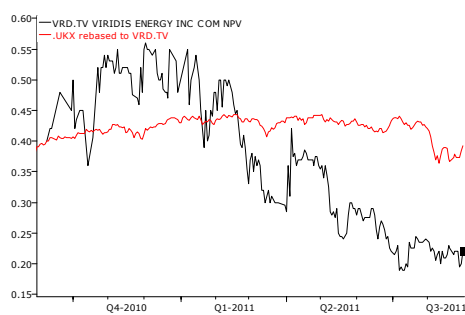


# Viridis Energy Inc. 18c.

## Q3 Results. Deferred Expectations and Reduced Estimates

20 December 2011



**12m High:** 55c

**12m Low:** 18c

**Market Cap:** CAN\$7m

**Shares in Issue:** 41.28m ordinary shares  
Plus 35m out-of-the-money options,  
warrants and convertibles.

**NAV/Share:** 17c/share inc intangibles.

3c/share excluding intangibles

**Gearing:** 106% including intangibles/goodwill

**Interest Cover:** n.a.

**EPIC Code:** TSX: VRD.V / VRD.TV

**Sector:** Forest Products

**Market:** Toronto TSX Venture Exchange (move to Main Board planned). Also OTC QX. A European market quote is likely shortly.

**Broker:** To be Announced

**IR Agent:** Grannus Financial Advisors, 001 212 681 4108

**PR:** -

**Website:** www.viridisenergy.ca

**Description:** Manufacturer and distributor of carbon neutral wood pellets for domestic heating and commercial power generation.

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In our last research note, we said that Q2 2011 would be the nadir in the fortunes of Canadian wood pellet specialist Viridis Energy. Our timing was out by three months. The Q3 results were worse, but the p & I ought to see improvement from now on. The company should turn into profit during the course of 2012, and is benefitting from increasingly favourable industry conditions.

There are challenges ahead, however, which include:

- Lack of scale. The planned acquisition of the Confluence wood pellet plant in Colorado has not gone ahead. Acquisition is still possible if the price is right, but management says it is no longer a priority. The build-out at Monte Lake, BC, will now come on stream in 2013 rather than H2 2012 (although it will be substantially cheaper). There has been no progress on the proposed second press at Okanagan, BC.
- Limited funds. Over half the £6.4m raised from equity and convertible debenture issues during Q3 has gone into loan repayments. Also the Q3 loss needed funding, leaving only \$1.5m cash in the bank.
- The collapse of the deal to sell palm kernel pressings from Asian palm estates into China. This additional source of revenue and cash flow, which earlier this year the directors stated would be considerable, has not been available.
- A minor, but irritating legal dispute with a past chairman has yet to be resolved.

Some good things are happening. The surplus inventory has been run off, as we predicted, the new bulk supply contracts into Europe are performing well, and the major wholesale contract with Canada's largest wood pellet company is keeping the plant running at full capacity.

Viridis Energy lacks economies of scale. G & A expenses are currently soaking up 36% of sales revenue, which is clearly unsustainable long term. The opportunities are huge, but in order to generate a meaningful profit, as well as to take advantage of these opportunities, Viridis Energy needs to be more than a one plant company.

We have reduced our estimates and expect Viridis Energy to approach its shareholders for further funding during H1 2012.

Y/E	Sale	Declared Pre-tax Profit	Adjusted Pre-tax Profit	Undiluted EPS	P/E	Divi	Yield
Dec	CAN\$ m	CAN\$m	CAN\$m	c.	X	c.	%
2009A	0					-	-
2010E	7.81	-0.1	-2.9	-14.1	-	-	-
2011E	12.0	-4.6	-4.6	-13.3	-	-	-
2012E	15.4	-1.8	-1.8	-4.3	-	-	-

## Viridis Energy Inc.

20 December 2011

**Q3 Results**

Q2 results showed higher sales but a margin squeeze.

\$m	Q3/10A	Q4/10A	Q1/11A	Q2/11A	Q3/2011A
Sales	2.66	2.90	2.67	2.87	3.31
Cost of Sales	1.68	2.66	1.75	2.50	3.36
Gross Profit	0.98	0.24	0.92	0.37	-0.04
Gross Margin %	36.8%	8.3%	34.3%	12.9%	-1.3%
Expenses	1.77	2.74	1.49	1.18	1.21
EBIT	-0.79	-2.50	-0.57	-0.81	-1.25
Interest + Other Income	-0.11	-0.13	-0.14	-0.18	-0.14
Pre-Tax Profit	-0.90	-2.63	-0.71	-0.99	-1.40
Tax	0.00	0.00	0.00	0.00	0.00
<b>Net Income</b>	<b>-0.90</b>	<b>-2.63</b>	<b>-0.71</b>	<b>-0.99</b>	<b>-1.40</b>

Reasons for the gross margin squeeze were:

- Inventory built up during last year's disappointing winter had a higher cost per tonne than current output, because significant efficiencies have been made in production during the past nine months. This inventory pushed up the average production cost per tonne.
- Freight costs as a percentage of revenue were almost double those of the previous two quarters. The need for off-site storage of the surplus inventory resulted in extra freight costs and double handling charges.
- Some legacy loss making "pre-paid" contracts.
- Lack of production capacity meant that pellets need to be purchased from a third party supplier, at a high price.
- The inclusion of employee benefits, depreciation and other costs under "cost of sales" under IFRS accounting standards, which accounted for \$0.14m of costs at this level.

