







Dali Foods 达利食品 (3799 HK)

China's Nestlé

Supported by nationwide distribution network and production bases, Dali foods Group has become a leading branded F&B company in China through diversified and multi-brand product portfolios. The group continues to innovate and expand into different categories successfully to suit rapid change of consumer trends in China where consumers pursuit for health, food safety and premium products. In our opinion, two new segments of soymilk and quality breakfast will become another growth engine from 2018 and the prospects for development remain tremendous. We thus initiate coverage on Dali Foods with BUY rating and DCF-based TP HK\$7.0.

-  **A solid track record of revenue and profit.** From 2012 to 2017, total revenue and net profit grew at CAGR of c.23.6%. With wide and multi-brands of products, the Group sustained to grow significantly in 2018H1, total revenue and net profit grew at 11.4% and 12.3% respectively.
-  **The sales of beverage segments with higher margin grew faster than the food segments.** The revenue contribution from the beverage segment has surpassed the food segment for the first time in 2018H1.
-  **Strong distribution network with nationwide production bases.** More than 4,500 distributors are all over China to penetrate the market from urban downtown areas of largest cities to countries, townships and villages across all of China's provinces through 30 F&B production bases in 16 provinces.
-  **Growth momentum of "Quality Breakfast" and "Doubendou" soymilk.** Two new segments of soymilk and quality breakfast were launched in 2017 to satisfy customers' demands for fresh and healthy breakfast products. Those products have been well received by the market and delivered significant growth of sales with high margins. Further products expansion and continuous penetration in different channels will drive these two segments growth.
-  **Cut its dividend payout and proposed not less than 50% in future.** The Group cut the dividend payout ratio from 65% to 53% yoy in 2018H1. This is mainly due to 1) most of the Group's revenue is denominated in RMB and foreign exchange is more strictly controlled in China. 2) Looking for M&A which could have synergies with the company in future.
-  **Initiate BUY.** We value the counter at HK\$7.0 based on our DCF valuation, which translates into 21.7x FY18 P/E and 6.1x FY18 P/B. Parameters include 35% discount and 3% terminal growth rate. We initiate coverage with BUY rating and TP of HK\$7.0.

Investment Summary

FY-end Dec	2016	2017	2018E	2019E	2020E
Turnover (RMB mn)	17,842	19,799	22,175	24,947	28,439
Chg (%)	6	11	12	12	14
Net Profit (RMB mn)	3,137	3,434	3,863	4,406	5,090
Chg (%)	8	9	13	14	16
EPS (HK\$)	0.229	0.251	0.282	0.322	0.372
Chg (%)	(5)	9	13	14	16
P/E (x)	21.1	19.3	17.1	15.0	13.0
P/B (x)	4.8	4.8	4.2	3.7	3.2
P/OCF (x)	19.4	27.5	17.3	15.3	13.4
EV/EBITDA (x)	12.8	11.8	10.6	9.4	8.2
DPS (RMB)	0.157	0.150	0.171	0.197	0.227
Yield (%)	3.2	3.1	3.5	4.1	4.7

Source: Company data, Orient Securities (Hong Kong)

BUY
Share Price
HK\$5.46
Target Price
HK\$7.0

China / Consumer goods / F&B

15 October 2018

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Latest Key Data

Total shares outstanding (mn)	13,694
Market capitalization (HK\$m)	74,770
Enterprise value (HK\$m)	65,614
12M daily turnover (HK\$m)	84.4
12M volatility (%)	31.7
PEG FY17-19E (x)	1.4
RoE avg FY17-19E (%)	25
P/B FY18E (x)	4.2
Net debt/equity FY18E (%)	Net cash

Performance (%)

	1M	YTD	12M
Absolute	0	(23)	(10)
Relative to HSI	2	(9)	(1)

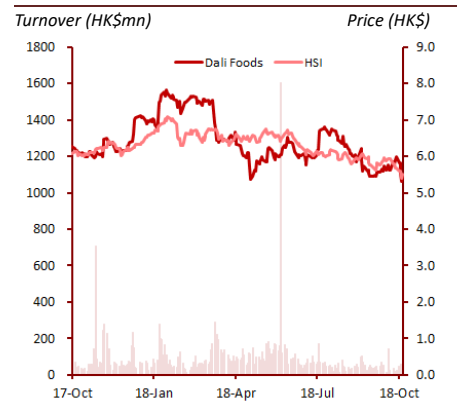
Major Shareholders (%)

Divine Foods	85
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Auditor

Ernst & Young

Price Chart

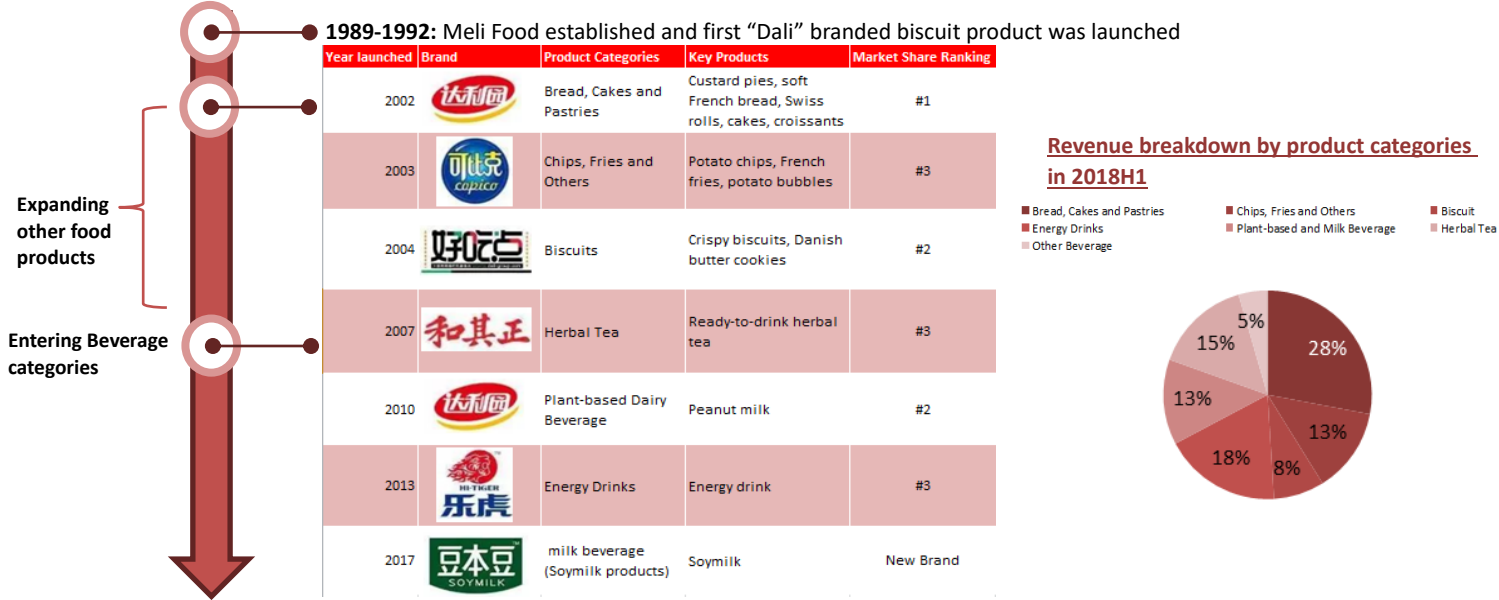


Source: Bloomberg, Orient Securities (Hong Kong)

Dali Foods- One of the few nationwide Chinese F&B Company

Founded in Fujian province in 1989, Dali Foods Group started as a biscuit manufacturer and has now developed into the leading branded snack food and beverage company in China with a diversified multi-brand product portfolio. The Group offers products in seven F&B categories under six core brands.

Figure 1: key milestones and core product categories

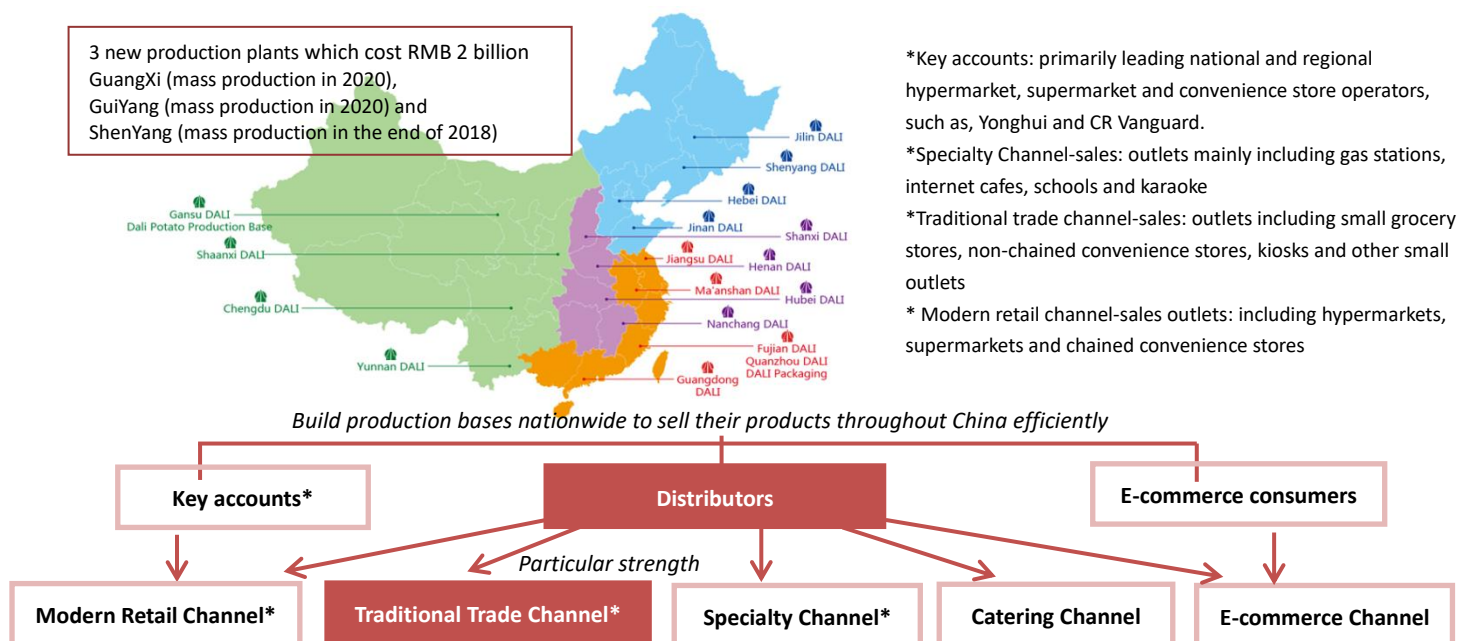


Source: company data, Orient Securities (Hong Kong)

Build an extensive nationwide manufacturing and distribution network

The Group has established 18 subsidiaries with 30 food and beverage production bases, one mashed potato production base and packaging and printing company in 16 provinces, including the new plants in ShenYang. **The Group sells their products primarily through their vast network of distributors** (more than 4,500 distributors), who sell their products to sub-distributors and retailers. This network penetrates the Chinese market from urban downtown areas, townships and villages across all of China's provinces. The Group is also developing two new production plants in GuangXi, GuiYang.





