ING FINANCIAL MARKETS

Initiating coverage | 2 September 2002

China

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China Rare Earth Holdings

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Buy

Initiating Coverage

Bottom-fishing from rare earth

We believe worries over depressed rare earth prices are fully priced in. Share price revaluation is likely to be triggered by a top-down industry consolidation over the next 18 months. We initiate coverage with a BUY.

Difficult operating environment is in the price. Oversupply and a price war have put the rare earth industry in its most difficult situation over the last year. Based on our analysis, however, the industry environment is unlikely to get worse, thus limiting the downside risk.

Resilient EPS growth. We expect China Rare Earth's fast-expanding capacity and stabilised prices to drive attractive EPS growth of 28% pa over FY02-04. Our conservative assumptions on prices and output mean any surprise is likely to be on the upside.

Valuation implies 39% upside potential. Currently, China Rare Earth is trading at substantial discounts to its peer groups. Our target price of HK$1.60 is based on what we consider an undemanding FY03F PER of 11x, where it would be trading close to our China universe.

Forecasts and ratings

Yr to Dec	00	01	02F	03F	04F
Sales (HK$m)	558	618	688	710	851
EBITDA (HK$m)	172	179	161	173	250
Net profit (HK$m)	141	142	112	118	180
EPS (HK$)	0.23	0.19	0.14	0.15	0.22
Ch to previous EPS (%)	N/A	N/A	N/A	N/A	N/A
Consensus EPS (HK$)	N/A	N/A	0.18	0.22	N/A
EPS growth (%)	N/A	-15.9	-25.7	5.8	51.6
PER (x)	N/A	6.0	8.3	7.9	5.2
EV/EBITDA (x)	5.0	3.9	4.2	3.6	2.3
Yield (%)	3.5	3.5	2.4	2.5	3.9

Source: Company data, ING estimates

HK$1.15 29/8/02

Target price: 12 months

HK$1.60 (+39%)

Financial data

	FY01	FY02F
ROE (%)	19.7	11.6
ROA (%)	21.8	15.9
Net debt/equity (%)	N/C	N/C
Book value/sh (HK$)	1.2	1.2
Price/book (x)	0.9	0.9
Interest cover (x)	N/C	N/C
EBITDA margin (%)	28.9	23.5

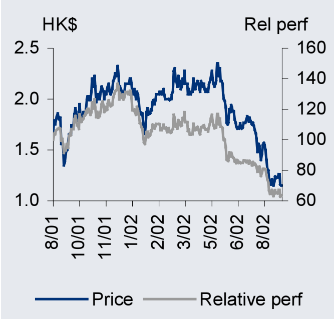
Share data

Market cap (US$m)	119.5
No of shares (m)	810
Daily turnover (US$m)	1.1
Free float (%)	48.5
52-week hi/lo (HK$)	2.38-1.12

Price performance (%)

	Absolute	Relative to HSCEI
3m	-43.9	-33.5
6m	-42.5	-37.8
12m	-30.7	-39.1

Price chart



Source: Bloomberg

World's leading rare earth producer

We initiate coverage on rare earth products and refractory materials producer China Rare Earth Holdings (CREH) with a BUY rating. Valuations have fallen to a very low level along with product prices. Looking forward, we expect product prices to stabilise in FY03 and improve slightly in FY04. We expect some consolidation in the China market to provide further support to sales and margins. We value the stock at 0.9x P/BV and 8x FY03F PER, with an 11% FY03F ROE. We see 39% upside potential to our HK$1.60 target price.

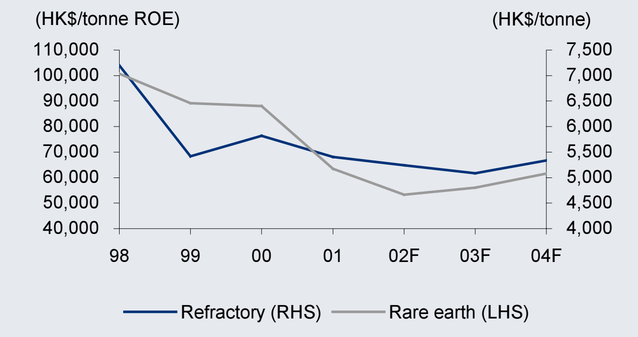
Fig 1 Key products

Product	Description	Applications
Rare earth	Comprises 17 elements, characterised by their high fusing points, great density and high thermal and electric conductivity.	Metallurgy, petroleum and chemical engineering, glass, high-tech electronic devices, fibre optics.
Refractory	Refractory materials are manufactured from natural ores including quartzite, dolomite and graphite ore.	Construction of kilns and furnaces used in the steel, construction and metallurgy industries.

