

Fufeng Group

Tighten the belt one notch

to summarize...

- Net profit over tripled in FY12/09A to RMB928.3m with extra fuel from skyrocketed MSG price in 4Q and 250,000 tonne cheap corn procured from government.
- MSG market is anticipated to stay in balance in 2010 with additional ~140,000 tonnes supply solely from Fufeng.
- Both Fufeng and Eppen's expansion will test MSG market in 2011.
- New synthetic ammonia plant and production base in North East China will fortify the company's cost advantage.
- The management targets at 40%+ domestic MSG market share. We reckon this target will be realised by 2015, accompanied by continuous market consolidation.
- Expected three-year average dividend yield at 4.37%. BUY unchanged with target price revised up to HK\$7.08.

Supreme profit advance in FY12/09A. Revenue went up 29.2% to RMB4,632.9m. Gross margin improved substantially by 12.2pcp to 30.2%. Consequently, net profit soared 215.0% to hit RMB928.3m. We contribute this strong growth to:

- Favorable market environment witnessed by rising MSG price during the period as well as softened raw materials costs (coal, liquid ammonia, sulphuric acid and soy bean).

Table 1. Major price movements

(RMB/tonne)	FY12/08A		FY12/09A				Change	
	Full year	1Q	2Q	3Q	4Q	Full year	YoY (%)	
Products								
Glutamic acid	6,474	6,797	6,762	7,369	8,534	7,135	10.2	
MSG	6,865	6,962	6,817	7,332	9,193	7,680	11.9	
Fertilizer	1,026	838	915	621	623	727	(29.1)	
Xanthan gum	21,941	22,162	22,162	20,201	n.a.	21,120	(3.7)	
Raw materials								
coal - MSG	369					254	(31.2)	
coal - xanthan gum	365					228	(37.5)	
corn - MSG	1,424					1,413	(0.8)	
corn - xanthan gum	1,409					1,403	(0.4)	
liquid ammonia	2,700					2,209	(18.2)	
sulphuric acid	923					212	(77.0)	
soybean	4,354					3,512	(19.3)	

Source: Company data

- Timely expansion of glutamic acid and MSG capacities when other major players kept silent.

Table 2. Effective capacities

Year end Dec (tones '000)	07A	08A	09A	10F	11F
Glutamic acid	280	275	350	460	540
MSG	75	172	305	540	640
Fertilizer	490	405	460	560	660
Starch sweeteners	140	100	100	100	100
Xanthan gum	8	21	32	41	44

Source: Company data

- MSG price's sharp gain in 4Q 09 (Fufeng's ASP jumped from RMB7,329/tonne

Ticker	0546 HK
Rating	BUY
Price (HK\$)	5.86
Target Price (HK\$)	7.08 (+21%)
12m Price Range (HK\$)	1.05-6.55
Market cap. (US\$m)	1,247.1
Daily t/o (US\$m)	2.9
Free float (%)	41.4

Financial summary

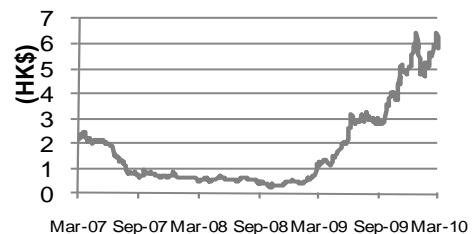
Year to Dec	08A	09A	10F	11F	12F
Turnover (RMBm)	3,585	4,633	6,030	6,706	7,699
Net Profit (RMBm)	294.7	928.3	943.3	844.2	920.7
EPS (RMB)	0.178	0.559	0.568	0.509	0.555
P/E (x)	13.9	14.8	12.1	10.2	9.0
P/B (x)	2.62	1.92	1.71	1.51	1.34
EV/EBITDA (x)	10.7	10.5	8.1	6.8	6.1
Yield (%)	2.2	1.9	2.5	2.9	3.3
ROE (%)	18.5	44.9	35.3	26.5	24.9
ROCE (%)	16.6	39.4	26.4	20.0	19.1
N. Gear. (%)	20.1	11.1	34.5	55.1	37.6

Source: SBI E2-Capital

	10F	11F	12F
Consensus EPS (RMB)	0.616	0.750	1.060
Previous earnings (RMBm)	1,017.5	1,066.8	n.a.
Previous EPS (RMB)	0.613	0.643	n.a.

