

Hong Kong/ China & Singapore

Small/ Mid Cap Research

HK Team

Kennedy Tsang

(852) 2533 3713

kennedytsang@sbie2capital.com

Andes Cheng

(852) 2533 3721

andescheng@sbie2capital.com

Norman Zhang

(852) 2533 3715

normanzhang@sbie2capital.com

E Wuen Tan

(852) 2533 5697

ewuantan@sbie2capital.com

Helena Qiu

(852) 2533 3709

helenaqiu@sbie2capital.com

Catherine Hua

(852) 2533 3708

catherinehua@sbie2capital.com

SG Team

Eric Ong

(65) 6826 0831

eric.ong@sbie2capitalasia.com

Andreas Chan

(65) 6826 0820

andreas.chan@sbie2capitalasia.com

Cynthia Chiang

(65) 6826 0251

cynthia.chiang@sbie2capitalasia.com

Avoiding the mousetrap

China's consumption sector rose 11.4% YoY in real terms in 2007. We expect the pace of growth to be sustained in 2008, backed by strong macro drivers including rising personal incomes, improving social welfare system and growing consumer confidence. Overall, we continue to be bullish on this sector and believe that it would remain a core investment focus in 2008. However, inflation, government policies and the recent spell of cold weather may pose short-term threats to the earnings of some enterprises. Amid this backdrop, we believe the key to recording outperformance is selecting companies with fundamental attributes that minimize or negate these short-term risks, while possessing a reasonable risk-to-reward ratio. Meanwhile, we reduce weight on pure downstream food companies on rising regulatory risks. For 2008, our China consumption strategy is built around the following themes:

- **Non-traditional consumption plays** – We are especially bullish on this theme as companies such as Guangzhou Pharmaceuticals (874 HK, HK\$5.18, BUY), which manufactures the popular herbal tea beverage Wanglaoji and Guangnan (1203 HK, HK\$1.36, BUY), which supplies tinfoil, a key packaging material for consumer products can tap its exposure to China's domestic consumption market but are currently trading at undemanding valuations.
- **Vertically integrated or robust business models** – Vertically integrated companies have a better control over its margins. Our favourite in under this theme is China Green (904 HK, HK\$8.02, BUY). We also like Yip's Chemical (408 HK, HK\$5.40, BUY). This non-traditional consumption play has a unique natural hedging mechanism in its business model which partially insulates it against raw material price volatility.
- **Potential gainers from inflation** – China Fishery (CFG SP, S\$1.68 BUY) is an ocean fisher, whose main produce are Alaska Pollock, an important food groundfish and Peruvian anchovy, used in producing fishmeal as feedstock to live poultry.

SBI E2-Capital's "Recommended List"

Company	Ticker	Recomm.	Share price*	Target price	Upside (%)
Hong Kong					
China Green	904 HK	BUY	HK\$8.02	HK\$11.84	47.6
Guangnan	1203 HK	BUY	HK\$1.36	HK\$2.04	50.0
Guangzhou Pharmaceutical	874 HK	BUY	HK\$5.18	HK\$8.80	69.9
Yip's Chemical	408 HK	BUY	HK\$5.40	HK\$7.40	37
Singapore					
China Fishery	CFG SP	BUY	S\$1.68	S\$3.17	88.7

* All prices are as of market close of 6 Feb, 2008

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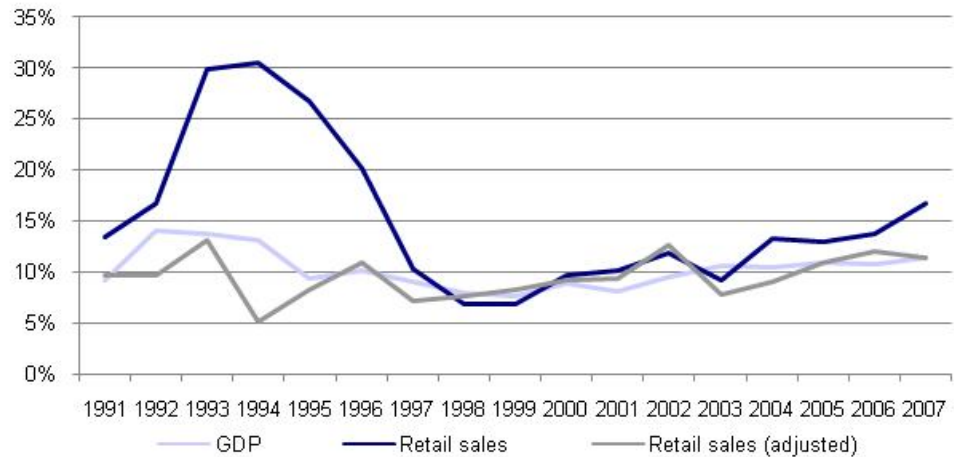
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Domestic consumption maintains good shape in 2007

Avoiding the mousetrap

Buoyed by robust economic growth, China's domestic consumption remained in good shape in 2007. Total sales of consumer goods was up 16.8% YoY at RMB RMB8,921bn. After stripping off the effect of inflation (CPI up 4.8% YoY in 2007), we put the real increase in consumer goods sales at 11.4%, in line with GDP growth in the period.

Chart 1: China's GDP and retail sales (consumer goods) growth



Source: National Bureau of Statistics, SBI E2-Capital

Growing spending confidence

We expect China's domestic consumption sector to sustain its current boom underpinned by rising household incomes and the improving social welfare system and one-off catalyst such as the 2008 Beijing Olympics. As a leading indicator, consumer confidence index stood at a high of 96.9 in Dec 2007, up from 96.0 in November.

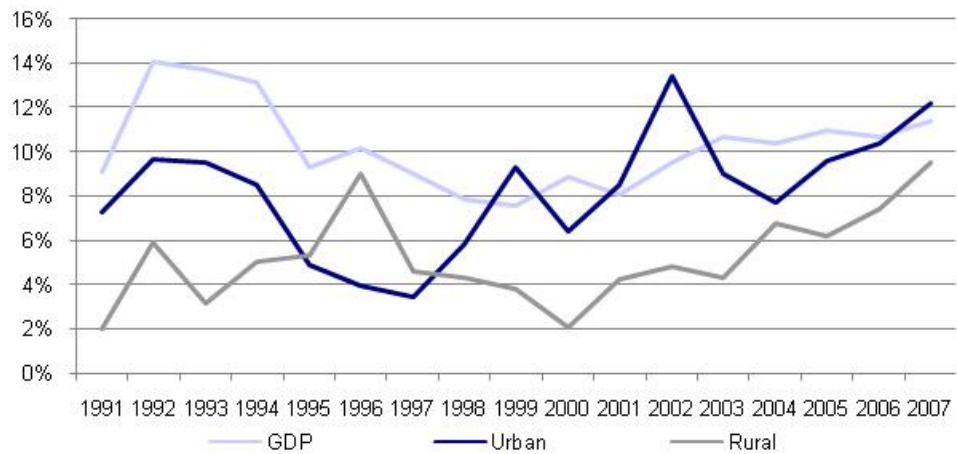
Chart 2: Consumer confidence index in China



Source: National Bureau of Statistics

Rising incomes

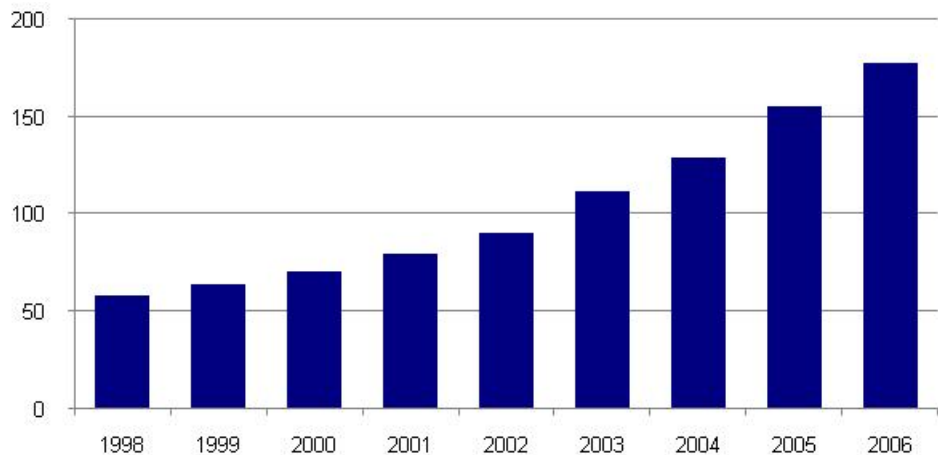
The average per capita disposable income (in real terms) in 2007 increased 12.2% YoY in urban areas and 9.5% in rural areas. We expect this pace of growth to be sustained this year thanks to China's sustained economic expansion and the government's plan to boost incomes via raising of minimum salaries and issuing of new labor laws.

Chart 3: China's GDP and per capita disposable income

Source: National Bureau of Statistics

Increase government spending on healthcare to further spur domestic consumption

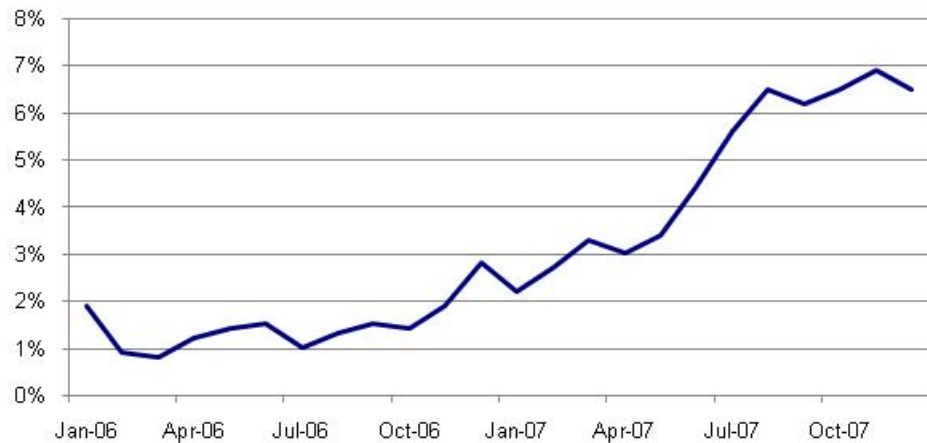
China's social welfare system is improving with the public health spending up 14.2% YoY at RMB177.4bn in 2006. The total number of people covered by basic pension, medical and unemployment insurance schemes was 186.5m, 157.4m and 111.9m, respectively, at the end of 2006. China traditionally has a high savings ratio as the high level of out-of-pocket healthcare expenses had forced the average consumer to save more, preparing for the "rainy day". The improvement and greater coverage in the social welfare system, together with increased government expenditure on healthcare, should partially alleviate this burden, help reduce the savings ratio across the country and encourage personal spending in the long term.

Chart 4: Government budgetary healthcare expenditure (RMBbn)

Source: MoH

Inflation will test profitability of many consumption stocks

China's CPI climbed 4.8% for 2007 (6.5% in December). In 2008, inflation may persist given the high crude oil price and tight food supply worldwide. The recent blizzard in southern China may exacerbate the situation and further drive up food prices. In an inflationary environment, we expect margins for many consumption related companies to come under pressure as they will find it hard to fully pass on extra costs to customers due to keen competition. Among the 20 food-related stocks we surveyed and reviewed based on their recent financial results, 13 reported a gross margin retreat, with most of them attributing the main cause to increasing raw materials costs.

Chart 5: China's CPI

Source: National Bureau of Statistics

Risks from government efforts to curb inflation

In order to control inflation, the Chinese government has implemented a series of new food policies, which we believe may threaten the profitability of some food producing companies. Chief amongst these were the recent price interference policy issued by the National Development and Reform Commission (NDRC). The details of this policy include:

- Provincial price authorities should submit lists of food wholesalers / retailers, who are required to obtain approval before price adjustment; and
- City / county-level price authorities should submit lists of food wholesales / retailers, who are required to justify price adjustments.

Table 1: Summary of recent government food-related policies

Date	Policy details
14 Dec 2007	Ministry of Finance and the State Administration of Taxation announced the abolishment of export VAT rebates (5-13%) for 84 types of grains and grain products, starting from 20 December
04 Jan 2008	China Customs imposed export duties, ranging from 5% to 25%, on 57 types of grains and grain products, effective from 1 Jan to 31 Dec 2008
15 Jan 2008	NDRC launched temporary price control measures on important daily necessities such as processed grains, edible oil, meat, dairy products and eggs. According to the new rules, sizable producers have to obtain governmental approval before raising their prices

Source: NDRC

The first two policies aim to raise grain export costs substantially and therefore boost China's domestic supply. The NDRC's policy will make it more difficult for producers to raise selling prices and create a price adjustment lag. For the third policy, despite the government re-iterating that it is aimed at curbing irrational price hikes, rather than a "price frozen" policy, we nevertheless expect this to adversely impact margins. To date, Anhui and Hubei has released their list of food producers under monitoring and going forward, we think it is possible for them to put more producers on the list. Meanwhile, we expect other provinces to progressively release their monitor lists.

Table 2: Food producers currently impacted by price interference policy

Sector	Companies
Instant noodle	Tingyi (322 HK), Uni-president (220 HK), 今麥郎, 白象
Edible oil	益海投資, China Agri-Industries (606 HK), 九三糧油, 魯花集團
Dairy products	Yili (600887 CH), Mengniu (2319 HK), Bright (600597 CH), 三鹿

Source: NDRC

Our strategy

Overall, we continue to be bullish on China's domestic consumption sector and believe that it would remain one of the core focus of the investment community in 2008.

However, inflation, government policies and the recent spell of cold weather may pose short-term threats to the earnings of some enterprises. Amid this backdrop, we believe the key to recording outperformance is selecting companies with fundamental attributes that minimize or negate these short-term risks, while possessing a reasonable risk-to-reward ratio.

We reduce weight on pure downstream food companies as growing regulatory risks and competition may restrict food producers / sellers' ability to pass on incremental costs to customers.

For 2008, our China consumption strategy is built around the following themes:

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- **Potential gainers from inflation** – China Fishery (CFG SP, S\$1.68 BUY) is an ocean fisher, whose main produce are Alaska Pollock, an important food groundfish and Peruvian anchovy, used in producing fishmeal as feedstock to live poultry.

COMPANY REPORT – HK

China Green: Capitalize on price hike

Recommendation: BUY (unchanged)
China Agriculture

Price	HK\$8.02	Year to	Net profit	EPS	EPS	P/E	P/B	EV/EBITDA	Yield	ROE	ROCE	N. Gear.
Target price	HK\$11.84 (+48%)	Apr	RMBm	RMB	Δ %	x	x	x	%	%	%	%
12 mth range	HK\$4.50-9.60	06A	271.3	0.364	32.4	20.7	4.9	13.1	1.4	26.9	22.6	Cash
Mkt cap.	US\$907.4m	07A	346.0	0.417	14.6	18.1	3.8	8.9	1.5	24.6	21.7	Cash
Daily t/o, 3 mth	US\$2.9 m	08F	473.8	0.498	19.4	15.1	2.9	5.7	1.9	23.8	20.0	Cash
Free float %	49.5%	09F	580.1	0.592	18.9	12.7	2.4	4.0	2.2	23.1	18.8	Cash
Ticker	0904.HK/904 HK	10F	690.9	0.705	19.1	10.7	2.0	2.8	2.6	23.1	20.5	Cash

Relative to Hang Seng Index (1 mth, 3 mth, 12 mth): +12.0%, +18.5%, +55.5%
Actual price changes (1 mth, 3 mth, 12 mth): -4.5%, -5.5%, +76.7%
Consensus EPS (08F-09F): RMB0.470, RMB0.565

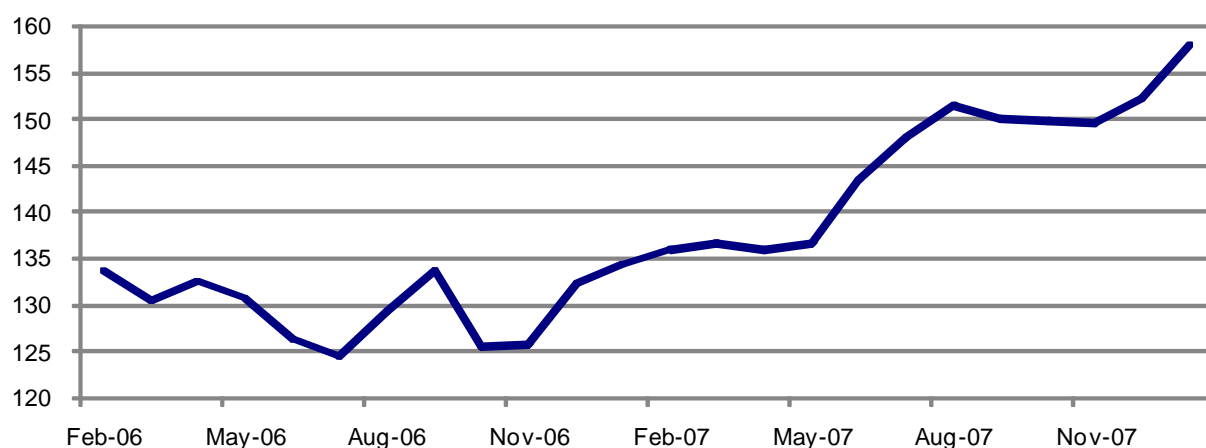
Key points:

- 5.0% price increase during 1H FY04/08A.
- Gross margin of fresh produce widened when price rose.
- Targets 15.0% increase in cultivation area for FY04/09F.
- Setting up organic farming base in Hubei.
- Beverage business is exploring markets outside Fujian and Jiangxi.
- Three new instant noodle production lines will launch operation in Jul – Aug.
- Target price raised from HK\$11.29 to HK\$11.84 to reflect better-than-expected 1H FY04/08A results.

Investment summary. With upstream farming operation, we expect China Green (CG) to benefit from food price hike in the PRC. Both fresh produce and processed food segments are likely to be strengthened continuously in FY04/09F and FY04/10F with acquisition of new farmland and establishment of organic farming base in Hubei. For the downstream branded beverage and instant noodle division, we expect strong top-line growth to offset potential margin squeeze under cost pressure. CG is our top pick among China consumption sector.

- ❑ The company observed 5.0% increase in ASP of fresh produces in 1H FY04/08A. Gross margin improved 0.6pcp YoY.
- ❑ CG plans to lease 10,000 – 12,000 mu (666.7 – 800.0 hectares) for FY04/09F, with 4,000 mu (266.7 hectares) already secured. Total cultivation area then will reach 76,100 – 78,100 mu (5,073.3 – 5,206.7 hectares).
- ❑ The organic agriculture base in Hubei with a cultivation area of 10,000 mu (666.7 hectares) is expected to start operation in Sep – Oct 2008.
- ❑ Beverage products are tapping into markets outside Fujian and Jiangxi.
- ❑ Existing 6,800 tonnes capacity of instant noodle has been fully utilized. Three new lines in Jiangxi and will launch production in Jul – Aug, bringing in additional 12,000 tonnes capacity.

Higher ASP. The ASP of CG's fresh products (broccoli, radish, long onion, soya bean, etc) rose about 5.0% YoY in 1H FY04/08A and we expect similar rates of growth in 2H FY04/08F and FY04/09F given: 1) China's rising vegetable prices; 2) accelerating appreciation of the RMB against USD (the company is allowed to renegotiate prices with overseas customers once RMB appreciates more than 3.0% during the contract period); 3) lag in revenue recognition (4 – 9 months between contract signing and final delivery). We expect prices of processed food products to rise as well.

Chart 1: China's agriculture products wholesale price index

Source: Ministry of Agriculture of the PRC

Table 1: RMB appreciation against US\$

	4-month (%)	9-month (%)	6-month (%)
Dec-07	3.2	5.9	4.2
Nov-07	2.4	4.7	3.4
Oct-07	2.0	4.2	3.2
Sep-07	1.9	4.1	3.1
Aug-07	2.2	3.8	2.7
Jul-07	2.1	4.0	2.6
Jun-07	1.8	3.9	2.7

Source: Bloomberg

Note: The normal length of the company's contracts is 4 – 9 months and the average is around 6 months.

