

Hong Kong

April 22, 2010

**China Rare Earth Holdings Limited (0769.HK)**

**Undervalued Strategic Metals**

Research analyst Fan Guohe

☎ (8621) 51699200-110

FAX(8621) 60911155

✉ fanguohe@phillip.com.cn

### Summary

The additional contributions from the businesses which were newly acquired offset the decline of old business, but its most products prices slumped, the revenue of China Rare Earth (the Company) shrunk in 2009. Meanwhile its profitability saw sharp drop. However, due to no similar provision was made, the Company turned loss to profit, with net profit realizing HK\$85 million.

Taking consideration of incentive policies for new industries and tightening supply, the rare earth products prices will be optimistic. Plus with new profit growth by new projects, we expect net profit for the Company will reach HK\$248 million and HK\$ 361 million in 2010 and 2011, equal to HK\$0.17 and HK\$0.25 of the EPS. We conservatively give it the P/E with 15X to FY10 EPS, the 12-m TP of the Company will be HK\$2.5, over 30% premium than current price. We initiate it Buy rating.

### The performance entered the growing period again

China Rare Earth declared its 2009 annual report on 19th, April, which shows that the revenue and gross profit of the Company were HK\$1.212 billion and HK\$231 million, decreasing by 11% and 34% year-on-year. However, the Company turned loss to profit in the year, with net profit realizing HK\$85 million.

Looking into its main businesses, it was the economic recession that negatively impacted the downstream demand. The refractory materials business shrunk on the whole, its sales of ordinary refractory materials and high temperature ceramics decreased about 25%, and the sales for the fused magnesium grain business was down by more than 60%. As for the rare earth business, the Company's rare earth oxides sales decreased about 30%. However, thanks to the additional contributions from the businesses via the

### Recommendation

## Buy

Previous call: NA

Previous TP: NA

### Price

Last close : HK\$1.90  
12-month TP : HK\$2.50

### Basic Data

Market cap. 2,916  
(HK \$ mil)  
Shares in issue (m) 1,551  
52-wk high/low HK\$2.30/0.91  
Major shareholder YY Holdings  
Limited  
Flow proportion 58%

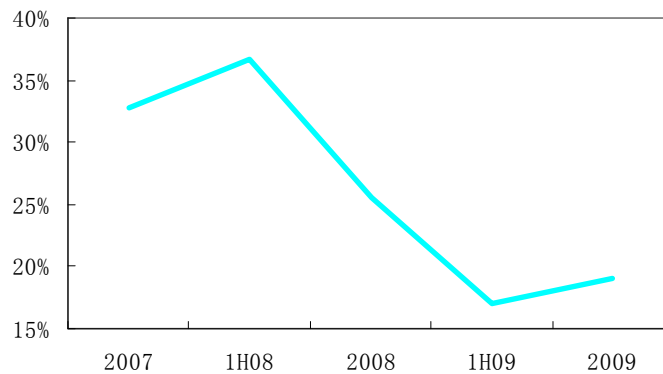
### Share Price Performance



(Source: AASTOCK)

acquisition of Xinghua Rare Earth and Dongye Rare Earth in 2008, its sales of rare earth and downstream products grew 32%. What's more, sales volume of its fluorescent materials in 2009 remained nearly the same as in 2008.

**Figure 1: Gross margin declined sharply since 2008**



(Sources: Company reports, Phillip Securities)

Against the different changes of sales volume, most of its rare earth products reported a decreased selling price with praseodymium oxide, neodymium oxide and terbium oxide mainly used in magnetic materials experiencing the biggest decline of more than 40% on average over 2008. The selling price of dysprosium oxide was also lower by more than 15% on average over last year. In addition, the selling price of yttrium-europium co-precipitates that mainly used in fluorescent materials also decreased by about 10% on average year-on-year, and the prices of fluorescent materials in 2009 was down ranging from 25% to 35%. However, price movements of refractory materials products varies, with prices of major products such as fused magnesium chrome bricks, alumina-graphite bricks and the Sialon series experienced fluctuations of less than 10%.