Price performance

Year to Dec	1m	3m	12m
Relative to HSI (%)	+5.6	+19.0	+234.1
Actual price changes (%)	+7.5	+14.9	+409.6



Source: Bloomberg

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in 3Q to RMB9,193/tonne in 4Q)

- Procurement of 250,000 tonnes corn from the government at RMB1,570/tonne in 2H when the market price strengthened to RMB1,800-1,900.

MSG market to remain balanced in 2010. MSG price corrected violently in 1Q, diving from peak RMB11,100/tonne in Dec 09 to below RMB7,000/tonne in Feb and, then, rebounded to RMB7,600/tonne in Mar. According to the management, such extreme fluctuation should be mainly due to speculation. Supply-demand wise, we see major capacity expansion within the sector still comes from Fufeng in 2010, which will add 110,000 tonnes glutamic acid effective capacity, resulting in ~140,000 tonne net increase in MSG supply. We reckon the market can accommodate ~150,000 extra MSG capacity each year, comprising ~100,000 tonnes from organic growth (~5% p.a.) and ~50,000 tonnes from inefficient capacities, which are continuously ruled out by cost competition and tightening environmental regulations. Therefore, the market supply-demand is likely to remain balanced in 2010. Accordingly, we assume the industry will maintain its normal profitability and expect MSG price to further pick up (average at RMB7,713/tonne for the full 2010) backed by increased raw materials costs post the financial crisis and general inflation expectation.

Over-supply is possible in 2011. For 2011, we smelled over-supply possibility. Fufeng's new plant in North East China will contribute ~80,000 tonnes glutamic acid effective capacity (equivalent to ~100,000 tonnes MSG). Meanwhile, Eppen () is building a comprehensive processing centre (including 120,000 tonnes MSG 120,000 tonnes glutamic acid), which should launch operation by the end-10. In order to absorb these incremental supplies, we expect MSG price will be pushed down to completely eliminate small players' profitability and drive them out of the market.

Market share expansion at cost of short-term profitability. Fufeng intends to capture 40%+ domestic MSG market share. In view of the company's cost advantage, we reckon this target is feasible and estimate it can be achieved by 2015 based on the company's historical expansion speed (~100,000 tonne MSG capacity each year). During the process, other players, especially leading ones, will certainly make their response. Thus, the whole market will probably stay in over-supply situation, depressing MSG price continuously. Market concentration will largely improve after 2015 and we reckon the top three players will occupy ~90% market share. MSG market will move into oligopoly stage and the industry's profitability will recover.

Table 3. MSG industry estimates

Year end Dec	09A	10F	11F	12F	13F	14F	15F
Major expansion	Fufeng	Fufeng	Fufeng, Eppen, other players	Fufeng, other players	Fufeng, other players	Fufeng, other players	Fufeng, other players
Market equilibrium	balance	balance	over-supply	over-supply	over-supply	over-supply	over-supply
Top 3 players' market share (%)	~45.0						~90.0
Tier-two players' net margin (%)	9.5	8.2	2.7	0.0	0.0	0.0	0.0
Small players' net margin (%)	5.3	5.4	0.0	(2.8)	(2.8)	(2.8)	(2.8)

Source: SBI E2-Capital

Fufeng's attempt to further bring down production cost. We estimate Fufeng's MSG production cost is ~10% lower than tier-two players (mainly located in Shandong), which constitute the company's core competitiveness. Fufeng plans to steepen this advantage by:

- building in-house ammonia production capacity – a 80,000 tonnes synthetic ammonia production line will launch operation in 2011 in Inner Mongolia. We estimate this will reduce the IM plant's ammonia cost by ~18% or overall MSG production cost by ~RMB140/tonne.
- establishing a new base (in North East China at the junction of Inner Mongolia and Heilongjiang – this new NE plant will contain capacities of 160,000 tonnes glutamic acid, 200,000 tonnes MSG, 200,000 tonnes fertilizer and 100,000 tonnes synthetic ammonia. Construction will start in May and operation is expected to commence in 2H 11. According to the management, corn locally is ~RMB200/tonne cheaper than which of the IM plant. Together with integrated ammonia capacity, the NE plant's MSG production cost could be ~8.0% lower than the IM plant.