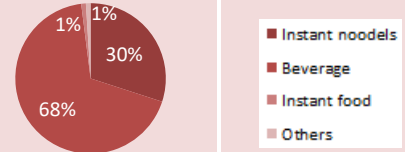
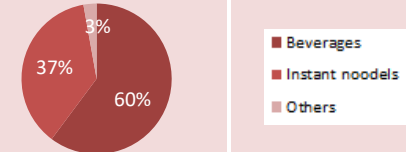
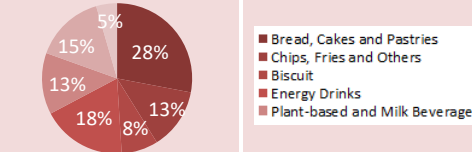
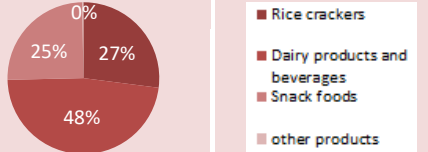
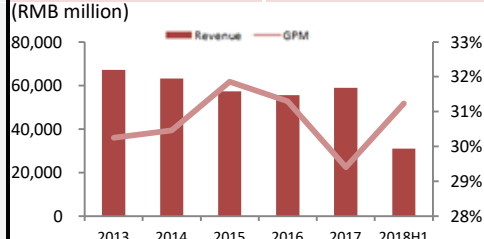
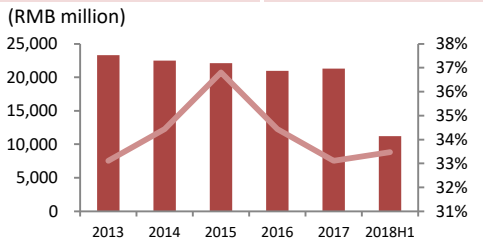
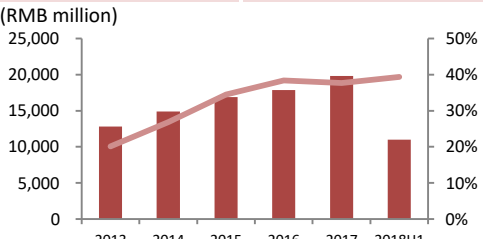
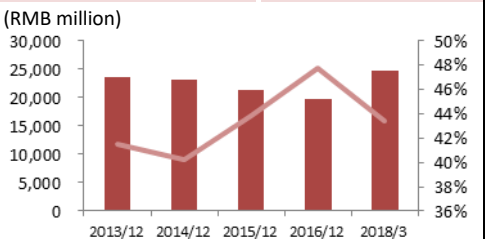
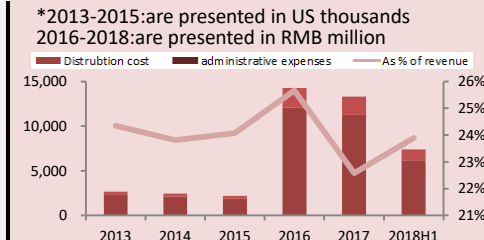
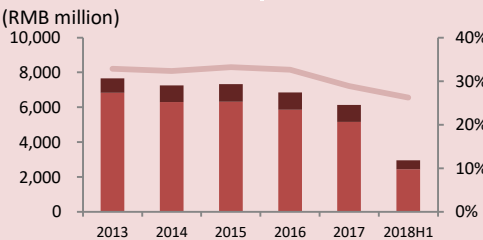
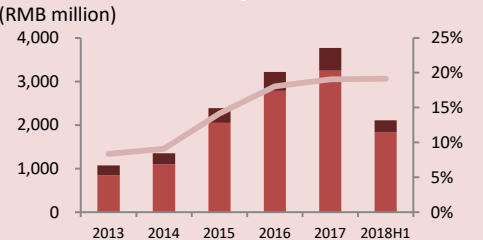
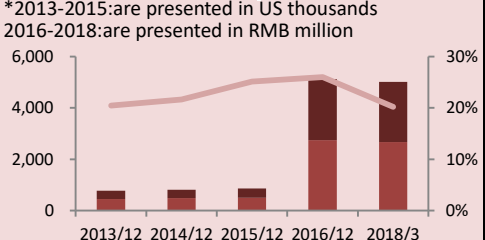
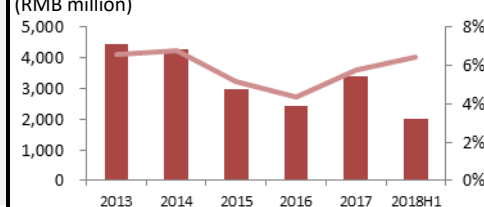
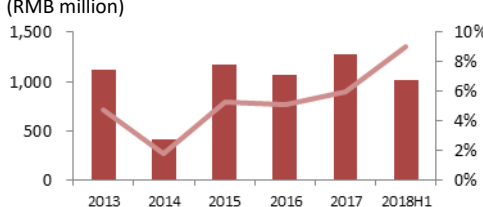
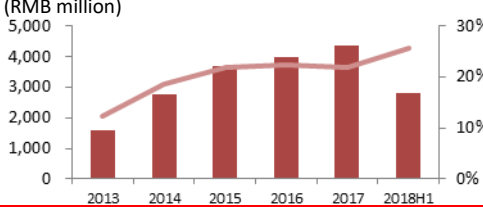
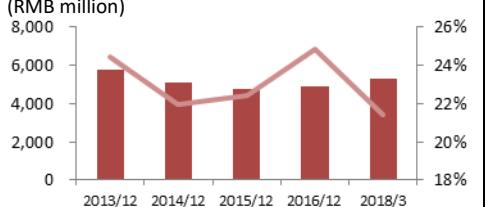
Figure 2: Structure of channel strategy and production bases



Source: company data, Orient Securities (Hong Kong)

See last page for disclaimer.

A comparison of major PRC F&B companies- strong revenue and pretax profit growth versus peers

Brands	 TingYi (322.HK)	 Uni-President China (220.HK)	 Dali Foods (3799.HK)	 WANG WANG CHINA (151.HK)
Founded & Market Cap	Founded in 1991 and headquarter in Tianjin, China. Market Cap:73.7 billion	Founded in 1992 and headquarter in Shanghai, China. Market Cap:34.3billion	Founded in 1989 and headquarter in Fujian, China. Market Cap:74.8billion	Founded in 1992 and headquarter in Shanghai, China. Market Cap: 71.2 billion
Product mix	 Instant noodles 68%, Beverage 30%, Instant food 1%, Others 1%	 Beverages 60%, Instant noodles 37%, Others 3%	 Bread, Cakes and Pastries 28%, Chips, Fries and Others 18%, Biscuit 15%, Energy Drinks 13%, Plant-based and Milk Beverage 8%	 Rice crackers 48%, Dairy products and beverages 27%, Snack foods 25%, other products 0%
Revenue & GPM	 (RMB million) Revenue (bars), GPM (line) 2013-2018H1	 (RMB million) Revenue (bars), GPM (line) 2013-2018H1	 (RMB million) Revenue (bars), GPM (line) 2013-2018H1	 (RMB million) Revenue (bars), GPM (line) 2013/12-2018/3
A&P and S, G&A	 *2013-2015:are presented in US thousands 2016-2018:are presented in RMB million Distribution cost, administrative expenses, As % of revenue 2013-2018H1	 (RMB million) 2013-2018H1	 (RMB million) 2013-2018H1	 *2013-2015:are presented in US thousands 2016-2018:are presented in RMB million 2013/12-2018/3
Pretax Profit & Pretax profit Margin	 (RMB million) 2013-2018H1	 (RMB million) 2013-2018H1	 (RMB million) 2013-2018H1	 (RMB million) 2013/12-2018/3
Comments	Tingyi is the largest F&B producer, based on sales volume but Want Want China generated the highest pretax profit. Most of material price rebounded from 2016 and eroded companies' gross profit but Dali foods is the only one out of these four giant F&B companies that gross profit margin reached a record high. Dali foods operating profit margin are higher than peers because the Group sells its products with lower ex-factory price to its distributors who will undertake most of the sales work such as penetration fee to more regions.			

A global comparison: Nestlé



Founded in small town of Vevey, Switzerland by Heinrich in 1866, Nestlé has gone from strength to strength and has become the largest F&B Company in the world. Nestlé owns over 2000 brands which almost covers every F&B categories and sells in 189 countries. They have 413 factories in 85 countries and employ 323,000 employees.

