China Agriculture Sector

China agriculture

Sector

Agriculture

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Favoured by China's rural reform

Favourable policy. The third plenary session of the 17th CPC Central Committee approved plans related to China's rural reform and development. The government will spend more on rural public services and double per capita disposable income of rural residents by 2020 from the 2008 level. It will also allow farmers to "lease their contracted farmland or transfer their land-use rights". It will set up and maintain markets to facilitate land transactions.

Beneficiary. Potential gainers from this policy, in our view, include agriculture, infrastructure, health care and consumer sectors. Beneficiaries among the listed agricultural companies include:

- First Tractor (38 HK) and China Farm (CFE SP) – the government will probably raise subsidy to farmers for their purchases of agricultural machinery. Efforts to increase the scale of farming and improve infrastructure will spur demand for tractors (First Tractor) and harvesters/plough machines (China Farm).
- Chaoda Agriculture (682 HK) – we expect the supply of cultivation land to increased as a result of the new land policy. The company will be able to sign longer leases, from present 20 – 30 years to even 40 – 50 years, which will reduce operating uncertainty.
- China Green (904 HK) – we expect the company to expand its cultivation land reserve (79,100mu or 5,273 hectares at end-Apr), which will help boost output enhancement and improvement its top line.

Featured companies

Company	Ticker	Recomm.	Share price*	Target price	*Upside (%)*
China Green	904 HK	BUY	4.50	8.17	*81.6*
Chaoda Agriculture	682 HK	NR	4.06	n.a.	n.a.
First Tractor	38 HK	NR	0.96	n.a.	n.a.
China Farm	CFE SP	BUY	S$0.110	S$0.450	*309.1*

** All prices are as of market close of 23 Oct 2008*

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Favoured by China's rural reform

Favourable policy change

The third plenary session of the 17th CPC Central Committee approved plans related to China's rural reform and development.

- The country will improve its rural basic economy system, which is based on the household contract responsibility system. A strict and normative land management system will be established in rural areas.
- The government will spend more on rural public services, including education, health care, employment, housing and pensions.
- Per capita disposable income of rural residents will double by 2020 from the 2008 level.

Easing land transfer control

The Chinese government plans to allow farmers to "lease their contracted farmland or transfer their land-use rights" in a bid to spur rural economic development and narrow the economic gap between urban and rural areas. Under the plan, the government will set up and maintain markets to facilitate various forms of transactions, including sub-contracting, lease/swap of land-use rights and/or joint share-holding of farmland.

Implications

- We expect more budged to be earmarked for rural areas, initially for infrastructure construction and health care / social welfare system. The new land policy, by facilitating land transfers, will boost scale farming, which, together with the improving infrastructure system, will boost demand for agricultural machinery.
- For agricultural companies, we reckon the reform's effect will be double-sided. On the one hand, it will encourage expansion by facilitating obtaining land from individuals. On the other, it will intensify competition, with more sizable farmers to emerge. However, we expect the overall impact to be positive for competitive players.
- Consumption will increase as a result of rising rural incomes. However, improvements will be slow and gradual, coming from a very low basis.

Impact on listcos

We believe the policy will favour agricultural companies in general. For Hong Kong listcos, specifically:

- First Tractor (38 HK) and China Farm (CFE SP) – the government will probably raise subsidy to farmers for their purchase of agricultural machinery. Efforts to increase the scale of farming and improve infrastructure will spur demand for tractors (First Tractor) and harvesters/plough machines (China Farm).
- Chaoda Agriculture (682 HK) – we expect the supply of cultivation land to increased as a result of the new land policy. The company will be able to sign longer leases, from present 20 – 30 years to even 40 – 50 years, which will reduce operating uncertainty.
- China Green (904 HK) – we expect the company to expand its cultivation land reserve (79,100mu or 5,273 hectares at end-Apr), which will help boost output enhancement and improvement its top line.

Company Profiles

Hong Kong

China Green

Caught in the milk storm

BUY (unchanged)

China Agriculture

Fri, 24 Oct 2008

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Involvement. Recently, the company explained to us its involvement in and the potential impact of China's tainted milk scandal. The company imports milk powder from New Zealand and uses it as raw material to make corn milk, generating 11.7% (RMB147.8m) of the total turnover in FY04/08A. Although no quality problem has been reported yet, its sales of corn milk in October declined in the aftermath of the melamine-tainted milk scandal. The company expects sales to recover next year.

