

China Environmental Resources

Scalable Organic Fertilizer Play

Not Rated

Financial summary

Year to Jun	08A	09A
Turnover (HK\$m)	0.0	121.5
Net Profit (HK\$m)	(41.3)	96.0
EPS (HK\$)	(0.023)	0.023
EPS Δ%	n.a.	n.a.
P/E (x)	n.a.	5.5
P/B (x)	2.85	1.66
EV/EBITDA (x)	n.a.	n.a.
Yield (%)	n.a.	n.a.
ROE (%)	n.a.	34.5
ROCE (%)	n.a.	28.2
N. Gear. (%)	n.a.	24.5

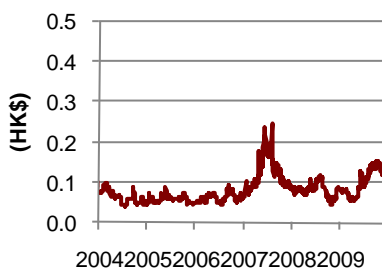
Source: Bloomberg

Price Performance

	1 mth	3 mth	12 mth
Relative to HSI (%)	-8.4	-15.7	+8.1
Actual price changes (%)	-10.7	-13.2	+50.6

	10F	11F	12F
Consensus EPS (RMB)	n.a.	n.a.	n.a.
Previous forecasts (RMBm)	n.a.	n.a.	n.a.
Previous EPS (RMB)	n.a.	n.a.	n.a.

Price Chart



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Intent with Cathay Capital in Jul 09 to acquire only technologies in related to fertilizer production, which can be also regarded as a compensation for Cathay Capital, in our view. Consideration is set at HK\$114m, which will be satisfied by issuing new shares at HK\$0.08 each. CER acquires all sales orders from the JV and the latter, including old plants, will be phased out.

- In Oct 09, CER announced to set up a JV with XPCC. CER owns 70.0% interest in the JV. An organic fertilizer factory then will be established and total investment is RMB36.0m.
- In Dec 09, CER announced to acquire 70.0% interest in a fertilizer distribution company from Beijing Jianong Yongxing Agricultural Production Materials (JNYX) for RMB37.0m consideration including RMB2.0m cash and RMB35.0m shares issued at HK\$0.112 each.

Ticker:	1130.HK	12 mth range:	HK\$0.05-0.16
Price:	HK\$0.125	Market cap:	US\$115.0m
Target:	n.a.	Daily t/o, 3 mth:	US\$0.5m
		Free float %:	52.7%

Key points:

- ✦ Re-directed to agriculture sector in 2008.
- ✦ Acquired 60,000 mu forest in Xinjiang.
- ✦ Completed development of waste treatment system.
- ✦ Scalable business model with total solution for big farmers.
- ✦ Projects in pipeline.
- ✦ Earnings from sole organic fertilizer segment to hit HK\$98.0m by FY06/12F

Business summary and background. China Environmental Resources (CER), formerly known as Benefun, used to be engaged in garment, property rental and development businesses. It re-directed itself to agriculture sector in 2008. Garment and property rental businesses have been scaled down. Remaining property development business is also subject to disposal in near future. Core operations will then include organic fertilizer and plantation, which contributed 35.5% and 6.1% of total HK\$121.5m turnover in FY06/09A,

□ In Sep 08, the company acquired Foshan Gold Vantage Forestry Limited (FGVF) (佛山市凱金林業有限公司), which has a 30-year leasing contract with The Agricultural No. 8 Division No.142 Regiment of the Xinjiang (XPCC) (新疆生產建設兵團農八師 142團) for 60,000 mu plantation land in Shihezi, Xinjiang. Total consideration was HK\$500m, settled by HK\$100m promissory notes and HK\$400m worth of convertible bonds with initial conversion price of HK\$0.064.

□ Mr. Choy Ping Fai, as the vendor of FGVF, obtained the CBs, of which HK\$330m has been converted. Mr. Choy now owns 21.2% equity interest of CER and becomes the largest shareholder. Consequently, the senior management of CER changed. Three new executive directors, Ms. Kam Yuen (CEO), Mr. Kwok Wai and Leung Kwong Choi, were appointed in 2008 and 2009.

□ CER launched its organic fertilizer business, which can be somewhat regarded as a successor of an existing JV between Mr. Choy and Cathay Capital. The JV produced and sold organic fertilizer under "Tianmimi" ("田密密") brand with two plants in Shandong and Jiangsu. However, this centralized production model was subject to change after CER completed development of O-Live Organic Waste Treatment System. Thus, instead of this entire JV, CER entered into the Letter of

- In Dec 09, CER announced entering into the Letter of Intent with Jiangxi Wanzai County government regarding the establishment of production and sale of organic fertilizers.

