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Feihe: Tainted Future Of A Cashless Cow

Sep. 5, 2012 5:18 PM ET
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While the international infant formula brands continue to take market share from the domestic players during the Dragon Baby Boom, Feihe International Inc. (NYSE:ADY) has been losing market share to both international and domestic dairy companies in China, as we will show. After the tainted milk incidents in China, dairy upstream (i.e. dairy farming) ownership and management has become crucial for domestic dairy companies' survival.

Unfortunately, ADY's dire financial situation has forced ADY to jettison its dairy farms after serious upstream mismanagement that resulted in heavy operating losses. Its inability to compete in China's dairy market and its imminent financial implosion raise substantial doubt about ADY's ability to continue as a going concern. Our valuation analysis reached a price target for ADY of $1.75, which is 71.4% lower from its Friday closing price of $6.11, and 21.2% lower from its 52-week low of $2.22 from earlier in the year.

Summary

- **ADY is losing market share in its core powdered milk business**. In the rapidly growing China powdered milk market, ADY's first six-month 2012 milk powder volume sales actually decreased by 458,000Kg YoY to 9.9 million Kg from 10.4 million Kg, losing market shares to its competition.

- **Heavy marketing cannot save its out-dated business model.** ADY cannot boost sales growth even after sharply increasing its marketing expenses in 2Q12 by 25.7% YoY, or $5.1 million, to $25.0 million from $19.9 million, clearly reflecting ADY's difficulty in selling its high-end products in a competitive market.

- **ADY's sustainable earnings are much lower** when adjustments are made to measure its pure operating performance. For example, when normalized for government subsidies, ADY's 2Q12 adjusted net income shows a decrease of 55.4% YoY (versus company's reported 11.5% increase in net income.)

- **Upstream ownership and management represents the new paradigm shift** in China's modern dairy industry that has been forced to become increasingly quality driven. US private equity firm KKR's $150 million investment in Chinese dairy farms and China's Big3 dairy company Mengniu Dairy's recent talks in acquiring China's largest raw milk producer China Modern Dairy Holdings (a pure play dairy farm company) are just two examples highlighting China dairy market's urgent push to secure quality raw milk supply. ADY's inability to compete and manage effectively in this key area has led to ADY selling its dairy cow farms which are considered a long-term strategic core competence for most domestic Chinese dairy companies - detrimental to ADY's future in our opinion.

- **To avoid working capital deficiency ADY was forced to sell valuable assets**including the strategically important dairy farms. Successive missteps in strategic and investment decisions by management have drained the company's cash position to a scant $2.6 million by 2Q12. It now has $52.6 million of near-term obligations due, including $46.7 million of short-term bank loans that mature between August 30, 2012 and December 31, 2012.

- **If ADY cannot "milk" growth even in the Year of the Dragon**, then next year the Year of the Snake will certainly bite ADY's bottom line deeply. We expect ADY to experience negative revenue growth and significant operating losses as infant formula sales begin to "normalize*"* in 2013*.*

- **Three different auditors in less than two years**, CFO and VP Finance both unqualified for US GAAP, and self-admitted material weakness in its internal control over financial reporting expose investors to high financial accounting risk. Last week's announcement of resignation of an ADY's board member is just another sign of ADY's unstable corporate governance.

- **Recurring management misguidance** has repeatedly entrapped investors and have befallen even some of the top institutional investors in past years.

- **We expect negative top line and bottom line growth and significant cash flow problem** for ADY starting in 2013 if not sooner as ADY faces heavy financial burden and core structural challenges ahead. Our comparative valuation analysis reached a price target for ADY of $1.75, or 71.4% lower from Friday's closing price of $6.11, and 21.2% lower from its 52-week low of $2.22 from earlier in the year.

Losing Market Share Despite Heavy Marketing Push

The international dairy companies - Wyeth, Dumex, Mead Johnson (NYSE:MJN), Nestle (OTCPK:NSRGY), etc. - have the dominant position in China and are growing sales and expanding market share rapidly in China during the Dragon Baby Boom year. Many domestic powered milk players also benefited from the boom and saw increase in sales.

For example, Synutra's (NASDAQ:SYUT) powdered formula revenues increased 26% YoY for the 3-month ended June 30, 2012, comprised of 12% increase in volume sales and 12% increase in pricing during the quarter.

While the overall China infant formula market has been expanding rapidly in the Dragon Baby Boom year, ADY's 2Q12 top line was flat both YoY and QoQ. More important to note is that ADY has been losing market share to competition in its core product group: milk power, which represents over 95% of its total sales. ADY's 1H12 (2Q12) milk powder sales volume actually decreased YoY by 458,000Kg (134,000Kg) to 9.9 (5.3) million Kg. This drop in the company's product sales volume in a rapidly growing milk powder market in China during the Year of the Dragon indicates to us that ADY is losing market share in its core product segment. Furthermore, ADY's sales and marketing increased sharply by $5.1 million or 25.7% YoY to $25.0 million from $19.9 million and resulted in only a flat 0.8% sales growth in 2Q12, which clearly reflects ADY's difficulty in selling its high-end products in a competitive market.

