

China VTM Mining (893.HK)

Commodities Sector

2 Sep. 2011

1H Production on Track; Maintain Buy

1H results overview. Revenue increased 21% yoy and net profit rose 30% yoy. Gross margin dropped by 1.2 ppts yoy to 51% due to higher costs for processing iron pellets through third-party contractors. These costs should fall going forward after the company started up its own pelletizing plant in May 2011. Iron product sales remained the main business, contributing 91% of revenue 1H11, even though sales of titanium concentrate tripled.

Volumes on track with stable/rising ASPs. Production of vanadium bearing iron concentrate reached 1.04 mt in 1H11, while ASP was stable at RMB666/t vs. RMB664/t in 1H10. Based on VTM's iron concentrate production capacity of ~2.1 mtpa (dry basis) as at end-FY10, utilization was 90%+ in 1H11. ASP was lower than expected due to weaker demand, as ramping up new capacities at Dazhou and Desheng Steel was slower than expected. ASPs for iron pellets and high-grade titanium concentrate rose 3% yoy and 104% yoy, due to stronger demand.

More M&A to come. VTM targets to increase iron resources and iron concentrate production capacity from the current 397 mt and 2.75 mtpa to 600mt and 5mtpa within the next three years, for CAGRs of 51% and 82%. It will form a JV to develop Dashanshu Section of Pingchuan Iron Mine, which has 50 mt of resources of Fe grades 10%-18%. VTM will hold 51% of the JV, with an initial capital contribution of RMB51m. Commercial production is expected to start in June 2013. Total consideration for VTM once the JV partner injects mining rights into the JV remains unknown. This transaction would add only ~250 ktpa of effective annual production capacity to VTM assuming a 20-year mine life, equivalent to ~11% of FY11 production volumes, but we see more M&A to come given its production targets and current net cash position.

Switch to spot pricing in anticipation of higher ASP in 2H11 as Pangang's new vanadium and titanium production base in Xichang is expected to commence production in October 2011. Ramping up this capacity will be gradual, perhaps stretching to 2013, but we nonetheless expect this to drive up local demand for vanadium-bearing iron, since VTM's mines are in the Panxi region and close to the new Sichuan production base. Sichuan/Chongqing steel capacity is set to increase by 10.7 mt over 2011-12, which could create 19 mtpa of iron concentrate demand once it reaches full production. Use of vanadium-bearing iron is expected to increase as 1) the Panxi region is set to be among the first batch of vanadium and titanium bases in China; 2) steel producers such as Chuanwei, VTM's parent, are shifting their focus from low-margin steel to vanadium, a high-value-added by-product.

FY11E-FY13E EPS revised down 12%-26% on i) lower ASP assumptions, as technical difficulties could continue for new steel production capacity in Sichuan/Chongqing, and demand growth could slow in respect to the development of high-speed rail; ii) lower expected production volumes for FY11-FY13.

Valuation. We lower our target price to HK\$3.80 from HK\$5.00, given our downward EPS revisions and based on 9.7X FY12E P/E and 5.3X EV/EBITDA, in line with the current 9.1X and 5.8X for steelmaking input players. Our forecasts only include M&A that has been announced; further deals (which seem likely given that this is VTM's predominant growth strategy) would provide further upside. We continue to see the company as a defensive play on Western China development, given its relatively stable ASP due to local operations, and the current valuation as attractive given the ~40% fall from its year high in the past few months. Maintain Buy.

12m rating

Buy

Maintained

Price
HK\$2.30
12m target price
HK\$3.80

(Revised down from HK\$5.00, 65% upside)

View at a Glance

Track record			3
Competitiveness			4
Earnings visibility			3

Scale of 1-5; 5 is the highest

Performance (%)

	1m	3m	12m
Absolute	(18.7)	(20.7)	(19.6)
Relative to HSI	(9.6)	(7.8)	(19.4)

VTM – Price Chart


HSI	20,585
52W high/low (HK\$)	4.37/2.00
Shares in issue – millions	2,075.00
Market cap – HK\$m (US\$m)	4,773 (613)
Free float – %	42.28
3M avg. t/o – HK\$m (US\$m)	15.01 (1.93)
Major shareholder – %	
Trisonic International Ltd.	48.85

