

China Rare Earth

Deteriorating fundamentals to drive share price lower

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

Sector rel to market **Overweight**

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)
12/2000a	558	161	141	0.23	141	0.23	38.1	5.3	3.2	4.7	2.4	45.5	0.7
12/2001a	618	164	142	0.19	142	0.19	-17.7	11.5	1.8	9.4	3.1	28.5	1.1
12/2002f	706	172	111	0.14	111	0.14	-28.5	10.8	1.7	5.5	1.4	16.5	0.8
12/2003f	937	214	138	0.17	138	0.17	24.0	8.7	2.0	4.5	1.2	16.8	0.7
12/2004f	1,060	248	158	0.19	158	0.19	14.7	7.6	2.4	3.7	1.0	17.1	0.6

- ▶ **Weakening demand, declining prices and increasing competition in rare earth products**
- ▶ **Refractory materials business being hammered by cost-cutting initiatives of domestic steel mills**
- ▶ **Downgrade to Reduce in view of deteriorating fundamentals; recent share price fall only part of the necessary adjustment**

Industry restructuring on hold

Management has told us that there is no definite timetable for the next round of industry restructuring discussions after the last meeting in June. As it was the Beijing government that initiated the June talks, the restructuring of the rare earth industry is likely to now take a back seat ahead of preparations for the forthcoming National People's Congress. Industry restructuring therefore is on hold.

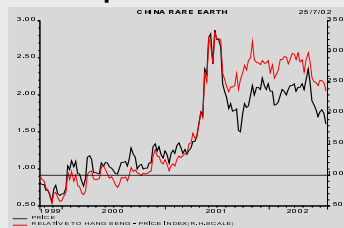
Meanwhile, new export quota for the year has been issued in June after the restructuring meetings. Despite a slowdown in exports of rare earth products in the first five months, selling prices have not risen. The risk now is that competitors rush to the market to compensate for the lost sales, which in turn could drive prices further down in view of the sliding confidence in the US recovery. Management admitted that selling prices for some rare earth products have started to fall, a trend that could worsen.

Poor 1H02 result

In 1H02, we estimate CRE sold only 2,000 tonnes of rare earth products, down about one-third from the 3,000 tonnes in 1H01. For earnings, we estimate 1H02 net profit was HK\$37m, down 53% from the HK\$79m in 1H01. While management is confident about achieving sales of 6,000 tonnes in 2H02, we fear this may only be achieved through lower selling prices. In the absence of a top-down directed industry restructuring, it is difficult to expect a near-term recovery in product prices, which means CRE remains vulnerable to problems caused by an industry glut. Management also admits that a recovery in selling prices is unlikely this year.

Red Alert

Relative price



Source: Thomson Financial Datastream

Red Alert Company

Country	China
Sector	Mining
Bloomberg	769 HK
Reuters	0769.HK
Mkt cap (HKDm)	1,205
Mkt cap (USDm)	155
Free float (%)	48.5
Daily t/over (12M av) (USDm)	1.12

Price

	1M	3M	12M
Absolute	1.73	2.13	1.88
Absolute (%)	-14.45	-30.35	-21.28
Relative (%)	-8.18	-19.61	-2.73

Relative to	H S I
Index level	9884.777

Current (HKD)	Target (HKD)
1.48	1.25

Disclaimer & disclosures

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

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Double whammy: refractory materials business under margin pressure

Management also disclosed that domestic steel mills are exerting greater pressure for cuts in the prices of refractory materials, which is being supported by their moves towards competitive tendering for supply of these products. As a result, management says gross margins could be squeezed by 3-5ppts over the rest of the year.

Earnings forecasts revised downward

We are now assuming that the average selling price of rare earth products drops 7% in FY02 (18% y-o-y in 1H02) while refractory material prices remain more or less at current levels. Our revised gross margin assumptions are in the table below.

Gross margin assumptions

	FY01	Old FY02	New FY02
Rare earth products	27.5%	30.0%	21.5%
Refractory materials	32.8%	34.0%	27.0%

Source: HSBC

Our sales volume assumption for rare earth products has been cut from 6,900 tonnes to 5,100 tonnes for FY02. We have made no change to our sales assumption for refractory materials of 65,000 tonnes.

Earnings forecast changes

	-----Old-----		-----New-----	
	Earnings (HK\$m)	EPS (HK\$)	Earnings (HK\$m)	EPS (HK\$)
FY2002	162.5	0.200	111.2	0.137
FY2003	202.3	0.248	138.0	0.169
FY2004	239.1	0.294	158.3	0.194

Source: HSBC

Share price down, but still room for downside

CRE's share price has fallen sharply recently due to the following negative factors:

- ▶ Investors have become sceptical towards privately-owned enterprises (POE) due to the recent slew of accounting scandals
- ▶ Fears of a double-dip recession in the US have hammered stocks of export-oriented companies such as CRE
- ▶ De-rating along with hi-tech stocks given its high exposure to this sector

As we have previously written (*Red Alert* dated 19 April), CRE's shares enjoyed a strong re-rating in 2001. The next few months are likely to see an undoing of this performance. We believe its forward PE of 10x (based on revised forecast) is unsustainable in the current industry and equity market environments, and have downgraded it to a **Reduce** and set HK\$1.15 as a re-entry price.

