

## China Agri-Industries: Fueled by ethanol

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**Recommendation: Not Rated**

**China Agriculture**

Price	HK\$5.00	Yield (12/06A)	n.a.
12 mth range	HK\$3.30-7.33	ROE (12/06A)	19.0%
Market cap.	US\$2,303.8m	Net gearing (12/06A)	81.4%
No. shares o/s	3,593.9m	Net debt/sh. (12/06A)	HK\$1.46
Daily t/o, 3 mth	US\$10.8m	BV/sh. (12/06A)	HK\$2.14
Free float %	38.4%	Consensus EPS	
Major shareholder	COFCO – 57.7%	- 12/07F	HK\$0.273
Ticker	0606.HK/ 606 HK	- 12/08F	HK\$0.347

### Key points:

- Backed by COFCO, CAIH is China's major producer of fuel ethanol.
- Some projects postponed to 2010 from 2008 due to government anti over-expansion measures.
- Oilseed and brewing sectors will drive growth in the short term.
- Short-term catalysts - potential assets injection, new fuel ethanol policy.

**Comprehensive food supplier.** China Agri-Industries Holdings (CAIH) is the listed flagship of China National Cereals, Oils & Foodstuffs Corporation (COFCO), China's largest food importer/exporter and leading food producer. CAIH is involved in oilseed processing, brewing materials, rice trading and processing, wheat processing and biofuel & biochemicals. With its leading position and economies of scale in almost every business segment, it is able to gain market share from smaller players. In 1H FY12/07A, the company's revenue rose 54.1% YoY to HK\$11,601.6m and net profit 95.2% YoY to HK\$615.2m.

**Table 1: Summary of business segments**

Segment	Principal product	Market position
Oilseed processing	bulk edible oil, oilseed meals & feeds	No. 2, 10-15% market share
Brewing materials	malt, malting barley	No. 2, 12% market share
Rice trading and processing	white rice, parboiled rice	One of the only two licensed rice exporters, 70% market share
Wheat processing	flour, noodles, wheat bran, instant noodles	Supplement to other businesses
Biofuel and biochemical	fuel ethanol, consumable ethanol, anhydrous ethanol, crude corn oil	15-20% market share

Source: Company data

**Aiming at fuel ethanol market.** China started using ethanol gasoline (a mixture of 10% fuel ethanol and 90% gasoline) in 2001. So far nine provinces (Heilongjiang, Liaoning, Jilin, Henan, Anhui, Hubei, Shandong, Hebei and Jiangsu) have joined trials, consuming around 1m tonnes fuel ethanol each year. CAIH is a major producer of fuel ethanol in the country, with a total annual capacity of 260k tonnes, which will increase to 460k tonnes end-2007 when its new Guangxi plant comes on stream.

**Table 2: China's fuel ethanol plants**

Location	Sales region	Annual capacity (tonnes '000)	Ownership
Heilongjiang	Heilongjiang	180	CAIH (100%)
Jilin	Jilin, Liaoning	400	CAIH (20%) and third parties
Anhui	Henan, Hubei, Hebei, Jiangsu	440	COFCO (20.74%) and third parties
Henan	Anhui, Shandong, Hebei	300	Third parties

Source: Company data, SBI-E2 Capital

**Table 3: CAIH's expansion plan for fuel ethanol**

Location	Original plan		New plan	
	Annual capacity (tonnes '000)	Start of operation	Annual capacity (tonnes '000)	Start of operation
Guangxi	200	late 2007	200	late 2007
Liaoning	300	late 2008	Cancelled	cancelled
Hebei	300	mid 2008	100	2010
Hubei	100	late 2008	100	2010
Others			500	2010

Source: Company data

**Double-edged sword of industry tightening.** The company suspended the construction of its new fuel ethanol plants, except the Guangxi facility, after the Chinese government tightened approvals in December 2006 in an attempt to avoid over-expansion. Despite delays, the tightening should benefit CAIH in the long term as it raises entry barriers for other players. Currently, the old policy is under review and new measures should come out shortly. We believe the government will continue to encourage the development of environmentally friendly energies and that the outlook of China's ethanol gasoline industry remain promising.

**New oilseed processing capacity.** The company's oilseed processing division contributed more than half of its total operating profit, with turnover up 62.6% YoY to HK\$7,793.0m in 1H FY12/07A. The gross margin widened 3.4pcp to 6.9% mainly due to a 47.8% YoY increase in ASP, driven by robust demand. According to the company, its utilization has reached 80%, compared with the industry average of 50-60%, which probably cap its short-term growth. CAIH's plan to boost its oilseed processing capacity by 30% in 2008 should drive earnings growth in FY12/08 and FY12/09.

**Brewing expansion.** CAIH supplies malt to some tier-one brands like Tsingtao, Yanjing, Snow, Budweiser, Heineken, etc. Its segmental gross margin widened 14.9pcp YoY to 30.7% because of rising product prices and better cost controls. The company expects the gross margin to narrow in 2H following gradual resume of the selling prices and reach 20-25% in the long term. Its Jiangyin I plant started operation in June 2007, bringing in additional 120k tons capacity to the current 360k tons. CAIH expects its total brewing capacity to reach 1.08m tones by 2011.