Sources: Bloomberg and Sun Hung Kai Financial

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Figure 1: China VTM Mining – earnings summary

Year end 31 Dec.	FY08	FY09	FY10	FY11E	FY12E	FY13E
Revenue – RMBm	791.2	1,083.9	1,554.1	1,838.4	3,012.3	4,316.6
Net profit – RMBm	248.7	327.9	533.4	640.1	659.3	698.3
Net-profit growth – %	363.2	31.8	62.7	20.0	3.0	5.9
EPS – RMB fen	N/A	20.0	26.0	30.8	31.8	33.7
EPS growth – %	N/A	17.6	30.0	18.6	3.0	5.9
P/E – X	N/A	9.4	7.2	6.1	5.9	5.6
Dividend yield – %	N/A	0.0	2.8	3.3	3.4	3.6
P/B – X	N/A	1.6	1.4	1.2	1.0	0.9
EBIT margin – %	44.5	41.1	46.1	44.4	32.7	25.3
Issue shares - millions	N/A	2,075.0	2,075.0	2,075.0	2,075.0	2,075.0

Sources: Bloomberg and Sun Hung Kai Financial

We expect a surge in revenue and drop in EBIT margin over FY12E-FY13E, mainly due to a new lower-margin trading project in Indonesia, announced in May.

Figure 2: China VTM Mining – earnings revision summary

	FY11E		FY12E		FY13E	
	Previous	Revised	Previous	Revised	Previous	Revised
Revenue – RMBm	1,927.5	1,838.4	2,463.8	3,012.3	2,932.8	4,316.6
Net profit – RMBm	724.9	640.1	799.3	659.3	948.6	698.3
EPS – RMB fen	34.9	30.8	38.5	31.8	45.7	33.7
Our net profit vs. consensus – % above / (below)		(2)		(11)		(18)

Sources: Bloomberg and Sun Hung Kai Financial

* Our forecast only includes announced M&As; Revenue upward revision in FY12-13 mainly relates to offtake sales from Indonesia iron project.

Figure 3: China VTM Mining – 1H11 results review, key financials highlights

	1H11	2H10	1H10	2H09	1H09	1H11 hoh change (%)	1H11 yoy change (%)
Revenue (RMBm)	845.4	868.2	699.8	597.8	486.0	(2.6)	20.8
Gross profit (RMBm)	431.4	470.8	365.4	292.2	209.5	(8.4)	18.0
Net profit (RMBm)	303.7	299.9	250.6	194.4	133.4	0.2	30.2
EBIT (RMBm)	433.4	398.4	352.0	262.6	181.7	(4.4)	23.1
EBITDA (RMBm)	375.4	453.1	313.5	285.7	201.2	(5.8)	19.8
Gross margin (%; chg in ppts)	51.0	54.2	52.2	48.9	43.1	(3.2)	(1.2)
Net margin (%; chg in ppts)	35.9	37.8	35.8	36.3	30.8	(1.9)	0.1
EBIT margin (%; chg in ppts)	51.3	52.2	50.3	47.8	41.4	(0.9)	1.0
EBITDA margin (%; chg in ppts)	44.4	45.9	44.8	43.9	37.4	(1.5)	(0.4)

Sources: The Company and Sun Hung Kai Financial

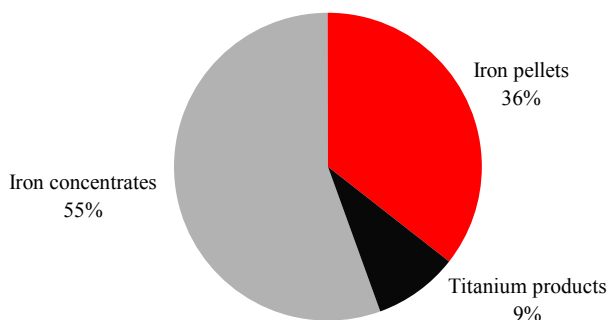
Figure 4: China VTM Mining – 1H11 operational data summary

