

GLG Life Tech

Moving ahead with formal Luo Han Guo deal

Update – contract
and results

Pharma & biotech

20 August 2014

Price **C\$0.25**

Market cap **C\$8m**

C\$1.09/US\$

Net debt at Q214 (includes C\$3.3m convertible notes and C\$6.0m interest payable) C\$81.9m

Shares in issue 33.4m

Free float 57%

Code GLG

Primary exchange TSX

Secondary exchange N/A

Share price performance



% 1m 3m 12m

Abs (11.1) (52.9) (79.3)

Rel (local) (12.3) (55.9) (83.2)

52-week high/low C\$1.20 C\$0.22

Business description

GLG Life Tech is a vertically integrated supplier of stevia-derived extracts primarily for use as low-calorie, high-intensity sweeteners (HIS) in the food and beverage industries. It sources stevia in China and processes extracts at its China-based facilities.

Next events

Q314 results November 2014

Q414 results March 2015

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GLG has signed a 12-month agreement to sell between US\$9m and US\$12m of Luo Han Guo (LHG) extract to an undisclosed customer. This transaction cements the firm's move to diversify its revenue stream beyond stevia, and should help improve margins starting in Q414. Our C\$144.2m NPV is derived from our projection that the company will return to generating consistently positive EBITDA in 2016, supported by the LHG business and the harvesting of higher-yielding leaf as part of GLG's core stevia business.

Year end	Revenue (C\$m)	PBT* (C\$m)	EPS* (C\$)	DPS (C\$)	P/E (x)	Yield (%)
12/12	21.7	(24.3)	(0.89)	0.0	N/A	N/A
12/13	16.0	(21.7)	(0.55)	0.0	N/A	N/A
12/14e	25.2	(15.4)	(0.46)	0.0	N/A	N/A
12/15e	51.5	(11.0)	(0.31)	0.0	N/A	N/A

Note: *PBT and EPS are normalised, excluding intangible amortisation, exceptional items and share-based payments.

Validation of firm's foray into the LHG market

The transaction provides a material validation of the firm's efforts in recent months to incorporate LHG extracts (mainly mogroside V) as part of its operations. GLG has secured LHG raw material supply from Chinese suppliers in recent months, and is working on completing modifications to its Runhai processing facility to commence shipping extract to the customer in Q414.

Increased utilisation should improve profitability

Once LHG operations begin, increased capacity utilisation at GLG's Runhai facility should improve the firm's overall margins, as the site had been mostly idle since mid-2011 and GLG had been recording expenses due to the fixed costs for maintaining the site. GLG expects long-range LHG extract gross margins in the c 20-30% range.

Working on differentiated LHG offerings longer term

GLG is also developing LHG seedlings (over the next two to five years) that would produce crop with higher extract content, along with proprietary formulations combining LHG and stevia. These offerings could result in more competitive pricing, strengthen GLG's positioning in the emerging LHG market and justify future initiatives to further expand the firm's LHG extract processing operations.

Valuation: NPV of C\$144m, equity valued at C\$62.4m

Our model previously assumed that GLG would generate C\$12.3m in LHG and other extract revenues in 2015. However, given the formal announcement of a secured LHG contract, we have increased confidence that such LHG-related revenues will be realised, and we have mildly raised our sales forecasts for LHG and other non-stevia extracts. This leads to a mildly increased NPV of C\$144.2m (from C\$136.3m, previously).

Update: GLG secures key Luo Han Guo contract

Validation of firm's foray into the Luo Han Guo market

GLG Life Tech announced on 23 July that it has signed a 12-month agreement (with potential for renewal) with an undisclosed global food industry participant (situated outside Asia), whereby GLG would produce and supply Luo Han Guo (LHG) extracts (such as mogroside V, the primary zero-calorie ingredient conveying sweetness in this plant). GLG expects revenues from this agreement to be in the range of US\$9-12m, and that it will commence shipping product and recording revenue in Q414, with the bulk of revenue from the arrangement recognised in H115. GLG qualifies that the revenues called for as part of the arrangement will depend on the market price of LHG extracts, and we estimate the firm's current guidance is based on the current market pricing for 50% mogroside V extracts at about US\$350-400/kg.

The transaction provides material validation of the firm's efforts in recent months to incorporate LHG extracts as part of its operations. The firm has secured supply relationships in recent months with farmers based in China to gain access to LHG raw material. In order to produce commercial volumes, it is continuing to work on completing modifications to its Runhai processing facility to enable the production of LHG extracts meeting desired specifications. Management is confident that these adjustments will be completed prior to Q414 (when initial shipments of LHG extracts to the customer are scheduled).

