

28 December 2001

China Rare Earth	Price	HK\$2.08	Reuters	0769.HK
BUY	Target	HK\$3.40	Bloomberg	769 HK

What's new?

- ❑ Oligopoly formed with largest northern competitor to support prices
- ❑ Weak rare earth pricing leads to earnings downgrade
- ❑ Downstream expansion proceeding well
- ❑ Target price of HK\$3.40 or 8x 03CL EPS, a 20% premium to regional metals & mining plays

When the going gets tough...

oligopoly with Inner Mongolia Rare-Earth Hi-Tech

In a move that should cement China Rare Earth's position as the world's largest rare earth processor, the company has formed an oligopoly with A-share **Inner Mongolia Rare-Earth Hi-Tech** (600111.SS) to halt the slide in rare earth prices. Together, the two companies have a 25% share of the global rare earth product market and should be able to expand this as sliding prices are forcing smaller competitors into bankruptcy.

co-operate to control raw material and product supply

China Rare Earth and Rare Earth Hi-tech will co-operate to control raw material and product supply. There are two types of rare earth ore in China: northern (Inner Mongolia) and southern (Jiangxi). China Rare Earth processes both and is the largest processor of southern ore and second largest processor of northern ore. Rare Earth Hi-Tech is the largest processor of northern ore as well as controlling 65% of the supply of northern rare earth ore.

we have cut our rare earth price assumptions

Revisions to forecast: we are revising down our 01-03CL EPS for Rare Earth by 16-25% to reflect 1) lower rare earth prices: we have cut our rare earth price assumptions from flat in 01CL and +10% in 02CL to -5% in 01CL and -2.5% in 02CL, 2) new rare earth production line commenced operation on 28 June 2001 but the whole separating process took 3 months to complete and thus

Earnings forecast	Any change? Yes				
Year to 31 Dec	99A	00A	01CL	02CL	03CL
Revenue (HK\$m)	448	558	759	1,030	1,384
Net profit (HK\$m)	81	141	183	242	359
Net profit forecast change(%)			(21.2)	(24.7)	(16.2)
EPS (HK¢)	16.72	23.10	24.50	29.74	44.04
EPS (%YoY)	21.3	38.1	6.1	21.4	48.1
PEx (@HK\$2.08)	12.4	9.0	8.5	7.0	4.7
CLSA/consensus (%)	100.00	100.00	106.00	118.00	151.00
DPS (HK¢)	4.0	3.0	6.1	7.4	11.0
Dividend yield (%)	1.9	1.4	2.9	3.6	5.3
ROAE (%)	38.2	34.9	31.4	32.1	36.6
Price/book (x)	4.1	2.8	2.6	2.0	1.5

Key data

Market capitalisation	HK\$1,690m(US\$217m)			
Share capital	814.5m			
12M high/low	HK\$3.05/1.08			
3M average daily volume	HK\$9.4m(US\$1.3m)			
Major shareholders	YY Hldgs (51.0%)			
Estimated free float (%)	49.0			
Share performance (%)	1W	1M	3M	12M
Absolute	(6.7)	0	42.1	82.0
Relative to CLSA ChinaW	(3.4)	2.5	26.6	98.3
Absolute (US\$)	(6.7)	0.0	42.1	82.0

Performance



2002 should see an acceleration in profit growth

contribution to bottomline only started in Oct, 3) the construction of the new rare earth production line led to fixed asset write-off for the old facilities as the new line is situated on the old site, and this has impact on this year's profits but the impact is one-off. We have factored in a HK\$20m provision.

global leader

2002 should see an acceleration in profit growth as prices stabilise and new capacity begins to contribute. Not only will the new rare earth separating line make a 12 month contribution as compared to 3 months in 2001, but also the 2 new refractory material workshops (mainly supplying Nippon Steel) will start contribution by May 2002 and that will double existing refractory material capacity. Thirdly, the new 500-ton fluorescent powder factory will commence operation in 2Q 2002 and we estimate the annual profit will be at least Rmb80m at current price and cost levels. The company has 67% stake in this JV which has secured long term contract to supply 450 tons to Osram, the world's largest producer of light bulbs.

20% premium to the regional metals and mining sector

By 2003, we expect the company will be well established as the global leader in rare earth separating, down-stream processing and rare earth metal production. The company already has the largest number of rare earth elements separated and highest purity, resulting in the highest margins in the industry. We also expect the company to become the largest producer of high-end refractory materials in China with the highest return and best profitability, largest exports in the industry in China.

Target price: we expect Rare Earth to trade up to HK\$3.40 or 8x 03CL EPS. This would put it at a 20% premium to the regional metals and mining sector (Yanzhou Coal, Hindalco, Chalco etc), which we believe is justified given the rare earth industry's better growth prospects and the company's global leadership.

Note: In the interests of timeliness, this document was not edited.

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