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# Agritrade Resources Ltd. (1131_HK)

Energy: Coal Operations

| | |
|---|---|
| Target Price | HK$ 2.10 |
| Current Price | HK$ 1.50 |
| Upside Potential | 40% |

| | |
|---|---|
| Market Cap. | HK$9,554 mn<br>US$1,217 mn |
| Shares Outstanding | 6,369.5 mn |
| Free Float (FF %) | 2,424.7 mn / 38% |
| 52 Week Range (HK$) | 0.38 / 1.70 |
| Avg. Daily Value | HK$24.5 mn<br>US$3.1 mn |
| Hang Seng Index Level | 30,309 |
| Insider Holding % | 62% |

| | |
|---|---|
| P/E | 14.2x (FY 3/2020E) |
| EV/EBITDA | 8.4x (FY 3/2020E) |
| P/B | 1.6x (FY 3/2020E) |


Risk: Above Average

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## Surging Growth, Strong Asset Base, Underfollowed Stock

Agritrade Resources is in a sweet spot in its life cycle, with surging growth as its core coal operations achieve critical mass among favourable Asian market conditions. Agritrade has grown its revenues at 22% CAGR over six years, while net income has had a rapid 42% CAGR over a seven year period, off of a small base. **Indeed, Agritrade issued a Positive Profit Alert several days ago indicating mining segment revenues will increase by more than 60%, leading to a robust greater than 100% growth in profits for the just ended FY 03/2018.** In our conversations with senior management a few days ago, they indicated that they will strive to maintain historical growth rates in the mining business in the range of 25%-30%. Since its initial entry into the mining industry in 2010, the company has grown production from 2.5mn tonnes in FY03/2012 to ~5mn tonnes in FY03/2017 and the company's eventual target of 6mn tonnes. With 35+ years of proven coal reserves life, Agritrade has strong customer relationships with established large entities in China [24% of sales], India [22% of sales], in addition to a strong presence with nearly 50% of revenues in its home Indonesian market. As detailed later in this update note, the demand outlook for coal in these three key markets remains strong, notwithstanding growth in newer alternative energy sources.

Agritrade [ARL], publicly listed since 1997 and with experienced management and 62% insider/management ownership, has a stock price which remains undervalued, despite gains during the past one year. Additionally, with a market cap over US$1 billion, the company remains underfollowed and arguably undiscovered; with Evaluate Research now the only firm actively researching the company. Our DCF [Discounted Cash Flow] model suggests a HK$2.10 stock price target, implying 40% upside. On more traditional metrics, Agritrade is attractively valued at 14.2x P/E and a very attractive 6.8% FCF Yield on our FY 03/2020 forecasts. In addition to rapid growth, the company has increasingly solid financial metrics of a low debt balance sheet [13% net debt to equity as of September 2017], and strong FCF with several larger CAPX and M&A projects now behind them.

ARL's most recent new business initiative, acquiring a biodiesel plant in the USA, has a promising future in a secular growth space. Importantly, the company has made this investment in a very opportunistic fashion, by committing relatively modest capital and buying an existing facility at a fraction of the cost of starting a new greenfield venture. Most significantly, while the biodiesel venture ramps up to profitability, investors are not paying for future growth as the current ARL stock price has no value ascribed to this venture, and thus investors have essentially a "free option" on any biodiesel upside.

**Positive Profit Alert – Surging Growth**

Agritrade issued a Positive Profit Alert several days ago indicating a substantial increase in the company's revenue and profits for the year ended March 2018. Such an increase was primarily attributable to the strong performance of group's mining segment under prevailing favourable coal market conditions, which benefited from good coal demand in China and India. Both Indonesian and international coal prices have also demonstrated a positive upward trend on average during the past fiscal year. Agritrade was able to continue to increase its coal production to take advantage of favourable conditions. Overall, the company has indicated mining segment revenues to increase by more than 60%, leading to a robust greater than 100% growth in profits. Looking ahead, with demand estimated to remain robust and coal prices expected to sustain at these levels, Agritrade's financials should continue to benefit.

Over the past five years, Agritrade has grown its revenues at 19.8% CAGR, and if one were to include our 03/2018 estimates, the revenue growth becomes 22% CAGR over a six year period. In terms of net income, the company has had a rapid 32% CAGR over the past six years off of a small base, and 42% CAGR over a seven year period if we factor in our 03/2018 forecasts. The company remains poised to achieve robust production growth in its core coal mining operations, especially with the commissioning of a 2nd longwall mining line. We expect at least 10% growth in coal production going forward. This, augmented by M&A and biodiesel ramp-up, should lead to 20% revenue and earnings growth for the company,

**Price Target & Key Model Assumption**

Agritrade's stock remains undervalued, despite gains during the past one year. Additionally, with a market cap over US$1 billion, the company remains underfollowed and arguably undiscovered; with Evaluate Research now the only firm actively researching the company. Our DCF [Discounted Cash Flow] model suggests a HK2.10 stock price target, suggesting 40% upside. The key assumptions in our DCF are a 6.2% risk free interest rate, 5.8% equity risk premium, and 3% terminal growth. On more traditional metrics, Agritrade is attractively valued on 14.2x P/E and a very attractive 6.8% FCF Yield on our FY 03/2020 forecasts.

