

## Xian Leng Holdings

Recommendation: **BUY**

Stock Code: 7121

Bloomberg: XLH MK

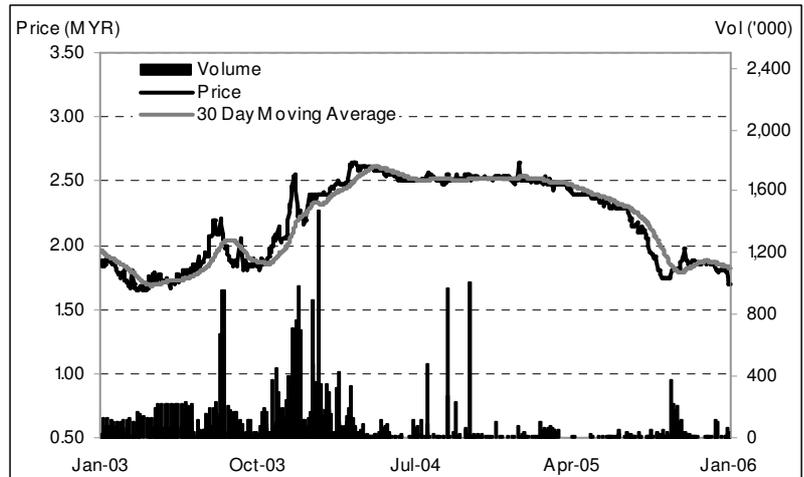
Price: MYR1.70

12-Month Target Price: MYR2.00

Date: January 9, 2006

**Board:** Main**Sector:** Consumer products**GICS:** Consumer Discretionary / Specialty Stores**Market Capitalization:** MYR123.6 mln

**Summary:** Xian Leng Holdings (XL) is involved in the commercial captive breeding of the Asian Arowana and other ornamental fish, as well as trade in related aquarium accessories.

**Analyst:** Alexander Chia, ACA**Highlights**

- We like XL for its strong niche position in a highly regulated industry that has high barriers to entry. XL has developed proprietary breeding techniques that has consistently produced high quality Arowana fingerlings.
- The group enjoys enviable profit margins and ROEs, with a consistent profit track record since 1997. Earnings growth may not be spectacular in the near-term due to production limitations but the increasing popularity of ornamental fish breeding and of the Arowana in particular, will ensure consistently strong demand for XL's products. A third farm with over 140 ponds is currently nearing completion to enable XL to gradually raise its production of Arowana.
- 3QFY06 results showed uncharacteristic weakness due to severe price competition by smaller farms. Management does not expect this situation to last beyond the current quarter.

**Investment Risks**

- Risks to our recommendation and target price include an economic downturn in the key markets that XL exports to that could negatively affect demand and a change in consumer preferences that could affect the popularity of the Asian Arowana among hobbyists
- In our view XL is over-dependent on certain key management personnel to ensure that operations are run smoothly.

**Key Stock Statistics**

FY Jan.	2005	2006F
EPS (sen)	23.9	22.0
PER (x)	7.1	7.7
Dividend/Share (sen)	4.5	4.5
NTA/Share (MYR)	1.74	1.92
Book Value/Share (MYR)	1.74	1.92
Issued Capital (mln shares)	72.7	
52-week Share Price Range (MYR)	1.69 - 2.54	
Major Shareholders:	%	
Ng Huan Tong	23.3	
Lim Wan Hong	23.3	
Employees Provident Fund Board	7.8	

**Recommendation**

- We initiate coverage on XL with a Buy recommendation. Our 12-month target price of MYR2.00 implies an upside of 18%, having been derived using a relative PER valuation of 8x FY07 earnings and adding the forecast FY06 DPS of 4.5 sen.
- At our target price the implied FY06 and FY07 PER is 9.1x and 8.2x respectively, which we believe fairly reflects XL's risk/reward profile.
- XL has a solid balance sheet fed by strong operating cash flows. Although capex requirements are high in FY06 and FY07, estimated at between MYR25-30 mln p.a. XL should be able to meet these demands comfortably without having to resort to additional borrowings.
- XL's management has a good track record and appears to have a careful and considered approach to its business operations, with few disappointments since its 2001 IPO.
- While near-term earnings growth will likely come from its new farm, the medium-term kicker to earnings could come from the possible opening up of the lucrative US market, which currently prohibits trade in the Asian Arowana.

