

# China Rare Earth

FY01 forecasts scaled down, but not detrimental to recovery theme

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	81	0.17	-	3.9	3.0	2.5	1.7	47.1	0.4
12/2000a	558	161	141	0.23	141	0.23	38.1	5.3	3.2	4.7	2.4	47.0	0.6
12/2001f	693	182	156	0.21	156	0.21	-10.5	10.6	2.3	8.6	2.8	29.5	1.1
12/2002f	881	280	195	0.24	195	0.24	15.1	8.2	2.8	4.6	1.7	26.6	0.7
12/2003f	1,047	340	235	0.29	235	0.29	20.7	6.8	3.1	3.6	1.4	28.2	0.6

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- ▶ **Impact of global slowdown on earnings larger than market expects**
- ▶ **Remain positive on the recovery theme, although short-term performance could be dragged down**
- ▶ **Downgrade to Add as market set to also lower FY01 forecasts**

We are lowering our forecasts, as we believe the global slowdown, particularly after 11 September, has had a larger-than-expected negative impact on earnings.

## Earnings revisions

(HK\$m)	Before		After		Consensus	
Year to 31 Dec	Earnings	EPS	Earnings	EPS	Earnings	EPS
2001	176.7	0.237	155.6	0.208	175.3	0.237
2002	204.7	0.251	194.8	0.239	203.8	0.250
2003	244.5	0.300	235.1	0.289	NA	NA

Source: HSBC

As a result of our revisions, we are below consensus by roughly 11.2% and 4.4% for FY01 and FY02 respectively. We have revised down our six-month target price to HK\$2.65, in anticipation of a near-term drag on its share price performance.

## Impact from decline in rare earth prices larger than expected in 4Q01

For FY01, we have revised up our rare earth volume sales assumption from about 5,500 tonnes to 6,000 tonnes. Despite this, as a result of a price slump, turnover fell short of our original projection of HK\$438m (up 18%); we have since lowered our estimate to HK\$416m (up 12% y-o-y). We have also lowered our FY01 gross margin estimate from 31.5% to 30.5%. In 1H01, gross margin of rare earth products was about 32% and turnover was up 25% y-o-y.

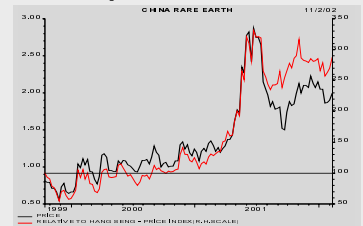
Prices of hi-tech-related rare earth products, such as neodymium and dysprosium, were

## Red Alert

Stock rel to market **Add** Changed from Buy

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)	1,588
Mkt cap (USDm)	204
Free float (%)	49
Daily t/over (12M av) (USDm)	1.36

## Price

	1M	3M	12M
Absolute	2.05	2.05	1.27
Absolute (%)	-2.9	-2.9	56.7
Relative (%)	8.1	-2.7	137

Relative to Index level H S I 10,519

Current (HKD)	Target (HKD)
<b>1.95</b>	<b>2.65</b>

## Disclaimer & disclosures

This report must be read with the disclaimer & disclosures on p5 that form part of it.

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particularly hit in 4Q01 with prices down more than 50% y-o-y. We have assumed a drop of 25% in the average selling price as the above two products accounted for about 25% of turnover. Henceforth, product prices have stabilised, according to the management, as:

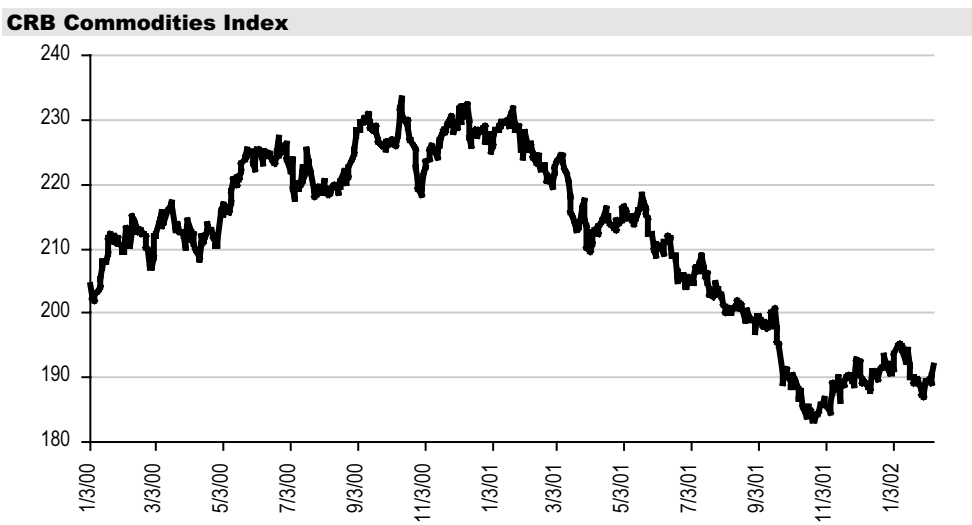
- ▶ Most of the large producers, including China Rare Earth (about 15% of China’s total output) have cut down supplies and some smaller, non-profit producers had shut down production.
- ▶ The upstream mines had intermittently shut down as selling prices of minerals had dropped significantly.
- ▶ Customers have started to reach re-stocking levels.

