HSBC Global Research

Consumer Staples
October 2012

China Food & Beverage

Distribution is essential; branding differentiates

We initiate coverage of the sector with an Overweight rating on Tingyi (322 HK, TP HKD29.0), Underweights on Uni-President China (220 HK, TP HKD7.0) and Tsingtao Brewery (168 HK, TP HKD35.0), an Underweight (V) on China Mengniu Dairy (2319 HK, TP HKD19.7), and a Neutral on Want Want (151 HK, TP HKD10.6)

Investing in the Food and Beverage (F&B) companies, which supply a basic necessity, is generally thought to be a natural play on the consumption theme. We agree, but are increasingly selective, just like Chinese consumers

Chinese consumption is focusing more and more on quality and branding as the domestic economy develops. Winners must master distribution and branding as Chinese F&B companies adopt 'premiumisation' strategies, making them less 'staples' and more 'discretionary' in nature

By Christopher K Leung and Erwan Rambourg

Contents

Summary

As Chinese consumers become wealthier, they are growing more selective. China's F&B companies have spotted this trend – which we expect to catch on fast in the next decade – and are increasingly adopting strategies to leverage both distribution and branding. We initiate coverage of the sector with an Overweight rating on Tingyi (TP HKD29.0), Underweights on UPC (TP HKD7.0) and Tsingtao (TP HKD35.0), an Underweight (V) on China Mengniu Dairy (TP HKD19.7), and a Neutral on Want Want (TP HKD10.6).

Debunking the China consumption myth

China's consumption story is well known: the trend of rising income and urbanisation will continue to boost consumption prospects. Investing in the Food and Beverage (F&B) sector, which supplies a basic necessity, is generally thought to be a natural play on the consumption theme, especially in an economic downturn. However, we argue this industry has evolved in terms of complexity. Stock picks within the sector, therefore, will require fresh perspectives. We often come across two observations on the China F&B sector: 1) the sector is resilient in economic downturns and 2) the brand loyalty of Chinese consumers is low, which in our view, are proving to be different. We believe that:

- **The F&B sector remains sensitive to economic conditions**, especially given the large group of low-income consumers it caters to. Rural consumers widely spend on F&B products as gifts/tokens of appreciation, which is correlated with the economic performance.
- **Chinese consumers' brand loyalty is higher than what was thought**. Yum! Brands' Kentucky Fried Chicken (KFC) is a classic example, given its effective penetration of the local market. Two top brands still dominate the instant noodles and carbonated drinks market.

Shift in focus towards branding and higher quality products

Consumers are going beyond the basic necessities to focus more on higher quality and branding. This trend is catching on fast in the wake of continual food safety issues in China. Over the past decade, F&B companies have progressed by expanding their distribution networks to reach more customers. For instance, Tingyi achieved sales at a CAGR of 24% between 2001 and 2011, while its number of direct retailers increased at a 14% CAGR. Although China's GDP per capita grew from around USD1,038 in 2002 to USD5,570 in 2011, we estimate around c.60% of the population was still earning less than USD5,500.

We have seen a rise in spending power of the higher-income Chinese consumers and their willingness to pay a premium for better quality and branded products. We believe lower income earners will increasingly follow this preference over the next 10 years. We call this 'income evolution' in the report.

Distribution is still key, but branding differentiates

Current industry leaders are large players with established sizeable and effective distribution networks, allowing them to achieve both operating scale and the ability to respond to market changes faster. Within the diverse F&B industry, Tingyi and Want Want clearly have excelled in this regard, in our view. The efficiency of Tsingtao's sizeable production network has been undermined by its limited penetration in the local beer market, in our view, as it lacks the volume to improve utilization.

We believe distribution networks will still play in important role for most F&B companies in the next 10 years, as the distribution market in many regions is fragmented and infrastructure in many rural areas is still underdeveloped. However, as the country's infrastructural bottlenecks have eased, we believe that the benefit for F&B companies investing in distribution networks will slowly decline as bargaining power shifts from vendors to retailers and that China will become a more brand-driven market. In our view, Tingyi, Want Want, Tsingtao, and Uni-President China (UPC) have all successfully established clear brand images, while Mengniu Dairy's reputation has suffered some setbacks due to the milk scandal.

We believe that Chinese consumer preferences will only become more refined going forward. A brand is more than just a name on a product. We foresee increased branding sophistication over the next decade and argue that brand management would be the key factor for F&B companies, differentiating them along various parameters such as track record, variety and quality (in terms of taste, nutritious value and food safety). These can be achieved through advertising, M&A, JVs, upstream investment (proven to be a good strategy in preventing food contamination in many cases) and product innovation (a recent good example is UPC's successful launch of pickled cabbage and beef flavoured noodles and milk tea products).

Factoring in our aforementioned income distribution ratio in China, we believe branding and distribution will emerge as the two key factors, of equal significance, in determining F&B companies' success in the coming years. On the one hand, a strong distribution network brings the advantage of higher market penetration, reaching a large group of low-income earners. On the other hand, companies with solid branding can capture a larger number of people in the high-income group in the premium branded products space. This will help strengthen their presence in this new and expanding market segment and thereby achieve higher margins.

Who is well positioned?

Taking into consideration the distribution size and positioning, we prefer Tingyi and Want Want. We like UPC and Tsingtao for their branding strategy, but further investment in their distribution networks to increase market share might dilute their profitability, in our view. Mengniu's near-term efforts to rebuild the brand image will determine its ability to maintain its sector leader status.

China F&B companies – Distribution and Brand positioning comparison

Company	RIC	FY End	Mkt cap USDm	Ccy	Price 28-Sep	TP	HSBC Rating	PE (x) 2011	PE (x) 2012	PE (x) 2013	EPS growth 2011	EPS growth 2012	EPS growth 2013	Distribution positioning	Brand positioning
Tingyi	0322.HK	Dec	16,553	HKD	23.35	29.0	Overweight	43.1	48.7	27.4	-18%	-11%	78%	Extensive distribution platform Deep penetration in lower tier cities High operating efficiency and bargaining power over distributors and suppliers	Most well-recognized F&B brand in China Diversified product portfolio and Long track record Alliance with Pepsi is positive to elevate brand image Long track record and experienced mgmt team
UPC	0220.HK	Dec	4,002	HKD	8.92	7.0	Underweight	85.4	28.2	25.2	-40%	197%	11%	Distribution platform still not sizeable Lack of scale to achieve operating efficiency	Well recognised food and beverage brand in China Strong on product innovation but high product concentration Long track record and experienced management team
Tsingtao	0168.HK	Dec	3,620	HKD	42.80	35.0	Underweight	27.6	25.1	22.9	14%	8%	9%	Extensive production and distribution network Many regions still lack operating scale to be profitable. Expanding aggressively to non-core markets	Most famous local beer brand in China Strong pricing power in its core markets Premium positioning but limited mass market exposure
China Mengniu	2319.HK	Dec	5,324	HKD	23.20	19.7	Underweight (V)	21.3	23.4	20.5	27%	-11%	13%	Multi-regional distribution network, not national Capacity expansion still on-going	Brand image affected by numerous milk scandals High investments on upstream sourcing and quality control Shifting focus to more premium products
Want Want	0151.HK	Dec	16,616	HKD	9.89	10.6	Neutral	40.0	30.8	24.7	17%	30%	25%	Extensive production and distribution network Strong control on distribution channel and deep penetration in lower tier cities Putting extra resources on 1st and 2nd tier cities to improve point-of-sales productivity	Well recognised brand in China and strong pricing power High concentration on dairy beverage and rice crackers Effective marketing strategies

Source: Thomson Reuters Datastream, HSBC estimates

Valuation and rating

- Consumer staples underperformed the market by 3% y-t-d but outperformed consumer discretionary by 19%
- At current PE valuations, the large-cap F&B sector trades at 66% premium to the large-cap discretionary sector
- Valuations look demanding to us; investors should be selective

Demanding valuations

While consumer staples have underperformed the market by 3% y-t-d, they outperformed discretionary by 19%. At current PE valuations, the large-cap F&B sector is trading at 66% premium to the large-cap discretionary sector.

Selected F&B companies under our coverage show even stronger performance. UPC has been the best performer, gaining 92% y-t-d, to outperform the market by 79%. Want Want and Mengniu Dairy have also traded well, both up 28% y-t-d (HSI up 13%). Following their good performance so far this year, we believe selected stocks have run ahead of fundamentals and therefore urge investors to be selective.

Our top pick is Tingyi. Our key Underweight recommendations are UPC, Mengniu Dairy, and Tsingtao Brewery; we are Neutral on Want Want.

Stocks calls

Tingyi (322 HK, OW, TP: HKD29.00)

We like Tingyi for its large and deep distribution network and strong brand positioning in both instant noodles and ready-to-drink (RTD) tea segments. While we do not expect its alliance with Pepsi to provide significant earnings in the near term, we believe it will enhance Tingyi's long-term competitive advantage given co-branding synergy and widened access to global beverage products. Sales momentum should be strong in the coming quarters given the recovery in the tea business, further market share gain in the juice segment, and new contribution from the Pepsi alliance. We believe Tingyi shares will be re-rated due to (1) strong sales recovery, (2) margin improvement, (3) greater visibility on the turnaround process of the Pepsi business, and (4) ROE improvement.

Share price performance

Year to Dec-31	2008	2009	2010	2011	1Q11	2Q11	3Q11	4Q11	1Q12	2Q12	2012 YTD
Tingyi	-29%	114%	4%	19%	-4%	30%	-20%	23%	-5%	-12%	**-1%**
Uni-President	-67%	184%	-27%	12%	-4%	21%	-12%	9%	17%	32%	**92%**
Tsingtao	-38%	166%	-5%	6%	-9%	22%	-4%	0%	-2%	5%	**0%**
Mengniu Dairy	-65%	175%	-26%	-12%	0%	30%	-8%	-24%	25%	-11%	**28%**
Want Want	na	69%	25%	14%	-10%	23%	-6%	9%	12%	9%	**28%**
Hang Seng Index	-48%	52%	5%	-20%	2%	-6%	-21%	5%	12%	-5%	**13%**

Note: As at 28-Sept-2012. Source: Thomson Reuters Datastream

UPC (220 HK, UW, TP: HKD7.00)

While UPC has strong product innovation, we believe its biggest disadvantage is lack of distribution scale. Aggressive expansion is positive in the long run, but scale benefits are unlikely to materialise in the near term. In addition, sales momentum for both instant noodles and milk tea are likely to slow due to heightening direct competition from Tingyi and other local brands. We believe the stock will be de-rated due to concerns about (1) slower sales momentum, (2) decline in net margin, and (3) stagnant ROE. We would turn positive on the stock when we see the company achieving scale benefits.

Tsingtao (168 HK, UW, TP: HKD35.00)

While Tsingtao Brewery owns the most well-recognised brand in China and has established a large production network, we see high margin pressure in the next two years given intense competition in the mass beer market. Barley prices are rising, which could further pressurise margin in 2013. We expect Tsingtao shares to be de-rated due to concern about (1) margin contraction, (2) rising competition from both local and foreign brands, and (3) decline in ROE.

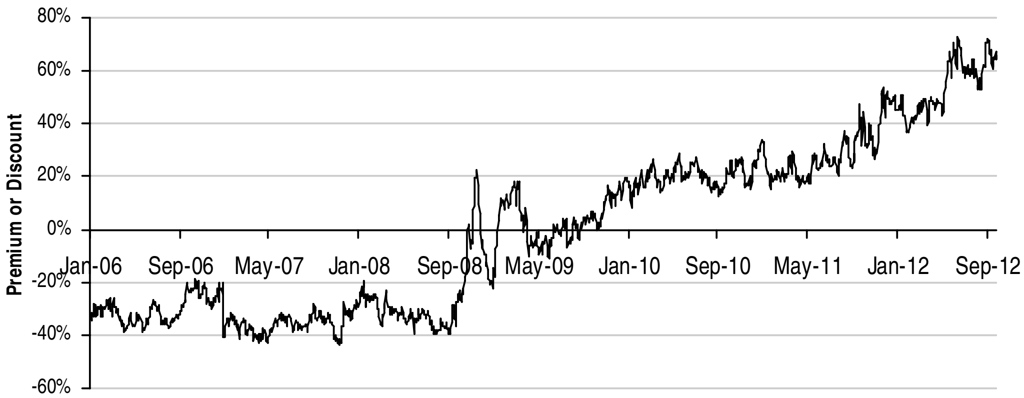
Mengniu Dairy (2319 HK, UW(V), TP: 19.70)

Our Underweight rating on Mengniu is mainly premised on our belief that the market is too optimistic on its sales and margin recovery. We believe the company is still at a transformative stage, and see limited room for significant margin expansion in the near term. We expect the stock to be de-rated due to slower-than-expected recovery in sales and margin.

Want Want (151 HK, N, TP: 10.00)

We believe that Want Want will continue to register strong sales growth in its dairy beverage products, but that the sales momentum for its rice crackers product will suffer in the coming quarters, as the price hike late last year seems to have caused a shift in consumer preference. However, gross margin should continue to rise in 2H12 and 2013 due to the decline in imported milk powder prices. The Want Want share price has gained 28% y-t-d (HSI up 13% over the same period), and we believe it fully reflects the strong earnings momentum.

Valuation comparison – China large-cap consumer staples vs China large-cap consumer discretionary



Priced as of 28-Sept-2012. Large cap consumer staples companies include Tingyi, UPC, Want Want, Mengniu Dairy, Tsingtao, Hengan, China Agri, China Foods, China Resources Enterprise, SunArt Retail. Large cap discretionary companies include Golden Eagle, Intime Department Stores, Lifestyle, Parkson, Belle, and Chow Tai Fook Jewellery
Source: Thomson Reuters Datastream and HSBC

China F&B – Summary of investment thesis, valuation, catalysts, and earnings comparison

Company	Ticker	Market-cap	Avg t/o	Rating	Price	TP	Investment thesis	Valuation	Catalysts	Earnings comparison
Tingyi	0322.HK	USD16,841m	USD16m	OW	HKD23.4	HKD29.0	** Sales momentum should recover strongly in coming quarters ** Extensive and deep distribution network remains the key competitive advantage ** The Pepsi alliance will further enhance Tingyi's brand positioning	** We use DCF to value Tingyi given its steady cash flow and return. Our DCF target price of HKD29.0 implies a 34x 2013 PE, around 1 standard deviation above the historical average PE of 29x ** We believe Tingyi shares will be re-rated due to 1) Strong sales recovery, 2) Margin improvement, 3) Greater visibility on the turnaround process of the Pepsi business, and 4) ROE improvement	** Q312 and FY12 results ** Faster-than-expected turnaround on the Pepsi bottling business ** Market share gains in RTD tea, instant noodles, and juices	** Our 2012/13/14 earnings estimates are 1%/4% /4% ahead of consensus
UPC	0220.HK	USD4,141m	USD5m	UW	HKD8.9	HKD7.0	** Sales momentum for both instant noodles and milk tea are likely to slow due to heightening direct competition from Tingyi and other brands ** Aggressive expansion is positive in the long run, but scale benefit is unlikely to realize in the near term ** Further investments on branding, distribution, and production network will cap its margin upside and ROE potential	** We use PE ratio to value Uni-President and our target price is based on 20x 12-month forward PE, around 0.5 standard deviation below the historical average PE of 25x ** We believe the stock will be de-rated due to concerns about 1) Slower sales momentum, 2) Decline in net margin, and 3) Stagnant ROE	** Q312 earnings and FY12 results ** Lower-than-expected market share gains	** Our 2012 and 2013 earnings estimates are 11% and 2% higher than consensus, respectively, but our 2014 earnings estimates are 7% below consensus
Tsingtao	0168.HK	USD3,616m	USD9m	UW	HKD42.8	HKD35.0	** Tsingtao Brewery is stepping up its effort to gain market share in the mass market and we see margin pressure from change of sales mix and higher marketing efforts ** Barley prices are rising and it could further pressure margin in 2013	** We use PE ratio to value Tsingtao and our target price is based on 19x 12-month forward PE, around 1 standard deviation below the historical average PE of 26x and is more in line with the peer group average ** We expect Tsingtao shares to be de-rated due to concern about 1) Margin contraction, 2) Rising competition from both local and foreign brands, and 3) Decline in ROE	** Q312 results and FY12 results ** Unfavourable barley price movement	** Our 2012/13/14 estimates are 4%/10%/13% below consensus
Mengniu Dairy	2319.HK	USD5,290m	USD11m	UW (V)	HKD23.2	HKD19.7	** Sales recovery likely to be weaker than expected and we see high earnings downside risk over 2012-14 ** Mengniu Dairy is still on transformation stage, and we see limited room for significant margin expansion in the near term	** We use PE ratio to value Mengniu Dairy and our target price is based on 18x 12-month forward PE., around 1 standard deviation below the historical average PE of 23x ** We expect the stock to be de-rated due to slower-than-expected recovery in sales and margin	** Sales updates ** Sluggish industry growth data	** Our 2012/13/14 earnings estimates are 9%/20%/19% below consensus, respectively
Want Want	0151.HK	USD16,872m	USD17m	N	HKD9.9	HKD10.6	** Strong top-line growth to be driven by dairy beverages; but rice crackers sales seem to have affected by a shift in consumer preference ** Gross margin should continue to in 2H12 and 2013 due to decline in imported raw milk powder prices ** Extensive and deep distribution network in China	** We use DCF to value Want Want given its steady cash flow and return. Our DCF target price of HKD10.60 implies a 26x 12-month forward PE, slightly higher than the historical avg PE of 24x. ** Want Want's share price has gained 26% y-t-d and we believe it has fully reflected its strong earnings momentum	** Sales updates ** Favourable milk powder price movement	** Our 2012/13/14 earnings estimates are in line with consensus

Source: Thomson Reuters Datastream and HSBC

Selected valuation comparison – Greater China F&B companies (ranked by one-month share price movement)

Company	RIC	FY End	Mkt cap USDm	Ccy	Price 28-Sep	HSBC TP*	Rating	P/E (x) 2011a	P/E (x) 2012a/e	P/E (x) 2013e	EPS Growth 2011a	EPS Growth 2012a/e	EPS Growth 2013e	P/B (x) 2011a	P/B (x) 2012a/e	P/B (x) 2013e	ROE 2011a	ROE 2012a/e	Share price movement 1M	3M	6M	YTD
China (Large Caps)																						
Uni-President China	0220.HK	Dec	4,141	HKD	8.92	7.0	UW	85.4	28.2	25.2	-40%	197%	11%	3.9	3.4	3.1	5%	13%	20%	32%	75%	92%
China Foods	0506.HK	Dec	2,898	HKD	8.0	N.R.	N.R.	33.5	24.4	19.6	60%	38%	24%	3.5	3.0	2.7	11%	13%	16%	15%	12%	33%
CRE	0291.HK	Dec	8,019	HKD	25.9	N.R.	N.R.	25.4	20.4	20.6	-8%	25%	-1%	1.9	1.6	1.5	8%	6%	13%	16%	-8%	-3%
Tingyi	0322.HK	Dec	16,841	HKD	23.4	29.0	OW.	43.2	48.8	27.5	-18%	-11%	78%	8.0	7.2	6.3	20%	16%	3%	19%	10%	-1%
Sun Art	6808.HK	Dec	11,847	HKD	9.7	11.0	OW	30.0	26.1	21.5	100%	15%	22%	4.9	4.6	4.2	21%	15%	2%	10%	-9%	-1%
Mengniu Dairy	2319.HK	Dec	5,290	HKD	23.2	19.7	UW(V).	21.3	23.4	20.5	28%	-11%	13%	4.3	2.6	2.4	15%	12%	1%	16%	6%	28%
Want Want	0151.HK	Dec	16,872	HKD	9.9	10.6	N	40.0	30..8	24.7	17%	30%	25%	12.8	10.8	9.2	35%	38%	0%	9%	15%	28%
Tsingtao H	0168.HK	Dec	3,616	HKD	42.8	35.0	UW	27.6	25.1	21.0	14%	8%	9%	4.3	3.7	3.2	17%	16%	0%	-4%	-3%	0%
Hengan	1044.HK	Dec	11,412	HKD	73.3	95.0	OW	34.0	25.0	22.9	8%	36%	20%	7.3	6.5	5.9	23%	28%	0%	1%	0%	1%
				Weighted average (by market cap)				**37.2**	**24.5**	**23.6**	**17%**	**25%**	**30%**	**7.1**	**6.1**	**5.4**	**21%**	**21%**	**4%**	**12%**	**8%**	**13%**
China (Small Caps)																						
China Agri	0606.HK	Dec	2,286	HKD	4.4	N.R.	N.R.	6.6	9.0	7.8	56%	-27%	14%	0.8	0.8	0.7	14%	8%	17%	-5%	-18%	-26%
China Yurun	1068.HK	Dec	1,307	HKD	5.6	N.R.	N.R.	4.6	11.6	10.5	-23%	-60%	10%	0.6	0.6	0.6	14%	4%	14%	-25%	-49%	-45%
Shenguan	0829.HK	Dec	1,831	HKD	4.3	N.R.	N.R.	16.5	14.5	11.6	31%	14%	25%	5.4	4.7	3.7	35%	36%	4%	-3%	-10%	-5%
Biostime	1112.HK	Dec	1,530	HKD	19.9	23.3	OW (V)	20.8	14.6	12.0	23%	42%	22%	4.9	4.1	3.3	26%	31%	4%	5%	-2%	45%
China Green	0904.HK	Apr	206	HKD	1.8	N.R.	N.R.	2.7	2.5	1.9	-4%	9%	29%	0.4	0.4	0.3	12%	12%	3%	1%	-31%	-12%
Yashili	1230.HK	Dec	668	HKD	1.5	N.R.	N.R.	13.3	10.0	9.2	-44%	33%	8%	1.1	1.0	1.0	9%	11%	3%	26%	17%	26%
Real Nutriceutical	2010.HK	Dec	348	HKD	2.4	N.R.	N.R.	4.4	3.5	3.1	29%	25%	13%	0.8	0.6	0.5	19%	19%	2%	38%	-13%	-6%
Global Bio-Chem	0809.HK	Dec	345	HKD	0.8	N.R.	N.R.	3.0	2.8	1.8	125%	7%	55%	0.2	0.2	0.2	13%	10%	1%	-25%	-48%	-48%
Labixiaoxin	1262.HK	Dec	356	HKD	2.5	N.R.	N.R.	14.2	8.3	7.1	na	71%	17%	1.5	1.3	1.2	20%	17%	0%	-4%	-10%	21%
Huabao	0336.HK	Mar	1,790	HKD	4.4	N.R.	N.R.	8.3	7.6	6.8	9%	8%	13%	2.4	2.1	1.7	32%	28%	-5%	15%	-21%	11%
China Modern Dairy	1117.HK	Jun	1,250	HKD	2.0	N.R.	N.R.	23.5	14.9	10.6	180%	57%	41%	1.6	1.5	1.3	7%	10%	-6%	10%	-10%	23%
China Fishery	CNFG.SI	Sep	604	SGD	0.7	1.0	OW	4.9	5.3	5.6	-7%	-7%	-6%	0.8	0.7	0.6	16%	14%	-8%	-18%	-40%	-21%
Huiyuan Juice	1886.HK	Dec	448	HKD	2.4	N.R.	N.R.	13.6	21.2	23.9	17%	-36%	-11%	0.5	0.5	0.5	4%	2%	-9%	-16%	-20%	-11%
Wumart	1025.HK	Dec	805	HKD	11.6	13.8	UW (V)	18.6	17.7	15.9	20%	5%	11%	na	na	na	21%	19%	-10%	-26%	-32%	-29%
Lianhua	0980.HK	Dec	889	HKD	6.2	N.R.	N.R.	7.4	9.3	8.5	21%	-21%	9%	1.8	1.5	1.4	23%	17%	-15%	-16%	-33%	-38%
Vinda	3331.HK	Dec	1,322	HKD	10.7	14.4	OW	25.1	19.5	12.9	7%	29%	51%	3.2	2.6	2.3	14%	16%	-17%	-9%	-8%	7%
					Weighted Avg (By mkt-cap)			**13.0**	**11.8**	**9.9**	**32%**	**7%**	**20%**	**2.3**	**1.9**	**1.6**	**19%**	**18%**	**1%**	**-3%**	**-18%**	**-4%**
China (A-shares)																						
Kweichow Moutai	600519.SS	Dec	40,503	RMB	245.8	N.R.	N.R.	31.4	18.9	13.6	90%	66%	38%	9.9	7.1	5.0	36%	42%	8%	2%	22%	27%
Yili Dairy	600887.SS	Dec	5,405	RMB	21.3	N.R.	N.R.	20.5	20.1	15.4	126%	2%	30%	5.2	3.4	3.0	29%	20%	3%	2%	-6%	4%
Tsingtao A	600600.SS	Dec	3,590	RMB	32.5	N.R.	N.R.	25.4	22.4	18.8	13%	13%	19%	3.9	3.4	2.9	16%	16%	-1%	-12%	-5%	-3%
Wuliangye Yibin	000858.SZ	Dec	20,425	RMB	33.9	N.R.	N.R.	20.4	14.4	11.1	43%	42%	30%	5.5	4.2	3.2	28%	31%	-1%	6%	-2%	3%
Henan Shuanghui	000895.SZ	Dec	10,566	RMB	60.5	N.R.	N.R.	43.2	22.5	18.4	-22%	92%	22%	10.7	6.2	5.1	18%	25%	-5%	-4%	-15%	-14%
Beingmate	002570.SZ	Dec	1,444	RMB	21.4	N.R.	N.R.	19.4	17.9	14.6	na	8%	23%	2.8	2.5	2.2	20%	14%	-8%	0%	-18%	-11%
Bright Dairy	600597.SS	Dec	1,657	RMB	8.5	N.R.	N.R.	37.0	30.4	24.3	21%	22%	25%	3.5	3.0	2.7	9%	10%	-8%	-8%	-11%	-5%
Beijing Yanjing	000729.SZ	Dec	2,110	RMB	5.3	N.R.	N.R.	15.1	14.2	12.0	9%	6%	19%	1.3	1.2	1.3	9%	10%	-16%	-26%	-31%	-22%
Changyu Pioneer A	200869.SZ	Dec	1,143	HKD	38.2	N.R.	N.R.	11.4	9.6	7.8	30%	19%	23%	4.3	3.3	2.6	42%	38%	-17%	-27%	-42%	-42%
					Weighted Avg (By mkt-cap)			**28.6**	**18.5**	**14.1**	**60%**	**53%**	**32%**	**7.9**	**5.6**	**4.2**	**29%**	**33%**	**2%**	**0%**	**6%**	**11%**
Hong Kong																						
Café de Coral	0341.HK	Mar	1,604	HKD	21.8	N.R.	N.R.	25.9	24.1	21.2	-7%	7%	14%	4.0	3.8	3.5	16%	16%	0%	4%	3%	22%
Fairwood	0052.HK	Mar	248	HKD	15.4	N.R.	N.R.	19.7	13.6	12.3	322%	45%	11%	5.1	3.5	3.1	20%	27%	-2%	10%	22%	51%
					Weighted Avg (By mkt-cap)			**25.1**	**22.7**	**20.0**	**37%**	**12%**	**13%**	**4.1**	**3.7**	**3.5**	**17%**	**18%**	**0%**	**5%**	**6%**	**26%**
Taiwan																						
Uni-President	1216.TW	Dec	8,562	TWD	52.0	55.0	OW	26.8	19.1	18.2	-14%	40%	5%	3.2	3.3	3.0	13%	18%	4%	22%	30%	26%
Family Mart	5903.TW	Dec	1,114	TWD	146.5	N.R.	N.R.	31.5	32.3	28.0	11%	-3%	16%	7.3	7.3	6.8	24%	23%	-2%	5%	-5%	21%
Hon Chuan	9939.TW	Dec	568	TWD	64.2	74.0	OW	13.0	11.9	10.4	-4%	9%	14%	1.4	1.4	1.3	12%	12%	-4%	-3%	-5%	15%
PSCS	2912.TW	Dec	5,576	TWD	157.0	162.0	N	25.7	25.2	22.9	11%	2%	10%	7.9	9.5	9.0	31%	34%	-5%	0%	-3%	-5%
					Weighted Avg (By mkt-cap)			**26.2**	**21.9**	**20.3**	**-3%**	**22%**	**8%**	**5.1**	**5.7**	**5.3**	**20%**	**24%**	**0%**	**12%**	**14%**	**14%**

Source: Datastream, I/B/E/S consensus estimates and HSBC estimates

Selected valuation comparison – Int'l F&B companies (ranked by one-month share price movement)