**Per Share Data**

FY Jan.	2003	2004	2005	2006F
Book Value (MYR)	1.32	1.53	1.74	1.92
Cash Flow (sen)	26.9	34.0	36.9	36.1
Earnings (sen)	19.5	22.9	23.9	22.0
Dividend (sen)	2.0	3.0	4.5	4.5
Payout Ratio (%)	10.3	13.1	18.9	20.5
PER (x)	8.7	7.4	7.1	7.7
P/Cash Flow (x)	6.3	5.0	4.6	4.7
P/Book Value (x)	1.3	1.1	1.0	0.9
Dividend Yield (%)	1.2	1.8	2.6	2.6
ROE (%)	14.7	16.1	14.6	12.0
Net Gearing (%)	9.6	12.6	10.8	9.8

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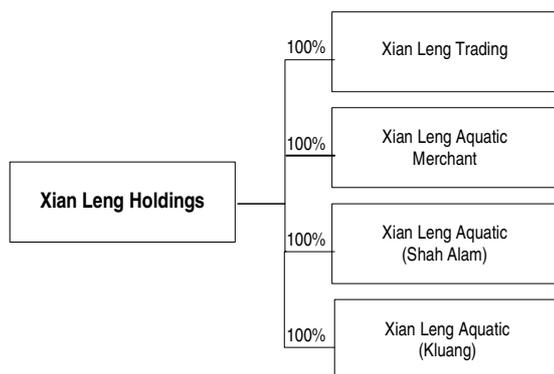
**Background****Corporate Profile**

XL is a pioneer captive commercial breeder of the Asian Arowana fish. The group is involved in wholesale and retail trade of the Asian Arowana and also other ornamental fish, recently moving into the ornamental fish aquarium accessory business. Other than the Asian Arowana, XL also trades in Japanese Koi, Discus, Cichlids, Anabantids and Gold Fish.

XL's founder, Mr. Ng Huan Tong is now its Managing Director, having been an ornamental fish enthusiast in the 1970s. Beginning with a one-acre farm in 1980, the company expanded into a five-acre farm in Sungei Suluh in 1986 and another 50-acre farm in Parit Sulong in 1996. XL was initially listed on Bursa Malaysia's Second Board in 2001 and transferred to the Main Board in 2003.

The group's major shareholders are Mr. Ng Huan Tong and his wife Lim Wan Hong (Executive Director) who together hold a combined 46.5% equity stake.

No corporate governance issues were noted. The Board of XL consists of three independent directors (out of ten) which is the minimum mandated by the Bursa's listing requirements.

**Corporate Structure**

Source: Company Data

**Business**

XL currently generates about 75-80% of its revenues from the sale of fish, principally the Arowana. The remainder comes from the sale of aquarium accessories to the local market. Fish exports contribute about 52% to group's revenues while local sales make up 23%. Japan is currently XL's largest export market taking up about half of XL's overseas sales. Other export markets include China, Taiwan, Hong Kong, Southeast Asia, Switzerland, Canada and the United Kingdom. XL's products are marketed through wholesale importers and distributors, which will then distribute to their own client network.

The Asian Arowana (*Scleropages Formosus*) is also known in Malay as the "Ikan Kelisa" and in Chinese as the "Dragon Fish". It is a slender and graceful fish that can grow up to 39" in length. It has an elongated body with a large mouth, eyes and barbels on the lower jaw, which resemble a mythical dragon. It is highly sought after as an ornamental fish with some enthusiasts believing that the fish can bring prosperity and harmony. Geomancers encourage a Red Asian Arowana to be kept to bring good

luck and to ward off evil. The fish is especially popular in Japan where it is seen as a prestige product.

The Asian Arowana occurs naturally in only a few places in the world, mainly in Malaysia and Indonesia. Their natural population in the wild has been severely depleted over the years and is classified as an endangered species by the Convention on International Trade in Endangered Species (CITES). CITES is an international body based in Switzerland and its aim is to ensure that international trade in specimens of wild animals and plants does not threaten their survival. Malaysia has been a party to CITES since 1978. XL was the first company in the world to be registered by CITES for the commercial captive breeding of Asian Arowanas in 1994. Under CITES regulations, only the second generation (F2) of fish and beyond can be traded, a process that takes at least eight years. The breeder also has to conclusively demonstrate that it is able to breed the fish in captivity under the close supervision of the Management Authority of the country concerned, in this case the Department of Fisheries. The farm has to be registered by CITES.

The Arowana fish spawns an average of 30 eggs and as such has a low reproductive rate (fecundity). Production in the wild is also low due to the destruction of their natural habitats. XL currently has broodstock numbering over 5,000, one of the largest in the industry. In recent years XL has produced and sold about 12,000 tails annually. A good specimen can fetch over US\$10,000 per fish.

