

2 July 2010

Produced by: The Royal Bank of Scotland N.V., (Hong Kong) Branch

# Fufeng Group

## Bigger feast, better taste

Initiation of coverage

### Buy

Target price

HK\$7.10

Price

HK\$5.02

Short term (0-60 days)

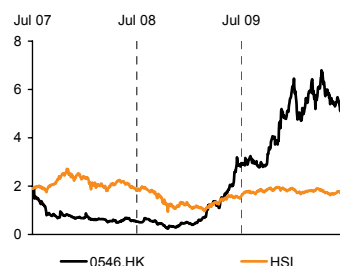
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Market view

Underweight

### Price performance

	(1M)	(3M)	(12M)
Price (HK\$)	5.42	5.50	3.20
Absolute (%)	-7.4	-8.7	56.9
Rel market (%)	-9.0	-3.1	43.2
Rel sector (%)	-12.3	-5.2	28.0



### Market capitalisation

HK\$8.33bn (US\$1.07bn)

### Average (12M) daily turnover

HK\$24.20m (US\$3.11m)

Sector: BBG AP Food Prod & Proc  
 RIC: 0546.HK, 546 HK  
 Priced HK\$5.02 at close 2 Jul 2010.  
 Source: Bloomberg

### Key forecasts

	FY08A	FY09A	FY10F	FY11F	FY12F
Revenue (Rmbm)	3,585	4,633	6,476	8,228	10,407
EBITDA (Rmbm)	520.7	1,241	1,448	1,695	2,244
Reported net profit (Rmbm)	294.7	928.3	1,028	1,136	1,486
Normalised net profit (Rmbm) <sup>1</sup>	294.7	928.3	1,028	1,136	1,486
Normalised EPS	0.18	0.56	0.56	0.62	0.81
Dividend per share	0.01	0.22	0.25	0.27	0.36
Dividend yield (%)	0.23	5.04	5.67	6.26	8.19
Normalised PE (x)	24.6	7.82	7.76	7.03	5.37
EV/EBITDA (x)	14.6	6.06	5.54	4.58	3.19
Price/book value (x)	4.17	3.03	2.61	2.11	1.66
ROIC (%)	14.8	37.3	33.6	26.6	32.5

1. Post-goodwill amortisation and pre-exceptional items  
 Accounting standard: Local GAAP  
 Source: Company data, RBS forecasts

year to Dec, fully diluted

### Leading player in glutamic acid and MSG markets

Fufeng is China's largest producer of glutamic acid and the second largest producer of MSG, with respective market shares of 22% and 12% in terms of production volume as at end-2009. Glutamic acid is the primary raw material for MSG and Fufeng self-supplies all of the glutamic acid for its own MSG production. The company is also the world's largest xanthan gum manufacturer, with a 30% share of production volume globally. Given its leading market position, we believe Fufeng is positioned well to benefit from the growing demand for MSG in the domestic food processing and catering business.

### New capacity should strengthen leading market position and increase pricing power

Fufeng plans to increase its effective capacity in MSG by 77% in FY10, 19% in FY11 and 16% in FY12, as its new factories in Inner Mongolia (completed in December 2009) and northeast China (to be completed in June 2011) start to contribute. We expect Fufeng's market shares in glutamic acid and MSG to increase to 30% and 22% by 2012.

### Strong cost advantages over competitors

The strategic location of Fufeng's plants in Shaanxi and Inner Mongolia provides it with cheap raw material (notably corn) and coal supplies, which helps it sustain a higher gross margin than the MSG sector average. Its gross and operating margins of 30.2% and 22.6%, respectively, for FY09, were higher than Vedan's 24.7% and 10.7% and Lianhua's 11.7% and 1.3%. We expect Fufeng's gross margin to dip a bit from 25% in FY10 to 23% in FY11, weighed down temporarily by new glutamic acid and MSG capacities to be completed in June 2011, and then return to the normal level of 24% in FY12.

### Buy rating for superior profitability and undemanding valuation

Our DCF-based target price of HK\$7.10 implies 42% upside potential, with a target FY11F PE of 11.0x. Fufeng's PEs of 7.8x FY10F and 7.0x FY11F, with dividend yields of 5.7% for FY10F and 6.3% for FY11F, seem undemanding to us.

Important disclosures can be found in the Disclosures Appendix.

### Analysts

#### Lei Yang, CFA

Hong Kong  
 +86 21 2893 9757  
 lei.yang@rbs.com

#### Yiwen Chen, CFA

Hong Kong  
 +86 21 2893 9532  
 yiwen.chen@rbs.com

38/F Cheung Kong Center, 2 Queen's Road Central, Hong Kong

<http://research.rbsm.com>

# The basics

## Versus consensus

Net profit (Rmbm)	RBS	Cons	% diff
2010F	1,028	1,042	-1.3%
2011F	1,136	1,219	-6.8%
2012F	1,486	1,432	+3.8%

Source: Bloomberg, RBS forecasts

## Forced ranking\*

Company	Rec	Upside / Downside
Fufeng	Buy	42%
China Agri	Buy	40%
Yurun	Buy	22%
Mengniu	Buy	17%

\* by difference to target price as at time of publication. Recommendations may lie outside the structure outlined in the disclosure page.  
Source: RBS forecasts

## Key events

Date	Event
August 2010	1H10 results

Source: Company

## Catalysts for share price performance

We believe the following catalysts will support our target price in the next 12 months:

- Increased market shares through new glutamic acid and MSG capacities; we expect Fufeng's market shares in glutamic acid and MSG to increase to 30% and 22% (in terms of production volume) by 2012, from 22% and 12% at end-2009;
- Further improved cost advantages along with the completion of the northeast China plant and synthetic ammonia projects in June 2011;
- The completion of the back-door listing of Fufeng's major competitor, Meihua, in the A-share market in 3Q10;
- The announcement of strong 1H10 results in mid-August.

## Earnings momentum

We expect Fufeng's capacity expansion to drive a sales CAGR of 27% over FY10-12. We forecast that the gross margin will be 25% in FY10, weakening slightly to 23% in FY11, weighed down temporarily by the completion of the new glutamic acid and MSG capacities in June 2011, before reverting to the 'normal' level of 24% in FY12.

## Valuation and target price

We value Fufeng at HK\$7.10 using our three-stage DCF model, based on a beta of 1.04, long-term growth rate of 3%, risk-free rate of 5.5% and WACC of 12.08%. Based on our forecasts, Fufeng is currently trading at 7.8x FY10F and 7.0x FY11F P/E.

## How we differ from consensus

Our FY10 earnings estimate is in line with Bloomberg consensus, while our FY11 earnings forecast is 6.8% lower. However, our FY12 forecast is 3.8% higher, since we assume that, after being temporarily weighed down by the new capacities in FY11, Fufeng's margin will revert to its normal level in FY12.

## Risks to central scenario

The key risks related to our earnings forecasts and target price are as follows:

- A sudden increase in corn and coal prices could add pressure to the gross margin;
- More stringent environmental requirements by the Chinese government could result in a suspension in production or significant costs related to environmental protection facilities;
- Capacity expansion by competitors could take some market share from Fufeng, resulting in a price war or some loss of Fufeng's pricing power;
- EPS dilution from potential share placement, if Fufeng decides to undertake a significant acquisition.
- Exercise of share options by senior management could put pressure on the share price.

# Key assumptions and sensitivities

**Table 1 : Key assumptions**

	FY09	FY10F	FY11F	FY12F
<b>Effective capacity (tonnes)</b>				
Glutamic acid	350,000	460,000	540,000	620,000
MSG	305,000	540,000	640,000	740,000
Fertiliser	460,000	560,000	660,000	760,000
Xanthan gum	32,000	41,000	44,000	44,000
Starch sweeteners	100,000	140,000	140,000	140,000
<b>ASP growth</b>				
Glutamic acid	10%	20%	0%	8%
MSG	12%	20%	0%	8%
Fertiliser	-29%	-5%	3%	5%
Xanthan gum	-4%	-6%	5%	3%
Starch sweeteners	13%	6%	5%	5%
<b>Overall ASP growth</b>	<b>2%</b>	<b>25%</b>	<b>3%</b>	<b>7%</b>
<b>Revenue growth</b>				
Glutamic acid	-31.6%	-61.9%	-0.3%	33.5%
MSG	123.6%	89.5%	30.4%	28.8%
Fertilisers	-4.9%	-11.8%	28.7%	26.2%
Xanthan gum	-9.7%	27.0%	21.6%	12.0%
Starch sweeteners	50.4%	17.1%	15.2%	11.3%
Corn refined products and others	22.4%	26.0%	26.0%	26.0%
<b>Total</b>	<b>29.2%</b>	<b>39.8%</b>	<b>27.1%</b>	<b>26.5%</b>
<b>Cost structure (% contribution)</b>				
Corn kernels	53%	57%	58%	61%
Liquid ammonia	10%	8%	6%	5%
Other raw materials	2%	2%	2%	2%
<b>Total raw materials</b>	<b>65%</b>	<b>67%</b>	<b>66%</b>	<b>68%</b>
Coal	12%	11%	11%	10%
Labour	5%	4%	4%	4%
Depreciation	5%	5%	5%	4%
Other costs	14%	13%	14%	14%
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

Source: Company data, RBS forecasts

**Table 2 : Sensitivity analysis to corn kernel price**

% change in corn kernel price	FY10F net profit (Rmbm)	FY11F net profit (Rmbm)
10%	793	824
5%	910	980
3%	958	1,042
0%	1,028	1,136
-3%	1,099	1,230
-5%	1,146	1,292
-10%	1,264	1,448

Source: RBS forecasts

**Table 3 : Sensitivity analysis to MSG price**

% change in MSG price	FY10F net profit (Rmbm)	FY11F net profit (Rmbm)
10%	1,380	1,589
5%	1,204	1,362
3%	1,134	1,272
0%	1,028	1,136
-3%	923	1,000
-5%	853	910
-10%	677	683

Source: RBS forecasts

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Strong cost advantages	9
Gross margin well above sector average	12

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<b>We forecast FY10-12 earnings CAGR of 20%</b>	<b>14</b>
We forecast Fufeng will achieve a 20% earnings CAGR over FY10-12, driven by capacity expansion and improving cost savings.	14

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<b>Recommend Buy with HK\$7.10 target price</b>	<b>16</b>
We initiate coverage on Fufeng with a Buy rating, based on its leading market position and strong cost advantages. Our target price of HK\$7.10 implies 42% potential upside from current levels.	16

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<b>Gains from catering, food processing growth</b>	<b>20</b>
We believe Fufeng will benefit from the growing demand for MSG emerging from strong growth of the catering and food processing businesses in China. Market consolidation and higher entry barriers should further strengthen Fufeng's leading position.	20
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The risks for Fufeng lie mainly in the volatility of corn and coal prices and the strict environmental control by the government .	26

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# Vertically integrated leading player

Fufeng's leading market positions in glutamic acid, MSG and xanthan gum should continue to provide it with strong pricing power. Meanwhile, improving cost advantages should help the company sustain a higher gross margin than competitors.

## Vertically integrated business model

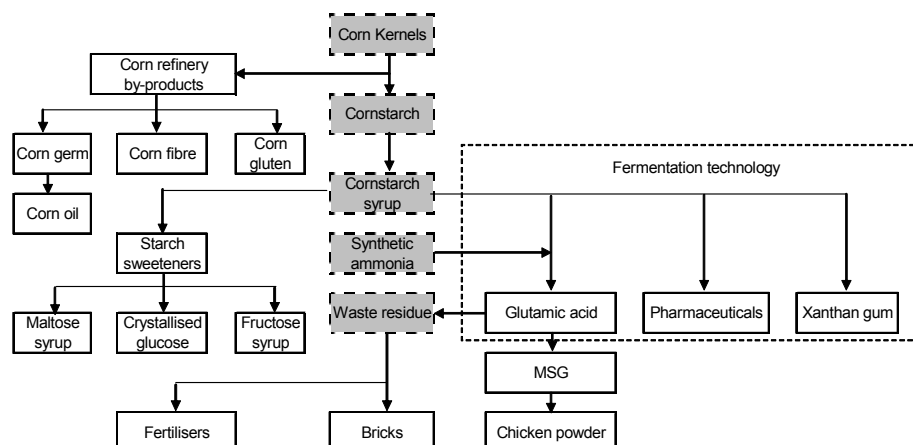
### Diversified corn-based biochemical products

Fufeng has a vertically integrated business model, with glutamic acid, MSG and xanthan gum as the key products

Fufeng is a leading Chinese manufacturer of corn-based biochemical products. Its vertically integrated business model ranges from corn sourcing and corn processing to sales of glutamic acid and MSG and the distribution of consumer packs of MSG in the retail market. In our view, Fufeng makes good use of the by-products of each step of the production processes, helping it offer a diversified product range. The principal products derived from the different stages of corn processing include glutamic acid, MSG, xanthan gum, fertilisers and starch sweeteners.

According to the China Fermentation Industry Association, Fufeng is the largest glutamic acid and the second-largest MSG manufacturer in China as at the end of 2009, and the largest xanthan gum producer in the world, in terms of production volume. By end-2009, Fufeng had 460,000 tonnes pa of glutamic acid capacity, 540,000 tonnes pa of MSG capacity and 32,000 tonnes pa of xanthan gum capacity, with effective capacities of 350,000, 305,000 and 32,000 tonnes, respectively.

Figure 1 : Diversified products



Source: Company data

Table 4 : Business overview

Segment	Product	Use of product	Capacity (tonnes) by end-FY09	Market share (in terms of vol) for FY09
<b>MSG</b>	Glutamic acid	Main raw material for MSG production	460,000	22% in China
	MSG	Flavour enhancer in food industry, households and restaurants	540,000	12% in China
	Fertiliser	Improving soil fertility	560,000	NA
	Starch sweeteners	Sweet additives in food, beverage and pharmaceutical industry	100,000	NA
	Corn oil	Cooking oil	35,000	NA
	Chicken powder	Flavour enhancer used in food seasoning	10,000	NA
<b>Xanthan gum</b>	Xanthan gum	Effective thickener, stabiliser or suspension agent used in petroleum exploration, food, personal care items and pharmaceutical items	32,000	30% globally

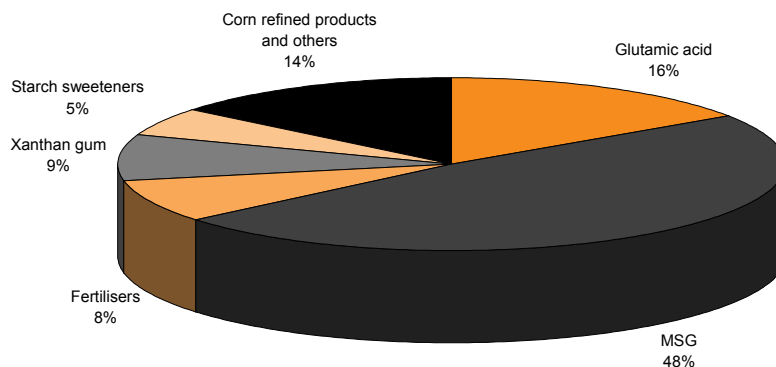
Source: China Fermentation Industry Association, Company data

**MSG accounted for an increasing 48% of sales and 56% of gross profit in FY09.**

Prior to 2007, Fufeng concentrated on the manufacture of glutamic acid, the primary raw material for MSG. It has gradually expanded into the downstream business of MSG production and distribution with a view to improving its gross margin after establishing new plants in Baoji and Inner Mongolia from 2008.

In FY09, sales of MSG accounted for 48% of total revenue, significantly up from 11% in FY06, while the sales contribution of glutamic acid decreased from 59% in FY06 to 16% in FY09. We expect this trend to continue, with the contribution of glutamic acid declining further to 4% in FY10F and 3% in FY11F, and MSG's share increasing to 66% in FY10F and 67% in FY11F.

