

## Tontine Wines Group Ltd.

### Emerging star from Changbai Mountain

**Company background.** Tontine's history dates back to Jan 2001 when Chairman and CEO, Mr. Wang Guangyuan, recognized the emerging trend for red wine in China and in particular the potential for sweet wines amongst Chinese consumers and led a group of key management team away from a renowned State-owned sweet wine producer to establish the company. Over the years, Tontine has established itself as one of the leading sweet wine producers in China. Its brands "Tongtian" ("通天") and "Tongtian Hong" ("通天红") have been awarded both Top 500 Brands of the PRC (中国品牌 500 强) and Top 10 PRC Grape Wine Industry Brands (中国葡萄酒行业十大品牌). Tontine listed in HKEx main board in November 2009.

#### Investment summary

- Favourable long term secular growth in China's wine market – As the world's fifth largest wine consuming country, China still has a very low per capita consumption of wine products at 0.53L/year (worldwide average 3.5L/year). Long term secular growth is driven by rising income and emerging wine consumption culture.
- Tontine is Tonghua's largest wine producer – Tontine is Tonghua's largest native wine producer by revenue (FY12/08A: RMB486.7m). It accounted for around 31.7% market share in terms of production capacity amongst the sizeable producers in the region.
- Clear positioning with differentiated products – Focus on sweet wines and ice wines gives differentiated positioning. We are positive on this strategy as it avoids direct competition with Dynasty (828 HK), Changyu (000869 CH) and Great Wall (under China Foods (506 HK)), which are more notable for their dry wine products.
- Stable and sustainable supply of quality grapes – Company has 20 year exclusive long term supply agreements with local farmers, giving them access to around 40% of total grape growing areas in Tonghua.
- Potential to become top equity wine brand – China's sweet wine market is still emerging. Leveraging its: 1) famous origins; 2) Tonghua region brand association; 3) its quality products and 4) increased A&P spending, Tontine has the potential to emerge from other tier-two producers to become a top equity brand in Chinese sweet wines.

**BUY call with target price HK\$2.23.** We initiate coverage on Tontine with a BUY call with target price of HK\$2.23, representing 21.5x FY12/09P/E and 18.1x FY12/10F P/E based on our estimate. We think the positive growth of the company would come from: 1) 105% increase in production capacity; 2) sales of more higher margin product; 3) continue improvement in brand image; 4) strengthening of product promotion and expansion of distribution network; 5) industry growth.

Ticker	389 HK
Rating	BUY(Int. Coverage)
Price (HK\$)	1.70
Target Price (HK\$)	2.23(+31%)
12m Price Range (HK\$)	1.25-1.81
Market cap. (US\$m)	374.7
Daily t/o (US\$m)	-
Free float (%)	39.1

#### Financial summary

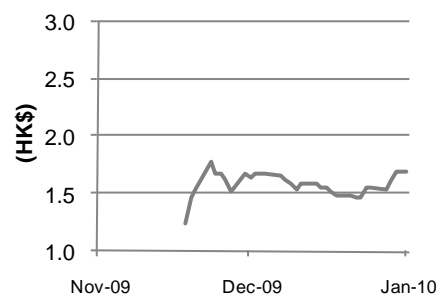
Year to Dec	07A	08A	09F	10F	11F
Turnover (RMBm)	391.6	486.7	580.9	670.0	827.2
Net Profit (RMBm)	105.2	136.8	178.1	211.8	270.9
EPS (RMB)	0.079	0.103	0.104	0.123	0.158
P/E (x)	21.4	16.5	16.4	13.8	10.8
P/B (x)	15.29	6.07	2.87	2.37	1.94
EV/EBITDA (x)	15.7	10.4	8.7	7.1	5.3
Yield (%)	3.0	-	-	-	-
ROE (%)	71.1	52.8	25.6	18.8	19.8
ROCE (%)	93.7	77.4	35.4	25.2	25.9
N. Gear. (%)	Cash	Cash	Cash	Cash	Cash

Source: SBI/Bloomberg

	09F	10F	11F
Consensus EPS (RMB)	0.110	0.135	0.150
Previous earnings (RMBm)	-	-	-
Previous EPS (RMB)	-	-	-

#### Price performance

Year to Dec	1m	3m	12m
Relative to HSI (%)	+2.3	-	-
Actual price changes (%)	+1.2	-	-



Source: Bloomberg

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## Business strategy and development

**Tontine focuses on sweet wine made from mountain grapes.** Tontine specializes in the production of sweet wines (though it also produces a series of dry wines). Its wines are produced from a variety of grapes known as *vitis amurensis* (commonly referred to as “mountain grapes”) that are indigenous to the Tonghua region, one of the 3 original grape growing regions in China. Its signature wines are generally sold under the “Tongtian” (“通天”) and “Tongtian Hong” (“通天红”) labels. The company currently produces 18 varying wine series. Tontine’s wine products range from ~RMB6 to RMB115+ per bottle ex-factory.

**Table 1. Tontine’s representative key brands and wine products**

Wine product	Year launched	Major raw Material	Alcohol Content (%)	Photo
Tongtian Hong Mountain Grape Wine (通天红山葡萄酒)	2006	mountain grapes	7.0	
Tongtian Hong Full Juice Mountain Grape Wine (通天红全汁山葡萄酒)	2006	Mountain grapes	11.0	
Tongtian Wild Rose Grape Wine (通天野玫瑰葡萄酒)	2007	mountain grapes, wild rose petals	8.5	
Tongtian Ice Wine (通天冰酒)	2004	Frozen mountain grapes	8.5	
Tongtian Hong Cellar Stored Premium Mountain Grape Dry (通天红窖藏精品干红山葡萄酒)	2006	mountain grapes	11.5	
Tongtian Hong Dry Wine (通天红干红山葡萄酒)	2006	Mountain grapes	11.5	
Tongtian Dry Wine (通天干红山葡萄酒)	2001	Mountain grapes	12.0	

Source: Company data

**Tonghua region is renowned for its wild mountain grapes.** Tonghua region is renowned for grape growing and wine production. It was one of the 3 original grape growing regions in China and one of the 10 grape growing regions as identified by Chinese authorities today. Its species of grape, the indigenous *vitis amurensis* (commonly referred to as “mountain grapes”) is native to China. This is important given that many of the other grape growing regions in China have had their grape species originally imported from overseas countries (e.g. France, Italy etc). Thus, wines bearing its origins from Tonghua possess an inherent reference to quality and history and the wines produced using these wild mountain grapes have a distinctive taste that is unique to this area.

According to the Tonghua city government, Tonghua had a grapevine growing area amounting to 37.5m sqm in 2008. This will be increased to 73.3m sqm by 2011, though newly planted grapevines usually require around 3 year time to their first harvest.

**Tontine is Tonghua’s largest wine producer.** Based on our background and channel checks, Tontine is Tonghua’s largest native wine producer by revenue. The company recorded revenues of RMB486.7m in FY12/08A, and had production capacity of 19,000 tonnes. According to Tonghua city government, the total production capacity of sizeable wine producers (9 enterprises) in the area amounted to 60,000 tonnes, with total production capacity amounting to 75,000 tonnes (97 enterprises). This implies that Tontine accounted for around 31.7% market share in terms of production capacity amongst the sizeable producers. In fact, we expect that Tontine’s market share in terms of actual tonnes of wine produced to be even higher as it is privately owned and maintains a relatively high utilization rate (06A: 70.1%, 07A: 78.2%, 08A: 89.8%, 1H 09A: 89.1%). Many others, including Shanghai-listed Tonghua Grape Wine (600365 CH) are SOEs and tend to have a lower operating efficiency and utilization. Comparing to Tontine, Tonghua Grape Wine derived revenue of RMB79.7m in 2008.

**Clear positioning with differentiated products.** Tontine focuses on the development of sweet wines and ice wines (1H FY12/09A: 68.2% of total revenues). In particular, the company’s ice wine products benefit from the wintery climate of Tonghua region and its contracted grapevines in Ji’An City, allowing the grapes to be harvested whilst still frozen on the vines. We are positive on the company’s differentiation strategy as it avoids direct competition with the likes of Dynasty (828 HK), Changyu (000869 CH) and Great Wall (506 HK), whom are more notable for their dry wine products.

Though most of the industry data does not breakdown sweet wines from overall wine consumption, we reckon that this segment is arguably growing at a faster rate than the overall wine consumption market in China. This is because: 1) the sweet wine market is coming off a lower base; 2) consumption of ice wine as an after dinner wine or dessert wine is an emerging trend amongst Chinese consumers and 3) the “sweeter” taste of the sweet wines caters better to China consumer’s taste (in many instances in China, Coke or Sprite is often mixed with wine to lessen the degree of “bitter” taste).

**Natural advantages to become a top wine brand.** Brand recognition and equity is especially important in the fragmented wine industry, as it offers a perception on aspects such as confidence, pricing and quality. Despite a moderate advertising and promotion (A&P) budget (RMB22.0m in FY12/08, 4.5% of sales vs. RMB272.2m, 22.0% of sales for Dynasty), Tontine has been able to leverage its: 1) famous origins and 2) differentiated sweet wine products and has successfully established solid brand awareness amongst China’s wine consumers. Its key brands of “Tongtian” (“通天”) and “Tongtian Hong” (“通天红”), with their strong references to their unique grape origins has further reinforced Tontine as one of the leading sweet wine producers in the market.

In our view, the combination of brand name reference, company origins and clear product differentiation are natural advantages and potentially allows Tontine to get more “bang for buck” for each A&P dollar spent. The company has already earmarked 18.6% of the IPO proceeds (about HK\$85.3m) on advertising and marketing. We think that accelerated brand building efforts at a time when the sweet wine industry is emerging provides Tontine an opportunity to solidify itself as the preferred choice for domestic produced sweet wines and in the process further drive demand in its wine products.

