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CLSA ChinaW @ 601.29

China

Materials

 Reuters 0769.HK
 Bloomberg 769 HK

Market cap

HK\$1.46bn (US\$186.9m)

Shares in issue

814.6m

Estimated free float

49%

3M average daily volume

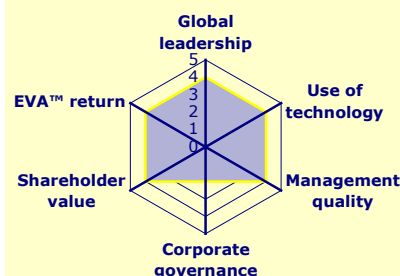
US\$1.68m

12M high/low

HK\$3.05/1.00

Major shareholder

YY Hldgs 51.0%

Jet Stream® radar

Stock performance (%)

	1M	3M	12M
Absolute	(11.6)	(37.2)	49.2
Rel. index	2.0	(17.2)	108.4
Absolute (US\$)	(11.6)	(37.2)	49.2



Source: Reuters

www.cls.com

Industrial Viagra

China Rare Earth is a global leader in rare earth processing, an industry that is undergoing rapid growth as industrial technology evolves. Rare Earth is also the flagship of the private enterprise sector. The company's dynamic management, global leadership, high returns and low valuation present a rare combination among China equities. We expect the stock to trade up to 10x 03CL EPS.

At the forefront of new technology

In addition to its traditional use in heavy industry, rare earth is now used in semiconductors, fuel cells, optical fibre, catalytic converters, magnetic memory chips, electronic motors, mobile phones, display monitors and precision optics. Intensive research is being conducted on its uses in nano technology.

Non-stop expansion

Having just finished China's most advanced rare earth separation plant, the company recently raised HK\$255m to expand rare earth metals, fluorescent powder and refractory material capacities by 4x, 10x and 60% respectively. Expansion of the former will enable the company to capture a bigger chunk of the value created by the rare earth processing chain.

Refractory material exports surging

China Rare Earth's other core business is supplying high-quality refractory bricks to steel, chemical, power and float-glass plants. According to the cooperation plan with Kurosaki, Nippon Steel's refractory material supplier, exports of refractory materials will be boosted from 10% to 50% of production.

Full order book

Strong demand and higher pricing of refractory materials is helping offset weakness in rare earth prices (company's ASP down 5% YTD). The company's rare earth oxide order book is full until 4Q02 and refractory materials' orders are full until 2003. Sixty percent of rare earth sales are made on a long-term contract basis, with the remainder on a spot basis.

Financials

Year to 31 Dec	99A	00A	01CL	02CL	03CL
Revenue (HK\$m)	448	558	720	1,056	1,387
Net profit (HK\$m)	81	141	232	322	428
EPS (HK¢)	16.7	23.1	31.1	39.5	52.5
CLSA/consensus	–	–	1.05	1.05	1.24
EPS change (%)	21.3	38.1	34.5	27.0	32.9
PEx (@HK\$1.69)	10.1	7.3	5.5	4.2	3.2
Dividend yield (%)	2.3	1.8	4.6	5.8	7.7
ROE (%)	38.2	34.9	38.6	39.3	38.9
EVA™/inv capital (%)	37.1	29.5	28.6	32.2	31.7
Net gearing (%)	(23.7)	(14.8)	(33.2)	(46.6)	(58.0)
EV/Ebitda (x)	6.9	6.0	4.4	2.3	1.2

Source: CLSA Emerging Markets

China Rare Earth

Key earnings drivers

Year to 31 December	1999A	2000A	2001CL	2002CL	2003CL
Rare earth oxides:					
Capacity (tons) – year end	3,500	4,900	7,900	7,900	7,900
WA capacity (tons)	3,500	3,850	5,650	7,900	7,900
Sales (tons)	3,000	3,300	4,500	6,200	7,900
WA price (YoY %)	5	15	-	10	-
Gross margin (%)	33	33	34	38	40
Refractory materials:					
Capacity (tons) – year end	30,000	50,000	50,000	80,000	80,000
WA capacity (tons)	30,000	40,000	50,000	65,000	80,000
Sales (tons)	23,000	30,000	37,500	48,750	63,375
WA price (YoY %)	11	2	(1)	(0)	(1)
Gross margin (%)	43	37	37	37	37

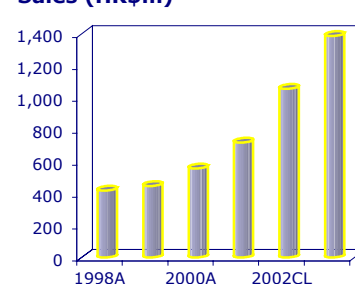
Summary P&L forecast (HK\$m)

