

China Vanadium

OUTPERFORM (unchanged)

PRICE (as at 10 September 10)	BLOOMBERG	REUTERS	EPS EST. CHANGE					
HK\$3.15	893 HK	0893.HK	2010E	0.0%	2011E	0.0%	2012E	0.0%
12 MONTH RANGE	MARKET CAP							
HK\$2.25 - 5.61	HK\$6,536m (US\$841m)							

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Expansion on track. Hidden value of vanadium yet to be reflected.

We took China VTM's management on a NDR in Hong Kong (when). Management is very confident that the Sichuan Province iron ore market will be facing a much larger deficit two years from now once its 10mt/pa new steel capacity gradually becomes operational, which should also drive up demand for vanadium and allow China VTM to realise better selling prices.

Management is also delivering the production growth it promised before IPO and China VTM is likely to beat our current production estimate for 2011E. Currently the transportation cost from the closest sea port to Sichuan is about RMB240/t, which renders imported iron ore uncompetitive, and creates arbitrage opportunities for local producers like China VTM when the market faces rising deficits.

On acquisition front, management is working proactively on a number of projects, and believes it will not need to come to the market to raise money in the near future, given that it believes it has strong balance sheet and cash flow positions.

Overall, we feel that the company is still undervalued at 8.9x PER 2011E. Our fair value of HK\$4.2 (assuming US\$100/t iron ore price from 2011 onward) implies 33% potential upside.

Production capacity expansion

Management confirmed that its production capacity will reach the following levels:

- Iron concentrate: 2.3mt by October 2010 (up from c.2mt now);
- Iron pellet: 1.36mt by Q2 2010 (up from c.360kt now) when Phase I of the new iron pellet plant is completed. The construction of Phase II of 500kt/pa will be dependent on market conditions.
- High-grade titanium concentrate: 420kt by year-end 2010 (up from 220kt now).

The hidden value of vanadium

The vanadium content in the iron ore that China VTM sells is currently given for free as only two large steel mills (Pangang Group in Sichuan Province and Chengde Vanadium and Titanium Co in Hebei Province) have scaled capacity to extract vanadium from iron ore. Currently, vanadium's (V_2O_5) price is still hovering around RMB100k/t in Sichuan area, down from the RMB300k-400k/t levels seen pre-crisis in 2008.



Management is very bullish on where vanadium is going from here. All of Sichuan Province's planned new steel capacity of 10mt is engineered to specifically use vanadium-rich iron ores, which can be used to extract vanadium as a key ingredient to produce high-strength steel. As the new mill capacity gradually comes on stream (3.8mt in 2010, 4.1mt in 2011, and 2.2mt in 2012), it should, we believe, inevitably push up the demand for and price of vanadium.

Acquisition pipeline

The management team has been working on an active pipeline of more than ten projects, although no details have been disclosed yet. We expect it will focus on expanding both resources and production volume.

The company has already expanded its iron ore resources to about 366mt via acquisitions, up from 240mt (including the 78mt in the Xiushuihe expansion plan), when it was listed in October 2009. The company stated it aims to add another 100mt by the end of 2011.

The company's balance sheet is still very strong even after making the acquisitions in 1H 2010. Currently, it has net cash of about RMB900m, with total equity standing around RMB2.9bn. If we assume the company increases net debt to 30% while continuing to make operating cash flow of RMB600m in 2011E (we estimate RMB624m for 2010E), then it would still have a RMB2.3bn war chest without needing to execute a share placement. Given that in 1H 2010 it acquired an iron ore resource of c.120mt, iron concentrate processing capacity of 1.1mt/pa and high-grade titanium concentrate capacity of 120kt/pa, all at a cost of RMB1bn, our assumed RMB2.3bn war chest would allow the company to engage in some meaningful acquisitions should any interesting project(s) materialise.

Market outlook

Management is very confident that the iron ore market will gain strength over the next few years as the new steel capacity hits the market gradually. Once the 10mt/pa new capacity is fully operational by 2012, the iron ore deficit in Sichuan Province could rise as high as 10mt (compared with the total iron ore production of about 27mt in Sichuan Province in 2009).

On the other hand, the transportation cost to Sichuan from the closest sea port (which is Fangcheng Port in Guangxi Province) is about RMB240/t, which is quite high compared with the current iron ore price of c.RMB740/t in Sichuan). The transportation cost renders imported iron ore uncompetitive in the Sichuan market, which should create arbitrage opportunities for local iron ore producers such as China VTM.

Fig 1: China VTM's trading multiples

	2009	2010E	2011E	2012E
PE	17.6	11.4	8.9	7.2
EV/EBITDA	10.0	6.6	4.4	3.5
PB	2.3	1.9	1.7	1.4
Dividend yield	0.0%	0.0%	3.4%	4.1%

Source: Standard Chartered Research estimates

**Income statement (RMBm)**

Year end: Dec	2008	2009	2010E	2011E	2012E
Sales	791	1,084	1,388	1,910	2,459
Gross profit	427	502	750	1,030	1,308
SG&A	-55	-64	-70	-96	-124
Other income	17	41	0	0	0
EBIT	372	438	680	934	1,184
Depreciation & Amortization	26	42	50	163	179
EBITDA	398	479	730	1,097	1,363
Net interest	-3	-9	0	0	0
Associates	-	-	-	-	-
Other expenses	-37	-33	0	0	0
Pretax profit	349	437	680	934	1,184
Taxation	-30	-70	-116	-215	-296
Minority interests	-70	-39	-60	-77	-95
Net profit	249	328	504	643	794
Net profit (adjusted)	249	328	504	643	794
Basic EPS (RMB)	0.17	0.20	0.24	0.31	0.38
EPS (adjusted) (RMB)	0.17	0.20	0.24	0.31	0.38
DPS (RMB)	0.00	0.00	0.09	0.11	0.13

