Corporate Snippet

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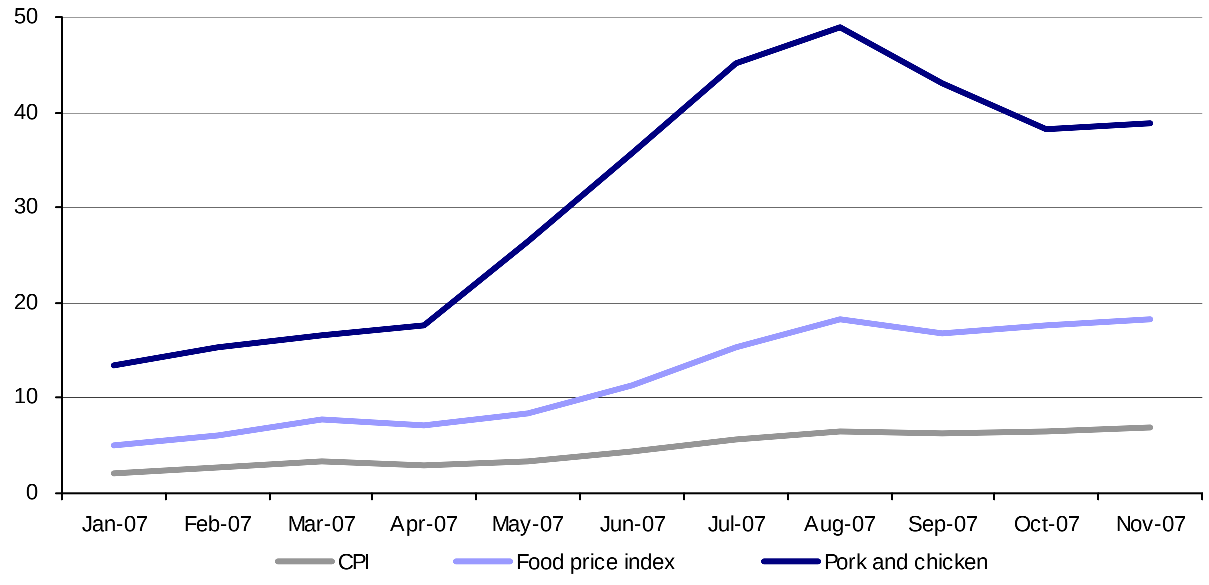
Sandwiched in the middle — China Consumption Sector

Price control. In a bid to curb surging prices, China will temporarily require all sizable food producers of processed grains, edible oil, pork, beef, mutton, diary products, eggs, etc to obtain government approval before rising their prices, the National Development and Reform Commission (NDRC) said in its 15 Jan 2008 announcement. Wholesalers and retailers will be required to justify their prices adjustment to the authorities. This is the government's third recent attempt to control food prices. On 14 Dec 2007, the Ministry of Finance and the State Administration of Taxation decided to abolish export tax rebates of 5-13% for 84 types of grains and grain products, effective from 20 Dec 2007. On 4 Jan 2008, the General Administration of Customs imposed export duties of 5-25% on 57 types of grains and grain products, with effect from 1 Jan to 31 Dec 2008.

Inflation. The CPI jumped 6.9% in November and 4.6% in the first 11 months of 2007, mainly due to rising food prices. The price of pork rose 30.9% YoY in the Jan-Nov period and of grain 6.4% YoY (+2.7% in 2006 and +1.4% in 2005). The price of corn and wheat has strengthened considerably, especially in 2H.

Chart 1: YoY change of price indices in China (%)



Source: National Bureau of Statistics

Expected impact of new policies. The first two policies aim to raise grain export costs substantially and therefore boost China's domestic supply. We expect their impact on grain prices to be limited and temporary because: 1) China exports only a small proportion of its grain output (around 1.0% of rice and 3.0% of corn); 2) strong local demand is backed by rising living standards; 3) global grain supply remains tight. The NDRC's policy, despite allowing a reasonable margin, will make it more difficult for producers to raise selling prices (especially of high-margin products such as milk) and create a price adjustment lag (in low-margin products such as edible oil).

