

Company Flash

Zhongsheng Resources 2623 HK

Strong reserve fogged by near-term uncertainty

- ❑ *Mining company shifting focus to titanium concentrate*
- ❑ *Sound story of organic and inorganic expansion*
- ❑ *Uncertain near-term growth; Awaiting better entry point*

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Stock Data

Rating	Not Rated
Price (HK\$)	3.22
Target Price (HK\$)	n.a.
12m Price Range (HK\$)	1.23-3.95
Market cap. (HK\$m)	2,321.2
Daily t/o (HK\$)	1,810,249.1
Free float (%)	16.9

Source: Bloomberg

Financial Summary

Year to Dec	10A	11A	12A
Turnover (RMBm)	485.5	1,010.3	871.5
Gross profit (RMBm)	204.4	276.2	152.8
Net Profit (RMBm)	107.2	132.2	46.9
EPS (RMB)	n.a.	0.22	0.07
P/E (x)	n.a.	11.9	38.4
P/B (x)	7.7	5.5	4.0
EV/EBITDA (x)	18.5	13.6	26.2
Yield (%)	-	4.2	0.1
ROE (%)	34.5	35.7	9.2
ROCE (%)	14.7	13.8	5.0
N. Gear (%)	114.2	71.9	45.1

Source: Company data, Bloomberg

Zhongsheng Resources is a privately-owned iron ore and ilmenite producer in Shandong province. It differentiates by: i) having the largest known iron ore reserve in Shandong Province, totalling about 718.6mt; and ii) being one of the five mining companies named in the first batch of "state-level green mines pilot units". Most of its customers are iron pellets and steel manufacturers in the neighbourhood.

Zhongsheng currently owns four mines: Yangzhuang Iron Mine (YZ), Zhuge Shangyu Ilmenite Mine (ZGSY), Qinjiazhuang Ilmenite Mine (QJZ) and Luxing Titanium Mine (LX). For FY12/12, YZ is the only operating mine, producing 310.3kt of iron concentrates during the period. Given that ZGSY, QJZ and LX all have considerable titanium reserves, the company plans to expand into titanium concentrate business.

What's New. Zhongsheng faced unexpected government scrutiny with regard to granting mining permits and hence postponed expansion plans. Despite the turbulence, ZGSY and LX mines are both operating now. QJZ is, however, still awaiting approval for commencing mining. In addition, Zhongsheng announced in early June that it has entered into two separate non-binding MOUs to acquire two ilmenite mines, one in operation and one not yet started mining.

Our View. Titanium concentrate business will be the future growth drivers for Zhongsheng. ZGSY and LX are expected to contribute 40kt and 30kt of titanium concentrate in FY12/13 in spite of the delay in capacity expansion. ZGSY's production can be further ramped up upon the renewal of mining permit with annual mining production scale of 8mt, up from the current 1.2mt. As unit production costs for iron concentrate and titanium concentrate are similar, gross margin for Zhongsheng is likely to improve in FY12/13 with a further uplift should iron ore prices rebound. However, for QJZ, the asset currently does not possess a mining permit and may not be capable to contribute this year.

The recent intended acquisition of two ilmenite mines is consistent with the company's strategy to transform into a titanium-iron company in the longer term. With aid of its production scale as well as the track record of safety, the company is likely to benefit from an industry consolidation approved of by the government for larger mining companies to consolidate smaller ones in view of safety concerns. Meanwhile, domestic titanium supply is expected to continue falling short of the demand in the coming years and Zhongsheng's vast reserve will provide ample room for expansion.

Table 1: Zhongsheng mine asset details

Mines	Total Ore Reserve (Mt)	Average Fe Grade (%)	Average TiO ₂ Grade (%)	Current Status	Expected Fe output (kt)	Expected Ti output (kt)
Yuangzhuang (YZ)	41.7	24.6	n.a.	In operation	320	n.a.
Zhuge Shangyu (ZGSY)	546.3	12.8	5.7	In operation	40	40
Qinjiazhuang (QJZ)	86.6	13.6	4.5	Pending approval	n.a.	n.a.
Luxing (LX)	44.1	4.5	6.6	In operation	100	30

Source: Company data

Valuation. Zhongsheng's FY12/12 historical P/E for 38.4x, which is pricing in the future growth aggressively. Expected additional production for FY12/13 is 140kt of 57% Fe concentrates and 70kt of 46% Ti concentrates (with potential addition of 100kt 20%~30% Ti concentrates from QJZ), as compared to YZ's 310kt~320kt of 65% Fe contribution for these two years. Even if iron concentrates prices were to increased 25% YoY back to 2011 level about at RMB1,200 per tonne, FY12/13 net profit is unlikely to bring P/E ratio back to single digit levels like its peers.

From the perspective of reserves, Zhongsheng is trading at HK\$20.1 per tonne of metal content, as compared to HK\$17.1 of IRC (1029 HK), Zhongsheng's closest comparable. The heavier weight of titanium dioxide in Zhongsheng's reserve should more than explain the difference.

Titanium exposure key differentiator. The differentiator of Zhongsheng is its sizable reserve and exposure to titanium market, but the near term performance is constrained by the government permit review schedule. The company may turn to inorganic growth via acquisitions to boost operating scale, but it would need to strike a balance as how to best apply its balance sheet to generate returns for shareholders, especially in light of the company's intrinsic potential for organic capacity growth. Zhongsheng currently has a moderate net gearing of 43.1% with RMB82.9m cash assets on hand.

Table 2: Peers valuation table

Company	Ticker	Market Cap (HK\$m)	Historical P/E (x)	Historical P/B (x)	ROE (%)	EV per tonne* (HK\$)
China Zhongsheng Resources	2623 HK	2,414.9	40.7	3.5	9.2	3.8
IRC Ltd.	1029 HK	3,664.8	n.a.	0.5	(6.7)	5.7
China VTM	893 HK	2,531.5	4.9	0.6	12.0	11.2
Newton Resources Ltd.	1231 HK	2,480.0	n.a.	1.7	(3.2)	7.5
China Hanking Holdings Ltd.	3788 HK	3,056.1	6.8	1.9	28.1	7.8
Average		2,829.5	17.4	1.6	7.88	7.2

*Enterprise value per tonne of proved and probable reserve; did not adjust for mineral contents

Source: Bloomberg, SBI E2-Capital

Table 3: Profit and loss items

RMB m	FY12/10A	FY12/11A	FY12/12A
Revenue	485.5	1,010.3	871.5
Cost of goods sold	(281.1)	(734.1)	(718.7)
Gross profit	204.4	276.2	152.8
Selling and marketing expenses	(4.6)	(9.6)	(11.0)
General and administrative expenses	(31.7)	(41.5)	(49.0)
Other net gains / (loss)	(2.5)	3.0	7.4
Operating profit	165.6	228.1	100.2
Finance cost	(23.7)	(50.9)	(35.2)
Finance income	1.2	2.4	1.5
Share of loss of an associate	(0.9)	(1.6)	-
Income tax	(39.6)	(48.0)	(24.1)
Net profit	102.6	130.0	42.4
Minority Interest	(4.6)	(2.2)	(4.5)
Shareholders' profit	107.2	132.2	46.9

Source: Company data

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