Hong Kong

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China Rare Earth Holdings Limited (0769.HK)

Reiterate Buy rating for too low valuation

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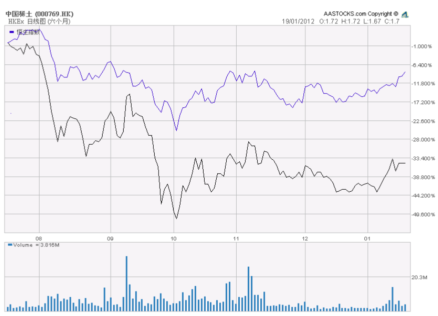
Recommendation	
Buy	
Previous call: Buy	
Previous TP: 3.60	

Price	
Last close	: HK$1.70
12-month TP	: HK$2.66

Basic Data	
Market cap. (HK $ mil)	2,843
Shares in issue (m)	1,673
52-wk high/low	HK$3.85/1.27
Major shareholder	YY Holdings Limited
Flow proportion	64.40%

Share Price Performance



(Source：AAstock)

Summary

The share price of China Rare Earth (the Company or CRE) has spiraled down in 2011 and even returned to the low horizontal trading range before the 2010 rapid rise in the fourth quarter, which has significantly deviated from the fact that it has achieved the highest profit growth in the past year and the profitability has gotten stronger. Looking forwards, 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. Moreover, the tri-band phosphors project will also breed future growth for the Company.

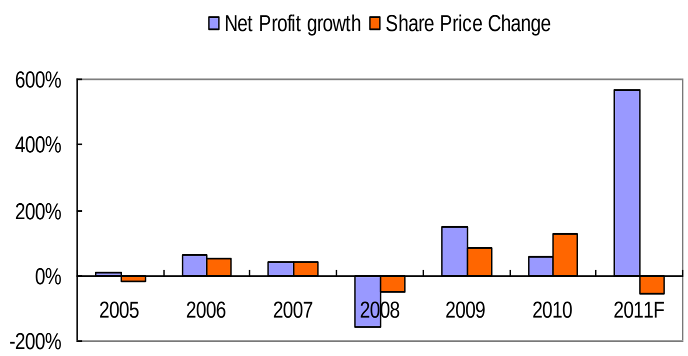
We expect its net profit will reach HK$889 million and HK$ 1,157 million respectively in 2011 and 2012, increasing568% and 30% YoY, which amount to HK$0.53 and HK$0.69 of its EPS. Conservatively giving it the P/E with 5X to FY11 EPS, the 12-m TP of the Company will be HK$2.66, over 50% premium than current close. We reiterate it Buy rating.

Performance jacks up with the value of rare earth becoming outstanding

Though facing positive factors like rapidly rising rare earth prices and largely increased profit in 2011, the share price of CRE has spiraled down in 2011 and even returned to the low horizontal trading range before the 2010 rapid rise in the fourth quarter because of worsening European sovereign debt crisis and the weak market. Meanwhile, the 58% decline was also worse than the peers. However, we think its valuation is too low because the value of rare earth has become more and more outstanding under the background of economic structural reform.

Firstly, its profit growth in 2011 has been the highest level in past years and the profitability has gotten stronger, so the decline of the share price has deviated from the well-run business. Historically, its share price performance can often react to the profit growth. Therefore, we don't think present deviation can persist in long term and the share price will recover and follow its intrinsic value.

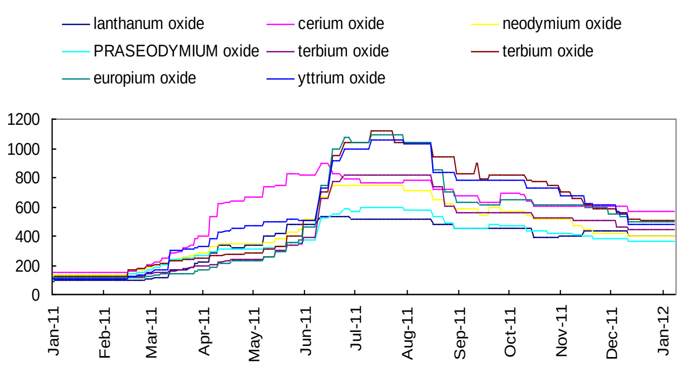
Figure 1: Its share price performance can often follow the profit growth



（Sources： Company reports, Phillip Securities）

Second, rare earth prices have plunged since August, but the average price of rare earth products of CRE in 2H11 has still doubled that in 1H11. In the first half, it was the price rise that lets its earning capability become significantly higher. The prices of neodymium oxide, dysprosium oxide, terbium oxide and yttrium oxide tripled while those of lanthanum oxide and holmium oxide quadrupled. Prices of europium oxide, gadolinium oxide and cerium oxide soared five to seven folds. Therefore, the gross profit margin of rare earth business had increased from previous less 20% to more than 60% in 1H11. If considering that CRE doesn't hold the mineral resources, we think that it enjoys strong capability to pass on increased costs and the ability to bargain. Therefore, higher products prices will underpin its high profitability.

