

CER Report

OTC/BB: CHGI

June 1, 2010

Rating: **Speculative Buy**
(Unchanged)

Recent Price: **\$0.90**
(5/28/10)

Price Target: **\$2.25**
(Unchanged)

MARKET DATA

52-Week High/Low	\$3.50 - \$0.60
Ave. Daily Volume (6-mos.)	264 K
Shares Outstanding	20.2 M
Inside Ownership	47%
Institutional Ownership	<1%
Float	10.6 M
Short Interest (% of float)	<1%

FINANCIAL DATA

Market Capitalization	\$18.2 M
- Cash & Equivalents	\$ 4.0 M
+ Preferred Stock	\$ 1.4 M
+ Long-term Debt	<u>\$ 3.2 M</u>
Enterprise Value	\$18.8 M
Book Value	\$37.4 M
Working Capital	\$ 8.0 M
Dividend Yield	Nil

Balance sheet figures pro forma as of 3/31/10

	SALES	INC*	CFO	EPS*
2009A	\$15.4	(\$2.2)	\$1.9	(\$0.16)
1Q10A	\$ 4.8	(\$1.0)	\$3.1	(\$0.06)
2Q10E	\$ 5.0	\$0.2		\$0.01
3Q10E	\$ 9.5	\$1.2		\$0.06
4Q10E	\$11.0	\$1.7		\$0.09
2010E	\$30.3	\$2.1	\$4.4	\$0.10

Dollars in millions, except EPS; Fiscal year ends Dec.
*Income and earnings available to shareholders

VALUATION

Price/Sales	1.0 X
Price/CFO	4.2 X
Price/Trailing 12-mo. Earnings	Neg
Price/Book Value	0.5 X
Consensus EPS Estimate 2010	NA
Forward PE	NA
Consensus EPS Estimate 2011	NA
Forward PE	NA

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China Carbon Graphite Group, Inc.

Specialty Materials

China Carbon Graphite Group is a fast growing producer of carbon graphite materials based in China. The Company recently completed an expansion and upgrade of its production facilities located in Inner Mongolia. With production capacity now at 26,000 tons per year, the Company is expected to expand its distribution relationships to target new, fast growing markets with higher margin products. A pending acquisition could integrate the Company forward into finished graphite products, expanding addressable market and increasing profitability.

HIGHLIGHTS

- Profitable Quarter.** The reported note loss in 1Q10 was \$0.06 per share. We estimate that excluding the non-cash charges associated with the Company's warrant derivative liability, net income would have been \$361,773 or \$0.02 per share.
- Improved Sales.** China Carbon Graphite reported \$4.9 million in sales in the March 2010 quarter, well above our estimate for \$3.3 million in revenue. At least partial recovery in the graphite electrodes market for China's steel industry and sales into new markets helped drive the top-line.
- Cash Flow from Operations.** Operations generated \$3.1 million in cash during the March 2010 quarter, primarily from the collection of accounts receivable and the elimination of non-cash charges that were included in the net loss figure.
- Land Use Right.** The Company reported an investment of \$4.9 million in cash for the purchase of a land use right during the March 2010 quarter. The land is adjacent to the Company's present production facility and is to be used in part for expansion.
- Rating and Price Target.** We continue to rate CHGI a Speculative Buy and maintain our price target at \$2.25. Our price target represents a multiple of 22.5 times our revised 2010 EPS estimate of \$0.10 - a multiple which we believe is below the Company's long-term future growth rate.

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HIGHLIGHTS FROM FIRST QUARTER 2010 RESULTS

China Carbon Graphite reported \$4.9 million in sales in the March 2010 quarter, well above our estimate for \$3.3 million in revenue. At least partial recovery in the graphite electrodes market for China's steel industry and sales into new markets helped drive the top-line. The appearance of order momentum was welcome given the tough fourth quarter 2009, when sales barely topped \$3.2 million as orders of graphite electrodes from the steel industry slowed to a trickle in the last half of 2009. The near quarter also compares well to the same period last year (March 2009) when the Company was still recovering from a mandatory production stoppage for China's Summer Olympics in August 2008. Sequential and year-over-year quarterly growth rates at the top-line were 52.1% and 69.0%, respectively.

Gross profit in the March 2010 quarter was 20.8% compared to 27.6% in the year-ago quarter. The decline in profit margin is due in part to a shift in the sales mix toward lower margin graphite electrodes in the near quarter. Furthermore, there was a decrease in selling prices, particularly for graphite electrodes, that were not accompanied by decreases in raw materials costs. We believe the fixed-cost base has also increased subsequent to the completion of new production capacity.

