

Company Flash

Ping Shan Tea Group ^{0364 HK}

Diversify into tea business

- Ping Shan Tea, previously known as Hua Feng Group, has decided to diversify its business into China tea industry
- Ping Shan Tea's retail business and brands are developing which gives its business a high potential for growth
- The valuation of the company is lower than its peers but we believe it will deserve a higher valuation once it builds a track record and the loss-making business is disposed

Ping Shan Group, previously known as Hua Feng Group, is primarily engaged in producing oolong teas in China. It is also engaged in the provision of fabric processing services and the manufacture and sale of fabrics and yarns.

What's New. Due to increases in the costs of raw material coupled with increasing market competition, the fabric business of the company performed poorly over the past few years. Therefore, the company has decided to diversify its business by entering into the Chinese tea industry in China in 2013.

In Jan 2013, the company entered into a Sale and Purchaser's Agreement with several vendors, which include Ample Gold, Exalt Wealth, Great Vantage, Shine Strategy, Smart Fujian, Templeton and Teya. Under the agreement, the company agreed to purchase from the vendors the entire issued share capital of China Natural Tea Holdings (中國大自然茶業控股), which is one of the top ten refined oolong tea producers in the PRC.

The total consideration of the transaction was HK\$2,487.48m, which was settled partly in cash and partly by the issue of shares and CB (See Fig. 1). The acquisition was completed in July and since then China Natural Tea Holdings has become the wholly owned subsidiary of the company.

Figure 1: Consideration of the acquisition

	HK\$ m
Cash	193.85
Issue of the consideration shares	1,678.86
Issue of the Convertible Bonds	614.77
Total consideration	2487.48

Source: the company

Figure 2: Profit and loss items of China Natural Tea Holdings

	FY12 / 10 RMB'000	FY12 / 11 RMB'000	FY12 / 12 RMB'000
Turnover	310,358	408,241	389,047
Cost of sales	-151,533	-188,135	-201,071
Gross profit	158,825	220,106	187,976
Changes in fair value of biological assets	189	33,383	38,602
Other income	79	1,083	5,058
SG&A	-26,808	-47,410	-33,448
Other expenses	-844	-1,555	-506
EBIT	131,441	205,607	197,682
Finance costs	-181	-866	-510
Profit before taxation	131,260	204,741	197,172
Income tax expense	-4,632	-10,493	-6,618
Profit attributable to shareholders	126,628	194,248	190,554

Source: the company

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Stock Data (0364 HK)

Rating	Not Rated
Price (HK\$)	0.249
Target Price (HK\$)	n.a.
12m Price Range (HK\$)	0.176-0.315
Market cap. (US\$m)	2926.7
3M average Daily t/o	2,751,779.0
Free float (%)	26.1

Source: Bloomberg

Background of China Natural Tea Holdings

One of the top 10 refined oolong tea producers in China. China Natural Tea Holdings is an oolong tea producer with a tea plantation base, production facilities and established sales network in the PRC. The company was the largest raw tea leaves producer in China in terms of sales value in 2011, and it was also one of the top 10 refined oolong tea producers in China in terms of sales volume in the same year.

The company's tea cultivation bases are comprised of 770 mu Forest Lands, 29.5k mu Economic Forest Lands and 8k mu Ecological Forest Lands. Economic Forest Lands refers to the land that the company can have plantation for tea plant, while Ecological Forest Lands refers to the land that the company can only plant trees to protect the land from natural damage. The company cannot plant tea plants or other plantations on Ecological Forest Land for profit making purposes.

Anxi County is famous for tea plantation. The tea cultivation bases are located in Da Ping and Xi Ping, Anxi County in Quanzhou, which is well known for its favorable climate, soil and geographic conditions to grow oolong tea plants. The area is famous for being the source of origin of Tie Guan Yin and other varieties of oolong teas.

The company currently provides four types of oolong teas, namely, Tie Guan Yin, Mao Xie, Huangjin Gui and Ben Shan. The tea will either be sold to retailers as raw teas (wholesale), or the Tie Guan Yin will be processed and sold to customers directly as refined teas under its own brand, Ping Shan Famous Tea (retail).

