

China Rare Earth

Well position for growth

◆ Lower supply and increase in demand for rare earth products.

The Ministry of Land and Resources requested in April that no new mining licences were to be issued for rare earths and no expansion was to be permitted. According to the China Rare Earth Information Centre, rare earth product output should fall by 27.1% from 118,700 tonnes in FY05 to 86,520 tonnes in FY06. On the other hand, demand for rare earth products is strong, with increase in the application for products such as LCDs and Plasma screen TVs, magnets and hybrid vehicles. This distorted demand and supply will inevitably drive up prices for both rare earth raw material and end products. We believe "mid-stream" players such as China Rare Earth (CRE) should be able to pass on the increment in raw material costs to customers. In fact, the flexibility and scale of CRE's production lines offers them the opportunity to re-shuffle product mix to achieve a better gross margin, which its competitors may struggle to achieve.

◆ Strong balance sheet offers chances for up and down-stream.

CRE remains cash rich after the recent placement, and now is a good opportunity for the Company to expand both up and down-stream. The acquisition of Suhai Magnesium in late 2005, an upstream player in the refractory business, may be the first step of a series of vertical integrations. The Company also started producing downstream fluorescent rare earth products and polishing powder. We believe that there are ample opportunities for the Company to expand, such as acquiring rare earth mines in upstream and developing more downstream production lines, in coming years. This will further strengthen their dominant position in the rare earth market.

◆ BUY with target price of HK\$2.14.

Despite earning dilutions from the placement, we project EPS growth for FY06 to be around 20%, generating FY06 PER of 7.4X. Trading at 0.75X P/B, we believe the market has ignored its business expansion potential. We initiate coverage of China Rare Earth with a **BUY** rating and a target price of HK\$ 2.14, representing 82% upside. Further upside is possible if the Company can further fix up its vertical expansion plan.

Year to Dec 31	2003	2004	2005	2006E	2007E
Sales (HK\$m)	457	665	769	951	1,151
Pre-tax profit (HK\$m)	76	139	172	247	320
Net profit (HK\$m)	67	120	130	187	231
EPS (HK\$)	0.08	0.12	0.13	0.16	0.19
EPS growth (%)	62.1	48.3	8.8	19.8	23.4
PER (x)	14.3	9.7	8.9	7.4	6.0
EV/EBITDA (x)	10.5	6.2	5.4	3.5	2.9
Yield (%)	1.7	1.7	3.4	4.3	5.1

Hong Kong Materials

25 May 2006

BUY

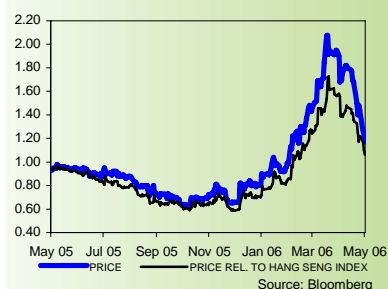
Company Report

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Price	HK\$1.17
Target	HK\$2.14
HSI	15,696

Historical Chart



Performance	1m	3m	6m
Absolute (%)	(38.4)	18.2	64.7
Relative (%)	(33.1)	18.4	59.8

Stock Information

Bloomberg code	769 HK
Market Cap (US\$m)	177.7
52-week high (\$)	2.10
52-week low (\$)	0.62
Shares issued (m)	1,184
6M avg. daily turnover (US\$)	1.67
Free float (%)	49.9
Major shareholders (%)	
	YY Holdings Limited (50.1%)

Key Indicators

ROE (%)	10.1
Net gearing (%)	Net Cash
NTA (HK\$)	1.40
Interest cover (x)	N/A

Business model

Two revenue streams

China Rare Earth's (CRE) principal business is the manufacture and sale of various rare earth products and refractory materials. The Company sources rare earth materials from domestic rare earth mines and separates, purifies and processes these into various rare earth products. Similarly, the Company sources refractory materials from domestic natural ores and processed into various kinds of refractory products.

For FY05, rare earth products and refractory products accounted for 45% and 55% of the Company's turnover respectively. 72% of rare earth products and 82% of refractory products were sold domestically. The current capacity of CRE for rare earth and refractory products stands at 6,500 tons and 100,000 tons respectively. Utilisation of the production lines is currently at around 70%.

