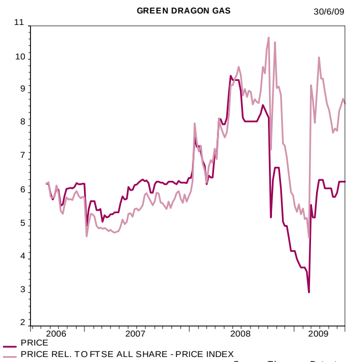
Evolution SECURITIES

29 June 2009

Price / Target:	**$6 / $13**
Mkt Cap:	**$686m**
Net Cash / (Debt):	**$13m**



Source: Thomson Datastream

Dec	2008A	2009E	2010E
PBT	(27.6)	(21.2)	(20.1)
EPS ($)	(26.9)	(16.5)	(15.7)
DPS ($)	0.0	0.0	0.0
P/E	(0.2x)	(0.4x)	(0.4x)

Green Dragon Gas (GDG.L) Buy

Integrated CBM business takes shape

Green Dragon's FY08 results are more about tangible progress in the establishment of a vertically integrated CBM supplier and marketer in China and less about the P&L account.

GDG reported revenue of $24.6m (zero in prior the year), with most of the revenue coming from pipeline gas distribution and CNG gas stations and equipment sales.

The reported loss of $27m was larger than we expected, caused by a low gross margin, large share based-payments and higher financial charges.

Progress towards the strategic goal of being a vertically integrated CBM gas supplier was made both organically through the drill bit and through strategic acquisitions – including Pace (drilling and upstream), Giant Power (gas distribution), Zhengzhou Nanhai Gas, Zhengzhou Clean Technology and Zhengzhou Clean Petro-equipment (CNG stations and equipment).

The company raised $38m in May 2008, the bulk of which was used to fund the acquisition of PACE. The company ended the year with net cash of $13m.

The year-end CPR report has increased the NPV (10) of the 3P resource base to $7.2bn from $4.5bn on the back of the success of the application of SIS drilling technology on the GSS block.

Going forward, we expect the profitable mid and downstream business to generate the bulk of the revenue, with the upstream division becoming a main component of the company after three years.

The profile of CBM continues to grow globally with major companies such as RDS, BP, Chevron and BG Group. We believe that the CBM gas business in China is set for exponential growth and Green Dragon remains the dominant international player. The challenge is to monetise its large resource base. We increase our target price to $13 (was $12.4), to reflect the latest CPR report and other progress.

Year End Dec	2007A	2008A	2009E	2010E
Sales ($m)	0.0	24.6	32.0	45.2
EBITDA ($m)	(4.3)	(11.8)	(5.9)	(3.1)
EVO PBT ($m)	(2.7)	(27.6)	(21.2)	(20.1)
EPS ($)	(2.6)	(26.9)	(16.5)	(15.7)
DPS ($)	0.0	0.0	0.0	0.0
Growth PBT (%)	-	-	-	-
Growth EPS (%)	-	-	-	-
P/E (x)	-	-	-	-
EV/Sales (x)	-	27.4x	24.8x	18.5x
EV/EBITDA (x)	-	-	-	-
Yield (%)	0.0%	0.0%	0.0%	0.0%

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The company has reviewed a draft of this research note and factual changes have been made

FY 08 results and update

Green Dragon Gas is a vertically integrated gas supplier in China with an established large upstream coal bed methane (CBM) gas resource.

2008 reserves report

The year end 2008 independent competent persons report (CPR) from Netherland Sewell and Associates (NS&A) attributes the company's in-place gas resource at 23.3tcf. The recoverable 2P and 3P reserves are put at 258bcf and 2.2Tcf respectively with a NPV (10) valuation of $1bn and $7.2bn respectively. This is a significant increase over the previous report. The increase in the 3P NPV (10) of $2.7bn is largely due to the successful application of Surface in seam drilling (SIS) technology on the Shizhuang South block (GSS).

According to the company the NS&A results are conservative with low recovery factors and no 2P or 3P numbers attributed to 3 of the 6 blocks. Therefore as drilling progresses there is likely to be continuous increase in numbers for the group as a whole and a gradual upward shift from prospective resources to 3P reserves and 2P reserves.

Acquisitions

In 2008 the company carried out four transactions as part of its strategy towards becoming a vertically integrated gas supplier. These included acquisitions in drilling and upstream (PACE) – which brought with it the JV with Mitchell Drilling and exclusive access to the SIS drilling technology in China, mid stream (Giant Power), and downstream (Zhengzhou Nanhai Gas, Zhenghzhou Clean Technology and Zhengzhou Clean Petro-Equipment). The latter businesses give access to pipelines and distribution in areas adjacent to CBM production and access to consumers through CNG retail stations.

