

30 July 2018

Consumer Cyclical | Retailing

Dairy Farm

Neutral (from Buy)

Inadequate Food To Be Healthy And Beautiful

Downgrade to NEUTRAL, from Buy with new USD9.60 TP from SGD9.66, offering 5% upside. Switch to Sheng Siong (SSG SP, BUY, TP: SGD1.27) for stable earnings growth via store count and margin expansion. Strong results from health & beauty business were diluted by losses from South-East Asia supermarket segment and weak Yonghui performance. We expect to see continued high opex in the next 12-24 months, as Dairy Farm rejigs supermarkets and invests in IT infrastructure. Potential headwinds in 2H18 include rising rental rates and depreciation of ASEAN currencies against USD.

Downgrade to NEUTRAL. Dairy Farm has a 5-year transformation plan to eventually improve market proposition, supply chain competence and omnichannel capabilities. While we are positive on long-term prospects, we expect to see opex remaining high over the next 12-24 months, as it restructures and invests in stores and IT infrastructure. Associate Yonghui Superstores should also to chart slower growth, as it invests in new digitised offline format – *Chaoji Wuzhong*, leading to start-up losses in the current gestation phase. Consensus cut Yonghui's earnings by 4-8% over FY18F-20F in the past month.

As such, we cut FY18F-20F EPS by 6-14% to reflect higher costs in the supermarket division and slower growth from Yonghui. We now expect EPS to grow at 7% CAGR over the next three years. This reduces our DCF-derived TP to USD9.60.

Prefer Sheng Siong for Singapore-listed consumer stock, which trades at 19x FY19F P/E, a discount to Dairy Farm. We think it offers a defensive investment since almost all of its income is derived from Singapore. We expect earnings growth to be stable at 10% CAGR over the next three years, driven by new store openings (six new stores YTD) and margin expansion.

1H18 results showed robust growth in health & beauty. The division registered double digit growth in sales and operating profit across most of the markets. Improved operating leverage also raised EBIT margin by 3.2pts compare to the same period last year. We expect the strong performance to continue into 2H18, with an increase in mainland Chinese tourists in Hong Kong and Macau driving the growth.

However, we note that the food division experienced higher rental and labour cost in Hong Kong in 1H18. As such, we think there could be potential cost pressures limiting further margin upside for the health & beauty segment moving into FY19F.

Tough luck for the food division. YoY, operating profit from the supermarket segment has halved, led by losses in the South-East Asian markets. Management cited these markets as having suffered a lack of investments in the past. Turning the business around would involve more time and, as we see it, more cost to come through this year.

Target Price: USD9.60
Price: USD9.15
Market Cap: USD12,377m
Bloomberg Ticker: DFI SP

Share Data

Avg Daily Turnover (USD/USD) 11.5m/11.5m
52-wk Price low/high (USD) 7.43 - 9.30
Free Float (%) 22
Shares outstanding (m) 1,352
Estimated Return 5%

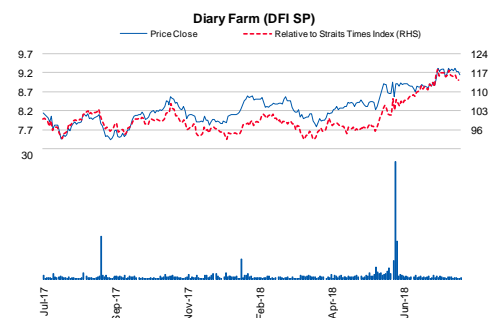
Shareholders (%)

Jardine Strategic Holdings 77.6
Franklin Resources 6.6

Share Performance (%)

	YTD	1m	3m	6m	12m
Absolute	16.4	3.4	9.1	6.5	12.4
Relative	18.6	1.1	16.1	13.2	13.2

Source: Bloomberg



Source: Bloomberg

Forecasts and Valuations	Dec-16	Dec-17	Dec-18F	Dec-19F	Dec-20F
Total turnover (USDm)	11,201	11,289	11,632	11,906	12,161
Reported net profit (USDm)	469	404	502	537	576
Recurring net profit (USDm)	469	404	502	537	576
Recurring net profit growth (%)	10.5	(14.0)	24.3	7.1	7.3
Recurring EPS (USD)	0.35	0.30	0.37	0.40	0.43
DPS (USD)	0.21	0.21	0.25	0.27	0.27
Recurring P/E (x)	26.4	30.7	24.7	23.0	21.5
P/B (x)	8.22	7.32	6.51	5.87	5.34
P/CF (x)	24.2	17.8	18.9	16.2	15.4
Dividend Yield (%)	2.3	2.3	2.7	3.0	3.0
EV/EBITDA (x)	17.3	19.4	16.3	15.4	14.3
Return on average equity (%)	32.6	25.3	27.9	26.8	26.0
Net debt to equity (%)	40.6	34.3	35.1	25.7	17.9
Our vs consensus EPS (adjusted) (%)			(2.1)	(7.4)	(5.3)

