



VISIT NOTE

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HK\$1.58	---

China / Basic Materials

31 December 2009

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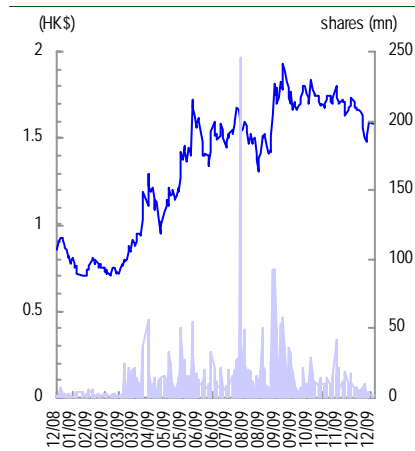
Key stock data

12-month High / Low	HK\$1.99/0.69
1m avg daily vol	7.74m
Issued shares (H shares)	1,551m
Market cap (H shares)	HK\$2,451m
PER FY09F (x)	N/A
P/B FY09F (x)	N/A
Net debt / equity (%)	Net cash
Board lot	2,000
Major shareholder	YY Holdings Ltd. (38.37%)

Source: Bloomberg

Performance	1M	3M	12M
Absolute (%)	-4.82	-6.51	83.72
Rel (HSI) (%)	-3.33	-9.09	34.31

Source: Bloomberg



China Rare Earth (769 HK)

Creating a vertically-integrated rare earth business chain

China Rare Earth Holdings (769 HK) (CRE) is a leading rare earth oxide and high-grade refractory material producer in China. Its major customers include Angang, Baogang, Magang, as well as international names such as GE, NKK and LG. CRE has been actively seeking expansion opportunities. Recent acquisitions include Xinghua and Dongye Rare Earth. It has also formed a joint venture with OSRAM to engage in research and development. We believe the integration strategies can allow CRE to gain greater market share amid the recovering market.

- ◆ **Leading rare earth products and refractory materials producer in China.** China Rare Earth (CRE) is a leading rare earth oxide and high-grade refractory material manufacturer in China. CRE operates a rare earth separating factory and a refractory production factory in Yixing, Jiangsu Province. It has a total annual production capacity amounting to 6,500 tons of rare earth products and 100,000 tons of refractory products.
- ◆ **Acquisition of Dongye Rare Earth enhances product mix.** CRE's rare earth products segment has been hard hit by the economic slowdown. To alleviate the negative impacts of a weakened demand, CRE acquired Dongye Rare Earth in Guangdong, which is also engaged in rare earth products and refractory products business. This strengthened its product mix and enhanced its economies of scale by adding metal products into its product portfolio.
- ◆ **Active vertical integration of upstream and downstream rare earth business.** CRE also acquired Xinghua Rare Earth in Hunan, which has long-term supply agreement with local rare earth mining companies. It has established a joint venture in PRC with OSRAM to engage in research, development, production and sale of fluorescent powder products. CRE has also invested in high-end LCD rare earth polishing powder production line, in response to a rising demand for polishing powder.
- ◆ **Refractory materials business is also expanding.** CRE also aims to expand its refractory materials business. It has invested over HK\$200mn on new high purity magnesium grain plant which is targeted to achieve 150,000 tons of production capacity upon completion of the entire investment project. The company also seeks to invest in mines or processing plants to secure raw material supply.

Key Financials

Year to 31 Dec	2006	2007	2008	1H09
Turnover (HKD '000)	1,031,082	1,385,345	1,364,890	499,943
Growth (%)	34.0	34.4	-1.5	-36.2
Net Profit (HKD '000)	211,691	299,080	(172,407)	20,605
Growth (%)	60.7	41.3	-157.6	-90.8
EPS (HKD)	0.18	0.21	(0.12)	0.01
Growth (%)	38.4	15.3	-157.9	-90.6
P/E(x)	8.8	7.6	(13.1)	106.9
P/B (x)	0.8	0.9	0.9	0.9
DPS (HKD)	0.06	0.05	0.01	-
Yield (%)	3.7%	3.2%	0.6%	-