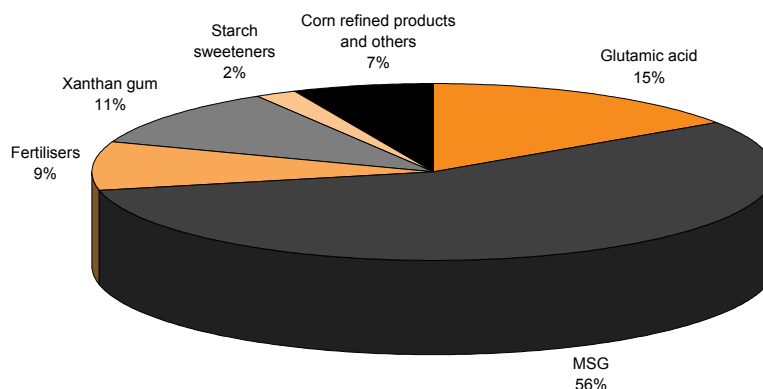
**Chart 1 : Revenue breakdown - FY09**



Source: Company data

Consumer-pack MSG currently accounts for a small proportion of Fufeng's total MSG sales – about 2-3% in FY09 – despite the company having its own Uo Fresh brand for its consumer-pack MSG and chicken powder products in the retail market. However, according to management, this retail segment offers a higher gross margin than its normal MSG products – by about 10ppt – and more stable pricing. As a result, Fufeng aims to increase sales of consumer-pack MSG to 5-8% of total MSG sales in the next three years.

**Chart 2 : Gross profit contribution – FY09**



Source: Company data, RBS estimates

Fufeng is the largest glutamic acid and second-largest MSG producer in China

## Leading glutamic acid and MSG producer in China

Glutamic acid is the primary component for the production of MSG. On average, 1 tonne of glutamic acid can produce 1.25 tonnes of MSG. The glutamic acid produced by Fufeng is either used internally as a raw material for MSG production or sold to other MSG manufacturers in China and overseas. According to management, exports accounted for 15-20% of Fufeng's MSG sales volume in FY09. Given Fufeng's expansion in MSG business in recent years, its internal use of glutamic acid has increased significantly, from 13% in FY06 to 71% in FY09.

**Table 5 : External sales and internal use of glutamic acid**

	FY06	FY07	FY08	FY09
External sales	86.6%	64.0%	59.1%	28.6%
Internal use	13.4%	36.0%	40.9%	71.4%
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

Source: Company data

According to the China Fermentation Industry Association, Fufeng was the largest glutamic acid producer in China in terms of production volume in 2009, with a market share of about 22%. In FY09, its effective glutamic acid production capacity reached 350,000 tonnes per annum. It added 110,000 tonnes of new capacity in its Baoji Plant and Inner Mongolia Plant in December 2009, which should raise effective capacity by 31% to 460,000 tonnes in FY10. We expect Fufeng to add further capacity of 160,000 tonnes in its new production base in northeast China in 2H11, increasing effective capacity by 17% in FY11F and 15% in FY12F.

**Table 6 : Glutamic acid – effective production capacity**

(tonnes)	FY06A	FY07A	FY08A	FY09A	FY10F	FY11F	FY12F
Junan, Shandong	50,000	40,000	-	-	-	-	-
Baoji, Shaanxi	120,000	120,000	135,000	150,000	240,000	240,000	240,000
Hohhot, Inner Mongolia	10,000	120,000	140,000	200,000	220,000	220,000	220,000
Northeast	-	-	-	-	-	80,000	160,000
<b>Total</b>	<b>180,000</b>	<b>280,000</b>	<b>275,000</b>	<b>350,000</b>	<b>460,000</b>	<b>540,000</b>	<b>620,000</b>
yoy change %		56%	-2%	27%	31%	17%	15%

Source: Company data, RBS forecasts

As at the end of 2009, Fufeng was the second largest MSG producer in China with a market share of about 12% in terms of production volume. Its effective production capacity of MSG in FY09 was 305,000 tonnes pa, up almost tenfold from 33,333 tonnes pa in FY06. We expect Fufeng's MSG production capacity to rise further to 740,000 tonnes pa in FY12 once the new production base in northeast China starts to contribute.

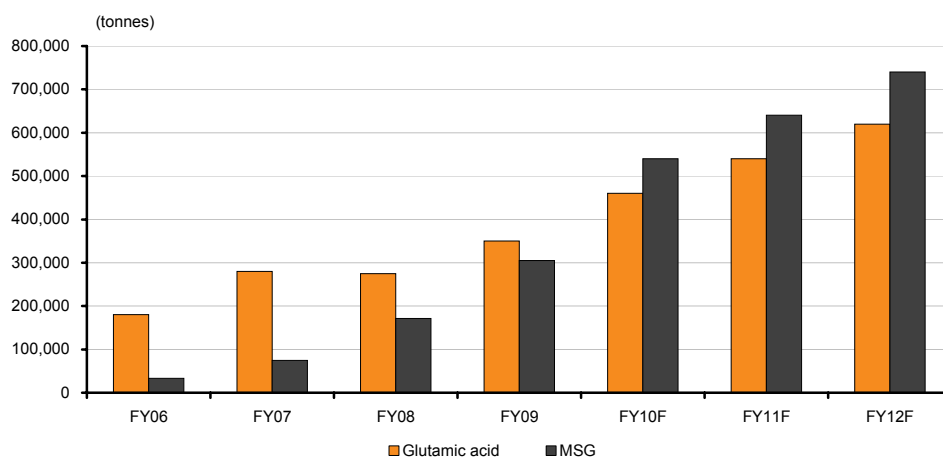
We expect MSG effective capacity to reach 740,000 tonnes in FY12, from 305,000 in FY09

**Table 7 : MSG effective production capacity forecast**

(tonnes)	FY06A	FY07A	FY08A	FY09A	FY10F	FY11F	FY12F
Junan, Shandong	33,333	75,000	65,000	80,000	90,000	90,000	90,000
Baoji, Shaanxi	-	-	16,667	100,000	150,000	150,000	150,000
Hohhot, Inner Mongolia	-	-	90,000	125,000	300,000	300,000	300,000
Northeast	-	-	-	-	-	100,000	200,000
<b>Total</b>	<b>33,333</b>	<b>75,000</b>	<b>171,667</b>	<b>305,000</b>	<b>540,000</b>	<b>640,000</b>	<b>740,000</b>
YoY change %		125%	129%	78%	77%	19%	16%

Source: Company data, RBS forecasts

We believe Fufeng's ability to expand its MSG production is secured by its self-supply of glutamic acid. Based on the assumption that 1 tonne of glutamic acid can produce 1.25 tonne of MSG, we estimate that Fufeng's production of glutamic acid is sufficient for its internal use of MSG production during FY10-12F.

**Chart 3 : Glutamic acid production capacity matching MSG production capacity**

Source: Company data, RBS forecasts

In the past few years, Fufeng has achieved full utilisation for its glutamic acid production capacity. For MSG production as well, its utilisation rate was 99% in FY09. We expect Fufeng to maintain utilisation rates at 92% for glutamic acid and 90% for MSG in FY10, slightly lower than in previous years, mainly due to the new capacity added in December 2009. Management guided that new capacity would achieve full utilisation in three months. In FY11 and FY12, we believe utilisation rates will improve gradually to 96% and 99% for glutamic acid, and 95% and 97% for MSG.

**Table 8 : Utilisation rates forecasts**

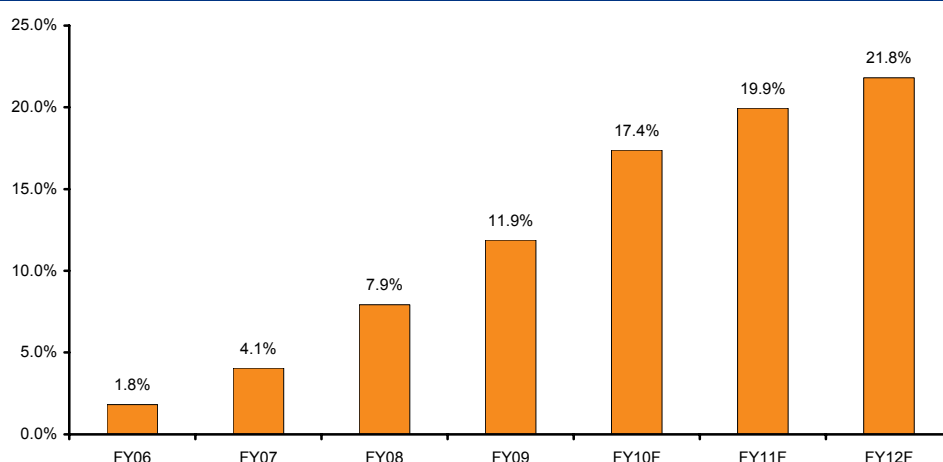
	FY06	FY07	FY08	FY09	FY10F	FY11F	FY12F
Glutamic acid	110%	100%	100%	101%	92%	96%	99%
YoY <i>ppt</i>		(10.0)	0.3	0.9	(9.5)	4.5	3.0
MSG	93%	103%	88%	99%	90%	95%	97%
YoY <i>ppt</i>		10.1	(15.3)	11.4	(9.0)	5.0	2.0

Source: Company data, RBS forecasts

## Increasing pricing power

Expansion in market share should increase Fufeng's pricing power.

We believe Fufeng's improving market share should increase its pricing power in MSG. After significantly increasing its MSG production capacity in Inner Mongolia and Shaanxi, its market share in MSG rose to 12% by end-2009, from 2% in 2006, and we expect it to increase further to 17% in FY10, 20% in FY11 and 22% in FY12.

**Chart 4 : Fufeng's MSG market share in China (in terms of sales volume)**

Source: Company data, China Fermentation Industry Association, RBS forecasts



Leading 30% global market share in xanthan gum

## Largest xanthan gum producer in the world

Fufeng is the largest xanthan gum producer in the world, with a market share of 30%. Its capacity expansion in Inner Mongolia increased its xanthan gum effective production capacity from 5,333 tonnes pa in FY06 to 32,000 tonnes pa in FY09. Fufeng added another 12,000 tonne capacity in its Inner Mongolia plant in April 2010, which should further increase its effective capacity by 28% in FY10F and 7% in FY11F.

**Table 9 : Xanthan gum effective production capacity forecast**

(tonnes)	FY06A	FY07A	FY08A	FY09A	FY10F	FY11F	FY12F
Junan, Shandong	5,333	8,000	8,000	8,000	8,000	8,000	8,000
Hohhot, Inner Mongolia	-	3,333	13,000	24,000	33,000	36,000	36,000
<b>Total</b>	<b>5,333</b>	<b>11,333</b>	<b>21,000</b>	<b>32,000</b>	<b>41,000</b>	<b>44,000</b>	<b>44,000</b>
yoy change %		113%	85%	52%	28%	7%	0%

Source: Company data, RBS forecasts

The utilisation rate of its xanthan gum capacity was 101% in FY08, but fell to 88% in FY09. This was mainly due to capacity expansion at the Inner Mongolia plant in November 2008. We expect the utilisation rate to decrease 3ppt yoy to 85% in FY10, as additional new capacity in Inner Mongolia begins operations in April 2010. By FY12, we estimate utilisation will recover to 88%.

**Table 10 : Xanthan gum utilization rate forecast**

	FY06	FY07	FY08	FY09	FY10F	FY11F	FY12F
Xanthan gum	95%	83%	101%	88%	85%	86%	88%
YoY ppt		(12.5)	18.6	(13.3)	(3.0)	1.0	2.0

Source: Company data, RBS forecasts

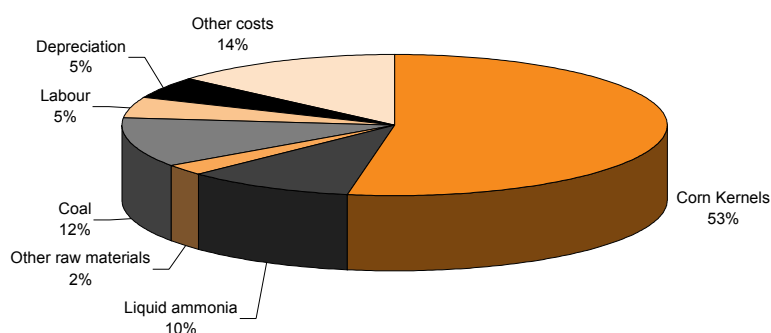
## Strong cost advantages

### Corn, coal and liquid ammonia are the major raw materials

Corn kernel is the primary raw material, accounting for 57% of MSG's cost of sales and 23% of xanthan gum's cost of sales

Corn, coal and liquid ammonia are the three major raw materials for Fufeng, accounting for 53%, 12% and 10% of its overall cost of sales in FY09. Due to the strategic location of the company's plants in Shaanxi and Inner Mongolia, it can source corn and coal at lower prices than its competitors. Fufeng is also constructing its own production facilities for liquid ammonia in its Inner Mongolia and northeast China plants to further reduce its liquid ammonia costs.

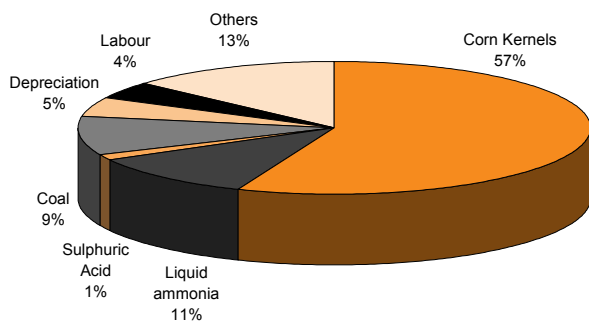
**Chart 5 : Fufeng's overall cost structure for FY09**



Source: Company data

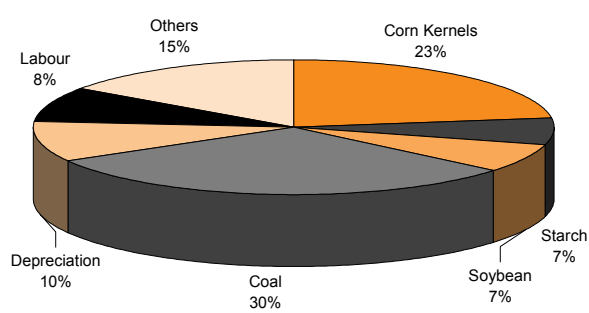
The cost structures for MSG and xanthan gum production are different (see Charts 6 and 7). Corn kernels are the primary raw material in both MSG and xanthan gum production, but MSG production relies on them more heavily. Corn kernels accounted for 57% of the total cost of sales in the MSG segment in FY09, compared with 23% in the xanthan gum segment. Energy, ie coal, is another important cost component, accounting for 9% of the total cost of sales for MSG and 30% for xanthan gum in FY09.

**Chart 6 : MSG segment cost structure (FY09)**



Source: Company data

**Chart 7 : Xanthan gum segment cost structure (FY09)**



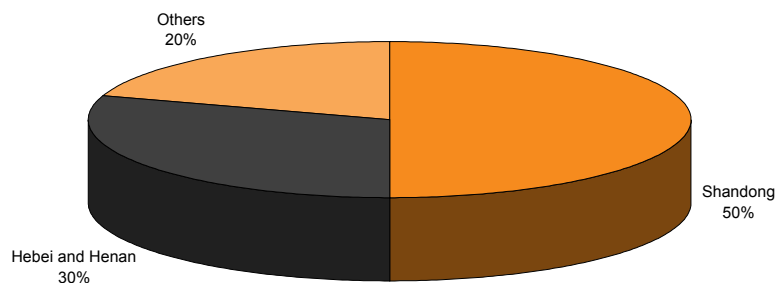
Source: Company data

### Cost advantages for corn

**Competitors' MSG production bases are mainly in Shandong province, where corn prices are typically higher**

Geographically, about 50% of China's MSG production capacity is in Shandong province, according to the China Fermentation Industry Association. By contrast, Fufeng's MSG production facilities are located mainly in Shaanxi (Baoji plant) and Inner Mongolia (Hohhot plant). As explained in more detail below, the typically lower corn and coal prices in these provinces compared to Shandong provide Fufeng with strong cost advantages in corn kernel and coal supplies over those competitors whose plants are based in Shandong.

