

China

Top-Down Lowdowns

China Strategy

Pork Supply will be Hamstrung

- A pork shortage is looming over the next 6–18 months.
- Higher pork prices mean windfall profits for A-share hog farms.
- At 12x–18x peak 2020E PER, some of the good news has been discounted
- We highlight some of the beneficiaries, including poultry and overlooked companies.

A pork shortage is inevitable

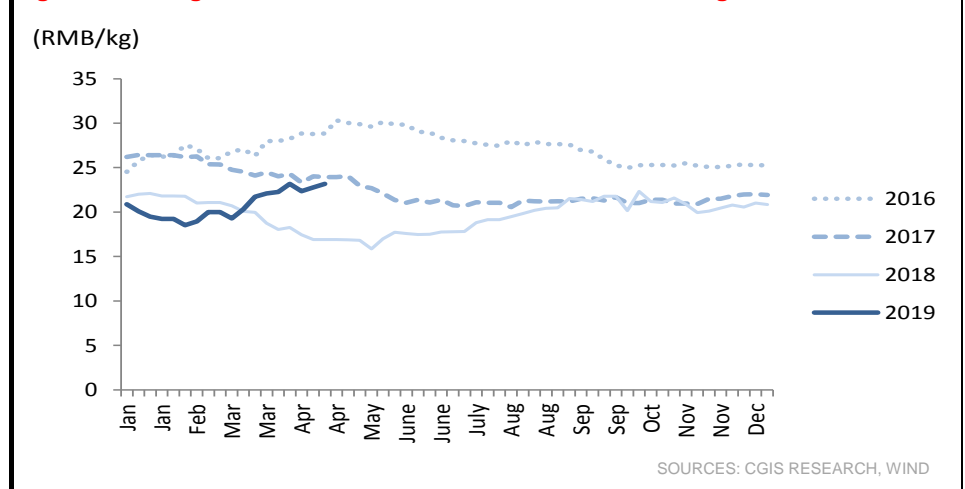
The outbreak of the African Swine Fever (ASF) will create a pork shortage that may last into 2020. More than 129 cases have been reported (with 11 new cases in April), and close to 1 million pigs have been culled. This and early slaughtering by farmers have caused a 20%+ decline in the number of breedable sows. Given four months of pregnancy and six months for a piglet to reach market size, the supply of pork should be hamstrung for 6–18 months.

Pork prices have yet to reflect the shortage

We remain bullish on pork prices for 2019–20, which have stabilised temporarily due to (i) seasonal demand weakness, (ii) culling by the farms, and (iii) destocking by slaughterhouses and cold storage facilities. They are still below previous peaks, and the lower supply should manifest itself from May on.

With China accounting for 52% of the global pork supply, we do not believe the 20%+ drop in livestock can be fully compensated by other countries. The blue-ear disease outbreak in 2006 and the milder swine flu in 2010 each caused pork prices to double. This time, the Ministry of Agriculture estimated that pork prices might increase by as much as 70% YoY in 2019H2 to RMB30/kg.

Figure 1: Average Pork Price in China, still below historical highs



Pig Stocks May Fly

The higher hog prices will produce a massive windfall for Chinese hog producers, whose share prices have risen 50%–280% YTD. They are valued at 50x–360x trailing earnings, but with the impending earnings jump, they are trading at 9x–12x peak 2020E PER. China's livestock industry is very fragmented, so government policies promoting modern animal husbandry should help the larger pig farms. Other beneficiaries include vaccine producers, animal feed companies, and perhaps downstream meat suppliers, depending on the spread of ASF and the effectiveness of government policies to contain it.

Considering the commodity nature of pig rearing and the low barriers to entry, supply will eventually catch up. The three largest hog farms account for only 5.5% of the livestock, but their combined market capitalisation exceeds **US\$55bn!** This valuation and the fact that they are also vulnerable to ASF mean investors should be selective.

Stocks that should continue to benefit from the pork shortage include Wens and COFCO Meat, while feed companies including Zhengbang and CP Pokphand may see stronger demand from 2019Q3 onwards. Chinese demand has also propelled global pork prices, with WH Group and Tyson Foods up 40% YTD and Brazil's JBS almost 70%. Chicken prices have risen to new high in China, so broiler suppliers such as Minhe and Sunner will also profit from this. Even meat substitutes such as Beyond Meat stand to benefit.