While mogroside V is currently considerably more expensive than high-purity Rebaudioside A (RebA, the primary commercial stevia extract, with an estimated market price of US\$100-125/kg) for an equivalent level of "sweetness", this ingredient is believed to convey less bitterness and could potentially cater to a wider variety of food and beverage applications. Nonetheless, the LHG market as it stands is in its infancy (compared to other natural sweeteners such as stevia), and its actual size (in value) is not fully known. However, GLG believes that the terms of the transaction will position it as one of the leading players for this ingredient. Notable competitors in the LHG space include BioVittoria (which has a customer relationship with Tate & Lyle), Guilin Layn Natural Ingredients Corp, Blue California and Niutang.

GRAS filing for LHG extracts likely a key catalyst

We believe that a catalyst that facilitated the securing of the contract is the Generally Recognized as Safe (GRAS) notification filed with the FDA by GLG in May 2014 for its LHG extract products (consisting of extracts containing 30%, 50% and 60% purity mogroside V), enabling their usage in food and beverage (F&B) products for the US market. These LHG extracts can legally be incorporated in US F&B products, as long as the FDA does not issue an objection letter to restrict their use (which we do not anticipate). While this has not been confirmed, we expect that the customer intends to include the US market as part of its commercial reach for F&B products that will contain GLG's LHG extracts. Even for territories outside the US, the GRAS filing provides a dossier of (safety) information on the ingredient to support its use.

Increased capacity utilisation should improve GLG profitability

Once LHG extraction and sales operations to the customer begin, increased GLG utilisation at its Runhai facility should improve the firm's overall margins. GLG expects long-range LHG extract gross margins in the c 20-30% range. With the Runyang facility having been mostly idle since mid-2011 (and with some of GLG's other processing facilities including Runhai working below peak capacity), GLG had been recording capacity charges in its financial statements; these charges related to the fixed overhead costs of maintaining and/or running GLG's processing facilities while

they were operating below peak or optimal utilisation. LHG extract revenue should improve company-wide capacity utilisation, which should lead to lower capacity charges.

Future tier of LHG revenues would require additional capex

GLG estimates that the present contract will tie up the majority (c 75%) of its currently planned LHG processing capacity (at the Runhai facility). We estimate GLG's planned capacity at 35-40Mt (metric tonnes) of >50% purity mogroside V extract per year. While we believe GLG can support an additional US\$3-4m in LHG extract orders (such as from additional potential customers) at current market prices, any further demand would prompt the need for future LHG processing capacity. We estimate GLG will need to undertake additional capex modifications (which can cost up to US\$3m) to add an incremental US\$15m in LHG extract revenue. Given GLG's current high balance sheet leverage (C\$81.9m net debt on 30 June 2014), we estimate the firm will be very cautious towards investing to increase its LHG processing capacity until company-wide operations reach sustainable profitability (which depends on continued improvement in its core stevia business) or until its leverage is reduced (such as through asset sales of underutilised processing facilities).

In the longer term, GLG is also developing and breeding LHG seedlings (over the next two to five years) that would produce a crop with a higher mogroside V extract content, which can lead to more competitive LHG extract pricing and more consistent LHG extract commercial availability. The firm is also developing a proprietary LHG/stevia combination extract that combines the benefits of each ingredient to provide a clean sweet taste profile without aftertaste, and that would be competitively priced in relation to single ingredient mogroside V extracts. Improving raw material costs and/or marketing unique competitively priced offerings could strengthen GLG's positioning in the LHG market and could help justify future initiatives to expand LHG extract processing operations.

Naturals+ revenue driver likely; COFCO guided towards 2015

GLG expects to win contracts as part of its GLG's Naturals+ initiative in H214. The GLG Naturals+ unit, which started in fall 2013, involves the company using its existing customer relationships to market and re-sell China-sourced food ingredients complementary to stevia (such as fructose, erythritol, inositol, inulin and lycopene) to F&B industry participants. Management indicates that it has had good progress in discussions with multiple potential customers and believes it can secure contracts (with combined annual revenue potential in the US\$2-3m range) in H214.

The firm is also continuing R&D formulation work with China National Cereals, Oils and Foodstuff Corporation (COFCO) as part of their partnership to develop and formulate stevia-sweetened F&B products for intended distribution in China.¹ GLG indicates that it does not expect any revenue from its collaboration with COFCO until 2015. We continue to believe that, given the size of the Chinese market, the longer-term extract sales potential to COFCO could be substantial, but we do not make specific forecasts for this opportunity in our financial model.

