

China Rare Earth Holdings

Recovery of global industrial production positive for rare earth prices; refractory products to see good growth

Year to	Revenue (HKDm)	EBITDA (HKDm)	Reported net profit (HKDm)	EPS (HKD)	HSBC net profit (HKDm)	HSBC EPS (HKD)	HSBC EPS growth (%)	PE (HSBC) (x)	Yield (%)	EV/EBITDA (x)	EV/IC (x)	ROIC (%)	REP (x)
12/1999a	448	130	81	0.17	82	0.17	-	3.9	3.0	2.5	1.7	47.1	0.6
12/2000a	558	161	141	0.23	143	0.23	38.1	5.3	3.2	4.7	2.4	47.0	0.7
12/2001f	728	204	177	0.24	180	0.24	2.0	9.0	2.6	7.1	2.8	35.5	0.5
12/2002f	902	292	205	0.25	209	0.25	6.3	8.5	2.8	4.0	1.6	29.5	0.3
12/2003f	1,064	352	245	0.30	250	0.30	19.4	7.1	3.1	3.0	1.3	29.9	0.3

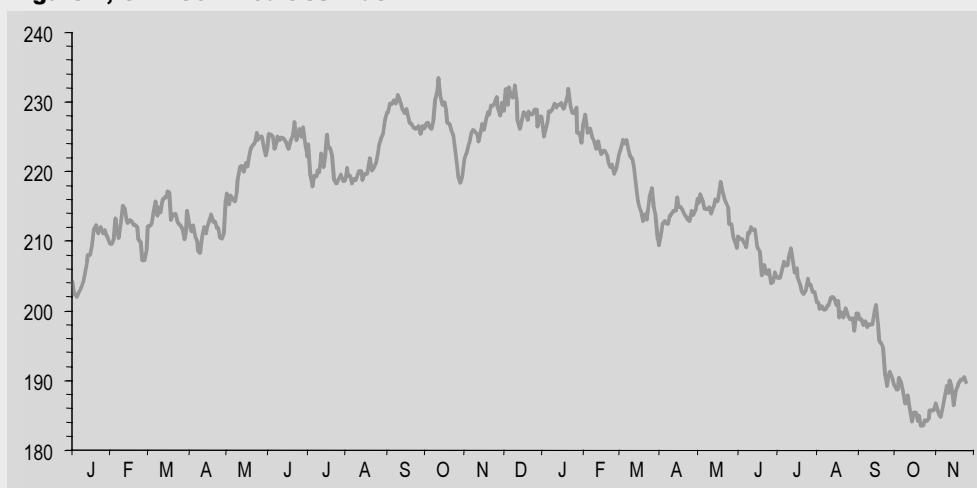
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- ▶ **Rebound of CRB Commodities Index augurs well for demand for manufacturing materials such as rare-earth products**
- ▶ **Growth remains intact while valuation attractive**
- ▶ **Underperformance creates good opportunity to buy**

CRB Commodities Index bottoming out, good news for rare earth

China Rare Earth admits that rare-earth product prices remain under pressure as the global economy slows. We expect average prices for the company's rare-earth products this year to come down by 14% y-o-y. However, as a result of the introduction of a new rare-earth production line last July, volume growth is still expected for China Rare Earth in FY01. In 1H01, sales from rare earth products increased by 25% y-o-y,

Figure 1; CRB Commodities Index



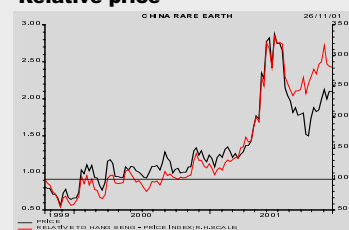
Source: Datastream

Red Alert

Stock rel to market
Buy
Changed from
N/A

Sector rel to market
Neutral

Relative price



Source: Thomson Financial Datastream

Red Alert Company

Country	China
Sector	Mining
Bloomberg	769 HK
Reuters	0769.HK
Mkt cap (HKDm)	1,731
Mkt cap (USDm)	222
Free float (%)	49.0
Daily t/over (12M av) (USDm)	1.16

Price

	1M	3M	12M
Absolute	1.99	1.78	1.34
Absolute (%)	7	19.7	59
Relative (%)	-2.2	16.7	100.6
Relative to	H S I		
Index level	11391.957		

Current (HKD)	Target (HKD)
2.13	3.20

Disclaimer & disclosures

This report must be read with the disclaimer & disclosures on p4 that form part of it.

