IRC

Adverse iron ore price movement downgrading to Hold

to summarize

- **IRC reported turnover dropped by 4% YoY to US$51.7m, while net loss was US$19.8m as compared to previous profit of US$3.7m.**
- **Turnover was 2% worse than our adjusted estimation, while net profit before tax was 51% worse than our estimate.**
- **Iron ore spot price presented a sharp decrease since beginning of 2H. The current China import 62% Fe spot price in Tianjin port is US$106.4/t**
- **We downgrade IRC rating to HOLD at target price HK$1.12 from HK$1.37 to reflect the worse than expected iron ore spot price movement in June and July.**

1H result summary. IRC reported its interim result on Wednesday followed by a profit warning on 12 July 2012. Turnover dropped by 4% YoY to US$51.7m, which consisted of iron ore sales of US$51.7m (dropped by 4% YoY) and turnover from engineering of US$5.3m (dropped by 19% YoY), while net loss was US$19.9m as compared to previous profit of US$3.6m. The net loss was largely resulted from the decline of iron ore concentrate price as well as one-off impairment loss on a early stage JV investment due to uncertainty of project prospect. Iron ore concentrates ASP dropped by 17% YoY to US$121.8/t from US$146.8/t. Yet, production volume increased by 23% YoY/dropped by 4% HoH to 432,310 tonnes, and sales volume increased by 16% YoY/by 5% HoH to 424,000 tonnes, whereas ilmenite concentrate production volume increased by 1.5x YoY/34% HoH to 55,445 tonnes while sales volume increased by 3.6x YoY/32% HoH to 52,966 tonnes. The increase on year over year basis was largely as a result of production ramp up in 1H period. Table 1 summarized 1H operational result comparison:

Table 1. 1H Operating Result

	1H 11A	2H 11A	1H 12A	YoY	HoH
Prod volume					
iron ore	349,236	451,055	432,310	24%	(4%)
ilmenite	22,172	41,319	55,445	150%	34%
Sales volume					
iron ore	366,984	403,103	424,000	16%	5%
ilmenite	11,515	40,222	52,966	360%	32%

Source: SBI E2-Capital

Development progress update. K&S project development is largely in line with plan as mentioned in the profit warning announcement update, that management is still confident to commence production of the project in 2014F. In terms of the new ilmenite separators in Kuranakh, management expects the new separators will arrive in August 2012.Given the actual production for 1H of 55,445 tonnes with the new separators arrived on time in Aug, we believe that IRC is capable to achieve 2012 production target of 125,000 tonnes of ilmenite concentrate.

Our view and expectation. Operating result was mostly in line with our expectation. However, financial result was worse than our previous forecast. One of the reasons was that we didn't anticipate by-product credit for ilmenite result in our financial model. (more comprehensive comparison made on page 2 of this report). The net loss before tax was 51% higher than our estimate. Despite, challenging environment for metal miners, we continue to see IRC as having a good potential to become a good mid size player in the market. However, June and July iron ore spot price did not recover as expected and continue to drop in August. China import 62% Spot price of 62% iron ore imports into China dropped sharply since the beginning of the 2H 12A to current US$106.4/t, which was 18% lower than management expectation and our low-end forecast, and is closing to our floor price estimate of US$100/t. Since, there is no sign of price recovery in the near term. We downgraded IRC rating to HOLD at target price HK$1.12 (down 18%)

Ticker	**1029 HK**
Rating	**HOLD**
Price (HK$)	0.70
Target Price (HK$)	1.12
12m Price Range (HK$)	0.64–1.59
Market cap. (US$m)	313.6
Daily t/o (US$m)	0.2
Free float (%)	29.2

Financial summary

Year to Dec	**11A**	**12F**	**13F**	**14F**
Turnover (US$m)	122.2	113.1	119.8	236.8
Net Profit (US$m)	1.6	(32.5)	(29.7)	(6.1)
EPS (US$)	0.03	(0.97)	(0.88)	(0.18)
P/E (x)	196	-	-	-
P/B (x) pre-CB	0.38	0.39	0.41	0.41
EV/EBITDA (x)	-	-	52.6	17.2
Yield (%)	-	-	-	-
ROE (%)	-	(4)	(4)	(1)
ROCE (%)	-	(3)	(2)	2
N. Gear. (%)	Cash	7	30	42

