

China Vanadium

OUTPERFORM (unchanged)

Price target: HK\$4.52 (from HK\$4.20)

PRICE (as at 21 March 11)	BLOOMBERG	REUTERS	EPS EST. CHANGE		
HK\$3.16	893 HK	0893.HK	2011E	-6.5%	2012E -10.5%
12 MONTH RANGE	MARKET CAP				
HK\$2.25 - 5.17	HK\$6,557m (US\$841m)				

Yan Chen, CFA

Y.Chen@sc.com
+852 3983 8518

Wei OuYang

Wei.OuYang@sc.com
+852 3983 8519

Pure iron ore play on cheap valuation with stable growth

- We reiterate our Outperform rating for China Vanadium (China VTM) to reflect our bullish view on a potentially firmer iron ore price and production expansion.
- We raise the selling prices of iron concentrates, iron pellets and high-grade titanium concentrates for FY11E to RMB656/t, RMB910/t and RMB855/t, respectively, implying a 4% increase from the 2010realised prices. We also raise the unit cost of iron ore concentrates to RMB278/t (+4% YoY) and SG&A/revenue to 7.3% (from 5%). As a result, we slightly revise down our FY11 earnings forecast to RMB610m from RMB643m.
- We raise our PT to HK\$4.52 from HK\$4.20, as a result of the company's resource expansion and the rollover of our DCF-based price target by one year. China VTM's current share price implies it is trading at about 8.8x PER FY11E, which we regard as inexpensive vs our conservative forecast of 3-year CAGR earnings growth of 12%.

Investment summary

- **FY10 results: Solid production and earnings growth:** China VTM is a pure iron ore play in Sichuan province. Its final products are iron ore concentrates, iron pellets and titanium concentrates. The results saw good growth in production (+23% YoY) and earnings (+63% YoY).
- **Strong operating cash flow to fund expansion and acquisition:** By end FY10, the company had cash of RMB1bn, or net cash of RMB796m. We estimate cash flow from operations will be around RMB900m in 2011, which would be more than enough to fund its organic expansion. The company's robust balance sheet and cash flow position it well for further acquisition of iron ore assets in Sichuan province.
- **Potential beneficiary of vanadium-titanium mine consolidation in the area:** There has been discussion that the NDRC could potentially elevate the resource of vanadium-titanium ore to the status of strategic commodity reserve, in which case, only large players with scalable mine resource and production capacity will be allowed to conduct mining. China Vanadium could be a beneficiary in the consolidation process.
- **We remain positive on iron ore price:** We reiterate our bullish view of a firmer iron ore price and believe this will benefit China Vanadium. We think it could surprise the street with earnings upside. Our report, *Whatever happened to new supply?* (19 August 2010), concludes that the credit crunch in 2008 affected new iron ore projects worldwide. As funding was difficult and prices were falling sharply, 50 projects were postponed, which anticipates a delay in the supply of iron ore to the market and we expect supply to be tight until 2012. China Vanadium produces and sells to the Sichuan market, a relatively closed one due to its traffic inaccessibility, and which renders its price trend relatively less volatile. However, it still tracks the international iron ore price. We think China's 12th Five-Year Plan will add steel mill capacity of c.37.25m tonnes in south-west China by 2013. Such a development will benefit China VTM, with iron ore supply outside the region constrained by inaccessibility and difficult delivery.



FY10 result: Solid production and earnings growth

- Net profit of RMB533m came in about 6% above our estimate of RMB504m, similar to the consensus estimate.
- The FY10 net profit of RMB533m was up a strong 63%YoY, a clean result with no obvious one-off items. The key drivers behind strong profit growth were 23% YoY production growth in iron ore concentrates and a 14.7% YoY selling price increase. The company delivered slightly better production of 2mt of iron ore concentrates than its guidance of about 1.9mt.
- SG&A/revenue increased from 5.9% in 2009 to 8% in 2010. If the stock option expense of RMB19m were to be stripped out, SG&A/revenue would have been 6.7%, a mild increase from 2009.
- Cash flow from operations increased by 123% YoY to RMB764m in 2010. At the end of 2010, the company had a net cash position of RMB796m, after spending RMB1.2bn on acquisitions in 2010.
- China VTM announced a cash dividend of HK\$0.062 per share, implying a 1.9% dividend yield on the current share price.

