

China Hongqiao

Most profitable Aluminum producer in China

Company overview. China Hongqiao, a Shongdong-based aluminum producer, produced 1,585.8k tons of aluminum products in 11A ranked as the fourth largest in China. Hongqiao has been developing upstream business via building own power plants and alumina refinery plants. By the end of 2011, the in-house power capacity reached 1,740MW, covering 44% of total power usage. Hongqiao also secured a long term supply contract with strategic alliance that provides alumina and power supply at a discount to the market price. The distinguished business model secures China Hongqiao's position as one of the cost leaders among major aluminum producers in the world. China Hongqiao listed on HKEx on 11 Feb 2011 at listing price HK\$7.2 and priced at 7.0x 10A P/E raising net proceeds of HK\$931.3m.

To summarize...

- Recent China's Car Dealerships are struggling as stockpiles increase along with depress real estate performance in China, might suggest weakening future demand for aluminium projects.
- Commodity price was generally adversely affected by Marco-economy factors; the LME 3 Months forward price for aluminium alloy is trading below US\$1,950/t.
- China Hongqiao is the best performer among peers in terms of financial performance in FY12/11A. While most producers are expected to be loss making for 1H FY12/12F, we believe Hongqiao will continue to be one of the few profit making players in the industry under the crisis.
- Integrating into upstream business, Hongqiao continues to expand its power capacity to 2,730MW by the end of this year, and will complete 2m tons alumina refinery plant in 1H FY12/12F.

Strong position in the operating regions with strong backup. China Hongqiao possesses a very unique business model. Hongqiao is the fourth largest aluminum producer in China. The parent company of Weiqiao Pioneering Group employs over 160,000 employees, whereas the entire population in Zhouping is around 730,000 people. The major shareholder of the company is actually ranked as the richest person in Shandong and within top 20 in China.

Strategic alliance supplies major raw material at a discount to market. China Hongqiao has the ability to survive (profit making) under current economic crisis due to numerous factors. First of all, company is able to purchase key raw materials at low cost. Gaoxin Aluminum & Power is the Hongqiao sole and key supplier of alumina and electricity. Gaoxin sells alumina products at a around RMB500/t discount to market price, while Gaoxin also sells off-grid electricity at tax inclusive price RMB0.34/kWh.

Self-owned power grid, and in house power generation. When people are taking about the electricity, they often mention a term 'Weiqiao Mode (魏桥模式)'. Weiqiao actually provides electivity to local household at the price 1/3 below that state grid charge. Weiqiao (2698 HK) is actually a sister company of Hongqiao, and they share the private power grid and electricity network. The private network can eliminate/avoid paying additional wheedling cost of RMB0.15-02/kWh for off-grid electricity charges. Hongqiao has the power generation capacity to cover around 45% of power usage in 11A, and expects further increase to 55%, 70% in 12F and 13F respectively.

Valuation. The distinguished business model provides the company with better resistance against undesirable changes in ASP and COGS than peers. According to Bloomberg consensus, the current P/E and 12F P/E are trading at 3.0x and 2.8x respectively.

Ticker	1378 HK
Rating	Noted Rated
Price (HK\$)	3.73
Target Price (HK\$)	-
12m Price Range (HK\$)	3.43-7.85
Market cap. (US\$m)	2,814.2
Daily t/o (US\$m)	1.3
Free float (%)	15

Financial summary

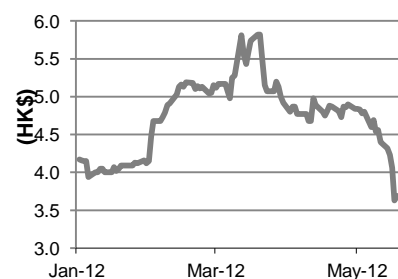
Year to Dec	09A	10A	11A
Turnover (RMBm)	8,668	15,131	23,626
Net Profit (RMBm)	577	4,165	5,875
EPS (RMB)	0.1	0.8	1.0
P/E (x)	40.4	5.4	3.8
P/B (x)	32.0	4.3	3.0
EV/EBITDA (x)	20.7	3.3	2.1
Yield (%)	-	-	9%
ROE (%)	20%	80%	46%
ROCE (%)	26%	80%	49%
N. Gear. (%)	132%	19%	N. Cash

Source: SBI E2

	12F	13F	14F
Consensus EPS (RMB)	1.06	1.25	1.4
Previous earnings (RMBm)	-	-	-
Previous EPS (RMB)	-	-	-

