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The Thick Skin of Shenguan's High Margins

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The Basics		Emerson Analytics Estimates
Ticker:	HK:00829	Target Price: HK\$1.10 (-60%)
Recent Price:	HK\$2.80	
Market Cap:	HK\$9.3bn	

Shenguan Holdings (Group) Limited (HK:00829) has been doctoring its books since its October 2009 IPO when it raised Rmb1.2bn from the Hong Kong market.

1. Hidden raw materials costs

The core raw material for collagen sausage casing production is cattle inner skin. Our research and investigation show that Shenguan consumed 70,000 tons of cattle inner skin in 2013. With an average price of Rmb7,200 per ton (VAT included), total cost of cattle inner skin amounted to Rmb430.8m last year, and that alone exceeded the Rmb295.5m total raw materials costs reported by the company.

We reckon that total raw materials costs actually amounted to Rmb662.7m with total cost of sales at Rmb1,054.3m, the latter being 53.5% higher than that reported by the company. We believe Shenguan simply removed some costs off its books to dress up its financial performance, as in the Longtop case.

2. Charging the biggest client a premium price

Our analysis shows that Shenguan's sales to its largest customer during 2006-08 were priced at an average 41.3% above those to all other customers. This is just absurd. The company's overall average selling price is at least 13% below the reported.

3. Phony sales to Zhongshan Defu

Shenguan claimed in its IPO prospectus that Zhongshan Defu, controlled by a connected person, was one of its top five customers accounting for as much as 12.8% of sales in 2006. Zhongshan Defu's business registration information shows that its cost of sales was way below the revenue claimed by Shenguan.

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4. Incredibly high margins

Shenguan has reported very high EBIT margins that averaged 53% in the last few years, much higher than the 18% or so enjoyed by two global giants Viscofan Group and Devro PLC. Its gross margin at 55-60% was also a lot higher than the 25-40% reported by Liuzhou Honsen, a smaller Chinese competitor. This is just too good to be true.

As the company is in such an obscure business with no other Chinese listed peers, analysts and investors who loathe doing their own research simply take the management's word for granted. Now, our investigations and research show that in 2013, Shenguan inflated its revenue by at least 10-15% and hid part of its raw materials costs (the actual cost is about 124% higher than the reported amount). This bloated its EBIT margins from our estimated 19.8% to a reported 52.4%.

5. Other irregularities

There are a number of irregularities in Shenguan's accounts. First, the international auditor Ernst and Young only audits the Hong Kong holding company subsidiaries. All Mainland operating subsidiaries were audited by an infamous Chinese firm, Shenzhen Pengcheng, during the IPO process. Second, average monthly wages have been declining in the last two years, which is down right impossible in China where wage inflation has been in double-digit during the last few years. Third, the R&D expenses are so big (13% of revenue) as to be ridiculous and impossible to fit into the cost analysis.

6. "Subsidy" recovery and the truth of high dividend ratio

Why do the controlling shareholders led by chairwoman Zhou Yaxian want to dress up Shenguan's book by under-reporting raw materials costs? By presenting a rosy picture, they obtained a high valuation that yielded a Rmb1.2bn net proceeds, and then enriched themselves through three "legitimate" channels. They sold a tiny stake in the principal operating subsidiary to the listco after the IPO at an exorbitant valuation, they disposed of some shares in the listco barely a year after IPO, and they paid a generous dividend which mostly ended up in their own pockets. These three paths have so far generated Rmb1.94bn, which we believe far exceeds the Rmb1.66bn of costs that the company has under-reported.

Looking at the controlling shareholders and the listco as an organic whole, we can see that they have pocketed Rmb1.71bn since 2009 by paying public shareholders merely Rmb0.44bn. This is the truth about Shenguan's high dividend payout ratio.

7. Valuation

Even if one would generously accord Shenguan the same valuation in terms of P/E multiple, the stock should trade at about HK\$1.1 per share compared with the current HK\$2.8.

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Disclaimer

We are a group of seasoned equities analysts with many years of experience in the research of economic and political trends as well as individual stocks around the world. With background in various international investment banks, we have followed the development of the Chinese equities market right from day one.

We are determined to expose as much of the fraud in the Chinese stock market as we can. The most widespread and serious fraud is probably that undertaken by listed companies, in fabricating non-existent businesses and stealing shareholders money, among other tricks.

In exposing these crimes we challenge the listed companies to prove the integrity of their announcements and financial statements. The listed companies, of course, want everybody to believe that their announcements and financial statements are true. Their auditors, employees, independent directors, lawyers, shareholders and even the general public all hope that these announcements and financial statements are true.

We have made our best effort to ascertain that everything we say in this report is accurate. We have obtained our information from public sources that we believe to be accurate and reliable, or from sources whom we believe are not insiders or connected parties to the companies mentioned herein. However, we are certainly NOT in business of making investment recommendations. This is not an investment report and should not be regarded as such. Read and use our reports at your own risk. Most important of all, DO YOUR OWN RESEARCH BEFORE YOU COMMIT OTHER PEOPLE'S MONEY.

We and/or our associates/partners may have long or short positions in the equities and/or their derivatives at the time of publication of our reports, and we and/or our associates/partners may maintain or change our positions at any time.

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Introduction

Over the last six months, we have spent much time and resources analyzing Shenguan.

We contacted all collagen sausage casing manufacturers in China to get to understand the production process, use of raw materials and the economics of the industry. We visited Shandong Crown Collagen Casing Co., Ltd (山东冠华胶原肠衣有限公司), Zibo Longbao Biological Food Co., Ltd (淄博龙宝生物食品有限公司), Zhongshan Baidefu Casing Co., Ltd (中山市百德富肠衣有限公司) and Handan Dike Collagen Casing Co., Ltd. (邯郸帝科肠衣有限公司) in person, and we had a telephone conversation with Liuzhou Honsen Collagen Casing Co., Ltd. (柳州宏升胶原蛋白肠衣有限公司).

We visited several leather factories to understand how raw skin is turned into limed skin for use in the manufacture of collagen sausage casings. This helped us to ascertain the cost of cattle inner skin for casing manufacturers such as Shenguan.

We spent much time and effort to identify the two most important cattle inner skin suppliers (together they account for more than 50% of the use) to Shenguan, even though the company wants investors to believe that it relies on a large number of small suppliers for its cattle inner skin. We have no doubt that we have a good grip on Shenguan's cattle inner skin consumption and costs.

We diligently prowled through all documents published by Shenguan since its 2009 IPO, and we found that its average selling price to its largest customer was significantly higher than that for all other customers.

We examined State Administration of Industry and Commerce documents of Zhongshan Defu, one of Shenguan's top five customers in 2006-07, and found proof that the reported sales were non-existent.

Through all these efforts, we now have a better understanding of Shenguan, its operations and its financials than any bank, analyst or investor.

This is not a statement of opinion. It is a statement of fact.

Below, we present our findings and analyze the true profitability of Shenguan.

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Shenguan was listed on the Hong Kong stock market in October 2009 as China's preeminent supplier of edible collagen sausage casing products with by far the largest market share and apparently very high margins. While the IPO prospectus issued in September 2009 was fairly detailed and included all kinds of statistics, over time the company's disclosure has deteriorated and by 2012 the company ceased to disclose some of its key operating metrics. That, in our experience, is a sure sign of trouble.

Part 1. Analysis of Cost of Cattle Skin

The core raw material for collagen sausage casing production is cattle inner skin. The total cost of cattle inner skin obviously depends on consumption volume and unit price, which are discussed below.

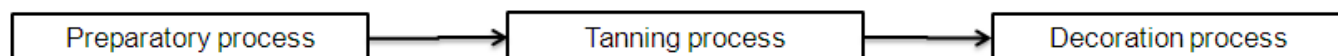
1.1. Consumption Volume of Cattle Inner Skin

The consumption of cattle inner skin obviously depends on the production and sales volume of sausage casings.

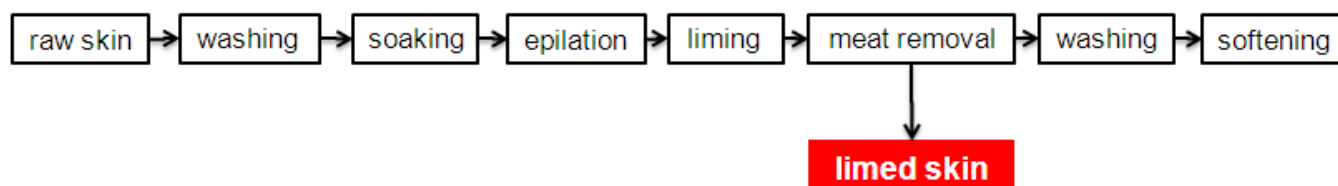
The following exhibit shows leather-making process. After a series of steps involving soaking, liming and meat removal, raw skin is turned into limed skin, which can then be used for the manufacture of collagen sausage casings.

Exhibit 1 – Processing Cattle Skin

Leather-making process



Preparatory process



Source: Emerson Analytics

1.1.1. Estimation of 2012-2013 collagen sausage casings volume

Before 2012, Shenguan had always disclosed sales volume and production capacity of its collagen sausage casings. For some reason, from that year onward, Shenguan no longer discloses such figures.

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Without any official production and/or sales figures, we can only make an educated guess based on the year-on-year growth rates in Shenguan's cost of sales, raw materials costs, energy and utilities costs and packaging material costs.

Year end Dec 31 (Rmb k)	2011	2012	YoY growth
Cost of sales	571,709	689,255	20.6%
Raw materials & consumables	234,652	312,780	33.3%
Water, electricity and coal	138,051	166,462	20.6%
Packaging materials from Wuzhou Junye	18,147	22,162	22.1%
Our estimate			25.0%

Sources: Shenguan annual reports, Emerson Analytics estimates

In the above table, Wuzhou Junye represents Wuzhou Junye Trademark Printing Material Co., Ltd., a connected party of Shenguan. The data come from the disclosure on connected transactions in the annual reports.

It can be seen that in 2012, Shenguan's sales volume should have grown more than 20% from the 2011 level. We believe a 25% sales volume growth estimate is not far off the mark.

According to the [2013 annual report](#), sales volume rose slightly on the 2012 level. We shall therefore put the 2013 sales volume growth at just 1%.

The following table shows Shenguan's collagen sausage casings sales volume from 2006 through 2013, based on the company's official data for the first six years and our educated guess for the last two.

Year end Dec 31	2006	2007	2008	2009	2010	2011	2012	2013
Sales volume (million meters)	457	632	1,041	1,779	2,576	3,385	4,231*	4,274*
YoY growth		38.3%	64.7%	70.8%	44.8%	31.4%	25.0%*	1.0%*

Sources: Shenguan annual reports, Emerson Analytics estimates

* Our estimates

1.1.2. Estimates of cattle inner skin consumption

Now that we have an estimate for the 2013 sales volume, what was the consumption of cattle inner skin that year? Obviously, this depends on how many meters of collagen sausage casings can be produced from a ton of cattle inner skin. The key variables include the production process, the quality of the

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machinery used, the technological standard, the diameters and the thickness of the sausage casings, among others. The diameters of the casings are the single most important factor in the length of casings that can be produced from a ton of cattle inner skin. What we are talking about is obviously the output for the average of various diameters of casings produced, rather than for a particular diameter.

To obtain the data, we visited Shandong Crown and Zibo Longbao. We were comfortable that the conversations were not biased against anyone, certainly not Shenguan.