**Positioned for rebound**

We expect that, as with other industrial materials, rare earth prices to slowly crawl out of their troughs. The CRB Index has continued to trend up after the recent adjustment. For China Rare Earth, it has already positioned for the rebound as:

- ▶ By the end of last year, it had stocked up raw materials worth about HK\$200m (30% of turnover or 100 inventory days), more than our expectation of HK\$160m (22% of turnover)
- ▶ Its expanded capacity could easily lift its production volume to at least 7,000 tonnes.

China Rare Earth’s recent announcement to co-operate with Shanghai A-share listed Baotou Rare Earth Hi-tech to maintain a more balanced market is part of a move to quicken the recovery of the industry. The two companies have a combined market share of at least 25%. And as China is already the largest producer of rare earth products, the co-operation will be beneficial to China Rare Earth over the long term.



Source: HSBC

### Moving up the value chain to drive growth

This year, China Rare Earth will also increase production of its high-value rare earth phosphor products. Proceeds from the last share placement in July had also been used to expand production capacity of phosphor products from about 50 tonnes pa to 500 tonnes. This year, we expect the company to sell about 250 tonnes of phosphor products.

In terms of phosphor products, China Rare Earth is focusing on the energy-saving lamp market given fast-growing demand in China at the moment and more stable prices. China Rare Earth's mainland clients include Osram and Foshan Lighting. Given the phosphor products have a better margin and in anticipation of a recovery, we thus assume that China Rare Earth's overall gross margin will recover to 33.5% this year. Meanwhile, as there is still a base effect on prices to be seen this year, the average selling price is still expected to see a 3% y-o-y decline for the current year.

### Again, refractory materials division a solid performer

While FY01 performance was dragged by the rare earth division, its refractory materials division has continued to benefit from robust demand. Most of the major industries that use refractory materials, such as steel mills, cement producers and glass manufacturers, registered healthy production growth last year. 1H01 sales of refractory materials grew 44% and we expect it to have risen by 48% for the full year.

We expect sales volume of refractory materials to have reached 45,000 tonnes last year, and to reach 65,000 tonnes this year, up 44%. Focusing on high-quality products to compete with import equivalents, China Rare Earth expects to see strong volume growth from exports this year. The key export markets will be North Asia, with sales mostly through Krosaki.

We forecast refractory materials to account for 45% of turnover this year, as growth is expected to be much better than for rare earth. In FY00, sales of refractory materials accounted for only 33% of total turnover as prices of rare earth products soared that year.

### Production growth of major industries that consume refractory materials 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%
2001	12%	13%	19%	7%

Source: HSBC

### Recommendation downgrade on cautious stance

We remain positive over the recovery theme for China Rare Earth. After our earnings revisions, China Rare Earth is expected to register a 10% y-o-y growth in FY01 net profit, the lowest ever since the company published its earnings result. As there was a share placement last year, its weighted-average EPS is expected to drop 11% y-o-y.

However, we do not think investors should leave the stock as:

- ▶ Its valuation is not demanding by any measures, particularly against some of the cyclical-recovery plays such as chemicals.
- ▶ The company is financial healthy with a cash hoard of more than HK\$230m as at end-FY01 and will pay a dividend.

But as the market should begin to lower earnings expectations for FY01, near-term share price performance could be dragged down. As a result, we downgrade our recommendation from Buy to **Add**.

