Corporate Flash

International Standard Resources 0091 HK

Potential turnaround earnings from new project

- ***The company has entered into a production sharing contract with China United Coalbed Methane Corporation ("China United"), a state owned company in which China National Offshore Oil Corporation (CNOOC) holds 70% of its equity interest.***
- ***The company is expected to turn around from loss to profit after the production of CBM in Lu Ling is kicked off in FY12/15.***
- ***Concentration of CBM reserve is believed to be eight times higher in Su Nan District.***
- ***Natural gas price and government subsidies for CBM production are expected to rise, which is beneficial to the company's future earnings.***

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Stock Data (91 HK)

Rating	Not Rated
Price (HK$)	0.4
Target Price (HK$)	n.a.
12m Price Range (HK$)	0.105-0.66
Market cap. (HK$m)	1,627.6
Daily t/o (HK$m)	34.9
Free float (%)	52.7

Source: Bloomberg

The company is expected to turn around from loss to profit after the production of CBM in Lu Ling is kicked off in FY12/15. The company registered for an approved CBM reserve of Lu Ling District, 3.16b m^3 with 1.5b m^3 economically recoverable CBM reserve, from the PRC Ministry of Land and Resources in June 2014. With the current CBM wholesale price of RMB3.3/m^3 and economically recoverable CBM reserve of RMB1.5b m^3, the total revenue derivable from production in Lu Ling is expected to be RMB5.0b over the 12-16 years of steady production phase. The company has been also in a framework discussion with prospective buyers of the CBM yield, which includes some state-owned enterprises.

Concentration of CMB reserve is believed to be eight times higher in Su Nan District. Su Nan District accounts for approximately 63% of the total contract area, which is lager in size as compared to Lu Ling. However, the concentration of CBM reserve in Su Nan District is believed to be eight times higher than that of Lu Ling District. The company strongly believes there exists a CBM reserve in Su Nan District by excess of 30b m^3, implying derivable revenue of RMB48b over the 15-year production phase.

Natural gas price and CBM production subsidies from government are expected to rise. Subsidies from government are expected to increase to RMB0.4/m^3 or RMB0.6/m^3 from existing RMB0.2/m^3 given NDRC approval. Thanks to the government's encouragement of using clean energy, a reform in the price structure of compressed natural gas is going to occur that a gradual increase in price can be expected in the future.

Figure 1: Financials and valuation

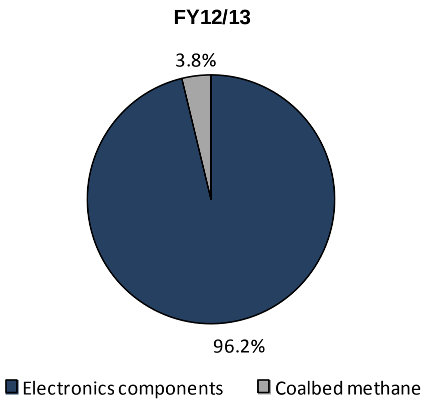
	FY12/11	FY12/12	FY12/13	1H FY 12/14
Total revenue (HKD m)	**36.4**	**37.7**	**97.9**	68.2
Revenue growth (YoY)	*-24.3%*	*3.6%*	*159.6%*	*79.0%*
PBT (HKD m)	**(565.1)**	**(257.3)**	**(453.9)**	(137.3)
PBT growth (YoY)	*2507.4%*	*-54.5%*	*76.4%*	*85.8%*
Net profit (HKD m)	**(394.1)**	**(203.0)**	**(353.8)**	(124.0)
Net profit growth (YoY)	*-4052.9%*	*-48.5%*	*74.3%*	*108.9%*
EPS (HKD cents)	**(10.0)**	**(3.1)**	**(10.1)**	(3.4)
DPS (HKD cents)	0.0	0.0	0.0	0.0
P/E (x)	n.a.	n.a.	n.a.	n.a.
Dividend yield	0.0%	0.0%	0.0%	0.0%

