

Ko Yo Group

Dazhou, Dazhou, Dazhou!

Headquartered in Chengdu, Sichuan province, Ko Yo (KY) is a regional chemical fertilizer manufacturer with principal products including bulk blend (BB) fertilizer and urea. Although its existing businesses, in our view, are somewhat steady, our interest is on the new Dazhou plant, which, with 450,000 urea capacity in phase I, has potential to substantially change KY's landscape. The Dazhou project was introduced to the market four years ago. Now it entered into the last stage, the final trial, which will launch soon. We think execution risk has been largely lowered and now the stock offers a sound risk / return tradeoff.

Investment summary

- Construction and testing of Dazhou plant was completed already. Final trial will kick off shortly.
- Mass production is planned in 2H. Profit contribution could reach RMB14.2m in FY12/10F and RMB58.3m in FY12/11F even under assumption that urea price will remain at current low level.
- We value the plant at RMB1,794m (HK\$2,063m), compared with KY's overall market capitalization of HK\$1,387.9m.
- Execution risk reduced substantially and is mostly controllable at this stage. The trial result is the only major uncertainty.
- FY12/09A earnings are shadowed by weak fertilizer price.

Natural gas supply is convenient and has been secured for Dazhou plant. The Dazhou project was initiated in 2006. Located in Dazhou, Sichuan province, the plant is designed to utilize local rich natural gas resources. It is connected to Sinopec's Puguang Gas Field ("普光氣田") nearby, which is one of the largest gas fields in China with annual natural gas production capacity of 12b m³ (4b m³ in 2010). According to the management, KY has reached agreement with Sinopec to purchase 450m m³ gas from Puguang Gas Field each year. Price in 2010 is RMB1.28/m³ (plus RMB0.07/m³ pipeline distribution charge),

Final trial will start soon and operation is expected to commence in 2H.

Dazhou plant's phase I construction was completed in 4Q 09 with a production line for 450,000 tonnes urea and 400,000 tonnes ammonia (~260,000 tonnes ammonia will be processed into urea and consumed internally). The plant can be further expanded in phase II to accommodate capacities of 800,000 tonnes urea and 470,000 tonnes ammonia (all for internal use). When we visited the plant in Mar., KY had just finished testing of each individual part of the production line. During our latest discussion with the management, we were told final trial of the whole device will launch in days. Accordingly, mass production is reasonably anticipated for 2H.

Earnings contribution is estimated at RMB58.3m under current urea price.

According to the management's assessment, Dazhou plant's production cost for urea will be at ~RMB1,450/tonne (ammonia: ~RMB1,650/tonne) on a full operation basis. Based on present selling prices (urea: RMB1,650/tonne, ammonia: RMB2,050/tonne, excl. VAT tax), we estimate the plant can generate RMB57.9m and RMB145.6m gross profit in FY12/10F and FY12/11F, respectively, with corresponding net profit at RMB14.2m and RMB58.3m. Net profit will drop to RMB57.5m if phase II (urea capacity will enhance to 800,000 tonne and consume all ammonia internally) is implemented, because, under current price and cost structure, ammonia yields much better gross margin than urea (urea: 12.1%, ammonia: 19.5%).

Ticker	0827 HK
Rating	Not Rated
Price (HK\$)	0.197
Target Price (HK\$)	n.a.
12m Price Range (HK\$)	0.103-0.285
Market cap. (US\$m)	177.9
Daily t/o (US\$m)	1.4
Free float (%)	37.9

Financial summary

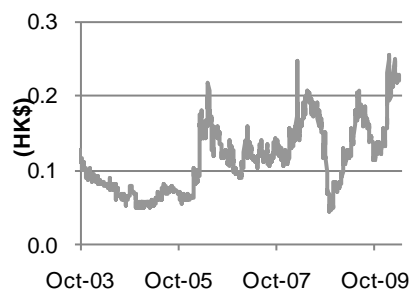
Year to Dec	07A	08A
Turnover (RMBm)	774.9	654.9
Net Profit (RMBm)	41.4	60.7
EPS (RMB)	0.016	0.010
P/E (x)	10.7	17.1
P/B (x)	1.43	1.39
EV/EBITDA (x)	20.0	14.4
Yield (%)	0.7	0.2
ROE (%)	7.0	8.4
ROCE (%)	6.7	8.2
N. Gear. (%)	36.0	29.6

Source: SBI E2-Capital

	09F	10F	11F
Consensus EPS (RMB)	0.002	0.028	0.041
Previous earnings (RMBm)	-	-	-
Previous EPS (RMB)	-	-	-

Price performance

Year to Dec	1m	3m	12m
Relative to HSI (%)	-8.9	-4.6	+2.8
Actual price changes (%)	-10.9	-1.5	+42.8



Source: Bloomberg

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Table 1. Unit cost breakdown by raw materials (RMB/tonne)

	Ammonia	Urea
Natural gas	1,310.0	
Ammonia		957.0
Utilities	120.0	300.0
Packaging		65.0
Labor, depreciation and others	220.0	128.0
Total	1,650.0	1,450.0

