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Hong Kong

Small caps

Bloomberg 1076 HK

Priced on 26 April 2007
HSI @ 20,667.29

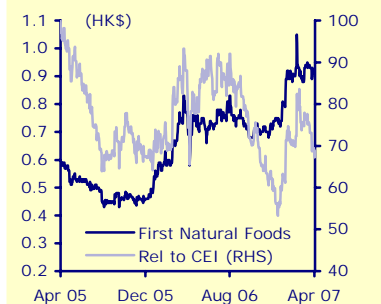
Fair value target HK\$1.25
±% up/downside +21%
Target set on 26 April 2007

Market cap US\$133m
Shares in issue 995m
Free float (est.) 31%
Gearing: net cash
3M average daily volume US\$0.3m
12M high/low HK\$1.09/HK\$0.58

Major shareholders
Yeung Chung Lung 37.6%
SFP Val Realiztn 7.0%
Value Partners 5.8%

Stock performance (%)

	1M	3M	12M
Absolute	13.8	25.9	84.5
Relative	6.1	22.0	24.3
Abs (US\$)	13.7	25.7	83.0



Source: Bloomberg

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Small fish to big fish?

First Natural Foods has just released FY06 results with revenue up 26% to RMB 547m while net profit was up 22% to RMB 138m. There was a 1% decrease YoY on GP and NP margins due to price fluctuations in certain raw materials which had a slight effect on GP margin. Nevertheless, stock is up 17% since results announcement and release of our small caps report three days ago. There is further upside with this small US\$133m which is still trading at a rather low 6.6x current year PE.

- Revenue for frozen marine food products division was up 22% YoY and accounted for 54% of Group turnover as a result of expansion of market share and increased recognition from customers.
- Convenient food products division accounted for 3% of Group revenue in FY06. It is expected there will be increased contributions going forward from this division given low base and are cooperating with various nutrition authorities to improve the products.
- Revenue for frozen functional food products division was up 26% YoY and accounted for 43% of Group turnover. In 2007, a prominent trading agent in the PRC has increased its sales orders on eel products. It is also expected that the company will be supplying 300 tons of eels to a Japanese customer in 2007. The company is also going under qualification and approval by the USFDA at present.
- New integrated processing workshop in Fuqing will begin operations in 2H07 and capex will be RMB 160m. Moreover, the Group in Feb 2007 leased 5000 mu of organic rice crop farm in Heilongjiang for 10 years which would be able to begin providing organic rice crop by end 2007. Fishery plant in Zhejiang will be completed end 2007 as well.
- First "Longyu" retail shop will start operations in Shanghai in May 2007. Company will aim to open 3-5 shops this year, with start up costs of RMB 3m each. Breakeven period will be approx. 18 mths.
- Co. has net cash of RMB 550m as of end-06. Assume RMB 250m capex in FY07, RMB 300m cash is equivalent to 29% market cap.

Financials

Year to 31 Dec	04A	05A	06CL	07CL	08CL
Revenue (Rmbm)	434	433	546	681	823
Net profit (Rmbm)	120	114	138	174	211
GP margin (%)	45.7	46.4	45.5	45.8	45.8
EPS (RMB¢) ¹	13.3	12.4	14.8	15.6	18.9
EPS (% YoY) ¹	(1.7)	(6.9)	21.7	5.4	21.1
PEx (@HK\$1.04)	7.8	8.3	7.8	6.6	5.5
DPS (Rmb¢)	3.2	1.6	4.5	4.7	5.7
Dividend yield (%)	3.1	1.5	4.4	4.6	5.5
ROAE (%)	17.8	14.1	14.4	15.8	17.0

¹ This company is not under formal CLSA coverage. Source: CLSA Asia-Pacific Markets

- Trading liquidity is thin and management is aware of institutions trying to build position in the stock. However, given plentiful of cash on hand, new share placement will not be considered at the moment, but has not identified at this moment any means of rectification.
- Management also indicated cash is not likely to be kept idle in order to enhance shareholder value and will continue to look for new investments.
- We have revised down earnings numbers in FY07-08 by 3% to reflect the slight decrease in margins. Management aims to keep GP margin at 45-46% despite RMB appreciation being a negative due to most products being exported. However, a change in focus with more domestic sales, e.g. Longyu, will help keep margins stable.
- Our revised base case fair value based on 8x 07CL PE is HK\$1.25 and 21% upside. Blue-sky scenario if stretched out to 8x 08CL PE will give fair value of HK\$ 1.50 and 44% upside.

Background (reprinted from HK small caps report)

First Natural Foods was established in 1995 and produces frozen natural foods operating out of Fujian province. Target customers are mostly in Japan (60% of turnover) and the US (33% of turnover), including Maruha and Select Brands. Its Hong Kong customers include Maxim's and Great in Pacific Place on Hong Kong island. In May 2006, First Natural secured Fairwood as a key customer for clam products.

The company has three main divisions: Frozen Marine Food, representing 55% of turnover (packaged seafood products including shellfish, octopus and clams); Frozen Functional Food, makes up 40% of turnover (vitamin-rich, health-inducing processed foods which include roasted eel and flying fish roe); Seasonal convenient food represents 5% of FY05 turnover and includes convenient meal packs.

- ❑ First Natural has two aqua farms, which are the main source of supply to produce frozen seafood products. In June 2006, two production lines built for producing convenient meal packs commenced operations, which will have full effect in FY07-08 earnings.
- ❑ The company has entered into a contractual agreement with Select Brands of the US to be a core supplier of their meal packs; orders are likely to reach Rmb100m by 2008.
- ❑ The company plans to invest Rmb150m to expand production capacity and another HK\$100m to set up a fishery processing plant for seafood products.
- ❑ In August 2006, First Natural issued a HK\$116m convertible note (exercise price HK\$0.85) to expand downstream by setting up 20 to 30 "Longyu Food" retail chain stores and six distribution centres in key mainland cities.
- ❑ The company has net cash of Rmb200m estimated at the end of 2006, equivalent to 24% of its market cap.
- ❑ Accounting for the dilution from the convertibles, the stock is trading at 5x FY07 PE with a yield close to 4% and FY07 return of equity of 17%. We value First Natural Foods at 8x 07CL PE, which translates to a fair value of HK\$1.30.

Key to CLSA investment rankings: **BUY** = Expected to outperform the local market by >10%; **O-PF** = Expected to outperform the local market by 0-10%; **U-PF** = Expected to underperform the local market by 0-10%; **SELL** = Expected to underperform the local market by >10%. Performance is defined as 12-month total return (including dividends).

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Note: In the interests of timeliness, this document has not been edited.

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