China

Eva Chun / Jim Fong
(852) 2283 7321
Eva.chun@kingswaygroup.com
www.liberresearch.com

China Asean Resources Ltd

8186.HK / 8186 HK

NOT RATED

HK$0.236 (Feb 27, 2008)

HSI:24,483.84 (Feb 27, 2008)

A high beta stock

Transforming into forestry play - The company has been moving into forestry business in Cambodia by acquiring their first forestry asset in Oct-07. The company has also committed to acquire the second forest. While we believe acquisition of new forests being a key element to long-term growth, cash flow may be a concern.

New business model - Under the new business model, the company generates revenue from initially logging of the existing trees from a natural forest and the logs will be processed into wood plank and other value-added wood products such as flooring materials for export to China.

A high beta stock - We concede that the company is a high beta stock with significant risks, both systematic risks, related to the economic outlook in China and in Cambodia, and with company specific risks. Key company specific risks include: (1) execution risks; (2) low earnings visibility; (3) ability to meet guaranteed profit; (4) significant potential share dilution; (5) natural disasters; (6) earnings instability; (7) failure to renew forest exploitation rights.

Valuation - Based on the guaranteed profit, the company trades at 3X PER for 2008, one of the lowest PE among its peers, which also reflects their inherited risk level. We take reference to the Canada-listed forestry play Sino-Forest, which has a longer trading record. Sino Forest used to trade below 5X PE for a few years at their pre-mature stage, and is now trading at a range 15X-18X as their plantation turned matured.

Share Data

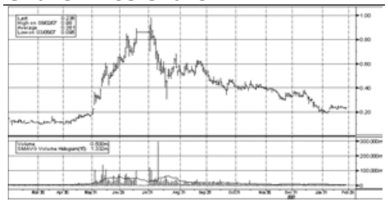
52week Hi/Lo (HK$)	0.98/0.095
Avg. daily t/o (US$m)	0.11
Market cap. (US$m)	51.71
Total issued shares (m)	1,705
Public float (%)	48.2%
Major shareholders:	
Mr. Pen Sophal and Ms. Zhang Jie	27.5%
PPM	11.3%
UBS AG	7.0%
Keywise Capital	6.0%

Source: Company & HKEx

Company profile

China Asean Resources Ltd provides medical devices for cancer treatment and promotes sales of anti-cancer drugs in China. It has been moving into forestry business in Cambodia.

Share Price Chart



Source: Bloomberg

Earnings Summary

Year ended 31 Dec	04A	05A	06A
Sales (HK$m)	32	36	35
EBITDA (HK$m)	8	2	(26)
Net profit (HK$m)	**4**	**(2)**	**(29)**
EPS - Fully diluted (HK$)	0.004	(0.003)	(0.035)
YoY change (%)	-116.7	-160.9	+1255.7
EV/EBITDA (x)	24.5	98.0	(7.2)
ROE (%)	6.1	(1.8)	(27.3)
Net debt/equity (%)	Net cash	Net cash	Net cash

Source: Company data

We have met the management of China Asean Resources (formerly known as Medical China Ltd) recently. The company has been moving into forestry business in Cambodia by acquiring their first forestry asset in Oct-07. Under the new business model, the company generates revenue from initially logging of the existing trees from a natural forest and the logs will be processed into wood plank and other value-added wood products such as flooring materials for export to China. The company has also committed to acquire the second forest. While we believe acquisition of new forests being a key element to long-term growth, cash flow may be a concern. The performance of the company's legacy business, selling of medical devices for cancer treatment and anticancer drugs, shows no signs of turning around. We concede that the company is a high beta stock with significant risks, both systematic risks, related to the economic outlook in China and in Cambodia, and with company specific risks, such as execution risks. Based on the guaranteed profit , the company trades at 3X PER for 2008, one of the lowest PE among its peers, which also reflects their inherited risk level. We believe the company should trade at a significant discount to Samling due to its tiny scale and early stage of development. Samling trades at 8.5X forward PE for the year ends Jun-09. We also take reference to the Canada-listed Sino-Forest, which has a longer trading record. Sino Forest used to trade below 5X PE for a few years at their pre-mature stage, and is now trading at a range 15X-18X as their plantation turned matured.

