

12 October 2007

**First Natural Foods (1076.HK)**
**BUY**

Ben Leung (852) 2913 6329

benleung@vcgroup.com.hk

|                              |      |
|------------------------------|------|
| Price (11/10/2007)<br>(HK\$) | 1.06 |
| 12-month Target<br>(HK\$)    | 1.50 |
| Market Cap. (HK\$ m)         | 1117 |
| 52-week high                 | 1.37 |
| 52-week low                  | 0.76 |

- **Surge in 1H07 profit.** Revenue increased 48% yoy to Rmb386m and net profit surged 31% yoy to Rmb91m.
- **High and stable margins.** The company maintains a stable and high gross margin and net profit margin at about 48% and 25%, respectively, over the past few years.
- **Capacity expansion.** We estimate the company's total production capacity will increase from 27,000 tonnes in FY06 to 36,000 tonnes in FY08, following the new plant in Fuqing commences production in 4Q07 .
- **Retail Expansion.** The first "UBI" retail shop has started operation in Shanghai since May07. The company looks to open 2-3 more UBO shops by the end-FU07. We believe the move will help the company in brand building.
- **Valuation.** We estimate that FNF will post a net profit of Rmb175m and Rmb239m in 2007 and 2008, representing an increase of 26.93% yoy and 36.76% yoy respectively. The figures translate into a 6.05x PE for FY07 and 5x PE for FY08. Our 12 months target price is set at HK\$1.5, implying 8.5x FY07P/E, which we think is undemanding if compared with an average of 13.1x FY07P/E of FNF's listed peers in Hong Kong. Our target price represents a total return of 46.5%, including a 41.5% capital appreciation gain and a 5% dividend yield, for a 12-month investment horizon.

|                    |       |
|--------------------|-------|
| Historical P/E (x) | 6.93  |
| Forward P/E (x)    | 6.05  |
| Historical P/B (x) | 1.12  |
| Forward P/B (x)    | 1.05  |
| Est. ROE (%)       | 17.3% |
| Dividend Yield (%) | 5.0   |

### Company Profile

We initiate coverage on First Natural Food Holdings (FNF) with a BUY recommendation. Established in 1995, the company is engaged in the production of frozen natural foods from Fujian Province. The company's business can be classified into three major segments, namely frozen marine food, frozen functional food and seasoned convenient food. As of 30 Jun07, sales to Japan and US accounted for about 69.8% and 25.9% of the company's total revenue.

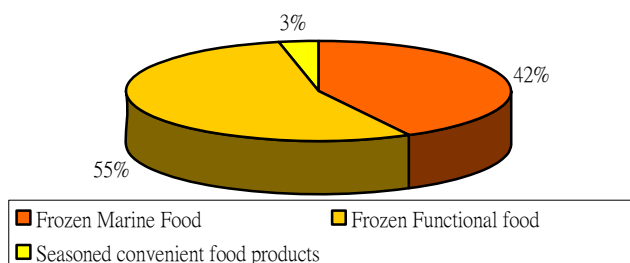
**Frozen marine food.** This business includes shellfish, octopus and clams.

**Frozen functional food.** Frozen functional food products (including flying fish roes, roasted eel).

**Seasoned convenient food.** Products from this segment are mainly convenient rice meal and seasoned tuna fish packs.

**1H07 profit surged.** The company announced its 1H07 result on 20 Sep07, which saw revenue increase 48% yoy to Rmb386m and profit surged by 31% to Rmb91m. The earnings contributions from the various business segments are set forth as follows.

#### 1H07 Revenue Mix



Source: Company data

**Frozen marine food.** Revenue from this segment reached Rmb163.2m, representing a 12% yoy increase and accounted for 42.23% of total turnover in 1H07.

**Frozen functional food.** This segment generated about Rmb210m revenue for the company in 1H07, implying a near 85% yoy growth and accounted for 54.49% of the total revenue. Turnover of sea eel products was about Rmb32m (8% of the total revenue) in 1H07 and its sales volume surged to 280 tonnes, almost accomplishing the full years sales target of 300 tonnes. We expect full year sales volume of sea eel products to reach about 600 tonnes. The strong sea eel sales led to a huge increase in export to Japan, which saw revenue from Japanese market rise 67% to Rmb270m from Rmb161m in 1H07, representing 69.89% of the total revenue.

**Seasoned convenient food.** Turnover from this segment is about Rmb 12.6m, accounted for about 3% of the group's total turnover. In 1H07, sales volume of tuna and rice products were approximately 300 tones and 230 tones respectively.

