

# China Vanadium Titano-Magnetite

## Production loss to weigh on earnings

- We downgrade China Vanadium (VTM) to In-Line due to the lack of production growth; but we expect valuation support, given that net cash represents 50% of the share price.
- Given the suspension of production at the Baicao mine, we believe production will return to normal levels only in 2015, when iron ore prices could be weak due to increasing supply.
- The stock trades at 10.6x 2013E and 8.1x 2014E PER, based on our revised earnings, versus peers' average of 7.6x and 9.4x, respectively.

**Production loss at Baicao mine.** In July, China VTM announced that it had decided to suspend production at the Baicao mine (its biggest mine) for about one year, to explore niobium and tantalum resources (which could be economically mineable) at the mine. According to management guidance, the suspension could cut production by c.14% and c.12% in 2013 and 2014, respectively.

**Weak ASP in 1H13 due to a declining steel market.** In 1H13, the realised selling price of iron ore concentrate was c.RMB 594/t, down from RMB 608/t in 1H12. However, the selling price this year included some transport costs, which earlier used to be borne by clients. Therefore, the effective ASP fell c.10% YoY, compared with a 6% YoY decline at the Tangshan port.

**Increased production of higher-margin products.** Starting 2013, China VTM stopped producing medium-grade titanium concentrates; instead, it produces higher grades that enjoy a much higher margin. The contribution of ordinary iron ore from the Maoling mine also has a higher margin. However, the shift in the product mix is not enough to offset the production loss impact.

**Negative iron ore price outlook.** We think iron ore prices could be under pressure from 4Q13 owing to new supply. Our commodity team estimates that iron ore prices will average USD 127/t in 4Q13 (versus USD 134/t spot) and USD 120/t in 2014.

**Earnings revision.** We lower our 2013E and 2014E earnings by 41% and 17%, respectively, mainly due to the downward revision in our production volume and selling prices. Without M&A, we believe it will be difficult to achieve significant production growth (and, hence, earnings) over the next three years. We lower our PT to HKD 1.43 (from HKD 2.46) and downgrade the stock to In-Line.

## IN-LINE (from OUTPERFORM)

PRICE as of 12 Sep 2013

PRICE TARGET

**HKD 1.30**

**HKD 1.43**

### Bloomberg code

893 HK

### Reuters code

0893.HK

### Market cap

HKD 2,698mn (USD 348mn)

### 12-month range

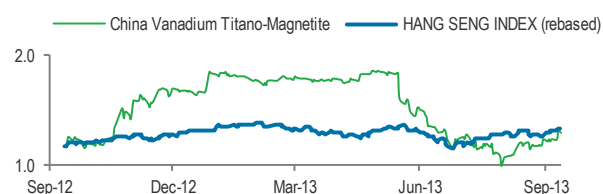
HKD 1.00 - 1.87

EPS adj. est. change 2013E nm 2014E nm

Year-end: December	2012	2013E	2014E	2015E
Sales (RMB mn)	1,534	1,490	1,998	2,086
EBITDA (RMB mn)	708	538	570	559
EBIT (RMB mn)	573	370	401	394
Pre-tax profit (RMB mn)	531	301	344	370
Net profit adj. (RMB mn)	403	203	260	283
FCF (RMB mn)	955	(79)	466	360
EPS adj. (RMB)	0.19	0.10	0.13	0.14
DPS (RMB)	0.00	0.02	0.03	0.03
Book value/share (RMB)	1.69	1.77	1.86	1.96
EPS growth adj. (%)	-33.5	-49.6	27.8	9.0
DPS growth (%)	nm	nm	27.8	9.0
EBITDA margin (%)	46.1	36.1	28.5	26.8
EBIT margin (%)	37.4	24.8	20.1	18.9
Net margin adj. (%)	26.3	13.6	13.0	13.6
Div. payout (%)	0.0	25.0	25.0	25.0
Net gearing (%)	-31.1	-26.3	-35.2	-40.4
ROE (%)	12.0	5.7	6.9	7.1
ROCE (%)	16.4	10.1	10.6	9.9
EV/sales (x)	1.1	0.8	0.4	0.2
EV/EBITDA (x)	2.4	2.2	1.3	0.7
PBR (x)	0.9	0.6	0.5	0.5
PER adj. (x)	<b>6.3</b>	<b>10.6</b>	<b>8.1</b>	<b>7.3</b>
Dividend yield (%)	<b>0.0</b>	<b>2.4</b>	<b>3.1</b>	<b>3.4</b>

