



BUY

Price

HK\$2.10

HS Index

11,893

769.HK

Company Data

Shares issued	814.5m
Market cap	1710.4m
Avg daily vol (shrs)	1.3m
52-week Hi	3.125
52-week Lo	1.07
Free float	49.1%
ROE	34.9%
P/book	2.8
Net debt/equity	Net cash

Forecast

Y/E: Dec 31	2001	2002
N Profit (HK\$ m)	169	202
EPS (HK\$)	0.23	0.25
% growth	0.6	6.6
PER (x)	9.0	8.4
Rel PER (x)	0.6	0.5
Div yield (%)	2.1	2.3

CE Research

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China Rare Earth

8 January 2002

China Rare Earth is a unique industrial play. Its core businesses include the manufacture of rare earth and refractory products. The development of new uses for rare earths and the increasing demand for refractory products should see net profit rise by a CAGR of 24% from FY00-FY03. Despite EPS dilution due to a share placement and the conversion of CBs, we expect the use of the net proceeds to expand the refractory division and its downstream rare earth products to enhance earnings growth beyond FY02.

A rare mainland private enterprise. The company is the largest supplier of high-purity rare earth oxide in China. Since listing in Hong Kong in October 1999, it has performed well. Turnover and EPS increased by 33% and 68% respectively in the period FY98-FY00, making it one of the best-performing mainland private enterprises.

Benefiting from IT expansion. Rare earth products are widely used in the IT industry in products such as computers, magnetic memory chips, fibre optics, and mobile phone batteries. The expected recovery of the IT sector, together with the development of new applications for rare earth products, should enable the company to sustain growth. Gross margins should be maintained at about 32%, even though rare earth prices dropped significantly in 2001. Meanwhile, the company has linked up with universities on R&D to explore new production techniques and develop new products.

Seizing modernisation opportunities. The major buyers of the company's refractory products are large steel producers. With WTO entry, competition in the steel industry and other heavy industries is intensifying. The upgrading of production techniques and product quality will be key to survival. Demand for high-quality refractory products to produce top-grade steel should therefore rise, underpinning the company's capacity expansion programme.

Protected from competition. Due to an oversupply of rare earth products and the sector's strategic importance to the country, the Chinese government regulates the industry through the issue of production licences and export quotas. Recently, the company signed a strategic alliance with an Ashare listed company, Inner Mongolia Baotou Steel Rare Earth Hi-Tech Co. (600111.CH), to stabilise supply and product price.

Undemanding valuation. The counter is trading at 9x PE against a CAGR in EPS of 12.8% for FY00-FY03. In the past three years, the company achieved a CAGR in EPS of 29.7%. Earnings upside should come from increased uses for rare earth products. Given the company's sound fundamentals, we recommend the counter as a **BUY**.



BUSINESS OUTLOOK

Rare Earth Products

The so-called "rare earths" comprise 17 elements in the chemical periodic table, which are essential for the production of various products such as cars, magnets, phosphors, electronics and glass. About 80% of the world's total reserves of rare earths are found in China, mainly in Inner Mongolia, Jiangxi province and Guangdong province. The annual production of rare earth oxide is about 83,000 tonnes, of which 70% comes from China.

In China, there are numerous firms engaged in the production of rare earth products: most are SOEs that produce rare earth products of low-purity, ranging from 40% to 90%. To differentiate itself from these firms the company produces high-purity rare earth products, with purity levels of up to 99.9999%. Competition is, therefore, not too great. Furthermore, China controls the industry by issuing licenses to production firms. Hence, the supply of rare earth products is controlled.

We expect the company to benefit from a recovery in product prices, following heavy falls in 2001. Global consumption of rare earth products last year is estimated at 75,000 tonnes, a decrease of 9.1% over 2000 due to the world economic slowdown. Prices dropped by more than 20% from their 2000 peaks. They started to stabilise in October 2001 and rebounded by 5% in November. We expect the rise in prices to continue this year, as world consumption is forecast to increase, aided by the recovery of the industrial and IT sectors.

The largest supplier of high-purity rare earth oxide with a 15% share of the global market, China Rare Earth has strengthened its position with the net proceeds raised from its IPO. In 2001 it increased its annual production capacity from 3,500 tonnes to 6,500 tonnes. In addition, its expanded production line can separate 15 rare earth elements in a single process, thus reducing wastage and allowing economies of scale.

Financially, rare earth products account for about 63% of the company's gross profits. About 67% of sales are to Japan, the US, Europe and South Korea, with the remainder sold in China. Its major clients are multinationals such as GE, MQ and Osram. With long-term relationships established, the company is able to reduce earnings volatility and work with the research teams of its clients to satisfy their needs. It is unfeasible for its large SOE competitors to do this as their products are of a different standard.

The company plans to expand its downstream products, which sell at a premium to rare earth oxide. The capacity of this production line is about 1,000 tonnes. In addition, new applications for rare earth products in the IT industry will be explored. For example, they can be

used in nano-technology and Bluetooth technology to enhance product efficiency.