**Chart 8 : Geographic breakdown of MSG production in China**

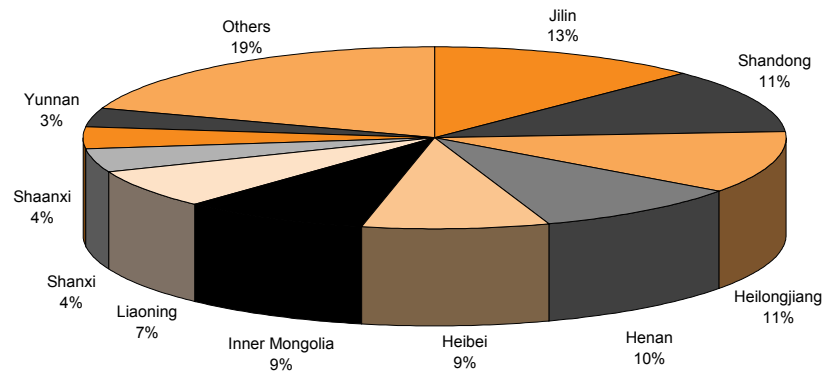


Source: China Fermentation Industry Association

Fufeng currently has three MSG production bases, ie Junan (Shandong), Baoji (Shaanxi) and Hohhot (Inner Mongolia), with effective capacities of 80,000 tonnes, 100,000 tonnes and 125,000 tonnes pa in FY09. Its Baoji and Hohhot bases also produce glutamic acid, with effective capacities of 150,000 tonnes and 200,000 tonnes pa in FY09. Therefore, Fufeng mainly purchases corn from Shaanxi and Inner Mongolia, rather than just from Shandong, as in the case of many of its competitors.

Shandong, Inner Mongolia and Shaanxi are respectively the second, sixth and ninth largest corn-producing areas in China, accounting for 11.4%, 8.5% and 3.8% of total corn output in 2008.

**Chart 9 : China corn output by provinces (2008)**

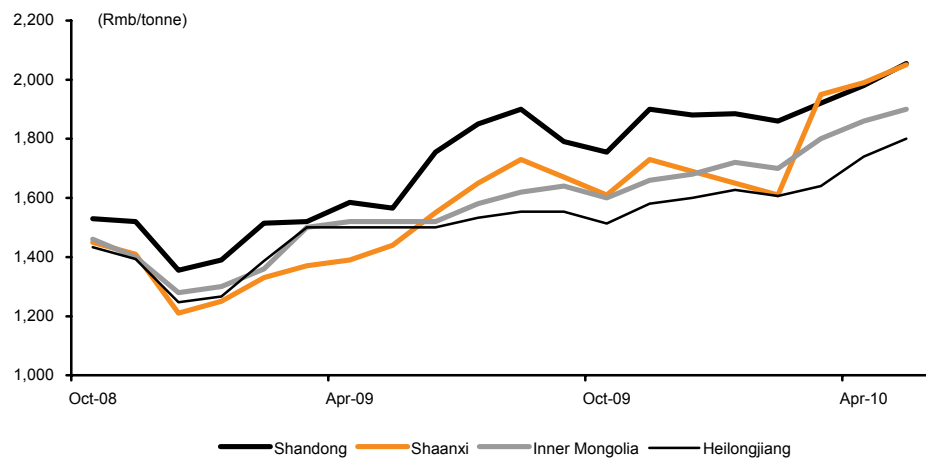


Source: China Statistics Year Book

Historically, corn prices in Shaanxi and Inner Mongolia have been similar, at discounts of about Rmb140/tonne and Rmb124/tonne, or 8% and 7% respectively, to prices in Shandong in the past two years. The lower prices in Shaanxi and Inner Mongolia are mainly attributable to the lower labour costs in these two provinces, leading to Fufeng's cost advantages over those competitors based in Shandong.

Corn prices surged in Shaanxi in March-April 2010. However, this was largely due to drought in the area, and we expect prices to fall once the drought eases. In May 2010, corn prices were similar in Shaanxi and Shandong, but were about Rmb150/tonne, or 8%, higher than the price in Inner Mongolia.

**Chart 10 : China corn prices**



Source: Bloomberg

### The new plant in northeast China should further reduce corn costs

Fufeng plans to open a new production base in northeast China in FY11, located in Inner Mongolia and close to the border with Heilongjiang. The new plant is to source corn from Heilongjiang, and we believe this will help Fufeng to further lower its raw material costs.

Heilongjiang was the third largest corn production area in China in 2008 and has an even lower labour cost than Inner Mongolia. Hence, the average corn price in Heilongjiang is also lower. In May 2010, the corn price in Heilongjiang was about Rmb100/tonne, or 5% lower than the price in Inner Mongolia.

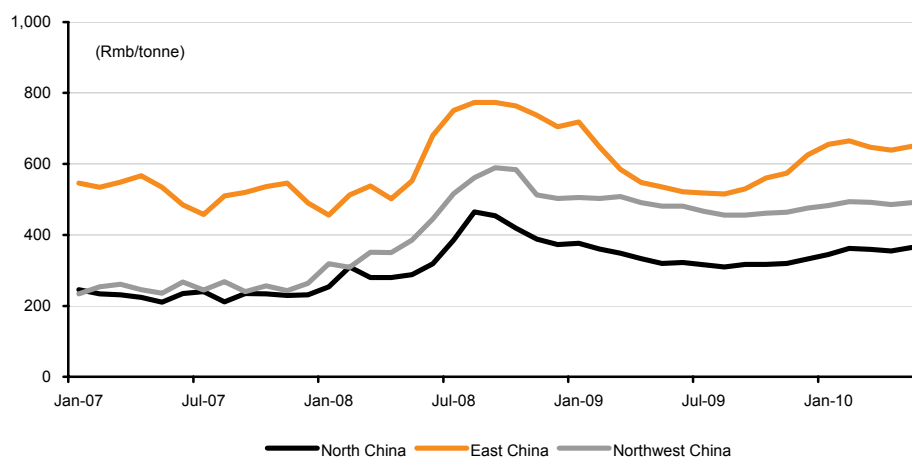
### Cost advantages for coal

Fufeng's production bases in Shaanxi (in northwest China) and Inner Mongolia (in north China) also enjoy lower coal costs than its competitors in Shandong (in east China). Comparing to East China, the major coal consumption area, coal prices in north China and northwest China have

Inner Mongolia and Shaanxi also enjoy lower coal prices

been around 47% and 32% lower on average in the past three years. In May 2010, coal prices in north China and northwest China were about Rmb285/tonne and Rmb159/tonne, respectively 44% and 24% below prices in east China. Fufeng's management has said its new production base in northeast China should have similar coal costs to those in Inner Mongolia.

**Chart 11 : China coal prices**



Source: SXCoal

**Synthetic ammonia projects in Inner Mongolia and northeast China plants should further reduce cost of sales by Rmb400/tonne**

### Synthetic ammonia projects should further reduce costs

In the MSG segment, liquid ammonia is a key raw material used to produce glutamic acid. It accounted for 10% of Fufeng's total cost of sales in FY09.

With a view to reducing the cost of glutamic acid, Fufeng is constructing two projects to generate self-produced synthetic ammonia. In 1Q10, it started constructing a synthetic ammonia project in its Inner Mongolia plant – with a planned annual capacity of 80,000 tonnes, and expects to commence operation in early 2011. Based on the assumption that 1 tonne of glutamic acid production uses 0.4 tonnes of ammonia, this project should cover about 91% of the company's use of ammonia for glutamic acid production in Inner Mongolia. The company also plans a similar project for its new plant in northeast China with the aim of self-supplying 100% of the liquid ammonia it needs for its glutamic acid production in this plant.

Management expects that the use of self-produced synthetic ammonia will reduce the cost of glutamic acid by Rmb400/tonne, ie 6% of glutamic acid's total cost of sales in FY11F, and that it will enhance the gross margin of glutamic acid by about 4ppt in FY11.

**Table 11 : Synthetic ammonia projects**

Plant	Synthetic ammonia capacity (tonnes)	Facilities	Expected date of commencement
Inner Mongolia	80,000	Power facility and railway siding	Beginning of 2011
Northeast China	100,000	Power facility and railway siding	Second half of 2011

Source: Company data

## Gross margin well above sector average

### MSG segment gross margin should be sustainable at 22-25%

We expect Fufeng's continued leading market position and increasing market share to bring it stronger pricing power in the MSG market. That, together with the cost advantages discussed above, should allow it to continue to achieve a gross margin well above the average for the Chinese MSG industry.

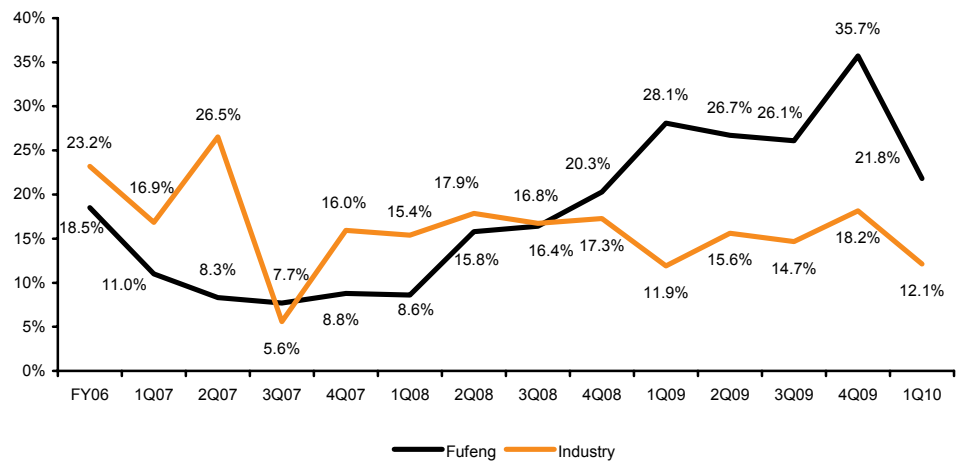
**Fufeng has sustained a gross margin well above the MSG sector average since establishing a leading market position in 2H08**

Prior to 2008, when Fufeng focused on glutamic acid production, its gross margin was lower than the MSG industry's average. It started expanding in the MSG market by increasing capacity in its bases in Shaanxi and Inner Mongolia, which started production in 2H08. Thereafter, its gross margin increased to 20.3% in 4Q08, higher than the average gross margin of 17.3% for the MSG

industry, according to the China Statistical Bureau. Fufeng maintained a gross margin of 26-28% in 1Q09-3Q09, well above the industry's average of 12-16%.

In 4Q09, a sudden surge in MSG prices, mainly due to expectations of rising demand as well as supply constraints, drove Fufeng's gross margin to 35.7%. The company took the opportunity to further expand its market share by being the first in the industry to cut MSG selling prices from January 2010. Although its gross margin dropped sharply to 21.8% in 1Q10 as a result, this was still higher than the industry average of 12.1% for this quarter. We expect Fufeng to maintain a gross margin in the range of 23-27% for its MSG segment from FY10-12, still above the industry average.

**Chart 12 : MSG gross margin trend: Fufeng vs industry**



Source: Company data, China Statistical Bureau

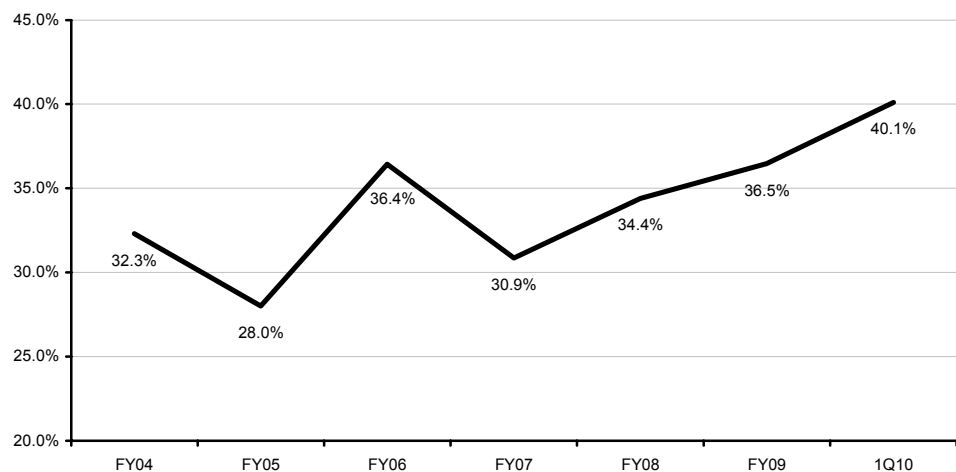
### Xanthan gum segment gross margin has continued to improve

**Fufeng's gross margin for the xanthan gum segment has improved continuously since FY07**

Fufeng has continuously improved its gross margin in the xanthan gum segment for the past three years, from 30.9% in FY07 to 40.1% in 1Q10, thanks largely to the lower cost of coal in Inner Mongolia than in Shandong. We expect gross margin for xanthan gum to expand further to 37-39% during FY10-12, backed by Fufeng's increasing pricing power and cost advantages.

It currently has two production bases to produce xanthan gum – in Junan, Shandong and Hohhot, Inner Mongolia – with effective capacity of 8,000 tonnes and 24,000 tonnes in FY09, respectively. Fufeng started xanthan gum production in Inner Mongolia in 4Q07 and gradually added capacity in FY08 and FY09. Coal prices in north China (Inner Mongolia) have been 47% lower than those in East China (Shandong) in the past three years.

**Chart 13 : Xanthan gum gross margin trend**



Source: Company data

# We forecast FY10-12 earnings CAGR of 20%

We forecast Fufeng will achieve a 20% earnings CAGR over FY10-12, driven by capacity expansion and improving cost savings.

## Earnings momentum to emerge in FY12

We expect Fufeng's revenue to grow 40% yoy in FY10, 27% in FY11 and 26% in FY12, driven by capacity expansion

We expect Fufeng's effective production capacity of MSG to reach 740,000 tonnes pa in FY12, more than double the 305,000 tonnes pa in FY09. We also expect its xanthan gum capacity to increase from 32,000 tonnes pa in FY09 to 44,000 tonnes pa in FY12. Capacity expansion should allow Fufeng to further expand its market share.

We expect Fufeng to achieve a market share of 22% in China's MSG market in FY12, which would significantly enhance its pricing power. Moreover, we expect its new production base in northeast China to begin operations in June 2011, providing with further cost advantages.

We forecast revenue will increase 40% in FY10 to Rmb6,476m, 27% in FY11 to Rmb8,228m and 26% in FY12 to Rmb10,407m. We expect MSG average selling price (ASP) to increase 20% in FY10, driven mainly by a 30% surge in the cost of corn kernels. However, after the new plant in northeast China begins operations in 2H11, we expect Fufeng to maintain a flat MSG ASP in FY11 to absorb the new capacity. We forecast Fufeng's MSG ASP will rise 0% in FY11 and 8% in FY12, as a result of a 10% corn price increase for each year.