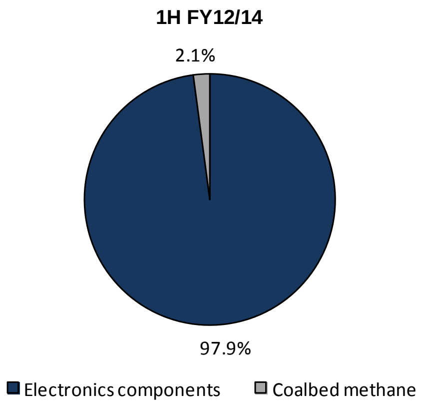
Source: Company data

Company Background

Overview: International Standard Resources Holdings Limited (International Standard Resources) is a Gas and Oil company focused on 3 segments of business: i) the exploration and exploitation of Coalbed Methane (CBM) in China; ii) electronic components distribution, such as Notebooks, mini PCs, hard drives, memory storage devices, etc.; and iii) treasury business, including securities trading and money lending business. Currently, the trading of computer components is the main revenue contributor, representing around 97.9% and 96.0% of its total revenue in 1H FY12/14 and FY12/13, respectively. The remaining businesses account for a tiny portion of total revenue (See Figure 2). In fact, the company has commenced a new business project in the exploration of Coalbed Methane since 2008. In 2008, the company acquired the entire issued capital of Merit First Investment Limited for a total consideration of HKD2.5b, with HKD2.0b satisfied by issuing convertible notes, HKD200m satisfied by issuing new shares, HKD240m satisfied by issuing promissory notes and HKD60m satisfied by cash. Upon the completion, International Standard Resources held the entire equity interest of Merit First, which in turn holds the entire equity interest in Powerful Sky, which in turn holds the entire equity interest of Can-Elite Energy Limited. Can-Elite was incorporated in Canada in 2007. Its principal business activities include coalbed methane exploration, development and production. Can-Elite has since entered into a production sharing contract with China United Coalbed Methane Corporation (China United) in 2007.

Figure 2. Revenue breakdown by segment in FY12/13 & 1H FY12/14*



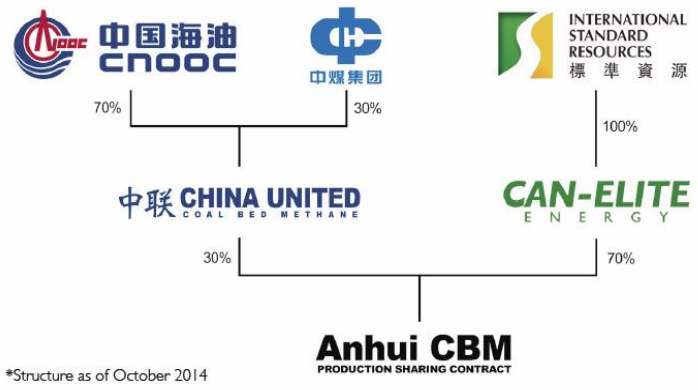


Source: Company data
**excluding treasury business*

Coalbed methane is a form of natural gas extracted from coal beds. Unlike traditional natural gas resources such as those derived from oil refinery processes, CBM is cleaner with a higher purity of methane (CH_4) under a relatively straightforward extraction process in refining the raw CBM for consumption at end-user level. It is able to transport from extraction point at on-site facilities to the location of end users efficiently by delivering compressed nature gas (CNG). Coalbed methane can be used in a variety of commercial applications such as industrial, chemical, electric and transportation purposes, etc. It can also be provided to retail consumers via pipelines in cities.