Target price revised to HK\$7.08 with extra support from generous dividend. Following the adjustment in our industry assumptions, we revised our estimates. FY12/10F and FY12/11F earnings were penciled down by 7.3% and 20.9%, respectively, to reflect: 1) faster-than-expected correction of MSG price after it skyrocketed in 4Q 09; 2) additional capacities of 110,000 tonnes glutamic acid and 40,000 tonnes MSG from re-engineering existing facilities; 3) Eppen's expansion (started in Dec 09), which is anticipated to break market equilibrium in 2011. Nevertheless, we highly credit the company's move to establish in-house ammonia capacity and construct the NE plant, which will provide a solid ground in terms of production cost, underpinning future growth and market expansion. Meanwhile, the expected market consolidation will reward Fufeng in long run with larger market occupancy. We maintain our BUY call on the stock. Our new target price is HK\$7.08, which is also the fair value derived from our DDM model. Given the company's generous dividend policy (40.0% payout ratio), which allow an arithmetic average yield of 4.37% (or 3.61% based on the target price), versus Hang Seng Utilities Index's 3.37%, we believe downside risk is limited.

Table 4. Key assumptions

Year end Dec	09A	10F	11F	12F	13F	14F	15F
Market demand (tonnes '000)							
Glutamic acid	1,586	1,662	1,745	1,832	1,924	2,019	2,120
MSG	1,913	2,009	2,109	2,214	2,325	2,441	2,563
Fufeng							
Effective capacity (tonnes '000)							
Glutamic acid	350	460	543	622	622	702	782
MSG	305	540	640	740	740	840	940
Output (tonnes '000)							
Glutamic acid	354	442	491	570	656	749	850
MSG	302	508	591	686	791	903	1,025
Market share (%)							
Glutamic acid	22	27	28	31	34	37	40
MSG	16	25	28	31	34	37	40

Source: SBI E2-Capital

Table 5. P&L

Year end Dec (RMBm)	08A	09A	10F	11F	12F
Turnover	3,585.3	4,632.9	6,030.0	6,706.1	7,699.0
Cost of sales	(2,941.0)	(3,233.3)	(4,511.2)	(5,069.6)	(5,909.5)
Gross profit	644.3	1,399.6	1,518.8	1,636.6	1,789.5
Other income	44.3	63.9	89.8	97.1	117.5
Selling and marketing expenses	(166.4)	(215.7)	(280.5)	(322.4)	(384.4)
Administrative expenses	(142.0)	(194.9)	(223.9)	(258.4)	(294.4)
Other operating expenses	(12.2)	(4.0)	(4.0)	(4.1)	(4.2)
Profit from operations	368.0	1,048.8	1,100.1	1,148.8	1,224.0
Finance costs	(42.7)	(25.3)	(29.9)	(143.2)	(167.3)
Profit before income tax	325.4	1,023.6	1,070.2	1,005.6	1,056.6
Income tax expenses	(30.7)	(95.3)	(127.0)	(161.4)	(136.0)
Profit for the period	294.7	928.3	943.3	844.2	920.7
Attributable to:					
Equity holders of the Company	294.7	928.3	943.3	844.2	920.7
Minority interests	0.0	0.0	0.0	0.0	0.0
EPS - Basic (RMB)	0.178	0.559	0.568	0.509	0.555
EPS - Diluted (RMB)	0.178	0.559	0.568	0.509	0.555
Proposed DPS (RMB)	0.088	0.232	0.227	0.203	0.222
Proposed dividend	146.3	365.7	377.3	337.7	368.3

