

# Management Discussion and Analysis

## Business review

### Sales and marketing

According to the China Fermentation Industry Association, the Group was the largest glutamic acid manufacturer and the second largest xanthan gum manufacturer in the PRC in terms of production volume in both 2005 and 2006.

In 2006, glutamic acid continued to be one of the major products of the Group. As the economy and income level in the PRC continued to grow, it is expected that the per capita consumption of MSG will grow in tandem, thus driving the sales of glutamic acid and MSG. In addition, the full year operation of Baoji Plant Phase II in the year 2006 increased the production volume of glutamic acid which was fully absorbed by the market. Following the adjustments and testing of the new MSG production facilities in the Group's Junan Plant Phase II in November 2006, the Group's production of MSG was further increased.

The Group has commenced production of xanthan gum since 2003. Although the Group had recorded growth in the sales of xanthan gum in the past, turnover of xanthan gum experienced a significant growth in the year 2006 as a result of production capacity expansion. The Group continued to improve the quality of its products which are widely accepted by the market. Since September 2006, the production capacity of the xanthan gum was increased by 4,000 metric tonnes to 8,000 metric tonnes.

The Group currently has over 1,000 domestic customers and overseas customers in 36 countries. During the year 2006, the Group participated in various trade conferences and exhibitions of its products in both the PRC and overseas to promote the products of the Group. With the commencement of the operation of Inner Mongolia Plant Phase I, the geographical coverage of the Group in the PRC further expanded and the sales of the products are expected to increase accordingly.

Since establishment, the Group has obtained various awards and below are two representative awards obtained in respect of year 2006.

- The Group was awarded Leading Enterprise in Food Industry for year 2005-2006 by China National Food Industry Association in the year 2006.
- The brand of “福瑞” was awarded the Most Market Competitive Brand for the year 2006 by the Ministry of Commerce in January 2007.

### Production

Since the commencement of its business, the Group has developed into a highly vertically integrated enterprise from the production of corn starch to the production of corn-based biochemical products, such as glutamic acid, MSG, xanthan gum and starch sweeteners. The products produced at different stages along the Group's production chain can either be further processed internally or sold to end users or other manufacturers for further processing.

The Group is also aware of its environmental protection responsibility. The Group has installed a waste water treatment system in each of its existing fully-operational plants. Such treatment system not only minimises the negative environmental impact from the discharge of waste water during the production process, but also enables the Group to utilise certain waste to produce fertilisers at low capital investment and operating cost.

## Management Discussion and Analysis

The Group has increased its production capacity by building new production plants and production facilities in order to satisfy the increasing market demand for its products. The annual design production capacity, the actual production output and the utilisation rate of each of the major products in 2006 together with the comparative figures in 2005 were as follows:

Product	2006 (metric tonnes)	2005 (metric tonnes)	Change (%)
<b>Glutamic acid</b>			
Annual design production capacity <i>(Note)</i>	<b>180,000</b>	130,000	39
Actual production output	<b>197,560</b>	139,922	41
Utilisation rate	<b>110%</b>	108%	
<b>MSG</b>			
Annual design production capacity <i>(Note)</i>	<b>33,333</b>	25,000	33
Actual production output	<b>30,927</b>	25,956	19
Utilisation rate	<b>93%</b>	104%	
<b>Xanthan gum</b>			
Annual design production capacity <i>(Note)</i>	<b>5,333</b>	4,000	33
Actual production output	<b>5,079</b>	1,972	158
Utilisation rate	<b>95%</b>	49%	
<b>Fertiliser</b>			
Annual design production capacity <i>(Note)</i>	<b>306,667</b>	206,667	48
Actual production output	<b>272,036</b>	201,102	35
Utilisation rate	<b>89%</b>	97%	

*Note: the annual design production capacity is expressed on a pro-rata basis.*

In 2006, the total output of glutamic acid was either consumed by the Group for its MSG production or sold to customers. In 2006, the average production ratio of MSG versus glutamic acid was 1:0.8 by volume.