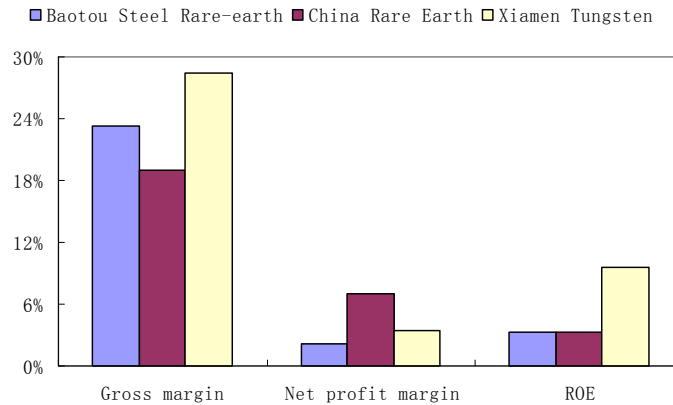
Overall speaking, The additional contributions from the businesses which were newly acquired offset the decline of old business, but its most products prices slumped, the revenue of China Rare Earth shrunk in 2009. Meanwhile, its gross margin drop over 6 percentage points to 19.06%. However, due to no similar provision was made, the Company turned loss to profit. In 2008, China Rare Earth made the provision of more than HK\$300 million for the impairment of goodwill and machinery and equipment during the economic downturn.

### **Better financial situation than peers**

Compared to its peers in China mainland, the performance of the Company in 2009 behaved generally. However, regarding its financial situation, the Company keeps at conservative and excellent level for both long term and short term solvency. Meanwhile, its cash and cash

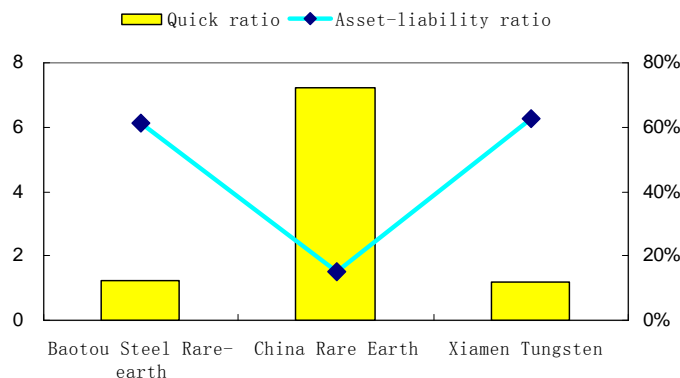
equivalent accounts for 33% in the total assets. All those indicate that the Company is able to expand the businesses and enlarged the leverage. In 2H09, China Rare Earth picked the phosphors and polishing powder to expand its businesses, which will become the Company's profit growth in our opinion.

**Figure 2: Lower profit margin than peers**



(Sources: Company reports, Phillip Securities)

**Figure 3: Better financial situation than peers**

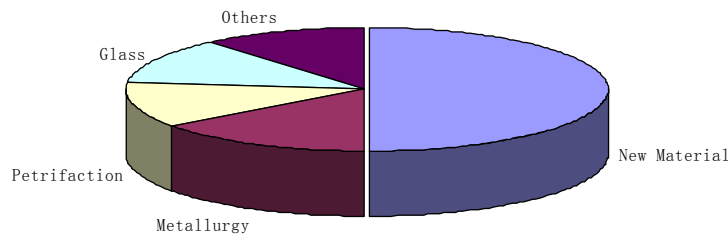


(Sources: Company reports, Phillip Securities)

### Wide demand market for Strategic Metals

One of main businesses is to operate rare earth smelting and separation, and then supply rare earth oxide, rare earth metals and downstream products. As the rare metals, rare earth has been used traditionally for many industries including the metallurgy, infrastructure, petrochemical engineering, glass, ceramics, agriculture, light manufacturing and textile. In the past few years, high-technology industry and advanced technology materials industry have become the main consumers of rare earth, with the share accounting for 50% above, which is also expected to reach 70%. In all, rare earth is experiencing a profound change from industrial gourmet powder to industrial food, and then holds the position of strategic metals.

Figure 4: Downstream Demand Breakdown of Rare Earth in China



(Sources: Phillip Securities)

Looking back on the history, global rare earth consumption had realized the CAGR of 6% from 2000 to 2008, far higher than the GDP growth rate. In China, the rate had been as high as 17%, also leading its GDP growth rate. Since 2003, new materials have consumed rare earth with the high 30% growth rate. In 2008, the consumption by new materials was 38.5 thousand tons, accounting for 53%.