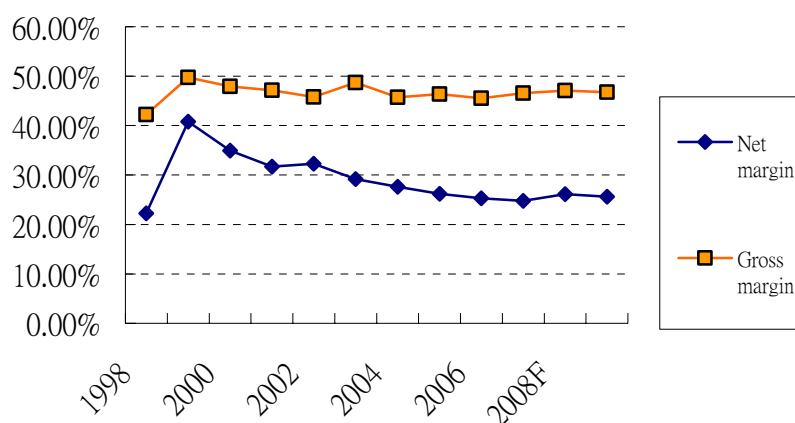
## Income Statement

| Rmb'000                             | 1H06       | 1H07       | Comment   |
|-------------------------------------|------------|------------|---|
| Turnover                            | 260,292    | 386,415    | Surged 48% yoy  |
| Frozen marine food                  | 145,785    | 163,189    |   |
| Frozen functional food              | 113,833    | 210,560    | 85% yoy due to stronger than expected sea eel sales           |
| Seasoned convenient food products   | 674        | 12,666     | Accounted for only 3% of total turnover                       |
| Cost of sales                       | (139,632)  | (208,773)  |   |
| Gross profit                        | 120,660    | 177,642    | Gross margin stood at 46%                                     |
| Other revenue                       | 2,159      | 7,829      | Increased sharply due to interest income                      |
| Distribution expenses               | (813)      | (1,991)    | Only at around 0.52% of total revenue                         |
| General and administrative expenses | (19,689)   | (16,024)   | Below 5% of total revenue                                     |
| Other operating expenses            | (2,235)    | (20,073)   | Surged near 10 times  |
| Profit from operations              | 100,082    | 147,383    | EBIT Margin at 38.14%, slightly lower than 38.45% in 1H06     |
| Interest expenses                   | (4,100)    | (16,783)   | Rose sharply due to newly issued convertible notes in Sep 06. |
| Profit before taxation              | 95,982     | 130,600    |   |
| Taxation                            | (25,965)   | (39,040)   |   |
| Profit attributable to shareholders | 70,017     | 91,560     | Rose 31% yoy  |
| EPS                                 | 9.15 cents | 7.57 cents |   |

Source : company data

**High and stable margin.** According to the company, that it can maintain a relatively high and stable gross and net margins over the past few years can be attributable to its effective business strategy. Every year, the company will sign a one year sales and purchase agreement with its major customers with stated quantity. The final selling prices of the products will be decided by the company, after taking into consideration of a comfortable profit margin and the variations in production costs, ahead the completion of the sales. As such, the company is capable of maintaining gross margin at 46%-48% and net margin at 25%-30% in recent years.