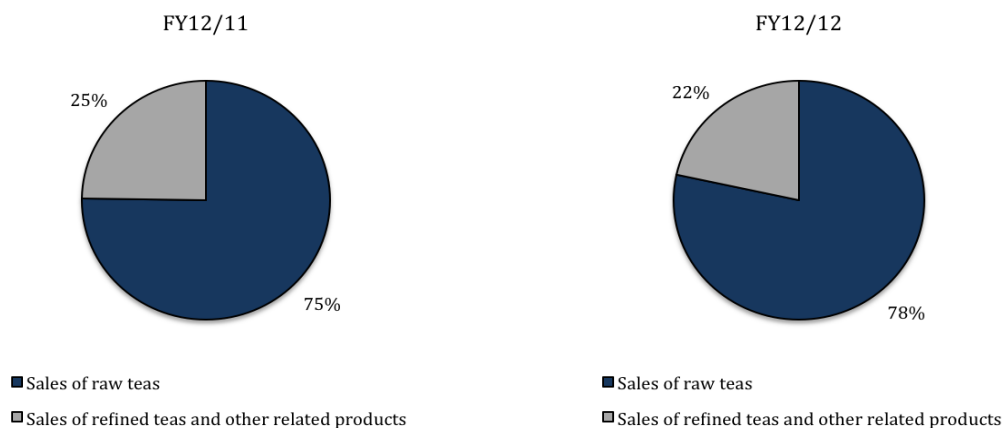
Figure 3: Refined teas of China Natural Tea Holdings



Source: the company

Raw tea is the largest contributor to overall revenue. The majority of revenue of China Natural Tea Holdings is generated from the sale of raw tea. In FY12/11 and FY12/12, the sales of raw teas respectively contributed 75.2% and 78.4% to the total revenue of the company, while the remaining was contributed from the sale of refined tea and other related products (See Fig. 4).

Figure 4: Revenue breakdown of China Natural Tea Holdings in FY12/11 and FY12/12



Source: the company

Investment Thesis

Broadening retail network will help expand gross margin. Although the sale of refined teas and other related products currently accounts for only a small proportion of total revenue, it is more profitable than the wholesales business. As shown in Figure 5, refined teas command a gross margin of 60%-90%, while raw teas only command 40% gross margin. It is not surprising given the ASP of raw teas is far lower than that of refined teas, and there are only two more simple steps involved (filtrating and packaging) in processing the raw teas into refined teas.

Figure 5: Price range, ASP and gross margin of wholesale and retail business

	Price range (RMB/kg)	ASP (RMB/kg)	Gross margin (%)
Raw Teas (wholesale)	30-200	50	40
Refined Teas (Retail) - third party retailers	130-5200	960	60
- company's retail outlets	240-11,600	2100	90

Source: The Company

However, as the company began the refined tea business only in 2008, their market network (retail outlets) and brand image are still developing. As a means to develop its sales network, the company has increased its number of retail outlets, both those self operated or by third party retailers, from 60 in Dec 2010 to 144 in Jun 2013. Apart from that, the company has also appointed Li Lian Jie as the spokesperson of its Ping Shan Famous Tea brand since of Dec 2010. We believe that the company will be able to increase the revenue from the sale of refined teas as the marketing network further develops and its brand image enhances.

