



Hong Kong

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

Performance expected to grow significantly as the strategic metals manufacturer

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### Summary

Though the refractory products business shrunk, both the production and ASP of rare earth products rallied, then its profitability went up, driving the performance of China Rare Earth (the Company or CRE) increase over 200%, and it has stepped in the growing trend again. After succeeding in raising capital continually, CRE will expand the rare earth business, and may breed new growth for future development.

Taking consideration of incentive policies for emerging industries and tightening supply policies, the rare earth products prices will be optimistic. We expect net profit for the Company will reach HK\$203 million and HK\$ 304 million in 2010 and 2011(with the growth of 139% and 50% respectively), equal to HK\$0.17 and HK\$0.25 of the EPS. We conservatively give it the P/E with 30X to FY10 EPS, the 12-m TP of the Company will be HK\$3.86, about 12% premium than current close. We give it Hold rating.

### Performance grew rapidly in 1H10

Going through the drop in 1H09, CRE has stepped in the growing trend again. According to the financial reports for 1H10, the Company recorded the revenues of HK\$599 million, increasing nearly 20% y/y. Meanwhile, the performance increased more, with the net profit realizing HK\$64 million and above 200% growth.

The growth was attributable to the higher sales volume and ASP of rare earth products. During the period, the Company sold about 1,600 tons of rare earth oxides and downstream products, a surge of about 60% against the same period last year, among which 1,400 tons came from rare earth oxides, with the growth of above 70%. However, the refractory materials business dropped about 11% for the lower sales volume and ASP, with its turnover recording only HK\$215 million.

### Recommendation

# Hold

Previous call: Buy

Previous TP: 2.50

### Price

Last close : HK\$3.45  
12-month TP : HK\$3.86

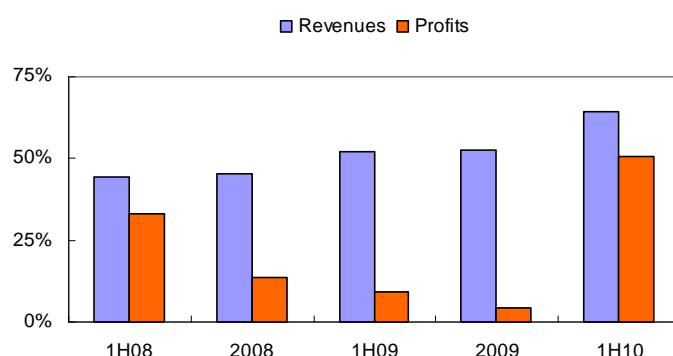
### Basic Data

Market cap. 5,768  
(HK \$ mil)  
Shares in issue (m) 1,672  
52-wk high/low HK\$4.81/1.44  
Major shareholder YY Holdings Limited  
Flow proportion 50.54%

### Share Price Performance



(Source: AAstock)

**Figure 1: Rare Earth products contribute more**

(Sources: Company reports, Phillip Securities)

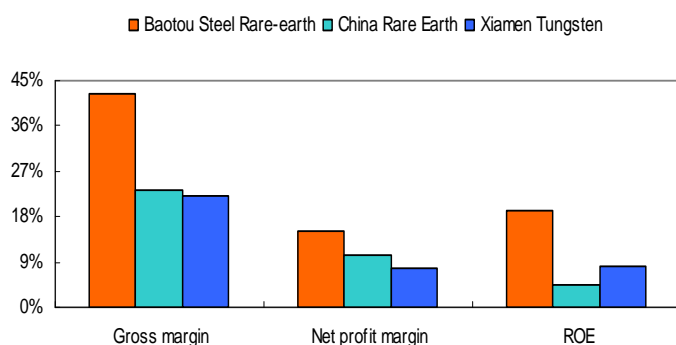
Overall speaking, benefitting from China's economic structural reform and the stimulus plan for emerging industries, rare earth business has accounted for 64%, far higher than 50% in past years. At the same time, higher ASP of rare earth products also brought about stronger earning capability. For example, the selling price of certain products like terbium oxide rose by about 40% while the selling price of both lanthanum oxide and dysprosium oxide more dramatically increased by more than 70%. The price of praseodymium oxide and neodymium oxide rocketed to double-to-triple of last year's. So the gross margin of rare earth division increased to 17% in 1H10 from 6% in 2009.

