a cheese stick snack.

**Figure 65: A typical cheese counter at Yonghui grocery store in China**

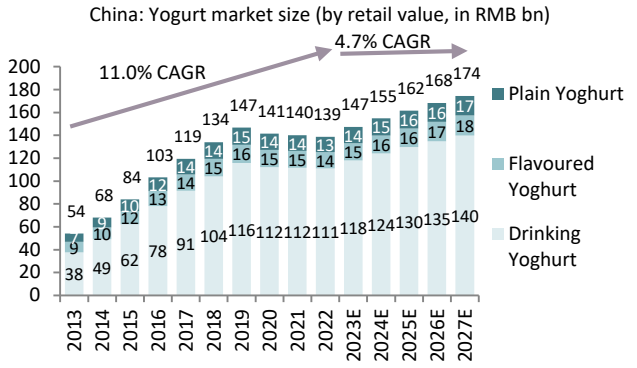



*Source: BOCOM int'l*

## (5) Yoghurt – Near-term Weakness Persists, Long-term Driven by "Functional" Yoghurt

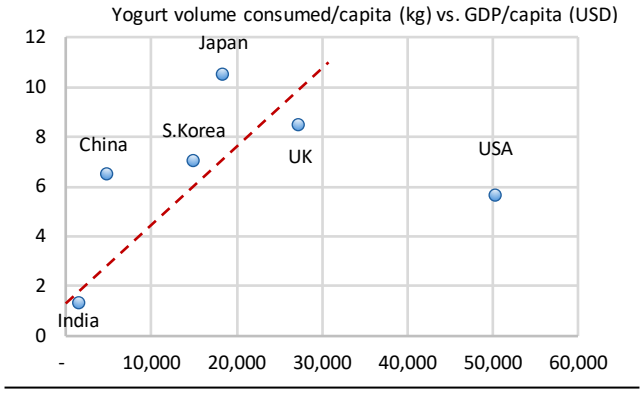
China's yoghurt and sour milk market grew at a 3.0% CAGR from 2017-22, making up 20% of China's dairy industry in 2022. However, the market declined by 2% CAGR in the last three years (2020-22), as a result of fallen demand during the pandemic. The yoghurt market will likely remain weak in 2023, as its consumption is more discretionary in nature, and its perceived value as a nutritious snack is increasingly replaced by other nutritious dairy products like fresh milk and cheese.

**Figure 66: Yoghurt: Market size and growth**



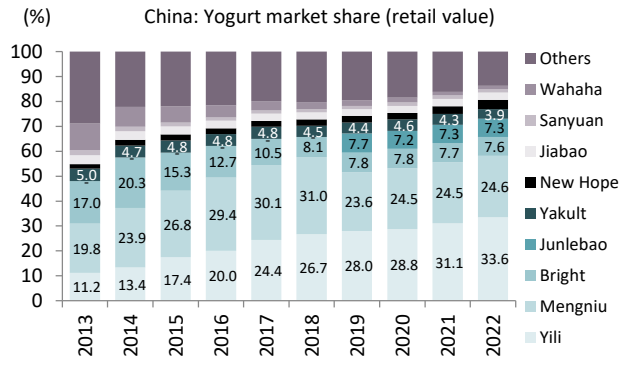

*Source: Euromonitor estimates, BOCOM Int'l*

**Figure 67: Yoghurt per capita consumption vs developed countries**



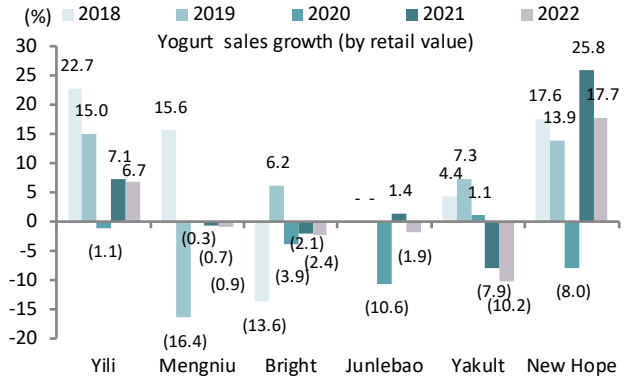

*Source: Euromonitor, BOCOM Int'l*

**Figure 68: Yoghurt: Market share by company**




*Source: Euromonitor, BOCOM Int'l*

**Figure 69: Yoghurt: Key players' sales growth**




*Source: Euromonitor, BOCOM Int'l*

**Yoghurt category weakness has continued:** In recent years, yoghurt and sour milk products' growth has lagged liquid milk, declining by 2% CAGR in 2020-22. Similar to the US market, China's yoghurt market is relatively concentrated, where the top three players' market share exceeded 50%. Yoghurt demand continued to be weak in 1H23, more so for room-temperature yoghurt than chilled yoghurt.

**Room-temperature yoghurt is a relatively soft spot** within the overall category, due to its lower nutritional value (compared to chilled yoghurt), which means it is often considered more as a snack with discretionary consumption nature, making it more vulnerable to an uncertain consumer sentiment. Reduced outing during the pandemic has also affected the consumption of this category. Compared to chilled yoghurt, room-temperature yoghurt has the advantage of longer shelf life and is more suitable for expansion into tier 3-4 cities where cold-chain logistics is less developed.

**Chilled yoghurt is faring better due to its better nutritional value. Product R&D will be key going forward:** Chilled yoghurt faces similar challenges as fresh milk, which is that shelf life is relatively short, so its sales volume will continue to rise in the future on the back of expanded capacity of cold-chain logistics. Chilled yoghurt is sold mostly through the modern channel (supermarket, convenience stores), and decline in foot traffic during the pandemic as well as subsequent store closures has affected its sales. Chilled yoghurt contains live micro-organisms, and this probiotic feature allows it to have more health benefits than room-temperature yoghurt, which will likely be the direction of future product innovation.

**Yoghurt margins vary, higher for premium products:** Similar to drinking milk, margins of yoghurt can vary: higher for premium products and lower for basic products. E.g., we estimate Yili's Ambrosial (sales scale of RMB20bn) to have 36-37% GPM, 7-8ppt higher than 29% for basic yoghurt. As companies launch more functional yoghurt with higher nutritional value (e.g. probiotics, high protein), we expect margins to trend up from product mix improvement.

**Recent trends:** Based on our channel checks, room-temperature yoghurt market is weak in 1H23, with YoY decline of about mid-single-digit. Chilled yoghurt market is faring better, driven by new functional products with new nutritional value, and is seeing slight positive growth.

**Figure 70: Product offering by segment – Yoghurt**

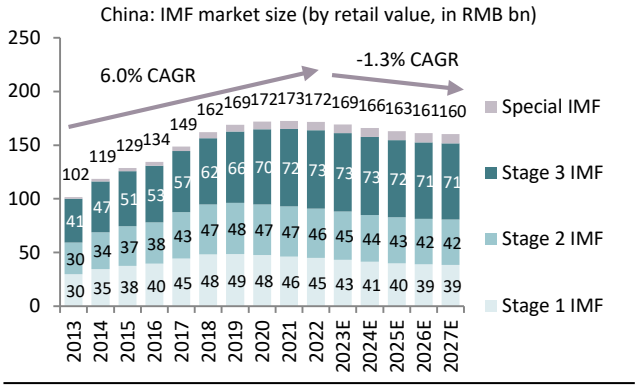
| Company<br>公司<br>Ticker 股票代号 | Mengniu<br>蒙牛<br>2319 HK | | Yili<br>伊利<br>600887 CH | | | Bright dairy<br>光明<br>600597 CH | | |
|---|---|---|---|---|---|---|---|---|
| 常温酸奶 | | | | | | | | |
| Product series<br>产品系列 | Just Yoghurt light<br>纯甄轻酪乳 | Just Yoghurt Yummy<br>纯甄馋酸奶 | Ambrosial<br>安慕希 | | | Momchilovtsi<br>莫斯利安 | Yanjian<br>研简 | |
| Price/200g (Rmb) | 6.9 | 17.7 | 4.5 | | | 5.8 | 5.0 | |
| 低温酸奶 | | | | | | | | |
| Product series<br>产品系列 | Champion<br>冠益乳 | Zero sucrose<br>0蔗糖酸奶 | Changqing<br>畅轻 | Zero sucrose<br>0蔗糖酸奶 | Pure Day<br>帕瑞提炭烧 | Rushi<br>如实 | Chagnyou<br>畅优 | Jcan<br>健能 |
| Price/100g (Rmb) | 6.6 | 1.3 | 3.1 | 2.0 | 1.8 | 2.2 | 3.1 | 2.8 |

*Source: tmall.com, BOCOM Int'l*

## (6) Infant Milk Formula — Likely to Remain Challenged from Demographic Headwinds

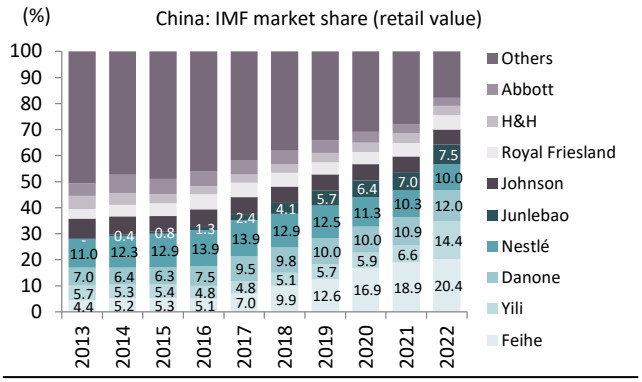
Infant milk formula ("IMF") market grew at a 6% CAGR in 2013-22, but it decelerated in the last two years due to falling birth rate and impact from the pandemic. The market is expected to decline by 1.3% CAGR from 2022-27E, based on Euromonitor estimates. Annual consumption per capita of IMF in China is similar to that in the US, but still below that in the UK. Adult milk formula, on the other hand, grew at a 6.7% CAGR

**Figure 71: IMF: Market size and growth**




*Source: Euromonitor estimates, BOCOM Int'l*
*Note: *Stage 1 is targeted at infant aged 0-6 months, stage 2 is targeted those aged 6-12 months, stage 3 is targeted at those aged 12-36 months*

**Figure 72: IMF: Market share**




*Source: Euromonitor, BOCOM Int'l*

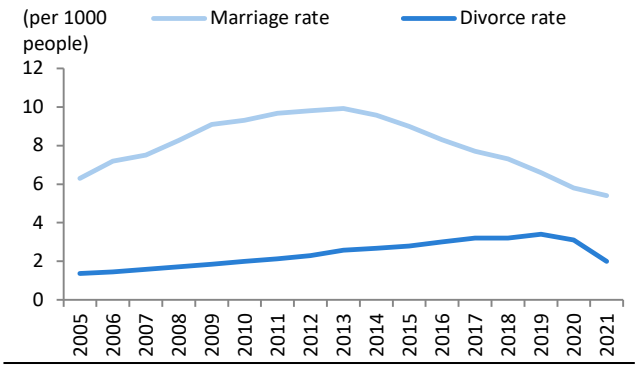
**Market share trends**: Given tightening regulations on milk formula, bigger players with stronger R&D capabilities are advantageous in meeting regulations and bringing their new products to market quicker. This has resulted in share gain for bigger players. We expect accelerated market consolidation in the wake of new National Standards for IMF product licensing should help market leaders Feihe and Yili to post better sales growth (>10% YoY in 2023E) while smaller players (H8H) may post weaker growth (flattish YoY in 2023 E). 2024 being the Year of Dragon and a year after China's reopening may also provide an uptick to new birth numbers.

**IMF demand is anti-cyclical, but it is structurally shrinking…** Infant milk formula and baby food are seen as a necessity by many parents and as such its demand is anti-cyclical - resilient and immune to economic cycle. Its demand is tied to several drivers, including:

- **Demographic changes**, specifically the number of new births, as baby formula is typically consumed by those aged 0-3 years. Fertility rate also varies by age (on average, highest for women aged 25-29, which falls as age increases) and so is indirectly linked to age of marriage (which has been getting later), which is in turn a function of the number of marriageable population and marriage rate;
- **Rate of breastfeeding,** which is a substitute for the use of IMF. In China, earlier surveys show that breastfeeding rate is relatively low, at 20.8% at 6 months. The Chinese government's policies to promote breastfeeding, including improving

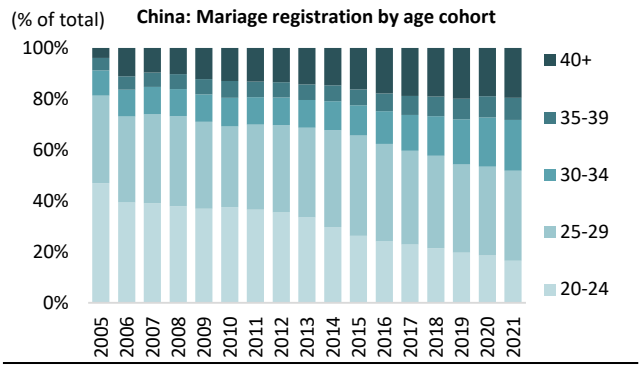
hospitals' consultancy services, public support facilities and protecting women's working rights during lactation, could threaten demand for IMF in the long run.

**Figure 73: Contributing to the falling birth rate: (1) Less people are getting married …**



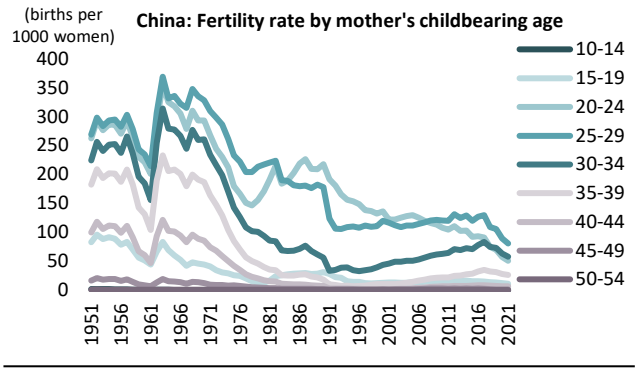

*Source: National Bureau of Statistics, BOCOM Int'l*

**Figure 74: ….and (2) People are getting married later…. | China's marriage registration by age**



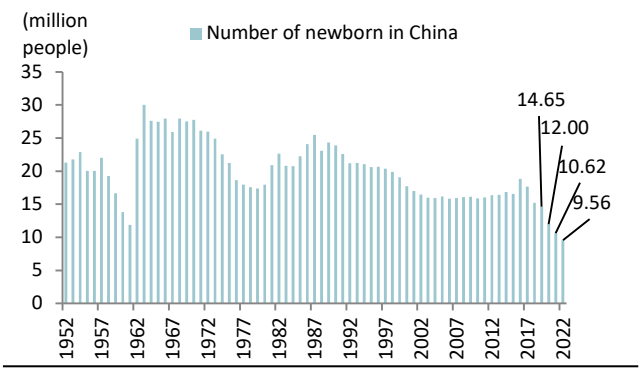

*Source: National Bureau of Statistics, BOCOM Int'l*

**Figure 75: …while (3) Fertility rate falls as the mother's childbearing age rises after 25-29…**




*Source: United Nations, BOCOM Int'l*

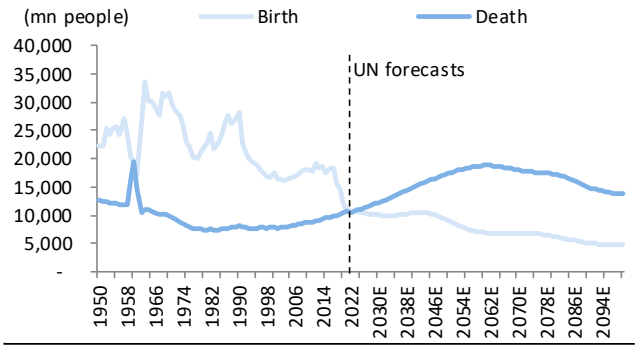
**Figure 76: (4) China's number of newborns has fallen**




*Source: National Bureau of Statistics, BOCOM Int'l*

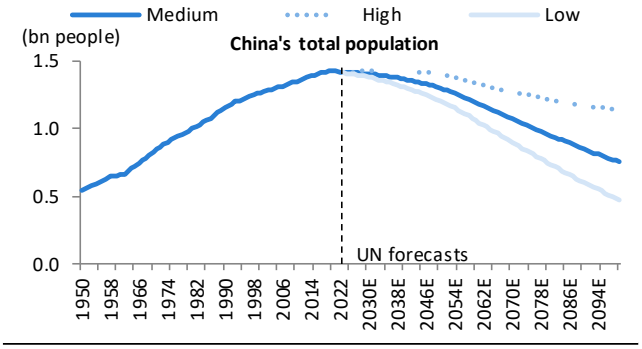
**What does the "death cross" (when there are more deaths than births) mean for the population?** In a nutshell, population growth is the addition of people born minus the number of people who died, so the natural population growth rate is birth rate (number of people born, divided by population, x 1000) minus death rate (number of people died, divided by population, x 1000). When death rate line crosses above the birth rate line, i.e. the "death cross", then population declines. According to the official statistics, the year of 2022 saw the first year in China where total deaths (10.41m) exceeded total births (9.56m, vs. 10.62m in 2021). China's population fell by 850,000 people to 1,411.8m in 2022, from 1,412.6m in 2021.

**Figure 77: China: death rate has exceeded birth rate in 2022**




*Source: United Nations estimates, BOCOM Int'l*

**Figure 78: China's population peaked in 2021, and has started to decline from 2022 onwards…**




*Source: United Nations estimates, BOCOM Int'l*

**Birth rates falling: People are getting married later on average, and fewer want babies:** There are various factors behind birth and death rates. For death rate, it has gradually fallen due to higher life expectancy of Chinese people (77.9 in 2022, up remarkably from 67.6 years in 1982, and even higher than that in the US, at 76.1 years in 2021) due to better science and healthcare, healthier lifestyles (e.g. 37.2% of the population regularly took part in physical exercises, up from 33.9% in 2014, according to China's General Administration of Sport), better nutritional intake, and higher living standards in general.

Birth rate is more complicated, and is a culmination of marriage rate (number of marriages, divided by population, x 1000), and fertility rate (number of births per woman, x 1000). The willingness to get married and give birth are affected by various socio-economic reasons, including the cost of living and raising a child, and government policies (e.g. three-child policy implemented in May 2021, as well as various government stimulus including tax breaks for married couples and for having children). The number of couples that registered for marriage in China is on pace to hit a historic low, attributable to the shrinking size of China's marriageable population, but also an increasing reluctance to marry.

**The IMF market, targeted at infants aged 0-3 years, would shrink further in the next few years:** Fewer births and those aged 0-3 years means the IMF market will take a direct hit. For the IMF industry, 53% of sales is derived from Stage 1 (targeted at infants aged 0 to 6 months) and stage 2 (aged 6-12 months), with another 42% of sales derived from stage 3 (aged 12-36 months), according to the company. This means, >50% of the IMF industry sales is derived from babies born in the same year (i.e. stage 1 and 2 IMF sales in 2023 would be tied to the number of newborns within the year of 2023), with another 42% of sales derived from babies born 1-2 years ago (in years 2021 and 2022). Therefore, IMF sales in 2023 would be highly correlated with the number of newborns in 3-year period from 2021-23, while IMF sales in 2024 would be tied to newborns in 2022-24.

**We expect a 8%/3% decline in IMF industry sales in 2023/24E, although market leaders could still grow by gaining market share from smaller peers:** For 2023, the number of new births is looking to fall further based on 1Q23 data released by some provinces so

far, with decline ranging from 2% to 12% for various regions, which drove some predictions for new births to fall below 8m in 2023 (vs. 9.56m in 2022 and 10.62m in 2021). We note that new births in the past 3 years (2020-22) has fallen at a pace of 13% CAGR. In our industry model, we estimate China's IMF industry volume would still fall by 8% YoY in 2023E and 3% in 2024E.

**Strategy in IMF:**

**Feihe:** Feihe has been a success story, increasing its market share from 4% in 2013 to 20% in 2022, overtaking international brands that were popular in the aftermath of the 2008 melamine incident. Its strategy of using local raw milk and turning them into powder within 2 hours at its self-owned dairy farms in Heilongjiang (it acquired YST Dairy in 2020) for freshness and nutrition, coupled with effective marketing that its formula is tailored for Chinese babies, has won over Chinese parents' wallets. Its flagship Astrobaby Classic series accounts for >40% of sales (sales scale of RMB10bn) and was getting too large for comfort, therefore management is trying to groom other new products series, including two new products launched in 2022: Astrobaby ZhuoYao, ZhuoShu (goat milk). Its focus, however, is to groom its high-end Astrobaby ZhuoRui, which is looking to double its sales this year. Feihe believes the premium segment of IMF remains more resilient amid demographic headwinds, and it will continue to penetrate lower-tier cities.

**Yili:** Yili is the second biggest player in infant milk formula. Yili has taken advantage of an accelerating consolidation in the infant formula sector to acquire high quality assets, such as Ausnutria (1717 HK/NR), which owns the Hyproca 1897 (cow's milk) and Kabrita (goat milk) brands. The addition of Ausnutria would complement Yili's existing baby formula product and brand portfolio, which consists of infant formula, adult formula and yoghurt business. Yili uses the brand JinLingGuan (金领冠) for its infant milk formula lines and QQ Star (QQ 星) for its follow-up milk formula for young children. Ausnutria puts its emphasis on high-end positioning and boasts imported milk from the Netherlands, Australia and New Zealand. In July 2023, Ausnutria obtained approval from the US FDA for distribution and marketing of its Kabrita IMF brand in the US market, and this opening up of a new market bodes well for its sales prospects.

**H&H:** Infant formula is its largest sales contributor (41% of 2022 sales, where Biostime is ranked #7 in China's IMF market; #4 within premium IMF with 12.1% share). H&H believes the high-end segment of IMF will be more resilient and continues to see strong demand from consumers in lower-tier cities, therefore its high-end positioned Biostime (mostly produced and packaged in France) should be more resilient than peers. It also expects to benefit from accelerated consolidation in the IMF space after the roll-out of the new National Standard for product registration.

## Figure 79: Product offering by segment – IMF (domestic brands)

| Company<br>公司<br>Ticker 股票代号 | Feihe<br>飞鹤<br>6186 HK | | Mengniu / Yashili<br>蒙牛 / 雅士利<br>2319 HK / 1230 HK | | | Ausnutria<br>澳优<br>1717 HK | | | H&H Biostime<br>合生元<br>1112 HK | | Yili<br>伊利<br>600887 CH | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Super premium 超高端 | | | | | | | | | | | | |
| Product series<br>产品系列 | Astrobaby<br>星飞帆 | Organic Zhenzhi<br>臻稚有机 | Doraler (goat milk)<br>朵拉小羊 | | | Hyprocal 1897<br>海普诺凯 | Mygood<br>美优高 | Allnutria<br>遨游能立多 | Healthy Times<br>爱斯时光 | | Sai Na Mu<br>金领冠塞纳牧 | |
| Price/700g (Rmb) | 324 | 351 | 375 | | | 356 | 340 | 348 | 337 | | 311 | |
| Premium 高端 | | | | | | | | | | | | |
| Product series<br>产品系列 | Zhenai Beihu<br>臻爱倍护 | | Yashili Kieember<br>雅士利菁珀 | Ruibu'en<br>瑞哺恩 | Arla Baby&Me<br>阿拉宝贝与我 | Kabrita (goat)<br>佳贝艾特 | Puredo<br>美纳多 | Eurlate<br>欧选 | Pi Star<br>派星 | Beta Star<br>贝塔星 | Zhenhu<br>金领冠珍护 | Ruihu<br>金领冠睿护 |
| Price/700g (Rmb) | 218 | | 313 | 313 | 287 | 274 | 252 | 313 | 325 | 255 | 276 | 244 |
| Regular 中档 | | | | | | | | | | | | |
| Product series<br>产品系列 | Feifan<br>飞帆 | Xingjie Youhu<br>星阶优护 | | | | Ausnutria<br>澳优爱优 | | | Alpha Star<br>阿尔法星 | | Jinghu<br>金领冠菁护 | PRO-Kido<br>金领冠 |
| Price/700g (Rmb) | 185 | 240 | | | | 235 | | | 208 | | 221 | 171 |

*Source: tmall.com, BOCOM Int'l*

## Figure 80: Product offering by segment – IMF (international brands)

| Company<br>公司<br>Ticker 股票代号 | Wyeth (Nestle)<br>惠氏（雀巢）<br>NESN SW | | | Danone<br>达能<br>BN FP | | Reckitt Benckiser<br>利洁时/美赞臣<br>RB LN | | Royal Friesland<br>菲仕兰<br>private | Abbot<br>雅培<br>ABT US | | A2 Milk<br>A2牛奶公司<br>A2M AU |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Super premium 超高端 | | | | | | | | | | | |
| Product series<br>产品系列 | Illuma Organic<br>启赋 有机 | | | | | Enfinitas<br>美赞臣蓝臻 | Enfagrow<br>美赞臣安儿宝 | Friso Prestige<br>皇家美素佳儿 | Eleva Organic<br>菁挚 有机 | | A2<br>至初 | |
| Price/700g (Rmb) | 380 | | | | | 366 | 334 | 340 | 377 | | 380 | |
| Premium 高端 | | | | | | | | | | | | |
| Product series<br>产品系列 | Illuma<br>启赋 蓝钻 | Wyeth S-26<br>惠氏 铂臻 | NAN H A<br>超启能恩 | Aptamil Profutura<br>爱他美-卓萃 | | Enfa Gentlease<br>美赞臣亲舒 | | Friso Gold<br>金装美素佳儿 | Eleva Pure<br>菁挚 纯净 | Similac Qinhu<br>恩美力亲护 | | |
| Price/700g (Rmb) | 296 | 262 | 276 | 292 | | 312 | | 225 | 302 | 283 | | |
| Regular 中档 | | | | | | | | | | | | |
| Product series<br>产品系列 | Latogen<br>力多精 | | | Nutrilor<br>诺优能 | Aptamil<br>爱他美 | Enfamil<br>美赞臣铂睿 | | Friso<br>美素佳儿 | Similac Plus<br>铂优恩美力 | Similac<br>经典恩美力 | A2 Platinum<br>至初海外版 | |
| Price/700g (Rmb) | 157 | | | 170 | 223 | 238 | | 186 | 225 | 185 | 233 | |

*Source: tmall.com, BOCOM Int'l*

## Figure 81: BOCOM Int'l Consumer sector coverage

| Stock code | Company name | Rating | CP (local ccy) | TP (local ccy) | Upside | Last TP/rating publication date | Sub-sector |
|---|---|---|---|---|---|---|---|
| 1876 HK | Budweiser Brewing APAC | Buy | 18.38 | 20.70 | 12.6% | 3 Aug 2023 | Beer |
| 291 HK | China Resources Beer | Buy | 50.15 | 76.00 | 51.5% | 27 Mar 2023 | Beer |
| 600887 CH | Inner Mongolia Yili Industrial Group | Buy | 28.11 | 34.70 | 23.4% | 9 Aug 2023 | Dairy |
| 600597 CH | Bright Dairy & Food | Buy | 10.98 | 14.50 | 32.1% | 9 Aug 2023 | Dairy |
| 2319 HK | China Mengniu Dairy | Buy | 27.95 | 37.10 | 32.7% | 9 Aug 2023 | Dairy |
| 1112 HK | H&H Int'l | Neutral | 10.48 | 10.10 | -3.6% | 9 Aug 2023 | Dairy |
| 600882 CH | Shanghai Milkground Food Tech | Neutral | 22.21 | 19.20 | -13.6% | 9 Aug 2023 | Dairy |
| 6186 HK | China Feihe | Neutral | 4.88 | 5.00 | 2.5% | 9 Aug 2023 | Dairy |
| 9633 HK | Nongfu Spring | Neutral | 44.90 | 47.40 | 5.6% | 29 Mar 2023 | Food & Beverage |
| 2313 HK | Shenzhou International | Buy | 79.80 | 91.90 | 15.2% | 29 Sep 2022 | Garment OEM |
| 1044 HK | Hengan International | Buy | 30.55 | 41.70 | 36.5% | 23 Mar 2023 | Household & Personal Care |
| 3331 HK | Vinda Int'l | Neutral | 17.82 | 19.20 | 7.7% | 21 Jul 2023 | Household & Personal Care |
| 9922 HK | Jiumaojiu International | Buy | 14.42 | 23.20 | 60.9% | 21 Feb 2023 | Restaurant |
| 2020 HK | Anta Sports | Buy | 87.00 | 127.00 | 46.0% | 22 Mar 2023 | Sportswear Brand |
| 2331 HK | Li Ning Co | Buy | 43.85 | 56.90 | 29.8% | 5 Jun 2023 | Sportswear Brand |
| 6110 HK | Topsports International | Buy | 7.28 | 8.20 | 12.6% | 27 Jun 2023 | Sportswear Distributor |
| 3813 HK | Pou Sheng International | Buy | 0.67 | 1.52 | 126.9% | 11 May 2023 | Sportswear Distributor |

*Source: FactSet, BOCOM Int'l estimates, as of 7 Aug 2023*

# Appendix

## Policy Support Behind China's Dairy Sector

**National strategy to boost dairy consumption:** There has long been a focus to boost Chinese people's dairy consumption by the Chinese government. In 1988, the "Dietary Guidelines for Chinese Residents" recommended for the first time that every Chinese should drink 300 grams of milk daily, encouraging the habit of drinking milk consumption. In 2009, the issuance of the "Dairy Industry Policy" mentioned that dairy consumption per capita is an important gauge of a country's living standard. At that time, China's consumption level was less than 100 grams per day, falling short of the government's recommended intake of 300 grams.

**Dairy consumption expected to see faster growth than meat, vegetables, fruits and seafood:** Compared to other staples products, dairy is a large category with still a long runway for growth. According to the "China Agricultural Outlook Report (2022-2031)" released by China's Ministry of Agriculture and Rural Affairs, dairy products are expected to grow at a **4.1% CAGR** in the next decade (2022-2031), higher than meat (1.4% CAGR), vegetables (0.9%), fruits (2.0%) and seafood (0.9%).

**The perception of nutritional benefit has long been the reason for milk consumption:** The perception of nutritional benefits of milk, including its high calcium and vitamin D content as a promoter of growth, has long been touted as a benefit of dairy milk consumption. Marketing campaigns by Mengniu, Yili and Bright Dairy have frequently emphasized the correlation between calcium and growth. Milk consumption was also encouraged as a way to boost immunity at the onset of COVID**.** On 8 February 2020, the National Health Commission suggested consuming at least 300 grams of milk products a day as one of its dietary recommendations for fending off the disease.

**Figure 82: Key policies concerning China's dairy industry**

| Issue date | Government policy | Key objective and goals |
|---|---|---|
| 5/20/2022 | Dietary Guidelines for School-age Children in China | ● Drink milk every day, drink plenty of water, do not drink sugary drinks, and alcohol consumption is prohibited. Drink milk every day, 300ml or more of liquid milk or an equivalent amount of dairy products per day. |
| 4/20/2021 | China Agricultural Outlook Report (2021-2030) | ● In 2020, China's per-capita milk consumption was 38.14kg, and in 2030 it will reach the average level of developing countries (1/3 of the global per-capita consumption) of 47.90kg per capita, with an average annual growth rate of 2.3%. Compared with the growth rate of per-capita disposable income in the same period (8%), this goal is not difficult to achieve. |
| 6/4/2008 | Industrial Policy for the Dairy Industry | ● As China's first issuance of a systematic dairy industry policy, the new policy encourages raw milk production bases to optimize the dairy farming model, develop suitably scaled dairy farming and the construction of a standardization system, enhance the modernization for dairy farming, and build high-quality, efficient, reasonably planned, safe and environmental-friendly raw milk supply ecosystem. The new policy also puts forward strict requirements in terms of promoting industrial and technological progress for in the dairy industry, enhancing quality standards, and ensuring food safety. |
| 9/27/2007 | Opinions of the State Council on Promoting the Sustainable and Healthy Development of the Dairy Industry | ● **The main tasks for promoting the sustainable and healthy development of the dairy industry:** (1) Strengthen the breeding and promotion of fine breeds to improve the production level of dairy cows; (2) promote the transformation of breeding methods and enhance the quality of raw milk; (3) actively develop industrialized management, form a reasonable raw milk pricing mechanism; (4) optimize the industry landscape of the dairy industry and improve enterprise quality; (5) improve the classification and labeling system for quality standards in order to maintain market order; (6) lead and guide dairy product consumption and further develop the dairy industry.<br>● **Increase policy support for the development of the dairy industry:** (1) Increase subsidies for dairy farming; (2) establish a policy-based insurance system for dairy cows; (3) support the construction of standardized dairy farming communities; (4) strengthen credit support for dairy farming households; (5) refine industrial policies. |
| 1988 | Dietary Guidelines for Chinese Residents (1988) | ● Recommended for the first time that Chinese residents should drink 300 grams of milk on a daily basis, encouraging the habit of drinking milk consumption. |

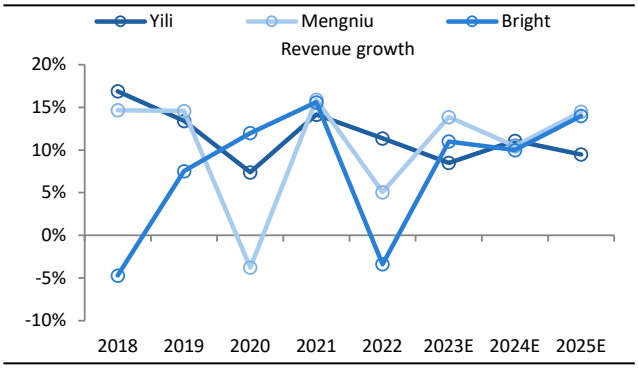
*Source: Various Chinese government websites, BOCOM Int'l*

## Financial Comparison – Diversified Dairy Producers

**Sales growth:** We expect Mengniu to have the highest sales growth in 2023 due to its consolidation of Milkground operations, without which, we forecast only 8% YoY growth (instead of 14%) in 2023. We expect Bright Dairy to have the next highest growth of 13% given its low base last year, given its disproportionate impact from having a high sales concentration to Shanghai. We expect Yili to post an 8.5% sales growth in 2023.

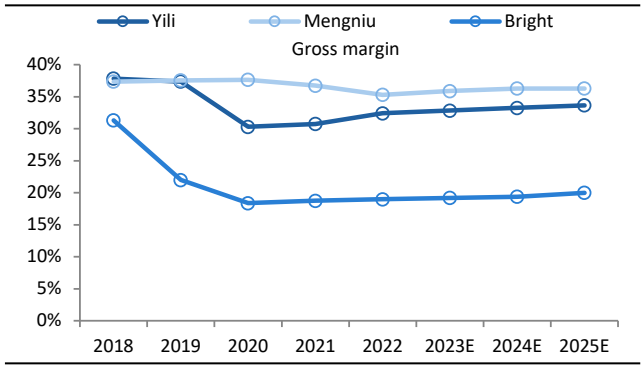
**Gross margin:** Overall, Mengniu has the highest GPMs, followed closely by Yili, while the top 2 players have a sizeable lead over Bright. With declining raw milk price, we expect Mengniu/Yili's GPM to rise further, but not for Bright given it own upstream operations.

**Figure 83: Revenue growth**




*Source: Various companies, BOCOM Int'l estimates*

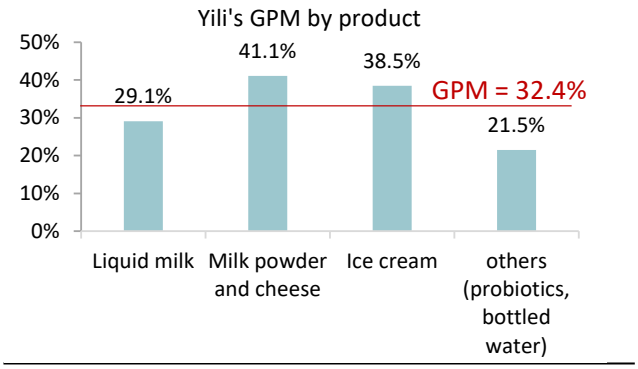
**Figure 84: Gross margin**




*Source: Various companies, BOCOM Int'l estimates*

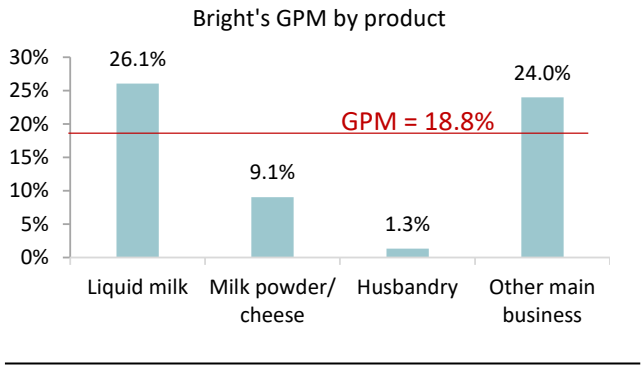
**GPM by category:** It is difficult to compare GPM across products given Mengniu does not disclose its GPM by product (only EBIT margin), while within each category, margins also vary greatly among different product series (there can be 7-8ppt GPM differential between flagship and basic series). Overall, Yili's GPM of 29% in liquid milk is higher than that of Bright's 26%, while Yili's has even higher GPMs in milk powder/cheese (41%) and ice-cream (38%). But this is not too surprising given infant formula players like Feihe has GPM of 65-70% and H&H's infant formula business has c.60% GPM. Given Yili's IMF is less premium, so a lower GPM of 40% is reasonable. Meanwhile, Mengniu's 35%-owned Milkground has GPM of 34%.

**Figure 85: Yili's GPM by product (2022)**



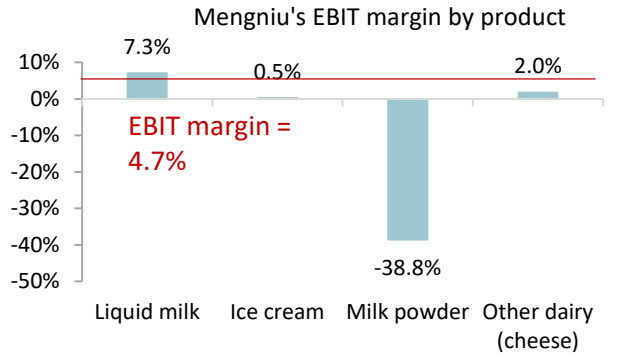

*Source: Company data, BOCOM Int'l*

**Figure 86: Bright Dairy's GPM by product (2022)**



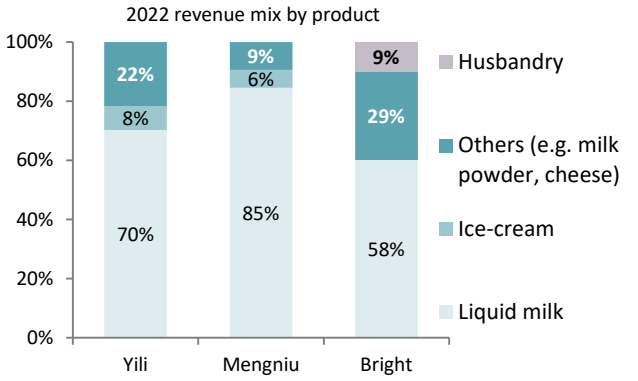

*Source: Company data, BOCOM Int'l*

**Figure 87: Mengniu's overall 2022 EBIT is dragged down by milk powder (Yashili, Bellamy)**



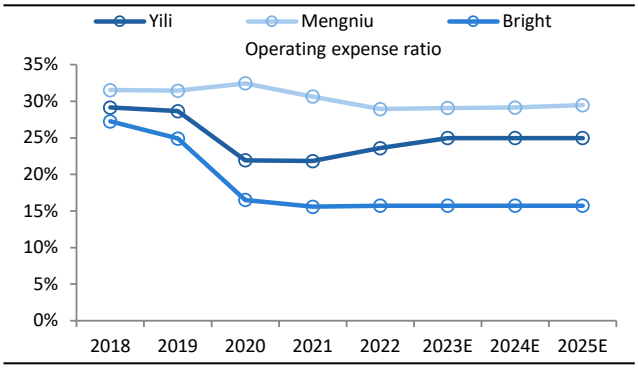

*Source: Company, BOCOM Int'l*

**Figure 88: Revenue mix by product (2022). Bright has higher mix in fresh milk, others higher in UHT**



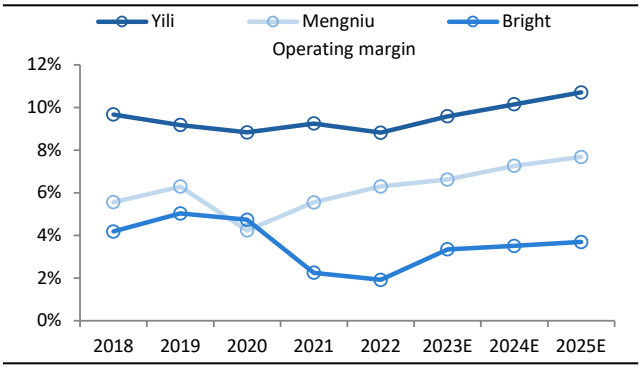

*Source: Company, BOCOM Int'l*

**Figure 89: Operating expense ratio**




*Source: Various companies, BOCOM Int'l estimates*

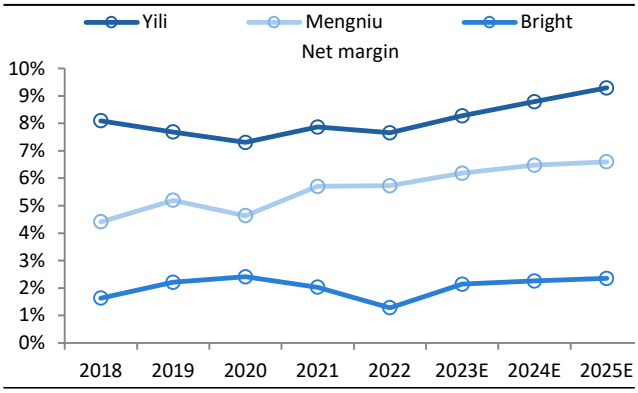
**Figure 90: Operating margin**




*Source: Various companies, BOCOM Int'l estimates*

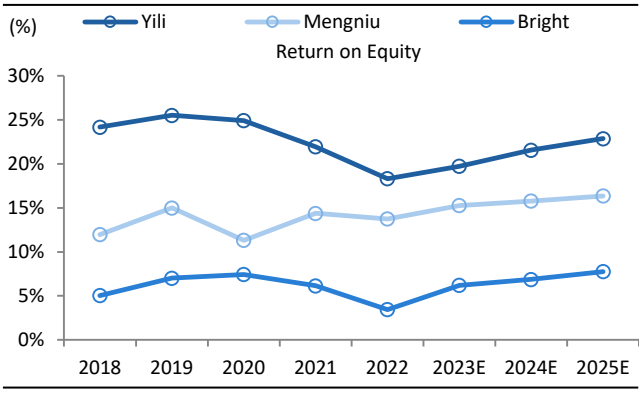
**Net margin:** As a result of lower operating expense (despite slightly lower GPM than Mengniu), Yili is able to command the highest OPM and net margin. Its ROE is also the highest, at 19%, compared to 14% for Mengniu and single-digit for Bright. Bright's ROE, as discussed in Valuation section, is likely dragged by its low profit margin.

**Figure 91: Net margin**




*Source: Various companies, BOCOM Int'l estimates*

**Figure 92: Return on Equity**




*Source: Various companies, BOCOM Int'l estimates*

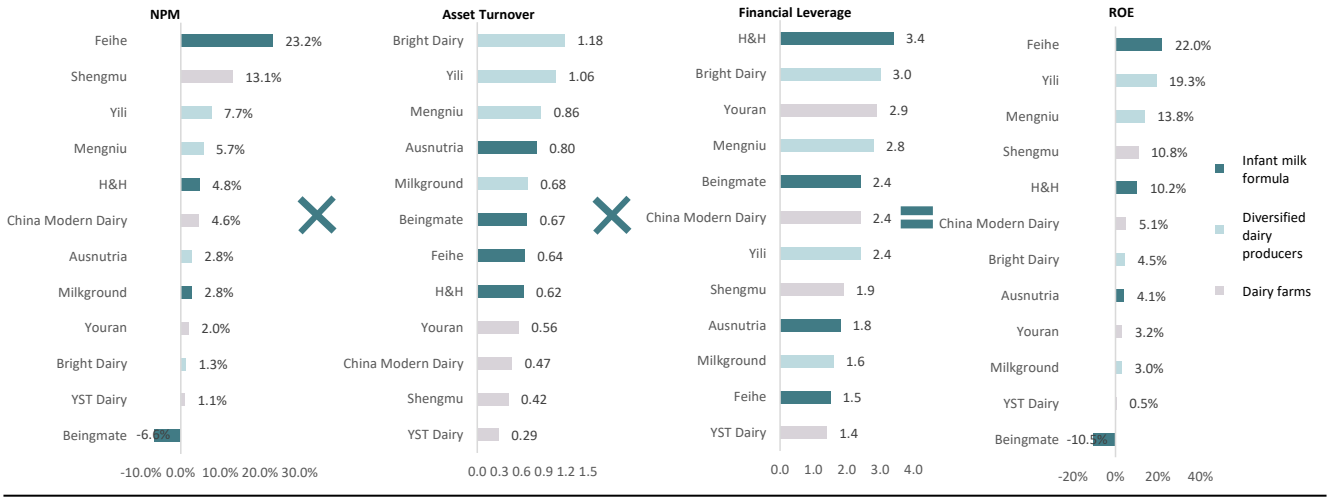
## Financial Comparison – Upstream vs. Downstream

**We prefer downstream to upstream based on different ROE profile:** Upstream dairy farms' ROE ranged from 3-11% for Modern Dairy, Youran and Shengmu. The Dupont analysis below shows that ROE is lower for dairy farms mostly due to lower asset turnover, due to their asset heavy business model, as well as low margin, as a result of the falling raw milk price in the past year. Bright, which is vertically integrated with its own self-operated dairy farm, also has a lower ROE of 5% as a result of both low margins for its upstream business (GPM of 1.3% vs. 26.1% for its liquid milk business in 2022), as well as lower asset turnover of 0.42x for its upstream business, vs. 1.39x for the rest of its business in 2022).

Meanwhile, downstream dairy goods producers like Yili and Mengniu have higher ROE of 19% and 14% respectively, while IMF players like Feihe also have higher ROE of 22%.

Secondly, we expect raw milk price to continue to fall in the next 1-2 years (-8% YoY in 2023, -3% YoY in 2024), which is positive for downstream players that uses raw milk as a raw material, but negative for upstream dairy farms that sells raw milk. Past losses by upstream dairy farms when raw milk price declined suggests downstream producers have stronger negotiation power over upstream when it comes to pricing, which is typically the case for commodity, where producers are price takers.

**Figure 93: Dupont analysis of Return on Equity (ROE, 2022) along dairy supply chain**




*Source: Bloomberg, BOCOM Int'l*

## Company Analysis

BOCOM Int'l Research

**Initiation of Coverage**

| Consumer | Last Close | Target Price | Upside |
|---|---|---|---|
| | RMB 28.11 | RMB 34.70 | +23.4% |

9 August 2023

# Inner Mongolia Yili Industrial Group (600887 CH)

## Cream of the crop with strong innovation, global ambitions; Initiate at Buy

- **Dairy top pick. Leading dairy conglomerate in China, with global, "beyond dairy" ambitions:** Yili is our top pick in the China dairy space. Yili has five main business lines in drinking milk, yoghurt, milk powder, ice-cream, and cheese with a multi-brand strategy under each category. In 2022, Yili ranked 1st in drinking milk (with 33.4% share), yoghurt (33.6% share), adult milk formula (25.3% share) and ice-cream (#1 for 28 straight years, c.21% share) in China, and 2nd in infant milk formula ("IMF", 12.4% share), according to AC Nielsen/Euromonitor. Yili targets to become a top 3 dairy company globally by 2025 and top 1 globally by 2030, with international expansion underway. Yili is also exploring "beyond dairy" categories like bottled water and AMX-branded chocolate cakes.
- **Solid track record of grooming star products, supported by strong innovation:** One of Yili's strengths and growth drivers is its ability to continuously create successful new SKUs, adding to its already strong portfolio of star SKUs. It has 15 R&D centers in Asia, Europe, Oceania and America, while new products accounted for 10-15% of sales in the past three years, even higher in yoghurt and ice-cream. While it already has market-leading Ambrosial in room-temperature yoghurt (65% market share with RMB20bn sales in 2022, ahead of Mengniu's Just Yoghurt), Changqing in chilled yoghurt (RMB2bn sales) and QiaoLeZi in ice-cream (RMB5bn), it continues to launch new products, e.g. many new ice-cream SKUs that exceed RMB100m sales, or in 2H23, yoghurt with more functionality, e.g. probiotics, zero sugar, high protein.
- **Highest ROE among top 3 diversified dairy players, likely to rise further on NPM expansion:** Yili has the highest ROE among top 3 diversified dairy producers, with 19% in 2022, vs. Mengniu's 14% and Bright's 5%, reflecting its highest net margin (1.9ppts above Mengniu) and high asset turnover. Management recently reiterated its guidance for NPM to expand by 30bps (ex margin-accretive Ausnutria) in 2023, and NPM to reach 9-10% by 2025 (vs. 7.7% in 2022), i.e. 43-77bps per year. It also guided 2023 sales/pretax profit to grow 10%/18% YoY. While sales could be slightly softer than expected due to weak consumption sentiment this year, we expect pretax profit to be on track, helped by raw milk cost decline.
- **Initiate with Buy, RMB34.7 TP:** We expect Yili's sales/net profit to grow by 10%/17% CAGR over 2023-25E. Our 2024-25E EPS are 1-3% higher than consensus. Our TP of RMB34.7 is based on 17.0x 2024E P/E, a 1.0x PEG to our 17% EPS CAGR.

### Financial highlights

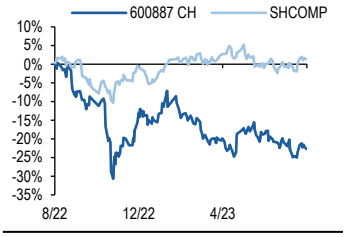
| Y/E 31 Dec | 2021 | 2022 | 2023E | 2024E | 2025E |
|---|---|---|---|---|---|
| Revenue (RMB m) | 110,595 | 123,171 | 133,629 | 148,450 | 162,519 |
| YoY growth (%) | 14.2 | 11.4 | 8.5 | 11.1 | 9.5 |
| Net profit (RMB m) | 8,705 | 9,431 | 11,058 | 13,049 | 15,102 |
| EPS (RMB) | 1.36 | 1.47 | 1.73 | 2.04 | 2.36 |
| YoY growth (%) | 16.9 | 8.4 | 17.3 | 18.0 | 15.7 |
| P/E (x) | 20.7 | 19.1 | 16.3 | 13.8 | 11.9 |
| BVPS (RMB) | 7.45 | 7.86 | 8.42 | 9.24 | 10.15 |
| P/B (x) | 3.77 | 3.58 | 3.34 | 3.04 | 2.77 |
| Dividend yield (%) | 3.4 | 3.7 | 4.4 | 5.2 | 6.0 |

*Source: Company data, BOCOM Int'l estimates*

**Stock Rating**

**BUY**

### 1-year stock performance




*Source: FactSet*

### Stock data

| | |
|---|---|
| 52w high (RMB) | 36.62 |
| 52w low (RMB) | 25.24 |
| Market cap (RMB m) | 176,404.87 |
| Avg daily vol (m) | 30.13 |
| YTD change (%) | (9.32) |
| 200d MA (RMB) | 29.40 |

*Source: FactSet*


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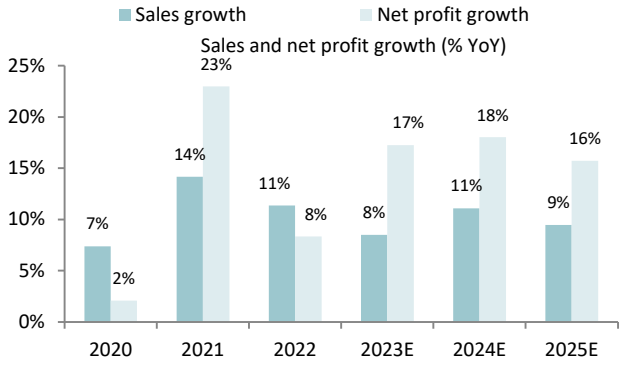


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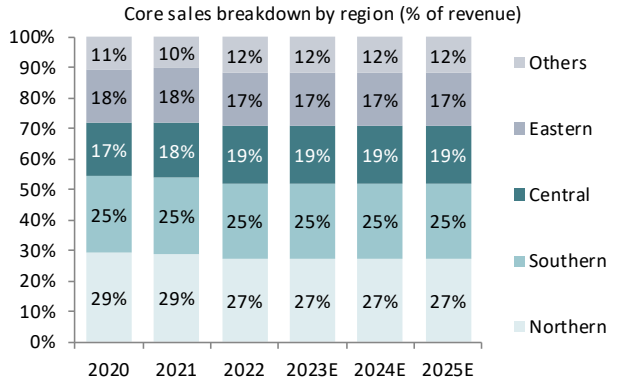
## Company at a Glance

### Figure 94: Yili: Sales and net profit growth



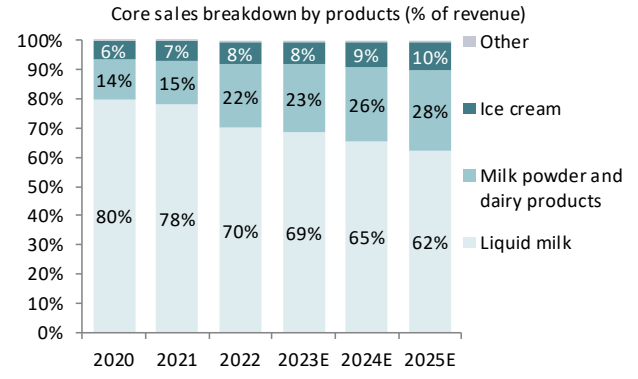

*Source: Company data, BOCOM Int'l estimates*

### Figure 95: Yili: Sales breakdown by region



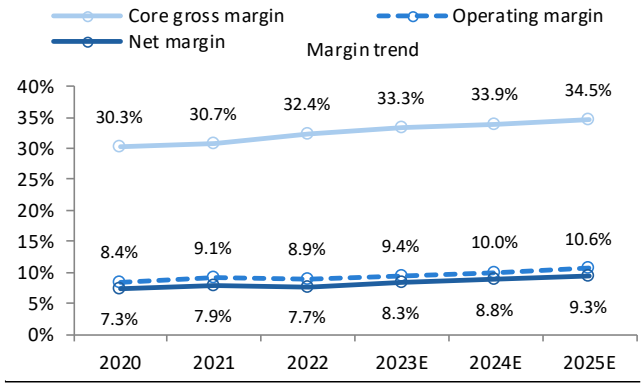

*Source: Company data, BOCOM Int'l estimates*

### Figure 96: Yili: Sales breakdown by product



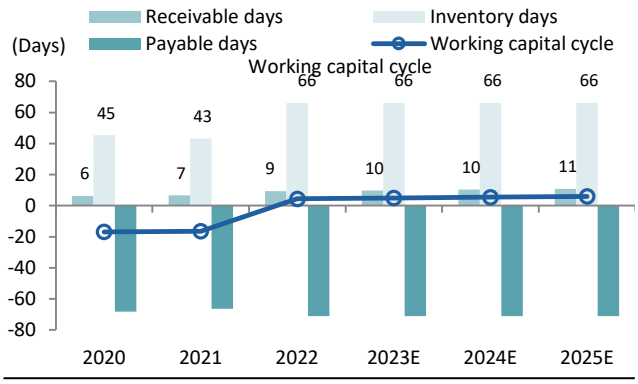

*Source: Company data, BOCOM Int'l estimates*

### Figure 97: Yili: Overall margin trends



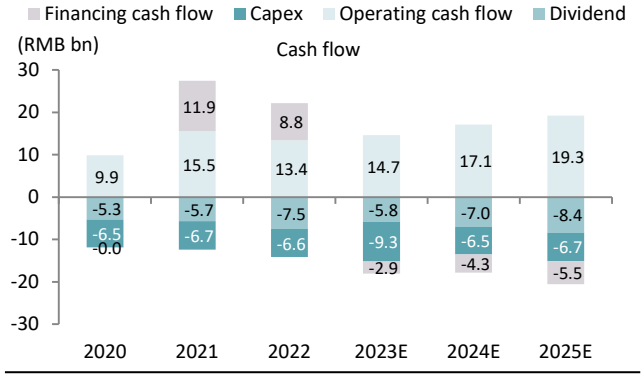

*Source: Company data, BOCOM Int'l estimates*

### Figure 98: Yili: Working capital




*Source: Company data, BOCOM Int'l estimates*

### Figure 99: Yili: Key cash flow




*Source: Company data, BOCOM Int'l estimates*

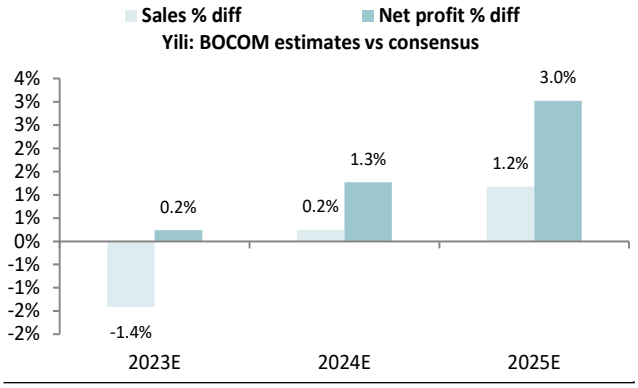
# Valuation

## Initiate with Buy and TP of RMB34.7 (23% upside)

We initiate coverage on Yili with a **Buy** rating and a TP of RMB34.7, based on 17.0x P/E on our 2024E EPS. Our target P/E multiple is derived from 1.0x PEG to our EPS CAGR (2023-25E) of 17.0%. We find this PEG reasonable relative to China dairy peers and is consistent with what we use for peer Mengniu.

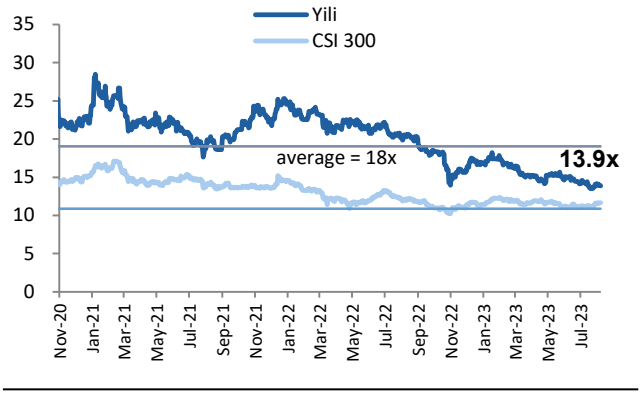
**Downside risks:** (1) Weaker-than-expected demand; (2) higher-than-expected raw milk costs increase leading to GPM pressure, (3) fierce competition leading to irrational price competition and GPM pressure, (4) food safety issues.

**Figure 100: Yili: BOCOM vs. consensus**




*Source: Bloomberg consensus, BOCOM Int'l estimates*

**Figure 101: Yili: forward P/E**

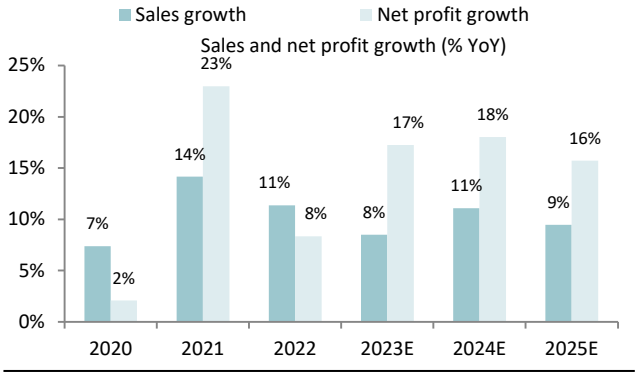



*Source: Bloomberg consensus, BOCOM Int'l*

## Financial Forecast

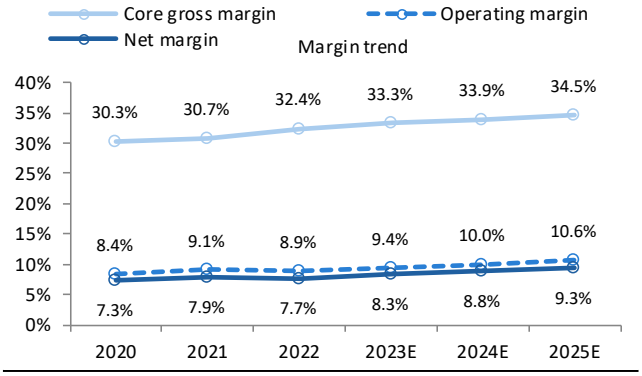
We forecast sales and net profit CAGR of 10% and 17% respectively for the next 3 years (2023-25E), driven by an average increase of 70bps in GPM and 63bps in OPM each year, on decline in raw milk price as well as product mix improvement (e.g. premiumization within each category, flagship SKUs usually command 7-8ppt higher GPM compared to entry-level SKUs). We expect Yili to slightly miss (by 1%) its full-year sales target of RMB135.5bn, but meet its pretax profit target of RMB12.5bn (BOCOM est. RMB12.56bn in 2023E).

**Figure 102: Yili: Sales and net profit growth**




*Source: Company data, BOCOM Int'l estimates*

**Figure 103: Yili: margin trends**



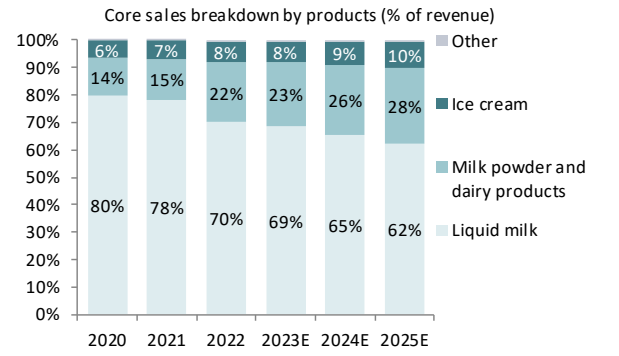

*Source: Company data, BOCOM Int'l estimates*

**By product:**

- We are modelling **liquid milk**, the largest category with 70% sales contribution in 2022, to grow at a slower 5% CAGR in the next 3 years, but stronger growth to come from the smaller categories.
- We expect **milk powder and dairy products** (i.e. cheese) segment to grow by a 19% CAGR. Its sales contribution rose from 15% in 2021 to 22% in 2022 due to its consolidation of Ausnutria since 2Q22. Despite industry headwinds, the segment's sales grew at a 27% CAGR from 2020-21, and even stronger 62% growth including the Ausnutria consolidation.
- **Ice-cream** (17% CAGR) will likely also be strong, helped by Yili's expansion into Thailand and Indonesia.
- **Other products** will likely also see a strong 26% CAGR, driven by Yili's expansion into bottled water and other new categories.

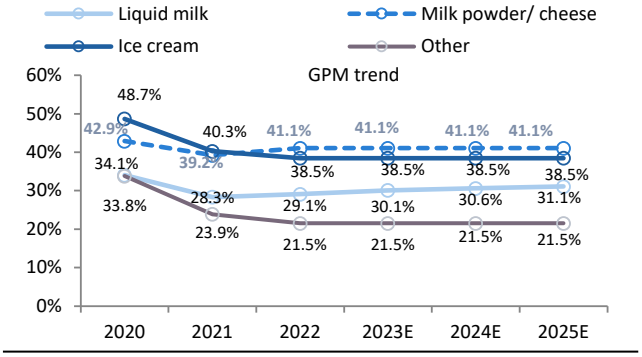
**Recent trends: Recovery slower than expected, but full-year pretax profit guidance still on track:** In spite of Yili's market leadership, it is not immune to market headwinds. It saw low-single-digit growth in drinking milk and chilled yoghurt in 2Q23, but offset by a mid-single-digit decline in room-temp yoghurt and weakness in probiotics. Yoghurt's snack-like consumption nature does not fare well when consumers are becoming more value conscious. 3Q23 is expected to be better due to low base.

