

Set to acquire second forest

China Resources

China ASEAN Res. (8186 HK, HK\$0.20) **STRONG BUY (unchanged)**

Target price: HK\$2.09 (+945.0%)

New forest deal. China Asean Resources said today that it had agreed to acquire for HK\$270.0m the entire issued share capital of Agri-Industrial Crop, which owns land use rights to a 9,555 hectare forest in Cambodia, adjacent to its 10,082 hectare forest. The consideration will be satisfied in cash (HK\$80.0m), new shares (HK\$120.0m) issued at HK\$0.6 each and two-year bonds (HK\$70.0m), with an annual coupon rate of 2.0%.

Consideration shares. The issue price of consideration shares is equal to the weighted average issue price of the group's share placement in Jul 2007. The shares are subject to a six-month lock-up period from the date of issue. The headline price tag looks higher than that of the company's first forest (HK\$208.4m) acquired in Oct 2007, which implies higher amortization charges. However, based on the market price of HK\$0.20 per share, the total consideration is about HK\$190.0m. The additional 200.0m shares to be issued will dilute the EPS but we believe the deal is necessary and positive to the group's long-term development. The vendor's confidence in the group's prospects is evident in its acceptance of 200.0m consideration shares at HK\$0.6 each, a three-fold premium to the market price.

Overview. The group's Cambodian legal advisers expect Agri-Industrial Crop to be granted exclusive rights to exploit the forest for 70 years upon completion of administrative procedures. The forest has timber reserves of about 2.3m m³, compared with the first forest's 3.2m m³. According to a draft valuation report (based on a technical report from the Research Institute of Tropical Forestry of China Academy of Forestry), the forest's valuation is HK\$1,840.0m, or HK\$796.5/m³. The group's first forest was acquired at a 92.6% discount to its appraised value of HK\$2,801.6m, or HK\$875.5/m³.

Resource base expansion. The new forest will boost the group's wood resources by 71.9% to 5.5m m³, enhancing economies of scale for logging facilities and sawn wood and flooring mills, as well as boosting their utilization rate. Processing and transportation synergies are expected between the two forests, due to their proximity and similar vegetation. The second forest will also help bridge the group's revenue and earnings gap in 2013-2016, after timber resources in the first forest are exhausted and before the rubber plantation starts contributing in 2016.

Sub-concession of the first forest. On Mar 2008, the group has conditionally agreed to sub-lease to Qiong Hai Agriculture a 1,000 hectare site (10% of total) in its first forest for 70 years till Nov 2077 for US\$10.0m in cash. It is expected that the group would realize a gain of HK\$51.6m from the transaction.

Distribution network expansion. Qiong Hai Agriculture, a Chinese company based in Hainan province is principally engaged in the forestry business. It is expected to clear up the land and plant rubber trees, giving China ASEAN Resources the right of first refusal to process salvaged logs from the site. Qiong Hai will also allow the group to use its distribution network in China to assist in the sale of wood products and latex produced in the group's forests.

Attractive. Based on the HK\$120.0m profit guarantee for FY12/08F provided by the vendor and the fully-diluted share capital of 1,905.0m shares, the group is trading at P/E of 3.2x for FY12/08F, compared with 1.4x, based on our earnings forecast of HK\$249.4m. It has made significant progress in the development of its first forest (paving access roads, setting up infrastructure) and its factory will start commercial sales Apr 2008.

We are in the process of updating our earnings model on the group.

Disclosure of interests: SBI E2-Capital Securities Ltd. acted as the Sole Bookrunner and Joint Placing Agent for China Asean Resources in July 2007.