2008 financial results

The company reported its maiden revenue of $24.6m – coming mainly from its pipeline gas business. However, there were also contributions from CNG stations, CNG equipment sales and CBM gas sales.

Summary of 2008 revenue split by division

Division / segment	$m
CBM gas sales	0.033
Well drilling	2.865 (intra-group)
Pipeline gas distribution	19.188
CNG gas station sales	4.059
CNG filling equipment sales	1.369
Consolidated revenue	24.649

Source: Company

The 2008 numbers are the first from the company to show significant revenue. This came mainly in 2H08 after the acquisition of the Midstream/downstream businesses.

Revenue came from the pipeline gas distribution business (ahead of our forecast), the contribution from the CNG stations (in line with forecast) and equipment sales (larger than forecast). The “upstream” CNG gas sales were very small in 2008, but in line with our expectations.

In the P&L, the administration expenses were significantly higher than we expected, due mainly to a $6.2m non-cash share based payment charge (5 yr options on 7.9m shares at $6.5/share).

Of the acquisitions made in 2008, Giant Power was profitable contributing $683,000 between July 4th and end Dec. The other acquired businesses Zhengzhou Manufacturing (GMC) and Zhenghzou Technical (GTC) made a profit and Zhengzhou Downstream (GGD) made a loss in the period August to Dec 2008. The PACE group contributed a loss from July to December.

Cash flow

In a start-up business such as Green Dragon, it is more important to look at cash flows rather than profitability.

In 2008, cash flow from operations was a modest negative ($0.595m). Expansion particularly the acquisition of PACE, was funded by the issuance of shares at $7.98 to raise $38m in May 2008.

Since the year end the company raised $9.6m through an offer to shareholders at $3.68/share (February 2009) of which the CEO subscribed for $3m – the maximum allowed under the offer.

On our current forecasts, GDG does not generate positive cash flow from operations for several years, and therefore even with only a modest capex spend, the company is likely to be absorbing cash.

Indeed, the CEO has pointed out that the substantial asset base requires something in the order of $1bn to fully develop, around half of which is likely to be self financing, which still leaves a substantial sum to be funded from the debt and/or equity markets

The company still has plans for a LSE main board of Hong Kong listing. A decision is likely to be announced prior to year end and the intention then is to enhance the current 18% free float.

Outlook for 2009/10

Drilling - GDG expects to have five rigs active with continuous drilling in GSS and other blocks.

In addition, 2 rigs under Greka-Mitchell JV, drilling Dymaxion horizontal wells (SIS) are expected to be active in 2009/10. Rigs are expected to drill around 2 SIS wells per month.

Upstream - Drilling and dewatering is expected to continue on all six blocks under pilot operations.

A new compressor station/power station should be constructed and along with a gathering system should allow gas sales to commence from GFC block – to be followed by similar projects in the GPX, GQY and GSN blocks in 2010.

However, at present the level of gas production from the CBM wells and the likely forecast for production in 2009/10 is unclear.

The Company and its joint venture partner's (CUCBM) submission to the National Development and Reform Commission (NDRC) has been reviewed and vetted. Attaining the final approval will mark the start of the 20 year production period and related commercial sales. This is expected in 3Q09.

Trucking of CBM gas from the GSS block is then likely to increase, although the company has indicated that it is studying the possibility of constructing a pipeline to market once volumes are sufficient perhaps in 2010.

The medium term objective is to have all six field areas in production and selling gas by 2011/12.

Midstream - GDG should continue to trade gas profitably through distribution centres off the East West pipeline, marketing to end users. A full year contribution should be received from both Zhengzhou and Wuhu distribution sites.

GDG is looking at the potential of establishing its own transportation fleet for CNG/CBM gas deliveries from its production centres to retail stations.

Downstream - The roll out of CNG stations should continue with a total of 4 expected to be in operation by end 2009 with a potential capacity of 35,000 m3.

Technology and Manufacture - The manufacturing business should continue to develop CNG conversion kits, CNG loading and dispensing systems and card readers.

We expect 2009/10 to be a period of organic growth after the strategic acquisitions of 2008, as the company now has all the components necessary for robust growth of the business model.

Valuation

We have used the new reserve estimates published in February in our NAV calculation for GDG (see First take Feb 23rd). We take the 2P reserve base of 258 bcf with an NPV (10) value of $1075m as our core "upstream NAV" – to which we add value for the mid stream, downstream and drilling divisions at cost or based on typical Revenue/EBITDA multiples (see our note of December 2008 for details). This arrives at a core NAV of $13/share, using a fully diluted number of shares in issue. At present, because the market is still risk averse, it ascribes little or no value for 3P reserves and resources. Therefore, we have excluded much of the upside, other than taking a risked (1 in 5) value for the 3P reserves – again using the NPV (10) value arrived at by NS&A. If this is added to the core NAV, the core plus risked value rises to more than $21/share.