In Nov 2007, Can-Elite has entered into a production sharing contract with China United Coalbed Methane Corporation (China United), a state owned company in which China National Offshore Oil Corporation (CNOOC) holds 70% of its equity interest. Under the contract, Can-Elite can exploit the CBM resources in a total area of approximately 567.8 km^2, located in Anhui Province, for a term of 30 years from Apr 2008. The profit sharing ratio between Can-Elite and China United is 70:30. The project is divided into three phases; exploration period, development period as well as production period. During the exploration period, the company will conduct core testing and run pilot production to evaluate the potential commercial value of the CBM field. This period will last for around five years starting from 2008 and is completed this year. For the development period, stages towards CBM production will be carried out, including planning, design, construction, installation, drilling, developing transportation systems and related research work. During the final production period, extraction, injection, storage and transportation will take place. In 2013, there were eighteen gas wells constructed on site, of which seven wells were under operation.

Figure 3. Shareholding structure of Anhui CBM Production Sharing Contract



Source: Company data

Our views

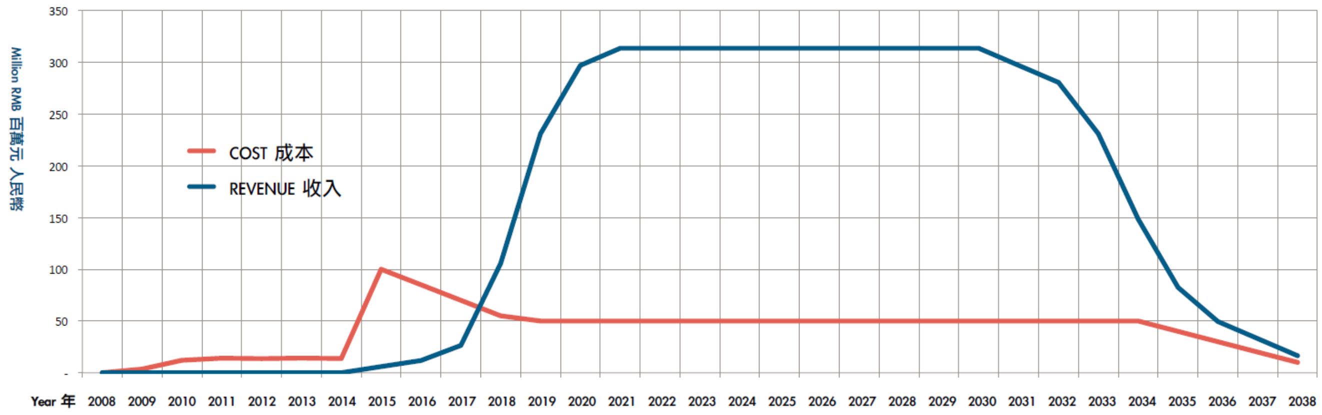
Potential turnaround from loss to profit after the production of CBM in Lu Ling is kicked off in FY12/15. The contract area is divided into two production districts; Lu Ling (211.0 km^2) and Su Nan (356.8 km^2). The exploration phase of the smaller district Lu Ling was completed in early 2014. This area accounts for 37.2% of the total contract area. More importantly, the company registered for an approved CBM reserve in the area, 3.16b m^3 with 1.5b m^3 economically recoverable CBM reserve, by PRC Ministry of Land and Resources in June 2014. This is an important issue for the company estimating the expected profit generated in the future. With the current CBM wholesale price of RMB3.3/m^3 and economically recoverable CBM reserve of RMB1.5b m^3, the financial forecast for revenue derivable from production would be RMB5.0b. The fixed and lifetime variable cost is estimated at RMB1.4b. Moreover, there is RMB0.4 of subsidies from the PRC Central Government for every m^3 of production. Therefore, net profit attributable to the project under Lu Ling District is expected to be approximately RMB3.2b. Since International Standard Resource shares 70% profit under the contract, the company will be expected to generate a net profit of RMB2.2b over an estimated 12-16 years of steady production phase for the project in Lu Ling District. Due to the potential profit generating asset of the proven CBM reserve, it is expected that the valuation will be adjusted.

