

Yurun Food



Not Rated

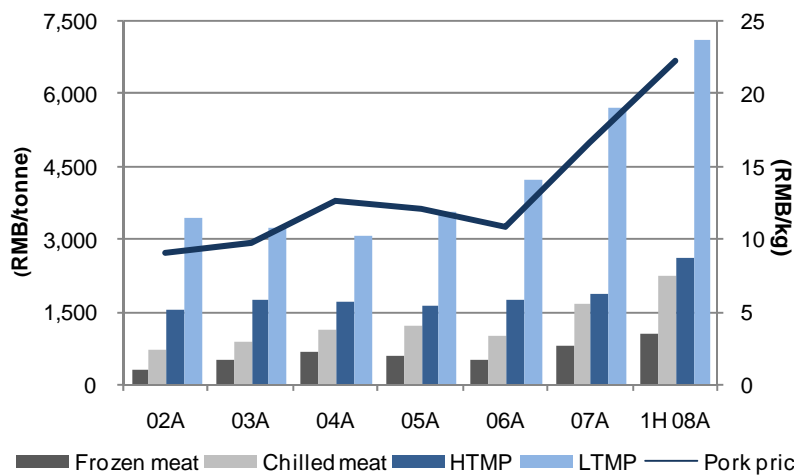
Changing engine from price to volume

Key points:

- Defensive due to China's inelastic pork demand.
- Weakening pork price to erode the dollar gross margin.
- Sales volume boosted by recovering hog supply.
- Good long-term prospects due to rising demand for quality food.
- M&A expansion model.

Profitability linked to pork price. Correlation coefficients between the pork price and dollar gross margin (i.e. gross profit per tonne) of Yurun's four product categories (chilled pork, frozen pork, low temperature meat products (LTMP) and high temperature meat products (HTMP)), were 0.986, 0.907, 0.768, 0.744, respectively, from 2002 to 2007. An apparent profit expansion was observed in FY12/07A and 1H FY12/08A (turnover: up 86.9% and 75.2%; net profit: up 78.7% and 70.9%) when the pork price in China rose considerably due to a shortage during the period caused by the unusual blue-ear disease and natural disasters.

Chart 1: Yurun's dollar gross profits (RMB/tonne) and average pork price in China (RMB/kg)



Source: Company data, Ministry of Agriculture, SBI E2-Capital

Competitive edge. We reckon that Yurun's earnings growth is backed by its:

- Favourable position in the industry value chain – upstream suppliers (e.g. farmers) and downstream consumers (e.g. urban inhabitants) are mainly individuals and somewhat isolated from each other.

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China Consumer

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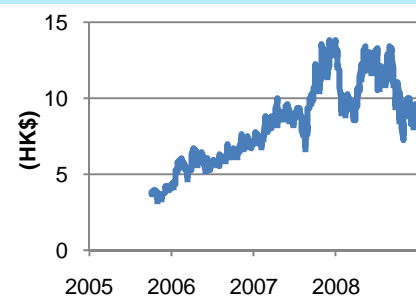
Stock data

Price	HK\$8.97
12 mth range	HK\$6.30-13.96
Market cap.	US\$1,760.7m
No. shares o/s	1,531.1m
Daily t/o, 3 mth	US\$8.1m
Free float %	38.7%
Major shareholder	Mr. Zhu & Ms. Wu – 52%
Ticker	1068.HK/1068 HK

Financial summary

Year to Dec	07A
Yield (%)	1.7
ROE (%)	26.1
Net gearing (%)	(26.6)
Net debt/sh. (HK\$)	(0.591)
BV/sh. (HK\$)	2.71
Consensus EPS (HK\$)	
- 12/08F	0.732
- 12/09F	0.863

Price Chart



Intermediate companies such as Yurun are larger and have access to information allowing them to capitalize on pork price fluctuations.

- Long-standing relationship with suppliers – the company's processing plants normally procure hogs from local pig farmers and distributors, based on annual contracts. This long term cooperation enables Yurun to foster close relationships with suppliers, securing its hog supply during shortages.
- Well-known brand with long track record – we regard the increasing consumer focus on food quality and safety as the company's long-term organic driver. Yurun has been positioning itself as a quality, hygienic and safe producer since its establishment in 1993. This brand image allows it to charge premium prices and gain market share from small & individual pork producers.

Strong performance in 1H FY12/08A. Although Yurun's sales volume was capped by China's tight hog supply, driven by the surging ASP, turnover jumped 75.2% in 1H FY12/08A to HK\$6,043.5m, comprising HK\$3,728m (up 119.0% YoY) from chilled meat, HK\$1,425m (up 27.8% YoY) from frozen meat, HK\$1,273m (up 65.1% YoY) from LTMP and HK\$132m (up 33.5% YoY) from HTMP. The blended gross margin expanded substantially from HK\$1,597.7 per tonne to HK\$2,467.8, though it narrowed 1.2pcp to 13.6% in percentage terms. As a result, net profit increased 70.9% to HK\$672.1m.

Boost sales volume to preserve growth. In 2H, we expect the ASP and dollar gross margin to drop slightly due to the softening pork price, which was around RMB18.9/kg on average, versus RMB22.3 in 1H and RMB19.2 one year earlier. Nevertheless, the sales volume rebound backed by the recovering hog supply nationwide should offset this negative impact and sustain bottom line growth. The company might have some pressure in FY12/09F given that the falling pork price (RMB16.2/kg in Nov) might further depress its ASP and dollar gross margin. Growth will mainly come from market share and capacity expansion.