	1H11	2H10	1H10	2H09	1H09	1H11 hoh change (%)	1H11 yoy change (%)
Vanadium-bearing iron concentrate							
Total sales (RMBm)	466.4	538.9	336.8	290.3	239.4	(13.5)	38.5
Quantity (kt)	702.8	810.0	506.8	486.6	463.3	(13.5)	38.7
ASP* (RMB/t)	631.0	632.1	630.4	628.6	489.2	(0.2)	0.1
Ordinary iron concentrate							
Total sales (RMBm)	3.0	N/A	13.8	N/A	N/A	N/A	(78.2)
Quantity (kt)	2.7	N/A	23.5	N/A	N/A	N/A	(88.5)
ASP (RMB/t)	1,118.5	N/A	589.0	N/A	N/A	N/A	89.9
Iron pellets							
Total sales (RMBm)	301.6	307.1	330.1	296.6	240.5	(1.8)	(8.6)
Quantity (kt)	334.8	351.6	376.2	360.8	332.5	(4.8)	(11.0)
ASP (RMB/t)	900.7	873.4	877.4	822.1	723.3	3.1	2.7
Medium-grade titanium concentrate							
Total sales (RMBm)	9.6	5.1	3.2	10.9	6.1	90.1	202.8
Quantity (kt)	54.3	46.5	36.9	102.4	64.9	16.8	47.2
ASP (RMB/t)	177.2	108.8	86.1	106.3	94.5	62.8	105.8
High-grade titanium concentrate							
Total sales (RMBm)	64.7	17.1	15.8	-	-	278.0	309.6
Quantity (kt)	57.2	30.8	30.9	-	-	85.7	85.1
ASP (RMB/t)	1,131.9	556.1	511.5	-	-	103.5	121.3

Sources: The Company and Sun Hung Kai Financial

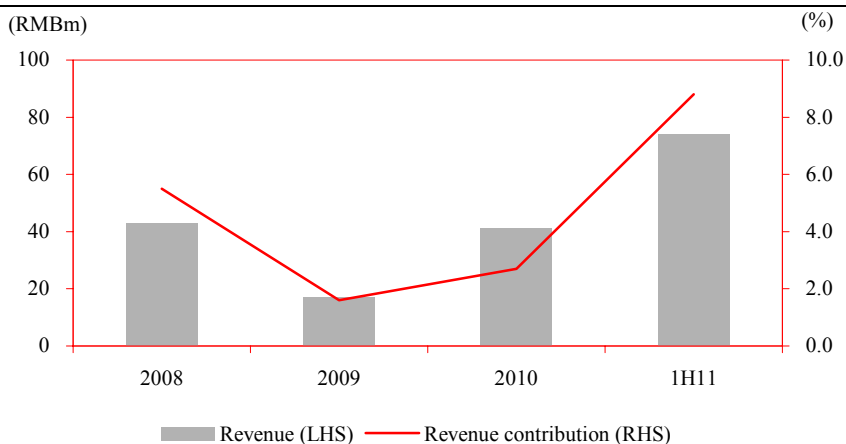
* Excluded reimbursement of transport costs, assumed to be equal to selling & distribution costs for comparison purposes

