China Dairy And Beverages: A Hungry Thirst

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Corporate Ratings

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S&P Global
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Key Takeaways

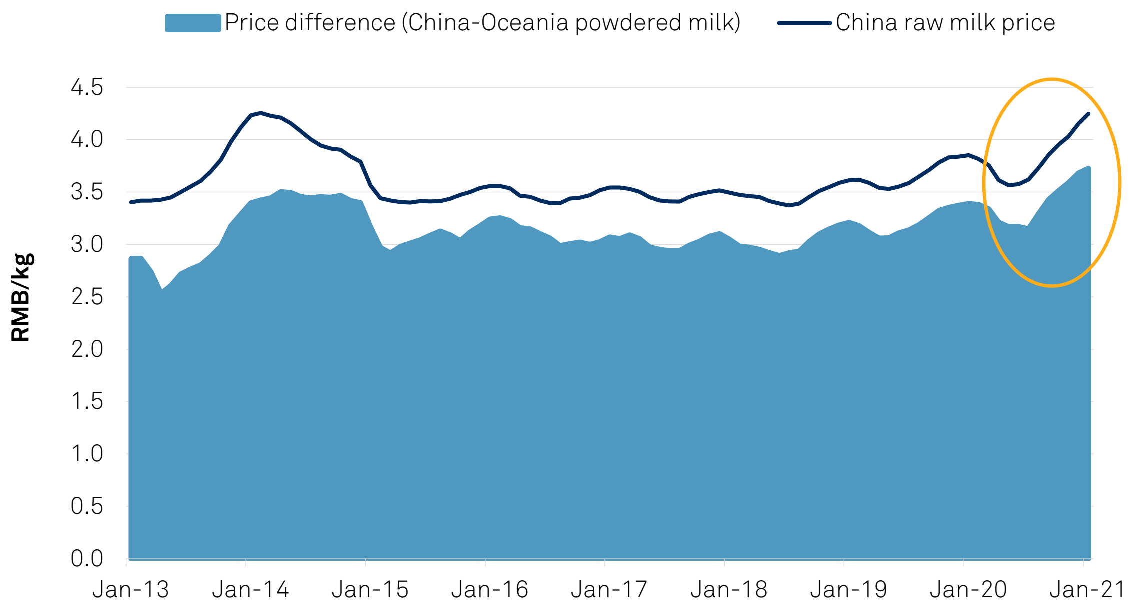
- We have revised our forecast for annual dairy price rises over 2021-2022 to 2%-7% (vs. 0-5% previously). This is in view of higher consumer demand, owing to rising health awareness in the post-pandemic era.
- Rated dairy producers will likely maintain margins by increasing imports as domestic raw milk prices rise, improving product mix, and moderately increasing prices. We also expect beverage firms to recover from COVID-19 disruptions and return to mid-single digit growth from 2021 onward.
- Key risks for the sector are food safety, fierce competition, and expanding balance sheets stemming from higher capital investments. Acquisition risks persist as downstream producers continue to secure offshore dairy sources and diversify product portfolio.
- Producers can manage fluctuations in raw material cost and limited pandemic-related disruptions. This underpins our stable outlook. Ratings headroom, though ample, will decrease in 2021 and recover in 2022 as expansion needs will be followed by EBITDA growth.
- Key rating differentiators are competition strategy and financial policy.

S&P Global Ratings believes there remains high, albeit moderating, uncertainty about the evolution of the coronavirus pandemic and its economic effects. Vaccine production is ramping up and rollouts are gathering pace around the world. Widespread immunization, which will help pave the way for a return to more normal levels of social and economic activity, looks to be achievable by most developed economies by the end of the third quarter. However, some emerging markets may only be able to achieve widespread immunization by year-end or later. We use these assumptions about vaccine timing in assessing the economic and credit implications associated with the pandemic (see our research here: www.spglobal.com/ratings). As the situation evolves, we will update our assumptions and estimates accordingly.