Conclusion

2008 has seen Green Dragon successfully demonstrate the viability of a vertically integrated CBM/CNG gas business in China based around the pilot production in GSS. This includes successful drilling using the SIS Dymaxion technology which accesses more gas using fewer wells. The group has also successfully demonstrated midstream transportation between the CBM production facility and downstream CNG retail stations. These achievements show that GDG has the "tools" required to push forward with a phased modular build-out in its five other PSC's which should lead to spectacular growth in the medium term.

In the meantime the midstream/downstream gas business will provide a steady and growing revenue stream, providing part of the funds required for expansion.

The demand for the Company's domestic coal-bed methane production is undeterred and continues to be a core area of the Chinese government incentive schemes as it continues to focus domestically to meet its ballooning demand. In addition to traditional uses within households and for power, CBM is being established as an alternative to gasoline for transport throughout the country.

Green Dragon's large CBM asset base clearly has a substantial value and is of attraction to global majors such as BG, Conoco, BP and RDS - as has been seen in transactions in Australia and elsewhere. Independent assessment of the NPV (10) of the 2P reserve base is 1.5x the current market capitalisation whilst the 3P reserve base is valued at 10x the current market cap. A sum of the parts assessment must also attribute value to the drilling business as well as the mid and downstream assets which generate cash and play an important part in capturing the value in the gas chain. Our revised sum of the parts calculation using the latest CPR reserve data increases our target price to $13/share (up from $12.4/share).

Disclosures

Analyst details

Keith Morris - Research Analyst

AMEC	Gulf Keystone⦿	Melrose Resources	Wellstream⦿
Bateman Litwin	Hunting PLC	Nautical Petroleum◆⦿	Wood Group
Dragon Oil⦿	Irvine Energy◆⦿	Petroceltic⦿	Hamworthy⦿
Emerald Energy◆⦿	JKX Oil⦿	Petrofac	Hallin Marine⦿
Faroe Petroleum⦿	Kentz Corp Ltd◆⦿	Sound Oil◆⦿	
Green Dragon Gas◆⦿	Lamprell	Sterling Energy◆⦿	

Richard Griffith - Research Analyst

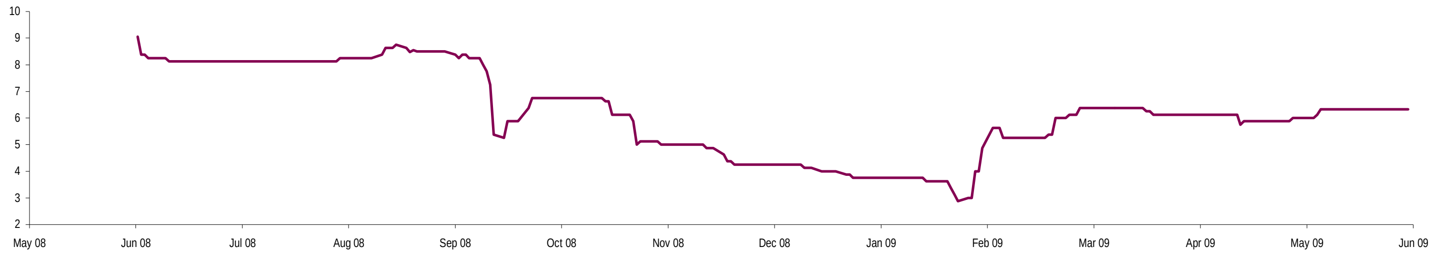
Afren⦿	Dana Petroleum	SOCO International	Bowleven
BG Group	Premier Oil	Tullow Oil	Heritage Oil
Cairn Energy	RDS	Venture Production	BP

David Farrell - Research Analyst

Key: ◘ Analyst has financial interest, ▣ Analyst has material interest, ✱ Analyst is a director, ◈ Analyst has a business interest, ◆ EVO Securities is broker and/or advisor and has in the last twelve months acted as broker and/or advisor or provided investment banking services, for which it has received compensation within the next three months, ◇ EVO Securities is no longer broker and/or advisor, but has in the last twelve months acted as broker and/or advisor or provided investment banking services, for which they have received compensation or are expecting compensation within the next three months, ⦿ EVO Securities makes markets in the company, ✚ EVO Securities has shareholdings in the Company in excess of 5%, ✖ The Company has shareholdings in Evolution Group plc in excess of 5%

