

Analyst: Sam Ho

Main Board Listing- Research

中國蒙牛乳業有限公司

China Mengniu Dairy Company Limited - [Stock Code: 2319]

Joint Global Coordinators, Joint Bookrunners and Joint Lead Managers : BNP Paribas Peregrine Morgan Stanley
Sponsor : BNP Paribas Peregrine

Sector : Dairy

Business : Production and sale of dairy products in China

Total share offer: 350,000,000 shares
(35% of the enlarged share capital)

Placement: 315,000,000 shares (90%)
-215,000,000 new shares
-100,000,000 sale shares

IPO: 35,000,000 shares (10%)

Greenshoe: 52,500,000 shares

Price: HK\$3.125-HK\$3.925 per share
Market cap: HK\$3,125 mln-HK\$3,925 mln

Staffing: 9,973

Prospective 2004 P/E: 15.1x-19.0x (fully-diluted)
Adjusted NAV per share: RMB1.09-RMB1.24

Book opens: 26th May 2004
Book closes: 4th June 2004
IPO commences: 1st June 2004
IPO ends: 4th June 2004

Share registrar: Computershare Hong Kong
Investor Services
Receiving bank: Bank of China (Hong Kong)

Listing date: 10th June 2004

Business of Mengniu

Established in 1999, the Company has been 1 of the leading dairy-product manufacturers in China. Its principal products are liquid milk (including UHT milk & milk beverage), yogurt, ice cream and other dairy products (such as milk powder and milk tablets).

It has a wide variety of products that offer consumers a range of choices, including 20 varieties of milk beverage, over 40 yogurt products and over 100 ice-cream products.

It currently processes the majority of its products at 8 production bases. Based on its production capacity as of 31/12/2003, it was able to produce 1.26 million tonnes of dairy products annually.

Major Shareholders after Listing

(Assuming the over-allotment option is not exercised and before the conversion of convertible instruments)

Yinniu Milk Industry Limited	33.6%
Jinniu Milk Industry Limited	15.8%
MS Dairy Holdings *	7.4%
Mr Niu Gensheng, chairman of the Company	4.6%
CDH China Fund, L.P *	2.3%
CGU-CDC China Investment Company Limited *	1.3%
	<u>65.0%</u>

*- these shareholders were granted convertible instruments (principal amount of US\$35.2 million & conversion price of US\$0.096 per share into 368.4 million shares), which had a maturity of 5 years and are redeemable at the occurrence of certain events of default

Use of Proceeds

Net proceeds from the offer are estimated to be HK\$824 million

(Assuming the over-allotment option is not exercised, and at an issue price of HK\$3.525 each, which is the mid-point of the indicative price range)

	RMB million
To expand liquid-milk production facilities	494
To expand ice-cream production facilities	190
To expand other dairy-product production facilities	46
To serve as general working capital	balance

Financial Highlights

	Year ended 31 st December 2003 RMB'000	Period from 5 th June 2002 to 31 st December 2002 RMB'000
Turnover	<u>4,071,468</u>	<u>459,020</u>
Operating profit	305,950	45,885
Net profit	<u>164,372</u>	<u>18,525</u>
Dividend	<u>61,860</u>	=
EPS- basic	<u>RMB0.192</u>	<u>RMB0.025</u>

Note: Since the Company underwent a corporate reorganization on 05/06/2002 following the "First Round Investment" by foreign investors using purchase accounting, we would present the profit and loss account data of the Mengniu Group, the principal operating subsidiary, as a reference:

	Year ended 31 st December		
	2003 RMB'000	2002 RMB'000	2001 RMB'000
Turnover			
Liquid milk	3,498,162	1,296,769	436,128
UHT milk	2,916,068	1,110,034	353,045
Milk beverages	406,486	137,458	75,855
Yogurt	175,608	49,277	7,228
Ice cream	475,233	329,128	272,355
Other dairy products	<u>98,073</u>	<u>42,848</u>	<u>15,514</u>
	<u>4,071,468</u>	<u>1,668,745</u>	<u>723,997</u>
Operating profit	303,957	142,762	55,913
Net profit	<u>225,747</u>	<u>76,694</u>	<u>33,521</u>

Strengths/ Opportunities

- ✓ China's liquid-milk sales grew at a remarkable CAGR of 25% over 1998-2003. The growth in the liquid-milk segment should be further underpinned by China's rising GDP and a growing awareness of the nutritional value of liquid milk.
- ✓ With strict quality control and hygienic production environment, the Company has obtained GMP, HACCP, ISO9001, ISO14001 and OHS18001 certifications.
- ✓ Mengniu is a famous brand in China, despite its short history. It received the "Famous Trademark" award from the National Trademark Office in 2002 and its "Mengniu" brand UHT milk also won the "Famous Brand Product" award in the same year.
- ✓ The Company is the most efficient operator among the leading dairy-product producers in China. For 2003, its EBIT margin of 7.5% and ROE of over 26% were much higher than the 2nd-highest efficiency operator, Bright Dairy & Food's 6.7% and 15.2%, respectively.
- ✓ With shares priced at 2004E P/E of 15.1x-19.0x, valuation of Mengniu is undemanding, when compared with mainland A-share peers Inner Mongolia Yili's 2004E P/E of 20x and Bright Dairy & Food's 2004E P/E of 23.3x. Moreover, global peers are trading at an average 2004E P/E of 18.7x.

Weaknesses/ Threats

- × Competition in the fragmented dairy industry is intensive as there were over 1,500 enterprises engaging in the production of dairy products as at 31/12/2003. Moreover, foreign dairy companies also actively participate in China's dairy market through joint ventures and taking minority stake in local operators. Furthermore, China's accession to the WTO requires the dairy industry to reduce tariffs in respect of various imported dairy products from the current levels of 20%-50% to 10%-15% by the end of 2005.
- × Raw milk is the primary raw material for the Company to produce liquid milk and other dairy products, representing 45.5% of total raw-material cost in 2003. Since the Company does not own any dairy cows, but instead sourcing raw milk from over 1,000 milk-collection centres with exclusive supply, any shortage in raw milk will negatively affect the Company's production. In addition, the rising cost of raw milk should erode the profit margins of the Company.
- × The production and packaging of Mengniu's UHT milk and a portion of milk beverages rely significantly on Tetra Pak production equipment, packaging technology and packaging materials. In the event that Tetra Pak fails to continue to supply such equipment, technology and packaging materials, or the Company is unable to find substitute-packaging suppliers, production will be interrupted and delivery of dairy products could be delayed.

Recommendation: Trading Buy