Spilling Over – Rising Milk Prices In China To Drive Dairy Imports

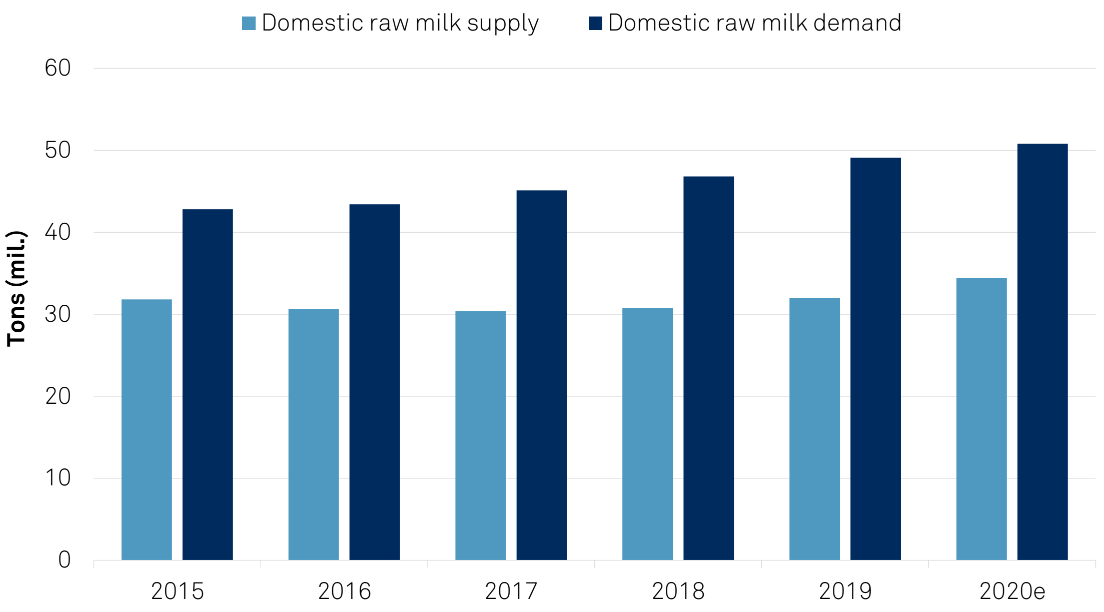
- We forecast raw milk prices in China will rise 2%-7% annually over the next 12-24 months. Downstream producers will likely increase imports of cheaper milk from New Zealand as price gaps between China and Oceania exports reach a seven-year high.
- Despite China's goal to increase domestic supply, the country will remain a net importer. Supply increases cannot catch up with rising demand and the significant raw milk price differences between Oceania and China.

Raw Milk Prices Hit Seven-Year High



RMB--Chinese renminbi. Source: National Bureau of Statistics of China, Wind, AHDB, S&P Global Ratings.

Supply Shortage Could Be Over 15 Million Tons

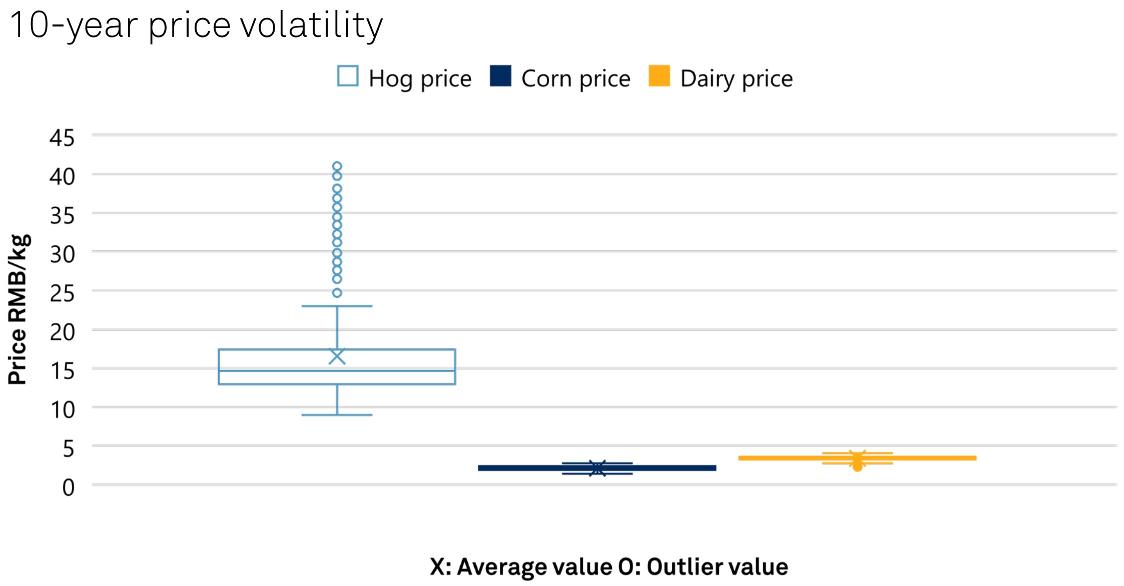


Mil.--Million. e--Estimate. Source: National Bureau of Statistics, Frost & Sullivan, Wind, S&P Global Ratings.

