

December 12, 2016
Company Update

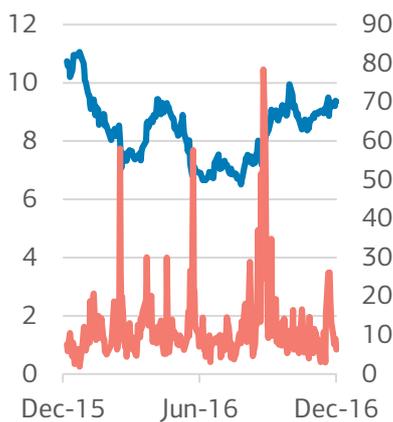
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Tingyi (0322 HK)

Price	HKD 9.37
Rating	BUY
Price Target	HKD 11.5
Difference	22%
Market Cap	HKD 53 bln
Avg. vol (3 mth)	12 mln
P/E	27x

Tingyi (0322 HK) last share price in HKD (blue) and volume (pink, in mln shares)



Source: Bloomberg December 12, 2016

Tingyi (0322 HK)

Noodles Turn Around

► Rebound

Distributors and industry participants suggest that noodle sales have turned the corner and are approaching the volumes before Tingyi implemented its price hike in October 2015. Our conversations with distributors have been more positive than management guidance.

► More skeptical on drinks

Q3 results were strong, with Tingyi reporting record segment margins of 11% and share gains in bottled water. But we are more cautious on the drinks recovery, since results benefited from unusually hot weather.

► UPC waving white flag

In its Q3 briefing, UPC announced that it will cut sales staff outside and leave sales and marketing efforts to its distributors in lower tier cities and rural areas. We read this as positive for Tingyi.

► Price target HKD 11.5

We raise our target price from HKD 9.4 to HKD 11.5 and recommend a BUY due to Tingyi's faster-than-expected recovery in the noodles division.

► Ongoing risks to our thesis

Tingyi has struggled to get traction in some new high-priced products, such as Nong Nong Tea. Our conversations with ex-sales reps indicate that Tingyi cut marketing support only two months after this product launch. Management may be overly conservative on marketing spend.

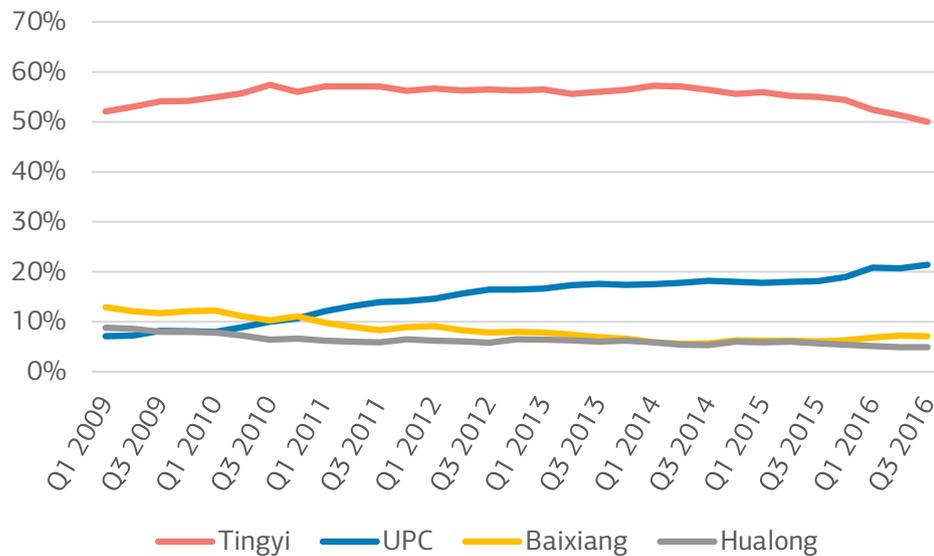
Though the market remains cautious on Tingyi's loss of market share, we expect market share to rebound in Q4 and Q1 2017.