**Table 12 : Sales volume and ASP assumptions for key products**

	FY09	FY10F	FY11F	FY12F
<b>Sales volume (tonnes)</b>				
<b>MSG segment</b>				
Glutamic acid	100,999	32,100	32,000	39,560
yoy %	-38%	-68%	0%	24%
MSG	292,358	461,700	601,920	717,800
yoy %	100%	58%	30%	19%
Fertiliser	497,205	461,720	576,840	693,120
yoy %	34%	-7%	25%	20%
Starch sweeteners	117,869	130,200	142,800	151,410
yoy %	33%	10%	10%	6%
Corn refined products	436,683	524,020	628,823	754,588
yoy %	19%	20%	20%	20%
<b>Xanthan gum segment</b>				
Xanthan gum	19,343	26,138	30,272	32,912
yoy %	-6%	35%	16%	9%
<b>ASP (Rmb/tonne)</b>				
<b>MSG segment</b>				
Glutamic acid	7,135	8,562	8,562	9,247
yoy %	10%	20%	0%	8%
MSG	7,680	9,216	9,216	9,953
yoy %	12%	20%	0%	8%
Fertiliser	727	691	711	747
yoy %	-29%	-5%	3%	5%
Starch sweeteners	2,080	2,205	2,315	2,431
yoy %	13%	6%	5%	5%
Corn refined products	1,494	1,568	1,647	1,729
yoy %	3%	5%	5%	5%
<b>Xanthan gum segment</b>				
Xanthan gum	21,099	19,833	20,825	21,450
yoy %	-4%	-6%	5%	3%

Source: Company data, RBS forecasts

Gross margin should improve to 24% in FY12, from 23% in FY11, on increasing cost advantage due to the northeast plant and stronger pricing power

We do not expect the 30% gross profit margin of FY09 to be sustained, because the high MSG prices in 4Q09 were abnormal. New MSG capacity to be installed in 2H11 is likely to pressure Fufeng's gross margin, and we expect a 2.6ppt contraction, from 25.4% in FY10 to 22.8% in FY11. However, we believe it should return to 24.0% in FY12 on cost savings from the new northeast China plant and greater pricing power following a potential increase in Fufeng's market share through the new capacity.

**Table 13 : Gross margin forecasts**

	FY09	FY10F	FY11F	FY12F
MSG segment	30%	24%	22%	23%
yoy ppt	14.0	(5.2)	(2.8)	1.3
Xanthan gum segment	36%	37%	38%	39%
yoy ppt	2.1	0.5	1.0	1.0
<b>Overall</b>	<b>30%</b>	<b>25%</b>	<b>23%</b>	<b>24%</b>
<b>yoy ppt</b>	<b>12.2</b>	<b>(4.8)</b>	<b>(2.6)</b>	<b>1.1</b>

Source: Company data, RBS forecasts

Other key assumptions affecting net profit include the following.

- **Effective tax rate** – We now assume the effective tax rate will reach 17% in FY12, from 9% in FY09. Management guided that in June 2010 it obtained the state government's approval for qualification as high-tech enterprises for all its three existing plants (Shandong, Shaanxi and Inner Mongolia), and can continue to enjoy the 15% preferential tax rate in 2011 and beyond. For its new plant in northeast China, we now conservatively assume there is no preferential tax treatment and the effective tax rate is 25%. However, management guided it would apply for the high-tech enterprise qualification for the new plant as well.
- **Capital expenditure** – Management is planning Rmb1,200m capex for the new production base in northeast China and the synthetic ammonia project and fructose production at Inner Mongolia in 2010. We expect capex of Rmb500m-600m for FY11 and FY12.

**Table 14 : Effective tax rate actuals and forecasts**

	FY09	FY10F	FY11F	FY12F
<b>Shandong plant</b>	<b>15%</b>	<b>15%</b>	<b>15%</b>	<b>15%</b>
– Preferential enterprise income tax rate of 15% as a high-tech enterprise to expire on 31 December 2010. But in June 2010 the company obtained the state government's approval for qualification as a high-tech enterprise, and can continue to enjoy the 15% preferential tax rate in 2011 and going forward.				
<b>Shaanxi plant</b>	<b>7.5%</b>	<b>15%</b>	<b>15%</b>	<b>15%</b>
– Preferential enterprise income tax rate of 15% under Opening Up of Western China policy to expire on 31 December 2010 and 50% tax holiday expired on 31 December 2009. But in June 2010 the company obtained the state government's approval for qualification as a high-tech enterprise, and can continue to enjoy the 15% preferential tax rate in 2011 and going forward.				
<b>Inner Mongolia plant</b>	<b>7.5%</b>	<b>7.5%</b>	<b>7.5%</b>	<b>15%</b>
– Preferential enterprise income tax rate of 15% under Opening Up of Western China policy to expire on 31 December 2010 and 50% tax holiday to expire on 31 December 2011. But in June 2010 the company obtained the state government's approval for qualification as a high-tech enterprise, and can continue to enjoy the 15% preferential tax rate in 2011 and going forward.				
<b>Northeast China plant</b>			<b>25%</b>	<b>25%</b>
– Standard tax rate				
We now conservatively assume there is no preferential tax rate for the northeast China plant. However, management guided that it would apply for the high-tech enterprise qualification for the new plant as well.				
<b>Overall effective tax rate</b>	<b>9%</b>	<b>10%</b>	<b>12%</b>	<b>17%</b>

Source: Company data, RBS forecasts

**Table 15 : Other key assumptions**

	FY09	FY10F	FY11F	FY12F
<b>P&amp;L</b>				
Distribution expenses as % of revenue	4.7%	4.4%	3.9%	3.7%
Admin expenses as % of revenue	4.2%	3.9%	3.4%	3.2%
Effective tax rate	9%	10%	12%	17%
<b>Balance sheet</b>				
Depreciation expenses/average fixed assets	8.5%	8.7%	9.3%	10.0%
<b>Cash flow statement</b>				
Capex (Rmb m)	745	1200	625	575

Source: Company data, RBS forecasts

**Table 16 : 2010 Capex plan**

New projects development	Planned amount (Rmb m)	Expected date of construction	Expected date of commencement
200,000 tonnes capacity for MSG and package facility at the northeast China plant	600	May-10	2H11
Synthetic ammonia capacity at the Inner Mongolia plant with power plant facility and railway siding	560	Mar-10	Beginning of 2011
5,000 tonnes fructose capacity at the Inner Mongolia plant	40	Jan-10	2H10
<b>Total</b>	<b>1200</b>		

Source: Company data

# Recommend Buy with HK\$7.10 target price

We initiate coverage on Fufeng with a Buy rating, based on its leading market position and strong cost advantages. Our target price of HK\$7.10 implies 42% potential upside from current levels.

## Profit margins higher than competitors'

Fufeng's profit margins are higher than those of its major competitors, mainly due to its lower raw material costs and distribution expenses

The strategic location of Fufeng's production bases in Shaanxi and Inner Mongolia provides the company with strong cost advantages. Meanwhile, its expansion in capacity has achieved economies of scale and established a leading position in the glutamic acid, MSG and xanthan gum markets. As a result, Fufeng has higher margins than its major competitors in the MSG manufacturing business. Compared with Vedan and Lianhua (the No 3 MSG player in China), two listed peers in the MSG market, Fufeng achieved an operating margin of 22.6% in FY09, significantly higher than Vedan (10.7%) and Lianhua (1.3%).

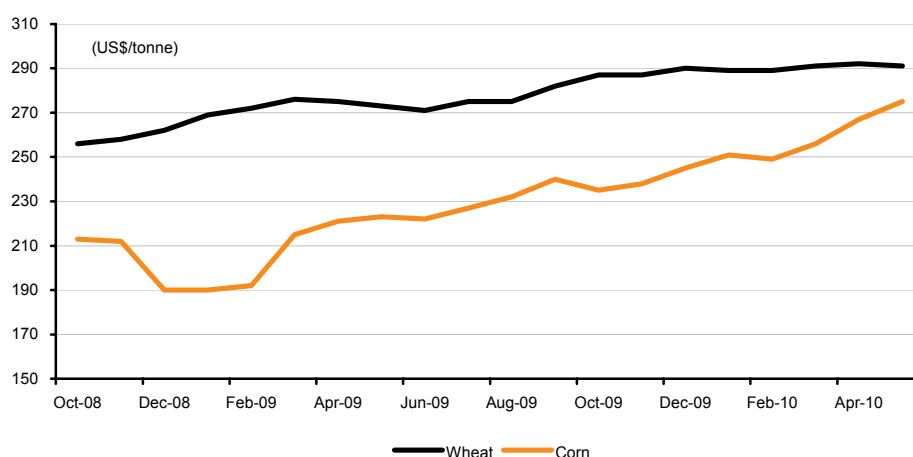
Fufeng is able to achieve a higher margin than competitors primarily because of its raw material cost advantage. Vedan has two plants, ie. one in Vietnam and one in Taiwan, and the company uses molasses, a by-product of processing sugar cane or sugar beets into sugar, as the major raw material for MSG production. Lianhua's major raw material for MSG production is wheat, and the company cannot self-supply 100% of its glutamic acid requirement for MSG production. Fufeng is able to achieve a higher gross margin than Vedan and Lianhua because using corn to produce MSG is cheaper than using molasses and wheat, and Fufeng's integrated business model (self-supplying 100% of its glutamic acid) is superior to Lianhua's. In addition, Fufeng has a lower ratio of SG&A to sales than Vedan and Lianhua, reflecting Fufeng's better ability to control expenses, leading to its higher operating margin.

**Table 17 : Comparison of Fufeng with Vedan and Lianhua, FY09**

(Rmb m)	Fufeng	Vedan (2317 HK)	Lianhua (600186 CH)
Sales	4,632.88	1,975.28	2,472.26
Sales growth	29.2%	-18.5%	21.2%
Gross profit	1,399.61	487.31	289.90
Gross margin	30.2%	24.7%	11.7%
yoy change (ppt)	12.24	6.16	(3.46)
Operating profit	1,047.35	211.39	32.27
Operating margin	22.6%	10.7%	1.3%
yoy change (ppt)	12.40	6.10	(1.26)
Net profit	928.29	122.85	17.31
Net profit growth	215.0%	110.4%	38.7%
Net margin	20.0%	6.2%	0.7%
yoy change (ppt)	11.82	3.81	0.09
SG&A cost		280.69	257.62
SG&A cost % of sales	8.9%	14.2%	10.4%
Equity		1,854.59	1,627.93
ROAE	44.9%	6.8%	1.1%
Net gearing	10.67%	2.18%	33.88%
Inventory days	62	116	56
Account payable days	56	23	68
Account receivable days	46	35	108

Source: Company data, Bloomberg



**Chart 14 : Corn vs wheat prices**

Source: Bloomberg

**Issuance of Rmb1bn convertible bonds in April 2010 should provide Fufeng with sufficient cash for its new plant in northeast China**

### Issuance of convertible bonds for capacity expansion

Fufeng issued Rmb1,025m Rmb-denominated, US dollar-settled convertible bonds (CB) on 1 April 2010, at 4.5% interest rate and five-year maturity. The conversion price is HK\$7.45/share. Fufeng plans to use the proceeds mainly on the new production base in northeast China and the synthetic ammonia project in Inner Mongolia, which involve capital expenditure of about Rmb1.2bn in FY10.

The bonds will be convertible to 165.7m shares, implying a 9.08% dilution of the issued share capital. After full conversion of the bonds, the chairman's interests would be reduced from 47% to 43%.

**Table 18 : Changes in shareholding structure after CB conversion**

	Before CB conversion	After CB conversion
Chairman - Li, Xue Chun	47%	43%
Directors	11%	10%
Bondholders	0%	9%
Other	41%	38%
<b>Total</b>	<b>100%</b>	<b>100%</b>

Source: Company, RBS forecasts

**We expect Fufeng to maintain 40% dividend payout in FY10-12**

### High dividend payout ratio backed by strong balance sheet

Fufeng's dividend payout ratio was high at 50% in FY08 and 39% in FY09. We expect the company to maintain a 40% payout ratio during FY10-12, supported by its strong balance sheet and operating cash flows. The Rmb1bn CB issuance should raise Fufeng's net gearing ratio from 10.7% in FY09 to 25.1% by end-FY10, which is still reasonable, in our view. We estimate its net gearing ratio will decrease to 13.5% in FY11 and turn to a net cash position in FY12, given strong operating cash flows. Hence, we believe Fufeng's sufficient cash on hand should support a high dividend payout ratio in FY10-12, with dividend yields of 5.7%, 6.3% and 8.2%.

**Table 19 : Strong balance sheet and cash flow**

	FY09	FY10F	FY11F	FY12F
Net cash/(debt) (Rmb m)	(255)	(769)	(511)	89
Net gearing ratio (%)	10.7%	25.1%	13.5%	-1.9%
Free cash flow (Rmb m)	290	828	682	1,062

Source: Company data, RBS forecasts

Fufeng's stock is trading at PE multiples of 7.8x FY10F and 7.0x FY11F, which we find attractive

## We recommend buying for attractive valuation

Based on our forecasts, Fufeng is trading at PE multiples of 7.8x FY10F and 7.0x FY11F, below its MSG producing and corn processing peers listed on the Hong Kong Stock Exchange, which are trading at average PEs of 10.3x for FY10F and 8.6x for FY11F, based on Bloomberg consensus forecasts. Fufeng is also trading at a discount to its MSG producing and corn processing peers listed on the A-share market, which are trading at average PEs of 24.4x for FY10F and 21.6x for FY11F, based on Wind consensus forecasts. In addition, Fufeng is trading at a discount to its MSG and fermentation producing peers listed on the international market, which are trading at average PEs of 17.5x for FY10F and 14.0x for FY11F, based on Bloomberg consensus forecasts.

We also like Fufeng's high dividend yield. Its current dividend yield is 5.7% for FY10F and 6.3% for FY11F (see Table 21), which is higher than the averages for its Hong Kong listed peers (2.0% and 2.5%), A-share listed peers (2.8% and 2.4%), and global peers (2.0% and 2.0%).

Our 12-month target price of HK\$7.10 is derived from our three-phase DCF valuation, and translates to 11.0x FY10F PE and 9.9x FY11F PE. Given Fufeng's leading market position and pricing power, we believe the stock should trade at a premium to its Hong Kong listed peers, ie Global Bio-chem and Xiwang Sugar. Besides, Global Bio-chem and Xiwang Sugar focus more on upper-stream corn-processed products, which have lower profit margins. The FY09 gross and operating margins for Global Bio-chem were 13.5% and 4.7%, and for Xiwang Sugar they were 12.8% and 6.9%, significantly lower than Fufeng's 30.2% and 22.6%. In addition, Fufeng's ROAE of 44.9% for FY09 was much higher than Global Bio-chem's 1.6% and Xiwang's 13.0%.

## Completion of Mei Hua's back-door listing in 3Q10 to be a catalyst

One of Fufeng's major competitors – Mei Hua, the largest MSG producer and the second-largest glutamic acid producer in China in FY09 – is undergoing a back-door listing in the A-share market. According to Mei Hua's public announcement, the China Securities Regulatory Committee accepted its application for asset injection in May 2010, and we expect the company to complete the asset injection process in 3Q10. The shell company that Mei Hua will use is Wuzhou Minovo (600873 CH, NR) and, according to Wind consensus forecasts, after Mei Hua injects its assets into Wuzhou Minovo, the company will achieve FY11 EPS of Rmb1.05. This translates into an FY11F PE of 17.9x, based on Wuzhou Minovo's closing price on 1 July 2010, much higher than Fufeng's FY11F PE of 7.0x based on our forecasts. We believe the completion of Mei Hua's back-door listing should provide a re-rating opportunity for Fufeng.

