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January 2007

Food processing sector
Listing: London AIM (CFC.L)

China Food Company plc

Economic changes are driving demand for more sophisticated food products in China. While the current share price reflects a reasonable value for current performance, there is no allowance for China Food's expansion plans.

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Initiation Report

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I certify that this report represents my own opinions.

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About Objective Capital:

Objective Capital is a leading UK provider of objective corporate research.

We offer investors two levels of insight – a regular survey of the complete small and mid-cap segment, highlighting those stocks where attention should be focused, and our detailed institutional-quality, sponsored research coverage. As always, our research doesn't offer trading recommendations or advice but an objective uptodate assessment of the prospects, and risks, of the companies we cover.

While the companies we cover sponsor our research, it is always written on behalf of our readers. It is of the essence of our research that it be **independent** — that is opinions, estimates and valuations be solely those of Objective's analyst; **objective** — that is based upon verifiable data; and **transparent** — that is based upon explicit assumptions.

Our research complies with all FSA recommendations as may arise out of CP172 and CP176, i.e., that it be independent of any broking or trading interests; and CP205, i.e., that it comply with standards for objectivity.

Key Points

China Food Company comprises a portfolio of well-established Chinese food companies and new management. It serves the second largest province of China where economic and demographic changes are combining to drive demand for more sophisticated food products. The current share price reflects a reasonable value for current performance but no allowance for management's expansion plans.

- ***Expanding an established business***
  China Food comprises a portfolio of Chinese food companies, the oldest of which commenced trading in 1994. The existing product range extends from animal feed to condiments, from trough to table! Immediate growth prospects focus on the expansion of soy sauce production where its brand is one of the most recognised in the province.

- ***Significant growth potential from a large, local region***
  China Food is based in Shandong province, the second largest in China. Its population of 92m generated GDP of US$274bn in 2006. Further steady growth and other demographic changes are expected to continue the demand growth for both basic and, increasingly, more sophisticated food products. The expanded soy sauce facility is the immediate focus of the new management's response to that growth potential.

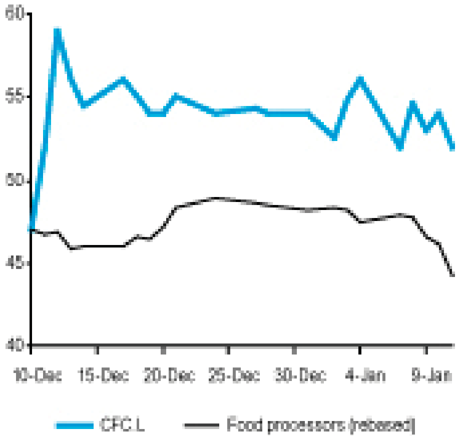
- ***Possible expansion into new product areas ….***
  The current product portfolio extends from animal feed to condiments. Within condiments China Food has an option to purchase wholly owned interests in kelp-based MSG. The market for MSG is large, 2m tonnes annually, and kelp is thought likely to overcome the reportedly neurotoxic side effects of traditional ingredients.

- ***…. and into new geographic territories***
  China Food has its manufacturing base and major market in Shandong province. New management is exploring the possibility of expanding into other provinces. It is aware however that local tastes may vary and that different distribution models may carry inherent risks.

- ***Our valuation is at a premium to the recent share price***
  The sheer scale of China is always bound to impress and China Food has the advantage of starting from a portfolio of existing businesses. However we have taken what we believe is a cautious view of growth rates and their associated costs. We have not included possibilities for expansion into new areas, including kelp-based MSG; nor have we included any gearing in the business model. Nonetheless this is essentially a story about new management and methods applied to existing products and markets.

14 January 2008
Price: 52p

Price chart (p)



Current value of equity

Expected Value	£47.1m
Value per share	**71p**
Pessimistic Scenario	£35.3m
Optimistic Scenario	£57.5m
Value per share	53p - 87p

Company details

Quote	
Shares	
- London AIM	CFC.L
Hi-Lo last 12-mos. (p)	60 - 32
Shares issued (m)	66.4
Fully diluted (m)	67.7
Market Cap'n (£m)	36.2
Financial PR:	Hansard Group
	www.hansardcommunications.com
Nominated Advisor:	Strand Partners
	www.strandpartners.com
Website:	*www.chinafoodcompany.com*

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Overview

China Food Company plc, formerly known as Vestpa, was incorporated in February 2007 as an acquisition vehicle with a broad remit to acquire a company in one of a number of sectors, including consumer goods. On 10 December 2007 it completed a capital reorganisation and acquired the entire share capital of Full Fortune Group, a Singapore incorporated holding company which fulfilled its takeover criteria. The consideration was approximately £25.17m in what was effectively a reverse takeover. China Food Company plc is listed on the London AIM under the ticker CFC.L.

China Food has two main businesses, both based in the People's Republic of China in Shandong Province. Fuss Feed is an animal feed business selling 97 percent of its product within the province through a network of distributors and expected to generate approximately £12.17m turnover in 2007. Fu-Rich is a condiments business manufacturing soy sauce, vinegar and bean paste. It sells 83 percent of its products within the province of Shandong mainly through a network of distributors.

The animal feed business will contribute just over half the company's sales in 2007 but is a lower margin business than the condiments business. Fuss Feed's strategy is threefold: to continue to grow organically within Shandong by adding distributors and continuing to educate and support its existing ones; to continue expansion into neighbouring provinces; and to increase its sales to large farms and compound feed manufacturers. China's growth is leading to a more affluent consumer, which in turn is leading to increased demand for meat, dairy and poultry products. In such an environment Fuss Feed has been able to generate steady annual growth.

Fu-Rich is also benefiting from the increased prosperity China's growth is bringing to the consumer. This is reflected in a demand for better quality condiments with a more subtle taste. To accommodate this demand for higher quality products, Fu-Rich is building a new 50,000 tonne soy sauce processing plant at the group's new premises in Shouguang. The plant will produce a higher grade, traditionally brewed soy sauce with a longer six-month fermentation period. It is intended to use this product to promote growth and build up the brand.

The company intends to continue to build its presence in neighbouring provinces through adding distributors but also by extending its network through various supermarket chains. The company believes that its premium products will be important in driving this process.

The company has also been granted an option to purchase a new business, set up by the founder of Fuss Feed and Fu-Rich, called Xian Meishen Technology. For the last three years Xianka has been developing Xianka powder, a kelp based MSG substitute. China is the world's largest producer and consumer of MSG, with the Chinese market estimated to be worth US$1.8bn. Although the US FDA classifies MSG as Generally Regarded as Safe, this is certainly not a majority view. Xianka powder being derived from kelp and not chemically synthesised may be able to develop a market share as a healthier substitute. The company has a call option exercisable at any time during the two years following 10 December 2007 for a cash consideration not exceeding RMB80m (£5.2m at current rates).