Figure 5: China VTM Mining – revenue mix in 1H11



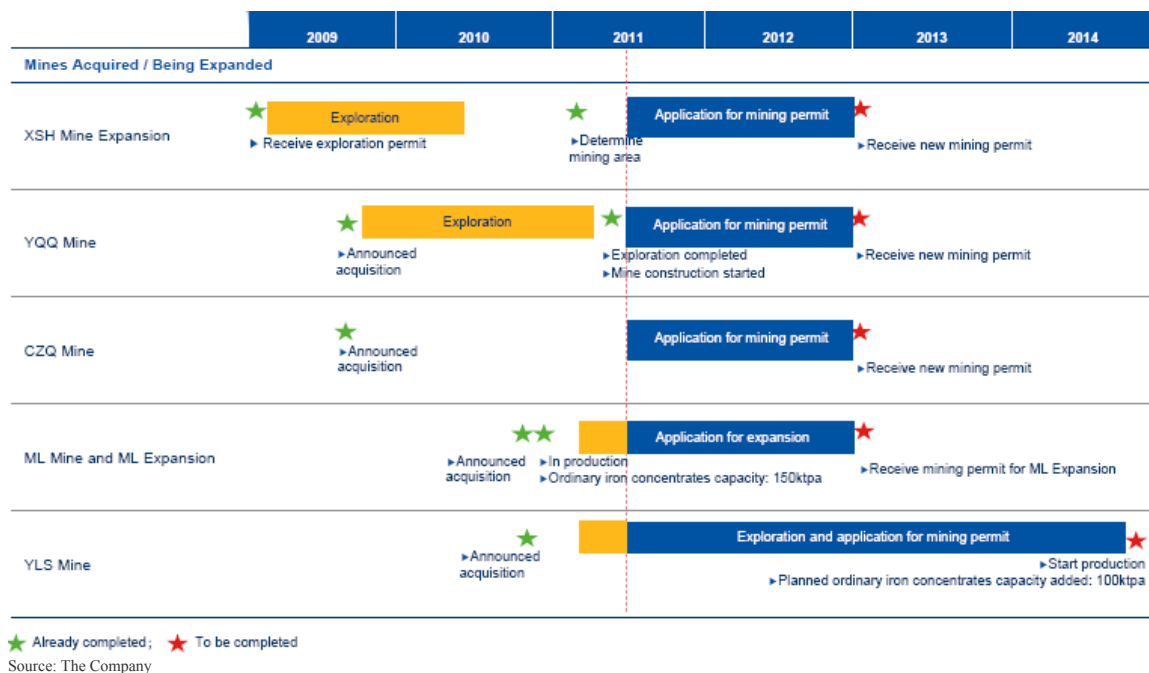
Sources: The Company and Sun Hung Kai Financial

Figure 6: China VTM Mining – increasing contribution from titanium product sales in 1H11



Sources: The Company and Sun Hung Kai Financial

Figure 7: China VTM Mining –project pipeline



Valuation

Figure 8: Peer comparison

	P/E (X)		EV/ FY11	FY12E P/B	FY12E	EPS growth (%)	
	FY11E	FY12E	EBITDA		ROE	FY11E	FY12E
			(X)	(X)	(%)		
China steelmaking input producers							
CMOC (3993.HK)	14.6	12.5	8.3	1.4	12.1	27.0	17.1
Hidili Industry (1393.HK)	9.1	7.4	8.2	0.8	11.6	14.9	23.0
Shougang Resources (639.HK)	9.0	8.1	4.8	0.9	12.0	25.0	11.9
Sector average	9.1	7.9	5.8	1.1	12.0		
China steelmakers							
Angang Steel (347.HK)	32.6	17.1	7.2	0.7	3.8	(45.7)	91.0
Maanshan Iron & Steel (323.HK)	20.4	11.0	5.6	0.6	5.9	(24.0)	85.5
Chongqing Iron & Steel (1053.HK)	N/A	95.6	29.4	0.4	0.2	N/A	N/A
Shougang Int'l (697.HK)	8.3	4.9	11.2	0.4	9.1	14.6	70.0
Baoshan Iron & Steel (600019.CH)	7.5	6.1	5.2	0.8	12.1	(6.5)	23.3
Wuhan Iron & Steel (600005.CH)	11.7	9.0	7.6	0.9	9.3	36.6	30.0
Sector average	9.4	8.1	6.4	0.7	8.6		
China VTM Mining (893.HK)	6.1	5.9	3.1	1.0	18.2	18.6	21.4*

Sources: Bloomberg and Sun Hung Kai Financial

* Adjusted to exclude the one-off impact of expiration of tax holiday for comparison purpose

** Figures other than those for VTM are based on consensus.

*** We consider other HK-listed iron companies not so comparable as they do not yet have significant production up to 2011.

Financial Statements

Figure 9: China VTM Mining – Profit and Loss Statement

Year end 31 Dec., RMBm	FY08	FY09	FY10	FY11E	FY12E	FY13E	FY08-13E CAGR (%)
Revenue	791.2	1,083.9	1,554.1	1,838.4	3,012.3	4,316.6	40.4
COGS	(364.1)	(582.1)	(723.7)	(876.4)	(1,859.6)	(3,045.1)	52.9
Gross profit	427.0	501.7	830.4	962.0	1,152.7	1,271.5	24.4
Operating expenses	(92.4)	(96.7)	(141.3)	(171.2)	(173.7)	(188.5)	15.3
Other operating income	17.1	40.6	26.7	25.0	7.0	7.0	(16.4)
Operating profit	351.7	445.6	715.8	815.8	986.0	1,090.0	25.4
Finance expenses	(3.0)	(7.8)	(10.0)	(20.0)	(20.0)	(20.0)	45.7
PBT	348.8	436.6	701.3	795.8	966.0	1,070.0	25.1
Tax	(30.1)	(69.7)	(117.3)	(139.3)	(289.8)	(321.0)	60.6
Net profit	248.7	327.9	533.4	640.1	659.3	698.3	22.9
EPS –RMB fen	N/A	20.0	26.0	30.8	31.8	33.7	14.6