**Figure 104: Yili: Sales breakdown by product**




*Source: Company data, BOCOM Int'l estimates*

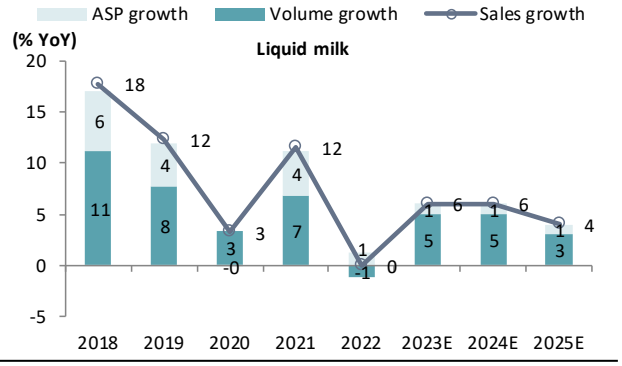
**Figure 105: Yili: GP margin by product segment**




*Source: Company data, BOCOM Int'l estimates*

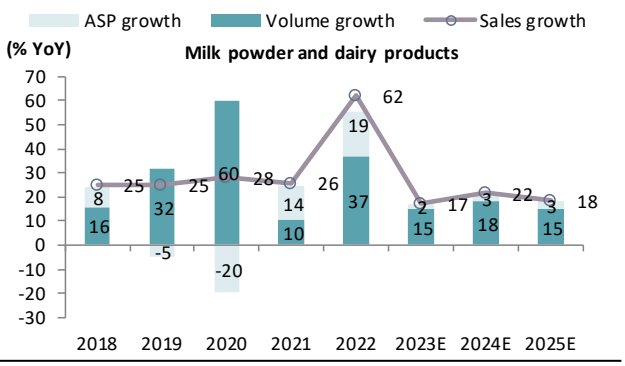
Breaking down into ASP and volume, we expect volume growth to be the main driver for various segments in 2023-25E, with generally only 2-3% ASP growth in the next 3 years.

**Figure 106: Liquid milk segment: Sales growth mix by ASP and volume**



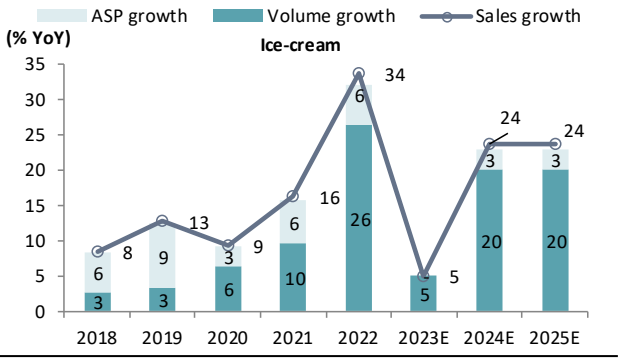

*Source: Company data, BOCOM Int'l estimates*

**Figure 107: Milk powder and dairy products segment: Sales growth mix by ASP and volume**



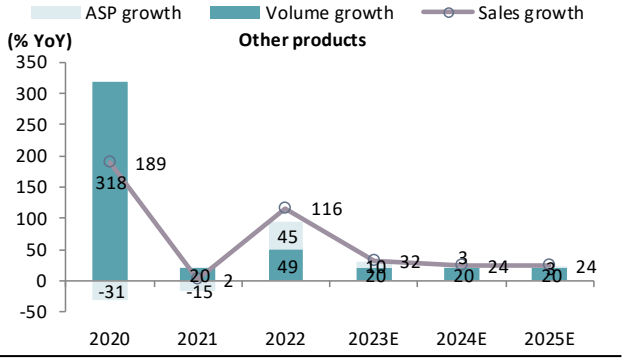

*Source: Company data, BOCOM Int'l estimates*

**Figure 108: Ice-cream segment: Sales growth mix by ASP and volume**




*Source: Company data, BOCOM Int'l estimates*

**Figure 109: Other products segment: Sales growth mix by ASP and volume**




*Source: Company data, BOCOM Int'l estimates*

### Figure 110: Yili: Key assumptions on segmental sales, volume and ASP

| Segment info | 2019 | 2020 | 2021 | 2022 | 2023E | 2024E | 2025E |
|---|---|---|---|---|---|---|---|
| **Sales volume ('000 tons)** | | | | | | | |
| Liquid milk | 8,709 | 9,005 | 9,613 | 9,495 | 9,970 | 10,468 | 10,782 |
| Milk powder and dairy products | 143 | 229 | 253 | 346 | 398 | 469 | 539 |
| Ice-cream | 406 | 432 | 473 | 598 | 627 | 753 | 903 |
| Other products | 11 | 44 | 53 | 79 | 95 | 114 | 137 |
| **Total** | **9,269** | **9,710** | **10,392** | **10,517** | **11,090** | **11,804** | **12,362** |
| **Sales volume (% YoY)** | | | | | | | |
| Liquid milk | 7.8% | 3.4% | 6.7% | -1.2% | 5.0% | 5.0% | 3.0% |
| Milk powder and dairy products | 31.6% | 60.0% | 10.3% | 36.6% | 15.0% | 18.0% | 15.0% |
| Ice-cream | 3.2% | 6.4% | 9.6% | 26.3% | 5.0% | 20.0% | 20.0% |
| Other products | | 317.6% | 20.5% | 49.4% | 20.0% | 20.0% | 20.0% |
| **Total** | | **4.8%** | **7.0%** | **1.2%** | **5.4%** | **6.4%** | **4.7%** |
| **ASP (per '000 tons)** | | | | | | | |
| Liquid milk | 8.47 | 8.45 | 8.83 | 8.94 | 9.03 | 9.12 | 9.22 |
| Milk powder and dairy products | 70.11 | 56.16 | 64.07 | 75.97 | 77.49 | 79.82 | 82.21 |
| Ice-cream | 13.88 | 14.26 | 15.14 | 16.01 | 16.01 | 16.49 | 16.99 |
| Other products | 5.89 | 4.07 | 3.44 | 4.99 | 5.49 | 5.65 | 5.82 |
| **Overall** | **9.66** | **9.82** | **10.44** | **11.52** | **11.85** | **12.37** | **12.93** |
| **ASP growth (% YoY)** | | | | | | | |
| Liquid milk | 4.2% | -0.2% | 4.5% | 1.3% | 1.0% | 1.0% | 1.0% |
| Milk powder and dairy products | -5.0% | -19.9% | 14.1% | 18.6% | 2.0% | 3.0% | 3.0% |
| Ice-cream | 9.2% | 2.8% | 6.1% | 5.8% | 0.0% | 3.0% | 3.0% |
| Other products | | -30.9% | -15.4% | 44.9% | 10.0% | 3.0% | 3.0% |
| **Overall** | **5.3%** | **1.7%** | **6.3%** | **10.4%** | **2.9%** | **4.4%** | **4.5%** |
| **Revenue (RMB m)** | | | | | | | |
| Liquid milk | 73,761 | 76,123 | 84,911 | 84,926 | 90,064 | 95,513 | 99,362 |
| Milk powder and dairy products | 10,055 | 12,885 | 16,209 | 26,260 | 30,803 | 37,438 | 44,346 |
| Ice-cream | 5,631 | 6,158 | 7,161 | 9,567 | 10,046 | 12,417 | 15,347 |
| Other products | 62 | 179 | 182 | 395 | 521 | 644 | 796 |
| **Core revenue** | **89,509** | **95,345** | **108,462** | **121,149** | **131,434** | **146,012** | **159,851** |
| **Total revenue** | **90,223** | **96,886** | **110,595** | **123,171** | **133,629** | **148,450** | **162,519** |
| **Sales growth (% YoY)** | | | | | | | |
| Liquid milk | 12.3% | 3.2% | 11.5% | 0.0% | 6.1% | 6.1% | 4.0% |
| Milk powder and dairy products | 25.0% | 28.1% | 25.8% | 62.0% | 17.3% | 21.5% | 18.5% |
| Ice-cream | 12.7% | 9.3% | 16.3% | 33.6% | 5.0% | 23.6% | 23.6% |
| Other products | | 188.6% | 1.9% | 116.5% | 32.0% | 23.6% | 23.6% |
| **Core revenue** | **13.7%** | **6.5%** | **13.8%** | **11.7%** | **8.5%** | **11.1%** | **9.5%** |
| **Total revenue** | **13.4%** | **7.4%** | **14.2%** | **11.4%** | **8.5%** | **11.1%** | **9.5%** |
| **Revenue mix (% of core revenue)** | | | | | | | |
| Liquid milk | 82.4% | 79.8% | 78.3% | 70.1% | 68.5% | 65.4% | 62.2% |
| Milk powder and dairy products | 11.2% | 13.5% | 14.9% | 21.7% | 23.4% | 25.6% | 27.7% |
| Ice-cream | 6.3% | 6.5% | 6.6% | 7.9% | 7.6% | 8.5% | 9.6% |
| Other products | 0.1% | 0.2% | 0.2% | 0.3% | 0.4% | 0.4% | 0.5% |
| Core revenue | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

*Source: Company data, BOCOM Int'l estimates*

### Figure 111: Yili: Key assumptions on segmental gross profit margins

| Segment info | 2019 | 2020 | 2021 | 2022 | 2023E | 2024E | 2025E |
|---|---|---|---|---|---|---|---|
| **Revenue (RMB m)** | | | | | | | |
| Liquid milk | 73,761 | 76,123 | 84,911 | 84,926 | 90,064 | 95,513 | 99,362 |
| Milk powder and dairy products | 10,055 | 12,885 | 16,209 | 26,260 | 30,803 | 37,438 | 44,346 |
| Ice-cream | 5,631 | 6,158 | 7,161 | 9,567 | 10,046 | 12,417 | 15,347 |
| Other products | 62 | 179 | 182 | 395 | 521 | 644 | 796 |
| **Core revenue** | **89,509** | **95,345** | **108,462** | **121,149** | **131,434** | **146,012** | **159,851** |
| **Total revenue** | **90,223** | **96,886** | **110,595** | **123,171** | **133,629** | **148,450** | **162,519** |
| | | | | | | | |
| **COGS by products** | | | | | | | |
| Liquid milk | 47,798 | 54,867 | 60,853 | 60,201 | 62,943 | 66,273 | 68,447 |
| Milk powder and dairy products | 5,216 | 7,836 | 9,851 | 15,477 | 18,154 | 22,064 | 26,135 |
| Ice-cream | 3,012 | 3,640 | 4,277 | 5,886 | 6,180 | 7,639 | 9,442 |
| Other products | 40 | 143 | 139 | 310 | 409 | 505 | 625 |
| **Core COGS** | **56,067** | **66,487** | **75,120** | **81,873** | **87,686** | **96,482** | **104,649** |
| Total COGS | 56,392 | 67,453 | 76,417 | 83,119 | 89,069 | 98,060 | 106,413 |
| **Gross profit** | | | | | | | |
| Liquid milk | 25,963 | 21,256 | 24,057 | 24,725 | 27,122 | 29,240 | 30,915 |
| Milk powder and dairy products | 4,838 | 5,049 | 6,358 | 10,784 | 12,649 | 15,374 | 18,211 |
| Ice-cream | 2,619 | 2,518 | 2,884 | 3,681 | 3,865 | 4,778 | 5,905 |
| Other products | 22 | 36 | 44 | 85 | 112 | 139 | 171 |
| **Core gross profit** | **33,442** | **28,858** | **33,342** | **39,275** | **43,749** | **49,530** | **55,202** |
| Total gross profit | 33,831 | 29,433 | 34,178 | 40,052 | 44,560 | 50,389 | 56,106 |
| | | | | | | | |
| **GP margin (%)** | | | | | | | |
| Liquid milk | 35.2% | 27.9% | 28.3% | 29.1% | 30.1% | 30.6% | 31.1% |
| Milk powder and dairy products | 48.1% | 39.2% | 39.2% | 41.1% | 41.1% | 41.1% | 41.1% |
| Ice-cream | 46.5% | 40.9% | 40.3% | 38.5% | 38.5% | 38.5% | 38.5% |
| Other products | 34.8% | 19.9% | 23.9% | 21.5% | 21.5% | 21.5% | 21.5% |
| **Core GPM** | **37.4%** | **30.3%** | **30.7%** | **32.4%** | **33.3%** | **33.9%** | **34.5%** |
| Total GPM | 37.5% | 30.4% | 30.9% | 32.5% | 33.3% | 33.9% | 34.5% |

*Source: Company data, BOCOM Int'l estimates *2020 GPM restated in 2021, according to Yili's financial statements*

# Investment Positives

## Positive #1: Top position in most dairy sub-categories

**Leading dairy conglomerate in China:** Yili has five main business lines in drinking milk, yoghurt, milk powder, cheese and ice-cream, with a multi-brand strategy under each category. In 2022, Yili ranked 1st in drinking milk (with 33.4% share), yoghurt (33.6% share), adult milk formula (25.3% share) and ice-cream (#1 for 28 straight years, c.21% share) in China, and 2nd in infant milk formula ("IMF", 12.4% share), according to AC Nielsen and Euromonitor.

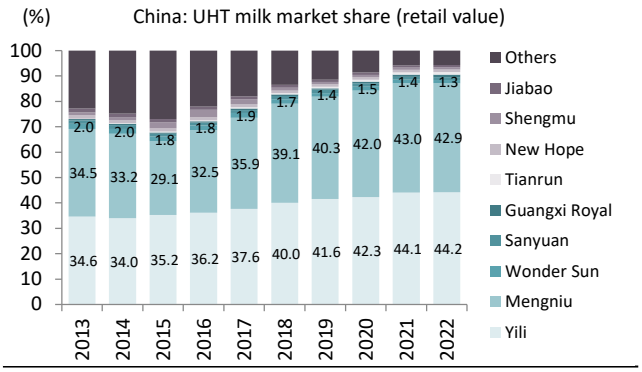
- **UHT milk (1st):** Satine is the flagship brand of Yili's high-end drinking milk, which is positioned to capture consumers' consumption upgrade. As of 2022, Yili's liquid milk business has a market share of 33.4%, staying the 1st in the market.
- **Fresh milk (6th):** Yili is currently ranked 6th in the market, but we think the market share situation is far from settled, given the nascent stage of development of the fresh milk market. Yili believes its production capacity of UHT milk can be easily switched to fresh milk when the market demand is more mature. We believe Yili can rise up the leader board given its strong track record of grooming star products in every other product category.
- **Yoghurt (1st):** In the yogurt segment, Yili has a market share of 33.6% in 2022, with 65% market share in room-temperature yogurt.
- **Milk powder (1st in AMF, 2nd in IMF):** Yili has a 25.3% market share in adult milk formula and a 12.4% share (2nd) in infant milk formula.
- **Cheese (3rd):** Yili is ranked 3rd in the market and rose up the market share board quickly, catching up to first-place Milkground.
- **Ice-cream (1st):** Yili is the clear market leader, ranking 1st for 28 consecutive years (with 21% market share in 2022), with well-known brands such as QiaoLeZi and GEMICE. The revenue scale of ice-cream business continues to grow, with 33.6%/35.7% YoY growth in 2022/1Q23.

**Figure 112: Yili leads in most dairy categories**

| Dairy sub-sectors | % of dairy market (2022) | Yili | Mengniu | Bright |
|---|---|---|---|---|
| UHT milk | 30.6 | 1st | 2nd | 13th |
| Fresh milk | 7.5 | 6th | 2nd | 1st |
| Yoghurt | 20.2 | 1st | 2nd | 3rd |
| Ice-cream | 7.9 | 1st | 3rd | |
| Cheese | 2.1 | 3rd | 1st* | |
| Infant milk formula | 25.0 | 2nd | 13th | |
| Adult milk formula | n/a | 1st | 3rd | |

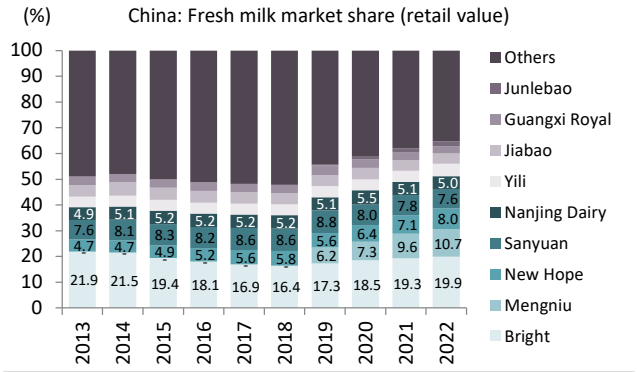
*Source: AC Nielsen, Euromonitor, company data * Mengniu is ranked first in cheese after including 35%-owned Milkground*

**Figure 113: UHT milk: Market share by company**



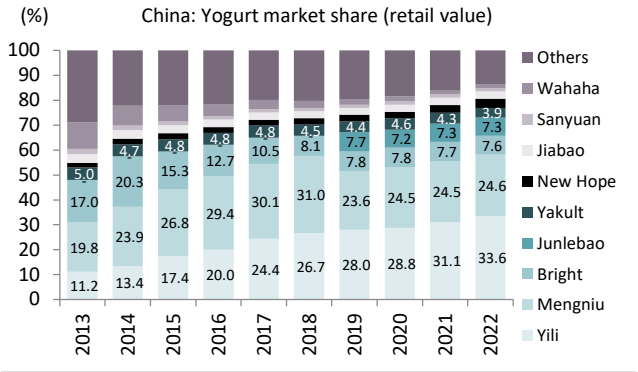

*Source: Euromonitor, BOCOM Int'l*

### Figure 114: Fresh milk: Market share by company



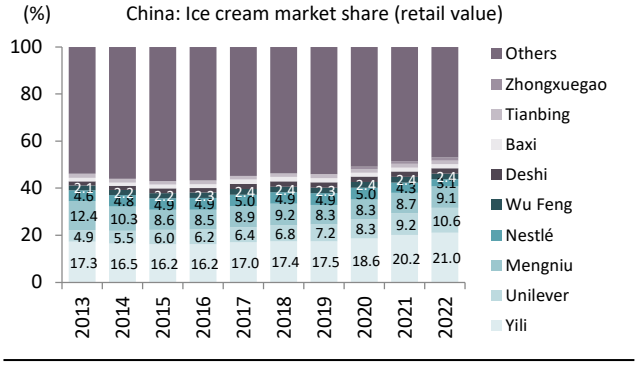

*Source: Euromonitor, BOCOM Int'l*

### Figure 115: Yoghurt: Market share by company



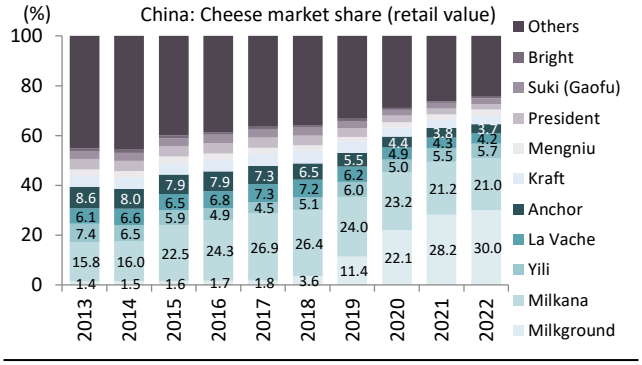

*Source: Euromonitor, BOCOM Int'l*

### Figure 116: Ice-cream: Market share by company



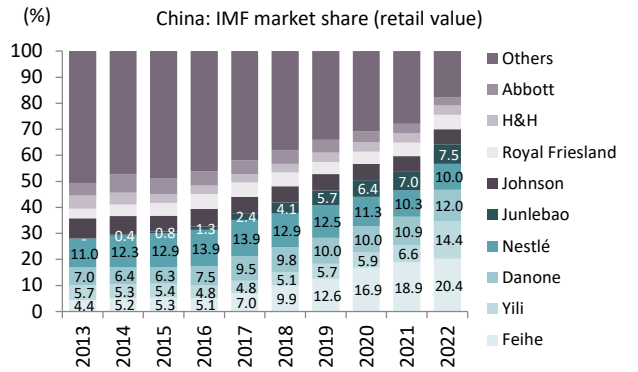

*Source: Euromonitor, BOCOM Int'l*

### Figure 117: Cheese: Market share by company



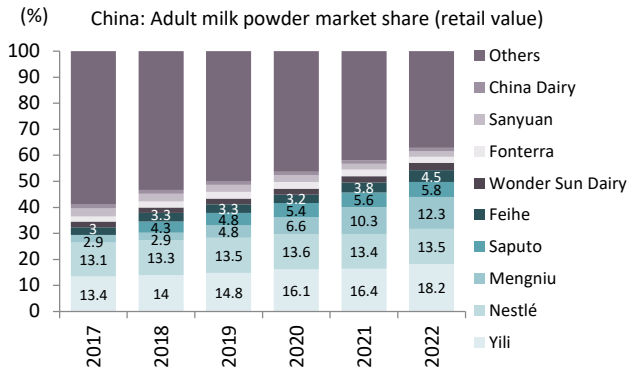

*Source: Euromonitor, BOCOM Int'l*

### Figure 118: Infant milk formula: Market share




*Source: Euromonitor, BOCOM Int'l*

### Figure 119: Adult milk formula: Market share




*Source: Euromonitor, BOCOM Int'l*

## Positive #2: Strong R&D and product innovation underline successful product portfolio

**Strong R&D and product innovation support Yili's leading market position**: Yili's leadership in various categories are usually anchored by a flagship star SKU, surrounded by constantly refreshed product line-up, a testament to Yili's ability to both market and groom star SKUs, as well as to innovate new products. Yili has 15 R&D centers globally, in Asia, Europe and America, while new products accounted for 10-15% of sales in the past three years, even higher in certain fast-moving categories like yoghurt and ice-cream.

**Satine, Yili's flagship UHT milk brand, constantly launches new variations, e.g. Jersey milk, active lactoferrin organic pure milk:** Satine, Yili's high-end UHT milk brand, was established in 2006 to fill the gap in China's organic dairy market, and now has 12 product series with products constantly innovating towards organic and low fat. In 2022, Yili introduced "Jersey" series, with the native milk protein content raised from 3.5g/100ml to 4.0g/100ml, which is 34% higher than the national standard, satisfying consumers' demand for high-end liquid milk.

On 5 May 2023, Yili announced a new product "Satine Active Lactoferrin Organic Pure Milk". The product has proven Yili's advanced R&D capabilities as it is the first room-temperature product in the market that can maintain the natural activity of lactoferrin, which is beneficial to the immune system. Yili also expanded its organic milk and A2 milk business under "Classic Satine" brand. Driven by continuous innovation and product upgrading, the Satine series has doubled its revenue scale in three years.

**Figure 120: Satine brand product line-up**




*Source: Company website, BOCOM Int'l*

**Ambrosial (AMX), the leader in room-temperature yoghurt with 65% market share:** Ambrosial is the main brand of Yili's room-temperature yogurt. In 2013, yogurt started to become popular in China. Based on the market's recognition of room-temperature yogurt, Yili accelerated the pace of innovation and launched Ambrosial brand (Ambrosial originates from Greece, meaning a special delicacy).

In 2022, Yili added new products under its Ambrosial brand including AMX milk shake and carbonated yoghurt drinks. The new products introduced in 2022 added 0.6ppt to Yili's market share in room-temperature yoghurt drinks. Ambrosial's sales exceeded RMB20bn in 2022 and maintain a continuous growth momentum, where sales of new products have historically been 10-15% of total sales, according to management.

**QiaoLeZi is a long-time leader in ice-cream with RMB5bn sales, continuous innovations:** Despite being the ice-cream market leader of 28 consecutive years, Yili has continued to innovate and upgrade its products in terms of packaging, quality and brand value to achieve steady growth. QiaoLeZi has become a big SKU with over RMB5bn revenue contribution annually, and new SKU also contributed over RMB100m.

**Yili's strong R&D capability for both products and packaging is award winning, being the recipient of World Food Innovation Awards:** In the World Food Innovation Awards held in March 2023 in the UK, Yili received various awards or nominations:

- Received the top packaging award for its environmental-friendly packaging, where the cartons are composed of FSC-certified packaging materials and the caps are made of plant-based materials.
- Satine Active Lactoferrin Organic Pure Milk was also endorsed by the Artisan Product Award for being the first room-temperature active lactoferrin organic pure milk product in the dairy market.
- Cujinhuan Cheese flavored ice-cream was also nominated for the Chilled Product Award, while it is also certified by the Global Green Union.
- Kabrita goal milk formula, Shuhua Sugar control lactose-free milk, Cute Star Natural DHA Pure milk and Changyi 100% lactic acid bacteria drink were commended for various awards.

**Figure 121: Satine new product "Satine Active Lactoferrin Organic Pure Milk"**



*Source: Company website, BOCOM Int'l*

**Figure 122: Food Innovation Awards 2023**




*Source: Company website, BOCOM Int'l*

**Figure 123: Food Innovation Awards 2023**




*Source: Company website, BOCOM Int'l*

## Positive #3: Executing grand aspirations beyond China's dairy sector

**Not satisfied with simply being China's dairy sector leader, Yili is transforming itself into a global health food company.** Yili aims to become a top three dairy company globally by 2023 and top one dairy company globally by 2025. Meanwhile, Yili has set another goal, to be a top 5 global health food company by 2030. Its global network of 15 R&D and innovation centers, covering Asia, Europe, Oceania, the Americas, and other regions, lays the foundation for its global expansion and development of health products for various consumer groups. In 2022, Yili and its wholly-owned subsidiaries entered into a joint investment with RMB350m to establish Jianling Seed Fund, which will focus on investment in health food-related areas and provide external R&D support.

**"Beyond dairy": Cross development into other categories, such as snack and beverage:** Yili has made initial attempts in beverage business, such as bottled water, milk beverages, and milk sodas. It also leverages its expertise in various categories to cross-develop new product offerings. e.g. by combining its knowledge in yoghurt and ice-cream, it was able to create a chocolate cake under the AMX brand as a dessert item on the dining table, thus expanding its category to a new channel. Yili is also exploring new growth paths such as pet food. Successful R&D will sow the seeds for new growth.

**"Beyond China": International expansion, starting with ice-cream in Southeast Asia:** Yili is also executing its plan for international expansion. Yili has strengthened its supply of raw milk through the acquisition of enterprises such as Westland in New Zealand. On the other hand, through factory construction in Indonesia and the acquisition of Chomthana (the largest ice-cream company in Thailand), Yili is looking to expand internationally with categories that are less dependent on milk source proximity and are suitable for local consumption in Southeast Asia. Thailand and Indonesia are the largest markets in SE Asia for ice-cream and demand for ice-cream is expected to rise with income level, similar to the growth trajectory of ice-cream in China. These visionary plans are expected to contribute to Yili's medium and long-term growth.

**Figure 124: Yili is exploring new opportunities in adjacent fast-moving consumer goods (FMCG) categories such as bottled water and carbonated drinks, by leveraging on its leadership in the dairy sector**

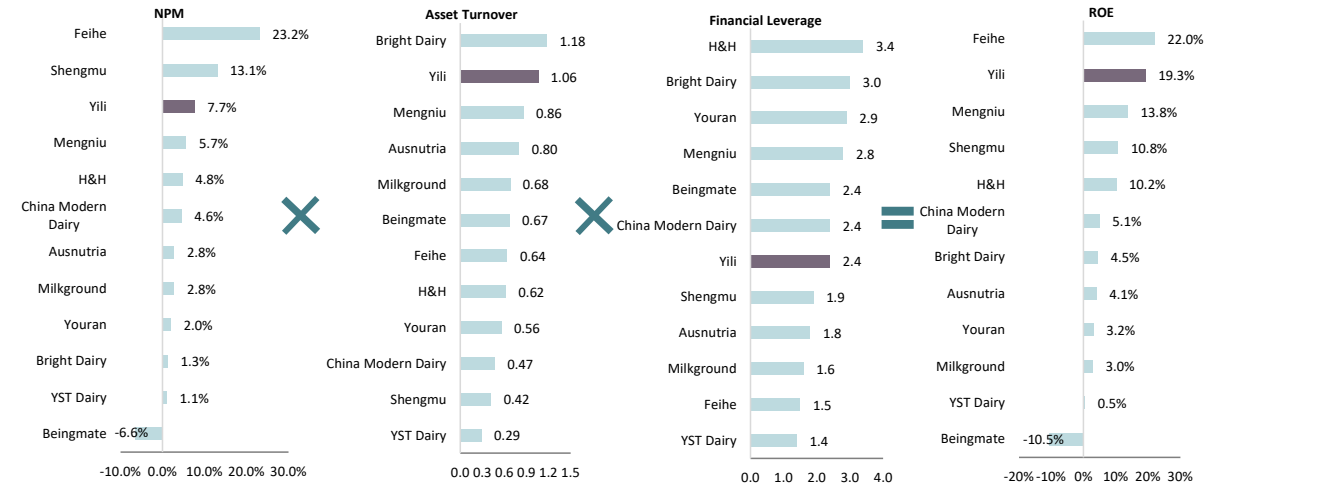



*Source: Company data, BOCOM Int'l*

## Positive #4: Highest ROE among 3 diversified dairy players

Yili has ROE of 19% in 2022, higher than 14% for Mengniu and 5% for Bright Dairy. This reflects its high profitability (third-highest net margin within dairy), strong sales generation from its assets (high asset turnover) and a relatively low amount of financial leverage.

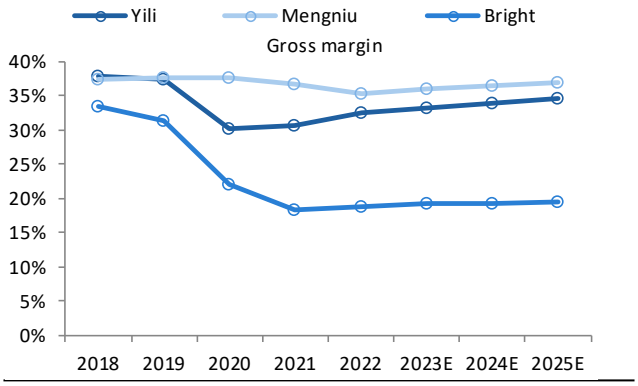
**Figure 125: Dupont analysis of return on equity (ROE, 2022) along dairy supply chain**




*Source: Bloomberg, BOCOM Int'l*

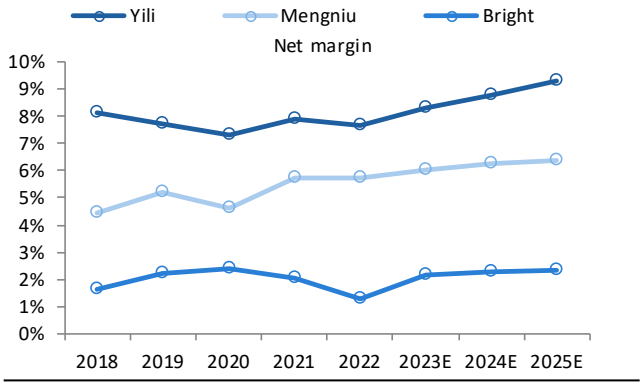
While Mengniu has slightly higher gross margin (by 2.9ppts in 2022), Yili is still able to have higher operating margin (by 2.5ppts) and net margin (by 1.9ppts in 2022) given its lower operating expenses. This suggests that Yili has better operating leverage and cost efficiencies than Mengniu. Mengniu's profitability was also dragged down by its loss-making IMF business, while Yili's IMF business is profitable.

**Figure 126: Yili's GPM is lower than Mengniu's…**




*Source: Various companies, BOCOM Int'l estimates*

**Figure 127: … but Yili enjoys the highest net margin**




*Source: Various companies, BOCOM Int'l estimates*

## Company Overview

Inner Mongolia Yili Industrial Group ("Yili") is the number one dairy manufacturer in China with 15 research and development centers and 75 production bases globally. Yili mainly engages in dairy products and healthy beverage procurement, along with its own brand in liquid milk, dairy beverage, milk formula products, yoghurts, ice-cream and cheese etc. With the improvement in optimizing global resources and expansion, Yili is now the number one dairy player in China and Asia, and number 5 globally.

**Founded in 1993 and led the trend of UHT milk in China:** Yili was founded in 1993 and listed in 1996 as the first A-share dairy company in China. In 1999, Yili established its liquid milk business division in Inner Mongolia where it is headquartered. Riding on the rising UHT milk demand in China and expanded its business nationally in the 2000s, where Inner Mongolia contributed c. 60% revenue. Prior to expanding liquid milk business, Yili focused on ice-cream and dairy products such as milk powder products.

**Figure 128: Yili's main products**



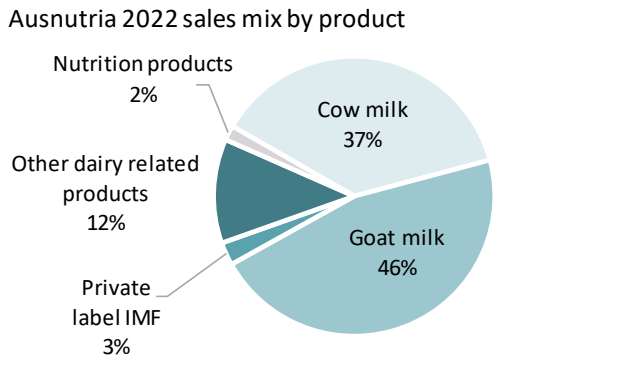

*Source: Company data, BOCOM Int'l*

**Ausnutria acquisition bolsters baby formula business:** Yili is the second biggest player in infant milk formula, behind only IMF pure play Feihe. Yili has taken advantage of an accelerating consolidation in the infant formula sector to acquire high quality assets, such as Ausnutria (1717 HK/NR), which owns the Hyproca 1897 (cow's milk) and Kabrita (goat milk) brands. The addition of Ausnutria would complement Yili's existing baby formula product and brand portfolio, which consists of infant formula, adult formula and yoghurt business. Yili uses the brand JinLingGuan (金领冠) for its infant milk formula lines, QQ Star (QQ 星) for its follow-up milk formula for young children, and Xinhuo (欣活) brand for adult milk formula for elderly consumers.

**Ausnutria is higher-end positioned, with international presence:** Ausnutria puts its emphasis on high-end positioning and boasts imported milk from the Netherlands, Australia and New Zealand, selling both cow milk formula and goat milk formula under its own brands (Hyproca 1987, Allnutria, Puredo and Neolac for its cow's milk formula, as well as Kabrita for goat's milk formula). The company has a leading position in goat milk, which are all produced in the Netherlands and marketed globally in 66 countries and regions (its sales was split 93%-7% between the PRC and overseas markets, as of 2021). According to AC Nielsen, Ausnutria accounts for >60% of all imported infant goat milk formulas in the PRC from 2018 to 2020. In July 2023, Ausnutria obtained approval from the US FDA for distribution and marketing of its Kabrita IMF brand in the US market, and this opening up of a new market bodes well for its sales prospects.

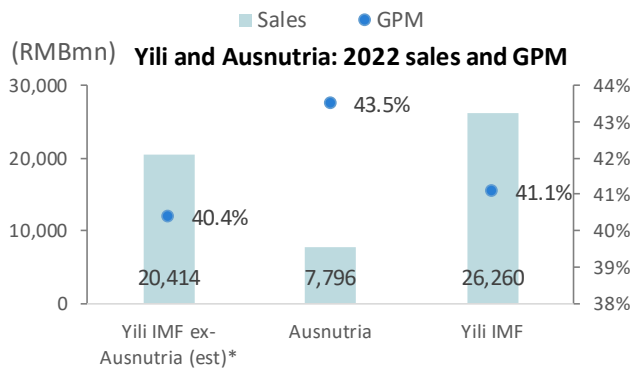
**Background of the acquisition:** On 28 January 2022, Yili acquired 34.33% stake in Ausnutria with a total consideration of HK$6,245m (621m shares at HK$10.06/share, implying a 13.7% premium over the preceding day's closing price). Upon completion, Yili made a general offer for all remaining shares and on 17 March 2022, further raised its stake to 59.17%. As such, Ausnutria's financials was consolidated by Yili starting 2Q22. Yili's "milk powder and dairy products" division sales grew by 62% YoY in 2022 (vol +37%, ASP +19%), helped by Ausnutria's consolidation. Yili's IMF business GPM rose from 39.2% in 2021 to 41.1% in 2022, helped by Ausnutria's higher GPM of 43.5% in 2022. The net proceeds of HK$905m raised from Yili's subscription on 28 Jan 2022 allowed Ausnutria to expand its upstream production facilities and acquire nutrition-related businesses.

**Figure 129: Ausnutria's sales mix by product**




*Source: Company data, BOCOM Int'l*

**Figure 130: Ausnutria is GP margin accretive to Yili**




*Source: Company data, BOCOM Int'l estimates *we assume 75% of Ausnutria's 2022 results was consolidated into Yili's financials in 2022*

**Expansion in upstream milk source:** Since 2013, Yili along with its peers have been actively expanding its milk source. Yili acquired minority stakes in Youran (which in turn acquired a majority stake in Saikexing) as well as Zhongdi, and has effective control over them given Yili accounts for a large proportion of their sales. Yili also acquired Westland in 2019, which was the second largest dairy farm in New Zealand at the time of the acquisition.

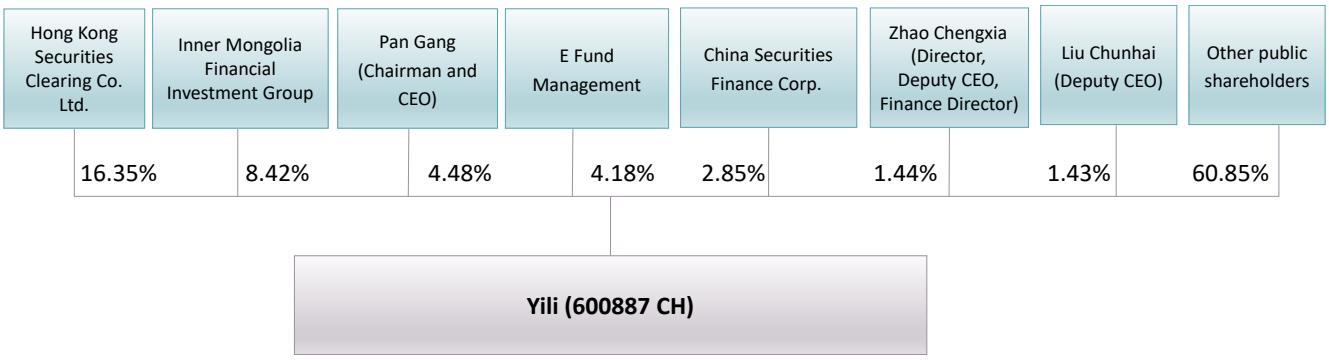
**Figure 131: Shareholding by dairy conglomerates in dairy farms**

| Acquirer | Stake owned | Target | Stock ticker | Business nature |
|---|---|---|---|---|
| Mengniu | 56.35% | China Modern Dairy | 1117 HK | Dairy farm in China |
| Mengniu | 29.99% | China Shengmu | 1432 HK | Dairy farm in China |
| Yili | 13.72% | Youran | 9858 HK | Dairy farm in China |
| Yili | 16.6% | Zhongdi | 1492 HK | Dairy farm in China |
| Youran (13.7% owned by Yili) | 58.36% | Saikexing | 834179 CH | Dairy farm in China |
| Yili | 100% | Westland Milk Products | private | Dairy farm in New Zealand |
| Bright Dairy | 100% of certain assets | Huishan Dairy | 6863 HK | Dairy farm in China |
| Bright Dairy | 60% | Qinghai XiaoXiNiu | private | Dairy farm in China |
| Bright Dairy | 51.0% | Synlait Milk | private | Dairy farm in New Zealand |

*Source: Company data, BOCOM Int'l*

## Shareholders and Management

### Figure 132: Yili: Shareholding structure



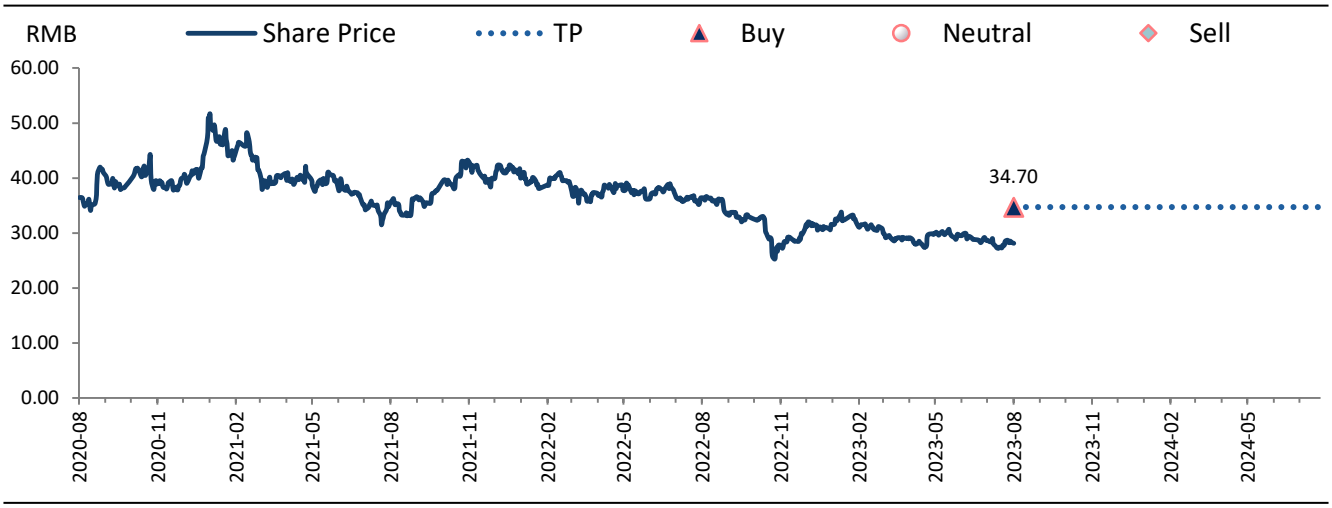

*Source: Bloomberg (2022), BOCOM Int'l*

### Figure 133: Yili: Board of directors and senior management

| Name | Position | Experience |
|---|---|---|
| **Pan Gang** | Chairman and CEO | Has previously served as the director of Production Department, Chairman and General Manager of Yili Mineral Beverage Co, CEO Assistant of Yili Group. |
| **Zhao Chengxia** | Director, Deputy CEO, Finance Director | Has previously served as the assistant of Finance Department's director, CEO Assistant, General Manager of Finance Management Department |
| **Wang Xiaogang** | Director | Has previously served as the Chairman of Supervisory Committee, and General Manager of Information Technology Center of Yili Group. Currently, Mr. Wang is the Director of Yili Group, as well as the Deputy General Manager of Digital Technology Center. |
| **Zhao Ying** | Director | Has previously served as the Administrative Director of the Ice Cream Division of Yili Group. |
| **Wang Aiqing** | Director | Has previously served as Human Resource Manager of Logistics Management Department of Liquid Milk Division, the Deputy Director of Presidents Assistant Office |
| **Lv Gang** | Director | Has previously served as the CEO of Dalian Haite Ecological Agriculture Co., General Manager of Dalian Ruichang Finance Leasing Co. Currently, Mr. Lv is the Director of Yili Group, and the General Manager of Dalian Liancheng Enterprise Management Development Co. |
| **Peng Heping** | Independent director | Has served as the Supervisor of Yili Group, assistant to the President of Renmin University of China, secretary-general of education foundation. |
| **Ji Shao** | Independent director | Has served as the Professor of Economics of Capital University of Economics and Business. Currently, Mr. Ji is the Independent Director of Yili Group, and the Dean of the School of Economics and Management at China University of Labor Relations. |
| **Cai Yuanming** | Independent director | Has served as the global Deputy CEO of Alstom Group, and Deputy CEO and Board Secretary of Xi'an Shaangu Power Co. |
| **Liu Chunhai** | Deputy CEO | Has previously served as Director of the Company, currently serves as Deputy CEO |
| **Qiu Xiangmin** | Board Secretary | Has served as the Deputy Director of Finance Department of Raw milk division, Deputy Director of Finance Department of Liquid Milk Division, Deputy Director of Presidents Assistant Office. |

*Source: Company website, BOCOM Int'l*

**Figure 134: Inner Mongolia Yili Industrial Group (600887 CH) TP & rating**




*Source: FactSet, BOCOM Int'l estimates*

## Financial Statements

**Income statement (RMB m)**

| Y/E 31 Dec | 2021 | 2022 | 2023E | 2024E | 2025E |
|---|---|---|---|---|---|
| Revenue | 110,595 | 123,171 | 133,629 | 148,450 | 162,519 |
| COGS | (76,417) | (83,119) | (89,069) | (98,060) | (106,413) |
| **Gross profit** | **34,178** | **40,052** | **44,560** | **50,389** | **56,106** |
| SG&A | (23,542) | (28,251) | (31,089) | (34,495) | (37,728) |
| R&D | (601) | (822) | (891) | (990) | (1,084) |
| Other operating income, net | 0 | 0 | 0 | 0 | 0 |
| **Operating profit** | **10,036** | **10,980** | **12,580** | **14,904** | **17,295** |
| Net finance expenses | 29 | 255 | 812 | 838 | 864 |
| Other non-op. income, net | 48 | (604) | (834) | (923) | (1,008) |
| **Pre-tax profit** | **10,112** | **10,630** | **12,558** | **14,820** | **17,151** |
| Tax | (1,380) | (1,312) | (1,633) | (1,927) | (2,230) |
| Non-controlling interests | (27) | 113 | 132 | 156 | 181 |
| **Net profit** | **8,705** | **9,431** | **11,058** | **13,049** | **15,102** |
| Net profit for EPS calculation | 8,705 | 9,431 | 11,058 | 13,049 | 15,102 |

**Balance sheet (RMB m)**

| As of 31 Dec | 2021 | 2022 | 2023E | 2024E | 2025E |
|---|---|---|---|---|---|
| Cash & cash equiv | 31,742 | 33,853 | 35,639 | 41,995 | 49,094 |
| Marketable securities | 37 | 30 | 30 | 30 | 30 |
| Acc & bills receivable | 2,233 | 3,450 | 3,914 | 4,535 | 5,173 |
| Inventories | 8,917 | 14,836 | 15,889 | 17,483 | 18,963 |
| PUD and land/lease prepayments | 1,520 | 1,834 | 2,096 | 2,447 | 2,809 |
| ST income receivables | 0 | 0 | 0 | 0 | 0 |
| Other current assets | 5,705 | 7,460 | 7,460 | 7,460 | 7,460 |
| **Total current assets** | **50,155** | **61,463** | **65,029** | **73,950** | **83,529** |
| Investment properties | 508 | 612 | 612 | 612 | 612 |
| PPE | 29,379 | 33,735 | 38,332 | 39,515 | 40,734 |
| Other tangible assets | 5,513 | 5,219 | 5,219 | 5,219 | 5,219 |
| Intangible assets | 1,609 | 4,648 | 4,741 | 4,836 | 4,933 |
| Investment in associates/JCE | 4,210 | 4,563 | 4,563 | 4,563 | 4,563 |
| Long-term income receivables | 0 | 0 | 0 | 0 | 0 |
| Other non-current assets | 10,589 | 20,726 | 20,726 | 20,726 | 20,726 |
| **Total non-current assets** | **51,807** | **69,502** | **74,191** | **75,469** | **76,785** |
| **Total assets** | **101,962** | **130,965** | **139,221** | **149,420** | **160,314** |
| Short-term loans | 12,596 | 26,799 | 28,943 | 31,259 | 33,760 |
| Trade and other payables | 20,745 | 23,603 | 24,984 | 27,061 | 28,992 |
| Other current liabilities | 9,955 | 11,767 | 11,928 | 12,128 | 12,333 |
| **Total current liabilities** | **43,296** | **62,170** | **65,855** | **70,448** | **75,085** |
| Long-term loans | 5,380 | 9,298 | 9,763 | 10,056 | 10,358 |
| Long-term payables | 3,188 | 3,482 | 3,831 | 3,945 | 4,064 |
| Other non-current liabilities | 1,307 | 1,872 | 1,867 | 1,867 | 1,867 |
| **Total non-current liabilities** | **9,875** | **14,653** | **15,461** | **15,869** | **16,289** |
| **Total liabilities** | **53,171** | **76,822** | **81,316** | **86,317** | **91,374** |
| Share capital | 6,400 | 6,399 | 6,399 | 6,399 | 6,399 |
| Reserves & other capital items | 41,308 | 43,869 | 47,499 | 52,697 | 58,534 |
| **Shareholders' equity** | **47,708** | **50,269** | **53,898** | **59,096** | **64,933** |
| Financial instruments classified as equity | 0 | 0 | 0 | 0 | 0 |
| Non-controlling interests | 1,083 | 3,874 | 4,007 | 4,007 | 4,007 |
| **Total equity** | **48,791** | **54,143** | **57,905** | **63,103** | **68,940** |

**Cash flow (RMB m)**

| Y/E 31 Dec | 2021 | 2022 | 2023E | 2024E | 2025E |
|---|---|---|---|---|---|
| Pre-tax profit | 8,732 | 9,318 | 10,926 | 12,893 | 14,921 |
| Depreciation & amortisation | 3,284 | 3,933 | 4,633 | 5,192 | 5,342 |
| Change in working capital | 2,180 | (2,013) | (80) | (47) | (101) |
| Interest inc/exp adjustment | 826 | 1,377 | (812) | (838) | (864) |
| Other operating cashflow | 506 | 806 | (11) | (66) | (41) |
| **Cash flow from operation** | **15,528** | **13,420** | **14,656** | **17,135** | **19,257** |
| Capex | (6,683) | (6,646) | (9,343) | (6,490) | (6,677) |
| Investment | (657) | (6,225) | 0 | 0 | 0 |
| Other investing cashflow | (457) | (6,643) | 0 | 0 | 0 |
| **Cash flow from investing** | **(7,797)** | **(19,514)** | **(9,343)** | **(6,490)** | **(6,677)** |
| Net chg in interest-bearing debt | 4,981 | 16,670 | 2,957 | 2,723 | 2,921 |
| Net change in equity | 12,255 | 166 | 0 | 0 | 0 |
| Dividends paid | (5,693) | (7,500) | (5,819) | (7,013) | (8,401) |
| Other financing cashflow | 402 | (555) | 0 | 0 | 0 |
| **Cash flow from financing** | **11,945** | **8,781** | **(2,862)** | **(4,290)** | **(5,480)** |
| Exchange gain/loss | 371 | (577) | (665) | 0 | 0 |
| **Cash & cash equiv. at year start** | **11,695** | **31,742** | **33,853** | **35,639** | **41,995** |
| **Cash & cash equiv. at year end** | **31,742** | **33,853** | **35,639** | **41,995** | **49,094** |

**Financial ratio**

| Y/E 31 Dec | 2021 | 2022 | 2023E | 2024E | 2025E |
|---|---|---|---|---|---|
| **Per share data (RMB)** | | | | | |
| Core EPS | 1.360 | 1.474 | 1.728 | 2.039 | 2.360 |
| Fully-diluted EPS | 1.360 | 1.474 | 1.728 | 2.039 | 2.360 |
| Non-GAAP EPS | 0.000 | 0.000 | 0.000 | 0.000 | 0.000 |
| DPS | 0.960 | 1.036 | 1.227 | 1.448 | 1.676 |
| BVPS | 7.454 | 7.856 | 8.423 | 9.235 | 10.148 |
| **Margin analysis (%)** | | | | | |
| Gross margin | 30.9 | 32.5 | 33.3 | 33.9 | 34.5 |
| EBITDA margin | 12.0 | 12.1 | 12.9 | 13.5 | 13.9 |
| EBIT margin | 9.1 | 8.9 | 9.4 | 10.0 | 10.6 |
| Net margin | 7.9 | 7.7 | 8.3 | 8.8 | 9.3 |
| **Profitability analysis (%)** | | | | | |
| ROA | 10.1 | 8.1 | 8.2 | 9.0 | 9.8 |
| ROE | 22.3 | 19.3 | 21.2 | 23.1 | 24.4 |
| ROIC | 20.5 | 17.8 | 15.1 | 16.9 | 19.4 |
| **Others** | | | | | |
| Net debt to equity ratio (%) | Net Cash | 4.1 | 5.3 | Net Cash | Net Cash |
| EBITDA/gross interest expenses (x) | 16.5 | 15.5 | 16.6 | 18.2 | 19.3 |
| Current ratio (x) | 1.2 | 1.0 | 1.0 | 1.0 | 1.1 |
| Inventory turnover (days) | 43.3 | 66.1 | 66.1 | 66.1 | 66.1 |
| Acc receivable turnover (days) | 6.6 | 9.3 | 9.8 | 10.3 | 10.8 |
| Acc payable turnover (days) | 66.4 | 71.0 | 71.0 | 71.0 | 71.0 |

*Source: Company data, BOCOM Int'l estimates*

| Consumer | Last Close | Target Price | Upside |
|---|---|---|---|
| | HK$ 27.95 | HK$ 37.10 | +32.7% |

9 August 2023

# China Mengniu Dairy (2319 HK)

## Well-balanced dairy conglomerate with entrenched competitive advantage

- **Well-balanced team that can both defend (UHT milk)…** We like Mengniu ("MN") for its diversified product portfolio that balances defensiveness with growth. It has a defensive duopoly position (43% share vs. 44% for rival Yili) in **UHT milk**, the largest segment in China's dairy industry. Star UHT product Milk Deluxe accounted for c.32% of MN's sales and grew at an 18% CAGR in 2017-22 (+low-teen % in 2022).
- **…and attack (fresh milk, ice-cream, cheese):** On the other hand, MN has also positioned itself strongly in future categories like **fresh milk,** where MN's sales grew 30% YoY in 2022. Mengniu's 30%-owned **Shengmu** (1432 HK/NR) supplies it with premium organic fresh milk that fetches 40-140% retail price premium over competing products. Fresh milk is a segment that we expect to grow strongly given consumers' rising health awareness and cold-chain logistics development. Similarly, ice-cream will also grow strongly (MN's sales +33% YoY in 2022), where MN's partnership with **Moutai** has lifted its brand positioning. While cheese is a soft spot this year given its discretionary consumption nature amid a lackluster spending environment, MN has secured its leadership early at the nascent stage of cheese's development in China via its 35%-owned **Milkground** (600882 CH/**Neutral**).
- **More focus on profitability, than sales growth, in the long-run.** MN mgmt has earlier guided 2023 sales to grow by double-digit % YoY (or organic growth of mid-to-high-single digit, before Milkground consolidation), although weakness in 2Q23 could spell downside risk to this. Despite sales headwinds, mgmt seems confident in its OPM guidance of 30-50bps rise (it gave a similar OPM guidance last year, and over-delivered with 75bps expansion). We expect this year's GPM to benefit from raw milk price decline (market -6% YoY, Modern Dairy (1177 HK/NR) -4%) and a benign pricing competition, slightly offset by increased SD&A given increased marketing upon reopening. In the long-term, margin should rise from better category mix, premiumization and efficiency gains in sales channel and digital capabilities.
- **Initiate with Buy and TP of HK$37.1:** We expect MN's sales/net profit to grow by 13%/17% CAGR over 2023-25E. Our 2023-25E EPS are above consensus by 1-3%, on higher sales and margins. Our TP of HK$37.1 is based on 17.3x 2024E P/E, derived from 1.0x PEG on our 3-year EPS CAGR of 17.3% (2022-25E).

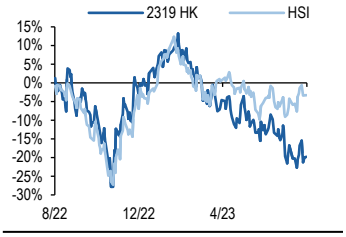
### Financial highlights

| Y/E 31 Dec | 2021 | 2022 | 2023E | 2024E | 2025E |
|---|---|---|---|---|---|
| Revenue (RMB m) | 88,141 | 92,593 | 105,443 | 116,465 | 133,333 |
| YoY growth (%) | 15.9 | 5.1 | 13.9 | 10.5 | 14.5 |
| Net profit (RMB m) | 5,026 | 5,303 | 6,404 | 7,343 | 8,554 |
| EPS (RMB) | 1.27 | 1.34 | 1.62 | 1.86 | 2.16 |
| YoY growth (%) | 42.0 | 5.3 | 20.8 | 14.7 | 16.5 |
| P/E (x) | 20.2 | 19.2 | 15.9 | 13.8 | 11.9 |
| BVPS (RMB) | 9.34 | 10.19 | 11.38 | 12.72 | 14.30 |
| P/B (x) | 2.75 | 2.52 | 2.26 | 2.02 | 1.80 |
| Dividend yield (%) | 1.5 | 1.6 | 1.9 | 2.2 | 2.5 |

*Source: Company data, BOCOM Int'l estimates*

### Stock Rating
**BUY**

### 1-year stock performance




*Source: FactSet*

### Stock data

| | |
|---|---|
| 52w high (HK$) | 39.45 |
| 52w low (HK$) | 25.15 |
| Market cap (HK$ m) | 109,995.83 |
| Avg daily vol (m) | 5.33 |
| YTD change (%) | (21.05) |
| 200d MA (HK$) | 32.38 |

*Source: FactSet*

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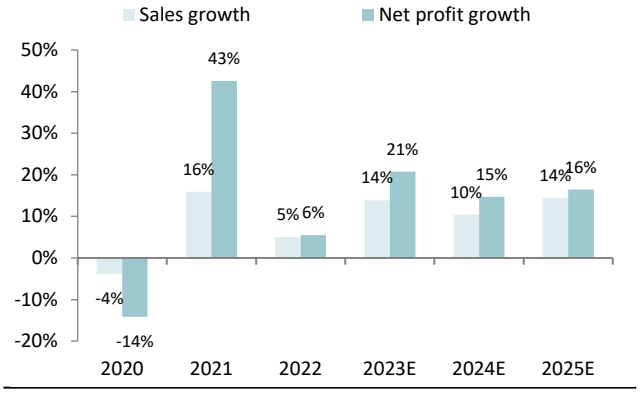
**Kay Tan**, FRM
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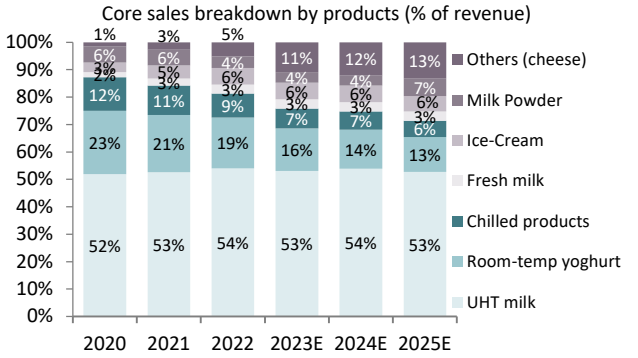
## Company at a Glance

**Figure 135: Mengniu: Sales and net profit growth**



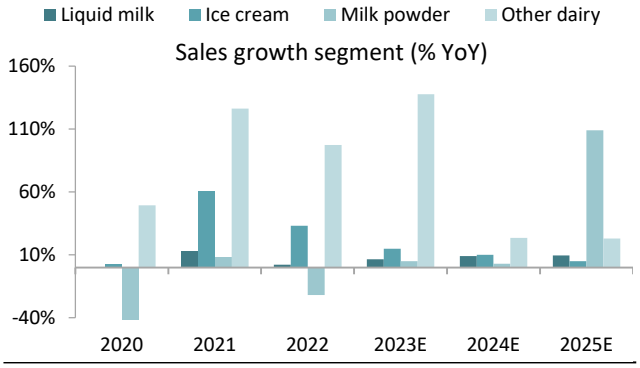

*Source: Company data, BOCOM Int'l estimates*

**Figure 136: Mengniu: Sales breakdown by product**



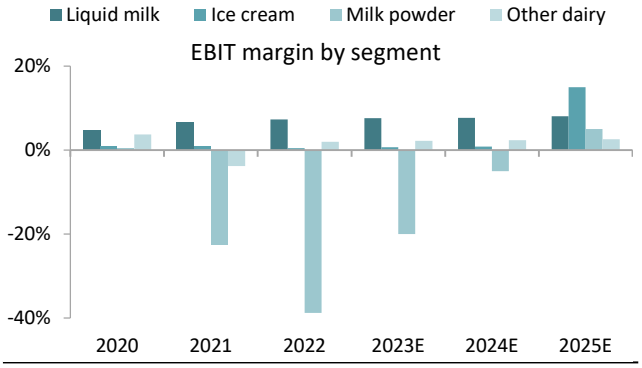

*Source: Company data, BOCOM Int'l estimates*

**Figure 137: Mengniu: Sales growth by segment**



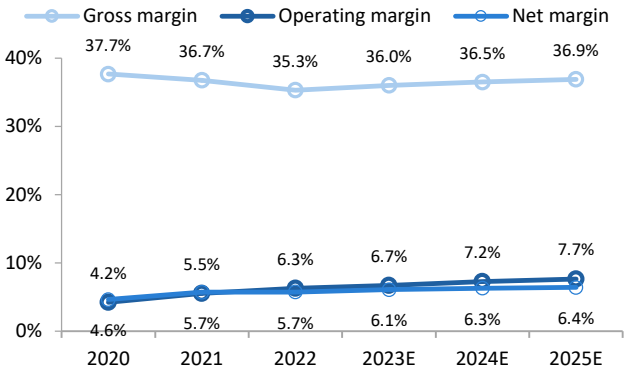

*Source: Company data, BOCOM Int'l estimates*

**Figure 138: Mengniu: EBIT margin by segment**



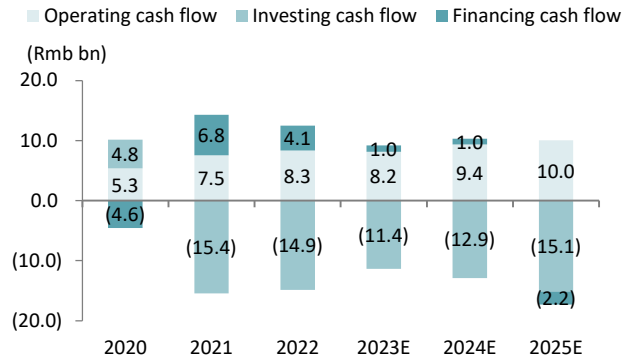

*Source: Company data, BOCOM Int'l estimates*

**Figure 139: Mengniu: Margin trends**




*Source: Company data, BOCOM Int'l estimates*

**Figure 140: Mengniu: Cash flow**




*Source: Company data, BOCOM Int'l estimates*

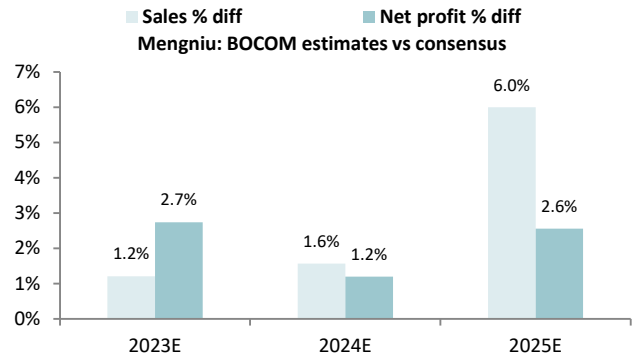
# Valuation

## Initiate with Buy and TP of HK$37.1 (33% upside)

We initiate coverage on Mengniu with a **Buy** rating and a TP of HK$37.1, based on 17.3x P/E on our 2024E EPS. Our target P/E multiple is derived from 1.0x PEG to our EPS CAGR (2023-25E) of 17.3%. We find this PEG reasonable relative to China dairy peers and is consistent with what we use for peer Yili.

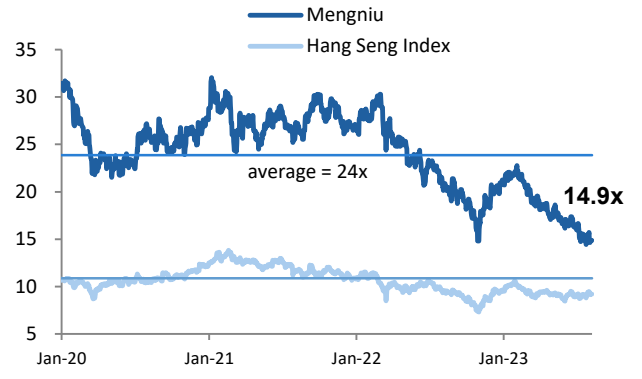
**Downside risks:** (1) Weaker-than-expected demand; (2) higher-than-expected raw milk cost increase leading to GPM pressure; (3) fierce competition leading to irrational price competition and GPM pressure; (4) food safety issues.