**Table 20 : Comparison of Fufeng and Mei Hua, 1H09**

(Rmb m)	Fufeng (546 HK)	Mei Hua (600873 CH)
Sales	2,055.4	1,970.6
Sales growth	26.1%	NA
Gross profit	577.0	571.4
Gross margin	28.1%	29.0%
yoy change (ppt)	13%	NA
Operating profit	400.5	347.7
Operating margin	19.5%	17.6%
yoy change (ppt)	12%	NA
Net profit	353.9	301.1
Net profit growth	312.2%	NA
Net margin	17.2%	15.3%
yoy change (ppt)	12%	NA
SG&A cost % of sales	8.6%	11.3%
yoy change (ppt)	0.2%	NA
ROAE	19.2%	17.6%
Net gearing	10.9%	24.9%
Inventory days	40	73
Account payable days	64	54
Account receivable days	49	18

Source: Company data

**Table 21 : Valuation comparison**

		1 Jul 10		EPS growth (%)				PER (x)				FY10-12	FY10	FY10	Dividend yield (%)			
Company name	Ticker	Price (LC)	M cap (US\$m)	09A	10F	11F	12F	09A	10F	11F	12F	CAGR (%)	PEG (x)	P/B (x)	09A	10F	11F	12F
Listed in Hong Kong market																		
Vedan	2317 HK	0.83	162	113.8%	n/a	n/a	n/a	9.1	n/a	n/a	n/a	n/a	n/a	n/a	5.5%	n/a	n/a	n/a
China Agri*	606 HK	9.08	4,502	-29.1%	41.1%	15.1%	13.1%	17.5	12.4	10.8	9.6	14.1	0.9	1.9	1.4%	2.0%	2.3%	2.6%
China Corn Oil	106 HK	0.46	109	16.8%	n/a	n/a	n/a	6.9	n/a	n/a	n/a	n/a	n/a	n/a	0.0%	n/a	n/a	n/a
Global Bio-chem	809 HK	1.08	450	-102.2%	n/m	15.7%	11.8%	-180.0	5.5	4.7	4.2	13.8	0.4	0.3	0.0%	1.9%	2.0%	2.4%
Xiwang Sugar	2088 HK	1.89	235	57.8%	74.0%	29.1%	89.5%	13.9	8.0	6.2	3.3	56.4	0.1	0.8	2.2%	2.5%	3.4%	9.0%
China Starch	3838 HK	0.78	579	31.0%	85.5%	21.6%	n/a	28.4	15.3	12.6	n/a	n/a	n/a	n/a	0.8%	1.8%	2.2%	n/a
Average			6,037	14.7%	57.5%	20.0%	38.2%	-17.4	10.3	8.6	5.7	28.1	0.5	1.0	1.6%	2.0%	2.5%	4.7%
Listed in A shares markets																		
Lianhua	600186 CH	4.39	687	33.3%	n/a	n/a	n/a	274.4	n/a	n/a	n/a	n/a	n/a	n/a	0.0%	n/a	n/a	n/a
Star Lake Bios	600866 CH	10.08	775	673.6%	85.9%	15.5%	3.9%	23.4	12.6	10.9	10.5	9.5	1.3	4.0	0.0%	2.3%	n/a	n/a
Angel Yeast	600298 CH	35.00	1,579	101.2%	25.6%	24.8%	19.7%	45.2	n/a	n/a	n/a	22.2	n/a	8.3	0.4%	0.7%	n/a	n/a
Hengshun Vinegar	600305 CH	13.53	254	-162.0%	70.5%	31.6%	32.4%	56.4	33.1	25.1	19.0	32.0	1.0	2.9	0.5%	0.8%	1.0%	1.1%
Guitang Group	000833 CH	7.97	348	-54.0%	100.3%	25.4%	n/a	78.7	39.3	31.3	n/a	n/a	n/a	n/a	1.3%	n/a	n/a	n/a
Nanning Sugar	000911 CH	13.57	574	377.8%	145.2%	-32.3%	n/a	31.6	12.9	19.0	n/a	n/a	n/a	2.3	2.2%	7.5%	3.8%	n/a
Average			4,217	161.7%	85.5%	13.0%	18.6%	84.9	24.4	21.6	14.7	21.2	1.2	4.3	0.7%	2.8%	2.4%	1.1%
Global peers																		
Ajinomoto	2802 JP	794	6,346	-134.9%	-353.4%	28.9%	7.4%	-54.2	21.4	16.6	15.5	n/a	n/a	0.9	2.0%	2.1%	2.1%	2.0%
CJ Corp.	001040 KS	58600	1,383	-45.6%	-24.0%	14.2%	-18.0%	9.5	12.5	10.9	13.3	-3.2	-3.8	0.8	1.4%	2.0%	2.0%	1.6%
Wei Chuan Food	1201 TT	37.90	596	29.8%	51.5%	27.6%	n/a	28.1	18.5	14.5	n/a	n/a	n/a	2.9	0.0%	n/a	n/a	n/a
Average			8,325	-50.2%	-108.7%	23.6%	-5.3%	-5.6	17.5	14.0	14.4	-3.2	-3.8	1.5	1.1%	2.0%	2.0%	1.8%

Source: Bloomberg, Wind, and \*RBS forecasts

# Gains from catering, food processing growth

We believe Fufeng will benefit from the growing demand for MSG emerging from strong growth of the catering and food processing businesses in China. Market consolidation and higher entry barriers should further strengthen Fufeng's leading position.

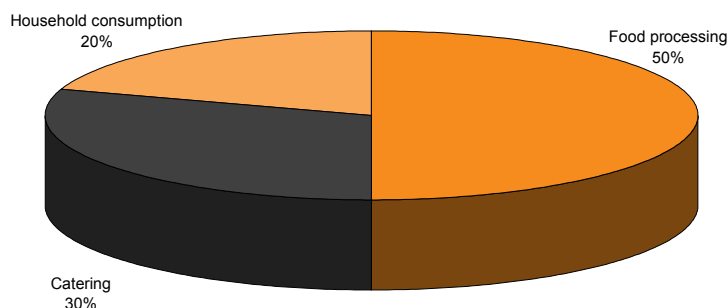
## Growth backed by a substantial market in China

### Demand driven by domestic catering and food processing businesses

MSG is most commonly used in the food processing and catering industry

Monosodium glutamate (MSG) is commonly used as a food additive for flavour enhancement. According to the China Fermentation Industry Association, in China 50% of MSG is used in the food processing industry, while 30% is consumed by the catering industry and 20% by households. We think the food processing and catering businesses will both benefit from strong growth in domestic consumption, increasing disposable income and continuous urbanisation in China.

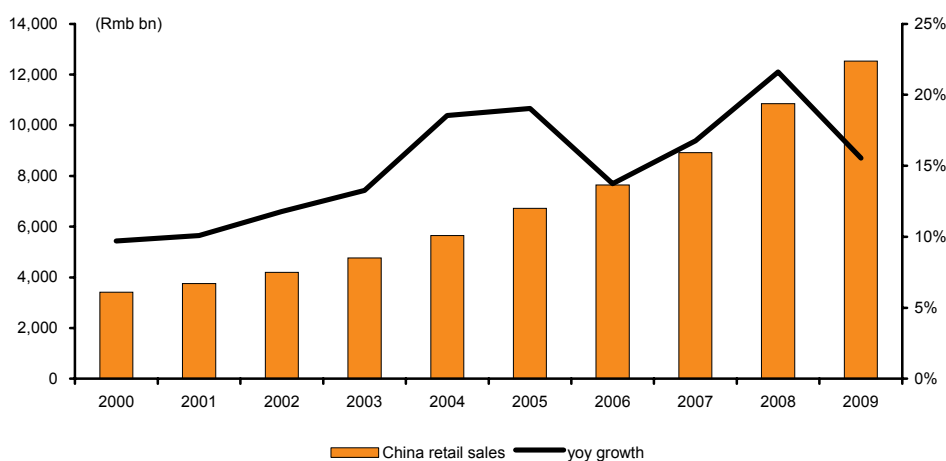
Chart 15 : Usage of MSG in China (2009)



Source: China Fermentation Industry Association

China's domestic consumption market has expanded rapidly over the past decade. Total retail sales in China reached Rmb12.5trn in 2009, with a 16% CAGR over 2000-09, according to the National Statistics Bureau.

Chart 16 : China retail sales and growth

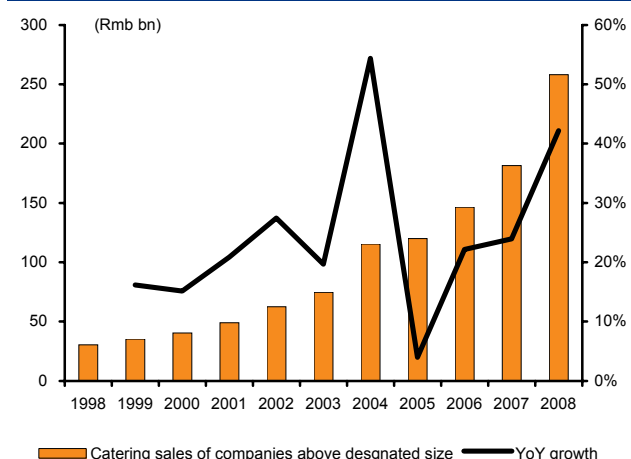


Source: China National Statistics Bureau

**We expect the catering industry and food processing industry to expand 15-20% every year over the next three years**

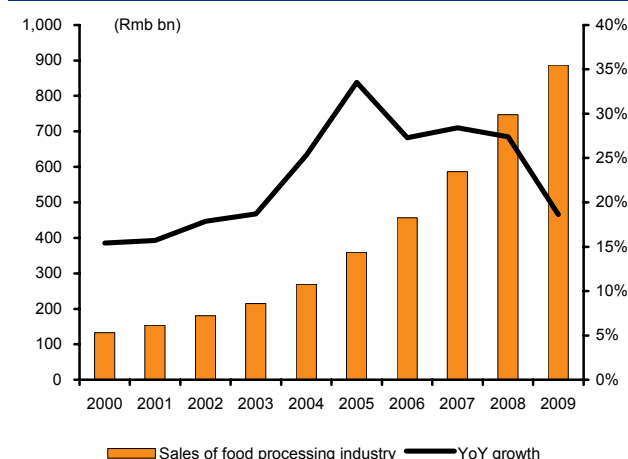
Among retail sales, catering business sales were about Rmb1.8trn in 2009, representing around 14% of total retail sales in China. According to the National Statistics Bureau, catering sales by companies above the designated size (ie, annual sales over Rmb2m) achieved a CAGR of 26% over 2000-08. For the food processing industry, overall sales also delivered a CAGR of 24% over 2000-09. We believe the catering industry and the food processing industry will continue to expand at a rate of 15-20% pa over the next three years, which should support the growing demand for MSG in China.

**Chart 17 : Sales by catering companies above designated size**



Note: Designated size = annual sales over Rmb2m  
Source: China National Statistics Bureau

**Chart 18 : Sales by food processing industry**



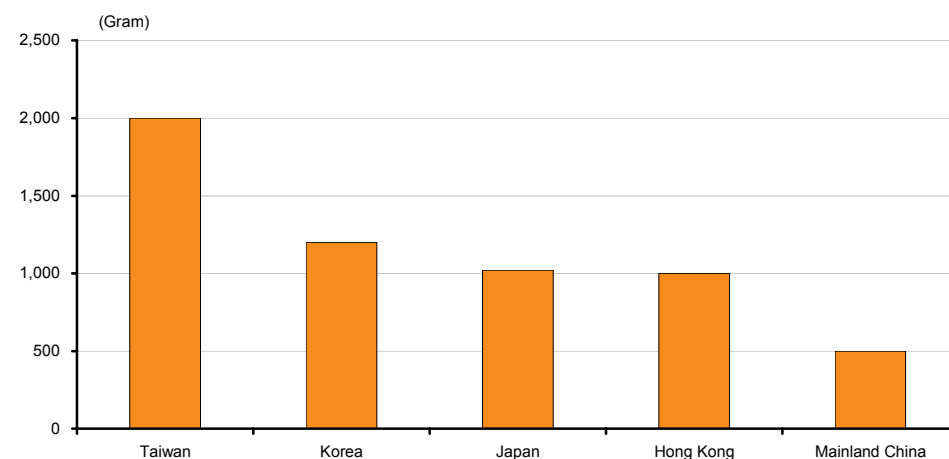
Source: China National Statistics Bureau

#### Low penetration of MSG in mainland China

Besides, the penetration of MSG in mainland China is still lower than in other Asian countries and regions. According to the China Fermentation Industry Association, consumption of MSG per capita was only 500g in China in 2009, vs 2000g in Taiwan, 1,200g in Korea, 1,020g in Japan and 1,000g in Hong Kong. We believe there is room for growth in China's MSG consumption per capita.

We forecast MSG demand will grow 8-10% each year during 2010-12, backed by strong growth in catering and food processing sales in the domestic market.

**Chart 19 : Per capita consumption of MSG in Asia (2009)**



Source: China Fermentation Industry Association

MSG production is constrained by glutamic acid supply, with the top eight MSG producers controlling 64% of glutamic acid capacity

Demand and supply gap for glutamic acid and MSG production in China remains in the short term

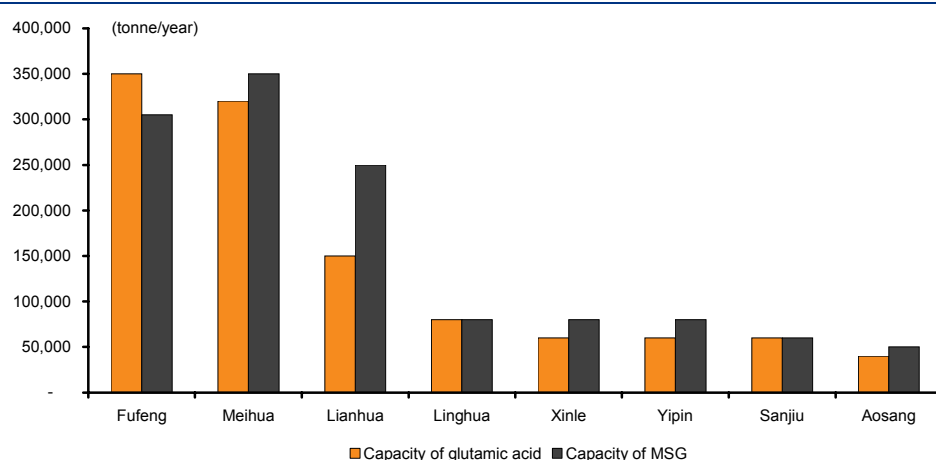
## MSG supply constrained by glutamic acid production

As mentioned previously, glutamic acid is the primary raw material for MSG production. In China, over 90% of glutamic acid produced is used in MSG production. According to the China Fermentation Industry Association, among the top 10 MSG producers in China, eight are equipped with their own glutamic acid production capacity. In China, MSG output has seen a 13% CAGR over 2002-09. During 2006-09, the government eliminated 200,000 tonnes of MSG capacity among manufacturers with capacity less than 30,000 tonnes, due to environment control considerations.

Currently, there is still a demand/supply gap for glutamic acid for domestic MSG production. In 2009, MSG output reached 254m tonnes, indicating demand for glutamic acid was about 200m tonnes. However, domestic glutamic acid production capacity was estimated to be 1.7m-1.8m tonnes, leaving a demand/supply gap of 200,000-300,000 tonnes.

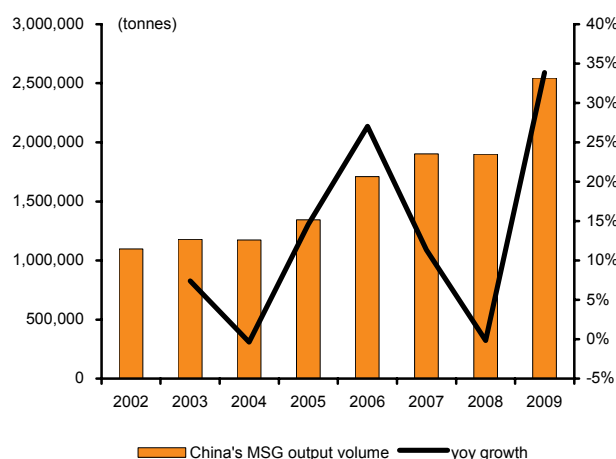
We expect supply of glutamic acid to remain tight, which should limit expansion of MSG production capacity by smaller players. Hence, market leaders, especially those that have their own glutamic acid production capacities, should benefit more from the growing MSG market.