Figure 4. The contract area

Source: Company data

From the project timeline of Lu Ling District, the company is expected to complete evaluation reports on 15 test-wells as well as associated assessments this year. At the same time, solid prospective sales partners, including wholesalers and retailers, will be sought during the long-term gas production phase. The company has also been in framework discussions with prospective buyers of the CBM yield, which includes some state-owned enterprises. In addition, the company targets to monetize the small-scale test-well groups to regional buyers with a production goal of 10k m^3 per day before June 2015. During the period, it is also expected that the company will be granted official approval from the PRC National Development and Reform Committee (NDRC). The company is expected to increase its production output gradually and reach full-scale production phase with a projected production goal of 95m m^3 per year by 2020.

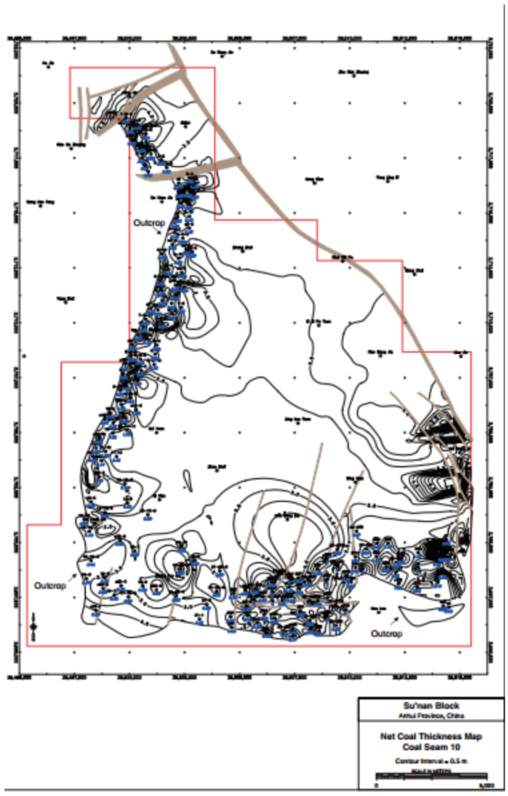
Figure 5. Projected revenue and cost in Lu Ling District



Source: Company data

Concentration of CMB reserve is believed to be eight times higher in Su Nan District. Su Nan is located beside Lu Ling in Anhui Province. This area accounts for 63% of the total contract area that is a larger in size compared to Lu Ling. However, a denser concentration of CBM reserve is believed to exist, which is eight times higher than that of Lu Ling District. Through early scientific findings, the company strongly believes there is a CBM reserve in excess of 30b m^3, implying derivable revenue of RMB48b over 15-year production phase. The project in Su Nan is still in the exploration phase, but the company is expected to be granted an approved reserve report certified by the NDRC in 2016, after which the project cycle in Su Nan will be similar to Lu Ling. In short, total output will be able to reach a steady production state for 12-16 years, with Lu Ling District at 95m m^3 per year and Su Nan District at 750m m^3 per year.

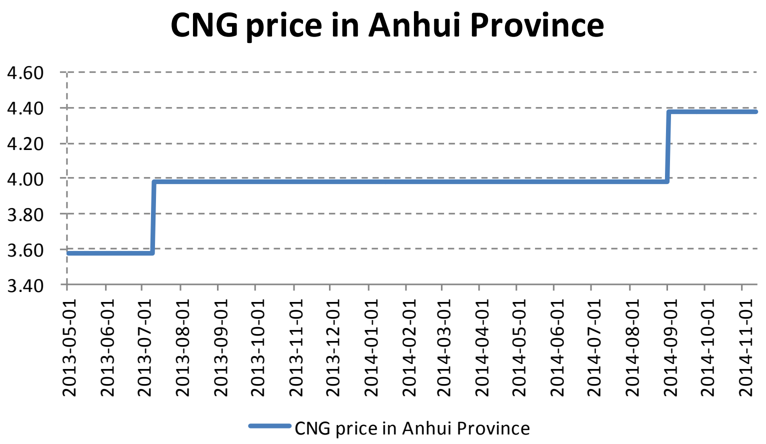
Figure 6. Net coal thickness map in Su Nan



