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Stock Research Report

Tsingtao Brewery Company Limited

OTC Ticker Symbol: TSGTY.PK **Report Date: November 14, 2004**

COMPANY OVERVIEW

Founded in 1903 by German settlers, Tsingtao Brewery Company Limited (Tsingtao) is the largest beer company in China. The Tsingtao brand today is sold in more than 40 countries worldwide and accounts for more than 50 percent of China's total beer exports. Located in the eastern city of Qingdao, Tsingtao has grown from 4 breweries in 1996 to 48 today.

A former state-run operation known as Qingdao Beer Plant, Tsingtao was established on June 16, 1993. On July 15, 1993, the company issued H shares on the Hong Kong Stock Exchange, and later, on August 27, 1993, it was listed on the Shanghai Stock Exchange. It is traded on the over-the-counter (OTC) market in the U.S. under the symbol TSGTY. The Chinese government owns more than 30 percent of the company. St. Louis-based Anheuser-Busch, the world's largest beer company currently has a 9.9 percent stake in Tsingtao with an agreement to increase ownership to 27 percent over the next few years.

REPORT SUMMARY

Factors which we believe will play significant roles in the company's performance are highlighted below.

Positive Factors

- Still room for further growth in China's beer market
- Segmented markets provide broad opportunities for M&A
- Strategic alliance with Anheuser-Busch boosts Tsingtao's market leader position
- Brand recognition gives Tsingtao competitive advantage
- Revenue and income continue healthy growth

Risk Factors

- Rising energy and raw material costs may squeeze Tsingtao's profit margin
- Foreign entries level playing field
- Tsingtao's brand could be compromised
- Policymakers' tightening bias a wildcard

Valuation

Our DFCF Model forecasts a 1-year target price of $9.50.

POSITIVE FACTORS

Still Room for Further Growth in China's Beer Market

Twenty years ago, beer consumption was not common among the Chinese, who stuck with traditional alcoholic drinks like distilled spirits and rice wine. In 1986, China's Department of Light Industry announced that there would be a significant change in the national development plan for the alcoholic beverage industry. Essentially, the development of the industry must follow the "Four Shifts" rule, i.e., shifts from spirits with high-percent alcohol content to low-percent; distilled liquor to fermented alcoholic beverages; grain and cereals alcoholic liquor to fruit wine; and from common-grade to high-grade. At the same time, China was beginning to shift from a state-run economy to a modern market economy as Beijing unfolded plans for massive and wide-ranging economic reforms.

In the early to mid-1990s, beer consumption in the country rose to an estimated six to seven liters per capita annually. With a continued rise in affluence, beer consumption in the country of a now 1.3 billion population has already tripled to approximately 19 liters per person and will continue to expand in the next decade. Separately, older people (the majority spirit drinkers in China) are drinking less traditional spirits, replacing these with beer due to its lower alcohol levels, thus reducing health risks associated with the consumption of traditional spirits.

As the Chinese economy continues to grow, people will have increasingly more spending power. Despite the recent October 29 rate hike, we believe China's GDP is on track to grow at around 9 percent, quite possibly reaching 9.5 percent. Based on the current CPI, it is possible there will be further rate hikes, but we do not expect the tightening pace to be severe. Accordingly, with sustained economic growth and continued rise in living standards, Chinese beer consumption is expected to grow at 12 percent in 2004.

Notably, China has surpassed the U.S. as both the world's largest consumer and producer of beer. But with a per capita consumption rate far behind other industrilized countries (19 liters compared to 29 liters in Hong Kong, 42 liters in Japan, 44.5 liters in South

Korea, 75 liters in Europe, and 84 liters in the U.S.), we see the market as having much room for development.

Segmented Markets Provide Further Opportunities for M&A

As the world's biggest beer producer, China has about 600 breweries with 1,500 brands. The four leading Chinese beer companies are Tsingtao, China Resources Breweries (CRB), Yanjing Brewery, and Harbin Brewery. The beer industry in China is characterized by regional brands. In 2003, the top four beermakers' total market share in terms of beer production was only 36.2 percent. Local breweries often monopolize a given region, but have minimal exposure in regions outside their home. For example, Zhujiang Beer occupies about 60 percent of the Guangzhou market, while its market share elsewhere is less than one percent.

However, this situation is slowly changing with the recent rash of M&A activities in the industry. For example, Yanjing, the only leading Chinese brewery without foreign investment, bought 38 percent of Huiquan Beer, a large listed Chinese brewer in July this year. In 2003, the top 10 Chinese brewers occupy 54 percent of the domestic market share, an 11 percentage points jump from 2002. Meanwhile, faced with matured markets at home and lured by China's beer drinking potential, the world's top brewing groups have been busy competing to quench the Chinese thirst. Just as Warren Buffet once dreamt of a billion Chinese drinking a Coke a day, foreign beer CEOs are likely frothing at the thought of hundreds of millions of Chinese gulping down tons of beer.