### Research and development

Research and development is an important component for the future growth of the Group. Currently, there are 36 personnel in the research and development department with qualifications in various relevant disciplines including fermentation engineering, biological technology, applied biology and food engineering. To further strengthen and equip the Group's research and development capabilities, a research and development building was built and used in February 2007. The Group continues its cooperation with various research institutions on new products development, with the aim to explore means of refining the Group's production technologies and developing new products by leveraging on both parties' research and development capacities.

In 2006, the Group was one of the participants in drafting the fermentative organic fertilisers industry standard to be promulgated by the National Development and Reform Commission.

# Management Discussion and Analysis

## Financing

Following the development of Inner Mongolia Plant Phase I, the bank borrowings of the Group increased significantly to RMB749.6 million as at 31 December 2006 (2005: RMB250.4 million). The increase in bank borrowings led to the increase in interest expenses of the Group in the year 2006. Among the total bank borrowings, current borrowings amounted to approximately 55% as at 31 December 2006 (2005: 17%). Approximately RMB312.0 million of loan borrowed from ABN AMRO Bank ("ABN AMRO loan") was repaid upon listing of the Company in February 2007.

## Research and development

As mentioned above, research and development is an important component for the future growth of the Group and the Group will continue to strengthen its research and development capacity.

## Merger and acquisition

Merger and acquisition is an important component for the expansion of the Group. In order to assure the leading position in the industry, the Group will continue to look for potential companies for merger and acquisition opportunities.

## Financial Review

### Results for the year

The profit attributable to shareholders of the Company for the year 2006 was RMB240.5 million, at a similar level of that for the year 2005.

### Turnover

The turnover of the Group was about RMB1,787.2 million for the year 2006 which represents the growth of 38% or RMB490.8 million as compared with that in 2005. The growth was mainly in two folds: 1) due to the expansion of the market; and 2) due to the full year contribution of Baoji Plant Phase II (which commenced production in November 2005) in the year 2006. Set out below are the average selling prices of the Group's major products for the year 2005 and 2006:

	<b>2006</b> <b>(RMB/metric</b> <b>tonne)</b>	2005 (RMB/metric tonne)	Change (%)
Glutamic acid	<b>6,140</b>	6,368	-4
MSG	<b>6,394</b>	6,796	-6
Xanthan gum	<b>25,598</b>	26,061	-2
Fertilisers	<b>541</b>	658	-18

There was a decrease in average selling prices of both glutamic acid and MSG in the year 2006 mainly due to the increase in market supply and the lowering of selling prices sold to certain customers who were required to pay for freight expenses during the year 2006. In general, the selling prices of glutamic acid and MSG follow similar trend of selling price of corn kernels which are also affected by changes in market supply and demand dynamics.

The average selling price of xanthan gum remained relatively stable in the year 2006 when compared with that of the year 2005.

The decrease in average selling price of fertilisers in the year 2006 was attributable to the general decrease in market price and the increase in production capacity in the Baoji Plant in Shaanxi Province where the average selling price of the fertilisers was lower than that in Shandong Province.

### **Glutamic Acid**

The turnover of glutamic acid for the year 2006 was RMB1,050.1 million, representing a growth of 39% or RMB295.7 million as compared with that in 2005. The growth is mainly due to the increase in production capacity with the production commencement of the Baoji Plant Phase II in November 2005 and Inner Mongolia Plant Phase I in December 2006.

Glutamic acid remained to be the major product of the Group which accounted for 59% of the turnover in the year 2006.

### **MSG**

The turnover of MSG for the year 2006 was RMB199.4 million which represents a growth of 13% or RMB22.5 million from that of the year 2005. It is mainly because of the over 100% utilisation of MSG facilities.

### **Xanthan gum**

The turnover of xanthan gum for the year 2006 was RMB139.6 million which represents a growth of 110% or RMB73.1 million from that of the year 2005. The substantial growth is mainly due to the increase in production capacity of 4,000 metric tonnes following the expansion of xanthan gum production facilities in September 2006 which doubled the overall production capacity of xanthan gum. The sales volume for the four months ended 31 December 2006 accounted for half of the total turnover for the year 2006.