**Chart 20 : Production capacity of glutamic acid and MSG by domestic players (2009)**



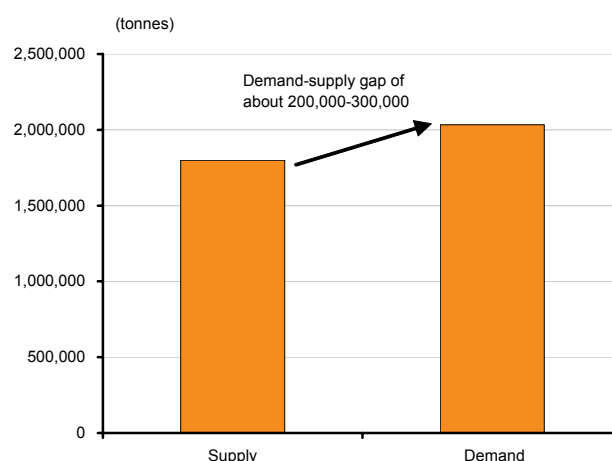
Source: China Fermentation Industry Association, company data

**Chart 21 : China's MSG production by volume**



Source: China National Statistics Bureau

**Chart 22 : Demand and supply gap of glutamic acid, 2009**



Source: China National Statistics Bureau, RBS estimates

**High entry barrier for glutamic acid production, due to capital requirements and strict environmental control by local government**

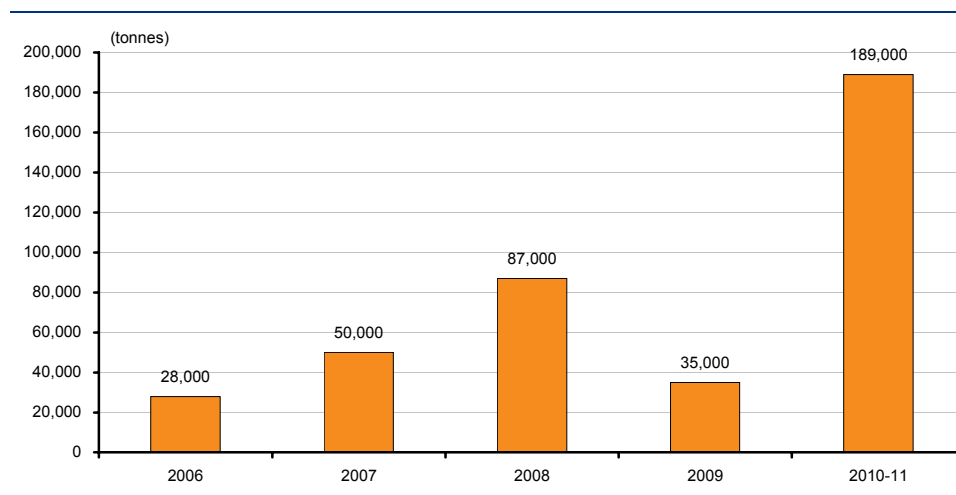
## Entry barrier is high

The entry barriers are high for glutamic acid production, which is strictly controlled by the government for environmental protection. First, glutamic acid production is capital intensive. According to Fufeng, a 100,000-tonne glutamic acid project requires an investment of Rmb400m-500m. This has kept some smaller MSG producers from producing glutamic acid internally, which makes them highly dependent on glutamic acid producers and leads to their lower gross margins.

The costs related to environmental issues are also significant. The fermentation process for glutamic acid results in mainly two kinds of pollutions: waste water and flue gas. The cost of environmental governance for a 100,000-tonne glutamic acid project is estimated to be Rmb50m-100m, according to Fufeng's management. Meanwhile, the government has restricted capacity expansions by under-scale MSG producers due to environmental concerns. In October 2007, the National Development and Reform Commission (NDRC) and the Ministry of Environmental Protection issued a notice regarding the elimination of under-scale MSG production capacity, aimed mainly at producers with capacity of less than 30,000 tonnes pa. The target was to eliminate 200,000 tonnes of MSG production capacity among under-scale manufacturers by end-2009.

The NDRC recently issued a notice to reinforce elimination of under-scale MSG production capacity in 2010-11. The government now targets closing down 189,000 tonnes of MSG capacity by 2011. In particular, the local government in Shandong aims to shut down one plant with capacity of 25,000 tonnes in 2010 and three plants with a total capacity of 85,000 tonnes in 2011.

**Chart 23 : Government target for MSG capacity elimination**



Source: NDRC

Fufeng has been striving to solve environmental issues during development. The company has invested more than Rmb2bn in environmental protection. By end-April 2009, the Baoji plant had adopted a flue gas treatment initiative by installing additional flue gas desulfurisation facilities. It has alleviated the impact of flue gas released during the production process. Management plans to apply the flue gas treatment in the Inner Mongolia plant in 2010 and in the northeast plant in the future. This should further raise the entry barriers for the MSG production business while keeping Fufeng as a leader in the market.

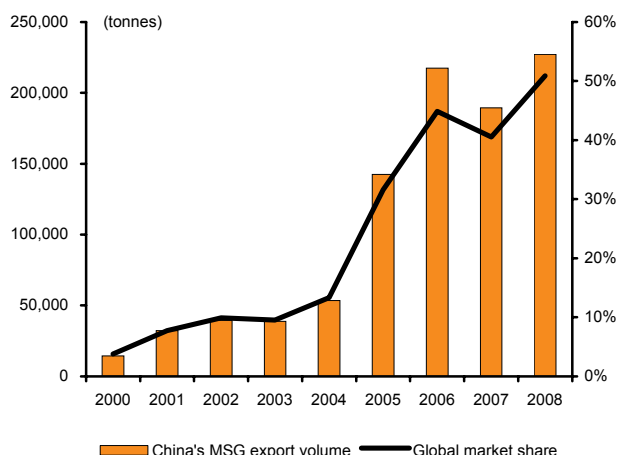
## China becomes the largest MSG exporter in the world

China has become the largest MSG exporter in the past few years. In 2008, China exported 227,192 tonnes of MSG (about 12% of the country's output), accounting for 51% of total global exports of MSG.

**China accounts for about 77% of MSG supply in the world**

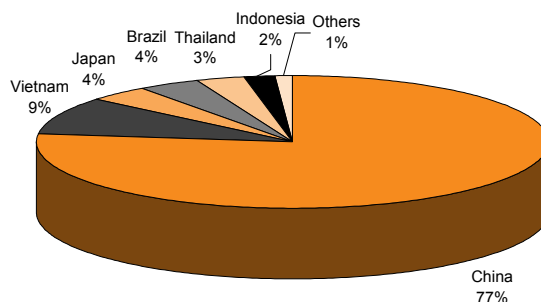
Currently, about 77% of global MSG production is based in China, according to the China Fermentation Industry Association. Most global MSG manufacturers are located in Asia, including Vietnam, Japan, Thailand and Indonesia, accounting for about 95% of global MSG production. We think this is closely related to the dietary habits of Asians. Given China's large catering and food processing market and cost advantages in raw material and labour, we believe the country will continue to be the dominant MSG producer in the next few years.

**Chart 24 : China's MSG exports**



Source: Bloomberg

**Chart 25 : Geographic breakdown of MSG capacity (2009)**



Source: China Fermentation Industry Association

## Competitive landscape: a concentrated glutamic acid market

**Domestic glutamic acid market is relatively concentrated**

The top eight MSG producers held about a 49% share of the MSG market and a 70% share of the glutamic acid market in 2009.

**Table 22 : MSG and glutamic acid market shares in 2009**

Company	Market shares for MSG	Market shares for glutamic acid
Fufeng	12.0%	21.9%
Meihua	13.8%	20.0%
Lianhua	9.8%	9.4%
Linghua	3.1%	5.0%
Xinle	3.1%	3.8%
Yipin	3.1%	3.8%
Sanjiu	2.4%	3.8%
Aosang	2.0%	2.5%
<b>Total</b>	<b>49.4%</b>	<b>70.0%</b>

Source: China Fermentation Industry Association

There are about 20 MSG producers in China with capacities above the designated 30,000 tonnes. They can be divided into three tiers. Tier-1 players are Fufeng, Meihua and Lianhua, each having MSG production capacity of more than 200,000 tonnes pa. However, among the top three, Fufeng and Meihua are quite similar in size and are also much bigger than the third player, Lianhua. The top three players had 35.6% of the MSG market and 51.2% of the glutamic acid market in China in 2009. Tier-2 players rank from No 4 to No 8, with MSG production capacities of 50,000-80,000 tonnes. 2009 market shares of the five tier-2 players were 13.8% for MSG and 18.8% for glutamic acid. The rest of the MSG producers have capacities of 30,000-50,000 tonnes each.

## Balanced demand/supply for xanthan gum

### Promising demand outlook

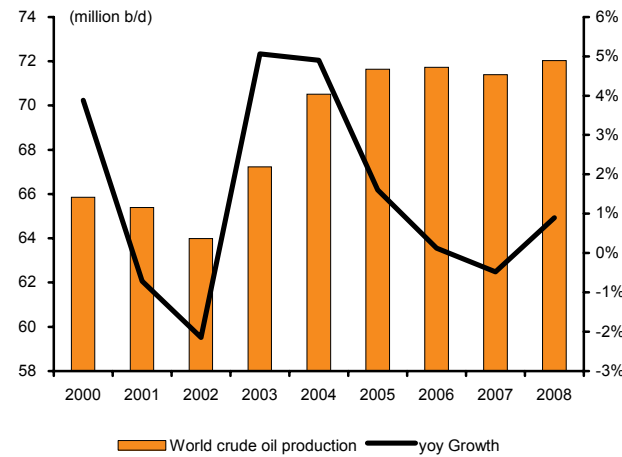
With its special characteristic of adding volume and viscosity, xanthan gum is widely used in petroleum exploration, food processing, personal care items and pharmaceutical items. The largest two global markets for xanthan gum are petroleum exploration and food processing, each of which account for over 40% of total consumption of xanthan gum produced globally. In China, the market for xanthan gum is primarily food processing.

**Demand for xanthan gum is driven by global oil production**

In petroleum exploration, xanthan gum is used to thicken drilling mud without contaminating the environment. Hence, demand for xanthan gum is closely related to oil production. OPEC forecasts that world oil demand will see a 1.3% CAGR over 2010-13, growing from 84.6m barrels/day to 87.9m barrels/day. We expect oil demand to achieve sustainable growth, despite the near-term slowdown due to concerns about the global economic recovery. We estimate the global demand for xanthan gum to be 80,000-100,000 tonnes in 2009.

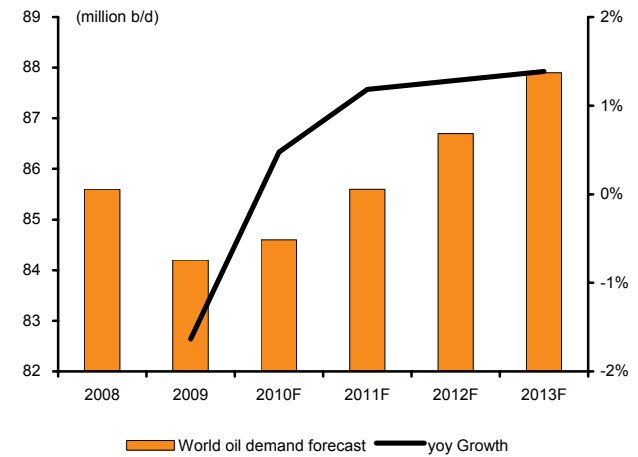


**Chart 26 : World crude oil production**



Source: OPEC

**Chart 27 : World oil demand**



Source: OPEC

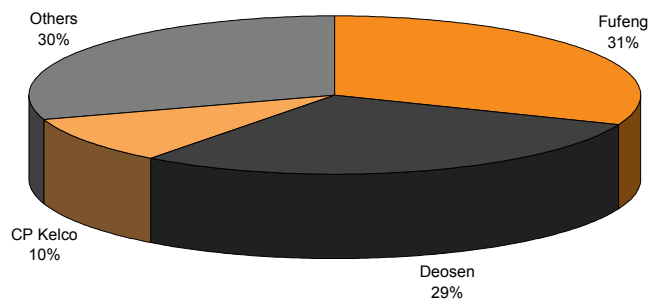
**Top three players account for over 70% of global market share**

### Leading players supplying 70% of the market

The supply of xanthan gum is highly concentrated, with the top three players accounting for over 70% of the global market share in 2009. We estimate global xanthan gum production capacity is 100,000 tonnes, which is balanced with demand.

The largest xanthan gum producer is Fufeng, with a capacity of 32,000 tonnes pa in 2009, and 31% share of the global market. Deosen, located in Shandong, is the second largest player, with a market share of about 29% in 2009. CP Kelco, based primarily in the US and Europe, is another major player, with a market share of 10% in 2009.

**Chart 28 : Xanthan gum market share by major players, 2009**



Source: China Fermentation Industry Association

Fufeng should have 44,000 tonnes pa of xanthan gum capacity by end-2010, after the new production line at the Inner Mongolia plant starts operations. This would further increase the company's market share to 37%, thus strengthening its leading market position.

# There are risks

The risks for Fufeng lie mainly in the volatility of corn and coal prices and the strict environmental control by the government .

## Surge in corn prices may squeeze margins

We estimate a 3% increase in the corn kernel price could cause Fufeng's net profit to decline 7% in FY10F and 8% in FY11F

Corn kernel is the major raw material for Fufeng, accounting for 53% of the company's FY09 cost of sales. Fufeng purchases corn kernels locally in the spot market, where prices may be affected by market demand/supply, climate changes, natural disasters and domestic government policies. The company has limited control over corn kernel costs, so a surge in corn prices could squeeze its gross margins and adversely affect profitability. According to our sensitivity analysis, a 3% increase in corn kernel prices may cause net profit to decline 7% in FY10F and 8% in FY11F.

That said, we believe Fufeng is able to pass on a large part of corn price increases to customers by raising selling prices, due to its leading market position in the MSG sector.

**Table 23 : Fufeng's cost structure in FY09**

	% contribution
Corn kernels	53%
Liquid ammonia	10%
Other raw materials	2%
<b>Total raw materials</b>	<b>65%</b>
Coal	12%
Labour	5%
Depreciation	5%
Other costs	14%
<b>Total</b>	<b>100%</b>

Source: Company data

**Table 24 : Sensitivity analysis – corn kernel**

% change in corn kernel price	FY10F net profit (Rmbm)	FY11F net profit (Rmbm)
10%	793	824
5%	910	980
3%	958	1,042
<b>0%</b>	<b>1,028</b>	<b>1,136</b>
-3%	1,099	1,230
-5%	1,146	1,292
-10%	1,264	1,448

Source: RBS estimates

Coal represented about 12% of total costs in FY09. Hence, a sudden surge in the coal price may also adversely impact Fufeng's gross margin. However, earnings sensitivity to coal prices is less than to corn kernel prices. We estimate that a 3% increase in the coal price might lower net profit by 1% each in FY10F and FY11F.

**Table 25 : Sensitivity analysis – coal**

% change in coal price	FY10F net profit (Rmbm)	FY11F net profit (Rmbm)
10%	993	1,090
5%	1,011	1,113
3%	1,018	1,122
<b>0%</b>	<b>1,028</b>	<b>1,136</b>
-3%	1,039	1,150
-5%	1,046	1,159
-10%	1,063	1,182

Source: RBS forecasts

**Failure to meet environmental standards set by the government may lead to suspension of operations and shutdown of plants**

## Environmental control

Environmental protection has become an increasingly important issue for the Chinese government in recent years. The waste products and fuel gas generated from the fermentation process can cause serious environmental problems, so the government has set stringent environmental laws and regulations. Producers that cannot meet the standards set by the government may have to suspend operations or close down. Currently, Fufeng is in compliance with all material environmental laws and regulations. However, if the government launches higher standards of environmental controls, Fufeng is subject to the risk of not meeting such standards.

That said, we believe Fufeng is ahead of other competitors regarding environmental protection, given its leading technologies in fuel gas desulfurisation and continuous investment in R&D.

## Share options granted to senior management

Fufeng adopted two share option schemes – a pre-IPO scheme on 10 January 2007 and a post-IPO scheme on 14 July 2009. As of 31 December 2009, the outstanding number of share options was at 143.8m, representing 8.7% of its total shares. The exercise of options by senior company management could put pressure on the share price, in our view.

