



Hong Kong
June 3, 2011

China Rare Earth Holdings Limited (0769.HK)

Rapidly surging rare earth prices may double CRE's revenue

Summary

Entering into 2011, rare earth prices have kept surging rapidly. Based on the strengthening regulation on the industry and the support to emerging industries by central government, plus with the low level of rare earth prices from a historical point, we don't think the rare earth prices in the bubble. China Rare Earth (the Company or CRE) actively stocked raw material in 2010, and its products enjoy strong capability to transfer higher cost, therefore, we estimate it will realize high gross margin above 20% in future. With regards to its financial situation, CRE takes conservative operation, so it has wide space to expand by leverage. What's more, the tri-band phosphors project will also breed future growth for the Company.

Taking consideration of incentive policies for emerging industries and tightening supply policies, the prices of rare earth products will still be upward. We expect net profit for the Company will reach HK\$240 million and HK\$ 344 million in 2011 and 2012(with the growth of 81% and 43% respectively), equal to HK\$0.14 and HK\$0.21 of the EPS. We conservatively give it the P/E with 25X to FY11 EPS, the 12-m TP of the Company will be HK\$3.60, about 20% premium than current close. We give it Buy rating.

Are rare earth prices too high?

In 2010, the prices of most rare earth doubled up: the price of praseodymium neodymium oxide and erbium oxide more than doubled when compared with last year; the price of lanthanum oxide increased by nearly 1.8 times, and the price of terbium oxide and dysprosium oxide rose by about 50% to 90%. Entering into 2011, those products prices have experienced accelerated rise. For example, the price of cerium oxide has increased 475% in just 5 months, and the prices of neodymium oxide and dysprosium oxide also have rose over 300%. Meanwhile, the export prices have also seen more substantial increase. Taking Shandong port as the

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Recommendation

Buy

Previous call: Hold

Previous TP: 3.86

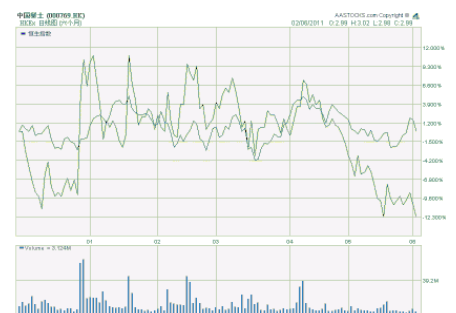
Price

Last close : HK\$2.99
12-month TP : HK\$3.60

Basic Data

Market cap. 4,999
(HK \$ mil)
Shares in issue (m) 1,672
52-wk high/low HK\$4.81/1.66
Major shareholder YY Holdings
Limited
Flow proportion 64.40%

Share Price Performance



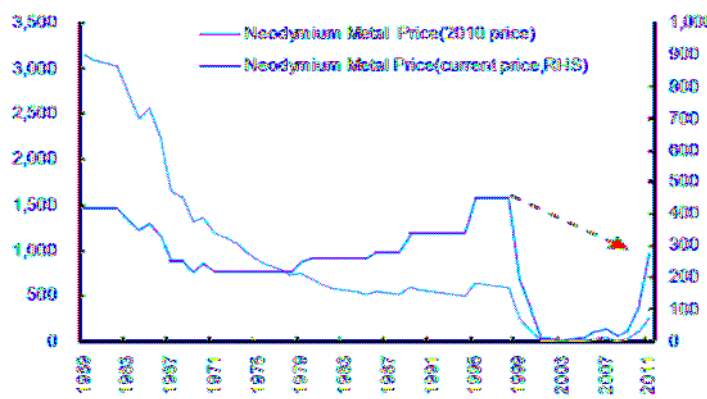
(Source: AAstock)

example, 353.5 tons of rare earth products had been shipped abroad in first four months, 52.9% lower than that in same period last year. However, the average export price had increased 16.5 times to US\$8.3/ton.