Source: Company, Standard Chartered Research estimates

## Share price performance



Share price (%)	-1 mth	-3 mth	-12 mth
Ordinary shares	8	-4	11
Relative to index	5	-10	-3
Relative to sector	-	-	-
Major shareholder	Trisonic (48.4%)		
Free float	42%		
Average turnover (USD)	569,110		

Source: Company, FactSet

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## Production decline to weigh on earnings

### 1H13 earnings declined 43% YoY due to lower ASP

In 1H13, China VTM reported a net profit of RMB 126mn, down 43% YoY, which was largely due to lower selling prices of iron ore and high-grade titanium concentrates. If commodities prices were flat YoY, earnings would have been stable, in our view.

Figure 1: 1H13 P&L – A summary

RMB mn	1H13	1H12	YoY (%)
Revenue	837	774	8%
Gross profit	328	365	-10%
Gross margin	39%	47%	
SG&A	-108	-67	62%
SG&A/revenue (%)	13%	9%	
EBIT	220	298	-26%
EBIT margin	26%	39%	
Profit before tax	198	303	-34%
Tax	-70	-83	-16%
Tax rate	35%	27%	
Net profit attributable to shareholders	126	220	-43%
EPS (RMB per share)	0.09	0.09	0%

Source: Company, Standard Chartered Research estimates

**Iron ore prices fell due to a challenging steel market in Sichuan.** In 1H13, China VTM realised an ASP of RMB 594/t (excluding VAT) for vanadium-bearing iron ore concentrate, compared with RMB 608/t in 1H12. However, the selling price this year included some transport costs, which earlier used to be borne by clients. Therefore, the effective ASP declined c.10% YoY, compared with a 6% YoY decline at Tangshan Port. High-grade titanium prices also declined to RMB 870/t in 1H13 from RMB 1,296/t in 1H12.

**Pelletisation plant facing competition from steel mills.** China VTM shut down an old pelletisation plant in August (disposal loss negligible) and is currently maintaining just one pelletisation plant. However, the utilisation of this new plant was quite low in 1H13 (actual production was 25.7kt in 1H versus the total annual capacity of 1mt). The pelletisation market dropped steeply because steel mills raised their own pelletisation aggressively in 1H13 to cut costs in a weak market. We are concerned because if this situation continues, the company may need to do an asset write-down on this RMB 100mn-capex pelletisation plant.

**Production cost.** The unit production cost for vanadium-bearing iron ore concentrate rose to RMB 350/t in 1H13, from RMB 320/t a year ago, largely because the mine was getting deeper, and the grade, lower. Currently, it takes about 4.3 tonnes of raw ore (versus 4 tonnes last year) to produce 1 tonne of iron ore concentrate.

**Tax issues.** The effective tax rate in 1H13 was 35%, mainly because of a one-off retrospective provision of RMB 17mn for the Xiushuihe mine in 2012. In 2H13, we believe the company is likely to pay 25% on both Xiushuihe and Baicao mines, until they get approval from the tax bureaus for the 15% favourable tax rate for enterprises under the “Encouraged” category.



**Balance sheet.** China VTM's balance sheet remains in good shape, with net cash of about RMB 1bn (excluding pledged term deposits). The company is still working on acquiring a vanadium-bearing iron ore mine in the Panzhihua area. Exploration is still underway at the mine to quantify its resource and, therefore, the final selling price. In our view, it is too early to estimate the magnitude of the cash outlay for this acquisition.