Our conversations with Shandong Crown and Zibo Longbao were taped secretly. To protect the safety of the interviewees, we will not make public any audio recording in which they reveal evidence of Shenguan's lies or exaggerations. Retaliation by Chinese companies against whistleblowers has been well documented by the media (for one example, check out www.publiccompanyprisoner.org). We are, however, sharing such audio recordings as well as the interviewees' names, positions, contact telephone numbers and dates of meeting with the Securities and Futures Commission (SFC) of Hong Kong.

Shandong Crown is the second largest Chinese supplier of collagen sausage casing after Shenguan. The two companies participated in the setting of Chinese national standards for collagen sausage casing.

Evidence 1 – English Transcript of Shandong Crown_Output Per Ton.mp3

Emerson investigator: With one ton of cattle skin how many meters of collagen sausage casing can you produce? Do you have the statistics?
Shandong Crown: One ton of cattle skin, right?
Emerson investigator: Yes.
Shandong Crown: We will need to add additives and ingredients so that the weight is certainly more than a ton. If you start with a ton of cattle skin you'll get about 60,000-70,000 meters of collagen sausage casing.
Emerson investigator: 60,000-70,000 meters, right?
Shandong Crown: Yes, 60,000-70,000 meters.
Emerson investigator: Is this the average number or is this for a specific diameter?
Shandong Crown: Average.

Source: Emerson Analytics

Zibo Longbao is another Chinese collagen sausage casing manufacturer, also located in Shandong province.

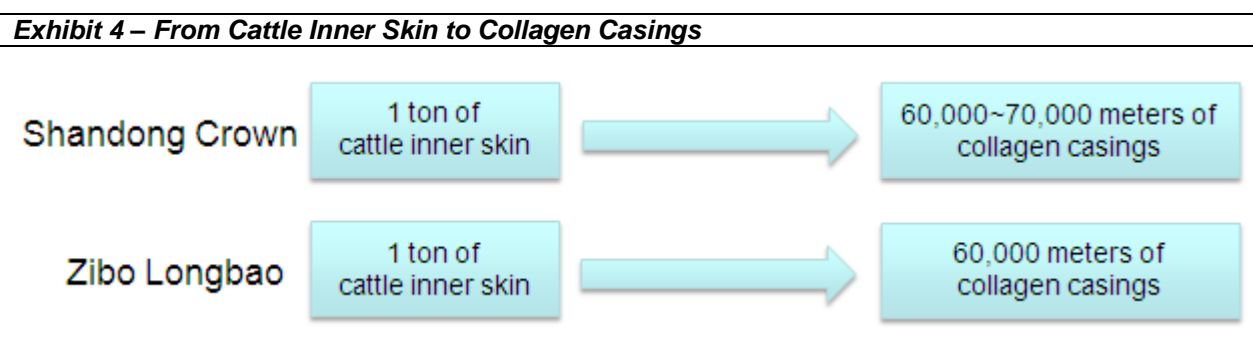
Evidence 2 – English Transcript of Zibo Longbao_Output Per Ton.mp3

Emerson investigator: How much collagen sausage casings can you get out of a ton of cattle inner skin?
Zibo Longbao: Almost 60,000 meters.
Emerson investigator: 60,000 meters per ton?
Zibo Longbao: Yes, that's right.

Source: Emerson Analytics

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Summarizing the above two conversations, we can arrive at the following.



Source: Emerson Analytics

Shenguan is the training ground of the Chinese collagen sausage casing industry. Other manufacturers tap Shenguan for their core technicians, and use similar production process as Shenguan with a similar level of technology. In six months of investigations, we have not found any evidence that Shenguan's products are on average of smaller diameter than those of other manufacturers. We are therefore convinced that data provided by Shenguan's competitors can be applied to Shenguan itself.

If a ton of cattle inner skin can produce about 60,000-70,000 meters of collagen sausage casings, then Shenguan would have used about 61,053-71,228 tons of cattle inner skin in 2013, based on our estimate of 4,273.7 million meters of sales volume, as shown in the following table,

$$4,273,700,000\text{meters} / 60,000 \text{ meters per ton} = 71,228 \text{ tons}$$

Exhibit 5 – Cattle skin required

Casings output (meters per ton)	Cattle skin required (tons)
60,000	71,228
65,000	65,749
70,000	61,053

Source: Emerson Analytics

1.1.3. Consumption volume according to cattle skin supplier

In p.91 of its [IPO prospectus](#) dated September 30, 2009, Shenguan said that for the years ended 31 December 2006, 2007 and 2008 and the six months ended 30 June 2009, it purchased cattle inner skin “from 15, 26, 37 and 32 different suppliers, respectively. Over 85% of these suppliers of cattle inner skin are operated on an individual basis”.

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This implies that the company relied on a large number of small suppliers for its cattle inner skin. However, the company has not made any additional disclosure on its suppliers since its listing.

Our investigations, on the other hand, reveal a totally different picture. Our investigators have successfully identified two key suppliers of cattle inner skin to Shenguan. One of them supplies about 12,000 tons of cattle inner skin to Shenguan every year (we'll call it inner skin supplier number 1 or ISS1 in short). The other supplies more than 25,000 tons a year (we'll call it inner skin supplier number 2 or ISS2). Both have been doing business with Shenguan for many years.

Detailed information about these two companies has also been provided to SFC, listed as **Evidence 3:ISS1_Info.mp3** and **Evidence 4:ISS2_Info.mp3**, but is not supplied here for security reasons.

ISS1 told our investigator that Shenguan's demand for cattle inner skin was about 70,000 tons a year.

Evidence 5 – English Transcript of ISS1_Total Cattle Skin Volume.mp3

Emerson investigator:	For such a large plant as Shenguan, does it need 100,000 tons a year? Shouldn't be as much as 100,000 tons, right?
ISS1:	No, it's only 70,000 tons.
Emerson investigator:	About 70,000 tons?
ISS1:	Yes.

Source: Emerson Analytics

Thus, one can see that the consumption of cattle inner skin calculated from collagen sausage casings sales volume is not that different from the consumption that we unearthed in our investigations.

We'll now base our analysis of Shenguan on the 70,000 tons of cattle inner skin consumption as provided by ISS1.

1.2. Analysis of Cattle Inner Skin Price

1.2.1. Whole piece or small pieces of skin?

There is some price difference between a whole piece of cattle inner skin and small pieces of skin. Before we discuss the unit price of cattle inner skin we need to ascertain what kind of skin is used in Shenguan's collagen sausage casings production.

In its 2013 annual report, Shenguan says that it has begun to use whole pieces of cattle skin for its production. In p.9, it says that "in order to maintain better quality assurance and achieve production cost-effectiveness, the Group started switching to larger pieces of cattle skin for raw material during the Year". Then in p.11, it says that "... the extensive use of whole pieces of cattle inner layer skin, which has been proved to be more cost efficient ...".

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According to our understanding, most other collagen sausage casings manufacturers in China now use whole pieces of cattle inner skin for their production. Shandong Crown, the second largest manufacturer as we have mentioned previously, is one of them. The English transcript of the relevant audio recording of a conversation with our investigator follows:

Evidence 6 – English Transcript of Shandong Crown_Whole Piece of Skin.mp3

Emerson investigator: I mean can you use the inner skin of the head and neck (to make collagen sausage casings)?
Shandong Crown: No, no. We use whole skin.
Emerson investigator: A whole piece of inner skin?
Shandong Crown: Yes, yes.

Shandong Crown: Shenguan is the biggest.
Emerson investigator: Right. According to your understanding, do they use the whole piece of skin?
Shandong Crown: They use the whole piece.
Emerson investigator: The whole piece of inner skin?
Shandong Crown: Yes.

Source: Emerson Analytics

ISS1 also confirmed to us that the company began to use whole pieces of inner skin from 2013.

Evidence 7 – English Transcript of ISS1_Whole Piece of Skin.mp3

Emerson investigator: When did Shenguan begin to use whole pieces of inner skin?
ISS1: Last year. They made this requirement last year.
Emerson investigator: Oh! They began using whole pieces of skin last year?
ISS1: They wanted some breakthrough in quality.
Emerson investigator: Whole pieces of skin are more expensive?
ISS1: Whole pieces of skin are definitely more expensive.

Source: Emerson Analytics

1.2.2. Peer companies' cattle inner skin price

We asked some collagen sausage casings manufacturers for their cattle inner skin price on an anonymous basis. Shandong Crown and Zhongshan Baidefu told us their average price was about Rmb7,000 per ton in July.

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Evidence 8 – English Transcript of Shandong Crown_Skin Price.mp3

Emerson investigator: What was the average price of cattle inner skin last year?
Shandong Crown: It's now a bit more than 7,000.
Emerson investigator: Oh, more than 7,000?
Shandong Crown: Yes, yes.

Source: Emerson Analytics

Zhongshan Baidefu is another collagen sausage casing manufacturer and is located in Guangdong province. Its core technical staff came from Shenguan. The following is a transcript, in English, of our conversation with its staff on cattle inner skin price:

Evidence 9 – English Transcript of Zhongshan Baidefu_Skin Price.mp3

Emerson investigator: Can you tell us your purchase price (of cattle inner skin)?
Zhongshan Baidefu: We're paying about Rmb7,000.
Emerson investigator: How much?
Zhongshan Baidefu: Rmb7,000.

Source: Emerson Analytics

1.2.3. Shenguan suppliers' prices

We have also asked Shenguan's cattle inner skin suppliers for their prices.

According to ISS1, their price was about Rmb7,000 per ton as of July.

Evidence 10 – English Transcript of ISS1_Skin Price.mp3

Emerson investigator: Your supplies to Shenguan now, how much are you charging them?
ISS I: Rmb7,000 per ton.

Source: Emerson Analytics

The other supplier ISS2 told us their price was Rmb7,200 per ton (**Evidence 11:ISS2_Skin Price.mp3**).

We use Rmb7,200 rather than Rmb7,000 per ton in our calculations because of the following reasons:

- The prices from comparable companies are buyers' prices which tend to be lower;
- Shenguan buys much more from supplier ISS2 than from ISS1, and ISS2 quoted a price of Rmb7,200 a ton;

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- We checked cattle inner skin prices during June and July, the hot summer months when prices tended to be lower due to seasonal factor. That is to say, Rmb7,000-7,200 a ton are probably the lowest price for the year. The full year average price should be a bit higher.

1.3. Cost of Cattle Inner Skin Analysis

Based on our previous analysis, Shenguan used about 70,000 tons of cattle inner skin in 2013. With unit price at Rmb7,200 per ton inclusive of a 17% value-added tax (VAT), the total cost of cattle inner skin for Shenguan amounted to about Rmb430.8m, as shown below.

Exhibit 6 – Cost Analysis of 2013 Cattle Skin

	Unit	2013
Volume used	Tons	70,000
Price (VAT included)	Rmb/ton	7,200
Cost of cattle skin	Rmb k	430,769

Source: Emerson Analytics

During our investigations, we have found another piece of evidence that supports our analysis that Shenguan spent about Rmb431m last year on cattle inner skin. This comes from industry peers' assessments that Shenguan's overall unit cost is about Rmb0.25 per meter. They also admit that their unit costs are higher than Shenguan's because the market leader enjoys a better economy of scale. They also noted that there's no way their unit cost would be double that of Shenguan.

Evidence 12 – English Transcript of Shandong Crown_Unit Cost.mp3

Shandong Crown:	Shenguan's unit cost is about Rmb0.25 per meter.
Emerson investigator:	Rmb0.25?
Shandong Crown:	If all our production lines are running, our unit cost can be about Rmb0.27. If we are running fewer lines, then it's Rmb0.29 or Rmb0.30.