Sources: Bloomberg and Sun Hung Kai Financial

Figure 10: China VTM Mining – Profit and Loss Statement (Year on Year Growth)

Year end 31 Dec., %	FY08	FY09	FY10	FY11E	FY12E	FY13E	FY08-13E CAGR (%)
Revenue	115.8	37.0	43.4	18.3	63.9	43.3	40.4
COGS	93.9	59.9	24.3	21.1	112.2	63.7	52.9
Gross profit	138.7	17.5	65.5	15.8	19.8	10.3	24.4
Operating expenses	(9.4)	4.6	46.2	21.1	1.4	8.5	15.3
Other operating income	1,152.2	136.9	(34.2)	(6.4)	(72.0)	0.0	(16.4)
Operating profit	349.8	26.7	60.6	14.0	20.9	10.6	25.4
Finance expenses	58.8	154.8	29.3	99.1	0.0	0.0	45.7
PBT	360.9	25.2	60.6	13.5	21.4	10.8	25.1
Tax	2,081.9	131.8	68.3	18.7	108.1	10.8	60.6
Net profit	363.2	31.8	62.7	20.0	3.0	5.9	22.9
EPS attributable to shareholders	N/A	17.6	30.0	18.6	3.0	5.9	14.6

Sources: Bloomberg and Sun Hung Kai Financial

Figure 11: China VTM Mining – Profit and Loss Statement (Common Size)

Year end 31 Dec., %	FY08	FY09	FY10	FY11E	FY12E	FY13E	FY08-13E Average
Revenue	100.0	100.0	100.0	100.0	100.0	100.0	100.0
COGS	(46.0)	(53.7)	(46.6)	(47.7)	(61.7)	(70.5)	(54.4)
Gross profit	54.0	46.3	53.4	52.3	38.3	29.5	45.6
Operating expenses	(11.7)	(8.9)	(9.1)	(9.3)	(5.8)	(4.4)	(8.2)
Other operating income	2.2	3.7	1.7	1.4	0.2	0.2	1.6
Operating profit	44.5	41.1	46.1	44.4	32.7	25.3	39.0
Finance expenses	(0.4)	(0.7)	(0.6)	(1.1)	(0.7)	(0.5)	(0.7)
PBT	44.1	40.3	45.1	43.3	32.1	24.8	38.3
Tax	(3.8)	(6.4)	(7.5)	(7.6)	(9.6)	(7.4)	(7.1)
Net profit	31.4	30.2	34.3	34.8	21.9	16.2	28.1

Sources: Bloomberg and Sun Hung Kai Financial

Figure 12: China VTM Mining – Balance Sheet

As at 31 Dec., RMBm	FY08	FY09	FY10	FY11E	FY12E	FY13E	FY08-13E CAGR (%)
Cash and securities	133.1	1,884.0	665.6	859.7	1,697.4	2,523.9	80.1
Accounts receivable	87.6	137.4	207.6	245.6	402.4	576.6	45.8
Inventory	65.6	70.9	69.6	84.2	178.8	292.7	34.9
Other current assets	119.3	140.9	530.1	436.8	512.4	596.4	38.0
Total current assets	405.7	2,233.3	1,472.8	1,626.4	2,790.9	3,989.6	58.0
Net fixed assets	380.4	544.7	1,528.0	1,964.7	1,962.8	1,961.0	38.8
Other long-term assets	165.2	295.5	732.6	733.4	714.2	694.9	33.3
Total assets	951.3	3,073.5	3,733.4	4,324.5	5,467.9	6,645.5	47.5
Short-term debt	0.0	100.0	175.0	175.0	175.0	175.0	N/A
Accounts payable	108.0	85.9	254.9	284.3	603.4	988.0	55.7
Other current liabilities	181.9	275.0	383.2	384.6	646.3	809.7	34.8
Total current liabilities	290.0	460.9	813.1	843.9	1,424.7	1,972.7	46.7
Long-term debt	0.0	0.0	125.0	125.0	125.0	125.0	N/A
Other long-term liabilities	57.2	5.7	6.1	6.5	7.3	8.1	(32.4)
Total liabilities	347.2	466.6	944.2	975.4	1,557.0	2,105.8	43.4
Shareholders equity	604.1	2,606.8	2,789.2	3,349.0	3,910.9	4,539.7	49.7
Minorities	64.8	92.8	14.5	29.1	42.7	90.1	6.8
Total equity and liabilities	951.3	3,073.5	3,733.4	4,324.5	5,467.9	6,645.5	47.5