**Accounts receivable.** In 1H13, receivables rose to RMB 184mn from RMB 109mn at end-2012. The increase in bills receivable led to an interest expense of RMB 36,500, on discounting those bills during the period.

#### **Business outlook: Production clouded by the exploration effort**

**Production loss at the Baicao mine.** Management announced in July that it had decided to suspend production at the Baicao mine to explore the potential ore resources of niobium and tantalum at the mine. As guided by management, the estimated production loss will be 300kt in 2H13 and 250kt in 1H14.

**Good progress at the Indonesian iron ore mine.** China VTM invested USD 30mn in this mine, with a 10mt p.a. capacity. The mine plans to produce c.1mt in 2013. Since China VTM has a small stake in the mine, the profit contribution is unlikely to be significant in 2013-14.

#### **Earnings revision**

We revise down our earnings estimate for 2013E and 2014E by 41% and 17%, respectively, largely because of the downward revision in our production volume and selling price assumptions. Without M&A, we believe it will be difficult to achieve significant production growth over the next three years.

**Figure 2: China VTM – Operating assumptions and P&L forecast**

	2012A	New 2013E	2014E	2015E	Old 2013E	2014E	2015E
<b>Production volume (kt)</b>							
Vanadium-bearing Iron concentrates	2,154	1,901	1,951	2,201	2,298	2,298	2,798
Iron pellet	700	50	500	500	1,000	1,000	1,000
Titanium concentrate - medium grade	5	-	-	-	45	45	45
Titanium concentrate - high grade	257	355	360	385	200	200	200
Ordinary Iron concentrates	47	50	500	500	50	100	150
<b>Sales volume (kt)</b>							
Vanadium-bearing Iron concentrates	1,454	1,851	1,451	1,951	1,298	1,298	1,798
Iron pellet	494	50	500	250	1,000	1,000	1,000
Titanium concentrate - high grade	148	355	360	385	200	200	200
Ordinary Iron concentrates	63	50	500	500	50	100	150
<b>Average selling price (RMB/t)</b>							
Vanadium-bearing Iron concentrates	600	550	538	527	560	560	560
Iron pellet	844	750	735	720	755	755	755
Titanium concentrate - high grade	1,175	870	783	783	1,250	1,125	1,125
Ordinary Iron concentrates	1,098	1,040	1,019	999	1,037	1,037	1,037
<b>Unit cost (RMB/t)</b>							
Vanadium-bearing Iron concentrates	317	355	373	384	333	349	349
Iron pellet	550	588	606	617	566	582	582
Titanium concentrate - high grade	563	570	599	616	591	621	621
Ordinary Iron concentrates	520	582	612	630	546	573	573
<b>P&amp;L</b>							
Revenue (RMB mn)	1,534	1,490	1,998	2,086	1,788	1,814	2,146
Gross profit (RMB mn)	693	572	633	631	629	581	710
Net profit (RMB mn)	403	203	260	283	348	314	392
EPS (RMB)	0.19	0.10	0.13	0.14	0.17	0.15	0.19

Source: Company, Standard Chartered Research estimates



Our downward revisions are partially offset by the higher production volume of high-grade titanium concentrate (which has a high margin) and by the small contribution from the Indonesian mine. Moreover, the contribution of ordinary iron ore concentrates from the Maoling mine also helps, as it carries higher margins than vanadium-bearing iron ore concentrates.

Based on our revised earnings estimate, without any M&A, we expect China VTM's 2015 earnings to be lower than its 2012 earnings, because of higher production costs and lower iron ore prices assumptions.

We estimate 2013-2015 earnings to render an ROE of 5.8-7.1%, or an ROCE of 13.1-13.7% (primarily because of the large net cash on the balance sheet). We think an ROCE of 13% in a down-cycle is decent, as long as the company effectively deploys the cash.

