

Getting Mad For Wine

Second-tier wine plays worthy to be on your radar screen

China's wine market is continuing to experience strong growth in 1H 2010. Aside from internal issues in selective companies, such as Great Wall, through China Foods (506 HK, HK\$4.98), mainstream wine makers Changyu (000869 CH, RMB90.0) and Dynasty (828 HK, HK\$3.28) are reporting strong growth. We are generally bullish on the sector and see interesting opportunities for niche players in the sector that might be flying under the radar screen of many investors. We have been meeting with them recently have picked three smaller players that has exposure to the China's wine sector in China. on the sector and see interesting opportunities for niche players in this sector that might be flying under the radar screen of many investors. We have been meeting with them recently have picked three smaller players that have exposure to the China's wine sector in China.

Investment summary

- China Tontine Wines Group Limited (389 HK, HK\$1.59) - Sweet, Sweet, Sweet!
- JLF Investment Company Limited (472 HK, HK\$0.57) - Growth through acquisitions
- Silver Base Group Holdings Limited (886 HK, HK\$3.42) - Small but growing wine portfolio

China Tontine Wines Group Limited

Sweet, Sweet, Sweet!

Descriptions

Tontine is a small grape wine producer based in Tonghua County, Jilin province. Tonghua region is renowned in China for growing quality grapes. The grape grown there is known as "mountain grapes", which has a distinctive taste that is suitable for sweet and ice wine. Tontine sells wine in two categories, sweet wine and dry wine. They mainly sells their products to distributors, who then sells to third party retailers such as: supermarkets, restaurants and hotels. Tontine successfully listed on Hong Kong Stock Exchanges in November 2009.

Business Model & Strategies

Focusing on Sweet Wine: Tontine's business strategy is to focusing on sweet wine products, as the company believes sweet wine tailors better to the taste of mass mainland wine consumers. Tontine focuses on the production of sweet wines and ice wine, this strategy allows them to not directly compete with its larger rival such as Dynasty, Changyu and Great Wall which mainly produces dry wines. Tontine has plan to launch four new products in the sweet wine segment in this year, the "Tontine Special Selection Ice Red", "Tontine Premium Ice Wine", "Tontine Premium Blueberry Wine" and "Tontine Premium Rose Wine". The selling price on them will be targeting in the premium price range which is over RMB 100. By introducing products in the premium price range allows them to attain a higher profit margin.

Building Image stores: They have plan to establish at least twenty outlet in PRC within the next four years, with five direct sales outlet in plan for this year in: Beijing, Shanghai, Chengdu, Shenyang and Wuhan. The purpose of the retail outlets are use for brand building, providing marketing support to the distributors and also sales of their exclusive Estate Wine & Wine cellar in the coming years.

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Ticker	389 HK
Rating	BUY
Price (HK\$)	1.60
Target Price (HK\$)	2.38 (+48.75%)
12m Price Range (HK\$)	1.25-2.05
Market cap. (US\$m)	352.4
Daily t/o (US\$m)	1.4
Free float (%)	52.96

Source: Bloomberg

Financial summary

Year to Dec	08A	09A	10A	11F	12F
Turnover (RMBm)	486.70	584.30	709.50	874.50	1,007.50
Net Profit (RMBm)	136.79	174.10	212.20	272.00	322.90
EPS (RMB)	0.103	0.101	0.124	0.158	0.188
P/E (x)	15.5	15.8	12.9	10.1	8.5
P/B (x)	5.7	2.9	2.4	2.0	1.7
EV/EBITDA (x)	9.5	8.1	6.6	5.0	3.9
Yield (%)		1.6	2.0	2.5	3.0
ROE (%)	52.8	26.0	20.0	21.5	21.5
ROCE (%)	77.4	37.0	27.9	29.2	28.6
N. Gear. (%)	Cash	Cash	Cash	Cash	Cash

Future Expansion Plans: Tontine will double their annual production capacity from 19,000 tonnes to 39,000 tonnes by the end of 2010. The second phase of production building target to be complete in Q3, 2010. And the installation of production facility target to be complete by Q4 of this year. The construction of Estate Wine will be commenced in second half of 2010 and complete by 2014. The construction of Wine Cellar will be completed by the end of 2010, cellar wine target to be launched by 2011.

Recent financials

Tontine reported sales of RMB584.3m for FY2009, an increase of 20% from FY2008. Revenue from sweet wine accounted for 70% and the rest came from sale of dry red wines. This is consistent with their sales strategies of focusing on sweet wine products. Gross profit for the group increased approximately 22% to RMB338.2m for FY2009. Gross profit margin increased one percentage point to 57.9%. The reason for the increase was due to their shift in sales towards higher margin products. Their selling and distribution expense increased slight to 11.6% in FY2009 from 11% in FY2008, this was primarily due to their increase in sales commission and increase in transportation and advertising cost. Profit attributed to the equities holder's increased 27% to RMB174m in FY2009.