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Lately, we have seen a rebound in the CRB Commodities Future Index (see Figure 1), which is a positive sign suggesting the de-stocking process of the major industrial economies has advanced well. Our Asia economist Geoffrey Barker suggests that a trough in global manufacturing activity appears likely over the next 3-6 months.

This is, of course, positive for China Rare Earth since exports to the US and Japan account for the bulk of its rare earth sales (last year: 60%). Rare earth products are used in many manufacturing activities such as glass polishing and hi-tech products such as semiconductors and electronic components. A recovery in global manufacturing will thus relieve price pressures and rejuvenate demand for rare earth products. We have assumed a 2% y-o-y increase in the average selling price of China Rare Earth's products next year.

Domestic demand for refractory products still strong

Meanwhile, the refractory products business of the company is in good shape as domestic production of steel, glass and cement (the industries that together with petrochemicals consume most of the refractory products) continued to register good growth this year. The domestic market accounted for 91% of refractory product sales last year. In 1H01, refractory-product sales were up 66% y-o-y, to HK\$121m. We expect growth momentum to continue and sales to reach HK\$290m for the full year.

China Rare Earth has focused on the high-end segment of the market. Since steel producers in China are upgrading their facilities to compete with imported products due to WTO entry, China Rare Earth anticipates an increase in domestic demand for high-quality refractory materials. Proceeds from its 105m-share placement in July will be used to expand the capacity from current 50,000 tpa to 80,000 tpa next year. This will underpin further growth for its refractory product business.

China still relies on import for high quality refractory products. In 2000, import of refractory products amounted to 28,000 tonnes. The quality of China Rare Earth's refractory material has been recognised and Krosaki Harima, one of the world's leading manufacturers of refractory products, has agreed to help develop export sales for China Rare Earth.

Figure 2: Production growth of major refractory-product users in China (%)

	Plated Glass	Steel	Steel Products	Cement
1997	6	8	11	3
1998	1	6	10	5
1999	3	8	15	5
2000	8	2	10	8
Year-to-October 2001	10	11	19	6

Source: HSBC

Valuation attractive; earnings to enjoy 20% CAGR over FY99-03

As a privately-owned enterprise (POE), China Rare Earth holds its own with other POEs on valuation. Compared with Yanzhou Coal Mining, another mining stock, China Rare Earth is trading at a slightly higher valuation, but Yanzhou Coal Mining is forecast to see flat earnings growth in FY02 while we expect China Rare Earth to post 16% y-o-y earnings growth next year. We forecast weighted average EPS will enjoy a 9% CAGR over FY99-03.

We have shaved our earnings forecasts for FY01 and FY02 by about 1% each, taking into consideration the interim results. We remain positive on the stock with a revised target price of HK\$3.20. Its market underperformance in the past month provides a good opportunity to buy this inexpensive growth stock. **Buy.**

Peer group comparison

			Enterprise measures					Equity measures			
			EV/ Sales	EV/ EBITDA	EV/ EBIT	EV/ IC	HSBC REP	PE	PEG	Price to Book	PCE
China Rare Earth Holdings 0769.HK	Buy	12/1999a	0.7	2.5	2.7	1.7	0.6	3.9	-	1.3	3.5
		12/2000a	1.4	4.7	5.2	2.4	0.7	5.3	0.1	1.7	4.9
		12/2001f	2.0	7.1	7.9	2.8	0.5	9.0	0.3	1.9	8.1
		12/2002f	1.3	4.0	4.6	1.6	0.3	8.5	2.2	1.3	5.9
		12/2003f	1.0	3.0	3.6	1.3	0.3	7.1	0.7	1.1	4.9
Chaoda Modern Agriculture 0682.HK	Buy	6/2000a	-	-	-	-	-	-	-	-	-
		6/2001a	3.8	5.9	6.2	10.6	0.5	6.6	-	3.4	6.2
		6/2002f	2.6	4.6	5.4	4.6	0.4	5.5	0.0	2.7	4.8
		6/2003f	1.7	3.0	3.8	2.4	0.3	4.3	0.2	1.9	3.5
		6/2004f	1.1	2.1	2.7	1.6	0.2	3.7	0.2	1.4	2.9
Greencool Technology 8056.HK	Buy	12/1999a	-	-	-	-	-	-	-	-	-
		12/2000a	5.4	7.7	8.1	16.2	1.1	6.3	-	1.7	6.0
		12/2001f	7.2	10.9	10.1	14.1	0.9	11.0	0.0	2.8	10.7
		12/2002f	5.3	8.3	7.7	7.9	0.7	8.5	0.5	2.3	8.2
		12/2003f	4.0	6.4	6.0	5.3	0.5	6.5	0.3	1.8	6.3
Yanzhou Coal Mining 1171.HK	Add	12/1999a	1.6	3.3	4.8	1.0	1.1	7.2	-0.2	1.0	4.5
		12/2000a	1.4	3.4	5.2	0.9	0.9	7.9	-0.8	0.9	
		12/2001f	1.2	2.6	3.5	0.9	0.3	7.5	1.0	0.9	4.3
		12/2002f	0.9	2.1	3.0	0.7	0.3	7.7	0.6	0.8	4.1
		12/2003f	0.5	1.3	1.7	0.5	0.2	6.7	1.3	0.7	3.7