### Valuation

China VTM trades at 10.6x 2013E and 8.1x 2014E PER, based on our revised earnings, compared with peers' (mid-tier pure iron ore producers) average of 7.6x and 9.4x, respectively. We do not think the current share price is attractive, given no catalysts in sight.

We also revise down our DCF-based price target to HKD 1.43 from HKD 2.46, due to downward revisions in our operating assumptions (highlighted in Figure 2). Our new price target implies 11x 2013E and 9x 2014E PER. We think the current share price should be well supported, given that net cash represents nearly 50% of the current share price.



**Income statement (RMB mn)**

Year-end: Dec	2011	2012	2013E	2014E	2015E
Sales	1,713	1,534	1,490	1,998	2,086
Gross profit	827	693	572	633	631
SG&A	(149)	(164)	(234)	(273)	(303)
Other income	110	65	46	42	66
Other expenses	(19)	(21)	(14)	0	0
<b>EBIT</b>	<b>769</b>	<b>573</b>	<b>370</b>	<b>401</b>	<b>394</b>
Net interest	(21)	(43)	(70)	(57)	(25)
Associates	0	0	0	0	0
Other non-operational	0	0	0	0	0
Exceptional items	0	0	0	0	0
<b>Pre-tax profit</b>	<b>748</b>	<b>531</b>	<b>301</b>	<b>344</b>	<b>370</b>
Taxation	(135)	(120)	(95)	(81)	(83)
Minority interests	(7)	(8)	(2)	(3)	(3)
Exceptional items after tax	0	0	0	0	0
<b>Net profit</b>	<b>606</b>	<b>403</b>	<b>203</b>	<b>260</b>	<b>283</b>
<b>Net profit adj.</b>	<b>606</b>	<b>403</b>	<b>203</b>	<b>260</b>	<b>283</b>
<b>EBITDA</b>	<b>890</b>	<b>708</b>	<b>538</b>	<b>570</b>	<b>559</b>
EPS (RMB)	0.29	0.19	0.10	0.13	0.14
EPS adj. (RMB)	0.29	0.19	0.10	0.13	0.14
DPS (RMB)	0.07	0.00	0.02	0.03	0.03
Avg fully diluted shares (mn)	2,075	2,075	2,075	2,075	2,075

**Balance sheet (RMB mn)**

Year-end: Dec	2011	2012	2013E	2014E	2015E
Cash	947	1,649	1,519	1,920	2,209
Short-term investments	0	0	0	0	0
Accounts receivable	134	109	184	246	257
Inventory	137	180	173	258	275
Other current assets	261	392	392	392	392
<b>Total current assets</b>	<b>1,479</b>	<b>2,331</b>	<b>2,268</b>	<b>2,816</b>	<b>3,133</b>
PP&E	1,727	1,779	1,857	1,857	1,857
Intangible assets	592	582	536	493	455
Associates and JVs	0	0	0	0	0
Other long-term assets	660	725	725	725	725
<b>Total long-term assets</b>	<b>2,979</b>	<b>3,085</b>	<b>3,118</b>	<b>3,076</b>	<b>3,037</b>
<b>Total assets</b>	<b>4,458</b>	<b>5,416</b>	<b>5,386</b>	<b>5,892</b>	<b>6,170</b>
Short-term debt	322	467	467	467	467
Accounts payable	341	817	632	940	1,002
Other current liabilities	456	494	615	615	615
<b>Total current liabilities</b>	<b>1,119</b>	<b>1,778</b>	<b>1,714</b>	<b>2,022</b>	<b>2,085</b>
Long-term debt	101	79	79	79	79
Convertible bonds	0	0	0	0	0
Deferred tax	0	0	0	0	0
Other long-term liabilities	18	13	13	13	13
<b>Total long-term liabilities</b>	<b>119</b>	<b>92</b>	<b>92</b>	<b>92</b>	<b>92</b>
<b>Total liabilities</b>	<b>1,238</b>	<b>1,869</b>	<b>1,806</b>	<b>2,114</b>	<b>2,177</b>
Shareholders' funds	3,199	3,517	3,670	3,864	4,077
Minority interests	22	29	32	35	38
<b>Total equity</b>	<b>3,221</b>	<b>3,546</b>	<b>3,701</b>	<b>3,899</b>	<b>4,115</b>
<b>Total liabilities and equity</b>	<b>4,458</b>	<b>5,416</b>	<b>5,508</b>	<b>6,013</b>	<b>6,291</b>
Net debt (cash)	(524)	(1,103)	(973)	(1,374)	(1,662)
Year-end shares (mn)	2,075	2,075	2,075	2,075	2,075

