

Growth momentum picks up

China F&B

Fu Ji (1175 HK, HK\$23.55)

BUY (unchanged)

Target price: HK\$30.01 (+27.4%)

Key takeaways from our recent telephone conference with management.

Gross margin enhancement. The gross margin widened to 60.1% in 1Q FY03/08A from 54.9% a year ago, thanks to cost savings due to direct sourcing of raw materials by its sourcing and initial processing centers (SIPCs). An increase of the seafood portion in its lunch box menu mix, to 37.0% from 31.0%, helped to offset pressure from rising pork prices.

Operating margin. The margin narrowed to 34.9% from 36.4% a year ago, mainly on high rentals and depreciation costs due to huge start up costs for capacity expansion. The company expects the margin to stabilize at the current level and gradually rebound in FY03/08F.

Bullet train revenue. Turnover from its new railway segment totaled RMB5.0m for the first two and a half months of operations, with a gross margin of around 40.0%. In July, turnover reached RMB3.0m. Currently, Fu Ji provides catering services to around 20 bullet trains out of China's 40, on Beijing-Harbin, Beijing-Henan and Beijing-Shanghai routes. China is expected to have more than 180 bullet trains by FY03/09F and up to 1,000 by FY03/10F. Assuming that the company will serve 100 bullet trains by FY03/09F and 500 by FY03/10F, we expect turnover from the division to reach RMB70.0m and RMB250.0m, respectively. The ASP per head should stand at around RMB15, while the current overall ASP is around RMB6.3.

Other new revenue drivers. Fu Ji has signed catering contracts in early 2007 with two leading exhibitors in Shanghai. The ASP is RMB7.0–8.0 per meal and Fu Ji is expected to arrange around 30,000 meals per day. During the Beijing Olympics, assuming 300,000 volunteer workers and ASP of RMB7.0–8.0 per meal, turnover should reach RMB150.0m by FY03/09F.

Rapid development of processing centres. Fu Ji's production stands at 1.0m meals per day with the overall utilization rate of 61.0%. The company will upgrade its existing SIPCs in Shouguang, Shandong (fruit and vegetable sourcing), Linqu, Shandong (meat and poultry sourcing), and Ningbo, Zhejiang (seafood sourcing). The new Wuxi SIPC is expected to start operations by 4Q FY03/08F and upgraded by Sept 2009. In addition to its current four SIPCs, the company may in the next two year add one SIPC in Wuxi and one in Anhui, mainly for chicken processing. Jiading RDPC (regional distribution and processing center) will commence operations by 4Q07, with 300,000 meals per day and Beijing RDPC 1Q08 with 300,000 meals per day. We expect the total designed capacity per day to reach 1.6m by FY03/09F.

Table 1: Financial summary

Year to Mar	Net profit RMBm	EPS RMB	EPS Δ %	P/E x	P/B x	EV/EBITDA x	Yield %	ROE %	ROCE %	N. Gearing %
06A	251.4	0.555	20.0	35.7	6.2	30.5	0.8	23.7	20.6	Cash
07A	348.1	0.693	24.8	28.6	5.5	23.4	1.0	21.5	18.4	Cash
08F	525.5	1.020	47.2	19.4	4.7	16.0	1.5	26.6	21.4	26.9
09F	828.6	1.608	57.7	12.3	3.8	11.2	2.4	34.3	26.8	17.4
10F	1,238.3	2.404	49.4	8.2	3.0	9.8	3.6	36.8	32.3	14.1

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Table 2: Local distribution and processing centre (LDPC) expansion

Local distribution and processing center	Commencement date	Utilization as at 30 June 2007
Sunqiao processing center	Apr 04	96.0%
Suzhou	May 05	84.0%
Shenzhen	Jul 05	80.0%
Kunshan	Jul 05	65.0%
Songjiang	Aug 05	74.0%
Hangzhou	Sepl 06	32.0%