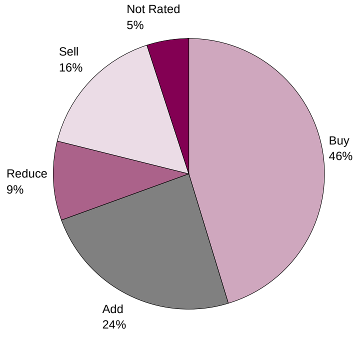
Recommendation history chart (for the last 12 months to previous days close)

Green Dragon Gas - Ratings Plotter as at 30/06/2009

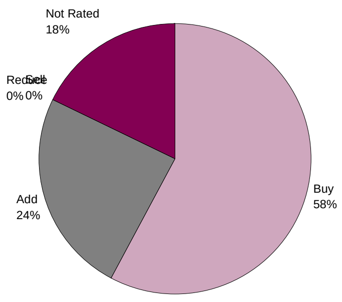


Source: FactSet / Evolution Securities ratings

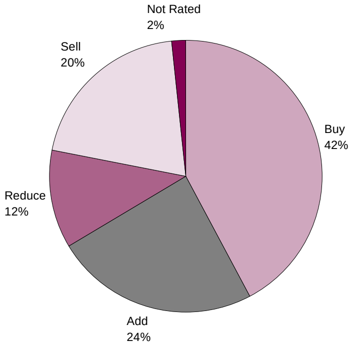
% of recommendations
(all stocks)



% of recommendations
(corporate stocks)



% of recommendations
(non-corporate stocks)



Evolution Securities – Recommendation Guide

We have three main ratings: Buy, Neutral and Sell; and we have two intermediate ratings: Add and Reduce.

Buy is defined as a stock where we expect excess positive performance;

Sell is where we expect excess negative performance;

Neutral is where we don't expect excess performance;

Add and Reduce are where we expect positive and negative performance respectively but not excessively so.

"Excess" means more than the local relevant market adjusted for individual stock risk. If there is a conflict between the target price and the recommendation, and there may be when prices have moved significantly, the recommendation takes precedence over the price target.

Previous recommendation until 9 June 2009 was:

Buy: Expected to outperform the FTSE All-Share Index by 10% or more in the next 12 months

Add: Expected to underperform the FTSE All-Share Index by up to 10% in the next 12 months

Reduce: Expected to underperform the FTSE All-Share Index by up to 10% in the next 12 months

Sell: Expected to underperform the FTSE All-Share Index by 10% or more in the next 12 months

Disclosures in relation to ESUS and/or any affiliate's role in managing or co-managing a public offering of securities for the issuer, receiving compensation for investment banking services from the issuer in the past 12 months and/or expecting or intending to receive compensation for investment banking services from the issuer in the next three months and/or making a market in the issuer's securities is set out in the main disclosure section of this publication.

Evolution SECURITIES

Green Dragon Gas (GDG.L)

Rating	Price Target	Price	Market Cap	Net Cash	EV
Buy	$13	$6	$686m	$13m	$675m

Year End Dec	2007A	2008A	2009E	2010E
P&L($m)				
Sales	0.0	24.6	32.0	45.2
Operating Profit	(4.3)	(14.4)	(8.9)	(7.8)
EVO PBT	(2.7)	(27.6)	(21.2)	(20.1)
EPS ($)	(2.6)	(26.9)	(16.5)	(15.7)
DPS ($)	0.0	0.0	0.0	0.0
Cash flow($m)				
Operating cash flow	(4.0)	(0.8)	(0.9)	(3.1)
Interest and tax paid	4.7	11.4	0.0	0.0
Capex and acquisitions	(6.4)	(25.7)	(25.0)	(25.0)
Dividends	0.0	0.0	0.0	0.0
Share issues	95.0	36.8	9.6	0.0
Other items	(53.9)	(63.1)	(11.3)	(11.2)
Change in net cash	35.3	(41.5)	(27.6)	(39.3)
Balance Sheet($m)				
Closing net cash	54.3	12.8	(14.8)	(54.0)
Net assets	664.0	720.2	685.0	626.7

Year End Dec	2007A	2008A	2009E	2010E
Growth				
Sales	-	-	+30%	+41%
Operating profit	-	-	-	-
EPS	-	-	-	-
DPS				
Operating Ratios				
Operating margin		58%	28%	17%
Effective tax rate	2%	1%	10%	10%
Leverage				
Net debt/Equity	4.9x	7.4x	13.0x	21.6x
Net debt/EBITDA	-	-	-	-
Operating profit/Net interest	-	1.1x	0.7x	0.6x
EPS/DPS				

Year End Dec	2007A	2008A	2009E	2010E
Valuation				
P/E	-	-	-	-
EV/EBITDA	-	-	-	-
Yield	0.0%	0.0%	0.0%	0.0%

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