Source: Company, Standard Chartered Research estimates

**Cash flow statement (RMB mn)**

Year-end: Dec	2011	2012	2013E	2014E	2015E
EBIT	769	573	370	401	394
Depreciation & amortisation	122	134	167	169	165
Net interest	(20)	(12)	(70)	(57)	(25)
Tax paid	(124)	(112)	(95)	(81)	(83)
Changes in working capital	(63)	525	(252)	161	34
Others	5	(18)	0	0	0
<b>Cash flow from operations</b>	<b>688</b>	<b>1,090</b>	<b>121</b>	<b>593</b>	<b>486</b>
Capex	(244)	(136)	(200)	(127)	(127)
Acquisitions	(344)	(61)	0	0	0
Disposals	0	0	0	0	0
Others	(459)	(705)	0	0	0
<b>Cash flow from investing</b>	<b>(1,046)</b>	<b>(902)</b>	<b>(200)</b>	<b>(127)</b>	<b>(127)</b>
Dividends	(108)	(122)	(51)	(65)	(71)
Issue of shares	0	0	0	0	0
Change in debt	91	122	0	0	0
Other financing cash flow	(100)	(10)	0	0	0
<b>Cash flow from financing</b>	<b>(117)</b>	<b>(10)</b>	<b>(51)</b>	<b>(65)</b>	<b>(71)</b>
<b>Change in cash</b>	<b>(475)</b>	<b>179</b>	<b>(130)</b>	<b>401</b>	<b>289</b>
Exchange rate effect	0	0	0	0	0
<b>Free cash flow</b>	<b>445</b>	<b>955</b>	<b>(79)</b>	<b>466</b>	<b>360</b>

**Financial ratios and other**

Year-end: Dec	2011	2012	2013E	2014E	2015E
<b>Operating ratios</b>					
Gross margin (%)	48.3	45.2	38.4	31.7	30.2
EBITDA margin (%)	52.0	46.1	36.1	28.5	26.8
EBIT margin (%)	44.9	37.4	24.8	20.1	18.9
Net margin adj. (%)	35.4	26.3	13.6	13.0	13.6
Effective tax rate (%)	18.0	22.6	31.6	23.6	22.5
Sales growth (%)	10.2	-10.5	-2.8	34.1	4.4
Net income growth (%)	13.6	-33.5	-49.6	27.8	9.0
EPS growth (%)	13.6	-33.5	-49.6	27.8	9.0
EPS growth adj. (%)	13.6	-33.5	-49.6	27.8	9.0
DPS growth (%)	17.7	nm	nm	27.8	9.0
<b>Efficiency ratios</b>					
ROE (%)	20.3	12.0	5.7	6.9	7.1
ROCE (%)	24.6	16.4	10.1	10.6	9.9
Asset turnover (x)	0.4	0.3	0.3	0.4	0.3
Op. cash/EBIT (x)	0.9	1.9	0.3	1.5	1.2
Depreciation/capex (x)	0.5	1.0	0.8	1.3	1.3
Inventory days	42.6	68.9	70.2	57.6	66.8
Accounts receivable days	36.4	29.0	35.9	39.3	44.0
Accounts payable days	122.7	251.4	288.0	210.2	243.5
<b>Leverage ratios</b>					
Net gearing (%)	-16.3	-31.1	-26.3	-35.2	-40.4
Debt/capital (%)	12.7	15.0	14.9	14.1	13.4
Interest cover (x)	36.4	13.5	5.3	7.0	16.0
Debt/EBITDA (x)	0.4	0.7	1.0	1.0	1.0
Current ratio (x)	1.3	1.3	1.3	1.4	1.5
<b>Valuation</b>					
EV/sales (x)	2.2	1.1	0.8	0.4	0.2
EV/EBITDA (x)	4.1	2.4	2.2	1.3	0.7
EV/EBIT (x)	4.8	3.0	3.2	1.8	1.0
PER (x)	7.2	6.3	10.6	8.1	7.3
PER adj. (x)	7.2	6.3	10.6	8.1	7.3
PBR (x)	0.8	0.9	0.6	0.5	0.5
Dividend yield (%)	3.5	0.0	2.4	3.1	3.4

