

**Analyst: Kelvin Li**

## Main Board Listing – Research

小肥羊集團有限公司

Little Sheep Group Limited [Stock Code: 00968]
**Joint Global Coordinators, Joint Bookrunners,  
Joint Sponsors and Joint Lead Managers**

: Deutsche Bank Merrill Lynch

**Sector** : Hotels, Restaurants & Leisure

**Business** : A hot-pot restaurant chain operator in the PRC

|   |  |
|---|--|
| <b>Total share offer:</b> <u>245,188,000</u> shares<br>(23.86% of the enlarged share capital,<br>including 174,699,870 new shares and<br>70,488,130 existing shares)<br><br><b>Public Offer:</b> 24,519,000 shares (10%)<br><b>Placing:</b> 220,669,000 shares (90%)<br><b>Greenshoe:</b> 36,778,000 shares       | <b><u>Business of Little Sheep</u></b><br><br>Little Sheep is a full-service restaurant chain operator in the Mainland. The Group specialized in Mongolian-styled hot pot cuisine with a signature menu characterized by its aromatic soup base and Mongolian lamb specialties.<br><br>Since establishment in 1999, the Group has built a nationwide restaurant network in China under its "Little Sheep" brand name. By the end of 2007, the Group had 81 company-owned and 249 franchise restaurants in the Mainland. Besides, it also had 9 company-owned and 8 franchised restaurants in HK and Macau.<br><br>The Group is also engaged in the processing and sales of lamb and soup base products and the wholesale distribution of fresh and dry foods. Little Sheep now owns and operates two processing facilities in Inner Mongolia, processing more than 5,000 tonnes of lamb in 2007, which met 45% of the Group's lamb requirement. It also owns and operates a production facility in Baotou, Inner Mongolia, which produces hot pot soup base served in Little Sheep restaurants and sold to other clients via the Group's wholesale channels. |
| <b>Price:</b> HK\$2.68 – HK\$3.68 per share<br><b>Market Cap:</b> HK\$2.75 billion–HK\$3.78 billion<br><b>Pro forma FY2008E PER:</b> 19.7x to 27.1x<br><b>Adjusted NTA per share:</b> RMB0.51 – RMB0.67<br><b>Staffing:</b> 5,242 (as of 31 <sup>st</sup> December 2007)  |  |
| <b>HK Public Offer period:</b><br>2 <sup>nd</sup> June 2008 – 5 <sup>th</sup> June 2008 noon<br><br><b>Receiving bank:</b> Bank of China (HK)<br>Standard Chartered Bank<br>Hang Seng Bank<br><br><b>Share registrar:</b> Tricor Investor Services Limited<br><br><b>Listing date:</b> 12 <sup>th</sup> June 2008 |  |

### Shareholders after Listing (Assuming the over-allotment option is not exercised)

|   |                |
|---|----------------|
| Possible Way, which is 25.5% owned by Mr. Zhang Gang (Chairman), 18.36% by Mr. Chen Hongkai (a co-founder and non-executive director) and 14.4% by Mr. Li Xudong (a co-founder and a passive investor). The remaining stake in Possible Way is owned by other executive and non-executive directors, senior management and independent third parties. | 50.86%         |
| Billion Year, which is owned by 7 staff members and 32 independent 3 <sup>rd</sup> party individuals.   | 11.13%         |
| The 3i Investors, led by 3i Group plc – a London Stock Exchange-listed company  | 11.32%         |
| PraxCapital – a private equity fund   | 2.83%          |
| Public Investors  | 23.86%         |
|   | <u>100.00%</u> |

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### Use of Proceeds

Net proceeds from the offer are estimated to be HK\$462 million (Assuming an offer price of HK\$3.18, being the mid-point of the indicative offer price range, and the over-allotment option is not exercised)

|  | HK\$ million |
|--|--------------|
| To increase the number of company-owned restaurants at selected locations in the larger and more developed cities in the PRC and to undertake refurbishment programs for the existing company-owned restaurants. | 277.2        |
| To upgrade and expand the capacity of Group's lamb processing and soup base production facilities and logistics centre.  | 92.4         |
| To upgrade IT system and staff training in order to enhance efficiency in the Group's centralized operation management.  | 23.1         |
| For the potential acquisitions of franchise restaurants.   | 46.2         |
| For working capital.   | 23.1         |

