

China VTM Mining (893.HK)

Commodities Sector

23 Nov. 2010

Further Value-Accretive Deals to Boost Earnings

Upgrade to Buy, target price revised up to HK\$5.00 (from HK\$4.00), for 30% upside, after meeting with management, on:

1. 5% upward EPS estimate revisions for FY11-FY12, mainly from increasing stake in Huili Caitong.
2. Defensive nature of VTM and further catalysts, including i) more mine acquisitions by exercising options held before IPO, ii) higher ASP from a possible switch to spot pricing, and iii) favorable developments for West China in the 12th Five Year Plan, and higher iron ore prices on increased demand from newly added steel capacity.
3. Undemanding valuation of 9X FY11X P/E vs. steelmaking input players' 13X, with further earnings upgrades possible.

For further in-depth analysis, please see our more detailed Company Report published on 2 Sep. 2010.

We see recent acquisitions of Huili Caitong and Aba Mining as value accretive. VTM recently announced the acquisition of a further 7.23% interest in Huili Caitong, the principal operating subsidiary of VTM, for RMB445m. Upon completion, Huili Caitong would become a wholly-owned subsidiary of VTM. We see the consideration as fair at an implied 7X FY11E P/E, a 14% discount to VTM's current valuation.

VTM also proposed to acquire a 100% interest in Aba Mining for RMB150m. Its main assets include 78 mt of iron ore resources (from Maoling Mine and Yanglongshan Mine) and a 150 ktpa iron concentrate processing plant. Despite the higher-grade iron ore at Maoling Mine, the acquisition consideration for Aba Mining is only RMB2-3/mt, significantly less than the RMB5-RMB11/t for VTM's earlier acquisitions this year.

Revising up earnings and EPS for FY11E-FY12E by 5% to factor in the above acquisitions. Revenue projections have also been revised up slightly to factor in a higher ASP for iron concentrate from Maoling Mine. However, this mine is only expected to post ~75 kt of sales in FY11 and 150 kt in FY12, accounting for 3%-5% of total sales.

Figure 1: China VTM Mining – earnings revision summary

	FY10E		FY11E		FY12E	
	Unchanged	Previous	Revised	Previous	Revised	
Year end 31 Dec.						
Revenue – RMBm	1,489.9	1,918.4	1,927.9	2,469.6	2,490.0	
Net profit – RMBm	525.1	694.0	730.5	772.6	809.2	
EPS – RMB fen	25.3	33.4	35.2	37.2	39.0	
P/E – X	12.6	9.5	9.0	8.5	8.1	
Our EPS vs. consensus – % above / (below)	(3)		1		4	

Sources: Bloomberg and Sun Hung Kai Financial

12m rating

Buy

Upgraded from Neutral

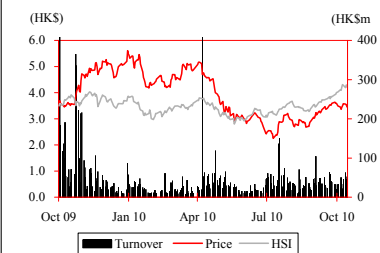
Price	HK\$3.82
12m target price	HK\$5.00
(Revised up from HK\$4.00, 31% upside)	

View at a Glance (+ / O / -)

Fundamental	+
Valuation	+

Performance (%)	1m	3m	12m
Absolute	5.9	31.6	(23.0)
Relative to HSI	7.6	20.8	(24.6)

VTM – Price vs. HSI, Share Data



52W high/low (HK\$)	5.70/2.22
Shares in issue – millions	2,075.00
Market cap – HK\$m (US\$m)	7,781 (1,003)
Free float – %	42.19
3M avg. t/o – HK\$m (US\$m)	50.54 (6.52)
Major shareholder – %	
Trisonic International Ltd.	48.52

Sources: Bloomberg and Sun Hung Kai Financial

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Defensive play in volatile commodities market. VTM's earnings growth will mainly be driven by volume growth, not ASP growth. While Hebei iron ore prices recently reached a 2010 high at ~RMB1,300/t (up 40%+ in 2010), Sichuan iron ore prices are still low at ~RMB600/t (only up ~10% in 2010). Less volatile Sichuan iron ore prices make VTM a defensive play. Over the medium term, there could be further scope for ASP to rise, as we expect the Sichuan-Hebei price gap to narrow on improving transport infrastructure in Sichuan.