Business model

The company generates revenue initially from the logging of existing trees from a natural forest, and, when the site is cleared, it will be for rubber plantation. The trees logged will be processed into wood plank and higher value added wood flooring products for export to China. It is estimated that the initial clearing stage will last for about 5 years. Rubber trees will be planted progressively for the subsequent production of latex, and upon maturity the plantation will produce latex for sale. The company will outsource the upstream logging function to professional logging companies. Generally it will take 5 years before the first harvest of latex, and that older trees tend to yield more latex.

Moving into forestry sector in Cambodia

China Asean Resources acquired its first forest in Cambodia from Tong Min Group in October 2007. Tong Ming Group is a private investment company owned by Mr. Zhang Zhenzhong (70%), Ms. Zhang (20%), and Mr. Pen Sophal (10%). The management of the Tong Min group is well experienced in doing business in Cambodia. The forest is located in Kratie District, in Cambodia and has a site area of about 9,965 hectares (about 99.65m sq m). The total consideration for the acquisition amounted to HK$208m which will be satisfied by (a) HK$50m in cash; (b) HK$70m by the issue of bonds to Mr. Zhang; (c) HK$13.16m convertible bonds at a conversion price of HK$0.188, to Mr. Pen and Ms. Zhang; and (d) the balance of HK$75.2m by issue of 400m new shares, to Mr. Pen and Ms. Zhang, at HK$0.188. Post conversion of CBs, Mr. Pen Sophal and Ms Zhang Jie shall become the largest shareholder of China Asean Resources with 39.3% of the company. On top of this, China Asean Resources will pay a one-off HK$55m premium to the Cambodian government for the rights to the forest exploitation.

Profit guarantee and compensation mechanism

According to the purchase agreement, the sellers guaranteed that the audited net profit after tax and minority interests of Tong Min prepared under HKGAAP to be no less than HK$170m for Dec year ended 2008, and no less than HK$700m for the three years ending Dec 2009, 2010, and 2011. If the audited net profit of Tong Min is less than 70% of the guaranteed amount of HK$170mn in Dec 2008, i.e. less than HK$119mn, or the audited net profit of Tong Min for the three years ending Dec 2011 is less than 490mn, Mr. Pen Sophal and Ms Zhang Jie will be obliged and to compensate the company for the shortfall.

Small manufacturing scale could cap growth

The company will focus on downstream manufacturing operation and outsource the upstream logging function to third parties. It is constructing two wood processing factories; (1) a wood plank processing plant with production capacity of 25,000 cu m per annum; and (2) a semi-finished floor decking plants with production capacity of 50,000 cu m per annum. In terms of manufacturing capacity, the company has a combine capacity of 75,000 cu m per annum. The production plants shall commence production in March 2008. However, we estimate that they would require approximately 400,000-600,000 cu m p.a. in order to meet their target to clear the land in five years.

Still more capex needed to build up capacity

Nevertheless, the production scale remains small, even at full capacity, and the company still needs to invest more on downstream processing. Their tree logging function is currently outsourced to a group of 40 members divided into two teams to handle timber logging, and the management expects the logging team should expand as the wood processing plants commence operation.

Funding ability is the key to survive/success

Their ability to raise fund and maintain cash flow is the key to survive. While the majority of the forestry plays promulgate their rapid earnings growth stories, the key to success behind the strong earnings growth relies on their ability to acquire new forestry assets.

Sales growth

We expect rapid growth for China Asean Resources over the next three years due to its start-up stage and acquisition. But the growth will slow down as the company matures. For instance, turnover from Samling Global (3938 HK) declined 14% for the 1H08 due to lower selling prices and volumes sold. Furthermore, earnings growth generally slowdown for the more matured forestry companies listed in Canada and the US.

