

## China Rare Earth: don't catch the falling knife

**Recommendation: SELL (unchanged)**

**China Materials**

Price	HK\$1.09	Year to	Net profit	EPS	EPS	PE	P/B	EV/EBITDA	Yield	ROE	ROCE	Gearing
Target price	HK\$0.80 (-27%)	Dec	HK\$m	HK\$	D%	x	x	x	%	%	%	%
12 mth range	HK\$1.08-2.355	00A	140.9	0.232	38.1	4.7	1.3	5.0	3.7	34.9	31.2	Cash
Market cap.	US\$113.8m	01A	142.2	0.191	(17.7)	5.7	0.9	3.9	3.7	20.9	20.6	Cash
Daily t/o, 3 mth	US\$1.1m	02F	60.9	0.075	(60.9)	14.6	1.0	5.5	1.4	6.9	10.2	Cash
Free float %	49.0%	03F	82.4	0.101	35.3	10.8	0.9	4.6	1.9	8.7	11.9	Cash
Ticker	0769.HK/769 HK	04F	87.0	0.107	5.6	10.2	0.8	4.2	2.0	8.6	11.8	Cash

Relative to MSCI China Free (1 mth, 3 mth, 12 mth): -27.2%, -36.6%, -37.6%

Actual price changes (1 mth, 3 mth, 12 mth): -27.3%, -43.2%, -39.1%

Previous forecasts (02F-04F): HK\$115m (\$0.141), HK\$129m (\$0.151), HK\$139m (\$0.178)

### Key points:

- Share price continues its free fall as the market factors in substantial FY02 earnings decline.
- Average rare earth prices retreated by >40% YoY in 1H FY02 with no signs of bottoming out.
- We think price cartel is unlikely to succeed even though the industry restructuring does take place.
- We have cut our earnings forecasts by 47%, 36% and 37% for FY02 to FY04.
- Our new target price of HK\$0.8/share is based on 8x FY03F PE.
- Maintain SELL and expect more selling pressure in the run up to the interim results due end-Sep.

**Deteriorating fundamentals.** Rare earth prices remain sluggish in 1H 02, falling >40% YoY on the average. The slide began in 4Q 01 which saw price dropping >20% YoY during the period. Worst still, rare earth output was down by 20% to just 2,500t in 1H 02. We think full year output will be just around 5,000t, substantially lower than the original expected 6,500t and the 5,900t sold last year. For refractory materials, 1H sales were in line but there was an unexpected 3% price decline as customers are looking for more competitive pricing through tendering and online bidding. In addition, refractory export sales (16% of the total in 2001 and 9% in 2000) has increased this year whereby the selling prices are 1-2% lower than that of the domestic market.

**Uncertain regulatory environment.** No progress is made on the rare earth industry restructuring regarding the forming of two geographical giants in the North and South respectively. Management suggested that the State Economic and Trading Commission has approved the restructuring plan. Despite this, we keep our fingers crossed as the likelihood of forming a price cartel successfully is quite low, in our opinion, due to the vested interest and the re-distribution of power. As such, we think product prices will remain under downward pressure given the current sluggish technology investment environment. In addition, the State Planning Commission has recently issued new regulations prohibiting foreign ownership of rare earth mining companies and foreign wholly owned smelting and extraction companies. This further clouds the stock's outlook.

**More earnings downgrades.** Our earnings forecasts have always been the lowest in the market. We have decided to slash our 2002F, 2003F and 2004F forecasts (earnings and EPS) by a further 47%, 36%, 37% to HK\$61m (HK\$0.075), HK\$82m (HK\$0.101) and HK\$87m (HK\$0.107) respectively. We are now looking for an earnings decline of 61% to HK\$61m for FY2002F, the lowest forecast in the market. Our new target price is HK\$0.8, based on 8x FY03 PE.

**Don't catch the falling knife.** We expect more selling pressure in the run-up to the interim results, which will be announced by end-Sep (likely after the 15<sup>th</sup>). In the meanwhile, we re-iterate our SELL call, which we have had since the beginning of the year when the share price was at HK\$2.05.

**Table 1: earnings model**

Year to 31 Dec (HK\$m)	2000A	2001A	2002F	2003F	2004F
<b>Turnover</b>					
Sales of rare earth products	371.1	374.7	292.1	321.3	321.3
Sales of refractory products	187.1	243.1	347.7	427.9	470.7
	<b>558.2</b>	<b>617.8</b>	<b>639.8</b>	<b>749.3</b>	<b>792.1</b>
% chg	24.6%	10.7%	3.6%	17.1%	5.7%
<b>EBITDA</b>	162.3	180.6	138.1	172.1	187.4
<b>Depreciation</b>	(14.3)	(21.4)	(35.1)	(40.8)	(46.2)
<b>EBIT</b>	148.0	159.3	103.0	131.3	141.2
<b>Interest income</b>	4.6	6.3	6.1	6.2	6.2
<b>Operating profit</b>					
Sales of rare earth products	100.8	99.0	43.8	49.8	49.8
Sales of refractory products	59.5	66.4	80.0	102.7	113.0
HQ expenses	(7.7)	(14.4)	(14.7)	(15.0)	(15.3)
	<b>152.6</b>	<b>165.5</b>	<b>109.1</b>	<b>137.5</b>	<b>147.5</b>
% chg	-5.1%	8.4%	-34.1%	26.1%	7.3%
<b>Selling and distribution costs</b>	(5.1)	(11.2)	(12.3)	(13.6)	(14.9)
<b>Administrative expenses</b>	(33.0)	(20.9)	(23.0)	(25.5)	(28.0)
<b>Interest expenses</b>	(5.8)	(2.6)	(3.5)	(4.7)	(5.3)
<b>Other revenue</b>	4.6	6.3	6.4	6.5	6.6
<b>Other income/ (expenses)</b>	(5.8)	(7.9)	(8.3)	(8.5)	(8.6)
<b>Pre-tax profit</b>	145.7	146.7	68.1	92.1	97.3
<b>Tax</b>	-	-	(5.1)	(6.9)	(7.3)
<b>After-tax profit</b>	145.7	146.7	63.0	85.2	90.0
<b>Minority interests</b>	(4.8)	(4.5)	(2.1)	(2.8)	(3.0)
<b>Net profit</b>	<b>140.9</b>	<b>142.2</b>	<b>60.9</b>	<b>82.4</b>	<b>87.0</b>
% chg	73.6%	0.9%	-57.2%	35.3%	5.6%
<b>Dividends</b>	(26.3)	(32.6)	(12.2)	(16.5)	(17.4)
<b>Payout %</b>	18.6%	22.9%	20.0%	20.0%	20.0%
<b>Retained earnings</b>	100.1	109.6	48.7	65.9	69.6

Source: SBI E2 -Capital