

Corporate Flash

China Shengmu Organic Milk ^{1432 HK}

A niche player in the raw milk industry

- Organic production model has been supported by its vertical operation
- IPO kicked off with P/E of 37.2x for FY12/13.

A dairy company focused on producing organic milk. China Shengmu Organic Milk (CSOM) is the largest organic dairy company in China and the only vertically integrated organic dairy company in China that meets E.U. organic standards, according to F&S Report. In terms of organic raw milk production volume in 2013, CSOM had a 54.2% market share in China (See Figure 1). Together with its associate, Shengmu Forage, their vertically integrated “grass-to-glass” organic production model covers the entire dairy industry value chain, adhering to E.U. organic standards for all major stages of the dairy production process: forage growing, dairy farming to produce raw milk, and processing the milk to produce high-end liquid milk products. The F&S Report also states that CSOM is a major producer of organic liquid milk with a market share of 25.3% in terms of retail sales value in China in 2013. Furthermore it is also among the top eight producers of premium non-organic raw milk in 2013.

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Stock Data (1432 HK)

Rating	Not Rated
Price (HKD)	2.36
Target Price (HKD)	n.a.
12m Price Range (HKD)	2.3-2.46
Market cap. (HKD m)	14,805.8
Daily t/o (HKD m)	28.5
Free float (%)	18.3
<i>Source: Bloomberg</i>	

Figure 1: Market share of organic milk producers by productivity (2013)

Rank	Organic raw milk	Organic raw milk	Market share
1	Shengmu	94.2	54.2
2	Yili	40.2	23.1
3	Yunhai Qiulin	16.7	9.6
4	Others	22.7	13.1
Total		173.8	100

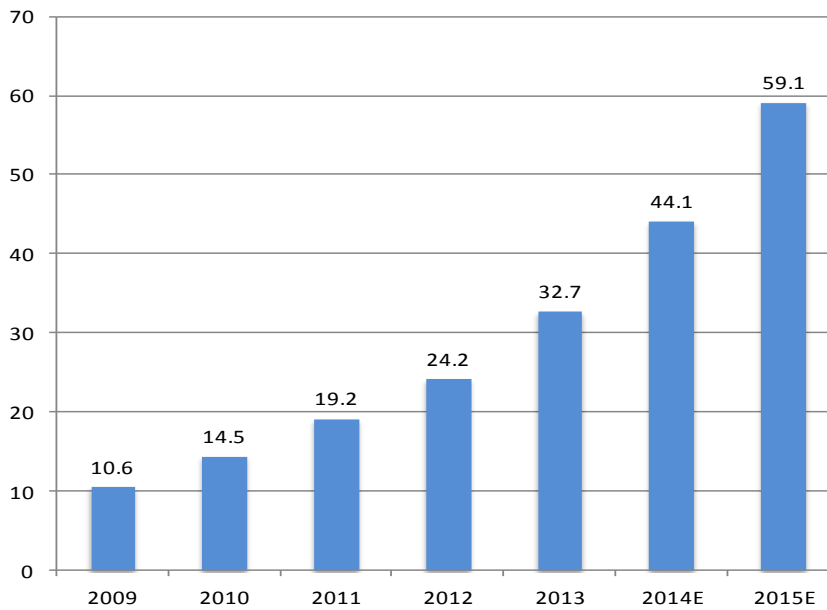
Source: Certification and Accreditation Administration of PRC, Frost & Sullivan

Based on its operation, CSOM’s herd can be divided into two groups: organic and non-organic. For its organic herd, the number of cows was 30,621 in 2013, 54.9% of which were milkable cows; for its non-organic herd, the number of cows was 29,836 in 2013, 63.8% of which were milkable cows. In total, including both organic and non-organic herds, the average raw milk production for each cow is around 8.5 tons per year.

For its FY12/13, the company recorded revenue of RMB1,143.7m, a 63.2% YoY increase; gross profit of RMB490.4m, a 109.5% YoY increase with gross margin of 42.9%; and profit attributable to shareholders of RMB327.3m, a 67.2% YoY increase. CSOM’s revenue can be divided based on its sectors. For its dairy farming sector, it generated approximately 73.5% of total revenue in 2013, specifically around 41.9% were contributed by the organic business; for its liquid milk business, CSOM generated 26.5% of the total revenue in 2013.

The future of this company will be significantly dependent on its organic milk business, including organic raw milk and organic liquid milk, which is on the fast track of development (See Figure 2).

Figure 2: China's consumption of organic food from 2009 to 2015 (RMB b)



Source: Frost & Sullivan

Organic production model has been supported by its vertical operation. First, it involves the environment. Its organic farm is located in the Ulan Buh Desert in Inner Mongolia, which provides outstanding benefits to its dairy farm business. As we know, cows prefer relatively cool temperature and dry weather. The temperature in Ulan Buh Desert ranges from 0°C to 15°C, which is a favorable range for dairy cows. The clean environment also helps the dairy farm business. Additionally, no chemical or industrial plants have been realized within a close vicinity of the organic dairy farms so far.