Our view. Since CG sources milk powder from New Zealand, its chances to be linked to the scandal are low. Taking liquid milk as a reference, consumption of liquid milk fell over 70.0% in September and recovered to around 60.0 – 70.0% of the previous normal level in October. As an alternative dairy product, we expect contraction in corn milk sales to be moderate.

Exports intact. Geographical expansion is the major driver for its overseas business. The company is developing new markets, especially in Europe and the Middle East.

Gains from the rural reform. We expect China's rural reform to accelerate market consolidation. As a sizable player, CG better positioned to benefit from the trend and obtain market share from smaller players.

Forecast adjustments. We cut our beverage sales estimates for FY04/09F by 12.5% to RMB262.4m but hold the segmental growth assumption for years thereafter. Meanwhile, we raise our growth assumption for CG's domestic sales of fresh produce and processed food by 5.0pcp (fresh produce: 10.0% to 15.0%; processed products: 20.0% to 25.0%) for FY04/10F and FY04/11F to reflect potential benefits from the rural reform. Overall we lower CG's earnings forecast by 5.6% to RMB486.2m in FY04/09F, 2.5% to RMB567.4m in FY04/10F and 1.7% to RMB688.8m in FY04/11F.

Valuation. Despite the cuts, we remain bullish on the counter, given its: 1) good position to benefit from China's rural reform; 2) strong overseas sales driven by geographic expansion. Our target price is unchanged at HK$8.17, which represents a forward P/E of 13.1x.

Stock data

Price	**HK$4.50**
Target price	HK$8.17(+82%)
12 mth range	HK$4.04-11.30
Market cap.	US$49.9m
Daily t/o, 3 mth	US$1.3m
Free float %	49.6%
Ticker	904.HK/0904 HK

Financial summary

Year to Dec	06A	07A	08F	09F	10F
T/O (RMBm)	954.1	1,267.1	1,626.8	2,058.9	2,520.3
NP (RMBm)	346.0	471.0	486.2	567.4	688.8
EPS (RMB)	0.448	0.538	0.550	0.642	0.779
EPS Δ %	20.1	20.1	2.3	16.6	21.4
P/E (x)	8.8	7.4	7.2	6.2	5.1
P/B (x)	1.81	1.55	1.33	1.14	0.99
EV/EBITDA (x)	6.3	4.2	4.2	3.2	2.0
Yield (%)	2.4	3.2	4.0	4.9	5.8
ROE (%)	24.6	24.0	20.0	19.9	20.9
ROCE (%)	21.7	19.9	16.2	17.9	23.3
N. Gear. (%)	Cash	Cash	Cash	Cash	Cash

Price Chart

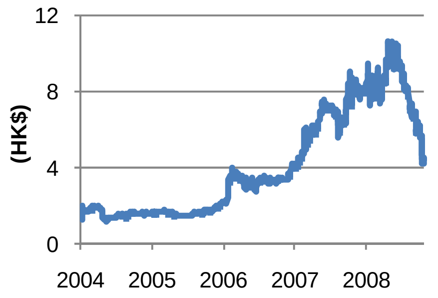

Table 1: P&L

Year to Apr (RMBm)	07A	08A	09F	10F	11F
Turnover	954.1	1,267.1	1,626.8	2,058.9	2,520.3
Cost of sales	(456.2)	(590.5)	(761.5)	(941.1)	(1,138.9)
Gross profit	497.9	676.6	865.2	1,117.8	1,381.4
Other revenue	23.8	58.3	58.9	40.0	36.0
Gain arising from changes in fair value less estimated point-of-sale costs of biological assets	15.2	19.9	23.7	29.0	34.8
Selling and distribution expenses	(92.9)	(125.2)	(194.8)	(261.9)	(302.7)
General and administrative expenses	(83.8)	(119.4)	(177.7)	(214.5)	(237.4)
Operating profit	360.1	510.3	575.3	710.3	912.0
Finance cost	(14.4)	(26.6)	(58.0)	(58.0)	(29.0)
Profit before taxation	345.8	483.7	517.3	652.2	883.0
Income tax	0.2	(12.8)	(31.0)	(84.8)	(194.3)
Net profit	346.0	471.0	486.2	567.4	688.8
EPS - basic (RMB)	0.448	0.538	0.550	0.642	0.779
EPS - diluted (RMB)	0.417	0.506	0.550	0.630	0.771