Figure 2: Rare earth products prices trend in 2011(%)



（Sources： Bloomberg, Phillip Securities）

Third, higher products prices may negatively impact on the demand, CRE sold only around

1,100 tons of rare earth oxides during 1H11, around 20% less than the corresponding period last year. However, compared to the price increase from two to seven folds, the extent of demand cut seems small and strongly exemplifies that the downstream demand for rare earth products is unelastic and the price rise can offset the negative impact by the decline of demand. Especially speaking, the export demand seems stronger. The average export prices of lanthanumoxide and yttrium oxide were three times above domestic prices in 1H11, while those of gadolinium oxide and yttrium-europium coprecipitates were two times higher. However, the volume of rare earth products purchased by overseas enterprises has still been over 50 thousand tons in 2011, and much of them are exported by abnormal ways.

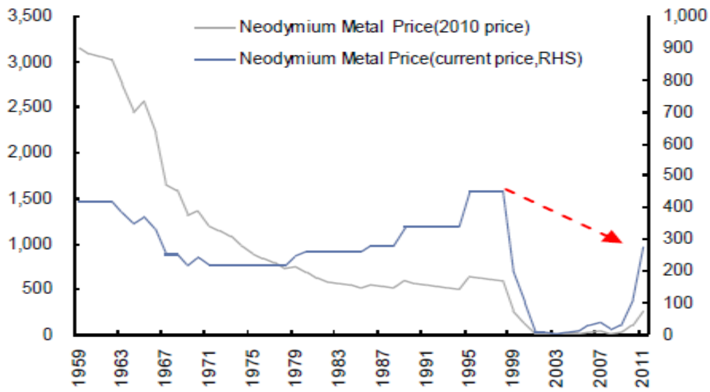
Considering the doubled average rare earth prices in 2H11 and inflexible downstream demand, we expect CRE’s profitability will be improved continually and net profit may reach nearly HK$900 million in 2011, with a 568% increase. Meanwhile, on the background of economic structural reform and the support to emerging industries, we think it is not temporary or spasmodic for CRE to realize largely increased performance in 2011. Looking forwards, the high profitability and sound performance may become normal for CRE.

Are rare earth prices too high?

After sharp rise and steep fall of rare earth prices in 2011, their price still have climbed up two times as a whole. Therefore, some think the rare earth industry is in the bubble. However, after reviewing their historical price trend and the supply and demand situation, we don’t think rare earth prices in the bubble, and it is still high probability of ramping up in future.

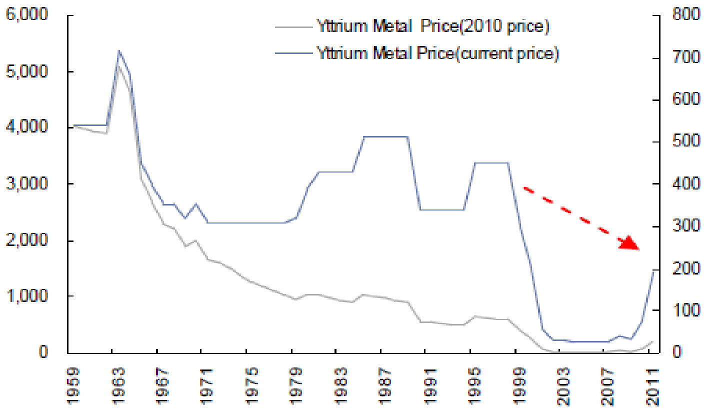
First, rare earth prices have been at a low level in past ten years because of USA’s substantially increased production of rare earth in 1960s and China’s inundant exploration on rare earth since 1998, especially for the inflation-adjusted prices.

