JCAP

Beverages
China

December 19, 2016

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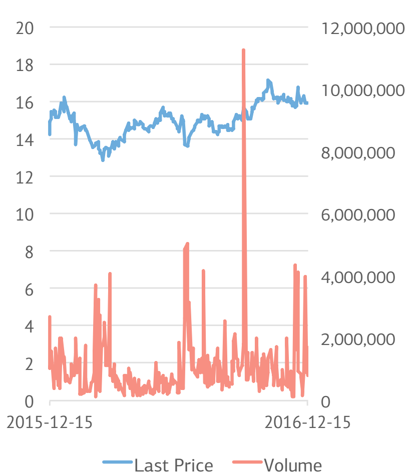
Vitasoy International Holdings (0345 HK)

Price	HKD 15.82
Target Price	**HKD 19.40**
Upside	**23%**
Recommendation	BUY
Market cap	HKD 16.7 bln
Float	79%
TTM P/E	24.53x
Av volume	1.06 mln shares
Yield	1.91%

Source: Bloomberg December 19, 2016

Vitasoy International Holdings (0345 HK) last share price in HKD (blue) and volume (pink)



Source: Bloomberg December 19, 2016

Vitasoy International Holdings (0345 HK)

Delivering on Profit

Disappointing Sales in China

China sales were up 7% in HKD terms and 13% in local currency, well below our bottom-end expectations of 20% growth in local currency.

Improved Sales in Australia and New Zealand

Vitasoy sales were up 11% in H1 and operating profit up 39% due to the launch of an almond milk product series in September 2015. Vitasoy is once again the top brand in the non-dairy beverage category.

Improved Gross Margin

Gross margin improved from 51% to 53%, as the low-margin U.S. business was divested and raw materials costs were down.

Valuation: Target Price HKD 19.40 upside of 22%

We lower our target price from HKD 20.43 to HKD 19.40, as we lower our expectations of China sales growth from 25% to 15%

Revenue and Profit H1 2017 (Mar – Sep 2016)

HKD Mlns	H1 2017	H1 2016	YoY
Revenue	**3,013.2**	**3,116.7**	**-3%**
Mainland China	1,618.8	1,513.2	7%
Hong Kong and Macau	1,110.8	1,076.7	3%
Australia and New Zealand	236.5	211.4	12%
Singapore	47.0	52.6	-11%
North America	0.0	262.6	-100%
Profit	**527**	**485.5**	**9%**
Mainland China	282	262.7	7%
Hong Kong and Macau	189	194.1	-3%
Australia and New Zealand	50	36.2	38%
Singapore	5	4.6	9%
North America		-12.1	-100%

Source: Company Reports

Until we see Vitasoy achieve better results in penetrating new markets and improving winter sales, we feel it prudent to lower our sales growth forecast for China.

Slower Turnaround in China

Vitasoy has cleaned up its declining market segments by divesting North America and turning around the Australia and New Zealand markets. But the China and Hong Kong markets continued to underperform expectations in H1 2017. We had expected China to return to stronger growth in this half. Although this did not happen, China does appear to be well positioned for 15% growth in H2 201. Gross margins also improved, as the company benefitted from lower material costs, primarily low PET and sugar prices.

Getting Rid of the Us

Disposing of the loss-making US business has had a positive impact on the profit for the group. Apart from the extraordinary profit of HKD 189 mln from the sale in H1, there has been an improvement in the gross margin from 51% to 53%. The Hong Kong business has also picked up HKD 66 mln in export sales to the U.S. that were previously in the U.S. business. U.S. exports provide a potential source of growth for that stagnant Hong Kong market. We estimate this will add an additional 1% growth to the Hong Kong market.

Until we see Vitasoy achieve better results in penetrating new markets and improving winter sales, we feel it prudent to lower our sales growth forecast for China. We have revised our forecast for China revenue growth down from 25% to 15% for FY2018 and beyond. We have revised up our forecast for Australia and New Zealand, with the net result being a revision of EBIT growth down from 15% to 13% growth.

We believe the turnaround in China is just delayed.

China: Sales Disappoint

China sales were up 7% in HKD terms and 13% in local currency, well below our bottom-end expectations of 20% growth in local currency. Our original survey of Vitasoy China sales overstated growth by around 5-10% due to inventory issues. The company stated that there was excess inventory in the channels at the beginning of the period, and we estimate from our checks that the excess inventory took around 2–3% points of growth out of the period. In effect, the poor performance of H2 2016 continued into H1 2017 due to channel stuffing and a failure to get traction in new markets.

The company stated that Q1 growth was below 13%, and Q2 growth was over 13%, so we believe the turnaround in China is just delayed. Vitasoy China has two challenges to solve before strong growth returns: penetrating new markets and reducing the huge seasonality in sales.

Vitasoy is trying to address its seasonality problem with new product introductions. Winter sales are 30% lower than summer sales, and profits are only a third. Vita Lemon Tea sells very well in summer, and then sales almost disappear in the winter. Vitasoy is launching new plant-based products that have been successful in mature markets, to grow the winter sales. These new products include almond milk, coconut milk, five-grain wheat milk, and Health Plus Soya Milk, which is enriched with nutrients and protein.