Source: ING, Company data

Rare earth prices plunged 28% last year, and we are factoring in a further 16% drop in 2002. We expect this, coupled with the end of a tax holiday, to result in a 22% decline in CREH's net profit in FY02. However, rare earth prices stabilised in July and August, and we expect the trend to continue through 2H02 and into FY03.

Fig 2 Average realised prices



Source: Company data, ING estimates

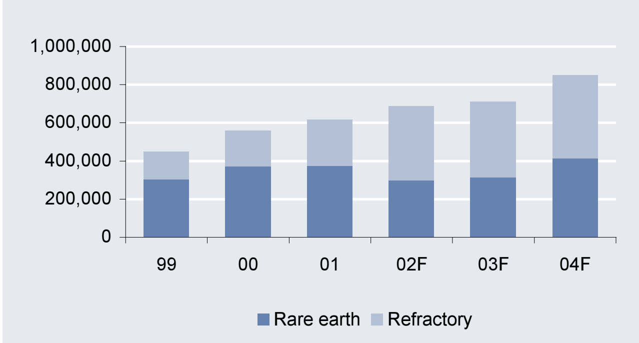
Prices should be near the bottom

We believe conditions in the rare earth segment have bottomed and expect a better environment moving forward. We see four positive elements: 1) many inefficient small producers are operating at very close to breakeven, limiting their ability to cut prices further; 2) price wars have already sent some inefficient producers into bankruptcy, reducing overall supply; 3) ING expects a global economic recovery, which should provide demand support; and 4) industry sources indicate that inventories are relatively low. This should help shorten recovery time and support a price recovery.

Product mix enhances defensiveness

In view of its relatively stable prices, CREH has expanded its production capacity for refractory materials by 65% this year. This helped provide a stable stream of income, especially during periods of volatility in rare earth prices, such as we are now witnessing. As a result, the revenue contribution from refractory products should jump from 40% in FY01 to 57% in FY02. Despite lower gross profits for rare earth products, we expect overall gross margins to drop by only a mild 5% in FY02.

Fig 3 Revenue split (HK$ 000)

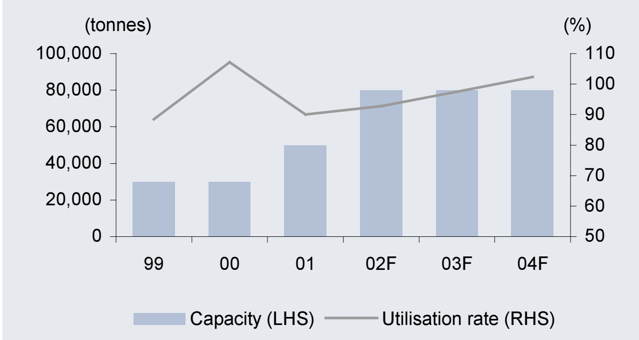


Source: Company data, ING estimates

Fast-expanding capacity

Production capacity more than doubled between FY98 and FY02. Currently CREH has the capacity to produce 6,500 tonnes ROE (rare earth oxide) of rare earth products and 80,000 tonnes of refractory products, operating at a 90% utilisation rate. Once prices pick up, the multiplier effect from its expanded capacity will be substantial.

Fig 4 Refractory product capacity and utilisation



Source: Company data, ING estimates

Government is pushing sector restructuring

We expect CREH to be assisted by a government restructuring push in the rare earth segment, although changes are likely to take place slowly. Incrementally, this should help to reduce some of the oversupply problems that have hurt pricing. The preliminary proposal is to consolidate the current 170 producers into two oligopolies – an Inner Mongolia-led Northern Group (mainly public enterprises) and a Jiangxi-led Southern group (mainly private enterprises). However, conflicts of interest among existing players on difficult issues such as profit sharing, transfer of assets and quota allocations are likely to impede progress. CREH's management recently indicated that the approval procedure has been accelerated, but no timetable has been issued yet.