General and Administrative expenses fell significantly between their peak in Q4 2010 and Q2 2011. This latest quarter, Q3, showed them maintained at the Q2 level. They would have been lower still but for the legal costs involved in a messy suit and counter-suit legal action with a past chairman, and some expensed costs associated with the capital raising that took place during the quarter.

However, Q3 G & A expenses were 36.5% of sales revenue. In our view this is an unsupportably high level.

**Production Capacity**

For the second successive quarter, the Okanagan wood pellet production plant ran at maximum capacity. It produced ~14,000 tonnes, slightly less than in the previous quarter because of an unexpected maintenance issue, but nevertheless more than its nameplate capacity.

This output was supplemented by the sale of the final 6,000 tonnes of surplus inventory from stockpile following last winter's disappointing sales, and ~2,000 tonnes of bought in product. The company is at full stretch, and with no further surplus inventory to dispose of, is reliant on additional bought-in product or higher prices in order to progress short term.

**Sales and Customers**

Three major new sales sources were identified and signed up earlier during 2011. These were:

- A bulk contract with Canada's largest supplier of wood pellets, the customer to be

## Viridis Energy Inc.

20 December 2011

responsible for railcar transport so a low price per tonne was partly counterbalanced by lower outgoing freight costs in the G & A costs line (plus the benefits of working the production plant at full capacity, which significantly lowers costs per tonne). This contract will be bigger in Q4 and in 2012 than it was in Q3, when shipments were restricted by a shortage at the customer end of available railcars.

- A contract with Indian company Abellon CleanEnergy to export wood pellets, partly into the European market. Abellon has recently become a 10% shareholder in Viridis because it contributed to the Q3 capital raising in addition to signing a major offtake contract.
- A deal to sell oil palm kernel residues out of Malaysia into China signed with a company called Heracles International. Management at the time stated that this would produce revenues of \$2.8m a month, and that margins of 10% - 15% were expected. This turns out to have been a chimera. Product was never taken. Viridis Energy's management says that attempts are being made to sell the product into Europe as a fuel for power stations.

*For the first time, Viridis Energy product found its way into Europe. Previously its output had been sold entirely within North America. During Q2, 22% of sales revenue came from Italy (where energy producers were starved of oil because of the Libyan civil war) and 18% from the UK, where the wood pellets are being co-burnt in coal fired power stations.*

The company has three major customers that took between 10% and 15% of its output during the quarter.

Overall Viridis Energy has orders for far more wood pellets than it is currently in a position to deliver, and a supply (and possibly inventory) of palm kernel residues in the Far East for which it has no customer.

## Future Production Capacity

Much of the increase in production capacity that we were looking forward to has either been delayed or will not now be implemented. This includes:

- The purchase of Confluence of Colorado. This might not take place. We understand that there has been a difference of opinion between Confluence's owners and the Viridis directors and advisors about the value of the Confluence business. Therefore the Confluence deal is currently regarded as "not a priority" and Viridis is exploring other, better priced transactions. Instead of buying the company, Viridis Energy is buying pellets from Confluence to sell to its high margin NE US customers, because freight costs are cheaper from Colorado. Confluence was supposed to be a distress purchase. The rise in the market price of wood pellets, coupled to the delay while Viridis Energy undertook its fundraising, appear to have killed this deal. This is a shame, because it would have been a good one.
- The purchase of Monte Lake, BC. This deal has been unpicked, and as currently being negotiated, Viridis Energy will buy the unused half of the Monte Lake site as well as rights that the vendor has negotiated to timber from adjoining properties. Thus, Viridis Energy will not be going into the fence post or timber preservation treatment businesses, which would have been a distraction, but will gain a site on which to erect a second wood pellet mill. The delay, and the fact that the renegotiated contract is unlikely to be signed for several more weeks, means that production the new plant will not go into production during Q3 2012 as we had anticipated. A start-up some time during 2013 is now more likely. Monte Lake will give the company access to large quantities very cheap diseased/dead timber that is ideal for wood pellet production but of no use for any other purpose. Management expects that a Monte Lake build-out will be largely financed by project finance and operated as a JV with Abellon.
- A second pressing plant at the Okanagan BC facility. This will be of limited use because there is no space at Okanagan for additional drying so will only add 15,000 tonnes/year of additional capacity. The equipment has yet to be ordered.

