

FIRST NATURAL FOODS (1076) – US BAN ON SELECTED CHINA SEAFOOD HAS LITTLE IMPACT ON BUSINESS – MAINTAIN BUY

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Price: HK\$1.15 (Target Price: HK\$2.09)

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FYE December 31	2006	2007E	2008E		
Revenues (RMB mn)	545.7	683.7	886.1	52-week Range	0.67-1.37
EBITDA (RMB mn)	247.1	303.3	389.0	Dividend/Yield	3.9%
Net Profit (RMB mn)	138.0	177.5	247.5	Market Cap (US\$ mn)	147.4
EPS (RMB)	0.132	0.169	0.233	Avg Daily Volume ('000)	n/a
P/E (x)	7.6	6.3	4.8	Est. 5-year EPS Growth	16%
Price Performance	2004	2005	2006 YTD	L-T Debt/Capital	32.7%
Absolute	n/a %	n/a %	n/a %	ROE (E)	17.4 %
Relative	n/a %	n/a %	n/a %	Current Book Value per share	RMB0.96
				Price/Book	1.16 x

Source: Company data and Riedel Research estimates

Share price performance of First Natural Foods has been dampened by the news at the end of June that select seafood imported into the U.S. from China was detained by regulators due to possible contamination by unsafe drugs. We have recently visited the Company and discussed the impact with management. The fear that the ban on select seafood imported from China by U.S. regulators would lead investor concern over a possible slow down in revenue and net profit in 2007 and 2008 was overblown. In fact, a review of the list of seafood products detained by U.S. regulators and the percentage sales to the U.S. market clearly indicate that the negative impact on revenue and earnings is insignificant.

We are surprised to learn that eel exports to Japan have been stronger than expected, thanks to its high quality food safety standards that have won recognitions and confidence from its key customers. In addition, management indicated that both selling prices (up 3-8%) and margins on its frozen marine and frozen functional food products are trending upward and indicated to us that the volume sale of sea eels would be the revenue and earnings driver in 2007 and 2008.

The Company will announce its financial results for the six months that ended June 30, 2007 on September 20th or 21st and will reveal more information on the progress of its business after the detention of seafood imported from China by the U.S. regulators. Based on our upward revised revenue and earnings forecasts, the stock is trading at a very attractive 2008 PE of below 5x, compared to 14.5x for the average of selected agriculture and food companies in China. We believe this is unjustified, given the stock's growth prospects. Based on a 40% (as compared to 35% previously) valuation discount to its peers or 8.7x 2008 PE, our price target is HK\$2.09, relatively unchanged from previous target of HK\$2.10, we maintain our Strong Buy recommendation on the stock.

Company Profile

First Natural Foods Holding Limited (the Group) is principally engaged in the production of frozen natural foods in Fujian Province, the PRC, by serving as a value-added manufacturing platform to process natural, convenient and nutritional food products. The Group's principal business can be broadly classified into three major divisions, namely frozen marine food products, which include shellfish, octopus and clams; frozen functional food products such as roasted eel and flying fish roes, and seasoned convenient food such as convenient rice meals and tuna fish packs.

Impact of US Ban on Selected Seafood Imports from China

Towards the end of June this year, it was widely reported that some seafood imported to the U.S. from China were detained by regulators because of possible contamination with unsafe drugs. The Food and Drug Administration put a hold on all farm raised shrimp, catfish, basa, dace and eel from China until the shipments showed to be free of residues from drugs that are not approved in the U.S. However, the news report in Bloomberg indicated that FDA said that drug residues in the seafood were at "very low" levels and regulators were not seeking to recall products already in the U.S. and need not destroy or return imported seafood because the concern is for long-term exposure.

It was interesting to see that the U.S. regulators' actions did not include immediate recall the named seafood or recommended destroy or return the imports from China to protect against the health of U.S. consumers. Criticism from China officials said the detention of selected of selected seafood imports from China could be related to political pressure from the U.S. for faster RMB appreciation to reduce the huge trade deficits with China. Nevertheless, share price of First Natural Foods has suffered from selling pressure since the incidence.