Sources: Bloomberg and Sun Hung Kai Financial

Figure 13: China VTM Mining – Balance Sheet (Common Size)

As at 31 Dec., %	FY08	FY09	FY10	FY11E	FY12E	FY13E	FY08-13E Average
Total assets							
Cash and securities	14.0	61.3	17.8	19.9	31.0	38.0	30.3
Accounts receivable	9.2	4.5	5.6	5.7	7.4	8.7	6.8
Inventory	6.9	2.3	1.9	1.9	3.3	4.4	3.4
Other current assets	12.5	4.6	14.2	10.1	9.4	9.0	10.0
Total current assets	42.6	72.7	39.5	37.6	51.0	60.0	50.6
Net fixed assets	40.0	17.7	40.9	45.4	35.9	29.5	34.9
Other long-term assets	17.4	9.6	19.6	17.0	13.1	10.5	14.5
Total assets	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Total equity and liabilities							
Short-term debt	0.0	3.3	4.7	4.0	3.2	2.6	3.0
Accounts payable	11.4	2.8	6.8	6.6	11.0	14.9	8.9
Other current liabilities	19.1	8.9	10.3	8.9	11.8	12.2	11.9
Total current liabilities	30.5	15.0	21.8	19.5	26.1	29.7	23.8
Long-term debt	0.0	0.0	3.3	2.9	2.3	1.9	1.7
Other long-term liabilities	6.0	0.2	0.2	0.2	0.1	0.1	1.1
Total liabilities	36.5	15.2	25.3	22.6	28.5	31.7	26.6
Shareholders equity	63.5	84.8	74.7	77.4	71.5	68.3	73.4
Minorities	6.8	3.0	0.4	0.7	0.8	1.4	2.2
Total equity and liabilities	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Sources: Bloomberg and Sun Hung Kai Financial

Figure 14: China VTM Mining – Cash Flow Statement

Year end 31 Dec., RMBm	FY08	FY09	FY10	FY11E	FY12E	FY13E
Profit before tax	348.8	436.6	701.3	795.8	966.0	1,070.0
Depreciation and amortization	26.6	42.5	91.4	162.5	146.1	146.1
Change in WC	72.1	(106.1)	54.6	(57.0)	138.1	151.9
Other adjustments	(24.5)	(31.0)	(83.0)	(103.0)	(156.3)	(281.2)
Cash flows from operations	423.0	342.1	764.4	798.3	1,093.9	1,086.8
Capex	(184.6)	(276.4)	(978.6)	(600.0)	(125.0)	(125.0)
Other adjustments	(82.5)	(51.4)	(771.8)	(318.5)	0.0	0.0
Cash flows from investing	(267.1)	(327.7)	(1,750.4)	(918.5)	(125.0)	(125.0)
Shares issues/(purchases)	0.0	1,661.7	0.0	0.0	0.0	0.0
Dividends	0.0	(20.0)	0.0	(115.7)	(131.3)	(135.2)
Change in debt	(30.0)	100.0	200.0	0.0	0.0	0.0
Cash flows from financing	(30.5)	1,736.6	(232.4)	(115.7)	(131.3)	(135.2)
Cash at beginning of year	7.6	133.1	1,884.0	665.6	859.7	1,697.4
Change in cash	125.5	1,750.9	(1,218.4)	(235.9)	837.6	826.6
Cash at end of year	133.1	1,884.0	665.6	859.7	1,697.4	2,523.9