For organic forage planting, the group sources all of its organic forage from Shengmu Forage, an associate company of CSOM with a share interest of 8.6%, in the Ulan Buh desert without the use of any agricultural chemical fertilizers. The intensity and long hours of sunlight in the desert also supports the growth of forage crops. In November 2011, the company received the certification from ECOCERT S.A. under the E.U. standard for organic dairy farming for the first time. The following table describes the organic standards in both E.U. and China.

Figure 3: Organic standards in E.U. and China

	Farmland	Feeding	Breeding	Production
E.U. standard	No polluting risks exist nearby	At least two years conversion period before sowing; At least 60.0% feed from self-owned or partnered organic dairy farm	Six months conversion period; 6.0 sq.m. inside and 4.5 sq.m. outside active area per cow	Use minimum non-organic ingredients (no more than 5.0%); No GMO additives
China standard	Far from city, industrial and mining area	At least two years conversion period (at least 1 year for lands that are newly cultivated, uncultivated for over three years, or free from banned substances for over three years); Over 50.0% feeds from self-owned or partnered organic dairy farm; No chemical synthetic fertilizer permitted	At least six months conversion period Natural birth with at least 3 months suckling period unless emergencies 6.0 sq.m. inside and 4.5 sq.m. outside active area per cow	Use minimum non-organic ingredients (no more than 5.0%); No GMO additives

Source: Company

IPO kicked off with P/E of 37.2x for FY12/13. On July 14, the company has announced its global offering results, under which the stock has been traded at a fully diluted historical P/E of 37.2x for FY12/13. And based on our estimates, its P/E for FY12/14E will be around 30.5x. We think the P/E ratio is relatively high compared with its peers, like China Huishan Dairy (CHD) (6863 HK) and China Modern Dairy (CMD) (1117 HK) (See Figure 4).

Figure 4: Peer comparison

Company	Ticker	Spot (HKD)	Market cap (HKD m)	Fiscal year end	P/E (x) (last fiscal year)	P/E (x) (Next fiscal year)	ROE (%)	ROA (%)	Total debt/ Total equity (%)
China Huishan Dairy	6863 HK	1.82	26,072.4	March	14.5	13.9	13.1	7.9	37.2
China Modern Dairy	1117 HK	3.73	18,195.1	December	30.3	28.7	8.9	4.5	53.1
Yuanshengtai Dairy	1431 HK	1.29	4,963.0	December	11.2	10.3	9.7	5.7	21.3
China Shengmu Organic Milk*	1432 HK	2.36	14,802.5	December	37.2	30.5	19.2	10.5	45.1
Average			16,008.2		23.3	20.9	12.7	7.2	39.2

Source: Bloomberg, Hong Kong Exchange, SBI China Capital

First, it is due to its herd size. By the end of 2013, CMD and CHD had approximately cows of 186,838 and 144,191, with the proportion of milkable cows around 52.9% and 42.5%, respectively. However, CSOM had only 60,457 cows by the end of 2013 (See Figure 5).

Figure 5: Herd size comparison among CMD, CHD, CSOM and YST (2013)

	Productivity of cow (tons/year)	Number of cows	Number of milkable cows	Proportion of milkable cows
CMD	8.5	186,838	98,791	52.9%
CHD	9.1	144,191	61,286	42.5%
CSOM	8.5	60,457	35,850	59.3%
YST	9.0	40,396	21,544	53.3%

Source: Company

Moreover, its cow-importing plan surprised us on the down side. CSOM will receive net proceeds of HKD996.3m from this IPO, only approximately 30.0% of which will be allocated to purchase around 15,000 dairy cows from FY12/14 to FY12/15. However, CMD, as its peer company, is planning to purchase 25,000 calves each year from 2014 to 2016.

Second, its raw milk price. In terms of CSOM's dairy farm sector, the average raw milk price is approximately RMB4,771.0/ton in FY12/13, compared with CHD's RMB4,515.0/ton in FY03/14 and CMD's RMB4,790.0/ton in FY12/13. Accordingly, CSOM's ASP of raw milk does not show any advantage if we consider the raw milk sector as a whole.

Even though the ASP of CSOM's liquid milk price was around RMB14,625.0/ton in FY12/13, much higher than the ASP of the liquid milk price of CHD and CMD, which is RMB7,957.0/ton in FY03/14 and RMB11,163.9/ton in FY12/13 respectively (See Figure 6), we find that the liquid milk sector only accounted for around 26.5% of its revenue in FY12/13 while the dairy farm sector still dominates its revenue.

Figure 6: Raw/liquid milk price of CSOM, CHD and CMD.