Early growth stage

Enrich product mix, scale up the business, accumulate capital and experience

- 1867:** Nestlé's founder launched his 'farine lactée' ('flour with milk')
- 1904:** began selling chocolate
- 1905:** merged to form the Nestlé & Anglo-Swiss Milk Company, build up factories globally.
- 1914-1921:** The demand for condensed milk and chocolate were increased during the WWI.
- 1916:** Acquired Norwegian dairy company Egron which had patented a spray-drying process for producing milk powder

Rapid growth stage

Enrich product mix, Merger and acquisitions, consolidate existing products categories to dominate the market

- 1829:** bought Switzerland's largest chocolate company Peter-Cailler-Kohler
- 1904:** continued to develop baby and infant foods and launched melted chocolate drink *Milo* in Australia
- 1936:** launched vitamin supplement Nestrovit
- 1938:** launched as a 'powdered extract of pure coffee' that retained coffee's natural flavor with simply adding hot water.
- Late 1940s:** Launched Nestea

Comprehensive development

Enrich product mix, Merger and acquisitions to expand their business to emerging markets and build up a global scale

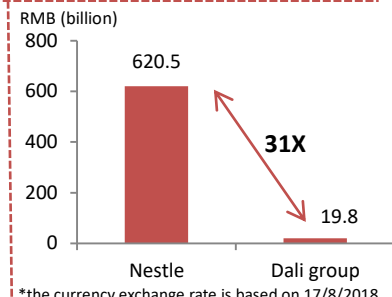
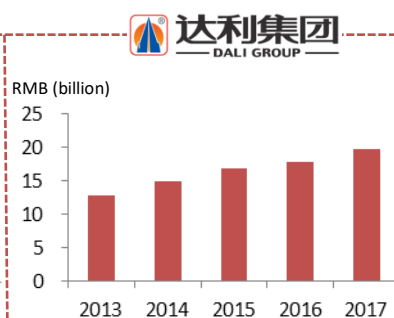
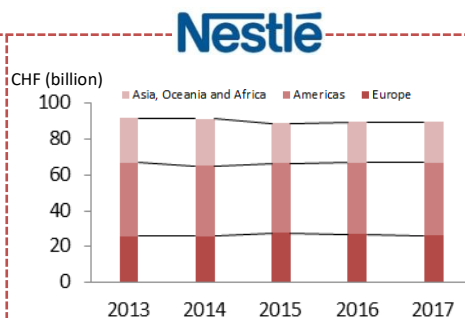
- 1947:** Merged with Swiss company Alimentana, which produces Maggi soups, bouillons and seasonings
- 1960s:** Enriched their product mix to ice-cream, frozen foods, yoghurts and mineral waters through mergers and acquisitions.
- 1970s-1980s:** diversified to cosmetics products, pharmaceutical and ophthalmic products, pet food
- 1990s-2017s:** positioned as the leader in 'Nutrition, Health and Wellness', continuous to merger and acquisitions to dominate the market.



Dali Group which is a local F&B company in China is in **early growth stage**. The group owns seven F&B categories under six core brands and established 18 subsidiaries with 30 F&B production bases in 16 provinces to support them to sell their products nationwide.



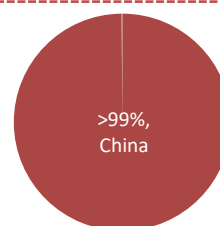
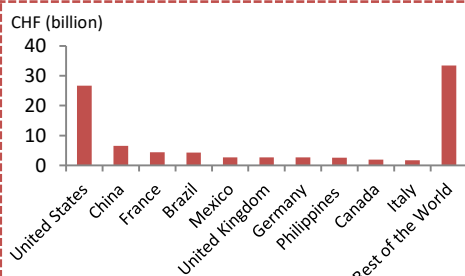
Scale Comparison (Revenue)



Nestlé is the global leader in the F&B industry and sales were RMB620.5 billion*, **31X** more than Dali Group (RMB 19.8 billion) in 2017. Nestlé enlarges their brands through mergers and acquisitions and now they have more than 2000 brands all over the world.

- Nestlé DNA:**
- ① Standardization: developing standardized products marketed worldwide to enjoy the low cost through economies of scale.
 - ② Localization: combine with standardization and customization strategies to minimize costs while providing a perfect match to tastes and preference in different nation.

Market Comparison (Top 10 Revenue)



Nestlé diversified their product portfolio globally. The United States and China are Nestlé's #1, #2 largest markets, accounted for around 30% and 7% of total sales respectively. Thus, the rest of the world's countries contribute 37% of total sales. Dali Group is mainly focus on Chinese market.

Source: Company data, Orient Securities (Hong Kong)

Dali Foods is just at the beginning when compared with Nestle

The list below is the main brands owned by Nestle.

Product Width



Source: Company data, Orient Securities (Hong Kong)

China's consumption upgrade & sinking

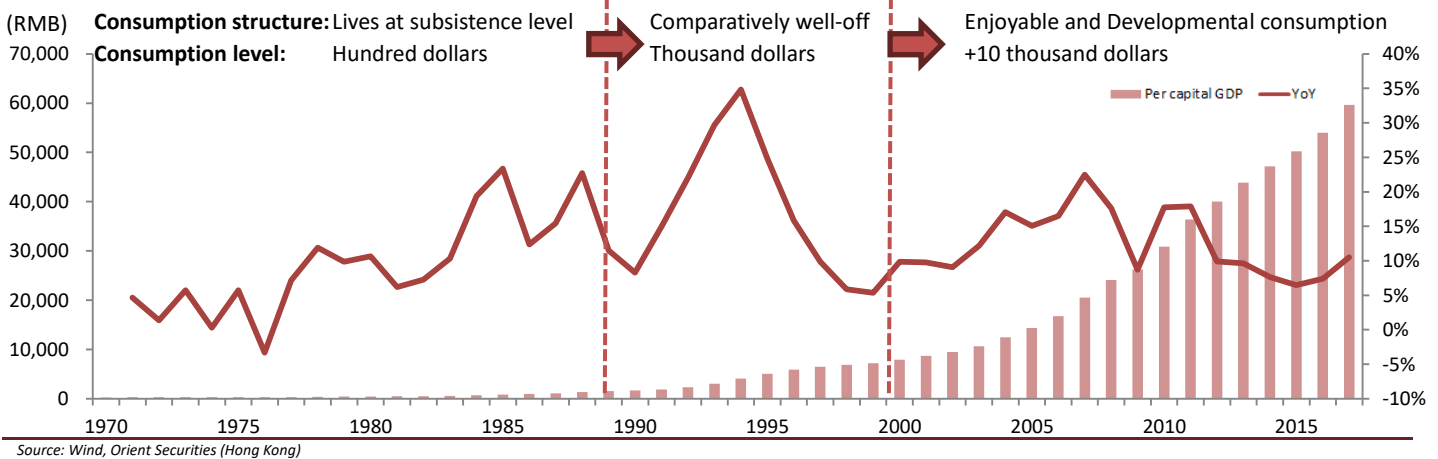
Consumption, exports and investment are three of the “troika” driving economic growth in China and consumption is still the major growth engine, contributing 78.5% of economic growth in 1H18. China’s retail sales of consumer goods expanded 10.2% to exceed RMB 36 trillion in 2017.

Consumption upgrade boost economic growth

Since adopting the reform and opening-up policy, three stages of consumption upgrades have been occurred in China and per capita GDP was up by 155 times to RMB 59.66 thousands between 1978 and 2017. The consumption upgrades are a trend in China and change the consumption structure. Nowadays, consumers are willing to spend more money on improving the quality of life, seeking for psychological and spiritual satisfaction, not just for basic requirements of life.



Figure 4: Per Capital GDP (experienced at least three times consumption upgrade since China's reform)



Consumption sinking to rural areas

Driven by the growth of consumer spending power and continuous optimization of the consumer environment, the urban and rural consumer goods market has maintained rapid growth, especially in rural areas.

The nation is working hard and aiming to eliminate poverty by 2020. Several policies are launched to meet this goal such as promoting tourism in poor, helping poor households gain access to microcredit loans and pairing work units and other institutions with poor villages to assist residents. The rejuvenate countryside with 2018 rural policy and the increase in rural residential income narrowed rural-urban residential income and consumption gap.

Figure 5: Per capital disposable income

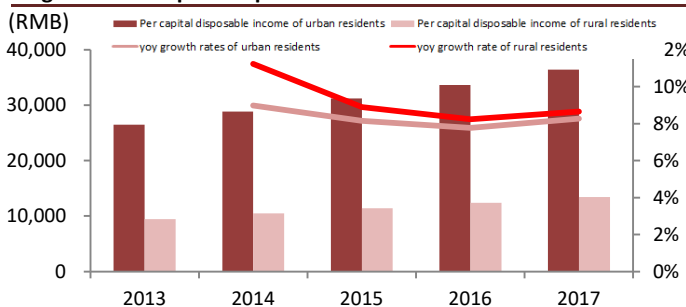
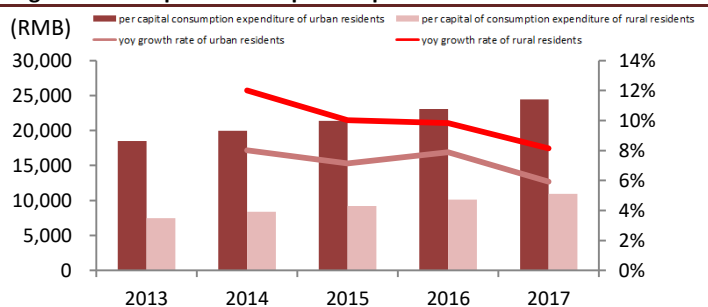


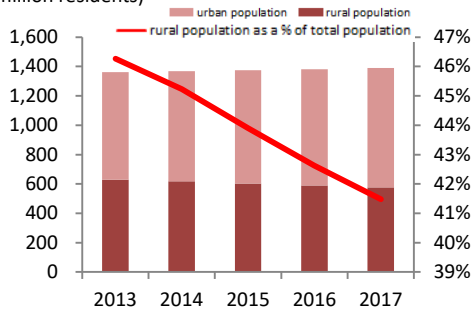
Figure 6: Per capital consumption expenditure



Source: Wind, Orient Securities (Hong Kong)

China's lower-tier cities offer most growth in the total retail sales

Figure 7: urban and rural population in China
(million residents)



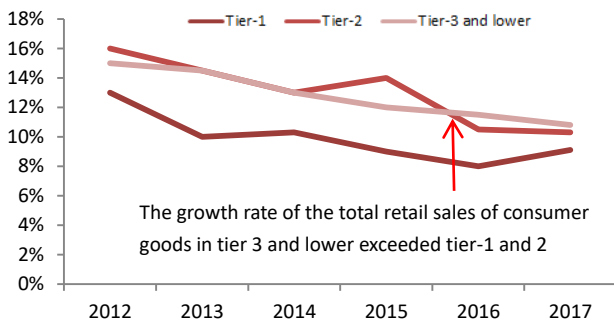
Source: Wind, Orient Securities (Hong Kong)

China's urban population reached 813.47 million by the end of 2017, up 20.49 million on the year, accounted for 58.52% of the total population, with a target rate of 60% by 2020. China is expanding its cities rapidly and building new urbanized centers in rural regions. With the advancement of urbanization, lower-tier cities will be bigger, wealthier and more eager to spend.

