

Fu Ji Catering: Fighting inflation

Recommendation: BUY (unchanged)

China F&B

| Price | HK\$16.10 | Year to | Net profit | EPS | EPS | P/E | P/B | EV/EBITDA | Yield | ROE | ROCE | N. Gear. |
|------------------|--------------------|---------|------------|-------|------|------|-----|-----------|-------|------|------|----------|
| Target price | HK\$23.64 (+46.8%) | Mar | RMBm | RMB | Δ % | X | x | x | % | % | % | % |
| 12 mth range | HK\$13.8-29.2 | 06A | 251.4 | 0.555 | 20.0 | 29.0 | 5.0 | 32.7 | 1.0 | 23.7 | 20.6 | Cash |
| Market cap. | US\$1,117.3m | 07A | 348.1 | 0.689 | 24.2 | 23.4 | 4.5 | 24.6 | 1.3 | 21.5 | 18.4 | Cash |
| Daily t/o, 3 mth | US\$6.0m | 08F | 453.3 | 0.880 | 27.7 | 18.3 | 3.9 | 19.4 | 1.6 | 23.0 | 18.4 | Cash |
| Free float % | 47.6% | 09F | 703.6 | 1.251 | 42.2 | 12.9 | 3.4 | 12.8 | 2.3 | 29.0 | 22.7 | Cash |
| Ticker | 1175.HK/1175 HK | 10F | 920.6 | 1.510 | 20.7 | 10.7 | 2.9 | 12.1 | 2.8 | 30.0 | 24.3 | Cash |

Relative to Hang Seng Index (1 mth, 3 mth, 12 mth): -7.2%, -39.3%, -40.3%

Actual price changes (1 mth, 3 mth, 12 mth): -12.4%, -32.9%, -13.2%

Consensus EPS (08F-09F): RMB0.912, RMB1.315

Previous forecasts (08F-10F): RMB525.5m (RMB1.020), RMB828.6m (RMB1.608), RMB1,238.3m (RMB2.404)

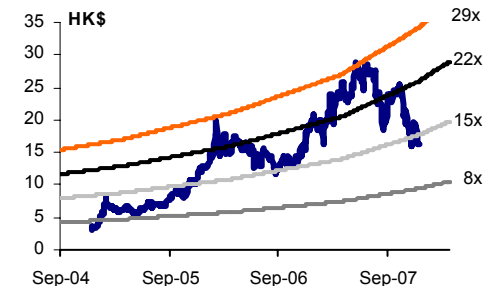
Key points:

- Existing business recorded healthy growth with new clients coming in.
- New businesses in pipeline.
- Continuous improvement in raw material structure.
- Gross margin declined to expansion.
- Inflation pressure persists in mid term.
- Strong top line growth to offset impact of margin squeeze.
- Target price revised down to HK\$23.64, maintain BUY.

Results highlight. Net profit rose 14.3% YoY to RMB196.8m in 1H FY03/08A, below our expectations as well as market consensus, and turnover 45.9% to RMB780.2m, with strong growth offset by shrinking operating margin. An interim dividend of RMB0.115 per share was declared, with the dividend payout ratio at 30.6%.

- ❑ Gross margin down 0.7pcp to 56.8% in 2Q FY03/08A, up 2.0pcp to 58.3% in 1H.
- ❑ Operating margin down 8.2pcp to 29.6% in 2Q FY03/08A, down 5.1pcp to 32.0% in 1H.
- ❑ EPS up 9.9% YoY to RMB0.376 in 1H FY03/08A.
- ❑ Acquisition of Golden Hans completed in Nov 07.