**Coal Mining – Ongoing Production Growth**

In FY03/2017, coal production was ~5mn tonnes, which has grown in FY03/2018 as per management [FY03/2018 results haven't been announced yet]. Management's short-term target is for coal production to touch 6mn tonnes. **Management has indicated to us and investors that it will strive to maintain historical growth rates in the mining business, in the range of 25%-30%.** While being a relatively new entrant in coal mining, the company has grown production from 2.5mn tonnes in FY03/2012 to ~5mn tonnes in FY03/2017 and the company's eventual target of 6mn tonnes. In 1HFY18, coal production was 2.7mn tonnes, an increase of 3.8% YoY. Along with the production increases, Agritrade has also been able to improve their marketability with the progress from being a supplier of one type of coal to now being able to provide 3 types. The company is able to provide various grades of bituminous, sub-bituminous, low sulphur and low pollutant thermal coal. In FY12-FY17, revenues from coal mining have grown exponentially at 59.1% CAGR. The company has 215mn tonnes in reserves and 417mn tonnes of resources. The mining operations do not currently require material CAPX, other than the PT Merge mine for which $100mn will be required. Optimizing production capacity, improving efficiencies, lowering cost and strengthening the coal supply chain are key to Agritrade's mining strategy.

**Coal Pricing Remains Firm**

Coal pricing has remained strong in the last year which has aided the financial performance of Agritrade. Earlier this month, the company has also released a positive earnings alert highlighting the substantial growth witnessed in FY03/18. The reasons for this include a strong demand environment, elevated coal pricing and higher production. FY03/18 mining revenues are expected to jump by over 60% with profits before interest and tax seeing an even sharper jump by more than doubling. In 1HFY18, coal mining revenues were up 64.6% YoY with EBITDA increasing at a faster clip by 91.3% YoY, largely driven by strong revenue performance at all three mines and an improvement in operational profits at SEM. Further, EBITDA margins improved from 35.4% in 1HFY17 to 41.1%. Looking ahead, with demand estimated to remain robust and coal prices expected to sustain at these levels, Agritrade's financials should continue to benefit.

**Cost Efficiency in Coal Mining**

Cost management has and continues to be a key part of the company's mining strategy. Its mines are competitive on a cost basis with the SEM mine being at the bottom of the low rank coal supply curve. The Bunda Kandung mine too is competitive, being in the third quartile for sub-bituminous and low rank coal. For the Merge mine, cash costs are now below $50 and are expected to decline with higher capacity. The mines' cost competitiveness is also highlighted with their ability to remain profitable even in a difficult coal environment historically. In FY03/2017, for the SEM mine, cash costs including royalty stood at US$16.2/MT as against an average selling price [ASP] of $26.3. Even in 2016, when ASP was down

~15% YoY to $24.1/MT, the company was able to control cash costs to $16.4/MT [$20.0 in FY15] at SEM enabling to maintain coal EBITDA margins at a high of 62.2% [FY03/15 margin of 30.8% and FY03/17 margin of 43.4%]. For the Merge mine cash cost in FY17 was $42.5 while it was $25.1 for Bunda Kandung.

**Longwall System to Increase Production in the Merge mine**

This past month, in May, Agritrade announced the acquisition of a second longwall system for its Merge mine. The longwall system is to be purchased from a leading coal mining and excavating equipment manufacturer for RMB 139.4mn [~$22mn]. With this acquisition, the Merge mine will have two longwall systems which will enhance production capacity significantly. The annual capacity increase, after this longwall addition, is expected to be 2.5mn tonnes per year. This will result in 3.5mn tonnes of total production capacity from Merge. The additional longwall system will also aid the company in lowering operational costs. Some additional benefits of longwall mining include its fully mechanized operations, lower labour force requirements and fewer stoppages for weather related issues. The increase in capacity from the new system will allow Agritrade to eventually increase production and sales and could provide a significant boost to revenues and profits.

**Strong Coal Demand in Key Markets**

Coal produced by Agritrade is sold through intermediaries with end customer key destinations being India, China, Indonesia and other Asian countries. In terms of the geographical split, the company is fairly diversified with coal mining revenues from end customers in Indonesia accounting for 49%, China 24%, India 22% and the balance 5% being all other countries. With the majority of power plants being fuelled by coal in its key markets of Indonesia, China and India, Agritrade's coal operations are well positioned to benefit from rising demand in these economies. Cumulatively, these markets require close to 4 billion tonnes of coal. Demand for Indonesian coal is expected to remain robust given its geographical presence close to these large Asian markets. Furthermore, even while there has been some push towards gas in China, management feels that their products, with low sulphur and ash content, should not be negatively impacted by this policy.

**Biodiesel – Promising Future**

ARL's most recent new business initiative has a promising future in a secular growth space. Importantly, the company has made this investment in a very opportunistic fashion, by committing relatively modest capital and buying an existing facility at a fraction of the cost of starting a new greenfield venture. Most significantly, while the biodiesel venture ramps up to profitability, investors are not paying for future growth as the current ARL stock price has no value ascribed to this venture, and thus investors have essentially a "free option" on any future biodiesel growth.

ARL acquired a 51% stake in Biofuel Holdings in Arkansas, USA in December 2016. The price paid was reasonable in absolute terms, with a total consideration of US$17 million. Purchasing a "mothballed" plant at a cost of US$400,000 per million tonne capacity is much cheaper than establishing a new greenfield operation which would likely cost $40 million, at the "rule of thumb" industry metric of $1 million cost for 1 million tonne in biodiesel capacity.