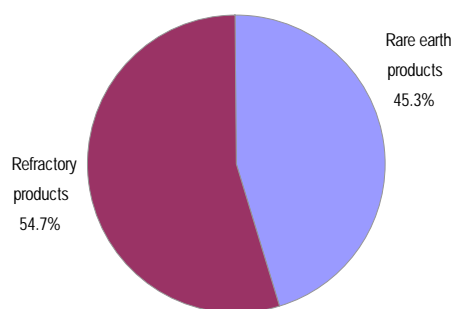
Sources: company data and Core Pacific - Yamaichi

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Industry leader with comprehensive product range

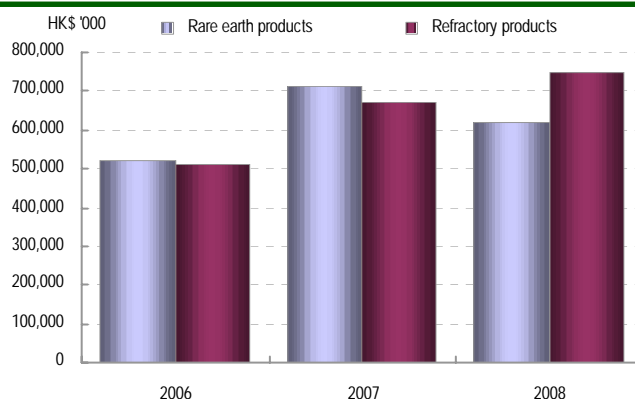
Leading rare earth products and refractory materials producer in China. China Rare Earth (CRE) is a leading rare earth oxide and high-grade refractory material manufacturer in China. CRE operates a rare earth separating factory and a refractory production factory in Yixing, Jiangsu Province. It has a total annual production capacity amounting to 6,500 tons of rare earth products and 100,000 tons of refractory products. Other major product lines of the company include fluorescent materials, polishing agents and high temperature ceramics.

Figure 1: Turnover by segment in 2008



Source: Company data

Figure 2: Turnover by segment 2006-2008



Source: Company data

Rare earth products: Rare earth oxides have a wide range of applications. They are mainly used for producing high-tech electronic devices, computers, hybrid vehicles, LCDs, DVDs, magnetic materials, mobile phone batteries, precision optics and many energy-saving environmental protection products. CRE has a comprehensive product range with over 30 types of rare earth products. According to the management, it is the largest supplier of highly purified rare earth oxide in the PRC and it has almost 20% share in the global market.

Table 1: Major rare earth elements and their applications

Rare Earth Element	Symbol	Major Applications
Lanthanum	La	Optical glass, portable phone batteries, capacitors
Cerium	Ce	Fluorescent powders, optical glass, petroleum cracking
Praseodymium	Pr	Magnet, ceramic pigments, watches
Neodymium	Nd	Hybrid vehicles, superconductors, hard disks
Terbium	Tb	Computer memory chips, hybrid vehicles, LCD and plasma screens
Dysprosium	Dy	Magnetic materials, lasers, halogen lamps
Europium	Eu	LCD and plasma screens

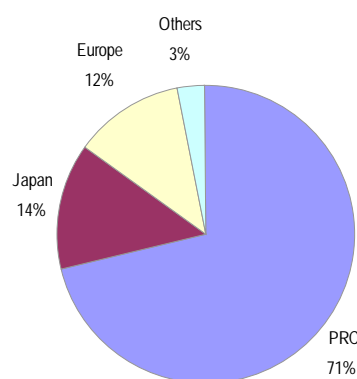
Source: Company data

Refractory products: Refractory materials generally refer to the inorganic non-metal materials with high temperature resistance of up to 1580°C. Refractory products are used extensively in heat-treatment facilities for petrochemical, steel metallurgy, non-ferrous metallurgy, glass, construction materials, chemical fertilizer and ceramics industries. CRE produces refractory bricks which are sold to steel mills, glass mills and power plants. Key customers of CRE's refractory products include Angang, Baogang, Magang, as well as overseas clients such as NKK and Pilkington.