Source: Company data, RHB

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Financial Exhibits

Financial model updated on : 2018-07-27

Asia		Financial summary	Dec-16	Dec-17	Dec-18F	Dec-19F	Dec-20F
Singapore		Recurring EPS (USD)	0.35	0.30	0.37	0.40	0.43
Consumer Cyclical		EPS (USD)	0.35	0.30	0.37	0.40	0.43
Dairy Farm		DPS (USD)	0.21	0.21	0.25	0.27	0.27
Bloomberg	DFI SP	BVPS (USD)	1.11	1.25	1.41	1.56	1.71
Neutral		Weighted avg adjusted shares (m)	1,352	1,352	1,352	1,352	1,352
Valuation basis		Valuation metrics	Dec-16	Dec-17	Dec-18F	Dec-19F	Dec-20F
DCF		Recurring P/E (x)	26.4	30.7	24.7	23.0	21.5
		P/E (x)	26.4	30.7	24.7	23.0	21.5
		P/B (x)	8.22	7.32	6.51	5.87	5.34
		FCF Yield (%)	2.1	3.3	2.9	3.7	4.1
		Dividend Yield (%)	2.3	2.3	2.7	3.0	3.0
		EV/EBITDA (x)	17.3	19.4	16.3	15.4	14.3
		EV/EBIT (x)	25.3	31.1	25.0	24.5	22.9
Key drivers		Income statement (USDm)	Dec-16	Dec-17	Dec-18F	Dec-19F	Dec-20F
Revenue growth from:		Total turnover	11,201	11,289	11,632	11,906	12,161
i. More convenience stores;		Gross profit	3,386	3,433	3,583	3,715	3,843
ii. Returning Chinese tourist in Hong Kong.		EBITDA	672	589	694	715	756
Margin expansion on:		Depreciation and amortisation	(213)	(221)	(243)	(264)	(285)
i. More direct sourcing, cutting out middleman;		Operating profit	459	368	451	451	472
ii. Selling more fresh produce;		Net interest	(22)	(26)	(23)	(22)	(21)
iii. Increase penetration of corporate brands;		Income from associates & JVs	118	144	157	192	214
iv. Elimination of non-performing stores.		Pre-tax profit	555	486	585	621	664
		Taxation	(85)	(93)	(83)	(84)	(88)
		Minority interests	(1)	11	0	0	0
		Recurring net profit	469	404	502	537	576
Key risks		Cash flow (USDm)	Dec-16	Dec-17	Dec-18F	Dec-19F	Dec-20F
i. Slowdown in consumption spending and soft SSSG especially in ASEAN countries;		Change in working capital	(130)	115	37	57	57
ii. Labour cost and rental pressures.		Cash flow from operations	510	694	654	762	804
		Capex	(245)	(279)	(300)	(300)	(300)
		Cash flow from investing activities	(428)	(281)	(474)	(300)	(307)
		Dividends paid	(270)	(284)	(291)	(331)	(365)
		Cash flow from financing activities	(42)	(388)	(282)	(451)	(390)
		Cash at beginning of period	259	324	332	230	241
		Net change in cash	40	25	(103)	11	107
		Ending balance cash	298	349	230	241	348
Company Profile		Balance sheet (USDm)	Dec-16	Dec-17	Dec-18F	Dec-19F	Dec-20F
Dairy Farm is the largest retailer in Asia ex-Japan, with a strong market presence in China, Hong Kong, Taiwan, India and ASEAN. The company operates hypermarkets, supermarkets, convenience stores, pharmacies, home furnishing and restaurants- through its 50% associate Maxim's. Its brands, which are well-known, include <i>Wellcome</i> , <i>Cold Storage</i> , <i>Giant</i> , <i>Hero</i> , <i>Mannings</i> and <i>Guardian</i> . Dairy Farm is a member of the Jardine Matheson Group and is head-quartered in Hong Kong and listed on the London Stock Exchange, Bermuda and Singapore.		Total cash and equivalents	324	332	230	241	348
		Tangible fixed assets	1,100	1,184	1,220	1,235	1,231
		Intangible assets	765	815	836	857	877
		Total investments	1,462	1,601	1,854	1,950	2,056
		Total other assets	186	196	203	203	217
		Total assets	5,129	5,467	5,587	5,714	5,938
		Short-term debt	370	413	320	300	275
		Total long-term debt	595	522	600	500	500
		Other liabilities	184	177	200	200	200
		Total liabilities	3,550	3,712	3,620	3,542	3,554
		Shareholders' equity	1,505	1,690	1,901	2,107	2,318
		Minority interests	74	66	66	66	66
		Total equity	1,579	1,756	1,967	2,172	2,383
		Net debt	641	602	690	559	427
		Total liabilities & equity	5,129	5,467	5,587	5,714	5,938
Key metrics		Key metrics	Dec-16	Dec-17	Dec-18F	Dec-19F	Dec-20F
		Revenue growth (%)	0.6	0.8	3.0	2.4	2.1
		Recurrent EPS growth (%)	10.5	(14.0)	24.3	7.1	7.3
		Gross margin (%)	30.2	30.4	30.8	31.2	31.6
		Operating EBITDA margin (%)	6.0	5.2	6.0	6.0	6.2
		Net profit margin (%)	4.2	3.6	4.3	4.5	4.7
		Dividend payout ratio (%)	60.5	70.4	66.1	68.0	63.4
		Capex/sales (%)	2.2	2.5	2.6	2.5	2.5
		Interest cover (x)	21.0	14.0	19.5	20.5	22.4