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Hog prices are still below previous peaks

Pork prices in China reached RMB19.99/kg at the end of February, a 12% increase from the June 2018 level, but they are still below levels reached in previous hog cycles (Figure 2). There are a few reasons for this: (1) the seasonal post-CNY demand slowdown, (2) aggressive culling of the livestock by farms in the afflicted districts, and (3) the drawdown of inventory in cold storage by the slaughterhouses.

African Swine Fever here to stay

Since Aug 2018, 129 outbreaks of ASF have been reported in 28 provinces, according to the Ministry of Agriculture. ASF can result in death within 10 days for pigs, according to the World Organisation for Animal Health, but it is not a risk to humans. With 11 reported cases in April, five in western China and six in Hainan Province, ASF is still a major risk. Due to these concerns, the number of breedable sows owned by the farms has dropped by almost 20% YoY.

Figure 2: Pork prices in previous cycles

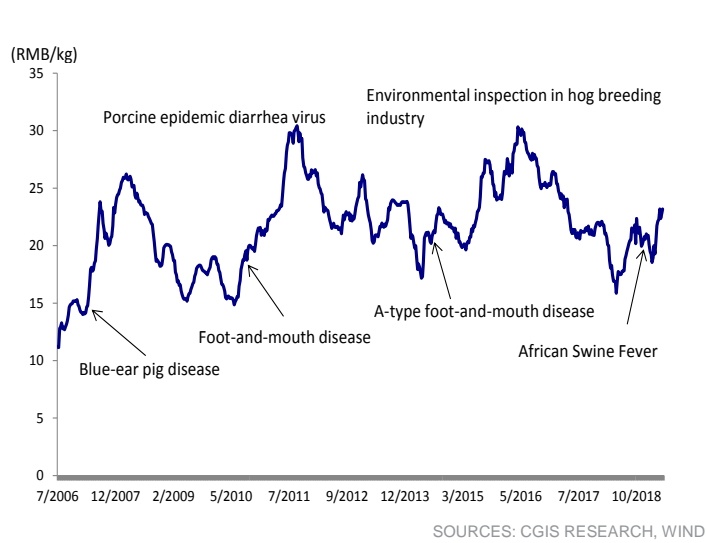
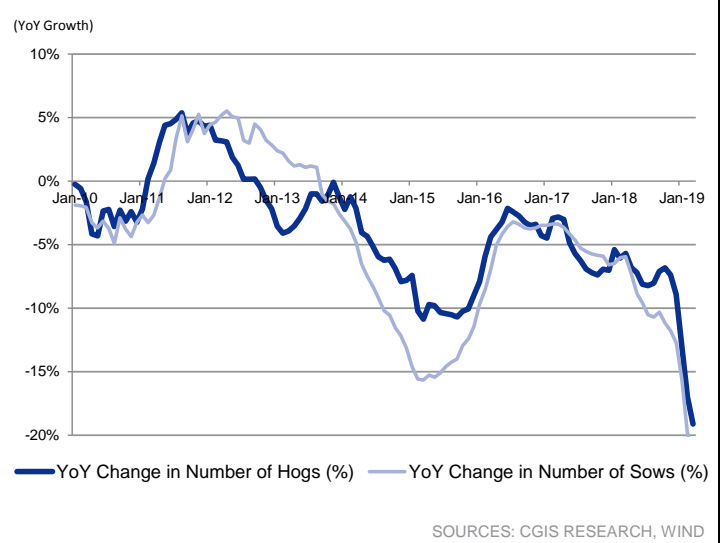


Figure 3: Inventory of Sows down significantly



The severe shortage will lead to huge price rally

The drastic decrease in breedable sows will have severe implications. It typically requires four months of pregnancy and another six months to raise a pig to market size. Hence, the drop in the number of sows will limit the pork supply in the next 12–18 months. It is easy to see how the shortfall in pork supply will persist until 2019H2 (assuming the ASF epidemic can be controlled).