Expansion in upstream via M&A. According to the management, the company will concentrate on its upstream operation (chilled and frozen meat, especially chilled meat) in the future and plans to raise its capacity mainly through acquisitions (building new capacity for downstream LTMP and HTMP). China's rising food standards have been pushing small players, who lack sufficient capital to upgrade facilities, out of the market. By acquiring these firms, Yurun can expand its capacity cost and time effectively (e.g. priced at NAV and reach profitable within 6-12 months). The company budgeted HK\$1.7bn in capex for FY12/08F, of which HK\$700m was spent in 1H. For FY12/09F and FY12/10F, total capex is HK\$4bn.

History and corporate governance. Yurun was established by Mr. Zhu and Ms. Wu in 1993, starting from producing HTMP and LTMP and, expanded into slaughtering in 1997. The company listed in Hong Kong in Oct 2005, offering 416.1m shares (66.3m old shares) at HK\$3.70 each. Substantial shareholders include Mr. Zhu & Ms. Wu (51.63%), Goldman Sachs (13.14%) and AllianceBernstein (8.89%).

Valuation. We think the counter is defensive during an economy slowdown given the inelastic nature of China's pork consumption. Yurun is trading at forward FY12/09F P/E of 10.3x, which is in line with the average 10.9x of the Hong Kong-listed food & beverage sector. The valuation gap among meat processors might be a result of differences in the benchmark market.

Table 1: HK-listed F&B companies

Company name	Ticker	Fiscal Year end	Mkt Cap (US\$m)	His P/E(x)	Curr-Yr Fwd P/E(x)	Nxt-Yr Fwd P/E(x)	ROE (%)
Fairwood	52 HK	03/2008	86.9	7.2	5.8	4.7	28.7
First Pacific	142 HK	12/2007	1,110.9	3.1	4.6	3.8	59.4
Want Want	151 HK	12/2007	5,295.7	22.3	14.4	16.8	24.5
Tsingtao	168 HK	12/2007	3,143.5	31.1	24.7	19.8	10.0
Uni-President	220 HK	12/2007	869.7	11.8	12.5	8.2	11.0
Tingyi	322 HK	12/2007	6,332.8	28.1	27.8	22.3	20.1
Café de Coral	341 HK	03/2008	1,122.4	19.5	18.2	16.1	19.2
Haisheng	359 HK	12/2007	77.0	2.4	1.9	1.7	20.6
China Foods	506 HK	12/2007	1,040.4	12.4	16.8	12.7	11.1
Ajisen	538 HK	12/2007	489.9	15.6	14.0	10.6	19.7
Tao Heung	573 HK	12/2007	195.6	8.3	7.5	6.8	31.0
China Agri-Industries	606 HK	12/2007	1,852.1	6.6	5.9	6.4	13.4
Dynasty	828 HK	12/2007	171.2	9.2	8.7	7.9	8.5
China Green	904 HK	04/2008	679.4	9.8	9.0	7.6	24.0
Yurun	1068 HK	12/2007	1,757.2	11.7	12.2	10.3	26.1
Pacific Andes	1174 HK	03/2008	152.9	3.1	2.3	1.7	13.2
Fuji Catering	1175 HK	03/2008	272.0	4.0	3.5	3.2	18.3
Huiyuan	1886 HK	12/2007	1,812.2	18.7	35.2	31.9	20.6
Mengniu	2319 HK	12/2007	1,990.9	12.1	86.7	21.4	23.1
Andre	8259 HK	12/2007	167.2	3.8	3.9	3.8	24.9
Average			1,431.0	12.0	15.8	10.9	21.4

Source: Bloomberg

Table 2: Meat processors

Company name	Ticker	Fiscal Year end	Mkt Cap (US\$m)	His P/E(x)	Curr-Yr Fwd P/E(x)	Nxt-Yr Fwd P/E(x)	ROE (%)
Yurun	1068 HK	12/2007	1,757.2	11.7	12.2	10.3	26.1
People's Food	PFH SP	12/2007	92.2	5.4	5.7	4.8	11.6
Shuanghui	000895 CH	12/2007	2,492.2	34.5	28.6	22.3	26.7

Source: Bloomberg

Table 3: P&L

Y/F 31 Dec (HK\$m)	06A	07A	1H 07A	1H 08A
Turnover	4,621.3	8,635.1	3,449.6	6,043.5
Cost of sales	(3,910.2)	(7,414.8)	(2,937.7)	(5,222.7)
Gross profit	711.2	1,220.4	512.0	820.8
Other operating income	89.4	190.7	118.6	189.0
Distribution expenses	(216.1)	(351.0)	(137.1)	(243.5)
Administrative and other operating expenses	(109.8)	(188.5)	(86.2)	(143.3)
Profit from operation	474.7	871.6	407.2	623.1
Finance income	25.6	63.4	17.4	136.0
Finance expenses	(13.7)	(22.2)	(6.1)	(25.3)
Share of loss of an equity accounted investee (net of income tax)	(1.2)	(0.8)	(0.5)	(0.5)
Profit before taxation	485.4	912.0	418.1	733.2
Income tax	(5.5)	(51.2)	(24.5)	(60.8)
Profit for the period	479.9	860.8	393.6	672.4
Attributable to:				
Equity holders of the Company	481.0	859.3	393.2	672.1
Minority interests	(1.1)	1.5	0.4	0.3
EPS - Basic (HK\$)	0.331	0.584	0.271	0.440
EPS - Diluted (HK\$)	0.331	0.582	0.270	0.435
Proposed DPS (HK\$)	0.084	0.150	0.070	0.110
Sales breakdown (incl. Internal sales)				
Frozen meat	1,470.2	2,736.3	1,114.9	1,424.8
Chilled meat	2,082.0	4,677.0	1,702.0	3,728.0
HTMP	225.3	276.6	99.0	132.2
LTMP	1,159.0	1,753.0	771.0	1,273.0

Source: Company data