**Figure 141: Mengniu: BOCOM vs. consensus**




*Source: Bloomberg consensus, BOCOM Int'l estimates*

**Figure 142: Mengniu: forward P/E**



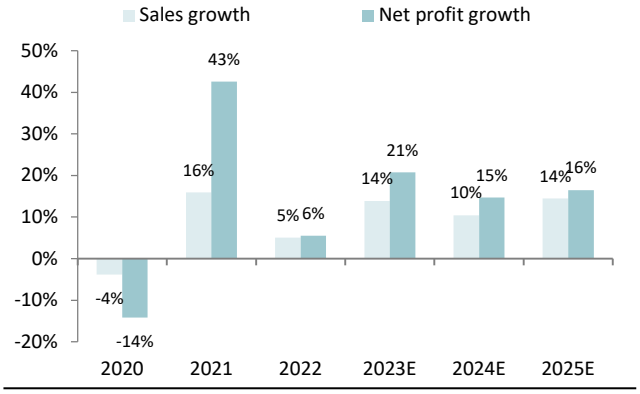

*Source: Bloomberg consensus, BOCOM Int'l*

## Financial forecast

**Sales and EPS forecast**: We forecast sales/EPS growth of 13%/17% CAGR for the next 3 years (2023-25E), driven by an average 43bps expansion of OPM per year in the next 3 years on the back of 53bps GPM improvement per year, helped by decline in raw milk price, better category mix, premiumization and efficiency gains in sales channel and digital capabilities.

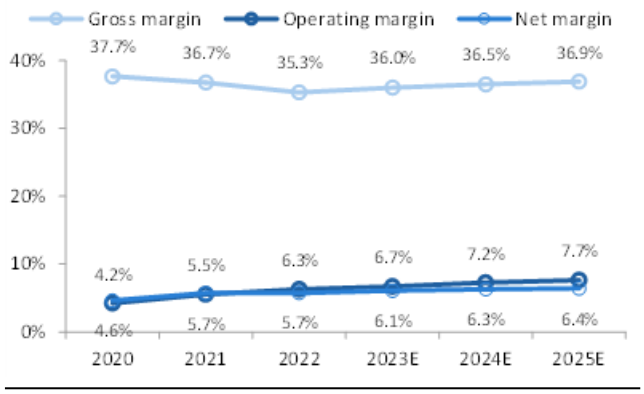
**2023 guidance:** Management has guided for mid-to-high single-digit sales growth organically, or double-digit sales growth including Milkground consolidation (since Dec'22) in 2023. Margin-wise, Mengniu is guiding for 30-50bps OPM expansion. Our forecast is in-line, forecasting 13.6% sales growth (or 8.0% YoY excluding Milkground). We are expecting OPM to expand 34bps in 2023.

**Figure 143: Sales and net profit growth**




*Source: Company data, BOCOM Int'l estimates*

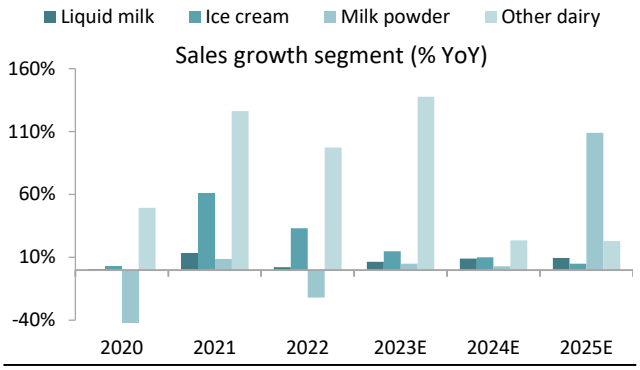
**Figure 144: Margin trend**




*Source: Company data, BOCOM Int'l estimates*

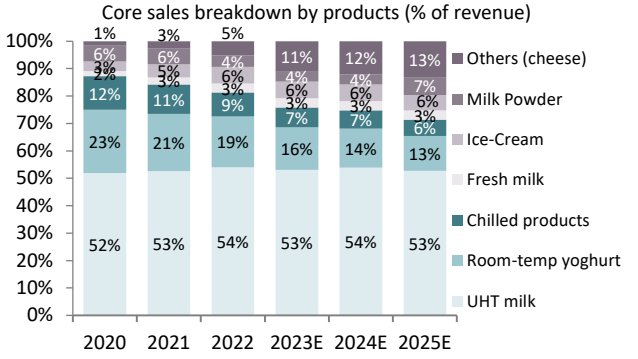
**By segment sales forecast:** By product, we expect **UHT milk** (>50% of sales) to remain stable, growing at a 12% CAGR for the next 3 years, helped by resumption of gifting demand in 2023 which should help Milk Deluxe. We also expect **fresh milk** business to grow at a 15% CAGR for the next 3 years, although it should remain small at 3% of sales. We expect weaker growth for **yoghurt** (declined by 5% in 2023, before stabilizing in 2024). We are forecasting **baby food** sales to grow at a single-digit CAGR. **Cheese business** (under "Other dairy") should also increase in contribution after consolidating Milkground.

**Figure 145: Sales growth by segment**




*Source: Company data, BOCOM Int'l estimates*

**Figure 146: Sales breakdown by segment/product**




*Source: Company data, BOCOM Int'l estimates*

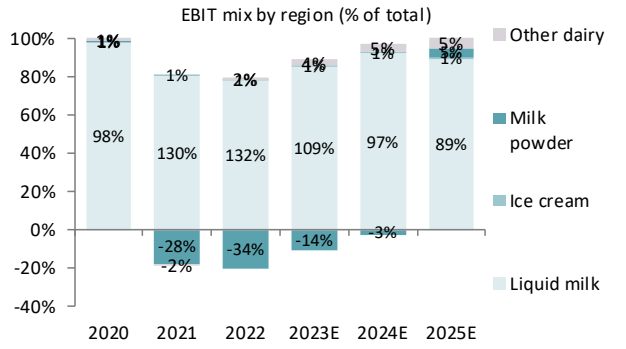
### Figure 147: Mengniu: Sales by segment breakdown

| | 2020 | 2021 | 2022 | 2023E | 2024E | 2025E |
|---|---|---|---|---|---|---|
| **Sales (RMB m)** | | | | | | |
| Liquid Milk | 67,751 | 76,514 | 78,269 | 83,456 | 91,001 | 99,700 |
| - Room-temp products | 57,001 | 64,764 | 67,237 | 72,375 | 79,403 | 87,278 |
| - Chilled products | 9,300 | 9,450 | 8,033 | 7,631 | 7,631 | 7,860 |
| - Fresh milk | 1,450 | 2,300 | 3,000 | 3,450 | 3,968 | 4,563 |
| Ice-Cream | 2,633 | 4,240 | 5,652 | 6,500 | 7,150 | 7,508 |
| Milk Powder | 4,573 | 4,949 | 3,862 | 4,055 | 4,177 | 8,726 |
| Others (e.g. cheese) | 1,077 | 2,438 | 4,810 | 11,432 | 14,137 | 17,400 |
| **Total sales** | **76,034** | **88,141** | **92,593** | **105,443** | **116,465** | **133,333** |
| **Growth (% YoY)** | | | | | | |
| Liquid Milk | 0% | 13% | 2% | 7% | 9% | 10% |
| - Room-temp products | 0% | 14% | 4% | 8% | 10% | 10% |
| - Chilled products | -7% | 2% | -15% | -5% | 0% | 3% |
| - Fresh milk | 93% | 59% | 30% | 15% | 15% | 15% |
| Ice-Cream | 3% | 61% | 33% | 15% | 10% | 5% |
| Milk Powder | -42% | 8% | -22% | 5% | 3% | 109% |
| Others (eg, cheese) | 49% | 126% | 97% | 138% | 24% | 23% |
| **Total** | **-3%** | **16%** | **5%** | **14%** | **10%** | **14%** |
| **Sales mix (% of total)** | | | | | | |
| Liquid Milk | 89% | 87% | 85% | 79% | 78% | 75% |
| - Room-temp products | 75% | 73% | 73% | 69% | 68% | 66% |
| - Chilled products | 12% | 11% | 9% | 7% | 7% | 6% |
| - Fresh milk | 2% | 3% | 3% | 3% | 3% | 3% |
| Ice-Cream | 3% | 5% | 6% | 6% | 6% | 6% |
| Milk Powder | 6% | 6% | 4% | 4% | 4% | 7% |
| Others (eg, cheese) | 1% | 3% | 5% | 11% | 12% | 13% |
| Total | 100% | 100% | 100% | 100% | 100% | 100% |

*Source: Company, BOCOM Int'l estimates*

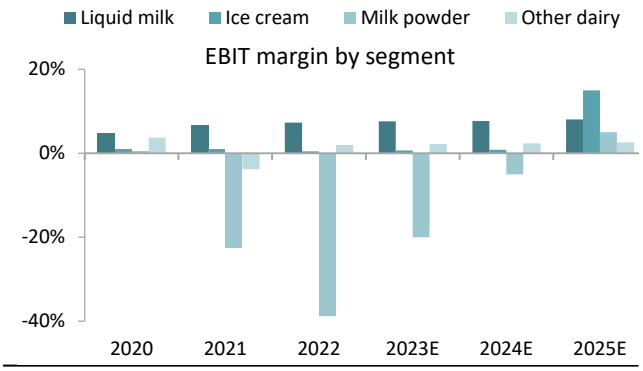
**EBIT by segment:** Liquid milk should contribute the bulk of profit in our forecast period. We expect the losses for the milk powder business to have peaked in 2022, and to narrow going forward, although we expect it to remain a drag on profitability in 2023. We also expect ice-cream and other dairy (mostly cheese) to contribute increasing profit.

**Figure 148: Mengniu: EBIT mix by segment**




*Source: Company data, BOCOM Int'l estimates*

**Figure 149: Mengniu: EBIT margin by segment**




*Source: Company data, BOCOM Int'l estimates*

**Figure 150: Mengniu: EBIT breakdown by segment**

| | 2020 | 2021 | 2022 | 2023E | 2024E | 2025E |
|---|---|---|---|---|---|---|
| **EBIT (RMB m)** | | | | | | |
| Liquid Milk | 3,193 | 5,090 | 5,721 | 6,282 | 6,911 | 7,891 |
| Ice-Cream | 24 | 38 | 26 | 43 | 61 | 79 |
| Milk Powder | 17 | -1,114 | -1,499 | -811 | -209 | 436 |
| Others (eg, cheese) | 40 | -93 | 96 | 246 | 329 | 439 |
| Segment EBIT | 3,273 | 3,921 | 4,345 | 5,759 | 7,093 | 8,846 |
| Total EBIT | 3,216 | 4,891 | 5,833 | 6,988 | 8,322 | 10,075 |
| | | | | | | |
| **EBIT margin (%)** | | | | | | |
| Liquid Milk | 4.7% | 6.7% | 7.3% | 7.5% | 7.6% | 7.9% |
| Ice-Cream | 0.9% | 0.9% | 0.5% | 0.7% | 0.9% | 1.1% |
| Milk Powder | 0.4% | -22.5% | -38.8% | -20.0% | -5.0% | 5.0% |
| Others (eg, cheese) | 3.7% | -3.8% | 2.0% | 2.2% | 2.4% | 2.6% |
| Core EBIT margin | 4.3% | 4.4% | 4.7% | 5.5% | 6.2% | 6.7% |
| Total EBIT margin | 4.2% | 5.5% | 6.3% | 6.6% | 7.2% | 7.6% |
| | | | | | | |
| **EBIT mix (% of total)** | | | | | | |
| Liquid Milk | 98% | 130% | 132% | 109% | 97% | 89% |
| Ice-Cream | 1% | 1% | 1% | 1% | 1% | 1% |
| Milk Powder | 1% | -28% | -34% | -14% | -3% | 5% |
| Others (eg, cheese) | 1% | -2% | 2% | 4% | 5% | 5% |
| Total | 100% | 100% | 100% | 100% | 100% | 100% |

*Source: Company, BOCOM Int'l estimates*

# Investment positives

## Positive #1: Diversified product portfolio that balances defensiveness with growth

We like Mengniu for having a well-balanced team that can both defend (UHT milk) and attack (fresh milk, ice-cream, cheese). It has a defensive duopoly position (43% share vs. 44% for rival Yili) in UHT milk, the largest segment in China's dairy industry, where Mengniu's dominance is supported by its star UHT product Milk Deluxe, which has a sales scale of RMB30bn, accounting for c.32% of MN's 2022 sales and still growing at a double-digit pace despite its large size (18% CAGR from 2017-22, grew by low-teen % YoY in 2022).

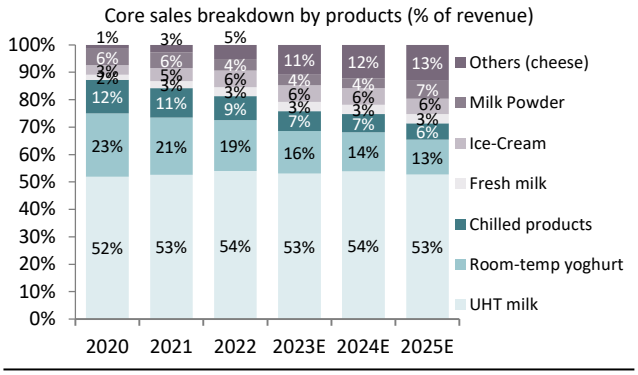
On the other hand, MN has also positioned itself strongly in future categories like fresh milk, where MN's sales grew by 30% YoY in 2022. Mengniu's 30%-owned **Shengmu** (1432 HK/NR) supplies it with premium organic fresh milk that fetches 40-140% retail price premium over competing products. Fresh milk is a segment that we expect to grow strongly given consumers' rising health awareness and cold-chain logistics development.

Similarly, ice-cream will also grow strongly (MN's ice-cream sales +33% YoY in 2022) as disposable income continues to rise and premiumization trend is apparent, where MN's partnership with Moutai has lifted its brand positioning and is successfully tapping into consumers' desire for premium ice-cream.

While cheese is a soft spot this year given its discretionary consumption nature amid a lackluster spending environment, MN has secured its leadership early at the nascent stage of cheese's development in China via its 35%-owned Milkground.

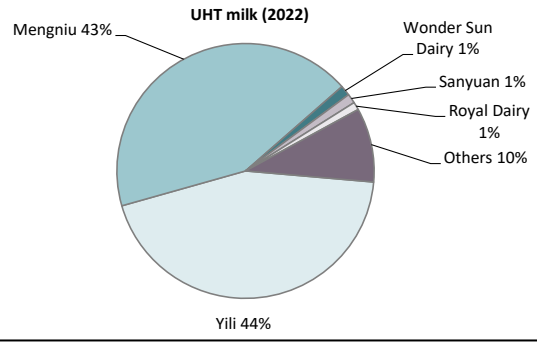
We think Mengniu's ability to defend with its resilient dominance in liquid milk during cyclical market weakness, while on the other hand, tap into the growth of emerging categories in fresh milk, cheese and ice-cream in the long-run, makes it an attractive investment holding.

**Figure 151: Mengniu: Sales breakdown by product**




*Source: Company data, BOCOM Int'l estimates*

**Figure 152: Mengniu and Yili make up an entrenched duopoly in UHT milk in China**




*Source: Euromonitor, BOCOM Int'l*

**Figure 153: Market share ranking in various dairy sub-sectors**

| Dairy sub-setors | % of dairy market (2022) | Yili | Mengniu | Bright | Milkground | H&H | Feihe |
|---|---|---|---|---|---|---|---|
| UHT milk | 30.6 | 1st | 2nd | 13th | | | |
| Fresh milk | 7.5 | 6th | 2nd | 1st | | | |
| Yoghurt | 20.2 | 1st | 2nd | 3rd | | | |
| Ice-cream | 7.9 | 1st | 3rd | | | | |
| Cheese | 2.1 | 3rd | 1st* | | 1st | | |
| Infant milk formula | 25.0 | 2nd | 13th | | | 8th | 1st |
| Adult milk formula | 3.5 | 1st | 3rd | | | | 5th |

*Source: AC Nielsen, Euromonitor, Company data*

**Figure 154: Mengniu's acquisition of Milkground makes it a leader in the cheese segment, which is expected to grow by 13% 2023-25E CAGR**



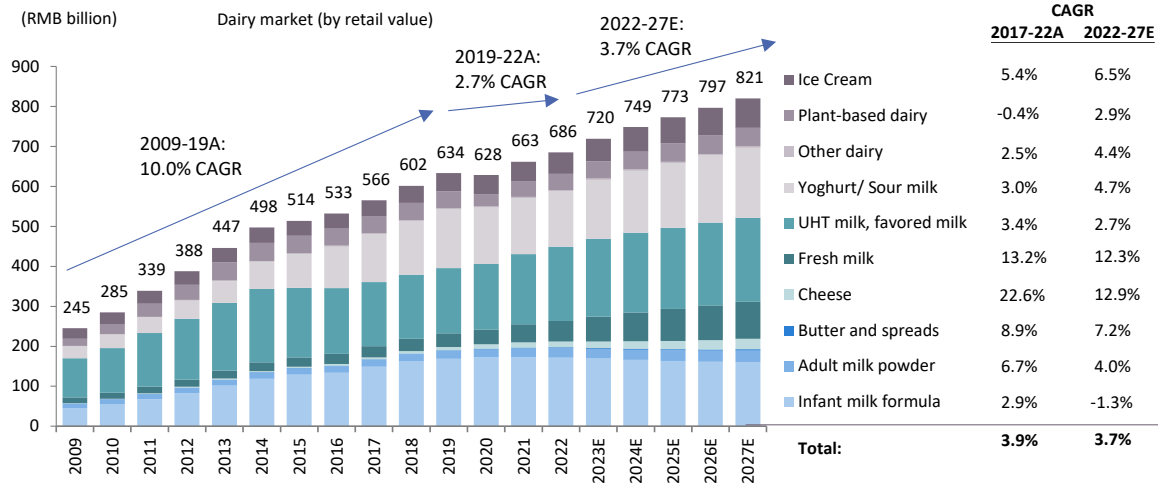
*Source: BOCOM Int'l (photo taken from a supermarket in Shenzhen in May 2023)*

**Figure 155: Mengniu's ice-cream profitability is improving. Its partnership with Moutai allows it to ride on the ice-cream premiumization trend**



*Source: China Daily, BOCOM Int'l*

**Figure 156: China's dairy industry is expected to grow by 3.7% CAGR in the next five years, but certain segments are expected to post faster growth, e.g. cheese (13%), fresh milk (12%) and ice-cream (6%)**




| | CAGR 2017-22A | CAGR 2022-27E |
|---|---|---|
| Ice Cream | 5.4% | 6.5% |
| Plant-based dairy | -0.4% | 2.9% |
| Other dairy | 2.5% | 4.4% |
| Yoghurt/ Sour milk | 3.0% | 4.7% |
| UHT milk, favored milk | 3.4% | 2.7% |
| Fresh milk | 13.2% | 12.3% |
| Cheese | 22.6% | 12.9% |
| Butter and spreads | 8.9% | 7.2% |
| Adult milk powder | 6.7% | 4.0% |
| Infant milk formula | 2.9% | -1.3% |
| **Total:** | **3.9%** | **3.7%** |

*Source: Euromonitor estimates, BOCOM Int'l Research*

## Positive #2: Long-term margin to rise in mix of higher-margin products and higher-margin categories

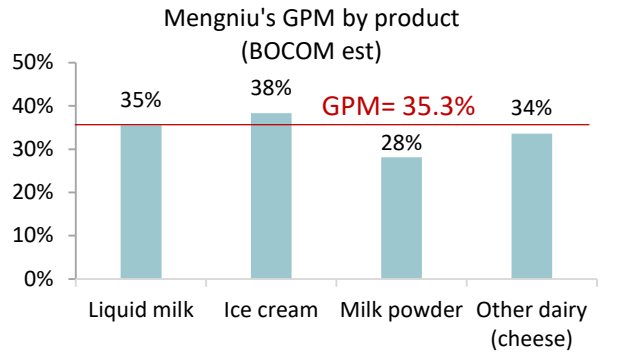
**Mengniu is guiding for 30-50bps OPM improvement for a few years, with a track record where it over-delivered (e.g. OPM rose by 75bps in 2022).** Management has made clear its focus on "high quality growth", i.e. focusing their effort on improving profitability and would not blindly chase after sales expansion. During Mengniu's 2022 annual results briefing, management gave out its 2023 operating margin (OPM) guidance of 30-50bps increase for 2023, despite only guiding a relatively modest sales growth of mid-to-high single-digit % YoY (or double-digit % YoY including Milkground consolidation), which had taken into account a relatively slower retail sales recovery environment in early 2023. The fact that management was confident in its OPM guidance despite the sales softness suggests that Mengniu's margin improvement can be achieved on its own, rather than dependent on external circumstances.

**Margin improvement depends on Three keys:** Management said its OPM improvement would be driven by (1) better category mix, (2) premiumization and (3) efficiency gains, including in channel (diversifying to online channels), sales and digital capabilities.

In terms of premiumization, Mengniu has shown its success in creating star, premium brands within each category (e.g. Milk Deluxe in UHT, and Shiny Meadow in fresh milk).

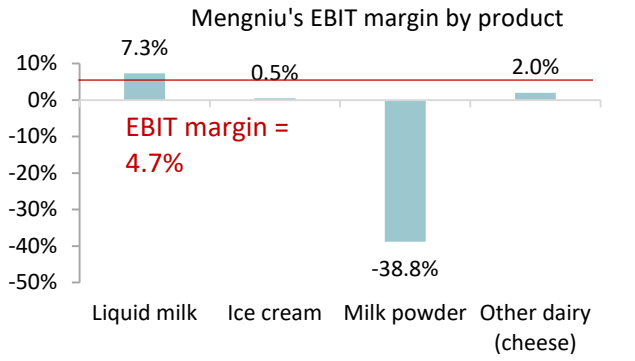
**Margins is the highest for leading brands, e.g. Milk Deluxe and Shiny Meadow:** Margins can vary slightly across segments, but the biggest difference actually exist within the same product category between high-end series (e.g. Milk Deluxe, Shiny Meadow) and basic product series, with a GPM differential of up to 10-20ppt, which are more important in determining the margin of a category.

**Figure 157: Mengniu: GPM margin by segment (BOCOM estimate, 2022)**




*Source: BOCOM Int'l estimates*

**Figure 158: Mengniu: EBIT margin by segment (reported, 2022)**




*Source: Company, BOCOM Int'l*

**Milk Deluxe is Mengniu's biggest single brand, with high margins:** Milk Deluxe's sales reached around RMB30bn in 2022, accounting for a third of Mengniu's sales, making it by far the largest single brand contribution. Milk Deluxe started off as a high-end, differentiated product. In 2005, the national standard for milk protein content was 2.9g, and no dairy producer had thought of surpassing this standard, so Mengniu launched Milk Deluxe with 3.3g milk protein as a key differentiation. In 2008, the concept of organic milk was gradually being recognized by consumers, and Milk Deluxe launched its first organic milk. At present, the brand's product line covers pure milk, skim milk, organic milk, grain milk, high-calcium milk and other categories. In 2022, Deluxe also launched its Desert Organic Pure Milk, sourced from organic dairy farm Shengmu, in its continuous drive to create more high-end products, which also includes differentiated UHT milk products that include CPB high-calcium pure milk, 3.6g protein and low fat. Mengniu's Milk Deluxe has also developed into a popular gifting idea for family and friends during festivities, e.g. Chinese New Year and Mid-autumn festival, and we expect China's reopening this year could spur a rebound in gifting demand.

**Fresh milk business continues to gain share under Shiny Meadow, sub-brand Xiaoxianyu and Modern Meadow brands, and is growing via sales channel expansion:** Mengniu is also rapidly developing its fresh milk business, which turned profitable in 2021 with improved margins in 2022. Its fresh milk is marketed under its higher-end Shiny Meadow brand and more mass market Modern Dairy brand, which we estimate to have a sales scale of RMB3bn in 2022 with about 30% YoY growth. Mengniu ranks first in China in the premium segment of fresh milk. Shiny Meadow also launched a sub-brand, Xiaoxianyu (小鲜语) in June 2022, targeting youngsters with its unique selling point of yummy light fresh milk, mainly sold via the **convenience stores channel**, which grew strongly and increased share. In 2022, when supply chain was disrupted during the pandemic, Mengniu partnered with **community group buying platforms** and expanded its sales in Eastern China, expanding its customer base in this competitive market where Bright Dairy dominated with c.70% market share. Mengniu also cooperated with Ovaltine, launching cocoa malt milk beverage and developed new business models through specialty channels such as **tea houses and cafes** to expand its customer base.

## Positive #3: Shengmu provides access to premium, organic milk supply for Mengniu's premiumization strategy

**Securing upstream access to premium milk (e.g. organic, jersey cattle) will be key to downstream players' premiumization drive:** Mengniu owns 30% stake in Shengmu (1432 HK/NR), which is the largest producer of organic milk in China, accounting for >30% of organic certification for raw milk and >40% of organic milk production in China, according to the China Food and Agricultural Product Certification Information System. This gives an advantage to Mengniu, which sources 90% of its organic milk from Shengmu, to have a steadier supply of organic milk to sell to end consumers. Shengmu's milk are used in Mengniu's higher-end products, e.g. Shiny Meadow fresh milk and Milk Deluxe Desert Organic Milk (UHT).

As can be seen in the table below, given Shengmu's premium quality milk, its COGS/unit and ASP are the highest amongst its peers, at RMB34.1/kg and RMB5.0/kg respectively. However, it also allows Mengniu to charge a retail price premium of 40-140% over competing products, using the example of its Milk Deluxe Desert Organic Milk, which retails for RMB10.0.

**Figure 159: Upstream dairy farm's raw milk business operating metrics (2022)**

| Raw milk sales | Sales (RMB m) | Volume (0,000 tones) | ASP (RMB/Kg) | COGS per Kg | Gross profit (RMB m) | GPM (%) |
|---|---|---|---|---|---|---|
| **2022 reported data** | | | | | | |
| Modern Dairy | 9,945 | 232.7 | 4.3 | 29.4 | 3,095 | 31.1% |
| Youran | 10,854 | 232.8 | 4.7 | 32.0 | 3,412 | 31.4% |
| Shengmu | 3,176 | 63.5 | 5.0 | 34.1 | 1,013 | 31.9% |
| **Growth (% YoY)** | | | | | | |
| Modern Dairy | 42.0% | 46.7% | -3.1% | 4.4% | 22.1% | -5.1 |
| Youran | 13.8% | 19.6% | -4.9% | 11.4% | -13.7% | -10.0 |
| Shengmu | 6.4% | 8.5% | -2.0% | 3.8% | -4.9% | -3.8 |

*Source: Companies, BOCOM Int'l Research*

**Figure 160: Product offering by segment – Liquid milk (UHT & fresh milk)**

| Company 公司 Ticker 股票代号 | Mengniu 蒙牛 2319 HK | | | | | Yili 伊利 600887 CH | | Bright Dairy 光明 600597 CH | | |
|---|---|---|---|---|---|---|---|---|---|---|
| UHT | | | | | | | | | | |
| Product series 产品系列 | Milk Deluxe 特仑苏 | Mengniu pure milk 蒙牛纯牛奶 | Student's Milk 蒙牛早餐奶 | Future Star 未来星 | Desert organic 沙漠有机牛奶 | Satine pure milk 金典纯牛奶 | Yili Pure Milk 伊利纯牛奶 | Zhi you 优加 | Bright Youji 光明有机 | Qiaofeng 巧风 |
| Price/ 250ml (Rmb) | 5.4 | 3.1 | 3.2 | 5.0 | 10.0 | 4.1 | 3.2 | 7.2 | 5.2 | 3.7 |
| 鲜奶 | | | | | | | | | | |
| Product series 产品系列 | Shiny Meadow 每日鲜语 | | Modern Meadow 现代牧场 | | | Satine fresh milk 金典鲜牛奶 | Yili fresh milk 伊利鲜牛奶 | Ubest 优倍 | Zhi you 致优 | Fresh pasture 新鲜牧场 |
| Price/ 250ml (Rmb) | 11.7 | | 4.9 | | | 8.3 | 6.3 | 2.8 | 11.8 | 7.5 |

*Source: tmall.com, BOCOM Int'l*

**Figure 161: Mengniu's high-end Shiny Meadow fresh milk usually retails at RMB20-30/950ml with a high GPM. It is sourced from EU-GAP certified farms with higher protein (3.6g/100ml) and calcium (120mg/100ml) content**




*Source: BOCOM Int'l (photo taken from a supermarket in Shenzhen in May 2023)*

**Figure 162: Mengniu's lower-end fresh milk brand Modern Meadow (left, RMB10/960ml) has ample competition with smaller brands, e.g. New Hope on the right with purple cap, which is also the 2nd largest shareholder in China Modern Dairy**




*Source: BOCOM Int'l (photo taken from a supermarket in Shenzhen in May 2023)*

**Figure 163: One of Mengniu's formidable competitors in fresh milk is Bright's Ubest, which is also available in premium, organic option and retails at RMB23.5/780ml**




*Source: BOCOM Int'l (photo taken from a supermarket in Shenzhen in May 2023)*

**Figure 164: Premium milk segment also has competition from smaller players, given the high margins. This one from ChenGuang markets itself as organic milk and retails at RMB32.8/960ml**

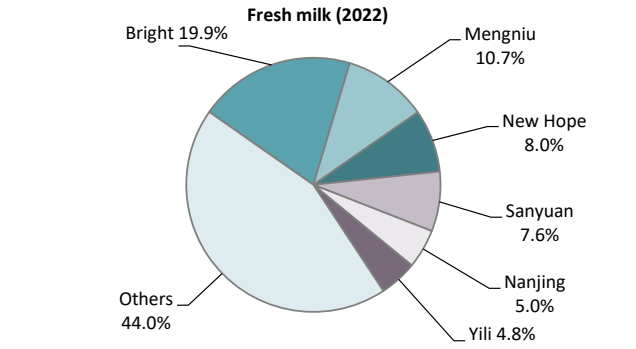



*Source: BOCOM Int'l (photo taken from a supermarket in Shenzhen in May 2023)*

## Positive #4: China Modern Dairy provides access to nationwide presence of dairy farm, to drive Mengniu's fresh milk strategy

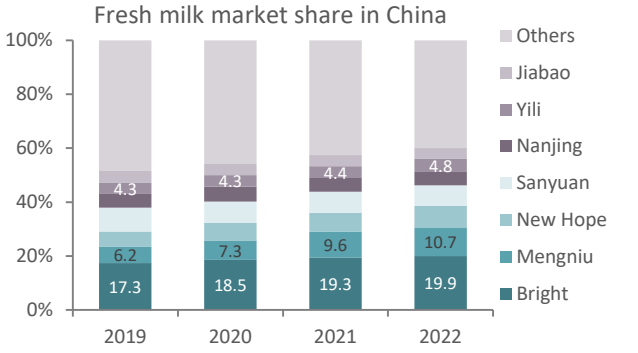
**Mengniu is fast gaining ground in the fresh milk segment:** Mengniu gained 4.5ppt market share in the past 3 years in the fresh milk category, to reach 10.7% in 2022, the most out of all competitors, closing in on Bright's 20% share (which gained a smaller 2.6ppt share in the same period). Mengniu is the only one of the big 3 dairy players to have seen sales growth in fresh milk in 2022, with about 30% YoY growth. Yili and Bright both saw sales decline in fresh milk given disruption to cold chain during the pandemic.

**Figure 165: Market share in fresh milk (2022)**




*Source: Euromonitor, BOCOM Int'l*

**Figure 166: Mengniu has gained the most market share in fresh milk market in the past 3 years**




*Source: Euromonitor, BOCOM Int'l*

**Dairy farm proximity a key for fresh milk distribution:** As discussed in our Dairy sector initiation, fresh milk remains underdeveloped in China. We think in order for fresh milk products to be available in lower tier cities, the key bottlenecks to be resolved are:

**(1) Short shelf life.** Fresh milk's shelf life is typically 5-7 days, or up to 15 days for fresh milk with newer pasteurization techniques. While cold chain can help partly resolve the logistical challenge of delivering them to lower tier cities, the long travel time means the shelf life would be cut even shorter when they are made available on shelves for consumers in lower tier cities. Cold chain also adds to the overall cost of the product, which affects the affordability for consumers and profitability for producers.

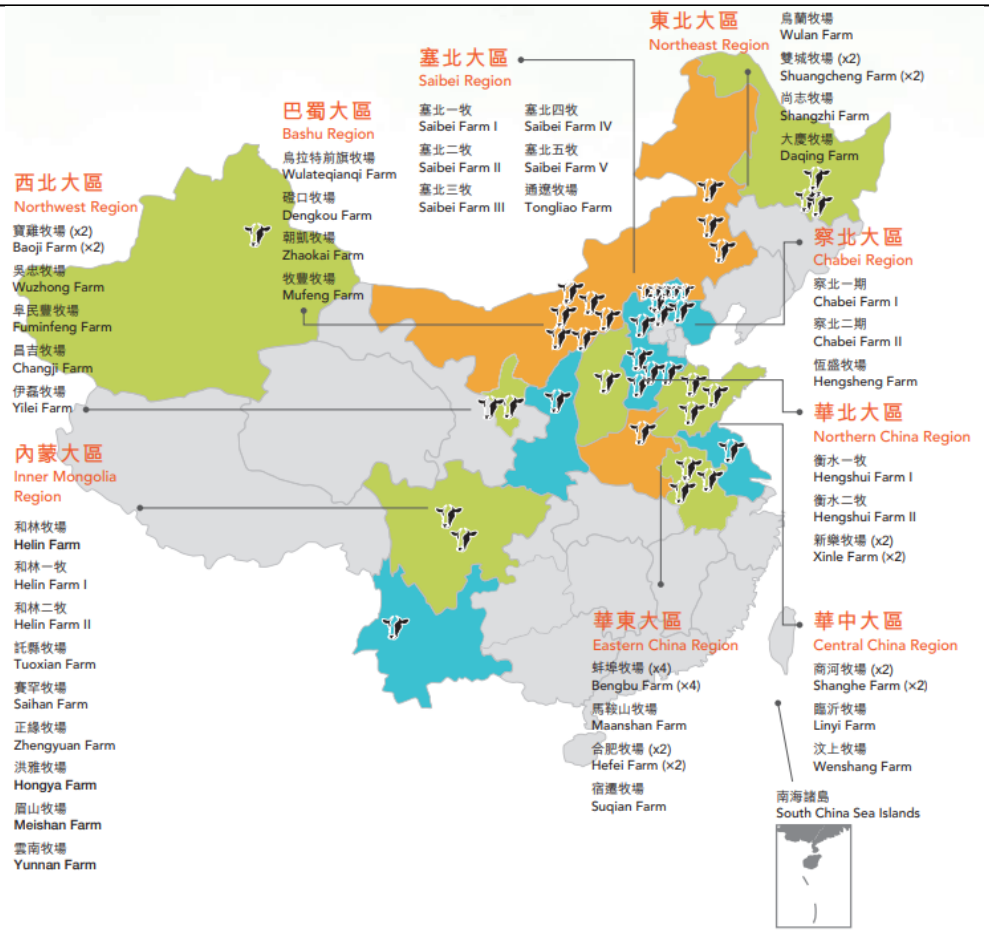
**(2) Consumer behavior:** Consumers in lower tier markets may not have the same demand and knowledge about fresh milk as those in tier 1-2 cities, and are used to using milk powder or soy milk as substitutes. Therefore, fresh milk industry's development would require stronger marketing and consumer education, in order to raise consumers' knowledge and trust and groom their habitual consumption for fresh milk.

**(3) Channel construction:** The retail channels in lower tier cities may not be as developed as those in tier 1-2 cities, and fresh milk needs local distributors and retailers (supermarkets, convenience stores) to distribute and increase point of sales. Fresh milk companies also need to use new channels like internet and social media to develop online sales in order to increase adoption of fresh milk.

**China Modern Dairy (1177 HK/NR) helped Mengniu achieve nationwide presence of dairy farms, helping to resolve the short shelf life issue:** We think the first issue of short shelf-life is key. Due to the importance of having dairy farms that are located near the end market in order to reduce transportation time, it may not be surprising that market share of fresh milk is so far dominated by regional players like Bright Dairy (Shanghai), New Hope (002946 CH/NR, Sichuan) and Sanyuan (600429 CH/NR, Beijing). Mengniu's acquisition of China Modern Dairy (CMD) has given it the ability to have a nationwide presence of dairy farms.

Below is a map of CMD's dairy farms, which made 93% of its raw milk sales to Mengniu in 2022. In turn, Mengniu sources 35-40% of its raw milk from CMD. For Shengmu, which supplies mostly organic milk, it sells 92% of its raw milk to Mengniu, while Mengniu sources 10% of its raw milk (but 90% of its organic raw milk) from Shengmu. Shengmu's dairy farm are located in the Ulan Buh dessert in Inner Mongolia.

**Figure 167: CMD's farm map. CMD is Mengniu's largest raw milk supplier, producing 2.36m tonnes of raw milk in 2022. 93% of CMD's sales was made to Mengniu in 2022.**

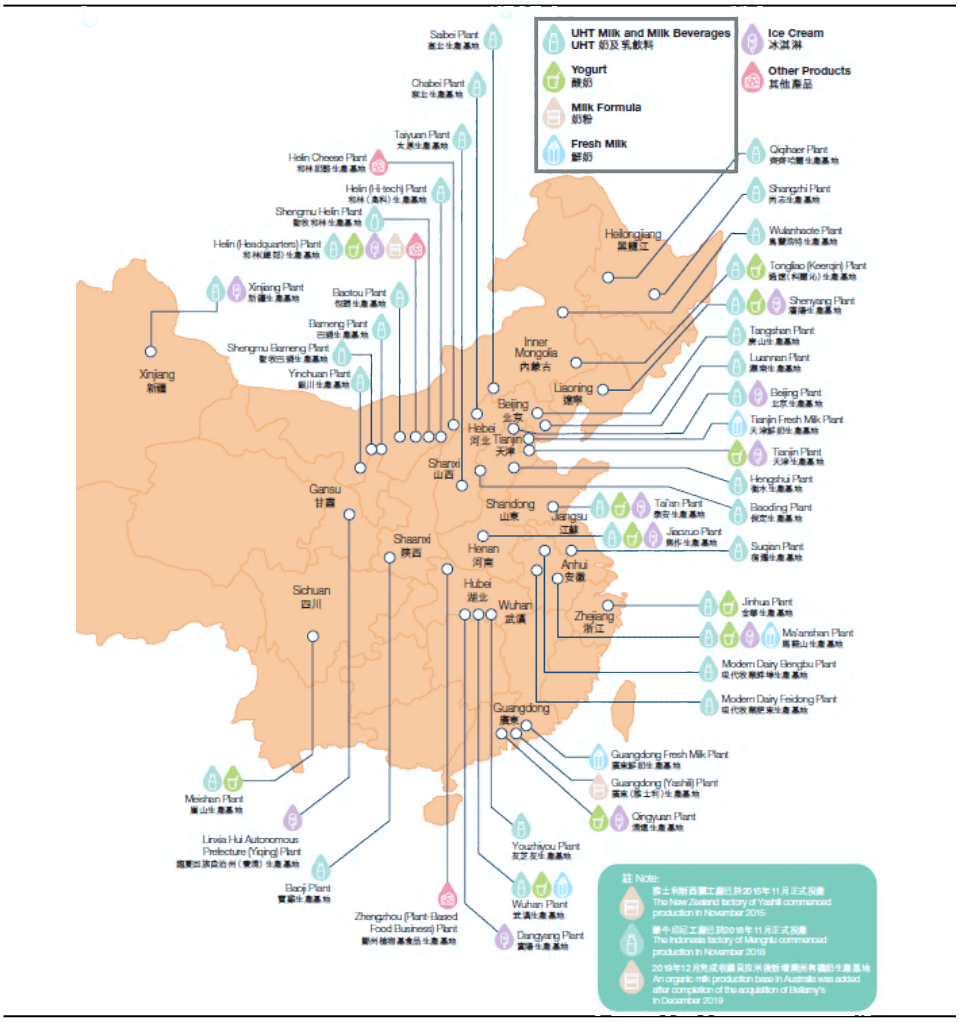



*Source: China Modern Dairy annual report (2022), BOCOM Int'l Note: Approximate of herd size: x2 = 20,000 heads: x4 = 40,000 heads*

**Mengniu's production bases are built near its upstream partners' dairy farms:** Mengniu's production bases are usually built relatively close to dairy farms operated by Mengniu's upstream partners, given the time sensitivity to immediately pasteurize, process and package the milk, or dried and turned them into milk powder, in order to maintain their freshness and nutritional value. As of 31 December 2022, Mengniu had 41 production bases in China, in addition to two production bases in Indonesia, two in Australia and one in New Zealand, respectively. It had a total annual production capacity of 12.91m tons by end-2022, which expanded at a double-digit YoY rate in the past two years (11% YoY in 2022, 18% YoY in 2021).

As can be seen below, Mengniu has fresh milk production plants in Ma'anshan in Anhui (East), Tianjin (North). Guangdong (South) and Wuhan (Central). However, processing plants for UHT milk can easily be transformed into fresh milk production, if needed.

**Figure 168: Mengniu's production plant map in China (2022).**




*Source: Mengniu annual report (2022), BOCOM Int'l*

# Business overview

**History:** Founded in Hohhot, Inner Mongolia in 1999 and listed on the Hong Kong Stock Exchange in June 2004, China Mengniu Dairy Company Limited (2319 HK, "Mengniu") is the second largest dairy conglomerate in China by revenue. It was founded by Mr. Niu Gensheng, a former employee of rival Inner Mongolia Yili (600887 CH, "Yili"), which is the largest dairy conglomerate in China. Mengniu is engaged in the production, marketing and distribution of a diversified portfolio of dairy products under different brands. Through various M&A, Mengniu has achieved horizontal and vertical integration with companies that it either controls or has invested in.

## Products segments

Mengniu's largest sales contributor by product category is **(1) liquid milk** (85% of sales in 2022), followed by **(2) ice-cream** (6% of sales), **(3) infant milk formula ("IMF")** (4%) and **(4) other dairy products** (5%) that include cheese.

**Liquid milk brands:** Liquid milk is further split into three divisions: room-temperature products (UHT, yoghurt, milk beverage), chilled products (chilled yoghurt, chilled milk beverage) and fresh milk.

- Within **room-temperature product business,** there are (1) UHT, sold under the Mengniu Pure Milk (蒙牛纯牛奶) and the higher-end Milk Deluxe (特仑苏); (2) yogurt, sold under the Just Yoghurt (纯甄) brand; and (3) milk beverage, sold under the Real Fruit (真果粒) and Suan Suan Ru (酸酸乳) brands.
- Within the **chilled product business**, there are (1) chilled yoghurt, sold under the Champion brand (冠益乳) and Mengniu brands, and (2) chilled milk beverage, e.g. yogurt drink sold under the Yoyi C (优益 C) brand.
- Finally, there is **fresh milk business,** sold under Shiny Meadow (每日鲜语) and Modern Meadow (现代牧场) brands.

**Infant formula business:** This is sold under Mengniu, Yashili (雅士利) and Australian brand Bellamy (贝拉美).

**Cheese:** Sold under Mengniu and Milkground (妙可蓝多) brands.

## Distribution channels

Mengniu distributes through a variety of channels, relying mostly on key accounts, traditional channels (distributors, groceries, supermarket, hypermarkets), B2B (restaurants) and e-commerce, but has in recent years increasingly relied on e-commerce for sales. Mengniu's catering and e-commerce sales reached 50% of sales in 2022. Mengniu's products are sold through 3-4m points of sales ("POS") nationwide, and the expansion of POS continues to be key growth driver, especially to increase penetration of lower-tier cities, as well as farms and villages. It is also working to increase and optimize operations of its POS in order to better control costs and operating efficiencies.

**Figure 169: Mengniu product SKUs**




*Source: Company, BOCOM Int'l*

## Mengniu's 5-year Plan

2021 was the beginning of the Group's five-year (2021-25) strategic plan of "**Creating a new Mengniu**", with a focus on promoting the development of five core capabilities of (1) milk source control, (2) research & development and innovation, (3) digital marketing, (4) route-to-market development, and (5) organization safeguard.

**Eye on product and technology innovation:** In the next few years, the Group will continue to promote product and technology innovation to meet the different needs of consumption upgrades. The Group will accelerate the transformation and upgrade of its digitalization strategy and improve the efficiency of operation and management. Through consumer data analysis, digital precision marketing will be realized. The Group will promote the establishment of quality milk source bases and improve the economic benefits of farms, and continue to focus on the dairy industry, strengthen investment, acquisition, and integration capabilities to develop driving forces for business growth. It will strive to become the consumer's first choice, by becoming a digitalized and internationalized Mengniu and a Mengniu with strong cultural genes and social responsibility.

**Figure 170: Mengniu development milestone**

| Year | Event |
|---|---|
| 1999 | Inner Mongolia Mengniu Dairy was established |
| 2004 | Listed on HKEx |
| 2005 | Launched Suan Suan Ru (蒙牛酸酸乳) and premium brand Deluxe (特仑苏) |
| 2006 | Co-launched the Mengniu Arla brand with Denmark's Arla Foods, and worked together on milk powder products |
| 2009 | COFCO acquired ~21% of Mengniu's shares at a price of RMB6bn, and became Mengniu's largest strategic shareholder |
| 2010 | Acquired Junlebao Dairy to consolidate its position in the yogurt market |
| 2013 | Acquired Yashili's 75.3% equity stake; Acquired Modern Dairy's 26.9% equity stake |
| 2014 | Danone became the company's second largest strategic shareholder |
| 2016 | Its indirectly owned subsidiary Yashili completed acquiring 100% equity of Dumex China |
| 2017 | Increased its interest in Modern Dairy to 61.25% and became its controlling shareholder |
| 2019 | Acquired 51% equity stake in Shengmu; Acquired 100% equity stake in Bellamy, an Australian premier milk powder producer; Sold 51% equity stake in Junlebao |
| 2020 | Became Milkground's shareholder through private placement |
| 2021 | Increased stake in Milkground to 28.5% |
| 2022 | Raised stake in Milkground to 35.01% and became its controlling shareholder; Parted ways with Danone (see next page for details) |

*Source: Company data, BOCOM Int'l*

## Mengniu's Strategic Equity Stakes and Latest Business Moves

Mengniu also holds equity stake in various public and private companies along the dairy supply chain, including upstream dairy farms such as China Modern Dairy (1117 HK) and Shengmu (1432 HK), IMF producer Yashili (delisted, formerly 1230 HK), Australian baby food company Bellamy's (private) as well as A-share listed cheese producer Milkground (600882 CH). Horizontal integration has allowed Mengniu to tap into the expertise of leaders in fast-growing product segments, while vertical integration allows it to ensure stable supply of raw milk to support its long-term growth. On the other hand, Mengniu is itself part of the COFCO group of companies with COFCO as its major shareholder with 23% stake, which has various agricultural, meat and food related businesses.

**Parted ways with Danone:** Mengniu previously collaborated with French dairy conglomerate Danone in IMF and chilled food business. However, the two companies effectively parted ways in May 2022 after Danone disposed its 25% stake in Yashili (IMF producer) and 20% stake in the chilled business JV back to Mengniu, in return for taking full control of Dumex, Danone's infant formula business in China.

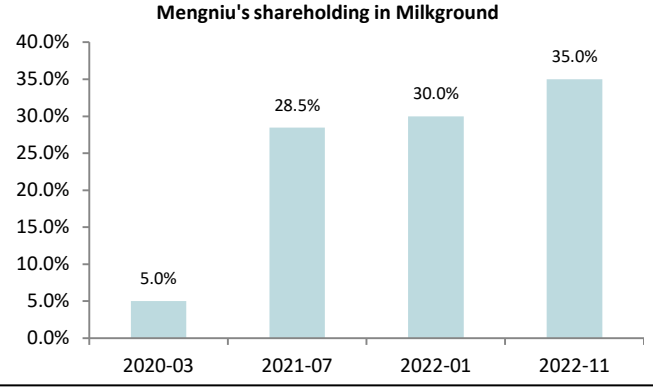
**Yashili privatization:** On 27 May 2022, Mengniu, along with offeror Star Future Investment Co. Ltd, announced that it would together privatize Yashili, which has been completed. Yashili was officially delisted from HKEx on 5 July 2023.

**Figure 171: Mengniu's key associate or controlled companies**

| Companies | Stake owned by Mengniu | Stock ticker | Business nature |
|---|---|---|---|
| China Modern Dairy | 56.36% | 1117 HK | Dairy farm |
| China Shengmu | 29.99% | 1432 HK | Dairy farm |
| Milkground | 35.01% | 600882 CH | Cheese producer |
| Burra Foods | 90.00% | private | Milk powder producer |
| Yashili | 100.00% | delisted | Baby formula |
| Bellamy's | 100.00% | private | Baby food |
| AICE | 42.3% | private | Ice-cream in SE Asia |

*Source: Company data, BOCOM Int'l*

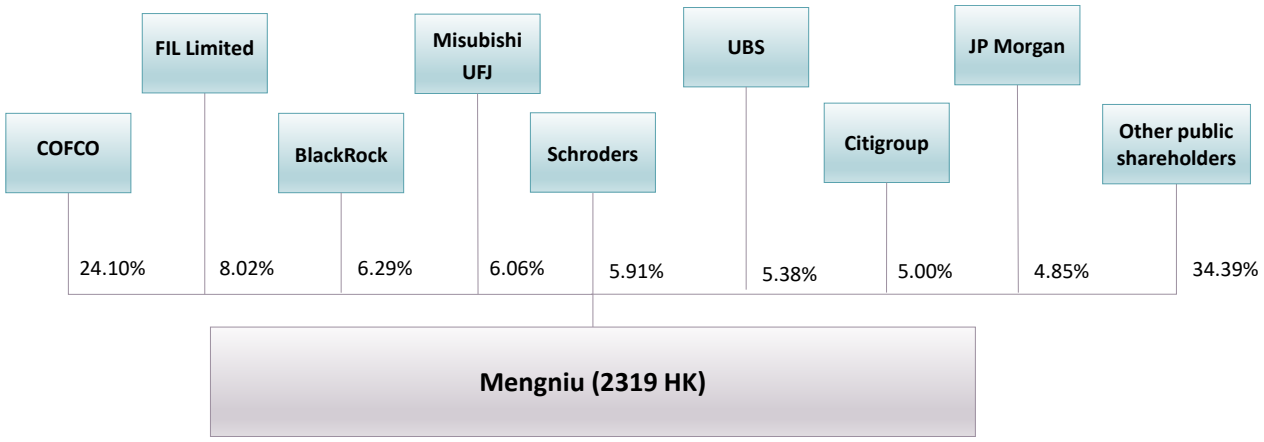
**Figure 172: Mengniu's shareholding in Milkground has increased since 2020**




*Source: Company data, BOCOM Int'l*

## Management and Shareholder

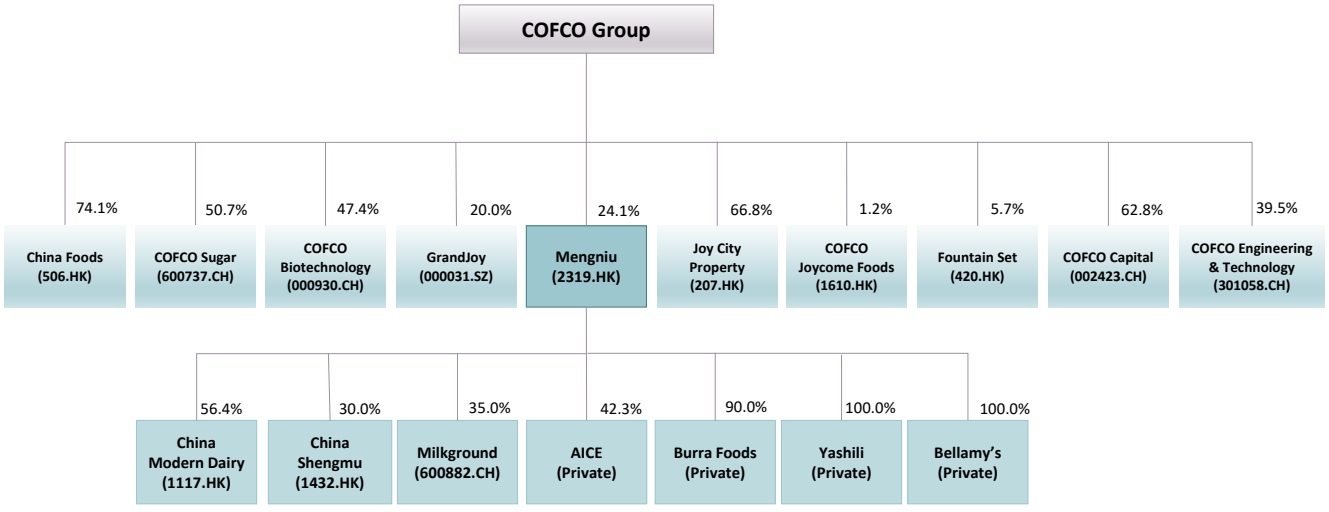
**Figure 173: Mengniu: List of substantial shareholders (2022)**




*Source: Company data, BOCOM Int'l*

**COFCO Group of companies:** Mengniu is part of the COFCO Group of companies, which owns a variety of agricultural, meat and food businesses.

**Figure 174: COFCO group and its subsidiaries (including Mengniu), and Mengniu's associate companies**



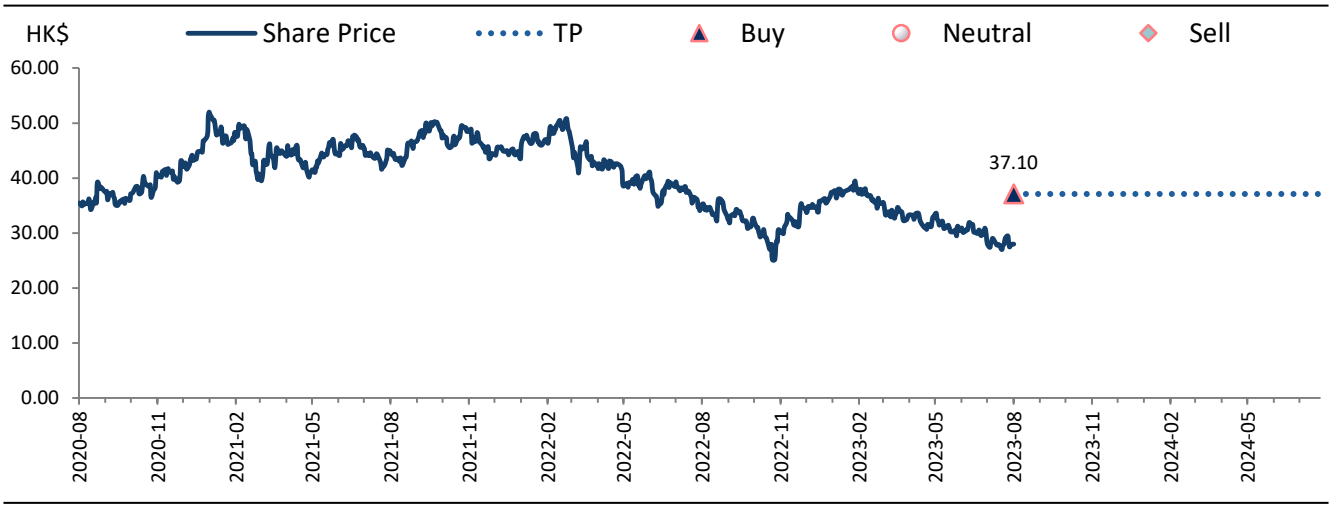

*Source: Company data, BOCOM Int'l*

## Figure 175: Mengniu: Board of directors and senior management

| Name | Position | Experience |
|---|---|---|
| **Lu Minfang** | Executive director, CEO | Mr. Lu is the chairman and a non-executive director of Yashili International Holdings Ltd, also a non-executive director and the chairman of the board of directors of China Shengr listed in Hong Kong, and a non-independent director and the chairman of the board of di associate of the Company listed on the Shanghai stock exchange. Mr. Lu is a director of Bachelor's degree from Fudan University. |
| **Wang Yan** | Executive director<br>Vice president | Ms. Wang has previously served various roles including general manager of talent devel director of the human resources department at COFCO Corporation. Ms. Wang holds a r University of China specialising in human resources management. |
| **Zhang Ping** | Executive director<br>CFO | Mr. Zhang Ping is a director of a number of the Group's subsidiaries, including the Group (Group) Company Limited and Inner Mongolia Tegaoxin Dairy Co., Ltd. Mr. Zhang Ping v Holdings Limited. He graduated from the Beijing Information Science and Technology Ur Engineering. |
| **Chen Lang** | non-executive director<br>Chairman of the board | Mr. Chen is currently an executive vice president of COFCO Corporation, and a non-exe of Joy City Property Limited. Mr. Chen had served as a director and the chairman of the chairman of China Resources Snow Breweries, etc. Mr. Chen holds a Bachelor of Econc from the University of San Francisco. |
| **Wang Xi** | non-executive director | Mr. Wang currently serves as the assistant to the director of the Strategy Department an of COFCO Corporation. Mr. Wang holds a bachelor's degree in economics and a dual ba degree of master of public administration from Columbia University. |
| **Simon Dominic Stevens** | non-executive director | Mr. Stevens graduated from Loughborough University in 1988 with a Bsc honours degre experience in sales and marketing roles based in U.K., Netherlands and Italy. |
| **Yih Dieter** | independent non-executive director | Mr. Yih received his Bachelor of Laws degree from King's College London and he is a Fe practice law in Hong Kong. Mr. Yih currently is an independent non-executive director of director of Sun Art Retail Group Limited. |
| **Li Michael Hankin** | independent non-executive director | Mr. Li has more than 30 years of experience in financial and accounting, fundraising, me business development. He obtained a bachelor's degree in accountancy from California He is a member of the American Institute of Certified Public Accountants |
| **Ge Jun** | independent non-executive director | Mr. Ge had previously served as the assistant engineer of Shanghai Research institute o Institute, and associate dean of the Shanghai Institute of Advanced Finance at Shanghai director of the National Innovation and Development Strategy Research Association. |
| **Gao Fei** | Senior vice president<br>Head of UHT business unit | Mr. Gao graduated from Shandong University and Tsinghua University, and obtained an Gao has abundant practical experience in sales, marketing and promotion, and is curren Group. |
| **Wen Yongping** | Vice president<br>Head of research and development and innovation | Mr. Wen graduated from China Agricultural University and obtained a Doctoral Degree in served as the general manager of production direction center, operations assistant vice p product business unit of the Group. |
| **Zhao Jiejun** | Vice president<br>Head of milk sourcing and animal husbandry industry china business unit | Mr. Zhao graduated from the Beijing University of Aeronautics and Astronautics with a pc experience in dairy industry and served successively as greater regional sales manager, manager of planning and logistics and head of supply chain of the Group. |
| **Luo Yan** | Vice president<br>Head of chilled product business unit and fresh milk business unit | Mr. Luo graduated from the China Textile University and Fudan University. Mr. Luo was tl was responsible for sales in China Region, as well as the retail and food and beverage b the food industry for 30 years with extensive experience in the industry and managemen |
| **Chen Yiyi** | Vice president<br>Head of strategy management | Mr. Chen graduated from Fudan University with Bachelor's degree in law. Before joining International Paper and other well-known international companies and listed companies management position in the past 25 years. |

*Source: Company data, BOCOM Int'l*

**Figure 176: China Mengniu Dairy (2319 HK) TP & rating**




*Source: FactSet, BOCOM Int'l estimates*

## Financial Statements

**Income statement (RMB m)**

| Y/E 31 Dec | 2021 | 2022 | 2023E | 2024E | 2025E |
|---|---|---|---|---|---|
| Revenue | 88,141 | 92,593 | 105,443 | 116,465 | 133,333 |
| COGS | (55,752) | (59,904) | (67,484) | (73,955) | (84,133) |
| **Gross profit** | **32,390** | **32,690** | **37,960** | **42,510** | **49,200** |
| SG&A | (27,012) | (26,789) | (30,451) | (33,412) | (37,910) |
| Other operating income, net | (487) | (67) | (433) | (666) | (1,083) |
| **Operating profit** | **4,891** | **5,833** | **7,076** | **8,432** | **10,208** |
| Net finance expenses | 284 | 260 | 49 | (232) | (553) |
| Income from JCEs and asso. | 693 | 409 | 270 | 300 | 270 |
| **Pre-tax profit** | **5,868** | **6,502** | **7,395** | **8,500** | **9,925** |
| Tax | (905) | (1,318) | (1,109) | (1,275) | (1,489) |
| Non-controlling interests | 62 | 118 | 118 | 118 | 118 |
| **Net profit** | **5,026** | **5,303** | **6,404** | **7,343** | **8,554** |
| Net profit for EPS calculation | 5,026 | 5,303 | 6,404 | 7,343 | 8,554 |

**Balance sheet (RMB m)**

| As of 31 Dec | 2021 | 2022 | 2023E | 2024E | 2025E |
|---|---|---|---|---|---|
| Cash & cash equiv | 11,217 | 12,766 | 10,553 | 7,979 | 663 |
| Acc & bills receivable | 4,160 | 3,660 | 4,168 | 4,604 | 5,271 |
| Inventories | 6,485 | 8,073 | 9,095 | 9,967 | 11,339 |
| PUD and land/lease prepayments | 4,286 | 4,640 | 4,732 | 4,827 | 4,924 |
| Other current assets | 203 | 806 | 829 | 853 | 853 |
| **Total current assets** | **31,020** | **36,777** | **36,346** | **35,338** | **30,300** |
| PPE | 17,335 | 19,653 | 23,183 | 27,388 | 32,622 |
| Other tangible assets | 0 | 0 | 0 | 0 | 0 |
| Intangible assets | 14,999 | 24,045 | 24,079 | 24,113 | 24,147 |
| Investment in associates/JCE | 15,794 | 10,396 | 15,396 | 20,396 | 25,396 |
| Other non-current assets | 18,953 | 26,942 | 28,061 | 29,819 | 32,556 |
| **Total non-current assets** | **67,081** | **81,036** | **90,720** | **101,716** | **114,722** |
| **Total assets** | **98,101** | **117,813** | **127,065** | **137,054** | **145,022** |
| Short-term loans | 4,265 | 9,095 | 9,095 | 9,095 | 9,095 |
| Trade and other payables | 23,380 | 23,782 | 25,073 | 26,175 | 27,908 |
| Other current liabilities | 1,426 | 276 | 276 | 276 | 276 |
| **Total current liabilities** | **29,072** | **33,153** | **34,444** | **35,546** | **37,279** |
| Long-term loans | 18,786 | 26,106 | 28,717 | 31,589 | 31,589 |
| Long-term payables | 3,981 | 3,908 | 4,103 | 4,308 | 4,308 |
| Other non-current liabilities | 4,262 | 4,594 | 5,054 | 5,559 | 5,559 |
| **Total non-current liabilities** | **27,030** | **34,608** | **37,874** | **41,456** | **41,456** |
| **Total liabilities** | **56,102** | **67,761** | **72,318** | **77,002** | **78,735** |
| Share capital | 360 | 360 | 360 | 360 | 360 |
| Reserves & other capital items | 36,495 | 39,914 | 44,610 | 49,915 | 56,149 |
| **Shareholders' equity** | **36,855** | **40,274** | **44,970** | **50,275** | **56,509** |
| Financial instruments classified as equity | (29) | (176) | (176) | (176) | (176) |
| Non-controlling interests | 5,174 | 9,953 | 9,953 | 9,953 | 9,953 |
| **Total equity** | **41,999** | **50,052** | **54,748** | **60,052** | **66,287** |

*Source: Company data, BOCOM Int'l estimates*

**Cash flow (RMB m)**

| Y/E 31 Dec | 2021 | 2022 | 2023E | 2024E | 2025E |
|---|---|---|---|---|---|
| Pre-tax profit | 5,868 | 6,502 | 7,395 | 8,500 | 9,925 |
| Depreciation & amortisation | 2,098 | 2,561 | 2,561 | 2,561 | 2,561 |
| Interest inc/exp adjustment | (801) | (1,044) | (1,125) | (1,209) | (1,301) |
| Tax paid | (903) | (930) | (1,109) | (1,275) | (1,489) |
| Other operating cashflow | 361 | 922 | 267 | 548 | 869 |
| **Cash flow from operation** | **7,545** | **8,333** | **8,152** | **9,371** | **10,021** |
| Capex | (6,105) | (4,836) | (6,213) | (6,886) | (7,917) |
| Investment | (5,869) | 53 | (5,000) | (5,000) | (5,000) |
| Other investing cashflow | (3,466) | (10,079) | (173) | (1,010) | (2,218) |
| **Cash flow from investing** | **(15,440)** | **(14,862)** | **(11,386)** | **(12,896)** | **(15,135)** |
| Net chg in interest-bearing debt | 3,513 | 8,667 | 2,611 | 2,872 | 0 |
| Net change in equity | 111 | 25 | 0 | 0 | 0 |
| Dividends paid | (1,077) | (1,517) | (1,590) | (1,920) | (2,202) |
| Other financing cashflow | 4,226 | (3,028) | 0 | 0 | 0 |
| **Cash flow from financing** | **6,773** | **4,147** | **1,021** | **952** | **(2,202)** |
| Exchange gain/loss | (11) | 43 | 0 | 0 | 0 |
| **Cash & cash equiv. at year start** | **9,225** | **8,092** | **5,693** | **3,480** | **906** |
| **Cash & cash equiv. at year end** | **11,217** | **12,766** | **10,553** | **7,979** | **663** |

**Financial ratio**

| Y/E 31 Dec | 2021 | 2022 | 2023E | 2024E | 2025E |
|---|---|---|---|---|---|
| **Per share data (RMB)** | | | | | |
| Core EPS | 1.274 | 1.342 | 1.621 | 1.858 | 2.165 |
| Fully-diluted EPS | 1.267 | 1.336 | 1.613 | 1.850 | 2.155 |
| Non-GAAP EPS | 0.000 | 0.000 | 0.000 | 0.000 | 0.000 |
| DPS | 0.380 | 0.401 | 0.484 | 0.555 | 0.646 |
| BVPS | 9.343 | 10.193 | 11.381 | 12.724 | 14.302 |
| **Margin analysis (%)** | | | | | |
| Gross margin | 36.7 | 35.3 | 36.0 | 36.5 | 36.9 |
| EBITDA margin | 10.5 | 10.9 | 8.3 | 8.8 | 9.3 |
| EBIT margin | 7.9 | 7.9 | 8.3 | 8.8 | 9.3 |
| Net margin | 5.7 | 5.7 | 6.1 | 6.3 | 6.4 |
| **Profitability analysis (%)** | | | | | |
| ROA | 5.6 | 4.9 | 5.2 | 5.6 | 6.1 |
| ROE | 14.4 | 13.8 | 15.0 | 15.4 | 16.0 |
| **Others** | | | | | |
| Net debt to equity ratio (%) | 28.2 | 44.8 | 49.8 | 54.5 | 60.4 |
| Current ratio (x) | 1.1 | 1.1 | 1.1 | 1.0 | 0.8 |
| Inventory turnover (days) | 39.3 | 44.4 | 46.4 | 47.0 | 46.2 |
| Acc receivable turnover (days) | 14.8 | 15.4 | 13.5 | 13.7 | 13.5 |
| Acc payable turnover (days) | 54.9 | 57.9 | 58.7 | 59.4 | 58.4 |
| Dividend payout ratio (%) | 29.8 | 29.8 | 29.8 | 29.8 | 29.8 |

BOCOM Int'l Research

**Initiation of Coverage**

| Consumer | Last Close | Target Price | Upside |
|---|---|---|---|
| | RMB 10.98 | RMB 14.50 | +32.1% |

9 August 2023

# Bright Dairy & Food (600597 CH)

## Vertically-integrated model tailored for fresh milk leadership; Initiate at Buy

- **Market share leader in fresh milk, the future growth area:** Bright is the clear market leader in fresh milk with 20% share currently (doubled that of the next player, Mengniu). China's fresh milk market is expected to grow at a CAGR of 12.3% in the next five years, making it one of the fastest-growing segments. However, fresh milk market share situation remains far from settled, and as the market further develops into lower-tier cities riding on cold-chain development and income growth, Yili and Mengniu could step up their competition and fight for market share.

