

Company results

China

China Rare Earth

Strong momentum

Basic materials

10/9/04

HK\$1.00

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Maintained

Outperform

13 September 2004

Target Price

HK\$1.56 (+56%)

Bloomberg

769 HK

China Rare Earth's (CRE) 1H net profit rose 174% as margin expanded significantly on the back of a rebound in rare earth prices. CRE sees rare earth prices being sustained at high levels and further volume growth in 2H. We maintain our profit forecasts and re-iterate our Outperform rating on the stock.

1H profit up 174% as ASPs rebounded. 1H net profit rose 174% YoY to HK\$60m, driven by top-line growth of 71% and margin expansion. Operating margin widened to 21.1% from 12.8%. The reported net profit is slightly better than our forecast of HK\$55m for 1H.

2H outlook promising. CRE sees sustainable high prices for rare earth products as well as its refractory products. The company will launch new high-margin products. In the longer term, it is considering acquiring a rare earth mine to ensure a steady supply of raw materials.

Maintaining our positive view. In view of the healthy pricing trends for rare earth and refractory products, we maintain our profit forecasts. Our target price is based on 10x forward PER, ie, HK\$1.56/share. We envisage further upside from CRE's potential acquisition of rare earth mines in the longer term.

Forecasts and valuations

Yr to Dec	2002	2003	2004F	2005F	2006F
Sales (HK\$m)	468.0	457.1	715.8	847.2	996.5
EBITDA (HK\$m)	105.7	109.9	205.1	253.1	300.2
Net Profit (HK\$m)	41.0	66.6	132.6	168.7	202.5
EPS (HK\$)	0.050	0.082	0.140	0.171	0.205
Ch to previous EPS (%)			0.2	-3.7	-16.6
Consensus EPS (HK\$)			0.132	0.174	
EPS growth (%)	—	62.3	71.8	21.7	20.0
PER (x)	19.8	12.2	7.1	5.9	4.9
EV/EBITDA (x)	7.3	7.0	3.8	3.1	2.6
Yield (%)	2.0	2.2	4.0	5.1	6.2

Source: Company data, Macquarie Research estimates

Financial data

	2003	2004F	2005F
ROE (%)	6.9	12.7	14.7
ROA (%)	6.3	11.6	13.0
Net debt/equity (%)	Cash	Cash	Cash
BVPS (HK\$)	1.2	1.1	1.2
Price/book (x)	0.8	0.9	0.8
Interest cover (x)	NA	NA	NA
EBITDA margin (%)	24.0	28.7	29.9

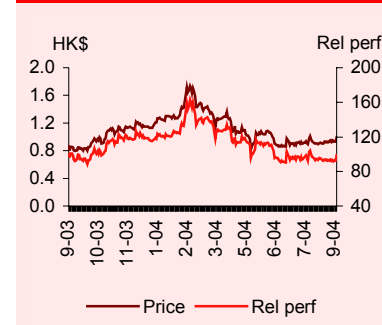
Share data

Market cap (US\$m)	127
Number of shares (m)	987
Daily turnover (US\$m)	0.3
Free float (%)	38.5
52-week hi/lo (HK\$)	1.79 - 0.78

Performance (%)

	Absolute	Relative to HSI
1m	9.9	4.4
3m	-5.7	-10.1
12m	17.6	-1.5

Share price performance



Source: Datastream

1H04 profit up 174%; 2H outlook positive

China Rare Earth reported turnover growth of 71% YoY to HK\$336.5m, and net profit growth of 174% YoY to HK\$59.8m (9% above our estimate of HK\$55m for 1H04).

Fig 1 1H04 results analysis

HK\$m	1H04	1H03	YoY change (%)
Turnover	336.5	196.5	71.2
Operating profit	71.0	25.1	182.8
OP margin (%)	21.1	12.8	65.2
Finance cost	-1.2	-0.1	1189.2
Net profit	59.8	21.8	174.2
Net margin (%)	17.8	11.1	60.2
EPS (HK\$)	0.062	0.027	132.5
DPS (HK\$)	0.0	0.0	NA

Source: Company data

Rare earth division

Revenue from rare earth products increased 63% YoY to HK\$158.6m in 1H04. CRE sold 1,950 tonnes of rare earth products (+10% YoY), while the average selling price of rare earth products was up more than 50% YoY. Allowing for the increase in input costs of rare earth ore, the gross profit margin from rare earth products rose from 10% last year to 15%.