Chart 1: P/E bands



Source: SBI E2-Capital

Table 1: 1H FY03/08A Interim results

| Year to | Turnover | Gross profit | Gross | Operating | Pre-tax profit | Tax rate | Net profit | EPS Basic |
|-------------|----------|--------------|------------|-----------|----------------|----------|------------|-----------|
| Mar | (RMBm) | (RMBm) | margin (%) | profit | (RMBm) | (%) | (RMBm) | (RMB) |
| 1H FY03/08A | 780.2 | 455.0 | 58.3 | 249.8 | 214.1 | 8.1 | 196.8 | 0.376 |
| 1H FY03/07A | 534.8 | 301.3 | 56.3 | 198.7 | 188.6 | 8.7 | 172.2 | 0.342 |
| YoY (%) | 45.9 | 51.0 | | 25.7 | 13.5 | | 14.3 | 9.9 |

Source: Company data

Healthy catering business. Turnover of this business division rose 51.7% YoY to RMB627.9m, accounting for 80.5% of total revenue in 1H FY03/08A. Fu Ji secured over ten new customers during the period, including Cherry Automobile, Green Air-conditioner and Shanghai Pudong International Airport. Daily production volume enlarged by 42.1% YoY to 657,000 sets. Looking forward, the management plans to expand its school catering business to primary and secondary schools thanks to Jianding RDPC (Regional distribution and

processing centre), which is expected to start operation by the end of FY03/08F. The company also expanded business to exhibition and event sector by signing contracts with two leading exhibition centers in Shanghai and getting two catering services contracts for the 2008 Beijing Olympics.

Table 2: Turnover breakdown

| (RMBm) | 1H FY03/07A | % of total | 1H FY03/08A | % of total | Change (%) |
|-----------------------------|--------------|------------|--------------|------------|-------------|
| Catering Services | 413.8 | 77.4 | 627.9 | 80.5 | 51.7 |
| Chinese Restaurants | 102.4 | 19.1 | 125.5 | 16.1 | 22.6 |
| Convenience Food and others | 18.6 | 3.5 | 26.8 | 3.4 | 44.0 |
| Total | 534.8 | | 780.2 | | 45.9 |

Source: Company data

Other segments in track. As in 1H FY03/08A, Fu Ji operated six Chinese restaurants, four in Shanghai and two in Suzhou. Segmental revenue increased 22.6% YoY to RMB125.5m and operating profit reached RMB30.4m, up 22.6% YoY, thanks to higher average per-head spending and an increase in the number of restaurants. For convenience food and other business, turnover increased 44.0% YoY to RMB26.8 and operating profit decreased 80.6% YoY to RMB1.8m mainly due to additional payout for the development of distribution channels and logistic networks.

New business. The acquisition of Golden Hans was completed on 1 Nov 2007 and Sky Charm became Fu Ji's majority-owned subsidiary. The consideration will be lower than HK\$800.0m. Sky Charm is mainly engaged in the Golden Hans buffet restaurant chain, with presence in 24 cities in China. The management is very bullish on this theme restaurant business and expects a spin-off in the next 2-3 years. In addition, Fu Ji provided catering business on 24 trains since June 2007 and will offer this service to 50 more next year. In order to further expand this business, the Group has set up a JV with Wuhan Railway administration.

Optimized raw material structure. Amid the backdrop of soaring food prices in China, gross margin improved 2.0pcp YoY to 58.3% in 1H FY03/08A while for the single second quarter, it dipped 0.7pcp YoY to 56.8%. The company protects its gross margin mainly via: (1) optimization of raw material structure (e.g. introducing more aquatic products to replace pork) based on industry experience and know-how; (2) mild adjustment of selling price (raising selling prices to around 35.0% of its customers during the second quarter).

Costs due to expansion. The 0.7pcp decline in gross margin during 2Q FY03/08A can be mainly attributed to: (1) surging growth of semi-finished food catering service, which, started from 2H FY03/07A and represented around 27.0% of the entire catering business, carries lower margins than existing one (around 10.0pcp lower in gross margin and 4.0-5.0pcp lower in operating side); (2) recognition of some one-off expenses (near RMB1.0m) used for setting up train catering service; (3) exposure to food prices fluctuation during a certain month (the company sets food menu and selling price at the beginning of each month).

