

CER Report

OTC/BB: CHGI

Rating: **Speculative Buy**
(Unchanged)

Recent Price: **\$0.55**
(8/20/10)

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

MARKET DATA

52-Week High/Low	\$3.50 - \$0.52
Ave. Daily Volume (6-mos.)	25 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	\$11.1 M
- Cash & Equivalents	\$ 8.1 M
+ Preferred Stock	\$ 1.3 M
+ Long-term Debt	<u>\$ 3.2 M</u>
Enterprise Value	\$ 7.4 M
Book Value	\$38.7 M
Working Capital	\$ 7.6 M
Dividend Yield	Nil

Balance sheet figures pro forma as of 6/30/10

	SALES	INC*	CFO	EPS*
2009A	\$15.4	(\$2.2)	\$1.9	(\$0.16)
1Q10A	\$ 4.8	(\$1.0)	\$3.1	(\$0.06)
2Q10A	\$ 3.3	\$0.7		\$0.04
3Q10E	\$ 5.0	\$0.0		\$0.00
4Q10E	\$ 5.5	\$0.0		\$0.00
2010E	\$18.6	(\$0.2)	\$5.0	(\$0.02)

Dollars in millions, except EPS; Fiscal year ends Dec.

*Income and earnings available to shareholders

VALUATION

Price/Sales	0.7 X
Price/CFO	2.1 X
Price/Trailing 12-mo. Earnings	Neg
Price/Book Value	0.3 X
Consensus EPS Estimate 2010	NA
Forward PE	NA
Consensus EPS Estimate 2011	NA
Forward PE	NA

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Update

September 21, 2010

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

- Outlook.** We expect more visibility on the part of management and more frequent communications with shareholders to have a positive impact on trading volume and valuation as investors gain confidence in China Carbon's future. Currently, we view CHGI shares as undervalued against a multiple of 2.1 times trailing CFO of \$5.2 million.
- Conference Call with Management.** We came away from a recent conference call with Donghai Yu, CEO of China Carbon Graphite, with renewed confidence in the Company's direction. Yu pledged commitment to providing greater transparency for shareholders.
- 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. During our conference call Yu explained that the Company is preparing for future production expansion. The provincial government was to stop the issuance of inexpensive land use for industrial purposes by the end of 2009.
- Strategic Acquisition.** The Company is still on track to purchase Chiyu Carbon Graphite Ltd, a privately held producer of graphite products. Through the end of 2009, Chiyu had been characterized as a profitable and growth operation, but Yu cited confidentiality pledges and declined to provide details on more recent performance.

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RECENT EVENTS

We came away from a recent conference call with Donghai Yu, CEO of China Carbon Graphite, with renewed confidence in the Company's direction. Yu pledged commitment to providing greater transparency for shareholders and explained that the recent slip in communications with shareholders was temporary following the rather abrupt departure of the Company's chief financial officer.

The shifting sands of demand have presented a challenge to China Carbon, particularly coming during a time when the Company has been attempting a migration to higher margin products. China Carbon is targeting domestic and export markets for high purity and fine grain graphite materials and announced its intention to acquire a finisher of graphite products, Chiyu Carbon Graphite.

Following is a summary of Yu's comments in response to questions regarding the recently reported June 2010 quarter results.

Demand Conditions; Sales Momentum

The Company reported a shift in the sales mix toward lower margin graphite blanks and semi-processed products. Such products are sold year round. In the June 2010 quarter, these types of products, which command lower margins than fine grain and high purity graphite, represented a higher portion of the sales mix. Graphite blanks and semi-processed products are used by manufacturers for molds.

While sales have appeared soft in recent quarters, Yu is confident that its distribution network remains sound. The Company retains most of its distributors, some of which specialize in high purity or fine grain graphite materials. The Company plans to increase its own direct sales personnel to help drive sales of the high purity and fine grain materials. There have been recent reports of increases in steel production in China, in part due to an increase in selling prices for raw steel. China Carbon expects to benefit from any increases in steel production in the coming months.

Strategic Acquisition

The Company is still on track to purchase Chiyu Carbon Graphite Ltd, a privately held producer of graphite products. Through the end of 2009, Chiyu had been characterized as a profitable and growth operation, but Yu cited confidentiality pledges and declined to provide details on recent performance. The two parties continue to sort out the implications of changing sales and profits on the agreement. The impact of China's attempts to slow growth may have reduced its sales in the last couple of months.