Figure 6: Advertisement Ping Shan Famous Tea brand



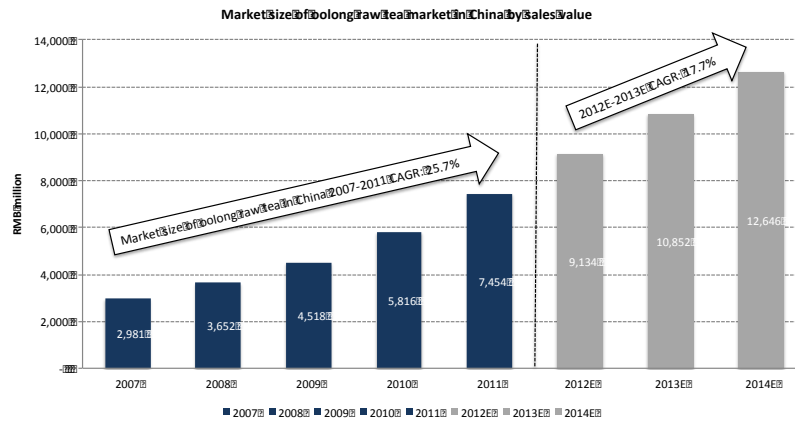
Source: The Company

Disposal of the loss-making business will enhance the financial position. Due to the global economic slowdown, which resulted in decreased demand for textile products, and increases in costs of production, the textile industry in China has undergone a very challenging transition over the past two years. The fabric processing business recorded a net loss attributable to shareholders of HK\$138.5m and HK\$190.8m in FY09/11 and FY09/12 respectively. Although the business still exists after acquisition, it is expected that it will be disposed of since management revealed that the company will mainly focus on its tea production business in the future. We expect that the disposal of the loss-making business, which has been the drag on the overall profit, will enhance the overall profitability and financial position of the company.

Inorganic growth from potential M&A. The company is open to the possibility of prospective M&As, which may include brand-name tea shops, green tea and red tea plantation bases, tea utensils and packaging companies. The company expects its plantation base will expand from 38,800 mu currently to over 100,000 mu, over the coming few years which is expected to cover not only oolong tea, but also black tea and green tea. The retail product mix will also expand to cover not only Guan Yin, but also black tea, green tea, tea sets, tea utensils and tea food.

Rapid growth in the oolong tea market in China. According to Euromonitor International, oolong tea represented the 2nd largest portion of sales of raw teas in China in 2011 by sales value. As shown in Figure 7, sales value in the oolong raw tea market in China increased from RMB2,981m in 2007 to RMB7,454m in 2011, representing a CAGR of 25.7% during the 4-year period. It is also expected that the sales value will further increase to RMB9,134m in FY2012E and RMB12,646m in 2014E.

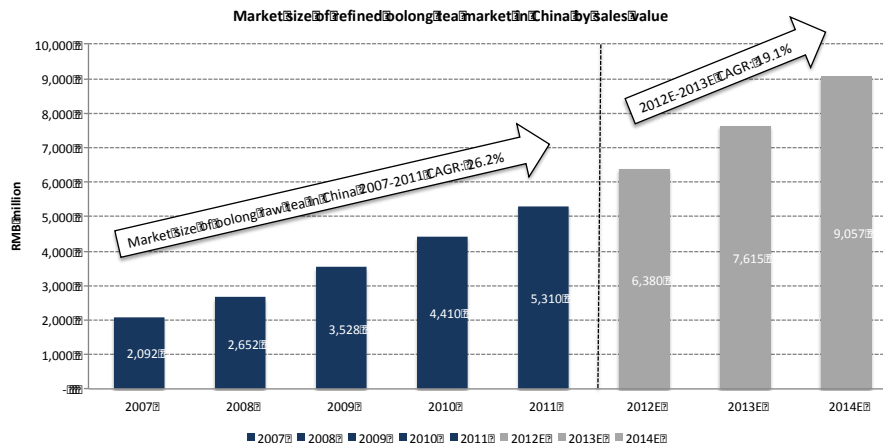
Figure 7: Market size of oolong raw tea market in China by sales value



Source: The Company

Also, according to Euromonitor International, refined oolong tea is the second most heavily consumed tea product in China, following green tea, representing 13.2% of the total refined tea consumption in 2011. The sales value of refined oolong teas in China experienced rapid growth over the past few years. As shown in Figure 8, it increased from RMB2,092m in 2007 to RMB5,310m in 2011, representing a CAGR of 26.2% over the 4-year period. It is also expected that the sales value will further increase to RMB6,380m in FY2012E and RMB9,057m in 2014E.

Figure 8: Market size of refined oolong tea market in China by sales value



Source: The Company

Financials. As mentioned above, the fabric processing business is still in the company after the acquisition. Therefore, both the financial information of Hua Feng and China Natural Tea Holdings will be consolidated into the company's financial account. Figure 9 shows the pro-forma consolidated income statement of the company in FY2012. It should be noted that the income statement assumes the acquisition has been completed as of 1 Jan 2012, in order to give a whole picture of the consolidated result in a full year.