The rationale for the investment in the food manufacturing industry in China is straightforward. China is still in the midst of a period of strong growth, with GDP forecast to grow by just under ten percent in 2008, about five times the G7 average. This growth is characterised by increased industrialisation, a migration from rural communities to the cities and an increased affluence among the population. Chinese consumers, already keen on their food, are demanding more meat, dairy and poultry products and a higher quality in processed foods such as sweets and cakes, as well as better quality, healthier condiments. Furthermore as Chinese consumers get wealthier they are becoming more aware of premium brands.

China Food's two businesses both benefit from this growth trend. The animal feeds business expects growth as increased demand for meat, poultry and dairy products drives farmers to increase yields and as farming becomes more industrialised. The condiments business benefits from the move from basic to branded and premium products. Both businesses benefit from their presence in the most populous country on the planet which coincidentally happens to have one of the fastest growing economies in the world.

Valuation

We have valued China Food on a discounted cash flow basis, modelling the cash flows expected to be generated under three different scenarios:

- **A central case**
  Our core scenario assumption is that growth in both animal feeds and condiments will continue to be robust but tail off gradually over the forecast period. We have assumed that condiments plateau in the second half of 2008 while a new plant comes on stream but that growth resumes apace in 2009. We have forecast that gross margins weaken gradually as the proportion of sales outside the province and to supermarkets increases and that for similar reasons there is a gradual increase in selling costs.

- **An optimistic case**
  In this scenario we forecast a faster pick up in sales once the new plant is on-line, preservation of gross margins for longer and the purchase of Xianka in 2009.

- **A pessimistic case**
  This scenario sees slower growth after the new plant is completed and with increased sales coming as a result of greater competition and to the detriment of margins. We also see slower growth in the animal feeds business and the Xianka business does not proceed.

In all cases we have forecast a gradual increase in the working capital requirement as the increased percentage of premium product carries a higher work in progress content and the changing mix of customers begins to require the offering of greater credit terms.

Results

Using a WACC of 14.8 percent our free cash flow forecasts give a central case valuation of 73p per share based on the number of shares currently issued. Our optimistic case gives a valuation of 88p per share, while our pessimistic case gives a lower valuation of 55p per share.

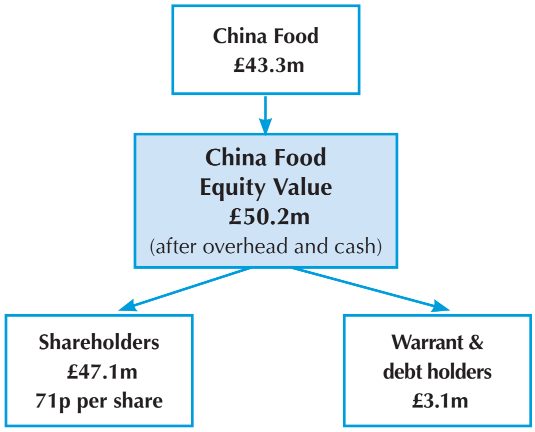
The recent share price suggests that the market is valuing the company on the basis of existing performance with little regard for likely growth. This is not an unreasonable caution given the history of some Chinese 'growth story' floats. As performance is demonstrated we would expect a more appropriate level of valuation.

Comparisons with similar quoted companies are not particularly easy or meaningful due to the relatively small size of China Food and the availability of reliable data for similar sized companies. The two well known Japanese branded condiments companies, Kikkoman and Ajinomoto are capitalised at Yen 297bn ($2.7bn) and Yen 932bn ($8.3bn) respectively. While they trade on earnings multiples in the mid twenties or higher they are well-established mature companies with dominant brands. Reuters data suggests that the food processing sub-segment of the consumer non-cyclical sector trades at 21.7 times earnings and has net margins of 9.3 percent. By comparison China Food was recently trading on 7.4 times 2007 earnings and has net margins of twenty percent.

Valuation summary (£m)

	Scenario		
	Core	Pessimistic	Optimistic
Value of firm	43.3	31.2	54.0
Add: starting cash + new funds	6.9	6.9	6.9
Total current value for firm	50.2	38.1	60.9
Less: starting & new debt	2.2	2.2	2.2
Total value to equity claims	48.0	35.9	58.7
Less: options & warrants	0.9	0.6	1.2
Ordinary equity holders	47.1	35.3	57.5
Value per share (£ps)	**0.71**	**0.53**	**0.87**

Components of CFC's entity value



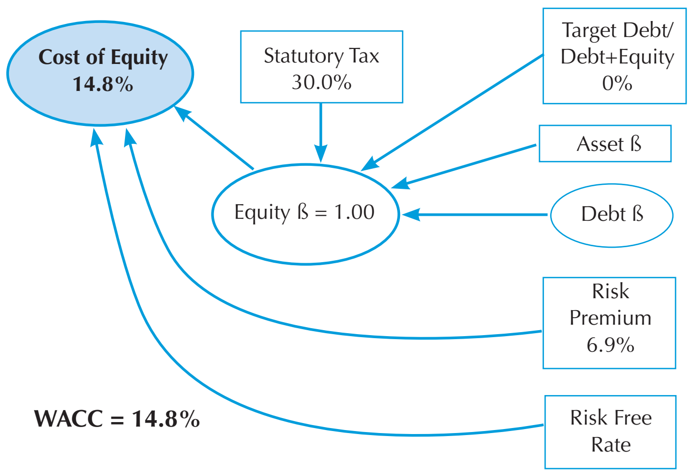
Scenarios

	Pessimistic				Core				Optimistic			
£000's	2007F	2008F	2009F	2010F	2007F	2008F	2009F	2010F	2007F	2008F	2009F	2010F
Fuss Feed												
Sales	12,698	14,222	15,644	17,208	12,698	14,603	16,355	18,318	12,698	14,603	16,793	19,312
COGS	(9,714)	(11,235)	(12,515)	(13,939)	(9,714)	(11,244)	(13,084)	(14,654)	(9,714)	(11,244)	(13,099)	(15,256)
Gross profit	2,984	2,987	3,129	3,270	2,984	3,359	3,271	3,664	2,984	3,359	3,694	4,056
Gross margin %	24%	21%	20%	19%	*24%*	*23%*	*20%*	*20%*	*24%*	*23%*	*22%*	*21%*
Fu Rich												
Sales	12,342	13,885	17,357	20,828	12,342	14,811	19,995	25,993	12,342	14,811	20,735	27,993
COGS	(6,171)	(8,331)	(10,848)	(13,538)	(6,171)	(8,516)	(11,997)	(15,856)	(6,171)	(8,516)	(11,404)	(15,396)
Gross profit	6,171	5,554	6,509	7,290	6,171	6,295	7,998	10,137	6,171	6,295	9,331	12,597
Gross margin %	*50%*	*40%*	*38%*	*35%*	*50%*	*43%*	*40%*	*39%*	*50%*	*43%*	*45%*	*45%*
Xianka												
Sales										200	4,000	5,600
COGS										—	(3,000)	(3,640)
Gross profit										200	1,000	1,960
Gross margin %										*100%*	*25%*	*35%*
Total revenues	25,040	28,107	33,000	38,036	25,040	29,414	36,350	44,311	25,040	29,614	41,528	52,905
COGS	(15,885)	(19,566)	(23,363)	(27,477)	(15,885)	(19,760)	(25,081)	(30,510)	(15,885)	(19,760)	(27,503)	(34,292)
Gross profit	9,155	8,541	9,637	10,559	9,155	9,653	11,269	13,801	9,155	9,853	14,025	18,612
Gross margin %	37%	30%	29%	28%	*37%*	*33%*	*31%*	*31%*	*37%*	*33%*	*34%*	*35%*
Selling costs	(326)	(562)	(1,650)	(1,902)	(326)	(588)	(1,272)	(1,772)	(326)	(1,185)	(1,869)	(2,645)
Admin costs	(1,526)	(843)	(990)	(1,141)	(1,526)	(735)	(1,090)	(1,329)	(1,526)	(735)	(1,090)	(1,329)
EBITDA	7,304	7,135	6,997	7,516	7,304	8,330	8,906	10,699	7,304	7,933	11,066	14,638
EBITDA margin %	*29.2%*	*25.4%*	*21.2%*	*19.8%*	*29.2%*	*28.3%*	*24.5%*	*24.1%*	*29.2%*	*26.8%*	*26.6%*	*27.7%*

