

China Kingstone

Delivering maiden net profit

to summarize...

- Kingstone announced maiden net profit since listing. Adjusted 1H FY12/11A net profit at RMB57.8m (after exclusion of one-off listing expense, non cash share option expenses and forex translation expenses)
- Cash operating costs for marble block and marble slab reduced to RMB1,951/m³ and RMB151/m² respectively on increased operating scale and higher initial mine stripping costs in previous quarters
- Work disruptions in Jul and Aug due to inclement weather may mean a revision of 2011 mining capacity down to 32,000m³ (from 45,000 m³)
- Two acquisitions since IPO, including the Tujisi Mine, with an estimated resource of 11-12Mm³ at block rate of >20%+
- In our view, company's FY12/12F earnings more indicative of earnings potential given work disruptions and one off expenses. Company is trading at a FY12/12F P/E of 3.3x

Company Overview. China Kingstone (Kingstone) is a Sichuan-based marble producer, with mining rights to China's largest beige marble mine in terms of marble reserves as of Aug 2010. The company's key asset is the Zhangjiaba Mine, located in Sichuan Province. The principal operation business was established in 2005 as an early stage mining development company and commenced commercial production in September 2010. The mine covers an area of 0.44km² with an elevation from 590m to 938m above MSL (Mean Sea Level). Kingstone was granted a mining permit with an initial term of 10 years in Feb 2011. Kingstone's main products are processed marble slabs and marble blocks mined from its marble reserves. The company was listed on HKEx on 18 Mar 2011, raising HK\$1,016.0m net proceeds at HK\$2.25/share. Largest shareholder is Huang Xian You (61.3%) and Morgan Stanley (5.3%). Remaining 33.4% is public float.

Marble resources and mine life. According to the Technical Report prepared by Behre Dolbear Asia, Inc. contained in the Prospectus, the Zhangjiaba Mine contains a resource of 44.2Mm³ of measured and indicated reserves (based on JORC standard) and 16.8Mm³ of proved and probable marble reserves based on a block rate of 38.0%. With mining capacity expected to reach 150,000m³ by the end of 2014, it is estimated that the asset would have an estimated mine life of 112 years. Since the company's listing, it has further acquired other marble mine assets (see below).

Comparable quality to overseas products, with pricing advantage. One key aspect of the Zhangjiaba Mine is its quality. The company's pure beige and mixed beige marble products are considered premium marble products are considered high end products, competing with the likes of Royal Batticino (Iran) and Cream Marfil (Spain) and Frasn Beige (France). According to the Technical Report, the beige marble products account for 83.7% of its marble reserves. Kingstone's beige marble slab products, while having comparable quality to overseas imported products, enjoy pricing advantage of between 30-40%.

Offtake agreements gives revenue visibility. Kingstone mainly sells its products to construction material suppliers in China, which in turn "on-sells" to property developers and construction companies after processing. Revenue stream has good visibility as the company has entered into long term offtake contracts with construction material suppliers for the years 2011 to 2013. For these 3 years, the 7 offtake contracts total would account for 63%, 56% and 45% of the company's planned marble slab production.

Ticker	1380 HK
Rating	Not Rated
Price (HK\$)	1.22
Target Price (HK\$)	n.a
12m Price Range (HK\$)	1.15 -2.4
Market cap. (US\$m)	314.8
Daily t/o (US\$m)	0.4
Free float (%)	33.4

Financial summary

Year to Dec	08A	09A	10A
Turnover (RMBm)	0.0	0.0	6.6
Net Profit (RMBm)	(1.7)	(5.4)	(21.1)
EPS (RMB)	n.a	n.a	n.a
P/E (x)	n.a	n.a	n.a
P/B (x)	n.a	52.5	42.4
EV/EBITDA (x)	n.a	n.a	n.a
Yield (%)	n.a	n.a	n.a
ROE (%)	n.a	n.a	n.a
ROCE (%)	n.a	n.a	n.a
N. Gear. (%)	0.5	84.1	cash

Source: SBI

	11F	12F	13F
Consensus EPS (RMB)	0.123	0.305	-
Previous earnings (RMBm)	-	-	-
Previous EPS (RMB)	-	-	-

Price performance

Year to Dec	1m	3m	12m
Relative to HSI (%)	1.4	(15.2)	n.a
Actual price changes (%)	(1.6)	(28.2)	n.a



Source: Bloomberg

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1H FY12/11A results, adjusted net profit RMB57.8m. Kingstone announced its maiden net profit since listing during its 1H FY 12/11A results (30 Aug). Turnover was RMB104.4m, while net profit came in at RMB9.7m though this was weighed down by one-off listing and non cash expenses. Gross profit margin was 86.3%. Excluding the non cash share option expenses (RMB20.4m), listing expenses RMB24.9m) and forex translation differences (RMB2.7m), the adjusted net profit was approximately RMB57.8mm.