Source: Emerson Analytics

Based on the unit cost and estimated sales volume discussed above, we believe Shenguan's cost of sales in 2013 should have been about Rmb1,068m.

In addition to raw materials costs, Shenguan's cost of sales includes utilities (mainly water, electricity and coal), employee costs (salary and benefits) and other costs.

Assuming that the company does not lie about its costs other than raw material costs, its total raw material costs in 2013 should have been Rmb676.9m, as shown below.

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Exhibit 7 – Estimation of Raw Materials Cost

Year end Dec 31 (Rmb k)	2013
Unit cost (Rmb/meter)	0.250
x Sales volume (million meters)	4,274
= Cost of sales	1,068,422
- Water, electricity and coal	-174,424
- Salary and employee benefit	-105,513
- Others	-111,617
= Raw materials & consumables	676,868

Source: Emerson Analytics

Shenguan's raw materials for the production of collagen sausage casing products include cattle inner skin, other auxiliary materials such as glycerol, lime and cellulose, and packaging materials.

The company has never disclosed its total cattle inner skin cost or the proportion of that cost to total raw material costs. We tried to clarify this issue with Ng Yuk-yeung, Shenguan's financial controller, in July, but Ng declined to discuss anything with us, saying that he was due to attend a meeting.

Subsequently, we found on the Internet an article published August 2, 2012 on *Guangxi Daily*, the official daily newspaper of Guangxi province, which is where Shenguan is based. According to the article (http://www.gxrb.com.cn/html/2012-08/02/content_713736.htm) retrieved on July 21, 2014, "the company bought cattle inner skin worth more than Rmb420m during 2008-2011".

This Rmb420m of cattle inner skin cost equals to about 65.1% of total raw materials costs during the period, as shown in the following table:

Exhibit 8 – Cattle Inner Skin Proportion

Year end Dec 31 (Rmb k)	2008	2009	2010	2011	Total
Raw materials & consumables	79,676	131,826	198,969	234,652	645,123
Cattle skin procured					420,000
Proportion					65.1%

Sources: Shenguan, Emerson Analytics

Based on the 65.0% ratio, we can see that Shenguan's cattle inner skin cost was about Rmb440m in 2013.

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Exhibit 9 – Cost Analysis of 2013 Cattle Skin

Year end Dec 31 (Rmb k)	2013
Raw materials & consumables	676,868
x Cattle skin proportion	65.0%
Cost of cattle skin	439,964

Sources: Shenguan, Emerson Analytics

1.4. Summary of Cost

The above two paths suggest that Shenguan's cattle inner skin cost was about Rmb431-440m in 2013. This was considerably more than the total raw materials cost of Rmb295.5m as disclosed by the company.

To be conservative, we use the smaller number, Rmb430.8m, in our calculations. This means total cost of sales in 2013 should have been Rmb1,054.3m, about 53.5% higher than the disclosed amount, as shown in the following table:

Exhibit 10 – Cost of Sales Structure – Shenguan Data and Our Estimates

Year end Dec (Rmb k)	Claimed	Estimated	Difference	Percentage
Cost of cattle skin		430,769		
/ Cattle skin proportion		65.0%		
= Raw materials & consumables	295,456	662,722	367,266	124.3%
Water, electricity and coal	174,424	174,424		
Salary and employee benefit	105,513	105,513		
Other	111,617	111,617		
Total	687,010	1,054,276	367,266	53.5%
Unit cost (Rmb/meter)	0.161	0.247		

Sources: Shenguan 2013 annual report, Emerson Analytics estimates

Shenguan reminds us of Longtop Financial Technologies Ltd (LFT.N), a US-listed Chinese company which collapsed after Citron Research publicly accused it of committing fraud. Longtop's insiders shifted its labor costs off the company's books to an undisclosed related party, making Longtop's performance stunning by comparison to its competitors. We believe that something similar may be happening with Shenguan.

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Part 2. Analysis of Shenguan's Average Selling Price

2.1. The Unusual Premium Paid by Major Clients

In addition to the problems with its raw materials costs as we have analyzed above, we also have grave doubts over Shenguan's revenue.

According to the company's [IPO prospectus](#), Shenguan's average selling price (ASP) rose from Rmb0.39 per meter in 2006 to Rmb0.41 in 2007 and Rmb0.44 in 2008.

The IPO prospectus also discloses in p.101 that Shenguan's single largest customer (which was Shuanghui Group, the largest meat products manufacturer in China recently listed on the Hong Kong stock market as WH Group (0288.HK), even though the prospectus does not actually name the company) accounted for 13.9%, 19.9% and 37.8%, respectively, of its total revenue during 2006-08. This implies that the company sold Rmb24.7m, Rmb51.7m and Rmb171.5m, respectively, of collagen sausage casings to its largest customer during the period. During the period, the corresponding sales volume was 49.2 million meters, 88.5 million meters and 319.1 million meters, respectively, according to p.149 and p.153 of the IPO prospectus.

The following table presents the revenue, sales volume and ASP of Shenguan's largest customer and all other customers. We can see that during 2006-08, ASPs of Shenguan's largest customer were 33.4%, 53.0% and 37.4% higher, respectively, than the ASPs of all other customers. Average premium of 2006-2008 was 41.3%.

Exhibit 11 – Shenguan's Reported ASPs

Year end Dec 31	2006	2007	2008
Sales (Rmb k)	178,279	259,291	454,053
largest customer	24,711	51,678	171,480
other customers	153,568	207,613	282,573
Sales volume (million meters)	457.1	632.4	1,041.4
largest customer	49.2	88.5	319.1
other customers	407.9	543.9	722.3
ASPs (Rmb per meter)	0.39	0.41	0.44
largest customer	0.50	0.58	0.54
other customers	0.38	0.38	0.39
Largest customer ASP premia	33.4%	53.0%	37.4%

Sources: Shenguan annual reports, Emerson Analytics estimates

This is clearly not a normal phenomenon. Generally speaking, large customers always enjoy some

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discounts and in any case will not be paying a higher price for the same products.

Perhaps Shenguan was selling something different to Shuanghui, some superior quality collagen sausage casings? The answer is NO! Shenguan's collagen sausage casings are classified into two categories, first class products (which make up the bulk of sales) and sub-standard products (which are much cheaper).

In fact, Shuanghui's sales executive indicated to our investigator that Shuanghui's prices are much below average, as demonstrated below.

Evidence 13 – English Transcript of Shenguan Sales.mp3

Emerson investigator:	Is this Shenguan Holdings?
Shenguan sales executive:	Yes.
Emerson investigator:	I'd like to ask, what's the price per meter of your sausage casings.
Shenguan sales executive:	What's your diameter?
Emerson investigator:	From 18-23(mm). How much is 21?
Shenguan sales executive:	0.54, with tax.
Emerson investigator:	That's your first class product, right?
Shenguan sales executive:	Yes, first class product.
Emerson investigator:	Are you mostly selling first class products or do you have other classes?
Shenguan sales executive:	If you need first class products then I'll send you first class products. If you want sub-standard products I'll give you sub-standard products. Sub-standard products are priced different.
Emerson investigator:	How much is that?
Shenguan sales executive:	They are 40% off. We only have first class products and sub-standard products.
Emerson investigator:	Is that your lowest price?
Shenguan sales executive:	That's our price. Everyone is the same.
Emerson investigator:	What about Shuanghui?
Shenguan sales executive:	Shuanghui? If you can reach the volume of Shuanghui I'll give you the price of Shuanghui.
Emerson investigator:	I can't reach Shuanghui's volume.
Shenguan sales executive:	Normally all our customers are given this price, except for a few special customers.

Source: Emerson Analytics

2.2. Estimate of Actual ASPs

So, what is the real ASP actually achieved by Shenguan?

According to Shenguan's sales executive, except for a few special customers everyone buys at the same price. We assume that only the biggest customer enjoys a certain discount. This assumption is the most advantageous to Shenguan. During the 2006 to 2008 period, the proportion of sales volume to the largest customer rose from 10.8% to 14.0% and finally 30.6%. For simplicity's sake we assume that this customer enjoyed a 10% discount throughout that period. We believe that it would not be unreasonable for a leading customer with a 10% share to enjoy a 10% discount, and that a 10% discount would be rather small for a customer with a 30% share. In other words, our assumptions are advantages to Shenguan.

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If we assume that all the sales volume figures during the period were accurate and that the sales revenue (and hence ASP) numbers for all other customers were also accurate, and if we further assume that the largest customer's ASPs were always 10% below those for all other customers, we can arrive at the actual sales revenue generated by the largest customer.

According to our calculations, the actual ASP in 2008 was about 13% below the number disclosed by Shenguan.

Exhibit 12 – Estimates of Actual ASPs

Year end Dec 31	2006	2007	2008
Sales (Rmb k)	170,238	238,015	394,925
largest customer	16,670	30,402	112,352
other customers	153,568	207,613	282,573
Sales volume (million meters)	457.1	632.4	1,041.4
largest customer	49.2	88.5	319.1
other customers	407.9	543.9	722.3
ASPs (Rmb per meter)	0.37	0.38	0.38
largest customer	0.34	0.34	0.35
other customers	0.38	0.38	0.39
<i>Deviation to reported numbers</i>			
ASPs	-4.5%	-8.2%	-13.0%

Source: Emerson Analytics

After Shenguan was successfully listed on the Hong Kong market, it stopped disclosing details with regard to its single largest customer or major customers. It is therefore not possible to analyze the company's actual ASPs for subsequent years in a similar manner. Experience tells us that this is a bad sign.

2.3. Phony Sales to Zhongshan Defu

Our skepticism with Shenguan's sales does not stop at the ASPs for the largest customers. According to p.101 of Shenguan's IPO prospectus, Zhongshan Defu was one of Shenguan's five largest customers for the years ended December 31, 2006 and 2007. During 2006-08, Shenguan's sales to Zhongshan Defu amounted to Rmb22.9m, Rmb28.8m and Rmb10.3m, respectively, representing approximately 12.8%, 11.1% and 2.3% of the total.

Zhongshan Defu was established on Aug 29, 2006 and was owned as to 90% by He Xiangji (何祥吉), a connected person at the time of the IPO. Our investigations into the business registration information of Zhongshan Defu suggested that Shenguan's sales did not actually exist. Please see appendix for details of Zhongshan Defu's business registration information.

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In 2006, Zhongshan Defu achieved sales of merely Rmb1.8m. The IPO prospectus suggests that it bought Rmb22.9m of sausage casings from Shenguan in that year. How could a company with merely Rmb500,000 of registered capital buy such a large amount of sausage casings in merely four months? And how could its procurement amount to 12.7x of its sales in that year?

In 2007, much the same happened. In 2008, Zhongshan Defu reported sales of Rmb13.3m on cost of sales of Rmb12.2m. While both figures were higher than the sales claimed by Shenguan, there was still a high degree of exaggeration. It is simply impossible for the cost of collagen sausage casings to amount to 84% of Zhongshan Defu's cost of sales.

Did Zhongshan Defu stock up all the collagen sausage casings that it bought from Shenguan? That's also not possible. One can see from the following table that Zhongshan Defu's total inventory never exceeded 8% of the sales claimed by Shenguan.

Exhibit 13 – Zhongshan Defu Key Financial Data

Year end Dec (Rmb k)	2006	2007	2008
Sales revenue from Zhongshan Defu claimed by Shenguan	22,900	28,800	10,300
Sales revenue reported by Zhongshan Defu	1,807	7,325	13,308
Cost of sales reported by Zhongshan Defu	1,679	6,655	12,199
Inventory reported by Zhongshan Defu	1,227	2,287	651

Sources: Shenguan, Zhongshan Defu SAIC Filings

One can therefore confidently conclude that sales to Zhongshan Defu claimed by Shenguan were largely phony.