**US Tariffs Boost for Agritrade's Biodiesel**

Recent actions by the Trump Administration as well as several US agencies are quite favorable for Agritrade's Arkansas biodiesel business, and serve as a tailwind impetus and catalyst for a growth jumpstart off a low base. The U.S. International Trade Commission (ITC) in October 2017 made a final finding that biodiesel imports from Argentina and Indonesia harm U.S. producers, ensuring that anti-dumping and anti-subsidy duties remain in effect for at least five years. The U.S. Commerce Dept, in response to this judgment, set steep trade barriers that brought to halt shipments of soyoil-based biodiesel from Argentina and palm oil-based supplies from Indonesia.

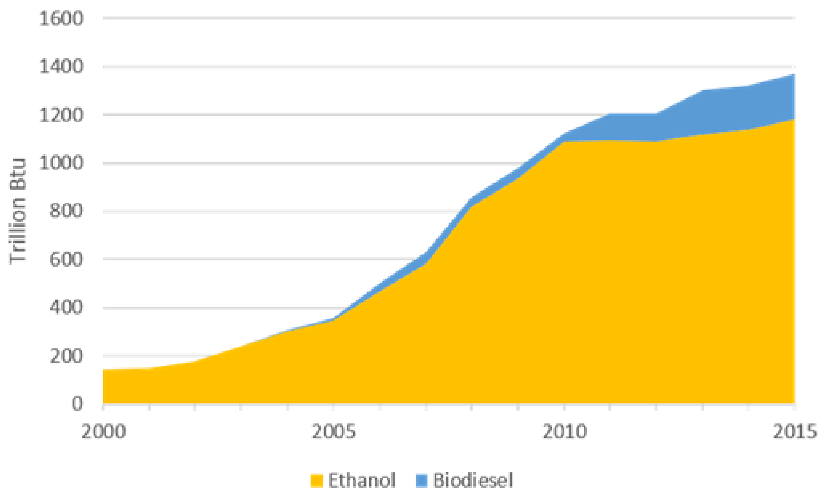
ITC ruled in the finding that "U.S. industry is materially injured by imports from Argentina and Indonesia that the U.S. Dept of Commerce has determined are subsidized locally," it said in a statement. The ITC's affirmation effectively locks in place the duties set by the Commerce Department for five years. Argentina's foreign ministry in November 2017 said the anti-subsidy duties that were as high as 72.3% made their biodiesel too expensive for the U.S. market. Its biodiesel exports in the third quarter fell 30%, due in part to the duties.

**Biodiesel in the US: Long-term Outlook**

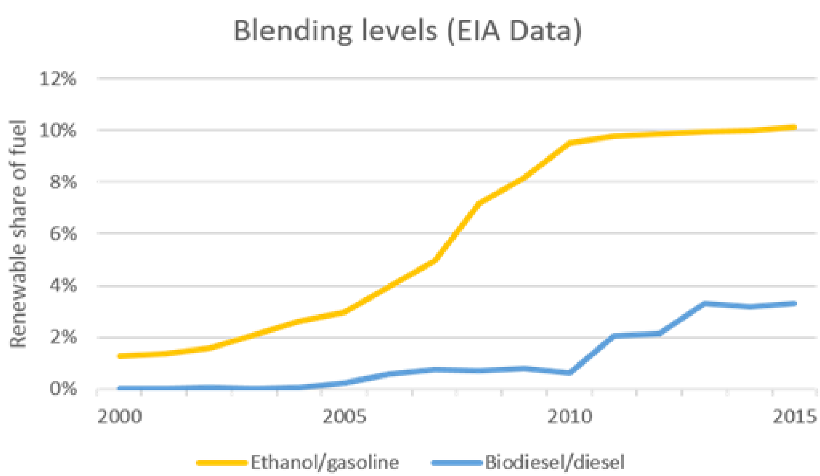
Biodiesel is a renewable, clean-burning diesel replacement that is reducing U.S. dependence on foreign petroleum, creating jobs and improving the environment simultaneously. Made from a diverse mix of feedstocks including recycled cooking oil, soybean oil, and animal fats, it is the first and only EPA-designated Advanced Biofuel in commercial-scale production across the country and the first to reach 1 billion gallons of annual production.

The biodiesel market has increased from about 25 million gallons in the early 2000s to more than 2.8 billion gallons of advanced biofuel in 2016. However, this represents a small but growing component of the annual U.S. on-road diesel market of about 35 billion to 40 billion gallons. Consistent with projected feedstock availability, the industry has established a goal of producing about 10% of the diesel transportation market by 2022. What this means in the bigger picture sense, is that U.S. would significantly reduce its dependence on imported oil, therein bolstering national security and reducing US trade deficit. At the same time, biodiesel's growth would boost the U.S. economy by increasing the number of jobs available.

There are currently about 200 biodiesel plants across the United States with a registered capacity to produce some 3 billion gallons of fuel. The industry there is supporting nearly 48,000 jobs, generating billions of dollars in GDP, household income and tax revenues. The industry's economic impact is poised to grow significantly with continued production increases. The industry supports jobs in a variety of sectors, from manufacturing to transportation, to agriculture and services in the country. Source: The National Biodiesel Board (NBB) is the national trade association representing the biodiesel industry in the United States.