Inflation pressure to persist. Almost all operating items, from staff costs to fuel and utility costs, recorded substantial increase during 1H FY03/08A due to business expansion as well as inflation environment in the PRC. Operating margin narrowed from 37.2% last year to 32.0%. As we expect inflation in China to retain at a relatively high level in the next two years, plus the company's intention to expand train / semi-finished food catering service (extra expenses and margin dilution), we reckon its gross and operating margins will keep staying under pressure.

Table 3: Margin analysis

| Year to Mar (RMBm) | 1H FY03/07A | 1H FY03/08A | Change (pcp) |
|--------------------|-------------|-------------|--------------|
| Gross margin | 56.3 | 58.3 | 2.0 |
| Operating margin | 37.2 | 32.0 | (5.2) |
| Net margin | 32.2 | 25.2 | (7.0) |

Source: Company data

Revising estimates. We have penciled down our earnings forecast for the counter to reflect possible impact of costs pressure. We estimate the company will have RMB1,806.0m turnover in FY03/08F, up 50.6% YoY. Net profit will increase 30.2% YoY to RMB453.3m. Despite the rising raw material costs and operating expenses, net profit will likely be pushing by the strong growth of top line. In our model, the company's turnover will grow at a CAGR 47.1% from FY03/08F to FY03/10F, which of bottom line is 38.3% and EPS 29.9%. We maintain our BUY recommendation with a new target price of HK\$23.64 based on 18.0x FY03/09F forward P/E.

Table 4: Comparison of forecast

| Year to Mar (RMBm) | FY03/08F Old | FY03/08F New | Change (%) |
|--------------------|--------------|--------------|------------|
| Revenue | 1,800.0 | 1,806.0 | 0.3 |
| Gross profit | 1,044.0 | 1,066.9 | 2.2 |
| Operating profit | 631.8 | 569.9 | (9.8) |
| Net profit | 525.5 | 453.3 | (13.7) |
| EPS | 1.020 | 0.880 | (13.7) |
| Gross margin | 58.0 | 59.1 | 1.9 |
| Operating margin | 35.1 | 31.6 | (10.0) |

Source: Company data

Table 5: P&L

| Year to Mar (RMBm) | 2005A | 2006A | 2007A | 2008F | 2009F | 2010F |
|--------------------------------|--------------|--------------|----------------|----------------|----------------|----------------|
| Revenue | 454.7 | 796.8 | 1,199.4 | 1,806.0 | 2,877.8 | 3,814.4 |
| COGS | (173.7) | (344.1) | (504.1) | (739.1) | (1,192.1) | (1,599.2) |
| Gross profit | 281.0 | 452.6 | 695.4 | 1,066.9 | 1,685.7 | 2,215.2 |
| Other revenue | 8.8 | 31.9 | 52.0 | 53.8 | 59.2 | 58.1 |
| Staff costs | (19.2) | (56.2) | (97.8) | (162.5) | (273.4) | (362.4) |
| Operating lease rentals | (15.3) | (14.8) | (29.4) | (63.2) | (100.7) | (133.5) |
| Depreciation | (26.1) | (45.5) | (94.4) | (162.5) | (259.0) | (343.3) |
| Fuel and utility costs | (10.1) | (13.8) | (24.9) | (54.2) | (86.3) | (114.4) |
| Other operating expenses | (17.2) | (46.8) | (67.1) | (108.4) | (172.7) | (228.9) |
| Exceptionals | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Operating profit | 201.9 | 308.2 | 433.7 | 569.9 | 852.8 | 1,090.9 |
| Finance costs | (5.1) | (23.1) | (49.9) | (71.4) | (74.9) | (74.9) |
| Share of results of associates | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Profit before tax | 196.8 | 285.1 | 383.8 | 498.5 | 777.8 | 1,015.9 |
| Tax | (31.4) | (33.7) | (35.7) | (42.4) | (66.1) | (86.4) |
| Minority interests | 0.0 | 0.0 | 0.0 | (2.8) | (8.1) | (9.0) |
| Net profit | 165.4 | 251.4 | 348.1 | 453.3 | 703.6 | 920.6 |

Source: Company data

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