Outside of the tier-one brands of Dynasty, Changyu, Great Wall and Weilong, there has yet to be a tier-two domestic wine producer with strong brand presence. We think that Tontine’s inherent brand advantages would allow the company to emerge from the pack to become a top wine brand once it ramps up its A&P spend.

Essentially, the “Tongtian” (“通天”) and “Tongtian Hong” (“通天红”) brand acts as the company’s defensiveness, especially as foreign imported wines becoming more established in China. Its’ unique brand, with its Tonghua origin association attributes, and focus on sweet wines, gives the company clear differentiation in its brand positioning.

**Table 2. Awards and recognition**

Year	Awards / Certificate	Awarding body
2001	PRC Public Recommended Brand (全国公众推荐名优品牌)	The China Socio-Economic Strategy Consultation Centre /Famous Brand Protection & Inspection Institute (中国社会经济决策咨询中心)(名牌产品市场保护调查所)
	China Famous Premium Wine Award (中国名优葡萄酒)	The China Food Industry Association (中国食品工业协会)
2002	Asia-Pacific Satisfactory Consumer Products Awards (亚太地区消费者满意产品)	The China International Food Industry Association (中国国际食品工业协会)
2004	Wine of Excellent Quality (优秀葡萄酒)	The Expert Committee of the Grape and Fruit Wine, China Food Industry Association (中国食品工业协会葡、果酒专家委员会)
	Green Food – Class A (绿色食品 A 级标准)	The China Green Food Development Centre (中国绿色食品发展中心)
2006	Famous Product of Jilin Province Award (吉林省名牌产品)	People’s Government of Jilin Province (吉林省人民政府)
	The Geographic Indication Protected Products of the PRC (中华人民共和国地理标志保护产品)	The Association for Geographic Indication Protected Products of Jilin Province (吉林省地理标志产品保护协会)
2007	Green Food – Class A (绿色食品 A 级标准)	The China Green Food Development Centre (中国绿色食品发展中心)
2008	Top 500 Brands of the PRC (中国品牌 500 强)	The China Market Brands Strategy Forum Organising Committee (中国市场品牌战略论坛组委会)
	Top 10 PRC Grape Wine Industry Brands (中国葡萄酒行业十大品牌)	The China Market Brands Strategy Forum Organising Committee (中国市场品牌战略论坛组委会)

Source: Company data

**Stable and sustainable supply of quality grapes.** Grapes are the principal and most important raw material in the production of Tontine’s red wine. The company’s wines are made from mountain grapes native to the area and source them from local farmers in the area surrounding Ji’An City. In total, Tontine has entered into exclusive long term supply agreements with 173 local farmers in Ji’An City for a period of 20 years (commencing 2004). These agreements contain terms relating to duration, quantities to be supplied, breakdown (by area) of the grape varieties to be grown and broad payment settlement terms. Farmers prefer to enter into such agreements with Tontine as it provides them with sales visibility for their agricultural produce.

The agreements allow the company to have access to approximately 14.8m sqm of mountain grapes, representing around 40% of total grape growing areas in the region. These supply agreements guarantees grape supply and more importantly, origin consistency, leading to quality consistency in Tontine’s wine products. Harvesting season for the grapes is typically between September and November.

Tontine pays the grape farmers in cash. In terms of pricing, it is generally negotiated with the farmers and the local government based on

prevailing market prices. Given the partnership nature stemming from the long term supply agreements between Tontine and the local farmers, the company is typically subject to less pricing volatility. During time of high grape prices, Tontine can typically source the grapes at a price slightly below market price. However, in times of low grape prices, Tontine would pay a price slightly higher than market price to support the farmers. The grape prices are agreed each year prior to the harvesting period.

**Nationwide sales and distribution network.** Tontine's wine products are sold in 19 provinces and 3 municipal cities via a nationwide sales and distribution network comprising 71 distributors. Tontine's regional sales breakdown is relatively evenly distributed, with a bias towards the eastern regions (1H FY12/09A: 35.2% of overall revenues). This is expected, given the higher GDP, level of affluence and the general preference of wine products over other alcoholic beverages in that region. All distributors are independent third parties and the company generally assigns a sales manager in each of the provinces and cities to work with the distributors. Tontine typically extends an average of 90 day credit term to these distributors.

The distributorship agreements are typically for one year and renewed on an annual basis after a review of their sales and other items such as promotion, credibility, sales network and inventory accumulation. Prior to signing the agreement, the sales manager would agree with the distributor the targeted sales volume for the coming year. The company does not offer its distributors any volume rebates, but also, does not penalize distributors should they fail to meet pre-agreed targets.

The company typically sets a range of recommended retail prices for their wine products to their distributors. The final price setting is at the discretion of the distributor, based on their interpretation of market conditions. In general, retail prices are around 40-60% above Tontine's prices sold to the distributors. The company recognizes revenue when the wine products are delivered to the distributors.

**Table 3. Distributor breakdown**

Province / City	No. of distributors
<b>Municipal cities</b>	
Shanghai	3
Beijing	3
Chongqing	1
<b>Provinces</b>	
Shandong	12
Sichuan	9
Hebei	6
Shanxi	4
Heilongjiang	4
Jilin	4
Anhui	4
Zhejiang	4
Guangdong	3
Liaoning	2
Henan	2
Hubei	2
Yunnan	2
Inner Mongolia	1
Shaanxi	1
Jiangsu	1
Fujian	1
Hunan	1
Guizhou	1
<b>Total</b>	<b>71</b>

Source: Company data

**Table 4. Regional sales breakdown**

	06A		07A		08A		1H 09A	
	RMBm	%	RMBm	%	RMBm	%	RMBm	%
North East	38.7	13.7	58.4	14.9	76.5	15.7	33.1	13.6
North	61.0	21.6	71.7	18.3	89.5	18.4	48.3	19.9
Eastern	89.8	31.9	136.1	34.8	166.9	34.3	85.5	35.2
South Central	33.3	11.8	42.8	10.9	58.5	12.0	29.6	12.2
South West	59.2	21.0	82.6	21.1	95.2	19.6	46.3	19.1
<b>Total</b>	<b>281.8</b>	<b>100.0</b>	<b>391.6</b>	<b>100.0</b>	<b>486.7</b>	<b>100.0</b>	<b>242.7</b>	<b>100.0</b>

Source: Company data

**Management team with strong track record.** Chairman and CEO Mr. Wang Guangyuan and most of the founding management have had over of 20 years experience in China's wine industry. The management and other senior technical staff have in the past received numerous provincial and national industry technical certifications and accreditations. The collective know-how base enables the company to develop new wine products and better respond to market conditions.

**Table 5. Management Team**

Position	Name	Experience
Founder, Chairman and CEO	Mr. Wang Guangyuan	Worked for Tonghua Winery Limited (600365 CH) for 14 years before he established Tontine with other founders in 2001
Founder and Executive Director	Mr. Zhang Hebin	Worked for Tonghua Winery Limited (600365 CH) for 14 years before he established Tontine with other founders in 2001
Founder and Executive Director	Ms. Wang Lijuan	Worked for ICBC Tonghua Branch for 15 years before she established Tontine with other founders in 2001
Founder and Chief Winemaker	Ms. Ji Chunhua	Worked for Tonghua Winery Limited (600365 CH) for 21 years before he established Tontine with other founders in 2001
CFO	Mr. Kwok Yuen Ying, Riki	Worked as company secretary and financial controller for Daqing Petroleum and Chemical Group Ltd (362 CH) before he join Tontine in 2007

Source: company data

**Production facilities up to 90% utilization.** Tontine has two facilities, located in Ji'An City and Tonghua County respectively, Jilin Province.

The Ji'An facility accommodates the early stages of the wine production process including crushing, pressing, fermentation, chaptalisation, filtering and stabilization. The overall site of around 6,555 sqm houses grape crushing, pressing machinery and 289 tanks (80 self-owned and 209 leased).

The semi-produced wine is transported to Tontine's Tonghua facilities for latter stage ageing, blending and bottling. The facility, which occupies an area of 58,343 sqm, houses 28 storage tanks and 2 fully automated bottling and packaging lines.

**Table 6. Tontine production capacity and utilisation**

	06A		07A		08A		1H 09A	
	Prod Vol (tonnes)	Avg Util (%)	Prod Vol (tonnes)	Avg Util (%)	Prod Vol (tonnes)	Avg Util (%)	Prod Vol (tonnes)	Avg Util (%)
Finished wine products	13,324	70.1	14,853	78.2	17,057	89.8	8,461	89.1

Source: Company data

**R&D for better quality and better taste.** Tontine is committed and places a strong emphasis on innovation, to continually improve the quality of its wine products. The company maintains a wine product development team of 7, led by its chief winemaker, Ms. Ji Chunhua. The team is responsible for the formulation of new wine series to broaden the company's existing product portfolio and improving on the taste and quality of existing wines. The team experiments with varying degrees of alcohol contents and flavours, conducts research on market trends and changing consumer tastes and also samples wines produced by other competitors to compare taste and quality of competitor's wine products.

In addition to in-house research and development, the company would also commission third parties e.g. Northwest A&F University (西北农林科技大学) to conduct research projects on new wine varieties and other related topics.

Budget-wise, the company's R&D expenditure is only nominal, given that R&D relating to winemaking is not capital intensive and is more of a matter of acquiring and utilizing the team's experience.

The company also has a dedicated package design team responsible for the design of all of the company's product packaging. Packaging design is important since in China, wine products (especially high end wines) are typically used as gifts during festive seasons. Moreover, product packaging can enhance the value of the wine products, reinforce brand image and increase the visibility of its wines at points-of-sales. Therefore, Tontine consistently tries to create new and attractive packaging corresponding to the respective target markets.

### Expansion strategy

Tontine has in place a series of expansion strategies to take the company's business to the next level and reinforce its sustainable growth. These include:

- Increasing production capacity;
- Develop wine cellar capabilities;
- Establish Tongtian Estate Wine label; and
- Reinforce brand equity through marketing.