### **Keep on expanding rare earth business after succeeding raising capital**

Compared to its peers in China mainland, the profitability of the Company in 1H10 behaved generally, which was mainly caused by the sources dependent on the external. However, regarding its financial situation, CRE keeps at conservative and excellent level for both long term and short term solvency. After raising capital of nearly HK\$500 million in October, its cash and cash equivalent accounts for nearly 40% in the total assets, with the asset-liability ratio around 10% and current ratio over 7X. All those indicate that the Company is able to expand the businesses and add the leverage.

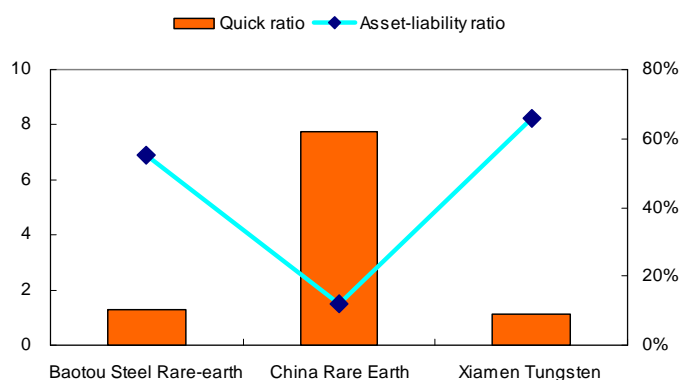
Nowadays, CRE is carrying out the tri-band phosphors and high-end LCD rare earth polishing powder projects. What's more, to acquire rare earth mines is also one of future strategic plans. In our view, above measures will expand its production lines and improve its industrial chain, which will drive up its profitability and breed future growth.

**Figure 2: Lower earning capability than peers**



(Sources: Company reports, Phillip Securities)

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

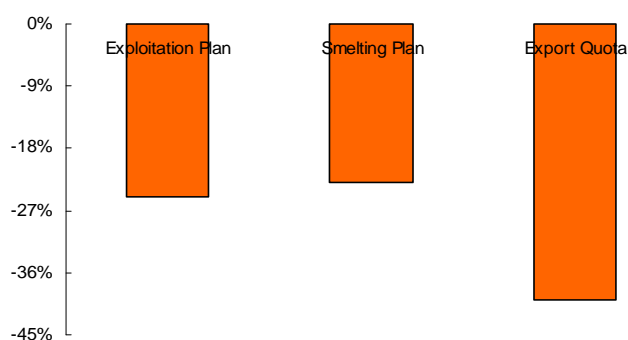


(Sources: Company reports, Phillip Securities)

### Optimistic prospect for rare earth business supported by the policies

In 3Q10, rare earth products prices present considerably well, and the share prices of rare earth related stocks behaved far better than the whole market. In special, CRE's share price surged 72% in the single September and 26% in October, once recording a new high of HK\$4.81. We think high share price is underpinned by the adjustment of export to Japan of rare earth and the unique status of CRE as the rare earth-related stock in HKSE. Especially, the strategic status of rare earth has been recognized by China's central government, which then continually put forward some control policies and stimulus plans. Therefore, though some negative factors come out, like the export reopening to Japan of China's rare earth products and the plans to develop homeland rare earth mines of the US and Australia, the share price of CRE is still lingering around the high HK\$3.5, far higher than previous platform between HK\$0.5-2.9 since listed.

Regarding to the newest policies, rare earth industry has been enlisted in the rare metals industry integration plan and the twelfth Five-Year plan, which show that the regulation over rare earth will be stricter. Therefore, the rare earth export quota will be tight but not loose.

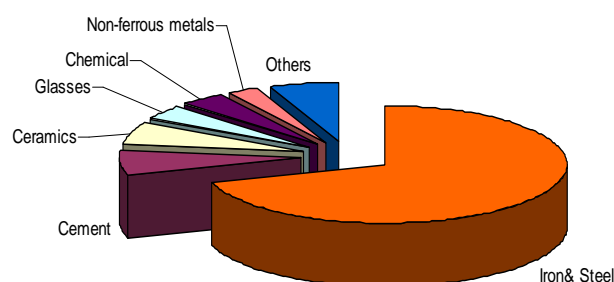
**Figure 4: Production & Export Plan of China's Rare Earth in 2010**

(Sources: Phillip Securities)

Basing on the incentive policies for emerging industries and tightening supply policies, we think the downstream demand for rare earth products will be unlimited. Among the seven emerging industries put forward by the central government, there are four industries are related to rare earth products. Firstly, the rare earth materials itself belong to the new material industry. Secondly, various types of phosphor blended in some rare earth elements are applied to electricity-saving lamp and flat display screen, which are part of energy-saving and environment-friendly industry. Thirdly, the neodymium iron boron, made of rare earth elements, is the best permanent-magnet material currently and used for permanent magnet direct -driven synchronous generator and the motor system for new energy automobile. Fourthly, in the NI-MH battery car and fuel-cell vehicles, rare earth alloy is also used for hydrogen storage material. Therefore, besides the new material industry, the energy-saving and environment-friendly industry, the new energy industry and the new energy automobile industry will be highly correlated to rare earth products. According to the government's plan, emerging industries will contribute about 20% in the GDP by 2010. From this perspective, rare earth industry will face a high growth over 20%, or even 30% in medium to long term.

