China XLX Fertiliser

Expanding upon cost edge

to summarize…

- Urea market in China is fragmented and under consolidation. Production cost is a decisive factor behind.
- The company is one of the largest non-state-owned coal-based urea producers in China with obvious cost advantage (~15% lower than industry average), which ensures its profitability and advises further expansion probability.
- ~60% urea producers are loss making under pressure of high coal price. We expect XLX's net profit in 4Q FY12/10F to retreat 29% YoY to Rmb20m.
- Urea market is in its downside cycle and 4Q 10 might be the bottom. Under our normal scenario, XLX's existing capacities can generate 374m net profit a year.
- The #4 line has been planned. Operation is expected to commence in 2013, enlarging the company's urea capacity from 1.25m mt to 2.25m. With an expected payback period of 6 years and potential profit contribution of Rmb344m, this expansion decision seems rational.
- Capex on the #4 line is estimated at Rmb3b. Extra ~Rmb800m equity financing will be needed if current capital structure applies.
- The counter is one of the cheapest one among the peers group, trading at 2.0x historical P/B.
- Major uncertainties are associated with urea price and expansion execution.

A major urea producer. China XLX (XLX) is one of the largest non-state-owned coal-based urea producers in China. Located in Xinxiang, Henan province, the company has capacities of 1.25m mt urea, 0.2m mt methanol and 0.6m mt compound fertilizer. The three products accounted for 66%, 14% and 20% of the total revenue in 1-3Q FY12/10A, respectively. The company went to public in 2007 through a public offering in Singapore main board and, then, was dually listed in Hong Kong in 2009.

Coal-based technology prevails. Urea is widely used in fertilizer as a main source of nitrogen and can be produced either from natural gas or coal. ~70% of China's existing urea capacity is coal based due to abundant coal resources locally. Although natural gas-based producers enjoyed cost advantages, they are losing their edge after the Chinese government substantially raised the natural gas price lately and restricted its applications in the chemical industry.

Industry under consolidation. China's urea market is believed to be over supplied. Apparent consumption was 52m mt in 2008 while production capacities totaled 59m mt. However, the market is fragmented, consisting of 180+ players, implying consolidation potential. Notably, urea, as a commodity, is highly liquid and a certain producer's profitability is mainly defined by its production cost. Therefore, despite the over-capacity fact, cost leaders enjoy decent profit margin and have strong motivation to expand.

Table 1. China's urea industry

Year to Dec	08A	00-08 CAGR (%)
China's grain output (mt m)	528.7	1.7
Urea capacity (mt m)	59.0	6.4
Apparent urea consumption (mt m)	52.0	7.4

Source: Ministry of Agriculture, CNCIC

Advanced cost control ability. For each tonnage of urea production, XLX consumes only 627 kg coal (~55% of COGS) and 740 kwh electricity (~20% of COGS), compared to industry average of 824 kg and 850 kwh, resulting in lower cost and better gross margin. We attribute this difference to technology, scale,

Ticker	**1866 HK**
Rating	**Not Rated**
Price (HK$)	3.51
Target Price (HK$)	n.a.
12m Price Range (HK$)	2.64-4.84
Market cap. (US$m)	450.0
Daily t/o (US$m)	0.1
Free float (%)	32.1

Financial summary

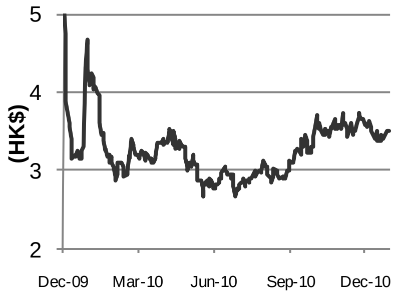
Year to Dec	07A	08A	09A
Turnover (RMBm)	1,541	2,085	2,330
Net Profit (RMBm)	268	332	119
EPS (RMB)	0.317	0.332	0.119
P/E (x)	9.6	9.2	25.6
P/B (x)	2.61	2.10	2.07
EV/EBITDA (x)	11.5	8.3	12.2
Yield (%)	2.4	2.7	1.0
ROE (%)	22.9	25.3	8.2
ROCE (%)	18.4	19.5	6.5
N. Gear. (%)	cash	32.2	52.5