Source: Company data, SBI E2-Capital

Chaoda Agriculture

Good numbers, but some concern

Note Rated

China Agriculture

Fri, 24 Oct 2008

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Results highlights. According to Tuesday's announcement, Chaoda's top line went up 30.7% to RMB5,032.6m in FY06/08A. Its gross margin widened 1.0pcp to 69.4%. Net profit edged up 12.9% to RMB1,955.8m due to a RMB726.5m loss booked from the fair value change of convertible bonds. Excluding this one-off non-cash item, bottom line rose 35.5% to RMB2,682.2m. The company cut its final dividend from last year's HK$0.056 per share to HK$0.032.

Future plans. The company will likely to redeem all convertible bonds (HK$1,344.0m principal issued in May 2006 with an initial conversion price of HK$6.72) in May 2009 at a cost of HK$1,558.6m. In addition, its US$225.0m senior notes (around RMB1,539.4m issued in Feb 2005 with an annual interest rate of 7.75%) are due in Feb 2010. In view of this debt repayment, Chaoda budgeted its capex at RMB2.5 – 2.8bn for FY06/09F and FY06/10F, to support an increase of around 20.0% in its cultivation land area (494,815mu or 32,988 hectares at end-Jun 2008) each year.

Our view. We consider its FY06/08A turnover and core earnings growth impressive. As the Chinese government is shifting its development focus from urban to rural regions, we expect agricultural growth to accelerate. Chaoda, as a leading agriculture company in the country, provides an opportunity to get exposure to this sector. We are, however, concerned about its:

- Relatively tight cash chain - the company had RMB1.3bn cash in hand at end-Jun 2008 and operating cash inflow each year of RMB3.0 – 4.0bn, which may not be sufficient to cover potential expenses (RMB3.0bn debt repayment and RMB5.0bn capex), in the next two years.
- dividend payout cut - considering the substantial bottom line improvement, we believe the dividend cut could send a negative signal to the market.

Valuation. The counter is trading at 3.2x current-year forward and 2.6x one-year forward P/E.

Stock data

Price	**HK$4.06**
Target price	n/a
12 mth range	HK$3.02-12.00
Market cap.	US$587.3m
Daily t/o, 3 mth	US$7.7m
Free float %	60.0%
Ticker	0682.HK/682 HK

Financial summary

Year to Jun	06A	07A	08A	09F	10F
T/O (RMBm)	2,797.1	3,849.9	5,032.6	6,278.8	7,841.0
NP (RMBm)	1,358.2	1,732.7	1,955.8	2,824.0	3,625.0
EPS (RMB)	0.560	0.721	0.807	1.132	1.363
EPS Δ %	n/a	28.6	12.5	39.8	20.4
P/E (x)	6.4	5.0	4.4	3.2	2.6
P/B (x)	1.70	1.50	0.78	0.64	0.58
EV/EBITDA (x)	6.3	5.1	3.7	2.9	2.1
Yield (%)	3.4	2.3	0.8	5.5	8.4
ROE (%)	21.7	21.2	19.4	20.7	27.1
ROCE (%)	16.8	16.4	13.3	16.3	20.1
N. Gear. (%)	8.2	17.0	19.2	7.6	Cash