Fig 1: FY10 results overview

RMBm, year end December	1H FY10	2H FY10	FY10	FY09	YoY %
Revenue	686	868	1554.1	1,084	43.4%
Gross profit	360	471	830.4	502	65.5
Gross margin %	52.4	54.2	53.4	46.3	
SG&A	48	76	123.8	64	93.8
SG&A / revenue %	7.0	8.7	8.0	5.9	
EBIT	312	395	706.6	438	61.4
EBIT margin	45.4	45.5	45.5	40.4	
Profit before tax	307	394	701.3	437	60.6
Tax	(52)	(66)	(117)	(70)	68.3
Tax rate %	16.8	16.7	16.7	16.0	
Net profit	256	328	584	367	59.2
Net margin %	37.3	37.8	37.6	33.9	
Minority interest	22	29	50.6	39	29.6
Net profit attributable to shareholders	234	300	533.4	328	62.7
EPS (RMB per share)	0.113	0.144	0.257	0.200	28.5
Key operating data					
Production volume - iron concentrate (kt)	865.9	1,142	2007.9	1631.3	23.1
Production volume - iron pellet (kt)	361.6	352	713.2	687.6	3.7
Sales volume - iron concentrate (kt)	506.8	810	1316.8	949.9	38.6
Sales volume - iron pellet (kt)	376.2	352	727.8	693.3	5.0
Sales volume - medium grade titanium concentrate (kt)	40.2	43	83.4	167.3	-50.1
Sales volume - high grade titanium concentrate (kt)	30.9	31	61.7	n.a.	n.a.

Source: Company, Standard Chartered Research estimates



Outlook: Continuous production growth

Production volume

We expect iron concentrates production to reach 2.3 million tonnes (on a dry basis) in 2011, which would mean growth of 15% YoY, comprising 1.35 million tonnes from Baicao Mine, 747,000 tonnes from Xiushuihe Mine, and the rest from new mines. We expect the contribution from Yangqueqing and Cizhuqing Mines could rise steadily to 300,000 tonnes per year during the next few years.

In 2012, we expect iron concentrates production to grow further to 2.55 million tonnes on the back of production growth at Yangqueqing Mines and 150,000 tonnes coming on stream from Aba Mining, after completion of the acquisition process. In 2013, another 100,000 tonnes of contribution from Yanglongshan Mine will be added, which would bring China VTM's total production to 2.75 million tonnes.

Production volume of Iron Pellets will increase by 300,000 tonnes in 2011 when the new iron pelletising plant with a planned annual production capacity of 1,000Kt becomes operational in June, and we expect the new plant to be fully operational in 2012, but the actual output will depend on demand.

We expect the production of medium-grade Titanium Concentrates to stay at the 80Kt p.a. level and production of high-grade Titanium Concentrates to grow to 200Kt p.a. by 2012.

Cost

The management mentioned that the rising oil cost puts pressure on the company's production cost this year but the expansion of capacity and thus the dilution of fixed cost could alleviate unit cost. Overall, it expects a 4% unit cost increase in 2011. Production cost for iron concentrates, pellets, medium-grade and high-grade titanium concentrates were RMB267/t, RMB455/t, RMB270/t and RMB330/t respectively in 2010, and is expected to rise to RMB278/t, RMB466/t, RMB281/t and RMB343/t in 2011.

Selling price

On iron concentrates, the company signed a guaranteed minimum price of RMB600/t, excluding VAT for 1H 2011. The pricing scheme for 2H2011 is yet to be decided. We expect an average 4% price increase in 2011 compared to 2010, to reflect our bullish view of a rise in the international iron ore price in 2011 and 2012.

The price difference between iron pellets and iron concentrates in the region hovers around RMB250/t. And the fabricators usually make a margin slightly above RMB50/t by converting the iron concentrates into pellets.

The company management expressed their bullish view on high-grade titanium concentrates price for 2011. In 1Q2011, the spot price has already reached RMB855/t excluding VAT. The titanium concentrates resource is of strategic importance to China and thus the government will possibly limit the total production volume. The actual plan on titanium resources is still being discussed. A possible outcome is that only companies with certain production capacity will be allowed into this area and the production quota might be assigned to each producer. We believe this policy, once it materializes, could provide strong support for the high-grade Titanium Concentrates price.

Capex

Capital expenditure was RMB1.4bn for 2010, and the company estimates this will fall to RMB600m-700m in 2011. This would include capex on existing projects (excluding M&A) of RMB500m-600m for 2011, among which RMB150m is to be paid on the acquisition of Aba Mining and RMB90m is for the resource fees outstanding on the Xiushuihe expansion. Normal maintenance capex without any acquisition would be RMB200-300m. There are no worries over capex fulfilment as by the end of FY10, the company had RMB1b at hand and RMB796m in net cash. The estimated RMB900m operating cash flow in 2011 from the core business should be sufficient to fund the expansion and acquisition.

**Resource expansion**

In 2010, the company completed a series of acquisitions. In January 2010, it acquired Yangqueqing mine, which has resources of 17.9m tonnes and potential resources of 81.6m tonnes. In February 2010, it acquired Cizhuqing mine with resources of 25.6m tonnes. In November 2010, it announced the acquisition of Aba Mining (including Maoling and Yanglongshan mines) with total resources of 78.2m tonnes.