Sensitivity to cost of capital assumptions

Sovereign risk premium (%)	*0.00%*	*1.00%*	*2.00%*	***3.00%***	*4.00%*
Value (p/share)	95	86	79	**73**	67
% change	*+31.1%*	*+18.7%*	*+8.5%*		*-7.2%*
Equity beta	0.90	0.95	**1.00**	1.05	1.10
Value (p/share)	*77*	*75*	**73**	*71*	*69*
% change	*+5.7%*	*+2.8%*		*-2.6%*	*-5.1%*
Target gearing (Debt/Equity) (%)	***+0%***	*+10%*	*+20%*	*+30%*	*+40%*
Value (p/share)	**73**	73	74	75	75
% change		*+0.9%*	*+1.9%*	*+2.8%*	*+3.8%*

Weighted cost of capital



Delay to new facility

Fu-Rich is building a new 50,000 tonnes capacity soy sauce plant, the intention being to use the additional capacity to increase production of premium traditionally brewed soy sauce. It is due to be completed in June 2008. Any delay to the completion of the plant could set back the growth in premium product sales. This is however potentially mitigated in the very short term by using spare capacity at the existing facility.

Scaling the business model

China Food currently provides limited credit terms to its customers and distributors. In part this reflects the early stage of financial services in Shangdong as many of its customers do not have bank accounts. To grow the business at the anticipated rates it may be necessary to extend the payment terms offered to its distributors and customers beyond our assumptions. This would materially slow cash flow and increase the risk of bad debts.

Tastes and preferences

Fu-Rich's existing products are mainly attuned to the taste of consumers in North China, particularly in Shandong. It may face difficulties in expanding into other regions in and beyond the PRC. Furthermore as consumers become more affluent their tastes may change and unless Fu-Rich is able to respond to these changes with suitable product it could suffer loss of market share.

Fluctuations in the price of raw materials

A significant percentage of the raw materials used in the production of China Food's products are commodity-based. The prices of raw materials such as corn and soya bean used in the production of animal feed and condiments may fluctuate due to changes in supply and demand conditions. Shandong is vulnerable to periods of low rainfall. Cereal commodities are also facing demand from alternative/bio fuel manufacturers which has been creating shortages and driving up prices.

Outbreaks of infectious diseases

China Food's animal feed business may be adversely affected by an outbreak of an infectious animal disease such as bird flu, foot and mouth, blue-ear etc. Demand for feed would be expected to fall significantly as a result of any consequent culling. Travel restrictions and quarantines would also limit the ability to redirect product to alternative markets.

Foreign exchange risks

While China Food is essentially a domestic business with little foreign exchange risk in its operations, investors are exposed to translation risk as its shares are quoted in sterling on the London market.

Industry change

In the medium term, as the maturity of the Chinese consumer economy increases, China Food's condiments business will face increasing pressure from the buying power of the supermarkets and the branding power of the major international brands. While we have factored in margin erosion, increased selling costs and higher working capital requirements these may not be sufficient. Whether China Food can leverage its London listing to act as a consolidator in this environment is difficult to predict at this stage.

Political & economic risk

While China offers enormous opportunities, risk factors include weak financial and legal systems, perceptions over human rights and the potential for currency revaluation. In the long run, deep social inequalities and the mis-match of growing personal wealth and limited "political" freedom is an unpredictable brew. While, at least in the next decade, external measures such as bond yields suggest a so far benign interpretation of these issues, particularly since accession to the WTO, it is unclear how these factors will develop.

Corporate Overview

Vestpa was incorporated in February 2007 as an acquisition vehicle, with a broad remit to acquire a company in one of a number of sectors including consumer goods, with *inter alia*:

- an experienced management team in place;
- attractive growth prospects;
- located in Europe, North America or Asia.

Full Fortune Group was incorporated in Singapore in 2005 to act as the holding company for Fuss Feed, Fu-Rich and Fortune Nutritech as part of a corporate restructuring programme. The business is a food manufacturing and wholesaling business with established activities in animal feeds and condiments. The entire share capital of Full Fortune has been acquired by China Food Company Plc for a consideration of approximately £25.17m, comprising 40,333,333 new ordinary shares (the acquisition shares) issued at 50p plus a cash payment of £5m. The £5m cash component was raised by the issue of 16,666,667 new ordinary subscription shares at 30p, raising £4.1m net of expenses.

Fuss Feed is the oldest company in the group and at present the cash cow, although still growing at a respectable pace. It began trading in 1994 and its principal activity is the production of animal feeds for cows, pigs and poultry. It operates two production lines at a 15,000 sqm plant in Shouguang.

Fu-Rich produces and sells a range of condiments including soy sauce, vinegar and bean paste. In addition it sells other products such as pickles, chilli oil and flavour enhancers (including MSG and chicken bouillon sourced from third party manufacturers and re-branded). It has its own 17,633 sqm premises in Weifang, Shandong province. It was recognised as one of the top ten brands for soy sauce and vinegar products in Shandong in 2006.

Fortune Nutritech is a dormant company set up to hold land use rights in connection with the development of the group's new premises in Shouguang city.

Concurrent with the reverse takeover of Full Fortune group on 10 December 2007 the company changed its name to China Food Company plc. The name better reflects the current nature and location of the company's business.

The condiments business

Although founded some seven years after the animal feeds business, Fu-Rich is the engine of growth for the business. It is essentially a food manufacturing business with three principal products, contributing to sales as follows:

- 37.9 percent soy sauce;
- 30.5 percent bean paste;
- 29.7 percent vinegar.

The remaining 1.9 percent comprises other manufacturers' products, branded as Fu-Rich and sold through Fu-Rich's established distribution chain. The link between these products is fermentation technology. Soy sauce, vinegar and bean paste are all produced by a process that involves a degree of fermentation and all use soya beans or other grain. The raw material is thus a basic agricultural commodity, which is then processed to produce a basic staple food accompaniment or cooking ingredient.