Source: Company data & SBI E2-Capital

ASP remains firm. The ASP for stated-owned enterprises (30% of total customers) is around Rmb 6.0 per meal, for multinational corporations RMB8.0 (30.0% of total customers), for schools RMB5.0 (10.0% of customers) and for Taiwan accounts RMB4.0 (25.0% of total customers). The overall ASP for the catering segment in 1Q FY03/08F reached RMB6.3 per meal, exceeding our estimate. We expect the ASP should remain stable due to the higher ASP achieved by the railway segment (RMB15.0 per meal) and Beijing Olympics (RMB7.0 – 8.0 per meal).

Strong sector growth. The Ministry of Commerce said on 17 September 2007 that China's catering sales grew 19.1% YoY in August to RMB98.5b, up 2.3pcp compared with July's growth, and 18.1% YoY to RMB772.2b in the January-August period.

1Q FY03/08F results recap. Fu Ji's net profit increased 23.3% YoY to RMB95.1m in 1Q FY03/08F, below expectations because of surging financial costs of the CB. Turnover was up 47.6% at RMB357.1m. Catering services, which grew 53.0% YoY, remained its key contributor and accounted for 80.4% of its total turnover. As of 30 June 2007, Fu Ji produced 614,000 meals per day (excluding railway meals).

Table 3. 1Q FY03/08 results

Year to Mar	Turnover (RMBm)	Gross profit (RMBm)	Operating profit (RMBm)	Pre-tax profit (RMBm)	Tax rate (%)	Net profit (RMBm)	Basic EPS (RMB)
FY07	357.1	142.5	124.6	103.2	9.3	95.1	0.185
FY06	242.0	109.2	88.0	83.7	11.8	77.1	0.154
YoY (%)	47.6	50.1	41.6	34.6		23.3	20.1

Source: Company data & SBI E2-Capital

Net margins. Financing costs surged 384.0% to Rmb21.0m in 1Q FY03/08A mainly due to non-cash amortization charges against the redemption premium of the CB issued in Oct 2006. Currently around 526.0m of CB have been converted, which implies that such non-cash costs will decrease and net margins should gradually rebound.

Valuation. We are positive on the company's and industry's prospects. We expect the company's overall ASP to remain stable due to higher ASPs achieved by its railway segment (RMB15.0 per meal) and Beijing Olympics contracts (RMB7.0 – 8.0 per meal). The counter is trading at P/E of 19.4x for FY03/08F and 12.3x for FY03/09F. We lowered our net profit estimate to RMB525.2m for FY03/08F and RMB828.6m for FY03/09F, as significant earnings contributions from its railway segment will come in FY03/10F. We also introduce our FY03/10F net profit estimate of RMB1, 238.3m. We retain our BUY call and lift our target price to HK\$30.01 (from HK\$24.80), representing 18.0x FY03/09F.

Table 4. Peer comparison

Company	Ticker	Year end	Mkt cap. (US\$m)	His. P/E (x)	1 yr fwd P/E (x)	2 yr fwd P/E (x)	ROE (FY05) (%)	EBIT Margin (%)	PEG (x)
Compass	CPG LN	Sep	24,54.5	19.7	20.6	17.7	11.8	4.7	2.1
Sodexo	SW FP	Aug	10,578.9	20.4	21.0	18.0	15.4	4.7	1.6
Café de Coral	341 HK	Mar	1,060.9	22.2	21.7	18.8	19.1	10.8	0.9
Fairwood	52 HK	Mar	161.9	14.7	13.9	11.7	27.2	7.6	0.5
Singapore Food	SFI SP	Dec	276.0	13.9	11.8	10.9	21.1	7.4	na
Fu Ji	1175 HK	Mar	1,626.4	35.7	28.6	19.4	21.5	33.4	0.9
Ave				21.1	19.6	16.1	17.8	7.2	1.3

Source: Bloomberg & SBI E2-Capital