Margin expansion. Despite rising raw material (fertilizer, packaging etc) and labor costs, we expect the ASP increase to underpin the gross margin of fresh produce and processed product divisions. The gross margin of fresh produce will widen 0.5pcp to 54.2% in FY04/08F (up 0.6pcp in 1H) and of processed products will narrow 0.3pcp (down 0.7pcp in 1H).

Strong Japan, slowdown in Europe. Japan remained the company's largest overseas market in 1H FY04/08A, generating RMB172.2m in revenue (up 36.0%) compared with 8.1% growth in FY04/07A, due to the launch of frozen products. Sales in Europe fell 4.7% to RMB35.8m (up 134.8% in FY04/07A) because of fewer mushroom contracts due to price renegotiation. We expect European sales to recover in 2H FY04/08F.

Table 2: Sales by market in 1H FY04/08A

	Turnover (RMBm)	% of total	YoY growth (%)
Japan	172.2	32.3	36.0
China	293.4	55.0	39.8
Other Asian countries	28.0	5.2	117.8
Europe	35.8	6.7	-4.7
Australia	0.6	0.1	45.6
South America	2.8	0.5	n.a.
Africa	1.1	0.2	n.a.

Source: Company data

Seeking more land. The company has 66,100 mu (4,406.7 hectares) of farmland with a total output of 273,200.0 tonnes crops in FY04/08F. In preparation for FY04/09F, it plans to lease additional 10,000 – 12,000 mu (666.7 – 800.0 hectares), with 4,000 mu (266.7 hectares) already secured. We estimate its output at 313,389.0 tonnes in FY04/09F, including 171,322.5 tonnes of fresh produce (up 7.1% YoY) and 142,066.5 tonnes as raw materials for processed products (up 25.5% YoY).

Organic farming. From 2H FY04/08F, the company will allocate 10,000 mu (666.7 hectares) in Hubei for an organic agriculture base, expected to start operation in Sep - Oct 2008. This will reduce the fresh produce division's output in 2H FY04/08F (segmental sales up 25.4% YoY in 1H). We expect this new business to contribute 9.3% of

CG's total turnover in FY04/10F. The company plans to have 20,000 mu (1,333.3 hectares) under organic cultivation in three years.

Beverage segment in good shape. Turnover of beverage products rose 66.5% to RMB89.3m in 1H FY04/08A. CG is expanding its sales network from two provinces (Fujian and Jiangxi) to Hunan, Hubei and Zhejiang. This geographic expansion will be a major driver of the beverage business, in our view.

Instant noodle operation on track. CG launched its non-fried instant noodle business in Jan 2007. The product has been well accepted by the market and its existing capacity (6,800 tonnes p.a.) has been fully occupied. Three new production lines, with 4,000 tonnes each, will be added in Jiangxi in Jul – Aug 2008. We expect the segment to grow rapidly in the next two years. The company raised its selling price of instant noodles by around 3.0% (RMB0.1 in end prices) in Oct 2007, which will boost the segment's gross margin in 2H FY04/08F.

Limited impact of new food policy. The company's corn products have been categorized as vegetables and are not subject to China's new grain export duties. The central government's control of prices of important daily necessities, such as instant noodles, will restrict CG's ability to pass incremental costs to customers. However, as a producer of non-fried instant noodles (no palm oil needed in production), CG enjoys much higher gross margins than traditional players such as Tingyi (25.0% in 1-3Q FY12/07A) or Uni-president (20.8% in 1H FY12/07A). This gives CG an edge in this competitive market.

Earnings forecast. Driven by its increasing crop output and maturity of the branded beverage and instant noodle business, we estimate CG's top line will grow at a CAGR of 26.1% from FY04/07A to FY04/10F. Branded beverage and instant noodle business will stay under cost pressure due to rising raw material costs (corn powder, sugar, packaging materials). Nevertheless we expect blended gross margin to improve backed by change of sales mix (lower growth in sales of lower-margin rice products - gross margin 28.1% in 1H FY04/08A). According to the company, its rice and rice flour product sales will grow at single-digit rate (5-7% p.a.) in the next two to three years, with stable margins. In 1H FY04/08A the blended gross margin widened 0.6pcp to 51.6%. Overall, we expect CG's net profit to increase 37.1% in FY04/08F to RMB473.8m and 22.4% in FY04/09F to RMB580.1m.

Target price lifted. We have increased our FY04/08F EPS to RMB0.498m from RMB0.473m to reflect the better-than-expected 1H results. We have adopted more conservative assumptions for CG's organic agriculture business (10,000 mu (666.7 hectares) cultivation area by FY04/10F instead of 20,000 mu previously), which resulted in minor net profit estimates cut for FY04/09F and FY04/10F. The counter is our top pick in China's consumption sector for its ability to benefit from inflation. Our new target price of HK\$11.84 represents 19x FY04/09F fully diluted PE.

P & L (RMBm)	06A	07A	08F	09F	10F
Year to Apr					
Turnover	686.6	954.1	1,236.1	1,559.3	1,913.7
% chg	45.9	39.0	29.5	26.1	22.7
Gross profit	354.4	497.9	648.5	822.5	1,014.7
EBITDA	314.7	415.8	582.7	750.1	923.6
Depre./amort.	(53.1)	(70.5)	(90.4)	(115.9)	(133.5)
EBIT	261.6	345.3	492.3	634.3	790.1
Net int. income/(exp.)	0.7	0.4	22.7	36.4	47.3
Exceptionals					
Associates					
Jointly-controlled entit.					
Pre-tax profit	262.3	345.8	515.0	670.6	837.5
Tax	9.0	0.2	(41.2)	(90.5)	(146.6)
Minority interests					
Net profit	271.3	346.0	473.8	580.1	690.9
% chg	47.8	27.5	36.9	22.4	19.1
Dividends	(75.2)	(91.3)	(131.4)	(159.6)	(187.8)
Retained earnings	196.1	254.7	342.4	420.5	503.2
EPS (RMB) - Basic	0.373	0.448	0.542	0.655	0.780
EPS (RMB) - F.D.	0.364	0.417	0.498	0.592	0.705
DPS (RMB)	0.104	0.110	0.140	0.170	0.200
No. sh.s o/s (m) - W.A.	728.1	772.5	874.0	885.7	885.7
No. sh.s o/s (m) - Y.E.	731.3	847.0	885.7	885.7	885.7
No. sh.s o/s (m) - F.D.	760.8	864.8	953.6	979.5	979.5
Margins (%)					
Gross	51.6	52.2	52.5	52.7	53.0
EBITDA	45.8	43.6	47.1	48.1	48.3
EBIT	38.1	7.0	39.8	40.7	41.3
Pre-tax	38.2	36.2	41.7	43.0	43.8
Net	39.5	36.3	38.3	37.2	36.1
Cash Flow (RMBm)	06A	07A	08F	09F	10F
Year to Apr					
EBIT	261.6	345.3	492.3	634.3	790.1
Depre./amort.	53.1	70.5	90.4	115.9	133.5
Net int. paid	6.4	5.6	22.7	36.4	47.3
Tax paid	0.0	0.0	(37.8)	(87.0)	(142.8)
Dividends received					
Gross cashflow	321.1	421.3	567.6	699.5	828.1
Chgs. in working cap.	(7.4)	8.3	10.4	(8.6)	(9.5)
Operating cashflow	313.7	429.7	578.0	690.9	818.6
Capex	(257.1)	(190.9)	(323.1)	(254.0)	(212.8)
Free cashflow	56.7	238.8	254.8	436.9	605.8
Dividends paid	(57.5)	(83.7)	(108.8)	(143.3)	(171.5)
Net distribution to MI					
Investments					
Disposals					
New shares	0.0	280.8	247.0	0.0	0.0
Others	20.2	(1.1)	(11.4)	(7.7)	(5.3)
Net cashflow	19.3	434.8	381.6	285.8	429.0
Net (debt)/cash - Beg.	531.8	551.1	985.9	1,367.5	1,653.4
Net (debt)/cash - End.	551.1	985.9	1,367.5	1,653.4	2,082.4
Interim Results (RMBm)	06A	07A	08A		
Six months to Oct					
Turnover	262.5	387.2	533.7		
% chg		47.5	37.8		
Profit from operations	106.4	148.0	218.5		
Interest expenses	0.0	(6.4)	(1.1)		
Associates					
Jointly-controlled entit.					
Pre-tax profit	106.4	141.5	217.3		
Tax	0.0	0.0	(9.5)		
Minority interests					
Net profit	106.4	141.5	207.8		
% chg		33.0	46.8		
EPS (RMB) - Basic	0.150	0.190	0.240		
DPS (RMB)	0.040	0.048	0.063		
Balance Sheet (RMBm)	06A	07A	08F	09F	10F
Year to Apr					
Fixed assets	400.9	475.5	689.9	815.9	877.4
Intangible assets	132.9	176.8	189.7	198.1	210.8
Other LT assets	0.0	0.0	0.0	0.0	0.0
Cash	852.9	1,050.5	2,232.8	2,518.6	2,947.6
Accounts receivable	22.6	11.4	21.7	27.3	33.5
Other receivables	37.8	39.2	12.7	16.0	19.7
Inventories	7.7	14.3	26.5	33.4	41.0
Due from related co.s					
Other current assets	63.6	73.3	89.3	100.7	111.1
Total assets	1,518.4	1,841.0	3,262.5	3,710.1	4,241.2
Accounts payable	(16.2)	(22.4)	(28.7)	(36.0)	(44.0)
Other payable					
Tax payable	(67.3)	(67.6)	(71.0)	(74.5)	(78.3)
Due to related co.s					
ST debts					
Other current liab.	0.0	(0.8)	0.0	0.0	0.0
LT debts	(301.8)	(64.6)	(865.2)	(865.2)	(865.2)
Other LT liabilities	(0.5)	0.0	0.0	0.0	0.0
Total liabilities	(385.8)	(155.4)	(964.9)	(975.8)	(987.5)
Share capital	77.5	88.9	98.0	98.0	98.0
Reserves	1,055.1	1,596.6	2,199.6	2,636.4	3,155.8
Shareholders' funds	1,132.6	1,685.5	2,297.5	2,734.3	3,253.8
Minority interest					
Total	1,132.6	1,685.5	2,297.5	2,734.3	3,253.8
Capital employed	1,434.4	1,750.1	3,162.8	3,599.5	4,119.0
Net (debt)/cash	551.1	985.9	1,367.5	1,653.4	2,082.4
Shareholding Structure					
				Shares o/s (m)	%
Sun Shaofeng				405.3	45.9
Carlson Investment				46.2	5.2
Janus Capital				43.4	4.9
Others				387.7	43.9
Total				882.6	100.0
Background					
Established in 1998, China Green is a vertically-integrated food producer with headquarter in Fujian province. The company has three business segments: fresh produce, processed products and branded beverage and instant noodle products. In 2007, it owns total 66,100 mu (4,406.7 hectares) farmland, located in Fujian, Jiangxi, Hubei and Hebei, 440,900 tonnes processing capacity, 28,000 tonnes production capacity for beverage and 6,800 tonnes for non-fried instant noodle. The company listed in Hong Kong exchange in 2004.					
Key Ratios	06A	07A	08F	09F	10F
Net gearing (%)	Cash	Cash	Cash	Cash	Cash
Net ROE (%)	26.9	24.6	23.8	23.1	23.1
EBIT ROCE (%)	22.6	21.7	20.0	18.8	20.5
Dividend payout (%)	27.7	26.4	27.7	27.5	27.2
Effective tax rate (%)	(3.4)	(0.1)	8.0	13.5	17.5
Net interest coverage (x)	na	na	na	na	na
A/R turnover (days)	8.5	6.5	4.9	5.7	5.8
A/P turnover (days)	10.4	7.4	7.6	7.6	7.6
Stock turnover (days)	7.1	8.8	12.7	14.8	15.1

Norman Zhang

(852) 2533 3715

normanzhang@sbie2capital.com

Guangnan: Beneficiary of China consumption boom

Recommendation: BUY (initiating coverage)

China Industrials

Price	HK\$1.36	Year to	Net profit	EPS	EPS	P/E	P/B	EV/EBITDA	Yield	ROE	ROCE	N. Gear.
Target price	HK\$2.04 (+50.0%)	Dec	HK\$m	HK\$	Δ %	x	x	x	%	%	%	%
12 mth range	HK\$1.15-2.86	05A	175.8	0.195	0.163	6.9	1.3	15.4	1.1	18.5	17.5	Cash
Market cap.	US\$157.9m	06A	121.3	0.135	(31.0)	10.0	1.1	11.4	2.6	12.0	10.2	Cash
Daily t/o, 3 mth	US\$0.4m	07F	130.9	0.145	7.9	9.3	0.9	6.9	2.5	10.9	9.0	(4.3)
Free float %	40.7%	08F	166.8	0.184	26.9	7.3	0.7	4.2	3.5	11.7	10.4	(3.6)
Ticker	1203.HK/1203 HK	09F	196.8	0.217	18.0	6.2	0.6	3.4	4.2	11.7	10.1	Cash

Relative to Hang Seng Index (1 mth, 3 mth, 12 mth): +1.1%, -8.6%, -27.0%

Actual price changes (1 mth, 3 mth, 12 mth): -11.1%, -27.7%, -13.4%

Key points:

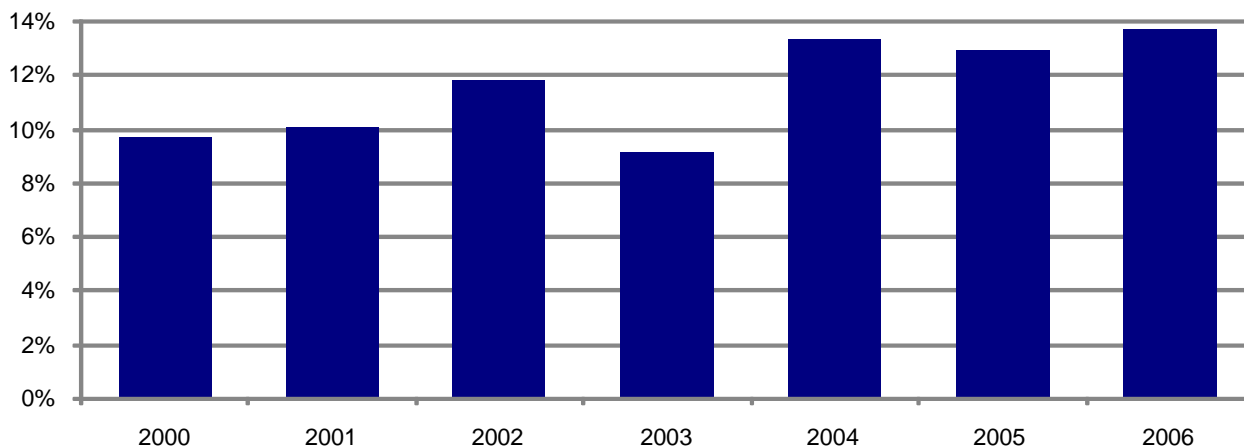
- China's second largest producer of tinplate, a packaging material for consumer products.
- Vertical integration to help contain costs.
- Capacity expanded 125.0% in FY12/08F
- JV with POSCO, a global steel giant.
- Undervalued - trading at 33.3% discount to our appraised FY12/08F NAV per share.

Overlooked by the market. China's fast expanding economy, rising affluence and huge population have fuelled a consumption boom over the last few years. China consumption counters, the main focus of investor attention, are trading at substantial premiums to the Hang Seng Index (HSI) and HSCEI index. The HSI and HSCEI are trading at three-year average P/E of 15.4x and 19.0x, respectively, while Hong Kong-listed China consumption plays are trading at an average one-year forward P/E of 40.1x and two-year forward P/E of 32.1x. However, investors have overlooked peripheral products/services providers of the consumption sector who are benefitting from the boom. Among them is Guangnan Holdings, the country's second largest producer of tinplate in terms of capacity (450,000.0 tons), which is a common packaging material for food, beverage and consumer products. The company's is gearing for a period of high earnings growth after its recent capacity expansion, vertical integration and a JV with POSCO, a global steel giant. Its tinplating business is trading at FY12/08F P/E of 6.3x, a 49.6% discount to its peers. Since our NAV-based target price of HK\$2.04 represents an upside potential of 50.0%, we initiate coverage on the group with a BUY call.

China's increasing affluence. Between 2002 and 2006, China's GDP increased at a four-year CAGR of 10.3%, making it one of the world's fastest growing economies. In 2007, its economy expanded 11.4%. Personal income per capita increased at a CAGR of 7.4% in 2002-2006, spurring consumption growth and boosting retail sales, 12.2% YoY in the period and 16.8% in 2007.

Urbanization spurs demand. China's rapid urbanization is another driver of consumption growth. Between 2002 and 2006, the country's total population increased at a four-year CAGR of 0.6%, while its urban population rose at 3.5%. Euromonitor estimates that China will have 645.3m urban residents by 2011, representing a five-year CAGR of 3.1%. An increase in the number of retail chains, such as supermarkets, has made consumer goods more accessible and fuelled demand.

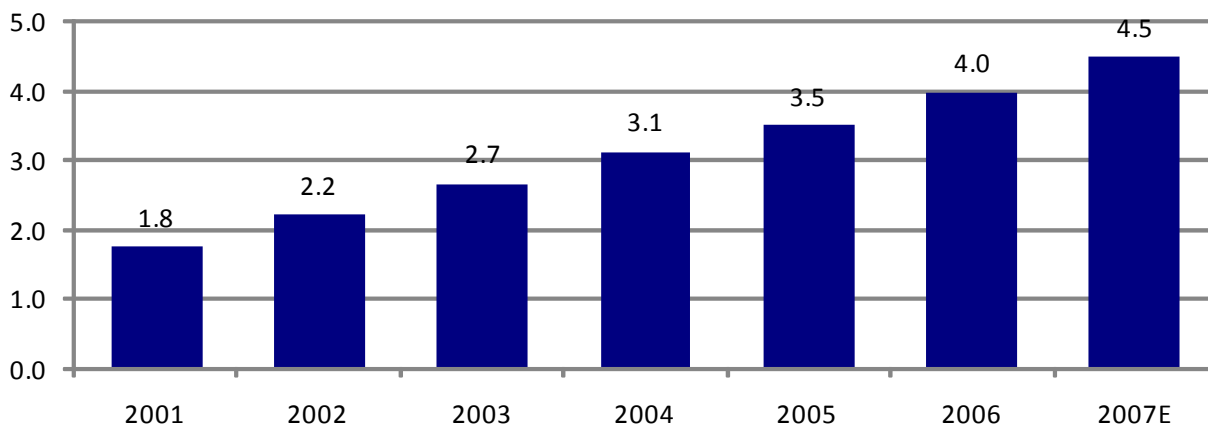
Consumption - major growth engine. China's economic growth is fuelled by exports, fixed assets investment and domestic consumption. To curb the country's over expanding domestic fixed assets investment and mounting inflation, the government has introduced a series of measures such as hiking banks' reserve ratios and interest rates. As the economic growth of China's major trade partners such as the US is decelerating due to the sub-prime mortgage market meltdown, the country's export growth will slow and domestic consumption will become the major economic growth engine in 2008. The Beijing Olympic Games will also stimulate the domestic market given heavy promotion campaigns launched by consumer product producers.

Chart 1: China retail sales value growth (%)

Sources: National Bureau of Statistics of China

Packaging material sector. The investment community has overlooked the fact that the packaging/packaging material sector is a direct beneficiary of China's consumption boom. When a consumer buys a product, he buys the content, the brand (the image created by marketing campaigns) and the package. Thus, an increase in demand for consumer products will boost demand for packaging materials. Packaging materials are like commodities and their makers lack the pricing power of their downstream clients. They are also vulnerable to cost hikes and market changes.

Broad application. Tinsplate is used by food and beverage industries in the packaging of meat, fish, fruit and vegetable products, canned beverages, dry-miscellaneous and confectionary products (biscuits, candy, tea leaves, alcoholic drinks) and canned consumer/chemical products (paint, lubricants, sprays and pesticide). According to the China Canned Food Association, China's canned food production volume increased at a five-year CAGR of 17.7% in 2001-2006 and 12.5% YoY in 2007, to 45.0m tons. According to ACNielsen, in 2004-2006, the sales of carbonated drink and juice products increased at a two-year CAGR of 10.4% and 17.1%, respectively, to 4,451.0m litres and 2,292.0m litres.