Sector outlook. We expect China's inflation to persist in 2008 backed by high crude oil prices and the current tight supply of grain worldwide. The Chinese government may introduce more measures to curb price rises. Against this backdrop, we believe food producers' margins may come under pressure because of: 1) rising raw material costs; 2) pressure on selling prices from competition and government policies. Those whose end products fall into government-controlled categories, such as Mengniu (2319 HK), China Agri-Industries (606 HK), Yurun (1068 HK) and People's Food (PFH SP), will face severe margin pressure because of surging raw material costs (raw milk, soybean, hogs, etc) and directly regulated selling prices of diary products, edible, meat, etc.

Stock picks. We prefer companies that are best equipped to pass on their cost increments and upstream players, for their lesser costs pressure and rising selling prices amid inflation. China Green (904 HK, HK$8.78, BUY), a vertically integrated food producer, remains our top pick. We expect its turnover to grow 30.0% YoY to RMB1.24b in FY04/08F and net profit 25.8% YoY to HK$435.3m. Its EPS should increase 18.3% YoY to RMB0.473. The company's major growth drivers include: 1) its newly launched non-fried noodles; 2) expansion of its processed and pickled products business: 3) enlarged cultivation area. The company has yet to confirm whether its products (mainly packaged corn) will be subject to the new export duty. However, its FY04/08F outlook should be intact based on signed contracts. Despite a potential negative impact of China's new food export policy, we believe China Green's growth will be sustainable given: 1) strong food demand; 2) expanding upstream production capacity; 3) cost advantages over overseas peers (even including the new export duty).

Other attractive counters include China Fishery (CFG SP, S$1.56, NR) and Pacific Andes (1174 HK, HK$1.68, BUY). China Fishery is an ocean fisher focusing on Alaska pollock, an important food groundfish and Peruvian anchovy, used in fishmeal production. Pacific Andes is the parent of China Fishery. It also owns other two business segments: frozen fish supply chain management (similar to fish trading) and fish processing and distribution.

Table 1: Stock list

	Recomm.	Target Price	
Upstream player			
China Fishery (CFG SP)	NR	n.a.	The company said its fish product prices rose 10% in 2007. Gross margin of the ocean trawling segment narrowed 22.4pcp to 17.5% in 1-3Q FY12/07A due to efficiency ramp-up of new 3rd and 4th VOAs and fee structure changes in 4th VOA. We estimate its gross margin expanded 2.6pcp YoY in 3Q (if 4th VOA has the same fee structure as the 3rd one).
Vertically-integrated company			
China Green (904.HK)	BUY	HK$11.29	Blended gross margin dipped 2.8pcp in 2H FY04/07 versus a 0.6pcp improvement in 1H, mainly due to sales mix changes (higher contribution from the lower-margin branded food & beverage segment). The company will announce interim results by end-January. The major concern is the impact of the new food export policy.
Pacific Andes (1174 HK)	BUY	HK$3.55	The company said the overall impact of rising food prices has been positive and the blended gross margin widened 1.7pcp to 17.8% in 1H FY03/08, thanks to sales mix changes (higher contribution from the higher-margin fishing segment). The gross margin of fish processing narrowed 3.2pcp to 12.8% during the period.
Dachan Food (3999 HK)	NR	n.a.	The company said the overall impact of rising food prices has been positive. Its blended gross margin narrowed 4.4pcp in Jun - Sep 2007. As most of its income comes from the feed business (including internal sales), we expect the margin to be eroded further because of the high corn price.
Food processor			
China Starch (3838.HK)	NR	n.a.	Blended gross margin widened 0.7pcp in 1H FY12/07A due to sales mix changes. The company can pass on s substantial portion of raw materials cost rises in its cornstarch segment (corn prices up 21.5% YoY versus 13.9% up-adjustment of cornstarch selling prices)
Fufeng Group (546.HK)	NR	n.a.	Gross margin narrowed 10.7pcp in 1H FY12/07A while corn prices rose 23.7% and the selling price of MSG declined 1% YoY due to increased supply in China.
Xiwang Sugar (2088.HK)	NR	n.a.	Gross margin narrowed 6.7pcp in 1H FY12/07A due to higher corn prices (up 12% YoY) and low sugar prices. With the strong sugar price rebound recently, we expect the gross margin to recover in 2H.
China Agri-Industries (606.HK)	NR	n.a.	Blended gross margin widened 1.6pcp in 1H FY12/07A. The gross margin of its core business, oilseed, should stay at the 2H level as the prices of oilseed (raw material) and edible oil (end product) have risen. The gross margin of brewing materials will decline HoH because the company used its old inventory in production in 1H, which cut costs. The company expects to pass on cost hikes to customers as beer producers try to use the same suppliers of malt to maintain their beer taste.
Global Bio-chem (809.HK)	NR	n.a.	Gross margin narrowed 0.4pcp in 1H FY12/07A to 22.0%. Corn price hikes were kept at 16% thanks to its extensive storage ability. Selling prices of upstream products rose 21% YoY. The gross margin of downstream products narrowed 2pcp to 25.1% due to lower selling prices.
Global Sweeteners (3889.HK)	NR	n.a.	Gross margin narrowed 1.5pcp to 20.0% in 1H FY12/07A. The company sources a substantial portion of raw materials from parent. Corn cost increased 16.4% YoY. The company also has an exposure to sugar through Xiwang Sugar (2088 HK)
People's Food (PFH SP)	NR	n.a.	Gross margin narrowed 4.8pcp in 1-3Q FY12/07A due to higher costs of live pigs in China