Company	RIC	FY End	Mkt cap USDm	Ccy	Price** 27-Sep	HSBC TP	Rating	P/E (x) 2011a	P/E (x) 2012a/e	P/E (x) 2013e	EPS Growth 2011a	EPS Growth 2012a/e	EPS Growth 2013e	P/B (x) 2011a	P/B (x) 2012a/e	P/B (x) 2013e	ROE 2011a	ROE 2012a/e	Share price movement 1M	Share price movement 3M	Share price movement 6M	Share price movement YTD
Korea																						
Daesang	001680.KS	Dec	725	KRW	23,500	n/a	N.R.	15.4	10.3	9.9	65%	49%	5%	1.5	1.4	1.3	11%	14%	35%	39%	46%	46%
Kook Soon Dang Brewery	043650.KS	Dec	147	KRW	9,200	n/a	N.R.	22.9	15.0	11.6	-55%	53%	30%	0.9	0.9	0.9	4%	6%	33%	22%	6%	15%
Binggrae	005180.KS	Dec	931	KRW	105,500	n/a	N.R.	24.0	17.5	15.6	-21%	37%	12%	2.6	2.3	2.1	11%	14%	18%	46%	86%	77%
Ottogi	007310.KS	Dec	768	KRW	249,000	n/a	N.R.	13.4	12.2	10.8	16%	10%	12%	1.6	1.4	1.4	13%	12%	16%	57%	61%	61%
Lotte Samkang	002270.KS	Dec	644	KRW	571,000	n/a	N.R.	15.7	11.3	9.4	-8%	39%	21%	1.3	1.3	1.1	9%	12%	14%	8%	32%	39%
Dongwon F&B	049770.KS	Dec	242	KRW	70,000	n/a	N.R.	8.4	14.6	8.4	-4%	-42%	74%	0.7	0.7	0.7	9%	5%	9%	5%	-3%	-2%
Orion Corp	001800.KS	Dec	4,990	KRW	971,000	1,280,000	OW	58.5	37.7	30.1	-48%	55%	25%	6.6	5.7	4.9	12%	16%	8%	3%	23%	43%
Nongshim	004370.KS	Dec	1,463	KRW	265,500	260,000	UW	18.7	78.1	13.6	-31%	-76%	473%	1.1	1.1	1.0	6%	1%	3%	29%	17%	14%
HiteJinro	000080.KS	Dec	1,524	KRW	24,400	27,000	N (V)	9.9	12.0	12.4	65%	-18%	-3%	2.1	2.0	1.9	14%	17%	2%	14%	-5%	-3%
CJ Cheil Jedang	097950.KS	Dec	3,619	KRW	307,500	420,000	OW (V)	29.3	11.4	9.7	43%	158%	17%	1.6	1.4	1.3	6%	13%	-2%	-6%	-10%	6%
Lotte Chilsung Beverage	005300.KS	Dec	1,529	KRW	1379,000	n/a	N.R.	17.6	16.6	13.7	190%	6%	21%	0.8	0.9	0.8	4%	5%	-5%	-2%	12%	-6%
Lotte Confectionery	004990.KS	Dec	1,977	KRW	1552,000	n/a	N.R.	19.7	17.8	16.7	-22%	11%	6%	0.8	0.8	0.8	4%	5%	-8%	5%	-7%	-9%
					Weighted Avg (By mkt-cap)			**30.5**	**25.3**	**17.1**	**13%**	**45%**	**53%**	**2.8**	**2.5**	**2.2**	**9%**	**12%**	**5%**	**10%**	**15%**	**22%**
Europe																						
Heineken	HEIN.AS	Dec	34,075	EUR	46.0	47.0	N	17.0	16.3	14.5	5%	4%	12%	2.8	2.5	2.2	16%	16%	2%	16%	9%	29%
Diageo	DGE.L	Jun	70,841	GBP	17.44	18.0	N	20.7	17.9	16.1	16%	21%	12%	7.3	5.8	4.7	40%	37%	2%	7%	14%	24%
Carlsberg	CARLb.CO	Dec	10,683	DKK	521.0	N.R.	N.R.	14.7	14.3	12.0	-3%	3%	20%	1.2	1.1	1.0	8%	9%	2%	16%	16%	29%
AB InBev	ABI.BR	Dec	138,032	EUR	66.8	73.0	OW	21.2	18.3	16.9	28%	16%	9%	3.7	3.0	2.6	18%	18%	1%	14%	22%	41%
Pernod Ricard	PERP.PA	Jun	30,080	EUR	88.2	93.0	N	19.8	17.1	15.0	9%	16%	16%	2.5	2.3	2.1	13%	14%	0%	8%	12%	23%
Unilever	UNc.AS	Dec	55,585	EUR	27.9	33.0	OW	17.6	16.0	14.7	3%	10%	9%	5.7	5.0	4.4	32%	33%	0%	8%	9%	5%
Nestle	NESN.VX	Dec	204,745	CHF	59.7	67.0	N	19.0	17.6	16.4	-7%	8%	8%	3.4	3.1	2.9	17%	18%	-1%	7%	5%	10%
SABMiller	SAB.L	Mar	70,584	GBP	27.34	29.5	N	21.3	18.8	17.1	19%	12%	14%	2.9	2.7	2.4	14%	15%	-1%	8%	6%	21%
Danone	DANO.PA	Dec	40,732	EUR	49.2	58.0	OW	16.9	16.0	14.7	7%	6%	9%	2.1	2.2	2.1	12%	13%	-4%	4%	-5%	1%
					Weighted Avg (By mkt-cap)			**19.5**	**17.5**	**16.0**	**9%**	**11%**	**10%**	**3.8**	**3.4**	**3.0**	**20%**	**20%**	**0%**	**9%**	**10%**	**20%**
US																						
Mead Johnson	MJN.N	Dec	15,152	USD	74.4	N.R.	N.R.	26.7	24.0	21.1	15%	11%	14%	n/a	n/a	n/a	0%	na	2%	-14%	-10%	8%
General Mills	GIS.N	May	25,738	USD	39.9	N.R.	N.R.	15.8	15.2	14.3	8%	3%	4%	4.0	3.7	3.3	27%	25%	1%	6%	2%	-1%
Coca-Cola	KO.N	Dec	172,469	USD	38.3	44.0	OW	19.9	19.2	17.3	10%	4%	11%	5.6	5.2	4.8	28%	28%	0%	0%	7%	10%
Kellogg	K.N	Dec	18,477	USD	51.7	N.R.	N.R.	15.3	15.7	14.4	2%	-2%	8%	10.5	6.6	5.8	63%	56%	0%	6%	-3%	2%
Heinz	HNZ.N	Apr	17,898	USD	55.9	N.R.	N.R.	17.1	16.2	15.1	7%	9%	5%	6.2	5.9	5.2	38%	38%	-1%	5%	5%	3%
Campbell Soup	CPB.N	Jul	10,981	USD	34.8	N.R.	N.R.	13.9	14.0	13.4	3%	-4%	4%	n/a	n/a	8.1	82%	72%	-2%	7%	5%	5%
Hershey	HSY.N	Dec	11,739	USD	70.8	N.R.	N.R.	25.1	21.9	19.8	11%	15%	11%	18.8	15.2	12.4	71%	70%	-3%	2%	16%	15%
Pepsi	PEP.N	Dec	109,935	USD	70.6	78.0	OW	15.9	17.3	15.9	8%	-8%	9%	5.4	5.0	4.5	34%	30%	-3%	1%	7%	6%
					Weighted Avg (By mkt-cap)			**18.3**	**17.9**	**16.4**	**9%**	**2%**	**9%**	**3.0**	**9.0**	**5.8**	**30%**	**29%**	**-1%**	**3%**	**6%**	**8%**

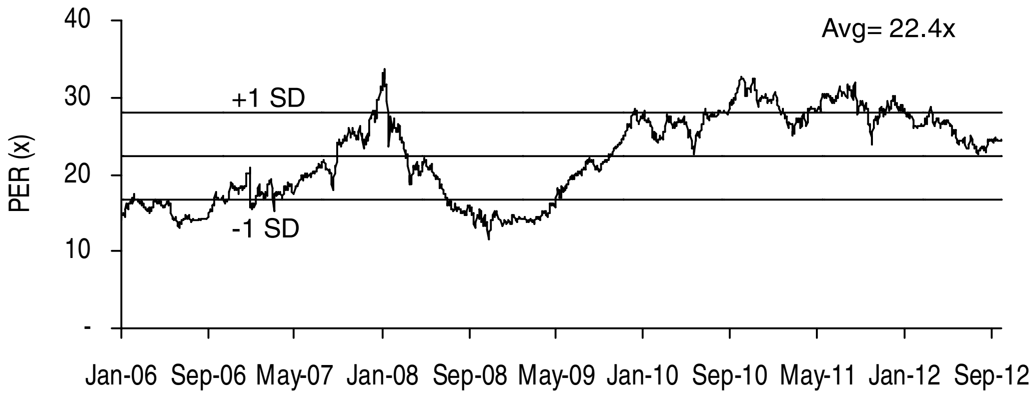
** Korea F&B companies are priced on 28-Sept-2012. Europe and US F&B companies are priced on 27-Sept-2012.

Source: Datastream, I/B/E/S consensus estimates and HSBC estimates

This page has been left blank intentionally.

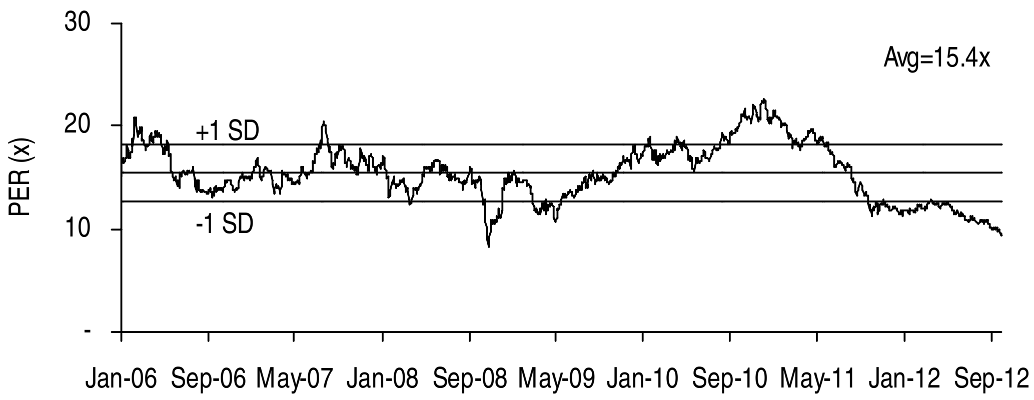
China consumer staple PE band charts

Large caps – One-year forward PE band, Jan-06 to present



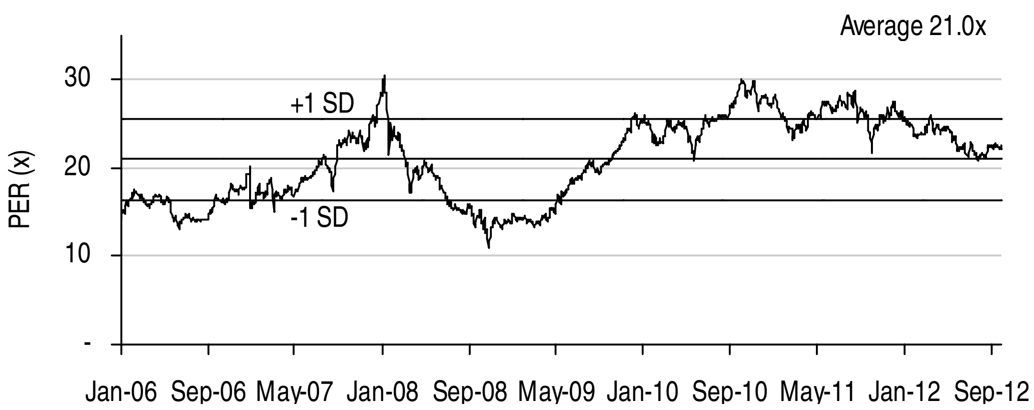
Note: Large cap companies include Tingyi, UPC, Want Want, Mengniu Dairy, Tsingtao, Hengan, China Foods, China Resources Enterprise, and Sun Art Retail
Source: Thomson Reuters Datastream, HSBC Research

Small caps – One-year forward PE band, Jan-06 to present



Note: Small cap companies include Wumart, Huaboa, Shenguan, Labixiaoxin, Yashili, Biostime, Real Nutriceutical, Global Bio-chem, China Green, Lianhua Supermarket, Ausnutria, China Agri, and Vinda.
Source: Thomson Reuters Datastream, HSBC Research

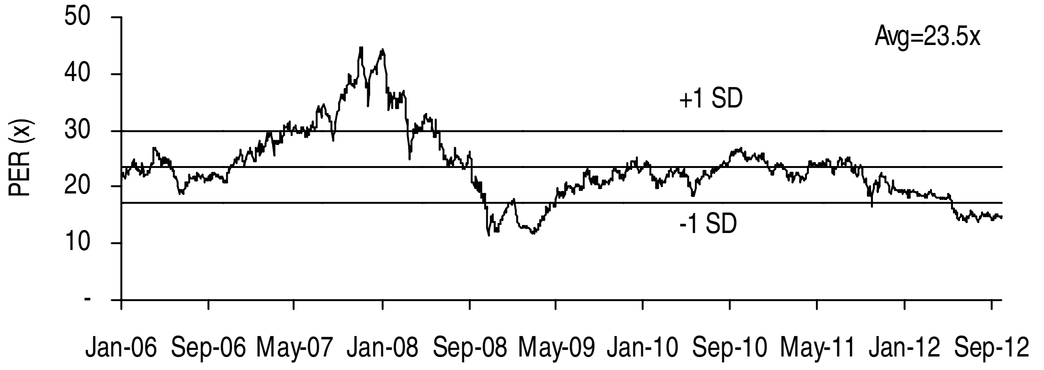
Overall – One-year forward PE band, Jan-06 to present



Note: Companies include Tingyi, UPC, Want Want, Mengniu Dairy, Tsingtao, Hengan, China Foods, China Resources Enterprise, and Sun Art Retail, Wumart, Huaboa, Shenguan, Labixiaoxin, Yashili, Biostime, Real Nutriceutical, Global Bio-chem, China Green, Lianhua Supermarket, Ausnutria, China Agri, and Vinda
Source: Thomson Reuters Datastream, HSBC Research

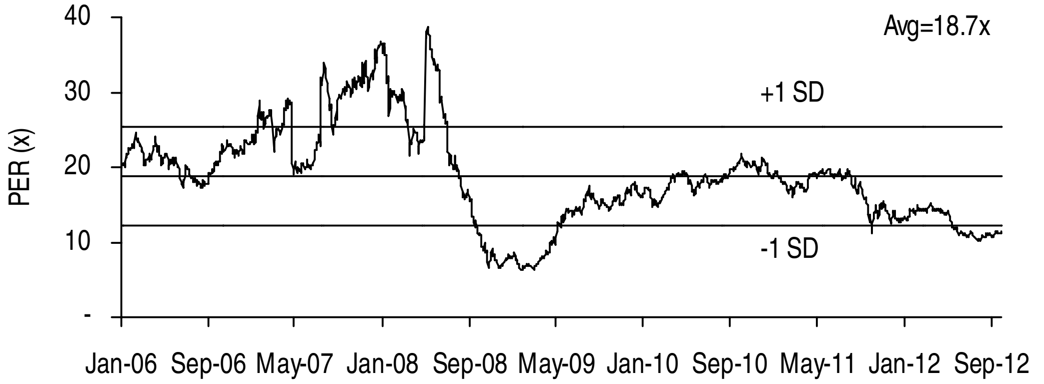
China consumer discretionary PE band charts

Large caps – One-year forward PE band, Jan-06 to present



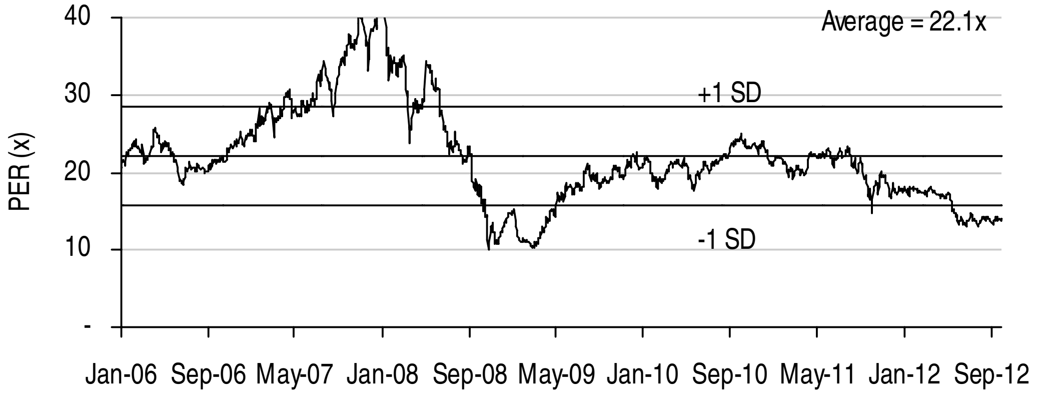
Note: Large cap companies include Golden Eagle, Intime Dept Store, Lifestyle, Parkson, Belle, Chow Tai Fook Jewellery
Source: Thomson Reuters Datastream, HSBC Research

Small caps – One-year forward PE band, Jan-06 to present



Note: Small cap companies include Anta Sport, Daphne Trinity, Hengdeli, SaSa, Maoye, New World Dept Store, Luk Fook, and China Lilang
Source: Thomson Reuters Datastream, HSBC Research

Overall – One-year forward PE band, Jan-06 to present



Companies include Golden Eagle, Intime Dept Store, Lifestyle, Parkson, Belle, Chow Tai Fook Jewellery, Anta Sport, Daphne Trinity, Hengdeli, SaSa, Maoye, New World Dept Store, Luk Fook, and China Lilang
Source: Thomson Reuters Datastream, HSBC Research

The income evolution

- Strong economic development will boost the purchasing power of low-income consumers, helping them move up the value chain
- Branding and distribution will be the success factors for F&B players, to fully capture this trend; Tingyi & Want Want have excelled in this regard
- But branding will emerge the key differentiator as distribution advantage will diminish with China's easing infrastructure woes in the long run

Preference shift

Consumer preference evolves as income grows, a phenomenon seen across the world. With rising income, the preference shifts towards higher quality and branded products. RTD bottled tea drinks is a good example. In the early 1990s, most Chinese families consumed tea at home from glass bottles filled with tea leaves, but as household income increased and consumer value moved towards convenience, the demand for RTD bottled drinks surged, significantly expanding its market size from RMB15bn in 2000 to RMB84bn in 2011, according to Euromonitor International's April 2012 report, *Passport: Soft Drinks in China.*

When China's GDP per capita was around USD1,038 a decade ago, consumer spending was driven by basic needs. Owing to the rapid economic developments, China's GDP per capita rose to USD5,570 in 2011. At first glance, the current stage of China consumption looks similar to that of Korea in the late 80s when GDP per capita there was just around USD6,000. At this income levels, the general interpretation is that consumers' basic needs are well satisfied, and consumers are believed to move up the value chain, i.e. from staples to higher-quality and branded products.

However, this is not entirely the case for China given its much larger population (27 times Korea's). Also, we observe a huge disparity between the two categories of China's earning groups, the one above and the one below the national GDP per capita average of USD5,500.

The group with the higher GDP per capita earns around USD8,763, close to Korea's during the early 1990s. Yet this group only represents 39% of the total population of China. The average GDP per capita of the other group is around USD4,458, similar to that of other developing countries such as Indonesia and Thailand, and makes up 61% of population.

Therefore, China has two clearly defined groups of consumers. The higher-income group has benefited significantly from rising income and is seeking higher quality and branded products, whereas the other group is earning relatively low income, so opting for staples is still a priority for them.

However, if the economic development in China remains strong in the next decade, the lower income group should move up the value chain, with their preference shifting towards higher quality and branded products. Many food contamination scandals across the different food categories in the past few years have also made them more conscious about food quality.

Branding for success

We believe Chinese consumers will become increasingly refined in their preferences and expect F&B companies to increase their focus on advertising, product innovation, and quality control to further enhance their brand positioning and garner higher market shares. In particular, we believe companies will incur higher advertising and promotional (A&P) spending and focus increasingly on product mix upgrades. Compared with the global F&B companies, we note that Want Want and Mengniu Dairy's A&P spend is lower, while Tingyi and Tsingtao are largely in line with the global F&B companies. UPC has a higher A&P to sales ratio, and we believe this is due mainly to smaller revenue size and more costly A&P spend for the beverage business.

China F&B companies A&P/sales ratio comparison, 2011-14e

Year to 31 December	2011	2012e	2013e	2014e	1H12
UPC	10.0%	13.1%	13.2%	13.4%	13.2%
Tingyi	7.8%	8.9%	9.3%	9.5%	8.0%
Tsingtao	9.1%	7.3%	8.0%	8.5%	8.7%
Mengniu	7.8%	7.0%	7.4%	7.5%	n/a
Want Want	2.8%	2.9%	3.2%	3.4%	2.5%

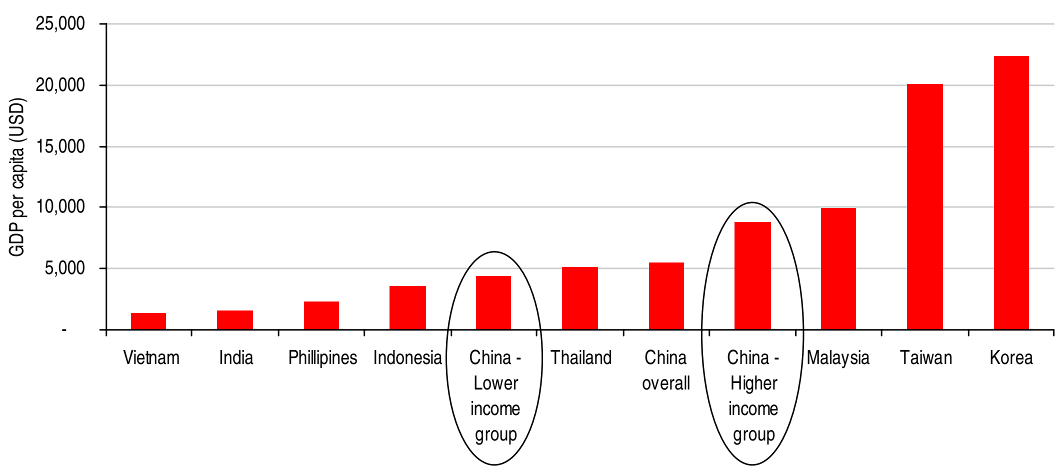
Source: Company data, HSBC estimates

Global F&B companies A&P/sales ratio comparison, 2009-11

Year to 31 December	2009	2010	2011
Danone**	10e-11e%	10e-11e%	10e-11e%
Unilever Food	n/a	n/a	8%
Kellogg	8.7%	9.1%	8.6%
General Mills*	5.7%	5.9%	5.6%
Kraft	4.1%	4.6%	4.4%
Orion (Group)	9.9%	10.9%	9.9%

*Calendarised
**HSBC estimates
Source: Company data, HSBC estimates

GDP per capita comparison



Source: CEIC, HSBC

Product innovation and mix upgrade

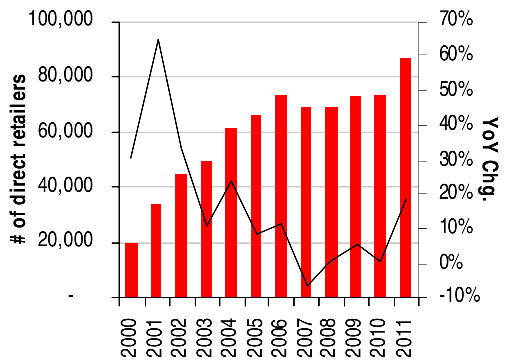
Product innovation is important for successful branding, increasingly so in China as consumers become more open to new tastes and flavours. The capacity to launch new products and flavours and to cater to specific market needs will become a key differentiating factor for companies looking to gain market share. This is especially crucial for companies competing in China's higher income group market, where consumer tastes are becoming more sophisticated and health conscious.

We find that it is not easy for downstream F&B companies to fully pass through higher costs to consumers; therefore, they often improve their product mixes to enhance or sustain margins. We believe the companies will increase their focus on product mix upgrade to improve margins. For examples, Tingyi has exited the low-end instant noodle market and is increasing its focus on high-end packet and bowl noodles. Mengniu is reducing the contribution from lower-margin production and increasing focus on high-end category. Tsingtao, the country's most well-recognised beer brand, is also increasing the share of high-end beer products in its portfolio, for which the gross margin could be as high as 50%, based on our estimates

Distribution still important

Throughout the last decade, F&B companies have come a long way, by expanding their distribution network to serve customers. Tingyi, for example, achieved sales at a CAGR of 24% between 2001 and 2011, while its number of direct retailers grew 14%.

Tingyi – Number of direct retailers, 2000-2011



Source: Company reports

We believe distribution network is still an important aspect for most F&B companies in the next 10 years as there are many small grocery retail outlets in China and the infrastructure in many rural areas are under-developed. A research study of Euromonitor indicated that there are over 3.6m grocery retail stores in China, but only less than 120,000 have the modern grocery retail format.

However, as the country's logistic infrastructure and national retail chains continue to develop, we believe the advantage of having a sizeable distribution network will diminish in the long run.

Distributing in China

Wholesaling is the most common distribution method in the F&B industry, but it varies with companies. Companies usually wholesale their products to their regional distributors, which will then resell to sub-distributors or end-retailers in suburban and rural areas. In developed cities such as Shanghai and Beijing, companies usually will sell directly to the modern grocery retailers such as supermarkets/hypermarket. However, in some cases, companies such as Wahaha (one of the biggest beverage companies in China) and Mengniu Dairy, allow their distributors to sell directly to modern grocery retailers.

Our study at the large F&B companies such as UPC and Want Want indicated that over 80% of their sales are derived from wholesaling to distributors. For Mengniu Dairy, it does not sell directly to modern retailers such as hypermarkets or supermarkets, so it has 100% contribution from sales to distributors. The key benefit of wholesaling is that it can help companies to expand its distribution network quickly, but there is lesser control on sell-through.

Sales breakdown by distribution channel

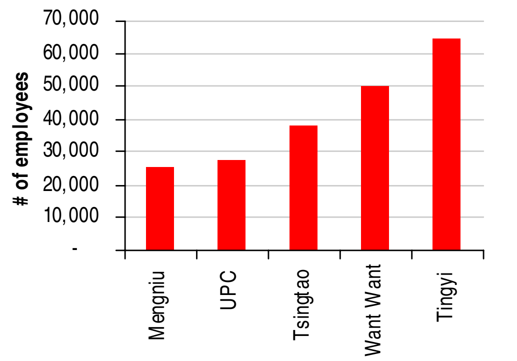
Company	Direct sales to large retailers	Wholesale to Distributors
Want Want	10-15%	85-90%
UPC	12%	88%
Mengniu Dairy	--	100%

Source: Company data

We believe wholesaling will continue to be the key distribution method for most F&B companies in the next 10 years, but we expect higher contribution from direct sales to end-retailers, driven by both commercialisation of logistic networks and rising competition.

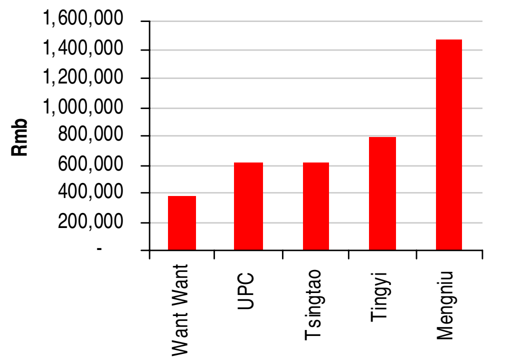
Companies such as Tingyi and Want Want have already established a large sales force to increase direct coverage of small distributors and end-retailers; this move will give them the advantage of greater control on its distribution channel and the ability to respond to market changes faster.

Number of employees, 2011



Source: Company reports, HSBC

Employee productivity – Revenue/number of employees, 2011



Source: Company reports, HSBC

Most F&B companies do not disclose the size of their distribution network, but we could interpolate it based on production lines/factories and their employee numbers. The tables below summarise the employees and production network of Tingyi, UPC, Tsingtao Brewery, China Resources Enterprises, and Beijing Yanjing Brewery. In the following page, we also compared the production network of Tingyi and UPC based on their locations.

Production line comparison – Instant noodles

Company	# of production lines
UPC	61
Tingyi	208

Source: Company reports

Production line comparison – Beverage

Company	# of production lines
UPC	58
Tingyi	287

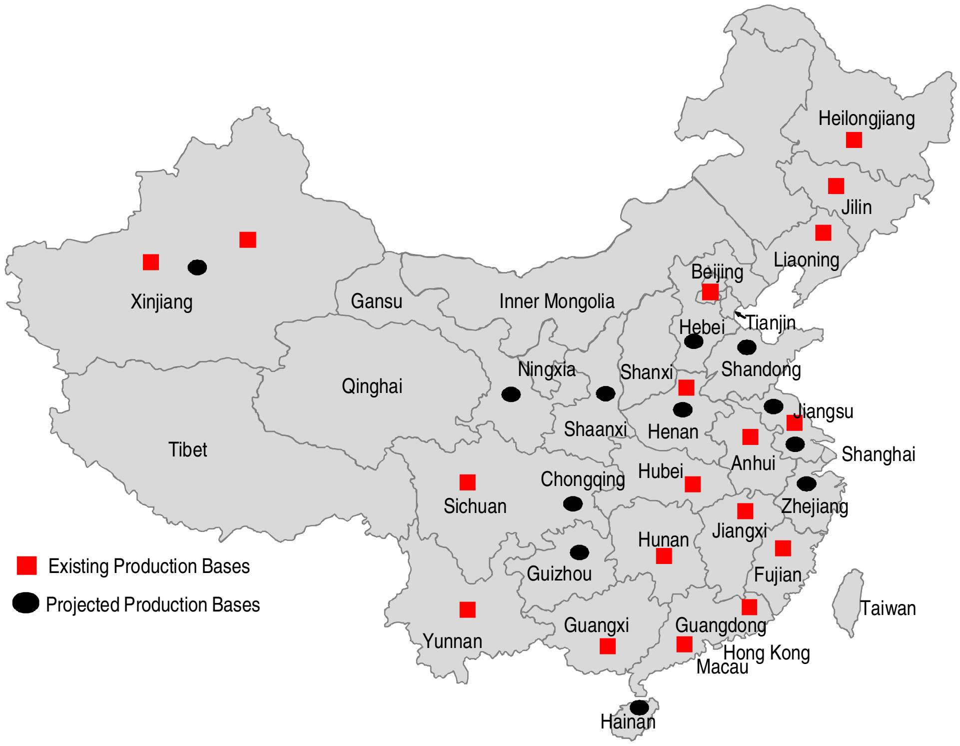
Source: Company reports

Production base comparison – Beer

Company	# of factories
China Resources Enterprise	82
Tsingtao Brewery	55
Beijing Yanjing Brewery	31

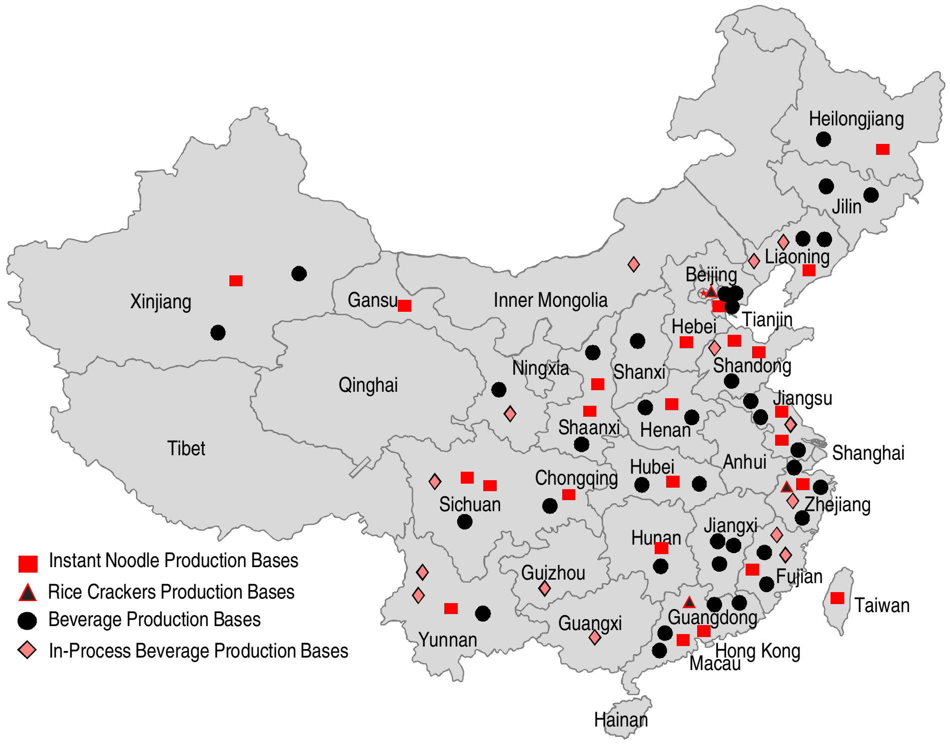
Source: Company reports

UPC – Production network in China



Source: Company reports, HSBC

Tingyi – Production network in China



Source: Company reports

Sector implications

The F&B sub-sectors are in different stages of maturity, and the companies are taking various approaches to strengthen their brand position and distribution network.

In this section, we look at the key players in five different sub-sectors: instant noodles, soft drinks, dairy, beer, and snack foods, and highlight their key trends in branding and distribution.

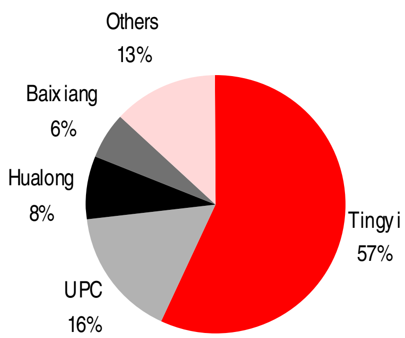
In our view, some companies, such as UPC, Mengniu Dairy and Tsingtao, are not comprehensive on both distribution and branding, and their strategic approach to enhancing these two areas could impact their profitability and returns on capital in next few years.

Instant noodles

Tingyi's scale vs UPC's catch-up

- **Key players.** The instant noodles market is highly concentrated. Smaller players are losing market share. Competition between Tingyi and UPC is intensifying of late due to successful new product roll-outs by UPC.
- Tingyi, as a dominant player, enjoys scale benefit over its peers. Its large distribution network helps it react to market changes quickly. Although UPC has successfully captured market share in the past two years, it still lacks the scale to improve efficiency and further increase margin.

