

China Environmental Resources Group

Move on up

to summarize...

- Meeting with YT's management suggests CER's W2V machine can offer farmers an efficient solution of organic fertilizer supply.
- Opportunity to deal with livestock farms also exists.
- Most projects go well. The company is seeking more proactively. Funding is likely the main obstacle at the moment.
- Organic fertilizer sales in 1H FY06/10A were beyond expectation. Cash flew out due to rapid business expansion.

Site visit in Guiyang. We visited one of CER's key clients, Yue Tung (YT), an agriculture company, last Thursday in Guiyang, Guizhou. YT plants and sells vegetables. Major customers are super market chains such as Wal-mart and ParknShop. YT has two cultivation bases in Guiyang, located in Qingzhen (清镇) and Anliu (暗流), respectively. One CER W2V machine is installed in the Qingzhen base (3,000 mu directly-owned land) to produce organic fertilizer for self-use. The business model can be summarized as:

- YT bought the W2V machine from CER. The prior is responsible for raw materials (bio-wastes), labour, electricity power and water supply.
- CER provides necessary microorganisms (for fermentation and agricultural use) and technical support. Usually it has 1-2 technicians there to monitor the whole operation.
- All outputs (organic fertilizer) are purchased by YT by paying a certain fee (at around 30% discount to the organic fertilizer's market price after deduction related costs) to CER.

Rationals for W2V machine. According to our discussion with YT's management, major benefits from using the W2V machine include:

- Efficient processing method – The W2V machine can shorten fermentation time from traditional ~30 days to 24-48 hours.
- Standardized fertilizer composition – CER's technician tests output to ensure it meet certain standards.
- Minimal operation requirements – The W2V machine is highly automated.

In addition, by producing organic fertilizer from bio-waste, the W2V machine can also be regarded as an efficient tool for livestock farms to handle their daily waste. This method can be cost-effective, as CER commits to purchase all outputs from the machine. Of course, this leaves CER risk and it has to carefully balance its clients for W2V machine and organic fertilizer.

Projects update. CER's management updated us progress of their major projects. Presently there are 30+ W2V machines in operation, mainly in Xinjiang. CER plans to raise the number to 50+ by the end of this year. Meanwhile, some small processing plants (20,000-30,000 tonnes capacity) will be set up to produce solid fertilizer (major product of W2V machine is in liquid form). Most projects mentioned in our previous report ([Scalable Organic Fertilizer Play](#), 11 Dec 09) are on schedule, although:

- Acquisition of Beijing Jianong Yongxing Agricultural Production Materials Co. Ltd (JNYX) was terminated in Mar as the target was unable to complete restructuring. Nevertheless, according to CER's management, the termination will not hurt its cooperation with JNYX. CER will cooperate with JNYX to sell fertilizer products in North East provinces through the latter's distribution network.
- Two projects (“南雄烟草基地” and “四川猕猴桃基地”) have been postponed due

Please refer to important disclosures at the end of this report

Ticker	1130 HK
Rating	Not Rated
Price (HK\$)	0.122
Target Price (HK\$)	n.a.
12m Price Range (HK\$)	0.052-0.159
Market cap. (US\$m)	135.1
Daily t/o (US\$m)	1.3
Free float (%)	63.0

Financial summary

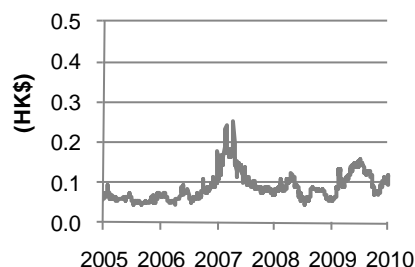
Year to Jun	08A	09A
Turnover (HK\$m)	0.0	121.5
Net Profit (HK\$m)	(41.3)	96.0
EPS (HK\$)	(0.023)	0.023
P/E (x)	n.a.	5.4
P/B (x)	2.78	1.62
EV/EBITDA (x)	n.a.	n.a.
Yield (%)	n.a.	n.a.
ROE (%)	n.a.	34.5
ROCE (%)	n.a.	28.2
N. Gear. (%)	n.a.	24.5

Source: SBI E2-Capital

	09F	10F	11F
Consensus EPS (HK\$)	-	-	-
Previous earnings (HK\$m)	-	-	-
Previous EPS (HK\$)	-	-	-

Price performance

Year to Dec	1m	3m	12m
Relative to HSI (%)	+14.1	+51.4	+44.7
Actual price changes (%)	+15.1	+50.6	+100.0



Source: Bloomberg

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to resources constraint.