** Bloomberg estimates*

Price Chart

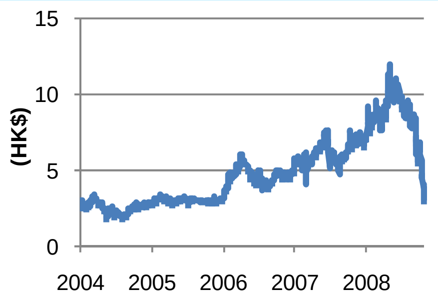

Table 1: P&L

Year to Jun (RMBm)	06A	07A	08A
Turnover	2,797.7	3,849.9	5,032.6
Cost of sales	(904.1)	(1,213.4)	(1,538.4)
Gross profit	1,893.6	2,636.6	3,494.2
Other revenues	116.6	83.2	65.3
Gain arising from changes in fair value less estimated point-of-sale costs of biological assets	153.1	148.9	113.3
Selling and distribution costs	(293.6)	(401.3)	(554.7)
General and administrative expenses	(153.2)	(247.2)	(210.4)
Research expenses	(64.4)	(71.8)	(57.2)
Other operating expenses	(160.8)	(140.3)	(146.1)
Profit from operations	1,491.3	2,008.0	2,704.4
Finance costs	(193.6)	(145.2)	(137.8)
Share of profits and losses of associates	103.3	119.0	131.9
Change in fair value of convertible bonds	(5.1)	(247.0)	(726.5)
Gain on deemed disposal of interests in associates	(37.5)	0.5	0.9
Profit before tax	1,358.3	1,735.3	1,972.9
Income tax expense	(0.3)	(0.5)	(20.7)
Profit for the year	1,357.9	1,734.8	1,952.3
Attributable to:			
Equity holders of the parent	1,358.2	1,732.7	1,955.8
Minority interests	(0.3)	2.1	(3.5)
EPS - basic (RMB)	0.570	0.721	0.807
EPS - diluted (RMB)	0.560	0.700	0.769

Source: Company data, Bloomberg

First Tractor

Plow forward

Not Rated

China Agriculture

Fri, 24 Oct 2008

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Business summary. FT is an agricultural machinery manufacturer in China, with three main business lines: agricultural machinery, construction machinery, and diesel engines and fuel jets. It has about 32.0% of China's large & middle wheeled tractor market.

- Agricultural machinery (RMB2,656.9m turnover in 1H FY12/08A, up 9.1%) - sales of small wheeled tractors dropped 19.6% in 1H FY12/08A to 46,875 units as the company scaled down its exposure to this low-entry-barrier market. Large and middle wheeled tractor sales grew 62.4% and 10.5%, respectively, to 15,156 and 11,086 units. The segmental ASP rose 8.5% due to product mix changes and price adjustments due to rising raw materials prices (mainly steel). Strong demand from overseas boosted relevant turnover 190.3% to US$36.0m.
- Construction machinery (RMB894.0m, up 8.9%) - lacking the effect of scale, this segment carries very thin margins. In 1H FY12/08A, rising raw material costs eroded the gross margin by 1.6pcp to 2.7%. The company booked an operating loss of RMB40.5m, up from RMB11.8m in the year-earlier period.
- Diesel engines and fuel jets (RMB489.7m, up 44.7%) - encouraging growth in 1H FY12/08A was backed by the rapid growth of China's agricultural and construction machinery market.

Outlook.

- We are bullish on China's agriculture machinery market and expect its development to somewhat accelerate following the country's rural reform. This will favor FT's agricultural machinery, diesel engine and fuel je7,609.0ts segments, given the company's solid brand and market position.
- Although the construction machinery sector represents another exciting market, we do not expect FT to achieve any major progress in the short term considering its weak presence compared with other domestic players.
- On the raw material side, the steel price has been softening since July, which will help the company's gross margin. However, on a YoY basis, the steel price remains much higher than last year. We expect some margin expansion to happen in FY12/09F.
- The company expects to sell 25,000 large wheeled tractors and 20,000 middle ones in FY12/08F (FY12/07A: 23058 and 18261, respectively).

Valuation. The counter is trading at 6.5x current-year forward and 5.3x one-year forward P/E.

Stock data

Price	**HK$0.96**
Target price	N/A
12 mth range	HK$0.920-5.757
Market cap.	US$29.8m
Daily t/o, 3 mth	US$1.8m
Free float %	83.2%
Ticker	0038.HK/38 HK

Financial summary

Year to Dec	05A	06A	07A	08F	09F
T/O (RMBm)	4,765.8	6,101.5	6,775.4	7,609.0	8,599.0
NP (RMBm)	(50.4)	72.8	181.8	122.0	131.0
EPS (RMB)	(0.064)	0.093	0.228	0.130	0.160
EPS Δ %	n/a	n/a	145.2	(43.0)	23.1
P/E (x)	n/a	9.1	3.7	6.5	5.3
P/B (x)	0.43	0.95	1.21	n/a	n/a
EV/EBITDA (x)	n/a	12.0	11.2	15.9	12.9
Yield (%)	n/a	n/a	0.8	2.7	2.7
ROE (%)	n/a	3.5	7.6	n/a	n/a
ROCE (%)	n/a	3.2	7.0	n/a	n/a
N. Gear. (%)	Cash	Cash	Cash	Cash	Cash

