SBI E2-Capital

Corporate Snippet

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Capitalize on price hike — China Agriculture

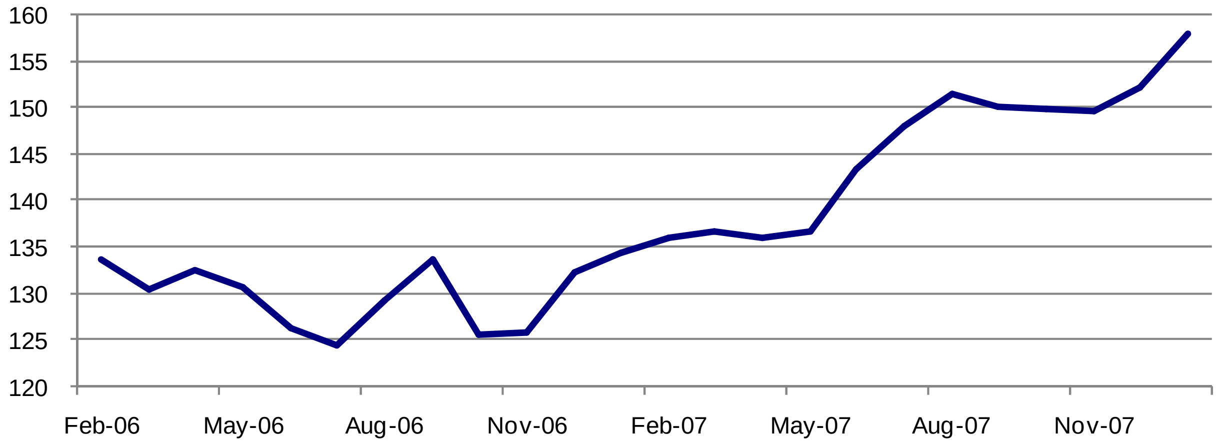
China Green (904 HK, HK$8.80) — BUY (unchanged)

Target price: HK$11.84 (+35%)

Target price lifted. We have increased our FY04/08F net profit to RMB473.8m from RMB435.3m to reflect the better-than-expected 1H results. We have adopted more conservative assumptions for CG's organic agriculture business (10.000 mu (666.7 hectares) cultivation area by FY04/10F instead of 20,000 mu previously), which resulted in minor net profit estimates cut for FY04/09F and FY04/10F. The counter is our top pick in China's consumption sector for its ability to benefit from inflation. Our new target price of HK$11.84 represents 20x FY04/09F fully diluted PE.

Higher ASP. The ASP of CG's fresh products (broccoli, radish, long onion, soya bean, etc) rose about 5.0% YoY in 1H FY04/08A and we expect similar rates of growth in 2H FY04/08F and FY04/09F given: 1) China's rising vegetable prices; 2) accelerating appreciation of the RMB against USD (the company is allowed to renegotiate prices with overseas customers once RMB appreciates more than 3.0% during the contract period); 3) lag in revenue recognition (4 – 9 months between contract signing and final delivery). We expect prices of processed food products to rise as well.

Chart 1: China's agriculture products wholesale price index



Source: Ministry of Agriculture of the PRC

Table 1: RMB appreiciation against US$

	4-month (%)	9-month (%)	6-month (%)
Dec-07	3.2	5.9	4.2
Nov-07	2.4	4.7	3.4
Oct-07	2.0	4.2	3.2
Sep-07	1.9	4.1	3.1
Aug-07	2.2	3.8	2.7
Jul-07	2.1	4.0	2.6
Jun-07	1.8	3.9	2.7

Source: Bloomberg

Note: The normal length or the company's contracts is 4 – 9 months and the average is around 6 months.

Margin expansion. Despite rising raw material (fertilizer, packaging etc) and labor costs, we expect the ASP increase to underpin the gross margin of fresh produce and processed product divisions. The gross margin of fresh produce will widen 0.5pcp to 54.2% in FY04/08F (up 0.6pcp in 1H) and of processed products will narrow 0.3pcp (down 0.7pcp in 1H).

Strong Japan, slowdown in Europe. Japan remained the company's largest overseas market in 1H FY04/08A, generating RMB172.2m in revenue (up 36.0%) compared with 8.1% growth in FY04/07A, due to the launch of frozen products. Sales in Europe fell 4.7% to RMB35.8m (up 134.8% in FY04/07A) because of fewer mushroom contracts due to price renegotiation. We expect European sales to recover in 2H FY04/08F.

Table 2: Sales by market in 1H FY04/08A

	Turnover (RMBm)	% of total	YoY growth (%)
Japan	172.2	32.3	36.0
China	293.4	55.0	39.8
Other Asian countries	28.0	5.2	117.8
Europe	35.8	6.7	-4.7
Australia	0.6	0.1	45.6
South America	2.8	0.5	n.a.
Africa	1.1	0.2	n.a.