Figure 3: The price trend of Neodymium metal



（Sources： USGS, Phillip Securities）

Figure 4: The price trend of Yttrium metal



（Sources： USGS, Phillip Securities）

Second, higher rare earth prices are still expectable, because they not only benefit from the strengthening regulation by the government, but also are supported by emerging industries. The former may keep down the supply, and the latter brings about wider demand. Looking into 2012, the policies will still lead rare earth to industrial concentration and standardized mining. The production quota and export quota will still be tightening, and the enforcement may be tighter.

On Dec. 27, China's Ministry of Commerce (MOFCOM) announced Chinese 11 exporters of rare earths elements will be allowed to sell 10,546 tons of in the first six months of 2012, meanwhile 14,358 tons are set aside for the exporters who haven’t passed environmental inspections, and both account for 80% of the quota in the whole year. In sum, the yearly export quota of rare earths elements is expected to increase 3.1% YoY to 31,130 tons, which seems basicly stable. However, the measure to set aside some quota highlights the importance of environmental protection, and the tighter policy enforcement may suppress the production of rare earth products.

What’s more, value-added tax invoices may be put forward in 2012, and the invoices will become the approval certificate for rare earth enterprises to operate relative business. The policy regulation faced by rare earth enterprises will be strengthened, then the cost to break the law will increase heavily. The rare earth mine enterprises can only supply material for their downstream companies under the quota limit, and the middle smelting enterprises also can only get the material from legal companies with the production quota, which will change the industrial phenomenon that the rare earth production by unapproved enterprises is close to the production quota. Therefore, we believe the supply of rare earth elements may still be tense and rare earth prices shouldn’t be pessimistic.

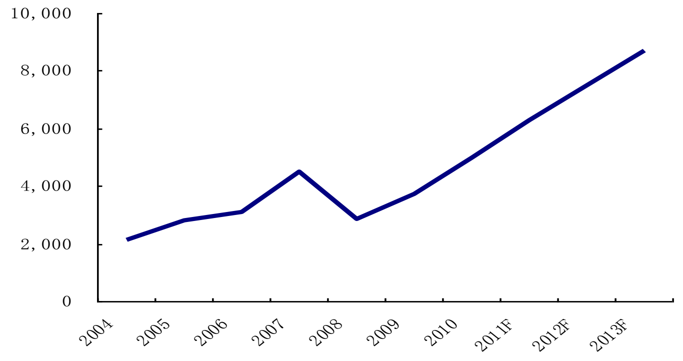
Capacity expansion will support its growth

Construction of Phase I at the production facility of OSRAM (China) Fluorescent Materials Co., Ltd., a joint venture set up with OSRAM GmbH, has been completed and has started trial production in July 2011, with an annual production capacity of 1,000 tons of tri-band phosphors. Nowadays, China is actively taking economic structural reform, products like phosphor can meet the demand by emerging industries for their low-carbon and energy-saving attributes, so we think the project will breed new growth for the Company's future development.

Compared to ordinary tungsten lamps, power saving fluorescent lamp with rare earth elements can reach same brightness with less 20% electrical energy, the energy-saving effect is above 80%, and the service life is also longer. Therefore, China has put forward the Green lighting project. On Nov. 1, 2011, the NDRC and the MOFCOM jointly issued "about gradually banned imports of and sales general illumination of incandescent lamp", which announces that China will gradually ban importing and selling incandescent lamps according to the different rates of the power from October 1, 2012. Therefore, the electricity-saving lamp industry will then still see a high growth.

As the pre-requisite raw material for electricity-saving lamp, the demand for rare earth luminescent material is expected to realize an explosive increase. In 2010, the consumption was 4,000-5000 tons. Looking into 2013, the demand will double to 8,000-10,000 tons, with the CAGR at 18%.

Figure 5:Rapidly developing rare earth luminescent material market in China(tons)



（Sources： Phillip Securities）

Risk

Global economy fall into the depression again;

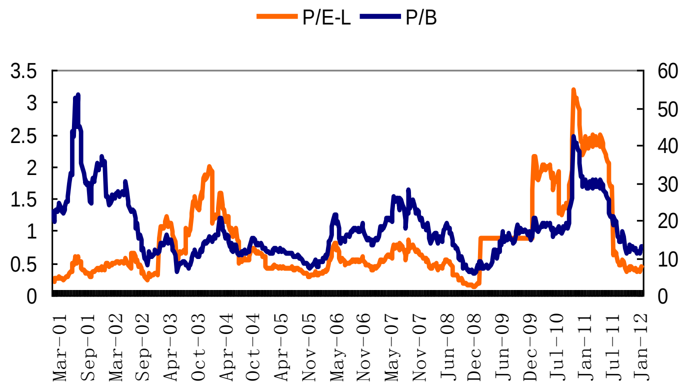
The raw material cost increase unexpectedly.