Table 1: Shareholder structure

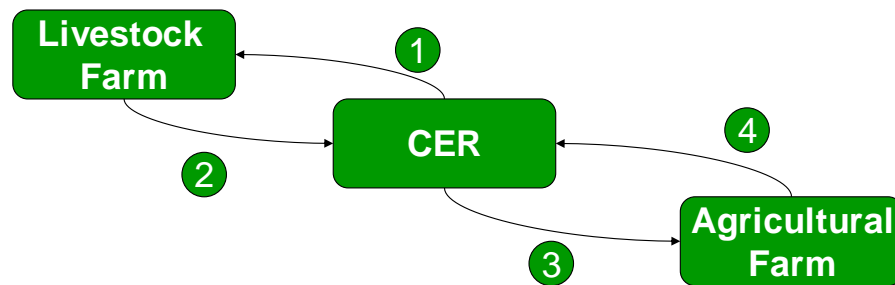
Shareholder name	% of outstanding	% of outstanding (after full conversion of CBs)
Choy Ping Fai	21.2	38.6
Edmond De Rothschild	8.5	6.6
Cheung Wai Yin	6.5	5.1
Others	63.8	41.4
Total	100.0	100.0

Source: Company data and SBI E2-Capital

Organic Fertilizer Segment

A scalable business model. A major obstacle of organic fertilizer industry is its scalability, especially at raw material supply side. Collection and transportation of raw materials (e.g. biological waste) for a centralized manufacturing centre carries huge expenses, though the waste itself is somewhat worthless. CER’s waste-to-value treatment system (W2V), according to the management, is installed next to a certain livestock farm. It helps the livestock farm handle daily waste. Meanwhile processed waste is collected and used as raw material in production of microbial organic fertilizer. Together with multiple choices for final production, such as a specially-designed processing vehicle or a small processing plant, subject to local demand, CER, thus, can be more flexible in expanding capacity.

Chart 1: Business model



- Stage 1:** Sell and install W2V unit at the livestock farm
- Stage 2:** Run W2V – turn animal manure into semi-fertilizers and these semi-fertilizers are guaranteed to be purchased by CER
- Stage 3:** CER adds microbe and additive into semi-fertilizers and package them into microbial organic fertilizers for sale to farms
- Stage 4:** CER receives favorable return from the sale of microbial organic fertilizers to agricultural farm

Source: Companies data

Chart 2: W2V machine



Source: Companies data

Chart 3: Fertilization effect



No organic fertilization



W2V organic fertilizers applied

Source: Companies data

Projects in pipeline. Major agricultural areas usually are simultaneously inhibited by both livestock farming and agricultural plantation. For them, CER, in fact, provides a total solution: handling biological waste generated from livestock farms and supplying organic fertilizer for crops plantation. CER mainly deals with large clients on project basis. According to the management, they are in negotiation with nationwide clients and have a quite strong pipeline.

Table 2: Projects list

	Sales target (tonnes '000)
新疆生產建設兵團	35.0
新疆畜牧專案	15.0
江西萬載有機縣	15.0
廣東南雄煙草基地	10.0
貴陽綜合資源專案	20.0
四川獼猴桃基地	10.0
北京佳農永興銷售管道	20.0
沃爾瑪農超對接基地	25.0
海南光華印棟樹種植基地	10.0
安徽蕩山肥料項目	10.0
全國銷售管道	15.0

Source: Company data

Plantation Segment

60,000 mu forest in Xinjiang. CER has a 30-year leasing contract with XPCC for 60,000 mu (4,000 hectares) plantation land in Shihezi, Xinjiang. According to the latest valuation report, the total timber volume available for logging is 719,421m³, comprising 718,482 m³ of poplar and remaining balance of other species like Elm and Willow. Based on a price range of RMB580-1,100/ m³, the entire stocks of standing trees were priced at RMB597m.

Financials

Earnings forecast of the organic fertilizer segment. According to the management, ASP of its organic fertilizer is RMB1,800-2,000 for solid type and RMB4,000-4,800 for liquid type. Gross margin is at 20-30% range. The W2V unit is produced under OEM model with production cost at RMB220,000-250,000 and sold at RMB400,000-480,000. Based on these figures as well as the project list, assuming all projects will come out gradually throughout the year, we calculate the organic fertilizer segment will have HK\$144.2m revenue in FY06/10F, HK\$509.2m in FY06/11F and HK\$763.8m in FY06/12F. Segmental net profit, accordingly, is estimated at HK\$15.6m, HK\$59.2m and HK\$98.0m, respectively.