### **Fertilisers**

The turnover of fertilisers for the year 2006 was RMB134.8 million which represents a growth of 18% or RMB20.8 million from that of the year 2005. The growth was mainly contributed by the full year operation of Baoji Plant Phase II in the year 2006 which increased the sales volume of fertilisers. Such effect was partially offset by the decrease in selling prices of fertilisers.

### **Starch sweeteners**

The Group commenced the production of starch sweeteners in July 2006. The turnover of starch sweeteners amounted to RMB35.9 million which accounted for about 2% of the turnover for the year 2006.

## Management Discussion and Analysis

### Corn refined products

Following the full year operation of Baoji Plant Phase II, the turnover of corn refined products increased by 23% or RMB42.8 million as compared with that in 2005. Such increase was a result of the increase in production of glutamic acid during the period.

### Cost of sales

The cost of sales of the Group was RMB1,432.1 million for the year 2006, representing an increase of 46% or RMB453.3 million as compared with that of 2005. The increase in cost of sales is higher than that of turnover because of the increase in cost of corn kernels which was partially offset by the decrease in cost of coal.

### Corn kernels

Corn kernels are the principal raw materials in the production of principal products of the Group. For the year 2006, corn kernels represented approximately 53% (2005: 49%) of the total production cost. The Group purchased corn kernels domestically. The three production plants of the Group were strategically located in corn-rich provinces in order to ensure stable supply of corn kernels.

The average cost of corn kernels of the Group for the year 2006 was RMB1,190 per metric tonnes, representing an increase of 12% or RMB125 per metric tonnes from that of the year 2005 of RMB1,065 per metric tonnes. The large number of new corn-processing plants set up in the PRC and the anticipation of high usage of corn kernels by the production of ethanol had driven up the demand for corn kernels in the PRC. Being one of the major basic foods and in view of the recent government's policy to control the corn-processing industry, the Directors expected that the price of corn kernels will stabilise in the year 2007.

### Coal

Coal, being another major raw material, represented approximately 13% of the total production cost of the Group for the year 2006 (2005: 14%). The average cost of coal of the Group for the year 2006 was RMB315 per metric tonnes, representing a decrease of 9% or RMB30 per metric tonnes from that of the year 2005. As the Group generates electricity in-house, the Baoji Plant and Inner Mongolia Plant are also strategically located in coal rich provinces in order to reduce the cost of production. With the commencement of Inner Mongolia Plant Phase I in December 2006, the Directors expected that the cost of coal used in production will further be lowered.

## Gross profit

Set out below are the gross profits of the Group's major products for the year 2005 and 2006:

	<b>2006</b>	<b>%</b>	2005	<b>%</b>
	<b>(RMB'000)</b>		(RMB'000)	
Glutamic acid	<b>222,925</b>	<b>21</b>	209,222	28
MSG	<b>31,883</b>	<b>16</b>	39,554	22
Xanthan gum	<b>50,864</b>	<b>36</b>	18,620	28
Fertilisers	<b>23,602</b>	<b>18</b>	33,530	29
	<u><u>          </u></u>		<u><u>          </u></u>	

The gross profit of the Group for the year 2006 was RMB355.1 million which represents a growth of 12% or RMB37.5 million from that of the year 2005. The gross profit margin decreased from 25% in the year 2005 to 20% in the year 2006 which was mainly due to the decrease in average unit selling price and the increase in price of major raw materials, partially offset by the decrease in average purchase cost of coal.

## Other income

Other income of the Group increased by 69% or RMB7.8 million from RMB11.4 million in the year 2005 to RMB19.2 million in the year 2006. The increase was mainly due to the increase in sales of waste products.

## Staff cost

Staff cost of the Group increased by 12% or RMB7.8 million from RMB63.9 million in the year 2005 to RMB71.7 million in the year 2006. The increase was mainly due to the full year operation of Baoji Plant Phase II which increased the number of staff in year 2006.

## Depreciation

Depreciation of the Group increased by 84% or RMB25.2 million from RMB29.8 million in the year 2005 to RMB55.0 million in the year 2006. The increase was mainly due to the full year operation of Baoji Plant Phase II in the year 2006.

