NEUTRAL

China food & beverages sector

Olive Xia CFA
Tel: 8621 6886 6902
olive.xia@cpy.com.hk

Margin pressure on input cost inflation

We expect near term margin pressure for food and beverage producers on input cost increase. We downgrade our rating on China food and beverage sector to ***NEUTRAL*** *from OVERWEIGHT, mainly due to concern on rising agriculture price inflation. Meanwhile, we expect sustained personal income growth will contribute to rising food expenditure in the long run. We like category leaders, such as* ***Tsingtao Brewery (168 HK)*** *and* ***China Mengniu Dairy (2319 HK)****, for strong pricing power amid growing cost concern. Moreover, we expect* ***Asian Citrus (73 HK)*** *will be the beneficiary of rising food prices.*

- **12th Five-Year Plan to boost domestic consumption.** According to the guideline of 12th Five-Year Plan, policy makers stressed the strategic importance of structural transformation from an investment-led economy to a balanced growth model leveraging on domestic consumption, investment, and export. Authorities will step up the progress of sustained industrialization and urbanization and commit to boosting personal income over the next five years (2011-15). The guideline aims at keeping personal income growth in tandem with GDP growth, which overwhelms the export strategy to keep a competitive edge in low labor cost.

- **Sustained income growth to support growing food expenditure.** We expect nominal personal income to increase at about 10% p.a. over the 12th five-year period on supportive government policy and vigorous economic growth. As China's Engel Index stood at 36.5% and 41.0% for urban and rural households in 2009, food expenditure is set to maintain sturdy growth momentum over the medium term, in our view.

- **Agriculture commodity prices surged from end-Jun.** Riding on buoyant downstream demand and tightening demand/supply mix, prices for major agriculture commodities rallied from end-Jun. Looking forward, we expect sturdy demand will support high food prices.

- **Accelerating food inflation.** China's CPI picked up from 3Q10 and stood at 4.4% for Oct10, which was mainly driven by rising agriculture commodity prices. In view of the strong momentum in food prices in recent months, we expect the upcoming CPI data will maintain at 4% in the near term.

- **Prefer category leaders with strong pricing power.** We expect near term margin pressure for food and beverage producers on input cost increase. Thus, we downgrade our rating on China food and beverage sector to **NEUTRAL** from OVERWEIGHT. Meanwhile, we expect sustained personal income growth will contribute to rising food expenditure in the long run. We like category leaders, such as **Tsingtao Brewery (168 HK)** and **China Mengniu Dairy (2319 HK)**, for strong pricing power amid growing cost concern. Moreover, we expect **Asian Citrus (73 HK)** will be the beneficiary of rising food prices.

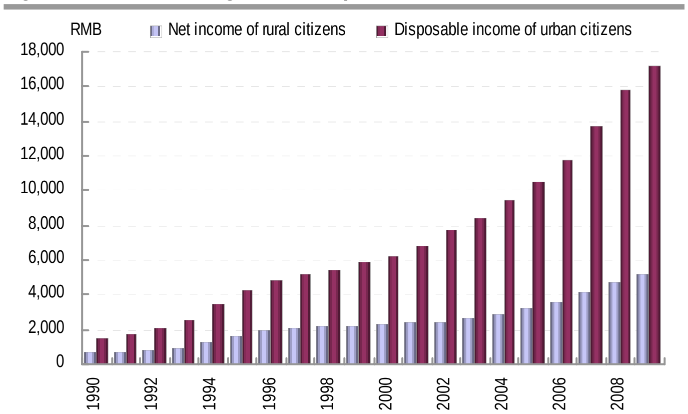
Rising agriculture commodity prices

12th Five-Year Plan to boost domestic consumption. Chinese authorities released the Guideline for 12th Five-Year Plan in late Oct. According to the guideline, policy makers stressed the strategic importance of structural transformation from an investment-led economy to a balanced growth model leveraging on domestic consumption, investment, and export. Authorities will step up the progress of sustained industrialization and urbanization and commit to boosting personal income over the next five years (2011-15). The guideline aims at keeping personal income growth in tandem with GDP growth, which overwhelms the export strategy to keep a competitive edge in low labor cost. To support long-term growth in consumer demand, government will (1) promote job creation, (2) optimize income distribution system, (3) lift income of low-/ mid-income citizens, (4) boost spending on social entitlement program, and (5) enhance the distribution efficiency and infrastructure in retail markets.

Sustained income growth to support growing food expenditure. The personal disposable income for urban and rural citizens grew at 11.4% and 8.8% respectively during 2000-09. Looking forward, we expect nominal personal income to increase at about 10% p.a. over the 12th five-year period on supportive government policy and vigorous economic growth. As China's Engel Index stood at 36.5% and 41.0% for urban and rural households in 2009, food expenditure is set to maintain sturdy growth momentum over the medium term, in our view.