Industry Outlook on Rare Earth

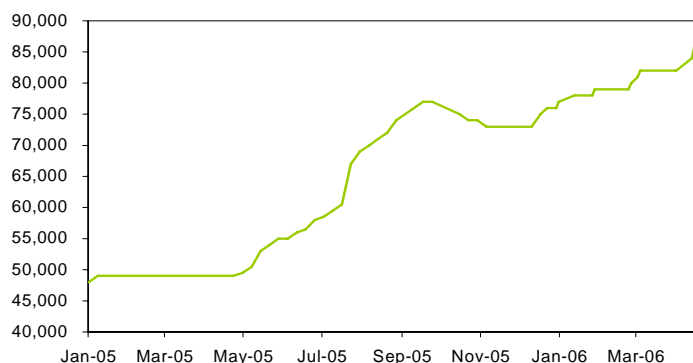
Cutting supply

China accounts for 80% of global rare earth reserves and over 90% of rare earth products production. Any reduction in output will inevitably put upward pressure on prices because demand continues to increase for specific rare earth products. The Chinese government's Ministry of Land and Resources announced in April that the production quota for rare earths is to be at 86,560 tons for FY06. According to the China Rare Earth Information Centre, rare earth product output reached 118,700 tons last year, which represented a rise of over 20% as compared to 98,300 tons in 2004, on the back of booming demand. This will now fall by 27.2% to 86,520 tons if the targets are achieved.

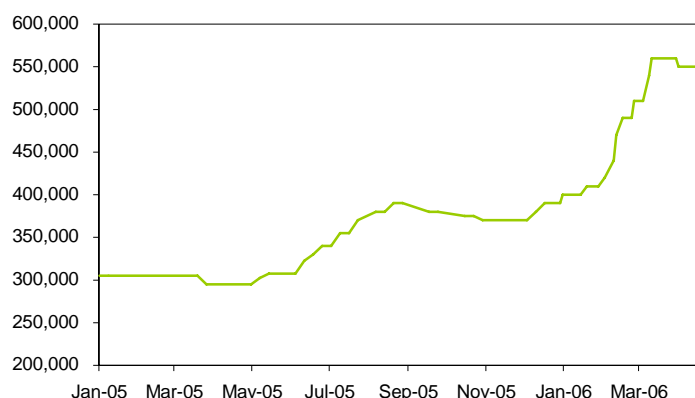
Growth in demand

Demand for rare earth products, on the other hand, is on an uptrend given the increase in applications on products such as LCDs and Plasma screen TVs, magnets and hybrid vehicles. These applications are usually luxury or environmentally friendly in nature, demand for which should continue to grow. For instance, an average hybrid car contains some 45 lbs of rare earth elements such as neodymium, mainly used in super magnets. It is anticipated that production of hybrid cars is going to escalate rapidly, as evidenced in recent announcements from Ford Motor Co. and other manufacturers. Prices for neodymium, according to Asian Metal, have risen 77.6% y-o-y and 19.2% since the beginning of the year.

Figure 1: Price trend of Neodymium Oxide (Rmb/ton)



Source: Asian Metal, Kim Eng Securities

Figure 2: Price trend of Dysprosium Oxide (Rmb/ton)

Source: Asian Metal, Kim Eng Securities

Figure 3: Application of Major Rare Earth Elements

Rare Earth Element	Symbol	Major Applications
Lanthanum	La	Optical glass, portable phone battery, capacitors
Cerium	Ce	Fluorescent powders, optical glass, petroleum cracking
Praseodymium	Pr	Magnet, ceramic pigments, watches
Neodymium	Nd	Hybrid vehicle, superconductors, computer hard disk drives
Europium	Eu	LCD and plasma screen
Terbium	Tb	Computer memory chips, hybrid vehicle, LCD and plasma screen
Dysprosium	Dy	Lasers, halogen lamp

Source: Company data, Kim Eng Sec

CRE - Rare Earth business

Better product mix

CRE sold 4,400 tons of rare earth products in FY05. We anticipate that the cut in supply will lower CRE's sales volume to around 4,000 tons in FY06. Despite the fall in sales volume, we expect the surge in rare earth prices, plus a higher price product mix, will generate top line growth of around 30% for rare earth products. To illustrate, the price of Lanthanum is only half that of Neodymium. Replacing Lanthanum with production in Neodymium will not hurt the top line.