** Bloomberg estimates*

Price Chart

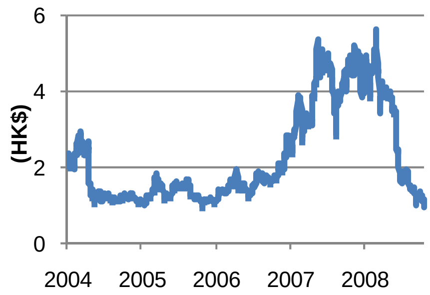

Table 1: P&L

Year to Dec (RMBm)	05A	06A	07A
Revenue	4,765.8	6,101.5	6,775.4
Cost of sales	(4,408.1)	(5,509.1)	(5,976.0)
Gross profit	357.8	592.4	799.4
Other income and gains	103.5	106.7	216.2
Selling and distribution costs	(172.0)	(229.6)	(273.9)
Administrative expenses	(262.5)	(338.6)	(395.8)
Other expenses	(86.1)	(28.6)	(63.9)
Finance costs	(11.2)	(16.6)	(31.6)
Share of profits and losses of associates	(7.0)	1.8	(12.6)
Profit before tax	(77.5)	87.5	237.8
Tax	17.2	(15.3)	(40.0)
Profit for the year	(60.3)	72.2	197.8
Attributable to:			
Equity holders of the parent	(50.4)	72.8	181.8
Minority interests	9.9	(0.6)	16.0
EPS - basic (RMB)	(0.064)	0.093	0.228
EPS - diluted (RMB)	n.a.	n.a.	n.a.

Source: Company data, Bloomberg

Singapore

China Farm

Bumper harvest

BUY (re-initiation)

China Agricurlture

Fri, 24 Oct 2008

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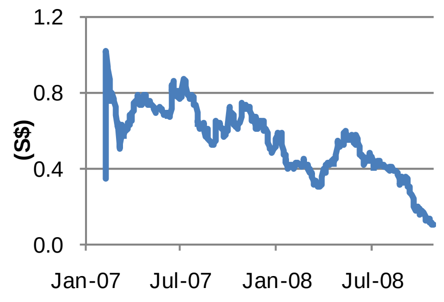
Stock data

Price	**S$0.110**
Target price	S$0.450 (+309%)
12 mth range	S$0.110-0.745
Market cap.	US$18.3m
Daily t/o, 3 mth	US$0.1m
Free float %	41.6%
Ticker	CFE SP

Financial summary

Year to Dec	06A	07A	08F	09F	10F
Net profit (RMB'm)	50.0	71.3	74.5	90.8	114.5
Turnover (RMB'm)	279.0	396.0	530.2	700.7	872.7
EPS (RMB)	0.278	0.295	0.308	0.375	0.473
EPS chg (%)	39.0	6.1	4.5	21.8	26.2
P/E (x)	2.0	1.9	1.8	1.5	1.2
P/B (x)	1.1	0.6	0.5	0.4	0.3
EV/EBITDA (x)	1.7	1.0	0.7	0.5	0.2
Yield (%)	9.3	9.2	8.4	10.2	12.9
ROE (%)	78.1	43.8	27.8	26.8	26.9
ROCE (%)	57.1	30.8	27.0	28.6	28.7
N. Gear. (%)	cash	cash	cash	cash	cash

Price Chart



Re-initiating with a BUY. We are re-initiating coverage on China Farm Equipment (CFE) with a BUY recommendation and a 12-month target price of S$0.45, pegged at 6x FY12/09 P/E. We believe the market has yet to fully appreciate the company's unique position in China's growing agri-business, which is set to receive a further boost from the government's recent rural reform.

Investment merits

Buoyant industry outlook. According to the China Agricultural Machinery Industry 2007/08 Report, the country's integrated mechanization level of plowing, seeding and harvesting has reached 41%. In contrast, Korea's mechanization rate for rice farming was 98%, 97% for transplanting and 96% for harvesting in 1996. China's agricultural machinery industry will continue its sustained development trend with total output likely to increase 10-15% YoY to RMB165-170b in 2008.