London-based SABMiller, maker of Miller Lite, holds a 49 percent stake in CRB. In September, CRB acquired the China brewery assets of Australian company, Lion Nathan. Earlier this summer, SABMiller lost a bidding war for Harbin Brewery, China's fourth-largest brewery, to rival Anheuser-Busch. Also in September, the world's fifth largest brewery, Denmark's Carlsberg acquired 34.5 percent of Wusu Brewery in Xinjiang Province, its fifth acquisition in China in 2004, completing its strategic layout in western China. In November, British beermaker, Scottish & Newcastle, the world's sixth largest brewer, completed its purchase of Chongqing Brewery, becoming its second biggest shareholder with a 19.51 percent stake of its total equity.

The entry of foreign companies brought in famous international brands, much-needed foreign investment, and advanced production technology and management models, while their domestic partners provide low production cost, extensive distribution channels, and local insights. 2004 marks the third year since China's entry into the WTO; thus over the next two years, it will need to eliminate non-tariff barriers such as quota and import/export licenses, and lift the limits on foreign companies' sales areas, quantity, and ownership. So going forward, we can expect the frenzy of local M&A activities and Sino-foreign partnerships to continue. Clearly, the trend is towards the consolidation of the industry into the control of a handful of major companies. As the largest player, we believe Tsingtao is well-positioned to capitalize on the industry's M&A trend.

Strategic Alliance With Anheuser-Busch Boosts Tsingtao's Market Leader Position

In October 2002, Tsingtao signed a strategic alliance agreement with Anheuser-Busch. According to the agreement, Tsingtao will issue $182 million convertible bonds to Anheuser-Busch, which will convert the bonds into Tsingtao stocks in three increments during a period of seven years. After all the bonds have been converted, Anheuser-Busch will hold 27 percent of Tsingtao's shares. By 2005, Anheuser-Busch will hold at least a 20 percent share, becoming the second largest shareholder of Tsingtao after Qingdao National Assets Management Office. For its 27 percent share, Anheuser-Busch will inject into Tsingtao necessary resources, including capital, technology, management skills and marketing expertise. Anheuser-Busch's capital contribution is used to improve Tsingtao's brewing assts, construct new brewing facilities, and make acquisitions. We believe the alliance has given and will continue to give Tsingtao the support it needs to solidify its leadership of the Chinese beer market, especially in light of the industry's consolidation. Further, the alliance will increase Tsingtao's global exposure and international presence.

Brand Recognition Gives Tsingtao Competitive Advantage

Of the 1,500 Chinese beer brands, there are very few premium names. Regional brands usually use a single-brand strategy, meaning both high-end and low-end products from the same brewery carry the same brand name. This strategy hurt many breweries because consumers were not able to distinguish between top-quality and lower-end products. As a result, price wars became the only way to win consumers, hurting profitability and destroying consumers' brand loyalty. It is important to note that Chinese consumers are highly brand conscious. And the more affluent the consumer, the greater his or her need for association with premium products.

In this environment, Tsingtao, the most famous beer brand in China, has a huge competitive advantage. Since its first gold medal in the 1906 Munich International Expo, Tsingtao Beer has won a string of prestigious international awards. In June 2004, at the World Brand Summit in Beijing, the World Brand Laboratory, one of the world's leading brand evaluation organizations and the World Economic Forum, issued the 2004 "Five Hundred Most Valuable Brands of China" list. Tsingtao was ranked 31st, with a brand value of RMB 16.9 billion, topping the beer industry. Its brand value is equivalent to approximately $2 billion, only slightly lower than Polo RL's brand value of $2.1 billion, which was ranked 100th in the 2004 BusinessWeek Global Brand Scoreboard issued in August 2004.

In a survey of the world's leading CEOs and organizational leaders in December 2003, the World Economic Forum found that corporate brand reputation outranks financial performance as the most important measure of success. 60 percent of respondents estimated that corporate brand or reputation represents more than 40 percent of a company's market capitalization. Globally, Tsingtao is undoubtedly the most recognizable Chinese beer. Introduced into the U.S. market in 1972, Tsingtao soon became the top-selling Chinese beer in the U.S. and has maintained this leadership position ever since.

Clearly, its name recognition constitutes a valuable intangible asset for Tsingtao. Besides consumer recognition, it also enables it to achieve synergy through M&A's. In the past few years, Tsingtao has acquired more than 40 breweries. It was able to enhance the brand value of its target companies with its own brand name during a short period of time. On the contrary, CRB, which acquired more than 30 breweries since 1994 has failed to form a strong national brand from those acquisitions. Therefore, Tsingtao's name alone has enabled it to reach economies of scale with relatively less capital, and gave it significant competitive advantages over its rivals.

Revenue and Income Continue Healthy Growth

In 2003, Tsingtao Beer realized revenues of RMB 7.5 billion and net income of RMB 254 million, up 8.2 percent and 10.1 percent, respectively, year-over-year. According to the China Beer Industry Association, Tsingtao's sales reached 3.26 million kiloliter in 2003, up 9.2 percent from 2002, significantly higher than the industry's average growth of 6.4 percent. Its market share in terms of beer production increased to 12.8 percent from 12.5 percent. It exported 78,000 kiloliters of beer to more that 40 countries, including the U.S., Canada, France, Germany, and the U.K, representing more than 50 percent of China's beer export. Its production, market share, revenue, net income and exports all ranked number one in the Chinese beer industry.