Source: SBI E2-Capital

	12F	**13F**	**14F**
Consensus EPS (US$)	(0.0)	0.02	0.02
Previous earnings (US$m)	-	-	-
Previous EPS (US$)	-	-	-

Price performance

Year to Dec	**1m**	**3m**	**12m**
Relative to HSI (%)	(21.4)	(34.1)	(56.9)
Actual price changes (%)	(21.2)	(39.1)	(63.4)

Source: Bloomberg

Isaac Lau
(852) 2533 3723
Isaaclau@sbie2capital.com

Please refer to important disclosures at the end of this report

Comparison between the first half result and our previous estimate: The reported ilmenite sales contribution during the period increased to US$9m from US$1.7m, while the ilmenite sales was 52,966 implied an average realized gain of US$170/t. Our estimation of total turnover for ilmenite was US$15.7m and total expenses for ilmenite was US$5.3m, which implied ilmenite sales contribution of US$10.4m or average realized gain of US$196.8/t which was 14% lower than actual value. The difference was largely due to higher than expected transportation costs by US$6/t to US$46/t and decrease of expected ASP of ilmenite by US$21/t. Yet, mining cash cost is higher than the expected, the actual mining cash cost excluding railway cost was US$28.2m/US$66.5/t as compared to our estimate of US$25.4m/US$60/t, implied 11% higher than our estimation. Yet, we forecast a profit of US$1.7m share result from the vanadium JV, as compared to the actual share loss of US$1.9m. Three major items add up a total difference of US$7.8m representing the majority of the difference between forecast and actual net profit before of US$6.6m. Table 2 illustrates the detail breakdown of comparison:

Table 2. Our 1H forecast result (adopted by-product credit teretment) and actual 1H result breakdown and comparison

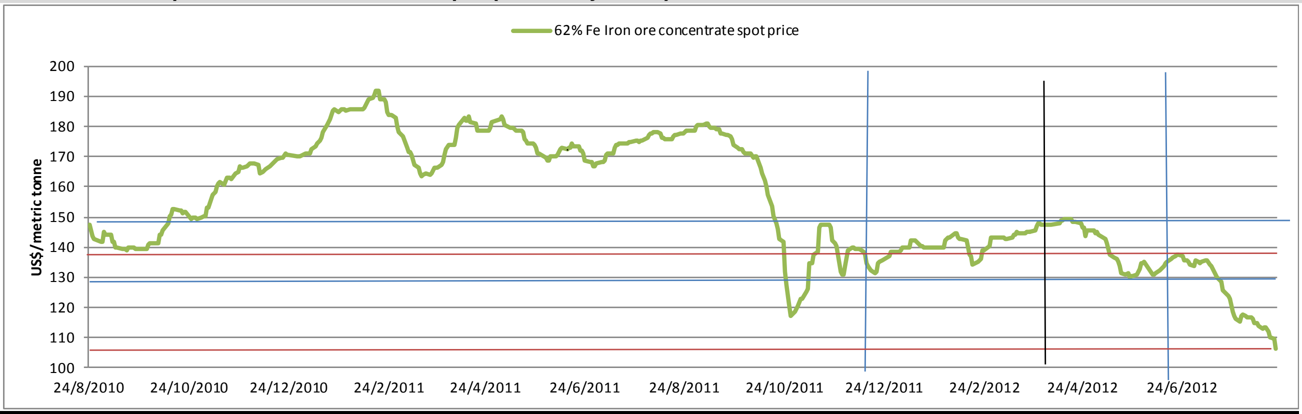
US$m	1H FY12F	+/-	1H 12A	Differ (%)
Turnover	57.97		56.95	-2%
Mining	51.67	(0.02)	51.66	0%
Engineering	6.30	(1.01)	5.29	-16%
Impairment charges	(6.06)	(0.00)	(6.06)	0%
Operating expense:				
Site operating expenses and service costs	(51.88)		(54.28)	5%
Mining cash cost	*(25.44)*	*(2.76)*	*(28.20)*	*11%*
contribution from ilmenite concentrate by-product	*10.42*	*(1.42)*	*9.00*	*-14%*
Central administrative expenses	(13.25)	(0.52)	(13.77)	4%
Operating loss	(13.22)		(17.16)	30%
Share results of JV	1.73	(3.60)	(1.88)	-209%
Others	(1.65)	(0.98)	(0.67)	-59%
Net profit before tax	(13.15)	(6.56)	(19.70)	50%