Risk to meeting guaranteed profit

Although the management is confident about meeting their earnings target, the current orders are still too small to meet the guaranteed profit. The company has secured orders amounted to US$32mn just for two major clients. It will deliver wood plank and wood flooring materials to a leading supplier of wood flooring products in the PRC (US$12m for FY08, and US$15m for FY09 respectively). A separate order for wood flooring materials and wooden doors amounted to US$5.1m for FY08.

ASP may change sharply depends on timber quality

We found a low visibility and predictability on product prices. The management estimates the ASP of wood plank at US$270-320 per cu m, and semi-finished floor decking at US$620-720 per cu m. The ASPs are, however, determined by a wide variety of factors including tree species as well as supply and demand dynamics. A change in timber mix would significantly impact the company's revenue. For instance, Samling Global's gross margin fell over 15 percentage points to 14.4% in 1H08 (from 29.9% in 1H07) as ASP for log, plywood and veneer declined 6% - 13%. According to a technical report prepared by BMI on the company's first forest, only 5% are special timber, 42% are first class timber, and the remaining 53% are general timber. We believe ASP among these different product grades varies significantly and different timber mix would change the company's revenue accordingly.

Average Selling Price Comparison

Products	ASP per cubic metre			chg %
Samling Global (3938)		**1H08**	**1H07**	
hardwood logs (exports)	US$	163	169	-3%
hardwood logs (local)	US$	88	95	-7%
softwood logs (exports)	US$	56	65	-14%
softwood logs (local)	US$	80	72	12%
plywood (exports)	US$	438	488	-10%
plywood (local)	US$	335	349	-4%
veneer (exports)	US$	315	337	-6%
veneer (local)	US$	268	294	-9%
China Asean Resources (8186)				
sawn timber	US$	270-320		
semi-finished floor decking	US$	620-720		
China Grand Forest (910)				
standard timber - mixed hardwood	US$	791		
standard timber- other wood	US$	314		
pulpwood	US$	119		

note both Samling and China Asean Resources are quoted at FOB prices

Source: Company data, LiberResearch estimates

Strong ties with the Cambodia government

The forestry industry in Cambodia has a high entry barrier since it opens only selectively to foreign investors. Tong Min's ability to enter the country's forestry sector shows their strong ties with the government. Tong Min has several government officials on its advisory board, including a "three-star" General in the army, who is also the Deputy Chief of Cabinet to the Prime Minister, an advisor to the Prime Minister and the deputy head of the Department of Rubber Development.

Issue new shares at significant premium… showing confidence

In addition to the first forest, the company has further committed to acquire its second forest. Although the acquisition should help building up forest reserves, the deal has tightened their cash position. The acquisition costs for the second forest will be no more than HK$300m and will be satisfied by cash and shares, a similar structure to its first forest acquisition. The new shares will be priced at HK$0.60, which is at a significant premium to their current share price. The price was determined based on a weighted average of the prices of the placing of the shares conducted by the company in July 2007. Assuming a similar payment structure to the first forest, the company needs about HK$100m cash, including approx HK$55m fee for land premium payable to the Cambodian government payable six months after the transaction, to pay for the second forest acquisition. The significant price premium meant to show the management's commitment to the project.

Natural forest carries high timber density

We have made a simple comparison with other forestry companies, the company carries a relatively high timber density in both forests and we expect a better timber quality as well. The second forest has similar size compared to the first forest but with a smaller timber reserve of 2.2 m cu m and an initial valuation of US$256mn (or HK$2bn). There is no technical report available on the timber quality for the second forestry.

Average Land Costs Comparison

Location	Date acquired	Consideration (Rmb mn)	Forest land (area in hectare)	Forest land (area in Mu)	Acquisition cost (Rmb/hectare)	Acquisition cost (Rmb/Mu)
China Asean Resources (8186)						
Cambodia - forest no 1	**Oct 2007**	208	10,082	151,230	20,631	**1,375**
Cambodia - forest no 2	**2008 (proposed)**	300	10,000	150,000	30,000	**2,000**
China Grand Forest (910)	**FY07**	427		993,351		**430**
	FY08	1,445		2,465,200		**586**

Source: Company data, LiberResearch estimates

Synergy from the second forestry

Due to the proximity of the two forests, in terms of the geographical locations, and the nature of the timbers contained, the acquisition should benefit the company and should create substantial synergistic value for better economy of scale, and substantial increase in timber reserves. In addition to the second forest, the company currently holds the option to acquire two additional plots of forest with an area of approximately 10,000 hectares each in Cambodia.