China instant noodles market share, by sales value, 1H12



Source: Company report

UPC – Laotan pickled cabbage and beef flavoured bowl noodles (retail price: RMB3.50 per pack*)

*Price date was 17-Sept-2012 in Zhenzhou City
Source: HSBC

Tingyi – Braised beef flavoured bowl noodles (retail price: RMB3.40 per pack*)

*Price date was 17-Sept-2012 in Zhenzhou City
Source: HSBC

- We believe the instant noodle market is approaching to a mature stage given the strong growth in the per capita consumption of the past few years. We think the growth driver going forward will be higher ASP though new product introductions as consumers trade up from low-end to more high-end packet and bowl noodles.
- Companies like Tingyi and UPC should continue to benefit from the consumer trade-up and continue to gain market share from the small players in the long run. However, in the short term, we think UPC market share growth will be hindered by rising competition from Tingyi and other small players.

Soft drinks

Within the soft drinks sector, there are different sub-sectors but the major categories are bottled water, carbonated drinks, RTD tea, and juice.

With the exception of juice products, all major soft drinks markets are fairly concentrated, and most of the leading players already have established a clear brand positioning in China.

The biggest entry barrier in the soft-drink sector is the production and distribution network as capital investment for infrastructure is high.

Carbonated drinks

Pepsi stepping up

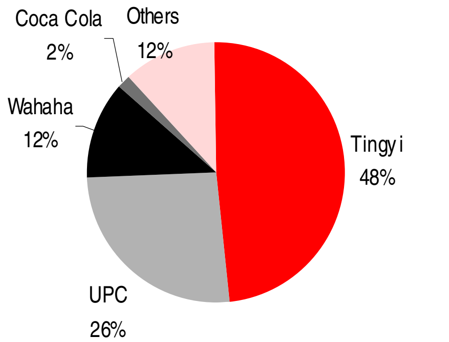
- This market segment is dominated by Coca-Cola (KO.N) and Pepsi (PEP.N). We believe both Coca-Cola and Pepsi can maintain their dominant positions in the carbonated drinks market in China in the long run given their strong brand positioning.
- Pepsi is stepping up its efforts in China by partnering with Tingyi for expansion in the soft drinks market. However, we do not think this will substantially increase its market share in the near term, as it will take time for Tingyi to establish new bottling plants. Pepsi currently has 24 bottling plants in China.
- Coca-Cola is also accelerating its expansion in China, with investments to rise from USD3bn during 2009-11 to USD4bn 2012-14. Coca-Cola now has 42 bottling plants in China.

RTD tea

Tingyi's milk tea to gain market share

- Tingyi (0322.HK) and UPC (0220.HK) are the biggest players in this segment. New products such as milk tea and sugar-free Chinese tea are increasingly becoming popular and registering rapid growth
- Price competition in RTD tea is not as severe as in bottled water, but its pricing upside is limited due to rising competition.
- Despite the RTD tea industry growth has slowed in recent years, we believe there is still strong growth potential in the long run as the current product offering in China is still limited and we see potential for companies to stimulate consumptions through new product introductions. Companies like Tingyi and UPC should benefit most from the trend.
- In the near term, we think Tingyi should regain market share after the launch of the milk tea drinks.

China RTD bottled tea market share, by sales value, 1H12



Source: Company reports

UPC – Milk tea (500ml); retail price: RMB3.80/bottle*

*Price date was 17-Sept-2012 in Zhenzhou City
Source: HSBC

Tingyi – Milk tea (500ml); retail price: RMB3.70/bottle*

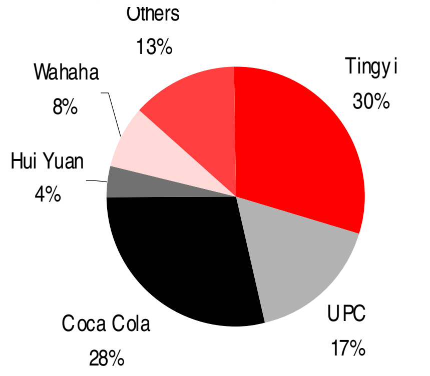
*Price date was 17-Sept-2012 in Zhenzhou City
Source: HSBC

Juice

Co-branding with Tropicana

- Tingyi is the largest player in the diluted juice markets. Other key players are UPC (0220.HK) Coca-Cola, Huiyuan Juice (1886.HK), and Wahaha.
- We believe there is ample room for growth in the juice market as pure juice (100% juice) is still not a popular product in China. Tingyi, as the exclusive manufacturer and distributors for Tropicana's juice drinks in China, stands to benefit most when pure juice consumption becomes popular given Tropicana's strong product offerings in the pure juice category.
- Pure juice production is different from diluted juice production and therefore companies may need to incur additional capex when they expand pure juice production.

China diluted juice market share, by sales value, 1H12



Source: Company report

Tingyi – Master Kong juice (retail price: 2.40 per bottle*)

*Price date was 17-Sept-2012 in Zhenzhou City
Source: HSBC

Tingyi – Master Kong juice with Tropicana logo

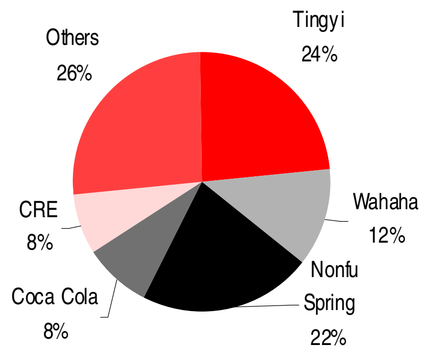
Source: HSBC

Bottled water

Little product differentiation

- Tingyi is a dominant player with 24% market share. Other key players include Wahaha (unlisted), Nonfu Spring (unlisted), C'estbon (0291.HK), and Coca-Cola (KO.N).
- There is little product differentiation in bottled water, as distilled water accounts for more than 95% of consumption, not the sparkling water category.
- Profit margin is also lower than for other soft drinks products due to lower price point and intense competition.

China bottled water market share breakdown by sales volume, 1H12



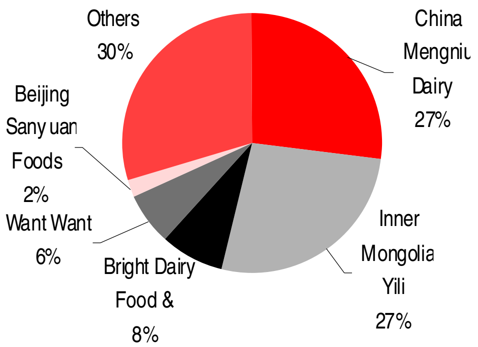
Source: Company report

Dairy

Mengniu vs Want Want

- Flavoured milk demand has been exceptionally strong; Want Want is gaining market share from other dairy companies.
- Ultra-high temperature processing (UHT) and pasteurised milk consumption was affected by numerous milk scandals.
- Mengniu Dairy and Inner Mongolia Yili are two key players in the UHT milk market.
- Dairy companies are increasing investments in their raw milk suppliers and have started building corporate-owned dairy farms. The government is also providing financial incentives to upstream investments.
- Although milk contamination has weakened consumer confidence and UHT milk consumption growth is likely to remain low in the near-term, we believe long-term prospects remain sound given the current low level of per capita dairy consumption.
- There will be high growth potential when consumers regain confidence in domestically-made milk products. We believe dairy companies like Mengniu Dairy that have started to invest in their upstream raw milk supply will benefit most in the medium and long term.

China drinking milk market share breakdown by sales value, 2011



Source: HSBC estimates

Snack foods

Rising competition from foreign players

- Want Want is a leading player with more than 10% market share. The other key players are Strong (Unlisted), QiaQia (Unlisted), Pepsi (PEP.N), QinQin (1044.HK), Labixiaoxin (1262.HK), and Orion (001800.KS)
- Entry barriers to the snack foods market are not high given this segment is less capital intensive compared with soft-drinks.
- Industry consolidation is expected given the current brand proliferation, and we think Want Want and other foreign players should be the dominant players in the long run given their strength in product offering and marketing.
- Foreign players such as Orion have already stepped up their efforts to penetrate suburban and rural areas.

Beer

Consolidation to continue, with more direct competition

- **Key players.** Top four players now account for 60% of market share, including Tsingtao (0168.HK), CRE (0291.HK), AB InBev (ABI.BR), and Beijing Yanjing (000729:CH).
- The remaining 40% market share is taken up by the key regional and small local brewing companies. Key regional brewing companies include Zhujiang Brewery, Chongqing Brewery, and Kingway Brewery, accounting for 11% of market share.
- Small local brewing companies account for 29% of market share and usually have less than 100,000 ton production capacity, with some registering low profitability or suffering from losses.
- **Consolidation to continue.** Despite years of consolidation, the beer market in China is still fairly fragmented on a countrywide basis. On a regional basis, it is more concentrated; there are 17 provinces and municipalities that are dominated by a single brewery company with more than 50% shares.

Want Want – Rice crackers (105g); retail price: RMB7.90 per pack*

*Price date was 17-Sept-2012 in Zhenzhou City
Source: HSBC

Want Want – Hot-Kid milk (245ml); retail price: RMB4.40 per can*

*Price date was 17-Sept-2012 in Zhenzhou City
Source: HSBC

- We believe industry consolidation will continue, but not driven by key regional brewery companies' M&A, as acquisitions in China are becoming more expensive. We think consolidation will come from small regional breweries either exiting the markets or being acquired by the top four players or key regional brewery companies.
- **Pricing potential.** Key players like Tsingtao and CRE have already started developing their high-end beer products to capture rising demand from first- and second-tier cities. CRE, for example, launched its high-end beer products in 2009, and the contribution from high-end beer products has increased from 12% of sales volume in the first year to the current of 28%. Tsingtao, as the most famous beer brand in China, has also expanded its high-end beer offerings in past few years, and we estimate that high-end beers now account for 20% of its sales volume.
- With rising income and consumers continue to trade up, we believe demand for high-end beer will remain strong, especially in eastern China. However, competition should also intensify, as all top brewery companies are focusing on this segment.
- Foreign beer brands such as Budweiser and Heineken have always been focusing on the high-end market, and their selling prices are also much higher than the locals. For example, the retail price of Budweiser beer is around 2x higher than the local high-end beers. See the following table for a retail price comparison.

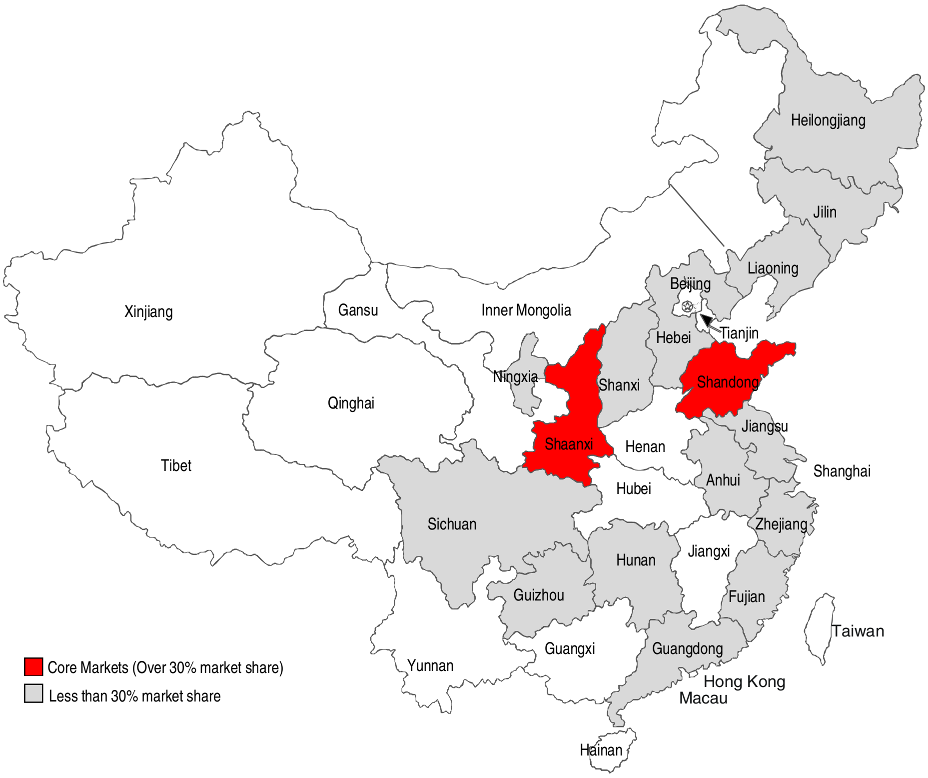
Selected retail price comparison

Company	Beer (330ml)	Retail price*
Foreign brands		
AB InBev	Budweiser Draft Beer	RMB6.80
AB InBev	Budweiser Beer	RMB5.80
AB InBev	Harbin King of Wheat	RMB1.90
Heineken	Heineken Beer	RMB5.90
Local brands		
Tsingtao	Tsingtao Chun Hou Beer	RMB3.30
Tsingtao	Bing Chun Beer	RMB2.00
Tsingtao	New Laoshan Beer	RMB1.80
Yanjing	Yanjing Draft Beer	RMB2.95
Yanjing	Party Beer	RMB2.00
Yanjing	Yanjing Beer in White Can	RMB2.10
Yanjing	Yanjing Ben Sheng Beer	RMB1.75
Yanjing	Yanjing Draft Beer	RMB2.70
CRE	Snow Refined Pasteurized Beer	RMB2.00
CRE	Snow Draft Beer	RMB4.00
CRE	Snow Yong Chuang Tian Ya	RMB2.80
CRE	Snow Light Beer	RMB1.85

*Price date was 17-Aug-2012 in Beijing
Source: HSBC

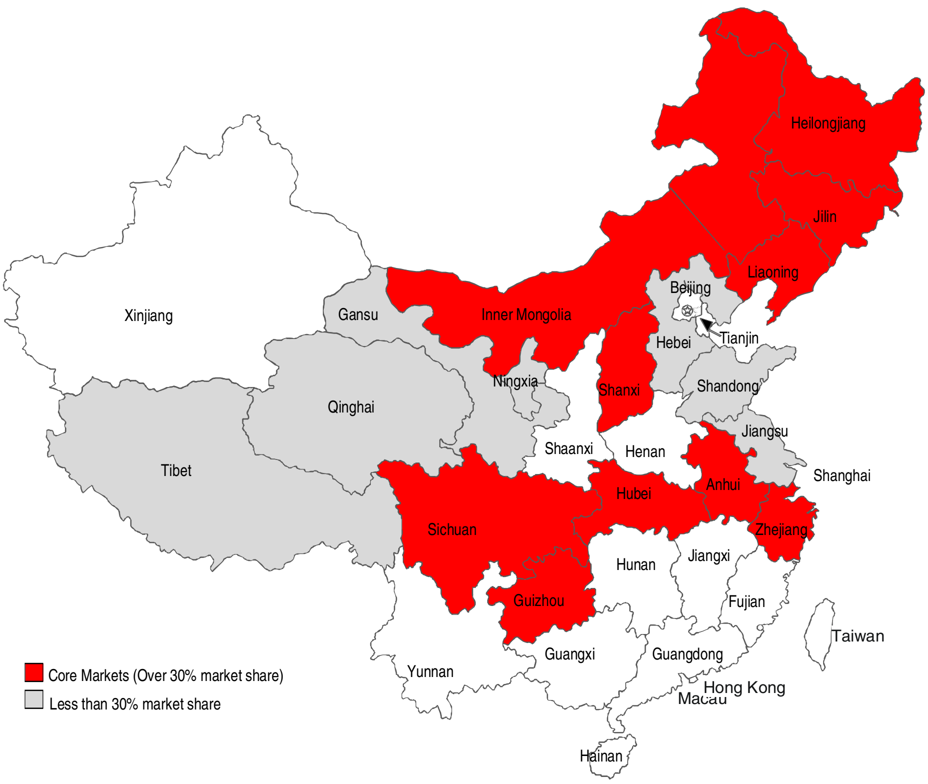
- **Competition.** We believe direct competition between the top four brewing companies will intensify going forward as they pursue a multi-region strategy for market share. Competition from foreign brands is intensifying as they aim to capture fast growth in the high-end segment. A prime example is the recent acquisition of Asian Brewer by Heineken, as it may enable the company to broaden its footprint in China and focus on the high-end segment with both the Heineken and Tiger brands.

Tsingtao core markets



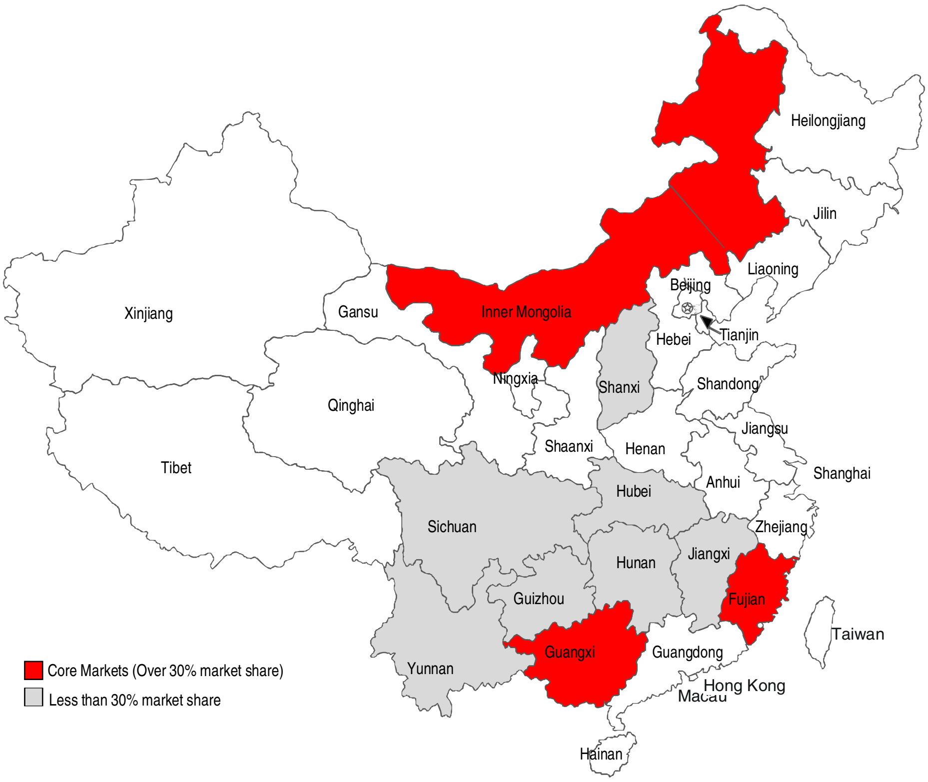
Source: Company reports, HSBC estimates

CRE core markets



Source: Company reports, HSBC estimates

Yanjing core markets



Source: Company reports, HSBC estimates

Company section

HSBC

Tingyi

- Extensive and deep distribution network remains the key competitive advantage over its peers
- The Pepsi alliance will further enhance its brand positioning on co-branding synergy and access to global beverage products
- Initiate coverage with an Overweight rating and price target of HKD29.00

Strong leadership in both branding and distribution

We initiate coverage of Tingyi with an Overweight (V) rating and price target of HKD29.00. We like Tingyi for its large and deep distribution network and strong brand positioning in both instant noodles and ready-to-drink (RTD) tea segment.

The company has recently established an alliance with Pepsi earlier this year, in which Tingyi will become an exclusive manufacturer and distributor for Pepsi in China until 2050. This cooperation not only expanded Tingyi's product portfolio to carbonated soft drinks but also to a number of global beverage products including Tropicana juices, Gatorade sport drinks, and Aquafina non-carbonated water beverages.

While we do not think the alliance will provide significant earnings in the near term, we do believe it will enhance Tingyi's competitive advantage in the long run given the co-branding synergy and widened access to global beverage products.

Strong sales momentum

Sales momentum should recover strongly in coming quarters given the recovery in the tea business, market share gain in the juice segment, and new contribution from the alliance with Pepsi. However, its near-term margin will be dragged down by the initial losses of Pepsi alliance, but we should see a gradual recovery in 2013 and 2014 due to stringent cost rationalization efforts.

Management is expecting the Pepsi business to achieve breakeven by end-2013, but we think there is a high likelihood that it could turn profitable in mid-2013 as management recently indicated the integration process has been progressing well and if the turnaround comes earlier than expected, it could be a positive catalyst to the share price.

We project Tingyi's headline earnings will increase 17% in 2012 to USD490m, but this includes a one-off non-cash gain of USD191m related to the alliance with Pepsi. Excluding this one-off item, we estimate core earnings will decline 11% y-o-y to USD347m. However, we think earnings should recover strongly in 2013 and 2014 due to gross margin improvement and cost savings in the Pepsi business. Our model currently projects 26% y-o-y headline earnings growth in both 2013 and 2014. Our 2012/13/14 earnings estimates are 1%/4% /4% ahead of consensus forecasts.

Tingyi – Earnings summary, 2012-14e

Year to 31 Dec (USDm)	2012e	2013e	2014e
Sales	9,417	11,252	13,038
EBIT	969	1,149	1,430
Net profit	490	618	779
Core net profit	347	618	779
Sales growth	19.7%	19.5%	15.9%
EBIT growth	44.1%	18.6%	24.5%
Net profit growth	16.7%	26.2%	26.0%
Core net profit growth	-11.1%	78.2%	26.0%

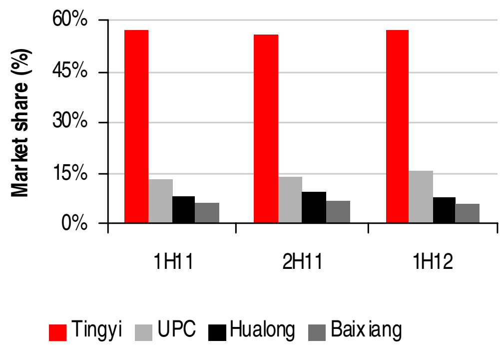
Source: HSBC Research

Instant noodles

While the instant noodles market in China is maturing and competition has also become more intense in recent years, we believe leading players like Tingyi and UPC should continue to outperform the smaller players due to better product offerings and consumers continue to trade up to high-end packet and bowl noodles.

Despite UPC made a strong push on its pickled cabbage and beef flavoured noodles in the past two years, Tingyi's leading position has remained strong with steady market share. We think this reflected Tingyi's strong branding and product offering, as well as its strength on distribution

China – Instant noodles market share

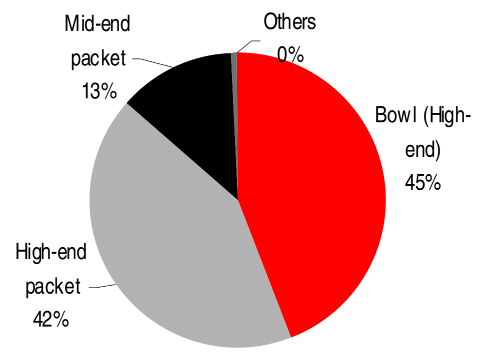


Source: Company reports

because it can respond to market changes quicker. Indeed, the ones who suffered market share loss in the past two years were the smaller players like Hualong and Baixiang as their products are mostly focused on the mid-to-low end products and they also have narrower product variety.

Since early 2011, Tingyi has been gradually moving away from low-end instant noodles as it is a low margin product and the company is putting more resources in developing the high-end packet and bowl noodles. We believe this change can help Tingyi to further enhance its margin, and we should also see faster growth in the high-end packet and bowl noodles going forward.

Tingyi – Instant noodles revenue breakdown



Source: Company data

In our recent store visits in China, we noticed that Tingyi has introduced bigger-sized packet noodles for its flagship braised beef flavoured noodles, and we think this also helped in stimulating more consumption of high-end noodles.

Tingyi – Braised beef flavoured packet noodles

Source: HSBC

During 1H12, instant noodle revenue was up 16% y-o-y to USD1,873m, and this was mainly driven by the high-end packet noodles, which was up 19% y-o-y. Bowl noodles was up 13% y-o-y and this was lower than the high-end packet noodles, and we think this was due to high comparison base and less consumption in a slowing economy when business travels and overtime work activities were less active.

Note that Tingyi raised its bowl noodle price from RMB3.50 to RMB3.80 in Aug-2011, and we estimated its sales volume growth was only a low single digit in 1H12, compared with around 15% in 2011. For high-end packet noodles, Tingyi raised prices by 4.5% from RMB2.20 to RMB2.30 in Feb-2011, and we estimated the sales volume growth was around 9%.

Tingyi – Instant noodles revenue breakdown, 2011-14e

Year to 31 Dec (USDm)	2011	2012e	2013e	2014e
Bowl noodles	**1,661**	**1,817**	**1,984**	**2,276**
Change	24.3%	9.4%	9.2%	14.7%
High-end packet	**1,444**	**1,736**	**2,072**	**2,484**
Change	24.6%	20.3%	19.3%	19.9%
Mid-end packet	**471**	**536**	**569**	**628**
Change	17.5%	13.8%	6.2%	10.4%

Source: Company data, HSBC research

Tingyi – Instant noodles revenue breakdown, 1Q12-4Q12e (USDm)

Year to 31 Dec (USDm)	1Q12	2Q12	3Q12e	4Q12e
Bowl noodles	**488**	**379**	**492**	**458**
Change	7.3%	20.3%	8.1%	5.1%
High-end packet	**404**	**346**	**479**	**508**
Change	12.8%	26.7%	21.5%	21.3%
Mid-end packet	**129**	**113**	**131**	**165**
Change	17.3%	15.3%	12.5%	12.4%

Source: Company data, HSBC research

RTD tea to see strong recovery

We expect RTD tea to have a strong recovery in 2013 and 2014 due to market share gain in the milk-tea market and low comparison base. RTD tea revenue dropped by 34% y-o-y in 1H12 as demand was impacted by poor weather, plasticize incident, and a change of pre-peak season promotion program. However, as Tingyi has launched milk-tea drinks in 2Q12 and channel inventory starting to normalize, we believe we should see gradual recovery in 2H12 and a stronger growth in 2013 and 2014. For its milk tea products, we expect it will have a 7% market share by end of Dec-2012, compared with UPC's 60%.

Tingyi – RTD tea revenue breakdown, 2011-14e

Year to 31 Dec (USDm)	2011	2012e	2013e	2014e
RTD ice tea and green tea	2,477	1,896	2,205	2,576
RTD milk tea	-	51	136	169
Total	**2,477**	**1,947**	**2,342**	**2,744**

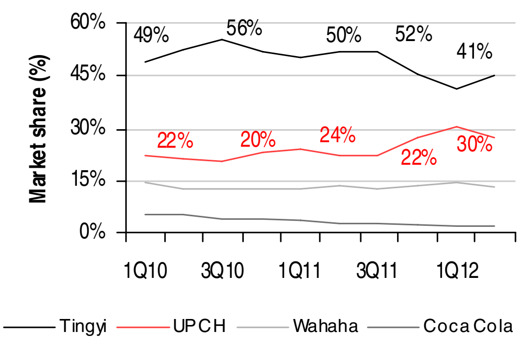
Source: Company data, HSBC research

Tingyi – RTD ice tea and green tea revenue, 1Q12-4Q12e

Year to 31 Dec (USDm)	1Q12	2Q12	3Q12e	4Q12e
Sales	**477**	**585**	**611**	**224**

Source: Company data, HSBC research

China – RTD tea market share, by sales value, 1Q10-1H12



Source: Company reports

Further market share gain in juice

Juice drink sales were strong in 1H12, up 74% y-o-y, thanks to market share gain and new contribution from the Pepsi alliance (Tropicana juice). Similar to UPC, the strong performance in its juice business was driven by further market share gain after the introduction of the Chinese style juice drinks like the pear juice.

We think sales momentum of juice should remain strong in coming quarters as we believe there is still room for further penetration. In addition, we estimated the contribution from Tropicana was around USD47m in 1H12, which is still small for now as it has limited distribution channel. But given the strength of Tropicana's pure juice product, we think Tingyi will gradually increase pure juice production to capture the high-end market.

Tingyi – Juice revenue breakdown, 2011-14e

Year to 31 Dec (USDm)	2011	2012e	2013e	2014e
Revenue	**684**	**1,225**	**1,509**	**1,848**
% Chg	18.5%	79.1%	23.2%	22.4%

Source: Company data, HSBC research

Tingyi – Juice revenue breakdown, 1Q12-4Q12e

Year to 31 Dec (USDm)	1Q12	2Q12	3Q12e	4Q12e
Revenue	**208**	**437**	**361**	**220**
% Chg	41.5%	88.4%	86.8%	96.2%

Source: Company data, HSBC research

Tingyi – Pepsi sales & margins

Year to 31 Dec (USDm)	2011	2012e	2013e	2014e
Revenue	n/a	930	1,413	1,501
COGS	n/a	(558)	(848)	(900)
Gross profit	n/a	372	565	600
Opex	n/a	(409)	(551)	(555)
EBIT/(Loss)	n/a	(37)	14	45
Margin				
Gross margin	n/a	40.0%	40.0%	40.0%
EBIT margin	n/a	n/a	1.0%	3.0%

Source: Company data, HSBC research

Tingyi – Instant noodles segment financials, 2011-14e

Year to 31 Dec (USDm)	2011	2012e	2013e	2014e
Revenue	**3,592**	**4,110**	**4,650**	**5,417**
COGS	(2,614)	(2,896)	(3,267)	(3,792)
Gross profit	**979**	**1,214**	**1,383**	**1,625**
Opex	(560)	(708)	(806)	(904)
EBIT	**418**	**506**	**577**	**721**
Margins				
Gross margin	27.2%	29.5%	29.7%	30.0%
EBIT margin	11.6%	12.3%	12.4%	13.3%

Source: Company data, HSBC research

Tingyi – Bevaregs (incl Pepsi) segment financials, 2011-14e

Year to 31 Dec (USDm)	2011	2012e	2013e	2014e
Revenue	**3,999**	**4,996**	**6,240**	**7,190**
COGS	(2,972)	(3,521)	(4,305)	(4,961)
Gross profit	**1,026**	**1,475**	**1,936**	**2,229**
Opex	(818)	(1,076)	(1,272)	(1,412)
Core EBIT	**208**	**399**	**664**	**817**
Margin				
Gross margin	25.7%	29.5%	31.0%	31.0%
EBIT margin	5.2%	8.0%	10.6%	11.4%

Source: Company data, HSBC research

Valuation and risks

We use DCF to value Tingyi as we believe its strong brand positioning and large distribution network should allow the company to generate steady cash flow and returns. Our DCF analysis uses a WACC of 7.2% and a terminal growth rate of 1%. This yields a valuation of HKD29.0. The DCF valuation implies a 34x 2013 PE. See the following page for details of our DCF assumptions.

Looking at the historical PE trend, we note that Tingyi shares have substantially re-rated from around 15x in 1H09 to around 35x in 2H11, driven primarily by strong revenue growth, continuous market share gains, and a good track record on margin delivery, in our view. However, the stock was de-rated to around 30x in 1H12, and we think this was due mainly to concerns on its sales momentum and margin pressure from rising competition and integration of the Pepsi business.