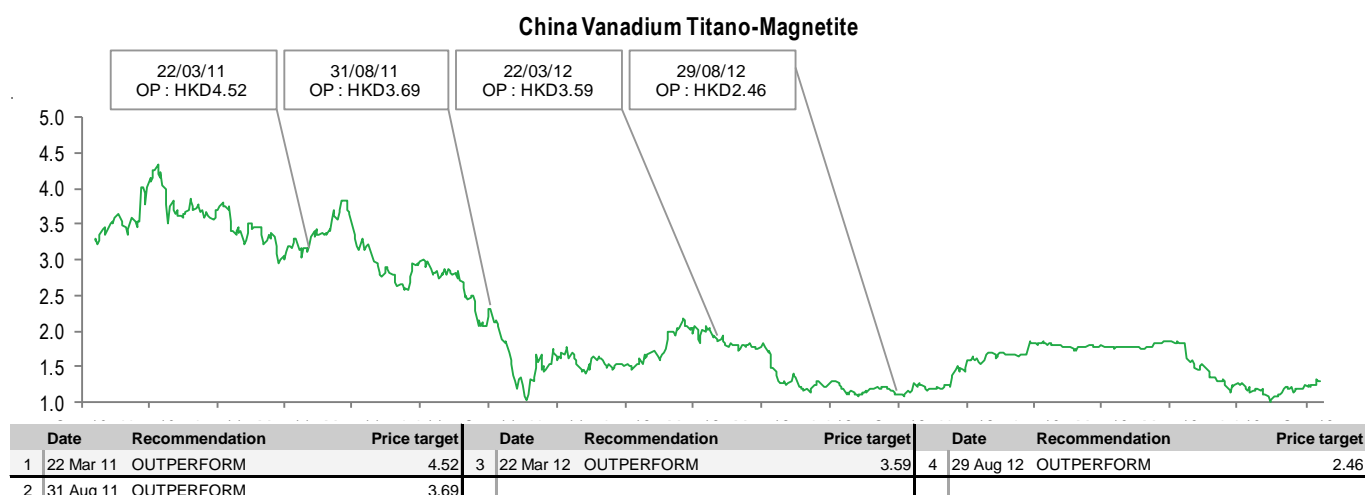


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Source: FactSet prices, SCB recommendations and price targets

### Recommendation Distribution and Investment Banking Relationships

	% of covered companies currently assigned this rating	% of companies assigned this rating with which SCB has provided investment banking services over the past 12 months
OUTPERFORM	52.6%	14.3%
IN-LINE	34.3%	16.1%
UNDERPERFORM	13.1%	9.0%

As of 30 June 2013

### Research Recommendation

Terminology	Definitions
OUTPERFORM (OP)	The total return on the security is expected to outperform the relevant market index by 5% or more over the next 12 months
IN-LINE (IL)	The total return on the security is not expected to outperform or underperform the relevant market index by 5% or more over the next 12 months
UNDERPERFORM (UP)	The total return on the security is expected to underperform the relevant market index by 5% or more over the next 12 months

SCB uses an investment horizon of 12 months for its price targets.

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