SBI China Capital

Corporate Flash

China Huishan Dairy 6863 HK

A shining beacon amongst its peers

- Its upstream resources command a gross margin of 58.1% in 1H FY03/14, much higher than its peers.
- We expect the proportion of milkable cows to gradually increase after the complementation of its cow importing plan
- The milk powder business will flourish after establishing cooperation with FrieslandCampina

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Stock Data (6863 HK)

Rating	Not Rated
Price (HKD)	1.77
Target Price (HKD)	n.a.
12m Price Range (HKD)	1.5-3.24
Market cap. (HKD m)	25,501.8
Daily t/o (HKD m)	156.4
Free float (%)	33.6

Source: Bloomberg

Why does its GM stand out amongst its peers? Its upstream resources. China Huishan Dairy's (CHD) commanded a GPM of 58.1% in 1H FY03/14, much higher than the 22.6% GPM recorded by China Modern Dairy (CMD) (1117HK, HKD3.46) in 1Q FY12/14, and the 42.6% GPM Yuanshengtai Dairy (YST) (1431HK, HKD1.38) recorded in FY12/13 (See Figure 1).

Figure 1: GPM of CHD, CMD, and YST

China Huishan Dairy		China Modern Dairy		Yuanshengtai Dairy	
FY03/13	1H FY03/14	FY12/13	1Q FY12/14	FY12/12	FY12/13
54.0% (58.7%*)	58.1% (59.5%*)	26.7%	22.6%	37.8%	42.6%

** For CHD's raw milk business only*

Source: Company data

We believe the higher-than-average GPM achieved by CHD was significantly aided by the presence of its upstream resources, a unique advantage for the company within the industry. During 1H FY03/14, CHD expanded its alfalfa plantation field from 120,000mu (80.0km^2) to an aggregate area of approximately 140,000mu (93.3km^2), an increase of 16.7%, solidifying the company's position as having the largest commercial alfalfa field in China (See Figure 2).

Figure 2: Major alfalfa producers by production volume in 2012

Ranking	Grower	Output (Thousand tons)	Percentage of total Alfalfa in China
1	Huishan Group	113.0	28.3%
2	Qiushi	84.8	21.3%
3	Yasheng Tianyuan Muge	80.0	20.1%
4	Daye	55.0	13.8%
5	Nongken Maosheng	30.0	7.5%

Source: Company data

In the same period, the cost of producing alfalfa increased to USD89.0 per ton, a YoY increase of 27.1%. However, it is still substantially lower than the price of imported alfalfa, which was approximately USD400.0 per ton.

As well, CHD participated in China's Alfalfa Development Convention held by the China Animal Agriculture Association (CAAA), and achieved the highest score among all the participants. The self-planted forage confirmed the lower cost of operating. If CHD were to buy the same amount of forage with the same quality in 1H FY03/14, an additional expenses of RMB641.7 would have incurred, and GPM would have been dragged down to 16.2%

The proportion of milkable cows will improve gradually after the complementation of its cow importing plan. By the end of September 2013, CHD had a total number of 128,352cows, of which 44.4% were milkable cows. CMD and YST, on the other hand, have a much bigger proportion of milkable cows, 52.9% and 53.3% of their total cows respectively by the end of December 2013 (See Figure 3).

Figure 3: Proportion of milkable cows for CHD, CMD, and YST

	CMD (FY12/13)	CHD (1H FY03/14)	YST (FY12/13)
Number of cows	186,838	128,352	40,396
Number of milkable cows	98,791	57,040	21,544
Proportion of milkable cows	52.9%	44.4%	53.3%

Source: Company data

Some investors expressed their concerns as to the current herd structure of CHD. However, we believe that the lower-than-average proportion of milkable cows was mainly due to its cow importing strategy, under which only calves can be imported, according to China's Law. We also believe the proportion will gradually increase, as our simulation model shows that a long-term equilibrium structure for a developed herd will be achieved when the proportion of milkable cows reaches ~60% (See Figure 4).