We recently visited First Natural Foods and discussed with management about the impact of US ban on selected seafood imports from China on the company's business. Management indicated that they have not seen any visible slowdown in seafood exports since late June. The Company will announced its interim financial results for the six months ended June 30, 2007 on September 20 or 21 and will release more information on the progress of its seafood sales, which should help remove investors' concern about the negative impact of US ban on selected seafood import from China. Details of our discussion with management are summarized as follows:

- **Limited negative impact on overall revenue growth** – This is mainly due to the fact that the U.S. market accounted for only 36% of total revenue by country in 2006 and functional food products, including eel and flying fish roe accounted for only 43% of total sales by products in 2006. In addition, the major market for First Natural Foods' eel product is Japan, not the U.S. Farm raised shrimps, catfish, basa and dace from China, which had been detained by the U.S. authorities, are not the Company's products.
- **Highly recognized food quality certification and customer base** - As indicated in our previous report in June, the major imports into the U.S. market are tuna products and convenient rice meal pack, for which Select Brands USA and Orbit Brands LLC are the Company's major customers in the U.S. The fact that First Natural Foods is being accredited the recognition of Kosher Certification from Orthodox Union Kosher Certification Department has confirmed the product quality and food safety standards.
- **Eel exports to Japan are stronger than expected** – It is generally agreed that Japan has one of the highest quality food standards among the Western countries. Management indicated that during the eel festival in July and August in Japan, the Company's eel exports to Japan did not suffer any set back as a result of the reports of detention of selected seafood import from China in late June. Instead, sea eel sales to one of its core customer, Sugamiya Co. Ltd. had already reached 280 tons in the first half of 2007, compared to the initial order of 300 tons of sea eel for the full year. Based on the current trend of order book, management believes that sales of sea eel to this customer should reach 600 tons in 2007. In addition, one of its three new Japanese customers has also increase the purchase of sea eel from First Natural Foods. Management hints

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that our forecast frozen functional food sales of 1,992 tons in 2007 should increase by 5-10% to 2,100 – 2,200 tons.

- **High quality sea eel farm in Fujian examined by fund manager** – Management indicated that a Chief Investment Officer of an international fund house had visited the Company's sea eel farm in Fujian and subsequently bought a sizeable stake in First Natural Foods in the past two months. As the shareholding in First Natural Foods is still below 5%, the international fund house is not required to disclose its interest to the public, though we believe this is a vote of confidence for the Company's seafood quality by institutional investors.

Product Price Trend and Margins

Management indicated that selling prices of frozen marine food products such as shellfish, octopus and clams in 1H2007 remained relatively stable at around the levels in 2006, while the prices of frozen functional food products such as flying fish roes and roasted eel had increased by more than 5% in 1H2007. Selling prices for other products increased by about 3% so far this year. The Company expects the overall increase in selling price of flying fish roes and roasted eel would be 5-8% higher in 2007 and rise a further 4-5% in 2008. Even though raw material prices had also increased during 1H2007, the Company expects gross margins for frozen marine food to remain stable this year while margins for flying fish roes and roasted eel would be higher than originally expected. Management indicated that our forecast gross margins of 43.5% in 2007 and 43.2% in 2008 are too conservative and has confidence that gross margins should be in the range of 44-45% in 2007 and 2008.

New Products Development and Retail Expansion

To enhance its product portfolio and to improve profit margins, First Natural Foods has begun to launch other higher profit margin products, which include mixed seafood packs, North Pacific squid and South Pole seaweed. Management indicated that North Pacific squid received very encouraging response from the market. We believe the launching of these new products would enable the Company to improve overall profit margins.