## Gross margin and net margin trend

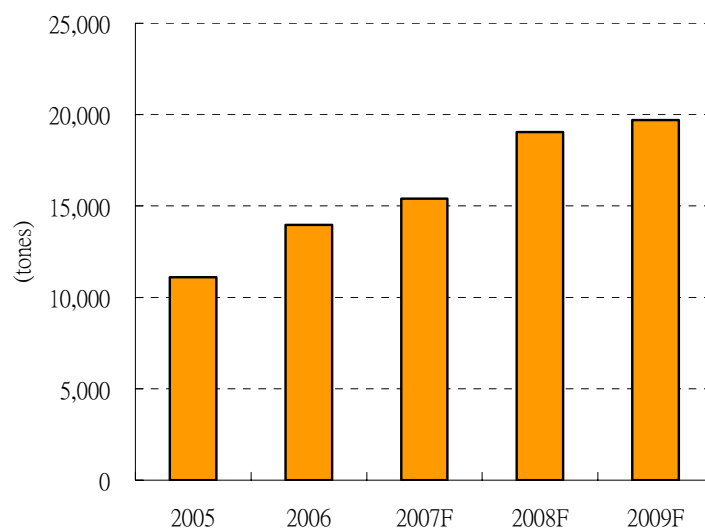


Source: Company data, VC estimates

**Production Capacity Expansion.** Management indicated that the new Fuqing workshop will commence operation in 4Q07. It consists of three production lines, including one for high-temperature seasoned convenient foods and two for frozen marine food products. Following the expansion, management believes that the production capacity of high temperature seasoned convenient food will double from the level in 2006, and production capacity of frozen marine food products will increase by 5,000 tonnes. We estimate the company's total production capacity will increase from 27,000 tonnes in 2006 to 36,000 tonnes in 2008. The total actual production will increase 41% from 13,968 tonnes in 2006 to 19,710 tonnes in 2009.

In view of FNF's high and stable margin, we believe the enhancement in production capacity will boost sales expansion, which will result in a significant improvement in the company's net profit growth in coming years.

Actual Production Volume



Source: Company data, VC estimates

| Production Volume                        |         |         |         |         |         |
|--|---------|---------|---------|---------|---------|
|  | 2005    | 2006    | 2007F   | 2008F   | 2009F   |
| <b>Actual Production volume (tonnes)</b> | 11,105  | 13,968  | 15,400  | 19,050  | 19,710  |
| <b>Production Capacity</b>               |         |         |         |         |         |
| Frozen marine food                       | 15,000  | 18,000  | 18,000  | 23,000  | 23,000  |
| Frozen functional food                   | 4,700   | 5,000   | 5,000   | 5,000   | 5,000   |
| Seasoned convenient food                 | 700     | 4,000   | 4,000   | 8,000   | 8,000   |
| <b>Actual Production</b>                 |         |         |         |         |         |
| Frozen marine food                       | 9,200   | 11,906  | 12,600  | 14,950  | 14,950  |
| Frozen functional food                   | 1,658   | 1,633   | 2,000   | 2,500   | 3,000   |
| Seasoned convenient food                 | 247     | 659     | 800     | 1,600   | 1,760   |
| <b>Capacity Utilization rate</b>         |         |         |         |         |         |
| Frozen marine food                       | 61.33%  | 66.14%  | 70%     | 65%     | 65%     |
| Frozen functional food                   | 35.28%  | 32.66%  | 40%     | 50%     | 60%     |
| Seasoned convenient food                 | 35.29%  | 16.48%  | 20%     | 20%     | 22%     |
| <b>Sales Revenue</b>                     |         |         |         |         |         |
| Frozen marine food                       | 239,177 | 292,816 | 358,412 | 442,997 | 552,860 |
| Frozen functional food                   | 186,797 | 236,180 | 309,834 | 414,868 | 560,901 |
| Seasoned convenient food                 | 6,664   | 16,743  | 38,285  | 59,151  | 92,275  |
| <b>Sales Volume (tones)</b>              |         |         |         |         |         |
| Frozen marine food                       | 9,200   | 10,648  | 12,778  | 15,333  | 18,400  |
| Frozen functional food                   | 1,658   | 2,332   | 3,000   | 3,900   | 5,070   |
| Seasoned convenient food                 | 247     | 670     | 1,500   | 2,250   | 3,375   |

Source: Company data, VC estimates

**Retail Expansion.** The first "UBI" retail shop has commenced operation in Pudong, Shanghai since May07. Over 60 different types of mid-to-high end food products such as tuna, spring rolls and flying fish roes are available at the retail shop, targeting mid-to-high end customers. We think the company is correct in its strategy in promoting its brand name to mid-to-high end customers as they are more likely to pay attention to food safety and nutrition.

The company indicates that two to three more retail shops are scheduled to open in 4Q07. Capital expenditure on each retail shop is around Rmb2m and break-even period will be about 18 to 24 months, according to management. Management reiterates that the major objective of the retail business is to promote its brand name and it hopes the retail shops will eventually help attract local wholesaler to join its distribution network and reach bulk customers like hotel, resorts and restaurant chains at a later stage.