Downstream Producers Aren’t Overly Sensitive To Input Price Volatility

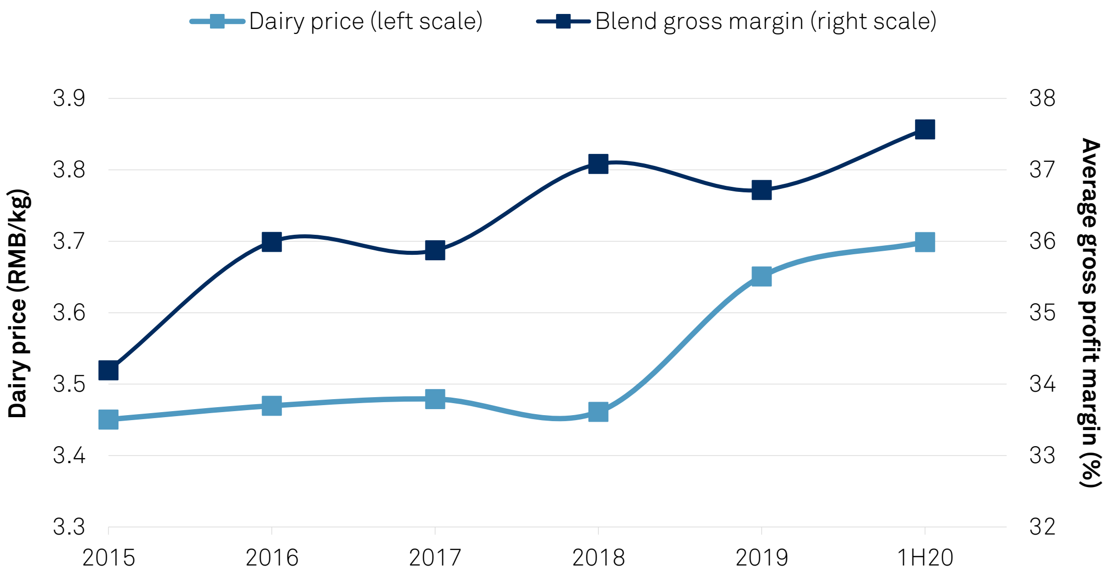
- Dairy is not as volatile as other Chinese livestock industries, such as hogs, in part because of long-term contracts between upstream and downstream producers.
- Branding power and product innovation also support margins for leading Chinese branded dairy firms as demonstrated by margin recovery in 1H20, despite the initial impact from rising raw milk prices. For Fonterra, higher margins from its ingredients business can help offset rising farmgate milk prices.

Dairy Prices Are Relatively Less Volatile Than Hog Prices



RMB—Chinese renminbi. kg--Kiilogram. Source: Wind, S&P Global Ratings.