Price performance

Year to Dec	1m	3m	12m
Relative to HSI (%)	(15.7)	(18.1)	(40.4)
Actual price changes (%)	(23.6)	(27.6)	(51.1)



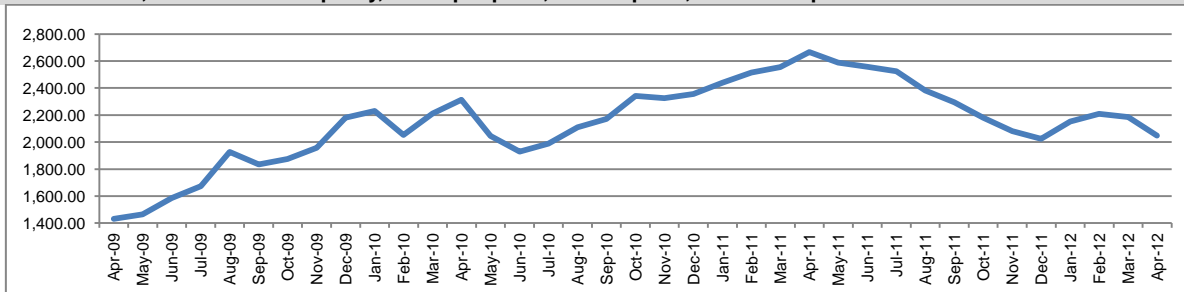
Source: Bloomberg

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Market sentiment. Aluminum spot price has been adversely affected the worries of future global economy growth. The spot price dropped from the peak at around US\$2.7k/t in April and hit year low at US\$2.0k/t in Dec 2011. The LME spot price then gradually recovered to around US\$2.2k/t during 1Q 12A, but subsequently moving toward the previous year low in April due to the intension in EU sovereign debt crisis. World leading aluminum producers, such as CHALCO (2600 HK), reported a negative cash flow from operating activities of RMB2.0b as well as operating loss of RMB1.5b for 1Q FY12/12A, as a result of decline in ASP and increase in operating expenses. The overall industry, since 2H FY11A, has been suffered due to low selling price coupled with increase in various operating costs while there is no sign that the demand is going to recover anytime soon, overall market sentiment is fairly bearish.

Table 1. Aluminum, 99.5% minimum purity, LME spot price, CIF UK ports, US Dollars per Metric Ton

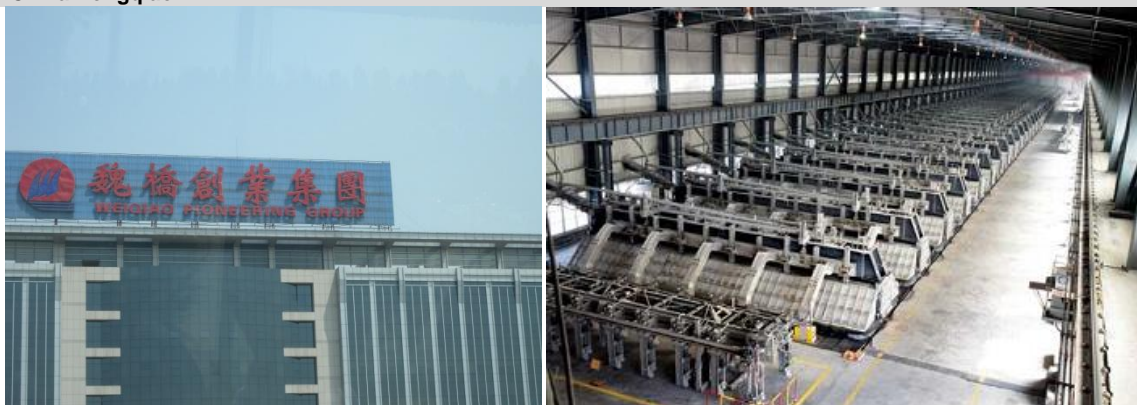


Source: SBI E2

Aluminum, similar to other base-metals, is considered as an integrated part of the economy development. The industry is fairly consolidated, top ten suppliers accounted for over 60% of market share. Most of the aluminum products consume in the construction sector followed by electronics and auto industry, which are closely correlated to the economy growth. Therefore, spot price often traded bases on the future economy expectation. The production of aluminum is cost intensive (very similar to steel industry), that requires huge amount of electricity power as well as stable supply of alumina (major raw material). Alumina supply (and Bauxite) is sufficient in China, especially in Shongdong where Hongqiao operates, whereas power supply in China is asymmetrical between regions and insufficient as a whole. The rapid growth in economy, especially the manufacturing segment, led to high coal price, and consequently upward price pressure on electricity charges.