In our view, higher rare earth prices not only benefit from the strengthening regulation on rare earth industry by central government, but also are supported by emerging industries. The former may keep down the supply, and the latter brings about wider demand. It is noteworthy that China's State Council on May 19 issued a national guideline that aims to promote sustainable and healthy development of the country's rare earth industry, which was the first guideline for the rare earth industry separately by the State Council since 2000. Moreover, the country will also expand the strategic reserves of rare earth resources, and bring rare earth-iron alloy into the export quota management for rare earth. All those indicate that the control policies on rare earth industry won't change, and the supply and demand situation will still be tight.

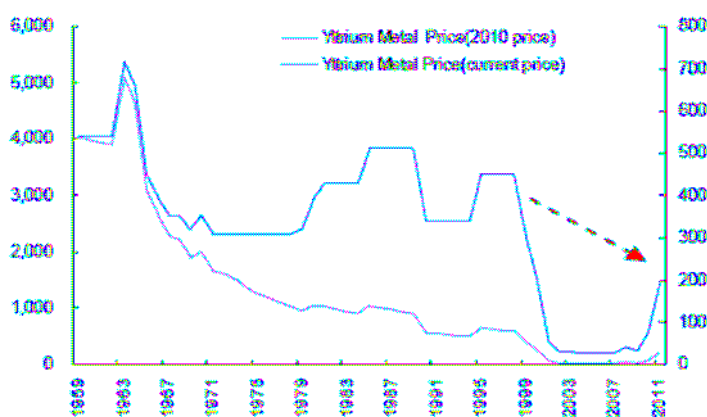
From a historical point, rare earth prices are still at a low level because of USA's substantially increased production of rare earth in 1960s and China's inundant exploration on rare earth since 1998, especially for the inflation-adjusted prices. Plus with the expansion of application breadth and depth of rare earth products from emerging industries, we don't think rare earth prices in the bubble, and it is still high probability of ramping up in future.

Figure 1: The price trend of Neodymium metal



(Sources: USGS, Phillip Securities)

Figure 2: The price trend of Yttrium metal

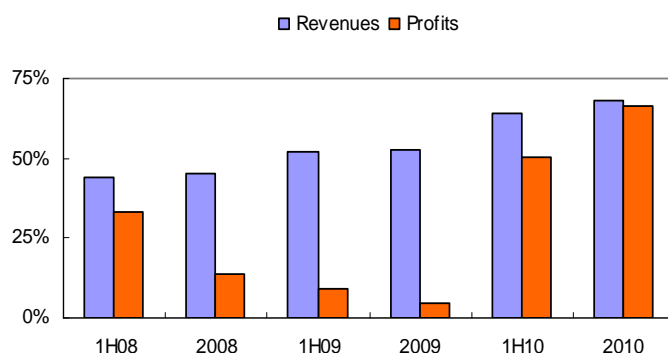


(Sources: USGS, Phillip Securities)

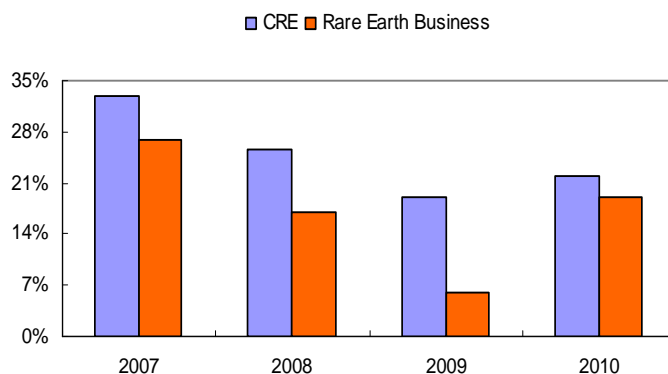
Earning capability will keep high

CRE is mainly engaged in rare earth smelting and separation and doesn't hold rare earth resources. Therefore, rising raw material may cause the worry over its earning capability. However, we don't think so.