Chart 2: China canned food production (m tonnes)

Sources: China Canned Food Association

Capacity expansion. The company's tinsplate capacity increased to 200,000t.p.a. from 120,000t.p.a. in FY12/02A-12/06A, representing a CAGR of 13.6%. Its tinsplate production volume increased at a four-year CAGR of 11.4%. The expansion led to a drop in the company's utilization rate to 85.6% in FY12/06A, from 92.6% in FY12/02A. Tinsplate sales revenue increased at a four-year CAGR of 18.3% during the period. After its JV, Zhongyue POSCO (Qinhuangdao) Tinsplate Industrial, commenced operations at the beginning of FY12/08F, the company's tinsplate production capacity surged 125.0% to 450,000.0 t.p.a. It will further be boosted by 50,000t.p.a. after the upgrade of Guangnan's flagship tinsplate-manufacturing arm, Zhongshan Zhongyue Tinsplate Industrial. We estimate that by end-FY12/09F, the company's capacity will reach 500,000.0t.p.a.

Table 1 : Guangnan's tinplating production capacity

	05A	06F	07F	08F	09F
Tinplate (tons)	120,000	200,000	200,000	450,000	500,000
Blackplate (tons)	-	-	150,000	150,000	150,000

Source: Company, SBI E2-Capital

Self-sufficient in blackplate. Although its tinplate revenue increased at a four-year CAGR of 18.3% in FY12/02A-12/06A, the division's pre-tax profit dropped at four-year CAGR of 2.5% due to higher raw material costs. Blackplate is the major raw material in the production of tinplate and accounts for about 91.0% of the per-ton cost. To secure its supply of blackplate, Guangnan added a 150,000.0t.p.a. capacity at Zhongshan Zhongyue in March 2007. This will generate savings of up to RMB700.0/ton. The company has no plans to sell any blackplate externally.

Strong partner. In 2007, the company formed with South Korea-based POSCO a 66:34 JV called Zhongyue POSCO (Qinhuangdao) Tinplate Industrial. About 50.0% of the HK\$468.0m investment came from bank loans and the balance from the two companies, according to their stakes. The 50-year JV is still undergoing trials and will be fully launched by end-1Q 2008. Founded in 1968, POSCO was in 2006 the world's seventh largest steel manufacturer by revenue, according to Fortune Global 500, and the fifth largest steel producer. It is listed and traded in Seoul, New York, London and Tokyo. In FY12/06A, POSCO produced 30.2m tons of crude steel and sold 28.8m tons of steel products. Its revenue and earnings reached US\$27,787.4m and US\$3,563.6m, respectively, in FY12/06A. At end-FY12/06A, POSCO's total and net assets stood at US\$33,493.6m and US\$23,561.9m, respectively. The JV will allow the company to leverage on POSCO's expertise in tinplate production, rich blackplate resources and extensive global sales network.

Leveraging on partner's expertise. POSCO sold its production facilities to the JV for HK\$137.3m. The 250,000.0t.p.a. electrolytic tinplate plant includes an electrolytic tinning line, three shearing lines and testing equipment. The plant uses the modified Ferrostan type technology, the most advanced in China so far. The aggregate original cost and net book value of the plant at end-FY12/06A was HK\$400.1m and HK\$136.1m, respectively. POSCO also provided 46 man-month on-site consultation services and 12 man-month training services to the JV at its plant in Korea.

Developing exports via partner's network. POSCO has been the company's blackplate supplier and the JV is expected to strengthen their working relationship. Their one-year term framework agreement, starting from Jan 2008 and involving two POSCO subsidiaries, makes POSCO the JV's sole overseas sales agent and allows it to sell at least 35.0% of the JV's tinplate to POSCO. POSCO's network covers 25 cities in the world. The deal will give Guangnan access to POSCO's clients in China.

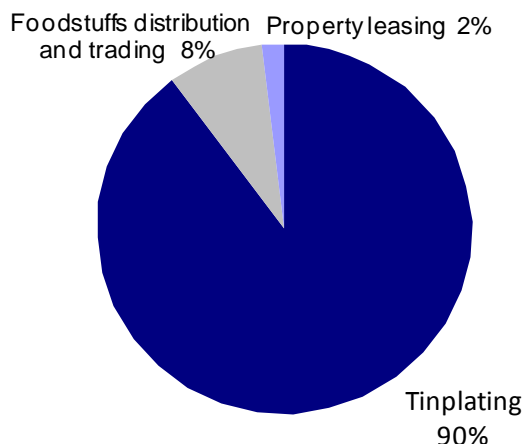
Market leader. Currently, China has 10 tinplate manufacturers with a total capacity of 2.9m t.p.a. Guangnan, with its total production capacity of 450,000.0 t.p.a., was the country's second largest tinplate manufacturer in April 2007, after Baosteel. It had more than 1,600 steel printing and steel manufacturing customers and sold its products directly to more than 400 of them. Zhongshan Zhongyue was recognized as the maker of the "Top Brand-name Packaging Product in China" in April 2006.

Table 2: Top ten tinplate producers in China

	Capacity (m t.p.a.)
Baosteel	1.00
Guangnan	0.45
Fujian and Jiangsu Tonyi	0.42
Pacific	0.20
Xinda Zhong Steel Sheet	0.20
Sino-Japan Metal	0.15
Hainan Haiwoo	0.15
Xinda Zhong Steel	0.14
Wuhan Steel	0.10
ShanDong FongYang	0.06

Source: Estimated by the company

Chart 3: 1H FY12/07F revenue breakdown



Sources: Company

Blackplate manufacturing division and POSCO JV. Due to the steep learning curve of blackplate manufacturing and the plant's low utilization rate (50.0%), we expect the group's blackplate manufacturing arm to report a loss of HK\$6.7m in FY12/07F. The division is the company's cost center rather than a revenue center. Its poor performance will affect the group's COGS. We reckon that the group incurred some pre-opening expenses for the JV, such as consultation and training fees to POSCO and interest expenses on bank loans in FY12/07F. After a year of trials, we expect the plant's efficiency to improve and utilization rate to reach 70.0%, making it profitable from FY12/08F. The JV, officially launched at the beginning of FY12/08F, will start its full-scale production by end-1Q 2008. We prudently assume its utilization rate at 50.0% for FY12/08F and expect a small profit of HK\$6.4m in the year.

Zhongshan Zhongyue. The plant should remain the major revenue and earnings contributor, (69.4% of revenue and 61.3% of pre-tax earnings in FY12/07F). We put its gross profit margin at 9.1% in FY12/07F, compared with the group's blended margin of 13.5% in FY12/06F, mainly due to higher raw material costs, which Zhongshan Zhongyue finds hard to contain, as its blackplate production facility has yet to reach its optimal stage. We expect the segment's gross profit margin to improve to 12.5% when the blackplate plant's utilization rate tops 70.0%.

Foodstuff distribution and trading – upgrade catalyst. The company was appointed one of Hong Kong's three licensed live pig distributors in July 2007 (with Ng Fung Hong and the Hong Kong Agriculture Special Zone - 香港農業專區有限公司). Ng Fung Hong, a subsidiary of China Resources, is Hong Kong's largest live pig distributor, accounting for 75.0% of total imports. Guangnan Hong, a wholly owned subsidiary of Guangnan accounts for about 15.0% and the Hong Kong Agricultural District for 12.5%. The operating margin of the company's foodstuff distribution and trading division was estimated at 18.8% and 20.0% respectively, for 1H FY12/06A and 1H FY12/07F. Hong Kong imports about 4,000.0-5,000.0 heads of live pigs a day. Assuming the wholesale price of live pigs is HK\$50.0/kg and daily import quantity 280,000.0kg, the potential value of Hong Kong's live-pig import market is about HK\$5.0b per annum, with Guangnan's revenue estimated at HK\$756.0m a year. However, the operating margin of its live pig wholesale business is yet to be determined and the operation's short operating history gives no firm indication of its long-term profitability. Thus, we have not factored it in our model.

Associate - high corn price to erode Yellow Dragon's margin. The group's 40.0% owned corn food and feed manufacturer, Yellow Dragon Food Industry, may suffer due to the rising price of corn. In FY12/06A, its turnover increased 15.3% YoY to HK\$1.1b, due to a 4.6% increase in corn starch sales to 403,484.0 tons. However, its net profit declined 0.8% YoY to HK\$50.3m, eroding its contribution to Guangnan by 5.2% YoY to HK\$19.3m. Despite a 6.5% YoY drop in corn starch sales to 188,987.0 tons in 1H FY12/07F, Yellow Dragon still managed to increase its turnover by 12.6% YoY to HK\$604.1m thanks, in our view, to higher ASP, and net profit 13.7% to HK\$34.0m, due to margin enhancement, possibly because it used corn purchased before the price hike. Yellow Dragon's contribution rose 14.5% to HK\$13.4m in 1H FY12/07F. As the corn price keeps rising, we expect its gross margin to shrink.

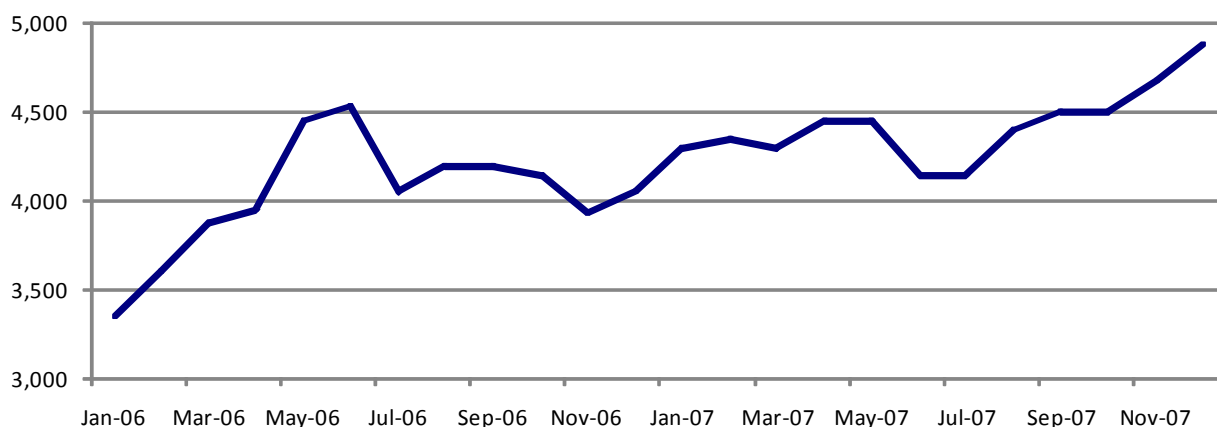
Leasing division. The group owns an industrial complex in Zhongshan and an office unit at Shui On Centre, Wan Chai, Hong Kong. In FY12/06F and 1H FY12/07F, the two properties generated HK\$25.5m and HK\$13.3m, in rental revenue, respectively. The operating profit of the leasing division was HK\$16.6m and HK\$9.1m, respectively, for FY12/06A and 1H FY12/07F. We expect the leasing division to continue generating stable income to the group.

Gross margin forecast. We expect the company's blended margin, at 13.4% in FY12/06A, to narrow to 7.8% in FY12/07F and 8.5% in FY12/08F due to higher depreciation charges and high raw material costs.

Higher depreciation charges. Zhongshan Zhongyue has been operating for years and its annual depreciation charge is low at HK\$16.7m. We estimate that the launch of the company's blackplate plant and JV boosted its depreciation charges 197.5% YoY in FY12/07F and 85.2% YoY in FY12/08F. Given the 10-year useful life of the HK\$364.5m plant, its depreciation charge is estimated at HK\$36.5m per annum, or 7.7% of the total cost per ton of blackplate. The JV's depreciation charge is estimated at HK\$46.8m per annum. Better economies of scale and higher utilization rates at both plants should lower the proportion of depreciation in the total fixed cost.

Surge in raw material costs. The cost of 3.0mm hot roll sheet, the major raw material of blackplate and in turn of tinplate, represents 72.0-75.0% of the total cost per ton of blackplate. One ton of blackplate requires about 1.1 tons of hot roll sheet. The hot roll sheet price in Guangzhou rose 20.5% YoY between Dec 2006 and Dec 2007, which eroded the gross profit margin of tinplate. The company is expected to keep the price of blackplate at RMB700.0 per ton by sourcing the material internally. One ton of tinplate requires 0.002 ton of tin. We estimate that the price of tin surged more than 139.4% between 2006 and 2007. Tin accounts for about 5.2% of the total cost per ton of tinplate, and any increase in tin costs will put pressure on the group's gross profit margin.

Chart 4: Monthly average 3.0mm hot rolled sheet price in Guangzhou (RMB/tonne)



Sources: Bloomberg

Upbeat FY12/08F outlook. We expect the group's total turnover to rise 73.2% YoY to HK\$2,115.0m in FY12/07F and revenue from the tinplating division to increase 78.2% YoY, mainly due to an 18.9% YoY rise in the ASP of tinplate. Nevertheless, due to the margin squeeze and higher financing costs (debt financing for the POSCO JV), we expect the group's net profit to increase only 7.9% YoY to HK\$130.9m. In FY12/08F, we expect the group's turnover to rise 72.1% YoY to HK\$3,639.4m, due to: 1) 9.0% increase in tinplate's ASP; 2) POSCO JV's contribution. Thus, we project the group's tinplate sales will increase 75.0% YoY to 315,000.0 tons, assuming the JV's utilization rate at 50.0%. We expect the group's blended margin to expand 0.7ppt on the blackplate plant's 70.0% utilization rate. We expect the blackplate plant to satisfy 47.6% of the group's needs. We estimate that the group's effective tax rate will increase by 3.5ppt to 18.5%, as the POSCO JV will be subject to a corporate tax rate of 25.0%. The group's FY12/08F net profit should reach HK\$166.8m, up 27.4% YoY.

Re-rating deserved. We expect the group's net profit to increase at a three-year CAGR between of 27.7% between FY12/07F and FY12/10F. We adopt the sum-of-parts method to arrive at our NAV-based target price of HK\$2.04, implying an upside potential of 50.0%. Appraised at 6.3x of FY12/08F earnings, the group's tinplating division is trading at a steep discount to the global packaging material sector's average two-year forward P/E of 12.5x. By adopting a 20.0% discount (due to Guangnan's relatively small market capitalization) to the sector average, we arrive at the target FY12/08F P/E of 10.0x, or HK\$1.63 per share. For the valuation of Guangnan's 40.0% stake in Yellow Dragon, we adopt a 20.0% holding company discount to Hong Kong-listed corn refiners' average two-year forward P/E of 10.4x, translating into a target P/E of 8.3x, or HK\$0.19 per share. For the valuation of its investment property, we adopt the book value into our valuation. Major Hong Kong-listed China consumption plays are trading at one-year forward P/E of 40.1x and two-year forward P/E of 32.1x. Their high valuations imply that investors are bullish on the outlook of China's consumption sector. Guangnan, as one of the beneficiaries, deserves a re-rating, in our view. We initiate coverage on the group with a BUY call.

Table 3: NAV valuation

Division	Target valuation	Description
Tinplating (HK\$m)	1,474.2	Traget FY12/08F P/E : 20.0% of the peer group average P/E of 12.5x
Yellow Dragon (HK\$m)	174.8	Traget FY12/08F P/E : 20.0% of the peer group average P/E of 10.4x
Investment properties (HK\$m)	253.1	Book value
Net debt (HK\$m)	(53.6)	
NAV (HK\$m)	1,848.5	
NAV per share (HK\$)	2.04	

Source: SBI E2-Capital

Table 4: Valuation of packaging materials producers

Company name	Ticker	Year end	Currency	Market cap (US\$m)	P/E (x) 1-yr forward	P/E (x) 2-yr forward
AMVIG Holdings	2300 HK	Dec	HKD	1,181.8	23.3	15.0
Ton Yi Industrial	9907 TT	Dec	TWD	588.2	10.9	9.7
Taiwan Hon Chuan	9939 TT	Dec	TWD	149.2	11.1	9.9
Youlchon Chemical	008730 KS	Dec	KRW	175.4	7.4	5.9
Fuji Seal International	7864 JP	Mar	JPY	566.4	14.7	13.2
Fujimori Kogyo	7917 JP	Mar	JPY	131.5	13.4	7.3
FP Corp	7947 JP	Dec	JPY	667.9	15.0	13.0
Ball Corp	BLL US	Dec	USD	4,176.7	11.4	10.2
Crown Holdings	CCK US	Dec	USD	3,592.0	16.6	13.3
Greif	GEF US	Oct	USD	2,757.8	15.7	12.9
Owens-Illinois	OI US	Dec	USD	6,585.8	18.0	13.3
Silgan Holdings	SLGN US	Dec	USD	1,762.2	14.2	12.7
<i>Average</i>					15.7	12.5

Source: SBI E2-Capital

Table 5: Valuation of HK-listed corn refiners

Company name	Ticker	Year end	Currency	Market cap (US\$m)	P/E (x) 1-yr forward	P/E (x) 2-yr forward
Global Bio-Chem Tech	809 HK	Dec	HKD	721.7	8.9	7.3
Fufeng Group	546 HK	Dec	HKD	129.7	3.0	2.8
Xiwang Sugar	2088 HK	Dec	HKD	338.9	8.3	6.9
China Agri-Industries	606 HK	Dec	HKD	2,227.7	15.1	12.4
<i>Average</i>					12.6	10.4

Source: SBI E2-Capital

Table 6: Valuation of HK-listed China consumption plays

Company name	Ticker	Year end	Currency	Market cap (US\$m)	P/E (x) 1-yr forward	P/E (x) 2-yr forward
Tingyi Cayman	322 HK	Dec	HKD	8,259.8	41.1	33.6
Kingway Brewery	124 HK	Dec	HKD	448.1	55.4	68.3
Tsingtao Brewery	168 HK	Dec	HKD	5,514.7	52.8	39.1
China Green	904 HK	Apr	HKD	1,011.6	17.3	14.4
China Foods	506 HK	Dec	HKD	1,830.4	30.3	25.1
China Mengniu Dairy	2319 HK	Dec	HKD	3,853.8	29.0	22.6
<i>Average</i>					40.1	32.1

Source: SBI E2-Capital

Risk factors. 1) Threat from steelmakers – i) Baosteel, China’s largest tinplate producer is also the major supplier of hot roll sheet. Other steel conglomerates in China also produce tinplate. Technically, steel producers can drive independent tinplate producers out of the market by increasing their price of hot roll sheet and blackplate; ii) if the profit margin of hot roll is high enough, steel producers will reduce the supply of blackplate and sell more hot roll, squeezing the margin of tinplate producers; 2) higher raw material costs; 3) increase in other production input costs; 4) low utilization rates at Guangnan’s blackplate plant and POSCO JV; 5) leverage increase. We expect the company to move from net cash (HK\$54.5m in FY12/06A) to a net debt position of HK\$53.8m by end-FY12/07F.

Corporate profile. Guangnan group was established in 1982 and listed on the HKEx in Dec 1994. It is about 59.3% owned by GDH Ltd, which is a 100.0% subsidiary of Guangdong Yue Gang Investment Holdings Co. Ltd, a window company of the Guangdong Provincial Government. In 2000, the group restructured disposing of its

non-core assets and reducing debt. The tinplating business was injected into the group in 2001. To remove the accumulated loss in its reserve arising from the restructuring, the group reorganized its share capital in FY12/05F and resumed dividend payouts in FY12/06F.

