

## Value fertilizer play

## China Agriculture

**Ko Yo (8042 HK, HK\$0.64)**

**BUY (unchanged)**

### Target price: HK\$1.21 (+89%)

**Interim results in line.** 1H FY12/06 net profit rose 12% YoY to RMB28.2m, in line with our expectations. An interim dividend of HK\$0.005 was declared (same as for 1H05). Nonetheless, both ASP and margins were lower compared with that of a year ago (refer to table 2 and 3) due to 1) droughts in Sichuan and inner China which affected demand for fertilizers; 2) the closure of Qinghai-Tibet Railway which disrupted the supply of potassium chloride, a main raw material for complex fertilizer; 3) small complex fertilizer factories were forced to stop production and hence affected the demand for ammonium chloride; and 4) a maiden 20,499-tonne export order to Cargill was priced at very low margin (single-digit gross margin).

**2H outlook.** The company targets to produce 300,000 tonnes in 2H06, compared with 260,093 tonnes in 1H06. Of which, BB/complex fertilizers are expected to account for 120,000 to 130,000 tonnes while export orders account for 30,000 to 50,000 tonnes at more attractive margins (double-digit gross margins). The export orders (BB and complex fertilizers) will be mainly served by the new Qingdao plant, which is scheduled to commence operation in Sep 06 with a capacity of 300,000 tpa. As coastal areas like Fujian and Guangdong were hit hard by a number of typhoons recently, the harvest season in Aug/Sep might be affected. Prices are believed to have stabilized in 2H06 though.

**Cost savings programs to kick in from 2H06.** Starting from Jun 06, the company has started to manufacture its own "large granule urea" internally, a component, for its BB fertilizers. An annual saving of RMB5m is expected. In addition, the company has embarked on a technological upgrade in July 06. This improvement can increase urea capacity by 16,000 tonnes and lower the production cost of the 50,000tpa ammonia. An annual saving of RMB15-16m is expected to kick in from 2007.

**Healthy financials.** The company turned from net debt to a net cash of HK\$55m at end-Jun 06. In addition, it recorded a strong operating cash inflow of RMB55.4m (cf. RMB3.7m a year ago) in 1H06.

**Valuation and forecasts.** We have fine-tuned our forecast downward by 3-6% for FY06 to FY08. Our target price is set at HK\$1.21 (from HK\$1.24), based on 8x FY12/07 P/E. Trading at just above 5x forward P/E, we think the downside risk is rather limited at the current price level. The biggest concerns are scale and liquidity for this stock, but we think the low valuations have discounted most of them already.

**Catalyst.** The company is waiting for project finance approval for its 450,000-tonne urea plant investment in Dazhu, Sichuan. The total investment will cost c.RMB800m. Ko Yo may account for a majority stake in this project.

**Table 1: Financial summary**

Year to Dec	Net profit RMBm	EPS RMB	EPS Δ %	P/E x	P/B x	EV/EBITDA x	Yield %	ROE %	ROCE %	N. Gearing %
04A	32.7	0.078	18.2	8.5	1.8	7.0	2.3	23.9	16.1	47.2
05A	46.8	0.111	42.3	6.0	1.4	4.2	3.1	26.4	18.8	15.9
06F	58.0	0.122	9.6	5.4	1.1	3.2	3.4	22.4	18.8	Cash
07F	78.6	0.155	27.6	4.2	0.9	2.6	4.9	22.6	21.3	Cash
08F	105.6	0.209	34.4	3.2	0.7	1.8	6.5	25.1	25.0	Cash

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Table 2: Segment breakdown

Year to Dec	Turnover			ASP (RMB/tonne)			Sales volume (tonnes)		
	1H05	1H06	YoY (%)	1H05	1H06	YoY (%)	1H05	1H06	YoY (%)
BB/ complex fertilizers	166.9	167.9	0.6	1,783	1,626	(8.8)	93,632	103,184	10.2
Urea	51.6	45.0	(12.9)	1,454	1,622	11.6	44,954	43,273	(3.7)
Ammonium chloride	27.4	20.3	(25.9)	758	534	(29.6)	36,088	37,975	5.2
Ammonium bicarbonate	52.1	110.4	112.1	484	460	(5.0)	35,799	68,080	90.2
Sodium carbonate	6.6	3.6	(46.2)	1,147	1,038	(9.5)	4,009	2,454	(38.8)
Ammonia	10.0	2.4	(76.5)	1,647	1,448	(12.1)	20,700	5,127	(75.2)
	<b>314.6</b>	<b>349.5</b>	<b>11.1</b>				<b>235,182</b>	<b>260,093</b>	<b>10.6</b>