Tingyi's Solid Q3

Tingyi announced strong numbers for Q3, and our Q4 checks in Henan, Hunan, and Guangdong suggest that the noodles turnaround is under way. We are less sanguine on drinks, where strong Q3 results benefited from hot weather.

Noodles segment margins rebounded from 1.3% in Q2 to 11.5% in Q3 on account of improved sales. Still, the market remains cautious on Tingyi's loss of market share and Q3 YoY sales decline of -8.8%. In RMB terms, however, the decline was only about 4% YoY, versus a 14% decline in H1 2016. We think the 4% decline is impressive, given that distributors stocked heavily in Q3 2015 ahead of Tingyi's price hike.

Chart 1. Noodles Market Share by Value



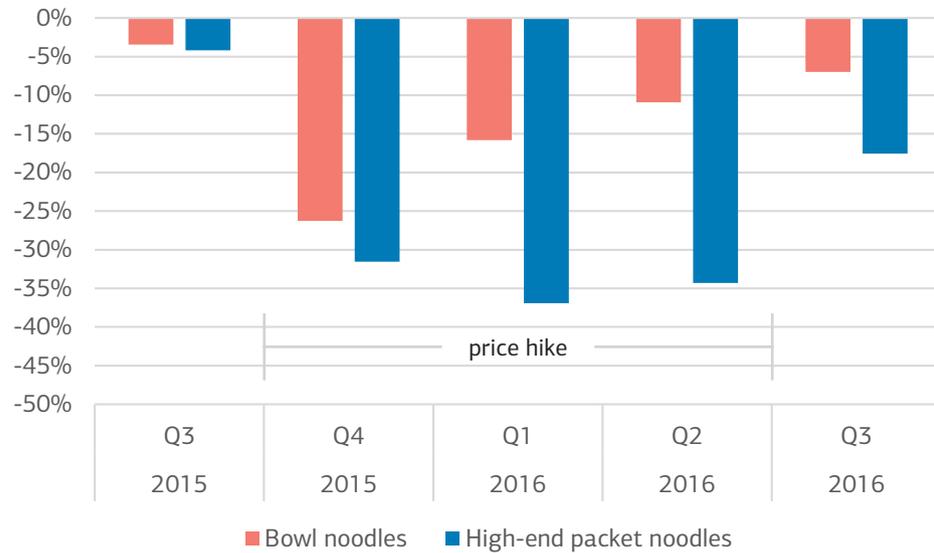
Source: Company presentations

Currency aside, Tingyi's price cut appears to be delivering an improving picture in bowl noodles and high-end packet noodles. Tingyi cut prices in June for its Classic Noodle series. Sales remain down YoY, but it's a hard comp: distributors aggressively stocked on heavy inventory levels in Q3 2015 ahead of the price hike.

Our checks with noodles distributors in Henan, Hunan, and Guangdong consistently spoke to steadily improving sales figures as a result of Tin-

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Chart 2. YoY Growth: Bowl and High-end Packet Noodles



Source: Company presentations, J Capital Research

gyi’s price cut in the Classic Noodles Series. The turnaround, however, has not been immediate, and most distributors described volumes returning to pre-price hike levels only as of late October.

There is typically about 4-6 weeks of inventory between first tier distributors and end retail consumption, so improved market share figures will probably begin to show only in Q4.

“... June was the worst month in sales. June is when Tingyi finally implemented its cut. Then a slow recovery began... Sales fell about 50% after Tingyi’s price hike in October 2015... In October, sales are up 30% YoY from before when the price hike occurred...”

Noodles Distributor, Henan Province

“... After Tingyi hiked noodle prices in October 2015, sales fell about 20%. After Tingyi cut prices, sales have basically recovered to pre-price hike levels as of October ... In 2012 and 2013, Tingyi probably had about 60% share of the noodles market in Central China), which includes Hubei, Hunan, and Jiangxi provinces. Now it’s basically flipped – Tingyi is probably 40% share and UPC 60%. In Eastern China, which includes Jiangsu, Zhejiang, Anhui, Fujian, Jiangxi, and Shandong, Tingyi probably holds about 80% share in noodles...”