For 2H04, management remains upbeat about rare earth products and expects selling prices to remain high. This is due mainly to the improved demand/supply situation as the rare earth processing sector in China has been consolidating from 2001.

Fig 2 Sales volume and gross profit margin

	1H04 Sales volume (tonnes)	YoY Volume change %	GP margin 1H04
Rare earth products	1,950	10%	15%
Refractory products	26,800	30%	30%
High temperature ceramics	6,400	First year operation	40%

Source: Company data

Refractory products

The refractory products division includes both refractory bricks sold to steel mills and glass factories as well as high-temperature ceramics sold to power plants. The high-temperature ceramics command a much higher 40% gross profit margin vs the 30% for refractory bricks and 15% for rare earth products. CRE has considerable technology advantages over its peers in China for refractory products and, hence, expects to remain the price leader in China for these products. Excluding the effect of the newly launched high-temperature ceramics, refractory products would maintain a similar gross margin in 2004 of 30% relative to 2003. Management sees a stable margin trend for its refractory products in 2H.

Fig 3 Sales and operating profit breakdown by product

	% of sales	% of operating profit
Rare earth products	47%	34%
Refractory products + high-temperature ceramics	53%	66%

Source: Company data

Although there is no significant change in its customer mix, ie, it still sells to many major international companies such as Osram and GE, CRE is increasingly shipping its products to their factories located in China. As a result, the proportion of sales to China increased relative to other markets during 1H04. Management sees this trend continuing in the future.

Fig 4 Sales breakdown by market

	1H2003 (%)	1H2004 (%)
China	57	77
Japan	25	11
Europe	15	11
US and others	3	1

Source: Company data

Maintaining our positive view

In view of the healthy pricing trends for rare earth and refractory products, we maintain our profit forecasts. Our target price is based on 10x forward PER, ie, HK\$1.56/share. We envisage further upside from the company's potential acquisition of rare earth mines in the longer term.

Fig 5 Profit and loss (HK\$m)

Yr to Dec	02	03	04F	05F	06F
Turnover	468	457	716	847	997
EBITDA (ex-associates)	106	110	205	253	300
Depreciation	(33)	(38)	(49)	(54)	(59)
EBIT (ex-associates)	73	72	156	199	241
Net interest inc/(exp)	4	3	2	2	(0)
Associates' profits	—	—	—	—	—
Exceptional items/others	(28)	1	—	—	—
Pre-tax profit	49	76	158	201	241
Tax	(9)	(9)	(21)	(26)	(31)
Minority interest	1	(0)	(5)	(6)	(7)
Preference dividends	—	—	—	—	—
Net profit	41	67	133	169	202
Others	—	—	—	—	—
Dividends	(16)	(18)	(40)	(51)	(61)
Retained earnings	25	49	93	118	142

Source: Company data, Macquarie Research estimates

Fig 6 Cash flow statement (HK\$m)

Yr to Dec	02	03	04F	05F	06F
Pre-tax profit	49	76	158	201	241
Taxes paid	(9)	(4)	(5)	(21)	(26)
Depreciation/amortisation	33	38	49	54	59
Associates' adjustments	—	—	—	—	—
Exceptional items	28	(1)	—	—	—
Gross cash flow	101	109	202	235	274
Capex	(114)	(146)	(100)	(100)	(100)
Change in working capital	(21)	(31)	(116)	(72)	(82)
Free cash flow	(35)	(68)	(14)	62	92
Dividends	(24)	(8)	(18)	(45)	(55)
Investments	—	—	(207)	—	—
Disposals	120	—	—	—	—
Share issues	—	—	208	—	—
Others	34	(7)	(1)	—	—
Net cash flow	95	(83)	(32)	18	36
Net cash (debt) start	233	329	246	214	232
Adj. for FX valuation	—	—	—	—	—
Net cash (debt) at Y/E	329	246	214	232	268
Shareholders' funds + MI	954	1,013	1,110	1,234	1,383
Net gearing (%)	Cash	Cash	Cash	Cash	Cash