If the sales revenues to the largest customer and another major customer disclosed by Shenguan in its IPO prospectus are exaggerated, one must doubt the integrity of the company's financial statements throughout the years.

We fully expect Shenguan to challenge our accusation regarding Zhongshan Defu by saying that business registration information is not publicly available and that it has no idea of Zhongshan Defu's financial performance.

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Part 3. Other Abnormal Circumstances

Based on our earlier analysis of Shenguan's costs, sales revenues and average selling prices, one can see that the company's financial statements are seriously flawed from 2006 through 2013. There are other abnormal circumstances with its financial statements, which we'll discuss below.

3.1. Did Ernst and Young Really Audit?

Ernst and Young was the auditor who signed off the accountant's report in Shenguan's IPO prospectus and all subsequent annual reports. However, buried in small prints in p.I-3, in note 2 to the cover letter, in reference to Wuzhou Shenguan, the principal operating subsidiary, is this:

Exhibit 14 – Ernst & Young Disclaimer in Shenguan IPO Prospectus

(2) The financial statements for the years ended 31 December 2006, 2007 and 2008 were audited by 深圳市鹏城會計師事務所有限公司 (Shenzhen Pengcheng Certified Public Accountants Co., Ltd.) registered in the PRC.

Source: Shenguan IPO Prospectus

In fact, all PRC registered subsidiaries were audited by Pengcheng! Ernst and Young only audited or reviewed companies registered in Hong Kong and BVI. But these were all holding companies with no real businesses.

Shenzhen Pengcheng is a “famous” auditing firm. In May 2013, it had its [securities business permit revoked](#) by the China Securities Regulatory Commission and the Finance Ministry for its failure to perform due diligently in the IPO of Yunnan Green-Land Biological Technology Co Ltd (002200.SZ).

Subsequent to Shenguan's listing, Ernst and Young's audit coverage further narrowed to exclude all BVI and some Hong Kong subsidiaries. For the 2009 annual report, just a few months after listing, E&Y only audited three Hong Kong subsidiaries, one of which was dormant. This has remained the case through the 2013 annual report. However, Shenguan has not disclosed the identity of the auditor(s) for other subsidiaries after its IPO.

Exhibit 15 – Note 16 to Shenguan's 2013 Accounts

* Not audited by Ernst & Young, Hong Kong or another member firm of the Ernst & Young global network.

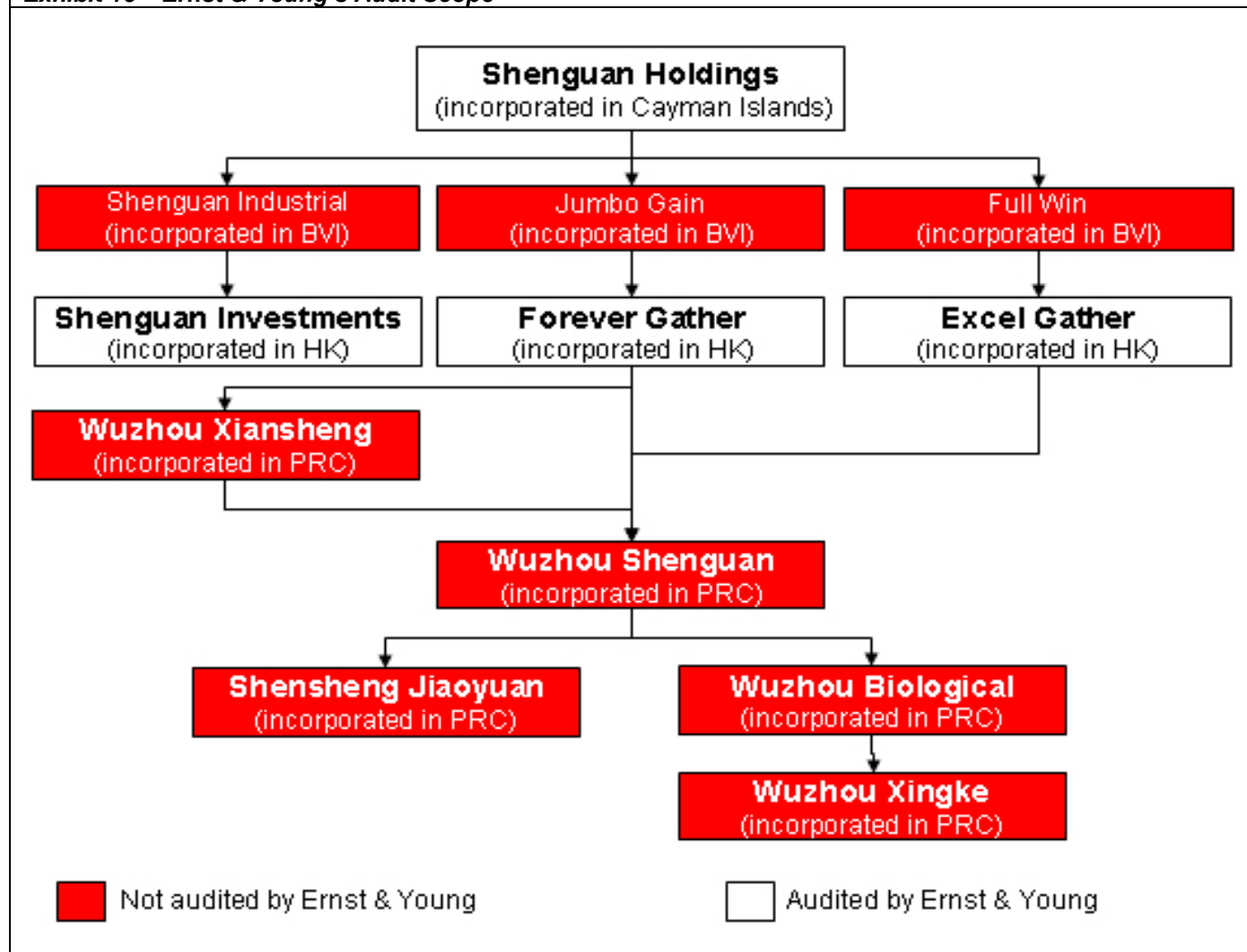
Source: Shenguan 2013 annual report

We regard this as a highly unusual arrangement. Shenguan is not a huge organization with dozens or even

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hundreds of subsidiaries that have had a long relationship with other auditors. In late 2004, when the original state-owned Wuzhou Protein Factory was auctioned off and reorganized into a Sino-foreign joint venture (which would later become the listco), there might or might not have been an audit. Many companies (Chinese included) with existing audit relationship are willing to hire a new international auditor for their IPO and replace their old auditors.

Exhibit 16 – Ernst & Young's Audit Scope



Source: Shenguan

In Shenguan's case, there is only one operating subsidiary that really matters, and it remains off limit to the international auditor even to this day, more than four years after the IPO.

Given the disrepute of Shenzhen Pengcheng, does E&Y really know what's going on inside Shenguan's Mainland China operations? If it didn't audit the Chinese subsidiaries, did it ever visit them? Why should any one have any confidence in this kind of audit?

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3.2. An Outrageous Acquisition

Shenguan made an outrageous acquisition in mid-2011 to benefit its controlling shareholders and recycled 31.3% of the IPO proceeds back to the controlling shareholder and her associates. The company announced on June 1, 2011 that it had agreed to acquire the entire share capital of Wuzhou Xiansheng Collagen Technologies Advisory Services Company Limited (梧州市先盛膠原蛋白技術諮詢服務有限公司) for Rmb372m.

The acquisition was a connected transaction because Shenguan's chairwoman held 35.6% of Wuzhou Xiansheng. However, as each of the relevant ratios (the size of the acquisition/target relative to the listed company in terms of asset, profit, revenue, equity capital and consideration) was less than 5%, the deal was a discloseable transaction that did not require shareholders' approval.

Wuzhou Xiansheng was set up in May 2006 with a registered capital of Rmb500,000. Zhou Yaxin, Shenguan's controlling shareholder and chairwoman, was the major shareholder with a 72.4% stake, while six other individuals held 4.6% each. Three of them would later become Shenguan's executive directors. The other three remained unconnected persons under the listing rules. In March 2008, He Xiangji of Zhongshan Defu bought 36.8% from Zhou at par value of the share capital.

According to Shenguan's announcement, Wuzhou Xiansheng's main business was to provide consultancy services in respect of collagen and other biotechnologies, in addition to holding a 3% stake in Wuzhou Shenguan, the listco's principal operating subsidiary.

With regard to advisory services, did Wuzhou Xiansheng ever engage in any connected transactions with the listed company? The IPO prospectus and subsequent annual reports do not include Wuzhou Xiansheng in any discussions on connected transaction. Did it ever advise Shenguan's competitors in collagen and other biotechnologies businesses?

According to Shenguan's June 2011 [acquisition announcement](#), Wuzhou Xiansheng achieved net profit of Rmb75.8m in 2009 but only Rmb8.5m in 2010. We know that Shenguan's principal operating subsidiary was (and still is) Wuzhou Shenguan, which in turn held (and still holds) 100% of all other group subsidiaries. This implies that all of the listco's minority interest is Wuzhou Xiansheng's share in Wuzhou Shenguan's profit.

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Exhibit 17 – Wuzhou Xiansheng's Profit Analysis

Year end Dec 31 (Rmb k)	2009	2010
Shenguan net income	351,101	530,302
attributable to shareholders	326,061	513,458
non-controlling interests	25,040	16,844
Wuzhou Xiansheng net income	75,840	8,489
contribution from Wuzhou Shenguan	25,040	16,844
other businesses	50,800	-8,355

Sources: Shenguan acquisition announcement, Emerson Analytics estimates

If the profit attributable to minority shareholders reported by Shenguan was exactly the same as Wuzhou Xiansheng's share in Wuzhou Shenguan's profit, then we can see that in 2009 Wuzhou Xiansheng was doing some excellent businesses that generated about Rmb50.8m of net profit. But in 2010, Wuzhou Xiansheng's fortune turned for the worst – its other businesses generated a loss of about Rmb8.4m. That's a whopping Rmb59.2m downturn into the red! What happened? What sort of advisory business would generate Rmb50.8m of profit one year and Rmb8.4m of loss the next? What else did it do to deserve such misfortune? Could it ever regain its former glory in subsequent years, after being sold to Shenguan.

The Shenguan acquisition announcement says that the acquisition price of Rmb372m was arrived at after arm's length negotiations between Shenguan and Wuzhou Xiansheng's shareholders, half of whom (in terms of both number of persons and percentage interest) were buyers and sellers at the same time. In any case, it said the price was determined "with reference to 3% of the average of the market capitalization of the Company from April 2011 to mid of May 2011".

On the surface, that seems a fair valuation method. However, as we have shown above, Wuzhou Xiansheng's other businesses just reported a loss in 2010. The listco was therefore buying Wuzhou Xiansheng at about 44x historical P/E. That's expensive by almost any benchmark, especially given that nothing is known about Wuzhou Xiansheng's other businesses.

3.3. Steadily Declining Staff Cost

The following table shows Shenguan's employee benefit expenses, director's remuneration and headcount for the 2010-2013 period. The footnotes indicate the page numbers for the corresponding items in the company's 2013 annual report.

In the following table, average monthly wage = (Employee benefit expense - directors' remuneration) * 1,000 / (simple average headcount) / 12. For example, in 2013, average monthly wage = (132,591 - 11,428) * 1000 / ((4000 + 3900) / 2) / 12 = Rmb2,556 per month.

