

Xian Leng Holdings Berhad		Price:	RM1.12
		Market Capitalisation:	RM81.4m
		Board:	Main Board
		Sector:	Consumer Products
Stock Code:	7121	Recommendation:	HOLD

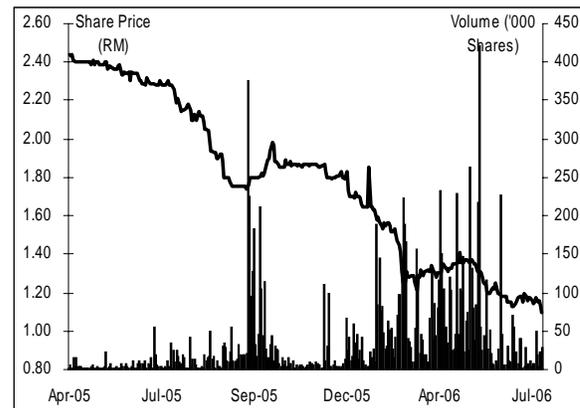
Key Stock Statistics	FY06	FY07F	FY08F
EPS (sen)	20.9	13.0	13.9
P/E on EPS	5.4	8.6	8.1
Dividend/Share	4.5	4.5	4.5
NTA/Share (sen)	1.91	1.99	2.08
Book Value/Share (sen)	1.91	1.99	2.08
Issued Capital (m shares)	72.7	72.7	72.7
52-weeks price range (RM)	1.09 – 2.23		

Major Shareholders:	%
Ng Huan Tong	23.3
Lim Wan Hong	23.3
Employees Provident Fund Board	7.8
Chua Bah Bee @ Chua Chong Seng	6.9

Per Share Data	2005	2006	2007F	2008F
Book Value (RM)	1.74	1.91	1.99	2.08
Cash Flow (sen)	43.4	28.9	30.6	32.3
Earnings (sen)	23.9	20.9	13.0	13.9
Dividend (sen)	4.5	4.5	4.5	4.5
Payout Ratio (%)	18.9	21.5	34.7	32.4
PER (x)	4.7	5.4	8.6	8.1
P/Cash Flow (x)	2.6	3.9	3.7	3.5
P/Book Value (x)	0.6	0.6	0.6	0.5
Dividend Yield (%)	4.0	4.0	4.0	4.0
ROE (%)	9.3	7.5	4.1	4.3
Net Gearing (x)	0.1	0.2	0.2	0.2

P&L Analysis (RM mil)	2005	2006	2007F	2008F
Year-end: 31 Jan				
Revenue	49.2	45.4	40.6	43.5
Operating Profit	25.6	22.3	15.0	15.6
Depreciation	(9.4)	(11.1)	(12.8)	(13.4)
Interest Expenses	(1.2)	(1.6)	(1.9)	(1.6)
Pre-tax Profit	24.4	20.7	13.1	14.0
Effective Tax Rate	29%	26%	28%	28%
Net Profit	17.3	15.2	9.4	10.1
Operating Margin	52%	49%	37%	36%
Pre-tax Margin	50%	45%	32%	32%
Net-Margin	35%	33%	23%	23%

Share Price Chart



1. Latest Developments

- We met up with the Xian Leng's (XL) management recently to get an update on the group's prospects. Among the key points of the meeting were that management felt sufficiently confident that the steep Asian Arowana price competition encountered in the 2H of last FY06 is now tapering off and this will help to stabilise XL's earnings performance hopefully from the 2H of the current FY.
- Recall that the group's 1QFY07 results were still weak due principally to higher operating costs and lower revenue, which led to a significant reduction in the profit margins of the group's core Asian Arowana operations. However, with Asian Arowana prices now apparently stabilising after their unprecedented fall last year, we understand that the upcoming 2Q results will probably approximate that of the 1Q.
- Going forward, management said it is trying to achieve similar results as for FY06, implying a much stronger 2H performance for the year will be required. We think this remains a high challenge for now given that the effect of the

steep price discounting will linger on in the industry for a while coupled with higher depreciation charges to be incurred on the group's new third farm. Note that the new farm (Farm 3) is only about 25% operational currently because of the decline in demand of the higher priced premium Asian Arowana.

- The worst may be over for the group for now even though we are not sure how long it will take for the Asian Arowana prices to recover to the highs of an average of RM5,000/tail from the current RM3,500/tail, given that the price war was unprecedented in the industry. Pending the actual recovery of the industry, we are maintaining our lower profit forecasts for the group and a HOLD rating on the stock for now.