Noodles Distributor, Hunan Province

Cautious guidance

During the Q3 2016 results briefing, we were surprised to hear management offering cautious guidance on the noodle recovery. Our checks in three different provinces have consistently informed us that sales as of late October had returned to levels similar to those before Tingyi's price hike. We also recall management guiding to a mild noodles recovery in the Q2 results briefing and believe results for Q3 have been strong. We are modeling our expectations for Q4 and 2017 based on feedback we have heard in the marketplace and expect Tingyi's share loss in noodles to stabilize in Q4 2016.

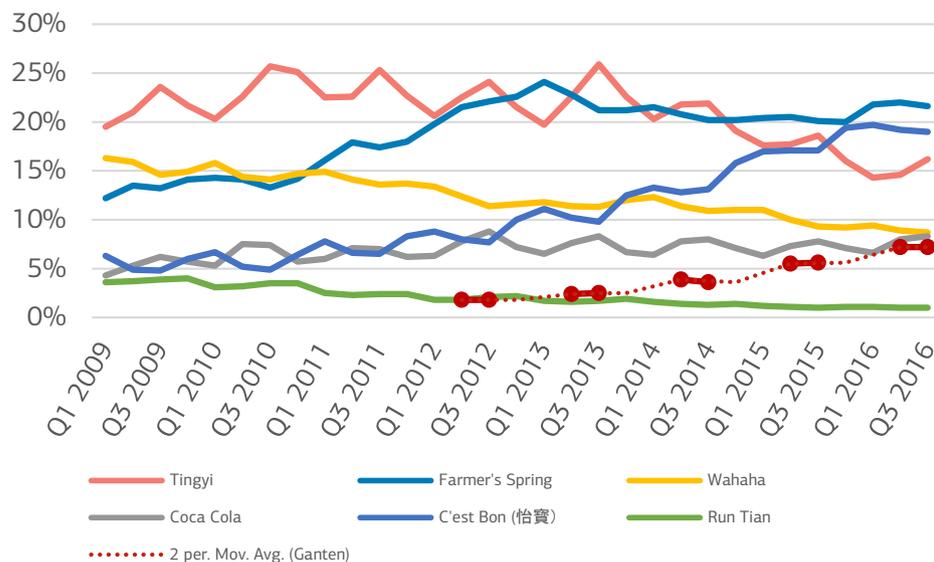
Drinks: Still Cool

Tingyi delivered strongly on drinks performance, with sales growth increasing 3.5% YoY, or about 9% growth in RMB terms. Segment operating margin rebounded from 3.2% in Q2 to 11.4% in Q3 due to improved utilization.

In spite of Tingyi's strong Q3 performance, we remain cautious on a near term turnaround in the drinks segment. Hot weather in Q3 contributed to strong results, and we think Tingyi has yet to prove a sustained turnaround. Tingyi also incurred sharply reduced termination expenses in Q3 vs Q2, incurring only USD 2 mln in Q3 against USD 9.6 mln in Q2. Tingyi still has about USD 15 mln of these termination expenses left for Q4 until

Hot weather in Q3 contributed to strong results; we think Tingyi has yet to prove a sustained turnaround.