Further catalysts would include:

- 1. Announcements of additional value-accretive acquisitions.** VTM entered into options prior to its IPO to acquire five mines, including the latest Maoling Mine acquisition. Exercising its option to acquire Jingzhi Mine, with 100 mt of reserves, could boost output by a further 900 ktpa, equivalent to 30%+ of FY11 output. Estimated net cash of RMB592m at end-FY10 plus RMB600m operating cash flows p.a. should be sufficient for further acquisitions.
- 2. ASP could increase with change to spot pricing.** Channel checks indicate that the 3.8 mt of newly added crude steel capacity in Sichuan is still at the trial phase. Iron ore demand from this capacity is expected to emerge in 2H11. Sichuan iron ore prices have recently been relatively low at ~RMB600/t, and though we expect them to stay at this level through early 2011, they should gradually rise with higher iron ore demand in 2H11. Thus, following the expiration of customer contracts at end-2010, we expect the company to switch to spot pricing in 2011 to improve profitability.
- 3. Favorable policy/macro environment** including i) further policy direction on west China development, including implementation details for the 12th Five Year Plan, and ii) higher-than-expected iron ore prices on increased demand from newly added crude steel production capacity.

Undemanding valuation at 9X FY11X P/E vs. steelmaking input players' 13X. Our target price is equivalent to 12X FY11E earnings, and could be revised up further once the acquisition of Jingzhi Mine comes through. Excluding estimated net cash of RMB592m at end-FY10 that could be spent on this, our target FY11E P/E would fall to 11X, a 15% discount to Chinese steelmaking input companies. We see such a discount as fair given VTM's slower EPS growth in FY12 from the expiration of tax concessions, which would lift its effective tax rate by 12.5 ppts to 30%, from 17.5%.

Figure 2: Peer comparison

	P/E (X)		P/B (X)	FY1 ROE (%)	EPS growth (%)	
	FY1	FY2			FY1	FY2
China steelmaking input producers						
CMOC	23.3	19.1	2.5	9.2	145.9	22.2
Hidili Industry	19.2	13.4	2.0	12.2	79.5	42.9
Fushan Energy	14.8	12.5	1.7	11.7	47.5	18.7
Sector average*	16.2	12.8	1.8	11.9	65.6	20.7
China steelmakers						
Angang Steel	17.4	12.4	1.3	7.7	446.9	40.2
Maanshan Iron & Steel	18.6	13.0	1.1	5.8	297.9	43.3
Chongqing Iron & Steel	22.6	12.9	0.6	3.9	55.9	75.6
Shougang Concord.	10.1	7.2	1.1	10.6	1,193.5	40.3
Baoshan Iron & Steel	9.3	8.1	1.1	11.6	113.0	14.4
Wuhan Iron & Steel	14.1	10.5	1.3	7.2	68.9	34.7
Sector average	12.2	9.8	1.2	9.2	179.7	23.2
China VTM Mining	12.9	9.3	2.4	18.1	26.0	39.1

Sources: Bloomberg and Sun Hung Kai Financial

* CMOC is not included to calculate the sector average given its much higher valuation

Further key takeaway from meeting: VTM should have enough cash for more capex post-acquisitions. VTM would have 400+ mt of iron ore resources following the acquisition of Aba Mining, sufficient for 30+ years of production. If necessary, the company could even delay capex and outsource processing or palletizing, as it has in the past.

Key risks: 1) operational risks from using third-party contractors; 2) higher than expected production costs; 3) possible production disruptions from natural disasters.