Downstream: Dairy Price vs Reported GP Margin

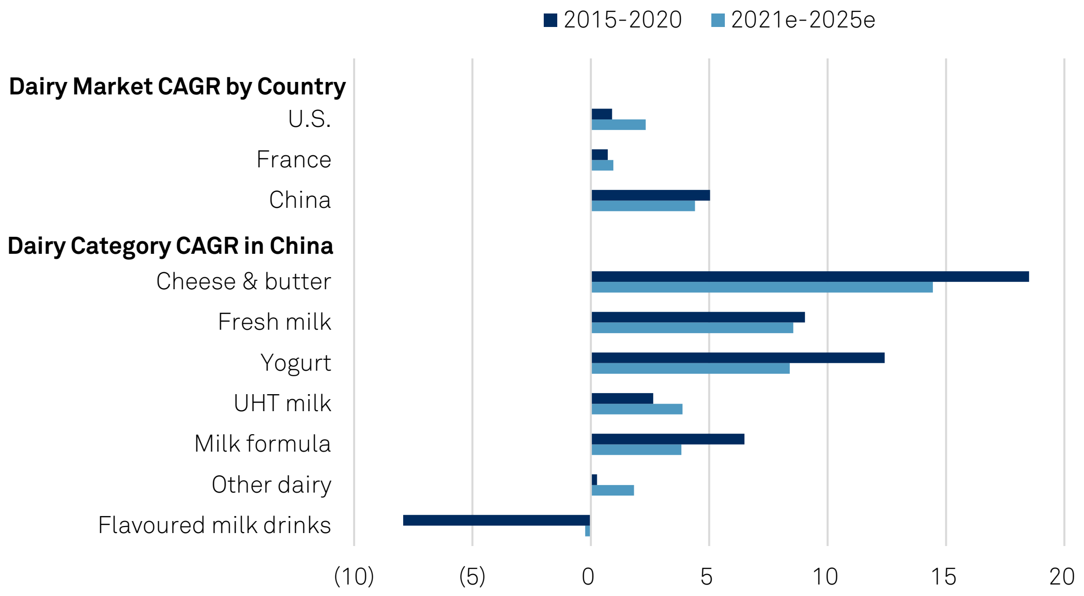


**Selected industry players include Mengniu, Yili, and Bright Dairy.*
Source: Wind, Capital IQ, S&P Global Ratings.

Leaders To Gain From Favorable Market Growth

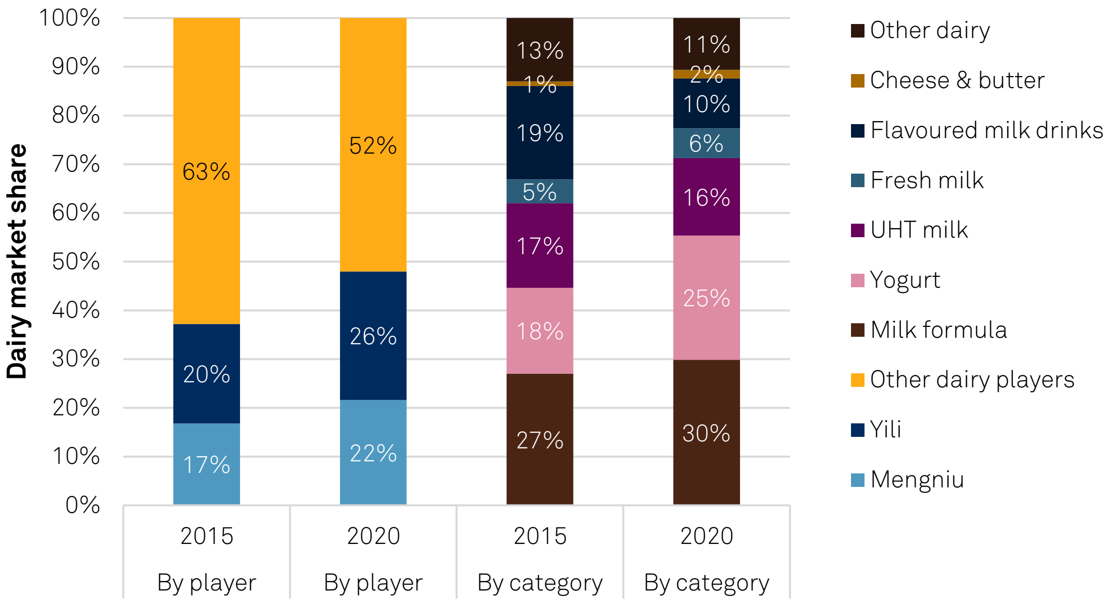
- We expect the Chinese dairy industry to grow sales at 4%-7% annually over the next five years, primarily driven by rising dairy consumption as China gets wealthier. Leading categories are fresh milk, yogurt, and cheese followed by UHT milk and baby formula.
- Industry leaders (Yili and Mengniu) are likely to expand sales at 10%-15% over the next 18-24 months and gain market share from regional players, thanks to their good brand equity, strong distribution network, and better control of dairy sources. We believe Mengniu is better positioned to capitalize on growing categories in low-temperature products and fresh milk and cheese.

Fresh Milk, Yogurt And Cheese To Grow Above GDP At 7%-12%



e—Estimate. Source: Euromonitor, S&P Global Ratings.

Industry Leaders Will Continue To Gain Share



** UHT milk--Ultra-high temperature processing milk that normally has shelf life up to six months. Source: Euromonitor, S&P Global Ratings.*

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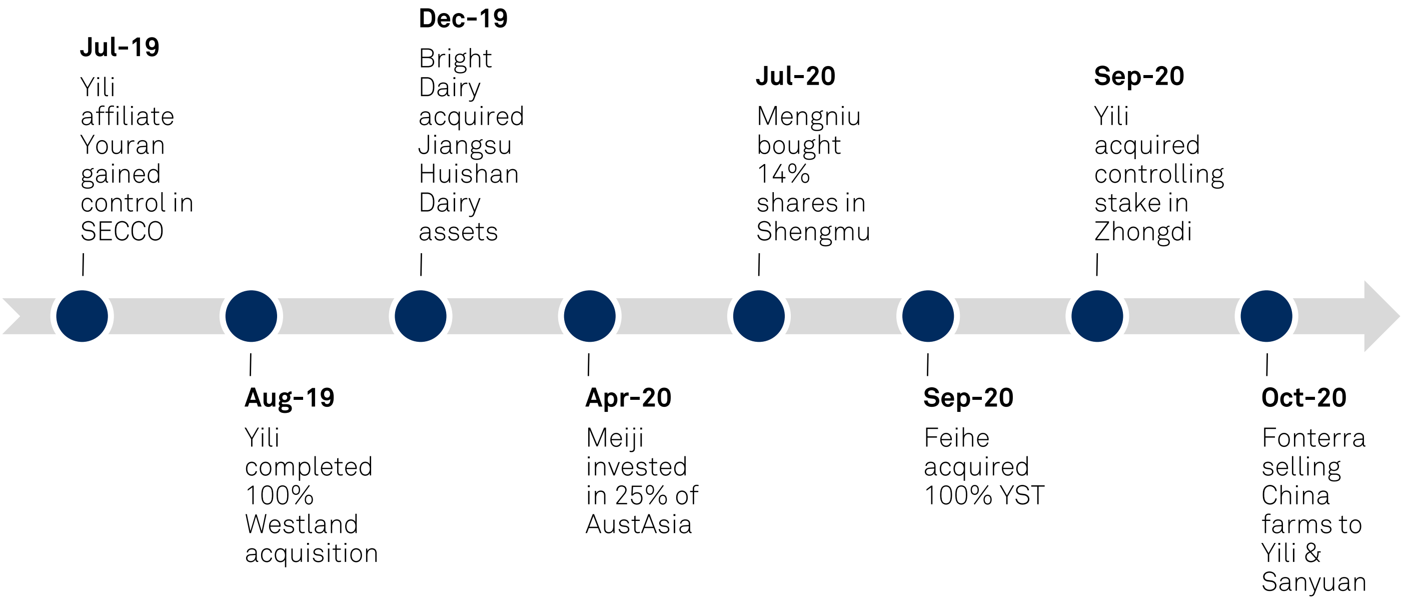
Milk Source Competition Will Spur More M&A