Future expansion

In addition to acquiring 2-3 more forests in the same region, the company also plans to expand to downstream processing which should help increase the overall profit margins. The company may need to raise additional funds to pay for its future acquisition, and the amount will depend on the size of future forest.

We concede that the company is a high beta stock

We concede that the company is a high beta stock with significant risks, both systematic risks, related to the economic outlook in China and in Cambodia, and with company specific risks, which include: (1) execution risks – although the management of Tong Min has strong relation in Cambodia; (2) low earnings visibility – product ASP varies according to timber quality; (3) ability to meet guaranteed profit; (4) significant potential share dilution; (5) natural disasters - the company is not insured against natural disasters such as fire; (6) earnings instability due to their start-up stage, and that their limited processing capacity, which is still low at 75,000 cu m p.a.; (7) failure to renew forest exploitation rights. Besides, funding needs will remain high due to the need to acquire new forest reserves and also capex for building processing plants for downstream processing.

Financial data

Year ended 31 Dec	FY04A	FY05A	FY06A
Income Statement (HK$m)			
Turnover	**32**	**36**	**35**
YoY%	(7)	14	(3)
COGS	(16)	(15)	(14)
Gross profit	**16**	**21**	**21**
Gross margin	50.1%	57.6%	59.7%
Other income	5	2	2
Selling & distribution	(3)	(6)	(7)
Admin	(8)	(9)	(10)
Other opex	(3)	(10)	(32)
Total opex	**(15)**	**(25)**	**(50)**
Operating profit (EBIT)	**6**	**(2)**	**(26)**
Operating margin	19.5%	-5.5%	-75.7%
Finance costs	(0)	(0)	(0)
Profit after financing costs	6	(2)	(27)
Associated companies & JVs	(0)	0	0
Pre-tax profit	6	(2)	(27)
Tax	(3)	0	(0)
Minority interests	0	0	(2)
Net profit	**4**	**(2)**	**(29)**
YoY%	(117)	(161)	1,256
Net margin	11.3%	-6.0%	-84.0%
EBITDA	**8**	**2**	**(26)**
EBITDA margin	24.8%	5.3%	-74.5%
EPS (HK$)	**0.004**	**(0.003)**	**(0.035)**
YoY%	(117)	(161)	1,256
DPS (HK$)	0.000	0.000	0.000

Year ended 31 Dec	FY04A	FY05A	FY06A
Cash Flow (HK$m)			
Op'n cash b/f work'n cap chg	8	2	(26)
Chg in working cap	(1)	(44)	2
Others	(1)	7	31
Operating cash	**6**	**(35)**	**7**
Tax	0	0	0
Net cash from operations	**6**	**(35)**	**7**
Capex	(2)	(3)	(8)
Investments	0	0	0
Dividends received	0	0	0
Interests received	2	2	1
Sales of assets	4	0	0
Investing cash	**4**	**(1)**	**(7)**
FCF	**10**	**(36)**	**0**
Issue of shares	0	0	0
Buy-back	0	0	0
Interests paid	(0)	(0)	(0)
Minority interests	0	0	0
Dividends paid	0	0	0
Net change in bank loans	2	2	(1)
Others	(11)	40	(3)
Financing cash	**(9)**	**43**	**(4)**
Net change in cash	**1**	**6**	**(4)**
Adj.			**1**
Opening cash	8	9	15
Closing cash	**9**	**15**	**12**
CFPS (HK$)	**0.010**	**(0.041)**	**0.010**