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According to our calculations, in 2012 and 2013, Shenguan's average monthly wage fell 9.3% and 17.5%, respectively, from the year-ago levels. In two years, average wage fell 25.1% to Rmb2,556 a month from Rmb3,414 a month.

During the past few years, China's average wages have consistently grown at double-digit rates every year. Shenguan claimed that it had been doing roaring businesses but managed to reduce its average monthly wage substantially. This is totally unbelievable!

Exhibit 18 – Shenguan Average Monthly Wages

Year end Dec 31	2010	2011	2012	2013
Employee benefit expense (Rmb k)	131,125	160,172	152,154	132,591 ¹
Directors' Remuneration (Rmb k)	12,371	12,804	12,804	11,428 ²
Headcount	3,695	3,500	4,000	3,900 ³
Avg monthly staff cost (Rmb/month)	3,211	3,414	3,097	2,556
YoY growth		6.3%	-9.3%	-17.5%

Sources: Shenguan annual reports, Emerson Analytics estimates

3.4. R&D Costs Included in Cost of Sales?

The following table shows Shenguan's research and development (R&D) costs from 2006 through 2013. We can see that the company's R&D budget has grown rapidly over the years. In 2012, the company spent as much as Rmb215m in R&D to account for whopping 13.1% of sales! Is it a pharmaceutical company? Most food and beverages companies spend less than 1% on R&D. Even Apple Inc. (AAPL.O) spent only 2.6% on R&D last year.

Exhibit 19 – Shenguan R&D Costs

Year end Dec 31 (Rmb m)	2006	2007	2008	2009	2010	2011	2012	2013
R&D costs	1,116	10,893	22,952	22,085	87,054	158,521	215,562	N/A
YoY growth		876.1%	110.7%	-3.8%	294.2%	82.1%	36.0%	N/A
% of revenue	0.6%	4.2%	5.1%	2.8%	7.6%	10.6%	13.1%	N/A

Sources: Shenguan annual reports, Emerson Analytics estimates

However, in 2013, the company did not disclose such an important cost item. When one compares the 2012 and 2013 annual reports, one can see that the 2012 figure is completely omitted in the 2013 annual report.

¹<http://www.hkexnews.hk/listedco/listconews/SEHK/2014/0410/LTN201404101064.pdf> p71

²<http://www.hkexnews.hk/listedco/listconews/SEHK/2014/0410/LTN201404101064.pdf> p72

³<http://www.hkexnews.hk/listedco/listconews/SEHK/2014/0410/LTN201404101064.pdf> p13

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Exhibit 20 – Shenguan Note 6 in 2012 and 2013 Annual Reports

6. Profit Before Tax				6. Profit Before Tax			
The Group's profit before tax is arrived at after charging/(crediting):				The Group's profit before tax is arrived at after charging/(crediting):			
	Notes	2013 RMB'000	2012 RMB'000		Notes	2012 RMB'000	2011 RMB'000
Employee benefit expense (including directors' remuneration (note 7)):				Employee benefit expense (including directors' remuneration (note 7)):			
Wages and salaries		118,153	124,176	Wages and salaries		124,176	135,516
Equity-settled share option expense	29	623	1,144	Equity-settled share option expense	31	1,144	1,908
Retirement benefit contributions		13,815	26,834	Retirement benefit contributions		26,834	22,748
		132,591	152,154			152,154	160,172
Auditors' remuneration		1,937	2,020	Auditors' remuneration		2,020	1,980
Cost of inventories sold		295,456	275,191	Cost of inventories sold		275,191	217,719
Depreciation	13	72,977	52,764	Depreciation	13	52,764	42,687
Amortisation of prepaid land lease payments	14	2,355	2,293	Amortisation of land lease payments	14	2,293	2,086
Amortisation of a patent*	15	-	285	Amortisation of a patent*	15	285	859
Minimum lease payments under operating leases in respect of buildings		815	811	Research and development costs		215,562	158,521
Loss on disposal of items of property, plant and equipment		140	3	Minimum lease payments under operating leases in respect of buildings		811	819
Write-back of inventories to net realisable value**		-	(6,697)	Gain on disposal of an available-for-sale investment	18	(6)	-
Impairment of trade receivables	21	464	3,207	Loss on disposal of items of property, plant and equipment		3	1,420
Fair value loss of derivative instruments, net				Impairment/(reversal of impairment) of inventories**		(6,697)	6,697
- transactions not qualifying as hedges	26	2,906	2,385	Impairment of trade receivables	22	3,207	148
				Foreign exchange differences, net		(2,465)	(31,924)
				Fair value loss of derivative instruments, net			
				- transactions not qualifying as hedges		2,385	-

Source: Shenguan annual reports

R&D costs are presented in the item “Note 6: Profit Before Tax” in the notes to the accounts of Shenguan’s annual reports, and are deductible from revenues in the consolidated statement of profit and loss and other comprehensive income. Normally, R&D costs are included in administrative expenses. According to p.141 of Shenguan’s IPO prospectus, “administrative expenses mainly consist of salaries and benefits for our management and administrative staff, depreciation of PP&E used for administrative purposes, amortization of technical know how, office supplies expenses, lease expenses, and other miscellaneous expenses”. We can see that R&D costs are not part of administrative costs. In any case, the Rmb215.6m R&D costs in 2012 far exceeded the Rmb81.2m administrative expenses in the same year.

If R&D costs were not part of administrative costs, were they part of cost of sales? If yes, that was a very strange accounting treating. In 2012, Shenguan reported total cost of sales of Rmb689.3m. After taking out Rmb215.6m of R&D costs, Shenguan’s manufacturing cost would have come to Rmb0.112 per meter of collage sausage casing, 60% lower than those of its competitors. Obviously this is impossible.

It baffles us why Shenguan bothers to make up its R&D spending because it doesn’t really fit anywhere in the income statement. Perhaps the company wants to impress investors that its super-high margins could be explained by unusually high R&D spending? We are convinced that it has gone too far in fabricating a “sexy” story.

3.5. An Absurd Industry Ranking by www.chinacasing.cn

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Shenguan claims in p.88 of its IPO prospectus that, according to the ranking published by China Meat Association (中国肉类协会), it was the largest manufacturer of edible collagen sausage casing products in China from 2006 to 2008 based on such criteria as total assets, revenue, market share and market reputation⁴.

The IPO prospectus also claims that China Sausage Casing Net (中国肠衣网) (www.chinacasing.cn) was one of the official websites of China Meat Association, a not-for-profit national organization registered with the Ministry of Civil Administration (中国民政部)⁵.

So, what is China Sausage Casing Net and is it really related to China Meat Association?

If one is willing to spare a few minutes for this website, <http://www.chinacasing.cn/index.htm>, one will see that although it seems to provide a lot of information, there is actually little substance behind. For example, the “Interviews with Officials”⁶ column consisted of only 10 items, three published in 2013, two in 2011, one in 2005 and four in 2004. It rather looks like a website run by an amateur who's busy with other things and have little time to take care of it.

We checked with China Meat Association, and its staff confirmed that China Sausage Casing Net was not its affiliate. The audio clip, **Evidence 14:CMA_Chinacasing.mp3**, is not exhibited here but has been provided to SFC.

The IPO prospectus says in p.67 that “the information extracted from the China Sausage Casing Net (中国肠衣网) for disclosure in this prospectus is not commissioned by our Company, and can be accessed by the public free of charge”. Towards the top of the home page on www.chinacasing.cn one can see a list of rankings. The rankings for collagen sausage casings can be found in the following webpage: <http://www.chinacasing.cn/hy50q.asp?cid=%C8%CB%B9%A4%B3%A6%D2%C210%C7%BF>. In this page are rankings from 2005-2013 except for 2009, which is blank. A casual perusal reveals that the rankings for 2006-2008 are exactly the same, while those for 2010-2013 are also exactly the same. The only difference between the first batch (the 2006-2008 lists) and the second batch (the 2010-2013 lists) is the number two-ranked company. In the first batch it was a Beijing company, and in the second batch it was a Tianjin company. All through those years, none of these companies moved up or down the rankings at all. The Tianjin company simply jumped into number two out of nowhere in 2010, when the Beijing company disappeared without a trace. The rankings seem to be tailor-made for Shenguan.

We searched the registration information of China Sausage Casing Net (www.chinacasing.cn), and found that it was registered by an individual named He Zhonghua, as shown below. This person is associated with 81 other domains.

This is clearly an amateur website run by a private citizen who may well be a crook. The website then publishes some phony rankings which include irrelevant entities and show only one change over a seven year period (skipping 2009). The rankings (for 2006-2008) then made its way into an IPO prospectus that helped a company raise Rmb1.2bn! How did the professional advisers do their due diligence?

⁴<http://www.hkexnews.hk/listedco/listconews/SEHK/2009/0930/LTN20090930002.pdf> p88

⁵<http://www.hkexnews.hk/listedco/listconews/SEHK/2009/0930/LTN20090930002.pdf> p67

⁶<http://www.chinacasing.cn/onlineask.asp?cid=%B9%D9%D4%B1%D7%A8%B7%C3&csid=%B9%FA%CE%F1%D4%BA>

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Exhibit 21 – China Sausage Casing Net Registration Information

— Whois & Quick Stats		
Email	hsh74@sohu.com is associated with ~99 domains He Zhonghua	
Registrant Org	何忠华 is associated with ~81 other domains	
Dates	Created on 2004-04-16 - Expires on 2015-04-16	
IP Address	223.223.176.112 - 26 other sites hosted on this server	
IP Location	 - Beijing - Beijing - Elink Space	
ASN	 AS4808 CHINA169-BJ CNCGROUP IP network China169 Beijing Province Network,CN (registered Jan 09, 1996)	
Whois History	23 records have been archived since 2010-09-23	
Whois Server	whois.cnnic.cn	

Source: <http://whois.domaintools.com/chinacasing.cn>

The Thick Skin of Shenguan's High Margins

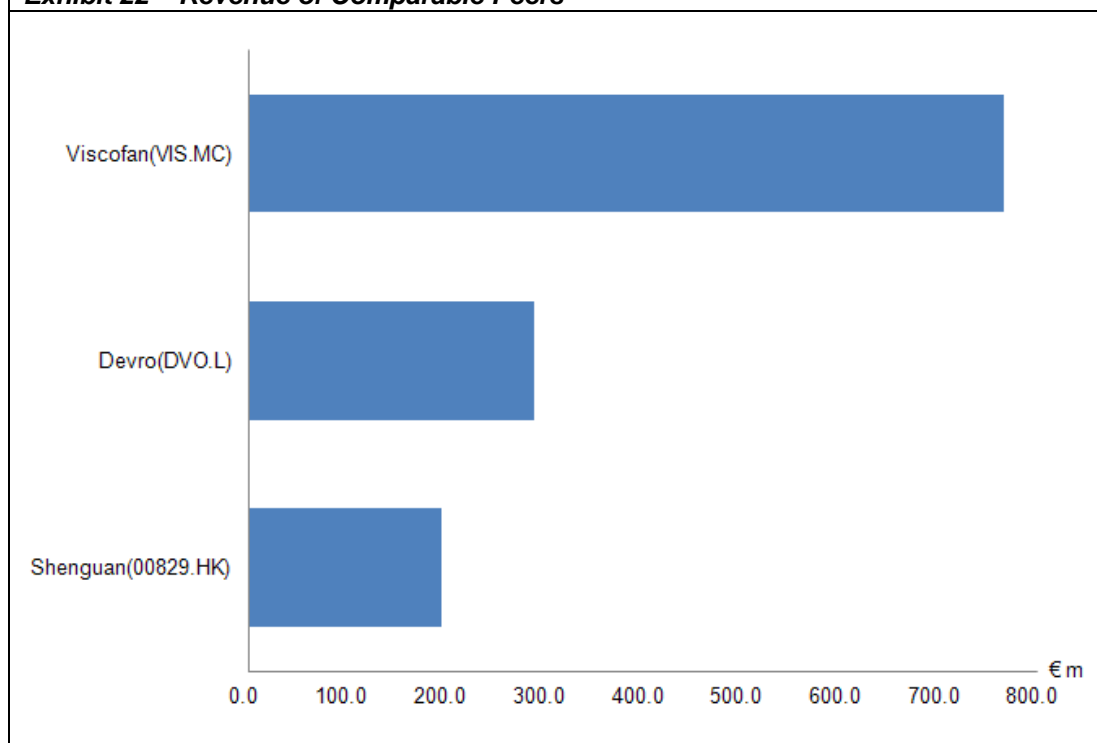
Part 4. Financial Analysis and Valuation

4.1. Ridiculously High Margins

As we have seen, Shenguan has been concealing its costs and inflating its revenues for years. As a result, it has been reporting absurdly high margins when compared with industry peers.