Downstream Branded Firms Grappling For Domestic Upstream Supply



Source: News sources, S&P Global Ratings.

- **Fresh milk in trend.** Fresh milk demand is rising and can only be locally supplied.
- **M&A boom.** More than RMB13 billion worth of deals announced in the past 18 months as leading dairy firms seek to secure downstream supply.
- **Top farms taken.** Top 10 farms supply ~20% of raw milk in China, and the largest player about 5%. Among the top 12 farms in China, 11 were controlled by downstream brands. Yili and Mengniu control an estimated 15% of local dairy sources.
- **Future focus offshore.** Dairy farm consolidation continues but deal size may become smaller. Future focus will be offshore milk sources.

Stable Outlook On Greater China Dairy And Beverages

One new ratings and one positive outlook for the sector

Ratings And Actions On Issuers In The Past 12 Months

		To	From
New rating	**Segment**		
Inner Mongolia Yili Industrial Group Co. Ltd.	Dairy	A-/Stable/--	N/A
Existing rating			
Bright Food (Group) Co. Ltd.	Food conglomerate	BBB/Stable/--	
China Mengniu Dairy Co. Ltd.	Dairy	BBB+/Stable/--	
Fonterra Co-operative Group Ltd.	Dairy	A-/Stable/--	
Health and Happiness (H&H) International Holdings Ltd.	Dairy	BB+/Stable/--	
Tingyi (Cayman Islands) Holding Corp.	Beverage	BBB+/Positive/--	BBB+/Stable/--

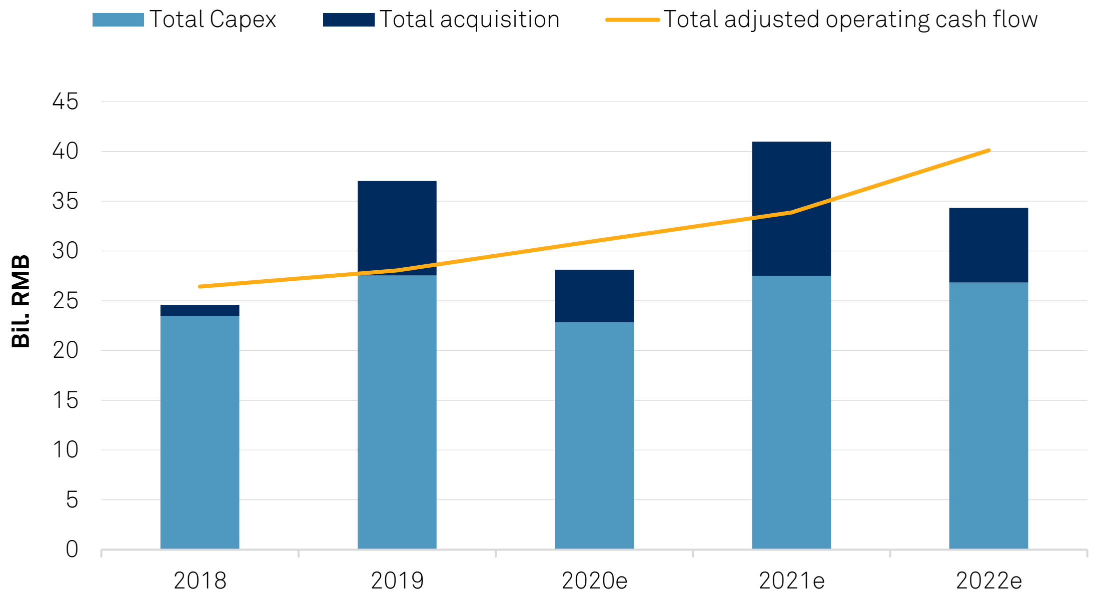
N/A—Not applicable. Source: S&P Global Ratings.