Source: Company data

Natural gas price and CBM production subsidies from government are expected to rise which will benefit the company's earnings. Since air pollution is an important issue in China, the government encourages supplying clean energy sources in which natural gas is one of those. Thus, the incentive policy in the form of CBM production subsidies has been put in place. Subsidies from the government are expected to be raised to RMB0.4/m^3 or RMB0.6/m^3 from existing RMB0.2/m^3 given NDRC approval. We think this move will have a positive effect to the net profit generated. On the other hand, Provincial Price Bureau in China currently controls the retail price of compressed natural gas. Thanks to the government's encouragement of using clean energy, a reform in the price structure of compressed natural gas is going to occur so that a gradual increase in price can be expected going forward. In July 2013, Anhui Price Bureau increased the retail price of natural gas by RMB0.4/m^3. Later on, a further upward adjustment of RMB0.33/m was made, reaching RMB4.38/m^3. In our opinion, a gradual increase in price can be expected in the future. This is a critical factor affecting the total potential revenue of the project.

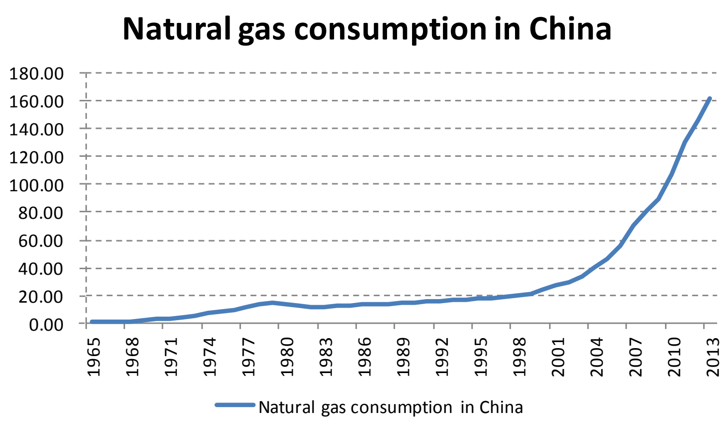
Figure 7. CNG price in Anhui Province



Source: Wind

Overall CBM industry development will be boosted by the persistent demand in natural gas. In a foreseeable period of time, the PRC Central Government will try to reform the domestic natural gas market towards a market-driven market where price level is dependent on the supply and demand of the market. By general consensus, growth of the demand in natural gas will progressively rise under continuous growth of economic activity. Certainly, it will boost the overall CBM industry development. International Standard Resources, being a CBM producer, will benefit under this circumstance.

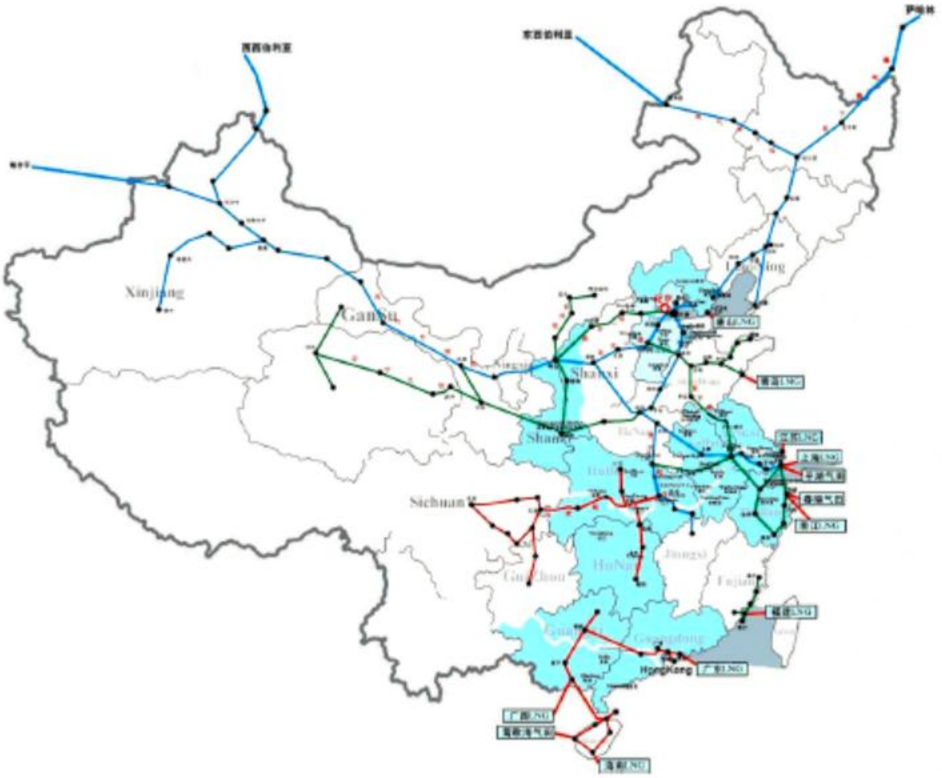
Figure 8. Natural gas consumption of unit 1b m^3 in China