Nowadays, major economies are seeking new growth engine after economic recession, and the low-carbon and new energy industry have been picked to be promoted. In China, the wind energy has taken above 100% growth in consecutive four years, electric automobile industry is facing the consumption upgrading and the stimulus plan for new energy vehicles. What's more, the government is promoting the lighting policy with saving energy, and planning to popularize electricity-saving lamp to 150 million units, 25% higher than that of 2009. Apparently, many parallel industries have adopted the application of rare earth products including rare-earth permanent magnetic material, rare-earth hydrogen storage material, catalysts and fluorescent powder. We expect the rare earth demand will keep a rapid growth in medium term, with 20% rate in 2010.

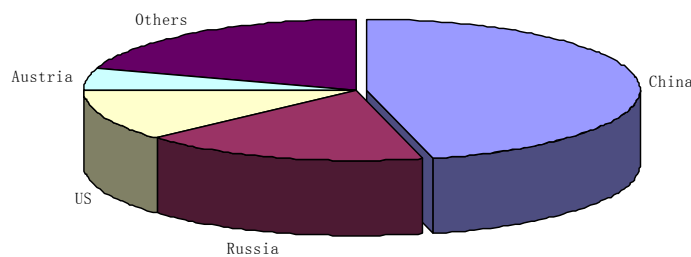
To meet new needs, China Rare Earth adopted two projects in 2009. Firstly, the Company entered into a joint venture agreement in China with OSRAM, a leading global lighting manufacturer, on 18 October 2009. The total investment cost of the whole project would be EURO43.5 million with the Company owning a 49.9% interest. The major products of the joint venture are tri-band phosphors for the lighting industry, and the annual production capacity will be 2,000 tons when in full operation. Secondly, the Company has also finalised the planning of construction of the high-end LCD rare earth polishing powder production line which will be located at the existing plant in Yixing. Upon completion of the project, the Company's annual production capacity of polishing powder will reach 2,000 tons. With regard to their downstream demand, the former is in accordance with the policy guidance of energy saving, and the latter is expected to edge out the import. In all, new projects both

face good challenges and will become the new profit growth of the Company.

### **The supply will be tightened methodically due to the administration of quotas**

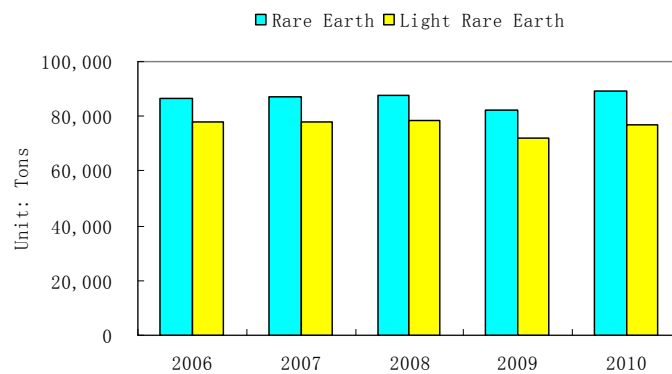
As the rare metals, rare earth resources are distributed intensively on the earth, with 80% located in China, Russia, America and Australia, among which China has taken the first position in rare earth resources, production, consumption and export. However, because of the negligence on dominant minerals like rare earth in previous years, China's bargain power on rare earth products has been weakened gradually, and the prices increase of rare earth are very limited, far below than that of copper and iron ores.

**Figure 5: Rare Earth Distribution on the earth**



(Sources: Phillip Securities)

However, China has carried out the export quotas and tariff administration on rare earth since 2006, which make the rare earth export decline gradually. Since 2008, Jiangxi and Inner Mongolia have begun to store up their rare earth resources. All those indicate that the government has taken long term program to assure the development of China's rare earth industry. Furthermore, compared to increasing demand, present policies will let the supply of rare earth be tightened methodically. In our views, economy recovery and newly emerging industries will boost the demand for rare earth. In medium and long term, the supply of rare earth will gradually be in shortage, which will benefit their prices. As a matter of fact, the selling prices of some rare earth products have showed a significant upwards trend, among which the average selling prices of praseodymium oxide, neodymium oxide and dysprosium oxide have risen 50%-60% than that of 2009. We think the downturn period of rare earth market has passed and their prices will become optimistic. Driven by the upwards prices and expanded sales, the profitability of China Rare Earth will regain rapidly, with the gross margin expected to reach 30% or higher.