Table 1. 1H FY12/11A results

6 months to June	Turnover (RMBm)	Gross Profit (RMBm)	Gross Margin (%)	Pre-tax profit (RMBm)	Tax rate (%)	Net profit (RMBm)
1H FY11	104.4	90.2	86.3	33.3	16	9.7
1H FY10	0	0	n.a	(5.9)	63	(4.9)
YoY (%)	n.a	n.a		39.2		14.7

Source: Company data

2011 target mining capacity on track, stripping work on Knoll 3-4 commenced. For the period total marble resources mined was approx. 80,000m³ with the mining platform at Knoll 1-2 mined down 6m since the IPO. Currently, the mining platform at Knoll 1-2 has a working area of 19,500m². Daily marble block mined reached 150m³ in Jul 2011. Meanwhile, stripping works at Knoll 3-4 has also commenced.

Sales volume analysis. Relating to sales and production volume, marble block production volume reached 8,521m³ in 2Q FY12/11A (1Q: 850m³) while marble block sales volume came in at 6,156m³ (1Q: 1,458m³). Marble slab output was 85,716m² for the reporting quarter (1Q:5,744m²) and sales volume was 82,640m² (1Q: 5,744m²). While Kingstone focuses on the production of marble slabs, the company saw higher percentage of marble block production and sale volume in 1H FY12/11A. This was due to the early stage of mining, the hardness of marble is weaker with low block rate of 12-16% resulting in lesser marble slab output. Management guided that going forward, marble slabs sales volume will continuously increase whereas marble block sales volume will decline as marble hardness increases down the Knoll platform and block rate gradually reverts back to the expected mean of 38%.

Decreasing cash cost. Operating cash cost for the 2Q FY12/11A for marble block and marble slab fell to RMB1,951/m³ and RMB152/m² respectively (1Q FY12/11A: RMB4,624/m³ and RMB232/m²) on increasing operating scale and higher initial mine stripping costs in previous quarters.

Marble block ASP doubles on one-off demand. Marble block ASP increased significantly 1.29x to RMB10,773m³ from RMB4,696m³ in 1Q FY12/11A. The sudden increase in price was due to the urgent demand from one customer and the sales of premium pure beige marble block. We believe this is an one off gain and the price of marble block is likely to return to its normal level around RMB5,000m², in the subsequent quarters. The higher of pure beige slab ASP was due to higher than expected beige marble quality. The offtake contracts entered into by Kingstone contains adjustment clauses that take into consideration the quality of the mined marble. Management has guided that the marble will continuously delivery high-than expected marble quality, we expect the ASP of pure beige slab to be around RMB850/m² for the remainder of the FY12/11, slightly below the achieved ASP for 2Q but still higher than the contracted ASP of RMB830/m²

Table 2. Production Details

	4Q 10A	1Q 11A	2Q11A
Marble block:			
Quarterly overall ASP (RMB/m ³)	3,414	4,696	10,773
Total Production (m ³)	1,145	850	8,521
Total Sales volume(m ³)	24	1,458	6,156
Cash margin (%)	(105.4)	1.5	81.9
Marble slabs:			
Quarterly marble pure beige slab ASP(RMB/m ²)	842	865	865
Quarterly marble mix beige slab ASP(RMB/m ²)	570	568	568
Quarterly marble other slab ASP(RMB/m ²)	n.a	538	540
Total Production (m ²)	12,452	5,744	85,716
Total Sales volume(m ²)	12,000	5,744	82,640
Cash margin (%)	49.1	62.2	72.9

Source: Company data

Minor production disruptions in 2H. Kingstone suffered some production disruptions in Jul and Aug due to heavy rain periods and mudslides (not on their mine knolls). This led to several days of work stoppages. We estimate the 2011 annual capacity would decrease to 32,000m³ (from 45,000m³).