- **Bright's vertically-integrated model (from self-owned farms, R&D, cold-chain to ordering app) creates closed-loop, competitive advantage for fresh milk business:** Bright is the only one of the top three dairy giants to own its farms (16 of 26 nationwide located in Eastern China including nine in Shanghai) providing c.40% of its raw milk, which embodies the industry saying that "those who secure raw milk supply secure the market", given Bright's c.70% market share in Shanghai. Bright is also the only one of the trio to own its cold-chain logistics company, Speed Fresh, with over 50,000 daily delivery outlets, which is a competitive advantage given cold-chain is a bottleneck for fresh milk distribution to lower-tier cities. Bright's R&D center helps develop new pasteurization techniques to lock in more nutrition while extending shelf-life from 7 to 15 days, increasing availability for lower-tier cities, while its ordering app SuiXinDing locks in customers for regular, repeat purchasing.

- **Eastern China concentration creates low base effect:** Bright was disproportionately affected last year due to its sales concentration in Shanghai (27% of sales), which means it will have a low-base effect this year, in 2Q (-2% YoY) and 3Q (-10%).

- **Self-owned farms could be a double-edged sword:** While self-operated farms provide certain benefits such as protecting raw milk supply in competitive markets like Eastern China and ensuring close coordination for upstream expansion near Bright's processing plants, it is also capital intensive and asset heavy, dragging down Bright's ROE vs. peers. Expected raw milk price decline for the next 1-2 years, in addition to potential bio-asset FV losses, may also be a drag on near-term margins.

- **Initiate with Buy and TP of RMB14.5:** We expect Bright's sales/net profit to grow by 12%/37% CAGR over 2023-25E. Our 2023-25E EPS are above consensus by 3-6%, on higher margins. Our TP of RMB14.5 is based on 22.0x 2024E P/E, implying 0.6x PEG on our 3-year EPS CAGR of 36.7% (2023-25E). The reason for our use of a lower PEG is due to a sharp drop in 2022 EPS growth (base year for CAGR calculation) given Bright's high sales concentration in Shanghai.

### Financial highlights

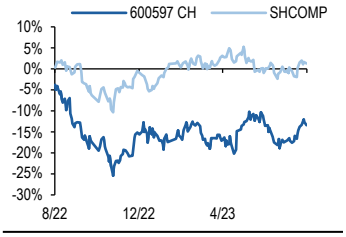
| Y/E 31 Dec | 2021 | 2022 | 2023E | 2024E | 2025E |
|---|---|---|---|---|---|
| Revenue (RMB m) | 29,206 | 28,215 | 31,319 | 34,450 | 39,273 |
| YoY growth (%) | 15.6 | -3.4 | 11.0 | 10.0 | 14.0 |
| Net profit (RMB m) | 592 | 361 | 669 | 777 | 921 |
| EPS (RMB) | 0.43 | 0.26 | 0.49 | 0.56 | 0.67 |
| YoY growth (%) | -13.4 | -39.1 | 85.4 | 16.1 | 18.6 |
| P/E (x) | 25.6 | 42.0 | 22.6 | 19.5 | 16.4 |
| BVPS (RMB) | 5.70 | 5.80 | 6.14 | 6.53 | 6.99 |
| P/B (x) | 1.93 | 1.89 | 1.79 | 1.68 | 1.57 |
| Dividend yield (%) | 1.5 | 0.7 | 1.4 | 1.6 | 1.9 |

*Source: Company data, BOCOM Int'l estimates*

### Stock Rating

**BUY**

### 1-year stock performance




*Source: FactSet*

### Stock data

| | |
|---|---|
| 52w high (RMB) | 12.20 |
| 52w low (RMB) | 9.46 |
| Market cap (RMB m) | 15,137.25 |
| Avg daily vol (m) | 7.03 |
| YTD change (%) | 2.04 |
| 200d MA (RMB) | 10.75 |

*Source: FactSet*


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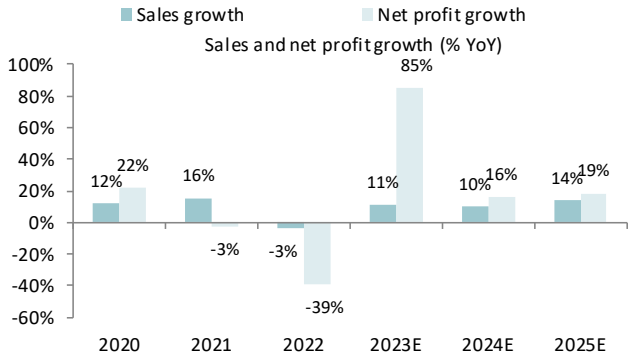


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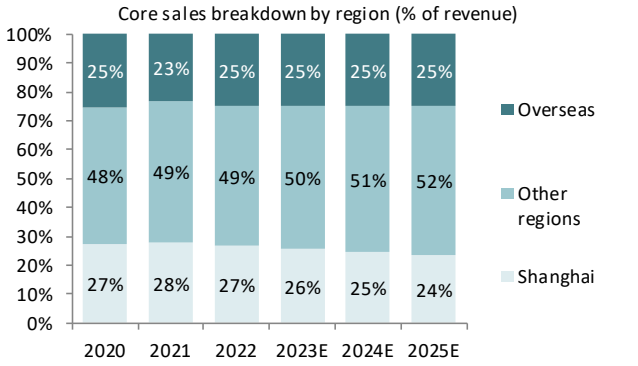
## Company at a Glance

### Figure 177: Bright: Sales and net profit growth



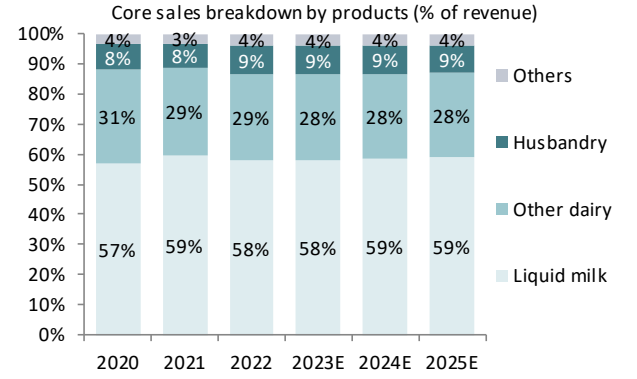

*Source: Company data, BOCOM Int'l estimates*

### Figure 178: Bright: Sales breakdown by region



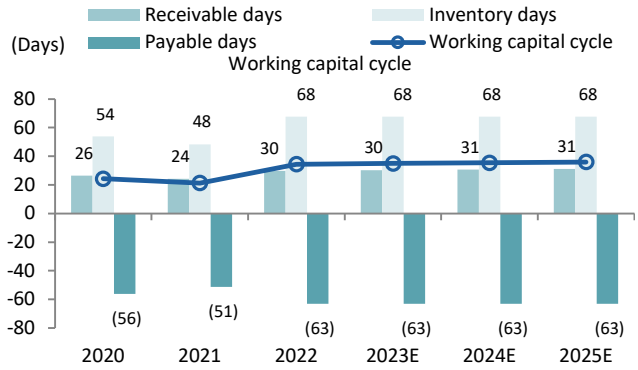

*Source: Company data, BOCOM Int'l estimates*

### Figure 179: Bright: Sales breakdown by product



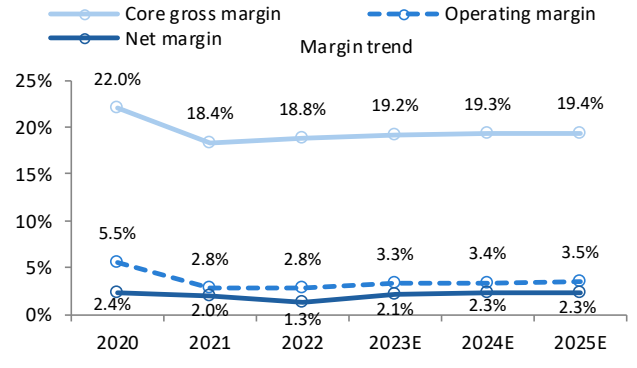

*Source: Company data, BOCOM Int'l estimates*

### Figure 180: Bright: Working capital



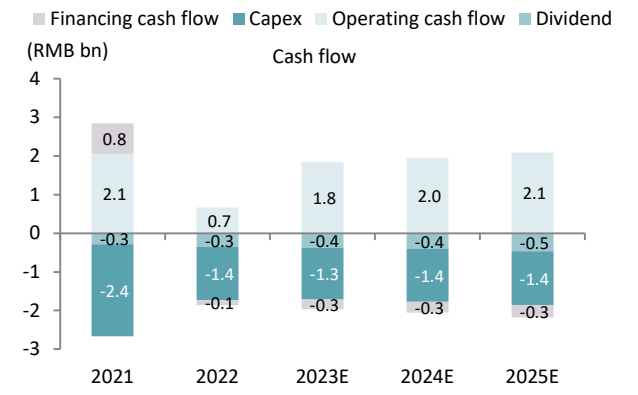

*Source: Company data, BOCOM Int'l estimates*

### Figure 181: Bright: Overall margin trends




*Source: Company data, BOCOM Int'l estimates*

### Figure 182: Bright: Cash flow




*Source: Company data, BOCOM Int'l estimates*

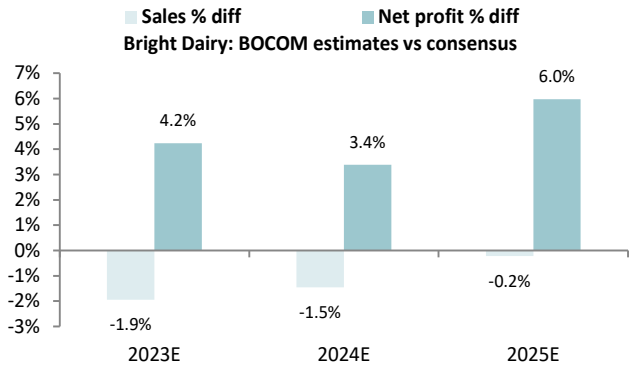
# Valuation

## Initiate with Buy and TP of RMB14.5 (32% upside)

We initiate coverage on Bright Dairy with a **Buy** rating and a TP of RMB14.5, based on 22.0x P/E on our 2024E EPS. Our target P/E multiple is derived from 0.6x PEG to our EPS CAGR (2023-25E) of 36.7%. The reason for our use of a lower PEG (0.6x) compared to the 1.0x we use for Yili and Mengniu is due to a sharp drop in Bright's 2022 EPS growth (base year for CAGR calculation) as a result of its high sales concentration in Shanghai. We expect this to be a one-off distortion that overstated the EPS CAGR, hence we find using a lower PEG to be reasonable.

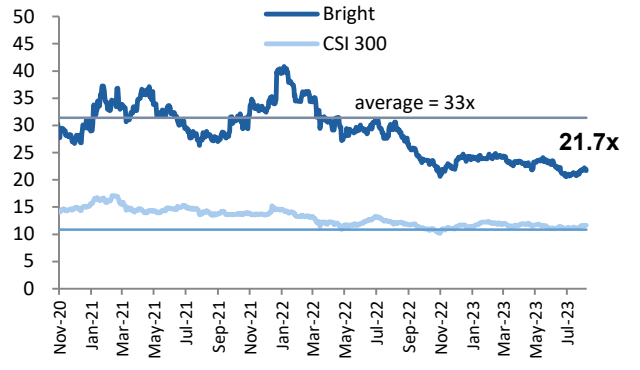
**Downside risks:** (1) Weaker-than-expected demand; (2) higher-than-expected raw milk costs increase leading to GPM pressure, (3) fierce competition leading to irrational price war and GPM pressure; (4) food safety issues.

**Figure 183: Bright: BOCOM vs. consensus**




*Source: Bloomberg consensus, BOCOM Int'l estimates*

**Figure 184: Bright: forward P/E**



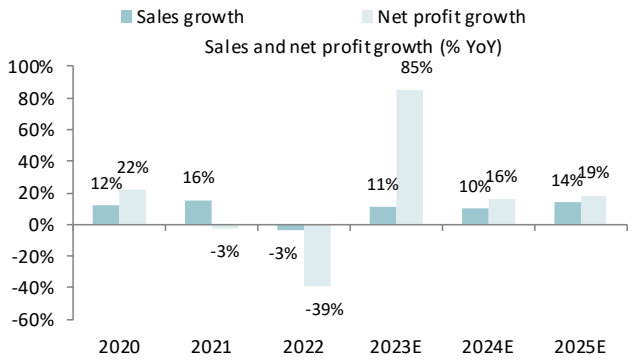

*Source: Bloomberg consensus, BOCOM Int'l*

## Financial Forecasts

A series of challenges in 2022 brought headwinds and Bright Dairy missed its operation target, with completion rates of around 89% and 54% for revenue and attributable profit, respectively. The company's targets for FY23E are: **(1) a total revenue of RMB32.05bn**, equivalent to c.14% YoY growth; and **(2) an attributable profit of RMB680m,** equals to c.88% YoY growth, with an attributable profit margin of 2.12%. Our 2023 forecasts of RMB31.3bn sales and RMB669m net profit assumes a 98% completion rate of the company's target, which reflects a slower-than-expected recovery of consumer sentiment across the industry year-to-date.

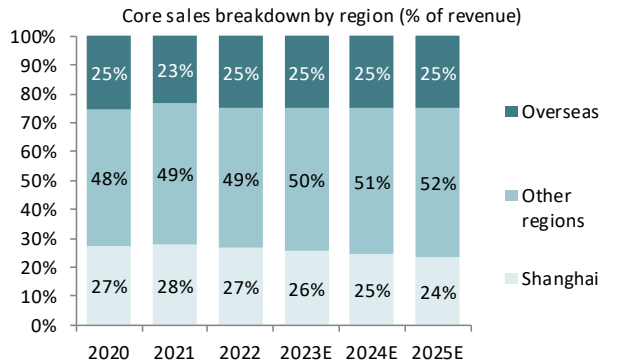
**Expect sales/EPS CAGR of 12%/37% (2023-25E):** In 1Q23, Bright Dairy experienced 2.4% YoY decline in revenue to RMB7bn, while the attributable profit scored 13% YoY growth to RMB187m, benefiting from declining expenses. Looking forward, riding on the current growth momentum of China fresh milk market, coupled with the company's accelerated market expansion outside of Shanghai, we expect that Bright Dairy can achieve 12% sales/37% EPS CAGR in the next 3 years (2023-25E), driven by faster revenue growth in regions outside Shanghai, Product-wise, drinking milk will continue to be the focus.

**Figure 185: Sales and net profit growth**




*Source: Company data, BOCOM Int'l estimates*

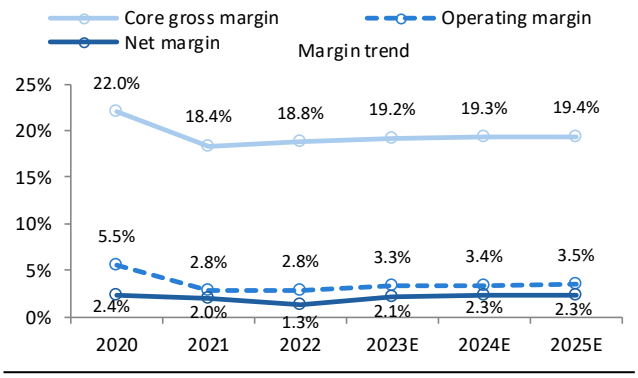
**Figure 186: Core sales breakdown by region**




*Source: Company data, BOCOM Int'l estimates*

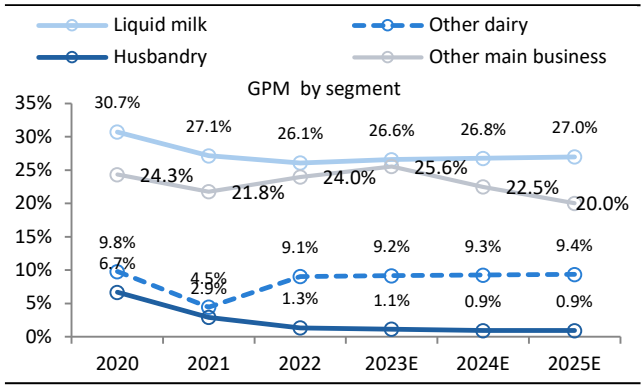
**Expect margin uptrend:** On margins, we expect relatively stable GPM trend going forward, with liquid milk to grow faster than the rest of its business, including other dairy (IMF, AMF, cheese, probiotics), husbandry and others. Liquid milk is the largest sales category, including drinking milk (60% fresh milk, 40% UHT milk and milk beverages) as well as yoghurt. It accounts for almost 60% of Bright's sales. It also has the highest GPM among all segments. We expect liquid milk's sales contribution to rise in the next 3 years with rising GPM as well, which would drive an overall GPM uptrend.

**Figure 187: Bright: we expect overall GP margin to trend up given rising mix of liquid milk, which also has the highest GPM among all segments**




*Source: Company data, BOCOM Int'l estimates*

**Figure 188: Bright: We expect GPM for liquid milk to trend up gradually, but husbandry GPM to fall**




*Source: Company data, BOCOM Int'l estimates*

**Figure 189: Bright: Key sales assumptions**

| Revenue breakdown (core) | 2020 | 2021 | 2022 | 2023E | 2024E | 2025E |
|---|---|---|---|---|---|---|
| Liquid milk | 14,269 | 17,101 | 16,091 | 18,022 | 20,005 | 22,905 |
| Other dairy | 7,789 | 8,480 | 8,000 | 8,800 | 9,592 | 10,935 |
| Husbandry | 2,062 | 2,290 | 2,641 | 2,918 | 3,143 | 3,511 |
| Other main business | 899 | 930 | 1,110 | 1,265 | 1,366 | 1,530 |
| **Core revenue** | **25,020** | **28,800** | **27,841** | **31,005** | **34,106** | **38,881** |
| **Total revenue** | **25,266** | **29,206** | **28,215** | **31,319** | **34,450** | **39,273** |
| | | | | | | |
| **Core revenue mix (%)** | | | | | | |
| Liquid milk | 57% | 59% | 58% | 58% | 59% | 59% |
| Other dairy | 31% | 29% | 29% | 28% | 28% | 28% |
| Husbandry | 8% | 8% | 9% | 9% | 9% | 9% |
| Other main business | 4% | 3% | 4% | 4% | 4% | 4% |
| **Growth (% YoY)** | | | | | | |
| Liquid milk | 3% | 20% | -6% | 12% | 11% | 15% |
| Other dairy | 24% | 9% | -6% | 10% | 9% | 14% |
| Husbandry | 24% | 11% | 15% | 11% | 8% | 12% |
| Other main business | 40% | 3% | 19% | 14% | 8% | 12% |
| **Core revenue** | **12%** | **15%** | **-3%** | **11%** | **10%** | **14%** |
| **Total revenue** | **12%** | **16%** | **-3%** | **11%** | **10%** | **14%** |

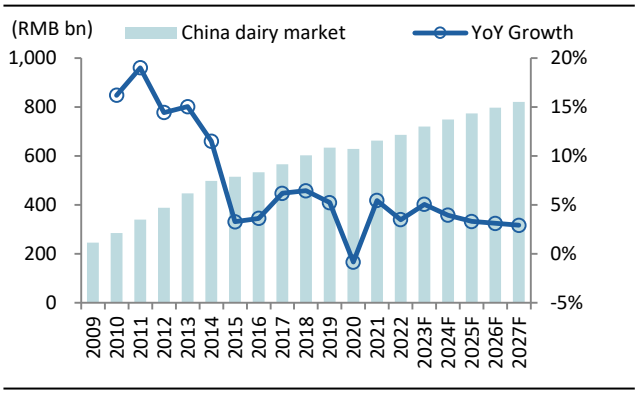
*Source: Company data, BOCOM Int'l estimates*

# Investment Positives

## Positive #1: Fresh milk will become the next main driver of China dairy market; Bright Dairy's leading position should drive outperformance

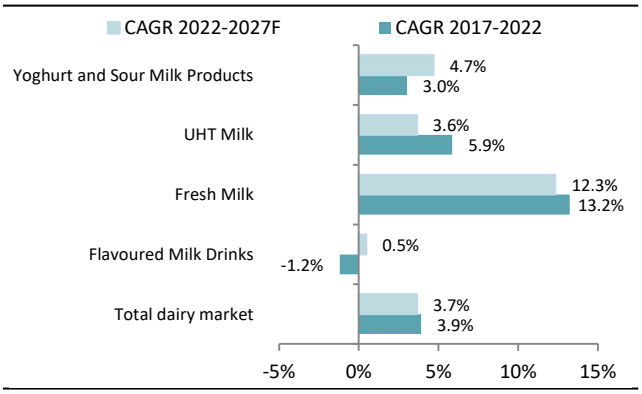
**China dairy market maintains steady growth, with healthy consumption driving the fresh milk segment.** According to Euromonitor, the size of China dairy market (including ice-cream) reached nearly RMB686bn in 2022, growing at a CAGR of 3.9% from 2017-22, and is expected to further grow at a CAGR of 3.7% over the next five years, expanding to RMB820bn in 2027. Increasing consumer preference towards nutrition and health, especially catalyzed by the pandemic, is the main growth driver of the fresh milk market. During 2017-22, the CAGR of four main dairy segments – fresh milk/UHT milk/yogurt/flavored milk drinks grew by a 13.2%/5.9%/3.2%/-1.2% CAGR respectively, indicating a high growth stage of the fresh milk segment.

**Figure 190: China dairy market maintains its steady growth**




*Source: Euromonitor estimates, BOCOM Int'l*

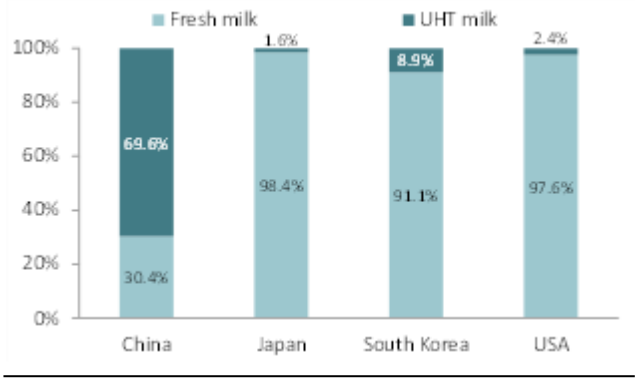
**Figure 191: CAGR comparison across main segments in China**




*Source: Euromonitor estimates, BOCOM Int'l*

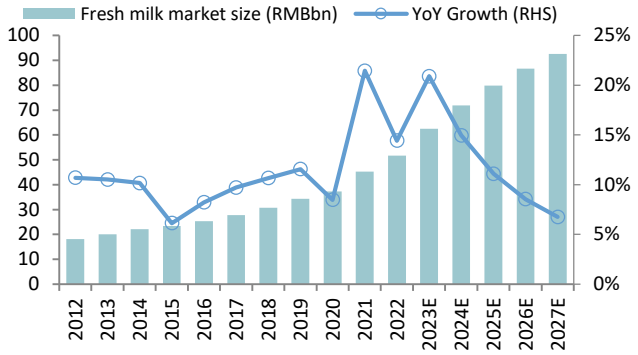
**Expansion opportunities in fresh milk segment.** In 2022, fresh milk accounted for c.20% of the consumption of drinking milk products in China, seeing a big gap vs. 89%/65%/77% vs. Japan/South Korea/United States. In terms of the cow milk consumption structure, China's fresh milk consumption share was around 30%, still lagging behind the other three countries with over 90%. With reference to Japan and South Korea, which have similar dietary habits with China, we expect ample growth room for China fresh milk market. Plus, with the release of China's new five-year plan for cold-chain logistics, the efficiency and quality of cold-chain, a major part of fresh milk market development, is expected to be enhanced. According to ASKCI, China cold-chain market scored c.18% CAGR from 2018 to 2022 and is expected to reach RMB648.6bn in 2023E. Therefore, infrastructure development should be another support for the distribution of fresh milk. Also, as fresh milk has been included in the product categories in National Student Milk Promotion Plan (2021-2025), the popularity of fresh milk should increase going forward.

**Figure 192: Fresh cow milk accounts for 30% of China's drinking milk, but >90% for developed countries (2022)**




*Source: Euromonitor, BOCOM Int'l*

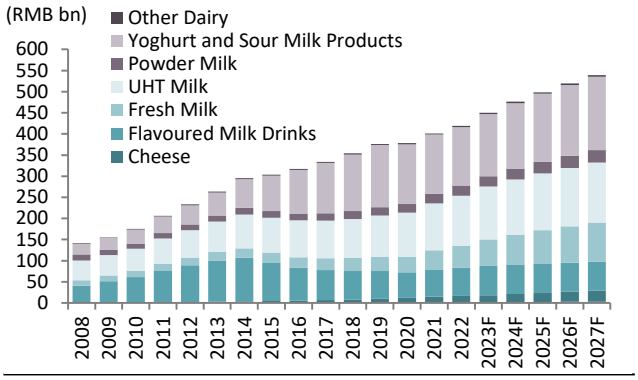
**Figure 193: China fresh milk market size and YoY growth**




*Source: Euromonitor estimates, BOCOM Int'l*

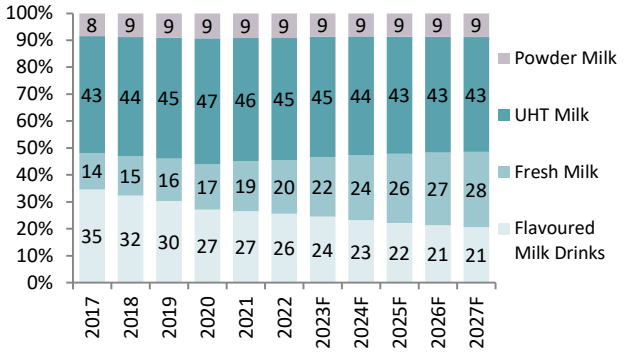
In 2022, the market size of fresh milk segment grew by 14% YoY to RMB51.7bn, accounting for 8% of China dairy market. The market size is expected to exceed RMB93bn by 2027, growing at a CAGR of 12.3% over the next five years. The market share of flavored milk drinks should continue to decline given the healthy consumption trend, while fresh milk is expected to overtake flavored milk as the second largest segment in China dairy market in the near future.

**Figure 194: China dairy product consumption structure (by absolute value)**




*Source: Euromonitor estimates, BOCOM Int'l*

**Figure 195: Within liquid milk, fresh milk is expected to increase in sales mix going forward**

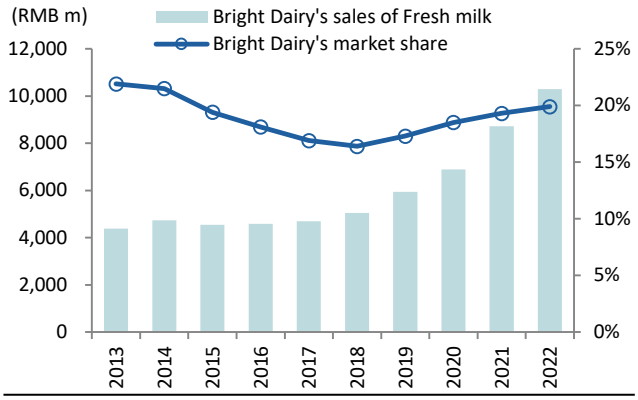



*Source: Euromonitor estimates, BOCOM Int'l*

**Bright Dairy should benefit from its leading position.** China fresh milk market is relatively fragmented, with a CR3 of 38.6% in 2022. Bright Dairy is the leading fresh milk player in China with a market share of 19.9% in 2022, followed by Mengniu/New Hope/Sanyuan with 10.7%/8.0%/7.6%, respectively. The company's fresh milk sales growth has accelerated in recent years, scoring a CAGR of 17% from 2017-22, compared to around 13% of industry level over the same period. The rapid growth momentum has also driven a continuous market share rebound. Going forward, industry leader is expected to benefit

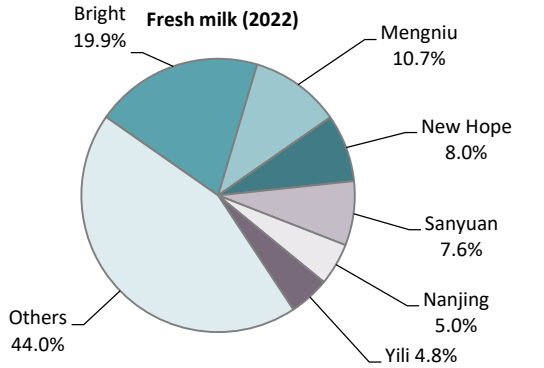
from the potential industry concentration given the rapid growth momentum and increasing popularity, as well as the cold-chain development nationwide.

**Figure 196: Bright Dairy's sales and market share of its fresh milk business**




*Source: Euromonitor, BOCOM Int'l*

**Figure 197: Market share of China fresh milk sub-market in 2022**




*Source: Euromonitor, BOCOM Int'l*

**Figure 198: Bright's Ubest is the national leading brand for fresh milk, which is also available in premium, organic option and retails at RMB23.5/780ml**




*Source: BOCOM Int'l (photo taken from a supermarket in Shenzhen in May 2023)*

**Figure 199: There is plenty of competition, including Mengniu's high-end Shiny Meadow fresh milk usually retails at RMB20-30/950ml, sourced from EU-GAP certified farms with higher protein (3.6g/100ml) and calcium (120mg/100ml) content**




*Source: BOCOM Int'l (photo taken from a supermarket in Shenzhen in May 2023)*

## Positive #2: Vertically integrated into upstream

**First-mover advantage in Eastern China with dairy farms in near proximity**

While industry giants Yili and Mengniu own stakes in various upstream dairy farms, Bright actually has its own dairy farms, which supply around 40% of its raw milk needs. The rest of its milk are sourced from cooperative large-scale dairy farms that adhere to its stringent, high food safety standards.

Milk source is a critical resource for dairy players, and a quality supply of raw materials is the basis for producing high-quality dairy products. The capability to supply raw milk creates a competitive barrier in this market, as sales distance of fresh milk is limited given the higher requirements for cold-chain transportation. Currently, Bright Dairy has 26 ranches, most of which (around 16) are located in high-consumption areas such as Shanghai and Jiangsu, which are also the main sales areas of the company. **The centralized layout of the dairy farms ensures the supply of Bright's raw milk and secures its competitive advantages in this region.**

**Figure 200: Bright Dairy's dairy farm distribution. The centralized layout of the dairy farms ensures the supply of Bright's raw milk and secures its competitive advantages in this region.**



*Source: Company data, BOCOM Int'l*

**Expanding production capacity.** Meanwhile, Bright Dairy has acquired and built dairy farms across China to enhance its supply capacity. In 2019, the company acquired the assets of Jiangsu Huishan, which should facilitate further expansion of the fresh milk market in Jiangsu, Shandong and Anhui. In 2021, the company took the controlling stake in local peer Qinghai Xiaoxiniu to improve its production capacity layout in western China. Overall, the gradual improvement of the high-quality raw material supply capacity should benefit the company's further expansion of its market scale.

Bright has raised capital a few times in recent years to upgrade its upstream raw milk capacity and the national implementation of its "fresh strategy". In 2021, it raised RMB1,930m, among which RMB1,355m was used to expand its upstream dairy farm. In 2022, it invested to expand dairy farms in Zhongwei city in Ningxia province, Funan county in Anhui province, Huaibei city in Anhui province, phase 2 of Hachuan etc.

Bright's acquisition of a 60% stake in Qinghai XiaoXiNiu in 2021 served to expand its upstream raw milk source in the western part of China.

In June 2022, it announced its "Dingyuan dairy farm" project with an investment amount of RMB2,493m. It is designed to build four dairy farms with a total of 47,500 dairy cows on a land covering 3,928 *mu* (262 hectares). It is expected to enter into production in 2028 with an ultimate raw milk production of 295,900 tons.

**Figure 201: Shareholding by dairy conglomerates in dairy farms**

| Acquirer | Stake owned | Target | Stock ticker | Business nature |
|---|---|---|---|---|
| Mengniu | 56.36% | China Modern Dairy | 1117 HK | Dairy farm in China |
| Mengniu | 29.99% | China Shengmu | 1432 HK | Dairy farm in China |
| Yili | 13.72% | Youran | 9858 HK | Dairy farm in China |
| Yili | 16.6% | Zhongdi | 1492 HK | Dairy farm in China |
| Youran (13.7% owned by Yili) | 58.36% | Saikexing | 834179 CH | Dairy farm in China |
| Yili | 100% | Westland | Private | Dairy farm in New Zealand |
| Bright Dairy | 100% of certain assets | Huishan Dairy | 6863 HK | Dairy farm in China |
| Bright Dairy | 60% | Qinghai XiaoXiNiu | private | Dairy farm in China |
| Bright Dairy | 39% | Synlait Milk | private | Dairy farm in New Zealand |

*Source: Various companies, BOCOM Int'l*

## Positive #3: Continuous enhancement in distribution channel

**Strengthening market advantages in Shanghai.** Since its establishment, Bright Dairy has been actively expanding its market presence in Shanghai and other cities in East China. Especially in Shanghai, where the company has achieved high coverage via continuous channel penetration. According to Brilliance Ratings, Bright Dairy has a leading position in East China, maintaining a long-term market share of nearly 60% and over 70% in Shanghai in the fresh milk segment in 2022. In 2018, Bright Dairy took a significant step towards strengthening its market position by acquiring 66.27% stake in Shanghai Dairy Shed Foods (a bakery chain brand with over 200 stores in Shanghai), leveraging on its channel resources to further enhance the channel deployment in the city.

**Rapid growth of O2O channel.** As one of the main O2O channels for fresh milk, home-delivery can meet consumers' demand for high-frequency consumption of fresh milk, and increasing customer stickiness and brand loyalty. Bright Dairy's own O2O channel (e.g. ordering app SuiXinDing makes it easy for consumers to have repeat purchasing) has achieved rapid growth since 2019, and its current scale has exceeded RMB2bn (about 1/3 of its fresh milk sales, based on our estimate). Coupled with the support of the company's logistics, which can deliver to over 50,000 terminal outlets on a daily basis, Bright Dairy's O2O business has touched more than 100 cities across China, covering east, central and north China.

**Nationwide and lower-tier market expansion.** In addition to safeguarding its leading position in Eastern China, Bright Dairy is also proactively exploring opportunities in other regions. Generally, the shelf life of fresh milk is seven days, while the company has developed new fresh milk products with over 15-day shelf life. Extended shelf life enables the transportation of products over long distances, allowing Bright Dairy to tap into markets in non-ranch locations or lower-tier markets with limited logistics facilities. The continuous nationwide market expansion and lower-tier market development are expected to drive the customer base expansion, promoting the top-line growth.

**Own cold-chain logistics:** Bright Dairy's own online ordering app (Bright SuiXinDing) and cold chain logistics company, Speed Fresh, with over 50,000 daily delivery outlets, is also a differentiating factor for the company, given cold chain logistics is a bottleneck for fresh milk distribution.

**Figure 202: Bright's own cold chain logistics company, Speed Fresh**



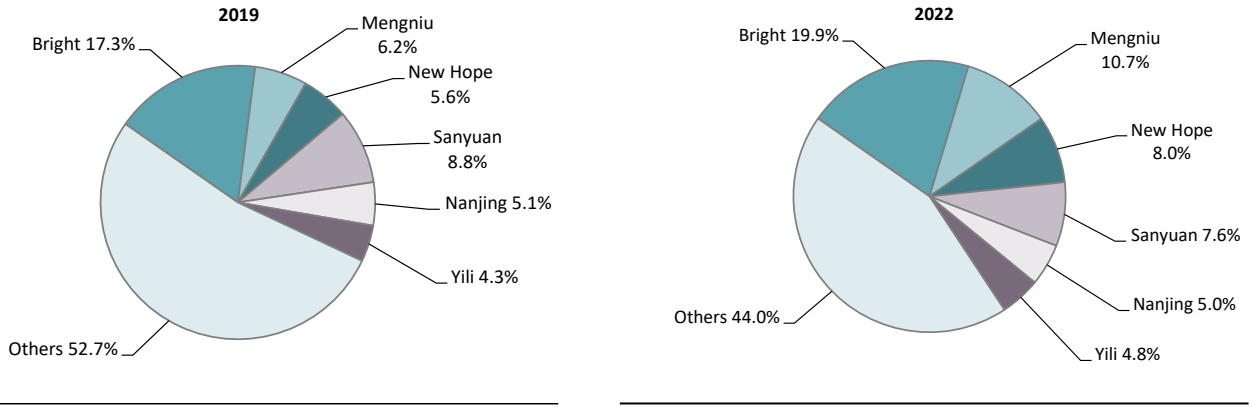

*Source: Company data, BOCOM Int'l*

# Investment Concerns

## Concern #1: Fresh milk market is difficult to reach a national scale in the short-term, while we see increasing market competition

Fresh milk market is difficult to achieve nationwide distribution in the short-term, due to the higher requirements of raw milk source and cold-chain logistics on the supply side, and lower-tier city consumers' income vs. raw milk's affordability on the demand side. Moreover, other dairy players are gradually joining the competition given the increasing popularity of fresh milk. For example, Mengniu has achieved a market share expansion of more than 4ppts over the past four years, and third-ranked New Hope also scored 2.4ppts market share growth. Despite its 1st place in this market, Bright Dairy's leadership in East China should be difficult to replicate in other regions in the near term. Local dairy companies are more likely to compete for market share in regions where Bright Dairy does not have the same advantages as Eastern China that require brand promotion and supply chain construction.

**Figure 203: Fresh milk market share comparison**

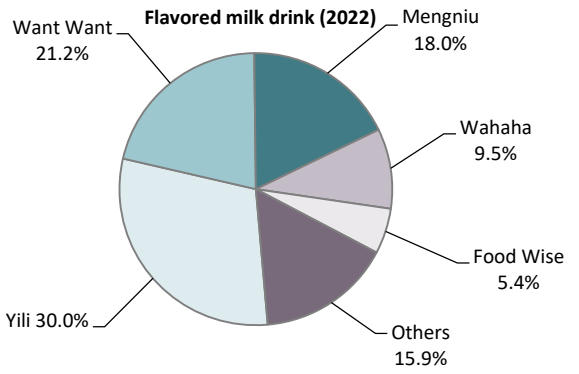



*Source: Euromonitor, BOCOM Int'l*

## Concern #2: Limited competitive advantages across different dairy segments

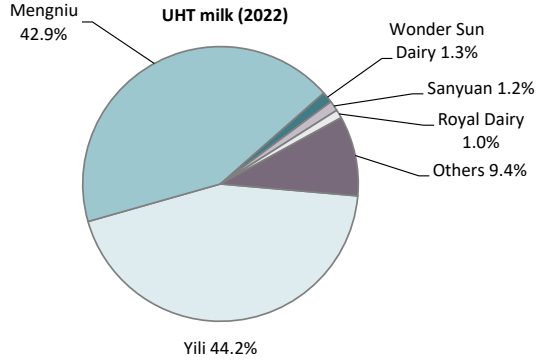
Bright Dairy's competitive advantage is limited to the fresh milk segment while exhibiting a weaker market position in other dairy segments. The company's market share of flavored milk drinks, UHT milk, and powder milk is less than 1%, with Yili and Mengniu dominating these markets. Although Bright Dairy is currently ranking 3rd in the yoghurt and sour milk segment, its declining market share will lead to weakened competitiveness. Given the fierce market competition and likely continuation of a duopoly, it is difficult to make significant breakthroughs in the development of other dairy segments in the short term. If the development of fresh milk is lower than expected, Bright Dairy could easily lose its market position.

**Figure 204: Market share: China flavored milk drinks**



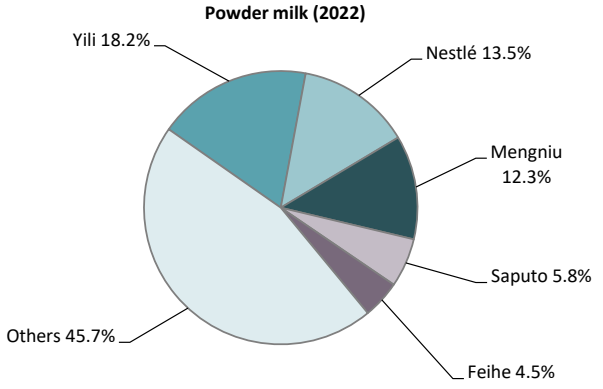

*Source: Euromonitor, BOCOM Int'l*

**Figure 205: Market share: China UHT milk**



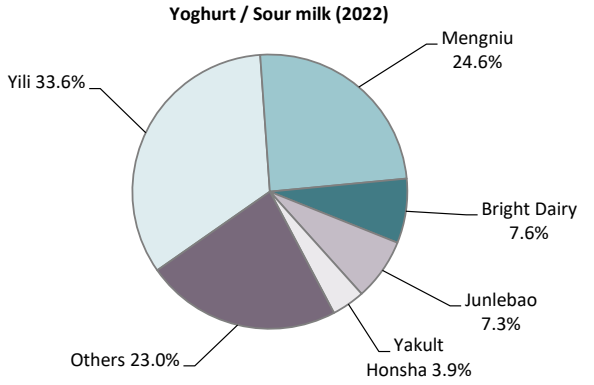

*Source: Euromonitor, BOCOM Int'l*

**Figure 206: Market share: China powder milk**




*Source: Euromonitor, BOCOM Int'l*

**Figure 207: Market share: China yogurt and sour milk products**



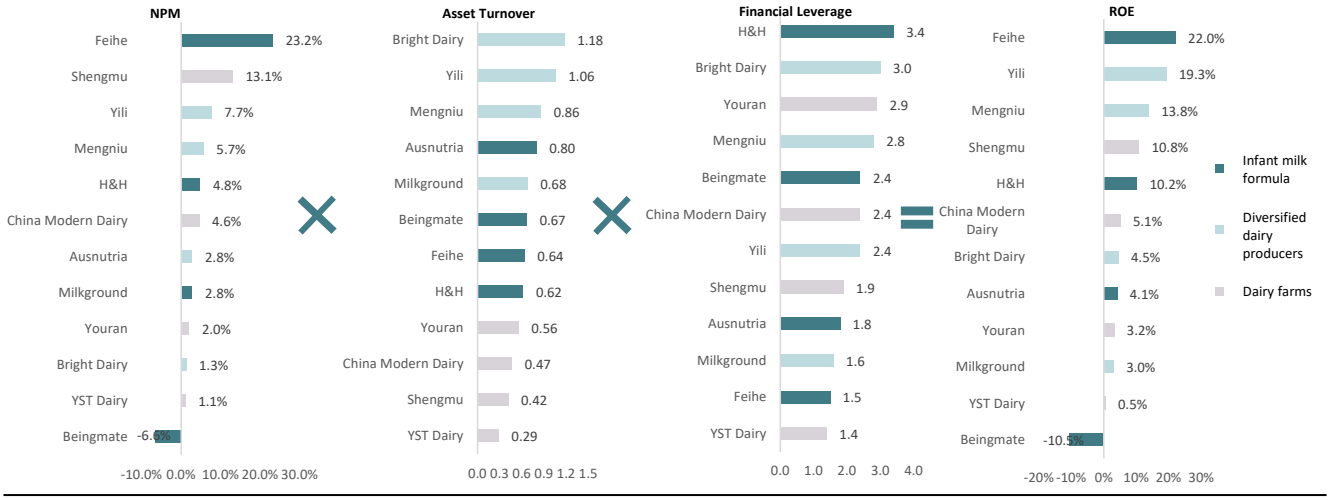

*Source: Euromonitor, BOCOM Int'l*

## Concern #3: Self-owned dairy farms could be a drag on returns and margins, given its lower ROE and currently declining raw price

Upstream dairy farms typically have lower ROE of 3-11% (based on China Modern Dairy, Shengmu and Youran) due to their asset-heavy business model, which pulls down asset turnover. Also, upstream dairy farms are often exposed to fluctuation in biological asset fair value changes. Given Bright owns its dairy farms, we believe it is why Bright's ROE (5% in 2022) is also relatively low compared to its peers Yili (19% in 2022) and Mengniu (14% in 2022), as a result of both lower margins for its upstream business (GPM of 1.3% vs. 26.1% for its liquid milk business in 2022), as well as lower asset turnover of 0.42x for its upstream business, vs. 1.39x for the rest of its business in 2022).

Secondly, we expect raw milk price to continue to fall in the next 1-2 years (-8% YoY in 2023, -3% YoY in 2024), which is positive for downstream players that uses raw milk as a raw material, but negative for upstream dairy farms that sells raw milk. As Bright is vertically integrated, its cost savings from raw milk price downtrend will likely be less obvious than its peers, while its upstream costs will also be pressured by rising feed costs.

**Figure 208: Dupont analysis of Return on Equity (ROE, 2022) along dairy supply chain**



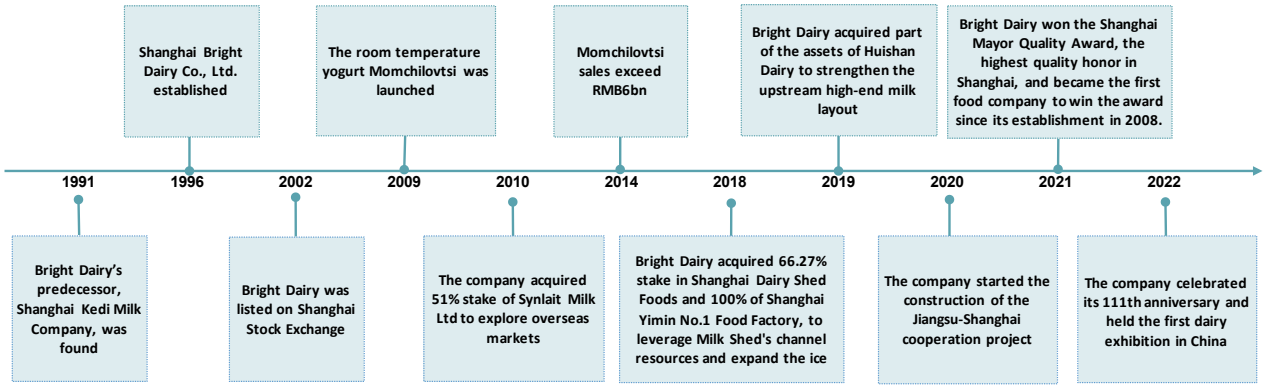

*Source: Bloomberg, BOCOM Int'l*

# Company Overview

## Company history

**A dairy brand with over 100-year history in China.** Bright Dairy, the leading fresh milk company in China, was founded in 1996, its predecessor was founded in 1991. The company has gradually developed its main business of development, production, and selling of dairy products, including fresh milk, UHT milk, chilled yogurt, room temperature yogurt, and other dairy products such as milk power, cheese, room temperature drinks, and vegan protein drinks.

**Figure 209: Bright Dairy's development history**




*Source: Company, BOCOM Int'l*

**Figure 210: Bright Dairy's M&A activities**

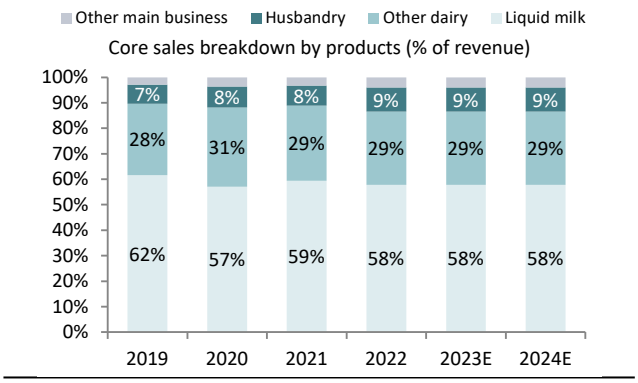
| Year | M&A | Motivation |
|---|---|---|
| 2010 | Bright Dairy acquired 51% stake of Synlait Milk Ltd | Overseas powder milk business expansion, and brand image enhancement |
| 2018 | Bright Dairy acquired 66.27% stake in Shanghai Dairy Shed Foods | Leveraging on Dairy Shed's channel resource to further enhance the market position in Shanghai |
| 2018 | Bright Dairy acquired 100% of Shanghai Yimin No.1 Food Factory | Product-mix enrichment, expanding the ice product business |
| 2019 | Bright Dairy acquired the assets of Jiangsu Huishan | Enhancing the expansion of the fresh milk market in Jiangsu, Shandong and Anhui |
| 2021 | Bright Dairy acquired 60% of Qinghai Xiaoxiniu | Enhancing the supply chain and channel deployment in west China |

*Source: Company , BOCOM Int'l*

## Main products and markets

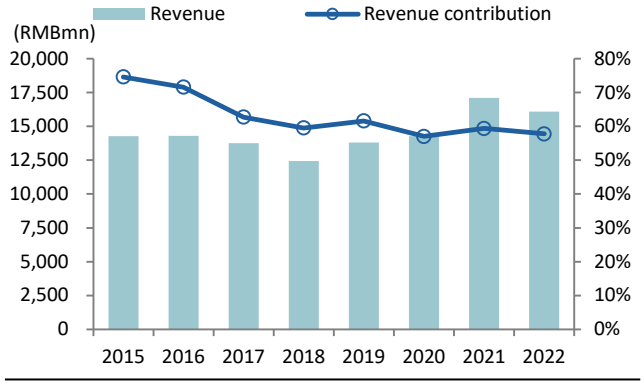
**Liquid milk is the core business, with an enriching product mix.** Bright Dairy has three business segments: liquid milk, other dairy products, and livestock, of which liquid milk and other dairy products account for over 85% of Bright Dairy's revenue. In 2022, the liquid milk segment achieved around RMB16.1bn revenue, accounting for 58%, while the dairy products and livestock segments contributed 29% and 9% of revenue, respectively. As the company has gradually developed into new product categories such as cheese and ice products over the recent years, coupled with the expansion of farms, the revenue contribution from other dairy products and livestock segment has gradually increased.

**Figure 211: Revenue contribution: by segment**




*Source: Company data, BOCOM Int'l estimates*

**Figure 212: Liquid milk segment performance**




*Source: Company data, BOCOM Int'l*

**Liquid milk business:** Bright classifies liquid milk as including drinking milk, yoghurt and milk beverage. The split between chilled business (fresh milk, yoghurt) and room temperate (UHT milk, room-temperate yoghurt) is around 60-40%. Within chilled business, fresh milk and chilled yoghurt is also with a similar 60-40 split. In terms of margins, fresh milk is higher than other categories.

**Other dairy business:** Other dairy includes infant milk formula, mostly internationally sourced from Bright's 39%-owned Synlait Milk dairy farm in New Zealand, selling mostly infant formula to international customers like the A2 Milk Company and Munchkin. International sales accounted for 24% of total sales in 2022. It also includes a smaller proportion of domestically-produced Bright-branded milk formula for adults, which rides on the ageing demographic trend. Other dairy also includes probiotics, as well as a small sales contribution from cheese.

**Fresh milk products, increasing products with 15-day shelf life:** Bright's Youbei 7-day fresh milk products are available nationwide, but only in large cities/provinces, like Shanghai, Beijing, Tianjian, Zhengzhou, Changsha, Wuhan, Xi'an, Chengdu, Guangdong, Shenzhen and Hainan. However, in order to penetrate into lower-tier (tier 2-3) cities, Bright has leveraged on its nationally accredited R&D center to extend the shelf life without sacrificing on nutritional value. This is why it has developed and launched a new 15-day shelf life product in 2H22 that it hopes can better penetrate lower-tier cities.

**Fresh milk:** Bright is currently the market leader in fresh milk, with its Zhiyou, Fresh Pasture and Ubest (Youpei) fresh milk, with sales scale close to RMB6bn in 2022, but sales declined YoY due to the pandemic and Bright's sales concentration in Shanghai (27% of 2022 sales). Bright Dairy's self-owned dairy farms (provides 40% of its raw milk supply), own online ordering app (SuiXinDing) and cold chain logistics company, Speed Fresh, with over 50,000 daily delivery outlets, is also a competitive advantage for the company, given cold chain logistics is a bottleneck for fresh milk distribution into lower-tier cities, and the online ordering app locks in customers for regular repeat purchasing of fresh milk.

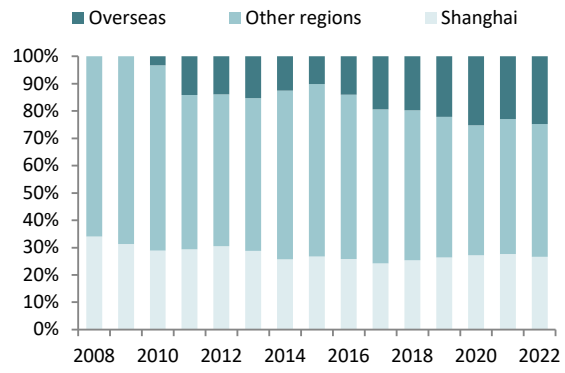
**Figure 213: Bright Dairy's main products**




*Source: Company data, BOCOM Int'l*

**Shanghai is the main market.** Bright Dairy's revenue mainly comes from three regions: (1) Shanghai, which achieved a total sale of RMB7.4bn in 2022, accounting for 27% of the Group's revenue; (2) other regions in China, scored RMB13.5bn in 2022 and contributed 49%; and (3) overseas markets, with revenue of RMB6.9bn, accounting for 25%. In the early stage of development, Shanghai accounted for about 1/3, and other regions in China accounted for the rest, while the proportion of overseas business has gradually increased after the acquisition of Synlait Milk Ltd in New Zealand in 2010.

**Figure 214: Revenue contribution: by region**

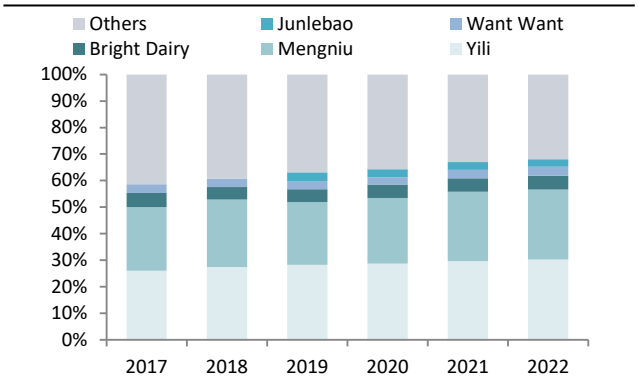



*Source: Company data, BOCOM Int'l*

## Market share

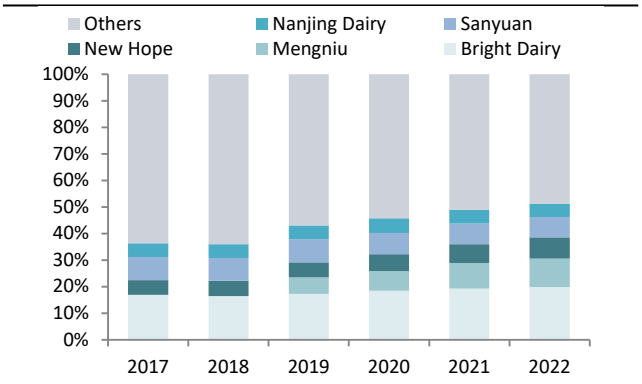
**3rd largest player in China's dairy market, 1st in the fresh milk segment.** Bright Dairy ranks 3rd in China dairy market year-round, with Yili and Mengniu taking the lead, accounting for a combined share of more than 55%. However, in the fresh milk segment, Bright Dairy has dominated the 1st position for more than a decade, and still saw continuous market share expansion during the recent years, reaching c.20% in 2022, nearly twice the share of the 2nd place, demonstrating absolute dominant position.

**Figure 215: Market share: China dairy market**



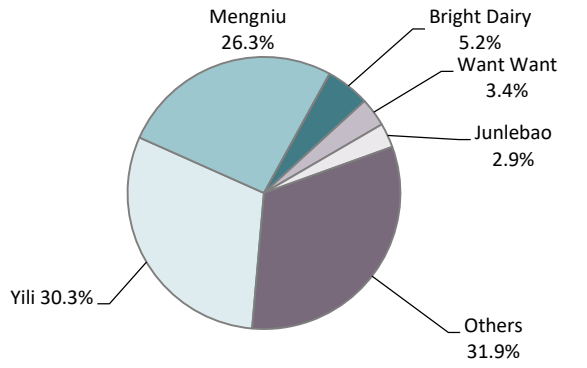

*Source: Euromonitor, BOCOM Int'l*

**Figure 216: Market share: China fresh milk sub-market**



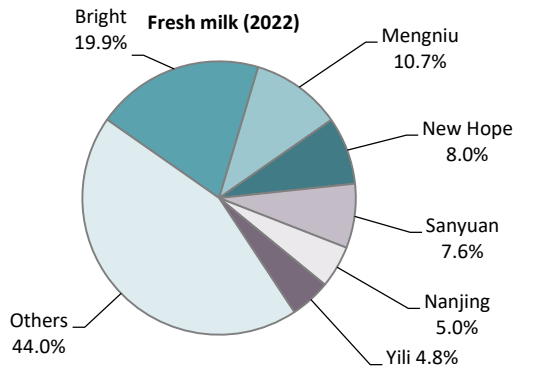

*Source: Euromonitor, BOCOM Int'l*

**Figure 217: Market share of China dairy market in 2022**




*Source: Euromonitor, BOCOM Int'l*

**Figure 218: Market share of China fresh milk sub-market in 2022**



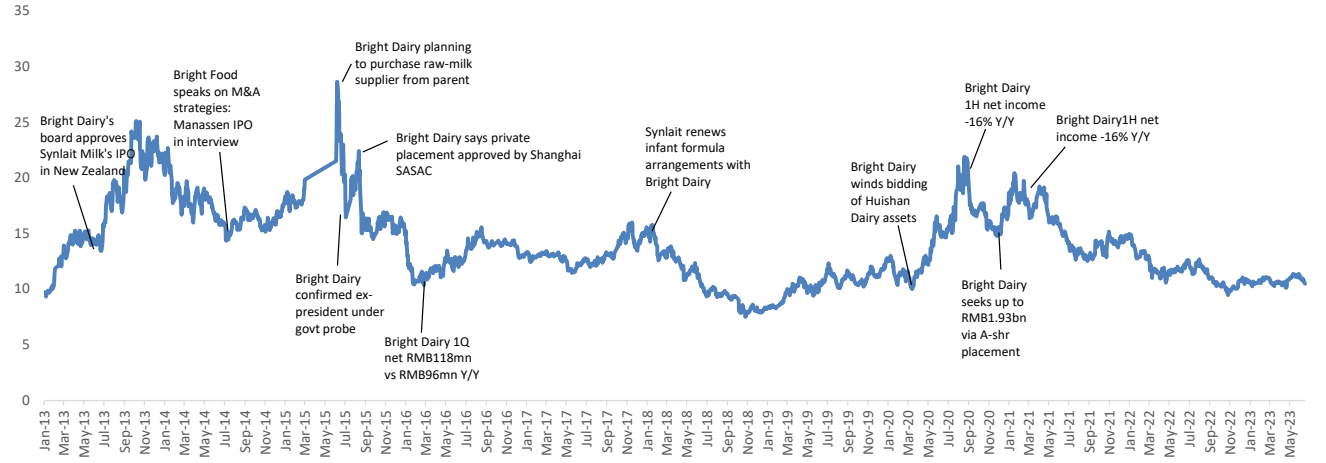

*Source: Euromonitor, BOCOM Int'l*

## Historical share price movers

**Results driven:** Bright Dairy debuted on Shanghai Stock Exchange on 28 August 2002, and reports results four times a year (FY/1Q/1H/3Q results in Mar/Apr/Aug/Oct).

**M&A-related news:** The fluctuation of the company's share price is closely related to the M&A events. Bright Dairy has strengthened its supply chain capabilities through several M&A since 10 years ago, which have had a positive impact in terms of market position enhancement and product mix enrichment.