First Natural Foods opened its first "UBI" retail shop in Pudong, Shanghai in May this year. 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 at the mid to higher income consumers. Two more retail shops are scheduled to open in October this year and management maintains its target of opening 4-5 retail shops in 2007. Capital expenditure on each retail shop is around RMB2-3 million and management reiterates that the major objective of the retail business is to promote its quality food products in China and to build up its brand image and differentiate its products from other items in the market. Ultimately, the Company expects the greater versatility from retail chain stores will tout local wholesaler to join its distribution network, as well as promoting sales to leading bulk consumers such as hotel, resorts and restaurant chains.

Production Capacity Expansion

Management indicated that further expansion of production scale and at the new workshop in Fuqing is near completion and is on schedule to commence operation in October this year. However, the fishery processing plant near Zhejiang, which involves investment of RMB170 million in a modern, large scale frozen fishery paste production plant and related environmental conservation facilities at a nearby port in Zhejiang Province would experience some delay. However, due to our initially projected low capacity utilization rate of around 50%, we do not expect such delay in product capacity expansion to have significant negative impact on production capacity to meet growing demand in the market. We have fine-tuned our forecasts for production capacity, actual production and capacity utilization rate as shown in Table 1 below.

Table 1. Revision of Production Volume and Revenue Forecasts by Business Segment

	2005A	2006A	2007E		2008E	
			Old	New	Old	New
Year-end Production Capacity (Tons)						
Frozen Marine Food	15,000	18,000	19,000	19,000	27,000	24,000
Frozen Functional Food	4,700	5,000	5,500	5,000	6,000	5,000
Seasoned Convenient Food	700	4,000	7,600	7,600	9,000	9,000
Total	20,400	27,000	32,100	31,600	42,000	38,000
Year-on-year Growth (%)		32%	19%	17%	31%	20%
Actual Production (Tons) ^{^^}						
Frozen Marine Food	9,200	11,906	13,394	13,394	15,738	15,738
Frozen Functional Food	1,658	1,633	1,992	2,100	2,261	2,800
Seasoned Convenient Food	247	659	1,800	1,600	2,610	2,500
Total	11,105	14,198	17,187	17,094	20,609	21,038
Growth (%)		28%	21%	20%	20%	23%
Capacity Utilization Rate (%)						
Frozen Marine Food	61%	66%	70%	70%	58%	66%
Frozen Functional Food	35%	33%	36%	42%	38%	56%
Seasoned Convenient Food	35%	16%	24%	21%	29%	28%
Total	54%	53%	54%	54%	49%	55%

^{^^}Actual production could be higher or lower than actual sales due to inventory adjustments

	2005A	2006A	2007E		2008E	
			Old	New	Old	New
Turnover (RMB million)						
Frozen Marine Food	239.18	292.82	377.55	386.98	450.28	466.07
Frozen Functional Food	186.80	236.18	228.19	254.96	260.29	353.54
Seasoned Convenient Food	6.66	16.74	45.58	41.73	67.42	66.51
Total	432.64	545.74	651.32	683.67	777.98	886.13
Growth (%)	-0.3%	26%	19%	25%	19%	30%
Unit Price (RMB per ton)						
Frozen Marine Food	25,998	27,500	28,188	28,892	28,610	29,614
Frozen Functional Food	112,664	101,253	102,266	108,401	102,777	112,738
Seasoned Convenient Food	26,980	25,023	25,323	26,083	25,830	26,605

Source: Company data and Riedel Research estimates

Revision of Profit Forecasts

Based on our revised assumptions in production and sales volume, as well as higher selling prices for different products, particularly those for flying fish roes and roasted eel, we have raised our total revenue forecast by 5.0% from RMB651.3 million to RMB683.7 for 2007 and that for 2008 by 13.9% from RMB778.0 million to RMB886.1 million. We have also raised our gross margin assumptions from 43.5% to 43.8% in 2007 and from 43.2% to 44.0% in 2008, which are the low-end management's guidance of 44-45%. After these adjustments, our net profit projections have been increased from RMB167.2 million to RMB177.5 million in 2007, and RMB211.8 million to RMB247.5 million. Fully diluted EPS forecasts for 2007 and 2008 are now at RMB0.169 and RMB0.233 respectively, compared to our previous forecasts of RMB0.159 in 2007 and RMB0.20 in 2008.