Chart 3. Bottled Water Share by Volume



Source: Company presentations

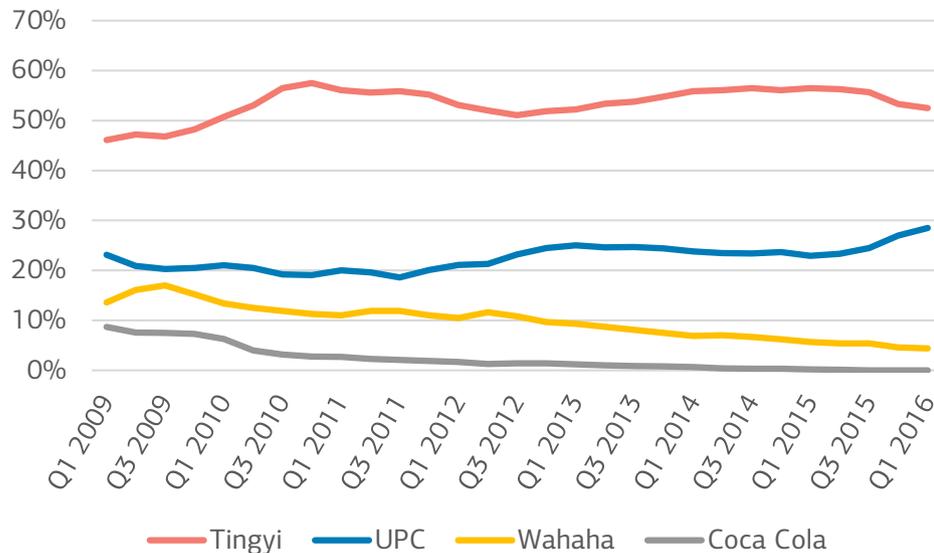
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Tingyi's price cut strategy on bottled water appears to be gaining traction.

they completely roll off in 2017. These termination expenses are likely to negatively impact Q4 results.

On a positive note, Tingyi's price cut strategy on bottled water appears to be gaining traction. Tingyi has recovered some share in bottled water sales since the price cut and packaging alteration in Q2. Our ground checks in Guangdong indicate that Tingyi is continuing to promote its 1 RMB bottled water aggressively into December, with discounts of 20 free cases of water out of every 100 sold to distributors.

Chart 4. RTD Tea (Including Milk Tea) Share by Value



Source: Company presentations

In the Ready-to-Drink (RTD) tea segment, Tingyi also captured some market share from Uni-President, primarily on UPC's continued weakness in the milk tea segment.

Risks

Noodles Division — Insufficient Investment in New Products

On the noodles division, we heard that UPC generally offers stronger dis-

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tributor incentives for new products than Tingyi does:

"UPC's noodles have been growing about 10% this year. About half of the growth is from new products. Tingyi introduces many fewer products to the market. New products from Tingyi are only about 2% of total sales. . .

. . . Distributors like new products because manufacturers typically give higher margins. UPC gives higher profit to distributors with new product introductions – typically RMB 3-5 per case. UPC's sales reps can also get higher commissions from new products, so new noodle products like Soup Daren (汤达人) get distributed very quickly. The high commissions usually last 3-6 months on UPC products. . .

Tingyi, however, only gives about RMB 1.1 per case on new products – the same as they do on their old traditional products. This makes distributors and sales reps less eager to push the new products."

Noodles Distributor, Hunan Province

Beverages Division — Too Cautious

In the beverages division, we heard similar feedback in Guangdong. For Nong Nong Tea, a new RMB 5 product, Tingyi apparently pulled some marketing spend after only two to three months of promotion. These promotions were store payments of ~ RMB 100 per month to small retail outlets for key shelf space in refrigerators. According to sales representatives, Tingyi has not been spending enough on marketing to support new products. Sales reps and logistics distributors say new products may require longer-term promotional spend to ensure good placement and consumer uptake.

A few years back, production capacity was the limiting factor in a brand's success. Today there is a proliferation of new brands in the market, and management may need to spend for longer periods of time to develop consumer loyalty.

Valuation

We revise our estimates to include a faster-than-expected recovery in noodles. On a DCF basis, we increase our target price to HKD 10.4.

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Table 1. DCF Analysis

		Discount Rate				
		9%	10%	11%	12%	13%
Terminal Mult.	15.0x	11.7	11.2	10.8	10.3	9.9
	14.5x	11.5	11.0	10.6	10.2	9.7
	14.0x	11.3	10.9	10.4	10.0	9.6
	13.5x	11.1	10.7	10.2	9.8	9.4
	13.0x	10.9	10.5	10.1	9.7	9.3

Source: J Capital Research

On a PE basis and assuming a 25x multiple on our 2018 numbers, we reach a valuation of HKD 12.6 per share.

We average the respective values of these two methods, arriving at an updated target price of HKD 11.5 per share.

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