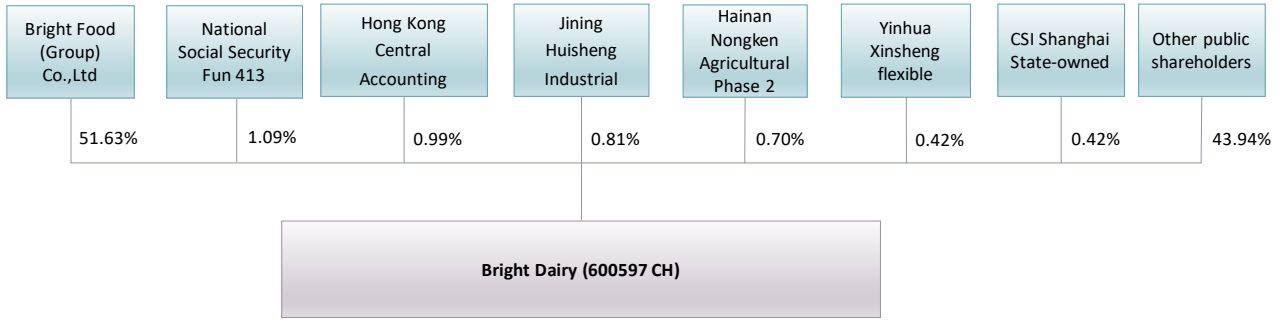
**Figure 219: Bright Dairy: Historical share price movers – financial results and M&A activities dominated share price movements**




*Source: Bloomberg, BOCOM Int'l, as of 21 June 2023*

## Shareholders and Management

### Figure 220: Bright Dairy: Shareholding structure



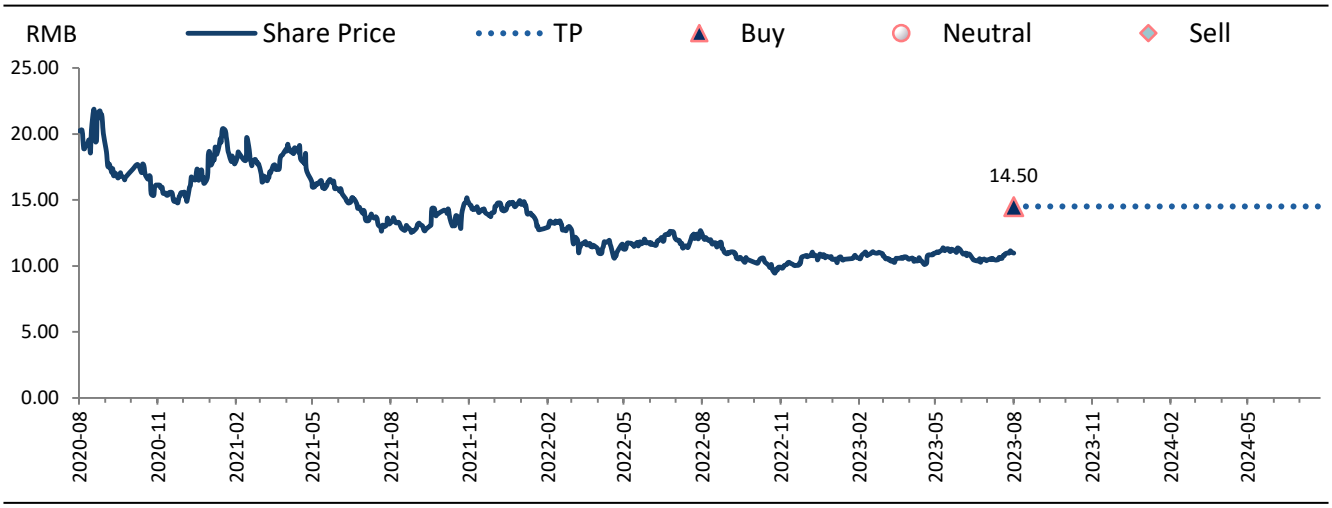

*Source: Bloomberg, BOCOM Int'l*

### Figure 221: Bright Dairy: Management Introduction

| Name | Position | Experience |
|---|---|---|
| **Huang Liming** | Party Secretary Chairman | Mr. Huang was the Party Secretary, CEO, and the Chairman of Shanghai Sugar Cigarette & Wine Group, Co., Ltd. After joining the Group, he previously served as various senior management positions such as Deputy General Manager, General Manager. |
| **Bi Min** | Vice President Deputy Party Secretary | Bi Min previously served as the Party committee, Secretary of the Commission for Discipline Inspection, and Director of Public Affairs in Bright Dairy and Food Co., Ltd. |
| **Lu Qikai** | Board Member | Lu Qikai is the Board member in Bright Dairy, as well as the General Manager of Investment and development department in Bright Food (group) Co.,ltd. Lu previously served as the supervisor of Bright Dairy's International business department, and the audit manager in KPMG. |
| **Xu Meihua** | Employee Representative | Xu Meihua previously served as the Party committee and Secretary of the Commission for Discipline Inspection in Bright Food International Limited, and used to be the Secretary of the Commission for Discipline Inspection and Union president in Shanghai Maling Aquarius Co. |
| **Mao Huigang** | Board Member | Mao Huigang is the board member of Bright Dairy, the legal representative of Jin Mao Law Firm, as well as the board member of Shanghai Rural Commercial Bank. Mao Huigang previously served as the partner and lawyer in Jin Mao Law Firm. |
| **Zhao Ziye** | Board Member | Zhao Ziye is the board member of Bright Dairy, Professor in Shanghai University of Finance & Economics, and the board member in Shanghai Chlor-Alkali Chem Co, Jiangsu Feiliks International Logistics Inc, Hubei Benxing New Materials Co. Zhao Ziye previously served as the board member in Shanghai Phoenix Enterprise Group. |
| **Gao Li** | Board Member | Gao Li is the board member of Bright Dairy, Professor in Shanghai University. Gao Li previously served as the Associate Professor in Shanghai International Studies University, and Human Resource Director in Alcatel-Lucent Enterprise. |
| **Zhang Yuzhen** | Chairman of the Supervisory Board | Zhang Yuzhen previously served as the Office Manager in Bright Dairy, and the Party committee, Supervior, Deputy Party Secretary and Secretary of the Commission for Discipline Inspection in Shanghai Langyou Group. |
| **Zhou Wen** | Supervisor | Zhou Wen is the Supervisor of Bright Dairy, and the Board Member of Shanghai Vegetable (Group) Co., Ltd.. Zhou Wen previously served as various positions in Shanghai Sugar Cigarette & Wine Group, such as Deputy Party Secretary and Secretary of the Commission for Discipline Inspection. |
| **Liu Ruibing** | CFO | Liu Ruibing previously served as the CFO of Shanghai Vegetable (Group) Co., Ltd and Shanghai Xijiao International Agricultural Product Trade Co., Ltd. |
| **Li Xiukun** | Deputy General Manager | Li Xiukun previously served as the General Manager of the Marketing center, and the regional manager of Zhejiang in East China Division. |
| **Shen Xiaoyan** | Secretary of the Board | Shen Xiaoyan previously served as the Securities Affairs Representative of Bright Dairy. |

*Source: Company data, BOCOM Int'l*

**Figure 222: Bright Dairy & Food (600597 CH) TP & rating**




*Source: FactSet, BOCOM Int'l estimates*

## Financial Statements

**Income statement (RMB m)**

| Y/E 31 Dec | 2021 | 2022 | 2023E | 2024E | 2025E |
|---|---|---|---|---|---|
| Revenue | 29,206 | 28,215 | 31,319 | 34,450 | 39,273 |
| COGS | (23,846) | (22,952) | (25,052) | (27,523) | (31,338) |
| **Gross profit** | **5,360** | **5,263** | **6,266** | **6,927** | **7,936** |
| SG&A | (4,464) | (4,352) | (4,831) | (5,314) | (6,058) |
| R&D | (89) | (85) | (94) | (103) | (118) |
| Other operating income, net | 0 | (40) | (313) | (345) | (393) |
| **Operating profit** | **807** | **786** | **1,028** | **1,165** | **1,367** |
| Net finance expenses | (114) | (158) | (166) | (173) | (182) |
| Other non-op. income, net | 7 | (131) | 165 | 176 | 214 |
| **Pre-tax profit** | **700** | **498** | **1,027** | **1,168** | **1,400** |
| Tax | (133) | (107) | (308) | (350) | (420) |
| Non-controlling interests | 25 | (30) | (50) | (41) | (59) |
| **Net profit** | **592** | **361** | **669** | **777** | **921** |
| Net profit for EPS calculation | 592 | 361 | 669 | 777 | 921 |

**Balance sheet (RMB m)**

| As of 31 Dec | 2021 | 2022 | 2023E | 2024E | 2025E |
|---|---|---|---|---|---|
| Cash & cash equiv | 3,206 | 2,649 | 2,880 | 3,189 | 3,561 |
| Marketable securities | 0 | 1 | 1 | 1 | 1 |
| Acc & bills receivable | 1,961 | 2,331 | 2,639 | 2,949 | 3,416 |
| Inventories | 3,115 | 4,197 | 4,648 | 5,107 | 5,815 |
| PUD and land/lease prepayments | 555 | 488 | 553 | 618 | 716 |
| ST income receivables | 0 | 0 | 0 | 0 | 0 |
| Other current assets | 342 | 242 | 253 | 265 | 277 |
| **Total current assets** | **9,178** | **9,908** | **10,975** | **12,129** | **13,785** |
| Investment properties | 0 | 0 | 0 | 0 | 0 |
| PPE | 8,067 | 8,598 | 8,803 | 9,011 | 9,223 |
| Other tangible assets | 2,634 | 2,892 | 2,892 | 2,892 | 2,892 |
| Intangible assets | 571 | 786 | 833 | 883 | 936 |
| Investment in associates/JCE | 130 | 81 | 81 | 81 | 81 |
| Long-term income receivables | 0 | 0 | 0 | 0 | 0 |
| Other non-current assets | 2,871 | 2,187 | 2,191 | 2,195 | 2,200 |
| **Total non-current assets** | **14,272** | **14,544** | **14,799** | **15,062** | **15,332** |
| **Total assets** | **23,450** | **24,452** | **25,774** | **27,191** | **29,117** |
| Short-term loans | 713 | 1,203 | 1,299 | 1,403 | 1,515 |
| Trade and other payables | 6,331 | 7,080 | 7,783 | 8,498 | 9,600 |
| Other current liabilities | 1,646 | 2,452 | 2,480 | 2,509 | 2,549 |
| **Total current liabilities** | **8,689** | **10,735** | **11,562** | **12,410** | **13,664** |
| Long-term loans | 910 | 202 | 208 | 214 | 221 |
| Long-term payables | 775 | 789 | 812 | 837 | 862 |
| Other non-current liabilities | 2,724 | 2,179 | 2,179 | 2,179 | 2,179 |
| **Total non-current liabilities** | **4,409** | **3,170** | **3,199** | **3,230** | **3,261** |
| **Total liabilities** | **13,098** | **13,904** | **14,761** | **15,640** | **16,925** |
| Share capital | 1,379 | 1,379 | 1,379 | 1,379 | 1,379 |
| Reserves & other capital items | 6,482 | 6,621 | 7,085 | 7,624 | 8,264 |
| **Shareholders' equity** | **7,861** | **8,000** | **8,464** | **9,003** | **9,643** |
| Financial instruments classified as equity | 0 | 0 | 0 | 0 | 0 |
| Non-controlling interests | 2,491 | 2,549 | 2,549 | 2,549 | 2,549 |
| **Total equity** | **10,352** | **10,548** | **11,013** | **11,552** | **12,191** |

**Cash flow (RMB m)**

| Y/E 31 Dec | 2021 | 2022 | 2023E | 2024E | 2025E |
|---|---|---|---|---|---|
| Pre-tax profit | 567 | 391 | 719 | 818 | 980 |
| Depreciation & amortisation | 1,171 | 1,309 | 1,078 | 1,100 | 1,123 |
| Change in working capital | 143 | (1,376) | (40) | (39) | (46) |
| Interest inc/exp adjustment | 56 | 163 | 166 | 173 | 182 |
| Other operating cashflow | 121 | 180 | (109) | (99) | (149) |
| **Cash flow from operation** | **2,058** | **667** | **1,814** | **1,953** | **2,089** |
| Capex | (2,383) | (1,386) | (1,334) | (1,363) | (1,393) |
| Investment | 3 | 5 | 0 | 0 | 0 |
| Other investing cashflow | (215) | 279 | (4) | (4) | (4) |
| **Cash flow from investing** | **(2,595)** | **(1,103)** | **(1,338)** | **(1,368)** | **(1,398)** |
| Net chg in interest-bearing debt | (570) | 548 | 126 | 135 | 144 |
| Net change in equity | 1,968 | 0 | 0 | 0 | 0 |
| Dividends paid | (281) | (348) | (370) | (411) | (463) |
| Other financing cashflow | (334) | (327) | 0 | 0 | 0 |
| **Cash flow from financing** | **783** | **(126)** | **(244)** | **(276)** | **(319)** |
| Exchange gain/loss | (2) | 4 | 0 | 0 | 0 |
| **Cash & cash equiv. at year start** | **2,961** | **3,206** | **2,649** | **2,880** | **3,189** |
| **Cash & cash equiv. at year end** | **3,206** | **2,649** | **2,880** | **3,189** | **3,561** |

**Financial ratio**

| Y/E 31 Dec | 2021 | 2022 | 2023E | 2024E | 2025E |
|---|---|---|---|---|---|
| **Per share data (RMB)** | | | | | |
| Core EPS | 0.430 | 0.262 | 0.485 | 0.563 | 0.668 |
| Fully-diluted EPS | 0.430 | 0.262 | 0.485 | 0.563 | 0.668 |
| Non-GAAP EPS | 0.000 | 0.000 | 0.000 | 0.000 | 0.000 |
| DPS | 0.160 | 0.080 | 0.148 | 0.172 | 0.204 |
| BVPS | 5.702 | 5.802 | 6.139 | 6.530 | 6.994 |
| **Margin analysis (%)** | | | | | |
| Gross margin | 18.4 | 18.7 | 20.0 | 20.1 | 20.2 |
| EBITDA margin | 6.8 | 7.4 | 6.7 | 6.6 | 6.3 |
| EBIT margin | 2.8 | 2.8 | 3.3 | 3.4 | 3.5 |
| Net margin | 2.0 | 1.3 | 2.1 | 2.3 | 2.3 |
| **Profitability analysis (%)** | | | | | |
| ROA | 2.7 | 1.5 | 2.7 | 2.9 | 3.3 |
| ROE | 8.4 | 4.5 | 8.1 | 8.9 | 9.9 |
| ROIC | 6.7 | 6.0 | 3.5 | 6.3 | 7.0 |
| **Others** | | | | | |
| Net debt to equity ratio (%) | Net Cash | Net Cash | Net Cash | Net Cash | Net Cash |
| EBITDA/gross interest expenses (x) | 18.0 | 13.1 | 10.1 | 10.3 | 10.7 |
| Current ratio (x) | 1.1 | 0.9 | 0.9 | 1.0 | 1.0 |
| Inventory turnover (days) | 48.4 | 67.7 | 67.7 | 67.7 | 67.7 |
| Acc receivable turnover (days) | 24.3 | 29.7 | 30.2 | 30.7 | 31.2 |
| Acc payable turnover (days) | 51.3 | 63.0 | 63.0 | 63.0 | 63.0 |

*Source: Company data, BOCOM Int'l estimates*

BOCOM Int'l Research

**Initiation of Coverage**

| Consumer | Last Close | Target Price | Upside |
|---|---|---|---|
| | HK$ 4.88 | HK$ 5.00 | +2.5% |

9 August 2023

# China Feihe (6186 HK)

## Champion fighting an uphill battle; Initiate at Neutral

- **Infant milk formula ("IMF") champion with successful localized strategy:** Feihe has been a success story, increasing its market share from 4% in 2013 to 20% in 2022, overtaking international brands that were popular in the aftermath of the 2008 melamine incident. Its strategy of using local raw milk and turning them into powder within 2 hours at its self-owned dairy farms in Heilongjiang (it acquired YST Dairy in 2020) for freshness and nutrition, coupled with effective marketing that its formula is tailored for Chinese babies, has won over Chinese parents' wallets.

- **Amid industry headwinds, consensus expectation is high and assumes blue sky scenario:** China's IMF industry market fell by 0.5% YoY in 2022 and is expected to decline by 1.3% CAGR in the coming five years on falling birth rate in China, according to Euromonitor. Meanwhile, consensus expects Feihe to post 9% sales CAGR for the next three years, which implies Feihe needs to gain 2ppt market share each year (from its market-leading 20% in 2022, to 26% by 2025). While this is possible amid accelerating market consolidation driven by new National Standards in Feb 2023, it will be no easy feat. Feihe is guiding double-digit sales growth in 2023, but we expect 1H23 sales to be flattish YoY, which implies ~20% growth is needed for 2H23. Apart from sales, consensus expects margins to remain flattish in the next three years (despite falling 7ppts over 2021-22), which may also be optimistic given a shrinking market tends to drive price competition and squeeze GPMs.

- **GPM upside hinges on growth of high-end Astrobaby ZhuoRui:** Feihe wants to reduce dependence on the basic Astrobaby series to lower operational risks, as its sales reached RMB10bn (>40% of sales) but saw excessive inventory in 2021. Astrobaby's inventory is now back to healthy (at 1.5x) after its successful "fresh" destocking strategy, but not without cutting prices, from RMB280/can to RMB220, which hurt its GPM (fell 7ppts to 70%). Future GPM upside would depend on its higher-end ZhuoRui (RMB270-280), which is growing strongly by >100% YoY in 2023.

- **Initiate with Neutral and TP of HK$5.0:** We expect Feihe's sales/net profit to grow by 6%/8% CAGR over 2023-25E. Our 2023-25E EPS are below consensus by 2-4% on lower sales and GPM. Our TP of HK$5.0 is based on 7.1x 2024E P/E, derived from 0.85x PEG on our EPS CAGR of 8.3% (2023-25E). Our 0.85x PEG represents a 15% discount to the rest of our dairy universe (1.0x PEG), given the structural industry headwinds facing the infant formula market that Feihe operates in.

### Financial highlights

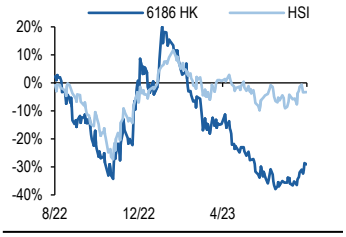
| Y/E 31 Dec | 2021 | 2022 | 2023E | 2024E | 2025E |
|---|---|---|---|---|---|
| Revenue (RMB m) | 22,776 | 21,311 | 22,657 | 24,104 | 25,658 |
| YoY growth (%) | 22.5 | -6.4 | 6.3 | 6.4 | 6.4 |
| Net profit (RMB m) | 6,959 | 4,954 | 5,362 | 5,807 | 6,292 |
| EPS (RMB) | 0.78 | 0.55 | 0.60 | 0.65 | 0.70 |
| YoY growth (%) | -6.3 | -29.0 | 8.2 | 8.3 | 8.4 |
| P/E (x) | 5.8 | 8.1 | 7.5 | 6.9 | 6.4 |
| BVPS (RMB) | 2.34 | 2.68 | 3.03 | 3.41 | 3.81 |
| P/B (x) | 1.91 | 1.67 | 1.48 | 1.32 | 1.18 |
| Dividend yield (%) | 8.7 | 5.6 | 6.1 | 6.6 | 7.1 |

*Source: Company data, BOCOM Int'l estimates*

**Stock Rating**

**NEUTRAL**

### 1-year stock performance




*Source: FactSet*

### Stock data

| | |
|---|---|
| 52w high (HK$) | 8.25 |
| 52w low (HK$) | 4.27 |
| Market cap (HK$ m) | 44,179.08 |
| Avg daily vol (m) | 16.69 |
| YTD change (%) | (26.51) |
| 200d MA (HK$) | 5.50 |

*Source: FactSet*


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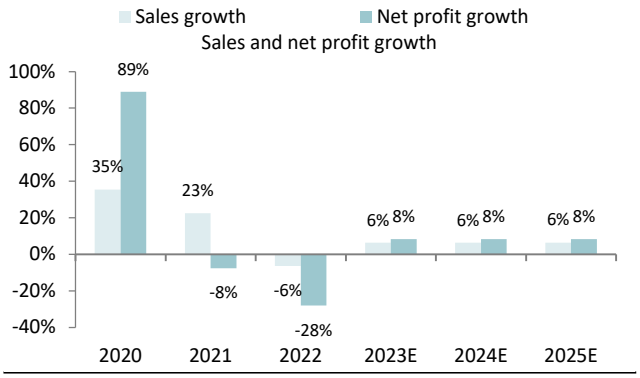


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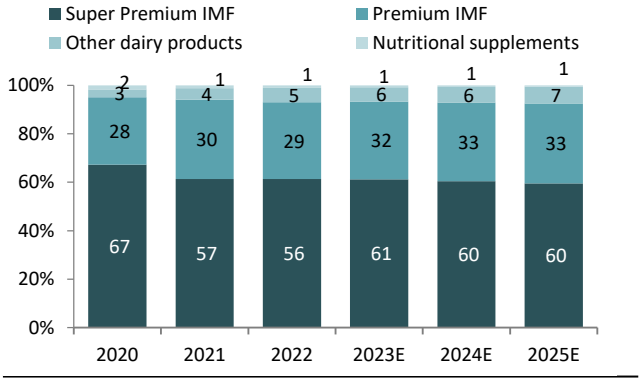
## Company at a Glance

### Figure 223: Feihe: Sales and net profit growth



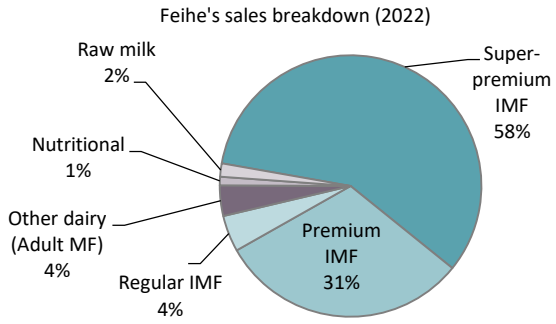

*Source: Company data, BOCOM Int'l estimates*

### Figure 224: Feihe: Sales breakdown by product



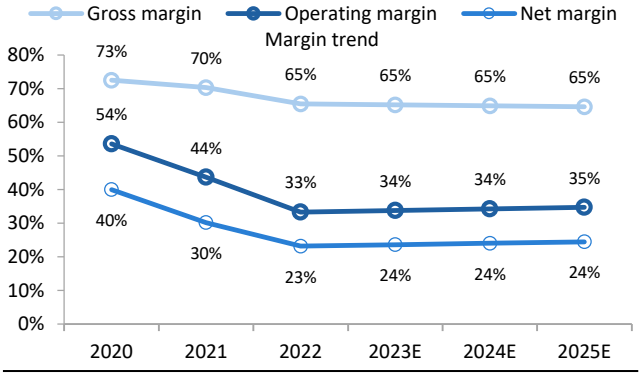

*Source: Company data, BOCOM Int'l estimates*

### Figure 225: Feihe: Sales growth by product (2022)



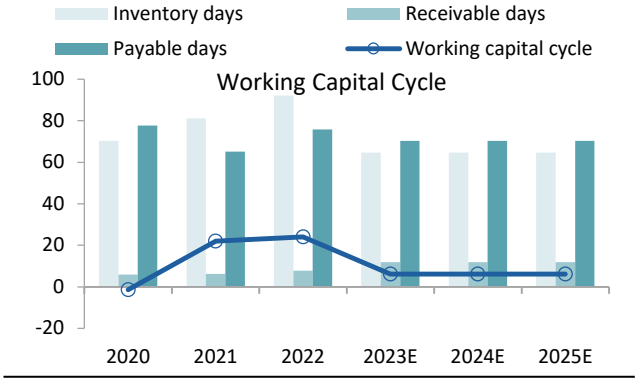

*Source: Company data, BOCOM Int'l*

### Figure 226: Feihe: Overall margin trends



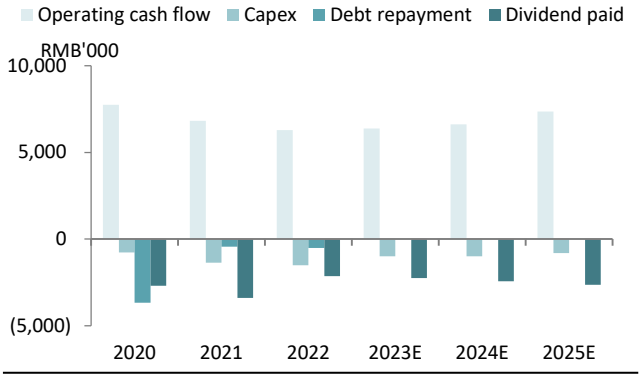

*Source: Company data, BOCOM Int'l estimates*

### Figure 227: Feihe: Working capital cycle (days)




*Source: Company data, BOCOM Int'l estimates*

### Figure 228: Feihe: Cash flow




*Source: Company data, BOCOM Int'l estimates*

# Valuation

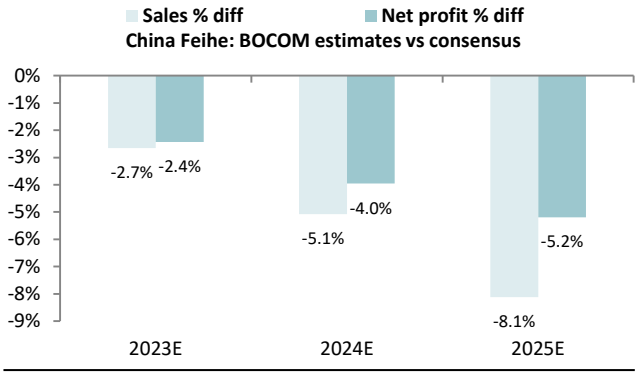
## Initiate with Neutral rating, TP HK$5.0 (2.5% upside)

We initiate coverage on Feihe with a **Neutral** rating and a TP of HK$5.0, based on 7.1x P/E on our 2024E EPS. Our target P/E multiple is based on 0.85x PEG to our EPS CAGR (2023-25E) of 8.3%. We find this PEG reasonable, which represents a 15% discount to the PEG we use for diversified dairy producers (1.0x PEG for Mengniu and Yili), given the structural industry headwinds facing the infant formula market that Feihe operates in.

**Upside risks:** (1) Year of Dragon and China's reopening could provide a stronger than expected uptick in new births in 2024; (2) better-than-expected sales of high-end products (e.g. ZhuoRui series) leading to strong GPM rebound.

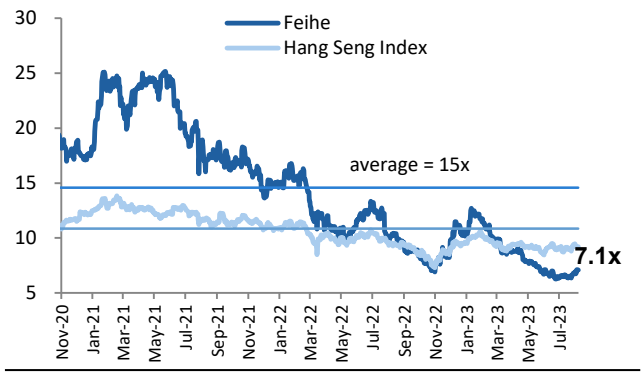
**Downside risks:** (1) Weaker-than-expected market share gain; (2) higher-than-expected raw material cost increase leading to GPM pressure; (3) price competition as a result of market consolidation leading to GPM pressure; (4) food safety issues.

**Figure 229: Feihe: BOCOM vs. consensus**




*Source: Bloomberg consensus, BOCOM Int'l estimates*

**Figure 230: Feihe: Forward P/E**




*Source: Bloomberg consensus, BOCOM Int'l*

## Financial Forecast

**Consensus seems too high considering industry headwinds:** China's IMF industry market is expected to decline by 1.3% CAGR in the coming five years on falling birth rate in China, according to Euromonitor. However, consensus expects Feihe to post 9% sales CAGR for the next three years, which implies Feihe would gain 2ppt market share each year (from its market-leading 20% in 2022, to reach 25-26% in 2025). While this is possible, it would not be easy.

**BOCOM forecast:** We expect 1H23 sales to be flattish, which would make management's full year sales growth guidance of "double-digit % YoY growth" a tough task, as it implies 2H23 growth need to be near 20%. We expect 2023 sales to grow by 6% YoY, below guidance. Feihe's sales growth will likely be driven by its Astrobaby ZhuoRui series, which is on track to grow by >100% YoY and reach 16-17% of sales in 2023, up from 8% in 2022.

We expect GP margin to stay stable for the next 3 years amid market consolidation (again, not an easy feat), driving EPS CAGR of 8% for the next 3 years (vs. -29% YoY in 2022).

**Figure 231: Feihe: Key sales assumptions**

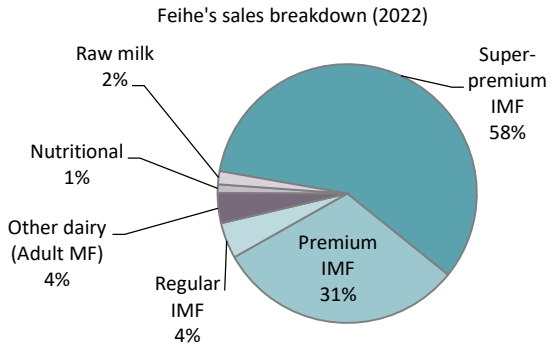
| | 2019 | 2020 | 2021 | 2022 | 2023E | 2024E | 2025E |
|---|---|---|---|---|---|---|---|
| **Revenue (RMB m)** | | | | | | | |
| Dairy products | 13,143 | 18,269 | 22,275 | 20,737 | 22,053 | 23,460 | 24,963 |
| IMF | 17,674 | 21,515 | 19,932 | 21,128 | 22,396 | 23,740 | 23,740 |
| Other dairy products | 595 | 760 | 804 | 925 | 1,064 | 1,223 | 1,754 |
| Nutritional supplements | 578 | 312 | 270 | 225 | 203 | 182 | 164 |
| Raw milk | | 12 | 231 | 349 | 401 | 462 | 531 |
| **Total sales** | **13,722** | **18,592** | **22,776** | **21,311** | **22,657** | **24,104** | **25,658** |
| **Sales mix (% of total)** | | | | | | | |
| Dairy products | 96% | 98% | 98% | 97% | 97% | 97% | 97% |
| IMF | 95% | 94% | 94% | 93% | 93% | 93% | 93% |
| Other dairy products | 3% | 3% | 4% | 4% | 4% | 5% | 7% |
| Nutritional supplements | 4% | 2% | 1% | 1% | 1% | 1% | 1% |
| Raw milk | n/a | 0.1% | 1% | 2% | 2% | 2% | 2% |
| **Total** | **100%** | **100%** | **100%** | **100%** | **100%** | **100%** | **100%** |
| **Sales growth %** | | | | | | | |
| Dairy products | 35% | 39% | 22% | -7% | 6% | 6% | 6% |
| 36% | 41% | 22% | -7% | 6% | 6% | 6% | 6% |
| 10% | -2% | 28% | 6% | 15% | 15% | 15% | 15% |
| Nutritional supplements | -10% | -46% | -13% | -17% | -10% | -10% | -10% |
| Raw milk | n/a | n/a | n/m | 51% | 15% | 15% | 15% |
| **Total** | **32%** | **35%** | **23%** | **-6%** | **6%** | **6%** | **6%** |

*Source: Company data, BOCOM Int'l estimates*

**Consensus on margins leaves no room for misstep:** Feihe's GPM has fallen by 7ppts over the past two years (2021-22), from 73% to 65%. We think a shrinking market tends to drive price competition, intensified price competition and squeeze GPMs, which means

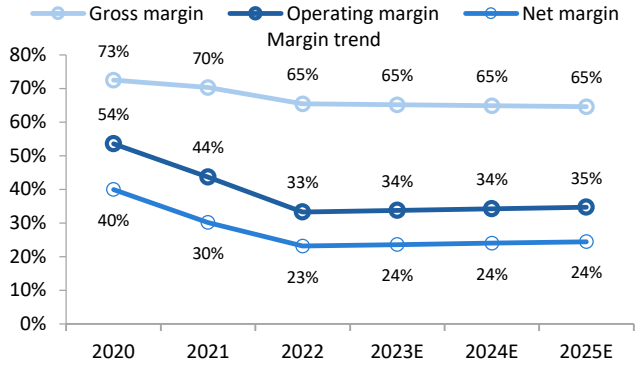
there would likely continue to be downward pressure on its GPM. We give Feihe the benefit of the doubt and expect margins to remain flattish in the next three years, in-line with consensus, as we assume Feihe would be successful in boosting sales of its higher-end Astrobaby ZhuoRui. However, this assumes Feihe is able to execute its super premium expansion plan flawlessly and leaves no room for execution hiccup.

**Figure 232: Feihe: Sales growth by product (2022)**




*Source: Company data, BOCOM Int'l*

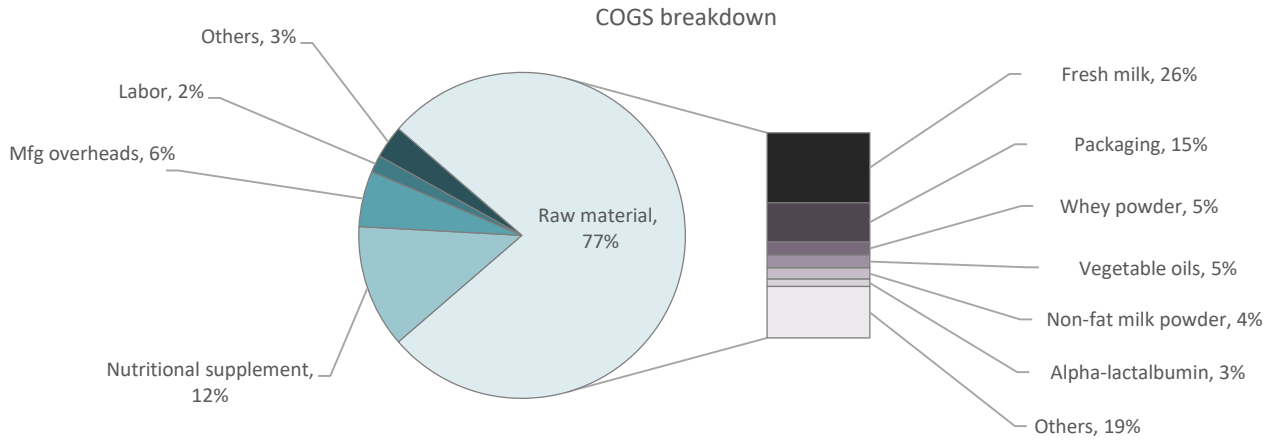
**Figure 233: Feihe: Overall margin trends**




*Source: Company data, BOCOM Int'l estimates*

**COGS breakdown:** The biggest COGS item is fresh milk, which accounts for 26% of total COGS, followed by packaging material. Feihe currently fulfills >90% of its raw milk needs from its 71.26%-owned YST Dairy. (YST Dairy in turn sells 83% of its raw milk to Feihe). It still sources 10% of raw milk from other third party suppliers.

**Figure 234: Feihe: COGS breakdown – the biggest item is fresh milk, which is sourced >90% from YST Dairy**



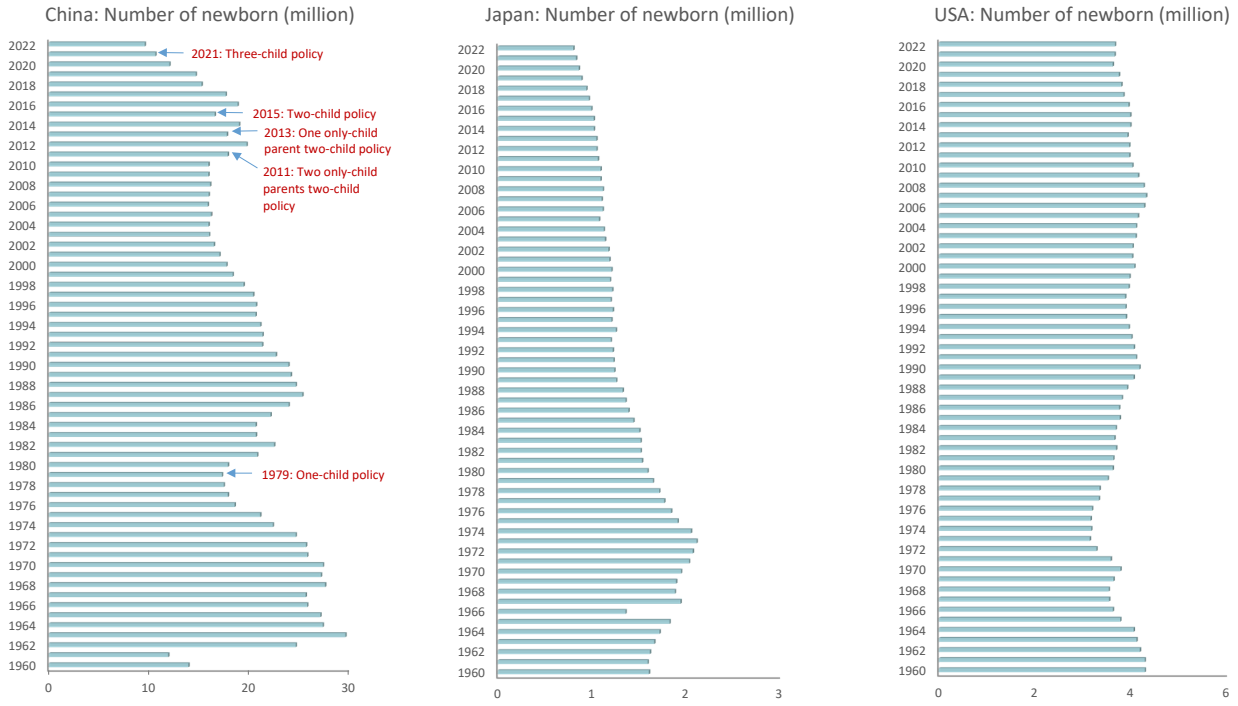

*Source: IPO prospectus (2019), BOCOM Int'l*

# Investment Concerns

## Concern #1: IMF market is directly impacted by demographic headwinds

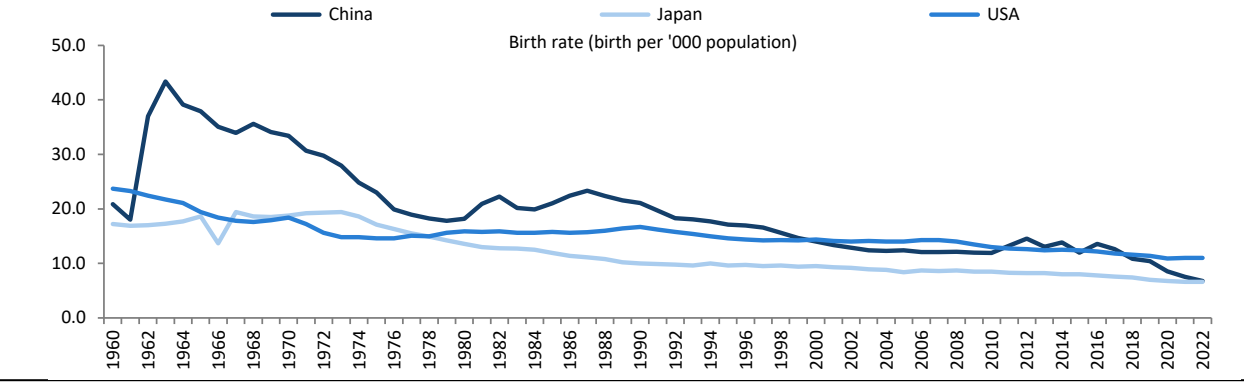
**Newborns reached new low in China:** The number of newborns in China registered in 2022 was 9.56m, a decline of 10% YoY from 10.62m babies in 2021. This represented a birth rate of 6.77 births for every 1,000 people in 2022, down from 7.52 in 2021. We note that China is not alone, as new birth globally has suffered from the pandemic.

**Figure 235: Number of newborns in China fell to a new low in 2022, Japan newborns also slumped**




*Source: World Bank, NBS, Nikkei, CDC, BOCOM Int'l*

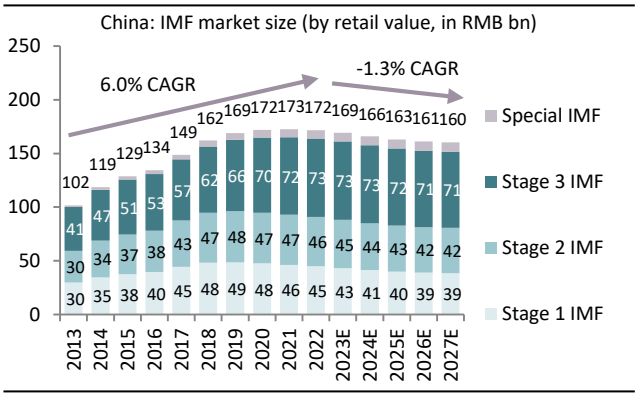
**Figure 236: Birth rate in China is converging with those of more developed countries like the US, Japan**




*Source: World Bank, BOCOM Int'l*

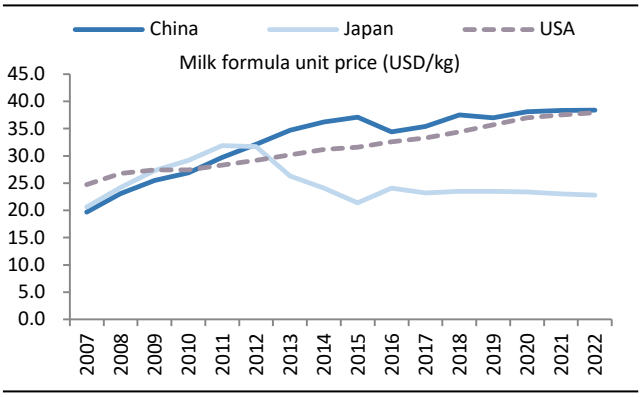
This would have a direct impact on IMF players given stage 1 and stage 2 IMF, which account for 53% of the entire market's revenue in 2022, are targeted at infants aged 0-6 months and 6-12 months respectively. Stage 3 IMF, which accounts for another 42% of the industry's revenue, is targeted at those aged 12-36 months old. This means the market demand for IMF is directly linked to the number of newborns in the past three years, especially those born in the past year.

**Figure 237: IMF: Market size and growth**




*Source: Euromonitor, BOCOM Int'l*
*Note: *Stage 1 is targeted at infant aged 0-6 months, stage 2 is targeted those aged 6-12 months, stage 3 is targeted at those aged 12-36 months*

**Figure 238: Pricing of China's baby milk formula is comparable to the US and exceeds that in Japan**




*Source: Euromonitor, BOCOM Int'l*

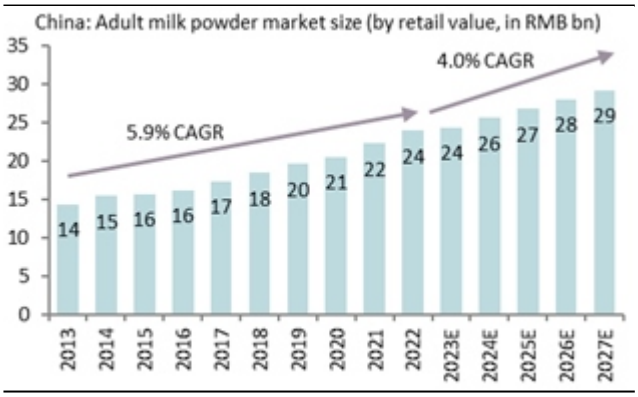
**Government's promotion of breastfeeding could hurt IMF volume in the long-run:** Infant milk formula has been instrumental in freeing women into the workforce and enhancing a society's overall labor productivity. Mothers who have full-time work often need to rely on IMF, given their work commitment and commute. In China, earlier surveys show that breastfeeding rate is relatively low, at 20.8% at 6 months, 11.5% at 1 year and 6.9% at 2 years, compared to those in western countries, among which, the highest breastfeeding rate is at 98% in Croatia. Duration of breastfeeding is also not long. However, the Chinese government's policies to promote breastfeeding, including improving hospitals' consultancy services, public support facilities and protecting women's working rights during lactation, could threaten demand for IMF in the long-run.

**Government could see high ASP for IMF as unhelpful in its drive to encourage more new births, while high financial costs could also spur uptick in breastfeeding:** While industry volume would likely see limited upside, or in fact downside, in the medium- to long-run, we see limited upside to ASP as well. China's ASP for infant milk formula is currently comparable to those in more developed markets, such as Japan and the US. While Chinese parents are often willing to spend a premium to secure the best for their children (especially given most families currently still have one child, despite the rolling out of three-child policy in 2021), the high financial cost to procure this necessity suggests future growth to ASP could be difficult. The Chinese government could see the high costs of IMF, which is deemed an essential staple, as detrimental to its drive to encourage more new births, and could require IMF players to lower prices, which has happened before.

## Concern #2: Small exposure to fast-growing sub-segments, e.g. adult milk formula, goat milk, nutritional supplement

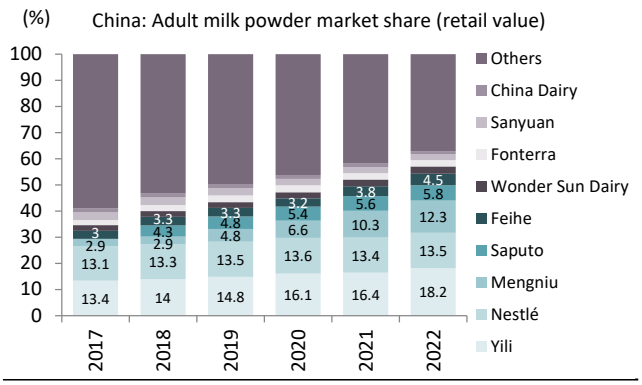
Feihe has only 3-4% of sales in adult milk formula, which is expected to grow quicker than IMF: Within the milk powder industry, adult milk formula (AMF) will likely post higher growth going forward. According to Euromonitor, adult milk powder should post 5% CAGR in the next 5 year (vs. -1.3% CAGR for IMF). Feihe launched its adult milk formula products in 1H21, and is only 3-4% of its sales in 2022. Its future plans also remain focused on the infant milk formula segment, rather than looking to accelerate the growth of its adult milk formula business. While this lack of focus on AMF is justifiable, given AMF market is only 14% the size of the IMF market in 2022, any help to offset the challenging headwinds in the IMF market could be useful.

**Figure 239: Adult milk powder: Market size and growth**




*Source: Euromonitor estimates, BOCOM Int'l*

**Figure 240: Adult milk powder: Market share. Feihe is ranked 5th, while it ranks 1st in IMF**




*Source: Euromonitor, BOCOM Int'l*

**Figure 241: Product offering by segment – Adult milk powder**

| Company 公司 | Yili 伊利 | | Mengniu 蒙牛 | | Bright Dairy 光明 | | Feihe 飞鹤 | |
|---|---|---|---|---|---|---|---|---|
| Ticker 股票代号 | 600887 CH | | 2319 HK | | 600597 CH | | 6186 HK | |
| Product series 产品系列 | Xinhuo 欣活 | Goat Milk Powder 倍畅 | Platium 铂金 | Yourui 悠瑞 | High Calcium & Vitamin E Milk Powder for Middle-aged & Senior 中老年高钙维生素E调制奶粉 | Youjia 优加 | Classic 962 经典1962 | Aiben 爱本 |
| Price/ 800g (Rmb) | 139 | 258 | 108 | 128 | 78 | 109 | 58 | 141 |

*Source: tmall.com, BOCOM Int'l*

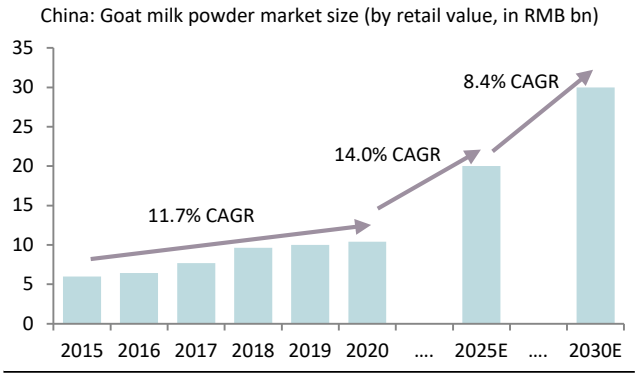
**Within the infant milk formula market, goat milk is outgrowing cow's milk:** According to the 2022 Report on China's Goat Milk Powder Industry Development, the goat milk formula market continues to outpace the infant formula market when compared with other categories, with a growth of 12% CAGR from 2015-20, and is expected to grow by 14% CAGR from 2020-25E. Such strong growth of the goat milk formula industry has

prompted many industry players to roll out goat milk formula products. While competition has intensified, market recognition of goat milk formulas is also on the rise.

**Feihe has only 1% of sales from goat milk in 2022, while competitor Yili and H&H are expanding:** Feihe also has goat milk powder products, including the newly launched Astrobaby ZhuoShu, but goat milk powder is relatively small at only 1% of sales in 2022. Back in its 2020 annual results (in March'21), management mentioned its goal to reach number 1 market position in goat milk segment within 5 years (i.e. by 2025), but that goal seems to have derailed after the excess inventory problems the company faced in 2022.

On the other hand, Feihe's main competitor Yili acquired Ausnutria recently, which owns Kabrita, the leading goat milk formula brand in China with a market share of 29.2% as of April 2023, as well as a dominant share of >60% in China's imported infant and child goat milk powder market for five consecutive years from 2018 to 2022, according to Nielsen IQ and Chemlinked. H&H has also aggressively expanded its distribution network for its goat milk powder products in China, as it entered into partnership with Kidswant and Aiyingshi.

**Figure 242: Goat milk powder: China market size**




*Source: Chemlinked, BOCOM Int'l*

**Figure 243: Top 10 best-selling goat milk infant formula on Tmall (LHS) and JD (RHS) in 2022**

| Rank | Brand | Rank | Brand |
|---|---|---|---|
| 1 | Kabrita | 1 | Kabrita |
| 2 | Karicare | 2 | Yili |
| 3 | Blue River | 3 | Bubs |
| 4 | Bekari | 4 | Blue River |
| 5 | Biostime | 5 | Bekari |
| 6 | Karihome | 6 | Karicare |
| 7 | Bubs | 7 | Karihome |
| 8 | oli6 | 8 | Biostime |
| 9 | Meling | 9 | Junlebao |
| 10 | Jinlingguan | 10 | Feihe |

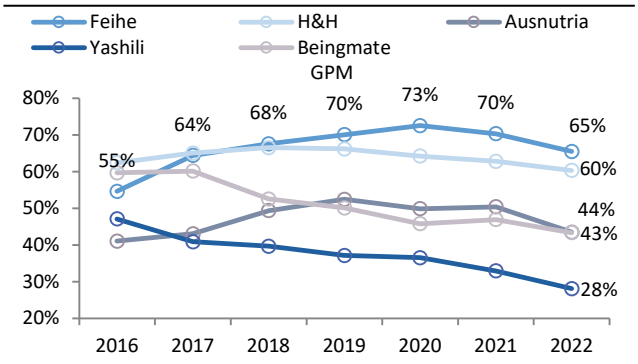
*Source: CHEMLINKED, BOCOM Int'l*

**Expansion into vitamin supplement segment in the US, but sales has declined during the pandemic.** Feihe acquired Vitamin World in the US, now a wholly owned subsidiary, in December 2017, but it has declined in sales contribution and now accounts for only 1% of Feihe's sales. It currently has 50 stores, down from a peak of 200+ stores, mostly selling in the USA. Sales has slowed and have seen many physical stores closures during the pandemic.

## Concern #3: Margins could come under pressure as price competition intensifies amid accelerated market consolidation

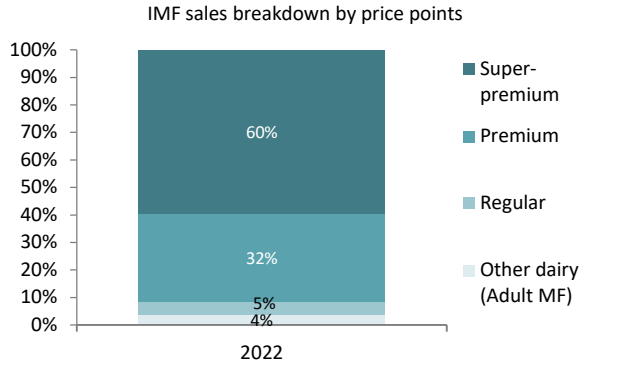
**Feihe is focused on the super premium segment with high margins, but could face downward pressure:** Feihe's margins is the highest in China's dairy sector, almost unsustainably high. Its GPM peaked at 72.5% in 2020, which came down to 65.5% in 2022 after its inventory issues that forced it to destock. Recently, Feihe had to lower prices of its Astrobaby Classic series from RMB270-280/can to RMB220/can, driving the product's GPM down 7ppt to 70%. Under the current macro environment where consumer sentiment is still recovering slowly, in addition to market consolidation, we think there could be intensified price competition, while premium and super premium segments could be more vulnerable.

**Figure 244: GP margin: Feihe vs. peers**




*Source: Company data, BOCOM Int'l*

**Figure 245: Feihe's sales leans towards premium**




*Source: Company data, BOCOM Int'l estimates*

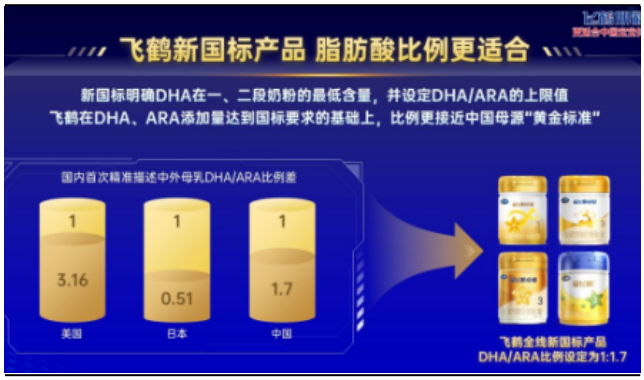
**Feihe's strategy is to focus on premium, super premium segments:** Feihe launched four new products in August 2022 that met the requirements of the new National Standard for infant milk formula, including **Astrobaby ZhuoYao** (RMB270/750g can), **Astrobaby ZhuoShu** (goat milk powder, RMB268/700g can), **Astrobaby classic** (RMB220/700g can) and **Astrobaby ZhuoRui** (RMB328/750g can, originally launched in January 2022). However, these could face intensified price competition from both domestic and international brands.

**Figure 246: Feihe launched 4 product series**




*Source: crnews.net, BOCOM Int'l*

**Figure 247: .. that fulfills the new National Standard for infant milk formula**




*Source: crnews.net, BOCOM Int'l*

## Figure 248: Product offering by segment – Chinese brands

| Company 公司 Ticker 股票代号 | Feihe 飞鹤 6186 HK | | Mengniu / Yashili 蒙牛 / 雅士利 2319 HK / 1230 HK | | | Ausnutria 澳优 1717 HK | | | H&H Biostime 合生元 1112 HK | | Yili 伊利 600887 CH | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Super premium 超高端 | | | | | | | | | | | | |
| Product series 产品系列 | Astrobaby 星飞帆 | Organic Zhenzhi 臻稚有机 | Doraler (goat milk) 朵拉小羊 | | | Hyprocal 1897 海普诺凯 | Mygood 美优高 | Allnutria 遨游能立多 | Healthy Times 爱斯时光 | | Sai Na Mu 金领冠塞纳牧 | |
| Price/700g (Rmb) | 324 | 351 | 375 | | | 356 | 340 | 348 | 337 | | 311 | |
| Premium 高端 | | | | | | | | | | | | |
| Product series 产品系列 | Zhenai Beihu 臻爱倍护 | | Yashili Kieember 雅士利菁珀 | Ruibu'en 瑞哺恩 | Arla Baby&Me 阿拉宝贝与我 | Kabrita (goat) 佳贝艾特 | Puredo 美纳多 | Eurlate 欧选 | Pi Star 派星 | Beta Star 贝塔星 | Zhenhu 金领冠珍护 | Ruihu 金领冠睿护 |
| Price/700g (Rmb) | 218 | | 313 | 313 | 287 | 274 | 252 | 313 | 325 | 255 | 276 | 244 |
| Regular 中档 | | | | | | | | | | | | |
| Product series 产品系列 | Feifan 飞帆 | Xingjie Youhu 星阶优护 | | | | Ausnutria 澳优爱优 | | | Alpha Star 阿尔法星 | | Jinghu 金领冠菁护 | PRO-Kido 金领冠 |
| Price/700g (Rmb) | 185 | 240 | | | | 235 | | | 208 | | 221 | 171 |

*Source: tmall.com, BOCOM Int'l*

## Figure 249: Product offering by segment – International brands

| Company 公司 Ticker 股票代号 | Wyeth (Nestle) 惠氏（雀巢） NESN SW | | | Danone 达能 BN FP | | Reckitt Benckiser 利洁时/美赞臣 RB LN | | Royal Friesland 菲仕兰 private | Abbot 雅培 ABT US | | A2 Milk A2牛奶公司 A2M AU |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Super premium 超高端 | | | | | | | | | | | |
| Product series 产品系列 | Illuma Organic 启赋 有机 | | | | | Enfinitas 美赞臣蓝臻 | Enfagrow 美赞臣安儿宝 | Friso Prestige 皇家美素佳儿 | Eleva Organic 菁挚 有机 | | A2 至初 | |
| Price/700g (Rmb) | 380 | | | | | 366 | 334 | 340 | 377 | | 380 | |
| Premium 高端 | | | | | | | | | | | | |
| Product series 产品系列 | Illuma 启赋 蓝钻 | Wyeth S-26 惠氏 铂臻 | NAN H.A. 超启能恩 | Aptamil Profutura 爱他美-卓萃 | | Enfa Gentlease 美赞臣亲舒 | | Friso Gold 金装美素佳儿 | Eleva Pure 菁挚 纯净 | Similac Qinhu 恩美力亲护 | | |
| Price/700g (Rmb) | 296 | 262 | 276 | 292 | | 312 | | 219 | 302 | 283 | | |
| Regular 中档 | | | | | | | | | | | | |
| Product series 产品系列 | Latogen 力多精 | | | Nutrilon 诺优能 | Aptamil 爱他美 | Enfamil 美赞臣铂睿 | | Friso 美素佳儿 | Similac Plus 铂优恩美力 | Similac 经典恩美力 | A2 Platinum 至初海外版 | |
| Price/700g (Rmb) | 157 | | | 170 | 223 | 238 | | 186 | 225 | 185 | 233 | |

*Source: tmall.com, BOCOM Int'l*

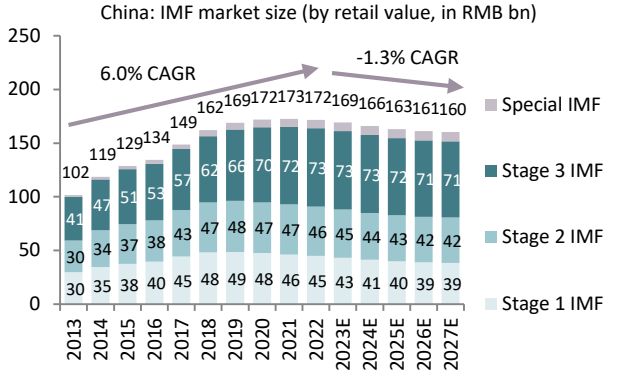
# Investment Positives

## Positive #1: IMF champion with a well-received localized strategy

Feihe has been a success story, increasing its market share in China's infant milk formula (IMF) market from 4% in 2013 to 20% in 2022, overtaking international brands that were popular in the aftermath of the 2008 melamine incident. Its production strategy of using domestic raw milk and turning them into milk powder within 2 hours at its self-owned dairy farms in Heilongjiang to better lock in freshness and nutrition adds to the competitive advantage it has over international peers, and has won over Chinese parents' wallets.

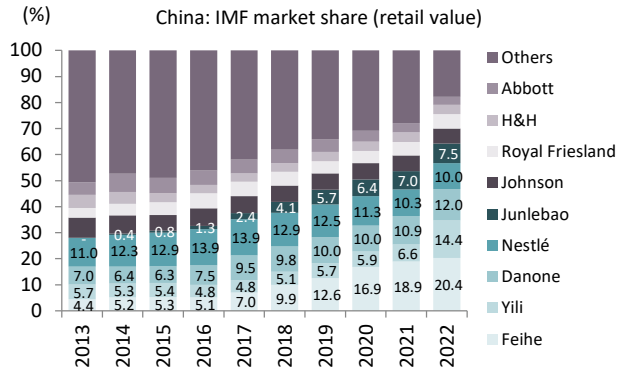
Feihe's market slogan that its products are "more suitable for Chinese babies" has resonated with Chinese consumers and plays up its advantage as a domestic brand with tailor-made formula that suits Chinese babies' physiques and nutritional needs better. Feihe has set up R&D and scientific research platforms jointly with academic institutions like Peking University Health Science Center, Jiangnan University and Chinese Academy of Agricultural Sciences in order to optimize and improve the research on breast milk and physique of Chinese people.

**Figure 250: IMF: Market size and growth**




*Source: Euromonitor estimates, BOCOM Int'l*
*Note: *Stage 1 is targeted at infant aged 0-6 months, stage 2 is targeted those aged 6-12 months, stage 3 is targeted at those aged 12-36 months*

**Figure 251: IMF: Market share**




*Source: Euromonitor, BOCOM Int'l*

**"2-hour ecosystem" enabled by YST Dairy acquisition guarantees freshness of dairy products:** Feihe acquired a 71.26% stake in **YuanShengTai Dairy Farm Limited** ("YST Dairy", 1431 HK/NR) in September 2020. YST Dairy owns a total of nine dairy farms, with eight of them in Heilongjiang province where Feihe is based, as well as a dairy cow farm in Jilin province and a dairy goat farm in Shaanxi province. This allows Feihe to create a 2-hour ecosystem with its upstream milk sources, meaning that the fastest time from milking a cow (in YST's farms) to processing (in Feihe's processing plants) would be 2 hours, ensuring the freshness of its raw materials in order to maximize the nutritional value in its product and minimize the risk of contamination.

Compared to other infant formula brands in China that either use foreign-sourced whole milk powder (usually from Australia or Fonterra in New Zealand) or are produced and packaged entirely overseas, Feihe's use of local fresh milk to produce its infant milk formula within 2 hours gives Feihe an advantage in guaranteeing the freshness of its products, which has become popular with Chinese parents.

**Production plant location:** As of December 2022, Feihe had 10 production facilities to manufacture its products, with a designed annual capacity of approximately 307,000 tons in total. Its plans include its **Kedong Plant**, **Gannan Plant**, **Longjiang Plant**, and **Baiquan Plant** in Heilongjiang province, **Feihe Zhenlai Plant** in Jilin province, as well as a new **Kingston plant** in Canada. The group is also constructing a new production facility (Qiqihar plant). Feihe also commenced operation of its **Harbin intelligent industrial park**, which includes an infant milk formula factory with an annual capacity of 70,000 tons. The plants in Harbin and Canada entered into production in 2022, so we expect an additional RMB200m of depreciation expense will kick in starting 2023.

**"Fresh" strategy implemented in 1H22 has been a success:** As a result of fallen birth rate in the past few years, the sales growth of China's IMF industry has slowed, which has led to channel inventory buildup in 2021-22. Feihe issued a profit warning for 1H22 on 22 July 2022, and at the same time, announced the implementation of its "fresh" strategy, which aims to reduce channel inventories by reducing the product delivery to distributors with high inventory in order to enhance freshness of products on the shelves, as well as implementing stricter control over the overall inventory level in its distribution channels, in particular for its flagship IMF product Astrobaby. Feihe also added barcodes in its IMF products to prevent product arbitrage. We note that Feihe sells to >2,700 customers (distributors and retailers) through c.94,000 retail point of sales (POS), as well as to end consumers through e-commerce platforms.

Subsequently reported 1H22 sales and net profit declined by 16% and 40% YoY respectively. The overall restructuring was completed in 1H22, and 2H22 sales returned to a growth of 4% YoY. Our recent communication with the company, in mid-2023, suggests its channel inventory-to-sales for AstroBaby remains healthy, at around 1.5x monthly sales.

## Positive #2: Feihe likely to gain share in the long-run given accelerating market consolidation, but not without a fight

**Policy-driven market consolidation benefits leaders**: Despite slow growth for the baby formula market overall as a result of fallen birth rate and impact from the pandemic, the industry is undergoing market share consolidation, which benefits market leaders such as Feihe. This is driven by tightening industry regulations and policies that support vertical integration into upstream dairy farms aimed to shore up food safety in the aftermath of the melamine incident in 2008, as well as the periodic revision to the national standard for IMF products, which forces out smaller players that are unable to obtain new product registrations. As a result, top players will likely still see positive growth, driven by market share consolidation, despite industry headwinds.

**What reforms were made after the melamine incident in 2008?** Back in 2016, there were over 2,500 brands of infant formula in the PRC, manufactured by about 108 and 77 factories in the PRC and overseas, respectively, which are registered with Certification and Accreditation Administration of the PRC. In the aftermath of the Melamine incidence in 2008, in order to enhance food quality and safety standards for infant nutrition products, new regulations and policies have been proposed and rolled out by the PRC government.

China's State Council has issued directives to reform the dairy industry in June 2013. The government deems food safety for dairy products to be important livelihood and social economic issues as it affects the health of the nation's future generations. China Food and Drug Administration ("CFDA") issued the "Specifications for the Review of Production License for Infant Formula Milk Powder" (2013), which stipulates that: "If raw milk is used as the main raw material to produce infant formula milk powder, all raw milk should come from the enterprise's self-built, self-controlled milk source, and gradually develop to the point that the raw milk comes from dairy farms that are wholly-owned or built through majority-controlled entity."

**New National standard for IMF, effective from Feb 2023:** The new national standard (also known as "new GB standard", 新国标 in Chinese) for infant milk formulas was introduced in March 2021 and became effective on 22 February 2023 in China. The updated GB standard separated the guidelines for stage 2 formula (GB-10766) and stage 3 formula (GB-10767), which were previously grouped together. The rationale behind the new GB standards is to improve the nutrition profile of infant formula products based on scientific research and to make them more similar to human breast milk.