Source: Wind

Geographical advantage of the CBM field allows for greater price flexibility. The retail price level of CBM in the western China is different to that in the East. Major natural gas pipelines were constructed from the West to the East. Many natural gas productions are originated from the Central-Northern and Western part of the country. Therefore, the logistics of natural gas are costly. Yet, Anhui Province, which the contract area is located, is situated between a one of the major West-to-East pipelines. This helps facilitate International Standard Resources to transport CBM with fewer logistics costs since the distance from the pipeline to the producer is relatively shorter. Moreover, a shorter distance of logistic routes also implies a lower risk in operating loss. As a result, the company will enjoy a greater operational margin against its competitors.

Figure 9. Major natural gas pipeline network in China, 2013



Source: Company data

Valuation

As mentioned, the potential revenue generated from the new CBM project of the company is substantial. If the current production is to reach to full-scale production phase as expected in Lu Ling District, the asset value of the CBM reserve will be fully adjusted on the company's book value. Its P/B will be greatly lower than other HK-listed Gas and Oil companies, which are trading at an average 1.5x of P/B. The company is currently trading at a 1.1x of P/B, slightly lower than the P/B of its peers. Furthermore, the three-month average turnover of the company is significantly higher than its peers. Its higher liquidity provides less market impact for potential buyers and sellers. We think that if the project is able to generate revenue as expected, its valuation will be revised upward to a great extent.