Expanding through vertical integration

Sluggish demand for rare earth products due to the financial crisis. China accounts for around 58% of the world's rare earth resources, and over 90% of rare earth products. CRE holds almost 20% share in the global market of highly purified rare earth oxide. Battered by the global financial crisis, the prices for most of the rare earth products fell substantially – praseodymium, neodymium, terbium and dysprosium dropped 30% -70% yoy in 1H09. Due to the sluggish market conditions, turnover for the period decreased by over 50% yoy and CRE recorded operating loss for rare earth oxides business during the period. As for the performance of fluorescent materials, sales were also disappointing. Since majority of lighting factories in China are exporters to overseas markets in Europe and the U.S. and those economies were hard hit by the financial crisis, turnover of fluorescent materials slid about 60% yoy during the period.

Figure 3: Rare earth products turnover by region in 2008



Source: company data

Rare earth products prices remain weak in 2H09. In 2H09, as the global economic conditions improved, demand for rare earth products started to climb again. Yet, prices for the products remained low as the rare earth industry is plagued by the overcapacity problem. Management did not provide any guidelines about the earnings in 2H09 but expects the market atmosphere continues to be slack in the near term as it takes times for demand to fully pick up.

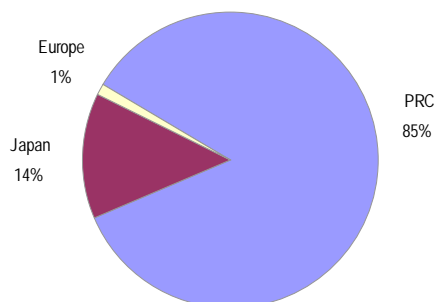
Acquisition of Dongye Rare Earth allows wider product range. To alleviate the negative impacts of a slowing demand, CRE acquired Dongye Rare Earth in Guangdong, which is also engaged in rare earth products and refractory products business, to strengthen its product mix and enhance economies of scale by adding metal products into its product portfolio.

Active expansion through upstream and downstream integrations. CRE also acquired Xinghua Rare Earth in Hunan, which has long-term supply agreement with local rare earth mining companies. The acquisition secures CRE's steady supply of rare earth materials and enhances economies of scale. The company also targets to increase the proportion of turnover contribution from downstream rare earth products to 50% of total turnover within next few years. CRE has entered into an investment contract with OSRAM, a company wholly-owned by Siemens AG, to establish a joint venture company in PRC to engage in research, development, production and sale of fluorescent powder products. Estimated investment amounts to EUR43.5mn and annual production capacity will be about 2,000 tons when it is in full operation. To take advantage of the rising demand for polishing powder in China, CRE has invested in high-end LCD rare earth polishing powder production line. Total investment of the project amounts to RMB200mn and annual production capacity of 2,000 tons.

Refractory materials business also slowed amid adverse market environment.

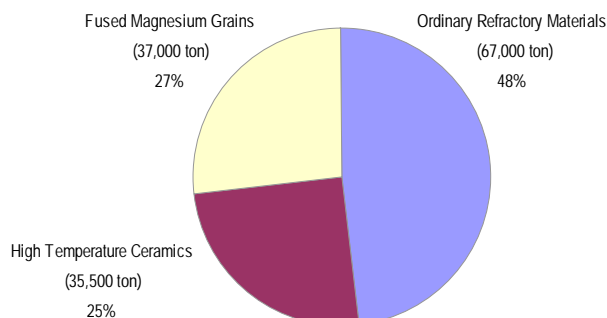
Refractory materials business also shrank substantially amid the economic downturn. Sales were sluggish in 1H09 as the operating environment of the steel and glass industries was affected by macroeconomic slowdown in China. Turnover and sales volume from the ordinary refractory materials and high temperature ceramics fell by 42% and 48% yoy respectively. As for the fused magnesium grains business, its performance was also not satisfactory. CRE sold only 5,000 tons of fused magnesium grains to external party in 1H09, down more than 70% yoy. The decline in sales volume also led to a rise in average cost and this dragged gross profit margin down to less than 20%.

Figure 4: Refractory products turnover by region in 2008



Source: company data and Core Pacific - Yamaichi

Figure 5: Refractory products turnover by products in 2008



Source: company data and Core Pacific - Yamaichi

Vertical backward integration allows steady raw material supplies. Looking ahead, management expects the refractory materials business to face pressure in the short term due to the challenges faced by heavy industries but will demonstrate faster rebound for products used in the glass and cement sectors. CRE also aims to expand its refractory materials business. It has invested over HK\$200mn on new high purity magnesium grain plant which is targeted to achieve 150,000 tons of production capacity upon completion of the entire investment project. The company also seeks to invest in mines or processing plants to secure raw material supply. With the heavy investments, we believe CRE can gain greater market shares in future.