## Finance cost

Finance cost of the Group increased by 59% or RMB5.5 million from RMB9.3 million in the year 2005 to RMB14.8 million in the year 2006. The increase was mainly due to the increase in bank borrowings for the expansion of Inner Mongolia Plant Phase I.

# Management Discussion and Analysis

## Taxation

The income tax expenses for the year 2006 represents the PRC Enterprise Income Tax.

Income tax expenses increased by RMB9.2 million from RMB0.1 million in the year 2005 to RMB9.3 million in the year 2006. The increase was mainly because 山東阜豐發酵有限公司 (Shandong Fufeng Fermentation Co., Ltd.) (“Shandong Fufeng”) was subject to 15% tax rate in the year 2006 and was exempted according to the tax law applicable to foreign investment enterprise in the year 2005.

## Liquidity and financial resources

During the year, the Group’s source of fund was cash generated from operating activities and bank borrowings. As at 31 December 2006, the Group’s cash and cash equivalent and restricted bank deposits were RMB64.6 million (2005: RMB76.9 million) whereas current bank borrowings were about RMB414.6 million (2005: RMB43.5 million) and non-current bank borrowings were about RMB335.0 million (2005: RMB206.9 million).

As at 31 December 2006, the Group recorded net current liabilities of RMB464.2 million. However, upon the listing of the shares of the Company and the repayment of approximately RMB312.0 million ABN AMRO Loan in February 2007, the Company turned to net current asset position.

## Pledge of assets

As at 31 December 2006, certain leasehold land, property, plant and equipment of the Group with carrying value of about RMB318.2 million were pledged to certain banks to secure general bank facilities of the Group.

## Foreign exchange exposure

In the year 2006, the Group operated mainly in the PRC and most of the Group’s transactions, assets and liabilities were denominated in RMB. Foreign currencies were however received from sales of products and proceeds of borrowing in US\$. Foreign currencies are also required to pay dividends in Hong Kong Dollars (“HK\$”) and to settle the Group’s borrowings in US\$. The Group does not consider that there is a high exchange risk between RMB and US\$ or between RMB and HK\$.

## Recent Development and Future plan

The Group’s objective is to maximise returns to its shareholders through exploiting its competitive advantage to grow further with a view to becoming the leading corn-based biochemical product manufacturer in the PRC. To achieve this, the Group will continue to expand production capacity, pursue product diversification, expand marketing and distribution network and strengthen technological advancement. The PRC MSG market has been under consolidation, and such process has speeded up in 2007. In order to capture this opportunity to further strengthen the Group’s position in the market, the Group would focus on increasing the production capacity of MSG this year. In addition, the Group will continue expanding the capacity of xanthan gum.



### **Junan Plant**

A new 50,000 metric tonnes MSG production facilities in Junan Plant Phase II commenced the adjustments and testing in November 2006 which increased the Group's overall production capacity of MSG to 75,000 metric tonnes.

### **Baoji Plant**

The Group is planning for the construction of production facilities for 70,000 metric tonnes of MSG in the Baoji Plant.

### **Inner Mongolia Plant**

Inner Mongolia Plant Phase I commenced production in December 2006.

Inner Mongolia Plant Phase II started its preliminary development preparation in the first quarter of the year 2007 for 10,000 metric tonnes of xanthan gum and 80,000 metric tonnes of MSG production capacity. Certain deposits have been made for the acquisition of plant and machineries.

### **Employees**

As at 31 December 2006, the Group had about 1,140 employees. Employee's remuneration are paid in accordance with relevant policies in the PRC. Appropriate salaries and bonuses are paid which are commensurate with the actual practices of the Group. Other corresponding benefits include pension, unemployment insurance, housing allowance, etc..

The Directors' emolument comprises Directors' fees, basic salaries, bonuses, share options and allowances. based on their responsibilities and contribution to the Group.

### **Gearing ratio**

As at 31 December 2006, the total assets of the Group amounted to about RMB1,924.3 million (2005: RMB971.0) whereas the bank borrowings amounted to RMB749.6 million (2005: RMB250.4 million). The gearing ratio was about 39% (2005: 26%).

Upon repayment of the ABN AMRO Loan after the listing of the Shares in February 2007, the Group's gearing ratio has been significantly improved.