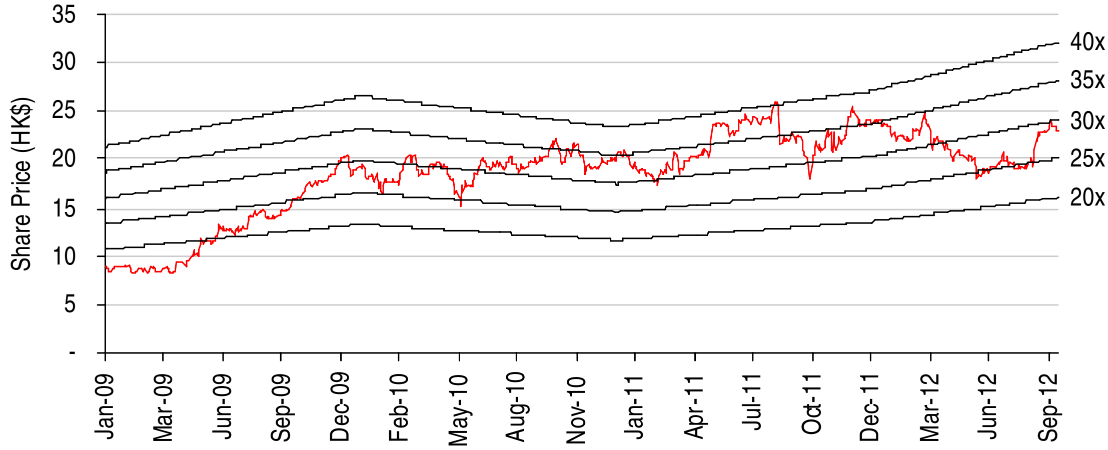
Over the next 12 months, we believe Tingyi shares will be re-rated again driven by strong recovery in its sales momentum (31% in 2H12 vs 9.5% in 1H12 and 8.4% in 2H11), margin recovery due to cost rationalization on Pepsi's bottling business, and improving visibility on the turnaround process on the Pepsi's bottling business. In addition, we expect its ROE will also recovery strongly from 16% in 2012 to 25% in 2013e and 27% in 2014e, compared with 27% in 2008-10.

Under our research model, the Neutral rating band for non-volatile China equities equals a hurdle rate of 10% for China, plus or minus 5ppt. Our target price of HKD29 implies a potential return of 25.7% (including 1.5% forecast dividend yield), which is above this band; we therefore rate the shares Overweight. Potential return equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated.

Risks to our view

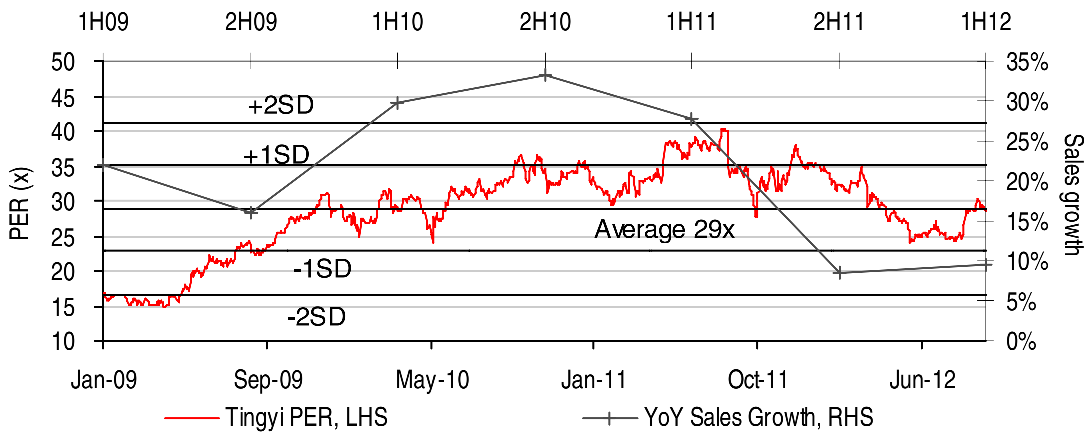
Key downside risks to our rating and estimates include (1) lower-than-expected sales volume or market share gains, (2) higher-than-expected A&P expenses due to rising competition, (3) a sharp increase in raw material and packaging material costs, and (4) longer-than-expected turnaround in its Pepsi's bottling business.

Tingyi – 1-yr forward PE band chart, Jan'09 to present



Source: Thomson Reuters Datastream, HSBC Research

Tingyi – 1-yr forward PE band chart vs sales growth, Jan'09 to present Tingyi – 1-yr forward PE band chart, Jan'09 to present



Source: Thomson Reuters Datastream, company data, HSBC Research

Tingyi DCF valuation

Year to 31 Dec (USDm)	2011	2012e	2013e	2014e	2015e	2016e	2017e	2018e	2019e	2020e
Revenue	**7,867**	**9,417**	**11,252**	**13,038**	**14,994**	**17,243**	**19,484**	**22,017**	**24,659**	**27,618**
Change		*20%*	*19%*	*16%*	*15%*	*15%*	*13%*	*13%*	*12%*	*12%*
EBIT	**672**	**969**	**1,149**	**1,430**	**1,649**	**1,897**	**2,046**	**2,312**	**2,466**	**2,762**
EBIT margin	*9%*	*10%*	*10%*	*11%*	*11%*	*11%*	*11%*	*11%*	*10%*	*10%*
Depreciation & Amortisation	321	365	392	417	480	552	624	705	790	884
EBITDA	**994**	**1,334**	**1,540**	**1,847**	**2,129**	**2,449**	**2,670**	**3,017**	**3,256**	**3,591**
EBITDA margin	*13%*	*14%*	*14%*	*14%*	*14%*	*14%*	*14%*	*14%*	*13%*	*13%*
Tax	**(163)**	**(228)**	**(268)**	**(335)**	**(532)**	**(612)**	**(667)**	**(815)**	**(879)**	**(970)**
– Effective tax rate	25%	24%	24%	24%	25%	25%	25%	27%	27%	27%
EBIDA	**830**	**1,106**	**1,272**	**1,512**	**1,597**	**1,837**	**2,002**	**2,202**	**2,377**	**2,621**
Capex	(1,327)	(700)	(700)	(700)	(800)	(800)	(800)	(900)	(900)	(900)
FCF	**(497)**	**406**	**572**	**812**	**797**	**1,037**	**1,202**	**1,302**	**1,477**	**1,721**
Discount rate		**1.0**	**1.1**	**1.1**	**1.2**	**1.3**	**1.4**	**1.5**	**1.6**	**1.7**
DCF		**406**	**534**	**707**	**647**	**785**	**849**	**858**	**908**	**987**
Terminal growth										1%

CAPM	
Beta vs HSI (B)	0.6
Risk free rate of return (Rf)	3.0%
Market expect return (Rm)	10.0%
Equity risk premium (Rm-Rf)	7.0%
Discount rate (R) = Rf+(Rm-Rf)*B	**7.2%**
DCF	**6,704**
PV of Terminal Value	15,152
Total EV	**21,856**
Net (Debt) / Cash	(466)
NAV	**20,971**
Equity value	
Number of shares (m)	5,658
Value per share (USD)	3.7
Value per share (HKD)	**29.0**

Source: Company data, HSBC research

HSBC

Tingyi – Income statements, 2010-14e

Year to 31 Dec (USDm)	2010	2011	2012e	2013e	2014e	1H11	2H11	1H12	2H12e
Sales	**6,681**	**7,867**	**9,417**	**11,252**	**13,038**	**4,140**	**3,727**	**4,533**	**4,884**
COGS	(4,782)	(5,779)	(6,629)	(7,815)	(9,039)	(3,057)	(2,721)	(3,182)	(3,447)
Gross profit	**1,899**	**2,088**	**2,789**	**3,437**	**3,999**	**1,082**	**1,006**	**1,352**	**1,437**
Other net income	183	170	306	116	116	95	75	254	52
Distribution costs	(1,121)	(1,323)	(1,774)	(2,006)	(2,240)	(666)	(657)	(862)	(913)
Admin expenses	(126)	(189)	(254)	(287)	(320)	(95)	(94)	(145)	(109)
Other operating expenses	(92)	(73)	(98)	(111)	(124)	(18)	(56)	(44)	(54)
EBIT	**743**	**672**	**969**	**1,149**	**1,430**	**399**	**274**	**555**	**414**
Finance costs	(7)	(9)	(25)	(37)	(37)	(5)	(4)	(13)	(12)
Share of results of associates	10	-	5	5	5	-	-	5	-
PBT	**747**	**663**	**948**	**1,116**	**1,397**	**393**	**270**	**546**	**402**
Tax	(134)	(163)	(228)	(268)	(335)	(86)	(77)	(125)	(102)
PAT	**613**	**500**	**721**	**848**	**1,062**	**307**	**192**	**421**	**300**
Minority	(136)	(80)	(231)	(230)	(283)	(78)	(2)	(136)	(95)
NI	**477**	**420**	**490**	**618**	**779**	**229**	**191**	**284**	**205**
Core earnings	**477**	**390**	**347**	**618**	**779**	**229**	**161**	**142**	**205**
Key ratios									
Margins									
Gross Margin	28.4%	26.5%	29.6%	30.5%	30.7%	26.1%	27.0%	29.8%	29.4%
EBITDA Margin	15.3%	12.6%	14.2%	13.7%	14.2%	13.1%	12.1%	16.5%	12.0%
EBIT Margin	11.1%	8.5%	10.3%	10.2%	11.0%	9.6%	7.3%	12.2%	8.5%
Core EBIT margin	8.4%	6.4%	7.0%	9.2%	10.1%	7.3%	5.3%	6.6%	7.4%
PBT Margin	11.2%	8.4%	10.1%	9.9%	10.7%	9.5%	7.2%	12.0%	8.2%
Net Margin	7.1%	5.3%	5.2%	5.5%	6.0%	5.5%	5.1%	6.3%	4.2%
Core net margin	7.1%	5.0%	3.7%	5.5%	6.0%	5.5%	4.3%	3.1%	4.2%
Distribution costs as % of sales	16.8%	16.8%	18.8%	17.8%	17.2%	16.1%	17.6%	19.0%	18.7%
Adm exp as % of sales	1.9%	2.4%	2.7%	2.6%	2.5%	2.3%	2.5%	3.2%	2.2%
Effective tax rate	18.0%	24.6%	24.0%	24.0%	24.0%	21.8%	28.7%	22.9%	25.4%
Growth rate									
Sales growth	31.5%	17.7%	19.7%	19.5%	15.9%	27.6%	8.4%	9.5%	31.0%
Gross profit growth	8.0%	9.9%	33.6%	23.3%	16.3%	7.5%	12.6%	24.9%	42.9%
EBITDA growth	23.3%	-2.9%	34.2%	15.5%	19.9%	16.0%	-18.8%	37.3%	30.5%
EBIT growth	18.3%	-9.5%	44.1%	18.6%	24.5%	11.2%	-28.9%	39.2%	51.2%
NI growth	24.4%	-12.0%	16.7%	26.2%	26.0%	15.9%	-31.8%	24.2%	7.8%
EPS growth	24.2%	-12.1%	16.3%	25.7%	26.0%	15.8%	-31.8%	24.2%	7.3%

Source: Company data, HSBC research

Financials & valuation: Tingyi

Overweight

Financial statements

Year to	12/2011a	12/2012e	12/2013e	12/2014e
Profit & loss summary (USDm)				
Revenue	7,867	9,417	11,252	13,038
EBITDA	994	1,334	1,540	1,847
Depreciation & amortisation	-321	-365	-392	-417
Operating profit/EBIT	672	969	1,149	1,430
Net interest	-9	-25	-37	-37
PBT	663	948	1,116	1,397
HSBC PBT	663	948	1,116	1,397
Taxation	-163	-228	-268	-335
Net profit	420	490	618	779
HSBC net profit	390	347	618	779
Cash flow summary (USDm)				
Cash flow from operations	629	1,137	1,291	1,623
Capex	-1,327	-700	-700	-700
Cash flow from investment	-1,278	-698	-698	-698
Dividends	-302	-245	-309	-389
Change in net debt	909	-194	-284	-535
FCF equity	-700	434	588	919
Balance sheet summary (USDm)				
Intangible fixed assets	343	343	343	343
Tangible fixed assets	4,030	4,365	4,673	4,955
Current assets	1,436	2,283	2,725	3,333
Cash & others	600	1,293	1,577	2,112
Total assets	5,809	6,990	7,741	8,631
Operating liabilities	1,741	1,948	2,159	2,377
Gross debt	1,250	1,749	1,749	1,749
Net debt	650	456	172	-363
Shareholders funds	2,100	2,345	2,654	3,043
Invested capital	3,467	3,749	4,004	4,142

Ratio, growth and per share analysis

Year to	12/2011a	12/2012e	12/2013e	12/2014e
Y-o-y % change				
Revenue	17.7	19.7	19.5	15.9
EBITDA	-2.9	34.2	15.5	19.9
Operating profit	-9.5	44.1	18.6	24.5
PBT	-11.2	43.1	17.7	25.2
HSBC EPS	-18.3	-11.5	77.5	26.0
Ratios (%)				
Revenue/IC (x)	2.8	2.6	2.9	3.2
ROIC	17.8	20.4	22.5	26.7
ROE	19.9	15.6	24.7	27.3
ROA	9.5	11.6	11.9	13.3
EBITDA margin	12.6	14.2	13.7	14.2
Operating profit margin	8.5	10.3	10.2	11.0
EBITDA/net interest (x)	106.0	53.5	41.2	49.4
Net debt/equity	24.2	14.4	4.6	-8.3
Net debt/EBITDA (x)	0.7	0.3	0.1	-0.2
CF from operations/net debt	96.8	249.4	751.1	–
Per share data (USD)				
EPS Rep (diluted)	0.07	0.09	0.11	0.14
HSBC EPS (diluted)	0.07	0.06	0.11	0.14
DPS	0.04	0.04	0.05	0.07
Book value	0.37	0.41	0.47	0.54

Valuation data

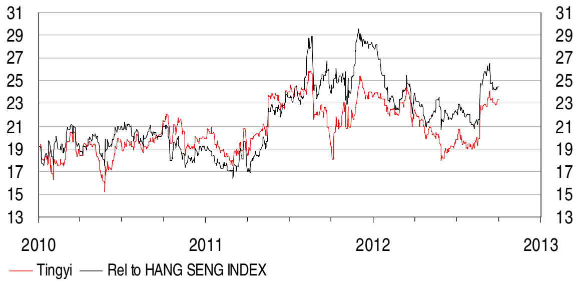
Year to	12/2011a	12/2012e	12/2013e	12/2014e
EV/sales	2.3	1.9	1.6	1.4
EV/EBITDA	18.2	13.6	11.7	9.6
EV/IC	5.2	4.8	4.5	4.3
PE*	43.3	48.9	27.6	21.9
P/Book value	8.0	7.3	6.4	5.6
FCF yield (%)	-4.0	2.5	3.3	5.1
Dividend yield (%)	1.4	1.4	1.8	2.3

*Based on HSBC EPS (diluted)

Issuer information

Share price	(HKD)23.35	Target price	(HKD)29.00
Reuters (Equity)	0322.HK	Bloomberg (Equity)	322 HK
Market cap (USDm)	16,840	Market cap (HKDm)	130,587
Free float (%)	33	Enterprise value (USDm)	18,113
Country	China	Sector	Food Products
Analyst	Christopher K Leung	Contact	+852 29966531

Price relative



Source: HSBC

Note: price at close of 28 September 2012

Uni-President China

- Sales momentum for both instant noodles and milk tea are likely to slow due to heightening direct competition from Tingyi and other brands
- Aggressive expansion is positive in the long run, but scale benefit is unlikely to realize in the near term
- Initiate coverage with an Underweight rating and price target of HKD7.00

Slower growth ahead

We initiate coverage of Uni-President China (UPC) with an Underweight rating and price target of HKD7.00. We think the market views UPC as a turnaround story: it senses that UPC could further increase its market share through its two flagship instant noodles and milk-tea products; it also thinks UPC could further improve its margin through efficiency gains. We take a cautious view on these two points: we believe rising competition will limit the company's top-line growth and further investments on branding, distribution, and production network will cap its margin upside and ROE potential.

UPC has strong branding and product innovation, achieving robust sales growth in the past two years thanks to the successful introduction of two new flagship products: Laotan pickled cabbage and beef flavoured noodles and milk tea. However, such strong growth has not fully translated to the bottom line as UPC's small-scale distribution – what we see as its biggest disadvantage – has limited its marketing effectiveness and capped potential gains in operational efficiency.

During 1H12, UPC benefited from the decline in raw material costs, its gross margin gained 6.4ppt y-o-y to 34.6%. However, due to higher spending on A&P and admin, its EBIT margin only increased 3.3ppt to 5.1% and its net margin rose only 2.7ppt to 4.7%.

A&P expenses increased from 9.9% of sales in 1H11 to 13.2% in 1H12, an increased investment in marketing efforts in response to higher competitive pressure from its peers, in our view.

Admin expenses also increased slightly from 2.9% in 1H11 to 3.3% in 1H12, suggesting that UPC is still in an expansion mode requiring further infrastructure investment as the company continues to roll out its distribution network.

We forecast that UPC's earnings growth will slow from 197% in 2012 to 11% in 2013 and 9% in 2014. Our 2012 and 2013 earnings estimates are 11% and 2% higher than consensus, respectively. But our 2014 earnings estimate is 7% below consensus.

UPC – Earnings summary, 2012-14e

Year to 31 Dec (RMB M)	2012e	2013e	2014e
Sales	20,714	24,378	28,256
EBIT	1,031	1,165	1,305
Net profit	926	1,025	1,113
Sales growth	22.3%	17.7%	15.9%
EBIT growth	294.5%	13.1%	12.0%
Net profit growth	197.0%	10.6%	8.6%

Source: HSBC Research

Aggressive expansion plan

UPC is taking an aggressive expansion plan and is aiming to substantially increase its production capacity in 2012 and 2013. Its total capex for 2012 is budgeted at around RMB4bn, and management is planning to add 6 new production lines in 2H12, including 5 for beverages and 1 for instant noodles.

UPC – Noodles production lines, 2010-12e

Year to 31 Dec	2010	2011	2012e
Packet noodles	17	19	23
Bowl noodles	17	24	27
Snack noodles	16	18	18
Total	**50**	**61**	**68**

Source: Company data, HSBC research

UPC – Beverages production lines, 2010-12e

Year to 31 Dec	2010	2011	2012e
TP	27	25	29
Heat PET Line	23	26	33
Aseptic PET Line	6	7	16
Total	**56**	**58**	**78**
Outsourcing ratio	**30%**	**25-30%**	**15-20%**

Source: Company data, HSBC research

It is worth to highlight that UPC's production base is only around one-third the size of Tingyi, a direct competitor of UPC and has established an extensive production and distribution network in China. The key advantage of large production scale is that, as sales grow, it could provide savings on transportation costs and other fixed operating expenses. In addition, a large production base could also support a wider distribution network.

Tingyi & UPC – Production capacity comparison

As of Jun-2012	No. of factories	Instant noodle	Beverage
Tingyi	65	208	287
UPC	18	61	58

Source: Company data

UPC has not disclosed the size of its distribution network, but we can interpolate it given its employee numbers (only 43% those of Tingyi) and sales per employee (around 30% those of Tingyi). Please refer to page 14 for comparison.

Sales momentum likely to slow

While we think the capacity expansion will widen UPC's footprint in China, we are concerned that rising competition from its peers will slow its sales momentum. In particular, we think UPC is facing increasing headwinds on its sales momentum for both its milk tea and its instant noodles.

Tingyi launched a milk tea product in 2Q12 that, given Tingyi's advantage on distribution, could lead to market share loss for UPC in coming quarters. Similarly, we noted UPC's peers have been offering bigger promotional discounts on noodles similar to UPC's pickled cabbage and beef flavoured noodles, which we are concerned will stall its instant noodles sales momentum.

During 1H12, UPC's instant noodles business achieved 22% revenue growth. The pickled cabbage and beef flavoured noodles represented 61% of this instant noodle revenue in 1H12, and its sales were up 32% y-o-y. According to Nielsen research, UPC had a 15.7% market share in instant noodles in 2Q12, up from 14.1% in 4Q11.

UPC's instant noodle revenue growth may slow to around 16% in 2H12, as we expect sales growth of the pickled cabbage and beef flavoured noodles to slow from 31% in 1H12 to 15% in 2H12. Still, we think that UPC can continue to outperform the smaller players in the industry and that its market share will increase to 16.1% in 2H12.

UPC – Instant noodles revenue breakdown, 2011-14e

Year to 31 Dec (RMB M)	2011	2012e	2013e	2014e
Bowl noodles	**3,028**	**3,587**	**4,171**	**4,811**
% Chg	82.0%	18.5%	16.3%	15.4%
Packet noodles	**2,256**	**2,711**	**3,125**	**3,540**
% Chg	72.0%	20.0%	15.3%	13.3%
Snack noodles	**653**	**754**	**777**	**800**
% Chg	*14.0%*	*15.5%*	*3.0%*	*3.0%*
Total	**5,936**	**7,052**	**8,072**	**9,152**

Source: Company data, HSBC research

UPC – Instant noodles revenue breakdown, 1H11-2H12e

Year to 31 Dec (RMB M)	1H11	2H11	1H12	2H12e
Bowl noodles	**1,436**	**1,592**	**1,779**	**1,808**
% Chg	112.6%	60.9%	23.9%	13.6%
Packet noodles	**1,017**	**1,239**	**1,266**	**1,445**
% Chg	101.8%	53.2%	24.5%	16.7%
Snack noodles	**341**	**312**	**376**	**378**
% Chg	16.8%	11.1%	10.4%	21.1%
Total	**2,794**	**3,143**	**3,420**	**3,631**

Source: Company data, HSBC research

UPC – Laotan pickled cabbage and beef flavoured noodles revenue, 2011-14e

Year to 31 Dec (RMB M)	2011	2012e	2013e	2014e
Sales	**3,600**	**4,392**	**5,270**	**6,219**
Change	140.0%	22.0%	20.0%	18.0%
% of instant noodles revenue	**60.6%**	**62.3%**	**65.3%**	**68.0%**

Source: Company data, HSBC research

UPC – Laotan pickled cabbage and beef flavoured noodles revenue, 1H11-2H12e

Year to 31 Dec (RMB M)	1H11	2H11	1H12	2H12e
Sales	**1,600**	**2,000**	**2,100**	**2,292**
Change	220.0%	100.0%	31.3%	14.6%
% of instant noodles revenue	**57.3%**	**63.6%**	**61.4%**	**63.1%**

Source: Company data, HSBC research

Growth in milk tea likely to moderate

We expect milk tea sales growth to moderate from 182% in 2011 to 72% in 2012 and 35% in 2013, as we believe Tingyi's recent introduction of similar milk tea products will impact UPC sales. We expect UPC's market share in milk tea category to decline from 63% in 2011 to 60% in 2012 and 58% in 2013.

UPC's milk tea products are classified under the other beverage category, which represented 29% of UPC's total beverage sales in 1H12. In 2011, milk tea made up 86% of 'other beverage' sales and it is the biggest contributor to the 'other beverage' business.

During 1H12, other beverage delivered 82% y-o-y sales growth, mainly due to the strong performance of milk tea. Management has not disclosed the exact figure of milk tea sales but has indicated the sales were up 91% y-o-y, with the product's market share in value term increasing from 58.2% in 1H11 to 62.1% in 1H12.

Management has also indicated that the RTD milk tea market accounted for 18.4% of the overall RTD tea market in 1H12 compared with just 9.2% a year ago, suggesting a strong growth in milk tea demand.

UPC – Other beverages revenue breakdown, 2011-14e

Year to 31 Dec (RMB M)	2011	2012e	2013e	2014e
– Milk tea	**2,130**	**3,655**	**4,946**	**5,936**
Change	182.0%	71.6%	35.3%	20.0%
– Coffee	**176**	**238**	**322**	**434**
Change	59.0%	35.0%	35.0%	35.0%
– Bottled Water & Others	**178**	**187**	**197**	**226**
Change	-18.9%	5.0%	5.0%	15.0%
Total	**2,485**	**4,080**	**5,464**	**6,596**

Source: Company data, HSBC research

RTD tea to benefit from low base and new product introductions

The RTD tea business (44% of beverage revenue) posted only 0.6% y-o-y sales growth in 1H12, due mainly to reduced SKUs (as management terminated production of organic tea and Oolong tea products) and a shift in consumer consumption from tea drinks to juice and milk tea.

Within the RTD tea segment, management has indicated that sales of its key iced tea and green tea products actually increased 9% y-o-y in 1H12 and their market share also increased from 20% in 1H11 to 21.4% in 1H12.

Despite sluggish performance in 1H12, we think strong y-o-y sales growth of RTD tea should resume in 2H12, rising from 1% in 1H12 to 26% in 2H12e, due to low comparison base and the introduction of new jasmine tea and honey jasmine tea products.

UPC – RTD bottled tea revenue, 2011-14e

Year to 31 Dec (RMB M)	2011	2012e	2013e	2014e
RTD bottled tea revenue	**4,987**	**5,496**	**6,046**	**6,725**
% Chg	-0.4%	10.0%	10.0%	11.2%

Source: Company data, HSBC research

UPC – RTD bottled tea revenue, 1H11-2H12e

Year to 31 Dec (RMB M)	1H11	2H11	1H12	2H12e
RTD bottled tea revenue	**3,098**	**1,889**	**3,116**	**2,380**
% Chg	9.3%	-13.1%	0.6%	26.0%

Source: Company data, HSBC research

Chinese traditional juice drinks to drive juice sales

UPC's juice segment (27% of beverage sales) registered 21% y-o-y sales growth in 1H12, and this was mainly driven by the introduction of a new crystal sugar pear drink, which is a traditional Chinese dessert drink.

Management indicated that sales of this new drink have been robust, reaching over RMB1,000m in 1H12, which means this single product now represents over 50% of UPC's juice revenue.

The crystal sugar pear drink was launched in 2011, and we believe its sales momentum should remain strong in 2H12 and 2013 given the product is still at an introduction stage.

UPC – Juice revenue, 2011-14e

Year to 31 Dec (RMB M)	2011	2012e	2013e	2014e
UPC Juice Revenue	**3,217**	**3,871**	**4,623**	**5,611**
% Chg	21.2%	20.3%	19.4%	21.4%

Source: Company data, HSBC research

UPC – Juice revenue, 1H11-2H12e (RMBm)

Year to 31 Dec (RMB M)	1H11	2H11	1H12e	2H12e
UPC Juice Revenue	**1,610**	**1,607**	**1,949**	**1,921**
% Chg	22.6%	19.8%	21.1%	19.6%

Source: Company data, HSBC research

HSBC

Segment financials

UPC – Beverages segment income statement, 2011-14e

Year to 31 Dec (RMB M)	2011	2012e	2013e	2014e
Revenue	**10,689**	**13,447**	**16,133**	**18,933**
COGS	(7,557)	(8,706)	(10,446)	(12,264)
Gross profit	**3,132**	**4,741**	**5,688**	**6,669**
Opex	(2,903)	(3,970)	(4,773)	(5,608)
EBIT	**229**	**770**	**915**	**1,061**
Margin and key ratios				
Gross margin	29.3%	35.3%	35.3%	35.2%
EBIT margin	2.1%	5.7%	5.7%	5.6%
Key ratios				
Opex to sales ratio	27.2%	29.5%	29.6%	29.6%

Source: Company data, HSBC research

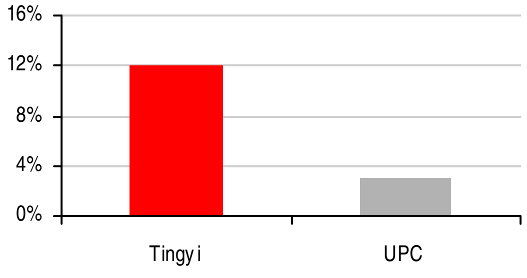
UPC – Instant noodles segment income statement, 2011-14e

Year to 31 Dec (RMB M)	2011	2012e	2013e	2014e
Revenue	**5,936**	**7,052**	**8,072**	**9,152**
COGS	(4,167)	(4,625)	(5,294)	(6,002)
Gross profit	**1,769**	**2,427**	**2,778**	**3,149**
Opex	(1,604)	(2,082)	(2,514)	(2,853)
EBIT	**165**	**345**	**264**	**296**
Margins				
Gross margin	29.8%	34.4%	34.4%	34.4%
EBIT margin	2.8%	4.9%	3.3%	3.2%
Key ratios				
Opex to sales ratio	27.0%	29.5%	31.1%	31.2%

Source: Company data, HSBC research

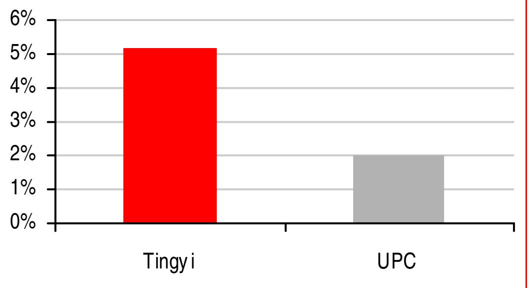
Tingyi and UPC key ratio comparison

Instant noodles EBIT margin, 2011



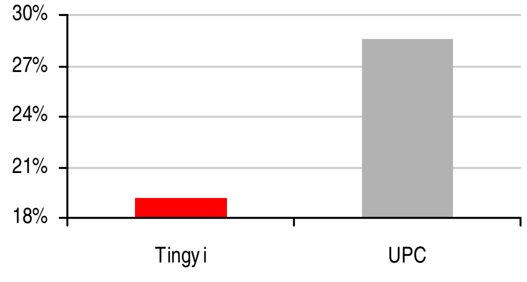
Source: Company data, HSBC

Beverages EBIT margin, 2011



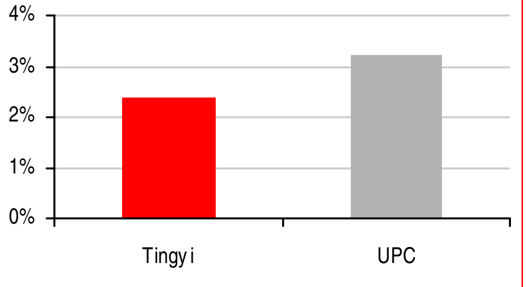
Source: Company data, HSBC

Total opex/sales ratio, 2011



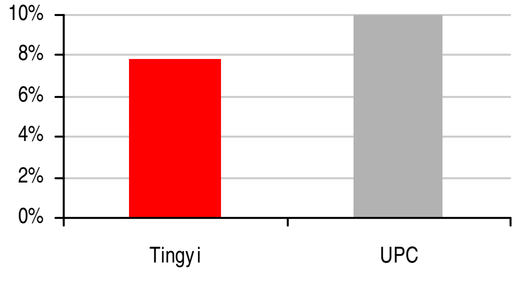
Source: Company data, HSBC

Admin exp/sales ratio, 2011



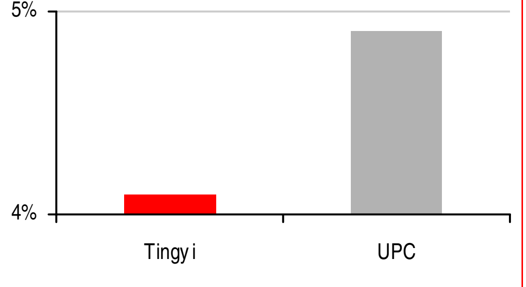
Source: Company data, HSBC

A&P exp/sales ratio, 2011



Source: Company data, HSBC

Transportation exp/sales ratio, 2011



Source: Company data, HSBC

Valuation and risks

We use PE ratio to value Uni-President as we believe it can better capture the company's earnings growth momentum. Our target price of HKD7.0 is based on an 20x 12-month forward PE, which is taken from a multiple that is 0.5 standard deviation below the group's historical average PE of 25.0x since 2009.