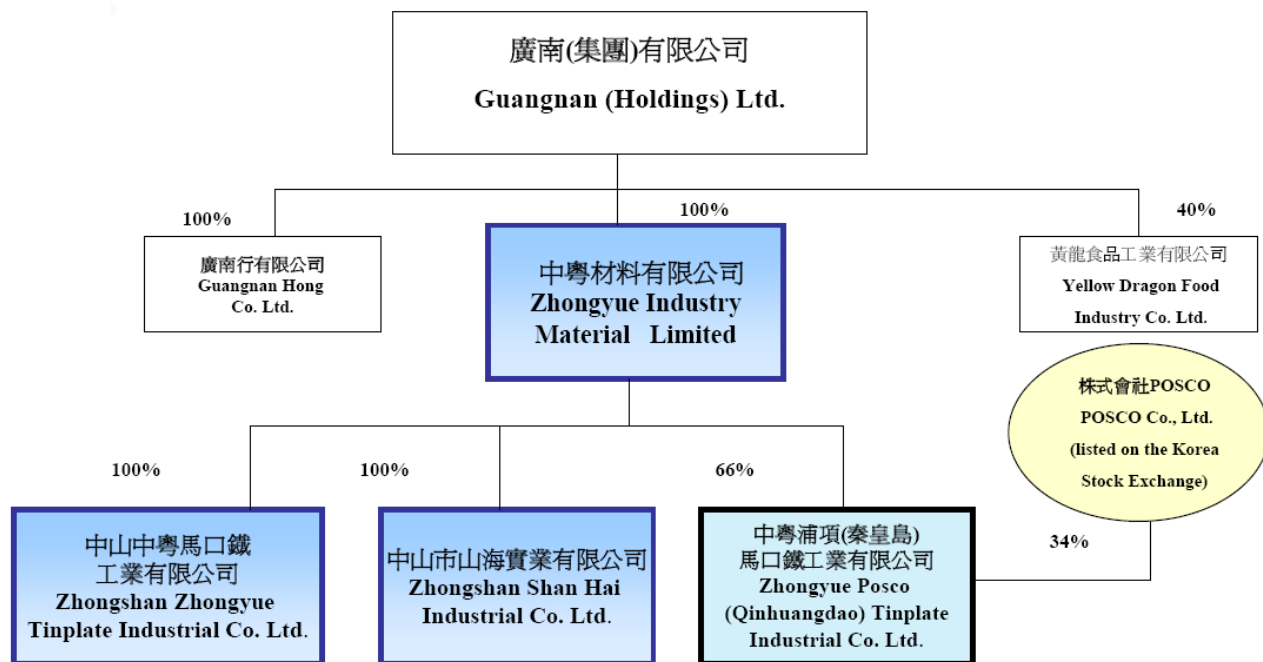
What is tinplate? Guangnan produces two types of tinplate (steel sheet covered in a thin layer of tin), electrolytic tin-coated steel plate and electrolytic chromium-coated steel plate. Electrolytic tinplate is mainly used in the packaging of canned food and beverages, confectionary products and chemicals. Electrolytic chromium-coated plate is more anti-vulcanized and paint coating adhesive than electrolytic tinplate and is used to package canned food that contains sulfide (fish and fruit) and in steel plate for beverage cans. It is a better suited for the production of turn caps and crown closure for beverage cans.

Chart 5: Corporate structure 1



Sources: Company data

Chart 6: Corporate structure 2



Sources: Company data

P & L (HK\$m)	05A	06A	07F	08F	09F
Year to Dec					
Turnover	921.2	1,221.3	2,115.0	3,639.4	4,650.8
% chg	35.1	32.6	73.2	72.1	27.8
Gross profit	122.9	163.5	165.8	307.5	386.0
EBITDA	82.6	111.6	184.9	306.3	378.0
Depre./amort.	(9.9)	(18.5)	(54.9)	(101.7)	(101.7)
EBIT	72.8	93.1	130.0	204.5	276.3
Net int. income/(exp.)	3.5	0.5	(21.7)	(16.9)	(13.3)
Exceptionals	83.9	37.5	16.2	-	-
Associates	20.3	19.3	23.5	21.0	21.2
Jointly-controlled entit.	-	-	-	-	-
Pre-tax profit	180.5	150.3	147.9	208.6	284.3
Tax	(0.7)	(23.5)	(22.1)	(38.5)	(73.5)
Minority interests	(4.0)	(5.5)	5.1	(3.3)	(13.9)
Net profit	175.8	121.3	130.9	166.8	196.8
% chg	19.9	(31.0)	7.9	27.4	18.0
Dividends	(13.5)	(31.6)	(31.1)	(43.4)	(51.2)
Retained earnings	162.2	89.8	99.8	123.4	145.7
EPS (HK\$) - Basic	0.195	0.135	0.145	0.184	0.217
EPS (HK\$) - F.D.	0.195	0.135	0.145	0.184	0.217
DPS (HK\$)	0.015	0.035	0.034	0.048	0.057
No. sh.s o/s (m) - W.A.	901.6	901.6	901.6	905.3	905.3
No. sh.s o/s (m) - Y.E.	901.6	901.6	905.3	905.3	905.3
No. sh.s o/s (m) - F.D.	901.6	901.6	905.3	905.3	905.3
Margins (%)					
Gross	13.3	13.4	7.8	8.5	8.3
EBITDA	9.0	9.1	8.7	8.4	8.1
EBIT	7.9	7.6	6.1	5.6	5.9
Pre-tax	19.6	12.3	7.0	5.7	6.1
Net	19.1	9.9	6.2	4.6	4.2

Balance Sheet (HK\$m)	05A	06A	07F	08F	09F
Year to Dec					
Fixed assets	434.4	805.8	1,218.9	1,132.2	1,045.4
Intangible assets	-	-	-	-	-
Other LT assets	176.0	182.4	205.9	226.9	248.2
Cash	96.9	157.7	32.4	159.4	458.9
Accounts receivable	292.0	274.7	338.4	382.1	372.1
Other receivables	-	-	-	-	-
Inventories	236.3	115.5	311.9	333.2	341.2
Due from related co.s	-	-	-	-	-
Other current assets	3.1	3.2	3.2	3.2	3.2
Total assets	1,238.6	1,539.3	2,110.6	2,237.0	2,468.9
Accounts payable	(200.6)	(306.4)	(389.9)	(383.2)	(426.5)
Other payable	-	-	-	-	-
Tax payable	(19.6)	(18.8)	(25.4)	(37.0)	(59.0)
Due to related co.s	-	-	(200.0)	-	-
ST debts	(27.0)	(81.6)	(48.6)	(175.4)	-
Other current liab.	-	-	-	-	-
LT debts	-	-	-	-	-
Other LT liabilities	(12.2)	(21.7)	(37.6)	(37.6)	(37.6)
Total liabilities	(259.4)	(428.4)	(701.5)	(633.1)	(523.1)
Share capital	450.8	450.8	452.0	452.0	452.0
Reserves	499.1	622.5	882.0	1,072.6	1,401.2
Shareholders' funds	949.9	1,073.3	1,334.0	1,524.5	1,853.2
Minority interest	29.3	37.6	75.2	79.3	92.6
Total	979.2	1,110.9	1,409.1	1,603.8	1,945.8
Capital employed	1,006.2	1,192.5	1,457.7	1,779.2	1,945.8
Net (debt)/cash	57.7	54.5	(53.8)	(53.6)	421.3

Cash Flow (HK\$m)	05A	06A	07F	08F	09F
Year to Dec					
EBIT	72.8	93.1	130.0	204.5	276.3
Depre./amort.	9.9	18.5	54.9	101.7	101.7
Net int. paid	(3.5)	(0.5)	21.7	16.9	13.3
Tax paid	6.4	(15.5)	(15.5)	(27.0)	(51.4)
Dividends received	(0.2)	(0.2)	(0.1)	(0.2)	(0.2)
Gross cashflow	85.3	95.4	191.0	296.0	339.7
Chgs. in working cap.	(248.3)	122.7	(176.6)	(71.7)	45.4
Operating cashflow	(162.9)	218.1	14.3	224.3	385.1
Capex	(89.2)	(225.8)	(308.9)	(30.0)	(30.0)
Free cashflow	(252.1)	(7.7)	(294.5)	194.3	355.1
Dividends paid	(0.5)	(27.0)	(36.1)	(31.6)	(46.7)
Net distribution to MI	-	-	-	(0.8)	(3.5)
Investments	-	-	-	-	-
Disposals	0.4	6.4	-	-	-
New shares	-	-	-	-	-
Others	16.4	25.1	222.3	(161.5)	170.0
Net cashflow	(235.7)	(3.2)	(108.3)	0.2	474.9
Net (debt)/cash - Beg.	293.4	57.7	54.5	(53.8)	(53.6)
Net (debt)/cash - End.	57.7	54.5	(53.8)	(53.6)	421.3

Interim Results (HK\$m)	06A	07A
Six months to Jun		
Turnover	622.8	688.7
% chg	55.8	10.6
Profit from operations	55.3	59.1
Interest expenses	(1.4)	(4.1)
Associates	11.8	13.5
Jointly-controlled entit.	-	-
Pre-tax profit	71.4	121.3
Tax	(10.4)	(3.4)
Minority interests	(2.4)	0.3
Net profit	58.6	118.2
% chg	(50.0)	101.6
EPS (HK\$) - Basic	0.065	0.131
DPS (HK\$)	0.015	0.020

Shareholding Structure	Shares o/s (m)	%
Guangdong Yue Gang	536.4	59.3
Public	368.9	40.7
Total	905.3	100.0

Background
Established in 1982, Guangnan Group was listed on the mainboard of HKEX in December 1994. It is 59.5%-owned by Guangdong Yue Gang Investment Holdings Co Ltd., which is wholly-owned window company of the Guangdong Provincial Government. Guangnan Group is engaged in the manufacturing and sales of tinplate, as well as distribution and trading of live and fresh foodstuffs. The group's 40.0%-owned associate, Yellow Dragon Food Industry Co., Ltd. is engaged in the manufacturing and sales of cornstarch.

Key Ratios	05A	06A	07F	08F	09F
Net gearing (%)	Cash	Cash	(4.3)	(3.6)	Cash
Net ROE (%)	18.5	12.0	10.9	11.7	11.7
EBIT ROCE (%)	7.2	8.5	9.8	12.6	14.8
Dividend payout (%)	7.7	26.0	23.7	26.0	26.0
Effective tax rate (%)	0.4	15.6	15.0	18.5	25.9
Net interest coverage (x)	na	na	6.0	12.1	20.8
A/R turnover (days)	115.7	84.7	52.9	36.1	29.6
A/P turnover (days)	79.5	75.8	60.1	38.8	31.8
Stock turnover (days)	108.0	60.7	40.0	35.3	28.9

Guangzhou Pharmaceutical: Leader in spring wind

Recommendation: BUY (initiating coverage)		China Pharmaceuticals										
Price	HK\$5.18	Year to	Net profit	EPS	EPS	P/E	P/B	EV/EBITDA	Yield	ROE	ROCE	N. Gear.
Target price	HK\$8.80 (+70%)	Dec	RMBm	RMB	Δ %	x	x	x	%	%	%	%
12 mth range	HK\$5.08-9.55	05A	197.8	0.244	-	19.7	1.4	20.6	1.5	7.5	15.1	30.2
Mkt cap. (H-shs)	US\$1,379.6m	06A	218.1	0.269	10.2	17.9	1.3	19.8	1.7	7.8	10.1	20.6
Daily t/o, 3 mth	US\$0.84m	07F	273.3	0.337	25.3	14.3	1.2	19.5	2.1	8.9	9.9	15.0
Free float %	43.6%	08F	391.0	0.482	43.1	10.0	1.0	17.9	3.0	11.1	8.1	5.9
Ticker	0874.HK/874 HK	09F	440.7	0.543	12.7	8.9	1.0	15.7	3.4	11.2	9.7	14.4

Relative to Hang Seng Index (1 mth, 3 mth, 12 mth): -14.5%, -23.8%, NA

Actual price changes (1 mth, 3 mth, 12 mth): -3.0%, -23.7%, +162%

Consensus EPS (07F-08F): RMB0.34, RMB0.46

Key points:

- Vertically integrated pharmaceutical manufacturer and China's second largest distributor with a network covering 2,000 hospitals, 5,000 distributors and 1,000 retailers.
- Offers exposure to China's burgeoning internal consumption sector with its strong Wanglaoji (王老吉) beverage products and over-the-counter (OTC) drugs (about 80% of revenue).
- JV with leading international pharmacy-led health and beauty group Alliance Boots and Beijing Med-Pharm (BJGP US) to provide growth catalysts for its distribution business.
- Earnings growth accelerate with adjusted net profit of RMB263.7m, RMB345.1m and RMB442.0m between FY12/07F to FY12/09F, represents a YoY growth of 20.9%, 30.8% and 28.1% respectively.
- Initiate coverage with a BUY call and target price of HK\$8.80. Our sum-of-the-parts valuation values GPs' Wanglaoji JV at a conservative 30.0x FY12/08F P/E and the remaining pharmaceutical business at 16.0x FY12/08F P/E. The counter is currently trading at an undemanding 10.0x FY12/08F P/E.

Investment summary. Guangzhou Pharmaceutical (GP) offers exposure to China's burgeoning domestic consumption boom through its Wanglaoji beverage and OTC healthcare products. One of China's largest pharmaceutical distributors, GP has become leaner after selling 40.09% in its distribution subsidiary to form a JV with Alliance Boots. The company has steadily reduced costs after its current chairman joined in 2004 and we expect its adjusted net profit growth to re-accelerate from 20.9% YoY (RMB263.7m) in FY12/07F to 28.1% YoY (RMB442.0m) in FY12/09F, fuelled by: 1) sustained runaway growth of its Wanglaoji products; 2) growth and margin improvement in its Alliance Boots distribution JV; 3) steady growth in its core blockbuster drugs; 4) growing contribution in emerging drugs and 5) shrinking losses in previously loss making subsidiaries. We like the company for its limited downside risk and share price appreciation potential, which makes it an attractive play within a volatile market.

Established drug maker, distributor and retailer. GP is a vertically integrated pharmaceutical maker in China. Through its nine main subsidiaries and one JV, it manufactures, distributes and retails pharmaceutical products. It makes more than 400 types of western and traditional Chinese medicines (TCM) and has a distribution portfolio of over 4,000 medicinal and healthcare products. It is the exclusive manufacturer and distributor of around 20 TCMs, including some time-honoured brands such as Cai Zhi Lin (采芝林), Pan Gao Shou (潘高寿), Jing Xiu Tang (敬修堂), Chen Li Ji (陈李济) and Wang Lao Ji (王老吉). The company derives about 80% of its revenue from sales of over-the-counter (OTC) drugs.

China's second largest distributor. According to independent research institute PICO, Guangzhou Pharmaceutical Corp (GPC), the company's main distribution subsidiary, was China's second largest distributor in terms of revenue in 2006, after Shanghai Pharmaceutical (600849 CH). Its nationwide network covers 2,000 hospitals, 5,000 distributors and 1,000 retailers. It also sells via 115 healthcare pharmacies in southern China comprising 27 Jianmin (健民) stores for western medicines (under subsidiary GP Corp) and 88 Caizhilin (采芝林) stores for TCM (under subsidiary Chinese Medicine Corp). Each of GP's manufacturing subsidiaries maintains its own marketing and distribution force allowing them to be profit centres in their own right and minimizing conflict of interest issues.

Existing brands to drive profit growth. Over the past few years, several key products have driven much of the company's growth. The sales of Guangzhou Zhongyi (Zhongyi), its subsidiary which makes Xiaokewan (消可丸),

a well known and popular oral drug for the treatment of Type II diabetes, increased 20.0% from FY12/05A to FY12/06A and net profit 35.6% in the period. Its revenue reached RMB380.0m in 1H FY12/07A and we estimate that Xiaokewan generated about 80% of it. Outside of GP's distribution subsidiaries, Zhongyi is its largest revenue contributor. In 1H FY12/07A, Zhongyi accounted for 6.4% of GP's total revenue and 30.9% of its overall net profit. It has other products coming off a relatively small base though growing fast. In FY12/07A sales of An Shen Bu Nao Ye (安神补脑液) increased 65.0%, Qian Lie Tong Pian (前列通片) increased 47.2% and Xu Han Ting (虚汗停) increased 83.0%, Xiao Er Qi Xin Cha(小儿七星茶冲剂) increased 28.6% compared to a year ago. We expect this to sustain the company's overall growth momentum and offset slowing growth in products with a large revenue base

Favorable industry environment. After the implementation of government-led industry-wide restructuring initiatives and with the State Food and Drug Administration's (SFDA) new, more stringent drug registration process, we expect fewer new products to come on the market. This will help extend the product life cycle of incumbent famous branded blockbusters and increase focus on distribution strength. GP, as one of China's largest distributors/wholesalers with a number of blockbuster products (Xiaokewan, Wanglaoji and Huatuozaizaowan) will benefit. Other macro stimuli include government trials to flatten the tiered distribution system, which will favour large distributors such as GP, and rising disposable incomes, which will lead to a increase in healthcare spending.

Table 1: Historical turnover percentage breakdown

Year to Dec (RMBm)	1H 07A (RMBm)	% of revenue	% of Manufacturing revenue	% of distribution revenue
Manufacturing	1,322.7	20.2	100.0	-
Guangzhou Xing Qun	209.5	3.2	15.8	-
Guangzhou Zhongyi	380.0	5.8	28.7	-
Guangzhou Chen Li Ji	127.1	1.9	9.6	-
Guangzhou Qi Xing	207.5	3.2	15.7	-
Guangzhou Jin Xiu Tang	123.7	1.9	9.4	-
Guangzhou Pan Gao Shou	167.2	2.5	12.6	-
Others	107.7	1.6	8.2	-
Distribution/trading	5,236.6	79.8	-	100.0
Guangzhou Pharmaceutical Corp	4,253.0	64.8	-	81.2
Chinese Medicine Corp	659.6	10.0	-	12.6
Guangzhou Pharma Import and Export Corp	169.1	2.6	-	3.2
Others	154.9	2.4	-	3.0
Elimination	(571.8)			
Total	5,987.5			

Source: Company data

Table 2: Historical turnover growth

Year to Dec (RMBm)	FY05	FY06	YoY chg (%)	1H FY06	1H FY07	YoY chg (%)
Manufacturing	2,187.7	2,452.1	12.1	1,146.4	1,322.7	15.4
Guangzhou Xing Qun	273.5	328.3	20.0	188.5	209.5	11.1
Guangzhou Zhongyi	569.9	651.9	14.4	301.1	380.0	26.2
Guangzhou Chen Li Ji	222.4	176.6	-20.6	120.9	127.1	5.1
Guangzhou Qi Xing	352.6	356.5	1.1	197.0	207.5	5.3
Jing Xiu Tang	159.4	207.3	30.1	99.4	123.7	10.0
Guangzhou Pan Gao Shou	240.9	271.6	12.7	151.1	167.2	10.7
Others	369.0	459.9	24.6	88.4	107.7	21.8
Distribution/trading	7,672.6	9,066.0	18.2	4,541.9	5,236.6	15.3
Guangzhou Pharmaceutical Corp	6,436.8	7,384.4	14.7	3,715.9	4,253.0	14.5
Chinese Medicine Corp	789.8	1,093.0	38.4	511.2	659.6	29.0
Guangzhou Pharma Import and Export Corp	305.4	321.0	5.1	164.3	169.1	2.9
Others	140.6	267.6	90.3	150.5	154.9	2.9
Elimination	(833.9)	(1,277.0)		(606.4)	(571.8)	
Total	9,026.3	10,241.0	13.4	5,101.9	5,987.5	17.3

Source: Company data

Distribution JV with Alliance Boots. In Feb 2007, GP announced its drug distribution JV with Alliance Boots and Beijing Med-Pharm (BJGP US). In the deal, GP will sell part of GPC to Alliance BMP (80%-owned by Alliance Boots and 20%-owned by Beijing Med-Pharm), with each holding 50.0% of the resulting JV.

Details. GP currently owns 90.09% of GPC, with the remainder held by minority shareholders including employees/management. Alliance BMP will come into 50.0% of the JV by:

- acquiring 9.91% from minority shareholders for RMB60.0m
- effectively acquiring 40.09% from GP for RMB485.1m

Based on GPC's FY12/06A net profit (after minority interest) of RMB61.1m and adjusted NAV of RMB605.0m, the Alliance Boots acquisition valuations are as follows:

- 9.91% tranche from minority shareholders - 8.9x FY12/06A P/E and 1.0x P/B
- 40.09% tranche from Guangzhou Pharmaceutical - 19.8x and 2.0x P/B

Partner value. Alliance Boots is a leading international pharmacy-led health and beauty group, engaged in both wholesale and retail. Formed on 31 July 2006 through the merger between Alliance UniChem and Boots Group, it employs around 100,000 people and has a distribution network across Europe, as well as retail healthcare outlets in Ireland, Italy, the Netherlands, Norway, Thailand and the United Kingdom. Alliance Boots own self-branded products are sold through retailers in Europe, the US, the Middle East and Asia.