### **Demand for refractory materials will still be a little optimistic**

The other main business of CRE is about the refractory materials, which are used for the iron & steel and glass industry. By far, Chinese government has strengthened the regulation on real estate market, especially on the speculative demand, which has apparently influence the sales volume of refractory materials of CRE in 1H10.

**Figure 5: Downstream Breakdown of Refractory Products**

(Sources: Phillip Securities)

However, the central government is still intending to increase the housing supply, especially the government-subsidized houses, and the housing land-use supply will still increase significantly. Meanwhile, to construct the central and western regions of China and medium and small towns is still the focus of developing strategy. Overall speaking, we don't think the demand for refractory materials will be pessimistic. It is still expected to keep on growing steadily. As a matter of fact, the performance of domestic refractory materials has presented well in past years. From 2004 to 2009, the CAGR for the turnover had been 27.9%, and that for the profit had been 34.1%. Even in 2009, the output value of refractory materials still increased 23.6%. Therefore, the high growth character is apparent for the industry.

It is also worth noting that the earning capability of refractory materials keeps strong, even in 2008 and 2009, when the iron & steel industry fell into losses caused by international financial crisis. Taking CRE as the example, its gross margin for refractory materials has been around 30% since 2008.

## 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.

## Recommending Hold temporarily despite the high-growth prospect

Benefiting from 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\$1.382 billion and HK\$1.625 billion respectively in 2010 and 2011. Net profit will reach HK\$203 million and HK\$ 304 million, increasing 139% and 50% respectively, which amount to HK\$0.13 and HK\$0.18 of its EPS.

Considering the growing perspective of the Company, we take P/E as the valuation method. Tracking its valuation since listed, the P/E in past years maintained around 15X. Since 2009, emerging industries has strengthened the strategic status of rare earth products, then the P/E of CRE has also improved significantly. We conservatively give it the P/E with 30X to

FY10 EPS, the 12-m TP of the Company will be HK\$3.86, about 12% premium than current close. We give it Hold rating. However, it is also worth noting that the valuation may go up significantly if the export of rare earth products is faced with disputes or explosive demand comes from the downstream industries.

**Figure 6: Historical Valuation of CRE**



(Sources: Bloomberg, Phillip Securities)