### Financial Highlights

|  | Year ended 31 <sup>st</sup> Dec |                   |                   |
|--|---------------------------------|-------------------|-------------------|
|  | 2005                            | 2006              | 2007              |
|  | RMB '000                        | RMB '000          | RMB '000          |
| Revenue                                    | 513,122                         | 702,713           | 949,174           |
| Gross profit                               | 319,642                         | 432,623           | 579,880           |
| Operating profit                           | 86,042                          | 112,567           | 148,207           |
| <b>Profit attributable to shareholders</b> | <b>60,078</b>                   | <b>79,555</b>     | <b>91,163</b>     |
| Gross profit margin                        | 62.29%                          | 61.56%            | 61.09%            |
| Operating profit margin                    | 16.77%                          | 16.02%            | 15.61%            |
| Net profit margin                          | 11.71%                          | 11.32%            | 9.60%             |
|  | <b>31/12/2005</b>               | <b>31/12/2006</b> | <b>31/12/2007</b> |
| Net debt/(cash) to Equity                  | (16.6%)                         | (79.7%)           | (36.5%)           |

### Breakdown of revenue in terms of business lines

|                               | Year ended 31 <sup>st</sup> Dec |                |                |
|-------------------------------|---------------------------------|----------------|----------------|
|                               | 2005                            | 2006           | 2007           |
|                               | RMB '000                        | RMB '000       | RMB '000       |
| Restaurant operations         | 403,299                         | 562,259        | 750,867        |
| Sale of food products         | 98,642                          | 127,897        | 170,479        |
| Franchise income              | 10,126                          | 11,310         | 26,375         |
| Management service fee income | 1,055                           | 1,247          | 1,453          |
| <b>Total</b>                  | <b>513,122</b>                  | <b>702,713</b> | <b>949,174</b> |

**Strengths/Opportunities**

- ✓ Little Sheep could be regarded as an investment proxy for improving standard of living in the Mainland, as more people dine out for convenience, rather than just for special occasions in the past. Besides, statistics also showed that dining out spending of urban households in China has accounted for a growing proportion of their total annual food expenditure, up from 16.9% in 2001 to 22.2% in 2006, implying more people choose to dine out rather than cook at home.
- ✓ The Group has built up a strong brand name since its establishment a decade ago and is a leading hot pot restaurant operator in the Mainland, serving hot pot cuisine and lamb dishes.
- ✓ Hot pot cuisine involves less kitchen preparation and gourmet expertise, which enables the Group to maintain its food quality amid business expansion. To further strengthen its network, the Group is planning to open another 40 new company-operated restaurants before the end of this year.
- ✓ The Group's revenue was mainly generated during dinner hours, because hot pot cuisine is more time-consuming and people seldom have hot pot meals during lunchtime. In order to boost the same-store sales, Little Sheep plans to introduce convenient lunch combination menus to attract customers seeking quick and affordable meals.

**Weaknesses/Threats**

- × Lamb is the key raw material used in Little Sheep's menu, which is mainly supplied by shepherd unions in the Inner Mongolia. Breakdown of business relationship with these shepherd unions may lead to disturbance of lamb supply and harm the Group's operations.
- × Lamb is the Group's signature dish. Any distortion or suspension of the lamb menus because of unforeseeable factors like the outbreak of foot-and-mouth disease could create serious impact on Little Sheep's operation.
- × The Group plans to diversify its menu, via the introduction of non-hot pot and non-lamb products, to boost its sales. Nonetheless, such strategy may fail or see limited impact, given Little Sheep is only famous for its hot-pot and lamb dishes and it may find little competitive edge against rivals in other products.
- × Rising staff costs is drawing attentions. In 2007, the Group's staff costs grew 38.6% y-o-y to RMB165.9 million, higher than its top-line growth of 34.8%. As a result, the share of staff cost in the Group's total costs surged to 20.0% in 2007, up from 19.7% in 2006 and 19.1% in 2005. It is expected that the ratio of staff cost to total cost would rise in the future, as the Group is planning to open more company-owned restaurants.

**Recommendation:    Trading Buy**

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