The condiments business has grown steadily since it was founded, reaching RMB129m (£8.53m) in 2006 and expected to grow by about thirty percent in 2007 to RMB185m (£12.24m). Fu-Rich built up its business firstly in Weifang, a city in Shandong province of about 8.5m people where it is estimated to have a 63 percent market share in its segment. Thereafter they developed in the wider Shandong province which has a population of over 92m. Market share is estimated to be four percent and we understand that Fu-Rich is recognised as one of the top ten condiments brands in the province.

The opportunity for Fu-Rich lies in:

- expanding sales within Shandong by extending its range of products up-market, to which end it is building a new plant in Shouguang city, where it intends to manufacture a more refined product, with a longer fermentation period;
- extending its sales outside Shandong and into neighbouring provinces.

If one takes the region of Shandong and the immediate neighbouring Henan, Jiangsu, Hebei, Tianjin and Anhui the company has a potential market of 450m people, a market not dissimilar in size to the EU. Further down the line there is the prospect of international sales in Asia and beyond.

At present Fu-Rich sells its product through a chain of around 200 distributors and retailers and some 400 outlets of large supermarket chains. The marketplace is highly fragmented and extremely competitive. The brands are local or regional rather than the globally known brands such as Amoy, a subsidiary of Danone, or Kikkoman.

Animal feeds

Animal feeds accounted for almost 55 percent of the group's sales in 2006. Fuss manufactures and sells over 50 types of animal feed products in three broad categories: Premix, Concentrate feed and Compound feed. Last year it generated RMB155m (£10.24m) in sales after discounts and is expected to grow by more than 20 percent in 2007 to around RMB190m (£12.7m). This is an agricultural product intended for end use by farmers raising cattle, pigs and poultry. It is sold mainly in Shandong, which is one of the largest agricultural and livestock producing provinces in China.

Fuss uses a network of around 250 distributors who have both an extensive knowledge of the product but also a detailed knowledge of animal husbandry and nutritional requirements. These distributors advise farmers, who presently are mainly smallholders, on improving livestock yield and quality, which naturally involves improved quality feed.

There are two fully automated production lines, one dedicated to Premix, producing 17,000 tonnes pa and running at about seventy percent capacity utilisation. The other is producing about 45,000 tonnes pa of Compound feed and Concentrate feed and is running at about 45 percent capacity utilisation. Raw materials are mostly sourced locally in the Weifang area.

The opportunity for Fuss is several-fold. Like most things Chinese the livestock market is vast. China's population is just over 1.3bn and, although growing only slowly at around 0.6 percent pa, it is still adding mouths to feed equivalent in number to a city the size of London every year. In addition to the population growth, the country's faster economic growth, industrialisation and urbanisation are bringing growth in per capita income and changes in diet.

China's growing affluence has resulted in increased demand for livestock products at the same time as increased livestock numbers and industrialisation have resulted in a growing scarcity of suitable grassland for livestock. Consequently the importance of animal feed is increasing. This trend is unlikely to slow or stop any time soon, indeed, if anything the need for better animal feeds that improve yields will increase as an increasingly hysterical green lobby drives competition for grain crops from the biofuels industry. This is already happening, as evidenced by sharp increases in the price of grain, milk, etc in this year.

Fuss Feed may be thought of as a steady growth business and something of a cash cow, but its growth rates are more than respectable and are likely to continue to be so for the foreseeable future. One further factor that may drive growth is the transformation of the farming community from small farmers to large scale farming corporations. This trend is likely to favour the larger feed businesses like Fuss as they have the scale to supply larger customers.

Xianka

A further element of "blue sky" is represented by an option to buy a third newly formed business, Xianka Limited, from Mr Fu Guoping, the founder of both Fuss Feed and Fu-Rich. Xianka powder is a flavour enhancing food additive that has been in development for the last three years by Fu-Rich's research and development team.

Along with soy sauce, Chinese cooking has also long been associated with the use of monosodium glutamate or MSG. The market for this food additive is dominated by Ajinomoto with 34 percent market share and estimated by it to be a 2,100,000 MT market by 2010. It's a big market and growing by four percent pa, however there is a darker side to MSG. Although classified by the US FDA as "Generally Regarded as Safe" there is a growing body of scientific research that suggests it be anything but. Increasingly considered a neurotoxin, the harmful effects claimed for MSG include headaches, arrhythmia and obesity.

Xianka powder is principally extracted from kelp and is believed to contain less harmful chemical compounds than MSG. The company anticipates Xianka becoming a MSG substitute appealing to an ever more health conscious, better educated and affluent Chinese population. Mr Fu Guoping has granted China Food an option to purchase Xianka Limited for a maximum of RMB80m at any time in the next two years.

Shares in issue

Following the 1 for 40 share consolidation and the issue of new ordinary shares, including the acquisition shares and 16,666,667 subscription shares at 30p which raised £5m additional capital before expenses, there are now 66,400,001 ordinary shares in issue and listed on AIM. These were readmitted to trading on AIM on 10 December 2007.

Albany Capital holds in aggregate 13,280,000 ordinary shares, or twenty percent of the enlarged issued share capital of the company. In addition John McLean holds 97,300 shares or 0.15 percent of the enlarged issued share capital of the company and Derek Marsh holds 33,333 shares or 0.05 percent of the enlarged issued share capital of the company.

Mr Fu Guoping (the husband of Ms Feng Bo, the COO) is the sole shareholder of Main World Investments.

Key shareholders

Shareholder	Shareholding	%
Albany Capital	13,280,000	20%
Andorra Banc Agricol Reig SA	1,155,855	1.7
Sound Venture Holdings Inc	20,771,516	31.3
Main World Investments Ltd	14,882,883	22.4
IFS Capital Assets	4,165,984	6.3
Lam Soon Realty	2,511,612	3.8

Source: China Food

Operating Environment

At present China Food has two distinct but related food manufacturing businesses: Fuss Feed, an animal feeds business with a projected turnover in 2007 of RMB190m (£12.7m) and Fu-Rich, a condiments business comprising the manufacture and sale of soy sauce, vinegar and bean paste, with forecast turnover of RMB185m (£12.2m) in 2007. All operations are based in Shandong province in China.

Both businesses have their headquarters and manufacturing operations in Shandong province, located on the coast in the north-east of China. Shandong is the second largest province in the PRC, with an estimated population of about 92m people. Fuss Feeds is based in Shouguang city and Fu-Rich in Weifang.

For the foreseeable future, and unless China Food makes a non Chinese acquisition, this is a Chinese domestic market story. China Food's markets are primarily Shandong and thereafter its neighbouring provinces of Jiangsu (population 75m), Anhui (population 62m), Henan (population 97m), Hebei (population 66m), Tianjin (population 10m) and Liaoning (population 42m). This makes for a potential market of just over 440m, not dissimilar to the EU in size. At present the management estimates that just sixteen percent of its condiment sales come from outside Shandong province.