Source: SBI E2-Capital

Major risks. unexpected price fluctuation of either end-products or raw materials; execution risk in building ammonia production line

P&L (RMBm)	08A	09A	10F	11F	12F	Cash Flow (RMBm)	08A	09A	10F	11F	12F
Year to Dec						Year to Dec					
Turnover	3,585.3	4,632.9	6,030.0	6,706.1	7,699.0	EBIT	365.9	1,047.3	1,098.1	1,134.1	1,211.6
% chg	46.6	29.2	30.2	11.2	14.8	Depre./amort.	141.4	167.8	231.3	380.2	463.1
Gross profit	644.3	1,399.6	1,518.8	1,636.6	1,789.5	Net int. paid	(40.5)	(23.7)	(27.8)	(128.5)	(155.0)
						Tax paid	(18.2)	(25.1)	(152.8)	(160.7)	(134.8)
EBITDA	507.3	1,215.1	1,329.3	1,514.3	1,674.7	Dividends received	0.0	0.0	0.0	0.0	0.0
Depre./amort.	(141.4)	(167.8)	(231.3)	(380.2)	(463.1)	Gross cashflow	448.6	1,166.3	1,148.7	1,225.1	1,384.9
EBIT	365.9	1,047.3	1,098.1	1,134.1	1,211.6						
Net int. income/(exp.)	(40.5)	(23.7)	(27.8)	(128.5)	(155.0)	Chgs. in working cap.	(2.2)	(590.7)	(102.8)	(380.3)	31.7
Exceptionals	0.0	0.0	0.0	0.0	0.0	Operating cashflow	446.4	575.6	1,045.9	844.9	1,416.6
Associates											
Jointly-controlled entit.						Capex	(405.7)	(228.6)	(1,400.3)	(1,376.0)	(716.7)
Pre-tax profit	325.4	1,023.6	1,070.2	1,005.6	1,056.6	Free cashflow	40.7	347.1	(354.4)	(531.1)	699.9
Tax	(30.7)	(95.3)	(127.0)	(161.4)	(136.0)						
Minority interests	0.0	0.0	0.0	0.0	0.0	Dividends paid	(13.5)	(292.7)	(388.9)	(378.1)	(368.0)
Net profit	294.7	928.3	943.3	844.2	920.7	Net distribution to MI					
% chg	553.9	215.0	1.6	(10.5)	9.1	Investments					
						Disposals	4.2	4.3	0.0	0.0	0.0
Dividends	(81.9)	(77.8)	(103.2)	(122.9)	(140.7)	New shares	0.0	0.0	0.0	0.0	0.0
Retained earnings	212.8	850.5	840.1	721.2	780.0	Change in bank loans	(60.3)	10.0	1,788.0	188.3	145.2
						Others	24.8	49.3	40.7	74.1	25.0
EPS (RMB) - Basic	0.178	0.559	0.568	0.509	0.555	Net cashflow	(4.1)	118.0	1,085.3	(646.7)	502.0
EPS (RMB) - F.D.	0.178	0.559	0.568	0.509	0.555						
DPS (RMB)	0.088	0.232	0.227	0.203	0.222	Cash reserve - Beg.	228.8	224.7	342.7	1,428.0	781.3
No. sh.s o/s (m) - W.A.	1,660.0	1,660.0	1,660.0	1,660.0	1,660.0	Cash reserve - End.	224.7	342.7	1,428.0	781.3	1,283.4
No. sh.s o/s (m) - Y.E.	1,660.0	1,660.0	1,660.0	1,660.0	1,660.0						
No. sh.s o/s (m) - F.D.	1,660.0	1,660.0	1,660.0	1,660.0	1,660.0						
						Interim Results (RMBm)	07A	08A	09A		
						Six months to Jun					
Margins (%)						Turnover	1,119.1	1,630.4	2,055.4		
Gross	18.0	30.2	25.2	24.4	23.2	% chg					
EBITDA	14.1	26.2	22.0	22.6	21.8						
EBIT	7.0	7.0	7.0	7.0	7.0	Profit from operations	10.5	117.1	401.3		
Pre-tax	9.1	22.1	17.7	15.0	13.7	Interest expenses	(18.8)	(22.4)	(13.5)		
Net	8.2	20.0	15.6	12.6	12.0	Associates					