Table 1: Stock list (cont)

	Recomm.	Target Price	
Yurun Food (1068 HK)	NR	n.a.	Gross margin narrowed 2.2pcp in 1H FY12/07A mainly due to sales mix changes with a higher share of upstream products (chilled/frozen pork). Gross margin of downstream products (LTMP and HTMP) narrowed 0.3pcp to 25.9%, thanks for better controls of raw hog costs. Gross margin of upstream products narrowed 1.4pcp to 10.1%.
Fuji Catering (1175 HK)	BUY	HK$23.64	Gross margin widened 2.0pcp in 1HFY03/08A but narrowed 0.7pcp in 2Q. The company can pass cost hikes to customers. However the blended margin may narrow further because of the expansion of lower-margin semi-completed food products
Tingyi (322 HK)	NR	n.a.	Gross margin narrowed 1.1pcp in 3Q FY12/07, with cost pressure from flour and palm oil. The company expects to expand its market share, as competitors can no longer maintain low prices under inflation.
Uni-president (220 HK)	NR	n.a.	Gross margin widened 3.9pcp in 1H FY12/07A mainly due to the margin expansion of its beverage business. The gross margin of instant noodles narrowed 0.6pcp because of rising raw material costs.
Beverage company			
Mengniu (2319 HK)	NR	n.a.	Gross margin widened 1.2pcp in 1H FY12/07A. The rising price of raw milk will likely hurt its gross margin in FY12/07F. The price of raw milk increased 10% in 1Q and 15-20% in 4Q (average 13% for FY12/07F). The company increased selling prices in Dec 2007
Haisheng Juice (359 HK)	NR	n.a.	Gross margin narrowed 3.0pcp in 1H FY12/07A. Though selling prices of juice concentrate increased in the period, the gross margin was eroded higher purchase costs of apples.
Huiyuan Juice (345 HK)	NR	n.a.	Gross margin widened 3.3pcp in 1H FY12/07A. ASP rose 9.9% during the period. Raw materials (juice concentrate and purees) rose much faster than top line (52.8% versus 24.7%) The margin expansion should contribute to better control of other costs.
Kingway (124 HK)	NR	n.a.	Gross margin narrowed 6.3pcp in 1H FY12/07A. ASP declined 2.0% YoY while costs increased 8.7% YoY. The company issued profit warning in Dec 2007.
Tsingdao (168 HK)	NR	n.a.	Gross margin was stable in 1H FY12/07A. ASP increased 4.0% in 1H and 3.9% in 3Q. The company expects to mitigate cost pressure via group purchases and the revamp of its product structure.

Source: SBI E2-Capital