When it comes to production of both Ethanol and Biodiesel, the latter is slowly gaining in numbers. Although ethanol production is much larger, biodiesel has grown more quickly since 2010, more than tripling between 2010 and 2015.




Today, biodiesel accounts for about 3% of the diesel fuel sold. For comparison, 10% ethanol is blended into most of the gasoline sold today.

**Optimizing Shipping Assets via Disposal**

Agritrade announced a couple months back that it is selling one of its ships for US$18.5 million [HK$145 million]. The company's vessel storage operation is mainly conducted through its three sets of VLCCs, and management regularly performs review and assessment on the utilization and efficiency of the VLCCs during the course of its vessel storage operation, which may cover the vessel market conditions, VLCC conditions and prevailing market rate for vessel chartering services. Management accepted the purchase offer received for this particular ship, given the fact that the age of the Vessel of more than 20 years is considered to be old and less attractive as the charterers in the market prefer younger vessels, which also leads to a higher cost of operations and maintenance. In addition, the offer price was considered as attractive for VLCCs of similar age with reference to the prevailing vessel market conditions and vessel valuation. This price is just slightly below the carrying value of the ship on the balance sheets of the company which was approximately HK$154 [as on March 2018], resulting in a pre-tax loss of approximately HK$9 million [US$1.2 million].

**Coal Mining – Operational Details & History**

The company started mining operations in 2010 and currently coal mining accounts for 84% of Agritrade's revenues and 79% of EBITDA [1H FY 03/2018]. Agritrade's coal mining operations include 2 mines in Indonesia - the SEM Mine [64.6% ownership] and the Merge Mine [51% ownership]. In addition, the company operates the Bunda Kandung mine, also in Indonesia. The mines are strategically located with good roads and logistics access. Agritrade is one of the first companies in Indonesia to implement large-scale, fully mechanised longwall underground mining at its Merge mine. The SEM mine began operations in 2010 and the Merge mine and Bunda Kandung production starting in 2016 and 2015, respectively. Along with the SEM mine, Agritrade operates the 41 km Pertamina toll road, which runs between the SEM mine and the jetty facilities. This allows the company to have a fully integrated supply chain, from "pit-to-port", at SEM. The SEM mine has the largest production across Agritrade's mines of 4.2mn tonnes in FY03/17 and a mine life of 20 years. The company endeavours to further increase coal production at this mine to a sustainable level of 4.6mn tonnes.

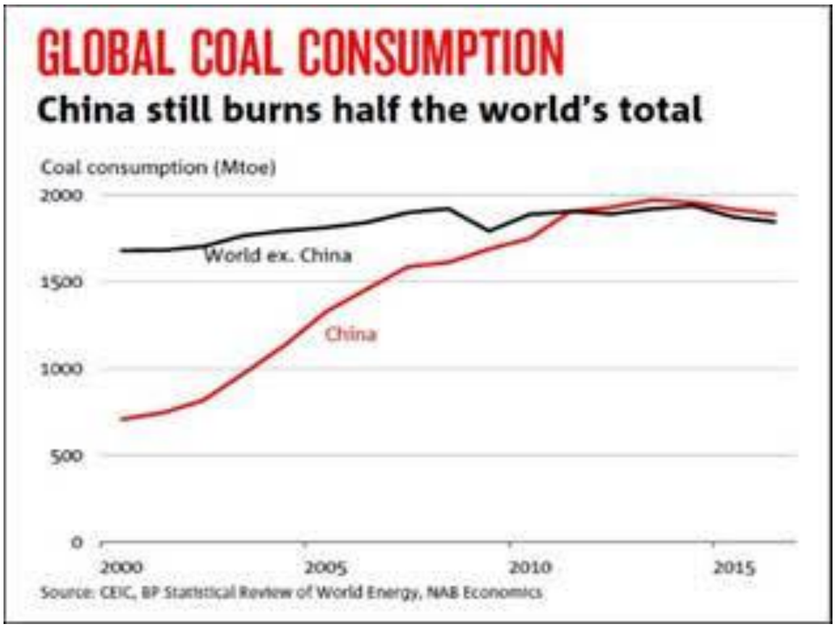
At Merge, where mining began in 2016, FY03/17 production was 0.36mn tonnes with coal product quality better than that of the average Indonesian thermal coal. We expect this to ramp up from here as the mine moves to full production [this is expected to be seen in FY03/18 results] and with the recent acquisition of the second longwall mining system for this mine [details later in the report]. The Merge mine has a mine life of 18 years. At Bunda Kandung, production stood at 0.45mn tonnes in FY03/17 and the company had a 5 year contract to operate this mine with an option to renew. Production at this mine is expected to continue increasing over the next few years. All three mines offer coal with varying degrees of calorific value, enabling Agritrade to offer coal with low calorific value such as 3800 kcal/kg at SEM to 4200 kcal/kg at Bunda Kandung and 6426kcal/kg at Merge. The Merge mine has no leverage and no debt at the mine level. Bunda Kandung too, has no leverage with only low leverage at the SEM mine. With a low net debt to EBITDA of 0.9x, there is headroom for further M&A activity. Management's target net debt to EBITDA ratio is 2.0x. The company has a number of blue-chip energy customers, with whom they have shared long standing relationships, who have contracts ranging from long-term to spot contracts. Agritrade also has some recent contract wins from two international traders with contract values of $56mn and $80mn for 0.7mn tonnes and 1mn tonnes respectively.

