

China VTM Mining (893.HK)

Commodities Sector

24 Aug. 2010

Key Takeaways

We attended iron ore miner VTM's interim results presentation and came away positive on the stock. VTM is based in fast-growing Sichuan province, which has the PRC's third largest iron ore reserves. Provincial crude-steel production capacity is set to rise by 10 mt in 2010-12, equal to over 60% of 2009 output. 6.7X FY11 P/E ex cash on consensus numbers looks attractive vs. 10X average of Chinese steelmaking input and steel companies, especially given 1) its consensus 28% two-year EPS CAGR, 2) China's iron ore shortage, 3) lack of margin pressure. Further upside potential: possible acquisitions, such as its current moves to acquire Jingzhi Mine (fourth largest iron mine in Sichuan). M&A can be fueled by net cash of RMB905m as at end-1H10, equal to 17% of market cap.

Better 2H10 outlook, could well beat FY10 consensus. Interim results were in line with consensus. 1H10 revenue grew 41% yoy to RMB685.9m; net profit increased 75% yoy to RMB233.6. These reached 46% and 49% of the full-year market consensus respectively, largely in line with expectations. Better 2H10 results are expected, as droughts in southwest China affected operations for the first four months in FY10.

ASP and volumes both grew in 1H10, could ASP trend higher in 2H10? ASPs for iron concentrate and iron pellets increased by 19% and 13% over FY09 to RMB665/t and RMB878/t respectively in 1H10. The company delivered a total of 883 kt of iron concentrate and pellets in 1H10, up 16% yoy. This suggests it should meet its production target of 1.9 mt for FY10. ASP could trend higher in 2H10 as demand for iron ore rises in Sichuan, due to newly added crude steel production capacity of 3.8 mt (20% of 2009 output).

Medium-term target to increase output to 4.5 mtpa. Self-owned iron ore processing capacity is set to rise to 2.6 mtpa at end-FY10 from the current 2.3 mtpa. Management targets to increase this further to 4.5 mtpa within 2-3 years, for a 20% capacity CAGR. This suggests production volumes might grow at a similar rate in coming years.

Strengthening iron resource base, more acquisitions underway. VTM has more than doubled its iron resources from 162 mt when it listed to 366 mt now. We believe the current resource base is sufficient for more than 30 years of FY10 production. The company has further options to acquire Maoling Mine (10 mt) and Jingzhi Mine (100 mt), which would increase its resources to 476 mt. This would improve economies of scale and strengthen VTM's hand when negotiating other mine acquisitions.

More details to follow. We will issue a detailed report on VTM soon.

Figure 1: Earnings Summary

Year ending 31 Dec	FY08	FY09	FY10E	FY11E
Revenue – RMBm	791.2	1,083.9	1,409.3	1,799.5
Net profit – RMBm	248.7	327.9	508.3	635.7
Net-profit growth – %	363.2	31.8	55.0	25.1
EPS – RMB fen	17.0	20.0	24.5	30.6
EPS growth – %	325.0	17.6	22.5	24.9
P/E – X	15.2	12.9	10.2	8.2
DPS – RMB fen	0.0	0.0	3.8	6.7
Dividend yield – %	0.0	0.0	1.5	2.7
BVPS – RMB	N/A	1.2	1.6	1.9
P/B – X	N/A	2.1	1.6	1.3
Oper. cash flow/share – RMB fen	28.2	21.0	34.0	44.5
Free cash flow/share – RMB fen	N/A	4.0	N/A	N/A
Free cash flow yield – %	N/A	1.6	N/A	N/A
Net cash/share – RMB fen	N/A	(86.0)	N/A	N/A
Net cash/price – %	N/A	(33.2)	N/A	N/A
EBIT margin – %	44.5	41.1	50.9	51.1
Issued shares – millions	N/A	2,075.0	2,075.0	2,075.0

Sources: Bloomberg and Sun Hung Kai Financial; Forecasts from consensus numbers

 12-month rating **Not Rated**

 12m target price **N/A**

View at a Glance	(+ / O / -)		
Fundamental	+		
Valuation	+		
Performance (%)	1m	3m	12m
Absolute	0.7	(9.1)	N/A
Relative to HSI	0.4	(15.2)	N/A