Source: Company data, RHB

Growth from Yonghui slows. Associates income used to be one of the key drivers of Dairy Farm's growth. However, this year, Yonghui disappointed the market with lower earnings YoY, as it invests in new digitised offline format – *Chaoji Wuzhong*, leading to start-up losses in the current gestation phase. This resulted in the street cutting Yonghui's earnings by 4-8% over FY18-20F in the past one month. We now forecast a slower growth rate in Yonghui's contribution, as we see potential cut from consensus numbers.

New management team gives new hope. With the new leadership team, Dairy Farm has consolidated and centralised trading operations to two divisions – North Asia and South-East Asia. We believe this should lead to an increase in centralised procurement over the next five years, leading to stronger bargaining power for suppliers' rebates and higher margins.

With regional exposure, revenue from Dairy Farm's supermarket segment is 10x larger than Singapore-listed peer Sheng Siong. We believe it should be able to command greater economies of scale if it is able to execute the consolidation and centralise procurements in the long run.

Figure 1: 1H18 results summary

FYE Dec (USDm)	1H18	1H17	YoY (%)	2H17	HoH (%)	Comments
Revenue	5,928.7	5,505.3	7.7	5,638.7	5.1	Sales were up across all segments, with Health & Beauty and Home Furnishing showing double digit growth.
Gross Profit	1,802.6	1,655.8	8.9	1,737.4	3.8	
Gross Margin (%)	30.4	30.1		30.8		
Operating Profit	217.6	200.1	8.7	261.9	(16.9)	Losses from Southeast Asia supermarkets offset margin expansion from Health & Beauty.
Operating Margin (%)	3.7	3.6		4.6		
Net Profit	214.8	211.4	1.6	260.9	(17.7)	Net margin declined on higher financing costs and slower growth from associates.
Net Margin (%)	3.6	3.8		4.6		