Figure 3: China VTM Mining – earnings summary

Year end 31 Dec.	FY07	FY08	FY09	FY10E	FY11E	FY12E
Revenue – RMBm	366.7	791.2	1,083.9	1,489.9	1,927.9	2,490.0
Net profit – RMBm	53.7	248.7	327.9	525.1	730.5	809.2
Net-profit growth – %	133.0	363.2	31.8	60.1	39.1	10.8
EPS – RMB fen	4.0	17.0	20.0	25.3	35.2	39.0
EPS growth – %	100.0	325.0	17.6	26.5	39.1	10.8
P/E – X	81.7	19.3	16.3	12.9	9.3	8.4
DPS – RMB fen	0.0	0.0	0.0	5.1	7.0	7.8
Dividend yield – %	0.0	0.0	0.0	1.6	2.2	2.4
BVPS – RMB	N/A	N/A	1.2	1.5	1.8	2.1
P/B – X	N/A	N/A	2.6	2.1	1.8	1.5
Oper. cash flow per share – RMB fen	N/A	N/A	21.0	29.7	42.7	46.6
Free cash flow per share – RMB fen	N/A	N/A	4.0	(32.9)	(7.5)	27.5
Free-cash-flow yield – %	N/A	N/A	1.3	(10.1)	(2.3)	8.4
Net debt per share – RMB fen	N/A	N/A	(86.0)	(50.0)	(37.1)	(57.4)
Net debt/ price – %	N/A	N/A	(26.3)	(15.3)	(11.3)	(17.6)
EBIT margin – %	21.3	44.5	41.1	47.3	48.0	48.0
Issued shares – millions	N/A	N/A	2,075.0	2,075.0	2,075.0	2,075.0

Sources: Bloomberg and Sun Hung Kai Financial

Financial Statements

Figure 4: China VTM Mining – Profit and Loss Statement

Year end 31 Dec., RMBm	FY07	FY08	FY09	FY10E	FY11E	FY12E	FY07-12 CAGR (%)
Revenue	366.7	791.2	1,083.9	1,489.9	1,927.9	2,490.0	46.7
COGS	(187.8)	(364.1)	(582.1)	(706.2)	(912.2)	(1,189.6)	44.7
Gross profit	178.9	427.0	501.7	783.7	1,015.7	1,300.4	48.7
Operating expenses	(102.1)	(92.4)	(96.7)	(111.6)	(122.7)	(138.3)	6.3
Other operating income	1.4	17.1	40.6	32.0	32.0	32.0	87.9
Operating profit	78.2	351.7	445.6	704.1	925.0	1,194.1	72.5
Finance expenses	(1.9)	(3.0)	(7.8)	(19.8)	(16.9)	(8.4)	34.5
PBT	75.7	348.8	436.6	684.3	908.1	1,185.6	73.4
Tax	(1.4)	(30.1)	(69.7)	(119.8)	(158.9)	(355.7)	203.6
Net profit	53.7	248.7	327.9	525.1	730.5	809.2	72.0
EPS –RMB fen	4.0	17.0	20.0	25.3	35.2	39.0	57.7

Sources: Bloomberg and Sun Hung Kai Financial

Revenue growth over FY10E-12E will be driven by an 86% rise in sales volumes, in line with a 1.6 mt increase in iron ore demand for VTM due to rising crude steel production capacity in Sichuan.

Figure 5: China VTM Mining – Profit and Loss Statement (Year on Year Growth)

Year end 31 Dec., %	FY07	FY08	FY09	FY10E	FY11E	FY12E	FY07-12 CAGR (%)
Revenue	73.7	115.8	37.0	37.5	29.4	29.2	46.7
COGS	87.5	93.9	59.9	21.3	29.2	30.4	44.7
Gross profit	61.2	138.7	17.5	56.2	29.6	28.0	48.7
Operating expenses	71.7	(9.4)	4.6	15.3	9.9	12.7	6.3
Other operating income	1,472.4	1,152.2	136.9	(21.2)	0.0	0.0	87.9
Operating profit	51.5	349.8	26.7	58.0	31.4	29.1	72.5
Finance expenses	7.1	58.8	154.8	154.5	(14.6)	(50.0)	34.5
PBT	53.1	360.9	25.2	56.7	32.7	30.6	73.4
Tax	(92.0)	2,081.9	131.8	71.8	32.7	123.8	203.6
Net profit	133.0	363.2	31.8	60.1	39.1	10.8	72.0
EPS attributable to shareholders	100.0	325.0	17.6	26.5	39.1	10.8	57.7

Sources: Bloomberg and Sun Hung Kai Financial

Revenue growth in FY10E will be driven by a 19%/14% increase in ASPs for iron concentrates/pellets. COGS will therefore grow slower than revenues.