**Increase production capacity by 105%.** The company plans to increase its wine production capacity by 105.3% to 39,000 tonnes (30 Jun 2009: 19,000 tonnes) by end-2010. The capacity increase will include completion of the facilities structure as well as procuring and installing the wine-making equipment. The new facilities are located adjacent to the company's existing plant in Tonghua County, Jilin. This current expansion commenced in Apr 2008. Progress to date has been slow as the expansion had been largely supported by internally generated cash flow. In our view, given Tonghua government's plans to increase the overall grape growing areas to 73.3m sqm (from 37.5m sqm in 2008), grape supply will unlikely be a bottleneck to Tonghua's additional production capacities.

**Develop wine cellar capabilities.** To complement its current wine production facilities, Tontine plans to construct an active wine cellar, where temperature and humidity are controlled. This will allow the company to not only maintain the quality of its wine, especially the

good vintages, during storage, but also provide a controlled environment for the stored wines to improve in aroma, flavour and complexity as they mature. The company plans to construct a wine cellar with a storage capacity of up to 2,000 oak barrels (each ~225L in volume). In our view, the availability of the wine cellar would aid the company in the development of high end products such as estate label wines and wines from good grape vintages.

**Establish Tontine Estate Wine label.** To move up the value chain and develop higher end wines, Tontine plans to start its own premium range of estate bottled wines. The term “estate wines” generally means that the wine’s: 1) winery and vineyards have to be in the same area; 2) vineyards have to be controlled or owned by the winery; and 3) the wine has to be made from start to finish at the winery. Estate wines typically has a higher level of quality, given the additional quality control stemming from the stricter control of both the vineyard and wine production process and is premium priced. Tontine plans to acquire a vineyard of ~2,000mu (target not yet identified) to develop grapes of premium quality with a target to yield between 500-600 tonnes of wine (400,000 to 480,000 750ml bottles) per year.

**Expand sales and distribution network and establish retail outlets.** Tontine plans to further expand its sales and distribution network by both increasing the amount of self-employed sales managers and third party distributors. In addition, the company will establish up to 20 Tongtian wine estate branded retail outlets (over a 4 year period). These outlets will have the functions of: 1) enhancing brand awareness and brand image; 2) function as direct sales and marketing channels to selective clients and 3) provide local marketing support to distribution partners in the surrounding area.

**Reinforce brand equity through marketing.** To further reinforce “Tongtian” and “Tongtian Hong” brand names among Chinese wine consuming consumers and solidify Tontine’s position as a leading producer of sweet wines in China, the company plans to increase its A&P spending going forward. Management plans to increase A&P spending across all media platforms including nationwide TV channels, new media (Internet, out-of-home etc) magazines, exhibitions and trade shows.

#### Historical finance

The company has recorded strong revenue growth with a CAGR of 31.4% to RMB486.7m from FY12/06A to FY12/08A. For 1H FY12/09A, the total revenue increased 17.8% YoY to RMB242.7m. Sweet wine growth has overtaken dry wine with a 35.6% CAGR of while the dry wine was increased at a 24.3% CAGR over the track record period. For 1H FY12/09A, the sweet wine sales increased 19.3% YoY to RMB165.5m while the dry wine sales increased 14.7% YoY to RMB77.2m. Sweet wine accounted for 68.2% of total sales (dry wine: 31.8%).

Tontine’s sweet wine growth was driven by a 16.7% CAGR in volume to 11,198 tonnes from FY12/06A to FY12/08A with a 16.1% CAGR in ASP to RMB28,700 per tonne. Sales volume of dry wine increased at a CAGR of 17.4% to 6,000 tonnes while its ASP only increased at a CAGR of 5.9% to RMB27,600 per tonne. For 1H FY12/09A, the sales volume of sweet wine increased 12.6% YoY to 5,654 tonnes with ASP up 6.2% to RMB29,300 per tonne. The sales volume of dry wine increased 12.8% YoY to 2,774 tonnes with ASP up 1.5% to RMB27,800 per tonne.

Table 7. P & L

Year to Dec (RMBm)	06A	07A	08A	1H08A	1H09A
<b>Revenue</b>					
Sweet Wine	174.8	239.9	321.4	138.7	165.5
Dry Wine	107.0	151.6	165.3	67.3	77.2
	<b>281.8</b>	<b>391.6</b>	<b>486.7</b>	<b>206.0</b>	<b>242.7</b>
Cost of sales	(140.5)	(182.6)	(209.8)	(89.4)	(105.3)
<b>Gross profit</b>	<b>141.3</b>	<b>209.0</b>	<b>276.9</b>	<b>116.6</b>	<b>137.4</b>
Other income	0.1	0.1	0.2	0.1	0.5
Selling and distribution expenses	(35.4)	(64.8)	(53.5)	(26.1)	(26.0)
Administrative expenses	(4.2)	(5.6)	(9.8)	(3.2)	(3.8)
Other expenses	-	-	(13.0)	-	(1.6)
Finance costs	(2.9)	-	-	-	-
<b>Profit before tax</b>	<b>99.0</b>	<b>138.7</b>	<b>200.9</b>	<b>87.4</b>	<b>106.6</b>
Income tax expense	(36.8)	(33.5)	(64.1)	(27.3)	(31.2)
<b>Net profit</b>	<b>62.2</b>	<b>105.2</b>	<b>136.8</b>	<b>60.1</b>	<b>75.4</b>

Source: Company data

**Table 8. Sales volume and ASP**

	06A	07A	YoY (%)	08A	YoY (%)	1H 08A	1H 09A	YoY (%)
Sweet wine								
Vol (tonnes)	8,216	10,172	23.8	11,198	10.1	5,020	5,654	12.6
ASP(RMBk/t)	21.3	23.6	10.8	28.7	21.6	27.6	29.3	6.2
Dry wine								
Vol (tonnes)	4,352	5,629	29.3	6,000	6.6	2,459	2,774	12.8
ASP(RMBk/t)	24.6	26.9	9.3	27.6	2.6	27.4	27.8	1.5
Total								
Vol (tonnes)	12,568	15,801	25.7	17,198	8.8	7,479	8,428	12.7
ASP(RMBk/t)	22.4	24.8	10.5	28.3	14.2	27.5	28.8	4.5

Source: Company data

Tontine's production costs mainly includes: 1) production raw material of grape; 2) grape juice; 3) yeast and other additives; 4) packaging material; 5) production overheads; 6) consumption tax and other tax. For 1H FY12/09A, these items accounted for 40.5%, 5.0%, 3.8%, 24.5%, 2.9%, and 23.0% respectively of total costs. The total cost increased at a CAGR of 22.2% from FY12/06A to FY12/08A, which is slower than the revenue growth benefiting from scale effect and relatively stable raw material cost for tontine. Because the ASP of sweet wine has improved faster than dry wine, its gross margin has also improved more than dry wine with 8.8 pcp increase to 52.8% from FY12/06A to FY12/08A and further improved 0.2 pcp YoY for 1H FY12/09A. The gross margin of dry wine increased 5.4 pcp to 56.9% from FY12/06A to FY12/08A with a slight drop of 0.1 pcp YoY to 64.4% for 1H FY12/09. Overall gross margin increased 6.7 pcp to 56.9% from FY12/06A to FY12/08A and maintain stable at 56.6% for 1HFY12/09A comparing to 1H FY12/08A.

**Table 9. Cost structure breakdown**

	06A	%	07A	%	08A	%	1H08A	%	1H09A	%
Raw material										
Grape	50.9	36.2	71.3	39.1	84.0	40.0	34.9	39.0	42.7	40.5
Grape juice	12.3	8.8	10.4	5.6	9.9	4.8	4.8	5.4	5.3	5.0
Yeast & others	4.4	3.2	6.1	3.3	7.6	3.6	3.5	3.9	4.0	3.8
Packaging	35.3	25.1	45.2	24.8	52.5	25.0	22.5	25.1	25.8	24.5
Others	0.4	0.3	0.5	0.3	0.8	0.4	0.3	0.3	0.3	0.3
Subtotal	103.3	73.6	133.5	73.1	154.8	73.8	65.9	73.7	78.1	74.1
Others										
Prod'n o/heades	4.7	3.3	5.6	3.1	6.3	3.0	2.9	3.3	3.0	2.9
Tax	32.5	23.1	43.5	23.8	48.7	23.2	20.6	23.0	24.3	23.0
Subtotal	37.2	26.4	49.1	26.9	55.0	26.2	23.5	26.3	27.3	25.9
<b>Total</b>	<b>104.5</b>	<b>100.0</b>	<b>182.6</b>	<b>100.0</b>	<b>209.8</b>	<b>100.0</b>	<b>89.4</b>	<b>100.0</b>	<b>105.3</b>	<b>100.0</b>

Source: Company data

**Table 10. Gross Margin breakdown**

	06A	07A	08A	1H 08A	1H 09A
Sweet wine					
Gross profit (RMBm)	77.7	113.5	169.6	73.2	87.7
Margin (%)	44.4	47.3	52.8	52.8	53.0
Dry wine					
Gross profit (RMBm)	63.7	95.5	107.3	43.4	49.7
Margin (%)	59.5	63.0	64.9	64.5	64.4
Total					
Gross profit (RMBm)	141.3	209.0	276.9	116.6	137.4
Margin (%)	50.2	53.4	56.9	56.6	56.6

Source: Company data

Tontine's net profit increased at a CAGR of 48.3% to RMB136.8m from FY12/06A to FY12/08A. For 1H FY12/09A, net profit increased 25.4% YoY to RMB75.4m. The net margin of the company improved 6.0 pcp YoY to 28.1% from FY12/06A to FY12/08A. From FY12/06A to FY12/07A, the net margin increased 4.8 pcp YoY to 26.9% because 3.2 pcp YoY improvement in gross margin and the decreased of 13.1 pcp YoY in effective tax rate offset the increase of 4.0 pcp YoY in selling and distribution expenses. From FY12/07A to FY12/08A, the net margin further improved 1.2 pcp YoY due to the 3.5 pcp YoY improvement in gross margin, 5.6 pcp YoY decrease in selling and distribution expenses rate although the effective tax rate increased 7.8 pcp YoY. The net margin further improved 0.8 pcp YoY to 31.0% for 1HFY12/09A because of lower selling and distribution expenses rate and effective tax rate.