Med-Pharm synergies cannot be overlooked. While many have focused on the contribution of Alliance Boots, we believe that Beijing Med-Pharm will also bring certain synergies into the JV. The company, which has a proprietary regional network, is an end-to-end solutions provider for US and western pharmaceutical companies looking to introduce their products into China. It has equity stakes in pharmaceutical wholesalers and distributors in Beijing, Shanghai and Hong Kong, regions where the use of western medicines is more prevalent. Med-Pharm's management is formerly from Xian-Janssen Pharmaceutical Ltd., a Sino-foreign JV with Johnson & Johnson (JNJ US). In Mar 2007, the company signed a letter of intent to acquire a minority stake in PICO, a healthcare information company. PICO is subsidiary of the SFDA's South Economic Research Institute. This access to the extensive database of China's healthcare market will no doubt benefit the GPC JV when formulating strategies or introducing new drugs to the market.

Advantages from the JV. In our view, the JV will significantly boost GP's prospects. While GPC generates significant top line sales (RMB4,253.0m in 1H FY12/07A), its margins are extremely low at only 0.8% (net profit of RMB32.6m), compared with 2-6% for international pharmaceutical wholesalers and retailers. Thus, there is a tremendous room for improvement in terms of network and operation efficiency. As part of the agreement, GP will reinvest the RMB485.1m into the JV. The new JV will benefit GP in the following ways:

- **Boost wholesale and retail network** – Alliance Boots will place a CFO in the JV. The capital injection will fund the expansion of the JV's wholesale and retail network nationwide while Alliance Boots' management expertise and wholesale know-how will help to streamline operations and improve efficiency.
- **Distribution of Alliance Boots products** – Alliance Boots already sells some products in China and when the JV deal is completed, we expect it to progressively shift its product portfolio into the JV, granting it exclusive distribution rights. We expect this to be done on a product basis starting in the Guangdong region.
- **Improvement in balance sheet and P&L** – The deconsolidation of the results from the P&L to the JCE level will mean: 1) strengthening of the balance sheet; 2) improving margins of the consolidated P&L and 3) improving receivables and payables.
- **Relief of working capital** – GPC historically used to tie up much of GP's working capital and it was the main reason behind the group's negative operating cashflow in FY12/06A. Moving GPC off the balance sheet will significantly improve the company's financial health and free up working capital to develop and restructure other subsidiaries.
- **Operating flexibility** – With GP holding 50.0% (from 90.1%), the JV will be more independent from its SOE parent. This is a positive in our view as it will reduce a lot of the "red tape" involved in the decision making process allowing greater operating flexibility in reacting to the market's dynamics and competition.
- **Preferred partner for overseas pharmaceutical companies** – We expect Beijing Med-Pharm to use GPC's nationwide network to introduce new US and western pharmaceutical products into China.

JV's expansion strategy. The deal was closed on 28 Jan 2008. In our view, the new management will aggressively focus on developing its distribution and wholesale network. In 1H FY12/07A, GPC derived some 86.6% of its distribution revenue from China's southern regions. Therefore, especially with Beijing Med-Pharm's input, we believe it is well positioned to expand outside its core stronghold to eastern and south western areas.

Wanglaoji to drive growth. In 1H FY12/07A, the sales of Wanglaoji tea doubled to about RMB340.0m, as its distribution network expanded beyond Guangdong province. Sales of core tea products accounted for around

64% of Wanglaoji Corp JV's revenues. Sales of the 48.05%-owned JV jumped 59.5% YoY to RMB528.2m and net profit 45.0% YoY to RMB52.9m in 1H FY12/07A. Wanglaoji has been one of GP's key profit growth drivers over the past few years with a CAGR of 109.5% between FY12/05A to FY12/07F. Though officially a Chinese herbal tea, Wanglaoji has effectively become a "beverage" for Chinese consumers. GP's Wanglaoji JV is the exclusive manufacturer and distributor of the "green label" packet and bottle beverage products, which were launched in 2003 (the rights to the Wanglaoji "red can" belong to Carnaud Metal Box (HK) Ltd.). However, Wanglaoji JV and its products have a number of advantages over the "red can". They retail at RMB1.80-2.20 per carton, compared with the red can's RMB3.60-3.80. The green bottle can leverage the brand value of the red can and save on marketing/advertising expenses, reducing product launch risks and fast tracking its growth development.

Table 2: Turnover breakdown (2)

Year to Dec (RMBm)	FY05	FY06	YoY chg(%)	1H FY06	1H FY07	YoY chg (%)
Wanglaoji JV	244.7	661.9	170.5	331.2	528.2	59.5

Source: Company data

Wanglaoji margins are better than competitors. Its explosive growth has been driven by a combination of: 1) high demand for beverages in China; 2) positioning of Wanglaoji herbal tea as a beverage and 3) expanding distribution network. Wanglaoji JV's growth outpaces that of other beverage producers such as Tingyi (322 HK) and Uni-President (220 HK) and its margins are also better.

Table 4: Beverage drinks comparisons

Year to Dec	FY05		FY06		1H FY07	
	Sales YoY (%)	Net margin (%)	Sales YoY (%)	Net margin (%)	Sales YoY (%)	Net margin (%)
Wanglaoji JV	NA	13.2	170.5	11.0	59.5	10.0
Tingyi (322 HK)	25.8	6.7	26.3	6.4	35.2	6.4
Uni-President (220 HK)	14.9	3.9	20.6	1.9	6.6	5.8

Source: Company data

Three tiered expansion strategy. We expect this high growth rate of sales and net profit to be maintained over the next few years as the JV's strategy is to: 1) increase penetration in established regions; 2) expand to northeastern and northwestern parts of China and 3) develop new distribution channels. The Wanglaoji green label products are already selling through 40,000 supermarkets and they recently established new channels including selling its tea products to fast food outlets (such as KFC) and airlines.

Rabies vaccine will help Bai Di to breakeven. We believe a potentially promising new product for GP is its rabies vaccine, currently under development by Gangzhou Bai Di (Bai Di), a 95.7%-owned subsidiary of the company. The vaccine should be approved and registered by SFDA in 2H 2008. According to MoH, for the 3 consecutive months of April to June in 2007, rabies was the top ranked contagious disease in China. Chinese medical journals estimates demand for rabies vaccine in China was around 15m dosages in 2007, compared with the total supply (imports and domestic production) of around 8.5m dosages. Bai Di recorded net losses of RMB12.8m in FY12/06A and RMB4.6m in 1H FY12/07A as it has to date only been engaged in R&D services contracts. However, it has already constructed a plant with a production capacity of 1.5m dosages, and will obtain GMP certification for the facility on receipt of the vaccine's SFDA registration approval. At this stage, we are being conservative with our estimates for this product's contribution considering uncertainties related to regulatory approval and competition from most notably Liao Ning Chen Da Co. (600739 CH), which is building out its production capacity.

New chairman. The current chairman, Mr. Yang, came on board in 2004 as a result of GP's internal restructuring. He has since delivered value to shareholders in our view. Aside from successfully negotiating the Alliance Boots JV and re-invigorating turnover growth, he has introduced synergies among subsidiaries such as: 1) centralized procurement, packaging and advertising expenses; 2) market information sharing; 3) increasing participation in strategy and budget development and 4) centralizing administration resources. The measures have boosted GP's operating efficiency and reduced SG&A costs (as a percentage of turnover) since FY12/05A. The one-off rise in distribution costs in FY12/06A was due to the government's industry restructuring initiatives.

Table 5: SG&A expenditure FY03 to 1H FY12/07

Year to Dec (% of turnover)	FY03	FY04	FY05	FY06	1H FY06	1H FY07
Distribution cost	7.2	7.2	6.8	7.6*	8.1	7.4
Administration cost	8.7	8.7	7.1	6.4	6.2	4.4
Other Operating cost	0.3	0.4	0.2	0.1	0.1	0.1
Total	16.2	16.3	14.1	14.1	14.3	11.9

* Rise in distribution costs in FY12/06 was the result of Chinese government's industry restructuring initiatives

Source: Company data, SBI E2-Capital

Restructuring of the remaining subsidiaries. To cut costs, GP has been restructuring several subsidiaries, merging Guangzhou Huan Ye with its R&D subsidiary Guangzhou Han Fang (both are currently loss making) and making Guangzhou Pan Gao Shou share management and marketing resources with Guangzhou Xing Qun. These measures should limit the company's downside risk, while providing a platform to turn these companies around or re-accelerate growth. They also show the management's commitment to improving the overall profitability. Han Fang is GP's strategic subsidiary, being China's first research company to gain national accreditation for the research and development of extraction methods for Chinese medicines.

Distribution model is preferred to an OTC retail model. While the traditional approach to tapping China's burgeoning OTC market is through pharmacy retailers, we believe that distributors/wholesalers such as GP also constitute a viable vehicle as a significant portion of their products is sold to pharmacies and they have extensive networks. This distribution model is more scalable and less capital intensive than the retail pharmacy model as it requires less outlay such as rental and advertising expenses, allowing a distributor to use channel capital into providing value added services to product owners such as marketing and other third party logistics. The distribution model is also more flexible as it can own multiple channels. In GP's case, the company maintains distribution channels to: 1) OTC retailers; 2) hospitals and 3) lower tiered distributors.

Beneficiary of restructuring-led consolidation. GP is a key beneficiary of the government-led industry restructuring in 2005 and 2006 as SFDA and NDRC initiated a series of initiatives including: 1) trials on centralized tendering; 2) tightened governance by conducting trials to flatten the tiered distribution system; 3) price caps on medicines; 4) review of previously approved drug applications and 5) implementing a more stringent drug registration process. The overall effect has further strengthened GP's position within the pharmaceutical distribution value chain. Policies such as centralized tendering and limiting the number of tiered distributors are designed to promote industry champions and have a dual effect of reinforcing the bargaining power of GP while weeding out smaller players. The effect of lower prescription drug prices will serve to drive volume demand, which will also benefit GP's distribution business.

Tax reform and RMB appreciation - added bonus. GP will also benefit from both the unification of corporate tax policies and RMB appreciation. The company paid an effective tax rate of 34.4% in 1H FY12/07A and we conservatively expect it to drop to 28.0% in FY12/08F and beyond.

Re-accelerating growth. GP's growth drivers include: 1) runaway growth in Wanglaoji products; 2) growth and margin improvement in its Alliance Boots distribution JV; 3) steady growth in its core blockbuster products; 4) growing contribution in emerging products and 5) turnaround of previously loss making subsidiaries. Excluding an RMB82.0m one-off gain for the disposal of its stake in GPC as part of the Alliance Boots JV deal, (which will be booked in FY12/07F and FY12/08F), we project GP to record adjusted net profit of RMB263.7m, RMB345.1m and RMB442.0m between FY12/07F to FY12/09F, representing a YoY growth of 20.9%, 30.8% and 28.1%, respectively. We estimate that GP's raw material costs accounted for around 37% of manufacturing COGS and raw material price increases were one of the main reasons for the 2.2pcp YoY drop in the gross margin in 1H FY12/07A. We expect inflationary pressure to continue and have conservatively factored in a slight gross margin contraction into our P&L model. However, this contraction will be offset by efficiency gains from economies of scale. Our P&L model calls for an adjusted net margin of 2.3%, 7.0% and 7.7% over the three-year period.

Initiate coverage with BUY, target price HK\$8.80. We like GP for its leadership position, strong brand awareness, exposure to China's consumption sector and upside in its distribution business. We initiate coverage with a target price of HK\$8.80, representing 20.7x FY12/08F and 16.1x FY12/09F P/E and derived from a sum-of-the-parts valuation comprising 30.0x FY12/08F P/E for its Wanglaoji JV and 16.0x FY12/08F P/E for its pharmaceutical business. Hong Kong-listed pharmaceutical/medical companies with leadership position is trading at an average of 15.1x 1-year forward P/E while F&B companies are trading at an average of 27.6 1-year forward P/E. Our valuation is pragmatic against pharmaceutical peers (currently trading at 15.1x one-year forward P/E). The counter is currently undemanding, trading at 10.0x FY12/08F P/E, at a 65.7% discount to its A-shares counterpart.

Relationship and history with parent. Guangzhou Pharmaceutical Holdings Ltd, wholly owned by the Guangzhou Municipal Government, is the listco's parent. In Sep 1997, it injected eight TCM manufacturers and three medical distribution companies into GP in preparation for a listing. GP's H-shares were listed on HKEx in Oct 1997 and A-shares in Shanghai in Feb 2001.

Corporate governance. GP is an H-share company, with shares outstanding at 219.9m H-shares, 162.9m listed A-shares and 428.1m unlisted A-shares. Significant shareholders of H-shares include: 1) Baring Hong Kong China Fund (23.2%); 2) Wellington Management Co. Ltd. (8.0%); 3) Greenwoods Asset Management (7.6%); 4) Deutsche Bank AG (7.0%); 5) Martin Currie (5.6%) and 6) Value Partners (5.0%). The company has not undertaken any fund raising exercises since its H-shares and A-shares listing. PricewaterhouseCoopers is its auditor.

Dividend policy. GP's management has committed to maintaining a payout ratio of 30.0%.

Risks. 1) slowdown in Wanglaoji growth; 2) further regulatory adjustments by SFDA and NDRC; 3) acceleration of inflation leading to higher-than-expected raw material costs; 4) increased losses by loss making subsidiaries.

Table 6: P&L

Year to Dec (RMBm)	04A	05A	06A	07F	08F	09F
Turnover	7,709.6	9,026.3	10,241.0	11,705.8	4,971.4	5,759.5
Cost of sales	(6,313.6)	(7,473.0)	(8,472.2)	(9,901.0)	(3,877.3)	(4,450.0)
Gross profit	1,395.9	1,553.4	1,768.8	1,804.8	1,094.2	1,209.5
Other income and gains	65.1	91.6	75.2	77.5	29.8	34.6
Selling and distribution costs	(557.4)	(616.8)	(778.2)	(879.1)	(365.4)	(387.2)
Administrative expenses	(666.7)	(641.4)	(656.5)	(586.4)	(409.7)	(438.9)
Other operating expenses	(27.6)	(16.5)	(14.5)	(4.2)	(2.2)	(2.8)
Operating profit	209.4	370.3	394.8	412.7	346.7	415.2
Finance costs, net	(47.2)	(53.6)	(45.4)	(51.2)	(5.4)	(5.4)
Share of profits and losses of JCE		-	-	54.3	113.8	161.4
Share of profits of an associate	(0.6)	(1.2)	(0.3)	-	-	-
Exceptionals				16.4	65.6	
Profit before taxation	161.7	315.5	349.2	432.2	520.7	(571.2)
Taxation	(110.3)	(107.8)	(118.6)	(141.2)	(113.9)	(114.7)
Profit from continuing operations						
Profit from discontinued operations						
Profit after tax	51.4	207.7	230.6	291.0	406.8	456.5
Minority interests	(8.6)	(9.9)	(12.5)	(17.8)	(15.8)	(15.8)
Profit attributable to shareholders	42.8	197.8	218.1	273.3	391.0	440.7
% chg		362.1	10.3	25.3	43.1	12.7
Dividends	(20.3)	(56.8)	(68.1)	(82.0)	(117.3)	(132.2)

Source: Company data, SBI E2-Capital

Table 7: Valuation comparison

Company name	Ticker	Country	Mkt Cap (US\$m)	Last price (local)	Est Curr Yr P/E (x)	Est Next Yr P/E (x)	ROE (%)
HK-listed pharmaceuticals/medical leaders							
Mingyuan Medicare	233 HK	China	449.4	HK\$1.20	29.5	20.9	13.9
Guangzhou Pharma	874 HK	China	1,379.6	HK\$5.18	14.5	10.7	7.8
China Pharma	1093 HK	China	382.5	HK\$2.10	6.6	6.9	0.6
Sino Biopharmaceutical	1177 HK	China	383.0	HK\$1.40	15.0	11.0	7.5
Uni-Bio Group	690 HK	China	523.8	HK\$0.50	26.0	17.3	11.0
Golden Meditech	8180 HK	China	606.4	HK\$3.00	12.4	12.0	9.7
Shandong Weigao	8199 HK	China	1,676.7	HK\$13.90	40.5	27.2	27.0
<i>Average</i>					20.6	15.1	
China-listed pharmaceuticals							
Yunan Baiyao Group	000538 CH	China	2,353.9	RMB38.00	58.7	45.8	29.5
Beijing Tongrentang	600085 CH	China	1,658.4	RMB29.20	47.6	39.9	6.6
Guangzhou Baiyunshan	000522 CH	China	873.0	RMB14.10	45.4	29.6	-
Guangzhou Pharma	600332 CH	China	1,271.6	RMB15.10	41.0	34.3	7.9
<i>Average</i>					48.2	37.4	
<i>Average (HK & China)</i>					30.7	23.2	
HK-listed F&B related							
Uni-President	220 HK	China	1,914.6	HK\$4.20	31.1	22.5	5.8
Tingyi	322 HK	China	8,065.9	HK\$11.10	39.0	32.8	16.7
<i>Average</i>					35.1	27.6	

Source: Bloomberg

Industry Data

Beverage and RTD tea industry. Driven by increasing domestic consumption, China's beverage industry is booming. According to ACNielsen, beverage sales grew at a CAGR of 12.9% to RMB47.2b in 2004-2006, while volume consumption grew at a CAGR of 14.8% to 12.1b in the period. Despite this, China's per capita consumption is 25.2 litres compared with 262 litres in the US, 121 litres in Japan and 223 litres in Germany. In particular, ready-to-drink (RTD) tea products are experiencing the strongest growth, with sales surging at a CAGR of 32.2% to RMB7.4b in 2004-2006 and consumption at a CAGR of 36.2% to 1.5b litres. In our view, Wanglaoji herbal tea has been a prime beneficiary of this surging demand.

Table 8: 2004-2006 China beverage sales value

Segment	2006 (RMBm)	Market share (%)	2004-2006 CAGR (%)
Carbonated soft drinks	17,934	38.0	9.6
Juice	11,835	25.1	12.5
Bottled water	7,431	15.7	14.0
RTD tea	7,400	15.7	32.2
Functional drinks	2,601	5.5	-3.1
Total	47,201	100.0	12.9

Source: ACNielsen

Table 9: 2004-2006 China beverage sales volume

Segment	2006 (m litres)	Market share (%)	2004-2006 CAGR (%)
Carbonated soft drinks	4,451	36.9	10.4
Juice	3,556	29.4	15.9
Bottled water	2,292	19.0	17.1
RTD tea	1,452	12.0	36.2
Functional drinks	327	2.7	-11.0
Total	12,079	100.0	14.8

Source: ACNielsen

China's healthcare expenditure to continue growing. According to the Ministry of Health, China's total expenditure on healthcare grew at a CAGR of 13.6% in 2000-2005 to RMB866.0b, as rising wealth and income levels drove demand for healthcare services. While government healthcare spending remains low compared with developed countries, we expect it to increase significantly over the next few years, benefitting GP. In Mar 2007, the central government earmarked RMB31.3b for healthcare, up 86.8% from 2006. In the 11th Five-year Plan, the authorities aim to make medical insurance coverage available to all residents in the country by 2010.

Table 10: Health expenditure

	1980	1990	1995	2000	2003	2004	2005	2006
Total health expenditure (RMBb)	14.3	74.7	215.5	458.7	658.4	759.0	866.0	985.6
Government health expenditure (RMBb)	5.2	18.7	38.7	71.0	111.7	129.3	155.3	177.4
Social health expenditure (RMBb)	6.1	29.3	76.8	117.2	178.9	222.5	258.6	321.3
Personal health expenditure (RMBb)	3.0	26.7	100.0	270.5	367.9	407.1	452.1	486.9
Government health expenditure (%)	36.2	25.1	18.0	15.5	17.0	17.1	17.9	18.0
Social health expenditure (%)	42.6	39.2	35.6	25.5	27.2	29.3	29.9	32.6
Personal health expenditure (%)	21.2	35.7	46.4	59.0	55.8	53.6	52.2	49.4

Source: MoH

Strong growth in pharmaceutical products. The restructuring initiatives implemented by the SFDA and NDRC had resulted in a deceleration of YoY industry revenue growth from 26.3% in 2005 to 16.3% in 2006. However, it appears that the impact of most of these restructuring has largely been absorbed and industry growth has begun to normalise. We note that China's pharmaceutical industry has rebounded in 2007. For the first nine months of 2007, pharmaceutical sales increased 26.6% YoY to RMB416.3b. The growth has been broad based with chemical medicines, bio-chemical medicines and Chinese medicines growing at 27.2%, 27.6% and 23.7% YoY respectively. This macro trend is echoed at the micro level with the growth momentum of many listed pharmaceutical companies picking up and SFDA resuming product approvals.