Source: Company data, Macquarie Research estimates

Fig 7 Balance sheet (HK\$m)

As at Dec (HK\$m)	02	03	04F	05F	06F
Cash & deposits	333	254	222	240	277
ST marketable securities	—	—	—	—	—
Trade debtors	127	138	215	254	299
Other debtors	—	—	—	—	—
Inventories	187	204	286	339	399
Other current assets	29	102	102	102	102
Intangible assets	—	—	—	—	—
Other LT assets	—	—	—	—	—
Fixed assets	353	392	443	488	530
Total assets	1,029	1,091	1,269	1,424	1,606
Trade creditors	(71)	(65)	(107)	(127)	(149)
Other creditors	—	—	—	—	—
ST debt	(4)	(8)	(8)	(8)	(8)
Other current liabilities	(0)	(5)	(42)	(54)	(65)
LT borrowings	—	—	—	—	—
Deferred taxation	—	—	—	—	—
Other LT liabilities	—	—	—	—	—
Total liabilities	(75)	(78)	(158)	(189)	(223)
Share capital	81	81	81	81	81
Reserves	857	915	1,008	1,126	1,268
Shareholders' funds	938	997	1,090	1,208	1,350
Minorities	15	16	21	27	34
Total	1,029	1,091	1,268	1,424	1,606
Net cash (debt)	329	246	214	232	268
Total cap employed	954	1,013	1,110	1,234	1,383

Source: Company data, Macquarie Research estimates

Fig 8 Statistics and ratios

Yr to Dec	02	03	04F	05F	06F
Growth (%)					
Turnover	(24)	(2)	57	18	18
EBITDA (ex-associates)	(36)	4	87	23	19
EBIT (ex-associates)	(49)	(1)	117	28	21
Net profit	(71)	62	99	27	20
Fully diluted EPS	(74)	62	72	22	20
Margins (%)					
EBITDA (ex-associates)	23	24	29	30	30
EBIT (ex-associates)	16	16	22	23	24
Others (%)					
Effective tax rate	11	12	13	13	13
Payout ratio	40	27	30	30	30
EBIT ROCE	8	8	15	17	18
Net ROE	4	7	13	15	16
Net gearing	Cash	Cash	Cash	Cash	Cash
ROA	4	6	12	13	14
Interest cover (x)	NA	NA	NA	NA	715
Debtors (days)	96	106	90	101	101
Creditors (days)	66	71	61	72	72
Stock (days)	178	206	175	192	193

Source: Company data, Macquarie Research estimates

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Important Disclosures

Recommendation definitions

MRE Australia/New Zealand

Outperform – return >5% in excess of benchmark return (>2.5% in excess for listed property trusts)
 Neutral – return within 5% of benchmark return (within 2.5% for listed property trusts)
 Underperform – return >5% below benchmark return (>2.5% below for listed property trusts)

MRE Asia

Outperform – return >10% relative to US cash return
 Neutral – return within 10% of US cash return
 Underperform – return <10% relative to US cash return

Long term – 12 months to 2 years

Short term – 3 to 12 months

Volatility index definition*

This is calculated from the volatility of historic price movements.

Very high-highest risk – stock should be expected to move up or down 60-100% in a year – investors should be aware this stock is highly speculative.

High – stock should be expected to move up or down at least 40-60% in a year – investors should be aware this stock could be speculative.

Medium – stock should be expected to move up or down at least 30-40% in a year.

Low/medium – stock should be expected to move up or down at least 25-30% in a year.

Low – stock should be expected to move up or down at least 15-25% in a year.

* Applicable to Australian/NZ stocks only

MRE adjusted profit definition

The MRE adjusted profit number is pre-goodwill amortisation and pre-individually significant items, that is:

Adjusted profit = net profit - individually significant items + tax on individually significant items - preference dividends - minority interests + goodwill amortisation.

MRE recommendation proportions

MRE Australia/New Zealand

Outperform	29.45%
Neutral	53.33%
Underperform	17.22%

MRE Asia

Outperform	62.60%
Neutral	28.90%
Underperform	8.50%

For quarter ending 30 June 2004

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