Operating expenses remained largely unchanged, totaling \$456,269 in the March 2010 quarter compared to \$463,720 in the same quarter last year. Operating income was \$567,921 or 11.7% of total sales compared to an operating profit margin of 13.0% in the prior-year quarter.

Accounting for warrant derivatives that led to a non-cash charge of \$1.2 million resulted in a net loss in the quarter of \$1.0 million or \$0.06 per share. We estimate that excluding the non-cash charges associated with the Company's warrant derivative liability, net income would have been \$361,773 or \$0.02 per share.

Cash Flow and Balances

Operations generated \$3.1 million in cash during the March 2010 quarter, primarily from the collection of accounts receivable and the elimination of non-cash charges that were included in the net loss figure. Cash resources at the end of March 2010 totaled \$4.0 million. The Company added \$2.8 million in short-term loans and notes payable during the quarter. We estimate approximately \$8.5 million in short-term loans are due in June 2010. Management has indicated that they are confident this loan can be rolled over to a June 2011 due date.

The Company reported an investment of \$4.9 million in cash for the purchase of a land use right during the March 2010 quarter. The land is adjacent to the Company's present production facility as is to be used in part for production expansion as future, as yet undetermined purposes. This particular land use right gives the Company access to 4.0 million square feet of space.

UPDATED EARNINGS MODEL

Our earnings model has been updated to reflect first quarter 2010 results. We also made modest changes to our cost and spending rate assumptions to reflect the most recent trends. This change results in a revised 2010 sales estimate of \$30.3 million (from \$28.8 million), providing \$2.1 million in net income or \$0.10 per share (from \$3.0 million and \$0.15 per share). Our estimate of cash flow from operations is unchanged at \$4.4 million for the year 2010.

No changes were made to our sales estimates in the next three quarters. The annual sales estimate increased only due to the addition of higher-than-estimated sales during the first quarter 2010. We caution investors that achievement of our sales estimates for the balance of the year is predicated on continued strong demand in China, recovery of the steel making industry in the China and around the world, and successful penetration of new markets. Given recent trends in China and around the world expansion of sales to the levels we have estimated may be optimistic.

We note that between 40% and 50% of the Company's products are destined for domestic use with the balance exported by the Company's distributor-customers to U.S., Japan and European markets. Thus all geographies remain vital to China Carbon's future. That said, conditions appear mixed, particularly in the steel making industry. Central Government policy changes vis-à-vis growth rates and inflation in China, suggest the pace of domestic manufacturing growth could slow in the coming months. Such slowing could mean lower demand for steel for cars and other consumer durable goods in China. Europe is facing a different set of challenges related to weak credit markets and a possible end to economic recovery as central governments and the European Union implement fiscal austerity plans. The solid signs of recovery in the U.S. economy appear to be weakening and there is concern the widely reported return to production could stall for the U.S. steel making industry.

The key to growth for China Carbon may continue to be its ability to penetrate new markets and thereby achieving growth through expansion of its addressable market and market share. In late 2008, China Carbon had set out strategic plans to augment capacity for production of more fine-grain and high-purity graphite materials that typically earn higher margins than lower grade materials. That capacity expansion was underway at a time in the last half of 2009, when demand for high-purity and fine-grain graphite had slowed.

With new production capacity now on-line we expect the Company to make faster progress in market penetration as the Company's network of independent sales representatives have proven more willing to move aggressively with China Carbon products with production capacity completed. That said, we acknowledge that the Company is struggling against slowing demand for high purity graphite as China attempts to slow inflation and its runaway manufacturing base.

We have not included in our model the pending acquisition of Chiyu Carbon Graphite Ltd., a down-stream producer of graphite products in China. Nonetheless, if the deal closes as expected sometime yet in June 2010, the operation would contribute to both the top and bottom line. The legal arrangements have been completed and the Company is nearing completion of due diligence. We believe the deal could be accretive to China Carbon's earnings, depending upon the deal terms. The Company has not disclosed sales or profit margins.

NUCLEAR OPPORTUNITY

China Carbon is among few graphite producers in the world that have successfully produced graphite materials with sufficient purity to meet exacting specifications for use in nuclear reactors. The demand nuclear-grade graphite from China's nuclear power industry presents a so-called wild card for China Carbon's future growth and valuation. While orders from owners of operational graphite-cooled nuclear reactors appears to be at least two years away, the potential size of the nuclear market makes China Carbon's unique production capability in nuclear-grade graphite of importance in assessing the long-term potential in the Company.