Figure 4: Deduction to a developed herd*

	Number of calves	Number of milkable cows	Milkable cows/total cows (%)
Year 1	a	b	b/(a+b)
Year 2	(c) 0.5a+0.85*0.5b	(d) 0.5a+b	(0.5a+b)/(a+1.425b)
Year 3	(e) 0.5c+0.85*0.5d	(f) 0.5*c+d	(0.5c+d)/(c+1.425d)
Year 4	(g) 0.5e+0.85*0.5f	(h) 0.5*e+f	(0.5e+f)/(e+1.425f)
Year 5	(i) 0.5g+0.85*0.5h	(j) 0.5*g+h	(0.5g+h)/(g+1.425h)
Year 6	(k) 0.5i+0.85*0.5j	(l) 0.5*i+j-a	(0.5i+j)/(i+1.425j-a) (around 60.0%)

Source: SBI China Capital

** Assumptions we made before the deduction*

(1) For the milkable cows, they have 50.0% chance to born a female calve and it will take two years for the new born female calve to produce milk

(2) In the herd of calves and heifers, 50.0% of them will become milkable cows each year

(3) For the new born cows, the survival rate is around 85.0%

(4) For milkable cows, the average total number of lactations is 5

(5) No imported cows

From FY03/14 to FY03/16, CHD plans to import 25,000 calves each year. Given the fact that all the imported animals are calves, we think this will continue to drag down the company's proportion of milkable cows to total cows. However, from the simulation model above, we think this proportion will improve eventually after CHD stops importing from overseas. Thus, we believe there is still significant room to increase the total amount of raw milk that it produces after completing its cow importing plan.

The milk powder business will flourish after establishing the cooperation with FrieslandCampina. On 8 May, CHD announced a possible strategic partnership with FrieslandCampina. According to the announcement, the purpose of the joint venture to be established is to operate a fully integrated infant formula supply chain, whereby the company and FrieslandCampina shall both leverage on their respective experiences and specialties to produce, market, and sell high quality infant milk formula products in the PRC. Under the schedule, CHD will provide its high quality raw milk from its own dairy farms in China to the joint venture, and the joint venture will in turn produce dairy products including an infant milk formula brand that will be introduced to the Chinese market. Both companies will continue their original infant formula businesses separately. As such, CHD's Huishan brand will continue to be owned and marketed by the company, and FrieslandCampina's "Friso" brand will continue to be owned and marketed by FrieslandCampina and will continue to be exclusively produced in the Netherlands.

FrieslandCampina was one of the world's five largest dairy companies with regard to revenue in FY12/13. It supplies consumer products such as infant nutrition and dairy-based beverages, cheese, and desserts in Europe, Asia, and Africa. FrieslandCampina also supplies ingredients and half-finished products to manufacturers of infant nutrition, the food industry and the pharmaceutical sector around the world. In the PRC, FrieslandCampina is known by Friso, a premium brand of infant food, and by its sales of ingredients to Chinese food and infant food companies. In FY12/13, FrieslandCampina experienced stable growth in its revenue, but its profit stayed on the downward trend. Specifically, it recorded revenue of EUR11,400.0m, a 10.7% YoY increase; operating profit of EUR313.0m, a 35.7% YoY decrease; and profit attributable to shareholders of EUR157.0m, a 43.5% YoY decrease from EUR278.0m in FY12/12. The decline in profit was due to a EUR200.0m impairment of goodwill as expectations regarding results in Europe were adjusted downwards due to the persisting economic crisis. However, if we exclude this impairment write down, the company actually generated a profit of EUR357.0m, a 28.4% YoY increase.

In China, regulations on milk powder manufacturers are getting stricter. In 2013, the China Food and Drug Administration (CFDA) launched a new requirement called "The Rules for Infant Formula Powder Production (2013)", in which milk powder manufacturers were required to provide their own raw milk to manufacture their milk powder if they applied the wet-process production method. In other words, milk powder manufacturers, including foreign companies, can only apply the dry-process production method to produce milk powder if they do not have their own raw milk resources.