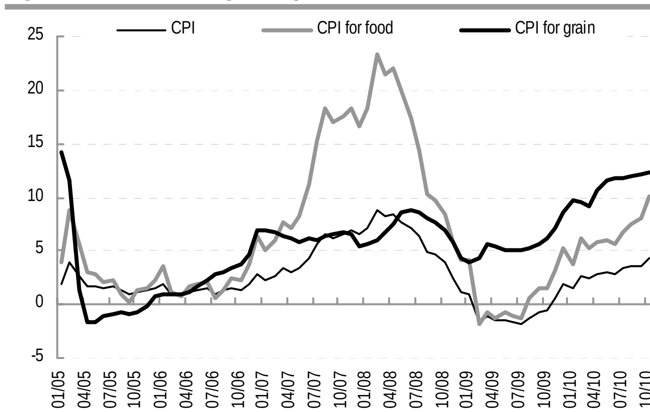
Accelerating food inflation. China's CPI picked up in 3Q10 and stood at 3.6%/4.4% for Sep/ Oct10, which was mainly driven by rising food prices. In view of the strong momentum in food prices in recent month, we expect the upcoming CPI data to remain at 4% in the near term.

Figure 1: **Sustained growth in personal income**



Source: Bloomberg and Core Pacific - Yamaichi

Figure 2: **Food CPI gaining momentum**



Source: Bloomberg and Core Pacific - Yamaichi

Downgrade to NEUTRAL on cost concern

Rising food demand to outpace production growth. Looking forward, we expect sturdy demand will support high food prices. In corn market, total world corn production will increase 1.6% yoy in FY10/11F, according to latest forecast from USDA report. However, global corn demand is estimated to outpace the production increase due to growing demand from developing countries and strong recovery in the US. World corn demand is expected to jump 3.7% on rising corn consumption in the US and China. In the soybean market, total world production is expected to edge down slightly on lower harvested area and yield while demand for soybean products remains strong.

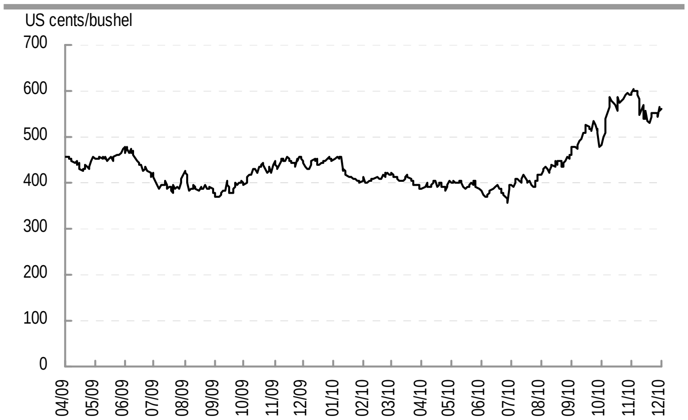
Agriculture commodity prices surged in 2H10. Riding on buoyant downstream demand, domestic corn price rallied from end-Jun. Meanwhile, CBOT corn price jumped 55% during the same period as investors turned optimistic on policy makers' quantitative easing and strong consumer demand for agriculture products. Prices of other agriculture commodity items also advanced in recent months. Domestic soybean price added 12% from end-Jun while CBOT soybean price soared 31% from a low level at end-Jun. Sugar prices also reached a record high on tightening demand/supply mix.

Prefer category leaders with pricing power. We expect near term margin pressure for food and beverage producers on input cost increase. Thus, we downgrade our rating on China food and beverage sector to **NEUTRAL** from OVERWEIGHT, mainly due to concern on rising input cost inflation. Meanwhile, we expect sustained personal income growth will contribution to rising food expenditure in the long run.

We like category leaders for strong pricing power amid growing cost concern. In Hong Kong-listed China food and beverage names, **Tsingtao Brewery (168 HK)** and **China Mengniu Dairy (2319 HK)** are the leaders in China beer/dairy market. Tsingtao Brewery remains our top pick for its successful sales mix improvement, premium brand name, rising ASP, and margin expansion. We maintain our **BUY** recommendation and target price at HK$46.0. For Mengniu, we expect rising agriculture commodity prices will pose margin pressure in the near term. We revised down our earnings forecast and lowered our target price to HK$27.5 in view of near-term margin pressure. However, we reiterate our **BUY** recommendation on Mengniu for undemanding valuation. Meanwhile, we maintain our **SELL** recommendation on **China Foods (506 HK)** as its ongoing business restructuring may drag on top-line growth.

