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China Rare Earth

Mine Digging

BUY

Key Statistics

Code	769
Close (HK\$)	0.76
Target price (HK\$)	1.50
Mkt Cap (HK\$m)	750.1
Forecast PE (x)	6.6
Forecast Yield (%)	2.6
P/B (x)	0.58
Beta (x)	1.29
ROE (%)	9.0
Net gearing (%)	Net cash
Avg Vol (HK\$m)	0.2
YTD Rel Rtn to HSI (%)	(30.3)
Year-end	12/2004
52 week high (HK\$)	1.12
52 week low (HK\$)	0.62

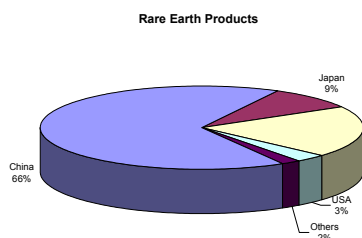
Source: Bloomberg, VC Brokerage

Event – Company Visit Note, met with Mr. Desmond Law, CFO

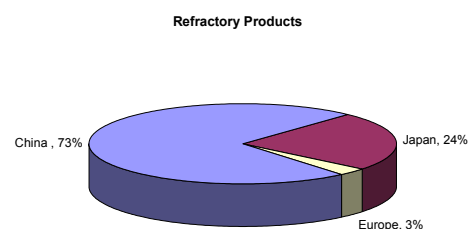
Key Points

- China Rare Earth (CRE) has two business divisions engaging in the processing and manufacture of (i) rare earth products and (ii) refractory materials. The Group operates one rare earth separating factory and one refractory production factory in Yixing, China. Total annual production capacities reach 6,500 tonnes of rare earth oxides (REO) and 100,000 tonnes of refractory materials.
- Rare earth products have a large variety of applications, they are mainly used for producing electronic devices, computers, magnetic materials, fluorescent lighting and special alloys. CRE's rare earth products are for domestic use (66%) and exports (34%) mainly to Europe, the US and Japan. Major clients include Nippon Electric Glass, Siemens, and General Electronics.
- The refractory materials are extensively used for heat-treatment facilities in the heavy industries, such as petrochemical, power generation, steel and cement manufacturing. CRE's refractory materials are 73% sold to the domestic market and 27% for export, mostly to Japan.
- China has the largest rare earth reserve in the world, estimated at 80%,** and produces c. 75% of the global demand. Having a low-cost advantage and its richness in the reserves, the market share of China's processed rare earths is expected to continue to grow in the future. Helped by its fast-growing manufacturing sector, China is also the largest consumer of the rare earth materials using up c. 45-50% of the global demand.
- All the rare earth mines are state-owned and the government is conveniently dividing up these mines into two regions: Northern mines and Southern mines. The Northern mines are concentrated in Inner Mongolia and their reserves are less rich having only 4 elements of the rare earth ores out of a total of 17. While the Southern mines are spread over a number of provinces and their compositions are complete possessing all 17 elements.

Turnover – Geographical Breakdown



Source: Company



Source: Company

FY05 Interim Results

Interim Results (HK\$ m)			
	1H 04A	1H 05A	% change
Turnover	336.5	375.5	11.6%
COGS	(247.9)	(284.2)	14.7%
Gross Profit	88.6	91.3	3.0%
Gross margin	26.3%	24.3%	
Interest income	1.1	0.9	-15.1%
Distribution cost	(8.4)	(8.5)	1.4%
Admin expenses	(10.7)	(10.3)	-3.9%
Other income	0.6	0.5	-16.5%
Operating profit	71.1	73.8	3.9%
Operating margin	21.1%	19.7%	
Finance cost	(1.2)	0.0	
Profit before taxation	69.9	73.8	5.7%
Taxation	(9.0)	(17.0)	89.1%
Profit after taxation	60.9	56.8	-6.6%
MI	(0.9)	(0.7)	-29.3%
Net Profit	59.9	56.2	-6.3%
Net margin	17.8%	15.0%	
Basic EPS (HK\$)	0.0624	0.0569	-8.8%

Source: Company

The 11% growth in consolidated turnover was mostly contributed by the better volume sales in rare earth products, turnover from rare earth products was up 18% yoy against 5.9% turnover growth for refractory products.