Table 11: Pharmaceutical product revenues

9M 2007	Revenue (RMBb)	YoY Chg (%)
Chemical raw materials	97.7	25.6
Chemical medicines	92.9	27.2
Bio-chemical medicines	30.9	27.6
Chinese medicines	74.2	23.7
Medical equipment	38.9	21.6
Healthcare material	18.0	32.6
Others	63.7	32.0
Total	416.3	26.6

Source: PICO

OTC industry. China's OTC sub-sector is growing at a rapid rate, driven by favorable demographics such as aging population and cultural trends. The Chinese, by nature, are health conscious and tend to self medicate. Thus, rising disposable incomes fuel demand for self-medication and preventative healthcare products, driving the growth of the OTC market. According to the Frost & Sullivan, China's revenue from non-hospital drugstores is expected to grow from RMB91.6m in 2006 to RMB226.4m to 2011, or from 28.4% to 41.0% of total revenue in the period. The Chinese government has been encouraging the development of non-hospital drug stores. In Mar 2007, the Ministry of Health issued new regulations requiring hospitals to allow prescriptions to be filled at non-hospital drugstores, which is expected to boost sales of OTC chains.

Table 12: China's pharmaceutical expenditure by distribution source

(RMBb)	02	03	04	05	06	07F	08F	09F	10F	11F
Hospital pharmacies	136.3	153.6	174.1	203.6	231.5	254.1	278.9	298.2	318.8	325.9
Non-hospital drugstores	51.2	60.0	68.5	79.0	91.6	107.3	125.8	152.4	184.5	226.4
Total retail drug sales	187.5	213.6	242.6	282.6	323.1	361.4	404.7	450.6	503.3	552.3
% non-hospital drugstores	27.3	28.1	28.2	28.0	28.4	29.7	31.1	33.8	36.7	41.0

Source: Frost & Sullivan

P & L (RMBm)	05A	06A	07F	08F	09F	Cash Flow (RMBm)	05A	06A	07F	08F	09F
Year to Mar						Year to Mar					
Turnover	9,026.3	10,241.0	11,705.9	4,971.4	5,759.5	EBIT	370.3	394.8	412.8	346.7	415.2
% chg	17.1	13.5	14.3	(57.5)	15.9	Depre./amort.	138.6	139.6	130.3	195.4	199.7
Gross profit	1,553.4	1,768.8	1,804.8	1,094.2	1,209.5	Net int. paid	(51.2)	(46.3)	(49.3)	(5.4)	(4.5)
EBITDA	508.9	534.4	543.0	542.1	614.9	Tax paid	(121.9)	(113.7)	(145.4)	(113.9)	(114.7)
Depre./amort.	(138.6)	(139.6)	(130.3)	(195.4)	(199.7)	Others	(13.3)	6.5	61.2	(1.7)	(20.1)
EBIT	370.3	394.8	412.8	346.7	415.2	Gross cashflow	322.5	380.9	409.5	421.0	475.6
Net int. income/(exp.)	(53.6)	(45.4)	(51.2)	(5.4)	(5.4)	Chgs. in working cap.	(256.7)	(400.3)	(203.2)	(125.2)	(114.3)
Exceptionals			16.4	65.6		Operating cashflow	65.7	(19.4)	206.3	295.8	361.3
Associates	(1.2)	(0.3)	(0.0)	0.0	0.0	Capex	(125.8)	(88.3)	(132.0)	(132.0)	(132.0)
Jointly-controlled entit.	0.0	0.0	54.3	113.8	161.4	Free cashflow	(60.0)	(107.7)	74.3	163.8	229.3
Pre-tax profit	315.5	349.2	432.2	520.7	571.2	Dividends paid	(48.7)	(20.3)	(55.3)	(82.0)	(117.3)
Tax	(107.8)	(118.6)	(141.2)	(113.9)	(114.7)	Net distribution to MI	(9.9)	(12.5)	(17.8)	(15.8)	(15.8)
Minority interests	(9.9)	(12.5)	(17.8)	(15.8)	(15.8)	Investments	(0.2)	11.7	18.7	0.0	0.0
Net profit	197.8	218.1	273.3	391.0	440.7	Disposals					
% chg	361.8	10.2	25.3	43.1	12.7	New shares					
Dividends	(56.8)	(68.1)	(82.0)	(117.3)	(132.2)	Others	(145.0)	(0.6)	36.3	308.0	0.8
Retained earnings	141.0	150.0	191.3	273.7	308.5	Net cashflow	(263.8)	(129.5)	56.3	374.1	97.0
EPS (RMB) - Basic	0.244	0.269	0.337	0.482	0.543	Net (debt)/cash - Beg.	882.4	618.6	489.1	218.2	592.2
EPS (RMB) - F.D.	0.244	0.269	0.337	0.482	0.543	Net (debt)/cash - End.	618.6	489.1	545.4	592.2	689.3
DPS (RMB)	0.070	0.084	0.101	0.145	0.163	Interim Results (RMBm)	05A	06A			
No. sh.s o/s (m) - W.A.	(810.9)	(810.9)	(810.9)	(810.9)	(810.9)	Six months to Sep					
No. sh.s o/s (m) - Y.E.	(810.9)	(810.9)	(810.9)	(810.9)	(810.9)	Turnover	4,596.2	5,194.0			
No. sh.s o/s (m) - F.D.	(810.9)	(810.9)	(810.9)	(810.9)	(810.9)	% chg	15.2	13.0			
Margins (%)						Profit from operations	216.2	218.0			
Gross	17.2	17.3	15.4	22.0	21.0	Interest expenses	(30.2)	(26.5)			
EBITDA	5.6	5.2	4.6	10.9	10.7	Associates	(0.4)	(1.7)			
EBIT	4.1	3.9	3.5	7.0	7.2	Jointly-controlled entit.	0.0	0.0			
Pre-tax	3.5	3.4	3.7	10.5	9.9	Pre-tax profit	185.6	189.8			
Net	2.2	2.1	2.3	7.9	7.7	Tax	(54.7)	(52.5)			
Balance Sheet (RMBm)	05A	06A	07F	08F	09F	Minority interests	(7.9)	(8.5)			
Year to Mar						Net profit	123.0	128.8			
Fixed assets	1,542.1	1,478.3	1,425.5	2,148.1	2,084.3	% chg	260.8	4.8			
Intangible assets	49.5	40.6	30.2	24.3	20.0	EPS (RMB) - Basic	0.244	0.269			
Other LT assets	263.6	302.5	562.6	910.4	1,072.0	DPS (RMB)	0.070	0.084			
Cash	618.6	489.1	545.4	592.2	689.3	Shareholding Structure					
Accounts receivable	1,683.2	2,004.0	2,235.0	893.5	1,007.5						
Other receivables											
Inventories	1148.6	1326.4	1527.6	512.1	563.5						
Due from related co.s											
Other current assets	10.9	0.0	0.0	0.0	0.0						
Total assets	5,316.4	5,641.0	6,326.2	5,080.6	5,436.6						
Accounts payable	(1,359.7)	(1,537.9)	(1,792.1)	(829.2)	(880.4)						
Other payable											
Tax payable	(25.4)	(42.5)	(33.9)	(38.2)	(36.1)						
Due to related co.s											
ST debts	(917.8)	(888.2)	(971.6)	(145.7)	(145.7)						
Other current liab.	0.0	0.0	0.0	0.0	0.0						
LT debts	0.0	0.0	0.0	0.0	0.0						
Other LT liabilities	(88.7)	(92.0)	(94.6)	(93.4)	(98.1)						
Total liabilities	(2,391.6)	(2,560.6)	(2,892.2)	(1,106.6)	(1,160.2)						
Share capital	810.9	810.9	1,592.0	1,592.0	1,592.0						
Reserves	1,912.2	2,086.5	1,649.8	2,180.3	2,472.5						
Shareholders' funds	2,723.1	2,897.4	3,241.8	3,772.3	4,064.5						
Minority interest	201.7	183.0	192.1	201.7	211.8						
Total	2,924.8	3,080.4	3,434.0	3,974.1	4,276.3						
Capital employed	3,842.6	3,968.6	4,405.6	4,119.8	4,422.1						
Net (debt)/cash	(299.2)	(399.1)	(426.2)	446.5	543.5						
						Key Ratios	05A	06A	07F	08F	09F
						Net gearing (%)	30.2	20.6	15.0	5.9	14.4
						Net ROE (%)	7.5	7.8	8.9	11.1	11.2
						EBIT ROCE (%)	15.1	10.1	9.9	8.1	9.7
						Dividend payout (%)	28.7	31.2	30.0	30.0	30.0
						Effective tax rate (%)	34.2	34.0	32.7	21.9	20.1
						Net interest coverage (x)	6.9	8.7	8.1	63.8	76.4
						A/R turnover (days)	64.7	65.7	66.1	61.6	60.2
						A/P turnover (days)	68.1	62.4	61.4	78.1	68.6
						Stock turnover (days)	54.4	53.3	52.6	45.7	43.1

Background
Guangzhou Pharmaceutical focuses on: 1) manufacturing and sales of Chinese Patent Medicine; 2) wholesaler, retail, import and export of western and Chinese pharmaceutical products and medical apparatus; 3) research and development of natural and biological medicines.

Kennedy Tsang/ Helena Qiu
(852) 2533 3713/ 3709

Kennedytsang/ helenaqiu@sbi2capital.com

Yip's Chemical: Accelerating growth ahead

Recommendation: BUY (unchanged)
Hong Kong Industrials

Price	HK\$5.40	Year to	Net profit	EPS	EPS	P/E	P/B	EV/EBITDA	Yield	ROE	ROCE	N. Gear.
Target price	HK\$7.40 (37%)	Mar	HK\$m	HK\$	Δ %	x	x	x	%	%	%	%
12 mth range	HK\$3.48-5.90	06A	168.4	0.355	35.0	15.2	2.88	10.1	2.6	20.4	17.5	27.7
Market cap.	US\$351.9m	07A	223.6	0.466	31.5	11.6	2.36	7.2	3.7	22.4	11.8	14.0
Daily t/o, 3 mth	US\$0.2m	08F	265.7	0.554	18.8	9.7	2.34	6.1	4.3	23.9	23.7	18.2
Free float %	37.0%	09F	324.2	0.676	22.0	8.0	1.96	5.2	5.3	26.2	26.2	22.4
Ticker	0408.HK/408 HK	10F	384.8	0.803	18.7	6.7	1.68	5.7	6.2	26.1	27.0	11.6

Relative to Hang Seng Index (1 mth, 3 mth, 12 mth): +9.4%, +29.3%, +19.3%
Actual price changes (1 mth, 3 mth, 12 mth): +3.1%, +10.6%, +48.3%
Consensus EPS (08F-09F): HK\$0.555, HK\$0.679
Previous forecasts (08F-09F): HK\$262.7m (\$0.548), HK\$314.2m (\$0.655)

Key points:

- With its solvents and coating products used in everyday consumption item, Yip's is an under-appreciated beneficiary of China's domestic consumption growth;
- Growth areas include: 1) plastic inks (used for packaging of fast moving consumer goods); 2) self-branded "Bauhinia" architectural paints and 3) diversification into offset printing inks;
- Yip's is benefiting from the recent toy recalls by US toy brand owners. Company has witnessed an increase in requests for qualification and sample submissions, boding well for revenue growth in this area.
- Recently announced acquisition of Taixing will allow Yip's to expand its solvents business to eastern China.
- Revise up our target price to HK\$7.40 (previously HK\$6.55), representing 11.0x FY3/09F P/E, on a more robust outlook. The counter is currently undemanding, trading at 8.0x FY3/09F P/E.

Company background. Yip's is a vertically integrated producer of solvents, inks, coatings and paint products. Its products are used in everyday consumer items from toys to furniture to packaging. The company is the largest solvent producer in China and fourth largest in the world. Accounting for 60%+ solvents sold in South China, Yip's has significant pricing power.

Increasing exposure to China's domestic consumption. Yip's Chemical is a little known China-based upstream consumption play. It produces coating products in 15 plants and solvents in 2 plants across the country and sells them to domestic consumption-related industries. Taking the company as a whole, management estimates that 90% of its downstream manufacturing clients sell their products domestically.

Natural hedging mechanism brings stability. Due to its unique position of producing both upstream and downstream products, Yip's business model has a built in natural hedging mechanism. This represents a key competitive advantage as it brings stability to the company's margins and lessens the effect of inflation pressures. The mechanism stabilizes margins as it favours different product segments in varying operating environments. In a period of aggressive rising oil prices, the solvent segment, acting as a commodity, tends to benefit as it can more effectively pass on increased raw material prices to customers. Conversely, the coatings segment will benefit from more stable raw material prices and hence enjoy higher margins.

China's largest ink supplier. Yip's coatings products include gravure inks for packaging printing and printing of decorative carry bags and plastic inks for the printing of plastic wraps and plastic packaging. Its plastic inks are used in the packaging of fast moving consumer goods and its key customers include food and beverage giants such as Tingyi (322 HK) and Want Want. We estimate that the company's total ink sales account for around 25% of its coatings turnover. While demand for gravure inks has been stable, plastic inks have experienced solid growth on the back of China's growing consumption. As consumption units and volume increases, there is a direct increase in demand for Yip's plastic inks, which is used for packaging. The growing proportion of plastic inks in the coatings segment will also benefit the company's profitability, as their margins are higher than those of gravure inks.

Horizontal expansion into offset printing ink. To further capture the printing market, Yip's plans to produce offset printing ink, which is generally used for the printing of magazines. Its addressable market is more than

double that of gravure inks. The company undertook production trials and qualifications in FY3/08 and will commence sales in FY3/09.

Leveraging the “Bauhinia” brand for architectural paints. The remaining 75% of its coatings segment turnover comes from sales of paint products such as domestic architectural paints, industrial paints, varnishes and resins. Architectural paints account for around 50% of the paint products in terms of revenue. The main brand under this line is “Bauhinia”, one of the domestic leaders, behind international brands such as ICI, Dupont and PPG. The company has recently launched a TV ad campaign on CCTV to further enhance its brand value. We estimate that this segment is likely to grow between 15-18% over the next few years.

Beneficiary of toy recalls. With the recent series of US toy recalls by Mattel and Toys “R” Us, Yip’s will benefit from the increased emphasis on paint safety and quality. Yip’s was already a supplier to Mattel prior to the recall and though its products were not involved in any of the quality issues, they have since passed all re-inspections/re-qualifications initiated by customers. Yip’s maintains a very stringent quality control system and imports all of raw materials for its colour pigments from renowned overseas suppliers such as Denko and Degussa. Much of the previous quality issues with other domestic industrial paint producers came when they sourced and used domestic colour pigments. The company internally tests every batch of pigments before incorporating it into its paint products. Its plant in Huiyang has both RoHS and national CNAS QC laboratory accreditation.

“Flight to quality” increases Yip’s bargaining power. Although toy paint ASPs were stable in 2007, the company believes there’s room to increase them in 2008 as a result of the “flight to quality”. Requests from potential new customers for qualification samples and quotations surged at the end of 2007 and demand for its paint products jump between 25-30%. In our view, though this magnitude of increase during the off-peak season may not be representative of the full year, it is a solid sign of Yip’s good prospects going forward. By our estimation, toy paint products account for just under 20% of the company’s coatings turnover. We are not overly concerned about a potential economic slowdown in the US in 2008 because the “toy budget” is generally the last item to be cut in typical household spending. As a testament, Toys “R” Us recently announced that same store sales grew 3.1% YoY during the holiday period, outpacing the performance of other retailers and consumer segments.

Taixing acquisition announced. Yip’s announced in Dec 2007 the acquisition of Taixing Jinjiang Chemical Industry through 75%-owned subsidiary Concord Chemical Storage Ltd. The Huadong-based facility produces ethanol (upstream raw material of the company’s solvents products) and absolute alcohol. The total consideration of HK\$73.7m comprises a cash payment of HK\$33.5m and taking on Taixing’s outstanding debt of HK\$40.2m. Based on the net asset value at end-Dec 2006, the consideration represents 1.5x P/B, though an independent valuer hired by the company has valued Taixing at HK\$68.0m. For FY12/05A and FY12/06A, Taixing recorded net losses of HK\$4.2m and HK\$2.6m, respectively. The plant’s production capacity currently stands at 80,000t.p.a of ethanol and 15,000t.p.a of absolute alcohol.

Strategic expansion into eastern China. The acquisition will allow Yip’s to expand its solvent business into the eastern China, extending its geographical reach beyond its current stronghold in southern China. The company plans to construct a 55,000t.p.a solvents plant adjacent to the existing facilities by end-2008 at a cost of around HK\$50.0m. An added advantage is that the existing ethanol plant lies on a 110mu (7.3ha) piece of land with ample space on the site and no additional land acquisition necessary for the construction of the new plant. On completion, the company will be able to internally supply ethanol to its solvents plant and sell the unused capacity to third parties.

Geographical expansion advantages. By ensuring Yip’s own supply of ethanol, while most other solvent producers in the region purchase from outside sources, the acquisition brings several strategic advantages in terms of the absence of consumption tax (5% on ethanol) and extending its already favourable supply agreement with Celanese to the eastern China area to create cost benefits. Lastly, the plant has “2+3” tax benefits that have yet to be utilized.

Solvents capacity to expand. Yip’s solvent capacity could reach 365,000t.p.a. by end-2008 thanks to: 1) the Taixing acquisition, 2) streamlining of its Jiangmen plant and 3) capacity expansion of its recently acquired Shengda plant. Given the company’s significant market share in southern China, the trend of “flight-to-quality”, cost advantages and new geographical market in Huadong, we expect this expansion to boost its solvents turnover. Yip’s solvent plants have historically run at 95-100% utilization.

Still exploring M&As. We understand that Yip’s is exploring M&A opportunities, in coatings and solvents segments. The company reduced its net gearing ratio to a comfortable 10.0% in 1H FY3/07A and has HK\$501.0m cash and cash equivalents as well as unused banking facilities of around HK\$890.6m.

Revised estimates. The Taixing acquisition is expected to be completed in Feb 2008 and we have largely left our FY3/08F net profit estimate unchanged at HK\$265.7m. However, on the back of accelerating growth in its

coatings segment and solvents capacity expansion, we have revised up our FY3/09F and FY3/10F estimates to HK\$324.2m and HK\$384.8m (c.f. HK\$314.2m and HK\$369.3m), respectively.

Target price raised to HK\$7.40. With Yip's: 1) focused and increasing exposure to China's overall consumption boom; 2) accelerating growth in paint/ink coatings segment; 3) diversification into gravure inks and 4) strategic expansion into the eastern China region, we believe that Yip's is deserved of a re-rating. We revise up our target price to HK\$7.40 (previously HK\$6.55), representing 11.0x FY3/09F P/E. The counter is currently undemanding, trading at 8.0x FY3/09F P/E.