Globally, there are two international giants in collagen sausage casings. Devro PLC (DVO.L) is a UK-based company. Its revenue in 2013 was about one-third bigger than that of Shenguan. Viscofan Group (VIS.MC) is a Spanish giant almost four times the size of Shenguan, as shown in the following chart.

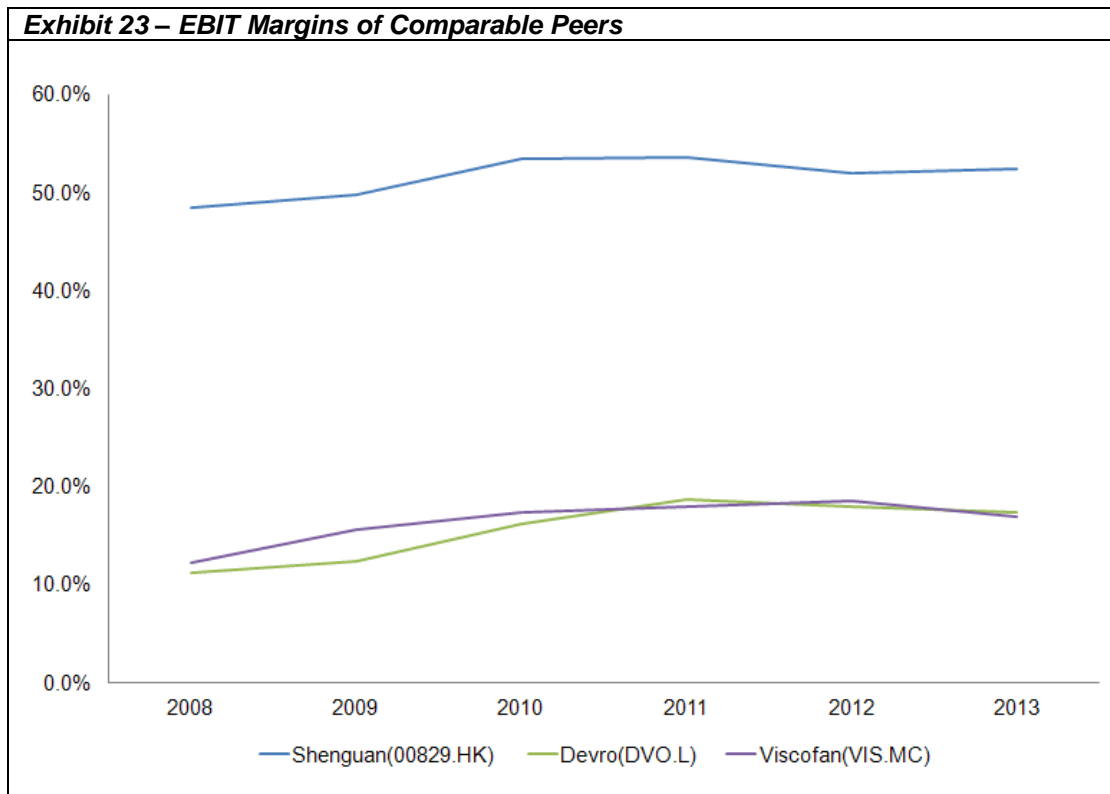
Exhibit 22 – Revenue of Comparable Peers



Sources: Company annual reports

In terms of EBIT margins, during the 2010-2013 period, all three companies had very stable margins, though Shenguan's were about three times better at around 50% while the other two were generally at the mid- to high-teens. This is totally incredible.

The Thick Skin of Shenguan's High Margins



Sources: Company annual reports, Emerson Analytics estimates

Although no one Chinese collagen sausage casing manufacturer is publicly listed, we have managed to find some information about Liuzhou Honsen when it was taken over by Qinghai Gelatin Company Limited (000606.SZ) in 2012. As one can see from the following table, Shenguan's gross margins are much higher than those of its competitors.

Exhibit 24 – Gross Margins of Comparable Peers

Year end Dec 31	2009	2010	2011
Shenguan (00829.HK)	61.1%	60.6%	61.9%
Devro (DVO.L)	29.8%	33.6%	37.3%
Liuzhou Honsen	10.7%	26.1%	23.3%

Sources: Company annual reports

Note: Data for Liuzhou Honsen can be found in p.10 of <http://www.cninfo.com.cn/finalpage/2012-03-08/60640486.PDF>

Liuzhou Honsen may be much smaller than Shenguan but it is difficult to believe that their gross margins can be so different. Devro is quite a bit bigger than Shenguan and therefore a long way bigger than Liuzhou Honsen, Its gross margins are moderately better than those of Liuzhou Honsen but much inferior to Shenguan's. The gap is just too big to be credible.

The Thick Skin of Shenguan's High Margins

4.2. Estimating Historical Real Profitability

We think that the company had been doctoring its books since day one, when it first entertained the idea of going public. The evidence? The consistently high gross margins, which fluctuated between a low of 52.5% in 2007 and a high of 61.9% in 2011.

The following table shows our attempt to reconstruct Shenguan's actual profitability by eliminating its inflated revenue and fully recognizing its raw materials costs over the years.

Exhibit 25 – Adjusting Shenguan's Historical Profitability

Year end Dec 31 (Rmb m)	2006	2007	2008	2009	2010	2011	2012	2013
Adjusted ASPs (Rmb/meter)	0.372	0.376	0.379	0.389	0.389	0.386	0.339	0.337
Sales volume(million meters)	457	632	1,041	1,779	2,576	3,385	4,231*	4,274*
Adjusted revenue	170	238	395	691	1,003	1,307	1,434	1,439
Cost of sales	-114	-191	-303	-473	-702	-863	-1,078	-1,054
Adjusted raw materials & consumables	-70	-122	-179	-296	-446	-526	-702	-663
Water, electricity and coal	-21	-34	-57	-81	-104	-138	-166	-174
Salary and employee benefit	-9	-13	-21	-54	-84	-113	-118	-106
Others	-15	-21	-46	-42	-68	-86	-92	-112
Adjusted gross profit	56	47	92	219	301	443	356	385
Selling and distribution expenses	-5	-6	-7	-11	-15	-23	-20	-22
Administrative expenses	-13	-18	-23	-80	-68	-102	-81	-78
Other expenses	0	-2	-1	0	0	0	0	0
Adjusted operating profit	38	22	60	128	218	319	255	285
Other income and gains	3	5	4	4	49	63	70	73
Finance costs	-1	-1	-9	-11	0	0	2	-6
Profit before tax	40	26	55	120	268	381	327	351
Adjusted income tax expense	1	3	-4	-11	-54	-72	-64	-61
Profit	41	29	51	109	213	309	263	290
Profit attributable to equity holders	39	28	50	106	207	300	263	290
Non-controlling interests	1	1	2	3	6	9	0	0
"Subsidized" costs	39	68	99	164	247	292	389	367
% of reported	124.3%	124.3%	124.3%	124.3%	124.3%	124.3%	124.3%	124.3%

Sources: Shenguan annual reports, Emerson Analytics estimates

* Our estimates

The Thick Skin of Shenguan's High Margins

Earlier, we have shown that Shenguan's ASP was actually 4.5%, 8.2% and 13% below the reported level during 2006-2008, respectively. The price gap mounted steadily mainly because the largest customer accounted for an increasingly large proportion of Shenguan's sales volume, from about 10% in 2006 to more than 30% in 2008. In subsequent years, Shenguan ceased to disclose sales volume to its major customers, but still revealed that sales revenue to the biggest customer accounted for 30-40% of total. To keep it simple, we'll assume that the actual ASP (or what we'll call adjusted ASP in the above table) held stable at 13% below the reported number during 2009-2013. On this basis, Shenguan has probably exaggerated its sales by about Rmb966m during the eight years from 2006-2013.

There was no change in the sales volume. This assumption is advantages to Shenguan, because we are ignoring the issue of phony sales to Zhongshan Defu (and possibly other customers).

On the cost front, we have earlier shown that the actual raw materials cost was about 124.3% of the number reported by Shenguan for 2013 (see Exhibit 10). We'll use this ratio to adjust all raw materials costs during 2006-2013, and assume that all other cost items were accurate. In aggregate, Shenguan's controlling shareholders have probably shaved some Rmb1.66bn of costs off the company's income statement.

We also adjust Shenguan's profit tax by referring to the effective tax rate reported by the company. This results in a smaller tax charge due to the higher actual cost base and hence lower earnings before interest and tax (EBIT).

In aggregate, Shenguan has exaggerated its profit by about Rmb2.14bn during the 2006-2013.

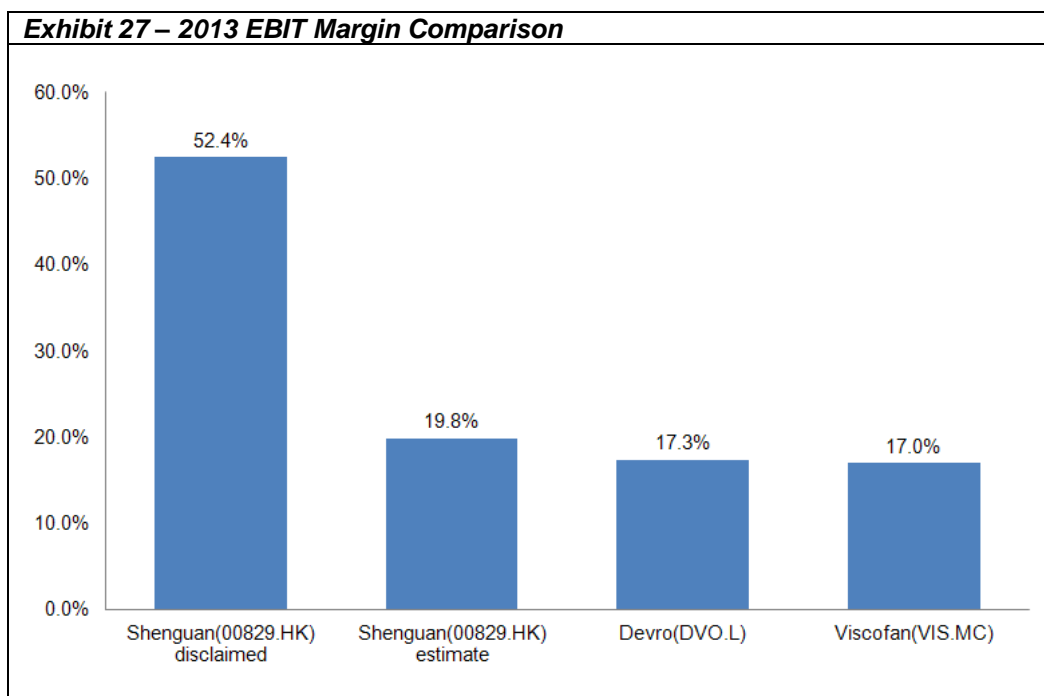
Using 2013 as an example, the main differences between Shenguan's reported numbers and our estimates are shown in the following table. Our calculations suggest that Shenguan's 2013 net income was probably about Rmb290.3m or 62.4% below the Rmb771.3m reported by the company.