**Table 26 : Share options**

Owner	Date of grant (dd/mm/yyyy)	No. of share options	Exercise price (HK\$)	Exercise period (dd/mm/yyyy)
<b>Pre-IPO</b>				
Mr. Wang Longxiang, executive director	10/1/2007	16,000,000	2.23	8/9/2009-7/8/2012
Mr. Gong Qingli, executive director	10/1/2007	16,000,000	2.23	8/8/2007-7/8/2011
Other eligible employees	10/1/2007	49,440,000	2.23	8/9/2009-7/8/2012
<b>Post-IPO</b>				
Ms. Li Hongyu, former executive director	14/7/2009	1,600,000	3.00	14/1/2012-13/1/2015
Other eligible employees	14/7/2009	60,760,000	3.00	14/1/2012-13/1/2015
<b>Total</b>		<b>143,800,000</b>		

Source: Company data

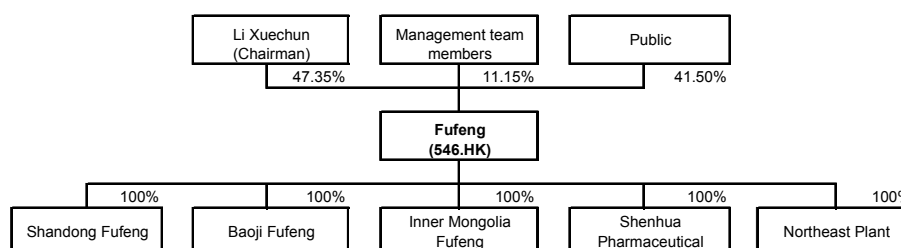
# Appendix

**Table 27 : Management profile**

Name	Age	Position	Profile and professional experience
LI Xue Chun	58	Founder, chairman and executive director	<ul style="list-style-type: none"> <li>– First joined Shandong Furui Brewery Group in 1982</li> <li>– Established Shandong Fufeng in 1999</li> <li>– Has 28 years' experience in fermentation industry</li> <li>– Owns 47.35% of Fufeng's issued share capital</li> </ul>
WANG Long Xiang	48	Executive director and general manager	<ul style="list-style-type: none"> <li>– Responsible for overall management of Fufeng's daily operations</li> <li>– Joined Fufeng in 2005</li> <li>– Has over 18 years' experience in fermentation industry</li> <li>– Indirectly owns 0.5% of Fufeng's issued share capital and was granted 16m shares of option (0.96% of total issued share capital)</li> </ul>
FENG Zhen Quan	40	Executive director and vice general manager	<ul style="list-style-type: none"> <li>– Currently a director of Shandong Fufeng, Baoji Fufeng and Inner Mongolia Fufeng</li> <li>– Responsible of operations of Baoji Fufeng</li> <li>– Joined Shandong Fufeng in May 2002</li> <li>– Has over 16 years of experience in fermentation industry</li> <li>– Indirectly owns 1.67% of Fufeng's issued share capital</li> </ul>
XU Guo Hua	41	Executive director and vice general manager	<ul style="list-style-type: none"> <li>– Currently a director of Shandong Fufeng, Baoji Fufeng and Inner Mongolia Fufeng</li> <li>– Responsible for operations and R&amp;D</li> <li>– Joined Fufeng in June 1999</li> <li>– Has over 19 years of experience in fermentation industry</li> <li>– Indirectly owns 1.67% of Fufeng's issued share capital</li> </ul>
LI De Heng	41	Executive director and vice general manager	<ul style="list-style-type: none"> <li>– Currently a director of Shandong Fufeng, Baoji Fufeng and Inner Mongolia Fufeng</li> <li>– Being responsible of operations of Inner Mongolia Fufeng</li> <li>– Joined Fufeng in January 2001</li> <li>– Has over nine years' experience in fermentation industry</li> <li>– Is the brother-in-law of Mr Li Xuechun, the chairman</li> <li>– Indirectly owns 1.67% of Fufeng's issued share capital</li> </ul>
GONG Qing Li	42	Executive director and chief financial officer	<ul style="list-style-type: none"> <li>– In charge of financial management and strategic planning, as well as internal control and corporate governance</li> <li>– Joined Fufeng in January 2007</li> <li>– Has over 20 years of experience in accounting, business advisory and risk management</li> <li>– Owns 16m shares of option of Fufeng (0.96% of total issued share capital)</li> </ul>

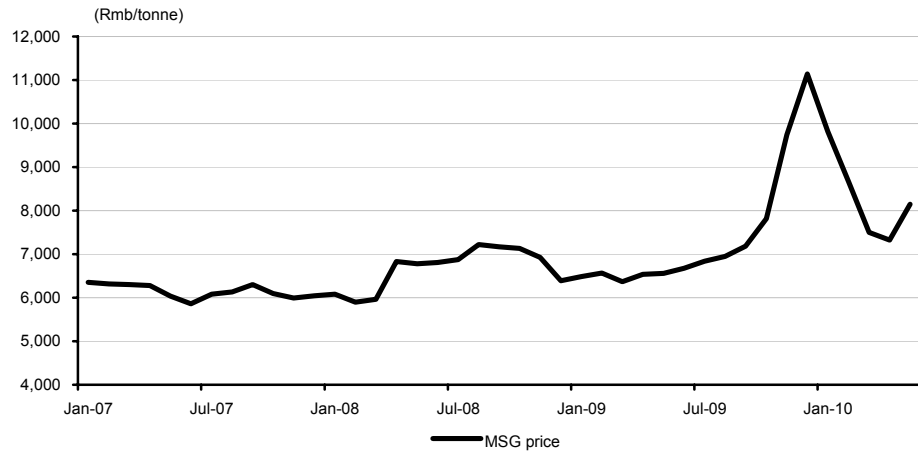
Source: Company

**Chart 29 : Shareholding structure**



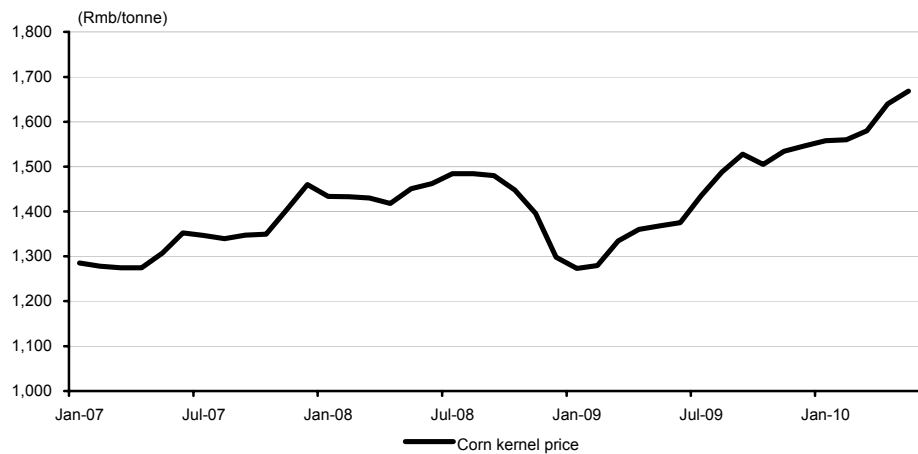
Source: Company

**Chart 30 : MSG market price**



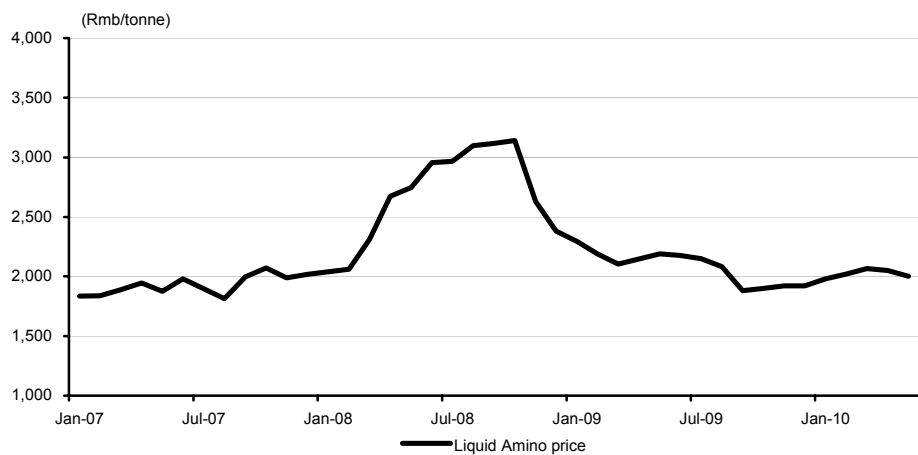
Source: China Fermentation Information Net

**Chart 31 : China corn market price**



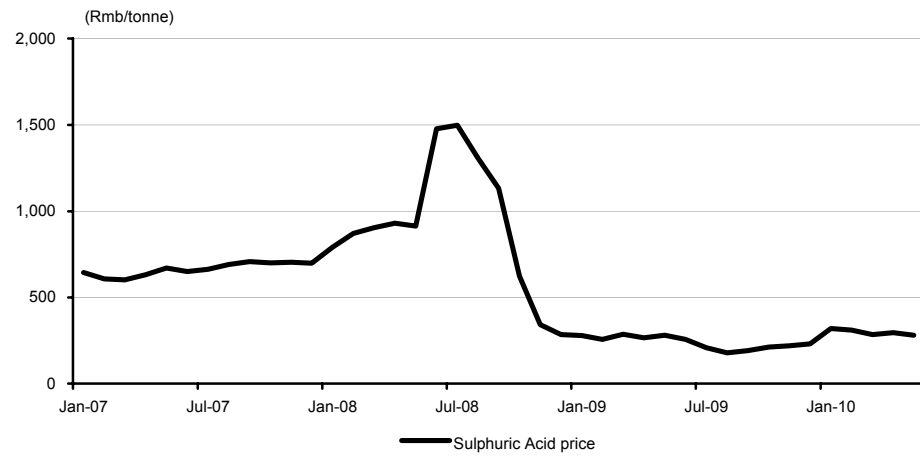
Source: China Corn Market Net

**Chart 32 : China liquid amino market price**



Source: China National Chemical Information Center

**Chart 33 : China sulphuric acid market price**



Source: China Chemical Product Net

## Income statement

Rmbm	FY08A	FY09A	FY10F	FY11F	FY12F
Revenue	3585	4633	6476	8228	10407
Cost of sales	-2941	-3233	-4828	-6348	-7911
Operating costs	-123.7	-159.0	-199.4	-184.9	-251.6
<b>EBITDA</b>	<b>520.7</b>	<b>1241</b>	<b>1448</b>	<b>1695</b>	<b>2244</b>
DDA & Impairment (ex gw)	-154.8	-193.3	-262.4	-337.8	-386.2
<b>EBITA</b>	<b>365.9</b>	<b>1047</b>	<b>1186</b>	<b>1357</b>	<b>1858</b>
Goodwill (amort/impaird)	n/a	n/a	n/a	n/a	n/a
<b>EBIT</b>	<b>365.9</b>	<b>1047</b>	<b>1186</b>	<b>1357</b>	<b>1858</b>
Net interest	-40.5	-23.7	-43.3	-66.0	-67.2
Associates (pre-tax)	0.00	0.00	0.00	0.00	0.00
Forex gain / (loss)	n/a	n/a	n/a	n/a	n/a
Exceptionals (pre-tax)	0.00	0.00	0.00	0.00	0.00
Other pre-tax items	0.00	0.00	0.00	0.00	0.00
<b>Reported PTP</b>	<b>325.4</b>	<b>1024</b>	<b>1143</b>	<b>1291</b>	<b>1791</b>
Taxation	-30.7	-95.3	-114.3	-154.9	-304.4
Minority interests	n/a	n/a	n/a	n/a	n/a
Exceptionals (post-tax)	n/a	n/a	n/a	n/a	n/a
Other post-tax items	0.00	0.00	0.00	0.00	0.00
<b>Reported net profit</b>	<b>294.7</b>	<b>928.3</b>	<b>1028</b>	<b>1136</b>	<b>1486</b>
Normalised Items Excl. GW	0.00	0.00	0.00	0.00	0.00
<b>Normalised net profit</b>	<b>294.7</b>	<b>928.3</b>	<b>1028</b>	<b>1136</b>	<b>1486</b>

Source: Company data, RBS forecasts

year to Dec

## Balance sheet

Rmbm	FY08A	FY09A	FY10F	FY11F	FY12F
Cash & market secs (1)	224.7	342.7	834.4	1142	1792
Other current assets	950.2	1265	1749	2194	2726
Tangible fixed assets	1955	2508	3449	3740	3932
Intang assets (incl gw)	n/a	n/a	n/a	n/a	n/a
Oth non-curr assets	132.8	145.3	152.1	158.8	165.2
<b>Total assets</b>	<b>3262</b>	<b>4261</b>	<b>6185</b>	<b>7235</b>	<b>8615</b>
Short term debt (2)	276.0	418.0	318.0	368.0	418.0
Trade & oth current liab	894.2	1154	1410	1685	1984
Long term debt (3)	312.0	180.0	260.0	260.0	260.0
Oth non-current liab	38.7	115.1	1140	1140	1140
<b>Total liabilities</b>	<b>1521</b>	<b>1867</b>	<b>3128</b>	<b>3453</b>	<b>3802</b>
Total equity (incl min)	1742	2394	3057	3781	4813
<b>Total liab &amp; sh equity</b>	<b>3262</b>	<b>4261</b>	<b>6185</b>	<b>7235</b>	<b>8615</b>
Net debt	363.3	255.3	768.6	510.6	-89.2

Source: Company data, RBS forecasts

year ended Dec

## Cash flow statement

Rmbm	FY08A	FY09A	FY10F	FY11F	FY12F
EBITDA	520.7	1241	1448	1695	2244
Change in working capital	-2.23	-590.7	-228.2	-169.5	-233.1
Net interest (pd) / rec	-42.7	-25.3	-47.3	-70.0	-72.2
Taxes paid	-18.2	-25.1	-114.3	-154.9	-304.4
Other oper cash items	-8.62	-13.5	0.00	0.00	0.00
<b>Cash flow from ops (1)</b>	<b>448.9</b>	<b>586.2</b>	<b>1058</b>	<b>1300</b>	<b>1634</b>
Capex (2)	-355.6	-217.8	-1200	-625.0	-575.0
Disposals/(acquisitions)	1.02	4.31	0.00	0.00	0.00
Other investing cash flow	-44.7	-9.30	-6.00	-6.00	-5.00
<b>Cash flow from invest (3)</b>	<b>-399.3</b>	<b>-222.7</b>	<b>-1206</b>	<b>-631.0</b>	<b>-580.0</b>
Incr / (decr) in equity	0.00	0.00	0.00	0.00	0.00
Incr / (decr) in debt	-60.3	10.0	1005	50.0	50.0
Ordinary dividend paid	-13.5	-292.7	-365.7	-411.3	-454.4
Preferred dividends (4)	n/a	n/a	n/a	n/a	n/a
Other financing cash flow	20.1	37.2	0.00	0.00	0.00
<b>Cash flow from fin (5)</b>	<b>-53.8</b>	<b>-245.5</b>	<b>639.4</b>	<b>-361.3</b>	<b>-404.4</b>
Forex & disc ops (6)	n/a	n/a	n/a	n/a	n/a
<b>Inc/(decr) cash (1+3+5+6)</b>	<b>-4.14</b>	<b>118.0</b>	<b>491.8</b>	<b>307.9</b>	<b>649.8</b>
Equity FCF (1+2+4)	93.3	368.4	-141.6	675.2	1059