Population boom, household income growth in lower-tier cities

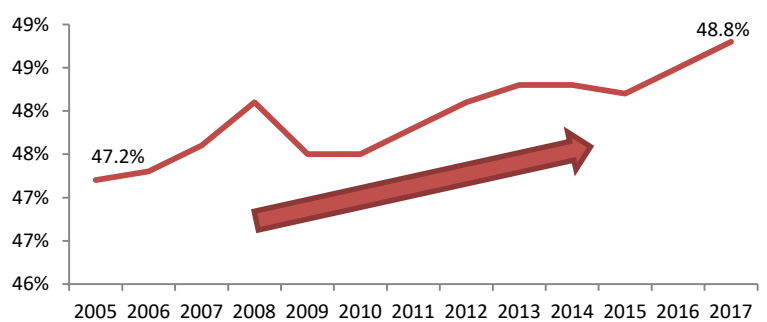
The growth rate of the total retail sales of consumer goods in lower-tier cities was higher than first-tier cities, and even exceeded the second-tier cities in the past two years and accounted for around 50% of the total retail sales of consumer goods in China in recent years. We believe the household income gap between lower-tier cities and first-tier cities will be narrowed continuously and tend to have a larger desire to consume than larger cities because of their lower housing-cost burden.

Figure 8: Growth rate of total Retail Sales of Consumer Goods



Source: Fang.com, Orient Securities (Hong Kong)

Figure 9: Tier-3 and lower cities' contribution



Consumption structure is different between lower-tier and upper-tier cities

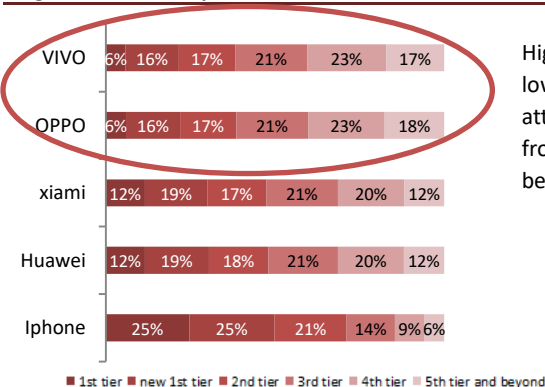
"Pinduoduo" is launched in 2015 and become one of the largest e-commerce apps in China which combines a group-buying strategy with cheap products. "Pinduoduo" has 300 million-strong user base in total, with 65% of users coming from third-tier cities and beyond. In January 2018, 114 million monthly active users are reported which is behind only Taobao (425 million) and JD (145 million). But, why it grows so fast? It offers good products with steeply discounts which attract those lower-income people from lower-tier cities. **High quality brands at low prices are the consumption structure in lower-tier cities.**

Figure 10: The incredible rise of Pinduoduo



Source: Pinduoduo, Orient Securities (Hong Kong)

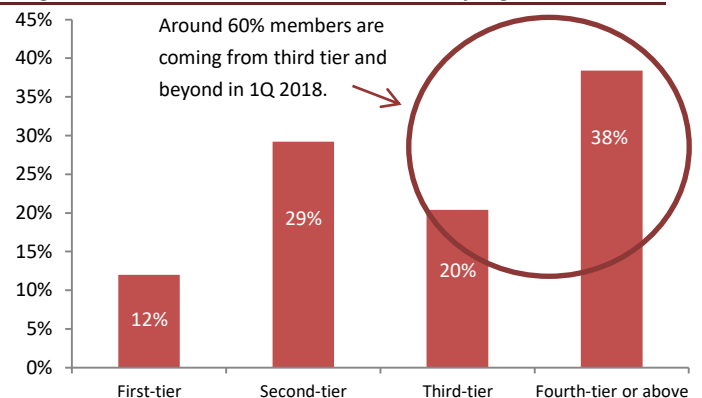
Figure 11: Consumption structure in different tier cities



High quality with low prices which attract customers from 3-rd tier and beyond

Source: JIGUANG, Orient Securities (Hong Kong)

Figure 12: Pinduoduo members distribution by regions



Around 60% members are coming from third tier and beyond in 1Q 2018.

Successful marketing strategy: Encircling the Cities from the Rural Areas

Dali Foods primarily relies on traditional trade channel which is the primary channel for snack F&B beverage industry in China, especially in lower-tier cities and rural areas to distribute their products.

However, Dali Foods has begun to enhance the strength of other channels, especially in modern retail channel which is the major channel for product distribution in top tier cities since 2014. The contribution of total sales through modern retail channel has increased by more than 25% for 4 years (in 2014, it accounted for 97.3% of total retail sales but dropped to around 70% of total retail sales in 2018H1). **This highlighted that Dali Foods penetrates to more top-tier cities successfully.**

Purchase Behavior in top-tier cities:

- More sophisticated purchasing consideration, both functional and emotional driven.
- Rise in health conscious lifestyle and willing to pay more for “green” and organic products.
- Willing to pay more for higher quality, natural and safe imported products.

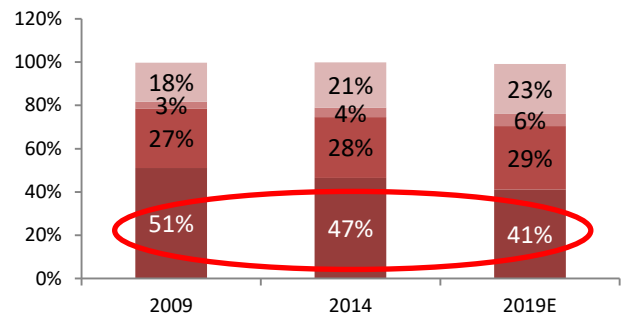
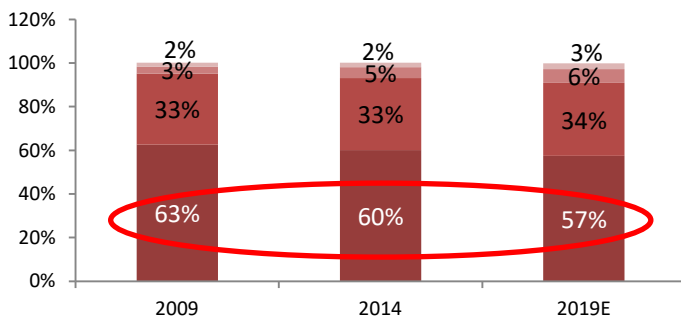
Figure 13: Snack Food Breakdown by channel

	09-14 CAGR	14-19 CAGR
Others channel	17.9%	15.7%
E-commerce channel	23.1%	18.4%
modern retail channel	13.0%	11.8%
traditional trade channel	11.7%	10.4%

Figure 14: Non-Alcoholic Beverage Market Breakdown by Channel

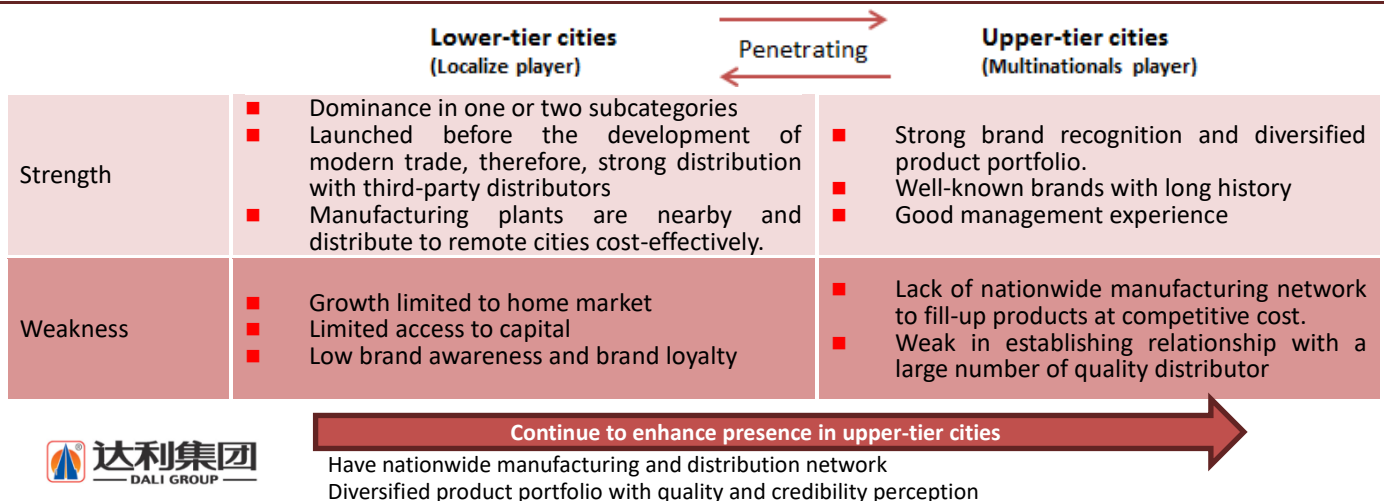
	09-14 CAGR	14-19 CAGR
Others channel	20.1%	14.7%
E-commerce channel	23.4%	19.4%
modern retail channel	17.2%	13.1%
traditional trade channel	14.5%	9.3%

- Although Traditional trade channel is still the major channel for F&B products distribution, demand for traditional trade channel will decrease in future.
- Expansion of other distribution channel is needed to increase market share



Source: Company, Orient Securities (Hong Kong)

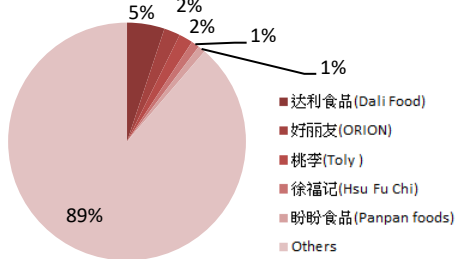
Figure 15: Localize players VS multinational players in different distribution channel



Source: AT Kearney, Orient Securities (Hong Kong)

Successful product strategy: #1 Brand Refreshing- bakery series

Figure 16: Bakery industry distribution by company



Source: ZSJJ(中商产业研究院), Orient Securities (Hong Kong)

Strong products innovation and products portfolio upgrade

In order to in line with the market trends and needs of customers, the group launches new product categories or extending existing brand lines with new products, new flavors or packaging. Two major segments of food and beverage products are launched in 2017.

