

## Fufeng Group: Corn pain

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**Recommendation: Not Rated**

**China Agriculture**

Price	HK\$0.78	Yield (12/06A)	7.6%
12 mth range	HK\$0.65-3.11	ROE (12/06A)	55.1%
Market cap.	US\$166.0m	Net gearing (12/06A)	171.9%
No. shares o/s	1,660.0m	Net debt/sh. (12/06A)	RMB0.571
Daily t/o, 3 mth	US\$0.7m	BV/sh. (12/06A)	RMB0.439
Free float %	40.3%	Consensus EPS	
Major shareholder	Li Xuechun – 47.4%	- 12/07F	RMB0.187
Ticker	0546.HK/ 546 HK	- 12/08F	RMB0.204

### Key points:

- China's largest producer of glutamic acid.
- Expanding MSG capacity.
- Pressure from potential oversupply of glutamic acid and MSG and high corn price.
- Xanthan gum to be the major growth driver.

**Market leader.** Founded in 1999, Fufeng Group (Fufeng) is China's largest glutamic acid manufacturer, accounting for 25% of the country's total capacity, and second largest xanthan gum producer (in terms of production volume in 2005). The company makes glutamic acid, monosodium glutamate (MSG), xanthan gum, fertilizer and starch sweeteners by refining and processing corn kernels. Glutamic acid represented 58.8% of its total revenue in 1H FY12/07A, followed by MSG's 11.8% and xanthan gum's 7.8%.

**Capacity expansion.** The company will complete Phase II of its Inner Mongolia plant by end-2008 in order to: (1) boost its overall production capacity (additional capacity of 150,000 tonnes of MSG, 20,000 tonnes of xanthan gum and 200,000 tonnes of starch sweeteners); (2) optimize raw materials sources (abundant supply of corn and coal in the region); (3) penetrate a new geographic market.

**Table 1: Capacity expansion**

Products	Existing capacity (tonnes p.a.)	Expected capacity (tonnes p.a.)
Glutamic acid	280,000	280,000
MSG	75,000	225,000
Xanthan gum	8,000	28,000
Starch sweeteners	140,000	340,000
Fertilizer	490,000	490,000

Source: Company data

**Downstream move.** With its enlarged production, MSG is likely to become the company's main product, overtaking glutamic acid. Though glutamic acid carries a better dolor gross margin (RMB661.8 vs. MSG's RMB576.2 per tonne in 1H FY12/07A), the expansion will improve Fufeng's earnings as each tonne of glutamic acid can yield about 1.25 tonnes of MSG.

**Sector outlook.** We are cautious about the outlook of China's glutamic acid and MSG industry because of: (1) potential oversupply; (2) firm corn price. China is the world's largest market of glutamic acid and MSG, representing around 75% of the total. The company said most big players in the country are expanding their production capacities, while the global demand is expected to grow at a CAGR of around 2% between 2006 and 2010. This means that oversupply is likely and may put pressure on selling prices of glutamic acid and MSG in the

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next two years.

**Soaring corn price.** The average price of corn, which represents around 50% of Fufeng's total cost of sales, increased 23.7% YoY to RMB1,352 per tonne in 1H FY12/07A, eroding the company's blended gross margin by 10.7pcp to 10.2%. According to the company, the corn price should stay at RMB1,400 per tonne in 2H and remain firm next year.

**Minor help from rule-out of small plants.** The Chinese government announced plans in October to phase out inefficient MSG plants (with annual capacity below 30,000 tonnes), which may favor large producers including Fufeng. However, we expect a minimal immediate impact as the abolished capacity target is 87,000 tonnes for 2008 and 35,000 tonnes for 2009, which represents only around 6% and 2%, respectively, of the country's total existing capacity.

**Xanthan gum to drive growth.** We believe Fufeng's major growth driver will be its xanthan gum business. Xanthan gum is a polysaccharide, which can be used as a food additive or rheology modifier, especially in oil exploration and drilling. The company booked an encouraging 35.5% gross margin, up 0.5pcp YoY, for its xanthan gum business in 1H FY12/07A, though the ASP dropped 2.4% YoY to RMB25,303 per tonne. New clients will mainly come from Mid-East Asia, which accounts for around 50% of Fufeng's sales of xanthan gum at present.

**Valuation.** Based on our preliminary estimates, the company's revenue will reach RMB3,780.5m and net profit RMB148.3m when all new capacity is in full-operation, likely in 2009. The counter is trading at HK\$0.78, which represents 8.3 multiple of our forecast (possibly in FY12/09F).

**Table 2: Peer comparison (corn refiners)**

Company name	Ticker	Market Cap (US\$m)	Last Price (HK\$)	P/E(x)			ROE (%)
				Historical	Current	1-yr Fwd	
China Agri-Indus	606 HK	2,557.2	5.55	21.9	18.0	14.0	19.0
Global Bio-Chem	809 HK	787.8	2.65	11.4	10.4	9.4	10.0
Xiwang Sugar	2088 HK	354.2	3.33	8.9	9.0	7.0	28.8
China Starch Hld	3838 HK	194.9	2.91	11.0	n.a.	n.a.	38.3
Global Sweetener	3889 HK	191.6	1.43	6.4	6.4	4.8	57.5

Source: Bloomberg

**Corporate governance.** Fufeng was listed in Hong Kong in Jan 2007 via a global offering of 400m shares at HK\$2.23 each. Substantial shareholders include Li Xuechun & Shi Guiling (47.35%) and Ever Soar Enterprises Ltd (12.39%).

**Table 3: P&L**

Year to Dec (RMBm)	04A	05A	06A	1H06A	1H07A
Revenue	625.3	1,296.4	1,787.2	816.6	1,119.1
Cost of sales	(516.8)	(978.8)	(1,432.1)	(645.9)	(1,005.0)
Gross profit	108.5	317.6	355.1	170.7	114.1
Other income	5.4	11.4	19.2	6.6	60.6
Selling and marketing costs	(7.5)	(47.2)	(61.8)	(31.9)	(50.4)
Administrative expenses	(21.1)	(34.9)	(40.5)	(16.5)	(53.8)
Other operating expenses	(4.3)	(1.2)	(7.4)	(2.0)	(17.2)
Operating profit	80.9	245.6	264.7	127.0	53.3
Finance costs	(2.9)	(9.3)	(14.8)	(9.2)	(18.8)
Profit before income tax	78.1	236.3	249.8	117.8	34.5
Income tax expenses	(7.1)	(0.1)	(9.3)	(3.5)	(1.7)
Net profit	71.0	236.2	240.5	114.2	32.8
Dividends	9.4	12.6	156.2	60.1	-
EPS - Basic (RMB)	0.059	0.197	0.200	0.095	0.021

Source: Company data