We are not revising our estimates at this time. We believe our current estimate of \$16.6 million for the year 2010 is a reasonable scenario for the second half of 2010. The estimate does not include a contribution from Chiyu Carbon. Should the deal close before the end of 2010, we expect a material impact on revenue, expenses and balance sheet accounts.

Profit Margins

As we noted in our August 31, 2010 report, China Carbon experienced an increase in operating costs in the June 2010 quarter. Yu explained that operating expenses included certain on-time expenses associated with stock-based compensation for professional services and increased audit and legal fees to support the Company's activities as a publicly listed company in the U.S.

Cash; Cash Flow from Operations

Cash on the balance sheet is earmarked in part to provide guarantees for trade notes payable totaling \$7.3 million at the end of June 2010. Operations generated \$4.9 million in cash in the June 2010 quarter, bringing total cash flow from operations for 1H10 to \$9.7 million. Favorable changes in working capital, including expansion of accounts payable and trade accounts payable, provided the majority of operating cash flow. Accounts payable increased to \$8.1 million compared to \$2.7 million three months earlier.

Capital Expenditures

The Company recently paid \$5.1 million to acquire a particular 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 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.

During our conference call Yu explained that the Company is preparing for future production expansion. Yu argues that the purchase of the land use right was timely despite the increased leverage on the Company's balance sheet and increasingly constrained working capital. The provincial government was to stop the issuance of inexpensive land use for industrial purposes by the end of 2009. In the future land use for industrial and commercial purposes is to be accomplished by a market auction process that is expected to increase the cost of land use rights. The Company believes the land right acquisition was timely and judicious.

OUTLOOK

We expect more visibility on the part of management and more frequent communications with shareholders to have a positive impact on trading volume and valuation as investors gain confidence in China Carbon's future. Currently, we view CHGI shares as undervalued against both trailing and projected earnings and cash flow from operations. The stock is trading at 2.1 times trailing CFO of \$5.2 million. As noted in the stock price chart below, we believe lines of price support/resistance may have become embedded at the \$2.50 level and in the \$1.25 to \$1.30 price range, the latter being the more pronounced and strong line of resistance. We believe completion of the Chiyu Carbon Graphite deal with serve as a very strong catalyst for upward price momentum and could push the stock back through the lower resistance level. Management has provided no time table for completion of the deal.

STOCK CHART



Source: Stockcharts.com

Additional information is available upon request.

Table I: Historical and Projected Sales and Expenses

Dollars in Thousands	2006	2007	2008	1Q09	2Q09	3Q09	4Q09	2009	1Q10	2Q10	3Q10E	4Q10E	2010E	2011E
Total revenue	17,199	25,357	27,304	2,894	3,658	5,581	3,237	15,370	4,847	3,248	5,000	5,500	18,595	30,000
Cost of sales	13,234	20,447	20,606	2,053	2,804	4,056	4,279	13,192	3,823	3,019	4,000	4,400	15,242	22,500
Gross profit	3,965	4,910	6,698	841	854	1,525	(1,042)	2,178	1,024	229	1,000	1,100	3,353	7,500
Operating expenses:														
Selling	330	124	505	309	9	14	34	366	25	21	50	55	151	300
General & administrative	556	1,121	1,952	136	322	219	1,918	2,595	404	988	625	688	2,705	3,000
Depreciation & amortization	17	16	68	19	19	19	18	75	27	11	35	35	108	150
Total operating expenses	903	1,261	2,525	464	350	252	1,970	3,036	456	1,020	710	778	2,964	3,450
Operating income (loss)	3,062	3,649	4,173	377	504	1,273	(3,012)	(858)	568	(791)	290	323	390	4,050
Other income (expense)														
Change in fair value of warrants	-	-	-	-	-	-	(309)	(309)	-	1,783	-	-	1,783	-
Interest expense	(422)	(495)	(581)	(198)	(206)	(357)	(73)	(834)	206	(268)	(271)	(271)	(1,017)	(1,023)
Other, net	41	440	390	292	232	19	(16)	527	(1,221)	(3)	-	-	(1,224)	-
Total other income (expense)	(381)	(55)	(191)	94	26	(338)	(398)	(616)	(1,427)	1,512	(271)	(271)	(458)	(1,023)
Income (loss) before income taxes	2,681	3,594	3,982	471	530	935	(3,410)	(1,474)	(859)	721	19	51	(68)	3,027
Provision for income taxes (benefit)	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Net income (loss)	2,681	3,594	3,982	471	530	935	(3,410)	(1,474)	(859)	721	19	51	(68)	3,027
Preferred dividend	-	-	(854)	-	-	-	-	(773)	(133)	-	-	-	(133)	-
Dividends									(36)	(15)	-	-	(51)	
Income available to shareholders	2,681	3,594	3,128	471	530	935	(3,410)	(2,247)	(1,028)	706	19	51	(252)	3,027
Foreign currency translation gain		1,794	2,043	45	3	76	-	46	(99)	146	-	-	47	
Total comprehensive income	2,681	5,388	6,025	516	533	1,011	(3,410)	(1,428)	(958)	867	19	51	(21)	3,027
Net EPS (loss), shareholders	\$ 0.26	\$ 0.34	\$ 0.21	\$ 0.03	\$ 0.04	\$ 0.06	\$ (0.23)	\$ (0.16)	\$ (0.06)	\$ 0.04	\$ 0.00	\$ 0.00	\$ (0.01)	\$ 0.14