XL is currently constrained by space limitations as its two farms with 122 ponds is currently considered to be over-crowded, with higher than the ideal numbers of fish in each pond. Management is concerned that this could be limiting their rates of reproduction. As such XL is currently completing its third farm, located close by to main farm in Parit Sulong. Sprawling over 38 acres, the new farm will have over 140 ponds and is targeted for completion by early 2006. A fourth farm on 250 acres of land leased from the Federal Government located in Kluang in Johor is currently being developed.

The main costs items include farm operation costs, feed costs and depreciation. The farm is operated as a high security zone with perimeter fencing, close circuit television (CCTV) security and watch dogs. XL's farm has a natural source of water supply and is located next to a forest reserve. It produces its own feed (mainly small fish and shrimp) to ensure the reliability and quality of the feed and also to control costs.

XL places significant emphasis on research and development encompassing farm design, hatchery set up and other support systems. Substantial effort has also been made in breeding and raising the Asian Arowana through R&D on biotechnology, genetic selection and husbandry techniques. Improvements in fish quality, color, physical appearance and robustness can enhance their selling price.

While there are no clear statistical data, XL is thought to be the largest and most sophisticated Arowana breeder in Malaysia, although there are other CITES registered farms in Malaysia, Singapore and Indonesia. Competing farms in Singapore tend to be much smaller due to the scarcity of land and water, while Indonesian farms are regarded as less cultured.

We believe that there is a substantial and growing interest in ornamental fish rearing, with numerous magazines, websites, trade shows and exhibitions catering to this hobbyist interest. A Department of Fisheries report estimated the annual value of the global trade in ornamental fish at about US\$600 mln.

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Trade in the Asian Arowana into Taiwan has been prohibited since the mid-1990s due to its classification as an endangered species. However entry into the Taiwanese market was re-opened in 2002-3, enabling XL to tap the significant demand there. Sales to China and Taiwan now make up 25% of XL's exports. Similarly the US currently bans trade in the Asian Arowana. From their discussions with the authorities, management believes the US government could soon reconsider their position and allow trade in the Asian Arowana, although the time frame for this remains uncertain. Management believes that the potential demand from the US could be significant due to its large population of overseas Chinese.

Going forward other than the new farms in various stages of planning previously mentioned, XL's management intends to move into breeding the Japanese Koi, which is also highly-prized and valued for its aesthetic qualities, as well as fresh water sting ray varieties. Additional retail outlets are also being considered.

### Earnings Outlook

XL's recently announced 3QFY06 results showed an uncharacteristic dip, with revenues and net profits declining 29% and 56% QoQ respectively. Management attributed this to unprecedented, severe price competition from smaller competitors resulting in XL deferring the sales of some of its higher quality fish to a later date when prices improve. This is reflected in the lower EBITDA margin for the quarter at 70.5% compared to 79% for 1HFY06. Earnings were also affected by higher depreciation charges relating to its new farm. Management believes that this situation is unlikely to last beyond the current quarter given the limited stocks that these competing farms are believed to possess. As such we expect that 4QFY06 to remain flat QoQ, leading to our forecast FY06 revenues and net profits of MYR46.7 mln (-5% YoY) and MYR16.0 mln (-7.8% YoY), respectively.

Going forward for FY07 we are forecasting a gradual quarterly improvement in sales as the effects of the price competition recedes and selling prices normalize. Additional high quality Arowana production from its new farm should also become available during FY07. We are forecasting revenues of MYR53 mln (+13.6%). However due to the additional supply of Arowanas from the new farm, we remain conservative on EBITDA margins, forecasting just 73% compared to 73.7% for FY06. The higher depreciation charges from the new farm will result in proportionately slower YoY net profit growth of 11.2% to MYR17.8 mln.

Management expects capex for FY07 to be between MYR25-30 mln, which we expect can be comfortably funded from internally generated funds without needing to resort to borrowings. XL expects to pay out 20% of earnings as dividends.

### Valuation

The closest listed peer is Qian Hu (QIAN SP, Not Ranked) listed in Singapore, which is also a CITES-registered breeder of the Asian Arowana. While almost all of XL's revenues and profits are from fish sales, only 47% of Qian Hu's 2004 turnover is derived from the sale of ornamental fish, with the remainder coming from the sale of aquarium and pet accessories and plastics. However 86% of its net profits are from ornamental fish sales.

Another listed (MESDAQ) local fish breeder is Borneo Aqua Harvest (BAH, BORN MK, Not Ranked). BAH is an integrated marine aquaculture

company that breeds and sells seawater fish such as groupers, trouts and snappers. Again BAH's business is not strictly comparable to XL's since BAH's products are not aquarium fish but meant for consumption.

