

China Agri-products Exchange

Rental play in China agricultural sector

to summarize...

- Focus on agri-products exchange and achieve profitability from 2011 onwards
- Receives fixed rent and turnover rent on agricultural products
- Typical 15-year IRR of rental segment could reach 12% on preliminary studies
- Additional non-cash fair value gain a large upside compared to CAPEX
- Valuation at 1.73 x P/B on shareholders' equity of HK\$755.8m ended 2011A

Focus on agri-products exchange and achieve profitability from 2011 onwards.

Back in Dec 2007, the listco acquired 90% of the agricultural wholesale market in Wuhan Baishazhou at HK\$1,156m and changed to its name to China Agri-products Exchange (CAPE) shortly afterwards. In Mar 2009, the company expanded its portfolio by acquiring 2 more wholesale centres in China. In Dec last year, CAPE disposed its loss-making restaurant operation. CAPE successfully reformed its business structure and focuses on running agricultural exchanges 2012 onwards. In 2011, the CAPE recognized HK\$212m turnover and HK\$553m fair value gain in investment properties that contributed a net profit of HK\$117.7m for the year.

A leading platform for agricultural products in China. CAPE is the owner and operator of 3 agricultural distribution centres in China. Cooperating with local partners, CAPE applies for licenses and designs the wholesale distribution centre while construction work is outsourced. Upon completion, a small portion of stalls within the centre are sold. CAPE largely receives fixed rent and turnover rent from local agricultural products suppliers of grains, vegetables, fruits, meat and seafood. CAPE currently owns 3 wholesale centres in Wuhan, Yulin and Xuzhou. Wuhan centre is currently 607Mu / 404,869m² with turnover volume up to 4m tons agricultural products a year. CAPE is also planning to establish the fourth agricultural products distribution centre in Qinzhou, Guangxi Autonomous Region.

Shareholders background. The ultimate parent company of CAPE is Wang On Group (1222 HK). Wang On Group holds 25% of Wai Yuen Tong Medicine Holdings (0897 HK), which holds 49% of PNG Resources (0221 HK). 28% equity stake of CAPE is currently held by PNG Resources since Sep 2011. Their business model is to effectively capture opportunity of food and vegetable products exchange market with the large yet growing population in the most popular country in the world. CAPE auditor is HLB Hodgson Impey Cheng.

Illustrate 1. Shareholding structure of CAPE



Source: HKEx

Ticker	0149 HK
Rating	Not Rated
Price (HK\$)	0.53
Target Price (HK\$)	n.a.
12m Price Range (HK\$)	0.12 - 1.00
Market cap. (US\$m)	167.2
Daily t/o (US\$m)	3.5
Free float (%)	96.2

Financial summary

Year to Dec	10A	11A
Turnover (HK\$m)	99	212
Reported Net Profit (HK\$m)	(326)	118
Reported EPS (HK\$)	(6.72)	0.13
Reported P/E (x)	n.a.	11.1
P/B (x)	15.1	1.73
EV/EBITDA (x)	n.a.	5.0
Yield (%)	0	0
ROE (%)	n.a.	16%
ROCE (%)	n.a.	24%
N. Gear. (%)	281%	57%

Source: SBI E2-Capital

	11F	12F	13F
Consensus EPS (HK\$)	-	-	-
Previous earnings (HK\$m)	-	-	-
Previous EPS (HK\$)	-	-	-

Price performance

Year to Dec	1m	3m	12m
Relative to HSI (%)	0.5	47.0	(39.3)
Actual price changes (%)	1.9	49.3	(45.1)



Source: Bloomberg

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Business model and turnover breakdown. CAPE focuses on primary wholesale market in China. It serves as a bridge between agricultural products suppliers (such as large-scale farmers, distributors, etc) and customers (including secondary wholesale market, retail channels as well as corporate customers). For dry goods, since dry products such as rice has longer duration for sales and consumption, suppliers incline to pay fixed rate for a specific area to market their products. On the other hand, for fresh goods such as fruits, suppliers are not provided with specific private area. In the contrary, CAPE charges suppliers a variable rent such as 2% to 4% on their dollar turnover made in a centralized area. As such, it is normal to see sharp increase in fixed rent in first 1-2 years of a new wholesale market and eventual momentum pick-up in turnover rent some time onwards. Note that CAPE may also choose to sell some of its space in dry goods section to improve cash flow in early stage. Table 1 shows turnover breakdown of CAPE in the past 2 years. In 2011A, fixed rent, turnover rent and property sales made up 37.0%, 29.8% and 33.1% of turnover from continuing operation respectively.