Figure 10. Peer comparison

Company	Ticker	Mkt Cap (HK$ m)	3M avg turnover (HK$ m)	2013 P/E (x)	2014E P/E (x)	2015E P/E (x)	P/book (x)	ROIC (%)	ROE (%)	ROA (%)	Dvd Yield (%)	Net Debt/Total Equity
International Standard Resources	**0091 HK**	**1,627.6**	**34.9**	**n.a.**	**n.a.**	**n.a.**	**1.1**	**n.a.**	**(26.3)**	**(13.7)**	**0.0**	**41.6**
Hoifu Energy	0007 HK	1,590.0	5.4	n.a.	n.a.	n.a.	5.1	n.a.	(12.2)	(6.2)	0.0	(42.6)
New Times Energy	0166 HK	443.2	8.3	n.a.	n.a.	n.a.	0.1	n.a.	(2.1)	(1.9)	0.0	6.3
Yanchang Petroleum International	0346 HK	4,615.3	5.8	50.0	n.a.	n.a.	0.4	1.1	0.8	0.7	0.0	(5.4)
Energy International Investments	0353 HK	279.8	1.9	n.a.	n.a.	n.a.	0.2	n.a.	(21.5)	(14.3)	0.0	(0.5)
United Energy	0467 HK	15,028.3	0.9	11.4	9.6	7.9	1.8	11.4	16.7	8.0	0.0	41.6
EPI	0689 HK	820.0	2.5	n.a.	n.a.	n.a.	2.5	n.a.	(240.8)	(92.5)	0.0	142.5
Sino Oil and Gas	0702 HK	3,590.8	11.4	n.a.	n.a.	100.0	0.9	n.a.	(0.9)	(0.7)	0.0	17.4
PetroAsian Energy	0850 HK	1,741.1	14.5	n.a.	n.a.	n.a.	2.9	n.a.	(23.9)	(16.6)	0.0	(1.9)
Brightoil Petroleum	0933 HK	22,179.2	21.2	37.0	15.8	15.8	2.9	n.a.	8.3	2.7	0.0	47.6
Sinopec Kantons	0934 HK	16,557.8	37.6	26.0	22.0	15.9	1.6	n.a.	6.5	6.1	0.7	(16.5)
Enviro Energy International	1102 HK	681.2	2.9	n.a.	n.a.	n.a.	0.5	n.a.	(15.5)	(8.0)	0.0	(3.9)
Citic Resources	1205 HK	8,812.8	5.0	n.a.	53.3	12.0	0.8	n.a.	(11.2)	(5.6)	0.0	57.4
MIE	1555 HK	2,816.4	5.2	14.6	7.1	9.0	0.6	4.8	4.2	1.6	2.8	91.1
Sunshine Oilsands	2012 HK	2,998.9	7.0	n.a.	n.a.	n.a.	0.4	n.a.	(3.2)	(2.8)	0.0	(1.8)
Polyard Petroleum International	8011 HK	472.8	0.5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	0.0	10.3
China CBM Group	8270 HK	525.1	0.5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	0.0	25.8
	Average	**5,197.0**	**8.2**	**27.8**	**21.6**	**26.8**	**1.5**	**5.8**	**(21.1)**	**(9.3)**	**0.2**	**23.0**

Source: Bloomberg

**International Standard Resources is not include in the average figures.*

Figure 11. Per share items

	FY12/11	FY12/12	FY12/13	1H FY12/14
EPS (HK cents)				
- Basic (HK cents)	(10.0)	(3.1)	(10.1)	(3.4)
- Diluted (HK cents)	(10.0)	(3.1)	(10.1)	(3.4)
DPS (HKD cents)	0.0	0.0	0.0	0.0
BVPS (HKD)	0.6	0.5	0.4	0.3

Source: Company data

Figure 12. Ratio analysis

	FY12/11	FY12/12	FY12/13	1H FY12/14
Growth (YoY)				
Revenue	-24.3%	3.6%	159.6%	79.0%
Loss before tax	2507.4%	-54.5%	76.4%	85.8%
Net loss	-4052.9%	-48.5%	74.3%	108.9%
Margins				
EBIT margin	-1517.8%	-658.1%	-391.2%	-141.4%
Net profit margin	-1083.4%	-538.4%	-361.5%	-181.8%
Other ratios				
Return on average assets	-10.3%	-6.0%	-11.5%	-4.1%
Return on average equity	-20.2%	-11.0%	-21.7%	-7.8%
Dividend payout ratio	0.0%	0.0%	0.0%	0.0%
Valuation measures				
P/E (x)	n.a.	n.a.	n.a.	n.a.
P/B (x)	0.7	0.8	1.0	1.2
Dividend yield	0.0%	0.0%	0.0%	0.0%

Source: Company data

Figure 13. Income statement (HKD m)