Profit & loss (consolidated)

Year to 31 Dec (HK\$'000)	2006	2007	2008	1H09
Turnover	1,031,082	1,385,345	1,364,890	499,943
Cost of sales	(732,577)	(931,232)	(1,015,603)	(414,488)
Gross profit	298,505	454,113	349,287	85,455
Other revenue	25,040	21,350	14,250	7,007
Selling & distribution expenses	(23,802)	(45,015)	(60,139)	(14,273)
Administrative expenses	(22,673)	(29,087)	(105,359)	(27,694)
Finance costs	(2,995)	(5,227)	(10,288)	(9,453)
Impairment loss	0	0	(306,302)	0
Profit before tax	274,075	396,134	(118,551)	41,042
Tax expenses	(62,384)	(97,054)	(53,856)	(20,437)
Profit attr. to shareholders	211,691	299,080	(172,407)	20,605
EPS	0.18	0.21	(0.12)	0.01
DPS	0.06	0.05	0.01	-

Cash flow (consolidated)

Year to 31 Dec (HK\$'000)	2006	2007	2008	1H09
Operating cash flow	253,918	255,922	252,144	141,052
Investing cash flow	(389,755)	(216,849)	(331,447)	(102,400)
Financing cash flow	627,816	(76,284)	105,759	56,626
Net cash flow	491,979	(37,211)	26,456	95,278

Balance sheet (consolidated)

As at 31 Dec (HK\$'000)	2006	2007	2008	1H09
Non-current assets	1,080,770	1,262,120	1,500,535	1,421,421
Property, plant & equipment	568,837	744,073	715,124	668,096
Goodwill	202,242	206,705	85,843	85,843
Prepaid lease payments	138,660	159,613	262,444	259,571
Intangible assets	0	0	379,014	363,842
bank deposits	0	25,000	37,678	23,250
Deferred tax assets	0	0	20,432	20,819
Others	171,031	126,729	0	0
Current assets	1,384,641	1,536,144	1,713,801	1,723,725
Inventories	231,164	296,254	308,837	285,100
Account receivables	344,614	381,623	412,019	376,911
Prepaid lease payments	3,002	3,508	5,746	5,746
Pledged and restricted bank deposits	102,644	100,004	124,106	131,834
Cash & cash equivalents	660,770	651,992	765,252	860,530
Others	42,447	102,763	97,841	63,604
Total assets	2,465,411	2,798,264	3,214,336	3,145,146
Non-current liabilities	0	0	261,337	295,780
Current liabilities	227,454	248,340	479,470	355,232
Account payables	50,384	62,113	116,189	108,747
Borrowings (current portion)	95,000	101,453	9,712	167,452
Other payables	35,207	45,185	97,120	69,798
Tax payable	36,251	39,029	115,659	8,457
Others	10,612	560	140,790	778
Total liabilities	227,454	248,340	740,807	651,012
Share capital	142,114	142,114	142,114	142,114
Reserves	2,074,519	2,379,578	2,302,253	2,323,264
Minority interests	21,324	28,232	29,162	28,756
Total Equity	2,237,957	2,549,924	2,473,529	2,494,134

Financial ratios

Year to 31 Dec	2006	2007	2008	1H09
Profitability (%)				
Gross profit margin	29.0	32.8	25.6	17.1
Operating profit margin	26.9	29.0	-7.9	10.1
Net profit margin	20.5	21.6	-12.6	4.1
Liquidity (x)				
Current ratio	6.1	6.2	3.6	4.9
Quick ratio	5.1	5.0	2.9	4.0
Return (%)				
ROA	8.6	10.7	-5.4	0.7
ROE	9.5	11.7	-7.0	0.8
Debt (x)				
Interest coverage	92.5	76.8	(10.5)	5.3
Debt-to-asset	0.09	0.09	0.23	0.21
Debt-to-equity	0.10	0.10	0.30	0.26

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