China's bakery market is highly fragmented

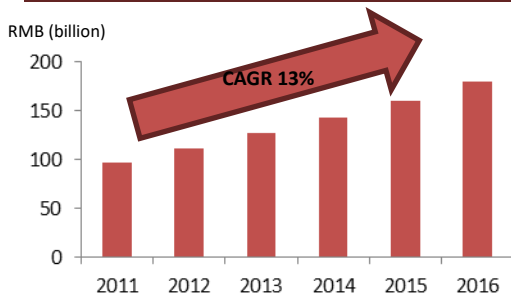
The baking market in China is fragmented with a wide range of international and local manufacturers, according to Euromonitor. Although the group is the largest manufacturer of bread, cakes and pastries in China, it accounted for only 5.1% of total baking industry in China.

Launch "Quality Breakfast" bakery series

Nowadays, Chinese consumers, influenced by Western culture, are increasingly favor bread over more traditional breakfast fare. According to Euromonitor, Chinese baking industry has experienced rapid growth in recent years and ranked second in the world with RMB 179.5 billion in 2016. Among them, bread and cakes accounted for 60% of Chinese baking industry.

The Group has successfully launched "Quality Breakfast" of bakery series with a total of 10 major products, 2 major series and 33 packaging specifications under the "Daliyuan" brand to provide the quality breakfast of "nutrition, quality, convenience and cheap price".

Figure 17: The volume of Bakery Industry in China



Source: ZSJJ(中商产业研究院), Orient Securities (Hong Kong)

Figure 18: Bakery Industry distribution by products

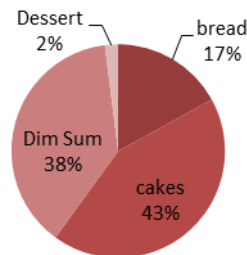
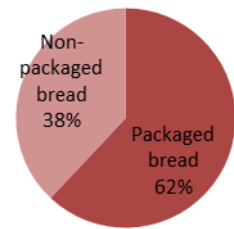


Figure 19: Bread distribution



Expand to short shelf-life bread products

Along with consumption upgrade, consumers have higher expectation for products in terms of freshness, healthy ingredients and diversified flavors. Short shelf-life bread products (3-7days) have less additives and preservatives on bread which is more natural, safer and healthier. According to statistics, medium shelf-life bread and short shelf-life bread in China generated double digit growth every year and expected to account for more than RMB 10 billion of total market size separately. Therefore, the Group scheduled to launch short shelf-life bread products on November, 2018.

Figure 20: Roadmap for quality breakfast

	Stage 1 (Jun 2017)	Stage 2 (April 2018)	Stage 3 (Mid of 3Q in 2018)	Stage 4 (4Q of 2018)	Stage 5 (2018-2019)
Launch Quality Breakfast series	Launch Quality Breakfast series	Launch the first batch of medium shelf-life (2 months) breakfast products	Launch the second batch of medium shelf-life (1 months) breakfast products	Launch short shelf-life bread products	Continue to expand and upgrade the products
Distributors selection	Distributors selection	Change the mindset and model of operation and PoS	Enhance sales management and logistics and capabilities	Increase product placement and display to enhance management of PoS	Optimise allocation of products via big data analysis

Source: Company data, Orient Securities (Hong Kong)

See last page for disclaimer.

* Price are collected from Tmall market on 13/9/2018

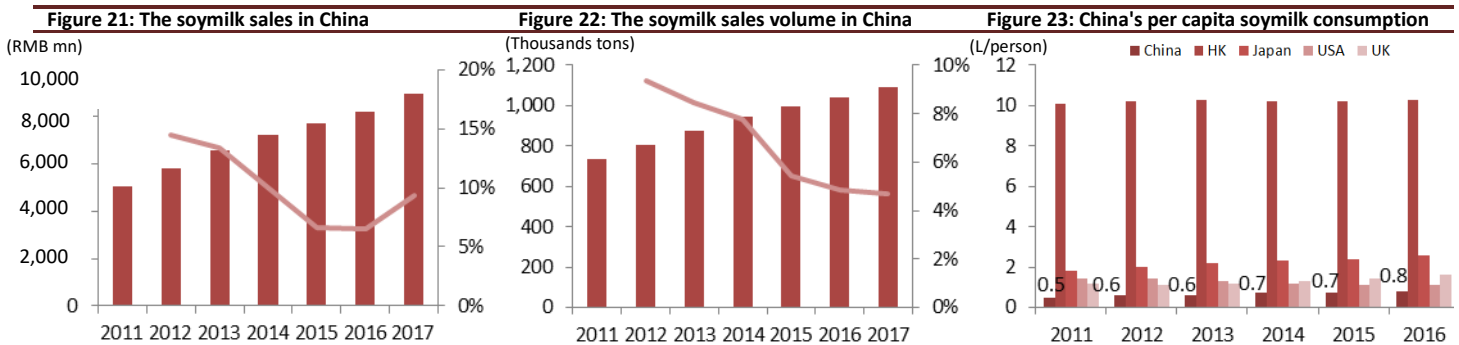
Successful product strategy:#2 Enters into soymilk market in China

Great potential of soymilk market in China (Health concept)

According to Euromonitor, China's soymilk sales increased from RMB 5.08 billion (sales volume: 737,000 tons) in 2011 to RMB 9 billion (sales volume: 1.09 million tons) in 2017 at a CAGR of about 10%. China has already become the world's largest soymilk market and the sales exceeded RMB 8 billion in 2017.

From our view, soymilk has become a category favored by the new generation group and we expect the demand of soymilk market in China will develop rapidly with the entry of giant food and beverage companies such as Mengniu dairy. In fact, the new entrants in recent years are not uncommon in the soymilk industry because of two main reasons:

- China enters the era of soymilk and expects RMB 100 billion soymilk market; In addition, China's per capita soymilk consumption was about 0.8L in 2016, which was the lowest compared to the other countries. Thus, we believe that the soymilk market in China has great growth potential in future.
- The domestic soybean milk industry is in a period of decentralized structure and low industry concentration. No a real enterprise are capable of being an absolutely leading leader.







Source: Euromonitor, Orient Securities (Hong Kong)

Launched of the soy milk series under "Doubendou" brand

The sales of plant-based and milk beverage increased by 32.9% in 2017, driven by the soymilk with pure natural-high-protein and non-additive. The sales of the soymilk reached RMB 1 billion between April and December in 2017 (RMB 900 million in 2018H1) and on target to RMB 10 billion within 3-5 years. Compared with main rivals, DoubenDou has the highest protein which is essential to good health with fewer ingredients but it sells the most expensive at the mean time.

Figure 24: Comparison with main rivals

Brand	Introduction	Energy	Protein	Fat	Cholesterol	Carbohydrates	Sodium	Price*
	Launched in 1940, is an F&B icon in Hong Kong. Leading brand of RTD soymilk in China.	196 KJ	2.0g	1.4g	0.0mg	6.5g	35mg	250ml*24boxes =RMB 56.9 RMB0.948/100ml
	Launched in 1993 and focus on dairy industry. Started to launch soymilk at the end of 2017.	281 KJ	3.6g	3.4g	0.0mg	5.5g	80mg	250ml*12boxes =RMB 43.3 RMB1.44/100ml
	Launched in 1989, first attempt to launch soymilk on April, 2017 and achieved sales of RMB1 billion in 2017.	205 KJ	4.0g	2.8g	0.0mg	1.7g	0mg	250ml*16boxes =RMB 79.9 RMB1.998/100ml
	Launched in 1999, top dairy company in china. The sales of soymilk products achieved RMB 585m in 2017.	183 KJ	2.5g	1.5g	0.0mg	5.0g	53mg	250ml*15boxes =RMB 45 RMB 1.224/100ml

Source: taobao, Orient Securities (Hong Kong)

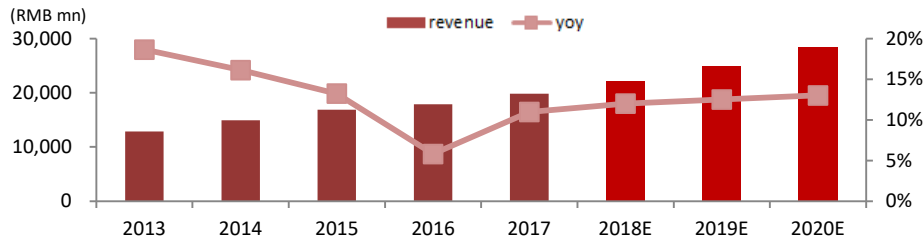
See last page for disclaimer.

* Price are collected from Tmall market on 13/9/2018



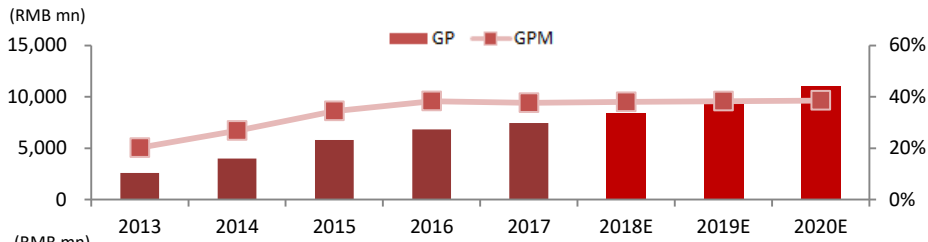
Is the Group really huge, steady & safe? We think so.

Revenue



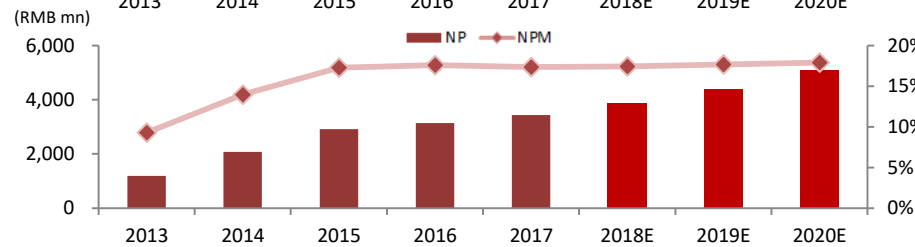
Top-3 F&B companies in China based on revenue in 2017.