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	Reduce	12/2000a	1.4	4.7	5.2	2.4	0.7	5.3	0.1	1.6	4.9
		12/2001a	2.5	9.4	10.8	3.1	1.1	11.5	0.8	1.9	10.0
		12/2002f	1.3	5.5	7.1	1.4	0.8	10.8	-0.5	1.2	8.0
		12/2003f	1.0	4.5	5.8	1.2	0.7	8.7	-1.9	1.1	6.5
		12/2004f	0.9	3.7	4.8	1.0	0.6	7.6	0.5	1.0	5.6
Yanzhou Coal Mining 1171.HK	Reduce	12/2000a	1.2	3.0	4.5	0.8	0.7	7.9	-0.8	0.9	4.7
		12/2001a	1.1	2.6	4.2	0.8	0.6	7.6	1.8	0.8	4.1
		12/2002f	1.2	2.8	4.4	0.8	0.6	7.8	0.5	0.9	4.2
		12/2003f	0.9	2.2	3.4	0.6	0.5	7.2	0.8	0.8	4.0
		12/2004f	0.6	1.5	2.3	0.5	0.3	6.5	0.7	0.7	3.7
Aluminum Corp of China 2600.HK	Add	12/2000a	-	-	-	-	-	-	-	-	-
		12/2001a	1.6	5.4	8.8	1.6	1.1	7.4	-	1.1	3.4
		12/2002f	1.3	4.8	7.5	1.1	0.8	7.9	-0.2	0.8	3.8
		12/2003f	1.1	3.1	4.5	0.9	0.5	4.5	0.4	0.7	2.5
		12/2004f	1.0	2.6	3.7	0.8	0.4	3.8	0.1	0.6	2.2

Year to	12/2000a	12/2001a	12/2002f	12/2003f	Year to	12/2000a	12/2001a	12/2002f	12/2003f
Per share data (HKD)					Ratios (%)				
Reported EPS	0.23	0.19	0.14	0.17	Revenue/IC (x)	1.7	1.2	1.1	1.1
HSBC EPS	0.23	0.19	0.14	0.17	NOPLAT margin	26.3	23.2	15.7	14.8
CEPS	0.26	0.22	0.18	0.23	ROIC	45.5	28.5	16.5	16.8
DPS	0.04	0.04	0.03	0.03	ROE	34.1	19.7	11.6	13.1
NAV	0.77	1.13	1.22	1.36	ROA	25.0	16.9	10.3	11.4
P&L summary (HKDm)					ROCE				
Revenue	558	618	706	937	ROIC/Cost of capital	3.6	2.9	1.7	1.7
EBITDA	161	164	172	214	Cost of capital	12.7	9.9	9.9	9.9
EBIT	147	143	133	166	EBITDA margin	28.9	26.6	24.3	22.8
Net interest	-1	4	6	7	EBIT margin	26.3	23.2	18.8	17.7
PBT	146	147	139	172	PAT margin	26.1	23.7	16.4	15.3
HSBC PBT	146	147	139	172	HSBC net profit margin	25.2	23.0	15.8	14.7
Taxation	-	-	-23	-28	Net debt/equity	-	-	-	-
Reported net profit	141	142	111	138	Net debt/EBITDA	-	-	-	-
HSBC Net profit	141	142	111	138	Growth (%)				
NOPLAT	147	143	111	138	Revenue	24.6	10.7	14.3	32.7
Cash flow summary (HKDm)					EBITDA	23.8	2.1	4.3	24.6
Op free cash flow	-58	11	-68	0	EBIT	21.4	-2.5	-7.3	24.9
HSBC cash flow	38	144	144	100	PBT	24.6	0.7	-5.4	24.0
Capital expenditure	-97	-130	-206	-94	HSBC Net profit	73.6	0.9	-21.8	24.0
Cash earnings	155	164	150	186	HSBC NOPLAT	68.6	-2.5	-22.6	24.9
Change in net debt	3	173	14	-14	HSBC EPS	38.1	-17.7	-28.5	24.0
Balance sheet summary (HKDm)					Valuation (x)				
Intangible fixed assets	-	-	-	-	PE	5.3	11.5	10.8	8.7
Tangible fixed assets	217	325	492	538	PNAV	1.6	1.9	1.2	1.1
Cash	150	249	263	249	PCE	4.9	10.0	8.0	6.5
Current assets	453	592	642	752	Yield (%)	3.2	1.8	1.7	2.0
Operating liabilities	102	79	117	153	EV/Revenue	1.4	2.5	1.3	1.0
Gross debt	74	-	-	-	EV/EBITDA	4.7	9.4	5.5	4.5
Net cash (debt)	76	249	263	249	EV/IC	2.4	3.1	1.4	1.2
Shareholders funds	532	938	1,017	1,136	ROIC/Cost of capital	3.6	2.9	1.7	1.7
Invested capital (avg)	323	503	671	821	HSBC REP	0.7	1.1	0.8	0.7

HSBC Securities (Asia) Limited does not have an interest in the companies being discussed in this report.

Recommendation structure

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

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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