We apply a discount to the historical valuation given our expectation of slower sales momentum, a decline in net margin, and limited room for further ROE improvement. We forecast the group net margin will decline from 4.5% in 2012e to 4.2% in 2013e and 3.9% in 2014e. We also expect its ROE will remain steady at 13% level over 2012-2014e. Historically, the share price movement of UPC is highly correlated to its sales performance. Our model currently expects revenue growth to slow from 22% in 2012 to 18% in 2013, and 16% in 2014.

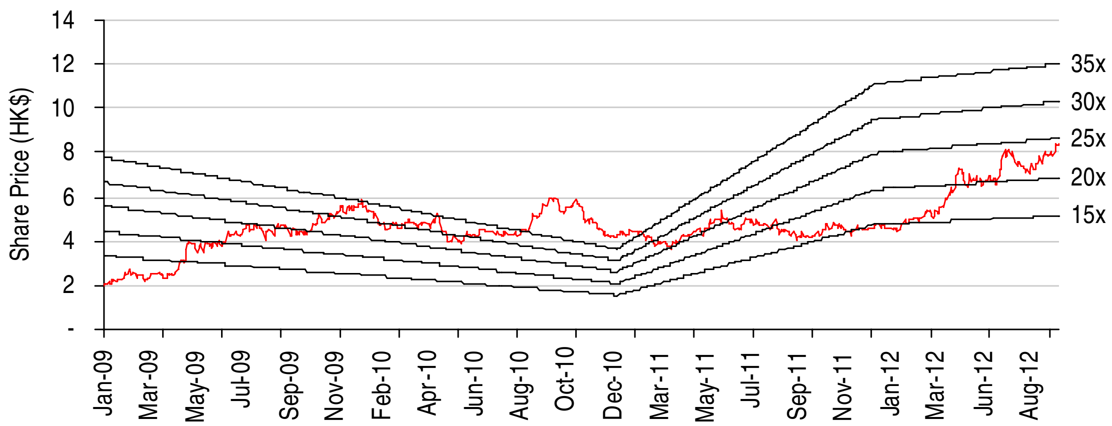
We cross reference our PE-based valuation using a DCF methodology. Our DCF analysis uses a WACC of 8.0% and a terminal growth rate of 1%. This yields a valuation of HKD7.70, which is 11% higher than our target price of HKD7.00. While our DCF valuation derives a higher target price, we think the stock could fall below that value given our expectation of slower sales momentum. The DCF valuation implies a 12-month forward earnings PE of 22x. See the following page for details of our DCF assumptions.

Under our research model, the Neutral rating band for non-volatile China equities equals a hurdle rate of 10% for China, plus or minus 5ppt. Our target price of HKD7.0 implies a potential return of 20.5% (including 1.1% forecast dividend yield), which is below this band; we therefore rate the shares Underweight. Potential return equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated.

Risks to our view

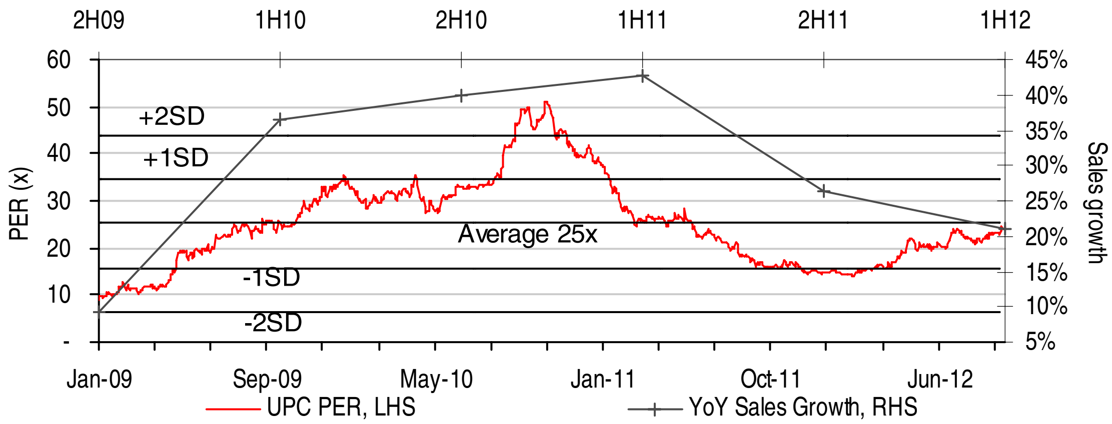
Key upside risks to our rating and estimates include (1) better-than-expected sales performance in both instant noodle and beverages, (2) lower-than-expected input costs and operating expenses, and (3) a lower-than-expected effective tax rate.

UPC – 1-yr forward PE band chart, Jan'09 to present



Source: Thomson Reuters Datastream, HSBC Research

UPC – 1-yr forward PE band chart vs sales growth, Jan'09 to present



Source: Thomson Reuters Datastream, company data, HSBC Research

HSBC

Uni-President China – DCF valuations

Year to 31 Dec (RMB M)	2011	2012e	2013e	2014e	2015e	2016e	2017e	2018e	2019e	2020e
Revenue	**16,932**	**20,714**	**24,378**	**28,256**	**32,495**	**37,369**	**42,974**	**48,561**	**54,873**	**62,007**
Change		*22%*	*18%*	*16%*	*15%*	*15%*	*15%*	*13%*	*13%*	*13%*
EBIT	**261**	**1,031**	**1,165**	**1,305**	**1,500**	**1,725**	**1,984**	**2,428**	**3,018**	**3,410**
EBIT margin		*5.0%*	*4.8%*	*4.6%*	*4.6%*	*4.6%*	*4.6%*	*5.0%*	*5.5%*	*5.5%*
Depreciation & Amortisation	530	*625*	*822*	*1,008*	*1,160*	*1,334*	*1,534*	*1,733*	*1,958*	*2,213*
EBITDA	**792**	**1,656**	**1,987**	**2,313**	**2,660**	**3,059**	**3,518**	**4,161**	**4,976**	**5,623**
EBITDA margin	*5%*	*8%*	*8%*	*8%*	*8%*	*8%*	*8%*	*9%*	*9%*	*9%*
Tax	**(84)**	**(210)**	**(233)**	**(253)**	**(532)**	**(642)**	**(774)**	**(915)**	**(1,194)**	**(1,350)**
– Effective tax rate	21%	19%	19%	19%	20%	21%	22%	22%	24%	24%
EBIDA	**707**	**1,446**	**1,755**	**2,061**	**2,128**	**2,417**	**2,744**	**3,246**	**3,782**	**4,274**
Capex	(3,051)	(3,000)	(3,000)	(3,000)	(2,000)	(2,000)	(2,000)	(1,500)	(1,500)	(1,500)
FCF	**(2,343)**	**(1,554)**	**(1,245)**	**(939)**	**128**	**417**	**744**	**1,746**	**2,282**	**2,774**
Discount rate		**1.0**	**1.1**	**1.2**	**1.3**	**1.4**	**1.5**	**1.6**	**1.7**	**1.8**
DCF		**(1,554)**	**(1,153)**	**(806)**	**102**	**307**	**507**	**1,102**	**1,334**	**1,502**
Terminal growth rate										1%
CAPM										
Beta vs HSI (B)	0.7									
Risk free rate of return (Rf)	3.0%									
Market expect return (Rm)	10.0%									
Equity risk premium (Rm-Rf)	7.0%									
Discount rate (R) = Rf+(Rm-Rf)*B	**8.0%**									
DCF	**1,340**									
PV of Terminal Value	22,529									
Total EV	**23,869**									
Net (Debt) / Cash	(633)									
NAV	**23,236**									
Equity value										
Number of shares (m)	3,599									
Value per share (RMB)	6.5									
Value per share (HKD)	**7.7**									

Source: Company data, HSBC research

HSBC

Uni-President China – Income statements, 2010-14e

Year to 31 Dec (RMBm)	2010	2011	2012e	2013e	2014e	1H11	2H11	1H12	2H12e
Sales	**12,591**	**16,932**	**20,714**	**24,378**	**28,256**	**8,799**	**8,133**	**10,648**	**10,066**
COGS	(8,548)	(11,989)	(13,505)	(15,879)	(18,405)	(6,318)	(5,671)	(6,968)	(6,537)
Gross profit	**4,043**	**4,943**	**7,208**	**8,498**	**9,851**	**2,481**	**2,462**	**3,680**	**3,529**
Other gains	56	69	106	92	84	8	61	52	54
Other income	75	136	154	166	179	76	60	87	67
Other expenses	-	(46)	(86)	(86)	(86)	-	(46)	(43)	(43)
Selling & mkting expenses	(3,291)	(4,292)	(5,632)	(6,655)	(7,736)	(2,157)	(2,135)	(2,882)	(2,750)
Admin costs	(324)	(548)	(719)	(850)	(988)	(252)	(296)	(353)	(366)
EBIT	**558**	**261**	**1,031**	**1,165**	**1,305**	**156**	**105**	**540**	**490**
Finance income	60	126	107	118	108	39	87	51	56
Finance costs	(5)	(31)	(81)	(106)	(128)	(10)	(22)	(39)	(42)
Share of result of JCEs & associates	69	40	80	80	80	42	(2)	64	17
PBT	**682**	**396**	**1,137**	**1,258**	**1,366**	**227**	**169**	**616**	**521**
Tax	(163)	(84)	(210)	(233)	(253)	(51)	(34)	(111)	(99)
NI	**519**	**312**	**926**	**1,025**	**1,113**	**177**	**135**	**505**	**421**
Key ratios									
Margins									
Gross Margin	32.1%	29.2%	34.8%	34.9%	34.9%	28.2%	30.3%	34.6%	35.1%
EBITDA Margin	7.4%	4.7%	8.0%	8.2%	8.2%	4.4%	5.0%	8.5%	7.5%
EBIT Margin	4.4%	1.5%	5.0%	4.8%	4.6%	1.8%	1.3%	5.1%	4.9%
PBT Margin	5.4%	2.3%	5.5%	5.2%	4.8%	2.6%	2.1%	5.8%	5.2%
Net Margin	4.1%	1.8%	4.5%	4.2%	3.9%	2.0%	1.7%	4.7%	4.2%
Distribution costs as % of sales	26.1%	25.4%	27.2%	27.3%	27.4%	24.5%	26.3%	27.1%	27.3%
Adm exp as % of sales	2.6%	3.2%	3.5%	3.5%	3.5%	2.9%	3.6%	3.3%	3.6%
Effective tax rate	23.9%	21.3%	18.5%	18.5%	18.5%	22.4%	19.9%	18.0%	19.1%
Valuations									
Sales growth	38.2%	34.5%	22.3%	17.7%	15.9%	42.8%	26.5%	21.0%	23.8%
Gross profit growth	11.8%	22.2%	45.8%	17.9%	15.9%	16.9%	28.2%	48.3%	43.3%
EBITDA growth	-14.6%	-14.9%	109.2%	20.0%	16.4%	-24.8%	-2.5%	132.3%	86.9%
EBIT growth	-27.2%	-53.2%	294.5%	13.1%	12.0%	-54.6%	-51.0%	246.5%	365.6%
NI growth	-26.4%	-39.9%	197.0%	10.6%	8.6%	-40.8%	-38.7%	185.9%	211.4%
EPS growth	-26.4%	-39.9%	197.0%	10.6%	8.6%	-40.8%	-38.7%	185.9%	211.4%

Source: Company data, HSBC research

HSBC

Financials & valuation: Uni-President China

Underweight

Financial statements

Year to	12/2011a	12/2012e	12/2013e	12/2014e
Profit & loss summary (RMBm)				
Revenue	16,932	20,714	24,378	28,256
EBITDA	792	1,656	1,987	2,313
Depreciation & amortisation	-530	-625	-822	-1,008
Operating profit/EBIT	261	1,031	1,165	1,305
Net interest	95	26	12	-19
PBT	396	1,137	1,258	1,366
HSBC PBT	396	1,137	1,258	1,366
Taxation	-84	-210	-233	-253
Net profit	312	926	1,025	1,113
HSBC net profit	312	926	1,025	1,113
Cash flow summary (RMBm)				
Cash flow from operations	1,338	2,159	2,463	1,855
Capex	-3,051	-3,000	-3,000	-3,000
Cash flow from investment	-4,144	-1,989	-3,021	-3,021
Dividends	-156	-94	-278	-307
Change in net debt	2,989	-76	836	1,474
FCF equity	-1,589	-841	-537	-1,145
Balance sheet summary (RMBm)				
Intangible fixed assets	835	674	672	672
Tangible fixed assets	7,262	9,890	12,170	14,263
Current assets	4,617	6,025	6,727	6,813
Cash & others	2,369	3,645	4,009	3,736
Total assets	13,737	16,589	19,570	21,748
Operating liabilities	3,665	4,484	5,518	5,690
Gross debt	3,096	4,296	5,496	6,696
Net debt	727	651	1,487	2,960
Shareholders funds	6,811	7,644	8,391	9,196
Invested capital	6,680	8,460	10,043	12,322

Ratio, growth and per share analysis

Year to	12/2011a	12/2012e	12/2013e	12/2014e
Y-o-y % change				
Revenue	34.5	22.3	17.7	15.9
EBITDA	-14.9	109.2	20.0	16.4
Operating profit	-53.2	294.5	13.1	12.0
PBT	-41.9	186.7	10.6	8.6
HSBC EPS	-39.9	197.0	10.6	8.6
Ratios (%)				
Revenue/IC (x)	3.3	2.7	2.6	2.5
ROIC	4.0	11.1	10.3	9.5
ROE	4.6	12.8	12.8	12.7
ROA	2.9	6.5	6.1	5.9
EBITDA margin	4.7	8.0	8.2	8.2
Operating profit margin	1.5	5.0	4.8	4.6
EBITDA/net interest (x)	–	–	–	120.2
Net debt/equity	10.7	8.5	17.7	32.2
Net debt/EBITDA (x)	0.9	0.4	0.7	1.3
CF from operations/net debt	184.1	331.7	165.6	62.7
Per share data (RMB)				
EPS Rep (diluted)	0.09	0.26	0.28	0.31
HSBC EPS (diluted)	0.09	0.26	0.28	0.31
DPS	0.04	0.08	0.09	0.09
Book value	1.89	2.12	2.33	2.55

Valuation data

Year to	12/2011a	12/2012e	12/2013e	12/2014e
EV/sales	1.5	1.3	1.1	1.0
EV/EBITDA	32.5	16.1	13.8	12.5
EV/IC	3.9	3.2	2.7	2.4
PE*	83.4	28.1	25.4	23.4
P/Book value	3.8	3.4	3.1	2.8
FCF yield (%)	-6.4	-3.2	-2.1	-4.4
Dividend yield (%)	0.6	1.1	1.2	1.3

*Based on HSBC EPS (diluted)

Issuer information

Share price	(HKD)8.92	Target price	(HKD)7.00
Reuters (Equity)	0220.HK	Bloomberg (Equity)	220 HK
Market cap (USDm)	4,140	Market cap (HKDm)	32,107
Free float (%)	27	Enterprise value (RMBm)	26,676
Country	China	Sector	Food Products
Analyst	Christopher K Leung	Contact	+852 29966531

Price relative

Source: HSBC

Note: price at close of 28 September 2012

HSBC

Tsingtao Brewery

- Strong branding and broad footprint should allow Tsingtao Brewery to expand its market share, but margins likely to be under pressure on change of sales mix and higher marketing efforts
- Barley prices are rising and it could further pressure margin in 2013; Our 2012/13/14 earnings estimates are 4%/10%/13% below consensus
- Initiate coverage with an Underweight rating and price target of HKD35.00

Stepping up to gain market share, but margin pressure to persist

We initiate coverage of Tsingtao Brewery with an Underweight rating and price target of HKD35.00. While Tsingtao Brewery owns the most well-recognized brand in China and has established a large production network, we are uncertain how it could defend its margin when the company is stepping up its effort to gain market share in a competitive environment.

Despite years of consolidation, the beer sector is still fairly fragmented on a countrywide basis but is more concentrated on a regional basis. We believe industry consolidation will continue in the next five years, but we do not think it will be driven by M&A of key regional brewery companies as acquisitions costs in China are becoming more expensive. We think consolidation will come from the small regional breweries that are either exiting the markets or being acquired by the top four players or key regional brewery companies. In addition, we believe competition among the top four brands will also intensify in next five years as they are likely to step up their efforts in their multi-region strategy for market share gain.

We expect Tsingtao Brewery to deliver 17% revenue CAGR over the next three years, but we believe its earnings CAGR will slow from 35% in 2009-11 to just 10% over 2012-14e. Our 2012/13/14 earnings estimates are 4%/10%/13% below consensus, respectively.

Tsingtao – Earnings summary, 2012-14e (RMB M)

Year to 31 Dec	2012e	2013e	2014e
Sales	26,261	31,635	36,901
EBIT	2,270	2,460	2,838
Net profit	1,869	2,031	2,342
Sales growth	13.4%	20.5%	16.6%
EBIT growth	8.0%	8.4%	15.4%
Net profit growth	7.6%	8.7%	15.3%

Source: HSBC Research

Aggressive sales target

After establishing a strong foothold in its core Shandong market, Tsingtao Brewery is targeting to increase its beer sales volume from 7.1m kiloliters in 2011 to 10m kiloliters in 2015, representing a CAGR of 12% over a 3-year period. Although it is much higher than our industry growth forecast of 3-5%, we believe the target is achievable as Tsingtao Brewery has a strong flagship brand and a large distribution network with 55 factories in 18 provinces.

The company plans to focus its expansion on eight regions, including Guangdong, Hainan, Shandong, Jiangsu, Shanghai, Hebei, Shanxi, and Shaanxi. In our view, it is a right expansion strategy as this could allow Tsingtao Brewery to widen its footprint and strengthen its market position in China.

However, our market share analysis shows that competition in few of its regions is quite intense, thus greater marketing efforts may be needed in order for the company to achieve the target. We expect its advertising and promotion-related expenses to increase from 7.3% in 2012 to 8% in 2013e and 8.5% in 2014e. In addition, to capture market share in those focused markets, we think Tsingtao will increase its focus on the secondary and other beer brands, which are lower priced and carry lower margins.

Recent sales trend already showed some signs

While overall beer production volume in the first eight months only increased by 1% y-o-y, Tsingtao Brewery performance was quite extraordinary with 11% y-o-y volume growth in 1H12, 16-17% in June and July.

While the headline numbers are impressive, the strong growth was mainly attributable to faster growth in the secondary and other brands, which was up 15% y-o-y during 1H12. The secondary and other brands made up 44% of sales volume in 2011, and management indicated its gross margin was less than 20%, much lower than the group gross margin of 31%.

Tsingtao – Sales volume breakdown ('000 kl), 2011-14e

Year to 31 Dec	2011	2012e	2013e	2014e
Principal Brand (Tsingtao)	**3,990**	**4,309**	**4,820**	**5,405**
Change	14.7%	8.0%	12.0%	12.0%
Secondary and Other Brands	**3,160**	**3,634**	**4,179**	**4,806**
Change	10.3%	15.0%	15.0%	15.0%
Total	**7,150**	**7,943**	**9,005**	**10,211**

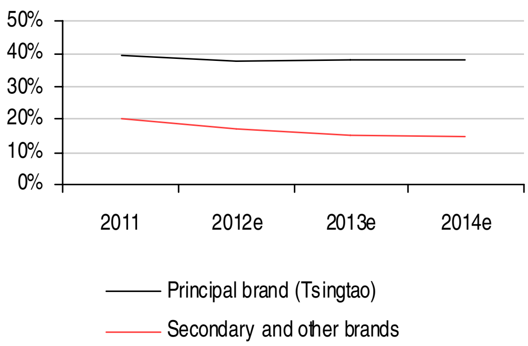
Source: Company data, HSBC research

Tsingtao – Sales volume breakdown ('000 kl), 1H11-2H12e

Year to 31 Dec	1H11	2H11	1H12	2H12e
Principal Brand (Tsingtao)	**2,030**	**1,960**	**2,200**	**2,109**
Change	23.0%	7.1%	8.4%	7.6%
Secondary and Other Brands	**1,720**	**1,440**	**1,980**	**1,654**
Change	17.8%	2.6%	15.1%	14.9%
Total	**3,750**	**3,400**	**4,180**	**3,763**

Source: Company data, HSBC research

Tsingtao – gross margin breakdown, 2011-14e



Source: Company data, HSBC research

Margin pressure to persist

We project Tsingtao brewery's gross margin will decline from 33% in 2011 to 31% in 2012 and remain at same level till 2014. The most apparent driver to the decline in gross margin is from increasing reliance on lower-margin products.

As Tsingtao Brewery plans to expand its market share in Hebei, Shanxi and Shaanxi provinces, where low-end products are more popular, we believe the company will promote more aggressively on its secondary and other brand products.

We expect volume growth of the secondary and other brand products will increase by 15% per annum over 2012-14e, and its contribution to total sales volume will also rise from 44% of total sales volume in 2011 to over 47% in 2014.

In addition to higher contribution from lower-margin products, we also see margin risk coming from higher barley prices. Barley represented 13% of total COGS in 2011, and we estimate the average cost of barley will increase only 3% this year.

However, ABARES recently warned that dry weather has delayed planting, and this is expected to decrease barley production by 15% in FY13 (YE: Mar). We believe average costs of barley will increase further next year. Our model currently has factored in a 10% increase in barley prices in 2013, followed by a 5% decline in 2014.

Pricing potential

Although the beer sector in China is still fragmented on a country-wide basis, with most of the brewery companies still focusing on the mass market, we find the key players have already started developing their high-end beer products to capture rising demand from first- and second-tier cities. CRE, for example, launched its high-end beer products in 2009, and the contribution from high-end beer products has increased from 12% of sales volume in the first year to the current of 28%. Tsingtao, as the most famous beer brand in China, has also expanded its high-end beer offerings in past few years, and we estimate that high-end beers now account for 20% of its sales volume.

With rising incomes and consumer continuing to trade up, we believe demand for high-end beer will remain strong, especially in eastern China. However, competition will also become more intense, as all top brewery companies are focusing on this segment. Indeed, foreign beer brands like Budweiser and Heineken have always been focusing on the high-end market, and their selling prices are also much higher than the locals. For example, the retail price of Budweiser beer is around 2x higher than the local high-end beers. See the table below for a retail price comparison.

While we expect strong demand for high-end beers, we do not think local brewery companies can significantly increase their overall ASP and margins, as the majority of sales are still focused on the mass market, where it is more difficult to raise selling prices than in the high-end segment.

We think an overall ASP growth of around 3-5% per annum for next few years would be a normal level. As for Tsingtao, we also think it will benefit from rising demand of high-end beers, but we believe this positive will be offset by the fast expansion of its sub-brand beers, for which the ASP and margins are much lower than for its core Tsingtao brand.

HSBC

Focused market analysis

In order to achieve the 10m kiloliters sales target, management indicated they plan to focus on eight regions, including Guangdong, Hainan, Shandong, Jiangsu, Shanghai, Hebei, Shanxi, and Shaanxi.

Out of these eight regions, there are only two regions – Shandong and Shannix provinces – where Tsingtao has a dominant market share (65% and 68%, respectively). If we include the recent joint venture with Suntory, Tsingtao will have three key regions with a dominant market share.

Looking at Tsingtao's distribution network, it has a broad footprint in China, with 55 factories in 18 provinces, but the company dominates in only three regions. We believe this partly reflects a historical strategy whereby management has been focusing more on profitability instead of market share. This is also evident on its EBIT margin in the past few years, which was up from 5% in 2006 to 9% in 2011.

The competitive landscape and growth potential in each of the focused markets are different, and Tsingtao Brewery would also need to use different strategies to cater various consumer price points and preference. For example, Hebei and Shangxi are generally dominated by low-end beer products but are fast growing due to rising affordability. They are also less sensitive to economic movement as they are geographically less exposed to financial or export related industries.

On competition, it is also worth highlighting that Tsingtao Brewery is increasingly in direct competition with China Resources Enterprise. For instances, in Jiangsu, CRE has a 30% market share while Tsingtao's share is less than 15%. In Shanxi, CRE has a 40% market share, but Tsingtao has less than 10%. Below, we summarize the key players in Tsingtao's focused markets and their market trend.

China – Per capita beer consumption (litre)

Province/Municipality	2009	2010	2011
Hebei	16	19	22
Shanxi	7	9	12
Shandong	50	56	67
Jiangsu	30	33	30
Shanghai	30	28	22
Guangdong	35	38	46
Hainan	20	19	12

Source: CEIC

China – Key players in selected provinces/municipalities

Province/Municipality	Key players
Hebei	Tsingtao, CRE, Yanjing
Shanxi	Tsingtao, CRE, Yanjing
Shandong	Tsingtao, CRE
Jiangsu	Tsingtao, CRE, Chongqing
Shanghai	Tsingtao, Suntory, CRE
Guangdong	Tsingtao, Kingway, Zhujiang
Hainan	Heineken

Source: HSBC

Valuation and target price

DCF is a common valuation method to value brewery stocks as it can capture long term return and cash flow. However, we argue that it may not be appropriate to use DCF method to value Tsingtao over the next 12 months given the margin uncertainty and earnings downside risk. We think it is more appropriate to use PE ratio to value Tsingtao Brewery as it can better capture the company's earnings growth momentum in the near term. Our target price of HKD35.00 is based on a 19x 12-month forward PE, which is taken from a multiple that is 1 standard deviation below the group's historical average PE of 26x since 2008 and is more in line with the peer group average. We apply a discount to the historical valuation given much lower growth profile over the next few years.

Historically, the stock price movement of Tsingtao does not have a high correlation with its earnings and sales performance. We note that Tsingtao shares have substantially re-rated from 16x in 1H09 to around 26x in the past three years, and we believe this was driven by the margin improvement from 4% in 2008 to 7% in 2009 and 8% in 2010 and 2011 as the company achieved scale benefits after successful integration of the acquired brewers between 2004-08.

However, as we expect Tsingtao Brewery's margin will continue to trend down, we think the market will begin to realize its current margin is unsustainable in the medium term and the stock will be de-rated. Our model current expect is net margin will decline from 8% in 2011 to 6% in 2014, and its earnings CAGR will also slow from 35% during 2009-11 to just 10% in 2012-14e. In addition, we expect its ROE to decline from 17% in 2011 to 16% in 2012 and 15% in 2013e and 2014e.

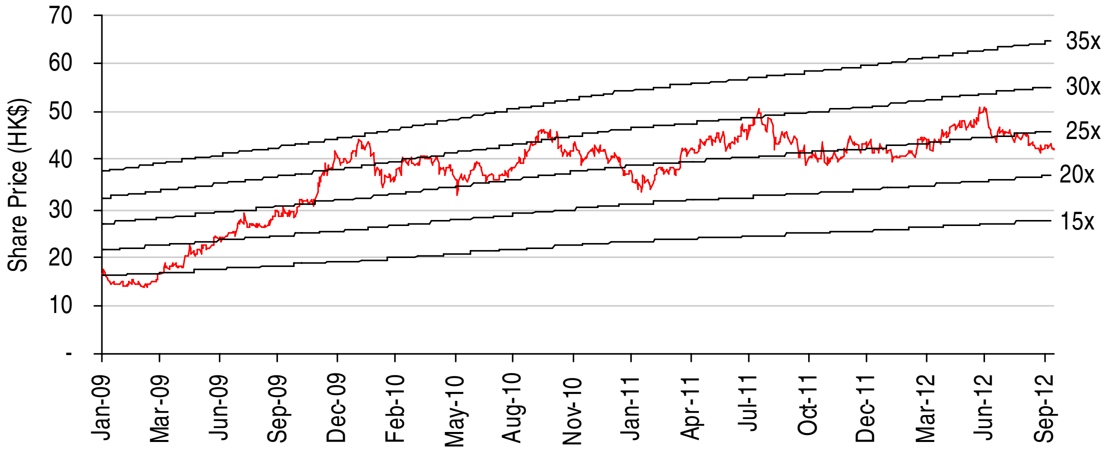
We cross reference our PE-based valuation to a DCF methodology. Our DCF analysis uses a WACC of 7.6% and a terminal growth rate of 1%. This yields a valuation of HKD41.4, which is 18% higher than our target price of HKD35. While our DCF valuation derives a higher target price, we think the stock could drop below that value over the next 12-months due to concerns about (1) margin contraction, (2) rising competition from both local and foreign brands, and (3) decline in ROE. See the following page for details of our DCF assumptions.

Under our research model, the Neutral rating band for non-volatile China equities equals a hurdle rate of 10% for China, plus or minus 5ppt. Our target price of HKD35.0 implies a potential return of 17.4% (including 0.8% forecast dividend yield), which is below; we therefore rate the shares Underweight. Potential return equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated.

Risks to our view

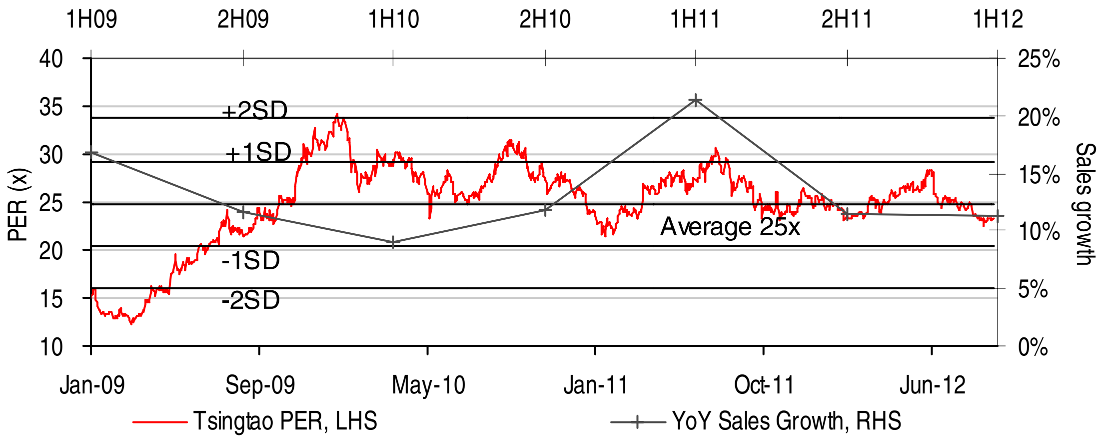
Key upside risks to our rating and estimates include (1) better-than-expected gross margins due to a higher-than-expected price hike or lower-than-expected input cost inflation, (2) any earnings-accretive M&A transactions or government subsidies, (3) a lower-than-expected effective tax rate, and (4) much faster-than-expected top-line growth due to market share gains.