EPS growth to slow to 11% in FY12E due to expiration of tax subsidies, which will lift the effective tax rate by 12.5 ppts.

Figure 6: China VTM Mining – Profit and Loss Statement (Common Size)

Year end 31 Dec., %	FY07	FY08	FY09	FY10E	FY11E	FY12E	FY07-12 Average
Revenue	100.0	100.0	100.0	100.0	100.0	100.0	100.0
COGS	(51.2)	(46.0)	(53.7)	(47.4)	(47.3)	(47.8)	(48.9)
Gross profit	48.8	54.0	46.3	52.6	52.7	52.2	51.1
Operating expenses	(27.8)	(11.7)	(8.9)	(7.5)	(6.4)	(5.6)	(11.3)
Other operating income	0.4	2.2	3.7	2.1	1.7	1.3	1.9
Operating profit	21.3	44.5	41.1	47.3	48.0	48.0	41.7
Finance expenses	(0.5)	(0.4)	(0.7)	(1.3)	(0.9)	(0.3)	(0.7)
PBT	20.6	44.1	40.3	45.9	47.1	47.6	40.9
Tax	(0.4)	(3.8)	(6.4)	(8.0)	(8.2)	(14.3)	(6.9)
Net profit	14.6	31.4	30.2	35.2	37.9	32.5	30.3

Sources: Bloomberg and Sun Hung Kai Financial

Gross margin is expected to be stable over FY10-FY12, along with ASPs. Unit costs are expected to stabilize as indicated by the 1H10 results.

Figure 7: China VTM Mining – Balance Sheet

As at 31 Dec., RMBm	FY07	FY08	FY09	FY10E	FY11E	FY12E	FY07-12 CAGR (%)
Cash and securities	7.6	133.1	1,884.0	1,337.4	919.0	1,315.3	180.4
Accounts receivable	0.0	87.6	137.4	188.9	244.5	315.7	910.3
Inventory	31.8	65.6	70.9	86.0	111.1	144.9	35.4
Other current assets	266.9	119.3	140.9	193.7	250.7	323.8	3.9
Total current assets	306.3	405.7	2,233.3	1,806.1	1,525.2	2,099.7	47.0
Net fixed assets	122.9	380.4	544.7	1,443.8	1,785.7	2,057.4	75.7
Other long-term assets	163.7	165.2	295.5	661.8	1,120.8	1,080.9	45.9
Total assets	592.9	951.3	3,073.5	3,911.7	4,431.7	5,237.9	54.6
Short-term debt	44.3	0.0	100.0	150.0	25.0	25.0	(10.8)
Accounts payable	64.4	108.0	85.9	94.4	121.9	158.9	19.8
Other current liabilities	193.2	181.9	275.0	293.6	340.0	393.8	15.3
Total current liabilities	301.9	290.0	460.9	537.9	486.9	577.7	13.9
Long-term debt	0.0	0.0	0.0	150.0	125.0	100.0	N/A
Other long-term liabilities	5.0	57.2	5.7	34.3	72.6	114.9	87.2
Total liabilities	306.9	347.2	466.6	722.2	684.5	792.6	20.9
Shareholders equity	286.0	604.1	2,606.8	3,189.4	3,747.2	4,445.3	73.1
Minorities	83.0	64.8	92.8	132.3	51.7	68.7	(3.7)
Total equity and liabilities	592.9	951.3	3,073.5	3,911.7	4,431.7	5,237.9	54.6

Sources: Bloomberg and Sun Hung Kai Financial

FY07 sales to Chuan Wei were on a cash basis, therefore no A/R.