ADY Has Unbelievable Gross Margins ~2,000 b.p. Above Its "Identical Twin"

The international dairy companies have been raising prices that can be meaningfully passed through to their bottom line. However, the domestic companies are having a difficult time in either category. For example, Synutra , which is very similar to ADY in terms of size and market share but has a slightly better brand name, has seen a sharp decrease in the gross margins of its powdered formula business in its calendar 2Q12 period to 37% (contrasting SYUT's lofty 55.7% 2Q12 reported gross margins - even including ADY's low-end products.) ADY has a whopping unbelievable gross margins that's almost 2,000 basis points above its "identical twin" in a competitive market place! Accounting wise, SYUT did the right thing by placing its marketing promotion costs in the COGS. SYUT has clearly stated in its earnings release that "The decrease in powdered formula margins reflected increased free products…"

It is also interesting to note that right before ADY dismissed its Big 4 auditing firm Deloitte and hired a smaller auditor in the last few days of December 2011, ADY's gross margins have been falling to 35.5% (4Q11) and 36.4% (3Q11) from 47.0% (2Q11). Then, all of a sudden ADY's gross margins surged to 54.0% and 55.7% in 1Q12 and 2Q12. This is even more unbelievable in the macro-context that its comparable domestic peers are experiencing declines in gross margins as only the international dairy formula companies have the real pricing power in China.

No Sustainable Earnings Power

In 2Q12 ADY boasted its increased earnings. But, once we adjust its earnings for real operating performance it is clear that its real operating results and profitability are very bleak. To more effectively gauge a company's long-term competitiveness and profit potential, we took out exogenous factors like government subsidies which are political vagary of the moment and are not sustainable and stable in the long run especially as bigger dairy players enter Heilongjiang province competing for the same government subsidy pie. When earnings are normalized by taking out government subsidies from both 2Q12 ($4.64 million) and 2Q11($2.47 million), ADY's 2Q12 adjusted net income shows an actual decrease of 55.4% YoY contrasting the company's reported net income of a 11.5% increase. And ADY's normalized EPS dropped 55.6% from $0.14 in 2Q11 to $0.06 in 2Q12 (vs its reported $0.29 EPS.)

Weak Financial Control and Questionable Gross Margins

ADY has had a long history of frequent financial statement reporting delays and financial accounting restatements, especially relating to the categorization of costs and expenses. Both its CFO and VP Finance are not qualified for US GAAP accounting. ADY has had changed many auditors in the past, including having three different auditors just in the last two years.

Now let's examine why ADY's reported financials show a sharp increase in gross margins on top of an already unbelievable above-industry gross margin. When looking at ADY's 2Q12 reported earnings, most investors would find it odd to see no YoY increase in ADY's operating income despite more than $2 million of extra government subsidy income padding (as shown above) and the company's claim of a sharp increase in gross margins. In China, marketing promotions comprised of product giveaways are used widely whenever domestic dairy companies want a quick spike in sales and as a disguised form of price cutting.

These promotions can be as "buy X number of products and give away an" identical or different dairy product. These promotion items represent real manufacturing costs or product purchase costs to the company and should be properly recognized as costs in COGS, not as expenses buried among the operating expenses below the gross profit line in the income statement. Coincidentally, ADY's reported 2Q12 marketing promotion expenses surged by 100% YoY to $10.6 million from $5.3 million. If ADY mis-categorized its COGS and operating expenses, which it has done so many times in the past, then it would need to restate its financial statements, which it was also forced to do so many times in the past.

Poor Management Decisions and Executions Have Depleted ADY's Cash Resources

After repeated failed attempts to elevate itself from its second-tier dairy company status in China, ADY is now in a dire financial position. After ADY RTO'd to become a US public company several years ago, it raised over $100 million in several rounds of PIPE financing in an attempt to grow into a national player - so the story goes. However, it has been rocky road for ADY as it has failed on many crucial initiatives that it had attempted. For example, because it didn't have a national brand name and distribution, it tried to partner with a supposedly Australian dairy brand to break into China's big cities. The partnership failed as the Australian dairy company was exposed by China's media including CCTV of falsely labeling its infant formula products as imported while it's really a domestic dairy company.

Then ADY spent heavy marketing and infrastructure dollars, including on its highly boasted dairy farms, which in its own marketing campaign has been promoted as a state-of-the-art centerpiece of quality that will differentiate itself from its peers. However, in 2011, after years of heavy investing and promoting the dairy farms, ADY did the unthinkable of selling a crown jewel after experiencing significant operating losses in this segment. Major management missteps over the years have caused ADY to lose its long-term competitiveness and resulted in today's financial dire situation, with a cash position of a scant $2.6 million by 2Q12.