Tsingtao – 1-yr forward PE band chart, Jan'09 to present



Source: Thomson Reuters Datastream, HSBC Research

Tsingtao – 1-yr forward PE band chart vs sales growth, Jan'09 to present



Source: Thomson Reuters Datastream, company data, HSBC Research

Tsingtao – DCF valuation

Year to Dec 31 (RMBm)	2011	2012e	2013e	2014e	2015e	2016e	2017e	2018e	2019e	2020e
Revenue	**23,158**	**26,261**	**31,635**	**36,901**	**42,436**	**48,801**	**54,657**	**61,216**	**67,338**	**74,072**
Change		13%	20%	17%	15%	15%	12%	12%	10%	10%
EBIT	**2,101**	**2,270**	**2,460**	**2,838**	**3,183**	**3,660**	**4,373**	**4,897**	**5,724**	**6,296**
EBIT margin		*8.6%*	*7.8%*	*7.7%*	7.5%	7.5%	8.0%	8.0%	8.5%	8.5%
Depreciation & Amortisation	698	793	883	972	1,090	1,254	1,498	1,678	1,961	2,157
EBITDA	**2,799**	**3,063**	**3,343**	**3,811**	**4,273**	**4,914**	**5,871**	**6,575**	**7,685**	**8,453**
EBITDA margin	*12%*	*12%*	*11%*	*10%*	*10%*	*10%*	*11%*	*11%*	*11%*	*11%*
Tax	**(657)**	**(679)**	**(738)**	**(851)**	**(1,111)**	**(1,278)**	**(1,526)**	**(1,710)**	**(1,998)**	**(2,198)**
– Effective tax rate	27%	26%	26%	26%	26%	26%	26%	26%	26%	26%
EBIDA	**2,141**	**2,384**	**2,605**	**2,960**	**3,162**	**3,636**	**4,344**	**4,866**	**5,687**	**6,255**
Capex	(2,442)	(2,500)	(2,500)	(2,500)	(2,500)	(2,500)	(2,500)	(2,500)	(2,500)	(2,500)
FCF	**(300)**	**(116)**	**105**	**460**	**662**	**1,136**	**1,844**	**2,366**	**3,187**	**3,755**
Discount rate		**1.0**	**1.1**	**1.2**	**1.2**	**1.3**	**1.4**	**1.6**	**1.7**	**1.8**
DCF		**(116)**	**98**	**397**	**531**	**847**	**1,278**	**1,523**	**1,906**	**2,087**
Terminal growth										1%
CAPM										
Beta vs HSI (B)	0.7									
Risk free rate of return (Rf)	3.0%									
Market expect return (Rm)	10.0%									
Equity risk premium (Rm-Rf)	7.0%									
Discount rate (R) = Rf+(Rm-Rf)*B	**7.6%**									
DCF	**8,550**									
PV of Terminal Value	31,304									
Total EV	**39,854**									
Net (Debt) / Cash	6,772									
NAV	**46,626**									
Equity value										
Number of shares (m)	1,351									
Value per share (RMB)	34.5									
Value per share (HKD)	**41.4**									

Source: Company data, HSBC research

HSBC

Tsingtao – Income statements, 2010-14e

Year to Dec 31 (RMBm)	2010	2011	2012e	2013e	2014e	1H11	2H11	1H12	2H12e
Sales	**19,898**	**23,158**	**26,261**	**31,635**	**36,901**	**12,050**	**11,108**	**13,405**	**12,855**
COGS	(11,234)	(13,417)	(15,702)	(19,091)	(22,232)	(6,840)	(6,576)	(7,979)	(7,723)
Taxes & surcharges	(1,663)	(2,024)	(2,369)	(2,881)	(3,355)	(1,056)	(968)	(1,166)	(1,203)
Gross profit	**7,000**	**7,717**	**8,190**	**9,664**	**11,314**	**4,154**	**3,563**	**4,260**	**3,929**
Selling & distribution expenses	(3,918)	(4,415)	(4,590)	(5,605)	(6,613)	(2,376)	(2,039)	(2,462)	(2,128)
General & admin expenses	(1,079)	(1,184)	(1,313)	(1,582)	(1,845)	(495)	(690)	(565)	(748)
Other gains	(0)	(0)	(0)	(0)	(0)	-	(0)	-	(0)
Asset impairment losses & others	(72)	(17)	(17)	(17)	(17)	(1)	(16)	(3)	(14)
EBIT	**1,931**	**2,101**	**2,270**	**2,460**	**2,838**	**1,282**	**819**	**1,231**	**1,039**
Financials income/(expenses), net	(5)	36	147	183	239	(2)	39	84	63
Share of profit of associates & JVs	10	4	4	4	4	2	3	6	(1)
Non-operating income	245	470	250	250	250	125	345	115	135
Non-operating expenses	(58)	(156)	(59)	(59)	(59)	(15)	(142)	(16)	(43)
PBT	**2,123**	**2,455**	**2,612**	**2,838**	**3,272**	**1,391**	**1,064**	**1,419**	**1,193**
Tax	(539)	(657)	(679)	(738)	(851)	(345)	(313)	(369)	(310)
Minority	(64)	(60)	(64)	(69)	(80)	(57)	(3)	(43)	(21)
Net profit	**1,520**	**1,738**	**1,869**	**2,031**	**2,342**	**990**	**748**	**1,007**	**862**
Key ratios									
Margins									
Gross Margin	35.2%	33.3%	31.2%	30.5%	30.7%	34.5%	32.1%	31.8%	30.6%
EBITDA Margin	12.5%	12.1%	11.7%	10.6%	10.3%	13.3%	10.8%	12.2%	11.1%
EBIT Margin	9.7%	9.1%	8.6%	7.8%	7.7%	10.6%	7.4%	9.2%	8.1%
PBT Margin	10.7%	10.6%	9.9%	9.0%	8.9%	11.5%	9.6%	10.6%	9.3%
Net Margin	7.6%	7.5%	7.1%	6.4%	6.3%	8.2%	6.7%	7.5%	6.7%
Distribution costs as % of sales	19.7%	19.1%	17.5%	17.7%	17.9%	19.7%	18.4%	18.4%	16.6%
Adm exp as % of sales	5.4%	5.1%	5.0%	5.0%	5.0%	4.1%	6.2%	4.2%	5.8%
Effective tax rate	25.4%	26.8%	26.0%	26.0%	26.0%	24.8%	29.4%	26.0%	26.0%
Growth rate									
Sales growth	10.4%	16.4%	13.4%	20.5%	16.6%	21.4%	11.4%	11.2%	15.7%
Gross profit growth	13.0%	10.2%	6.1%	18.0%	17.1%	16.4%	3.8%	2.6%	10.3%
EBITDA growth	13.3%	12.4%	9.4%	9.1%	14.0%	22.0%	1.7%	2.6%	18.6%
EBIT growth	17.1%	8.8%	8.0%	8.4%	15.4%	24.4%	-9.0%	-4.0%	26.9%
NI growth	21.6%	14.3%	7.6%	8.7%	15.3%	21.6%	5.9%	1.8%	15.2%
EPS growth	18.4%	14.3%	7.6%	8.7%	15.3%	21.6%	5.9%	1.8%	15.2%

Source: Company data, HSBC research

Financials & valuation: Tsingtao

Underweight

Financial statements

Year to	12/2011a	12/2012e	12/2013e	12/2014e
Profit & loss summary (RMBm)				
Revenue	23,158	26,261	31,635	36,901
EBITDA	2,799	3,063	3,343	3,811
Depreciation & amortisation	-698	-793	-883	-972
Operating profit/EBIT	2,101	2,270	2,460	2,838
Net interest	36	147	183	239
PBT	2,455	2,612	2,838	3,272
HSBC PBT	2,455	2,612	2,838	3,272
Taxation	-657	-679	-738	-851
Net profit	1,738	1,869	2,031	2,342
HSBC net profit	1,738	1,869	2,031	2,342
Cash flow summary (RMBm)				
Cash flow from operations	1,872	4,676	4,512	5,034
Capex	-2,442	-2,500	-2,500	-2,500
Cash flow from investment	-3,937	-3,238	-3,320	-3,279
Dividends	-336	-351	-374	-406
Change in net debt	1,900	-1,281	-1,022	5
FCF equity	-1,046	1,551	1,284	1,858
Balance sheet summary (RMBm)				
Intangible fixed assets	3,861	3,815	3,765	3,710
Tangible fixed assets	8,038	10,100	12,054	13,936
Current assets	9,583	10,282	11,783	12,223
Cash & others	6,108	7,389	8,411	8,406
Total assets	21,634	24,349	27,754	30,020
Operating liabilities	9,530	10,550	12,108	12,212
Gross debt	617	617	617	617
Net debt	-5,491	-6,772	-7,795	-7,790
Shareholders funds	11,110	12,741	14,520	16,602
Invested capital	5,845	6,257	7,083	9,249

Ratio, growth and per share analysis

Year to	12/2011a	12/2012e	12/2013e	12/2014e
Y-o-y % change				
Revenue	16.4	13.4	20.5	16.6
EBITDA	12.4	9.4	9.1	14.0
Operating profit	8.8	8.0	8.4	15.4
PBT	15.6	6.4	8.7	15.3
HSBC EPS	14.3	7.6	8.7	15.3
Ratios (%)				
Revenue/IC (x)	5.7	4.3	4.7	4.5
ROIC	38.2	27.8	27.3	25.7
ROE	16.8	15.7	14.9	15.0
ROA	9.0	7.9	7.5	7.8
EBITDA margin	12.1	11.7	10.6	10.3
Operating profit margin	9.1	8.6	7.8	7.7
Net debt/equity	-48.7	-52.2	-52.6	-45.9
Net debt/EBITDA (x)	-2.0	-2.2	-2.3	-2.0
Per share data (RMB)				
EPS Rep (diluted)	1.29	1.38	1.50	1.73
HSBC EPS (diluted)	1.29	1.38	1.50	1.73
DPS	0.26	0.28	0.30	0.35
Book value	8.22	9.43	10.75	12.29

Valuation data

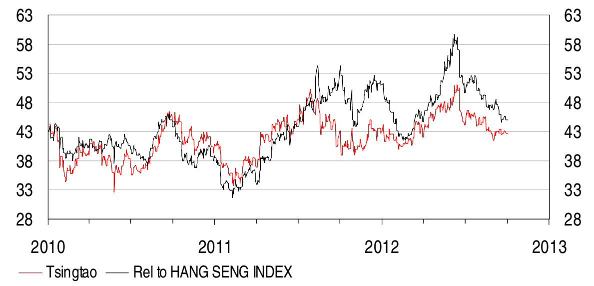
Year to	12/2011a	12/2012e	12/2013e	12/2014e
EV/sales	0.7	0.6	0.5	0.4
EV/EBITDA	6.2	5.2	4.5	4.0
EV/IC	3.0	2.6	2.1	1.6
PE*	27.0	25.1	23.1	20.0
P/Book value	4.2	3.7	3.2	2.8
FCF yield (%)	-4.6	6.8	5.6	8.1
Dividend yield (%)	0.7	0.8	0.9	1.0

*Based on HSBC EPS (diluted)

Issuer information

Share price	(HKD)42.80	Target price	(HKD)35.00
Reuters (Equity)	0168.HK	Bloomberg (Equity)	168 HK
Market cap (USDm)	3,615	Market cap (HKDm)	28,037
Free float (%)	50	Enterprise value (RMBm)	16,032
Country	China	Sector	Beverages
Analyst	Christopher K Leung	Contact	+852 29966531

Price relative



Source: HSBC

Note: price at close of 28 September 2012

Mengniu Dairy

- Sales recovery likely to be weaker than expected and we see high earnings downside risk over 2012-14
- Rebuilding consumer confidence is a right direction but it is also a timely and costly investment
- Initiate coverage with and Underweight (V) rating and price target of HKD19.70

Slow recovery

We initiate coverage of Mengniu Dairy with an Underweight (V) rating and target price of HKD19.70. Our Underweight (V) rating on Mengniu is premised mainly on our belief that the market is too optimistic on its sales and margin recovery as we believe the company is still on transformation stage, and we also see limited room for significant margin expansion in the near term. We project -3% y-o-y earnings decline in 2H12, followed by a 13% and 21% earnings recovery in 2013 and 2014, respectively. Our 2012/13/14 earnings estimates are 9%/20%/19% below consensus, respectively.

China Mengniu earnings summary, 2012-14e (RMB M)

Year to 31 Dec (RMB M)	2012e	2013e	2014e
Sales	37,645	41,397	47,384
EBIT	1,778	2,014	2,395
Net profit	1,409	1,587	1,915
Sales growth	0.7%	10.0%	14.5%
EBIT growth	-6.3%	13.3%	18.9%
Net profit growth	-11.3%	12.6%	20.7%

Source: HSBC Research

From a marketing point of view, we believe rebuilding consumer confidence is timely and requires large investments. Indeed, both the Chinese government and dairy companies, understanding the cause of those milk contamination incidents, have already made highly visible efforts to improve quality control and industry standards.

Overall dairy production in China was up 7% y-o-y in 1H12, but Mengniu Dairy's revenue during the same period was down 1% y-o-y. The drop was mainly driven by decline in sales volume, which was down 5% y-o-y. However, on the back of product mix improvement and price adjustment, the ASP growth was up 4% y-o-y and this offset the decline in sales volume.

Management indicated there were no price increases for liquid milk in 1H12. The price hike was on the ice-cream products, which were up 5-8% y-o-y at the beginning of year.

We do not expect sale volume will recovery sharply in 2H12 as consumers confidence are still being impacted by numerous milk contamination incidents, and we probably won't see a sound rebound until 2013 when there is a low base effect.

Overall dairy production in July was still weak, which was down 8.5% y-o-y. For Mengniu's key production areas, we estimated the average milk production was down 5% y-o-y, but it is also worth to note that one of its key markets – Inner Mongolia – recorded a 14.7% y-o-y decline in July-2012. The table on next page is a summary of milk production by province.

Slower industry growth

We are positive on the long-term growth prospect in the domestic dairy market, but we are doubtful of end demand in the near term, as numerous milk scandals in the past months have once again weakened consumer confidence in domestically made UHT milk products.

We expect industry growth will slow to 6% compared with 11% in 2011. For Mengniu Dairy in particular, we think that sales volume in 2013 and 2014 will be modest but that change in product mix will lead to higher ASP and sales growth.

The modest volume growth will be driven by market share gain, likely supported by spending on demand creation, such as local marketing events, distribution channel supports, and advertising spending.

Barring any food safety issues, we expect Mengniu Dairy's revenue growth to gradually recover from -1% in 1H12 to 2.5% in 2H12, and 10% in 2013.

Mengniu Dairy – Semi-annual revenue breakdown, 1H11-2H12e

Year to 31 Dec (RMB M)	1H10	2H10	1H11	2H11	1H12	2H12e
UHT Milk	**7,605**	**9,185**	**9,795**	**11,042**	**9,621**	**11,263**
Change	20.0%	16.9%	28.8%	20.2%	-1.8%	2.0%
Milk Beverages	**3,562**	**3,774**	**4,247**	**4,063**	**3,988**	**4,144**
Change	20.6%	9.9%	19.2%	7.6%	-6.1%	2.0%
Yogurt	**1,295**	**1,450**	**2,253**	**2,302**	**2,332**	**2,348**
Change	30.3%	25.2%	73.9%	58.7%	3.5%	2.0%
Liquid milk products	**12,462**	**14,410**	**16,295**	**17,406**	**15,941**	**17,754**
Change	21.1%	15.8%	30.8%	20.8%	-2.2%	2.0%
Ice-cream products	**1,821**	**1,290**	**2,083**	**1,176**	**2,158**	**1,234**
Y-o-y	9.9%	25.6%	14.4%	-8.9%	3.6%	5.0%
Other dairy products	**151**	**131**	**201**	**227**	**262**	**296**
Y-o-y	-1.0%	-4.1%	33.0%	73.4%	30.3%	30.0%
Total	**14,434**	**15,831**	**18,579**	**18,809**	**18,361**	**19,284**
Y-o-y	19.3%	16.3%	28.7%	18.8%	-1.2%	2.5%

Source: Company data, HSBC research

Recent milk scandals in China

Date	What happened
24-Dec-11	China's food safety regulator (AQSIQ) found a batch of Mengniu's boxed pure milk contained high levels of an aflatoxin M1.
28-May-12	Mengniu Dairy denied a claim that some dairy farmers in Hebei province had injected cow urine into the raw milk.
14-Jun-12	China's consumer quality regulator found an unusual amount of mercury in baby formula produced by Yili Industrial Group
27-Jun-12	Bright Dairy recalled 300 cartons of its Ubest-brand milk products that may have been contaminated with lye.
23-Aug-12	Mengniu's sales manager has been arrested for altering production dates on 5000 boxes of Mengniu Dairy's products.
10-Sep-12	Mengniu Dairy denied a claim that worms were found in a carton of its milk.
12-Sep-12	Shanghai Municipal Government ordered Bright Dairy & Food to revamp its production and transport operations. Recently, the 220ml bottle of fresh milk supplied by the dairy firm was found by some Shanghai consumers to have gone bad, which the company has explained was due to improper temperature settings inside the transport vehicles of the company.

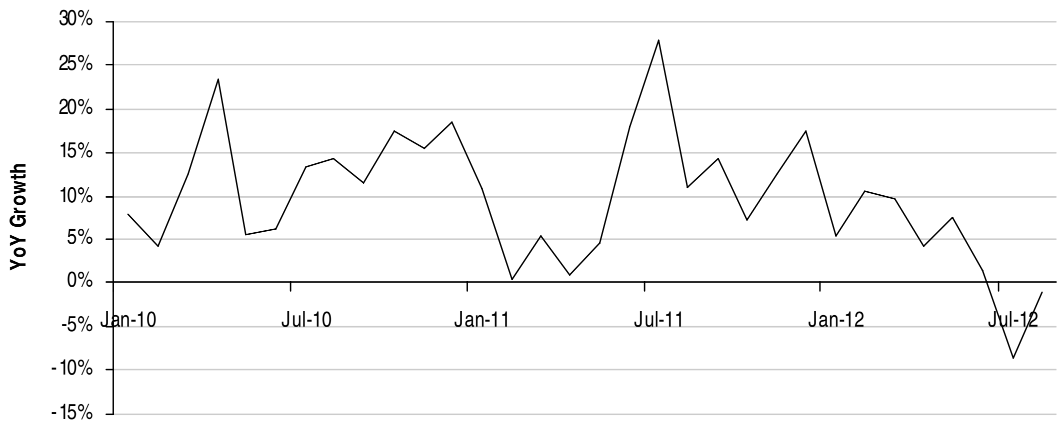
Source: Factiva.com, China Daily, and Sina news

Raw milk production in China, Jan-12 to Aug-12

Year to 31 Dec	Jan-12	Feb-12	Mar-12	Apr-12	May-12	Jun-12	Jul-12	Aug-12
Beijing	-8.2%	1.6%	-0.7%	-6.6%	-5.7%	-7.7%	-3.4%	-4.4%
Tianjin	-23.6%	-25.8%	52.9%	2.7%	11.2%	40.2%	32.9%	29.0%
Hebei	15.0%	11.0%	0.4%	-2.6%	-7.2%	-0.9%	3.6%	-6.5%
Shanxi	-18.9%	0.2%	33.4%	45.7%	45.6%	47.7%	85.5%	12.7%
Inner Mongolia	-19.3%	-14.1%	-2.4%	-20.0%	-10.3%	-15.9%	-14.7%	-18.5%
Liaoning	6.1%	19.4%	10.5%	-3.5%	9.2%	0.1%	3.1%	-4.8%
Jilin	-7.2%	2.0%	10.3%	9.0%	8.7%	-1.2%	-1.7%	15.2%
Heilongjiang	14.4%	7.0%	15.0%	20.0%	6.5%	-7.2%	1.3%	9.3%
Shanghai	10.4%	12.1%	15.2%	15.7%	24.9%	18.2%	17.7%	12.9%
Jiangsu	-18.5%	4.9%	0.3%	1.1%	6.1%	17.0%	5.3%	12.6%
Zhejiang	54.3%	-3.0%	27.9%	-2.0%	38.1%	40.7%	31.7%	33.9%
Anhui	-9.3%	29.5%	3.8%	-2.8%	2.0%	5.5%	-3.5%	-15.6%
Fujian	-56.4%	44.4%	8.9%	20.6%	32.8%	13.8%	7.6%	11.8%
Jianxi	4.0%	-10.8%	-7.9%	20.5%	-1.2%	-21.3%	-0.6%	-0.1%
Shandong	12.7%	10.3%	3.5%	27.6%	19.2%	9.9%	-54.6%	-15.2%
Henan	17.0%	15.4%	30.9%	28.3%	7.7%	16.5%	6.2%	11.8%
Hubei	-56.3%	-47.4%	36.1%	38.4%	57.9%	5.0%	12.4%	18.8%
Hunan	-17.0%	65.0%	3.9%	-21.9%	-14.5%	-10.3%	51.4%	-1.1%
Guangdong	1.1%	1.7%	15.4%	12.0%	-22.7%	12.8%	-3.1%	-15.3%
Guangxi	-5.9%	4.3%	26.4%	24.1%	22.5%	-1.3%	10.9%	14.6%
Hainan	-20.4%	48.2%	-3.7%	5.6%	-6.0%	6.7%	-13.6%	10.1%
Chongqing	-15.0%	-20.0%	-20.5%	-20.4%	-27.5%	0.0%	4.8%	5.0%
Sichuan	110.4%	49.8%	-17.5%	16.1%	4.0%	15.5%	6.5%	18.0%
Guizhou	0.7%	64.8%	-13.7%	32.1%	48.4%	16.4%	-3.1%	5.8%
Yunnan	14.6%	29.0%	34.7%	56.3%	39.7%	29.4%	38.7%	26.6%
Tibet	-6.7%	13.3%	78.7%	-9.9%	3.6%	-28.8%	-19.0%	-13.9%
Shaanxi	-11.9%	-1.3%	-5.3%	-11.4%	2.1%	-5.4%	3.0%	8.1%
Gansu	-11.3%	40.8%	31.3%	45.0%	67.7%	37.0%	103.7%	140.5%
Qinghai	14.9%	6.1%	3.2%	25.8%	21.5%	29.2%	28.8%	26.3%
Ningxia	311.0%	301.2%	373.6%	301.1%	266.3%	122.1%	73.6%	34.9%
Xinjiang	17.0%	-26.4%	9.1%	16.8%	13.2%	16.1%	-0.8%	24.5%
Total	**-0.6%**	**4.5%**	**8.2%**	**6.9%**	**7.9%**	**4.7%**	**-8.5%**	**-0.3%**

Source: China Dairy Association and HSBC

China monthly liquid milk production volume growth rate, Jan-2010 to Aug-2012



Source: China Dairy Association

Product mix upgrade for higher gross margin

Since the melamine incidents, Mengniu has been putting more focus on developing its high-end products such as Milk Deluxe and Future Star series, products for which gross margin is around 2ppt higher than the mid-end products and 4ppt higher than the low-end products.

The proportion of sales from high-end product segments increased from 15% in 2009 to 26% in 2011. We believe this is an appropriate strategy, as it no only allowed the company to achieve higher margins but also enabled it to improve its brand image by developing a premium position, differentiating itself from its competition, and gaining market share

Mengniu Dairy – Revenue breakdown by product category

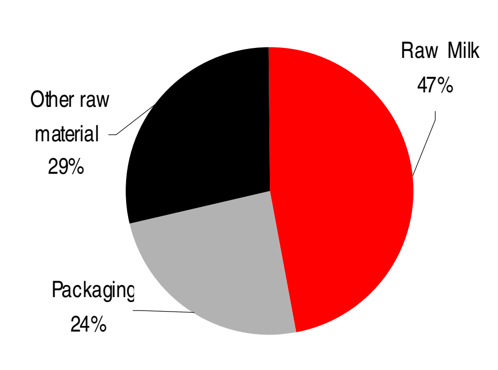
Year to 31 Dec	2011	2012e
High-end	26.0%	32.0%
Mid-end	49.0%	50.0%
Low-end	25.0%	18.0%
Total	**100.0%**	**100.0%**

Source: Company data, HSBC research

Management has indicated that they will continue their focus on developing high-end products, as they are now in the process of cutting down the number of SKUs and are targeting to eliminate lower margins products. We believe the group gross margin will increase further as the contribution from lower margin products continues to decline. However, it is worth to note that the gross margin is sensitive to promotional discount and raw milk price movement.

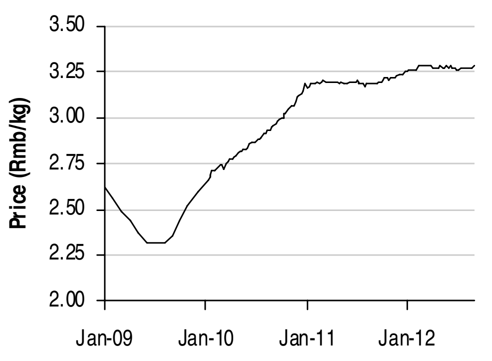
During 1H12, Mengniu offered higher promotional discounts to its distributor, and this resulted 0.3ppt drop in its gross margin. Further, because raw milk cost accounts for 47% of total COGS and we estimate every 5ppt increase in raw milk price could reduce its gross margin by 1.7ppt, assuming selling prices and product mix remain constant. The price of raw milk in China has been fairy steady year-to-date, being up 2.5% y-o-y. We believe the steady raw milk price this year was mainly due to weakened dairy demand and decline in imported milk powder prices. However, as we expect that feedstock prices (i.e. corn, soybean meal and alfalfa) to remain at a high level in the near term, we think the price of raw milk will increase by 4-5% next year.

Mengniu Dairy – FY11 COGS breakdown



Source: Company data

China raw milk prices, Jan-2009 to 1st week of Sept-2012



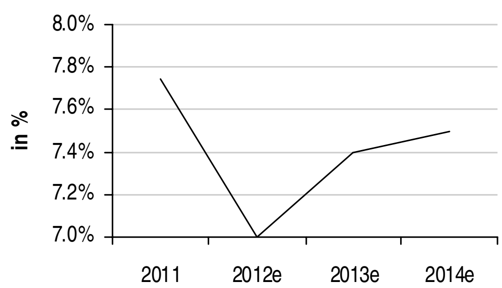
Source: China Dairy Association

…but not equally for the bottom line

While we expect Mengniu will achieve gross margin improvement through product mix upgrade, we think part of the benefit will be mitigated by higher investment on demand creation, which falls under the advertising and promotional (A&P) expense category. A&P spending accounted for 7% of revenue in 1H12, and we expect it will increase to 7.4% in 2013 and 7.5% in 2014. The A&P spending in 1H12 was around 1ppt lower than in 1H11, and we think this is because Mengniu reduced spending on media advertising to avoid negative publicity during the contamination scandal

. Overall, we expect its EBIT margin will only improve by around 0.2ppt in each of next two years to around 4.9% in 2013 and 5.1% in 2014.

Mengniu Dairy – A&P to sales ratio, 2011-14e



Source: Company reports and HSBC estimates

Cooperation with Arla Foods

Arla Foods acquired a 5.9% effective stake in Mengniu Dairy on June-2012, and also entered a strategic cooperation agreement with Mengniu Dairy. The cooperation between Arla Foods and Mengniu Dairy will be focused on four areas.

- Partnership – Mengniu will be the exclusive strategic partner for Arla Foods in China
- Sourcing and distribution – Mengniu will develop certain products bearing Arla Food's brands in China and selected countries, and Arla Foods' brand in China and selected countries, and Arla Foods will supply only Mengniu with such products.
- Technology – Arla Foods will provide technical, management, marketing, and innovation advice to Mengniu.
- Co-investment – Both Arla Foods and Mengniu Dairy will cooperate in the sourcing of ingredients from each other and will together invest in dairy business opportunities.

We believe this cooperation is an eventual positive for Mengniu Dairy because it can gain technical know-how from Arla Foods and eventually elevate its brand image through the introduction of more premium dairy products.

However, we do not think this cooperation will create significant earnings contribution in the near term as Mengniu's current focus is the distribution of imported infant formula from Arla Foods, expected to commence in Sept-2012. On a separate note, Arla Food had previously established a joint venture with Mengniu Dairy in 2006 to develop an infant formula business in China. The joint venture business has not progressed well due as there were some ambiguity in management control. However, given that Arla Foods has become a shareholder of Mengniu, we think their interests will be more aligned, which should help the development of the infant formula business.

Arla Foods and Mengniu Dairy – Co-branded Infant Formula

Source: HSBC

Upstream investments

In order to have a better control on raw milk sourcing, management believes it is important to have full sourcing from ranches and scaled farms as they have better control on feeding, vaccination, and quality control. The proportion of milk sources provided by ranches and scaled farms was around 80% in 2011, and Mengniu is targeting to increase it to 100% by 2015. Mengniu plans to invest approximately RMB3-3.5bn on dairy farms, including RMB2bn on building self-owned dairy farms and RMB1-1.5bn for minority investments on third-party dairy farms.

For self-owned dairy farms, it is expected each farm will initially carry around 2000-3000 cows, but will gradually increase to 10,000 cows. By 2015, these ranches will supply 1,200-1,300 tons of raw milk per day and management expects these new dairy farms will supply 8-9% of the company's raw milk need by 2015.

The capital expenditure for 2012 is budgeted at around RMB2.6-2.8bn, and this includes RMB800-900m for upstream investments and the rest for capacity expansion. The production capacity in 2011 was around 7.05m tons, and management expects it will increase by 5-8% this year.

Valuation and risks

We use PE ratio to value Mengniu Dairy as we believe it can better capture the company's earnings growth momentum. Our target price of HKD19.70 is based on an 18x 12-month forward PE, which is taken from a multiple that is 1 standard deviation below the group's historical average PE of 23.0x since 2009.

We apply a discount to the historical valuation because we think recovery in sales and margin will be slower than expected. Historically, the share price movement of Mengniu Dairy is highly correlated to its sales performance. We expect the stock to be de-rated on the back of disappointing sales performance. Our model currently expects revenue growth to be only 2.5% y-o-y in 2H12 and 10% in 2013, compared with 24% in 2011 and 18% in 2010.

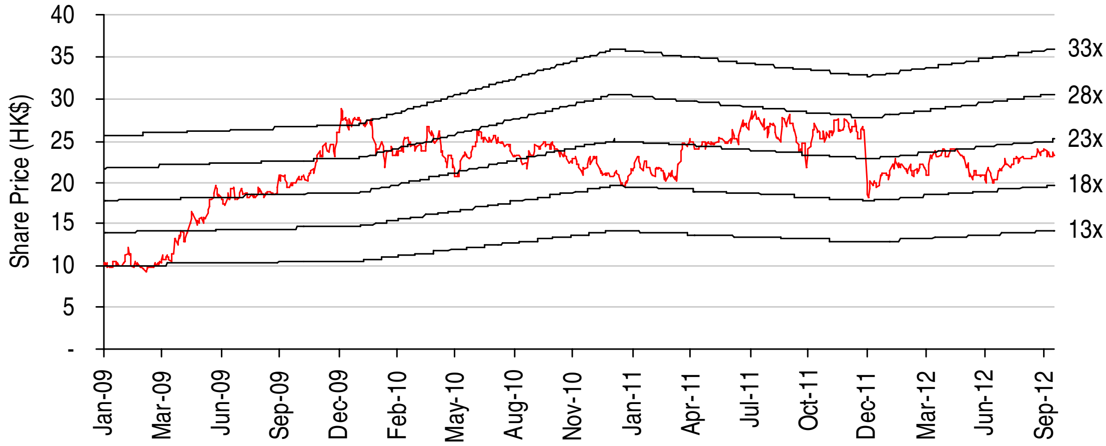
We cross reference our PE-based valuation using a DCF methodology. Our DCF analysis uses a WACC of 10.7% and a terminal growth rate of 1%. This yields a valuation of HKD22.1, which is 12% higher than our target price of HKD19.7. While our DCF valuation derives a higher target price, we do not think the stock could reach that value given slow recovery in the near term. The DCF valuation implies a 12-month forward earnings PE of 20x. See the following page for details of our DCF assumptions.

Under our research model, the Neutral rating band for volatile China equities equals a hurdle rate of 10% for China, plus or minus 10ppt. Our target price of HKD19.7 implies a potential return of -14.2% (including 0.9% forecast dividend yield), which is below this band; we therefore rate the shares Underweight (V). Potential return equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated.