Vitasoy had a particularly weak H2 last year and so we expect stronger YoY sales in H2 this year of around 15-20%, for total growth this fiscal year of around 15% in local currency terms. Inventory levels are back to normal, the new Wuhan plant has now been operating for six months and the company has new products launching in the winter months. We expect all these factors to contribute to a stronger H2.

E-commerce has grown from a small base in China to one of the company's top 10 channels. Vitasoy likes this because it enhances the strength of the brand to regions where Vitasoy doesn't have presence. This demonstrates

Vitasoy likes the rapidly growing e-commerce channel because it enhances the strength of the brand in regions where Vitasoy doesn't have presence.

that there is demand for Vitasoy's products outside the markets currently served. It also shows that Vitasoy is more of a pull business, driven by actual demand, as distinct from Tingyi's brands, which are the only option in many lower-tier cities.

Australia and New Zealand: Almond Milk a Winner

Vitasoy sales were up 11% in H1 and operating profit up 39% due to the launch of an almond milk range in September 2015. Vitasoy is once again the top brand in Australia-New Zealand's non-dairy beverage category. We expect this level of growth to continue for the next few years, as Vitasoy reclaims market share with its new almond milk and innovative new products like the Vitasoy Protein Plus Soya Milk.

Vitasoy was slow to get on the almond milk trend. Vitasoy revenue in Australia and New Zealand peaked in 2012 when soy milk was 50% of the non-dairy milk market. Soy milk shrunk to 38% in 2016. While the soy milk category declined by 7% a year, Vitasoy performance was slightly better, as it took market share. Still, by 2015 Vitasoy revenue had fallen 20% from the peak in 2012. Vitasoy was the clear market leader in the non-dairy milk market in 2012 and by 2015 it was equal to Sanitarium with 33% of the market. Almond milk was a small category in 2012 and is now larger than soy milk with 39% of the non-dairy milk market in Australia. The almond milk category grew at 18% in 2015. Vitasoy launched an almond milk range in September 2015 and by H1 2017 (Mar–Sep 2016) sales had taken off and have seen Vitasoy Australia return to growth.

Vitasoy Australia is a 50:50 joint venture established with Pacific Foods and later acquired by Kerin Group's Australian subsidiary Lion Nathan. Lion Nathan's business in Australia is in decline and there is currently a "Goodness Project" in place to turn around the dairy and drinks business which is the joint venture partner of Vitasoy Australia. We expect Lion Nathans new focus to assist the continued growth of Vitasoy Australia.

Hong Kong: Mature Market, Low Growth

Hong Kong added HKD 66 mln in export sales to the US that were previously accounted under the now divested US division lifting growth to 3%. Absent that injection, growth was down 3% in H1. Q1 had negative growth, and Q2 was slightly positive. Demand issues were a slower economy and less mainland visitor. On the supply side, there was a machinery breakdown in Q1 at the Hong Kong Tuen Mun factory. The company stated that "These manufacturing issues hindered deliveries, missing the opportunities to generate increased revenue during the important promotional period in the first quarter.

Vitasoy was slow to get on the almond milk trend.

To grow sales, the company is launching new innovative products like Vitasoy Black Soya Milk and providing strong marketing support on TV and social media. They are also consolidating brands like Calci-Plus Soya Milk under the flagship Vitasoy brand. They have extended their Hong Kong style coffee flavored drinks with VITA Coffee with Condensed Milk. Vitasoy Hong Kong plans to launch a hot-serve beverage campaign during the winter season to capture additional sales and business opportunities.

Singapore: Still a Mess

Singapore is a small market that is performing poorly. Sales were down 12%, as the company is in the process of changing distributors. Last year, Vitasoy passed the liquid drinks business on from the Hong Kong team to a Singapore team to manage. They chose the wrong partner and are changing distributors this year. Sales are down because, as you transition to a new distributor, you allow the old distributor to clear out its inventory. Tofu sales for Singapore were up 5%, and profits for the Tofu business up 8%. The liquid business is the more important category however and that was were performance was poor. We expect sales in H2 to improve on H1 and be flat YoY.

Healthy Balance Sheet and Profit Growth: Expect Dividend Increase of 10%

Having completed the Wuhan factory, capex fell from HKD 366 mln to 116 mln. The next capital expansion will be to increase capacity at the Wuhan plant, but that is at least one to two years away, and the cost will be low, as it is merely adding building and equipment at an existing facility. Cash balances were up from HKD 217 mln to HKD 515 mln and borrowings were only HKD 270 mln.

Receivables have increased at a faster pace than sales, but we do not see this as a major problem, as we know from our survey that Vitasoy has strong credit controls in place. We do not see heavy cash demand and therefore expect that the company will increase its dividend by 10% in line with the growth in profit expected. We expect the full year dividend to increase from HKD 0.30 to HKD 0.33

Valuation: Target Price Hkd 19.40 Upside of 22%

We value Vitasoy using a DCF model with a WACC of 8% and a terminal growth rate of 4%. Our price target is revised down from HKD 20.43 to HKD 19.40, a 22% upside to the current price. A P/E approach yields a similar price target with a multiple of 30x 2018 earnings.

The key driver for the lower valuation is lower revenue growth expectations for China, going from 25% to 15%. This factor is partially offset by increased sales growth in Australia and improved gross margin from lower costs and the divesting of the low-margin U.S. business.

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