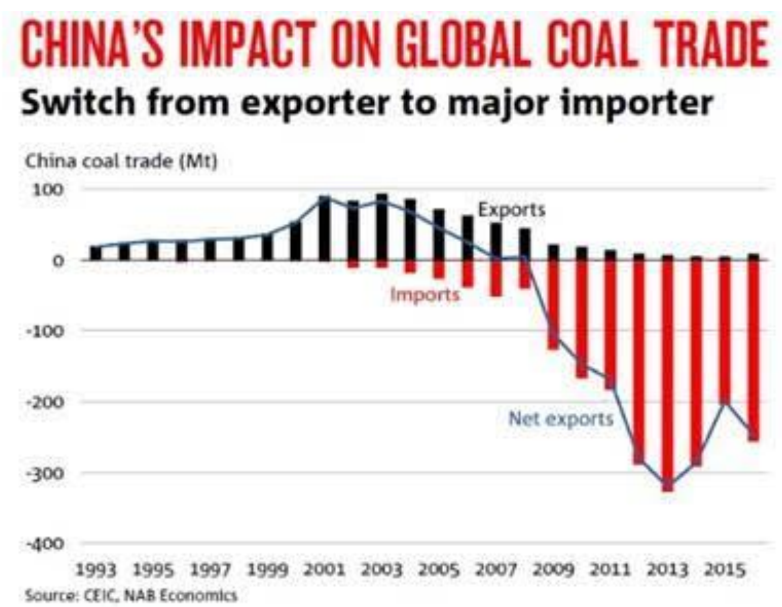
**Potential Acquisition in India**

In order to integrate their existing coal operations further, Agritrade has announced that they are in negotiations to possibly acquire a fully completed 600MW power plant in the northern Indian state of Chhattisgarh. Management estimates that this will have an investment value in the range of US$525mn - $550mn. This plant is coal fired and has agreements already in place for 2.6mn tonnes per year of thermal coal until 2033. Discussions for power purchase agreements with industrial consumers are also ongoing. With the existing 600MW already in place, there is an additional 600MW power plant, also coal fired, in the process of being constructed at the same location. This incremental power plant would require $400mn in investment. There is no assurance that any deal will be completed, and negotiations for the acquisition are currently underway and the actual investment amount will only be clear once these are completed. The company expects this potential acquisition to add to their sales and profits and will look at multiple financing options for this transaction, if it proceeds. In the management's view, with a number of distressed assets available through the India's National Company Law Tribunal [NCLT], there is a potential to acquire these at a significant haircut. While the acquisition is not certain, if Agritrade is able to acquire it at reasonable valuations it would be a positive for the company given the entry into the Indian market where demand for power is likely to remain strong, in our view. India suffers from chronic large shortages in electricity and coal production [versus rising demand], and the country's power plants will remain coal dominated for the next several decades.

