

More margin gain on technical upgrade

BUY (unchanged)

Financial summary

Year to Dec	07A	08A	09F	10F	11F
Turnover (RMBm)	2,445.73	585.34	3,377.25	5,020.36	2,636.6
Net Profit (RMBm)	45.1	294.7	603.2	439.7	692.9
EPS (RMB)	0.028	0.178	0.363	0.265	0.417
EPS Δ%	(86.0)	533.9	104.7	(27.1)	57.6
P/E (x)	91.1	14.4	7.0	9.6	6.1
P/B (x)	2.92	2.43	1.93	1.86	1.56
EV/EBITDA (x)	31.6	9.0	4.9	5.9	3.6
Yield (%)	0.3	3.5	8.6	6.2	9.8
ROE (%)	4.6	18.5	30.6	19.7	27.8
ROCE (%)	2.4	16.6	27.9	19.5	30.5
N. Gear. (%)	40.6	22.8	6.4	14.4	Cash

Source: SBI E2-Capital

Ticker:	0546.HK	12 mth range:	HK\$0.21-3.24
Price:	HK\$2.91	Market cap:	US\$619.3m
Target:	HK\$4.51 (+55%)	Daily t/o, 3 mth:	US\$1.3m
		Free float %:	40.2%

Key points:

- * Technical upgrade to reduce coal procurement cost by 30-50%.
- * Gross margin anticipated to widen 7pcp to 25.0% in FY12/09F.
- * Higher long-term market share based on strengthening cost advantage.
- * New round of capacity expansion industry-wide is likely.
- * More aggressive xanthan gum pricing in 2H to obtain market share.
- * New target at HK\$4.51.

Price Performance

	1 mth	3 mth	12 mth
Relative to HSI (%)	+22.7	+85.4	+572.5
Actual price changes (%)	+33.5	+136.6	+482.0

	09F	10F	11F
Consensus EPS (RMB)	0.350	0.390	0.405
Previous forecasts (RMBm)	503.1	552.3	591.8
Previous EPS (RMB)	0.303	0.333	0.356

Price Chart



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season in 4Q.

Another round of capacity campaign. As discussed in our initial coverage report (“lower cost to fuel earnings growth”, dated 11th Jun), the recovering profitability in MSG industry will encourage production. After discussion with Fufeng’s management, we smelled increasing possibility of another round of capacity expansion by leading players, which might result in over-supply in 2010, like what happened in 2007. Although this will surely hurt the industry’s profit margin in short term, it also will accelerate industry consolidation by ruling out weak players to reward survived leading ones.

To push xanthan gum sales in 2H. Suffering from the global economy slowdown, demand for xanthan from oil industry has contracted substantially, which also affected Fufeng’s sales in 1H and some inventories have been piled

Better-than-expected margin expansion. After an earnings alert issued on 2nd Jul, we visited Fufeng’s Inner Mongolia (IM) plant last week. A major technical upgrade, completed at the end of last year, allowing the company to adopt some lower calorific value coal during production, yields well this year, reducing coal procurement cost by 30-50% for the IM and Baoji plants, which is much better than we expected. Together with softened raw materials costs, especially soybean, liquid ammonia and sulphuric acid, and increasing economy of scale in the IM plant, significant gross margin improvement has been spotted in 1H. We estimate gross margin will widen from 18.0% last year to 25.0% in FY12/09F (previous forecast: 23.4%).

Enlarging cost advantage. With this new technology, the company’s cost advantage is likely to be further strengthened. We calculate its gross margin (MSG segment) is ~15pcp (the management’s estimate: 10-13pcp) higher than Shandong-based peers, which gives Fufeng a solid ground to increase its market occupancy.

Satisfactory waste treatment facilities. Environmental concern is a key issue of fermentation industry in general. Mei Hua, another leading MSG producer, has one of its plants in Hebei suspended operation due to environmental investigation. For Fufeng, we were told that it has met all necessary environmental standards and its waste water discharge is monitored by local authority on a real-time basis.

Mild increase in MSG price. MSG price rose slightly by ~RMB200 to ~RMB6,600/tonne recently due to higher corn cost backed by the governmental procurement. Nevertheless, the price will probably go down moderately in 2H due to abundant corn supply during the harvest

up. However the management, though cautious, is confident on 2H performance. Considering its much lower production cost compared with another major xanthan gum producer, Shandong Deosen (~RMB10,000/tonne versus ~RMB18,000/tonne), we reckon the company should be able to boost its sales in 2H via a more aggressive pricing strategy while maintaining a decent gross margin.

Forecast revised up. We now use the previous market-consolidation scenario as the base case to reflect the increasing possibility of industry-wide capacity expansion. Effect of the technical upgrade is also embedded. Meanwhile, the strengthened cost advantage has encouraged us to adopt a more optimistic assumption on the company's long-term market share for both MSG and xanthan gum (MSG: from 30% to 35%; xanthan gum: from 45% to 60%). In our new forecast, the company will have RMB603.2m net profit in FY12/09F (previous: RMB503.1m), up 104.7% YoY, followed by 27.1% decline in FY12/10F to RMB439.7m and 57.6% recovery in FY12/11 to RMB692.9m. The new target price is HK\$4.51 (previous: HK\$2.77), representing 10% discount to the DDM fair value of HK\$5.01 per share or 12.1x FY12/09F P/E.