Shandong province

Source: The Art and Images of China

China

Source: Society for Anglo Chinese Understanding

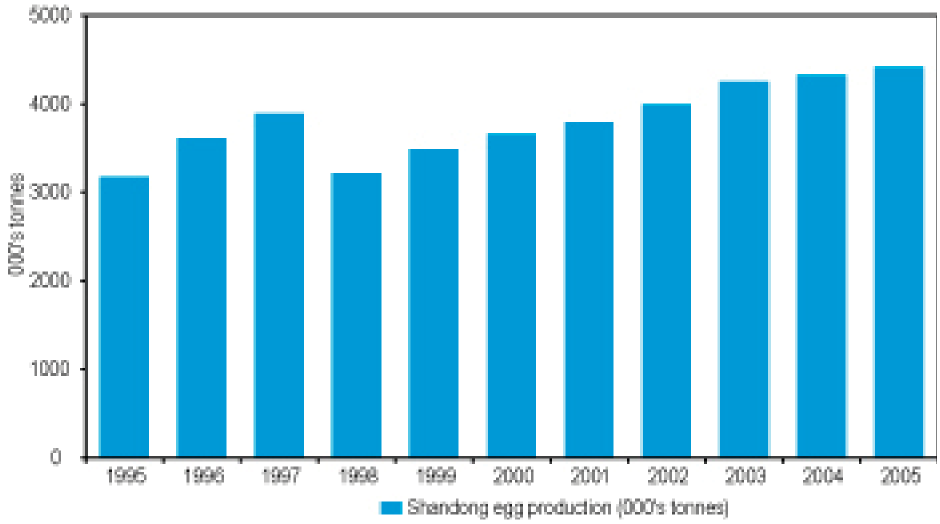
Key drivers

Although the businesses are distinct and obviously have a very different customer base the key business drivers are probably ultimately the same, namely the continuing industrialisation and urbanisation of China and the growing affluence of the Chinese population. Population growth in percentage terms is not in itself a factor although the numbers involved are substantial by virtue of the sheer size of China's population of around 1.3bn.

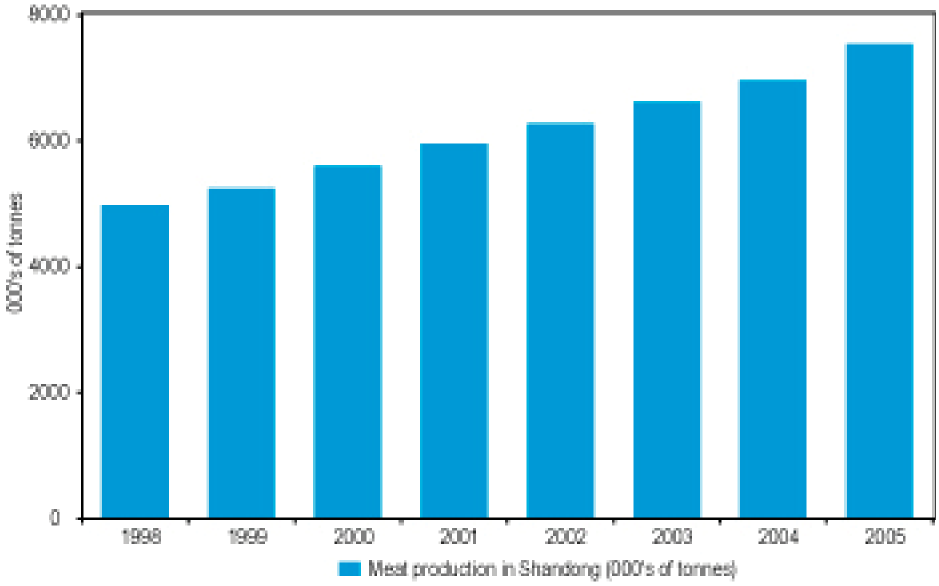
More important, in our opinion, has been the combination of the growth in per capita GDP and the urbanisation of large sections of the population, including particularly in Shandong province.

The combination has brought about changes in eating and shopping habits. The result is a richer diet with increased demand for meat and fish, hence a greater demand for livestock products; and increased demand for milk and an increased demand for sweets and cakes, also increasing demand for milk products, eggs, etc. This has also extended to demand for products with a better taste, hence more expensive condiments, and healthier products. China Food is a potential beneficiary of almost all these trends, and they have been driving growth in both its animal feeds business and the condiments business.