Throw the Baby Out, and Keep the Bathwater

While the international infant formula brands like Wyeth, Dumex, Mead Johnson, Nestle are flying off the shelves especially in first tier cities like Shanghai, Beijing, Guangzhou, and Shenzhen, domestic Chinese infant formula brands are slow-moving. After repeated cases of tainted milk problems in China, especially with baby formulas, where tens of thousands of Chinese babies become sick and some have died, the Chinese consumers now have no more trust in domestic dairy companies, especially in the infant formula sector.

Consequently, for the domestic Chinese diary companies to grow and to survive they have to show with real substance to the consumers and the regulatory bodies that their product quality control is really under control. Thus, successfully owning, building, and managing one's upstream supply operation is a cornerstone for any domestic dairy company in order to bring back consumer confidence. By not being able to own and manage and consequently had to sell its dairy farms, ADY in our opinion has in essence thrown away a crucial core business component that it needs to compete effectively in the rapidly changing China dairy market.

- **Upstream Dominance: the New Industry Trend**

In the last decade, "capture market share" was a ruthless priority for the Chinese domestic dairy players and they spent heavily on marketing and cut deeply on pricing. At one point, the price of branded milk products in cities like Shanghai was actually cheaper than that of the average bottled water. However, what's dark and insidious brewing underneath was a major degradation of product quality and weakened upstream management. Most major domestic dairy players did not own or had significant ownership in dairy farm operations and mostly "outsourced" the raw material to entities including the local milk collection stations.

Additives like melamine were often added at the collection station level and some directly by the individual cow farmers, who are mostly poor peasants that raise on average 4-5 dairy cows on the side to generate additional family income. They tend to feed their cattle the low-nutrition bare minimum and often leave their cows to roam freely and often exposing their cows to polluted water from nearby factories and pesticides from nearby farmlands. Because of these numerous upstream problems, the only fundamental way for the domestic dairy companies to really guarantee dairy quality is by owning and operating the dairy farms themselves, which naturally will create a fully-integrated upstream and downstream business model.

- **Major Upstream Initiatives by Major Dairy Players and Private Equity Firms**

Realizing this major industry trend, KKR (Kohlberg Kravis Roberts) invested $150 million in cow farm joint ventures in China. All Big3 domestic dairy players and many regional and local players including ADY have all jumped into the upstream build out. However, running the upstream is expensive and not easy, requiring deep operational expertise and experience. As such, dairy companies with successful upstream operations have been very attractive acquisition candidates - almost regardless of company size or geographic markets. For example, a local company in the 3rd/4th tiers market of Anhui province called Yiyi Dairy was acquired by a domestic national company, Beingmate, mainly because it has an attractive integrated dairy business with a well-run dairy farming operation. But perhaps the biggest acquisition targeting the dairy upstream was Mengniu's recent acquisition talks of acquiring China's largest raw milk producer China Modern Dairy Holdings, which is a pure play dairy farming company.

- **Regulations, Urbanization, Rising Cost Accelerate Upstream Paradigm Shift**

In response to the heavy media coverage and people's outcry from the tragic tainted milk baby deaths, China has enacted new laws setting timetable that would require domestic dairy companies to have direct control over substantial production of the raw milk that are used for downstream processing. Urbanization is a megatrend in China reflecting poor farmers improving their standard of living by moving into the urban cities**.** While urbanization is great for China's farmers, it has been creating supply disruptions for dairy companies like ADY that rely primarily on collection stations which in turn is dependent mostly on individual peasants who allow their dairy cows to assemble at the collection stations (either village or corporate owned) for daily milking. To make matters worse, due to the combining factors of rising cost of livestock feed and the suppressed prices of raw milk (mainly due to consumers shunning away from buying domestic Chinese dairy brands) many peasants had no choice but to slaughter their dairy cows and sell the meat and stop raising dairy cattle.

"Reverse Hockey-Stick Effect" in 2013

In 2011, most people expected some "hockey-stick" effect in 2012- the Year of the Dragon for the dairy players in China. The hospitals in China are flooded with pregnant women many of whom have planned a year in advance to give birth to a "Dragon baby". Chinese media have shown scenes of pregnant woman lying in bed in the hallways outside the delivery rooms of maternity units due to the overcrowding. One would expect this once every 12 year phenomenon would have catapulted ADY's business in 2012 especially its top line. Not the case here - ADY's 2Q12 top line growth was flat both YoY and QoQ, recording sales of $63.38 million, versus $62.87 million from the same period last year and $62.94 million from the previous quarter.