Background

- To recap, the founder of XL, Mr. Ng Huan Tong is an ornamental fish enthusiast, who set up XL and started commercial breeding and sale of fish in 1980. He noted the increased interest in Asian Arowana then and went on to focus on cultivating the specie, garnering extensive proprietary knowledge on the breeding and aqua husbandry of the species. In 1994, XL was the first company to be registered with CITES (Convention on International Trade on Endangered Species of wild fauna and flora) for the commercial captive breeding of Asian Arowanas.
- The company went from strength to strength, expanding from a 5-acre basic farm in Sungai Suloh (Farm 1), to a subsequent 50-acre high tech aqua farming complex in Parit Sulong (Farm 2), Johor; complete with hatchery, nursery, quarantine zone and facilities to enable the packaging and export of Asian Arowana worldwide. The company was listed on the Kuala Lumpur Stock Exchange Second Board in December 2001 and was transferred to the Main Board in August 2003.
- The recently completed farm in Batu Pahat (Farm 3) has raised the total number of ponds to approximately 250, which eased the problem of high density at its old farm of more than 50 tails/pond. With a more conducive environment (ideally 30 tails/pond), management is hoping that the Asian Arowanas will fare better and improve productivity. The reasons being that these fish have low fecundity of an average of about 30 offsprings each time in an earth pond, and once or twice a year at best. With this new farm, the group hopes to increase the production of the fish by a conservative 10% according to management.
- There are a total of 8 CITES registered breeders in Malaysia, with XL believed to be contributing approximately 50% of the total quantity of Asian Arowanas exported from Malaysia each year. Its biggest market is Japan, which comprises more than 50% of its total revenue. The group has 30 permanent employees, and 2 teams of contract workers (10 to 15 workers/team) who maintain the farms. Almost 90% of its costs are fixed costs, with depreciation and labour charges as the major components. At present, XL has about 5,000 tails of broodstocks at different stages of maturity, which are valued at the lower of cost or net realisable value.
- The group is going to develop its leased 250-acre land from the Government in Kluang in stages as a tropical fish breeding centre, a retail centre and an aquarium. XL is still in the midst of finalising the terms and conditions with its foreign partners, who will help to jointly develop the land. The group will provide the land and facilities, while the partners will provide the technical know-how and technology in the cultivation and breeding of tropical fish.

Asian Arowana

- The Asian Arowana, also known as the Dragon Fish, is regarded as an ancient fish and an endangered species; listed by CITES as one of the highest classes of protected fish due to its rapid decline in the wild. They are indigenous to the Southeast Asia region, especially in Borneo, Sumatra and Malaysia; and can be found in a number of specialised habitats only. The Asian Arowana exists in 4 main variants, namely Malaysian Golden (a bestseller), Indonesian Golden, red arowana and green arowana.
- Asian Arowanas take about 4 years to be sexually mature and typically 6-8 years when they can be used for commercial production. It spawns only 30 to 40 eggs each time compared to other tropical aquarium fish, which reproduce thousands and millions. Thus, mass production of the fish to flood the market is unlikely since the fish has a low procreation rate and breeds successfully only in specialised habitats. They are mouth brooders, carrying the eggs and fry in the mouth, with the male incubating the eggs and young for about 60 days.
- Pricing of the Asian Arowana largely depends on its features (colour, shape, whiskers, fins, eye clarity) and is sold according to grades. Each fish is tagged with a microchip with its unique identity number for tracking and

tracing, and also for the detection of congenital defects in a pedigree and to practice responsible breeding. The microchip tagging is ideally done when the fish is about 6-month old whereby it will start to show its colours.

Illegal activities and price war

- Although CITES has taken initiative to ensure its captive breeding program for the protection of the Asian Arowanas pedigree and the prevention of their extinction, a number of illegal activities still continue in Malaysia and Indonesia. Some breeders just dig up a big earth pond and throw in whatever Arowanas they have in their brood stock; hence a lot of hybrids are produced since these strains interbreed easily. Hybrids are usually more prone to sickness and birth defects that can cause disastrous consequences down the line, as future generations will suffer due to bad genes and mutations. These irresponsible breeders who care for only quantity, market these hybrids as genuine Asian Arowanas. Other breeders will catch Arowanas from the wild, and then tag them as CITES registered. For those Arowanas that do not have the desired colours, the breeders will treat them with hormones so that they can sell the fish at a higher price. As a result of such illegal activities, the quality of Arowanas has deteriorated.
- In order to trade Asian Arowanas legally, the breeder/traders are required to be certified by CITES as these fish are protected species. Ironically, because it is almost impossible to have mass production of high quality Asian Arowanas, the illegal breeders who “created” the price war with substandard Asian Arowanas last year, will soon run out of fish and therefore, the supply and the price may slowly but surely stabilised. According to XL’s management, this is the first time that they are experiencing such scale of fish dumping and price war in more than 20 years in the business.

2. Earnings outlook

- The 1Q07 results were below expectations but showed signs of recovery from 4Q06. The tapering off effect of the price war in the industry for Asian Arowana is evident from the increase in revenue and profits in 1Q07 as compared to 4Q06. Management however believes the operating environment is still expected to remain challenging for FY07. As such, we are inclined to maintain our forecast for FY07 and FY08 for the time being until there is a marked recovery in the demand and the price of the premium Asian Arowanas.
- Still, XL’s profit margin may face continuous downside pressure due to rising costs, especially the depreciation for Farm 3. Going forward, potential new earnings contributions could come from the rising demand for tropical fish that the group has started cultivating at its Farm 1, and future contributions from the Kluang Tropical Fish Centre when it is developed.

3. Recommendation

- XL’s balance sheet continues to be healthy with an estimated net gearing ratio of only 0.18x for FY07 and 0.17x for FY08. The group has been able to finance most of its capital expenditure (capex) from its operational cash flows in the past few years. We expect XL’s future capex to be focused on the Kluang farm.
- The group’s share price has been on a steady downtrend for the past year due to its weaker FY06 results. At the current price level, the stock is trading at a reasonable 8.1x PER based on a prospective EPS of 13.9 sen for FY08. Valuations are inexpensive but the stock clearly lacks the growth factor that can draw back investors for now. Further, with continuous challenging prospects facing the group, we are maintaining our HOLD rating on XL pending further developments in the industry price war.

Investment ratings:

Buy (generally >10% upside over the next 12 months)

Hold (generally negative 10% downside to positive 10% upside over the next 12 months)

Sell (generally >10% downside over the next 12 months)

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