**Table 4: Brewing business expansion**

Project	Annual capacity (tonnes '000)	Start of operation
Jiangyin I	120	2007
Jiangyin II	200	2008
I(nner Mongolia	100	2009
Dongguan	100	2010
Jiangyin III	200	2011

Source: Company data

**Assets injection from parent.** According to a non-competition agreement, CAIH has an option to acquire assets from its parent. As the listed vehicle of COFCO's food processing business, further assets injections are possible.

**Table 5: Assets to be acquired from COFCO**

Assets	Principal business
Fei County Zhong Zhi Oils & Fats Co.	oil extraction and soybean meal production
Dongguan Zhong Gu Oils & Fats Co.	oil extraction and soybean meal production
37.03% interest in China Resources (Jilin) Bio-chemical Co.	corn processing
20.74% interest in Anhui BBKA Biochemical Co.	production of fuel ethanol and other bio-chemical products

Source: Company data

**Valuation.** According to consensus estimates, the company's EPS will rise to HK\$0.274, up only 1.1% YoY, due to dilution from its global offering in March 2007. The counter now is trading at HK\$5.00, which represents a forward P/E of 18.2x for FY12/07F.

**Corporate governance.** CAIH listed on HKEx in March 2007 via a global offering of 802.5m shares at HK\$3.72 each. Substantial shareholder is COFCO (57.7%).

**Table 6: Segmental performances**

Year to Dec (HK\$m)	05A	06A	YoY growth (%)	1H06A	1H07A	YoY growth (%)
Revenue of continuing operation						
Oilseed processing	9,971.6	11,885.5	19.2	4,792.6	7,793.0	62.6
Brewing materials	865.1	878.8	1.6	455.1	520.8	14.4
Rice trading and processing	1,314.3	2,066.0	57.2	878.7	1,549.8	76.4
Wheat processing	1,662.2	1,764.4	6.2	828.9	974.2	17.5
Biofuel and biochemical	-	1,304.6	n.a.	571.1	763.8	33.7
<b>Total revenue</b>	<b>13,813.2</b>	<b>17,899.3</b>	<b>29.6%</b>	<b>7,526.4</b>	<b>11,601.6</b>	<b>54.1</b>
<b>Segmental results</b>						
Oilseed processing	141.1	464.2	229.0	97.6	375.1	284.2
Brewing materials	46.1	71.3	54.5	34.2	104.7	205.7
Rice trading and processing	117.8	128.7	9.2	98.6	135.0	36.9
Wheat processing	22.8	76.0	234.1	63.6	(1.6)	-102.6
Biofuel and biochemical	-	228.2	n.a.	118.8	60.2	-49.4
Corporate and others	-	(4.1)	n.a.	(0.0)	(27.0)	n.a.
<b>Aggregate</b>	<b>327.8</b>	<b>964.4</b>	<b>194.2</b>	<b>412.9</b>	<b>646.3</b>	<b>56.5</b>

Source: Company data

**Table 7: Other projects in pipeline**

Project name	Product	Annual capacity (tonnes '000)	Start of operation
HLJ Zaodong	consumable ethanol	150	1H 2007
Gongzhuling	starch & sweeteners	600*	late 2007
Yushu I	starch	600*	mid 2007
Yushu II	L-lactic acid	30	mid 2009
HLJ Longjiang	starch	600*	early 2009
HLJ Suihua	starch	600*	early 2009

Source: Company data

Note: \* Corn processing capacity

Table 8: P&amp;L

Year to Dec (HK\$m)	05A	06A	1H06A	1H07A
<b>Continuing operations</b>				
<b>Revenue</b>	13,813.2	17,899.3	7,526.4	11,601.6
Cost of sales	(13,100.7)	(16,506.7)	(7,003.0)	(10,603.6)
<b>Gross profit</b>	712.5	1,392.6	523.4	998.0
Other income and gains	156.6	405.4	227.2	387.1
Selling and distribution costs	(355.1)	(500.5)	(212.5)	(271.3)
Administrative expenses	(166.9)	(301.6)	(116.2)	(230.6)
Other expenses	(3.5)	(17.3)	(0.9)	(82.3)
Finance costs	(132.6)	(200.5)	(98.7)	(144.0)
Share of profits of associates	82.2	201.0	74.2	91.2
Profit before tax	293.2	979.1	396.5	748.3
Tax	(51.4)	(129.6)	(63.1)	(26.1)
<b>Profit for the period from continuing operations</b>	241.8	849.5	333.5	722.2
<b>Discontinued operations</b>				
<b>Profit for the period from discontinued operations</b>	41.6	64.5	24.1	0.0
Profit for the period	283.4	914.1	357.5	722.2
Minority interest	(28.5)	(158.7)	(42.4)	(107.0)
<b>Net profit</b>	254.9	755.4	315.1	615.2
Dividends	144.0	362.1	2.3	-
EPS - Basic (HK\$)	0.091	0.271	0.113	0.190
EPS - Diluted (HK\$)	0.077	0.254	0.105	0.190

Source: Company data