- **Stable outlook for most entities**
  Recovery since the pandemic-hit 1Q20 was swift and has sustained, especially for dairy products.
- **Tingyi with positive outlook**
  Tingyi is likely to maintain strong free cash flow and stabilizing market share. The rating headroom is large relative to peers', thanks to its conservative financial policy. Tingyi's outlook was revised to positive in July 2020.
- **New issuer Yili**
  Our 'A-' rating assignment reflects Yili's good brand equity, low leverage, and conservative financial policy. Yili issued US$ 500 million notes (issue rating 'A-').

Capital And Acquisition Needs Outweigh Operating Cash Flow in 2021

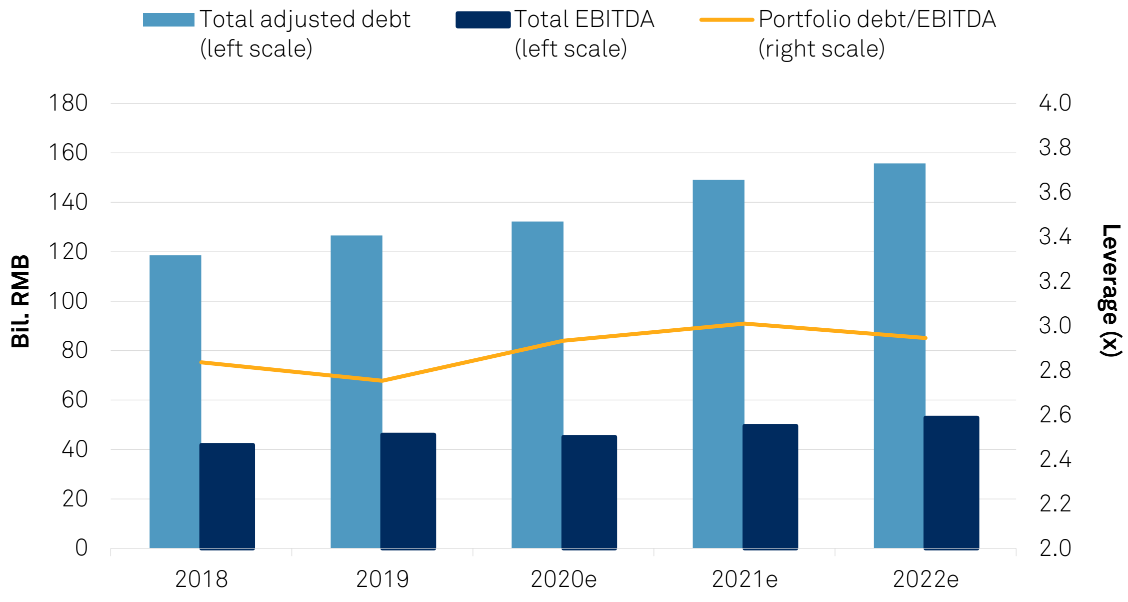
- **Higher investment needed to capture growth.** Higher demand and quests for dairy sources has increased capital expenditures (capex) and M&A, especially for Yili and Mengniu. By contrast, Fonterra is on track to reduce leverage to around 3x as it refocuses on its core function of processing and selling New Zealand milk, divesting noncore assets, and reducing capex.
- **Overall leverage to rise in 2021.** Debt to EBITDA will increase slightly but within our thresholds due to generally prudent financial policies. We foresee leverage improving by 2022 as EBITDA rises following heavy investments.

Expected Operating Cash Flow Usage In 2021-2022



We include Fonterra's 2020 actual financial data in 2020e. Our portfolio includes six rated companies. Bil.--Billion. RMB--Chinese renminbi. e--Estimate. Capex—capital expenditure. Source: Company data. S&P Global Ratings.