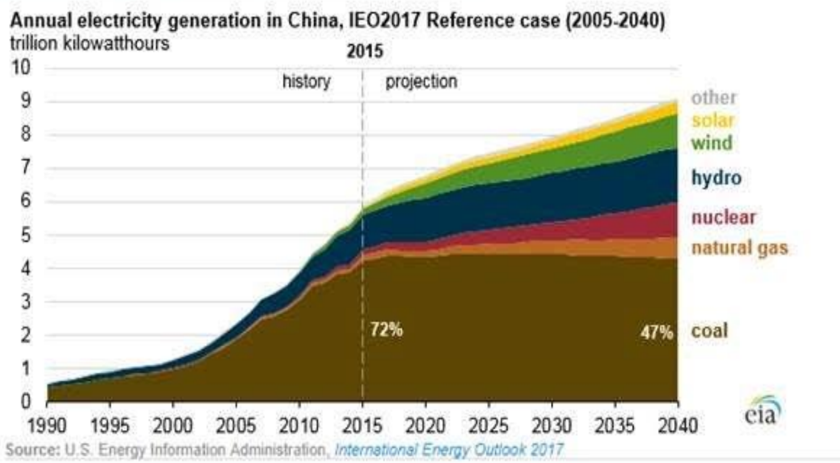
## Coal Demand in China

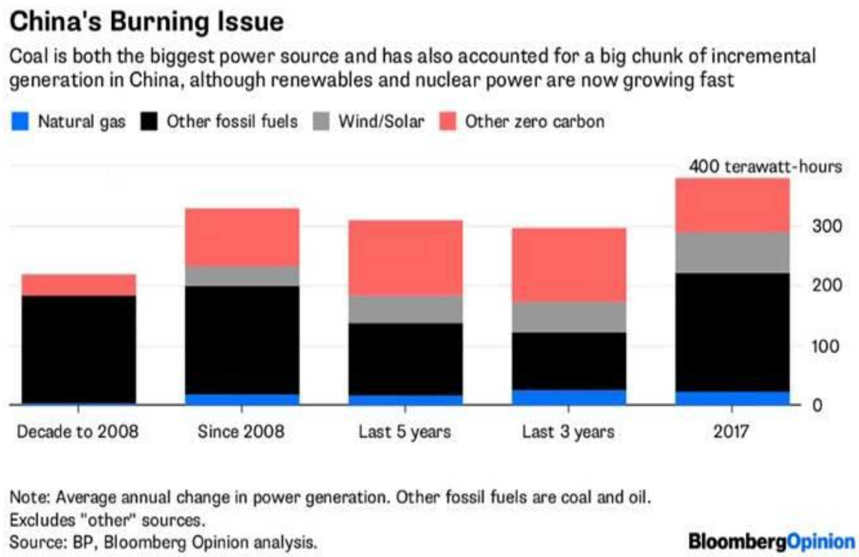
Coal-fired electricity generation in China, the world's largest coal consumer, is expected to remain flat through 2040, according to EIA's International Energy Outlook 2017 (IEO2017). Other fuels, such as renewables, natural gas, and nuclear power, are expected to make up increasing shares of China's electricity generation. Despite declines in coal's generation share, IEO2017 projects that coal will remain an important component of China's energy mix, peaking at nearly 4,400 billion kilowatthours (bkWh) by 2030. However, as China continues to replace older, less efficient generators with more efficient units, China's power sector coal consumption is expected to peak as soon as 2018, at 4,800 million metric tons.