Cash balance is expected to decline in FY11E due to the recently announced RMB595m of acquisitions. We also expect ~RMB450m capex for processing and pelletizing plants.

Fixed assets will increase, as VTM started building/buying processing and pelletizing plants in 2010.

Other long-term assets increase in FY10 due to the acquisition of mines with IPO proceeds.

Figure 8: China VTM Mining – Balance Sheet (Common Size)

As at 31 Dec., %	FY07	FY08	FY09	FY10E	FY11E	FY12E	FY07-12 Average
Total assets							
Cash and securities	1.3	14.0	61.3	34.2	20.7	25.1	26.1
Accounts receivable	0.0	9.2	4.5	4.8	5.5	6.0	5.0
Inventory	5.4	6.9	2.3	2.2	2.5	2.8	3.7
Other current assets	45.0	12.5	4.6	5.0	5.7	6.2	13.2
Total current assets	51.7	42.6	72.7	46.2	34.4	40.1	47.9
Net fixed assets	20.7	40.0	17.7	36.9	40.3	39.3	32.5
Other long-term assets	27.6	17.4	9.6	16.9	25.3	20.6	19.6
Total assets	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Total equity and liabilities							
Short-term debt	7.5	0.0	3.3	3.8	0.6	0.5	2.6
Accounts payable	10.9	11.4	2.8	2.4	2.8	3.0	5.5
Other current liabilities	32.6	19.1	8.9	7.5	7.7	7.5	13.9
Total current liabilities	50.9	30.5	15.0	13.8	11.0	11.0	22.0
Long-term debt	0.0	0.0	0.0	3.8	2.8	1.9	1.4
Other long-term liabilities	0.8	6.0	0.2	0.9	1.6	2.2	2.0
Total liabilities	51.8	36.5	15.2	18.5	15.4	15.1	25.4
Shareholders equity	48.2	63.5	84.8	81.5	84.6	84.9	74.6
Minorities	14.0	6.8	3.0	3.4	1.2	1.3	4.9
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 9: China VTM Mining – Cash Flow Statement

Year end 31 Dec., RMBm	FY07	FY08	FY09	FY10E	FY11E	FY12E
Profit before tax	75.7	348.8	436.6	684.3	908.1	1,185.6
Depreciation and amortization	11.6	26.6	42.5	96.6	144.6	164.6
Change in WC	(180.1)	72.1	(106.1)	(90.6)	(63.6)	(87.3)
Other adjustments	(4.1)	(24.5)	(31.0)	(73.1)	(102.7)	(295.4)
Cash flows from operations	(96.9)	423.0	342.1	617.2	886.4	967.6
Capex	(31.7)	(184.6)	(276.4)	(963.3)	(446.5)	(396.5)
Other adjustments	(4.5)	(82.5)	(51.4)	(398.7)	(595.4)	0.0
Cash flows from investing	(36.2)	(267.1)	(327.7)	(1,362.0)	(1,041.9)	(396.5)
Shares issues/(purchases)	0.0	0.0	1,661.7	0.0	0.0	0.0
Dividends	0.0	0.0	(20.0)	0.0	(110.1)	(146.1)
Change in debt	0.0	(30.0)	100.0	200.0	(150.0)	(25.0)
Cash flows from financing	137.4	(30.5)	1,736.6	198.2	(262.9)	(174.8)
Cash at beginning of year	3.3	7.6	133.1	1,884.0	1,337.4	919.0
Change in cash	4.3	125.5	1,750.9	(546.6)	(418.4)	396.3
Cash at end of year	7.6	133.1	1,884.0	1,337.4	919.0	1,315.3