Leverage Rise With Increased Debt



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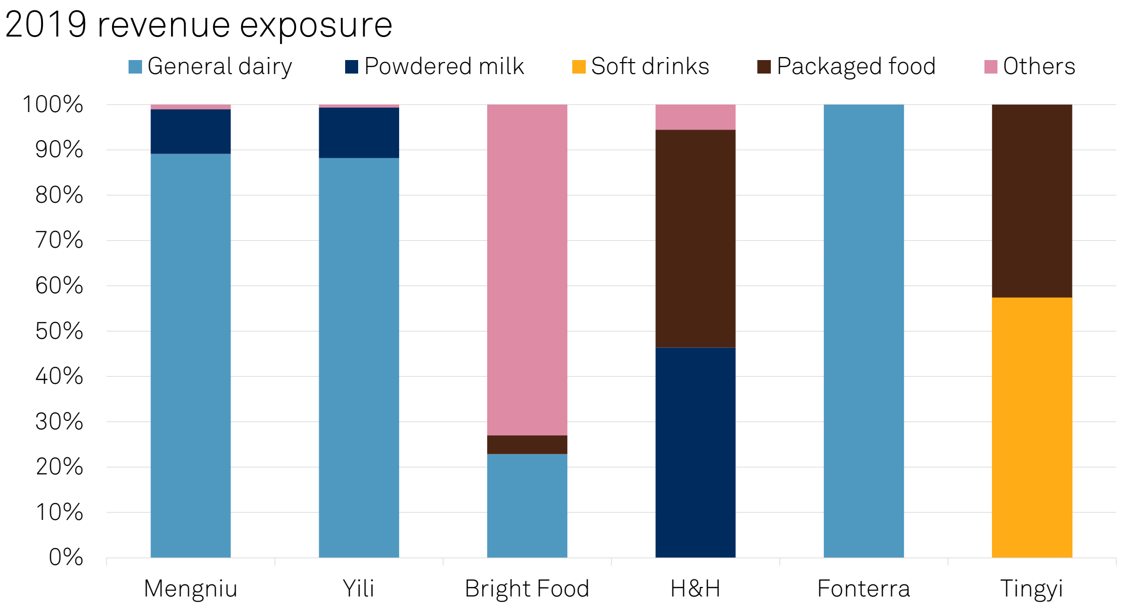
Peer Comparison

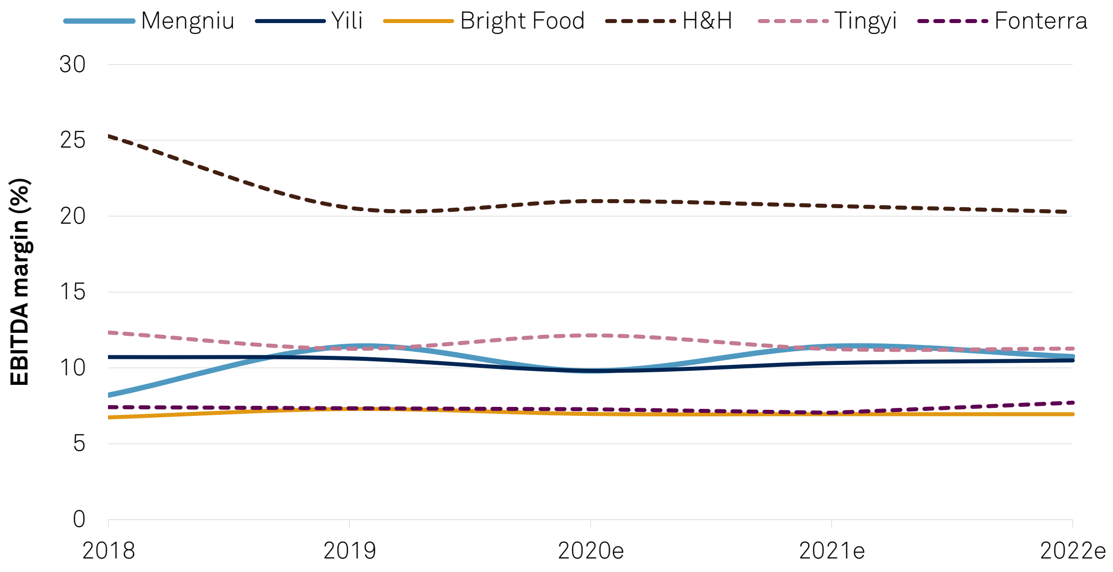
- **Yili, Mengniu, Tingyi, and Fonterra** are close peers with similar rating levels ('BBB+' to 'A-'). Fonterra fares better in geographic diversification and margin volatility, but Mengniu and Yili have higher growth prospects and better margins. Tingyi has lower growth in drinks and instant noodles, but its strengths lie in its highly efficient, tightly controlled nationwide distribution network.
- **EBITDA margin higher for formula and nutrition.** H&H enjoys the highest margin among peers, given its large exposure to formula business. Mengniu's margin volatility could be higher than close peer Yili or Tingyi due to its exposure to upstream dairy business.

Exposure Breakdown



Source: Company data. S&P Global Ratings.