**Figure 6: Production Quota of Rare Earth in China**

(Sources: Phillip Securities)

**Demand for refractory materials will still be hopeful**

The other main business of China Rare Earth is about the refractory materials, which are used for the iron & steel and glass industry relative to infrastructure and real estate. Recently Chinese government has strengthened the regulation on real estate market, especially on the speculative demand. New policies have triggered the worry over shrinking demand.

However, it is worth noting that the housing land-use supply will increase 135% according to the housing land-use plan in 2010, which shows the determination to increase the housing supply of the government. What's more, to construct the central and western regions of China and medium and small towns is still the focus of developing strategy. In general, we think present market is misunderstanding the policies. The demand for real estate and infrastructure may see increasing trends, but not shrinking tendency.

**Risk**

Expansion of production capacity is below expectation;

The controlling policies become stricter and the real estate market shrinks sharply;

The prices increase of rare earth products are less than expected.

**To buy actively because high growth is foreseeable**

Taking consideration of incentive policies for new industries and tightening supply, the rare earth products prices will be optimistic. Plus with new profit growth by new projects, we expect the revenue of the Company will be HK\$1.69 billion and HK\$1.969 billion respectively in 2010 and 2011, with 39% and 16.5% growth. Net profit will reach HK\$248 million and HK\$361 million, increasing 192% and 46% respectively, which amount to HK\$0.17 and HK\$0.25 of its EPS.

Considering the growing perspective of the Company, we take P/E as the valuation method.

Tracking its peers in mainland, the valuation level of China Rare Earth rank the lowest and show a big discount. For the same industrial fundamentals, we conservatively give it the P/E with 15X to FY10 EPS, the 12-m TP of the Company will be HK\$2.5, over 30% premium than current price. We initiate it Buy rating.

**Table 1: Valuation Comparison of Peers**

Company	Code	09PE	10PE	11PE	09PB	10PB	11PB
Xiamen Tungsten	600549 CH	106.85	46.77	37.35	15.39	5.65	4.88
Rising Nonferrous Metals	600259 CH	213.68	NA	NA	23.23	NA	NA
Baotou Steel Rare-earth	600111 CH	67.35	74.00	43.86	6.20	11.24	8.75
Average		129.29	60.39	40.61	14.94	8.45	6.82
<b>China Rare Earth</b>	<b>0769 HK</b>	<b>33.45</b>	<b>11.27</b>	<b>7.74</b>	<b>11.48</b>	<b>1.01</b>	<b>0.92</b>

(Sources: Bloomberg, Phillip Securities)