Year ended 31 Dec	FY04A	FY05A	FY06A
Ratios			
Gross margin (%)	50.1	57.6	59.7
Operating margin (%)	19.5	(5.5)	(75.7)
Net margin (%)	11.3	(6.0)	(84.0)
Selling & dist'n exp/Sales (%)	10.5	15.9	19.8
Admin exp/Sales (%)	25.7	25.9	29.3
Payout ratio (%)	0.0	0.0	0.0
Effective tax (%)	43.4	0.0	(0.8)
Total debt/equity (%)	3.1	3.8	3.7
Net debt/equity (%)	(4.6)	(9.0)	(9.0)
Current ratio (x)	1.65	2.65	2.59
Quick ratio (x)	1.54	2.47	2.44
Inventory T/O (days)	164	144	136
AR T/O (days)	20	59	44
AP T/O (days)	40	67	68
Cash conversion cycle (days)	144	136	112
Asset turnover (x)	0.17	0.21	0.24
Financial leverage (x)	1.63	1.46	1.36
EBIT margin (%)	0.2	(0.1)	(0.8)
Interest burden (x)	0.94	1.15	1.01
Tax burden (x)	0.62	0.94	1.10
Return on equity (%)	**0.0**	**(0.0)**	**(0.3)**

Year ended 31 Dec	FY04A	FY05A	FY06A
Balance Sheet (HK$m)			
Fixed assets	21	12	16
Intangible assets	55	58	28
Other non-current assets	0	0	2
Non-current assets	**76**	**70**	**47**
Inventories	7	6	5
AR	2	6	4
Prepayments & deposits	5	7	8
Other current assets	91	53	58
Cash	9	15	12
Current assets	**114**	**87**	**88**
Total assets	190	157	135
AP	2	3	3
Tax	0	0	0
Accruals & other payables	64	26	27
Bank loans	2	4	3
Finance leases	0	0	0
Other current liabilities	2	0	0
Current liabilities	**69**	**33**	**34**
Deferred tax	0	0	0
MI	4	4	6
Non-current liabilities	**4**	**4**	**6**
Total net assets	**117**	**120**	**94**
Shareholder's equity	**117**	**120**	**94**
Share capital	8	8	8
Reserves	108	112	86
Book NAV (HK$)	**0.14**	**0.14**	**0.11**
Total debts	4	5	3
Net cash/(debts)	5	11	9

Source: Company data

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Additional information is available upon request.

Head Office

Hong Kong
Kingsway Financial Services Group Limited
5/F., Hutchison House,
10 Harcourt Road,
Central, HK
Tel: 852-2877-1830
Fax: 852-2877-2665

Affiliated & Overseas Offices

Canada
Kingsway International Holdings Ltd.
Suite 1200, 8 King Street East,
Toronto, Ontario,
Canada M5C 1B5
Tel: 416-861-3099
Fax: 416-861-9027

Kingsway Capital of Canada Inc.,
Suite 1200, 8 King Street East,
Toronto, Ontario,
Canada M5C 1B5
Tel: 416-861-3099
Fax: 416-861-9027

Australia
Kingsway Capital Group Ltd.
Level 12, 32 Martin Place,
Sydney, NSW 2000,
Australia
Tel: 612-9238-3900
Fax: 612-9231-3911

China
Kingsway Financial Services Group Limited
Beijing Representative Office

Beijing Kingsway Financial Consultancy Limted
Rm 801, Building A,
Beijing Fortune Plaza,
No.7, Dongsanhuan Zhong Road,
Chaoyang District, Beijing,
100020, PRC
Tel: 8610-6530-8791
Fax: 8610-6530-8795

Shanghai Kingsway Financial Consultants Limited
Room 3303, Office Tower,
Jinmao Tower,
88 Century Avenue,
Pudong, Shanghai,
2000121, PRC
Tel: 8621-5049-0358
Fax: 8621-5049-0368

Shenzhen Kingsway Financial Consultants Limited
701, Tower A,
Aerospace Skyscraper,
4019 Shennan Road,
Futian District Shenzhen,
518048, PRC
Tel: 86-755-3333-6539
Fax: 86-755-3333-6536