The two key uncertainties in the industry consolidation plan are its timetable and the mode of restructuring. Unfortunately, these are primarily economically-driven political decisions that require approval from the Chinese government. No single market player has much control over the process. We conservatively assume that the restructuring will be carried out by 2004.

Financially healthy and debt free

We expect CREH to be debt free in FY02 with net cash of Rmb281m and a price-to-cash flow ratio of 3.3x (cash flow per share of HK$0.35). Inventory and accounts receivable turnover remain stable at three and two months, respectively. Although CREH's tax holiday ended last year, the company will continue to enjoy a 50% tax reduction for the next three years.

China's monopolistic position makes long-term prospects brighter

As China possesses more than 80% of the world's rare earth reserves, the future of China's rare earth industry is brighter. The key question now is who will dominate the market. CREH, which supplies 8% of global consumption, is a key player. Our sensitivity analysis indicates that a 10% increase in rare earth prices would increase CREH's FY03 pre-tax profit by 22%.

Fig 5 Sensitivity of profits to prices – FY03F

		Refractory product prices FY03F (%)				
		-10	-5	0	+5	+10
	+30	38	51	65	79	92
	+20	16	30	43	57	71
Rare earth	+10	-6	8	22	35	49
prices FY03F (%)	0	-27	-14	0	14	27
	-10	-49	-35	-22	-8	6
	-20	-71	-57	-43	-30	-16
	-30	-92	-79	-65	-51	-38

Source: ING estimates

Valuation looks undemanding

The fact that most rare earth producers are located in China makes global comparisons quite difficult. Overvalued 'A'-share rare earth peers (with PERs greater than 40x) do not provide a meaningful basis for comparison. Our target price of HK$1.60 is based on a PER of 11.6x for FY02F and 11.0x for FY03F, at which level CREH would be close to its other peer groups for FY03F. At the current price, CREH is trading at a discount of 32-34% in terms of its FY02F PER to its basic material and red-chip peers, and maintains a 16% discount to its 'H'-share peers. In FY03F, the PER discount shrinks to 16-35%, but bear in mind our conservative recovery assumption. Any mild price recovery in 2003 could make CREH look substantially cheaper.

CREH's yield is relatively low at 2%. It has a substantial net cash position to prepare for potential acquisitions of mine assets to ensure its raw material supply.

Fig 6 Valuation comparisons

Company	Rec	Price (HK$)	02F PER (x)	03F PER (x)	Yield (%)
Rare Earth's peers' ('A' shares)			**>40.0**	**N/A**	**0.62**
Jiangxi Copper - 'H' shares	NR	0.8	9.7	6.6	6.12
Yanzhou Coal Mining - 'H' shares	NR	2.8	6.9	6.5	3.40
Maanshan Iron & Steel - 'H' shares	NR	0.6	15.6	12.9	3.37
Sinopec Yizheng Chemical - 'H' shares	NR	1.0	18.7	12.0	1.85
Sinopec Shanghai Petrochem 'H' shares	BUY	1.1	12.4	9.3	-
Basic material peers			**12.7**	**9.5**	**3.7**
China universe - Red chips			**12.2**	**12.2**	**1.97**
China universe - 'H' shares			**9.9**	**10.0**	**4.80**
China Rare Earth – Current price			**8.3**	**7.9**	**2.4**
China Rare Earth – Target price			**11.6**	**11.0**	**1.7**
Discount to basic material peers (%)			**-34**	**-16**	
Discount to red-chip peers (%)			**-32**	**-35**	
Discount to 'H'-share peers (%)			**-16**	**-21**	

Source: IBES, Datastream, ING estimates

Interim results preview

We forecast a 39% YoY decline in net profit due to lower rare earth prices and incremental tax provisions. Turnover is expected to stay fairly stable with only a mild 7% drop, helped by higher refractory product output. Overall gross profit margin will also be squeezed by an estimated 7% to 25%.