Q2 results show positive gross margins

GLG reported Q214 results on 12 August, with revenue (essentially from the sale of stevia extracts) of C\$4.0m (+16% y-o-y), gross profit of C\$1.85m and an EBITDA loss of C\$0.39m. Note that our cost of sales and G&A expense calculations differ slightly from the firm's reported statements, as we remove depreciation and amortisation components from these items (the reported figures are inclusive of such amounts). Our EBITDA calculation also differs from the firm's reported figures, as we do not exclude certain components such as non-cash share compensation from our EBITDA assessment. While stevia extract revenue was below our C\$7.3m estimate, profitability was above our expectations, with a gross profit of C\$1.85m (ahead of our estimate of breakeven). As in Q114,

¹ COFCO and its subsidiaries will be responsible for the marketing and distribution of products developed under the collaboration.

international (ex-China) sales doubled year-over-year (reflecting 51% of revenue vs 31% in Q113), and the firm continued to move away from one-off sales of lower-margin and lower-purity extracts to customers based in China. Other factors driving improved profitability include increased stevia extract pricing, lower capacity charges² (C\$1.2m in Q214 vs C\$1.7m in Q213), and lower raw material costs (as higher-extract yielding leaf strains comprise a higher proportion of sourcing inputs). In H114, the majority of leaf processed in GLG's operations arose from its inventory of earlier-generation (H1 or H2) leaf, which carries lower yields of glycosides including RebA. GLG expects higher extract-yielding Huinong 3 (H3) leaf will begin to account for the majority of processed leaf in GLG's supply chain in H214, which we believe should lead to sustainable improved profitability. GLG indicates that H3 leaf carries a 13-15% glycoside content by weight (65-70% of which would be RebA), which we estimate could yield up to a ~50% raw material cost savings compared to H2 leaf.

Exhibit 1: Q214 financial results

Year-end 31 December (C\$000)	Q214	Q214e	% chg	Q114	% chg q-o-q	Q213	% chg y-o-y
Revenue							
Total corporate revenue	4,008	7,270	(45)	4,663	(14)	3,445	16
Expenses							
Cost of sales	(2,158)	(7,270)	(70)	(4,605)	(53)	(3,517)	(39)
Gross profit	1,850	-	N/A	59	3,046	(72)	2,672
Net R&D costs	-	-	N/A	-	N/A	-	N/A
G&A expense (excluding D&A)	(2,238)	(1,850)	21	1,781	26	,547)	(37)
EBITDA	(388)	(1,850)	(79)	(1,722)	(77)	(3,619)	(89)
Depreciation & amortisation	(1,565)	(545)	187	(791)	98	(1,462)	7
Operating income (loss) before exceptionals	(1,953)	(2,395)	(18)	2,513	(22)	5,080)	(62)
Net interest income (expense)	(1,823)	(1,668)	9	(1,896)	(4)	(1,740)	5
Foreign exchange gain (loss)	620	-	N/A	(540)	(215)	447	39
Financial and other income (loss)	378	-	N/A	(22)	(1,790)	1	41,212
Earnings (loss) before tax	(2,777)	(4,063)	(32)	(4,972)	(44)	(6,372)	(56)
Taxes	(32)	-	N/A	-	N/A	-	N/A
Net income (loss)	(2,809)	(4,063)	(31)	(4,972)	(44)	6,372)	(56)
Net EPS (IFRS, fully diluted) (C\$)	(0.08)	(0.12)	(30)	(0.15)	(44)	(0.19)	(57)

Source: Edison Investment Research, company documents

Debt situation stable; refinancing still expected in 2015

On 30 June 2014, GLG had C\$81.9m of net debt (gross debt of C\$84.3m offset by cash and equivalents of C\$2.5m), with C\$44.0m due within 12 months. C\$57.8m of GLG's debt was owed to Chinese government-affiliated banks, and C\$16.6m is owed to related parties (GLG Chairman and CEO Dr Zhang had lent C\$12.5m to the company as of 30 June 2014 bearing interest at China's 10-year benchmark government bond rate plus 11% pa). The debt calculations also include C\$3.3m in convertible notes (convertible to equity at C\$1.80/share), a C\$6.0m interest payable liability, and a C\$0.7m loan from a private lender. According to GLG, its C\$57.8m external debt due to Chinese government affiliated banks is secured by its four primary extract processing facilities (Runhai, Runyang, Runde and Runhao) and their recoverable values, as recorded under the Chinese lender agreements, exceed this outstanding debt by a ratio of about 2:1. Given the value of the assets secured against the debt, GLG is confident its lenders will continue to renew the loans as needed. GLG estimates that it will refinance these loans in 2015.