China's long-term economic development and energy production plans called for construction of nineteen so-called pebble-bed reactors that rely on thousands of graphite balls approximately the size of a billiard ball to the nuclear reactor. Construction of what China is now called its HTR-PM (previously HTR-10) reactor is still slated for 2010, in Shandong Province. The HTR-PM is to have twin reactors, each of 250 megawatts driving a single 210 megawatt steam turbine. Plant life is expected to reach sixty years. China Huaneng Group is the lead in a consortium that also includes China Nuclear Engineering & Construction (CNEC) and Tsinghua University's INET. Assuming construction begins yet in 2010, start-up is expected in 2013. If the first demonstration project works as expected, another eighteen units could be constructed also in Shandong Province.

In November 2008, Toyo Tanso Co., Ltd., a producer of nuclear grade graphite in Japan and one of China Carbon's competitors, announced the receipt of an order to supply nuclear grade graphite for the HTR-PM demonstration plant. Toyo Tanso is in partnership with Sumitomo also of Japan in the contract. At the time Toyo Tanso indicated shipments were to begin in the middle of 2010 and continue through the end of 2011.

We believe that China Carbon submitted its nuclear-grade graphite materials for testing and certification after the Toyo Tanso order was announced. Given the proclivity of China's Central Government to support domestic production and sourcing over importation, we believe that China Carbon's competitive position remains strong vis-à-vis Toyo Tanso and other foreign suppliers of nuclear-grade graphite. Fangda Carbon Tech Co., Ltd. (600516: Shanghai) remains China Carbon's principal domestic competitor in graphite materials production.

World Developments

In March 2009, Tsinghai's INET entered into a cooperative agreement with South Africa's developers of pebble bed nuclear reactors - the PBMR (Pebble Bed Modulated Reactor). South Africa's government-owned PBMR has been held back by development delays and cost overruns. Likely, INET's investment in the South Africa effort is providing the China group with insight in how to avoid South Africa's mistakes.

Developers in the U.S. passed over pebble bed reactors in the decades since the German's first originated the technology over fifty years ago. Not to be outdone by China, Westinghouse has also contracted with South Africa's PBMR for a pebble bed technology exchange. The deal is financed in part with a \$10 million grant from the U.S. Department of Energy.

The pebble bed reactor is not the only nuclear reactor design to rely on graphite materials for temperature moderation. The Soviet-designed RBMK (Reaktor Bolshoy Moshchnosty Kanalny) is a pressurized water-cooled reactor that uses graphite as its moderator. Unlike most power reactor designs that are intended only for power generation, the RBMK is used in Russia for both plutonium and power production. The combination of graphite moderator and water coolant is found in no other power reactors in the world. It was the design of the ill-fated reactor at Chernobyl, wherein faulty control rod design among other components was unsafe. Russia has since made significant design changes to address these deficiencies. In the RBMK a series of graphite blocks surround the separate the pressure tubes. They act as a moderator to slow down the neutrons released during fission.

It is not likely that South Africa, Russia or even the U.S. would present significant exportation opportunities for China Carbon. However, we believe the resurgence in interest in graphite moderate reactor designs bodes well for the use of graphite in general in nuclear power. The need to reduce reliance on fossil fuels for energy production has caused the leading economies of the world to return to the design table.

VALUATION AND OUTLOOK

Shares of China Carbon Graphite fell through a significant level of trading support at the \$1.30 to \$1.35 price range. We believe investor concerns began multiplying as the Company reported year-end 2009 results that revealed significant weakness at the top-line as the year came to a close. Exacerbating receipt of disappointing results, the Company's tardiness in submitted its annual filing to the SEC may have given investors even greater cause for concern.

In our view, the first quarter 2010 results should give investors some level of confidence that the Company is still on track in executing on its growth strategy. Macroeconomic trends in China still point to growth even if the Central Government has taken steps to curb the country's economic growth rate to the high single or low teens. With increased capacity to produce higher margin products and the Company's planned entrance into finished graphite products through its pending acquisition, we believe China Carbon is in a strong position to deliver value to customers. Shareholder value should follow.