Shift in business strategies. Previously, Kingstone had planned to construct large-scale marble slab processing facility at a location in close proximity to Zhangjiaba Mine. However, due to local government's inability to obtain the necessary permits to date and the uncertainty surrounding when it would be able to acquire these permits, the company is likely to shift its strategy by locating the processing facilities closer to its end customers. Moreover, this relocation would also reduce breakage risk as the processed marble slabs are

subject to during transportation. Management have left their options open as whether to construct, or acquire these facilities and are presently exploring potential locations in Bohai Sea, Yangtse Delta and Zhujiang Delta areas.

Guangdong Jiapeng acquisition adds network reach. In Jul 2011, the company acquired 49% stake in Guangdong Jiapeng for RMB15.0m. Guangdong Jiapeng is a construction company that engages in the design and construction of facade and architectural decoration business and is the primary contractor for many large scale development projects in the region, including Guangdong Telecom Plaza and Guangsheng Int'l Tower. Its current project pipeline has a marble slab demand of around 60,000m² and the management expects this pipeline could reach some 500,000m². In our view, this acquisition improves Kingstone's control of the supply chain by adding design capabilities and also moves its network reach closer to its end customers. Impact on the company's margin would be limited as the results are not expected to be consolidated into the P&L.

Increasing marble reserves through Tuisi Mine acquisition. The company also announced its intention to acquire the Tujisi Mine for the consideration of RMB6.0m. Tujisi Mine is located on the same mineral vein as the Zhangjiaba Mine and has an estimated resource of 11-12Mm³ at >20%block rate. We expect Tujisi Mine could enrich Kingstone's marble quality portfolio in the mid to high-end beige marble products when it starts commercial production in 2013 (capacity ramp up by 2015). The mine is planned to have mining and processing annual capacities of 50,000m³ and 1.0Mm³ respectively. Total planned capex including mining operations and processing facilities is estimated to be RMB424.0m.

Valuation, focus on FY12/12F P/E. Kingstone is presently trading at current year forward P/E and 1 year forward P/E of 8.1x and 3.3x respectively based on consensus, though we note that some of the Street estimates have yet to be revised to take into consideration 1H FY12/11A results. That said, we prefer to focus on the company's 1 year forward P/E (FY12/12F) as FY12/11F results are expected to be weighed down by production disruptions and one-off expenses.

Table 3. Valuation

Company Name	Ticker	Close Price (HK\$)	Mkt Cap (US\$m)	P/B (x)	ROE (%)	Hist P/E	Cur-Yr Fwd P/E	1 Yr Fwd P/E
MCC	1618 HK	1.90	8656.9	0.7	12.7	6.0	5.3	4.6
China Gold	2099 HK	33.00	1686.9	1.4	4.2	19.6	15.7	11.7
Shougang Fushan	639 HK	3.31	2298.0	0.9	10.6	7.7	8.1	7.2
Hidili	1393 HK	3.47	924.9	0.8	10.1	9.3	8.2	6.7
Sino Prosper	766 HK	0.196	198.1	1.1	20.2	5.4	4.9	4.4
China VTM	893 HK	1.85	495.3	0.9	(3.9)	n.a	15.1	2.0
Newton Resources	1231 HK	1.22	629.7	n.a	(8.3)	n.a	n.a	n.a
China Kingstone	1380 HK	1.22	314.8	n.a	(31.3)	n.a	8.1	3.3

Source: Bloomberg

Risks. 1) lower-than-expected block ratio, 2) lower-than-expected marble resource quality, 3) weather condition, 4) breach of contract, 5) changes in production mix, 6) inability to maintain consistency of high quality marble products.

Table 4. P&L

Year to Dec (RMBm)	08A	09A	10A	1H 10A	1H 11A
Revenue	-	-	6.6	-	104.5
Cost of sales	-	-	(2.0)	-	(14.2)
Gross Profit	-	-	4.6	-	90.2
Other Income	-	-	0.1	-	4.2
Selling and Distribution costs	(0.1)	(0.3)	(0.5)	(0.3)	(0.1)
Administrative Expenses	(1.2)	(2.6)	(25.7)	(3.9)	(57.2)
Finance Cost	(0.7)	(0.7)	(1.4)	(1.7)	(1.6)
Other Expenses	(0.0)	(2.0)	(2.3)	-	(2.1)
Profit/(loss)before tax	(2.0)	(5.6)	(25.3)	(5.9)	33.4
Income Tax (Expense)/Benefit	0.3	0.2	4.2	1.0	(20.9)
Profit/(loss) for the period	(1.7)	(5.4)	(21.1)	(4.9)	12.5

Source: Company data

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