Viridis Energy plans to fill the gap between its strong wood pellet forward order book and its

## Viridis Energy Inc.

20 December 2011

overstretched current capacity by acquisitions, hopefully in Eastern Canada. These will either have to be for cash or be accompanied by a further equity fundraising, as Viridis Energy does not at present have sufficient financial resources to embark on a major acquisition spree.

Also, Viridis Energy will need to address the expiry of its Okanagan lease in 2014. This will be a great deal easier to do if a second, and hopefully a third and fourth, production facility are in operation. Okanagan as a location is not ideal, the land area is too restrictive and there is no railhead, so if the funds are available management may prefer to move its plant to a cheaper, less cramped location with better rail access. The site is in a relatively upmarket area where the landlord may be tempted by alternative uses.

## Balance Sheet and Cash Flow

Stockholders' equity of \$6.1m is at present supporting \$4.0m of term debt and \$5.7m of short term debt. Set against this there is \$1.6m of cash in the bank. The Convertible Debenture is due August 2013 and is currently out of the money (it converts at 25c)..

The shareholders' equity includes intangibles and goodwill of \$5.8m.

The cash flow statement shows that during Q3 Viridis Energy raised \$6.4m in combined equity and convertible debentures. \$0.7m net went to replay related party loans, \$0.4m went on investment activities, and \$2.1m of cash was used absorbed by the operating activities because Viridis Energy ran a substantial loss at the net income, EBITDA and cash flow levels. There was some net repayment of debt to banks.

There are currently 41.3m shares in issue, undiluted. This gives an undiluted nav per share of 15c.

Additionally, there are 19.2m options and warrants outstanding, plus 15.7m potential new shares to issue if or when the 6% convertible converts; when this happens the company will save \$0.23m annually in interest charges. We understand that the holder, Cornwall Investments, intends to fully convert as soon as this is permitted.

All options and warrants and the convertible are out of the money, in most cases heavily so. As almost all the potential dilution has a short life, it can for practical purposes be ignored by investors in the ordinary shares.

## Directors

Vivek Rastogi, the New-York based Vice President of new 10% shareholder Abellon CleanEnergy, has been appointed to the board. The future of Viridis Energy is becoming closely aligned with Abellon, because Abellon also buys ~15% of group wood pellet output.

Isaac Moss has resigned as a director.

## Conclusion

Viridis Energy is still travelling hopefully, but has yet to arrive. Our forecasts show that without a deal a move into profit during the course of 2012 is possible. But because the company lacks scale the return, even in 2013, may be unexciting. Given more production capacity, it is possible to foresee very good returns, because wood pellets is an industry whose time has come; both the cost per Kilojoule and the carbon saving over coal are hugely persuasive.

Investors should expect to put their hands in their pockets twice more, however, once because the cash is likely to run out during 2012 and again when the convertible debenture comes up for re-financing in August 2013.

Viridis Energy Inc.

20 December 2011

Management	Major Shareholders
<p><b>Chairman: John Campbell.</b> He is also CEO of First Star Resources.</p> <p><b>Chief Executive Officer:</b> Chris Robertson, founder of Cypress Pacific Marketing, the largest subsidiary of Viridis Energy. Previously an executive with Forest City, a NYSE listed company.</p> <p><b>Chief Financial Officer:</b> Michele Rebiere. 18 years senior management experience. Studied finance at Wharton.</p> <p><b>Vice President of Operations:</b> Geordie Munro, part of the Cypress Pacific management team for five years.</p> <p><b>Export Manager:</b> Bob Wood, part of Cypress Pacific management team.</p> <p><b>Non-Executive Directors:</b></p> <p><b>John Heimbecker,</b> Vice President of Parrish &amp; Heimbecker, an agricultural company with \$1.7bn of sales. Also chairman of Canada Ports Clearing Association.</p> <p><b>Alphonse Plaktis,</b> Principal of Soho Ventures Inc.</p> <p><b>Vivek Rastogi,</b> Vice-President of Abellon CleanEnergy</p>	<p><b>Cornwall Investments llc of New Jersey</b> 18%</p> <p><b>Abellon CleanEnergy</b> 10%</p> <p><b>NextView Capital of Chicago</b> 6%</p> <p><b>Insider Shareholdings:</b> 17%</p>
Key Dates	Key Milestones
<p><b>March 2012:</b> Full Year Results Announcement</p>	<p><b>June 2009:</b> Sale of Grid Sense Systems, its previous business leaving a clean shell. Change of name to Viridis Energy.</p> <p><b>March 8 2010:</b> Acquisition of Cypress Pacific Marketing, a wood pellet distribution company.</p> <p><b>April 30, 2010:</b> Acquisition of Okanagan Pellet Company (known at the time as Westwood Fibre Products), a wood pellet producer in BC.</p> <p><b>February 2011:</b> Strategic switch of emphasis from seasonal domestic business to international commercial and residential contracts.</p> <p><b>April 2011:</b> Letter of Intent signed with Heracles International to supply oil palm biomass from Malaysia to China and other Asian countries.</p> <p><b>August 2011:</b> Closure of equity fundraising, doubling share capital.</p>

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