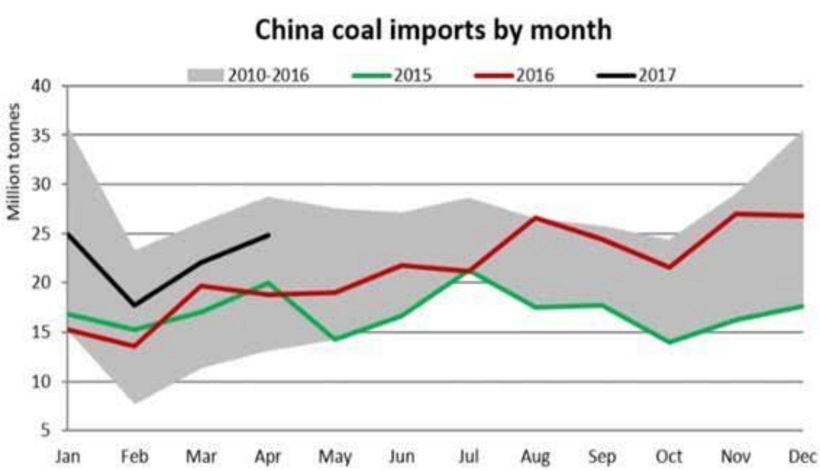


## Chinese coal-fired electricity generation expected to flatten as mix shifts to renewables

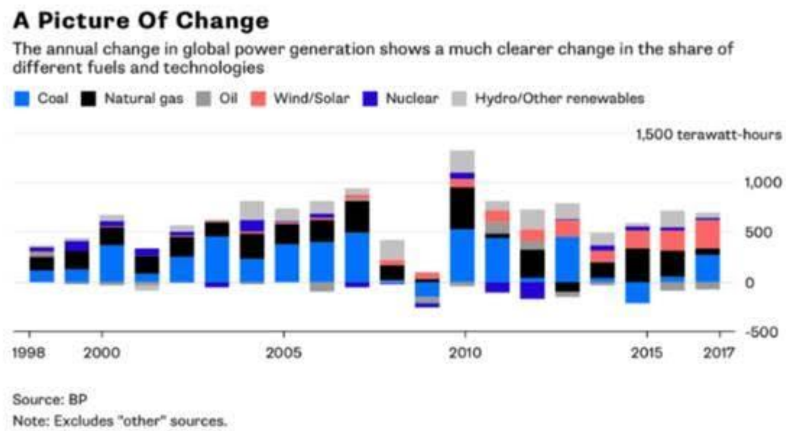


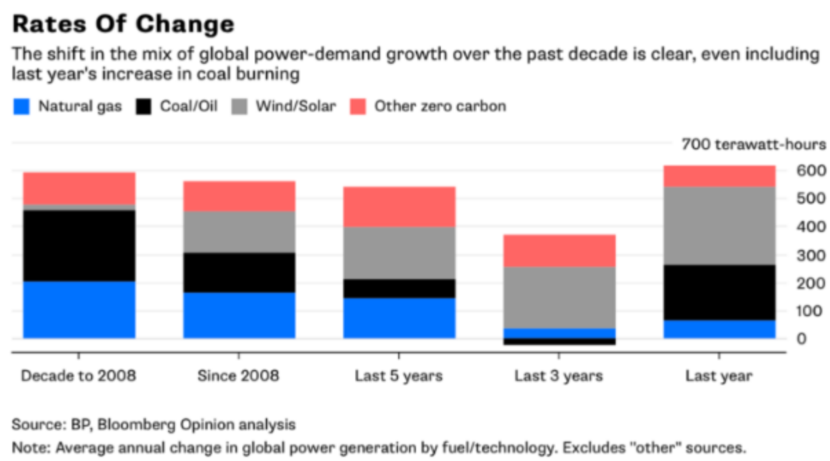



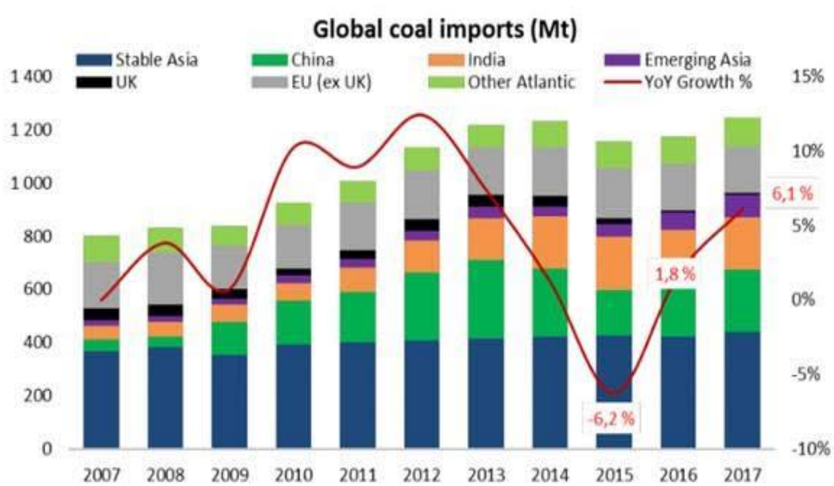



## Coal Demand Outlook Globally

Coal's share of the world's electricity mix was about 38% in 1997, and it has remained at this level even in 2017. Fossil fuels overall have actually increased their share, from 63% to 65%. Natural gas' share of growth in power generation has been squeezed over the past few years [chart below]. Competition among fuels and technologies has intensified dramatically and is accelerating as costs for renewable sources, in particular, have fallen.