Gross Profit & GPM

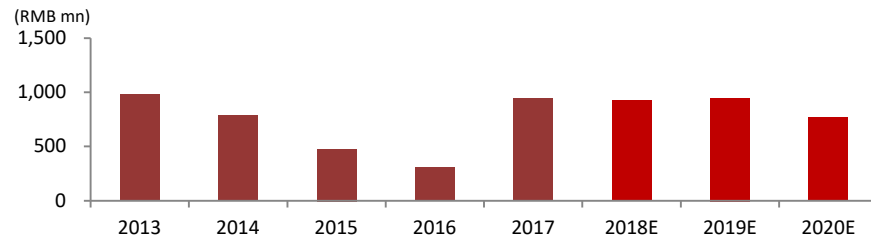


Steady increasing gross profit margin and net profit margin due to launching new products with high margin and effective cost control while variable cost increase

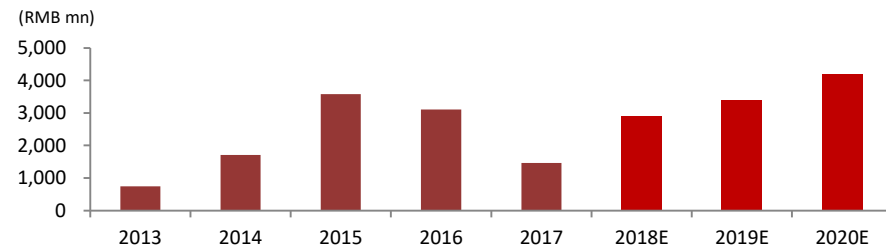
Net Profit & NPM



CAPEX

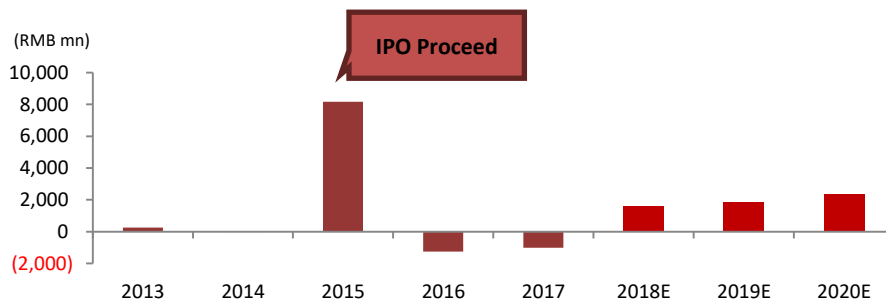


Free Cash Flow

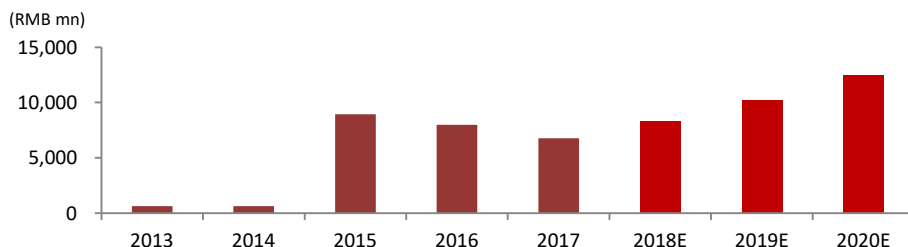


Strong positive operating cash flow can support growth internally. This means that the Group has ability to seek appropriate strategic acquisition and business cooperation opportunities to dominate the markets.

Net Cash Flow



Year-end Cash





Strong growth drivers boost Dali's revenue

The group sticks to the "Multi-Brands and Multi Products" development to further expand the household consumer market. In the meantime, consolidate its leading position in leisure food market though expanding distribution channels.

Product portfolio continues to improve

1) Two new segments of soymilk and quality breakfast with high margin will be the next sales growth engine

- In order to control channel inventory of Doubendou products, the Group reorganized the distributor team of Doubendou which has extensive related industry experience in 2018H1, resulting in RMB 900 million sales that worse than 2017, a year of its launched. However, all adjustments of Doubendou operations were completed and channel inventory were back to reasonable level.
- Quality breakfast series achieved around RMB 500 million in revenue in 2018H1, including first batch of medium shelf-life (2 months shelf-life) bread products which were launched on April, 2018 and recorded RMB 100 million in 2018H1. In addition, short shelf-life (3-7 days) bread products are expected to launch on November, 2018.

2) Extend existing brand lines with new products, new flavors or packaging and distribution channel improvement

- Copico has significantly increased its market share in certain major regions due to the introduction of fresh cut potato chips with different favors. The sales of Copico increased 15.3% yoy to RMB 1,369 million in 2018H1.
- The sales of energy drinks (Hi-Tiger) increased 21.2%yoy to RMB 1,899 million in 2018H1, mainly due to increasing the penetration of distributors in provinces of eastern and central China while consolidating existing channel advantages in the southeast and northwest regions of China.

Figure 25: Revenue breakdown by segments

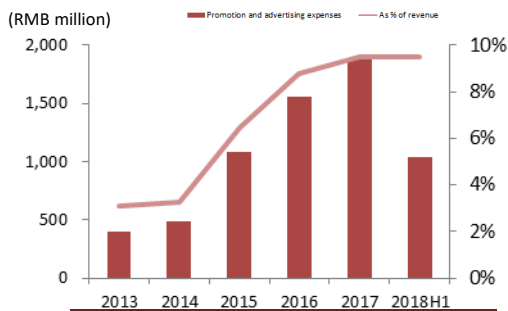
		2013	2014	2015	2016	2017	2017H1	2018H1
Bread, Cakes and Pastries	Revenue	5,000	5,726	6,325	6,336	6,106	2,850	2,912
	yoy growth	19%	15%	10%	0%	-4%		2%
	As % of Revenue	39%	38%	38%	36%	31%	29%	26%
Chips, Fries and Others	Revenue	1,267	1,512	1,782	1,878	2,256	1,188	1,369
	yoy growth	14%	19%	18%	5%	20%		15%
	As % of Revenue	10%	10%	11%	11%	11%	12%	12%
Biscuit	Revenue	1,148	1,257	1,412	1,551	1,610	794	820
	yoy growth	16%	9%	12%	10%	4%		3.2
	As % of Revenue	9%	8%	8%	9%	8%	8%	7%
Food	Total	7415	8495	9519	9765	9972	4832	5101
	yoy growth	17%	15%	12%	3%	2%		6%
	As % of Revenue	58%	57%	56%	55%	50%	49%	46%
Energy Drinks	Revenue	394	794	1,419	2,036	2,675	1,566	1,899
	yoy growth	-	102%	79%	43%	31%		21%
	As % of Revenue	3%	5%	8%	11%	14%	16%	17%
Plant-based and Milk Beverage	Revenue	1,691	1,816	1,965	1,649	2,192	800	1,376
	yoy growth	36%	7%	8%	-16%	33%		72%
	As % of Revenue	13%	12%	12%	9%	11%	8%	12%
Herbal Tea	Revenue	2,119	2,372	2,551	2,711	2,521	1,533	1,565
	yoy growth	4%	12%	8%	6%	-7%		2%
	As % of Revenue	17%	16%	15%	15%	13%	16%	14%
Other Beverage	Revenue	1,208	1,417	1,411	1,249	1,210	575	467
	yoy growth	0%	17%	0%	-11%	-3%		-19%
	As % of Revenue	9%	10%	8%	7%	6%	6%	4%
Beverage	Total	5,412	6,399	7,346	7,645	8,598	4,474	5,307
	yoy growth	20%	18%	15%	4%	12%		19%
	As % of Revenue	42%	43%	44%	43%	43%	45%	48%
Others	Revenue	0	0	-0	432	1229	583	604
	yoy growth	-51%	-85%	-5433%	270029%	185%		4%
	As % of Revenue	0%	0%	0%	2%	6%	6%	5%

The beverage segments' sales grew faster than the food segments. The revenue contribution from the beverage segment has surpassed the food segment for the first time in 2018H1.

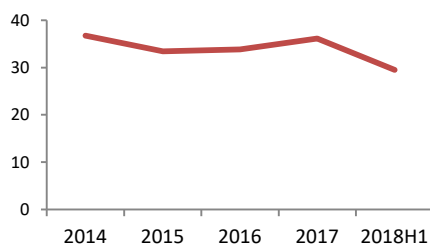
Figure 26: GPM of different categories

GPM (%)	2014	2015	2016	2017	2018H1
Food Products	26.6	30.3	34.2	35.2	35.0
Beverage Products	27.2	39.9	45.6	45.5	47.7
Others	26.6	30.3	34.2	35.2	35.0
Total	26.8	34.5	38.3	37.7	39.4

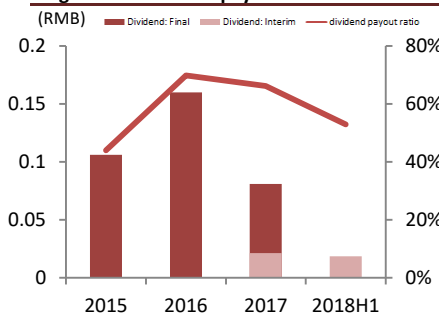
Source: company data, Orient Securities (Hong Kong)

Figure 27: Promotion and advertising expenses


Source: company data, Orient Securities (Hong Kong)

Figure 28: Inventory turnover days


Source: company data, Orient Securities (Hong Kong)

Figure 29: Dividend payment


Source: company data, Orient Securities (Hong Kong)

Effective cost management

The principal cost of sales: Raw materials and packaging materials

Raw materials costs (such as sugar, palm oil, flour) and packaging materials costs (such as chips, corrugated paper) represented 51.1% and 26.9% of total cost of sales respectively in 2018H1. Therefore, the market prices of raw materials and packaging materials costs will absolutely affect the Group's gross profit. See appendix for material price.

Ways to offset the impact of rising raw materials costs and packaging materials costs

Along with ① new products with high margin; ② the contribution of beverage segment which receive more markup than food increased continuously and ③ effective cost control, the gross profit margin of the Group increased 0.8% to 39.4% in 2018H1, totally offset the impact of rising cost of raw materials and packaging materials.

To alleviate potential cost pressure, we expect the Group will continue to focus on new products and upgrades existing products.

Celebrity endorsement

The group is mostly likely use celebrity endorsement with tagline through television channels, internet, billboards and other print media to enhance or build up the visibility and marketability of the products. For example, the group hires Sun Li, national goddess in China, who is best fit to strength the brand awareness of Doubendou with the marketing tagline "国民营养好豆奶, National nutritional soy milk".

Advertising and promotion cost to sales ratio has been increased since late 2014 because of promotion fee increased. The group adjusted its pricing and marketing strategies to conduct more marketing campaigns to strength its sales channel such as modern channel. We believe the group is still penetrating their distribution channel and more new products come out soon, therefore, advertising and promotion cost to sales ratio will remain in 8%-10%.