CSOM (FY12/13)				CHD (FY03/14)			CMD (FY12/13)		
		Revenue (RMB m)	ASP (RMB/ton)		Revenue (RMB m)	ASP (RMB/ton)		Revenue (RMB m)	ASP (RMB/ton)
Raw milk	Organic milk	352.9	5,151.0	Raw milk	983.9	4,515.0	Raw milk	1,697.0	4,790.0
	Non-organic milk	487.8	4,377.0						
Liquid milk	Organic milk	302.9	14,625.0	Liquid milk	2,287.9	7,957.0	Liquid milk	204.3	11,163.9

Source: Company

Figure 7: Per share items (RMB)

	FY12/11	FY12/12	FY12/13
EPS			
- Basic	-	-	0.04
DPS	-	-	-
BVPS	-	-	0.45

Source: Company data

Figure 8: Ratio analysis

	FY12/11	FY12/12	FY12/13
Growth (YoY)			
Revenue	-	80.0%	63.2%
Gross profit	-	104.3%	109.5%
Operating profit	-	-7.4%	94.0%
Net profit	-	-10.9%	88.3%
Margins	-		
Gross margin	-	33.4%	42.9%
EBIT margin	-	30.1%	35.8%
Net profit margin	-	28.4%	32.7%
Other ratios	-		
Return on average assets	-	13.1%	13.3%
Return on average equity	-	19.0%	25.6%
Dividend payout ratio	-	-	-
Valuation measures	-		
P/E (x)	-	-	37.20
P/B (x)	-	-	3.90
Dividend yield	-	-	-

Source: Company data

Figure 9: Income statement (RMB m)

	FY12/11	FY12/12	FY12/13
Revenue	389.4	700.8	1,143.7
Cost of sales	(274.8)	(466.7)	(653.3)
Gross profit	114.6	234.1	490.4
Other income	127.5	12.3	16.3
SG&A	(14.2)	(35.4)	(97.3)
Operating profit	227.9	211.0	409.4
Finance cost	(4.7)	(12.4)	(32.8)
Share of profit and (losses) of an associate	-	0.3	(1.3)
Profit before taxation	223.2	198.9	375.4
Income tax	-	-	(0.9)
Profit for the year	223.2	198.9	374.5
Non-controlling interest	0.0	(3.1)	(47.2)
Profit attributable to shareholders	223.2	195.8	327.3

Source: Company data

Figure 10. Balance sheet (RMB m)

	FY12/11	FY12/12	FY12/13
Non-current assets			
PP&E	194.9	450.2	922.8
Land lease payment	-	3.5	3.4
Other intangible assets	15.0	14.5	14.2
Interests in associations	14.8	17.6	17.7
Biological assets	713.8	1,029.5	1,510.2
Prepayment for PPE and biological asset	14.1	0.0	9.0
Deferred tax assets	-	-	0.2
Total non-current Assets	952.6	1,515.3	2,477.5
Current assets			
Inventories	103.9	204.2	335.2
Trade and bills receivables	10.0	24.5	63.5
Prepayments, deposits and other receivables	15.9	30.0	94.4
Pledged deposit	29.2	12.8	15.0
Cash and cash equivalents	69.6	29.8	127.1
Total current assets	228.6	301.4	635.2
Total assets	1,181.2	1,816.7	3,112.7
Current liabilities			
Trade and bills payables	(84.0)	(132.2)	(191.0)
Receipts in advance	(15.5)	(17.5)	(82.5)
Other payables and accruals	(82.5)	(124.6)	(198.6)
Interest-bearing bank and other borrowings	(75.0)	(324.0)	(932.0)
Total current liabilities	(257.0)	(598.3)	(1,404.1)
Non-current liabilities			
Interest-bearing bank and other borrowings	49.0	-	-
Total non current liabilities	49.0	-	-
Net assets	875.3	1,218.5	1,707.9
Equity			
Issued capital	-	-	-
Reserves	855.6	1,166.9	1,494.2
Non-controlling interests	19.7	51.6	213.7
Total equity	875.3	1,218.5	1,707.9

Source: Company data

Figure 11. Cash flow statement (RMB m)

	FY12/11	FY12/12	FY12/13
Operating activity			
Cash generated from operations	1,427.7	2,810.5	1,619.5
Net interest income	33.4	(56.4)	(76.1)
Income tax paid	(122.8)	(213.1)	(309.2)
Net cash flow from operating activities	1,338.4	2,541.0	1,234.1
Investing activities			
Acquisition of a subsidiary	(519.7)	-	-
Investment in associates	(320.9)	(11.9)	328.5
Payment and prepayment for land use right	(361.6)	(183.3)	717.2
Purchases of PP&E and others	(3,619.2)	(3,021.8)	(4,462.8)
Dividends received from jointly controlled entities	5.0	10.0	10.3
Proceeds from disposal of PP&E and financial assets	94.8	275.5	1,273.4
Dividends received	10.0	10.7	8.9
Cash flow from investing activities	(4,144.1)	(3,405.2)	(4,083.0)
Financing activities			
Proceeds from bank borrowings and notes payables	4,356.9	7,066.7	10,411.4
Repayments of bank borrowings	(1,451.6)	(6,186.9)	(8,264.8)
Dividends paid to equity holders of the company	(155.7)	(93.6)	(171.2)
Cash flow from financing activities	2,749.5	786.2	1,975.4
Net increase in cash and cash equivalent	(56.1)	(78.1)	(873.5)
Cash and cash equivalents at the beginning of the year	2,427.4	2,369.1	2,290.8
Effect of foreign rate exchange	(2.2)	(0.1)	(3.3)
Cash and cash equivalents at the end of the year	2,369.1	2,290.8	1,413.9

Source: Company data

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