Table 2. Revised Profit Forecast

Year ended December 31	2005A	2006A	2007E	2008E
	Rmb'000	Rmb'000	Rmb'000	Rmb'000
Revenue:				
Frozen Marine Food Products	239,177	292,816	386,982	466,073
Frozen Functional Food Products	186,797	236,180	254,960	353,545
Seasoned Convenient Food Products	6,664	16,743	41,733	66,512
Refrigerated Processed Meat Products	14	-	-	-
Total revenue	432,652	545,739	683,675	886,129
<i>Growth (%)</i>	<i>-0.3%</i>	<i>26.1%</i>	<i>25.3%</i>	<i>29.6%</i>
Cost of sales				
	(231,860)	(297,212)	(384,225)	(496,232)
Gross profit	200,792	248,527	299,450	389,897
Other revenue	3,866	11,429	8,086	10,526
Distribution costs	(4,120)	(6,094)	(6,837)	(8,861)
General and administrative expenses	(27,161)	(38,208)	(31,449)	(37,217)
Other operating expenses	(10,301)	(1,830)	(2,123)	(2,356)
Profit from operation	163,076	213,824	267,127	351,988
Finance costs	(7,304)	(21,571)	(20,566)	(17,525)
Profit before taxation	155,772	192,253	246,561	334,463
Income tax	(42,311)	(54,247)	(69,037)	(86,961)
Net profit	113,461	138,006	177,524	247,503
<i>Growth (%)</i>	<i>-5.3%</i>	<i>21.6%</i>	<i>28.6%</i>	<i>39.4%</i>
EBITDA (RMB '000)	194,461	247,139	303,340	389,010
Number of shares ('000)				
Weighted average	918,472	932,690	982,690	1,022,690
Fully diluted	952,580	1,046,411	1,051,411	1,061,411
EPS (Rmb)				
Weighted average	0.124	0.148	0.181	0.242
Fully diluted	0.119	0.132	0.169	0.233
<i>Growth (%)</i>	<i>-6.9%</i>	<i>10.7%</i>	<i>28.0%</i>	<i>38.1%</i>
Margin Analysis				
Gross margin	46.4%	45.5%	43.8%	44.0%
Operating margin	37.7%	39.2%	39.1%	39.7%
Net margin	26.2%	25.3%	26.0%	27.9%

Source: Company data and Riedel Research estimates

Institutional Shareholders and Share Buybacks

According to the information from the Hong Kong Stock Exchange website, First Natural Foods has a very strong institutional shareholder base, which include DKR Capital Inc., The SFP Asia Fund Ltd., Value Partners and UBS AG. In aggregate, these institutional shareholders own 29.62% of the Company's issued share capital. We understand that both Value Partners and the SFP Asia Fund are specialized in quality small cap companies with good growth potential. Their long-term commitments in the holding of First Natural Foods' shares and have not sold any shares in the Company after the news of US detaining selected seafood imports from China in late June are a vote of confidence on the Company's prospects and the understanding that First Natural Foods' business has not been affected by the actions of the U.S. regulators. The following table is a list of the substantial shareholders of First Natural Foods, but has not include other institutions holding less than 5% in the Company.

Table 3. List of Substantial Shareholders

Name	Number of shares held	% of issued capital	Date of notice filed
Yeung Chung Lung	384,025,000	36.43%	16/08/2007
DKR Capital	104,380,589	9.87%	09/08/2007
The SFP Asia Fund Ltd.	71,585,000	7.13%	02/05/2007
Value Partners	65,510,000	6.99%	29/11/2006
UBS AG	56,090,000	5.63%	08/05/2007

Source: Hong Kong Stock Exchange website

Meanwhile, the Company had been buying back its shares from the market since the news of US ban on seafood import from China. In aggregate, First Natural Foods had purchase 3.3 million shares from July 4 to 31 from prices between HK\$1.02 – 1.17 for a total consideration of HK\$3.7 million. Even though the number of shares buyback in the market only accounted for 0.33% of its issued share capital, the move is a clear indication of management confidence on the company's business not being affected by the US ban of selected seafood import from China.