						Jointly-controlled entit.	42.8				
						Pre-tax profit	34.5	94.7	387.8		
						Tax	(1.7)	(8.9)	(33.9)		
						Minority interests	0.0	0.0	0.0		
						Net profit	32.8	85.9	353.9		
						% chg					
							161.7	312.2			
Balance Sheet (RMBm)	08A	09A	10F	11F	12F						
Year to Dec						EPS (RMB) - Basic	0.021	0.052	0.213		
Fixed assets	2,087.2	2,648.1	3,761.4	4,710.6	4,900.8	DPS (RMB)	-	-	0.100		
Intangible assets											
Other LT assets	0.4	5.2	6.2	6.9	7.9	Shareholding Structure					
Cash	267.6	369.0	1,464.7	822.6	1,331.5						
Accounts receivable	548.4	687.8	1,201.3	1,676.5	1,924.7	Li Xuechun					
Other receivables						Management team					
Inventories	356.3	551.0	580.6	678.1	687.7	Others					
Due from related co.s	0.0	0.0	0.0	0.0	0.0	Total					
Other current assets	2.7	0.0	0.0	0.0	0.0		1,660.0	100.0			
Total assets	3,262.5	4,261.0	7,014.3	7,894.7	8,852.6						
						Background					
Accounts payable	(887.5)	(1,140.5)	(1,591.2)	(1,788.2)	(2,084.5)	Headquartered in Beijing, Fufeng has operations in Junan (Shandong), Baoji (Shannxi) and Hohhot (Inner Mongolia). Principal products include glutamic acid, monosodium glutamate (MSG) and xanthan gum, which contributed 15.6%, 48.5% and 8.8%, respectively, of the total revenue in FY12/08A. Market shares for the three products in 2009 were ~20% (domestic), ~10% (domestic) and ~20% (global), respectively, in turns of sales volume.					
Other payable											
Tax payable											
Due to related co.s	0.0	0.0	0.0	0.0	0.0						
ST debts	(276.0)	(418.0)	(1,386.0)	(1,574.3)	(1,719.5)						
Other current liab.	(6.7)	(13.7)	(20.2)	(26.2)	(19.6)						
LT debts	(312.0)	(180.0)	(1,000.0)	(1,000.0)	(1,000.0)						
Other LT liabilities	(38.7)	(115.1)	(68.8)	(91.9)	(62.2)						
Total liabilities	(1,521.0)	(1,867.3)	(4,066.2)	(4,480.5)	(4,885.7)	Key Ratios	08A	09A	10F	11F	12F
						Net gearing (%)	20.1	11.1	34.5	55.1	37.6
Share capital	169.0	169.0	169.0	169.0	169.0	Net ROE (%)	18.5	44.9	35.3	26.5	24.9
Reserves	1,572.5	2,224.7	2,779.1	3,245.2	3,797.8	EBIT ROCE (%)	16.6	39.4	26.4	20.0	19.1
Shareholders' funds	1,741.5	2,393.7	2,948.1	3,414.2	3,966.9	Dividend payout (%)	27.8	8.4	10.9	14.6	15.3
Minority interest	-	-	-	-	-	Effective tax rate (%)	9.4	9.3	11.9	16.1	12.9
Total	1,741.5	2,393.7	2,948.1	3,414.2	3,966.9	Net interest coverage (x)	9.0	44.1	39.5	8.8	7.8
						A/R turnover (days)	55.4	48.7	57.2	78.3	85.4
Capital employed	2,329.5	2,991.7	5,334.1	5,988.5	6,686.3	A/P turnover (days)	84.4	79.9	82.7	92.0	91.8
Net (debt)/cash	(320.4)	(229.0)	(921.2)	(1,751.7)	(1,388.0)	Stock turnover (days)	42.4	51.2	45.8	45.3	42.2

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