#### Peer group comparison

			Enterprise measures				Equity measures				
			EV/ Sales	EV/ EBITDA	EV/ EBIT	EV/ IC	HSBC REP	PE	PEG	Price to Book	PCE
<b>China Rare Earth Holdings</b> 0769.HK	Buy	12/1999a	0.7	2.5	2.7	1.7	0.4	3.9	-	1.3	3.5
		12/2000a	1.4	4.7	5.2	2.4	0.6	5.3	0.1	1.7	4.9
		12/2001f	2.3	8.6	9.6	2.8	1.1	10.6	0.5	2.0	9.4
		12/2002f	1.5	4.6	5.4	1.7	0.7	8.2	6.9	1.5	6.7
		12/2003f	1.2	3.6	4.2	1.4	0.6	6.8	0.5	1.3	5.5
<b>Sinopec Beijing Yanhua Petrochemical</b> 0325.HK	Sell	12/1999a	0.8	4.1	8.5	0.7	1.5	9.3	-0.7	0.6	3.2
		12/2000a	0.6	4.3	8.1	0.7	1.4	8.0	0.1	0.5	3.1
		12/2001f	0.9	8.9	34.8	0.8	4.7	45.1	-0.1	0.4	4.2
		12/2002f	0.8	5.8	12.8	0.7	1.6	14.0	-2.3	0.5	3.7
		12/2003f	0.7	3.4	5.5	0.5	0.7	5.0	0.1	0.5	2.4
<b>Yanzhou Coal Mining</b> 1171.HK	Reduce	12/1999a	1.6	3.3	4.8	1.0	0.8	7.2	-0.2	1.0	4.5
		12/2000a	1.4	3.3	5.1	0.9	0.8	7.9	-0.8	0.9	4.7
		12/2001f	1.1	2.3	3.6	0.8	0.5	7.2	1.1	0.8	4.0
		12/2002f	1.2	2.7	3.5	0.9	0.6	8.0	0.5	0.9	4.3
		12/2003f	0.8	1.9	2.2	0.7	0.4	6.6	0.5	0.8	3.8

Year to	12/1999a	12/2000a	12/2001f	12/2002f	Year to	12/1999a	12/2000a	12/2001f	12/2002f
<b>Per share data (HKD)</b>					<b>Ratios (%)</b>				
Reported EPS	0.17	0.23	0.21	0.24	Revenue/IC (x)	2.4	1.8	1.3	1.2
HSBC EPS	0.17	0.23	0.21	0.24	NOPLAT margin	19.4	26.3	23.4	22.6
CEPS	0.19	0.26	0.23	0.29	ROIC	47.1	47.0	29.5	26.6
DPS	0.02	0.04	0.05	0.06	ROE	38.9	34.9	22.0	19.7
NAV	0.51	0.74	1.12	1.31	ROA	22.3	24.9	18.3	17.2
<b>P&amp;L summary (HKDm)</b>					<b>ROCE</b>				
Revenue	448	558	693	881	ROIC/Cost of capital	3.9	3.8	2.6	2.4
EBITDA	130	161	182	280	Cost of capital	12.1	12.3	11.2	11.1
EBIT	121	147	162	239	EBITDA margin	29.1	28.9	26.2	31.8
Net interest	-4	-1	0	4	EBIT margin	27.0	26.3	23.4	27.1
PBT	117	146	162	243	PAT margin	18.8	26.1	23.4	23.0
HSBC PBT	117	146	162	243	HSBC net profit margin	18.1	25.2	22.5	22.1
Taxation	-33	-	-	-40	Net debt/equity	-	-	-	-
Reported net profit	81	141	156	195	Net debt/EBITDA	-	-	-	-
HSBC Net profit	81	141	156	195	<b>Growth (%)</b>				
NOPLAT	87	147	162	199	Revenue	-	24.6	24.1	27.2
<b>Cash flow summary (HKDm)</b>					EBITDA	-	23.8	12.7	54.3
Op free cash flow	-2	-58	-107	100	EBIT	-	21.4	10.3	47.3
HSBC cash flow	29	38	83	237	PBT	-	24.6	11.3	49.9
Capital expenditure	-35	-97	-190	-132	HSBC Net profit	-	73.6	10.4	25.1
Cash earnings	90	155	175	236	HSBC NOPLAT	25.3	68.6	10.3	23.0
Change in net debt	101	26	81	64	HSBC EPS	-	38.1	-10.5	15.1
<b>Balance sheet summary (HKDm)</b>					<b>Valuation (x)</b>				
Intangible fixed assets	-	-	-	-	PE	3.9	5.3	10.6	8.2
Tangible fixed assets	133	217	387	478	PNAV	1.3	1.7	2.0	1.5
Cash	124	150	231	295	PCE	3.5	4.9	9.4	6.7
Current assets	323	453	673	813	Yield (%)	3.0	3.2	2.3	2.8
Operating liabilities	104	123	128	201	EV/Revenue	0.7	1.4	2.3	1.5
Gross debt	50	74	0	0	EV/EBITDA	2.5	4.7	8.6	4.6
Net cash (debt)	73	76	231	295	EV/IC	1.7	2.4	2.8	1.7
Shareholders funds	313	512	932	1,090	ROIC/Cost of capital	3.9	3.8	2.6	2.4
Invested capital (avg)	185	313	549	748	HSBC REP	0.4	0.6	1.1	0.7

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#### Recommendation structure

Stock (vs market)	
(outperform >20%)	Buy
(outperform <20%)	Add
(market neutral)	Hold
(underperform <20%)	Reduce
(underperform >20%)	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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