However due to the falling ASP in rare earth products, year-on-year basis only, and unchanged raw material cost, CRE suffered a minor margin squeeze, net profit was down 6.3% to HK\$56m, with an EPS of HK5.69 cents.

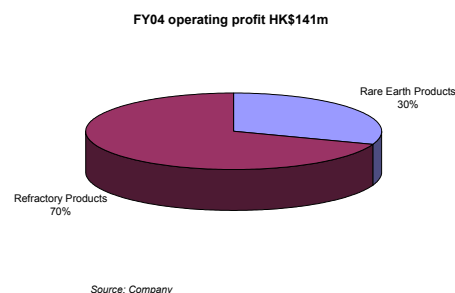
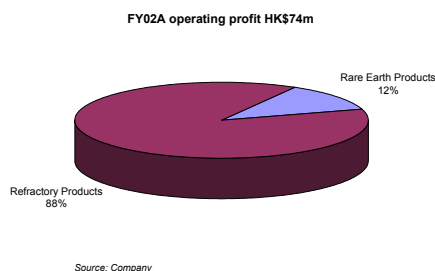
Divisional Profits			
	1H 04A	1H 05A	% change
Turnover			
Rare Earth Products	158.6	187.1	18.0%
Refractory Products	177.9	188.4	5.9%
Operating profit			
Rare Earth Products	26.0	22.9	-11.9%
Refractory Products	50.4	53.5	6.1%
Operating margin			
Rare Earth Products	16.4%	12.2%	
Refractory Products	28.3%	28.4%	

Source: Company

Our Views

- **The refractory products** – have been growing steadily during the past years with a typical 10-15% growth in sales per annum. The profit margin is also very stable with operating margin at 25-30%. After seeing the management, we are quite confident that this division would continue to enjoy stable growth of 8-12% pa in net profit in the foreseeable future. Utilization is at 60% and the factory is capable to handle more new orders before new capex is needed to expand capacity.
- **The rare earth products** – This is where our concern lies, but on the flip side of the coin, this is also the place to look for opportunity. CRE is in the mid-stream (the process is known as separation) of the industry value chain where **the entry barrier is only medium, in our view**.
- Competition is quite keen and the number of mid-stream players is large but they are typically small in size. CRE is one of the largest in China. Start-up capex is around HK\$200m for the smallest scale.
- Demand surged very rapidly during 1998-2001 being fuelled by the voracious appetite for semiconductor on the back of the internet boom. High profitability, CRE was earning an operating margin c. 30% at that time vs a12% today, lured the entry of many new players.
- When the frenzy subsided, a price war emerged driving down the industry profitability. Lacking the economies of scale, many smaller players are now either loss-making or at the verge of breaking-even. **A market consolidation is underway** but the exact duration is difficult to predict, this could be a rather lengthy process.
- The industry profitability reached a low point in 2002/2003, CRE achieved an operating profit of HK\$10m (on HK\$206m sales) in FY02 and HK\$16m (on HK\$208m sales) in FY03.
- Some smaller rare earth processors went out of business and the largest players decided to cut productions to avoid further falling in ASP. This facilitated tremendously and profitability rebounded in 2004. But the act is losing steam and the improvement fails to advance further in 2005, as shown in the latest interim results. CRE's latest utilization is only at 50%.
- Another encouraging development is that **the government has decided to stop issuing new licence** in order to stop pollution. If not handle properly, the separation process can produce a lot of unfriendly materials to harm the environment.