Year to	12/1999a	12/2000a	12/2001f	12/2002f
Per share data (HKD)				
Reported EPS	0.17	0.23	0.24	0.25
HSBC EPS	0.17	0.23	0.24	0.25
CEPS	0.19	0.26	0.26	0.36
DPS	0.02	0.04	0.06	0.06
NAV	0.51	0.74	1.14	1.58
P&L summary (HKDm)				
Revenue	448	558	728	902
EBITDA	130	161	204	292
EBIT	121	147	184	250
Net interest	-4	-1	0	5
PBT	117	146	184	255
HSBC PBT	117	146	184	255
Taxation	-33	-	-	-42
Reported net profit	81	141	177	205
HSBC Net profit	82	143	180	209
NOPLAT	87	147	184	209
Cash flow summary (HKDm)				
Op free cash flow	-2	-58	-61	66
HSBC cash flow	29	38	139	206
Capital expenditure	-35	-97	-200	-135
Cash earnings	90	155	196	247
Change in net debt	101	26	162	26
Balance sheet summary (HKDm)				
Intangible fixed assets	-	-	-	-
Tangible fixed assets	133	217	397	490
Cash	124	150	312	338
Current assets	323	453	718	860
Operating liabilities	104	123	165	236
Gross debt	50	74	35	35
Net cash (debt)	73	76	277	303
Shareholders funds	313	512	950	1,115
Invested capital (avg)	185	313	518	708

Year to	12/1999a	12/2000a	12/2001f	12/2002f
Ratios (%)				
Revenue/IC (x)	2.4	1.8	1.4	1.3
NOPLAT margin	19.4	26.3	25.3	23.1
ROIC	47.1	47.0	35.5	29.5
ROE	38.9	34.9	24.7	20.3
ROA	22.3	24.9	20.2	17.1
ROCE	30.2	29.5	22.9	19.8
ROIC/Cost of capital	2.9	3.7	5.8	4.8
Cost of capital	16.3	12.7	6.1	6.1
EBITDA margin	29.1	28.9	28.0	32.4
EBIT margin	27.0	26.3	25.3	27.7
PAT margin	18.8	26.1	25.3	23.6
HSBC net profit margin	18.3	25.6	24.7	23.1
Net debt/equity	-	-	-	-
Net debt/EBITDA	-	-	-	-
Growth (%)				
Revenue	-	24.6	30.4	24.0
EBITDA	-	23.8	26.4	43.5
EBIT	-	21.4	25.3	36.0
PBT	-	24.6	26.4	38.7
HSBC Net profit	-	73.9	25.8	16.1
HSBC NOPLAT	25.3	68.6	25.3	13.5
HSBC EPS	-	38.1	2.0	6.3
Valuation (x)				
PE	3.9	5.3	9.0	8.5
PNAV	1.3	1.7	1.9	1.3
PCE	3.5	4.9	8.1	5.9
Yield (%)	3.0	3.2	2.6	2.8
EV/Revenue	0.7	1.4	2.0	1.3
EV/EBITDA	2.5	4.7	7.1	4.0
EV/IC	1.7	2.4	2.8	1.6
ROIC/Cost of capital	2.9	3.7	5.8	4.8
HSBC REP	0.6	0.7	0.5	0.3

Recommendation structure

Stock (vs market)
(outperform >20%)
(outperform <20%)
(market neutral)
(underperform <20%)
(underperform >20%)

Buy
Add
Hold
Reduce
Sell

Our recommendations are based on stock performance relative to the market on a 6-12 months view. The target price is the level the stock should currently trade at if the market accepted the analysts' view of the stock and, therefore, abstracts from the need to take a view on the market or sector. In addition, a secondary recommendation is applied of stock relative to sector where there is a meaningful sector.

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