Valuation and our view

Tontine is currently trading at 13.0x cur-year fwd and 10.1x 1-yr fwd P/E. We believe that Tontine is unique in a sense that they are focusing on sweet wines that are not directly competing with larger mainland revivals. And outside of tier-one brands of Dynasty, Chanyu and Great Wall, there hasn't been a clear second tier brand, thus Tontine has a potential to become a top second tier brand. That asides, the competition in wine segment remains toughs, the company should be responsive to changing market demand and competition. The stock has retreated from its high of HK\$2.05 in Dec 2009 and current levels may represent an attractive entry point.

JLF Investment Company Limited

Growth through acquisitions

Descriptions

JLF engages in production and trading of red grape wine and Chinese liquor in China. The Company operates in two segments, the production and distribution of grape wine and the production and distribution of Chinese Liquor. The Company's manufacturing operations are located in the PRC.

Business Model & Strategies

Established own winery brand: JLF sells wine products under the brand Shangri-la and Tibetan Spirits. They currently have three category of winery products, grape wine, Tibetan barley wine and Chinese wine. They set their production base in Hebei and Shangdong, as they believe that the region gives high-quality grapes due to its natural condition and they use scientific cultivation to supply abundant raw materials. Currently their production and distribution of wine accounts for 64% of their total revenue in FY 03/2010.

Growth by acquisition in the Chinese Liquors segment: JLF's plan for Chinese liquor segment going forward is to grow by acquisitions. They plan to acquire two Chinese liquor plants in China per years. The high-end liquor market in China is currently dominated by Wuliangye and Moutai on a national sales level. However on the provincial and local level, there are many local brands that out sells Wuliangyue and Moutai. JLF's plan is to target brands that are top seller in their respective provincial or local level. With this strategy, they can build a nationwide portfolio of Chinese liquor that can potentially competes with Wuliangyue and Moutai.

Revitalizing inefficient brands: In addition to acquiring successful local brands, JLF had also acquired inefficient local distilleries and revitalized them into a competitive brand. They have in the past revitalized brand in province such as Hunan, Anhui, Guangdong, Sichuan and Yunnan. JLF deployed methods such as: re-capitalization, management improvement, marketing, brand management, restructuring and technology transfer. The acquisition of local brand in the past was usually met with welcome by local officials, since the success of mergers and acquisitions can benefit local economies, increased the income of local government, created more job opportunities, and

Ticker	472 HK
Rating	NR
Price (HK\$)	0.57
Target Price (HK\$)	n.a.
12m Price Range (HK\$)	0.41-0.86
Market cap. (US\$m)	121.9
Daily t/o (US\$m)	0.1
Free float (%)	32.47

Source: Bloomberg

Financial summary

Year to Dec	07A	08A	09A
Turnover (HK\$)	139.9	201.4	256.9
Net Profit (HK\$)	13.5	24.2	29.5
EPS (RMB)	0.01	0.02	0.02
P/E (x)	57.0	32.4	26.9
ROE (%)	6.0	5.9	6.6

Source: Bloomberg

encouraged the development of local brands, thus they will continue to employ this strategy to achieve a win-win situation for both JLF and local brand.

Recent financials

JLF reported a sales of HK\$260m for FY2009, which represents 29% increase from HK\$201m in FY2008. The company credits the large increase in sales to its marketing efforts made during the second half of the year. Wine sales accounted for HK\$166m and Chinese liquor accounted for HK\$94m. Their second half of sales accounted for 67% of the entire year. The growth was attribute to the economic rebound and marketing events. Their cost of sales for FY2009 is HK\$122m represents a 9.8% increase from HK\$111m in FY2008. Gross profit increased by 52.4% to HK\$138m in FY2009. Operating profit increased by 21.6% to HK\$50.7m in FY2009. However the operating profit margin had decrease to 19.5% in FY 2009 from 20.7% in FY2008. The decrease in margin was due to the increase in selling and distribution expenses. Profit attribute to equity holders in FY2009 increase by 22% to HK\$29.5m JLF is budgeting a HK\$50m for capital expenditure for FY2010. The use of capital will go towards relocating of their production facilities in Kunming.