² While only two of GLG's manufacturing facilities were in operation in H114, higher overall production volumes (and capacity utilisation) led to reduced capacity charges in Q214 vs Q213.

Financials and valuation

Our financial model previously assumed that GLG would receive C\$12.3m in LHG and other extract revenues in 2015. However, given the formal announcement of a secured LHG contract, we have increased confidence that such LHG-related revenues will be realised, and we have mildly raised our sales forecasts for LHG and other non-stevia extracts (ie from the firm's Naturals+ line). For the firm's stevia-related businesses, given lower than expected Q214 revenue, we have mildly lowered revenue estimates for the remainder of 2014 and 2015, to adopt a slightly more conservative near-term stance. However, we continue to expect H214 stevia sales to increase from H114, as the firm traditionally reports stronger sales figures in the second half of the year due to seasonality effects.

We have not modified our stevia revenue forecasts for 2016 and beyond (in US dollar terms). We continue to assume the stevia market (estimated at US\$220m in 2013) will expand to US\$430m by 2017. We maintain our existing assumption that GLG will capture 15% long-term market share (by value) of the stevia market, and that normalised margins will begin to improve significantly in H214 as the H3 leaf strain begins to make up the majority of its leaf supply for processing. We continue to assume GLG will return to generating consistently positive EBITDA in early 2016.

Exhibit 2: Changes to 2014 and 2015 forecasts

Year-end 31 December (C\$000s)	Q314e new	2014e old	2014e new	2015e old	2015e new
Revenue					
Stevia extract revenue	6,643	26,336	22,242	38,261	36,778
LHG and other revenue	531	2,734	2,924	12,281	14,739
Total corporate revenue	7,175	29,069	25,166	50,542	51,517
Expenses					
Cost of sales	(6,672)	(28,842)	(22,103)	(45,733)	(45,016)
Gross profit	502	227	3,063	4,809	6,501
Net R&D costs	-	-	-	-	-
G&A expense (excluding D&A)	(1,850)	(6,718)	(7,719)	(6,853)	(7,496)
EBITDA	(1,348)	(6,491)	(4,656)	(2,044)	(994)
Depreciation & amortisation	(496)	(2,416)	(3,343)	(2,109)	(1,930)
Operating income (loss) before exceptionals	(1,844)	(8,907)	(7,999)	(4,153)	(2,924)
Net interest income (expense)	(1,842)	(7,046)	(7,425)	(7,753)	(8,106)
Foreign exchange gain (loss)	-	(540)	80	-	-
Financial and other income (loss)	-	(22)	356	-	-
Earnings (loss) before tax	(3,686)	(16,516)	(14,988)	(11,905)	(11,030)
Taxes	-	-	(32)	-	-
Net income (loss)	(3,686)	(16,516)	(15,020)	(11,905)	(11,030)
Net EPS (normalised, fully diluted) (C\$)	(0.11)	(0.47)	(0.46)	(0.33)	(0.31)

Source: Edison Investment Research

We value GLG using a net present value (NPV) analysis. We use a weighted average cost of capital (WACC) of 10%, given a cost of equity of 12.5% and GLG's capital structure, which is weighted to debt at 90% given current market values (and its average cost of debt is estimated at 9.0%).

Exhibit 3: Revenue and gross margin forecasts for GLG

Year-end 31 December (C\$000)	2014e	2015e	2016e	2017e	2018e
Stevia extract revenue	22,242	36,778	50,437	66,268	74,386
LHG and other revenue	2,924	14,739	16,966	17,734	19,018
Total revenue	25,166	51,517	67,403	84,003	93,404
Gross profit	3,063	6,501	12,484	16,801	18,681
Gross margin	12.2%	12.6%	18.5%	20.0%	20.0%
EBITDA	(4,656)	(994)	4,838	9,002	10,726
EBITDA margin	N/A	N/A	7.2%	10.7%	11.5%

Source: Edison Investment Research

Given the minor changes in our G&A expense and working capital adjustments, we obtain a total NPV for GLG of C\$144.2m (vs C\$136.3m, previously, due primarily to increased longer-term LHG

and non-stevia revenue forecasts, and partly due to rolling our forecast forward by a quarter). Net of Q214 net debt of C\$81.9m, this provides an equity valuation of C\$62.4m, or C\$1.87 per share.