Downstream expansion

CRE also looks into new downstream rare earth products such as fluorescent products and polishing powder. Fluorescent products will continue to benefit from the difficult power supply and energy conservation environment in China while the polishing powder material market is still under-developed and relies heavily on imports. CRE started exporting its fluorescent products to Korea in March 2006 under the Company's own brand.

World class customers

The Chinese dominance in the rare earth market, and the products' wide applications, have secured a number of world class customers for CRE. These include General Electric, Motorola, Toshiba, Siemens, General Motors, Nippon Electric Glass, Showa Denko, Kumho Electric, to name but a few.

Upstream offers more upside

We see the major risk to CRE's rare earth business lying on the supply side. With Chinese Government stepping in to control the quantity of rare earth products, procurement of raw material will be vital. Currently, all the rare earth mines are state-owned. CRE's scale and flexibility in production gives it comparative advantages over the fragmented "mid-stream" players and should guarantee a reliable raw material supply from the government. In the long run, upstream integration will promise a brighter future.

Industry outlook on refractory materials**Wide application of refractory products**

The major characteristics of refractory material is its resistance of softening, fusion, the action of fluxes and slags, and other effects, physical and chemical, from high temperatures. Refractories are used wherever heat is utilized and high temperatures are encountered and contained, such as the steel, non-ferrous metals, construction materials, petrochemical, glass and cement industries. It is estimated that the global production of refractories was 28-30 million metric tons (mmt) in 2004 and China is by far the world's largest producer of refractories (18.7 mmt in 2004)

CRE - refractory materials**Acquisition brings in synergy**

The Company refractory bricks are manufactured and sold to 50-60 steel mills and glass mills. In 2004, the Company purchased a high temperature ceramic company, and also started to service power plants. In late 2005, the Company acquired an upstream player, Suhai Magnesium, for HK\$ 115.4m. Suhai Magnesium used to supply magnesium grains for CRE's refractory production. The acquisition will ensure a stable supply of this raw material as well as synergies from cost savings. Note that Suhai made HK\$ 18.2m net profit for FY05 and the acquisition should thus benefit the bottom line.

Steady growth and margin

CRE's refractory business recorded steady growth in the last 3 years, with turnover growing at a CAGR of 30% and gross margin steady at 30%. We expect the division to maintain a 15% growth per annum in the next 2 years.

Conclusion**Buy with a target of HK\$ 2.14**

Despite earnings' dilution from the placement, we project EPS growth for FY06 to be around 20%, putting the FY06 PER at 7.4X. Trading at 0.75X P/B, we believe the market has ignored its business expansion potential. Note that the relatively slow EPS growth rate in FY05 was mainly caused by the expiry of tax concessions for two of its four subsidiaries, resulting in effective tax rate jumping to 23% from 12%. The tax holiday for the other 2 subsidiaries will also expire in 2007, which we assume effective tax rate to further go up to 27%. We initiate coverage of China Rare Earth with a BUY rating and a target price of HK\$ 2.14, representing 82% upside. Further upside is possible if the Company can further fix up its vertical expansion plan.

Profit and loss

YE Dec (HK\$m)	2003	2004	2005	2006E	2007E
Sales	457	665	769	951	1,151
Cost of goods sold	(309)	(434)	(504)	(589)	(691)
Gross profit	148	231	265	361	461
Operating expenses	(76)	(94)	(98)	(121)	(150)
Operating profit	72	137	167	240	311
Net interest	3	(0)	2	3	5
Interest income	3	2	2	3	5
Interest expense	(0)	(2)	(0)	0	0
Net investment income/(loss)	1	2	3	3	4
Net other non-op. JV+Assoc.	0	0	0	0	0
Net extraordinaries	0	0	0	0	0
Pretax profit	76	139	172	247	320
Income taxes	(9)	(18)	(40)	(58)	(86)
Minority interests	(0)	(2)	(1)	(2)	(3)
Net profit	67	120	130	187	231
EBITDA	108	187	228	316	406
EPS (HK\$)	0.08	0.12	0.13	0.16	0.19