Peers comparison

We have constructed a peer group to include six Chinese red wine companies: China Food (506 HK), Dynasty (828 HK), Changyu (000869 CH), CITIC Guoan Vine (600084 CH), Tongpu (600365 CH) and Mogao (600543 CH). Changyu (“张裕”), Great Wall (“长城”, under China Food) and Dynasty (“王朝”) are the top three red wine brands in China while the three others · Suntime (“新天”, under CITIC Guoan Vine), Tonghua (“通化”, under Tongpu) and Mogao (“莫高”), are tier-two brands. Tongpu might be the closest comparable as it is also engaged mainly in producing sweet wine in Tonghua, though the company is undertaking a major merge with Yunnanhong (“云南红”) Group, another tier-two red wine brand. Where tier-one brands have vineyards nationwide to secure themselves with abundant grape supply, smaller brands usually are confined to a certain region, which surely constrains breadth of their product portfolios. Nevertheless, for Tontine in particular, we take this regard as a key factor to create the company’s niche given: 1) almost nil presence of tier-one brands in Tonghua and so does their exposure to mountain grape-made wine; 2) Tontine’s leading position in this sub-market (although there are 97 wine makers in Tonghua, only nine are sizable. Tontine is the largest one, controlling 25.3% of the city’s aggregate production capacity and 38.9% of local wine-used mountain grape vineyard).

Table 11. Peers group

Company	Ticker	Main products	Major brands	Vineyard location
Tontine	389 HK	Sweet, Dry	Tongtian, Tongtian Hong	Jilin
Tongpu	600365 CH	Sweet, Dry	Tonghua, Yunnanhong	Jilin, Yunnan
CITIC Guoan Vine	600084 CH	Dry	Xintian	Xinjiang
Mogao	600543 CH	Dry	Mogao	Gansu
Changyu	000869 CH	Dry, Brandy	Changyu	Shandong, Xinjiang, Ningxia, Shaanxi, Liaojing, Beijing
China Food	506 HK	Dry, Brandy dry	Great wall	Hebei, Shandong
Dynasty	828 HK	Dry	Dynasty	Tianjin, Shandong, Hebei, Ningxia

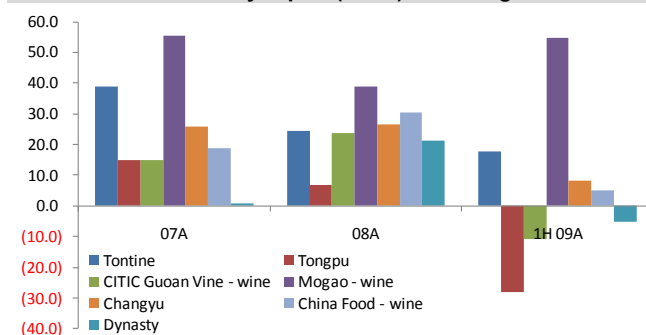
Source: Companies data

Thanks to its leading position as a major supplier of mountain grape-made wine, Tontine achieved a turnover of RMB242.7m in 1H FY12/09A, following the top three brands and ranking No. 4 (without consideration the merger of Tongpu and Yunnanhong as the deal has not completed yet). Growth pattern remained solid in the track record period. Top line grew at 31.4% CAGR from FY12/06 to FY12/08A and 17.8% in 1H FY12/09A, versus the peer group’s 18.2% and 4.0%.

Gross margin was 56.6% in 1H FY12/09A, behind only Changyu and Great Wall. We contribute this again to the company’s successful market positioning as a niche player as well as its well established product portfolio. Almost all brands have experienced margin expansion since FY12/06A, implying an upward movement in consumption to higher-end products buoyed by the rising living standard in China. We reckon this trend could be sustainable in middle-term, subject to each company’s ability in building up brand reputation and rolling out new products.

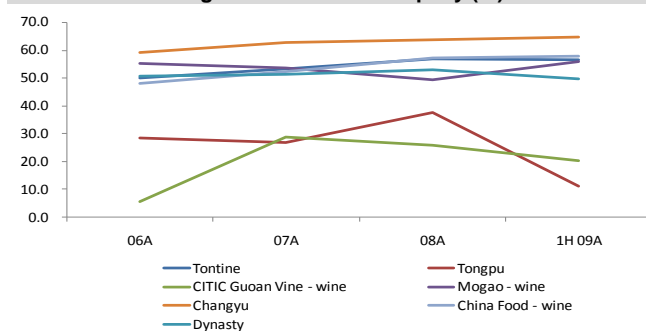
Tontine’s operating margin stood high at 43.9% in 1H FY12/09A, implying 12.7% of sales as operating expenses, which was lower than the top three brands’ 35.5% but broadly in line with tier-two brands (Tongpu: 19.4%, CITIC Guoan Vine: 35.0%, Mogao: 17.4%). We think a main reason is that top brands need substantial marketing expenses to maintain brand image, which, in turn, underpins their operation scale and gross margin. Thus, we can reasonably assume that Tontine’s marketing expenses will rise gradually and enlarging sales scale and improving gross margin will offset associated negative impact on bottom line.

Chart 1. China’s monthly export (US\$b) and YoY growth in 2009



Source: China Customs

Chart 2. Gross margin of each wine company (%)



Source: Companies data

Table 12. Margins (%) and operating expenses

	Tontine	Tongpu	CITIC Guoan Vine *	Mogao*	Changyu	China Food - wine	Dynasty
Gross margin (%)	56.6	11.1	16.8	36.6	64.6	57.9	49.8
Operating margin (%)	43.9	(8.3)	(18.2)	19.2	29.6	19.7	19.2
Opex (% of sales)	(12.7)	(19.4)	(35.0)	(17.4)	(35.1)	(38.2)	(30.7)

Source: Companies data

Note: \* figures of entire companies instead of wine divisions only

## Forecasts and valuation

**Earnings estimate.** We estimate that the revenue would increase 19.3% YoY to RMB580.9m for FY12/09F, 15.3% YoY to RMB670.0m for FY12/10F, and 23.5% YoY to RMB827.2m for FY12/11F with sweet wine up 23.1%, 17.3%, and 28.1% respectively and dry wine up 12.0%, 11.1%, and 13.0% respectively. The growth is driven by a combination of increased sales volume (facilitated by the company's expanded capacity) and rising ASP on a gradual shift in product mix to higher margin products.

Sweet wine products will be the company's key growth driver. For sweet wine, we estimate that volume will increase 11.5%, 15.0%, and 22.0% for FY12/09F, FY12/10F, FY12/11F respectively and ASP would be up 10.5%, 2.0%, and 5.0% respectively. Meanwhile, our estimates for the dry wine segment are more moderate. We project that the volume will increase 8.2%, 10.0%, and 12.0% for FY12/09F, FY12/10F, FY12/11F respectively and ASP would be up 3.4%, 1.0%, and 0.9% respectively.

Our estimate is based on the following assumptions:

- We expect that Tontine's sales volume and ASP in 2H FY12/09F would exceed 1H FY12/09A on: 1) seasonal stronger 2H ; 2) recovering macro economic conditions and 3) improvement in product mix;
- For FY12/10F, we would expect the company to get some extra capacity by increasing the working hour of current facility. However, capacity constraints (the new capacity would be completed at the end of the year) could be possible to lead Tontine's sweet wine sales slightly lagging industry average YoY growth of 23.8% (based on forecast by China Investment Consulting). Dry wine sales growth is expected to be even slower given the company's focus on sweet wine. We expect the ASP would still have room for improvement because of the potential in increasing selling price and shift towards the higher margin product; and
- We expect that Tontine's sweet wine sales in FY12/11F would exceed the industry average YoY growth of 17.1% with the completion of new capacity and as company begins to reap benefits from its market efforts.

**Table 13. Tontine production capacity and utilisation**

	09F		10F		11F	
	Prod Vol (tonnes)	Avg Util (%)	Prod Vol (tonnes)	Avg Util (%)	Prod Vol (tonnes)	Avg Util (%)
Finished wine products	18,973	99.9	21,494	100%	25,509	65.4
Total capacity	19000		21,494		39000	

Source: Company data, SBI E2-Capital

**Table 14. Sales volume and ASP**

	09F	YoY (%)	10F	YoY (%)	11F	YoY (%)
Sweet wine						
Vol (tonnes)	12,480.7	11.5	14,352.8	15.0	17,510.4	22.0
ASP(RMBk/t)	31.7	10.5	32.3	2.0	34.0	5.0
Dry wine						
Vol (tonnes)	6,492.1	8.2	7,141.3	10.0	7,998.2	12.0
ASP(RMBk/t)	28.5	3.4	28.8	1.0	29.1	0.9
Total						
Vol (tonnes)	18,972.7	10.3	21,494.0	13.3	25,508.6	18.7
ASP(RMBk/t)	30.6	8.2	31.2	1.8	32.4	4.0

Source: Company data, SBI E2-Capital

Due to the continuing improvement in ASP and favourable shift in product mix, we would expect gross margin to further improve to 57.1%, 57.8%, and 58.7% for FY12/09F, FY12/10F, and FY12/11F. We estimate that the selling and distribution expenses rate would be 9.9%, 12.9%, and 13.4% for FY12/09F, FY12/10F, and FY12/11F respectively given the company's intentions to put more effort in brand building and market promotion.

Overall, we expect that the net profit would increase 30.2% YoY to RMB178.1m for FY12/09F, 18.9% YoY to RMB211.8m for FY12/10F, and 27.9% YoY to RMB270.9m for FY12/11F.