We would describe XL's near- to mid-term earnings growth prospects as steady rather than spectacular given the short-term difficulties in increasing production levels. We like XL for being a pioneer and a market leader in its chosen field and while we believe that the ornamental fish hobbyist interest is well-entrenched with a strong world-wide interest, it is highly dependent on the state of the economy in its key markets of Japan, China and Taiwan. The Arowana industry's delicate supply and demand balance is also susceptible to moves by some suppliers as seen by the ongoing aggressive price competition which has affected 3QFY06 earnings and which is likely to drag on to the remaining quarter. As such we are inclined to value XL at 8x FY07 earnings, which is approximately a 35% discount to market. Including the forecast tax exempt FY06 DPS of 4.5 sen, we arrive at our 12-month target price of MYR2.00, which implies an 18% upside hence our Buy recommendation. At our target price the implied FY06 and FY07 PER is 9.1x and 8.2x, respectively, which we believe fairly reflects XL's risk/reward profile.

### Comparative Valuation

	XIAN LENG	QIAN HU <sup>^</sup>	BORNEO
Share Price (MYR) @ Jan. 6, 2005	1.70	S\$ 0.24	0.27
Mkt. Cap (MYR mln)	123.6	S\$ 30.3	79.50
Ave. Daily Vol. ('000)	19.3	14.4	1,270.3
PER FY04 (x)	7.4	4.2	NA
PER FY05 (x)	7.1	18.1	NA
P/NTA	1.0	0.8	2.4
Yield (%)	2.6	0.0	0.0

<sup>^</sup> Qian Hu and Borneo have a Dec. YE. EPS data is for 2003 and 2004

Source: Bloomberg, Company data

### Relative Share Price Performance of Comparables



Source: Bloomberg, S&P Equity Research

### Recent Developments

Dec. 2005: Reported 3QFY06 results with revenues of MYR9.8 mln and net profit of MYR2.7 mln, a QoQ decline of 29% and 56%, respectively.

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This was attributed to severe price competition and higher depreciation charges.

Sep. 2005: Released 2QFY06 results; Reported revenues of MYR13.9 mln and net profit of MYR6.2 mln for the quarter ended July 2005, a YoY increase of 7.85% and 18.93% respectively, due to improved volume and margin from sales of Asian Arowana.

Sep 2005: The company has indefinitely deferred its proposed joint venture in Hong Kong.

**Profit & Loss**

FY Jan. / MYR mln	2004	2005	2006F	2007F
Revenue	47.3	49.2	46.7	53.0
Operating Profit (EBIT)	23.2	25.6	24.2	26.8
Depreciation	-8.0	-9.4	-10.2	-11.9
Net Interest Income / (Expense)	-1.0	-1.2	-1.6	-1.8
Pretax Profit	22.3	24.4	22.7	25.0
Effective Tax Rate (%)	25.4	28.9	29.5	29.0
Net Profit	16.6	17.3	16.0	17.8
Operating Margin (%)	49.0	52.0	51.8	50.5
Pretax Margin (%)	47.0	49.6	48.5	47.2
Net Margin (%)	35.1	35.2	34.2	33.5

Source: Company data, S&P Equity Research

**Balance Sheet**

FY Jan. / MYR mln	2003	2004	2005
Total Assets	115.2	138.7	155.2
Fixed Assets	95.6	119.2	138.9
Current Assets	19.6	19.5	16.3
Other LT Assets	0.0	0.0	0.0
Current Liabilities	9.0	14.1	13.2
LT Liabilities	10.4	13.5	15.5
Share Capital	48.3	72.5	72.6
Shareholders' Funds	95.8	111.1	126.4

Source: Company data, S&P Equity Research

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**Glossary**

**Strong Buy:** Total return is expected to outperform the total return of the KLCI or KL Emas Index respectively, by a wide margin over the coming 12 months, with shares rising in price on an absolute basis.

**Buy:** Total return is expected to outperform the total return of the KLCI or KL Emas Index respectively, over the coming 12 months, with shares rising in price on an absolute basis.

**Hold:** Total return is expected to closely approximate the total return of the KLCI or KL Emas Index respectively, over the coming 12 months with shares generally rising in price on an absolute basis.

**Sell:** Total return is expected to underperform the total return of the KLCI or KL Emas Index respectively, over the coming 12 months and share price is not anticipated to show a gain.

**Strong Sell:** Total return is expected to underperform the total return of the KLCI or KL Emas Index respectively, over the coming 12 months by a wide margin, with shares falling in price on an absolute basis.

**S&P 12 Month Target Price** – The S&P equity analyst's projection of the market price a given security will command 12 months hence, based on a combination of intrinsic, relative, and private market valuation metrics.

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