As baby formula sales begin to normalize in 2013 we expect ADY's sales to drop significantly, experiencing a "reverse hockey-stick effect" towards mid-2013. While companies with strong upstream operations will be able to demonstrate their product quality control and be able to continue enjoy reasonable growth, ADY will likely spiral down a slippery road as its outdated milk-collection-station business model will be retired within the industry and spurned by the Chinese consumers.

Siren's Calling - Not Even Renowned Money Managers Can Resist

We have seen many savvy investors over the years have been allured to ADY's glorified potential and overpromised financial guidances. The temptation was hard to resist given the strong macro-economic and industry trends of rising middle class, one-child policy, vertical-integration, and so forth. On July 13, 2009 ADY announced its management"…

provided guidance for full year 2009 revenues of $330-$360 million, representing an annual growth rate of approximately 80% from 2008." Then within a month On August 12, 2009, the world renowned VC/PE firm Sequoia invested $63 million in ADY. However, on November 16, 2009, ADY announced it readjusted its guidance, "… company now anticipates that revenue for the full year 2009 will be between $270 million to $290 million, which represents year over year growth of 40% to 50%."

Subsequently, ADY's shares went on a negative 45 degree slide over the next year and a half dropping from about $30 to the single digits. This "over-promise and under-deliver" story has played out many times over the past years and have fooled institutional investors including well-known multi-billion dollar hedge funds, PE, and mutual funds alike. Once again, this time ADY's management would like you to believe that despite its dire business and financial situation, there is still light at the end of the tunnel. They may be right this time: the headlight of a financial train wreck.

Share Fair Value: $1.75 Based on Negative Short-term and Long-term Outlooks

We believe ADY's current rich valuation has not reflected the company's bleak long-term prospects and imminent dire financial situation. We expect ADY to exhibit negative top and bottom line growth starting in 2013 with increasing financial burden that would raise substantial doubt about ADY's ability to continue as a going concern. Due to the negative forecast EPS we cannot make good use of the P/E ratio and instead will use P/S ratio for comparative valuation analysis.

Since it's hard to find no-growth among the top dairy players in China, let's use public comparables from the mature US diary market. Dean Foods (NYSE:DF), the US traded dairy company, with relatively stable revenue and cash flow (revenues for 2011, 2010, 2009 were $13.1 B, $12.1B, and $11.1B, respectively) and market capitalization of $3.0 billion, indicating a P/S multiple of 0.23X. Considering ADY's deteriorating fundamentals and numerous risks associated with material weakness in its internal control over financial reporting and being an RTO company, we will use a P/S multiple of 0.15X.

If one assumes ADY can maintain 2012's current run rate of $253 million in annual sales in 2013, then one would reach a market value of $38 million by applying the 0.15X P/S multiple. With 19.7 million shares outstanding, one would arrive at a fair market per share price of $1.92. But we forecast ADY's sales is likely to decline in 2013 to below $230 million, which by applying the 0.15X P/S multiple arrived at a per share price of $1.75, representing a 71.4% decrease from the current price of $6.11.

M&A and liquidations considerations. ADY is not an attractive acquisition candidate in China. As we mentioned earlier, it is the dairy companies with successful upstream operations that are heavily pursued in the market place. We have already mentioned Yiyi Dairy in the 3rd/4th tier market being acquired. Good 2nd tier candidates include Jiabao Dairy of Jinan, and 1st tier candidates include Sanyuan Dairy of the Greater Beijing market, both of which have good local customer loyalty and solid upstream operations to guarantee supply quality. In a liquidation scenario, not only is ADY cash strapped and in heavy debt, the replacement value of its assets is likely to be much less than its book value, including the PPE's. That's a key reason why even ADY's friendly local bankers would require their $111 million loan facility due November 23, 2012 to be secured by a personal guarantee of Mr. Leng Youbin, ADY's chairman.

While Synutra, which is based in Qingdao, Shandong province, can enjoy a healthy valuation on its real estate, most of ADY's plants are in "no man's land", so scarcely populated by people that the local government is willing to grant generous incentives for companies that would build new plants and factories there - including free land and monetary subsidies. Thus, while the cost to enter Heilongjiang is low, the incentives to build new plants (vs buy old) is high. In fact, Big 3 domestic dairy players like Inner Mongolia Yili Dairy and the international dairy giant Nestle SA already have plants in ADY's core production base of Heilongjiang province.

In conclusion, while the China diary industry as a whole is expanding rapidly and investing heavily into the dairy upstream, ADY has been moving backwards and giving up its ability to contend as a legitimate dairy player with a fully-integrated and quality assured production process. Unable to compete in the free market, ADY now resorts to government subsidies to buttress its earnings and increasing reliance on bank debts to keep it on life support.

Disclosure: I am short ADY. I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it. I have no business relationship with any company whose stock is mentioned in this article.