Table 15. P &amp; L forecast

Year to Dec (RMBm)	07A	08A	09F	10F	11F
<b>Revenue</b>					
Sweet Wine	239.9	321.4	395.6	464.3	594.7
Dry Wine	151.6	165.3	185.2	205.7	232.5
	<b>391.6</b>	<b>486.7</b>	<b>580.9</b>	<b>670.0</b>	<b>827.2</b>
Cost of sales	(182.6)	(209.8)	(249.0)	(283.0)	(341.6)
<b>Gross profit</b>	<b>209.0</b>	<b>276.9</b>	<b>331.9</b>	<b>386.9</b>	<b>485.6</b>
Other income	0.1	0.2	1.5	6.7	8.3
Selling and distribution expenses	(64.8)	(53.5)	(57.7)	(86.7)	(111.2)
Administrative expenses	(5.6)	(9.8)	(12.2)	(16.7)	(19.0)
Other expenses	0.0	(13.0)	(16.0)	-	-
Finance costs	-	-	-	-	-
<b>Profit before tax</b>	<b>138.7</b>	<b>200.9</b>	<b>247.4</b>	<b>290.2</b>	<b>363.7</b>
Income tax expense	(33.5)	(64.1)	(69.2)	(78.4)	(92.7)
<b>Net profit</b>	<b>105.2</b>	<b>136.8</b>	<b>178.1</b>	<b>211.8</b>	<b>270.9</b>

Source: Company data, SBI E2-Capital

**Valuation.** Grape wine consumption has been rising rapidly in China since 2000. As a reference, production volume grew at a CAGR of 16.9% from 2000 to 2008. Nevertheless, per capita consumption is still far below its Asian neighbors, which, in 2008, was 0.53L in China, versus 1.3L in Korea, 1.9L in Singapore and 2.3L Japan. Combined with the country's robust economy growth, we believe it is rational to predict that the mid-teen volume growth rate will be sustainable. Our calculation shows, assuming a CAGR of 15%, per capita grape wine consumption in China will reach 1.4L in 2015, 1.9L in 2017 and 2.5L in 2019. Accordingly, we have defined our two-stage DCFE model. The first stage is from FY12/09F to FY12/15F with organic growth rate at 15.0% p.a. and the second stage from FY12/16F and afterwards with 2.0% growth rate perpetually. Under 12.0% market discount rate, Tontine's fair price is HK\$2.03, representing 19.6x FY12/09F and 16.5x FY12/10F P/E based on our earnings estimates.

Table 16. DCF valuation reference table

Discount Rate	Terminal Growth				
	0.5%	1.0%	1.5%	2.0%	2.5%
11.0%	2.10	2.16	2.22	2.29	2.38
12.0%	1.88	1.92	1.97	2.03	2.09
13.0%	1.69	1.73	1.77	1.81	1.86
14.0%	1.54	1.57	1.60	1.63	1.67

Source: SBI E2-Capital

From a comparison prospective, the A-share listed peer group is trading at 63.2x one-year forward P/E and 44.2x two-year forward P/E after excluding Tongpu and Citic Guoan Vine, which are under restructuring. Hong Kong Listed peers is trading at 24.6x one-year forward P/E and 19.9x two-year forward P/E. Compared with Changyu, Mogao unveiled a valuation premium on tier-two brands, which might be backed by their greater upside potential. Although Tontine is smaller than other Hong Kong market listed peers, China Food and Dynasty, we would think that it would trade at a close valuation to Hong Kong market listed peers. Hence, we would apply a 10% premium on our DCF-derived fair value for a target price of HK\$2.23, representing 21.5x FY12/09F and 18.1x FY12/10F. BUY.

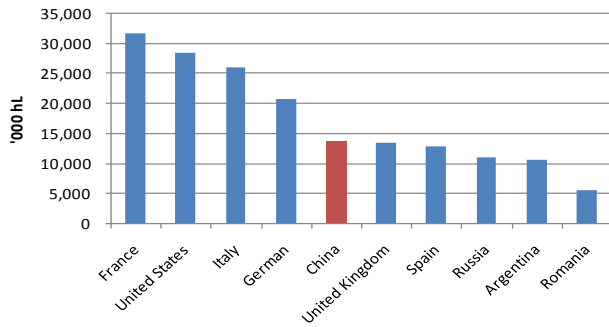
Table 17. Valuation comparison

Company name	Ticker	Mkt cap (US\$m)	Last Price (Local)	His P/E (x)	1-Yr P/E (x)	2-Yr P/E (x)	PB (x)	Est ROE (%)
HK-listed								
China Food	506 HK	2490.8	6.96	35.8	28.5	21.9	3.7	10.0
Dynasty	828 HK	402.2	2.52	26.1	20.7	18.0	1.7	8.7
<i>Average</i>				31.0	24.6	19.9		
China-Listed								
Tongpu	600365 CH	241.8	11.79	1149.1	294.8	67.4	8.5	1.1
CITIC Guoan Vine	600084 CH	1247.0	10.51	-	11.3	8.0	7.9	-
Mogao	600543 CH	617.7	13.13	151.2	89.3	57.8	4.2	6.7
Changyu	000869 CH	5472.3	76.02	38.6	37.1	30.5	15.2	37.5
<i>Average</i>				446.3	108.1	40.9		
<i>Average*</i>				94.9	63.2	44.2		

\*exclude the Tongpu and CITIC Guoan Vine

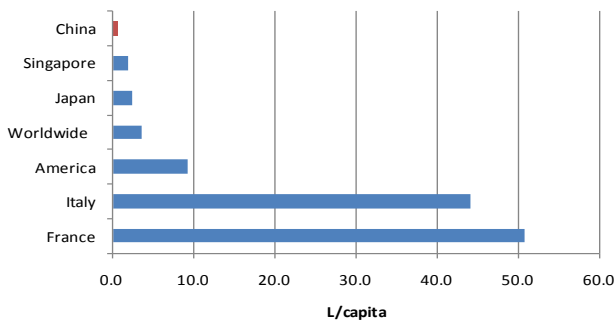
Source: Bloomberg

**Chart 4. Top 10 wine consumption countries**



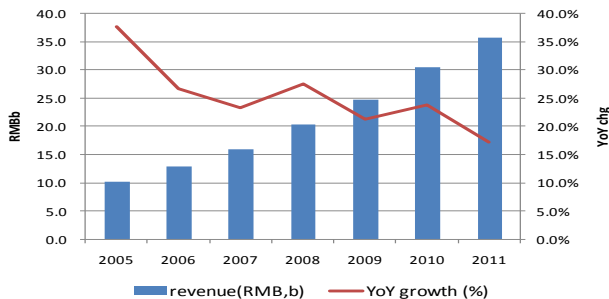
Source: OIV

**Chart 3. Per capita consumption of wine**



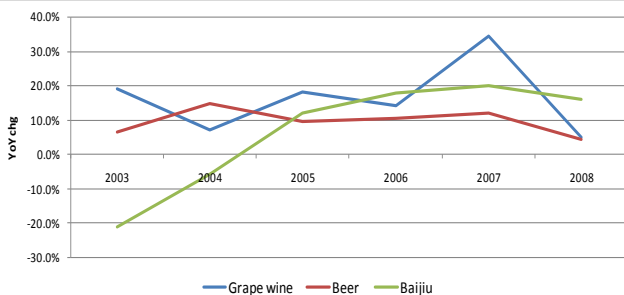
Source: SBI E2-Capital

**Chart 5. 2005A to 2011F revenue of domestic grape wine manufacturer**



Source: China Investment Consulting

**Chart 6. 2003-2005 grape wine, beer and baijiu production growth**



Source: 2003-2005 grape wine, beer and baijiu production growth

**Chinese wine market**

According to the International Organization of Vine and Wine (OIV), China is the world's fifth largest consumer of wine. The top 10 wine consuming countries accounted for 71.1% of worldwide consumption with China accounting for 5.6%. Despite the large overall volume of consumption, the per capita annual consumption of grape wine in China was about 0.53 litres in 2008, and far below the worldwide average of 3.5 litres. China has been an attractive market for the grape wine industry. Based on our estimates, grape wine consumption volume in China increased at a 3-year CAGR of around 21.0% from 2005 to 2008 while the worldwide consumption volume growth was only about 0.8%. This secular growth can be sustainable long term in our view given: 1) low per capita consumption; 2) rising disposable income and affluent; 3) emergence of wine drinking culture for both social and health purposes.

Domestic produced wines accounted for about 88.6% of the market share in China in 2008. Traditionally, domestic wines have dominated imported wines due to pricing and distribution channels advantages. The revenue of domestic grape wine producers increased at a 3-year CAGR of 25.8% to RMB20.4b from 2005 to 2008. According to third party independent researcher China Investment Consulting (中投顾问), revenue of domestic producers would maintain a 3-year CAGR of 20.7% to RMB35.8b from 2008 to 2011.

The grape wine market is still in its emerging phase in China. In production volume terms, grape wine production volume amounted to only accounted for 1.7% of beer production volume and 12.2% of baijiu production volume in China in 2008. With its lower base, not surprisingly, the 5-year CAGR of 15.3% of the grape wine industry in China exceeded both baijiu (11.5%) and beer (10.5%). We expect the long term secular growth trend in China would be driven by a number of factors including:

- Rising disposable income;
- Growing urbanization;
- Increased switching to wine as the preferred alcoholic beverage, from baijiu and beer, as awareness in wine's health benefits increases.

Grape wine industry was impacted the most during the global economic downturn in 2008. Growth in that year moderated to 5.0% from 34.3% growth in 2007. In our view, this slowdown was due to a combination of worsening macro conditions (at the time) as well as competition from foreign wines. Meanwhile, beer production growth moderated to 4.4% (from 11.8% in 2007) and baijiu production growth moderated to 15.8% (from 19.8% in 2007).

However, we think that this slowdown in the pace of growth has bottomed out and China's grape wine production looks set to return to a sustainable high growth going forward. On a HoH basis, 2H 2008 production fell to 321.8k tonnes, from 376.5k tonnes in 1H 2008, representing a contraction of 14.5% HoH despite a usually seasonal stronger 2H. However, the industry has since rebounded. 1H 2009 production volume reached 398.9k tonnes, rebounding 24.0% HoH and 5.9% YoY.

