

China Metro Rural Holdings' Earnings Report Suggests Continued Revenue Growth in 2012

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The challenging financial climate of 2011 was marked by uncertainties in all regions of the world, with an economic recession seen in the U.S., immense earthquake and tsunami damage done to the infrastructure in Japan, and a sovereign debt crisis that was seen developing in multiple Eurozone member nations. At the same time, consumer inflation price pressures in China led to a tightening of monetary policy in a move that, in theory, would be restrictive of business performance for companies in the region.

Despite all of the factors, however, China Metro Rural Holdings (CNR) managed to maintain its historically strong level of performance and its agricultural logistics interests posted net revenues of HK\$109,756,000 for the six months prior September 30, 2011 and an increase in gross profit percentage of 45.9% for the same period.

Previous Earnings Suggest Strong Performance in 2012

What is most encouraging for the future stock performance of the company is that the China Metro Rural managed to turn in these results during a global economic slowdown that has since shown signs of stabilizing, as the GDP figures in the U.S. have returned to positive



territory, the rebuilding effort in Japan has led to sharp rallies in their equity markets, and the potential contagion effects from the debt crisis in Europe have shown to have a far lesser impact than was previously thought to be the case. This bodes well for the company's next earnings report, which will be released next month and will show the profit performance for the previous 6 months. Given that China Metro Rural has shown an ability to post strong earnings performances during times of extreme economic uncertainty, management within the company is optimistic that the trend will continue and that the company

will continue to build on its previous successes.

Part of the reason for this optimism comes from their new projects, Dezhou and Qiqihar, are under the pipeline, after leveraging on their success on Tieling project. These programs are being aided by supportive tax policies from the Chinese government, which will aid in China Metro's plans to expand further into the country's second and third tier cities.

Essential Regional Programs: Tieling, Dezhou and Qiqihar

A significant portion of CNR's current program operations include

◀ developments in Tieling, Dezhou and Qiqihar. In Tieling, the first of the three programs to reach operational status, the company is focused on expanding its sales and marketing strategies as a means for enhancing the core competitiveness of the project and placing the market's focus squarely on China Metro rather than newer industry members entering into the agricultural trading space. In the six month period ending September 30, 2011, China Metro rural had sold roughly 27,000 square meters of space in the Tieling region of China.

In the Dezhou Project (which started in October of 2010), the company attracted nearly 1,900 potential buyers making reservations to purchase trade center units within the first year of the program's inception. These purchase reservations make up approximately 160,000 square meters of gross floor area, which makes it one of the most attractive aspects of the company's sales strategy moving forward. The population and GDP growth rates of Dezhou are even bigger than what is seen in Tieling, so the scope for increased revenues in the city is easy to envision. The Dezhou project has already started to contribute to 2012 revenue and is one of the main reasons for optimism for CNR's next earnings report.

The project in Qiqihar is in its earliest stages but even in its preliminary phase, the goal of the program will be to bring value to the company by allowing China Metro Rural to enter into a new aspect of the industry and capitalize on emerging trends that are forecasted to bring continued revenue growth. Local governments in the area are looking for ways to solve its infrastructure shortages and to improve on the quality of its commercial residential properties. To

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achieve this, the local government in Qiqihaer will give China Metro Rural 5 square kilometers for competitive cost and supportive policies. Plans for this area are heavily focused on "green" technologies and geared toward high-end business and residential structures to attract a high net-worth tenant base.

Forecasts for Industry Performance

In terms of its macroeconomic outlook, CNR is currently preparing for an increase in uncertainty and volatility in the wider economy over the next three months, but the company expects this environment to stabilize and return to growth in the next 12 months. This expectation equates to a positive outlook for both CNR and the Chinese Logistic market as a whole, as many analysts expect lower inflation in China to allow monetary policy in China to become less restrictive. In addition to this, the fund's management team expects that, politically, 2012 could be a year of reform and deregulation, given that we will see a change in leadership in China. The trends of the last decade have shown that China is moving increasingly toward a more open consumer environment that is

conducive to business growth and most of the evidence suggests that this will continue in 2012.

Key Themes for 2012

According to the managerial team, key themes in 2012 that will affect the profit performance of CNR will likely center on increases in consumer spending, social housing, tax reforms, deregulation within the Agriculture industry, and in the development of new strategic industries. "At CNR, we think China's growth will be based more on domestic demand, social welfare, and structural reforms, and less on infrastructure, investment, and exports," says Sam Sio, Chairman of CNR. Given that this expectation is mostly protected from external risks (for example, debt contagion from the Eurozone) fund inflows and expansion in investment is likely to remain positive.

Specifically, we will see some critical events that should provide a positive catalyst for revenue growth in CNR. First will be the National People's Congress meeting, held in March of 2012. It is at this meeting that deregulation and new policy directions are scheduled for announcement. In addition to this, a majority of market analysts are forecasting that the People's Bank of China will further reduce its reserve ratio requirements (RRR) in commercial banks, in a move which is intended to increase the amount of loan applications in these banks, and stimulate overall growth and productivity. At the same time, however, there are some potentially negative catalysts that have also been identified. Of primary importance are the potential insolvency risks that are seen for some listed property developers. If we see this type of event occur in conjunction with credit rating



◀ downgrades (or evidence of a major recession in the EU) we will likely see downward revisions to earnings forecasts not only for CNR but for equity prices across the globe. With this in mind, CNR is taking a longer-term view in its strategic approach.