Table 1. Summary of active coverage in 2009

Projects	Sales target (tones '000)	Status
新疆 142 兵团	35.0	A JV has been set up to sell CER's fertilizer in Xinjiang
新疆天康畜牧项目	15.0	Agreement will be signed soon and operation is expected to commence in 2H 10
江西万载有机肥县	15.0	A MOU has been signed. The project will be launched pending on funding
國家糖廠銷售渠道	10.0	CER will sell its fertilizer via this channel in Xinjiang. Operation has launched.
贵阳综合资源项目	20.0	Negotiation with local government will start.
東北省銷售渠道*	20.0	Operation has launched.
沃尔玛农超对接基地	25.0	Operation has launched.
海南光華印棟樹種植基地	10.0	Operation has launched.
安徽蕩山肥料項目	20.0	A MOU has been signed. The project will be launched pending on funding situation
全國銷售渠道	15.0	Operation has launched.
南雄烟草基地	10.0	The project has been postponed due to insufficient funding.
四川猕猴桃基地	10.0	The project has been postponed due to insufficient funding.

Source: compiled by SBI E2-Capital

Note: * this project is the cooperation with JNYX

Interim results recap. CER reported HK\$171.9m turnover in 1H FY06/10A, of which HK\$116.6m came from organic fertilizer business. Net profit during the period was H\$75.4m, versus HK\$0.7m loss last year. Despite the encouraging P&L figures, we noticed that the company's cash level dropped from HK\$9.5m at end-Jun 09 to HK\$6.4m. Main reasons behind might include: 1) HK\$66.5m non-cash gain from changes in fair value of biological assets (forest in Xinjiang); 2) HK\$67.7m increase in receivables. The latter reflects the company's desire for funding during expansion, in our view.

Table 2. Assumptions and estimates for organic fertilizer segment

Year to Jun	New estimates			Old estimates		
	10F	11F	12F	10F	11F	12F
Sales volume						
Organic fertilizer (tonnes '000)	107.2	208.5	301.0	43.9	192.7	300.2
W2V machine sold (units)	50	40	40	80	80	60
ASP						
Organic fertilizer (RMB/tonne)	2,100	2,100	2,100	2,150	2,150	2,150
W2V machine sold (RMB/unit)	400,000	400,000	400,000	400,000	400,000	400,000
Gross margin (%)						
Organic fertilizer	27.6	27.1	27.0	29.4	27.5	27.1
W2V machine sold	26.7	26.7	26.7	26.7	26.7	26.7
	37.5	37.5	37.5	37.5	37.5	37.5
Revenue (RMB m)						
	245.2	453.8	648.1	126.4	446.2	669.3
Gross profit (RMB m)						
	67.7	123.0	174.9	37.2	122.7	181.4
EBT (RMB m)						
	35.3	78.2	125.6	20.8	78.9	130.7
Net profit (RMB m)						
	26.4	58.7	94.2	15.6	59.2	98.0

Source: SBI E2-Capital

Table 3. Valuation comparison

Company	Ticker	Market cap		Historical P/E (x)	1-Yr P/E (x)	2-Yr P/E (x)	ROE (%)
		(US\$m)	Fiscal Year End				
Ko Yo	827 HK	190.6	12/2008	38.2	92.8	6.6	8.4
Century Sunshine	509 HK	105.4	12/2009	18.7	n.a.	n.a.	4.2
China Agrotech	1073 HK	79.1	06/2009	n.a.	n.a.	n.a.	1.6
Sinofert	297 HK	3,779.3	12/2009	n.a.	16.9	13.0	(11.1)
China XLX	1866 HK	451.3	12/2008	26.0	11.5	8.9	8.2
China BlueChem	3983 HK	2,836.9	12/2009	20.2	13.9	10.6	18.7
Average				25.7	33.7	9.8	

Source: SBI E2-Capital

Chart 1. YT's Qingzhen base



Chart 2. YT's Qingzhen base



Chart 3. CER's W2V machin at YT's Qingzhen base



Chart 4. CER's W2V machin at YT's Qingzhen base



Chart 5. CER's W2V machin – input side



Chart 6. CER's W2V machin – output side



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