Source: SBI E2-Capital

	10F	11F	12F
Consensus EPS (RMB)	0.200	0.289	0.341
Previous earnings (RMBm)	-	-	-
Previous EPS (RMB)	-	-	-

Price performance

Year to Dec	1m	3m	12m
Relative to HSI (%)	(6.1)	+1.4	(29.5)
Actual price changes (%)	(4.4)	+6.4	(24.8)



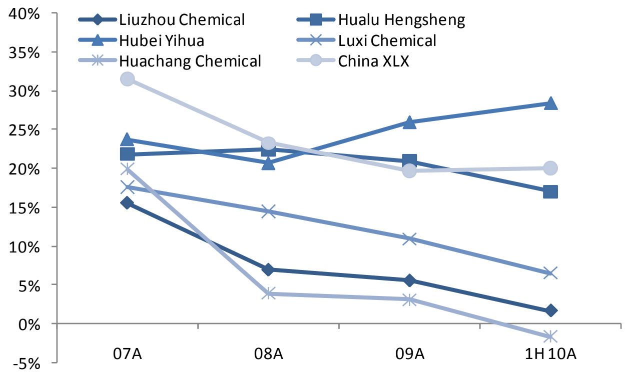
Source: Bloomberg

Norman Zhang, CFA
(852) 2533 3723
normanzhang@sbie2capital.com

experience and, in particular, management system. In 1-3Q FY12/10A, XLX's unit COGS for urea was Rmb1,328/mt, versus the industry's ~Rmb1,600/mt. Among the peers group, XLX had the second highest urea gross margin in 1H FY12/10A, following only Hubei Yihua (000422 CH), which has 29% urea capacity based on natural gas.

Urea market might hit the bottom. Urea price dipped in 2Q 10 partly due to the unusual weather conditions (e.g. drought in the South), which affected agricultural activities and reduced fertilizer consumption. The market is still weak. Although the price picked up in 2H from ~Rmb1,600/mt in Jul to ~Rm2,000/mt in Dec, it was driven mainly by hiking coal cost and can hardly transfer into profit. We reckon the 4Q 10 could be a bottom period for the industry as ~60% players are suffering net loss presently. The market should recover somewhat this year, following the normalized demand.

Chart 1. Peers' gross margin comparison



Source: compiled by SBI E2-Capital

Temporary earnings retreat in 4Q. According to our channel check, XLX's urea ASP in 4Q was ~Rmb1,850/mt, 15% higher than which of 3Q. However, its coal purchase cost (~60% of COGS) went up also from Rmb1,300/mt to Rmb1,650/mt. Additionally, the nationwide effort on "Energy Saving and Emission Cutting" ("節能減排") affected electricity the company's power supply and operation, resulting in ~10% reduction in 4Q output. The two factors (coal cost and lower utilization rate) together pushed up XLX's production cost to ~Rmb1,600/mt from Rmb1,338/mt in 3Q, up 20% QoQ. Therefore, we expect a moderate QoQ margin squeeze in 4Q FY12/10F and 29% YoY down in net profit to Rmb20m (full year: Rmb147m). Amid this weak market environment, urea producers were reluctant to sell and piled their inventories in preparation for the coming spring planting season. XLX also deferred part of sales (~30,000 mt urea) to 2011. With a simple assumption of steady urea gross margin on yearly basis, we estimate the company's net profit for FY12/11F will be Rmb169m.