## Valuation and conclusion:

We project FNF will post net profit growths of 26.9% yoy and 36.7% yoy for FY07 and FY08 to Rmb175m and Rmb239m, respectively. The figures represent 6.05x FY07 PE and 5x FY08 PE. We have set out 12-month TP at HK\$1.5, equivalent to 8.5x FY07 PE. Our target PE is undemanding compared with the average sector PE of 13.1x for FY07. Our target price represents a total return of 46.5%, including a 41.5% capital appreciation gain and a 5% dividend yield for a 12-month investment horizon.

| Peers comparison                     |        |              |            |               |          |
|--------------------------------------|--------|--------------|------------|---------------|----------|
| Company                              | FYE    | Share price  | Market cap | P/E (X)       |          |
|                                      |        | (11/10/2007) | HK\$ (M)   | 2007E         | 2008E    |
| Pacific Andes (1174 HK)              | Mar-31 | 2.53         | 4560       | 10.76         | 9.55     |
| China Gren (904 HK)                  | Apr-30 | 8.46         | 7386       | 18.28         | 22.9     |
| Four Seas Food (60 HK)               | Mar-31 | 1.38         | 358        | 10.29         | N/A      |
| Golden Resources Dev (677 HK)        | Mar-31 | 0.78         | 1097       | 13.45         | N/A      |
| <b>Sector Average:</b>               |        |              |            | <b>13.195</b> |          |
| <b>First Natural Foods (1076 HK)</b> | Dec-31 | 1.06         | 1117       | <b>6.05</b>   | <b>5</b> |

Source: Bloomberg, VC estimates

**Income Statement**

| Rmb'000                             | 2005      | 2006      | 2007F     | 2008F     | 2009F     |
|-------------------------------------|-----------|-----------|-----------|-----------|-----------|
| Turnover                            | 432,652   | 545,739   | 706,531   | 917,015   | 1,206,037 |
| Frozen Marine Food                  | 239,177   | 292,816   | 358,412   | 442,997   | 552,860   |
| Frozen Functional food              | 186,797   | 236,180   | 309,834   | 414,868   | 560,901   |
| Seasoned convenient food product:   | 6,664     | 16,743    | 38,285    | 59,151    | 92,275    |
| Cost of sales                       | (231,860) | (297,212) | (377,406) | (485,426) | (642,033) |
| Gross Profit                        | 200,791   | 248,527   | 329,125   | 431,589   | 564,004   |
| Other Revenue                       | 3,866     | 11,429    | 15,258    | 20,709    | 22,799    |
| Distribution Expenses               | (4,120)   | (6,094)   | (9,746)   | (12,230)  | (16,329)  |
| General and administrative expenses | (27,161)  | (38,208)  | (39,827)  | (47,574)  | (64,048)  |
| Other operating expenses            | (10,301)  | (1,830)   | (30,000)  | (38,973)  | (51,257)  |
| Profit from operations              | 163,075   | 213,824   | 264,810   | 353,520   | 455,168   |
| Interest expenses                   | (7,304)   | (21,571)  | (25,111)  | (24,997)  | (29,455)  |
| Profit before taxation              | 155,772   | 192,253   | 239,699   | 328,523   | 425,714   |
| Taxation                            | (42,311)  | (54,247)  | (64,532)  | (88,967)  | (116,413) |
| Profit attributable to shareholders | 113,461   | 138,006   | 175,167   | 239,556   | 309,301   |
| Basic EPS (cents)                   | 12.35     | 14.80     | 17.50     | 20.12     | 25.97     |
| Diluted EPS (Cents)                 | 11.91     | 13.19     | 14.71     | 20.12     | 25.97     |
| Dividend per shares                 | 0.02      | 0.05      | 0.05      | 0.06      | 0.08      |

Source : Company data ; VC estimates

**Cash Flow Statement**

| Rmb'000                                    | 2005A    | 2006A     | 2007F    | 2008F     | 2009F     |
|--|----------|-----------|----------|-----------|-----------|
| Profit before tax                          | 155,772  | 192,253   | 239,699  | 328,523   | 425,714   |
| Net cash flow from operating activities    | 152,567  | 101,495   | 175,559  | 229,813   | 280,333   |
| Net cash flow from investing activities    | (21,764) | (292,166) | 61,616   | (102,791) | (100,501) |
| Net cash flow from financing activities    | (43,496) | 279,148   | (94,620) | (43,404)  | (59,166)  |
| Net change in cash and cash equivalents    | 87,307   | 88,477    | 142,555  | 83,619    | 120,667   |
| Cash and cash equivalents at beginning     | 494,950  | 582,185   | 673,797  | 816,352   | 899,970   |
| Effect of foreign exchange rate changes    | (72)     | 3,135     | 0        | 0         | 0         |
| Cash and cash equivalents at end of period | 582,185  | 673,797   | 816,352  | 899,970   | 1,020,637 |