Valuation and our view

JLF Investment is currently trading at 27.1x historical P/E. Although the overall sales of grape wine in China is rising, the pace of growth for domestic brand seems to be slower than foreign produced wine. And since JLF's grape wine strategy is strictly focusing on mainstream domestically produced dry grape wine, we believe that they may potentially face headwinds from: 1) consumer preference towards foreign brands and 2) difficulty in differentiation of most established domestic brands. We also believe that the merger and acquisition strategy use by JLF may be a costly way to grow, especially when the local brand is already famous or a top-seller in its local region.

Silver Base Group Holdings Limited

Small but growing wine portfolio

Descriptions

Silver Based engages in the distribution of Wuliangye Liquor series, Chinese liquor products, grape wines and Chinese cigarettes. Currently, they distributes sixty plus wine brand from eight foreign countries. In the coming year, they will increase the number of country to ten. They mainly use five channels of distribution: supermarkets, hotel & restaurants, liquor & cigarette stores, groups purchases, and entertainments venues.

Business Model & Strategies

New product from Wuliangye: Silver Based had won a 15-year global exclusive distribution of the Yongfu Jiangiu. Youngfu Jiangiu is a new product on "Soy" label from the Wuliangye group. The Soy series is a soy type flavored liquor that will compete with the existing market leader in the Soy flavor market, Moutai. Silver Base has first year purchase target from Wuliangye group of 500 tones, which can be progressively increase up to 27,000 tons per year going forward.

Starting Wine distribution: Silver Base is actively expanding into wine distribution. They're expanding into foreign wine business to take advantage of the PRC's fast growing high-end consumer market. So far they are sourcing from eight countries: France, Portugal, Greece Italy, Argentina, Chile, Australia and New Zealand, with total around sixty brands of Wine and have exclusively right in China on about eighty percent of them.

Building image stores: Silver base is also launching image stores as a platform to boost their red wine business. The Store will aimed to serve as a platform to hold promotion activities such as wine tasting, wine seminar and training. So far seventy image stores have been open as of 31st of May 2010. The stores are located in grade A office building as prime shopping area for easy access. This will also serve as target VIP clients and potential group purchase customers.

Recent financials

Ticker	886 HK
Rating	NR
Price (HK\$)	3.40
Target Price (HK\$)	n.a.
12m Price Range (HK\$)	1.84-3.80
Market cap. (US\$m)	518.7
Daily t/o (US\$m)	1.6
Free float (%)	32.62

Source: Bloomberg

Financial summary

Year to Mar	08A	09A	10A
Turnover (RMBm)	1485.1	1252.2	1319.1
Net Profit (RMBm)	399.7	415.1	396.1
EPS (RMB)	0.4	0.5	0.3
P/E (x)	7.7	7.4	10.3
ROE (%)			28.5

Source: Bloomberg

For FY03/2010, Silver Based reported earnings of HK\$1,319m which is an increase of 5.3% from FY03/2009. PRC sales accounts for 44.2% of their total revenue and while the international markets accounts for the rest. The company credits the increase in revenue to the strong demand in high-end Chinese Liquor "Baijiu" in PRC. The gross profit was HK\$623m which is a slightly decrease from HK\$627m in FY03/2010. Their selling and distribution expenses increased significantly from HK\$74.3m in FY03/2009 to HK\$117m in FY03/2010, this was result of an increase in staff cost, channel development, marketing and promotion expenses. The profit attributable to equity holders was HK\$396m, which is a decreased of 4.6% from HK\$415m in FY03/2009. The decrease in profit was mainly due to spending on expansion of the group, spending was used in expanding and deepening of their net work and channel coverage in the PRC.

Valuation and our view

Silver Base is currently trading at 10.3x current year fwd and 6.6x 1-yr fwd P/E on consensus. We feel that the new soy series label may be onto a slow start as the soy flavor market is dominated by Moutai, it would be difficult to overtake Moutai anytime soon or even make any significant dent in the soy flavor liquor segment. On their grape wine distribution business, they should face tough competition as their current wine portfolio size is still small.

Table 1. Valuation Comparison

Company	Ticker	Market Cap(US\$m)	His P/E	1-Yr P/E	2-Yr P/E
China Tontine Wines	389 HK	352.4	11.0x	11.4x	9.5x
JLF Investment	472 HK	121.9	27.1x	n.a.	n.a.
Silver Base Group	886 HK	518.7	10.3x	6.6x	5.7x
Changyu	000869 CH	5,622	39.2x	34.6x	28.1x
China Food	506 HK	1,783	24.4x	23.4x	18.7x
Dynasty	828 HK	528.3	26.5x	22.8x	19.1x
Average			23.1x	19.8x	16.22x

Source: SBI E2-Capital

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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