In this regard, we believe the joint venture mentioned above can benefit both CHD and FrieslandCampina, if it can be successfully set up.

Valuation: Based on the nature of CHD's business, we chose China Modern Dairy and Yuanshengtai Dairy as its peers in the Hong Kong stock market. The company is currently trading at a 16.3x prospective P/E for 2014E, while CMD and YST are trading at 14.7x and 9.3xprospective P/E for 2014E, respectively. We believe the premium that the company is trading at relative to its peers is attributable to its integrated business line, including alfalfa planting, raw milk/liquid milk producing, and milk power business. We believe CHD deserves an even higher valuation after its cooperation with FrieslandCampina.

Figure 5: Peer comparison

Company	Ticker	Mkt Cap (HKD m)	2013 P/E (x)	2014E P/E (x)	ROE (%)	ROA (%)	Dvd Yield (%)	Total Debt/Total Equity
China Huishan Dairy	6863 HK	27,374.8	27.1	16.3	27.9	10.7	0.0	30.6%
China Modern Dairy	1117 HK	16,364.7	27.2	14.7	8.9	4.5	0.0	53.1%
Yuanshengtai Dairy	1431 HK	5,276.8	12.5	9.3	43.2	8.4	0.0	21.3%

Source: Bloomberg

Risks: Major risks to the company include: 1) Sharp declines in the prices of raw milk, liquid milk, and milk powder; 2) A sharp increase in the supply of raw milk; 3) Natural disasters, including drought, flood, and animal diseases, which could negatively impact the productivity of its dairy cows; and 4) general execution risks with regard to its new market expansion.

Figure 7: Per share items (RMB)

	FY03/11	FY03/12	FY03/13
EPS			
- Basic	-	-	0.04
DPS	-	-	0.00
BVPS	-	-	0.86

Source: Company data

Figure 8: Ratio analysis

	FY03/11	FY03/12	FY03/13
Growth (YoY)			
Revenue	-	284.1%	91.5%
Gross profit	-	358.9%	150.7%
Operating profit	-	459.2%	144.5%
Net profit	-	1080.1%	162.7%
Margins			
Gross margin	32.1%	41.2%	54.0%
EBIT margin	23.9%	37.5%	47.9%
Net profit margin	8.7%	28.9%	39.7%
Other ratios			
Return on average assets	0.6%	6.1%	13.1%
Return on average equity	8.4%	60.7%	42.5%
Dividend payout ratio	0.0%	0.0%	0.0%
Valuation measures			
P/E (x)	-	-	27.1
P/B (x)	-	-	2.3
Dividend yield	-	-	0.0%

Source: Company data

Figure 9: Income statement (RMB m)

	FY03/11	FY03/12	FY03/13
Revenue	**374.0**	**1,333.0**	**2,552.4**
Cost of sales	(254.2)	(783.2)	1,174.3
Gross profit	119.8	549.8	1,378.2
Other income	2.6	4.8	41.5
SG&A	(33.0)	(54.4)	(197.2)
Operating profit	**89.4**	**499.9**	**1,222.5**
Finance cost	(56.7)	(103.3)	(141.6)
Profit before tax	32.7	396.7	1,080.9
Tax	-	(10.8)	(67.0)
Profit for the year	**32.7**	**385.9**	**1,013.9**

Source: Company data

Figure 10. Balance sheet (RMB m)