Risks to our view

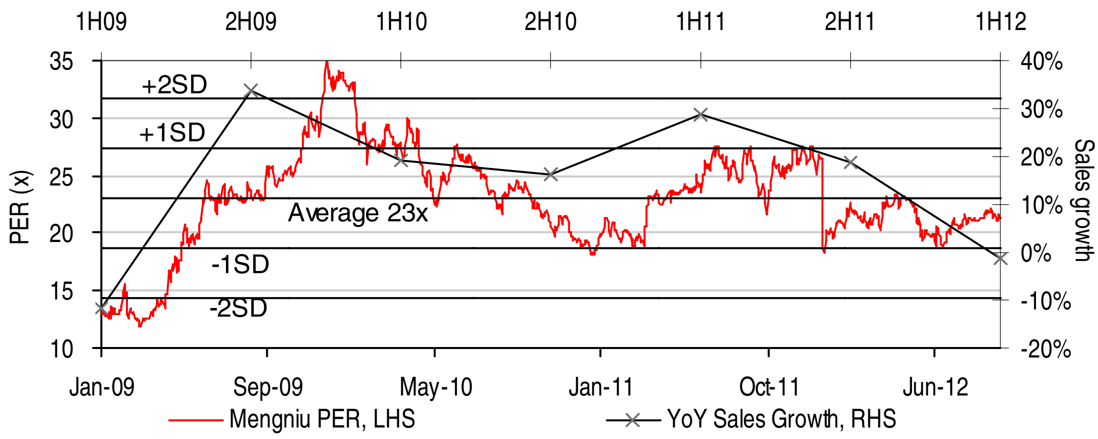
Key upside risks to our rating and estimates include (1) a faster-than-expected recovery of dairy consumption in China, (2) a better-than-expected product mix upgrade and improved cost control efforts resulting in higher-than-expected margins; (3) lower-than-expected raw material costs, and (4) any earnings-accretive new business initiatives.

Mengniu Dairy – 1-yr forward PE band chart, Jan'09 to present



Source: Thomson Reuters Datastream, HSBC Research

Mengniu – 1-yr forward PE band chart vs sales growth, Jan'09 to present



Source: Thomson Reuters Datastream, company data, HSBC Research

China Mengniu Dairy – DCF valuation

Year to 31 Dec (RMBm)	2011	2012e	2013e	2014e	2015e	2016e	2017e	2018e	2019e	2020e
Sales	**37,388**	**37,645**	**41,397**	**47,384**	**54,491**	**62,665**	**72,065**	**82,875**	**95,306**	**109,602**
% chg	24%	1%	10%	14%	15%	15%	15%	15%	15%	15%
EBIT	**1,896**	**1,778**	**2,014**	**2,395**	**2,754**	**3,167**	**3,642**	**4,972**	**5,718**	**6,576**
EBIT margin	*5.1%*	*4.7%*	*4.9%*	*5.1%*	5.1%	5.1%	5.1%	6.0%	6.0%	6.0%
Depreciation & Amortisation	864	1,022	1,196	1,352	1,555	1,788	2,056	2,365	2,719	3,127
EBITDA	**2,760**	**2,800**	**3,210**	**3,747**	**4,309**	**4,955**	**5,698**	**7,337**	**8,438**	**9,703**
EBITDA margin	*7%*	*7%*	*8%*	*8%*	*8%*	*8%*	*8%*	*9%*	*9%*	*9%*
Tax	**(276)**	**(329)**	**(369)**	**(443)**	**(776)**	**(892)**	**(1,026)**	**(1,394)**	**(1,603)**	**(1,844)**
– Effective tax rate	13%	17%	17%	17%	18%	18%	18%	19%	19%	19%
EBIDA	**2,484**	**2,471**	**2,840**	**3,304**	**3,533**	**4,063**	**4,672**	**5,943**	**6,835**	**7,860**
Capex	(2,293)	(2,700)	(2,800)	(2,800)	(2,800)	(2,800)	(2,800)	(2,800)	(2,800)	(2,800)
FCF	**191**	**(229)**	**40**	**504**	**733**	**1,263**	**1,872**	**3,143**	**4,035**	**5,060**
Discount rate		**1.0**	**1.1**	**1.2**	**1.4**	**1.5**	**1.7**	**1.8**	**2.0**	**2.3**
DCF		**(229)**	**37**	**411**	**540**	**841**	**1,126**	**1,708**	**1,980**	**2,244**
Terminal growth										1.0%

CAPM	
Beta vs HSI (B)	1.1
Risk free rate of return (Rf)	3.0%
Market expect return (Rm)	10.0%
Equity risk premium (Rm-Rf)	7.0%
Discount rate (R) = Rf+(Rm-Rf)*B	**10.7%**
DCF	**8,659**
PV of Terminal Value	23,110
Total EV	**31,768**
Net (Debt) / Cash	5,333
NAV	**37,101**
Equity value	
Number of shares (m)	1,757
Value per share (RMB)	18.1
Value per share (HKD)	**22.1**

Source: Company data, HSBC research

China Mengniu Dairy – Income statements, 2010-14e

Year to 31 Dec (RMBm)	2010	2011	2012e	2013e	2014e	1H11	2H11	1H12	2H12e
Sales	**30,265**	**37,388**	**37,645**	**41,397**	**47,384**	**18,579**	**18,809**	**18,361**	**19,284**
COGS	(22,479)	(27,796)	(27,935)	(30,574)	(34,785)	(13,754)	(14,042)	(13,650)	(14,285)
Gross profit	**7,786**	**9,592**	**9,710**	**10,824**	**12,599**	**4,825**	**4,767**	**4,711**	**5,000**
Other income & gains	193	296	200	207	214	101	195	109	92
Selling & distribution expenses	(5,429)	(6,695)	(6,801)	(7,547)	(8,730)	(3,311)	(3,383)	(3,297)	(3,504)
Admin expenses	(1,036)	(1,110)	(1,128)	(1,251)	(1,448)	(522)	(588)	(570)	(558)
Other operating expenses	(60)	(187)	(204)	(218)	(241)	(97)	(90)	(129)	(75)
EBIT	**1,455**	**1,896**	**1,778**	**2,014**	**2,395**	**995**	**901**	**824**	**954**
Interest income	88	173	198	186	183	66	107	102	96
Finance costs	(45)	(61)	(20)	(16)	(14)	(29)	(32)	(12)	(8)
Share of profit & loss of associates	40	52	(23)	(12)	41	16	36	(11)	(12)
PBT	**1,538**	**2,061**	**1,933**	**2,171**	**2,604**	**1,048**	**1,012**	**903**	**1,031**
Tax	(182)	(276)	(329)	(369)	(443)	(156)	(120)	(155)	(174)
PAT	**1,356**	**1,785**	**1,605**	**1,802**	**2,161**	**892**	**892**	**748**	**857**
Minority	(119)	(195)	(196)	(215)	(246)	(102)	(93)	(103)	(93)
Net profit	**1,237**	**1,589**	**1,409**	**1,587**	**1,915**	**790**	**800**	**645**	**774**
Key ratios									
Margins									
Gross Margin	25.7%	25.7%	25.8%	26.1%	26.6%	26.0%	25.3%	25.7%	25.9%
EBITDA Margin	7.2%	7.4%	7.4%	7.8%	7.9%	7.6%	7.2%	7.1%	7.7%
EBIT Margin	4.8%	5.1%	4.7%	4.9%	5.1%	5.4%	4.8%	4.5%	4.9%
PBT Margin	5.1%	5.5%	5.1%	5.2%	5.5%	5.6%	5.4%	4.9%	5.3%
Net Margin	4.1%	4.3%	3.7%	3.8%	4.0%	4.3%	4.3%	3.5%	4.0%
Distribution costs as % of sales	17.9%	17.9%	18.1%	18.2%	18.4%	17.8%	18.0%	18.0%	18.2%
Adm exp as % of sales	3.4%	3.0%	3.0%	3.0%	3.1%	2.8%	3.1%	3.1%	2.9%
Effective tax rate	11.8%	13.4%	17.0%	17.0%	17.0%	14.9%	11.8%	17.1%	16.9%
Growth rate									
Sales growth	17.7%	23.5%	0.7%	10.0%	14.5%	28.7%	18.8%	-1.2%	2.5%
Gross profit growth	13.6%	23.2%	1.2%	11.5%	16.4%	27.4%	19.2%	-2.4%	4.9%
EBITDA growth	9.6%	27.3%	1.4%	14.6%	16.7%	31.1%	23.6%	-6.8%	9.9%
EBIT growth	11.7%	30.3%	-6.3%	13.3%	18.9%	36.9%	23.8%	-17.2%	5.9%
NI growth	10.9%	28.4%	-11.3%	12.6%	20.7%	27.6%	29.3%	-18.4%	-3.2%
EPS growth	4.3%	27.3%	-11.3%	12.6%	20.7%	27.5%	28.1%	-19.5%	-3.2%

Source: Company data, HSBC research

Financials & valuation: China Mengniu Dairy

Underweight (V)

Financial statements

Year to	12/2011a	12/2012e	12/2013e	12/2014e
Profit & loss summary (RMBm)				
Revenue	37,388	37,645	41,397	47,384
EBITDA	2,760	2,800	3,210	3,747
Depreciation & amortisation	-864	-1,022	-1,196	-1,352
Operating profit/EBIT	1,896	1,778	2,014	2,395
Net interest	112	178	170	168
PBT	2,061	1,933	2,171	2,604
HSBC PBT	2,061	1,933	2,171	2,604
Taxation	-276	-329	-369	-443
Net profit	1,589	1,409	1,587	1,915
HSBC net profit	1,589	1,409	1,587	1,915
Cash flow summary (RMBm)				
Cash flow from operations	2,520	2,350	3,527	3,312
Capex	-2,293	-2,700	-2,800	-2,800
Cash flow from investment	-1,645	-2,602	-2,714	-2,717
Dividends	-331	-282	-317	-383
Change in net debt	-9	534	-496	-212
FCF equity	341	-130	926	654
Balance sheet summary (RMBm)				
Intangible fixed assets	1,536	1,638	1,739	1,838
Tangible fixed assets	7,694	9,370	10,973	12,422
Current assets	10,387	10,050	10,434	11,485
Cash & others	6,523	5,889	6,285	6,397
Total assets	20,202	21,643	23,732	26,331
Operating liabilities	7,473	7,692	8,396	9,316
Gross debt	657	557	457	357
Net debt	-5,866	-5,333	-5,828	-6,040
Shareholders funds	11,471	12,598	13,868	15,400
Invested capital	5,620	7,477	8,466	10,032

Ratio, growth and per share analysis

Year to	12/2011a	12/2012e	12/2013e	12/2014e
Y-o-y % change				
Revenue	23.5	0.7	10.0	14.5
EBITDA	27.3	1.4	14.6	16.7
Operating profit	30.3	-6.3	13.3	18.9
PBT	34.0	-6.2	12.3	19.9
HSBC EPS	27.3	-11.3	12.6	20.7
Ratios (%)				
Revenue/IC (x)	7.9	5.7	5.2	5.1
ROIC	34.8	22.5	21.0	21.5
ROE	15.0	11.7	12.0	13.1
ROA	9.8	7.8	8.0	8.7
EBITDA margin	7.4	7.4	7.8	7.9
Operating profit margin	5.1	4.7	4.9	5.1
Net debt/equity	-48.7	-39.9	-39.2	-36.3
Net debt/EBITDA (x)	-2.1	-1.9	-1.8	-1.6
Per share data (RMB)				
EPS Rep (diluted)	0.90	0.80	0.90	1.09
HSBC EPS (diluted)	0.90	0.80	0.90	1.09
DPS	0.20	0.16	0.18	0.22
Book value	6.53	7.17	7.89	8.77

Valuation data

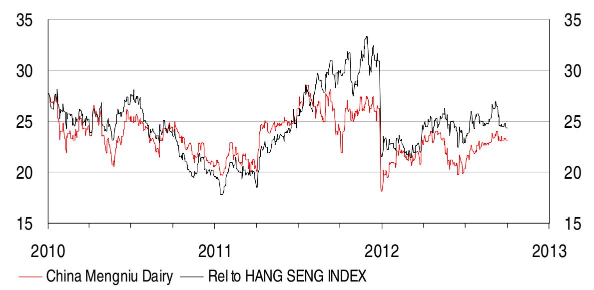
Year to	12/2011a	12/2012e	12/2013e	12/2014e
EV/sales	0.7	0.7	0.7	0.6
EV/EBITDA	9.9	10.0	8.7	7.4
EV/IC	4.9	3.8	3.3	2.8
PE*	20.8	23.4	20.8	17.3
P/Book value	2.9	2.6	2.4	2.1
FCF yield (%)	1.0	-0.4	2.8	1.9
Dividend yield (%)	1.1	0.9	1.0	1.2

*Based on HSBC EPS (diluted)

Issuer information

Share price	(HKD)23.20	Target price	(HKD)19.70
Reuters (Equity)	2319.HK	Bloomberg (Equity)	2319 HK
Market cap (USDm)	5,289	Market cap (HKDm)	41,015
Free float (%)	68	Enterprise value (RMBm)	28,102
Country	China	Sector	Food & Staples Retailing
Analyst	Christopher K Leung	Contact	+852 29966531

Price relative



Source: HSBC

Note: price at close of 28 September 2012

HSBC

Want Want

- Strong top-line growth to be driven by dairy beverages; rice crackers sales seem to have affected by a shift in consumer preference
- Gross margin should continue to in 2H12 and 2013 due to decline in imported raw milk powder prices
- Share price has gained 28% y-t-d and we believe it has fully reflected its strong earnings momentum; Initiate with a Neutral rating and price target of HKD10.60

Mixed outlook

We initiate coverage on Want Want with a Neutral rating and price target of HKD10.60. While we believe that Want Want will continue to experience strong growth in sales of its dairy beverage products, we think sales momentum for its rice crackers product will be slow in coming quarters as the price hike late last years seems to have caused a shift in consumer preference.

The price of Want Want shares has surged 28% year-to-date (HSI up 13%), and the current valuation at 26x 12-month forward PE seems to have already priced in the strong dairy beverage sales momentum. We project Want Want will achieve 30% y-o-y earnings growth in 2012, 25% in 2013 and 20% in 2014e. Our 2012/13/14 earnings estimates are in line with consensus.

Management has given guidance of 10-15% sales growth for its dry food business (rice crackers plus other snack foods) and 25% sales growth for dairy and beverage business in 2012. We believe this target is achievable, but it will be mainly driven by the dairy and beverage.

Want Want – Earnings summary, 2012-14e (USDm)

Year to 31 Dec	2012e	2013e	2014e
Sales	3,470	4,076	4,920
EBIT	715	899	1,082
Net profit	545	679	814
Sales growth	17.8%	17.5%	20.7%
EBIT growth	36.8%	25.8%	20.3%
Net profit growth	29.8%	24.7%	19.8%

Source: HSBC Research

Widening vehicle sales services

Over the past few years, Want Want has focused restructuring its distribution network and deepening its penetration of rural areas. The company started a vehicle sales project in 2006 by sending sales representatives in Want Want vehicles to the end retailers in tier 3 or lower cities. This project was remarkably effective as sales from tier 3 or lower cities now accounts fro 45% of group revenue and have been growing over 30% per annum in the past few years.

Starting in Aug-2012, Want Want will extend the vehicle sales services to tier 1 and 2 cities, which management believes it will give them greater control over retail point-of sales, further improving brand presence and sales productivity. We think this extension will be effective and support sales momentum in next few years.

Want Want – Distribution network and production facilities

Year to 31 Dec	2009	2010	2011
# of distributors	10,000	8,000	8,000
# of sales offices	329	330	346
# of production bases	34	34	34
# of factories	106	107	103
# of employees	45,000	51,000	50,000

Source: Company reports

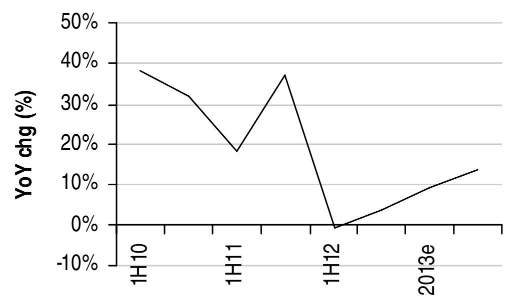
Rice crackers sales affected by the macro slowdown

Sales of rice crackers were down 0.5% y-o-y in 1H12, but it was largely driven by a 10% increase in ASP, suggesting a low double digit decline in sales volume. We believe the decline in sales volume was primarily due to the slowdown in the economy as it tends to make consumers more price sensitive and prompt shifts to products at lower price points.

We noted Orion (a Korean snack food company) has not increased prices during in the past 12 months and we think it might have gained market share from Want Want. During 1H12, Orion China sales surged by 40% y-o-y and this was largely volume driven.

Despite sluggish performance in 1H12, we think sales growth of rice crackers should resume in coming months, rising from -0.5% in 1H12 to 3.6% in 2H12, due to resumption of production of sub-brand rice crackers and a smaller decline in sales volume on higher market efforts.

Want Want – Rice crackers sales growth, 1H10 to 2014e



Source: Company reports and HSBC estimates

Want Want – Estimated rice crackers sales volume and ASP

Year to 31 Dec	2011	2012e	1H12e	2H12e
ASP (RMB/kg)	**25.0**	**27.1**	**26.8**	**27.3**
Change	2.7%	8.2%	10.0%	2.0%
Sales volume (Kg m)	**211**	**195**	**65**	**130**
Change	20.9%	-7.7%	-12.6%	-5.0%

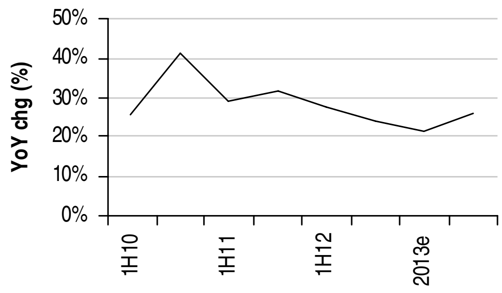
Source: HSBC estimates

Dairy beverages continue to gain market share

Despite UHT and pasteurized milk consumption being negatively affected by numerous milk scandals in the past few years, the demand for flavoured milk was remarkably strong with over 20% sales CAGR between 2008 and 2011. We believe such strong growth suggested a shift in consumer preference form UHT and pasteurized milk to flavoured milk. Want Want is benefiting from this trend and is gaining market share due to its strong brand recognition and good track record on food quality and safety issues.

Sales of dairy and other beverages were up 28% y-o-y in 1H12, and this was driven by the strong growth in its flavoured milk products, which were up 33% y-o-y. ASP growth in 1H12 was over 10%, suggesting over a high-teen growth in sales volume. We do not think the ASP growth in 2013 will be as high as in 2012, but we think it should able to sustain a strong volume growth in the next few years due to market share gains from other smaller local dairy brands. Our model currently assumes 24% sales growth in dairy and other beverage business in 2H12, and this will be driven by 12% ASP growth and 12% volume growth.

Want Want – Dairy beverage products sales growth, 1H10 to 2014e



Source: Company reports and HSBC estimates

Want Want – Estimated dairy beverage sales volume and ASP

Year to 31 Dec	2011e	2012e	1H12e	2H12e
ASP (RMB/kl)	**9.4**	**10.3**	**10.2**	**10.4**
Change	3%	10%	10%	12%
Sales volume (m kl)	**956**	**1,071**	**495**	**576**
Change	21%	12%	12%	12%

Source: HSBC estimates

Further gross margin improvement due to lower raw milk powder costs

We expect Want Want's gross margin will improve from 37% in 1H12 to 40% in 2H12 and 41% in 2013, as we believe the company will benefit from lower raw milk powder costs. The whole milk powder spot price in Oceania has fallen 20% in the first eight months of this year, and this should further improve its diary beverage gross margin.

During 1H12, despite over 10% increase in selling prices, the dairy and other beverage gross margin was only up 3ppt y-o-y as Want Want was digesting some higher priced raw milk powder inventory.

Raw milk powder made up 16% of total COGS in 1H12. Around 65% of milk powder is sourced from New Zealand and the other 35% are procured in China. Management indicated they usually will keep three to four months of milk-powder inventory.

Valuation and risks

We use DCF to value Want Want as we believe its strong brand positioning and large distribution network should allow the company to company to generate steady cash flow and returns. Our DCF analysis uses a WACC of 7.9% and a terminal growth rate of 1%. This yields a valuation of HKD10.60. The DCF valuation implies a 12-month forward earnings PE of 26x. See the following page for details of our DCF assumptions.

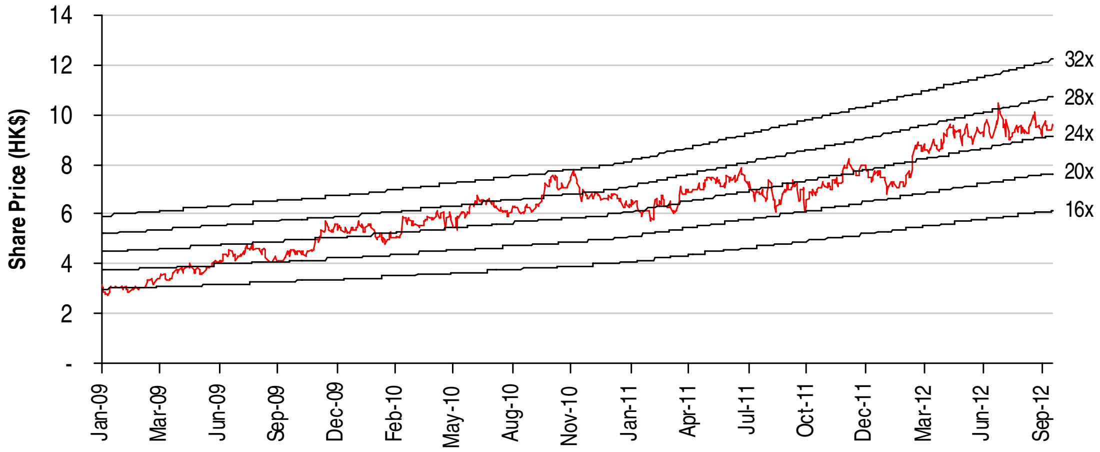
Under our research model, the Neutral rating band for non-volatile China equities equals a hurdle rate of 10% for China, plus or minus 5ppt. Our target price of HKD10.6 implies a potential return of 9.1% (including 1.9% forecast dividend yield), which is within this band; we therefore rate the shares Neutral. Potential return equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated. Potential return equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated.

Risks to our view

Key downside risks to our rating and estimates include (1) weaker-than-expected rice cracker sales due to further macro slowdown, (2) lower-than-expected margin improvement, especially in the dairy beverage segment, and (3) rising competition, which could lead to higher A&P investments or product price cut.

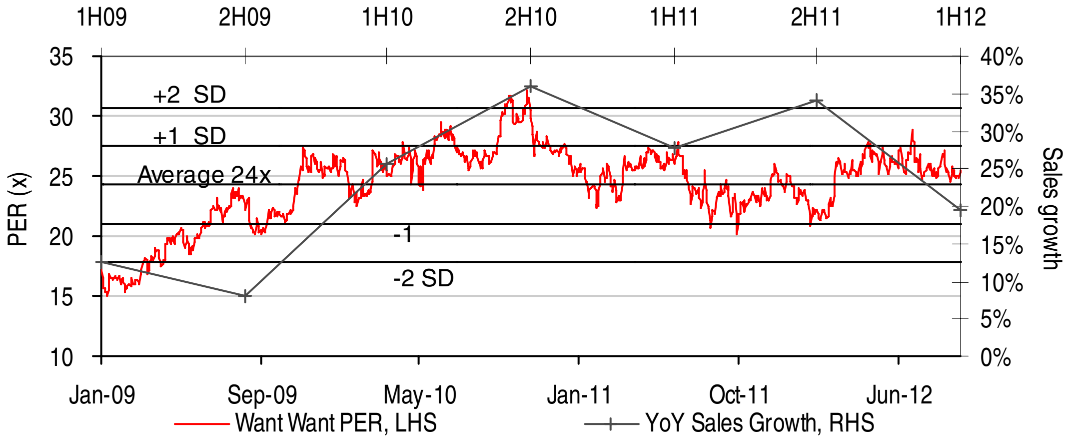
Key upside risks to our investment case include (1) significant improvement in point-of-sales productivity due to the extension of vehicle sales project into tier-1 and -2 cities, (2) any new earnings-accretive M&A transactions, and (3) higher-than-expected gross margin improvement.

Want Want – 1-yr forward PE band chart, Jan'09 to present



Source: Thomson Reuters Datastream, HSBC Research

Want Want – 1-yr forward PE band chart vs sales growth, Jan'09 to present



Source: Thomson Reuters Datastream, company data, HSBC Research

HSBC

Want Want – DCF valuation

Year to Dec 31 (USDm)	2011	2012e	2013e	2014e	2015e	2016e	2017e	2018e	2019e	2020e
Revenue	**2,947**	**3,470**	**4,076**	**4,920**	**5,805**	**6,850**	**7,946**	**9,218**	**10,600**	**12,190**
Change		18%	17%	21%	18%	18%	16%	16%	15%	15%
EBIT	**522**	**715**	**899**	**1,082**	**1,219**	**1,439**	**1,669**	**1,936**	**2,226**	**2,560**
EBIT margin		*20.6%*	*22.1%*	*22.0%*	21.0%	21.0%	21.0%	21.0%	21.0%	21.0%
Depreciation & Amortisation	72	87	105	122	143	169	196	228	262	301
EBITDA	**595**	**801**	**1,003**	**1,203**	**1,363**	**1,608**	**1,865**	**2,163**	**2,488**	**2,861**
EBITDA margin	*20%*	*23%*	*25%*	*24%*	*23%*	*23%*	*23%*	*23%*	*23%*	*23%*
Tax	**(119)**	**(196)**	**(245)**	**(293)**	**(361)**	**(426)**	**(494)**	**(573)**	**(659)**	**(758)**
– Effective tax rate	22%	27%	27%	27%	27%	27%	27%	27%	27%	27%
EBIDA	**476**	**605**	**758**	**910**	**1,001**	**1,182**	**1,371**	**1,590**	**1,829**	**2,103**
Capex	(216)	(300)	(300)	(300)	(400)	(400)	(400)	(500)	(500)	(500)
FCF	**260**	**305**	**458**	**610**	**601**	**782**	**971**	**1,090**	**1,329**	**1,603**
Discount rate		**1.0**	**1.1**	**1.2**	**1.3**	**1.4**	**1.5**	**1.6**	**1.7**	**1.8**
DCF		**305**	**425**	**524**	**479**	**577**	**664**	**692**	**781**	**874**
Terminal growth										1%
CAPM										
Beta vs HSI (B)	0.70									
Risk free rate of return (Rf)	3.0%									
Market expect return (Rm)	10.0%									
Equity risk premium (Rm-Rf)	7.0%									
Discount rate (R) = Rf+(Rm-Rf)*B	**7.9%**									
DCF	**5,321**									
PV of Terminal Value	12,233									
Total EV	**17,554**									
Net (Debt) / Cash	412									
NAV	**17,967**									
Equity value										
Number of shares (m)	13,228									
Value per share (USD)	1.4									
Value per share (HKD)	**10.6**									

Source: Company data, HSBC research

Want Want – Income statements, 2010-14e

Year to 31 Dec (USDm)	2010	2011	2012e	2013e	2014e	1H11	2H11	1H12	2H12e
Sales	**2,244**	**2,947**	**3,470**	**4,076**	**4,920**	**1,279**	**1,667**	**1,528**	**1,942**
COGS	(1,400)	(1,922)	(2,129)	(2,422)	(2,925)	(858)	(1,064)	(961)	(1,168)
Gross profit	**845**	**1,025**	**1,341**	**1,654**	**1,994**	**422**	**603**	**566**	**775**
Distribution costs	(277)	(332)	(394)	(461)	(551)	(149)	(183)	(169)	(225)
Admin costs	(169)	(232)	(282)	(326)	(394)	(100)	(132)	(123)	(159)
Other income	41	61	51	32	32	32	29	25	26
Other gains/(losses), net	(0)	0	-	-	-	(1)	2	(1)	1
EBIT	**439**	**522**	**715**	**899**	**1,082**	**204**	**319**	**298**	**417**
Finance income	10	26	37	36	36	9	17	27	10
Finance costs	(7)	(10)	(10)	(10)	(10)	(4)	(7)	(7)	(3)
Share of profit of associates	0	0	0	0	0	0	0	(0)	0
PBT	**443**	**538**	**741**	**924**	**1,107**	**209**	**329**	**318**	**424**
Tax	(84)	(119)	(196)	(245)	(293)	(42)	(77)	(87)	(110)
PAT	**359**	**420**	**545**	**679**	**814**	**167**	**253**	**231**	**314**
Minority	(0)	(0)	(0)	(0)	(0)	(0)	(0)	(0)	(0)
NI	**358**	**419**	**545**	**679**	**814**	**167**	**252**	**231**	**314**
Key ratios									
Margins									
Gross Margin	37.6%	34.8%	38.6%	40.6%	40.5%	33.0%	36.2%	37.1%	39.9%
EBITDA Margin	22.3%	20.2%	23.1%	24.6%	24.5%	18.7%	21.3%	22.3%	23.7%
EBIT Margin	19.6%	17.7%	20.6%	22.1%	22.0%	15.9%	19.1%	19.5%	21.5%
PBT Margin	19.7%	18.3%	21.4%	22.7%	22.5%	16.3%	19.7%	20.8%	21.8%
Net Margin	16.0%	14.2%	15.7%	16.7%	16.5%	13.1%	15.1%	15.1%	16.1%
Distribution costs as % of sales	12.4%	11.3%	11.4%	11.3%	11.2%	11.6%	11.0%	11.1%	11.6%
Adm exp as % of sales	7.5%	7.9%	8.1%	8.0%	8.0%	7.8%	7.9%	8.1%	8.2%
Effective tax rate	19.0%	22.0%	26.5%	26.5%	26.5%	20.1%	23.3%	27.3%	25.9%
Growth rate									
Sales growth	31.2%	31.3%	17.8%	17.5%	20.7%	27.6%	34.3%	19.4%	16.5%
Gross profit growth	22.0%	21.3%	30.8%	23.3%	20.6%	10.5%	30.2%	34.2%	28.5%
EBITDA growth	22.5%	19.0%	34.7%	25.2%	19.9%	6.6%	29.1%	42.2%	29.7%
EBIT growth	23.4%	19.0%	36.8%	25.8%	20.3%	4.2%	30.8%	46.3%	30.7%
NI growth	14.6%	17.0%	29.8%	24.7%	19.8%	3.6%	28.0%	38.2%	24.3%
EPS growth	14.6%	17.0%	29.8%	24.7%	19.8%	3.6%	28.0%	38.2%	24.2%

Source: Company data, HSBC research

HSBC

Financials & valuation: Want Want

Neutral

Financial statements

Year to	12/2011a	12/2012e	12/2013e	12/2014e
Profit & loss summary (USDm)				
Revenue	2,947	3,470	4,076	4,920
EBITDA	595	801	1,003	1,203
Depreciation & amortisation	-72	-87	-105	-122
Operating profit/EBIT	522	715	899	1,082
Net interest	16	26	26	26
PBT	538	741	924	1,107
HSBC PBT	538	741	924	1,107
Taxation	-119	-196	-245	-293
Net profit	419	545	679	814
HSBC net profit	419	545	679	814
Cash flow summary (USDm)				
Cash flow from operations	579	543	683	799
Capex	-175	-250	-250	-250
Cash flow from investment	-222	-300	-300	-300
Dividends	-259	-327	-408	-488
Change in net debt	-151	83	25	-11
FCF equity	368	331	471	587
Balance sheet summary (USDm)				
Intangible fixed assets	10	10	10	10
Tangible fixed assets	1,007	1,259	1,492	1,709
Current assets	2,103	2,343	2,413	2,577
Cash & others	1,437	1,604	1,579	1,590
Total assets	3,123	3,614	3,919	4,300
Operating liabilities	752	775	807	862
Gross debt	1,025	1,275	1,275	1,275
Net debt	-412	-329	-304	-315
Shareholders funds	1,330	1,548	1,819	2,145
Invested capital	932	1,233	1,530	1,845