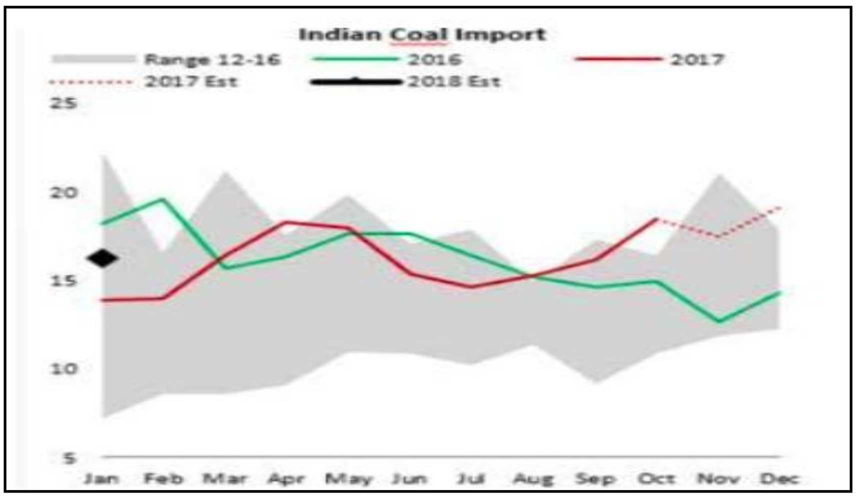


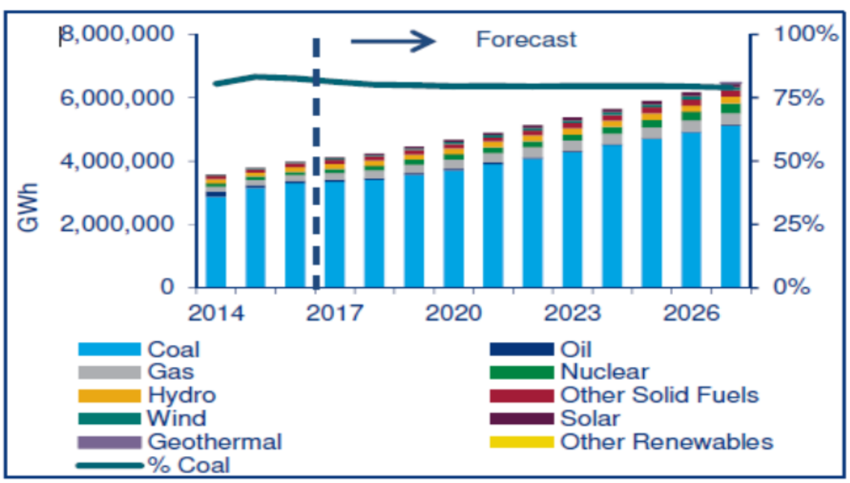



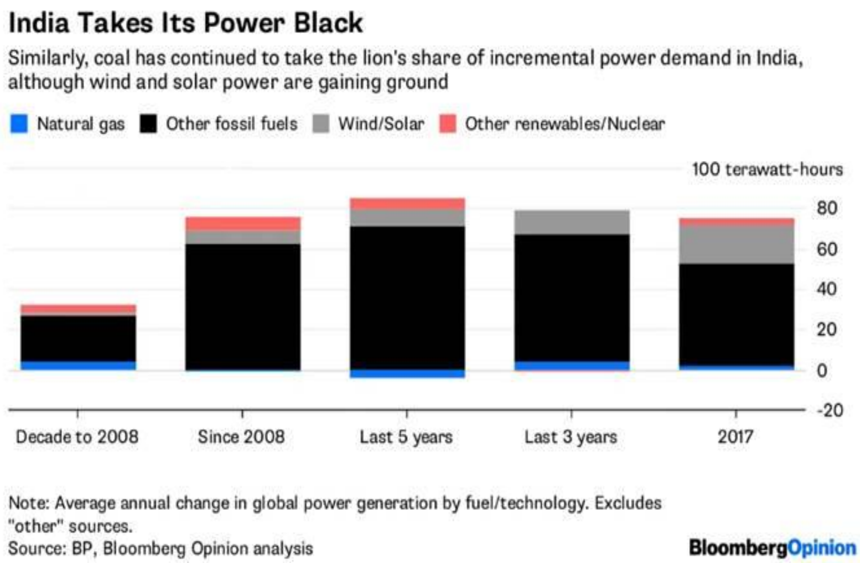
**Coal Demand Outlook in India**

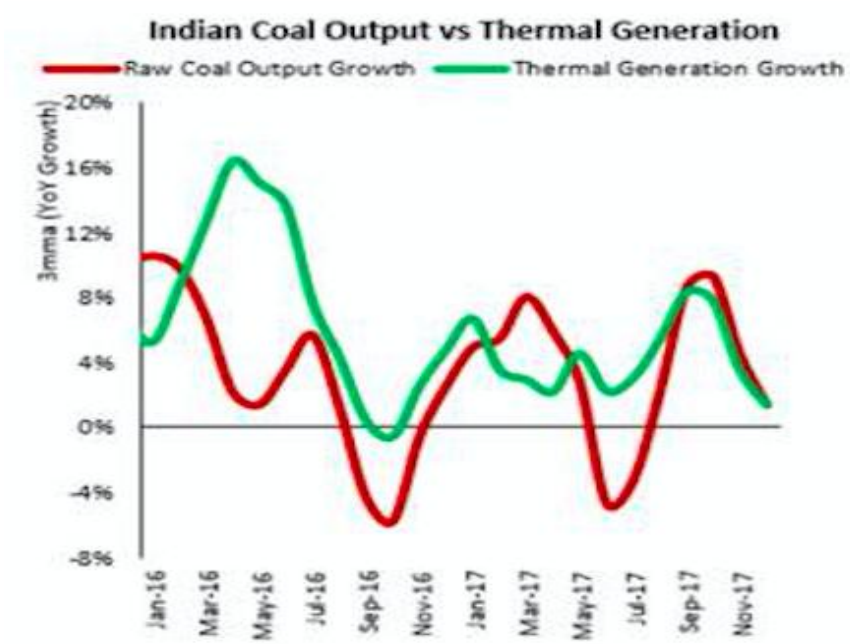
The fundamentals for Indian coal imports continue to look promising. On the demand side, there are some clear signs that Indian economy is recovering from the negative short term effects of the demonetization introduced in November 2016 and the Goods and Services Tax [GST] implemented in 2017.Coal-based power continues to hold the highest share in the country's installed capacity and total generation. Coal-based capacity has increased from 130 GW as of March 2013 to 192 GW as of March 2017, recording a CAGR of around 10%.Coal-based power generation currently occupies a share of over 75% in the total power generation in the country. This ratio is forecasted to continue to remain at over 70% going ahead. Given that India's economy is forecast to grow significantly over the coming decade, with gross domestic product rising 7-8% annually, the government expects electricity capacity needs to nearly double to 2027.




*Source: Wood Mackenzie*

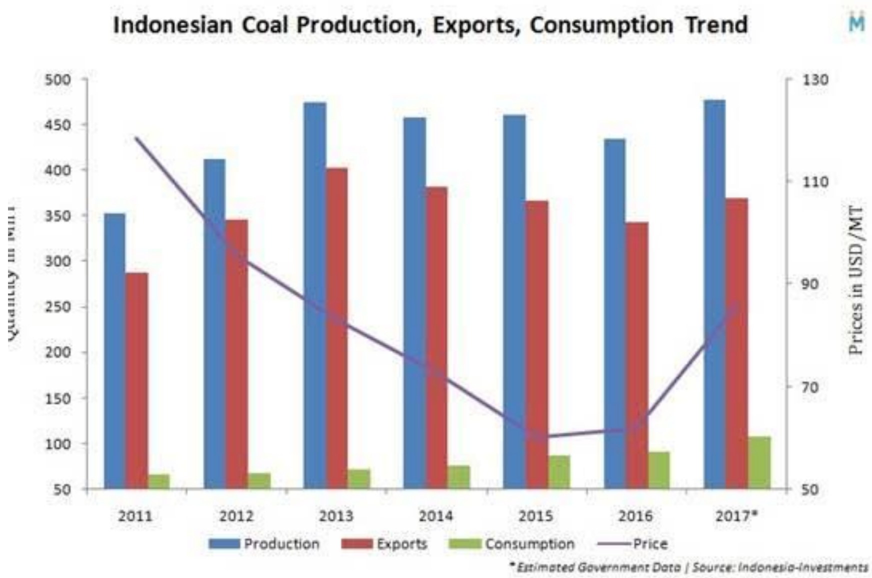



Electricity generation by fuel type in India

**Coal Demand in Indonesia**

Indonesia's coal industry is enjoying a resurgence, driven both by rising demand from China—the world's biggest consumer of the fossil fuel—and a push by the government in Jakarta to build more coal-fired power plants. This is also setting back efforts in both countries to shift to a greater share of renewable energy. Indonesian government is expecting domestic coal demand to reach 114.51 MnT in 2018, up 6% Y-o-Y from the estimated demand of 2017, largely driven by the coal-fired power plants in the country.



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