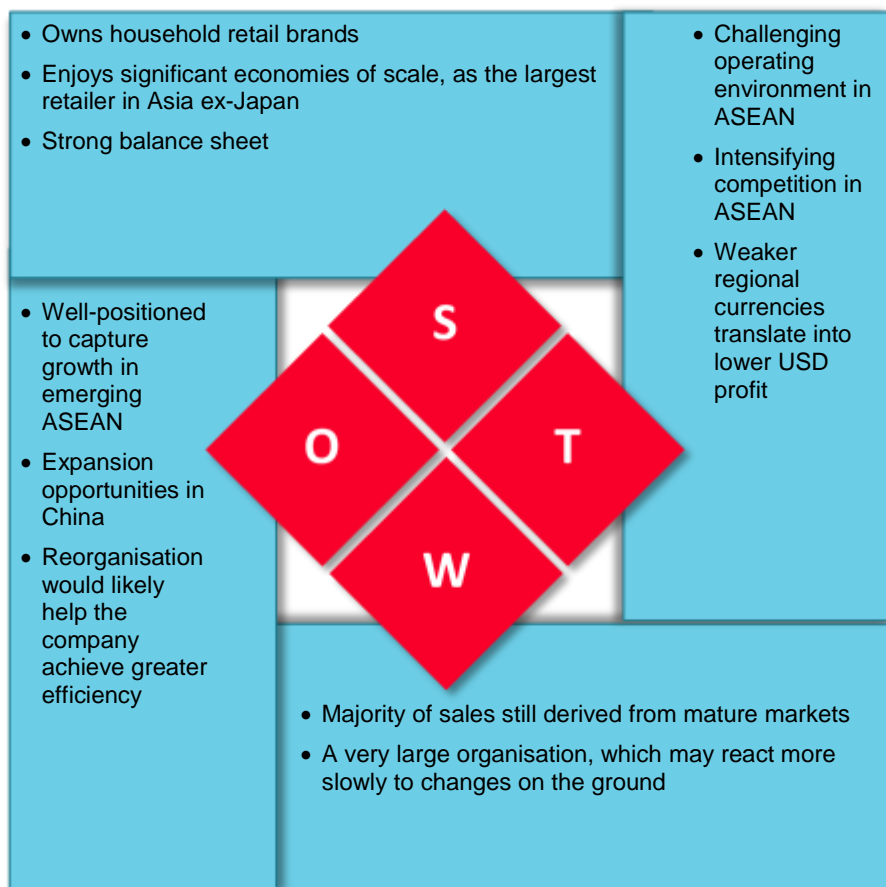
Source: Company data, RHB

Figure 2: DCF assumptions

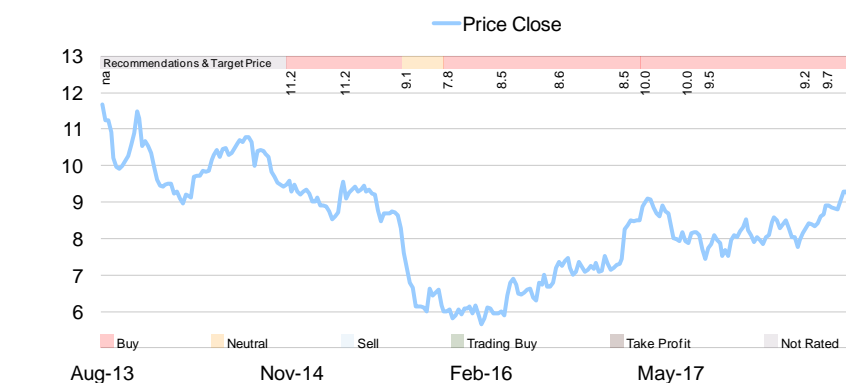
USD m	FY19F	FY20F	FY21F	FY22F	FY23F	FY24F
Net income	537.1	576.2	610.7	647.4	676.5	707.0
D&A costs	263.9	284.7	290.4	293.3	296.2	300.0
Net capex	(300.0)	(300.0)	(300.0)	(290.0)	(280.0)	(270.0)
Change in net working capital	57.2	56.8	58.5	60.2	62.0	63.9
Change in debt	(120.0)	(25.0)	0.0	0.0	0.0	0.0
Free cash flow to equity (FCFE)	438.2	592.6	659.6	710.9	754.8	800.8
Terminal value						15,635.6
Present value	406.7	510.4	527.3	527.4	519.7	10,502.8
Total discounted FCFE	12994.2					
Value/ share (USD)	9.60					
Cost of equity	7.8%					
Risk-free rate	2.8%					
Beta	0.8					
Market expected return	9.0%					
Market risk premium	6.3%					
Terminal growth	2.5%					

Source: RHB

SWOT Analysis



Recommendation Chart



Source: RHB, Bloomberg

Date	Recommendation	Target Price	Price
2018-05-21	Buy	9.7	8.8
2018-03-27	Buy	9.2	8.0
2017-08-07	Buy	9.5	7.8
2017-06-15	Buy	10.0	8.0
2017-03-05	Buy	10.0	8.5
2017-01-12	Buy	8.5	7.3
2016-08-08	Buy	8.6	6.8
2016-03-21	Buy	8.5	6.0
2015-11-12	Buy	7.8	6.1
2015-08-03	Neutral	9.1	7.9

Source: RHB, Bloomberg

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