Seaborne Alumina Supply concern – Supply from Indonesia. Indonesia is the largest alumina supplier for China market. Indonesia has been increasing restriction on material export. On 6th May 2012, 14 Indonesia banned exports of 14 raw minerals including alumina, with an exception for miner that plan to build local processing facilities. The miners will be taxed 20% on ore shipments. It is said that Indonesia may forbid completely export of alumina in 2014. Currently, around 80% of alumina seaborne supply imported from Indonesia, while roughly 60% of total alumina supply is import. Effectively, 48% of total alumina consumption was provided by Indonesia.

Table 2. China Hongqiao



Source: SBI E2

Strategic partnership with Chuangye Group and Gaoxin Aluminum & Power. Chuangye Group (Chuangye) and Gaoxin Aluminum & Power (Gaoxin) are the key of raw material and electricity suppliers to the company. Gaoxin, is an SOE engaged in alumina refinery and power generation business, is the sole supplier of alumina products and major electricity (roughly 60%) supplier for Hongqiao whereas Chuangye Group is a connected party to the company. 33.7% of equity interest is owned by major shareholder of Hongqiao Mr Chang. Chuangye used to be the sole alumina supply of the company prior to dispose entire alumina segment to Gaoxin at year end of 2010A for a consideration of RMB3.1b, and currently sells 'Carbon Anode Black' to China Hongqiao. For the period between 2007 and 2009, Chuangye is the sole alumina supplier and sold to Hongqiao at cost price, while Hongqiao has been selling steam, as a byproduct of in house power generation, to Chuangye. The sales of stream contributed 3% (RMB697m) of total revenue in FY12/11A. After the disposal, Gaoxin entered into a sales contract agreement (will expire on 24th Dec 2012) with Hongqiao and became the sole alumina supplier. Pursuant to the contract, Gaoxin will supply 1m tons of alumina products at a discount to market price (roughly RMB500/t discount), in exchange, Hongqiao will prepay RMB400m every year in advance. Gaoxin is also the company's major power supplier that Gaoxin agreed to sell off-grid electricity at tax inclusive price RMB0.34/kWh, as long as the 5,000karl coal selling price floats within the range between RMB560/t and RMB840/t. The selling price is around 16% discount as compared to market off-grid price. Hongqiao will prepay for the electricity costs every month and adjust the difference afterwards. This strategic relationship is one of the major cost advantages over the peers.

Table 3. New 330MW power plant



Source: SBI E2

Private power grid and in-house power generation. Another distinguish advantage of the company is private power grid. According to the management, they are the only one aluminum producer owned a private grid in the industry. As mentioned previously, electricity is the major cost component in aluminum production, which can be as high as 50% out of total cost. On the other hand, electricity supply in China is strictly controlled by the government. In fact, on-grid supply is monopoly by a SOE, namely State Grid. Normally, there are two options in electricity supply, 1) purchase directly from State grid at on-grid price around average RMB0.55/kWh or 2) via a direct supply agreement with power generating companies at the agreed price (around RMB0.405/kWh), on top of that, customers will have to pay RMB0.15-0.20/kWh to State Grid for wheeling fee. We consider the private power grid is the major competitive of Hongqiao over the peers. China Hongqiao has its own power plant. The current in-house power capacity is 1,740MW, which will further increase by 990MW to 2,730MW by the end of 12F. Taken into account of rump up in production, we expect in house electricity supply will cover 55% in 12F and 70% in 13F of total power usage.

Cost allocation. China Hongqiao has distinguished advantages in both energy and raw materials costs over the peers. The FY12/11A COGS is around RMB9,409/t for FY12/11A, up by 12% due to increase in both alumina cost and increase in coal price. The largest portion of COGS is raw materials cost, such as alumina, carbon anode black, water for processing and transportation, accounted for 57.2% COGS i.e. RMB5,384/t then following by energy costs, which accounted for 38% of COGS or RMB3,578/t. Other expenses, such as depreciation and administrative expenses, was around RMB447/t or 4.8% of COGS, adding up to the total cost of RMB9,409/t. Table 2 below, we hypothesise that the cost changes when the absence of Gaoxin transaction in cash base for FY12/12F.