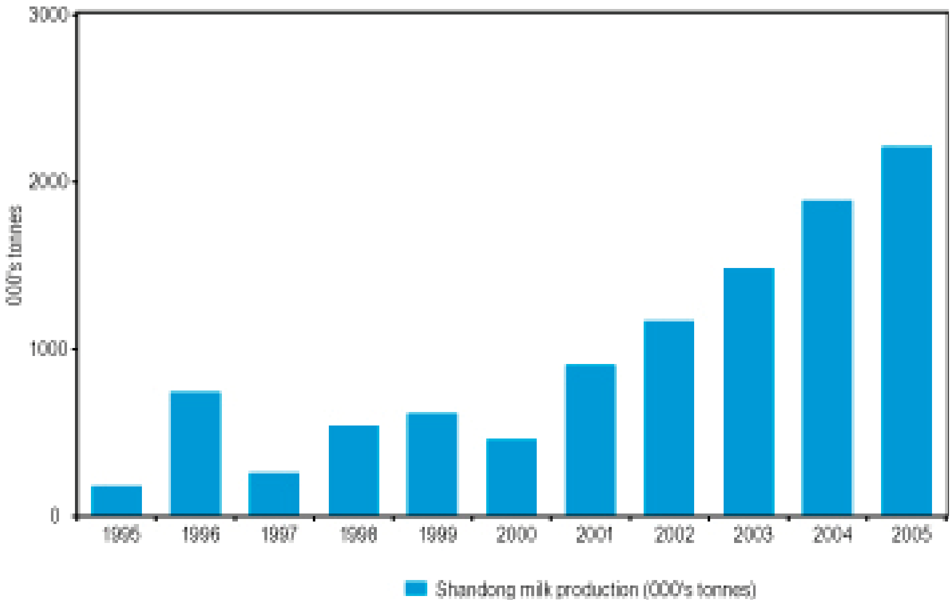
Shandong egg production



Shandong meat production

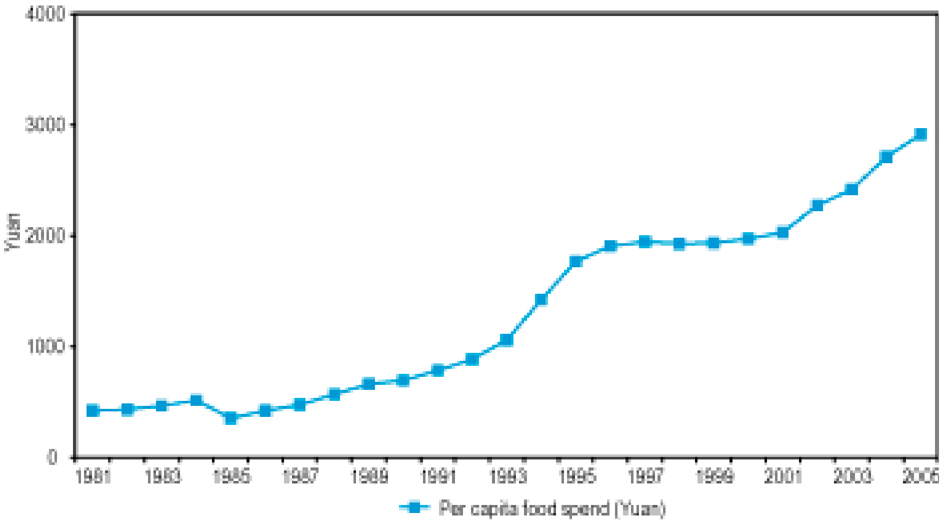


Shandong milk production



Source: US Department of Agriculture

Urban food spend



Source: US Department of Agriculture

Data for urban food expenditure per capita and the provincial data series for milk, egg and meat production in Shandong suggest that the process of urbanisation is increasing the per capita amount spent on food. Similarly it shows steady growth in the production of livestock and dairy product which we consider will be the principal market for Fuss Feed's products.

As this trend continues, which forecasts for Chinese GDP growth suggest is likely, existing local farmers in Shandong will seek to improve yields which will lead them to seek advice from their animal-feeds supplier. However, it is anticipated that there will also be a process of consolidation in the farming business, as larger corporations become involved in farming and possibly larger food manufacturers themselves do so. Farming will become more intensive and expenditure on feeds and supplements is also likely to increase. As a relatively large business, at least in the Weifang area, we anticipate that Fuss Feed is likely to benefit from this trend by having the capacity to deal with larger customers.

Fu-Rich is also benefiting from these same trends as an increasingly more affluent urban population seeks out more sophisticated products. In general this means the more recognised brand names, which are invariably the higher margin products as well. In the case of Fu-Rich this will hopefully mean an increased preference for the products with a longer fermentation stage. Fu-Rich is in the process of building a new plant in Shouguang and plans to increase its output of higher grade soy sauce with fermentation periods of around six months.

The blue sky element – MSG substitute

China Food has an option to purchase a business known as Xianka from Mr Fu Guoping. Although this business has not started manufacturing or selling any product yet it has been developing what it believes to be a natural substitute for MSG powder. Xianka powder is produced from kelp but is intended to have similar flavour enhancing properties to MSG but without the unpleasant side effects.

As Xianka is a new product it is difficult to estimate the market it might capture as first it must gain consumer acceptance. The world leader in production and sales is the Japanese company Ajinomoto, which estimates it has a share of approximately thirty percent. Ajinomoto's own estimates put global demand for MSG in 2006 at 1.95m tonnes with China alone having demand for 890m tonnes. It is difficult to estimate the monetary value of this market and Ajinomoto's financials do not make it particularly clear, as they include seasonings in domestic food products as well as in amino acids. Ajinomoto is a US$5.5bn turnover company. According to the web site FoodNavigator.com, the total market for amino acids (of which Lysine and MSG are the largest categories) is estimated to be worth around $4bn pa and is growing at around seven percent pa. China Food's own figures suggest a market price for MSG at around US$1,340 per tonne, giving a global market value of US$2.6bn.

While the potential market for Xianka is therefore large, with China being by far the largest market for MSG, it is dominated by Ajinomoto, with Archer Daniels Midland and BASF also having significant market shares. These companies maintain their market shares through extensive distribution networks, sponsored medical research to promote the safety of their products, extensive marketing and promotion, and aggressive pricing. The potential market may be big for a company the size of China Food but it will also be intensely competitive.

All China Food's manufacturing and distribution operations centre on its headquarters in Weifang for Fu-Rich and Shouguang for Fuss Feed, both in Shandong province.

Fuss Feed is an animal feeds business based in Shouguang city and is a wholly domestic business. It manufactures three generic types of animal feed, Premix, Concentrate feed and Compound feed. In 2007 animal feed will account for roughly 54 percent of the group's turnover. It operates two production lines at a 15,000 sqm plant. One production line is dedicated to Premix and currently produces some 17,000 tonnes pa operating at about 59 percent of designed capacity. The other line is used for Concentrate and Compound feeds and is currently producing approximately 45,000 tonnes per annum or roughly 47 percent of its designed production capacity.

As can be seen from the capacity utilisation figures Fuss Feed has sufficient additional manufacturing capacity to accommodate forecast increased sales. Fuss Feed also believes its production is highly flexible, allowing it to vary the formulations produced to respond to variations in customer orders and market demand.

Raw materials, comprising energy sources and protein sources, are sourced from a broad supplier base in Weifang and neighbouring cities, while additives (being vitamins, minerals and medicinal drugs) are obtained from either local pharmaceutical companies or foreign multinational corporations based in the PRC.

Fuss Feed's main market is Shandong, China's second largest province and a major agricultural producer, where it had 238 distributors as at the end of 2006. However it also sells its products in the neighbouring provinces of Anhui, Jiangsu, Hebei and Henan. It is part of its business strategy to sell its products in these regions and to this end it has established thirteen distributors in these provinces and they account for about 2.4 percent of animal feed sales. This is almost entirely a cash sales business as distributors and farmers usually pay when they collect; the working capital requirement is thus modest.

Fuss Feed's strategy is to concentrate on Premix, offering the best margin and allowing distributors or other feed manufacturers to buy their energy sources (wheat, oats etc) locally and save transport costs. This also reduces the requirement to carry inventory. The company provides small and medium sized farmers with veterinary and animal nutrition advice as part of its marketing initiatives to promote sales.

Exterior of coporate HQ

Interior of coporate HQ

Proposed cash management centre

Source: China Food

The animal feed business in China is highly competitive and fragmented and barriers to entry are low. That said the increased demand for livestock products and the need to increase yields is driving a gradually increasing sophistication which should benefit Fuss Feed due to its advisory and educational services. The company considers it is one of the largest such businesses in Shandong and that it has four main competitors in the province:

- **Zhong Ji Feed**, founded in 1987, is Fuss Feed's closest competitor. It was one of the first animal feed companies to be established in Shandong and produces a broadly similar range of feeds to Fuss Feed.
- **Liu He Feed**, state owned, one of the largest feeds businesses in Shandong. It is focused on Compound feed.
- **Huan Shan Feed** focused on the manufacture of Compound pig feed and based in Wehei.
- **Pu Rui Na Feed** based in Yantai and focused on the manufacture of Concentrate feed for pigs.

Fu-Rich is a condiments business currently based in Weifang. It produces a wide range of about sixty products which come into three main categories: soy sauce, vinegar and bean paste. It produces these products under its two main brand names "Fushi" and "Fushi Hao Tai Tai". In a similar way to animal feeds, this is very much a domestic operation, with all manufacturing in Shandong, raw materials sourced locally from a wide range of suppliers and 98 percent of sales made within Shandong and the neighbouring provinces. Foreign exchange risk is very low.