In the first three quarters of 2004, Tsingtao achieved beer production and sales of 3.13 million kiloliter, representing a year-on-year growth of 14 percent. Among which, the production and sales of its principal brand accounted for 0.95 million kiloliter, representing a year-on-year growth of 11 percent. From January to September 2004, its total sales reached RMB 7.1 billion, a 13.6 percent gain over the same period a year ago Net income reached RMB 286.5 million, up 10.2 percent from same period in 2003. Tsingtao plans to achieve annual sales of 3.6 million kiloliter in 2004, which will represent a 10.4 percent increase. We believe the company will continue to show healthy growth in the next few years.

RISK FACTORS

Rising Energy and Raw Material Costs May Squeeze Tsingtao's Profit Margin

Tsingtao is facing increasing pressure from rising energy and raw material prices. Energy prices have been setting new highs in 2004, driving up Tsingtao's production cost. And since June 2004, the Chinese CPI has stayed above 5 percent, with CPI indicators, such as food prices up more than 10 percent every month and grain prices rising around 30 percent each month. However, we do not believe Tsingtao has the pricing power to pass the higher cost onto consumers.

First, food price increases have, in general, been much lower than the increases in the prices of raw materials for beer making. Second, with rivalries heating up in the beer market, Tsingtao can ill-effort to initiate a price war, even in the premium lines. Consequently, we will see margins narrowing for Tsingtao's already thin margins.

Foreign Entries Level Playing Field

As China's fragmented beer industry continues to evolve with the entry of international brewing giants, the business landscape is slowly changing. Because foreign companies bring funding, technological advancements, and management and marketing savvy to their local partners, the playing field is being somewhat leveled. In some ways, this diminishes Tsingtao's advantages over its previously less sophisticated domestic rivals.

Tsingtao's Brand Could be Compromised

Acquisitions have certainly fueled Tsingtao's growth and while the company has been successful in achieving synergy with its acquisitions and enhancing their brand names, we are concerned that Tsingtao's own premium reputation maybe diluted by some of its low-end acquisitions. We believe that it is crucial for Tsingtao to continue building upon and reinforcing its high-end image. We believe that it is important for the company to work hard at maintaining a clear distinction between Tsingtao and its acquisitions. Otherwise, if consumers perceive that Tsingtao's brand name has been compromised, it could be an uphill task to reclaim its most valuable intangible asset.

Policymakers' Tightening Bias a Wildcard

At the end of October, the People's Bank of China, China's central bank, raised both the one-year benchmark deposit rate and the one-year benchmark lending rate by 27bps, despite some signs of a slowing economy in recent months. The major rationale for the rate hike comes from the CPI data, which surpassed the 5 percent threshold set by the Chinese central bank for four consecutive months. Currently, there are two major schools of thought in China holding opposing views on the economy. One group, comprising of overseas-educated economists, believe the Chinese economy is overheated. The other, represented by locally-educated economists, is of the opinion that the Chinese economy is not overheated and no tightening policies are necessary.

We do not believe it is necessary to continue tightening; however, we believe more rate hikes can be expected in the future. We do not expect the tightening pace to be severe, as such, we are quite optimistic that healthy economic growth will not be eroded. But should policy makers at China's central bank decide to accelerate the pace of rate hikes, then all bets are off. Non-essential consumer spending (and beer consumption is definitely one of them) will most likely slow significantly.

VALUATION

We see the company's revenue growing at approximately 14 percent in 2004, with general expenses expected to grow at a slower pace. A big component of the growth can be attributed to beer consumption increases, while price increases will be limited. In addition, we expect cost to rise at a much faster pace than revenue due to high energy and raw material prices. We forecast Tsingtao Beer will realize ESP of $0.32 to $0.34 per ADR in 2004.

The company's stock recently traded at 28X our 2004 EPS estimate and 31X its 2003 EPS, well above the industry average of 19X. Although the high P/E ratio reflects the huge market potential in China, we do not think such a high P/E is sustainable in the long run, due to growing competition and narrowing margins. Given the growth potential, risks embedded with the company, and current market conditions, our conservative estimate of its forward P/E Ratio is 29.

According to our Discounted Free Cash Flow Model, we estimate the 1-year target price to be $9.5, with a risk free rate of 5 percent, equity risk premium of 11 percent. In line with China's GDP growth and Tsingtao's situation, we estimate the long-term sustainable growth to be 7 percent.

Valuation Analytics		1-Year Target
k	15%	
Long Term Sustainable Growth	7%	
Forward P/E	29.0	**$ 9.5**
EPS_1	0.33	
Net Income Growth during the Next 4 Years	10%	
Free Cash Flow Growth during the Next 4 Years	13%	

seek the advice of a financial or securities professional before making any investment. The researcher does not own any shares in this security.