

DaChan Food: Chicken run

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Recommendation: Not Rated

China Food

Price	HK\$2.77	Yield (12/06A)	n.a.
12 mth range	HK\$2.52-3.55	ROE (12/06A)	20.1%
Market cap.	US\$360.2m	Net gearing (12/06A)	56.0%
No. shares o/s	1000.0m	Net debt/sh. (12/06A)	US\$0.024
Daily t/o, 3 mth	n.a.	BV/sh. (12/06A)	US\$0.074
Free float %	41.1%	Consensus EPS	
Major shareholder	Great Wall Enterprise – 52.9%	- 12/07F	US\$0.023
Ticker	3999.HK/ 3999 HK	- 12/08F	n.a.

Key points:

- China's largest chicken meat processor.
- To expand chicken meat production in south.
- Promised orders from KFC for new plants.
- New feed plant in Vietnam to come on stream in Jan 2008.
- Processed food production in Tianjin to start from mid-2008.

Competitive strength. Dachan Food (Dachan) is China's leading supplier of meat products and animal feed. Its principal business includes the manufacture of animal feed, chicken meat and processed food products. The company's competitive strength, in our view, mainly comes from its: (1) scale and well-accepted brands, (2) highly integrated business model, (3) stable and long-term relationships with customers. Driven by China's rising consumption of chicken meat (up at a CAGR of 6.0% in 1996-2005) and increasing penetration of quick-service restaurants (Dachan's major clients), the company's revenue rose from US\$429.7m in FY12/04A to US\$637.4m in FY12/06A and net profit from US\$2.6m to US\$13.4m.

Partner with fast-food chains. The company was China's largest chicken meat processor in terms of the number of chicken slaughtered in 2005. Its major clients are fast-food chains, including KFC, which accounts for about 16% of Dachan's chicken meat sales and 20% of all fast-food chain clients. Fast-food restaurant chains are important for Dachan is mainly due to their: (1) better margins (KFC - gross margin 7.5-8.0% vs the average of 7%); (2) promising growth prospects, (3) long-term relationship. The company now has seven chicken meat production plants, located in eastern coastal regions and plans to expand into southern areas. According to the company, KFC has promised to absorb 20% of the output of Dachan's new plants.

Vietnam expansion. The company produces chicken feed and sells it to contract farmers who raise the chickens. It also supplies pig feed to external clients. Its current utilization rate in China is 60-70%. The company also owns a feed plant in Vietnam, which has been fully utilized and represents around 40% of its entire feed revenue (US\$222.8m in FY12/06A). A new plant will be ready in Jan 2008, enlarging local capacity by 70%. The management expects demand for animal feed in Vietnam to remain strong and become a major growth driver for the segment.

Going north. Dachan also produces processed foods such as chicken, pork, fish and vegetables, which generated US\$37.9m in turnover (5.9% of total) in FY12/06A. Half of these processed products (mainly barbecue chicken) are sold in Japan via chain stores such as Ito-Yokado and 7-Eleven. Domestic sales are concentrated in the Shanghai area. The company will set up a new plant in Tianjin to cover China's northern regions. The capacity of the plant, which will start operation in mid-2008, will be similar to the Shanghai plant.