Table 1. Turnover breakdown

	2010A	2011A
Fixed rent	69.6	78.4
Turnover rent	29.8	63.2
Total rent	99.3	141.6
Property sales	0.0	70.2
Discontinued restaurant operation	30.6	32.3
Total	130.0	244.2

Source: SBI E2-Capital

Rental income of current agricultural market portfolio. While CAPE sells some of its area to improve cash flow, it is usually a small portion as much as 10% area of the whole project. Continuous rental income and non-cash fair value gain are expected to be the main drivers of valuation. Table 2 shows rental income related figures of the 3 existing wholesale markets. While Xuzhou market is the smallest among the 3 at 290 Mu, it generated as high as HK\$170,000+ rental income per Mu in 2011 and contributed HK\$49.6m rental income and HK\$23.2m rental EBIT in the year. Xuzhou wholesale market is relatively mature. On the other hand, Wuhan Baishazhou and Yulin Hongjin wholesale markets are at earlier stage. For Wuhan market, rental income and adjusted rental EBIT were HK\$66.1m and HK\$25.4m respectively in 2011; nevertheless there was a one-time promotion and marketing expense at HK\$53m not accounted in the EBIT. For Yulin market, the rental income was still small at HK\$25.9m with a small loss before interest and tax. Rental income of the 3 wholesale markets may continue to grow before entering into mature stage, in our view.

Table 2. Rental income of current agricultural market portfolio

HK\$m	2010A	2011A
Wuhan Baishazhou Agricultural By-product Grand market		
90% equity interest		
Actual land area Mu	607	607
Average rental income HK\$ per Mu	82,372	108,896
Rental income HK\$m	50.0	66.1
EBIT HK\$m before property revaluation and special promotion / consultation	(22.8)	25.4
Yulin Hongjin Agricultural By-product Wholesale Market		
65% equity interest		
Actual land area Mu	623	623
Average rental income HK\$ per Mu	16,533	41,573
Turnover HK\$m	10.3	25.9
EBIT HK\$m before property revaluation and special promotion / consultation	(9.7)	(6.0)
Xuzhou Agricultural By-product Central Wholesale Market		
51% equity interest		
Actual land area Mu	290	290
Average rental income HK\$ per Mu	134,828	171,034
Turnover HK\$m	39.1	49.6
EBIT HK\$m before property revaluation and special promotion / consultation	13.0	23.2

Source: SBI E2-Capital

Typical rental return of a mid-to-large-sized agricultural exchange market. We have developed a simple model to capture rental return profile of a mid-to-large sized agricultural exchange market. Assuming a land size of 500 Mu (333,000 sqm) with land cost at HK\$0.2m per Mu and construction cost of another HK\$0.2m per Mu, CAPEX would be at HK\$200m. We further assume 33% financing ratio on the CAPEX and assume loan repayment in full at the seventh year when the project comes approach mature stage. As such, while we assume minimal depreciation cost and neglect potential effect of revaluation gain, our estimated 15-year IRR for the project is 12.1%, which is higher than a general required IRR of 10%+. Table 3 shows our model assumptions and selected performance figures at year 1, year 3 and mature stage. Year 3 is singled out as we believe the third year should possibly be near-breakeven in terms of accounting profit, while year 7 and afterwards is assumed to be mature stage under our estimation.

Table 3. Typical rental return of a mid-to-large-sized agricultural exchange market

HK\$m			
<u>Assumptions</u>			
Land size			500 Mu
Land cost per Mu			HK\$0.2m per Mu
Construction cost per Mu (12 months)			HK\$0.2m per Mu
Total CAPEX			HK\$200m
Continual financing ratio from banks			33.0%
<u>Expected cash flow analysis</u>			
	<u>Year 1</u>	<u>Year 3</u>	<u>Mature stage</u>
Average rental income HK\$ per Mu	10,000	50,000	200,000
Rental income HK\$m	5.0	25.0	100.0
Operating cost	(25.0)	(25.0)	(25.0)
EBIT	(20.0)	0.0	75.0
Financing cost @ 7.5% interest rate	(5.0)	(5.0)	(5.0)
EBT	(25.0)	(5.0)	70.1
Net profit	(25.0)	(5.0)	52.5
Rough cash profit	(25.0)	(5.0)	52.5
Est 15-year IRR (leveraged)	12.1%		

Source: SBI E2-Capital

Cost and year-end fair valuation and pipeline. In addition to rental income, as we have discussed earlier, the wholesale markets are expected to recognize fair value gain due to their strong cash flows. Table 4 shows EBIT breakdown of CAPE, which demonstrated the significant impact of fair value gain on overall profit. In the pipeline, CAPE targets to complete construction of a wholesale market in Luoyang, Henan by the end of this year. Upon completion, another 500 Mu investment property will be added to CAPE portfolio. For 2013 and 2014, a total of 5 more projects are scheduled to be completed, ensuring a continuous expansion in portfolio and generates increasing rental income and fair value gain.