Table 3: Assumptions and estimates for Organic Fertilizer Segment

Year to Jun	10F	11F	12F
Sales volume			
Organic fertilizer (tonnes '000)	43.9	192.7	300.2
W2V machine sold (units)	80	80	60
ASP			
Organic fertilizer (RMB/tonne)	2,150	2,150	2,150
W2V machine (RMB/unit)	400,000	400,000	400,000
Gross margin (%)			
Organic fertilizer	29.4	27.5	27.1
W2V machine	26.7	26.7	26.7
	37.5	37.5	37.5
Revenue (HK\$m)	126.4	446.2	669.3
Gross profit (HK\$m)	37.2	122.7	181.4
EBT (HK\$m)	20.8	78.9	130.7
Net profit (HK\$m)	15.6	59.2	98.0

Source: SBI E2-Capital

Valuation discussion. HK-listed fertilizer companies are trading at 20.9x P/E one-year forward and 12.0x two-year forward with year-end in Dec. We approximate CER's net profit from the organic fertilizer segment in CY12/10F to arithmetic average of earnings in FY06/10F and FY06/11F, which is HK\$78.6m, suggesting a fair value of HK\$943.2m by multiplying 12.0x two-year P/E ratio.

Table 4. Valuation comparison

Company	Ticker	Market cap (US\$m)	Fiscal Year End	Historical P/E (x)	1-Yr P/E (x)	2-Yr P/E (x)	ROE (%)
Ko Yo	827 HK	135.5	12/2008	27.2	22.0	2.7	8.4
Century Sunshine	509 HK	86.7	12/2008	21.5	n.a.	n.a.	3.1
China Agrotech	1073 HK	65.2	06/2009	38.1	n.a.	n.a.	1.6
Sinofert	297 HK	3,867.4	12/2008	n.a.	n.a.	19.1	17.8
China XLX	1866 HK	517.9	12/2008	10.3	22.8	12.8	26.6
China BlueChem	3983 HK	2,807.4	12/2008	16.4	17.8	13.4	18.7
Average				22.7	20.9	12.0	12.7

Source: Company data, Bloomberg

Comparison between the plantation segment and China Forestry. For the plantation segment, we find reference from China Forestry (CF) (930 HK). CF, at end-Jun 09, owned forest area of 171,780 hectares, located in Sichuan and Yunnan. Species include birch, beech, fir and pine. Total forest stock volume was 35.5m m³, which was priced at RMB7,619m. The counter now has a total market capitalization of HK\$5,760m, implying ~34% discount to the estimated value of its forest stock. Under a same discount, a fair value of CER's plantation segment is derived at HK\$446m.

Fair value discussion. CER has a relatively clean balance sheet. Liabilities at end-FY06/09A included mainly HK\$124.9m CBs (deeply in-the-money), HK\$205.3m non-current deferred tax liabilities and HK73.7m payables. Thus, we assume the potential disposal of property development business will not incur any material negative impact on the company's financials and, therefore, its fair value is put at zero. Aggregating fair values of the three segments, we have CER's overall fair value at HK\$1,338.5m or HK\$0.162 per share (after conversion of CBs). The company issues new shares to project counterparties to link interest between each other, which, though can reduce capital expenditure, will dilute fair value (derived via a P/E multiple method) on per share basis. Our calculation shows, after conversion of CBs and completion of the Cathay Capital and JNYX transactions, fair value will drop to HK\$0.134.

Other Operation Facts

- CER intends to boost its organic fertilizer business scale through M&A. The management believes, by selecting suitable target, including production facilities and distribution network, this strategy will effectively improve the company's geographical coverage. A sound M&A will surely favor both the company's operation and financials, though requires additional capital investment.
- The price of CER's waste treatment system is comparable to other waste treatment method but at the higher-end. The company's guaranteed repurchase of output (semi-fertilizer) could be a major incentive for livestock farms to install the machine.

- In 2007, the average fertilizer cost nationwide for cotton is RMB150 per mu. Based on this number, the predicted HK\$736.4m sales of organic fertilizer in FY06/12F should be absorbed by around 4.3m mu cultivation land, which represents 0.2% of China's total cultivation land.

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