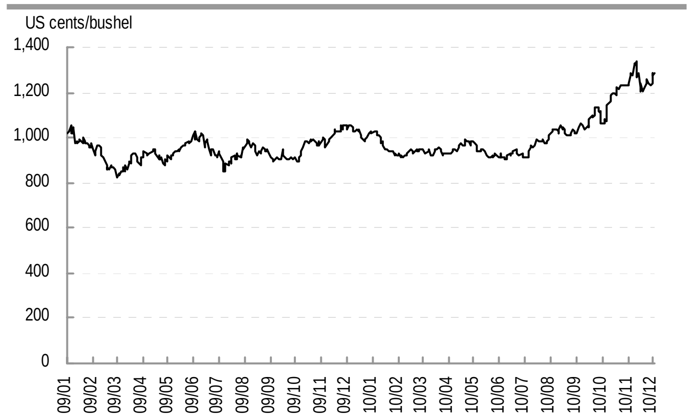
Additionally, we prefer upstream agriculture product names, which is positioned be benefit from food price increase. As the largest orange grower in China, **Asian Citrus (73 HK)** is likely to be a beneficiary and is expected to deliver ASP advancement for the upcoming harvest season.

Figure 3: **CBOT corn price**



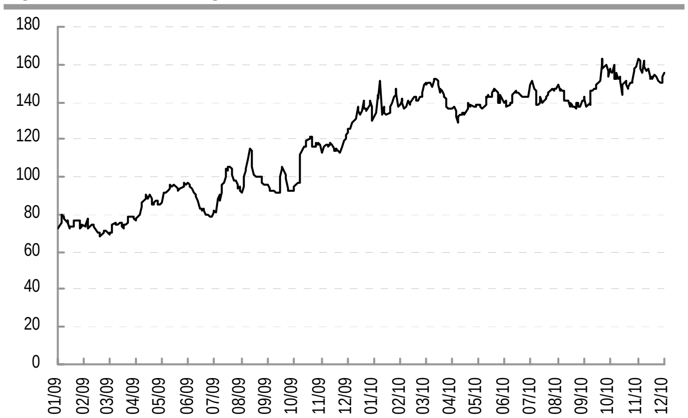
Source: Bloomberg and Core Pacific - Yamaichi

Figure 4: **CBOT soybean price**



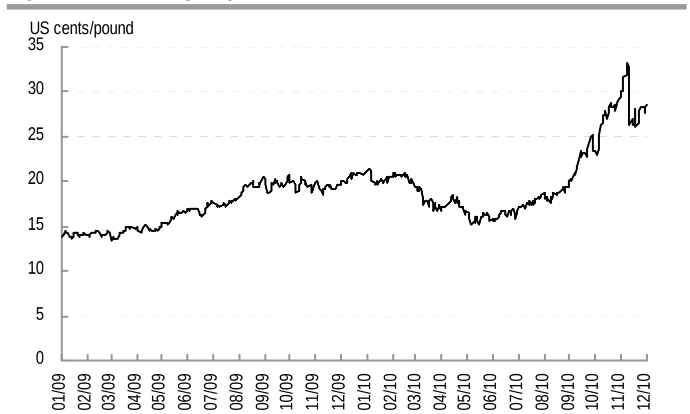
Source: Bloomberg and Core Pacific - Yamaichi

Figure 5: **JPM Orange Juice Price Index**



Source: Bloomberg and Core Pacific - Yamaichi

Figure 6: **ICE sugar price**



Source: Bloomberg and Core Pacific - Yamaichi

Table 1: **Food and beverage sector valuation (as at 30 November 2010)**

Company	Bloomberg code	Price	Mkt cap	P/E (x)		P/B (x)	
				FY10F	FY11F	FY10F	FY11F
		(HK$)	(HK$mn)				
China Foods	506 HK	5.56	15,396	30.9	21.5	2.7	2.5
China Mengniu Dairy	2319 HK	22.15	38,563	23.5	20.2	3.5	3.1
Tsingtao Brewery	168 HK	42.1	56,877	31.2	27.4	5.1	4.5
Asian Citrus	73 HK	9.3	9,533	10.8	8.4	1.8	1.3
China Yurun	1068 HK	27.75	50,260	21.3	17.7	4.0	3.3
Tingyi	322 HK	19.22	107,378	30.9	25.8	8.1	7.0
Want Want	151 HK	6.69	88,386	29.7	23.3	10.3	9.0
Uni-president	220 HK	4.87	17,529	24.8	20.0	2.6	2.4
		(RMB)	(RMBmn)				
Yili Industrial	600887 CH	45.98	36,752	45.6	34.6	8.8	7.1
Bright Dairy	600597 CH	9.73	10,209	50.9	40.9	4.3	3.8
Yanjing Brew	000729 CH	19.06	23,068	27.3	22.3	2.7	2.5

Source: Bloomberg and Core Pacific – Yamaichi