Chart 7. China main grape wine production provinces



Source: SBI E2-Capital

China currently has about 990,000 mu lands for growing wine grapes. They are located in 10 different regions. Northeast region, which mainly include Jilin province, accounted for about 6.1% of total wine grape growing land in China. Top 9 provinces accounted for 95.5% of total production in China. Among them, the production volume in Jilin province had been growing fastest with a 2-year CAGR of 95.7% from 2006 to 2008. Its market share in terms of production volume in China had increased to 15.8% in 2008 from 5.8% in 2006.

Table 18. 10 wine grape growing regions in China

Wine grape growing region	Land size (mu)	% of total	Type of grape wine	Climate
Shandong Peninsula region (胶东半岛产区)	250,000	25.3	dry wine	continental monsoon climate with Bohai Bay characteristics
Xinjiang region (新疆产区)	250,000	25.3	dry wine and sweet wine	temperate with arid/semi-arid climate
Changli and Tianjin region (昌黎和天津产区)	160,000	16.2	dry wine	semi-humid continental climate
Eastern Helan Mountain region (贺兰山东麓产区)	80,000	8.1	dry wine	temperate with semi-arid climate
Huai Zhuo Basin region (怀涿盆地产区)	70,000	7.1	dry wine	dry temperate with continental monsoon
Northeast region (东北产区)	60,000	6.1	mountain grape wine icy wine	cold and semi-humid/humid climate
Hexi corridor region (河西走廊产区)	50,000	5.1	dry wine, sweet wine and icy wine	continental arid climate
Southwest region (西南产区)	30,000	3.0	dry wine and wild grape wine	subtropical plateau monsoon/ subtropical humid climate
Yellow river region (黄河故道产区)	20,000	2.0	dry wine	warm-temperate with semi-humid climate
Loess Plateau region (黄土高原产区)	20,000	2.0	Dry wine	warm-temperate with semi-humid continental climate
<b>Total</b>	<b>990,000</b>	<b>100.0</b>		

Source: www.chinawine.com

Table 19. grape wine production volume analysis in province level

Provinces	2006 k,tonnes	% of total	2007 k,tonnes	% of total	YoY (%)	2008 k,tonne	% of total	YoY (%)	2-year CAGR(%)
Shandong province	230	46.4	256	38.4	11.3	281	40.2	9.9	10.6
Hebei province	106	21.3	92	13.9	-12.6	99	14.2	7.5	-3.1
Tianjin province	42	8.5	42	6.2	-1.0	45	6.5	9.3	4.0
Jilin province	29	5.8	46	6.9	60.6	110	15.8	138.4	95.7
Henan province	27	5.4	134	20.2	398.2	69	9.9	-48.7	59.9
Beijing municipal city	16	3.1	18	2.7	14.1	16	2.3	-10.5	1.0
Gansu province	9	1.8	11	1.6	20.5	15	2.1	39.9	29.8
Ninxia	12	2.5	20	3.0	63.1	14	2.0	-30.4	6.5
Xinjiang	7	1.4	9	1.4	28.0	17	2.5	90.7	56.2
<b>Total</b>	<b>477</b>	<b>96.3</b>	<b>628</b>	<b>94.4</b>	<b>28.0</b>	<b>667</b>	<b>95.5</b>	<b>90.7</b>	<b>18.2</b>
<b>China total</b>	<b>495</b>		<b>665</b>		<b>34.3</b>	<b>698</b>		<b>5.0</b>	<b>18.8</b>

Source: National bureau of statistics of China and SBI E2-Capital

## Regulations

In January 2008, new national standard for grape wine manufacturing came into effect. The new standard increases regulation and oversight in the grape wine industry. It clearly defines the scope of information to be displayed on the wine bottle.

Amongst others, the new standard mandates that at least 80% of the grapes shall be harvested in the vintage year as labeled on the bottle. Furthermore, the new standard also requires winemakers to display detailed ingredients use in producing the grape wine. In our view, the new standards will promote a better image of the wine industry and increase transparency. This would be favorable to the quality manufacturers, such as Tontine and gradually weed out fake grape wine producers.

Other key regulations related to wine industry are as follows:

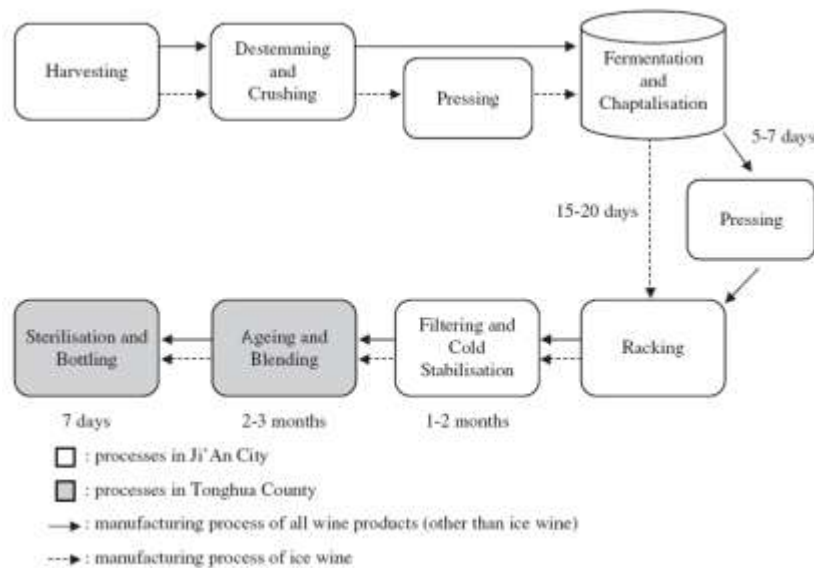
- ❑ The Alcohol Circulation Administration Rules promulgated by the Ministry of Commerce on 7 November 2005 came into effect on 1 January 2006;
- ❑ The Food Safety Law of the PRC promulgated by the Standing Committee of the National People's Congress on 28 February 2009 and took effect from 1 January 2009;
- ❑ The Law on Food Hygiene of the PRC promulgated by the Standing Committee of the national People's Congress on 30 October 1995;
- ❑ The Rule on Food Hygiene Permit promulgated by the Ministry of Health of PRC effective on 1 June 2006;
- ❑ The Administration Regulations on the Production Permit for Industrial Products promulgated by the State Council of PRC effective on 1 September 2005;
- ❑ The Provisional Rules on the Release of Food Advertisement promulgated by the State Administration for Industry and Commerce on 30 December 1996 as amended on 3 December 1998;
- ❑ Advertisement Administration Rule for Alcohol promulgated by the State Administration for Industry and Commerce on 17 November 1995; and
- ❑ The Trademark Law of the PRC amended as of 27 October 2001 and came into effect on 1 December 2001.

## Risks

- ❑ Competition – China's wine industry remains a fragmented one, with a high degree of competition. If the company is not responsive to changing market demand and competition, the company may not be able to realize its growth potential.
- ❑ Consumer confidence in the "Tongtian" ("通天") and "Tongtian Hong" ("通天红") brands – Consumer confidence in the equity of Tontine's brands is critical to the company's success. Should consumer confidence in the brands be adversely affected, either as a result of their own fault (e.g. wine contamination, deterioration) or by third party (e.g. counterfeit Tontine branded wines, sabotage etc), the company's earnings may be seriously affected.
- ❑ Capacity ramp up execution – Should there be delays to the completion of Tontine's production capacity expansion plans, the company would face production bottlenecks and may be unable to meet rising demand.
- ❑ Operational deleveraging from additional marketing costs – Should the company significantly increase A&P costs beyond the rise in the company's revenues, Tontine may face operational deleveraging and may face margin pressure.
- ❑ Supply of quality grapes from Tonghua region – Should there be any force majeure events (droughts, floods etc) that would affect the crop of the 173 farmers in Ji'An with which Tontine has signed supply agreements, the company may potentially face grape sourcing bottlenecks leading to the inability to meet demand.
- ❑ Trademark registration – The company has submitted a trademark application for the "Tongtian Hong" ("通天红") brand.

## Appendix I: Wine production process

Chart 10: Wine production process



Source: Company data

- Harvesting – The harvest season of grapes is between September and November of each year. When the harvest seasons approach, company will inspect and test the natural sugar level of the grapes in the vineyards of Ji'An City in order to determine whether they are of a desired balance. The grapes are handpicked by the grape farmers at the vineyard and are then carefully collected in buckets or crates and transported to our winery facility in Ji'An City.
- Destemming and Crushing – Once delivered to the winery facility in Ji'An City, the grapes are destemmed and crushed by grape crushing and pressing machines. Destemming is the process of removing the grapes from the main stem which holds each bunch of grapes. Crushing is the process of squeezing the grapes and breaking the skins. The freshly extracted grape juice, together with the skin and pulp pips is called the must. The solid, pulp portion of the must is called pomace and can provide the necessary colour for red wines.
- Fermentation and Chaptalisation – Extracted grape juice is pumped into stainless steel fermentation tanks for alcoholic fermentation with yeast at a specific temperature. The fermentation is initiated by yeast which converts the sugar into alcohol and carbon dioxide gas. The length of the fermentation process depends on the style of wine being made. Chaptalisation is a process that involves the adding of sugar to unfermented grape must in order to increase the alcohol content as required after fermentation.
- Pressing – The pomace is removed from the grape juice. The pomace is then pressed to extract the remaining juice. For ice wine production, because of its nature, the frozen mountain grapes are pressed to extract more juice immediately after destemming and crushing.
- Racking – During the racking process, yeast settled to the bottom of the tank is removed. This process may take place several times before the wine becomes clear. The grape juice has now become base wine, and is pumped out of the tank, leaving the yeast and sediment behind at the bottom of the container.
- Filtering and Cold Stabilisation – The base wine will undergo an extensive filtering process, where unwanted fine sediments are removed. After the filtering process is completed, the wines are then delivered to temperature-controlled stainless steel containers for further processing. Cold stabilisation removes tartrate crystals which are natural products that form when the wine gets too cold.
- Ageing and Blending – The base wine is then transported to Tontine's production facilities in Tonghua County, Jilin Province, to be stored in our stainless steel storage tanks for about 4 to 6 months for ageing. Blending refers to blending different batches of wines before bottling in order to achieve the desired taste.
- Sterilisation and Bottling – Once the ageing and the blending is completed, the wine has to go through stringent germfree filtration and assessment before bottling and packaging. Tontine has 2 bottling lines using advanced equipment to bottle, cork and label finished wine products.