Source: Company data, Kim Eng Securities estimates

Balance sheet

YE Dec (HK\$m)	2003	2004	2005	2006E	2007E
Total assets	1,091	1,427	1,594	2,043	2,273
Current assets	699	731	812	1,037	1,061
Cash & ST investment	254	227	153	284	202
Inventories	204	225	228	284	292
Accounts receivable	138	204	339	356	431
Others	102	75	92	113	137
Other assets	392	696	782	1,006	1,211
LT investments	0	0	0	0	0
Net fixed assets	392	550	570	795	999
Others	0	147	212	212	212
Total liabilities	78	108	145	188	244
Current liabilities	78	108	145	188	244
Accounts payable	43	56	56	70	84
ST borrowings	0	0	0	0	0
Others	35	52	89	119	159
Long-term liabilities	0	0	0	0	0
Long-term debts	0	0	0	0	0
Others	0	0	0	0	0
Shareholder's equity	1,013	1,320	1,449	1,855	2,029
Paid-in capital	81	99	99	118	118
Reserve	915	1,204	1,331	1,715	1,887
Minority interests	16	17	19	21	24

Source: Company data, Kim Eng Securities estimates

Cash flow

YE Dec (HK\$m)	2003	2004	2005	2006E	2007E
Operating cash flow	79	153	106	249	329
Operating profit	76	139	172	247	320
Depreciation & amortization	36	50	61	76	95
Change in working capital	(31)	(43)	(125)	(71)	(80)
Others	(3)	7	(1)	(3)	(5)
ROI, Serv. of Fin. and Tax	(11)	(36)	(44)	(74)	(111)
Investment cash flow	(146)	(95)	(143)	(300)	(300)
Net capex	(75)	(126)	(29)	(85)	(85)
Change in LT investment	(72)	31	(114)	(215)	(215)
Change in other assets	0	0	0	0	0
Cash flow after invt.	(79)	21	(81)	(126)	(82)
Financing cash flow	0	(47)	2	259	4
Change in share capital	0	(1)	0	256	0
Net change in debt	0	(47)	0	0	0
Change in other LT liab.	0	1	2	3	4
Net cash flow	(79)	(26)	(79)	133	(78)

Source: Company data, Kim Eng Securities estimates

Key ratios

YE Dec	2003	2004	2005	2006E	2007E
Growth (% YoY)					
Sales	(2.2)	45.6	15.6	23.6	21.1
Operating profit	(2.2)	90.7	22.1	43.7	29.2
EBITDA	0.9	73.7	22.0	38.4	28.4
Net profit	66.2	79.7	8.8	43.7	23.4
EPS	66.2	48.3	8.8	19.8	23.4
Profitability (%)					
Gross margin	32.4	34.7	34.4	38.0	40.0
Operating margin	15.7	20.6	21.8	25.3	27.0
EBITDA margin	23.6	28.1	29.7	33.2	35.2
Net margin	14.6	18.0	16.9	19.7	20.1
ROA	6.1	8.4	8.2	9.2	10.2
ROE	6.6	9.1	9.0	10.1	11.4
Stability					
Gross debt/equity (%)	0.0	0.0	0.0	0.0	0.0
Net debt/equity (%)	0.0	0.0	0.0	0.0	0.0
Int. coverage (X)	1,111	88	-	-	-
Int. & ST debt coverage (X)	1,111	88	-	-	-
Cash flow int. coverage (X)	811	72	5,057	-	-
Cash flow int. & ST debt (X)	811	72	5,057	-	-
Current ratio (X)	8.9	6.8	5.6	5.5	4.4
Quick ratio (X)	6.3	4.7	4.0	4.0	3.2
Net cash/(debt) (HK\$m)	254	227	153	284	202
Per share data (HK\$)					
EPS	0.08	0.12	0.13	0.16	0.19
CFPS	0.10	0.15	0.11	0.21	0.28
BVPS	1.22	1.32	1.45	1.55	1.69
SPS	0.56	0.67	0.78	0.80	0.97
EBITDA/share	0.13	0.19	0.23	0.27	0.34
DPS	0.02	0.02	0.04	0.05	0.06

Source: Company data, Kim Eng Securities estimates

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