Exhibit 4: Financial summary

	C\$000	2011	2012	2013	2014e	2015e	2016e
Year end 31 December		IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS							
Revenue		24,840	21,709	16,022	25,166	51,517	67,403
Cost of Sales		(26,422)	(26,958)	(17,724)	(22,103)	(45,016)	(54,919)
Gross Profit		(1,582)	(5,250)	(1,702)	3,063	6,501	12,484
General & Administrative		(35,021)	(10,229)	(8,425)	(7,719)	(7,496)	(7,646)
EBITDA		(36,603)	(15,479)	(10,127)	(4,656)	(994)	4,838
Operating Profit (before exceptionals)		(47,033)	(17,389)	(14,483)	(8,935)	(2,924)	2,967
Exceptionals		(128,545)	(10,436)	(8,096)	436	0	0
Other		0	0	3,378	0	0	0
Operating Profit		(175,577)	(27,825)	(19,200)	(7,563)	(2,924)	2,967
Net Interest		(5,538)	(6,913)	(7,181)	(7,425)	(8,106)	(8,396)
Profit Before Tax (norm)		(52,570)	(24,301)	(21,664)	(15,424)	(11,030)	(5,429)
Profit Before Tax (FRS 3)		(181,115)	(34,738)	(26,382)	(14,988)	(11,030)	(5,429)
Tax		(440)	(83)	(49)	(32)	0	0
Minority interests		(4,643)	(4,856)	3,378	0	0	0
Profit After Tax and minority interests (norm)		(57,654)	(29,240)	(18,335)	(15,456)	(11,030)	(5,429)
Profit After Tax and minority interests (FRS 3)		(186,199)	(39,676)	(23,052)	(15,020)	(11,030)	(5,429)
Average Number of Shares Outstanding (m)		32.0	32.9	33.4	33.8	35.9	38.4
EPS - normalised (C\$)		(1.80)	(0.89)	(0.55)	(0.46)	(0.31)	(0.14)
EPS - normalised and fully diluted (C\$)		(1.80)	(0.89)	(0.55)	(0.46)	(0.31)	(0.14)
EPS - (IFRS) (C\$)		(5.81)	(1.21)	(0.69)	(0.45)	(0.31)	(0.14)
Dividend per share (C\$)		0.0	0.0	0.0	0.0	0.0	0.0
BALANCE SHEET							
Fixed Assets		53,807	50,225	55,012	49,322	47,832	46,444
Intangible Assets		0	0	0	0	0	0
Tangible Assets		53,807	50,225	55,012	49,322	47,832	46,444
Current Assets		93,575	52,840	32,784	33,288	41,270	48,794
Cash		4,487	3,582	5,133	3,477	8,188	10,023
Other		89,088	49,258	27,651	29,811	33,083	38,770
Current Liabilities		(103,376)	(86,694)	(62,229)	(67,777)	(73,875)	(83,986)
Creditors		(32,802)	(26,811)	(21,566)	(23,056)	(29,154)	(39,265)
Short term borrowings		(70,574)	(59,883)	(40,663)	(44,721)	(44,721)	(44,721)
Long Term Liabilities		0	(8,683)	(38,935)	(43,668)	(53,668)	(53,668)
Long term borrowings		0	(8,673)	(35,755)	(40,334)	(50,334)	(50,334)
Other long term liabilities		0	(10)	(3,179)	(3,334)	(3,334)	(3,334)
Net Assets		44,006	7,688	(13,367)	(28,836)	(38,441)	(42,416)
CASH FLOW							
Operating Cash Flow		(26,797)	8,865	8,396	(3,563)	3,256	10,716
Net Interest		(5,538)	(6,913)	(7,181)	(7,425)	(8,106)	(8,396)
Tax		0	0	0	0	0	0
Capex		(9,006)	(568)	(81)	(246)	(440)	(484)
Acquisitions/disposals		0	0	0	0	0	0
Financing		54,240	0	0	0	0	0
Net Cash Flow		12,899	1,384	1,134	(11,235)	(5,290)	1,836
Opening net debt/(cash)		(23,252)	66,087	64,974	71,285	81,578	86,868
HP finance leases initiated		0	0	0	0	0	0
Other		(102,238)	(271)	(7,445)	942	0	0
Closing net debt/(cash)		66,087	64,974	71,285	81,578	86,868	85,032

Source: Edison Investment Research, GLG accounts. Note: *Convertible notes (valued at C\$3.2m in 2013 and C\$3.3m in 2014) are included as part of long-term borrowings.

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