| <b>Financials</b>                                |             |             |              |              |   |             |             |              |              |
|--|-------------|-------------|--------------|--------------|---|-------------|-------------|--------------|--------------|
| <b>Profit model (HK\$ Mil)</b>                   | <b>2008</b> | <b>2009</b> | <b>2010F</b> | <b>2011F</b> | <b>Balance sheet (HK\$ Mil)</b>                 | <b>2008</b> | <b>2009</b> | <b>2010F</b> | <b>2011F</b> |
| REVENUE  | 1,365       | 1,212       | 1,382        | 1,625        | Total non-current assets                        | 1,501       | 1,373       | 1,480        | 1,748        |
| Cost of sales                                    | (1,016)     | (980)       | (1,016)      | (1,121)      | Property, plant and equipment                   | 715         | 636         | 760          | 1,025        |
| Gross profit                                     | 349         | 231         | 366          | 504          | Land lease prepayments                          | 262         | 257         | 252          | 248          |
| Other revenue                                    | 14          | 19          | 25           | 40           | Intangible assets                               | 379         | 349         | 320          | 300          |
| Selling and distribution costs                   | (60)        | (38)        | (44)         | (52)         | Total current assets                            | 1,714       | 1,867       | 2,408        | 2,355        |
| Administrative expenses                          | (105)       | (58)        | (55)         | (58)         | Inventories                                     | 309         | 235         | 240          | 300          |
| Other revenue and gains                          | 1           | 8           | 5            | 6            | Trade and other receivables                     | 412         | 467         | 598          | 777          |
| Finance costs                                    | (10)        | (18)        | (18)         | (23)         | Pledged bank deposits                           | 120         | -           | -            | -            |
| Impairment loss on goodwill                      | (209)       | -           | -            | -            | Cash and cash equivalents                       | 765         | 1,065       | 1,450        | 1,160        |
| Impairment loss on property, plant and equipment | (97)        | -           | -            | -            | Total assets                                    | 3,215       | 3,240       | 3,888        | 4,103        |
| PROFIT BEFORE TAX                                | (119)       | 144         | 279          | 416          | Total current liabilities                       | 479         | 258         | 338          | 347          |
| Income tax expense                               | (54)        | (60)        | (70)         | (104)        | Trade payables                                  | 116         | 77          | 100          | 115          |
| PROFIT FOR THE YEAR                              | (172)       | 85          | 209          | 312          | Accruals and other payables                     | 97          | 54          | 68           | 82           |
| Minority Interests                               | 1           | 0           | (6)          | (8)          | Bank borrowings due within one year             | 140         | 108         | 150          | 130          |
| NET PROFIT Attributable to Equity holders        | (171)       | 85          | 203          | 304          | Deferred consideration payables for acquisition | 116         | -           | -            | -            |
| EPS  | (0.120)     | 0.058       | 0.129        | 0.182        | Total non-current liabilities                   | 261         | 234         | 97           | 49           |
| DPS  | 0.010       | 0.000       | 0.032        | 0.045        | Bank borrowings                                 | 155         | 136         | -            | 150          |
| Dividends  | 14          | 0           | 51           | 76           | Deferred tax liabilities                        | 106         | 98          | 90           | 82           |
|  |             |             |              |              | Equity attributable to equity holders           | 2,444       | 2,719       | 3,440        | 3,668        |
| <b>Growth &amp; margins (%)</b>                  | <b>2008</b> | <b>2009</b> | <b>2010F</b> | <b>2011F</b> | Total equity                                    | 2,474       | 2,748       | 3,453        | 3,706        |
| Revenue growth                                   | -1.44%      | -11.21%     | 14.03%       | 17.57%       | BVPS  | 1.74        | 1.77        | 2.07         | 2.22         |
| Gross Profit growth                              | -23.13%     | -33.81%     | 58.55%       | 37.54%       | <b>Key Ratios</b>                               | <b>2008</b> | <b>2009</b> | <b>2010F</b> | <b>2011F</b> |
| Net Profit growth                                | -157.97%    | -149.71%    | 138.96%      | 49.76%       | Asset-liability ratio                           | 23.05%      | 15.19%      | 11.19%       | 9.66%        |
|  |             |             |              |              | Current ratio                                   | 3.6         | 7.2         | 7.1          | 6.8          |
| Gross profit margin                              | 25.57%      | 19.06%      | 26.50%       | 31.00%       | Average Receivable Turnover                     | 106.2       | 132.4       | 140.6        | 154.4        |
| Net profit margin                                | -12.53%     | 7.01%       | 14.70%       | 18.72%       | Average Payable Turnover                        | 23.8        | 29.1        | 23.4         | 24.1         |
| ROE  | -6.81%      | 3.26%       | 6.55%        | 8.50%        | Inventory Turnover                              | 111.0       | 87.5        | 86.2         | 97.7         |
| ROA  | -5.69%      | 2.63%       | 5.70%        | 7.61%        | Average assets Turnover                         | 803.9       | 972.0       | 941.3        | 897.5        |
| <b>Cash flow statement (RMB mil)</b>             | <b>2008</b> | <b>2009</b> | <b>2010F</b> | <b>2011F</b> | Average Equity Turnover                         | 671.7       | 786.3       | 818.8        | 804.1        |
| (Loss)/Profit before tax                         | (119)       | 144         | 279          | 416          |   |             |             |              |              |
| Net cash flows from operating activities         | 252         | 603         | 272          | 104          | <b>Valuation</b>                                | <b>2008</b> | <b>2009</b> | <b>2010F</b> | <b>2011F</b> |
| Net cash flows from investing activities         | (331)       | (220)       | (250)        | (450)        | P/E basic (X)                                   | -           | 60.00       | 26.84        | 18.96        |
| Net cash flows from financing activities         | 106         | (83)        | 363          | 56           | P/B (X)   | 1.98        | 1.95        | 1.67         | 1.56         |
| Net change                                       | 26          | 300         | 385          | (290)        |   |             |             |              |              |

(Sources: Company reports, Phillip Securities)

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|      |   |
|------|---|
| BUY  | >15% upside from the current price            |
| HOLD | Trade within $\pm$ 15% from the current price |
| SELL | >15% downside from the current price          |

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