By the end of 2010, the existing Baicao Mine and Xiushuihe Mine had combined reserves of 118.6m tonnes and resources of 210.8m tonnes. The company's total resources, after the completion of Aba Mining, should be 332.5m tonnes.

Earnings and price target revision

We raise the selling prices of iron concentrates and iron pellets to RMB656/t and RMB910/t respectively, which imply a 4% increase from the realised prices in 2010. We raise the selling price of high-grade titanium concentrates to RMB855/t from RMB531/t to reflect the prevailing price in the region. We also raise the unit cost of iron ore concentrates by 4% to RMB278/t and SG&A/revenue to 7.3% (from 5%). As a result, we revise our earnings forecasts of 2011 slightly down to RMB610m from RMB643m.

We raise our PT to HK\$4.52 from HK\$4.20, as a result of the company's expansion of resources and the rollover of our DCF price target by one year.



Fig 2: Key operating assumptions and earnings estimates for China Vanadium

	New			Old		
	2010	2011E	2012E	2010E	2011E	2012E
Production volume (kt)						
Baocai	503	1,351	1,351	1,284	1,351	1,351
Xiushuihe	573	747	747	590	747	747
Cizhuqing	-	100	200	-	200	500
Yangqueqing	-	100	100	-	200	500
Aba	-	-	150	-	-	-
Other processing plant	932	-	-	-	-	-
Iron concentrate	2,008	2,298	2,548	1,874	2,498	3,098
Iron pellet	728	1,028	1,728	760	1,060	1,760
Titanium concentrate - medium grade	101	80	80	73	-	-
Titanium concentrate - high grade	67	140	200	169	220	220
Sales volume (kt)						
Iron concentrate	1,317	1,270	820	1,112	1,438	1,338
Iron pellet	728	1,028	1,728	760	1,060	1,760
Titanium concentrate - medium grade	83	80	80	72	-	-
Titanium concentrate - high grade	62	140	200	100	220	220
Average selling price (RMB/t)						
Iron concentrate	631	656	656	590	590	590
<i>Equivalent to (US\$/t)</i>	<i>94</i>	<i>103</i>	<i>108</i>	<i>86</i>	<i>86</i>	<i>86</i>
Iron pellet	875	910	910	868	868	868
<i>Equivalent to (US\$/t)</i>	<i>131</i>	<i>143</i>	<i>150</i>	<i>127</i>	<i>127</i>	<i>127</i>
Titanium concentrate - medium grade	99	170	170	103	103	103
Titanium concentrate - high grade	531	855	855	650	650	650
Unit cost without G&A (RMB/t)						
Iron concentrate	267	278	278	242	249	259
Iron pellet	453	466	466	408	403	403
Titanium concentrate - medium grade	270	281	281	223	-	-
Titanium concentrate - high grade	330	343	343	420	429	429
RMB/t						
Price difference between pellet and concentrate	244	254	254	278	278	278
Cost difference between pellet and concentrate	188	188	188	166	154	144
Profit from converting concentrate into pellet	56	66	66	112	124	134

Source: Company, Standard Chartered Research estimates

**Income statement (RMBm)**

Year end: Dec	2010	2011E	2012E	2013E	2014E
Sales	1,554	1,902	2,295	2,426	2,412
Gross profit	830	1,000	1,172	1,247	1,205
SG&A	-124	-140	-157	-166	-165
Other income	30	0	0	0	0
EBIT	707	860	1,014	1,081	1,040
Depreciation & Amortization	51	157	197	206	204
EBITDA	758	1,018	1,211	1,288	1,244
Net interest	-18	0	0	0	0
Associates	-	-	-	-	-
Other expenses	-18	0	0	0	0
Pretax profit	701	860	1,014	1,081	1,040
Taxation	-117	-198	-254	-270	-260
Minority interests	-51	-53	-61	-65	-62
Net profit	533	610	700	746	718
Net profit (adjusted)	533	610	700	746	718
Basic EPS (RMB)	0.26	0.29	0.34	0.36	0.35
EPS (adjusted) (RMB)	0.26	0.29	0.34	0.36	0.35
DPS (RMB)	0.09	0.10	0.11	0.10	0.11

Balance sheet (RMBm)