Lines in bold can be derived from the immediately preceding lines.  
Source: Company data, RBS forecasts

year to Dec

Standard ratios	Fufeng					China Yurun Food Group			China Agri-Industries		
Performance	FY08A	FY09A	FY10F	FY11F	FY12F	FY10F	FY11F	FY12F	FY10F	FY11F	FY12F
Sales growth (%)	46.6	29.2	39.8	27.1	26.5	42.0	30.2	21.4	23.4	25.6	24.9
EBITDA growth (%)	228.9	138.3	16.7	17.0	32.4	33.8	33.5	23.0	57.5	24.0	16.8
EBIT growth (%)	825.7	186.2	13.2	14.4	36.9	33.9	33.3	23.6	71.5	21.7	16.7
Normalised EPS growth (%)	12706	215.0	0.72	10.5	30.8	29.0	32.2	25.8	41.6	14.5	13.8
EBITDA margin (%)	14.5	26.8	22.4	20.6	21.6	10.6	10.9	11.0	8.31	8.21	7.67
EBIT margin (%)	10.2	22.6	18.3	16.5	17.9	9.57	9.80	9.98	6.90	6.68	6.24
Net profit margin (%)	8.22	20.0	15.9	13.8	14.3	7.84	7.96	8.25	5.22	4.76	4.34
Return on avg assets (%)	10.6	25.2	20.3	17.7	19.4	12.0	13.5	14.5	9.04	9.15	9.01
Return on avg equity (%)	18.5	44.9	37.7	33.2	34.6	17.1	19.2	20.5	16.4	16.2	16.3
ROIC (%)	14.8	37.3	33.6	26.6	32.5	18.3	18.6	19.5	12.3	10.7	10.6
ROIC - WACC (%)	2.55	25.0	21.3	14.3	20.2	7.43	7.80	8.67	3.93	2.33	2.27
	year to Dec					year to Dec			year to Dec		
Valuation											
EV/sales (x)	2.13	1.62	1.24	0.94	0.69	2.02	1.56	1.27	0.92	0.78	0.66
EV/EBITDA (x)	14.6	6.06	5.54	4.58	3.19	19.1	14.4	11.5	11.1	9.50	8.62
EV/EBITDA @ tgt price (x)	20.4	8.48	7.62	6.36	4.54	22.6	17.0	13.6	13.9	11.8	10.6
EV/EBIT (x)	20.8	7.17	6.77	5.72	3.86	21.1	15.9	12.7	13.4	11.7	10.6
EV/invested capital (x)	3.62	2.84	2.10	1.81	1.52	3.37	2.89	2.58	1.38	1.26	1.16
Price/book value (x)	4.17	3.03	2.61	2.11	1.66	4.07	3.43	2.92	1.88	1.65	1.46
Equity FCF yield (%)	1.29	5.08	-1.77	8.46	13.3	-1.86	0.72	2.97	-17.7	-5.22	-4.55
Normalised PE (x)	24.6	7.82	7.76	7.03	5.37	25.6	19.4	15.4	12.4	10.8	9.52
Norm PE @tgt price (x)	34.8	11.1	11.0	9.94	7.60	30.5	23.1	18.4	16.9	14.8	13.0
Dividend yield (%)	0.23	5.04	5.67	6.26	8.19	1.34	1.70	1.94	2.01	2.30	2.62
	year to Dec					year to Dec			year to Dec		
Per share data	FY08A	FY09A	FY10F	FY11F	FY12F	Solvency	FY08A	FY09A	FY10F	FY11F	FY12F
Tot adj dil sh, ave (m)	1660	1660	1826	1826	1826	Net debt to equity (%)	20.9	10.7	25.1	13.5	-1.85
Reported EPS	0.18	0.56	0.56	0.62	0.81	Net debt to tot ass (%)	11.1	5.99	12.4	7.06	-1.04
Normalised EPS	0.18	0.56	0.56	0.62	0.81	Net debt to EBITDA	0.70	0.21	0.53	0.30	-0.04
Dividend per share	0.01	0.22	0.25	0.27	0.36	Current ratio (x)	1.00	1.02	1.50	1.62	1.88
Equity FCF per share	0.06	0.22	-0.08	0.37	0.58	Operating CF int cov (x)	12.0	25.2	25.8	21.8	27.9
Book value per sh	1.05	1.44	1.67	2.07	2.64	Dividend cover (x)	2.01	2.54	2.50	2.50	2.50
	year to Dec					year to Dec					

Priced as follows: 0546.HK - HK\$5.02; 1068.HK - HK\$24.65; 0606.HK - HK\$9.08  
Source: Company data, RBS forecasts

## Valuation methodology

Economic Profit Valuation				HK\$ m	%	Discounted Cash Flow Valuation				HK\$ m	%	
Adjusted Opening Invested Capital				3967.7	31	Value of Phase 1: Explicit (2010 to 2012)				1,659.3	13.1	
NPV of Economic Profit During Explicit Period				2206.0	17	Value of Phase 2: Value Driver (2013 to 2020)				5,267.2	41.6	
NPV of Econ Profit of Remaining Business (1, 2)				4533.3	36	Value of Phase 3: Fade (2021 to 2045)				5,246.2	41.4	
NPV of Econ Profit of Net Inv (Grth Business) (1, 3)				1977.5	16	Terminal Value				486.8	3.8	
Enterprise Value				12684.5	100	Enterprise Value				12659.6	100.0	
Plus: Other Assets				0.0	0	FCF Grth Rate at end of Phs 1 implied by DCF Valuation					2.0	
Less: Minorities				0.0	0	FCF Grth Rate at end of Phs 1 implied by Current Price					-0.2	
Less: Net Debt (as at 23 Jun 2010)				895.3	7							
Equity Value				11789.2	93							
No. Shares (millions)				1660.0								
Per Share Equity Value				7.1								
FX Rate				1.0								
Per Share Equity Value (HK\$)				7.1								
Current Share Price (HK\$)				5.02								
Sensitivity Table		No of Years in Fade Period										
		15	18	20	23	25						
WACC	8%	8.73	9.07	9.28	9.57	9.76						
	9%	7.91	8.17	8.33	8.56	8.69						
	10%	7.19	7.39	7.52	7.69	7.79						
	11%	6.55	6.71	6.81	6.94	7.01						
	12%	5.99	6.12	6.19	6.29	6.35						
Performance Summary							Phase 2 Avg (2013 - 2020)					
	2010	2011	2012									
Invested Capital Growth (%)	44.2	11.1	11.1				5.6					
Operating Margin (%)	18.3	16.5	16.5				13.9					
Capital Turnover (x)	2.4	2.1	2.1				2.3					

### Returns, WACC and NPV of Free Cash Flow

Legend:

- Phase 1 NPV of FCF (RHS)
- Phase 2 NPV of FCF (RHS)
- Phase 3 NPV of FCF (RHS)
- Growth Business ROIC
- Remaining Business ROIC
- Total Business ROIC
- WACC

1. In periods following the Explicit Period i.e. Phase 2 and Phase 3  
2. Remaining Business is defined as Capital as at the end of Phase 1 and capex = depreciation thereafter  
3. Net Investment is defined as capex over and above depreciation after Phase 1  
Source: Company data, RBS forecasts

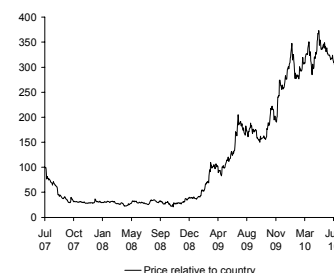


## Company description

Buy

Price relative to country

Fufeng, founded in 1999, is one of the leading vertically integrated manufacturers of corn-based biochemical products. By utilising fermentation and corn-processing technologies, the company produces glutamic acid, xanthan gum, MSG, starch sweeteners and fertilisers. According to the China Fermentation Industry Association, Fufeng was the largest glutamic acid producer and second-largest MSG producer in the PRC in terms of production volume in 2009 and the largest xanthan gum producer in the world. Fufeng has gradually expanded to downstream business of MSG production since 2008. In 2009, MSG accounted for 48% of total revenue, significantly up from 16% in 2006, while glutamic acid's contribution in total revenue decreased from 59% in 2006 to 16% in 2009.



## Strategic analysis

Average SWOT company score:

4

Revenue breakdown – FY09

### Strengths

4

Fufeng's leading position in MSG and xanthan gum production will likely enhance its pricing power and will promote brand recognition. The company's vertically integrated business model helps to reduce production costs and increases productivity.

### Weaknesses

3

Fufeng may be vulnerable to a surge in corn and coal prices, as it purchases corn kernel and coal locally in the spot market. It may be unable to fully pass on increasing costs to customers.

### Opportunities

4

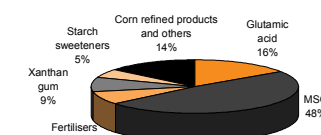
Demand for MSG should continue to grow, as China's expanding catering and food processing market benefits from strong growth in domestic consumption, increasing disposable income and continuous urbanisation in China.

### Threats

3

Capacity expansions by competitors and new entrants may take some of Fufeng's market share, resulting in a price war or loss of pricing power for Fufeng.

Scoring range is 1-5 (high score is good)



Source: Company data

## Market data

### Headquarters

Suite 2207-9, Tower 2 Lipco Centre, 89 Queensway, Hong Kong.

### Website

www.furugroup.com

### Shares in issue

1660.0m

### Free float

40%

### Majority shareholders

Li Xuechun, Chairman (47%)

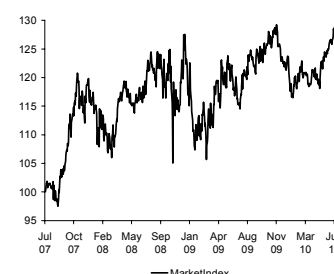
## Country view: China

Underweight

Country rel to Asia Pacific

We retain our cautious view on the region's biggest economy and market. Although the market underperformed in the first quarter, valuations remain unattractive in our view and have in fact deteriorated on an absolute basis and relative to bonds (where yields have risen). As elsewhere in the region, the economic momentum is still rising but at a stabilising rate, while policy attempts to control the pace of expansion and allocation of capital continue. Meanwhile, short-term rates have risen, reflecting marginally tighter liquidity and rising inflation. With the majority of regional investors still overweight, we believe the outlook here is well summarised in the words of Yogi Berra: 'The future ain't what it used to be'.

The country view is set in consultation with the relevant company analyst but is the ultimate responsibility of the Strategy Team.



## Competitive position

Average competitive score:

4+

Broker recommendations

### Supplier power

4+

Fufeng has a vertically integrated business model. Its MSG production is secured by in-house of glutamic acid.

### Barriers to entry

4+

Entry barriers for glutamic production are relatively high, due to capital requirements and strict environmental control by the local government.

### Customer power

4+

Fufeng's leading market position should strengthen its pricing power and brand recognition.

### Substitute products

3+

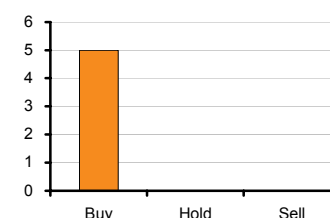
There are few perfect substitutes, and products that use other agricultural raw materials face similar supply issues (ie scarcity, price increases).

### Rivalry

4+

The market is relatively concentrated, with top three players - Meihua, Fufeng and Lianhua - having 35.6% of the MSG market and 51.2% of the glutamic acid market in China.

Scoring range 1-5 (high score is good) Plus = getting better Minus = getting worse



Source: Bloomberg



## Recommendation structure

Absolute performance, short term (trading) recommendation: A Trading Buy recommendation implies upside of 5% or more and a Trading Sell indicates downside of 5% or more. The trading recommendation time horizon is 0-60 days. For Australian coverage, a Trading Buy recommendation implies upside of 5% or more from the suggested entry price range, and a Trading Sell recommendation implies downside of 5% or more from the suggested entry price range. The trading recommendation time horizon is 0-60 days.

Absolute performance, long term (fundamental) recommendation: The recommendation is based on implied upside/downside for the stock from the target price and, except as follows, only reflects capital appreciation. A Buy/Sell implies upside/downside of 10% or more and a Hold less than 10%. For research produced by Nedbank Capital, a Buy implies upside in excess of 20%, a Sell implies an expected return less than 10%, and a Hold implies a return between 10% and 20%. For UK-based Investment Funds research, the recommendation structure is not based on upside/downside to the target price. Rather it is the subjective view of the analyst based on an assessment of the resources and track record of the fund management company. For research produced by Nedbank Capital and for research on Australian listed property trusts (LPT) or real estate investment trusts (REIT), the recommendation is based upon total return, ie, the estimated total return of capital gain, dividends and distributions received for any particular stock over the investment horizon.

Performance parameters and horizon: Given the volatility of share prices and our pre-disposition not to change recommendations frequently, these performance parameters should be interpreted flexibly. Performance in this context only reflects capital appreciation and the horizon is 12 months. Market or sector view: This view is the responsibility of the strategy team and a relative call on the performance of the market/sector relative to the region. Overweight/Underweight implies upside/downside of 10% or more and Neutral implies less than 10% upside/downside. Target price: The target price is the level the stock should currently trade at if the market were to accept the analyst's view of the stock and if the necessary catalysts were in place to effect this change in perception within the performance horizon. In this way, therefore, the target price abstracts from the need to take a view on the market or sector. If it is felt that the catalysts are not fully in place to effect a re-rating of the stock to its warranted value, the target price will differ from 'fair' value.

## Distribution of recommendations

The tables below show the distribution of recommendations (both long term and trading). The first column displays the distribution of recommendations globally and the second column shows the distribution for the region. Numbers in brackets show the percentage for each category where there is an investment banking relationship. These numbers include recommendations produced by third parties with which RBS has joint ventures or strategic alliances.

### Long term recommendations (as at 02 Jul 2010)

	Global total (IB%)	Asia Pacific total (IB%)
Buy	705 (0)	406 (0)
Add	0 (0)	0 (0)
Hold	399 (0)	218 (0)
Reduce	0 (0)	0 (0)
Sell	97 (0)	62 (0)
Total (IB%)	1201 (0)	686 (0)

Source: RBS

### Trading recommendations (as at 02 Jul 2010)

	Global total (IB%)	Asia Pacific total (IB%)
Trading Buy	4 (0)	4 (0)
Rec	00 (00)	00 (00)
Trading Sell	3 (0)	3 (0)
Total (IB%)	7 (0)	7 (0)

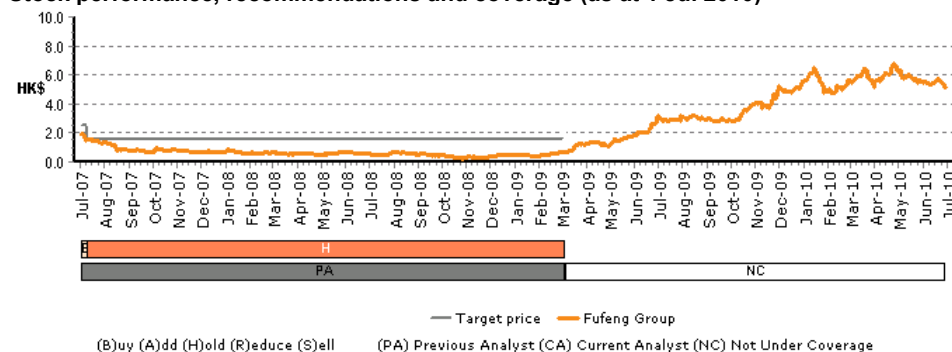
Source: RBS

## Valuation and risks to target price

**Fufeng Group (RIC: 0546.HK, Rec: Buy, CP: HK\$5.02, TP: HK\$7.10):** Key risks to our DCF-based target are: 1) a sudden increase in corn and coal prices, which may add pressure to gross margin; 2) more stringent environmental controls by China government that could result in suspension of production or significant costs; 3) capacity expansion by competitors, who may take market share, leading to a price war or some loss of Fufeng's pricing power; 4) EPS dilution from a share placement in the event of a big acquisition; and 5) exercise of share options by senior management.

## Fufeng Group coverage data

### Stock performance, recommendations and coverage (as at 1 Jul 2010)



Lei Yang, CFA started covering this stock on 2 Jul 10

Source: RBS

### Trading recommendation history (as at 02 Jul 2010)

Date	Rec	Analyst
	n/a	

Source: RBS

## Regulatory disclosures

RBS was a lead manager of a public offering of securities for this company in the previous 12 months.: **0546.HK**

RBS beneficially own 1% or more of a class of common equity securities of this company.: **0546.HK**

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