While Hua Feng incurred a loss attributable to shareholders of HK\$190.8m in FY09/12, China Natural Tea Holdings recorded a profit attributable to shareholders of HK\$234.5m in FY12/12. Due to some pro-forma adjustments, the consolidated result was a loss of HK\$22m in FY2012. However, as mentioned in the previous

section, we believe the overall profitability and financial position of the company will be enhanced after the company disposes of the loss-making business in the future.

Figure 9: Consolidated P/L of the company after acquisition (assume acquisition completed in Jan 2012)

	Huafeng HK\$'000	China Natural Tea Holdings HK\$'000	Consolidated HK\$'000
Turnover	539,118	478,827	1,017,945
Cost of services rendered and cost of sales	(478,493)	(247,472)	(725,965)
Gross profit	60,625	231,355	291,980
Changes in fair value of biological assets	0	47,510	47,510
Other income	9,145	6,225	15,370
SG&A	(75,779)	(41,167)	(116,946)
Other expenses	(6,392)	(623)	(7,015)
Impairment loss on property, plant and equipment	(114,383)	0	(114,383)
Loss on disposal of investment properties	(48,189)	0	(48,189)
EBIT	(174,973)	243,300	58,730
Finance costs	(11,224)	(628)	(68,436)
Loss on modifications of convertible bonds	(1,943)	0	(1,943)
Loss on disposal of subsidiaries	(2,386)	0	(2,386)
Profit before taxation	(190,526)	242,672	52,146
Income tax expense	(249)	(8,145)	(8,394)
Profit attributable to shareholders	(190,775)	234,527	(22,429)

Source: The Company

Valuation. Currently there is no 1-year trailing P/E ratio of Ping Shan, as the company has incurred a loss of HK\$190.8m in FY09/12. However, as mentioned in the previous section, the company will mainly focus on tea plantation business and the loss-making fabric processing business will be disposed of in the future. It would therefore be better to look at the tea plantation business alone from valuation perspective. As shown in Figure 10, the tea business of the company recorded a net profit attributable to shareholders of HK\$234.5m, implying a 2012 EPS of HK2.0cents. That would give a 1-year trailing P/E of 12.5x.

As for the peers, Tenfu Caymen (6868 HK), Longrun Tea Group (2898 HK), Ten Ren Tea Co. (1233 TT) and Emei Shan Tourism (000888 CH) are on average trading at a 1-year trailing P/E of 18.9x. The valuation of the company is lower than its peers as the asset has only recently been injected into the listco. However, we believe the company will deserve a higher valuation once it builds a track record and the loss-making business has been disposed in the future.

Figure 10: Peer comparison

Company	Ticker	Mkt Cap (HK\$ m)	3M avg turnover (HK\$ m)	2012E P/E (x)	2013E P/E (x)	P/book (x)	ROIC (%)	ROE (%)	ROA (%)	Dvd Yield (%)	Net Debt/Total Equity
Ping Shan Tea	364 HK	2,926.69	2.75	n.a.	n.a.	0.30	n.a.	-12.24	-9.13	0.00	-22.33
Tenfu Cayman Holdings	6868 HK	4,638.84	0.46	14.12	14.83	2.00	13.01	14.62	12.05	5.60	-29.75
Longrun Tea Group	2898 HK	442.10	0.10	n.a.	n.a.	1.03	0.13	1.50	1.16	0.00	-50.86
Ten Ren Tea Co.	1233 TT	1,065.87	0.60	17.44	n.a.	2.57	12.20	15.01	11.70	0.00	-0.18
Emei Shan Tourism	000888 CH	5,317.50	46.46	25.00	22.40	4.00	16.07	17.02	13.51	0.00	-12.14
Average		2866.08	11.90	18.85	18.61	2.40	10.35	12.04	9.61	1.40	-23.23

Source: The Company

* Ping Shan Tea group is not included in the average figures

Risks. Investing in Ping Shan Tea Group is not without risks. Major investment risks include 1) natural disasters and adverse weather conditions that could adversely affect the quality and quantity of tea leaves harvest, 2) failure of farmers to provide quality tea leaves to the company, 3) Increase in service fees for the tea farmers, 4) revaluation gains or losses on biological assets would increase fluctuation of the company's profit. 5) failure to promote the company's brand that may adversely affect the retail business of the company.

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