Figure 4: Breakdown of global pork supply (2018)

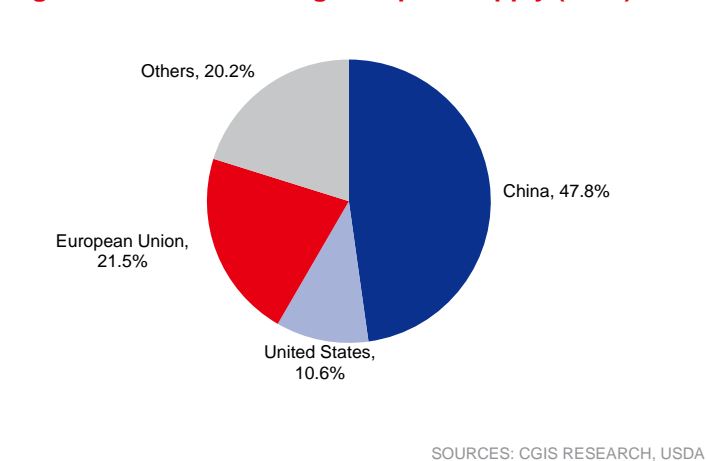
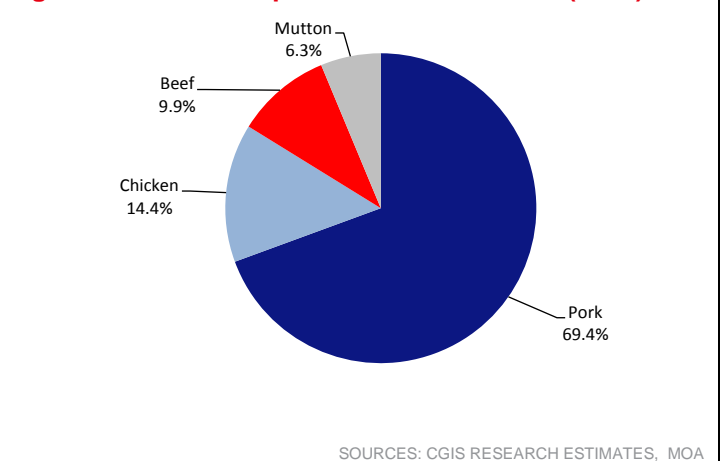


Figure 5: Sources of protein intake in China (2018)



How much pork prices will ultimately increase depends on price elasticity. In the Blue-ear disease (PRRS) outbreak in 2006 and the swine flu in 2010, the number breedable sows declined by approximately 15%YoY, yet pork prices almost doubled in the following 18 months. On this basis, a 70% YoY increase in pork price (as forecast by the Ministry of Agriculture) to the ~RMB30/kg level in 2H19 does not seem far-fetched.

Other meat prices rise in response

China is the largest pork consumer and supplier in the world. China imported 0.45 million tonnes of pork in 2017, which represented only 1% of the nation's supply. Given the scale of the deficit (pork supply may drop 20%, or 11m tonnes), China may only mitigate but not resolve the shortage by importing more pork, since the global industry is not large enough.

Nevertheless, rising pork prices will induce more imports. The anticipated higher Chinese import demand has already helped stage a jump in US pork prices. As Figure 6 shows, US lean pork prices have increased by 38%, from US\$0.55/lb to US\$0.77/lb in March.

Figure 6: US lean hog futures price

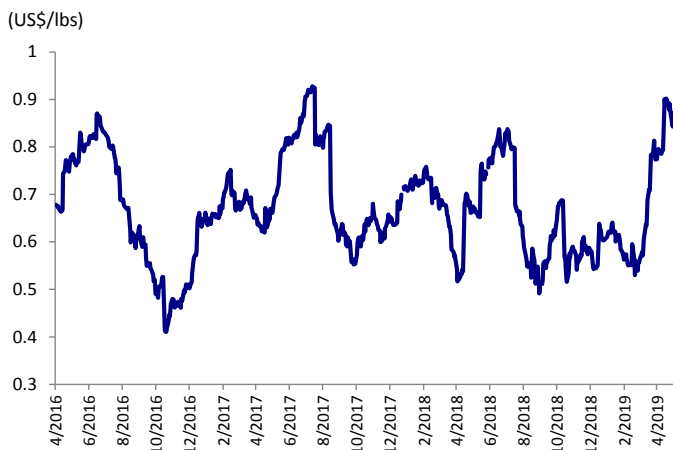
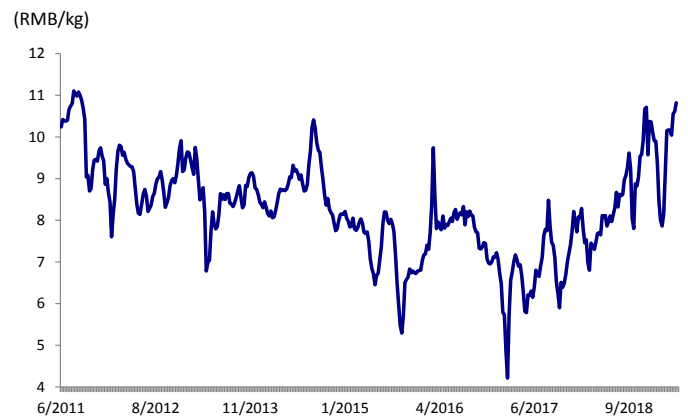