Appendix II: Snapshots of operations

Photo: Tonghua facility and main office building



Photo: Bottling operations (Tonghua)



Photo: Ageing tanks (Tonghua)



Photo: Fermentation tanks (Ji'An)



Photo: Grapes ready for crushing (Ji'An)



Photo: Wild mountain grapes (Ji'An)



Photo: Tontine wine products on retail shelves



Photo: Tontine wine products on retail shelves





## Appendix III: Company profile

**Business background**

Established in 2001, Tontine is one of the leading grape wine producers in China. Its signature wines are its sweet red wines produced from the indigenous grapes native to Tonghua region in Jilin Province. Its wines are sold in 19 provinces and 3 municipal cities via nationwide sales network and distribution channels.

**Shareholding structure (post IPO)**

	(%)
Mr. Wang Guangyuan	39.3
Other founding management	21.6
Public	39.1
Total	100.0

**Management team**

**Mr. Wang Guangyuan, Founder, Chairman and CEO.** He is responsible for overall business strategy and development and management of the company. He worked for Tonghua Winery Limited (600365 CH) for 14 years before he established Tontine with other founders in 2001.

**Mr. Zhang Hebin, Founder and Executive Director.** He is responsible for sales, marketing and products promotion. He worked for Tonghua Winery Limited (600365 CH) for 16 years before he established Tontine with other founders in 2001.

**Ms. Wang Lijuan, Founder and Executive Director.** She is responsible for overall administration and human resource matters of the company. She worked for the Industry and Commerce Bank of China Tonghua Branch for 15 years before she established Tontine with other founders in 2001.

**Ms. Ji Chunhua, Founder and Chief Winemaker.** She is responsible for product development, production and quality control. She worked for Tonghua Winery Limited (600365 CH) for 21 years before she established Tontine with other founders in 2001.

**Mr. Kwok Yuen Ying, Riki, CFO.** He is responsible for the financial and accounting management of the company. Before joining the company in 2007, he was the company secretary and financial controller for Daqing Petroleum and Chemical Group Limited (362 HK).

**Corporate milestones**

- 2003: Expand the capacity to 10,450 tonnes.
- 2004: Expand the capacity to 19,000 tonnes.
  - Award Tontine's grape wine product as "Wine of Excellent Quality".
  - Confer five of "Tongtian" and "Tongtian Hong" labeled wine as the "Green Food-Class A" certification.
- 2005: Installation of 22 additional 100 tonne wine storage tanks.
  - Award for "Tongtian" label as "Famous Product of Jilin Province".
- 2006: Awarded the Geographic Indication Protected Products of the PRC (GI Products).
- 2007: Converted into a wholly foreign-owned enterprise in preparation towards the listing of the company.
  - Awarded both the "Top 500 Brands of the PRC" and "Top 10 PRC Grape Wine Industry Brands".
- 2008: Commenced construction of additional facility for additional 20,000 tonnes, (expected to finished at end-2010)

**Corporate governance issues**

The Group will publish half year results with effect from FY12/09 to enhance transparency.

Audit committee (to review and supervise the financial reporting process and internal control system), executive committee (to implement group strategy and run day-to-day operation) and human resources committee (to oversee and implement the general human resource strategy) are set up.

**Use of proceeds**

	% of total
Expanding annual capacity by 20,000 tonnes	31.1
Establishment of Tongtian Estate Wine label	18.6
Development of wine cellar facilities	12.4
Developing and increasing awareness of brand	18.6
Expanding of distribution network	9.3
General working capital	10.0
Total	
100.0	

**Staff count**

A total of 362 staffs in different locations, of which:	
Management	10
Control and compliance	1
Production	267
Technical and product development	9
Sales and marketing	36
Finance	7
Procurement	7
Human resource and administration	25

**Expansion plans**

- Increasing production capacity by 105%.
- Develop wine cellar capabilities
- Establish Tongtian Estate Wine label.
- Expand sales and distribution network
- Reinforce brand equity through marketing

**Appendix IV: Qualitative analysis**

**Strengths**

Strategically located production facilities and access to good quality grapes.

Recognition of the “Tongtian” and “Tongtian Hong” brand names for niche sweet wine products in PRC.

Extensive nationwide sales and distribution network in PRC.

Experienced management team with extensive experience in the PRC wine industry.

Strong quality management system and the production of quality wine

**Opportunities**

Increasing switching to grape wine as the preferred alcoholic beverage from baijiu and beer, as consumers become increasingly aware of grape wine’s health benefits.

Rising disposable income and growing urbanization in China would increase the demand for grape wine.

Popular of sweet wine would encourage of sales of Tontine’s product.

Increasing “Tongtian” and “ Tongtian Hong” brand recognition in China by more marketing efforts.

**Competitors**

Other grape wine manufacturers in Jilin province, such as Tonghua Winery Ltd., Chang Bai Shan Wine holding Co. Ltd, and etc.

Other top 10 grape wine manufacturers, such as Changyu, Dynasty and etc., though these do not focus on sweet wine

Imported sweet wine from different countries, such as France, Canada and etc.

**Customers**

The products are sold through 71 distributors to third-party retailers, including supermarkets, specialty stores selling tobacco and alcohol, and food and beverage outlets such as restaurants.

The distributors also sold the product to end-consumers and other sub-distributors.

The products are sold in 19 provinces and 3 municipal cities in the PRC.

Five largest distributors together accounted for 10.9% of total sales for 1H FY12/09.

**Weaknesses**

Rely on the consistent and sufficient supply of quality grapes and grape juice.

Rely on the distributors and third-party retailers for the sales of the product to end-customers.

**Threats**

Third party claims for possible infringement of intellectual property rights.

Changes in the economic, political and social conditions in PRC.

Keen competition in wine industry.

Increasing imported wine product.

**Entry barriers**

High requirement in obtaining all related government approvals.

High standards required in food safety and hygiene.

Difficulty in securing stable, quality and sufficient grape resources.

Difficulty in branding building.

Difficulty in establishing the extensive distribution channels nationwide.

**Suppliers**

Secured 20 years exclusive supply agreements with 173 grape farmers for Tontine’s grape resources in Tonghua.

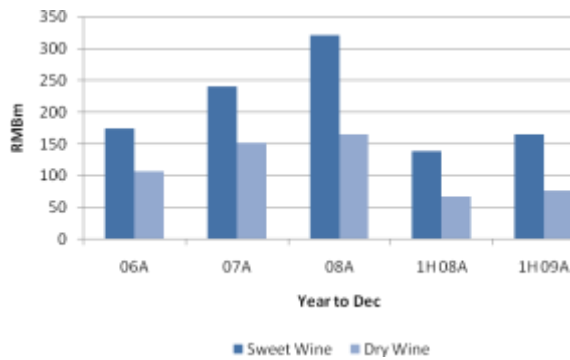
A pre-approved list of suppliers for raw material other than grapes.

Five largest suppliers together accounted for 65.7% of total raw material supply for 1H FY12/09.

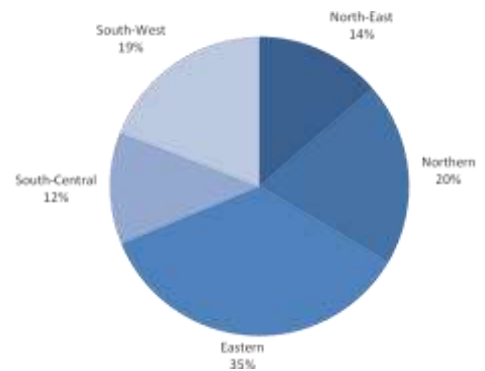
The largest supplier accounted for 16.3% of total raw material supply for 1H FY12/09.

Appendix V: Financial analysis

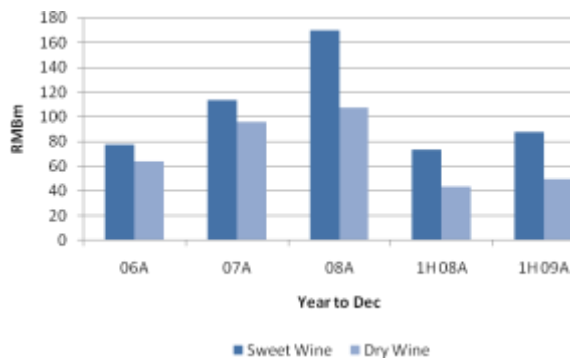
Turnover breakdown



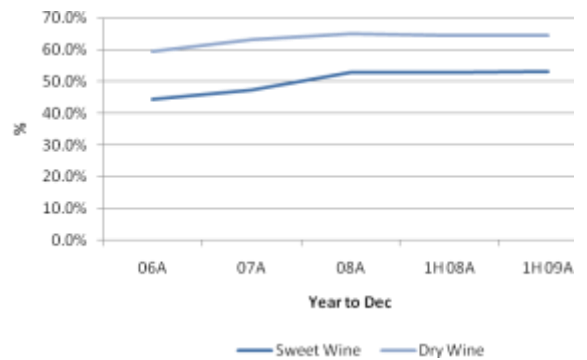
Geographical breakdown (1H FY12/09A)