## Financials

Profit model (HK\$ Mil)	2008	2009	2010F	2011F	Balance sheet (HK\$ Mil)	2008	2009	2010F	2011F
REVENUE	1,365	1,212	1,690	1,969	Total non-current assets	1,501	1,373	1,480	1,581
Cost of sales	(1,016)	(980)	(1,242)	(1,359)	Property, plant and equipment	715	636	760	875
Gross profit	349	231	448	611	Land lease prepayments	262	257	252	248
Other revenues	14	19	25	30	Intangible assets	379	349	320	300
Selling and distribution costs	(60)	(38)	(54)	(63)	Total current assets	1,714	1,867	2,040	2,296
Administrative expenses	(105)	(58)	(68)	(71)	Inventories	309	235	240	250
Other revenue and gains	1	8	5	6	Trade and other receivables	412	467	598	699
Finance costs	(10)	(18)	(20)	(23)	Pledged bank deposits	120	0	0	0
Impairment loss on goodwill	(209)	0	0	0	Cash and cash equivalents	765	1,065	1,100	1,232
Impairment loss on property, plant and equipment	(97)	0	0	0	Total assets	3,215	3,240	3,520	3,877
PROFIT BEFORE TAX	(119)	144	336	490	Total current liabilities	479	258	338	347
Income tax expense	(54)	(60)	(84)	(122)	Trade payables	116	77	100	115
PROFIT FOR THE YEAR	(172)	85	252	367	Accruals and other payables	97	54	68	82
Minority Interests	1	0	(4)	(6)	Bank borrowings due within one year	140	108	150	130
NET PROFIT Attributable to Equity holders	(171)	85	248	361	Deferred consideration payables for acquisition	116	0	0	0
EPS (HK\$)	(0.120)	0.058	0.169	0.246	Total non-current liabilities	261	234	247	320
DPS(HK\$)	0.01	0.00	0.04	0.06	Bank borrowings	155	136	157	238
Dividends	14	0	62	90	Deferred tax liabilities	106	98	90	82
					Equity attributable to equity holders	2,444	2,719	2,905	3,176
<b>Growth &amp; margins (%)</b>	<b>2008</b>	<b>2009</b>	<b>2010F</b>	<b>2011F</b>	Total equity	2,474	2,748	2,935	3,210
Revenue growth	-1.44%	-11.21%	39.44%	16.54%	BVPS(HK\$)	1.74	1.77	1.89	2.07
Gross Profit growth	-23.13%	-33.81%	93.87%	36.33%	<b>Key Ratios</b>	<b>2008</b>	<b>2009</b>	<b>2010F</b>	<b>2011F</b>
Net Profit growth	-157.97%	-149.71%	191.99%	45.65%	Asset-liability ratio	23.05%	15.19%	16.61%	17.21%
					Quick ratio	3.58	7.24	6.03	6.62
Gross profit margin	25.57%	19.06%	26.50%	31.00%	Average Receivable Turnover	106.16	132.36	114.98	120.20
Net profit margin	-12.53%	7.01%	14.69%	18.35%	Average Payable Turnover	23.80	29.06	19.11	19.92
ROE	-6.81%	3.26%	8.73%	11.76%	Inventory Turnover	108.67	101.31	69.79	65.80
ROA	-5.69%	2.63%	7.34%	9.77%	Average assets Turnover	803.94	971.98	729.97	685.44
<b>Cash flow statement (HK\$ Mil)</b>	<b>2008</b>	<b>2009</b>	<b>2010F</b>	<b>2011F</b>	Average Equity Turnover	671.71	786.32	613.70	569.42
(Loss)/Profit before tax	-119	144	336	490					
Net cash flows from operating activities	252	603	242	455	<b>Valuation</b>	<b>2008</b>	<b>2009</b>	<b>2010F</b>	<b>2011F</b>
Net cash flows from investing activities	(331)	(220)	(250)	(300)	P/E basic (X)	NA	33.04	11.27	7.74
Net cash flows from financing activities	106	(83)	43	(23)	P/B (X)	1.09	1.07	1.00	0.92
Net change	26	300	35	132					

(Sources: Company reports, Phillip Securities)



**PHILLIP RESEARCH STOCK SELECTION SYSTEMS**

<b>BUY</b>	<b>&gt;15% upside from the current price</b>
<b>HOLD</b>	<b>Trade within <math>\pm</math> 15% from the current price</b>
<b>SELL</b>	<b>&gt;15% downside from the current price</b>

We do not base our recommendations entirely on the above quantitative return bands. We consider qualitative factors like (but not limited to) a stock's risk reward profile, market sentiment, recent rate of share price appreciation, presence or absence of stock price catalysts, and speculative undertones surrounding the stock, before making our final recommendation

**GENERAL DISCLAIMER**

This publication is prepared by Phillip Securities (Hong Kong) Ltd ("Phillip Securities"). By receiving or reading this publication, you agree to be bound by the terms and limitations set out below.

This publication shall not be reproduced in whole or in part, distributed or published by you for any purpose. Phillip Securities shall not be liable for any direct or consequential loss arising from any use of material contained in this publication.

The information contained in this publication has been obtained from public sources which Phillip Securities has no reason to believe are unreliable and any analysis, forecasts, projections, expectations and opinions (collectively the "Research") contained in this publication are based on such information and are expressions of belief only. Phillip Securities has not verified this information and no representation or warranty, express or implied, is made that such information or Research is accurate, complete or verified or should be relied upon as such. Any such information or Research contained in this publication is subject to change, and Phillip Securities shall not have any responsibility to maintain the information or Research made available or to supply any corrections, updates or releases in connection therewith. In no event will Phillip Securities be liable for any special, indirect, incidental or consequential damages which may be incurred from the use of the information or Research made available, even if it has been advised of the possibility of such damages.