Fig 7 1H01 vs 1H02F interim results (HK$m)

Yr to Dec	1H01	1H02F	%ch
Turnover	333	311	-7
Gross profit	107	77	-28
Profit from operations	86	60	-30
Profit before tax	82	57	-30
Income tax	-	(10)	N/A
Profit after tax	82	47	-42
EPS - basic (HK$)	0.11	0.06	-46

Source: Company data, ING estimates

Fig 8 Profit breakdown (HK$m)

Yr to Dec	00	01	02F	03F	04F
Turnover	**558**	**618**	**688**	**710**	**851**
EBITDA	172	179	161	173	250
Depreciation	(14)	(21)	(27)	(30)	(33)
EBIT	**157**	**157**	**135**	**143**	**216**
Net interest inc	(1)	4	5	6	7
Associates	-	-	-	-	-
Exceptionals	-	-	-	-	-
Others	(10)	(14)	(5)	(6)	(6)
Pre-tax profit	**146**	**147**	**135**	**142**	**217**
Taxation	-	-	(20)	(21)	(33)
Minorities	(5)	(4)	(3)	(3)	(5)
Net profit	**141**	**142**	**112**	**118**	**180**
Pref div	-	-	-	-	-
Extraordinaries	-	-	-	-	-
Attrib profit	**141**	**142**	**112**	**118**	**180**

Source: Company data, ING estimates

Fig 9 Summary balance sheet (HK$m)

As at Dec	00	01	02F	03F	04F
Share capital	68	81	81	81	81
Reserves	453	840	930	1,024	1,168
Sh'ders' funds	**521**	**922**	**1,011**	**1,106**	**1,249**
Minorities	12	16	20	22	25
Other LT liabilities	34	-	-	-	-
Capital emp	**567**	**938**	**1,032**	**1,128**	**1,274**
Fixed assets	217	325	379	429	475
Other LT assets	-	100	100	100	100
Cash & equiv	123	248	281	329	389
Other	330	344	392	393	459
Current liabilities	102	79	120	123	149
Net current assets	350	513	553	599	699
Emp of capital	**567**	**938**	**1,032**	**1,128**	**1,274**

Source: Company data, ING estimates

Fig 10 Cash flow forecast (HK$m)

Yr to Dec	00	01	02F	03F	04F
PBIT	**146**	**147**	**135**	**142**	**217**
Depn/amort	14	21	27	30	33
Associate adj	-	-	-	-	-
Ch in work cap	(124)	(22)	(27)	(11)	(69)
Others	19	1	3	4	4
Op cash flow	**55**	**147**	**138**	**166**	**184**
Int (paid)/rec'd	1	4	5	6	7
Tax paid	(8)	-	(2)	(20)	(21)
Other CE	-	-	-	-	-
Cash earnings	**48**	**150**	**141**	**151**	**170**
Capex	(105)	(136)	(80)	(80)	(80)
Sale of FA	8	6	5	6	6
Dividend paid	(18)	(37)	(28)	(23)	(30)
Other CF	(36)	(113)	-	-	-
Ch cash/(debt)	**(1)**	**125**	**33**	**48**	**60**
End cash/(debt)	**88**	**248**	**281**	**329**	**389**

Source: Company data, ING estimates

Fig 11 Ratios

Yr to Dec	00	01	02F	03F	04F
EBITDA mgn (%)	30.7	28.9	23.5	24.3	29.3
ROE (%)	34.1	19.7	11.6	11.1	15.3
ROA (%)	33.4	21.8	15.9	15.2	21.5
Net DE (%)	N/C	N/C	N/C	N/C	N/C
Int cover (x)	130.8	N/C	N/C	N/C	N/C

Source: Company data, ING estimates

Fig 12 Key assumptions

Yr to Dec	01	02F	03F	04F
Turnover (HK$m)	618	688	710	851
Rare earth	375	299	314	414
Refractory	243	389	396	437
Realised prices (HK/tonne)				
Rare earth	63,502	53,342	56,009	61,610
Refractory	5,403	5,241	5,084	5,338
Sales volume (tonne)				
Rare earth	5,900	5,605	5,605	6,726
Refractory	45,000	74,250	77,963	81,861

Source: Company data, ING estimates

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