Table 1: Forecast adjustments

Year to Dec (RMBm)	07A	08A	09F	10F	11F	12F	13F	14F	15F
New forecasts									
Revenue	2,445.7	3,585.3	4,377.2	5,020.3	6,263.6	6,728.6	7,044.1	7,303.0	7,572.7
MSG	2,296.2	3,133.6	3,802.6	4,246.7	5,236.8	5,449.1	5,664.0	5,885.1	6,115.9
Xanthan gum	150.2	451.7	574.6	773.6	1,026.8	1,279.4	1,380.1	1,417.9	1,456.8
Gross profit	249.7	644.3	1,095.0	981.6	1,428.6	1,638.8	1,760.9	1,858.4	1,963.1
MSG	203.5	488.9	877.8	680.6	1,018.6	1,102.4	1,181.8	1,266.4	1,357.3
Xanthan gum	46.1	155.4	217.1	300.9	410.0	536.4	579.1	592.0	605.7
Net profit	45.1	294.7	603.2	439.7	692.9	854.4	833.2	893.1	957.7
Old forecasts (base-case)									
Revenue	2,445.7	3,585.3	4,377.2	4,827.5	5,426.7	5,705.5	5,865.6	6,030.6	6,200.5
MSG	2,296.2	3,133.6	3,802.6	4,140.5	4,603.6	4,739.1	4,872.8	5,010.6	5,152.5
Xanthan gum	150.2	451.7	574.6	686.9	823.2	966.4	992.8	1,020.0	1,048.0
Gross profit	249.7	644.3	1,026.3	1,114.1	1,253.1	1,354.9	1,388.7	1,426.5	1,465.4
MSG	203.5	488.9	817.9	882.8	975.9	1,011.7	1,038.6	1,068.0	1,098.2
Xanthan gum	46.1	155.4	208.4	231.3	277.2	343.2	350.1	358.6	367.2
Net profit	45.1	294.7	503.1	552.3	591.8	682.3	640.2	658.0	676.1
Old forecasts (market-consolidation)									
Revenue	2,445.7	3,585.3	4,377.2	4,492.5	5,190.0	6,163.8	6,419.9	6,600.5	6,786.6
MSG	2,296.2	3,133.6	3,802.6	3,805.5	4,366.8	5,197.4	5,427.1	5,580.5	5,738.6
Xanthan gum	150.2	451.7	574.6	686.9	823.2	966.4	992.8	1,020.0	1,048.0
Gross profit	249.7	644.3	1,026.3	841.5	1,056.5	1,405.7	1,509.1	1,548.6	1,590.9
MSG	203.5	488.9	817.9	609.5	779.3	1,069.0	1,163.2	1,195.0	1,228.9
Xanthan gum	46.1	155.4	208.4	232.0	277.2	336.7	345.9	353.5	362.0
Net profit	45.1	294.7	503.1	313.5	433.3	681.1	690.8	707.7	727.4

Source: SBI E2-Capital

Table 2: P&L

Year to Dec (RMBm)	07A	08A	09F	10F	11F
Turnover	2,445.7	3,585.3	4,377.2	5,020.3	6,263.6
Cost of sales	(2,196.0)	(2,941.0)	(3,282.3)	(4,038.8)	(4,835.0)
Gross profit	249.7	644.3	1,095.0	981.6	1,428.6
Other income	32.8	44.3	36.6	38.8	42.0
Selling and marketing expenses	(104.2)	(166.4)	(218.3)	(254.2)	(310.3)
Administrative expenses	(113.7)	(142.0)	(197.4)	(224.8)	(273.5)
Other operating expenses	(16.7)	(12.2)	(13.3)	(15.1)	(18.1)
Profit from operations	47.9	368.0	702.5	526.3	868.7
Interest income from IPO subscription deposits	42.8	-	-	-	-
Finance costs	(45.2)	(42.7)	(37.7)	(31.0)	(24.4)
Profit before income tax	45.5	325.4	664.8	495.3	844.3
Income tax expenses	(0.4)	(30.7)	(61.6)	(55.6)	(151.4)
Profit for the period	45.1	294.7	603.2	439.7	692.9
Attributable to:					
Equity holders of the Company	45.1	294.7	603.2	439.7	692.9
Minority interests	-	-	-	-	-
EPS - Basic (RMB)	0.028	0.178	0.363	0.265	0.417
EPS - Diluted (RMB)	0.028	0.178	0.363	0.265	0.417
Proposed DPS (RMB)	0.008	0.088	0.218	0.159	0.250
Proposed dividend	13.5	146.3	361.9	263.8	415.8

Source: SBI E2-Capital

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