Figure 7: Average price of white broilers in major producing areas in China



Switching to other meats will not be easy either. Increasing the supply of beef and mutton is a challenge, given the scale of global husbandry and the long production time. In comparison, chicken, which is increasingly popular on rising consumption of white meat, would be a reasonable replacement – in view of its traditional role in Chinese cuisine, its price, and the potential for a quick ramp-up in production, This should reinforce the secular trend of rising consumption of white meat. The average price of broilers has recently climbed to a 15-year high (Figure 7).

Stock Implications

Pig-related stocks have rallied on the prospect of higher pork prices, with some share prices rising 50%–280% YTD. They are trading at 50x trailing PER or more, but we believe 2020E earnings to be a better indicator of peak earnings (2019E profit estimates are still affected by poor 2019 Q1 results).

On this basis, hog producers are trading at 9x–12x 2020E PER. The industry leader, Wens Foodstuffs, is a 10.6x while Muyuan Foodstuff, which is a pure play, trades at 12x 2020E PER. Any share price corrections due to profit taking activity may provide a revisit opportunity.

Considering the commodity nature of pig rearing and the low barriers to entry, supply will eventually catch up. The three largest hog farms accounted for only 5.5% of the livestock, but their combined market capitalisation exceeds US\$55bn! This valuation and the fact that they are also vulnerable to ASF mean investors should be selective.

We have listed some of the hog farmers and other companies which may be affected by the higher pork prices in Figure 8. Stocks that should continue to benefit from the pork shortage include Wens and COFCO Meat, while other related plays such as feed companies including Zhengbang and CP Pokphand may see stronger demand from 2019Q3 onwards.

We also believe Chinese consumers will likely look for other sources of protein. Global pork prices also have rocketed, partly in anticipation of Chinese import demand. WH Group Tyson Foods are up 40% YTD and Brazil's JBS almost 70%. Chicken prices have risen to a 15 year high in China, so broiler suppliers such as Minhe and Sunner will also profit from this. Even meat substitutes such as Beyond Meat stand to benefit.

Wens Foodstuffs (300498.CH) is the largest pig farm in China, selling more than 22.3m hogs in 2018. The Company also manufactures and markets cooked meat and frozen meat. In 2018, the hog farming business represented 60% of total revenue, with the rest coming from the poultry segment (selling more than 748m chickens). Wens made a profit of RMB4.0bn in 2018, with most of this coming from poultry production.

Muyuan Foodstuffs (002714.CH) is the second largest pig farmer in China, and also sells breed stock, piglets and animal feed products. The Company is investing heavily in raising capacity, and sales this year should increase 20%+ on 2018's 11.1m hogs.

Zhengbang Tech (002157.CH) produces animal feed (livestock and poultry), which accounted for over 50% of revenue last year and profit of RMB200–250m. Hog raising accounted for 35% of revenue last year. Despite output of 5.5m hogs last year, this business was loss-making in 2018.

COFCO Meat (1610.HK) is the fourth largest hog farmer in China. With sales volume of 2.5m hogs last year, hog production accounted for RMB3bn in revenue. This should increase substantially in 2019 and 2020. COFCO Meat is also a large fresh meat seller (approx. RMB3bn in revenue) and a large meat importer.

Tech-Bank Food (002124.CH) produced 2.2m hogs in 2018, up 114%YoY. Hog raising accounted for 60% of its revenue. Its other businesses include aquatic feed (30% of revenue), food, engineering construction, and other services.