**Enhanced nutrition requirements, especially for whey protein and lactose in stage 2 formulas:** The new GB standards have updated the nutrition content requirement for calories, carbohydrates, proteins, and micronutrients such as vitamins. Notable changes include an increase in the requirement for whey protein content for stage 2 formula to at least 40% of total protein, and a requirement for lactose to make up at least 90% of total carbohydrates in stage 2 formula and at least 50% in stage 3 formula. Additionally, the new standards prohibit the mixing of soy-based and dairy-based protein in the same product. There are also new requirements for nutrients including choline (for stage 2 and 3), manganese, and selenium (for stage 2), which were previously optional. For DHA content, the quantity requirement has increased to 3.6mg-9.6mg/100kJ from 0mg-0.5mg/100kJ, while ARA quantity is required to be higher than DHA content.

**New standards shake up the industry, accelerates consolidation:** The implementation of the new GB standards is expected to lead to industry consolidation, as smaller players have struggled to meet the requirements due to the additional investment and capital needed for research and formula improvement in order to register their products. Despite the 22 February registration deadline, infant formula products manufactured before the deadline with a later expiration date are still allowed to be sold in retail channels. This has led to a surge in industry supply leading up to the deadline, given the uncertainty with obtaining approval, and the potential of lost sales/ shortages that can result from delayed approvals or unsuccessful applications.

**Feihe's products have received approval:** Most of Feihe's products have received approval for the new National Standard for infant formula rolled out in February 2023, which means its sales are largely unaffected. It also said that while some market competitors had been engaging in price competition in 1H23, Feihe was minimally affected as did not engage in pricing war with other brands. Feihe expects stable sales in 1H23, and has so far maintained its guidance for double-digit sales growth in 2023.

**Market competition remains fierce amidst consolidation:** While Feihe will likely emerge as a long-term winner from the IMF market consolidation, it will not be without a fight, as there is currently still ample competition, from domestic brands (e.g. Yili, Junlebao) to international brands (e.g. Danone, Nestle) who are fighting to gain share. Danone, with its Danone brand having the 3rd largest market share, is looking to step up investment in its baby food business after parting ways with Mengniu in mid-2022 (Danone sold its 25% stake in Yashili and a 20% stake in a chilled products JV with Mengniu, in return for Yashili's 100% stake in Dumex Baby Food Co. Ltd).

Others are struggling, for example, Mengniu-owned Yashili posted net losses in 2021-22 and was privatized and delisted in July 2023. Ausnutria (1717 HK/NR) was struggling in 2021-22 and was acquired by Yili in early 2022, the year when its sales fell by 18% YoY (its own-branded cow milk formula sales declined by 29% YoY, while its own-branded goat milk formula did better, with sales up 7% YoY).

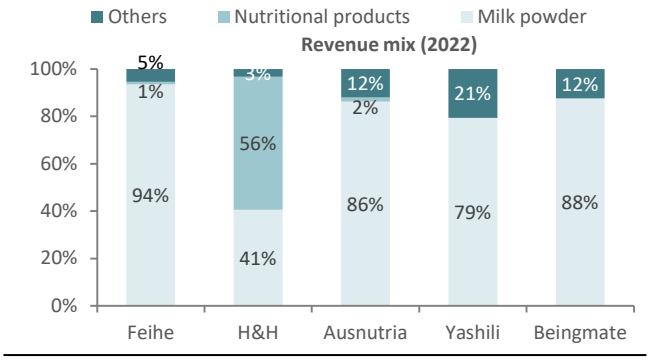
## Positive #3: Margins and ROE highest among peers, although it is trending down

Feihe commands superior margins to its infant milk formula peers, and its ROE (22% in 2022) compares favorably even against the best in our dairy coverage, including Yili (19%) and Mengniu (14%). Feihe also pays dividend, with a yield of 6%.

Among the five milk powder producers, four of them (Feihe, Ausnutria, Yashili and Beingmate) saw over 75% revenue contribution from the milk powder segment in 2022, with Feihe having the highest (94%). H&H's revenue sources are more diversified as its nutritional products (mainly include probiotics for infants and nutrition supplement for adults) contribute 56% of total revenue.

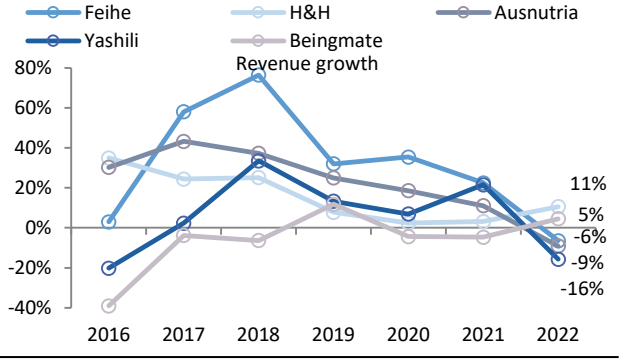
**Revenue growth** of the four peers (excl. H&H) has been rising from 2016 to 2018 in general as domestic milk powder companies have been taking market share from foreign players, but has been experiencing a declining trend since 2019 due to moderated demand, elevated inventory levels and further intensified competition. Feihe enjoys the highest revenue CAGR (29%) from 2017 to 2022 compared with the other four (21% for Ausnutria, 15% for H&H, 4% for Yashili and -7% for Beingmate).

**Figure 252: Product sales mix by of IMF peers (2022)**




*Source: Various companies, BOCOM Int'l *Note: Milk powder segments of Feihe and H&H include infant formula milk only, but refer to all kinds of milk powder products (incl. adult milk powder) for the other three peers*

**Figure 253: Feihe saw faster revenue growth**



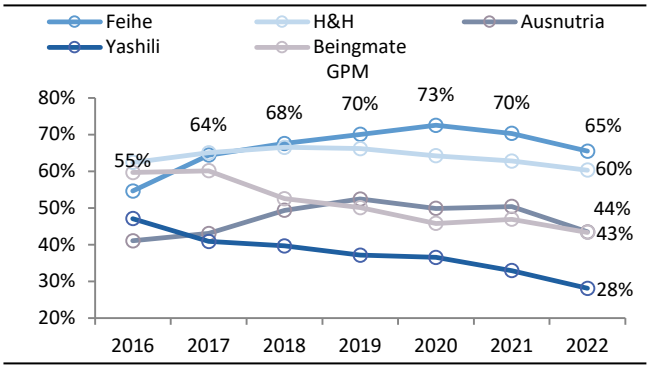

*Source: Various companies, BOCOM Int'l*

**Feihe remains highly profitable, with high GPM and OPM**

Feihe has the highest GPM among the five producers with about 20ppts more than the average of the other four, supported by its premiumization strategy. Similar to its peers, its GPM has been trending downwards as a result of higher discounts to destock given excess inventory has built up in the market as industry volume growth slows amid falling birth rate. As a result, its OPM has also fallen since 2021.

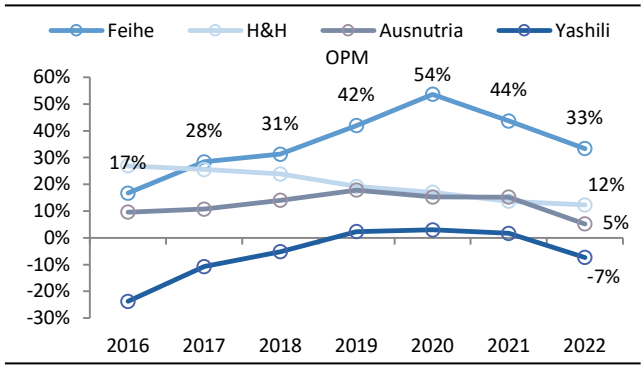
Putting together Feihe's higher GPM (65% in 2022) with its relatively low sales and distribution expense to sales ratio (31% in 2022), Feihe's OPM is far higher than peers, at 33% in 2022, higher by 20ppt than its next peer H&H at 12%.

**Figure 254: Feihe enjoys the highest GPM since 2018**



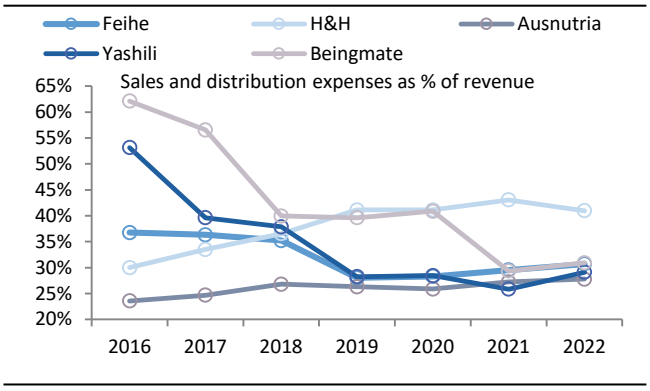

*Source: Various companies, BOCOM Int'l*

**Figure 255: … as well as highest OPM, although both GPM and OPM have been falling since 2021**



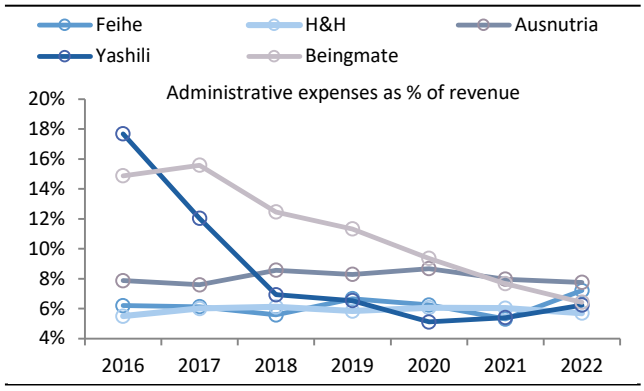

*Source: Various companies, BOCOM Int'l*

**Figure 256: Feihe's S&D expense ratio has been stable in the past 2 years, at around 28-31% for most peers (except H&H, which was higher, at 41%)**




*Source: Various companies, BOCOM Int'l*

**Figure 257: Feihe's administrative expense ratio is stable, at 7% in 2022, within the range of 6-8% for its peers**

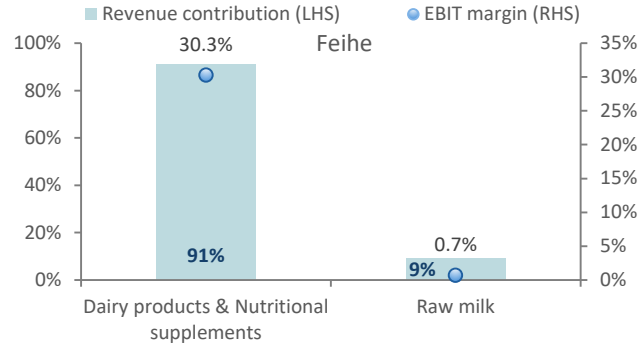



*Source: Various companies, BOCOM Int'l*

**Feihe's business model is simple, with >90% sales from its highest EBIT margin segment**

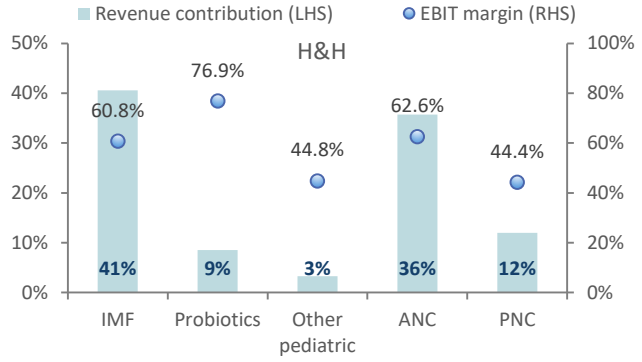
In terms of EBIT by segment, Feihe has the second highest EBIT margin by segment, after H&H. Feihe's high EBIT margin segment (at 30.3% EBIT margin) contributes the majority of sales (91% of total revenue in 2022). While H&H reports the highest EBIT margin by segment, it is likely explained by the fact that its S&D expenses and administrative expenses are not allocated to each segment (given they are shared amongst a few business divisions) but rather deducted at the group level. This results in H&H's higher segmental EBIT, but lower group-level OPM level than Feihe in 2021.

**Figure 258: Feihe's higher EBIT margin segment is generating 91% of total revenue in 2022**



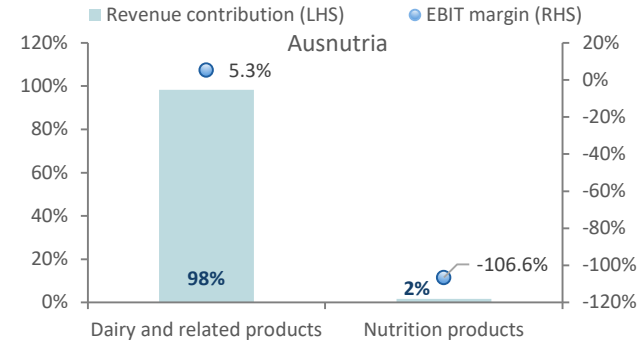

*Source: Various companies, BOCOM Int'l*

**Figure 259: H&H enjoys the highest by-segment EBIT margin on accounting differences (2022)**



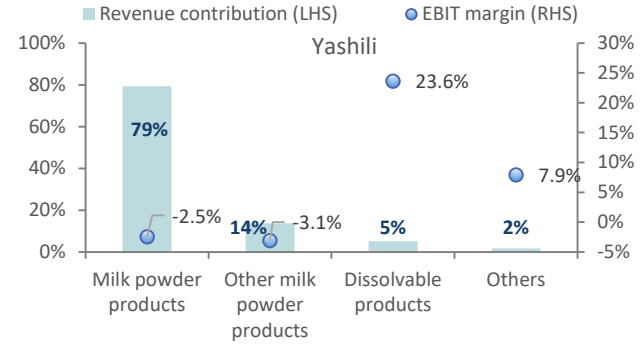

*Source: Various companies, BOCOM Int'l*
*Note: IMF = Infant milk formula products; ANC = Adult Nutritional & Care division; PNC = Pet Nutritional & Care division*

**Figure 260: Ausnutria's dairy related segment has an EBIT margin of 5.3%, much lower than Feihe's 30.3% (2022)**




*Source: Various companies, BOCOM Int'l*

**Figure 261: Milk powder segment of Yashili contributes nearly 80% of total 2022 revenue but is loss-making with an EBIT margin of -2.5%**

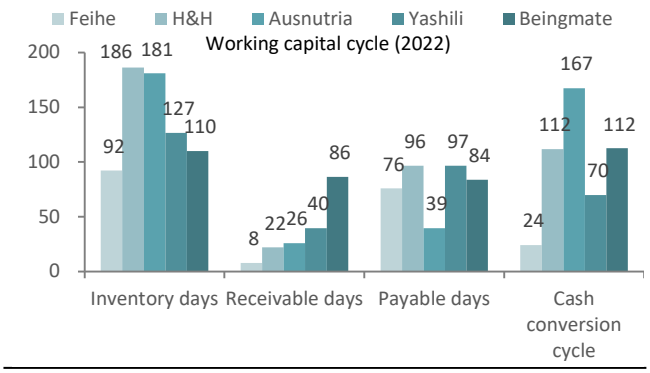



*Source: Various companies, BOCOM Int'l*

**Feihe has the shortest cash conversion cycle, and is in net cash position**

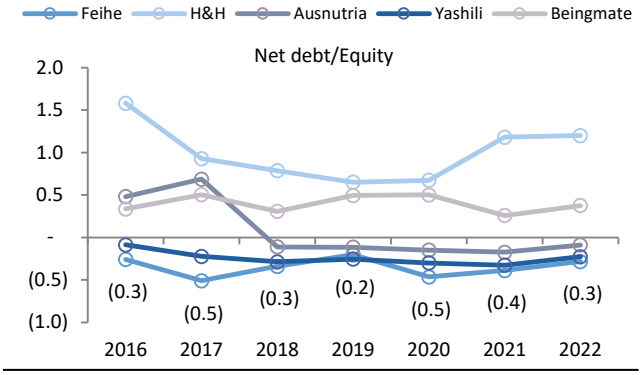
Comparing **working capital management**, Feihe showed the strongest inventory management and receivables & payables management. Its inventory days in 2022 was 92 days, compared to a 151 days average for its four peers, exhibiting great efficiency in cashing out inventory. Feihe comes second (after H&H) in upstream and downstream relationship management, with largest difference between payable days over receivable days in 2022 (76 payable days – 8 receivable days = 68 days). A bigger difference means stronger bargaining power in the supply chain (relationship with upstream suppliers and downstream distributors). Feihe also leads in having the shortest cash conversion cycle of only 24 days, vs. 115 days average for its peers. **Capital structure** is also healthy, as Feihe enjoys the lowest net debt/equity of -0.3x (i.e. net cash) among the five.

**Figure 262: Working capital cycle (2022)**




*Source: Various companies, BOCOM Int'l*

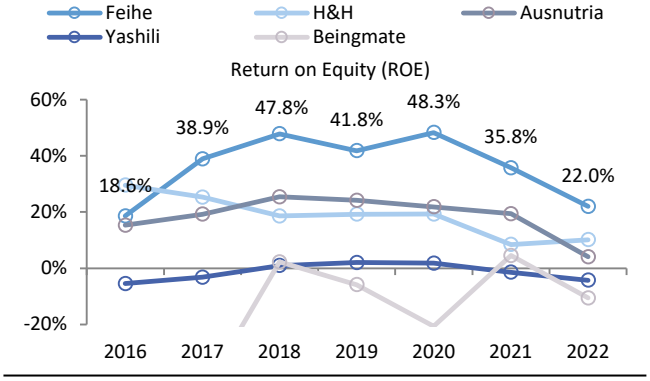
**Figure 263: Feihe maintained negative net debt level, with lowest net debt/equity among the five**




*Source: Various companies, BOCOM Int'l*

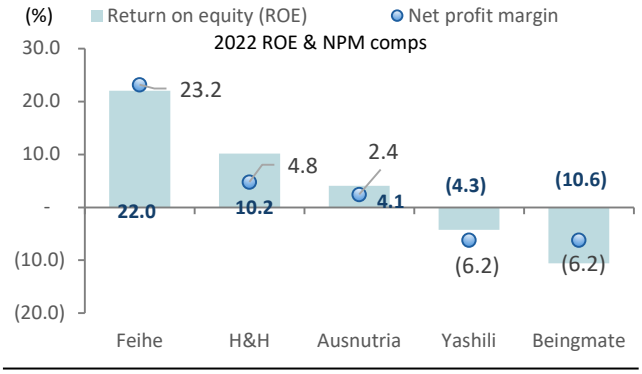
**ROE:** Feihe's ROE rose rapidly in 2017, and has maintained at a high level (over 35%), before falling after 2020. The difference in asset turnover and leverage level of the five names is much less distinct than the difference in their NPM. Thus, Feihe's higher-than-peer ROE mainly results from its significantly higher NPM.

**Figure 264: Feihe outperformed in ROE since 2017**




*Source: Various companies, BOCOM Int'l*

**Figure 265: …mainly on back of higher NPM**




*Source: Various companies, BOCOM Int'l*

## Company Overview

**Figure 266: Feihe development milestone**

| Year | Event |
|---|---|
| 1962 | Hongguang Dairy (later expanded as Zhaoguang Dairy), the predecessor of Feihe HLJ, was established |
| 1984 | "Feihe" trademark was registered in the PRC |
| 1996 | Feihe HLJ, the first member of the Group with business operation, was established |
| 1998 | Feihe HLJ acquired the assets of Zhaoguang Dairy |
| 2003 | Flying Crane U.S., whose shares were quoted on OTCBB, became the holding company of the Group |
| 2005 | Flying Crane U.S. became listed on the NYSE Archipelago Exchange and ceased to be traded on the OTCBB |
| 2009 | Flying Crane U.S. transferred the listing of its shares from the NYSE Archipelago Exchange to the NYSE |
| 2010 | Launched super-premium Astrobaby (星飞帆) product series |
| 2011 | Adjusted business strategy to exclude the production of fresh milk and to focus on the development, production and sales of infant milk formula products |
| 2013 | Flying Crane U.S. was privatized and its shares were delisted from the NYSE NHPEA became a shareholder of DIF Holding |
| 2014 | Established the Feihe Nutrition Laboratory at the Beth Israel Deaconess Medical Center of Harvard Medical School to engage in nutrition research and teaching |
| 2016 | Established Canada Kingston Dairy and Canada Royal Milk for the planned operations of the goat milk and cow milk infant formula production facilities at the Kingston Plant to be constructed in Kingston, Ontario, Canada |
| 2018 | Completed the acquisition of the retail health care business of Vitamin World |
| 2019 | Listed on HKEx under the stock ticker of 6186 HK |
| 2020 | China Feihe Limited became the largest shareholder of YST Group with the shares of 71.26%. |

*Source: Company data, BOCOM Int'l*

**Key business lines:** The majority of Feihe's sales came from **(1) Infant milk formula products** (94% of 2022 sales)**,** with the rest from **(2) other dairy products** (5% of sales, including adult milk-powder, liquid milk, and a small amount of soybean powder) and **(3) nutritional supplements** (1% of sales, which started in January 2018 after the acquisition of the retail health care business of Vitamin World that operates in the US).

**Within infant milk formula products,** there is a further breakdown based on price points:

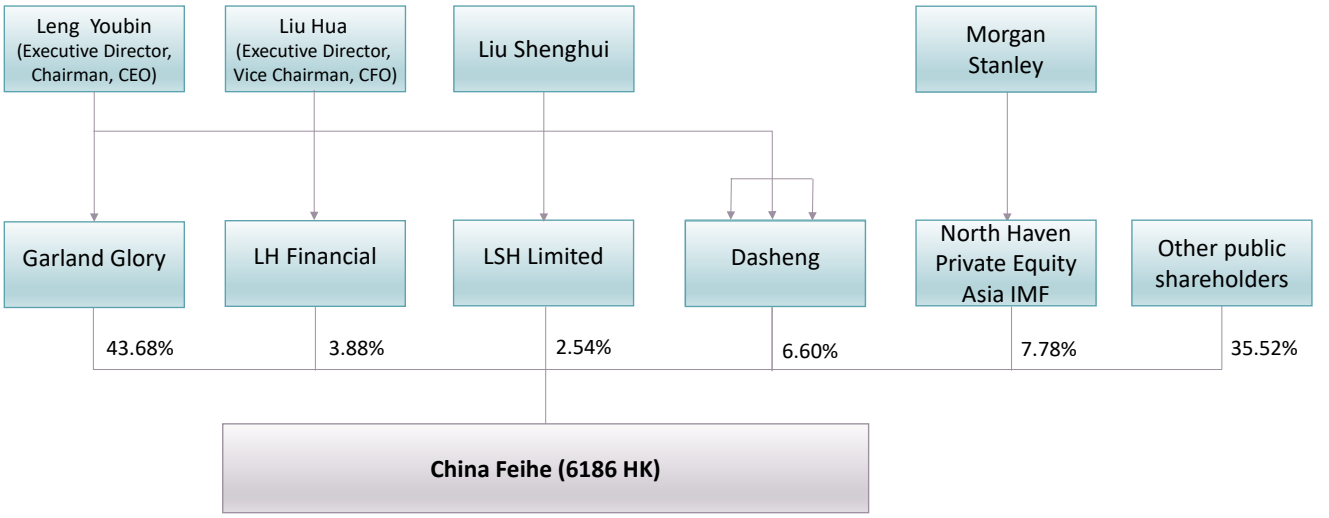
- **Super premium** IMF product series consist of the super-premium **Astrobaby** series (including classic, ZhuoRui, ZhuoShu, ZhuoYao), super premium **Organic ZhenZhi** series. It usually has a retail price of >RMB320/700g, and commands a GPM of >75%.
- **Premium** IMF product series includes premium **ZhenAi BeiHu**, **ZhenAi FeiFan**, and **JingCui YiJia**. It usually has a retail price of >RMB220/700g, and commands a GPM of >65%.
- **Regular IMF**, on the other hand, targets a more cost-conscious consumer base, including **Xingjie Youhu**, **Feifan**, **BabyRich**. It usually has a retail price of below RMB220/700g, and commands a GPM of >55%.

**Raw milk:** After the acquisition of YST Dairy, Feihe also sells raw milk, which accounts for 1.6% of its sales in 2022.

**Distribution channel:** In 2022, Feihe sold to >2,700 customers (distributors and retailers) through c.94,000 retail point of sales (POS), as well as to end consumers through e-commerce platforms.

## Shareholders and Management

**Figure 267: Feihe: Shareholding structure**



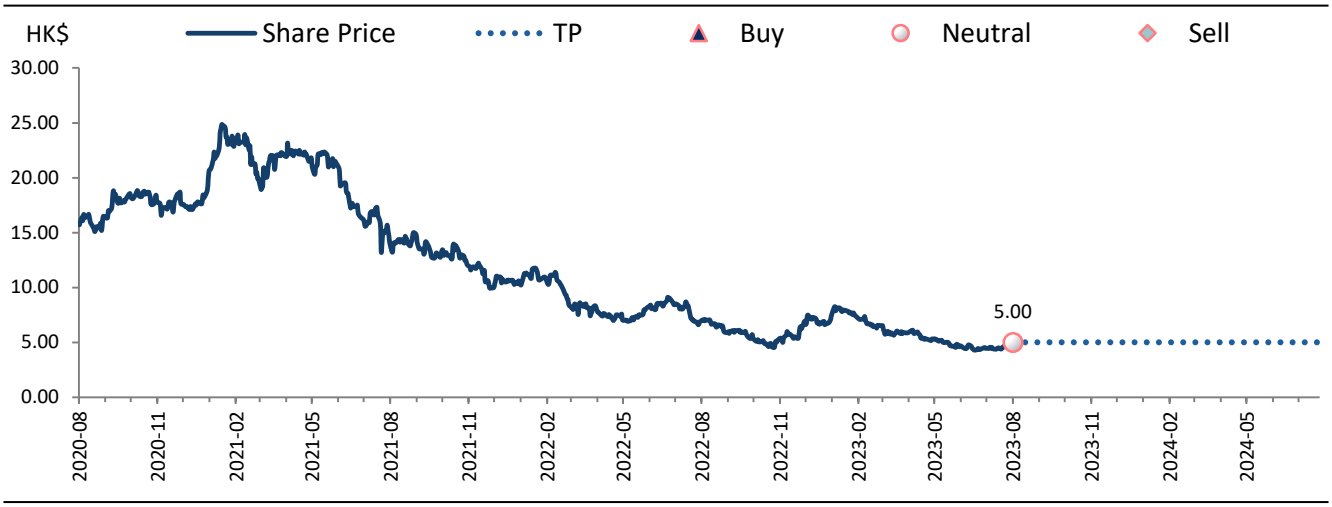

*Source: Company data (2022), BOCOM Int'l*

## Figure 268: Feihe: Board of directors and senior management

| Name | Position | Experience |
|---|---|---|
| **Leng Youbin** | Executive Director<br>Chairman<br>CEO | Mr. Leng has over 30 years of experiences in the dairy industry. He has been a director of Vitamin World USA, executive director of Feihe Gannan, director of Feihe HLJ, and the deputy head of Zhaoguang Farm. He graduated from Northeast Agricultural University, and obtained an EMBA degree from the School of Economics of Peking University and an EMBA degree from Guanghua School of Management of Peking University. Mr. Leng is a dairy engineer certified by the Personnel Bureau of Heilongjiang. |
| **Liu Hua** | Executive Director<br>Vice Chairman<br>CFO | He has been involved in the financing activities of the Group. He has been a non-executive director of YST. Mr. Liu received an EMBA degree in finance from the Advanced Institute of Finance of Shanghai Jiao Tong University. |
| **Cai Fangliang** | Executive Director<br>President | Mr. Cai has focused on the marketing management of the Group and the overall management and business development of the Company. Before joining the Group, Mr. Cai worked at Jiangxi Meilu Dairy Co., Ltd. and Yashili Group Co., Ltd. |
| **Judy, Fong-Yee Tu** | Executive Director<br>Vice President<br>Company Secretary | Ms. Tu has been extensively involved in the international business development and capital market matters of the Group, including the listing of Flying Crane U.S. on the NYSE, the acquisition of the retail health care business of Vitamin World, and the listing of the Company on the Stock Exchange. She obtained a bachelor's degree of arts in mass communications and political science with a minor in Asian studies from the University of California, and a Juris Doctor degree from Loyola Law School. She was admitted to the State Bar of California and is a licensed attorney in the State of California. |
| **Gao Yu** | Non-executive Director | Mr. Gao has a long history of working within the investment banking industry, and has been working in the Morgan Stanley as the co-chief investment officer of Private Equity Asia and head of China Investment business, the chairman of RMB Fund's investment committee as well as the member of China Management Committee. Mr. Gao received a dual bachelor's degree in engineering and economics from Tsinghua University, and a master's degree in engineeringeconomic system and operations research from Stanford University. |
| **Kingsley, Kwok King Chan** | Non-executive Director | Mr. Chan is currently a managing director of the Private Credit & Equity Division of Morgan Stanley Asia Limited. Before joining Morgan Stanley, Mr. Chan worked in Credit Suisse (Hong Kong) Limited and the Asia Investment Banking Department of Citigroup Global Markets Asia Limited. Mr. Chan obtained a bachelor's degree in business economics from the University of London and a master's degree in philosophy from the University of Cambridge. |
| **Cheng Kwok Wah** | Non-executive Director | Mr. Cheng was the Chairman of Vitamin World International and the Chairman of Vitamin World USA, and responsible for the development of the overseas infant nutrition market of the Group. Before joining the Group, Mr. Cheung held various senior positions within the Nestle Group, Wyeth Nutrition, and Coca-Cola China Company Limited. He obtained an honours bachelor's degree of social science from the Chinese University of Hong Kong, and an MBA degree from Kelley School of Business in Indiana University. |
| **Liu Jinping** | Independent Non-executive Director | Ms. Liu is currently a deputy director of the Center of Extracorporeal Circulation and the director of the Department of Pediatric Extracorporeal Circulation of Fu Wai Hospital. Ms. Liu received a bachelor's degree in medical science from Harbin Medical University, and a master's degree and then a doctorate degree in anesthesia from Peking Union Medical College. She was admitted as a practicing physician in May 1999, and was certified as a physician and chief physician by the Ministry of Health of the PRC. |
| **Song Jianwu** | Independent Non-executive Director | Mr. Song has been a professor and doctoral supervisor of Renmin University of China, and served in several positions, including the director of the School of Journalism and Communication and a deputy director of the School of Humanities. Mr. Song received a bachelor's degree in journalism and a doctorate degree in communication from Renmin University of China. He also obtained the qualification certificate of independent directors from the Shanghai Stock Exchange. |
| **Fan Yonghong** | Independent Non-executive Director | Mr. Fan served as an independent director and a member of the audit committee in several listing companies. He was also a member of Issuance Examination Committee of China Securities Regulatory Commission, where he was involved in the review of listing applications from all aspects of PRC companies. Mr. Fan graduated from the Postgraduate Department of Institute of Fiscal Finance under the Ministry of Finance and obtained a doctor's degree in economics. Mr. Fan currently serves as an external postgraduate supervisor of Chinese Academy of Fiscal Sciences. |
| **Jacques Maurice Laforge** | Independent Non-executive Director | Mr. Laforge has extensive experience in Canadian dairy industry. He was the CEO and commissioner with Canadian Dairy Commission. He was awarded the New Brunswick Innovation Recognition Award for Small Business and the Order of New Brunswick, and the Queen Elizabeth II Diamond Jubilee Medal. |

*Source: Company website*

**Figure 269: China Feihe (6186 HK) TP & rating**




*Source: FactSet, BOCOM Int'l estimates*

## Financial Statements

**Income statement (RMB m)**

| Y/E 31 Dec | 2021 | 2022 | 2023E | 2024E | 2025E |
|---|---|---|---|---|---|
| Revenue | 22,776 | 21,311 | 22,657 | 24,104 | 25,658 |
| COGS | (6,769) | (7,360) | (7,893) | (8,470) | (9,093) |
| **Gross profit** | **16,008** | **13,951** | **14,764** | **15,634** | **16,565** |
| SG&A | (7,937) | (8,080) | (8,345) | (8,616) | (8,893) |
| Other operating income, net | 1,885 | 1,233 | 1,233 | 1,233 | 1,233 |
| **Operating profit** | **9,955** | **7,104** | **7,652** | **8,252** | **8,906** |
| Net finance expenses | (29) | (34) | (34) | (34) | (34) |
| Other non-op. income, net | (253) | (407) | (407) | (407) | (407) |
| **Pre-tax profit** | **9,672** | **6,663** | **7,212** | **7,811** | **8,465** |
| Tax | (2,757) | (1,715) | (1,856) | (2,010) | (2,179) |
| Non-controlling interests | 44 | 6 | 6 | 6 | 6 |
| **Net profit** | **6,959** | **4,954** | **5,362** | **5,807** | **6,292** |
| Net profit for EPS calculation | 6,959 | 4,954 | 5,362 | 5,807 | 6,292 |

**Balance sheet (RMB m)**

| As of 31 Dec | 2021 | 2022 | 2023E | 2024E | 2025E |
|---|---|---|---|---|---|
| Cash & cash equiv | 9,629 | 9,336 | 12,826 | 16,367 | 20,447 |
| Acc & bills receivable | 477 | 431 | 1,034 | 524 | 1,135 |
| Inventories | 1,722 | 1,994 | 804 | 2,198 | 1,025 |
| PUD and land/lease prepayments | 576 | 507 | 539 | 574 | 611 |
| Other current assets | 7,565 | 9,962 | 9,962 | 9,962 | 9,962 |
| **Total current assets** | **19,970** | **22,230** | **25,166** | **29,625** | **33,180** |
| PPE | 8,437 | 9,500 | 9,500 | 9,500 | 9,500 |
| Intangible assets | 561 | 540 | 540 | 540 | 540 |
| Investment in associates/JCE | 128 | 110 | 110 | 110 | 110 |
| Other non-current assets | 2,386 | 3,136 | 3,136 | 3,136 | 3,136 |
| **Total non-current assets** | **11,512** | **13,286** | **13,286** | **13,286** | **13,286** |
| **Total assets** | **31,481** | **35,516** | **38,452** | **42,912** | **46,466** |
| Short-term loans | 313 | 447 | 447 | 447 | 447 |
| Trade and other payables | 1,284 | 1,774 | 1,267 | 1,996 | 1,507 |
| Other current liabilities | 5,345 | 5,239 | 5,580 | 5,948 | 6,346 |
| **Total current liabilities** | **6,942** | **7,460** | **7,293** | **8,391** | **8,300** |
| Long-term loans | 621 | 862 | 862 | 862 | 862 |
| Long-term payables | 647 | 628 | 628 | 628 | 628 |
| Other non-current liabilities | 868 | 1,091 | 1,091 | 1,091 | 1,091 |
| **Total non-current liabilities** | **2,136** | **2,581** | **2,581** | **2,581** | **2,581** |
| **Total liabilities** | **9,078** | **10,041** | **9,874** | **10,972** | **10,881** |
| Share capital | 0 | 0 | 0 | 0 | 0 |
| Reserves & other capital items | 20,921 | 23,986 | 27,089 | 30,451 | 34,096 |
| **Shareholders' equity** | **20,921** | **23,986** | **27,089** | **30,451** | **34,096** |
| Non-controlling interests | 1,482 | 1,489 | 1,489 | 1,489 | 1,489 |
| **Total equity** | **22,403** | **25,475** | **28,578** | **31,940** | **35,585** |

*Source: Company data, BOCOM Int'l estimates*

**Cash flow (RMB m)**

| Y/E 31 Dec | 2021 | 2022 | 2023E | 2024E | 2025E |
|---|---|---|---|---|---|
| Pre-tax profit | 9,672 | 6,663 | 5,350 | 5,795 | 6,280 |
| Depreciation & amortisation | 414 | 414 | 0 | 0 | 0 |
| Change in working capital | (770) | 828 | 388 | 179 | 435 |
| Interest inc/exp adjustment | 277 | 0 | 0 | 0 | 0 |
| Tax paid | (2,736) | (2,062) | 0 | 0 | 0 |
| Other operating cashflow | (42) | 437 | 0 | 0 | 0 |
| **Cash flow from operation** | **6,815** | **6,279** | **5,737** | **5,973** | **6,715** |
| Capex | (1,363) | (1,517) | 0 | 0 | 0 |
| Investment | (1,407) | (2,249) | 0 | 0 | 0 |
| Other investing cashflow | 326 | (1,038) | 0 | 0 | 0 |
| **Cash flow from investing** | **(2,444)** | **(4,804)** | **0** | **0** | **0** |
| Net chg in interest-bearing debt | (444) | 361 | 0 | 0 | 0 |
| Net change in equity | 0 | 0 | 0 | 0 | 0 |
| Dividends paid | (3,392) | (2,133) | (2,247) | (2,432) | (2,635) |
| Other financing cashflow | (409) | (204) | 0 | 0 | 0 |
| **Cash flow from financing** | **(4,245)** | **(1,975)** | **(2,247)** | **(2,432)** | **(2,635)** |
| Exchange gain/loss | (49) | 90 | 0 | 0 | 0 |
| **Cash & cash equiv. at year start** | **9,553** | **9,745** | **9,336** | **12,826** | **16,367** |
| **Cash & cash equiv. at year end** | **9,629** | **9,336** | **12,826** | **16,367** | **20,447** |

**Financial ratio**

| Y/E 31 Dec | 2021 | 2022 | 2023E | 2024E | 2025E |
|---|---|---|---|---|---|
| **Per share data (RMB)** | | | | | |
| Core EPS | 0.780 | 0.554 | 0.600 | 0.649 | 0.704 |
| Fully-diluted EPS | 0.765 | 0.554 | 0.599 | 0.648 | 0.702 |
| Non-GAAP EPS | 0.000 | 0.000 | 0.000 | 0.000 | 0.000 |
| DPS | 0.389 | 0.251 | 0.272 | 0.295 | 0.319 |
| BVPS | 2.345 | 2.683 | 3.030 | 3.406 | 3.813 |
| **Margin analysis (%)** | | | | | |
| Gross margin | 70.3 | 65.5 | 65.2 | 64.9 | 64.6 |
| EBITDA margin | 46.2 | 35.6 | 34.7 | 35.1 | 35.5 |
| EBIT margin | 44.0 | 32.9 | 31.8 | 32.4 | 33.0 |
| Net margin | 30.6 | 23.2 | 23.7 | 24.1 | 24.5 |
| **Profitability analysis (%)** | | | | | |
| ROA | 23.1 | 14.8 | 14.5 | 14.3 | 14.1 |
| ROE | 35.5 | 22.0 | 20.9 | 20.1 | 19.5 |
| **Others** | | | | | |
| Net debt to equity ratio (%) | Net Cash | Net Cash | Net Cash | Net Cash | Net Cash |
| Current ratio (x) | 2.9 | 3.0 | 3.4 | 3.4 | 3.9 |
| Inventory turnover (days) | 81.1 | 92.1 | 64.7 | 64.7 | 64.7 |
| Acc receivable turnover (days) | 6.1 | 7.8 | 11.8 | 11.8 | 11.8 |
| Acc payable turnover (days) | 65.2 | 75.8 | 70.3 | 70.3 | 70.3 |
| Dividend payout ratio (%) | 49.9 | 45.4 | 45.4 | 45.4 | 45.4 |

BOCOM Int'l Research

**Initiation of Coverage**

| Consumer | Last Close | Target Price | Upside |
|---|---|---|---|
| | HK$ 10.48 | HK$ 10.10 | -3.6% |

9 August 2023

# H&H Int'l (1112 HK)

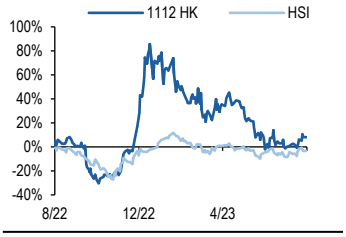
## Still too early to refocus back on equity growth story; Initiate at Neutral

- **Credit profile overshadows equity growth story for now, but could improve amid deleveraging drive:** H&H's credit-worthiness has dominated investor sentiment, especially amid rising interest rates. The issues are three-fold: **(1) Solvency:** H&H has a Ba3 rating from Moody's. Mgmt has committed to halting further M&A and using ~RMB1.5bn/year operating cash flow to deleverage, aiming to lower net debt/ adj. EBITDA from 3.6x by end-2022 to 3x/2x by end-2023/24. Our model suggests this could be difficult. **(2) Liquidity:** It successfully refinanced its US$270m note due Oct 2024 recently (at a 13.5% coupon, up from 5.625%) but still needs to refinance a US$1,125m term loan (SOFR +2.2%) in 1H24 before large repayments in Dec 2024/ Jun 2025. **(3) Earnings drag:** The challenge is to refinance while keeping financing costs low, which was 27% of EBITDA in 2022 vs. 15% in 2021.
- **Pure play on China's expanding middle-income via fast-growing supplements and pet care markets:** H&H is a pure play to China's middle-income expansion story with its portfolio of premium, market-leading nutrition and care ("N&C") brands targeting the entire household (baby, adult, pet). Baby N&C is its biggest division (Biostime is the #7 infant milk formula brand in China and #4 in the premium IMF segment), but H&H's faster-growing divisions are Adult N&C (Swisse is the #1 vitamin/supplement brand in China, #2 in Australia) and Pet N&C (Zesty Paws is the #1 pet supplement brand in the US; Solid Gold the #2 premium cat food brand in China). Continued channel and geographic expansion will drive future growth.
- **Synergies among portfolio brands to expand global footprint:** H&H's portfolio of leading brands produces great synergies in sales, marketing and distribution. H&H has a successful track record in international expansion by bringing Australian brand Swisse into China and making it the #1 vitamins, herbal and mineral supplements ("VHMS") brand, and aims to roll out recently acquired pet brands (e.g. Zesty Paws) in Europe and China. By relying on existing teams on the ground, H&H can roll out new brands with relative ease and low costs, driving operating leverage and margin expansion in the long run.
- **Initiate with Neutral:** Despite cheap valuation, we think the continued challenges in baby N&C (including falling margins) and upcoming debt maturities may suppress interest in an otherwise exciting growth story in H&H's adult N&C and pet N&C businesses. Our TP of HK$10.1 is based on 6.0x 2024E P/E, and 0.23x PEG on 26% EPS CAGR (2023-25E).

**Stock Rating**

**NEUTRAL**

**1-year stock performance**




*Source: FactSet*

**Stock data**

| | |
|---|---|
| 52w high (HK$) | 18.00 |
| 52w low (HK$) | 6.75 |
| Market cap (HK$ m) | 6,696.93 |
| Avg daily vol (m) | 0.27 |
| YTD change (%) | (37.09) |
| 200d MA (HK$) | 12.05 |

*Source: FactSet*


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**Financial highlights**

| Y/E 31 Dec | 2021 | 2022 | 2023E | 2024E | 2025E |
|---|---|---|---|---|---|
| Revenue (RMB m) | 11,548 | 12,776 | 13,696 | 14,763 | 15,953 |
| YoY growth (%) | 3.2 | 10.6 | 7.2 | 7.8 | 8.1 |
| Net profit (RMB m) | 508 | 612 | 720 | 940 | 1,210 |
| EPS (RMB) | 0.79 | 0.96 | 1.12 | 1.47 | 1.89 |
| YoY growth (%) | -55.3 | 21.2 | 17.6 | 30.6 | 28.8 |
| P/E (x) | 12.2 | 10.1 | 8.6 | 6.6 | 5.1 |
| BVPS (RMB) | 9.13 | 9.60 | 10.16 | 11.18 | 12.48 |
| P/B (x) | 1.06 | 1.00 | 0.95 | 0.86 | 0.77 |
| Dividend yield (%) | 4.7 | 5.6 | 4.7 | 6.1 | 7.8 |

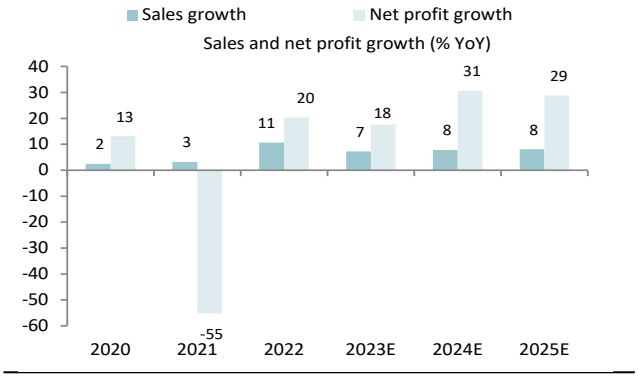
*Source: Company data, BOCOM Int'l estimates*


Analyst certifications, disclosures and disclaimer at the back forms part of this report and must be read.

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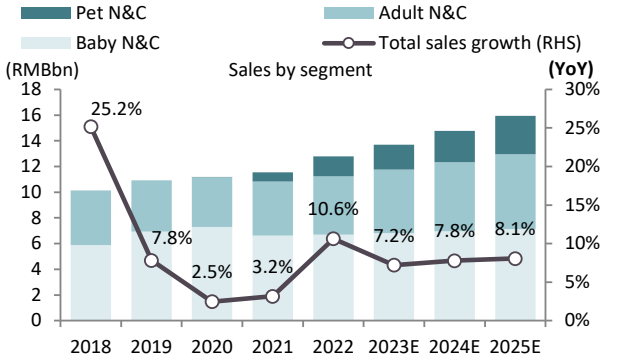
## Company at a Glance

### Figure 270: H&H: Sales and net profit growth



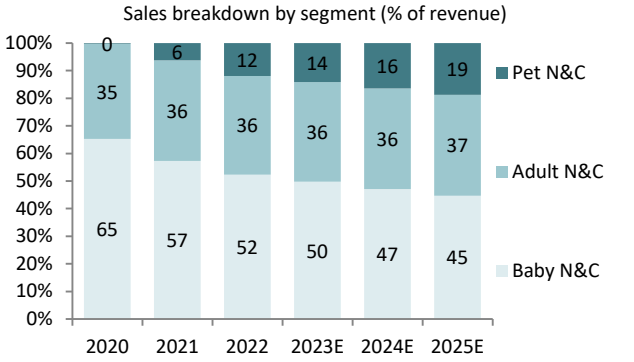

*Source: Company data, BOCOM Int'l estimates*

### Figure 271: H&H: Sales by segment and growth



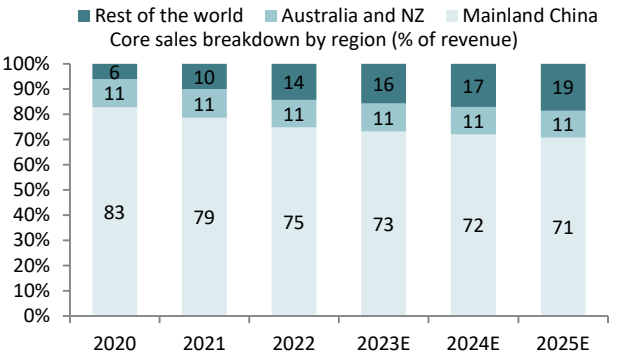

*Source: Company data, BOCOM Int'l estimates*

### Figure 272: H&H: Sales mix by segment



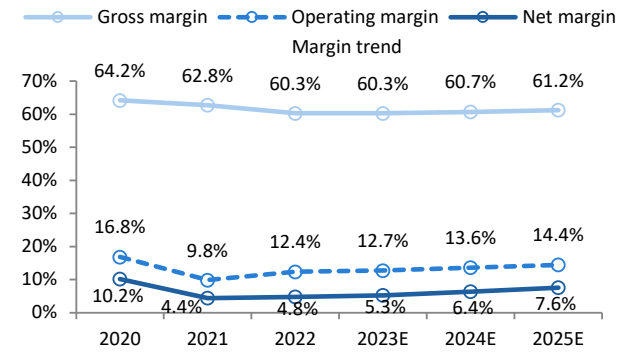

*Source: Company data, BOCOM Int'l estimates*

### Figure 273: H&H: Sales mix by geography



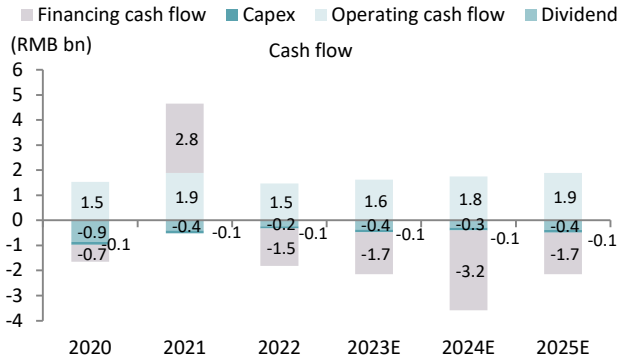

*Source: Company data, BOCOM Int'l estimates*

### Figure 274: H&H: Margin trends




*Source: Company data, BOCOM Int'l estimates*

### Figure 275: H&H: Key cash flow




*Source: Company data, BOCOM Int'l estimates*

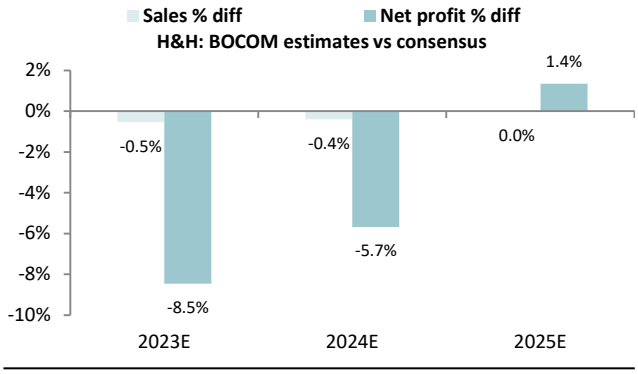
## Initiate with Neutral and TP of HK$10.1 (3.6% downside)

We initiate coverage on H&H with a **Neutral** rating and a TP of HK$10.1, based on 6.0x P/E on our 2024E EPS. Our target P/E multiple is derived from 0.23x PEG to our EPS CAGR (2023-25E) of 25.5%. This PEG is at a discount to the 0.85x we use for IMF leader Feihe (6186 HK/**Neutral**), given that H&H's credit profile is weaker and is the current focus for investors, which depresses its equity valuation. H&H's largest business segment, Baby N&C ("BNC"), is also under industry headwinds. As such, we think it is reasonable to assign a 6.0x P/E which is lower than the 7.1x P/E we assign for Feihe.

**Upside risks:** (1) Stronger-than-expected market share gain in infant formula segment; (2) better-than-expected sales of Adult N&C ("ANC") and Pet N&C ("PNC") leading to strong GPM expansion; (3) large uptick in new births in China leading to reacceleration of industry growth.

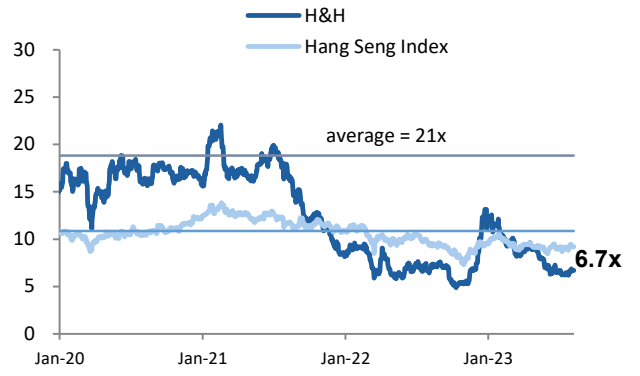
**Downside risks:** (1) Weaker-than-expected demand; (2) higher-than-expected raw material cost increase leading to GPM pressure; (3) price competition as a result of market consolidation leading to GPM pressure; (4) inability to get new nutritional supplement approved for sale in China; (5) food safety issues; (6) policy and regulatory risks, such as inability to get product registration for IMF products from the National Medical Products Administration and adhere to safety standards set by the National Health Commission, or cross-border e-commerce regulation by the Ministry of Commerce.

**Figure 276: H&H: BOCOM vs. consensus**




*Source: Bloomberg consensus, BOCOM Int'l estimates*

**Figure 277: H&H: forward P/E**

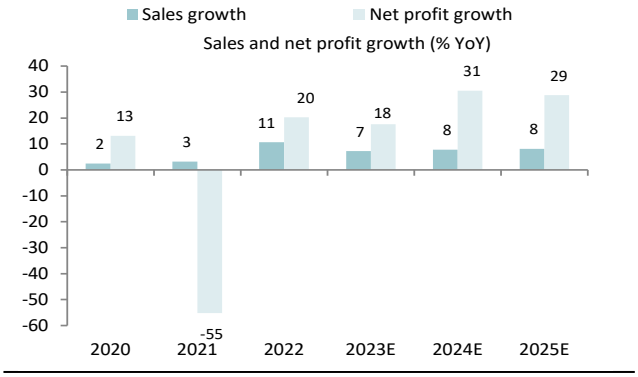



*Source: Bloomberg consensus, BOCOM Int'l*

## Financial forecast

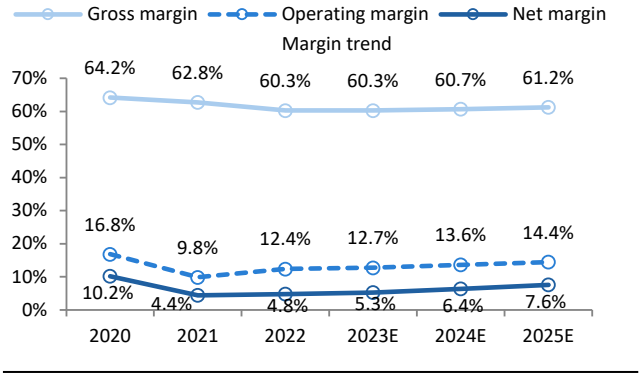
**Sales and EPS forecast:** We forecast sales and EPS to grow by 8%/26% CAGR in the next three years (2023-25E), driven by 40bps GPM improvement each year as well as operating leverage. H&H's international expansion should bring margin expansion as it can leverage on existing platform and teams in various local markets, e.g. bringing a new brand like Zesty Paws to China can leverage on existing channel and marketing teams for Solid Gold.

**Figure 278: H&H: Sales and net profit growth**




*Source: Company data, BOCOM Int'l estimates*

**Figure 279: H&H: Margin trends**



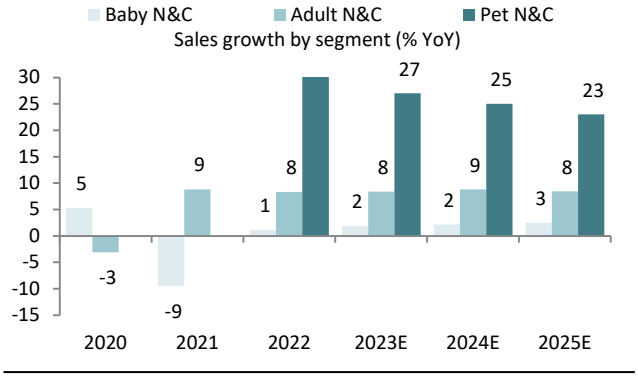

*Source: Company data, BOCOM Int'l estimates*

**Sales forecast by segment:** By segment, we expect sales growth to be driven by ANC and BNC. We expect sales for BNC/ANC/PNC to grow at 2.2%/8.6%/25.0% CAGR in the next three years (2023-25E).

**Margins:** Given BNC and ANC command higher GPMs and adj. EBITDA margins than PNC, there will be a slight unfavorable product mix impact on margins, to be offset by a general uptrend in both GPM and EBITDA margins for PNC as it ramps up in scale.

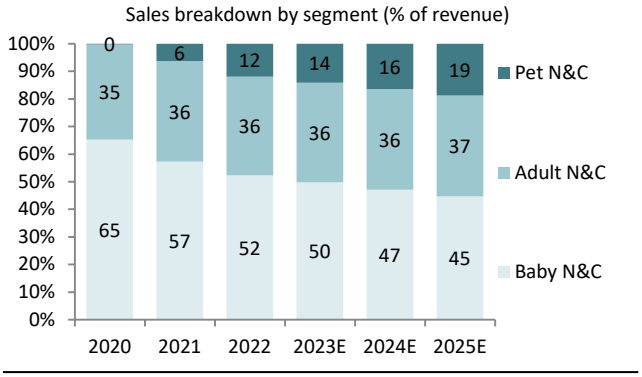
**Net profit:** We expect finance costs to rise to 31% of EBITDA in 2023E (vs. 27% in 2022), before falling to 26%/19% in 2024/25E. As such, we forecast net profit growth of 18%/31%/29% YoY in 2023/24/25E.

**Figure 280: H&H: Sales by segment**




*Source: Company data, BOCOM Int'l estimates*

**Figure 281: H&H: Sales mix by segment**



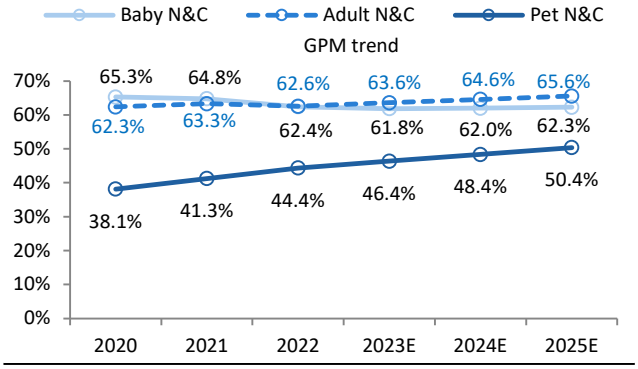

*Source: Company data, BOCOM Int'l estimates*

### Figure 282: H&H: Sales breakdown by segment

| | 2018 | 2019 | 2020 | 2021 | 2022 | 2023E | 2024E | 2025E |
|---|---|---|---|---|---|---|---|---|
| Revenue (RMB m) | | | | | | | | |
| **Baby Nutrition & Care** | **5,888** | **6,934** | **7,301** | **6,612** | **6,687** | **6,811** | **6,957** | **7,134** |
| Infant formulas | 4,509 | 5,072 | 5,244 | 5,146 | 5,180 | 5,128 | 5,077 | 5,026 |
| Probiotic supplements | 1,045 | 1,255 | 1,396 | 964 | 1,088 | 1,305 | 1,540 | 1,802 |
| Other pediatric products | 335 | 607 | 661 | 501 | 420 | 378 | 340 | 306 |
| **Adult Nutrition & Care (ANC)** | **4,244** | **3,991** | **3,868** | **4,209** | **4,559** | **4,943** | **5,378** | **5,832** |
| China (i.e. normal trade) | 1,511 | 1,904 | 2,371 | 2,673 | 2,937 | 3,349 | 3,784 | 4,238 |
| ANZ (domestic market + CBEC) | 2,509 | 1,792 | 1,207 | 1,260 | 1,356 | 1,356 | 1,356 | 1,356 |
| Others | 225 | 295 | 290 | 250 | 239 | 239 | 239 | 239 |
| **Pet Nutrition & Care (PNC)** | **-** | **-** | **26** | **726** | **1,530** | **1,943** | **2,428** | **2,987** |
| Total | 10,132 | 10,925 | 11,195 | 11,548 | 12,776 | 13,696 | 14,763 | 15,953 |
| | | | | | | | | |
| **Growth (% YoY) - reported** | | | | | | | | |
| **Baby Nutrition & Care** | **26%** | **18%** | **5%** | **-9%** | **1%** | **2%** | **2%** | **3%** |
| Infant formulas | 21% | 12% | 3% | -2% | 1% | -1% | -1% | -1% |
| Probiotic supplements | 34% | 20% | 11% | -31% | 13% | 20% | 18% | 17% |
| Other pediatric products | 84% | 81% | 9% | -24% | -16% | -10% | -10% | -10% |
| **Adult Nutrition & Care (ANC)** | **24%** | **-6%** | **-3%** | **9%** | **8%** | **8%** | **9%** | **8%** |
| China (i.e. normal trade) | 55% | 26% | 25% | 13% | 10% | 14% | 13% | 12% |
| ANZ (domestic market + CBEC) | 8% | -29% | -33% | 4% | 8% | 0% | 0% | 0% |
| Others | 75% | 32% | -2% | -14% | -4% | 0% | 0% | 0% |
| **Pet Nutrition & Care (PNC)** | **n/a** | **n/a** | **n/a** | **n/m** | **111%** | **27%** | **25%** | **23%** |
| Total | 25% | 8% | 2% | 3% | 11% | 7% | 8% | 8% |
| | | | | | | | | |
| **Sales mix (%)** | | | | | | | | |
| **Baby Nutrition & Care** | **58%** | **63%** | **65%** | **57%** | **52%** | **50%** | **47%** | **45%** |
| Infant formulas | 44% | 46% | 47% | 45% | 41% | 37% | 34% | 32% |
| Probiotic supplements | 10% | 11% | 12% | 8% | 9% | 10% | 10% | 11% |
| Other pediatric products | 3% | 6% | 6% | 4% | 3% | 3% | 2% | 2% |
| **Adult Nutrition & Care (ANC)** | **42%** | **37%** | **35%** | **36%** | **36%** | **36%** | **36%** | **37%** |
| China (i.e. normal trade) | 15% | 17% | 21% | 23% | 23% | 24% | 26% | 27% |
| ANZ (domestic market + CBEC) | 25% | 16% | 11% | 11% | 11% | 10% | 9% | 8% |
| Others | 2% | 3% | 3% | 2% | 2% | 2% | 2% | 1% |
| **Pet Nutrition & Care (PNC)** | **0%** | **0%** | **0%** | **6%** | **12%** | **14%** | **16%** | **19%** |
| Total | 100% | 100% | 100% | 100% | 100% | 100% | 100% | 100% |

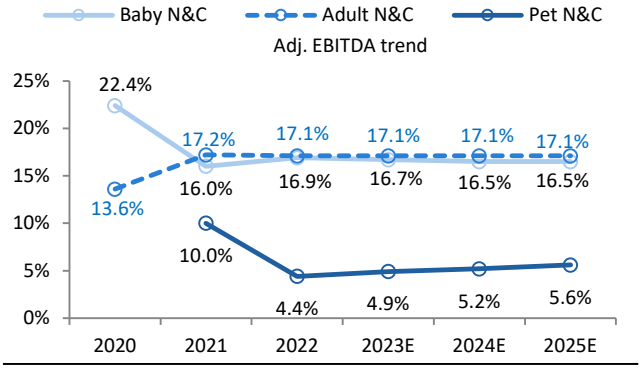
*Source: Company data, BOCOM Int'l estimates*

### Figure 283: H&H: Gross margin by division




*Source: Company data, BOCOM Int'l estimates*

### Figure 284: H&H: Adj. EBITDA margin by division




*Source: Company data, BOCOM Int'l estimates*

### Figure 285: H&H: Gross profit and adj. EBITDA by segment

| | 2018 | 2019 | 2020 | 2021 | 2022 | 2023E | 2024E | 2025E |
|---|---|---|---|---|---|---|---|---|
| **Gross profit (RMB m)** | | | | | | | | |
| Baby Nutrition & Care | 4,002 | 4,614 | 4,766 | 4,283 | 4,172 | 4,211 | 4,312 | 4,441 |
| Infant formulas | 3,013 | 3,335 | 3,344 | 3,281 | 3,148 | 3,026 | 2,945 | 2,865 |
| Probiotic supplements | 806 | 964 | 1,088 | 757 | 836 | 1,016 | 1,215 | 1,439 |
| Other pediatric products | 182 | 315 | 334 | 245 | 188 | 169 | 152 | 137 |
| Adult Nutrition & Care (ANC) | 2,738 | 2,614 | 2,411 | 2,665 | 2,853 | 3,142 | 3,473 | 3,824 |
| Pet Nutrition & Care (PNC) | - | - | 10 | 300 | 678 | 900 | 1,174 | 1,504 |
| **Total** | **6,740** | **7,229** | **7,187** | **7,248** | **7,703** | **8,254** | **8,958** | **9,769** |
| **Gross margin (%)** | | | | | | | | |
| Baby Nutrition & Care | 68.0% | 66.5% | 65.3% | 64.8% | 62.4% | 61.8% | 62.0% | 62.3% |
| Infant formulas | 66.8% | 65.8% | 63.8% | 63.8% | 60.8% | 59.0% | 58.0% | 57.0% |
| Probiotic supplements | 77.1% | 76.8% | 77.9% | 78.5% | 76.9% | 77.9% | 78.9% | 79.9% |
| Other pediatric products | 54.4% | 51.9% | 50.6% | 48.9% | 44.8% | 44.8% | 44.8% | 44.8% |
| Adult Nutrition & Care (ANC) | 64.5% | 65.5% | 62.3% | 63.3% | 62.6% | 63.6% | 64.6% | 65.6% |
| Pet Nutrition & Care (PNC) | 0.0% | 0.0% | 38.1% | 41.3% | 44.4% | 46.4% | 48.4% | 50.4% |
| **Total** | **66.5%** | **66.2%** | **64.2%** | **62.8%** | **60.3%** | **60.3%** | **60.7%** | **61.2%** |
| **Adj. EBITDA (RMB m)** | | | | | | | | |
| Baby Nutrition & Care | 1,179 | 1,463 | 1,635 | 1,058 | 1,130 | 1,137 | 1,148 | 1,177 |
| Adult Nutrition & Care (ANC) | 980 | 770 | 526 | 724 | 780 | 845 | 920 | 997 |
| Pet Nutrition & Care (PNC) | - | 2 | -5 | 73 | 67 | 95 | 126 | 167 |
| **Total** | **2,159** | **2,235** | **2,157** | **1,855** | **1,977** | **2,078** | **2,194** | **2,342** |
| **Adj. EBITDA margin (%)** | | | | | | | | |
| Baby Nutrition & Care | 20.0% | 21.1% | 22.4% | 16.0% | 16.9% | 16.7% | 16.5% | 16.5% |
| Adult Nutrition & Care (ANC) | 23.1% | 19.3% | 13.6% | 17.2% | 17.1% | 17.1% | 17.1% | 17.1% |
| Pet Nutrition & Care (PNC) | 0.0% | 0.0% | 0.0% | 10.0% | 4.4% | 4.9% | 5.2% | 5.6% |
| **Total** | **24.5%** | **20.5%** | **19.3%** | **16.0%** | **15.4%** | **15.2%** | **14.9%** | **14.7%** |

*Source: Company data, BOCOM Int'l estimates*

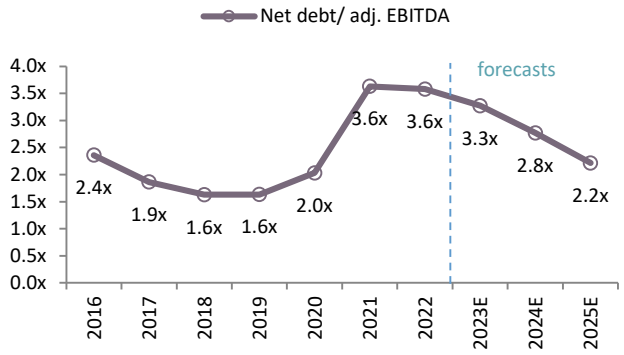
# Investment Concerns

## Key concern #1: Credit-worthiness remains an investor concern

**High leverage an investor concern:** H&H has relied on M&A in the past, to a certain extent, to drive its growth. This has resulted in considerable debt and H&H's currently high leverage. As of Dec 2022, H&H has an outstanding debt of RMB9,568m vs. cash balance of RMB2,304m (i.e. net debt of RMB7,265m), with a net debt-to-equity ratio of 1.2x and net debt-to-adjusted EBITDA ratio of 3.6x (based on the company's definition).