Year to 31 December	1999A	2000A	2001CL	2002CL	2003CL
Revenue	448	558	720	1,056	1,387
Cash operating costs	(319)	(387)	(462)	(645)	(851)
Ebitda	129	172	259	411	537
Ebitda margins (%)	28.8	30.7	35.9	38.9	38.7
Depreciation	(9)	(14)	(22)	(26)	(26)
Ebit	120	157	237	385	511
Ebit margins (%)	26.7	28.2	32.9	36.5	36.8
Interest income	-	-	-	-	-
Interest expense	(3)	(12)	1	1	1
Net interest inc/(exp)	(3)	(12)	1	1	1
Associates/investments	-	-	-	-	-
Forex/other income	-	-	-	-	-
Exceptional items	-	-	-	-	-
Profit before tax	117	146	238	386	512
Taxation	(33)	-	-	(58)	(77)
Effective tax rate (%)	28.0	-	-	15.0	15.0
Profit after tax	84	146	238	328	435
Minorities	(3)	(5)	(6)	(7)	(7)
Net profit	81	141	232	322	428
Dividends	(24)	(20)	(63)	(80)	(107)
Extraordinaries/others	-	-	-	-	-
Retained profit	57	121	168	241	321

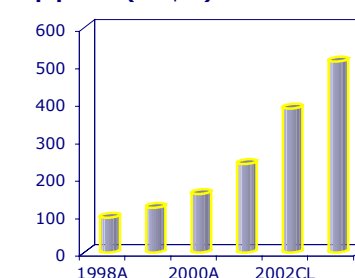
DuPont analysis

Year to 31 December	1999A	2000A	2001CL	2002CL	2003CL
Ebit margin (%)	25.8	27.3	32.0	35.7	36.2
Asset turnover (x)	1.22	0.99	0.95	1.06	1.04
Financial leverage (x)	1.73	1.39	1.27	1.22	1.21
Interest burden (x)	0.98	0.92	1.00	1.00	1.00
Tax burden (x)	0.72	1.00	1.00	0.85	0.85
Return on equity (%)	38.2	34.9	38.7	39.3	38.9

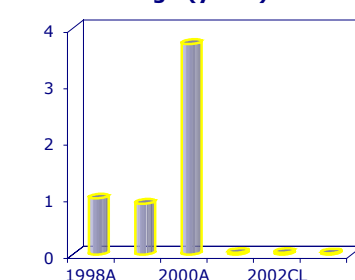
Sales (HK\$m)



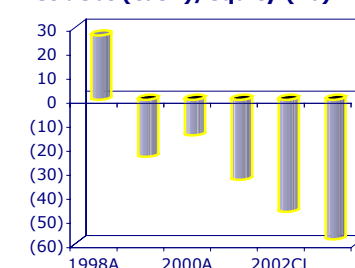
Op profit (HK\$m)



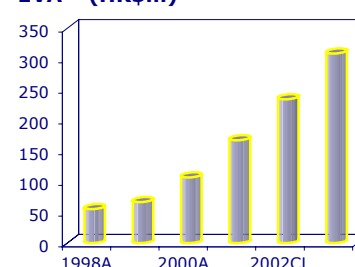
Debt coverage (years)



Net debt (cash)/equity (%)

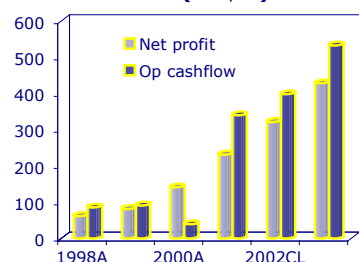


EVA™ (HK\$m)

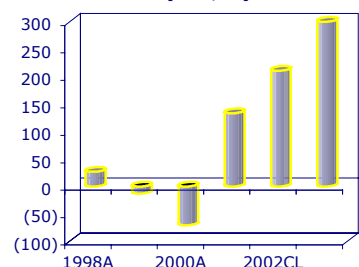


China Rare Earth

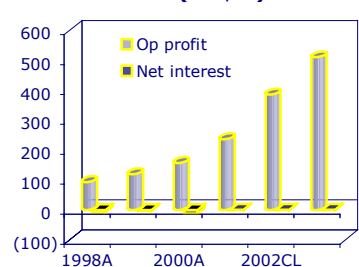
Profit or cash? (HK\$m)



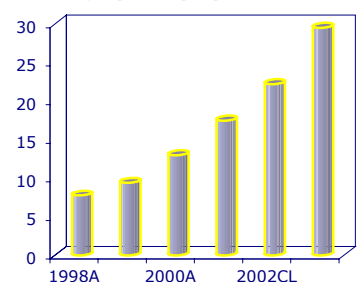
Net cashflow (HK\$m)



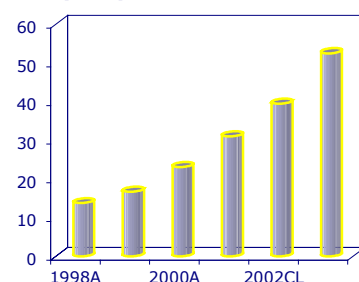
Interest cover (HK\$m)



Earnings yield (%)



EPS (HK¢)



Summary cashflow forecast (HK\$m)