Source: Company Reports and Crystal Equity Research Estimates

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

Dollars in Thousands	2006	2007	2008	1Q09	2Q09	3Q09	4Q09	2009	1Q10	2Q10	3Q10E	4Q10E	2010E	2011E
Total revenue	17,199	25,357	27,304	2,894	3,658	5,581	3,237	15,370	4,847	3,248	5,000	5,500	18,595	30,000
Operating income (loss)	3,062	3,649	4,173	377	504	1,273	(3,012)	(858)	568	(791)	290	323	390	4,050
Net income (loss)	2,681	3,594	3,982	471	530	935	(3,410)	(1,474)	(859)	721	19	51	(68)	3,027
Net EPS (loss), shareholders	\$ 0.26	\$ 0.34	\$ 0.21	\$ 0.03	\$ 0.04	\$ 0.06	\$ (0.23)	\$ (0.16)	\$ (0.06)	\$ 0.04	\$ 0.00	\$ 0.00	\$ (0.01)	\$ 0.14
Weighted shares outstanding, diluted	10,388	10,506	14,623	13,847	14,239	15,085	15,000	14,427	18,485	20,068	20,000	20,000	19,638	21,000
SELECTED MEASURES:														
Sales growth, yr/yr		47.4%	7.7%					-43.7%					21.0%	61.3%
Net income growth, yr/yr		34.1%	-10.8%					-137.0%					95.4%	-4532.2%
EPS growth, yr/yr		32.5%	-37.5%					-172.8%					91.8%	-1222.0%
Gross margin	23.1%	19.4%	24.5%	29.1%	23.3%	27.3%	-32.2%	14.2%	21.1%	7.1%	20.0%	20.0%	18.0%	25.0%
Operating margin	17.8%	14.4%	15.3%	13.0%	13.8%	22.8%	-93.0%	-5.6%	11.7%	-24.4%	5.8%	5.9%	2.1%	13.5%
Net margin	15.6%	14.2%	14.6%	16.3%	14.5%	16.8%	-105.3%	-9.6%	-17.7%	22.2%	0.4%	0.9%	-0.4%	10.1%
Direct costs, % sales	76.9%	80.6%	75.5%	70.9%	76.7%	72.7%	132.2%	85.8%	78.9%	92.9%	80.0%	80.0%	82.0%	75.0%
Selling expense, % sales	1.9%	0.5%	1.8%	10.7%	0.2%	0.3%	1.1%	2.4%	0.5%	0.6%	1.0%	1.0%	0.8%	1.0%
G&A expense, % sales	3.2%	4.4%	7.1%	4.7%	8.8%	3.9%	59.3%	16.9%	8.3%	30.4%	12.5%	12.5%	14.5%	10.0%
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%	0.0%
EBITDA, \$\$	4,036	4,796	5,428					956					1,790	5,550
EBITDA margin	23.5%	18.9%	19.9%					6.2%					9.6%	18.5%

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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CER REPORT RESEARCH UNIVERSE*

Speculative Buy	2	66%	Unproved business model; catalysts exist to generate higher returns
Accumulate	1	34%	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	0%	No rating
Total	3	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
Update	8/31/10	\$0.64	Speculative Buy	\$2.25
Update	9/21/10	\$0.55	Speculative Buy	\$2.25

DISCLOSURES

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

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