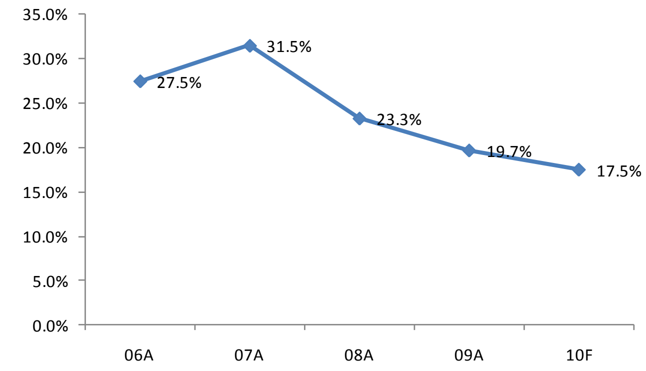
Table 2. Preliminary forecasts

Year to Dec	08A	09A	1Q 10A	2Q 10A	3Q 10A	4Q 10F	10F	11F
Capacity (mt '000)								
Urea	720.0	1,000.0	312.5	312.5	312.5	312.5	1,250.0	1,250.0
Methanol	100.0	200.0	50.0	50.0	50.0	50.0	200.0	200.0
Compound fertilizer	300.0	600.0	150.0	150.0	150.0	150.0	600.0	600.0
Sales volume (mt '000)								
Urea	676.9	1,070.7	305.0	275.2	278.8	277.0	1,136.0	1,232.9
Methanol	87.4	108.4	45.2	51.1	56.7	50.4	203.4	200.0
Compound fertilizer	251.1	231.2	54.1	58.2	114.7	52.9	279.9	300.0
ASP (Rmb/mt)								
Urea	1,707.0	1,594.0	1,728.0	1,574.1	1,608.8	1,850.0	1,691.2	1,940.0
Methanol	2,452.0	1,623.0	1,991.0	1,791.3	1,909.3	2,547.7	2,056.0	2,428.0
Compound fertilizer	2,821.0	1,895.0	1,978.0	1,719.4	1,877.6	2,159.1	1,917.4	2,199.4
Gross margin (%)	23.1	13.5	20.5	10.0	11.0	9.4	12.8	12.9
Urea	23.3	19.7	24.2	14.9	16.9	13.5	17.5	17.5
Methanol	19.7	(15.2)	5.3	(7.2)	(1.0)	9.5	2.2	5.0
Compound fertilizer	24.5	2.2	15.9	5.8	9.0	5.4	9.0	7.1
Revenue (Rmbm)	2,084.9	2,329.6	727.6	626.9	773.5	757.5	2,885.5	3,549.3
Gross profit (Rmbm)	481.9	315.4	149.4	62.9	84.8	71.2	368.3	456.6
Operating profit (Rmbm)	376.6	188.0	104.5	40.6	48.4	39.0	232.5	301.7
Net profit (Rmbm)	331.7	119.2	75.3	22.8	28.3	20.2	146.7	168.5

Source: Company data, SBI E2-Capital

Normal profit at Rmb374m. The urea industry turned out cyclical in terms of gross margin (i.e. profitability) and has been slipping in its downside phase since peaked in 2007.We tried to derive a normal scenario for XLX by averaging its gross margin in FY12/07A-10F, which is 23%. Accordingly, a normal annual profit will be Rmb374m based on existing production capacities. We also developed bull-case and bear-case scenarios by employing the gross margin in FY12/07A (31.5%) and 4Q FY12/10F (13.5%), respectively.

Chart 2. XLX' gross margin trend



Source: Company data

Table 3. Earnings scenario of existing capacities

Scenario	**Normal**	**Bull-case**	**Bear- case**
Capacity (mt '000)			
Urea	1,250.0	1,250.0	1,250.0
Methanol	200.0	200.0	200.0
Compound fertilizer	600.0	600.0	600.0
Sales volume (mt '000)			
Urea	1,097.0	1,097.0	1,097.0
Methanol	200.0	200.0	200.0
Compound fertilizer	600.0	600.0	600.0
ASP (Rmb/mt)			
Urea	2,078.0	2,335.0	1,850.0
Methanol	2,428.0	2,428.0	2,428.0
Compound fertilizer	2,355.9	2,647.3	2,159.1
Gross margin (%)	16.8	24.9	8.7
Urea	**23.0**	**31.5**	**13.5**
Methanol	5.0	5.0	5.0
Compound fertilizer	13.3	22.8	5.4
Revenue (Rmbm)	4,188.3	4,644.8	3,820.4
Gross profit (Rmbm)	702.0	1,158.5	334.1
Operating profit (Rmbm)	550.6	1,009.6	180.7
Net profit (Rmbm)	374.5	718.7	97.0