Table 1: Earnings model

Year to Mar (HK\$m)	06A	07A	08F	09F	10F
Turnover					
Solvents	1,973.6	2,194.7	2,583.5	3,348.1	3,794.2
Coating	1,196.0	1,398.7	1,599.2	1,868.5	2,112.1
Lubricants	219.3	205.1	232.8	267.7	307.8
Others	64.0	115.4	121.2	127.2	133.6
Elimination	(123.3)	-	-	-	-
	3,329.7	3,913.8	4,536.7	5,611.5	6,347.7
% chg	24.4	17.5	15.9	23.7	13.1
Cost of sales	(2,667.2)	(3,121.2)	(3,604.5)	(4,453.7)	(5,039.8)
Gross profit	662.5	792.6	932.2	1,157.9	1,307.9
Other revenue	16.2	26.4	61.2	56.1	57.1
Selling expenses	(98.6)	(106.4)	(131.6)	(179.6)	(203.1)
Administrative expense	(340.1)	(364.7)	(442.9)	(531.3)	(570.1)
Operating profit	240.0	348.0	419.0	503.2	591.8
Interest expense	(21.5)	(26.3)	(23.7)	(20.8)	(19.3)
Associates	-	-	-	-	-
Jointly-controlled entit.	-	-	-	-	-
Pre-tax profit	218.4	321.7	395.3	482.3	572.6
Tax	(21.7)	(52.0)	(64.0)	(78.1)	(92.8)
Minority interests	(28.3)	(46.1)	(65.6)	(80.0)	(95.0)
Net profit	168.4	223.6	265.7	324.2	384.8
% chg	36.7	32.8	18.8	22.0	18.7
Dividends	(66.8)	(81.7)	(111.6)	(136.2)	(161.6)

Source: Company data & SBI E2-Capital

P & L (HK\$m)	06A	07A	08F	09F	10F
Year to Mar					
Turnover	3,329.7	3,913.8	4,536.7	5,611.5	6,347.7
% chg	24.4	17.5	15.9	23.7	13.1
Gross profit	662.5	792.6	932.2	1,157.9	1,307.9
EBITDA	278.6	383.1	462.0	556.7	653.8
Depre./amort.	(40.4)	(40.5)	(49.1)	(59.3)	(67.0)
EBIT	238.2	342.6	413.0	497.4	586.8
Net int. income/(exp.)	(19.8)	(20.9)	(17.7)	(15.0)	(16.2)
Exceptionals	-	-	-	-	-
Associates	-	-	-	-	1.0
Jointly-controlled entit.	-	-	-	-	1.0
Pre-tax profit	218.4	321.7	395.3	482.3	572.6
Tax	(21.7)	(52.0)	(64.0)	(78.1)	(92.8)
Minority interests	(28.3)	(46.1)	(65.6)	(80.0)	(95.0)
Net profit	168.4	223.6	265.7	324.2	384.8
% chg	36.7	32.8	18.8	22.0	18.7
Dividends	(56.6)	(59.4)	(81.7)	(111.6)	(136.2)
Retained earnings	111.7	164.3	184.0	212.6	248.7
EPS (HK\$) - Basic	0.355	0.466	0.554	0.676	0.803
EPS (HK\$) - F.D.	0.352	0.461	0.550	0.672	0.797
DPS (HK\$)	0.140	0.200	0.233	0.284	0.337
No. sh.s o/s (m) - W.A.	474.8	479.4	479.4	479.4	479.4
No. sh.s o/s (m) - Y.E.	476.6	481.6	486.6	491.6	496.6
No. sh.s o/s (m) - F.D.	478.3	485.1	482.7	482.7	482.7

Margins (%)	06A	07A	08F	09F	10F
Gross	19.9	20.3	20.5	20.6	20.6
EBITDA	8.4	9.8	10.2	9.9	10.3
EBIT	7.2	8.8	9.1	8.9	9.2
Pre-tax	6.6	8.2	8.7	8.6	9.0
Net	5.1	5.7	5.9	5.8	6.1

Balance Sheet (HK\$m)	06A	07A	08F	09F	10F
Year to Mar					
Fixed assets	453.7	516.4	589.9	681.8	706.1
Intangible assets	2.0	1.0	0.7	-	1.0
Other LT assets	116.0	146.2	44.3	44.3	46.3
Cash	263.9	328.6	231.8	102.3	191.7
Accounts receivable	610.8	751.3	862.0	1,083.0	1,225.1
Other receivables	85.8	99.8	219.5	271.5	307.1
Inventories	341.7	417.8	444.6	533.1	603.0
Due from related co.s	-	-	-	-	1.0
Other current assets	2.3	2.2	2.7	2.9	2.9
Total assets	1,876.3	2,263.2	2,395.5	2,719.0	3,084.2
Accounts payable	(359.4)	(487.2)	(464.5)	(530.8)	(597.6)
Other payable	-	-	-	1.0	2.0
Tax payable	(18.4)	(56.2)	(126.7)	(154.6)	(183.5)
Due to related co.s	-	-	-	-	1.0
ST debts	(347.4)	(428.5)	(383.9)	(364.7)	(346.4)
Other current liab.	(0.2)	(0.1)	(0.3)	(1.3)	(4.3)
LT debts	(165.9)	(55.6)	(79.6)	(63.7)	(51.0)
Other LT liabilities	(1.8)	(1.9)	(1.9)	(1.9)	(2.9)
Total liabilities	(893.1)	(1,029.6)	(1,056.9)	(1,115.9)	(1,182.8)
Share capital	47.7	48.2	48.7	49.2	49.7
Reserves	846.3	1,055.6	1,074.9	1,301.9	1,545.3
Shareholders' funds	894.0	1,103.8	1,123.6	1,351.1	1,595.0
Minority interest	89.3	129.9	183.4	251.4	335.4
Total	983.2	1,233.7	1,307.0	1,602.5	1,930.3
Capital employed	1,496.5	1,717.8	1,770.5	2,030.9	2,327.7
Net (debt)/cash	(249.4)	(155.6)	(231.7)	(326.1)	(205.7)

Cash Flow (HK\$m)	06A	07A	08F	09F	10F
Year to Mar					
EBIT	238.2	342.6	413.0	497.4	586.8
Depre./amort.	40.4	40.5	49.1	59.3	67.0
Net int. paid	(19.8)	(20.9)	(17.7)	(15.0)	(16.2)
Tax paid	(15.4)	(14.2)	6.5	(50.2)	(63.8)
Dividends received	-	-	-	-	1.0
Gross cashflow	243.5	348.0	450.8	491.4	574.8
Chgs. in working cap.	(115.4)	(102.6)	(280.0)	(295.3)	(181.7)
Operating cashflow	128.1	245.4	170.8	196.1	393.0
Capex	(97.2)	(84.7)	(200.0)	(180.0)	(120.0)
Free cashflow	30.9	160.7	(29.2)	16.1	273.0
Dividends paid	(70.1)	(86.1)	(112.7)	(111.4)	(155.7)
Net distribution to MI	(10.7)	(12.0)	(12.0)	(12.0)	(11.0)
Investments	-	-	-	1.0	2.0
Disposals	3.8	-	-	-	-
New shares	5.8	-	-	-	-
Others	22.5	31.1	77.8	12.0	10.0
Net cashflow	(17.8)	93.8	(76.1)	(94.3)	120.4
Net (debt)/cash - Beg.	(231.6)	(249.4)	(155.6)	(231.7)	(326.1)
Net (debt)/cash - End.	(249.4)	(155.6)	(231.7)	(326.1)	(205.7)

Interim Results (HK\$m)	05A	06A
Six months to Sep		
Turnover	1,356.1	1,761.0
% chg	52.1	29.9
Profit from operations	112.1	124.0
Interest expenses	(1.5)	(8.8)
Associates	-	-
Jointly-controlled entit.	-	-
Pre-tax profit	110.6	115.1
Tax	(7.8)	(7.1)
Minority interests	(26.8)	(14.1)
Net profit	76.0	93.9
% chg	26.2	23.5
EPS (HK\$) - Basic	0.163	0.201
DPS (HK\$)	0.045	0.050

Shareholding Structure	Shares o/s (m)	%
Chairman, Tony Ip Chi Shing	189.4	39.6
Ip Fung Kuen	60.0	12.5
Yip Tsz Hin	56.5	11.8
Public	172.3	36.0
Total	478.2	100.0

Background
Yip's Chemical is engaged in the manufacture and trading of high molecular chemical products and mixed solvents (accounting for 20% of FY3/04 sales), paints (29%), raw solvents (32%), lubricants (6%) and inks (12%). The company is the largest raw solvent manufacturer in China, top 5 in the world, with the annual production capacity of 150,000 tonnes.

Key Ratios	06A	07A	08F	09F	10F
Net gearing (%)	(27.7)	(14.0)	(18.2)	(22.4)	(11.6)
Net ROE (%)	20.4	22.4	23.9	26.2	26.1
EBIT ROCE (%)	17.5	21.3	23.7	26.2	26.9
Dividend payout (%)	33.6	26.5	30.8	34.4	35.4
Effective tax rate (%)	9.9	16.2	16.2	16.2	16.2
Net interest coverage (x)	12.0	16.4	23.3	33.1	36.2
A/R turnover (days)	64.0	63.5	64.9	63.3	66.4
A/P turnover (days)	40.6	39.5	38.3	32.4	32.4
Stock turnover (days)	43.6	44.4	43.7	40.1	41.1

Kennedy Tsang
(852) 2533 3713
kennedytsang@sbie2capitalasia.com

COMPANY REPORT – SG

China Fishery: On top of the food chain

Recommendation: BUY (re-initiating coverage)

China Agriculture

Price	S\$1.68	Year to	Net profit	EPS	EPS	P/E	P/B	EV/EBITDA	Yield	ROE	ROCE	N. Gear.
Target price	S\$3.17 (+89%)	Dec	US\$m	US\$	Δ %	x	x	x	%	%	%	%
12 mth range	S\$1.25-2.88	05A	30.7	0.053	80.9	20.1	15.96	22.4	1.0	101.0	64.4	92.8
Market cap.	US\$864.4m	06A	48.0	0.067	27.5	15.7	6.68	14.6	1.4	62.6	23.8	262.0
Daily t/o, 3 mth	US\$1.8m	07F	76.7	0.099	47.2	10.7	3.27	7.3	2.1	42.2	24.2	127.2
Free float %	17.4%	08F	136.0	0.174	76.4	6.1	2.42	4.5	3.7	46.0	30.8	40.2
Ticker	CFG SP	09F	150.9	0.193	11.0	5.5	1.87	3.7	4.1	38.6	29.3	Cash

Relative to Straits Times Index (1 mth, 3 mth, 12 mth): +7.6%, +12.5%, -19.7%

Actual price changes (1 mth, 3 mth, 12 mth): -7.7%, -9.7%, -25.3%

Consensus EPS (07F-08F): US\$0.120, US\$0.146

Key points:

- Upstream food supplier.
- Fleet expansion in 2007 – nine new super-trawlers and 16 new purse seiner vessels.
- Three new fishmeal plants in Peru.
- Alaska pollock price, up 10.0% in 2007, expected to rise further in 2008 due to inflation and tight supply.
- Fishmeal prices to rebound backed by increasing pig farming in China.
- Net profit to grow at CAGR of 46.5% in FY12/06A-FY12/09F.
- BUY with a target price of S\$3.17, based on 12.0x FY12/08F P/E.

Investment summary. China Fishery Group Ltd (CFGL) is engaged in ocean trawling and fishmeal production. The company has been growing rapidly after acquiring licensed fishing vessels and processing plants in Russia and Peru. We expect fish and fishmeal prices to strengthen in FY12/08F due to food price hikes in China. We expect CFGL's net profit to grow at a three-year CAGR of 46.5%, from US\$48.0m (EPS: US\$0.067) in FY12/06A to US\$150.9m in FY12/09F (EPS: US\$0.193).

Major growth drivers.

FY12/07F - sales enhancement

- ❑ Expansion of super-trawler fleet to 23 ships from 14.
- ❑ Purchase of 16 purse seiner vessels and three fishmeal plants in Peru.
- ❑ Rising Alaska pollock price.

FY12/08F - margin widening

- ❑ Further Alaska pollock price hike.
- ❑ Rebound of fishmeal price.
- ❑ Full-year operation of vessels and plants acquired in 2007.

FY12/09F - steady growth

- ❑ Moderate change of Alaska pollock and fishmeal prices.
- ❑ Lower financing expenses.

Business overview. CFGL was originally an ocean-fish catcher with total 23 super-trawlers, mainly in Russia. In 2006, the company tapped into the fishmeal market by acquiring a small company called Carmen in Peru. Since then, CFGL has grown into one of Peru's leading fishmeal producers, with 34 purse seiner vessels and seven processing plants. In 1-3Q FY12/07A, its trawling business accounted for 65.6% of total revenue and fishmeal production for 34.4%.

Table 1: Segment summary

	Operating region	Major catch	Product forms
Ocean trawling	Russia	Alaska pollock	Fillet, Roe, Surimi, etc
Fishmeal processing	Peru	Anchovy	Fishmeal

Source: Company data

Ocean trawling segment

Expanding fleet. The company signed its third and fourth vessel operation agreement (VOA) in Jan 2007, which brought the number of its super-trawlers to 23 from 14. CFGL operates these ships mainly in Russia's part of the Berling Sea. Its major catch there is Alaska pollock, an important groundfish.

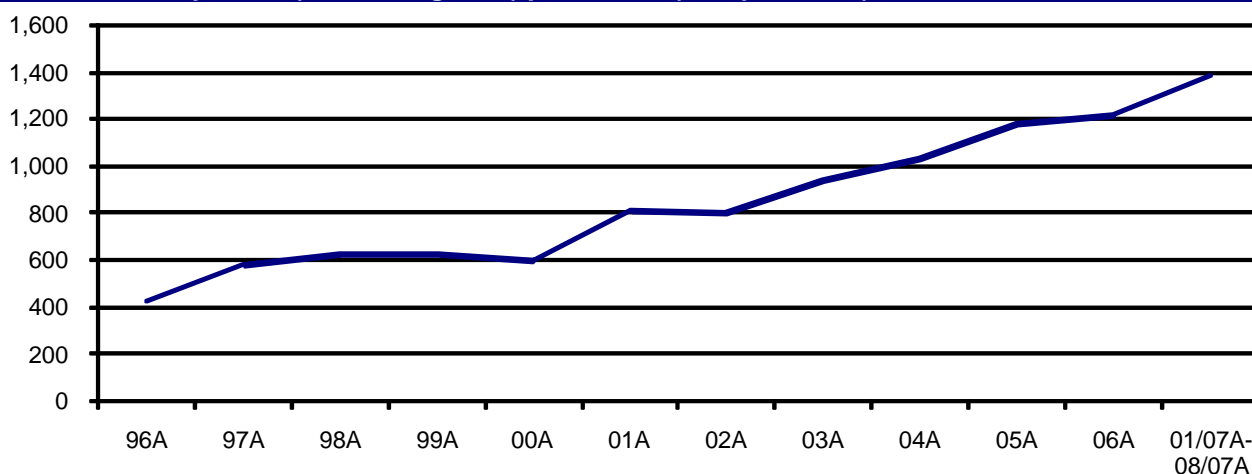
Table 2: Vessel operating agreements

	1st VOA	2nd VOA	3rd VOA	4th VOA
Date of signing	Jan-04	Feb-06	Jan-07	Jan-07
Period	10 years (renewable for 10 years on expiry)	10 years (renewable for 10 years on expiry)	18 years	5 years
Est. catch (based on 2007 TACs)	70,000 tonnes	70,000 tonnes	70,000 tonnes	60,000 tonnes
Number of super-trawlers	7	7	3	6
Fee structure	Prepaid fee US\$56m; plus 20% operating profit (before amortization of prepaid fee)	Prepaid fee US\$82m; plus 20% operating profit (before amortization of prepaid fee)	Prepaid fee US\$150m; plus 20% operating profit (before amortization of prepaid fee)	Daily fee US\$12,000 per vessel; plus 20% operating profit (after deduction of daily fee)

Source: Company data

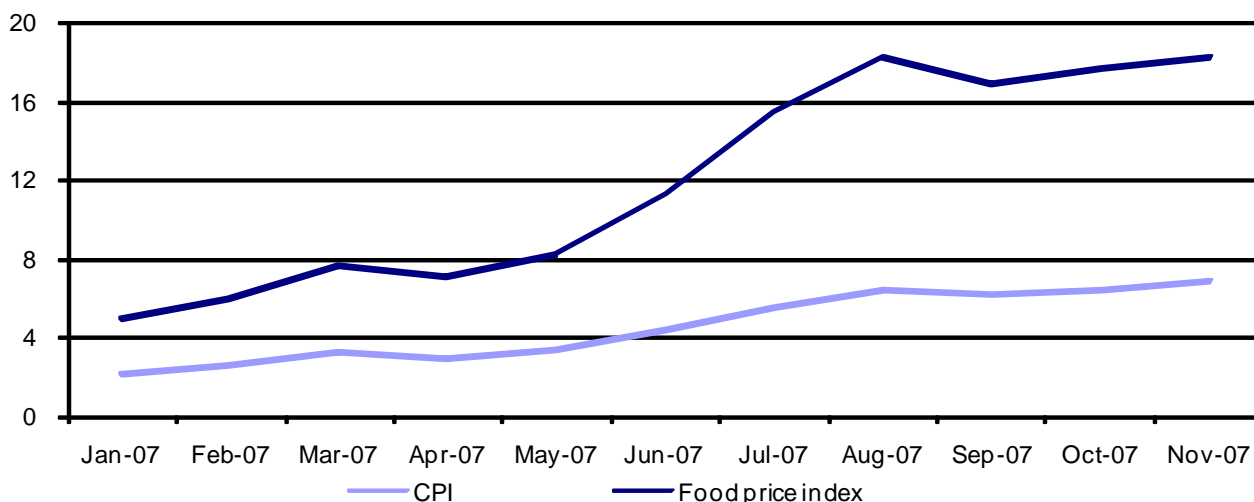
Increasing output. Most countries have set up strict quota systems to regulate local fishing activities. With its increased number of chartered ships, CFGL's aggregate capture volume of Alaska pollock is expected to represent around 20.0% of Russian TAC each year, according to the management. As Russia will raise its TAC to 1.5m tonnes in 2008 from 1.3m tonnes, we estimate that the company will harvest 290.0k tonnes of Alaska pollock, up 11.5% YoY.

Solid pricing. The company's fish product prices rose around 10.0% in 2007, which we believe was partly due to inflation in China (the country's food price index jumped 11.9% in Jan-Nov 2007). About 50% of CFGL's sales income comes from China. We expect inflation to persist in 2008 given: 1) strong domestic consumption buoyed by rising living standards; 2) firm crude oil prices. In fact, the recent strengthening of international commodities prices suggests inflation concerns worldwide. Meanwhile the overall supply of Alaska pollock will contract in 2008 due to a 0.4m tonne cut in the US's TAC to 1.0m tonnes, decreasing the aggregate TAC of the US and Russia, the world's two major Alaska pollock producers accounting for more than 80% of the total, by 9.0% for the year. Hence we expect CFGL's selling prices to rise 10.0% in FY12/08F.

Chart 1: Alaska pollock (headed & gutted) price trend (US\$ per tonne)

Source: Company data

Chart 2: YoY change of China's price indices (%)



Source: National Bureau of Statistics of China

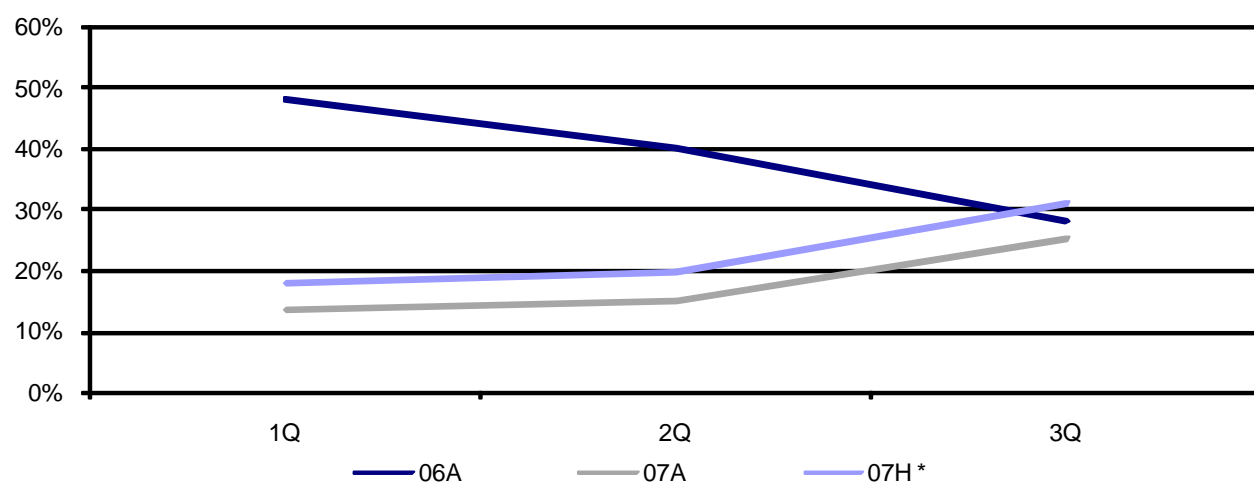
Margin enhancement. The company's divisional gross margin narrowed 22.4pcp in 1-3Q FY12/07A due to: 1) efficiency ramp-up of 3rd and 4th VOAs (gross margin widened from 13.7% in 1Q to 25.4% 3Q FY12/07A); 2) fee structure change in 4th VOA under which the company has to pay a daily fee of US\$12,000 per vessel instead of a lump sum prepayment. We estimate that this eroded the gross margin by 4.7pcp in 1-3Q FY12/07A or 5.6pcp in 3Q. After stripping off the effect of the fee structure change, we estimate the gross margin at 31.0% in 3Q, up 2.6pcp YoY. The company said that despite higher costs, the 4th VOA helps it lock in extra fishing quotas. With its relatively high fixed charter hire expenses (25.9% of turnover in 1-3Q FY12/07A), we expect the company's rising selling prices to translate into margin expansion.