**M&A spree is done for now, deleveraging to come:** Given its product portfolio is now complete and comprehensively covers the entire household from baby to adult to pet, management said it does not expect further M&A activities in the near future and will focus on deleveraging. Management has committed to lowering its net-debt-to-adjusted EBITDA ratio to 3x by end-2023 and 2x by end-2024. We do note that our model suggests this is difficult to achieve, especially given H&H continues to pay out its cash through dividend, as it had a high payout ratio of >50% in the past two years despite its high leverage. Management would likely have to choose between continuing to pay out a high dividend, or focusing on deleveraging, in the next few years.

**Figure 286: Net-debt-to-adjusted EBITDA ratio**




*Source: Company data, BOCOM Int'l estimates*

**Credit profile improved over H&H's recent successful refinancing of its bond due Oct 2024, but further refinancing needs exist over the next 18-24 months:** In managing its debt leverage and financing costs, H&H's key considerations are:

(1) to refinance any upcoming debt maturities at least one year before they become due, so as to prevent them being reclassified as current liabilities (from non-current liabilities), which could negatively impact its credit rating. Moody's recently assigned a Ba3 corporate family rating with a stable outlook to H&H and its proposed senior note.

(2) to use a mixture of debt instruments to achieve the lowest financing cost while still having an even repayment schedule and flexibility in terms of financial covenants. As of June 2023 and before the issuance of its proposed senior note, H&H's outstanding debt include a US$270m 5.265% senior note due Oct 2024 (to be cancelled before Oct 2023

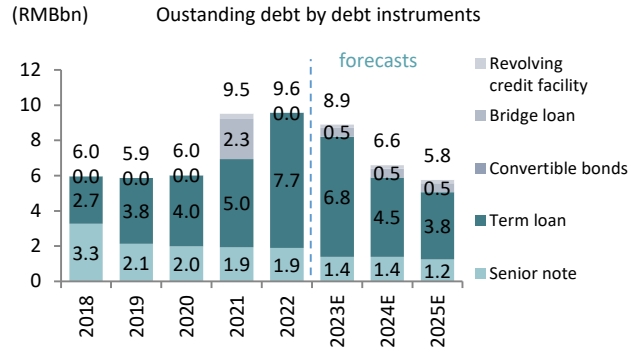
and refinanced by a new note, US$200mn 13.5% due June 2026), a US$1,125m term loan (to be amortized in 2023, and likely refinanced in 1H24), as well as approved bank credit facilities of at least RMB500m.

**Recent refinancing of US$270mn outstanding senior note eases near-term concern…** H&H's share price has been tied to its credit profile, given its upcoming debt maturities, which pressures H&H's liquidity profile. H&H recently partially refinanced its outstanding RMB270m 5.625% senior note due Oct 2024, among which:

- US$141.793m of the 2024 notes (52.58% of outstanding) was tendered by bondholders and accepted for exchange at a bond price of US$106 for the new note (13.5% senior note due June 2026). In addition to the exchange, it also issued a US$58m 13.5% senior note due June 2026, which combine to be a US$200m senior note due June 2026.
- US$29.9m to be purchased by the company, at a bond price of US$93.
- US$98m will remain outstanding, but likely to be redeemed before October 2023 (one year before its maturity, in order to avoid being classified as current liabilities which affects its credit rating).

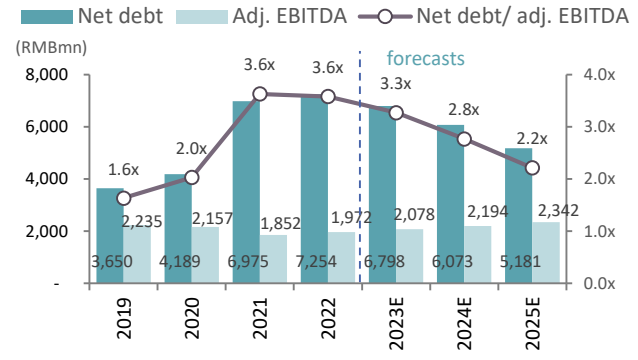
**…But more refinancing would need to be done in 2024:** Its near-term debt maturities include a US$1,125m syndicated loan (with scheduled repayments in June 2024 and December 2024), for which it will need to arrange refinancing in 1H24, likely with a lower amount as part of its deleveraging drive. On this loan, the interest rate was SOFR +2.2%, with about 38% of its interest rate hedged (fixed at around 5%). Interest rate will likely rise upon refinancing.

**Figure 287: Outstanding debt by instrument**




*Source: Euromonitor, BOCOM Int'l estimates*

**Figure 288: H&H mgmt expects net debt to adj. EBITDA to fall to 3x by end-2023, 2x by end-2024. We think it could be difficult to achieve**

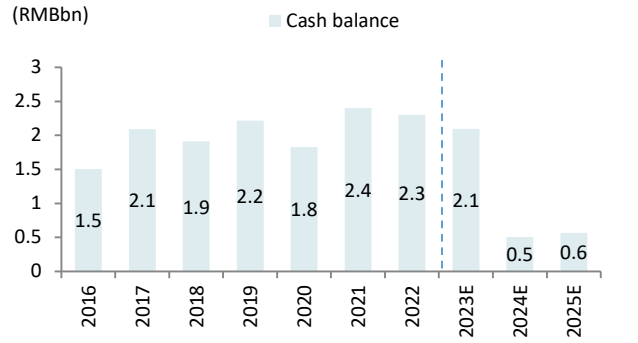



*Source: Euromonitor, BOCOM Int'l estimates*

**Interest expense likely to go up:** H&H's RMB526m interest expense in 2022 was equivalent to 27% of its adj. EBITDA (or 52% of pretax profit) for the year. Based on the company's expectation, interest expense may rise further to below RMB640m in 2023 as

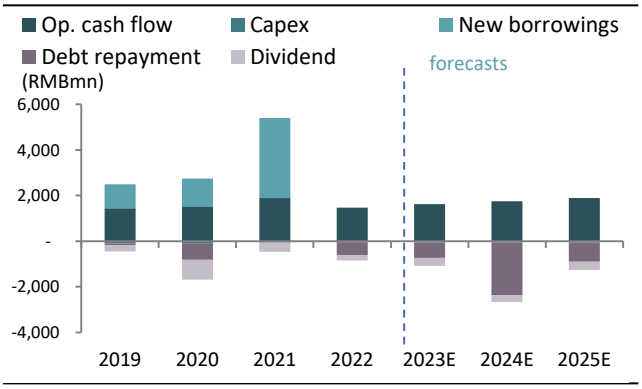
it (1) refinanced its outstanding 5.625% senior note (due Oct 2024) with a new note with coupon of 13.5% due June 2026; (2) recently secured a credit line of RMB500m from China Construction Bank, which it said will be drawn down before 30 June 2023; (3) plans to refinance its outstanding term loan (SOFR +2.2%) in 1H24, likely at a higher interest rate, albeit with a lower principle.

**Figure 289: Cash balance in our model would fall significantly in 2024 assuming H&H makes a big repayment (by only partially refinancing its US$1,125m term loan, in 1H24)**



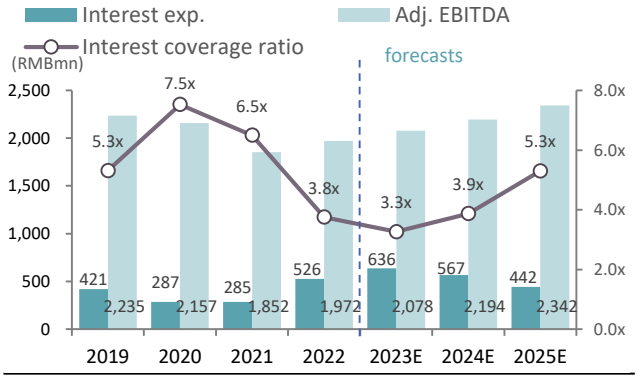

*Source: Company data, BOCOM Int'l estimates*

**Figure 290: Key cash flow items. We assume a big repayment in 2024 as H&H refinances its loan**



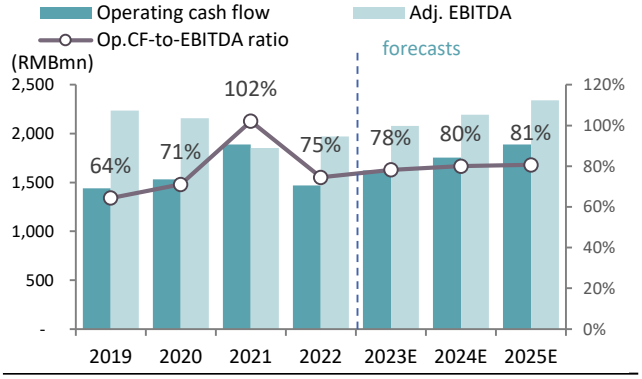

*Source: Company data, BOCOM Int'l estimates*

**Figure 291: Finance costs and interest coverage ratio (adj. EBITDA/interest expense)**




*Source: Company data, BOCOM Int'l estimates*

**Figure 292: Operating Cash flow to adj. EBITDA ratio has not always been 100%**

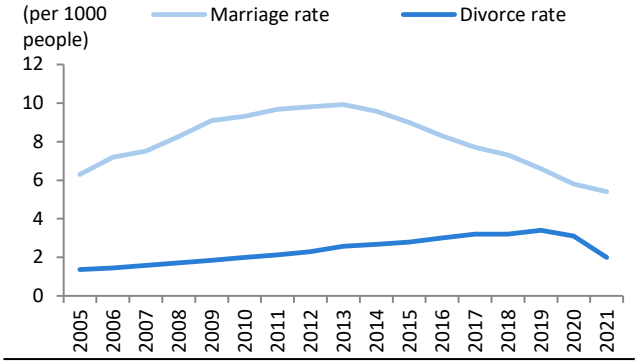



*Source: Company data, BOCOM Int'l estimates*

## Key Concern #2: Demographic headwinds for the BNC division

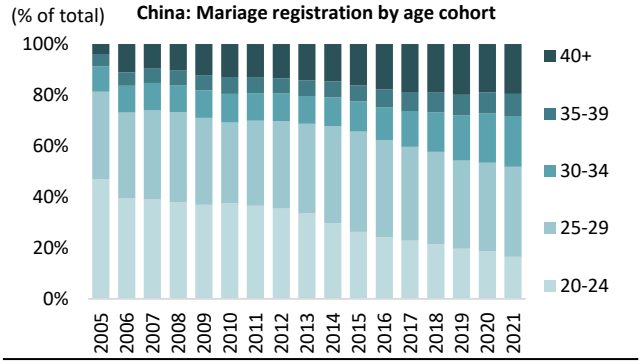
**BNC, the biggest division, remains challenged:** Despite its active diversification, Baby Nutrition & Care (BNC) division remains the biggest division, having contributed 52% of H&H sales in 2022, within which infant milk formula (IMF) accounted for 41% of sales, which means the demographic headwind from falling birth rate in China would continue to pressure the business.

**Figure 293: Contributing to the falling birth rate: (1) Less people are getting married …**



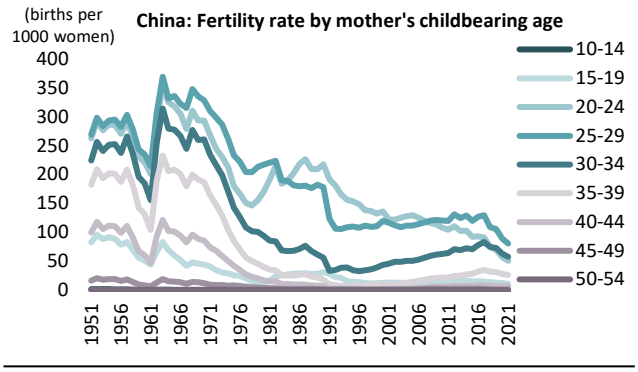

*Source: National Bureau of Statistics, BOCOM Int'l*

**Figure 294: ….and (2) People are getting married later…. | China's marriage registration by age**



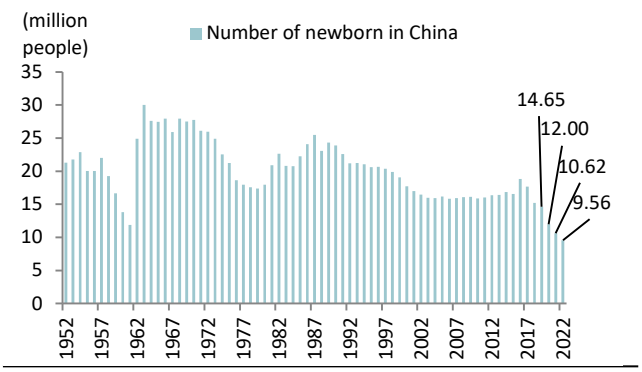

*Source: National Bureau of Statistics, BOCOM Int'l*

**Figure 295: …while (3) Fertility rate falls as the mother's childbearing age rises after 25-29…**




*Source: United Nations, BOCOM Int'l*

**Figure 296: (4) China's number of newborns have fallen.**




*Source: National Bureau of Statistics, BOCOM Int'l*

**Birth rates falling: People are getting married later on average, and fewer want babies:** There are various factors behind birth and death rates. For death rate, it has gradually fallen due to higher life expectancy of Chinese people (77.9 in 2022, up remarkably from 67.6 years in 1982, and even higher than that in the US, at 76.1 years in 2021) due to better science and healthcare, healthier lifestyles (e.g. 37.2% of the population regularly took part in physical exercises, up from 33.9% in 2014, according to China's General Administration of Sport), better nutritional intake, and higher living standards in general.

Birth rate is more complicated, and is a culmination of marriage rate (number of marriages, divided by population, x 1000), and fertility rate (number of births per woman,

x 1000). The willingness to get married and give birth are affected by various socio-economic reasons, including the cost of living and raising a child, and government policies (e.g. three-child policy implemented in May 2021, as well as various government stimulus including tax breaks for married couples and for having children). The number of couples that registered for marriage in China is on pace to hit a historic low, attributable to the shrinking size of China's marriageable population, but also an increasing reluctance to marry.

**The IMF market, targeted at infants aged 0-3 years, would shrink further in the next few years:** Fewer births and those aged 0-3 years means the IMF market will take a direct hit. For the IMF industry, 53% of sales is derived from Stage 1 (targeted at infants aged 0 to 6 months) and stage 2 (aged 6-12 months), with another 42% of sales derived from stage 3 (aged 12-36 months). Which means, >50% of the IMF industry sales is derived from babies born in the same year (i.e. stage 1 and 2 IMF sales in 2023 would be tied to the number of newborns within the year of 2023), with another 42% of sales would be derived from babies born 1-2 years ago (in years 2021 and 2022). Therefore, IMF sales in 2023 would be highly correlated with the number of newborns in 3-year period from 2021-23, while IMF sales in 2024 would be tied to newborns in 2022-24.

**We expect a 8%/3% decline in IMF industry sales in 2023/24, although market leaders could still grow by gaining market share from smaller peers:** For 2023, the number of new births is looking to fall further based on 1Q23 data released by some provinces so far, with decline ranging from 2% to 12% for various regions, which drove some predictions for new births to fall below 8 million in 2023 (vs. 9.56mn in 2022 and 10.62mn in 2021). In our industry model, we estimate China's IMF industry volume would still fall by 8% YoY in 2023E and 3% in 2024E.

# Investment Positives

## Key positive #1: Pure play to China's middle-income group expansion

**Comprehensive exposure to China's rising income story:** H&H has a diversified portfolio consisting of baby (BNC), adult (ANC) and pet (PNC) nutrition and care divisions. This makes it a comprehensive pure play to China's premium health and wellness sector, and a direct beneficiary of the structural growth story of China's expanding middle-income group. We believe consumers' willingness to spend on wellness and nutritional products increases in relation to their affluency, and price elasticity is usually high for these products. H&H has curated an attractive portfolio of imported international brands that are well-positioned to capture these trends.

**Strong premium brand portfolio:** Biostime is the 7th ranked infant formaul brand in China and #4 within premium IMF with 12.1% share), followed by adult supplement (36% of sales, Swisse is the #1 VHMS brand in China with 7.5% share). Pet food/supplement and baby probiotics/care products contributed another 12% of sales each in 2022.

## Key positive #2: ANC and PNC divisions ride on industry tailwinds that offsets headwinds for the BNC division

**Pet adoption rises as birth rate falls:** China is facing a demographic trend of falling birth rate. In contrast, singles and married couples are increasingly choosing to adopt pets as additions to their households, as evident from the rising pet adoption rate in China's cities, with nearly half of the population owned pets as of 2022 (Statista). According to Euromonitor, the market size of IMF (valued at RMB171,663m in 2022) is expected to fall by a total of RMB161,304m in the next four years (2023-26E). However, the market for pet food (valued at RMB48.7bn in 2022) is expected to rise to RMB72,313m in the same period. As such, we believe the rising total addressable market ("TAM") for H&H's PNC division would be able to partially offset the declining TAM for its BNC division.

**While an ageing population, there will be more demand for adult nutritional products:** As the number of new births falls and people live longer, older people become a bigger mix of the population, which means the average age of China's population rises (i.e. the society is ageing). This means people will allocate more spending on healthcare for elderly people, and there will be increasing demand for adult nutritional products.

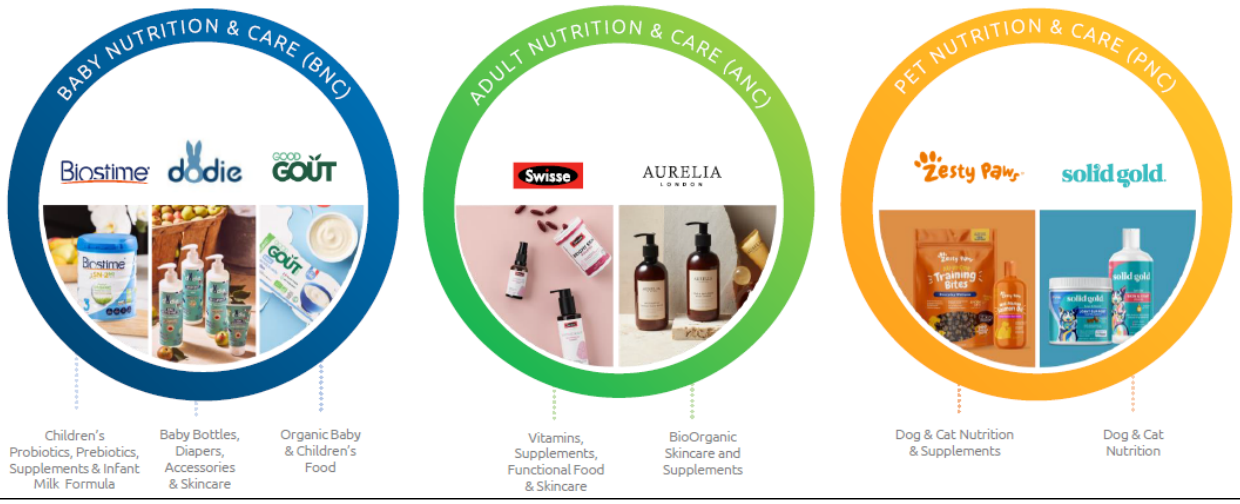
## Key positive #3: Future growth to come from international expansion

**Successful track record of bringing international brands into China:** H&H's strength lies in its ability to market and distribute premium, international brands in China, which it has demonstrated with its successful track record with Australian brand Swisse that reached #1 in a fast-growing market. It now plans to bring Zesty Paws and Solid Gold (American brands it acquired in 2020-21) to Europe and China. While Solid Gold has more exposure in the China market now, Zesty Paws have very little. H&H will continue to roll out these two brands in China, as well as Europe, by leveraging on its existing sales and distribution team in these countries, which means additional overhead costs will not be significant.

## Business Overview

**Three different business lines, under the same vision of providing for the entire household's health and happiness:** H&H was founded in 1999 in Hong Kong, China and listed on the HK Stock Exchange in 2010 originally under the name of "Biostime International Co Ltd", named after its high-end positioned infant formula brand Biostime that is wholly produced and packaged in France. The company changed its name to "Health & Happiness (H&H) International Holdings Ltd." in June 2017 to better reflect its increasingly diversified business model and product offering, as it has evolved from a pure provider of baby nutrition, food and care to one that provides for the entire household, from baby to adults to pets. H&H currently has 3 main business lines: **Baby Nutrition & Care** (BNC), **Adult Nutrition & Care** (ANC) and **Pet Nutrition & Care** (PNC). H&H aspires to become a global leader in premium nutrition and wellness, with a mission of "making people healthier and happier".

**Figure 297: H&H business units (BNC, ANC and PNC) and their respective brand portfolios**




*Source: Company data, BOCOM Int'l*

**H&H grew its portfolio of global premium brands through M&A:** The company acquired additional brands such as French baby care brand **Dodie** in 2016, French baby food brand **Good Gout** in 2018, both under its BNC division. The company expanded its product lines and formed the ANC division in 2015 following its acquisitions of Australian supplement brand **Swisse** in 2015 and British organic skincare brand **Aurelia** in 2019. In the past two years, it added a third business unit, the PNC division through its acquisitions of US pet supplement brand **Zesty Paws** in 2020 and pet food brand **Solid Gold** in 2021.

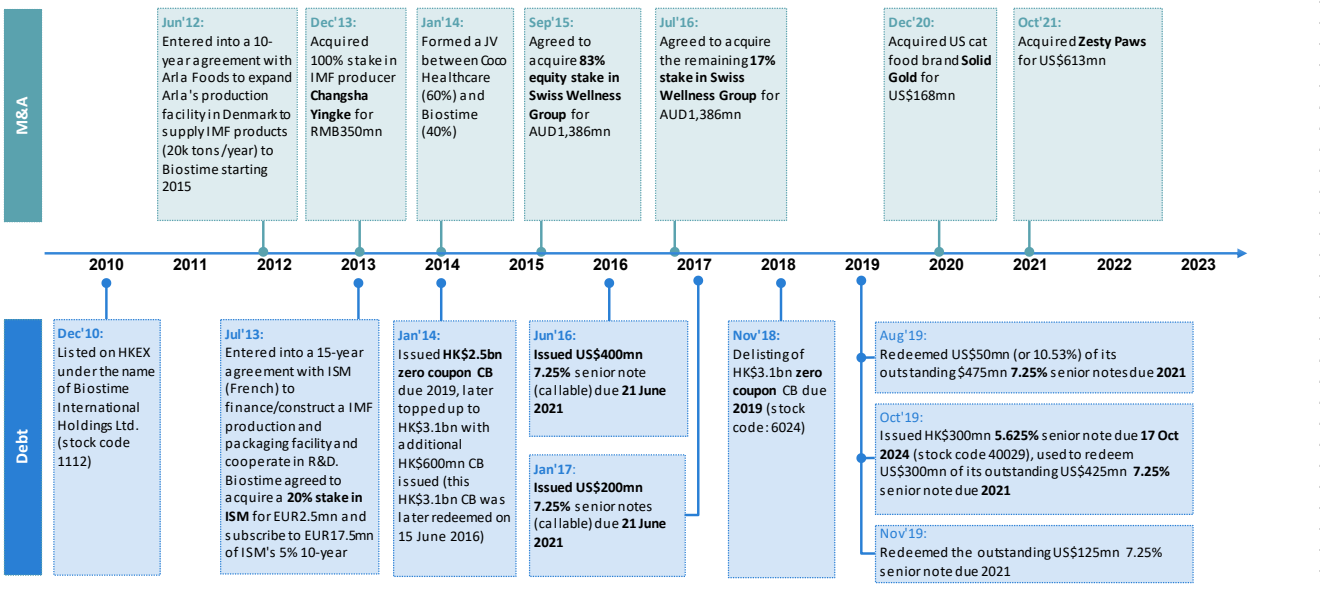
**No more M&A in the near future.** Management has made it clear that the company would not pursue further M&A in the near future as it has now completed the brand portfolio that it needs to grow into the future. It will also focus its free cash flow on reducing its debt leverage, with a goal of reaching net debt/EBITDA of around 3x by end of year 2023, and around 2x by end of 2024.

## Figure 298: List of H&H's mergers and acquisitions (M&A) activities by business unit

| Business unit<br>Brands/assets | Country of origin | Acquisition date | Valuation (m) | Deal Size<br>Original currency (m) | Deal Size<br>RMB (m) | Paid by |
|---|---|---|---|---|---|---|
| **Baby Nutrition & Care (BNC)** | | | | | | |
| Changsha Factory | China | Dec 2013 | RMB350 | RMB350 | 350.0 | Cash |
| Healthy Times | US | July 2015 | USD10.4 | USD10.4 | 64.6 | Cash |
| Good Goût | France | July 2018 | EUR30.7 | EUR30.7 | 238.2 | Cash |
| Dodie | France | Dec 2016 | EUR16.0 | EUR16.0 | 115.8 | Cash |
| Farmland | Australia | Aug 2018 | AUD35.9 | AUD35.9 | 178.0 | Cash |
| **Adult Nutrition & Care (ANC)** | | | | | | |
| Swisse | Australia | Sep 2015 | AUD1,761.2 | AUD1,449.9 (87% shares)<br>AUD311.3 (13% shares) | 6,490 (87% shares)<br>1,663.4 (13% shares) | Cash+shares |
| Aurelia | UK | Jan 2019 | GBP21.1 | GBP21.1 | 183.2 | Cash |
| **Pet Nutrition & Care (PNC)** | | | | | | |
| Solid Gold | US | Dec 2020 | USD167.8 | USD167.8 | 1,097.8 | Cash |
| Zesty Paws | US | Oct 2021 | USD613.3 | USD613.3 | 3,961.9 | Cash |

*Source: Company data, BOCOM Int'l*
*Note: For Swisse (under ANC), the remaining 13% of shares was acquired in Feb 2017.*

## Figure 299: H&H used debt extensively in the past to support its M&A-driven growth



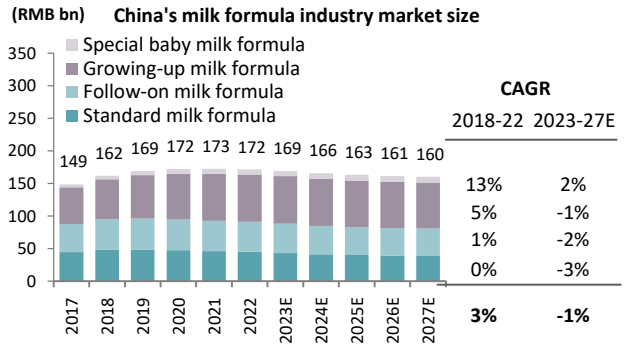

*Source: Company data, BOCOM Int'l*

## Baby Nutrition & Care (BNC)

**Product breakdown:** Within BNC, sales is made up of predominantly IMF (77% of BNC sales), followed by probiotic supplements (16%) and other pediatric products (6%). With IMF, H&H sells seven series (the same brand's stage 1, stage 2, stage 3 products are considered 3 separate series given the vastly different formulas) under the Biostime and Healthy times brands. Probiotic products are sold under the Biostime brand. Other pediatric products include dried baby food, baby care like diapers and supplements.

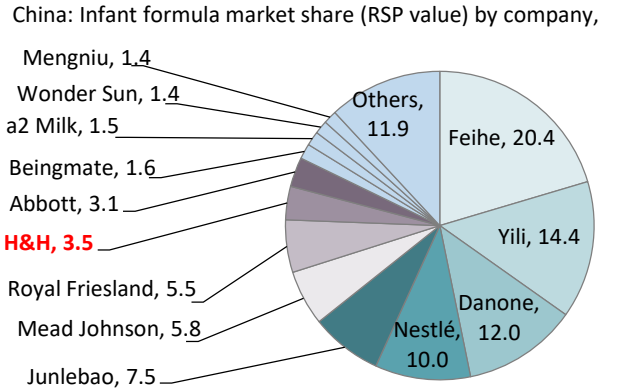
**China remains the core market focus:** China market accounted for 75% of H&H's total sales in 2022, but is even more important for the BNC division, accounting for 94% of BNC's sales. Within BNC, China market accounted for 97%/99%/45% of its infant formula/ probiotic supplements/other pediatric products divisions, respectively, in 2022.

**Figure 300: Baby Nutrition & Care division: China's milk formula market (in retail value)**



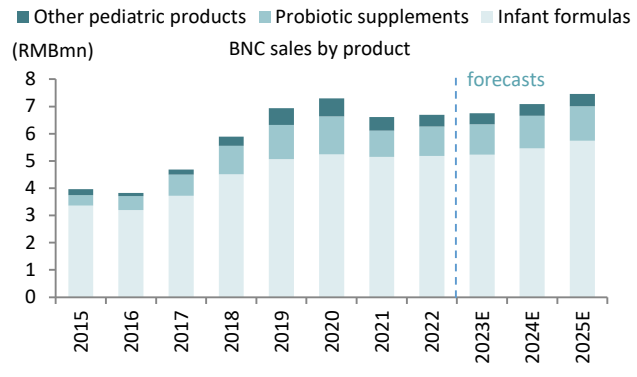

*Source: Euromonitor estimates, BOCOM Int'l*

**Figure 301: Milk formula market share by company in China (% by retail value, 2022)**



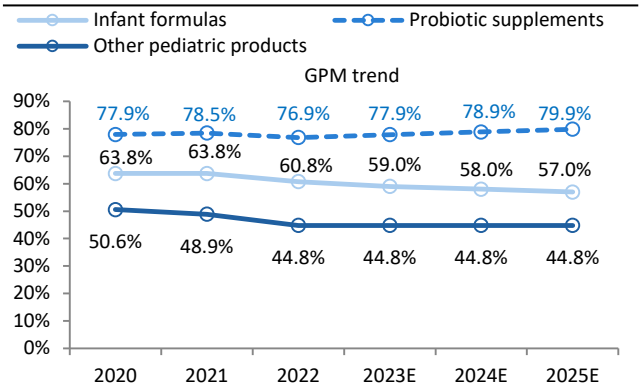

*Source: Euromonitor estimates, BOCOM Int'l*

**Figure 302: H&H's BNC sales by product; IMF accounted for 77% of sales**



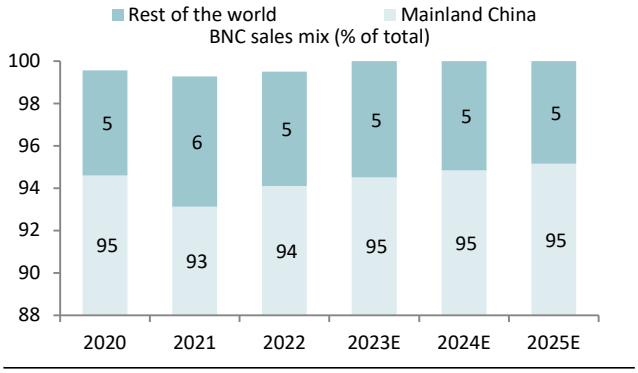

*Source: Company data, BOCOM Int'l estimates*

**Figure 303: H&H's gross margin by BNC product segment**



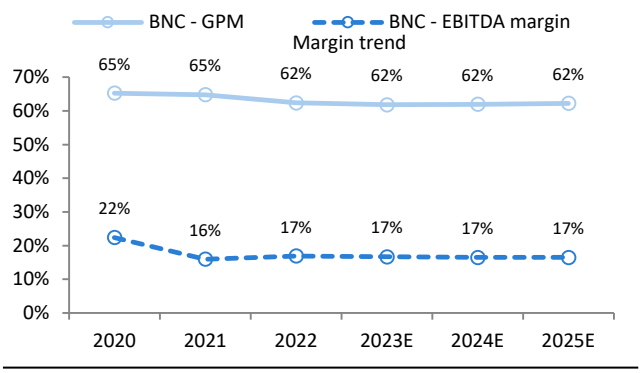

*Source: Company data, BOCOM Int'l estimates*

**Figure 304: H&H's BNC: Sales mix by geography**




*Source: Euromonitor, BOCOM Int'l estimates*

**Figure 305: H&H's BNC: GPM and EBITDA margin**




*Source: Company data, BOCOM Int'l estimates*

**Figure 306: Baby Nutrition & Care includes Biostime, Dodie (diapers) and Gout**




*Source: BOCOM Int'l*

**Recent update:** Total sales of H&H grew by 7.7% YoY in 1Q23, a slight acceleration from 4Q22 (5.4%), driven mostly by the ANC segment. In 1Q23, BNC declined by 9.2% (vs. 8.0% YoY growth in 4Q22), within which, infant formula / probiotics / other pediatric products' sales showed YoY changes of -22.6%/70.6%/-23.0% respectively (vs. 4Q22: 8.1%/9.5%/2.4%). Growth were stronger for ANC and PNC: ANC grew by 63.2% (vs. -6.6% in 4Q22) while PNC grew by 28.2% (vs. 21.2% in 4Q22).

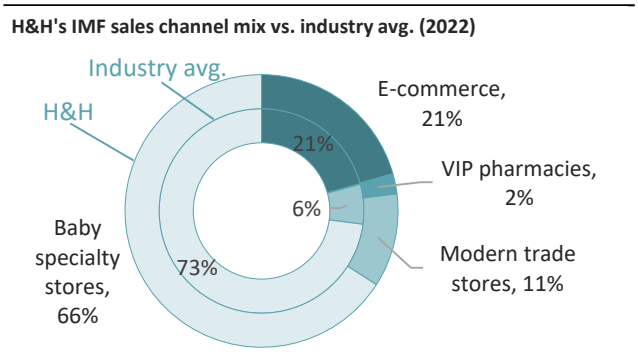
**BNC (52% of 2022 sales) – we expect 2% sales growth in 2023**

- **IMF – expect 1% sales decline in 2023:** IMF accounts for nearly 80% of BNC's sales in 2022, which we expect to see 1% YoY sales decline this year (guidance: stabilize YoY). 1Q23 saw a steep 23% YoY decline, attributable to (1) surge in market supply ahead of the roll-out of China's new National Standards in Feb 2023 that resulted in fierce competition and discounting; (2) pulling-forward of sales to 4Q22 due to an earlier

CNY; (3) the recent decline of new births in China. However, the premium and super premium segments that H&H focuses on will likely be more resilient. Going forward, H&H's growth will be driven by channel expansion, as it increases penetration in tier 3-5 cities in China, where H&H expects to reach >70% of sales, as birth rate is still increasing in lower-tier cities and there is still strong demand for product premiumization. For tier 1-2 cities, growth will likely be subdued given channel coverage is already at 94%, but H&H aims to increase point-of-sales ("POS") sales productivity and rank among the top 3 for super premium IMF (currently at #4). H&H is optimistic that 2024, being the Year of the Dragon, may also see some recovery in birth rate.

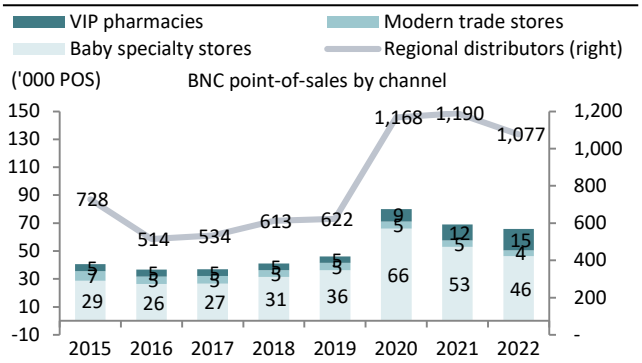
**Channel expansion:** As of end 2022, H&H sells to 1,077 distributors which retails their products in >65,000 point-of-sales (POS), including 46,000+ baby specialty stores, 4,000+ modern channel stores (e.g. supermarkets, hypermarkets) and 15,000+ pharmacies. H&H has a strong presence in top-tier cities, and will continue to expand to lower-tier cities. With that said, its channel coverage in tier 3-5 cities is already at around 94%, which means while it still has room to increase its POS count further, the majority of growth upside will come from increasing the sales output for its existing 65,000 POS. H&H management is not concerned about lower-tier city consumers' affordability for its high-end products, given demand for premium-quality IMF is very strong in lower-tier cities.

**Figure 307: H&H's IMF sales by channel, 2022**




*Source: Company data, BOCOM Int'l*

**Figure 308: H&H's POS count by channel**

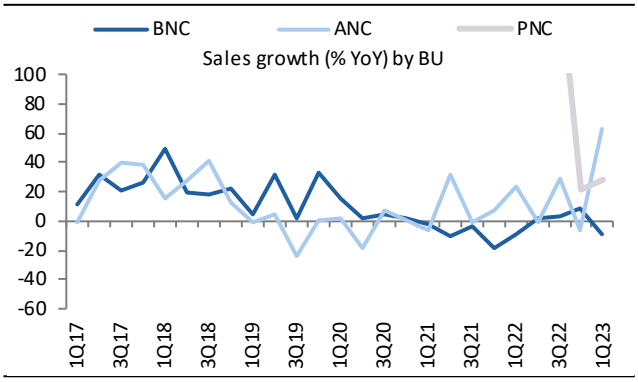



*Source: Company data, BOCOM Int'l*

- **Probiotics – we expect 20% YoY sales growth in 2023:** Consisting of Biostime branded probiotics, sales were exceptionally strong in 1Q23 (+71% YoY) following 13% growth in 2022, due to a rush for immunity boost following China's reopening. Sales will likely normalize and we expect 20% YoY (vs. guidance: teens) growth for 2023. Longer-term, growth will be driven by penetration rate increase. While Biostime already has high market share in the probiotics category (#1 in China in 2022), the overall market penetration is still not high, and there is room for further channel expansion given currently less than 50% of Biostime's IMF POS sells probiotics.

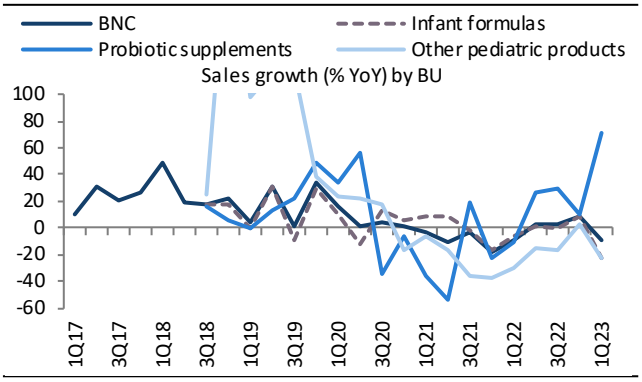
- **Other pediatric products – we expect 10% YoY decline in the near term:** Other pediatric products consisted mainly of Dodie branded diapers, where sales declined by 12% YoY in 2022, as a result of fierce competition. The business has not been profitable and will likely undergo restructuring in the near term as management consciously shifts attention to profitability from volume growth.

**Figure 309: H&H: Quarterly sales trends**




*Source: Company data, BOCOM Int'l*

**Figure 310: Within BNC, probiotics surged in 1Q23 given risen COVID infections, but infant formulas was weak ahead of the new GB roll-out in Feb'23**




*Source: Company data, BOCOM Int'l*

## New National Standard for infant formula to help H&H gain share

**New GB standard effective from Feb 2023:** The new national standard (also known as "new GB standard", 新国标 in Chinese) for infant milk formulas was introduced in March 2021 and became effective on 22 February 2023 in China. The updated GB standard separated the guidelines for stage 2 formula (GB-10766) and stage 3 formula (GB-10767), which were previously grouped together. The rationale behind the new GB standards is to improve the nutrition profile of infant formula products based on scientific research and to make them more similar to human breast milk. Notable changes include an increase in the requirement for whey protein content for stage 2 formula to at least 40% of total protein, and a requirement for lactose to make up at least 90% of total carbohydrates in stage 2 formula and at least 50% in stage 3 formula. For DHA content, the quantity requirement has increased to 3.6mg-9.6mg/100kJ from 0mg-0.5mg/100kJ.

**New standards shake up the industry, accelerates consolidation:** The implementation of the new GB standards is expected to lead to industry consolidation, as smaller players have struggled to meet the requirements due to the additional investment and capital needed for research and formula improvement in order to register their products. Despite the 22 February registration deadline, infant formula products manufactured before the deadline with a later expiration date are still allowed to be sold in retail channels. This has led to a surge in industry supply leading up to the deadline, given the uncertainty with obtaining approval, and the potential of lost sales/shortages that can result from delayed approvals or unsuccessful applications. In preparation for the registration deadline, H&H has also ramped up its inventory to one month on distributors' shelves to ensure that its products could continue to be sold in retail channels.

**H&H has obtained approval on 6 of its 7 IMF series:** H&H has obtained approval for 6 out of its 7 series of infant formula products. The remaining one (goat milk) is expected to also receive approval soon, according to management. Management reported that the approval process has been faster than expected, with two series obtaining approval in late June, three series obtaining approval in May, and its first approval (Alpha Star series) in February. H&H's expertise in research and development, exposure to high-end and premium markets, and its emphasis on the nutrient profile of its formulas position the company well to benefit from this wave of market consolidation.

**Figure 311: H&H's IMF product series subject to new GB approval**

| Approval status | Products | Chinese name |
|---|---|---|
| Approved (Feb 23) | Alpha Star | 阿尔法星 |
| Approved (May 23) | Healthy Times | 爱斯时光 |
| Approved (May 23) | Pi Star | 派星 |
| Approved (May 23) | Beta Star | 贝塔星 |
| Approved (Jun 23) | Manle | 满乐 |
| Approved (Jun 23) | Bei Su Bei Jia | 贝素贝加 |
| Expected to be soon | Ke Bei Si goat milk IMF | 可贝思羊奶 |

*Source: Company data, BOCOM Int'l*

## Figure 312: Product offering by segment – Infant milk formula (domestic brands)

| Company 公司 Ticker 股票代号 | Feihe 飞鹤 6186 HK | | Mengniu / Yashili 蒙牛 / 雅士利 2319 HK / 1230 HK | | | Ausnutria 澳优 1717 HK | | | H&H Biostime 合生元 1112 HK | | Yili 伊利 600887 CH | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Super premium 超高端 | | | | | | | | | | | | |
| Product series 产品系列 | Astrobaby 星飞帆 | Organic Zhenzhi 臻稚有机 | Doraler (goat milk) 朵拉小羊 | | | Hyprocal 1897 海普诺凯 | Mygood 美优高 | Allnutria 遨游能立多 | Healthy Times 爱斯时光 | | Sai Na Mu 金领冠塞纳牧 | |
| Price/700g (Rmb) | 324 | 351 | 375 | | | 356 | 340 | 348 | 337 | | 311 | |
| Premium 高端 | | | | | | | | | | | | |
| Product series 产品系列 | Zhenai Beihu 臻爱倍护 | | Yashili Kieember 雅士利菁珀 | Ruibu'en 瑞哺恩 | Arla Baby&Me 阿拉宝贝与我 | Kabrita (goat) 佳贝艾特 | Puredo 美纳多 | Eurlate 欧选 | Pi Star 派星 | Beta Star 贝塔星 | Zhenhu 金领冠珍护 | Ruihu 金领冠睿护 |
| Price/700g (Rmb) | 218 | | 313 | 313 | 287 | 274 | 252 | 313 | 325 | 255 | 276 | 244 |
| Regular 中档 | | | | | | | | | | | | |
| Product series 产品系列 | Feifan 飞帆 | Xingjie Youhu 星阶优护 | | | | Ausnutria 澳优爱优 | | | Alpha Star 阿尔法星 | | Jinghu 金领冠菁护 | PRO-Kido 金领冠 |
| Price/700g (Rmb) | 185 | 240 | | | | 235 | | | 208 | | 221 | 171 |

*Source: tmall.com, BOCOM Int'l Research*

## Figure 313: Product offering by segment – Infant milk formula (international brands)

| Company 公司 Ticker 股票代号 | Wyeth (Nestle) 惠氏（雀巢） NESN SW | | | Danone 达能 BN FP | | Reckitt Benckiser Royal Friesland 利洁时/美赞臣 菲仕兰 RB LN private | | Abbot 雅培 ABT US | | A2 Milk A2牛奶公司 A2M AU |
|---|---|---|---|---|---|---|---|---|---|---|
| Super premium 超高端 | | | | | | | | | | |
| Product series 产品系列 | Illuma Organic 启赋 有机 | | | | | Enfinitas Enfagrow 美赞臣蓝臻 美赞臣安儿宝 | | Friso Prestige 皇家美素佳儿 | Eleva Organic 菁挚 有机 | A2 至初 |
| Price/700g (Rmb) | 380 | | | | | 366 | 334 | 340 | 377 | 380 |
| Premium 高端 | | | | | | | | | | |
| Product series 产品系列 | Illuma 启赋 蓝钻 | Wyeth S-26/NAN HA 惠氏 铂臻 超启能恩 | | Aptamil Profutura 爱他美-卓萃 | | Enfa Gentlease 美赞臣亲舒 | | Friso Gold 金装美素佳儿 | Eleva Pure 菁挚 纯净 | Similac Qinhu 恩美力亲护 |
| Price/700g (Rmb) | 296 | 262 | 276 | 292 | | 312 | | 225 | 302 | 283 |
| Regular 中档 | | | | | | | | | | |
| Product series 产品系列 | Lat ogen 力多精 | | | Nutrilor Aptamil 诺优能 爱他美 | | Enfamil 美赞臣铂睿 | | Friso 美素佳儿 | Similac Plus 铂优恩美力 | Similac 经典恩美力 |
| Price/700g (Rmb) | 157 | | | 170 | 223 | 238 | | 186 | 225 | 185 |

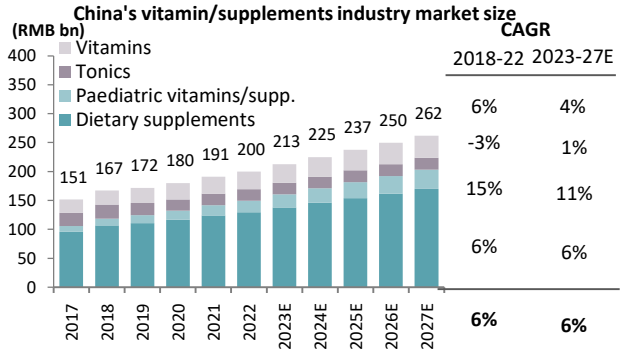
| A2 Platinum 至初海外版 |
|---|
| 233 |

*Source: tmall.com, BOCOM Int'l*

## Adult Nutrition and Care (ANC)

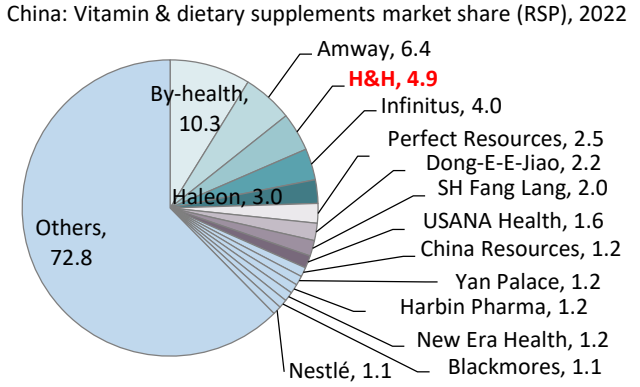
H&H's Adult Nutrition & Care (ANC) sales grew by 12.5% YoY organically (or 8.3% on reported basis) in 2022, accounting for 35.7% of total sales and 39.4% of total EBITDA. It mainly consists of Swisse brand. By region, H&H's ANC segment consists of 64% sales from China (within which 80% from cross-border e-commerce, 20% from "normal trade") and 30% of sales from the Australia and New Zealand market (69% from retail to local consumers and 31% from "corporate daigou" channel, i.e. buying in ANZ for shipping to China) in 2022.

**Figure 314: Adult N&C: China's vitamins/dietary supplements market (retail value)**




*Source: Euromonitor estimates, BOCOM Int'l*

**Figure 315: Vitamins/dietary supplements market share by company in China (% by retail value, 2022)**




*Source: Euromonitor, BOCOM Int'l*

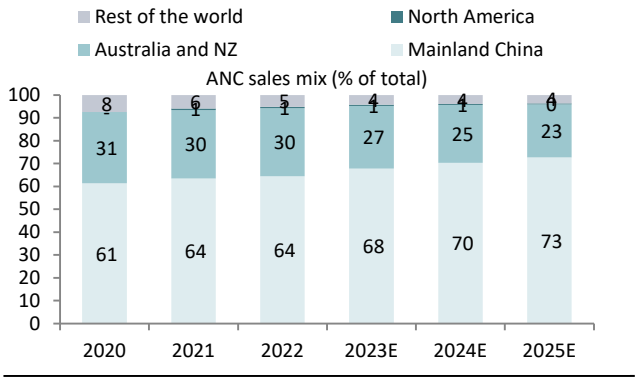
Sales growth from cross-border e-commerce ("CBEC") channel grew by 8% YoY in 2022 vs. 49% for normal trade in China.

- **"Corporate daigou"** exists because there is a larger variety of supplements which are also often cheaper in Australia for the same products, creating a market whereby third-party "Daigou" sellers (or cross-border price arbitragers) would buy these products in overseas markets and resell them to consumers in China. While "corporate daigou" does hurt H&H's China sales of the same products, it would still be recorded as sales for H&H for another region (Australia and New Zealand). Also, this channel is still beneficial to consumers because there is a larger variety of products available in overseas markets not yet approved to be sold in China.

- **Cross-border e-commerce (CBEC)** is a channel that emerged in the past 10 years that basically serves as a government-approved substitute for "corporate daigou". CBEC includes e-commerce platforms such as T-mall and JD Global, which purchase their goods from Swisse China on behalf of consumers in China. The rationale for the existence of this channel is similar to that for Daigous.

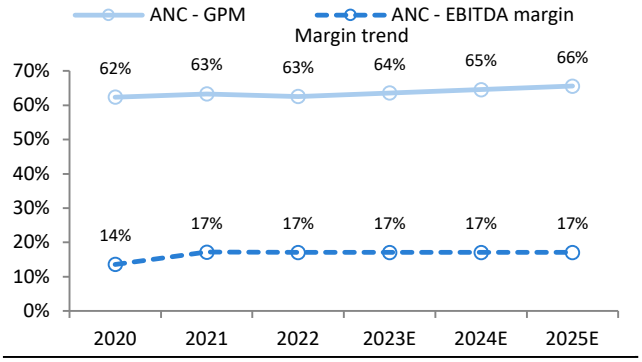
- **China's "normal trade sales",** i.e. products approved by local regulatory authorities and licensed to be sold in pharmaceutical stores, has increased in share in the past five years, from 9.2% in 2018 to 20.1% in 2022.

**Figure 316: H&H's ANC sales by region**




*Source: Company data, BOCOM Int'l estimates*

**Figure 317: H&H's ANC: GPM and EBITDA margin**




*Source: Company data, BOCOM Int'l estimates*

**Figure 318: H&H's Adult Nutrition & Care product line, consisting of Swisse and Aurelia brands**




*Source: BOCOM Int'l*

**Figure 319: H&H has leveraged the influence of celebrities to endorse its Swisse brand over the years, including Australian stars Nicole Kidman and Chris Hemsworth and Chinese stars Fan Bingbing and Dilraba**

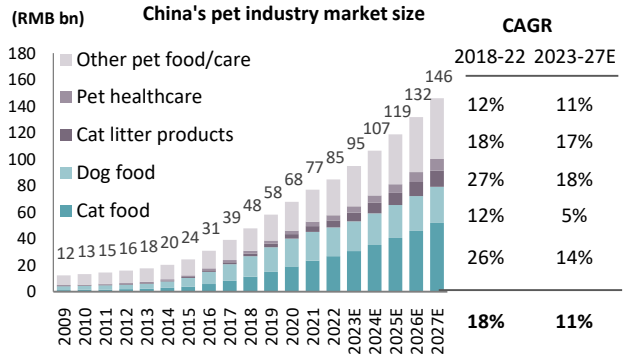



*Source: Company data, BOCOM Int'l*

## Pet Nutrition and Care (PNC)

**International expansion:** H&H further expanded into the pet business by acquiring US pet supplement brand **Zesty Paws** in 2020 and pet food brand **Solid Gold** in 2021. Zesty Paws is the #1 pet supplement brand in the US; Solid Gold the #2 premium cat food brand in China, according to the company. Future growth will be driven by their continued channel and geographic expansion.

**Figure 320: Pet Nutrition & Care: China's pet care market size (in retail value)**



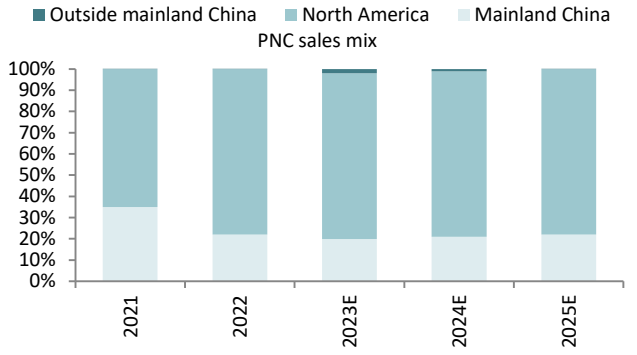

*Source: Euromonitor estimates, BOCOM Int'l*

**Figure 321: H&H's Pet Nutrition & Care product lines, including Solid Gold and Zesty Paws**



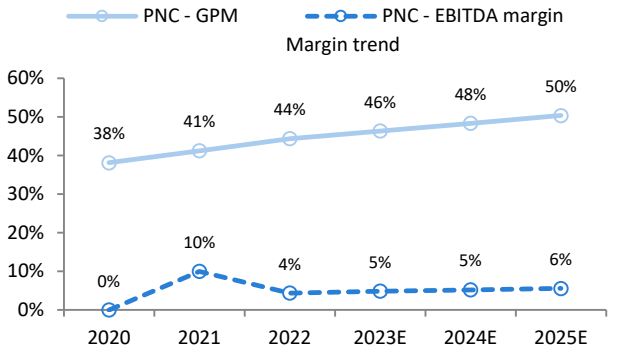

*Source: Company data, BOCOM Int'l*

**Figure 322: H&H's PNC sales by region**




*Source: Company data, BOCOM Int'l estimates*

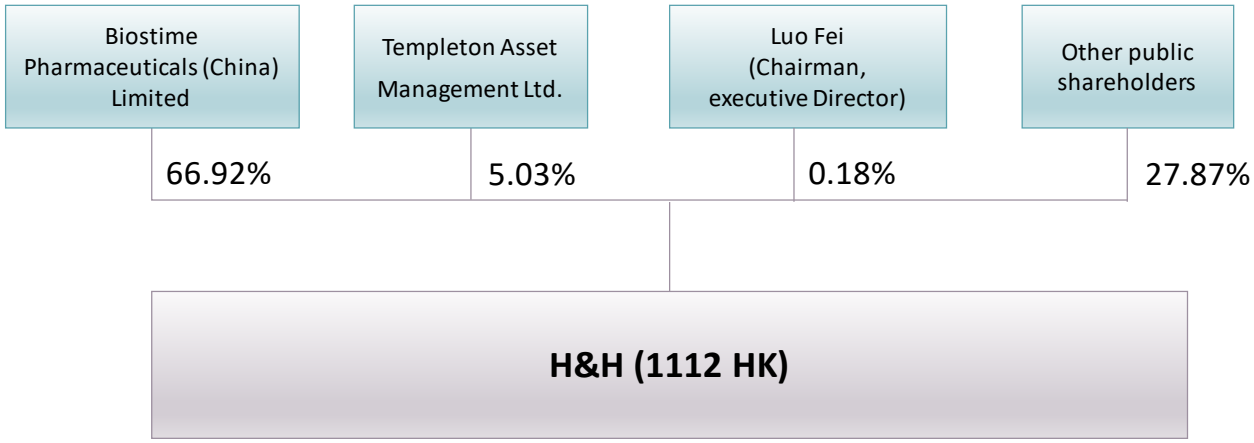
**Figure 323: H&H's PNC: GPM and EBITDA margin**




*Source: Company data, BOCOM Int'l estimates*

## Shareholders and management

**Figure 324: H&H: Shareholding structure**




*Source: Bloomberg (2022), BOCOM Int'l*

## Figure 325: H&H: Board of directors and senior management

| Name | Position | Experience |
|---|---|---|
| **Luo Fei** | Chairman executive Director | Mr. Luo Fei is the chairman and an executive Director of the company, leading the Board and supervises the Group's strategy, risk management and corporate governance. Mr. Luo was formerly the CEO of the company and a director of a variety of subsidiaries of the Company, including Health and Happiness (H&H) China Limited, Biostime (Guangzhou) Health Products Limited, Health and Happiness (H&H) Hong Kong Limited. Mr. Luo has over 20 years of experience in the biotechnology industry and received a bachelor's degree in microbiological engineering and a master's degree in industrial fermentation from South China University of Technology. Mr. Luo has also completed the China Europe International Business School EMBA program. |
| **Camillo Pane** | Chief Executive Officer (effective 1 Sep 2023) | Mr. Pane was the CEO and a member of the board of directors of Coty from 2016 to 2018. Before joining Coty, he was the Senior Vice President and Global Category Officer Consumer Health at Reckitt Benckiser, where he spent almost 20 years across Global and Regional operational roles. He has been a member of board of directors of Passione Beauty Srl since 2022. He has also been a senior advisor to private equity funds, such as Blackstone, Advent International, Apollo and Permira, where he worked as a lead advisor on several global projects in the Wellness and Beauty Space. Mr. Pane graduated from the University of Bocconi in Milan with a degree in business administration. |
| **Wang Yidong** | Executive Director CFO | Mr. Wang is the CFO, he has over 20 years of experience in financial management, accounting and corporate finance. Prior to joining the Group, he was the Corporate Vice President and Asia Pacific CFO of Henkel AG & Co. KGaA, a German consumer goods giant. Mr. Wang holds a MBA degree from New York University Stern School of Business. He is a member of AICPA and a fellow member of the ACCA. He is also a member of ACCA China Expert Forum. |
| **Laetitia Albertini (An Yuting)** | Non-executive Director | Previously she was the executive Director, CEO, and the General Manager of Group strategy and international business department of H&H. She was also a director of a variety of subsidiaries of the Company, including Health and Happiness China, Biostime Health, Health and Happiness Hong Kong. She obtained a master's degree in business administration and corporate strategy from Institute of Political Studies in Paris. |
| **Zhang Wenhui** | Non-executive Director | Dr. Zhang was previously an Executive Director of the Company. Dr. Zhang has over 20 years of experience in the biotechnology industry. Dr. Zhang joined the Group in 2005 as the chief technology officer of Health and Happiness China and became a general manager of the technology center of Biostime Health. |
| **Luo Yun** | Non-executive Director | Mr. Luo is also a director of the Company's substantial shareholder Biostime Pharmaceuticals. Mr. Luo held various positions in Health and Happiness China, and was the general manager and director of Biostime Health and Nutrition (Guangzhou) Limited, where he was responsible for the overall strategies and business development. Mr. Luo was awarded an EMBA degree at Fudan University in Shanghai. |
| **Akash Bedi** | Acting Chief Executive Officer | Mr. Bedi was the Chief Strategy and Operations Officer of the Company. Prior to joining the Company, Akash held the position of Director, Global Consumer & Retail at HSBC for over 10 years. Akash obtained a Bachelor degree of Engineering from Manipal Institute of Technology and an MBA degree from the Cardiff Business School. |
| **Hanno Cappon** | Chief Technology Officer | Dr. Cappon has over 25 years experience in Nutrition and Health innovation industry, and now responsible for H&H's Technology, Quality and Regulatory, R&D Strategies etc. Prior to joining the Group, Dr. Cappon was Vice President R&D, Nutritionals and Digestive Health in Bayer Consumer Health. He obtained a Master's degree as Engineer in Chemical Technology from Technical University Delft, and his Ph.D. in Bio-Organic Chemistry from Leiden University. |
| **Zhang Qizhang** | Chief People Officer | Mr. Zhang was appointed as the Director of Integrated Marketing Centre and the General Manager of new business development in H&H. Prior joining the company, he was the brand manager at Marketing Department of Procter & Gamble in China. Mr. Zhang obtained his bachelor's degree in public management in Renmin University of China. |
| **Li Fengting** | Chief Executive Officer for China | Ms. Li was as ANC China sales and marketing general manager in H&H. She had over 10 years of experience in fast-moving consumer goods sales, marketing and omni-channel management. Prior to joining the Group, she worked for P&G in China and Singapore. Ms. Li graduated from Zhejiang University and obtained the bachelor's degree in Industrial Design. |
| **Nicholas Russell Lamande Mann** | Chief Executive Officer for Asia, Australia and New Zealand | He was the sales director and managing director for Australia and New Zealand. Prior to joining the Group, Mr. Mann had over 20 years experience across FMCG, Technology and Beverage Alcohol industries. Mr. Mann obtained a Bachelor of Science Degree from The University of Melbourne. |
| **Michael Jean-Pierre J. M. Rondas** | Chief Executive Officer for Europe | Mr. Rondas had taken a great deal of experience in senior marketing and general management roles across FMCG, Health and Wellness companies. Mr. Rondas is a Belgian national, speaks 4 languages and obtained a Marketing Bachelor's Degree from The BMS in Ghent 1996. |
| **Rafi Kalachian** | Chief Executive Officer for North America | Mr. Kalachian has over 25 years of experience in consumer businesses such as MARS Petcare's Nutro, CANIDAE Pet Foods, Redbarn Pet Products, and Health Extension Pet Care. Mr. Kalachian has a Bachelor of Science Degree from the University of Southern California Marshall School of Business and a Master in Business from Woodbury University. |
| **Pascale Laborde** | Chief Sustainability Officer | Mrs. Laborde is responsible for leading the marketing, communications and sustainability strategy for H&H globally across BNC, ANC and PNC business segments. Prior to joining the Group, she worked at KFC France and Unilever France. She graduated from Hautes Etudes Commerciales and obtained a master's degree in marketing. |
| **Yang Wenyun** | Senior Director of Listing Affairs and Risk Management Department | Ms. Yang has acted as the company secretary and mainly in charge of overall listed corporation affairs, risk management and internal audit. She is also the Supervisor of a variety of subsidiaries of the company. Ms. Yang is an associate member of both Hong Kong Chartered Governance Institute and Chartered Governance Institute in the United Kingdom, and holds the Chartered Governance Professional. Ms. Yang obtained a bachelor's degree in law from Sun Yat-Sen University. |