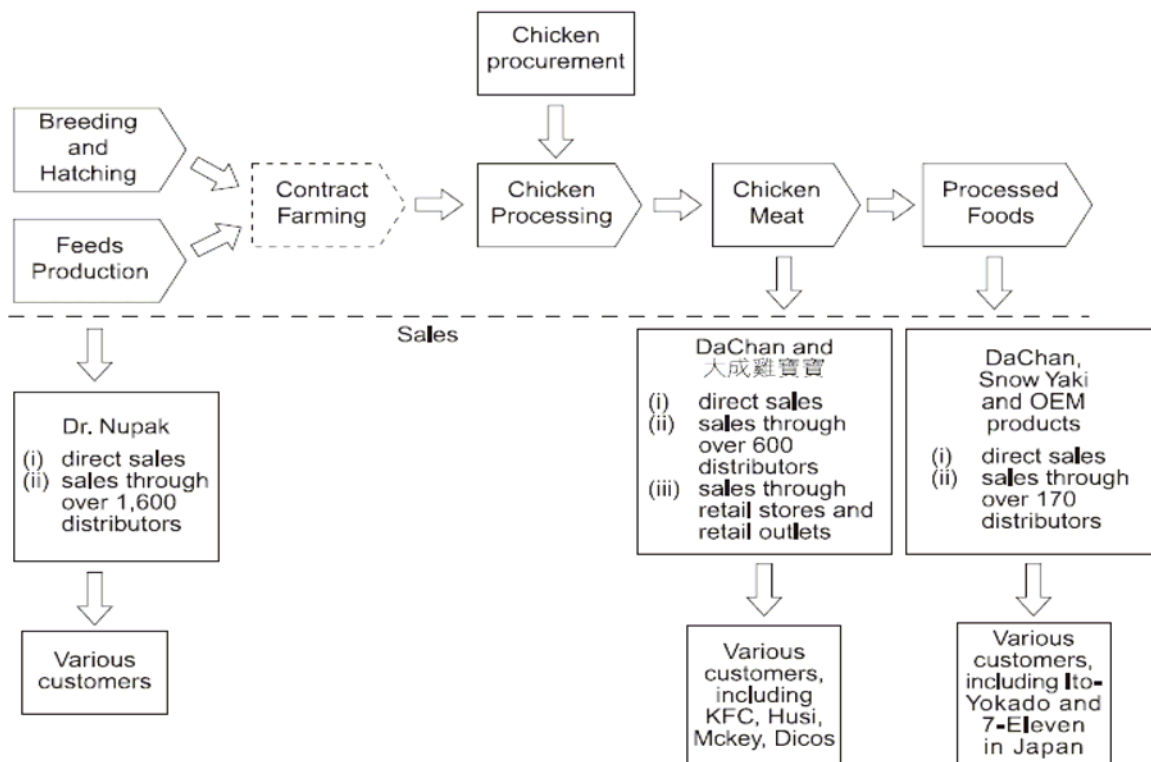
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Chart 1: Production flow



Source: Company data

Benefit from food price hikes. China’s price index of meat and poultry products surged 27.3% YoY in Jan-Aug 2007 or 49.0% YoY in Aug. Although the prices of corn and soybeans, Dachan’s main raw materials, have soared this year (corn prices rose around 30% YoY), the company expects to benefit from the rising food prices.

Encouraging 1-3Q FY12/07A results. During the period, revenue nearly doubled to US\$629.7m while net profit increased 54.1% YoY to US\$22.1m, near full-year target of US\$22.6m given in the IPO prospectus. Dachan’s gross margin was relatively flat, possibly because of changes in its sales mix, which offset the benefit of food price hikes.

Table 1: 1-3Q results

Nine months to Sep	Turnover (US\$m)	Gross profit (US\$m)	Gross margin (%)	Net profit (US\$m)
1-3Q FY07	629.7	54.6	8.7	22.1
1-3Q FY06	321.1	28.0	8.7	14.3
YoY (%)	96.1	94.7		54.1

Source: Company data

Valuation. The company is trading at HK\$2.84, representing a historical P/E of 19.6x or forward 15.1x, based on consensus estimates, above the food (diversified) industry average of 15.9x and 13.5x, respectively. We attribute the company’s premium valuation to its strong earnings growth.

Corporate governance. Dachan was listed on HKEx on 4 October 2007 via a global offering of total 310m shares (250m new and 60m old) at HK\$3.00 each. Its major shareholders include Great Wall Enterprise (52.88%), JP Morgan (8.40%) and Cazenove (7.35%)

Table 2: P&L

Year to Dec (US\$m)	04A	05A	06A
Revenue			
Chicken meat	268.2	303.9	376.7
Feeds	144.4	196.8	222.8
Processed foods	17.2	31.4	37.9
	429.7	532.1	637.4
Cost of sales	(401.2)	(488.6)	(583.9)
Gross profit	28.6	43.5	53.5
Change in fair value of biological assets less estimated point-of-sale costs	0.3	(0.1)	(0.2)
Fair value of agricultural produce on initial recognition	2.3	3.6	3.5
Reversal of fair value of agricultural produce due to sales and disposals	(2.5)	(3.7)	(3.1)
Other income	1.5	1.4	4.8
Distribution costs	(11.1)	(15.6)	(19.1)
Administrative expenses	(12.7)	(15.3)	(18.0)
Other operating expenses	(0.9)	(0.3)	(0.6)
Profit from operations	5.5	13.5	20.6
Finance costs	(2.7)	(2.9)	(2.7)
Share of profits less losses of jointly controlled entities	0.1	0.2	0.8
Profit before tax	2.9	10.8	18.7
Income tax	(1.2)	(1.9)	(2.2)
Profit for the year	1.7	8.9	16.5
Attributable to			
Equity holders of the Company	2.6	8.5	13.4
Minority interests	(0.9)	0.4	3.1
Dividends	1.0	-	-
EPS - Basic (US\$)	0.004	0.011	0.018

Source: Company data