Source: Company data, SBI E2-Capital

Further growth from capacity expansion. XLX announced in Sep 10 to build its fourth production line (800,000 mt urea). This new line will adopt Coal Water Slurry (CWS) technology and use cheaper sand coal as a key raw material instead of anthracite rock coal. Thus, its production cost can be ~16% lower than existing lines. Operation is anticipated to launch in 1H 13. Related capex is estimated at ~Rmb3b, comprising Rmb0.1b on land acquisition, Rmb0.3b on construction of buildings and Rmb2.6b on purchase and installment of equipment. We regarded the #4 line as a manageable and reasonable expansion plan, given:

- Financing wise – Assuming current capital structure (60% capital, 40% debt) will apply, the Rmb3b capex can be financed by Rmb1.8b equity and Rmb1.2b debt. When the latter has been covered by secured banking facilities (Rmb1.6b), we reckon, after taking into account cash in hand and potential operation cash inflow, the company needs to raise ~Rmb800m additional equity capital.
- Financial wise – Based on the margin level in the normal scenario, we estimate the #4 line can yield Rmb1.7b revenue and Rmb344m net profit (net of Rmb57m interest expense and Rmb115m tax) in its full operation, implying a payback period of ~6 years (depreciation in 20 years). Associated ROE will be 19.1%, which is comparable to existing lines' 18.1% (excl. compound fertilizer) or 23.8% (incl. compound fertilizer) under same assumptions.

Table 4. Preliminary calculations of #4 line

	Existing capacity (excl. compound fertilizer)	Existing capacity (incl. compound fertilizer)	#4 line	Aggregate
Annual capacity (mt '000)				
Urea	1,250.0	1,250.0	800.0	2,050.0
Methanol	200.0	200.0	-	200.0
Compound fertilizer	0.0	600.0	-	600.0
Sales volume (mt '000)				
Urea	1,250.0	1,097.0	800.0	1,897.0
Methanol	200.0	200.0	-	200.0
Compound fertilizer	-	600.0	-	600.0
ASP (Rmb/mt)				
Urea	2,078.0	2,078.0	2,078.0	2,078.0
Methanol	2,428.0	2,428.0	-	2,428.0
Compound fertilizer	2,355.9	2,355.9	-	2,355.9
Gross margin (%)	19.0	16.8	35.3	22.6
Urea	23.0	23.0	35.3	28.2
Methanol	5.0	5.0	-	5.0
Compound fertilizer	-	13.3	-	13.3
Revenue (Rmbm)	3,095.1	4,188.3	1,662.4	5,850.7
Gross profit (Rmbm)	587.9	702.0	587.2	1,289.2
Operating profit (Rmbm)	430.6	550.6	514.7	1,065.3
Net profit (Rmbm)	284.4	374.5	343.6	718.1
Total capital (Rmbm)	2,661.4**	2,661.4*	3,000.0	5,661.4
Total equity (Rmbm)	1,571.4**	1,571.4*	1,800.0	3,371.4
ROC (%)	12.1	15.5	12.9	14.1
ROI (%)	18.1	23.8	19.1	21.3

Source: SBI E2-Capital

Note:

** as end-Sep 10*

*** ignore investment on compound fertilizer capacities, which is insignificant compared with urea and methanol*

The bottoming-out fertilizer market may trigger the stock price. Given the capital intensive nature and depressed urea price, PB ratio might be a better valuation indicator for urea producers. XLX is trading at 2.0x of its 3Q FY12/10A book value, which looks inexpensive for us. In fact, it is one of the cheapest listing coal-based urea producers in our peers group. We reckon: 1) its primary listing in Singapore, where Chinese companies are usually entitled a lower valuation benchmark than which in Hong Kong; 2) the stock's relatively thin liquidity; 3) fund raising potential constitute the resistance to the share price. Current price is equivalent to 8.1 multiples of profit under the normal scenario. Catalysts include recovery of urea market as well as positive policy movement for the agriculture industry.