Year end Dec 31 (Rmb m)	Shenguan's Report	Our Estimates	Difference(%)
ASPs(Rmb/meter)	0.387	0.337	-13.0%
Revenue	1,654	1,439	-13.0%
Cost of sales	-687	-1,054	53.5%
- Raw materials & consumables	-295	-663	124.3%
Profit attributable to equity holders	771	290	-62.4%

Sources: Company annual reports, Emerson Analytics estimates

Based on our estimates, Shenguan's EBIT margin was 19.8% in 2013, still better than those of Devro and Viscofan but less than half of the 52.4% reported by the company. As shown in the following chart, our estimated EBIT margin for Shenguan is more in line with the international norm.

The Thick Skin of Shenguan's High Margins



Sources: Company annual reports, Emerson Analytics estimates

4.3. Recovery of “Subsidies” and the Truth of High Dividend Ratio

Our analysis above clearly demonstrates that Shenguan’s actual profitability in 2013 was easily 60% below that reported by the company.

At this point, the fundamental question must be asked: Why are the controlling shareholders “subsidizing” minority shareholders? They haven’t significantly reduced their stake in the company, so what do they gain? And even if the company’s profit margins are too good to be true, does the high dividend payout ratio suggest that it has real money in the banks?

To be honest, we cannot answer such questions on behalf of the controlling shareholders. However, we do know one thing, controlling shareholders are not philanthropists when it comes to dealing with minority shareholders.

Let’s go back to where the story began, when Shenguan raised Rmb1.2bn in its October 2009 IPO. If the company were to reveal its financial performance truthfully, that is to say, a profit merely 30% of the purported numbers, the IPO would not have been attractive and the company certainly would not have been able to raise Rmb1.2bn. After the listing, the market value of the shares and the presence of minority shareholders have allowed the controlling shareholders to recover their “subsidies” through various means.

We have shown earlier, in section 3.2, how the controlling shareholders swapped their residual 3% stake in the principal operating subsidiary for a staggering Rmb372m not even two years after the IPO. From

The Thick Skin of Shenguan's High Margins

what we can see, there are at least two other ways the controlling shareholders can recover their “subsidiaries” to minority shareholders.

Barely one year after the IPO, on October 20, 2010, Shenguan announced that its controlling shareholders had agree to sell 69.77m shares in Shenguan to a number of investors at HK\$8.60 each, raising a total of HK\$600m or Rmb515m based on the October 2010 month-end exchange rate of HK\$0.8587 to Rmb1.00.

We do note that in the last couple of years the major shareholder and chairwoman Zhou Yaxin has bought a few million Shenguan shares at the market. This is really insignificant compared to her stock sale in 2010, not just in terms of volume but also in terms of price.

The 2010 share disposal and the 2011 stake sale gave Rmb887m to the controlling shareholders without a dent to their tight grip on the listco. There is yet a third path for them to recover their “subsidiaries”, and that is through dividend payment.

For a company growing at a whopping 57% compound annual rate (during the 2006-2010 period), a 44% dividend payout ratio in 2010 was indeed quite generous. Subsequently, payout ratio has been maintained at rather high levels of 41-65%. As can be seen from the following table, controlling shareholders have collected Rmb1.05bn in dividends since listing.

Exhibit 28 – Shenguan Dividend Analysis

Year end Dec 31 (Rmb m)	2009	2010	2011	2012	2013	Total
Shenguan attributable profit	326.1	513.5	689.3	748.2	771.3	3,048.3
Dividend declared	67.3	226.9	279.5	413.0	500.2	1,486.9
minority shareholders	18.6	63.0	83.5	123.2	149.3	437.6
controlling shareholders	48.6	163.9	196.1	289.8	350.9	1,049.3
Payout ratio	20.6%	44.2%	40.6%	55.2%	64.9%	48.8%

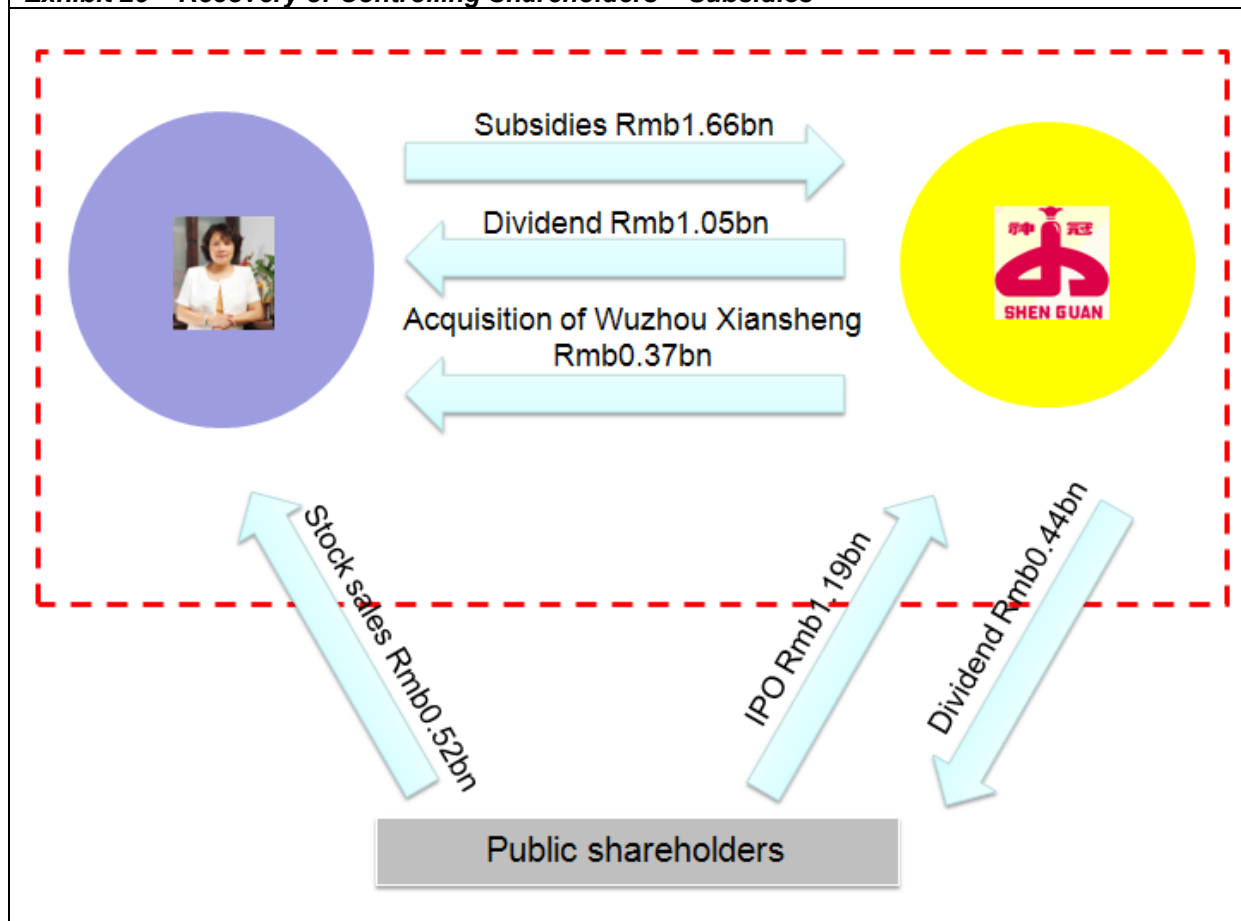
Sources: Shenguan annual reports, Emerson Analytics estimates

The following exhibit shows Shenguan controlling shareholders' money trail. Over the years, they “subsidized” listco's manufacturing costs to the tune of some Rmb1.66bn. However, they have so far collected about Rmb1.94bn by selling a tiny stake in Wuzhou Xiansheng, disposing of listco shares and collecting their share of dividend.

Looking at the controlling shareholders and the listco as an organic whole (the red box in the following chart), we can see that they have pocketed Rmb1.71bn since 2009 by paying public shareholders merely Rmb0.44bn. This is the truth about Shenguan's high dividend payout ratio.

The Thick Skin of Shenguan's High Margins

Exhibit 29 – Recovery of Controlling Shareholders' "Subsidies"



Sources: Company annual reports, Emerson Analytics estimates

4.4. Valuation

Our analysis above clearly demonstrates that Shenguan's actual profitability is easily 60% below that reported by the company.

If we generously accord the company the same valuation in terms of P/E multiple, the stock should trade at about HK\$1.1 per share compared with the current HK\$2.8.

Our judgment on Shenguan is more lenient than that on China Lumena New Materials, which we said should be delisted. As shown in our report published on April 1, 2014, China Lumena simply made up a whole load of non-existent businesses and siphoned away billions of dollars from the company.

A few final words.

If the controlling shareholders have been "subsidizing" minority shareholders by paying for part of the raw material costs out of their own pocket, they have by now more than made up their costs by collecting

The Thick Skin of Shenguan's High Margins

Rmb1.94bn through various channels and still control a listed company that could not possibly have raised anything near Rmb1.2bn in its IPO in 2009.

But all schemes of deception must end one day. The question is how. The really smart guys will wind it down slowly before the s--- hits the fan, and the greedy ones (i.e. the ones who think they are very smart) will act too late so that it all end in tears. We are not sure how Shenguan will end, but there are signs that it is winding down after it reported two consecutive years of single-digit growth in 2012 and 2013, with interim profit declines in both 1H13 and 1H14.

But are they fast enough? Or are we faster?

The Thick Skin of Shenguan's High Margins

Appendix – Zhongshan Defu SAIC Filings

Zhongshan Defu SAIC Fundamental Information



市场主体基本登记信息查询



提示：企业/个体工商户/农民专业合作社名称、注册号至少输入一项即可查询



查询结果

提示：一次查询最多只能显示30条符合查询条件的企业/个体工商户/农民专业合作社记录。如果查询结果中，没有包含您需要了解企业/个体工商户/农民专业合作社信息，请增加输入更具体的查询条件，重新查询。

中山市得福肉食制品有限公司

Zhongshan Defu Meat Products Co., Ltd.

地址：中山市黄圃镇食品工业园康盛路

注册号：442000000419372

登记机关：中山市工商行政管理局

企业类型：有限责任公司

法定代表人：何祥吉

Legal representative: He Xiangji

注册资本：50.000000万元

经营期限：自2006-08-29至2018-08-24

企业状态：登记成立

成立日期：2006-08-29

Registered capital: 500,000Rmb

经营范围：加工、销售：肉制品（腌腊肉制品）；国内贸易（法律、行政法规禁止的项目除外；法律、行政法规限制的项目须取得许可后方可经营）。

Date of establishment: August 29, 2006

返回

说明：

1. 仅提供全省（除广州、深圳）的企业/个体工商户/农民专业合作社的基本登记信息查询；
2. 我们力求但不保证数据的完全准确，所提供的信息请以市场主体登记机关签章确认的信息为准。

Source: <http://www.gdgs.gov.cn/>

The Thick Skin of Shenguan's High Margins

2006 Statement of P&L

Zhongshan Defu Meat
Products Co., Ltd.