Stable EBITDA Margin Expected In 2021-2022

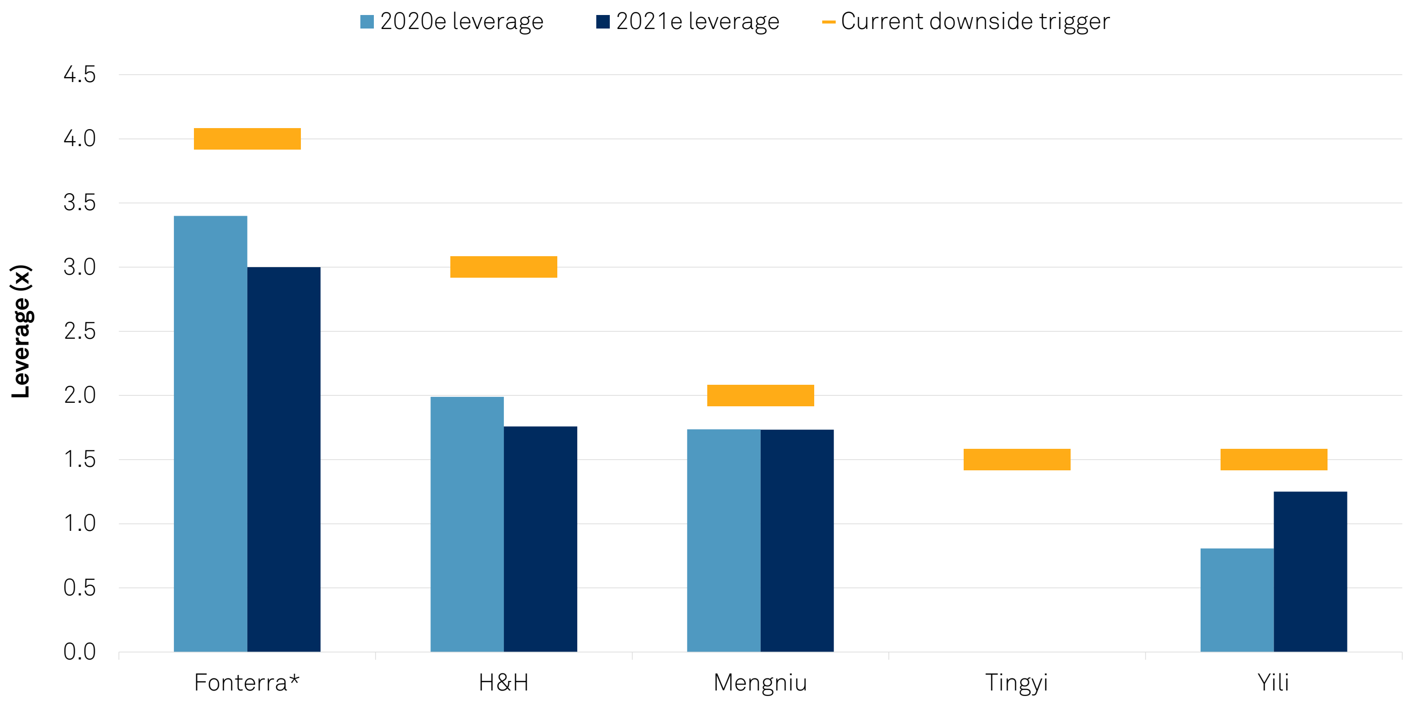


Note: 2020e is the actual number for Fonterra, as its fiscal year ends July 2020. e--Estimate.
Source: Company data. S&P Global Ratings.

Rating Buffer Over Next 12 Months

Rating Headroom Hinges On Future Capital Need And Financial Policy

Expected debt to EBITDA buffer in 2021



**Fonterra year ends July 20; we use 2020 actual leverage in the buffer comparison.*
Source: Company Data. S&P Global Ratings.

- **Enough rating buffer** for most entities. Tingyi has the largest headroom thanks to its robust cash balance and its asset-light strategy limiting capex needs.
- **Financial policies differ.** We expect increasing rating headroom for Fonterra and H&H on good EBITDA growth. Fonterra's asset divestment and deleverage plans are on track. H&H will have limited capex and M&A needs as it uses contract manufacturers and focuses on integration after buying a new pet business.
- **Narrowing or flat buffer** for Yili & Mengniu heavy capex and M&A needs could reduce headroom in 2021 & 2022, but we expect both issuers to maintain debt-to-EBITDA leverage within downgrade triggers.

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Related **Research**

Commentary:

- China Consumer Products And Retail--Opportunity Knocks, Jan. 27, 2021
- Community Buying: China's Next Big Thing, Or Cash-Draining Fad? , Jan. 19, 2021

Rating Actions:

- China Mengniu Dairy 'BBB+' Rating Affirmed, Rating Upside Updated; Outlook Stable, Jan. 29, 2021
- Inner Mongolia Yili Industrial Group Assigned 'A-' Rating With Stable Outlook; Proposed Notes Rated 'A-', Nov. 9, 2020
- Outlook On China Food Company Tingyi Revised To Positive On Strong Cash Flow; 'BBB+' Rating Affirmed, July 24, 2020

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