Year to 31 December	1999A	2000A	2001CL	2002CL	2003CL
Operating income	120	157	237	385	511
Depreciation	9	14	22	26	26
Working capital changes	(63)	(113)	82	(13)	(4)
Others	25	(19)	-	-	-
Operating cashflow	91	39	340	398	533
Net interest inc (exp)	(3)	(12)	1	1	1
Tax received (paid)	(33)	(8)	-	(58)	(77)
Dividends received	-	-	-	-	0
Free cashflow	56	20	341	341	457
Dividends paid	(18)	(18)	(20)	(63)	(80)
Capex	(27)	(105)	(142)	(50)	(50)
Others	(24)	32	(46)	(17)	(27)
Net cashflow	(13)	(71)	133	211	300
Shares issued	120	73	29	-	-
Exch rate movements	-	-	-	-	-
Net debt change	107	2	162	211	300
Open net (debt)/cash	(33)	74	76	238	449
Close net (debt)/cash	74	76	238	449	749

Summary balance sheet forecast (HK\$m)

Year to 31 December	1999A	2000A	2001CL	2002CL	2003CL
Fixed assets	132	217	340	364	388
Tangible	130	217	337	361	385
Associates/investments	-	-	-	-	-
Others	2	0	3	3	3
Current assets	323	453	514	781	1,131
Cash & equivs	124	150	250	460	760
A/C receivables/debtors	103	91	104	126	156
Inventories	55	111	125	160	180
Other current assets	41	101	35	35	35
Current liabilities	104	123	138	181	228
ST debt + current portion of LT	11	40	12	11	11
A/C payable/creditors	25	24	25	30	35
Others	68	59	101	140	182
Non-current liabilities	39	34	-	-	-
Debt	39	34	-	-	-
Other	-	-	-	-	-
Net assets	312	512	715	963	1,291
<i>Financed by:</i>					
Share capital	60	68	70	70	70
Convertible preference shares	-	-	-	-	-
Share premium	134	187	213	213	213
Reserves	112	246	414	656	977
Shareholders funds	306	501	698	939	1,260
Minority interests	6	12	18	24	31
Net assets	312	512	715	963	1,291

Other ratios

Year to 31 December	1999A	2000A	2001CL	2002CL	2003CL
Net debt (cash)/equity (%)	(23.8)	(14.8)	(33.3)	(46.6)	(58.0)
Interest cover (x)	46.8	13.6	(236.8)	(385.2)	(510.6)
Current ratio (x)	3.1	3.7	3.7	4.3	5.0
Dividend cover (x)	3.8	1.9	5.4	5.0	5.0

China Rare Earth

Key issues

Resource and export quotas. Better PRC government controls have eliminated poor-quality products, helping to tighten supply and raise prices. The government is also making efforts to transfer export quotas from state trading companies to the hands of the manufacturers, in line with the inevitable post-WTO accession plans. China Rare Earth's (CRE) high product purity and strong export track record have allowed the company to secure a relatively high export quota. Because rare earth ore supplies (from state-owned mines) will remain tight, the company is considering investing upstream to help secure its supply.

Tech sector slowdown. CRE sells 25% of its rare earth materials to the US, 34% to Japan, 33% in China and 8% to Europe and Korea. The company has not received any cancellations, but we estimate the company's ASP has fallen by 5% YTD as demand for low purity rare earth elements (ie, those that other producers in China can make) weakens. Prices for high-purity oxides have continued to increase due to tight supply and new technology breakthroughs. We are maintaining our forecast of HK\$230m in profit this year as both volumes and pricing of refractory materials are running ahead of forecast, thanks partly to 1) Nippon Steel's decision to source from the company and 2) emission upgrades at domestic power plants.

Competition. CRE has risen to the top of its industry through: 1) employing advanced technology (Phase III plant is China's most advanced, processing 15 of the 17 rare earth elements), 2) access to resources, 3) cost competitiveness and 4) dynamic management. CRE boasts higher margins than state-owned competitors and foreign companies on the mainland.

Corporate governance assessment

Criteria	China Rare Earth (%)	Forecast 6M trend	Country avg (%)	GEM sector avg (%)
Discipline	77	→	44	56
Transparency	40	↑	56	45
Independence	50	→	40	46
Accountability	62	→	39	42
Responsibility	66	→	52	41
Fairness	60	→	63	50
Social responsibility	50	→	57	66
Weighted CG score	58	→	47	47

CLSA's recommendation matrix

Outlook	1 year	Comment
Jet Stream® criteria		
Global leadership	✓	9% global share; even higher (c20%) for high purity oxides
EVA™ return	✓	Gross margins have been maintained above 30%
Shareholder value	✓	Downstream expansion to capture more value
Corporate governance	✗	Excellent capital discipline, but transparency can be improved
Management quality	✓	Entrepreneurial success story
Use of technology	✓	Operate China's only continuous separation facility
Valuations		
Earnings momentum	✓	First-time contribution from new oxide facilities
PE	✓	4x earnings
Price to book	✓	Low relative to ROE
Macro		
Country risk	✓	Smooth political succession expected
Strategy	✓	Non-reflexive market and low valuations
Liquidity	✓	Rmb7tr in household savings, 80% of GDP
Conclusion	BUY	

Source: CLSA Emerging Markets