损益表 Statement of Profit&Loss

12

多会合报表

编制单位: 中



2007年12月31日

Dec 31th, 2006

金额单位: 元 Unit: Yuan

		本年累计 This Year
一、产品销售收入 Sales	470,855.03	1,107,411.13
减: 产品销售成本 Cost of Sales	150,757.89	1,078,059.75
销售费用	0.00	24,177.00
产品销售税金及附加	8,730.85	11,681.00
二、产品销售利润	21,336.29	93,591.38
加: 其他业务利润	0.00	0.00
减: 管理费用	87,211.82	83,161.31
财务费用	-681.26	(1,203.24)
三、营业利润	-14,151.19	663.31
加: 投资收益	0.00	0.00
营业外收入	0.00	0.00
减: 营业外支出		0.00
四、利润总额	-14,151.19	663.31
减: 所得税	119.40	119.40
五、净利润	-15,070.59	543.91

企业负责人: 何祥吉 财务总监:

制表人: 王瑞芳

填报日期: 2007年1月5日

He Xiangji

Source: SAIC Filings

The Thick Skin of Shenguan's High Margins

2006 Balance Sheet

Zhongshan Defu Meat Products Co., Ltd.

Balance Sheet

附注: A-
会计: 01表
单位: 元

编制单位: (盖章) 中山市 中食食品 有限公司 2006年12月31日 Dec 31th 2006

资产	行次	年初数	期末数	负债及所有者权益	行次	年初数	期末数
				Unit: Yuan			
				This Year			
一、流动资产: 货币资金				一、流动负债: 短期借款	34		
其中: 银行存款	2			短期应付债券	35		
短期投资	3			应付票据	36		
应收票据	4			应付账款	37		624,084.75
应收账款	5	184,452.90		预收账款	38		
减: 坏账准备	6			其他应付款	39		578,000.00
应收账款净额	7			应付工资	40		40,916.80
预付账款	8			应付福利费	41		
其他应收款	9	-85.00		未交税金	42		28,250.11
存货 Inventories	10		Total: 1,227,147.21	未付利息	43		
其中: 原材料	11	1,170,501.05		其他未交款	44		2,730.85
产成品	12	56,646.16		预提费用	45		
在产品及自制半成品	13			待摊费用	46		
分期收款发出商品	14			一年内到期的长期负债	47		
待摊费用	15	44,512.89		其他流动负债	48		
待处理流动资产净损失	16			流动负债合计	49		1,365,986.54
一年内到期的长期股权投资	17			二、长期负债: 长期借款	50		
其他流动资产	18			应付债券	51		
	19			长期应付款	52		
流动资产合计	20		1,720,339.14	其他长期负债	53		
二、长期投资: 长期投资	21			长期负债合计	54		
三、固定资产: 固定资产原价	22	481,423.52					
减: 累计折旧	23	5,232.81		三、所有者权益	56		
固定资产净值	24		476,190.71	实收资本	57		500,000.00
固定资产清理	25			其中: 国家资本金	58		
在建工程	26			资本公积	59		
待处理固定资产净损失	27			盈余公积	60		
固定资产合计	28		476,190.71	其中: 公益金	61		
四、无形资产: 无形资产	29			未分配利润	62		663.31
五、递延资产: 递延资产	30			所有者权益合计	63		500,663.31
无形及递延资产合计	31						
六、其他长期资产	32						
资产总计	33		2,196,529.85	负债及所有者权益总计	66		2,196,529.85

企业负责人: 何祥吉 财务负责人: 王瑞芳 制表人: 王瑞芳 填表日期: 2007年1月5日

He Xiangji

Source: SAIC Filings

The Thick Skin of Shenguan's High Margins

2007 Statement of P&L

Zhongshan Defu Meat
Products Co., Ltd.

损益表 Statement of Profit&Loss 12

所属期 200712 Dec.2007

单位: 元 Unit: Yuan

编制单位: 中山市得福肉制品公司



项	行次	本月数	本年累计数
			This Year
一、主营业务收入 Sales	1	1137241.60	7320434.09
减: 主营业务成本 Cost of Sales	2	1003038.90	6665386.31
营业费用	3	(5032.00)	64238.00
主营业务税金及附加	4	2075.85	31919.99
二、主营业务利润	5	116094.25	584780.89
加: 其他业务利润	6		
减: 管理费用	7	35027.04	427070.87
财务费用	8	-784.28	-3813.48
三、营业利润	9	84250.89	181532.91
加: 投资收益	10		
补贴收入	11		
营业外收入	12		
减: 营业外支出	13		
加: 以前年度损益调整	14		
四、利润总额	15	84250.89	181532.91
减: 所得税	16	13756.84	50306.88
五、净利润	17	70494.05	168227.03

单位负责人: 何祥吉
He Xiangji

财会负责人: 黎桂芬 复核: 制表:

Source: SAIC Filings

The Thick Skin of Shenguan's High Margins

2007 Balance Sheet

Zhongshan Defu Meat Products Co., Ltd.

资产负债表 Balance Sheet

Unit: Yuan

编制单位: 中山市德富肉制品有限公司

所属期间: 2007.12

Del: 2007

行次	年初数	期末数	行次	年初数	期末数
流动资产:			流动负债:		
货币资金	32.34	250444.23	短期借款		
短期投资			应付票据		
应收票据			应付账款	626985.75	115288.93
应收账款	184452.50	878132.99	预收账款		
减: 坏账准备			其他应付款	970000.00	320000.00
应收账款净额	184452.50	878132.99	应付工资	40916.00	67139.00
预付账款			应付福利费		
应收补贴款			未交税金	28250.14	30912.39
其他应收款	85.00	40723.00	未付利润		
存货 Inventories	1227147.21	2286651.99	其他未交款	2730.85	2973.85
待摊费用	44912.00	278874.22	预提费用		
待处理流动资产损失			一年内到期的长期负债		
一年内到期的长期债券投资			其他流动负债		
其他流动资产					
流动资产合计	1720529.74	3754506.42	流动负债合计	1663996.54	3549298.05
长期投资:			长期负债:		
长期股权投资			长期借款		
长期债券投资			应付债券		
固定资产:			长期应付款		
固定资产原价	451434.52	454245.03	其他长期负债		
减: 累计折旧	5353.81	53953.63	其中: 住房周转金		
固定资产净值	446080.71	400291.40			
固定资产清理			长期负债合计		
在建工程			递延税项:		
待处理固定资产损失			递延税款借项		
固定资产合计	446080.71	400291.40			
无形资产及递延资产:			负债合计	1663996.54	3549298.05
无形资产			所有者权益:		
递延资产			实收资本	500000.00	500000.00
			资本公积		
无形资产及递延资产合计			盈余公积		
其他长期资产:			其中: 公益金		
其他长期资产			未分配利润	503.31	105901.77
递延税项:			所有者权益合计	503683.31	605901.77
递延税款借项					
资产总计	2166649.84	4154807.82	负债及所有者权益总计	2166649.85	4154807.82

补充资料:

- 已贴现的商业承兑汇票 _____ 元;
- 已包括在固定资产原价的融资租入固定资产原价 _____ 元;
- 国家资本 _____ 元;
- 法人资本 _____ 元;
- 个人资本 _____ 元;
- 外商资本 _____ 元;

单位负责人: 何祥吉 财务负责人: 蔡林芬 复核: 制表人:

He Xiangji

Source: SAIC Filings

The Thick Skin of Shenguan's High Margins

2008 Statement of P&L

Zhongshan Defu Meat Products Co., Ltd. **损益表** Statement of Profit&Loss

12

期间: 200812 Dec. 2008 单位: 元 Unit: Yuan

编制单位: 中山德福肉食品有限公司

项	行	月 数	本年累计数
			This Year
一、主营业务收入 Sales	1	922382.85	13307862.28
减: 主营业务成本 Cost of Sales	2	916785.54	12190361.78
营业费用	3	15773.00	132985.47
主营业务税金及附加	4	5886.93	45005.00
二、主营业务利润	5	57137.59	929709.43
加: 其他业务利润	6		
减: 管理费用	7	30784.71	588385.15
财务费用	8	-1015.60	-7017.87
三、营业利润	9	27366.88	378341.15
加: 投资收益	10		
补贴收入	11		
营业外收入	12		
减: 营业外支出	13		
加: 以前年度损益调整	14		
四、利润总额	15	27366.88	378341.15
减: 所得税	16	18345.73	94585.29
五、净利润	17	9016.15	283755.86

单位负责人: **何祥吉** 财务总监: 梁世芬 复核: 制表:

He Xiangji

Source: SAIC Filings

The Thick Skin of Shenguan's High Margins

2008 Balance Sheet

Zhongshan Defu Meat

Products Co., Ltd.

资产负债表

Balance Sheet

单位: 元 Unit: Yuan

填制单位: 中山市得福肉食制品有限公司

资产负债表日期: 200812 Dec. 2008

资产	行次	年初数	期末数	负债及所有者权益	行次	年初数	期末数
流动资产:				流动负债:			
货币资金	1	385244.23	325754.06	短期借款	30		
短期投资	2			应付票据	31		
应收票据	3			应付账款	32	115280.40	635885.51
应收账款	4	578132.99	513658.46	预收账款	33		
减: 坏账准备	5			其他应付款	34	531000.00	165500.00
应收账款净额	6	578132.99	513658.46	应付工资	35	67139.00	75225.00
预付账款	7		1193354.41	应付福利费	36		
应收补贴款	8			未交税金	37	32812.28	51644.35
其他应收款	9	60723.00	61410.00	未付利润	38		
存货 Inventories	10	2285631.99	651076.20	其他未交款	39	3075.85	3656.92
待摊费用	11	278574.22	173804.73	预提费用	40		
待处理流动资产净损失	12			一年内到期的长期负债	41		
一年内到期的长期股权投资	13			其他流动负债	42		
其他流动资产	14						
流动资产合计	15	3754606.43	2919166.76	流动负债合计	43	3548996.06	2712411.78
长期投资:				长期负债:			
长期投资	16			长期借款	44		
固定资产:				应付债券	45		
固定资产原价	17	454245.00	771517.03	长期应付款	46		
减: 累计折旧	18	53963.63	108552.93	其他长期负债	47		
固定资产净值	19	400281.40	662964.10	其中: 住房周转金	48		
固定资产清理	20			长期负债合计	49		
在建工程	21			递延税项:			
待处理固定资产净损失	22			递延税项贷项	50		
固定资产合计	23	400281.40	662964.10				
无形资产及递延资产:				负债合计	51	3548996.06	2712411.78
无形资产	24			所有者权益:			
递延资产	25			实收资本	52	500000.00	500000.00
无形资产及递延资产合计	26			资本公积	53		
其他长期资产:				盈余公积	54		
其他长期资产	27			其中: 公益金	55		
递延税项:				未分配利润	56	165901.77	365713.08
递延税款借项	28			所有者权益合计	57	665901.77	865713.08
资产总计	29	4154887.83	3581124.86	负债及所有者权益总计	58	4154887.83	3581124.86

补充资料:

1. 已贴现的商业承兑汇票 _____ 元;
2. 已包括在固定资产原值的融资租入固定资产原值 _____ 元;
3. 国家资本 _____ 元;
4. 法人资本 _____ 元;
5. 个人资本 _____ 元;
6. 外币资本 _____ 元;

单位负责人: **何祥吉** 财务负责人: 黎社芬 复核: _____ 制表人: _____

He Xiangji

Source: SAIC Filings