	FY12/11	FY12/12	FY12/13	1H FY12/14
Revenue	**36.4**	**37.7**	**97.9**	**68.2**
Cost of sales	(23.3)	(29.1)	(88.6)	(68.9)
Other revenue and other income	5.4	5.3	6.0	0.6
Administrative expenses	(44.3)	(42.1)	(46.0)	(23.4)
Impairment loss on poduction sharing contract	(424.3)	(100.7)	(283.5)	0.0
Amortisation of production sharing contract	(132.9)	(119.5)	(117.8)	(53.2)
Loss on restructuring of convertible notes	0.0	0.0	(7.4)	0.0
Impairment loss on available-for-sale financial assets	(0.7)	0.0	0.0	0.0
Fair value gain on convertible notes' embedded derivative	30.0	0.1	56.5	(19.7)
Gain on redemption of convertible notes	1.6	0.1	0.0	0.0
EBIT	**(552.1)**	**(248.1)**	**(382.8)**	**(96.4)**
Interest	(13.0)	(9.2)	(71.1)	(40.9)
Profit before tax	**(565.1)**	**(257.3)**	**(453.9)**	**(137.3)**
Income tax	136.6	54.3	100.1	13.3
Gain from sale of disposal group held for sale	34.4	0.0	0.0	0.0
Net profit	**(394.1)**	**(203.0)**	**(353.8)**	**(124.0)**
Owners of the company	(393.4)	(202.2)	(353.2)	(123.8)
Non-controlling interests	(0.7)	(0.7)	(0.6)	(0.2)
Total profit	**(394.1)**	**(203.0)**	**(353.8)**	**(124.0)**
EPS (HK cents)				
- Basic (HK cents)	-9.99	-3.05	-10.1	-3.43
- Diluted (HK cents)	-9.99	-3.05	-10.1	-3.43

Source: Company data

Figure 14. Balance sheet (HKD m)

	FY12/11	FY12/12	FY12/13	1H FY12/14
Non-current assets				
PP&E	44.2	59.6	59.8	57.1
Intangible assets	3,196.9	2,995.6	2,648.2	2,589.0
Available-for-sale financial assets	1.0	1.0	1.0	1.0
Total Non-current assets	**3,242.2**	**3,056.2**	**2,708.9**	**2,647.1**
Current assets				
Financial assets at fair value through pofit or loss	21.8	27.7	31.0	25.5
Trade and other receivables	88.8	89.8	99.7	102.7
Others	30.0	0.0	4.1	11.8
Cash and bank balances	167.8	81.7	42.3	47.1
Total current assets	**308.4**	**199.1**	**177.1**	**187.1**
Non-current liabilities				
Convertible notes-liability portion unsecured	(751.4)	0.0	(529.0)	(563.0)
Convertible notes-embedded derivatives, unsecured	(0.1)	0.0	(156.4)	(176.1)
Deferred taxation	(799.2)	(748.9)	(671.0)	(647.3)
Total non-current liabilites	**(1,550.7)**	**(748.9)**	**(1,356.4)**	**(1,386.4)**
Current liabilities				
Other borrowing, unsecured	(19.1)	(17.6)	(15.8)	(14.7)
Convertible notes	0.0	(687.0)	0.0	0.0
Trade and other payables	(35.7)	(45.9)	(38.2)	(37.2)
Taxation payable	(2.7)	(2.3)	(2.1)	(2.1)
Total current liablilites	**(57.4)**	**(752.9)**	**(56.1)**	**(54.0)**
Net assets	**1,942.4**	**1,753.6**	**1,473.5**	**1,393.8**
Equity				
Equity attributable to owners of the company	1,943.5	1,755.5	1,512.0	1,396.5
Non-controlling interests	(1.1)	(1.9)	(2.5)	(2.7)
Total Equity	**1,942.4**	**1,753.6**	**1,509.5**	**1,393.8**

Source: Company data

Figure 15. Cash flow statement (HKD m)

	FY12/11	FY12/12	FY12/13	1H FY12/14
Net cash generated from operating activities	**(159.7)**	**7.5**	**(52.5)**	**(15.1)**
Net cash flow from investing activities	**42.6**	**(18.4)**	**0.8**	**(12.6)**
Net cash flow from financing activities	**(70.4)**	**(75.1)**	**18.7**	**31.3**
Net increase/decrease in cash and cash equivalents	(187.6)	(86.0)	(33.0)	3.5
Cash and cash equivalents at the beginning of the year	353.6	164.6	78.5	42.1
Effect of foreign exchange rate changes	(1.5)	(0.1)	(3.4)	1.5
Cash and cash equivalents at end of year	**164.6**	**78.5**	**42.1**	**47.1**

Source: Company data

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SELL : absolute downside of >10% over the next six months

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