Supportive Macroeconomic Factors

Looking at the growth trends of the last several decades, it has become readily apparent investors should focus their attention on economic trends in Asia. Despite a slowdown in global growth last year, there is evidence of stabilization, which many expect to continue as central banks reduce lending restrictions. "We expect monetary policy headwinds in Asia to ease as inflation fades. We also believe the earnings risk and risk of a recession (though not a financial crisis) is currently priced-in. Fortunately, equities tend to perform well when inflation is falling and growth stabilizing," says Sio.

When looking at specific aspects

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of the macroeconomic environment both globally and within Asia, we can see some critical fundamental factors that are supportive of CNR's plans for growth this year. First, we can look at consumption upgrades in China, which have resulted in rapid increases in agricultural prices and labor wages. These pricing pressures have increased the wealth of individual Chinese consumers, with most of the growth seen in rural areas of the country. As long as these trends continue, it is expected that consumer spending will continue to be driven higher.

Next is the social housing

program being implemented by the government. With 10 million public housing units planned for 2012, there are currently 12 million total units now under construction. Of these, 8 million units are scheduled to be completed and made available next year. These urban rural migration exercises create additional business opportunities to CNR that will not be seen in other types of industries. Tax reforms scheduled for implementation in 2012 are also seen as supportive for the company, as most analysts expect the Chinese government to review and improve its current tax regime. Some of the potential changes could have far-reaching effects on the Agricultural logistics sector and put upward pressure on equity prices on the companies within that sector.

First of the expected reforms is the cancellation of the current business tax program and its conversion into a Value-Added Tax (VAT) program. A policy change of this sort will allow trading platforms that are currently being run by CNR to operate in a fuller capacity, and create additional revenue growth that will benefit the company. The second major alteration will likely be changes made to simplify approval processes so that a larger number of projects can be put into motion from their planning phases.

The last major reform is likely to be seen with a renewed government focus on supporting new strategic industries over the next five to 10 years. According to China's 12th Five-year Plan (FYP), the seven new strategic industries (as determined by the State Council) include energy conservation and environmental protection, alternative energies (solar, wind, nuclear), new materials and logistics, IT, bio-technology & agriculture, high-end equipment, and ▶

◀ alternative energy-equipped cars. Here, analysts expect a combination of tax reductions, subsidies, accommodative financing, and R&D support to aid in the performance of these industries.

The MAP Approach

In terms of business models, CNR has taken a "MAP" approach to the industry, which relies on Market Penetration and Development, Alternative Channels for Growth, and Product Development. "The least risky growth strategy for any business is to simply sell more of its current product to its current customers—a strategy perfected by large consumer goods companies," says Sam Sio. "Think of how you might buy a six-pack of beverages, then a 12-pack, and then a case. For our traders, we will offer three major markets for them in Northern China, so when you trade in Tieling, you can also trade in Dezhou, and so on."

The next step in the approach is to devise a way to sell more products to an adjacent market, to effectively offer the product or service to customers in another city or province. This approach helps protect against external shocks and provides a greater level of diversification in the consumer base. CNR's varied approach offers investors a protected position stance in the current economic climate, which is marked by high levels of volatility and uncertainty. In addition to this, an Alternative Channels growth strategy allows traders to pursue a variety of different purchasing venues. Specifically, this includes options such as internet trading services and warehouse developments that will appeal to a broader consumer base. Finally, Product Development strategies are constructed to provide logistic centers, not only

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for agricultural products but also for small industrial appliances and residential homes to facilitate the current trends in urban and rural migration.

The Global Outlook: Three Potential Possibilities

Given that CNR has historically shown strong performances in times of economic volatility, the key question going forward will be the extent to which external global factors can influence the company's revenue potential. CNR has taken many steps to protect against these external shocks but given the inter-related nature of the modern economy, external factors need to be considered as well. To achieve this, CNR has made preparations for three potential outcomes for global economic performance this year.

The first possibility is that the current debt crisis in Europe shows a slow to moderate progression with lower risk premiums and the likely effect is that Asian equities end positively in 2012. The second forecasted possibility is that the debt crisis in Europe worsens, and this would likely create a robust policy response from the European

Central Bank. The negative effects of these changes would weigh on Asian equities and could potentially lead stocks to fall to roughly 1x book value during the first half of the year. Even in this scenario, however, a recovery would be expected (with stocks performing similar to the recoveries seen in 1999 and 2009, where stocks improved to 1.9x book value before the end of the year). The final (and worst case) scenario would be that central bank policy measures become an outright failure and equity markets drop sharply as a result. Policy failures of this type would put pressure on global equities even if aggressive counter measures were implemented in Asia and this could have a dragging (if only limited) effect on CNR's yearly revenue performance.

In terms of probabilities, CNR expects the one of the first two positive scenarios to unfold: "We think scenarios one and two are more likely, and expect Asian equities to be higher by year end 2012 on this basis," Sam Sio says. The company, however, is preparing for each of these scenarios with a larger number of variables seen in more immediate timeframes: "In the short-term, with policy uncertainties still present, we are taking a protective stance, but with Asian productivity expected to fuel portfolio growth in 2012, we think that the negative scenarios are unlikely to materialize," Sio explains. Perhaps the most encouraging aspect of CNR's approach is that protective strategies are being implemented while global growth is still managing to show signs of stabilization. With this in mind, profit performance for the company looks set to continue in its historically positive direction.

At the time of publication, the author holds no position, long or short, in China Metro Rural. ■