Tangrenshen (002567.CH) engages in pig farming and meat processing. The Company also develops, produces and sells feed products. Tangrenshen's main products include feed products, raw meat, meat, and animal health products. In 1H18, hog farming represented only 3.7% of its total revenue. Feed products accounted for 92.2% of its total revenue.

Tecon Biology (002100.CH) manufactures and sells animal feeds, feed additives, and agricultural and livestock products in China. In 1H18, its hog farming business represented only 5.5% of its total revenue. Feed products accounted for 50.6% of total revenue.

WH Group (288.HK)'s total hog production was 20.9m in 2018, although most of this was in the US. It is primarily a downstream producer, with packaged meats accounting for over 50% of the revenue and 90% of the operating profit. The US subsidiary, Smithfield, accounted for 59% of revenue, and 73%-owned Shuanghui Development accounted for 33% of revenue last year.

Figure 8: Valuation (as of noon May 6, 2019)

Companies	Ticker	Mkt cap (US\$m)	Price (LC)	52 weeks		PER (x)			P/B (x)		Price Performance		
				high (LC)	low (LC)	2018	2019E	2020E	2018	2019E	WTD	QTD	YTD
Hog Production Companies													
Wens Foodstuffs Group Co Ltd	300498 ch	30,001	38.29	45.55	19.92	51.0	21.7	10.6	5.9	4.8	-7%	-6%	46%
Muyuan Foodstuff Co Ltd	002714 ch	18,641	60.62	74.45	20.40	356.6	31.5	12.0	12.9	7.9	-5%	-4%	111%
Jiangxi Zhengbang Technology C	002157 ch	7,029	20.10	24.67	3.44	251.3	24.4	9.0	7.1	6.1	-10%	23%	279%
Tech-Bank Food Co Ltd	002124 ch	3,102	18.14	23.47	3.74	n.a.	30.9	10.3	6.8	6.6	-10%	4%	167%
Tangrenshen Group Co Ltd	002567 ch	1,849	14.99	18.82	4.18	78.1	27.1	10.0	3.7	3.3	-10%	14%	164%
Other Hog-related Companies													
New Hope Liuhe Co Ltd	000876 ch	10,495	16.88	18.25	5.59	42.2	22.6	13.1	3.2	2.9	-2%	27%	132%
Henan Shuanghui Investment & D	000895 ch	12,637	25.97	29.89	21.00	17.4	16.4	15.4	6.6	5.8	-7%	0%	10%
Tecon Biology Co Ltd	002100 ch	1,364	9.60	12.82	3.65	27.9	17.3	9.3	2.9	2.5	-5%	6%	129%
Poultry-related Companies													
Shandong Yisheng Livestock & P	002458 ch	2,168	25.63	32.22	7.12	41.3	14.4	17.2	9.7	5.8	-4%	24%	204%
Shandong Minhe Animal Husbandr	002234 ch	1,679	37.69	43.00	9.62	34.8	15.2	19.6	10.2	6.1	-4%	47%	229%
Shandong Xiantan Co Ltd	002746 ch	1,290	28.30	32.31	10.27	22.9	12.4	10.8	3.6	2.9	-3%	22%	107%
Fujian Sunner Development Co L	002299 ch	4,670	25.55	35.73	13.56	23.4	11.6	11.0	4.1	3.2	-3%	3%	54%
H-shares and overseas													
WH Group Ltd	288 hk	15,499	8.28	9.95	5.11	16.4	12.4	11.1	2.0	1.7	-9%	-1%	37%
COFCO Meat Holdings Ltd	1610 hk	1,562	3.14	3.54	1.05	n.a.	14.5	6.7	2.3	1.9	-7%	10%	117%
CP Pokphand Co Ltd	43 hk	2,025	0.66	0.82	0.59	7.6	8.4	8.4	1.5	1.1	-3%	-7%	-1%
DaChan Food Asia Ltd	3999 hk	54	0.42	0.64	0.33	35.8	n.a.	n.a.	n.a.	n.a.	-1%	1%	5%
Tyson Foods Inc	TSN US	28,109	77.05	77.47	49.77	9.3	12.9	12.0	2.2	2.0	3%	11%	44%
Beyond Meat Inc	BYND US	4,469	74.79	74.84	45.00	-15.7	n.a.	n.a.	-4.3	n.a.	12%	n.a.	n.a.

SOURCES: CGIS RESEARCH, BLOOMBERG

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