Year end: Dec	2010	2011E	2012E	2013E	2014E
Cash	1,096	1,018	1,432	2,045	2,645
Prepayments, deposits, etc	100	100	100	100	100
Accounts receivables	208	211	255	269	268
Inventory	70	88	109	114	117
Other current assets	0	0	0	0	0
Total current assets	1,473	1,417	1,895	2,529	3,130
PP&E	1,476	2,008	2,169	2,169	2,169
Intangible Assets	481	442	406	373	343
Prepaid land lease	52	52	52	52	52
Other long term assets	252	252	252	252	252
Total long term assets	2,261	2,753	2,878	2,845	2,815
TOTAL ASSETS	3,733	4,171	4,774	5,374	5,945
Short term debt	175	175	175	175	175
Accounts payables	255	212	265	278	284
Other current liabilities	383	383	383	383	383
Total current liabilities	813	771	823	836	842
Long term debt	-	-	-	-	-
Provision for rehabilitation	6	6	6	6	6
Other long term liabilities	0	0	0	0	0
Total long term liabilities	131	131	131	131	131
TOTAL LIABILITIES	944	902	954	967	973
Shareholders' funds	2,667	3,201	3,691	4,214	4,716
Minority Interests	14	67	128	193	256
TOTAL LIAB AND EQUITY	3,626	4,171	4,774	5,374	5,945
Net cash / (debt)	796	718	1,132	1,745	2,345

Cash flow statement (RMBm)

Year end: Dec	2010	2011E	2012E	2013E	2014E
EBIT	707	860	1,014	1,081	1,040
Depreciation & amortisation	51	157	197	206	204
Net interest	-18	0	0	0	0
Taxes paid	-117	-198	-254	-270	-260
Changes in working capital	249	-64	-13	-7	5
Others	0	0	0	0	0
Cash flow from operations	885	756	944	1,010	989
Capex	-1,020	-650	-321	-173	-173
Acquisitions	-351	0	0	0	0
Disposals	0	0	0	0	0
Others	0	0	0	0	0
Cash flow from investing	-1,469	-650	-321	-173	-173
Dividends	-108	-183	-210	-224	-215
Issue of shares	0	0	0	0	0
Change in debt	200	0	0	0	0
Other financing	0	0	0	0	0
Cash flow from financing	92	-183	-210	-224	-215
	2	3	4	5	6
Change in cash	-492	-77	413	613	600
Free cash flow	-486	106	623	837	816

Key ratios

Year end: Dec	2010	2011E	2012E	2013E	2014E
Gross margin (%)	53.43	52.59	51.05	51.41	49.97
EBIT margin (%)	45.47	45.24	44.20	44.56	43.12
Effective tax rate (%)	16.8	23.0	25.0	25.0	25.0
Interest cover (x)	na	na	na	na	na
Deprn/capex (x)	0.1	0.2	0.6	1.2	1.2
Quick ratio (x)	1.8	1.8	2.3	3.0	3.7
ROE (%)	21.6	21.9	21.5	19.7	16.6
ROCE (%)	50.2	37.9	38.7	40.4	39.3
Net gearing (%)	net cash	net cash	net cash	net cash	net cash
Inventory days	35	35	35	35	35
Accounts receivable days	41	41	41	41	41
Accounts payable days	86	86	86	86	86
Total asset turnover (x)	0.4	0.5	0.5	0.5	0.4
PBR (x)	2.1	1.7	1.4	1.2	0.0
EV/Sales (x)	3.1	2.5	2.1	2.0	0.0
EV/EBITDA (x)	6.3	4.5	3.6	3.3	0.0
PER (x)	10.5	8.7	7.2	6.6	0.0
Dividend yield (%)	0.0	0.0	0.0	0.0	0.0
No of shares, fully diluted (m)	2,075	2,075	2,075	2,075	2,075

Source: Company, Standard Chartered Research estimates



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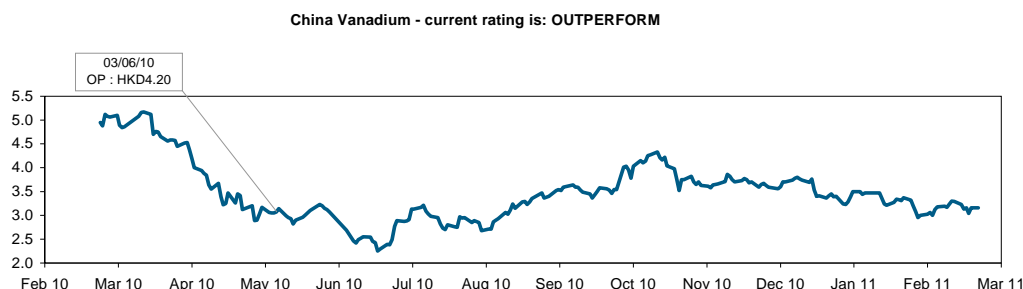
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Company China Vanadium

As at the disclosure date, the following applies:



Source: FactSet prices / SCB ratings and price targets

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Research Recommendation

Terminology	Definitions
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