VTM – Price vs. HSI, Share Data



Price – HK\$	2.85
HSI	20,889
52W high/low (HK\$)	5.70/2.22
Shares in issue – millions	2,075.00
Mkt. cap – HK\$m (US\$m)	5,913.75 (670.58)
Free float – %	42.19
3M avg. t/o – HK\$m (US\$m)	31.54 (4.06)
Major shareholder (%)	
Trisonic International Ltd.	48.36%

Sources: Bloomberg and Sun Hung Kai Financial

Derek Yew, CFA

+ (852) 2203 9583

derek.yew@shkf.com

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Company Background

VTM is the second largest Sichuan-based operator of iron mines, with a 9% provincial market share. It produces and sells iron concentrate, iron pellets and medium-grade titanium concentrate. Iron concentrate and pellets accounted for 97% of 1H10 sales (FY09: 98%). Sichuan iron concentrate is produced from vanadium-bearing titanomagnetite deposits, resulting in lower iron content of 55%. Thus local iron concentrate prices are lower than that in the eastern region.

The company's major competitive advantage is its low operating costs (lowest 10%-20% on the PRC cost curve), due to adoption of open-pit mining. This translated into high gross margins of 46%-54% over FY06-1H10.

Figure 2: China VTM Mining – Porter's Five Forces

Threat of substitute products – Low to medium

- Blast furnace iron is the predominant way of steel production, accounting for 99% of total steel production. Recycling of iron/steel scrap can also be used instead of mined iron for steel production, but it is uncommon due to high electricity costs involved. Aluminum could be a substitute of steel (mainly in automobiles), even though it is much more expensive.

Threat of entry of new competitors – High

- Sichuan is rich in iron ore reserves, ranking third among all China provinces. Entry barrier is low with the abundant reserves, as new entrants only need to acquire an iron ore mine while outsourcing all mining or processing operations.

Intensity of competitive rivalry – High

- Iron ore/pellets are commodities in which there is no differentiation, where competition is mainly based on price.

Bargaining power of customers – Low

- With iron ore shortage situation in overall China, bargaining power of customers is low as evidenced by that VTM only grants 30 days credit period to its customers.

Bargaining power of suppliers – Low to Medium

- VTM's current largest supplier is its mining contractor. Given the low technology content of open pit mining operations, the bargaining power of its suppliers are low. However, the use of only one mining contractor increases the contractor's bargaining power.

Source: Sun Hung Kai Financial

Figure 3: China VTM Mining – Profit and Loss Statement

Year ended 31 Dec., RMBm	FY06	FY07	FY08	FY09	FY06-09 CAGR (%)
Revenue	211.1	366.7	791.2	1,083.9	72.5
COGS	(100.1)	(187.8)	(364.1)	(582.1)	79.8
Gross profit	111.0	178.9	427.0	501.7	65.4
Operating expenses	(59.4)	(102.1)	(92.4)	(96.7)	17.6
Other operating income	0.1	1.4	17.1	40.6	675.6
Operating profit	51.6	78.2	351.7	445.6	105.1
Finance expenses	(1.8)	(1.9)	(3.0)	(7.8)	63.0
PBT	49.4	75.7	348.8	436.6	106.7
Tax	(17.1)	(1.4)	(30.1)	(69.7)	59.7
Net profit	23.0	53.7	248.7	327.9	142.3
EPS attributable to shareholders – RMB fen	2.0	4.0	17.0	20.0	115.4

Sources: Bloomberg and Sun Hung Kai Financial

Figure 4: China VTM Mining – Profit and Loss Statement (Year on Year Growth)

Year ended 31 Dec., %	FY06	FY07	FY08	FY09	FY07-09 CAGR (%)
Revenue	N/A	73.7	115.8	37.0	72.5
COGS	N/A	87.5	93.9	59.9	79.8
Gross profit	N/A	61.2	138.7	17.5	65.4
Operating expenses	N/A	71.7	(9.4)	4.6	17.6
Other operating income	N/A	1,472.4	1,152.2	136.9	675.5
Operating profit	N/A	51.5	349.8	26.7	105.1
Finance expenses	N/A	7.1	58.8	154.8	63.0
PBT	N/A	53.1	360.9	25.2	106.7
Tax	N/A	(92.0)	2,081.9	131.8	59.7
Net profit	N/A	133.0	363.2	31.8	142.3
EPS attributable to shareholders	N/A	100.0	325.0	17.6	115.4