Source: Company data

Seeking more land. The company has 66,100 mu (4,406.7 hectares) of farmland with a total output of 273,200.0 tonnes crops in FY04/08F. In preparation for FY04/09F, it plans to lease additional 10,000 – 12,000 mu (666.7 – 800.0 hectares), with 4,000 mu (266.7 hectares) already secured. We estimate its output at 313,389.0 tonnes in FY04/09F, including 171,322.5 tonnes of fresh produce (up 7.1% YoY) and 142,066.5 tonnes as raw materials for processed products (up 25.5% YoY).

Organic farming. From 2H FY04/08F, the company will allocate 10,000 mu (666.7 hectares) in Hubei for an organic agriculture base, expected to start operation in Sep - Oct 2008. This will reduce the fresh produce division's output in 2H FY04/08F (segmental sales up 25.4% YoY in 1H). We expect this new business to contribute 9.3% of CG's total turnover in FY04/10F. The company plans to have 20,000 mu (1,333.3 hectares) under organic cultivation in three years.

Beverage segment in good shape. Turnover of beverage products rose 66.5% to RMB89.3m in 1H FY04/08A. CG is expanding its sales network from two provinces (Fujian and Jiangxi) to Hunan, Hubei and Zhejiang. This geographic expansion will be a major driver of the beverage business, in our view.

Instant noodle operation on track. CG launched its non-fried instant noodle business in Jan 2007. The product has been well accepted by the market and its existing capacity (6,800 tonnes p.a.) has been fully occupied. Three new production lines, with 4,000 tonnes each, will be added in Jiangxi in Jul – Aug 2008. We expect the segment to grow rapidly in the next two years. The company raised its selling price of instant noodles by around 3.0% (RMB0.1 in end prices) in Oct 2007, which will boost the segment's gross margin in 2H FY04/08F.

Limited impact of new food policy. The company's corn products have been categorized as vegetables and are not subject to China's new grain export duties. The central government's control of prices of important daily necessities, such as instant noodles, will restrict CG's ability to pass incremental costs to customers. However, as a producer of non-fried instant noodles (no palm oil needed in production), CG enjoys much higher gross margins than traditional players such as Tingyi (25.0% in 1-3Q FY12/07A) or Uni-president (20.8% in 1H FY12/07A). This gives CG an edge in this competitive market.

Earnings forecast. Driven by its increasing crop output and maturity of the branded beverage and instant noodle business, we estimate CG's top line will grow at a CAGR of 26.1% from FY04/07A to FY04/10F. Branded beverage and instant noodle business will stay under cost pressure due to rising raw material costs (corn powder, sugar, packaging materials). Nevertheless we expect blended gross margin to improve backed by change of sales mix (lower growth in sales of lower-margin rice products - gross margin 28.1% in 1H FY04/08A). According to the company, its rice and rice flour product sales will grow at single-digit rate (5-7% p.a.) in the next two to three years, with stable margins. In 1H FY04/08A the blended gross margin widened 0.6pcp to 51.6%. Overall, we expect CG's net profit to increase 37.1% in FY04/08F to RMB473.8m and 22.4% in FY04/09F to RMB580.1m.

Table 3: P&L

Year to Apr (RMBm)	06A	07A	08F	09F	10F
Turnover	686.6	954.1	1,236.1	1,559.3	1,913.7
Cost of sales	(332.2)	(456.2)	(587.6)	(736.8)	(899.0)
Gross profit	354.4	497.9	648.5	822.5	1,014.7
Other revenue	8.6	15.5	25.0	37.4	48.7
Gain arising from changes in fair value less estimated point-of-sale costs of biological assets	15.2	15.2	68.1	82.0	94.9
Selling and distribution expenses	(64.9)	(92.9)	(118.9)	(150.0)	(184.1)
General and administrative expenses	(45.4)	(75.6)	(74.6)	(94.1)	(115.5)
Other operating expenses	0.0	0.0	(31.6)	(27.2)	(21.1)
Operating profit	268.0	360.1	516.4	670.6	837.5
Finance cost	(5.7)	(14.4)	(1.4)	0.0	0.0
Profit before taxation	262.3	345.8	515.0	670.6	837.5
Income tax	(9.0)	(0.2)	(41.2)	(90.5)	(146.6)
Net profit	253.3	345.5	473.8	580.1	690.9
EPS - basic (RMB)	0.373	0.448	0.542	0.655	0.780
EPS - diluted (RMB)	0.364	0.417	0.498	0.592	0.705
Proposed DPS (RMB)	0.104	0.110	0.140	0.170	0.200
Proposed dividend	75.2	91.3	131.4	159.6	187.8

Source: SBI E2-Capital