Source: Company data

Table 3: Quarterly results

Year to Dec (RMBm)	1Q04	2Q04	1H04	3Q04	4Q04	1Q05	2Q05	1H05	3Q05	4Q05	1Q06	2Q06	1H06
Turnover	85.1	114.0	199.0	109.9	113.8	142.9	171.7	314.6	163.4	149.6	177.4	172.4	349.9
Cost of sales	(68.9)	(91.5)	(160.5)	(86.4)	(89.8)	(113.4)	(135.4)	(248.8)	(125.4)	(123.7)	(147.0)	(142.8)	(289.7)
Gross profit	16.1	22.4	38.6	23.4	24.1	29.6	36.3	65.9	38.1	25.9	30.5	29.7	60.1
Interest income	0.1	0.0	0.2	0.0	0.6	0.2	0.2	0.4	0.6	(0.0)	0.1	0.8	0.8
Distribution costs	(4.4)	(7.8)	(12.3)	(5.0)	(11.2)	(7.8)	(9.5)	(17.2)	(8.5)	(12.9)	(6.6)	(7.7)	(14.2)
Administrative expenses	(7.8)	(5.9)	(13.7)	(5.9)	(8.8)	(7.6)	(10.3)	(17.9)	(12.3)	(8.4)	(9.1)	(8.0)	(17.1)
Other income	0.2	0.6	0.7	1.6	2.7	1.4	0.9	2.4	0.2	1.2	0.5	5.1	5.7
Operating profit	4.2	9.3	13.5	14.2	13.7	15.8	17.7	33.5	18.0	9.8	15.4	19.9	35.3
Finance costs	(1.9)	(1.6)	(3.6)	(1.7)	(2.2)	(1.7)	(1.9)	(3.7)	(2.1)	(2.3)	(1.2)	(2.3)	(3.5)
Profit before taxation	2.2	7.7	9.9	12.5	11.5	14.0	15.8	29.8	15.9	7.5	14.3	17.6	31.9
Taxation	(1.0)	(0.1)	(1.1)	(1.0)	0.9	(2.0)	(2.6)	(4.6)	(2.9)	1.1	(1.8)	(1.9)	(3.6)
Profit after taxation	1.2	7.6	8.8	11.5	12.4	12.0	13.2	25.2	13.0	8.6	12.5	15.7	28.2
Minority interests	0.0	0.0	0.0	0.0	0.0	(0.0)	(0.0)	(0.0)	0.0	(0.0)	-	-	-
Net profit	1.2	7.6	8.8	11.5	12.4	12.0	13.1	25.1	13.0	8.6	12.5	15.5	28.2
DPS (HK\$)			0.003					0.005					0.005
Gross margin (%)	19.0	19.7	19.4	21.3	21.1	20.7	21.1	20.9	23.3	17.3	17.2	17.2	17.2
EBIT margin (%)	4.7	8.1	6.7	12.9	11.6	10.9	10.2	10.5	10.7	6.5	8.7	11.1	9.9
Pre-tax margin (%)	2.6	6.7	5.0	11.4	10.1	9.8	9.2	9.5	9.7	5.0	8.0	10.2	9.1
Net margin (%)	1.4	6.7	4.4	10.4	10.9	8.4	7.7	8.0	8.0	5.7	7.0	9.0	8.1

Source: SBI E2-Capital and company data

**Table 4: Earnings model**

Year to Dec (RMBm)	2002A	2003A	2004A	2005A	2006F	2007F	2008F
<b>Turnover</b>							
BB fertilizers	97.2	81.7	156.4	240.4	375.3	506.7	684.1
Urea	61.1	81.7	105.7	198.3	253.2	329.1	427.8
Ammonium chloride	38.9	42.3	46.5	57.7	45.5	54.6	65.5
Ammonium bicarbonate	-	-	21.1	16.3	5.0	6.0	7.1
Sodium carbonate	74.9	70.5	84.5	104.2	95.8	105.4	116.0
Ammonia	5.6	5.6	8.5	10.7	13.0	14.3	15.7
	<b>277.6</b>	<b>281.8</b>	<b>422.7</b>	<b>627.6</b>	<b>787.8</b>	<b>1,016.0</b>	<b>1,316.2</b>
<i>% chg</i>		1.5	50.0	48.5	25.5	29.0	29.5
Cost of sales	(216.4)	(221.2)	(336.7)	(497.8)	(646.0)	(828.1)	(1,066.1)
<b>Gross profit</b>	<b>61.2</b>	<b>60.6</b>	<b>86.0</b>	<b>129.8</b>	<b>141.8</b>	<b>188.0</b>	<b>250.1</b>
Interest income	0.1	0.1	0.8	0.9	1.2	1.3	1.3
Distribution costs	(11.8)	(15.1)	(22.1)	(34.6)	(33.9)	(47.2)	(66.1)
Administrative expenses	(17.2)	(21.8)	(28.4)	(38.6)	(39.0)	(50.4)	(63.9)
Other income	3.5	6.2	5.0	3.8	4.0	4.2	4.4
<b>Operating profit</b>	<b>35.8</b>	<b>30.0</b>	<b>41.4</b>	<b>61.3</b>	<b>74.0</b>	<b>95.9</b>	<b>125.8</b>
Finance costs	(4.6)	(5.9)	(7.5)	(8.1)	(7.4)	(5.6)	(4.4)
<b>Profit before taxation</b>	<b>31.2</b>	<b>24.1</b>	<b>33.9</b>	<b>53.2</b>	<b>66.6</b>	<b>90.3</b>	<b>121.4</b>
Taxation	0.4	(0.0)	(1.2)	(6.4)	(8.7)	(11.7)	(15.8)
<b>Profit after taxation</b>	<b>31.6</b>	<b>24.1</b>	<b>32.7</b>	<b>46.8</b>	<b>58.0</b>	<b>78.6</b>	<b>105.6</b>
Minority interests	(0.3)	-	0.0	(0.0)	-	-	-
<b>Net profit</b>	<b>31.3</b>	<b>24.1</b>	<b>32.7</b>	<b>46.8</b>	<b>58.0</b>	<b>78.6</b>	<b>105.6</b>
<i>% chg</i>		(23.2)	35.9	42.9	24.0	35.5	34.4
Dividends	-	(5.9)	(6.5)	(8.8)	(11.1)	(15.7)	(21.1)

Source: SBI E2-Capital

**Disclosure of interests: SBI E2-Capital Securities Ltd. acted as the Sole Bookrunner and Placing Agent for the Ko Yo top-up placement (84m shares at HK\$0.78 each) on May 4, 2006.**