Firstly, CRE invested more than HK\$400 million in mass procurement of raw materials, including over 10,000 tons of rare earth salts in 2010, more than doubled when compared with that in 2009. Therefore, the Company may benefit from low-price raw material this year. Secondly, its rare earth products possess sound bargaining power and cost-transferring capability. In 2010, the prices of rare earth products rocketed generally, but the Company sold about 2,000 tons of rare earth oxides within China, a growth of more than 30% against last year. Meanwhile, the sales prices moved up at large, which let its rare earth business contribute 68% and 66% to the revenue and profit, far higher than 53% and 4.4% in 2009. Moreover, its earning capability had been improved significantly, with gross profit margin increasing from 6% in 2009 to 19% in 2010.

Figure 3: Rare earth business has contributed more and more

(Sources: Company reports, Phillip Securities)

Figure 4: Earning capability of rare earth business has been improved significantly

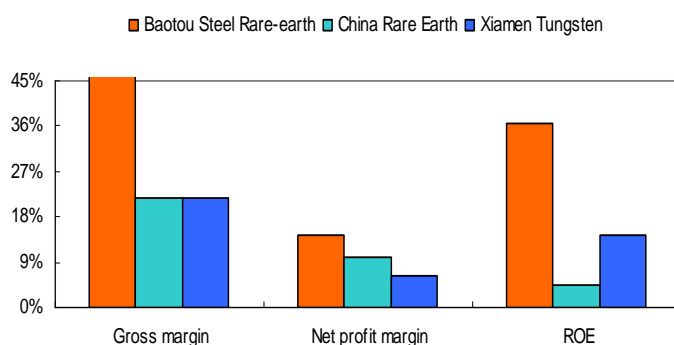
(Sources: Company reports, Phillip Securities)

Looking forward 2011, we forecast that CRE will double its revenue because of surging prices of rare earth products, and the rare earth business may contribute about 85% to the total revenue. Meanwhile, the gross profit margin of the Company is expected to keep above 20%.

Sound financial situation can support future expansion

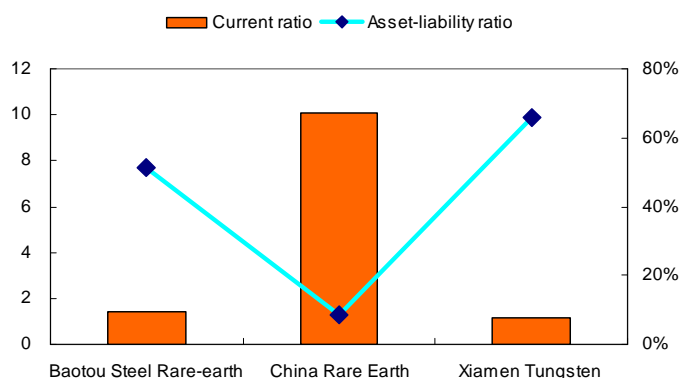
Compared to its peers in China mainland, the profitability of the Company in 2010 behaved generally. Its gross margin was far lower than Baotou Steel Rare-earth, a pure rare earth manufacturer, but the Company held lower expense ratio, so its net profit margin reached up to above 10%. What's more, its ROE seems very low, but it was dragged down by conservative operation. Currently, CRE keeps at conservative and excellent level for both long term and short term solvency. Its cash and cash equivalent accounts for over 30% in the total assets, with the asset-liability ratio at 8.65% and current ratio over 10X. All those indicate that the Company is able to expand the businesses and add the leverage.

Figure 5: Lower earning capability than peers



(Sources: Company reports, Phillip Securities)

Figure 6: Better financial situation than peers



(Sources: Company reports, Phillip Securities)

It is notable that CRE's construction of Phase I at the production facility of OSRAM (China) Fluorescent Materials Co., Ltd., a joint venture set up with OSRAM GmbH, is accelerating the construction progress, and the Phase I of the new facility is expected to commence

operation in June to July in 2011 with an annual production capacity of 1,000 tons of tri-band phosphors. Nowadays China is actively taking strategic restructuring, and tri-band phosphors are in accordance with low-carbon and energy-saving features of emerging industries. Therefore, the project will breed new growth for the Company's future development.

Risk

The controlling policies become stricter and the economy falls into stagflation;

The prices of rare earth products plunge unexpectedly.