Table 4. Impact of fair value gain – EBIT breakdown

HK\$m	2010A	2011A
Rental segment profit	27.8	(117.9)
Fair value gain on investment properties	1.1	553.4
Various impairments	(273.9)	(0.0)
Property sales segment profit	0.0	6.3
Unallocated net expenses	(59.6)	(53.7)
Discontinued restaurant operation	(1.7)	(1.2)
EBIT	(306.4)	386.9

Table 5. Project pipeline

	Planned land size	Target completion of 1 st phase
Luoyang, Henan Province	500 Mu	Q4 2012
Kaifeng, Henan Province	626 Mu	Q3 2013
Huzhou, Zhejiang Province	450 Mu	Q4 2013
Huaian, Jiangsu Province	338 Mu	Q4 2013
Dongguan Changping, Guangdong	250 Mu	Q3 2014
Pingzhang, Guangxi Region	200 Mu	Q4 2014

Source: SBI E2-Capital

Historical financial summary. Table 6 and Table 7 show balance sheet summary and selected P&L items of CAPE. By the end of 2011A, CAPE had HK\$2,928m asset, of which HK\$2,010m was investment properties and HK\$533m was cash. On the liability side, there were HK\$937m short-term borrowings as well as HK\$186m long-term bank loan. As such, there was a net debt of HK\$589m compared to HK\$756m net equity by end of the year, which represented relatively high net debt-to-equity ratio at 78%. On the other hand, on profit and loss point of view, CAPE generated HK\$212m revenue on rental and property sales which incurred HK\$102m COGS, HK\$281m SG&A as well as HK\$90m finance cost in 2011A. Nevertheless, there was a non-cash fair value gain in investment properties at HK\$553m in 2011A, reported net profit attributable to equity holders came in at HK\$118m.

Table 6. Balance sheet summary

HK\$m	FY12/09A	FY12/10A	FY12/11A
Non-current assets			
Investment properties	1,440	1,523	2,010
Intangible asset	182	0	0
Other non-current assets	47	34	37
Current assets			
Stock of properties	0	0	246
Trade and other receivables	17	40	98
Cash and cash equivalents	156	82	533
Other current assets	18	13	5
Non-current liabilities			
Bank and other borrowings	245	358	186
Promissory notes	312	332	0
Deferred tax liabilities	132	90	226
Other non-current assets	0	0	0
Current liabilities			
Trade and bills payable	273	380	397
Deposits receipts in advance	0	10	130
Bank and other borrowings	342	165	583
Promissory notes	0	0	353
Other current liabilities	78	81	18
Equity			
Total equity	478	275	1,035
Shareholders' equity	290	88	756

Source: SBI E2-Capital

Table 7. Selected P&L items

HK\$m	FY12/10A	FY12/11A
Revenue	99	212
Cost of goods sold	(24)	(102)
Gross profit	76	110
Operating expenses	(95)	(281)
Other operating expenses	(11)	(0)
Impairments	(274)	(0)
Finance costs	(73)	(90)
Fair value gain in investment properties	1	553
Profit before tax	(377)	292
Income tax expenses	43	(82)
Total profit	(334)	211
Net profit	(326)	118
Adjusted net profit on 25% tax rate	(121)	(297)

Source: SBI E2-Capital

Peers valuation. In HK, CAPE represents a unique business model to capture investment opportunities in China agricultural sector. Leveraging on reasonably stable cash income every year upon mature stage, CAPE enjoys fair value gain as well as long-term upside of holding large pieces of rural land. Currently CAPE is trading at HK\$1,304m market valuation with HK\$756m shareholders' equity by the end of 2011, which represents a P/B of 1.73x. One of its peers is Shenzhen Agricultural Products (000061 CH), which was trading at 2.66x P/B ended 2011 and 37.8x P/E for FY12/12F based on Bloomberg consensus.

Risk factors. CAPE is subject to certain risk factors: 1) Short-term liquidity requirement is up to HK\$936.7m on HK\$583.2m bank borrowing and HK\$353.4m promissory note while CAPE had HK\$533m cash on hand and potentially negative cash flow from operations for 2012; 2) A target to complete 6 more wholesale markets in next 2.5 years which put represents as much as HK\$900m+ CAPEX on 100% commitment basis; 3) Fair value gain of the wholesale markets are non-cash items and the properties themselves may not be very liquid in the market; 4) Apparent effective contribution by CAPE to Wang On Group is small and there is a series of vertical structure involved in shareholding.

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