Accordingly, we continue to rate CHGI a Speculative Buy and maintain our price target at \$2.25. Our price target represents a multiple of 22.5 times our revised 2010 EPS estimate of \$0.10 - a multiple which we believe is below the Company's long-term future growth rate. Our target remains below a level of price resistance which we believe may have developed at the \$2.75 price level in historic trading

sessions. That said an even more significant hurdle may be at the \$1.30 to \$1.35 price range where the stock had traded for much of the last eight to ten months. In our view, another strong quarter report for the June quarter and the anticipated closing of the Chiyu strategic acquisition might be sufficient to restore investor interest at prices above this price range, particularly if the Company can verify that it is achieving success with its attempts to penetrate new markets with its more refined graphite products.

Nuclear Opportunity, Valuation

In our view, investors with long-term investment horizons should consider the nuclear graphite market in valuing CHGI shares. However, investors with shorter-term horizons should trade with a focus on near-term markets. Nonetheless, we believe the stock appears undervalued from either perspective, trading at 0.5 times equity and 4.3 times trailing cash flow from operations.

STOCK CHART



Source: Stockcharts.com

Additional information is available upon request.

Table I: Historical and Projected Sales and Expenses

Dollars in Thousands	2007	2008	1Q09	2Q09	3Q09	4Q09	2009	1Q10	2Q10E	3Q10E	4Q10E	2010E	2011E
Total revenue	25,357	27,304	2,894	3,658	5,581	3,237	15,370	4,847	5,000	9,500	11,000	30,347	50,000
Cost of sales	20,447	20,606	2,053	2,804	4,056	4,279	13,192	3,823	4,000	7,125	7,975	22,923	35,000
Gross profit	4,910	6,698	841	854	1,525	(1,042)	2,178	1,024	1,000	2,375	3,025	7,424	15,000
Operating expenses:													
Selling	124	505	309	9	14	34	366	25	175	333	385	918	2,500
General & administrative	1,121	1,952	136	322	219	1,918	2,595	404	370	688	770	2,232	3,625
Depreciation & amortization	16	68	19	19	19	18	75	27	35	35	35	132	150
Total operating expenses	1,261	2,525	464	350	252	1,970	3,036	456	580	1,055	1,190	3,281	6,275
Operating income (loss)	3,649	4,173	377	504	1,273	(3,012)	(858)	568	420	1,320	1,835	4,143	8,725
Other income (expense)													
Change in fair value of warrants	-	-	-	-	-	(309)	(309)	-	-	-	-	-	-
Interest expense	(495)	(581)	(198)	(206)	(357)	(73)	(834)	(206)	(161)	(161)	(161)	(690)	(323)
Other, net	440	390	292	232	19	(16)	527	(1,221)	-	-	-	(1,221)	-
Total other income (expense)	(55)	(191)	94	26	(338)	(398)	(616)	(1,427)	(161)	(161)	(161)	(1,911)	(323)
Income (loss) before income taxes	3,594	3,982	471	530	935	(3,410)	(1,474)	(859)	259	1,158	1,674	2,232	8,402
Provision for income taxes (benefit)	-	-	-	-	-	-	-	-	-	-	-	-	-
Net income (loss)	3,594	3,982	471	530	935	(3,410)	(1,474)	(859)	259	1,158	1,674	2,232	8,402
Preferred dividend	-	(854)	-	-	-	-	(773)	(133)	-	-	-	(133)	-
Dividends	-	-	-	-	-	-	-	(36)	-	-	-	(36)	-
Income available to shareholders	3,594	3,128	471	530	935	(3,410)	(2,247)	(1,028)	259	1,158	1,674	2,063	8,402
Foreign currency translation gain	1,794	2,043	45	3	76	-	46	(99)	-	-	-	(99)	-
Total comprehensive income	5,388	6,025	516	533	1,011	(3,410)	(1,428)	(958)	259	1,158	1,674	2,133	8,402
Net EPS (loss), shareholders	\$ 0.34	\$ 0.21	\$ 0.03	\$ 0.04	\$ 0.06	\$ (0.23)	\$ (0.16)	\$ (0.06)	\$ 0.01	\$ 0.06	\$ 0.09	\$ 0.10	\$ 0.40
Weighted shares out, diluted	10,506	14,623	13,847	14,239	15,085	15,000	14,427	18,485	20,000	20,000	20,000	19,621	21,000