Table 3: VOA fee structure

	1st VOA	2nd VOA	3rd VOA	4th VOA
Actual fee structure	Prepaid fee US\$56m; plus 20% operating profit (before amortization of prepaid fee)	Prepaid fee US\$82m; plus 20% operating profit (before amortization of prepaid fee)	Prepaid fee US\$150m; plus 20% operating profit (before amortization of prepaid fee)	Daily fee US\$12,000 per vessel; plus 20% operating profit (after deduction of daily fee)
Comparable fee structure	US\$80.0 per tonne TAC, plus 20% operating profit (before amortization of prepaid fee)	US\$117.1 per tonne TAC, plus 20% operating profit (before amortization of prepaid fee)	US\$119.0 per tonne TAC, plus 20% operating profit (before amortization of prepaid fee)	US\$350.4 per tonne TAC, plus 20% operating profit (before amortization of prepaid fee)

Source: Company data, SBI E2-Capital

Chart 3: Gross margin trend



Source: Company data, SBI E2-Capita

Note: Hypothetic gross margin is calculated by assuming the 4th VOA has the same fee structure as the 3rd one

Additional fish sources. CFGL has minor quotas for some other species. To fully utilize its fleet (currently 15 trawlers in Russian waters), the company sends spare ships to public waters in the South Pacific region.

Fishmeal segment

Peruvian fishmeal industry. Fishmeal is a protein-rich product made from fish and used in fertilizer and animal feeds. Peru is the world's largest fishmeal producer and exporter, representing 34.0% and 46.0%, respectively, of the total in 2005. Under the current Olympic quota system, the country decides an overall TAC for each fishing season (Mar/Apr – Jun/Jul, Oct/Nov – Dec) and each licensed vessel is allowed to catch as much as it can until the whole TAC is reached. As Peru has capped its total vessel holding capacity at 210.0km³ and fishmeal processing plant capacity at about 8,900 tonnes per hour, the only way to expand is via mergers & acquisitions.

Emerging segment. CFGL tapped into the fishmeal market in 2006 by acquiring a small company called Carmen in Peru. Since then, it has grown into one of Peru's leading fishmeal producers. In 2007, CFGL completed acquisitions of 16 purse seiner vessels and three plants, expanding its total vessel holding capacity to 9.4 km³ (4.5% of Peru's total), up 79.7% YoY, and fishmeal processing capacity to 549 tonnes/hour (6.2% of Peru's total), up 44.1% YoY.

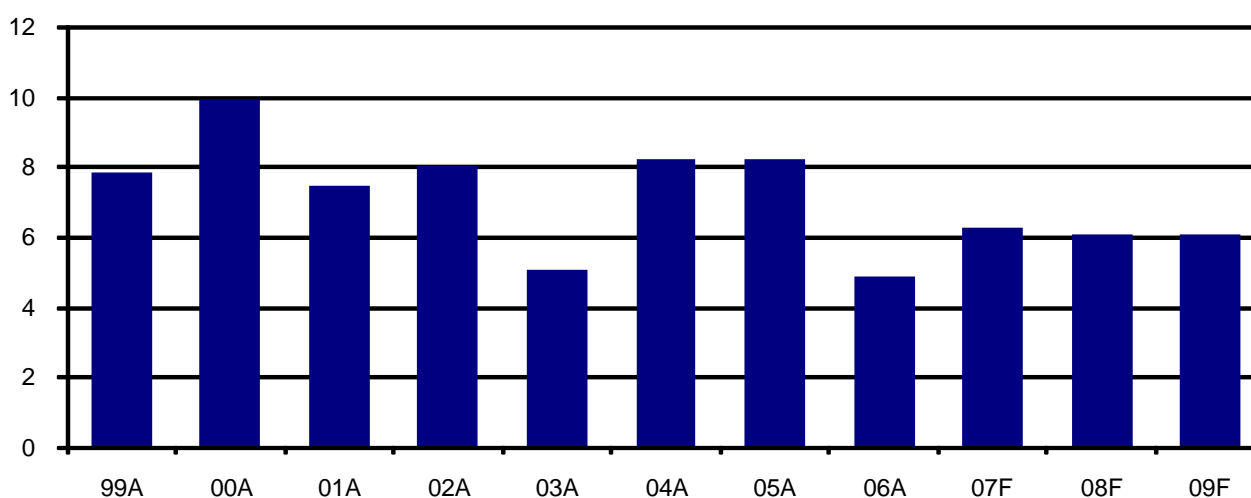
Table 4: Acquisition timeline in Peru

Date acquired	Acquired company	No. of vessels	Hold capacity (m ³)	No. of plants	Processing capacity (tonnes/hour)	Consideration (US\$m)
May-06	Carmen	2	606			n.a.
Jun-06	(individual)	1	383			n.a.
Oct-06	Alexandra	13	3,839	4	381	103.6
Dec-06	Isla Blanca	2	400			4.4
Feb-07	(individual)	1	243			n.a.
Mar-07	Grenadine Bay	4	1,200			14.0
May-07	Pocoma	3	692			10.5
Jun-07	Maru and Pillar	3	1,056	2	65	26.0
Jun-07	(individual)	5	976			19.5
Oct-07	n.a.			1	103	15.3
Total		34	9,395	7	549	

Source: Company data

Output estimates. In Oct 2007, Peru's Ministry of Production increased the fishing quota of anchovy for the second season (Nov-Dec) to 2.3m tonnes from 2.0m tonnes due to the good health and size of its biomass. This brings the total catch in 2007 to about 6.3m tones and this amount is expected to remain stable in the next two years. We expect CFGL's fishmeal production to reach 65,400 tonnes in FY12/07F and 82,200 tonnes in FY12/08F due to acquisition of fishmeal plants in Jun and Oct 2007.

Chart 4: Peruvian anchovy catch (tonnes m)

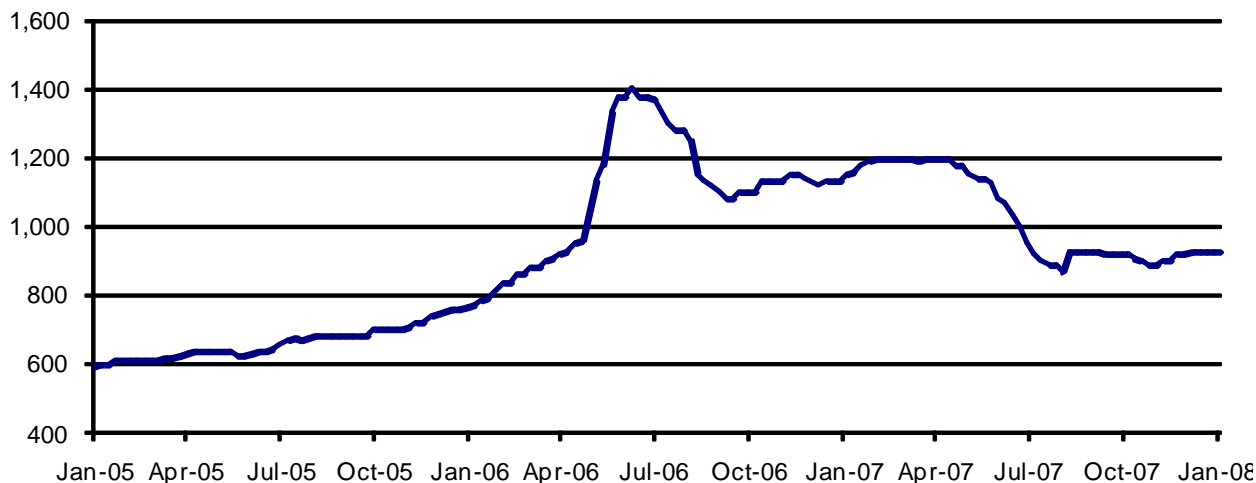


Source: Produce, Apoyo Consultoría, SBI E2-Capital

Price recovery. The fishmeal price surged 63.3% YoY in 2006 and fell 4.3% in 2007 due to lower demand in China, the largest consumer of Peruvian fishmeal (41.0% of total exports in 2006), as a result of swine fever and natural diseases which affected aquaculture harvest. The price index touched the bottom at US\$890.0/tonne in mid-Nov

and then recovered to US\$925.0, spurred by a sudden buying interest from China, which, we believe, is a result of increased pig farming activities stimulated by the soaring pork price in the country. With pig farming in full swing, meat prices on the rise and local governments' plans to boost their hog supply, we expect the fishmeal price to rise 15.0% YoY in 2008.

Chart 5: Peru broker SA prime fishmeal spot price (US\$/tonne)



Source: Bloomberg

Earnings forecast and valuation

Results review. Top line rose 170.9% in 1-3Q FY12/07A to US\$327.9m thanks to newly signed VOAs and acquisitions completed in Peru. Affected by the 3rd and 4th VOA, the gross margin narrowed 8.6pcp to 33.9%. Finance expenses increased to US\$19.5m from US\$2.4m in the year-earlier period due to the issuance of US\$225.0m senior notes (fixed annual interest rate of 9.25%) in Dec 2006. Net profit increased 56.8% to US\$70.3m YoY.

Profit projection. Based on TACs, we expect the company's turnover to rise 163.4% to US\$411.0m in FY12/07F, comprising US\$295.5m from ocean trawling, up 71.9% YoY, and US\$115.5m from fishmeal, up 1582.4% YoY. Net profit will increase 59.9% YoY to US\$76.7m. With increases expected in Alaska pollock and fishmeal prices, turnover should climb 33.9% in FY12/08F to US\$550.4m and gross margin widen 5.7pcp to 38.6%, leveraging bottom line up 77.2% to US\$136.0m.

Latest developments. The company has revealed plan to acquire one more fishmeal plant in Peru with a processing capacity of about 100.0 tonnes/hour and intends to change the 4th VOA's fee structure to a lump sum prepayment.

BUY. Our target price of S\$3.17 is based on 12.0x FY12/08F P/E, the lower end of the industry's average.

Table 5: Peer comparison

Company	Ticker	Currency	Mkt Cap. (m)	Gross margin (%)	Net gearing (%)	Fwd Yr. 1 P/E (x)	Fwd Yr. 2 P/E (x)	ROE (%)
Zhangzidao	002069 CH	RMB	13,684.0	46.4	cash	77.8	64.0	24.3
Homey Aquatic	600467 CH	RMB	10,397.4	22.8	28.0	61.0	51.4	11.3
Nippon Suisan	1332 JP	JPY	128,902.8	20.8	130.3	10.8	15.7	8.5
Katokichi	2873 JP	JPY	115,085.3	14.2	70.1	70.5	37.9	(10.6)
Kyokuyo	1301 JP	JPY	19,233.8	11.0	144.8	n.a	n.a	10.8
Toyo Suisan Kai	2875 JP	JPY	209,565.2	36.1	cash	16.8	15.9	4.5
Yonkyu	9955 JP	JPY	5,893.6	12.5	cash	n.a	n.a	2.7
Tassal	TGR AU	AUD	474.0	8.3	49.7	18.8	14.7	21.7
ITATA	ITATA CI	CLP	159,995.1	21.3	cash	n.a	n.a	17.8
Aker Seafoods	AKS NO	NOK	1,675.5	5.7	104.9	23.5	11.2	13.0
Copeinca	COP NO	NOK	2,340.0	11.1	200.8	224.7	31.7	26.4
Marine Harvest	MHG NO	NOK	11,028.1	32.7	54.5	13.4	12.9	24.2
Vinnlustodin	VNST IR	ISK	n.a	6.1	228.6	n.a	n.a	15.0
Pescanova	PVA SM	EUR	474.8	2.0	139.8	16.3	14.3	8.9
Average				17.9	115.1	53.4	27.0	12.7
Highest				46.4	228.6	224.7	64.0	26.4
Lowest				2.0	cash	10.8	11.2	(10.6)
China Fishery*	CFG SP	S\$	1,313.9	38.2	262.0	11.2	6.4	62.6

Source: Bloomberg, SBI E2-Capital

Note: Estimates from SBI E2-Capital

Risks. We believe main risks the company faces are:

- Political - fishing policy changes overseas.
- Market - fluctuation of TACs.
- Environmental - adverse weather conditions and unfavourable ocean currents.
- Operating - potential fee structure changes in 4th VOA.

P & L (US\$m)	05A	06A	07F	08F	09F	Cash Flow (US\$m)	05A	06A	07F	08F	09F
Year to Dec						Year to Dec					
Turnover	90.6	156.0	411.0	550.4	599.3	EBIT	32.4	53.6	108.3	170.6	184.7
% chg	(4.3)	72.3	163.4	33.9	8.9	Depre./amort.	5.7	16.3	36.4	39.4	38.5
Gross profit	37.9	59.6	135.4	212.4	233.8	Net int. paid	(1.2)	(4.3)	(27.1)	(25.3)	(21.5)
						Tax paid	0.0	(1.6)	3.1	(6.9)	(10.9)
EBITDA	38.1	69.9	144.7	210.0	223.3	Dividends received					
Depre./amort.	(5.7)	(16.3)	(36.4)	(39.4)	(38.5)	Gross cashflow	36.8	64.1	120.6	177.9	190.9
EBIT	32.4	53.6	108.3	170.6	184.7	Chgs. in working cap.	(24.7)	(46.1)	32.4	(7.7)	(6.2)
Net int. income/(exp.)	(1.8)	(5.2)	(27.1)	(25.3)	(21.5)	Operating cashflow	12.1	18.0	153.0	170.1	184.8
Exceptionals						Capex	(26.6)	(196.7)	(241.5)	(8.0)	(8.0)
Associates						Free cashflow	(14.4)	(178.7)	(88.5)	162.1	176.8
Jointly-controlled entit.						Dividends paid	(10.9)	(16.3)	(13.3)	(45.0)	(48.5)
Pre-tax profit	30.7	48.4	81.1	145.3	163.3	Net distribution to MI					
Tax	0.0	(0.4)	(4.4)	(9.4)	(12.3)	Investments					
Minority interests						Disposals					
Net profit	30.7	48.0	76.7	136.0	150.9	New shares	0.0	40.9	75.2	0.0	0.0
% chg	73.1	56.5	59.9	77.2	11.0	Others	(15.0)	(18.4)	(3.9)	(4.5)	(1.5)
Dividends	(10.9)	(16.3)	(13.3)	(45.0)	(48.5)	Net cashflow	(40.3)	(172.5)	(30.6)	112.6	126.8
Retained earnings	19.8	31.7	63.4	90.9	102.4	Net (debt)/cash - Beg.	12.1	(28.2)	(200.7)	(231.3)	(118.7)
EPS (US\$) - Basic	0.053	0.067	0.099	0.174	0.193	Net (debt)/cash - End.	(28.2)	(200.7)	(231.3)	(118.7)	8.1
EPS (US\$) - F.D.	0.053	0.067	0.099	0.174	0.193						
DPS (US\$)	0.016	0.022	0.033	0.058	0.065	Interim Results (US\$m)	05A	06A	07A		
No. sh.s o/s (m) - W.A.	610.1	724.1	782.1	782.1	782.1	Six months to Jun					
No. sh.s o/s (m) - Y.E.	610.1	716.6	778.4	782.1	782.1	Turnover	53.1	81.7	232.4		
No. sh.s o/s (m) - F.D.	610.1	716.6	778.4	782.1	782.1	% chg		53.8	184.4		
						Profit from operations	22.1	33.9	64.7		
Margins (%)						Interest expenses	(0.4)	(1.5)	(12.9)		
Gross	41.8	38.2	32.9	38.6	39.0	Associates					
EBITDA	42.0	44.8	35.2	38.2	37.3	Jointly-controlled entit.					
EBIT	35.8	7.0	26.3	31.0	30.8	Pre-tax profit	21.7	32.4	51.8		
Pre-tax	33.8	31.0	19.7	26.4	27.2	Tax	0.0	0.0	(1.1)		
Net	33.8	30.7	18.7	24.7	25.2	Minority interests					
						Net profit	21.7	32.4	50.6		
						% chg		49.6	56.3		
						EPS (US\$) - Basic	0.030	0.046	0.065		
						DPS (US\$)					
Balance Sheet (US\$m)	05A	06A	07F	08F	09F	Shareholding Structure				Shares o/s (m)	%
Year to Dec						Super Investment Ltd.				610.1	78.0
Fixed assets	0.5	89.7	165.1	155.7	147.2	Cazenove & Co PTE Ltd.				34.8	4.4
Intangible assets	39.2	168.8	303.0	282.2	261.5	HSBC				23.2	3.0
Other LT assets	0.0	11.6	0.0	0.0	0.0	Others				114.0	14.6
Cash	11.8	57.7	41.0	124.9	243.0	Total				782.1	100.0
Accounts receivable	2.1	8.2	14.4	19.3	21.1						
Other receivables	20.5	68.3	40.0	53.5	58.3	Background					
Inventories	0.0	12.9	8.5	11.4	12.4	Incorporated in Apr 2000, CFGL is a fast-growing fishing companies with operation mainly in Russia and Peru. The major catch of the company include Alaska pollock, an important food groundfish, and Peruvian anchovy, used to produce fishmeal. By the end of 2007, CFGL has 23 chartered supper-trawlers in Russia, 34 purse seiner vessles and seven fishmeal processing plants in Peru. CFGL's direct controlling shareholder, Pacific Andes (Holdings) Ltd., is also a listing ocpmany in Singapore stock exchange while its ultimate parent, Pacific Anders International Holdings lists in Hong Kong stock exchange.					
Due from related co.s											
Other current assets	8.3	20.7	34.5	38.6	40.1						
Total assets	82.5	437.8	606.5	685.8	783.5	Key Ratios	05A	06A	07F	08F	09F
Accounts payable	(1.4)	(11.0)	(15.0)	(21.1)	(22.1)	Net gearing (%)	92.8	262.0	127.2	40.2	Cash
Other payable	(0.8)	(21.4)	(28.7)	(40.4)	(42.2)	Net ROE (%)	101.0	62.6	42.2	46.0	38.6
Tax payable	0.0	(2.9)	(2.2)	(4.7)	(6.2)	EBIT ROCE (%)	64.4	23.8	24.2	30.8	29.3
Due to related co.s						Dividend payout (%)	35.5	33.9	17.4	33.1	32.1
ST debts	(17.1)	(10.4)	(30.0)	(10.0)	(15.0)	Effective tax rate (%)	-	0.9	5.4	6.5	7.6
Other current liab.	0.0	(2.7)	(3.2)	(0.2)	(0.2)	Net interest coverage (x)	18.5	10.3	4.0	6.7	8.6
LT debts	(22.9)	(248.0)	(242.3)	(233.6)	(219.9)	A/R turnover (days)	5.4	12.1	10.1	11.2	12.3
Other LT liabilities	0.0	(28.5)	(34.4)	(35.6)	(36.9)	A/P turnover (days)	60.0	14.6	11.6	12.0	13.2
Total liabilities	(42.3)	(324.9)	(355.9)	(345.6)	(342.4)	Stock turnover (days)	-	24.4	14.2	10.7	11.9
Share capital	30.5	36.2	39.1	39.1	39.1						
Reserves	9.7	76.7	211.5	301.0	402.0						
Shareholders' funds	40.2	112.9	250.6	340.1	441.1						
Minority interest											
Total	40.2	112.9	250.6	340.1	441.1						
Capital employed	80.2	371.2	522.9	583.7	676.0						
Net (debt)/cash	(28.2)	(200.7)	(231.3)	(118.7)	8.1						



HONG KONG OFFICE

SBI E2-Capital Asia Securities Ltd
43/F, Jardine House
One Connaught Place, Central
Hong Kong
Tel: (852) 2533 3700
Fax: (852) 2533 3733

SINGAPORE OFFICE

SBI E2-Capital Asia Securities Pte Ltd
143 Cecil Street,
#18-01 GB Building,
Singapore 069542
Tel: (65) 6826 0838
Fax: (65) 6826 0824

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