Source: Company data, VC estimates

| <b>Balance Sheet</b>                         |                |                  |                  |                  |                  |
|--|----------------|------------------|------------------|------------------|------------------|
| Rmb'000                                      | <b>2005A</b>   | <b>2006A</b>     | <b>2007F</b>     | <b>2008F</b>     | <b>2009F</b>     |
| <b>Non Current Asset</b>                     |                |                  |                  |                  |                  |
| Property, Plant and Equipment                | 151,951        | 242,324          | 321,291          | 395,568          | 464,473          |
| Leasehold land and rental prepayment         | 17,260         | 27,626           | 33,436           | 37,686           | 40,781           |
| Investment in subsidiaries                   | 0              | 0                | 0                | 0                | 0                |
| Deposit for acquisition of fixed asset       | 0              | 0                | 0                | 0                | 0                |
| Deferred tax assets                          | 912            | 812              | 812              | 812              | 812              |
| <b>Total Non Current Asset</b>               | <b>170,123</b> | <b>270,762</b>   | <b>355,539</b>   | <b>434,066</b>   | <b>506,066</b>   |
| <b>Current Assets</b>                        |                |                  |                  |                  |                  |
| Leasehold land and rental prepayment         | 13,078         | 9,566            | 12,528           | 14,726           | 16,357           |
| Inventories                                  | 28,756         | 26,768           | 38,660           | 50,178           | 70,583           |
| Trade & other receivables                    | 76,424         | 198,771          | 282,612          | 366,806          | 482,415          |
| Time deposits with original maturity         | 0              | 169,358          | 0                | 0                | 0                |
| Cash and cash equivalents                    | 582,185        | 673,797          | 816,352          | 899,970          | 1,020,637        |
| <b>Total Current Asset</b>                   | <b>700,443</b> | <b>1,078,260</b> | <b>1,150,152</b> | <b>1,331,680</b> | <b>1,589,992</b> |
| <b>Current Liabilities</b>                   |                |                  |                  |                  |                  |
| Trade & other payables                       | 30,440         | 38,792           | 38,494           | 52,964           | 76,240           |
| Bank loans, unsecured                        | 71,140         | 98,336           | 143,070          | 164,531          | 189,210          |
| Coupon bonds                                 | 31,977         | 0                | 0                | 0                | 0                |
| Provision for staff welfare benefit          | 13,960         | 12,988           | 12,988           | 12,988           | 12,988           |
| Taxation payable                             | 5,981          | 13,223           | 64,532           | 88,967           | 116,413          |
| <b>Total Current Liabilities</b>             | <b>153,498</b> | <b>163,339</b>   | <b>259,084</b>   | <b>319,450</b>   | <b>394,851</b>   |
| <b>Non Current Liabilities</b>               |                |                  |                  |                  |                  |
| Bank loans, unsecured                        | 0              | 196,370          | 160,000          | 192,000          | 230,400          |
| Coupon Bonds / Convertible notes             | 0              | 94,989           | 69,666           | 69,666           | 69,666           |
| Deferred tax liabilities                     | 0              | 3,391            | 3,391            | 3,391            | 3,391            |
| <b>Total non current liabilities</b>         | <b>0</b>       | <b>294,750</b>   | <b>233,057</b>   | <b>265,057</b>   | <b>303,457</b>   |
| <b>Net Assets</b>                            | <b>717,068</b> | <b>890,933</b>   | <b>1,013,550</b> | <b>1,181,239</b> | <b>1,397,750</b> |
| <b>Capital and Reserves</b>                  |                |                  |                  |                  |                  |
| Share capital                                | 48,679         | 51,750           | 51,750           | 51,750           | 51,750           |
| Reserves                                     | 668,389        | 839,183          | 961,800          | 1,129,489        | 1,346,000        |
| <b>Equity attributable to equity holders</b> | <b>717,068</b> | <b>890,933</b>   | <b>1,013,550</b> | <b>1,181,239</b> | <b>1,397,750</b> |

Source: Company data, VC estimates

## Analyst Certification

Each research analyst primarily responsible for the content of this research report, in whole or in part, certifies that with respect to each security or issuer that the analyst covered in this report: (1) all of the views expressed accurately reflect his or her personal views about those securities or issuers; and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by that research analyst in the research report.

© 2007 VC Brokerage Ltd. Opinions, projections and other information contained in this report are based upon sources believed to be accurate, but no responsibility is accepted for any loss occasioned by reliance placed upon the contents hereof. Further information on the companies mentioned here available upon request.