Sources: Bloomberg and Sun Hung Kai Financial

Figure 5: China VTM Mining – Profit and Loss Statement (Common Size)

Year ended 31 Dec., %	FY06	FY07	FY08	FY09	FY06-09 Average
Revenue	100.0	100.0	100.0	100.0	100.0
COGS	(47.4)	(51.2)	(46.0)	(53.7)	(49.6)
Gross profit	52.6	48.8	54.0	46.3	50.4
Operating expenses	(28.2)	(27.8)	(11.7)	(8.9)	(19.2)
Other operating income	0.0	0.4	2.2	3.7	1.6
Operating profit	24.5	21.3	44.5	41.1	32.8
Finance expenses	(0.8)	(0.5)	(0.4)	(0.7)	(0.6)
PBT	23.4	20.6	44.1	40.3	32.1
Tax	(8.1)	(0.4)	(3.8)	(6.4)	(4.7)
Net profit	10.9	14.6	31.4	30.2	21.8

Sources: Bloomberg and Sun Hung Kai Financial

Figure 6: China VTM Mining – Balance Sheet

As at 31 Dec., RMBm	FY06	FY07	FY08	FY09	FY06-09 CAGR (%)
Cash and securities	3.3	7.6	133.1	1,884.0	730.5
Accounts receivable	0.3	0.0	87.6	137.4	646.8
Inventory	20.5	31.8	65.6	70.9	51.3
Other current assets	58.7	266.9	119.3	140.9	33.9
Total current assets	82.8	306.3	405.7	2,233.3	199.9
Net fixed assets	100.6	122.9	380.4	544.7	75.6
Other long-term assets	27.6	163.7	165.2	295.5	120.5
Total assets	211.0	592.9	951.3	3,073.5	144.2
Short-term debt	44.3	44.3	0.0	100.0	31.2
Accounts payable	32.6	64.4	108.0	85.9	38.2
Other current liabilities	60.0	193.2	181.9	275.0	66.1
Total current liabilities	136.9	301.9	290.0	460.9	49.9
Long-term debt	0.0	0.0	0.0	0.0	N/A
Other long-term liabilities	0.5	5.0	57.2	5.7	131.7
Total liabilities	137.4	306.9	347.2	466.6	50.3
Shareholders equity	73.6	286.0	604.1	2,606.8	228.4
Minorities	23.7	83.0	64.8	92.8	57.6
Total equity and liabilities	211.0	592.9	951.3	3,073.5	144.2

Sources: Bloomberg and Sun Hung Kai Financial

Figure 7: China VTM Mining – Balance Sheet (Common Size)

As at 31 Dec., %	FY06	FY07	FY08	FY09	FY06-09 Average
Total assets					
Cash and securities	1.6	1.3	14.0	61.3	19.5
Accounts receivable	0.2	0.0	9.2	4.5	3.5
Inventory	9.7	5.4	6.9	2.3	6.1
Other current assets	27.8	45.0	12.5	4.6	22.5
Total current assets	39.3	51.7	42.6	72.7	51.6
Net fixed assets	47.7	20.7	40.0	17.7	31.5
Other long-term assets	13.1	27.6	17.4	9.6	16.9
Total assets	100.0	100.0	100.0	100.0	100.0
Total equity and liabilities					
Short-term debt	21.0	7.5	0.0	3.3	7.9
Accounts payable	15.4	10.9	11.4	2.8	10.1
Other current liabilities	28.4	32.6	19.1	8.9	22.3
Total current liabilities	64.9	50.9	30.5	15.0	40.3
Long-term debt	0.0	0.0	0.0	0.0	0.0
Other long-term liabilities	0.2	0.8	6.0	0.2	1.8
Total liabilities	65.1	51.8	36.5	15.2	42.1
Shareholders equity	34.9	48.2	63.5	84.8	57.9
Minorities	11.2	14.0	6.8	3.0	8.8
Total equity and liabilities	100.0	100.0	100.0	100.0	100.0