	FY03/11	FY03/12	FY03/13
Non-current assets			
Property, plant and equipment	1,844.2	2,839.5	3,636.8
Goodwill	-	-	932.0
Lease prepayments	383.7	417.5	521.3
Biological assets	1,304.9	2,277.9	3,241.9
Deferred tax assets	-	-	37.8
Total non-current assets	**3,532.8**	**5,534.9**	**8,369.7**
Current assets			
Inventories	202.7	412.7	446.6
Trade receivables	138.4	147.6	172.6
Prepayments, deposits and other receivables	1,176.6	581.6	696.2
Amounts due from the controlling shareholders	408.6	-	-
Cash and cash equivalents	47.7	512.9	825.7
Total current assets	**1,974.1**	**1,654.7**	**2,141.1**
Total assets	**5,506.9**	**7,189.6**	**10,510.8**
Current liabilities			
Trade and bills payables	(469.6)	(523.9)	(910.5)
Receipts in advance	(0.8)	(111.4)	(13.7)
Accured expense and other payables	(1,037.3)	(367.5)	(434.6)
Amounts due to controlling shareholders	(1,275.3)	(2,799.6)	(14.7)
Bank loans	(181.8)	(362.4)	(908.5)
Income tax payable	-	(1.6)	(10.1)
Total current liabilities	**(2,964.9)**	**(4,166.4)**	**(2,292.1)**
Non-current liabilities			
Bank loans	(1,960.8)	(1,917.0)	(2,102.8)
Derivative financial liability	-	(16.0)	0.0
Deferred income	(193.2)	(208.0)	(233.0)
Total non current liabilities	**(2,153.9)**	**(2,141.0)**	**(2,335.8)**
Net assets	**388.1**	**882.2**	**5,882.9**
Equity			
Share capital	0.0	0.1	0.1
Reserves	388.0	882.4	5,882.9
Total equity	**388.0**	**882.5**	**5,883.0**

Source: Company data

Figure 11. Cash flow statement (RMB m)

Operating activity	FY03/11	FY03/12	FY03/13
Profit before tax	327.9	460.4	1,012.4
Adjustments for:	-		
Depreciation and amortisation	23.9	36.8	68.9
Interest income	(9.9)	(8.0)	(4.3)
Interest expense	65.0	108.6	144.2
Foreign exchange (gain)/loss	(0.1)	1.8	0.5
Government grants amortisation	(2.8)	(4.8)	(6.8)
(Gain)/loss arising from the changes in fair value less costs to sell of biological assets	(295.2)	(63.8)	86.8
Changes in working capital	(63.9)	230.3	228.4
Others	0.4	0.0	(33.3)
Cash generated from operation	**45.3**	**761.3**	**1,496.9**
PRC income tax paid	**-**	**(9.2)**	**(53.8)**
Net cash generated from operating activities	**45.3**	**752.1**	**1,443.1**
Investing activities			
Payment for acquisition of a subsidiary	-	(17.1)	0.0
Payments for purchase of property, plant and equipment	(942.8)	(841.3)	(488.4)
Lease prepayments	(164.2)	(84.7)	(75.7)
Proceeds from disposal of property, plant and equipment	13.2	0.2	26.0
Payments for purchase of biological assets and breeding calves	(827.5)	(819.0)	(1,003.0)
Others	94.7	76.2	174.0
Net cash generated from investing activities	**(1,826.6)**	**(1,685.7)**	**(1,367.1)**
Financing activities			
Cash received from contributions by investors of the Group	242.7	-	907.4
Cash paid for acquisitions of the controlling equity	-	(533.1)	-
Proceeds from new bank loans	1,329.9	461.7	1,241.9
Repayment of bank loans	(156.5)	(313.2)	(856.0)
Interest paid	(122.1)	(169.6)	(190.8)
Others	375.4	1,965.6	(852.5)
Net cash generated from financing activities	**1,669.5**	**1,411.4**	**249.9**
Net increase in cash and cash equivalent	(111.8)	478.6	324.9
Cash and cash equivalents at the beginning of the year	162.3	47.7	512.9
Effect of foreign rate exchange	(2.8)	(13.4)	(12.1)
Cash and cash equalents at the end of the year	**47.7**	**512.9**	**825.7**

Source: Company data

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