Source: Company Reports and Crystal Equity Research Estimates

Table II: Selected Measures of Historical and Projected Sales and Expenses

Dollars in Thousands	2007	2008	1Q09	2Q09	3Q09	4Q09	2009	1Q10	2Q10E	3Q10E	4Q10E	2010E	2011E
Total revenue	25,357	27,304	2,894	3,658	5,581	3,237	15,370	4,847	5,000	9,500	11,000	30,347	50,000
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Net income (loss)	3,594	3,982	471	530	935	(3,410)	(1,474)	(859)	259	1,158	1,674	2,232	8,402
Income available to shareholders	3,594	3,128	471	530	935	(3,410)	(2,247)	(1,028)	259	1,158	1,674	2,063	8,402
Total comprehensive income	5,388	6,025	516	533	1,011	(3,410)	(1,428)	(958)	259	1,158	1,674	2,133	8,402
Net EPS (loss), shareholders	\$ 0.34	\$ 0.21	\$ 0.03	\$ 0.04	\$ 0.06	\$ (0.23)	\$ (0.16)	\$ (0.06)	\$ 0.01	\$ 0.06	\$ 0.09	\$ 0.10	\$ 0.40
Weighted shares out, diluted	10,506	14,623	13,847	14,239	15,085	15,000	14,427	18,485	20,000	20,000	20,000	19,621	21,000
SELECTED MEASURES:													
Sales growth, yr/yr	47.4%	7.7%					-43.7%					97.4%	64.8%
Net income from growth, yr/yr	34.1%	-10.8%					-137.0%					251.4%	276.5%
EPS growth, yr/yr	32.5%	-37.5%					-172.8%					167.5%	280.6%
Gross margin	19.4%	24.5%	29.1%	23.3%	27.3%	-32.2%	14.2%	21.1%	20.0%	25.0%	27.5%	24.5%	30.0%
Operating margin	14.4%	15.3%	13.0%	13.8%	22.8%	-93.0%	-5.6%	11.7%	8.4%	13.9%	16.7%	13.7%	17.5%
Net margin	14.2%	14.6%	16.3%	14.5%	16.8%	-105.3%	-9.6%	-17.7%	5.2%	12.2%	15.2%	7.4%	16.8%
Direct costs, % sales	80.6%	75.5%	70.9%	76.7%	72.7%	132.2%	85.8%	78.9%	80.0%	75.0%	72.5%	75.5%	70.0%
Selling expense, % sales	0.5%	1.8%	10.7%	0.2%	0.3%	1.1%	2.4%	0.5%	3.5%	3.5%	3.5%	3.0%	5.0%
G&A expense, % sales	4.4%	7.1%	4.7%	8.8%	3.9%	59.3%	16.9%	8.3%	7.4%	7.2%	7.0%	7.4%	7.3%
Effective tax rate	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
EBITDA, \$\$	4,796	5,428					956					5,543	10,225
EBITDA margin	18.9%	19.9%					6.2%					18.3%	20.5%

Source: Company Reports and Crystal Equity Research Estimates

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ANALYST

Debra Fiakas, CFA is a seasoned, credentialed investment professional with a diversified and successful track record as a research analyst and as an investment banker. Her decade-plus career includes solid experience in all aspects of the equity capital markets with particular emphasis on emerging growth companies operating in the technology sectors. Ms. Fiakas is also the principal member of Crystal Equity Research, LLC.

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Speculative Buy	2	40%	Unproved business model; catalysts exist to generate higher returns
Accumulate	2	40%	Long-term return potential above 10%; near-term catalysts may not exist
Hold	0	0%	Total return potential below 10%; an acceptable long-term holding
Sell	0	0%	Potential return greater than negative 10%; take profits or stem losses
Not Rated	0	20%	No rating
Total	4	100%	

*Research universe categorized by rating only; Crystal Equity Research provides no investment banking services.

HISTORICAL RECOMMENDATIONS AND TARGET PRICE: China Carbon Graphite / CHGI

<u>Report</u>	<u>Date</u>	<u>Price</u>	<u>Rating</u>	<u>Target Price</u>
Initial	9/8/09	\$1.30	Speculative Buy	\$3.40
Update	11/19/09	\$1.35	Speculative Buy	\$3.40
Update	4/22/2010	\$1.28	Speculative Buy	\$2.25
Update	6/1/10	\$0.90	Speculative Buy	\$2.25

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<u>Name</u>	<u>Symbol: Exchange</u>	<u>Disclosures</u>
China Carbon Graphite Group, Inc.	CHGI: OTC/BB	D, E

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- E The company has a convertible issue outstanding.
- F The securities covered in this report can be optioned.
- G The securities covered in this report can be margined.

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