Source: SBI E2-Capital

By-product accounting treatment. IRC adopted by-product credit accounting treatment for ilmenite in accordance to IASB. Costs of conversion of each product are not separately identifiable. They are allocated between the products on a rational and consistent basis. The accounting treatment for inventory are measured at net realizable value and the value is deducted from the cost of the main product (i.e. inventory sales value – estimated cost of completion and disposal), while the treatment in P&L is to report as a sub-item under operating expense that net of tariff and other railway changes.

Iron ore price trend and impact on company's 2H ASP. Illustrated in table 3 below, China import iron ore spot price presented a sharp decline since the beginning of second half. The average daily spot price in July and August to date were US$127.9/t and US$113.6/t respectively, as compared to 2Q average of US$139.4/t. Yet, as mentioned in the previous report, IRC's selling price bases in accordance to the previous quarter spot price. Hence, the July and August results are likely to be reflected on 4Q ASP. Given that IRC's iron concentrate's products are trading at a discount of spot price due to the grade and purity of the product, we forecast that the IRC's ASP for iron ore concentrate will be roughly US$120/t in 3Q and US$100/t 4Q 12F.

Table 3. China Import Iron Ore Fine 62% Fe Spot (CFR Tianjin Port) US$/Metric Tonne



Source: SBI E2-Capital

Downgrade to HOLD recommendation at target price HK$1.12 as a result of worse than expected iron ore price movement. The decrease in spot price at the first two months exceeded our expectation, while there is no indication that the price will resume in the short-run. Although we are confident that the long-run average price will maintain at low-end US$130/t as discussed in the coverage report, we concern that continuous sluggish commodity price trend might result to flat share price movement during 2H period. Yet, we expect another profit warning for year end result due to 1) previous annual 'accounting' profit to this year annual net loss 2) operating loss in 4Q (4QF IRC's iron ore ASP: US$100/t – (Mining cash cost: US$65/t + Railway cost: US$46/t) = Net operating loss: (US$11)/t), and therefore we lowered our target price to HK$1.12 with HOLD rating. Table 4 illustrats our estimate of next 3 year financial performance which is adjusted for the by-product credit accounting treatment:

Table 4. Our P&L estimate for next three years

US$'m	10A	11A	12F	13F	14F
Revenue	25.8	122.2	113.1	119.8	236.8
- Mining			*101.3*	*108.0*	*225.0*
- Engineering			*11.8*	*11.8*	*11.8*
Impairment charges	(36.0)		*(6.0)*	*0.0*	*0.0*
Operating expenses	(71.8)	(90.1)	(132.6)	(138.4)	(219.2)
Share of results of an associate		0.1	0.0		
Share of results of joint ventures	0.0	(0.5)	0.0	3.5	3.5
Net operating loss	(0.1)	(9.6)	(25.5)	(15.2)	21.0
Other gains and losses and other expenses	(71.9)	12.7			
Financial income	(5.6)	0.7			
Financial expenses	10.9	(0.6)	(5.0)	(12.5)	(24.7)
Profit (Loss) before taxation	(11.8)	3.3	(30.5)	(27.7)	(3.6)
Taxation credit/(expense)	(78.4)	(1.7)	(2.0)	(2.0)	(2.5)
Profit/(loss) for the year/period	(3.7)	1.6	(32.5)	(29.7)	(6.1)

Source: SBI E2-Capital