Table 4. Share Buybacks

Date	Number of shares	Price Range		Amount in HK\$
		High	Low	
4-Jul-07	1,000,000	1.16	1.15	1,158,000
5-Jul-07	300,000	1.17	1.16	349,000
6-Jul-07	400,000	1.16	1.15	463,000
9-Jul-07	100,000	1.15	1.15	115,000
18-Jul-07	200,000	1.16	1.16	232,000
31-Jul-07	1,300,000	1.05	1.02	1,359,000
	<u>3,300,000</u>			<u>3,676,000</u>

Source: Hong Kong Stock Exchange website

Conclusion and Valuation

In our view, First Natural Foods is a high quality small cap company which is experiencing rapid growth in its core business of frozen seafood products. By leveraging on its strong customer bases in Japan and its stringent quality control on food safety standards, the Company has gained strong confidence from its key customers and has been able to increase its revenue from nearly all frozen seafood products. In fact, management told us orders of eel products from its key customer in Japan has increased substantially even after the news of US ban on selected seafood imports from China. Both selling prices and margins are trending upwards and should exceed our forecasts in our initial report released in June.

After revising our assumptions for volume product and sales, as well as the selling prices and margin assumptions, we have raised our net profit forecasts from RMB167.2 million to RMB177.5 million in 2007 and that for 2008 from RMB211.8 million to RMB247.5 million. Diluted EPS forecasts have been upgraded from RMB0.159 to RMB0.169 in 2007 and that for 2008 from RMB0.20 to RMB0.233.

Based on the data in the peers comparison table below, the stock is trading at very attractive forecast 2008 PE of just 4.8x, which is at a substantial discount to the average 2008 PE valuation of 14.5x for the agriculture and food producing companies in China. We believe such valuation discount is unjustified and probably reflect investors' misunderstanding of the Company's risk related to the US ban of selected seafood imports from China. Based on a more conservative 40% discount (compared to 35% discount) to the sector PE in 2008 or just 8.7x 2008 EPS for the stock, our revised 12-month price target for First Natural Foods is \$2.09 per share, nearly unchanged from \$2.10 in our previous estimate. We continue to maintain our Strong Buy recommendation on the stock.

Table 5. Valuation and Peers Comparison

Company	FYE	Share price 7/9/2007	Mkt Cap. HK\$ mn	2006A	P/E (X) 2007E	2008E	Operating Margin	ROE (%)
Tingyi (322)	Dec-31	11.08	61,923	53.5	45.8	36.3	9.9%	16.7%
China Foods (506)	Dec-31	5.08	14,180	13.6	13.9	12.0	5.0%	12.7%
Global Bio-Chem (809)	Dec-31	3.13	7,258	14.5	13.6	12.5	11.7%	10.0%
China Yurun Food (1068)	Dec-31	9.98	14,490	29.6	22.8	16.6	10.5%	20.9%
Pacific Andes (1174)	Mar-31	2.45	4,416	15.4	9.1	7.4	6.9%	12.3%
Chaoda Modern (682)	Jun-30	5.99	14,291	10.5	8.7	6.8	46.2%	21.2%
China Green (904)	Apr-30	6.46	5,640	14.4	12.4	9.9	36.2%	24.6%
Sector Average:			17,457	21.7	18.0	14.5	18.1%	16.9%
First Natural Foods (1076)	Dec-31	1.15	1,148	7.6	6.3	4.8	39.2%	15.5%

Source: etnet.com.hk and Riedel Research Group estimates