Sources: Bloomberg and Sun Hung Kai Financial

Figure 15: China VTM Mining – Key Ratios

Year end 31 Dec.	FY08	FY09	FY10	FY11E	FY12E	FY13E	FY08-13E Average
Profitability ratios							
Gross margin – %	54.0	46.3	53.4	52.3	38.3	29.5	45.6
Operating margin – %	44.5	41.1	46.1	44.4	32.7	25.3	39.0
Net margin – %	31.4	30.2	34.3	34.8	21.9	16.2	28.1
ROAA – %	32.2	16.3	15.7	15.9	13.5	11.5	17.5
ROAE – %	55.9	20.4	19.8	20.9	18.2	16.5	25.3
Other ratios							
A/R/sales – %	11.1	12.7	13.4	13.4	13.4	13.4	12.9
Capex/sales – %	23.3	25.5	63.0	32.6	4.1	2.9	25.2
Capex/depreciation – %	979.7	889.5	1,343.6	369.3	85.5	85.6	625.5
Net debt/equity (net cash) – %	(22.0)	(68.4)	(28.5)	(16.7)	(35.7)	(49.0)	(36.7)
Inventory/sales – %	8.3	6.5	4.5	4.6	5.9	6.8	6.1
Effective tax rate – %	8.6	16.0	16.7	17.5	30.0	30.0	19.8
Inventory turnover – days	49.0	42.8	35.4	32.0	25.8	28.3	35.5
A/R turnover – days	20.3	37.9	40.5	45.0	39.3	41.4	37.4
A/P turnover – days	79.3	60.3	86.1	110.4	82.9	91.9	85.2
Cash conversion cycle – days	(10.1)	20.4	(10.2)	(33.4)	(17.8)	(22.3)	(12.2)
ROAA component analysis							
Revenue/average assets – %	102.5	53.9	45.7	45.6	61.5	71.3	63.4
COGS/average assets – %	(47.2)	(28.9)	(21.3)	(21.8)	(38.0)	(50.3)	(34.6)
Gross profit/average assets – %	55.3	24.9	24.4	23.9	23.5	21.0	28.8
Operating expenses/average assets – %	(12.0)	(4.8)	(4.2)	(4.2)	(3.5)	(3.1)	(5.3)
Other operating income/average assets – %	2.2	2.0	0.8	0.6	0.1	0.1	1.0
Operating profit /average assets – %	45.6	22.1	21.0	20.2	20.1	18.0	24.5
Finance expenses/average assets – %	(0.4)	(0.4)	(0.3)	(0.5)	(0.4)	(0.3)	(0.4)
PBT/average assets – %	45.2	21.7	20.6	19.8	19.7	17.7	24.1
Tax/average assets – %	(3.9)	(3.5)	(3.4)	(3.5)	(5.9)	(5.3)	(4.2)
Net profit/average assets – %	32.2	16.3	15.7	15.9	13.5	11.5	17.5
ROAE component analysis							
Revenue/average equity – %	177.8	67.5	57.6	59.9	83.0	102.2	91.3
COGS/average equity – %	(81.8)	(36.3)	(26.8)	(28.6)	(51.2)	(72.1)	(49.5)
Gross profit/average equity – %	96.0	31.3	30.8	31.3	31.8	30.1	41.9
Operating expenses/average equity – %	(20.8)	(6.0)	(5.2)	(5.6)	(4.8)	(4.5)	(7.8)
Other operating income/average equity – %	3.8	2.5	1.0	0.8	0.2	0.2	1.4
Operating profit/average equity – %	79.0	27.8	26.5	26.6	27.2	25.8	35.5
Finance expenses/average equity – %	(0.7)	(0.5)	(0.4)	(0.7)	(0.6)	(0.5)	(0.5)
PBT/average equity – %	78.4	27.2	26.0	25.9	26.6	25.3	34.9
Tax/average equity – %	(6.8)	(4.3)	(4.3)	(4.5)	(8.0)	(7.6)	(5.9)
Net profit/average equity – %	55.9	20.4	19.8	20.9	18.2	16.5	25.3

Sources: Bloomberg and Sun Hung Kai Financial

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