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objective corporate research

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.

Executive Summary

For the full report please visit:
http://www.ObjectiveCapital.co.uk/cfc.pdf

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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

14 January 2008
Price: 52p

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.

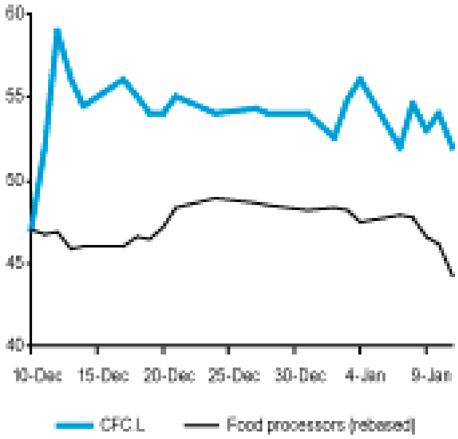
- ***Significant growth potential from a large, local region***
  China Food is based in Shandong province, the second largest in China. Its population of 92m generated GDP of US$274bn in 2006. Further steady growth and other demographic changes are expected to continue the demand growth for both basic 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.

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.

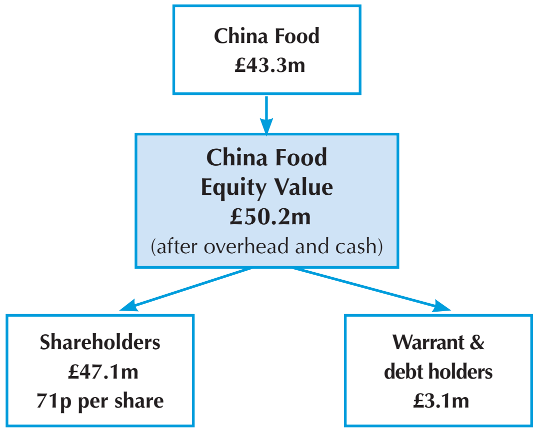
The recent share price suggests that the market is valuing the company on the basis of existing performance with little regard for likely growth. This is not an unreasonable caution given the history of some Chinese 'growth story' floats. As performance is demonstrated we would expect a more appropriate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



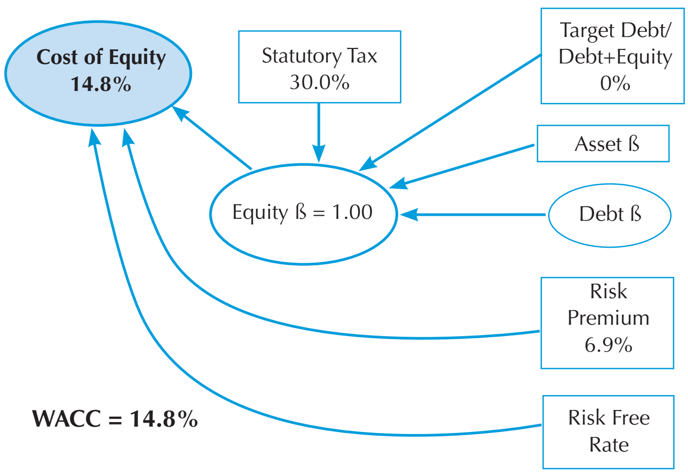
Scenarios

	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.

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.

We are pleased to bring you this report on **China Food Company plc**.

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As we are unconflicted by corporate finance or PR/IR agendas, our analysts are always free to give their true opinion of the businesses we cover.

As always, I welcome your comments and feedback on our research!

Gabriel Didham, CFA
Objective Capital

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.

About our relationship with China Food Company plc
Objective Capital has been sponsored by the company to provide research coverage of China Food Company plc.

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