*Source: tmall.com, BOCOM Int'l*

**Figure 326: H&H Int'l (1112 HK) TP & rating**




*Source: FactSet, BOCOM Int'l estimates*

## Financial Statements

**Income statement (RMB m)**

| Y/E 31 Dec | 2021 | 2022 | 2023E | 2024E | 2025E |
|---|---|---|---|---|---|
| Revenue | 11,548 | 12,776 | 13,696 | 14,763 | 15,953 |
| COGS | (4,300) | (5,072) | (5,443) | (5,805) | (6,184) |
| **Gross profit** | **7,248** | **7,703** | **8,254** | **8,958** | **9,769** |
| SG&A | (5,668) | (5,963) | (6,382) | (6,867) | (7,407) |
| Other operating income, net | (446) | (162) | (130) | (80) | (60) |
| **Operating profit** | **1,134** | **1,578** | **1,742** | **2,011** | **2,302** |
| Net finance expenses | (285) | (526) | (636) | (567) | (442) |
| Income from JCEs and asso. | 1 | (22) | 2 | 2 | 2 |
| **Pre-tax profit** | **850** | **1,031** | **1,107** | **1,446** | **1,862** |
| Tax | (342) | (419) | (388) | (506) | (652) |
| Non-controlling interests | 0 | 0 | 0 | 0 | 0 |
| **Net profit** | **508** | **612** | **720** | **940** | **1,210** |
| Net profit for EPS calculation | 508 | 612 | 720 | 940 | 1,210 |

**Balance sheet (RMB m)**

| As of 31 Dec | 2021 | 2022 | 2023E | 2024E | 2025E |
|---|---|---|---|---|---|
| Cash & cash equiv | 2,400 | 2,304 | 2,096 | 504 | 566 |
| Acc & bills receivable | 739 | 769 | 843 | 929 | 1,026 |
| Inventories | 2,088 | 2,588 | 2,777 | 2,961 | 3,155 |
| PUD and land/lease prepayments | 281 | 179 | 192 | 207 | 224 |
| ST income receivables | 0 | 0 | 0 | 0 | 0 |
| Other current assets | 6 | 20 | 20 | 20 | 20 |
| **Total current assets** | **5,513** | **5,859** | **5,927** | **4,622** | **4,990** |
| PPE | 444 | 388 | 392 | 396 | 400 |
| Intangible assets | 5,572 | 5,639 | 5,509 | 5,381 | 5,258 |
| Investment in associates/JCE | 68 | 152 | 160 | 168 | 176 |
| Long-term income receivables | 0 | 0 | 0 | 0 | 0 |
| Other non-current assets | 8,684 | 8,924 | 8,986 | 9,052 | 9,123 |
| **Total non-current assets** | **14,768** | **15,104** | **15,047** | **14,998** | **14,957** |
| **Total assets** | **20,282** | **20,963** | **20,974** | **19,619** | **19,946** |
| Short-term loans | 3,126 | 967 | 996 | 1,026 | 1,057 |
| Trade and other payables | 3,057 | 3,540 | 3,799 | 4,051 | 4,316 |
| Other current liabilities | 639 | 627 | 639 | 670 | 703 |
| **Total current liabilities** | **6,822** | **5,135** | **5,434** | **5,748** | **6,075** |
| Long-term loans | 4,311 | 6,695 | 6,523 | 4,177 | 3,453 |
| Long-term payables | 9 | 5 | 6 | 6 | 6 |
| Other non-current liabilities | 3,255 | 2,986 | 2,510 | 2,536 | 2,424 |
| **Total non-current liabilities** | **7,575** | **9,686** | **9,039** | **6,719** | **5,883** |
| **Total liabilities** | **14,397** | **14,821** | **14,473** | **12,466** | **11,959** |
| Share capital | 6 | 6 | 6 | 6 | 6 |
| Reserves & other capital items | 5,880 | 6,136 | 6,496 | 7,147 | 7,982 |
| **Shareholders' equity** | **5,885** | **6,142** | **6,501** | **7,153** | **7,987** |
| Non-controlling interests | 0 | 0 | 0 | 0 | 0 |
| **Total equity** | **5,885** | **6,142** | **6,501** | **7,153** | **7,987** |

*Source: Company data, BOCOM Int'l estimates*

**Cash flow (RMB m)**

| Y/E 31 Dec | 2021 | 2022 | 2023E | 2024E | 2025E |
|---|---|---|---|---|---|
| Pre-tax profit | 517 | 558 | 720 | 940 | 1,210 |
| Asso./JCE income adjustment | (1) | 22 | 0 | 0 | 0 |
| Depreciation & amortisation | 305 | 311 | 261 | 257 | 253 |
| Change in working capital | 256 | (201) | 8 | (8) | (17) |
| Interest inc/exp adjustment | 278 | 523 | 636 | 567 | 442 |
| Other operating cashflow | 535 | 257 | 0 | 0 | 0 |
| **Cash flow from operation** | **1,890** | **1,469** | **1,625** | **1,756** | **1,888** |
| Capex | (107) | (96) | (114) | (114) | (113) |
| Investment | 0 | 0 | 0 | 0 | 0 |
| Other investing cashflow | (3,904) | (9) | (52) | (54) | (56) |
| **Cash flow from investing** | **(4,011)** | **(105)** | **(166)** | **(168)** | **(169)** |
| Net chg in interest-bearing debt | 3,514 | (384) | (664) | (2,316) | (831) |
| Net change in equity | 12 | (57) | 0 | 0 | 0 |
| Dividends paid | (408) | (234) | (360) | (288) | (376) |
| Other financing cashflow | (350) | (816) | (643) | (575) | (450) |
| **Cash flow from financing** | **2,768** | **(1,490)** | **(1,667)** | **(3,179)** | **(1,657)** |
| Exchange gain/loss | (79) | 29 | 0 | 0 | 0 |
| **Cash & cash equiv. at year start** | **1,831** | **2,400** | **2,304** | **2,096** | **504** |
| **Cash & cash equiv. at year end** | **2,400** | **2,304** | **2,096** | **504** | **566** |

**Financial ratio**

| Y/E 31 Dec | 2021 | 2022 | 2023E | 2024E | 2025E |
|---|---|---|---|---|---|
| **Per share data (RMB)** | | | | | |
| Core EPS | 0.789 | 0.956 | 1.124 | 1.468 | 1.891 |
| Fully-diluted EPS | 0.789 | 0.956 | 1.124 | 1.468 | 1.891 |
| Non-GAAP EPS | 0.000 | 0.000 | 0.000 | 0.000 | 0.000 |
| DPS | 0.448 | 0.541 | 0.450 | 0.587 | 0.756 |
| BVPS | 9.128 | 9.596 | 10.157 | 11.176 | 12.480 |
| **Margin analysis (%)** | | | | | |
| Gross margin | 62.8 | 60.3 | 60.3 | 60.7 | 61.2 |
| EBITDA margin | 12.5 | 14.8 | 14.6 | 15.4 | 16.0 |
| EBIT margin | 9.8 | 12.4 | 12.7 | 13.6 | 14.4 |
| Net margin | 4.4 | 4.8 | 5.3 | 6.4 | 7.6 |
| **Profitability analysis (%)** | | | | | |
| ROA | 2.7 | 3.0 | 3.4 | 4.6 | 6.1 |
| ROE | 8.4 | 10.2 | 11.4 | 13.8 | 16.0 |
| ROIC | 9.8 | 3.9 | 4.6 | 5.4 | 7.1 |
| **Others** | | | | | |
| Net debt to equity ratio (%) | 85.6 | 87.3 | 83.4 | 65.7 | 49.4 |
| EBITDA/gross interest expenses (x) | 5.0 | 3.6 | 3.1 | 4.0 | 5.8 |
| Current ratio (x) | 0.8 | 1.1 | 1.1 | 0.8 | 0.8 |
| Inventory turnover (days) | 74.8 | 96.5 | 96.5 | 96.5 | 96.5 |
| Acc receivable turnover (days) | 177.2 | 186.2 | 186.2 | 186.2 | 186.2 |
| Acc payable turnover (days) | 125.8 | 111.7 | 112.2 | 112.7 | 113.2 |

BOCOM Int'l Research

**Initiation of Coverage**

| Consumer | Last Close | Target Price | Upside |
|---|---|---|---|
| | RMB 22.21 | RMB 19.20 | -13.6% |

9 August 2023

# Shanghai Milkground Food Tech (600882 CH)

## Bright long-term prospects, but waiting for inflection; Initiate at Neutral

- **Milkground has been the champion in an emerging cheese category with bright long-term prospects…** Cheese has been the fastest-growing category within China's RMB686bn dairy industry (2022), posting 22.6% CAGR over the past five years (2017-22), well above the overall CAGR of 3.9%. Milkground ("MG") has ridden the wave with its share in China cheese market increased from 3.6% in 2018 to 30.0% in 2022, overtaking international peers like Milkana, and third place Yili. Mengniu became MG's controlling shareholder with a 35% stake since Dec'22, which should propel MG to new heights by leveraging on Mengniu's supply chain and distribution.
- **…but caught in a cyclical downturn now:** MG's sales momentum has weakened since 4Q22 and remained in decline in 1H23, given an overall lackluster consumption sentiment. The "snack-like" discretionary nature of MG's flagship cheese sticks (c.50% of 2022 sales) makes it vulnerable to price-sensitive consumers, and margins also face downside as promotions increase. MG is actively responding by launching new products (e.g. Cup Cheese) and smaller packages with lower price tags of RMB3-4 (vs. RMB20 usually), and expects sales to recover in 2H23.
- **Expansion into restaurants (B2B) and at-home channels could diversify away from cheese sticks and pave way for healthy longer-term growth:** In order to diversify from cheese sticks, MG is actively growing new channels, e.g. selling to 400+ enterprise customers by the end of 2022, including restaurants like Saizeriya and tea drink cafes like Nayuki. It is also grooming the in-home channel, which requires active campaigning to broaden cheese's usage scenario (e.g. putting cheese in noodle and porridge, with varied response from consumers). MG is also investing in room-temperature cheese sticks (c.25% of sales) to penetrate into lower-tier cities.
- **Face tougher base, earnings downside:** MG gained market share in 2022 on the back of international players' difficulty in supplying the Chinese market. However, with reopening, MG could face more competition and a high base. We see downside earnings risk to consensus, which expects 28%/86% sales/net profit growth in 2023.
- **Initiate with Neutral rating:** We expect MG's sales/net profit to grow by 20%/44% CAGR over 2023-25E. Our 2023-25E EPS are well below consensus on lower sales and margins, but we believe consensus downgrade is in the cards following MG's 1H23 profit pre-announcement. Our TP of RMB19.2 is based on 44.0x 2024E P/E, derived from 1.0x PEG on our 3-year EPS CAGR of 44.0% (2023-25E).

### Financial highlights

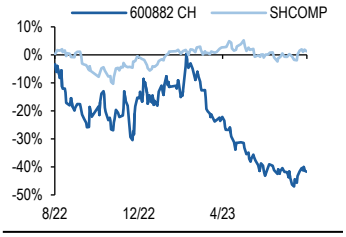
| Y/E 31 Dec | 2021 | 2022 | 2023E | 2024E | 2025E |
|---|---|---|---|---|---|
| Revenue (RMB m) | 4,478 | 4,830 | 5,158 | 6,521 | 8,449 |
| YoY growth (%) | 57.3 | 7.8 | 6.8 | 26.4 | 29.6 |
| Net profit (RMB m) | 154 | 135 | 115 | 226 | 404 |
| EPS (RMB) | 0.30 | 0.26 | 0.22 | 0.44 | 0.78 |
| YoY growth (%) | 106.6 | -12.3 | -15.0 | 96.4 | 78.8 |
| P/E (x) | 74.2 | 84.7 | 99.6 | 50.7 | 28.4 |
| BVPS (RMB) | 8.74 | 8.62 | 8.84 | 9.28 | 10.06 |
| P/B (x) | 2.54 | 2.58 | 2.51 | 2.39 | 2.21 |
| Dividend yield (%) | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |

*Source: Company data, BOCOM Int'l estimates*

**Stock Rating**

**NEUTRAL**

### 1-year stock performance




*Source: FactSet*

### Stock data

| | |
|---|---|
| 52w high (RMB) | 38.23 |
| 52w low (RMB) | 20.20 |
| Market cap (RMB m) | 9,079.23 |
| Avg daily vol (m) | 3.20 |
| YTD change (%) | (30.24) |
| 200d MA (RMB) | 27.22 |

*Source: FactSet*


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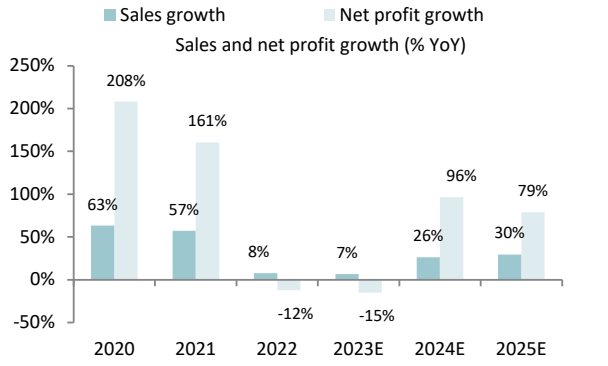


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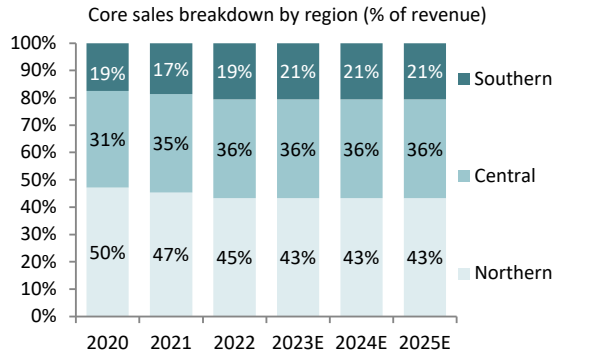
## Company at a Glance

### Figure 327: Milkground: Sales and net profit growth



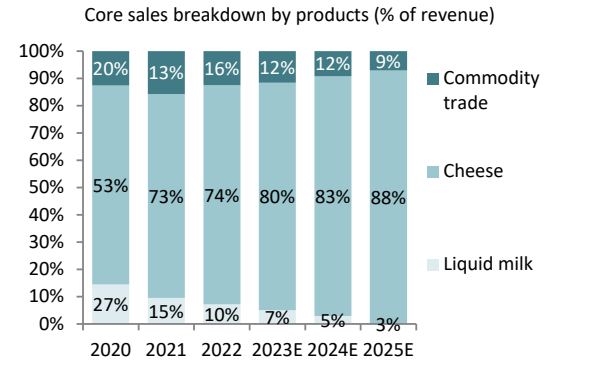

*Source: Company data, BOCOM Int'l estimates*

### Figure 328: Milkground: Sales breakdown by region



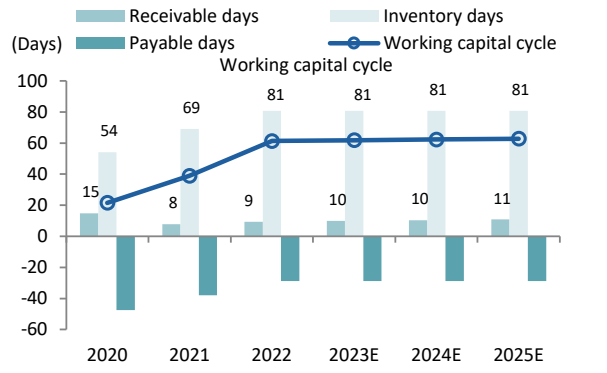

*Source: Company data, BOCOM Int'l estimates*

### Figure 329: Milkground: Sales breakdown by product



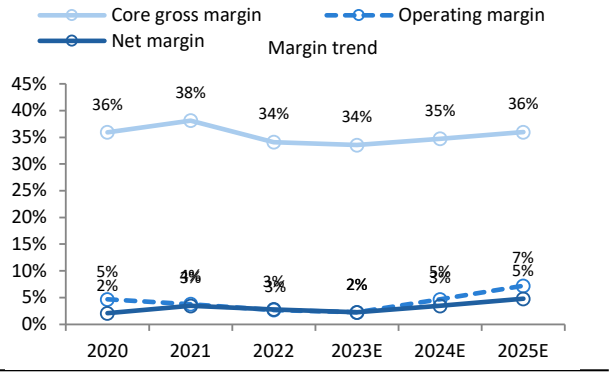

*Source: Company data, BOCOM Int'l estimates*

### Figure 330: Milkground: Working capital



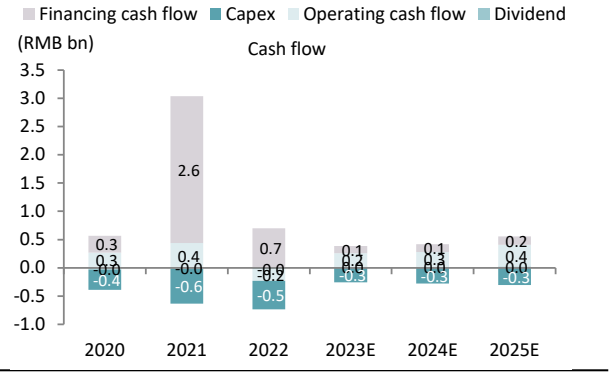

*Source: Company data, BOCOM Int'l estimates*

### Figure 331: Milkground: Overall margin trends




*Source: Company data, BOCOM Int'l estimates*

### Figure 332: Milkground: Cash flow




*Source: Company data, BOCOM Int'l estimates*

# Valuation

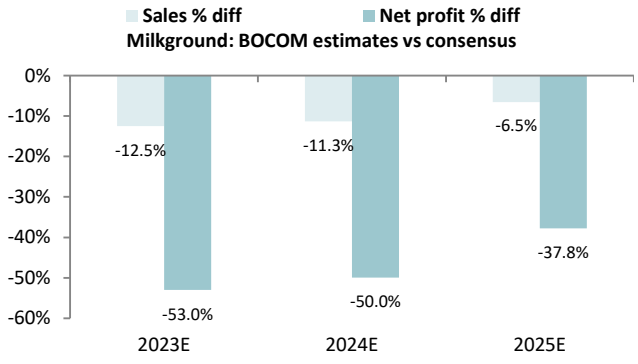
## Initiate with Neutral and TP of RMB19.2 (13.6% downside)

We initiate coverage on Milkground with a **Neutral** rating and a TP of RMB19.2, based on 44.0x P/E on our 2024E EPS. Our target P/E multiple is derived from 1.0x PEG to our EPS CAGR (2023-25E) of 44.0%. We find this PEG reasonable relative to China dairy peers and is consistent with what we use for Milkground's major shareholder Mengniu, as well as its rival Yili.

**Upside risks:** (1) Faster-than-expected demand recovery for cheese sticks; (2) better-than-expected growth from its B2B sales to restaurants/cafes and in-home channel expansion; (3) benign competition leading to continued share gain for Milkground; (4) stronger-than-expected operational improvement from partnership with Mengniu.

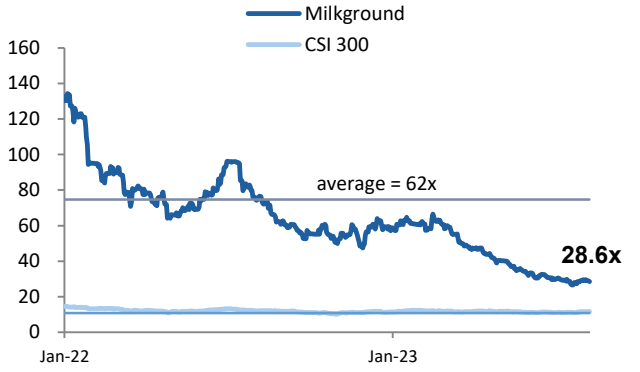
**Downside risks:** (1) Weaker-than-expected demand; (2) higher-than-expected raw material cost increase leading to GPM pressure; (3) fierce competition leading to irrational price competition and GPM pressure; (4) food safety issues.

**Figure 333: Milkground: BOCOM vs. consensus**




*Source: Bloomberg consensus, BOCOM Int'l estimates*

**Figure 334: Milkground: forward P/E**

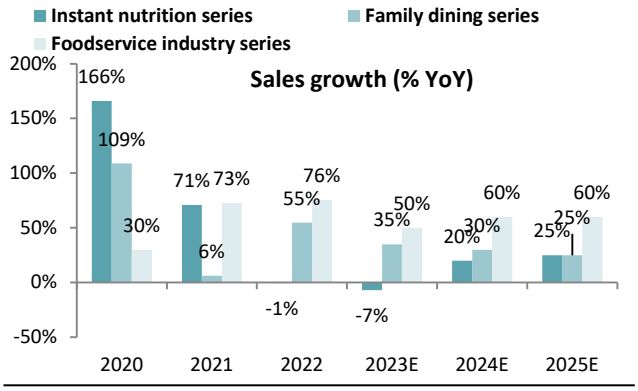



*Source: Bloomberg consensus, BOCOM Int'l*

## Financial Forecast: Tougher Base, Earnings Downside in 2023

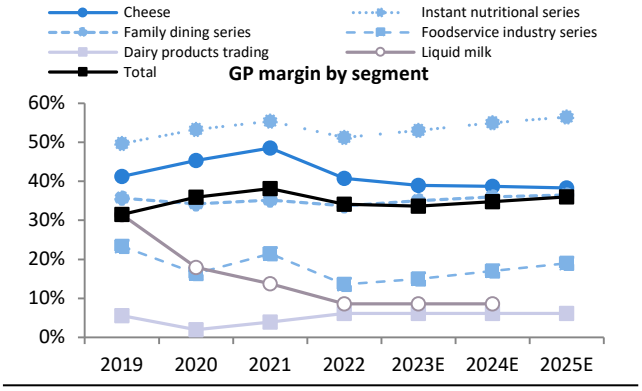
**2023 full year outlook:** While management does not provide quantitative guidance, it expects the overall sales trend to show a "V-shaped" recovery, with 2H22 and 1H23 being the trough, and 2H23 to be similar or better than 1H22 in terms of absolute sales level. Margin-wise, gross margin is expected to have tailwind from falling raw material costs, while potential RMB appreciation since mid-2023 will also benefit GPM. Net margin will likely remain at 2-3% level in 2023 (vs. 2.8% in 2022), but it will still be a tough task given 1H23 net margin was only at 0.5% (as implied by the mid-point of its 1H23 profit alert).

**Figure 335: Revenue growth by cheese product series**




*Source: Company data, BOCOM Int'l estimates*

**Figure 336: Gross margin by business segment and cheese product series**




*Source: Company data, BOCOM Int'l estimates*

**Cheese segment:** We expect weak growth for **instant nutritional series** in 2023 (-7% YoY) due to a weak spending environment that affects demand for snack-like cheese sticks. We expect chilled products within the series to see double-digit decline, while room-temperature products to see better growth.

We expect China's reopening to benefit **foodservice industry series**, which will likely be the best performing series within the cheese segment. Sales grew 76% YoY last year and we expect continued strong growth of 60% CAGR. Milkground has 400+ business customers by the end of 2022, including famous restaurants chains like Saizeriya and Nayuki, up from 300+ customers in 2021.

As consumers go back out to dine-in at restaurants, they will likely spend less time at home, which means the **family dining series** will likely be anti-cyclical to the foodservice industry. However, it is still growing off a low base, and we expect consumers' increasing adoption of cheese into their daily diet will underpin the long-term growth of this segment. Milkground is doing a lot of marketing to educate customers on the usage scenario for cheese, e.g. putting one piece of cheese in their noodle or porridge at home.

**The other two segments** are **dairy products trading**, which will not be an area of emphasis and will likely show limited growth going forward, and **liquid milk**, which will be terminated in the next two years after Mengniu's acquisition.

**Figure 337: Milkground: Sales assumptions**

| Sales breakdown | 2019 | 2020 | 2021 | 2022 | 2023E | 2024E | 2025E |
|---|---|---|---|---|---|---|---|
| **Revenue (main business) (RMB m)** | | | | | | | |
| Cheese | 921 | 2,074 | 3,335 | 3,869 | 4,297 | 5,725 | 7,849 |
| Instant nutritional series | 554 | 1,472 | 2,513 | 2,500 | 2,325 | 2,790 | 3,487 |
| Family dining series | 158 | 331 | 351 | 544 | 734 | 954 | 1,193 |
| Foodservice industry series | 209 | 272 | 470 | 825 | 1,238 | 1,980 | 3,169 |
| Dairy products trading | 343 | 357 | 704 | 600 | 600 | 600 | 600 |
| Liquid milk | 477 | 413 | 430 | 349 | 262 | 196 | 0 |
| **Total** | **1,744** | **2,847** | **4,478** | **4,830** | **5,158** | **6,521** | **8,449** |
| **Growth (% YoY)** | | | | | | | |
| Cheese | 102% | 125% | 61% | 16% | 11% | 33% | 37% |
| Instant nutritional series | | 166% | 71% | -1% | -7% | 20% | 25% |
| Family dining series | | 109% | 6% | 55% | 35% | 30% | 25% |
| Foodservice industry series | | 30% | 73% | 76% | 50% | 60% | 60% |
| Dairy products trading | 15% | 4% | 97% | -15% | 0% | 0% | 0% |
| Liquid milk | 2% | -13% | 4% | -19% | -25% | -25% | -100% |
| **Total** | **42%** | **63%** | **57%** | **8%** | **7%** | **26%** | **30%** |
| **Sales mix (% of total)** | | | | | | | |
| Cheese | 53% | 73% | 75% | 80% | 83% | 88% | 93% |
| Instant nutritional series | 32% | 52% | 56% | 52% | 45% | 43% | 41% |
| Family dining series | 9% | 12% | 8% | 11% | 14% | 15% | 14% |
| Foodservice industry series | 12% | 10% | 11% | 17% | 24% | 30% | 38% |
| Dairy products trading | 20% | 13% | 16% | 12% | 12% | 9% | 7% |
| Liquid milk | 27% | 15% | 10% | 7% | 5% | 3% | 0% |
| **Total** | **100%** | **100%** | **100%** | **100%** | **100%** | **100%** | **100%** |

*Source: Company data, BOCOM Int'l estimates*

### Figure 338: Milkground: Gross profit margin assumptions

| Sales breakdown | 2019 | 2020 | 2021 | 2022 | 2023E | 2024E | 2025E |
|---|---|---|---|---|---|---|---|
| **Gross profit (RMB m)** | | | | | | | |
| Cheese | 380 | 941 | 1,618 | 1,576 | 1,675 | 2,215 | 3,008 |
| Instant nutritional series | 275 | 784 | 1,393 | 1,281 | 1,232 | 1,534 | 1,970 |
| Family dining series | 56 | 113 | 124 | 183 | 257 | 344 | 435 |
| Foodservice industry series | 49 | 44 | 101 | 112 | 186 | 337 | 602 |
| Dairy products trading | 19 | 7 | 27 | 37 | 37 | 37 | 37 |
| Liquid milk | 150 | 74 | 59 | 30 | 23 | 17 | - |
| **Core gross profit** | **549** | **1,022** | **1,704** | **1,642** | **1,734** | **2,268** | **3,044** |
| **Total gross profit** | **550** | **1,022** | **1,711** | **1,649** | **1,734** | **2,268** | **3,044** |
| **Gross margin (%)** | | | | | | | |
| Cheese | 41.3% | 45.4% | 48.5% | 40.7% | 39.0% | 38.7% | 38.3% |
| Instant nutritional series | 49.7% | 53.3% | 55.4% | 51.2% | 53.0% | 55.0% | 56.5% |
| Family dining series | 35.7% | 34.2% | 35.2% | 33.7% | 35.0% | 36.0% | 36.5% |
| Foodservice industry series | 23.3% | 16.3% | 21.4% | 13.6% | 15.0% | 17.0% | 19.0% |
| Dairy products trading | 5.6% | 2.0% | 3.9% | 6.1% | 6.1% | 6.1% | 6.1% |
| Liquid milk | 31.4% | 17.9% | 13.7% | 8.6% | 8.6% | 8.6% | - |
| **Core GPM** | **31.5%** | **35.9%** | **38.1%** | **34.1%** | **33.6%** | **34.8%** | **36.0%** |
| **Total GPM** | **31.6%** | **35.9%** | **38.2%** | **34.2%** | **33.6%** | **34.8%** | **36.0%** |
| **Gross profit mix (% of total)** | | | | | | | |
| Cheese | 69% | 92% | 95% | 96% | 97% | 98% | 99% |
| Instant nutritional series | 50% | 77% | 82% | 78% | 71% | 68% | 65% |
| Family dining series | 10% | 11% | 7% | 11% | 15% | 15% | 14% |
| Foodservice industry series | 9% | 4% | 6% | 7% | 11% | 15% | 20% |
| Dairy products trading | 3% | 1% | 2% | 2% | 2% | 2% | 1% |
| Liquid milk | 27% | 7% | 3% | 2% | 1% | 1% | 0% |
| Total | 100% | 100% | 100% | 100% | 100% | 100% | 100% |

*Source: Company data, BOCOM Int'l estimates*

## 2Q23 Business Update: Sluggish Sales and Profit as Consumer and Channel Factors Weigh

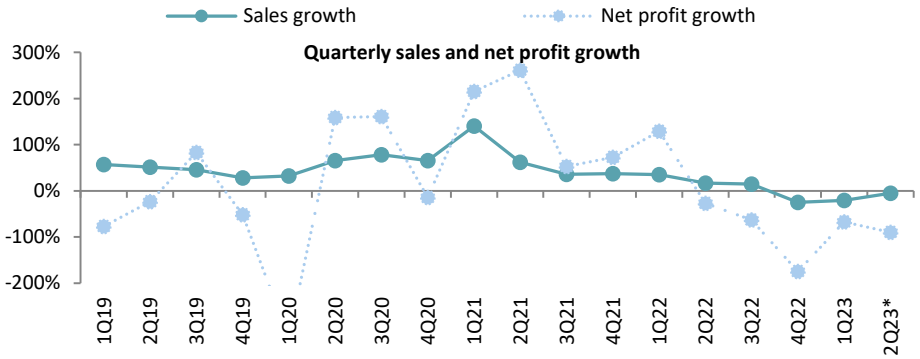
**2Q23 extended weakness from 4Q22/1Q23:** 4Q22 was affected by market-wide weakness (sales fell 25% YoY), while 1Q23 sales was also weak (down 20% YoY) as consumers' spending power recovery was slow. Milkground issued a 1H23 profit pre-announcement on 15 July, where it reported that 2Q23 sales saw sequential improvement from 1Q but remained in YoY decline (we estimate around -5% YoY), narrowing from the 20% decline recorded in 1Q23. It also expects 1H23 net profit attributable to shareholders of RMB26-34m (down 74-80% YoY). 2Q23 gross margin fell YoY mainly due to RMB depreciation which caused the costs of foreign-sourced raw material to rise (e.g. cheddar from Australia and New Zealand). Net margin fell to 0.5% (as implied by the mid-point of MG's 1H23 profit alert), vs. 2.4% in 1Q23, 4.5% in 2Q22.

**Recovery of consumer sentiment is gradual:** Consumer sentiment is recovering but the pace is slow, which bodes ill for the consumption of snack-like cheese sticks that carries a relatively high ticket price. A packet containing five cheese sticks retails for RMB22.80, while a packet of five-pieces of cheese retails for RMB15.9. To improve sales, MG has relied on smaller packages, room-temperature cheese sticks with lower prices, e.g. RMB3.5-4.0 for single-piece cheese stick, to cater to price-sensitive consumers.

**KA channel showing particular weakness, key for 2H23 recovery:** The main sales weakness in 2Q was in the Key Accounts ("KA") channel (i.e. supermarkets), while other channels like convenience stores remained healthy. MG's chilled cheese sticks, which account for two thirds of instant nutrition series' sales and are sold mainly through the KA channel, has been particularly weak (>10% decline in 1H23), while room-temperature cheese sticks (the remaining one third) are selling better with >10% YoY growth in 1H23.

**Management changes, July back to YoY growth:** In early June, MG made some changes to its management responsible for retail sales, hiring a former senior executive from a food and beverage market leader who brought in expertise regarding distributor management and direct sales to KA, as well as how to save costs and prevent price arbitrage. As a result of operational changes made, sales have started to show positive change and is back to positive YoY growth in July after some temporary disruption in June.

**Figure 339: Milkground: Quarterly sales and net profit growth**

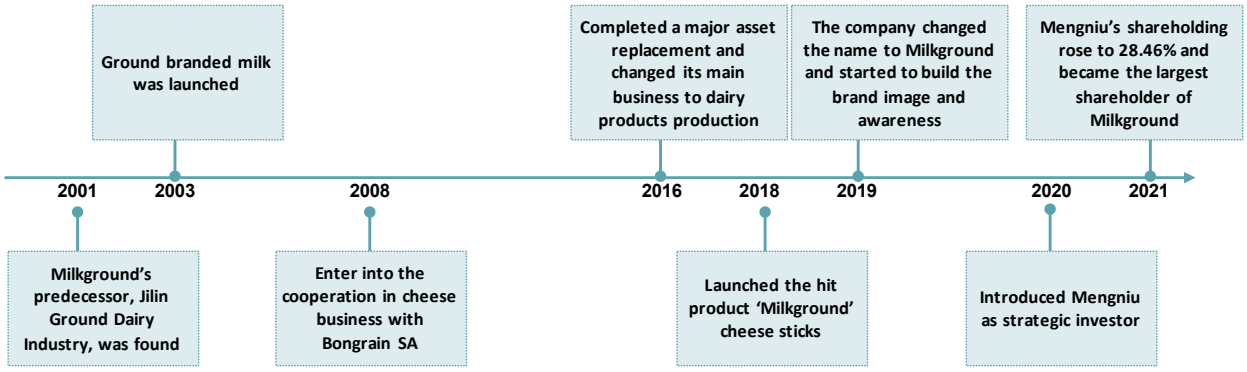



*Source: Company data, BOCOM Int'l * 2Q23 data is implied by the mid-point of MG's 1H23 profit pre-announcement*

## Company Overview

Milkground commands a leading position in China's cheese market. Milkground entered the cheese market in 2016 through an acquisition and then entered a fast growth phase since 2018 via the hit product 'Milkground' cheese sticks. It surpassed Milkana in market share in 2021 and leapt to the 1st place in the industry.

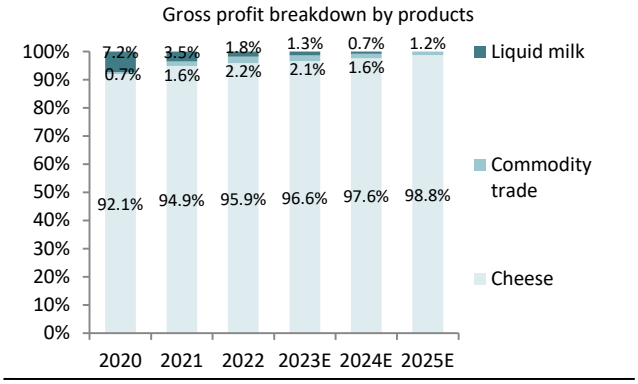
**Figure 340: Milkground's development history**




*Source: Company data, BOCOM Int'l*

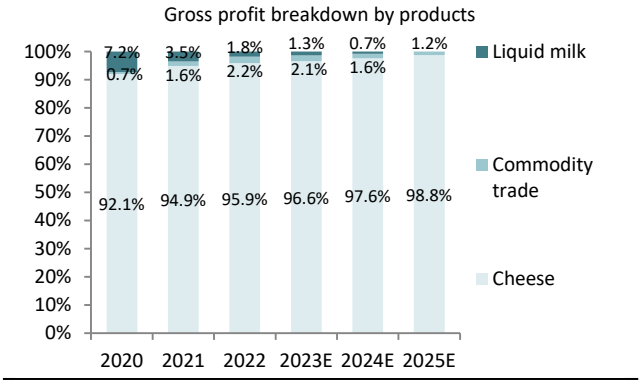
**Cheese is the core business, with continuous product-mix enrichment.** Milkground's business mainly includes cheese, commodity trade, and liquid milk. Cheese segment, accounting for 80.3%/95.9% of the Group's revenue/gross profit in 2022, is the core business of Milkground and is divided into three categories: **instant nutrition series, family consumption series,** and **foodservice industry series.** The main product of instant nutrition series is the cheese stick. After several rounds of R&D, Milkground has formed a comprehensive cheese stick product series, such as room temperature, chilled and zero-additive. In the family consumption series, Milkground has a variety of products such as cheese slices, butter, baked cheese to meet various needs.

**Figure 341: Revenue contribution: by segment**




*Source: Company data, BOCOM Int'l estimates*

**Figure 342: Gross profit contribution: by segment**




*Source: Company data, BOCOM Int'l estimates*

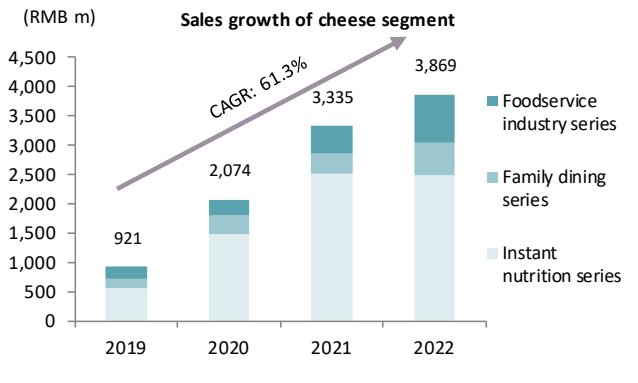
**Figure 343: Milkground's main products**




*Source: Company data, BOCOM Int'l*

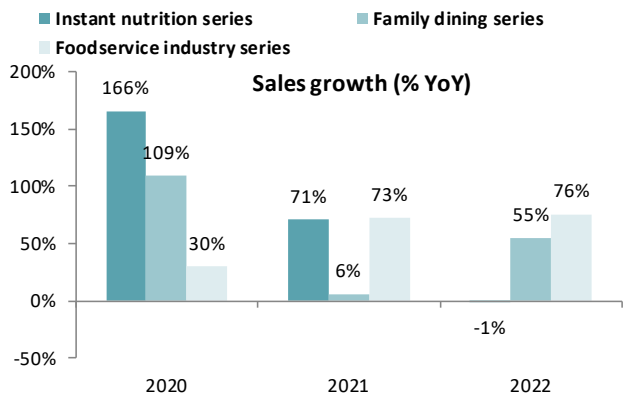
**Cheese is they key segment (80% of 2022 sales):** Milkground has achieved rapid growth over the past few years, with revenue growing from RMB512m in 2016 to RMB4,830m in 2022, representing a 6-year CAGR of 46%. Cheese segment contributed the major revenue increment (80% of total), growing from RMB921m in 2019 to RMB3,869m in 2022, with a CAGR of over 60% during the period. Cheese segment is divided into three series: **(1) Instant nutrition series** and **(2) family dining series** have shown doubling growth during 2020, followed by a slowdown in 2021 and 2022, while the **(3) foodservice industry series** showed accelerated growth momentum with over 70% YoY growth in the past two years.

**Figure 344: Revenue contribution: by segment**




*Source: Company data, BOCOM Int'l*

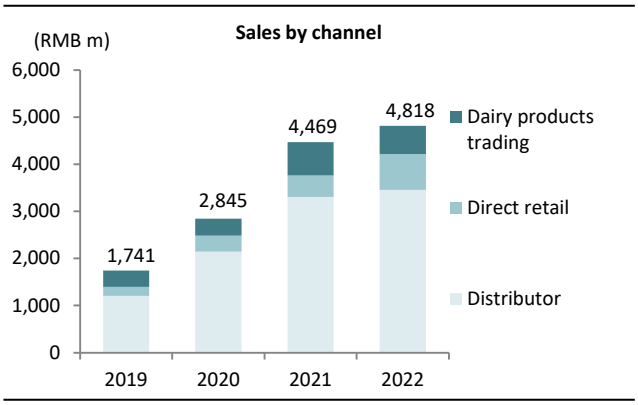
**Figure 345: YoY growth rate comparison**




*Source: Company data, BOCOM Int'l*

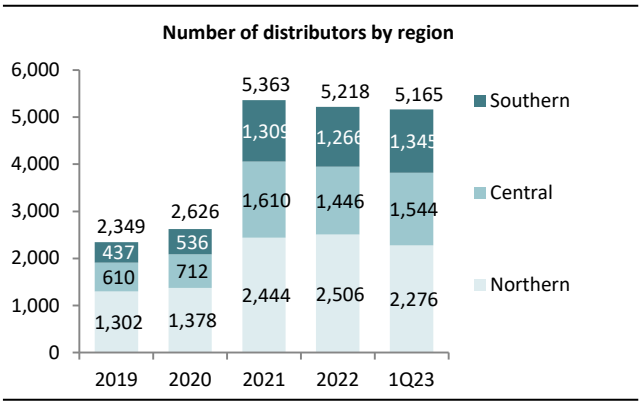
**Channel:** The majority of Milkground's sales is made via distributors (72% of 2022 sales), followed by 16% of sales via direct retail, and the remaining 12% of sales is dairy products trading. MG has 5,165 distributors as of 1Q23, with a regional mix of 44%/30%/26% in Northern/Central/Southern China respectively, which matches quite evenly with MG's sales mix by region of 43%/33%/23% for these three regions. On average, MG makes annual sales of roughly RMB0.9m to each distributor (highest in Central China at around RMB1.2m sales per distributor, followed by RMB0.8m in Northern China and Southern China respectively).

**Figure 346: Milkground: Core sales mix by channel**




*Source: Company data, BOCOM int'l*

**Figure 347: Milkground: No. of distributor by region in China**




*Source: Company data, BOCOM int'l*

**Figure 348: Milkground's sales to key accounts are categorized under sales to distributor. Below is a cheese section at a Yonghui supermarket in China**



*Source: BOCOM int'l*

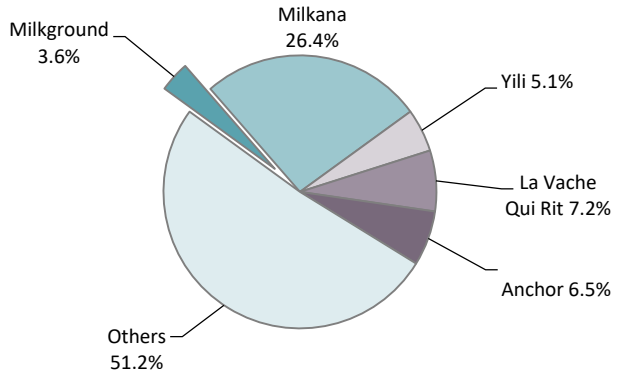
**Figure 349: Milkground's foodservice industry series sales, where it directly sells (B2B) cheese and butter to catering and tea drinks businesses, is categorized under direct retail channel**




*Source: BOCOM int'l*

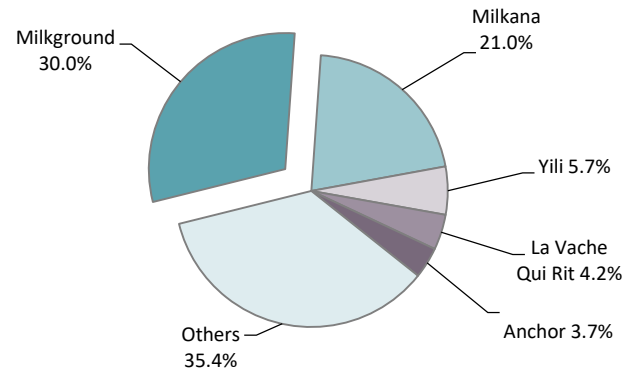
**Competition is fierce:** A typical cheese counter at a grocery store in China offers many choices of cheese. Therefore packaging, advertised nutritional benefits, pricing and product quality all play into consumers' purchasing decisions. For example, Milkground uses popular children cartoon characters from Paw Patrol on its packaging, Yili uses Argentina soccer team and Disney movie Frozen, and Milkana uses Japanese cartoon Doraemon, making a tough decision for children who want to purchase a cheese stick as snacks.

**Figure 350: China cheese market share (2018)**




*Source: Euromonitor, BOCOM Int'l*

**Figure 351: China cheese market share (2022)**




*Source: Euromonitor, BOCOM Int'l*

**Figure 352: Product offering by segment – Cheese**

| Company 公司 Ticker 股票代号 | Mengniu 蒙牛 2319 HK | | Milkground 妙可蓝多 600882 CH | | | Maofei 妙飞 |
|---|---|---|---|---|---|---|
| Product series 产品系列 | High calcium 蒙牛高钙奶酪棒 | Kids cheese stick 爱氏晨曦儿童奶酪棒 | Cheese stick 妙可蓝多奶酪棒 | High calcium 钙多多常温奶酪棒 | PAW Patrol 汪汪队常温奶酪棒 | Cheese stick 妙飞奶酪棒 |
| |  |  |  |  |  |  |
| Price/ 20g (Rmb) | 2.5 | 2.5 | 2.3 | 5.6 | 7.7 | 3.0 |
| Company 公司 Ticker 股票代号 | Bright dairy 光明 600597 CH | Mlkana 百吉福 | Yili 伊利 600887 CH | | | Dr. Cheese 奶酪博士 |
| Product series 产品系列 | Jcan 健能高钙奶酪棒 | Bangbang 棒棒奶酪 | Kids cheese stick 伊利儿童奶酪棒 | | Suckable cheese 可以吸的奶酪 | Golden stick 金装棒棒 |
| |  |  |  | |  |  |
| Price/ 20g (Rmb) | 2.5 | 2.9 | 2.6 | | 1.6 | 4.4 |

*Source: tmall.com, BOCOM Int'l*

**New product launches to broaden consumption scenario and target customers:** On 26 April 2023, Milkground launched three new products that it hopes to help it diversify away from cheese sticks and broaden the appeal and target market of its products. It introduced the "Cup Cheese" as an afternoon snack targeted at ladies (our personal view is that it tastes good with a fluffy, light texture similar to cheese soufflé), an organic cheese stick, and a "Halloumi cheese" for at-home consumption.

**Figure 353: Cup cheese for afternoon snacks targeted at female consumers**




*Source: BOCOM Int'l*

**Figure 354: Halloumi cheese for at home consumption**




*Source: BOCOM Int'l*

**Figure 355: Organic cheese stick, a premiumization of Milkground's core product**




*Source: BOCOM Int'l Research*

**Figure 356: Creating new usage scenarios for its products through active consumer education is key to growth of its "family dining" cheese series**




*Source: Bilibili, BOCOM Int'l*

## Shareholders and Management

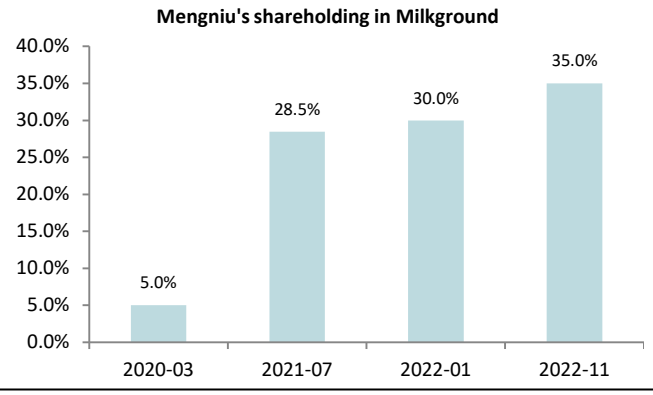
**Mengniu is the largest shareholder of Milkground**. In Jan 2020, Mengniu paid RMB287bn to acquire 5% shares of Milkground and continued to increase its stake. In July 2021, Mengniu invested RMB3bn to subscribe for approximately 101m additional shares of Milkground, and by the end of Sep 2021, Mengniu held 28.5% of shares of Milkground, becoming the largest shareholder. Mengniu continued to increase its shareholding, reaching 35.01% stake by the end of 2022.

Mengniu's relationship with Milkground will likely be similar to Mengniu's relationship with Yashili in the infant milk formula segment, which means Mengniu will be using Milkground as the main platform for Mengniu's cheese business. During Mengniu's 2022 interim results briefing, Mengniu's president mentioned that it is targeting to achieve a sales scale of RMB10bn for Milkground's cheese business by 2025 (BOCOM's sales estimate is more conservative, as we forecast only a sales of RMB7.8bn by 2025E), in order for Mengniu itself to achieve a sales scale of RMB150bn by 2025E. Milkground financials were consolidated into Mengniu's financials starting December 2022.

As part of the non-compete arrangement, Mengniu will inject its cheese, butter and related business into Milkground before the deadline of 9 July 2024 (original deadline was July 2023, which was extended), while Milkground has also agreed to terminate its liquid milk business before end 2025.

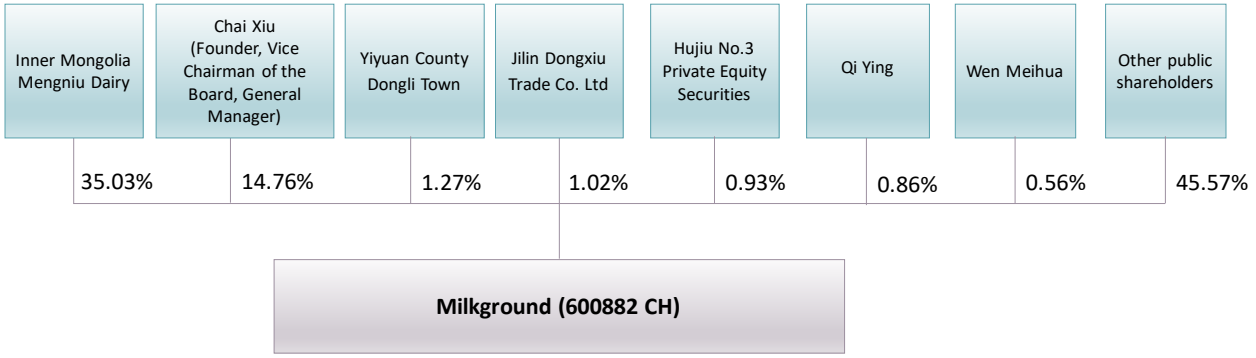
**Mengniu's value to Milkground:** What Mengniu can offer to Milkground is supply chain support including providing upstream milk source (including high-quality milk for cheddar production, thereby reducing import of cheddar from Australia and New Zealand), operational support and Mengniu's distribution network. We believe this partnership can fast track Milkground's next stage of growth, especially to lower-tier cities where Mengniu has a much more established presence.

**Figure 357: Mengniu's shareholding in Milkground has increased gradually since 2020**




*Source: Company data, BOCOM Int'l*

### Figure 358: Milkground: Shareholding structure



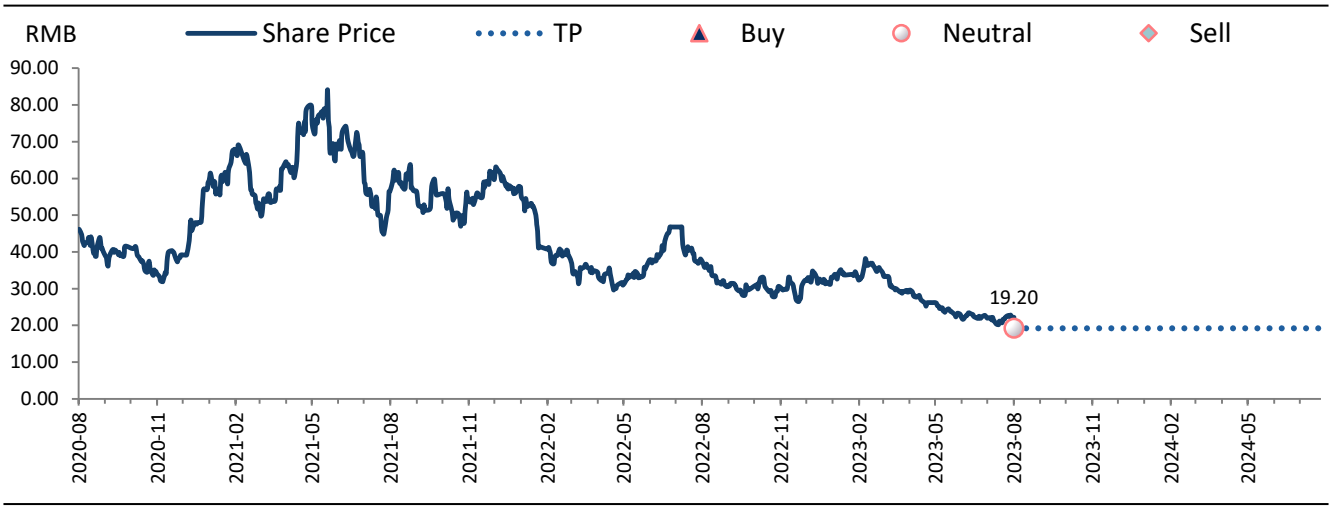

*Source: Wind, BOCOM Int'l*

### Figure 359: Milkground: Board of directors and senior management

| Name | Position | Experience |
|---|---|---|
| **Lu Minfang** | Chairman of the Board | Mr. Lu is the chairman and a non-executive director of Yashili International Holdings Ltd, a subsidiary of the Company listed in Hong Kong, and also a non-executive director and the chairman of the board of directors of China Shengmu Organic Milk Limited, an associate of the Company listed in Hong Kong, and a non-independent director and the chairman of the board of directors of Shanghai Milkground Food Tech Co., Ltd., an associate of the Company listed on the Shanghai stock exchange. Mr. Lu is a director of International Dairy Federation. He obtained his Bachelor's degree from Fudan University. |
| **Chai Xiu** | Vice Chairman of the Board, General Manager | Ms.Chai is the founder of Milkground. Currently, she is Vice Chairman and General Manager of Milkground. She was previously the president for Ground Investment Holding Group and CEO for Ground International Development. Ms.Chai received an MBA from Cheung Kong Graduate School of Business. |
| **Ren Song** | Executive General Manager, Director | Mr.Ren is Executive General Manager and Director of Milkground. He is also on the board of Changchun Lianxin Investment Consulting Co., Ltd. |
| **Zhang Ping** | Director | Zhang Ping is the Director of Milkground, and the CFO & Vice President for China Mengniu Dairy. In the past, he occupied the position of CEO of Coca-Cola Bottlers Manufacturing Holdings Ltd. He received an undergraduate degree from Shenyang University of Technology, a graduate degree from Beijing Information Science & Technology University and an MBA from Maastricht School of Management. |
| **Guo Yonglai** | Director | Guo Yonglai is Director of Milkground. He was General Manager of Ground Dairy Industry Co., Ltd. |
| **Kuai Yulong** | Chief Financial Officer, Director | Kuai Yulong is the CFO and Director of Milkground. He was the Assistant Vice President, head of strategy management and senior director of financial operations in China Mengniu Dairy. |
| **Wei Bo** | Independent director | Wei Bo is the Independent director of Milkground, and the lawyer in Shanghai Yingdong Law Firm. |
| **Jiang Hua** | Independent director | Jiang Hua is the Independent director of Milkground, partner of Kangda Law Firm. He was the partner of Zhong Yin Law Firm, and the partner of Dentons Law Firm. |
| **Wu Nan** | Independent director | Wu Nan is the Independent director of Milkground, and the director, CFO and Board Secretary of InferVision. Wu Nan was the director, Finance Officer and Board Secretary of ThunderSoft (300496 CH). |

*Source: Company data, BOCOM Int'l*

**Figure 360: Shanghai Milkground Food Tech (600882 CH) TP & rating**




*Source: FactSet, BOCOM Int'l estimates*

## Financial Statements

**Income statement (RMB m)**

| Y/E 31 Dec | 2021 | 2022 | 2023E | 2024E | 2025E |
|---|---|---|---|---|---|
| Revenue | 4,478 | 4,830 | 5,158 | 6,521 | 8,449 |
| COGS | (2,767) | (3,180) | (3,424) | (4,253) | (5,404) |
| **Gross profit** | **1,711** | **1,649** | **1,734** | **2,268** | **3,044** |
| SG&A | (1,502) | (1,463) | (1,557) | (1,885) | (2,334) |
| R&D | (40) | (51) | (55) | (69) | (90) |
| Other operating income, net | 0 | (7) | (7) | (9) | (12) |
| **Operating profit** | **169** | **129** | **115** | **304** | **608** |
| Net finance expenses | 31 | 20 | 19 | 22 | 25 |
| Other non-op. income, net | 33 | 87 | 59 | 54 | 47 |
| **Pre-tax profit** | **233** | **236** | **194** | **380** | **680** |
| Tax | (39) | (65) | (48) | (95) | (170) |
| Non-controlling interests | (39) | (36) | (30) | (59) | (106) |
| **Net profit** | **154** | **135** | **115** | **226** | **404** |
| Net profit for EPS calculation | 154 | 135 | 115 | 226 | 404 |

**Balance sheet (RMB m)**

| As of 31 Dec | 2021 | 2022 | 2023E | 2024E | 2025E |
|---|---|---|---|---|---|
| Cash & cash equiv | 2,436 | 1,358 | 1,413 | 1,511 | 1,717 |
| Marketable securities | 550 | 1,798 | 1,798 | 1,798 | 1,798 |
| Acc & bills receivable | 115 | 162 | 180 | 237 | 318 |
| Inventories | 523 | 702 | 756 | 939 | 1,194 |
| PUD and land/lease prepayments | 127 | 257 | 289 | 384 | 522 |
| ST income receivables | 0 | 0 | 0 | 0 | 0 |
| Other current assets | 132 | 102 | 107 | 113 | 118 |
| **Total current assets** | **3,884** | **4,379** | **4,544** | **4,981** | **5,667** |
| Investment properties | 0 | 0 | 0 | 0 | 0 |
| PPE | 0 | 0 | 45 | 95 | 150 |
| Other tangible assets | 1,386 | 1,608 | 1,608 | 1,608 | 1,608 |
| Intangible assets | 299 | 299 | 304 | 311 | 317 |
| Investment in associates/JCE | 227 | 229 | 229 | 229 | 229 |
| Other non-current assets | 901 | 922 | 941 | 960 | 980 |
| **Total non-current assets** | **2,813** | **3,058** | **3,127** | **3,202** | **3,284** |
| **Total assets** | **6,697** | **7,437** | **7,671** | **8,184** | **8,951** |
| Short-term loans | 350 | 1,356 | 1,465 | 1,582 | 1,708 |
| Trade and other payables | 880 | 681 | 729 | 891 | 1,116 |
| Other current liabilities | 203 | 165 | 167 | 175 | 186 |
| **Total current liabilities** | **1,433** | **2,202** | **2,361** | **2,648** | **3,011** |
| Long-term loans | 0 | 0 | 0 | 0 | 0 |
| Long-term payables | 0 | 0 | 0 | 0 | 0 |
| Other non-current liabilities | 357 | 358 | 358 | 358 | 358 |
| **Total non-current liabilities** | **357** | **358** | **358** | **358** | **358** |
| **Total liabilities** | **1,791** | **2,560** | **2,719** | **3,006** | **3,369** |
| Share capital | 516 | 516 | 516 | 516 | 516 |
| Reserves & other capital items | 3,995 | 3,930 | 4,045 | 4,271 | 4,675 |
| **Shareholders' equity** | **4,512** | **4,446** | **4,561** | **4,787** | **5,191** |
| Financial instruments classified as equity | 0 | 0 | 0 | 0 | 0 |
| Non-controlling interests | 395 | 430 | 391 | 391 | 391 |
| **Total equity** | **4,906** | **4,877** | **4,952** | **5,178** | **5,582** |

**Cash flow (RMB m)**

| Y/E 31 Dec | 2021 | 2022 | 2023E | 2024E | 2025E |
|---|---|---|---|---|---|
| Pre-tax profit | 194 | 171 | 145 | 285 | 510 |
| Depreciation & amortisation | 98 | 143 | 205 | 223 | 244 |
| Change in working capital | 2 | (532) | (22) | (69) | (100) |
| Interest inc/exp adjustment | 25 | 39 | (19) | (22) | (25) |
| Other operating cashflow | 118 | (26) | (68) | (160) | (250) |
| **Cash flow from operation** | **437** | **(205)** | **241** | **258** | **380** |
| Capex | (616) | (507) | (256) | (279) | (305) |
| Investment | (543) | (1,185) | 0 | 0 | 0 |
| Other investing cashflow | 0 | 90 | (18) | (19) | (20) |
| **Cash flow from investing** | **(1,159)** | **(1,602)** | **(274)** | **(299)** | **(325)** |
| Net chg in interest-bearing debt | (214) | 1,005 | 108 | 117 | 127 |
| Net change in equity | 3,089 | 0 | 0 | 0 | 0 |
| Dividends paid | (19) | (26) | 19 | 22 | 25 |
| Other financing cashflow | (257) | (281) | 0 | 0 | 0 |
| **Cash flow from financing** | **2,599** | **699** | **128** | **139** | **152** |
| Exchange gain/loss | (7) | 29 | (40) | 0 | 0 |
| **Cash & cash equiv. at year start** | **567** | **2,436** | **1,358** | **1,413** | **1,511** |
| **Cash & cash equiv. at year end** | **2,436** | **1,358** | **1,413** | **1,511** | **1,717** |

**Financial ratio**

| Y/E 31 Dec | 2021 | 2022 | 2023E | 2024E | 2025E |
|---|---|---|---|---|---|
| **Per share data (RMB)** | | | | | |
| Core EPS | 0.299 | 0.262 | 0.223 | 0.438 | 0.783 |
| Fully-diluted EPS | 0.299 | 0.262 | 0.223 | 0.438 | 0.783 |
| Non-GAAP EPS | 0.000 | 0.000 | 0.000 | 0.000 | 0.000 |
| DPS | 0.000 | 0.000 | 0.000 | 0.000 | 0.000 |
| BVPS | 8.740 | 8.615 | 8.838 | 9.276 | 10.059 |
| **Margin analysis (%)** | | | | | |
| Gross margin | 38.2 | 34.2 | 33.6 | 34.8 | 36.0 |
| EBITDA margin | 6.0 | 5.6 | 6.2 | 8.1 | 10.1 |
| EBIT margin | 3.8 | 2.7 | 2.2 | 4.7 | 7.2 |
| Net margin | 3.4 | 2.8 | 2.2 | 3.5 | 4.8 |
| **Profitability analysis (%)** | | | | | |
| ROA | 3.2 | 1.9 | 1.5 | 2.8 | 4.7 |
| ROE | 3.4 | 3.0 | 2.5 | 4.7 | 7.8 |
| ROIC | 2.5 | 4.0 | 2.7 | 2.2 | 4.2 |
| **Others** | | | | | |
| Net debt to equity ratio (%) | Net Cash | Net Cash | 1.0 | 1.4 | Net Cash |
| EBITDA/gross interest expenses (x) | 10.7 | 6.9 | 7.6 | 11.5 | 17.3 |
| Current ratio (x) | 2.7 | 2.0 | 1.9 | 1.9 | 1.9 |
| Inventory turnover (days) | 69.1 | 80.7 | 80.7 | 80.7 | 80.7 |
| Acc receivable turnover (days) | 7.8 | 9.3 | 9.8 | 10.3 | 10.8 |
| Acc payable turnover (days) | 37.9 | 28.8 | 28.8 | 28.8 | 28.8 |

*Source: Company data, BOCOM Int'l estimates*

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## Rating System

| Analyst Stock Rating: | Analyst Industry Views: |
|---|---|
| **Buy:** The stock's total return is expected to **exceed** that of the corresponding industry over the next 12 months.<br><br>**Neutral:** The stock's total return is expected to be **in line with** that of the corresponding industry over the next 12 months.<br><br>**Sell:** The stock's total return is expected to be **below** that of the corresponding industry over the next 12 months.<br><br>**Not-Rated:** The analyst **does not have conviction** regarding the outlook of the stock's total return relative to that of the corresponding industry over the next 12 months. | **Outperform:** The analyst expects the industry coverage universe to be **attractive** relative to the relevant broad market benchmark over the next 12 months.<br><br>**Market perform:** The analyst expects the industry coverage universe to be **in line with** the relevant broad market benchmark over the next 12 months.<br><br>**Underperform:** The analyst expects the industry coverage universe to be **unattractive** relative to the relevant broad market benchmark over the next 12 months.<br><br>Broad market benchmark for Hong Kong is the **Hang Seng Composite Index**, for China A-shares is the **MSCI China A Index**, for US-listed Chinese companies is **S&P US Listed China 50 (USD) Index.** |

## Analyst certification

The authors of this report, hereby declare that: (i) all of the views expressed in this report accurately reflect their personal views about any and all of the subject securities or issuers; and (ii) no part of any of their compensation was, is, or will be directly or indirectly related to the specific recommendations or views expressed in this report; (iii) no insider information/ non-public price-sensitive information in relation to the subject securities or issuers which may influence the recommendations were being received by the authors.

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