Any opinions, forecasts, assumptions, estimates, valuations and prices contained in this material are as of the date indicated and are subject to change at any time without prior notice.

This material is intended for general circulation only and does not take into account the specific investment objectives, financial situation or particular needs of any particular person. The products mentioned in this material may not be suitable for all investors and a person receiving or reading this material should seek advice from a financial adviser regarding the suitability of such products, taking into account the specific investment objectives, financial situation or particular needs of that person, before making a commitment to invest in any of such products.

This publication should not be relied upon as authoritative without further being subject to the recipient's own independent verification and exercise of judgment. The fact that this publication has been made available constitutes neither a recommendation to enter into a particular transaction nor a representation that any product described in this material is suitable or appropriate for the recipient. Recipients should be aware that many of the products which may be described in this publication involve significant risks and may not be suitable for all investors, and that any decision to enter into transactions involving such products should not be made unless all such risks are understood and an independent determination has been made that such transactions would be appropriate. Any discussion of the risks contained herein with respect to any product should not be considered to be a disclosure of all risks or a complete discussion of such risks.

Nothing in this report shall be construed to be an offer or solicitation for the purchase or sale of a security. Any decision to purchase securities mentioned in this research should take into account existing public information, including any registered prospectus in respect of such security.

**Disclosure of Interest**

Analyst Disclosure: Neither the analyst(s) preparing this report nor his associate has any financial interest in

or serves as an officer of the listed corporation covered in this report.

Firm's Disclosure: Phillip Securities does not have any investment banking relationship with the listed corporation covered in this report nor any financial interest of 1% or more of the market capitalization in the listed corporation. In addition, no executive staff of Phillip Securities serves as an officer of the listed corporation.

### **Availability**

The information, tools and material presented herein are not directed, intended for distribution to or use by, any person or entity in any jurisdiction or country where such distribution, publication, availability or use would be contrary to the applicable law or regulation or which would subject Phillip Securities to any registration or licensing or other requirement, or penalty for contravention of such requirements within such jurisdiction.

© 2010 Phillip Securities (Hong Kong) Limited

## **Phillip Capital - Regional Member Companies**

### **SINGAPORE Phillip Securities Pte Ltd**

Raffles City Tower  
250, North Bridge Road #06-00  
Singapore 179101  
Tel : (65) 6533 6001  
Fax : (65) 6535 6631  
Website : [www.poems.com.sg](http://www.poems.com.sg)

### **MALAYSIA Phillip Capital Management Sdn Bhd**

B-2-6 Megan Avenue II  
12 Jln Yap Kwan Seng  
50450 Kuala Lumpur  
Tel : (603) 2166 8099  
Fax : (603) 2166 5099  
Website : [www.poems.com.my](http://www.poems.com.my)

### **HONG KONG Phillip Securities (HK) Ltd**

11-12/F United Centre  
95 Queensway, Hong Kong  
Tel : (852) 2277 6600  
Fax : (852) 2868 5307  
Website : [www.poems.com.hk](http://www.poems.com.hk)

### **THAILAND Phillip Securities (Thailand) Public Co Ltd**

15/F, Vorawat Building  
849 Silom Road  
Bangkok Thailand 10500  
Tel : (622) 635 7100  
Fax : (622) 635 1616  
Website : [www.poems.in.th](http://www.poems.in.th)

### **JAPAN The Naruse Securities Co Ltd**

4-2, Nihonbashi Kabutocho  
Chuo Ku, Tokyo  
Japan 103-0026  
Tel : (81) 03-3666-2101  
Fax : (81) 03-3664-0141  
Website : [www.naruse-sec.co.jp](http://www.naruse-sec.co.jp)

### **UNITED KINGDOM King & Shaxson Ltd**

6th Floor, Candlewick House  
120 Cannon Street  
London EC4N 6AS  
Tel : (44) 207 426 5950  
Fax : (44) 207 626 1757  
Website : [www.kingandshaxson.com](http://www.kingandshaxson.com)