Reiterate Buy rating for too low valuation

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$2.644 billion and HK$3.265 billion respectively in 2011 and 2012. Net profit will reach HK$889 million and HK$ 1,157 million, increasing568% and 30% respectively, which amount to HK$0.53 and HK$0.69 of its EPS.

Considering the growing perspective of the Company, we take P/E as the valuation method. After the steep fall, it is traded at a safe low valuation, with present single-digital P/E, far lower than the average of 13.9X and previous high valuation of around 40X. Even considering the negative factors like the small scale, we conservatively give it the P/E with 5X to FY11 EPS, the 12-m TP of the Company will be HK$2.66, over 50% premium than current close. We reiterate it Buy rating.

Figure 6: Historical Valuation of CRE



(Sources: Bloomberg, Phillip Securities)

Financials

Profit model (HK$ Mil)	2009	2010	2011F	2012F	Balance sheet (HK$ Mil)	2009	2010	2011F	2012F
REVENUE	1,212	1,320	2,644	3,265	Total non-current assets	1,373	1,442	1,383	1,368
Cost of sales	(980)	(1,031)	(1,111)	(1,306)	Property, plant and equipment	636	614	554	524
Gross profit	231	288	1,534	1,959	Land lease prepayments	257	271	278	285
Other revenue	19	10	8	12	Intangible assets	349	330	330	340
Selling and distribution costs	(38)	(50)	(185)	(218)	Total current assets	1,867	2,325	3,545	4,816
Administrative expenses	(58)	(69)	(120)	(145)	Inventories	235	612	1,102	1,322
Other revenue and gains	8	7	7	8	Trade and other receivables	467	368	534	603
Finance costs	(18)	(8)	(14)	(17)	Cash and cash equivalents	1,065	1,229	1,620	1,960
PROFIT BEFORE TAX	144	178	1,230	1,599	Total assets	3,240	3,767	4,929	6,184
Income tax expense	(60)	(39)	(271)	(352)	Total current liabilities	258	231	373	449
PROFIT FOR THE YEAR	85	139	959	1,247	Trade payables	77	81	115	144
Minority Interests	0	(6)	(70)	(90)	Accruals and other payables	54	41	138	165
NET PROFIT Attributable to Equity	85	133	889	1,157	Bank borrowings due within one	108	99	100	120
EPS	0.06	0.08	0.53	0.69	Total non-current liabilities	234	95	115	125
					Bank borrowings	136	0	15	15
Growth & margins (%)	**2009**	**2010**	**2011F**	**2012F**	Deferred tax liabilities	98	95	100	110
Revenue growth	-11.21%	8.91%	100.31%	23.48%	Equity attributable to equity hold	2,719	3,404	4,393	5,550
Gross Profit growth	-33.81%	24.68%	432.50%	27.73%	Total equity	2,748	3,441	4,441	5,611
Net Profit growth	149.71%	56.47%	568.48%	30.15%	BVPS	1.77	2.06	2.66	3.36
					Key Ratios	**2009**	**2010**	**2011F**	**2012F**
Gross profit margin	19.06%	21.82%	58.00%	60.00%	Asset-liability ratio	15.19%	8.65%	9.90%	9.28%
Net profit margin	7.01%	10.08%	33.62%	35.44%	Current ratio	7.24	10.06	9.51	10.73
ROE	3.26%	4.30%	22.56%	23.02%	Average Receivable Turnover	132	115	62	64
ROA	2.63%	3.80%	20.45%	20.82%	Average Payable Turnover	29	22	14	14
Cash flow statement (HK$ Mil)	**2009**	**2010**	**2011F**	**2012F**	Inventory Turnover	101	150	282	339
(Loss)/Profit before tax	144	178	1,230	1,599	Average assets Turnover	972	969	600	621
Net cash flows from operating acti	171	(61)	204	459	Average Equity Turnover	786	856	544	562
Net cash flows from investing activ	10	(136)	185	(122)					
Net cash flows from financing activ	117	301	2	3	**Valuation**	**2009**	**2010**	**2011F**	**2012F**
Net change	300	105	391	340	P/E basic (X)	29.57	20.05	3.20	2.46
					P/B (X)	0.96	0.83	0.64	0.51

(Sources: Company reports, Phillip Securities)

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SELL	**>15% downside from the current price**

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