Efficiency in controlling inventory levels

Inventory turnover days remained relatively stable in these 4-5 years. The inventory levels increased in 2017 mainly due to two new segments are launched. Compared with 2017H1, the inventory turnover days improved from 30 days to 29.5 days in 2018H1.

Strong net cash position

The Group is a debt-free company and maintains a strong net cash position (c.10 billion yuan in 2018H1) helped by strong operating cash flow. However, the Group proposed to pay the interim dividend of HK\$0.085, cutting the dividend payout ratio from 65% to 53% yoy. This is mainly due to:

- Most of the Group's revenue is denominated in RMB and foreign exchange is more strictly controlled in China in 2018H1
 - Looking for M&A which could have synergies with the company in future
- Therefore, we believe that the dividend payout ratio will decrease continuously but not less than 50% to have sufficient cash for M&A in future.

Initiate at BUY with a TP of HK\$7.0

We initiate Buy on Dali Foods with a target price of HK\$6.93 based on two-stage growth DCF valuation method. The relevant assumptions are as follows: (We assume a HKDRMB rate of 0.87)

Figure 30: Key assumptions of Dali Foods' DCF model

WACC	9.5%
Terminal growth rate (%)	3%
Terminal value (HK\$m)	73,440
Total FCF (HK\$m)	137,093
NAV Price/Share (HK\$)	10.8
Target NAV Discount (%)	35
Target price (HK\$)	7.0
Upside potential	28%

Source: Company, Orient Securities (Hong Kong)

- **WACC.** We assume the weighted average cost of capital (WACC) and terminal growth rate are 9.5% and 3%, respectively. The WACC is derived by assuming a beta of 1.0 and a market risk premium of 3.75%.
- **Long-term growth.** We conservatively assume revenue growth will gradually slow in 2022-2028, while the margin will remain stable. We will apply a 3% terminal growth rate to follow the historical inflation rate.
- **CAPEX.** We expect the company will continue to 1) develop new categories and products through M&A and internal development; 2) Construct plants and production lines to penetrate into different cities. The high level of CAPEX is essential for growth and tool for moving a company from good to great.
- **Cash flow.** Supported by strong earnings growth, operating cash flow will maintain positive for the next decade. We expect the 2018-2027 CAGR of free cash flow (RMB) to reach 12.2%.

Figure 31: Dali Foods' DCF forecast

(RMBmn)	2018E	2019E	2020E	2021E	2022E	2023E	2024E	2025E	2026E	2027E
Pre-tax profit	4,896	5,584	6,451	7,419	8,346	9,264	10,190	11,107	11,996	12,716
Taxes paid	(1,033)	(1,178)	(1,361)	(1,565)	(1,760)	(1,954)	(2,149)	(2,343)	(2,530)	(2,682)
Depreciation & amortization	578	619	635	643	635	689	720	738	743	748
Change in working capital	(103)	(120)	(151)	(170)	(166)	(171)	(172)	(171)	(165)	(134)
Others	(162)	(161)	(152)	(145)	(147)	(147)	(146)	(146)	(149)	(158)
Operating cash flow	4,153	4,653	5,241	5,895	6,514	7,158	7,796	8,395	8,948	9,381
CAPEX	(925)	(947)	(767)	(719)	(571)	(1,124)	(977)	(881)	(787)	(793)
Annual free cash flow (RMB\$m)	3,228	3,707	4,474	5,176	5,943	6,035	6,818	7,514	8,161	8,587
Annual free cash flow (HK\$m)	3,711	4,260	5,143	5,950	6,831	6,937	7,837	8,636	9,380	9,870
Discounted free cash flow (HK\$m)	4,121	4,571	5,332	5,960	6,611	6,486	7,081	7,539	7,911	8,043

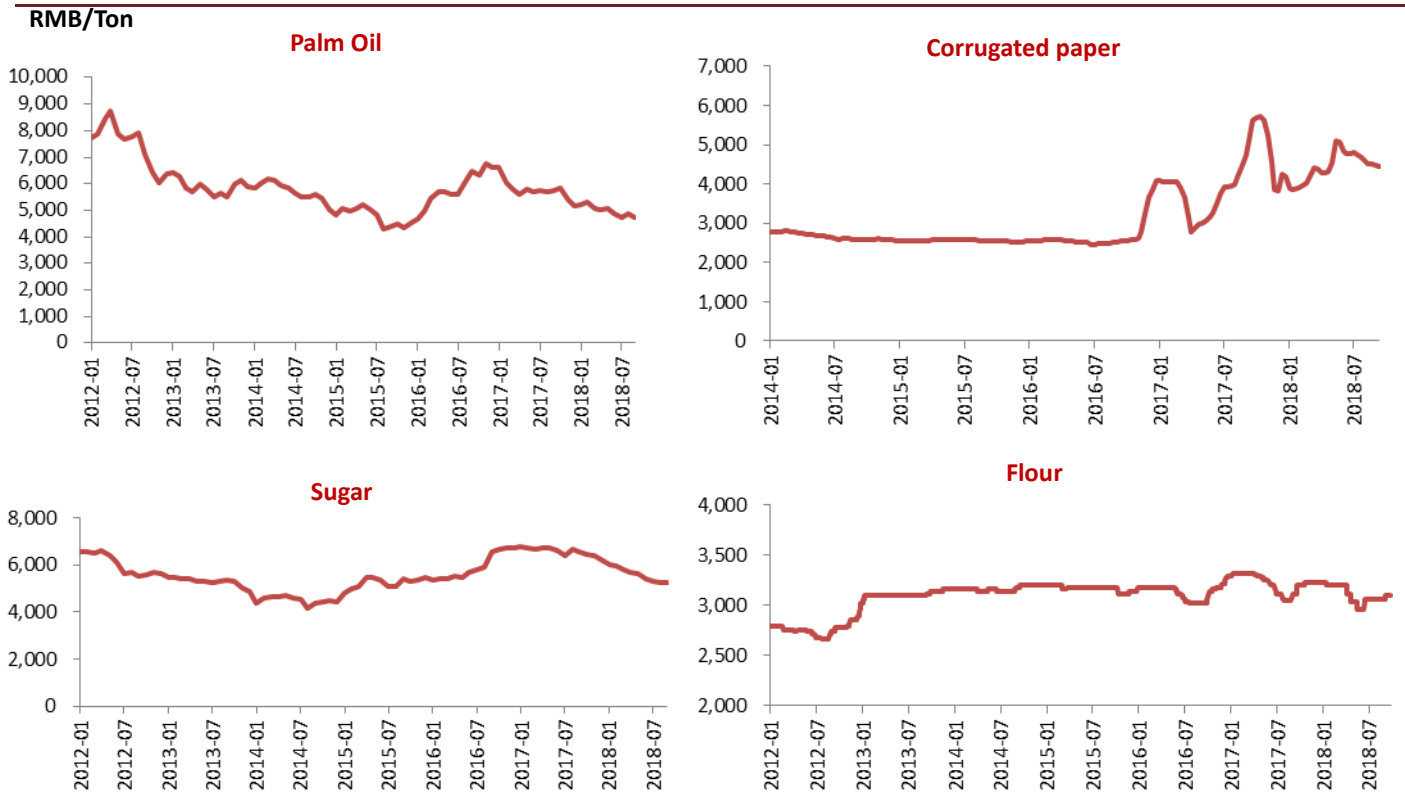
Source: Company, Orient Securities (Hong Kong)

Risks for our model - 35% discount to the DCF model

We estimated NAV price per share is HK\$10.8, implying 35% NAV discount relative to the current target price of HK\$7.0. Taking into account the economic and industrial uncertainties in the future, Dali Foods may suffer from the following risks:

- Any food safety and quality failures can definitely damage the Group's brand reputation and consumers' trust in their products.
- Increased competition in the industry results in lower-than-expected retail sales
- Sales growth decline due to 1) new products fail 2) Fail to seek appropriate strategic acquisition and business cooperation opportunities to further dominate markets 3) Fail to enter international markets

The above uncertainties will bring downside risks to our model or target price. Therefore, we apply a 35% discount to the DCF model to arrive at our target price.

Appendix
Figure 32: raw material price


Source: Wind, Orient Securities (Hong Kong)

Figure 33: Peer valuation table

Ticker	Company	Reporting Currency	Price (Local Ccy)	Market Capitalization (HK\$m)	P/E (x)				PEG (x)	P/B (x)		Div. Yield (%)		EV/EBITDA (x)		
					17	18E	19E	20E		17	18E	17	18E	17	18E	19E
3799 HK	DALI FOODS	CNY	5.46	74,770	19.3	17.1	15.0	13.0	1.4	4.8	4.2	3.1	3.5	11.8	10.6	9.4
322 HK	TINGYI	CNY	13.1	73,705	35.7	26.1	22.2	19.4	1.3	3.5	3.2	1.4	2.0	11.5	10.6	9.9
220 HK	UNI-PRESIDE	CNY	7.95	34,339	34.6	26.3	22.9	20.4	1.5	2.4	2.3	2.0	2.4	12.8	11.4	10.6
345 HK	VITASOY INTL	HKD	25.0	26,528	45.0	38.5	33.0	28.2	2.7	9.1	8.5	1.4	1.6	35.0	41.3	33.2
151 HK	WANT WANT	CNY	5.72	71,210	20.3	18.2	16.9	15.1	-0.2	-	3.9	0.0	3.1	13.0	12.1	11.4
1458 HK	ZHOU HEI YA	CNY	4.23	10,081	11.7	13.1	12.6	11.6	-3.3	2.2	1.9	2.7	2.2	8.2	9.1	8.7
1475 HK	NISSIN	HKD	3.42	3,674	14.4	17.4	15.1	14.3	-5.6	1.1	1.0	0.0	2.4	5.8	4.0	3.6
506 HK	CHINA	HKD	2.19	1,250	7.5	21.7	17.9	15.1	-0.1	-	2.1	0.0	1.4	4.4	8.7	7.7
603866 CH	TOLY	CNY	3.60	10,070	45.9	37.6	30.3	24.2	2.0	8.1	6.9	1.5	0.8	35.0	41.3	33.2
000848 CH	HEBEI	CNY	52.3	27,854	19.4	17.7	15.3	14.0	1.6	4.5	3.8	6.2	3.7	12.4	11.6	10.1
000895 CH	HENAN	CNY	8.13	8,998	19.1	16.4	15.0	13.6	1.5	6.2	5.4	4.4	5.4	-	-	-
600598 CH	HEILONGJIAN	CNY	24.9	93,219	21.0	18.3	16.7	15.6	-0.2	-	2.5	0.0	3.3	18.2	15.5	14.7
603517 CH	JUEWEI	CNY	9.21	18,517	30.5	24.5	20.1	16.7	1.3	6.1	5.1	1.2	1.5	24.0	24.5	20.5
Listed Food & beverage companies					24.9	22.5	19.5	17.0	0.3	4.8	3.9	1.8	2.6	16.0	16.7	14.4

Source: Bloomberg, Orient Securities (Hong Kong)

Comparison and analysis of current and historical P/E and P/B

We compared the historical and current P/E and P/B ratios with the P/E band and P/B band as well as the standard deviation. Dali Foods is currently trading at 21.7x FY18E P/E and 6.1x FY18E P/B, according to the historical valuation range, the current P/E and P/B ratios are at relatively high levels.