Sources: Bloomberg and Sun Hung Kai Financial

Figure 8: China VTM Mining – Cash Flow Statement

Year ended 31 Dec., RMBm	FY06	FY07	FY08	FY09
Profit before tax	49.4	75.7	348.8	436.6
Depreciation and amortization	10.8	11.6	26.6	42.5
Change in WC	(15.7)	(180.1)	72.1	(106.1)
Other adjustments	0.2	(4.1)	(24.5)	(31.0)
Cash flows from operations	44.7	(96.9)	423.0	342.1
Capex	(11.5)	(31.7)	(184.6)	(276.4)
Other adjustments	(18.1)	(4.5)	(82.5)	(51.4)
Cash flows from investing	(29.5)	(36.2)	(267.1)	(327.7)
Shares issues/(purchases)	0.0	0.0	0.0	1,661.7
Dividends	0.0	0.0	0.0	(20.0)
Change in debt	(14.8)	0.0	(30.0)	100.0
Cash flows from financing	(15.4)	137.4	(30.5)	1,736.6
Cash at beginning of year	3.5	3.3	7.6	133.1
Change in cash	(0.2)	4.3	125.5	1,750.9
Cash at end of year	3.3	7.6	133.1	1,884.0

Sources: Bloomberg and Sun Hung Kai Financial

Figure 9: China VTM Mining – Key Ratios

Year ended 31 Dec.	FY06	FY07	FY08	FY09	FY06-09 Average (%)
Profitability ratios					
Gross margin – %	52.6	48.8	54.0	46.3	52.6
Operating margin – %	24.5	21.3	44.5	41.1	24.5
Net margin – %	10.9	14.6	31.4	30.2	10.9
ROAA – %	10.9	13.4	32.2	16.3	10.9
ROAE – %	31.3	29.9	55.9	20.4	31.3
Other ratios					
A/R/sales – %					
Capex/sales – %	0.2	0.0	11.1	12.7	6.0
Capex/depreciation – %	5.4	8.6	23.3	25.5	15.7
Net debt/equity (net cash) – %	107.5	292.4	979.7	889.5	567.3
Inventory/sales – %	55.7	12.8	(22.0)	(68.4)	(5.5)
Effective tax rate – %	9.7	8.7	8.3	6.5	8.3
Inventory turnover – days	34.6	1.8	8.6	16.0	15.3
A/R turnover – days	N/A	50.8	49.0	42.8	47.5
A/P turnover – days	N/A	0.2	20.3	37.9	19.4
Cash conversion cycle – days					
ROAA component analysis					
Revenue/average assets – %	N/A	91.2	102.5	53.9	82.5
COGS/average assets – %	N/A	(46.7)	(47.2)	(28.9)	(40.9)
Gross profit/average assets – %	N/A	44.5	55.3	24.9	41.6
Operating expenses/average assets – %	N/A	(25.4)	(12.0)	(4.8)	(14.1)
Other operating income/average assets – %	N/A	0.3	2.2	2.0	1.5
Operating profit from continuing operations/average assets – %	N/A	19.5	45.6	22.1	29.1
Finance expenses/average assets – %	N/A	(0.5)	(0.4)	(0.4)	(0.4)
PBT/average assets – %	N/A	18.8	45.2	21.7	28.6
Tax/average assets – %	N/A	(0.3)	(3.9)	(3.5)	(2.6)
Net profit/average assets – %	N/A	13.4	32.2	16.3	20.6
ROAE component analysis					
Revenue/average equity – %	N/A	203.9	177.8	67.5	149.7
COGS/average equity – %	N/A	(104.4)	(81.8)	(36.3)	(74.2)
Gross profit/average equity – %	N/A	99.5	96.0	31.3	75.6
Operating expenses/average equity – %	N/A	(56.8)	(20.8)	(6.0)	(27.9)
Other operating income/average equity – %	N/A	0.8	3.8	2.5	2.4
Operating profit from continuing operations/average equity – %	N/A	43.5	79.0	27.8	50.1
Finance expenses/average equity – %	N/A	(1.1)	(0.7)	(0.5)	(0.7)
PBT/average equity – %	N/A	42.1	78.4	27.2	49.2
Tax/average equity – %	N/A	(0.8)	(6.8)	(4.3)	(4.0)
Net profit/average equity – %	N/A	29.9	55.9	20.4	35.4

Sources: Bloomberg and Sun Hung Kai Financial

Address: 42/F, The Lee Gardens, 33 Hysan Avenue, Causeway Bay, Hong Kong

Phone : (852) 3920 2888

Fax : (852) 3920 2789

Web : <http://www.SHKFG.com>

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