Mechanization drive. To ensure China's self reliance in food provision and bridge the income gap between rural and urban residents, the government has stepped up its mechanization drive. With only 7% of the world's cultivated farmland, China has to support 20% of the world's population. According to the 11th Five-year Plan and the 2015 Plan for the Mechanization Development of China's Paddy Rice Production, the government aims to raise the mechanization and harvest rates for paddy rice production from 6.8% and 29.3%, respectively, in 2004, to 20% and 55% in 2010, and 45% and 80% in 2015.

Strong government support. The Chinese government has been promoting long-term self-sufficiency through agricultural policies. We believe its new land use policy will boost the scale of farm production and speed up modernization in agriculture. This should help to spur demand for the company's farming equipment.

Company overview

Background. CFE mainly designs, manufactures and sells farm equipment and diesel engines in China. The company's key products are combine harvesters and plough machines, sold under the "Dragon Boat" brand, and diesel engines, sold under the "Dragon Boat" and "Binhu" brand names. The harvesters and plough machines are manufactured in the company's Industrial Park plant, while the diesel engines are made in the Xiufeng plant. CFE currently makes eight models of combine harvesters, two models of ploughs and 42 models of diesel engines.

Strategically located. The company is based in Hunan, China's key paddy rice farming region, which contributes 13% of the country's total paddy rice production. CFE has more than 40% of the local market and is a significant player in 12 provinces in central and southern parts of China. This close proximity to customers allows it to save on logistics and transportation costs, and ensures timely and tailored customer service.

1H08 results review. Net profit rose 12.7% YoY to RMB41.8m in 1H FY12/08 on the back of 25.7% YoY revenue growth to RMB230.5m. The increase in top-line was mainly due (i) higher sales volume and ASPs for harvesters and (ii) new contributions from agricultural trucks, driver cabins and related components, which began in 4Q07. However, the overall gross margin shrinked 3.8pcp YoY to 26.1% in 1H, as we understand, due to product mix changes (agricultural trucks generally command lower profit margins) and higher raw material costs.

To cope with the rising cost, the company has raised the average selling price of farm equipment and diesel engines by 7% and 11%, respectively, in 2Q FY12/08. In the near term, it is also looking to launch new models of harvesters and farm equipment, which can yield better gross margins.

Compelling valuation. The counter is currently trading at 1.8x FY12/08 and 1.5x FY12/09 P/E, based on our estimates. Our fair value is based on a target multiple of 6x forward EPS, which is in line with its closest comparable, First Tractor (38 HK).

Table 1: P&L statement

Year to Dec (RMB 'm)	FY06A	FY07A	FY08F	FY09F	FY10F
Revenue	279.0	396.0	530.2	700.7	872.7
Cost of sales	(206.7)	(291.6)	(403.4)	(530.1)	(656.1)
Gross profit	72.3	104.4	126.7	170.5	216.6
Other income	10.8	10.8	10.0	11.0	11.0
Distribution expenses	(16.3)	(22.5)	(31.8)	(42.0)	(52.4)
Administrative expenses	(15.9)	(20.0)	(23.9)	(31.5)	(39.3)
Profit from operations	50.9	72.8	81.1	108.0	136.0
Finance costs, net	(0.8)	(1.5)	(1.2)	(1.2)	(1.2)
Profit before tax	50.0	71.3	79.9	106.8	134.8
Tax	(0.0)	(0.0)	(5.4)	(16.0)	(20.2)
Net Profit	50.0	71.3	74.5	90.8	114.5
Gross margin (%)	25.9	26.4	23.9	24.3	24.8
EBIT margin (%)	18.2	18.4	15.3	15.4	15.6
Net margin (%)	17.9	18.0	14.1	13.0	13.1

Source: Company, SBI E2-Capital estimates

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SBI E2-Capital is a dedicated small/mid cap investment banking/ stockbrokerage house. Find our research on: *sbie2capital.com, thomsononeanalytics.comand multex.com*

SBI E2-Capital stock ratings:

STRONG BUY	: absolute upside of >50% over the next three months
BUY	: absolute upside of >10% over the next six months
HOLD	: absolute return of -10% to +10% over the next six months
SELL	: absolute downside of >10% over the next six months