Source: Company data

Table 2. Earnings forecast for Dazhou plant

Year to Dec (RMB m)	10F	11F	12F
Output (tonnes '000)			
Urea	225.0	450.0	800.0
Ammonia	200.0	400.0	464.0
Available for sales (tonnes '000)			
Urea	225.0	450.0	800.0
Ammonia	69.5	139.0	0.0
ASP (RMB/tonne)			
Urea	1,650.0	1,650.0	1,650.0
Ammonia	2,050.0	2,050.0	2,050.0
Revenue	513.7	1,027.5	1,320.0
Urea	371.3	742.5	1,320.0
Ammonia	142.5	285.0	0.0
COGS	(455.9)	(881.9)	(1,160.0)
Gross profit	57.9	145.6	160.0
Operating expenses	(41.1)	(77.1)	(92.4)
EBT	16.8	68.5	67.6
Tax	(2.5)	(10.3)	(10.1)
Net profit	14.2	58.3	57.5

Source: SBI E2-Capital

Dazhou plant can be cost effective. Under a dynamic business environment (i.e. volatile urea price), urea producers' profitability depends on their relative cost base. We think KY has cost advantages against other gas-based players, because:

- Dazhou plant is close to the Puguang gas field, which can not only save pipeline distribution fees but also be helpful in ensuring a stable gas supply. The latter is particularly critical amid the context of frequent gas shortage in China.
- Major equipment is second-hand products imported from the U.S., which effectively brings down capital expenditure on Dazhou plant and, sequentially, depreciation expenses. Investment on fixed assets (phase I) totalled RMB897m, ~50% lower than industry average (~RMB2b).
- With single device scale at 450,000 tonne urea (800,000 tonnes in phase II), Dazhou plant enjoys economy of scale, especially compared with other Sichuan-based urea producers.

Fair value is estimated at RMB1,794m. Considering urea production line's capital-intensive character as well as final product's commodity nature, we try to price Dazhou plant through a P/B multiple approach. Average P/B ratio of two HK-listed urea producers is 2.0x. By using this ratio, we calculate a value of RMB1,794m based on the total RMB897m fixed asset investment of Dazhou plant. Although the RMB897m investment is not 100% equity-based (i.e. actual NAV should be less due to financial leverage), its impact on valuation can be offset by the fact that Dazhou plant's capital expenditure is ~50% lower than industry average. Thus, we picked the RMB1,794m (HK\$2,063m) as the plant's fair value, which is 48.6% higher than KY's present market capitalization is HK\$1,387.9m.

Table 3. Valuation matrix

Company	Ticker	Market cap (US\$m)	Historical P/E (x)	1-Yr P/E (x)	2-Yr P/E (x)	ROE (%)	P/B (x)
China XLX	1866 HK	425.6	24.5	10.5	7.9	8.2	2.0
China Bluechem	3983 HK	2,819.2	20.0	13.8	10.5	9.9	2.0
Average							2.0
Liaoning Tongda	000059 CH	2,006.9	70.9	18.4	12.7	3.2	2.2
Sichuan Chemical	000155 CH	521.7	n.a.	8.6	n.a.	4.7	2.1
Sichuan Meifeng	000731 CH	573.9	33.5	20.3	16.2	8.3	2.3
Lutianhua	000912 CH	795.7	186.0	22.7	16.6	4.5	2.2
Jiafeng Chemical	000950 CH	830.3	41.7	16.4	13.9	12.6	2.5
Yuntianhua	600096 CH	1,829.8	61.9	28.5	16.0	1.9	2.8
Cangzhou Dahua	600230 CH	576.9	43.6	15.6	12.4	6.0	3.4
Chitianhua	600227 CH	876.4	32.3	29.3	18.9	7.7	1.8
Average							2.4

Source: Bloomberg

Execution risk has substantially declined. Apparently, the Dazhou project's execution risk is high, given its investment scale and capacity size both beyond KY's past experience. In particular, the project was delayed multiple times for different reasons, which further shook investors' confidence. Nevertheless, we see this risk was minimized after: 1) phase I construction was completed; 2) Puguang gas field started supplying natural gas; 3) every individual part of the production line was well tested. The remaining major uncertainty is that whether the mass production can launch in 2H as scheduled. As most problems, if any, may occur at the pure plant operation level, we regard them manageable and within KY's own control. The trial result will be available in Jun. We believe it is a major catalyst for the stock. A successful trial will surely boost investment sentiment and likely trigger re-rating on the stock.

Weak FY12/09A results are foreseeable. The company registered 11.7% decline in top line to RMB311.3m in 1H FY12/09A. Net profit retreated 75.6% to RMB9.4m. As fertilizer price remained soft in 2H, we do not expect any HoH improvement. The company will announce its full year results tomorrow.

Table 4. Ko Yo's capacity expansion

Year to Dec (tonnes '000)	08A	10F
Urea	170.0	620.0
Ammonia	130.0	530.0
Sodium carbonate	90.0	90.0
Ammonium chloride	100.0	100.0
BB fertilizers & compound fertilizers	700.0	700.0

Source: Company data

Chart 1. Dazou Plant



Chart 2. Dazou Plant



Chart 3. Dazou Plant



Chart 4. Dazou Plant



Chart 5. Dazou Plant



Chart 6. Dazou Plant



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