Operating Profit Breakdown



Our Views (cont'd)

- Instead of waiting for the tide to turn, **management is taking a more pro-active role aiming to move upstream, acquiring rare earth mines from the State.**
- The negotiation is still ongoing and the CFO did not reveal many details during our interview. If all go well, this could materialize in the next 6 months. Consideration is estimated at around HK\$300m – possibly a small- to medium-sized mine, but is adequate to supply all the raw material needs by CRE's factory.
- **With its own mine, CRE could lift gross margin for its rare earth products from the current 20% to 30-35%, a great boost to the bottom line.** The difficult part is on the acquisition arrangement as it is stipulated by the central government that no foreign entity has the right to own any rare earth mine in China.
- **We speculate that the mine will be acquired by its parent but funded by the listco,** and the two companies would have some kind of binding agreement whereby the listco would have the first right of refusal to buy the rare earth ores at some pre-determined fixed prices which, **of course, have to be at no added profit margin to be fair.** Effectively it would be similar to a long-term supply contract with prices fixed for a specified period of time, say 5-10 years.
- To fund this HK\$300m acquisition, CRE would need to seek new bank loans, given its un-leveraged balance sheet and the relatively small sum compared to its net asset value (HK\$1,302m), raising debt financing should pose no difficulty. In fact, with a cash reserve of HK\$210m, we think the company would only need to raise HK\$150-200m new funding. At 0.54X P/B, equity fund raising is not a sensible option.
- **Another uncertainty is the stage of the target mine currently at.** If the mine is already up and running, then the profit contribution would be immediate. However, if it is a green field project, then the profit recognition would likely be delayed by another 2 years.

Action

- **We have a Buy recommendation on the counter** because we believe the trough of the cycle for rare earth products is behind us, although the recovery is not yet in sight, but a successful upstream integration would definitely help to improve profit margins. Though we have to confess that we are unable to predict the exact timing of the acquisition.
- Even if the acquisition fails to realise, buying into a slow-growth company at 6.6X FY05's earnings, it is not excessive.
- Should the acquisition materialise, the bottom line impact is huge and we should see very strong profit growth (over 30% pa) in the years ahead. In our forecast, **we are taking a more optimistic approach assuming the added benefits would start kicking in from FY06 onwards.**
- Target price is set at HK\$1.50 representing 10X FY06 PE or 1X P/B.

Earnings Forecast - China Rare Earth (with acquisition)

Y/E Dec (HK\$ m)	2003 A	2004 A	2005 F	2006 F	2007 F
Turnover	457	665	754	851	961
EBITDA	112	190	215	272	377
Net profit	67	119	113	153	203
Basic EPS (HK\$)	0.08	0.12	0.11	0.15	0.21
Growth %	64%	50%	-7%	35%	33%
PER (X)	9.3	6.2	6.6	4.9	3.7
P/cash flow (X)	6.0	6.0	4.2	4.0	3.3
DPS (HK\$)	0.02	0.02	0.02	0.02	0.03
Yield (%)	3.2%	3.2%	2.6%	3.0%	4.1%
P/B (X)	0.62	0.62	0.58	0.54	0.49

Source: VC Brokerage, Company

Effect of Acquisition

Y/E Dec (HK\$ m)	2005 F	2006 F	2007 F
<u>Without Acquisition</u>			
EBITDA	214.5	238.1	264.7
Net profit	113.2	129.2	147.7
Basic EPS (HK\$)	0.115	0.131	0.150
Growth %	-6.8%	14.2%	14.4%
PER (X)	6.6	5.8	5.1
DPS (HK\$)	0.020	0.023	0.026
Yield (%)	2.6%	3.0%	3.4%

With Acquisition

EBITDA	214.5	271.9	376.9
Net profit	113.2	152.8	202.6
Basic EPS (HK\$)	0.115	0.155	0.205
Growth %	-6.8%	35.0%	32.6%
PER (X)	6.6	4.9	3.7
DPS (HK\$)	0.020	0.023	0.031
Yield (%)	2.6%	3.0%	4.1%

Source: VC Brokerage, Company

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