The Weifang factory is approximately 17,663 sqm and houses fermentation pools; bottling lines; a micro-organism cultivation centre for yeast, mould and bacteria; drying room; research and development centre and quality control. In other words everything needed to manufacture its products.

Soy sauce accounts for roughly 38 percent of condiment sales and in 2006 Fu-Rich was producing 27,000 tonnes pa and running at 54 percent of capacity. The growth in 2007 and projected into 2008 will have removed most of that spare capacity and Fu-Rich's strategy to move upmarket to more premium grade soy sauce will require more capacity. Currently it uses a hybrid production method of traditional fermentation and hydrolysis but the premium grades will require much longer fermentation and brewing.

To accommodate the need for more capacity and the longer fermentation times of around six months, Fu-Rich is currently building a new 50,000 tonne pa factory in Shouguang. It expects this to be completed in June 2008 and to start shipping in the fourth quarter of 2008. This facility will be for premium grade soy sauce and use the latest technology. It will free up capacity in the existing plant to produce more basic products.

The growth of Fu-Rich will be somewhat capacity constrained in 2008, but we expect it to resume at a much faster rate in 2009 once the new capacity is on stream.

The majority of its business is still through distributors who pay cash, and debtor days are currently very low. We expect the increasing portion of sales to supermarket chains, who typically get 30 to 45 days credit, will gradually increase the working capital requirement. Similarly the production of more premium grade soy sauce which use a six month fermentation period will increase the amount of work in progress. Our forecasts reflect these gradual changes in working capital requirement.

Competition has normally been local but the new found consumer affluence and brand awareness is starting to bring the need for advertising campaigns and a need to build up extensive distribution networks to get the products on shelves. Individual competitors are still regionally based like Fu-Rich.

Shoguang factory

Source: China Food

Financials

Profit & Loss					
Year ending December (£000s)	**2006**	**2007E**	**2008E**	**2009E**	**2010E**
Revenues	19,273	25,040	29,414	36,350	44,311
COGS	(12,239)	(15,885)	(19,760)	(25,081)	(30,510)
Gross profits	7,034	9,155	9,653	11,269	13,801
Other op income	25				
Selling costs	(297)	(326)	(588)	(1,272)	(1,772)
Admin costs	(258)	(1,526)	(735)	(1,090)	(1,329)
EBITDA	**6,504**	**7,304**	**8,330**	**8,906**	**10,699**
Depreciation & amortisation	(263)	(527)	(533)	(539)	(545)
EBIT	6,241	6,777	7,796	8,367	10,154
Interest	(164)	239	524	809	1,121
EBT	6,077	7,015	8,320	9,176	11,275
Pro forma tax	(1,640)	(1,964)	(2,330)	(2,546)	(3,340)
Earnings	**4,437**	**5,051**	**5,990**	**6,629**	**7,935**

Cashflow					
Year ending December	**2006**	**2007E**	**2008E**	**2009E**	**2010E**
EBIT	6,241	6,777	7,796	8,367	10,154
Depreciation	263	527	533	539	545
(Increase) decrease in debtors	600	(461)	(547)	(1,156)	(1,327)
(Increase) decrease in inventory	35	(146)	(969)	(1,171)	(1,357)
Increase (decrease) in creditors	142	304	323	443	452
Other non cash	(24)				
Net cash from Ops	**7,257**	**7,001**	**7,137**	**7,023**	**8,467**
Tax paid	(1,311)	(1,964)	(2,330)	(2,546)	(3,340)
Interest recieved (paid)	(121)	239	524	809	1,121
New equity	3	—	—	—	—
New deposits (borrowings)	312	—	—	—	—
Capital expenditure	(5,981)	(547)	(553)	(560)	(567)
Net cash from financing	**(7,098)**	**(2,273)**	**(2,359)**	**(2,298)**	**(2,786)**
Net increase (decrease) in cash	**159**	**4,728**	**4,778**	**4,725**	**5,681**

Balance sheet					
Year ending December	**2006**	**2007E**	**2008E**	**2009E**	**2010E**
Net fixed assets	10,188	10,207	10,227	10,248	10,269
Cash	3,823	8,551	13,329	18,054	23,736
Debtors	401	862	1,409	2,565	3,892
Inventory	288	434	1,402	2,573	3,930
Current Assets	**5**	**10**	**16**	**23**	**32**
Total Assets	**15**	**20**	**26**	**33**	**42**
Trade creditors	(1,943)	(2,247)	(2,570)	(3,013)	(3,466)
Net Current Assets	**2,568**	**7,600**	**13,570**	**20,179**	**28,092**
Financial (creditors) debtors	(2,211)	(2,211)	(2,211)	(2,211)	(2,211)
Net Assets	**10,545**	**15,596**	**21,586**	**28,216**	**36,150**

Source: Objective Capital

John McLean – Non-executive Chairman

John McLean, aged 54, is Chairman of Albany Capital plc, which he, with three other colleagues, founded in 2006 to invest in pre-IPO and other investments. He is also the Chief Executive Officer of Fairfax Classical Properties Limited, a company that he co-founded in 2003, which builds deluxe houses in the South of England. John has had extensive business experience in a variety of sectors including retail, branded products, property investment and development, textiles, mobile telephony, cable TV, manufacturing, licensing and logistics. He has managed operations globally, with specific expertise in China, Australia, the USA, Canada and Europe. In 1998, he was appointed by Gamma Holdings NV to carry out a strategic review of their UK interests, including Sanderson, the textile and wallpaper company. John remained with Sanderson until 2003, serving as its managing director to implement a turnaround and disposal plan. From 1992 to 1996, he was employed as General Manager with ICS and co-led a management buy-out of the company with 3i, prior to its successful disposal to Hays plc in 1996. John has a long track record in the development of growing companies and has operated as both managing director and finance director. John is a Chartered Accountant and was formerly with Coopers & Lybrand in both London and New York.

Raphael Tham Wai Mun – Chief Executive Officer

Raphael Tham Wai Mun, aged 37, was a director of Full Fortune and Tastyfood Holdings Limited, formerly a listed company on the Singapore Exchange. He has experience in various businesses within the technology, construction, retail and finance industries and has been involved in general management, strategic development, financing and corporate restructuring. Prior to joining Full Fortune, Mr Tham was the senior vice president of International Financial Network Holdings Limited, a Hong Kong based, GEM listed company involved in securities, corporate finance advisory and other related services and was the country manager of their Singapore subsidiary. Mr Tham has also founded and run other businesses and served on the board of listed companies in Singapore. He is also currently a non-executive director of Byte Power Group Limited, an Australian listed company. Mr Tham started his career with the Economic Development Board of Singapore and holds a Bachelor of Arts (Economics) from the National University of Singapore. Mr Tham is fluent in both English and Mandarin.