Table 5. Valuation matrix

Company	Ticker	Market cap (US$m)	Historical PER (x)	1-year PER (x)	2-year PER (x)	P/BV (x)	ROE (%)
China XLX	1866 HK	450.0	n.a.	15.0	10.3	n.a.	8.2
	CXLX SP	461.5	18.1	15.4	10.6	2.0	8.2
HK-listed fertilizer companies							
Sinofert	297 HK	3,636.5	n.a.	24.6	15.6	1.9	(11.1)
Ko Yo	827 HK	199.6	n.a.	47.1	7.5	1.5	(0.8)
China Bluechem	3983 HK	3,481.1	22.9	18.3	13.1	2.3	9.9
Peers group (coal-based urea producers)							
Hubei Yihua	000422 CH	1,556.2	20.8	18.3	13.8	4.1	11.4
Luxi Chemical	000830 CH	953.9	43.1	33.5	18.0	2.6	6.0
Hualu Hengsheng	600426 CH	1,011.2	28.8	26.4	19.5	2.4	16.5
Liuzhou Chemical	600423 CH	582.0	54.2	36.3	17.8	2.8	1.5
Huachang Chemical	002274 CH	444.1	n.a.	n.a.	88.8	2.4	(7.2)
Average			36.7	28.6	31.6	2.9	5.6

Source: Bloomberg

Risks exist. We identified major risks coming from two areas:

- Market – uncertain prices of urea, methanol and compound fertilizer as well as coal at cost side
- Execution – the #4 production line is significant for XLX in every means. Although we believe the management is experienced enough, the CWS technology is new for the company.

Table 6. Key financials

Year to Dec (Rmbm)	07A	08A	09A
Revenue	1,541.4	2,084.9	2,329.6
Gross profit	416.4	481.9	315.4
Operating profit	287.0	376.6	188.0
Net profit	267.6	331.7	119.2
EBITDA	331.2	456.4	312.5
Fixed assets	974.3	1,616.0	2,302.0
Inventories	178.5	235.0	221.9
Receivables	54.3	54.4	99.8
Payables	273.4	307.2	388.3
Cash	510.3	200.1	161.0
Short-term debt	287.0	145.0	110.0
Long-term debt	90.3	523.0	825.0
Shareholders' fund	1,170.9	1,450.9	1,474.6
Total equity	1,170.9	1,450.9	1,474.6
Net cash from operating activities	208.5	369.6	257.4
Net cash used in investing activities	(334.8)	(897.2)	(510.4)
Net cash from financing activities	475.5	220.9	192.7
Net change in cash and cash equivalents	349.2	(306.7)	(60.3)

Source: Company data

Table 7. P&L

Year to Dec (US$m)	07A	08A	09A	1-3Q 10A
Revenue	1,541.4	2,084.9	2,329.6	2,128.0
Cost of sales	(1,125.0)	(1,603.1)	(2,014.2)	(1,830.8)
Gross profit	416.4	481.9	315.4	297.1
Other income and gains	31.8	13.7	11.7	12.0
Selling and distribution expenses	(20.2)	(20.7)	(16.9)	(27.2)
General and administrative expenses	(76.6)	(91.3)	(110.5)	(78.8)
Other expenses	(64.3)	(7.0)	(11.6)	(9.6)
Profit from operations	287.0	376.6	188.0	193.5
Finance costs	(18.1)	(26.8)	(36.5)	(39.3)
Profit before tax	269.0	349.8	151.5	154.3
Taxation	(1.4)	(18.1)	(32.3)	(27.8)
Profit for the period	267.6	331.7	119.2	126.5
Attributable to:				
Equity holders of the Company	267.6	331.7	119.2	126.5
Minority interests	-	-	-	-
EPS - Basic (Rmb)	0.317	0.332	0.119	
EPS - Diluted (Rmb)	0.317	0.332	0.119	
Proposed DPS (SGD)	0.014	0.016	0.006	
Proposed dividend	71.5	75.9	29.2	

Source: Company data

Table 8. Shareholding structure

Shareholders	Interest (%)
Liu Xingxu	34.34
Yan Yunhua	28.09
Li Buwen	5.49
Others	32.08
Total	100.00

Source: HKEx