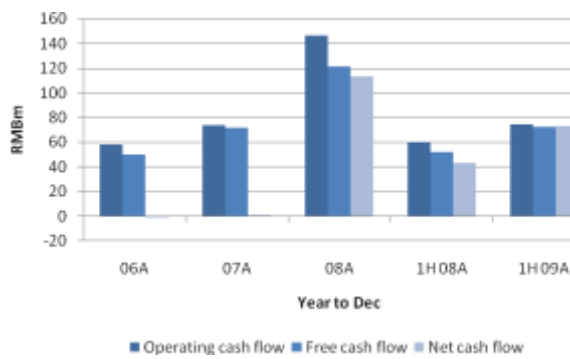
Gross profit breakdown



Gross margin by segment



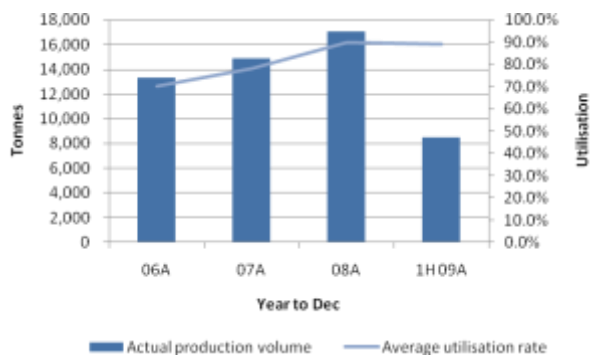
Cashflow generating ability



Margin trends



Production volume and utilisation



## Appendix VIII: Infopage

P&L (RMBm)	07A	08A	09F	10F	11F	Cash Flow (RMBm)	07A	08A	09F	10F	11F
<b>Year to Dec</b>						<b>Year to Dec</b>					
<b>Turnover</b>	<b>391.6</b>	<b>486.7</b>	<b>580.9</b>	<b>670.0</b>	<b>827.2</b>	EBIT	138.6	200.7	245.9	283.5	355.4
% chg	38.9	24.3	19.3	15.3	23.5	Depre./amort.	5.0	4.9	6.5	9.5	13.4
<b>Gross profit</b>	<b>209.0</b>	<b>276.9</b>	<b>331.9</b>	<b>386.9</b>	<b>485.6</b>	Net int. paid	0.1	0.2	1.5	6.7	8.3
EBITDA	143.7	205.5	252.3	293.0	368.8	Tax paid	(52.7)	(33.4)	(62.3)	(70.5)	(83.5)
Depre./amort.	(5.0)	(4.9)	(6.5)	(9.5)	(13.4)	Dividends received	-	-	-	-	-
EBIT	138.6	200.7	245.9	283.5	355.4	<b>Gross cashflow</b>	91.1	172.4	191.5	229.2	293.6
Net int. income/(exp.)	0.1	0.2	1.5	6.7	8.3	Chgs. in working cap.	(17.2)	(26.0)	(28.5)	(29.1)	(75.9)
Exceptionals	-	-	-	-	-	<b>Operating cashflow</b>	73.8	146.4	163.0	200.1	217.8
Associates	-	-	-	-	-	Capex	(0.2)	(25.0)	(20.3)	(80.0)	(80.0)
Jointly-controlled entit.	-	-	-	-	-	<b>Free cashflow</b>	73.6	121.4	142.7	120.1	137.8
<b>Pre-tax profit</b>	<b>138.7</b>	<b>200.9</b>	<b>247.4</b>	<b>290.2</b>	<b>363.7</b>	Dividends paid	(121.5)	0.0	0.0	0.0	0.0
Tax	(33.5)	(64.1)	(69.2)	(78.4)	(92.7)	Net distribution to MI	-	-	-	-	-
Minority interests	-	-	-	-	-	Investments	-	-	-	-	-
<b>Net profit</b>	<b>105.2</b>	<b>136.8</b>	<b>178.1</b>	<b>211.8</b>	<b>270.9</b>	Disposals	0.3	-	-	-	-
% chg	69.2	30.0	30.2	18.9	27.9	New shares	-	-	458.6	-	-
Dividends	(66.5)	-	-	-	-	Change in bank loans	-	-	-	-	-
Retained earnings	38.7	136.8	178.1	211.8	270.9	Others	48.5	(8.6)	0.0	1.1	0.9
EPS (RMB) - Basic	0.079	0.103	0.104	0.123	0.158	<b>Net cashflow</b>	1.0	112.8	601.3	121.2	138.7
EPS (RMB) - F.D.	0.079	0.103	0.104	0.123	0.158	Cash reserve - Beg.	2.0	3.0	115.8	717.1	838.3
DPS (RMB)	0.050	-	-	-	-	Cash reserve - End.	3.0	115.8	717.1	838.3	977.0
No. sh.s o/s (m) - W.A.	1,324.7	1,324.7	1,717.9	1,717.9	1,717.9						
No. sh.s o/s (m) - Y.E.	1,324.7	1,324.7	1,717.9	1,717.9	1,717.9						
No. sh.s o/s (m) - F.D.	1,324.7	1,324.7	1,717.9	1,717.9	1,717.9						
						<b>Interim Results (RMBm)</b>	<b>08A</b>	<b>09A</b>			
						<b>Six months to Jun</b>					
<b>Margins (%)</b>						<b>Turnover</b>	206.0	242.7			
Gross	53.4	56.9	57.1	57.8	58.7	% chg	-	17.8			
EBITDA	36.7	42.2	43.4	43.7	44.6	Profit from operations	87.3	75.4			
EBIT	35.4	41.2	42.3	42.3	43.0	Interest expenses	0.1	0.5			
Pre-tax	35.4	41.3	42.6	43.3	44.0	Associates	-	-			
Net	26.9	28.1	30.7	31.6	32.8	Jointly-controlled entit.	-	-			
						<b>Pre-tax profit</b>	87.4	106.6			
						Tax	(27.3)	(31.2)			
						Minority interests	-	-			
						<b>Net profit</b>	60.1	75.4			
						% chg	-	25.4			
						EPS (RMB) - Basic	0.045	0.057			
						DPS (RMB)	-	-			
<b>Balance Sheet (RMBm)</b>	<b>07A</b>	<b>08A</b>	<b>09F</b>	<b>10F</b>	<b>11F</b>						
<b>Year to Dec</b>						<b>Shareholding Structure</b>					
Fixed assets	83.2	105.1	119.4	190.2	257.1				<b>Shares o/s (m)</b>	<b>%</b>	
Intangible assets	4.0	3.9	3.5	3.2	2.9	Wang Guangyuan			675.6	39.3	
Other LT assets	1.7	0.0	5.7	4.6	3.7	Other founding management			370.9	21.6	
Cash	3.0	115.8	717.1	838.3	977.0	Public			671.4	39.1	
Accounts receivable	63.6	81.3	93.8	108.1	141.1	Total			1,717.9	100.0	
Other receivables	0.0	0.0	0.0	0.0	0.0	<b>Total</b>					
Inventories	123.5	143.0	170.8	185.9	244.6						
Due from related co.s	-	-	-	-	-	<b>Background</b>					
Other current assets	1.1	1.1	-	-	-	Formally established in 2001, Tontine is one of China's leading producers of sweet wines and ice wines. Its brands "Tongtian" ("通天") and "Tongtian Hong" ("通天红") have been awarded both Top 500 Brands of the PRC (中国品牌 500 强) and Top 10 PRC Grape Wine Industry Brands (中国葡萄酒行业十大品牌). Originating from Tonghua County, Jilin Province, the region is renowned, being was one of the 3 original grape growing regions in China. Its species, indigenous vitis amurensis, is native and unique to China.					
<b>Total assets</b>	<b>280.1</b>	<b>450.2</b>	<b>1,110.4</b>	<b>1,330.3</b>	<b>1,626.4</b>						
Accounts payable	(11.2)	(12.9)	(21.2)	(17.6)	(29.2)	<b>Key Ratios</b>	<b>07A</b>	<b>08A</b>	<b>09F</b>	<b>10F</b>	<b>11F</b>
Other payable	(25.8)	(35.4)	(38.9)	(42.8)	(47.1)	Net gearing (%)	Cash	Cash	Cash	Cash	Cash
Tax payable	-	(23.2)	(24.2)	(27.4)	(32.5)	Net ROE (%)	71.1	52.8	25.6	18.8	19.8
Due to related co.s	-	-	-	-	-	EBIT ROCE (%)	93.7	77.4	35.4	25.2	25.9
ST debts	-	-	-	-	-	Dividend payout (%)	63.2	-	-	-	-
Other current liab.	(95.7)	-	-	-	-	Effective tax rate (%)	24.1	31.9	28.0	27.0	25.5
LT debts	-	-	-	-	-	Net interest coverage (x)	-	-	-	-	-
Other LT liabilities	-	(7.6)	(6.9)	(7.8)	(9.3)	A/R turnover (days)	51	54	55	55	55
<b>Total liabilities</b>	<b>(132.8)</b>	<b>(79.0)</b>	<b>(91.2)</b>	<b>(95.6)</b>	<b>(118.0)</b>	A/P turnover (days)	31	21	25	25	25
Share capital	0.4	0.8	16.6	16.6	16.6	Stock turnover (days)	242	232	230	230	230
Reserves	146.9	370.4	1,002.6	1,218.1	1,491.9						
<b>Shareholders' funds</b>	<b>147.3</b>	<b>371.2</b>	<b>1,019.1</b>	<b>1,234.7</b>	<b>1,508.4</b>						
Minority interest	-	-	-	-	-						
<b>Total</b>	<b>147.3</b>	<b>371.2</b>	<b>1,019.1</b>	<b>1,234.7</b>	<b>1,508.4</b>						
Capital employed	147.3	371.2	1,019.1	1,234.7	1,508.4						
Net (debt)/cash	3.0	115.8	717.1	838.3	977.0						

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Disclosure of interests: SBI E2-Capital Securities Limited was acted as the sole bookrunner and lead manager for the China Tontine Wines Group Limited (stock code: 389) in November 2009.

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