Cash flow statement (RMBm)

Year end: Dec	2008	2009	2010E	2011E	2012E
EBIT	372	438	680	934	1,184
Depreciation & amortisation	26	42	50	163	179
Net interest	-3	-9	0	0	0
Taxes paid	-30	-70	-116	-215	-296
Changes in working capital	72	-106	10	-42	-44
Others	0	0	0	0	0
Cash flow from operations	423	342	624	840	1,023
Capex	-173	-239	-392	-354	-169
Acquisitions	-87	-51	-1,060	0	0
Disposals	-	1,251	0	0	0
Others	0	-1	0	0	0
Cash flow from investing	-267	-328	-1,452	-354	-169
Dividends	0	-20	0	-193	-238
Issue of shares	0	1,662	0	0	0
Change in debt	-30	100	0	0	0
Other financing	0	0	0	0	0
Cash flow from financing	-30	1,737	0	-193	-238
	0	1	2	3	4
Change in cash	126	1,752	-827	293	617
Free cash flow	-36	52	233	486	855

Source: Company, Standard Chartered Research estimates

Balance sheet (RMBm)

Year end: Dec	2008	2009	2010E	2011E	2012E
Cash	133	1,884	1,057	1,350	1,967
Prepayments, deposits, etc	89	91	91	91	91
Accounts receivables	88	137	144	198	255
Inventory	66	71	75	103	135
Other current assets	30	50	50	50	50
Total current assets	406	2,233	1,416	1,792	2,498
PP&E	357	496	1,908	2,109	2,109
Intangible Assets	141	142	132	122	111
Prepaid land lease	23	49	49	49	49
Other long term assets	24	153	153	153	153
Total long term assets	546	840	2,242	2,433	2,422
TOTAL ASSETS	951	3,073	3,658	4,225	4,920
Short term debt	0	100	100	100	100
Accounts payables	108	86	106	147	192
Other current liabilities	182	275	275	275	275
Total current liabilities	290	461	481	522	567
Long term debt	-	-	-	-	-
Provision for rehabilitation	5	6	6	6	6
Other long term liabilities	52	0	0	0	0
Total long term liabilities	57	6	6	6	6
TOTAL LIABILITIES	347	467	487	527	572
Shareholders' funds	539	2,514	3,018	3,468	4,024
Minority Interests	65	93	153	229	324
TOTAL LIAB AND EQUITY	951	3,073	3,658	4,225	4,920
Net cash / (debt)	133	1,784	957	1,250	1,867

Key ratios

Year end: Dec	2008	2009	2010E	2011E	2012E
Gross margin (%)	53.98	46.29	54.05	53.92	53.21
EBIT margin (%)	46.97	40.40	49.01	48.88	48.16
Effective tax rate (%)	8.6	17.0	17.0	23.0	25.0
Interest cover (x)	130.6	51.9	na	na	na
Depn/capex (x)	0.2	0.2	0.1	0.5	1.1
Quick ratio (x)	1.4	4.8	2.9	3.4	4.4
ROE (%)	71.6	22.9	19.5	20.9	22.1
ROCE (%)	95.9	67.7	44.8	40.1	48.1
Net gearing (%)	net cash	net cash	net cash	net cash	net cash
Inventory days	49	43	43	43	43
Accounts receivable days	20	38	38	38	38
Accounts payable days	94	61	61	61	61
Total asset turnover (x)	0.8	0.4	0.4	0.5	0.5
PBR (x)	10.8	2.3	1.9	1.7	1.4
EV/Sales (x)		4.4	3.5	2.5	1.9
EV/EBITDA (x)	12.2	10.0	6.6	4.4	3.5
PER (x)	23.5	17.6	11.4	8.9	7.2
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



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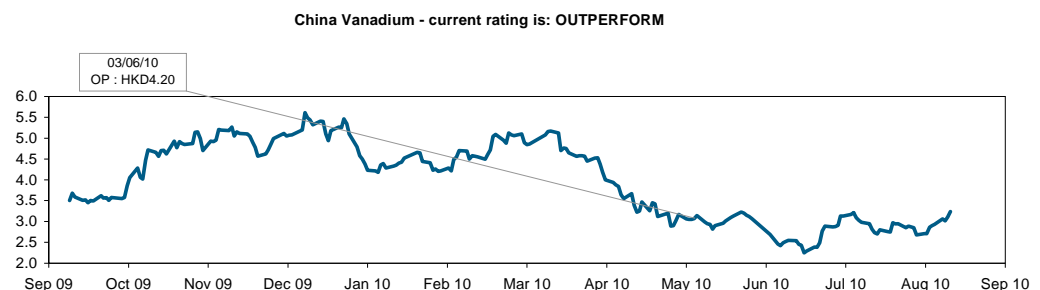
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Company China Vanadium

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Source: FactSet prices / SCB ratings and fair values

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Research Recommendation

Terminology	Definitions
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