Figure 34: P/E band



Source: Bloomberg, Orient Securities (Hong Kong)

Figure 35: Historical P/E

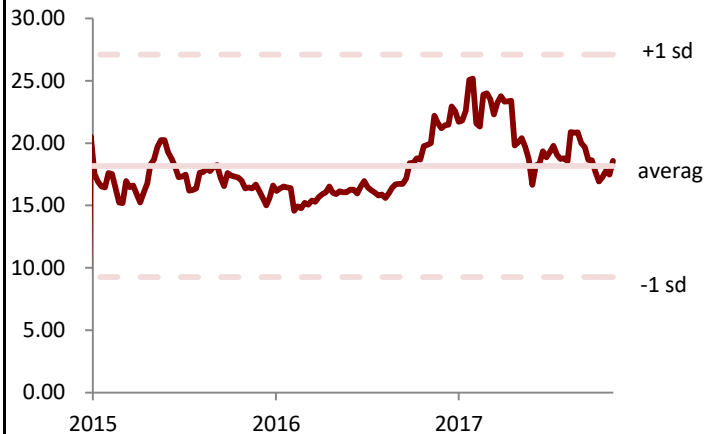
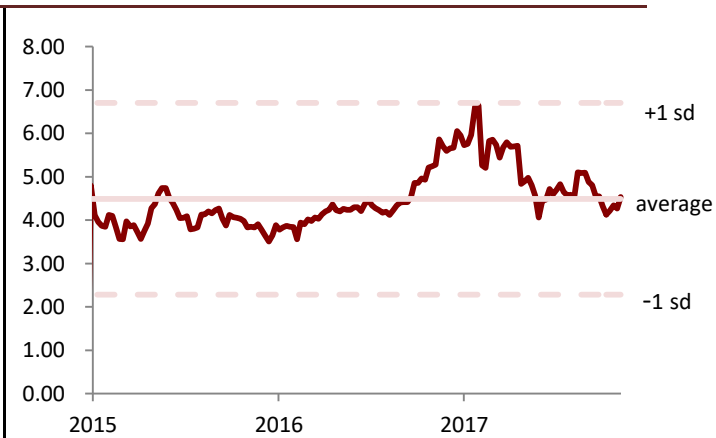


Figure 36: P/B band



Source: Bloomberg, Orient Securities (Hong Kong)

Figure 37: Historical P/B



Financial Statements & Forecast
Income statement (consolidated)

FY-end Dec (RMB mn)	2016	2017	2018E	2019E	2020E
Revenue	17,842	19,799	22,175	24,947	28,439
Bread, Cakes and Pastries	6,336	6,106	6,320	7,035	8,247
Chips, Fries and Others	1,878	2,256	2,794	2,994	3,128
Biscuit	1,551	1,610	1,685	1,746	1,792
Energy Drinks	2,036	2,675	3,215	3,617	3,982
Plant-based and Milk Beverage	1,649	2,192	3,215	4,740	5,972
Herbal Tea	2,711	2,521	2,550	2,594	2,645
Other Beverage	1,249	1,210	1,020	948	853
Others	432	1,229	1,375	1,272	1,820
Cost of sales	(11,001)	(12,341)	(13,749)	(15,392)	(17,462)
Gross profit	6,840	7,458	8,427	9,555	10,978
Selling and distribution expenses	(2,788)	(3,248)	(3,674)	(4,134)	(4,712)
Administrative expenses	(431)	(524)	(588)	(660)	(753)
Other income and gain, net	360	666	732	823	939
Operating profit	3,982	4,352	4,896	5,584	6,451
Finance costs	(5)	-	-	-	-
Pre-tax profit	3,977	4,352	4,896	5,584	6,451
Income tax expense	(840)	(918)	(1,033)	(1,178)	(1,361)
Net profit	3,137	3,434	3,863	4,406	5,090
EBITDA	4,522	4,922	5,475	6,203	7,086
EBIT	3,977	4,352	4,896	5,584	6,451
EPS (RMB)	0.229	0.251	0.282	0.322	0.372
DPS (RMB)	0.157	0.150	0.171	0.197	0.227

Cash flow (consolidated)

FY-end Dec (RMB mn)	2016	2017	2018E	2019E	2020E
Pre-tax profit	3,977	4,352	4,896	5,584	6,451
Income tax paid	(812)	(886)	(1,023)	(1,169)	(1,350)
Depreciation & amortization	545	571	578	619	635
Change in working capital	(274)	(1,377)	(103)	(120)	(151)
Others	(25)	(255)	(520)	(583)	(648)
Operating cash flow	3,412	2,404	3,829	4,331	4,937
CAPEX	(309)	(943)	(925)	(947)	(767)
Disposals	1	9	9	10	10
Investments	(1,219)	927	330	399	473
Others	(161)	(105)	62	68	80
Investing cash flow	(1,688)	(113)	(524)	(469)	(204)
Interest paid	(5)	-	-	-	-
Change of borrowings	(1,500)	-	-	-	-
Dividends paid	(1,460)	(3,305)	(2,048)	(2,335)	(2,698)
Others	(2)	0	0	0	0
Financing cash flow	(2,966)	(3,305)	(2,048)	(2,335)	(2,698)
Free cash flow	3,103	1,461	2,904	3,385	4,170
Net cash flow	(1,242)	(1,014)	1,581	1,849	2,340

Semi-annual breakdown

FY-end Dec (RMB mn)	2H16	1H17	2H17	1H18	2H18E
Revenue	8,821	9,889	9,910	11,012	11,163
Gross profit	3,307	3,816	3,642	4,338	4,089
Operating profit	1,885	2,238	2,114	2,524	2,373
Pre-tax profit	1,885	2,238	2,114	2,524	2,373
Tax	(390)	(483)	(435)	(554)	(479)
Adjusted net profit	1,495	1,755	1,679	1,970	1,894
Gross margin (%)	37.5	38.6	36.7	39.4	36.6
Operating margin (%)	21.4	22.6	21.3	22.9	21.3
Effective tax rate (%)	20.7	21.6	20.6	21.9	20.2
Adjusted net margin (%)	16.9	17.7	16.9	17.9	17.0
EPS (RMB)	0.109	0.130	0.121	0.140	0.142
DPS (RMB)	0.157	0.085	0.065	0.074	0.097

Source: Company, Orient Securities (Hong

Balance sheet (consolidated)

FY-end Dec (RMB mn)	2016	2017	2018E	2019E	2020E
Current assets	11,746	11,271	13,193	15,432	18,264
Inventories	1,109	1,333	1,485	1,663	1,886
Trade receivables	284	1,085	1,215	1,367	1,558
Prepayments, deposits and other receivables	176	457	509	570	647
Available-for-sale financial assets and at fair value through profit and loss	250	250	256	256	256
Pledged deposits	65	50	50	50	50
Cash and cash equivalents	9,861	8,096	9,677	11,526	13,866
Non-current assets	4,735	5,055	5,420	5,767	5,927
Property, plant and equipment	3,896	4,273	4,615	4,937	5,063
Prepaid land lease payments	591	577	571	565	560
Net intangible assets	3	4	5	6	7
Prepayments and others	218	150	168	189	215
Deferred tax assets	26	52	62	71	82
Total assets	16,480	16,326	18,613	21,200	24,190
Current liabilities	2,296	2,216	2,447	2,718	3,059
Trade and bills payable	1,027	889	991	1,109	1,258
Accruals and other current liabilities	1,092	1,143	1,274	1,426	1,618
Tax payables	177	183	183	183	183
Non-current liabilities	319	324	363	408	466
Deferred Revenue	319	324	363	408	466
Total liabilities	2,615	2,540	2,811	3,127	3,525
Share capital	113	113	113	113	113
Share reserves	13,753	13,673	15,689	17,960	20,553
Total equity	13,866	13,786	15,802	18,073	20,665
Total liabilities & equity	16,480	16,326	18,613	21,200	24,190
Net cash/(debt)	9,861	8,096	9,677	11,526	13,866
Working capital	(484)	893	995	1,115	1,266
Total capital employed	14,184	14,110	16,166	18,481	21,131
Net gearing (%)	NC	NC	NC	NC	NC
BVPS (RMB)	1.013	1.007	1.154	1.320	1.509

Key ratios

FY-end Dec	2016	2017	2018E	2019E	2020E
Growth (%)					
Revenue	5.8	11.0	12.0	12.5	14.0
Gross profit	17.6	9.0	13.0	13.4	14.9
EBITDA	7.5	8.8	11.2	13.3	14.2
EBIT	8.0	9.4	12.5	14.0	15.5
Net profit	7.7	9.5	12.5	14.0	15.5
EPS	(5.0)	9.5	12.5	14.0	15.5
Margin (%)					
Gross	38.3	37.7	38.0	38.3	38.6
EBITDA	25.3	24.9	24.7	24.9	24.9
EBIT	22.3	22.0	22.1	22.4	22.7
Net	17.6	17.3	17.4	17.7	17.9
Others (%)					
Effective tax rate	21%	21%	21%	21%	21%
Dividend payout ratio	47	63	53	53	53
RoCE	22	24	24	24	24
Average RoE	23	25	24	24	25
Average RoA	19	21	21	21	21
Interest cover (x)	845	-	-	-	-

Key assumptions

FY-end Dec	2016	2017	2018E	2019E	2020E
Operating figures					
Food Segments	9,765	9,972	10,799	11,775	13,167
Beverage segments	7,645	8,598	10,001	11,900	13,452

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