Feng Bo – Chief Operating Officer

Feng Bo, aged 38, graduated from the Beijing Agriculture Engineering University in 1991 with a Bachelor of Science. She then completed her graduate course in International Trade at China Ocean University in 2003. She is also a committee member of the China Animal Husbandry and Veterinary Institute of Animal Nutrition. She joined Fuss Feed in 1994 and subsequently became its General Manager. Feng Bo is currently a director of Fuss Feed, its legal representative and General Manager.

Frank Chau – Chief Financial Officer

Frank Chau, aged 35, has more than ten years experience in audit, corporate finance and financial management in Singapore, Hong Kong and mainland China. Mr Chau was the Financial Controller of a Singapore main-board listed company prior to joining Full Fortune.

Mr Chau started his career with the Hong Kong member of Grant Thornton International and holds a Master's degree in Business Administration from the University of Adelaide, Australia. Mr Chau is a fellow member of the Association of Chartered Certified Accountants. Mr Chau is fluent in both English and Mandarin.

Derek Marsh – CVO Non-executive Director

Derek Marsh, aged 61, has thirty eight years of Government experience, including with the British diplomatic service in East Asia where he was Deputy British Ambassador in Seoul from 1997 to 2001 and British Trade Representative in Taipei from 2002 to 2005. His other Government experience includes the following areas: export promotion, aerospace industry, large-scale information business, defence procurement and military operations. Derek was a non-executive director of Bovis Homes Limited between 1992 and 1994. Bovis Homes Limited was a subsidiary of the P&O Group plc. He is currently a non-executive director of the AIM quoted HaiKe Chemical Group Limited, based in the Shandong Province. Derek graduated from the Royal College of Defence Studies, London and the NATO Defence College, Rome and holds an MA from The Queen's College, Oxford.

The following table provides an explanation of certain technical terms and abbreviations used in this document.

Animal Feed Business

Additives:	refers to vitamins, minerals or drugs added to animal feed as nutritional supplements;
Compound feed:	a feed that contains Energy Sources, Protein Sources and Additives and represents a nutritionally complete meal for animals;
Concentrate feed:	a subset of Compound Feed that contains Protein Sources and Additives but lacks Energy Sources;
Energy sources:	this usually refers to coarse grains like oat, wheat and maize that act as the staple carbohydrates for animals;
Premix:	a subset of Compound Feed that consists of Additives but lacks Energy Sources and Protein Sources;
Protein sources:	this usually refers to oilseeds like soya beans, sunflower seeds and rape seeds which provide the necessary protein required by animals for their nutrition;
Soya bean:	a species of legume native to Eastern Asia.

Condiments Business

Bouillon:	refers to stock or broth for soup and sauces produced by cooking, either separately or in any combinations, vegetables, poultry, meat or fish in water, strained and thereafter dried and packed in the form of granules or cubes;
Condiment:	a substance applied to food, usually in the form of a garnish, powder or sauce to enhance or improve the flavour;
Fermentation:	typically refers to the conversion of one substance to another substance using micro-organisms through a bio-chemical process over a course of time;
MSG:	Mono Sodium-Glutamate (a flavour-enhancer)

Appendix: Soy sauce

How Soy sauce is made

Soy sauce is one of the world's oldest condiments, over 2000 years ago the people of Asia preserved meat and fish by packing them in salt. The liquid by-products that leeched from meat preserved in this way were commonly used as liquid seasonings for other foods. The influence of Buddhism lead to the replacement of meat seasonings with vegetarian alternatives. One such substitute was a salty paste of fermented grains, an early precursor of modern soy sauce. A Japanese Zen priest came across this seasoning while studying in China and brought the idea back to Japan, where he made his own improvements on the recipe. One major change the priest made was to make the paste from a blend of grains, specifically wheat and soy in equal parts. This change provided a more mellow flavour that enhanced the taste of other foods without overpowering them. By the seventeenth century this recipe had evolved into something very similar to the soy sauce we know today.

Today soy sauce is made by two methods: the traditional brewing method, or fermentation, and the non-brewed method, or chemical-hydrolyzation. The fermentation method takes up to six months to complete and results in a transparent, delicately coloured broth with balanced flavour and aroma. The non-brewed sauces can take only two days to make and are often opaque with a harsh flavour and chemical aroma, which is then modified with caramel and sweeteners.

The manufacturing processes

Traditional brewing

The traditional method of making soy sauce, consists of three steps: koji-making, brine fermentation, and refinement.

Koji-making – Soya beans and wheat are crushed and blended together, then boiled until the grains are thoroughly cooked and softened. The mash, as it is known, is allowed to cool to about 80°F (27°C) before a proprietary seed mould *(Aspergillus)* is added. The mixture then is allowed to mature for three days in large perforated vats through which air is circulated. This resulting culture of soy, wheat, and mould is known as *koji.*

Brine fermentation – the koji is transferred to fermentation tanks, where it is mixed with water and salt to produce a mash called moromi. Lactic acid bacteria and yeasts are then added to promote further fermentation. The moromi must ferment for several months, during which time the soy and wheat paste turns into a semi-liquid, reddish-brown "mature mash." This fermentation process creates over 200 different flavour compounds.

Refinement – after up to six months of moromi fermentation, the raw soy sauce is separated from the cake of wheat and soy residue by pressing it through layers of filtration cloth. The liquid that emerges is then pasteurised. The pasteurisation process serves two purposes. It helps prolong the shelf life of the finished product, and it forms additional aromatic and flavour compounds. Finally, the liquid is bottled as soy sauce.

Non-brewed method (chemical hydrolysis)

Instead of fermenting, many modern manufactures artificially break down the soy proteins by a chemical process known as hydrolysis because it is much faster. (Hydrolysis takes a few days as compared to several months for brewing.)

In this method, soya beans are boiled in hydrochloric acid for 15-20 hours to remove the amino acids. When the maximum amount has been removed, the mixture is cooled to stop the hydrolytic reaction. The amino acid liquid is neutralised with sodium carbonate, pressed through a filter, mixed with active carbon, and purified through filtration. This solution is known as hydrolysed vegetable protein. Caramel colour, corn syrup, and salt are added to this protein mixture to obtain the appropriate colour and flavour. The mixture is then refined and packaged.

Sauces produced by the chemical method are harsher and do not have as desirable a taste profile as those produced in the traditional brewed manner. The difference in taste occurs because the acid hydrolysis used in the non-brewed method tends to be more complete than its fermentation counterpart. This means that almost all the proteins in the non-brewed soy sauce are converted into amino acids, while in the brewed product more of the amino acids stay together as peptides, providing a different flavour. The brewed product also has alcohol, esters, and other compounds that contribute a different aroma and feel in the mouth.

In addition to the brewed method and the non-brewed method, there is also a semi-brewed method, in which hydrolysed soy proteins are partially fermented with a wheat mixture. This method is said to produce higher quality sauces than can be produced from straight hydrolysis.

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Simon Miller has over 25 years in finance. He was previous head of research for Bryan Garnier and managed funds for both Sagitta and Elysian. He is a former rated analyst.

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