Recommending Buy for 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\$2.648 billion and HK\$3.411 billion respectively in 2011 and 2012. Net profit will reach HK\$240 million and HK\$ 344 million, increasing 81% and 43% respectively, which amount to HK\$0.14 and HK\$0.21 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 25X to FY11 EPS, the 12-m TP of the Company will be HK\$3.60, about 20% premium than current close. We give it Buy rating.

Figure 7: Historical Valuation of CRE



(Sources: Bloomberg, Phillip Securities)

Financials									
Profit model (HK\$ Mil)					Balance sheet (HK\$ Mil)				
	2009	2010	2011F	2012F		2009	2010	2011F	2012F
REVENUE	1,212	1,320	2,648	3,411	Total non-current assets	1,373	1,442	1,655	1,816
Cost of sales	(980)	(1,031)	(2,118)	(2,678)	Property, plant and equipment	636	614	779	879
Gross profit	231	288	530	733	Land lease prepayments	257	271	278	285
Other revenue	19	10	20	20	Intangible assets	349	330	350	380
Selling and distribution costs	(38)	(50)	(93)	(119)	Total current assets	1,867	2,325	2,509	2,782
Administrative expenses	(58)	(69)	(132)	(171)	Inventories	235	612	918	1,102
Other revenue and gains	8	7	7	8	Trade and other receivables	467	368	478	541
Finance costs	(18)	(8)	(12)	(15)	Cash and cash equivalents	1,065	1,229	986	950
PROFIT BEFORE TAX	144	178	320	456	Total assets	3,240	3,767	4,165	4,599
Income tax expense	(60)	(39)	(70)	(100)	Total current liabilities	258	231	376	452
PROFIT FOR THE YEAR	85	139	249	356	Trade payables	77	81	150	187
Minority Interests	0	(6)	(9)	(12)	Accruals and other payables	54	41	76	95
NET PROFIT Attributable to Equity	85	133	240	344	Bank borrowings due within one year	108	99	130	150
EPS(HK\$)	0.06	0.08	0.14	0.21	Total non-current liabilities	234	95	105	115
					Bank borrowings	136	0	0	0
Growth & margins (%)	2009	2010	2011F	2012F	Deferred tax liabilities	98	95	105	115
Revenue growth	-11.21%	8.91%	100.61%	28.81%	Equity attributable to equity holders	2,719	3,404	3,644	3,988
Gross Profit growth	-33.81%	24.68%	83.89%	38.47%	Total equity	2,748	3,441	3,684	4,032
Net Profit growth	NA	56.47%	80.63%	43.20%	BVPS(HK\$)	1.77	2.06	2.20	2.41
Gross profit margin	19.06%	21.82%	23.50%	21.50%	Key Ratios	2009	2010	2011F	2012F
Net profit margin	7.01%	10.08%	9.07%	10.09%	Asset-liability ratio	15.19%	8.65%	11.54%	12.33%
ROE	3.26%	4.30%	6.74%	8.92%	Current ratio	7.24	10.06	6.68	6.15
ROA	2.63%	3.80%	6.06%	7.85%	Average Receivable Turnover	132.36	115.45	58.33	54.52
Cash flow statement (HK\$ Mil)	2009	2010	2011F	2012F	Average Payable Turnover	22.74	13.13	8.05	9.13
(Loss)/Profit before tax	144	178	320	456	Inventory Turnover	101.31	149.93	131.81	137.65
Net cash flows from operating activities	171	(61)	55	231	Average assets Turnover	971.98	968.77	546.63	468.87
Net cash flows from investing activities	10	(136)	(317)	(272)	Average Equity Turnover	786.32	855.68	491.03	412.81
Net cash flows from financing activities	117	301	19	5					
Net change	300	105	(243)	(36)	Valuation	2009	2010	2011F	2012F
					P/E basic (X)	52.00	35.26	20.81	14.53
					P/B (X)	1.69	1.45	1.36	1.24

(Sources: Company reports, Phillip Securities)

PHILLIP RESEARCH STOCK SELECTION SYSTEMS

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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