Table 4. Cost breakdown

Implied COGS per ton (RMB)		Private Grid(55% in-house/45% other)		State Grid (55% in-house/45% other)	
		Gaoxin	Ind. Avg	Off Grid	On Grid
Alumina	Gaoxin	9,422	9,784	11,941	12,243
	Spot Price	10,367	10,729	12,886	13,187

Source: SBI E2-Capital

We examine the COGS per ton changes under different scenario in 2012F based on 2011 data. We believe the worst case scenario would be termination of the co-operation contract with Gaoxin. Consequently, implied COGS would increase by 14% to RMB10,729/t, leading to the implied gross profit margin decrease to around 25~26%. We also simulate COGS per ton for normal aluminum producer that purchase electricity from State Grid and alumina at spot price, the result showed the COGS per ton would be over RMB13,000/t. Given the 1Q 2012A aluminum spot price was trading below RMB13,860/t, it is reason to say most alumina producer will record a net loss due to insufficient return to cover overhead expenses or even recording a gross loss.

In fact, during 2H FY12/11A most of the aluminum producers were already loss making. The table below illustrates the financial performance of large cap aluminum producers in HK. The competitive cost structure of Hongqiao gives good defensive in changes in ASP among peers. Table 5 showed the net margin for Hongqiao was significantly higher than peers.

Table 5. Peers comparison

Name	Ticker	Mkt Cap	P/E 11A	P/E 12F	GM 11A	GM 10A	Chg %	PM 11A	PM 10A	Chg %
Hongqiao	1378 HK	HK\$28.6b	3.3	3.7	34.6	37.9	(3.3)	24.9	27.7	(2.86)
Chalco	2600 HK	HK\$99.7b	155.8	-	5.3	6.3	(1.0)	0.2	0.6	(0.48)
Rusal	0486 HK	HK\$85.1b	31.7	7.0	28.5	31.7	(3.2)	1.9	26.1	(24.19)
Average			63.6	5.4	22.8	25.3	(2.5)	9.0	18.2	(9.2)

Source: Bloomberg

Expansion plan. Hongqiao aimed to become vertically integrated aluminum producer with cost leading position. They have integrated into in-house power generation. Three new 330MW power plants will be constructed by the end of this year, of which two have completed. Upon the completion of all three power plants, the total in-house power capacity will further increase to 2,730MW. As the new power generation capacity ramped up, management expects self-statistical power supply will increase to 55% in 12F and 70% in 13F. Company is constructing alumina refinery plant. The construction progress is on schedule and already reached the capacity to produce 0.42m tons of alumina. It is expected to reach the designate capacity of 0.83m tons at 1H FY12/12F. In terms of aluminum production expansion, the targeted production output will increase to 1.7m tons in 12F and 1.8m tons in 13F. Table 6 illustrated the bottom up analysis of major raw material and energy volume supply to meet the 12F and 13F aluminum volume.

Table 6. Major raw material volume forecast

Details	11A	12F	13F
Aluminum Production Volume mt	1.6	1.7	1.8
Alumina mt	3.0	3.2	3.4
Bauxite mt	7.1	7.7	8.2
Electricity Usage (kWh)	20,984	22,780	24,120

Source: SBI E2

Major Shareholder Background. Mr. Zhang Shiping is the chairman and controlling shareholder of the company, who currently owned 82% of diluted share capital of the company. He is also the major shareholder and chairman of another HK listco, namely Weiqiao Textile Company Limited (2698 HK) which is the largest textile company in China, and the chairman of the Chuangye Group. Mr Zhang has engaged in aluminum industry since 2006. He was also a deputy to the 9th and 10th National People's Congress. Mr Zhang ranked as the richest person in Shandong and within top 20th in China with total net worth roughly RMB30b.

Financial Informational .

Table 7. Selected income statement items

RMB m	FY12/09A	FY12/10A	FY12/11A
Revenue	8,668	15,132	23,626
Gross profit	899	5,742	8,176
Profit before tax	774	5,585	7,954
Total net profit	577	4,165	5,875
Gross margin	10%	38%	35%
EBIT margin	10%	38%	35%
EBT margin	9%	37%	34%
Net margin	6%	28%	25%

Table 8. Selected balance sheet items

RMB m	FY12/09A	FY12/10A	FY12/11A
ASSETS			
Non-current assets			
Property, plant and equipment	5,591.8	8,111.7	16,424.5
Other non-current assets	325.0	313.7	2,380.8
Current assets			
Inventories	548.4	1,122.1	1,908.6
Bank balances and cash	443.1	2,669.6	7,484.8
Other current assets	4,117.0	3,711.9	8,939.3
Non-current liabilities			
Total non-current liabilities	115.3	3,961.0	4,062.7
Current liabilities			
Trade and bills payables	1,552.4	2,009.3	3,998.7
Other current liabilities	6,572.0	72.9	3,210.6
Equity			
Total equity	3,147.5	7,302.5	18,397.0

Source: SBI E2-Capital

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