Sources: Bloomberg and Sun Hung Kai Financial

Figure 10: China VTM Mining – Key Ratios

Year end 31 Dec.	FY07	FY08	FY09	FY10E	FY11E	FY12E	FY07-12 Average
Profitability ratios							
Gross margin – %	48.8	54.0	46.3	52.6	52.7	52.2	51.1
Operating margin – %	21.3	44.5	41.1	47.3	48.0	48.0	41.7
Net margin – %	14.6	31.4	30.2	35.2	37.9	32.5	30.3
ROAA – %	13.4	32.2	16.3	15.0	17.5	16.7	18.5
ROAE – %	29.9	55.9	20.4	18.1	21.1	19.8	27.5
Other ratios							
A/R/sales – %	0.0	11.1	12.7	12.7	12.7	12.7	10.3
Capex/sales – %	8.6	23.3	25.5	64.7	23.2	15.9	26.9
Capex/depreciation – %	292.4	979.7	889.5	996.9	308.9	240.8	618.0
Net debt/equity (net cash) – %	12.8	(22.0)	(68.4)	(32.5)	(20.5)	(26.8)	(26.2)
Inventory/sales – %	8.7	8.3	6.5	5.8	5.8	5.8	6.8
Effective tax rate – %	1.8	8.6	16.0	17.5	17.5	30.0	15.2
Inventory turnover – days	50.8	49.0	42.8	40.6	39.4	39.3	43.6
A/R turnover – days	0.2	20.3	37.9	40.0	41.0	41.1	30.1
A/P turnover – days	88.9	79.3	60.3	45.6	42.1	41.9	59.7
Cash conversion cycle – days	(37.9)	(10.1)	20.4	34.9	38.4	38.4	14.0
ROAA component analysis							
Revenue/average assets – %	91.2	102.5	53.9	42.7	46.2	51.5	64.7
COGS/average assets – %	(46.7)	(47.2)	(28.9)	(20.2)	(21.9)	(24.6)	(31.6)
Gross profit/average assets – %	44.5	55.3	24.9	22.4	24.3	26.9	33.1
Operating expenses/average assets – %	(25.4)	(12.0)	(4.8)	(3.2)	(2.9)	(2.9)	(8.5)
Other operating income/average assets – %	0.3	2.2	2.0	0.9	0.8	0.7	1.2
Operating profit /average assets – %	19.5	45.6	22.1	20.2	22.2	24.7	25.7
Finance expenses/average assets – %	(0.5)	(0.4)	(0.4)	(0.6)	(0.4)	(0.2)	(0.4)
PBT/average assets – %	18.8	45.2	21.7	19.6	21.8	24.5	25.3
Tax/average assets – %	(0.3)	(3.9)	(3.5)	(3.4)	(3.8)	(7.4)	(3.7)
Net profit/average assets – %	13.4	32.2	16.3	15.0	17.5	16.7	18.5
ROAE component analysis							
Revenue/average equity – %	203.9	177.8	67.5	51.4	55.6	60.8	102.8
COGS/average equity – %	(104.4)	(81.8)	(36.3)	(24.4)	(26.3)	(29.0)	(50.4)
Gross profit/average equity – %	99.5	96.0	31.3	27.0	29.3	31.7	52.5
Operating expenses/average equity – %	(56.8)	(20.8)	(6.0)	(3.8)	(3.5)	(3.4)	(15.7)
Other operating income/average equity – %	0.8	3.8	2.5	1.1	0.9	0.8	1.7
Operating profit/average equity – %	43.5	79.0	27.8	24.3	26.7	29.2	38.4
Finance expenses/average equity – %	(1.1)	(0.7)	(0.5)	(0.7)	(0.5)	(0.2)	(0.6)
PBT/average equity – %	42.1	78.4	27.2	23.6	26.2	28.9	37.7
Tax/average equity – %	(0.8)	(6.8)	(4.3)	(4.1)	(4.6)	(8.7)	(4.9)
Net profit/average equity – %	29.9	55.9	20.4	18.1	21.1	19.8	27.5

Sources: Bloomberg and Sun Hung Kai Financial

Higher gross margin in FY10 due to 19%/14% higher ASP for iron concentrate/pellets vs. FY09.

ROE lower from FY08 due to larger reserves base built up from operations and IPO in FY09.

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