Given the rebound in the global economy and increased uses for rare earth products, turnover is expected to grow at 26% and 17% respectively in 2002 and 2003. The gross profit margin of this segment in 2001 will decline slightly, to 32%, due to the drop in product prices. We expect margins to recover in 2002 to 33% on the back of higher product demand and economies of scale from expanding production capacity.

Refractory Products

Refractory products are widely used in heat treatment facilities in the steel, metallurgy and petrochemical industries. Product quality in these industries depends to a large extent on the temperature of the furnaces, which can be controlled by using refractory products.

In China, the steel industry — the largest consumer of refractory products — is expected to increase its demand. China Rare Earth's major clients are Baoshan Iron & Steel, Capital Iron & Steel and Wuhan Iron & Steel. The steel industry is facing intense competition from high-quality imported products following WTO entry. The need to upgrade production facilities should result in greater demand for high-quality refractory products. The company utilises techniques from Nippon Steel, which should enable it to produce top-grade refractory products.

China Rare Earth should have little problem selling its refractory products. At present, 70% of refractory products are imported, the company has a 20% share of the market, and supply is lagging behind domestic demand. Its product prices are 40% lower than the imports, making it very competitive. The company is using the proceeds from its share placement to expand annual production capacity from 50,000 tonnes to 80,000 tonnes in 2002. Its market share in this segment is expected to rise substantially in the near future.

The earnings outlook for this division is promising. Currently, refractory products account for 33% of gross profit, and we expect this to increase to about 43% in 2003 following the expansion of production capacity this year. The gross margin for 2001 is expected to be 34%, which is lower than in the previous year. We expect margins to recover to 34.5% in the coming years as a result of increasing demand in the domestic market.



Earnings Projection

(YE: Dec)	1999A	2000A	2001F	2002F	2003F
HK\$m					
Turnover	448	558	725	957	1225
COGS	(287)	(367)	(488)	(638)	(809)
Gross Profit	161	191	237	319	416
Selling & distribution costs	(10)	(5)	(7)	(9)	(10)
Administration exp	(23)	(19)	(21)	(23)	(25)
Other operating exp/inc	2	(6)	(6)	(7)	(8)
Operating Exp	(31)	(30)	(34)	(38)	(43)
EBITDA	130	161	204	281	372
Dep & Amortization	(9)	(14)	(21)	(32)	(40)
EBIT	121	147	182	249	332
Int cost	(5)	(6)	(3)	(1)	(2)
Int Inc	1	5	1	3	4
Profit before taxation	117	146	180	251	334
Taxation	(33)	-	-	(41)	(55)
Minority Interest	(3)	(5)	(6)	(7)	(8)
Profit attributable to shareholders	81	141	174	202	271
EPS					
Basic	0.168	0.232	0.233	0.249	0.333
Diluted	0.168	0.226	0.233	0.249	0.333
DPS	0.020	0.043	0.043	0.048	0.064

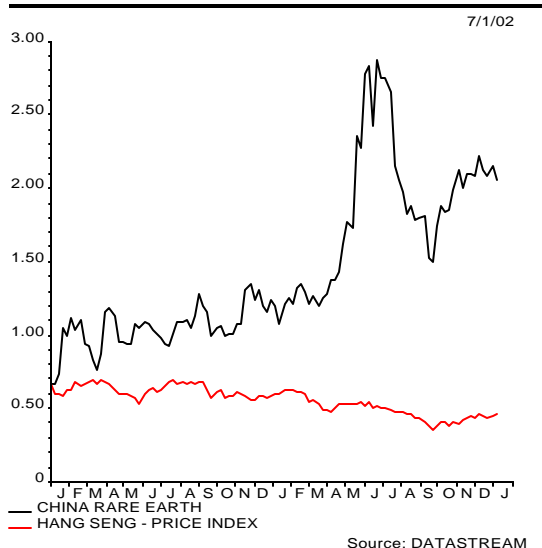
Source: CE Research

Financial Ratios

	1999A	2000A	2001F	2002F	2003F
Gross margin	35.9%	34.2%	32.7%	33.4%	33.9%
Rare Earth Products	32.6%	32.7%	32.0%	33.0%	33.5%
Refractory Products	42.9%	37.1%	34.0%	34.0%	34.5%
EBITDA margin	29.1%	28.9%	28.1%	29.4%	30.4%
EBIT margin	27.0%	26.3%	25.1%	26.0%	27.1%
Net margin	18.1%	25.2%	24.0%	21.2%	22.1%
PER (X)	12.5	9.3	9.0	8.4	6.3
Dividend yield	1.0%	2.1%	2.0%	2.3%	3.0%
Payout ratio	11.9%	18.6%	18.4%	19.3%	19.2%

Source: CE Research

Price Performance



Note: China Everbright Securities (HK) Limited participated in the initial public offering of the company in 1999.

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