JPM-pp1

Asia Pacific Equity Research

26 March 2015

Fufeng Group (546 HK)

Overweight

Price: HK$4.49

25 Mar 2015

Price Target: HK$5.70

PT End Date: 31 Dec 2015

More positive than we had expected – Key feedback from investor meetings

Fufeng is the largest producer of Monosodium Glutamate (MSG) in China, with over a 60% market share. We held investor meetings with management on Mar 25, 2015. Overall, the feedback was more positive than we had expected and the company has yet to benefit from consolidation in the MSG industry as well as the potential upside to high-end amino acid sales. Concerns over falling Xanthum gum prices and margins, and the company's investment in property seem overdone, in our view.

Short term

- **MSG market getting better.** Management mentioned that MSG prices remain stable in 1Q15 at around Rmb8,000-8,100 (incl VAT) or ~Rmb6,900-7,000 (ex VAT), similar to prices in 4Q14 on average. This is not a bad price because 1Q15 is the slack season and normally at a lower price (10-15%) compared to 4Q. We think the stable pricing reflects consolidation in the market (two players control close to 90%) as well as the closure of two lines by Fufeng in Baoji in Aug 2014 with a total capacity of 6-7% of the national total (120-130k tons per annum). Management mentioned that the market is in a healthy shape, but not in shortage like we saw in 2010.

- **No new capacity for Fufeng.** Fufeng has permanently dismantled the two older lines (moving the large one to Dongbei) and these will not come back into production. The company has no plans for 2016 to add capacity, but the decision to add new production in 2016 depends on the market in 2015. We see little likelihood of new MSG production being added unless the market is in a real shortage situation.

- **Xanthum gum in a gradual decline**. Xanthum gum is a product that is used 60% in the oil and gas industry (as a clogging agent) and 40% in the food industry. The recent decline in oil prices has had a mild dampening effect on the demand for Xanthum gum due to less exploration and development activities. New capacity added before oil prices fell in mid-2014 has also had a negative impact on pricing. However, Fufeng mentioned that the quality of Xanthum gum is quite important for users and since it is a tiny part of oil exploration costs, many users would not switch from Fufeng's products (market leader) for cheaper new entrants very easily. We do expect GPM to fall from 52.7% in 2014 to 44% in 2015 and ultimately to 36% by 2017, which we think is sustainable as that was the margin before the surge in oil and gas exploration in the US fracking boom.

Medium term

- **Low cost amino acid producer**. Fufeng will spend an additional Rmb400-500m on amino acid production to lift capacity from the current 60k tpa to 110k tpa by early 2016. At current prices and at maximum utilization, about Rmb1.5bn in amino acids can be produced, as per our estimates, and this compares to Rmb341m in sales for 2014 and our estimated sales of Rmb580m sales in 2015. By early 2016, Fufeng expects to be the largest and lowest cost producer in the world with over 20% of global capacity for amino acids. The key upside in amino acids is not the volume but the price. There are over 30 types of major amino acid products and the price varies greatly. Fufeng is only a recent entrant and is making lower-end products with selling prices below US$2,000 per ton. Some compounds can sell for thousands of dollars a kilogram and we believe Fufeng has a lot of room to lift ASP through enhancement of product mix.

- **Improving FCF**. Fufeng intends to keep capex in 2018 below Rmb800m ($400-500m for amino acid expansion) and has room to cut further in 2016 as recurrent capex without expansion is just Rmb200m or so a year. This level of spending is less than half of the average of close to Rmb2.0bn over the past five years. We see significant FCF commencing 2015 and management intends to focus on debt reduction in the near term.

- Fufeng acquired two pieces of land (in Baoji, Shanxi and in Shangdong) in 2014 and the purchase price was approximately the proceeds from the government inventive payments related to closure of production facilities in those areas. Management confirmed to us that they have no intention to do construction work on these pieces of land (now raw land) and they will dispose of them to property developers at an appropriate time in the near future. Some investor concerns that the company may be distracted by moving into property development may be overdone, in our view.

Longer term

- Fufeng intends to follow a technology-heavy and capital-light expansion strategy going forward. After spending to build some of the lowest cost fermentation production facilities in the world, Fufeng intends to use this advantage to expand into compounds used in pharmaceutical, neutraceuticals, cosmetics and high-end additives. The MSG business would continue to be a cash cow, but the new higher margin businesses is the key attraction for Fufeng.

Price, valuation and risks. Our PT (Dec-15, DCF-derived – WACC 13.2% and 3% terminal growth) of HK$5.7 implies a fwd P/BV a fwd P/E of 12.4x (CY16E). The key downside risks to our PT are the rise in corn prices and the implementation pace of consumer pack products.

Please refer to our latest note, "Fufeng Group: Lifting PT to HK$5.7 – New products with higher margins driving growth" dated Mar 24, 2015

Investment Thesis

Fufeng is the largest producer of monosodium glutamate (MSG) in China. We expect a moderate improvement in MSG margins driven by falling costs and a dearth of new supply.

Valuation

Our Dec-15 price target of HK$5.70 is based on a DCF valuation, which assumes a market risk premium of 6.0% and a risk-free rate of 4.2% (yield on 10-year government notes in China). We assume a beta of 1.5, higher than the Bloomberg beta of 0.8, given that the company has seen significant sales growth as well as a large increase in its capacity over the past 1-2 years.

Risks to Rating and Price Target

The key downside risks to our rating and price target include: 1) lower ASP and margins for xanthum gum as more competitors add capacity; 2) higher cost of corn could crimp margins; and 3) concern over debt levels could rise with credit tightening in China.

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Date	Rating	Share Price (HK$)	Price Target (HK $)
26-Oct-10	OW	6.42	9.00
21-Mar-11	OW	5.16	8.00
17-Aug-11	OW	4.28	6.50
09-Feb-12	N	4.22	4.70
21-Mar-12	N	3.59	4.20
15-Aug-12	N	2.79	3.50
02-Apr-13	OW	2.77	3.70
14-Aug-13	OW	3.56	4.30
23-Sep-14	OW	3.70	5.00
24-Mar-15	OW	4.55	5.70

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