Ratio, growth and per share analysis

Year to	12/2011a	12/2012e	12/2013e	12/2014e
Y-o-y % change				
Revenue	31.3	17.8	17.5	20.7
EBITDA	19.0	34.7	25.2	19.9
Operating profit	19.0	36.8	25.8	20.3
PBT	21.5	37.7	24.7	19.8
HSBC EPS	17.0	29.8	24.7	19.8
Ratios (%)				
Revenue/IC (x)	3.4	3.2	3.0	2.9
ROIC	46.5	48.5	47.8	47.1
ROE	34.9	37.8	40.3	41.1
ROA	15.8	16.4	18.2	20.0
EBITDA margin	20.2	23.1	24.6	24.5
Operating profit margin	17.7	20.6	22.1	22.0
Net debt/equity	-30.9	-21.2	-16.7	-14.7
Net debt/EBITDA (x)	-0.7	-0.4	-0.3	-0.3
Per share data (USD)				
EPS Rep (diluted)	0.03	0.04	0.05	0.06
HSBC EPS (diluted)	0.03	0.04	0.05	0.06
DPS	1.96	2.47	3.08	3.69
Book value	0.10	0.12	0.14	0.16

Valuation data

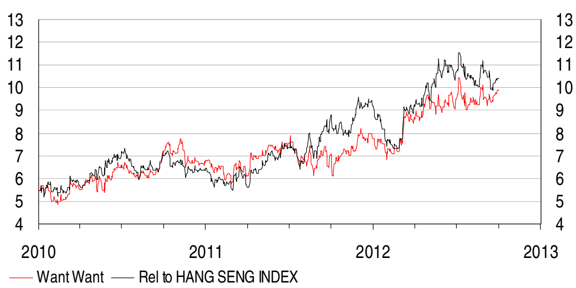
Year to	12/2011a	12/2012e	12/2013e	12/2014e
EV/sales	5.6	4.8	4.1	3.4
EV/EBITDA	27.7	20.6	16.5	13.8
EV/IC	17.7	13.4	10.8	9.0
PE*	40.2	31.0	24.8	20.7
P/Book value	12.7	10.9	9.3	7.9
FCF yield (%)	2.2	2.0	2.8	3.5
Dividend yield (%)	153.7	193.7	241.6	289.4

*Based on HSBC EPS (diluted)

Issuer information

Share price	(HKD)9.89	Target price	(HKD)10.60
Reuters (Equity)	0151.HK	Bloomberg (Equity)	151 HK
Market cap (USDm)	16,870	Market cap (HKDm)	130,822
Free float (%)	42	Enterprise value (USDm)	16,541
Country	China	Sector	Food Products
Analyst	Christopher K Leung	Contact	+852 29966531

Price relative



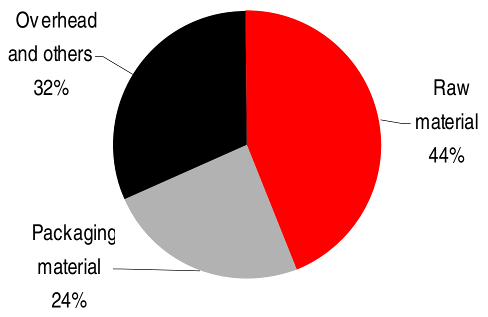
Source: HSBC

Note: price at close of 28 September 2012

Appendix

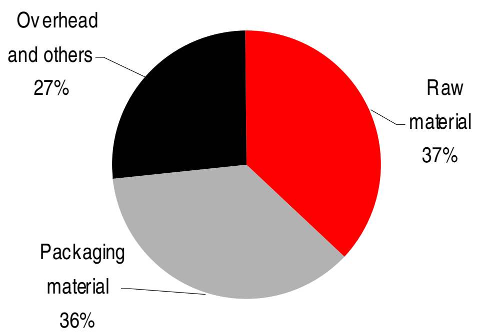
COGS breakdown

Tingyi – COGS Breakdown



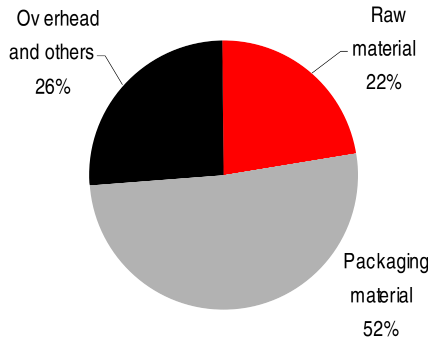
Note: Key raw materials include Flour (c.15% of noodles COGS), Palm oil (c14% of noodles COGS), PET (60% of beverage COGS), and Sugar (10% of beverage COGS)
Source: Company reports and HSBC estimates

UPC – COGS Breakdown



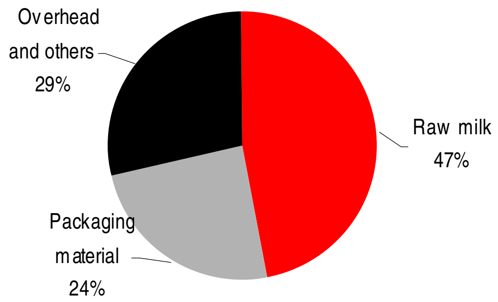
Note: Key raw materials include Palm oil (4% of COGS), PET (14% of COGS) and Sugar (14% of COGS).
Source: Company reports and HSBC estimates

Tsingtao – COGS Breakdown



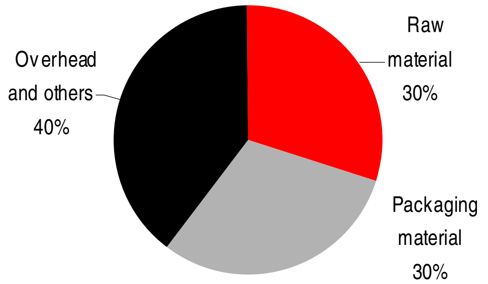
Note: Key raw materials include Malt/Barley (13% of COGS) and Rice (9% of COGS).
Source: Company reports and HSBC estimates

Mengniu Dairy – COGS breakdown



Source: Company reports and HSBC estimates

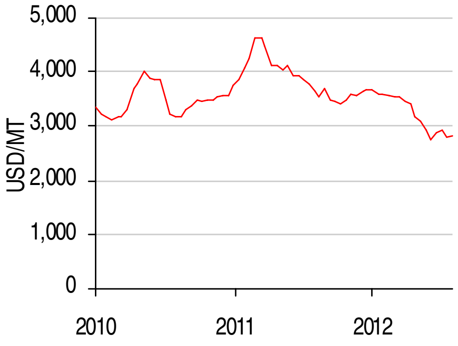
Want Want – COGS Breakdown



Note: Key raw materials include Milk Powder (16% of COGS), Sugar (7% of COGS) and Rice (3% of COGS).
Source: Company reports and HSBC estimates

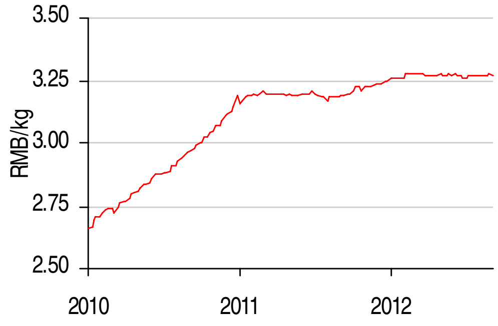
Food commodity price trend

USDA Whole Milk Powder Spot price / Oceania



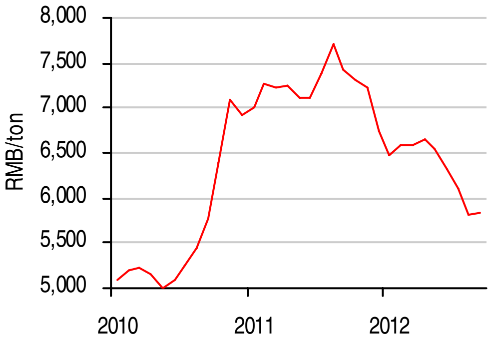
Source: Bloomberg

China Raw Milk Price



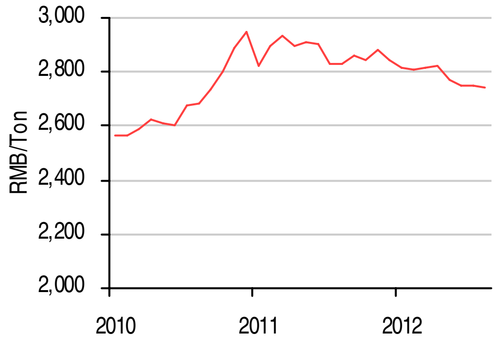
Source: China Dairy Association

China Sugar Price – Jan-2010 to Sept-2012



Source: CEIC

China Wheat Flour Price – Jan-2010 to Aug-2012

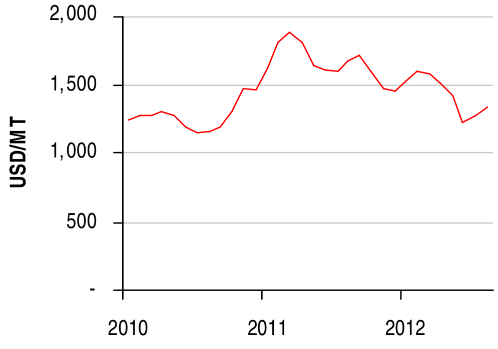


Source: China Grain Net

Malaysian Palm Oil Price

Source: Bloomberg

Northeast Asia PET Price



Source: CMAI

Notes

Disclosure appendix

Analyst Certification

The following analyst(s), economist(s), and/or strategist(s) who is(are) primarily responsible for this report, certifies(y) that the opinion(s) on the subject security(ies) or issuer(s) and/or any other views or forecasts expressed herein accurately reflect their personal view(s) and that no part of their compensation was, is or will be directly or indirectly related to the specific recommendation(s) or views contained in this research report: Christopher Leung

Important disclosures

Stock ratings and basis for financial analysis

HSBC believes that investors utilise various disciplines and investment horizons when making investment decisions, which depend largely on individual circumstances such as the investor's existing holdings, risk tolerance and other considerations. Given these differences, HSBC has two principal aims in its equity research: (1) to identify long-term investment opportunities based on particular themes or ideas that may affect the future earnings or cash flows of companies on a 12-month horizon; and (2) from time to time to identify short-term investment opportunities that are derived from fundamental, quantitative, technical or event-driven techniques on a 0- to 3-month horizon and which may differ from our long-term investment rating. HSBC has assigned ratings for its long-term investment opportunities as described below.

This report addresses only the long-term investment opportunities of the companies referred to in the report. As and when HSBC publishes a short-term trading idea the stocks to which these relate are identified on the website at www.hsbcnet.com/research. Details of these short-term investment opportunities can be found under the Reports section of this website.

HSBC believes an investor's decision to buy or sell a stock should depend on individual circumstances such as the investor's existing holdings and other considerations. Different securities firms use a variety of ratings terms as well as different rating systems to describe their recommendations. Investors should carefully read the definitions of the ratings used in each research report. In addition, because research reports contain more complete information concerning the analysts' views, investors should carefully read the entire research report and should not infer its contents from the rating. In any case, ratings should not be used or relied on in isolation as investment advice.

Rating definitions for long-term investment opportunities

Stock ratings

HSBC assigns ratings to its stocks in this sector on the following basis:

For each stock we set a required rate of return calculated from the cost of equity for that stock's domestic or, as appropriate, regional market established by our strategy team. The price target for a stock represents the value the analyst expects the stock to reach over our performance horizon. The performance horizon is 12 months. For a stock to be classified as Overweight, the potential return, which equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated, must exceed the required return by at least 5ppt over the next 12 months (or 10ppt for a stock classified as Volatile*). For a stock to be classified as Underweight, the stock must be expected to underperform its required return by at least 5ppt over the next 12 months (or 10ppt for a stock classified as Volatile*). Stocks between these bands are classified as Neutral.

Our ratings are re-calibrated against these bands at the time of any 'material change' (initiation of coverage, change of volatility status or change in price target). Notwithstanding this, and although ratings are subject to ongoing management review, expected returns will be permitted to move outside the bands as a result of normal share price fluctuations without necessarily triggering a rating change.

*A stock will be classified as volatile if its historical volatility has exceeded 40%, if the stock has been listed for less than 12 months (unless it is in an industry or sector where volatility is low) or if the analyst expects significant volatility. However, stocks which we do not consider volatile may in fact also behave in such a way. Historical volatility is defined as the past month's average of the daily 365-day moving average volatilities. In order to avoid misleadingly frequent changes in rating, however, volatility has to move 2.5ppt past the 40% benchmark in either direction for a stock's status to change.

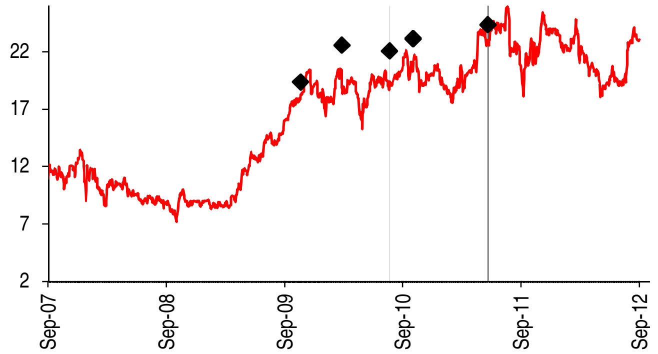
Rating distribution for long-term investment opportunities

As of 28 September 2012, the distribution of all ratings published is as follows:

Overweight (Buy)	48%	(27% of these provided with Investment Banking Services)
Neutral (Hold)	38%	(26% of these provided with Investment Banking Services)
Underweight (Sell)	14%	(22% of these provided with Investment Banking Services)

Share price and rating changes for long-term investment opportunities

Tingyi (0322.HK) share price performance HKD vs HSBC rating history



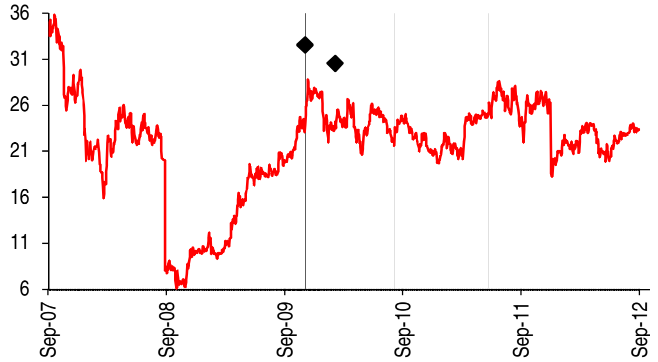
Source: HSBC

Recommendation & price target history

From	To	Date
Neutral	Overweight	17 August 2010
Overweight	Neutral	17 June 2011
Neutral	N/A	20 June 2011
Target Price	**Value**	**Date**
Price 1	19.30	16 November 2009
Price 2	22.50	23 March 2010
Price 3	22.00	17 August 2010
Price 4	23.10	29 October 2010
Price 5	24.30	17 June 2011
Price 6	N/A	20 June 2011

Source: HSBC

China Mengniu Dairy (2319.HK) share price performance HKD vs HSBC rating history



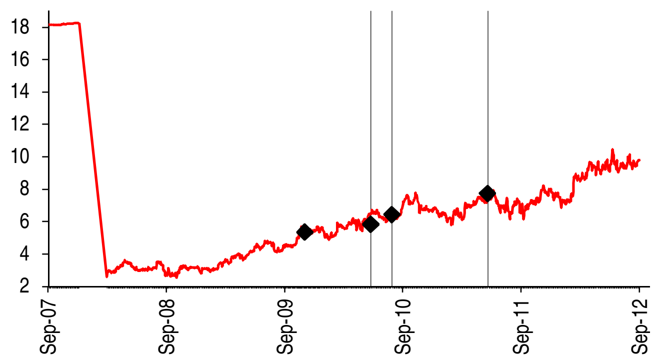
Source: HSBC

Recommendation & price target history

From	To	Date
N/A	Overweight (V)	30 November 2009
Overweight (V)	Overweight	31 August 2010
Overweight	N/A	20 June 2011
Target Price	**Value**	**Date**
Price 1	32.50	30 November 2009
Price 2	30.50	02 March 2010
Price 3	N/A	20 June 2011

Source: HSBC

Want Want (0151.HK) share price performance HKD vs HSBC rating history



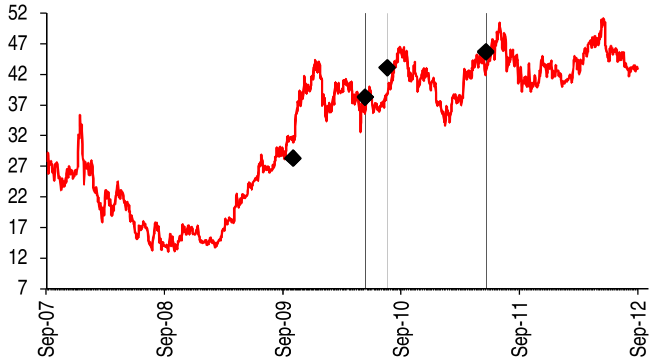
Source: HSBC

Recommendation & price target history

From	To	Date
Neutral (V)	Underweight	20 June 2010
Underweight	Neutral	24 August 2010
Neutral	N/A	17 June 2011
Target Price	**Value**	**Date**
Price 1	5.30	29 November 2009
Price 2	5.80	20 June 2010
Price 3	6.40	24 August 2010
Price 4	7.71	16 June 2011
Price 5	N/A	17 June 2011

Source: HSBC

Tsingtao (0168.HK) share price performance HKD vs HSBC rating history



Source: HSBC

Recommendation & price target history

From	To	Date
Underweight (V)	Neutral (V)	08 June 2010
Neutral (V)	Neutral	15 August 2010
Neutral	N/A	17 June 2011
Target Price	**Value**	**Date**
Price 1	28.20	29 October 2009
Price 2	38.20	08 June 2010
Price 3	43.00	15 August 2010
Price 4	45.58	16 June 2011
Price 5	N/A	17 June 2011

Source: HSBC

HSBC & Analyst disclosures

Disclosure checklist

Company	Ticker	Recent price	Price Date	Disclosure
TSINGTAO	0168.HK	42.85	27-Sep-2012	7
UNI-PRESIDENT CHINA	0220.HK	8.68	27-Sep-2012	6, 7

Source: HSBC

1 HSBC* has managed or co-managed a public offering of securities for this company within the past 12 months.
2 HSBC expects to receive or intends to seek compensation for investment banking services from this company in the next 3 months.
3 At the time of publication of this report, HSBC Securities (USA) Inc. is a Market Maker in securities issued by this company.
4 As of 31 August 2012 HSBC beneficially owned 1% or more of a class of common equity securities of this company.
5 As of 31 August 2012, this company was a client of HSBC or had during the preceding 12 month period been a client of and/or paid compensation to HSBC in respect of investment banking services.
6 As of 31 August 2012, this company was a client of HSBC or had during the preceding 12 month period been a client of and/or paid compensation to HSBC in respect of non-investment banking securities-related services.
7 As of 31 August 2012, this company was a client of HSBC or had during the preceding 12 month period been a client of and/or paid compensation to HSBC in respect of non-securities services.
8 A covering analyst/s has received compensation from this company in the past 12 months.
9 A covering analyst/s or a member of his/her household has a financial interest in the securities of this company, as detailed below.
10 A covering analyst/s or a member of his/her household is an officer, director or supervisory board member of this company, as detailed below.
11 At the time of publication of this report, HSBC is a non-US Market Maker in securities issued by this company and/or in securities in respect of this company

Analysts, economists, and strategists are paid in part by reference to the profitability of HSBC which includes investment banking revenue.

For disclosures in respect of any company mentioned in this report, please see the most recently published report on that company available at www.hsbcnet.com/research.

**HSBC Legal Entities are listed in the Disclaimer below.*

Additional disclosures

1 This report is dated as at 3 October 2012.

2 All market data included in this report are dated as at close 28 September 2012, unless otherwise indicated in the report.

3 HSBC has procedures in place to identify and manage any potential conflicts of interest that arise in connection with its Research business. HSBC's analysts and its other staff who are involved in the preparation and dissemination of Research operate and have a management reporting line independent of HSBC's Investment Banking business. Information Barrier procedures are in place between the Investment Banking and Research businesses to ensure that any confidential and/or price sensitive information is handled in an appropriate manner.

HSBC

Disclaimer

**Legal entities as at 8 August 2012*
'UAE' HSBC Bank Middle East Limited, Dubai; 'HK' The Hongkong and Shanghai Banking Corporation Limited, Hong Kong; 'TW' HSBC Securities (Taiwan) Corporation Limited; 'CA' HSBC Bank Canada, Toronto; HSBC Bank, Paris Branch; HSBC France; 'DE' HSBC Trinkaus & Burkhardt AG, Düsseldorf; 000 HSBC Bank (RR), Moscow; 'IN' HSBC Securities and Capital Markets (India) Private Limited, Mumbai; 'JP' HSBC Securities (Japan) Limited, Tokyo; 'EG' HSBC Securities Egypt SAE, Cairo; 'CN' HSBC Investment Bank Asia Limited, Beijing Representative Office; The Hongkong and Shanghai Banking Corporation Limited, Singapore Branch; The Hongkong and Shanghai Banking Corporation Limited, Seoul Securities Branch; The Hongkong and Shanghai Banking Corporation Limited, Seoul Branch; HSBC Securities (South Africa) (Pty) Ltd, Johannesburg; HSBC Bank plc, London, Madrid, Milan, Stockholm, Tel Aviv; 'US' HSBC Securities (USA) Inc, New York; HSBC Yatirim Menkul Degerler AS, Istanbul; HSBC México, SA, Institución de Banca Múltiple, Grupo Financiero HSBC; HSBC Bank Brasil SA – Banco Múltiplo; HSBC Bank Australia Limited; HSBC Bank Argentina SA; HSBC Saudi Arabia Limited; The Hongkong and Shanghai Banking Corporation Limited, New Zealand Branch incorporated in Hong Kong SAR

Issuer of report
The Hongkong and Shanghai Banking Corporation Limited
Level 19, 1 Queen's Road Central
Hong Kong SAR
Telephone: +852 2843 9111
Telex: 75100 CAPEL HX
Fax: +852 2596 0200
Website: www.research.hsbc.com

This document has been issued by The Hongkong and Shanghai Banking Corporation Limited ("HSBC") in the conduct of its Hong Kong regulated business for the information of its institutional and professional investor (as defined by Securities and Future Ordinance (Chapter 571)) customers; it is not intended for and should not be distributed to retail customers in Hong Kong. The Hongkong and Shanghai Banking Corporation Limited is regulated by the Hong Kong Monetary Authority. All enquires by recipients in Hong Kong must be directed to your HSBC contact in Hong Kong. If it is received by a customer of an affiliate of HSBC, its provision to the recipient is subject to the terms of business in place between the recipient and such affiliate. This document is not and should not be construed as an offer to sell or the solicitation of an offer to purchase or subscribe for any investment. HSBC has based this document on information obtained from sources it believes to be reliable but which it has not independently verified; HSBC makes no guarantee, representation or warranty and accepts no responsibility or liability as to its accuracy or completeness. Expressions of opinion are those of the Research Division of HSBC only and are subject to change without notice. HSBC and its affiliates and/or their officers, directors and employees may have positions in any securities mentioned in this document (or in any related investment) and may from time to time add to or dispose of any such securities (or investment). HSBC and its affiliates may act as market maker or have assumed an underwriting commitment in the securities of companies discussed in this document (or in related investments), may sell them to or buy them from customers on a principal basis and may also perform or seek to perform investment banking or underwriting services for or relating to those companies.

HSBC Securities (USA) Inc. accepts responsibility for the content of this research report prepared by its non-US foreign affiliate. All U.S. persons receiving and/or accessing this report and wishing to effect transactions in any security discussed herein should do so with HSBC Securities (USA) Inc. in the United States and not with its non-US foreign affiliate, the issuer of this report.

In the UK this report may only be distributed to persons of a kind described in Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001. The protections afforded by the UK regulatory regime are available only to those dealing with a representative of HSBC Bank plc in the UK. In Singapore, this publication is distributed by The Hongkong and Shanghai Banking Corporation Limited, Singapore Branch for the general information of institutional investors or other persons specified in Sections 274 and 304 of the Securities and Futures Act (Chapter 289) ("SFA") and accredited investors and other persons in accordance with the conditions specified in Sections 275 and 305 of the SFA. This publication is not a prospectus as defined in the SFA. It may not be further distributed in whole or in part for any purpose. The Hongkong and Shanghai Banking Corporation Limited Singapore Branch is regulated by the Monetary Authority of Singapore. Recipients in Singapore should contact a "Hongkong and Shanghai Banking Corporation Limited, Singapore Branch" representative in respect of any matters arising from, or in connection with this report. In Australia, this publication has been distributed by The Hongkong and Shanghai Banking Corporation Limited (ABN 65 117 925 970, AFSL 301737) for the general information of its "wholesale" customers (as defined in the Corporations Act 2001). Where distributed to retail customers, this research is distributed by HSBC Bank Australia Limited (AFSL No. 232595). These respective entities make no representations that the products or services mentioned in this document are available to persons in Australia or are necessarily suitable for any particular person or appropriate in accordance with local law. No consideration has been given to the particular investment objectives, financial situation or particular needs of any recipient. This publication is distributed in New Zealand by The Hongkong and Shanghai Banking Corporation Limited, New Zealand Branch incorporated in Hong Kong SAR.

In Japan, this publication has been distributed by HSBC Securities (Japan) Limited. It may not be further distributed in whole or in part for any purpose. In Korea, this publication is distributed by The Hongkong and Shanghai Banking Corporation Limited, Seoul Securities Branch ("HBAP SLS") for the general information of professional investors specified in Article 9 of the Financial Investment Services and Capital Markets Act ("FSCMA"). This publication is not a prospectus as defined in the FSCMA. It may not be further distributed in whole or in part for any purpose. HBAP SLS is regulated by the Financial Services Commission and the Financial Supervisory Service of Korea.

In Canada, this document has been distributed by HSBC Bank Canada and/or its affiliates. Where this document contains market updates/overviews, or similar materials (collectively deemed "Commentary" in Canada although other affiliate jurisdictions may term "Commentary" as either "macro-research" or "research"), the Commentary is not an offer to sell, or a solicitation of an offer to sell or subscribe for, any financial product or instrument (including, without limitation, any currencies, securities, commodities or other financial instruments).

Global Consumer Brands & Retail Research Team

Europe

Consumer Brands & Retail

Antoine Belge
Head of Consumer Brands and Retail Equity Research
+33 1 56 52 43 47 antoine.belge@hsbc.com

Sophie Dargnies
Analyst
+33 1 56 52 43 48 sophie.dargnies@hsbc.com

Cedric Besnard
Analyst
+33 1 56 52 43 66 cedric.besnard@hsbc.com

Florence Dohan
Analyst
+44 207 992 4647 florence.dohan@hsbc.com

Jérôme Samuel
Analyst
+33 1 56 52 44 23 jerome.samuel@hsbc.com

Emmanuelle Vigneron
Analyst
+33 1 56 52 43 19 emmanuelle.vigneron@hsbc.com

Paul Rossington
Analyst
+44 20 7991 6734 paul.rossington@hsbcib.com

Leisure

Lena Thakkar
Analyst
+44 20 7991 3448 lena.thakkar@hsbcib.com

CEEMEA

Consumer Brands & Retail

Michele Olivier
Analyst
+27 11 6764208 michele.olivier@za.hsbc.com

Specialist Sales

Lynn Raphael
+44 20 7991 1331 lynn.raphael@hsbcib.com

David Harrington
+44 20 7991 5389 david.harrington@hsbcib.com

Asia

Consumer Brands & Retail

Erwan Rambourg
Head of Consumer Brands and Retail Equity Research
+852 2996 6572 erwanrambourg@hsbc.com.hk

Chris Zee
Analyst
+852 2822 2912 chriscmzee@hsbc.com.hk

Christopher Leung
Analyst
+852 2996 6531 christopher.k.leung@hsbc.com.hk

Lina Yan
Analyst
+852 2822 4344 linayjyan@hsbc.com.hk

Catherine Chao
Analyst
+852 2996 6570 catherinefchao@hsbc.com.hk

Karen Choi
Analyst
+822 3706 8781 karen.choi@kr.hsbc.com

Jena Han
Associate
+822 3706 8772 jenahan@kr.hsbc.com

Sean Monaghan
Analyst
+65 6658 0610 seanmonaghan@hsbc.com.sg

Permada (Mada) Darmono
Analyst
+65 6658 0613 permada.w.darmono@hsbc.com.sg

Thilan Wickramasinghe
Analyst
+65 6658 0609 thilanw@hsbc.com.sg

Abel Lee
Analyst
+8862 6631 2866 abelchlee@hsbc.com.tw

Amit Sachdeva
Analyst
+91 22 2268 1240 amit1sachdeva@hsbc.co.in

North & Latin America

Consumer & Retail

Francisco J Chevez
Analyst, Latin America & US
+1 212 525 5350 francisco.j.chevez@us.hsbc.com

Stewart Ragar
Analyst
+1 212 525 3460 stewart.h.ragar@us.hsbc.com

Manisha A Chaudhry
Associate, Latin America & US
+1 212 525 3035 manisha.a.chaudhry@us.hsbc.com

Beverages

Lauren Torres
Analyst, Global Beverages
+1 212 525 6972 lauren.torres@us.hsbc.com

James Watson
Analyst, Global Beverages
+1 212 525 4905 james.c.watson@us.hsbc.com

Food & Agricultural Products

Pedro Herrera
Analyst, Global Food & Agricultural Products
+1 212 525 5126 pedro.herrera@us.hsbc.com

Ravi Jain
Analyst, Global Food & Agricultural Products
+1 212 525 3442 ravijain@us.hsbc.com

Diego T Maia
Analyst, Food & Agricultural Products, Brazil
+55 11 33718192 diego.t.maia@hsbc.com.br

Household Durables

Francisco Suarez
Analyst, Household Durables, Mexico
+52 55 5721 2173 francisco.suarez@hsbc.com.mx

Berenice Munoz
Associate, Household Durables, Mexico
+52 55 5721 5623 berenice.munoz@hsbc.com.mx

Christopher K Leung*
Analyst
The Hongkong and Shanghai Banking Corporation Limited
+852 29966531
christopher.k.leung@hsbc.com.hk

Christopher joined HSBC in June 2010. Prior to this, he worked as an equity analyst with a leading US research house for six years covering the small-cap and consumer sectors in Asia. Christopher also worked as a corporate finance analyst at i-CABLE Communications Limited for two years. He holds a bachelor's degree from York University and a Postgraduate Diploma in Corporate Finance from Hong Kong Polytechnic University.

Erwan Rambourg*
Head of Consumer Brands and Retail Equity Research, Asia Pacific
The Hongkong and Shanghai Banking Corporation Limited
+852 2996 6572
erwan.rambourg@hsbcib.com

Erwan Rambourg is Head of Consumer Brands and Retail Equity Research and is a top ranked analyst covering the luxury, sporting goods and spirits sectors. He joined HSBC in January 2005 and in 2011 relocated from London to Hong Kong as many stocks under coverage are now Asia-driven. Before moving to HSBC, Erwan worked for eight years as Marketing Manager in the luxury industry, notably for Richemont and LVMH.

*Employed by a non-US affiliate of HSBC Securities (USA) Inc, and is not registered/qualified pursuant to FINRA regulations.

HSBC Global Research